Rothschild & Co
Wealth Management

MARKET PERSPECTIVE | MAY 2022

# The Great Illusion

# Foreword

Norman Angell argued that the case for war in Europe was illusory: his book *The Great Illusion* was published in 1910. Our times have seen narratives which seem to echo his, and as we write, the risk of dreadful escalation in Ukraine is all too real. But history does not always repeat itself (and the person who most famously said it does has been wrong about much else besides).

We sadly have to assume that the conflict continues for now. The human and geopolitical cost of Russia's attack is horribly high and rising (it is "contained" only in logistical terms). It seems bad taste even to mention the financial consequences, but as yet the impact on the global economy appears muted, allowing stock markets for much of the last two months to display an even greater callousness than they often do when faced with humanitarian disaster.

The US economy in particular is not as fragile as first quarter GDP arithmetic seems to suggest. Business surveys for both the US and Europe suggest growth has not yet slowed sharply, partly perhaps because real oil prices are not that high (energy costs pose a distributional threat, not yet a macroeconomic one). Pent-up demand lingers from the pandemic. Labour markets are (even) tighter than before the invasion.

Unsurprisingly, the big western central banks continue to signal higher interest rates ahead, and more loudly than before. On 24th February the key economic theme seemed likely to be "ongoing conflict or higher interest rates". It may now be "ongoing conflict *and* higher interest rates". We think monetary tightening, and the passing of the conflict/commodity-driven peaks in headline CPI inflation (see the second essay), may eventually keep underlying inflation in check, though still at above-target levels (trend rates settling at 2–4%, say).

Bonds face continuing strategic headwinds, then, but are now a bit less expensive than they were. Stocks are tactically vulnerable too, and not cheap (though still best placed to deliver long-term inflation-beating returns). In the short term, there is a lot to be said for the nominal predictability of cash, even with today's inflation: purchasing power is less volatile than security prices.

**Kevin Gardiner/Victor Balfour**
Global Investment Strategists

Image sources: Euro banknotes
© Gettyimages

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Rothschild & Co or Bloomberg unless
otherwise stated.

# Big Pictures

And so, almost overnight, Europe finds itself again on the brink of continental conflict.

We have learned immediately that the fog of war is not, after all, dispelled by modern media, even of the social kind. Our press is free, but not necessarily objective or fully informed. Strategic experts struggle to model the moves of a protagonist acting against their own best interests.

If we can't credibly offer a view (as opposed to hope) as to the likely outcome, we have to assume that the current grim but localised struggle continues.

Big Pictures are being painted nonetheless. We read that Russia is capitalising on the decadence of a West which is enveloped in relativism, and lacking in self-confidence and leadership. We are reportedly seeing the end of the liberal, democratic, globalising "long peace" visible in (for example) the writings of Fukuyama and Pinker. Western enlightenment values allegedly have been just a passing conceit, to be replaced by "clashing civilisations", populism, a democratic deficit and/or "deglobalisation".

Believers in progress have certainly been guilty of hubris before. Norman Angell christened his best-selling thesis *The Great Illusion* in 1910, arguing that economic interdependence would work against the prospect of war between great industrial powers.

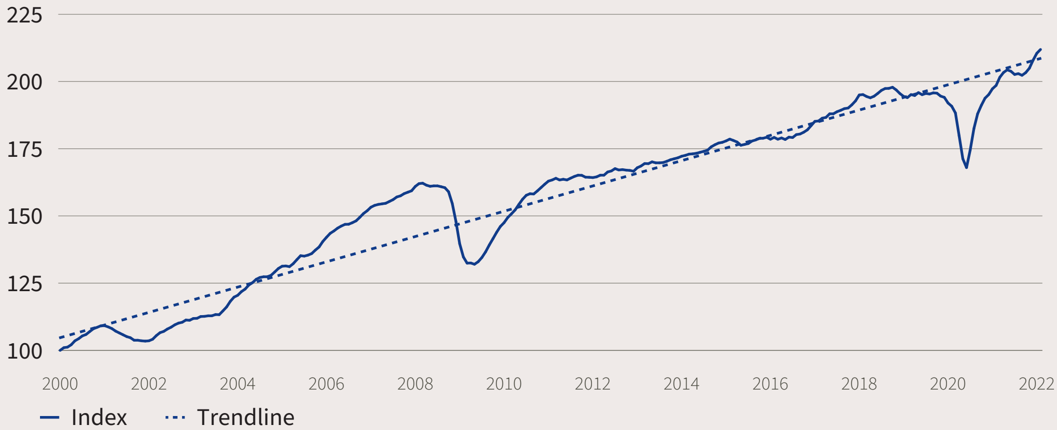
The "illusion" as he saw it was that nations gained from militarism. Angell did not say that war could not happen, but that it does not pay, and this (he thought) would prove a potent deterrent. A subsequent edition was published in 1933, with Angell receiving the Nobel Peace Prize that same year. The title was later adopted by Renoir in his 1937 film about French prisoners of war during the First World War.

