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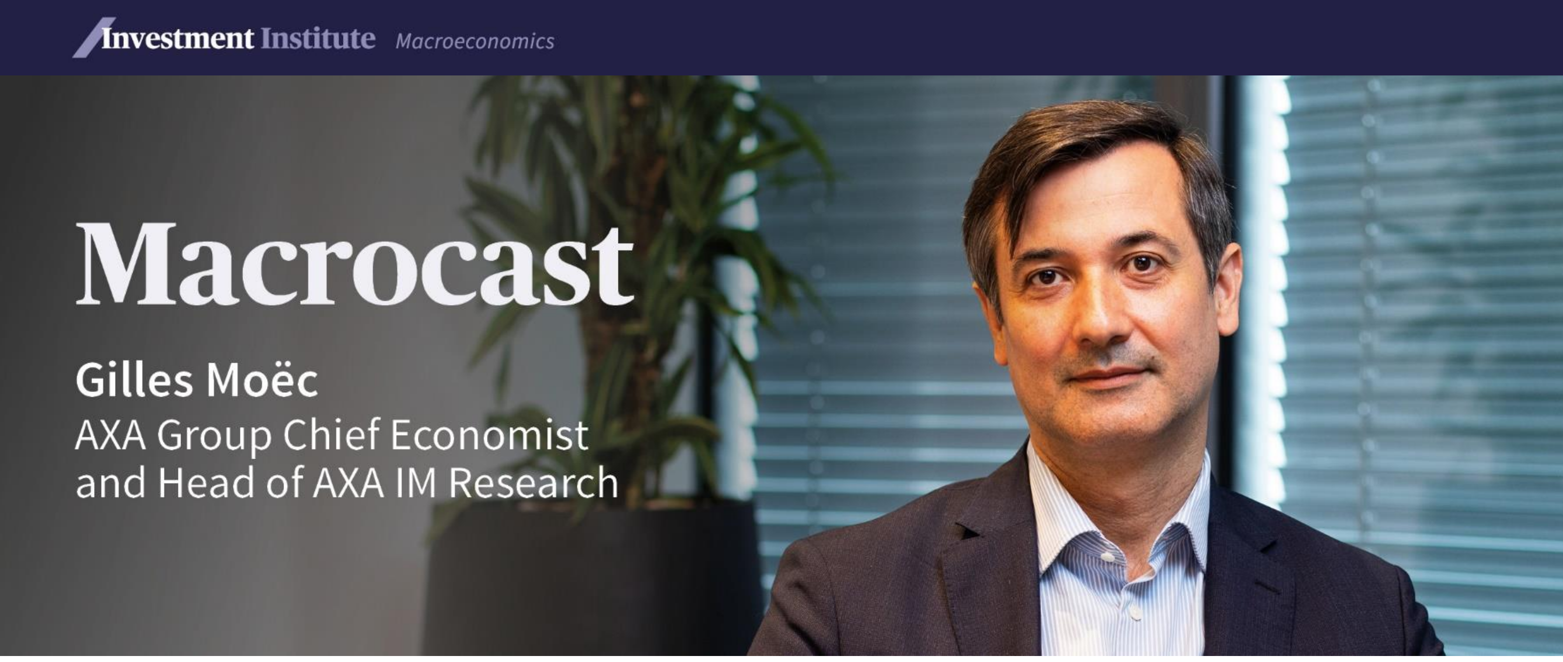


Testing Time Coming Early

- The ECB will have a tough job on anti-fragmentation as the political crisis in Italy could challenge some of the key features of the tool.
- In the US, the market is already focusing on what happens after the rate hikes.

