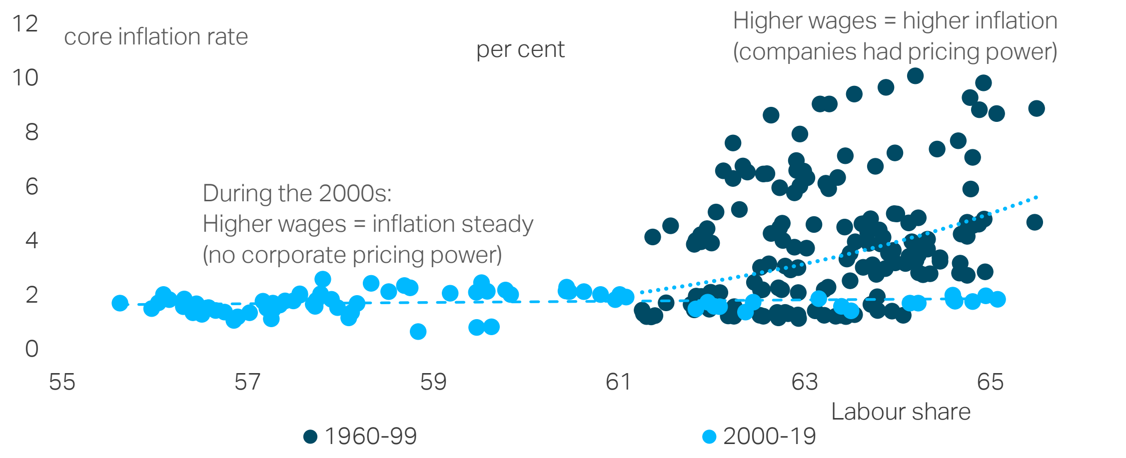
Macro Picture

# STICKY INFLATION OR PEAK MARGINS?

Dario Perkins

Booming corporate profits reflect successful policy stimulus, with governments protecting their economies from COVID-19 damage. Yet margins could face more sustained pressure in the post-pandemic environment, especially from stronger wage growth. If companies resist this squeeze, central banks will raise interest rates more forcefully. "Pricing power" is not bullish.

### Chart 1: Margins used to absorb wage pressures – will this change?




Sources: BLS, BEA, TS Lombard.

## PROFITS OF SIN

Massive COVID-19 policy stimulus was always going to boost corporate profits, which is why the US has seen earnings increase more than most other developed economies. But more of this boost has come from higher prices (less from output) than policymakers would have liked. Wall Street analysts think these margins can be sustained – they are likely to be disappointed.

## PEAK MARGINS

The pandemic has rekindled the debate about whether governments should use direct price controls to stifle "corporate greed" and suppress inflation. Even if these measures had helped during the pandemic – which seems unlikely – they are unsuitable for the inflation risks we face today. Now, the main inflation threat is from labour-market "overheating" and rapid wage growth.

## MONETARY SQUEEZE

While Wall Street strategists are confident the corporate sector can sustain record margins even in a "hot" labour market, central banks will have different ideas. Either margins must shrink or the authorities will need to squeeze aggregate demand by raising interest rates aggressively. Monetary tightening will ultimately be effective – but at what cost to the economy and markets?

# STICKY INFLATION OR PEAK MARGINS?

Corporate profits have boomed during the COVID-19 crisis – a radical deviation from what policymakers feared at the start of the pandemic. Back in March 2020, it seemed plunging demand would trigger a total collapse in revenues and a wave of bankruptcies. Corporate-sector resilience even explains, at least in part, the impressive performance of the stock market, which has shrugged off the macro turmoil of the past two years. Far from being angry or embarrassed by this performance, the authorities should welcome it: the rebound in corporate profits proves that their efforts to support the economy were successful. Simple accounting identities (e.g. the "Levy-Kalecki equation") show that government stimulus will always end up in higher corporate revenues, as long as households do not save all the proceeds or use it to buy more imports. This is why US earnings have outpaced those of most other nations – US fiscal stimulus was much larger. But now the authorities have a problem: a greater proportion of this rise in corporate profits has come from higher prices, not stronger output. Even as Wall Street analysts celebrate this "margins expansion" ("the return of pricing power"), it has triggered widespread complaints about "price gouging" and the abuse of "monopoly power". Some economists have even proposed radical solutions, including stricter antitrust enforcement and direct price controls.

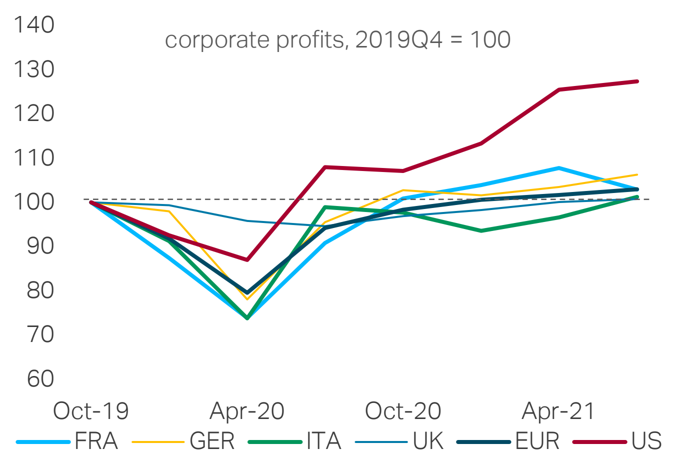
There is no doubt companies have taken advantage of the COVID-19 environment to raise their prices. Businesses that have experienced substantial cost increases during the pandemic have had no problem passing these costs onto consumers. And in some of the hottest sectors (e.g., the durable goods industry), the combination of severe supply bottlenecks and booming demand naturally allowed companies to expand their profit margins. We should be careful not to over-extrapolate from these trends. As the pandemic fades and economies rotate back to services-sector activity, any COVID-induced "pricing power" is likely to evaporate. When supply curves are steep, as they have been during the pandemic, shifts in demand – both up and down – will always cause large swings in margins. This means there is no real case for government interventions such as price controls or other regulatory changes. Even if these measures had been useful during the pandemic – which is questionable, given past experiences – now is not the time to experiment. Recently, in fact, the inflation threat has evolved in a way that has further undermined the case for these more radical interventions: if the consensus is wrong about the "transitory" nature of inflation, it will be due to "overheating" in labour markets and a persistent acceleration in wages, not pandemic "price gouging". Evidence from the 1970s shows that price controls are ineffective against strong demand and wage-price spirals, only delaying price hikes.

Over the past 30 years, faster wage growth has always undermined corporate margins. While Wall Street bulls are confident this time will be different because companies have rediscovered their "pricing power", central banks will have rather different ideas. In fact, if wage growth remains strong and the business sector is successful in protecting its margins, central banks will need to squeeze corporate earnings in other ways – namely by raising interest rates more aggressively. And we should not doubt the authorities' ability to squeeze their economies if they are serious about forcing inflation lower. Indeed, the impact of monetary policy has become highly asymmetric – while central banks have struggled to stimulate demand by reducing the cost of borrowing, they could certainly cause a great deal of economic damage by raising interest rates aggressively, especially in those sectors that have driven the post-COVID recovery (housing, finance and consumer durables). Worse, history shows it will be difficult for the authorities to calibrate their response. If inflation becomes a persistent problem, the danger will be that central banks tighten monetary policy too much, causing a recession. Given this threat, "enhanced pricing power" seems a rather myopic reason to be bullish equities in the post-COVID economy.

