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The New Era of Geopolitics and Inflation

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Summary: The New Era of Geopolitics and Inflation

Ukraine War and Covid transformed geopolitics and global economics

Geopolitics matters more to investment conditions than central bank policy

Inflation will *never* return to below 2%

Interest rates will *never* return to their 2010-20 trading ranges

Question now is whether New Normal is 2.5%, 3%, or 4%-plus inflation

1. Does Geopolitics really matter?

Sophisticated investors are conditioned to fade politics: "Buy on the sound of gunfire"

This is usually right, but not always: First and Second World Wars, Vietnam/1973 Oil Shock each transformed economic conditions for a generation

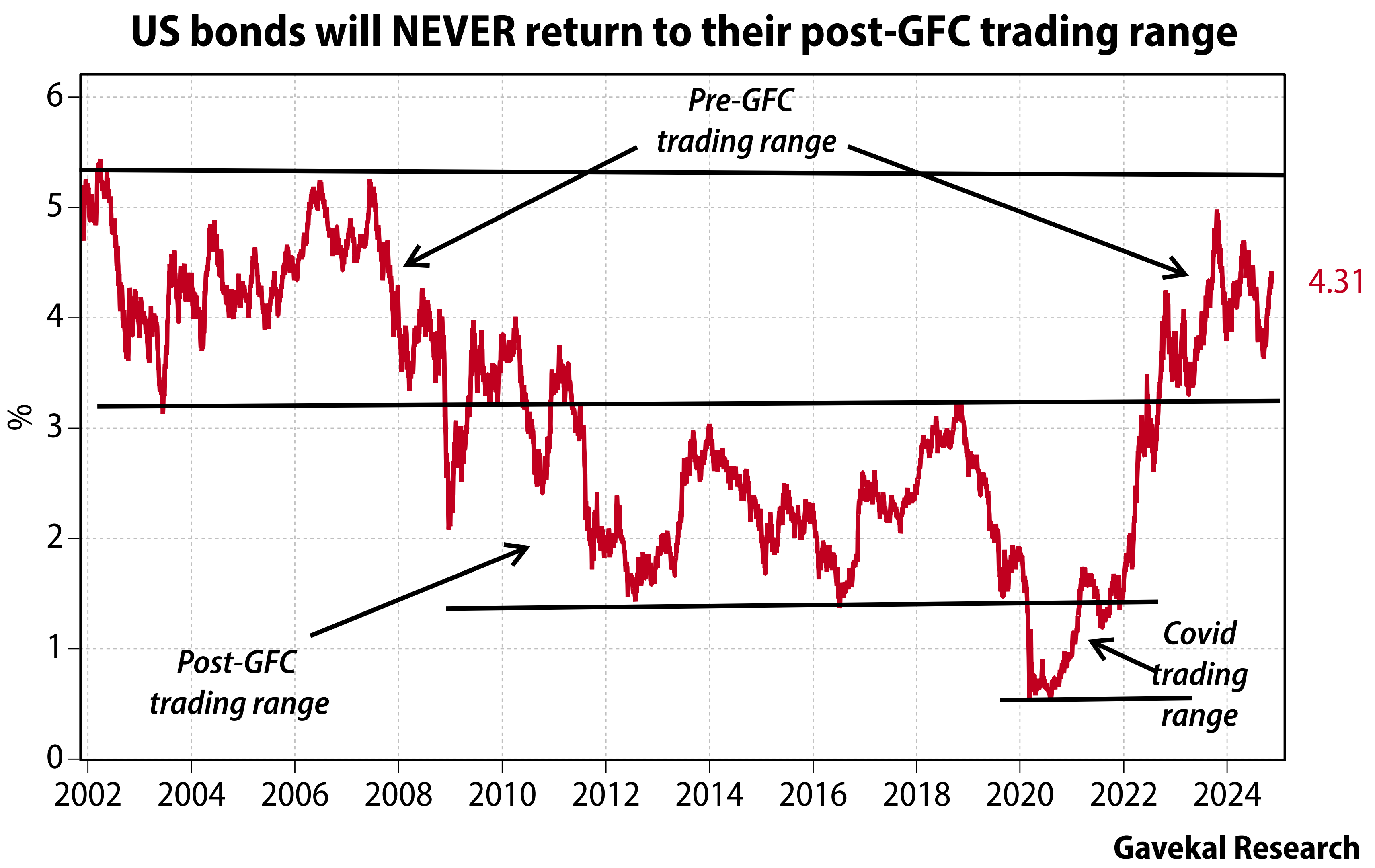
Stockmarkets hitting record highs may suggest that geopolitical risks do not matter, but three other changes are much more important:

