Morning Comment

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AFS Insights

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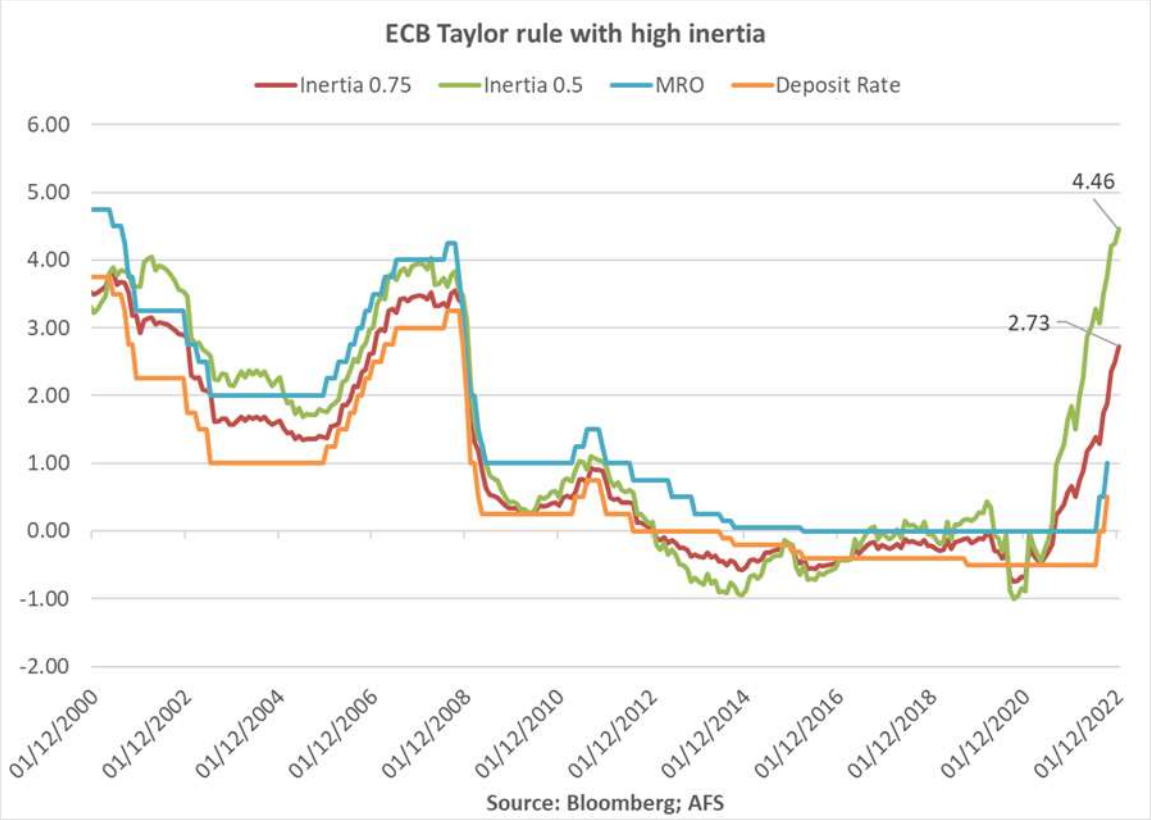
Headline Sweep

- Lindner Wants Binding EU Debt-Reduction Targets: Handelsblatt
- Fed's Daly Sees 50-Basis-Point Hike as Most Likely in September
- China begins 'unprecedented' military drills around Taiwan
- Pelosi Stares Down Xi Threats, Giving China a Reality Check

