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Less for more

Inflation is slowing. But it won't disappear as quickly as it arrived.

VP BANK

CONTENTS

4 Dawn of a new era

Inflation rates are at their highest in decades, and central banks are taking counter-measures. So what is the inflation outlook?

16 “We are already seeing second-round effects”

How does Ulrich Freund, head of purchasing at food producer Hilcona, deal with horrendous rises in input costs?

23 Inflation hedging: not straightforward

There is no simple way to protect investments against inflation, but there are strategies to reduce the pain.

10 Workshop report: Inflation forecasting

22 The person: Milton Friedman

25 Investment outlook

11 Recipes against inflation

Do the tried and tested measures against inflation still work?

20 Personal inflation

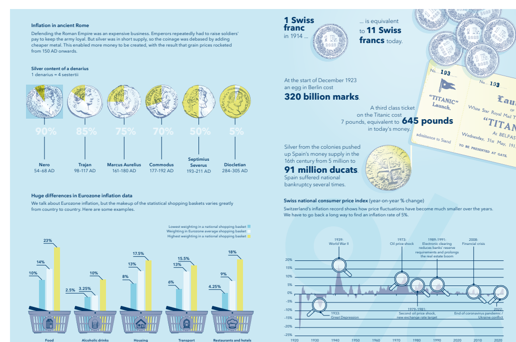
Inflation is experienced differently depending on a person's economic situation and lifestyle.

18 My best and worst investments

With Susanne Lebrument, Lead Director of the Swiss media company Somedia.

14 Infographic

Inflation is as old as money itself.



When prices climb

Dear Reader

Inflation has made a comeback. The central banks, whose job it is to keep prices stable, have been caught on the hop. In many parts of the world, inflation rates of 7% or even higher than 10% are something that individuals and businesses have not experienced since the 1970s or 1980s.

Understanding and explaining inflation is not easy. But one thing is certain: it makes us poorer. The precise impact will depend on an individual's economic situation and lifestyle (→ page 20). Take the price of eggs for example. In the US an egg now costs almost 40% more than a year ago. Someone who eats a lot of eggs will be hit harder than someone who doesn't. The head of purchasing at the Liechtenstein food company Hilcona knows that the rising cost of chicken feed means that he will soon have to pay much more for eggs and must budget accordingly (→ page 16). And while we are on the subject, what was the price of an egg in Germany 100 years ago? Answer on page 15.

So this issue of Telescope is devoted to inflation. But don't expect us to predict when inflation will come down to below 2% again. The central banks don't know (→ page 10), and nor do we. But what we can do is show you which investments are best suited for riding out the inflation surge. That is all the more important in view of the fact that the current bout of inflation is unlikely to end as suddenly as it started. Nevertheless, we can console ourselves with the thought that the central banks' tools for fighting inflation are still effective (→ page 11)

I wish you an interesting read.

Dr Felix Brill
Chief Investment Officer VP Bank

Dawn of a new era

Inflation is with us again. Prices are surging in a way that has not been experienced since the 1980s. Central banks have reacted by putting up interest rates. But where will inflation go from here?

Felix Brill

Everything has got more expensive: food, hotels, flights for the summer holidays. No product or service has escaped the inflation virus. For many years inflation was not an issue, but now it is back with a vengeance. Newspapers are full of it, and in the financial markets hardly a day passes without new price data being published and obsessively analysed. Speculation is rife: What do the new numbers mean? How should we interpret a central bank boss's latest utterances? Is the Fed really going to press the pause button on interest rate hikes? How many more rate increases does the ECB have up its sleeve? Amid the maelstrom of news reports and frenzied comment, it's easy to get lost in the detail.

In this issue of Telescope we step back from the short-term commotion and take a look at the longer term. The likely actions of the Fed and ECB are important in the short run and relevant for investors. But what about the more distant horizon? Is inflation going to remain an issue for longer than people might like to think? What are the factors at play and what are the implications for economic growth, monetary policy and investment?

It started in 2020

First we must take a step back and ask: Why have prices climbed, and where and when did the surge in inflation start? We quickly discover that it didn't start in the spring of 2022. The inflation tsunami was not triggered by the Russian attack on Ukraine. Russia's action aggravated the trend, but it was not the prime cause, contrary to much that has been said and written over the last year. We do not have to delve very deep to demonstrate this. Just look at the figures for annual inflation rates (→ chart on page 6). They started to climb at the end of 2020. When Russia marched into Ukraine and sent energy prices rocketing, inflation was already over 8% in the US and over 6% in the Eurozone. And core inflation (excluding energy and seasonal food prices) had already accelerated beyond the target rate of 2%.

The primary trigger for inflation was the coronavirus pandemic. Consumer behaviour was transformed by lockdowns. With less opportunities to spend (no cinemas, no restaurants, no hotels), saving rates climbed. When the lockdowns were lifted, people had a lot of extra money to spend, and there was a huge backlog of demand. This excess demand, in our view, was the principal cause of the inflation surge. And while consumers were flush with cash, the supply of consumer goods and services had been enormously reduced. The widely reported bicycle shortage is just one example of this. When supply is constricted and demand high, prices rise. That is one of the oldest truths in economics. But genuine supply shortages were not the only problem. Many companies seized the opportunity to exploit their pricing power.

Key takeaways

- The coronavirus pandemic created a backlog of demand, which then collided with reduced supply.
- Further bouts of inflation cannot be ruled out.
- Inflation expectations take time to adjust.

This was reflected in rising profit margins, e.g. in the energy, telecoms and software sectors. Overall inflation rates are now coming down again. US inflation in June 2022 was 9.1%, but by April 2023 it had fallen to 4.9%. The Eurozone is still battling with higher rates (7% in April), but here too there has been a significant reduction since the October peak, when inflation hit 10.1%.

> // Many companies have taken the opportunity to exploit their pricing power. //

Base effects help in the short term

Quieter times ahead? For the coming months, one might tend to say yes. The high previous rates against which year-on-year inflation is calculated suggest that published inflation rates have farther to fall (the so-called "base effect"). Classic inflation models (→ page 10) point in the same direction, as do the forecasts of the Fed and the ECB. Indeed, any other outcome would amount to a declaration of defeat: an admission that slamming on the emergency brakes by pushing up interest rates simply hadn't worked.

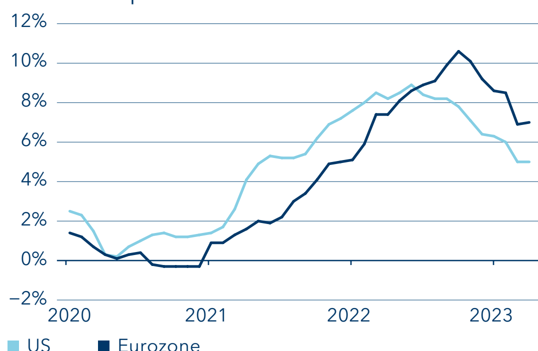
Even so, the inflation picture is going to present difficulties in the months ahead. This is partly because, despite sophisticated statistical models, inflation is far from easy to predict. When strong base effects are in operation as they are now, forecasting might work quite well for a horizon of a few months. But even then there is no guarantee. A lot can happen in three months, as we have experienced all too often in recent years.

Uncertainty is also due to the fact that many price movements occur only after a lag. Restaurant menus are not reprinted daily. Wage increases do not take effect immediately. Many prices are subject to negotiation, and others are indexed. In Switzerland, for example, rents are tied to a reference interest rate. If the rate goes up, so will rents. Many of these effects have not yet fed through.

