GENERALI INVESTMENTS

Focal Point
Inflation expectations remain anchored

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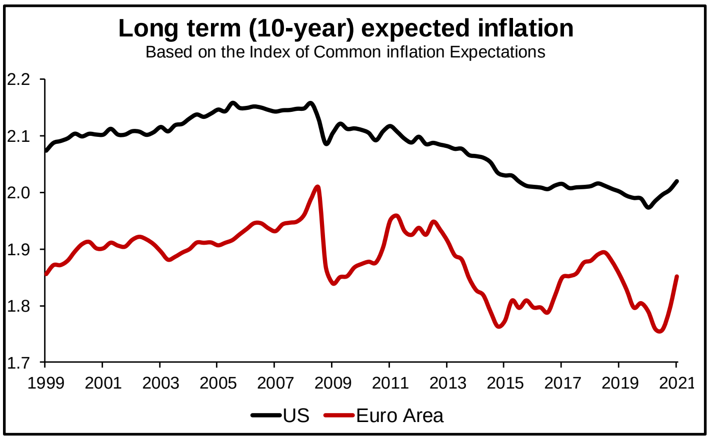
- The sharp and quick repricing of inflation expectations and risk has been a key driver of bond yields globally. This mainly reflects uncertainty over the impact of the reopening of the economy and an aggressive policy-mix. Once risk premia are stripped out, long term expectations are back at the pre-crisis level, but well below the levels prevailing before 2015.
- In the US, the spike is concentrated in the short term, and shows few signs of loss of faith in the Fed's long-term inflation target, despite the tolerance towards higher inflation within its new framework.
- The latest uptick in euro area inflation expectations is in line with fundamentals. They have potential to gradually rise further as the economy recovers and the ECB remains determined to lift inflation towards the 2% target.
- On financial markets we see less leeway for US inflation expectations (already elevated) to rise sustainably but longer-dated euro area inflation linked bonds are more attractive as inflation risks are still not priced adequately.

The spike in long-term interest rates has been to a large extent driven by fears that the combination of a large fiscal US stimulus and ongoing money printing will trigger a permanent increase in inflation. If it gets entrenched in expectations, this may lead to a step-up in bond term premiums, leading yields further up. Moreover, the prospects of rising inflation expectations may eventually lead central banks to put a brake on monetary stimulus, which would tend to pressure real yields upward. In what follows we will lay out our forecast of only a moderate increase in inflation expectations. It will be mostly led by short-term inflation volatility in the months to come. Looking further ahead, we see limited scope for further increase in inflation breakevens in the US but a larger one in the euro area. Therefore, we see value mostly in euro area inflation linked swaps (ILS) and see especially longer-dated tenors as attractive.

Making sense of expected inflation

First, a word of caution is needed when dealing with expected inflation. There is no perfect way to gauge (unobservable) inflation expectations. The signal gathered from bond yields and inflation swaps are blurred by risk premia (related to inflation uncertainty), liquidity frictions and, in the case of bonds, by the net supply of inflation-linked versus nominal securities. For example, as recently noted by the Bank for International Settlements from mid-2020, issuance of Treasuries picked up while that of inflation-linked bonds (TIPS) remained broadly stable. Fed's purchases mopped up TIPS issuance but did not offset in full the increase in Treasuries supply. The extra supply of Treasuries over TIPS may then have contributed to the increase in inflation breakevens. On the other hand, consumers' expected inflation measured by, for example, the University of Michigan survey, is known to be highly correlated to the current price of gasoline and other frequently purchased goods. Noise and premia related to liquidity or risk can be filtered out using different techniques. For example, information from bond yields can be interpolated with surveys to get a "cleaner" measure of expected inflation (for the US see, for example, the estimates by the Cleveland Fed and the Federal Reserve Board). As an alternative, it is possible to summarize the common dynamics shared by different metrics. We apply this latter approach, adapting the methodology developed by two economists at the Fed to long-term expected inflation for the US and the euro area. By this measure, expected inflation has increased in conjunction with the signs of economic recovery and a brighter growth outlook. But it is just back to the pre-pandemic level and still significant below the levels prevailing before 2015.

