Euro Inflation Swaps Maturity-Dependent

One of the great truisms of public policy is governments and central banks do not do a very good job of things they should not be doing in the first place. Let's take the whole question of inflation targeting. The assumption, and it is no more than an assumption based on a small sample of observations across a small number of advanced economies over the postwar era, is birds do a better job of singing and flowers do a better job of blooming if inflation comes in around 2%.

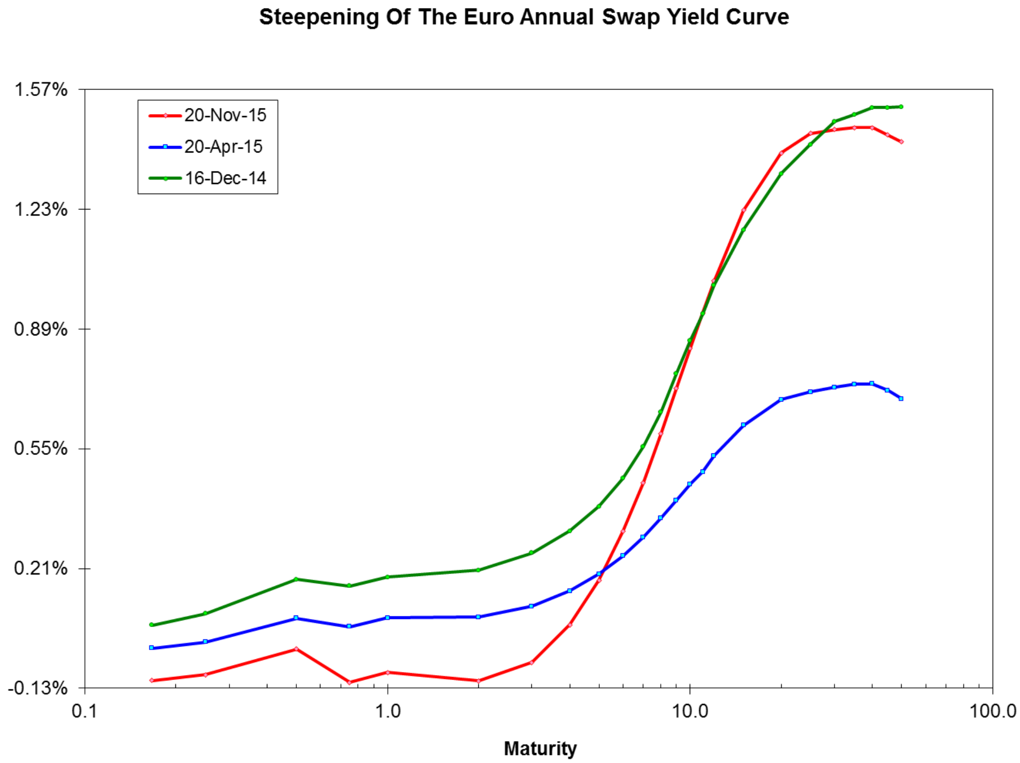
Do you remember voting to have the dollars in your pocket debauched at a 2% annual clip? Do you remember Congress enshrining such as goal in various laws and statutes? No, you did not for the very simple reason neither ever happened.

Now let's pose a simple thought-experiment: In an economy with cheap capital, high debt ratios, aging demographics and accelerating production efficiencies should the natural price level rise or fall? This is not really a trick question; if goods and services can be produced at ever-lower cost and have to compete for consumers' budgets, the natural price level should fall.

Now let's pose a final question: Have central banks shown they can control or even deflect either inflationary or deflationary trends? It took more than a decade of rising inflation in the 1970s for the political will to crush inflation via absurdly high interest rates and Japan has been trying to combat deflationary pressures for the entirety of the 21st Century. Still, Mario Draghi believes he can and indeed should arrest declining price trends in the Eurozone by creating negative borrowing costs for governments as if this was an achievable or laudable goal. His efforts to-date have failed.

The Eurozone Experience

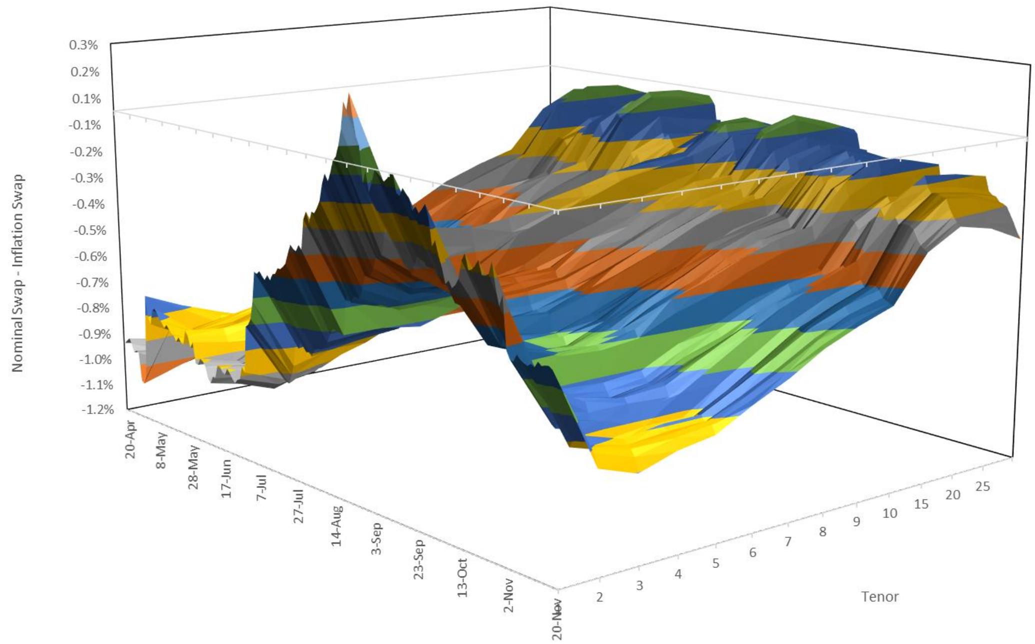
Direct European Central Bank QE became a virtual certainty in mid-December 2014. The initial response was a strong bullish flattening of the annual swap curve; this was rejected strongly in late April/early May. While the long end of the annual swap yield curve has returned to December 2014 levels following last week's ECB press conference, the short end continues to plumb new lows and is negative out to three years.



Now let's inject a little financial algebra. The nominal swap yields depicted above less swap breakeven rates of inflation produce inflation swap rates. The continued push lower in short-dated nominal swap rates has been exceeded by even stronger declines in swap breakeven rates. This has led to a rise in inflation swap rates at the short end of the yield curve since the end of the global equity selloff in August. Inflation swap rates of seven years' tenor and longer have not increased as much.

Restated, the ECB has not been able to destroy the purchasing power of the euro despite its efforts to do so. I will leave it to the good people of the Eurozone to decide whether this is a good or bad thing, but with one small observation. It is generally easier to destroy things than to create them. An organization incapable of doing bad things while cloaking itself with good intentions probably is incapable of doing good things under any circumstances.

Swap Breakeven Rates Of Inflation After Apr. 20, 2015



Inflation Swap Rates After Apr. 20, 2015