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Inflation expectations and share prices

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Abstract

Inflation is considered defeated. What does this mean for the performance of shares in individual sectors? Without new inflation worries, there is nothing to prevent prices from rising further in macroeconomic terms.

Zusammenfassung

Die Inflation gilt als besiegt. Was bedeutet dies für die Performance von Aktien einzelner Sektoren? Ohne neue Inflationssorgen steht weiter steigenden Kursen makroökonomisch nichts entgegen.

Inflation is considered defeated. As proof of this assessment, the Fed ended the fastest interest rate hike cycle in recent US history. What does this mean for the performance of shares in individual sectors? In the absence of renewed concerns about inflation, there is no macroeconomic obstacle to further price rises, particularly in the IT sector.

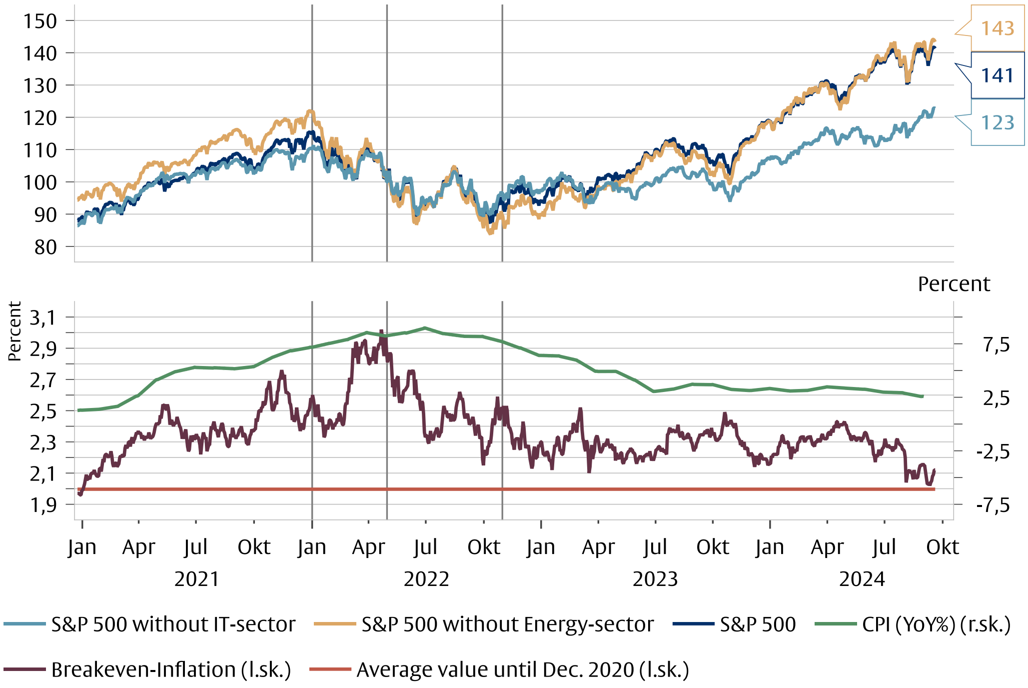
Regime change & AI boom - what has happened so far

In 2023, we analysed the influence of changes in inflation expectations on the share returns of individual sectors - under the then still fresh impression of high inflation rates.[1] We came to the conclusion that rising inflation expectations influence share prices differently depending on the sector, both directly and via interest rate and economic expectations: The US share index S&P 500 and in particular its IT sector suffer from rising inflation expectations, the energy sector benefits and the consumer staples sector remains unchanged.

Empirically, we observed the following: When the inflation rate rose to almost nine per cent at the beginning of 2022 and inflation expectations measured by 10-year breakeven inflation reached the three per cent mark, investors without energy stocks in their portfolio had to digest higher price losses (Fig. 1). From March 2022, the US Federal Reserve responded by raising interest rates. The post-pandemic rally on the US stock market thus came to an end in spring 2022 (Fig. 1, top panel). Over the summer months, the question arose as to whether the Fed could win the battle against inflation. From autumn onwards, both inflation and inflation expectations stabilised at lower levels. Since then, the IT sector has carried the entire S&P 500 from high to high. Avoiding IT stocks cost investors dearly and the energy sector underperformed this time.

