

Research

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Is it safe to raise interest rates?

- **Is it safe?** Is it... safe? Is it safe for the ECB to raise interest rates? We have been here before: a stagflationary, commodity price driven negative supply shock: 2008, 2011, and 2021. Twice, it ended in tears. Recessions in 2008 and 2011. But last time, the ECB managed to pull off a soft landing. Of course, in neither economics nor in broader society exists such a thing as a free lunch. The soft landing had its price. Underlying inflation never got below two percent. It stayed slightly above two percent. And while underlying inflation was grinding lower when the war broke out, the pace was slow. Regardless, with underlying inflation slightly above target, the ECB has no room for maneuver. Now that the downward momentum in underlying inflation has reversed, it must raise interest rates. Even if it isn't safe for the economy.
- **To be sure, I have penciled in two 25bps hikes.** One on June 11 and the next one in September. That compares with market pricing of nearly three hikes. And sell-side consensus of two hikes. Yes, I am guilty of consensus hugging (that, or the other way around). In the Governing Council statement, the ECB's go-to line that rates are not on a preset path will stay. Furthermore, President Lagarde will not drop a hint of another hike. Having said that, smarter analysts will read between the lines and notice that the ECB is inclined to hike again. Having said that, ECB-speakers will continue to lean against markets getting ahead of themselves by pricing in even more rate hikes than they currently do.
- **In my 12-month forecast horizon, I have penciled in cuts.** Starting with a 25bps cut in June 2027. I expect cuts relatively soon. Not just because of the historical track-record of there being about six to nine months before the last ECB hike and the first cut. I also happen to be in 'camp peace deal' with regards to the Iran war. I do not expect the war to return. At least not by design: accidents cannot be ruled out. The downside scenario would be a half-broken ceasefire, and US-Iran peace talks aborted, stalled, or dragging on. No deal from the art-of-the-deal-meister. However, I simply cannot fathom President Trump waging war or huddling with his advisors in the White House every now and then to plan another round of piecemeal strikes. To achieve what, exactly? He has been there, but it did not work out. That's why Trump is angry at a certain leader in a certain country. In any case, practically speaking, Hormuz must fully reopen in the course of several months.
- **I think our central bank overlords in the glitzy tower in Frankfurt think along the same lines.** A deal is more likely than not. However, a peace deal, or at least a normalization of Hormuz Strait traffic, will not magically squeeze inflation out of the economy. No Deus Ex Machina for our dear President

Lagarde. However, a deal would allow the ECB to look through high inflation figures in the present if household and business survey data and market-based measures of inflation expectations are easing on the back of a deal. Remain ‘anchored’ as central bankers like to say.

- **It is not difficult to see that rate hikes are forced upon the ECB by Trump and his misadventure – or excursion in his own words.** But raising rates is also as much of a pride thing. ECB-speakers, and in particular President Lagarde, have said that they believe that the public expects the ECB to act as the guardians of price stability. And with the war dragging on longer than the ECB had expected in its baseline scenario, and with inflation already above target before the war, the ECB simply has no choice.
- **So, while I’m fully on board with a couple of hikes, I have a beef with pricing exceeding just that: two tactical hikes.** Judging from ECB-speak in the past several months, I think our central bank overlords feel the same thing. They do not want to be forced to do more simply because the market has become over-enthusiastic about hikes. With three hikes more or less priced in already, there is no reason for Lagarde & Co to pour oil on the fire.
- **The data shows the same narrative: cool it with rate hikes.** In this note, with a handful of colorful tables I will show that this economy is vastly different than it was in 2021. Instead of a red-hot economy and a wall of demand, the economy was failing to speed up this year before the war (remember the 2025 stories that fiscal stimulus this year would finally drive-up Euro Area growth?). And falling demand for labor was more than just a sour spot before the war. The labor market, but also inflation grinding lower, was the reason that the market was biased towards cuts before the war turned everything upside down.
- **Let’s start with the economy through the lens of business survey data in the table below.** Be aware that I compare the 2021-2023 period of peak inflation with the run-up to the Iran war (from December 2025 on).

