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Contents

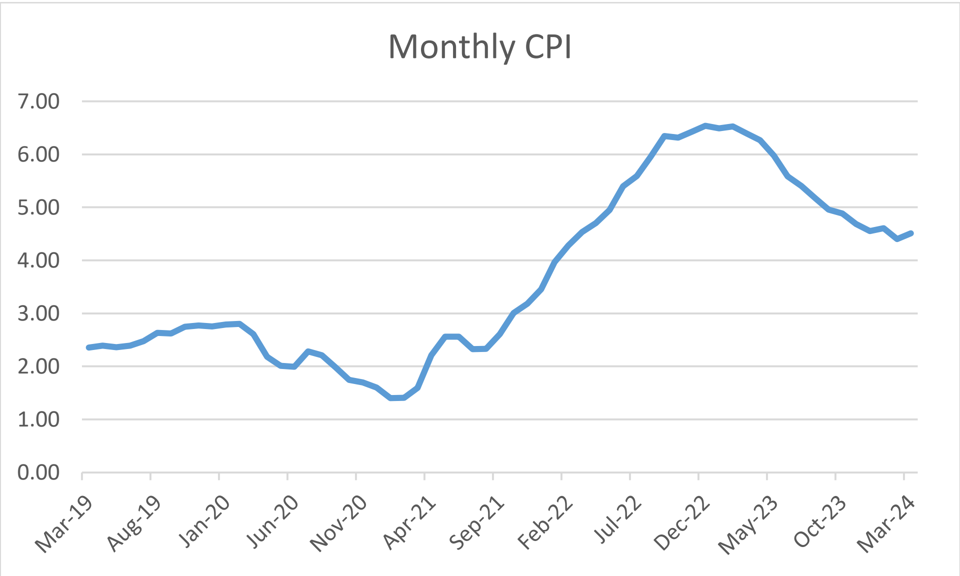
1. Introduction

The recent increase in commodity prices, following Russia's invasion of Ukraine, has worsened the already high inflationary pressures. A recent CEPR Policy Insight suggests that in the medium term, as recent shocks subside, inflation is projected to gradually decrease and align with target levels. However, it is important to consider the significant risks to this forecast, as exemplified by the Great Inflation of the 1970s. With inflation staying high, there is an increasing possibility that advanced economy central banks may have to implement a more aggressive policy response than originally expected in order to bring inflation down to its target level.

2. Today's inflation in the US: A DeJa'Vu of the Greate Inflation

2.1. What today's inflation recalls us from the Greate Inflation?

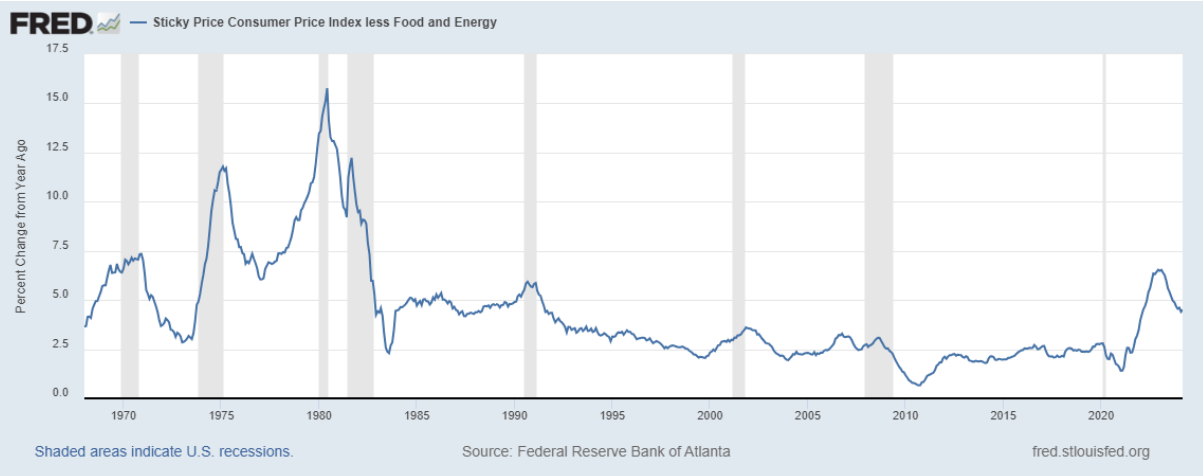
Considering the events of the 1970s, the argument for an extended period of elevated inflation is clear. The supply disruptions caused by the epidemic and the recent supply shock resulting from the war in Ukraine are similar to the oil shocks that occurred in 1973 and 1979-80. Furthermore, both in the past and at present, monetary policy has been quite accommodating leading up to these unexpected events.



