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Inflation worries burdening stock exchanges – part 2: the macro perspective

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Equity indices have undergone a global correction in the past days. The Dow Jones index has shed more than 10% from its January high. What is the macro-economic reason for the correction?

Goldilocks scenario coming to an end

Up to and including 2017, the economic scenario was best described as "Goldilocks": strong economic growth and sharply rising company earnings, low inflation, low interest rates, and low yields, accompanied by supportive and predictable monetary policies of the most important central banks (especially the US Federal Reserve Bank, the European Central Bank, and the Bank of Japan).

Also, volatility on the stock exchanges was very much contained – as were the fluctuations of macro-economic indicators. The prevalent investment theme was "TINA" ("There Is No Alternative To Risky Assets"), given that government bonds were promising only low yields. The strong inflows into risky asset classes caused prices to rise significantly. As a result, valuations were up by a significant margin as well. In other words, the stock exchanges were anticipating the good environment. In addition, the stock exchanges have not seen a correction in many months, which is unusual for this asset class.

Rising inflation pressure and the announcement of additional increases of the key-lending rates were happening too quickly

We are currently experiencing the transition from the Goldilocks scenario to a normal state of affairs. Since economic growth has remained strong and has at the same time become ever more self-supporting, the cyclical inflation pressure increased. – Particularly in the USA, where the central bank has already hiked the Fed funds rate and is implementing the reduction of central bank liquidity as we speak. This led US Treasury yields to increase.

The increase in the real yields of Treasury bonds, i.e. the level of yields taking into account inflation expectations, and the announcement of further interest rate hikes by the US Fed happened to quickly. This change in regime was the trigger for the high volatility that we have seen recently. The change was too much for the equity markets, and the uncertainty among market participants triggered a correction on the equity markets.

(Real) interest rates remain low, economic growth remains strong

The new scenario of normalising economic growth, inflation, and interest rates is actually not negative for risky asset classes such as equities or high-yield bonds. After all, economic growth remains strong. Inflation is no problem, as it is just increasing from an excessively low level towards the central bank target. Also, central banks continue to act cautiously as far as their monetary policies are concerned. The interest rate level is not restrictive for the economy or equities. This would also apply even if the yields were to rise a bit further in this new environment and central banks were to raise their key-lending rates by another notch.

Inflation remains the key parameter

As long as inflation rates remain low (or are rising only a bit), the central banks can react to a worsening financial environment. For example, at a certain point they cannot raise the key-lending rate anymore. But if inflation were to rise significantly in the USA, the central bank would be faced with a predicament. Does it fight inflation or support the financial markets? This risk is new and possibly the most important economic reason for the correction on the equity markets.

Legal note:

Prognoses are no reliable indicator for future performance.

Legal disclaimer

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He holds a degree from a polytechnical college and studied economics and business at Vienna University with a special focus on financial markets. He holds a CFA charter and participated from 2001 to 2003 in the doctoral programme for finance at the Center for Central European Financial Markets in Vienna.

From July 1997 to June 2007, he worked in research at CAIB, Bank Austria Creditanstalt, and UniCredit Markets & Investment Banking. His last position was as Executive Director for Fixed Income / FX Research and Strategy. He was responsible for research on asset allocation at Raiffeisen Zentralbank (RZB) in Vienna from July 2007 to February 2008.