Daiwa's View

Good opportunity to buy European bonds, euro?

- ECB expected to begin raising rates in July with deposit facility rate moving back into positive territory on multiple hikes this year
- We expect ECB rate hikes to end this year, which would produce downside for medium/long-term European bond yields
- Will euro rise over medium/long term due to balance of power among declining US/Europe interest rates?
- Euro (funding currency) may appreciate beyond just interest rate gap if European short-term rates break into positive territory

Fixed Income Research Section
FICC Research Dept.

Senior FX Strategist
Kenta Tadaide
(81) 3 5555-8466
kenta.tadaide@daiwa.co.jp

Daiwa Securities Co. Ltd.

Good opportunity to buy European bonds, euro?

Expect ECB rate hikes to end this year so falling European bond yields, euro appreciation possible

The market expects the ECB interest rate hikes to start in July, the deposit facility rate to return to positive territory by the end of this year, and multiple rate hikes by the ECB from 2023. We expect rate hikes to conclude within this year, after rates are returned to positive territory, and so believe that European bond yields will have room to decline, especially medium/long-term yields. If rate hikes are halted by the end of this year, the rise in hedging costs would be limited, which would probably make it easier for investors to buy 10-year German government bonds (1% yield) and 10-year French government bonds (1.5% yield).

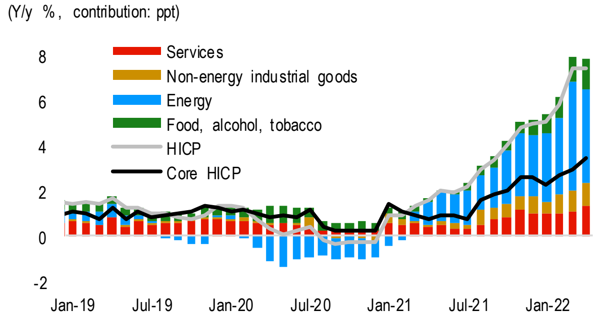
EUR/USD trends have mirrored US-German interest rate differential trends. The euro may depreciate over the short term due to the situation in Ukraine and falling expectations for ECB rate hikes. Still, we expect US interest rates to decline through the second half of the year, with the euro appreciating over the medium/long term due to the balance of power among declining interest rates. Also, if short-term interest rates break back into positive territory, the euro, which has been used as a funding currency until now, could appreciate to a degree over and beyond that based just on the interest rate differential.

Over the past few months, the ECB has clearly become more hawkish. Recently, even those members seen as doves have made forward-looking statements about rate hikes. For example, Bank of Finland Governor Olli Rehn said on 5 May, "I think it would be justified to raise the deposit facility rate by 0.25 percentage points in July and it would be at 0% when the autumn comes."

Also, ECB President Christine Lagarde said on 11 May, "My expectation is that they (asset-buying stimulus programs) should be concluded early in the third quarter." She also added, "The first rate hike, informed by the ECB's forward guidance on the interest rates, will take place some time after the end of net asset purchases and this could mean a period of only a few weeks." The market is increasingly anticipating a rate hike in July.

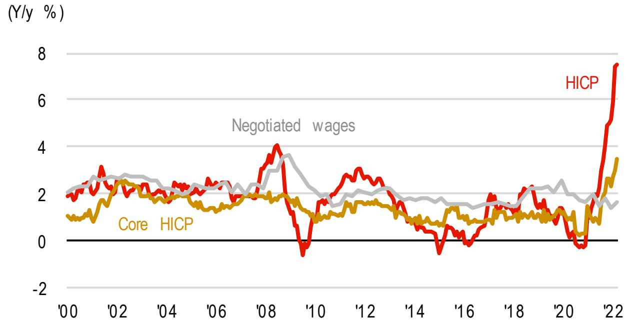
The ECB's willingness to raise interest rates appears to be driven by concerns about the spiraling rise for wages/prices and the risk of unanchoring inflation expectations, as well as the need to ensure that there is room for monetary accommodation in the event of a future recession. This need to prepare for a future recession can be seen in the words of Bank of Finland Governor Olli Rehn, who said that 2023 is seen as a difficult year and, under the worst-case scenario, the euro area risks falling into recession. He added that, as such, there is no need to delay the normalization of monetary policy.