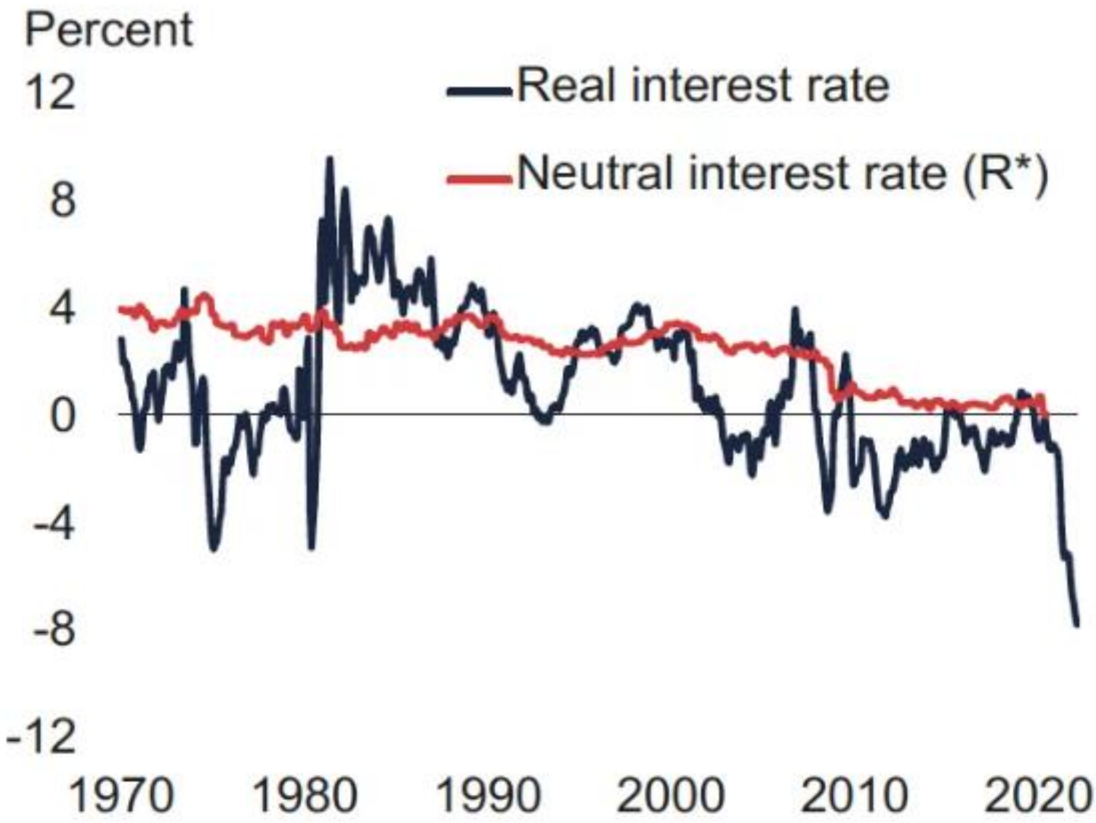
Following a period of inflation that exceeded expectations in major advanced economies for several months, it may now be necessary to implement a more aggressive policy tightening in order to bring inflation back to the desired level. This might potentially result in a severe economic downturn comparable to that experienced in the early 1980s.

2.2. Differences from the 1970s

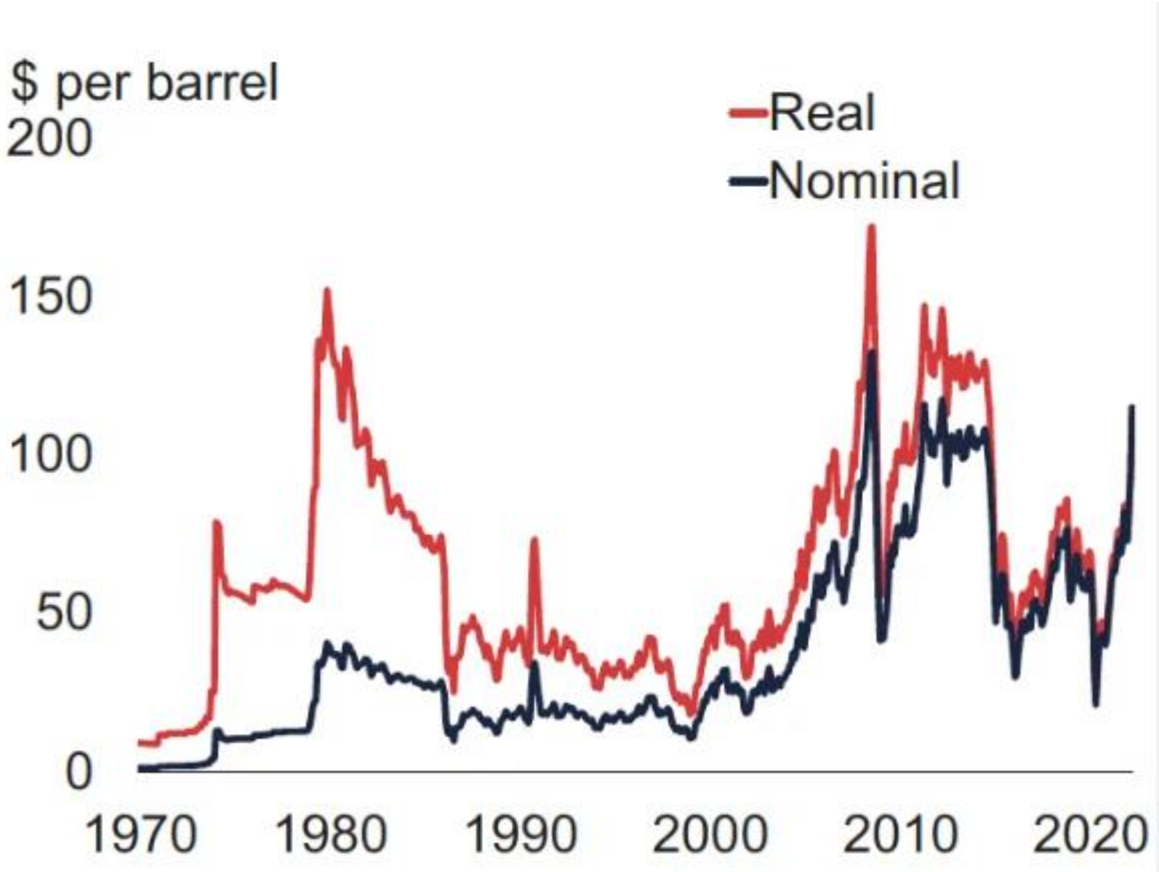
Significant disparities exist between the present circumstances and those of the 1970s. Currently, the extent of increases in commodity prices has been comparatively smaller than those experienced in the 1970s. Following significant oil shocks, the prices of oil increased fourfold in 1973-74 and doubled in 1979-80. The occurrence of 'stagflation' was a result of the simultaneous presence of high inflation and sluggish economic growth, which was exacerbated by recurring supply shocks (Lee, Olasehinde-Williams and Özkan, 2023). Currently, oil prices, when adjusted for inflation, remain at approximately two-thirds of the levels observed in 1980 or 2008.



