



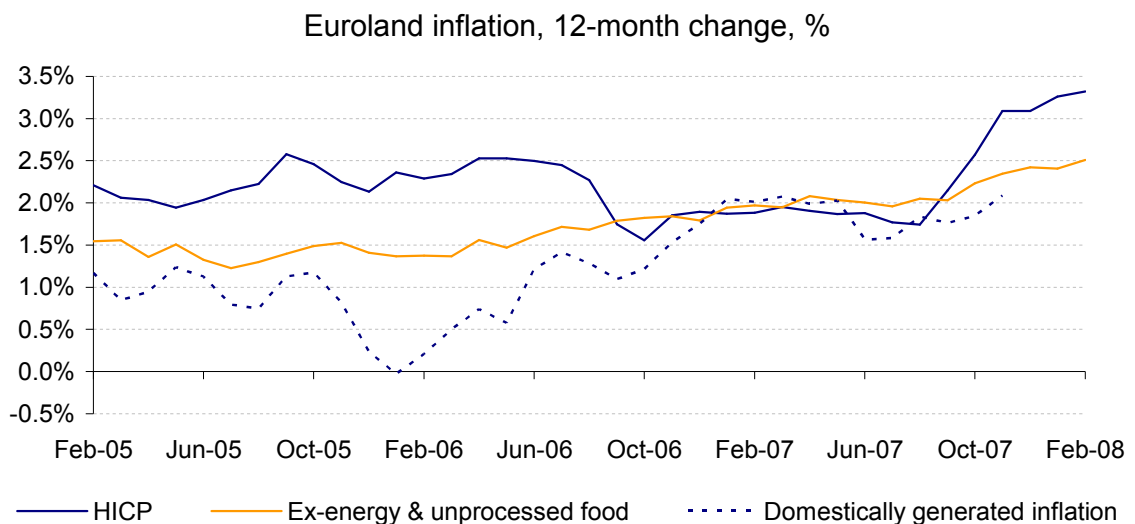
Daily Note: 14 March 2008

How to respond to inflation

WE SUGGEST: Euroland bonds eventually to outperform US

SUMMARY: Euroland car sales jumped in February. But inflation was faster than previously reported and labour cost inflation is accelerating. All grist to the ECB's mill and confirming the Bank's view that its current policy stance is correct. More fundamentally, the ECB's and the Fed's differing attitudes towards inflation is likely to mean Euroland bonds outperforming US, although not in the immediate future.

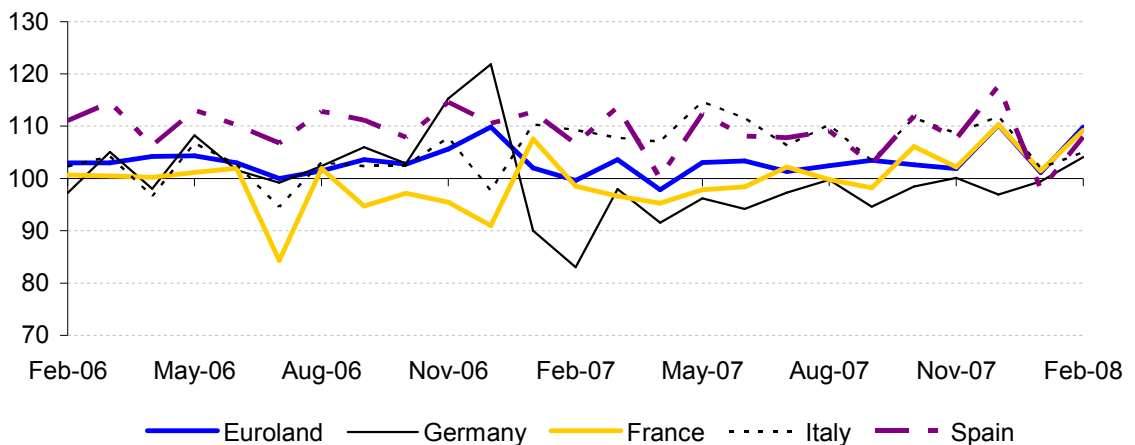
Euroland inflation turned out to be even higher in February. The flash indicator said 3.2%; the revised number published today said 3.3%, with underlying inflation (ex-energy and unprocessed food) at 2.5%. These numbers are bad. Admittedly, they show what happened in the last twelve months, not what will happen in the next twelve. But the trend of recent inflation – the monthly pace has averaged 0.4% in the last six months, compared with 0.2% in the preceding six – is ominous.



