Letter n°28

What should we think about the rise in long-term rates and should we fear inflation?

"Think about the event so as not to succumb to current events". Hanna Arendt

A year ago, containment began and the question of the monetary and fiscal policies to be implemented was asked: should austerity be allowed to take hold as in Europe before Draghi's "whatever it costs" at the turn of 2010? Should moderate support for the economy be preferred, just like the 2009 Obama plan? Or was there a need for a new policy of massive support, the implementation of the "Modern Monetary Theory" suggested in particular by Olivier Blanchard, former chief economist of the IMF? This option was chosen because austerity measures would have had a higher cost than the risk associated with cash injections to buy back government bonds.

As a result, unprecedented budget deficits have been associated with unparalleled cash injections in a context of surplus savings, and this is expected to change little in 2021.

Today, there is a congruence of various events that is timely and favorable to pressures on rates: the economic factor – with the vote in Congress of a stimulus package considered excessive by many economists, political factor - with Biden's desire to raise the minimum wage to $15/hour, oil factor – with a rise in the price of a barrel fortified by OPEC discipline, vaccination factor – with an expected acceleration of supply and the employment factor – with the release of positive job creation figures in the United States. These are all factors that are putting pressure on long-term rates.

All these factors contributed to a sharp rise in U.S.10-year rates from 0.91% in January to 1.55% and the U.S. 30-year mortgage rate, the key to the dynamism of the property market, to more than 3% against 2.65% at the beginning of the year.

Should we be concerned about a return of inflation? Should we be alarmed about real US rates at zero in the event of a 10-year nominal rate of 2%? Can we draw a parallel to the 1960s, which began with an inflation rate of less than 2% and ended with an inflation of more than 5% under the backdrop of strong growth, combined with accommodative fiscal and monetary policies? There are so many questions to be explored but without succumbing to current events so as to not neglect the advice of the philosopher Hanna Arendt.

1. ***The causes of the rate hike***: two certainties, one obvious and one possible concern

- *The first certainty* is the economic recovery.

The recovery in growth, anticipated from the second quarter or the second half of the year depending on the country, is expected to be rapid as government budgetary policies, business support and household aid have been infinitely higher than those proposed during the 2008 crisis. The budget deficit in OECD countries was on average more than 12% in 2020 (nearly 10% in Europe and 15% in the United States) compared to 8% in 2008-09.

It is traditional, and aligned with Keynesian logic, to increase public spending in times of crisis and, in the United States, for example, public spending, as a percentage of GDP, had risen from 37% to 43% between 2007 and 2010 before falling back to almost 38% in 2018. Similarly, in the Eurozone, it had increased from 45% in 2007 to 50.7% in 2009 and then contracted to 46.8% in 2018.

But this time, the governments have been more reactive. With the experience from the early 2010s, marked by the memory of the Greek crisis and the countries of Southern Europe, European states avoided aggravating the crisis with austerity policies and diligently agreed on a support plan of €750 billion.

While consumption has slowed down or even halted in some sectors, and household savings have reached record levels, budget deficits have been a temporary substitute for private consumption.

While recession has traditionally entailed an increase in bankruptcies, in 2020, government guarantees of corporate debts have been effective, and in many countries bankruptcies have even fallen.

Finally, cash injections – taking the example of the United States, its $120 billion/month, since June, has enabled additional public debt financing without any crowding-out effect and rise in business loans.

In short, there has been a combination of budgetary and monetary policy, of what the Americans call "helicopter money" with central bank liquidity injections and the effects are beneficial.

The rise in long-term rates in the United States is explained by the size of the stimulus package, $1900 billion, 9% of GDP, following the Trump plan of $900 billion in December 2020, 4% of GDP. This plan is considered disproportionate to a 3.5% recession in 2020 and this also has an impact on European long-term rates.

Olivier Blanchard estimates a maximum output gap (i.e. the gap between current GDP and what it would have been if the crisis had not occurred) of $900 billion but more likely at $680 billion. He therefore considers this plan excessive and potentially inflationary. ***Joseph Gagnon*** is more pessimistic about inflation because the success of the vaccination campaign could lead to a sharp increase in demand for services, an avenue to use the $1600 billion of savings accumulated in 2020 and a consumption of cheques paid by Trump and Biden because the propensity to save in the underprivileged classes is low. To date, only 20% of the $600 December cheque has been spent but this is expected to increase. And so, we would see temporary inflation rising and the markets are worried.

- *The second certainty* is that the monetary policies pursued by central banks in the OECD hold more than $17 trillion in bonds, including nearly $15 trillion in public debt compared to $2 trillion just 10 years ago. Their priority is no longer inflation but employment. In the United States, the unemployment rate in February, despite 379,000 job openings, is still 6.2%, up from 3.5% a year ago, and 4.2 million people have (temporarily?) left the labor market. In a broader sense, the unemployment rate is at 9.1%. In Europe, the unemployment rate is at 8.1%, lower than in 2013 where the rate had reached 12%, but the deterioration is masked by government aid.