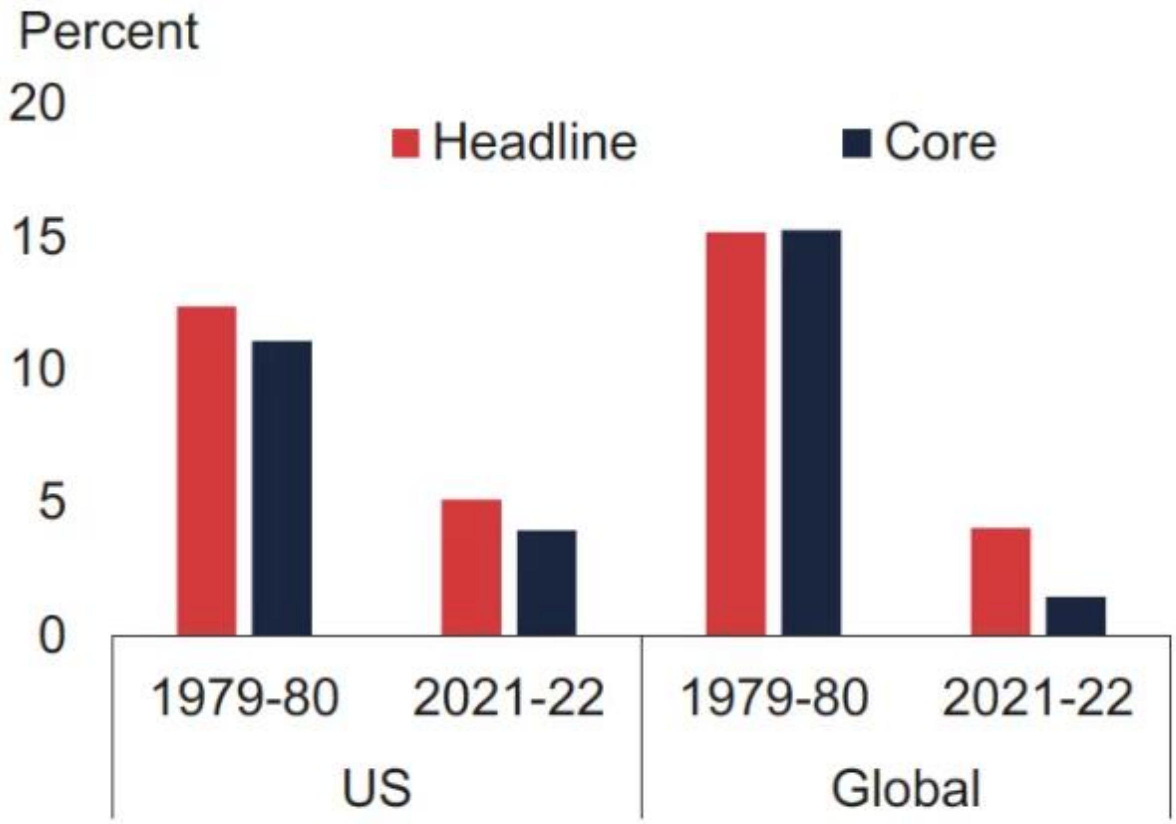
Furthermore, there has been a significant change in monetary policy frameworks since the 1970s. In the 1970s, central bank mandates encompassed other conflicting aims, such as output, employment, and price stability, rather than the current predominant emphasis on inflation (Kim and Lin, 2023). Following their liberation from the Bretton Woods system of fixed exchange rates in 1971, most central banks in industrialized nations sought to stimulate economic activity by monetary expansion (McGurk, 2020). However, they failed to see that the rate of potential production growth had begun to decline. Policymakers tended to attribute the increase in inflation to specific sources, while underestimating the widespread and long-lasting effects of excessive aggregate demand pressures.



