CHASING AWAY THE GHOST OF INFLATION

What the figures are really telling us

In May 2022, prices in the Eurozone increased at a rate of 8.1%, compared to 7.4% in April. Arguments that this is a temporary phenomenon seem less persuasive the longer the period of rising prices lasts and the higher they rise. Worse still, people start questioning central banks' ability to get a grip on the situation. In this apparently febrile atmosphere, "Keeping cool," as Spectrum Markets' Christian-Hendrik Knappe, German Sales Director advises, sounds downright provocative. We asked him to explain the development and how retail investors may position in the current market environment.

Christian, you're appealing to investors not to lose their heads and to stay rational. Are you turning a blind eye to the problem of inflation?

Not at all. What I'm encouraging is that consumers and investors should avoid aggravating effects on their portfolios by misinterpreting the various price-driving factors with a view to their origin, their relative importance or their persistence.

What does that mean?

Historically, rising rates have been considered heralds of a shrinking economy. As higher bond yields move investors towards credit markets with stocks declining as a result, the notion is that this must be the end of an economic cycle. Although prices seem to have exploded, central banks raise rates only moderately which makes investors believe that central banks consider higher borrowing costs a bigger problem for the economy than inflation. In other words, if central banks refuse more significant rate hikes, they must be in fear of leading an overheated economy directly into recession.

Are you denying the risks of a recession or even stagflation?

First, I'm denying that the economy is overheated. Second, for similar reasons, I doubt that rate hikes will have significant or even noticeable effects in the short run. Third, the likelihood of entering into stagflation – a period of high inflation and economic stagnation with high unemployment at the same time – is anything but on the cards. By that, I'm neither denying the clear and present high inflation nor any recession risks. However, it is important to understand that blaming inflation solely on oversupply of money is as wrong as just attributing it to post-pandemic effects. There are structural, cyclical and one-off factors to consider in order to adequately address the issue.

Can you please comment on these factors?

Thinking of one-off effects, there is, for example, the much-cited "base-effect" which is due the measuring of inflation on a year-on-year comparison basis. If the rate of price increases was very low in a base year because of exceptional circumstances and if prices then bounce back once these circumstances cease, the sudden price increase appears as a net inflation effect. The VAT reductions that were introduced in some European countries in 2020 as compensation for pandemic-related burdens are one such example.

Or consider goods that have built-in microchips, predominantly cars but all sorts of electronic equipment, too. Firms cut their output and plans, so did semiconductor producers. Demand was quickly reinvigorated post-pandemic, which caught them on the back foot – not only did they have to compensate for the underproduction; they have also been facing renewed demand well above pre-pandemic levels.

Another supply-chain-related problem has been disruption to the transportation sector, also due to the pandemic.

Then there is the non-negligible effect of energy and food prices without which Eurozone inflation would have been at 3.8% in May[1] instead of the 8.1% that includes all components.

While the causes of inflation may not make a difference for consumers, they underpin the effects that unpredictable or irregular developments have on prices. As such, they must make a difference for investors with a view to how to react.

A little bit more detail please...

Some argue that there's just too much money in the economy. In which case shortening the supply would be a simple way to reduce inflation. As we have seen, however, there are many more factors that determine how prices develop than just the supply of money. Thus, the question is what a central bank could do to curtail price movements which are attributable to structural or exceptional problems, i.e., which are not cyclical in the classic sense. The answer is probably: not much. Economists are increasingly split over whether central banks still have the power to immediately influence prices that they may have had in the past. According to the BIS[2], monetary policy is operating "Through a remarkably narrow set of prices, concentrated mainly in the more cyclically sensitive service sectors".

Now, what we've seen during the pandemic has been a clear shift of demand from services to goods sectors. In other words, the effect open market operations have on inflation had been eroding anyway due to a new globalised economic structure.

Please tell us why you don't think there is stagflation ahead

Again, mainly due to structural reasons. We discuss shortages anywhere, but job markets have proved extremely robust across the board. If the current stress factors haven't distorted labour demand yet, then it's hard to imagine how this will change going forward. Bear in mind the demographics: baby boomers are reaching retirement and the low birth rate years will determine job markets in most mature economies. I'm saying this with particular reference to the wage-price-spiral discussions that have grown louder lately. Structurally, unemployment is unlikely to rise in the mid to long-term. This will of course also have effects on economic output but rather in terms of lower growth rates. On the other hand, the wave of insolvencies that was predicted to be an inevitable result of the pandemic didn't materialise.

Note, however, that although I have doubts regarding the immediate technical impact of rate hikes, I believe that they will have an important psychological effect, which is why I'm in favour of the monetary tightening.

Coming back to the original statement that you'd recommend investors remain calm in light of current developments...

Looking back at the past two years, it's fair to say that it was quite a turbulent time. And I dare to predict the coming years will be no different – at least as far as volatility is concerned. Fundamentally speaking, if you follow my interpretation regarding the components of the current inflation, then it is consistent to continue to believe in companies that can generate superior earnings and cash flow over the long term. In other words, the current flight to value is understandable but seems only justified where dividends clearly suggest this. Otherwise, I still believe that the e-commerce and health sectors have outperformance potential. It may sound surprising, but financials traditionally also benefit from rising rates: and some seem undervalued. However, investors with a sufficiently diversified portfolio should stay quite relaxed about the interest rates turnaround. For investors with a more aggressive risk profile or for those that look into hedging certain positions it may be worth looking into securitised derivatives.

Thank you very much!

[1] Eurostat: Euro area annual inflation rate and its main components
[2] Bank for International Settlement: Looking under the hood: The two faces of inflation

Christian-Hendrik Knappe, 46, has joined Spectrum Markets in May 2022 to oversee Spectrum's sales operations in Germany. Christian has more than 25 years of experience in the investment and financial industry and held various positions at the Stuttgart Stock Exchange and Deutsche Bank in the retail derivatives sector. Before joining Spectrum, he was responsible for securities data sales at WM Datenservice, the leading data provider for the German securities sector.

Get in touch today to discuss how the seamless market access that our venue provides, can help to grow your retail client business.

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