Contemporary notions of progress accept the possibility of relapse and/or accident. One reading of recent setbacks is that they have been inspired not by the failure of the western model, but by its success. Authoritarian grips may have been loosened by the allure of freedom and prosperity: external aggression may be a defensive response to a fear of losing domestic control.

Big Pictures are seductive, and can lead to closed minds. There is a lot to be said for the "muddle through" view of the world (and we have often said it). But if we have to pick one, we haven't yet given up on the notion of progress – and resumed long-term globalisation with it (Figure 1).

**FIGURE 1: TRADE WAS GROWING STRONGLY**

World trade volume: index, 3mth moving average. 100 = 31/01/2000




Source: CPB World Trade Monitor, Rothschild & Co

## AN UNPREDICTABLE PROTAGONIST

We hope peace will break out soon. But as noted, it is difficult to model the actions of the main protagonist. The Russian president's speech of 21st February was a clear statement of objectives and (in retrospect) intent, but Russia now appears weaker, not stronger.

Setting aside Russia's unknown human and material losses, and the damage to its military reputation (which could yet be reversed of course), the North Atlantic Treaty Organisation appears revitalised, not intimidated. Finland and Sweden reportedly may join. Russia's current and potential economy has been materially damaged. Its capital markets are ostracised: echoing the St Petersburg index in 1917, MSCI Russia has effectively fallen to zero.

Russia's balance of payments – and its currency, for now – is healthy, but only in the most mercantilist context. Invoicing arrangements do not alter its underlying predicament: it needs high-value manufactures, not roubles (it can always print those).

It must find new buyers for much of its oil (and eventually gas), even as its actions help accelerate the end of the oil age. And it cannot easily spend its current oil revenue if it wants to. Its consumers will have to do without many of the cars, phones, computers and branded goods they value.

If it can behave this irrationally, what might it not do? If such things as risk premia existed, now would surely be the time for them to widen.

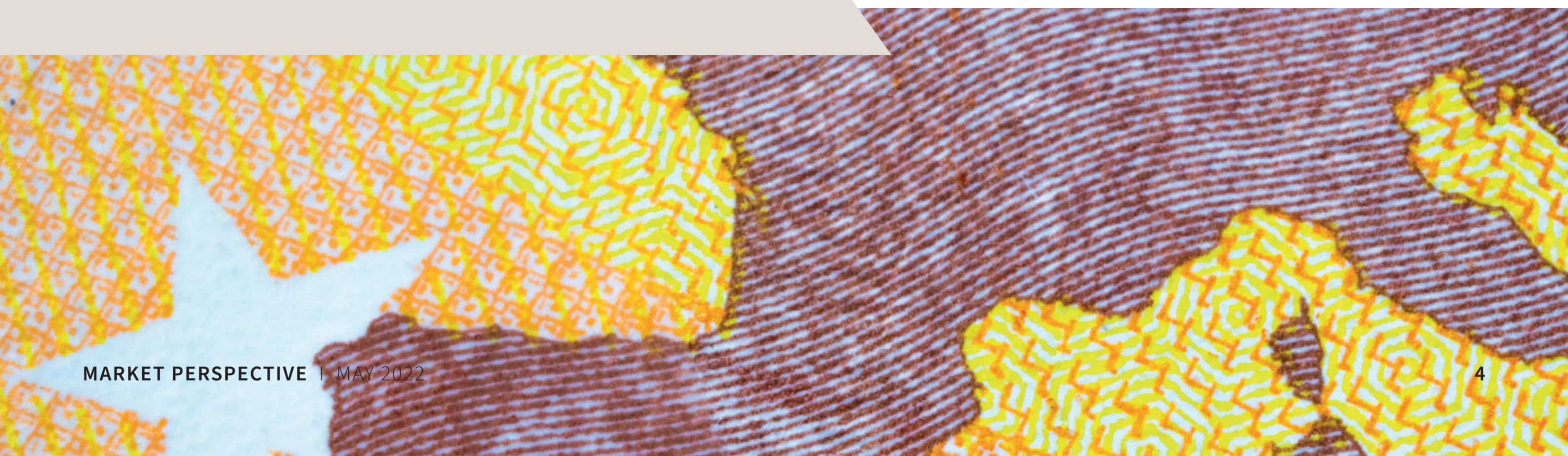
## SLOWER GROWTH, MORE INFLATION...

The economic impact of the invasion on the rest of the world was immediately clear: less growth, and higher consumer prices, as a result of disruption to the supply of key commodities and other inputs. The first two batches of business surveys published since the invasion show a relatively modest slowing in growth prospects.

The data has not all been resilient: there was a remarkable fall in the expectations component of the widely watched IFO survey in Germany (since partially reversed); China has renewed some counter-covid lockdowns; and most recently a surprising 1% annualised fall in US GDP has been reported for the first quarter. This latter news will only encourage talk of a policy mistake in the offing as the Fed continues to hike interest rates (see below), but it reflects what we think will turn out to be an erratic contribution from net trade – final domestic spending actually accelerated towards 4%.

