SCENARIOS, DANGERS AND OPPORTUNITIES

As former Federal Reserve Chairman Ben Bernanke was fond of saying, the work of a central banker consists of 98% words and 2% action. But the same words, spoken over time, become narrative. That is, a story, with a plot, that one listens to with pleasure because it consolidates the certainties of those who must take, perhaps by trade, risks. The narrative does not strike everyone immediately, because one does not always identify with the first words revealed. But gradually the concatenation of terms is transformed into rational organization of thought. In politics this is the process by which ideologies are born, first exalting vitality, then maturing by imprisoning thought in the becoming of the everyday. These are the stages of history that are identified with "single thought," when it is easy to say that ideologies are dead precisely because we no longer realize that we are totally engulfed by them. The mechanism is also expressed in economic thought. Here the organization of ideas is reassembled in cycles, between phases of more state, with relative closure of the domestic market, and those of less state, where productive forces are freer to face international competition by accepting it even at home. The *trait d'union* between one phase and another, between one dominant thought and another, is given by inflation trends. Prices tend to rise in closed markets while falling in more open ones. Is this an oversimplification? Definitely. But, as a famous French poet wrote, "Life is a harmony of opposites and demands of us reasonably simple and light behavior."

By the end of World War II, the habit of centralization of emergency powers in the hands of governments and the challenge of the Soviet communist model had created economies that tended to be protected. At first, growth had managed to outpace inflation. But then the latter took over. In the 1970s growth was further curbed by inflation exacerbated by the oil crises (1973 and 1979). But the narrative remained the same. However, a new term, "stagflation," was invented to signal a change that the narrative was not ready to accept. This was enough to prepare a new rational organization of ideas that paved the way for the neoliberal revolution of Margareth Thatcher and Ronald Reagan.

The fall of the Berlin Wall and the end of the Cold War grafted on a liberal ideology that would become the undisputed dominant paradigm. Fewer states, open markets, low inflation enabled the growth of the world economy dragged on first by the United States, then by Europe (when the latter ventured with Jacques Delors the supranational shift) and finally with China. The narrative that has accompanied this journey has continued to hail the chain of successes that has enabled at least 1.5 billion people to achieve unprecedented levels of prosperity. But even at this stage the narrative obscured the imbalances that were being created as inequality increased between states and between members of the same societies. Here again a new term was coined, especially in the old, wealthy economies, "secular stagnation," to signal that growth was gradually losing momentum, dragging down inflation as well.

The transition to the current phase, to which a new narrative does not yet correspond but whose story elements are being reassembled, sees a return of the state brought about by the coronavirus pandemic and the need to manage the energy transition to a de-carbonized world. Not surprisingly, there was talk of a "state of war" in the acute phase of the pandemic. And, perhaps, this language predisposed the spirits, *les ésprits*, to a more classic context of war, that unleashed by Russia's attack on Ukraine. So it is understandable that central banks, particularly the Federal Reserve, have taken too long to realize that the inflation now plaguing much of the world economy is not transitory. Now even the Bank for International Settlements (the bank of central banks) is wondering whether we are not facing a regime change, from one of low inflation toward an upward price environment. [1] And, even, the influential institution also wonders if the world economy is not flirting with stagflation. Simply to ask these questions is to force oneself to reexamine the entire narrative of the past fifty years. But there is also a big change at this historical stage: "the monetary and financial system is grappling with the digital revolution." [2]

Markets interpret changes in their own way through sudden and violent reactions; then they settle down when they are convinced that they have discounted all the factors of

[1] *Annual Economic Report*, BRI, June 2022, p. *ix*.

[2] *Ibidem*.

transformation. That we are facing a clear regime change is told by the performance of financial assets in this first half of the year: the worst in fifty years. The S&P, the flagship U.S. index, has lost 20% since the beginning of the year, after hitting bear market lows in June. The Nasdaq nearly 30%, but only after a good rebound since June 16. But the Eurostoxx50 also ends the six-month period leaving 20% on the ground, as does the protective Swiss SMI index (-17%). Taking refuge in bonds did not help either; on the contrary. Here losses ranged from -10 to -15%. Gold actually held its value, but without shining, while the commodity index remained positive, thanks to energy and agricultural products, after hitting significant highs. Bitcoin, the digital gold, even reduced its value by nearly 60% since the beginning of the year (-39% in June). At the currency level, the U.S. dollar has shone, with the Dollar Index surpassing its highs of the past 10 years, and the Ruble, which has strengthened thanks to the price of oil and because of anomalies in this currency market. The most representative stock on the world's stock exchanges, Apple, has lost just over 20% since the beginning of the year. But it was worth 80 usd before the collapse due to the pandemic in March 2020 and now the price is still approaching 140 usd, maintaining a 75% appreciation.

