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War, Energy and Inflation: Back to the 1970s?

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Markets are usually right to ignore geopolitics but "this time is different"

1. **"Buy on the sound of gunfire" ?**

   Often, but not always: 1973 Arab Oil Shock caused worst bear markets since 1929-33

   War means buying low. But asset prices and valuations are near record highs

2. **Inflation is peaking?**

   Energy and base effects will embed inflation and create wage-price spirals

   Interest rates remain deeply negative in real terms: unlikely to curb inflation

3. **Bear markets are caused by recession, not inflation?**

   Curbing 5% plus inflation always requires recession: so tightening will continue

   Inflation will cause capital flight into equities from bonds, but at what valuations?

4. **Russia is losing the war?**

   Maybe, but what matters is impact of sanctions on inflation via energy and food prices

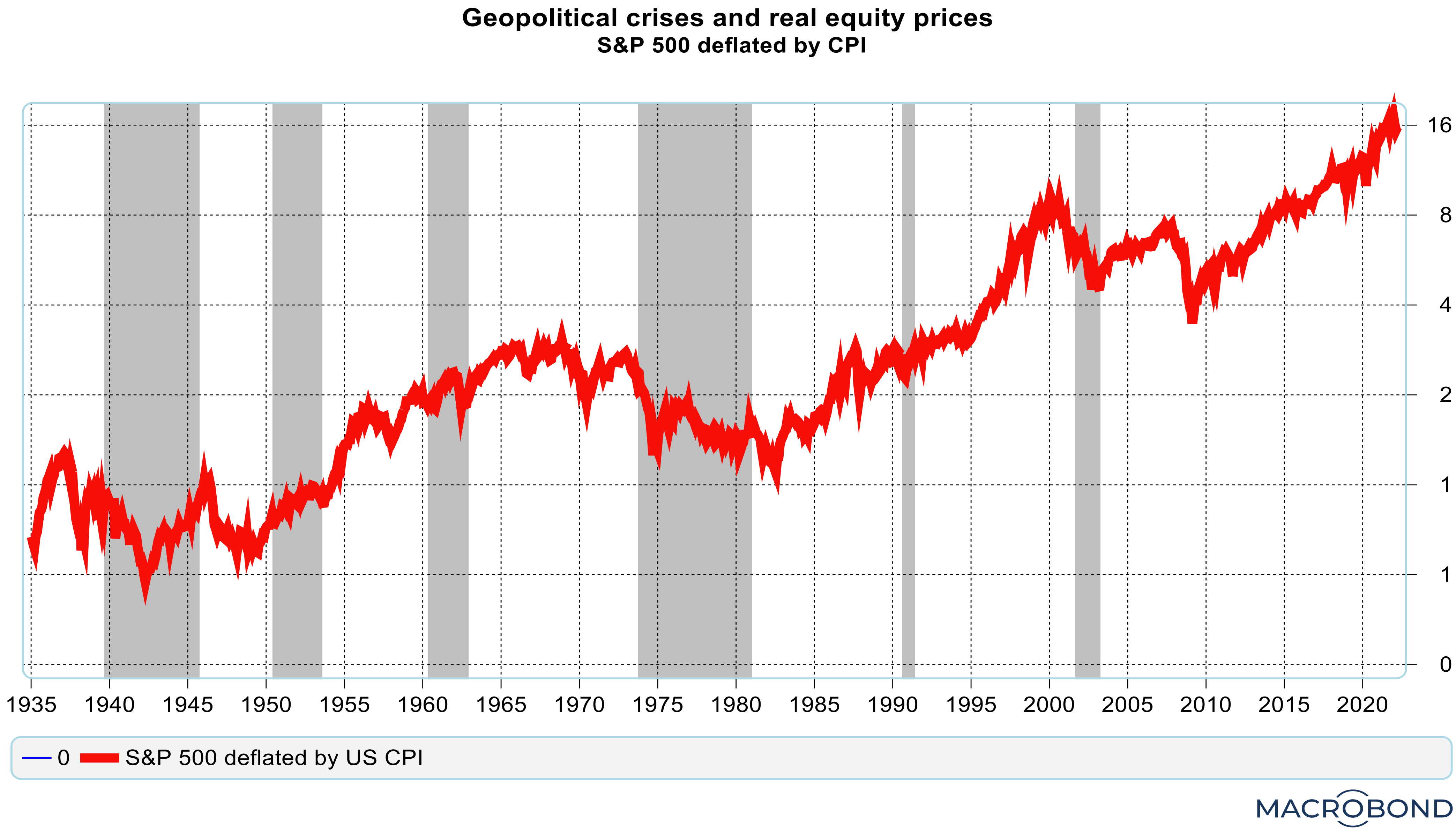
   Sanctions will continue or tighten even if Russia defeated – unless Putin falls

5. **All risks above are now obvious, so bad news is already "priced-in"?**

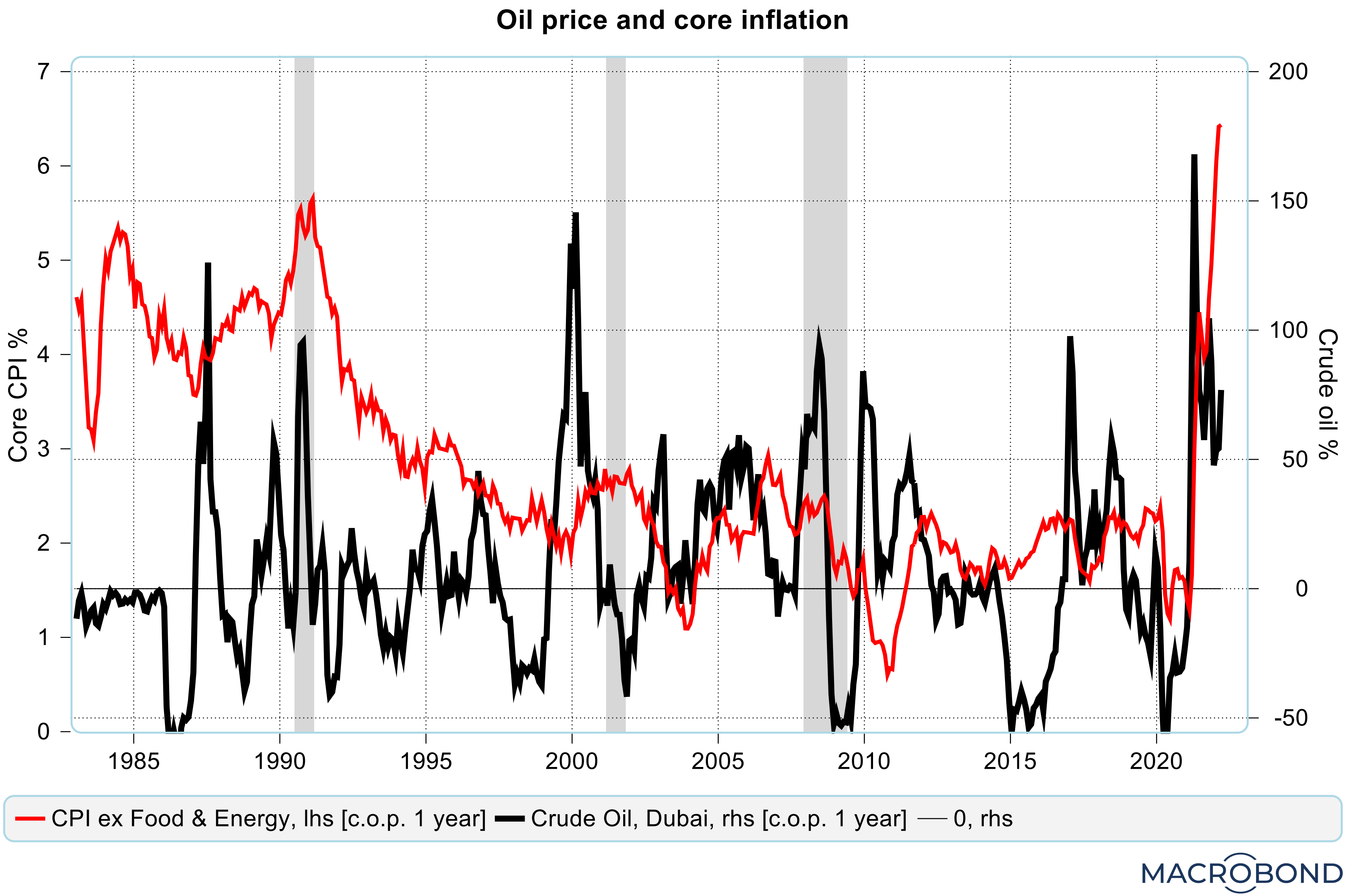
   Prices usually retest previous highs before bear markets really get going

   Buy-the-dip reflex and near-record valuations mean bad news *cannot* be priced-in