This policy of maintaining a passive approach to monetary matters led to a prolonged period of inflation that increased over several decades and remained consistently high. The global median inflation rate began the 1960s at a modest 1.5%, but subsequently experienced a strong upward trend, ranging between 1.5% and 4.7% during the decade (J Li et al., 2023). By 1970, the percentage had reached 5.5% and thereafter increased within the range of 5.5–14.4% during the 1970s, ultimately peaking at 14% in 1980 (Xu et al., 2022). Currently, worldwide inflation has surpassed pre-pandemic levels only in the recent past, starting from mid-2021. The average inflation rate for 2021-22 is 5%, with a spike to 7% in March 2022. However, based on model estimates and consensus expectations of Batten and Szilagyi (2022), it is anticipated that global inflation may increase to about 10% in the next months before it begins to decrease.



On the other hand, central banks in developed countries currently possess well-defined objectives for maintaining stable prices, which are specified as explicit targets for inflation (Fanzeres, 2023). They have implemented transparent operational protocols, publicly disclosing and rationalizing their decisions about the policy rate. Throughout the last thirty years, they have successfully established a reliable history of meeting their inflation objectives.



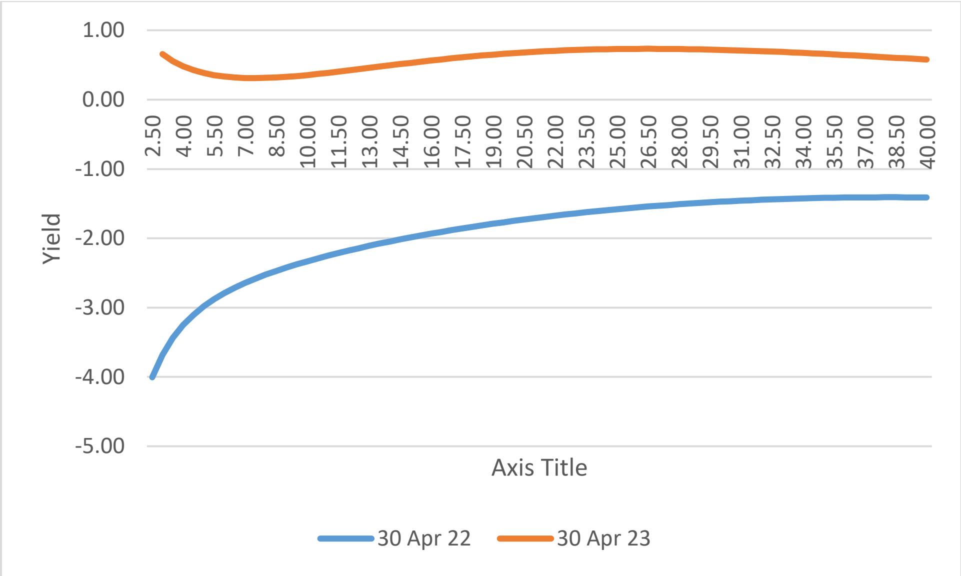
Due to enhancements in policy frameworks and more firmly established inflation expectations, inflation, especially core inflation, has become less responsive to inflationary shocks. Furthermore, at present, the rise in inflation has only affected a limited number of sectors that heavily rely on energy and have been impacted by the epidemic (J Li et al., 2023). However, there are indications that inflationary pressures may be expanding more widely in recent times. In contrast to the period of 1979-80, where inflation rates were uniformly high across all sectors, the current situation is characterized by a lack of broad-based inflation acceleration (Chandrarin et al., 2022). Therefore, it is anticipated that inflation would decrease in certain industries after the disruptions in supply are resolved and commodity prices become stable.

3. Different markets, different reactions-the case of US-UK

3.1. UK market

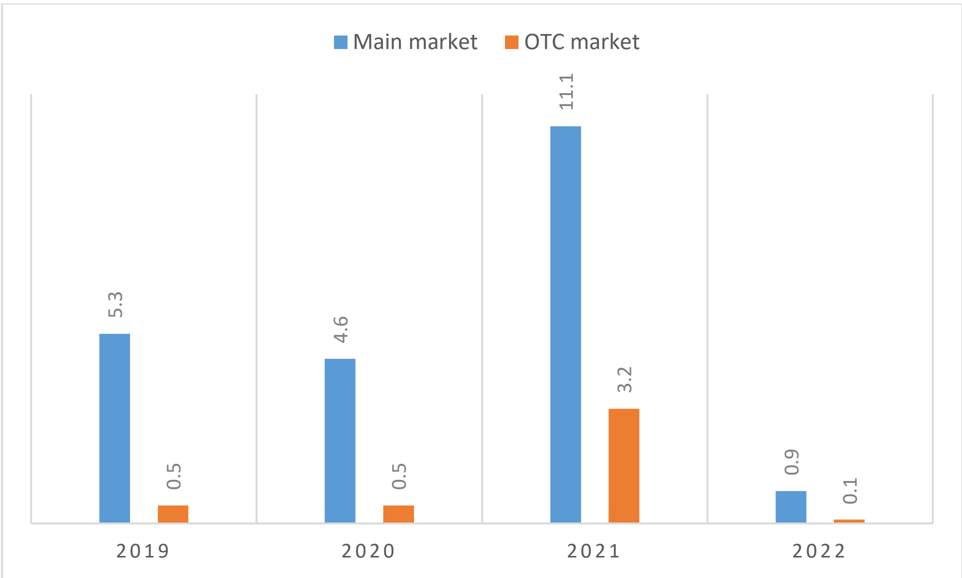
The decline in asset values coincides with Britain's confronting a cost-of-living crisis that may be more severe compared to other affluent nations. One reason for this is the increase in energy price limits for consumers, along with the fact that short-term mortgage payments are more responsive to interest rate hikes by the central bank (Fang, Shao and Zhao, 2023). Meanwhile, Brexit persists in causing supply chain challenges for firms. Since the start of this year, the UK stock and bond market has experienced a cumulative loss of over 550 billion pounds ($672 billion) (Ullah et al., 2023).

