

Research

Arne Petimezas
 Director Research
 +31 20 522 0244
 a.petimezas@afsgroup.nl

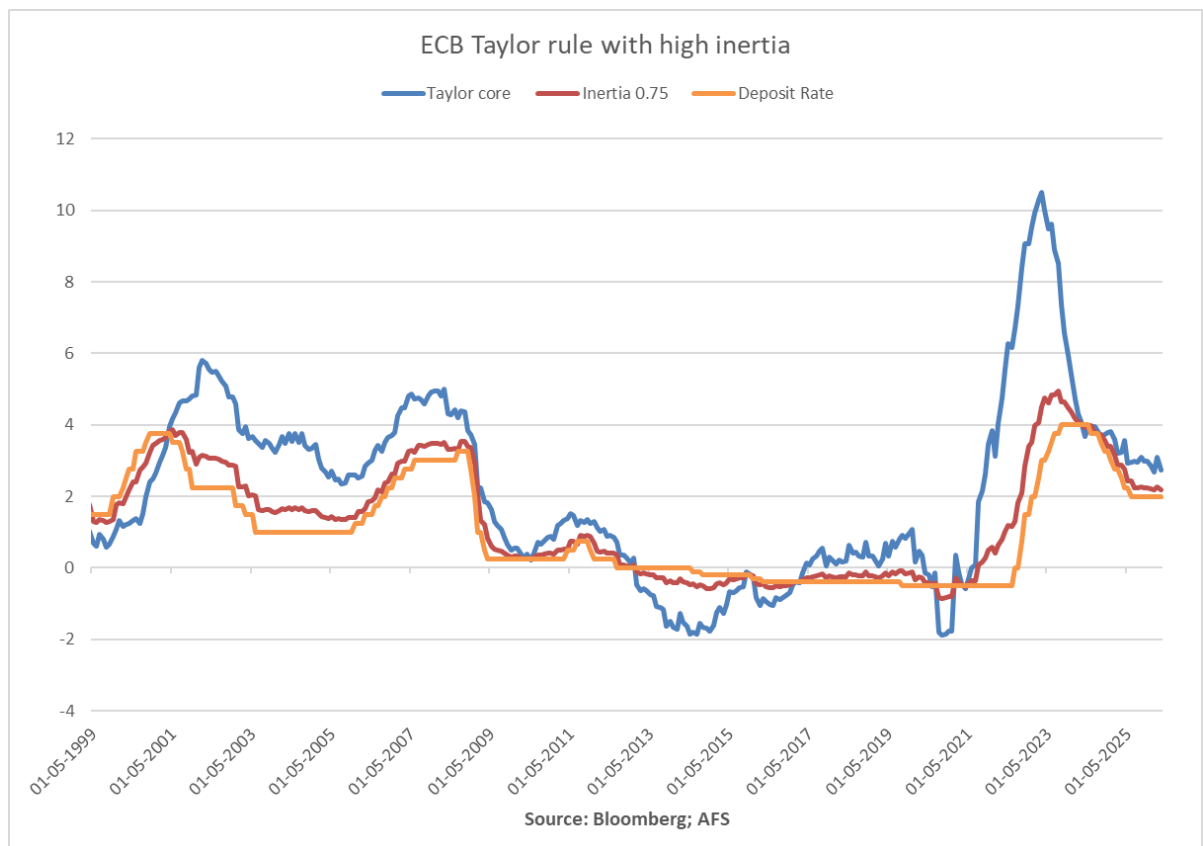
Caught between a rock and a hard place

- **Spare a thought for our poor central bank overlords in that wonderful glitzy tower in Frankfurt.** Hit by a stagflationary shock (negative supply shock in economists' parlance), the result of the action of one hell of an erratic US President named Donald Trump, the only thing our central banker friends can think about is Hormuz. The Strait of Hormuz: open (delay/tone down or even abort tightening) or closed (tighten).
- **With no resumption of peace talks in sight, and with the US having reverted to economic warfare against Iran instead of the conventional shooting and bombing stuff, it seems like a textbook case of be careful what you wish for.** Fighting has ended as we all hoped for. But in return we ended up with *something potentially worse*. I am a war optimist in the sense that I am confident that the shooting won't return. But about economic warfare being resolved soon I am not so sure.
- **When the ECB started to prod markets mid-April that the Governing Council meeting on April 30 was likely going to be a hold, Brent crude futures were hovering around \$95 a barrel.** And a resumption of peace talks was still in the air. Oil is now around \$114 a barrel and awfully close to the March highs. The news flow on the resumption of peace talks has become quite negative as of late.
- **And, as I will show further down below, the economic news has been disappointing too.** So, while the ECB cannot undo its hold-in-April guidance, President Lagarde will likely validate market pricing and consensus of a 25bps hike in June. For the record, the ECB guidance stating no particular future rate path will stay. But notice how this 'no particular path' language certainly doesn't rule out a hike.
- **Simple rule of thumb models point to just two 25bps ECB hikes.** Given the tightening of financial conditions that is happening right under the ECB's nose without a single rate hike having been realized, I don't think the ECB needs to do more than that.
- **Model one, a simple Taylor rule, suggests a 2.50 percent deposit rate.** Assumptions are a (basically) zero neutral real rate according to the latest Holston-Laubach-Williams estimate; the actual unemployment rate (it doesn't change much over the next six months or so); and core inflation rising to 2.8 percent. Regarding core inflation, I assume a half percentage point pass through of energy prices to underlying inflation as per the Bank of Italy study on the 2021-2022 inflation wave. That's in a strong pass-through scenario. For the record, I expect headline inflation to peak at around four percent. That

compares with headline peaking at 10.6 percent and core inflation at 5.8 percent during the post-pandemic inflation wave, which was rooted in fiscal and monetary largesse stemming from the pandemic (which we don't have currently).

Future modelled rate	
Neutral rate HLW)	0.1
Natural unemployment rate (SPF)	6.1
Unemployment actual	6.1
Core CPI	2.8
Prior ECB rate	2.00
Unadjusted Taylor Rule estimate	3.70
With 0.75 inertia	2.43

- **A high inertia model, a slow ECB response to changes in unemployment and inflation, best captures the central bank's historical reaction function.** Here's the chart:

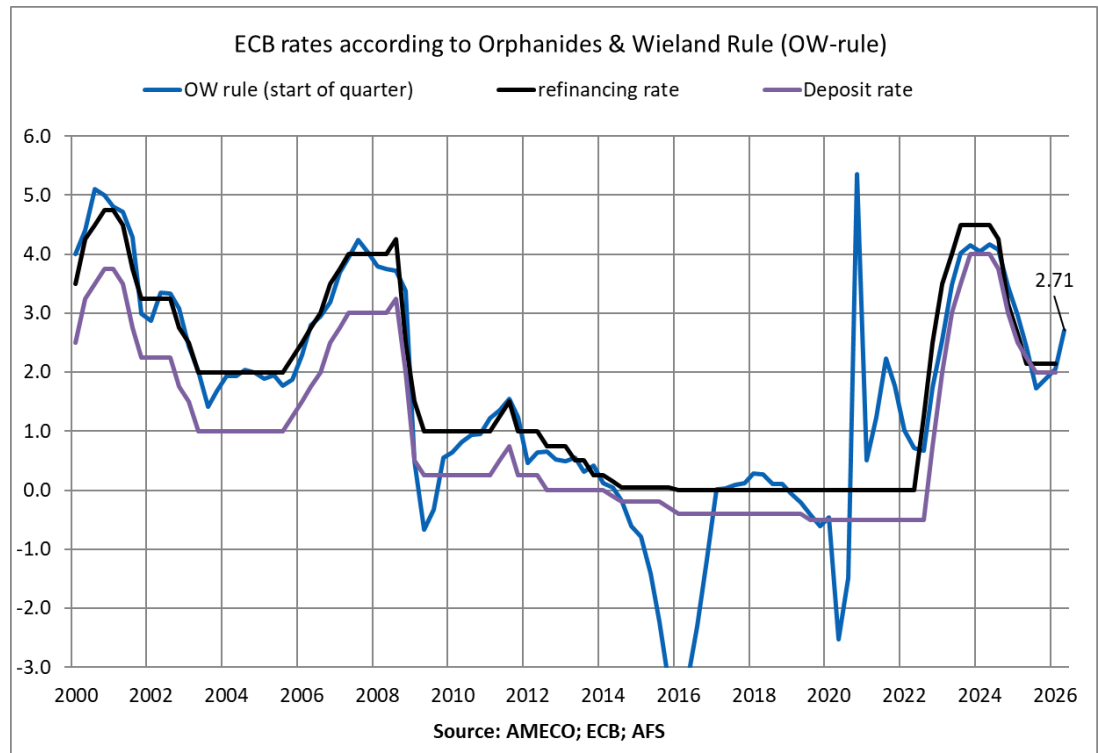


So, a Taylor rule tells us two 25bps hikes.

- **Another, albeit lesser-known model is the Orphanides-Wieland rule.** The rule, which is forward-looking by nature because it uses forecasts instead of actual datapoints, is named after former Cyprus central bank head and academic Athanasios Orphanides and ECB-watcher and academic Volker Wieland. Inputs are the inflation and GDP forecasts from the ECB's quarterly Survey of

Professional forecasters (SPF), and the EU Commission’s estimate for potential GDP growth.

- **Since we must wait another week for the next survey round and since the Q1 SPF forecasts are stale – pre-war – I took it upon myself to forecasts economists’ SPF forecasts using Bloomberg sell-side consensus and the ECB’s own forecasts.** Forecasting economists probably produces the most unreliable stats ever produced. But, for argument’s sake, assume I am not too far off economists’ forecast. And while those economist forecasts are wrong most of the time, that doesn’t mean the Survey of Professional forecasters isn’t useful. On the contrary, the SPF data/Orphanides-Wieland rule is incredibly useful because of its strong track-record in forecasting ECB rates.