The European Central Bank (ECB) is not going to have an easy job this Thursday. While the rate decision itself – a 25 basis points-hike – has been pre-announced in June (and noises from the Governing Council did not point to massive enthusiasm for going bolder – this will in all likelihood wait until September), the central bank is expected to unveil the details of its anti-fragmentation instrument exactly at the moment the resumption of political instability in Rome is triggering a widening of the Italian spread. The new framework could thus be tested much earlier than expected. The features of the ongoing political drama in Italy raises questions on at least two key issues: can conditionality be light, and what exactly are the "right circumstances" under which the tool could be deployed. Indeed, some of the debates currently straining the coalition in Rome are connected to the reform agenda attached to the Next Generation programme, which is widely seen as the right basis for "light conditionality". Moreover, would the ECB be legitimate in countering a spread widening if it was triggered by a change in the intrinsic risk profile of a member state brought about by domestic political choices? Our concern is that what will come out on Thursday could still be too vague, or too narrow in scope, to signal the market that the "cavalry is coming" quickly to shore up the Italian bond market.

Meanwhile, in the US the "inflation peak" continues to be elusive, especially on core. Still, risk-free rates continue to fall. Investors are already focusing on the medium-term consequences of the Federal Reserve (Fed) action – high recession risks, ultimately forcing rate cuts – while both the markets and households' inflation expectations are improving, suggesting the Fed remains fully credible. Yet, the condition for this credibility remains that first the Fed delivers a series of hikes in quick succession. The message from inflation expectations, and the fact that for most businesses, financial conditions remain in restrictive territory despite the recent drop-in risk-free rates, should however dampen support for radical options, such as emulating the Bank of Canada's 100 basis point (bp) hike last week. Just a few months ago, 75bps in one go would have seem reckless. It's probably safe not to exceed this quantum.

A lot on the ECB's plate

Europe does not have much luck at the moment. The decline in wholesale oil prices will help of course, but gas is what matters for the Euro area. While on oil there is a measure of feedback effect from economic growth to prices – OPEC cannot always ignore the signals from lower demand – there is no amount of macro slowdown in Europe which could reduce gas prices on its own. Everything is in the hands of Vladimir Putin. This week will be crucial with the "maintenance period" of Nord Stream 1 in principle ending on July 21. Irrespective of Russia's decision, gas prices have already shot up (Exhibit 1) and will push inflation up – and take purchasing power down.

As if it was not enough**, the drought/heatwave which is affecting large swathes of the continent may trigger some logistical disruptions.** Water levels on the Rhine have hit a lowest point in decades (Exhibit 2). A similar episode in 2018 – barges returned to full capacity only in December – had significantly impaired German production given the still significant role waterways play there to shift supply for the manufacturing sector. In the current configuration, the main concern is that shipments of coal to power plants – which are supposed to offset the lack of gas should Russia turns the tap off – could be impacted. Our readers with an interest in the notion of "Karma" may find it interesting that the use of the dirtiest form of power production could be blocked by one of the consequences of global warming.

The "gas dependence risk" explains why the market is heavily discriminating between the two sides of the Atlantic at the moment. While a growing number of US analysts have significantly taken down their forecasts for the US – we noted last week that Bank of America is now expecting a "proper recession" there – the size of the shock would differ widely. Bank of America expects GDP to contract by 0.2% in 2023 in the US – but that would be dwarfed by the depth of the recession in Europe should Russia cuts access to gas. A recent paper by the Bundesbank (see here) estimated the impact on the German economy to 5% of GDP (leaving GDP down by 3.2% in 2023). **This asymmetry is in our view the main reason why the euro's exchange rate has taken such a battering these last few days.**