The UK's 10-year bond yields have risen by about 2 percentage points in 2021, reaching their highest level since 1994. The Bank of England (BoE) raised interest rates at the fastest rate in over three decades in order to curb double-digit inflation. Despite a decrease in yields following the announcement of the "mini budget" by former Chancellor Liz Truss, the sense of fiscal confidence has not yet entirely regained its previous level.



Several sterling corporate bond issuances have been delayed this year due to a range of variations. Despite the passage of two weeks since the mini-budget was declared, there was a lack of trading activity in sterling bonds, leading to a subsequent crisis in debt-intensive investment (LDI) that necessitated action from the BoE (O'Donnell, Shannon and Sheehan, 2023). As the yields on bonds rise over time, pension funds can easily implement a LDI strategy, which is beneficial for the financial well-being of the funds. However, when there is a sudden increase in bond yields, it might lead to a catastrophe. The volatility of the 30-year British Government bond yield during the final four days of September exceeded that observed during the most challenging phase of the Covid-19 outbreak. Corporate bond issuance has reached approximately £115 billion this year, marking the lowest level since 2018 (O'Donnell, Shannon and Sheehan, 2023).

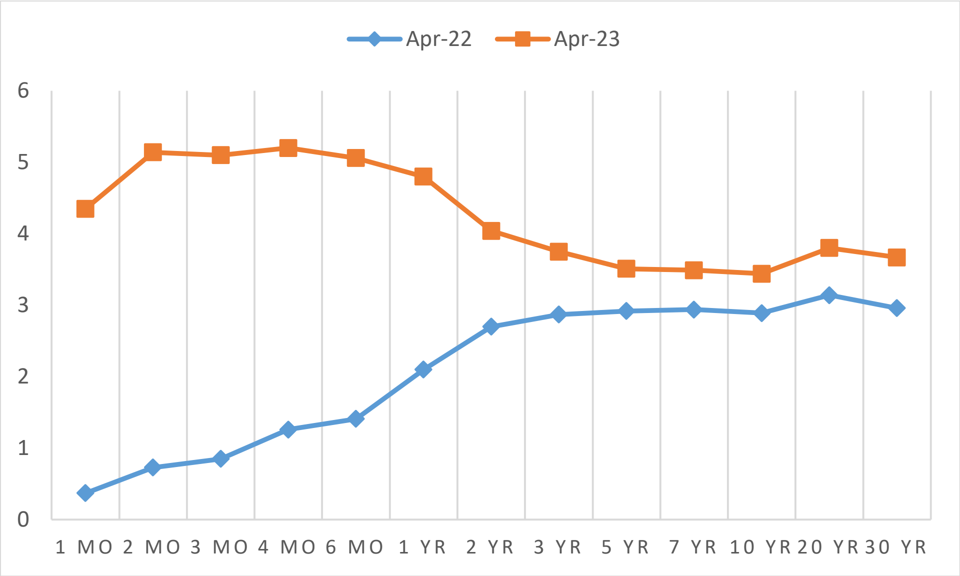
The supremacy of British stocks is restricted to stock codes of esteemed enterprises with robust financial standing and substantial market capitalization (blue-chips). Nevertheless, the FTSE 250 mid-cap index and the FTSE Local UK index, which both measure the performance of equities in the country, have both experienced a decline of over 20% since the start of this year (Halabi et al., 2021). This is the highest degree of decline since the financial crisis. The establishment of a worldwide government occurred in 2008. Worries regarding the UK economy, increasing interest rates, and the repercussions of Brexit have impeded industries such as housebuilding, banking, real estate investment, and retail. London is relinquishing its position not merely in terms of market value.



