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Within ***Focus*** we comment on extraordinary market events and analyse capital market related special topics.

## What comes after the inflation hump? Implications for investors

*No return to the low inflation environment of the last two decades after the inflation hump*

The markets' focus is currently justifiably very much on high inflation and restrictive central banks. The US central bank, the Fed, has seemingly convinced the markets that it will do everything it can to fight inflation. As a result, inflation expectations priced into the bond markets have fallen significantly since April. This so-called break-even inflation is again between 2.5% and 3.0% for all maturities between two and 30 years and thus at levels as in spring 2021. Indeed, there is much to suggest that inflation will fall significantly in the coming year at the latest – we also expect this. However, investors should not succumb to the illusion that we will quickly return to the low inflation environment of the last two decades once inflation has passed the inflation hump. In the coming years, we expect not only higher inflation on average than in the last decade, but also significant fluctuations in inflation, i.e. increased inflation volatility. The reason lies primarily in the longer-term supply bottlenecks for raw materials, the energy transition, deglobalisation, as well as demographic developments that are likely to lead to an increasing shortage of labour.

*Higher inflation than in the last decade and increased volatility of inflation are to be expected*

**Supply bottlenecks for raw materials and labour in the longer term**

*Commodity supply shortages exacerbated by lack of investment and Putin's war*

There are supply bottlenecks in raw materials both for industrial metals, which are indispensable for the energy transition, and for fossil fuels. For years, there was insufficient investment in both areas. In addition to low commodity prices, companies' focus on dividends and political considerations (environmental and sustainability aspects in particular) played a significant role here. Now Putin's war is further tightening the supply of fossil fuels, which is accelerating the trend towards renewable energies and thus also the structural demand for industrial metals.[1]

*Commodity prices and wages likely to come under renewed, swift upward pressure as economy recovers*

The reduction in demand due to China's zero-covid policy, higher interest rates and the expected recession should temporarily dampen commodity price developments and lead to declining inflation. It should also temporarily ease the tightness of the labour markets. However, if the economy recovers afterwards, both commodity prices and labour markets are likely to quickly tighten again. This is because supply remains limited, while demand continues to increase due to both the energy transition and the growth of emerging economies. For example, the household share of air conditioners in India is only about 10% – and rising. The number of registered cars is also rising steadily there thanks to a growing middle class. In the longer term, wage pressures are also likely to become more pronounced as a result of a permanent shortage of labour. A renewed upward pressure on inflation thus seems unavoidable, which the central banks will then have to tackle again. In addition, the energy transition, increased climate-related natural disasters ("crop failures") as well as social and geopolitical unrest could also contribute to stronger fluctuations in inflation. The consequence of stronger movements in inflation is likely to be stronger and faster monetary policy cycles and thus also shorter, more pronounced and more erratic economic cycles.

[1] See "The industrial metals super-cycle has accelerated, not slowed down", Berenberg Markets Focus, 11 August 2022

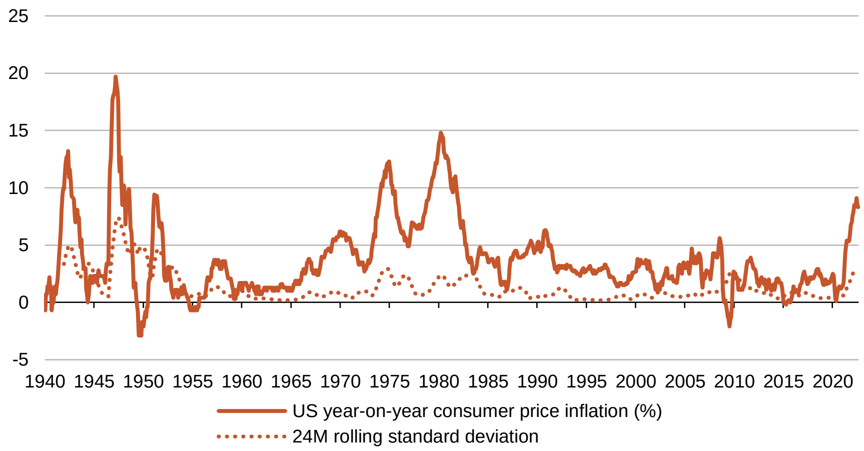
This setting would not be entirely dissimilar to the 1960s and 1970s, when inflation kept building in three waves (see Fig. 1). After years of low and stable inflation in the early 1960s, the US Federal Reserve then tried to finance the US budget deficit, which had increasingly risen due to the costs of the Vietnam War and comprehensive social reforms, with a low interest rate policy in the mid-1960s and to stimulate the economy, which was stuck in recession. The resulting high demand for goods and services subsequently led to rising wages and consumer prices. The current counterpart to this policy of the mid-1960s is probably the Fed's low interest rate policy in the wake of the Corona crisis combined with the concurrent excessive fiscal stimulus after years of low and fairly stable inflation. This time, too, the resulting high demand for goods and, after the end of the pandemic-related restrictions, for services led to rising consumer prices and wages.