Today's European labour cost data, showing Euroland whole-economy labour costs rising by 2.7% in the year to Q4 and by 2.8% in industry (in both cases an acceleration from Q3) will further add to the ECB's view that there are still serious upside risks to inflation. Moreover, Euroland car sales – a key indicator of household demand and one previously painting a fairly depressing picture of domestic demand – suddenly shot up in February. It is obviously too early to say whether the February jump – a 6.3% rise in the month itself and a 10.2% rise from last February – is a blip. However, it is notable that German car sales rose for a second month (and fourth month in five) implying that German households may finally be opening their purses somewhat more. Since these numbers come on the back of other fairly healthy Euroland data (retail sales, industrial production, etc), it is fair to say that the upshot will once again be to confirm the ECB's

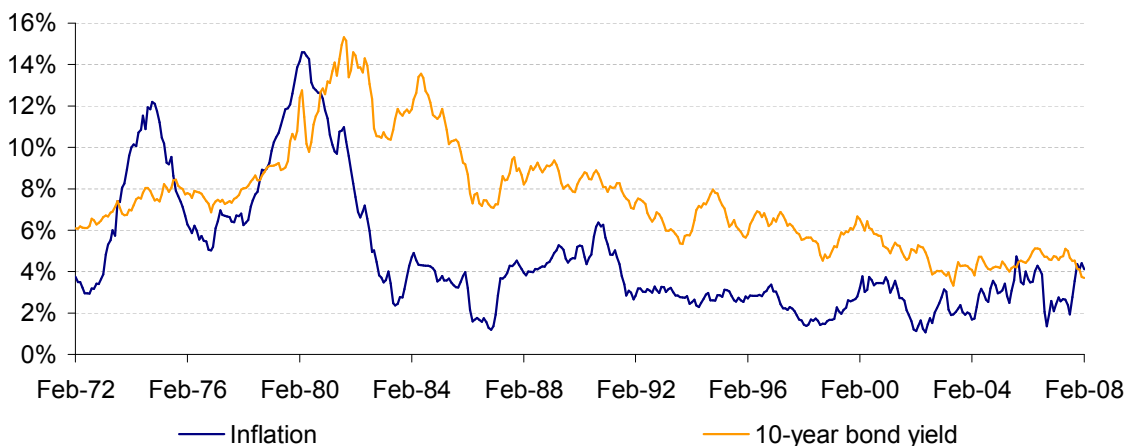
view that its current monetary policy is correct – even with the continued rise of the euro, which M. Trichet has recently commented on in more worried terms than usual.

Euroland car sales, levels, index 2001=100



What the data really shows, is, of course, that the euro-zone is in a different stage of the business cycle than the United States. Notably, there is currently no risk of an imminent recession. Hence the need for different policy responses from the respective central banks. But there is also a more fundamental point about monetary policy, and this concerns the response to inflation. Both the Fed and the ECB claim to set great store by inflation expectations. However, both history and bond markets clearly show a difference in how they act and how they are perceived.

US inflation and yield on 10-year Treasury



In the US, bond markets perceived the first oil shock(1973-74) to be temporary – a natural enough reaction, given a history of subdued inflation since the Korean War. Hence, although bond yields rose, they remained negative in real terms until inflation began to fall back. By contrast, in the second oil shock, markets had taken on board the lesson from the early 1970s and bond yields not only rose sharply, but also remained very high by historic standards until the late 1990s – a clear sign of distrust in monetary policy. Recently, the yield on the 10-year Treasury has again turned negative. It may remain so for some time. But it is difficult to see bond market accepting negative real yields for long, particularly if – as outlined in yesterday’s *Daily Note* – the Fed’s policy

