Daiwa Securities

Daiwa's View

Business sentiment tells of high barriers to ECB rate hike

➢ Rates drop sharply in Europe

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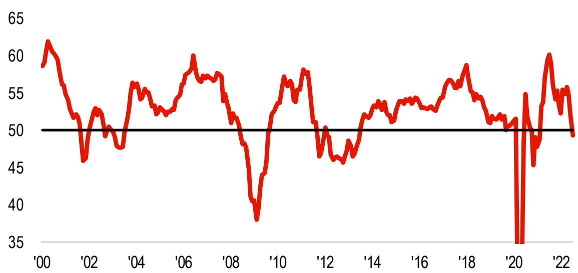
The EU is in turmoil. Last week on 21 July, Italian Prime Minister Mario Draghi submitted his resignation to President Sergio Mattarella, and it was accepted. Parliament will be dissolved and a general election held on 25 September, but the market did not like this political fluidity, and spreads on Italian government bonds over German Bunds widened. Then the announcement of a weak July PMI the following day on 22 July sent European rates sharply lower. The 10yr Bund yield had risen as high as 1.3781% following the ECB's Governing Council meeting on the 21st, but it plunged below 1% down to 0.9861% on the 22nd, and Europe's bond market has become extremely volatile.

The euro zone composite PMI for July (all figures below are preliminary) dropped to 49.4, down from 52.0 in June, its first time below the threshold between positive and negative sentiment of 50 (Chart 1) since February 2021. The manufacturing PMI, which had driven post-pandemic growth, came in at 49.6 (vs. 52.1 in June) its first print below 50 since June 2020. On a country basis, all three of Germany's PMIs (composite, manufacturing, and services) were below 50 (Chart 2), while in France, the services and composite PMIs were above 50 but the manufacturing PMI dropped below to 49.6 (vs. 51.4 in June).

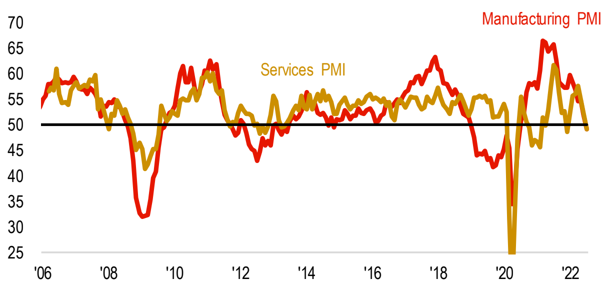
Although rising costs and declining orders explain some of this worsening of business sentiment, the reduction in Russia's supply of gas to Germany through the Nord Stream 1 pipeline in mid-June and consequent increased awareness that Russia could cut off gas supplies may have also had an impact. Although gas supplies through Nord Stream 1 resumed as scheduled on 21 July after 10 days of periodic maintenance (back to the same level as prior to the periodic maintenance, which was 60% of normal), there is concern that euro zone growth will turn negative in Jul-Sep.

Chart 1: Euro Zone Composite PMI



Source: Markit, Bloomberg; compiled by Daiwa Securities.

Chart 2: Germany Manufacturing PMI, Services PMI



Source: Markit, Bloomberg; compiled by Daiwa Securities.

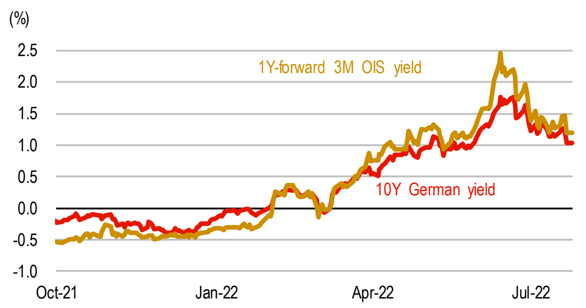
At its policy meeting on 21 July, the ECB hiked rates for the first time in 11 years and also announced its Transmission Protection Instrument (TPI). The ECB's forward guidance at its June meeting was for a 25bp hike at the July meeting, but it instead decided to raise rates by 50bp. The ECB also indicated plans to make policy decisions on a meeting-by-meeting basis, and at her post-meeting press conference, ECB President Christine Lagarde commented that while the TPI allows the ECB to make bold moves, the terminal policy rate target is unchanged.

The July policy meeting was not a hawkish turn in the ECB stance, since although it is front-loading its normalization it has not changed the terminal rate. The ECB does want to normalize interest rates further based on the high-level inflation, but as evidenced by the July PMI the economy has already started slowing and there is considerable uncertainty over where it is heading. Furthermore, there are signs that a recession is steadily approaching not only in Europe but in the US, as well, and it is unclear at this point whether the ECB will accelerate its pace of rate hikes or even make it to the terminal rate that it currently envisions.

The results of the July PMI substantially reduced the market's pricing in of ECB rate hikes. After the ECB policy meeting on 21 July, the market was pricing in a policy rate of about 1.2% at end-2022 and about 1.5% a year ahead, but the market reacted to the weaker-than-expected PMI by reducing its policy rate expectation to around 1.0% at end-2022 and 1.2% a year ahead. This lowering of ECB rate hike expectations pushed the 10yr German Bund yield sharply lower, to around 1% (Chart 3). With the ECB's rate hike path having become more difficult and US rates having already peaked, we think European rates may also be nearing their ceiling (Chart 4).

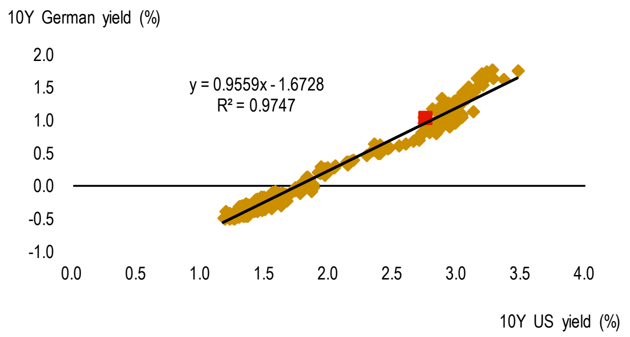
Lastly, the yen strengthened the most of any G10 currency in the FX market on 22 July, and the USD/JPY momentarily dropped into the mid-135 range. The BOJ decided at its policy meeting on 20-21 July to maintain monetary accommodation, and at his post-meeting press conference BOJ Governor Kuroda said the BOJ "had absolutely no intention of raising rates." Despite using such strong language to indicate continued easing, the yen strengthened by more than Y3 from 21 to 22 July. Although the EUR/USD was also volatile amid various events on 21-22 July, it only rose slightly over that two-day period. There are selling pressures on the yen from Japan-specific factors, namely the BOJ's accommodative monetary policy and a growing trade deficit brought by sharply higher commodity prices, but price changes since Russia's game-changing invasion of Ukraine have been largely driven by dollar strength on the back of Fed rate hikes, and this includes recent moves. As has also been made clear by the ECB's policy decision, a home currency cannot be strengthened by rate hikes that are contrary to fundamentals, and the only way to prevent a currency's slide is to wait for the strong dollar trend to peak. The timing for that is steadily approaching.

Chart 3: OIS Forward Yield, 10Y German Yield



Source: Bloomberg; compiled by Daiwa Securities.

Chart 4: 10Y US Yield, 10Y German Yield



Source: Bloomberg; compiled by Daiwa Securities.

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