1. US interest rates have *permanently* broken out of sub-3% post-GFC trading range

2. China-US decoupling has turned globalization into Orwell's Three Bloc World

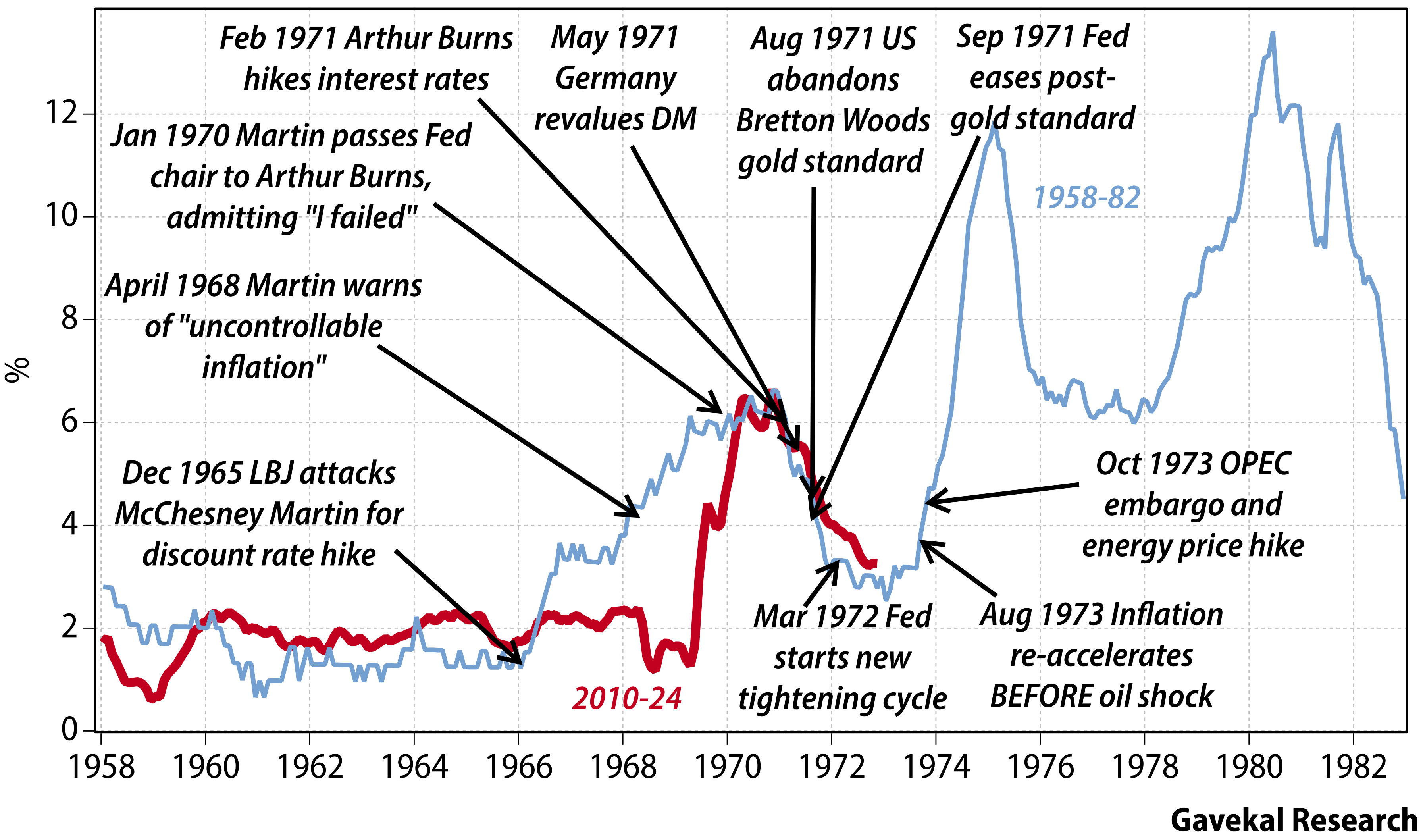
3. Europe is the biggest victim of Three Bloc World; Germany's economic model is broken

Bonds broke out of 2010-20 trading range in early 2022: post-GFC rates will *never* return



The 2021-23 inflation may turn out to be just the first wave

Three waves of inflation: US Core CPI 1958-82 and 2010-24



2. Why markets will be wrong (again) in 2025?

3%+ inflation and 5%+ bond yields are probable even with "immaculate disinflation"

Ukraine War was the detonator for an inflationary explosion; and explosions are irreversible

Explosive charge:

Long-term :

Changing global forces have weakened structural disinflation

Medium-term :

