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Liquid Insight

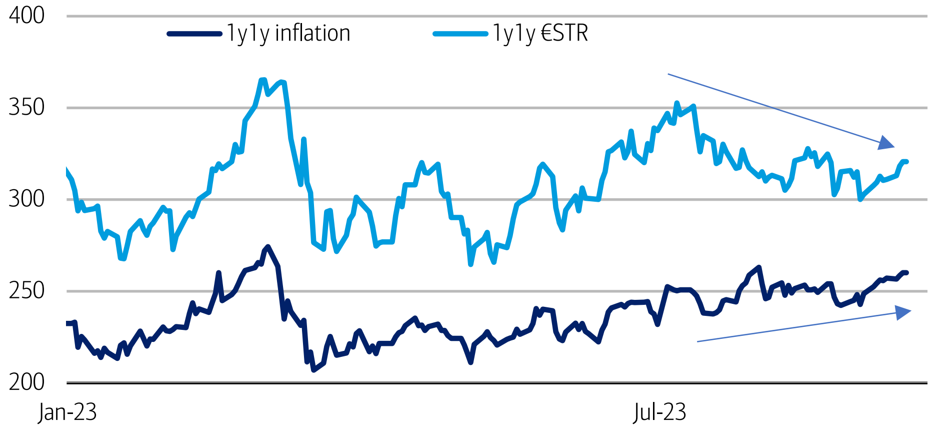
Pay 1y1y real rates in Euro – the ECB seems to agree that they're too low

Key takeaways

- ECB's Schnabel recently suggested that the fall in real rates threatened to undermine the fight against inflation.
- To us the easing of real policy rates priced sits uncomfortably with the stubborn inflation that is also priced.
- We would pay 1y1y real rates, combining positions in 1y1y EUR inflation and 1y1y €str.

By Mark Capleton

Chart of the day: Easing 1y1y €str conflicts with firming 1y1y inflation (to well above 2%), bp
ECB's Schnabel unhappy with recent narrowing in real rates; this suggests a trade idea to us.



Source: BofA Gloal Research, Bloomberg

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A trade with the ECB on your side?

From time to time we've had differing views from those of the ECB's Isabel Schabel. However, her view that the recent easing in real rates might undermine the ECB's efforts to rein in inflation chimes with our own (rather simpler) view that it looks wrong.

The drop in 1y1y €str since July, coupled with the rise in 1y1y EUR inflation, means that 1y1y real rates – the difference between the two – has fallen quite sharply. The market prices both a sharp easing of real policy rates and stubbornly high above-target inflation.

Those two things sit uncomfortably together. We think they could be resolved through either the market softening its inflation profile (our most likely scenario) or having to defer policy rate cuts. We would pay 1y1y real rates. It's unlikely perhaps, but If the ECB were to voice its displeasure with real rates where they are, that would benefit the trade today.

14 September 2023

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Hawkish spin from ECB today could hint at displeasure with softer real rates

> *"Real risk-free rates have fallen recently, counteracting efforts to restore price stability"*
>
> The title of the final slide of Isabel Schnabel's 31 August speech: "Disinflation and the Phillps Curve".

We don't always agree with ECB board member Isabel Schnabel's perspective on the Euro area's inflation outlook, but we now firmly align with her in the view that the market has got ahead of itself in pricing a material early easing of real policy rates. Below, we explain why, and discuss how we would oppose market pricing.

Real rates are the true measure of effective policy tightness, so the fall in real policy rates that is priced doesn't square with the stubbornly above-target inflation that is also priced.

