Truist Advisory Services, Inc.

Global Perspective from the Investment Advisory Group

ECB hiking rates aggressively into a slowing economy

Sept 9, 2022

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Executive summary

Due to high inflation readings, the European Central Bank (ECB) was forced to hike policy rates for the second time this year, this time 75 basis points (bps). The bank also hinted that more hikes are in the offing. The ECB has been playing catch-up with the Fed but will likely fail as the economic momentum of the Eurozone economies is deteriorating quickly. Rate differentials, a worsening energy crisis, and related recessionary pressures will push the Euro even further down against the U.S. dollar; we expect an exchange rate of 90 cents to the Euro within the next 12 months.

What happened

The European Central Bank (ECB) raised its policy rate by 75-bps from zero percent to fight runaway inflation. The last time the ECB raised policy rates by 75-bps was in 1999, before the launch of the common currency, so technically, this is the largest increase while the currency is in everyday use. The ECB's action matched the Fed's last move, and ECB President Christine Lagarde noted that policy rates might move higher than normal at the next several meetings. The rate hike is the second consecutive increase by the bank.

In Europe, surging energy prices crippled energy-heavy businesses, like aluminum smelters and fertilizer producers. The central bank acknowledged that the Eurozone economy would stagnate later in the year and reduced its 2023 GDP growth outlook to 0.9% from 2.1%, still too optimistic compared to consensus estimates. The inflation outlook for 2022 was revised up to 8.1% from 6.8%, and the region's inflation is expected to stay above the ECB's mandate of 2% until 2025. Current annual inflation is at 9.1%.

To avoid dislocations in peripheral sovereign bond markets, like Italy, Greece, or Spain, the ECB will continue to reinvest maturing bonds and related cashflows disproportionately where the bank deems necessary.

After the rate decision and relatively hawkish Q&A session, the Euro climbed above parity briefly against the U.S. dollar and yields for short-term maturities rose with the expectation of a higher rate hike path, while longer-term maturities rose less with the expectation that inflation will be under control eventually.

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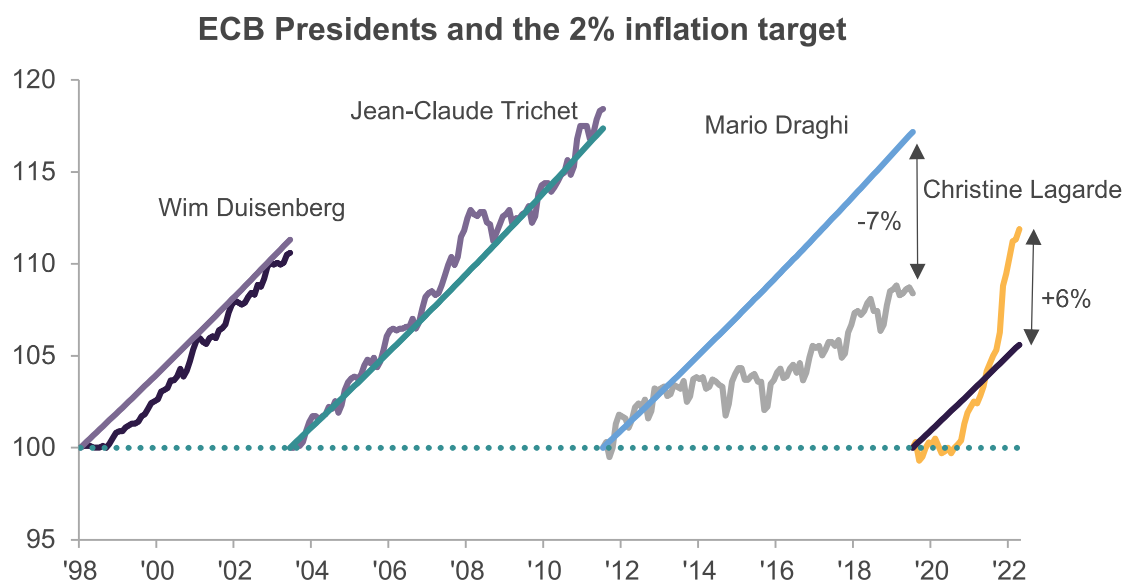
Our take

Isabel Schnabel and the hawkish wing of the ECB

ECB President Christine Lagarde holds significant sway in the bank's decision-making. Still, Isabel Schnabel, the German representative in the governing council of the ECB, has equal importance. When she speaks, people listen. When she spoke at the Jackson Hole gathering of central bankers in favor of a forceful ECB action, a 75-bps hike at the next ECB meeting was what she meant. The hawkish wing of the ECB is now in control. They may continue to push hard until inflation comes to sensible levels.