[1] See Duarte & Ebert (2023), How sensitive are equity returns to changes in the macroeconomic environment? Study, Flossbach von Storch Research Institute.

Figure 1: Performance of the S&P 500, S&P 500 excluding the energy sector and S&P 500 excluding the IT sector as well as the development of break-even inflation



Source: Flossbach von Storch Research Institute, Macrobond. As at: 12/09/2024. Historical performance is not a reliable indicator of future performance.

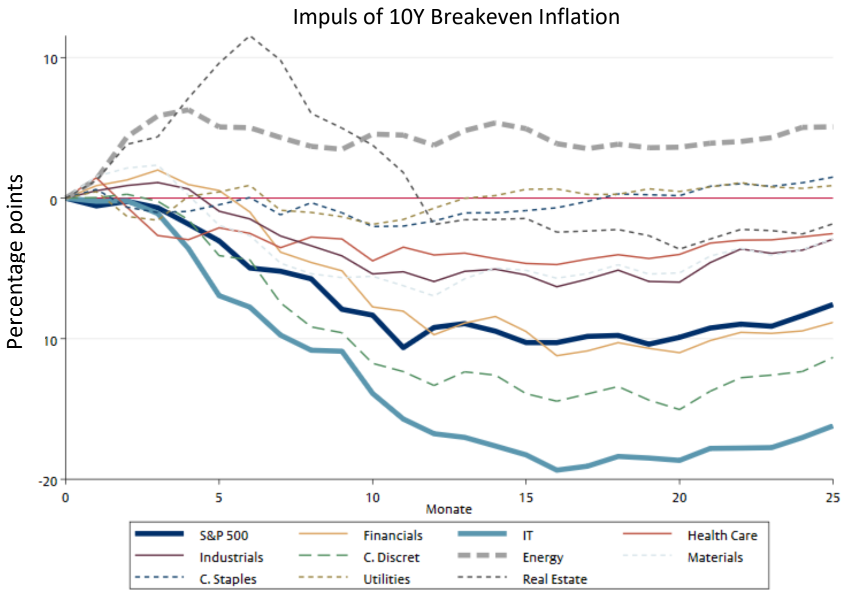
In addition to the macroeconomic effects mentioned above, another important point should be mentioned for the share price rally that has been ongoing since the end of 2022: Technological progress and the associated higher productivity of the factor "capital" have pushed share valuations to new levels for some time now. Our colleague Thomas Mayer explained this correlation in detail back in the spring. [2]

Inflation expectations and equity performance - what our model says today

In our study from last year, we used a simple vector autoregressive model to estimate the impact of changes in inflation expectations on the equity returns of various sectors (Fig. 2). Updated for the data points up to the end of August, we estimate that an increase in inflation expectations of one standard deviation (approx. 44 basis points) leads to a return in the IT sector that would have been approx. 18 percentage points lower 15 months later than without the increase in inflation. The performance of the overall index would have been 10 percentage points lower and that of the energy sector around seven percentage points higher than without the rise in inflation.

[2] Thomas Mayer: [US equity market: Expensive, but also good? - Flossbach von Storch Research Institute]

Figure 2: Cumulative impulse responses of the various sectors of the S&P 500 after an impulse from breakeven inflation



Source: Flossbach von Storch Research Institute, own calculations. The size of the shock is equal to one standard deviation or 44 basis points.

Will the rally continue? - What we expect in the future

By construction, our econometric model assumes that the effect of decreases or increases in inflation expectations on share prices is equally strong. However, the reality is asymmetrical: empirically, the S&P 500 reacts more strongly upwards when inflation falls than it does downwards when inflation rises.[3] Attempts to quantify the asymmetry show strongly fluctuating estimates of the model parameters, so that the differences in the size of positive and negative inflation surprises initially remain uncertain. However, the asymmetry itself is robust: falling inflation expectations help prices more than rising ones harm them.

Ultimately, this means that unless there is an inflation surprise that pushes breakeven inflation up again, nothing seems to stand in the way of the current upward trend of the S&P 500 in macroeconomic terms. In particular, the IT sector is likely to record further price gains and the energy sector is likely to suffer. Consumer staples remain unaffected.

[3] See Table 2 in Duarte & Ebert (2023), How sensitive are equity returns to changes in the macroeconomic environment? Study, Flossbach von Storch Research Institute.

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