Exhibit 1 – Fossil energy divergence

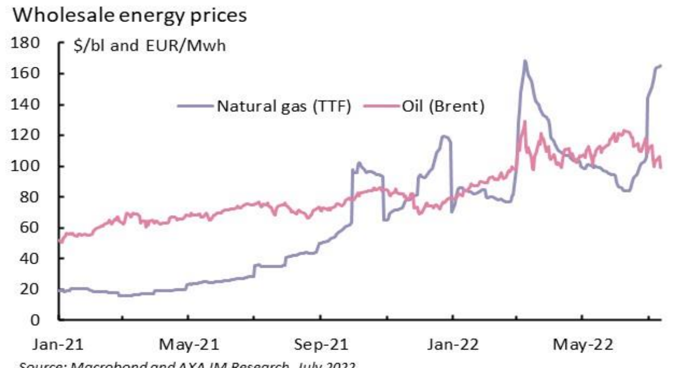
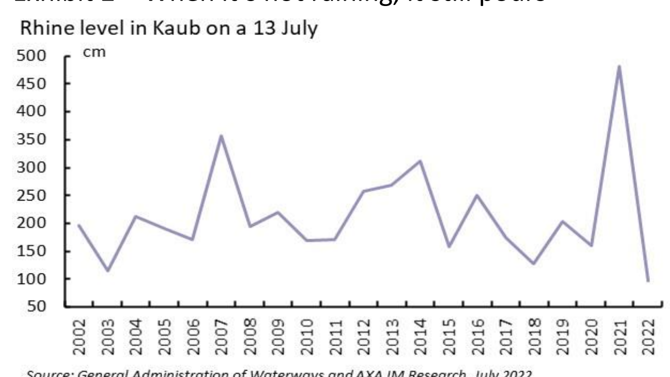


Exhibit 2 – When it's not raining, it still pours



This adds another layer of complexity for the ECB. Beyond the mechanical effect of a weaker currency on imported inflation, "breaking parity" may be an important psychological moment for the ECB playing into the hands of the hawks, the Euro weakness being seen as the price Europe pays for failing to modify its monetary policy stance as swiftly as the US. However, we note that there has not been too much public clamouring for hiking by more than 25bps on 21 July in the recent "ECB-speak". The intention was probably too explicit in the June forward guidance for a debate to really shoot up. However, it may well be that Christine Lagarde will have to be open to a move of more than 50 basis points in September – depending on the inflation dynamics until then - to assuage the concerns of the hawks.

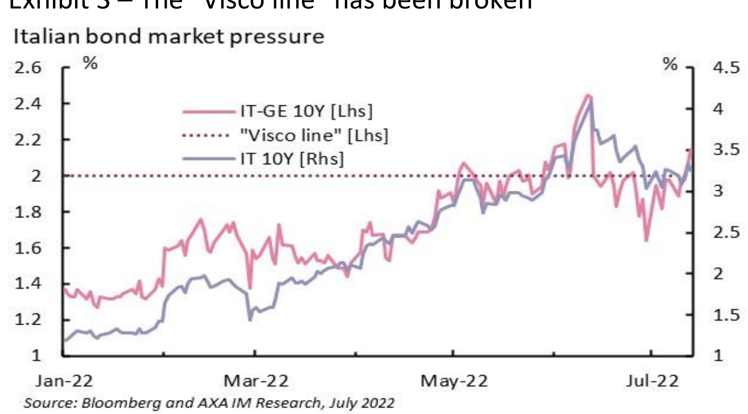
Yet, we suspect that one of the reasons Governing Council members did not go too far in discussing openly more than 25bps for July lies in **the need to come up with a very convincing anti-fragmentation tool if the ECB wanted to "speed things up" on the monetary tightening**. The chatter from Frankfurt suggests some key details were still not fully agreed

as of the end of last week, while **the instrument may be tested much earlier than initially expected**. Indeed, the resumption of the political crisis in Italy has brought the 10-year spread between the Italian *Buoni del Tesoro Poliennali* (BTPs) and the German Bunds above the "Visco line", the 200-basis points Ignazi o Visco, Governor of the Banca d'Italia, signalled as being a possible "problematic threshold", warranting intervention, for the spread (Exhibit 3).

