Global Markets Daily: European Rates - Inflation Risk Rising (Cole)

- European traded inflation continues to rise as higher energy prices push up spot prints. Although these headline pressures should ultimately prove temporary, the rise in both actual and traded inflation in Europe and across the G10 is sustaining a broader repricing of European inflation and nominal yields.
- Part of this increase in inflation pricing is due to a rising inflation risk premium. The rise of this factor, after a long period of absence, is likely to see ongoing upward pressure on European nominal rates. Stay short 5y EUR rates on the swap curve.

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European Rates - Inflation Risk Rising

Last week, European 5y inflation swaps (HICP) reached 2% for the first time since 2012. 5y HICP has rallied around 40bp in the last two months, on top of an already strong recovery from pandemic lows in March 2020. 5y5y HICP reached 1.8%, a level last seen in 2015 in the early days of ECB QE. This rise in inflation has corresponded with a marked shift in the distribution of inflation outcomes, as priced by inflation options markets. The market is now putting the lowest weight on sub-1% inflation in the next five years as it has for a decade (Exhibit 1).

This rise in inflation is not only an increase in inflation expectations (although survey evidence does indicate inflation expectations are rising). But as we have argued, our model estimates suggest some of this move is explained by a rise in inflation risk premium – perhaps 5-10bp of the 40bp increase in 5y HICP. We continue to estimate that the inflation risk premium at the 5y point on the curve is negative, which we discuss below. But this increase is consistent with our previous work that highlights the empirical link between inflation risk premium and both inflation volatility and skew, given the recent upward shift in the inflation distribution.

A higher inflation risk premium is also consistent with increasing worries around 'stagflation', namely a worsening trade-off between growth and inflation, caused, for example, by negative supply shocks. For standard asset pricing models (such as the CAPM or CCAPM) it is not just the expected level of inflation that should matter for inflation pricing, but the covariance of inflation with either risk assets or consumption. The more inflation is positively correlated with the market, or with output, the higher the excess return needed to hold inflation in a portfolio. To generate this excess return, inflation then may theoretically trade *below* inflation

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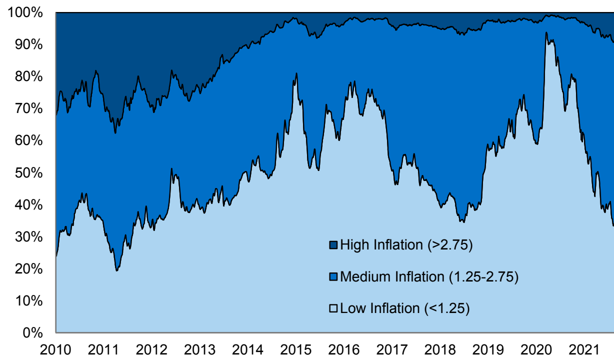
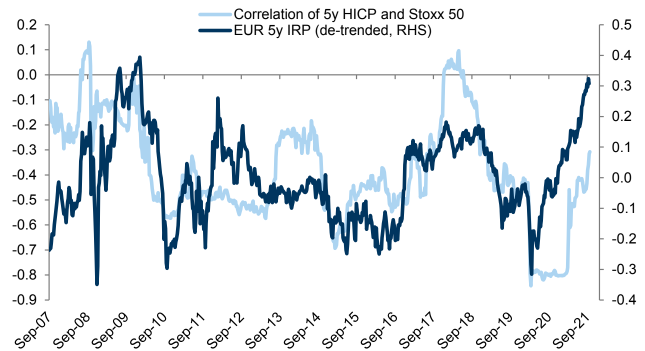
expectations with a negative inflation risk premium. However, if inflation is negatively correlated to output, such as in a severe negative demand shock and/or de-anchoring of inflation expectations, then the argument reverses – less excess returns are required to hold long inflation positions, because long inflation becomes negatively correlated with risk assets. In this environment, inflation risk premium would increase.