Western consumer confidence has been hit hard admittedly, but these surveys are of less use as leading indicators: we do not usually look at them. Who wouldn't be feeling less confident about things currently? Whether that makes us spend less or not is moot. We don't feel good about higher petrol prices, but their immediate effect is probably to raise total nominal spending. Similarly, we don't feel good about spending more now to pre-empt the impact of inflation on our future spending power.

Labour markets on both sides of the Atlantic look even tighter than they did in January. There are always new potential workers who can be enticed back into the workforce – in the jargon, "participation rates" have room to rise – and the exact level of "full" employment is difficult to pin down. Whatever it is, we have rarely been closer to it in recent times.



We are not especially surprised by the initial momentum, and the (so far) encouraging post-invasion resilience of the global economy.

We have long suggested that the period of above-trend growth in the wake of the pandemic might last longer than official forecasts have suggested. There is a greater potential for a catch up (a backfilling of lost output) as a result of the prolonged period of lax monetary and fiscal policy, the existence of frustrated or pent-up consumer and capex demand, and the more prosaic need to rebuild inventories (to refill shelves).

Meanwhile, the post-invasion disruption to oil supply has not yet resulted in as dramatic a squeeze on spending power as it might have. As we write, real (that is, inflation-adjusted) oil prices are roughly two-fifths above their 10-year trend, but lower than in 2011–12 for example (Figure 1). Energy prices currently pose a political or distributional threat to western governments, not yet a macroeconomic one.

The high and rising level of capacity utilisation – for both plant and labour – represents an underlying, ongoing inflation risk that is unlikely to go away, even as oil and other commodity prices stop surging. And stop surging they almost inevitably will. There need be no sustained global shortages, even if (as seems likely) Europe decides it can afford the cost of more formally shunning Russian oil and (eventually) gas.

This is the reason we have been anticipating a rise in trend inflation since the pandemic. Higher oil and other commodity prices are amplifying the risk, but are neither necessary nor sufficient for sustained inflation, as we suggest below. The inflation of the 1970s was gathering momentum well before the formation of OPEC; and without poorly functioning labour markets, and slack monetary and fiscal policies, the surge in oil prices then would not have resonated as it did.

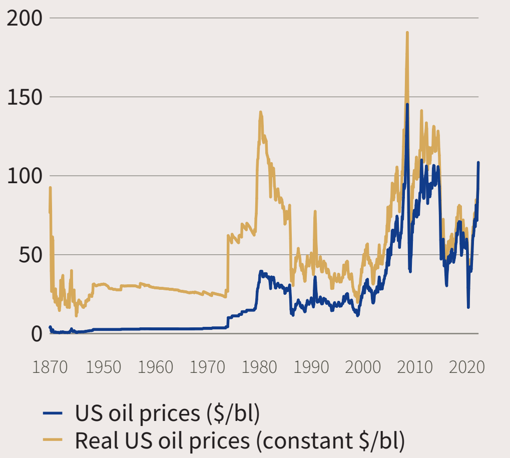
Real commodity prices are anything but stable – they can be dramatically volatile, and on a longer-term view have been trending lower. They are not always the natural inflation "hedge" that many believe them to be – even if it were possible for ordinary investors to own them directly, which it isn't (precious metals excepted). The nickel fiasco at the London Metal Exchange has just weakened a little further the case for owning them indirectly.

## ... BUT NOT YET "STAGFLATION"

Pundits are proclaiming the pending mix of slower growth and higher inflation as the return of "stagflation". They are premature.

### FIGURE 2: CRUDE OIL PRICES

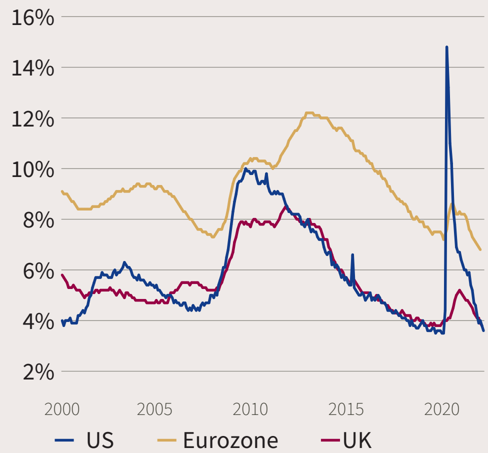
Nominal ($pb) and real (2022 prices, indexed), WTI




Source: Bloomberg, EIA, FRED, Rothschild & Co
Note: Annual data 1870 to 1945; Monthly data Jan 1946 to Mar 2022

### FIGURE 3: UNEMPLOYMENT RATES

LFS basis, %




Source: Datastream, Rothschild & Co

The label was first applied to the decade-long mix of slow growth and high inflation that lasted until around 1983 ("stagflation" = stagnation + inflation). US growth halved and inflation doubled (more in each case for the UK). It lasted a long time, and had been a long time brewing (as noted).

