FROM REAGANOMICS TO BIDENOMICS

The month of June ended like the first half of the year: positive in spite of the constant bouts of scepticism. At the end of 2022, many were looking at the new year with the same fear with which they ended the old one. Instead, January saw the best performance of 2023 so far. And even in June there was no shortage of worries. Artificial Intelligence (AI) stocks had reached extreme levels from which it seemed natural to expect at least a natural correction. But no. Apple even managed to exceed three trillion dollars in market capitalisation. Since the beginning of the year, the S&P has gained 17%. The EuroStoxx50 continued its upward trend with +3% in the last week of the month (+17% since the beginning of the year). More deflected was the Swiss SMI, which was only up just over 4% in 2023. Wiser investors are quick to point out that this rally is being driven by a few stocks: Apple, Amazon, Google, Meta, Tesla, NVIDIA which, by capitalisation, have a preponderant weight in the S&P, as well as in the Nasdaq (+31% since the beginning of the year). If we take the S&P, but equi-weighted, the half-year performance is only slightly positive. Evidently, it is the expectations of a world brought about by artificial intelligence that moves the markets. Is there therefore a risk of fuelling a bubble on these stocks, as happened at the beginning of the millennium with those of the then nascent internet world? Legitimate questions that reveal the unease of those who did not let themselves be swept away by the AI wave and now risk having to ride it despite themselves. The VIX, the fear index that measures fluctuations in the broad US market, has fallen below its pre-covid level. And algorithms have been known to react with automatic purchases when volatility shrinks that much.

In this first half of the year, starting in January, it has always been inflation expectations that have moved the markets upwards. If this declines, central banks will not only not have to continue their turbo-charged rate hikes, but may even start to reduce them, in particular the Federal Reserve, which sets the pace. Technology

stocks dragged the stock markets down last year precisely because they valued their future earnings at interest rates just above zero: discounting them to the 4-5% inevitably meant discounting them in the light of financial costs that had risen four, five times. But rates have not fallen in the meantime; on the contrary, they have risen. The markets are becoming convinced that inflation has already started to contract: the highs reached in recent months now seem to have been set aside. In the US, PCE inflation, the Fed's preferred inflation rate, fell to 3.8% in May from 4.3% in April. For this reason, the central bank decided to take a break in June and refrained from raising interest rates. The problem is that core inflation, adjusted for energy and food (the course of which does not depend directly on monetary policy but on international factors), seems more 'sticki', more persistent: it dropped to 4.6% from 4.7%. This indicator has maintained a relatively stable pace since December, without showing any real signs of slowing down. It is a similar story for services which, across the Atlantic, rose at an annual rate of 5.3% from 5.5% in April, while Federal Reserve rates are at 5-5.25%.[1]

The situation is quite different in Europe. Eurostat's flash data show an overall index increasing by 5.5% per year, while it was at 6.1% in May. However, the slowdown is all due to the drop in energy prices (-5.6% from the level of a year ago). Core inflation remains very high and persistent: 6.8% in June from 6.9% in May (7.5% in March). In Europe, the cycle of rate hikes appears to be lagging behind the United States: real rates (nominal 4%) are still negative, unlike the United States, where they have risen 5% in just 14 months (we have to go back to the Volcker era to find such restrictive policies). Central bankers, as the number one at the Bank for International Settlements, Agustín Carstens, recently summed up in Lugano, are determined to bring inflation back close to the 2% target. But even if the disinflation process is underway, the fact that core inflation is so persistent fuels uncertainty and even attacks on central banks. Does it make sense to risk dragging economies into recession when we cannot even clearly understand what

[1] "Eurozona, scende l'inflazione ma l'indice 'core' resta alto", *Il sole 24 Ore*, 1. Luglio 2023.

the mechanisms of this inflation are? Is it still relevant to fight to contain price rises to 2% with an ongoing war in Ukraine and a potential one in Asia?

