

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.

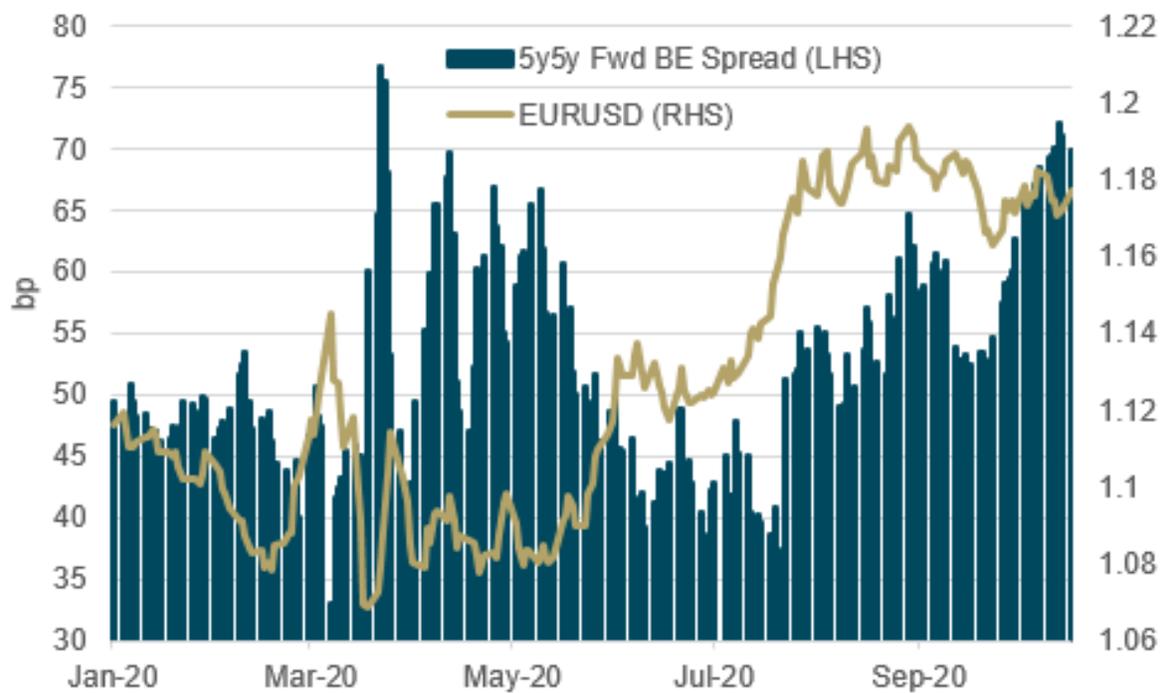
Growth and inflation disappointments throughout the eurozone's existence and genuine structural weaknesses (both in absolute and relative terms) support the view that long-term inflation expectations in the US should be higher than in the eurozone.

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.

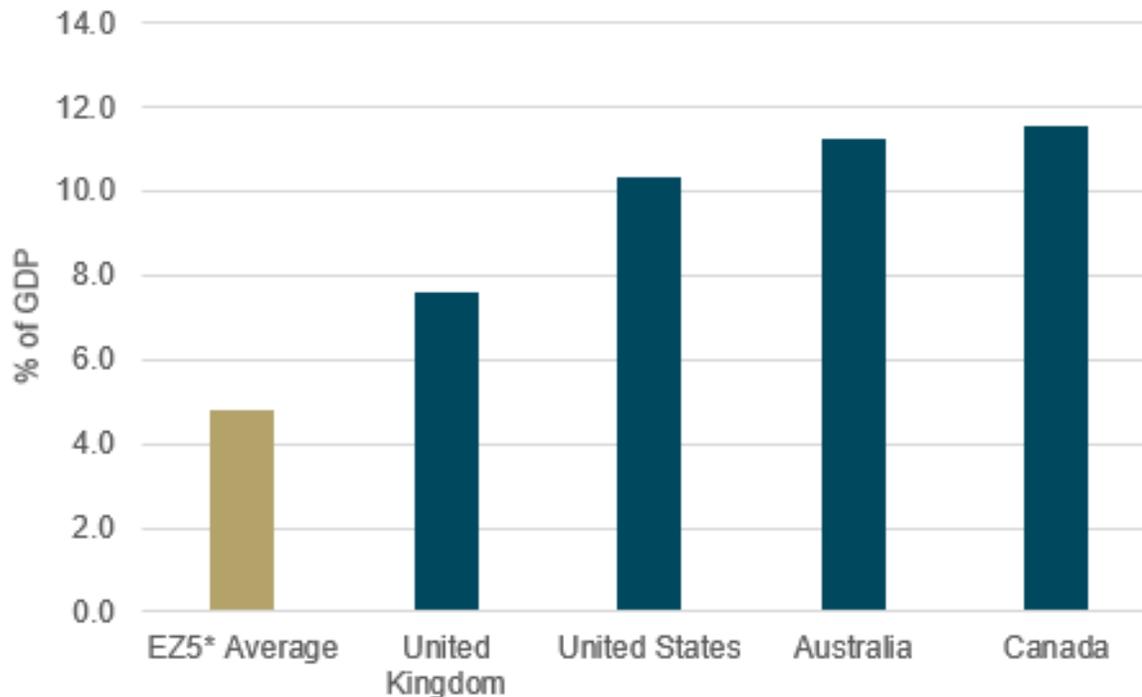
Finally, perhaps one valid criticism or source of caution over the eurozone's current growth trajectory is that despite the solid future commitments, current support is actually quite weak. There are different ways of measuring fiscal stimulus, but above the line measures such as discretionary government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