Even if the pending slowdown turns out to be sharper than we think – perhaps because Europe does decide to shun Russian energy more comprehensively, triggering recessions later this year in Germany and elsewhere – there is no reason not to expect a rebound afterwards (again, assuming no horrible escalation in the conflict). We do think (as noted) that trend inflation will be higher, but well below today's headline rates, and on a scale which is unlikely to hurt the real economy and corporate profitability significantly.

If there were to be another stagflationary epoch, wealth managers would face a particularly challenging climate. Poor growth is bad for corporate profitability and stocks, while high inflation is bad for interest rates and bonds (and for stocks too). There would be few places to hide in conventional securities-based portfolios.

## POLICY SETTINGS TO NORMALISE

The big western central banks have belatedly moved further towards our way of seeing things. Today's emergency-level settings of interest rates are simply not necessary, and are likely amplifying that underlying inflation pressure. The curve which the central banks are so far behind is not the one traced in today's money markets – which they after all partially control – but the one that may be embarrassingly visible to the history books.

Admittedly, for a brief period after the invasion it did look as if the need to damp aggregate demand might become less pressing – but as noted, subsequent data have suggested that it has some momentum, and labour markets especially are tighter than the central banks had expected.

The Federal Reserve seems poised to accelerate the pace at which it is raising rates, maybe moving in half-point increments, rather than quarters. The money market curve now shows US rates peaking above 3% in 2023. This is only a "high" rate by the remarkable standards of the last two decades, and in inflation-adjusted terms is likely still to be on the low side of normal.

Even the European Central Bank has now acknowledged publicly that eurozone interest rates ought to be higher, soon: rate increases from July seem likely (with the Swiss National Bank following in due course, unless the franc strengthens further). The Bank of England, which was the first of the big three to move back in December, now appears the most equivocal about the extent of tightening needed – but here too rates seem likely to rise through the rest of the year.

Much prospective normalisation of rates is now priced in to money and fixed income markets. Bonds have (by their standards) had a torrid 2022 to date, but are now (almost) pricing in the sort of ongoing inflation risk we have had in mind: "break-even" 10-year inflation rates are close to 3% in the US, Germany and the UK (the latter after adjusting the implied RPI rate to a CPI basis).

Real yields have also risen, which is why many inflation-linked bond prices have fallen (albeit by less than those of conventional bonds). They are still very low, however: they remain firmly negative in Germany and the UK, and close to (but still just below) zero in the US. This may be where the headroom now is greatest.

The restoration of monetary credibility in the early 1980s saw measures of real interest rates move quickly from being firmly negative to firmly positive. Today's threat to monetary credibility is smaller in scale, and the likely adjustment in real yields and rates ought to be smaller too. But in today's highly priced markets, it could still be unsettling, and not just to bonds.

Nobody knows for sure where exactly interest rates will end up, of course (very definitely including the central banks themselves). But on current economic prospects, we think a material increase from recent levels is needed to maintain monetary credibility and ensure that inflation does indeed stick in the 2–4% range and not spiral higher. Our best guesses at "fair value" 10-year US Treasury, bund and gilt yields remain well above today's market levels – though we realise we may not travel towards them in a straight line.

Small interest rates and big central bank balance sheets are not the only policy settings which need correcting. Fiscal policy is also in play – but here, largely unreported, a process of normalisation is already well underway.

Budget deficits in the US and Europe have been falling faster than official forecasts suggested (again, this will not surprise our regular readers) as economies have rebounded and some tax rates have risen. The cumulative impact will be significant: debt-to-GDP ratios will be lower than feared (Figure 4).

Improved public finances do not (we think) alter the case for higher interest rates materially: they are largely an economic effect, not a cause. What it does mean, though, is that governments may have a bit more room for manoeuvre when we face the next recession (or election – if you think that is a bit cynical, remember that the UK government has already committed to lower income tax rates from 2024).

## INVESTMENT CONCLUSIONS

Stocks are usually volatile, bonds aren't. So to see both global stocks and bonds recently down by a double-digit amount in 2022 to date is remarkable (Figure 5).

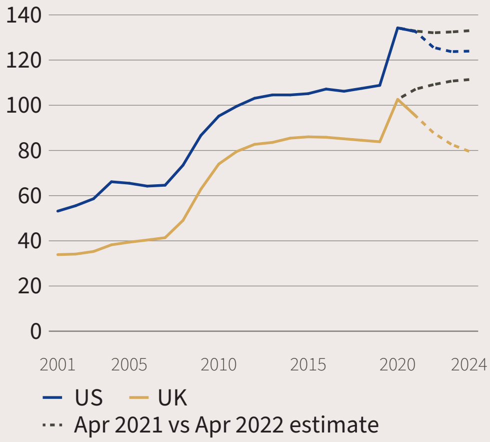
After selling off so sharply, bonds are no longer as fiercely expensive as they were. And as noted above, they may not rise all the way back to "normal" levels in a straight line, in a single cycle. Nonetheless, real yields are still low, as noted, and bonds still seem unlikely to us to be able to deliver inflation-beating returns on a long-term view from here.

