Trading European Inflation Expectations

The saying, "All roads lead to Rome" allows for people like Silvio Berlusconi to be seen hiking in the other direction. Just remember, if you are having half as much fun as Silvio, he is having twice as much fun as you.

European fixed-income markets are worried all roads to inflation. This is a time-dishonored way of governments to repudiate debts. Another time-dishonored way, tried here in the U.S. with varying degrees of what we might have to call success, as if the completion of a fraud against creditors was an actual accomplishment, is currency debasement. However, you need to be a reserve currency, which is a polite way of saying when you plop the stuff on the lunch trays, they have to eat it. Turn the clock back five or six years and a number of less-informed commentators were palavering the euro was on its way to joining the dollar as a reserve currency.

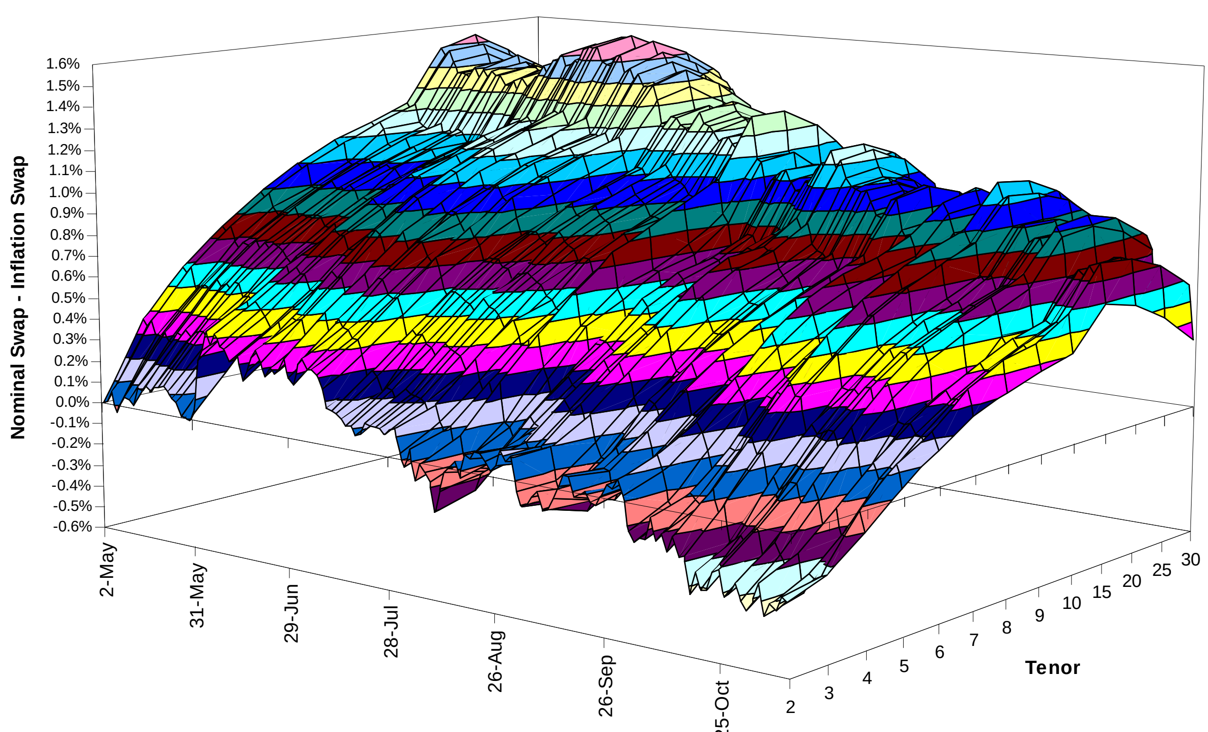
To paraphrase Inspector Clousseau: Not anymore!

