

<https://blog.en.erste-am.com/increase-inflation-come-end-now/>

Increase in inflation has come to an end for now

Gerhard Winzer



© (c) iStock

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 deflation 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.

Legal disclaimer

This document is an advertisement. Unless indicated otherwise, source: Erste Asset Management GmbH. The language of communication of the sales offices is German and the languages of communication of the Management Company also include English.

The prospectus for UCITS funds (including any amendments) is prepared and published in accordance with the provisions of the InvFG 2011 as amended. Information for Investors pursuant to § 21 AIFMG is prepared for the alternative investment funds (AIF) administered by Erste Asset Management GmbH pursuant to the provisions of the AIFMG in conjunction with the InvFG 2011.

The currently valid versions of the prospectus, the Information for Investors pursuant to § 21 AIFMG, and the key information document can be found on the website www.erste-am.com under "Mandatory publications" and can be obtained free of charge by interested investors at the offices of the Management Company and at the offices of the depositary bank. The exact date of the most recent publication of the prospectus, the languages in which the key information document is available, and any other locations where the documents can be obtained are indicated on the website www.erste-am.com. A summary of the investor rights is available in German and English on the website www.erste-am.com/investor-rights and can also be obtained from the Management Company.

The Management Company can decide to suspend the provisions it has taken for the sale of unit certificates in other countries in accordance with the regulatory requirements.

Note: You are about to purchase a product that may be difficult to understand. We recommend that you read the indicated fund documents before making an investment decision. In addition to the locations listed above, you can obtain these documents free of charge at the offices of the referring Sparkassen bank and the offices of Erste Bank der oesterreichischen Sparkassen AG. You can also access these documents electronically at www.erste-am.com.

N.B.: The performance scenarios listed in the key information document are based on a calculation method that is specified in an EU regulation. The future market development cannot be accurately predicted. The depicted performance scenarios merely present potential earnings, but are based on the earnings in the recent past. The actual earnings may be lower than indicated. Our analyses and conclusions are general in nature and do not take into account the individual characteristics of our investors in terms of earnings, taxation, experience and knowledge, investment objective, financial position, capacity for loss, and risk tolerance.

Please note: Past performance is not a reliable indicator of the future performance of a fund. Investments in securities entail risks in addition to the opportunities presented here. The value of units and their earnings can rise and fall. Changes in exchange rates can also have a positive or negative effect on the value of an investment. For this reason, you may receive less than your originally invested amount when you redeem your units. Persons who are interested in purchasing units in investment funds are advised to read the current fund prospectus(es) and the Information for Investors pursuant to § 21 AIFMG, especially the risk notices they contain, before making an investment decision. If the fund currency is different than the investor's home currency, changes in the relevant exchange rate can positively or negatively influence the value of the investment and the amount of the costs associated with the fund in the home currency.

We are not permitted to directly or indirectly offer, sell, transfer, or deliver this financial product to natural or legal persons whose place of residence or domicile is located in a country where this is legally prohibited. In this case, we may not provide any product information, either.

Please consult the corresponding information in the fund prospectus and the Information for Investors pursuant to § 21 AIFMG for restrictions on the sale of the fund to American or Russian citizens.

It is expressly noted that this communication does not provide any investment recommendations, but only expresses our current market assessment. Thus, this communication is not a substitute for investment advice, does not take into account the legal regulations aimed at promoting the independence of financial analyses, and is not subject to a prohibition on trading following the distribution of financial analyses.

This document does not represent a sales activity of the Management Company and therefore may not be construed as an offer for the purchase or sale of financial or investment instruments.

Erste Asset Management GmbH is affiliated with the referring Sparkassen banks and Erste Bank.

Please also read the "Information about us and our securities services" published by your bank.

Subject to misprints and errors.



Gerhard Winzer

Gerhard Winzer has worked at Erste Asset Management since March 2008. Up until March 2009, he was Senior Fund Manager in Fixed Income Asset Allocation; he has been Head Economist since April 2009.

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.