Truist Advisory Services, Inc.

Global Perspective from the Investment Advisory Group

The European Central Bank promises first rate hike in 11 years

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Executive summary

The European Central Bank (ECB) decided to end net asset purchases and promised a rate hike next month. The Russian invasion of Ukraine is taking a toll on European economies, inflation outlook worsened, and economic slowdown became more visible in ECB's projections. The Euro is on a path to parity with the U.S. dollar as we expect the ECB to stay accommodative for longer than the consensus estimates.

What happened

The European Central Bank (ECB) joined global central bank peers in tightening financial conditions as it announced ending its quantitative easing (QE) asset purchase program. While keeping monetary policy rates unchanged, the ECB telegraphed a 0.25% hike in July. The ECB hinted another 0.25% hike in September, and kept the door open for 0.5% increases if inflation remains persistently high. The guidance beyond September is murky in order to maintain optionality with a data-dependent approach.

The ECB accepts inflation will remain undesirably high, the current reading at 8.1% annually with the full year 2022 inflation assumption at 6.8%, followed by a decline to 3.5% in 2023. This is still much higher than the 2% inflation target. The ECB's economic growth rate assumption was downgraded to 2.8% for 2022, with further downward revisions likely as it is still above consensus. Russia's invasion of Ukraine is a significant headwind for European economies, especially for travel-oriented Mediterranean countries since minimal Russian tourist activity is expected. Energy and industrial material deficit countries like Germany or the Netherlands will also have difficulty locating new energy suppliers, creating new bottlenecks for already-strained European production lines.

The ECB is balancing between fighting inflation and maintaining stability in the periphery economies, like Greece and Italy, as rising rates will put funding pressures in those vulnerable economies. The ECB plans to use the Pandemic Emergency Purchase Program (PEPP) to mitigate dislocations in Eurozone periphery country bond markets. The central bank has been working with the region's banks for Targeted Long-Term Refinancing Operations (TLTRO). This is a key funding source for banks, and with European rates rising slower than global peers, the availability of funding via this facility is critical for the profitability of European banks.