Month	Eurozone Composite PMI	Economic Sentiment Index implied YoY% GDP growth
31-07-2021	60.2	4.8
31-08-2021	59	4.7
30-09-2021	56.2	4.8
31-10-2021	54.2	4.9
30-11-2021	55.4	4.5
31-12-2021	53.3	4.2
31-01-2022	52.3	3.9
28-02-2022	55.5	4.1
31-03-2022	54.9	2.5
30-04-2022	55.8	2.3
31-05-2022	54.8	2.3
30-06-2022	52	2.2
31-07-2022	49.9	1.3
31-08-2022	48.9	1.1
30-09-2022	48.1	0.5
31-10-2022	47.3	0.3
30-11-2022	47.8	0.5
31-12-2022	49.3	0.9
31-01-2023	50.3	1.2
28-02-2023	52	1.1
31-03-2023	54.1	1.1
30-04-2023	54.4	1.2
31-05-2023	53.3	0.8
30-11-2025	52.4	0.9
31-12-2025	51.5	0.8
31-01-2026	51.3	1.2
28-02-2026	51.9	1.0
31-03-2026	50.7	0.7
30-04-2026	48.6	0.2
31-05-2026	47.5	0.2

- **During the 2021-2023 inflation surge, growth was incredibly strong on the back of fiscal and monetary stimmie fueling pent-up demand.** On the eve of the Iran war, survey data was consistent with the economy growing by about one percent on a year-on-year basis: nothing to write home about. Because of the war, the economy has now gotten stuck in neutral. If you read the PMI surveys, demand is coming from panic stock building, not because final demand expectations are so great (they aren't).
- **Let's go to the labor market, where the contrast with the post-pandemic bounce is even starker.** In the table below are business survey expectations for employment levels, employment growth rates according to the national accounts, and my favorite indicator these days: the incredibly timely Indeed vacancies tracker.

Month	Employment expectations manufacturing net percent.	Employment expectations services net percent.	Employment expectations construction net percent.	Indeed vacancies tracker Euro Area (index)	Quarterly employment QoQ annualized %
31-07-2021	13.4	13.1	1.1	120.8	
31-08-2021	13.1	13.5	2.1	126.3	
30-09-2021	13.6	14.9	2.9	132.6	4.66
31-10-2021	15.1	15.5	5.4	139.8	
30-11-2021	15.5	16.4	6.1	144.2	
31-12-2021	16.7	11.7	7.5	145.4	2.31
31-01-2022	16.9	10.9	6.9	146.5	
28-02-2022	18.3	15.3	7	152.2	
31-03-2022	11.1	13.8	6.2	158.2	2.09
30-04-2022	10.6	13.0	4.1	162.8	
31-05-2022	11.7	14.7	3.1	167.6	
30-06-2022	10.5	13.2	2.1	168.2	2.12
31-07-2022	9.9	11.0	0.4	169.8	
31-08-2022	8.1	12.0	-0.8	168.6	
30-09-2022	6.6	11.2	-1.7	168.9	1.12
31-10-2022	7.0	7.8	-2.3	170.8	
30-11-2022	7.5	10.7	-2.4	174.1	
31-12-2022	7.8	10.3	-2.1	177.2	1.67
31-01-2023	8.0	12.1	-3.2	176.2	
28-02-2023	6.9	10.9	-3.3	172.6	
31-03-2023	6.3	12.2	-3.9	172.2	2.01
30-04-2023	3.8	10.9	-4.5	172.1	
31-05-2023	2.4	8.5	-5.3	170.1	
31-12-2025	-4.2	-0.3	-10.2	115.8	0.73
31-01-2026	-3.6	1	-9.7	115.7	
28-02-2026	-3.7	0.1	-10	116.8	
31-03-2026	-3.6	-0.1	-10.1	114.5	0.34
30-04-2026	-6.1	-4.9	-11.1	109.2	
31-05-2026	-5.3	-1.8	-12.5	109.1	

- **Labor demand was strong right up to the eve of the 2023-2024 rate ECB rate hike cycle, with vacancies at a record by the turn of 2022/2023.** In 2026 YTD, vacancies have extended last year's decline. Hiring plans are even slightly negative these days. Employment growth of 0.3 percent translates to sub-par real GDP growth when we optimistically assume half a percent of productivity growth.

- Financial and monetary conditions are doing the ECB’s job of slowing demand.** The table below shows bank lending to the private sector (defined as bank loans to households and firms and bank purchase of private sector debt securities), inflation adjusted M1 money supply growth, and banks’ expectations for loan demand according to the quarterly Bank Lending Survey.

Month	Real M1 YoY %	Bank lending to the private sector YoY %	BLS expected demand for mortgages net percent.	BLS expected demand for corporate loans net percent.
31-07-2021	8.67	1.88	31	12
31-08-2021	8.07	1.51		
30-09-2021	7.75	2.10		
31-10-2021	6.50	2.34	23	-1
30-11-2021	5.07	2.59		
31-12-2021	4.75	3.10		
31-01-2022	4.46	3.86	8	6
28-02-2022	3.61	3.94		
31-03-2022	1.55	4.26		
30-04-2022	1.29	5.09	12	-10
31-05-2022	0.34	5.08		
30-06-2022	-0.78	5.53		
31-07-2022	-1.39	5.70	-5	-47
31-08-2022	-1.84	6.07		
30-09-2022	-4.06	6.30		
31-10-2022	-6.17	5.69	-4	-64
30-11-2022	-7.14	5.52		
31-12-2022	-8.43	4.70		
31-01-2023	-9.10	3.99	-15	-49
28-02-2023	-10.59	3.61		
31-03-2023	-10.75	3.04		
30-04-2023	-11.91	2.42	-18	-39
31-05-2023	-12.21	2.48		
30-11-2025	2.79	3.87		
31-12-2025	2.63	3.53		
31-01-2026	4.18	4.02	6.22	2.8
28-02-2026	3.57	3.94		
31-03-2026	3.04	4.32		
30-04-2026	1.83	4.05	-10.3	-19.65