*Today's inflation environment shows parallels to the 60s and 70s*

Later, between 1973 and 1981, especially in the two oil crises of 1973/74 and 1979/80, numerous price shocks for oil and food repeatedly caused inflation rates to shoot up. Due to rising inflation expectations and high wage demands by the trade unions, the individual shocks led to persistent inflation. The current parallels are the energy crisis and the sharply rising food prices due to the Russian war of aggression in Ukraine.

**Fig. 1: Inflation and inflation volatility likely to remain high this decade**

US consumer price inflation over time




Time period: 01/01/1940 - 30/09/2022
Source: Bloomberg, own calculation

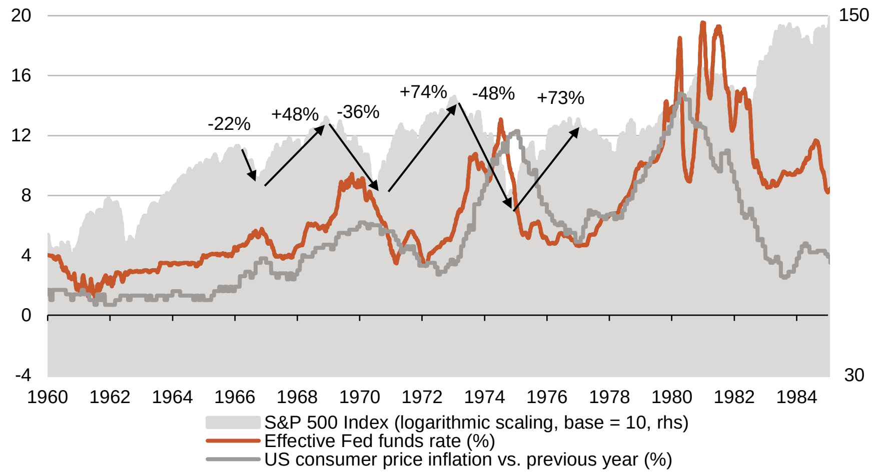
### Lessons from the 60s and 70s

Central banks are likely to be decisive for the further course after the inflation hump. The course of consumer price inflation in the US compared with the effective Fed funds rate in the 1960s and 1970s in Fig. 2 shows that the Fed quickly loosened the reins of interest rate policy again when inflation fell. Moreover, in 1973 the Fed temporarily lowered interest rates in response to the Yom Kippur War and the oil shock, despite high and continuously rising inflation. One background to this was that the governments of the industrialised countries were pursuing ambitious employment targets at the time and the central banks were also acting less independently, which is why monetary policy remained quite expansionary throughout the 1970s, especially in the US. This behaviour had certainly favoured the continuous build-up of inflation in several waves at that time. It was not until the Fed took a much more restrictive approach under Chairman Paul Volcker at the beginning of the 1980s and kept the key interest rate above realised inflation for a long time that inflation came back sustainably.

