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The ECB's hawks are hedging their bets

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SNEAK PEEK

— Bonds rally as ECB hawks bring the end of the rate hike cycle into sight

— **U.K. June CPI data to set stage for next BoE rate decisions,** with markets still pricing in more aggressive tightening

— Bank of England reveals the numbers on the great LDI liquidity fiasco, and they have some wild implications

Good morning, and welcome to the pivotal day of what is shaping up to be a pivotal week. Eurozone bonds executed two pretty much perfect pivots in the space of a few hours yesterday, as it became clear that not even the European Central Bank's most influential hawks have the stomach to carry on arguing mechanically for more interest rate hikes after the summer.

Dutch central bank governor Klaas Knot followed Bundesbank President Joachim Nagel on Tuesday in admitting that, while a rate increase at next week's meeting is all but nailed on, the September meeting is wide open, with the chance of a September move "at most a possibility but by no means a certainty." Notably, he acknowledged that the balance of risks to the ECB's assumptions is "gradually shifting" as the effects of past rate hikes start to be felt, and warned that the bank will need to pay more attention to the risk of tightening too much.

Knot and Nagel both represent two of the eurozone's most open economies, hugely exposed to a world economy at a time when global trade is suffering both cyclical and structural headwinds. They've seen their respective manufacturing and logistics sectors fall off a cliff in recent months as the much-touted Chinese rebound has fallen flat and U.S. consumers have run down their pandemic savings. Their export sectors will probably not be enjoying the sight of the euro hitting another 17-month high on Tuesday, and it's probably no coincidence that their comments came on the sidelines of a meeting when their G20 peers have confirmed their fears for the next couple of years.

Despite what appeared to be a pretty decisive shift in messaging, eurozone bond yields had a topsy-turvy day, reversing the gains they made on Knot's comments after Bloomberg ran a source story that was somewhat more equivocal about the rate outlook than the earlier headlines. At the end of the day short-term rates futures still implied expectations that the deposit rate will peak at 4 percent, i.e., that there will be two more hikes, not just the one coming this month.

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POLICY TICKER

ECB 3.75% ↑ — BOE 5% ↑ — FED 5.25% ↑— SNB 1.75% ↑— BOJ -0.10% ↓— RBA 4.10% ↑— PBOC 3.55%↓— CBR 7.5% ↓ — BOC 5% ↑

DRIVING THE DAY

— U.K. to publish consumer and producer price inflation figures for June, 8 a.m.

— Eurostat publishes final eurozone June CPI, 11 a.m.

— BoE Deputy Governor Dave Ramsden speaks on quantitative tightening, 6 p.m.

The U.K. publishes consumer and producer price inflation data for June, with a lot riding on the outcome, now that expectations for both the ECB and the Fed seem to be geared to an imminent end to rate hikes.

Eurostat publishes final consumer price data for June in the eurozone. There have been no major revisions at national level, so expect it to stick with the original 0.3 percent increase on the month and 5.5 percent annual inflation rate.

BoE Deputy Governor Dave Ramsden will speak on quantitative tightening, possibly giving some hints as to how the Bank will adjust the pace of QT for the next year when it meets at the end of the summer.

FINANCIAL STABILITY

LDI BY THE NUMBERS: The BoE has crunched the numbers on the notorious LDI stamped in September last year, and they're pretty mind-boggling. With all the usual caveats about hindsight, it's enough to make the average reader wonder whether Liz Truss's government had any idea of how structurally vulnerable the Gilt market actually was on the eve of its ill-fated budget.

The vicious circle: Liability-driven investment funds use leverage in order to juice returns so that their pension fund backers can meet their liabilities in an environment of low interest rates. The leverage comes in the form of interest-rate swaps and, predominantly, through repos, most of which were done in the Gilt market. As long-term interest rates rose, the value of the bonds that they had pledged as collateral plummeted, and they ran into big margin calls. The only way that LDI funds could raise money to meet the margin calls was to sell even more Gilts — a vicious circle that the Bank had to stop with circuit-breaking intervention.

Leveraged up to the gills: That much has already been clear for a long time, but what was less clear was the scale of the debacle. The Bank's researchers estimated that LDI funds went into the stress period with £205 billion in net Gilt borrowing through the repo market, over 60 percent of the total Gilt borrowing done by non-banks. They also had exposure to a notional £167 billion in interest rate swaps, receiving a fixed rate and paying a variable one (which was rising rapidly), and another £57 billion in inflation swaps for good measure.

Gilty as a girl can be: As bond prices slumped in response to the budget, LDI funds faced some £66 billion in calls for variation margin (that part of the margin that moves to reflect how much the trade has gone against you), according to what the Bank said were conservative estimates. All this drove 10-year Gilt yields up by around 1.5 percent in the space of three weeks, threatening to choke the U.K. economy and dooming Truss's premiership, but the actual net selling by LDI funds between the announcement of the budget and the Bank's intervention seems bizarrely small, at only £6 billion. For comparison, the Bank's interventions allowed them to reduce their repo exposure by £25 billion over the following three weeks.

Ignorance or recklessness? The Bank's researchers said their blog "illustrates how a combination of granular regulatory data sets can help to deepen understanding of stress events," which is true enough as far as it goes. But MCB would also argue it illustrates a couple of other things. Firstly, it shows the fragility and vulnerability that the U.K. pension system had had to accept in its quest to meet obligations to pensioners during a decade of zero interest rates. That highlights the risks of years of QE and financial repression. Secondly, it suggests strongly that the Truss government had little or no understanding of this vulnerability. Because, if it *had* understood, it surely wouldn't have risked the biggest fiscal giveaway in 50 years, at a time of double-digit inflation and unusual labor market tightness, would it? *Would* it? Oh, alright, I guess it might have.

