ECB has shown their hand

After two ECB meetings in June – one planned and one not so planned – the European central bank has shown its hand and it is not a strong one. With no grip on inflation and a seeming lack of intention to get it, this will lead to difficult times for investors as well as normal income earners.

Sorry ECB, but we are eating and using energy every day

The headline figures for inflation (HICP) have been rising all year and there is so far little evidence that this will change short term.

While headline inflation is topping 8% the ECB in the policy meeting on 9 June announced that they expect headline inflation in 2022 of 6.8%.

Table 1 - Euroarea - current indicators and ECB staff projections

	Inflation (HICP)	Inflation ex food & energy	GDP*
May 2022 / 2021*	8.1%	3.8%	5.4%
		ECB staff projection	
2022	6.8%	3.3%	2.8%
2023	3.5%	2.8%	2.1%
2024	2.1%	2.3%	2.1%

ECB has been arguing that inflation ex food and energy is not that high. Unfortunately, most people in the Euroarea are eating and using energy everyday. In real terms they are far worse off on items that matter to the normal family. It can be inflation will come down but purchasing power lost is still purchasing power lost.

Furthermore, it is striking that ECB is nervous about the economy entering into a recession, but their GDP forecast is showing robust growth rates until 2024.

As unemployment rates are at the lowest level for more than 30 years in EU, it is surprising that inflation is falling that fast in the staff projections.

The implied goods and service inflation in the staff projection should fall to under 2% in 2024. That is a very optimistic view, and difficult to reconcile with current supply chain problems, the war in Ukraine, and low unemployment rates.

Anti-fragmentation instrument

After the 9 June meeting, where ECB signaled their intention to increase interest rates, European government bonds sold off heavily with German 10-year Bunds reaching 1.75% in yield and Italian 10 year government bonds 4.25%.

The spread between German and Italien 10-year bonds reach 2.5%.

These are levels of interest rates with the Italian government cannot handle with a debt to GDP ratio of more than 150%, which the Italian premier minister Mr Draghi probably has explained this to his successor as president of the ECB.

ECB's Governing council has "decided that it will apply flexibility in reinvesting redemptions coming due in the PEPP portfolio" as well as implement "a new anti-fragmentation instrument".

Our interpretation of the press release is that the Governing Council will in fact put a cap on the interest rates which Italy and other countries with high debt to GDP ratio will have to pay.

If 4.25% was too high an interest rate then an educated guess is it going to be less. We will have to wait for the actual announcement from ECB.

Impact for investors

If ECB increases the short-term interest rates as expected and de facto put a maximum level on the interest rate on long government bonds the yield is going steep in the short end and completely flat from the 3-5 years to 30 years for countries with a high debt to GDP ratio.

The German government yield curve could be almost completely flat in this scenario from 1 to 30 years.

Credit spreads, which are not linked to government bonds will more correctly excess the risk premium for holding for instance an Italian credit risk. Most likely the credit market will become highly volatile for a number of years.

If the credit market becomes volatile so will equity markets. Most likely we are going into a period with risk on/risk off all the time. It is highly unlikely, that ECB staff projection will materialize, and continued high inflation will most likely have an adverse impact on equity prices.

Capital will flow in and out of the government bonds which for the first time in 5 years will give a positive interest rate depending on actual risk appetite in the market.

Roller Coaster and summer

ECB and the governing council has managed to get to far behind the curve, that they will have to invent a new financial policy instrument to save the situation.

In our opinion this will lead to a roller coaster environment in the coming year in the financial market which will be very difficult to navigate. However, it will also create a lot of opportunities for the investor which are well prepared for such an environment.

Speaking of roller coaster, the summer is over us, the amusement parks are open and everyone should get out and enjoy a hopefully wonderful summer.

We wish all a warm and sunny summer with family and friends.

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