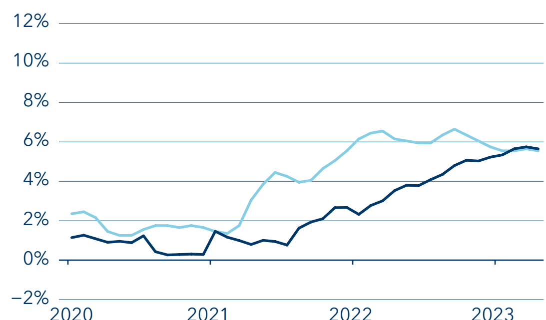
A look at past experience shows that it can take some time for price movements to calm down again after a major inflationary episode. In the 1980s it took well over three years (from September 1982 to April 1986) for US inflation to fall from 4.9% (the same rate as now) to below 2%. And when US inflation accelerated again to above 5% at the start of the 1990s, the cure administered by Fed Chairman Alan Greenspan took six years to achieve the desired result. The picture is even worse for core inflation. In April 1986 the core rate was still 4.2%, and it did not fall below 3% until 1994.

Inflation in the US and in the Eurozone (in %)

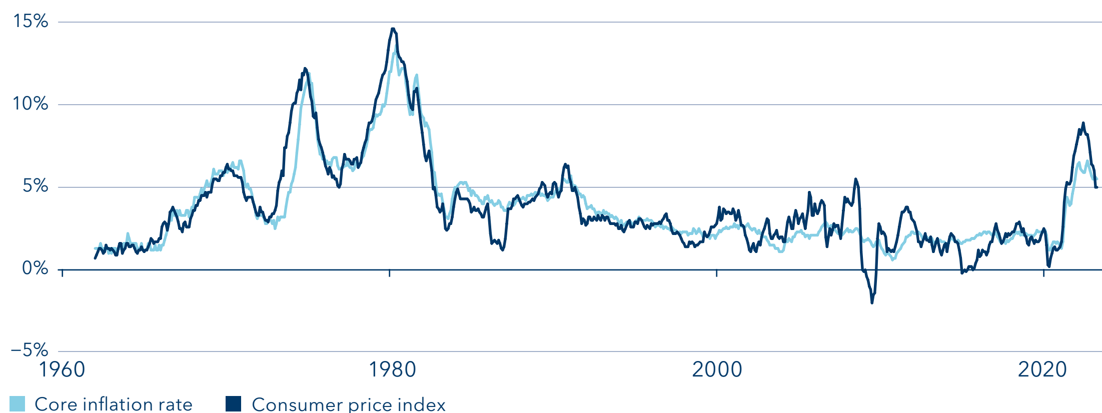
Consumer price index



Core inflation rate



A long-term view of inflation in the US (in %)



History also shows another pattern. The acceleration of inflation in the 1980s was not an isolated case. It followed two previous episodes: at the end of the 1960s and in the mid-1970s. Each of these bouts of inflation had its special features, the 1973 oil crisis being an obvious case in point. Nevertheless, the three episodes were not unrelated. If an economy is forced too far from its long-term path, it often takes years for the system to settle down again. This time, too, it is conceivable that inflation will not simply fall towards the central bank target rate of 2% and stay there. The first wave could be followed by a second and perhaps even a third.

Inflation psychology

The stubbornness of inflation also depends on how players in the economy react, i.e. whether and how they adjust their inflation expectations. These expectations are measured by regular surveys of businesses and private households and can also be estimated on the basis of financial market data, e.g. inflation swaps or the performance of inflation-indexed securities.

Experience typically shows that if everything has got dearer in recent months, most consumers will assume that the trend will continue. It takes time for expectations to be adjusted downwards again in response to changing price movements. The longer an inflation episode persists, the harder it is to get inflation expectations under control again. That is why central banks pay so much attention to what businesses, households and the markets are thinking. It also explains why they have been so reluctant to raise their 2% target inflation rate, say to 4%.

As the example of the Liechtenstein food company Hilcona shows (→ interview on page 16), businesses have to keep a close watch on the prices of their inputs in order to avoid being wrong-footed. They can then adjust their cost calculations and budgets accordingly. But few companies can completely avoid inertia in their price expectations. After all, decision-makers are human and therefore subject to psychological influences.

Structural inflation drivers

Then there are structural factors, such as demographics, deglobalisation and artificial intelligence, which can all have a bearing on inflation trends. The same goes for the power of global corporations like Apple, Google and Amazon, which present a huge challenge for competition policy.

In fact, it is not always clear whether such structural factors curb inflation or fuel it. Take climate change, for example. In some countries, e.g. Germany and Switzerland, politicians want to achieve a situation in which heating is fuelled mainly by renewables. Legal measures to this effect have already been enacted or are in the pipeline. House owners therefore face major investment costs in the years ahead, and increased demand for heat pumps will drive up their prices. On the other hand, a general upgrading of household heating should enhance heating efficiency nationwide. Even with no change in population and with the same standards of housing and indoor temperatures, we could therefore expect to see a decline

in energy consumption, which would have a depressing effect on energy prices. However, these movements are unlikely to happen in parallel in such a way that they neatly cancel each other out.

Even if such effects and their timing cannot be predicted, one thing is clear: developments over the coming decade will not be a simple continuation of the trends seen in the four decades since 1980. Jean-Pierre Danthine, a member of the governing board of the Swiss National Bank from 2010 to 2015, gave a speech in which he listed the many well-known reasons why inflation trended downwards for so long after the 1980s, but then he added: "Perhaps it was just luck." He was half joking, but there might be more truth in his remark than today's central bankers would like to admit.

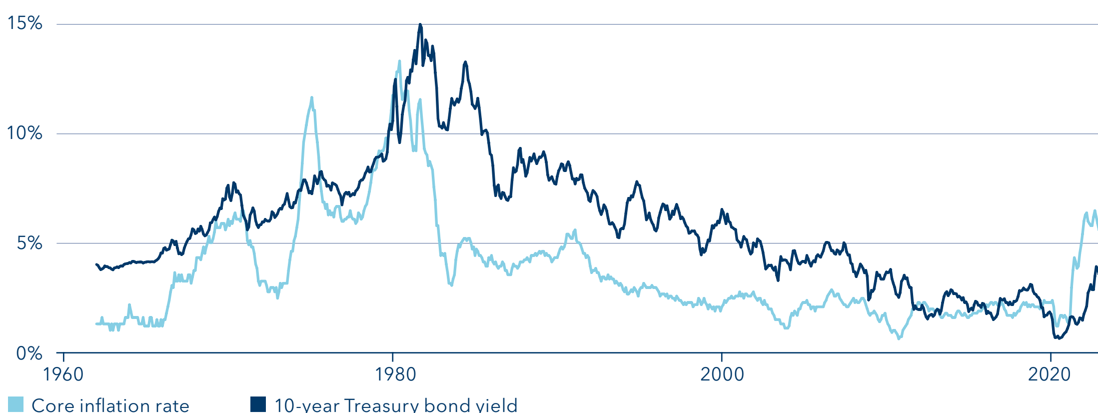
> // Models are contaminated by the previous downward inflation trend. //

Economics has unquestionably made great progress since the 1970s. Monetary policy has been refined and shown itself capable of overcoming crises. That sounds confidence-inspiring (→ page 11). But it is also a fact that the Fed, the ECB and many other central banks reacted too late to the recent spurt in inflation. They then tried to remedy the situation by means of an aggressive change of course. But why was their response so tardy? Did they assess the situation wrongly? Did they overestimate their ability to predict? Trying to answer such questions would be a long and probably fruitless exercise. Perhaps it was partly because today's central bankers have no experience of a high-inflation world. 40 years of downtrending inflation is a long time.

