Morning Comment

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AFS Insights

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Headline Sweep

- RBA's Lowe Says Case for Large Hikes Diminished as Rate Climbs
- Summers Expects Fed to Raise Rates Above 4.3% to Curb Inflatio
- Texas sends migrants to vice-president's Washington residence

Overnight/Day Ahead Comment

- **Meanwhile in markets, we have almost perfect picture of the proverbial hammer hitting the anvil soon**. With inflation disappointments stacking up, and the last central banker doves turning into hawks, the stronger and more lasting the inversions in yield curves. Or in plain English: recession pricing is all around us.
- **Take the US 2y10y spread, which plunged back to the mid minus 40s in the wake of the US CPI release.** We're now at 58 days of an inverted curve in this spread, with a large max inversion and an equally sizeable average inversion:

2y10y inversion

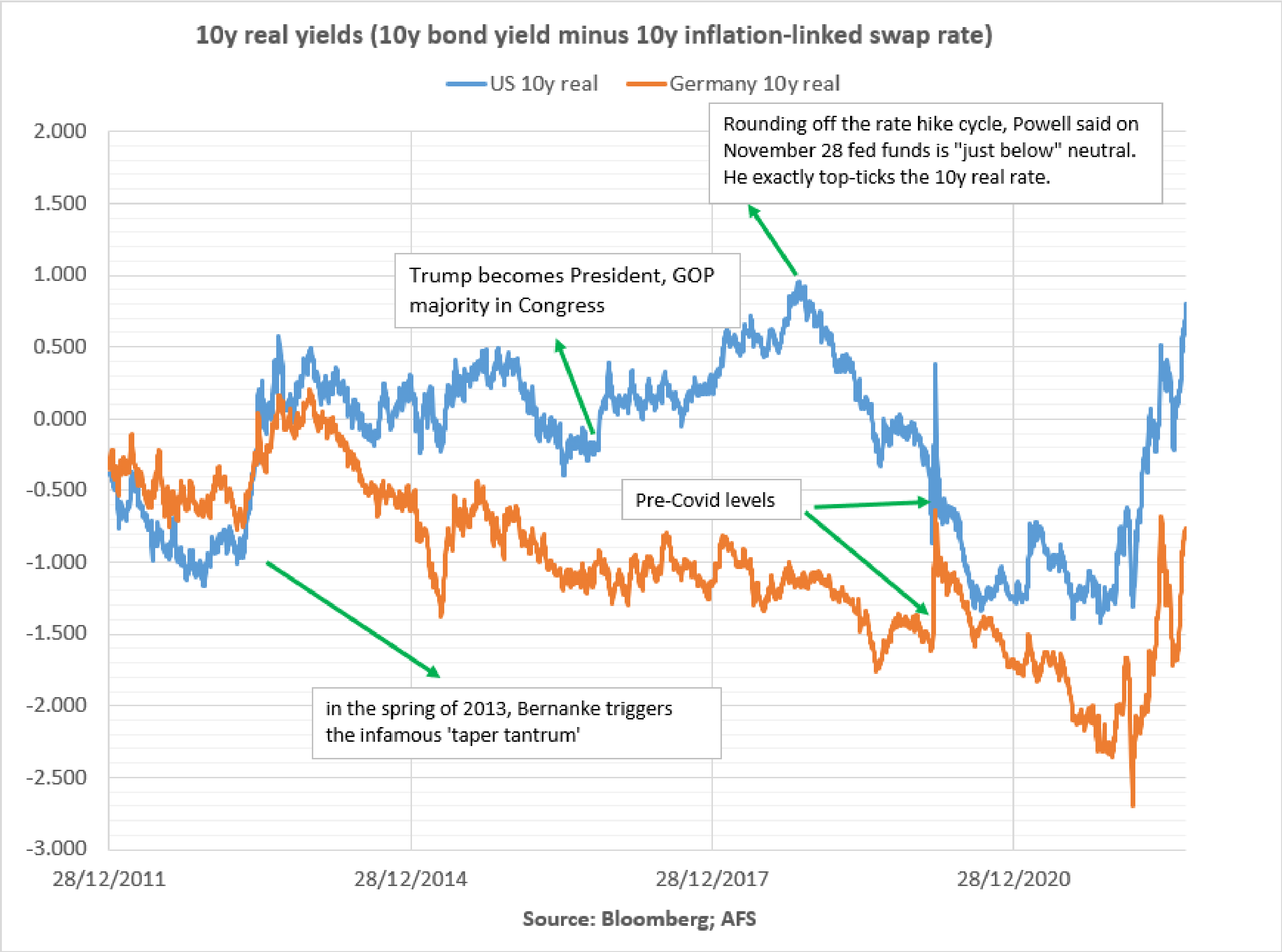
NBER recession dates	# of days inverted	First inversion date	Last inversion date	max inversion, in bps	average inversion, in bps	Lag between first Inversion and onset of recession
July 1990-March 1991 recession	185	14/12/1988	29/03/1990	-44	-15	19 months
March 2001-November 2001 recession	233	03/02/2000	02/01/2001	-56	-26	12 months
December 2007-June 2009 recession	245	27/12/2005	05/06/2007	-20	-19	24 months
March 2019 yield curve inversion*	8	14/08/2019	02/09/2019	-5.3	-1.8	---
April 2022 yield curve inversion	58	31/03/2022	---	-49.6	-25.5	---

