

Letter n°76

Two consequences of the war in Ukraine for the global economy and markets: (2) The price-wage spiral and the impact of rates.

"In financial matters, everything that is pleasant is unhealthy, and everything that is healthy is unpleasant." Churchill, speech at the Waldorf in 1926.

Central banks were wrong about inflation expectations as inflation will have exceeded the cumulative of the past ten years in just two years. After years of injecting liquidity, they had to raise rates more quickly than ever before, and as Churchill noted, this necessity has "unpleasant" consequences.

In just a few months, the global bond environment has radically changed. The \$18 trillion stock of negative-yielding bonds has disappeared, making debt servicing more expensive.

The inflation virus has reappeared with Covid: lockdowns have caused an inflation of freight rates and temporary supply disruptions for certain products.

Then, the use of savings accumulated during lockdown, the massive purchases of durable goods thanks to generous stimulus plans, have generated demand shocks, shortages and an exacerbation of inflation.

Finally, the war in Ukraine has caused a sharp increase in the prices of raw materials, cereals and food products, oil and gas in a matter of months.

Today, many of these problems are being resolved, but the inflation rate is slow to decline and could remain significantly above the 2% target in the coming months because inflation has spread to services and employees are demanding compensation for the decline in purchasing power.

Let's be clear, inflation is the expression of a struggle between three categories of economic actors: the State, i.e. taxpayers, companies and employees, to share an additional cost.

Labor shortages are reversing the balance of power between employers and employees and will affect margins in certain service sectors, potentially affecting stock markets.

Today, inflation is the main concern of the markets and has an impact on the evolution of bonds as well as on the valuation of stocks. The anticipation of inflation's evolution determines the evolution of rates, and therefore the potential risks of recession.

Let's analyze 3 points and examine the example of 6 countries:

The immediate consequences of inflation and the risks of more structural inflation :

- *The decline in purchasing power:*

After 30 years of disinflation followed by negligible inflation, 30 years of low wage growth, and 30 years of capital advantage over wages in value-added sharing, the Covid crisis has caused a renaissance of inflation, first by costs, then by demand. These two causes, now under control as seen in the example of up to 90% reductions in freight prices compared to their highs, have given way to the consequences of the war in Ukraine,

a temporary inflation of energy and cereal prices since Russia accounts for 20% of global wheat exports and 12% of fertilizer exports, while Ukraine is also an important player.

But despite a poor harvest in Argentina, prices, at €272/ton for wheat, are falling back to pre-war levels, far from the peak of €440/ton for wheat in 2022, as the sown areas increased by more than 8% for wheat and 2.7% for corn in the United States.

- ***Wage demands:***

These 3 years of erosion of purchasing power have led to wage demands, and today central banks, all focused on their objective of controlling inflation at 2%, are concerned about the impact of wage inflation exceeding 4% in the majority of countries.

Strictly speaking, there is no wage spiral. In the United States, the rise in wages is 4.4% compared to 6.4% for inflation, in Europe 4.9% compared to 9.2%, but the stagnation of productivity, in both the United States and Europe, is a barrier to disinflation.

The inflation rates should decrease as commodity prices have corrected, but everywhere, in the United States, Great Britain, Germany (with demands up to 10%), France, the Netherlands (agreements for increases of 5 to 6%), and even in Japan, wage inflation will fuel inflation because employees want to take advantage of tight job markets. This could lead to a rebalancing of the capital-labor ratio, which has been very favorable to capital over the past 30 years. This is particularly noticeable in the United States and the United Kingdom, and less so in Europe, where employment rates are increasing, and to avoid social conflicts, governments have substantially increased minimum wages, up 22% in Germany in 2022, 12% in the Netherlands, and 5 to 8% elsewhere in Western Europe.

However, there is a risk for companies' margins struggling with stagnant productivity. Hence, the temptation for central banks to continue raising interest rates to break the economic momentum, but is this not giving too much power to unelected institutions, and should governments not get more involved?

- ***More structural inflation factors?***

Many of the inflation factors mentioned above are temporary, but we cannot ignore the persistence of "core" inflation at a high level, despite the decline in commodity prices and the elimination of bottlenecks or excess demand, due to price increases in services, nor can we neglect more structural causes of inflation.

In the long term, energy will be cheaper, but in the short term, the acceleration of the energy transition, the repatriation of production chains, such as drugs, and the relocation of technological components have an estimated cost of between 2 and 4 percentage points of GDP/year. These are inflationary factors because they impose asset write-downs on companies and reduce household purchasing power.

