Who will be right in the end?

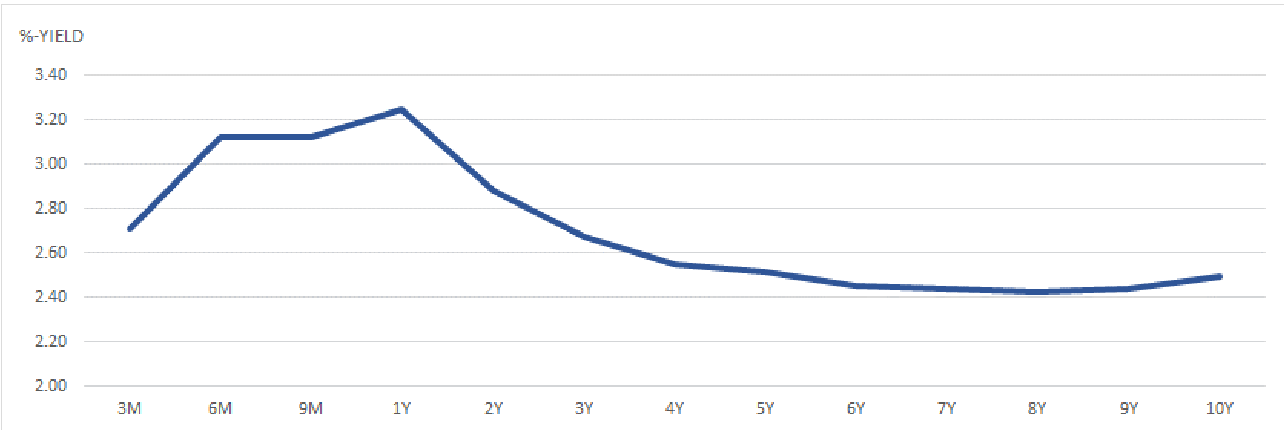
Currently, the central banks and the financial markets do not see eye-to-eye on the development in inflation and henceforth monetary policy. Financial markets are – as shown by the yield curve – convinced that we are one or maybe two rate hikes from the top; recession is just around the corner and central banks will soon be forced to lower rates. The central banks themselves are more cautious and do not expect to lower rates this year. Who will be right, or could both in the end be wrong, as we might not return to 2% inflation within the next five years?

The inflation story of the yield curves

In economics, yield is the price an agent wants to receive to postpone consumption from this period to the next. The yield curve is therefore an expression of expectations over time.

Put simply, the yield curve is what the market anticipates inflation will do in future. So, what do current yield curves tell us about inflation expectations?

Figure 1 Germany yield curve 18-4-2023 Source investing.com



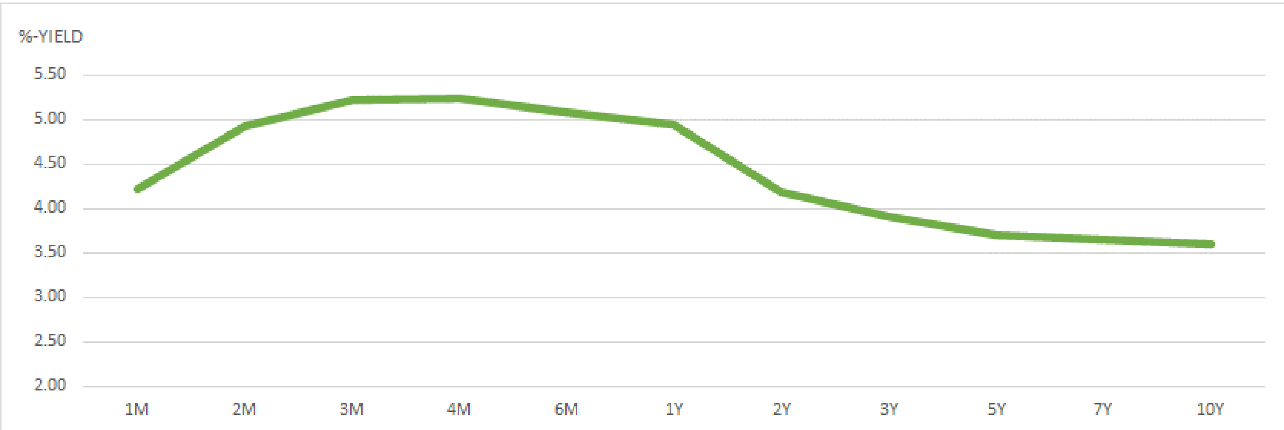
In March 2023, the year-on-year inflation rate in the eurozone was 6.8%; the German yield curve is telling us that this is only a temporary phenomenon and that the rate will fall to under 2% over the next ten years.