Monetary and fiscal policies provided fuel for inflation

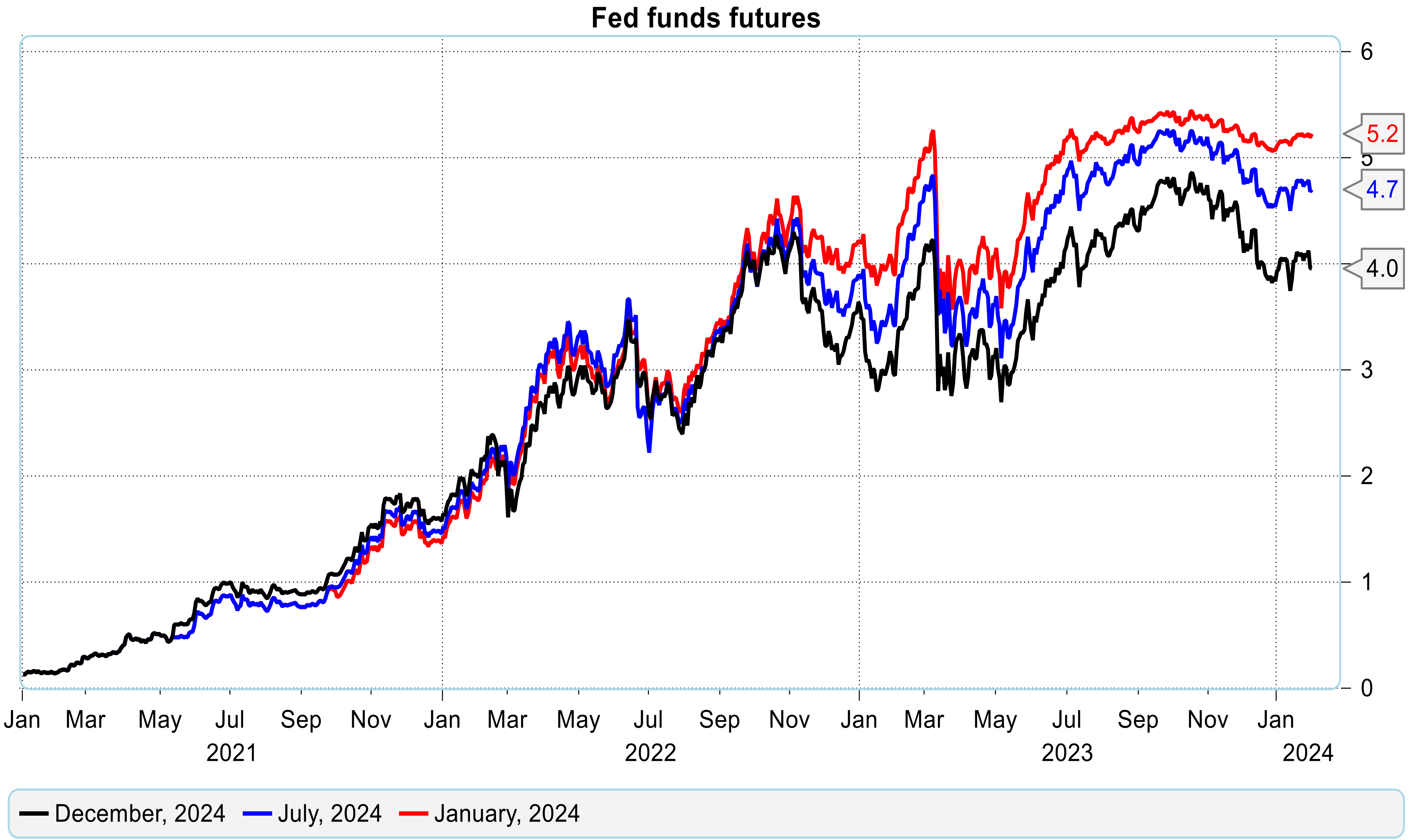
Short-term:

Covid bust-boom created *transitory* supply- demand imbalances

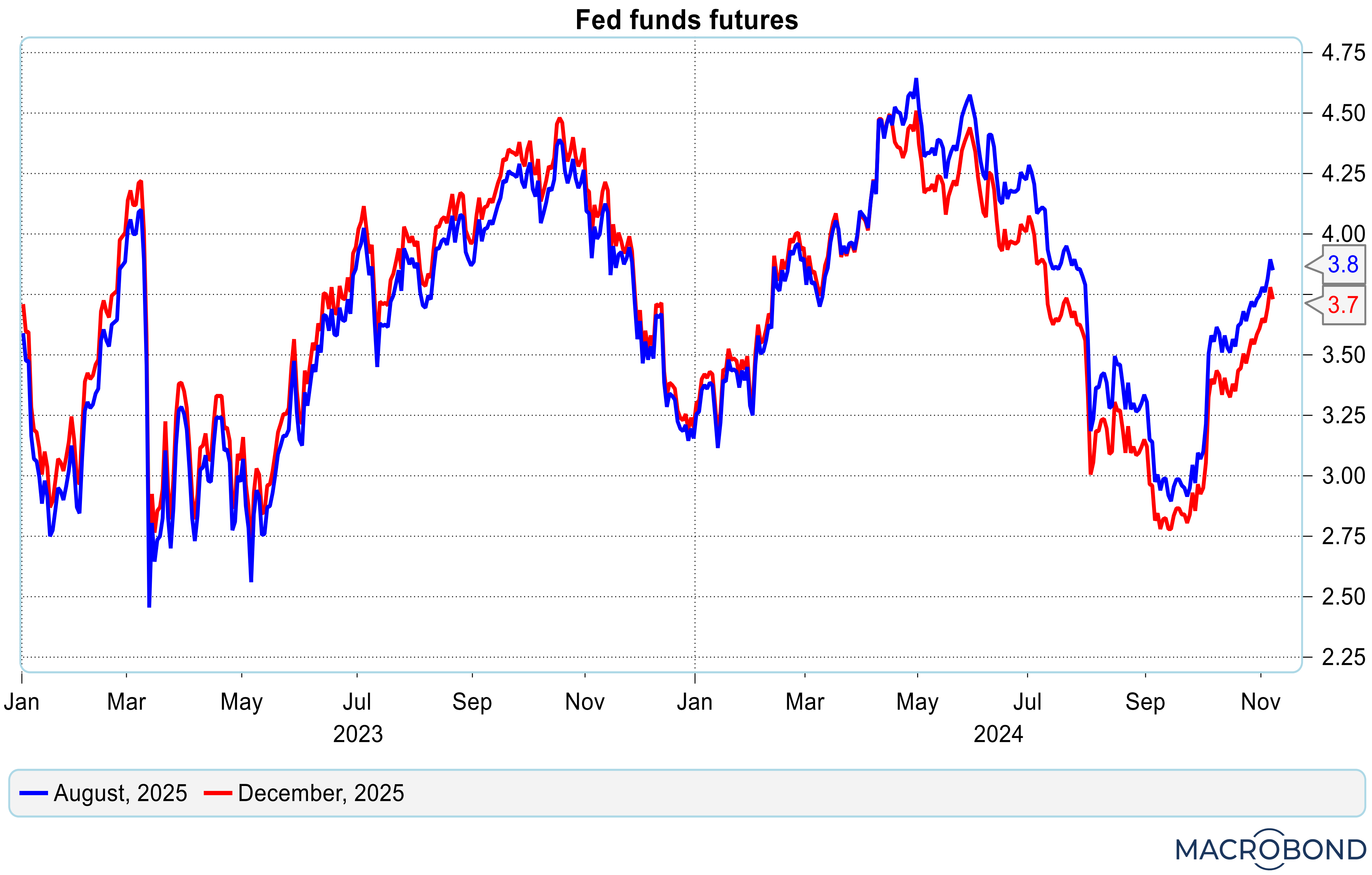
Detonator:

Russia-Ukraine sanctions > energy, food and commodity shocks

In late 2023 US markets were priced for 120bp of rate cuts in 12 months



Now investors are again expecting 120bp rate cuts in next 12 months



Long term: Structural shifts mean inflation instead of deflation

- **Deglobalization**: Global competition replaced by trade blocs
- **Protectionism:** End of "The China Price," at least for US and EU
- **Technology**: Disruptors become monopolists
- **Politics**: Power shifts from capital to labor
- **Demographics**: Fewer producers and expansionary fiscal policy

End of secular stagnation means return to higher *real* interest rates

1) Industrial structure

- Energy, transport and urban transformations are very capital-intensive
- Formerly capital-light sectors—software, social media, ICT—are now capital-intensive.

2) Geography and geopolitics

- Infrastructure and housing boom will spread from China to all EMs
- Deglobalization means supply-chain redundancy and over-investment
- New Cold War creates financial competition in non-aligned Third World countries
- Rearmament reverses post-1989 “peace dividend” military underinvestment

3) Demographics

- Baby Boomers retire in US and China, as well as Europe and Japan
- Health care & pensions mean fiscal deficits keep expanding with no chance of reversal

Medium Term: Post-Covid economic policies mean the end of 2% inflation

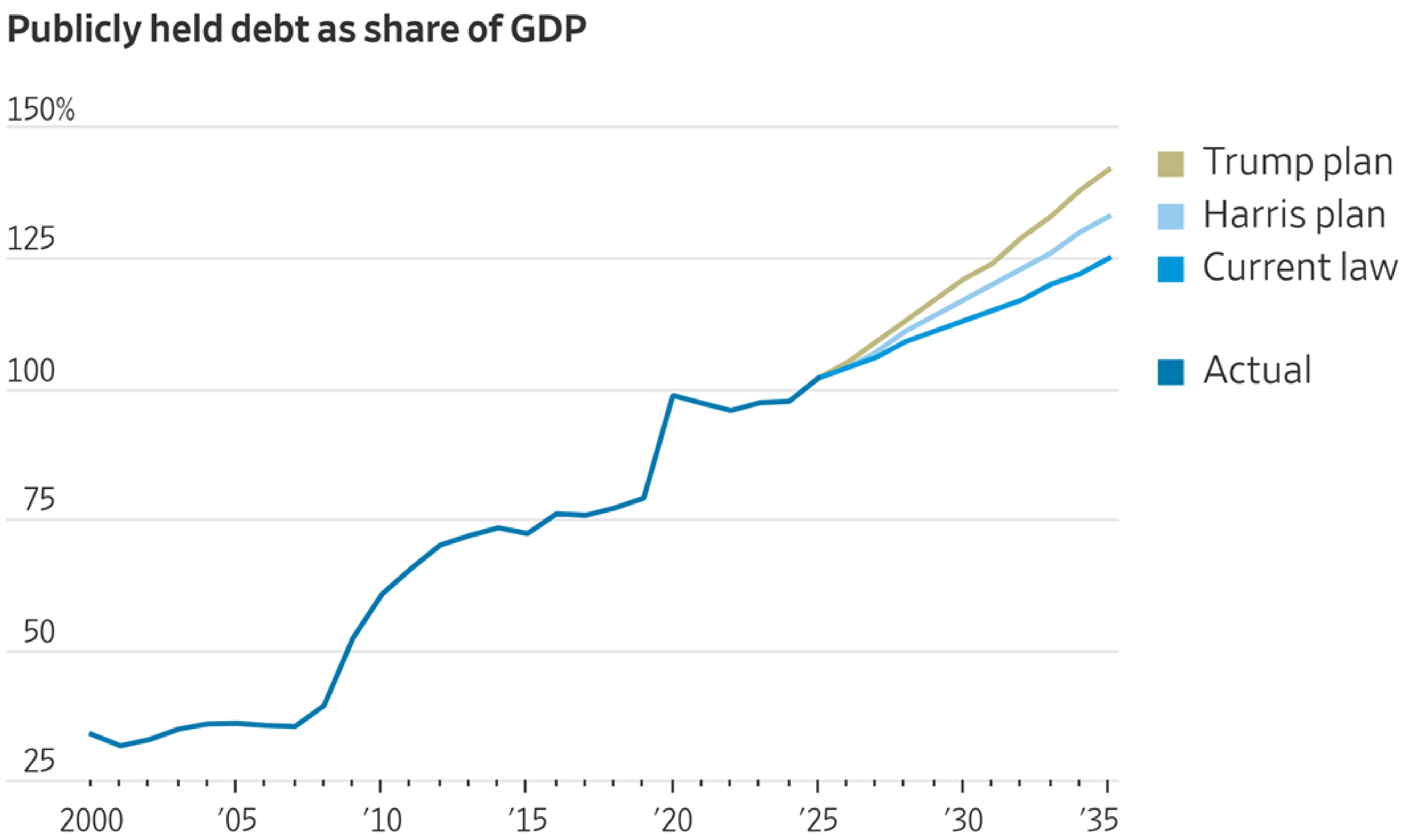
- **Monetary policy**:
  2% "target" is now a floor instead of ceiling or average

- **Fiscal profligacy:**
  Politics and demographics mean expansionary fiscal policies