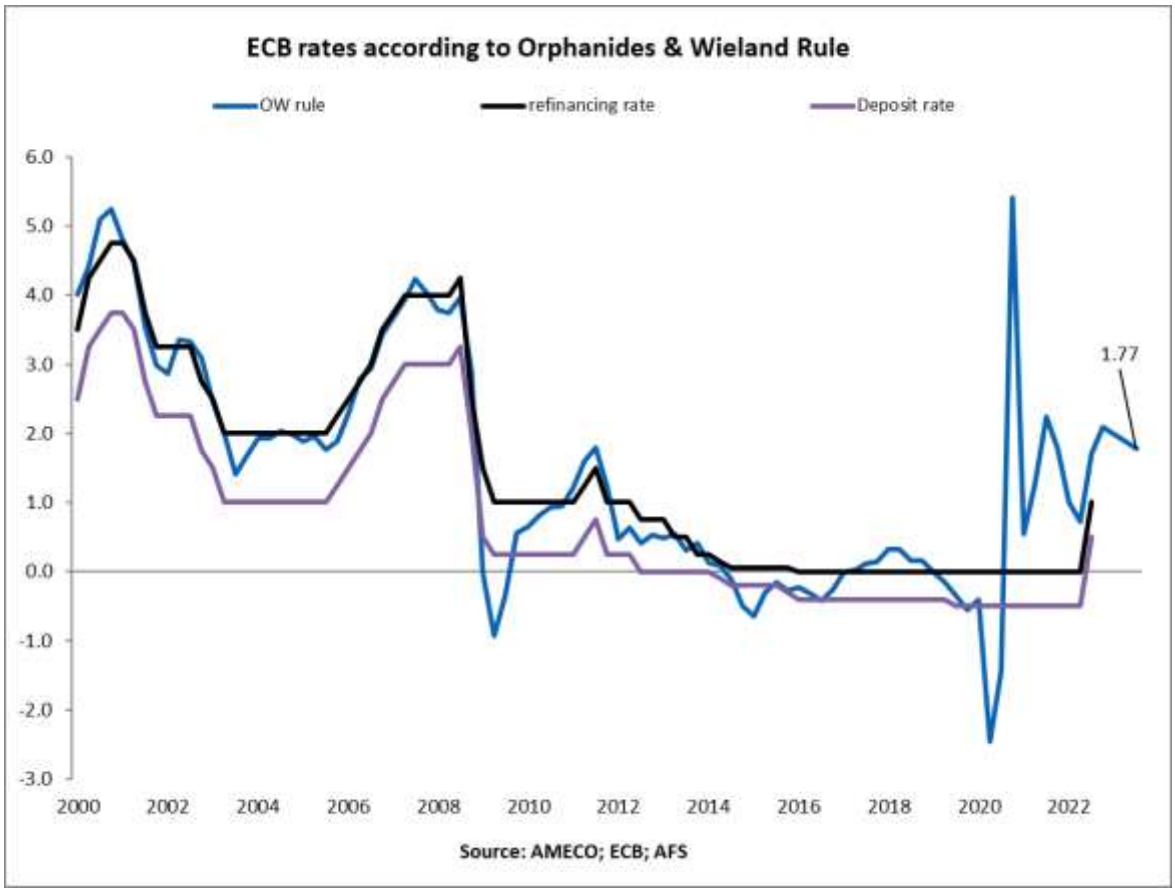
2008 and 2011 Redux

- **It is not an understatement when we say that ECB pricing has come back down to earth.** At the peak of the bond/rates market tantrum in June, the cyclical peak in forward pricing for the current business cycle[1] was an ECB deposit rate of about 2.5 percent. At the time of writing, the cyclical peak for ECB forward pricing was slightly more than a percent. Which – by accident or not – happens to be bang in line with our own call. Since the June ECB meeting, we resolutely stuck with a call of 150bps in rate hikes this year. We dared not make forecasts for 2023 because we felt there was nothing to work on to make forecasts that far out. Too much guesswork if you will. In any case, so far, 50bps of our call for 150bps in hikes for 2022 have been realized. We're certain another 50bps will be realized. But we starting to get doubts about the final 50bps. And especially the last 25bps.
- **Current market pricing and our own call (they mostly align at this point in time) are at stark odds what models tell us ECB rates should be.** ECB-watchers rely on two rules of thumb when making calls for the central bank rate: the well-known Taylor rule; and the (far) less well-known Orphanides-Wieland rule.[2] Regarding the former, we use short-term forecasts instead of actual readings of core inflation and unemployment as inputs. The chart below shows prescribed ECB rates according to our slightly modified Taylor rule. Note that 'inertia' is a factor for central banks' lagged response to changes in unemployment and inflation. The high inertia model, which has the best historical fit with ECB rates, prescribes an ECB rate of 2.73 percent by year end:

[1] For the purpose of defining the longevity of the business cycle, we looked at forward periods of up to two years ahead. Forward periods of 18 months and 2 years ahead both peaked at 2.5 percent.
[2] The rule is named after its inventors: the German professor and OG ECB-watcher Volker Wieland; and former Cypriot central bank President Athanasios Orphanides.



- **Inputs for year-end pricing are unemployment of 6.6 percent and core inflation of 4.2 percent and the ECB raising the deposit rate to 1.0 percent by December as per our current forecast.** The core inflation forecast is based on the assumption that it will continue to rise at its current pace (so, no slowdown in month-on-month increases, basically). Unemployment is a rather inert variable – it doesn't move much over the course of several months.
- **Our reading of the tealeaves is that no one in the ECB Governing Council – not even unrepentant hawks like Austrian central bank chief Holzmann – are dreaming of a 2.75 percent deposit rate by year-end.** And even if we assume a slowdown in core inflation – a year-end reading of 3.6 percent as per ECB-collected consensus – we arrive at a deposit rate of 2.25 percent to 2.50 percent. Which is still far north of both market pricing and what we perceive to be ECB preferences. So, the (modified) Taylor Rule, which has been pretty useful during the first half of the year, no longer appears to be much of a guide to near-term ECB policy. But what about that other rule, the Orphanides-Wieland rule (OW-rule for short)?
- **The OW-rule uses forecasts and not actual data as inputs by design.** It can forecast the ECB rate up to 12 months ahead. Inputs are the 1-year and 2-year ahead forecasts for headline inflation and GDP taken from the ECB's quarterly Survey of Professional Forecasters. Note that 1-year and 2-year ahead forecasts are different than conventional full year forecasts (i.e. 2022, 2023 etc.). The 1-year and 2-year ahead forecasts are forecasts for inflation/GDP in the 1-year/2-year period starting in the quarter the survey was taken.
- **The chart below shows the prescribed ECB rate according to the OW-rule:**