As we write these lines the outcome of the current political drama in Rome remains very uncertain. President Mattarella has refused Mario Draghi's resignation and the Prime Minister (PM) will address parliament again on Wednesday. The root cause of the problem is not new. Draghi has steered Italy on a reformist agenda despite a parliament which remains in majority controlled by populists. As the elections are getting nearer – they must be organized by next spring at the latest – parties need to differentiate more and more and appeal to their core electorate or risk disappearing. 5-star, the point of origin of the current crisis, has lost roughly half of its initial support according to the latest polls and is already faced with a "mass dissent" organized by Di Maio who took MPs with him to form a splinter group. Ex- PM Conte wants to steer closer to what remains of his party's fundamentals by disagreeing with Draghi's pro-Ukrainian stance and defending the "citizen income" – the only key plank of 5-star's manifesto which they managed to implement during their coalition with Lega – against any "reformist encroachment".

It's unclear if a solution can be patched up. On the one hand, according to La Repubblica on Sunday at least 30 MPs from what remains of 5-star were ready to support Draghi in a confidence vote against Conte's views. On the other, Lega and Forza Italia released a communiqué on Sunday stating that under the current circumstances they could not continue to support a Draghi-led coalition. In any case**, the whole affair is casting a crude light on two intertwined issues any successful anti-fragmentation tool must address: defining the right circumstances under which support can be triggered and defining the right macroeconomic conditionality under which support can be maintained.**

Exhibit 3 – The "Visco line" has been broken



Source: Bloomberg and AXA IM Research, July 2022

Let's start with conditionality. Just like nearly everyone else in the ECB watching community we expect the ECB to opt for a form of "light conditionality" which would not make a formal "deal" necessary with the governments receiving support. The ECB would simply regularly express its satisfaction that enough progress would be made on macro policy to warrant the continuation of bond buying. The Next Generation EU Fund from this point of view offers a great framework on which the Transmission Protection Mechanism (as the anti-fragmentation tool seems to have been named according to Bloomberg) could be simply plugged. But precisely, delivering on some of the NGEU "milestones" is one of the issues triggering strife in the Italian political system. An optimist could argue that, precisely, linking the TPM to NGEU would create another incentive for ALL parties in Italy – or in any member state – to "toe the line". One could for instance imagine that a government led by the far-right "Fratelli d'Italia" after the next elections would choose to focus on "societal issues" (e.g. security and immigration) while appointing a mainstream finance minister who would make sure that the NGEU milestones would be complied with, ensuring both the continuation of the flow of funds from Brussels and the possibility for the Italian bond market to be protected by the ECB. Still, the fact that the *current* Italian coalition is already "straining at the seams" on the agenda could make the market doubt that TPM could be maintained for sure for a long period of time.

This gets us to the "right circumstances" under which TPM could be activated. The ECB has always presented its anti-fragmentation tool as a way to deal with "unwarranted" widenings in spreads. It's unclear how this notion would apply in the current circumstances. After all, the current widening could appropriately reflect a change in the *intrinsic* risk profile of the Italian sovereign given the ongoing political developments. We could see some members of the Governing Council resisting the use of the TPM. Bundesbank Governor Nagel has already called for the narrowest of scope: *"Unusual monetary policy measures to combat fragmentation can be justified only in exceptional circumstances and under narrowly-defined conditions".*

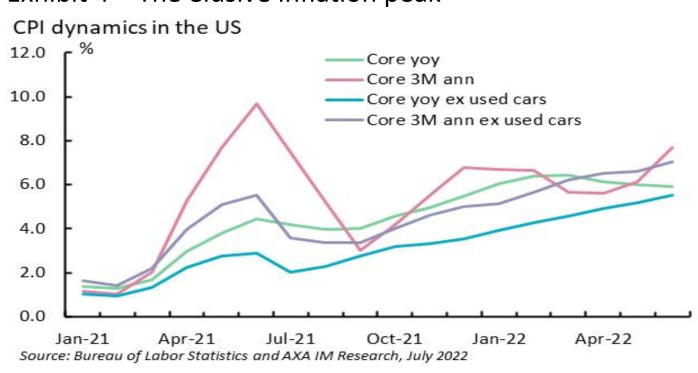
Habitual readers of Macrocast know that your humble servant is very concerned with one of the options to "sterilize" potential interventions under the TPM (when purchases of BTPs would be offset by sales of other assets, e.g., OATs, rather than by mopping up excess liquidity through the banking sector). Yet, the resumption of political difficulties may shift the focus. There is a real risk that what the ECB unveils this Thursday comes out as either too imprecise, or too narrow in scope, to convince the market that the "cavalry is coming" to shore up the Italian bond market. Hawks could always argue that some added pressure on Italian financial conditions is exactly what's needed to convince the various political stakeholders in Rome to find a compromise. This is a costly approach though. Summer could be hot, and not just temperature-wise.