What moved markets downward was the war in Ukraine and the resulting rise in energy prices. China's policy of absolute lockdowns caused the bottlenecks that jammed the global production chain. Demand remained substantial because of the strong incentives and the large amount of liquidity injected into the market, with central bank balance sheets swollen. Since the pandemic, there has been a rotation of demand from services to goods. This has prompted companies to try to hoard products in the markets to fill warehouses. Faced with this inflationary environment, central banks have begun raising rates, primarily the Federal Reserve, 0.75% in May, and reducing their balance sheets. The mantra now is no longer growth, but inflation. More than 60 central banks have raised rates or announced that they will revise them soon, such as the European Central Bank (ECB). Unexpectedly, even the Swiss National Bank (SNB) has raised its head rate by half a point: despite having a lower inflation rate than many others, it preferred to anticipate a future that is now outlined. The problem is thus clearly structural. The first goal is to prevent price increases from becoming self-fulfilling, also inevitably dragging wage claims into adjusting to price increases. So urgent action must be taken on inflation expectations, through talk, certainly, but also through action. In the United States, the 10-year Treasury rate doubled: from 1.5% at the beginning of the year to 3% at the end of June. This phenomenon is general, however. Markets, working on the future, are therefore adjusting their valuations by revising future earnings that they previously discounted with rates just above zero, with today's rates.

The debt world has probably already adjusted rates to the new reality. Ten-year inflation expectations seem under relative control: about 2.4% for the dollar area and the euro area. But overseas the real rate is positive (3% the 10-year rate), while in Europe it is still negative (1.4% the Bund). The Old Continent is closer to recession: it pays a higher energy bill and is at risk of fragmentation in credit, even though the ECB is preparing a plan to support peripheral debts (that is why the 10-year BTP is to be bought on yields around 4%).

What lies ahead in the second half of the year? If more state means more inflation, central banks, particularly the FED, know that they can curb that within their sphere of influence by decreasing demand. They seem convinced that a (hopefully soft) recession is better than the persistence of inflation. So they will not be satisfied with a few scant signals on consumption to curb rate hikes. The bond market has probably already figured this out. The stock market has adjusted stock valuations, but not earnings expectations. It is therefore likely that these still need to be revised, especially by bottom-up managers (those who favor analysis of individual company balance sheets), while top-down managers, who frame valuations in the macroeconomic framework, have already adjusted expectations. This means that the S&P, now at 3750 points, could perhaps retrace at least as far as 3,500 points because of this discrepancy between analysts, so still a -6.6%.

The discourse is more open globally. China, which has a lower level of inflation, is reopening its market (end of absolute lockdown) and seems to be concerned about its growth with monetary and fiscal stimulus. The strength of this process will certainly affect world inflation, but more importantly growth. Chinese interventions could have a macroeconomic, but also an important geopolitical impact. They could save global growth, confirm the soft landing in the United States, and perhaps reopen channels of communication. The evolution of such a process (already underway, just look at the Chinese indexes, to buy) would bring international markets back to the upside and the S&P at least around the 4,250-point mark. In November there are both congressional elections in the United States and the Chinese Communist Party Congress. Getting there with a positive economic environment is in Joe Biden's interest as well as Xi Jinping's. But without China's indirect complicity, markets will have to deal with persistent inflation that is difficult to contain: the S&P would also return below 3,200 points. The scenarios are confusing, but also open-ended. As the Italian historical manager, Lino Cardarelli, writes in his recently published memoirs, "*chaos* often generates vitality, opportunities if one approaches it with respectful participation, with positive attitudes, while *order*, to which one aspires, might only perpetuate habit, generate habituation to the existing." [3]

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[3] Lino Cardarelli*, Dalla Montedison a Bagdad, Dal ginepraio della finanza alle eterne crisi del Medio Oriente*, ed. Guerini e Associati, San Giuliano Milanese, 2022, p.36.