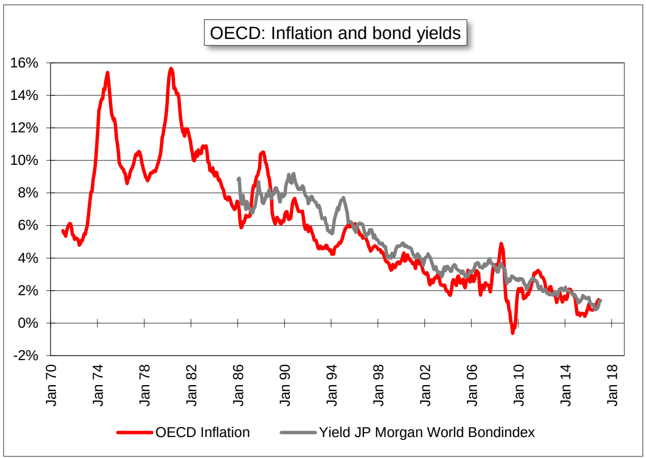
ECONOMIC SITUATION AND STRATEGY

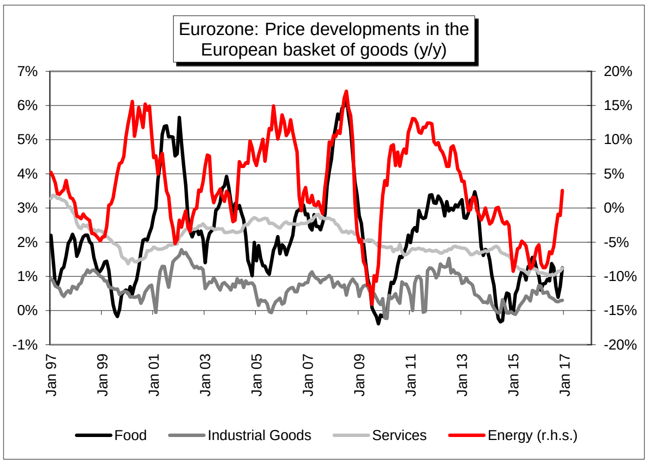
Inflation comeback: Interest rate reversal now?

From autumn 2011 to the end of last year, inflation moved almost exclusively in one direction – downward. In 2011, inflation rates peaked at 3% in the euro zone, 3.5% in the United States, and 5% in Great Britain. The low point in the price trend was then reached in the United States and Great Britain in 2015, but not until spring 2016 in the euro zone. Deflation was the main concern of most central banks in the past years and led to an unprecedented form of accommodative monetary policy. In particular, the central banks of industrialized countries proved very creative and willing to experiment. Low interest rates, micro interest rates, zero interest rates, negative interest rates, quantitative easing of monetary policy through asset purchases became the central points of monetary policy evolution and terminology. This meant hard times for investors who put their money in banking and savings accounts or interest-bearing instruments, since returns on these quickly evaporated. The global interest rate trend then reached its lowest point to date last summer. Yields on government bonds fell below zero in many cases. Even the yield on German government bonds (Bunds) with residual maturities up to 15 years turned negative!



But inflation has been enjoying a comeback for a while now. Although economists already pointed to this foreseeable development very early, it nevertheless comes as a surprise to the public, especially in Germany, and is accordingly arousing greater skepticism and criticism regarding the appropriateness of the European Central Bank's monetary policy. After all, the harmonized German inflation rate rose to 1.6% in December 2016, its highest level since November 2013. Moreover, it seems likely that inflation will continue to rise in the near future and in Germany will surpass the "magic threshold" of 2% that the ECB considers central to its monetary policy actions.

Nevertheless, nobody should expect that this will compel the ECB to change its monetary policy in haste. For one thing, prices in the euro zone were only up by 1.1% year-on-year in December 2016, which is significantly less than in Germany. For another, the increase of inflation is at least so far primarily due to a base effect. Since the inflation rate measures the change of prices in a defined basket of goods compared with the year-earlier level, one must keep an eye on the groups of goods whose prices have changed sharply in the past 12 months. So far, that has applied almost exclusively to energy prices.