# 1. PROFITS OF SIN

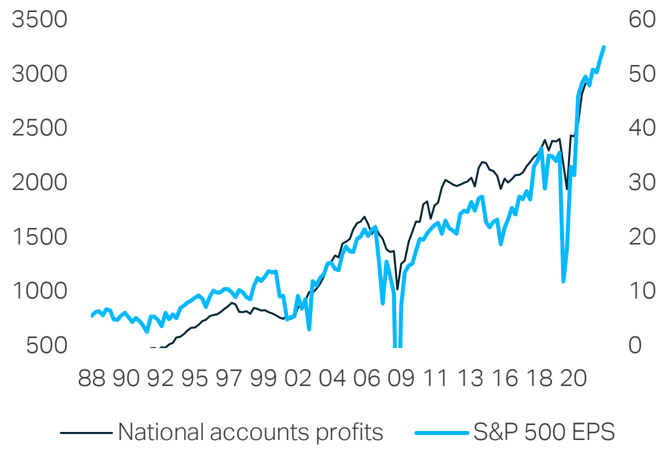
Corporate earnings have boomed during the pandemic, especially in the United States. US profits are up almost 30% and, while the improvement in Europe and other developed nations has been less spectacular, their companies have performed remarkably compared with what many investors feared in March 2020. Remember, business revenues were at the heart of the COVID-19 economic crisis: reduced social interaction forced consumers to cut their spending and profits looked destined to collapse, which could have triggered a wave of bankruptcies and a permanent increase in unemployment. But thanks to decisive policy action, the world was spared this fate. Corporate revenues suffered only a temporary V-shaped contraction and there was no sustained deterioration in the credit cycle. Global bankruptcy rates stayed low, bucking the trend of every previous economic downturn. This strong performance even justifies – at least in part – the buoyancy of stock markets over the past two years. Though there was more to the equity bull market than just this simple earnings story (since forward PE ratios have increased, too, during this period), it seems investors were right to "look through" the crisis.

**Chart 2: US profits have outperformed**




Sources: BEA, Eurostat. ONS.

**Chart 3: Equities looked through profits' 'V'**




Sources: S&P, BEA, TS Lombard.

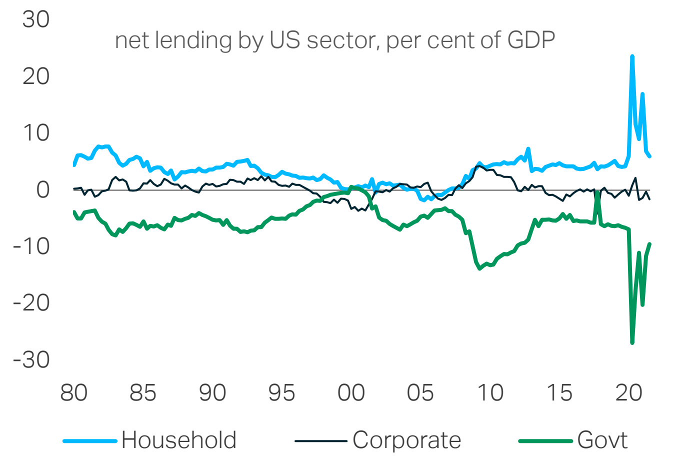
## Corporate greed to blame?

While record profits remain a source of optimism for Wall Street, they have caused serious controversy on Main Street. Some politicians believe the boom reflects "corporate greed", with unscrupulous businesses capturing all the benefits of government stimulus programmes. Yet the increase in profits alone tells us nothing about whether corporate behaviour has changed during the pandemic. In fact, we can use simple accounting principles to show that government stimulus – if successful – was always going to provide a powerful boost to corporate earnings. This insight comes from the "Levy-Kalecki profits equation", based on the work of Michal Kalecki and Jerome Levy, two men with radically different backgrounds who independently arrived at the same basic accounting framework. The Kalecki-Levy model shows that the total amount of nominal profits in the economy must always add up to the sum of net business investment, dividends and corporate taxes, minus the sum of personal savings, the government's budget balance and the current account deficit[1]. So, when governments send stimulus cheques to

[1] Note that if we ignore the government and foreign sectors, this also means profits must equal investment. The intuitive reason for this is simple. Investment does not count as a cost. So, when a company spends more on capex, it injects money into the system, boosting other companies' earnings.

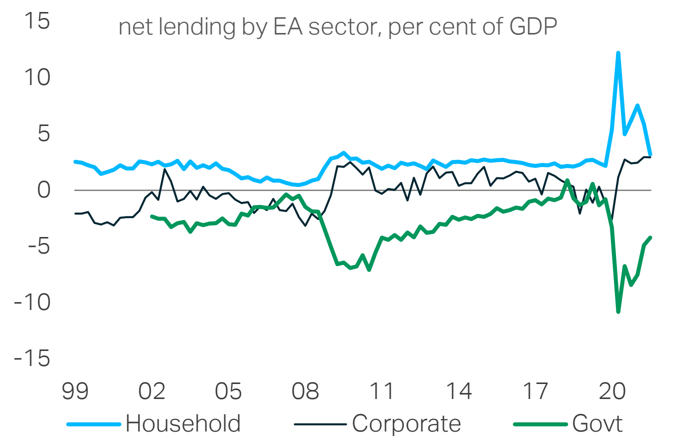
households, these funds always find their way into corporate profits – as long as households do not save the cash or spend it on imports (in which case the “stimulus” would not work).

**Chart 4: US fiscal policy supported the economy**




Sources: BEA, TS Lombard.

**Chart 5: Euro public deficits were smaller**

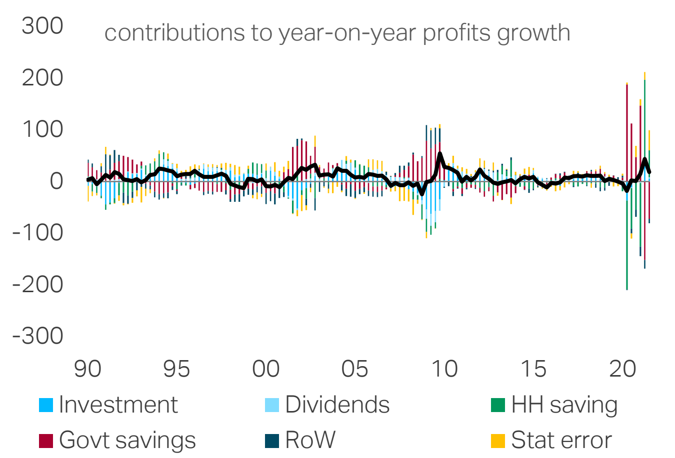



Sources: Eurostat, TS Lombard.

## COVID profits reflect successful policy stimulus

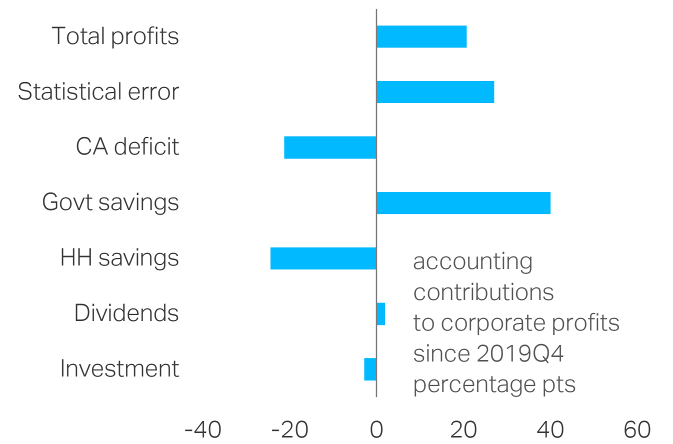
Charts 6 and 7 show our Levy-Kalecki decomposition of corporate profits based on US national accounts data. Clearly, government stimulus has played a crucial role in boosting profits over the past two years, especially during the early phase of the downturn. This is intuitive – as households spent these transfers, the government supported the business sector indirectly. And this simple model also explains why US companies have generated larger revenues than their counterparts in Europe or Asia – the US government’s budget deficit was much larger. So record profits are not a sign of policy failure but rather a sign of policy success. Nevertheless, this situation has clearly become a hot political issue, with some US politicians even looking at ways to restrain “corporate power”. The problem is not the amount of money US companies are making, but rather the combination of record profits and high inflation. The Kalecki-Levy identity can tell us only what total nominal profits should look like, not their composition in terms of real output and prices. US companies could have achieved the same record profits by producing more output at lower prices. Instead, they have hiked prices and raised their margins.