The data that are fed into today's inflation-forecasting models mostly go back only 10 to 20 years, in some cases perhaps 30. They hardly stretch back to the 1970s. In other words, all the data are contaminated by the downward inflation trend. This can seriously obstruct the models and lead to systematically wrong results. Such problems apply not only to inflation forecasting but also to many other models used in the financial services industry. Portfolio optimisation calculations are a key example. Slower inflation went hand in hand with falling interest rates. That was not only positive for fixed-income securities but also pushed up the value of equities and real estate (→ Ideas for investors, page 23.)

Will we be able to put inflation worries on the back burner in a few months' time? Or is inflation going to remain an issue for years to come? We simply do not know. But after recent experience it would be negligent to ignore the less optimistic possibility.

US core inflation and 10-year Treasury bond yield (in %)



FEDERAL RESERVE NOTE
THE UNITED STATES OF AMERICA
ONE DOLLAR
WASHINGTON, D.C.

How inflation forecasts are made

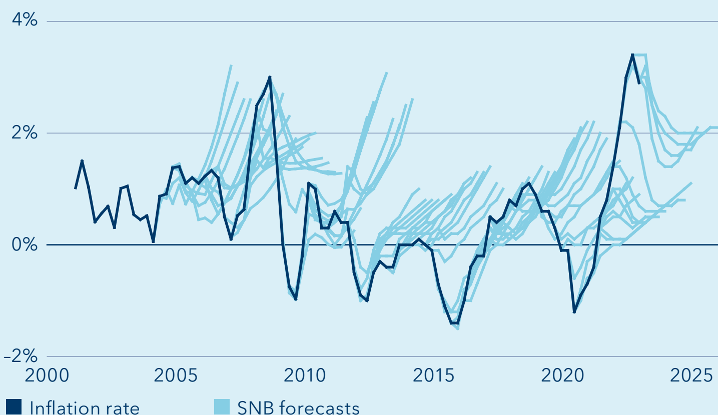
Felix Brill

Inflation forecasts are a prime input for central banks' monetary decisions. But how are these forecasts arrived at? There are three main approaches.

The **first approach** is based on ARIMA (autoregressive integrated moving average) models. In these models the previous behaviour of a time series is used to predict future behaviour. If, for example, the price of petrol has fallen over the last three months, how likely is it to fall further in the next month or the month after that? This calculation is made for all goods and services in the consumer price index, and the results are then aggregated. Importantly, the history of each individual time series is treated in isolation. The behaviour of other prices is not factored in. The time horizon of such forecasts tends to be short-term, ranging from a few months to half a year.

The **second approach** employs vector autoregression (VAR) models. These models also attempt to predict the future behaviour of a time series on the basis of previous observations. Unlike in ARIMA models, however, the various time series are not treated in isolation but are combined. By looking at their interaction, additional information can be obtained. Typically, a small number of time series are fed into each model, e.g. inflation rate, money supply, GDP growth and long-term interest rate. In this way various small models with individual time series are created and the resultant forecasts then averaged out. This provides more robust results, with a forecast period of around 18–24 months. Longer horizons are difficult, because the forecasts then start to oscillate around the historical average.

Inflation in Switzerland (in %)



For longer time horizons a **third approach** is employed, using larger macroeconomic models such as dynamic stochastic general equilibrium (DSGE) models. These are based on multiple theoretically derived equations calibrated by reference to historical data. The advantage of these models is that they make it possible to replicate the interaction between individual variables, e.g. consumption, energy prices and unemployment, in such a way as to simulate complex scenarios, such as an oil price shock. However, the models are very labour- and time-intensive to operate. And they are only as good as the data that are fed into them.

All three approaches have the same problem: they show what could happen but provide no assurance that it will happen. A look at the past inflation forecasts of the Swiss National Bank (SNB) illustrates this vividly. The thin lines show the SNB's quarterly forecasts for the following three years. The thick line shows how inflation in Switzerland actually behaved. Sometimes the forecasts got the direction right, mainly when a firm trend had been established. Turning points, however, have almost never been foreseen.

Recipes against inflation

Higher levels of debt mean that tried and tested methods of countering inflation are now more effective than ever.

Thomas Gitzel

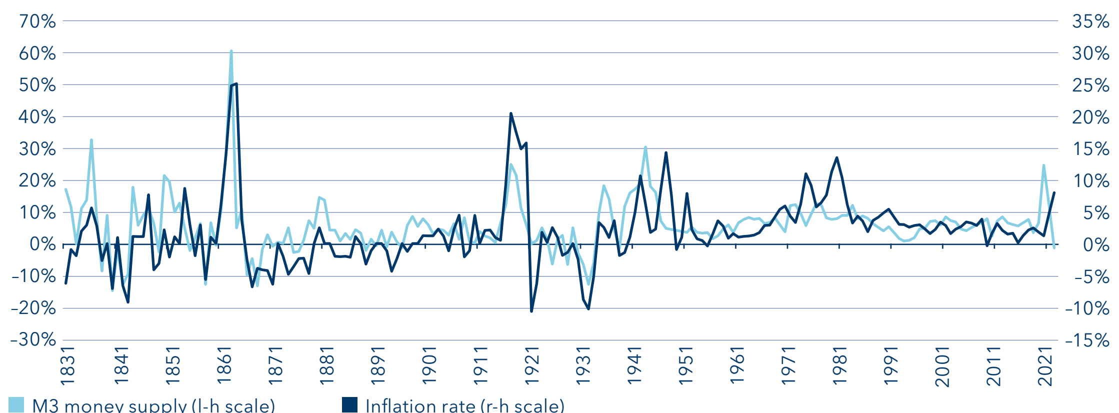
The world economy has changed significantly since the last bout of high inflation in the 1970s and 1980s. International commerce has intensified, trade restrictions have been dismantled, and financial markets have become more tightly regulated. Central bank policy has likewise not stood still. Quantitative easing, i.e. expanding the money supply by buying up debt securities, has established itself as a key addition to the monetary toolbox. Negative interest rates have also made an appearance, and central banks are now regularly providing forward guidance, i.e. indicating how interest rates are likely to move in the future. And, unlike in the past, the main central banks now publish concrete inflation targets, mostly in the region of 2%.

Inflation is a monetary phenomenon

So how will central banks tackle the current inflation surge? Will they show the same sort of determination and consistency as they did 40 or 50 years ago in bringing inflation back to the target level? And are the tools at their disposal adequate?

The decisive factor in fighting inflation is the money supply, as the economist Milton Friedman recognised (→ page 22). The ultra-expansionary monetary policies pursued after the 2007/08 financial crisis did not result in an excessive growth of money supply. But the picture was changed dramatically by the coronavirus pandemic (2020 to 2022), when the money supply let rip. The US Federal Reserve and the European Central Bank acquired almost 9 trillion US dollars worth of bonds under their coronavirus asset purchase programmes. But unlike what happened after the 2007/08 financial crisis, the purchased assets did not lie fallow but were used to provide large-scale government-guaranteed lending to companies to tide them over the economic fallout from the pandemic. In other words,

US money supply and inflation since 1831 (yoy change in %)



money created by central banks was channeled to commercial banks, companies and ultimately to consumers. The long-term parallel movement of US money supply and inflation clearly indicates that the recent price acceleration is attributable to the massive expansion of M3 money supply in reaction to the coronavirus pandemic (→ chart on page 11). M3 is the broadest definition of the supply of money in the economy.

