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Daiwa's View

ECB unlikely to suspend rate hikes until autumn

➢ Stress on European financial system warrants attention

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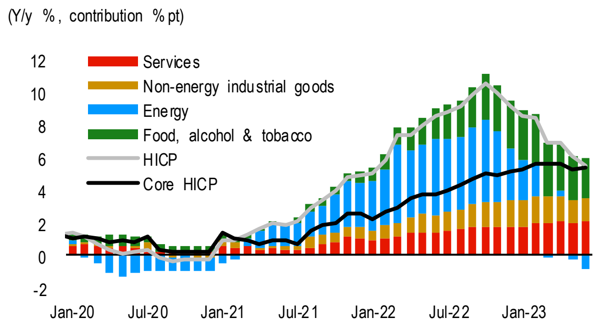
The euro area CPI for June (HICP, flash estimate released on 30 Jun) was largely in line with the market estimate (Chart 1). The growth rate for HICP came in at +5.5% y/y, slowing for the second consecutive month (+6.1% in May). Meanwhile, the growth rate for core HICP accelerated slightly to +5.4%, from +5.3% in May, although it was lower than the market estimate (+5.5%). The growth rate for HICP declined by more than 5ppt from its peak of +10.6% logged in October 2022, which was a big movement. However, people are now showing more interest in trends with core inflation.

Prices for core goods (non-energy industrial goods) rose 5.5% y/y, slowing for the fourth consecutive month. However, the growth rate for service prices came in at +5.4%, accelerating for the first time in two months (+5.0% in May), hitting a record high on a y/y basis. In the Apr-Jun quarter, HICP and core HICP grew 6.2% and 5.5%, respectively, both of which were in line with recent ECB projections. Accordingly, it is highly likely that the ECB will decide to implement a 25bp rate hike at the July Governing Council meeting, as President Christine Lagarde strongly suggested.

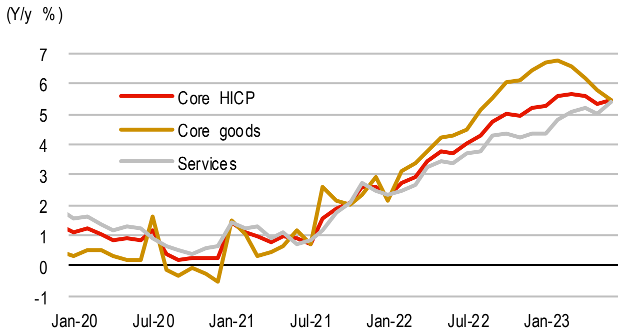
Remarks from ECB officials indicate that opinions are divided regarding the action to be taken from September onwards. However, due to further acceleration in service inflation in June HICP, the possibility appears to have increased that the terminal rate will exceed 4% due to additional rate hikes within the year (after an anticipated hike in Jul). As we discussed in our 26 June 2023 report *Risk-off emanating from Europe*, suspension of rate hikes by the ECB would necessitate greater confidence regarding service inflation subsiding via a clearer slowdown in the service sector.

Chart 1: Euro Area CPI (HICP)



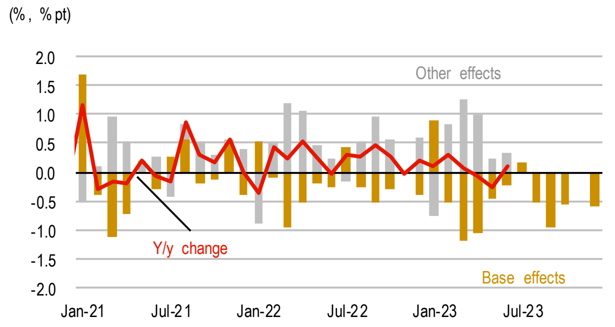
Source: Eurostat; compiled by Daiwa Securities.

