AND NOW, A NEW BEAR MARKET RALLY?

It seems that the evils of 2022 have found solace in the uncertainties that usually characterise the month of September. The war in Ukraine continues, but with Kiev forces - it seems - managing to regain territory. Inflation is struggling to come to a halt, threatening global financial stability. Nearly all the world's central banks have been forced to follow the Federal Reserve and raise interest rates, just as the recovery falters. The market is becoming increasingly aware that the combination of high inflation, tightening monetary policy and persistent geopolitical uncertainty will have a negative impact on global economic growth. By the last quarter of 2022, it is unfortunately easy to imagine that governments in the global North could be forced to reduce or even ration energy consumption, especially in the event of abnormally low temperatures, while in the South, high food and energy prices and rising interest rates will be fertile ground for social and political unrest and financial crises.

According to the OECD, global growth will remain weak in the second half of 2022 and slow down again in 2023, increasing by just under 3% this year and 2.2% next year. Compared to projections made in December 2021, before the war in Ukraine, global output in 2023 could be $2.8 trillion (2% of world GDP) lower. The new estimates express the consequences of the war in Ukraine, combined with soaring prices, the tightening of central banks and the long wave of the 'zero covid' policy in China. Among the hardest hit countries is Europe's economic engine, Germany, which will have a GDP contraction of 0.7% next year (in June the forecast was +1.7%), while this year it will stop at 1.2%. The Eurozone will still grow by 3.1 % this year, then stagnate in 2023 (0.3 %) and the situation could worsen, possibly dragged down by modulating gas supplies. For the UK, growth will be 3.4 % this year, before falling to zero in 2023. The slowdown will also be sustained in the US (1.5 % this year and 0.5 % in 2023). The double-digit expansion, to which China had accustomed us in the recent past, will eventually come to a halt at 3.2% this year, due to the anti-coveted emergency measures and the persistent crisis in the real estate market. Next year, the support measures launched by Xi Jimping's government (worth 2% of GDP) are expected to take shape, which could translate into 4.7% growth.[1]

Stock markets were hardly surprised by the revisions in the OECD report at the end of September. In fact, they managed to accelerate their contraction during the month. The MSCI World index lost 9.5% in September, totalling a loss of over 26% since the beginning of the year. The US flagship index, the S&P, dropped almost 25% since the start of the year (-8.63% in September), the Nasdaq 32% (-9%), the Eurostoxx almost 23% (-6.38%), and the SMI 20% (-5.73%).

At the root of these movements, both in the macroeconomic and stock market spheres, is the emergence of inflation and the subsequent action of central banks. The OECD report notes that even "prior to Russia's invasion of Ukraine, inflation was above central bank targets in most G20 economies, driven by the initial rise in energy prices as economies reopened after the pandemic, bottlenecks in supply chains, rising transport costs and a shift in the composition of private consumption towards commodities. Food prices have also risen sharply in many countries. The war in Ukraine has reinforced these price pressures'.[2]

In fact, the covid economy survived the pandemic. And the central banks, as well as politics, did not have the courage to intervene in time. The biggest and most obvious responsibility lies with the Federal Reserve, which until a few months ago continued to claim that inflation was transitory. The models on which forecasts of future price trends are based seek to be macro-economically measurable, hence estimable and concrete. But the pandemic has changed the way people consume and work. A young man working at Starbucks figures in the employment statistics. But if he earns money by posting videos on TikTok it doesn't, even if it has a positive impact on growth by helping to make it more resilient than central bank projections might suggest. Geopolitics also has only a relative weight in the

[1] *Paying the Price of War, OECDE Economic Outlook*, Interim Report, 2022 September.

[2] Ibidem.

models. They can estimate the increase in energy and commodity prices due mainly to the war in Ukraine and the US-China challenge. But they can hardly capture the rising costs of relocation and reshoring: companies tend to bring back some of the activity they had previously concentrated in low labour cost areas, especially in China. When they fail to do so, they still try to diversify production in more countries (India, Vietnam, etc.). What is the impact of these new phenomena on production and sales costs?

The redevelopment of central bank parameters is particularly complex and slow because it involves reviewing the entire paradigm that underpins them. How to measure the end of the globalisation that has helped drag prices down over the past thirty years? And how to define the deflationary impact of digitisation, which now also has to reckon with the great costs of cybersecurity? Finally, how much does the new state interventionism in the economy cost after the neoliberal intoxication?

These revisions also have a strong cultural impact. It took years for central banks to consider the postulates of *Modern Monetary Theory*, which in fact calls for growth to be induced by printing money. But this theory has two limitations: the first is that it concerns states that have their own independent and well-credited currency; the second is that there is no inflation. In this context, the idea also developed that the energy transition, so much proclaimed before the outbreak of the war in Ukraine, could magically be financed precisely by printing money (*Quantitative Easing*), because the impact on productivity would help reduce future costs, thus keeping inflation low. Even the huge amount of public debt in this trajectory did not cause much concern, because debt is made sustainable by the possibility of pushing GDP. But the outbreak of inflation disrupts this whole approach.