- Real M1 growth has slowed and is consistent with slightly negative real GDP growth.** You might think: ha, recession! Hold your horses though. Real M1 is a business cycle turning point indicator, not a tool for forecasting real growth. Real M1 tells us nothing more than that the odds of the economy entering a recession have increased because of the war.
- Bank lending growth trends at four percent, which is a bit higher than nominal GDP growth.** However, the Bank Lending Survey tells us that loan demand growth has started to shrink in the current quarter, signs of which we could see in the softer monthly growth rate of bank lending in April of 2.1 percent annualized.

- **Last but not least is inflation.** The table shows the annual percentage change in monthly inflation. For starters, notice how soaring red hot inflation was after the pandemic and how comparatively tame it currently (still) is.

Month	Headline inflation YoY %	Services inflation YoY %	Core inflation YoY %	Goods excluding energy YoY %
31-07-2021	2.35	1.17	0.99	0.58
31-08-2021	3.16	1.49	1.86	2.42
30-09-2021	3.47	1.87	2.00	2.18
31-10-2021	4.11	2.14	2.12	2.04
30-11-2021	4.78	2.51	2.50	2.44
31-12-2021	5.01	2.49	2.68	2.97
31-01-2022	5.09	2.41	2.25	2.01
28-02-2022	5.83	2.54	2.68	2.91
31-03-2022	7.50	2.80	3.04	3.43
30-04-2022	7.42	3.17	3.44	3.88
31-05-2022	8.08	3.45	3.77	4.29
30-06-2022	8.65	3.32	3.71	4.35
31-07-2022	8.77	3.61	3.91	4.38
31-08-2022	9.08	3.72	4.22	4.99
30-09-2022	9.94	4.25	4.76	5.56
31-10-2022	10.62	4.30	5.01	6.13
30-11-2022	10.09	4.28	5.03	6.23
31-12-2022	9.26	4.45	5.25	6.51
31-01-2023	8.81	4.77	5.49	6.64
28-02-2023	8.57	5.07	5.66	6.61
31-03-2023	6.96	5.21	5.77	6.64
30-04-2023	6.94	5.17	5.60	6.27
31-05-2023	6.09	4.99	5.33	5.86
30-11-2025	2.11	3.40	2.38	0.51
31-12-2025	1.93	3.35	2.29	0.37
31-01-2026	1.68	3.20	2.19	0.40
28-02-2026	1.88	3.35	2.39	0.65
31-03-2026	2.53	3.18	2.23	0.52
30-04-2026	3.04	2.98	2.21	0.79
31-05-2026	3.21	3.48	2.57	0.89

- **Because of the war, headline inflation, which was trending below two percent, jumped.** Goods inflation is still relatively modest, but services inflation really picked up notably in May, fully reversing disinflation progress from last winter. However, I suspect last month’s jump in services inflation – and thus core inflation – can in large part be attributed to the infamous package holidays. Namely, a jump in the prices of airline tickets. While I can attest that airfares have become painfully expensive, they are no bellwether for the trend in underlying inflation. As a matter of fact, because of the comically large swings in package holiday prices, I strip them out completely from core inflation. Unfortunately, that exercise is only possible later this month, when Eurostat releases the detailed inflation figures for last month.

- **So, to conclude, this is not 2021-2023.** The key difference is the vastly different economic backdrop. The economy was mediocre before the war and has likely stalled ever since. Five years ago, overheating was the name of the game. So, the ECB will stick with tactical rate hikes. In this regard, the comparison with the ECB hikes 2008 and 2011 on the back of energy-driven inflation are unavoidable. However, the shock hitting the economy – a negative supply shock (stagflation) – is much, much stronger than it was in either 2008 or 2011. That suggests the risks to rate hikes are to the upside. Hence the market having shifted to pricing in a third hike. On the other hand, a relatively rapid opening of Hormuz, and the panic-driven inventory stocking reversing will go a long way in dousing inflationary pressures without the ECB lifting a finger. The economic momentum from the panic restocking will inevitably reverse. The question is when.

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