Stocks seem still to offer better value – prospective global returns in excess of the 2–4% inflation we expect – but are also vulnerable, tactically at least, to those rising interest rates. Growth may not be especially fragile, but it is slowing against a geopolitically fraught backdrop; and rising interest rates both amplify that cyclical risk and undercut valuations. On the day of the invasion we found ourselves arguing in favour of reducing equity weightings even as markets were falling – a position we have not been in recently (if ever).

In this context, the short-term nominal stability of cash has more going for it than usual. Even at today's inflation rates, consumer prices are less volatile than bonds and stocks. Gold can play a safe haven role too of course, but is volatile in the short term and often struggles when real interest rates are rising.

### FIGURE 4: GOVERNMENT DEBT/GDP RATIOS

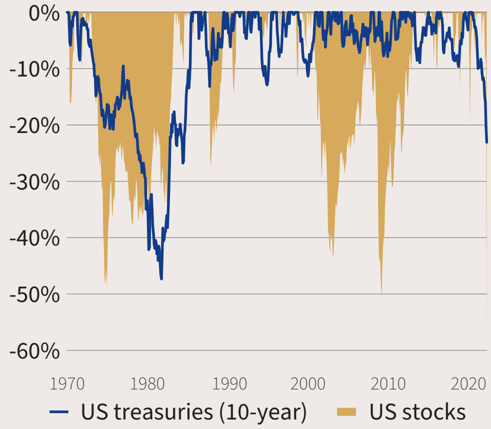
IMF projections: % GDP




Source: IMF, Rothschild & Co

### FIGURE 5: DECLINES FROM PEAK LEVELS

Drawdowns in global stocks and bonds (real, USD, %)



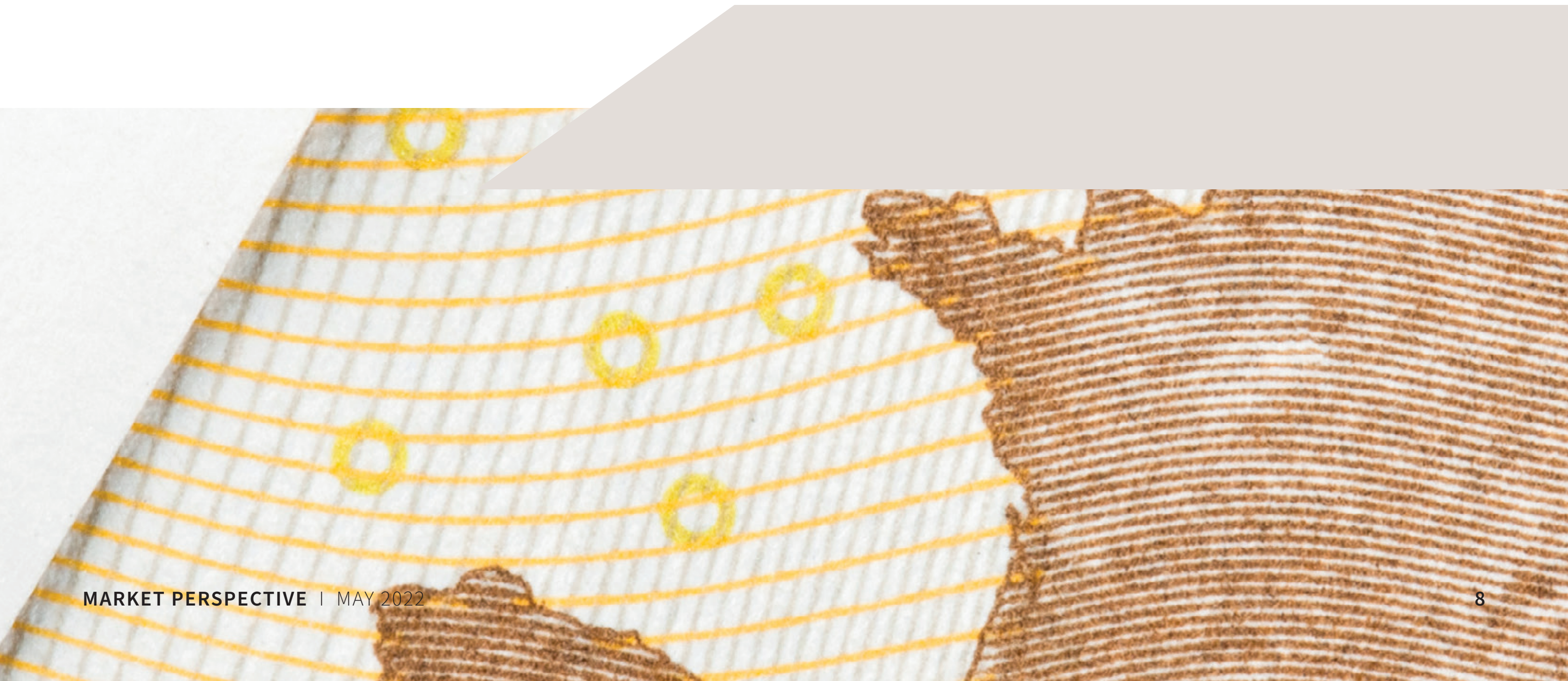

Source: Bloomberg, Rothschild & Co

Currency-wise, the recent strength in the dollar is neither surprising nor outlandish. A mix of elevated global investment risk and a US-led interest rate cycle is a classic backdrop for “the dollar smile”, but the dollar has yet to break decisively out of recent trading ranges against the euro or sterling (it has done so against the yen, but Japan’s capital markets are often special – and not in a usefully predictive way). Generally, foreign exchange markets remain more stable than usual compared to stocks and (especially) bonds.

