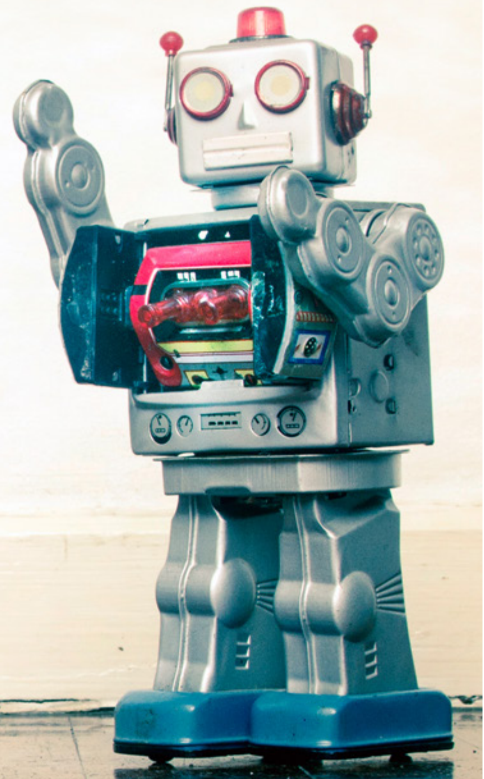
The war on inflation: a fair fight, or a losing battle?



Central banks across developed economies have faced a vivid credibility issue in 2022: control inflation, or face a widespread loss of faith. How much longer will the fight go on, and are they winning?

The US central bank is leading the charge, with the UK hot on its heels

Like the US economy, the US central bank – the Federal Reserve Bank (Fed) – sets the tone for its developed world peers. Over the course of 2022, US interest rates have gone from 0.25% to 4.5%, at the time of writing (mid- December).

The Fed is now on a clearly marked path, and one which has been well-signalled. In August, Fed Chair Jerome Powell made a forceful speech outlining the Fed's total focus on bringing down inflation by slowing economic activity. In doing so, he acknowledged that efforts to control inflation (most notably by raising interest rates) would cause short-term pain to households and businesses, but declared that "a failure to restore price stability would mean far greater pain."

This rhetoric has been likened to an infamous speech made by Mario Draghi (then President of the European Central Bank) a decade earlier. In the summer of 2012, Draghi said that he would do "whatever it takes" to save the euro area. For Powell and inflation, it's not so much a case of 'whatever it takes' as 'whatever it costs'. And what it costs, it seems, will be some US economic growth.

On home shores, the Bank of England has been on a similar path. The Bank's policymakers have been forced to choose between raising rates to bring inflation under control (and doing so in a deteriorating economic environment) and supporting struggling consumers. To date they have prioritised the former, taking interest rates to 3.5%, at the time of writing.

Interest rates have shot up in 2022

Benchmark central bank rates in the US, UK and Europe

31/12/21	31/12/21	30/12/21
0.25%	0.10%	-0.50%
31/12/22	31/12/22	31/12/22
4.50%	3.50%	2.00%

Source: Bloomberg

How high will interest rates go?

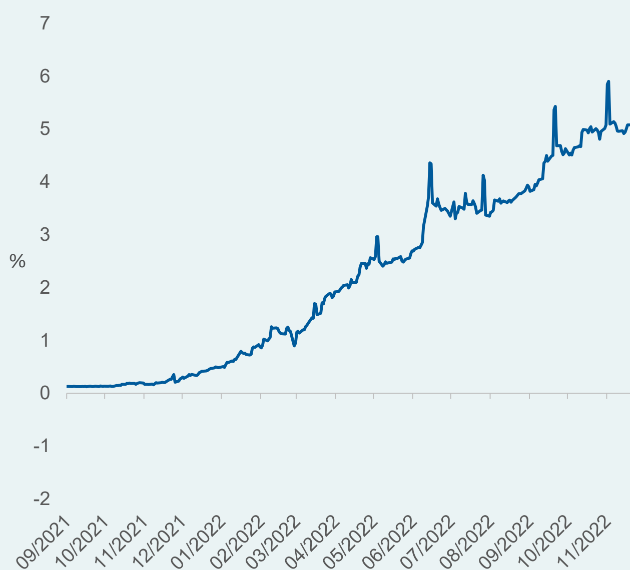
Until relatively recently, financial markets had anticipated a pause in interest rate hikes from the Fed early next year, and possibly even a rate cut during the first half of 2023. This is no longer the case. While headline US inflation has shown signs of peaking and core inflation (which excludes items with volatile prices like energy and food) came in lower than expected in October, the more persistent component of inflation like wages and shelter (rental costs) are still rising. Inflation may be turning in the right direction, but the war is not over yet.

Markets now expect the Fed to continue raising rates until they reach around 5% in the first half of 2023. In the UK, market expectations for the Bank are to reach a peak of around 4.5%, once again in the first half of 2023.

Ultimately the question of how high interest rates will go and how long they rest there will be determined by the path of inflation over the next twelve months. It's the world worst kept secret that inflation will fall from its 2022 highs, but the important questions are how quickly it will fall and where it will settle.

2022 saw investor expectations for the future of US interest rates increase rapidly

Market predictions over time for the benchmark US 'Fed Funds' rate by May 2023



Source: Bloomberg

What will happen to inflation?

Only time will tell how effective central bank aggression will be in bringing demand and supply back into balance in the global economy (without causing too much pain). Commodity prices will also be dictated by ever-present geopolitics. That's the short-term conundrum. In the medium term, we believe the developed world will have to adapt to a higher inflation regime than we have grown used to over the past 20 years, with inflation likely between 2% and 4%.