A similar situation can be seen in the Eurozone, though here the connection is not so close (→ chart below). If we calculate the trend on the basis of a three-year moving average, we find that here too there is a degree of correlation between changes in money supply and inflation. In fact, measured by money supply, the inflation rate has recently overshot.

We see, therefore, that inflation is indeed a monetary phenomenon and that the central banks' recipe for controlling it via the money supply is correct. In recent months the Fed and the ECB have been putting a brake on monetary growth or even taking steps to reduce money supply by selling off bonds (by definition, the sale of a bond from the central bank's holdings means a reduction of money supply). M3 money supply in the US has recently contracted by almost 2% compared with a year earlier, something that had never happened since the Second World War.

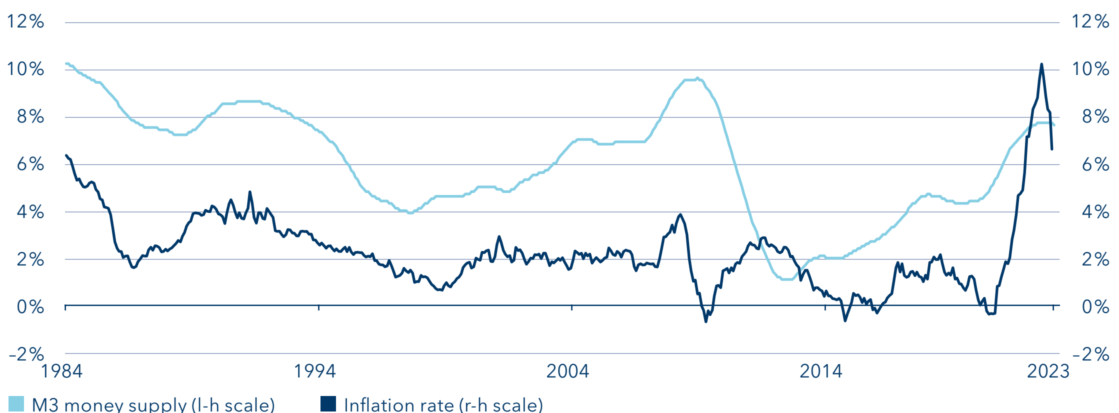
The ECB is still some way from achieving a genuine reduction of money supply, but monetary growth has been substantially slowed. The Swiss National Bank is on a similar road to the Fed, with M3 registering a year-on-year fall. These examples show that the central banks are serious about taking liquidity out of the economy in order to tackle inflation.

> // Higher debt makes monetary tightening even more effective. //

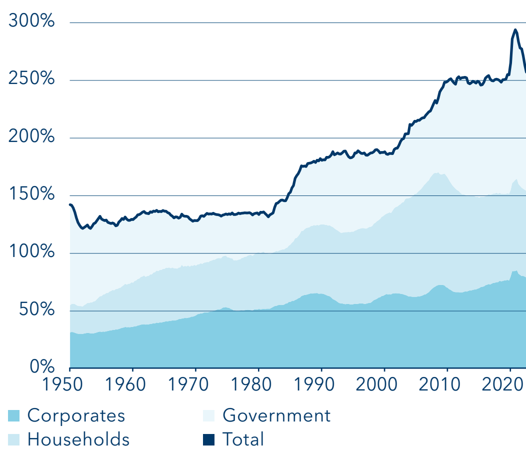
Impact of debt on monetary policy

Monetary tightening has not yet run its course. Even if the Fed does not raise interest rates any further, it will continue to offload securities. The ECB, too, must continue to act. But how far will the central banks go? It is often said that high levels of government and private sector debt make it difficult for the monetary authorities to act decisively. Total debt in the US now amounts to almost 260% of GDP, which is around twice as high as in the 1970s. Does that mean that previously effective central bank measures against high inflation are now impossible?

Eurozone: money supply and inflation rate (moving three-year average, yoy in %)



Total US debt (in % of GDP)



In fact the opposite is the case. The higher the level of debt, the more effective monetary tightening becomes. A study published by the Bank for International Settlements (the "central bank of central banks") in February 2023 demonstrates this. The results of the study showed that a high level of debt makes an economy more sensitive to monetary tightening.

Several factors are at work here. First, a higher level of debt magnifies the impact of a rise in interest rates. A look at total debt in the US illustrates this. US corporations, private households and the public sector are currently in debt to the tune of 64 trillion US dollars (→ chart above). If interest rates rise by 3%, that results in additional interest payments of 1.9 trillion US dollars per year, money that is then unavailable for other purposes. In 1980, an interest rate increase of the same magnitude pushed up debt service costs by only 107 billion US dollars. In other words, the overall economic cost of a 3% rate hike is now about 18 times higher than then. Over the same period per capita income in the US has risen just under sixfold. True, long maturities mean that a rise in interest rates does not immediately push up the overall cost of debt service. However, the longer interest rates stay at their present level, the more this effect will be felt. This in turn puts pressure on disposable incomes and spending.

Second, a higher level of debt aggravates the "distribution effect" of inflation, i.e. the differential impact of inflation depending on people's economic situation. Households on low incomes are typically net borrowers with a more variable propensity to consume. If they have additional money at their disposal, they tend to increase their consumption more steeply than more affluent households do. Conversely, a reduction of disposable income due to higher debt servicing costs resulting from official interest rate hikes will tend to hit their consumption harder. All in all, the higher the level of private sector debt, the more drastic will be the deflationary effects of monetary tightening. Thirdly, higher debt in the economy as a whole can lead to added stress in the financial markets. Watch out for turbulence in the US banking sector.

Painful interest payments

Thus the higher the level of debt in the economy, the more sensitively total demand will react to a change in monetary policy. Moreover, the research by the Bank for International Settlements shows that economic growth in countries with a high level of private debt is more negatively affected by interest rate hikes than in low-debt countries. If the public sector is also highly indebted, the effects can be even stronger, because increased public sector financing costs narrow the room for manoeuvre in fiscal policy. Governments are therefore forced to reduce their spending, with negative effects on total demand in the economy.

The risk that monetary tightening will plunge an economy into recession is much greater if debt levels are high. But the fall in demand pushes down inflation. In other words, central banks have to tighten much less stringently than a few decades ago to achieve the same restrictive effect. One can therefore postulate that monetary actions should be especially effective in the present high-debt environment. The measures employed by the monetary authorities in the 1970s and 1980s are therefore still apropriate.

