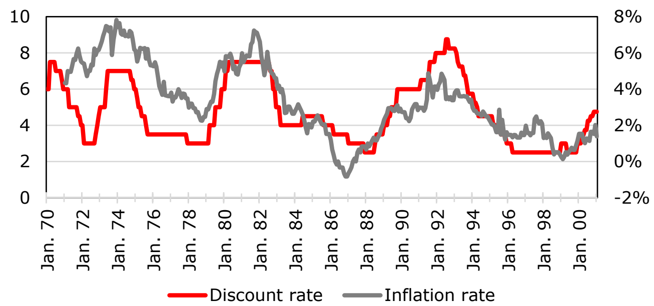
ECONOMIC SITUATION AND STRATEGY

20. August 2021

Why the ECB is Comfortable with High Inflation

Inflation has steadily crept up in Germany over the past few months from 1.0 percent in January to 3.8 percent in July. Almost no economist saw this coming – and neither did we. Moreover, the end is not yet in sight and inflation could reach five percent by late fall. It is thus not surprising that many Germans are wondering if inflation could get out of hand. In Deutschmark times the Bundesbank wielded monetary policy with an iron fist brutally battling any specter of inflation with higher interest rates. However, since the 2008/2009 financial crisis at the latest is has become apparent that the European Central Bank pursues goals more important than price stability.

Germany: Key interest rate and inflation rate

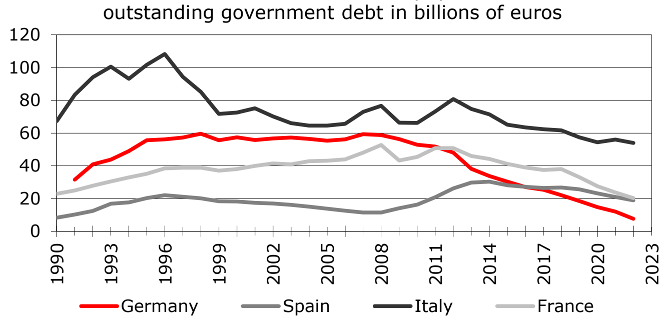


Source: Refinitiv Datastream

Particularly southern European countries are heavily in debt. From 2007 to present, the debt ratio (ratio of government debt to nominal economic performance) in Italy has grown from 104 to 155 percent, in Spain from 36 to 120 percent, in Portugal from 73 to 133 percent, and in Greece from 103 to 205 percent. Comparable figures for Germany (64 to 70 percent) and the Netherlands (43 to 54 percent) are much less problematic.

Extensive stimulus programs to counteract economic impact of the pandemic have piled on debt in almost all countries last year. European countries still could easily refinance their spending on the capital market thanks to low interest rates and the ECB's bond purchase programs. Thanks to the ECB's monetary policy, the price of new debt, i.e. interest rates, has come down ever more over the past few years. This has led to the unusual situation that European finance ministers now have to pay significantly less interest on much higher debt than in the past. Germany is the prime beneficiary of this paradox followed by France and Italy. While Germany had to pay EUR 59 billion in interest on its debt in 2007 this had dropped to EUR 15 billion last year. France's debt service went from EUR 48 billion to EUR 28 billion, and Italy's from EUR 73 billion to EUR 54 billion in the same period. The average coupon on Italy's debt decreased from almost five percent in 2010 to just over two percent recently and German average coupons dropped from four to under one percent with continuing downtrend. The relative advantage for Italy is implicitly greater than for any other European country, though, as interest on government debt financing would probably be substantially above five percent by now if the ECB had not intervened.

