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Elston Insights

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# War or Peace? Politicians, and Bankers, should fight inflation

- Rate hikes can slow easy money, but can't stop price inflation
- Choking off growth would be a policy own-goal
- Inflation is a problem, as long as war is a problem

Markets entered panic mode this week on fears, that all three "macro" factors – Growth, Interest Rates and Inflation – are all heading the wrong direction.

1. Inflation risk: This has been rising since September 2020 – aided by years of easy money from near-zero Interest Rates Policy and "Quantitative Easing", abetted by supply-chain disruptions in the post-Covid restart, and finally ignited with the Russia/Ukraine war and sanctions blowback.
2. Interest Rates: Policy error at the Fed through 2021 resulted from believing their own rhetoric that inflation was "transitory". Whether "been behind the curve", or "asleep at the wheel", Central Banks are now having to show they are playing catch up with assertive rate hikes. Whilst tighter monetary policy will slow down lending and monetary inflation, it won't do anything to stop price inflation. That's for the politicians to solve.
3. Growth Risk: the combination of inflation (reduced spending power, lower disposable income), rising interest rates (higher mortgage costs is undermining consumer confidence and could trigger a recession. It is this latter risk that has rattled markets so much this week.

## Big spending to the rescue?

In our interview with Professor Patrick Minford, Margaret Thatcher's economic adviser in the 1970s, he advocated the best policy response to the inflation surge was a fiscal one: Governments should pre-emptively use the "free money" of low interest rates/negative real rates, to spend our way out of recession risk. We agreed. But it's unlikely that Treasury officials – who are focused on reducing debt levels from post Covid highs – would support such a move.

In summary, there's a risk that the monetary policy error of the Governor will be compounded by a fiscal policy error of the Chancellor. By the time the Government gets round to kicking off a spending plan to rescue the economy (unlikely any time soon – nobody's talking about one), it may be too late to swerve a recession.

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## Blame the Politicians, not the Bankers

So, you have to feel a little bit sorry for Andrew Bailey who was roasted by MPs on 16th May for stating the truth.

*"To forecast 10 per cent inflation and to say there isn't a lot we can do about it is an extremely difficult place to be*," explained Bailey[1] after identifying rising prices for energy, goods and food resulting from Russia's invasion of Ukraine and China's zero-Covid policy.

We now have the unusual spectacle of Central Bankers raising rates to look like they're in charge of something they can't control and to "do something", whilst knowing it will not solve the problem (inflation) and could cause a bigger one (recession).

We are <u>not</u> experiencing is textbook monetary inflation from an overheating economy, with interest rates raised incrementally to slow it down. What we <u>are</u> experiencing is price inflation resulting from supply chain disruptions, and exacerbated by war.

The West wants to exact a direct high price on Russia for its invasion of Ukraine using sanctions. Russia wants to exact an indirect high price on the West, for its support for Ukraine "using" inflation.

Applying Western sanctions on Russian companies and exports was a political imperative following the invasion of Ukraine. But Western politicians (and generals) also need to understand the resulting blowback on trade and raw material costs. Trying to cut off exports from a leading exporter (by volume) of oil, gas, fertilizer and wheat may be the right thing to do morally. But it comes at a cost. And it's a cost that Western consumers, electorates and economies will be paying. And that will impact elections, which after all are about "the economy, stupid"[2].

## Politicians' nerve

As Western political leaders fear that resulting economic damage and inflation risk from the cost of living crisis could jeopardise their re-election, their resolve in supporting Ukraine against Russia shows signs of weakening.

Over the last two weeks, as Russian military has relentlessly ground away with advances through the Donbass, the human cost of the war, the economic cost to the West, and the tacit acknowledgement by Western observers that Russia could indeed achieve its objectives militarily (securing a landbridge to Crimea, and possibly Transnistria, leaving Ukraine with no access to the Black Sea)

In short, having supported Ukraine's struggle against the invasion to a level not seen at any other time following the end of the Cold War, Western governments are beginning to acknowledge that diplomacy may have to restart. And those negotiations won't be easy.

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[1] https://www.ft.com/content/0a8f0465-12ed-412b-94cb-571f9fb6f0d4
[2] https://en.wikipedia.org/wiki/It%27s_the_economy,_stupid

## A question of war or peace

So whilst this war continues, the energy crisis will continue, inflation will continue, rate tightening will be steeper and the risk of a hard landing is higher.

If there's a chance of peace, the energy crisis will subside, inflation will moderate, rate tightening will be shallower and the risk of a hard landing is lower.

Andrew Bailey is right to acknowledge his powerlessness. The decision of how to fight inflation is a political one: it is a question of war or peace.

## What about client portfolio

We are in a period of extreme volatility. Not just equity market volatility, but inflation volatility, interest rate volatility and currency volatility. Making big lurching moves that fundamentally alter the risk characteristics of a long-term plan could provide short-term comfort, but create long-term opportunity cost.

Investing in risk assets means taking risk, and sometimes that can feel unpleasant – like now. That doesn't mean doing nothing either. Building in inflation resilience into portfolios was prudent to limit exposure to longer-duration equities and nominal bonds.

As a recap, in February we suggested how advisers could adapt portfolios for inflation, by:

1. rotating equities towards shorter-duration equities with a Value/Income bias
2. reducing duration and overall exposure to Bonds;
3. incorporating Alternative Assets (such as liquid real assets) and Alternative Strategies (selecting good all weather strategies) as alternatives to Bonds.

Furthermore, in May, as it became clear how far the Bank of England was behind the curve, we also advocated removing any GBP-hedged exposure within bond portfolios (subject to guidelines), and proposed using USD-based floating rate notes and USD-based ultrashort bonds as a liquidity buffer, whilst sterling was structurally under pressure.

## Portfolio review

For advisers wanting a review of their model portfolios to test their inflation resilience, please get in touch.

## Further reading

All our inflation-related research is published on our Insights page under the Inflation tab.

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