**Chart 6: The Levy-Kalecki profits decomposition**




Sources: BEA, TS Lombard.

**Chart 7: Fiscal supports boosted profits**

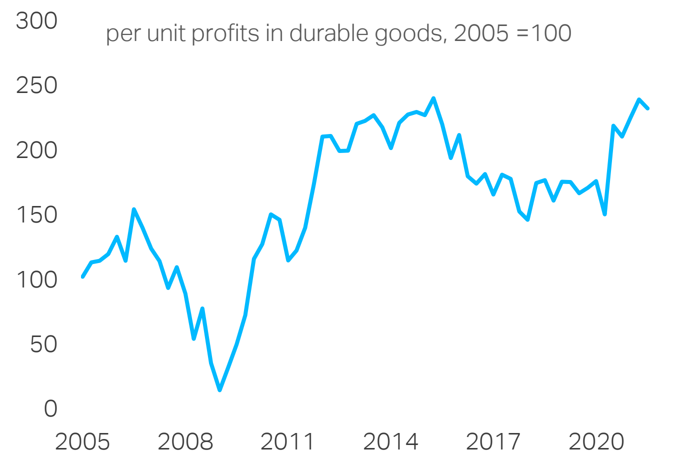



Sources: BEA, TS Lombard.

## Profit margins have increased

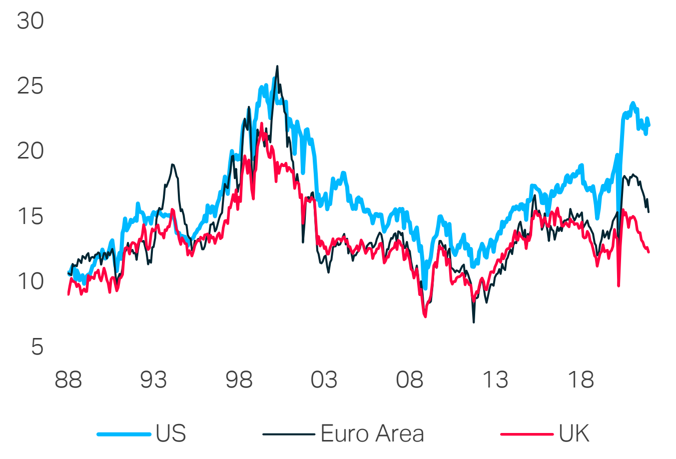
Profit margins (or "markups") reflect the per unit amount of money businesses make, rather than their total earnings. Chart 11, based on NIPA data, shows the official US decomposition of unit prices in terms of margins, labour costs and non-labour costs (raw materials etc.). There has clearly been an expansion in US profit margins during the COVID-19 period, with markups responsible for more than 70% of the increase in unit prices (since, arithmetically, margin expansion accounted for about 3.5% pts of the 4.7% pts rise in prices between 2019Q4 and 2021Q3). Given these findings, popular accusations about US companies "price gouging" or "taking advantage of the pandemic situation" are not totally unreasonable. In some industries, especially those that have faced a combination of exceptionally strong demand and severe supply shortages (such as the durable goods sector), companies have expanded their margins without fear of losing customers. Digital.com, a survey research firm reports that 60% of retailers believed "inflation had given them the ability to raise prices beyond what was required to offset higher costs." (These price hikes were concentrated among the big retailers, rather than SMEs.) But even in sectors that have not suffered severe supply disruption, it seems companies have had no problem passing on the costs of the pandemic to consumers.

### Chart 8: 'Hot' sectors expanded margins




Sources: BEA, TS Lombard.

### Chart 9: Equity strength not just about profits

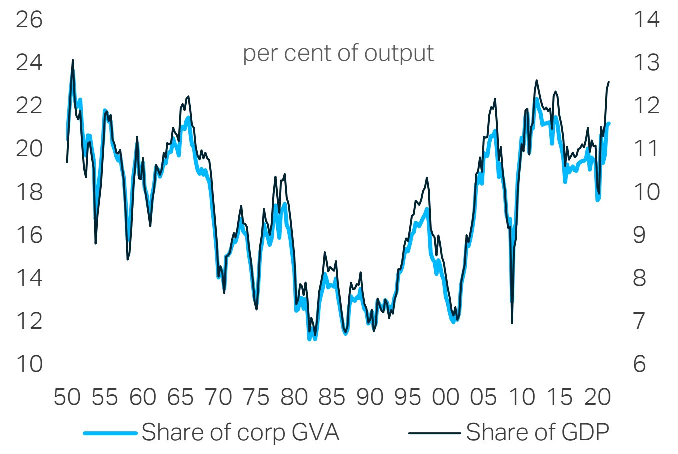



Sources: Datastream, TS Lombard.

## What happens next?

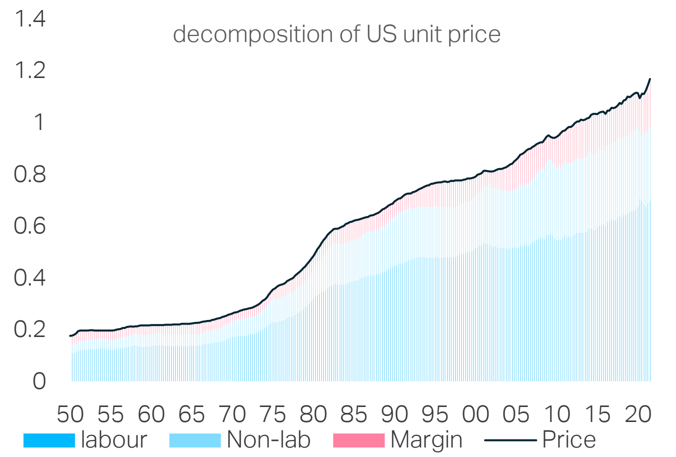
There are good reasons to think the business conditions of the past two years are specific to COVID-19 and not the start of a new regime of "enhanced pricing power". Demand was extremely strong in particular sectors of the economy and supply could not respond, which allowed companies to expand their profit margins. (Analytically, whenever there is a steep supply curve – as has been the case during the pandemic – large swings in demand must always show up in prices and profit margins, rather than output.) As the distortions associated with the pandemic unwind, both inflation and profits margins are likely to plunge (which would make corporate markups another "transitory" COVID-19 story). The most important shift, of course, is likely to be the rotation in consumer spending from goods to services activity. Companies in previously "hot" sectors look set to suffer a serious slump in demand; and if this happens alongside the resolution of previous supply bottlenecks (perhaps because the bullwhip effect shifts into reverse), a powerful disinflationary force could be unleashed. Far from a new regime of higher profit margins, investors may discover that corporate earnings have already peaked.

Chart 10: US profit share hit records highs




Sources: BEA, TS Lombard.

Chart 11: Clear pandemic margins expansion

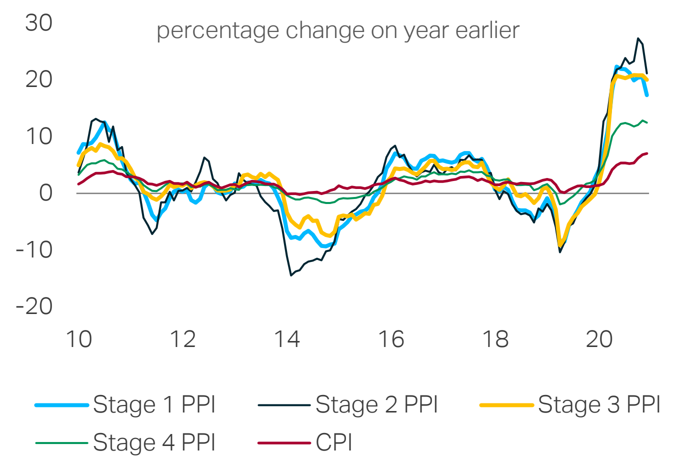



Sources: BEA, BLS, TS Lombard.