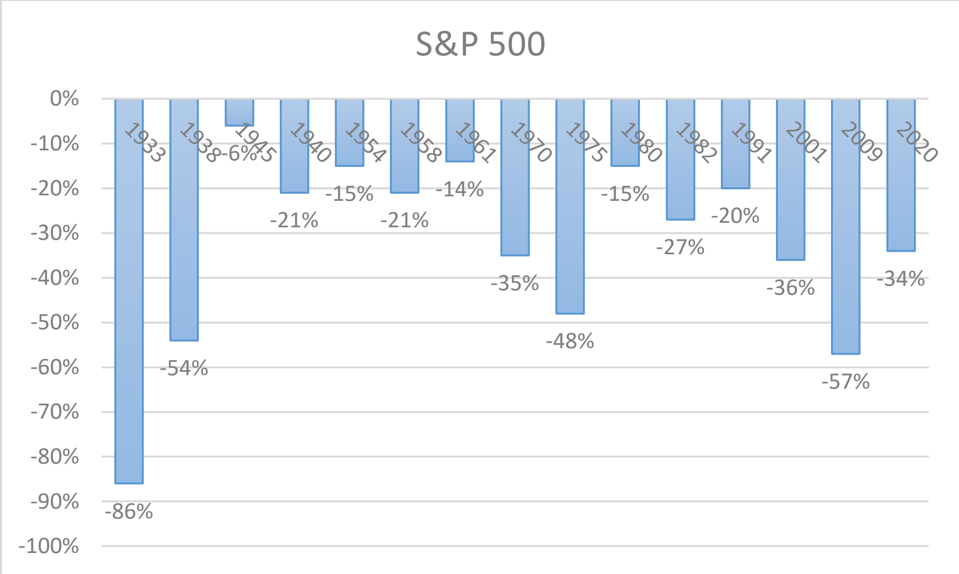
Despite a challenging year for initial public offerings (IPOs) worldwide, the percentage of funds raised from UK IPOs has reached its lowest point since 2009. Based on the available data provided by Bloomberg, the new listings on the London stock exchange have generated a mere £1.5 billion this year, representing only 9% of the whole value of European IPOs (Dinçkol, Ozcan and Zachariadis, 2023).

3.2. US market

An inverted Treasury yield curve is a reliable signal that a recession is likely within the next year. However, when a recession has begun or is about to begin, the curve will steepen because long-term bond yields fall faster than short-term bond yields. This is a sign that investors consider long-term investments in relatively safe assets. According to Consiglio, Saunders and Zenios (2022) , this appears to have happened, as the yield spread between the 2-year Treasury note (4.058%) and the 10-year Treasury note (3.44%) has narrowed. below 50 percentage points, from a difference of more than 100 percentage points a month ago.



In eight of the past 10 recessions, the S&P 500 index recorded a decline of more than 20% compared to the previous year. This means there is still room for the market to decline further if the global economy continues to decline - BofA strategists predict.

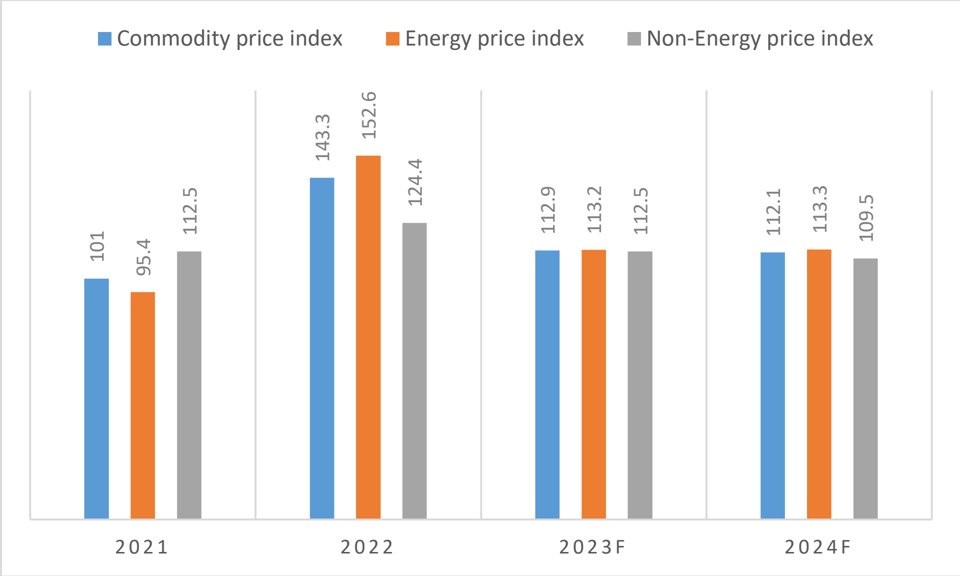


At the present time, asset classes are sending mixed signals about the possibility of a recession. Gold prices - at near record highs - appear to indicate a recession is imminent (Dang and Nguyen, 2020). Prices of small-cap stocks and domestic bank stocks in the US also indicate the same thing. Meanwhile, the stock price movements of some large-cap stocks such as Microsoft and Apple show that investors do not seem to care about these risks.

3.3. Commodities market

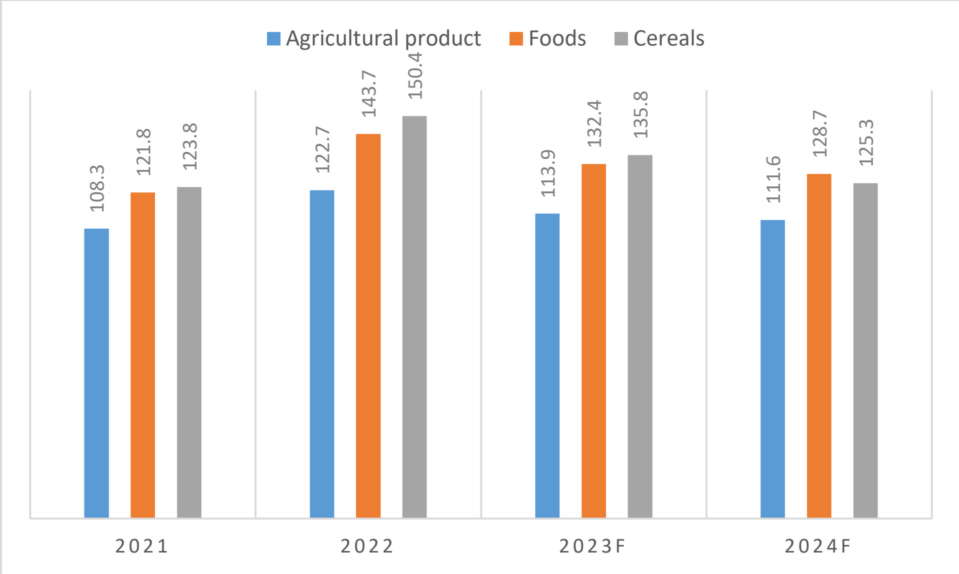
On April 27, 2023, the World Bank (WB) published an updated report on price market developments and prospects globally.