Chart 1: Eurozone Harmonised Index of Consumer Prices (HICP)



Source: Eurostat; compiled by Daiwa Securities.

Chart 2: Eurozone HICP, Negotiated Wages



Source: Eurostat, ECB; compiled by Daiwa Securities.

As for inflation, the ECB seems to have further recognized the need for an early rate hike after a sharp acceleration for the April preliminary Harmonised Index of Consumer Prices (HICP) growth rate, released on 29 April. The HICP growth rate for April (preliminary) accelerated slightly to 7.5% y/y (from 7.4% in Mar), to a new record high (Chart 1). Energy price growth, which accounts for more than half of inflation, slowed. Still, price growth for food, liquor, tobacco, and non-energy industrial goods and services were all at record highs. Core HICP growth rate of 3.5% exceeded expectations and marked a record high.

Meanwhile, April was the first month since November 2020 that energy prices, the main driver of inflation, declined m/m. The near-term inflation outlook remains highly uncertain, as it depends on energy market developments. However, unless crude oil and natural gas prices rise again, the upward pressure that energy exerts on inflation is expected to diminish more significantly over the next few months. There is room for non-energy industrial goods and services to push up inflation as higher costs are passed on to prices. However, inflation has most likely already peaked considering that a strong base effect will emerge from here, significant wage growth has not been confirmed, and inflationary pressure on the demand side is weak.

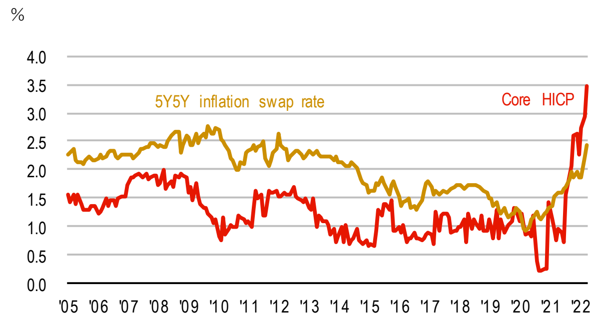
At this juncture, there are no signs of a marked acceleration in the rate of negotiated wage growth in the euro area. Negotiated wage growth was up only 1.6% y/y in Oct-Dec 2021 and German monthly data also shows only 1.2% y/y growth in April (up 1.5% when including bonuses) (Chart 2). Meanwhile, policymakers are very concerned about accelerating inflation due to higher wages. Indeed, on 6 May ECB Executive Board member Isabel Schnabel said, *"*It's not realistic to think that wages will not at some point react.*"* German Finance Minister Christian Lindner echoed this view on 9 May when he said, *"*The risk of wage and price (upward) spirals is real. There are already signs that one-time payments could play a role this year."

Schnabel also said on 11 May that, *"*The fact that inflation is, to a considerable extent, driven by global factors does not mean that monetary policy can or should remain on the sidelines. On the contrary, persistent global shocks imply that the strong anchoring of inflation expectations has become more important than ever.*"* Indeed, the expected inflation rate in terms of the 5-year forward 5-year inflation swap rate is rising (Chart 3). Although it could be said that this inflation swap rate has only returned to the level seen just before the European debt crisis, the ECB is concerned about the risk of inflation expectations rising and inflation becoming unchecked. As such, it is now motivated to raise interest rates multiple times.

