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Inflation is breaking out everywhere, but it may not be the rewarding strategy to go for reflation trades during H1 2017

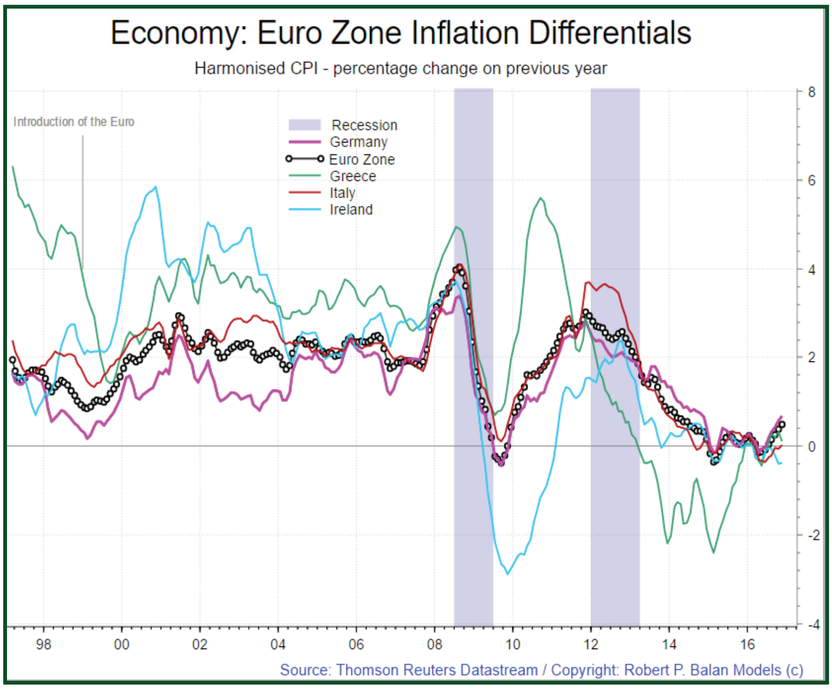
The latest inflation data from the Eurozone indicate a substantial jump in inflation in Europe's largest economy in December, eliciting calls, especially from Germany, that the European Central Bank president Mario Draghi end his ultra-loose monetary policy and raise the ECB's policy rate. Draghi once more faces the wrath of Germans fearful that savers face devastation due to zero or even negative interest rates, and fretting that the supposed "guardian of price stability" will let them down. This reaction is natural in Germany, where people have been conditioned to fear inflation. But the situation is complicated by the fact that the ECB sets monetary policy not only for Germany, but for the whole euro area.

On a eurozone-wide view, the numbers are more benign -- CPI growth in the currency bloc is at 1.1 percent in December, almost twice as fast as the previous month but still well below the goal of just under 2 percent. The ECB predicts euro-area inflation won't reach that target until at least 2019. ECB policymaking in the past several years has been conditioned by the slow economic growth in the eurozone and the actual fear of deflation, driving the central bank to adopt radical measures, like negative interest rates, in efforts to underpin growth. The ECB's drive towards zero and even negative rates has been the biggest single factor that has kept the EUR lower against the US Dollar over the past several quarters.

However, the first inflation data in the new year brings a reminder of just how strong the German economy has become during this time. The number of jobless fell more than forecast in December; the unemployment rate remains at a low of 6 percent, and inflation (boosted by higher energy, food and goods costs) increased a record 1.7 percent from 0.7 percent (see graph below).

The reaction to the data was immediate and predictable -- Clemens Fuest, president of the respected Munich-based Ifo research institute, called on the ECB to consider ending its bond-buying the program in March, which the ECB Governing Council decided just last month to extend until at least the end of 2017. Germans have always been leery of the ECB's bond buying program, and the low interest rate regime that comes with it. Bild, Germany's most-read newspaper, in an opinion piece wrote that people "are seeing a net devaluation of their savings while governments in euro countries can continue borrowing at historically low costs," in a regime of rising inflation while deposit accounts' interest rates are at near zero. The Handelsblatt newspaper reported that Germans could lose tens of billions of euros a year on the real value of their savings under those conditions, which Bavarian Finance Minister Markus Soeder told the paper would be "devastating."

The reality is that with energy costs rising quickly in the past few months, the strong disinflationary pulse that the globe had seen in 2015 and during the early part of 2016 is all but neutralized. The deflation meme, as we stated before, is dead. Inflationary expectations have jumped up in Europe, and along with rising inflationary



expectations in the United States, the picture emerging is one where inflation may become an issue again for investors and central banks across the globe in the near future. So far, we see that rising inflation in the US is being driven by the rapid rise in energy costs in the past four quarters of 2016.

But we also see some indications of lower energy pricesduring the early parts of H1 2017, as energy prices moderate somewhat. This may be illustrated with the comovements of gold, crude oil and Headline CPI as illustrated on the graph 2 on this page. Gold has the tendency to lead crude oil prices by almost two months, and oil prices lead the CPI by about a month. The weakness in gold prices in the past few weeks (among other things, including the oil term structure) is signaling lower oil prices, and therefore lower Headline CPI during Q1 2017 or even in Q2 .

Most economic and asset price projections for the first half of 2017 do not include this kind of picture for energy prices (see graph3), and therefore for inflationary expectations and actual inflation, making assumptions that US President-elect Donald Trump's fiscal initiatives will carry on lighting up reflation trades, with devastating implications of sharply rising interest rates. The kind of interest rate displacement pundits are talking about, if it comes to pass, may just spell the end of the bond bull market.

However, we have issues with the timing element of those assumptions. Let's just say that Mr. Trump will become president by January 20, 2017 but those initiatives will definitely take some time before we arrive at the get-go moment. In the meantime, interest rates will likely continue to be impacted by the evolution of energy prices, which determine the path of Headline CPI, which in turn, significantly influences the trajectory of interest rates.