BNY Mellon is the corporate brand of The Bank of New York Mellon Corporation and may be used as a generic term to reference the corporation as a whole and/or its various subsidiaries generally. This material and any products and services may be issued or provided under various brand names in various countries by duly authorized and regulated subsidiaries, affiliates, and joint ventures of BNY Mellon, which may include any of the following. The Bank of New York Mellon, at 225 Liberty St, NY, NY USA, 10286, a banking corporation organized pursuant to the laws of the State of New York, and operating in England through its branch at One Canada Square, London E14 5AL, UK, registered in England and Wales with numbers FC005522 and BR000818. The Bank of New York Mellon is supervised and regulated by the New York State Department of Financial Services and the US Federal Reserve and authorized by the Prudential Regulation Authority. The Bank of New York Mellon, London Branch is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request. The Bank of New York Mellon SA/NV, a Belgian public limited liability company, with company number 0806.743.159, whose registered office is at 46 Rue Montoyerstraat, B-1000 Brussels, Belgium, authorized and regulated as a significant credit institution by the European Central Bank (ECB), under the prudential supervision of the National Bank of Belgium (NBB) and under the supervision of the Belgian Financial Services and Markets Authority (FSMA) for conduct of business rules, and a subsidiary of The Bank of New York Mellon. The Bank of New York Mellon SA/NV operates in England through its branch at 160 Queen Victoria Street, London EC4V 4LA, UK, registered in England and Wales with numbers FC029379 and BR014361. The Bank of New York Mellon SA/NV (London Branch) is authorized by the ECB and subject to limited regulation by the Financial Conduct Authority and the Prudential Regulation Authority. Details about the extent of our regulation by the Financial Conduct Authority and Prudential Regulation Authority are available from us on request. The Bank of New York Mellon SA/NV operating in Ireland through its branch at 4th Floor Hanover Building, Windmill Lane, Dublin 2, Ireland trading as The Bank of New York Mellon SA/NV, Dublin Branch, is authorised by the ECB and is registered with the Companies Registration Office in Ireland No. 907126 & with VAT No. IE 9578054E. The Bank of New York Mellon, Singapore Branch, subject to regulation by the Monetary Authority of Singapore. The Bank of New York Mellon, Hong Kong Branch, subject to regulation by the Hong Kong Monetary Authority and the Securities & Futures Commission of Hong Kong. If this material is distributed in Japan, it is distributed by The Bank of New York Mellon Securities Company Japan Ltd, as intermediary for The Bank of New York Mellon. If this material is distributed in, or from, the Dubai International Financial Centre ("DIFC"), it is communicated by The Bank of New York Mellon, DIFC Branch, regulated by the DFSA and located at DIFC, The Exchange Building 5 North, Level 6, Room 601, P.O. Box 506723, Dubai, UAE, on behalf of The Bank of New York Mellon, which is a wholly-owned subsidiary of The Bank of New York Mellon Corporation. This material is intended for Professional Clients only and no other person should act upon it. Not all products and services are offered in all countries.

The information contained in this material is intended for use by wholesale/professional clients or the equivalent only and is not intended for use by retail clients. If distributed in the UK, this material is a financial promotion.

