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Economic and Financial Newsletter
Quo Vadis?

Thinking the unthinkable: Five potential surprises for 2023
#1 Inflation is not under control, the seventies are back!

Introduction

Every new year brings, to the frustration of many an investor, plenty of surprises. Some, like Covid, are unpredictable, but others - to some extent - are. Often, we, yours truly included, are just not attentive enough. After which the "unthinkable", such as the crash of the US real estate market in 2008, the Brexit and the Russian invasion of Ukraine, happen anyway. Quo Vadis therefore wants to "think the unthinkable", provided, of course, that the potential scenarios make sense. There must be at least some solid arguments to go against the market consensus. Our potential scenarios may not be very likely, but they are nevertheless more likely than generally thought.

Pericles (c. 495-429 BC) already knew: *Our job is not to predict the future, but to prepare for the future*. That way, there is less risk of being unpleasantly - or pleasantly - surprised.

Quo Vadis formulates five potential surprises for 2023 in five separate editions. Today the first, around inflation.

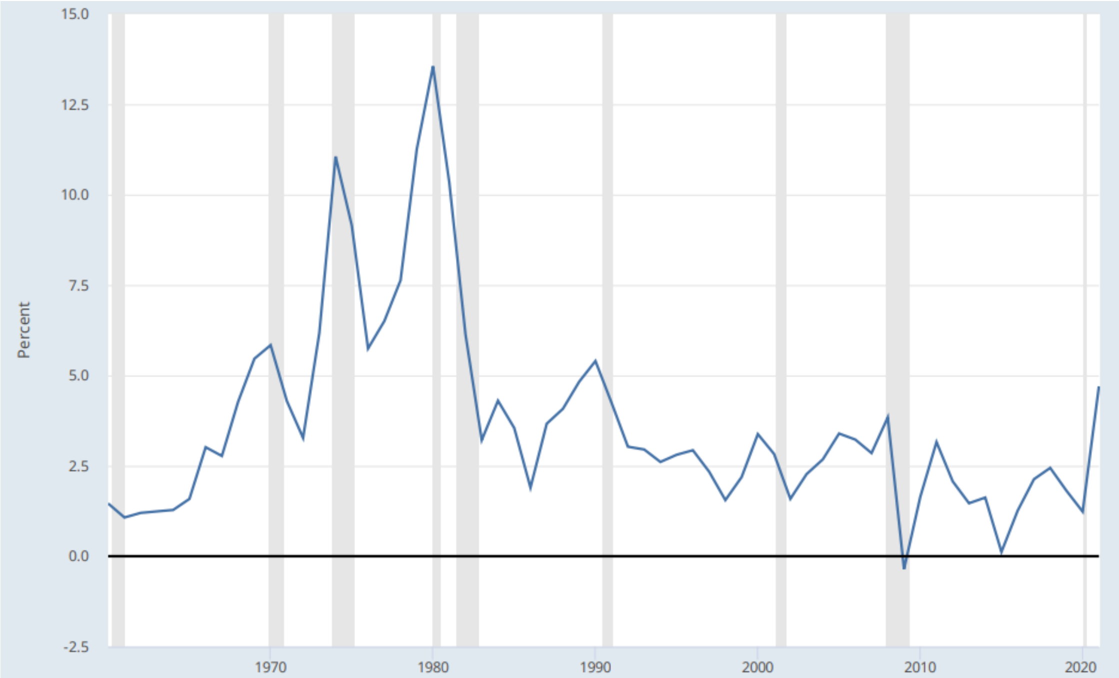
Consensus view: "Inflation will fall significantly in 2023."

In the United States, the consensus view is that inflation will gradually fall to 2% by the end of 2025. In Europe, the decline would be somewhat slower, but the inflation problem would also disappear there. For the next 10 years, the inflation-protected bond market expects an average inflation rate around 2% and this in both the United States and Europe. Central banks have everything under control, don't they? Didn't they save us from the financial crisis? And from the pandemic? It is unthinkable that the 1970s could come back!

Quo Vadis: "On the contrary, the 1970s are back!"