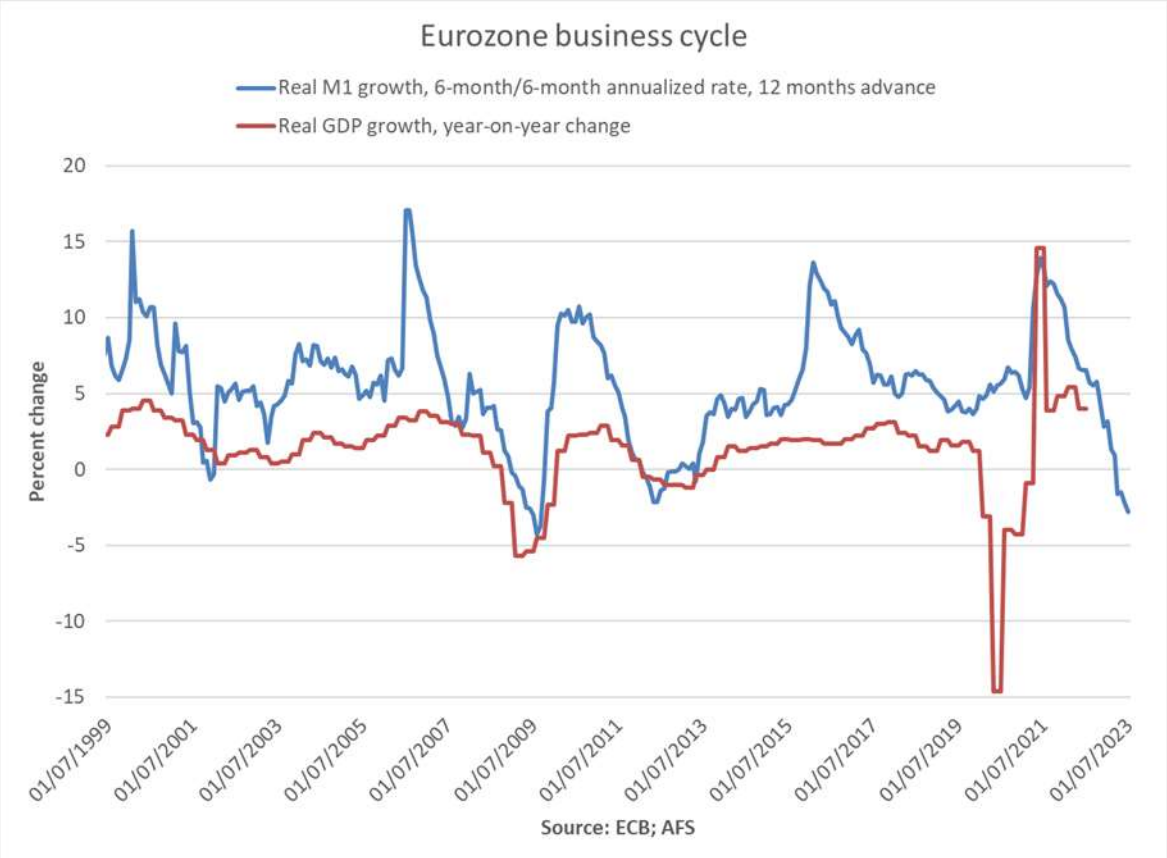


The Covid shutdowns pulled a number on the OW-rule. Since 2020 the model outcomes have been all over the place and substantially higher than actual ECB rates. Having said that, by the early spring of 2021, the model consistently called for higher ECB rates (about six months before our Taylor rule did). And a *mea culpa*: in 2021 we paid too little or no attention for too long to what our own models were telling us with regards to ECB rates. Years of negative rates and the failed ECB hikes of 2008 and 2011 had made us complacent. In any case, the current prescribed rate of 1.77 is not that far off from market pricing and perceived ECB preferences.

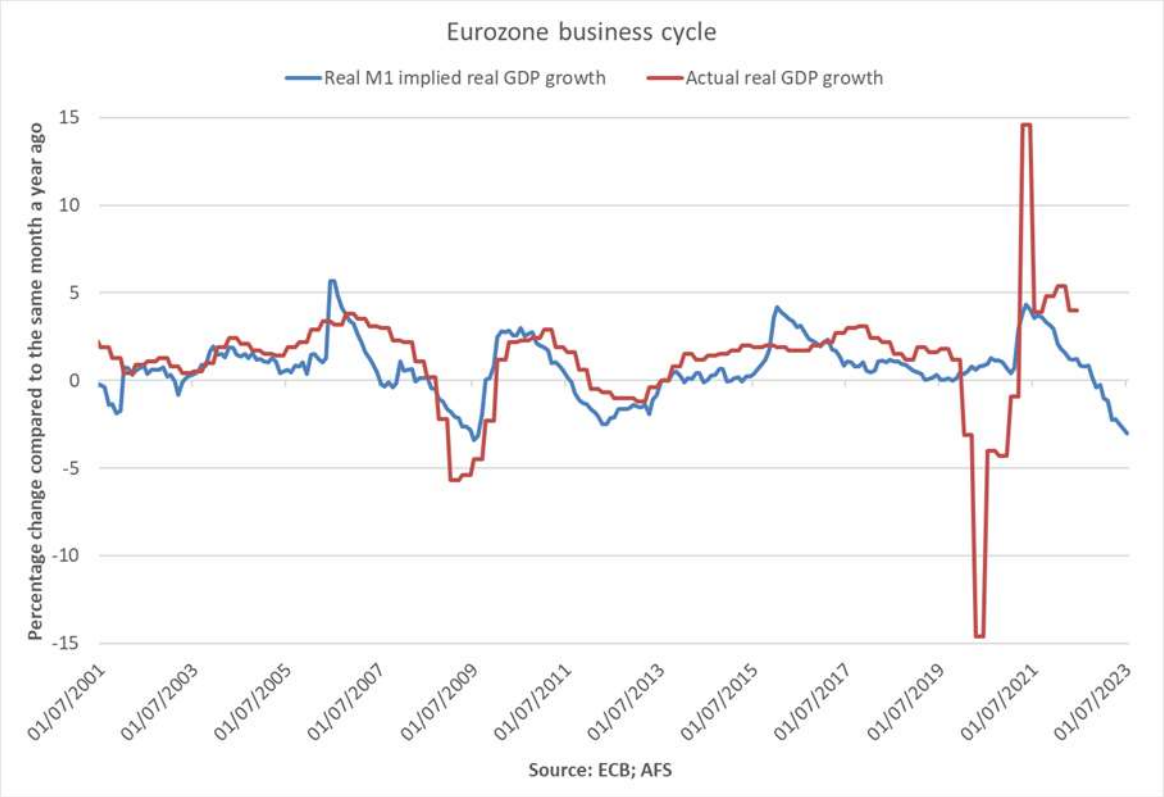
- **So, the OW-rule prescribes a terminal ECB rate of 1.77**. The Taylor suggests a rate that is a full percentage point higher. The difference between the Taylor rule and OW-rule model outcomes can be explained as follows: the latter takes into account expectations of inflation easing. The latest 1-year ahead forecast for inflation stands at 3.6 percent[3] while 2-year ahead stands at 2.2 percent. Then again, neither rule takes into account a recession in the Euro Area, which – as we will show below – is now extremely likely. Regarding the Taylor rule, a 6.6 percent unemployment rate, the lowest level ever, suggests that the economy will not experience a recession during the forecast horizon. The GDP forecasts for the OW-rule are 1.0 percent growth between the second quarter of 2022 and the second quarter of 2023; and 1.7 percent growth between the second quarter of 2023 and the second quarter of 2024. So, a year of below trend growth but no recession. And a return to slightly above potential growth over the course of 2024.