**resulted in a soft landing*

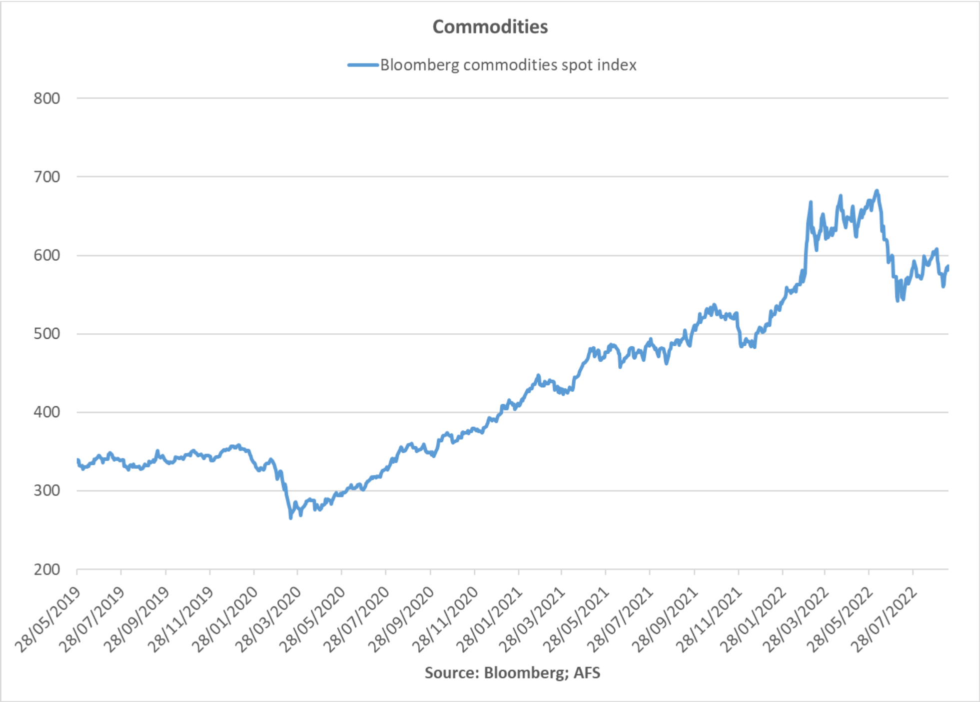
- **This thing will fly – become even more negative – if the Fed ups the ante with 100bps hikes or wants to shock markets with unexpectedly large hikes**. Note that the history of yield curve inversions allows us to estimate (or guesstimate) the date of the onset of the recession. Anywhere between April 2023 or April 2024. One is inclined to believe it will be closer to the former than the latter.
- **Fed funds futures have priced in close to 200bps of hikes for the year.** At 4.5 percent, the terminal fed funds rate pricing is at the high for the cycle.
- **ECB pricing has also moved up further, with the year-end deposit rate priced at 2.0 percent.** At least markets and the ECB agree on something here. We want to highlight Wednesday's comments by the French ECB Governing Council member Villeroy de Galhau, who came clean on the central bank's rate hike plans. Villeroy de Galhau, who is somewhat of a bellwether on the Council, called for 2 percent deposit rate by year-end, or a 75bps and 50bps hike. In any case, while the debate

on the ECB Governing Council on the October rate hike increment is far from settled, we will have to review our own calls (50bps/25bps) soon.