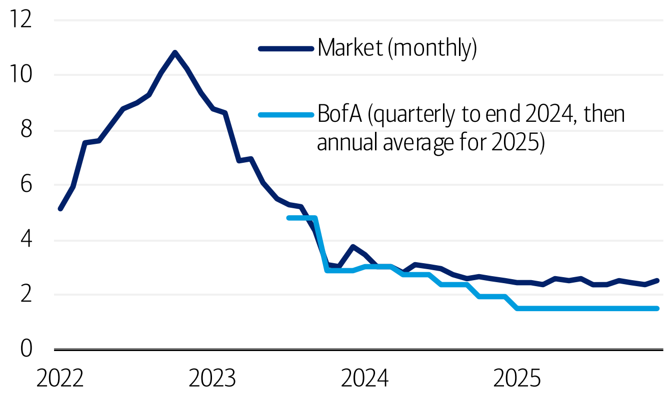
We may be extrapolating here, but since Schnabel chose to make that the main conclusion of her final slide in her 31 August speech, we wonder whether this framing of the rates market may find its way into the ECB's message today, particularly if it wants to deliver a hawkish spin.

Core inflation – less than meets the eye

Our European economics team has a profile for Euro inflation that slides comfortably below market pricing (and, by 2025, below the ECB's target - Exhibit 1). A recent weekly report of theirs (see 'Not as gloomy as the headlines', 1 September 2023) contained a striking chart which we have shamelessly stolen (Exhibit 2).

It uses a "bottom up" approach to seasonally adjusting monthly inflation – adjusting the individual components before aggregation, rather than adjusting the aggregate index – and it suggests much slower monthly goods inflation over the past two months. An earlier piece of theirs showed a similar story for services inflation.

Exhibit 1: Euro area inflation – BofA versus market, %
We see a return to target that the market remains sceptical of.



Source: BofA Global Research

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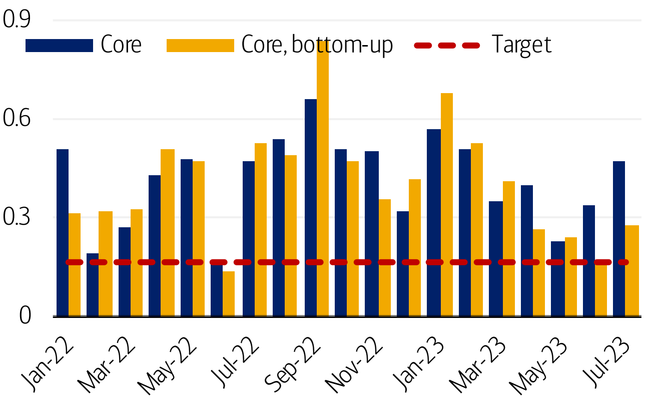
Exhibit 2: Seasonal adjustments matter (core goods, sa mom)
Much more disinflation with a bottom-up approach



Source: BofA Global Research, Eurostat, Haver

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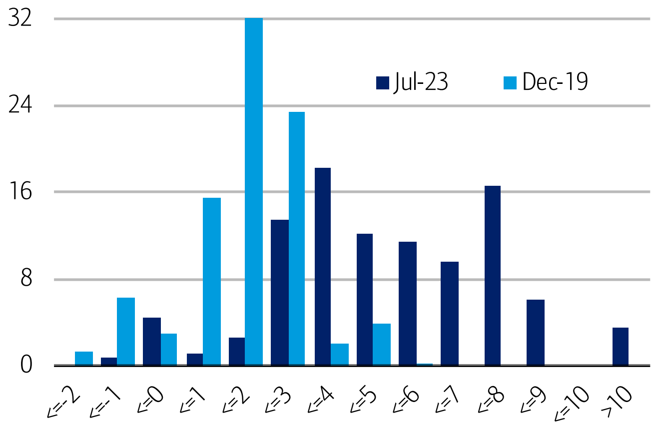
In the past we have talked about a broad dispersion of core component inflation rates as a sign that inflation is in flux. That's certainly true of the Eurozone now, compared to the pre-pandemic situation, although the proportion of the core index reading below 2% fails to hint at what we see in the monthly annualized pattern. It's also interesting to note how country headline inflation rates remain broadly dispersed, as they fall (hinting that there's a lot more to go for).

