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Investment Strategy Bulletin

Risks in Europe finely balanced as ECB raises rates

Investment Solutions

22 July 2022

Key takeaways

- High inflation has forced the ECB to raise interest rates by 50 bps – even amid political instability, weak growth and a far-from-resolved energy crisis
- Although the rate hikes by the ECB will be somewhat more front-loaded that we previously thought, we still expect the hiking cycle to peak with the deposit rate at 1.25% in early 2023 – with monetary policy stance turning neutral but not restrictive
- The ECB's new Transmission Protection Instrument, designed to limit spread widening, eased some market concerns – although Italian political instability and potential legal challenges pose non-negligible risks.

Europe is under pressure on multiple fronts – and the timing has been terrible for the European Central Bank. Mario Draghi's resignation as Italian Prime Minister came the same day the ECB raised interest rates for the first time since 2011, and by a larger than expected 50 basis points. Signs of market strain – notably widening spreads between German and Italian sovereign debt – had already triggered an emergency ECB meeting in June, and a new 'anti-fragmentation' tool was announced on 21 July. Meanwhile, relief over Russia's decision to restart gas flows via the Nord Stream 1 pipeline do not spell an end to Europe's energy crisis, even if it makes the worst-case scenarios somewhat less likely. Pipeline flows at just 40% of capacity and still insufficient storage levels pose the risk of a serious winter squeeze.

Inflation forces the ECB's hand

The ECB had little choice but to raise rates, even amid weakening growth, political instability, and a largely supply-led spike in inflation (higher food and energy prices linked to the war in Ukraine). With headline inflation now running at 8.6%, and price pressures broadening out across more areas of goods and services (see charts on page 2) the ECB needed to act to prevent expectations of future inflation from rising too high. Except for the Bank of Japan, the ECB is the last major developed market central bank to raise rates. Its policymakers have been relatively slow to respond to rising inflation, and want to avoid falling too far behind the curve.

In implementing a 50bps hike, the ECB has proved that it is willing to take bold action in pursuit of price stability, given the deterioration in the medium-term inflation outlook. It has now dropped its typical forward guidance and will be taking a meeting-by-meeting approach to the path of future rate rises, where President Christine Lagarde confirmed that further hikes will be appropriate.

A shallower hiking cycle

We now expect the ECB to front-load more of its rate hikes, following in the path of the US Federal Reserve. Our

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Data as of 22 July 2022 unless otherwise stated.

expectation is for another 50bp increase at its next meeting, in September. Overall, however, we still expect a much shallower hiking cycle in Europe than in the US (see chart on page 3). We believe that the ECB's 'terminal' or peak rate will be 1.25%, reached in early 2023 – a level at which we judge monetary policy to be roughly neutral, i.e. neither actively encouraging nor restricting growth. This is meaningful in a context where rates started at -0.5% (pre-July's meeting), and have been in negative territory for eight years. Still, this peak in European interest rates is nowhere near the 3.75% terminal rate we expect in the US. Market expectations have also seen a material repricing lower in recent weeks.

This lower level of rates reflects the fact that the majority of Europe's inflation is imported, and therefore largely beyond the ECB's control, and that domestic demand is still below pre-pandemic levels, with few signs of overheating in the labour market.

Amid political turmoil in Italy, markets were also eagerly awaiting the announcement of an 'anti-fragmentation' tool, designed to prevent spreads between core and peripheral sovereign bonds from widening too far, thus limiting the effectiveness of monetary policy. The ECB had to be convincing here, with a double blow of rate rises and Mario Draghi's governing coalition collapsing leading Italian bond (BTP) spreads over German Bunds to widen – having risen by around a quarter in July alone – from 1.85 to 2.33 percentage points. Italian bonds are likely to remain under some pressure until clarity emerges on the political front, with general elections scheduled for 25 September.