Inflation is way above the 2% mandate

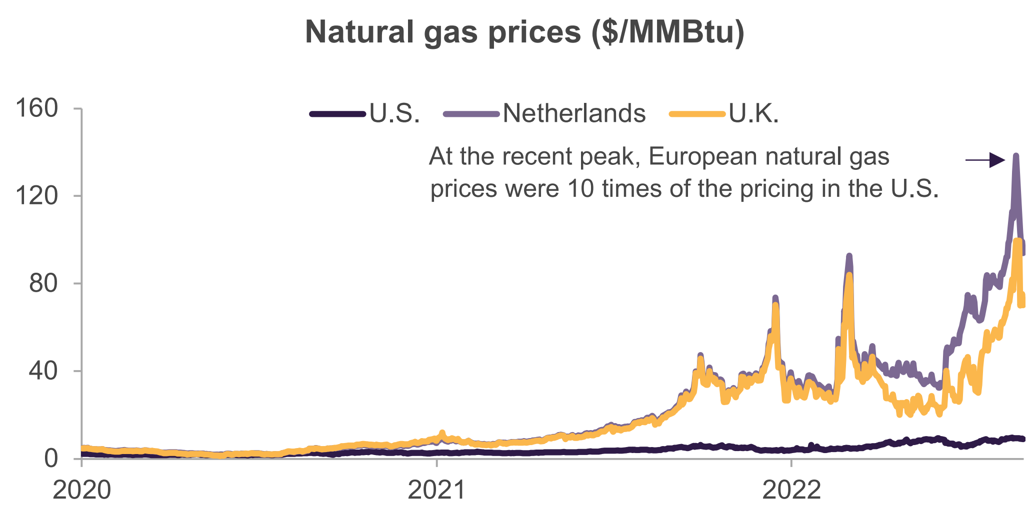
Since 1998, we have had four ECB presidents. The first two, Wim Duisenberg and Jean Claude Trichet finished their terms by staying very close to the ECB's 2% inflation target. After the global financial crisis and the subsequent European sovereign debt crisis, Eurozone inflation stalled in a lower gear, leading to a 7% gap in inflation during Mario Draghi's presidency. Current annual inflation is at 9.1%, and since the start of Lagarde's presidency, the cumulative Eurozone inflation is 6% higher than the 2% mandate trajectory. She has no choice but to agree with the hawkish camp within the ECB's governing council.



Data Source: Truist IAG, Bloomberg

An energy crisis last seen in 1970s

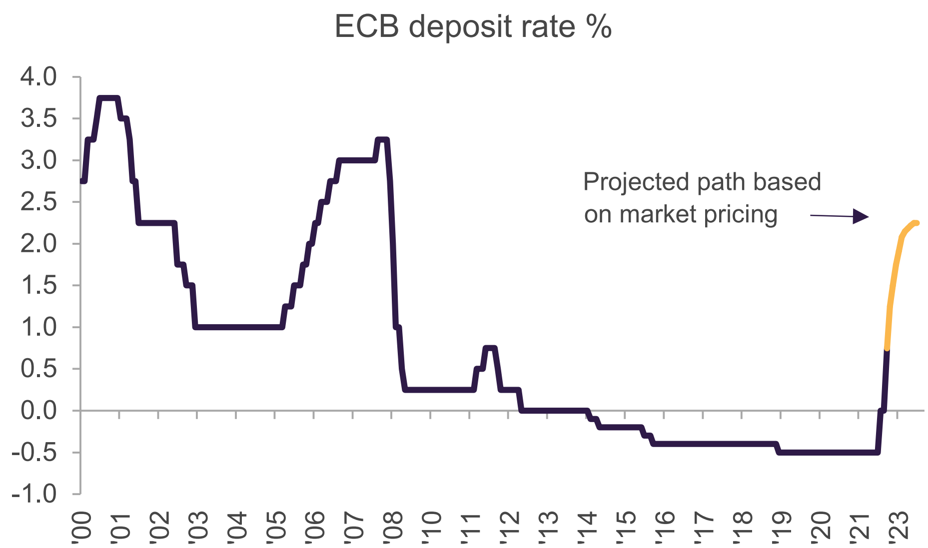
European natural gas prices hit all-time highs above €343 ($100 per million British thermal units). European gas pricing are roughly ten times higher than in the U.S.; however, limited LNG (liquid natural gas) export capacity in the U.S. is limiting U.S. exporters' ability to capture the price differences between the two continents. This energy crisis is significantly different from the previous crises we experienced during the 1970s, as the curtailed energy is delivered via pipelines to Europe in the form of natural gas. Therefore, even though the global pricing of natural gas has increased, the increases in Europe have been disproportional. It is hard to predict when Putin's war in Ukraine will end, but sanctions against Russia and Russia's reaction against western sanctions will not end anytime soon. Analysts argue that the energy price cap will eventually bring inflation down. Indeed, that is a possibility, but this is the first time we are experiencing an event like this, and a corresponding action related to it. Capping prices could lead to higher consumption of energy, creating an unlimited exposure to already strained government budgets. Non-energy related consumption and therefore, prices could rise if consumer budgets are shielded from energy related increases.



