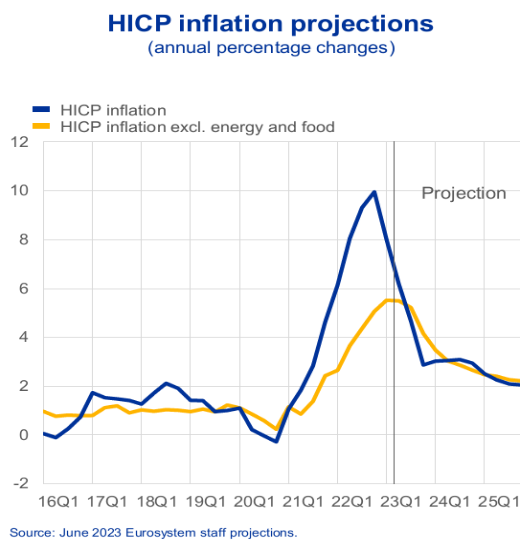
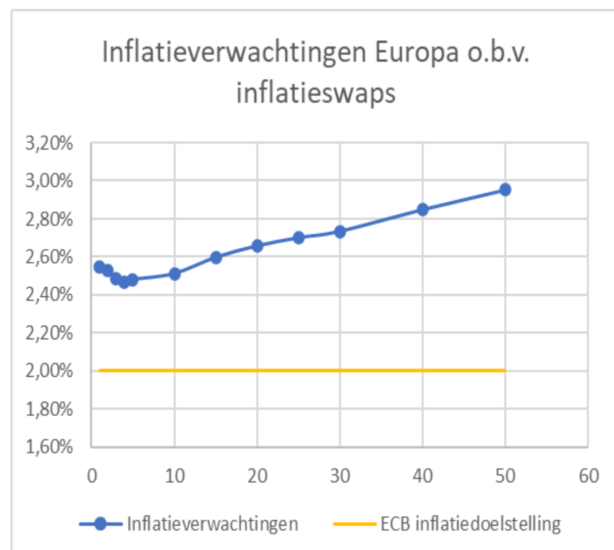
"The ECB will never meet its inflation target again..."

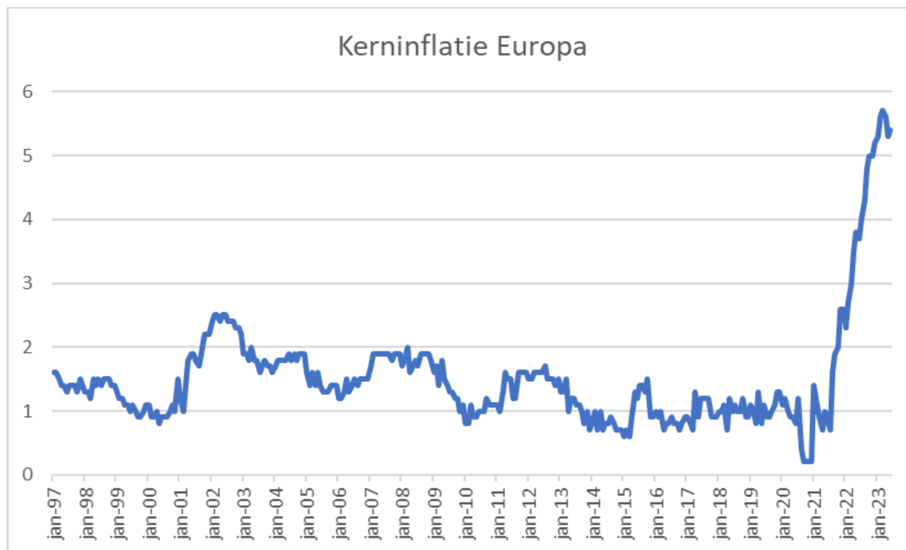
Inflation has been the number one topic on everyone's mind in recent times. That will be no different in the period ahead. Inflation figures seem to have peaked. There are many different opinions on how fast and to what level inflation is going to fall (see below left, for example, the ECB's end-June expectations). Yet everyone seems to agree that inflation is going to be consistently higher than we have been used to over the past decade. The only question is how much higher.

Without rehashing the reflections in the market update from June, it is far more interesting to take a closer look at the market expectations. In the chart below right, for example, we see that zero-coupon inflation swaps indicate that the ECB is 'never' going to meet its inflation target again. Currently, the expected average inflation rate for the next 50 years is close to 3%, putting it almost 1% above the ECB's target of 2%.





An interesting fact, especially when we know that core inflation, since it has been tracked Europe-wide since 1996, has averaged just 1.5%. After the 2008-2009 financial crisis, the ECB spent more than a decade doing everything in its power to push up inflation in the eurozone and fears of deflation or disinflation prevailed.

