Increase in inflation has come to an end for now

Gerhard Winzer

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Two developments are prominently noticeable on the markets at the moment: on the one hand, the indicators of real economic growth suggest a stable real economic growth rate of about 3%. On the other hand, we have seen global consumer price inflation decline since the beginning of the year. The reflation phase, i.e. the general increase in inflation in the second half of 2016, seems to be over (for now).

Low inflation beneficial for markets

Low, stable inflation generally constitutes a favourable environment for the markets. However, the momentum has been on the decrease in the past months. Global consumer price inflation has fallen from 2.3% y/y in January to 1.8% y/y in May. This movement has so far been regarded as driven by noise, i.e. random fluctuations (e.g. the oil price). Inflation is consolidating on low levels. Even if it is not rising, the economic environment would not suggest a sustainable increase.

Unemployment rates are falling

The main argument against a further decline in prices is the fact that the comparably good economic growth causes unemployment rates to fall on a global scale. If this trend continues, the unemployment rate will hit the lower threshold where the inflation pressure increases (i.e. the non-accelerating inflation rate of unemployment, or NAIRU) in more and more countries. According to OECD estimates, this threshold has been reached already in the USA, the UK, Germany, Japan, Australia, and Sweden. We just have to be patient for inflation to rebound towards the inflation target set by the ECB. This may take years.

Low interest rates

As odd as it may sound at first, but the current level of interest rates may still be too high. Recent experience shows that interest rates can also drop below zero percent. This does not make the so-called zero-lower-bound concept totally obsolete. It has shifted to the effective-lower-bound (of interest). This is where the interest rates hit an absolute lower bound on negative territory. However, if the interest rate required for a sustainable rise in inflation remains below this lower bound, inflation remains low. **The practical effect is that bond yields remain low in such a scenario as well.**

Neutral interest rate level as upper boundary

There is also a theoretical upper bound for interest rates, i.e. the neutral interest level. If rates rise above this level, they dampen economic growth and inflation (restrictive interest level). Current estimates by the Fed put the real upper bound of interest for the USA at only 0.4% (Eurozone: -0.5% !). The lower the inflation rate, the lower the neutral nominal interest level (i.e. real interest level plus inflation). At an inflation of 2%, it is 2.4% in the USA (0.4% real interest rate plus 2% inflation). In the USA, the key-lending rate (Fed funds rate) is currently in a bandwidth of 1% to 1.25%. At the same time, the chairwoman of the FOMC, Janet Yellen, has indicated a continued cycle of interest rate hikes. The closer the Fed funds rate gets to the estimated neutral interest level of 2.4%, the higher the probability of the rates being raised above this neutral level.

Real-life effect: the difference between long-term and short-term yields of US Treasury bonds is on the decline. Generally speaking, the slope of the yield curve is a very good economic indicator. The yields at the short end rise in line with the increases in the Fed funds rate. The yields at the long end, as average of the future expected short-term yields, have already started to price in a decline in economic growth and inflation.

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