The important points are how far will the ECB continue hiking rates and can the central bank continue hiking rates. Apparently, the ECB expects a neutral interest rate of around 1.5%. For example, during a 6 May speech, Bank of France Governor Francois Villeroy de Galhau said, *"*The level of the neutral rate cannot be precisely determined ex ante. However, current estimates of real neutral rates point to levels between –1% and 0% in the euro area. Given an inflation target of 2%, this suggests a nominal short-term neutral rate possibly between 1% and 2% in the euro area.*"*

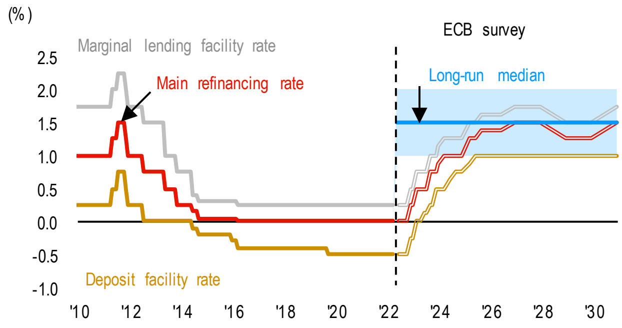
The ECB also conducts and publishes the results of a survey of market participants' outlooks on financial markets as part of its "ECB Survey of Monetary Analysts." The long-term outlook (long run) is presented along with the short- and medium-term outlooks for key policy rates. In the most recent survey (Apr 2022), the median long run deposit facility rate was 1% and the median long run main referencing operations rate was 1.5%. This means that the views of market participants are generally in line with the abovementioned views held by Bank of France Governor Francois Villeroy de Galhau (Chart 4).

Chart 3: Eurozone HICP, Inflation Expectations



Source: Eurostat, Bloomberg; compiled by Daiwa Securities.

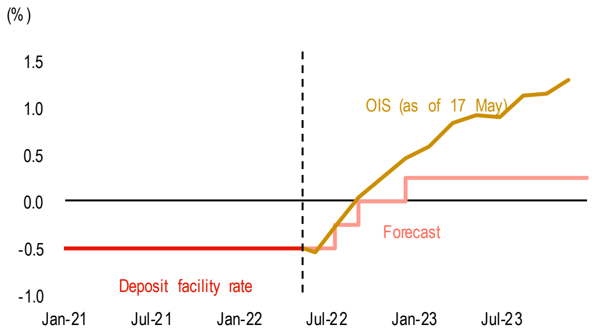
Chart 4: ECB Policy Intereset Rates, Neutral Rate



Source: ECB; compiled by Daiwa Securities.
Note: The double line for each policy rate is the median forecast from the April 2022 ECB Survey of Monetary Analysts. Longer run is the main refinancing operations interest rate, shaded area is the 25-75% range.

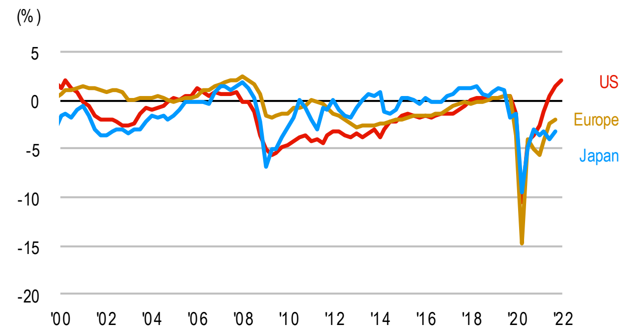
The market is factoring in the ECB starting rate hikes in July, raising the deposit facility rate to 0.45% as of end-2022 with several rate hikes in 2023 to eventually reach 1.0% in the summer of that year (Chart 5). Our economists also expect rate hikes to start in July and the deposit facility rate returning to positive territory within 2022. However, they then expect rate hikes to cease. In other words, they have adopted a more dovish outlook than that being factored in by the market.

Chart 5: Deposit Facility Rate, Rate-hike Pricing



Source: ECB, Bloomberg; compiled by Daiwa Securities.

Chart 6: Output Gap in Japan, US, Europe



Source: CBO, Cabinet Office, Bloomberg; compiled by Daiwa Securities.