## Wages are the new threat to margins

Yet, as we have acknowledged in recent months, the risks to the "transitory" inflation view have shifted. COVID distortions have been stickier than we were assuming, while the cost and price pressures that have emerged seem increasingly broad-based. Like central banks, we are now paying close attention to labour markets, which have recovered rapidly and are currently showing signs of "overheating". While it is difficult to know whether this is the start of a sustained acceleration in labour costs (it might reflect temporary demand-supply imbalances in specific sectors), it raises some important questions about the evolution of profit margins and inflation in the post-COVID economy. Before the pandemic, an acceleration in wages always forced the corporate sector to accept lower margins because they did not feel they could increase their prices (this was one of the defining features of the Lowflation era – Chart 1). Yet many Wall Street executives claim the situation is different now. They believe "pricing power" has returned. If they are correct, this could have profound implications for the conduct of monetary policy in 2022 and beyond. But before we discuss what this means for central banks, it is worth considering some of the more radical ideas that have emerged about how to deal with "corporate power".

Chart 12: Pass-through from non-labour costs

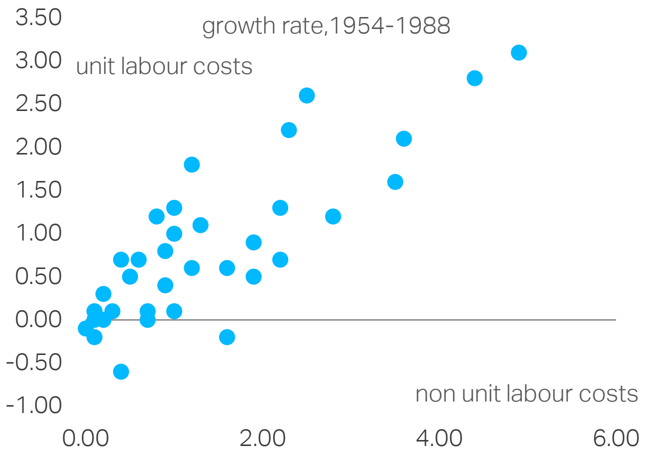



Sources: BLS, TS Lombard.

Chart 13: So far, inflation is not a wage story

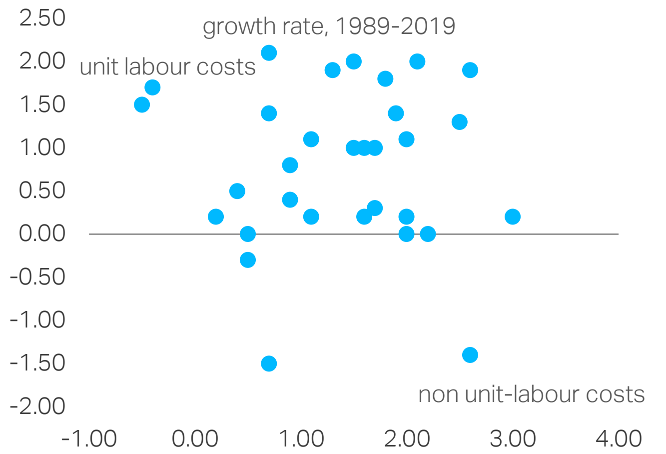

Source: Economic Policy Institute (see here).

### Chart 14: Workers used to have 'power'



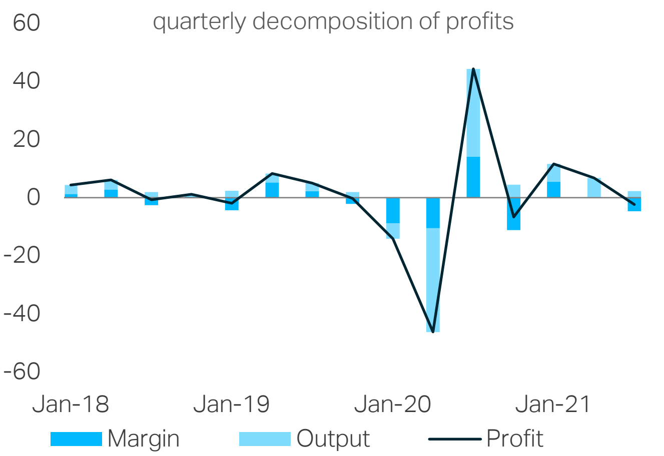

Source: Economic Policy Institute (see here).

### Chart 15: These days, workers get squeezed



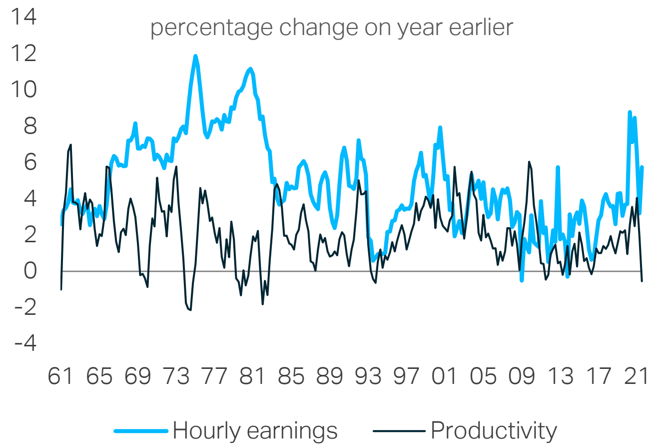

Source: Economic Policy Institute (see here).

### Chart 16: Has a margin squeeze now started?




Sources: BLS, BEA, TS Lombard. Note: margins – inverse of real ULC.

### Chart 17: Wages now outstripping productivity

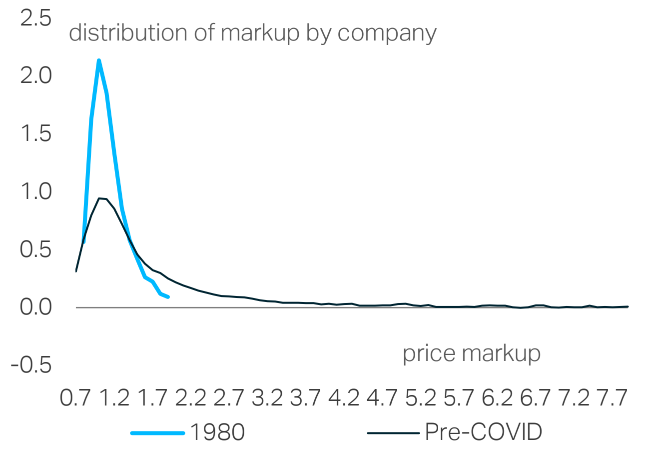



Sources: BLS, BEA, TS Lombard.

# 2. PEAK MARGINS

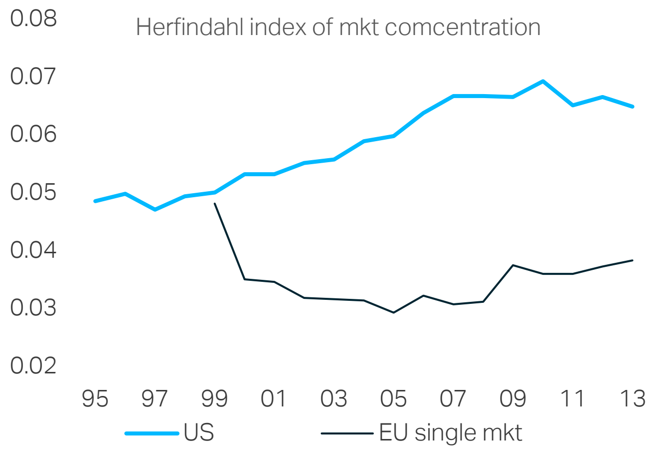
The combination of high inflation and fat margins has sparked a discussion about whether governments need to intervene. One option, which has dominated the debate in the US, is to tackle monopoly power through stricter antitrust enforcement. In fact, political sentiment was tilted in this direction even before the pandemic, since US markets were becoming more concentrated and this phenomenon seemed to be contributing to secular stagnation. There were even claims, albeit rather dubious ones, that the US was becoming less competitive than Europe, where the Single Market had discouraged the emergence of corporate "superstars". On one level, it is not clear how monopoly power can explain an episode of high inflation (as opposed to a situation where prices are just structurally higher). But it is possible that companies with "power" found it easier to exploit the COVID economy. At the start of the pandemic, we pointed out that history provides plenty of examples of large companies exploiting national emergencies. Yet, in reality, there is no real prospect of using antitrust enforcement to tackle the current inflationary episode. Market abuse is hard to prove and passing legislation is slow.