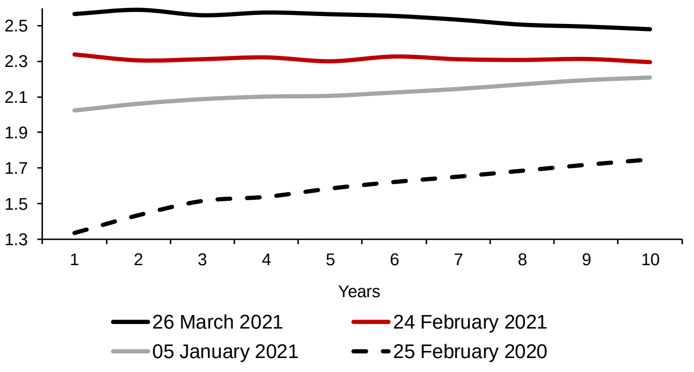


US: only short-term expectations rise

Worries about an uncontrollable rise in inflation are particularly acute in the US, for two main reasons. First, the forthcoming US$ 1.9 tr fiscal stimulus will add substantial purchasing power to households. The wealthier ones have piled up forced savings worth around 8% of 2020 GDP as restrictions curtailed consumption. Therefore, household purchases will accelerate markedly already from Q2 on as the vaccination campaign will allow for a quick reopening of most activities. The spike in demand may meet supply bottlenecks, as the past cuts in investment and employment may be reversed only slowly. Moreover, the Fed has become much more tolerant of higher inflation. First, the usual unemployment inflation trade-off has given way to an order of priorities, where getting the economy back to full employment ranks clearly first. Secondly, according to the new Flexible Average Inflation Targeting (FAIT) regime the Fed plans to allow inflation to overshoot the 2% target for a while, to make up for the persistent undershooting seen over the years. Finally, policy will be recalibrated based on the actual inflation print rather than on expectations. This means, as stated by board member Clarida, that the Fed may want to see "*around one year*" of PCE inflation slightly above target before intervening, and only when a "*hot*" labour market is achieved. The risk is that this experiment in monetary policy – added to the unprecedented demand shock – would lead to a persistent upswing in inflation. This, in turn could feed through firms' and workers' expectations, accelerating the rise in wages and prices. This could eventually force the Fed to curb monetary accommodation too early. Looking at long-term expectations for signals of de-anchoring becomes then crucial. The (limited) evidence we have for the period after the announcement of the fiscal expansion points to limited worries. Looking at the term structure of inflation expectations gathered from financial markets and surveys, it appears that the brightening of the economic outlook has mostly influenced expected inflation over the next few years, and much less over a longer horizon; the upshot is that confidence remains high on the capability of the Fed to keep inflation in check in the long run.

US Inflation Linked Swap curve

Three day average



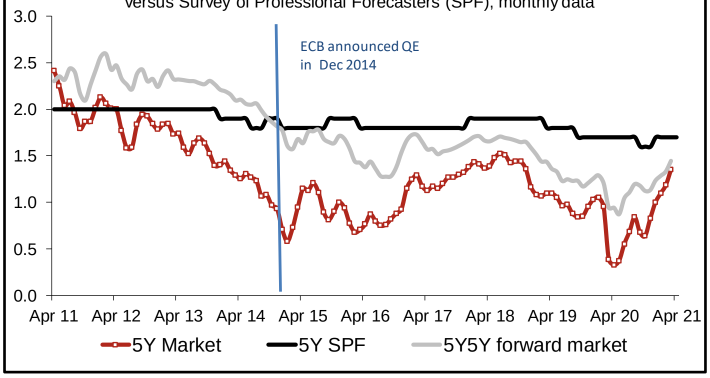
Euro area inflation expectations to trend up

After having fallen to a low when the pandemic started to bite the euro area one year ago, financial market inflation expectations have then recovered. Short-term inflation expectations rose sharply on the back of higher oil prices and special effects like the end of the German temporary VAT cut in H2/2020. However, it is quite noteworthy that long-term inflation expectations have remained low. For example, with a reading of currently 1.50%, EUR 10-year inflation swaps (ILS) are still 20 bps below the historical average.

Fundamentally, a key factor determining the evolution of inflation expectations is underlying inflation. Its current reading of just 1.2% yoy is well below the ECB's target. With the output gap not closed before 2023 and huge labour market slack fostering muted wage growth, the uptrend in euro area underlying inflation will be only gradual. We see it trending higher from an annual average of 0.9% in 2021 to 1.7% by 2025. According to our projections core as well as headline inflation will average 1.5% on a five-year horizon. This is in line with the rate currently priced by markets. Looking beyond this horizon we expect inflation to further creep up, thereby also giving leeway to higher inflation expectations.