The reality is that, despite the sharp rate hikes, economies are more resilient than expected even a few months ago. Financial operators have been accustomed for the past thirty years or so to focusing on the activities of central banks to assess the future performance of the economy and, above all, the stock markets. The role of the state, in a free market economic framework, now seemed irrelevant. It had taken Margaret Thatcher and Ronald Reagan in the 1980s to convince the world that the best way to grow was not to intervene in economies and to let capital go naturally there where it is best remunerated. This intellectual approach, nurtured by Milton Friedman, had surprising practical implications as it lifted hundreds of millions of people (especially in China) out of poverty. But in the then industrial world, it caused the middle class to lose power: workers were cheaper in emerging markets and multinational corporations therefore moved their production chains. The European Union, in addition to experiencing this transformation, suffered for years from the austerity policies promoted by Germany, which best of all had been able to seize the opportunity to produce abroad and take advantage of the discount prices of Russian raw materials, becoming a fierce export player. The combined weight of these policies fuelled the growth of Chinese power and, at the same time, trivialised the potential of the 500 million rich consumers in the Old Continent.

The international distortions of this approach contributed to the great financial crisis of 2008, which started in the US. To overcome it, central banks took on an even more key role. By flooding the world with liquidity, they averted a terrible recession like the one seen in the 1930s. The theory was that even if wealth poured into financial assets (and those who held them), some of it would still trickle down into the real economy. And so it did. However, further distortions were fuelled: the top 1% of the US population came to hold more than half of all US wealth. The middle class could only maintain a semblance of past prosperity through debt, facilitated by extremely low rates. Frustration led Americans to vote for

Donald Trump, who promised 'America First'. Then, on a more structured view, he chose Joe Biden.

With the new Democratic president, the paradigm changes. It is now about 'growing the economy from the middle and from the bottom up instead of just from the top down'.[2] I'm tired, Biden says, of waiting for the trickle-down: it's time to stop restricting investment in infrastructure and public education and letting jobs migrate overseas. 'My predecessor,' Biden says, 'applied the latest iteration of a failed theory. He cut taxes for the rich. This did not pay off, the estimated cost of the operation was two trillion dollars'.[3] What Biden now explicitly calls 'Bidenomics' is a strategy to 1) stimulate smart investment in America, 2) educate and empower the American worker to grow the middle class, and 3) promote competition to lower costs and help small businesses.[4] It is about supporting targeted investments to strengthen national, energy and climate security. The bipartisan agreement on infrastructure, the president says, has already created 35,000 projects across the country: 'we are repairing crumbling bridges, renewing our power grid as well as our ports and airports. With Bidenomics, Biden continues, there is already 490 billion in private investment from American companies and others around the world who have chosen to come to the United States. With the Inflation Reduction Act, the prices of many medicines have fallen sharply, saving families $160 billion and $800 a year in health insurance premiums.

Acting with the same driving force on the Old Continent is much more complicated, as there is still no clearly defined common state within the framework of the European Union (EU). But the pendulum of history also swings on this side of the Atlantic. States have returned to investing in the economy, supported by the expansive monetary policy of the European Central Bank (ECB) exacerbated by the pandemic. At the same time, spending has also begun at EU level: Italy, for example, is receiving EUR 200 billion for its investment and resilience plan from the EU, a historic opportunity to revive an economy that has been depressed for at least twenty years.

[2] *Remarks by President Biden on Bidenomics*, Chicago, IL, 28 giugno 2023.

[3] *Idem*.

[4] *Idem*.

The financial operators who have populated the markets over the past decades have become accustomed to looking only at the expansive or restrictive policies of central banks in order to have their finger on the pulse of general economic trends: precisely the top-down approach. As inflation exploded, they continued to focus on the words of Jerome Powell and Christine Lagarde. In this paradigm, companies increase profits if rates and taxes go down. In the new approach that is emerging, companies grow with the economy if state-directed and private-sector investment is the trigger. Central banks and states are now more in competition than ever: while the former aim to bring inflation back close to the 2% target at any cost, the latter aim to stimulate growth. This is a dangerous tension but, if well managed, can prove constructive, given how much there is to recover in the real economy. The stock markets will continue to be driven by signs of falling inflation and the possibility that artificial intelligence, by improving productivity, will lower overheads.

But they will also be attentive to the ability of states to provoke growth at levels above inflation. We will have volatile markets because the tension between growth and inflation will be with us. But markets will also be resilient because they will find support in falling inflation or rising growth. A tricky bet? Certainly, but for now even the Bank for International Settlements is not ruling out a soft landing.

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