Accordingly, after accelerating due to the war in Ukraine, world commodity prices began a downward trend due to weak economic activity, combined with a warm winter and efforts to reallocate trade flows. Global. By the end of the first quarter of 2023, world commodity prices decreased by 14% compared to the beginning of the year and decreased by nearly 30% compared to the peak in June 2022 (World Bank n.d.). In the remaining months of 2023, prices are forecast to not change significantly, but will still be higher than pre-pandemic prices, continuing to negatively impact food security.

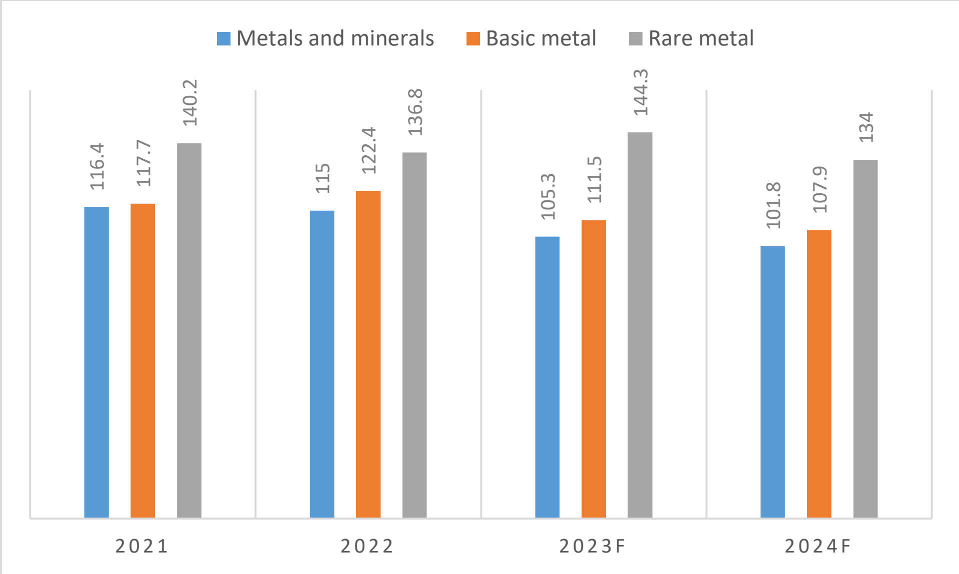


In the past six months, commodity prices have decreased rapidly, after many items increased to record prices, peaking in June 2022. According to the World Bank, the commodity price index has decreased by 32%, the deepest decline since the outbreak of the Covid-9 pandemic. By March 2023, wheat flour and gas prices have dropped quite deeply compared to the peaks recorded in May and August 2022. However, prices of key commodity groups with 4/5 items are still higher than the average price in the period 2015-2019. In 2022, fertilizer prices set historical records, and food prices also increased to their highest level in recent decades, second only to prices recorded during the 1975-1977 grain shortage period.

In the first quarter of 2023, energy prices decreased by 20% compared to the end of 2022. After peaking in June 2022, Brent oil prices decreased by 35%, but still fluctuated strongly in March 2023. In Europe, a mild winter thanks to rising liquefied gas imports along with efforts to improve efficiency and energy conservation have contributed to cooling natural gas prices by up to 80% compared to the peak recorded in August 2022. Rising exports and efforts to reorient trade routes are factors influencing coal and natural gas markets to minimize risks stemming from the Russia-Ukraine war. After attacking Ukraine, Russia redirected gas exports from Europe to China, India and other developing and emerging countries (Li et al., 2021; X Li et al., 2023). Despite relying on natural gas for input, fertilizer prices have also dropped sharply.



As of the end of March 2023, prices of agricultural products were generally unchanged over the past 6 months, down 14% compared to the peak in April 2022. Efforts to reopen trade routes through the Black Sea have helped Ukraine export grain to world markets, while bumper harvests in other grain-producing countries and falling energy prices are factors at play. reduce prices of agricultural products (X Li et al., 2023). In the first quarter of 2023, cereal prices decreased by 5%, while most other foods increased slightly. In the short term, food prices continue to stand at higher levels than during the 2007-2008 food crisis. Escalating food prices are negatively affecting food security and livelihoods, especially for the poor in many developing countries. Compared to the same period last year, food prices in February 2023 increased by an average of 20% in 146 countries, the highest inflation level in the past two decades. Of these, 90% of low- and middle-income countries face food price inflation above 5% (Fiorillo et al., 2023).



