KATHREIN PRIVATBANK

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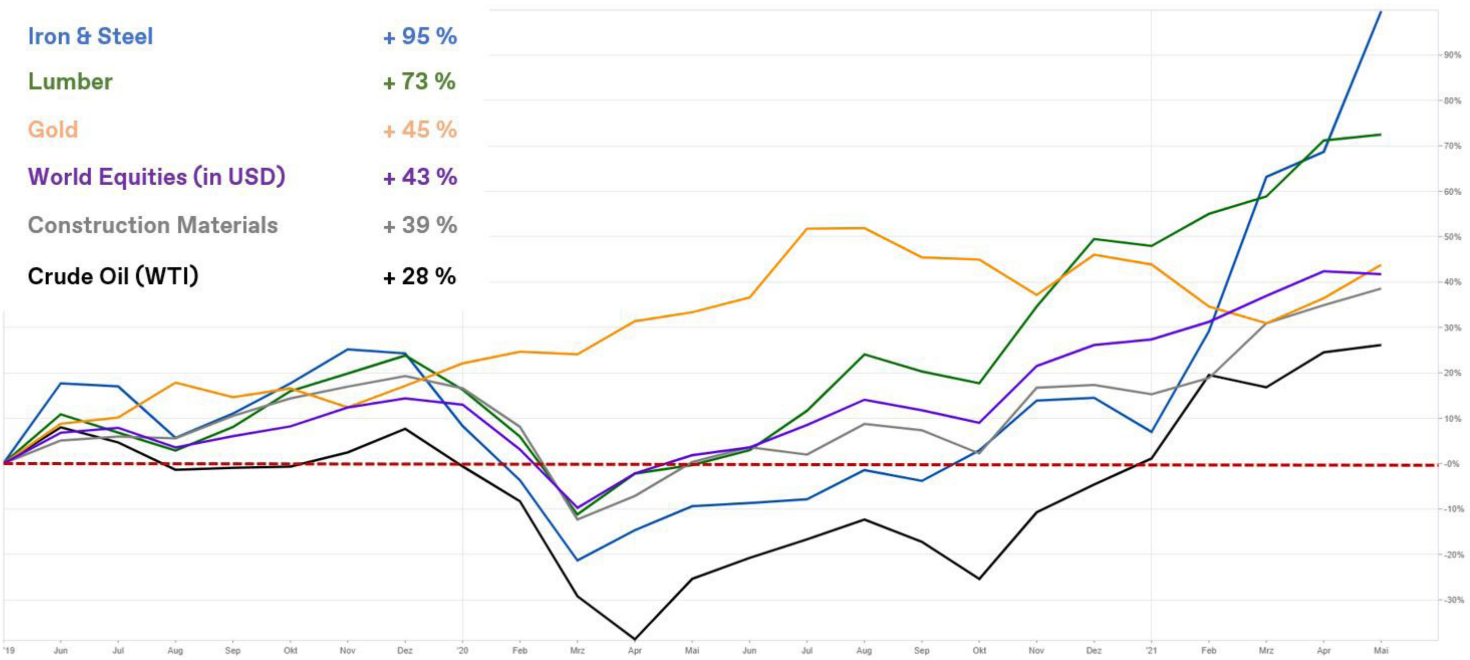
The evil I-word: an inflation update

Who dares to say, or overtly pronounce, what is causing so many investors restless nights? Inflation! It has seemingly arrived in the U.S. with full force, with the recent news of April's 4.2 % year-over-year increase causing short-term market turmoil. Europe is following suit, but at a lower level (cf. 1.6 %). Is the fear (un)justified, asset classes already „fairly" valued or do we perhaps expect interest rates again soon? We have the answers for you!

Inflation: come to stay?

On the part of the European Central Bank (ECB), the actual inflation target for the entire euro area of „below, but close to 2 percent" in the medium term remains realistic. President Christine Lagarde considers the current rise in the inflation rate to be merely temporary and points to temporary special statistical effects in the current developments, which will already be lower again next year. Low wage pressure, the output gap and the euro exchange rate are also likely to dampen inflation in the euro zone again.



Source: baha GmbH; overall performance since 01.05.2019 until 01.05.2021 retrieved on 19.05.2021

Meanwhile, the U.S. consumer price index (CPI) rose by 0.8 % on a monthly basis compared with March, marking the biggest monthly jump since 1982. While the U.S. Bureau of Statistics shows that the April figure marks an increase from March's annual inflation rate of 2.6 %, which is the highest since September 2008, we are far from a sustained level here. Why, in fact?

Base effects and real wages

On the one hand, there are the often cited base effects, which are described as the effect when high percentage increases become increasingly difficult with increasing absolute size. In other words, if the initial or base value is very small, the relative increases are much more noticeable and vice versa. One of the main reasons for rising inflation is commodity prices. The prime example of this is the price of crude oil, which has rallied considerably year-over-year after even being NEGATIVE at times last April.

This has at times more than doubled since its low last year. On a longer time frame, however, the „recovery" looks different, because the supposedly called „black gold" is still far away from the non-inflation-adjusted 90 dollar mark of the last heyday of the 2010s, today that would be around 100 USD, more than 30 % above the current price! As can be seen in the chart above, other commodities besides oil have risen tremendously, which are not always due to a weak underlying.

However, whether the current price levels will be maintained is not only a question of the monetary policy of the central banks, but also of credit growth and wage pressure. Neither of these factors currently points to sustained inflationary pressure.

But what if...?

Internationally, many record highs in commodities, including lumber, are due in part to the construction industry. After entire production plants were put on hold in the spring during the outbreak of the pandemic, supply bottlenecks occurred and prices skyrocketed. While this may be a problem for „home builders“ currently, over time capacity and production will grow in response to higher demand and prices, helping to address the imbalance.

It is the labor market, particularly for service workers, that holds the potential for inflation. Although the employment rate is still below pre-Corona levels, demand for service sector labor is recovering faster than supply, putting pressure on employers and driving up wages. Flash openings may lead to further staff shortages.

For this reason, we will be keeping a close eye on service-sector wages over the next few months, rather than dramatic but likely temporary increases in commodity prices. If we get an inflation problem sooner than expected, it will likely start in the labor market.

A portfolio for every case

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