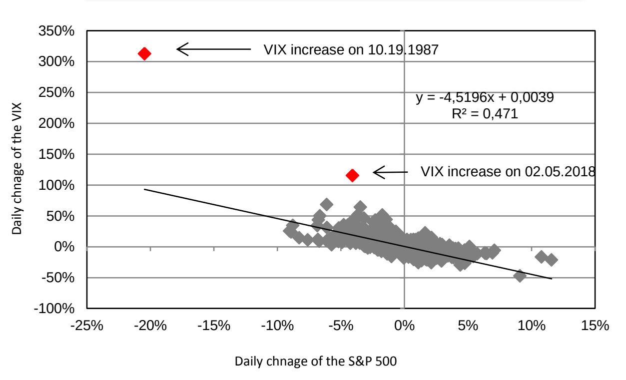
More inflation, higher interest rates: Much ado about nothing?

Many investors are still feeling the volatility crash of February 5. It hit the S&P 500 hard, cutting 4.1% of its value, but that is not a record price loss by historical comparison. In contrast, the impact was significantly greater on the VIX volatility index. That day saw the second-largest increase in its history at 116%. The only time volatility has risen more sharply was on Black Monday, October 19, 1987. The predecessor of today's VIX shot up more than 300% then, while the S&P 500 actually crashed, with prices plunging 21%. There has been a close connection between the S&P 500 stock index and the VIX volatility index for 30 years. If the VIX drops by 1%, the S&P 500 falls on average by about 0.25%, and vice versa. However, this close connection did not exist on February 5 of this year. If it had, either the S&P 500 would have lost more than 25% on a volatility spike of 115%, or volatility would have increased less than 20% on an S&P 500 decline by just over 4%. We believe this shows that the market gyrations were primarily technical in nature, and not justified fundamentally.

USA: Daily change of volatility and S&P 500 since 01-01-1986



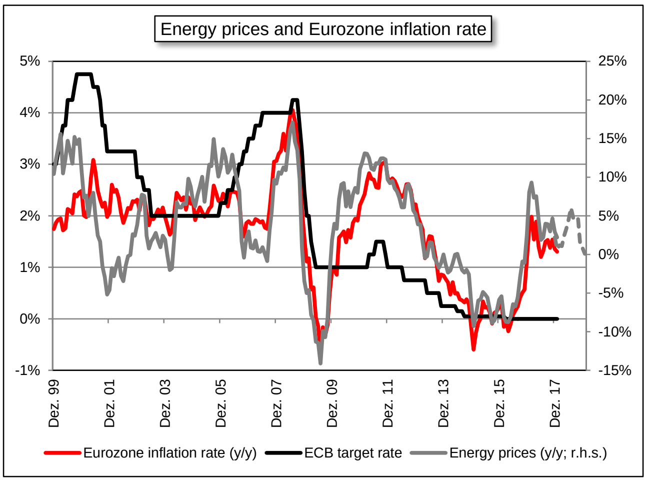
If one nevertheless seeks fundamental reasons for the slump, the topic of inflation and related fear of rising interest rates often comes up. Worries about higher inflation rates are worsening particularly in the United States. That is due partly to the good economy, which supposedly might overheat as a result of tax cuts and higher government spending, and partly to low unemployment, which might lead to higher wage agreements. If businesses could pass on higher costs in their prices, that would cause more inflation. The Fed is concerned about these two topics, as demonstrated by the just-released minutes of the FOMC meeting at the end of January. After raising its real GDP growth forecast for this year in December 2017 from 2.1% to 2.5%, the Fed has now signaled an even more positive assessment of growth prospects in light of the tax cuts and strong global economic growth accompanied by a weaker US dollar. Moreover, the inflation forecast has been raised somewhat, but the inflation rate is not likely to reach the Fed's target of 2% until 2020. However, the central bank has not provided concrete figures, and we will have to wait for them until the next Fed meeting on March 20-21. Overall, conditions thus suggest that the Fed will gradually raise US interest rates further this year.

This is where the war of words starts. What exactly does "gradually" mean? The Fed has held out the prospect of three interest rate hikes for 2018. But after the latest data, some market participants fear interest rates might even be increased a fourth time this year. However, we see no indications for that in the FOMC minutes. The December dot plot shows where the individual FOMC members expect the key interest rate to be in the coming years, and the message is clear. Of the 16 members surveyed, 12 regarded at most three rate hikes as probable, while three expected four, and one member even said there would be five. So, at least four members would have to adjust their interest rate opinion upward. A look at changes in previous dot plots shows that such significant adjustments from one meeting to the next are unlikely. We therefore believe a majority of FOMC members will advocate three interest rate increases again in March. A look at fed funds futures reveals that this also corresponds to the market's majority opinion. Just over 35% of market participants now anticipate fewer than three interest rate steps, 40% expect three, and about 25% foresee more than three.

