THE PILLAR OF REAL RATES

Uncertainty reigns supreme on the markets. It is not clear what the objectives of the war in Ukraine are, but it is evident that it marks a watershed in international relations and their currency expression. As if that were not enough, this crucial issue is overlapped by other issues, less dramatic from a humanitarian point of view, but full of consequences for the world economy: the prices of raw materials that continue to rise, inflation, COVID-19 in China with its consequences and the choices of central banks, in particular the Federal Reserve.

In the last twenty years there has certainly been no lack of difficult moments, from the bursting of the Nasdaq bubble at the beginning of the millennium, to the great financial crisis of 2008, to the Pandemic of 2020. In one way or another, these crises are the expression of globalization, which was characterized by the modest role of states, which raised the white flag in the face of the overwhelming power of economic forces in the field. Only central banks, independent of politics, seemed to have the tools to manage globalization and its crises. Over the years, they have developed the "toolbox" to oxygenate the markets at times when the rarefied area endangered the health of the entire system. At the basis of their elaborations was the assumption that inflation, in the face of globalization and digitization, was struggling to raise its head. *Modern Monetary Theory* even clearly defined that states, unlike households and businesses, can print money at will. They have only one limit: inflation. Since inflation was more of a goal than a danger, the central banks' balance sheets continued to swell. When the pandemic broke out, the central banks were not surprised by the urgency. They began injecting additional liquidity into the markets by purchasing bonds (effectively nationalizing the bond market). States also implemented fiscal policies that preserved jobs and supported demand. Since 2020, the major central banks (Federal Reserve, European Central Bank, Central Bank of Japan, Bank of England) have acted synchronously by inflating financial markets. Among the big ones, only China has been watching. Stimulus from others has also supported its economy, allowing it to implement reforms that others continue to postpone.

During 2021, the macroeconomic environment has changed. The problems are no longer on the demand side, but on the supply side. The coronavirus has contributed to blocking production centers (due to lack of personnel) and the supply of some important raw materials. Ships sat idle in front of clogged ports to unload goods. This contributed to rising prices, while people, who had accumulated savings during the lockdowns, increased their spending. Inflation rose last year in the United States to 5.7 percent and globally to 6.2 percent. And stock markets, with exceptions such as China, had exploded. The Federal Reserve, the world's flagship monetary policy institution, should probably have raised rates in this new environment, or stopped buying - earlier - 120 billion dollars of bonds a month. It acted late because it considered inflation to be transitory, postponing the first intervention until 2022.

But on February 24 of this year, Russia invaded Ukraine. The economic consequences were immediate: the cost of energy increased, with oil rising from $90 to almost $140 a barrel in just a few days and gas prices doubling. In general, all commodities have been affected, including and above all foodstuffs. In the United States, with unemployment below 4%, the risks of wage pressures have increased. And lockdowns, end in the West, but resume in China, maintaining supply bottlenecks. Inflation now appears more persistent than the Fed expected a few weeks ago. It is now more difficult to intervene. Raising rates too quickly can turn the prospect of a solid recovery into a recession.

The consequences of war affect everyone, but not equally. Economies are not all in the same phase of the economic cycle. Central banks, this time, are unlikely to act in a synchronized manner and their "toolbox" is rather depleted. Of course, the end of the war could provide some breathing space. But for now it is too early to think of a quick resolution of the conflict. The main way to stimulate economies is to reduce the cost of energy, which is the basic component of the current exasperation of rising prices. If this were to happen, central banks could more easily orchestrate a soft landing. The United States is trying: it will release a third of its reserves and expects allies to take a similar step. By releasing a million barrels a day into the market (basically until the November midterm elections), Biden is trying to smooth the Fed's path to a more sustainable rate hike. The central bank wants to act quickly and can count on popular support: Americans now fear inflation above all, because with unemployment at 3.6% they do not consider a possible recession that the bond market is beginning to signal. The dollar is therefore destined to remain at high levels. It is difficult to say if and how much it will strengthen against the euro: A large part of the expected rise is already priced.

The situation is more difficult in the Old Continent, where the consequences of the war are immediate. Inflation in March rose to 7.5% in the Eurozone. The lack of significant wage pressures and the desire to sustain growth for as long as possible has maintained an expansive monetary policy that is also shared by the historically more restrictive Germany. Now, however, fears that rising prices could dampen consumption and increase wage claims could put the central bank in difficulty. The bond market is already beginning to discount one or two interest rate increases between 0.5% and 1% for the end of the year, bringing nominal interest rates back into positive territory. The euro is expected to remain weak, because restrictive monetary policies would block the already struggling growth and undermine the sustainability of public debts. Certainly, the export industry would benefit, but without solving the problem of the cost of raw materials, which are more expensive if paid with a devalued euro. Therefore, the European stock market must be approached selectively, choosing stocks with good balance sheets and historical ability to maintain a growing dividend policy, perhaps because they are able to transfer price increases to the consumer faster than others.

In contrast to Europe and the USA, the Japanese central bank is maintaining a very expansive monetary policy. The yen is therefore suffering, which lends itself to carry trades (one borrows in yen at zero interest and invests in dollars at around 2%), but the stock market has good support. China, due to the lockdown, has difficulty in restarting, but during the year, once this phase has passed, it could open the taps of liquidity and recalibrate its targets on companies in the new economy.

The UK stock exchange is currently benefiting from commodity-related stocks and could then be supported by those in services if the end of restrictions brings back demand in this area. The pound could reflect this context and strengthen against the euro, as it has positive nominal rates (its 10-year yield is 1.6%).

GDP (Gross Domestic Product) growth rates have almost halved in relation to the excesses of 2021 (worldwide from 6.2% in 2021 to forecasts of 3.6% for 2022, which will probably be revised downwards). But they are still acceptable relative to historical averages, as shown by the industrial PMI data (survey of business expectations). Only China is in dangerous territory, but that is because of its extremely restrictive anti-Covid policies, which may fade in the coming months.

The stock exchanges will not be as effervescent this year as in 2021. But the correction that began in January, which accumulated fears of inflation and then also the outbreak of the war in Ukraine, was not excessive, guaranteeing substantial resistance in relation to the growth of the previous year. The minimum reached on February 24th could remain as a support for the entire year, unless the war in Ukraine causes fears. If this finds an initial form of resolution and if strategies to contain the rise in energy work, monetary policies will be less restrictive and growth can continue to benefit from the post-pandemic momentum. To be monitored are the expectations on inflation and the rates that central banks and markets will express: as long as real rates are negative, stock markets have a good pillar on which to rest their fears, because bonds are not yet an alternative. But the room for maneuver now is very narrow.

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