Daiwa's View

Rate-hike pricing in Europe not moving forward

➢ Speculation about European monetary policy is swaying between concerns about inflation and the risks of economic recession

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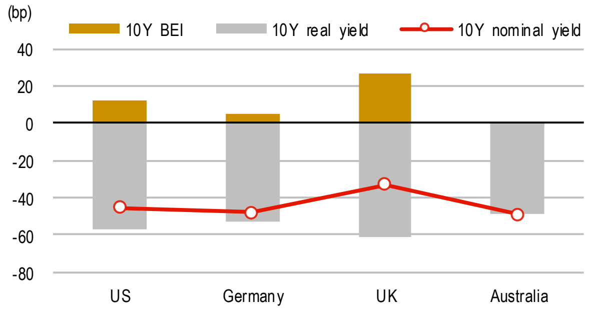
Global yields declined substantially from late July to the beginning of August. The US, Germany, and Australia saw 10-year yields decline more than 45bp. The UK also saw the yield fall by 33bp. Breaking down the change in the nominal yield into the BEI and the real yield, we found that the yield decline in these nations was prompted by a drop in the real yield. In three nations, excluding Australia, the BEI acted to boost yields (Chart 1).

Beginning with preliminary data for July PMI and US Apr-Jun real GDP, these nations' economic indicators have worsened across the board since late July. This suggested that the risk of a global economic recession was growing. Under the circumstances, speculation emerged in the market that central banks, led by the Fed, would lean towards a dovish stance. Therefore, yields have dropped amid a decline in the projected levels of terminal rates.

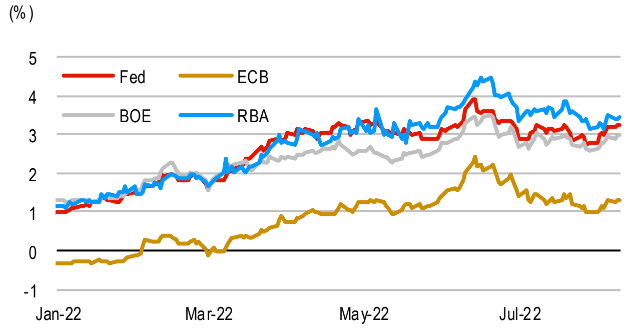
That said, the current situation does not allow the Fed to shift to a dovish stance. Reflecting the results of the July US jobs data, projections for terminal rates were repriced upwards over the past week. These projections have already recovered to levels before they declined in late July. It is also true that the risk of an economic setback is increasing. Accordingly, a further rise in projected terminal rates from current levels would necessitate additional factors, such as an overshoot of inflation.

Chart 1: Breakdown of Factors in Yield Change (20 Jul-1 Aug)



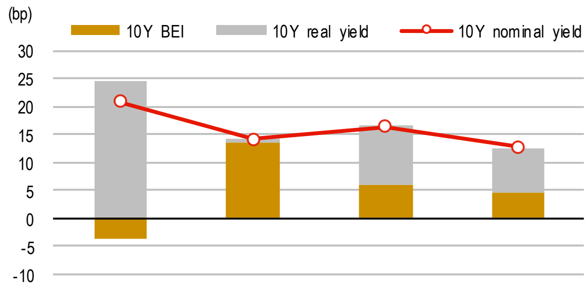
Source: Bloomberg; compiled by Daiwa Securities.

Chart 2: Market Projections for Terminal Rates



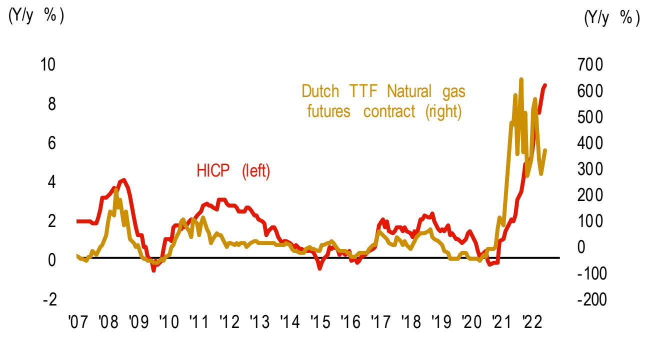
Source: Bloomberg; compiled by Daiwa Securities.
Note: 1Y-forward 3M OIS yield.

Chart 3: Breakdown of Factors in Yield Change (1 Aug-9 Aug)



Source: Bloomberg; compiled by Daiwa Securities.

Chart 4: HICP in Euro Area, European Natural Gas Price Index



Source: Eurostat, Bloomberg; compiled by Daiwa Securities.

Breaking down the factors in the yield change over the past week, we found that the yield rise was led by the real yield, mainly in the US. Particularly in the US, the BEI contributed to the yield drop, while real yields led the yield rise. In contrast, as far as Germany was concerned, yields were boosted by the BEI, and real yields did not make positive contributions (Chart 3). Speculation about European monetary policy is swaying between concerns about inflation and the risks of economic recession that are growing day by day. Therefore, rate-hike pricing has not recovered to the levels before yields declined.

July HICP inflation in the euro area (released 29 Jul) increased 8.9% y/y, higher than the +8.6% for June. Core HICP (excl. items with volatile prices, such as energy, food, alcohol, and tobacco) came in at +4.0%, which was also higher than the +3.7% for June, which contributed to accelerated inflation.

The outlook for both the inflation rate and economic growth remains highly uncertain. Regarding the inflation rate, Germany implemented measures to cope with soaring energy prices in June, such as a cut in fuel taxes and the introduction of subsidies for public transportation fees. However, with these measures set to end at the end of August, upward inflation pressure is expected to heighten. Also, the wholesale price of natural gas is currently surging because Russia has once more reduced the supply of natural gas via the Nord Stream 1 pipeline. Due to this surge, the inflation outlook is becoming more uncertain (Chart 4).

There are also lingering risks to distribution related to climate factors. The water level of the Rhine River around Kaub, a key waypoint for shipping in Germany, was 50cm as of 9 August. (Normally, it is about 200cm.) It has declined to the lowest level since 2018 due to extreme heat. The loading weight of large ships is supposedly restricted when the water level around Kaub is below 75cm, and large ships are thought to be unable to navigate when the water level is below 40cm. Coal-fired power generation is used as an alternative energy source to Russian natural gas. However, it has been reported that coal transportation has already been restricted by low water levels, and operation costs at coal-fired power plants are swelling due to the rising cost of coal transportation. If the water level declines further, coal transportation will be disrupted, which may have adverse effects on inflation and production.

With inflation rising faster than ECB projections, it is highly likely that the ECB will be forced to raise its inflation projections again in September, and, as a result, will implement another large rate hike. That said, as we have already seen signs of a slowdown in the European economy, such a large rate hike in fear of higher inflation would raise the risk of economic overkill. Due to the energy shortage, Europe has a relatively high risk of a sharp fall in production. There will be limited leeway for the 10-year German yield to rise by way of acceleration in the pricing of ECB rate hikes.

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