Data Source: Truist IAG, Bloomberg

The ECB will throw in the towel against the Fed

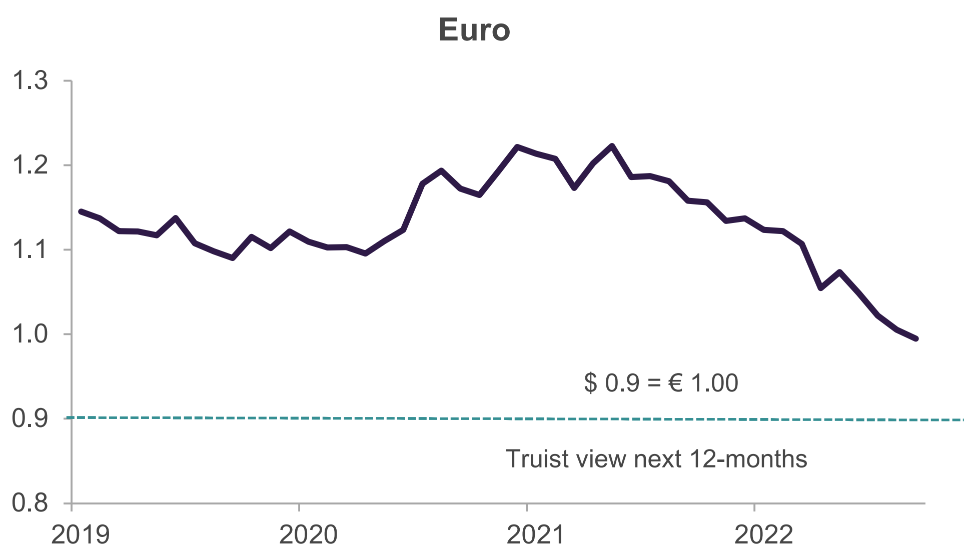
Demand destruction or a significant drop in energy prices will bring inflation down in Europe, not the ECB's interest rate hikes. Currently the market is pricing that policy rates will rise to 2.25% before next summer and will flatline after that. With rates rising this fast and the European energy crisis expected to reach its pinnacle during the winter months, the ECB will soon realize that they cannot raise rates in an economy already in recession. Economic momentum in the U.S. is much stronger than in Europe. Therefore, the Fed may continue with rate hikes while the ECB pauses to give breathing room to the stressed economy. Thus, the ECB will throw in the towel sooner and will not be able to match the Fed's future rate hikes.



Data Source: Truist IAG, Bloomberg

We expect Euro to lose value against U.S. dollar for another year

Three main factors are pushing the Euro down: (1) the energy crisis is disproportionately affecting Europe; (2) the interest rate differential between the U.S. and Europe, we believe, will widen as we go through the winter months; (3) the global slowdown affects European exports. Historically, Europe is an export-oriented region, especially Germany. Germany's monthly trade balance has been down eight consecutive months due to higher energy prices, bottlenecks created by the energy crisis, and lower external demand for European products. The trend in these three main factors is expected to stay intact unless there is a meaningful peace deal between Ukraine and Russia. Even if that is the case, it could take many years to reestablish a business relationship with Russia.



Data Source: Truist IAG, Bloomberg

Bottom line

With inflation running at 9.1%, the ECB had no choice but to go with an outsized policy rate hike. The looming energy crisis and slowing global economy will take a toll on European economic activity. A prolonged energy crisis could push Europe into a deep recession that could force the ECB to halt its rate hikes. The Euro still looks vulnerable even with this outsized rate hike and a hawkish stance. Therefore, we continue to recommend an underweight position in overseas equities, especially in Europe.

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CN2022- 4942658.1 EXP 09-2023

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