Now, beyond the short-term gyrations in spreads, **we need to connect the two "streams", the recession risk and fragmentation**. If Russia turns the tap off, Italy will be impacted more than many other European countries given its lack of nuclear energy and high dependency on Russian gas. We are concerned that the recession in Italy could be severe, bringing about even more stress on politics, while fiscal restraint, made necessary by a lack of ECB support, would make it impossible to mitigate the blow for businesses and households. Then, a proper "unwarranted spread widening" entirely out of the control of Rome could emerge. This would then make it easier for the ECB to step in, but this would be reactive, not pre-emptive, and therefore would entail more economic damage.

Who benefits from the rates' "bell shape"?

Meanwhile in the US, month after month, the inflation peak seems to become ever more elusive, with the US headline consumer price index for June coming out once again above expectations (9.1% year-on-year vs 8.8% expected, and markedly up from 8.6% in May).

Exhibit 4 – The elusive inflation peak



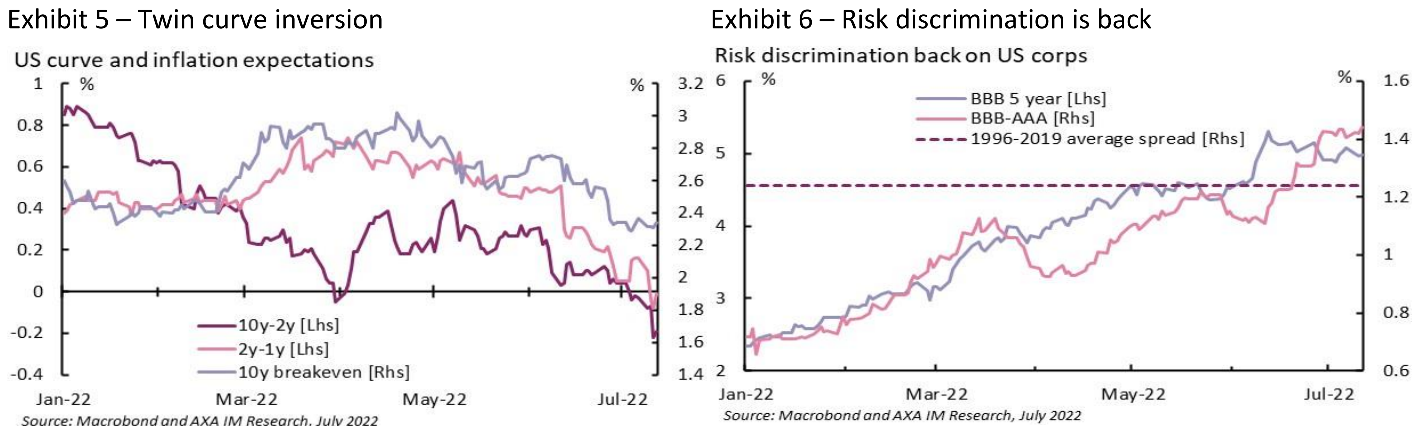
We can probably be more optimistic for July: wholesale oil prices have retreated below USD100/barrel and at the retail level, gasoline prices have been falling since the end of June. Core inflation dynamics are however crucial for the Fed, and on this front, we have received more bad news. True, on a year-and-year basis, we can see the beginning of a deceleration, but it is largely due to base effects. On a 3-month annualized basis, core inflation growth has been re-accelerating since March and if we correct it for the gyrations in used cars, as we have been doing for several months now, the accelerating trend is still obvious (Exhibit 4). Still, **despite these unfavourable consumer price dynamics, market interest rates continue to fall. The market is obviously much more fixated on the recession risks than on the possibility that inflation becomes persistent.** The inversion of the curve is now quite pronounced, with the 2- to 10-year spread now in the range seen in 2006, when the market was