While a barrel of Brent crude oil cost EUR 33 a year ago, the price has risen now to EUR 52, an increase of almost 60%. This has meant that the price of energy in the euro zone, which makes up a good 10% of the basket of goods, has become significantly more expensive. In December 2016, energy prices were 2.6% above their year-earlier level and consequently drove up the headline inflation rate by about 0.3 percentage points. This tendency has strengthened in January. Energy prices will presumably show a year-on-year increase of about 8% for this month and therefore account for 0.8 percentage points of headline inflation. If the rates of increase of the other basket components (food, manufactured goods, and services) remain unchanged, the headline inflation rate will turn out 0.5 percentage points higher than in December.

Changes in the euro zone inflation rate have been almost exclusively attributable to energy price swings in the past years. On the other hand, price movement for the rest and largest part of the basket of goods (about 90%) has been comparatively inconspicuous and stable. Most central banks, including the ECB, primarily base their monetary policy decisions on the development of core inflation and thus (to a large extent) exclude changes in energy and food prices. The logic behind this procedure may be seen in the fact that these two price components can scarcely be influenced by monetary policy. The decisive factor for energy prices is the supply of oil from OPEC, while most significant changes in food prices occur when weather conditions lead to especially good or bad harvests.

In December 2016, the core inflation rate in the euro zone stood at 0.9%, so the gap between that and the 2% threshold is still very large. Moreover, there is no sign so far that the core inflation rate will increase more significantly in the near future. As long as that is the case, the headline inflation rate will also not reach the central bank's 2% mark, especially since the base effect in the case of energy prices will peak in February and March. Only if oil prices were to move in the direction of EUR 70-80 in the next few months (which we do not expect) would energy prices make a sustainably larger contribution to the inflation rate. We therefore consider it likely that inflation in the euro zone will peak at just under 2% this spring, stay at that level for a while, and then decline somewhat towards year's end.

The fear of excessive inflation is unfounded, in our opinion. On the contrary, somewhat higher inflation rates will even have some positive side effects. This applies, for example, to government debt. Since it is not the absolute level of debt, but rather the ratio of debt to overall economic performance that is crucial to assessing a country's solvency, a higher inflation rate will create somewhat more maneuvering room for fiscal policy, especially in heavily indebted countries. A higher nominal economic growth rate, comprising real growth plus inflation, leads ceteris paribus to a lower debt ratio. That is at least the case if the state does not increase debt to the same extent. For example, if a country with nominal economic performance of EUR 1 trillion has government debt of EUR 600 billion, the debt ratio is 60%. If debt increases by 5% to EUR 630 billion and economic performance likewise rises by 5% to EUR 1.05 trillion (due to real growth of 3% and inflation of 2%), the debt ratio remains unchanged at 60%. On the other hand, if the inflation rate increases from 2% to 5%, nominal growth rises to 8% in this example, with the result that economic performance rises from EUR 1 trillion to EUR 1.08 trillion. Consequently, the debt ratio falls from 60% to 58.3%.

However, this kind of debt reduction in our example only works provided debt does not increase faster when growth or inflation rates turn out higher. In addition to discretionary government spending for social services, defense, transportation, and education, interest expense plays a crucial role. If interest rates rose to the same extent as inflation, nothing would be gained from the standpoint of debt. As a rule of thumb, the debt ratio declines when the interest rate is lower than the nominal growth rate – and the government simultaneously has a balanced primary budget. This means that (discretionary) government spending less interest payments is not higher than government revenues.

