Inflation: rising yields attract “BOT people” but pose a risk to public debt

by Raffaele Ricciardi

US rates on the rise, thanks to a combination of vaccine confidence and an economic upturn driven by generous injections of public funds. Repercussions on European sovereign rates, with small investors seeking safe returns. The experts: “Not the way to create extra wealth”

MILAN - Inflation is the awkward guest in the trading rooms and the main character in the investment banks’ reports. The prospect of a price recovery has already pushed US government bond yields to their highest levels since February 2020 and has made its effects felt in the euro zone as well. This reading “shows how much more sensitive the US is than Europe”, argues Riccardo Ambrosetti, founder and chair of Ambrosetti AM SIM. “The health crisis affects everything, It is now assumed that there will be a quicker and more effective resolution than was expected a few weeks ago. Governments meanwhile, continue to inject huge amounts of money into the economy, which could lead to the strong recovery of consumption. The States are finally first on the market, with great spending power. If all these factors were to be confirmed, prices should go up”.

The inflation hump

As a result, there are many “ifs” hanging over the real outlook for price growth. Even in the euro zone, the January inflation reading raised eyebrows with 0.9% annual growth, up from the -0.3% of the previous month. Marco Valli of Unicredit warns that there is a triple optical effect to keep in mind: acceleration in Germany due to the end of the VAT reduction effect (VAT was cut as an anti-pandemic measure), a renewal of the “basket of goods” used to define the price index, and a delay in winter sales, especially for clothes. This is why the bank sees no need for remedial action. The central banks would abruptly review their market support strategy.

Antonio Cesarano, chief global strategist at Intermonte SIM, expects a hump-shaped prices trend. “We will see a sharp rise for a few months due to the re-opening of economies and fuelled also by the effect of comparisons with prices of a year ago, when oil plummeted. Unlike the upturn of last summer, this time the vaccines are what's underpinning the outlook for a return to normal consumption and this means that market interest rates will rise”.

The availability of market liquidity also bolsters the reflation outlook. On the other hand, the Fed has seen its budget go “from 19 to 35% of GDP—sixteen GDP points printed in just a few months—much more than in 2008 when it stopped at nine,” notes Francesco Castelli, bond manager of Banor Capital. He further adds, “Economic thinking says that excess money supply combined with high government spending makes an explosive cocktail that produces hyperinflation in the long run”.

The return of treasury bond yields

Although alternative theories explaining this chain of cause and effect have recently gained ground, it is a fact that government bond yields are on the rise again. It is also happening to BTPs. At the end of Thursday's session, 10-year yields were back at 0.8%, just a few sessions on from historic lows of just over 0.4%. So, why does an inflationary scenario drive up government bond yields? Ambrosetti explains: “Bond issues reward the risk taken on by the investor who subscribes to them. When the debtor has total credibility, as in the case of the United States, the first parameter in the formation of the yield is the defence of purchasing power. That's why inflation expectations are the basis for calculating the rates for new issues”. Basically, when investors lend money to the government, they want at least to be sure of protecting it from the run on prices once it is repaid.

This scenario opens up new possibilities for investors, particularly in Italy, where treasury bonds are highly favoured. “If inflation expectations strengthen, subsequent government bond issues will have a higher rate”, says Ambrosetti, “and what we’ll see emerging is a dream for BOT people with cash to invest: opportunities to find better rates. But it may be no more than a psychological effect, because if inflation really does rise, they won't have created any extra financial wealth. People with existing securities, especially those with medium and long-term maturities, will find that the rates secured up to now will not be competitive, and the result will be a loss in capital value”.

Cesarano notes that in recent sessions nominal rates have risen above the inflation outlook and therefore real interest rates have also gone up. On the other hand, if the inflation upturn gathers pace, adds Castelli, “the situation would be disastrous for government securities, especially in Europe. European investors, unfortunately, will continue to struggle because German bond rates are in the negative. Italy, even with its credit risk, offers a little more, but our 10-year yield doesn’t even reach 1%. After fees and taxes, it doesn’t even cover inflation”.

Repercussions on the stock market

Equities may also be drawn into the unfolding spectacle. Castelli sums it up thus, “Every rise in ten-year rates makes bonds more attractive and equities less so. The ideal situation for equities would be a gradual but slow rise, which would placate investors. This is why central banks continue to be very cautious and are seeking to reassure investors that they don’t want to “break up the party”. For this reason, a rise in official rates remains a very far off threat, one to be discussed years down the line and not in 2021”.

In Cesarano’s view, “this phase will benefit certain equities, namely those related to banks, raw materials and the travel & leisure sector. It will be a tortuous path, and there will be volatility. The central banks will have a tricky job keeping balance. Investors will have to take a progressive approach, as they would in an accumulation plan, by aiming at the sectors most helped by government tax policies—digitalisation, green, and hydrogen—in the medium and long term, as well as the small US companies that stand to gain most from the second Biden infrastructure plan”.

Treasury savings to fade unless debt falls

The Treasury is, however, most likely to break up the party, since it will pay more to issue government bonds. This happened today, when the auction of 5-year BTPs ended with interest rates rising to their highest since October. “When the dust has settled, we’ll be left with a negative outlook, because of the higher cost of debt”, says Ambroseti, “but Italy currently pays a premium compared to competitor countries such as Spain or France, not to mention Germany. Draghi may have mitigated the risk from the government’s unreliability, but the debt burden of 160% of GDP remains. Only decisive action on this issue would lead foreign investors to reconsider Italy. The spread could fall by 90-100 points down to 20 and balance out the high interest rates created by inflation”.