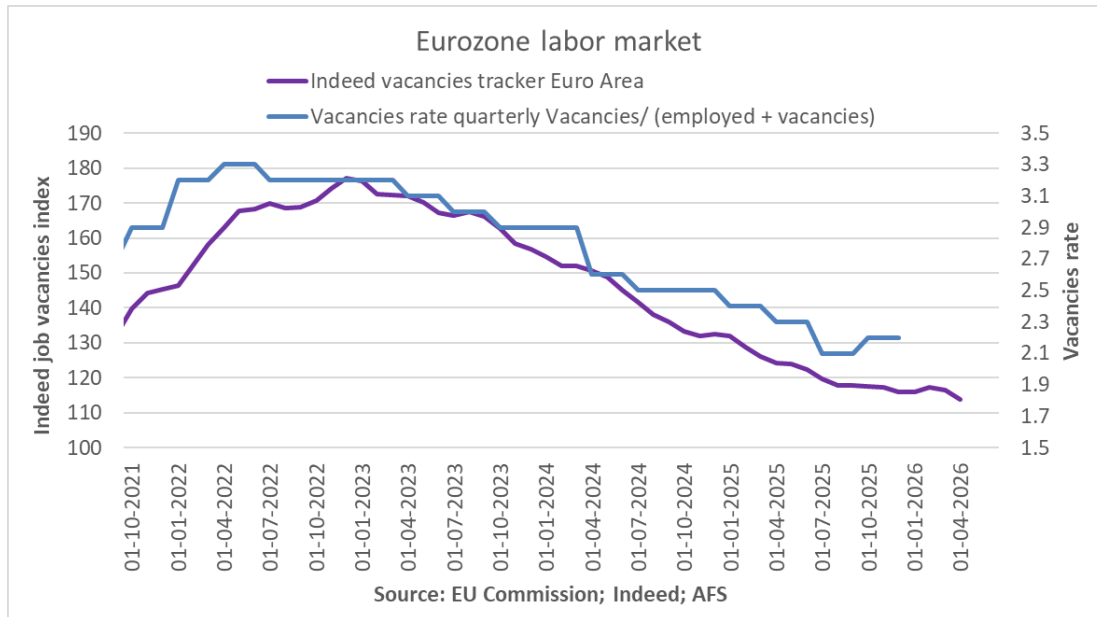


- **Taken at face value, the model suggests a 2.75 percent deposit rate.** Which is in line with market pricing. I have penciled in two hikes – 25bps in June and September. But I expect no third hike. On the contrary, I expect cuts next year. Starting with a 25bps cut in June 2027.
- **The scenarios I have in mind are 2008 and 2011.** In both cases, the economy was softening when the ECB raised interest rates. In both cases ECB tightening helped push the economy into a recession. The ECB quickly reversed course, cutting rates within six months. Now, I am not expecting a recession – I honestly have no clue. But the way I look at the economy is that the ‘flation’ part of stagflation will hit us first and that the ‘stag’ part – including the hangover from ECB tightening – will happen more gradually. Predictably, hiding here is an assumption that the Strait of Hormuz will reopen for business within twelve months after the start of the war, and preferably sooner than later. The longer the blockade lasts, the bigger the stagflation problem, and the bigger the headache for the ECB. When Hormuz inevitably reopens (I am an optimist!), the ECB will gradually gain the luxury of being able to look through high inflation in the near term.

- **I want to conclude with my observations on recent economic data and current market pricing.** Starting with the former, business survey data for April was bad. The modestly sub-50 reading for the PMI is consistent with slightly negative quarterly GDP growth. Furthermore, the EU Commission’s own business survey, the Economic Sentiment Index, is consistent with stall-speed growth. The details were equally discouraging, with the surveys pointing to rising input and output prices and falling the demand in the form of lower new orders (manufacturing) or slower growth (in the case of services).