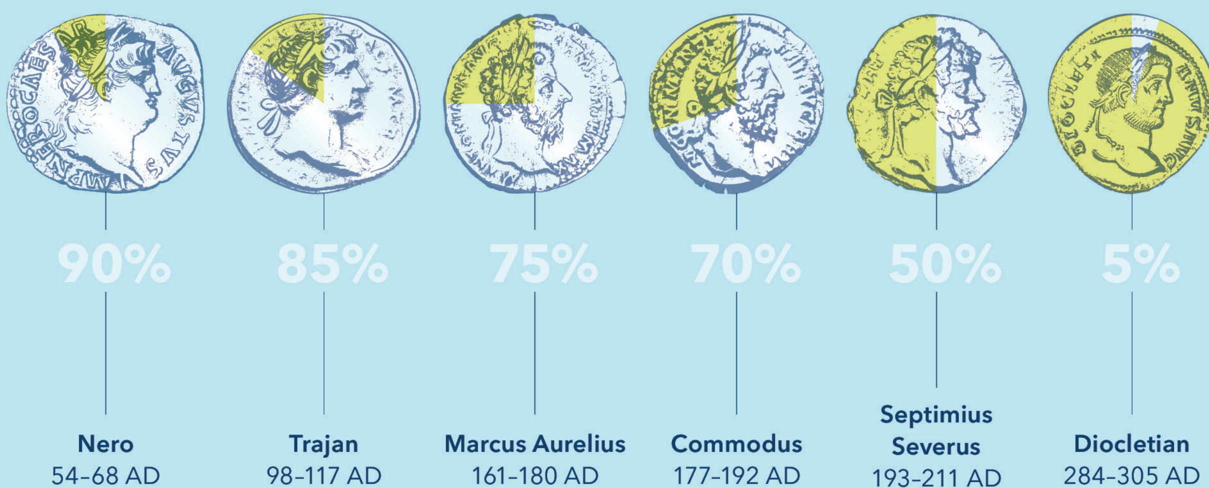
Inflation is as old as money itself

Inflation in ancient Rome

Defending the Roman Empire was an expensive business. Emperors repeatedly had to raise soldiers' pay to keep the army loyal. But silver was in short supply, so the coinage was debased by adding cheaper metal. This enabled more money to be created, with the result that grain prices rocketed from 150 AD onwards.

Silver content of a denarius

1 denarius = 4 sestertii



Huge differences in Eurozone inflation data

We talk about Eurozone inflation, but the makeup of the statistical shopping baskets varies greatly from country to country. Here are some examples.

Hard Swiss franc

Prices in Switzerland have risen by a factor of 11 since 1914. 1 US dollar in 1914 was equivalent in purchasing power to 30 dollars today. In Great Britain 1 pound in 1914 money would be worth 93 pounds now.

1 Swiss franc in 1914 …

… is equivalent to **11 Swiss francs** today.

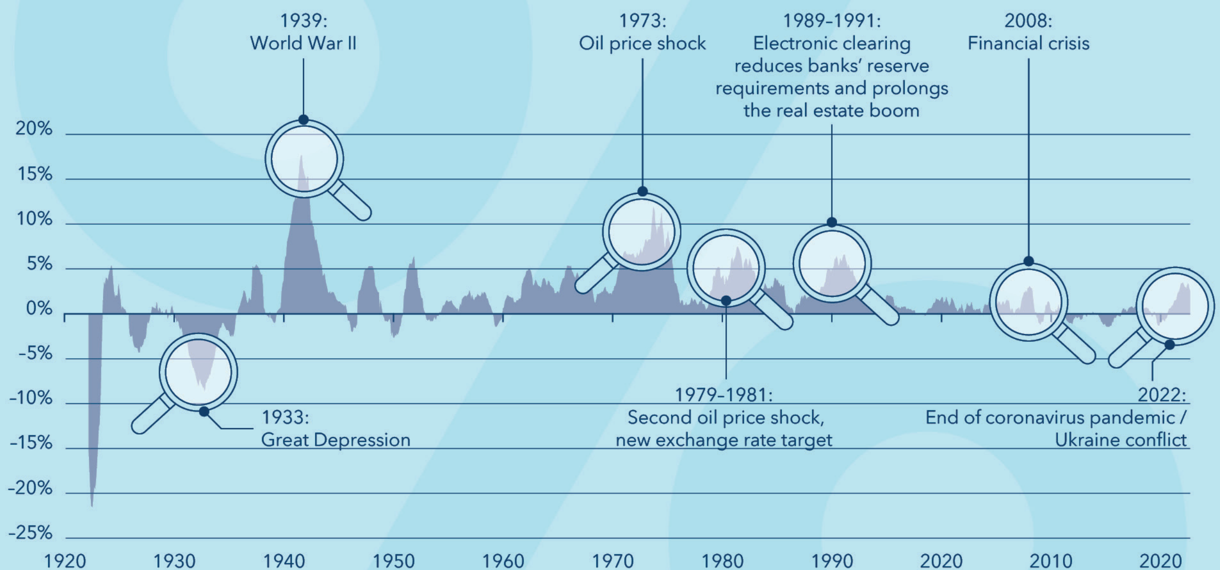
At the start of December 1923 an egg in Berlin cost **320 billion marks**.

A third class ticket on the Titanic cost 7 pounds, equivalent to **645 pounds** in today's money.

Silver from the colonies pushed up Spain's money supply in the 16th century from 5 million to **91 million ducats**. Spain suffered national bankruptcy several times.

Swiss national consumer price index (year-on-year % change)

Switzerland's inflation record shows how price fluctuations have become much smaller over the years. We have to go back a long way to find an inflation rate of 5%.



For sources see page 26

"We are already seeing second-round effects"

For Ulrich Freund, head of purchasing at the Liechtenstein food manufacturer Hilcona, dealing with the recent surge in inflation has demanded a lot of negotiating skill. He explains how he deals with horrendous rises in input costs.

Interview: Clifford Padevit

Mr Freund, when did you first become aware of the current surge in inflation?
It started around spring 2021. Crude oil prices climbed, livestock feeds became successively more expensive, and logistics prices in the sea freight sector rose sharply.

Was the jump in inflation different from previous episodes that you had experienced?
Essentially no, though perhaps a bit more extreme. At Hilcona we carry out a quarterly "market radar" exercise, in which we look at forward indicators and consider what impact they could have on our products. When we realised in 2021 that something was brewing, we compared the situation with the food price crisis of 2007/08 and found many similarities.

Were you able to assess the scale of the problem?
I have to admit that we couldn't see how large the price surge would be. And of course we could not foresee the extreme additional impact of the war in Ukraine. Ukraine is one of the world's biggest exporters of sunflower oil and wheat. Added to that, boycott measures caused a sharp rise in fertiliser prices, since phosphate and potash come mainly from Russia and Belarus. These input factors climbed exponentially overnight.

What sort of rises are we talking about here?
Average fertiliser prices tripled. Such huge increases have a massive impact, depending on the product concerned. Take an egg, for example. Chicken feed makes up about 60% of the cost of egg production. If the price of feed doubles, the cost of producing an egg climbs by 60%. Feed costs affect very many products, notably meat and milk.

You presumably can't simply absorb such huge price rises, can you?
Nobody could have foreseen that feed prices would double or that a war would break out in Europe and push energy costs through the roof. In such situations we have to sit down with our suppliers and talk. That happened frequently last year. As a buyer I suppose I could tell them it's their problem, not mine. But when you have long-term partners and security of supply is important, you have to listen sympathetically.

Price rises of this sort don't happen every day. What is the threshold at which you would normally start to feel nervous?
In eight out of nine years I can stay relaxed, because individual effects tend to cancel each other out due to the diversity of the portfolio. But in the ninth year I have to hear alarm bells and respond in good time.

And how do you respond?
One way is to cover our requirements physically before the price rises. We can also negotiate fixed prices or introduce a floating system with time lags. These days many raw materials can be bought on the futures market, where a price is fixed now for delivery at a future date. That facilitates price planning.

Are suppliers happy to make such arrangements?
Yes. We work together with long-term partners who understand our requirements. They get an assured sales volume, and we expect price transparency in return. Together with our partners we also seek to optimise procedures along the delivery chain, for example by using the most efficient batch sizes for the supplier. Or we can reduce our own costs by ensuring that the goods are delivered in a form that we can process efficiently.