Exhibit 3: Dispersion of Euro core inflation component inflation rates
Broad dispersion versus pre-pandemic pattern means inflation in flux, %



Source: BofA Global Research, Refinitiv

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Exhibit 4: Proportions of core inflation below 2% and above 8%, %
Mild moderation thus far is about the long upside tail starting to shrink.

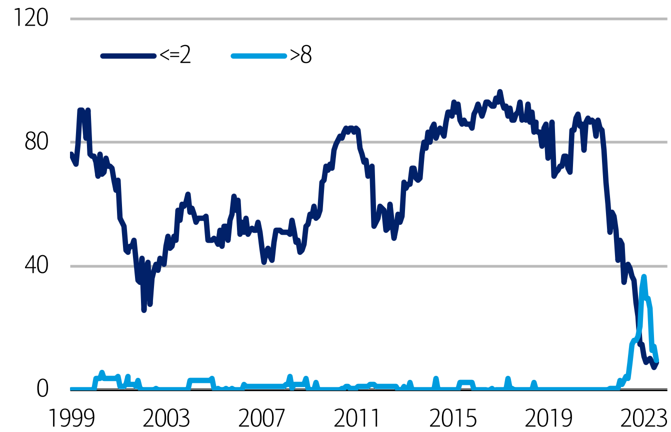

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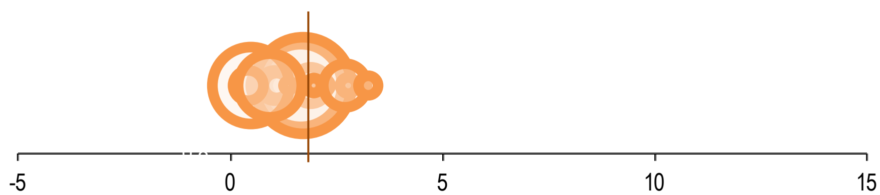
Exhibit 5: Euro member headline inflation rates in December 2019
Narrow dispersion tells us Euro inflation was anchored at 2%. Bubble size in proportion to country weights



Source: BofA Global Research, Haver

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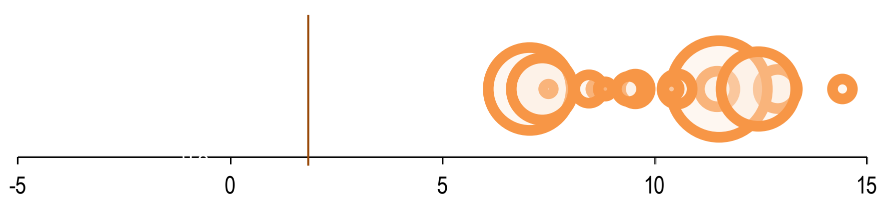
Exhibit 6: Euro member headline inflation rates at the October 2022 peak
All rates high, but very dispersed.



Source: BofA Global Research, Haver

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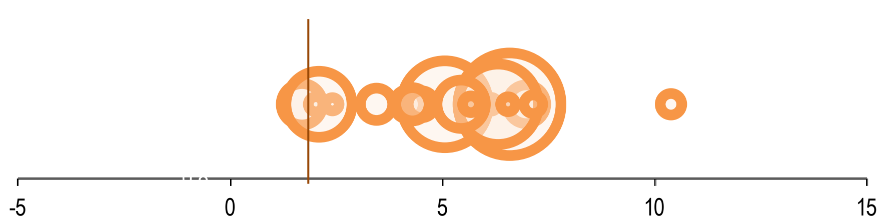
Exhibit 7: Euro member headline inflation rates in December 2019
A substantial fall, but still very dispersed, suggesting a lot more to go for?