We rarely advise significant trading positions in currency markets at the best of times, but there is one call we are happy to make: the dollar will remain the main reserve currency for the foreseeable future. China’s currency will continue to become more important, but renewed suggestions that it will supplant the dollar soon are fanciful. This is not a matter of crystal ball-gazing, but rather simple logistics.

If a country is running a structural balance of payments surplus, it is steadily accumulating net claims on the rest of the world. If its capital account is controlled, there is no easy way for those claims to be unwound.

So if the rest of the world wants to make the renminbi its reserve asset, how is it going to get enough of them?



# Commodities and inflation

War in Ukraine has pushed commodity prices higher, and consumer prices with them. The historical echoes are unsettling: the great wave of inflation which did so much damage in the 1970s and early 1980s was also associated with conflict (Arab–Israeli and Iran–Iraq wars) and spiking oil prices. Is inflationary history about to repeat itself?

As argued above, we do think inflation risk is more elevated than for some time, but not solely – or even primarily – on this account. Inflation can trend higher for other reasons, and higher commodity prices alone are unlikely to make it do so. There are several post-WWII episodes in which commodities spiked higher – in some cases because of conflict – without leading to a sustained increase in wider inflation. The main effect was a change in relative prices, which was often subsequently reversed.

Oil is still the most important commodity, but its prominence has faded over time – the energy intensity of the US economy, for example, has declined by two-thirds over the past half century.

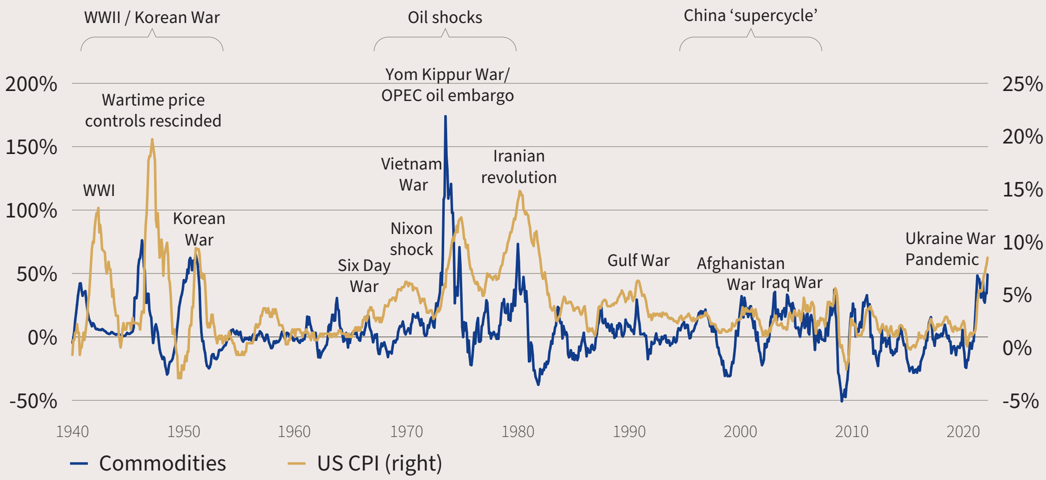
Commodities have a clear relationship with inflation – their prices are quick to reflect changes in economic activity and they are used widely. Food and energy are the most volatile components of consumer price indices, directly representing a fifth of the US basket (33% in the eurozone and 18% in the UK). They also make themselves felt indirectly, as higher input costs for manufacturers, processors and distributors in other sectors.

Commodities are prone to pronounced 'boom and bust' cycles historically. Prices respond quickly to short-term shortages; supply then eventually arrives, typically when demand has faded, leading to glut. Very few commodities are permanently scarce – and even those that are, such as gold, can see their prices fall as well as rise.

Conflict has often caused shortages. There were prominent spikes in commodity prices around WWII; the Korean War; Arab–Israeli and Iran–Iraq wars; during Iraq's invasion of Kuwait; and of course now. But of these, only the two 1970s episodes were followed by a sustained period of above-trend inflation (Figure 6).

**FIGURE 6: CONFLICTS, COMMODITIES AND INFLATION**

Commodity prices (USD) and the US CPI (% y-o-y)




Source: Rothschild & Co

The Vietnam War was part of the gathering inflation storm in the late 1960s and early 1970s, but there was less of a commodity impact. Then more recently, there was a pronounced surge in commodity prices in peacetime – the 'noughties "supercycle" – which had no wider inflation follow through.