Eurozone: Amount of interest payments on outstanding government debt in billions of euros



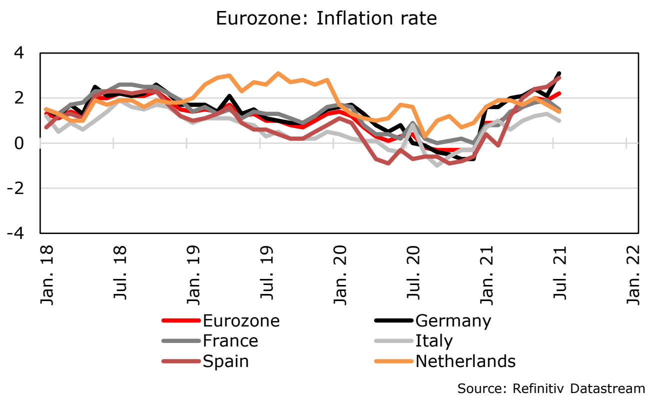
Source: Refinitiv Datastream

Unfortunately, politicians in many European countries have chosen not to use the financial leeway from a lower interest burden to pay down debt but are rather betting on interest rate levels staying low for keeping down their debt ratios and avoiding a debt crisis. They are doing this as it is becoming evident already that most if not all Euroland members will have negative primary state budgets in the next few years. That means their expenses before interest will exceed their income. However, if the interest burden on extant government debt already exceeds nominal gross domestic product growth, the debt ratio will rise already on an even primary balance. This snowball effect demonstrates the typical road to debt perdition.

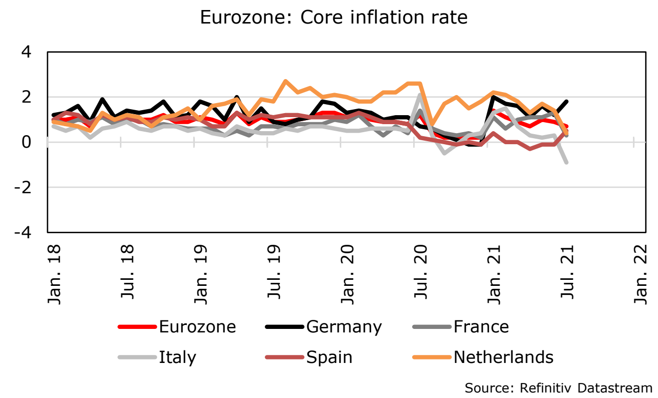
Supposing that the focus of ECB monetary policy has shifted away from upholding money value stability toward maintaining debt carrying capacity this may result in substantial conflicts of objective should Euroland's inflation grow substantially on a long-term basis. For the first time in three years, inflation exceeded the ECB's two-percent target at 2.2 percent in July. The new symmetrical inflation target gives the ECB somewhat more maneuvering room to counteract target deviations than before. Europe's central bank now tolerates inflation above two percent if such deviation is 'slight' and 'temporary.' However, the ECB fails to clearly define what these terms mean. That means it will become harder to gauge whether and when the European Central Bank is going to change its monetary policy going forward. As such, it will become ever more important to balance lower formal transparency with clearer and better communication.

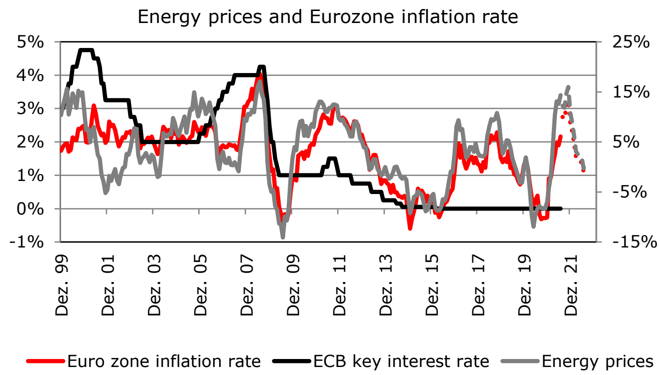
The current inflation excess should certainly qualify as 'slight.' But will it stay that way? Probably not - given the high likelihood of Euroland inflation temporarily reaching about three percent this fall. It therefore comes as no surprise that Germany in particular is going to keep a close eye on inflation, or at least a closer eye than most other countries. Germany's deep-rooted inflation fear may be part of the reason. However, German inflation has recently spiked at almost four percent and may even reach five percent this fall. There are three key factors driving this high inflation rate: Lifting the pandemic trade and business restrictions over the course of the year resulted in surging demand for goods and services. Since the supply side had not yet fully restored all supply chains and production capacities there was a decided lack of prefabs and input materials while logistics and commodity costs skyrocketed. Moreover, the value added tax hike from 16 to 19 percent dealt the inflation calculation a double blow one in January (direct price effect) and one in July (indirect effect due to the lower comparative base). The CO2 tax introduced at the beginning of the year put additional pressure on prices. The last two effect alone accounted for about one percentage point of inflation in Germany. It is therefore hardly surprising that the German public is keeping a keen eye on inflation development especially because many German market observers are already suspecting that the ECB is behind the eight ball, meaning that its monetary policy is lagging behind real economic developments. Inflation will definitely rise in Germany over the next few months.