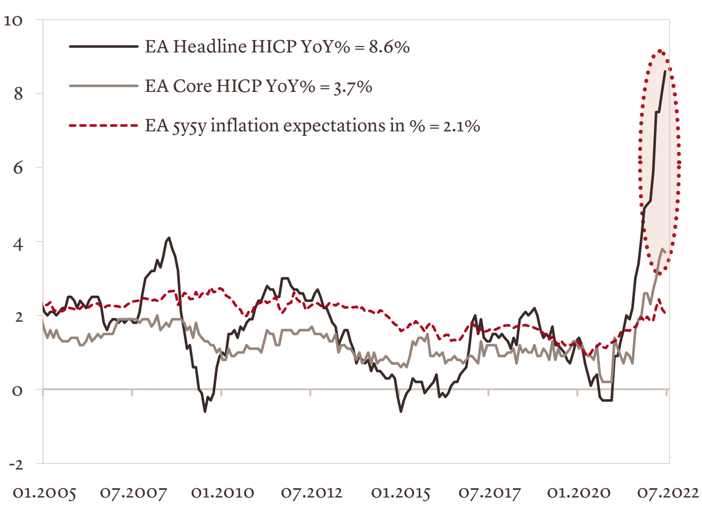
Fighting fragmentation

Following the announcement, the ECB now has two tools to limit fragmentation (a third potential one via outright monetary transactions, or OMT, has never been used and looks effectively redundant given the strict conditions attached). The first is flexible reinvestment from its existing pandemic emergency purchase programme (PEPP), although details on what flexibility means are still lacking. The second is its new Transmission Protection Instrument (TPI), which is another way for it to purchase primarily government bonds. On the plus side for markets, TPI purchases can in principle be unlimited, and have no specific conditions attached, other than "to counter unwarranted, disorderly market dynamics that pose a serious threat to the transmission of monetary policy."

However, in order to make a purchase under the TPI, the country issuing the debt must meet four criteria: compliance with the EU fiscal framework; absence of severe macroeconomic imbalances; sustainability of public debt; and sound and sustainable macro policies. The TPI may potentially be subject to legal challenge, in the event that it is viewed as going beyond the mandate of monetary policy with the central bank directly financing governments.

1. Inflation and inflation expectations in the euro area

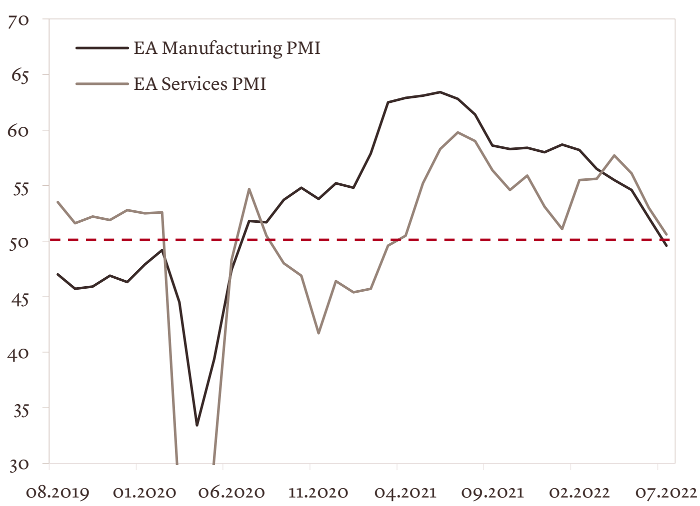
Core and headline HICP vs 5y5y inflation expectations



Sources: Bloomberg, Eurostat, Lombard Odier calculations

2. Manufacturing & services PMIs in the euro area

Above 50 indicates growth, below 50 indicates contraction



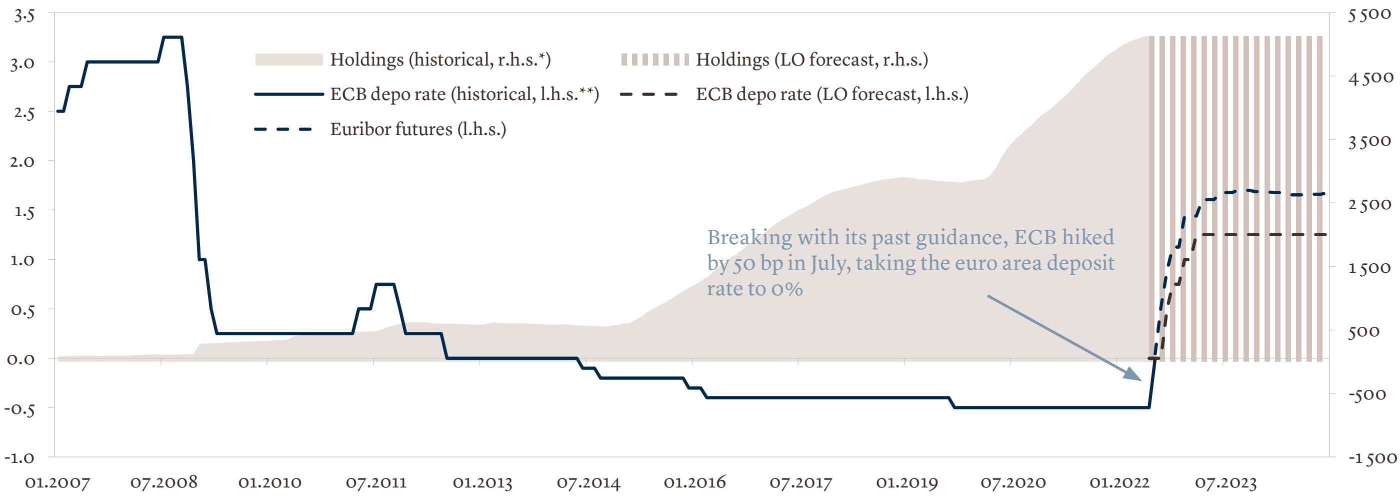
Sources: Bloomberg, Eurostat, Lombard Odier calculations