[3] This is the inflation forecasts for the Q3 2022/Q3 2023 period. And in case of 2-year ahead Q3 2023/Q3 2024.

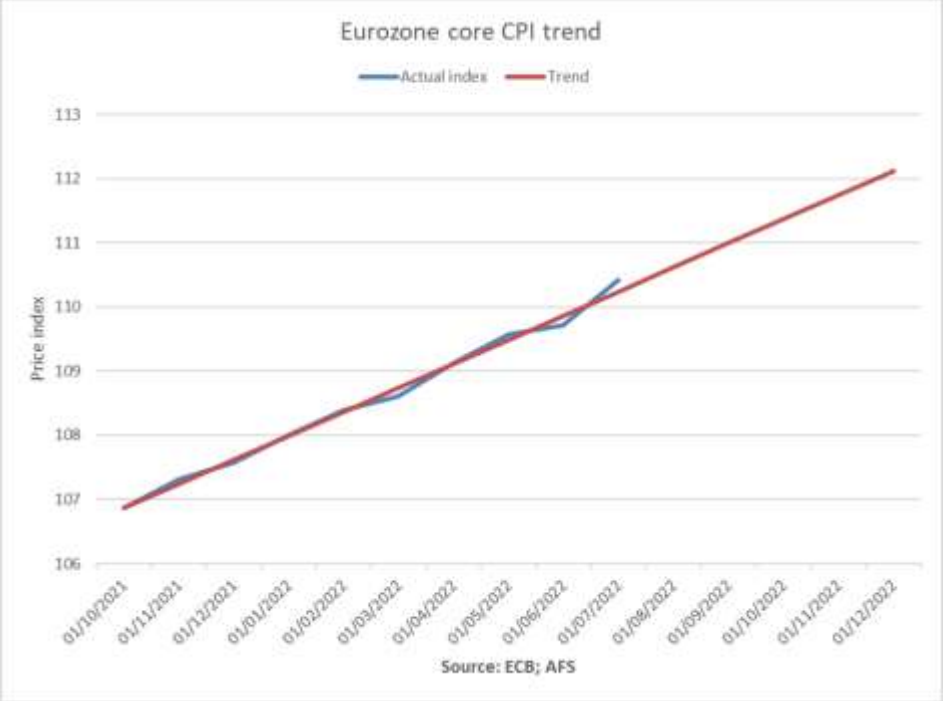
- **Recession talk and recession calls for the Euro Area have become increasingly prevalent because of the war and the resulting energy crisis**. While US firms and households experience higher energy prices, we have exorbitantly higher energy prices *and* energy shortages. Take German spot electricity prices, which have increased by more than 400 percent over the past twelve months. Large swathes of German industry are uneconomical when such prices persist.
- **In the wake of the outbreak of the war we postulated that without Russian gas, the German economy will enter a recession.** A not so difficult call to make, mind you. And, given Germany's size, it will likely take down the rest of the Eurozone with it. Now, Russian gas flows may continue at very low levels or stop altogether – we simply assume the gas/energy situation in Europe will remain critical for as far as the eye can see. So, recession inducing. However, when we venture to the energy situation in Europe, we are stepping out of our comfort zone. The European energy market clearly is outside our reservation. Which begs the question: are there better ways to call a recession or not? The answer is a full-throated yes.
- **When it comes to forward-looking indicators and recession calls, in case of the US we can simply take our cue from the shape of the Treasury yield curve**. In the Eurozone we have something similar but different, namely money supply data. M1 money supply deflated by the consumer price index – or Harmonized Index of Consumer Prices – has an excellent track record when it comes to flagging turning points in the Eurozone business cycle 12 months in advance. Even the ECB has taken notice of the predictive power of real money growth.
- **The chart below shows real M1 growth and real GDP growth**. Both are charted on an annual basis, that is compared to the same quarter a year ago:

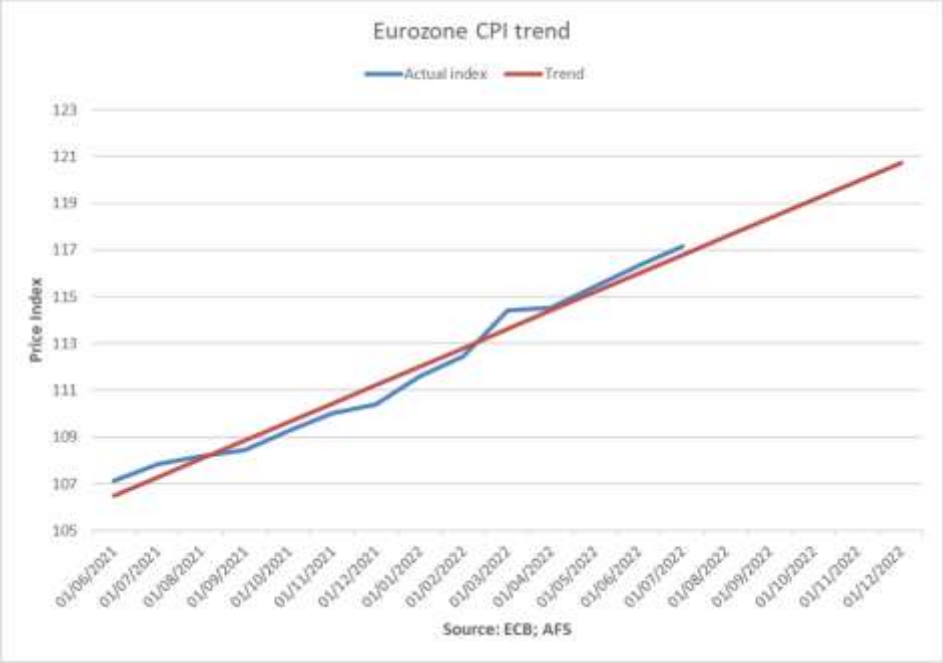


- **Note that we used a 6-month/6-month annualized percentage rate of change instead of the conventional year-on-year percentage change for real M1**. That's because the former picks up turning points slightly sooner. Furthermore, notice that every time real M1 growth turns negative, the Eurozone business cycle takes a turn for the worse. In 2000 we had slightly negative real money growth. And the Eurozone narrowly avoided a negative GDP print, though unemployment rose strongly in 2001 and subsequent years. Negative real M1 correctly predicted the 2008-2009 and 2011-2013 recessions. The current reading is the most negative reading since the financial crisis of 2008 and subsequent recession.
- **We can use a regression to estimate real GDP growth 12-months ahead based on real M1 growth**. The model doesn't predict the Covid-recession, but we do not consider that a problem because the pandemic was a truly one-off exogenous shock.

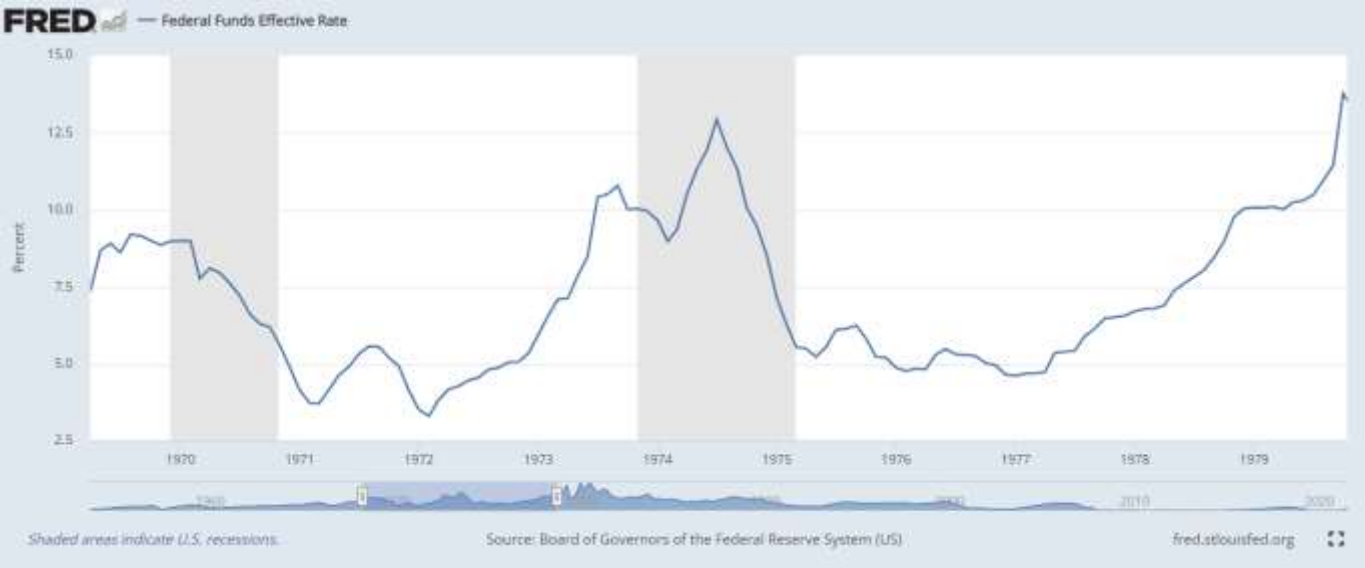


- **The model suggests GDP will start to print negative next winter**. Which confirms the notion that the nexus of the energy crisis, high inflation and tighter monetary policy will push the Eurozone into a recession by the winter. Which begs the question: what is the ECB going to do when a new recession hits the Eurozone economy? Cut rates, probably. In each recession since the Euro's inception, the ECB cut rates. But what about the elephant in the room: inflation? Does persistently high inflation foreclose rate cuts?
- **Let's get this out of the way about inflation first**. There has been no improvement at all in the inflation data, as we will show. The charts below show the consumer price index and the core price index (the index, not the percent change in the index). The current trajectory implies an 8 percent annual rate of headline inflation and a 4 percent annual rate of core inflation:





- **Surprisingly, similar stagflationary conditions didn't prevent the Federal Reserve from cutting rates during the 1973 oil crisis, which broke out in the autumn of the year:**



- **Note that oil prices never returned to pre-1973 levels.** And the Fed cut rates despite excessively high inflation:

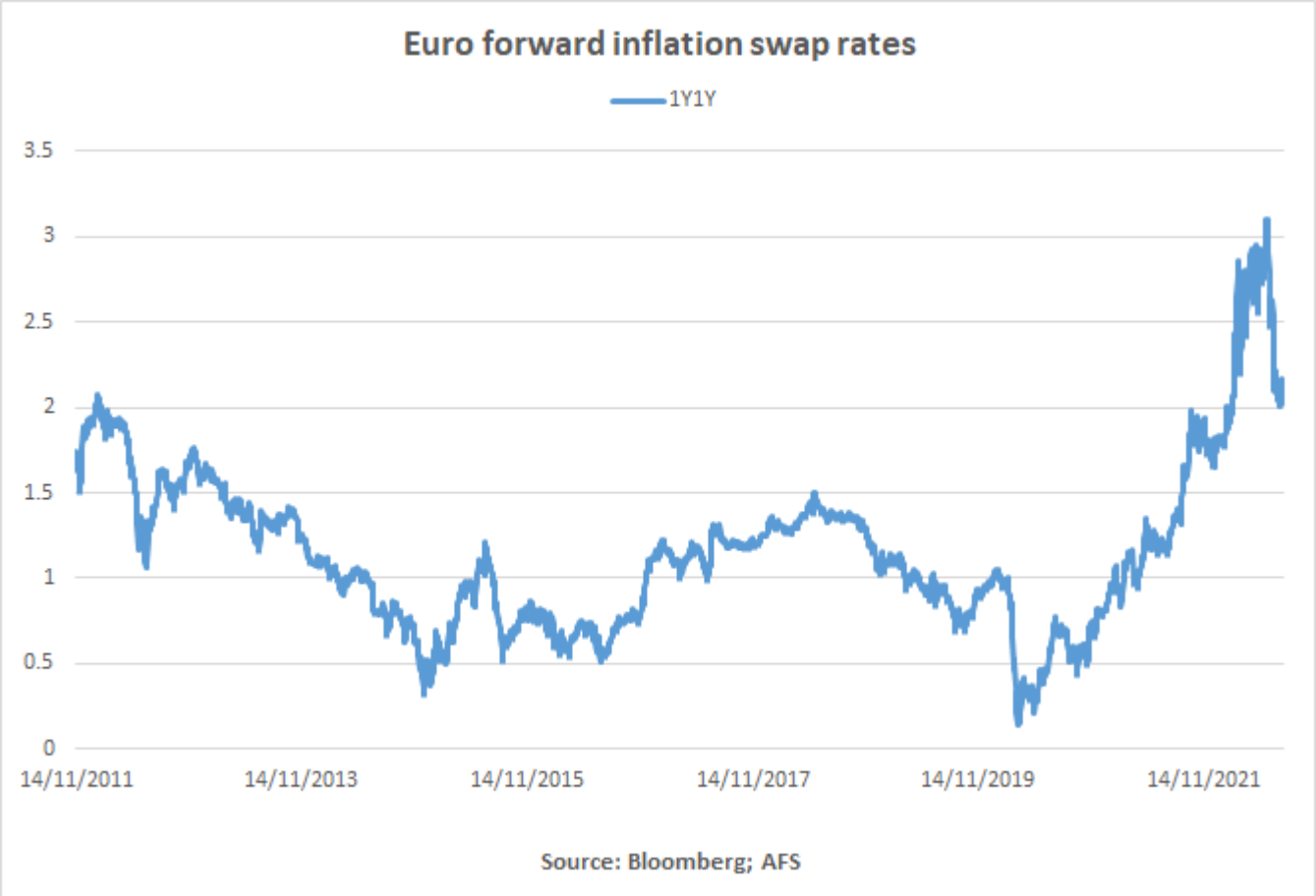
- **It was not just the Fed that cut rates.** Even the Bundesbank did:

Discount and lombard rates of the Bundesbank and special inte charged for failing to comply with the minimum reserve require