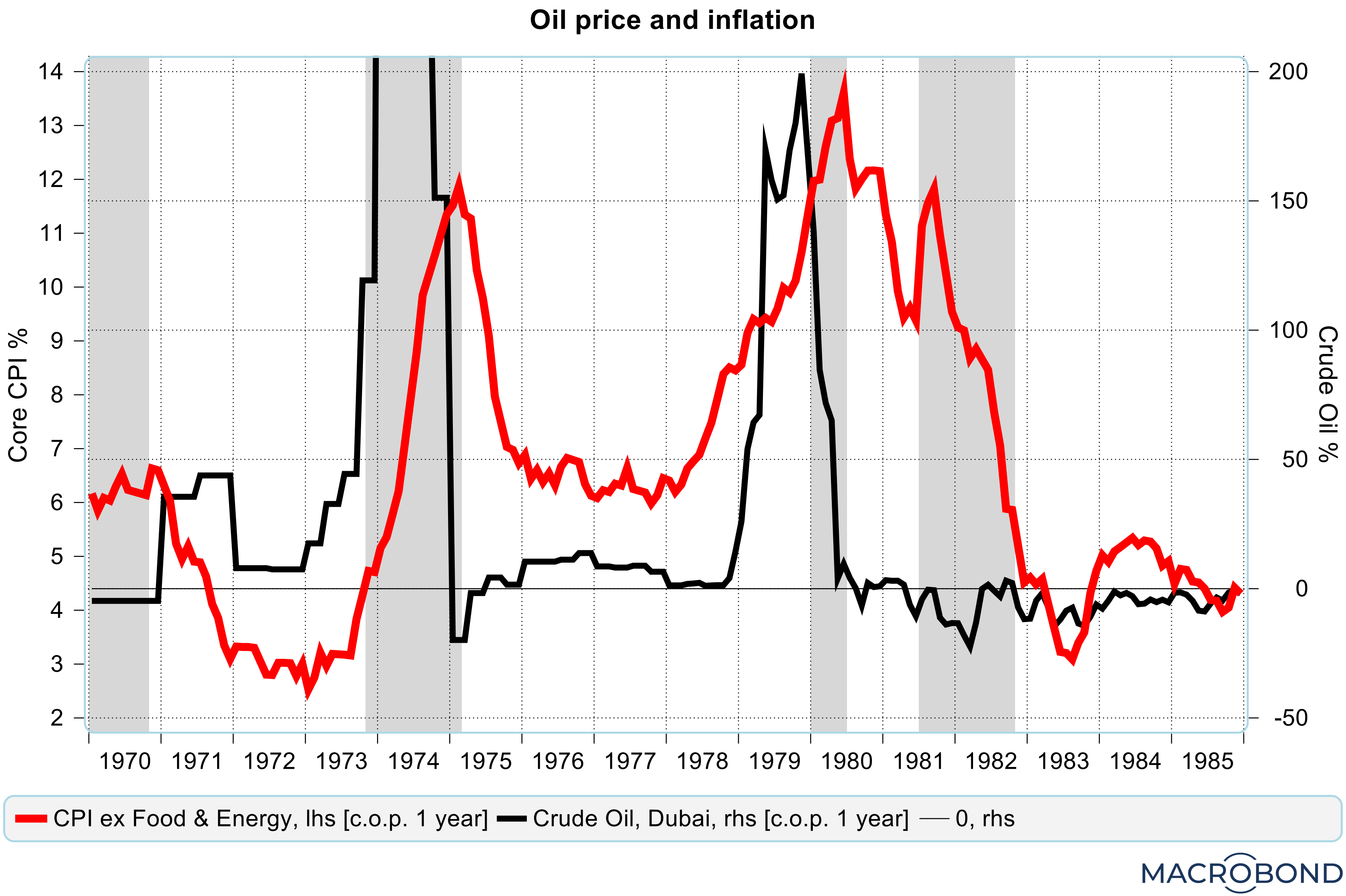
Wars, inflation and asset prices



Energy price spikes do not always cause broad-based inflation…

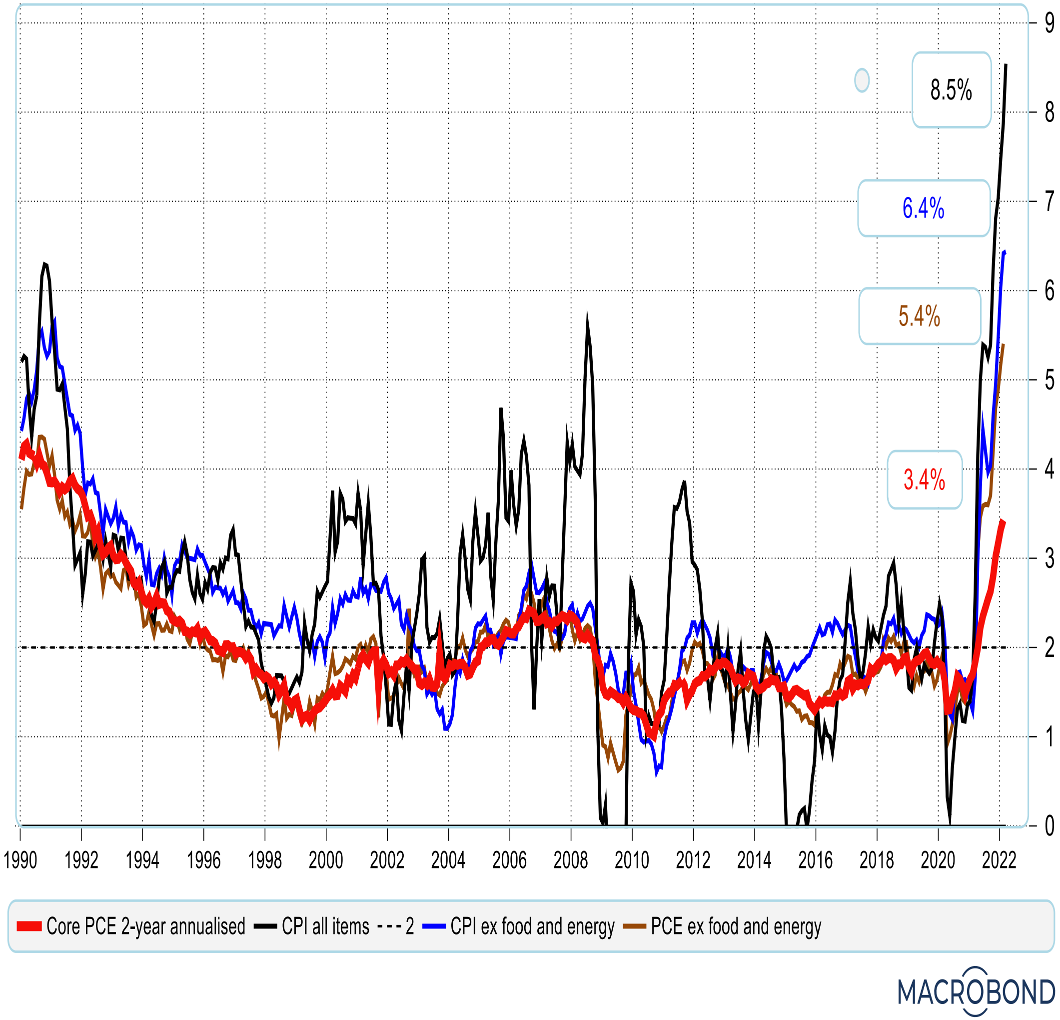


… But they did in the 1970s

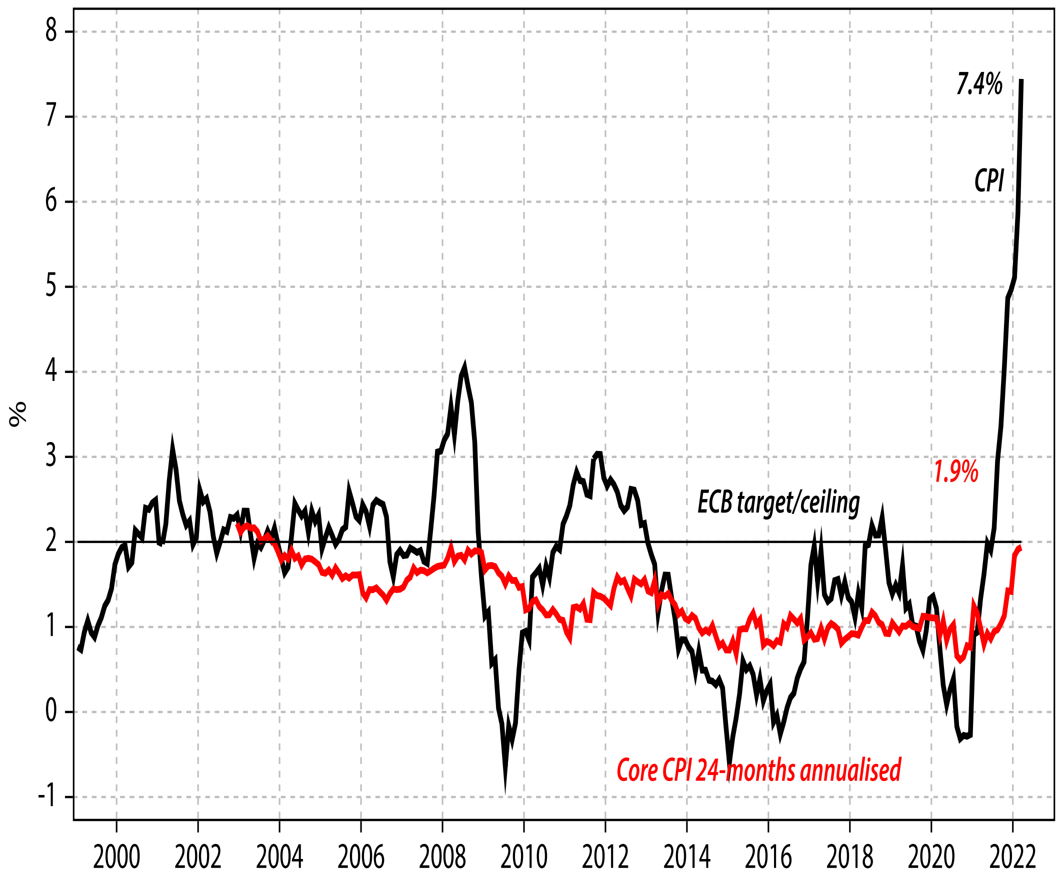


US inflation: energy and base effects explain more than half

US inflation measures



Euro Zone CPI inflation



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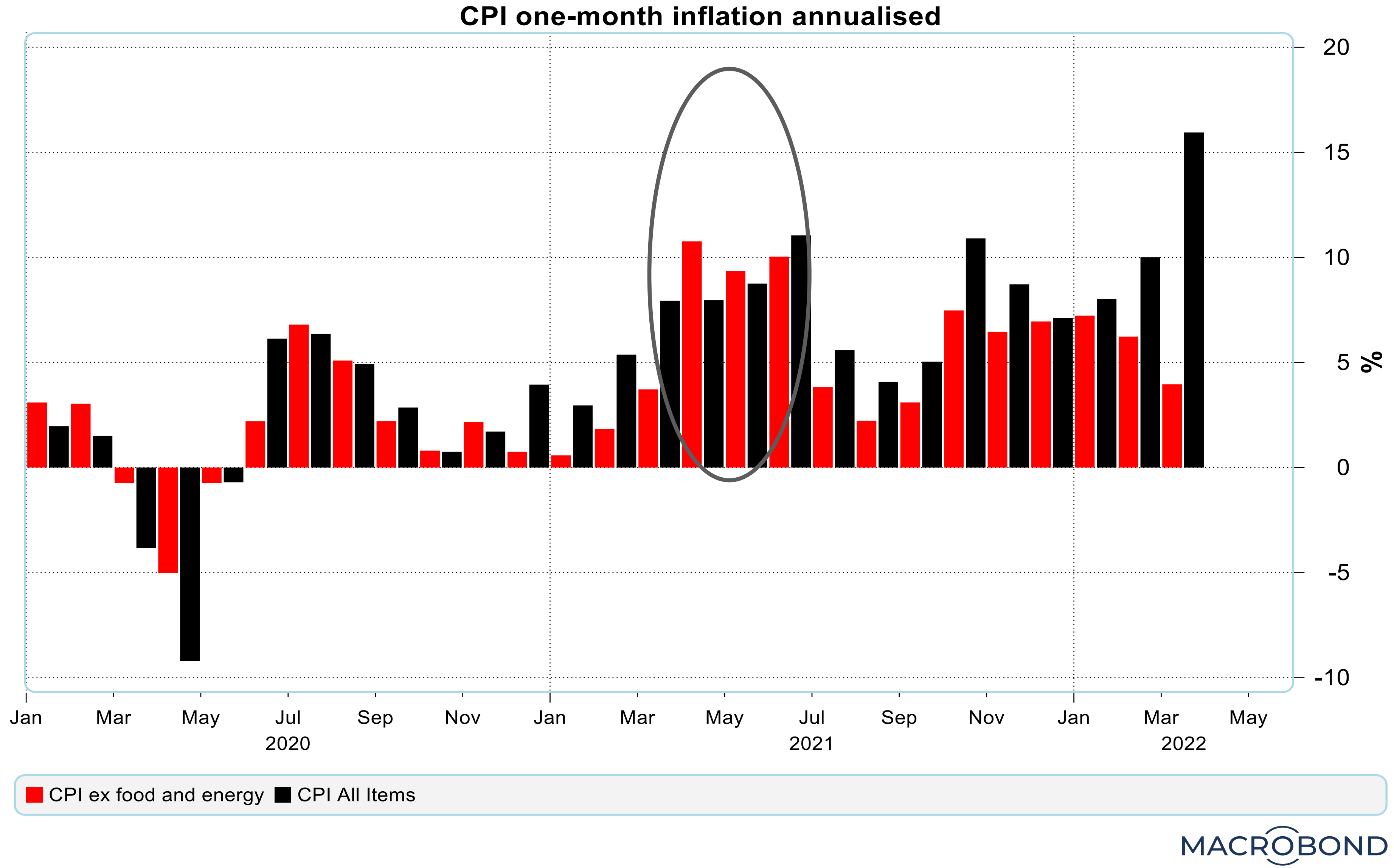
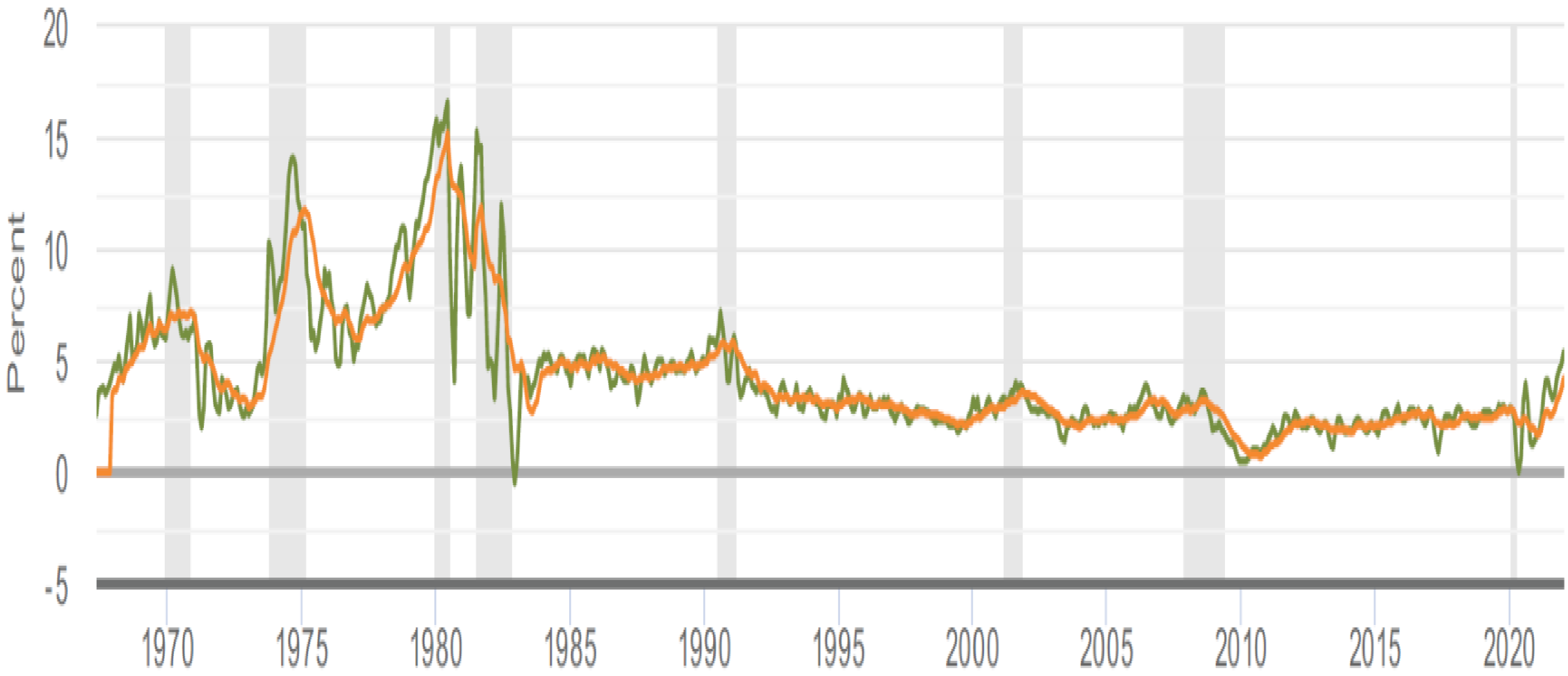
But war means that energy and base effects will NOT subdue inflation