The euro area real GDP for Jan-Mar (revised) returned to the pre-pandemic level, but is still more than 3% below the pre-pandemic trend, which is raising fears about stagflation. The euro area output gap was around minus 2% at the end of 2021. The situation is clearly different from that in the US, where the output gap is significantly positive and the economy is overheating (Chart 6).

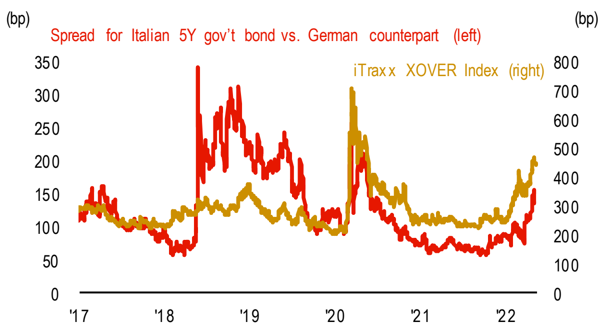
If demand weakens due to lingering uncertainty over the Russia-Ukraine situation and the sharp rise in the cost of living, we would expect upward pressure on prices to eventually decline. Since we fully expect that it may become difficult to justify continued aggressive rate hikes, we believe that the market's expectation for a string of rate hikes over the next year or so is excessive. This means that there is potential for European bond yields to decline, especially the medium/long-term yields, once those market expectations drop off. Also, if interest rate hikes stop by the end of this year, short-term interest rates would only just return to positive territory and upside for hedging costs would be limited even without the premium seen until now. Investors might see a good opportunity to buy the 10-year German government bond with the yield at 1.0% and the 10-year French government bond with the yield at 1.5%.

On the other hand, the spread for Italian 5-year government bond against German counterpart has widened in tandem with the credit index. Given the volatile credit market situation, we are likely to continue struggling to find such good opportunities to buy bonds of peripheral countries (particularly Italy) for now (Chart 7). General elections are scheduled to be held in Italy by 1 June 2023. Therefore, due to this fluid political situation and growing awareness that a right-wing government could emerge, there is the risk that this spread will significantly widen.

The currency market has tended to move in line with the US/German interest rate gap. Even though over the past few months the market has quickly factored in ECB rate hikes, the EUR/USD has not risen. This is because US interest rate hikes were factored in on a larger scale than that for the euro area. Since February, the US dollar has been the strongest currency within the G10, followed by the Canadian dollar in second place and the Oceania currencies in third and fourth place. The euro ranks fifth, performing better than the other European currencies.

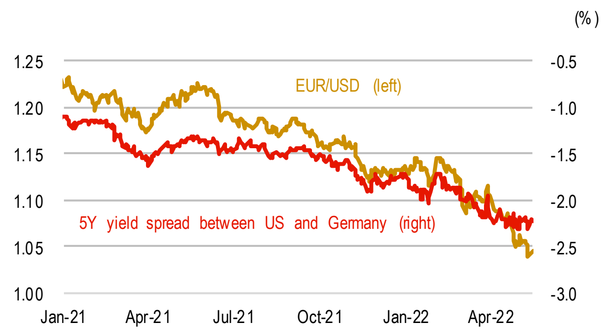
The euro may weaken over the short term due to the situation in Ukraine and falling expectations for ECB rate hikes. However, we expect US interest rates to decline through the second half of this year, and the euro will appreciate over the medium/long term due to the balance of power among declining interest rates. Also, if the ECB manages to raise interest rates multiple times before the end of the year and short-term interest rates move out of negative territory, the euro, which has been used as a funding currency until now, could probably appreciate to a degree over and beyond that based just on the interest rate gap.

Chart 7: iTraxx XOVER Index, Spread for Italian 5Y Gov't Bond vs. German Counterpart



Source: Bloomberg; compiled by Daiwa Securities.

Chart 8: EUR/USD, US/German Interest Rate Gap (5Y)



Source: Bloomberg; compiled by Daiwa Securities.

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