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## **Eurozone Inflation Update: Will ECB Actions Match Its Rhetoric?**

### **Executive Summary**

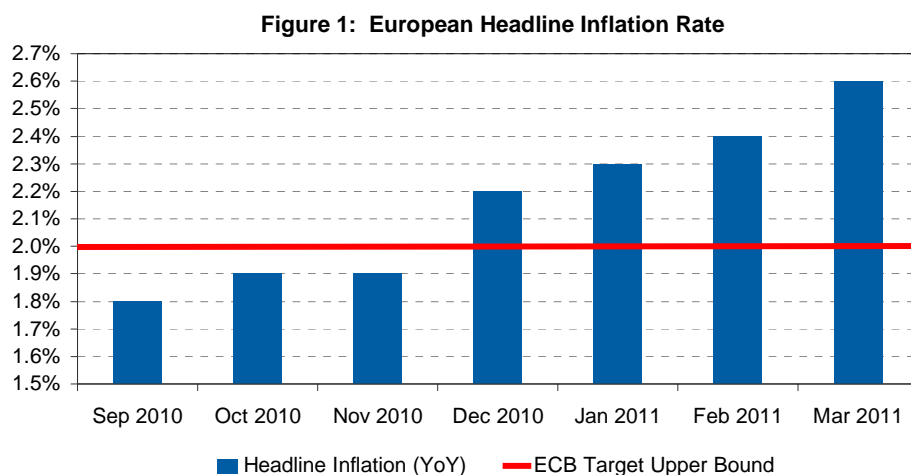
Inflation concerns are taking center stage in Europe.

- Global inflation risk has been on the rise due to increasing commodity prices and expansionary monetary policy in many of the world's largest economies.
- Since inception, the European Central Bank (ECB) has successfully continued the low inflation policy established by the German Bundesbank.
- However, the current state of Europe's various economies and financial institutions poses a unique challenge to the ECB in its quest to combat Eurozone inflationary pressures.
- Given current Eurozone inflation uncertainty, we urge investors to examine their asset allocations in light of changing inflation risks and to consider the potential effects on their overall portfolios.

This note elaborates on the challenges facing the ECB and discusses some implications for institutional investors.

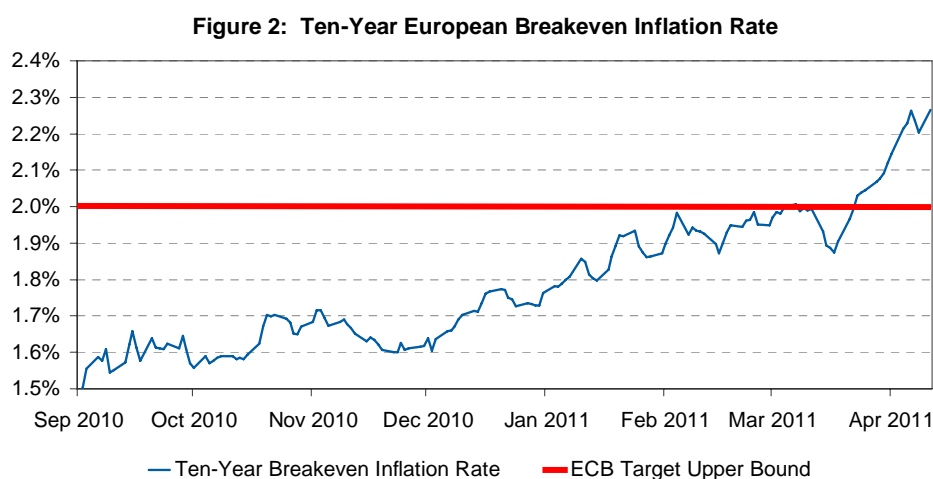
## Update on Eurozone Inflation and Markets

The 2.6% year-on-year headline inflation print in March, as announced by the European Union's statistics office on March 31<sup>st</sup>, marked the fourth consecutive month in which headline inflation printed above 2%, the upper bound of the European Central Bank's (ECB) target range (see Figure 1).<sup>1</sup>



Source: European Central Bank and AQR. Data September 30 through March 31, 2011

Higher inflation prints and the challenges faced by the ECB are beginning to affect investor behavior, both by increasing market uncertainty and by shifting expectations toward higher levels of future inflation. Breakeven inflation rates – the difference between nominal and real bond yields – are often used to infer market-implied inflation expectations over longer horizons. The ten-year European inflation breakeven rate, for instance, captures investor expectations of the average annual inflation rate over the next ten years (see Figure 2). For the Eurozone, this measure stood at 1.5% on September 1<sup>st</sup>, 2010 but has trended upward to its current value of 2.3% (as of April 11<sup>th</sup>), its highest value since September 2008<sup>2</sup>. Effectively, over the next ten years, investors require total inflation compensation (inflation expectation plus an inflation risk premium) above the upper bound of the ECB target range.