- **Fiscal dominance:**
  Fed's Triple Mandate: "moderate long-term interest rates"

- **Policy errors**:
  Fed, ECB, BoE still assume "neutral" real interest rates near zero

Fiscal policy can only get looser



Source: Congressional Budget Office (actual), Committee for a Responsible Federal Budget (projections)

[Interest Rates Will Be Higher in the Future, Especially if Trump Is President - WSJ]

Short-term: Inflation will probably accelerate in 2025

- **Inflation is near cyclical lows:**
  Monetary easing will mean business cycle upswings from 2025 onwards

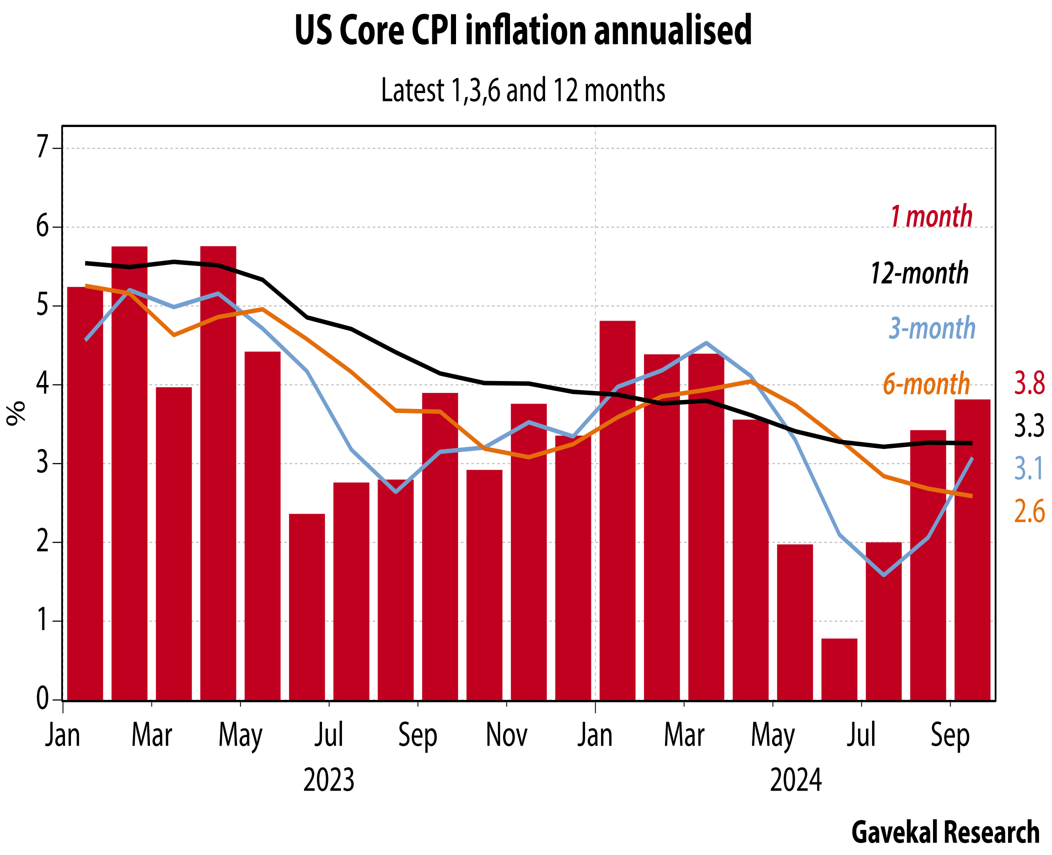
- **Core inflation is still above 2.5%**:
  Core is 2.7% US, 2.8% EU, 3.3% UK. Service inflation above 4% everywhere

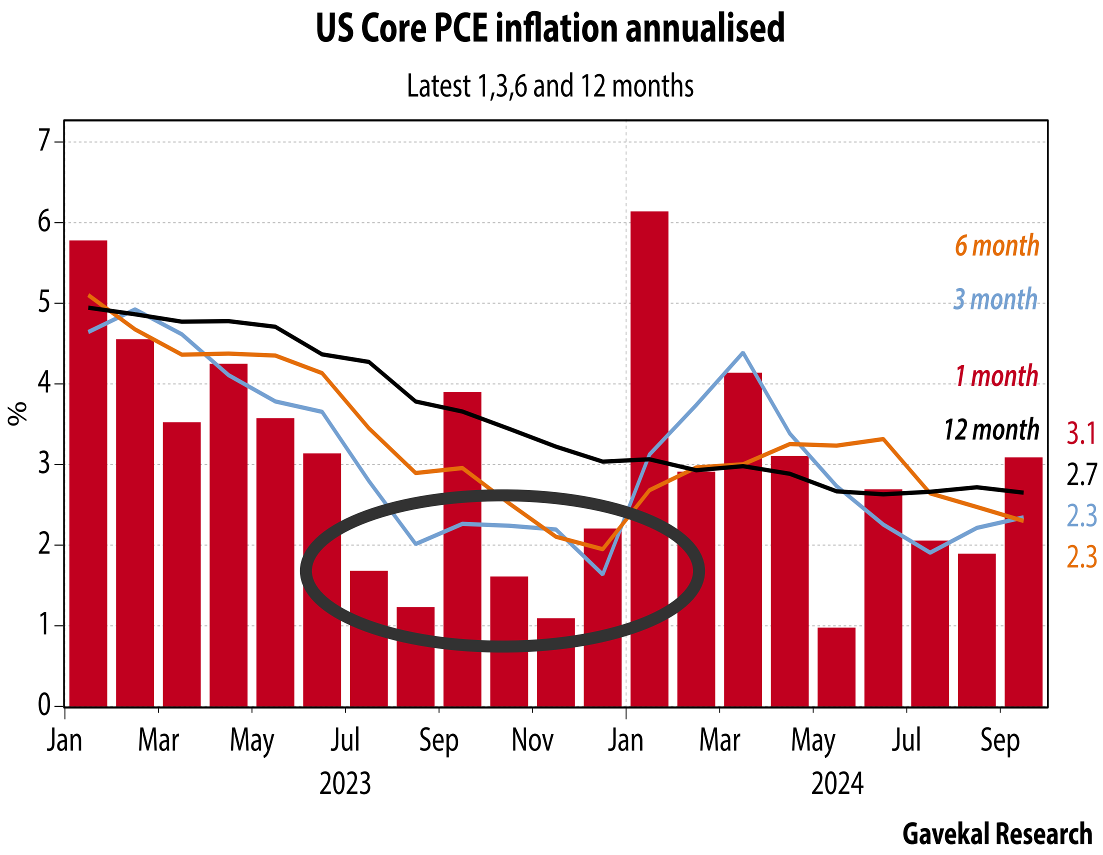
- **Wages and Services**:
  Wage inflation is still around 4% in US, UK and Europe