These considerations probably have even higher priority for ECB monetary policy than the question whether the inflation target will be reached or surpassed. For, the bond purchase program "guarantees" in a way that the interest rates at which governments must obtain refinancing will remain very low – even if the inflation rate climbs. We therefore believe that a change in interest rates worthy of being called a "trend reversal" is unlikely. Since the ECB controls the short end of the yield curve with its monetary policy and will ensure that yields remain low (or even negative), effects are likely to be small on the long end of the maturity spectrum. However, the long end depends more on capital market development, and less on monetary policy.

In this connection, capital market yields in the euro zone are considerably influenced by the development of US interest rates. The yield on 10-year US Treasury bonds has risen by about 100 basis points since the end of September, with the largest part of that being registered after Donald Trump's election. The reason is that implementing his campaign promises could lead to more economic growth and more inflation. The Federal Reserve has also reacted to Trump's election by holding out the prospect of three interest rate hikes this year instead of only two as it had projected before the election, but most capital market participants so far expect only two interest rate steps. However, since the Fed's growth and inflation forecasts for this year have come out very moderate, they might be surpassed for the first time in many years. It therefore seems plausible that there will be three interest rate increases. Since such a scenario is not yet reflected in bond prices, we regard a further a yield rise in the United States as likely, albeit only a moderate one.

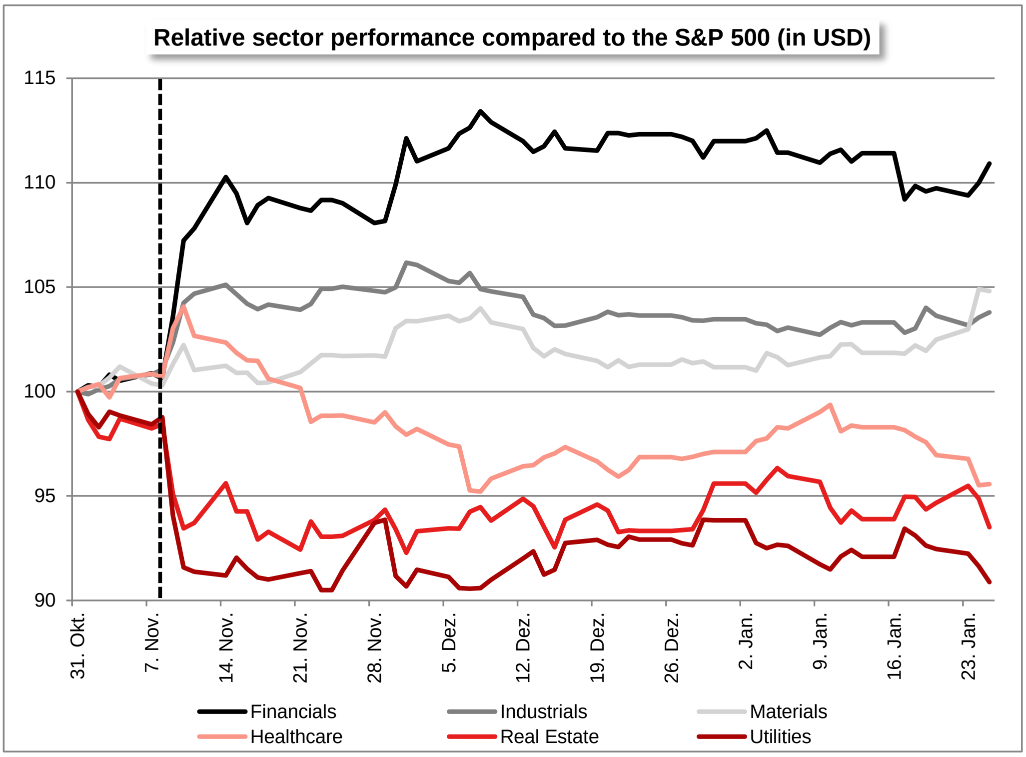
Although the ECB's monetary policy is following a very different path than that of its US counterpart, higher US yields are likely to affect the European bond market. However, the ECB, as a large market participant that will continue to purchase government bonds, will remain in the game for the time being. This tends to argue in favor of a sideways movement in yields. But suspense will mount in the second half of the year. For, at the end of the third or beginning of the fourth quarter at the latest, the ECB will express its view of monetary policy in 2018. The somewhat higher inflation rate and emerging stable economic growth suggest that the central bank will no longer remain "behind the curve" and will decide to taper its bond purchases. That also presupposes, however, that the many political risks we now face do not become reality. In that case, yields in the euro zone could advance more sharply again towards year's end. Nevertheless, that certainly does not mean "happy times are here again" for investors oriented to interest-bearing instruments. Interest rates and yields will probably remain low by historical comparison.

