ERSTE Group

Greatest risk of rising inflation from commodity prices

12.05.2011

Now is the time to cushion rising interest rates

- Inflation in the euro zone in April 2011: 2.8%
- Key lending rate forecast for end of 2011: 1.75%
- Interest rate hedging: Review your portfolio now

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Inflation to stay high
Although upwards pressure on food and crude oil prices has eased a bit in the past few days, monthly inflation rates of almost 3% are expected in the near future. What needs to be monitored is if it will be possible to pass on the latest price increases also within the country and if higher wage demands will trigger second round effects (wage-price spiral). If this latter trend were to emerge, the ECB would take firm countermeasures. Medium-term inflationary expectations are a decisive parameter for monetary policy, because an environment of price stability is supportive of economic growth and job creation. "If one eliminates food and energy prices from the current inflation rate, we arrive at a core inflation rate of around 1.3% now," explained Gudrun Egger, Head of Major Markets & Credit Research at Erste Group. Inflation is expected to settle at around 2% again only around year-end, because of basis effects on commodity prices.

Three reasons for risk of rising inflation
1. The risk of rising inflation results over the medium-term, for example, from energy prices rising more steeply than assumed due to continued political upheavals in North Africa and the Middle East.

2. Sustained high growth in emerging markets such as China or India could cause a demand-driven rise in commodity prices.

3. Upwards risks may also result also from sustained consolidation pressure on public budgets (value added tax hikes) or from a stronger economic recovery in the euro zone.

"However, the European Central Bank would step in and pull the emergency breaks in time should inflationary risks heighten," explained Egger. The development of commodity prices over the coming weeks and months will be decisive for the timing of the next interest rate hike. Erste Group analysts expect further interest rate hikes by 25 basis points each in the third and fourth quarters. Erste Group analysts expect only few interest rate moves in 2012 as well based on the emerging basis effects in commodity prices and moderate GDP growth. The ECB might even take a break after interest rates reach a slightly less expansive level. Over the medium term, the unemployment rate should decline only gradually and for this reason interest rate hikes are probable only every four months.

Protection against rising interest rates
Variable interest bonds are ideal investment products in rising bond markets. Variable interest rates permit investors to profit from higher interest rates, and at the same time, protect themselves from the full impact of negative price effects. The product, Erste Group Frühlings-Floater II (AT000B005897) pays a minimum interest rate of 3.125% with a 6-year maturity. When the 3-month Euribor (an important short-term interest rate indicator) rises over this level, the higher value is paid out, but as a maximum 6%.

Borrowers should also protect themselves against rising interest rates. Borrowers with variable-interest rate loans have to expect higher repayments. With an interest rate cap, borrowers can put a maximum limit on interest rates. This enables borrowers to avoid the disadvantages of rising interest rates above the limit. An interest rate cap warrant with a maximum interest rate protection limit of, for example, 3% delivers quarterly compensation payments when the 3-month Euribor rises over 3%. This neutralizes any further interest rate hikes for debtors. Erste Bank offers a large number of different interest rate caps. The maturity range is from five to approx. 25 years. The interest rate cap can be selected from 2.5% to 4.5%.

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“As interest rates will now start to rise successively, I can only recommend: Analyze your portfolio or financing now, and if necessary, optimize,” said Thomas Schaufler, Head of Retail Sales Austria Erste Group. Yields are currently oriented heavily on interest rate expectations. Yields may be expected to rise ahead of interest rate hikes, especially at the short end. “The two interest rate hikes will lead to slightly higher yields in all maturity ranges this year. On a one-year horizon, we expect the reaction to be heftier in the two-year maturity range than in the ten-year segment.“

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