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Macroeconomic Comment

Delayed tightening of monetary policy accompanied by a weakening of the global economy

August 26, 2022, Peter von Elten

The **striking recovery of stock markets on both sides of the Atlantic in July** raises the question of whether a sustained upswing on the equity markets can now be expected after the significant correction in the first half of the year. Leading U.S. banks such as Goldman Sachs, Morgan Stanley and JP Morgan Chase & Co. tend to view the rise in stock prices that led to an increase in value in the U.S. stock market of about USD 7 trillion in July as a rally within a bear market that is still underway. They argue that the unwinding of short positions by leading hedge funds was a key driver of the bull market.

If anything, the geostrategic risks to the global economy have increased with the political and military confrontations over Taiwan. China's declared "unlimited partnership" with Russia and the practical undermining of Western sanctions through increased purchases of Russian energy products has further intensified the rivalry between the two superpowers, the United States and China. The still noticeable effects of the pandemic and the aftermath of the Ukraine war continue to lead to significant restrictions in global trade, as well as to cost increases and efficiency losses in global value chains. The tightening of monetary policy urgently needed to combat inflation comes at a time when the global economy has already cooled significantly. However, inflation rates of over 10%, as feared in several major European countries in the fall and possibly also in the USA, are forcing central banks to give priority to combating inflation over growing risks of recession.

The slowdown in the global economy is being led by **China**, the previous growth guarantor. China hardly grew at all in the second quarter. Consumers as well as domestic and foreign investors are highly unsettled by the zero-covid policy and further government intervention in economic activity. In contrast to Western countries, China is cutting its key interest rate to boost weak demand for credit. This increases downward pressure on the Renminbi while boosting exports, which provide modest growth alongside state-driven investment in infrastructure. Domestically, the weakening real estate market, high youth unemployment of over 18% (National Bureau of Statistics / for youth aged 16 to 24) and rising budget deficits are weighing on the economy. Despite growing discontent among the population over the zero-covid policy as well as losses in the real estate market, Xi Jinping's re-election for a third five-year term this fall is considered safe. His promise of "common prosperity" will be a central theme of the party congress.

The **US labor market** continues to boom, resulting in an unemployment rate of 3.5% in July. Almost twice as many job openings as unemployed persons were reported. Wages have risen by more than 5% in the course of the year. Against the backdrop of record-high employment, it seems contradictory that the U.S. economy contracted slightly in the first half of the year and thus fell into a technical recession. Companies have anticipated a slowdown in consumption due to high inflation, currently around 9%, and have scaled back their inventories. The strength of the labor market is driving the Federal Reserve to tighten interest rate policy to nip a dangerous wage-price spiral in the bud. Influential observers are calling for a key interest rate that exceeds the central bank's projected rate of 3.25% by the end of the year in order to bring inflation back to a tolerable level even at the expense of a recession.

President Biden has been able to pass a package of significant measures in recent weeks despite continued high hurdles in working with Republicans:

- The Chips & Science Act, which provides over USD 50 billion in subsidies for investment in the expansion of the U.S. semiconductor industry, plus additional tax breaks. A further USD 170 billion is available for research & development. This is intended to counter the migration of the chip industry to Asia.

- The "Inflation Reduction Act", which is the most important climate law in the USA and is expected to mobilize around USD 370 billion for a 40% reduction in CO2 emissions by 2030 (compared with 2005 levels). Furthermore, improvements in the social network are planned, such as investments in health care and relief for taxpayers through measures to reduce energy costs. A new minimum tax for companies will provide partial financing.

- The Bipartisan Infrastructure Law allows for nationwide funding of an estimated USD 550 billion in infrastructure measures.

The above programs should put the U.S. in a strong position to compete globally after a possible recessionary phase, regardless of the outcome of the midterm elections on November 8 (latest polls suggest a Republican victory).

The war in Ukraine as well as the geographic proximity to Russia, energy dependency, the need for rearmament and the management of refugee flows present **Europe** with unprecedented challenges that will most likely lead to a recession. At the same time, political decision-making capacity in key European nations is weakened by upcoming eleeurctions or fragile majorities. In times of crisis, it becomes clear that the European monetary community, which has been bridled from behind, is always in danger of breaking apart without flanking political and fiscal union. In order not to jeopardize the debt sustainability of some southern European countries, the ECB is only

very hesitantly resorting to the necessary medicine of interest rate hikes in the fight against inflation and is launching another program that allows for the unlimited purchase of government bonds of the weaker Euro countries.

The resulting weakness of the Euro is more than a temporary phenomenon; it should also be interpreted as a visible sign of Europe's relative decline in the struggle of world powers for economic and geopolitical dominance.

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Mr. von Elten has decades of experience in the banking industry. Since 2008 he has been a member of the advisory board of BSZ AG, which took over IFP AG in 2014 and thus became Belvoir Capital AG. He enjoyed an international career at JP Morgan for close to 30 years. He returned to Switzerland as General Manager of Schroder & Co Bank AG from 1995 to 2003. Furthermore, Mr. von Elten's passion is art; he is a co-founder of the gallery Elten & Elten.

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