BNY MELLON

The Aerial View

Morning Briefing

Oct 21, 2020

Euro Faces Inflation Credibility Gap

- **Pandemic second wave pushing down eurozone expectations**
- **Clear divergence seen in inflation expectations versus US, despite stimulus plan**
- **Eurozone faces credibility gap on inflation and growth**

Geoff Yu
Senior EMEA Market Strategist

Email >

A resurgence in the pandemic across Europe and the prospect of new wave of social restrictions has boosted expectations of imminent easing to boost faltering growth.

The ECB appears willing to reserve judgement for now and simply keep up the rhetorical pressure on the euro, but risks to monetary policy are clearly skewed towards additional easing.

The month-end ECB decision is probably too early for a move and irrespective of the near-term growth trajectory, we would expect the December staff forecasts to remain robust: the 1.3% inflation forecast for 2022 published in the September round, subject to EUR/USD remaining at 1.18 and Brent crude remaining below $50/bbl, should be able to withstand another short-term shock.

Moreover, we contend that the front-loaded recovery package and national-level stimulus efforts will be able to limit economic scarring. In contrast, prospects for more comprehensive stimulus in the UK and US by year-end continue to fade.

As additional easing by major central banks is being factored into asset pricing, the fiscal/demand divergence should be supporting the euro's performance among the majors. However, judging by market gauges of inflation expectations, investors seem be reaching the opposite conclusion.

As the chart below shows, there has been a material pick-up in inflation expectations in the US, while its eurozone counterpart is falling again. The 5y5y forward breakeven for the US is now unchanged year-to-date, implying that markets have fully priced out any future disinflationary impact from the events of this year.

The eurozone figure is still nursing on a 20bp loss and at no point this year managed to move back to flat.

Change in 5y5y Forward Inflation Expectations, Year-to-Date

Source: Bloomberg, BNY Mellon

To be clear, absolute levels for both economies are below the 2% general central bank benchmark, so the case for stimulus stands for the Fed as well as the ECB. Yet, given that there is more on the table from Europe on an aggregate "fiscal + monetary" basis, we find the gap hard to justify.

Everything else being equal, it appears that the US enjoys the benefit of the doubt when it comes to growth policies, while no matter what the eurozone tries there is a credibility deficit on its ability to achieve growth and price targets.

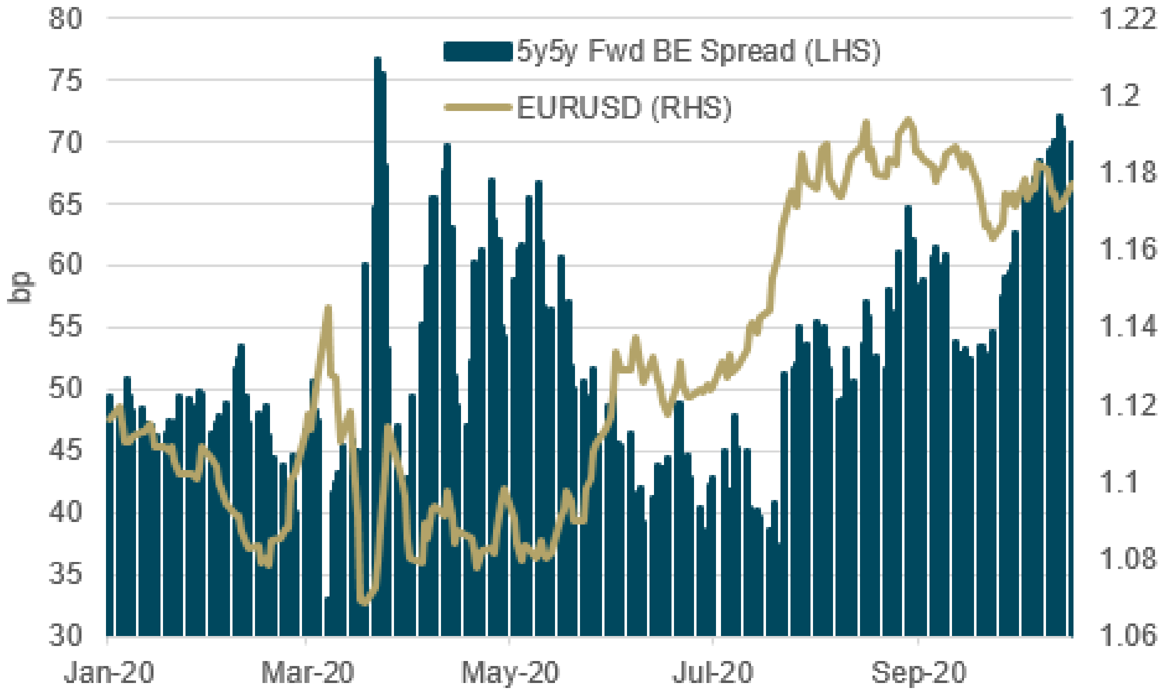
Growth and inflation disappointments throughout the eurozone's existence and genuine structural weaknesses (both in absolute and relative terms) support the view that long-term inflation expectations in the US should be higher than in the eurozone.

As the chart below shows, outright spread between the 5y5y US forward breakeven and the eurozone 5y5y inflation swap has broken through a relatively narrow range (discounting the volatility in Q2) of 40-50bps until late summer.

Again, we find this inconsistent with the fact the eurozone has agreed on a comprehensive stimulus package, while similar efforts in the US have stalled.