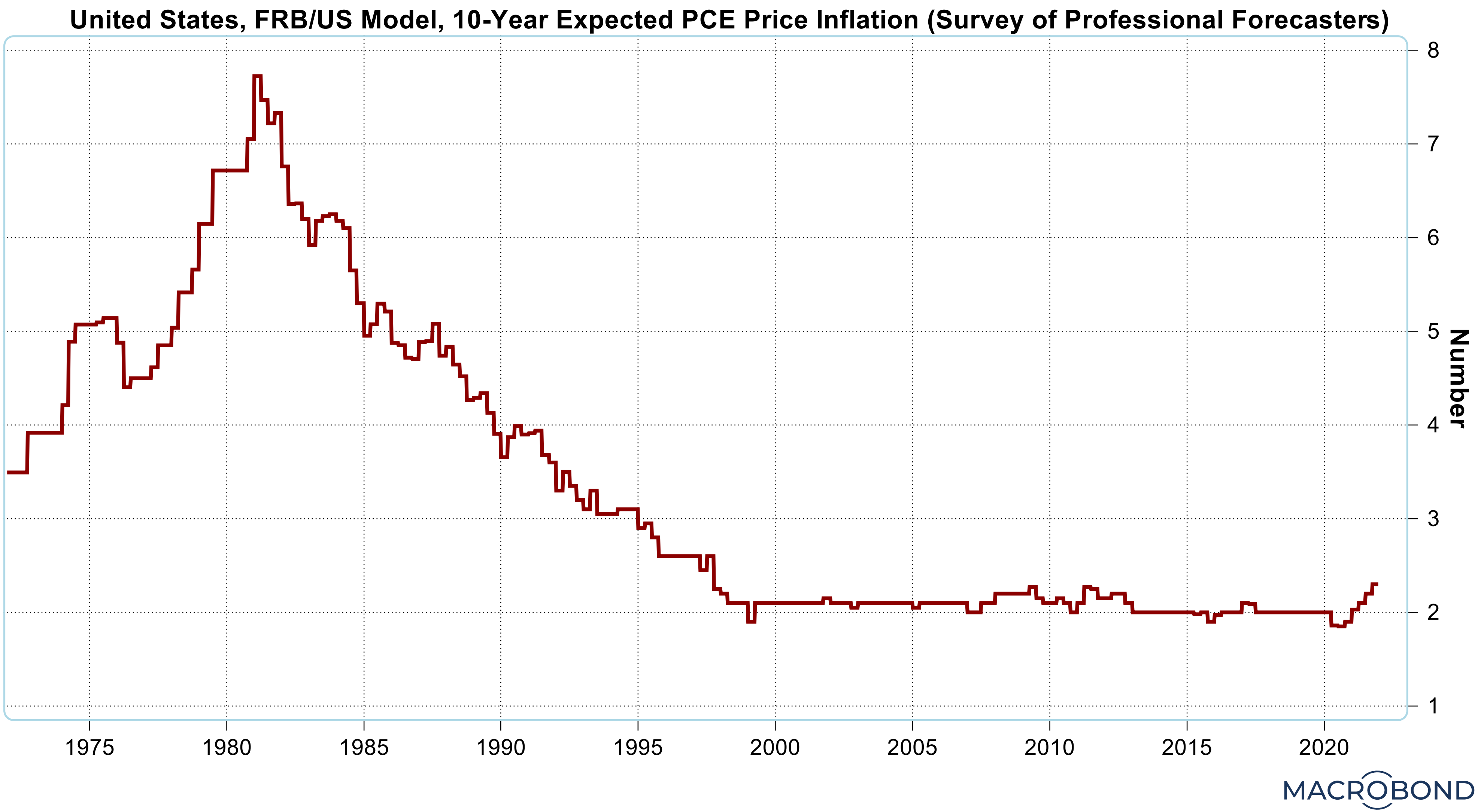


“Sticky” inflation is back to levels of 1980s (Atlanta Fed Index)