How important is an early warning system for prices?
For Hilcona it is absolutely vital to know how steeply raw material prices are going to climb. Raw materials are a significant part of our costs. We therefore need a sensitive system that can assess at an early stage how much input prices will rise and show us what sort of situation we must prepare ourselves for. Otherwise the firm could be in jeopardy.

How is that done in practice?
We are a planning-oriented company. Every year we draw up a budget for the year ahead. But if price fluctuations increase as they have recently, we shorten the cycle to as often as three times a year.

Do different sectors offer different possibilities for passing on price increases? You deliver to the restaurant sector as well as to retailers, don't you?
Yes. In the food service sector (restaurants, company catering, etc.) we have a pricing strategy, and the buyer makes the choice. In the retail sector prices are usually negotiated annually. That presents a challenge if costs rise too steeply. Then we have to present a credible argument to explain why price adjustments are necessary.

Have there been suppliers who tried to exploit inflation to justify excessive price increases?
Some have tried that. Then it's our job to see that they don't get away with it. We are always ready to talk, but only on the basis of solid facts. And occasionally we look for replacements for individual suppliers. Or we can make adjustments in the materials we use.

For example?
There are possibilities in the field of packaging materials. For the sake of sustainability we are endeavouring to use thinner plastic wrappings without impairing food security. A change of packaging materials can result in a weight reduction of 10% to 20%.

On the subject of sustainability, does the growing demand for vegetarian products affect prices in this sector?
The trend towards flexitarian, vegetarian or vegan cuisine is very noticeable. In the last two to three years the growth of demand has outstripped agricultural production in this sector. That has resulted in above-average price increases for vegetarian products. As a result the price differential vis-à-vis animal protein has become smaller again.

What does your price analysis point to for 2023?
We see some easing of price pressures but also the emergence of second-round effects. Over the last three months second-round effects in the personnel sector have again been driving up costs – not only for us, but for many of our suppliers too.

Profile

Dr Ulrich Freund, 58 years old, has been in Hilcona's purchasing department for 12 years. Together with his 25-strong team, he oversees the purchasing of around 2,000 different raw materials and 2,500 packagings that go into over 1,600 finished products. His team handles all the company's purchases: energy, equipment, potatoes ... everything! Based in Schaan in the Principality of Liechtenstein, **Hilcona** produces convenience foods for the gastronomy and retail sectors: rösti, pasta, sandwiches and much more. Hilcona was founded in 1935 and is part of the Swiss Bell Food Group.

Note: The opinions expressed in this interview may differ from those of VP Bank.

Things are not always what they seem

Susanne Lebrument is Lead Director of the Swiss media company Somedia. She didn't get where she is by chance.

Clifford Padevit

// I get bored when things go well. //

Susanne Lebrument

"I love a challenge," says 51-year-old Susanne Lebrument, Vice-Chair and Lead Director of Somedia, a Swiss media company which publishes "Südostschweiz" and a number of other regional newspapers. "When things go well, I get bored."

Time and again this attitude has helped her in her career. The story started in 2006. Her father, who was Chairman of Somedia and had been in the driving seat since 1971, telephoned out of the blue and asked if she would head up the firm's Advertising Market Department. This department was Somedia's main generator of income. For Susanne Lebrument it was a difficult decision. She was about to leave for the United States, where she intended to live and work for an extended period. (→ "My worst investment"). And since having chosen applied psychology as her subject at university she was not professionally close to her father. Nevertheless she said yes. What followed was a voyage of self-discovery, surmounting one hurdle after another and battling for the family firm.

The start was hard. "I had to work my way not only into a new job but into the firm and the family." She encountered scepticism and doubts. It wasn't an easy time. The print advertising business was in a period of weakness, partly because of digitalisation. At first Susanne imitated her father's management style: shouting loud to get results. Then she employed a coach and developed her own style. Time and again she realised that the family name by itself was not enough; she had to be a double role model: woman and mother.

Nothing annoys her more than stereotypes. As a trained journalist, she frequently addresses this theme in her regular column. "If you want to achieve something, you need to assert yourself. But why do people make it even harder for certain groups?" The teacher of one of her children once asked how many days a week she worked, as if being a working mother was a bad thing. In this respect there is still a big gulf between town and country, she says. She sometimes likes to "holiday" for a few days in Zurich, where she studied.

Susanne Lebrument is keen to help young women to clear such hurdles more easily. She is a mentor to two female high school graduates, and she is involved in a corporate initiative to encourage more girls to study natural sciences. She also campaigns for women to get a higher profile in media reporting and not be confined to stereotypical contexts.

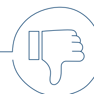
She faced her severest test as a businesswoman and daughter in 2017. Somedia, wholly owned by the Lebrument family and still under her father's leadership, was heading for an existential crisis. "If we carry on like this, we'll soon have to switch the lights off," she said, but her father wouldn't accept this. So together with her two brothers and the present management team, she worked out a new strategy. To her amazement her father agreed to the plan and gave the younger generation its head. The new succession arrangement was completely different from what had originally been envisaged. Susanne became Lead Director and the firm's new strongwoman. And Somedia is healthy again.

Having followed in her father's footsteps, Susanne Lebrument experiences the passion and elation that her father displayed about the business. It was a battle, and it would be completely wrong to say that she got where she is only because of her name. Things are often not quite what they seem.

My best investment

"Children"

"It's wonderful how children see the world. Recently my 14-year-old son took my hand and declared that it was great to touch old skin. I love that sort of comment."



My worst investment

"Not having lived for a long period abroad."

"A day before I was due to go for a lengthy stay in the United States, my father phoned and offered me an important job in the family firm. I said yes and have never regretted it. But I would advise any young woman to live for a while abroad."

Personal inflation

Inflation is experienced differently depending on a person's economic situation and lifestyle. This can be seen clearly in US statistics.

Angelina Sonderecker

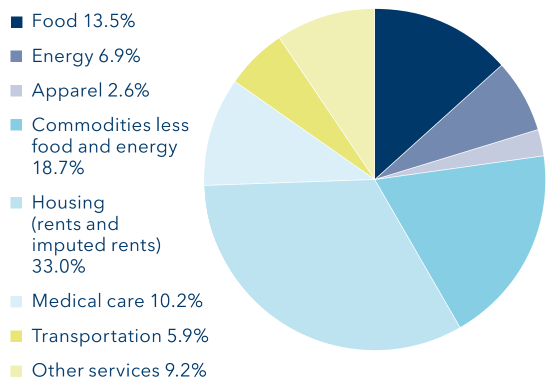
Almost every statistical office publishes a personal inflation calculator, i.e. a tool that enables people to estimate their personal inflation rate on the basis of their particular circumstances. The reason is obvious: no one is an average; no one spends money in exactly the proportions of the shopping basket used to calculate the official inflation rate. Personal inflation calculators can be found, for example, on the websites of Switzerland's Federal Office of Statistics, Germany's Federal Statistical Office or the UK's Office for National Statistics. They let people work out their personal inflation rate on the basis of their own consumer behaviour rather than that of an average household.

Big regional differences

Such calculations invite detailed analysis, especially in the US, where inflation is now gradually receding after an explosive rise. Price developments in America vary hugely from region to region. Miami had an inflation rate of 9.0% last April, while Alaska's was 3.1%. Differences in income distribution are also very pronounced.

