MARKET COMMENTARY

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13 September 2022

Inflation will come down on its own

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Christine Lagarde has announced last Thursday that policy rates will be raised two more times this year, and further in 2023, until inflation is under control. It had been no less than 9.1% y/y in August.

The ECB should not be too ambitious. Why try to reduce overall demand – which is very weak already – if the reason for the explosive increase of the general price level are problems on the supply side? Supply must be increased again. This is not the job of a central bank but of other economic policies, and usually takes a lot of time.

The only plausible justification for the new strategy is that inflation expectations must be prevented from rising towards actual inflation rates. This does indeed require a rapid and massive response in the near term. As it is, the risk of a wage-price spiral that will be hard to stop is fairly low, or non-existent, though, judging by the yield of long-duration bonds (10-year German government yields are still only a modest 1.7%) or by the pace of wage inflation where the latest settlements remain far below today's inflation rates. In spite of the surprisingly favorable situation on European labor markets workers' wage demands are not yet aggressive. In Q2, euro area employment reached 164 million, which was up an impressive 2.7% from one year ago.

Signs are multiplying that inflation rates will soon come down. The main reason are low rates of capacity utilization. According to the new ECB forecast overall demand will rise by less than the trend rate of potential GDP, well into 2023. Excess capacities are not only large but also on the rise. I cautiously estimate that the trend line of potential GDP has a slope of 1¼% per year, since 2008. The COVID crisis had led to a reduction of euroland's real GDP by about 6%, followed by a brisk recovery in 2021. According to the latest forecasts it will exceed its 2019 level by almost 3% in 2023. Even so, next year's output gap will be larger than in pre-crisis 2019, and may reach 7%. Business will find it therefore difficult to raise prices in such an environment, and wage settlements will remain well below actual inflation rates. These are risky times, but inflation will certainly not take off from here.

Here are some anecdotal observations which support this thesis: in China, a country that is also very dependent on energy imports, August consumer prices were only 2.5% y/y, after 2.7% in July; producer prices were 2.3% y/y, down from 4.2% in July; Japanese developments are similar. The price of a barrel of crude (Brent) has lately fallen to $90 which is down 30% from its high in June; even the prices for wheat have collapsed in recent months, in spite of the wide-spread fear of an imminent global hunger catastrophe. The German consumer price inflation rate ex food and energy, ie, the core rate, has declined to an annualized 3.4%. Across Europe, the steep fall of real household incomes in the wake of the energy crisis has led to a demand shock – which is good news for inflation.

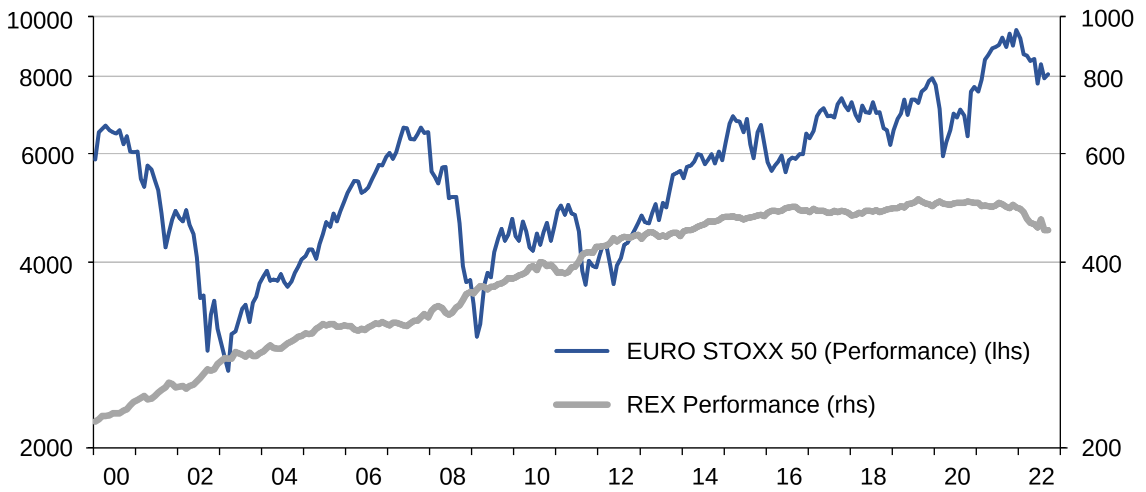
Another important reason for the coming reduction of inflation rates is the so-called wealth effect. European savers are experiencing a significant decline of the value of their assets – they have the impression that they are becoming poorer and react by cutting down on spending.

Bond yields have increased from -0.5% to +1.7% (10y Bunds) over the past year which translates into a price reduction of more than 20%. This is probably not the end of it, given the policy announcements of the ECB.

As to equities, the rising yield curve means that the present value of future profits and cashflows has fallen a lot. Since present values are the main determinants of stock prices it's surprising how resilient these have been this year. And let's not forget that profits themselves will come under pressure over the course of the recession (or stagnation). Since price-earnings ratios continue to be high, the market correction could be quite large. But, on the positive side, it would push down inflation rates.

performance of European stocks and German government bonds*)

log scales



*) monthly, end of period, last value: September 9, 2022

sources: Deutsche Börse, Deutsche Bundesbank; design & research: Uwe Richter ©UR

Finally, real estate prices. Combined with the fact that European construction activity has led to a big increase in housing supply, the sudden jump in financing costs suggests that they are more likely to fall than to rise. If it were not for the wave of refugees from Ukraine, real estate prices could well be in a free fall by now (more than one million refugees have so far arrived in Germany alone).

ECB economists do not believe that inflation is near a turning point, at least not officially. The near-term policy objective is to boost the standing of the euro which has suffered a lot recently. Big hikes of policy rates are needed to end the embarrassing weakness of the exchange rate. After the failure of the so-called forward guidance this instrument has quietly been discarded. Monetary policy will be driven, more modestly, from now on by incoming economic data.

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About Wermuth Asset Management

Wermuth Asset Management (WAM) is a Family Office which also acts as a BAFIN-regulated investment consultant.

The company specializes in climate impact investments across all asset classes, with a focus on EU “exponential organizations” as defined by Singularity University, i.e., companies which solve a major problem of humanity profitably and can grow exponentially. Through private equity, listed assets, infrastructure and real assets, the company invests through its own funds and third-party funds. WAM adheres to the UN Principles of Responsible

Investing (UNPRI) and UN Compact and is a member of the Institutional Investor Group on Climate Change (IIGCC), the Global Impact Investing Network (GIIN) and the Divest-Invest Movement.

Jochen Wermuth founded WAM in 1999. He is a German climate impact investor who served on the steering committee of "Europeans for Divest Invest". As of June 2017, he is also a member of the investment strategy committee for the EUR 24 billion German Sovereign Wealth Fund (KENFO).

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