The inversion of the yield curve (i.e. short-term yields higher than long-term yields) indicates that the market expects the ECB to tighten monetary policy during the next 3-12 months. Thereafter, the economy will enter a severe recession, inflation will fall dramatically, and the ECB will have to lower interest rates quickly to rescue the economy.

The same scenario is implied by the shape of the yield curve in the US. However, expectations there are much more extreme.

The US yield curve (Figure 2) indicates that the Federal Reserve will still increase Fed Fund rates at its next meeting but implies that it will begin lowering them again already during the summer.

Figure 2 US Treasury yield curve 17-4-2023 source Investing.com



Comments from the Federal Reserve suggest that it will continue to fight inflation despite the potential instability in the financial system created by the failure of Silicon Valley Bank.

The view of each member of the FOMC is expressed in its forward guidance on interest rates. The view for the coming three years is illustrated in Figure 3 (below) in combination with the implied 3-month SOFM (Secured Overnight Finance Rate) forward rates.

Explanation box:

The implied 3-month forwards can be calculated by using the yields on different maturities. A 10-year bond can be split into 3-month periods (40 periods), which each have a yield. The compounded yield of these 3-month periods has to be equal to the yield on 10-year bonds.

The advantage of using US data is that the Federal Reserve gives a much longer forecast for its expectations of the development of interest rates.

Figure 3 3-month SOFR implied forward curve 17-4-2023 with FED Dots source: Chatham Financial

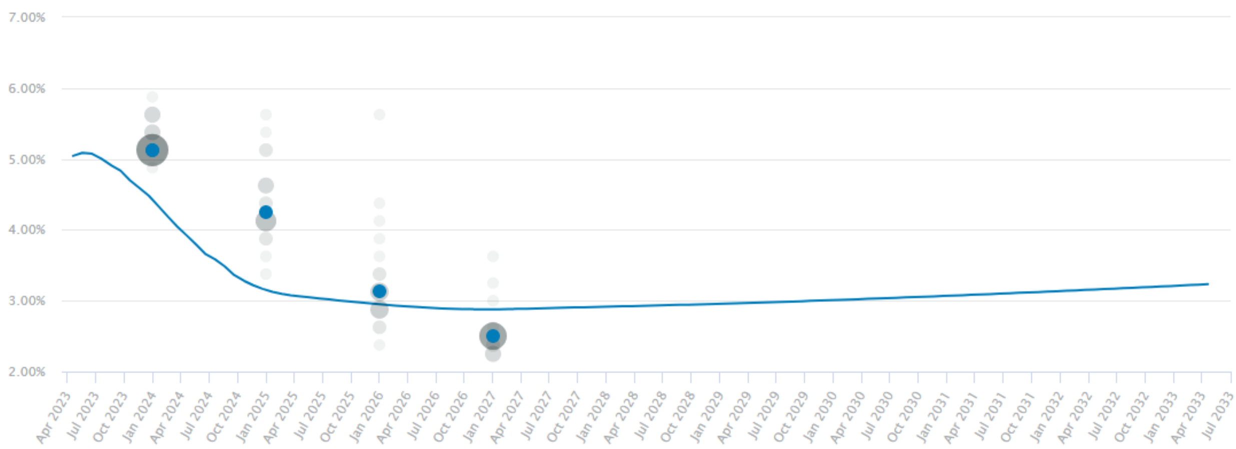


Figure 3 clearly illustrates the difference between the market's expectation of Fed Fund rates and that of policymakers.

The market expects interest rates to be hiked one last time and thereafter to fall from July 2023. The members of the FOMC expect rates to remain over 5% at least until the end of 2023 and then maybe begin to fall sometime in 2024.

In terms of outlook, this reveals a stark difference between Fed policymakers and the bond market that would appear to persist perhaps until January 2026.

Different paths - same target on inflation

In this situation, one has to consider whether the "all roads lead to Rome" approach is meant to offer comfort, or whether it is just a mantra among central bankers and economic forecasters that 2% inflation is where we are heading no matter what.