However – and we tend to give this point not its due respect – the ECB's mandate is to monitor price development in ALL of Euroland. Inflation in other European countries is quite different from Germany. The harmonized inflation rates (differing slightly in terms of national price indices owing to minor variations and weightings in their baskets of goods and services) in almost all of our neighbor countries are lower than in Germany, in some cases they are substantially lower. The next highest inflation rates after Germany are in Spain at 2.9 and Austria at 2.8 percent. By comparison, price pressure in France (1.5 percent), the Netherlands (1.4 percent) and Italy (1.0 percent) is considerably lower. Taking Germany out of the pan-European inflation calculation would put the harmonized inflation rate for July not at 2.2 percent but 1.8 percent.



July core inflation in Euroland came to 0.7 percent and excluding to Germany to a mere 0.4 percent. Part of the reason for this are three countries in deflationary territory namely Belgium (-1.2 percent), Greece (-1.1 percent), and Italy (-0.9 percent).





The core inflation rate demonstrates that the higher inflation in the past few months was primarily the result of a strong rise in energy prices (up to twenty percent year-on-year in some countries) which accounted for some two-thirds of the July euro area inflation. In Germany, for instance, diesel and gasoline prices rose almost 30 percent year-on-year and in Spain electricity prices soared almost 40 percent year-on-year. Assuming that oil prices remain at the currently high level, Euroland inflation will drop back to below two percent already in the beginning of next year. Germany will be a little slower to come down again not least because the closely watched national inflation rate reached almost four percent in July and thus came in markedly higher than Germany's harmonized July inflation rate of some three percent. Chances are that even German inflation will come down below two percent in the second of 2022. As such, we are comfortable with the ECB keeping the monetary reins slack for now.

Since inflation will come down again to normal levels next year, we think weighting stocks high in your portfolio remains a sound strategy. Stocks are expensive in terms of historic valuation ratios but that is true for virtually all assets. This is the result of the monetary policy for several years running and since this policy is unlikly to change much any time soon investors have to live with these high valuations. As we are expecting a sustained economic recovery, the opportunity-to-risk ratio for stocks seems to us still much more attractive as for bonds. We prefer corporate bonds over sovereigns in the fixed-income category as these would benefit more from an economic recovery while sovereign coupons are too low to buffer potential price losses. Even though there have hardly been any major setbacks on the stock market in recent months, investors should always allow for temporary consolidation phases and market corrections in the order of 10 to 15 percent. With no immediate prospect of another recession and central banks not switching to more restrictive monetary policies, any such consolidation or correction would be a good buying opportunity for investors with corresponding risk tolerances.