An analysis must start with the US national annual rate of inflation, which stood at 0.1% three years ago in May 2020 before climbing to 9.1% in June 2022. This national rate is an average figure calculated on the basis of eight weighted price groups: food, energy, apparel, etc. (see chart). These inputs, i.e. the composition of the basket of goods and services, are based on detailed consumer surveys, but they provide no insight into the homogeneity or heterogeneity of the database. They do not tell us, for example, about differences in consumer behaviour between old and young, high earners and low earners. To fill this gap, the US

US basket of goods and services for the consumer price index



Bureau of Labor Statistics conducts regular consumer expenditure surveys to look at the income and spending habits of representative private households. The samples consist of 20,000 interview questionnaires and 11,000 diary surveys completed annually and grouped by various socio-demographic criteria.

The survey results underline the fact that socio-demographic factors exert a major influence on spending behaviour and hence on personal inflation. Low-income households and persons living in rented accommodation or with a low level of education spend a larger proportion of their income on basic necessities like housing, food and transport. People who rent their accommodation spend an average of 39.4% of their income on housing, compared with 31.8% for home-owners.

Housing costs are key

Analysis also shows that the percentage of home owners rises with income. Among households in the lowest 10% income category, only

> // Personal inflation varies depending on an individual's economic situation and lifestyle. //

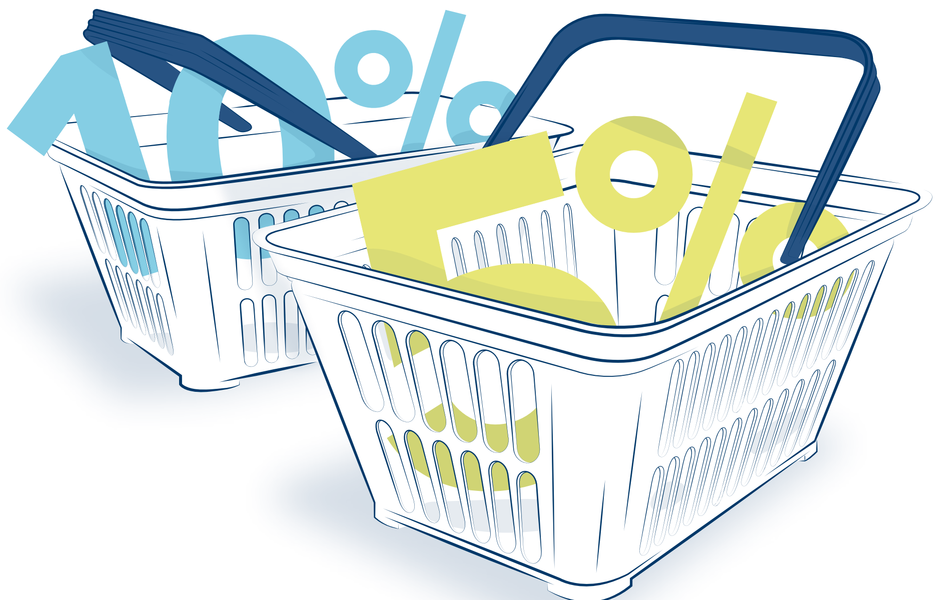
38% own their own home. This rises to 88% for households in the top income decile, where the proportion of mortgage payments is therefore higher. Housing costs are currently at the centre of attention. Expenditure on housing is now the principal driver of US inflation. This is not simply because rents and home prices are rising, but mainly because of the weightings applied. Housing costs are now by far the biggest component of consumer expenditure, accounting for about a third of outgoings. And here we see the big differences. People in urban areas spend a much higher proportion of their income on housing than those who live in rural areas (35.6% versus 28.7%). So rural dwellers come off better and experience a lower inflation rate than the average, though this is partly offset by higher transport costs, which amount to 14.8% in town as against 20% in the countryside.

Age also has a bearing on the personal inflation rate. Here a key factor, as one would expect, is healthcare costs, which amount to only 3.3% of spending for the under-25s as against 15.5% for the over-75s. That means that if a visit to a doctor costs USD 100 one year and USD 110 the next, seniors are hit five times as hard as young adults. Age also affects spending on clothing, accounting for 3.5% of spending in the under-25 category and falling to 1.6% for the over-75s.

Lifestyle effects

A personal inflation rate can therefore be calculated on the basis of income, housing, age and also lifestyle. Simple socio-demographic criteria are not the only factors to consider. Vegans, for example, have been unaffected by the horrendous rise in the price of eggs, up 36% in the 12 months to March. Owners of petrol powered cars are now driving more cheaply, because petrol prices have come down, while owners of electric vehicles have been hit by rising electricity prices. The deeper one delves, the more baffling the mass of data becomes. US statisticians track 80,000 prices, which are divided into 200 categories and then assigned to the eight main groups.

Defining the 200 categories and calculating their relative importance together with the percentage weightings of the eight principal price groups involves simplifying a very complex system. But without these statistics we would be unable to say anything definite about household consumption patterns. Individual consumption behaviour and inflation exposure are not self-evident but can be assessed on the basis of detailed official data.



Central bank influencer

Christina Strutz

"Inflation is always and everywhere a monetary phenomenon."

With this famous statement in 1963, Milton Friedman transformed economic thinking in the 20th century in a way unparalleled since John Maynard Keynes.

As the father of monetarism Friedman's influence on economic policy has been immense. One of his most important contributions to economic theory was his revival and refinement of the quantity theory of money in the 1950s and 1960s. This theory states that inflation is directly related to money supply. If the central bank expands money supply, prices will rise. Friedman regarded this connection as self-evident and universal. His approach revolutionised monetary policy.

In contrast to Keynesian thinking, Friedman argued that economic performance and the level of prices are determined by the central bank's management of the money supply. Friedman and his fellow monetarists gained influence in the 1970s, when inflation in the United States was far too high and had to be fought. Monetary concepts have been further refined since then, but Friedman's ideas continue to underpin monetary policy.

Friedman was a passionate champion of free markets and a famous critic of the previously dominant Keynesian approach, which emphasised the role of the state in tackling economic crises.

"Everyone now knows that the only path to success for underdeveloped countries is freer markets and globalisation," said Friedman in an interview with a Swiss newspaper in 2005. He held that competition and market forces are the best way of ensuring that resources are efficiently deployed and economic growth ensured. Friedman was a strong advocate of floating exchange rates, negative income tax and education vouchers, as explained in his book "Capitalism and Freedom" (1962), which he wrote together with his wife Rose. In their bestseller "Free to Choose" (1980) and the associated TV series, the Friedmans set out to explain market economy ideas to a broader public.

Given his free market views, it is not surprising that Friedman became an adviser to Republican Presidents Richard Nixon and Ronald Reagan. In 1976 he was awarded the Nobel Prize in Economics.

Milton Friedman was born on July 31, 1912 in Brooklyn, New York. He studied at Rutgers University (New Jersey) and the University of Chicago, where he later joined the faculty after gaining his PhD in 1946 at Columbia University. In 1932, while a student, he met his future wife Rose Director. They married in 1938 and were together for 68 years until Friedman's death in 2006 at the age of 94.

In a 2011 survey of 299 randomly selected US economics professors, Friedman and Keynes were voted the most important economists of the 20th century. Friedman's influence on modern economic theory and monetary policy remains uncontested. In modern parlance he was a major "influencer".

Inflation hedging – ditching the myths

Inflation is bad for investors, because it erodes purchasing power. There are no simple remedies, but there are investments that reduce the pain.

Bernd Hartmann

Inflation-linked bonds are helpful only when inflation accelerates unexpectedly.