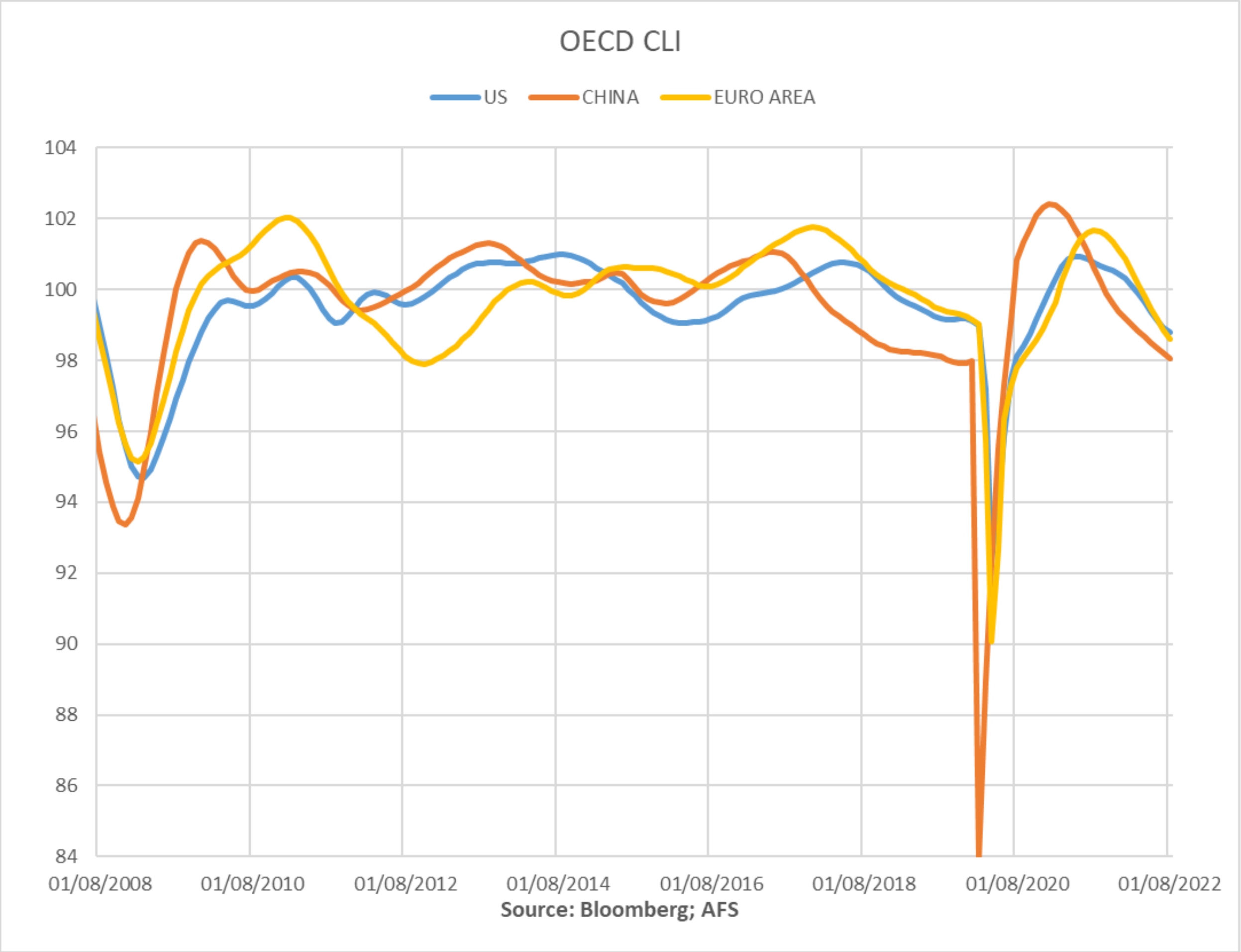
- **The ECB is still having transmission issues with rate hikes, owing to the scarcity of collateral, strained bank balance sheets (GSIB leverage ratios are very low), and overall way too much liquidity in the system**. As per our special from yesterday, we call for/on the ECB to end the TLTRO arbitrage to address the problem of too much liquidity and low leverage ratios in one swoop. In any case, the 1-month ESTR OIS closed at 0.646, suggesting a widening spread between ESTR and the deposit rate. We will keep a close eye on 1-month Euribor settlements before they are being spoiled for pricing for the next ECB maintenance period.
- **Resuming with some market commentary, Bund yields are up by 2-28bps for the week across a bear flattening curve.** At 1.81 percent, the 10y is a hair away from the June high. With the Italian elections later this month, the 10y BTP-Bund spread is near the recent highs. It's still a glass is half full story day as we haven't seen new highs yet in the spread. The ECB might be to blame, though we have to wait a while longer before we get a peek at the amounts that are involved with the ECB tilting reinvestments of maturing bonds to Italy.
- **Real yields are at a new cyclical high in case of the US and approach the cyclical high in case of the Eurozone.** And mind you, central banks aren't done pushing them higher:



- **Equities in Asia are down a good bit, with losses of around 1 to 2 percent for major markets**. For the week equities across the board are lower, with losses ranging from 0.8 percent for the Stoxx 50 to more than 4 percent for the S&P 500.
- **The dollar has been on a tear this week, rising 0.8 percent against the majors and more than 1 percent against a basket of Emerging Market currencies**. Note that Japanese policymakers and the ECB are becoming increasingly vocal on exchange rate weakness. This morning's comment by ECB Vice President De Guindos are a case in point. He remarked that the ECB is watching the exchange rate 'very carefully', repeating President Lagarde's FX remarks at last week's press conference.
- **Commodity prices remain relatively resilient despite recession fears**. For the week we clock the Bloomberg index just a percent lower. For the year commodity prices are still up 13 percent, much to the ECB's and Fed's chagrin.



- **Because of the empty calendar today, and since everyone is waiting for the FOMC meeting next week anyway, we want to take a quick detour to the state of the business cycle in the three big economic blocs: the US, the Eurozone and China.** The chart below shows the OECD's leading indicators (CLI for short) for the three economic blocs. Readings above 100 mean that the economy is growing above its potential rate. Below the breakeven level of 100 and we're looking at below potential growth:

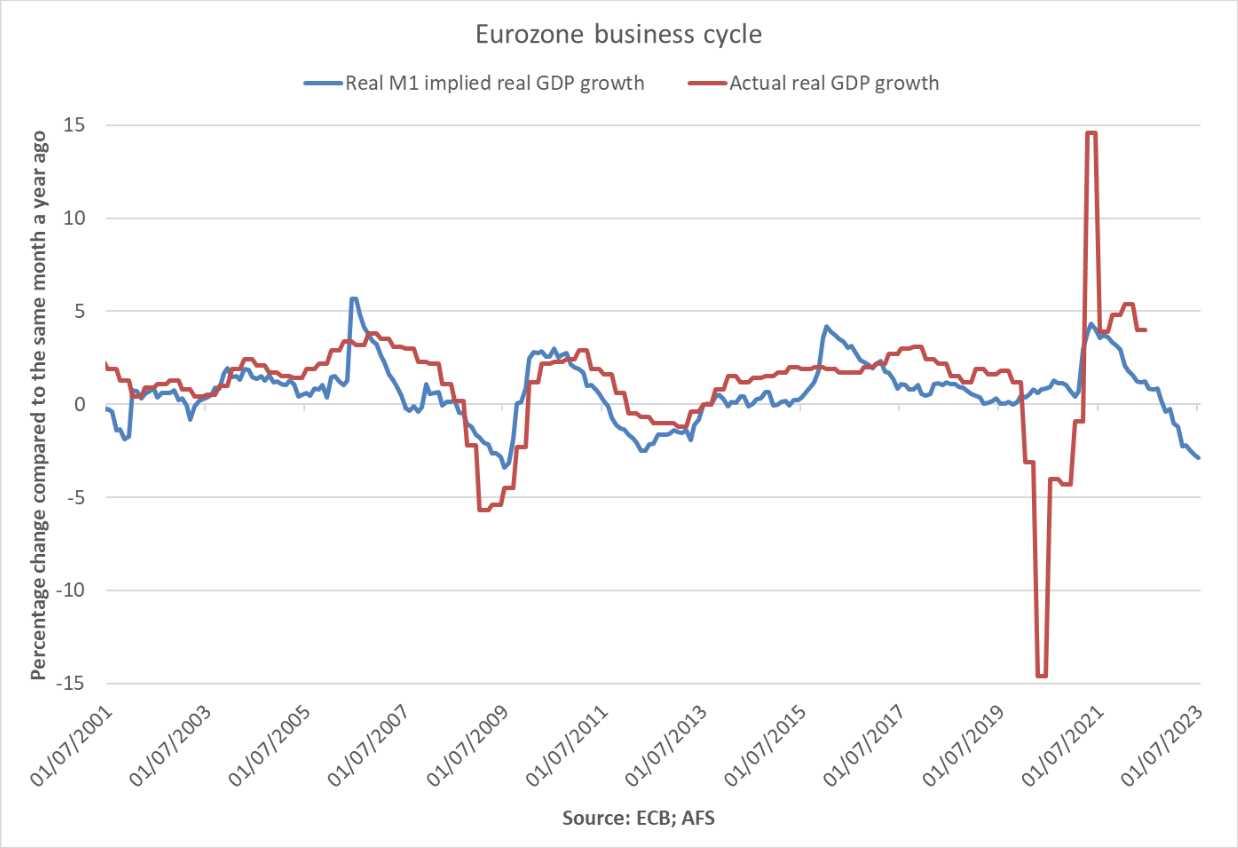


- **It is crystal clear where the business cycle is headed: we're in the middle of a synchronized global economic slowdown**. And chances are things will get worse before they get better. However, nowhere is the slowdown as bad as it was in 2008 or 2020. Then again, the US and Eurozone are cooling more than they did during the most recent growth scares: those of 2015/2016 and 2018/2019. And in both jurisdiction central banks are in banzai-tightening mode, a far cry from the gradualist approach to monetary policy of last decade.