*Expansive interest rate policy of the Fed during the 1960s and 1970s, with rapid interest rate cuts after inflation peaks*

**Fig. 2: In the 1960s and 1970s, the Fed very quickly lowered interest rates again when inflation fell**

Course of consumer price inflation in the US compared with the effective Fed funds rate in the 1960s and 1970s and the S&P 500 Index




Time period: 01/01/1960 - 31/12/1984
Source: Bloomberg, own calculation

*Avoiding premature monetary easing as a learning effect from history?*

The Fed has already emphasised several times this year that lessons must be learnt from these past mistakes and that a premature easing of monetary policy should be avoided. Accordingly, it is currently continuing to step firmly on the brakes, even though inflation in the US seems to have already peaked and the strong US dollar is increasingly causing problems in the global economy. In view of the still surprisingly robust economy, the still tight labour market in the US and the only moderate decline in inflation, this approach should be easy for the Fed at the moment.

However, if the economy and the labour market weaken significantly, it may be questioned to what extent the Fed will continue its restrictive monetary policy course and thus really avoid the mistakes of the past altogether or not. It is more likely that as soon as the Fed sees sufficient signs that the recession has sufficiently dampened inflationary pressures, it will lower interest rates again somewhat – probably starting in the second half of 2023. However, the Fed will not hold out this prospect for the time being. Of course, this is only true as long as the Fed is not forced by an exogenous shock or stress in the (bond) markets to lower interest rates beforehand as a rescue measure for the financial markets.

Cutting interest rates, if at all only one year after the inflation peak, would indeed be a much more restrictive approach than in the 1970s. This would probably avoid a continuous build-up of inflation as in the 1970s. However, several waves of inflation due to the supply bottlenecks in commodities and labour already discussed and higher inflation on average are unlikely to be avoided, especially since, unlike in the 1960s and 1970s, the Fed rate is currently still well below realised consumer price inflation and the structural drivers of inflation mentioned at the beginning – supply bottlenecks in commodities, energy transition, deglobalisation and demographics – cannot be directly solved by central bank policy.

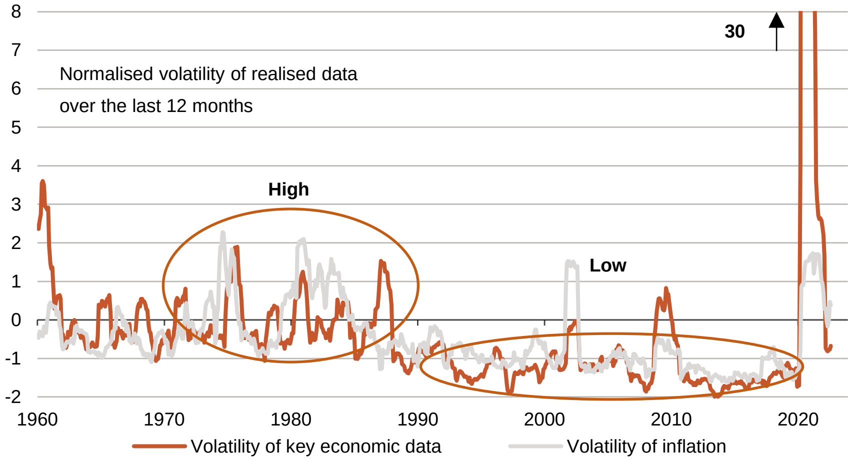
### Consequences for markets and investors

In an environment of increased inflation and especially increased inflation volatility, economic development is ultimately also more volatile, as Fig. 3 clearly shows. Planning certainty is thus significantly lower for companies and investors, which is why companies and investors are more reluctant to invest and justifiably demand a higher reward for the risks taken. This weighs on investment valuations and also suggests increased volatility across all asset classes. A higher inflation premium is also likely to be priced into long-term bonds again, so that yield curves should tend to steepen again.