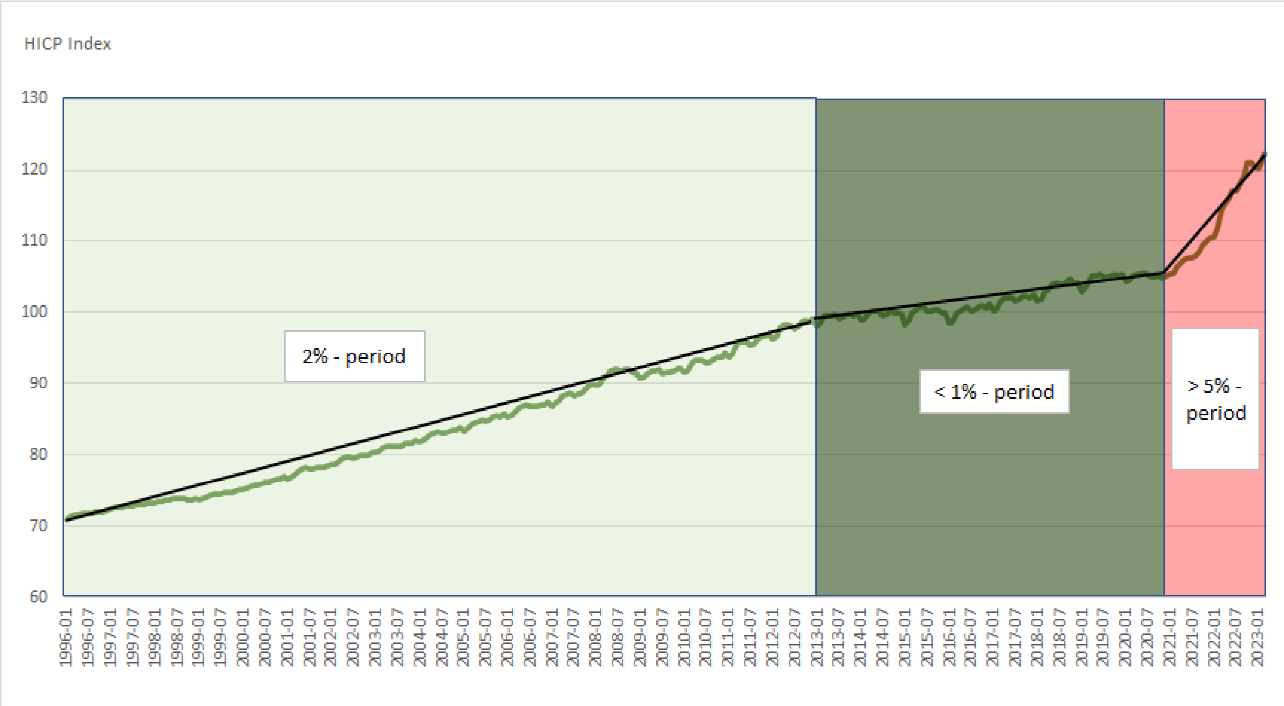
While the year-on-year inflation figure always makes the headlines, the long-term underlying trend is much more important for future developments.

Figure 4 (below) shows the eurozone overall HICP index with three main "average-inflation periods" depicted in different background colours.

From 1996 until 2012, there is the traditional ~2% inflation period, followed by the < 1% period from 2013-2020.

Since 2021, inflation has been out of control for the first time since the mid-1980s, with year-on-year inflation in the eurozone advancing temporarily into double-digit territory.

Figure 4 Euro area over all HICP index *source Eurostat*



Central bankers and the financial markets are hoping for inflation to return to the 2% average level maintained between 1996 and 2012. Judging by current valuations, equity markets in particular expect a severe recession over the summer followed by a swift easing of monetary policy.

In other words, the Federal Reserve "put" has still not expired. Central banks will once more save the financial markets by lowering interest rates and providing plenty of liquidity.

This has implications for credit spreads as well. The abundance of liquidity and lower interest rates will narrow credit spreads, as more investors accept greater risk in order to obtain higher returns.

Risk factors to look out for

Returning to 2% average inflation might seem a bit optimistic, given that some fundamental factors have changed significantly.

In our view, the following four factors will make it difficult to achieve the 2% inflation goal:

- labour markets in both the US and the EU are tighter than previously, with unemployment rates near all-time lows and employment at an all-time high;
- geopolitical tensions will not allow energy prices to return to previous levels (as the EU in particular needs to find a replacement for cheap Russian gas);
- global supply chains are not as secure as before, and production of important goods has begun to be on-shored or at least ”friend-shored” in order to avoid disruptions caused by tensions with China;
- the climate crisis will require huge investments to achieve prescribed targets over the coming years.

Any single one, or any combination of the above-mentioned factors, will make it difficult to achieve 2% inflation unless we enter into a long, severe recession, which currently appears unlikely given that labour-market conditions look set to persist.

Inflation in the range of 3-5%

If the EU and the US gravitate to an inflation range of 3-5% over the coming 2-5 years, which in our view is not unlikely, it will have a serious impact on valuations in the financial markets.

First and foremost, the current forward curve would be wrongly priced, especially by the financial markets and to a lesser extent by the central banks. If central bank interest rates stay around 4%, instead of 2-2.5%, in order to keep inflation under control, it will create a completely new situation.

The long end of the yield curves will rise (higher long-term interest rates) and therefore equity markets will need to adjust to higher funding costs and discounting rates, making current valuations difficult to justify.

Credit spreads will have to widen because of higher interest rates, reducing risk appetite, and companies with low valuations will have to pay more to obtain funding.

Currently, there are so many uncertainties in the financial markets, that keeping a relatively large cash position and awaiting better opportunities to invest is the prudent approach going forward.