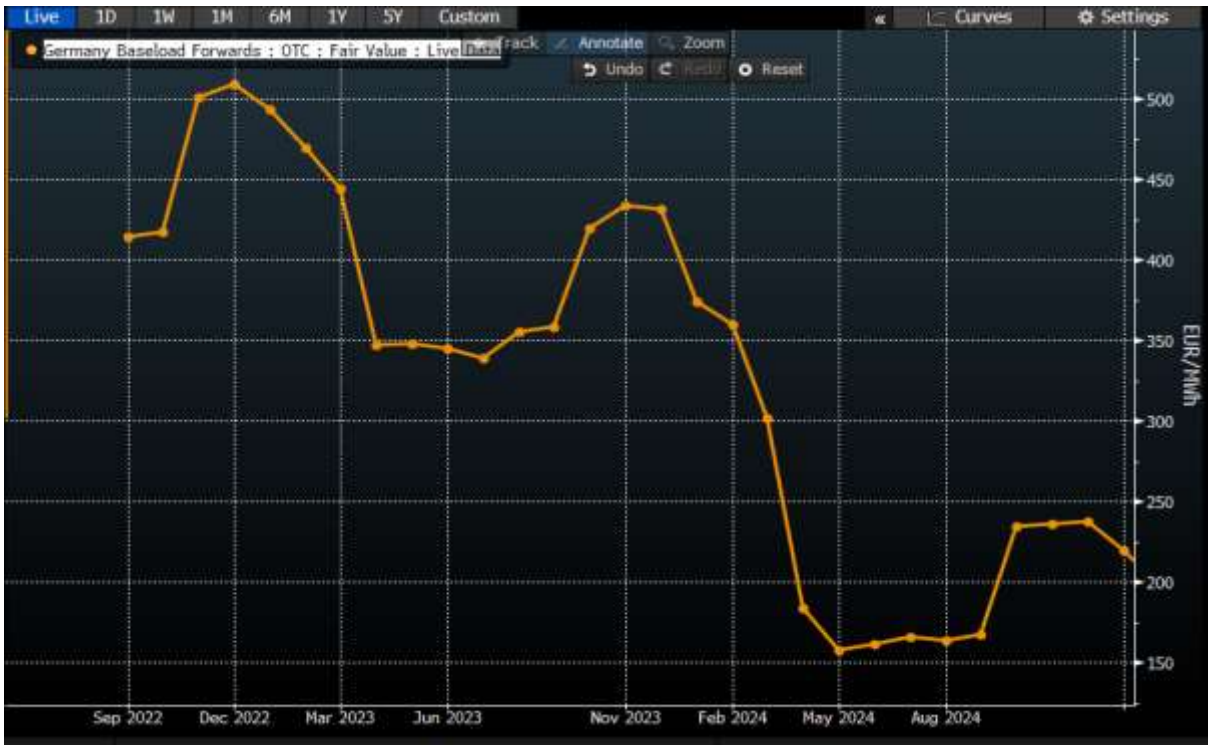
% per annum

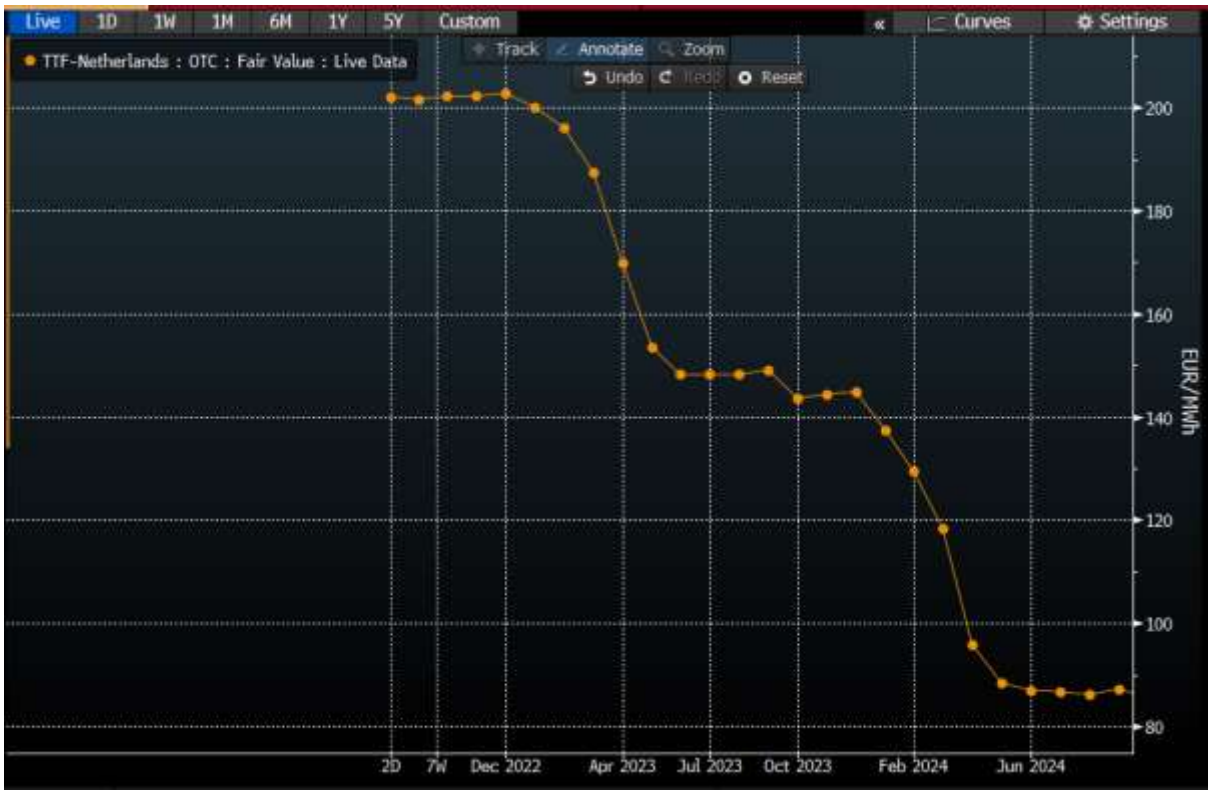
Applicable from	Discount rate [1]	Lombard rate
1948 July 1	5	6
1949 May 27	4 ½	5 ½
July 14	4	5
1950 Oct 27	6	7
1952 May 29	5	6
Aug 21	4 ½	5 ½
1953 Jan 8	4	5
June 11	3 ½	4 ½
1954 May 20	3	4
1955 Aug 4	3 ½	4 ½
1956 Mar 8	4 ½	5 ½
Apr 19	5 ½	6 ½
May 6	5	6
1957 Jan 11	4 ½	5 ½
Sep 19	4	5
1958 Jan 17	3 ½	4 ½
June 27	3	4
1970 Mar 9	7 ½	9 ½
July 16	7	9
Nov 18	6 ½	8
Dec 3	6	7 ½
1971 Apr 1	5	6 ½
Oct 14	4 ½	5 ½
Dec 23	4	5
1972 Feb 25	3	4
Oct 9	3 ½	5
Nov 3	4	6
Dec 1	4 ½	6 ½
1973 Jan 12	5	7
May 4	6	8
June 1	7	9
Nov 26	7	4 13
1974 Jan 12	7	9
Mar 14	7	4 13
Apr 9	7	9
May 28	7	4 10
July 4	7	9
Oct 25	6 ½	8 ½
Dec 20	6	8