The deflationary forces of globalisation (particularly since 2002 when China joined the World Trade Organisation) and plentiful supply of cheap energy are fading. A trend of diversifying away from China-based supply chains has accelerated in a post-COVID-19 world, and while the journey to cleaner energy will be hugely beneficial in the longer term, it will be inflationary in the short term as the required infrastructure is built.

Central banks have told us their plan of attack

This year, central banks have been on a journey of higher interest rates in a pattern unseen since the 1980s. Policymakers in most developed economies are following a similar roadmap: not only increasing interest rates, but also removing support in other forms (e.g. bond purchase programmes are being reduced or allowed to expire without replacement).

Central banks know the economic pain this will cause in the near term, but are wholly fixated on bringing down inflation. Much of the heavy lifting in terms of rate rises has been done in 2022, but with a bit more likely to come in the first half of 2023. Whether rates are paused, cut or hiked again from that point will be determined, as mentioned above, by the economic data and inflation over the next 12 months. We will be keeping a particularly keen eye on increases to the unemployment rate as central banks pursue their goal of bringing demand and supply back into a healthier balance.

> "So far, we think that bond markets - which are notoriously sensitive to interest rate changes - are pricing in central bank action more aggressively than stock markets, resulting in a very challenging period of performance for bond prices."
>
> **David Absolon** Investment Director

What does all this mean for our investment strategies?

While past performance is never a reliable guide to future results, financial markets typically react very quickly to perceived danger. Little surprise, then, that in 2022 we witnessed extended spells of turbulence in both bond and stock markets, as investors attempted to digest rapid signals from the world's leading central banks.

So far, we think that bond markets – which are notoriously sensitive to interest rate changes – are pricing in central bank action more aggressively than stock markets, resulting in a very challenging period of performance for bond prices. However, when asset prices fall, there is potential for long-term value to emerge, particularly in an asset class (like bonds) which has appeared to offer poor value for an extended period of time.

As a result, we see selective opportunities in government bonds and corporate debt, as well as more niche 'alternative' areas of debt markets. In keeping with this, we have dialled back some of our exposure to higher risk asset types like shares which we believe have further adjustments to make in this new world of higher central bank rates. Our strategies are also likely to be carrying a higher proportion of cash than usual, which should help our managers to remain as flexible as possible as the market picture evolves.

To find out more please get in touch:

communications.hwam@handelsbanken.co.uk

Assessing the performance of our investment strategies

Our 'target return' performance benchmarks

Most of our investment strategies aim to deliver financial returns at levels linked to the rate of UK inflation (measured by the Consumer Price Index, or CPI). Over any given five-year period, these strategies target returns which are a pre-defined level above the rate of inflation. Our CPI-linked goals are known as the strategies' target return benchmarks, and are designed to help customers evaluate the strategies' performance in a real-world context. These targeted returns range from CPI+1% for our lowest risk (Defensive) strategies up to CPI+4% for our higher risk (Growth) strategies. Our highest risk (Adventurous) strategy is the exception, as it does not use a CPI-linked goal. Instead, this strategy aims to beat the returns offered by the global stock market (represented by the MSCI All Country World Index).

If the strategies deliver total financial returns to investors (after all costs and charges have been taken) equivalent to the total return of their target return benchmarks, we consider the strategies to have achieved their targets.

Our financial market performance benchmarks

The performance of our investment strategies can also be compared to representative indices for two of the main asset types in which most of the strategies invest. These indices are 'MSCI United Kingdom (£) – net total return' (representing the performance of UK shares) and 'BoA Merrill Lynch UK Gilts' (representing the performance of conventional UK government bonds). These indices are known as the strategies' comparator benchmarks, and are designed to help clients evaluate the strategies' performance in a financial market context.

It is important to note that financial returns are not assured: there is no guarantee that the strategies' performance objectives will be met, or that a positive return will be delivered over any time period. When you invest, your capital is at risk.

Handelsbanken Wealth & Asset Management Limited is authorised and regulated by the Financial Conduct Authority (FCA) in the conduct of investment and protection business, and is a wholly-owned subsidiary of Handelsbanken plc. Tax advice which does not contain any investment element is not regulated by the FCA. Professional advice should be taken before any course of action is pursued.

- Find out more about our services by contacting us on 01892 701803 or visiting our website: wealthandasset.handelsbanken.co.uk
- Read about how our investment services are regulated, and other important information: wealthandasset.handelsbanken.co.uk/important-information
- Learn more about wealth and investment concepts in our Learning Zone: wealthandasset.handelsbanken.co.uk/learning-zone/
- Understand more about the language and terminology used in the financial services industry and our own publications through our Glossary of Terms: wealthandasset.handelsbanken.co.uk/glossary-of-terms/

All commentary and data is valid, to the best of our knowledge, at the time of publication. This document is not intended to be a definitive analysis of financial or other markets and does not constitute any recommendation to buy, sell or otherwise trade in any of the investments mentioned. The value of any investment and income from it is not guaranteed and can fall as well as rise, so your capital is at risk.

We manage our investment strategies in accordance with pre-defined risk and reward targets, which vary from strategy to strategy to suit a range of customer needs. Portfolios may include individual investments in structured products, foreign currencies and funds (including funds not regulated by the FCA) which may individually have a relatively high risk profile. The portfolios may specifically include hedge funds, property funds, private equity funds and other funds which may have limited liquidity. Changes in exchange rates between currencies can cause investments of income to go down or up.

Registered Head Office: No.1 Kingsway, London WC2B 6AN. Registered in England No: 4132340

wealthandasset.handelsbanken.co.uk