Outlook

The world is changing, again

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Two major events break with very long trends

- A 40-year trend towards zero inflation has turned
  - Globalisation disinflationary trend has evaporated
  - Home flagging strategic production
  - Significant wage pressures are rebuilding in the western economies
  - Supply line disruptions started the trend
  - Energy price increases made it worse

- 15 years of QE is being replaced by QT
  - EU+US central bank balances have been a better predictor of stock markets than any other single factor
  - Bond yields have fallen as investments have weakened and savings have increased

Supply-side inflation dominates

- Examples
  - Energy
  - Labour
  - Commodities and semi-finished products

- Makes inflation fighting more difficult
  - Alleviating supply-side pressures requires structural changes
  - Which takes years…

- Fighting supply-side inflation from the demand side
  - Requires engineering a deeper recession
  - Coordination of fiscal and monetary policies
  - Fiscal policy still too expansive?

Monetary policy is an unreliable partner in fighting inflation

- Monetary policy works in indirect ways
  - Affects primarily longer-term decisions
  - Business investments, construction, long-term consumption items
  - Peaks anywhere between 12 and 18 months later
- Fiscal policy works directly
  - Directly influences disposable income for households
  - Directly influences business income
  - But is subject to **long delays** in political decision processes

The cynic's view

- The supply-side chock of higher energy and commodities prices has already caused a significant reduction in real wages in Europe – driving a recession
- US consumers are less sensitive to those factors
  - Energy is a smaller budget item per the lower taxation
  - Consumers still feeding on direct CoVID subsidies
  - May narrowly avoid a recession
- China is unlikely to contribute to global economic growth
  - Banks' NPL
  - CoVID bungled
  - Workforce shrinking
  - Productivity gains have slowed
  - Too low return on investments in central sectors

Conclusion:
Inflation will not revert below 2%

- Nobody has the political will to impose a deep recession to fight inflation
- Inflation expectations are already ingrained
- Higher energy prices accelerates transition to sustainable energy sources
- Inflation in the 3-4% range secures a faster reduction of real value of government debt
- Strong disinflationary pressures from globalization put on hold for decades

Something went wrong

- Zero inflation/interest rates have lead to wrong asset allocation
  - Safe assets for long-term capital accumulation had zero or negative real yields for a long time
  - Has been leading the long-term savings institutions into a hunt for yields
- Assets with low, uncertain or absent cash yields have been major investment objects
  - Property
  - Private Equity
  - Cryptos
  - Zombie stocks (earnings do not cover interest rate costs)
  - High growth – no cash flow stocks
- Investment decisions taken on expectations of future asset prices (greater fool theory)

Investing in a time of positive interest rates and inflation

- Cash flows move back into focus
- With a positive yield on govies, the TINA era is over
- Assets with weak cash flows and rosy terminal value scenarios will be subject to intense scrutiny
- The art of granting corporate credits will in the end come back
- Asset allocation will become far more balanced between risk assets and secure assets

Principles

- Continued positive correlations between main asset classes temper our appetite for risk assets
- Uncorrelated hedge funds, such as market neutral strategies, remain attractive
- Bonds (govies and investment grade corporates) back in our good graces
- Stock market may get ahead of itself on lower inflation in the coming months. Sensitive to news for the contrary
- EM assets, lead by bonds, may offer good risk return pay-off
- Dollar likely to continue weakening, as long as market expects a swift end to monetary tightening cycle
- Avoid illiquid products whose real value is difficult to determine

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