As of this week, eurozone debt sales hit a record EUR1.5trn, topped off with a social bond offering of EUR17bn, which was almost 14 times covered. Clearly there isn't a lack of funding for Europe's growth efforts either.

EUR/USD vs. Spread in 5y5y Forward Inflation Measures



Source: Bloomberg, BNY Mellon

> ***Clearly there isn't a lack of funding for Europe's growth efforts***

Furthermore, the divergence in favor of the US began before the recent pickup in COVID-19 cases in Europe, suggesting that markets had begun to factor in growth and inflation disappointments in the eurozone not long after the ground-breaking July EU Summit.

While the chart above does not capture the inflation expectations premium that the US enjoys in undermining the euro’s exchange rate, such longstanding doubt among investors will certainly limit asset allocation flows and further euro strength.

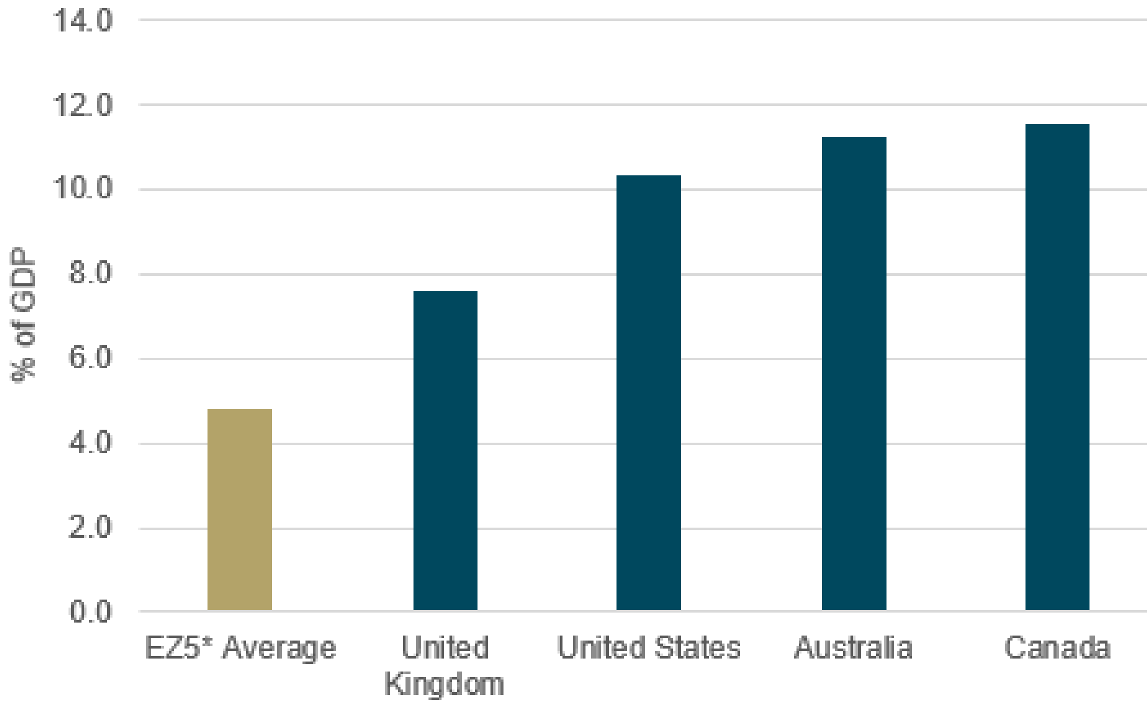
One source for the "credibility deficit" may lie in the euro itself. We have noted in the past that euro-related inflation pass-through can be a bit overblown and also ignores the positive demand affects for eurozone households arising from higher purchasing power.

On the other hand, the preponderance of ECB commentary on the matter cannot be ignored. It is almost as if a stronger euro and elevated inflation expectations simply cannot co-exist for a sustained period. We expect the impending public investment in the eurozone over the next two years to disprove this default asset allocation position, but it also means euro bulls will have to remain patient for the time being.

Finally, perhaps one valid criticism or source of caution over the eurozone’s current growth trajectory is that despite the solid future commitments, current support is actually quite weak. There are different ways of measuring fiscal stimulus, but above the line measures such as discretionary government spending have the highest growth multiplier.

As the chart below shows, such expenditures (ex-healthcare) in the five largest eurozone economies this year in response to the pandemic is running at below 5% of GDP. Removing Germany (at 7.7% of GDP), the average falls to 4.1%. In comparison, the US, Australia, Japan and Canada devoted above 10% of GDP to above the line spending.

Above the Line Discretionary Pandemic Spending (Non-Healthcare), as % of GDP



Source: IMF, BNY Mellon, EZ5 = Germany, France, Italy, Spain and the Netherlands

> *The eurozone does face a higher burden of proof for markets to reprice favorably*

It is impossible to prove the counterfactual, but the lack of stronger stimulus this year may undermine the effectiveness of getting inflation and growth back to trend next year.

However, it also means the opposite is possibly true: if a strong 2020 year of fiscal support cannot be extended into 2021, previous efforts would have been squandered. The recent spending boost in Australia (which spent 11.2% of GDP in above the line measures in 2020) for the 2020-2021 budget is precisely designed to avoid such a cliff-edge.

We still believe the market is underpricing the potential of the eurozone’s fiscal efforts in the near future. However, it seems the eurozone does face a higher burden of proof for markets to reprice favorably and it will take time for the evidence to start stacking up.

Please direct questions or comments to:

AerialView@BNYMellon.com

bnymellon.com