In the first quarter of 2023, the metal and mineral price index increased by 10%. Particularly in January 2023, expectations that demand would increase rapidly after China ended its zero Covid strategy pushed metal prices to accelerate, but only for a short period of time, due to international factors. This country consumes nearly half of global metal demand. In March 2023, metal prices dropped due to weak global demand. In the first quarter of 2023, the precious metals price index increased by 9%, due to the USD depreciation, increased buying demand to preserve assets after banking incidents in the US and Europe, and demand for silver and platinum for serving increased industrial production.

4. 2023's Inflation outlook

Overall, 2023's inflation is likely to grow modestly owing to: (i) steady economic resilience, (ii) FED has more space in fighting inflation, and (iii) falling commodities price.

4.1. Economic resilence

It is anticipated that the deceleration of economic development in the United States will contribute to a decrease in inflation, bringing it down to 2.6% by 2024 (Wang and Yang, 2023). This value is in proximity to the 2% inflation objective. Amidst a consistent upward trend, interest rates have been steadily rising over the past year. Despite the Federal Reserve indicating that the most severe phase has passed, the world's largest economy still faces possible hazards that could lead to an increase in inflation. As of November 2023, US families had built an excess savings of 290 billion USD (Song, Zhang and Hu, 2023). This surplus can potentially drive consumer demand and thus lead to an increase in inflation.

4.2. Are there further cuts in the interest rate?

The Fed becoming more cautious from almost certainly about to pivot its monetary policy by the end of 2023 means a revaluation of assets. This repricing is based on new expectations about when the Fed might start lowering interest rates and how quickly they will lower interest rates. At the beginning of this year, the market expected the Fed to start lowering interest rates in March and there would be 6-7 interest rate cuts throughout the year. Currently, the market believes that it will take until June at the earliest for the Fed to begin easing, and there will only be 3 reductions in the whole year, each reducing the federal funds rate by 0.25 percentage points.

The steady growth of the US economy is the reason why the Fed must rely on the next economic data to assess the inflation outlook, and at the same time prevents the Fed from being in a hurry to lower interest rates. An important driving force behind the steady growth of the US economy is strong consumption, which comes from a continuing hot job market. In February, the US non-agricultural sector added 275,000 new jobs, a number higher than forecast. Although the unemployment rate increased slightly to 3.9%, it is still a historically low unemployment level (Lee, Olasehinde-Williams and Özkan, 2023).

This strength of the US economy is considered by experts to be a "double-edged sword". Growth remains steady even in a high interest rate environment, giving the Fed more freedom to fight inflation without worrying about an economic recession. But on the other hand, solid economic growth also raises concerns that inflation may be more persistent than expected.

4.3. Commodities prices

After increasing 45% in 2022, commodity prices are expected to decrease 21% this year and continue to move sideways in 2024. After a deep decrease in the first quarter of 2023, energy prices are forecast to stabilize in the remaining months of this year, before a slight increase in 2024, when supply pressure will negatively impact markets. In contrast, prices of non-energy commodities will fall about 10% this year and 3% in 2024, as global demand is forecast to grow less than forecast in October. 2022.

Energy prices are expected to decline deeply with a decrease of about 26% this year, then may increase slightly by no more than 0.1% in 2024. In 2023, the average Brent crude oil price is expected to be at the level of 84 USD/barrel. Weak global demand has caused energy commodity prices to fall 15% compared to average prices in 2022 and is forecast to stabilize at this price level until the end of 2024. In Europe, natural gas prices However, it has plummeted, with a possible decline of up to 53% this year, but still 3 times higher than the average price in the period 2015-2019. In addition, Europe still faces difficulties in ensuring supply this coming winter and must compete in importing liquefied gas from Asia (Zheng, Zhao and Hu, 2023).

Coal prices are forecast to fall 42% this year and 23% next year. Rising coal consumption in China will offset weak demand in other parts of the world, as many countries switch to natural gas. Despite falling prices, coal production and exports from key exporting countries (Australia and Indonesia) are forecast to continue to increase. Along with the trend of decreasing coal and natural gas prices, fertilizer prices are expected to decrease by 37% this year, but still remain at the same high level as during the 2007-2008 food crisis (Go and Lau, 2020).

5. Strategies for remaining profitable

Currently, the world macro situation seems to be shifting from a period of stagflation to deflation - the high inflation rate gradually shifts to a lower level over the months (in the US). Based on the current situation, investors who can participate in the stock market should focus on a portfolio with quality stocks, with good assets, stable cash flow and growth. At this stage, stock selection skills will be extremely important, unlike the strategy in 2020 and 2021. The market in 2023 is probably similar to the 2019 scenario with expected profit reduction in most industries in 2019 and expected 2023). With such market forecasts, there will be a clear differentiation between industries and stocks.

For the commodity market, all forecasts point to a downward trend after 2 years of hot growth. Commodity prices are expected to decrease 21% this year and continue to move sideways in 2024. After a deep decrease in the first quarter of 2023, energy prices are forecast to stabilize in the remaining months of this year, before a slight increase in 2024, when supply pressure will negatively impact markets. In contrast, prices of non-energy commodities will fall about 10% this year and 3% in 2024, as global demand is forecast to grow less than forecast in October 2022. Similarly, Investors should consider developing speculative on the expected falling tendency of strategies commodity prices.

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