- **Housing costs**:
  Property markets are rebounding despite “very high” interest rates

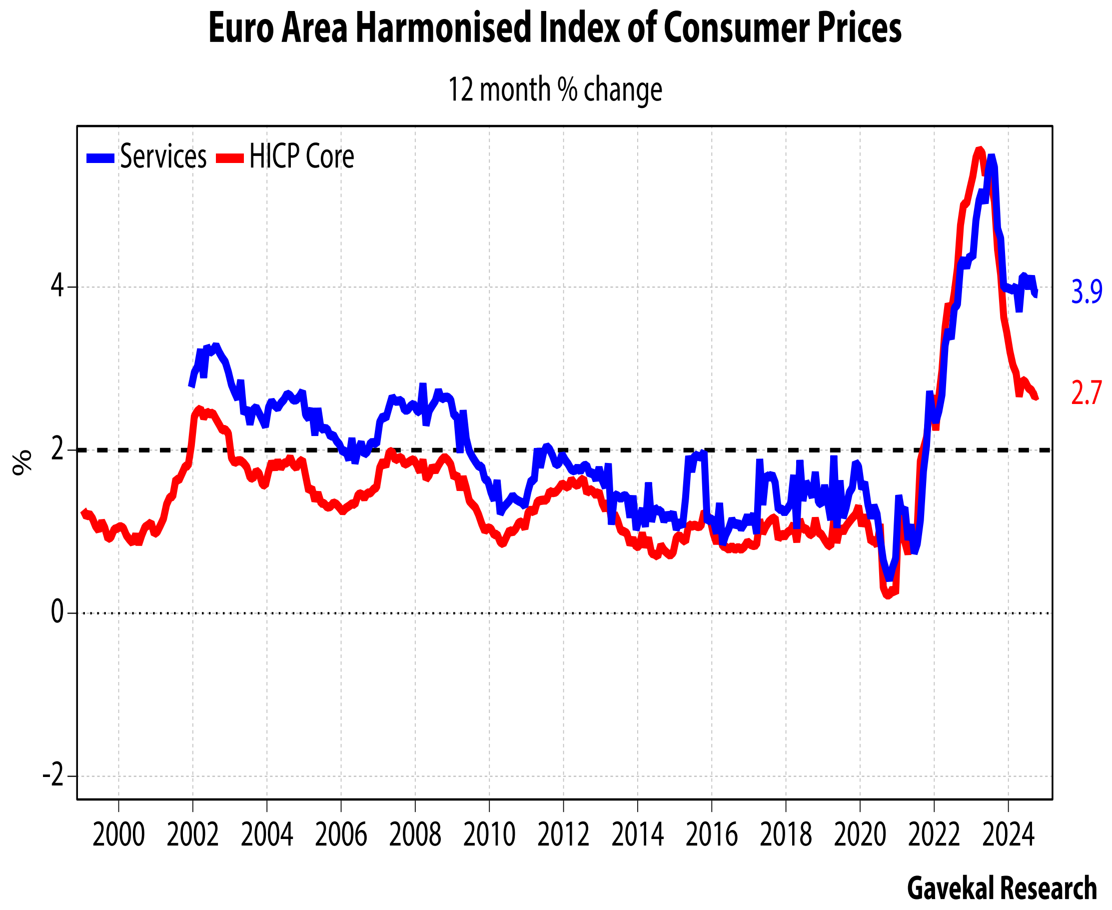
- **Energy prices**:
  Falling oil prices have reduced headline inflation, but will this continue?