One should not expect the Fed to change its monetary policy assessment until it anticipates a significant acceleration of inflation. But we do not foresee that. Average hourly wages did increase in January by 2.9% year-on-year and thus by more than at any time since summer 2009. However, the number of hours worked per week fell at the same time, so less money found its way into the pocketbooks of most consumers in January than in the preceding month. But one would only expect a general rise of prices triggered by higher wage costs if households had more money to spend. A stronger increase of wages has so far been observed only in a few industries. In the financial sector, for example, hourly wages are 4.2% and weekly wages even 5.0% higher than their year-earlier levels, with this sector not having an especially large share of total employment at just under 6%. On the other hand, hourly wages are only 2.2% and weekly wages only 1.2% higher than a year ago in the retail trade, which accounts for almost 11% of total employment.

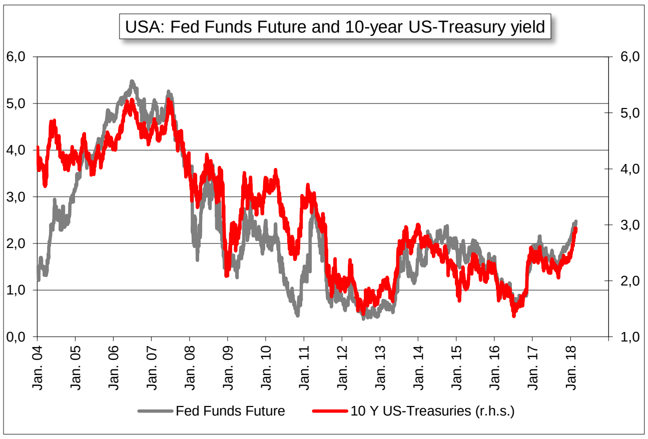
Even if wages in the United States were to rise more sharply in the months ahead, that need not affect the inflation rate. The correlation coefficient that measures the connection between the annual rate of change of the PCE inflation rate, which is the decisive metric for the Fed, and the annual rate of change of weekly wages amounts to about 0.5. Moreover, it appears that the rate of change of weekly wages trails the inflation rate, and does not lead it. That could indicate that the latest rise of wages is a lagging reaction to the temporary price pressure that contributed to higher inflation rates at the beginning of 2017. However, since the increase of consumer prices due to the oil price has fallen since last spring, the rise of wages might subside in the coming months.

Like the development of hourly wages, the consumer price data (CPI index) published last week and showing an increase in January 2018 by almost 2.1% year-on-year have been interpreted by some as heralding a further rise of inflation. This number corresponds exactly to the average of the last 12 months. The inflation rate was peaking between 2.4% and 2.8% in the beginning of 2017, before falling to significantly below 2% in the summer months. The relatively strong monthly rise of prices by just over 0.5% in January 2018 compared with December 2017 was the result of an increase observed across all major expense categories, but it appears to have been influenced by some special factors. For example, together with the already observed rise of oil prices, the "bomb cyclone" winter storm contributed to significantly higher energy prices. And the rise of food prices is also likely to have had something to do with the extreme weather. Consequently, there are good reasons to believe that the strong rise of prices last month will not continue.



Inflation is also not an issue in the global context. The inflation rate in the euro zone was 1.3% in January 2018; a lower rate was last registered in December 2016. In the last ten years, change in the inflation rate has been influenced primarily by energy prices, which account for just under 10% of the basket of goods. Furthermore, food prices, which have a weight of just under 20%, are mainly responsible for the inflation rate not being even lower. On the other hand, the two largest components in the consumer price index, manufactured goods (just over 26%) and services (just under 45%) have been very stable for a long time. If the oil price remains at its current level in the coming months – which now seems likely – the inflation rate will rise slightly in the summer months, however. This is due to a base effect, but that will subside already next autumn. It is therefore possible that the inflation rate in the euro zone will just reach the 2% mark for some time this year, but the increase will probably not prove sustainable.

Consequently, the rise of yields in recent weeks should also not continue much further. There has been some inflation hysteria in the United States, which has pushed the yield on 10-year Treasuries to almost 3%. It would not surprise us if that level is reached or surpassed in the near future. A regression analysis with the expected US key interest rate as explanatory variable for the Treasury yield indicates an increase to 3.2% as an upper limit. But even then, one should not panic. The "rapid" yield advance of almost 60 basis points since the beginning of the year, now cited by almost everyone and described as threatening, loses its impact if one looks at US bond market development in the past years. After Donald Trump's election in November 2016, US yields increased at times by more than 80 basis points. In 2015, yields rose by 60 basis points between the end of April and the middle of June. In 2013, triggered by then-Fed Chair Ben Bernanke's "taper tantrum," the yield climbed from 1.63% to 2.97% between May and September. In almost each of the last 20 years, there have been developments that were at least equivalent to the current one. One should therefore not be afraid of it.