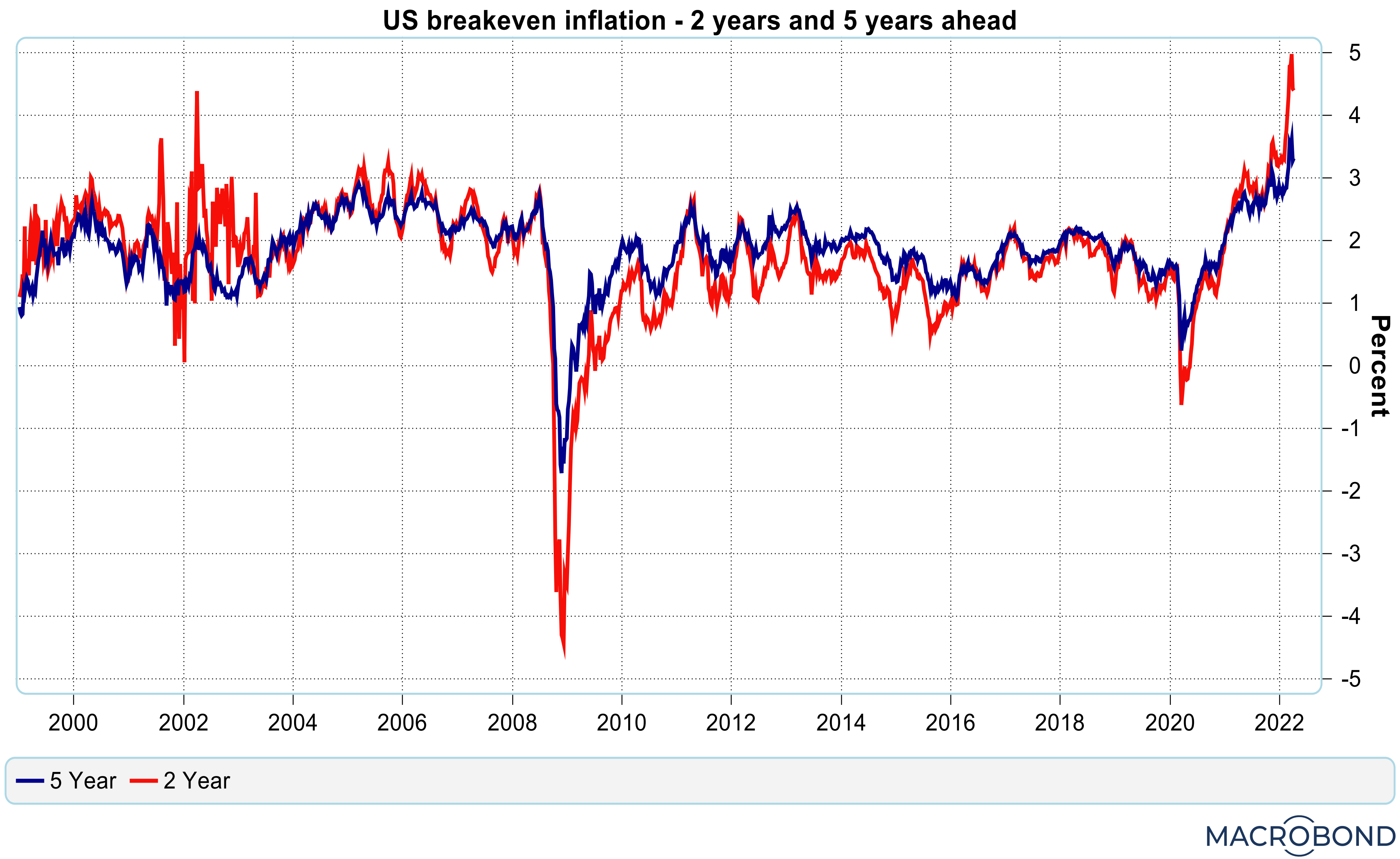


Gray bars indicate periods of recession.
Source: Federal Reserve Bank of Atlanta

Ten–year inflation expectations are 1% lower than before 1973 oil shock…



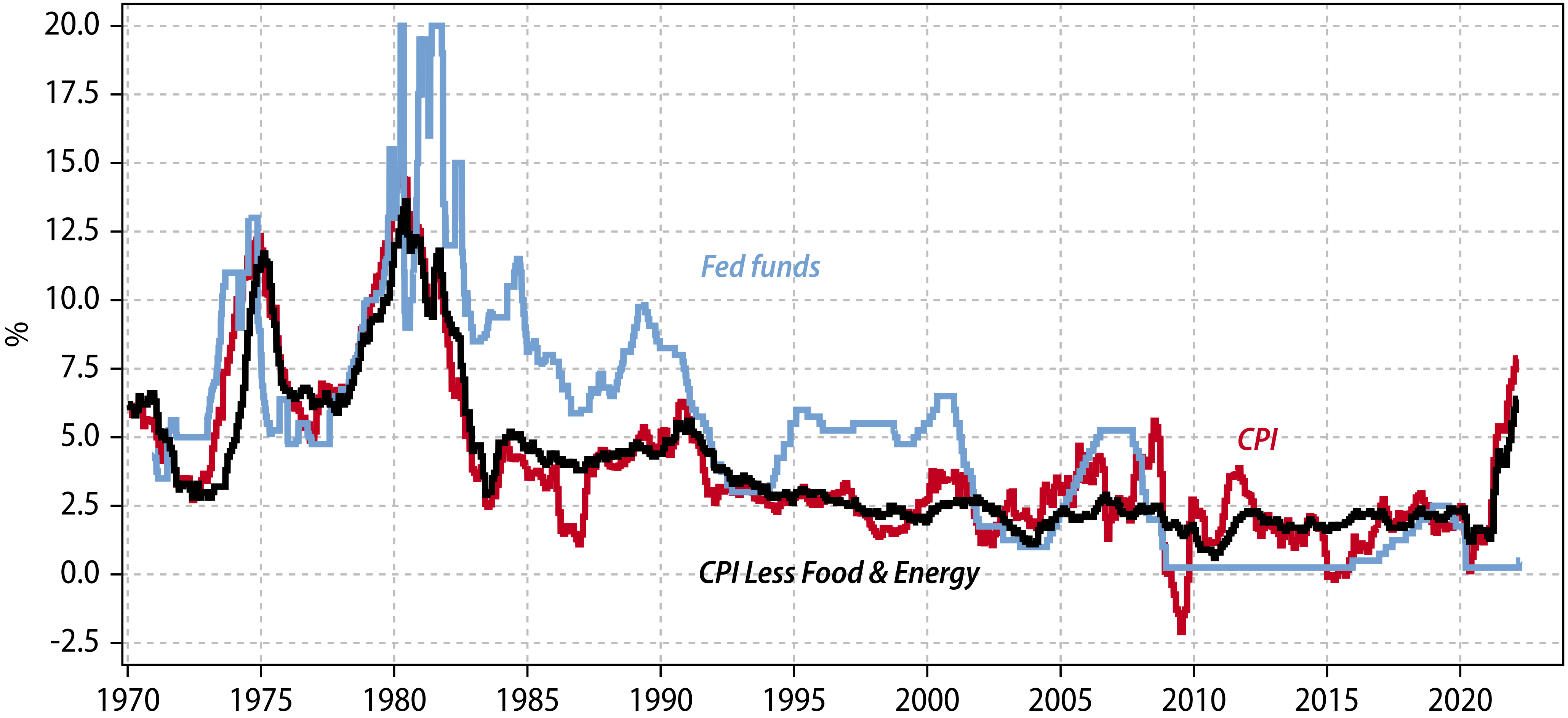
But five-year and two-ear break-evens are probably *higher* than in 1973



Can negative real interest rates cure inflation?

Fed policy and US inflation

Fed funds target vs US CPI



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Structural changes also point to higher inflation

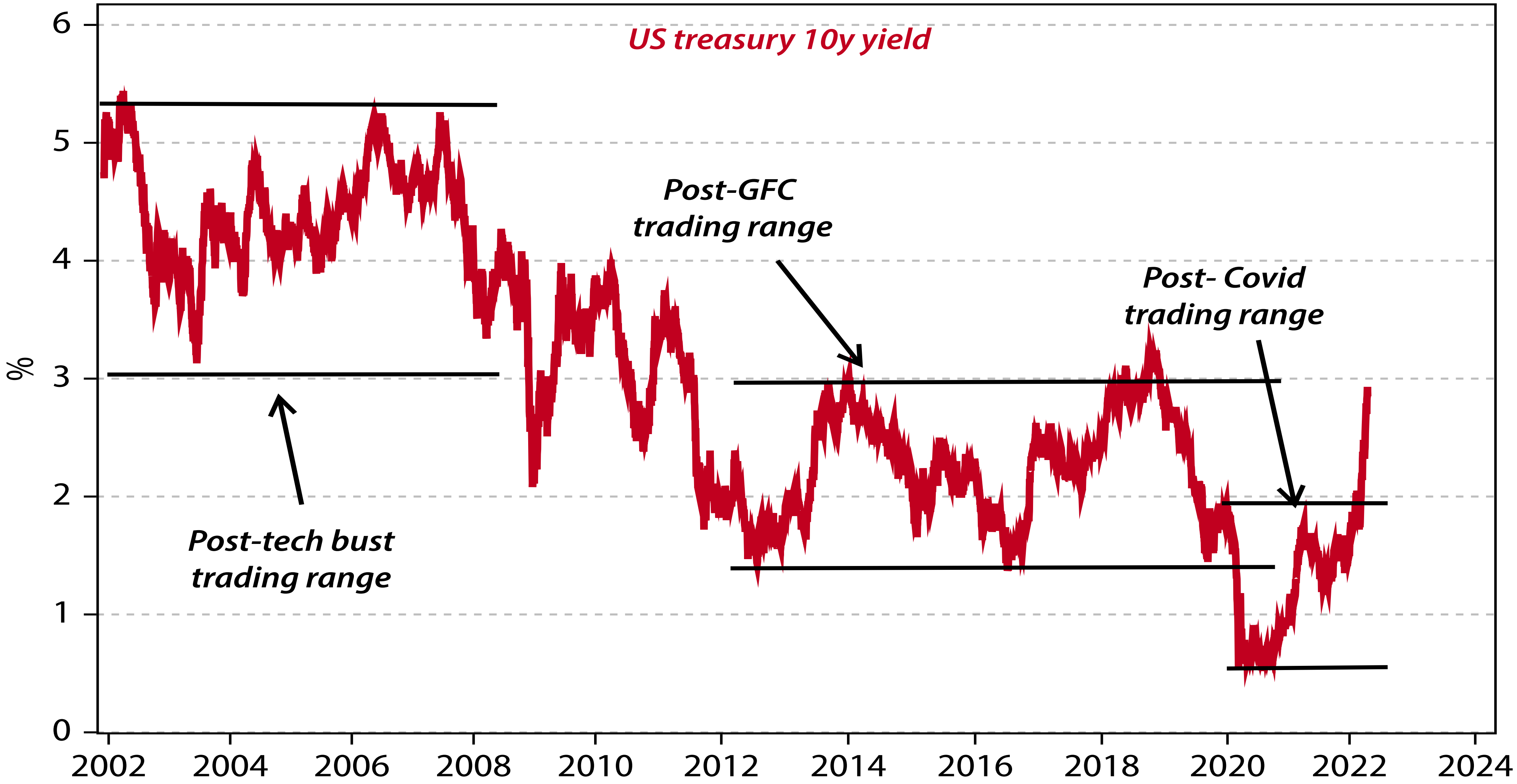
- **Macro policy** now expansionary and financed by central banks
- **De-globalization**: weakening of Chinese competition
- **Technology**: disruptors become monopolists
- **Energy transition:** capital intensive industries will lead growth
- **Politics**: balance of power shifts back towards labor
- **Demographics**: fewer producers, more consumers everywhere

Investment conclusions: high inflation hurts almost all asset classes

1. High inflation means rising interest rates and US bond yields in 2.5-3.5% range
2. Bond investors will lose money, but bond bubble will still be slow to deflate
3. US equities are expensive; many non-US equities more reasonably valued
4. Rotation from speculative sectors to energy and pricing power
5. Growth sectors: divergence between profitable and loss-making stocks
6. China and commodity-producing EMs should outperform US and Europe
7. Dollar will decline in long run, but mainly against Asian currencies (including RMB)

New trading range for US 10-year : 2% to 3%? Or 3% to 5%?

Bond yields have broken out: Post-GFC trading range or higher?



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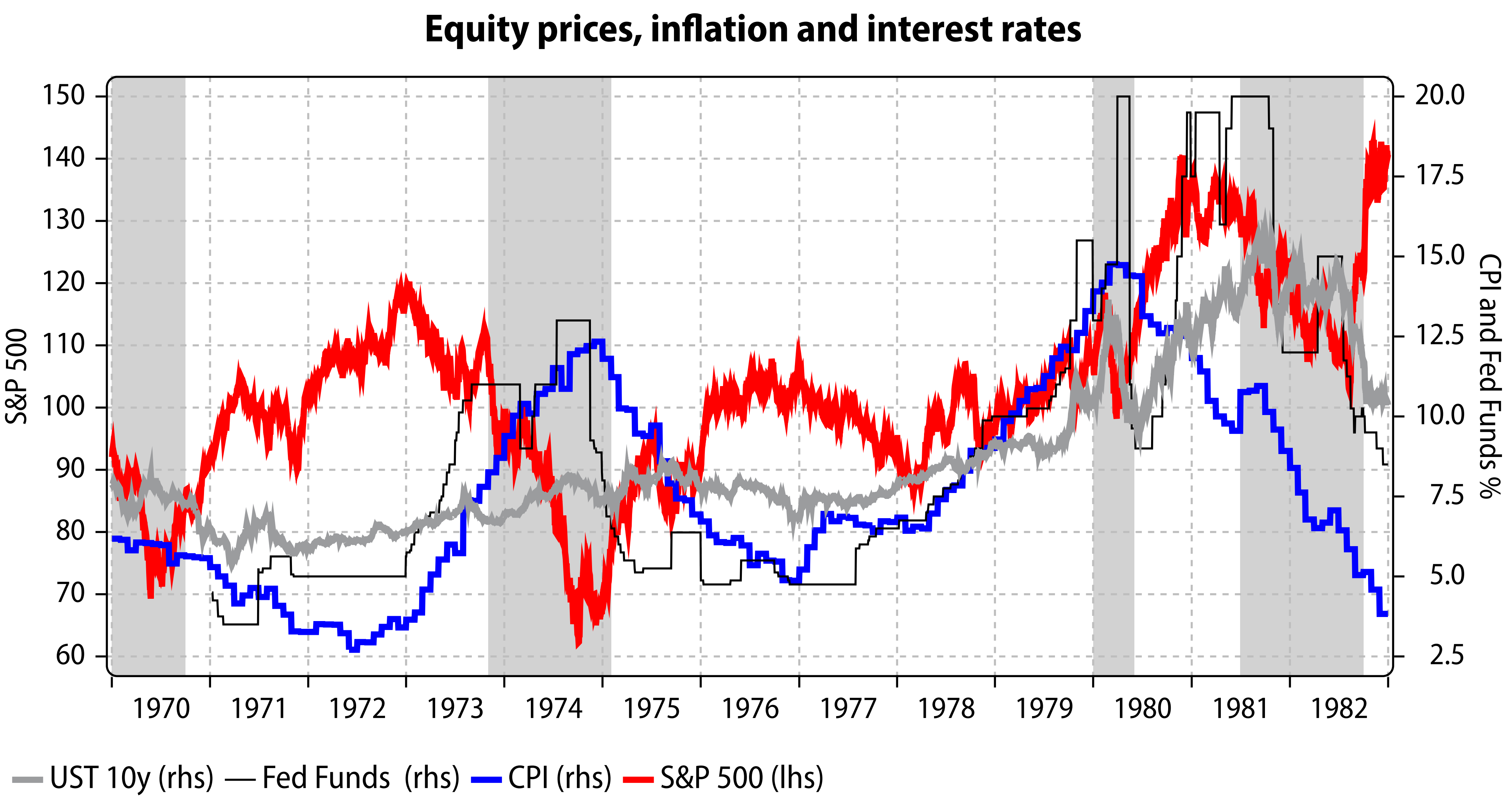
Are equities an effective inflation hedge?