The coupon on an inflation-linked bond moves in keeping with the consumer price index and would therefore seem to offer optimal protection against inflation. But empirical research has shown a negative correlation. When inflation climbs, the bond price falls. Inflation-linked bonds admittedly fare better than ordinary fixed-income securities in an inflationary environment, but that is only a small consolation.

Even so, inflation-linked bonds have their uses. They are always worth considering if an investor expects inflation to accelerate more than the market foresees. The market's expectation provides the break-even inflation rate, i.e. the rate at which the returns on an inflation-linked bond and a fixed-rate bond with the same maturity and credit rating are the same. This rate can fluctuate greatly. When the coronavirus pandemic burst on the world, US inflation expectations initially collapsed to 0.2% p.a. but two years later were over 3.7% p.a.

The market for inflation-linked bonds is much smaller than the fixed-income market. Only a few countries have issued them, including the US, UK, France, Italy, Japan and Germany, but not Switzerland.

Equities do not provide full protection in the short term, but in the long term they do.

Equities represent a share in the ownership of a company and are therefore regarded as real assets. However, empirical analysis shows that they do not offer full protection against inflation. They generate much lower real returns in periods of high inflation than when inflation is low. Thus equities do not provide an immediate shield if inflation accelerates rapidly. On the other hand, the long-term performance of the equity market outdoes the consumer price index.

Moreover, in many cases a company's results are not negatively affected by inflation at first, because the price increase passed on often exceeds the effective rise in the company's costs. There are two main reasons why equities do not perform well during a spurt in the inflation rate:

1. Inflation pushes up the level of interest rates, resulting in a fall in the value of future profits. Investors can then avail themselves of more attractive alternatives. The fair valuation level falls, pushing down the share price.
2. Higher inflation rates and resultant monetary tightening increase the likelihood of recession, undermining companies' prospects.

The inflation protection offered by equities can be improved by focussing on companies with a powerful market position. Such companies find it easier to pass on price increases.

Real estate: usually a safe asset, but ...

In the real estate market, the current income earned on an investment (i.e. rent) is more important than in the case of equities. Rental contracts vary from country to country and sector to sector. A full or partial inflation-indexing of rents obviously gives a higher level of inflation protection.

Returns on rented housing follow the inflation trend more closely than rented office space. However, higher inflation is usually accompanied by higher interest rates. Depending on the method of financing (money market or fixed mortgage) and the degree of leverage, this can reduce or even wipe out the increase in rental income. Inflation protection can also be nullified by government interventions in the housing market when inflation is running high, e.g. the imposition of rent ceilings.

Besides current income, movements in the value of a real estate investment are also important. Rising inflation rates are usually an indicator of a buoyant economy. So it is not surprising that real estate prices usually do well in times of accelerating inflation. But here, too, the trend can go into reverse if the central bank's countermeasures push the economy into recession. Commercial real estate, e.g. office space, industrial premises and hotels, is more exposed to monetary tightening than residential property. Overall, the inflation protection provided by real estate depends to an important degree on the market segment, the rental agreement and the mode and extent of financing.

Commodities overcompensate for inflation.

Among the various asset classes, commodities offer the best protection against inflation. Commodity prices show a positive correlation with overall price movements. If inflation rises, commodity prices move up disproportionately.

But the various types of commodity do not all react in the same way. Precious metals are regarded as the best hedge against inflation, and empirical research confirms that gold reacts especially sensitively to rises in the general level of prices. However, gold fulfils this hedge function primarily in phases of high inflation, reacting most strongly when there are doubts about a central bank's credibility. Investors then flee into gold, often in the form of physical bullion or coins. When the inflation rate is not particularly high, gold fails to provide an effective hedge. Other precious metals such as silver, platinum and palladium do not display the same positive characteristics in this respect. As they are used mainly for industrial purposes, their price movements have a more cyclical character.

While commodities behave advantageously in periods of high inflation, they tend to disappoint when inflation is low or receding. The broad-based Bloomberg Commodity Total Return Index, which comprises energy, cereals, other agricultural products and metals, is now at roughly the same level as 20 years ago. This is partly because of rollover costs in the futures market. Here, too, a straightforward gold investment has performed much better.

Keep your powder dry

Bernd Hartmann

The financial markets are behaving well this year, unlike in 2022. Bonds, equities and gold all chalked up gains in the early months. This reflects underlying strength rather than an absence of bad news. Market players are relaxed and confident. But is this confidence justified, or have investors simply got used to downbeat factors?

> // Market expectations unlikely to be fulfilled. //

Optimists dominate

The first test was the turbulence that erupted in the US regional banking sector, followed by the forced sale of the Swiss bank Credit Suisse to its competitor UBS. Perhaps it is too soon to tell whether the storm is over. Back in 2007-08 almost a year passed between the outbreak of the subprime crisis and the Lehman collapse. This time, however, the world seems to have avoided a broad loss of confidence and a global escalation of problems in the banking sector.

What we are witnessing is the result of an aggressive tightening of monetary policy rather than a general banking malaise. Further negative fallout from monetary tightening can be expected. Higher borrowing costs will lead to more loan defaults. Banks are already much less willing to to lend. That in turn is likely to lead to lower investment, with the pain therefore being felt not only in the credit sector but in the economy as a whole. The threat of a credit squeeze increases the probability that the economy will slide into recession, as often happens when central banks hike interest rates. At present, though, the financial markets are ignoring this prospect and celebrating the fact that the expected economic downturn has so far not materialised.

Recession avoided?

Confidence indicators are admittedly downbeat, but hard economic and corporate data are so far holding up amazingly well. The majority of investors now assume that a US recession can be avoided. Thus sentiment is very different from what it was half a year ago. With corporate profits stagnating, improved expectations have led to a rise in price-earnings ratios. The US equity market has recently been driven by a handful of big corporations, including iPhone manufacturer Apple. In May, for the first time ever, Apple's market capitalisation of around USD 2,700 billion exceeded the total capitalisation of all the companies in America's Russell 2000 small caps index.

The bond markets, too, have not yet priced in a recession. Despite the threat of a credit squeeze and a foreseeable rise in debt servicing costs following the hikes in interest rates, credit spreads remain at a comparatively low level. Only the higher gold price suggests that not all parts of the market view the future with equanimity.

Stay defensive

We believe that the financial markets' confident expectations will not be fulfilled. Given the difficult outlook, we view the chances of positive surprises as limited. We therefore recommend a more defensive positioning, as we did at the start of the year. We prefer (government) bonds to equities and recommend that the portfolio should include non-cyclical assets such as gold or insurance-linked securities.

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CIO Office · VP Bank Ltd
Aeulestrasse 6 · 9490 Vaduz
T +423 235 61 73 · F +423 235 76 21
cio-office@vpbank.com

Editorial staff
Dr Felix Brill, Chief Investment Officer
Felipe Gomez de Luis, Head of Group Communications & Marketing
Dr Thomas Gitzel, Chief Economist
Bernd Hartmann, Head of CIO Office
Angelina Sonderecker, Junior Data Scientist
Christina Strutz, Investment Communication Manager
Clifford Padevit, Head of Investment Communication (Lead Editor)

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Katja Schädler, Senior Visual Designer

Translation
Paul Courtney

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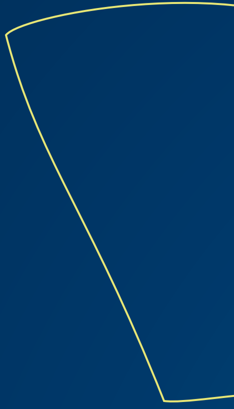

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