"predicting" what would end up being the Great Financial Crisis, or in 2000, when investors were focusing on what would become the "dot com bubble burst" of 2001. 10-year breakeven have retreated further, and at 2.3% even stand below the level consistent with the Fed's inflation objective, when considering the usual gap between PCE and CPI. What we also find interesting is the inversion which has appeared at another point of the curve. 2-year yields are now slightly below 1-year ones. **This is consistent with the Fed hiking "fast and hard" – even though 1-year rates are below the Fed's median forecast in the latest dot plot – but also being forced to cut quickly after that** (Exhibit 5).

Still, **this recent loosening in financial conditions is not universal.** We have started to look at the spread between what AAA and BBB companies pay on a 5-year maturity on the US market (Exhibit 6). The spread is now above its long-term average, suggesting that the adverse macro environment is triggering more discrimination across risk categories (even within the "investment grade" universe). Since a recent peak in mid-June, BBB names have enjoyed only half the reduction in yields seen on AAA names. Except for the very best corporates, the current refinancing gap is still very significant. This is also consistent with a market focused on the recession risks. Late last year the Fed was getting frustrated market pricing did not follow its hints at the beginning of a policy normalization, which was leaving financial conditions overly accommodative. It's difficult to argue today that the market is impairing the transmission of monetary policy in the US. 5-year BBB funding costs have only marginally retreated are currently hovering at about 5%. That is the equivalent of c.2.5% in real terms when taking current inflation expectations into consideration, higher than US trend GDP growth (1.75%). We reiterate the point we made a month ago: for all practical purpose, financial conditions are *already* restrictive in the US.

Exhibit 5 – Twin curve inversion

Exhibit 6 – Risk discrimination is back



Source: Macrobond and AXA IM Research, July 2022

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Yet, we are in a situation where both the market and the Fed need to follow a pre-definite script. While the market may already be focusing on the medium-term consequences of the Fed's action – a recession and eventually rate cuts – and deems it credible – otherwise inflation expectations would not have retreated – in the short run the Fed still needs to deliver on what the market expects, that is to perform a quick succession of hikes and bring the Fed Funds rate into restrictive territory. In a similar vein, the Fed may be happy to see that beyond investors, consumers also consider it credible, but still needs to hike. Indeed, 5-year ahead inflation in the latest Michigan survey has fallen back to 2.8%, below its long-term average for the first time since July 2021. It's highly likely though that at least part of this downward shift in long-term inflation expectations is a reaction to the much-publicized toughening stance of the central bank. Should this tougher stance fail to materialise, inflation expectations could again move higher.