In this context, it is difficult to imagine a drying up of cash injections. To convince the skeptics, central bankers were careful to announce their tolerance for inflation temporarily above 2% and the time it takes to regain full employment, that is the creation of 9.5 million jobs including 3.5 million in the leisure or hospitality sector in the United States. This is Powell's explicit statement as head of the Fed and Christine Lagarde's implicit speech to the ECB. The ECB's balance sheet already accounts for 40% of Eurozone's GDP and will grow further. The Fed's, too.

- *The evidence* is temporary inflationary pressures, stemming from four factors: the recent rise in agricultural, industrial and energy commodity prices, disruptions in industrial supply chains with the shortage of semiconductors, the rise in sea freight prices and the attempt by some companies to recover their margins.

The evidence is also the mirror effect. 2020 was a year of forced hoarding and of negative inflation in

many countries. 2021, then, inevitably marks a resumption of inflation – but should we be alarmed?

In February, the inflation rate excluding energy in Europe was 1.1% and it will tend towards 2% in the coming months but there is no cause for concern. In the same vein, the Chinese government anticipates 3% for the year and in the United States, the inflation rate of 1.4% in January will inevitably increase over the months of economic recovery.

Some figures reflect recent increases: over the past year, the price of wheat has increased by 25% and the price of soybeans by 40%. There are three reasons for these increases – China is replenishing its stocks, the South American harvest is being penalized by drought and Russia, the world's largest grain producer, is curbing its exports. For the record, at the end of October, in our November Economic and Stock Market Outlook, we recommended the purchase of soybeans, well before their current level.

Prices for copper increased by 60% over one year, metals and steel were up 100% in six months. The prices have increased significantly because China, the first country to record an economic recovery, accounts for about 50% of world demand and because copper is widely used in electric cars. Our purchase recommendation dates from the same publication.

The price of crude oil, currently at $67/b for Brent, multiplied threefold since the beginning of April 2020 and has exceeded its level in the pre-crisis days. A simple explanation for this is a resumption of consumption, a supply reduced by 7 million b/d by Saudi Arabia and the other members of OPEC+. That was our anticipation and we have been recommending the purchase of oil since the end of spring 2020.

Finally, the cost of transport by ship from Asia to Europe has increased by almost 5 times compared to June 2020 as there is a shortage of containers and a sudden increase in global cargo traffic.

In the long run, we cannot ignore the seeds of structural inflation: possible forced relocations, stricter health standards, wage increases in certain sectors such as education or health, an increase in health spending that is consistent with ageing, an increase of oligopolies, and therefore less competition of prices. We also have to consider Biden's desire to raise the minimum hourly wage to $15, which is currently being thwarted, and the decline in the labour force, observed in Japan, China, Eastern Europe, that could encourage wage increases.

But let us moderate these concerns because the brakes on wage increase observed in recent years persist – whether it is from the pressure of globalization, competition from emerging countries or the decline of trade unions, or the decline of the labour force in Japan – these have not led to wage inflation.

- *The potential concern* could be a distrust of investors in the face of debt accumulation.

Some analyze the craze for Bitcoin and cryptos as a way to escape traditional currencies backed by indebted economies, as a libertarian distrust against states. But Bitcoin's capitalization to date hardly exceeds $1 trillion, and is a speck of dust in the face of some $250 trillion in global debt – more than three times global GDP, and gold, a traditional haven against inflation, is hardly on the rise.

If one appreciates the recent demand for Italian 10-year debt or Greek debt, the concern is not there. Despite a debt ratio of 170% for the former and 220% for the latter, 10-year rates are 0.74% and 0.95% respectively. A fortiori, there is no cause for concern for Germany and France because the two countries went into negative rates in 2020 and therefore lowered the cost of their debt.

In Japan, the public debt is approaching 260% of GDP and the central bank's balance sheet is at 135% of GDP. Half of the public debt has been repurchased and the 10-year rate has only briefly reached

0.3%. In Europe, since spring, the ECB has acquired €800 billion bonds and, by March 2022, it aims to reach €1850 billion.

2. *Expectations on rates and consequences:*

- Expectations:

The low investment rate is expected to persist and acts as a break against inflation and rising long-term rates. In the United States, for example, while private investment growth, according to the IMF, was 4% per year between 1980 and 2000, it has since fallen to 2%.

There are three reasons and a temperament to this decline:

The first reason is the shift in the economies from industry to the tertiary sector, hence the lower capital intensity.

Secondly, there is the ageing population. Not only does an ageing population hold back investment because households are equipped with real estate and manufacturing assets, but also, as the marginal propensity to consume decreases with age, the savings rate increases. This is the famous "saving glut", the surplus of savings, that is often mentioned. Since 2000, the IMF has recorded a two-point increase in the savings rate from 24% to 26% of GDP.