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TRUIST

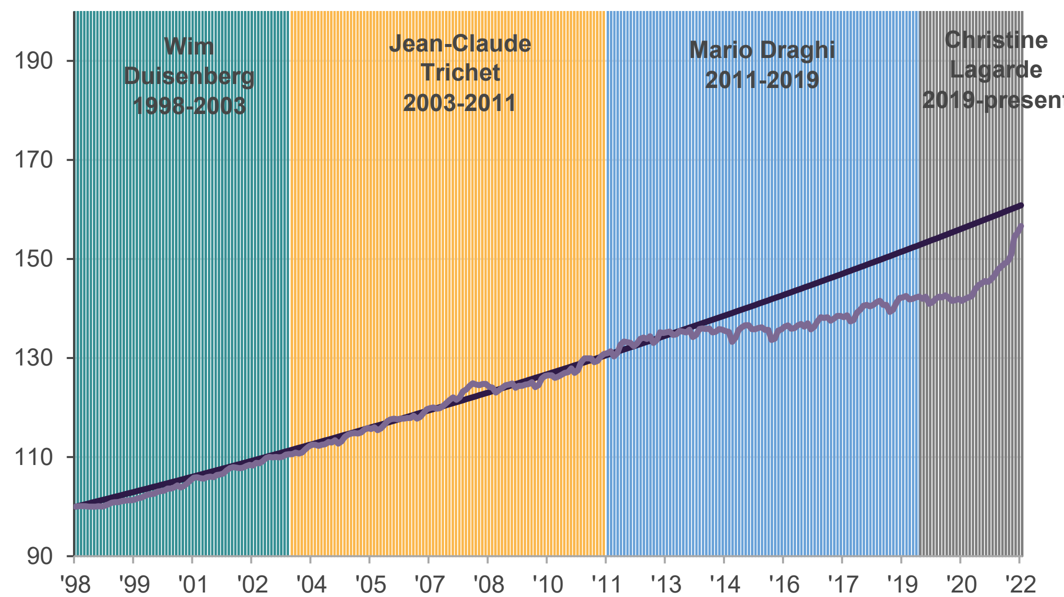
Wealth

Our take

Eurozone inflation is high but still below the historical 2% trend line

The current president of the ECB, Christine Lagarde, is the fourth ECB president since 1998. The first two, Wim Duisenberg and Jean Claude Trichet, finished their terms by staying very close to the ECB's 2% inflation target. The Eurozone faced deflation after the global financial crisis and the subsequent European sovereign debt crisis, leading to a 7% gap in inflation during Mario Draghi's presidency. Low inflation persisted during Christine Lagarde's first year, and the COVID-19 induced recession worsened the issue even worse.

Eurozone inflation and 2% inflation target (May-98 indexed 100)



Data source: Truist IAG, Bloomberg

A confluence of pandemic-related factors had shifted inflation into high gear globally at the eve of the war. Russia's invasion of Ukraine stressed Europe's reliance on Russian energy and Ukrainian food, aggravating the inflation situation even further. However, despite the recent bump in inflation, the Eurozone's long-term inflation is still below the historical 2% inflation target. This could provide a sufficient argument to keep Eurozone interest rates at accommodative levels relative to other global peers.

Europe is destined to return persistently low inflation, a.k.a. "Japanification"

Over the last two decades, Japan proved that without accelerating fiscal spending, monetary policy alone couldn't deliver higher inflation in an aging, industrialized country. Before the pandemic, Europe was stuck in a Japanese-style, low-inflation trap. Now, the hope is that inflation in Europe will stay above 2% for a period to close the gap relative to the 2% inflation trend line over the medium term. Once this cycle is over, Europe will likely return to a persistently low inflation period due to declining populations and other structural issues.

Yields are rising faster in the U.S. than in Europe

The U.S. is also dealing with persistently high inflation, and the Federal Reserve (Fed) has already hiked interest rates twice this year with additional hikes expected. This more aggressive stance relative to the ECB has kept bond yields higher yields in the U.S. relative to Germany. The euro hit a low of 1.035 euros to the U.S. dollar this year, a level very close to parity. A more robust U.S. economy could handle higher rates, but the same is not true for the Eurozone economies. The interest rate differential between the U.S. and Germany could stay elevated or continue its ascent, leading to a further drop in the euro against the U.S. dollar.

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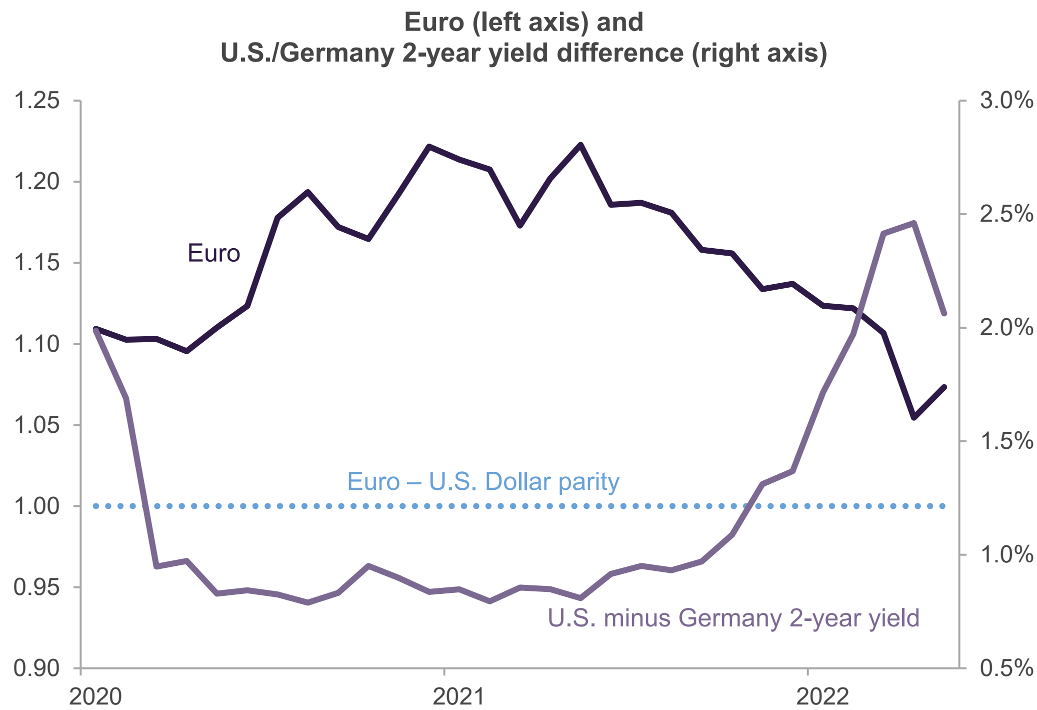