Euro area inflation expectations

Market (implicit average inflation expectations from inflation swaps) versus Survey of Professional Forecasters (SPF), monthly data

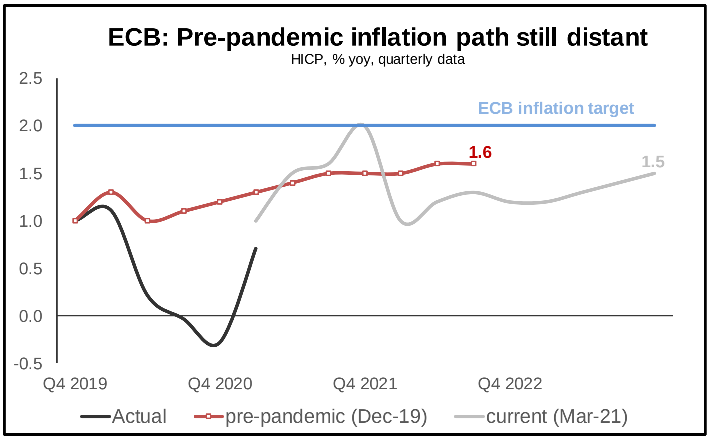


That said, there are various factors at work which are likely to add to volatility around this trend. Oil price fluctuations are a key determinant of short-term inflation expectations. Analogously, bouts of rising economic uncertainty have the potential to temporarily drag on inflation expectations while inflation uncertainty tends to boost expectations.

That said, our proprietary model indicates that US inflation expectations are a key driving euro area expectation. According to our models, an increase of US 10Y ILS by one point leads to an increase of the euro area equivalent by 0.36 points. Hence, an US inflation overshooting will also push euro area inflation expectations higher.

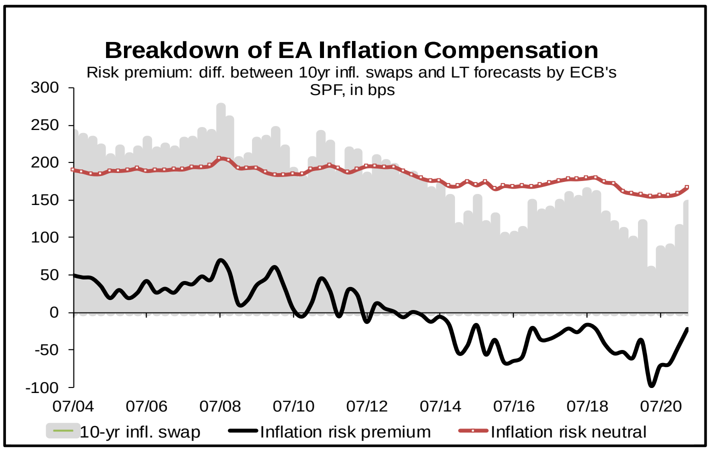
The ECB impacts inflation expectations through various channels. First, by setting its inflation target. The current formulation of an inflation rate "*below but close to two percent*" is broadly consistent with the Survey of Professional Forecasters' current expectation of a 1.8% inflation rate over the coming five years. The ECB strategy review will highly likely lead to the adoption of a symmetric inflation target around the 2% threshold and will imply tolerance if inflation rates rises above 2% over the coming years, thereby contributing to a further increase of inflation expectations.

Second, the ECB drives inflation expectations through its current policy stance. The regular APP as well as PEPP purchases are an empirically significant driver of inflation expectations. Moreover, by keeping real rates at extremely low levels, monetary policy fosters growth and thereby indirectly also inflation. The ECB committed itself also to reinvest the stock of APP assets "*for an extended period of time past the date when we (the ECB) start raising the key ECB interest rate*" and PEPP purchases until at least the end of 2023 while the roll-off will "*avoid interference with the* *appropriate monetary policy stance*". In its latest macro projections, the ECB expects the pre-pandemic inflation path not even to be reached by 2023; coming close to the inflation objective is even further out. Hence, the ECB will continue to employ tools lifting inflation and inflation expectations.



Some juice in euro area ILBs left

While the sharp increase in inflation expectations in recent months triggered a sell-off of nominal bonds, inflation-linked bonds (ILBs) have limited the losses to a significant extent. Accordingly, in addition to the expected actual future inflation trend it is also essential to assess the potential for inflation expectations priced into bond markets.