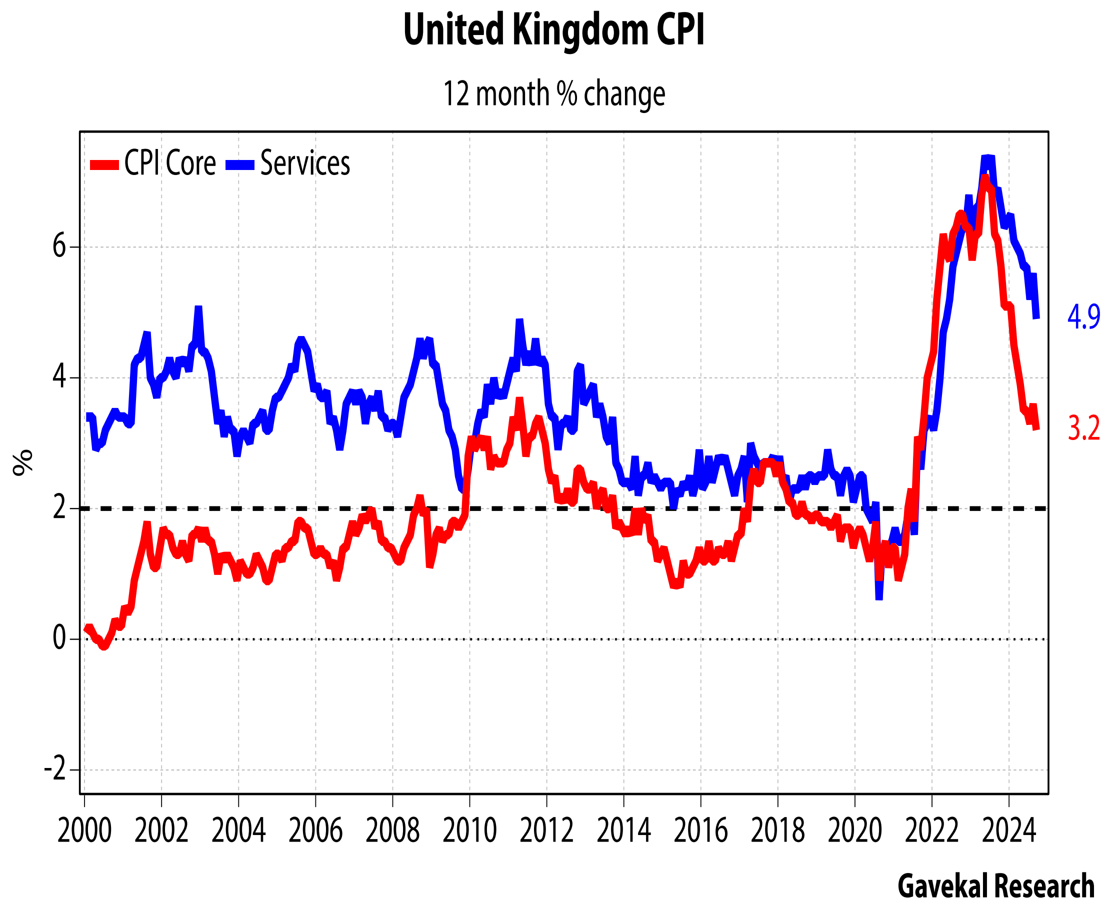
US core CPI inflation is still stuck at 3-4%. Is PCE in a reliable downtrend?





Service inflation is still very high in Europe - and even worse in Britain





Investment conclusions

1) Bonds investors will lose money, but bond bubbles will deflate slowly

2) Fixed income investors must avoid duration; favor credit and inflation protection.

3) Balanced portfolios should hedge mainly against inflation, not recession.

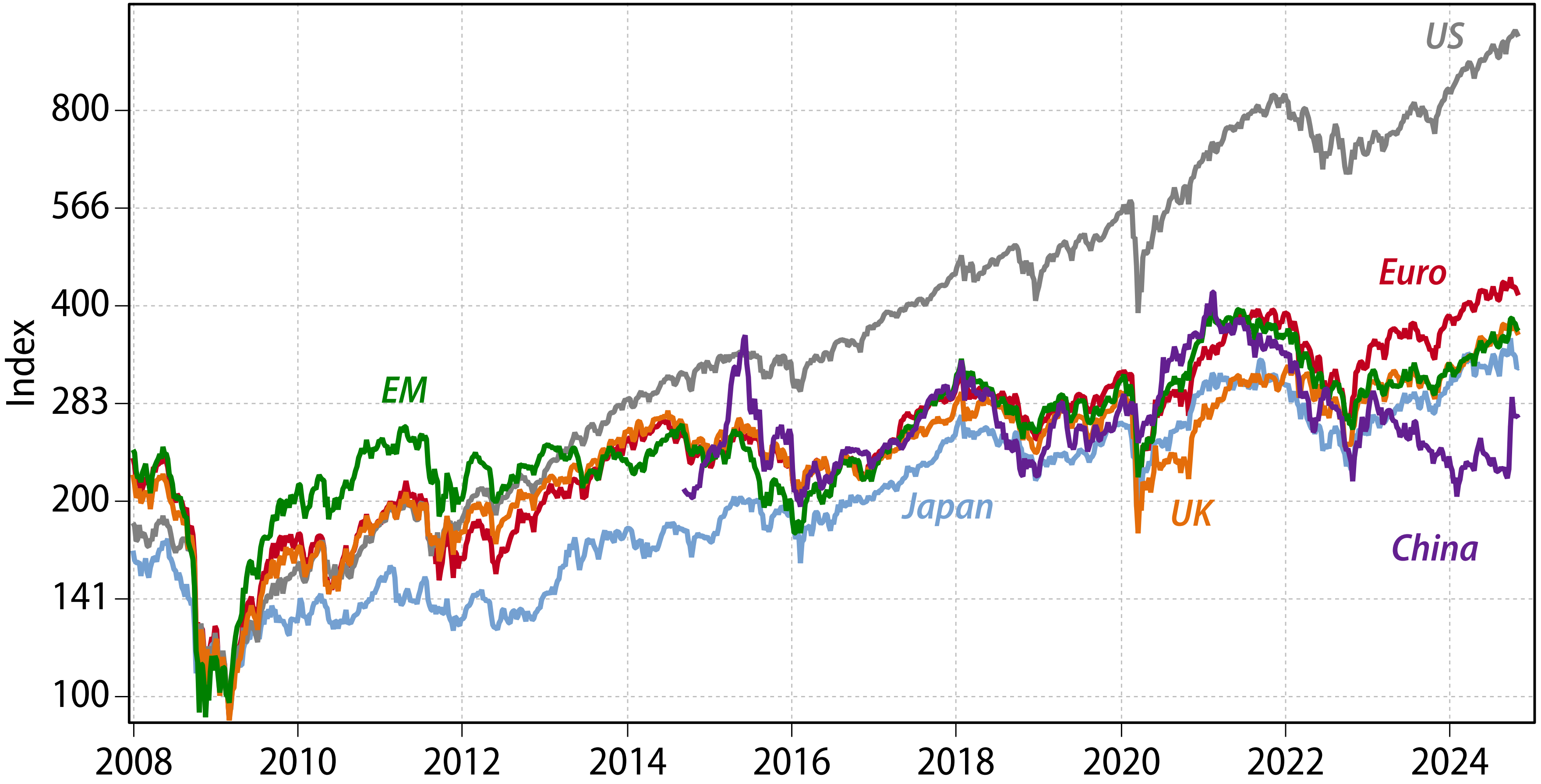
4) Equities leadership should rotate from growth to value as sectors reprice for permanently higher interest rates and inflation.

