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Daiwa's View

Premature rate hikes would lead to currency depreciation

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- Moves to sell the euro are accelerating due to concerns that natural gas supplies from Russia may stop
- "Selling Europe" picture is observed under concerns about economic overkill via rate hikes amid weak demand in Europe since beginning of 2022
- Strongly rooted opinion expects policy revisions by BOJ to respond to a weaker yen and inflation, but revisions amid a negative output gap may result in "selling Japan," rather than correcting yen depreciation

Premature rate hikes would lead to currency depreciation

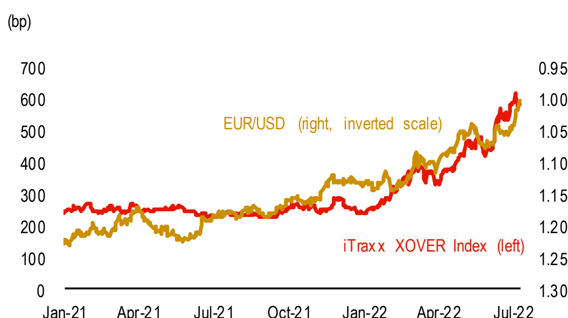
In Europe, the market is aware that rate hikes may fail; if Japan moves toward monetary tightening, we could see similar developments

Moves to sell the euro have not stopped. Since 24 February, when Russia started its invasion of Ukraine, market sentiment for the euro has been bearish partly because Europe is an epicenter of this battle. Since July, the pace of the decline in the EUR/USD rate has been fast. Yesterday, the euro closely approached the dollar parity level for the first time since 2002 (1.00005 according to Reuters), although it did not actually reach parity. As we explain later in this report, a complete stop of natural gas supplies from Russia is a current concern. Consequently, the euro is prone to be sold at least until 22 July.

One background factor to the moves to sell the euro is concerns about an economic slowdown in the region. In Europe, as inflation has been rising rapidly, the ECB is forced to raise interest rates. In the European credit market, the high-yield CDS index has been surging (it exceeded 600bp on 30 June for the first time since April 2020). With growing market concerns that rapid rate hikes to cope with high inflation will cause an economic slowdown and eventually a recession, the EUR/USD rate has been declining in line with the high-yield CDS index (Chart 1).

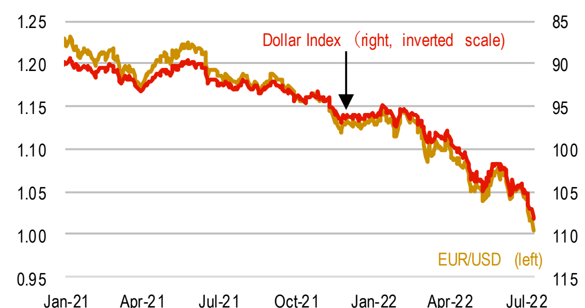
Since mid-June, the correlation between the USD/JPY rate and the Japan/US interest rate differential has collapsed in the forex market. Given ongoing correlation, we expected the USD/JPY rate to decline substantially amid a decline in US yields. However, the actual USD/JPY rate declined little. Rather, the rate rose to Y137.75 at one point on 11 July, hitting its highest value since September 1998, about 24 years ago. It appears that this divergence from the interest rate differential was influenced by increasing moves to buy the dollar in the overall forex market, while European currencies (represented by the euro) were sold (Chart 2).

Chart 1: European High-yield CDS Index, EUR/USD



Source: Bloomberg; compiled by Daiwa Securities.

Chart 2: Dollar Index, EUR/USD



Source: Bloomberg; compiled by Daiwa Securities.

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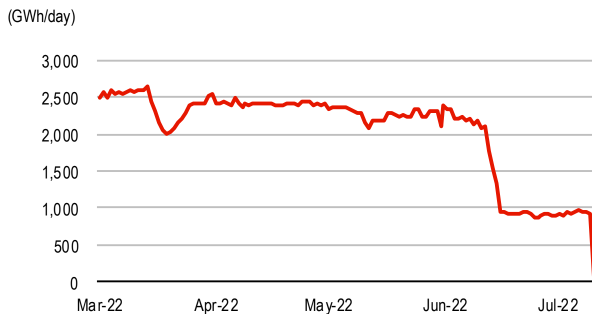
Chart 3: Gas Supply Volume from Russia to Germany



Source: Bundesnetzagentur; compiled by Daiwa Securities.
Note: Gas supply volume via Nord Stream 1.

Chart 4: Price Indicator for European Natural Gas (Dutch TTF next month delivery)

Source: Bloomberg; compiled by Daiwa Securities.

The European credit market has been deteriorating. The surge in the European high-yield CDS index since mid-June is caused by the increasing likelihood of a complete stop of natural gas supplies from Russia. On 15 June, Russia's state-owned Gazprom reduced the daily supply volume of gas to Germany via the undersea gas pipeline Nord Stream 1 (NS1) by 40% compared to the normal level. On the following day, it reduced the supply volume by 60% compared to the normal level (Chart 3).

