Daiwa's View

Risk-off emanating from Europe

➢ Strong pressure to sell the yen seen amid lower yields and stronger dollar

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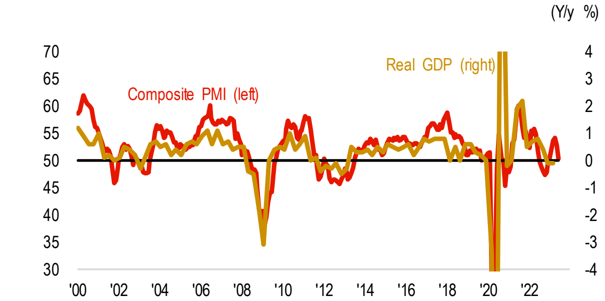
The June Eurozone Composite PMI released last Friday (hereinafter, flash data, in this report) declined to 50.3 from 52.8 in May. The index exceeded 50, which is the dividing line between boom and bust, for six consecutive months. On a quarterly average basis, the index came in at 52.4 in the Apr-Jun quarter, slightly up from 52.0 in the Jan-Mar quarter, but real GDP barely increased q/q (Chart 1). With the manufacturing PMI falling to 43.6 (from 44.8 in May), the lowest level in three years and one month, the services PMI also declined substantially to 52.4 (from 55.1 in May, Chart 2). Since the beginning of the year, business sentiment in the manufacturing sector had been decoupled from that in the services sector. However, there have been recent signs that the service sector is being pulled down by deterioration in the manufacturing sector. By nation, the manufacturing PMI in Germany worsened further from 43.2 in May to 41.0. France saw the services PMI plunge from 52.5 in May to 48.0, resulting in composite and manufacturing PMIs below 50.

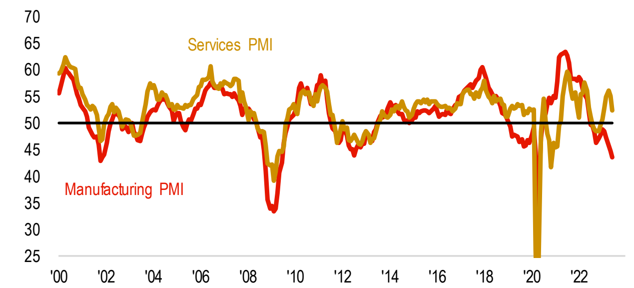
In light of the June PMI data, the 10-year German yield and French yield slid to 2.351% (down 14.1bp d/d) and 2.874% (down 14.6bp), respectively. In the forex market, the euro was sold against the dollar, and the EUR/USD rate fell to around 1.085 at one point. The Australian dollar and the NZ dollar also depreciated amid the increasing risk-off sentiment. The USD/JPY rate rose due to across-the-board strength of the dollar, hitting a YTD high, approaching Y143.87. The EUR/JPY rate also plunged temporarily, from the upper half of the Y156 range to just above Y155, but then recovered to the upper half of the Y156 range, making apparent strong selling pressure on the yen. Risk-off sentiment is emerging due to caution about overkill via excessive tightening by the Fed and ECB. However, there is now interest in the difference in the monetary policy stance with the BOJ, which is making it difficult for risk-off sentiment to lead directly to appreciation of the yen.

Chart 1: Eurozone Composite PMI, Real GDP



Source: Eurostat, S&P Global, Bloomberg; compiled by Daiwa Securities.

Chart 2: Eurozone Manufacturing PMI, Services PMI



Source: S&P Global, Bloomberg; compiled by Daiwa Securities.

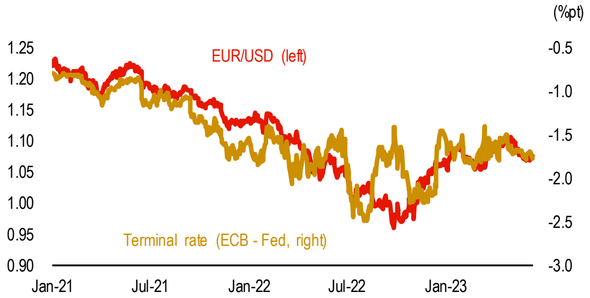
The market's pricing in of rate hikes by the ECB has receded, reflecting deterioration in business sentiment in the eurozone. As of 22 June, the market was pricing in a more than 90% probability of a rate hike at the July meeting, with at least one additional rate hike within 2023 expected. However, as of last Friday, while the market was still pricing in a more than 90% probability of a rate hike at the July meeting, it was not fully factoring in an additional rate hike within 2023.

That said, we need to pay attention to the fact that business sentiment is being cooled by the manufacturing sector. The June services PMI data certainly suggests a pause in growth in the services sector, which had driven the recovery thus far. However, the index is still above 50, which is not low. There is concern that core inflation in the eurozone could remain high due to substantial growth in negotiated wages and upward pressure on service prices. Accordingly, unless we see a clearer slowdown in the services sector, the ECB is likely to maintain its hawkish stance.

The ECB has also been cautious about stronger pressure on inflation due to depreciation of the euro. If it were to shift towards a dovish stance before the Fed, that would increase the possibility of a decline in the EUR/USD rate. In fact, we can confirm the close relationship between the EUR/USD rate and the terminal rate differential between the US and eurozone (Chart 3). Although the Fed made the hawkish decision to skip a rate hike at the June FOMC meeting, many forecast a rate hike at the July meeting. The Fed is expected to indicate the possibility of conducting additional rate hikes at meetings from July onwards, depending on data. Meanwhile, the ECB strongly hinted at a rate hike at the July Governing Council meeting, but opinion is divided regarding the action to be taken from September onwards.

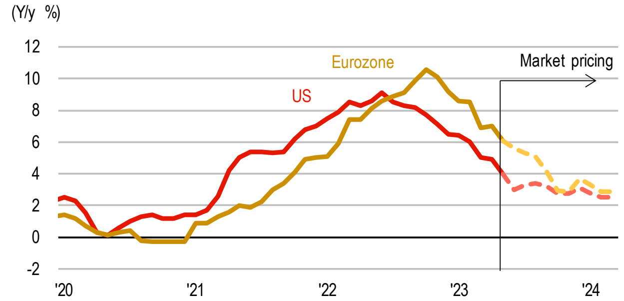
As previously mentioned, the slowdown in inflation in Europe has been lagging behind that in the US (Chart 4). As with the current cycle, historically, it is generally the case that the US starts monetary tightening ahead of the eurozone (Germany) and the US ends rate hikes prior to the eurozone. In the past, the ECB forced through rate hikes immediately before two financial crises, the Global Financial Crisis and the European debt crisis. Therefore, we would like to remain aware of the possibility of additional rate hikes from September onwards in the current cycle, as well.

Chart 3: EUR/USD, Market Pricing in of Terminal Rate in US and Europe



Source: Bloomberg; compiled by Daiwa Securities.
Note: Terminal rates indicate maximum values for interest rate futures up to two-year forward rates.

Chart 4: CPI in US and Europe



Source: US Department of Labor, Eurostat, Bloomberg; compiled by Daiwa Securities.

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