Exhibit 1: Low European inflation outcomes at lowest implied probability in a decade
Risk-neutral probability distribution from 5y EU inflation caps and floors



Source: Bloomberg, Goldman Sachs Global Investment Research

Exhibit 2: Inflation risk premium rising as risk correlation falls
Correlation of 5y HICP and Eurostoxx 50, inverted, vs 5y EU inflation risk premium



Source: Goldman Sachs Global Investment Research

This relationship is not just theoretical. Exhibit 2 shows the correlation between stocks and market-based inflation measures in Europe against our estimate of the 5y inflation risk premium (purely derived from the inflation curve). And on a higher frequency of correlation lookback, we can clearly see the correlation between inflation and risk assets weakening, namely inflation become *less* pro-cyclical. Since the 1970s and 1980s, inflation has become a more cyclical variable, with the 2008-09 crisis in particular cementing this into the market correlation structure – in such a world, inflation is cyclical and bonds act as an effective hedge for risk assets given 'bad' states of the world are associated with low inflation and thus higher bond returns. This was particularly evident in the decade following the financial crisis, in which demand shocks – which push inflation and output in the same direction – dominated supply shocks. But recently, the relative strength of these shocks have become much more balanced, again pointing to a higher inflation risk premium (Exhibit 3).

What are the implications? Given our view that much of the current inflationary pressure will subside, one answer might be 'not much' – central banks may be able to look through the current inflationary pressure and we soon return to the world of the previous decade. But this view, particularly in the European fixed income market, is largely priced and heavily subscribed. After all, long-end European rates remain exceptionally low on an absolute and relative basis. Instead, we see better risk reward for the market to continue to take out insurance against a rise in inflation that is proving to be stickier and less cyclical across other G10 economies. This would have implications for the level of inflation – our estimates suggest the inflation premium is still negative even after the recent repricing, suggesting more upside to come. In addition, this increase in inflation risk premium would also likely correspond with an increase in nominal term premium, with implications for 30y rates in Europe given how much low

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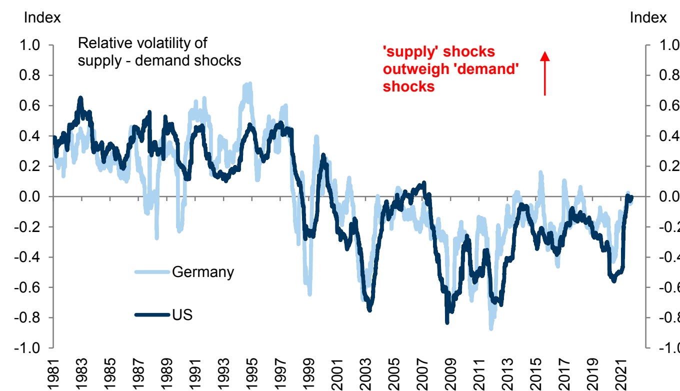
long-end yields currently rely on a low risk premium.

But the clearest implication for us is in the belly of the European curve, where upward pressure on inflation and inflation risk raises the possibility of ECB hikes earlier than expected by the market or our forecasts. European front-end forwards have started to rise in recent weeks, but remain low relative to the level of inflation risk currently priced (Exhibit 4). While the latest increase in 2y rates may soon reach a limit given the likely patience of the ECB into the recovery, we continue to recommend paying 5y rates on the curve in Europe.

The author would like to thank Tomas Pereira de Almeida for his contribution to this piece. Tomas is an intern with the Global Markets team.

Exhibit 3: Since 2010, 'demand' shocks outweighed 'supply', but relative strength has fallen