### Chart 18: The emergence of superstar power




Sources: IMF, TS Lombard.

### Chart 19: US market concentration increased

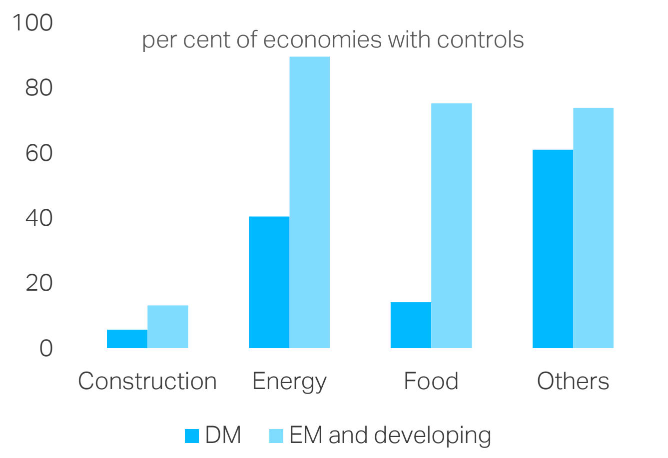



Source: European Commission (2015).

## A radical idea from the past

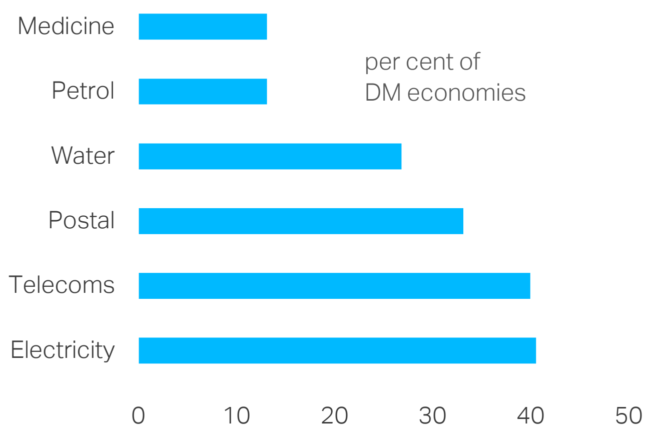
An alternative idea, which has proved even more controversial, is for the authorities to impose temporary "price controls", rules that limit how fast companies can raise their prices or set a cap on the overall price they are allowed to charge. In a recent *Guardian* op-ed, Isabella Weber – assistant professor of economics at the University of Massachusetts Amherst – triggered a major row in the economics community (admittedly, it does not take much..) when she argued that temporary price controls (similar to those adopted during WW2) could be beneficial in an environment of continued supply disruptions. Mainstream economists such a Paul Krugman and Larry Summers were quick to dismiss the idea, while many MMT and "New Keynesian" economists endorsed Weber's proposal, saying it was preferable to conventional monetary tightening (which they thought would be ineffective, or place too much burden on households). Since, in previous research, we, too, have highlighted the similarities between WW2 inflation and the current situation (see here), it is worth investigating Isabella Weber's proposal in more detail.

### Chart 20: Price controls still around today




Source: World Bank.

### Chart 21: Even DM economies use price caps

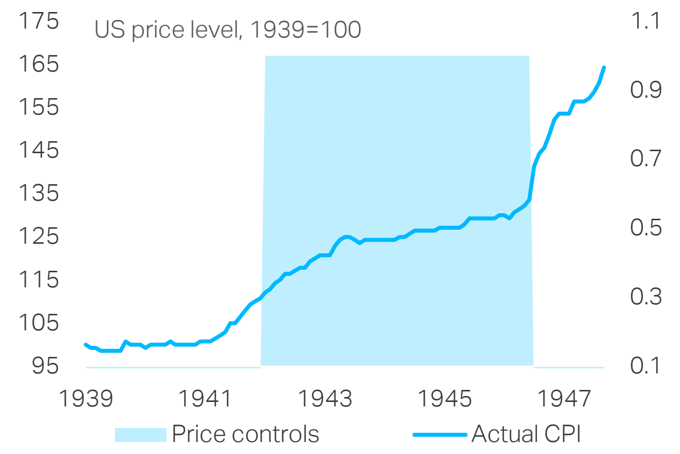



Source: World Bank.

## The case for price controls

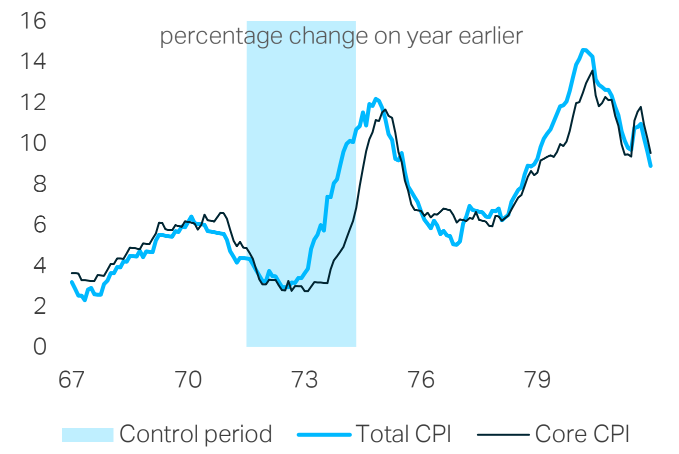
During WW2, the Roosevelt administration imposed strict price controls and instituted the Office of Price Administration. The measures were generally successful – in contrast with what happened during WW1, prices were generally low despite massive increases in output (as the government ramped up its production of military equipment). As Weber points out, in the final stages of the conflict there was an intense debate about what to do with these price controls once WW2 was over. Should they be released in one big bang as southern Democrats, Republicans and big business were urging? Or did price controls have a role to play in the transition to a post-war economy? In *The New York Times*, some of the most distinguished American economists of the 20th century called for a continuation of price controls. This included the likes of Paul Samuelson, Irving Fisher, Frank Knight, Simon Kuznets, Paul Sweezy and Wesley Mitchell, as well as 11 former presidents of the American Economic Association. Weber believes the reasons they were in favour of price controls are relevant today.

### Chart 22: Price controls during WW2




Sources: BLS, TS Lombard.

### Chart 23: Price controls during 1970s



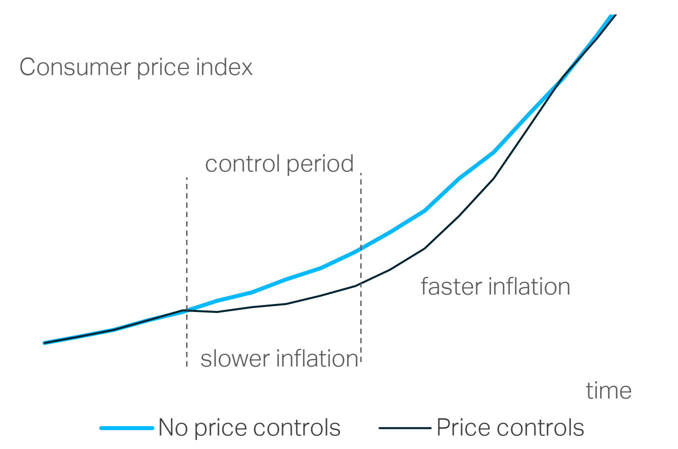

Source: BLS, TS Lombard.

