CULROSS GLOBAL

Macro Outlook Summary

July Supplement 2022

Data from the real economy in July was bleak. Despite some hopes that inflation data would peak there was no such relief with US inflation touching 9.1% in June vs 8.6% May, the UK reaching 9.4% after 9.1% in May and Eurozone inflation up 8.6% vs 8.1% in May with Spain reaching 10.2%. In the EU, food, alcohol and tobacco rose 8.9% vs 7.5% in May, evidencing how broadly based inflationary pressures have become.

Central Banks remained focused on the inflation issue and continued tightening. On the 27th July the Fed will announce their next hike, most likely 75bps rather than the 100bps some imagine. The ECB made their first move and somewhat surprised markets with a 50bps hike rather than the flagged 25bps. This was good news as it messaged that they do recognise the excess in monetary accommodation despite the Ukraine conflict and energy crisis in Europe. In addition, the bond buying programme has finally been halted so credibility has been retained for the time being.

But problems in Europe abound, not least in member state sovereign bond markets where cracks have reappeared yet again. Reforming archaic practices always presents great challenges to governments and Draghi's plans for much needed reforms in Italy have proven to be no exception. Weighed down by huge sovereign debt and a new political crisis, Italian government bond yields have risen to a spread of 240bps over Germany. One year ago in normal conditions that spread was 100bps. In the October 2018 crisis it touched 300bps.

The ECB have long been concerned with sovereign bond market 'fragmentation' across the 19 member states and in recent speeches have indicated they've been working on a new policy instrument to address this issue. President Lagarde rightly notes that such fragmentation hinders efficient monetary policy transmission and as Europe enters a very necessary rising rate regime so effective and fair transmission is paramount.

On 21st July the ECB announced the "Transmission Protection Instrument" which grants powers to the ECB to intervene and buy unlimited member state sovereign bonds when it believes that state is suffering from market speculation which is creating 'an unwarranted deterioration in financing conditions'. In other words bonds yields in that member state are too high in the minds of the ECB.

For a country to be eligible however it must meet certain criteria, including having a 'sound and sustainable macroeconomic policy' which complies with the EU's existing fiscal framework and adheres to requirements used to access the EU's recovery and resilience funds. In short it seeks to tie monetary support to the existing EU fiscal and governance framework. The instrument is expected to underpin countries like Portugal, Spain, Italy and Greece and limit the divergence in borrowing costs across the 19 EUR member states.

The ECB maintain the instrument will be used in emergency and extreme conditions only but they stress they will use it if required. As a countermeasure to deter market speculation it is clever and may well achieve the desired outcome. We don’t like manipulated markets but in the interests of European cohesion through difficult times ahead this makes sense.

Cynics will point to how subjective all the criteria really are and claim it provides a dangerous mechanism for core European countries to end up bailing out indisciplined fringe sovereign debtors, but for the time being it looks to have headed off one problem at least. Remembering the old adage ‘don’t fight the Fed’, this new measure may have created a core investment rule in Europe: ‘don’t fight the ECB’.