*Increased inflation and inflation volatility add to economic fluctuations*

**Fig. 3: In times of increased inflation and inflation volatility, economic data are also more volatile - economic cycles are shorter and more erratic**

Key economic data: Non-Farm Payrolls, Industrial Production and Real Personal Consumption Expenditures; Inflation: Core PCE and Core CPI




Time period: 01/01/1960 - 31/08/2022
Source: BofA Global Research

The experience of the 1970s shows that the long-term potential for equity markets in such an environment is limited. Apart from the dividend payment, the S&P 500 index ultimately only moved sideways in the 1970s (see Fig. 2). However, there were three bear markets and three bull markets of significant magnitude during these years. The short and violent monetary and economic cycles were also reflected in the equity market. In each case, the equity market found its bottom at or near the peak of inflation and the central bank rate and subsequently quickly recouped its losses with gains of between 50% and 75%. For active investors, there were thus clear opportunities for returns during this phase, while static index investments would have lost money in real terms during this period.

*Strong bear and bull markets with more limited potential for equities*

Another key consequence in such an environment is a stronger synchronisation of risk assets and safer havens, as shown in Figure 4 for US equities and US government bonds, as well as a lower correlation between risk assets such as equities and commodities but also between equity regions. Investors can therefore rely less on the diversification effect of safe government bonds and should consciously leverage the diversification effect between risk assets, across all asset classes, segments and regions.[2] We call this "true multi-asset". In this environment, a pronounced commodity position seems particularly sensible to us: on the one hand, to hedge against

*Stronger synchronisation between risk assets and safe havens reduces diversification*

*Broad diversification across all asset classes, segments and regions, especially commodities, all the more important*

[2] See "Stronger synchronisation of equities and government bonds is also likely to shape the coming years", Berenberg Markets Focus, 30 August 2021

a more sustainable high inflation rate, on the other hand, to participate in the coming super cycle of commodities due to the energy transition.

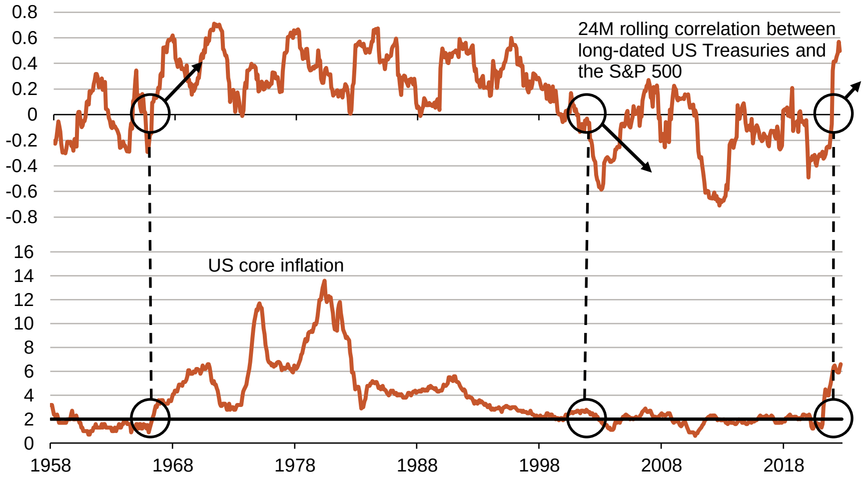
A strong focus on real assets also remains appropriate against the backdrop of high government debt worldwide, as higher inflation rates are likely to be leveraged by governments through financial repression to reduce debt. For example, with inflation currently at 3%, Japan continues to exercise yield curve control, which limits the yield on 10-year government bonds at 0.25% and enables debt sustainability. It is unlikely to be easy to achieve positive real returns with nominal investments in such an environment. With regard to equities, investors should focus on companies with strong market positions (pricing power) and robust cash flows, preferably with low valuations. Higher inflation volatility in the coming decade thus poses risks for the capital markets, but also opportunities, especially for flexible multi-asset investors.

*High sovereign debt levels indicate continued financial repression and thus further focus on real assets*

*For equities, quality companies with low valuations and pricing power should be preferred*

**Fig. 4: Higher inflation historically led to stronger synchronisation of risk assets and government bonds**

Path of the 24M rolling correlation between long-dated US government bonds and the S&P 500 Index and path of US core consumer price inflation




Time period: 01/01/1958 - 31/10/2022
Source: Bloomberg, own calculation

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