This material, which may be considered advertising, is for general information purposes only and is not intended to provide legal, tax, accounting, investment, financial or other professional advice on any matter. This material does not constitute a recommendation by BNY Mellon of any kind. Use of our products and services is subject to various regulations and regulatory oversight. You should discuss this material with appropriate advisors in the context of your circumstances before acting in any manner on this material or agreeing to use any of the referenced products or services and make your own independent assessment (based on such advice) as to whether the referenced products or services are appropriate or suitable for you. This material may not be comprehensive or up to date and there is no undertaking as to the accuracy, timeliness, completeness or fitness for a particular purpose of information given. BNY Mellon will not be responsible for updating any information contained within this material and opinions and information contained herein are subject to change without notice. BNY Mellon assumes no direct or consequential liability for any errors in or reliance upon this material.

This material may not be distributed or used for the purpose of providing any referenced products or services or making any offers or solicitations in any jurisdiction or in any circumstances in which such products, services, offers or solicitations are unlawful or not authorized, or where there would be, by virtue of such distribution, new or additional registration requirements.

The terms of any products or services provided by BNY Mellon to a client, including without limitation any administrative, valuation, trade execution or other services shall be solely determined by the definitive agreement relating to such products or services. Any products or services provided by BNY Mellon shall not be deemed to have been provided as fiduciary or adviser except as expressly provided in such definitive agreement. BNY Mellon may enter into a foreign exchange transaction, derivative transaction or collateral arrangement as a counterparty to a client, and its rights as counterparty or secured party under the applicable transactional agreement or collateral arrangement shall take precedence over any obligation it may have as fiduciary or adviser or as service provider under any other agreement.

Pursuant to Title VII of The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and the applicable rules thereunder, The Bank of New York Mellon is provisionally registered as a swap dealer with the Commodity Futures Trading Commission ("CFTC") and is a swap dealer member of the National Futures Association (NFA ID 0420990).

BNY Mellon (including its broker-dealer affiliates) may have long or short positions in any currency, derivative or instrument discussed herein. BNY Mellon has included data in this material from information generally available to the public from sources believed to be reliable. Any price or other data used for illustrative purposes may not reflect actual current conditions. No representations or warranties are made, and BNY Mellon assumes no liability, as to the suitability of any products and services described herein for any particular purpose or the accuracy or completeness of any information or data contained in this material. Price and other data are subject to change at any time without notice.

Rates: neither BNY Mellon nor any other third party provider shall be liable for any errors in or delays in providing or making available the data (including rates, WM/Reuters Intra-Day Spot Rates and WM/Reuters Intra-Day Forward Rates) contained within this service or for any actions taken in reliance on the same, except to the extent that the same is directly caused by its or its employees' negligence. The WM/Reuters Intra-Day Spot Rates and WM/Reuters Intra-Day Forward Rates are provided by The World Markets Company plc ("WM") in conjunction with Reuters. WM shall not be liable for any errors in or delays in providing or making available the data contained within this service or for any actions taken in reliance on the same, except to the extent that the same is directly caused by its or its employees' negligence.

The products and services described herein may contain or include certain "forecast" statements that may reflect possible future events based on current expectations. Forecast statements are neither historical facts nor assurances of future performance. Forecast statements typically include, and are not limited to, words such as "anticipate", "believe", "estimate", "expect", "future", "intend", "likely", "may", "plan", "project", "should", "will", or other similar terminology and should NOT be relied upon as accurate indications of future performance or events. Because forecast statements relate to the future, they are subject to inherent uncertainties, risks and changes in circumstances that are difficult to predict. iFlow® is a registered trademark of The Bank of New York Mellon Corporation under the laws of the United States of America and other countries.

This document is intended for private circulation. Persons accessing, or reading, this material are required to inform themselves about and to observe any restrictions that apply to the distribution of this information in their jurisdiction.

Currency Administration is provided under and subject to the terms of a definitive agreement between BNY Mellon and the client. BNY Mellon exercises no investment discretion thereunder, but acts solely pursuant to the instructions in such agreement or otherwise provided by the client. Unless provided by definitive agreement, BNY Mellon is not an agent or fiduciary thereunder, and acts solely as principal in connection with related foreign exchange transactions.

All references to dollars are in US dollars unless specified otherwise.

This material may not be reproduced or disseminated in any form without the prior written permission of BNY Mellon. Trademarks, logos and other intellectual property marks belong to their respective owners.

The Bank of New York Mellon, member FDIC.

© 2020 The Bank of New York Mellon Corporation. All rights reserved.