Data source: Truist IAG, Bloomberg

Markets are too optimistic about ECB's rate hike path

Based on current market pricing, the ECB's deposit rates could reach 1.50% within a 12-month period, which implies eight 0.25% rate hikes. European economies are vulnerable as they are close to the epicenter of Russian aggression. Hiking rates against a slowing economy is not an easy task. Eventually, the upcoming worsening data will convince the ECB's governing council to pause and let them re-evaluate the current situation. In 2011, after the global financial crisis, the ECB hiked rates twice, thinking the European economy could handle higher rates like the rest of the world. They regretted that decision a year later as the European financial crisis push the Eurozone into an existential crisis. Things have improved significantly since 2011; Europe showed admirable solidarity, especially while crafting a response to mitigate the pandemic-related slowdown. Nevertheless, Russia as a pariah state in the middle of Europe complicates the potential growth outlook of Europe for many years to come. To stay competitive, Europe will need a relatively cheap currency, and the ECB could deliver that by keeping rates below global peers.

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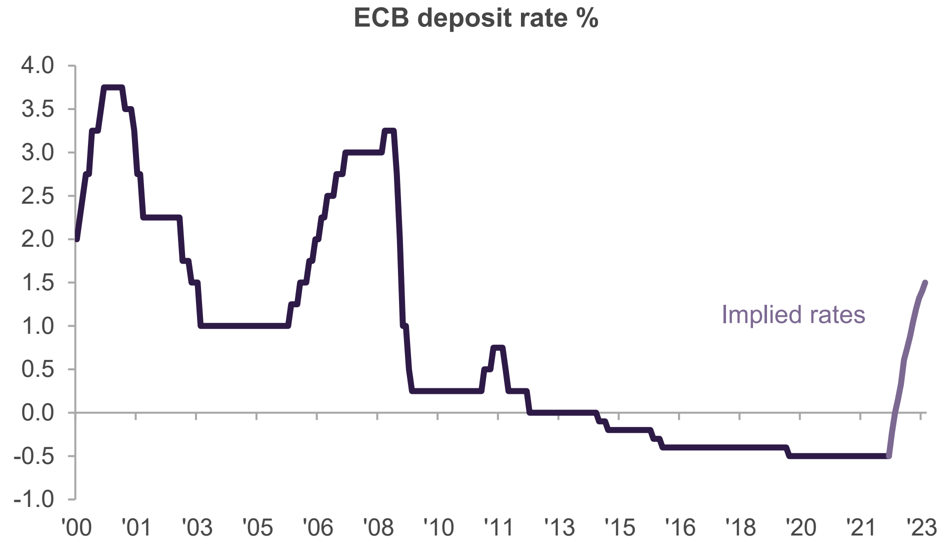

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Bottom line

Stronger economies can handle higher rates, and higher rates usually attract more foreign capital. It is hard to envision that the conflict in Ukraine has any positive impact for Europe's economic outlook. As the implied rates of Europe catch up to the reality of a worsening economy, and as the U.S. continues to have a stronger outlook relative to its European peers, the euro would continue its path to parity with the U.S. dollar. In short, we expect the ECB to let inflation run hotter than the long-term 2% target and stay accommodative for longer than the consensus estimates.

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