

Why did the central banks get it so wrong?

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At a client meeting this week we were asked why the central banks have made such a hash of managing inflation over the past two years. This is an interesting question to us, as we believe the answer to this question is rooted in the global response to the financial crisis of 15 years ago.

It was the lessons learned from the 1930s Depression era by the eminent scholar of the period, Ben Bernanke, who also happened to be the Governor of the Federal Reserve at the time of the 2008 financial crisis, that led to the policies of zero interest rates and an experimental central bank policy which acquired the sobriquet, Quantitative Easing, or QE.

Why QE and zero rates?: because the productive capacity of the world economy at that time was larger than the economy could absorb at the prevailing price levels. Thus, money was appreciating relative to the supply of goods and services leading to depressed demand via higher savings and deflation as firms lowered prices to stimulate sales and consumers waited for prices to drop further. Remember, that the financial crisis struck while Globalisation was still effective and the manufacturing capacity of vast labour forces in Asia were driving deflation.

The policy was designed to prevent recession turning into depression and to provide a “bridge” back to a more normal economy where supply and demand were in some equilibrium indicated by a stable rate of inflation of 2% – the de facto global inflation target.

In the short-run the policy was successful; in the long run it is too early to tell.

What is now the case is that fifteen years after the financial crisis, the world is saddled with major financial imbalances, bloated central bank balance sheets, and two, perhaps three, serious supply shocks impairing the productive capacity of the world economy: Covid, the Ukraine war, and Sino-US decoupling and broader fracturing of global supply chains (exacerbated in the UK by the withdrawal from the single-market and customs union).

The result is that “money” has been depreciating relative to the supply of goods and services provided by the world economy: inflation has returned after a long absence.

A great deal has been written recently about the distress caused principally to young, often heavily mortgaged homeowners, as interest rates have risen to bear down on rising prices. Bluntly, central banks led by the US Federal Reserve, are trying to “shrink” the economy to a point at which demand equals supply, and prices broadly stabilise.

Here is the good news: the medicine is beginning to work. In the US, the most recent inflation release, the index of Personal Consumer Expenditures (the Fed’s preferred measure of domestic inflation) had dropped from 8.5% in September 2022 to 4.4% today.

So-called “Core” inflation is moderating and not just in the US. Some of the key drivers of the “cost of living” crisis are beginning to go into reverse. Since the peak induced by the Ukraine war the cost of natural gas has dropped by 90%, lumber by 76%, wheat by 51% and oil by 40%. Other base commodity prices have fallen by similar amounts. Ironically for us as investors, interest rates not being close to zero is a return to more normal times. Benchmark interest rates are once again, after a long lacuna, a reasonable guide to valuations across the asset class universe. The cash flows available to investors from other assets such as equities and credit are now paying a ‘risk premium’ for investors to hold them whilst they wait for the official inflation numbers to show us that the central banks have done their job for this cycle. Trying to

time when this will be and how asset prices will react is not predictable; what is predictable however is that the risk premia associated with strongly cash generative assets will fall (and prices will rise).

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