Gazprom explained that the substantial cut in the supply volume was caused by delays in the return of equipment being repaired in Canada. The Canadian government had shown reluctance to ship the equipment back because of the economic sanctions against Russia, but it announced on 9 July that it would approve the return.

As the German government thinks that the cut in the gas supply volume is a retaliation for sanctions, more people think that gas supplies from Russia via the NS1 will stop completely. Every summer, gas transportation by NS1 is suspended for ten days for safety inspections. This year, the downtime is scheduled for 11 July through 21 July. However, the German government is concerned that Russia may not resume gas transportation via NS1 after the safety checks.

In line with the reduction in gas supplies, the Dutch TTF, a price indicator for European natural gas (next month delivery), has been surging. This is creating concerns about downward economic pressure via inflation due to a rise in energy prices (Chart 4). In addition, if gas supplies from Russia to Germany is stopped completely, a rationing system would be introduced for natural gas and the volume available to manufacturers may be restricted. If so, it is highly likely that economic activities will be directly pushed down by energy shortages both in terms of prices and volume.

Box 3 of the ECB staff macroeconomic projections released in June presented a downside scenario in the case of a complete cut in Russian energy exports to the euro area starting from the third quarter of 2022. It is estimated that this scenario will lead to "a rationing of gas supplies, significantly higher commodity prices, lower trade and intensified global value chain problems." Staff estimate that the euro area economy will post negative growth in 2023 (down 1.7%) under this scenario. In this situation where the region needs to face a possible stop of gas supplies from Russia, we would be forced to be aware of the possibility that the euro area economy will fall into negative growth next year.

Concerns about economic deterioration due to a stop of natural gas supplies are currently serving as a factor. Since the beginning of this year, however, the European credit market has been worsening, reflecting the severe economic conditions there. With the Russian invasion of Ukraine becoming a decisive factor, the ECB plans to start rate hikes in order to cope with unexpected inflation. That said, premature rate hikes amid weak demand entail a risk of economic overkill. It appears that the market expects rate hikes by the ECB to end in failure.

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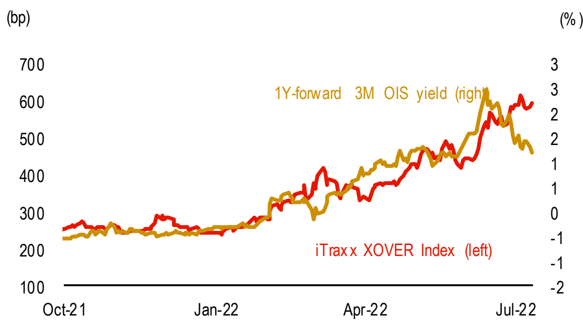
Chart 5 shows the European high-yield CDS index and the market's pricing of rate hikes by the ECB. After the beginning of 2022, the market temporarily factored in a rise in the policy interest rate of above 2%, assuming a start of the ECB's rate-hike cycle within the year. However, in line with such movements, sovereign bonds in Southern European nations with worries about fiscal conditions, such as Italy and Spain, were sold, leading to a rise in the European high-yield CDS index. Such pricing also induced a decline in the euro in the forex market. As such, a "selling Europe" picture was observed. Since mid-June, rate-hike pricing has diminished globally (incl. Europe). In Europe, however, concerns are growing about an economic slowdown in line with a stop of gas supplies from Russia, as mentioned above. Thus, deterioration of the credit market and moves to sell the euro are continuing.

This case of Europe is useful reference when thinking of the BOJ's policy. There is strongly rooted opinion that the BOJ will implement policy revisions, such as rate hikes and adjustments to the yield curve control (YCC) policy, in order to respond to a weaker yen and inflation pressure. However, as the BOJ persistently repeats a negative output gap in the Summary of Opinions at the Monetary Policy Meeting, Japan's output gap is negative and the economy remains weak, similar to Europe (Chart 6). If the BOJ steers toward monetary tightening in such a situation, this is unlikely to lead to correction in yen depreciation, contrary to expectations. A picture of "selling Japan" may emerge, like the current case in Europe.

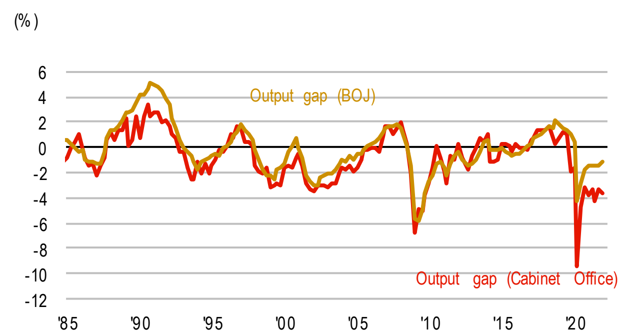
Given the current situation in Europe, we think that premature rate hikes would not cause currency appreciation. On the contrary, such moves could cause currency deprecation.

Chart 5: European High-yield CDS Index, OIS Forward Yields



Source: Bloomberg; compiled by Daiwa Securities.

Chart 6: Output Gap in Japan



Source: Cabinet Office, BOJ; compiled by Daiwa Securities.

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