The cliché is that in the 1970s, an oil shock triggered a long period of hyperinflation. In 1973, the Yom Kippur War broke out between Israel on one side and Egypt and Syria on the other. The war indeed led to a sharp rise in inflation, but in reality, inflation had already started to rise sharply in the second half of the 1960s. The graph below, which shows the annual evolution of US inflation, illustrates this:

Figure 1. Inflation in America (1960-2022; annual)

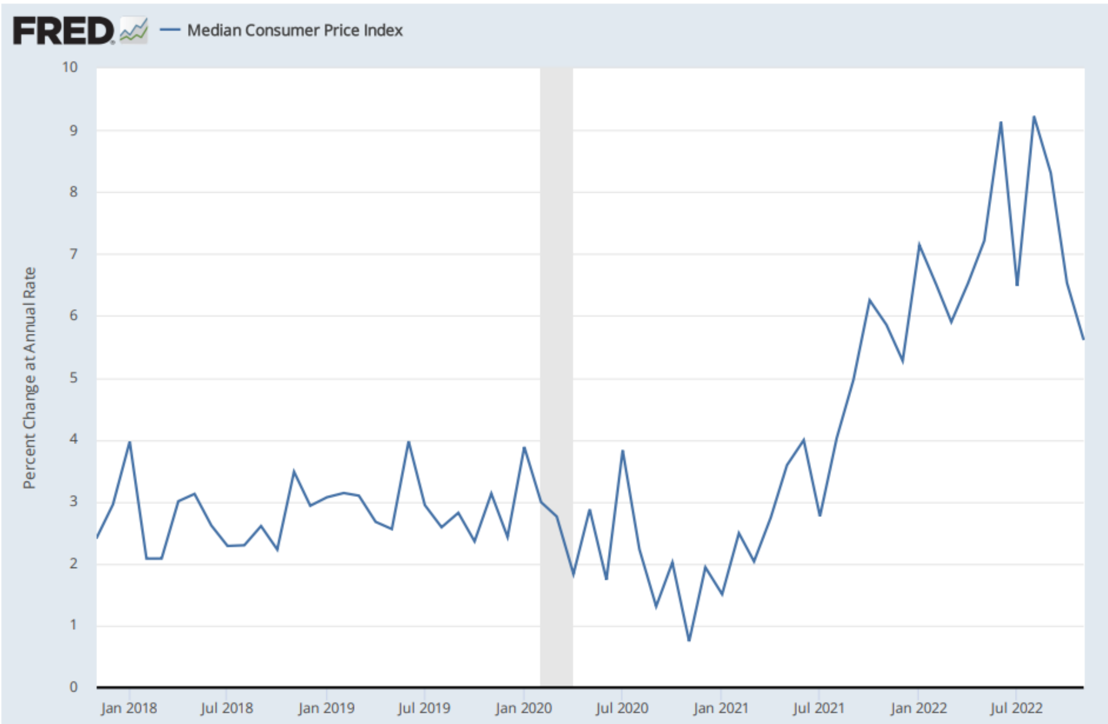


Source: World Bank, St Louis Fed.

The chart shows that inflation was already reaching 6% in the late 1960s, three years before the first oil shock. The reason was the lax monetary and fiscal policies of that period, ..., just like today. The mountain of debt today - we have just crossed the $300 trillion mark globally - is also much larger. In 1966, US government debt was 40% of GDP, today 120%, and the government deficit was 3% versus 8% today. The Belgian figures are not very different from the US figures, by the way.

If we zoom in on the inflation figures of the last five years, we again see that inflation started to derail even before that, and this both in America...