- **The ECB’s Q2 Bank Lending Survey was just as bad.** Loan demand (both realized and expected demand) is falling while banks tightened credit standards. As with the business surveys, the blame falls squarely on the war.
- **To make matters worse for the ECB, the in-house corporate and inflation expectations surveys point to – you guessed – higher expected inflation.** The table below is a snippet from my Eurozone economic dashboard on inflation expectations. Note that I left out 2023, 2024, and half of 2025 to fit the table (and the data is not relevant anyway). Note that SAFE survey is relatively new with little in the way of historical data:

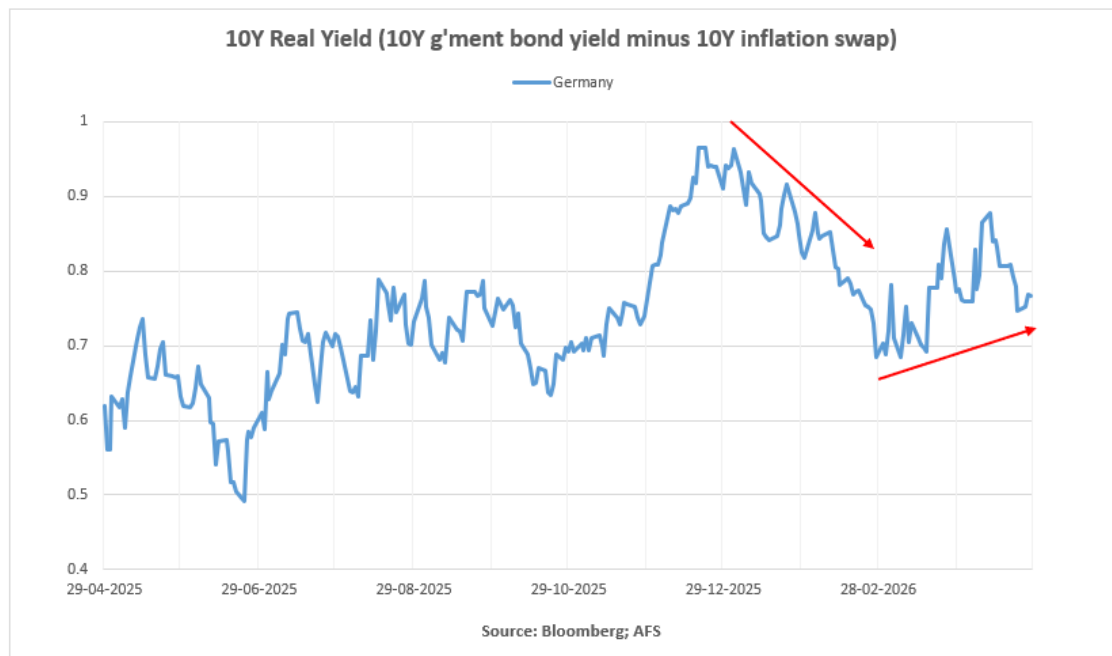
Month	ECB Household expectations 1-year ahead	ECB Household expectations 3-year ahead	SAFE survey corporate inflation expectations 1y ahead (median)	SAFE survey corporate inflation expectations 3y ahead (median)
31-07-2021	2.1	2.0		
31-08-2021	2.1	2.0		
30-09-2021	2.4	2.1		
31-10-2021	3.0	2.1		
30-11-2021	3.0	2.1		
31-12-2021	3.0	2.1		
31-01-2022	3.0	2.1		
28-02-2022	3.2	2.1		
31-03-2022	5.0	2.9		
30-04-2022	5.0	3.0		
31-05-2022	5.0	2.8		
30-06-2022	5.0	2.9		
31-07-2022	5.1	3.0		
31-08-2022	5.0	3.0		
30-09-2022	5.5	3.0		
31-10-2022	5.8	3.1		
30-11-2022	5.1	3.0		
31-12-2022	5.0	3.0		
31-07-2025	2.6	2.5		
31-08-2025	2.8	2.5		
30-09-2025	2.7	2.5	2.6	3.0
31-10-2025	2.8	2.5		
30-11-2025	2.8	2.5		
31-12-2025	2.8	2.6	2.6	2.9
31-01-2026	2.6	2.6		
28-02-2026	2.5	2.5		
31-03-2026	4.0	3.0	3.0	3.1