Finally, the third possible cause of low investment rate is the one pertinently suggested by ***Jacques de Larosière***, former Managing Director of the IMF. Imbued with Keynes' theory of "liquidity trap", he analyzes the decline in the world's investment rate as a consequence of zero interest rates. The investor moves his assets to non-risky investments, mainly bank accounts, because the return on risk is zero.

The brake on this decline in the investment rate is the energy transition – on one hand it is a reduction of capital, the abandonment and depreciation of certain oil fields and coal-fired power stations, on the other hand it entails massive investments in renewable energy, absorbing savings. This is the purpose of the infrastructure plan envisaged by Biden and it could tighten the yield curve.

- *The* consequences: debt servicing and tax changes.

The stock of public debt/GDP and its aggravation cannot be neglected but appears secondary in relation to the cost.

In Europe, the increase in long-term rates has increased by 30 basis points since 1st January, and in the United States and Great Britain, it is double. This is the drift but there is no turmoil.

States have a low average debt cost, lower than potential growth and the ability to reduce their debt. This is the essential point – a debt servicing cost that is lower than growth.

Higher debt servicing, should rates continue to rise, would only occur very gradually as governments take advantage of the windfall of negative rates to extend their debt. The British debt has an average maturity of 15 years and the French debt of 8 years.

The increase in taxes will not be decided until the recovery is consolidated: in Great Britain, corporate tax will increase from 19 to 25%, but only from 2023, and the increase in household taxation will result from the lack of adjustment of tax brackets to inflation. In the United States, the increase in corporate tax to 28% is included in Biden's program. At the European level, a carbon tax and a plastic tax will contribute to the financing of the €750 billion plan but they are not yet effective. At the international

level, Biden is in favor of reviewing how GAFAM and multinationals are taxed, but this will still take time and, in the meantime, further announcements are expected.

Conclusion: "*Friends of truth are those who seek it and not those who boast of having found it*" Condorcet.

Today, we are on six tipping points:

- *From a stock market perspective*, as recommended, the appreciation of cyclical stocks, commodity stocks, financial stocks, all of which have been long neglected, has been substantial in recent months. Growth stocks which have long been favored, have been the subject of profit-taking but this should be temporary because the fundamentals remain buoyant. Similarly, emerging countries, especially if they are net importers of commodities or are indebted, are sensitive to rising prices and rates, but the former, mainly Asian, compensate thanks to dynamic exports of electronic components.

As the stock market operates in anticipation, the recession has not prevented markets from rising in recent months. Today, the premise of the recovery is putting pressure on rates and markets are undergoing a correction, but concern about rising long-term rates will give way to earnings recovery.

- *From an economic point of view*, the gap between the current GDP in the United States and potential GDP if there had been no crisis that is 2.5 points should be closed rapidly but in Europe, the gap of 5.5 points will have to wait a few more quarters. Everywhere, the extent of unemployment to be addressed is a brake on wage inflation.

- *From a monetary perspective,* the implementation of the MMT, a modern monetary theory, has financed many expenditures and will pull economies out of the recession rut. However, monetary injections could be reduced by the end of 2021 and rate hikes could begin by the end of 2022. It remains to be seen whether, like the Bank of Japan in recent years, the ECB and the Fed will decide whether or not to freeze the 10-year rate at 0 to put an end to current tensions and preserve a low cost of financing for governments.

- *From a financial point of view*, to say that a country would be better off with lower debt is tautology, but lowering the debt in times of crisis would be heresy and therefore, tax increases are not imminent. Businesses could be more involved than households, a fair return after a reverse trend over the last two decades. The OECD's corporate tax rate has fallen from an average of 42% in the 1990s to 27% recently.

- *From a currency perspective*, the pressure on interest rates benefits the $ and penalizes the Swiss franc and the Yen because the rate differential is increasing, but this is temporary. A faster recovery in the United States than elsewhere entails a worsening U.S. trade deficit and a depreciation of the $.

- *From a wealth perspective*, cash injections as well as negative rates promote the appreciation of the stock market and increase inequality since 10% of Americans hold 85% of the shares. The rise in household savings, analysed worldwide, primarily benefits the wealthiest while many of the disadvantaged have suffered jobs and income losses. The rise in 30-year mortgage rates will further penalize the middle classes in their efforts to access home ownership or their willingness to refinance. However, let us make a nuance because at 3.02% today, the 30-year refinancing rate is far from the 3.7% of January 2020.

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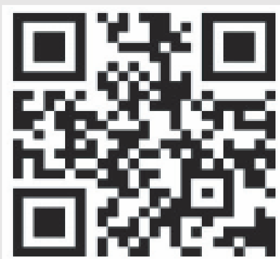

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