In a nutshell, that the Fed is credible cannot detract it from hiking. However, this may tilt the Fed away from opting for a spectacular move at its July meeting. On this, the goal posts are being moved almost on a daily basis. The Bank of Canada's surprise 100bp hike last week has created another "benchmark". Yet, we fail to see what the Fed would gain by emulating its Northern neighbour. We have issues with the notion the Fed is "behind the curve' now that, precisely, the curve is inverted. Just a few months ago, hiking by 75bps would have been seen as reckless. It's probably safe not to go beyond this quantum.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• CPI inflation (Jun) set a new 40-y record of 9.1%yoy, upside surprise • PPI inflation (Jun) rose to 11.3%yoy from 10.9% • US retail sales (Jun) rose 1%mom, one of final contributions to Q2 GDP estimates, due 28 July • Bank of Canada hiked by 100bps and raised market fears that Fed could follow suit in July • Beige Book (July) five Districts increased recession risk, all labour easing, price increases slowing	• Fed purdah and how markets react to economic news without guidance ahead of next week's FOMC • Dollar – after another blistering week – particular focus on euro cross • Housing market figures, starts and sales (Jun). These fell sharply in May and we will watch for continued declines • Philadelphia Fed index (Jul) and PMIs (Jul, p) – business indicators for Q3
	• Italian government and PM Draghi under threat as coalition partner Five Star boycotts confidence vote • Euro area IP picked up to 0.8% in May	• ECB Governing Council meeting (Thurs) +25bp hike expected and announcement on anti-fragmentation tool • Political developments in Italy • Nordstream 1 scheduled to reopen on Thurs
	• 5 candidates remain in conservative leadership elections w/ Sunak, Mourdant and Truss leading • UK GDP (May) surprised to the upside rising by 0.5% with services, IP and construction rising • Governor Bailey stressed 'no ifs or buts' in ensuring inflation returns back to target at OMFIF event	• ILO employment (May) and HMRC payrolls (June) to be watched for signs of wage growth • CPI inflation (Jun) expected to rise to 9.3% (cons) • Retail sales (Jun) further drop expected -0.2% (cons) following weak BRC sales figures • Flash PMIs (Jul)
	• Ruling coalition increased majority in the Upper House elections and LDP won 63/125 seats • Japan PPI (Jun) up 9.1%yoy • PM Kashida announced plans to ensure nine nuclear reactors are online by winter	• BoJ Meeting (Weds) no policy shift expected on policy rate and YCC • Trade balance (Jun) expected to widen owing to weaken yen and higher commodity prices • CPI (Jun) expected to rise to 2.4%yoy
	• Chinese GDP grew by 0.4%yoy in 2Q. June activities data showed improvement with housing market still remaining weak • Export growth rose surprising to the upside	• COVID continues to spread to multiple cities. More curbs are expected to be implemented
	• CB: BOK, MAS and BSP tightened monetary policy. Hungary +200bp to 9.75% • Annual inflation (June) accelerated in Brazil (11.9%), Czech Rep (17.2%), Chile (12.5%), Hungary (11.7%) & Romania (15.1%). It fell in India (7.0%) & Russia (15.9%) • Sri Lanka President Gotabaya Rajapaksa resigns	• CB: Policy rate decisions in Indonesia, Russia, South Africa & Turkey • June CPI (yoy) in Malaysia & South Africa • May retail sales in Mexico • May economic activity index in Colombia • June unemployment rate in Taiwan

Upcoming events		
	US:	Mon: NAHB housing market index (Jul), Long-term investment flows (May); Tue: Housing starts (Jun), Building permits (Jun); Wed: Existing home sales (Jun); Thu: Weekly jobless claims (16 Jul), Philadelphia Fed Index (Jul), Leading index (Jul)
	Euro Area:	Tue: EU19 CPI final (Jun), CPI – ex food, energy, alcohol & tobacco (final) (Jun); Wed: EU19 Consumer Confidence (prel.) (Jul), Ge PPI (Jun); Thu: EU19 ECB announcement (& press conference), Fr Insee manufacturing confidence (Jul)
	UK:	Mon: MPC member Saunders speaks; Tue: unemployment and employment (ILO) (May), BoE Bailey speaks; Wed: CPI – core, CPIH and RPI (Jun), PPI input, output, and output 'core' (Jun); PSNB ex-banking groups (Jun); Fri: GfK consumer confidence (Jul), Retail sales (Jun), Composite, Manufacturing, and Services 'flash' PMI (Jul)
	Japan:	Thu: Trade balance (Jun), BoJ announcement; Fri: CPI (Jun), National 'Core' CPI (Jun)
	China:	Wed : 1-year Loan Prime Rate

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