Source: Bloomberg and AQR. Data September 1 through April 11, 2011

<sup>1</sup> According to the ECB website, "The primary objective of the ECB's monetary policy is to maintain price stability. The ECB aims at inflation rates of below, but close to, 2% over the medium term." See <http://www.ecb.int/mopo/html/index.en.html>

<sup>2</sup> The European Inflation Breakeven Rate we present is the difference in yields between a 10 year French government nominal bond and a French 10 year government bond linked to Eurozone inflation.

To reassure markets, the ECB has taken an increasingly hawkish tone, affirming that its foremost obligation is to maintain price stability, regardless of whether economic conditions remain depressed across much of the Eurozone. The ECB acted by increasing its benchmark policy rate by 25 basis points on April 7<sup>th</sup>, a move that was largely anticipated by the market. Further hikes may follow: overnight interbank swap markets are currently pricing in two additional 25 basis point rate hikes by the end of 2011.

## Challenges

While the ECB has traditionally been diligent in guiding monetary policy to achieve its inflation objective, it faces three major implementation challenges:

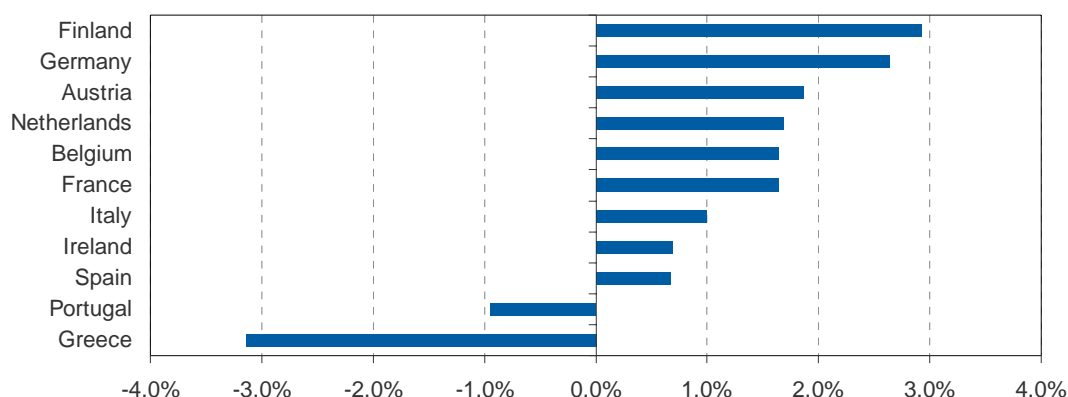
- 1) Economic divergence among Eurozone countries
- 2) Persistent fiscal imbalances in peripheral Europe
- 3) A vulnerable private banking sector

We discuss these issues in turn and highlight key questions investors should consider. Each raises important concerns about the ECB's willingness to pursue a monetary policy contractionary enough to keep investor inflation expectations within the ECB target range. Collectively, these issues will likely complicate the ECB's decision-making in the near term. To the extent the ECB is not able to pursue as contractionary a policy as it otherwise would, the Eurozone may be unusually vulnerable to inflation in the months ahead.

### *Economic Divergence*

There is a considerable degree of heterogeneity in economic conditions across Europe. Figure 3 displays forecasted 2011 GDP growth rates for Eurozone countries provided by Consensus Economics. Germany is expected to grow over twice as fast as the Eurozone average in 2011. Meanwhile, real GDP growth in Portugal, Ireland, Greece, and Spain is forecasted to be anemic as these countries implement austerity measures. This divergent growth outlook seriously complicates the ECB policy picture. Any policy tightening will constrict economic conditions across all of Europe and may cast peripheral countries further into recession. Therefore, a key question for investors remains: *How willing is the ECB to significantly tighten monetary conditions while peripheral economies are experiencing economic stagnation and high unemployment?*