In the upwardly revised OECD estimates, inflation in the G20 countries stands at 8.3% for 2022 and 6.6% in 2023. In the US, core inflation is estimated at 6.2 per cent this year and will fall to 3.4 per cent next year, while in the Eurozone 8.1 per cent will fall to 6.2 per cent in 2023. The Federal Reserve, the country furthest ahead in the business cycle, has decided to nip inflation in the bud with a mighty rate hike. As doubt creeps into its models, it has chosen to go from one extreme to the other: from transitory inflation to persistent, sticky inflation. So rates will have to rise until inflation reverses its trend. A few timid signs of price restraint are not enough. The turnaround has to be solid and well defined before the pressure to raise rates can be eased. For the time being, this policy has sustainable costs for the US economy, which has an unemployment rate of 3.4 per cent and two vacancies for every person seeking employment. But the violence of the rate hike, which rose from 0.25% at the beginning of the year to the current 3.25%, is beginning to show worrying signs. Amongst many examples, FedEx has warned that its volumes are falling (parcels travel at the pace of the economy), Nike collapses on the stock exchange due to unsold stock and Apple recalibrates its smartphone production.

Worst of all, the dollar's rate hike is forcing other countries' central banks to fall into line, even if they are starting from weaker macroeconomic backgrounds and with inflation caused mainly by energy prices (as in Europe) and not by the vitality of demand. The strong dollar, the currency with which commodities and much of international sales are priced, means higher imported inflation for most of the world's economies. Moreover, as the OECD report points out, "in a number of countries, including the United States, financial conditions are also tightening as a result of continued reductions in central bank balance sheets. Rising price pressures throughout the economy have led to stronger official rate hikes than previous forward guidance suggested to minimise the risks of high inflation becoming entrenched in expectations and feeding through into wage growth in historically tight labour markets. Delaying action would have increased the risk that even stronger measures would eventually be needed to reduce inflation'.[3]

There is no shortage of attempts to take alternative paths to that of the Federal Reserve. One example is Erdogan's Turkey, which is willing to tolerate 55% inflation in order to record 4.5% GDP growth. A case that does not, however, endanger the balance of international finance. The case of the rebellious British choice is different. The mini-budget presented by the newly appointed

[3] Ibidem.

Chancellor of the Exchequer Kwasi Kwarteng did not exactly please the markets. In order to revive growth, the minister announced the biggest package of tax cuts in fifty years: it was immediately sanctioned by the markets, which plunged the pound into the fastest daily slump since back in 1870. Also suffering were British treasury bonds, the Gilt, which only recovered after the British Central Bank promised unlimited intervention to support them. The cross-Channel experience revealed to the markets the real risk of not fighting inflation all the way. What if the markets become convinced that, in the new inflationary environment, debt is no longer sustainable?

This fear was evident by seeing the worried reaction across the Atlantic. Pressure on the UK came from many fronts. But at the same time some members of the Federal Reserve have hinted that, perhaps, the repressive American policy of excessively strengthening rates and the dollar is putting many in danger. Including a historic ally such as England, which in fact, probably without meaning to, has shown how much the international financial system would be at risk (even for the US) if, perhaps for electoral reasons, other countries chose to boost the economy with further debt. It is therefore to be hoped that the OECD is right when it states that inflation is expected to peak in the current quarter in most major economies and decline in the latter part of the year and throughout 2023. Even if it remains above central bank targets next year.

The Federal Reserve, while sticking to its trajectory, may now be more inclined to give some, albeit modest, signs of moderation in its willingness to raise rates further. That Jerome Powell does not consider Wall Street an ally at this stage is evident. In the United States, the falling stock market is contributing greatly to dampening demand. But the speed of the correction is beginning to be technically excessive, given that 24 trillion in value has already been burned. It is therefore possible that any positive signals will now be greeted by the markets with exaggerated relief, fuelling a new bear market rally. Investors are quick to question whether many fears are not already embedded in expected earnings. Extreme pessimism (American Investors Association survey), combined with more balanced valuations, could light the fuse for a rebound. The S&P's 2022 prospective price/earnings ratio is now at 16 and is estimated at 14.8 for next year: it was at 24 a year ago. At 3'505 points there is significant support for the S&P (50% retracement between the lows of the pandemic and the highs of the beginning of the year). With the start of the quarterly earnings season, one might realise that many concerns, to some extent, are already priced in. For those who like statistics, the S&P over the past twenty years has gained an average of 4.1% in the last quarter, while the MSCI has only closed negative three times in the same period. But the breathing space that the markets may want to give themselves must still come to terms with an ongoing war.

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