Market data

Stock marktes	As of 20.08.2021 10:21	Change versus 13.08.2021 -1 week	19.07.2021 -1 month	19.05.2021 -3 months	19.08.2020 -1 year	31.12.2020 YTD
Dow Jones	34894	-1,7%	2,7%	2,9%	26,0%	14,0%
S&P 500	4406	-1,4%	3,5%	7,0%	30,5%	17,3%
Nasdaq	14542	-1,9%	1,9%	9,3%	30,5%	12,8%
DAX	15673	-1,9%	3,6%	3,7%	20,8%	14,2%
MDAX	35410	-1,4%	4,5%	11,0%	29,2%	15,0%
TecDAX	3828	0,1%	7,3%	15,9%	23,0%	19,1%
EuroStoxx 50	4123	-2,5%	4,9%	4,7%	24,3%	16,0%
Stoxx 50	3600	-1,8%	4,4%	6,5%	20,0%	15,8%
SMI (Swiss Market Index)	12362	-0,8%	4,2%	11,9%	19,9%	15,5%
Nikkei 225	27013	-3,4%	-2,3%	-3,7%	16,9%	-1,6%
Brasilien BOVESPA	117165	-3,3%	-5,8%	-4,5%	16,2%	-1,6%
Russland RTS	1629	-2,3%	4,4%	4,9%	23,7%	17,4%
Indien BSE 30	55381	-0,1%	5,4%	11,0%	43,4%	16,0%
China CSI 300	4769	-3,6%	-6,7%	-7,8%	0,6%	-8,5%
MSCI Welt (in €)	3063	-1,2%	3,7%	10,1%	30,7%	19,7%
MSCI Emerging Markets (in €)	1232	-3,1%	-5,7%	-2,9%	14,6%	0,3%
Bond markets						
Bund-Future	177,04	40	152	814	47	-60
Bobl-Future	135,38	15	54	102	51	20
Schatz-Future	112,34	3	13	31	30	6
3 Monats Euribor	-0,55	2	2	2	-6	3
3M Euribor Future, Dec 2017	-0,54	0	-1	-2	-6	0
3 Monats $ Libor	0,13	1	0	-2	-12	-11
Fed Funds Future, Dec 2017	0,08	0	0	0	6	0
10 year US Treasuries	1,24	-4	5	-44	57	32
10 year Bunds	-0,49	2	-6	-38	2	8
10 year JGB	0,01	-1	1	-6	-2	-1
10 year Swiss Government	-0,40	-2	-3	-29	9	10
US Treas 10Y Performance	708,56	0,5%	-0,3%	4,7%	-2,9%	-1,0%
Bund 10Y Performance	683,31	0,2%	0,9%	4,0%	0,6%	-0,2%
REX Performance Index	498,75	0,1%	0,4%	1,8%	0,1%	-0,1%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	0,10	-1	-5	-24	-7	8
IBOXX BBB, €	0,47	-1	-6	-31	-49	-8
ML US High Yield	4,71	1	0	-13	-129	-27
Convertible Bonds, Exane 25	8288	0,0%	1,2%	1,7%	6,7%	-0,5%
Commodities						
MG Base Metal Index	414,15	-5,3%	-2,4%	-5,6%	31,9%	16,8%
Crude oil Brent	66,37	-6,1%	-3,4%	-0,5%	46,2%	27,9%
Gold	1785,37	0,6%	-1,2%	-5,2%	-9,1%	-5,9%
Silver	23,30	-2,2%	-7,6%	-16,8%	-15,1%	-11,7%
Aluminium	2562,26	-1,8%	6,5%	7,5%	45,7%	29,8%
Copper	8894,00	-6,8%	-3,2%	-10,9%	32,8%	14,8%
Iron ore	160,38	-4,5%	-26,9%	-24,3%	31,0%	2,9%
Freight rates Baltic Dry Index	3976	11,5%	30,0%	41,9%	153,6%	191,1%
Currencies						
EUR/ USD	1,1677	-0,7%	-0,8%	-4,4%	-2,1%	-4,8%
EUR/ GBP	0,8570	0,7%	-0,8%	-0,8%	-5,1%	-4,3%
EUR/ JPY	127,97	-1,3%	-0,8%	-4,0%	1,8%	1,2%
EUR/ CHF	1,0704	-1,2%	-1,3%	-2,8%	-1,0%	-0,9%
USD/ CNY	6,4982	0,3%	0,1%	1,0%	-6,1%	-0,5%
USD/ JPY	109,74	0,1%	0,3%	0,5%	3,4%	6,3%
USD/ GBP	0,73	1,7%	0,3%	3,8%	-3,2%	0,3%

Source: Refinitiv Datastream

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