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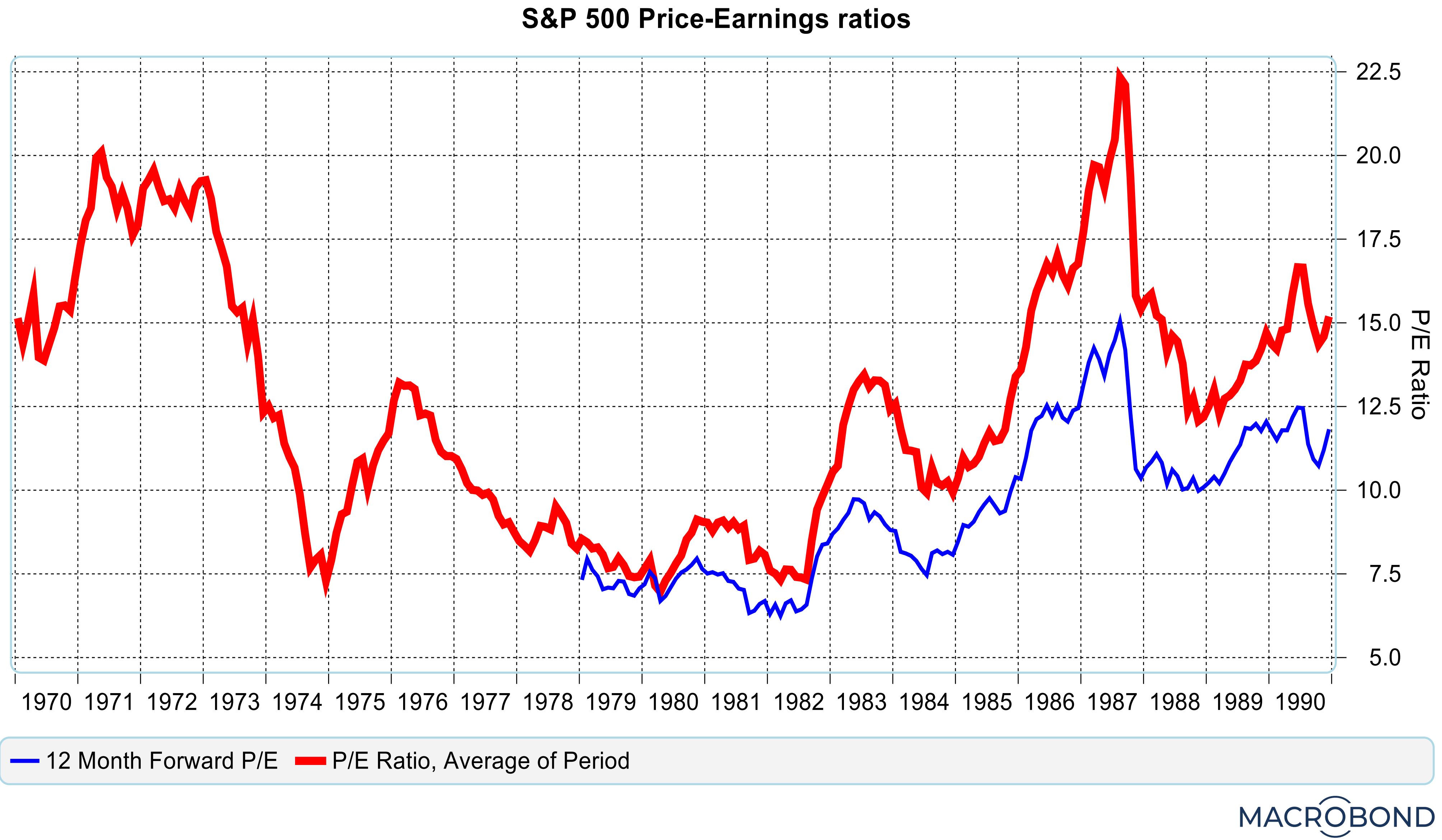
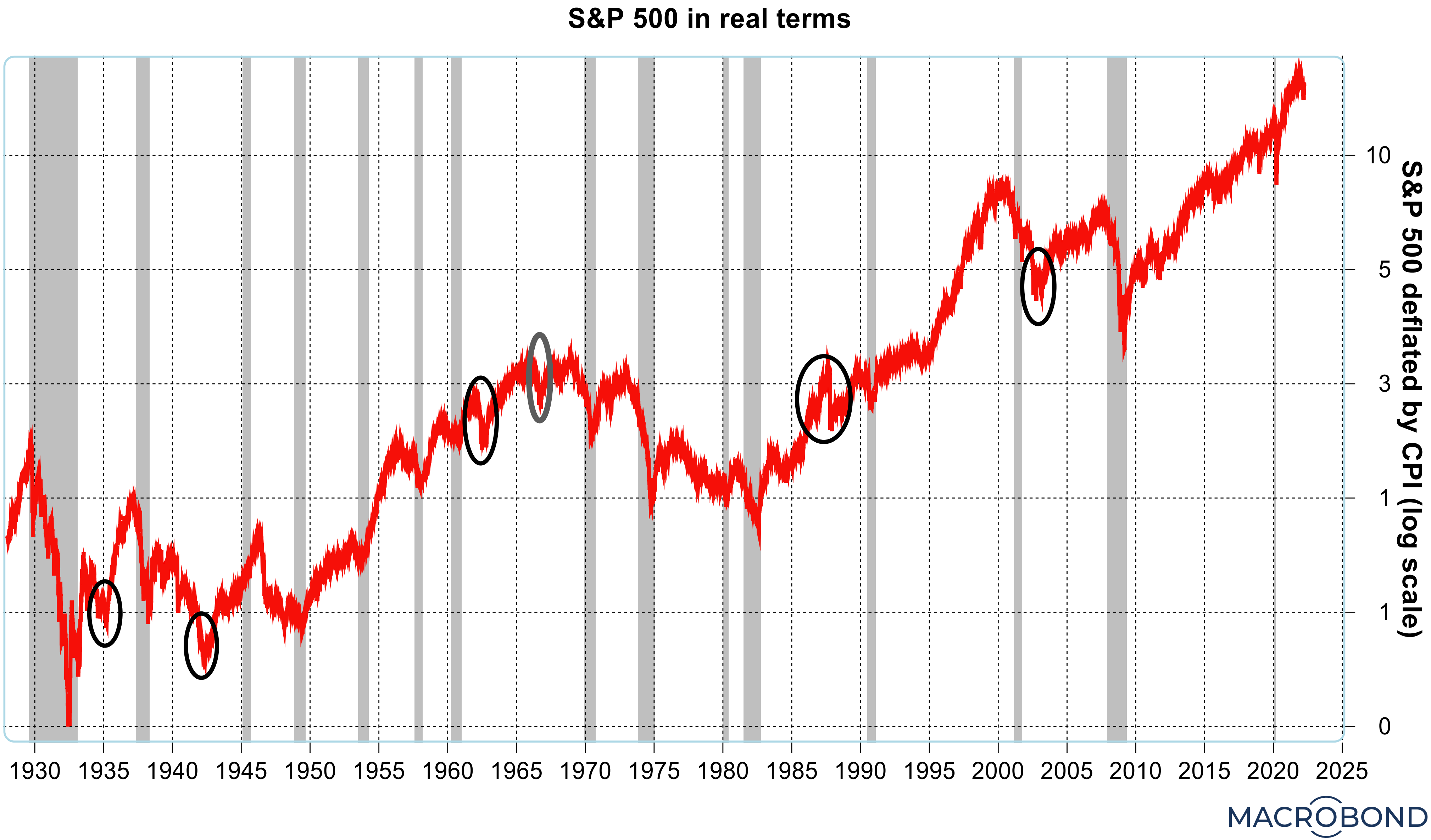
Not if valuations fall faster than inflation boosts revenues and profits