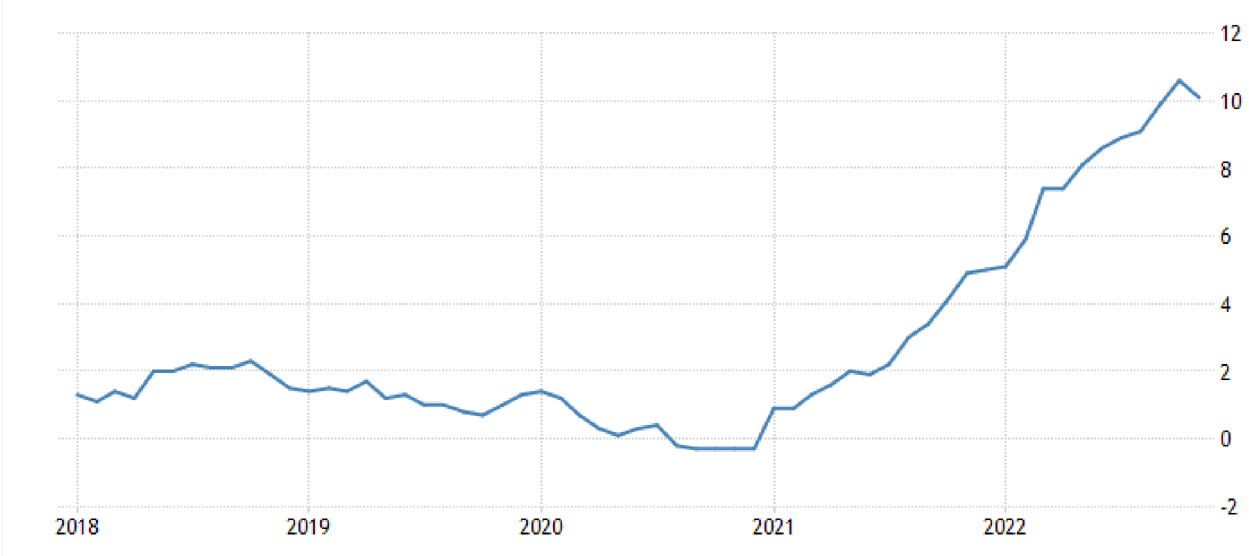
Figure 2. Inflation in America (2017-2022; annual)



Source: World Bank, St Louis Fed.

... and in the eurozone:

Figure 3. Inflation in the Eurozone (2017-2022; annual)



Source : Trading economics & Eurostat.

The Russian invasion of Ukraine, like the Yom Kippur War, led to a gas and oil shock that sent inflation soaring further. Over the past few hundred years, war - especially since the introduction of fiat money and the use of government deficits to finance war - has been by far the most determinant cause of periods of very high inflation (see Figure 4 which takes the UK as an example). However, the Yom Kippur war lasted only 19 days. The current war between Russia and Ukraine has lasted ... almost a year already. And the end is nowhere near. Today, we also see echoes of WWI, when, after the initial German attack momentum was lost, the battle degenerated into trench warfare. The Russians have lost momentum and winter is now giving them respite to dig in, cementing the front line. This could go on for years, until both sides fall over from war fatigue and financial exhaustion. This fact suggests that high inflation may well be of the party for longer than what the consensus, which sees inflation gradually slipping towards the 2% mark, foresees.

Figure 4. The relationship between war and inflation in the UK

The latest inflation figures show a slight decline. The Federal Reserve has hinted that short-term interest rates will stabilize around 5%. In Europe, gas prices have fallen back to pre-war levels. The inflation threat seems to have passed, or at least the worst seems to be over. Tighter monetary policy seems to be working. Bravo Fed! Bravo ECB! Or not? Don't announce the death of inflation too quickly. Central banks are not infallible. In the 1970s, the Fed paused interest rate hikes up to four times in the belief that inflation was under control. Each time a decline occurred, the belief was that the worst was over. But each time, inflation came back stronger than before. Indeed, in the sixties and seventies, inflation came back in four waves (see Figure 1.)

History shows that it is almost impossible to contain high inflation without causing a recession. And causing a recession requires positive real interest rates. Paul Volcker eventually had to raise short-term interest rates to 20% in 1980 to provoke a recession and thus curb the stubborn inflation of the 1970s. Today, however, real interest rates are still negative and this in both America and Europe. Moreover, the US economy shows hardly any signs of slowing down. A hesitant Fed could rekindle the fire of inflation.

In line with consensus expectations, inflation is indeed likely to fall in the first half of the year but could well be much more persistent than we think. The labour shortage in the US and in Europe is leading to strong wage demands. A re-opening of the Chinese economy in the second or third quarter of this year, when the worst of the covid wave is over, could renew inflationary pressures. And Poetin may have some new nasty surprises up his sleeve. If this scenario is confirmed, central banks will have to slam the monetary brakes. Short-term interest rates will be raised sharply and long-term rates will continue to rise. That is bad news for just about all asset classes: equities, real estate and "regular" bonds. Inflation-protected bonds, as long as the rise in nominal interest rates reflects a rise in inflation rather than a rise in real interest rates, offer an interesting way to protect your portfolio against persistent inflation. Buy them if you expect average inflation to exceed 2% over the next 10 years. Gold, as in 2022, would do relatively well.

In the next Quo Vadis edition: A potential price correction in the Belgian property market.

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