Russia is central not only to global energy supplies, but also to a number of key commodities, including metals, such as nickel and aluminium, as well as grains and fertiliser. Ukraine itself is a major grain exporter. With no end in sight to the conflict and western sanctions likely in place for some time, shortages of everything from car batteries to wheat are under threat.

But the shortages may not last. Russia needs key imports, and will try to sell its oil and gas to Asian buyers. There are other suppliers too, and some substitutes, even (eventually) for Russia's natural gas. Work will be underway now into the long-term redirection of Europe's energy demand, away from Russia and pipeline gas, and towards other suppliers, LNG, and perhaps even inorganic energy sources. A second, more dramatic spike in prices cannot be ruled out if Europe decides to act sooner; but how long that would stick is a moot point.

If there were to be a further spike, the special constellation of factors that led to the 1970s inflation are (in our view) not present now. Industrial relations has been transformed; output is less tangible (and so less metal and energy intensive); income levels are higher (reducing the economic importance of agricultural commodities); and – notwithstanding our oft-expressed misgivings, repeated above – monetary and fiscal policies will eventually prove less lax (we think and hope) than they were then.

Superimposed longer term on all this is the growing global imperative to produce and consume more sustainably. In the short term this adds to inflationary pressure – but as the oil (and metal?) ages slowly pass, demand will fade and place real commodity prices under more lasting downward pressure.

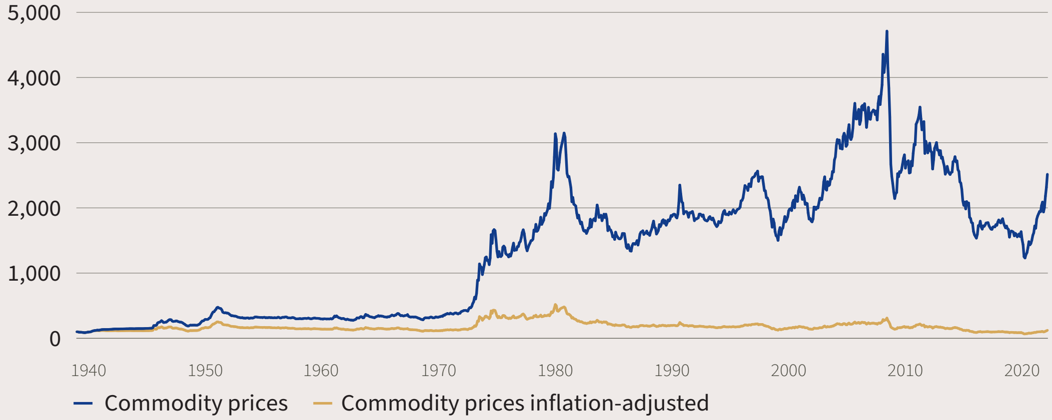
The longer-term outlook for commodity prices likely remains one of softness, then. As noted, scarcity is often overstated, and rather than commodity prices leading consumer prices higher, we suspect the probability is that they will once again start to lag.

Today's apparent cause-and-effect may be the opposite of what will eventually prevail, then. As noted earlier, we do think that inflation will remain firmer than for most of the last quarter century – but not because of commodities. Eventually, it may not be a case of oil prices squeezing real pay, but rather rising pay leaving oil looking steadily less important.

It follows from this that we would not see commodities in general as a long-term inflation "hedge", even if they were as directly investable as the asset allocation textbooks suggest. Investors wanting to capitalise on their booms and busts are best advised to do so indirectly via the stocks of the companies which mine and refine them – environmental budgets permitting, of course.

**FIGURE 7: COMMODITY PRICES: NOMINAL AND REAL**

Indices: US dollars, and adjusted for US inflation. 100 = 31/01/1940

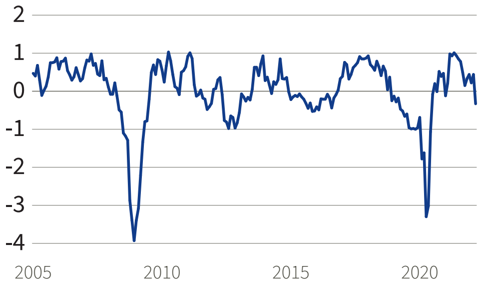



Source: NBER, Bloomberg, Rothschild & Co
Note: Data derived from NBER spot commodity index 1940 to 1960 and Bloomberg spot commodity index from 1960 onwards.

