Liquidity letter

n°25 I 28 July 2022

FED responds to ECB and doubles down

An aggressive approach to stop inflation

Further rate hikes expected in the second half of the year

- **Interest rate hikes** The FED decided to raise interest rates by 75 bp for the second month in a row in order to control runaway inflation despite the first signs of a slowing US economy
- **Target range** At the end of the Federal Open Market Committee meeting, the target range for Fed Funds rates was set at **2.25 - 2.50%.**
- **Not so aggressive since 1981** We have to go back four decades to find a Fed this determined: indeed, this decision follows the 50 bp increase in May and the 75 bp increase last month (the first such increase since 1994).
- **It's not over yet** With inflation at its highest level for 40 years, further interest rate rises are expected in the second half of 2022, although the pace or volume is not yet clear.
- **Like the ECB** the Fed will move to a "meeting-by-meeting" approach to setting monetary policy based solely on the economic data in its possession.

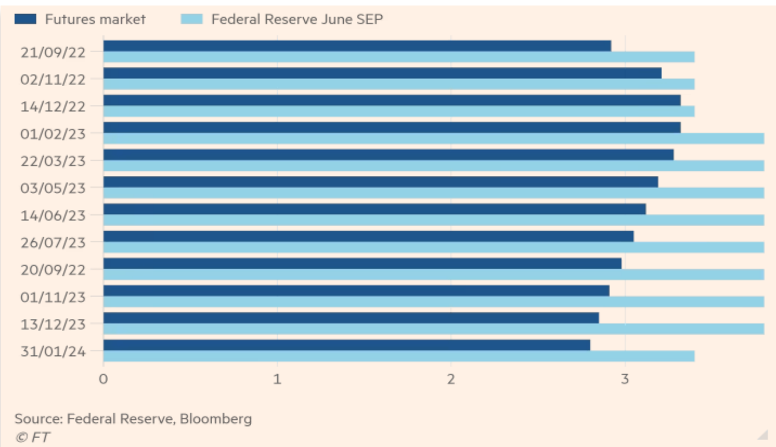
Number of the week

75

This is the increase in key rates in bp decided by the Federal Reserve on Wednesday 27 July.

The second 75 bp increase in two months

FED interest rate expectations



According to the chart above, the markets consider the Fed's rate projections to be incorrect. The difference would be in the order of two or three rate hikes upwards.

Jerome Powell

At the press conference, Powell said that as the central bank continues to tighten policy, ***"it will probably become appropriate to slow the pace of increases"*** while policymakers assess the impact of rate hikes on the economy and inflation.

However, Powell said that another large and unusual interest rate hike may be appropriate at the September meeting.

The FOMC will not hesitate to make a larger increase if the economic data warrants it. It also warned that a period of slower growth and a weaker labour market may be needed to reduce high inflation, but rejected the idea that the US is already in recession.

Eurozone: gas crisis increases risk of recession

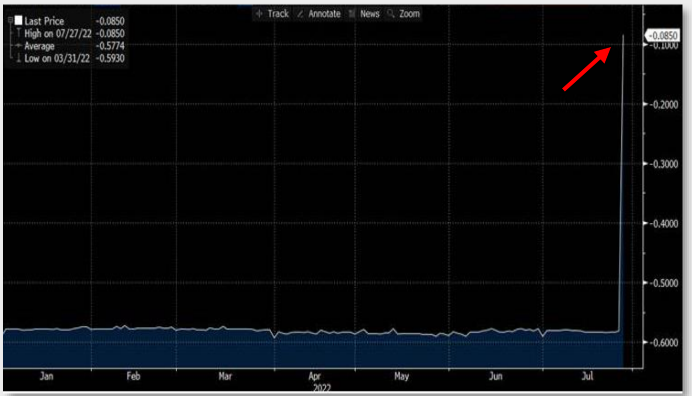
The Eurozone is expected to **grow** by **+0.1%** in Q2, down from +0.6% in Q1: economists expect a steady deterioration over the next year, due to recession risks. The Russian invasion of Ukraine has caused energy and food prices to soar, eroding consumer purchasing power while threatening to trigger a severe energy crisis.

While the tourism and hotel sectors appear to be enjoying a glimmer of hope this summer, thanks to the easing of pandemic restrictions and the savings tourists accumulated during the lockdown, a **prolonged reduction in gas flows** from Russia to Europe would leave the continent unable to fill its storage facilities sufficiently for the winter, forcing rationing of supplies to major industrial users.

> *As it relates to September, I said that another unusually large increase could be appropriate. But that's not a decision we're making now*
>
> *Jerome Powell, Chairman of the Federal Reserve, July 27, 2022*

How did the markets react?

€STR INDEX



5Y Italian Govies

Source : Bloomberg

The week on the European markets was characterized by the effective rise in the **€STR** index (-0.085% on Thursday 28 July) following the ECB's decision last week to raise interest rates by 50bp, bringing the index close to positive territory. On the chart on the right, we can see how can see how the ECB's other decision, the introduction of the Transmission Policy Instrument (**TPI**), has caused a positive reaction on Italian 5-year bond yields, which have fallen by 30bp over the last seven days, now trading at **+2.54%.**

Source : Bloomberg

German Treasury bonds also saw their yields fall over the past week.

In particular, maturities between 2 and 5 years saw a reduction of between 25 and 35 bps respectively.

The yield curve is now rather flat between the 2-year and 5-year maturities, which are separated by less than 30 bp. In contrast, yields for maturities below 2 years are rather stable.

Whatever it takes: it's already been 10 years!

On 26 July 2012, the President of the ECB was expected to give a conference in London.

The Eurozone was facing its worst episode of the sovereign debt crisis in two years and this episode was to be the final blow to the single currency.

At 12:00, Mervyn King hands over to **Mario Draghi**.
At 12:09 Bloomberg publishes the headline:

"*DRAGHI SAYS THE ECB IS READY TO DO WHATEVER IT TAKES FOR EURO - - - STORY TO FOLLOW"

Little did they know that what was to follow was not a "story", but history. Three words, recorded in an unnamed speech, Verbatim of the Remarks.

A few remarks, and the story before your eyes.

« The ECB is ready to do whatever it takes to preserve the Euro.

And believe me, it will be enough! »

Mario Draghi, former ECB President, 26 July 2012

News

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Agenda

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4 August I Bank of England interest rate decision

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