Weekly outlook for Jan. 30-Feb. 3, 2017

	Aug.	Sept.	Oct.	Nov.	Dec.	Jan.	Release
DE: Inflation rate, flash, m/m	0.0%	0.1%	0.2%	0.1%	0.7%	-0.5%	January 30
DE: Inflation rate, flash, y/y	0.4%	0.7%	0.8%	0.8%	1.7%	2.1%	January 30
DE: Unemployed, change in k	-8	-1	-14	-6	-17	-4	January 31
DE: Unemployment rate	6.1	6.1	6.0	6.0	6.0	6.0	January 31
DE: Retail sales, m/m	0.0	-1.4	2.7	-1.7	1.1		January 31
DE: PMI, manufacturing	53.6	54.3	55.0	54.3	55.6	56.5	February 1
DE: PMI, services	51.7	50.9	54.2	55.1	54.3	53.2	February 3
EUR19: Inflation rate, y/y	0.2%	0.4%	0.5%	0.6%	1.1%	1.6%	January 31
EUR19: Unemployment rate, sa	10.0	9.9	9.8	9.8	9.8		January 31
EUR19: PMI, manufacturing	51.7	52.6	53.5	53.7	54.9	55.1	February 1
EUR19: Producer prices, m/m	-0.2%	0.1%	0.8%	0.3%	0.4%		February 2
EUR19: Producer prices, y/y	-1.9%	-1.5%	-0.4%	0.1%	1.3%		February 2
EUR19: PMI, services	52.8	52.2	52.8	53.8	53.7	53.6	February 3
EUR19: Retail sales, m/m	-0.1%	-0.3%	1.4%	-0.4%	0.4%		February 3

MMWB estimates in red

Chart of the Week: Trump effect continues



The Dow Jones Industrial index of leading US stocks topped 20,000 points on Wednesday for the first time in its history. The rally that began on the stock markets after Donald Trump's election as the new US president has thus impressively continued. The broad S&P 500 index has advanced by almost 8% since the election results were announced, but accompanied by pronounced sectoral diffusion. Looking at the 11 GICS sectors, we find an absolute performance difference of almost 20 percentage points between the best sector (financials) and the worst (utilities). Inflation expectations have risen significantly due to the prospect of accommodative fiscal policy presented by Trump. Consequently, the fear of interest rates rising faster than expected has made the rate-sensitive utilities and real estate sectors appear the worst in relative comparison with the S&P 500. The big winners are stocks from the financial, industrial, and basic material sectors. Only the healthcare sector has been unable to benefit as expected. It had already lost relative to the broad market in the months before the election, since Trump's opponent, Hillary Clinton, had vowed in her campaign to fight the pricing policies of pharmaceutical companies. Accordingly, their share prices also reacted positively to the election outcome. In the meantime, however, the sector is now among the losers again, because Trump is starting to sound like Clinton on this issue.