Equity bear markets can occur without recessions



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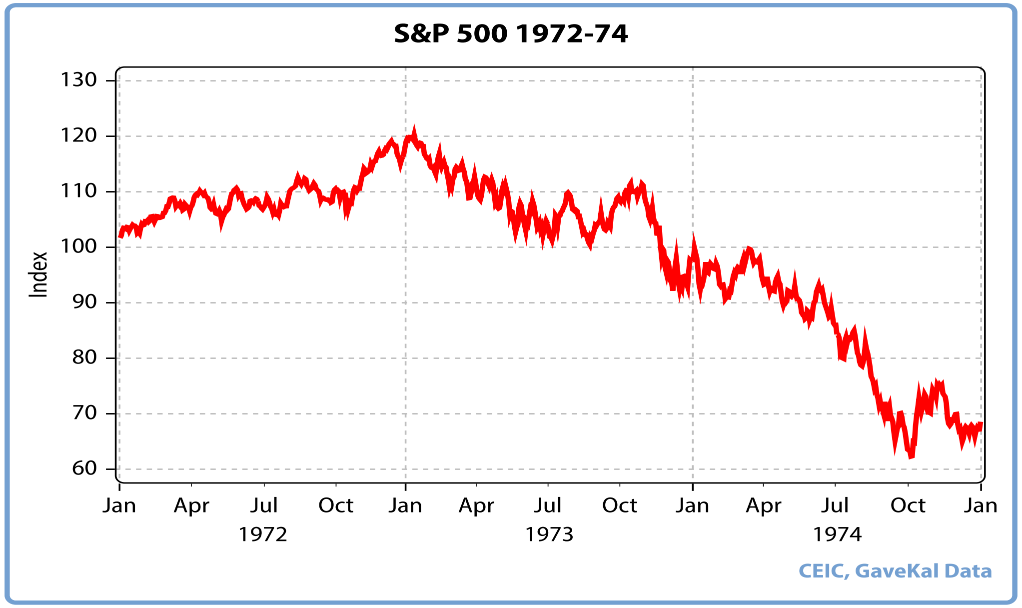
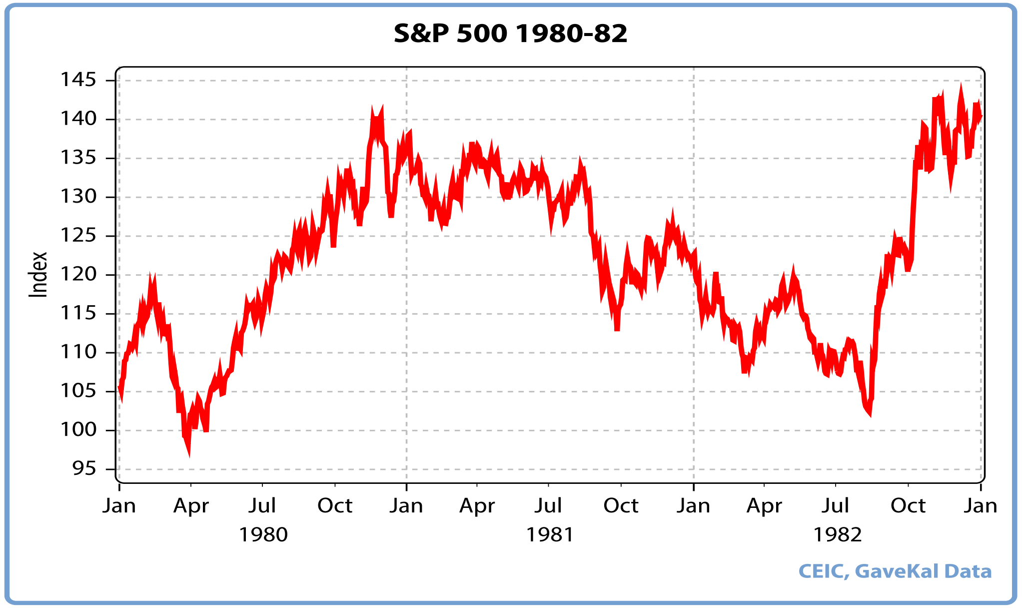
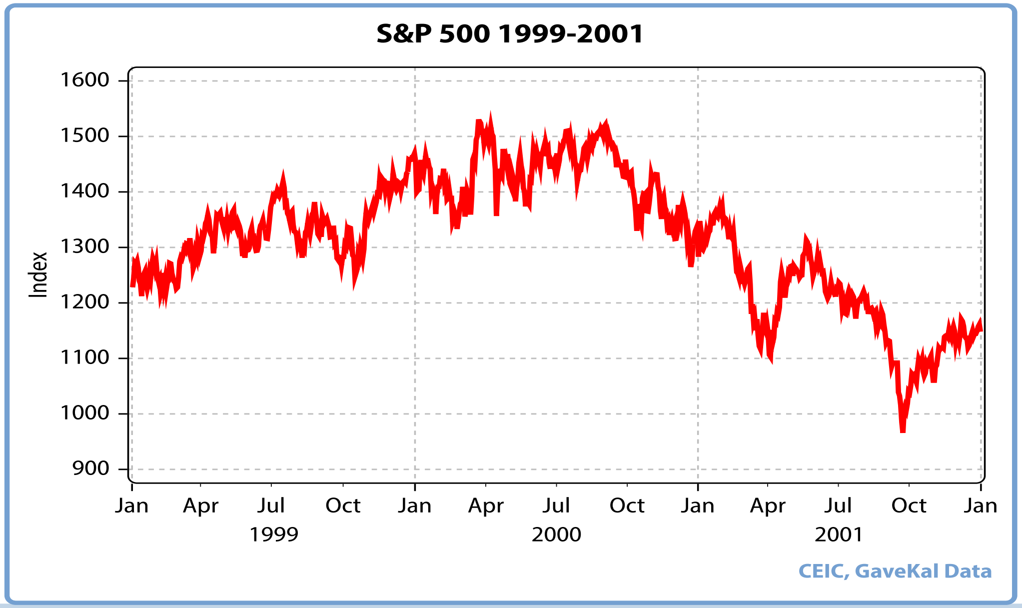
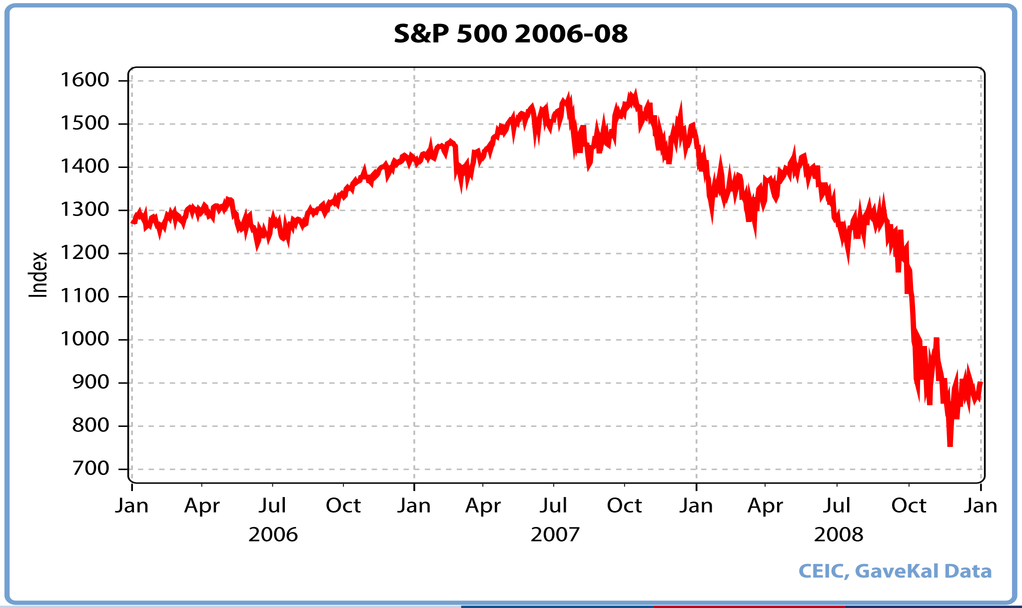
Highs are usually retested before a bear market sets in









Conclusions: reducing risk does not mean “risk-off”

1. **High inflation means rising interest rates and US bond yields in 2.5-3.5% range**

2. **Bond investors will lose money, but bond bubble will still be slow to deflate**

3. **US equities are expensive; many non-US equities still reasonably valued**

4. **Rotation from speculative sectors to energy, non-cyclicality and pricing power**

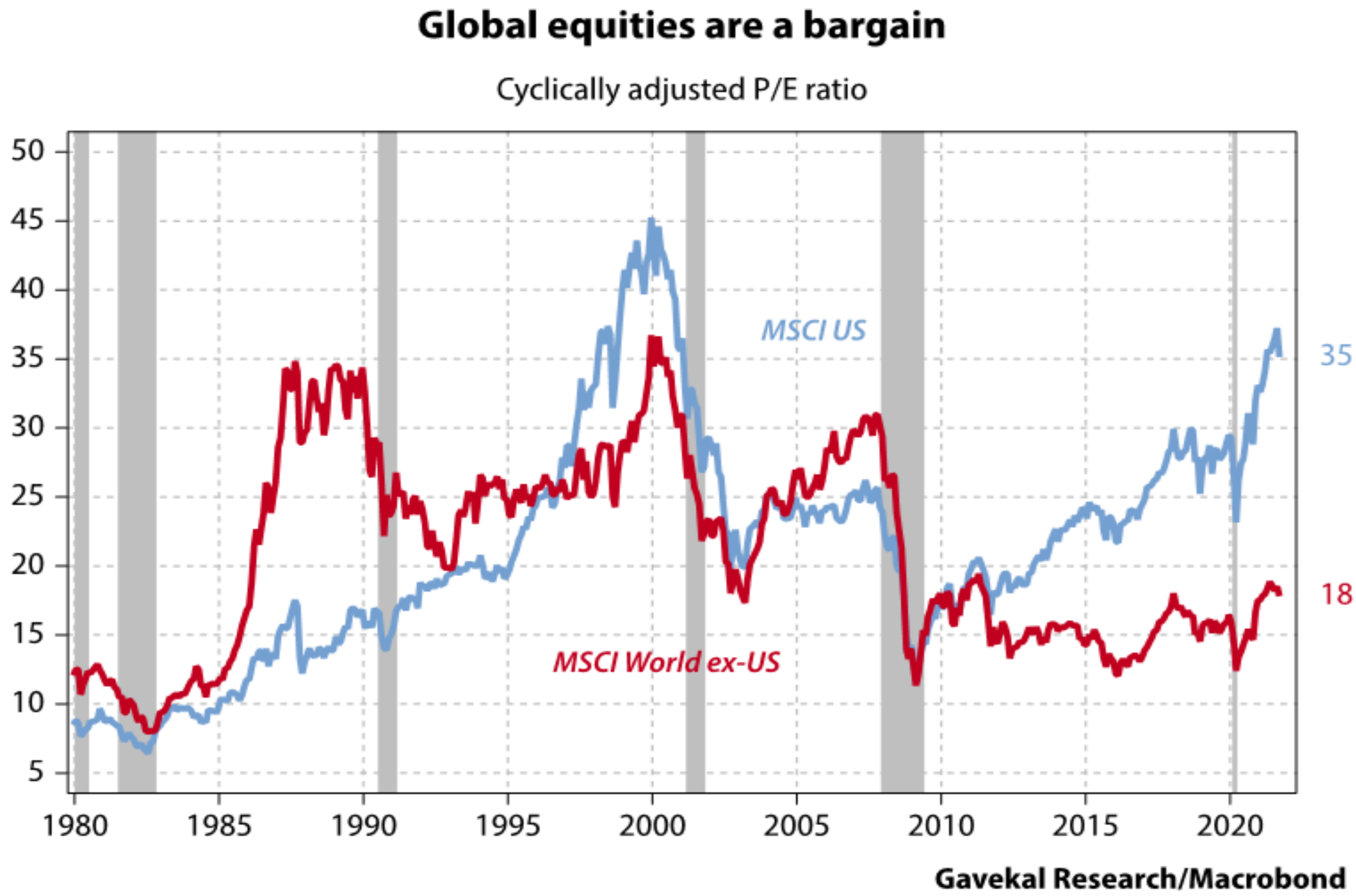
5. **Growth sectors: divergence between profitable and negative cash-flow stocks**

6. **China and commodity-producing EMs should outperform US and Europe**

7. **UK faces most serious inflation threat: inflation hedges and property will do best**

8. **Dollar will decline in long run, but mainly against Asian currencies (especially RMB)**