As we pointed out in our previous research, the post-WW2 economy was also characterized by pent-up demand, severe bottlenecks and supply chaos. There were shortages of commodities and basic materials, while global trade links and many dockyards had been destroyed. Labour markets were experiencing acute "mismatch", with governments struggling to reintegrate millions of soldiers into peacetime employment (like today, the Beveridge curve had shifted outwards). Many economists believed price controls should remain in place because supply bottlenecks would not be able to keep pace with the post-war surge in demand. But President Truman ignored this advice and withdrew the measures, which triggered a powerful acceleration in prices – the US CPI jumped 20% in 18 months. Weber believes the current administration should learn from this experience and use "strategic price controls" in an effort to keep inflation down until the pandemic is over once and for all and supply chains have recovered.

## Would price controls work?

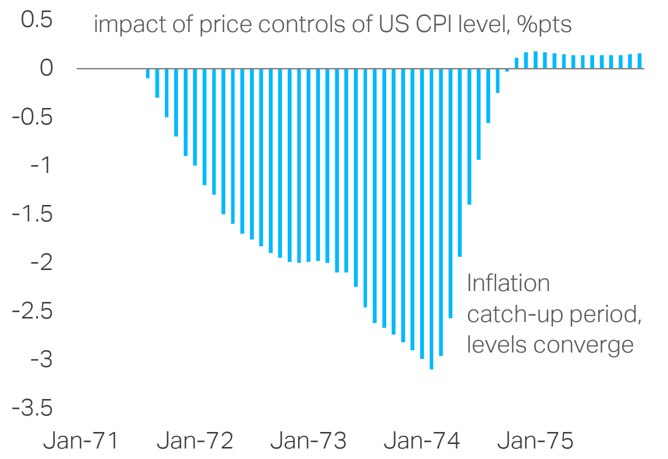
While price controls still exist in many parts of the world (especially in certain industries), many economists have a natural aversion to this sort of intervention. But there may be benefits to using these controls more widely, especially in national emergencies (wars, pandemics, etc.). There are certainly some goods – basic necessities such as food, energy and medical supplies – on which people cannot postpone spending and wait for prices to revert to their pre-crisis levels. (Obviously the argument is weaker when it comes to some of the price pressures we have seen during the pandemic, including double-digit inflation in cars, hot tubs and pedigree puppies). Yet the empirical evidence on the effectiveness of these measures is not exactly compelling. According to a recent review from Noah Smith, results range from price caps having no discernible economic impact to their having a massive distortionary impact and causing nasty side effects (including the intensification of supply shortages and the creation of black markets). Intuitively, this makes sense: if there is excess demand for a product, supressing its price can only make the situation worse or push buyers "underground". Even when the product becomes available again, people might even engage in hoarding, keeping supplies scarce. And since high prices are often the best solution for high prices, government caps could lengthen the adjustment period by discouraging the normal incentive to increase supply[2].

**Chart 24: Controls affect only inflation timing**




Source: TS Lombard.

**Chart 25: Price controls did not affect US CPI**




Source: Alan Blinder and William Newton

## Price controls will not fix 'overheating'

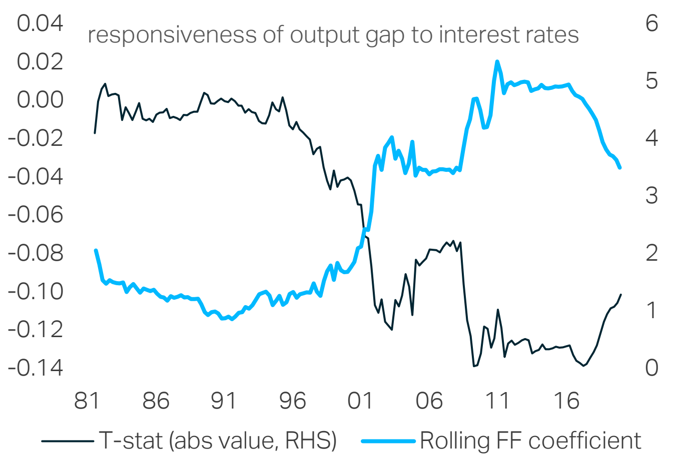
Returning to the current situation, even if there were a case for introducing price controls 18 months ago, that argument is weaker if we are now exiting the pandemic. Indeed, since the nature of the inflation risk has shifted – from direct COVID distortions to overheating in labour markets – price controls would not work. To understand why, consider what happened in the early 1970s when the Nixon administration tried to supress a secular acceleration in wages and prices through government legislation. Detailed analysis by Alan Blinder and William Newton shows that price caps had only a temporary effect on inflation: they kept prices lower as long as they were in place (1971–74) but caused inflation to accelerate as soon as the government lifted them (1974–75). For the entire 1970s episode, Nixon's controls made no real difference to the amount of inflation the US experienced, altering only the timing of price hikes. And it is unlikely price controls would be helpful today. Either the COVID-19 acceleration in consumer prices is transitory and inflation will decline by itself, in which case these measures will not be necessary, or the inflation backdrop is shifting and becoming more persistent – the result of "overheating" and an acceleration in wages – in which case price controls will not work. And if we are facing persistent inflation, there is only one tool available – conventional monetary tightening[3].

[2] The main exception is monopolies. Monopolies limit production to keep prices artificially high, so it is possible that price controls could reduce the amount consumers pay and increase their availability.
[3] If this were the case, price controls could be counterproductive as they would signal an unwillingness to tighten monetary policy. This is another lesson from the 1970s.

# 3. MONETARY SQUEEZE

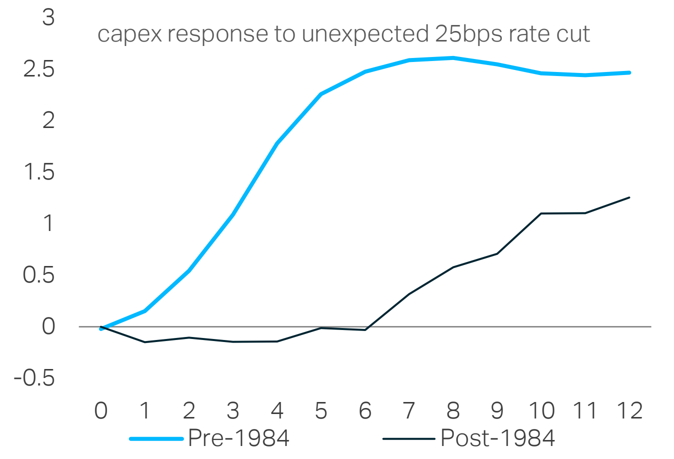
Even as inflation risks have evolved – from direct COVID imbalances to the emergence of potential "overheating" in labour markets – Wall Street executives (and, by extension, most sellside analysts) still have a remarkably sanguine view about the outlook for corporate earnings. They clearly believe "pricing power" has returned during the pandemic, which means companies can continue to pass on any cost pressures they face by increasing their prices. This was a key theme in recent earnings seasons. But the executives who bullishly make such claims do not appreciate the implications for monetary policy. If companies are successful in protecting their margins from faster wage growth, inflation is going to be more persistent than the consensus assumes – which is going to trigger more aggressive monetary tightening. Put another way, either margins must shrink post-COVID or central banks will raise interest rates more forcefully to squeeze consumer demand. It is hard to believe either of these scenarios would be good for the stock market, especially when the economic recovery is already fully priced in.

**Chart 26: Interest-rate sensitivity declines**




Source: TS Lombard estimates.