In this context, central banks are torn between the fear of raising rates too much and risking breaking the investment momentum and the fear of not raising them enough. If the IMF's growth assumptions materialize, that is, stronger than expected growth, central banks will not lower their rates this year. That is our scenario.

Developments in major countries:

- ***The American market:***

The PCE inflation rate, followed by the Fed, was 5.4% in January compared to 5.3%, and the "core" index at 4.7% compared to 4.6% is still well above the target of 2%. Rates, currently at 4.25% to 4.50%, could be raised by 0.50% in March instead of 0.25%.

The most lasting wage pressures may be in the United States as the job market is tight with an unemployment rate of 3.4%, the lowest level in 53 years, 11 million job offers unfilled, and unemployment claims at their lowest level since April 2022.

However, in recent months, wage increases have been lower at 4.4% in January compared to 4.8% in December, and this trend is expected to continue as a slowdown in the job market is being reported by online recruitment companies.

In the real estate sector, which is sensitive to the calculation of inflation, the Case-Shiller price index remains up 7.7% over 1 year but has declined for the fifth consecutive month in November. A decline in rents (-3.5% between August 2022 and January 2023 after +25%) is being observed and should result in a decrease in inflation in the coming months.

The price of gas has fallen 65% since mid-December and is at its lowest level since 2020 at \$2.14/Mbtu, compared to over \$9/Mbtu at its peak in 2022, due to significant oversupply, and this will have a favorable impact on the price index.

The Fed could still raise rates by 0.75%, but cannot do everything to combat inflation: immigration policy, with 1 million entries last year, to fill labor shortages has a significant impact on wage pressures, and gasoline prices are not controlled by the Fed.

- ***The English market:***

In January, the inflation rate was at 10.1% and the "core" inflation rate at 5.8%. In early February, rates were raised by 0.50% to 4%. Further rate hikes are expected to be decided as wage increases, 7.3% in the private sector and 4.2% in the public sector, are a concern for the central bank.

Fortunately, property prices, components of the price index, have fallen by 3.5% since the summer 2022 peak, the largest correction since 2009.

- ***The European market:***

The slowdown in inflation to 9.6% in December and then 8.5% in January with a "core" rate of 5.2% will continue, even if a spike is likely in the short term. In February, after the increase in inflation in France from 6 to 6.2% and in Spain from 5.9 to 6.1%, and the stabilization in Germany at 9.3% (the Bundesbank expects 7% for the year), the markets now anticipate an official rate of 4% compared to 2.5% today and 3.5% previously expected. The Commission anticipates inflation of 5.6% this year.

A further 0.5% increase in March is expected, and an identical increase should occur at the next meeting, knowing that disagreements persist within the ECB Council, as Isabel Schnabel anticipates 3.75% on official rates.

More worrying, since March, the reduction of the central bank's balance sheet, currently €9 trillion, at a rate of €15 billion/month, should have an impact on liquidity and credit.

- ***The Japanese market:***

The inflation rate was at 4.2% in January. It is partly driven by a beginning increase in wages, 1.9% in 2022, which should continue after 30 years of stagnation because wages are low, averaging \$39,700 compared to \$51,600 on average in the OECD, and this encourages young people to leave the country. This is a problem in a country facing a shrinking working-age population.

The central bank's policy of accepting higher interest rates is expected to weaken around 188,000 zombie companies, according to estimates by Teikoku Databank.

Since December, to defend its policy, the Bank of Japan has had to buy \$330 billion in bonds, more than 8% of GDP and three times the usual amounts, which is not sustainable. The IMF is urging Japan to consider widening the fluctuation bands.

The Bank of Japan holds 56% of public debt and, therefore, the situation is delicate because an increase in the ceiling on rates would cause a loss of \$60 billion on bonds.

Ueda, one of the advocates of liquidity injections policy when he served at BOJ between 2008 and 2015, will replace Kuroda. He could be the architect of the end of an accommodative policy.

Companies are protected against a rate hike as they have a lot of liquidity. The 70 companies in the Topix are 24% net cash, those in the mid-cap 400, 47%, and those in the Topix Small index, 58% according to the FT.

- ***The Chinese market:***

Inflation in January was modest, at 2.1%, and even 1% for core inflation, and the producer price index (PPI) has declined. Therefore, for these two reasons, monetary policy can remain accommodative.

- ***The Swiss market :***

The inflation rate was 3.3% in January, up from December but lower than neighboring countries because administered prices represent 30% of the index compared to 18% in France, 15% in Germany, 13% in the Eurozone, and due to the appreciation of the Swiss Franc.

A 0.50% rate hike is expected on 23 March, as the rate hike so far has only been 175bp.