- **Households’ short-term inflation expectations were already very high in March and likely to rise further this month.** For the 1-year horizon, we’re still ways off the post-pandemic peak, though longer-term expectations are basically already back at their record-high.
- **I want to conclude with the labor market.** Specifically, vacancies, which remain stuck in a downtrend according to the timely data from Indeed:



The ECB’s wage tracker is in line with the softening labor market as par vacancies, with the annual rate of increase falling to 2.7 percent by year-end, down from 3.0 percent at the end of 2025.

- **So, the bottom line is that stagflation – both the ‘stag’ and ‘flation’ part – are already upon us, but the latter more than the former.** The only ‘luck’ on the ECB’s part is that financial conditions are already tightening, and that the labor market isn’t a source of inflation. Furthermore, the ECB’s corporate survey also points to the beginning of a margin squeeze, cushioning a bit of the price rises for consumers.
- **As I wrote in our Markets Blog (you can read it on our corporate website) there is now a tug of war between short end ESTR OIS and long end bond yields.** With the ECB showing reluctance to hike in April, and with everything pointing to a measured and gradual tightening in the face of the inflation surge, the long end has started to sell off, re-steepening yield curves. The ECB’s look-through approach to the stagflationary shock has lowered real yields at the same time, thereby cushioning the negative shock to output.
- **Here is our real yield benchmark, the 10y Bund yield minus the 10-year inflation-linked swap rate (similar to the 10y breakeven):**



- **In January and February of this year, real yields fell as the economy failed to accelerate despite all the talk about German fiscal easing providing a rising tide for all.** Real yields bumped modestly higher after the outbreak of the war with Iran. But the increases have been relatively modest because of the ECB’s cautious approach to tightening.
- **Now, 10y and 30y Bund yields are basically at the highest level since the early 2010s.** At the same time, 2y yields are a basis point or 15 below the March highs, when central bank rate hike pricing was at its peak. The relative outperformance of the short end is all the more telling when we consider that the energy price shock is now much, much closer to the ECB’s adverse scenario than the base case scenario (which already implied a couple of hikes). The adverse scenario implies more hikes. However, as mentioned before, the ECB has been leaning against rapid hikes this month. Furthermore, on Thursday I don’t think Lagarde will guide for anything more than a measured tightening cycle;
- **Long story short, if the ECB sticks with its relatively laissez faire approach to the stagflationary shock, the long end will come under increasing pressure.** As I wrote in our Markets Blog, notice how Hormuz hangs ominously above our central bank overlords’ heads. The longer the Strait is closed, the bigger the pressure on Lagarde & Co to tighten more aggressively to protect the long end. It’s all about Hormuz. And President Trump of course.

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