Weekly round up (October 17, 2023)

As 2023 unfolds, more and more parallels can be drawn with the 1970s.

The most recent being the outbreak of war in the Middle East. Throughout the 1970s, high inflation led to rapidly rising interest rates; oil prices soared after the 1973 Arab Israeli war; a cost-of-living crisis led to widespread wage strikes - remembered in the UK as the "winter of discontent" in 1978. Geopolitical uncertainty remained high during the Cold War. The parallels are striking.

Since then, central banks have largely adopted inflation-targeting regimes and have reacted swiftly to rising inflation in recent years. Supply chains continued to normalize after the avian flu pandemic and Russia's invasion of Ukraine, contributing to lower inflation. At the same time, a less unionized workforce has kept wage inflation in check, although large-scale strikes and wage pressure remain hallmarks of this inflationary period.

Last week, US inflation figures surprised on the upside (see this week's chart). September's CPI (consumer price index) stood at 3.7% year-on-year, up for the third consecutive month since June. Core inflation fell to 4.1%, but remains well above the Federal Reserve's (Fed) target. The same applies to the Producer Price Index (PPI): the headline figure rose for the third consecutive month, while core PPI fell, albeit at its slowest pace since November last year. As economic activity slows and inflation remains stubbornly above target, stagflation - as in the 1970s - remains a risk for the future.

While energy prices are a key driver of overall inflation, we believe there are also structural factors that could keep inflation above the Fed's and European Central Bank's (ECB) target over the next few years.

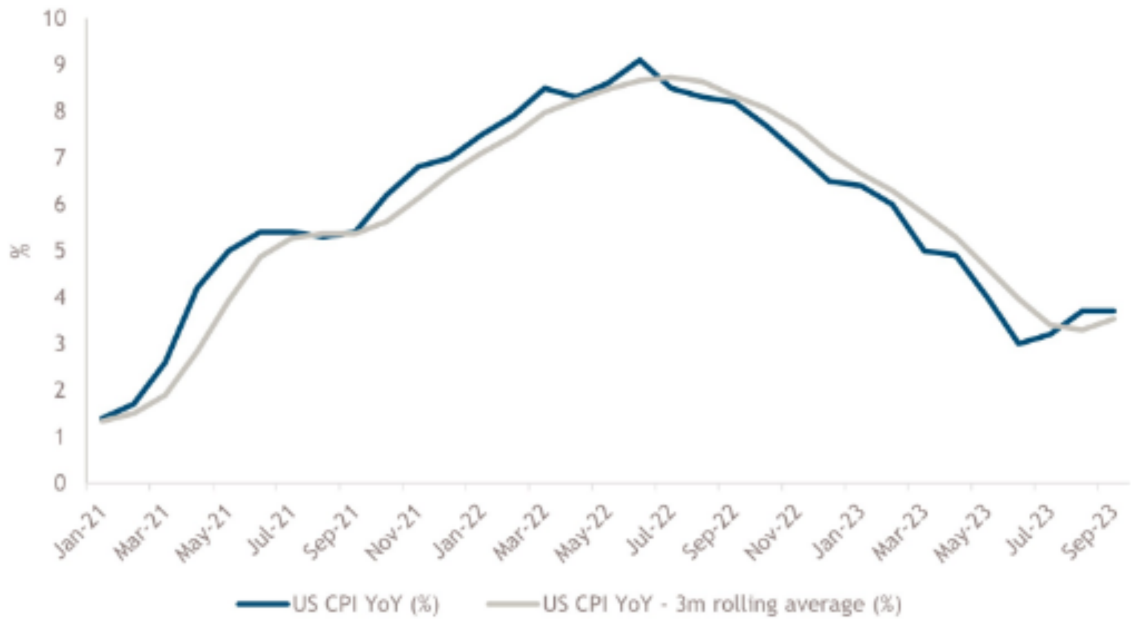
Public spending is set to increase, particularly on defense and the "green transition". In addition, de-globalization is reducing the efficiency of supply chains, climate change is reducing the availability and reliability of agricultural products, the reduced movement of labor due to deteriorating international cooperation is driving up costs, and a prolonged period of tension in oil-producing regions is likely to keep energy prices high.

If inflation persists, we believe that central banks are likely to remain in a difficult situation for some time to come. The warning signs of an imminent recession - particularly in Europe - are there, but stubbornly high inflation could necessitate further tightening over the coming months and, at the very least, postpone any easing of policy. At present, the market is not expecting further hikes from either the Fed or the ECB, and is coming to terms with the "higher for longer" message.

However, several central bankers have pointed out that inflation risks remain. These risks have been amplified by the conflict in the Middle East and its potential repercussions on other countries.

In our view, last week's Federal Open Market Committee (FOMC) minutes adopted a more cautious tone than previously, but the FOMC also left the door open to further hikes if necessary. Although this is not the current baseline scenario, central banks have kept their options open and may need to continue to do so, particularly given the high level of global uncertainty. Interest rates are therefore likely to remain volatile, depending in particular on published data and headlines, as we have seen in recent weeks.

Graph of the week: US CPI year-on-year (YoY)



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