In summary, 3 observations:

Currently, inflation has three increasingly less prevalent causes: housing, food, and energy, with only housing being affected by monetary policy.

Central banks must ensure the maintenance of market confidence to prevent, as observed in the UK last autumn, a surge in long-term rates, which is problematic given current debt levels.

In the coming months, there may be periods of negative inflation rates, as commodity prices have fallen significantly and demand pressures are easing. The IMF predicts inflation of 6.6% this year, down from 8.8% in 2022.

Conclusion: "*Convictions are more dangerous foes of truth than lies.*" *Nietzsche.*

Let us guard against convictions because the war is not over. To this day, while the daily war in Ukraine, like the course of the two world wars (see our Letter on this subject), has not had an impact on the evolution of markets, and while the decline of the stock markets in 2022 is primarily the result of the tightening of monetary policies and the resulting concerns about the sustainability of growth in the world, there remain influences on the global economy and markets.

In these two Letters 75 and 76, the spotlight was focused on two major consequences of the war in Ukraine, one lasting and the other temporary, hopefully.

- ***Confidence in avoiding a sustained recession:***

Against this backdrop, the IMF has been able to revise its estimates upward and anticipates global growth of 2.9% (1.4% in the United States, 0.5% for Europe, -0.6% for Great Britain, 5.2% for China, 7% for India). Many sectors will continue to invest, such as defense and the energy transition analyzed in Letter 75, but McKinsey observed a 22% decrease in industrial investment worldwide during the first nine months of 2022.

The expected figure for global growth follows a growth of 3.4% in 2022 and remains below the average of 3.8% between 2000 and 2019. However, let us be cautious, as Russia could, even if it is not in its interest, stop the 20% of gas deliveries that are still maintained and not renew the agreement on the grain corridor in mid-March for the sale of Ukrainian cereals.

The risk, however, in the coming years is to see long-term rates persistently higher than potential growth rates in most economies as this will affect household and business investment. At a time when countries need to invest in the energy transition, this could be a problem.

- **3 other risks related to rising interest rates:**

The vulnerability of poor countries: the deterioration of the overall debt of the 30 largest middle- and low-income countries is evident. Debt reached \$98 trillion in 2022, up from \$75 trillion in 2019, and there is a risk of default by several states. This is an indirect repercussion of the war in Ukraine with a sequence of rising inflation - increase in US interest rates - appreciation of the dollar - increase in the cost of debt service. Sri Lanka and Ghana have defaulted, as has Zambia. The most fragile in the coming months are Pakistan and Egypt.

The increase in the debt of almost all countries: on a planet indebted to the tune of, according to the IMF, \$225 trillion, or 2.5 times global GDP, compared to 1 time in 1970, a sustained rise in interest rates could be a concern for budgets and the evolution of long-term interest rates.

Nothing has been said about the growth of international trade, but according to the BCG, it is expected to be only 2.3% per year by 2031 as various relocation plans in the United States or elsewhere will reduce the growth of international trade.

Corporate default risks: nothing has been said about the increase in corporate defaults possibly caused by the rise in rates, as according to Moody's it is modest at 2.2% in the United States, compared to nearly 6% in 2016, 4% in 2017 and 2018. In Europe, the rate has just increased from 2.8% to 2.9%, a level comparable to that of 2016-2017, but still lower than the 4.1% rate at the beginning of 2018. The deterioration so far is minimal, but it should be monitored when choosing bonds.

Geneva, 3rd March 2023

Bruno Desgardins

Bruno Desgardins
CIO
Switzerland



SingAlliance Pte Ltd

20 McCallum Street
#18-01 Tokio Marine Centre
Singapore 069046
T: +65 6303 5050
E: info@singalliance.com

SingAlliance (Hong Kong) Ltd

Unit 908C, 9/F Dah Sing Financial Centre
248 Queen's Road East
Wanchai, Hong Kong
T: +852 2639 3659
E: info.hongkong@singalliance.com

SingAlliance (Switzerland) SA

16bis rue de Lausanne
1201 Geneve
Switzerland
T: +41 22 518 85 85
E: info.switzerland@singalliance.com

SingAlliance Pte Ltd

(DIFC Representative Office)

The Gate, Level 13 East, Office 10, DIFC
PO Box 121208 Dubai, UAE
T: +971 (0) 4 401 9158
E: info.dubai@singalliance.com



This document does not constitute an offer or a solicitation to purchase or subscribe financial instruments. Information contained in this document has been obtained from carefully selected public sources. Although every care has been taken to ensure that this information is accurate at the time of publication, no representation is made as to its accuracy, completeness, or truthfulness. Any opinion contained herein is subject to change at any time without notice. Past performance is not indicative of future results.