The ideal scenario for the ECB is that the TPI is never activated. However, in the wake of Italy's government collapse, rising political uncertainty certainly makes a scenario of sharply widening Italian spreads more likely. We would expect even a right-wing government with eurosceptic tendencies to avoid openly breaching the EU fiscal framework and Brussels budget recommendations in a way that puts the ECB's willingness to activate the TPI into question. Still, this is a downside scenario of non-negligible probability. Another question remains over whether the purchases will be 'sterilised', or offset to keep the money supply stable. This remains unclear for now, although the ECB would want to avoid a persistent expansion of its balance sheet because of TPI purchases. And while a credible TPI should mean less stress in peripheral bond markets, it will do nothing for Europe's broader macroeconomic strains: a supply shock in energy and food, and demand that has yet to rebound from the blow dealt by Covid.

Samy Chaar, Chief Economist
Bill Papadakis, Macro Strategist

3. ECB hiking cycle is now underway, but likely to be more shallow than in the US

First rate hike was announced in July ECB meeting, raising the deposit rate from -0.50% to 0%



* right hand scale, **left hand scale
Sources: Bloomberg, European Central Bank, Lombard Odier calculations

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Bank Lombard Odier & Co Ltd[1]
Rue de la Corraterie 11 · 1204 Genève · Suisse
geneva@lombardodier.com
Lombard Odier Asset Management (Switzerland) SA
Avenue des Morgines 6 · 1213 Petit-Lancy · Suisse
Support-Client-LOIM@lombardodier.com
Management Company regulated by the FINMA.

FRIBOURG

Banque Lombard Odier & Cie SA · Bureau de Fribourg[1]
Rue de la Banque 3 · 1700 Fribourg · Suisse
fribourg@lombardodier.com

LAUSANNE

Bank Lombard Odier & Co Ltd[1]
Place St-François 11 · 1003 Lausanne · Suisse
lausanne@lombardodier.com

VEVEY

Banque Lombard Odier & Cie SA · Agence de Vevey[1]
Rue Jean-Jacques Rousseau 5 · 1800 Vevey · Suisse
vevey@lombardodier.com

ZURICH

Bank Lombard Odier & Co Ltd[1]
Utoschloss · Utoquai 29-31 · 8008 Zürich · Schweiz
zurich@lombardodier.com

EUROPE

BRUSSELS

Lombard Odier (Europe) S.A. Luxembourg · Belgium branch[2]
Avenue Louise 81 · Box 12 · 1050 Brussels · Belgium
brussels@lombardodier.com
Credit institution supervised in Belgium by the National Bank of Belgium (NBB) and the Financial Services and Markets Authority (FSMA).

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Lombard Odier (Europe) S.A.· UK Branch[2]
Queensberry House · 3 Old Burlington Street · London W1S 3AB · United Kingdom
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Lombard Odier (Europe) S.A.
291, route d'Arlon · 1150 Luxembourg · Luxembourg
luxembourg@lombardodier.com
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Lombard Odier Funds (Europe) S.A.
291, route d'Arlon · 1150 Luxembourg · Luxembourg
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Lombard Odier (Europe) S.A. · Sucursal en España[2]
Paseo de la Castellana 66 · 4ª Pl. · 28046 Madrid · España · madrid@lombardodier.com
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Lombard Odier (Europe) S.A. · Succursale in Italia[2]
Via Santa Margherita 6 · 20121 Milano · Italia
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sao.paulo.office@lombardodier.com
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Bank Lombard Odier & Co Ltd · Representative Office Dubai
Conrad Business Tower · 12th Floor · Sheikh Zayed Road · P.O. Box 212240 · Dubai · UAE
dubai@lombardodier.com
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Israel Representative Office · Bank Lombard Odier & Co Ltd
Alrov Tower 11th floor · 46 Rothschild Blvd. · Tel Aviv 6688312 · Israel · telaviv@lombardodier.com
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South Africa Representative Office · Bank Lombard Odier & Co Ltd
4 Sandown Valley Crescent · Sandton · Johannesburg 2196 · South Africa · johannesburg@lombardodier.com
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NASSAU

Lombard Odier & Cie (Bahamas) Limited
Lyford Cay House · Western Road · P.O. Box N-4938 · Nassau · Bahamas · nassau@lombardodier.com
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Oceania Business Plaza Torre 2000 · Oficina 38-D · Blvd. Pacifica · Urb. Punta Pacifica · Corregimiento de San Francisco · Panamá · panama@lombardodier.com
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