**Chart 27: Interest rates no longer boost capex**




Source: Baldi and Lange (2019).

## The impact of monetary tightening

Let's assume the economy remains "hot" through 2022. Wage growth is robust and corporate CEOs are correct about their enhanced pricing power. Central banks would surely continue to raise interest rates, probably much faster than in previous cycles. But what would this policy achieve? Would higher interest rates be an effective way to squeeze demand and force inflation lower? Some economists are sceptical about the impact of monetary tightening, especially those of an MMT or "New Keynesian" persuasion. And there was plenty of evidence before the pandemic to back up their claims, with most economies becoming increasingly unresponsive to the cost of borrowing (as we documented at the time). To understand why this happened (and whether similar problems will apply as central banks start to tighten policy), it is useful to outline the monetary "transmission mechanism". Higher interest rates should do the following:

(Direct effects)

(i) Intertemporal substitution: Higher interest rates increase the rewards of saving, making it less attractive to spend today rather than postpone consumption. For households facing credit constraints, higher rates make it harder and more expensive to borrow, which should cut spending. These effects are particularly important for durable goods (e.g., autos and housing) which are more responsive to changes in interest rates than other categories of spending. At the same time, higher interest rates could reduce capex by raising the cost of capital and lowering the discounted value of future returns. Yet most studies show business investment (non-residential) has never been particularly sensitive to the cost of borrowing.

(ii) 'Cash-flow' effects: Raising interest rates also has "income effects". It increases savers' incomes, who receive a larger return on their deposits, while boosting the amount borrowers have to repay on their existing loans (cutting their incomes). In principle, these redistribution effects should net out. But spending "propensities" of the winners and losers could differ and the relative importance of these groups will vary considerably across different economies. If borrowers cut their spending by more than savers increase theirs, the net effect should reduce total output. Traditionally, policymakers assumed the "substitution" and (net) "income" effects from higher interest rates pushed in the same direction, to reduce GDP.

(Indirect effects)

(i) Labour demand: If the "direct" effects from monetary tightening are successful in discouraging households and businesses from spending, they should also have second-round effects on output. Weaker employment and wages, in particular, are likely to have a "multiplier" effect on GDP, reinforcing the stimulus. Central banks like to assume that their policies will alter expectations about future incomes and prices, including the confidence with which those expectations are held. But since "confidence effects" are hard to measure, these inferences can be speculative.

(ii) Wealth effects: Higher interest rates should reduce asset prices. If markets expect interest rates to rise, bond prices could fall, reducing the value of existing bond holdings. Similarly, interest rate hikes should automatically lower the discounted future earnings of riskier securities such as equities, reducing their value. Wealth effects occur when these changes in asset prices encourage consumers and businesses to alter their spending, either because they are less wealthy and need to save more or because lower net worth reduces their collateral, which makes it harder to secure loans. Studies have shown wealth effects are particularly large in housing (rather than equities) – especially where there is "money illusion"[4].

(iii) Exchange rate effects: The exchange rate is the relative price of domestic and foreign money, so it should depend on both domestic and foreign monetary conditions. Holding everything else constant, an unexpected increase in interest rates should cause the currency to appreciate because it makes domestic assets more attractive relative to equivalent foreign-currency assets. To the extent that a stronger currency cuts exports and lifts imports, GDP should be further reduced.

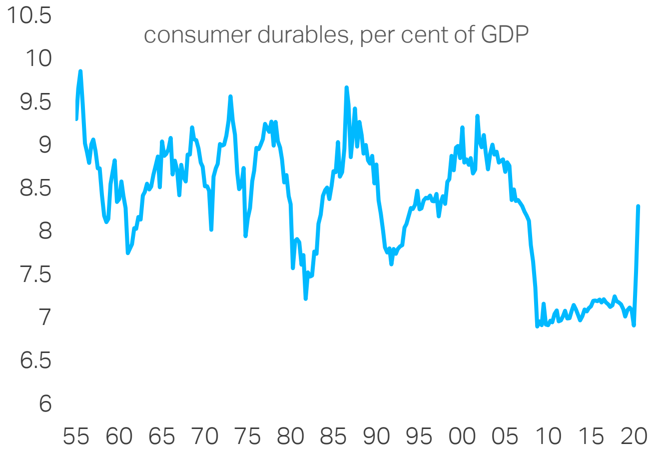
## Which effects will matter now?

Before the pandemic, most economies seemed increasingly unresponsive to monetary policy. Not only were central banks struggling to reduce interest rates further (because of the lower bound), the marginal impact of rate changes had diminished. There were good reasons for this. Over-leveraged borrowers were no longer willing to accumulate debt, while the most rate-sensitive parts of the economy – namely, housing and consumer durables – had shrunk as a

[4] It is debatable whether people are, in fact, wealthier if the value of their house increases, since – if they hope to move homes in the future – the price of their future house will have increased, too. Of course, this does not apply to people who trade down or leave the market.

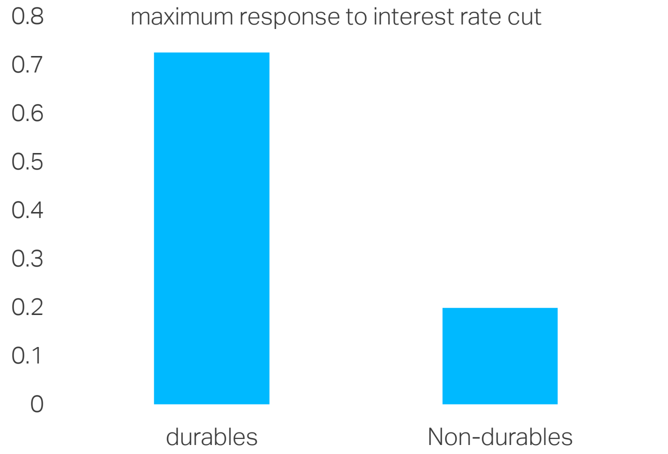
share of total GDP (see Chart 28). There were even signs that low interest rates were having adverse side-effects, by reducing the profitability of banks and cutting savers' income. And since all central banks were struggling with the same set of problems, it was difficult for any individual institution to devalue its currency (unlike in the past). By the time COVID-19 struck, the authorities had only one real tool for trying to boost demand – lifting stock prices. But since the "wealth effects" from equities were weaker than for housing, even this part of the transmission mechanism had become weaker. Yet the impact of monetary policy has become highly asymmetric and the inability of central banks to stimulate their economies before the pandemic does not mean they will struggle to rein in demand if the economy overheats. Famously, monetary policy is "like a string". The authorities can "pull the string" to reduce inflation when the economy is overheating, but they cannot "push the string" to raise prices during a depression.

**Chart 28: Rate sensitivity should have risen**




Sources: BEA, TS Lombard.

**Chart 29: Durable goods are rate-responsive**




Source: Erceg and Lewin (2005).

