Monetary Politics and Interest Rates - 2022

Prepare for rough financial markets

Dr. Michael Heise on Global Economics
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With the long underestimated and virtually global rise in inflation in recent months, central banks have come under pressure to exit their expansionary monetary policy soon. For investors, the question arises as to how consistently the central banks will take action, what this means for the economy and whether significant setbacks on the capital markets are to be expected?

In view of high inflation and a busy labor market, Federal Reserve Chairman Jerome Powell has signaled that the loose monetary policy could soon be outdated and that the central bank could be ready for several interest rate hikes as early as 2022. The Fed has already begun to reduce its bond purchases on the capital market, and a reduction in the central bank's bloated balance sheet is being discussed. The ECB has also announced corrections, but is sticking to a much more expansionary line than its American sister. According to the ECB's statements, there is no talk of interest rate hikes for the time being, and the ECB's bond purchases will continue, albeit at a somewhat reduced level.

The bond markets have so far reacted very calmly to the signs of a monetary policy turnaround. Yields on the capital markets have risen in recent months, but as can be deduced from the yield curve, which shows bond yields by maturity, no sharp increases in yields are expected in the next few years. The stock markets have also continued their upward trend with some setbacks. This is obviously based on expectation, that no very sharp correction of monetary policy will be required, which could result in a stabilization recession as experienced in the USA some 40 years ago under Federal Reserve Chairman Paul Volcker.

Today's Federal Reserve Chairman Powell rightly points out that the currently very high inflation is also attributable to various special effects of the pandemic. For example, widespread supply bottlenecks coupled with slower growth in demand for goods have boosted inflation worldwide in recent months. Inflation is expected to fall again as energy prices come off their highs, global supply chains start to function better again and the surge in demand for goods as a result of "lockdowns" subsides. The latter will also help to ensure that the economy soon returns to a normal cyclical pace after a recovery phase with above-average growth, thereby reducing inflation. Economic burdens from the development of the pandemic could be added.

But what happens if inflation rates in the USA, the EMU and other countries remain unexpectedly high after all, for example because energy prices do not stop soaring in an environment of rising geopolitical tensions, because the in some cases quite drastic increases in producer prices that have already occurred are passed on to consumers on a larger scale, and because the collective bargaining partners take this as an opportunity to demand significantly higher wages in tight labor markets? Such a scenario may still be seen as a risk scenario, but it has become much more likely as a result of the inflation dynamics of recent months. In this scenario, the central banks would have to take tough steps to bring inflation under control. In the euro zone, too, the first interest rate hikes and a complete halt to bond purchases could then be on the cards in 2022. In this scenario, capital market yields would have to trend much more strongly upward.

However, rising yields on safe government bonds would have very undesirable side effects. Because of the further increase in government and private debt in recent years, which is now very high, price losses on the capital markets would not only pose risks to financial stability, but would also have a considerable impact on government financing and trigger consolidation constraints, especially in highly indebted EMU countries. Many observers therefore believe that central banks will do everything possible to keep yields low even in the event of stronger inflationary trends, thus allowing fiscal policy and financial market risks to dominate their decisions. Would that be a solution and is that a likely scenario? More likely, no. Central banks that want to keep capital market yields at a given low level must be willing to buy bonds in principle in unspecified quantities, thus further expanding the volume of central bank money. With such a central bank policy, the money supply becomes an endogenous variable which the central bank cannot control directly. Since the money supply is an important determinant of inflation in the long run, such a strategy would further fuel inflation and inflation expectations. Limiting capital market yields can be an effective means in deflationary situations, such as those experienced by Japan for many years, but as soon as inflation expectations need to be stabilized, such a policy would be counterproductive. The conclusion is therefore clear: If inflation does not rapidly decline in the course of 2022 as expected by the central banks, we can also expect significant increases in yields on the capital markets and corresponding price volatility.

Consequently, investors would do well to brace themselves for somewhat stronger adjustments on the markets. The current, rather confident view that the central banks will find a very cautious exit from loose monetary policy and that it will be sufficient to reduce the expansive impulses of policy without taking hard countermeasures in order to stabilize inflation could be subjected to a test. The positive scenario assumes that inflation rates of currently around 7% in the USA and 5% in the EMU will soon decline significantly as supply bottlenecks are gradually overcome and demand momentum in the economies slows. This remains the most likely scenario, and it justifies the cautious approach of the central banks, but it cannot be relied upon. Investors should therefore arm themselves not only against increased inflation rates, but also against the risk of significant increases in yields. Investments in tangible assets and securities that are as insensitive to interest rates as possible can serve this purpose.

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Rating system of the absolute valuation	
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