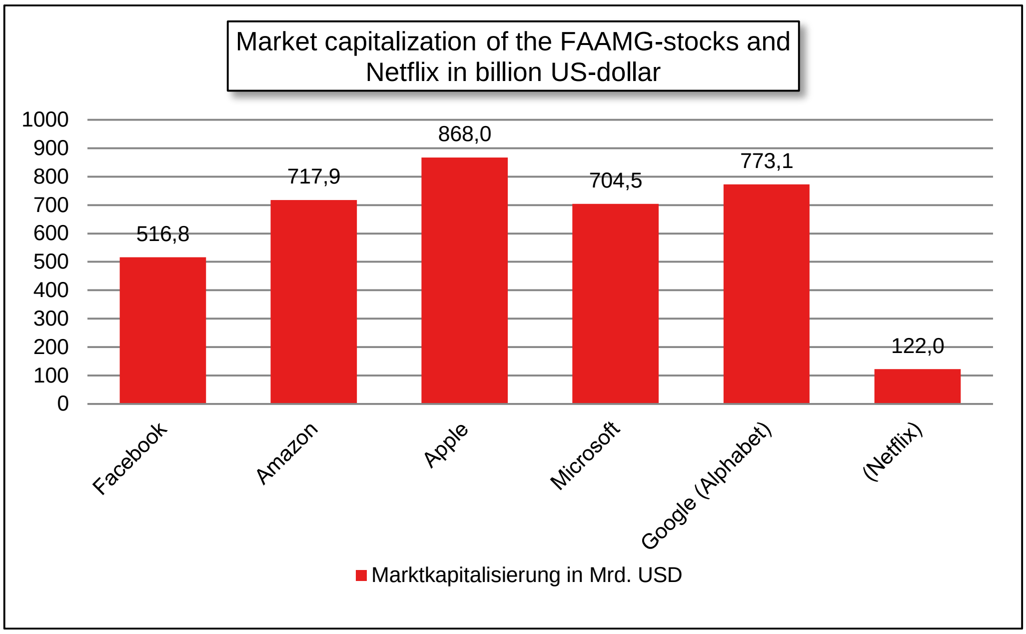


Weekly outlook for February 26-March 2, 2018

	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Release
DE: Inflation rate, m/m, flash	0.0%	0.3%	0.6%	-0.7%	0.5%		February 27
DE: Inflation rate, y/y, flash	1.6%	1.8%	1.7%	1.6%	1.5%		February 27
DE: GfK consumer climate	10.8	10.7	10.7	10.8	11.0	10.5	February 28
DE: Unemployed, change in k	-13	-21	-30	-24	-18		February 28
DE: Unemployment rate	5.6%	5.5%	5.5%	5.4%	5.4%		February 28
DE: PMI, manufacturing, final	60.6	62.5	63.3	61.1	60.3		March 1
DE: Import prices, m/m	0.6%	0.8%	0.3%	0.4%			March 1-2
DE: Import prices, y/y	2.6%	2.7%	1.1%	0.6%			March 2-2
DE: Retail sales, m/m	-1.1%	1.9%	-1.9%	1.6%			March 2
EUR19: M3, y/y	5.0%	4.9%	4.6%	4.8%			February 27
EUR19: Business climate	1.44	1.49	1.60	1.54	1.49		February 27
EUR19: Economic confidence	113.5	114	115.3	114.7	114.2		February 27
EUR19: Consumer confidence, final	-1.1	0.0	0.5	1.3	0.2		February 27
EUR19: Industrial confidence	8.0	8.1	8.8	8.8	8.3		February 27
EUR19: Inflation rate, y/y, flash	1.4%	1.5%	1.4%	1.3%	1.3%		February 28
EUR19: Unemployment rate, s.a.	8.8%	8.7%	8.7%	8.6%			March 1
EUR19: PMI, manufacturing, final	58.5	60.1	60.6	59.6	58.5		March 1
EUR19: Producer prices, m/m	0.4%	0.6%	0.2%	0.5%			March 2
EUR19: Producer prices, y/y	2.5%	2.8%	2.2%	1.6%			March 2

MMWB estimates in red

Chart of the Week: The FAAMG phenomenon



The US technology stocks that often come to mind first are called the FAANG stocks. Besides Facebook, Apple, Amazon, and Google (now Alphabet), this acronym includes Netflix, a leader in the area of internet-based streaming services. However, because of its comparatively low market capitalization, Netflix is not really in the same league as other software giants like Microsoft, which is why we prefer to talk about FAAMG stocks. These tech stocks have been the shooting stars of recent years. Except Microsoft, they were not among the top ten publicly traded companies in the United State ten years ago. But today they are the world's most important stocks in terms of market value. Altogether, America's Big Five have a market value of about EUR 3.5 trillion. Each company has a market capitalization of over at least half a trillion US dollars. And this enormous market cap makes sense, considering that disruptive innovations and outstanding growth rates are their foremost distinguishing features. This allowed the FAAMG companies to earn almost EUR 100 billion in calendar 2017, which is more than all 30 companies in Germany's DAX index combined.

