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Halloween: Tricks and treats for the capital markets

Column by Jürgen Callies

Halloween: Which spook outfit is scariest for capital markets this year? My pick for the final four: supply chain problems, Chinese project developers, Coronavirus and stagflation fears. But the winner is without doubt the costume that trivialises inflation.

The long-term framework conditions for sufficient economic growth actually look quite promising: most of the world's developed economies are in the process of making up for the growth hiccup caused by the Corona shock that started in the first half of 2020, and they are even progressing more quickly than expected. Fiscal and monetary policy are still having a supportive effect. The stronger consideration of climate aspects will force additional investments to be made, the labour market is improving and the high level of savings accrued during the pandemic should give rise to a backlog of demand and revive economic activity in the coming years. So is everything roses? No. There are significant challenges. Most of them tend to be short term, but not all.

My list of the five biggest challenges for the market – or to remain on topic, which are the scariest Halloween costumes this year and which might still be next year? Coming in 5th are the supply chain problems, followed by Corona in 4th place. I give bronze to the fears of stagflation, triggered to some degree by energy prices, and silver goes to the troubled property developers in China. But at the top of my list is the

accommodating and trivialising of a phenomenon that was thought to be extinct in the Western nations: inflation.

The big question at Halloween is always "trick or treat". So which of these issues are we trying to appease with a treat, and which are we not?

5th place: The supply chain problems are without doubt one of the acute issues. This evil clown is threatening markets with less growth – at least temporarily – and possibly more inflation, so parts of this costume can also be found in the bronze medallist. Computer chips are the products making the most headlines, but anecdotal evidence shows us that the matter is far more widespread than that. There is a "treat" being given however, with governments providing assistance for additional production, and higher prices that set off the usual economic adjustment processes. So supply chains look like they should be a problem for this year's Halloween, but not necessarily next year.

In 4th place in my view is Corona. It is quite simply not over yet. There is still the risk of further mutations, and the heart of the international capital markets in the northern hemisphere is heading into winter. But there is also candy to be found here: more vaccinations, better vaccines, a better understanding of the virus itself and announcements by the central banks of their intention to counteract its effects slowing growth. Infection numbers and strategies for fighting the virus are both risks for the markets. People are worried, but I think this costume will quickly go out of vogue in the Halloweens to come, even if it is spooky this year.

3rd place is a ghostly costume-throwback from the late 70s and early 80s: stagflation. People are drawing comparisons to the second oil crisis and rising prices for energy, especially natural gas, and warning of a "policy error" on the part of the central banks that could cause interest rates to jump and strangle the economic recovery. I think this is a serious issue, also because some of the structural background is being left out of the discussion, such as ruling out certain energy sources before a replacement has been found for them. But sweets are being handed out and there is still a bowl of candy

in the kitchen: state support, the announcement of central bank "reviews" in the event of inflation peaks, energy reserves ready for activation and additional pipelines, etc.

Coming in 2nd among the Halloween costumes this year is in my view the crisis being experienced by some Chinese property developers. This is not because I expect this issue to get out of hand. In a centrally governed system like China's, support payments can be issued at any time. But even during my own working career I have twice been shown that the real estate industry often lacks transparency: first in the Japanese crisis at the start of the 90s, and then in the subprime crisis that ultimately culminated in Lehman in 2008. Even US Federal Reserve Chairman Bernanke underestimated the subprime crisis as late as 2007. On top of that, the powers that be are not only dishing out candy to fight the crisis, but also a few not-so-tasty morsels. China has declared "housing is for living", which is a sugary treat for the buyers of the homes, but more certainly not for the project developers or their investors, which the Party says are charging too much for the properties. The lack of transparency leads to limited optimism on my part that detrimental effects to the world's capital markets can be prevented or that this particular costume might not be popular next Halloween again.

The top contender for scariest outfit this Halloween is to my mind undisputedly the trivialisation of inflation. This costume had no buyers for the last 30 years. If anyone wanted something of its ilk, it was deflation they went for. Due to the rapidly rising energy prices, inflation should peak year on year in the USA and Germany at the end of 2021, at least at over 5%. Will that prevail? Initially not. I expect inflation to drop from these high levels in the first half of 2022. That means that the current inflation is a burden, but not the main problem, I think. The central banks have already educated the market participants to consider an average inflation rate of 2% to equate to price stability, and made it clear that exceeding it will be tolerated.

But inflation is a creeping process. We found that out in the 70s. If you underestimate its horror, it grows and flourishes. I think the ECB is being too smug. When it hears "trick or treat", it simply leaves the door closed, and that although it is the central bank that will

experience the biggest problems if the inflation expectations become unanchored. Because the markets don't have as much confidence in the ECB as in the Fed that it will be able to counteract inflation, and Jens Weidmann's resignation won't have helped with this perception. There are even some market players making a joke of the issue with the word "growthflation", as if to say that stagflation is the only problem, and inflation with growth would be okay. 70s history shows that this is not the case.

Uncontrolled inflation is poison for the capital markets, be it for stocks or bonds. Some Emerging Markets such as Brazil or Russia that do not have a basis of trust on the markets, are acting to stop it. The Bank of England might also increase its rates as early as in the coming months. I would sleep easier if the ECB paid more heed to the danger of inflation. The "trick" that results from not taking it seriously could be a real shocker. Back in the 70s nobody thought the movie "Halloween" would provide so many years of box office successes, and excessive inflation is one costume I definitely don't want showing up on my doorstep every Halloween.