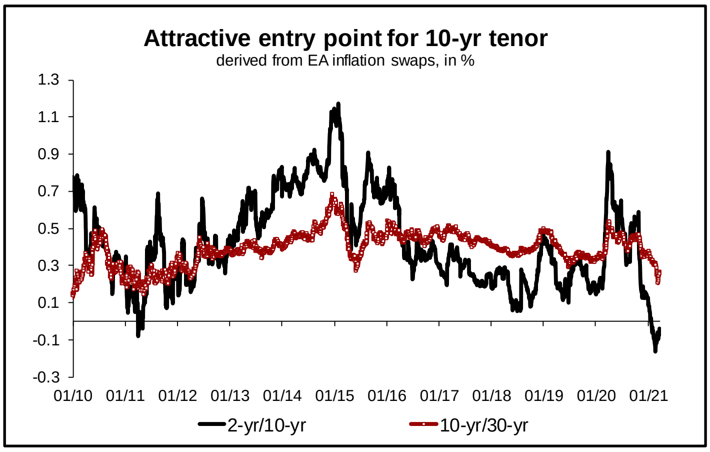


Digging into the elements of inflation compensation, expectations can be divided into an inflation risk premium and a risk neutral component, which proxies genuine expectations. Both in the US and in the euro area the bulk of the rise in inflation expectations over the last year can be traced to a higher risk premium. While the current premium is above average now in the US, in the euro area it is below average. In fact, the chart above shows that the inflation risk premium in the euro area is still negative, indicating more scope for a further rise in the euro area. In view of the high degree of uncertainty about the impact of the accommodative fiscal and monetary policy and the looming new ECB strategy we see leeway for the term premium to rise more.

The same pattern can be observed with the risk neutral component. While it is above the average in the US it has hardly moved in the euro area. Although there is some scope for a rise in the euro area, we do not forecast this to happen in the near term. Only in case the economic rebound accelerates even faster than expected and signs of increasing price pressure emerge, the risk neutral component is forecast to rise meaningfully.

Additionally, inflation expectations show a high correlation with commodity prices. Oil prices have soared by more than 80% and copper by almost 40% since November 2020. What is more, the extent of the forecast temporary spike in inflation in spring is hard to gauge as special factors blur the distinction between temporary and permanent factors, increasing the uncertainty about the underlying trend. Both factors represent an upside risk for inflation expectations.

In summary, a large part of the adjustment of inflation expectations has already been completed. 10-year US inflation expectations are at a 7-year high signalling limited leeway for a strong further increase (notwithstanding a possibly significant temporary overshooting). Euro area inflation expectations have risen as well but remain below the long-term average. The analysis indicates that there is some scope for euro area inflation expectations to rise. 10-year inflation swaps might inch up further by 20 bps or more on a 1-year horizon. Once the structural problems in the euro area are successfully tackled and the underlying inflation trend is sustainably upwards again it might rise further – but this is unlikely to happen in the short and medium term.



Nominal yields tend to be mainly driven by higher inflation expectations in the euro area. A simple regression of 10-year Bund yields versus 10-year inflation swaps shows an extremely negative residual. This exposes euro area yields to a possible repricing and indicates upward pressure for Bund yields. However, at least in the short term the macroeconomic backdrop will remain rather weak. This will allow euro area yields to decouple to a certain extent from the cyclically driven upward trend in the US at least in the months to come. Moreover, the remainder of the year will be much more cash flow-friendly than the first quarter which is traditionally characterized by a strong issuance activity. This applies even more as the ECB announced to increase its PEPP purchases in Q2. While some uncertainty remains, initial data indicate an additional monthly volume of around € 20 bn.

Although these factors will slow the yield increase, investors will not be able to prevent losses entirely. An attractive way to limit losses and to hedge versus a further yield increase driven by higher inflation expectations is an investment in ILBs. As future inflation rates are still not priced adequately in the euro area the purchase of ILBs is appealing. The inversion of the 2-yr/10-yr inflation curve and the rather flat 10-yr/30-yr curve indicate that particularly longer-dated ILBs offer an attractive entry point for inflation hedging.

Imprint

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Sources for charts and tables:	Refinitiv/Datastream, Bloomberg, own calculations Version completed: see front page

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