5) Global capital will flow from US to Asia and EMs, both equities and bonds.

6) Currencies: US dollar will eventually fall, but mainly against yen and RMB.

US equities were the only investment worth owning since 2009

MSCI equity indexes (US$ total returns), rebased to March 2009



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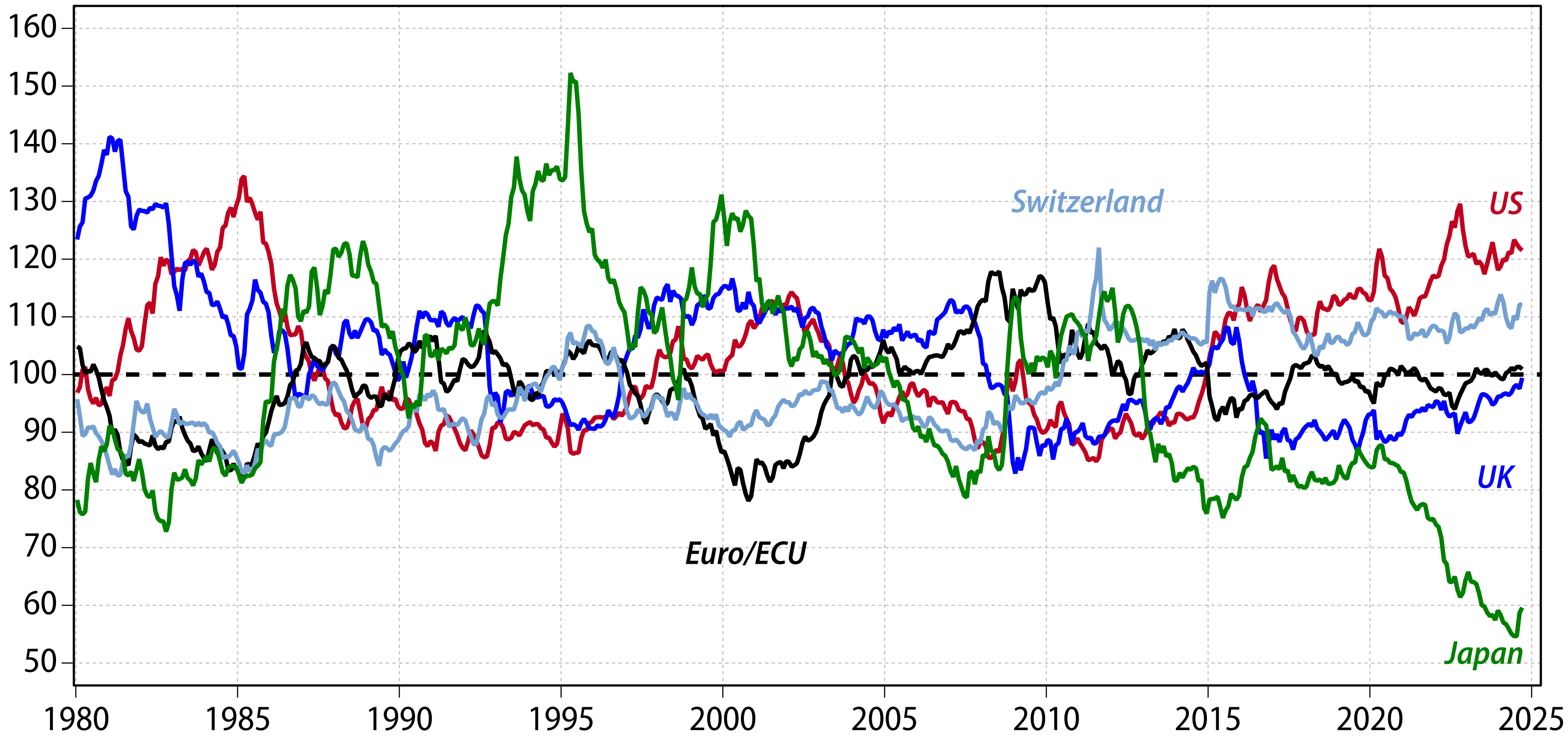
Dollar is very expensive, yen is absurdly cheap

Trade-weighted real exchange rates
BIS calculation based changes in relative CPIs (100 = mean since 1990)



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Contact and disclaimer

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