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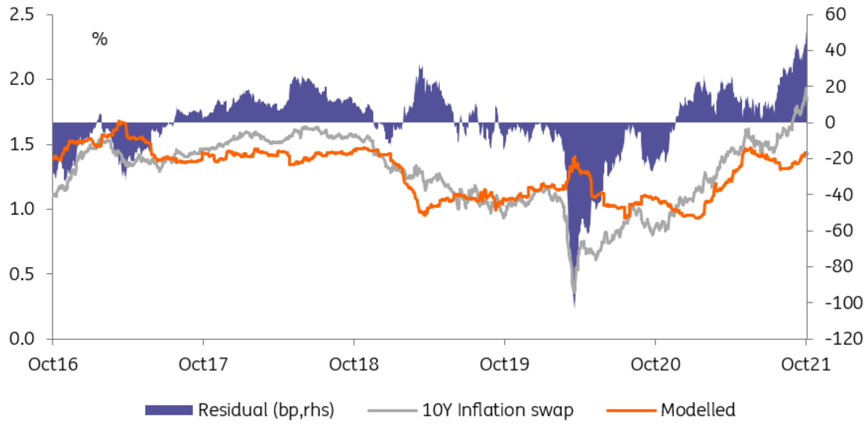
The inflation scare in financial markets is here to stay

Inflation risk is on every investor's mind. It extends beyond the effect of higher CPI prints into a rise in long-term inflation swaps and bonds. We conclude that the inflation scare is here to stay, and that higher market inflation expectations are becoming entrenched.

What drives long-term inflation swaps and bonds

Inflation swaps and inflation-linked bonds strike us as the most reliable instruments to hedge inflation risk, and thus to conduct an analysis of how financial markets see this risk. In effect, they guarantee their users cash flows directly linked to a price index, for a pre-determined period of time. As such, the inflation swap rate, or bond break even inflation, can be taken as the market's view on the average annual inflation rates over the life of the swap, or the bond.

Even correcting for inflation surprises and volatility, we find inflation expectations are at a record high



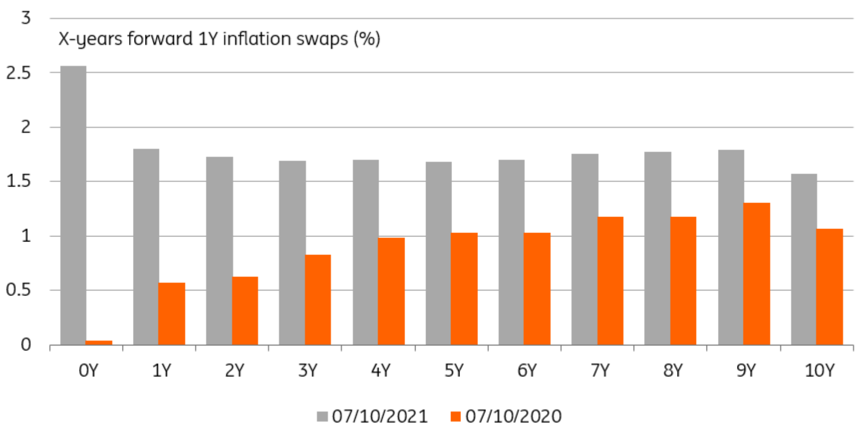
Source: Refinitiv, ING

Like any prediction of the future, they tend to be partially influenced by the present however. One way to isolate long-term inflation expectations from 10Y EUR inflation swaps (grey line on the chart above) is to remove the influence of current inflation surprise, and of market volatility (orange line). Our conclusion is that, even adjusting for these two effects that aren't related to long-term developments, inflation expectations (blue area) are indeed at a record high. This being said, whether near- or long-term, all factors are important in how financial markets will trade in the coming weeks and months.

Inflation to stay in the headlines

The first port of call in our view is with current price dynamics. The surge in energy prices over recent weeks has markets rightly concerned about the read-across to broader inflation. This surge is going to feed into inflation indices with a lag, in some cases, still impacting them well into the spring of next year. This comes on top of base effects that will, for instance, keep headline inflation rates well above the ECB's target this year, according to our economics team. These factors contributed to the rise in short-dated inflation swaps and bond break-evens.

It isn't just short-term inflation expectations that have risen



Source: Refinitiv, ING

They should also ensure that higher inflation remain in the headlines for months to come. What's interesting is that the prospect of higher inflation in the near-term is starting to feed into long-term inflation swap and bonds. This can be seen in the chart above showing the annual eurozone HICP inflation rate for each of the next 10 years implied by inflation swaps. The upshot is that while short-term inflation prospects have seen the largest adjustment since last year, long-term expectations have also moved higher.

In theory, near term inflation could propagate to long term through a number of channels. The most widely discussed is higher wages. It is possible that developed economies enter a phase of structurally higher wages but we do not see markets doubting central banks' ability to curtail demand with tighter monetary policy should wages take off.

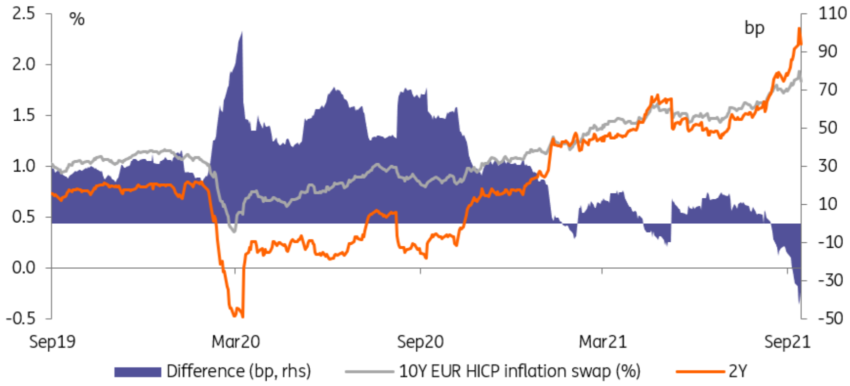
> *We do not see markets doubting central banks' ability to curtail demand with tighter monetary policy should wages take off*

Another oft-cited factor that could push inflation up over the long-term is a permanent change in the structure of the supply chain. According to this view, producers would accept, and be able to pass on, higher production costs to consumers in exchange for safer and more simpler supply chains, for instance by re-shoring factories. Another factor used to explain higher inflation in the long-term is the cost of the energy transition. Whilst this is a possibility, a long-term trend like this is notoriously difficult to assess, and beyond the scope of this publication.

Towards a re-steepening of the inflation curve

As highlighted above, the reliability of inflation swaps and bonds as hedges will ensure that they remain popular through the current phase of the inflation scare. Even when the stress on the energy markets fade, worries about the long-term structure of inflation will remain for some time, at least until central banks take decisive steps to tighten monetary policy. But not all factors explaining higher inflation swaps rates are controlled by the central bank. The risk is that high inflation expectations persist even as tightening cycles begin. A hint of that is visible in the continued rise in inflation swaps even as central bank tightening approaches.

2Y inflation swaps will retrace, but longer ones won't necessarily



Source: Refinitiv, ING

The next phase of the inflation scare may well see a steepening of the inflation curve, where long-term inflation rates climb above near term ones. This should also coincide with a re-steepening of nominal interest curves as durably higher inflation dynamics would restore market confidence in central banks' ability to raise rates at least as high as in the previous cycle. The recent loss of confidence is nowhere near as visible as in the USD, but the UK yields curve flattening in recent months is a symptom of the same doubts.

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