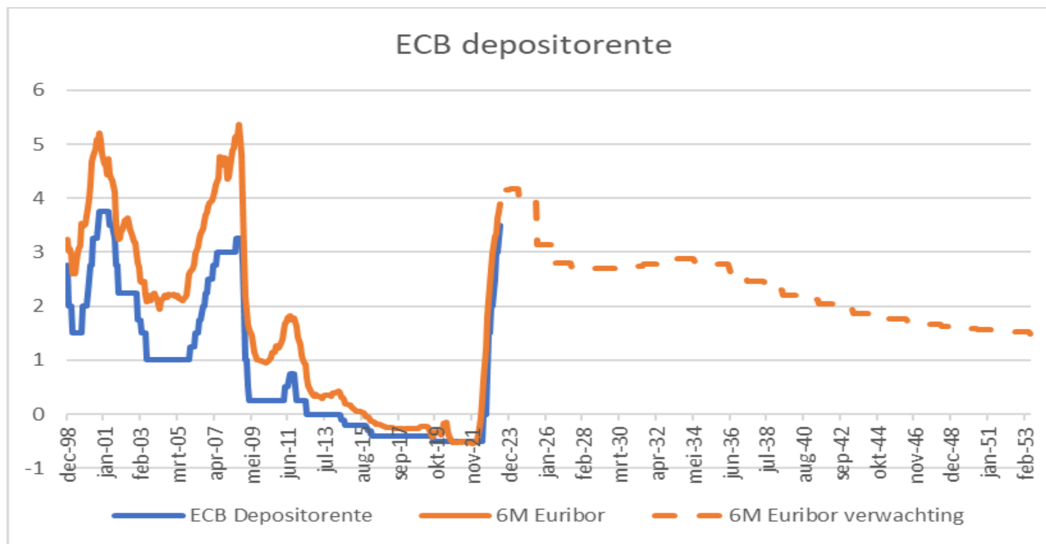


“... And that's why policy interest rates won't fall anytime soon”... right?

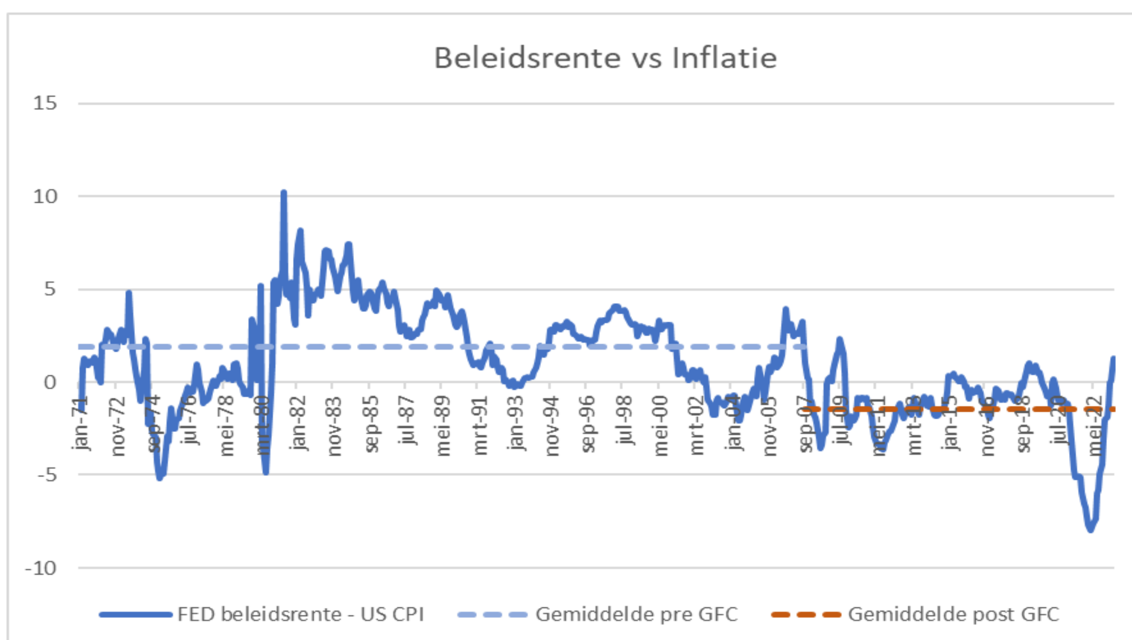
It is tempting to delve into the debate about wage-price spirals, demographics, transition to renewable energy, higher defence spending, technological developments and globalisation or deglobalisation, but first the focus on market expectations.