Breakeven And Inflation Swaps

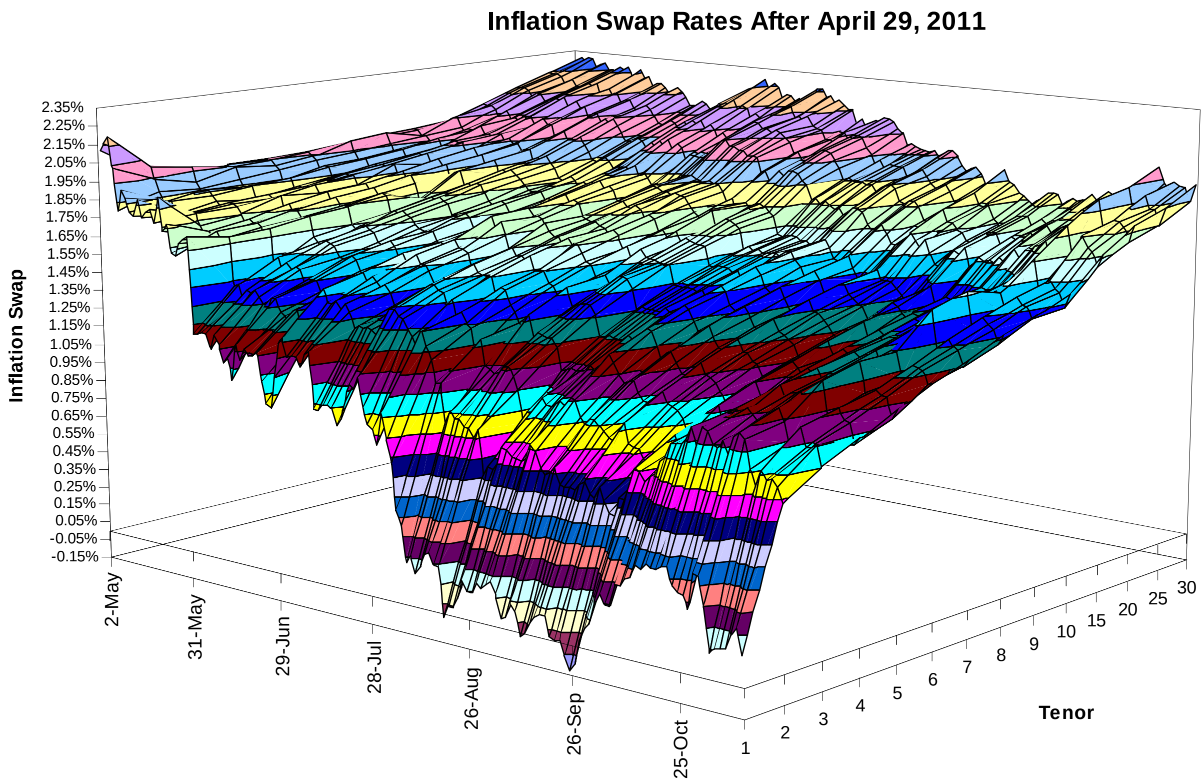
Let's take a look at two different instruments, breakeven swaps and inflation swaps. An inflation swap is based on a reported rate of consumer inflation; the breakeven swap is the difference between a plain-vanilla interest rate swap and an inflation swap.

Breakeven swaps, as I noted in How the Fed Has Distorted the Nature of the TIPS Market, often are distorted by the regular interest rate market, whether it is Treasuries in the case of American TIPS or Euribor-based swaps in this instance. Even with this admonition in mind, breakevens have a tendency to drive lower during times of financial crisis or recession; this is why we had negative TIPS breakevens during December 2008, for example. Breakevens also fall when the commercial banking system becomes dysfunctional and fails to convert money into credit, as I discussed in Commercial Lending Is on the Rise, Money Supply Is Up. It really should not surprise us to see how breakeven swap levels have declined across tenors since the start of May.

Swap Breakeven Rates Of Inflation Since April 29, 2011



The picture is different for inflation swaps. Here the short-dated tenors fell during the August crisis and have crept back higher only slowly, but the long-dated tenors show no such ambivalence: They are starting to rise. This suggests long-term bond investors in the Eurozone are pricing in higher inflation risks. I should note these swaps are based on Euribor rates and as the credit quality of the European banking system remains challenged, the risk premium for Euribor rises. This steepens the European yield curve bearishly and looks much like rising inflation expectations.



Now here is the key question: Under what circumstances should you as an investor welcome higher inflation in Europe and the repudiation of debt thereby? While some may argue inflation is easier to cope with than a financial crisis, I will counter it is a coward's way out and a regressive tax to boot. The principle remains: The money was lost by misallocating resources during the good times; all we are doing now is accounting for the losses over time and demography.

If all roads lead to inflation, some will lead over the side of a cliff.