Stock marktes	As of 23.02.2018 16:50	Change versus 12.02.2018 -1 week	16.01.2018 -1 month	16.11.2017 -3 months	29.12.2017 YTD
Dow Jones	25090	2,0%	-2,7%	7,0%	1,5%
S&P 500	2716	2,3%	-2,2%	5,0%	1,6%
Nasdaq	7239	3,7%	0,2%	6,6%	4,9%
DAX	12484	1,6%	-5,8%	-4,3%	-3,4%
MDAX	26318	4,4%	-2,6%	-0,5%	0,4%
TecDAX	2599	4,9%	-2,0%	3,7%	2,8%
EuroStoxx 50	3436	2,0%	-5,1%	-3,6%	-1,9%
Stoxx 50	3054	1,5%	-5,6%	-2,8%	-3,9%
SMI (Swiss Market Index)	8934	1,3%	-5,6%	-2,3%	-4,8%
Nikkei 225	21893	2,4%	-8,6%	-2,1%	-3,8%
Brasilien BOVESPA	86554	7,0%	8,4%	19,4%	13,3%
Russland RTS	1301	7,9%	3,2%	15,5%	12,7%
Indien BSE 30	34142	-0,5%	-1,8%	3,1%	0,3%
China Shanghai Composite	3289	4,3%	-4,3%	-3,2%	-0,5%
MSCI Welt (in €)	2117	1,7%	-3,8%	-0,4%	-1,8%
MSCI Emerging Markets (in €)	1201	3,9%	-1,9%	2,2%	1,1%
Bond markets					
Bund-Future	163,14	517	237	44	146
Bobl-Future	131,02	48	-17	-73	-59
Schatz-Future	111,96	5	8	-31	-2
3 Monats Euribor	-0,33	0	0	0	0
3M Euribor Future, Dec 2017	-0,26	1	-2	2	0
3 Monats $ Libor	1,88	5	15	45	19
Fed Funds Future, Dec 2017	2,07	9	10	33	0
10 year US Treasuries	2,87	0	33	50	46
10 year Bunds	0,65	-5	15	27	23
10 year JGB	0,05	-2	-3	0	0
10 year Swiss Government	0,11	-1	18	21	24
US Treas 10Y Performance	559,49	-0,2%	-2,8%	-3,9%	-3,8%
Bund 10Y Performance	595,04	0,5%	-1,4%	-2,4%	-2,0%
REX Performance Index	476,78	0,4%	-0,4%	-1,4%	-0,8%
US mortgage rate	0,00	0	0	0	0
IBOXX AA, €	0,78	-2	8	10	10
IBOXX BBB, €	1,35	-2	13	17	12
ML US High Yield	6,42	-12	35	20	27
JPM EMBI+, Index	816	0,9%	-2,4%	-1,4%	-2,4%
Convertible Bonds, Exane 25	7343	0,6%	-1,8%	-0,1%	-0,7%
Commodities					
CRB Spot Index	441,92	0,6%	0,7%	3,1%	2,2%
MG Base Metal Index	366,06	4,7%	2,9%	7,3%	2,0%
Crude oil Brent	66,78	5,7%	-3,8%	7,9%	0,3%
Gold	1328,93	0,3%	-0,5%	3,8%	2,0%
Silver	16,73	1,3%	-2,3%	-2,1%	-1,6%
Aluminium	2218,00	4,6%	1,7%	6,4%	-1,7%
Copper	7191,00	5,9%	2,2%	7,3%	-0,2%
Iron ore	77,55	2,5%	1,4%	25,9%	8,8%
Freight rates Baltic Dry Index	1167	3,9%	-4,4%	-14,3%	-14,6%
Currencies					
EUR/ USD	1,2294	0,3%	0,5%	4,4%	2,5%
EUR/ GBP	0,8788	-1,2%	-1,0%	-1,5%	-1,0%
EUR/ JPY	131,05	-1,6%	-3,2%	-1,6%	-2,9%
EUR/ CHF	1,1501	0,0%	-2,5%	-1,6%	-1,7%
USD/ CNY	6,3329	0,1%	-1,7%	-4,5%	-2,7%
USD/ JPY	106,32	-2,2%	-3,7%	-6,0%	-5,7%
USD/ GBP	0,72	-1,3%	-1,5%	-5,6%	-3,3%

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