It's possible that the ‘3% inflation forever’ is an anomaly of the not very liquid market for inflation swaps. It is therefore prudent to seek confirmation in other more liquid markets, e.g. the interest rate swap market. There we see the picture below based on the 6-month Euribor, which has been moving close to the ECB deposit rate since the introduction of central clearing and is therefore a pretty good approximation for future deposit rates. Here we see that policy interest rates are expected to peak in the short term and then start declining to 1.5% in due course. If we look at historical central bank cycles of the FED and ECB, no easing cycles can be found where interest rates fell so slowly and so minimally. This makes the path predicted by the markets seem unlikely. One explanation is that the current expected interest rate trajectory is an average of (i) a scenario in which inflation quickly comes under control and policy rates fall and (ii) a scenario in which inflation remains high for longer and policy interest rates need to be raised further.

We might question whether expected policy interest rates are to some extent consistent with inflation expectations. If inflation remains too high, the ECB will have to adopt more restrictive policies. But with the combination of rising inflation expectations and falling policy interest rates, there is no logical economic narrative to be derived. Therefore, we are now zooming in on the difference between interest rate and inflation levels.



Normally, there is a strong relationship between policy interest rates and inflation because central bankers use policy rates to steer inflation towards their target, but there is no scientifically traceable equilibrium level. Moreover, if we look at a long history for the United States, we see that there is a huge difference between the period before the great financial crisis of 2008-2009 and the period after. Over the entire history, the policy interest rate is 0.9% above actual inflation, but this is the average of almost 40 years with a difference of +1.9% and 15 years of extremely loose monetary policy with a difference of -1.5%. This can be seen in the chart on the next page. If we assume that the very loose monetary policy of the past 15 years is not a benchmark for the coming decades, we can at least draw the conclusion that a policy interest rate of 1.5% is not historically a level of interest rates appropriate for 3% inflation. Hence, current pencilled-in interest rate and inflation expectations are, in our view, inconsistent.



"This time is different", or is something else going on?

It could be that history tells little about the future and there is in the end a perfect explanation for expected lower interest rates and higher inflation. In fact, market expectations, while certainly not perfect predictors, are generally pretty good. However, market expectations are also ultimately the result of the actions of market participants. These are people, with all their emotions, strengths and shortcomings.

The rapid and huge rise in inflation and associated interest rate movement over the past two years was a shock to many. In the Draghi era, every self-respecting economist was researching a Japan scenario in Europe and there was a widely held belief that interest rates, like in Japan, would never again move to 'normal' levels. Also, investing in inflation-linked instruments was a long-term headache. The belief in permanently low interest rates and inflation was evident in many areas. Prices of swaptions, instruments widely used to protect investment portfolios against large interest rate fluctuations, were historically low. There was also record demand for (and hence supply of) very long-term loans, which is not very natural when the buyer has a higher interest rate expectation. It was therefore hardly surprising that during the 2022 interest rate hike, there were daily rumours in the market about parties adjusting their interest rate positions in a mild panic, after years of not having to do so. Similar voices were heard from inflation traders at several major financial parties. After years of lack of interest, inflation investments were suddenly popular again.

This period has undoubtedly left its mark in the minds of those involved. Just as people in the Draghi era could not imagine that interest rates would ever rise again, the same recency bias (i.e. the phenomenon of people overestimating the importance of recent observations in estimating future developments) may now have caused prices of financial instruments, and hence implied market expectations, to be warped.

Summary

There seems to be a clear inconsistency between current interest rates and inflation expectations. While interest rate markets indicate that the ECB will cut its interest rates, albeit tentatively, over the next few years, inflation markets show slowly rising inflation that will 'never' come close to the ECB target.

The next few years will show whether, after the COVID-19 crisis and other developments, there is indeed a different world with low interest rates and high inflation, or whether the inconsistency will disappear as either interest rates rise higher than thought or inflation falls (or a combination of both). An argument can be made for either scenario, but obviously they will not both materialise.

In the event that deflationary forces, which have kept inflation low for years, have now subsided (e.g. due to increased investment in the transition to sustainable energy and the strengthening of defence) and, in addition, inflationary pressures are coming from deglobalisation, interest rates will also be and remain significantly higher than we have been used to for years, and the interest rate market should be subject to substantial upward repricing.

If inflation does come under control sooner than expected and, despite the COVID-19 pandemic and other developments, the world has changed surprisingly little from the years prior to COVID-19, inflation expectations will have to fall and parties who bought inflation-linked investments in the hurry would be wise to dispose of them again.

Our base case is the second scenario of falling inflation, but at the same time, traffic jams in the Netherlands are now longer than pre-COVID-19 levels again, a confirmation that people mostly keep doing what they were already doing. On balance, the world has changed slightly, but not much. In this scenario, the expected ECB policy interest rate, previously described as an average of a high and low inflation scenario, will also show a downward trend.