Source: BofA Global Research, Haver

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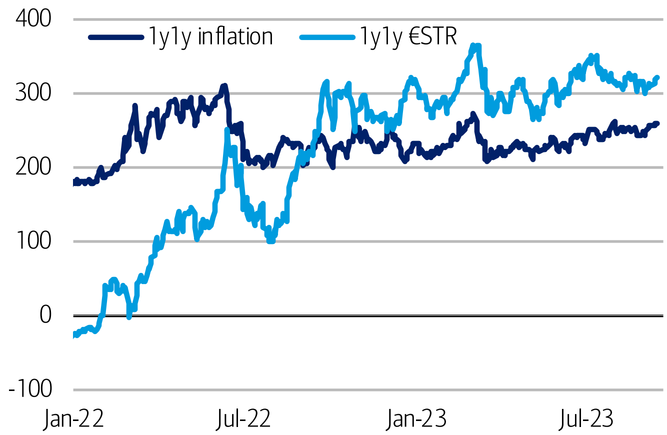
Exhibit 8: 1y1y EUR inflation and 1y1y €STR, bp
Since July, 1y1y inflation has firmed but this hasn't hampered softening rate expectations.



Source: BofA Global Research, Bloomberg

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Exhibit 9: 1y1y "real" €STR, bp
Real rate expectations have therefore fallen substantially, and are now close to their 2023 lows.

Source: BofA Global Research, Bloomberg

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Notwithstanding the prospect of a return to target for inflation, in our view (but not the market's) and a subdued-but-still-positive growth path, we still see the ECB hiking today – although it's finely balanced - with no policy rate cuts until June 2024.

Taking all of that into consideration should mean a much higher path for real rates than the market prices. Indeed, the market seems happy to price cuts with no return to inflation in prospect – something we would regard as a macro inconsistency (although not on the scale seen in 2022, with hindsight).

With 1y1y inflation at 260bp and 1y1y €STR at 321bp, 1y1y "real €STR" has narrowed to 61bp from almost 100bp in July. We would oppose this recent narrowing, and we think the ECB may lean against it too. Indeed, as Isabel Schnabel said on 31 August:

"Real risk-free rates have declined across the maturity spectrum and are now back to the level observed at the February Governing Council meeting, as investors have revised their expectations for economic growth, inflation and monetary policy. This decline could counteract our efforts to bring inflation back to target in a timely manner."

In last Friday's Global Rates Weekly, we recommended combining 1y1y inflation and 1y1y €STR positions to pay this 1y1y real €STR rate at a then prevailing spread of 54bp (currently 61bp), setting a target of 95bp and a stop-loss at 35bp. Risk to the trade is an ECB that doesn't hike and is interpreted dovishly, unable to (or choosing not to) oppose a market pricing.

Footnote – Shrinkflation in Italy. 13% of BTPei market extinguished on Friday

Summer in Euro linkers is a two act play. France's index events in July, an August interval with light or no supply, then Italy's events in September. For linker portfolio managers, what matters most now might be the BTPei Sep-24s index exit (with a value of €16.7bn), adding 0.21 to the modified duration of the Euro linker index at month end, by our calculations. The rebalancing associated with the extension will be augmented by €1.3bn in coupons from the six issues with a 15 September anniversary.

But that might not be the main event. It might easily go unnoticed but the BTPei market will shrink by 13% on Friday (tomorrow). The maturing Sep-23s will depart with an uplifted par value of €25bn, representing 13% of the Italian segment of the Euro linker market. To the extent that the maturing issue is asset-swapped, the extinguishing of these exposures should free-up capacity for new BTPei longs on asset swap, we argue.

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- Christmas will not likely come early this year **Global FX Weekly**, 8 Sep 2023
- The beginning of the end **Global Rates Weekly**, 8 Sep 2023
- August flows, **Liquid Cross Border Flows**, 4 Sep 2023

Rates, FX & EM trades for 2023

For a complete list of our open trade recommendations, as well as our trade recommendations closed over the past 12 months, see the reports below:

Global FX Weekly: Christmas will not likely come early this year 08 September 2023

Global Rates Weekly: The beginning of the end 08 September 2023

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