Figure 3: 2011 Consensus Mean GDP Growth Forecast

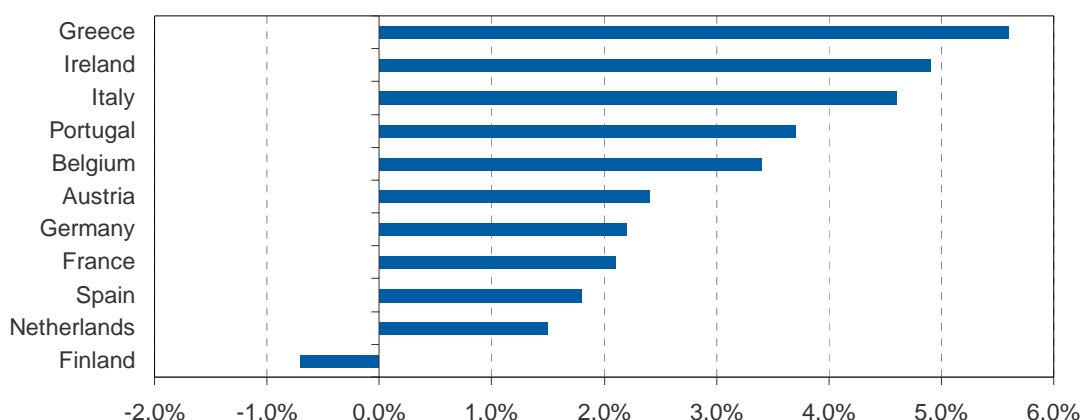


Source: Consensus Economics Inc. and AQR. Data as of March 31, 2011

### *Fiscal Imbalances*

In the most recent example of fiscal stress, Portugal announced on April 6<sup>th</sup> that it would seek a European bailout, following in the footsteps of Greece and Ireland. However, the stress will likely increase if inflation pressures lead to further ECB rate hikes. Higher short-term interest rates will have an adverse impact on fiscal expenditures and revenues of peripheral countries that are already facing elevated borrowing costs and rating agency downgrades of sovereign debt. On the expenditure side, higher interest rates will increase the cost of re-financing sovereign debt as previous issuance matures. As can be seen in Figure 4, current levels of interest payments as a percent of GDP are very high for countries experiencing the lowest growth rates. On the revenue side, higher interest rates tend to reduce aggregate demand, which results in lower GDP growth and a decline in tax receipts. Both outcomes reduce the effectiveness of fiscal austerity measures initiated by peripheral countries in the attempt to cut budget deficits. The ECB is likely aware that a meaningful increase in interest rates risks reigniting the European fiscal crisis. Therefore, a key question for investors remains: *How willing is the ECB to significantly tighten monetary conditions when such a policy risks sparking renewed sovereign debt concerns?*

**Figure 4: 2011 Net Debt Interest Payments  
(as a Percentage of GDP)**



Source: OECD and AQR. Data as of March 31, 2011

### *The Banking Sector*

Contractionary monetary policy has the potential to put further pressure on the European banking sector. According to the latest data from the Bank for International Settlements, European banks hold in excess of \$1.2 trillion in debt from Greece, Ireland, Portugal, and Spain.<sup>3</sup> Higher short-term interest rates elevate the risk of banks' debt holdings, particularly from peripheral countries. These countries will be forced to re-finance maturing debt at higher yields, increasing the probability of potential defaults or restructuring. In addition, if higher short-term interest rates cause the yield curve to flatten, banks would see a decline in profitability of their traditional lending activity. Both of these outcomes would be unwelcome developments in an already strained banking sector. Therefore, a key question for investors remains: *How willing is the ECB to significantly tighten monetary conditions when such a policy risks putting additional strain on a vulnerable banking sector and raises the possibility of a credit crisis?*

<sup>3</sup> As of September 2010. See [http://www.bis.org/publ/qtrpdf/r\\_qa1103.pdf#page=88](http://www.bis.org/publ/qtrpdf/r_qa1103.pdf#page=88).

## Conclusion and Implications for Investors

A meaningful interest rate hiking cycle to offset inflationary pressures may have a significant negative impact on peripheral countries already facing increasing debt burdens coupled with stagnating economies. Should the ECB remain vigilant in its quest to moderate Eurozone inflation and market expectations, inflation rates may remain near the 2% target. However, a rigid price stability policy is not without costs. It may put at risk the economic recovery of several Eurozone peripheral countries, an outcome the ECB would undoubtedly prefer to avoid. While it is evident there are Eurozone inflationary pressures, it is plausible that in the current environment the ECB may take a more accommodative stance than it otherwise would. Therefore, the Eurozone may be more vulnerable to realizing higher inflation rates than in recent years. This view is consistent with market indicators that reflect an increasing risk of higher inflation.

While the Eurozone inflation outlook remains uncertain, it is important to note that traditional institutional portfolios resemble a bet on low and stable inflation, since they tend to fare poorly in inflationary periods on a relative basis. We have discussed this extensively in prior research (*please contact us for a copy*). Given the current Eurozone inflation uncertainty, we urge investors to examine their asset allocations in light of changing inflation risks and to consider the potential effects on their overall portfolios. A greater allocation to strategies that are poised to perform well in an inflationary environment may be warranted as part of a long-term strategic plan.

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