- **Granted, this was the world before formal 2 percent inflation targets**. But it was also a world with strong unions, wages that were often indexed to inflation, no offshoring, and low debt levels. Then again in the present world of high finance, inflation swap markets suggest a year from now inflation will be back to benign levels:



- **And that's also the message from power and gas markets.** Prices will stay high in the near term before easing over the course of 2023 and 2024 if one takes forward pricing at face value:





Note the direct contribution of energy prices to inflation stops when they have reached a peak. And when prices fall, they have a strong disinflationary effect.

- **We forecast that by the end of the year, the onset of a recession will force the ECB to end the rate hike cycle prematurely.** If past precedent is any guide – the ECB has eased policy in response to every recession – and if inflation swaps, power and gas prices are remotely in the ballpark, the ECB will then reverse course completely because of the disinflationary tendencies on the horizon. This translates to the following forecast. We no longer see a December hike of 25bps. We still see a 50bps hike in September, followed by a 25bps hike in October. The ECB will need about six months to turn the ship around, meaning that we're looking at a May or June 2023 first rate cut. A low nominal policy rate – a deposit rate of 75bps – means that the ECB's room for maneuver is limited. We're thinking of 25bps rate cut increments. The deposit rate will go back to zero, but probably not go negative again. Regarding unconventional tools, we haven't made up our minds on the matter of new TLTROs or a resumption of QE. Suffice to say, the ECB will continue to reinvest QE proceeds fully. There will be no Quantitative Tightening.
- **Forecasting is highly contingent.** And pretty difficult. And that's an understatement. There is a saying about forecasting and astrology… we're not going to repeat it here. Every forecaster knows that saying by heart. Disclaimers aside, our forecast is contingent on no lasting stagflation. We expect a traditional recession: demand falls more than output, and to bring demand and supply into balance prices will have to adjust. So, a disinflationary recession. But it might be a while before such disinflation appears in the data. However, too high inflation readings didn't stop the ECB from cutting rates in the second half of 2008 and in late 2011.
- **The recession call is based on the real M1/real GDP relationship**. We believe that the current economic expansion has been fatally wounded. We see no realistic

way for the Eurozone economy to be pulled back from the brink: the ECB won't change course in time and the war and energy situation – suffice to say, we expect no *Deus ex Machina*.

- **Nominal money supply growth, which the ECB directly controls with asset purchases and indirectly through manipulating the banking system, has slowed sharply since the spring.** The ECB's latest Bank Lending Survey suggest bank lending and deposit growth will slow further in the second half of this year. That by itself is disinflationary. However, despite the disinflationary trends in bank lending and money supply growth, inflation has accelerated since the spring. The increase in inflation is the result of an increase in money velocity. Or put differently, a decline in money demand. If velocity continues to increase, inflation will not subside. In that case, the ECB might not be in a position to abort the tightening cycle later this year. In fact, the ECB might even to have raise rates more aggressively compared to our forecast and compared to its own preferences. Think of the Taylor rule and Orphanides-Wieland estimates that we discussed earlier. The double whammy of higher inflation and higher rates will topple the economy like it did during the 1970s energy crises. But we're looking at a longer and steeper ECB rates path and a delay of the easing cycle.
- **On a final note, we take note of market pricing of Fed rate cuts in the (late) spring of 2023.** Pricing of rate cuts has become quite firm, meaning that such pricing is highly likely to be realized. The market takes no prisoners in this regard. However, our ECB call isn't based on the notion that Fed easing will force the ECB to do the same, or anything along these lines. It's just that we see a recession in the US as a mid-2023 story, while the Eurozone is likely to enter a recession much sooner. And that the recession will be traditional in the sense that the ECB starts the rate hike cycle on the eve of the recession (just like it did in 2008 and 2011) and that the recession will be sufficiently disinflationary for the ECB to embark on rate cuts.

Calendar

TIME	REGION	EVENT	PERIOD	CONSENSUS	PRIOR
09:30	Germany	S&P Global Germany Construction PMI	Jul	--	45.9
10:00		ECB Publishes Economic Bulletin			
10:30	UK	S&P Global/CIPS Construction PMI	Jul	52.0	52.6
10:30	Spain	Sells Bonds			
10:50	France	Sells Bonds			
13:00		Bank of England Bank Rate	Aug/04	1.75%	1.25%
13:30	UK	BOE Governor Bailey press conference			
14:30		Czech National Bank Interest Rate Decision		7.13%	7.00%
14:30	US	Trade Balance	Jun	-$80b	-$85.5b
14:30	US	Initial Jobless Claims	Jul/30	260k	256k
14:30	US	Continuing Claims	Jul/23	1383k	1359k
15:00	Russia	Gold and Forex Reserve	Jul/29	--	567.0b
18:00		Fed's Mester Discusses the Economic Outlook			
		Federal Reserve Weekly Balance Sheet			

Consensus data: Bloomberg News; All Times Are in Central European Time