# Economy and markets: background

## GROWTH: MAJOR ECONOMIES

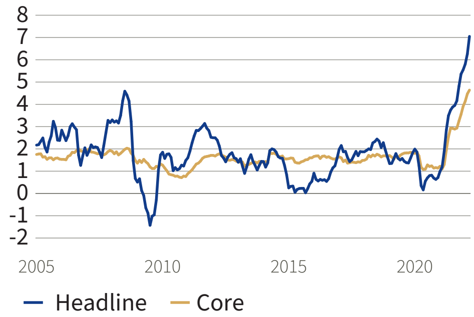
Business optimism: standard deviations from trend




Source: Bloomberg, Rothschild & Co
Composite of the forward-looking components of manufacturing surveys from China, Germany, Japan, UK and US loosely weighted by GDP

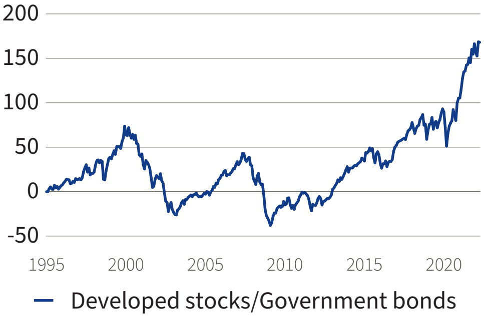
## G7 INFLATION

%, year-on-year



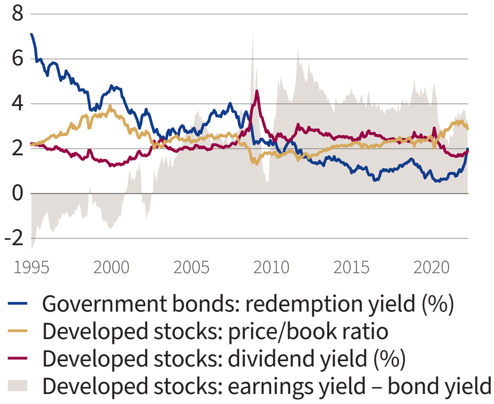

Source: OECD, Bloomberg, Rothschild & Co

## STOCKS/BONDS — RELATIVE RETURN INDEX (%)




Source: MSCI, Bank of America Merrill Lynch, Bloomberg, Rothschild & Co

## STOCKS/BONDS — RELATIVE VALUATIONS




Source: MSCI, Bank of America Merrill Lynch, Bloomberg, Rothschild & Co

## SELECTED BONDS

Current yields, recent local currency returns

| | YIELD (%) | 1YR (%) | 3YR (%) |
|---|---|---|---|
| 10-yr US Treasury | 2.8 | -8.5 | 1.6 |
| 10-yr UK Gilt | 1.9 | -6.7 | -2.9 |
| 10-yr German bund | 0.9 | -8.8 | -7.7 |
| 10-yr Swiss Govt. bond | 0.9 | -7.6 | -8.4 |
| 10-yr Japanese Govt. bond | 0.2 | -0.9 | -1.5 |
| Global credit: investment grade (USD) | 2.5 | -6.5 | 1.4 |
| Global credit: high yield (USD) | 7.3 | -6.9 | 5.0 |
| Emerging (USD) | 6.2 | -12.1 | -2.1 |

Source: Bloomberg, Rothschild & Co

## SELECTED STOCK MARKETS

Dividend yields, recent local currency returns (MSCI indices)

| | YIELD (%) | 1YR (%) | 3YR (%) |
|---|---|---|---|
| World: all countries | 2.0 | -0.4 | 36.3 |
| Developed | 1.9 | 2.1 | 40.1 |
| Emerging | 2.8 | -16.9 | 11.2 |
| US | 1.4 | 1.6 | 51.3 |
| Eurozone | 2.7 | -3.5 | 14.8 |
| UK | 3.9 | 15.4 | 13.6 |
| Switzerland | 2.5 | 9.5 | 30.0 |
| Japan | 2.4 | 2.0 | 27.6 |

Source: Bloomberg, Rothschild & Co

## SELECTED EXCHANGE RATES

Trade-weighted indices, nominal (2000 = 100)

| | LEVEL | 1YR (%) | 3YR (%) |
|---|---|---|---|
| US Dollar (USD) | 113.7 | 7.6 | 4.7 |
| Euro (EUR) | 124.7 | -5.1 | 1.0 |
| Yen (JPY) | 78.1 | -13.2 | -13.9 |
| Pound Sterling (GBP) | 80.8 | -0.4 | 2.7 |
| Swiss Franc (CHF) | 172.4 | 4.6 | 11.7 |
| Chinese Yuan (CNY) | 146.5 | 7.7 | 9.0 |

Source: Bloomberg, Rothschild & Co

## COMMODITIES AND VOLATILITY

| | LEVEL | 1YR (%) | 3YR (%) |
|---|---|---|---|
| CRB spot index (1994 = 100) | 308.0 | 53.7 | 66.8 |
| Brent crude oil ($/b) | 107.6 | 59.9 | 49.1 |
| Gold ($/oz.) | 1,888.7 | 6.4 | 46.9 |
| Industrial metals (1991 = 100) | 429.2 | 29.4 | 72.6 |
| Implied stock volatility: VIX (%) | 30.0 | 73.6 | 135.6 |
| Implied bond volatility: MOVE (bps) | 128.7 | 113.5 | 160.5 |

Source: Bloomberg, Rothschild & Co

Data correct as of 30 April 2022.

Past performance should not be taken as a guide to future performance.

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