- **Now take the US leading indicators, a composite of high-frequency US economic data, the fed funds/10-year spread, and the S&P 500.** Percentage changes in the leading index have become increasingly negative and are consistent with the economy flirting with a recession:

It might be a while before the US enters a recession in our view. But with inflation this high, and the Fed having to tighten hard, a soft landing is nigh impossible. So, a recession it is.

- **Our favorite Eurozone indicator, real M1 money supply growth, is flashing red for recession.** In the chart below we made a regression analysis for real GDP growth twelve months ahead based on real M1 growth. The model 'spotted' every man-made recession[1] - the early 2000s; 2008 and 2011 – well in advance:

[1] Excluding the Covid shock.



- **Model implied GDP growth rates are as negative as they were during the crisis of 2008, suggesting we're in for a deep recession starting in Q4 or the winter**. Now, if we have to offer a tourist view on equities in Europe and the US here, we fail to see anything but bear market rallies that may or may not materialize. And a lot more downside once the recession materializes. It will be a while before central banks can save the day for markets.

Calendar

TIME	REGION	EVENT	PERIOD	CONSENSUS	PRIOR
10:00	Italy	Trade Balance Total	Jul	--	-2166m
10:00		ECB's Rehn Speaks			
11:00	Eurozone	CPI YoY	Aug F	9.10%	9.10%
11:00	Eurozone	CPI MoM	Aug F	0.50%	0.50%
11:00	Eurozone	CPI Core YoY	Aug F	4.30%	4.30%
11:00	Italy	CPI EU Harmonized YoY	Aug F	9.00%	9.00%
16:00	US	University of Michigan Consumer Sentiment	Sep P	60.0	58.2
		NATO Meeting in Estonia			
		Fitch Reviews Belgium Rating			
		Fitch Reviews Cyprus Rating			
		S&P Reviews Belgium Rating			
		S&P Reviews Croatia Rating			
		S&P Reviews Spain Rating			
		S&P Reviews Saudi Arabia Rating			
		Moody's Reviews EU Rating			
		Moody's Reviews Greece Rating			

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