MARKET VIEWS

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Will inflation pick up in 2021 in Europe and the United States?

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In Europe, inflation will remain below 2%

Inflation in Europe increased sharply, from -0.7% in December to +1.6% in January, mostly fueled by technical and one-off factors like the reversal of the temporary reduction of the value added tax in Germany. We do not believe that this sudden surge reflects any real tension on prices or wages. Thus, **we expect that inflation in the euro area will remain below the ECB's target - below but close to 2% inflation in 2021** as real GDP will reach the pre-crisis level most likely not before mid-2022.

In the United States, inflation will increase to 2%+

In the U.S., we expect that inflation will surpass the Federal Reserve's 2% target in 2021. The increase in inflation in the U.S. stems from **a mix of demand-pull inflation and cost-push inflation.** The U.S. Congress has approved USD 900 billion in new spending measures in December 2020. In addition, the Biden administration has proposed USD 1.9 trillion in measures including additional checks to most American households which will lead to additional spending. Strong demand growth and rising input costs will lead to higher inflation if unemployment falls from currently elevated levels and the economy absorbs the slack of the COVID-19 pandemic.

Consequences of higher inflation for financial markets

Politicians in Europe and in the U.S. have reacted quickly and decisively to the COVID-19 crisis. They have significantly increased financial spending and eased monetary policy. **We expect strong growth in Europe and – due to massive fiscal support – even stronger growth in the United States in 2021**. During the pandemic, individuals were forced to save. This money will flow back in the economy when restrictions are lifted. **We see first signs that the long period of extremely low inflation will come to an end and that inflation will increase moderately – stronger in the United States, less in Europe. A more reflationary environment often coincides with a tailwind for equity markets through stronger growth and a rebound in earnings per share**. Analysts expect that earnings per share will increase by 28% for the MSCI World in 2021.

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Our convictions, based on our core scenario

An environment of strong growth and low real rates is good for equities and particularly emerging and cyclical equities. An increase in inflation might lead to a change in leadership in equity markets if higher inflation expectations push up bond yields. In the past, growth stocks have strongly outperformed value stocks. Based on price-to-book values, growth stocks included in the MSCI World are more than 280% more expensive than value stocks – and therefore more expensive compared to value stocks than during the internet bubble in 1999. Unlike in 1999, some growth stocks such as Microsoft and Alphabet are today highly profitable, and we believe that the digital transformation will continue. But **tactically, a rotation is required in your equity positioning towards European and emerging markets through their cyclical and value bias. Moreover, investing in smaller companies allow you to seize the opportunities coming from the recovery plans as they would be the main beneficiaries.**

Higher growth rates and higher inflation rates are also positive for commodity prices. Last, we strongly believe that yield curves will steepen mainly in the United States where we expect 10-year yields to exceed 1.8% in 2022. A rise in long-term interest rates is bad for long-duration assets. Long-term bonds will most likely generate low or even negative returns in 2021. Nevertheless, such an environment is not too damaging to the credit market as long as the increase in nominal rates is limited.

The German perspective:

the risk of monetary (hyper-)inflation remains a constant concern in Germany

In Germany, the fear remains high – mainly among conservatives – that the strong growth in central bank money in the Eurozone will lead to monetary inflation. Historical experiences remain fundamental cultural influences which shape the perception of the reality. The hyperinflation between 1921 and 1923 in Germany is an important reason for the high preference for price stability in Germany. And in fact, the base money in the Eurozone has increased by the factor of more than ten since 2000 due to several non-standard monetary policy measures of the ECB such as the Asset Purchase programmes (APP) and the Pandemic Emergency Purchase programme (PEPP).

The current challenge for the ECB is to restore the influence of central banks on the process of money creation. Since 2008, The ECB had to issue a significant amount of base money as demand for money remained low to reflate the real economy in the aftermath of two large crises. The ECB also faces a communication problem and has to explain its policy to Germans who fear excessive monetary inflation - which did not occur since 2008. Recent news that the monetary aggregate M3 has increased by 12.3% in December 2020 in the Eurozone leads to concerns mainly in Germany. These worries have to be taken seriously, excessive monetary growth is a possible reason for inflation in the distant future, but not now.

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