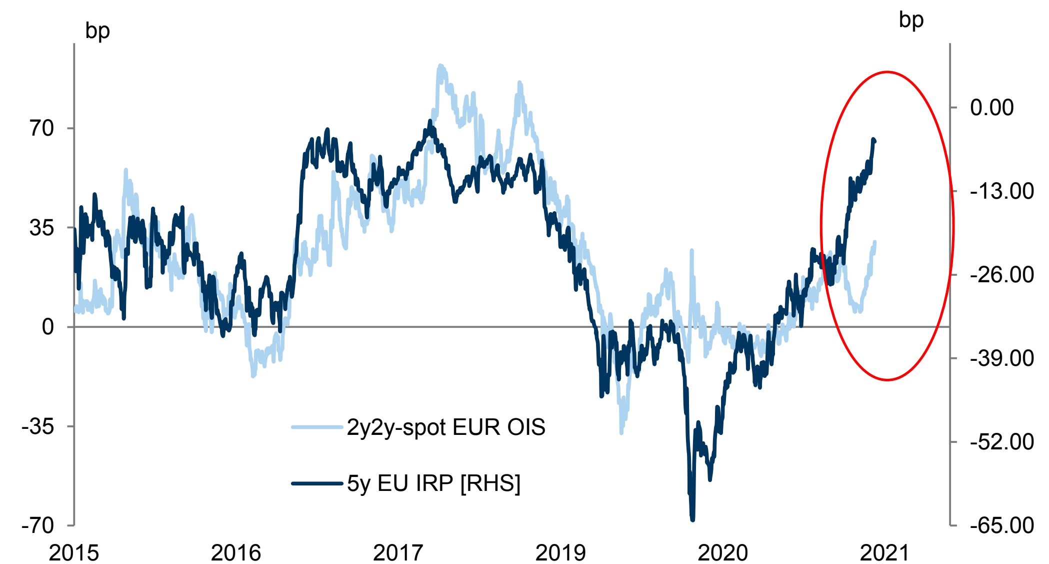
Relative strength of positive (demand) vs negative (supply) covariance shocks between bond yields and equities



Source: Goldman Sachs Global Investment Research

Exhibit 4: European front-end forwards are low relative to pricing of inflation risk

2y2y - spot OIS spread vs 5y EU inflation risk premium



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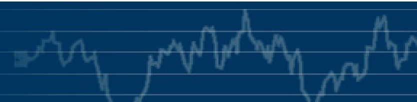
TRADE IDEAS



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1. Stay long MYR vs short THB, opened on October 21, 2020, at 7.52, with a target of 8.20, and a revised stop of 7.90, currently trading at 8.13.
2. Stay long SGD vs short TWD, opened on October 29, 2020, at 20.95 (indexed at 100), with a revised total return target of 107, and a revised stop of 104.75, currently trading at 106.92.
3. Stay long CMBX 6 BBB- vs. CDX HY index at a 1 to 1.25x notional ratio, opened on February 10, 2021, at 0%, with a target of +10% and a stop of -10%, currently trading at -5.59%.
4. Stay long South Africa and Russia equities, indexed to 100 on March 26, 2021, with a target of 115 and a revised stop of 102, currently trading at 108.76.
5. Stay long INR versus TWD, opened on April 23, 2021, at 0.374 (indexed at 100), with a target of 108 and a revised stop of 103, currently trading at 104.24.
6. Stay long 5-year KRW IRS payers, opened on May 26, 2021, at 1.51%, with a revised target of 2.10% and a revised stop of 1.86%, currently trading at 1.90%.
7. Stay paid INR 5y ND-OIS, opened on August 19, 2021, at 5.16%, with a target of 5.60%, and a stop of 4.85%, currently trading at 5.53%.
8. Stay long 20y UST spreads on the 10s20s30s spread fly, opened August 20, 2021 at -23bp, with a target of -15bp, and a stop of -28bp, currently trading at -21bp.
9. Stay long 10-year OFZs, USD-unhedged, opened on August 26, 2021 at a yield level of 7.02% and with USD/RUB at 74.02, with total return indexed at 100, a target of 110 and a stop of 94, currently trading at 101.12.
10. Stay long USD 2m7y A / A+25 payer spreads, opened on September 3, 2021, at 7.3bp net premium, with a revised target of 25bp and a revised stop of 12bp, currently trading at 20.4bp.
11. Close short 2y UST-OIS spreads, opened on September 17, 2021, at -0.26bp, with a target of -4bp and a stop of 2bp, currently trading at -0.51bp, for a potential profit of 1bp.
12. Pay 5s on 2s5s10s EUR OIS fly, opened on September 24, 2021, at -14bp, with a target of 0bp and a stop of -20bp, currently trading at -14bp.
13. Stay short 10y gilts, opened on September 24, 2021, at 92bp, with a trailing stop of -5bp, currently trading at 116bp.
14. Position for wider 12-year HGBs bond-swap spreads, opened on September 30, 2021, at -15bp, with a target of 40bp, and a stop of -50bp, currently trading at -8bp.
15. Stay short AUD/MXN, opened on October 5, 2021, at 100, with a target of 106, and

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a stop of 96, currently trading at 98.69.

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