Chart 2: Euro Area Core HICP



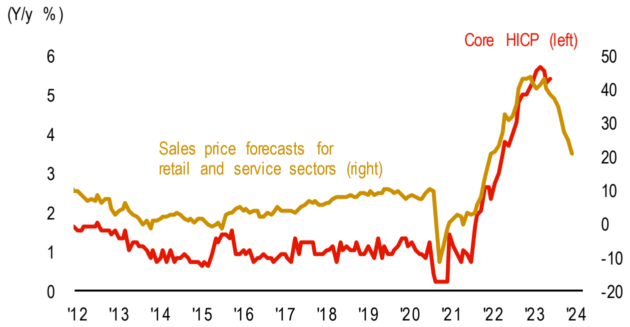
Source: Eurostat; compiled by Daiwa Securities.
Note: Core goods indicate non-energy industrial goods.

Chart 3: Monthly Trends of Y/y Change in Core HICP



Source: Eurostat; compiled by Daiwa Securities.

Chart 4: Core HICP, Sales Price Forecasts for Retail and Service Sectors



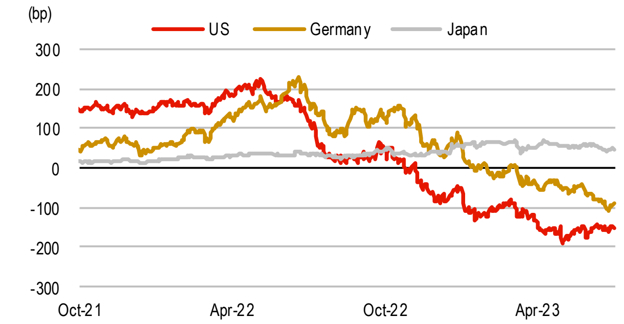
Source: Eurostat, European Commission; compiled by Daiwa Securities.
Note: Sales price forecasts for retail and service sectors are plotted 6 months into the future.

While prices remain high due to the spread of wage hikes and companies passing on higher costs onto product prices, the euro area core inflation rate is unlikely to decline that much, at least in July, partly owing to the influence of base effects, including the absence of a substantial cut in public transportation fees during Jun-Aug 2022 in Germany (Chart 3). However, thereafter the core inflation rate is expected to slow noticeably from around the end of the summer due to being pushed down from base effects, as suggested by sales price forecasts for retail and service sectors (Chart 4).

The market has already priced in two rate hikes within the year. If the ECB's terminal rate stays at 4%, the impact on German yields and the euro will be limited. However, something that is slightly worrying is the German yield curve. In Germany, inversion of the yield curve is deepening. The 2-year/10-year spread, which often attracts attention, deepened to a level not seen since 1992, which has become an issue. The spread between the 3-month and 10-year yields also deepened in excess of -100bp last week (Chart 5).

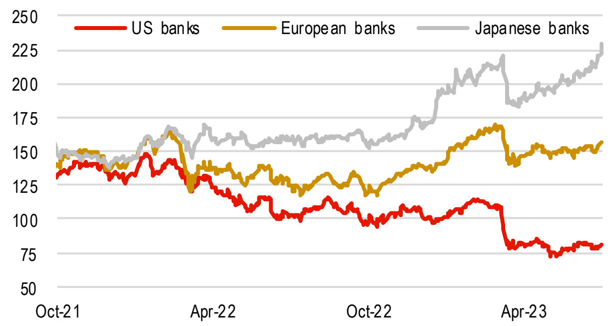
The spread between the 3-month and 10-year yields in Germany has deepened to the same level as that in the US at the time of the US bank shock in March, which is still fresh in our minds. Financial systems and rules differ from nation to nation, and the euro area has a single currency (monetary policy), so simplistic comparisons can't be made with the US. That said, the money stock (M3) in the euro area is also decreasing, similar to the US, although prices of European bank stocks are stable at the moment (Chart 6). We need to note the possibility that excessive stress on the European financial system could develop into concern about European banks.

Chart 5: Yield Curve (3M/10Y) **in Japan, US, Europe** (Germany)



Source: Bloomberg; compiled by Daiwa Securities.

Chart 6: Bank Stock Index in Japan, US, Europe



Source: Bloomberg; compiled by Daiwa Securities.

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