LIQUIDITY

LIQUIDITY DRIPS OUT: The ECB's balance sheet edged down marginally last week, shrinking by a mere €1.4 billion. But base money, a measure which tracks currency directly created by the central bank, and is therefore relevant for inflation dynamics, reverted to its downward trend, decreasing by €8.8 billion after rising by more than €87 billion a week earlier.

APP redemptions on the way up: However, balance sheet runoff is expected to gather pace in the second half of July as bonds held under the ECB's flagship Asset Purchase Programme (APP), are set to shrink by another €27 in the next two weeks, compared to just over €4 billion in the first half of this month. As of this month, the ECB is letting all the bonds it holds in the APP simply mature, having reinvested part of the proceeds until the end of June.

The long and winding road: Since the beginning of the year ECB's balance sheet has shrunk by €782 billion. About €723 billion of that is due to the repayment "long-term financing operation", aka TLTRO loans, while bond holdings declined by €77 billion. Yet, at the current pace it will take years for the ECB to reduce its balance sheet in any way that is meaningful for policy. Between now and the end of 2023 APP redemptions will sap another €145 billion euros, while TLTRO repayments will be at least €130 billion. Together, that would leave total assets still only just under €7 trillion and excess liquidity over €3 trillion — unless policymakers are willing to start reducing the much larger portfolio of bonds held under the Pandemic Emergency Purchase Program. And no-one on the Governing Council has gone *there* yet, even though (as we've said before) there is neither Pandemic nor Emergency any longer.

Banks are now regularly using MRO: Banks borrowed almost exactly €10 billion from the ECB at this week's 'main' refinancing operation. The amount is slowly coming down from a peak of €18.5 billion seen in the immediate aftermath of the massive TLTRO repayments at the end of June. Still, it is the fourth consecutive time that banks have taken at least €10 billion at the operation, something that hadn't happened since 2017. The numbers may still be very small by historical comparison, but it seems that, as other sources of funding become gradually tighter, the MRO may finally come back to life.

ECONOMIC INDICATORS

WAFTING OFF THE SHELVES: Boding ill for growth, U.S. retail sales rose more slowly than expected in June, driven by tighter financial conditions and a pivot away from tangible goods, according to advance estimates published Tuesday by the U.S. Census Bureau. Retail and food services, which are not adjusted for inflation, ran up to $689.5 billion, 0.2 percent higher than the previous month, but 0.1 percent lower than forecast. Only the "control" group — which excludes cars, construction materials, gas and food service components — overshot expectations, rising 0.6 percent from the previous month. The year-on-year increase was 1.7 percent.

Unsightly growth. That 1.7 percent figure is still being handily outpaced by inflation, which is running at 3 percent, according to last CPI report. "Retail sales are not rising as quickly as prices so the volume … for retail activity is down in YoY terms," James Knightley, chief international economist for ING, told Morning Central Banker. With consumer spending representing around 70 percent of economic activity, he added, that's also a concern for U.S. GDP growth, albeit not an entirely new one.

The greater good(s). Knightley said the recent trends of "fatigue" with buying physical things, and switching to "experiences like leisure and travel" (aka the Beyoncé index) are still very much intact. That's bound to affect spending, he said — along with the gradual sluicing off of Covid-era savings, and the recent Supreme Court decision that killed hopes of debt relief for thousands of former students.

Credit tightening is also becoming more of a factor: A survey by the New York Fed showed loan application rejections running at their fastest rate in five years.

QUOTED

"We have seen in core inflation … a pass-through of the massive increase of energy prices, especially gas prices, which is the major difference between Europe and the United States [and] which has been more intense than in the past. This explains why core inflation is stubborn. At the same time, since we have also been observing a substantial reduction in energy prices, we have to expect that this will be seen also in underlying inflation in the coming months, certainly by the end of the year." **Bank of Italy Governor Ignazio Visco** told Bloomberg TV at the G20 meeting in India.

"It is impossible to say because we have a lot of data points coming out between now and September … For July, I think it is a necessity. For anything beyond July it would at most be a possibility, but by no means a certainty," **Dutch Central Bank Governor Klaas Knot, head of the Dutch central bank**, told Bloomberg TV at the G20 meeting in Gandhinagar, India.

"The old joke is that if aliens invaded, the Fed would respond by cutting interest rates. I think we can add that Neel Kashkari would also propose suspending bank dividends." **Steven Kelly, Director of Research at the Yale Program on Financial Stability**, said via Twitter on Tuesday in response to Kashkari's call for tighter prudential measures at

undercapitalized banks.

WHAT WE’RE READING

— ECB officials see communication as toughest challenge in July (Bloomberg)

— Techies and firm-level productivity (VoxEU)

— Banks warned over ‘weak excuses’ for savings rates (BBC)

WHAT’S ON

(Editor’s note: this is intended as a selective list, giving precedence to European events). All times CET.

U.K. June CPI, PPI, 8 a.m**.**

EU June car registrations, 8 a.m.

Eurozone final June CPI, 11 a.m.

U.S. June housing starts and building permits, 2:30 p.m.

BoE Deputy Governor Ramsden speaks on quantitative tightening, 6 p.m.

HEADLINES

Here’s a recap of yesterday’s news, along with Pro articles and alerts from overnight.

ECB hawks edge back from future tightening as economy falters
Two of the eurozone’s most vocal advocates for higher interest rates have softened their stance.
By Ben Munster · Jul 18, 2023, 1:44 PM

Irish central bank backs global framework for investment funds
By Hannah Brenton · Jul 18, 2023, 1:00 PM

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