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The return of Stop-Go. **Investment Strategist Peter Lucas considers recent moves in markets, inflation and the likely return of that other relic of the past: stop-go economics.**

The past few months have been kind to my negative views on bonds and growth shares, but not so much my cautiously optimistic view on equities more generally and my negative view on the US dollar. All these things are very much connected. The Russian invasion of Ukraine caused food and energy prices to spike, incurring the wrath of consumers and politicians. Stung into action, the Fed started talking about getting rates to 2-3% in increments of 0.5% or even 0.75%. Bond investors took fright, with yields rising at their fastest rate since the nasty bond bear market of 1994. Growth shares, with their heightened sensitivity to rising bond yields, have experienced their biggest drawdown since the COVID collapse of 2020. Value shares have held up better but have also struggled as the outlook for the economy has darkened. And finally, a combination of rising risk aversion, widening bond yield differentials and shifting terms of trade have caused the dollar to strength dramatically against other developed world currencies.

This latter point deserves more explanation. The negative dollar call was predicated upon a benign economic backdrop and very uncompetitive real US interest rates. All that has changed in recent months, due in no small part to the invasion of Ukraine:

- Real interest rate differentials moved in the dollar's favour, partly because of rising inflation elsewhere (most notably Europe) and because of tighter monetary policy in America. Meanwhile, other central banks have not followed the Fed's lead, either because they want inflation to go up (Japan) or because they can't tighten policy for fear of unintended consequences (Europe). For many years the ECB has successfully maintained the integrity of the euro by pledging to do "whatever it takes" to defend it, but in an environment of high inflation that is looking more and more like an empty threat.
- Europe and Japan are more reliant on food/energy imports than America, and hence recent price trends have been to their detriment.
- The dollar has benefited from safe-haven flows, particularly from Europe.

The view on the dollar from here depends on one's time horizon:

- Short-term, with equity markets and economic indicators flagging a significant economic slowdown, it is surely only a question of time before we find that the Fed is not as hawkish as they would have us believe. And if the Fed hesitates, bond yields and the dollar will likely fall.
- Medium term, any easing in inflationary pressures should prove to be fleeting, in which case the Fed's attention will switch back to fighting inflation from protecting jobs. Bond yields will rise, dragging the dollar higher in their wake.
- In the long run the dollar should weaken due to its overvaluation and America's twin deficits (budget and trade). Furthermore, the decision to sanction Russia and its Oligarchs will surely lead to many reconsidering their policy of routinely parking money in the dollar and US financial markets. That cannot be healthy for the long-term future of the US dollar and US financial assets more generally.

Incidentally, the euro may also be vulnerable in the long run, if, as seems likely, the internal contradictions that stem from the euro being a currency without a country prove too much for the ECB to handle in an environment of poisonous geopolitics and stubbornly high inflation.

With most investors now expecting the Fed to raise interest rates 'until something breaks', if in fact they lose their bottle, the market reaction could be dramatic and broad-based. Growth will like lower bond yields and Value will like the brighter (or less bad) cyclical outlook. Certainly, comparisons of the chart patterns of today's speculative growth stocks with the technology bust of the early 2000's suggest that a rally is probably at hand, albeit that more downside probably beckons beyond the next few months. Gold should be another major beneficiary of this scenario.

Developed world policy makers would ideally like to get inflation down without hurting the economy and jobs, but in an environment of challenging geopolitics, high debt levels, overvalued markets, angry voters, and unhelpful demographics that is probably wishful thinking. More likely, they will be forced to choose, giving priority to what they see as being the most pressing problem of the day. Right now, it is inflation, but before too long it will probably be growth. Welcome to the new era of stop-go economics!

Peter Lucas

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