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Macroeconomic Comment

Further slowdown in the global economy

July 27, 2022, Peter von Elten

The global economy remains in the grip of further rises in inflation, forcing central banks to take more significant interest rate steps. The still existing after-effects of the pandemic in the form of distortions in the global supply and demand structure are again exacerbated by the distortions in the energy and food sectors as a result of the Ukraine war. As explained below, the growth locomotive China is also temporarily largely out of action due to zero-covid policies and other homegrown problems. Europe is suffering the most from the consequences of the war due to its geographic proximity to Russia and its energy dependence, and is proving to have only limited political capacity to act in this critical phase. The US is experiencing stubborn inflation, not least because wages are rising more sharply due to a widespread shortage of personnel. Even the relatively strong dollar, which is having a favorable impact on import prices, is unable to offset inflation. Many developing countries are particularly affected by the strength of the dollar and rising interest rates, so bonds issued by these countries are increasingly at risk of default.

The **financial markets** are reacting with a **market shakeout** in the major asset classes. Extremely expansionary monetary and fiscal policies to overcome the financial and economic crisis of 2008 have led to ultra-low interest rates and soaring government debt, leaving the financial system fragile. The glut of liquidity at zero interest rates has allowed bubbles to form in equities, bonds and real estate, which remained under control as long as interest rates and inflation remained at historically low levels. The fight against the pandemic with an additional global money creation of about USD 8 trillion, as well as severe distortions in global supply and demand behavior due to the pandemic and the Ukraine war, may ultimately have been the trigger for the significant increase in inflation. Combating this phenomenon is proving particularly challenging due to the fragile financial system, as illustrated by the reluctance of central banks to raise interest rates. In contrast to the oil shocks of the 1970s, when the USA accepted recession by drastically raising interest rates above the rate of inflation, the goal of central banks and governments today must be to let the air escape from asset prices in as controlled a manner as possible through moderate interest rate hikes in order to avoid a cascade of major credit defaults and corporate bankruptcies. Whether the soft landing of the global economy can succeed will depend heavily on further monetary policy and the severity and duration of the war. Although inflation is expected to peak soon, the belated start of monetary tightening is likely to continue for several months. Belvoir Capital went into more detail about the challenges ahead in its Q2 2022 report.

The Ukraine war has brutally exposed **Europe's dependence** on the military strength of the USA and on raw materials from Russia. In both cases, the necessary disengagement can only be achieved in the medium term; it will be associated with high costs as well as political tensions within Europe. The brutal destruction of the infrastructure, the management of the refugee flows and the subsequent reconstruction will pose a major challenge to European solidarity. At this time of all times when decisions are being made that will determine the future, the political ability to act is severely limited in important European countries such as Italy (Draghi's resignation and new elections in September), France (Macron's loss of his parliamentary majority), Germany (programmatic differences within the governing coalition) and the United Kingdom (Johnson's resignation and appointment of a successor in September).

The financial markets are responding to the flare-up of the euro crisis with a **significant weakening of the euro**. The European Central Bank has responded to the rise in inflation and the weakness of the currency by raising interest rates by 0.5%, but at the same time announced an instrument to control interest rates. Through targeted bond purchases, the "transmission hedging instrument" is intended to prevent the interest rate gap between highly indebted countries such as Italy and economically more robust economies within the euro zone from widening. This is seen as a further and legally controversial step toward the communitization of debt in the euro zone.

In addition to the above-mentioned dependencies, competition with or **dependence on China** is developing in the **new world of renewable energies and e-mobility,** in which Europe wants to play a significant role. In the so-called "green" metals copper, nickel, rare earths and lithium, China has become the **world market leader in renewable energies** by a wide margin through its own extraction or securing of resources and their processing.

The strong base on future issues and **China**'s geopolitical strengthening from the Ukraine war, which is driving Russia into China's hands, contrasts with the current **economic situation**. Three far-reaching decisions by President Xi Jinping weigh on the current situation:

- The **zero-covid policy** has led to massive lockdowns and a collapse in economic activity. More than 200 million people are still in lockdown. Economic growth in the first half of 2022 was only slightly more than 2%, accompanied by horrendous budget deficits (equivalent to about USD 750 billion according to Bloomberg). The projected economic growth of 5.5% will be missed by a wide margin despite the government's expected stimulus measures.

- Xi Jinping has **broken the grip of leading technology companies such as Tencent and Alibaba**, forcing them to align themselves more closely with the party's long-term goals at the expense of profitability. The prices of these shares, which are also very popular internationally, have now more than halved.

- In the fight against rampant corporate debt, Xi Jinping has **restricted access to credit**. This has **hit the real estate sector**, which is so important in China, particularly hard. More than 20 large real estate companies are said to have been driven to the brink of collapse as a result. The most prominent example is the insolvency of Evergrande, which has the equivalent of USD 300 billion in debt. The sharp slump in the real estate market in particular is proving especially threatening to the Communist Party because Xi has propagated "shared prosperity" as the core of China's social contract, and real estate ownership is the most important asset base of households.

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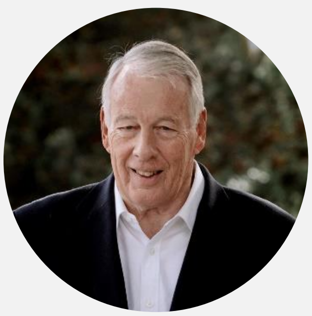

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Mr. von Elten has decades of experience in the banking industry. Since 2008 he has been a member of the advisory board of BSZ AG, which took over IFP AG in 2014 and thus became Belvoir Capital AG. He enjoyed an international career at JP Morgan for 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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