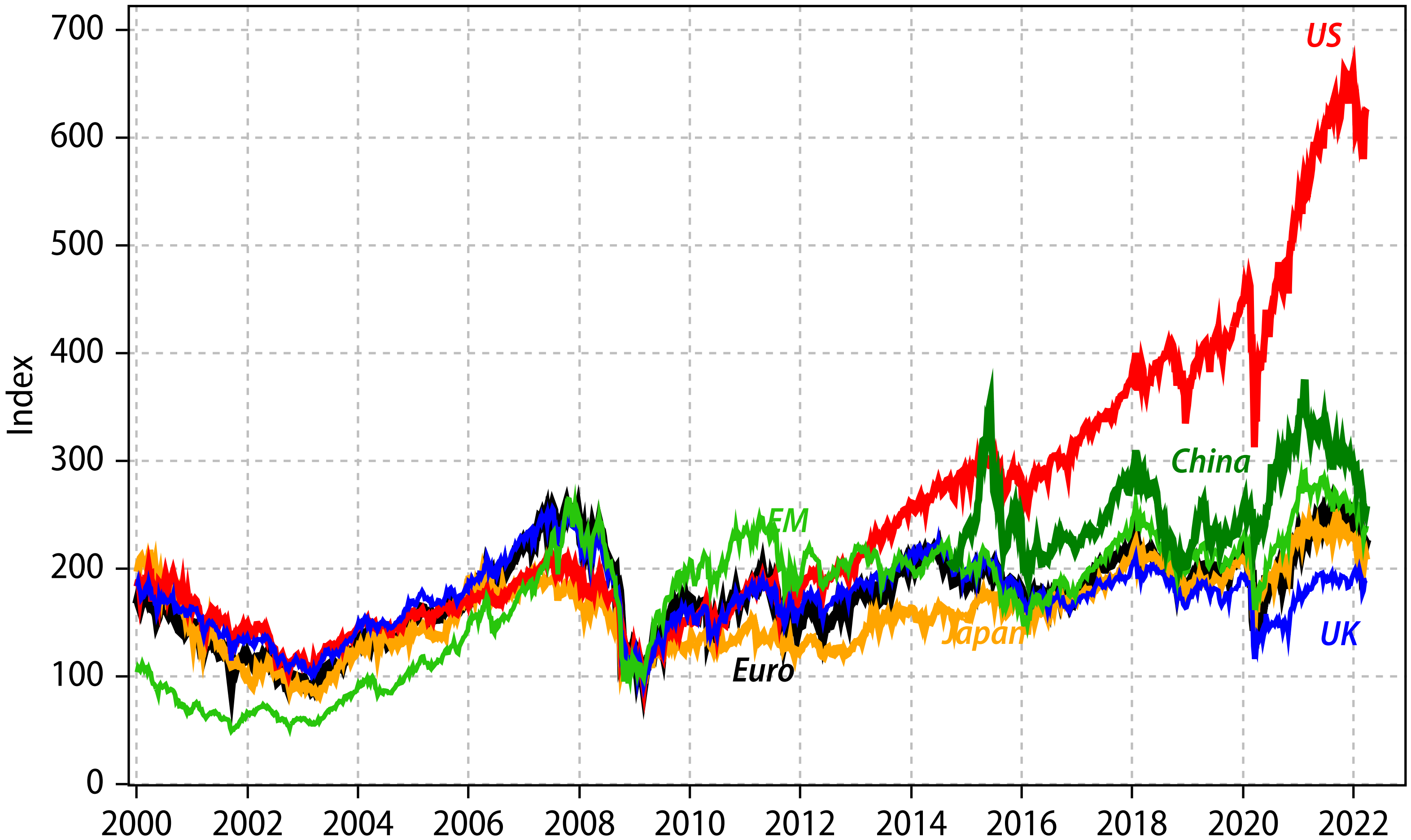
Equities outside US are not expensive by historic standards



Huge scope for relative rerating outside the US…

Outside US stockmarket gains have been very moderate since 2009

MSCI IMI all-cap country equity indices (US$), rebased to March 2009



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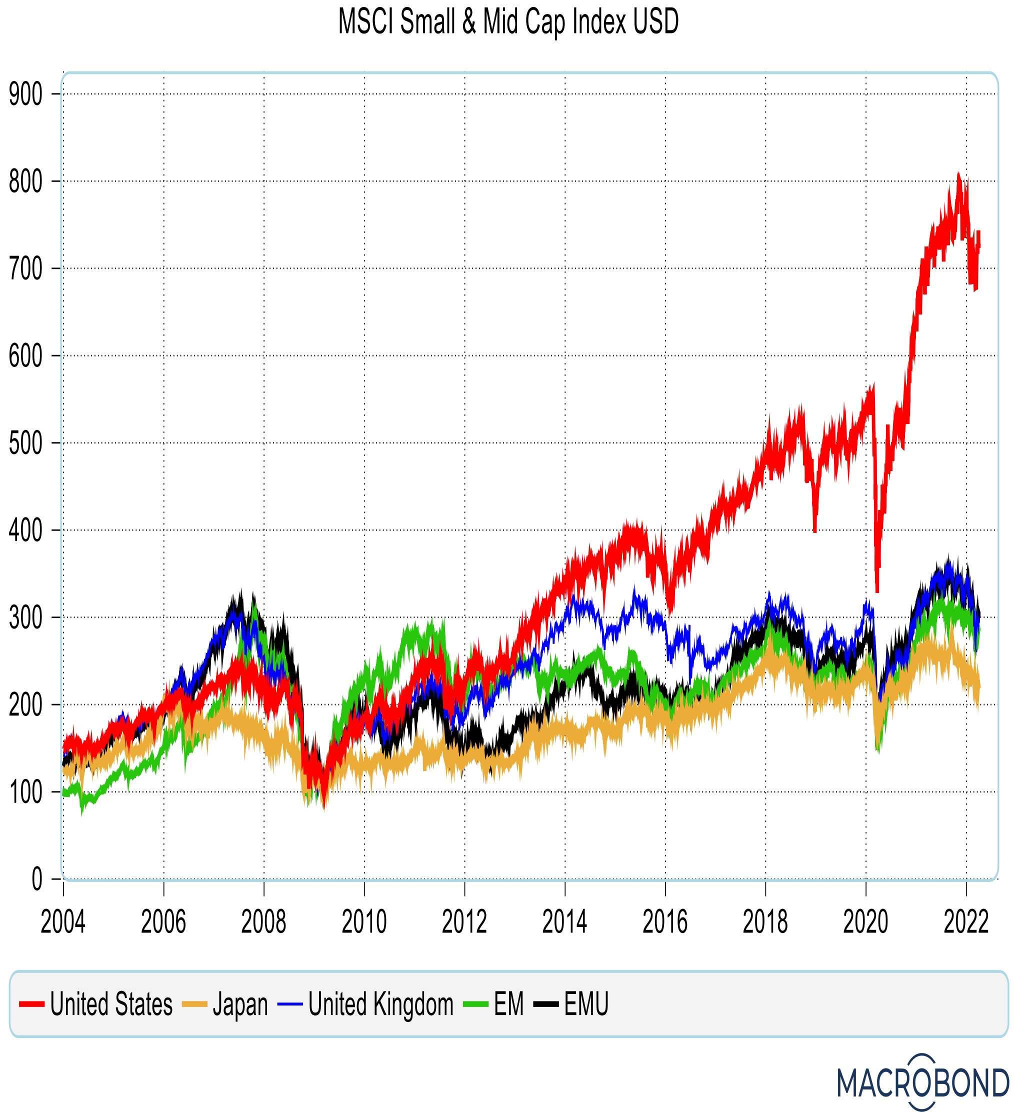
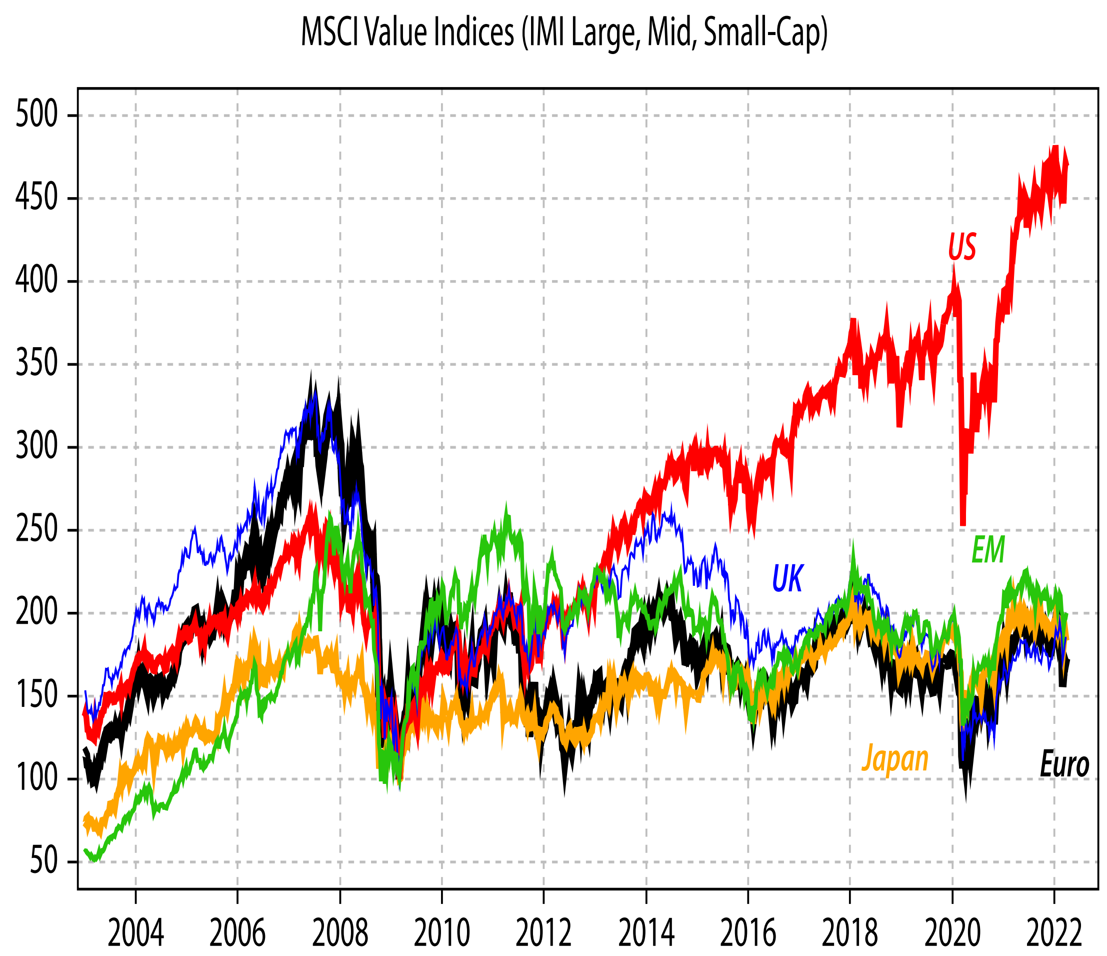
... and it's not just Big Tech that explains the difference

Small and Mid-Caps since 2009: US outperformance even greater



Value stocks since 2009: US, Europe, Japan and EM (in US$)