Stock marktes	As of 27.01.2017 11:40	Change versus 19.01.2017 -1 Woche	23.12.2016 -1 Monat	25.10.2016 -3 Monate	30.12.2016 YTD
Dow Jones	20101	1,9%	0,8%	10,6%	1,7%
S&P 500	2297	1,5%	1,5%	7,2%	2,6%
Nasdaq	5656	2,1%	3,5%	7,1%	5,1%
DAX	11820	1,9%	3,2%	9,9%	3,0%
MDAX	22859	1,0%	3,5%	7,5%	3,0%
TecDAX	1858	1,2%	3,9%	5,7%	2,6%
EuroStoxx 50	3297	0,2%	0,7%	6,8%	0,2%
Stoxx 50	3027	0,5%	1,0%	6,0%	0,5%
SMI (Swiss Market Index)	8377	1,3%	1,8%	5,6%	1,9%
Nikkei 225	19058	-0,1%	-1,9%	9,7%	-0,3%
Brasilien BOVESPA	66191	3,5%	14,2%	3,6%	9,9%
Russland RTS	1175	3,4%	5,1%	17,2%	2,0%
Indien BSE 30	27882	2,1%	7,1%	-0,7%	4,7%
China Shanghai Composite	3159	1,9%	1,6%	0,9%	1,8%
MSCI Welt (in €)	1804	1,5%	0,3%	8,0%	1,7%
MSCI Emerging Markets (in €)	917	2,4%	6,6%	1,7%	5,0%
Bond markets					
Bund-Future	161,69	-134	-197	-233	-246
Bobl-Future	132,76	-53	-69	115	-87
Schatz-Future	112,14	-8	-16	8	-15
3 Monats Euribor	-0,33	0	-1	-2	-1
3M Euribor Future, Dec 2017	-0,31	-4	-7	-1	0
3 Monats $ Libor	1,04	0	4	15	4
Fed Funds Future, Dec 2017	1,13	-1	-3	36	0
10 year US Treasuries	2,51	5	-3	76	7
10 year Bunds	0,47	10	34	52	36
10 year JGB	0,08	0	2	15	3
10 year Swiss Government	-0,06	11	10	44	15
US Treas 10Y Performance	565,55	-0,5%	0,2%	-5,6%	-0,7%
Bund 10Y Performance	601,49	-0,9%	-1,6%	-3,2%	-1,9%
REX Performance Index	481,21	-0,5%	-0,5%	-1,4%	-0,8%
US mortgage rate	0,00	0	0	0	0
IBOXX AA, €	0,83	7	12	36	16
IBOXX BBB, €	1,62	5	8	33	12
ML US High Yield	6,25	-4	-25	-10	-21
JPM EMBI+, Index	782	0,1%	1,7%	-3,5%	1,2%
Convertible Bonds, Exane 25	6958	0,1%	1,0%	2,7%	0,6%
Commodities					
CRB Index	431,75	0,6%	4,1%	2,3%	2,6%
MG Base Metal Index	300,32	1,4%	6,3%	16,3%	7,3%
Crude oil Brent	55,57	2,3%	1,5%	9,2%	-2,0%
Gold	1183,91	-1,5%	4,4%	-7,0%	2,3%
Silver	16,99	0,7%	7,7%	-4,3%	5,9%
Aluminium	1836,75	0,1%	6,0%	10,6%	7,8%
Copper	5922,25	3,7%	8,6%	25,4%	7,2%
Iron ore	83,50	2,5%	9,2%	38,0%	4,4%
Freight rates Baltic Dry Index	840	-10,8%	-12,6%	3,3%	-12,6%
Currencies					
EUR/ USD	1,0677	0,1%	2,2%	-1,8%	1,3%
EUR/ GBP	0,8518	-1,2%	-0,2%	-4,8%	-0,2%
EUR/ JPY	122,82	0,5%	0,2%	8,1%	-0,5%
EUR/ CHF	1,0678	-0,5%	-0,3%	-1,6%	-0,6%
USD/ CNY	6,8768	0,1%	-1,1%	1,4%	-1,1%
USD/ JPY	113,29	-1,4%	-3,5%	8,7%	-3,1%
USD/ GBP	0,80	-1,8%	-2,2%	-3,2%	-1,4%

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