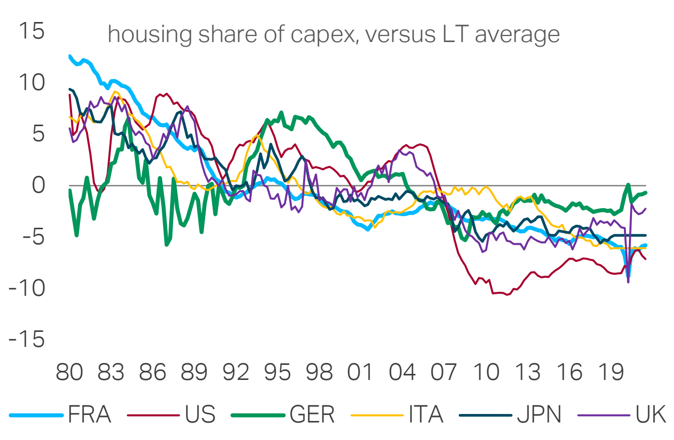
## Interest-rate sensitivities

The prospect of tighter monetary policy has already had an impact on financial markets. At a minimum, higher interest rates require a "rotation" from long-duration equities to those sectors that are less exposed to monetary policy. But a significant monetary tightening could cause more widespread destruction, by forcing an outright decline in asset prices. Higher interest rates simultaneously raise the "discount rate", widen risk premia and could hurt future earnings. Obviously, the extent to which they damage corporate profitability will depend on the degree to which higher interest rates reduce demand. And here, again, the impact of monetary policy is likely to have become asymmetric – tightening will have larger effects on the economy than previous easing. Conveniently, the parts of the economy that look most sensitive to higher interest rates are also those sectors where activity has been "hottest" during the pandemic – namely, housing and consumer durables. And since activity in these areas accounts for a larger share of GDP than it did two years ago, the potency of the "monetary transmission mechanism" has increased. Finally, we should not ignore the impact of higher interest rates on corporate debt, which has increased dramatically over the past decade. While most companies can probably live with interest rates back at 2019 levels, a more aggressive episode of tightening would quickly push debt servicing ratios to record highs. SMEs look particularly vulnerable.

## The risk of over-doing it

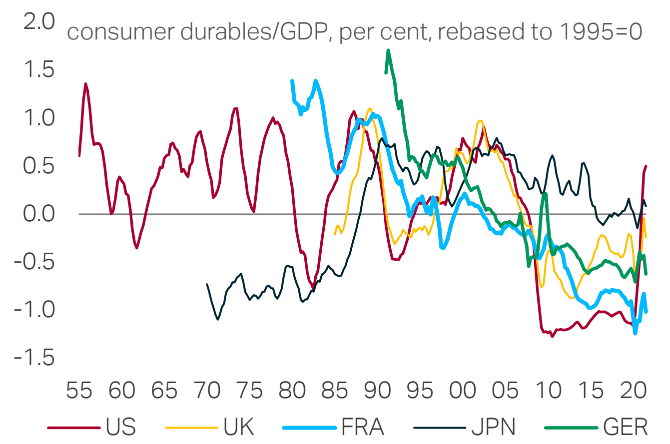
We can debate whether it is "right" for central banks to tighten monetary policy in response to current inflation, but it is clear this is something they are now determined to do. At a minimum, they want to get real interest rates back to where they were in 2019, if not go even further and try to squeeze the inflation out of their economies. We do not share the scepticism of those economists who believe monetary tightening will be ineffective. As we have shown, higher interest rates could have a significant impact, especially on durable goods demand, the stock market and the housing sector. The real issue is not whether monetary tightening would "work" but whether central banks will be able to calibrate it appropriately. This is where we agree with Stephanie Kelton, when she writes: "It's not that MMTers don't 'believe in monetary policy' (whatever that means). It's that we believe it's unrealistic to think that the central bank can steer our colossal macro ship by periodically nudging the overnight interest rate around in search of alignment with some mythical r*… [you cannot] dial down inflation, by dialling up interest rates."

### Chart 30: Housing share of GDP was low in 2010s




Sources: OECD, TS Lombard.

### Chart 31: Consumer durables share is up



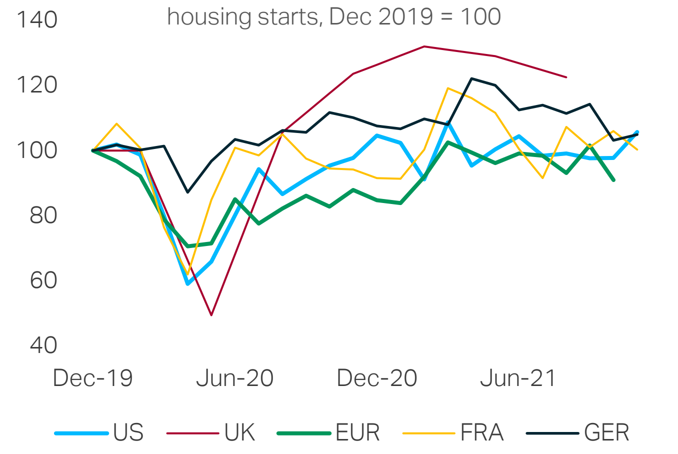

Sources: OECD, TS Lombard.

Past tightening cycles highlight the calibration problem. The impact of higher rates is unpredictable and non-linear. Central banks have a habit of "overtightening" – they hike rates and nothing happens, so they continue to tighten policy until the economy eventually slides into recession (at which point it is too late to stop). And with this tightening cycle, the dangers seem even greater. Starting with the highest inflation in 40 years and having waited for their economies to return to full employment before they even began to remove policy stimulus (a radically different approach from what they have always done in the past), the authorities are now in a hurry to raise interest rates much faster than in previous cycles. But this makes a "soft landing" more difficult. The current strategy reminds us of what Paolo Maldini, the legendary Italian defender, once said about his role on the football pitch: "If I have to make a tackle, I have already made a mistake." By which he meant that defending was mostly about positioning and timing, not physically taking the ball away from an opponent. If inflation were to become a persistent problem, we might discover that Maldini's logic also applies to monetary policy: if central banks have to intervene to force inflation lower, maybe they have already failed. And this failure could mean the next recession is a lot closer than everyone assumes right now.

## Bottom line

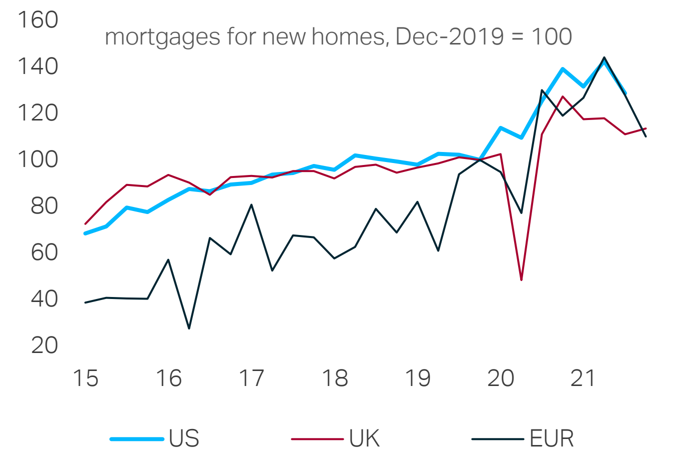
Corporate profits have boomed during the pandemic, especially in the US. This mainly reflects successful fiscal policy, since government transfers – as long as they were not saved or spent on imports – were always going to find their way into corporate surpluses. Yet the combination of large profits and high inflation shows that profit margins have widened, too, over the past two years, which was not an inevitable consequence of fiscal stimulus. Some companies, particularly in the US, have clearly taken advantage of supply shortages and surging demand to exercise their pricing power, while others have discovered they can pass on cost increases to consumers without accepting a margin squeeze. Naturally, this has angered politicians and there are even some influential economists who want to see government action, including via stricter antitrust enforcement and even "price caps". Yet the case for this sort of intervention is weak, especially as both inflation and profit margins are likely to decline in the post-COVID economy. But we will need to watch wage trends closely. Many business executives believe they now have the "pricing power" to avoid a wage-induced margins squeeze. If they are right, central banks will have to be a lot more forceful in tightening policy. Pricing power is not a reason to be bullish. If wage growth remains robust in the post-COVID economy, either margins must shrink or central banks will need to squeeze corporate profits in other ways – by reducing aggregate demand. While there was a lot of scepticism about the potency of monetary policy before the pandemic, we should not doubt central banks' ability to force inflation down, if required. Monetary policy is famously like a string. A decade of "pushing on the string" did nothing to reflate the economy, but one overly zealous "pull" could quickly kill any prospect of a post-COVID "secular revival".

**Chart 32: Rate hikes to cool hot housing markets**




Sources: Datastream, TS Lombard.

**Chart 33: Post-COVID mortgage boom**




Sources: National sources, TS Lombard.