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The great debate on interest rates in Europe

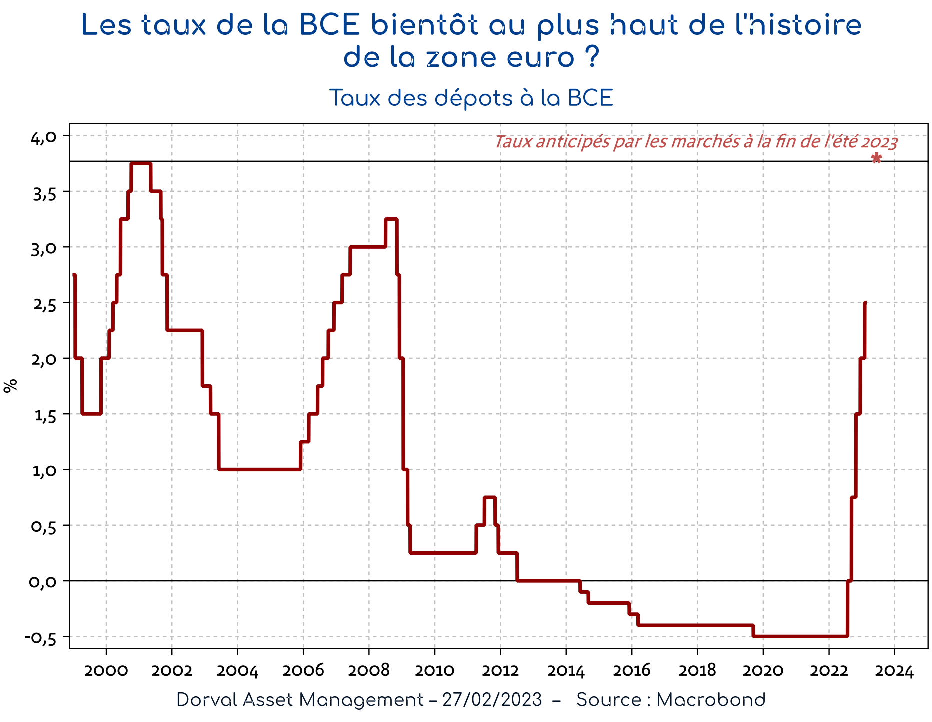
27 february 2023

Dear Clients and Partners,

Persistent inflation and the resilience of the economy are leading investors to significantly increase their interest rate expectations. In Europe, this trend is starting to raise concerns among some central bankers for the first time.

The turnaround is striking. Recently accused by many commentators of ignoring central banks' strong message against inflation, are markets straying too far the other way? In Europe, money markets now expect the ECB to raise its deposit rate from its current 2.5% to over 3.75% this summer – a new record high for the eurozone (cf. chart 1). According to Mr Villeroy de Galhau, whose opinion usually reflects the middle ground of ECB members, this is now going a little too fast. Bond markets are therefore reported to have swung from complacency to excessive pessimism.

ECB rates soon to reach an historic high for the eurozone?
ECB deposit rates



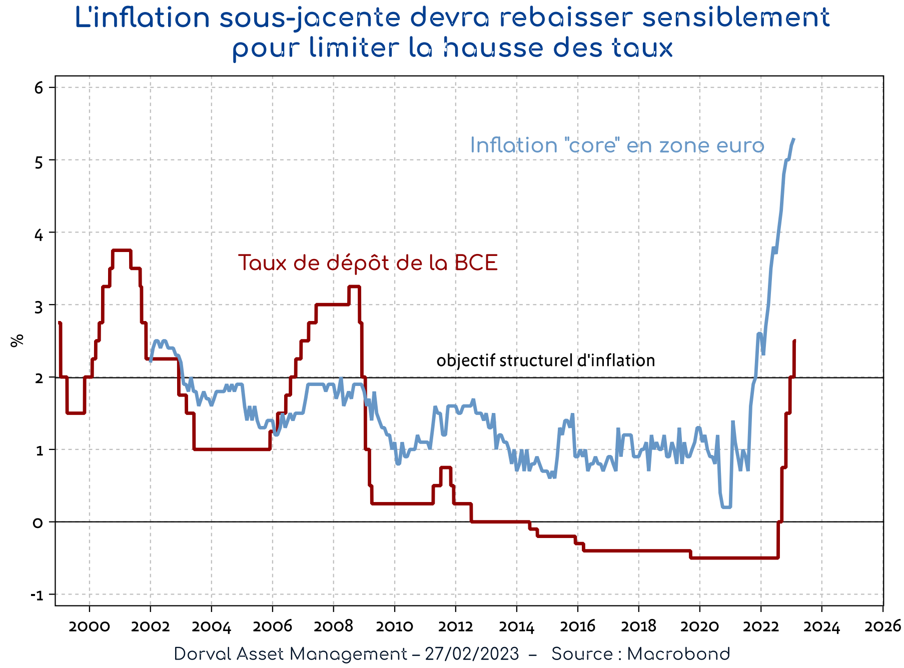
- *Rates anticipated by the markets at the end of summer 2023*

According to the Governor of the Banque de France, inflation is expected to begin to come down by the summer and the European economy is still too weakened by the energy shock to withstand a sharp and rapid rise in interest rates. He estimates that, at the current level of 2.5% and with the ongoing reduction in size of the ECB's balance sheet, European monetary policy is already starting to become restrictive. Moreover, as Ms Lagarde pointed out very recently, ECB consensus is that Europe is not under threat from a wage-price spiral. Going too far and too fast in the fight against inflation would therefore risk causing economic contraction that would force the ECB to quickly lower its rates.

Like the Fed, the ECB is patiently aiming for "neither too much nor too little", with a view to allowing the economy to continue to moderately grow while gradually reducing inflationary pressures. The ultimate goal is to find a new equilibrium – or even a new normal – leading to a resilient economy, albeit with inflation and interest rates higher than in 2010. This objective is particularly important for the ECB, which especially does not want to return to the negative rates and exceedingly low level of inflation seen before Covid.

Many observers, including, of course, the ECB's "hawks", do not quite share this vision. They are of the opinion that, with core inflation at around 5%, monetary rates of at least 4% would be more justified (cf. chart 2), especially as the labour market remains tight and fiscal policies are still expansionary. Moreover, with the US Federal Reserve set to raise its rates above 5% to fight persistent inflation, the eurozone cannot afford, in their eyes, to let the euro fall, as this could fuel inflation.

Core inflation will have to decline significantly to limit rate hikes



- *Core inflation in the eurozone / ECB deposit rate / structural inflation target*

How this debate will evolve will depend on inflation and growth figures in the coming months – on that point everyone agrees. The consensus among economists is that European inflation will gradually fall to around 3% within 12 months. If this is the case, there is no reason to anticipate more interest rate hikes than what is already seen in bond prices. We are beginning to tactically focus on eurozone short-term bonds for the first time in many years. However, our central strategy remains anchored on money market/equity investments, a pairing that has always seemed more attractive to us than the bond market.

We are maintaining a fairly high exposure to the equity market in our global flexible funds, but we have strengthened option-based hedging. We are focusing on the energy transition (basket of 40 equally weighted stocks) and European risk reduction (small stocks). We have sold our positions in emerging markets. Our bond duration remains very low, but we are cautiously starting to buy short-term bonds (two to three years to maturity) in Europe. We are continuing to earn increasing money returns by actively managing the cash portion of our portfolios.

Our exposure rates are as follows:

- Dorval Convictions: The equity exposure rate is 64%.

DORVAL ASSET MANAGEMENT

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