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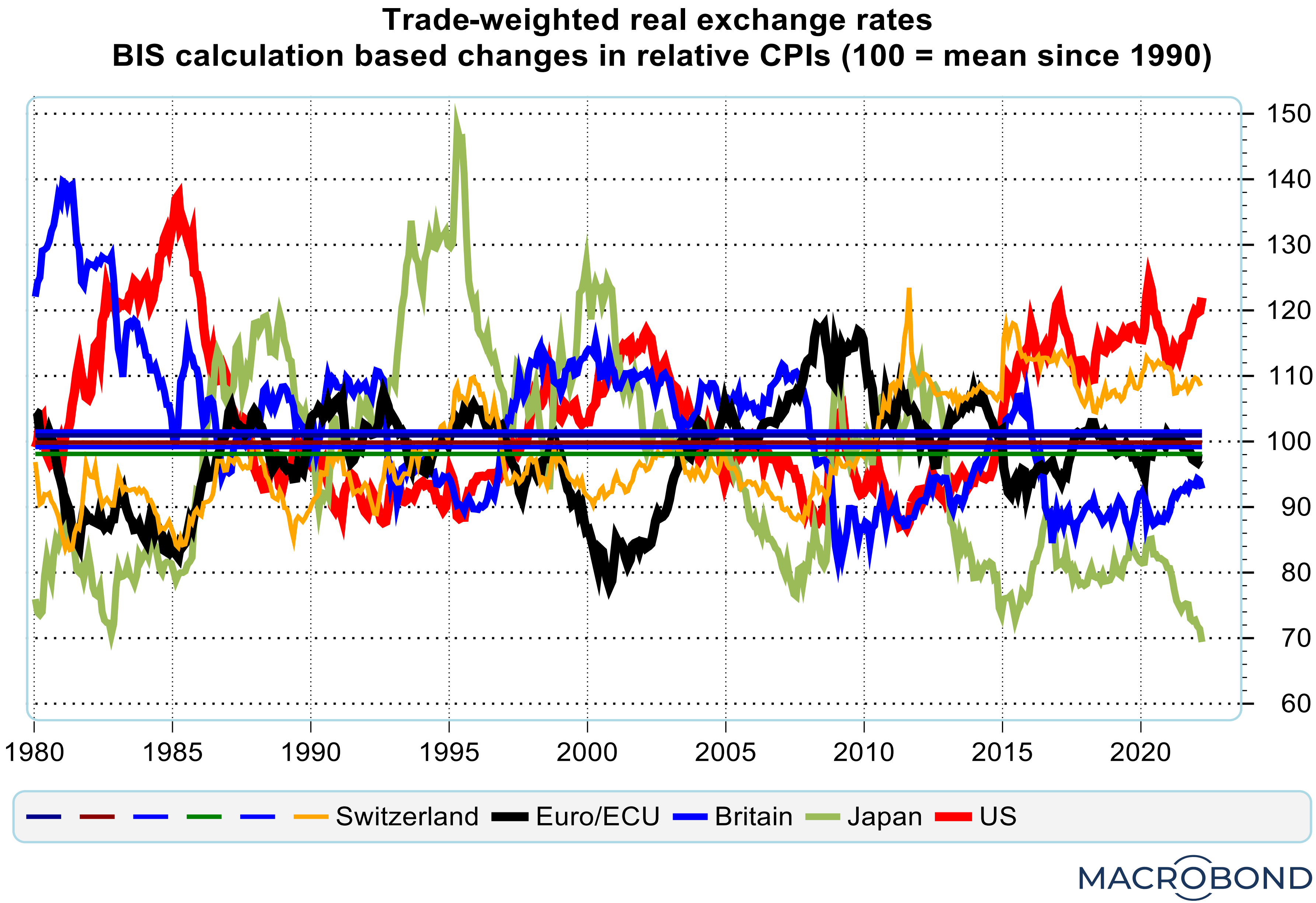
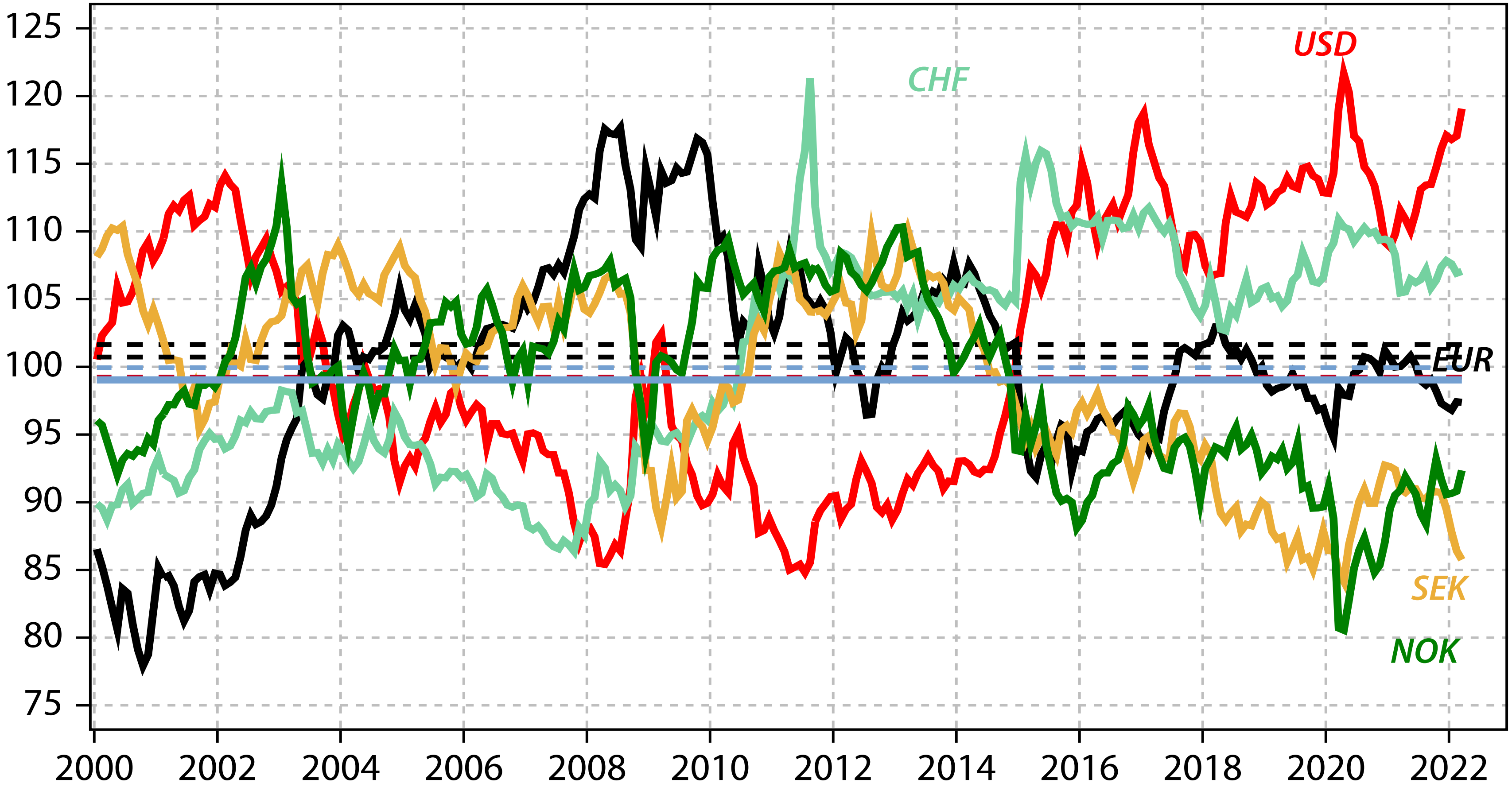
Dollar is now very expensive



Scandinavian currencies are undervalued

Real Exchange Rates (BIS based on relative consumer prices)
100 = mean since 2000



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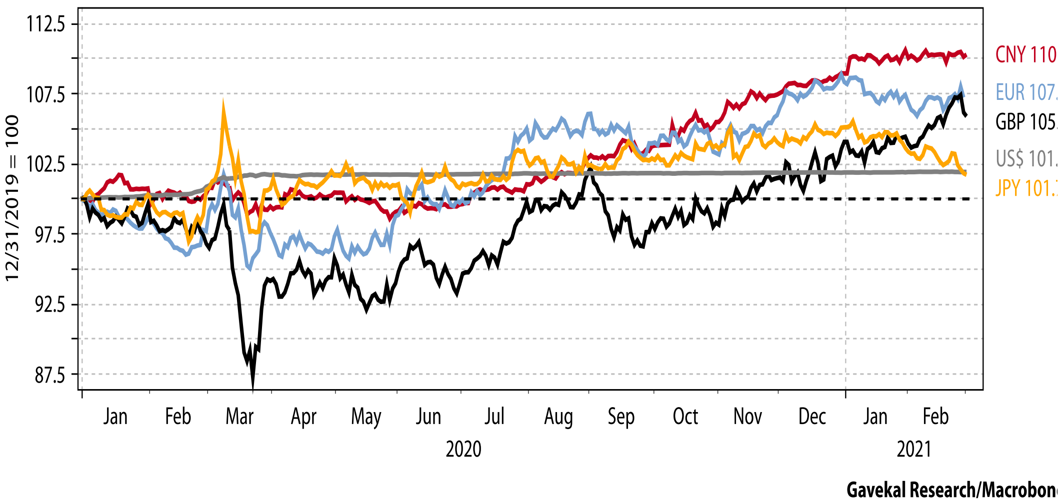
RMB has been best performing currency on any meaningful timeframe

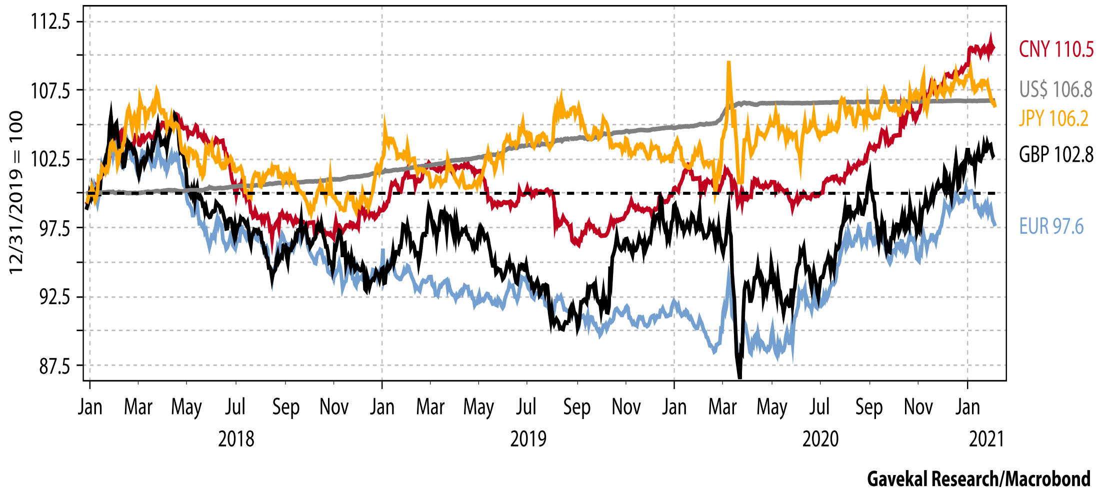
The renminbi is the best performing major currency since the start of the pandemic

Total return on 1y T-bills or equivalent, in US$ terms



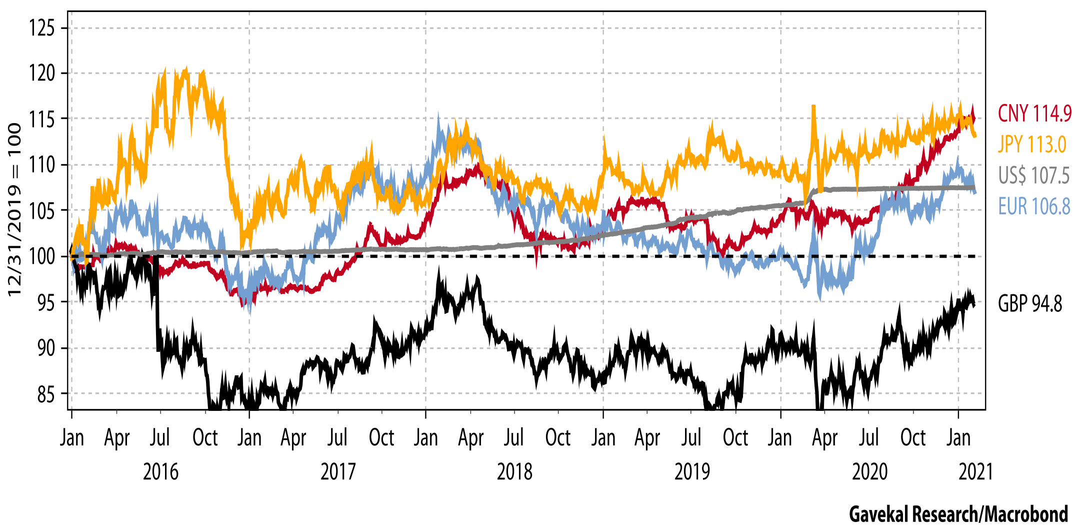
RMB is best performer over past three years

Total return on 1y T-bills or equivalent, in US$ terms



RMB is best performer over past five years

Total return on 1y T-bills or equivalent, in US$ terms



RMB is best performer over past ten years

Total return on 1y T-bills or equivalent, in US$ terms

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