

Another boost to reflation

Paris – June 13th, 2022

The dramatic war in Ukraine has been a major disturbance to world peace, a reminiscence of the cold war everyone could have hoped was behind us for good. It has also been a major headache for investors, left guessing the consequences of this conflict in a globalised world where every country needs other countries! No wonder, the worst is feared in such circumstances where geopolitics takes over the existing economic, business and social order. Passed the shock though, the economic reality tends to come back advocating for more pragmatism in the reaction to the conflict and its chain of consequences. Time has come to look deeper into the situation now that this feedback loop between politics and economics has taken place.

The first observation is that governments are keen to do “whatever it takes” to isolate people from any hardship coming from the geopolitical decisions taken against Russia. Subsidies, tax breaks, minimum wage increases, and one-off transfers rolled-over-as-long-as-necessary are common place, so that the shock to purchasing power from the conflict is by and large mitigated to the minimum. **As during Covid, more will be done if needed. This means that *ex ante* concerns related to the potential shock to purchasing power are largely misplaced, as confirmed by business surveys so far.** In the euro area, for example, initial expectations of a negative second quarter for GDP (Gross Domestic product) have swiftly returned to positive on the back of these resilient surveys.

The second observation is the incredible - and often overlooked - momentum that the world economy was displaying before the Russian invasion of Ukraine. Most of the commodity price shock has taken place in Q4 2021. The conflict has contributed to extend this dynamic from already elevated prices. Of course, specific commodities have shot up directly as a consequence of the conflict, but **the bulk of commodity inflation pre-dates the conflict.** This inflation push was itself the direct consequence of the world’s historical strength in demand in Q4 2021 that continued in January-February 2022. This is very important when assessing the economic trajectory post conflict. **Before the headwinds from this war arose, the world economy was cruising well above the speed limit.** Such high-speed train cannot be stopped so easily.

The strength, timing, and extent of economic revival post-Covid have been systematically under-estimated since April 2020. Today is no different. As usual way of life were being disrupted by the Covid crisis, forcing most people to curb their consumption of goods and services for a prolonged period of time, around 8% GDP-equivalent of Covid excess savings are still mostly there to be spent at any time by billions of individuals across the world. Labour markets are red hot in almost all the countries at the same time, an exceptional situation of quasi-full employment worldwide. This means that real wages, on aggregate, cannot decrease, beyond the initial shock, and should even continue to increase, leading the purchasing power of labour income to improve eventually, not decrease as expected by most today. Scattered sectoral evidence in Europe, including Germany, is already showing signs of this. One-off bonus payments in the spring are already generating labour compensation in tune with higher inflation, and this happened before the coming multi-year negotiations in the fall.

These talks will take place in the context of an elevated and persistent inflation. The only question should be how strong real wages will turn out to be this year.

A key feature of the observed Covid crisis-induced excess savings is its pro-cyclical / convex nature. Periods of Covid restrictions could be seen, from a purely macroeconomic standpoint, akin to ‘paid holidays’ during which one could not do much: with restrictions on our ability to move, travel or enjoy goods and services outside our homes, it mechanically led many households to reduce their consumption rate and accumulate their income in the form of above-average savings. Therefore, large fiscal transfers have been mostly saved not only due to uncertainty, but also because there were not that many alternatives. The so-called fiscal multiplier has been particularly weak as a mechanical consequence of physical restrictions. Now that these restrictions are by and large being lifted, there are plenty of things to do. Doomsayers in the heat of restrictions predicted no return to normality post-Covid. Well, evidence is showing the opposite. Not only travelling around the world is swiftly returning to normal, but people are, on aggregate, also keen to indulge themselves in anything they do following this period of sanitary stress and restricted freedom. Covid-excess savings conveniently offer extra means to do so.

Pro-cyclicality to the upside should be expected to continue, sustaining demand for the foreseeable future, with upside risk due to convexity, as the better the situation, the more likely one is inclined to spend past forced savings.

The war in Ukraine has generated transitory headwinds to a fast-track world economy. So far, although not immaterial, economic softness has been limited. **Active fiscal support will likely keep it that way in the short-term. More importantly, the war has also generated a sense of urgency regarding energy security and energy transition.** At the macroeconomic level, this is a huge medium-term positive shock for demand, and one that should maintain pressure on commodity prices. Indeed, capital needs are enormous, sustained over years if not decades, and rather commodity intensive. The war in Ukraine has moved fossil fuel from villain to super villain, contributing to speed up what was already the big plan, especially in Europe. Fast-pace energy transition is beginning now and nothing will stop it as it has become priority number one for society. **Combined with the large left-over from Covid excess savings, this leaves the world economy exposed to a sustained demand shock in the short, medium, and possibly long term.** Sustained demand is the reason and the necessary condition for higher and lasting inflation. Dealing with inflation remaining well above target is a major challenge for Central Banks, but also for investors currently stunned by a high level of uncertainty.

The current high degree of economic uncertainty is warranted, as the situation is truly exceptional. “This time is different” is a sure way to follow the wrong path, but the problem is what one means by “this time”. Looking at the history of the past decades, the mix of inflation, unemployment rate and curve shape is strongly pointing towards a high probability of recession in the next year or two. This is the positive statistical approach inferring from the past what is likely to happen in the future. Its track record is well established, but its robustness depends on the current situation being somewhat captured by the historical sample. For example, the oil shocks of the 70s were completely misunderstood at the time because they were new circumstances never experienced in the previous decades. **Today, economic circumstances are completely out of the range of the past decades. Covid restrictions and their aftermath are many standard deviations away from history.** This is dramatically and objectively different. What is most probably “not different this time” is the way the economy works. Plugging into a normally functioning world economy the initial conditions of full employment and large excess savings (commensurate to the magnitude of the Covid recession itself) leads to a very low probability of recession in the next two years.

These completely opposite signals for the coming economic trajectory are genuinely puzzling, but they boil down to one single question: are the Covid recession, the policy reaction, the V-shaped recovery, and its legacy in terms of excess saving truly exceptional? If you believe so, expect growth and high inflation to persist for the foreseeable future with now further upside risk from a hastened energy transition. **While investors should find some comfort in such reflationary scenario, life will not get easier for Central Banks.**

Edited by H2O AM in Paris in June 13th, 2022

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