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Europe's natural gas picture

Russia's actions take Europe to the verge of a supply shock possibly of a similar magnitude to the Arab and Iranian oil embargoes of 1973 and 1979.

The ECB

The eurozone economy is vulnerable, and the hawkish stance by the European Central Bank (ECB) has had a considerable impact on global markets.

Stringency measures in China

So far, the impact to economic activity seems much smaller than what we saw in the first half of the year as policymakers try to balance economic considerations and virus control.

So much has happened in recent days that it's hard to know what's most important to follow this week. Following are a few thoughts on what I'll be looking at most closely:

1. Europe's response to a natural gas cutoff

European Union (EU) member states have been frantically building energy reserves in advance of winter, working toward EU targets of at least 80% storage capacity by Nov. 1.¹ However, last week Russia announced it would not be reopening the Nord Stream I pipeline (which had been temporarily shut down for repairs), throwing a wrench into those plans. Russia has clarified that gas supplies will not resume until anti-war sanctions are lifted, so Europe will have to get through the winter without Russian gas (unless plans to continue supporting Ukraine change considerably). While reserves have been built up in some large EU member states well ahead of schedule — with storage capacity at the EU level at 80% as of the end of August — that only covers approximately 20% of average annual usage, which is concentrated in winter.² If this winter is relatively cold, this latest action by Russia takes Europe to the verge of a supply shock possibly of a similar magnitude to the Arab and Iranian oil embargoes of 1973 and 1979, respectively.

Despite Brexit, the UK is in no better position than the rest of Europe. The UK has virtually no storage and is integrated into the EU pipeline network as a transit hub for Norway's gas and US/MENA (Middle East and North Africa) liquefied natural gas (LNG).

This shifts the focus to substitutes for Russia's natural gas. The good news is that Germany's construction of two LNG terminals is expected to be completed this winter. It is estimated that these two facilities could provide about 60% of what had been the recent flow coming from the Nord Stream I pipeline, which was only about 20% of capacity.³ There is also the potential to increase natural gas imports from Norway. In addition, Germany just announced it will be keeping its nuclear plants open in the coming year in order to help provide energy during this crisis.

However, finding substitutes for Russian natural gas will only alleviate some of the pressure created by the natural gas cutoff. This crisis also has the potential to create more political division, calling into question ongoing European support for Ukraine. Over the weekend, approximately 70,000 protesters gathered in Prague to protest high energy bills and demand an end to sanctions against Russia over the war in Ukraine.⁴

2. European Central Bank meeting

Since mid-August, the overnight index swaps (OIS) market has been pricing in a more hawkish monetary policy stance by the European Central Bank (ECB). The OIS market now expects cumulative ECB policy rate hikes for 2022 and the first half of 2023 to be 125 basis points higher than anticipated at just the beginning of August.⁵

Although the OIS market tends to overestimate rate hikes, this large movement reflects a sizable change in market expectations. It appears that various hawkish comments made by a number of ECB officials moved market expectations, including those by Isabel Schnabel, a member of the ECB Executive Board, at Jackson Hole in late August.

This hawkish stance by the ECB has had a considerable impact on global markets. It has resulted in higher bond yields across the Euro Area but also has arguably contributed to a rise in the US 10-year bond yield — along with Federal Reserve Chair Jay Powell's own hawkish comments. The entrenchment of hawkishness across major central banks has in turn exerted downward pressure on global technology stock prices.

The stakes are high. The last two times the ECB hiked into rising headline inflation led by energy, in 2008 and again in 2011, were arguably among the most detrimental policy errors by a major central bank ever. The first precipitated the eurozone financial crisis; the second exacerbated it, almost blowing up the financial system and the euro, in my view. The inflation measure that the ECB targets is headline Harmonised Index of Consumer Prices (HICP) inflation, but it has paid closer attention to core HICP since Mario Draghi's presidency, at least in part because core HICP argued against raising rates in 2008 and more so in 2011.

Today, core HICP is rising sharply, which does not help ECB doves. Not surprisingly, ECB hawks are advocating for a 75 basis point hike due to high, rising inflation and tight labor markets. However, the eurozone economy is very vulnerable. S&P Global recently sounded an alarm on the eurozone economy, especially the buildup in inventory: "The euro area's beleaguered manufacturers reported a further steep drop in production in August, meaning output has now fallen for three successive months to add to the likelihood of GDP (gross domestic product) falling in the third quarter. Forward-looking indicators suggest that the downturn is likely to intensify — potentially markedly — in coming months, meaning recession risks have risen. Falling sales have not only led increasing numbers of factories to cut production but have also meant warehouses are filling with unsold stock to a degree unprecedented in the survey's 25-year history. Similarly, raw material inventories are accumulating due to the sudden and unexpected drop in production volumes. Weak demand and efforts to reduce high inventory levels are therefore combining to drive production lower in the months ahead"⁶

Needless to say, we will be waiting with bated breath for the ECB's decision this week.

3. The new UK prime minister and sterling

There has been a relatively high level of uncertainty around newly minted UK Prime Minister Liz Truss, given her change in political ideologies over time as well as her changing position on several issues since becoming a leading contender for prime minister. There is particular uncertainty around the Bank of England in a Truss government, given her comments about revisiting and potentially altering the central bank's mandate. There's also concern that she might confront the EU by suspending the Northern Ireland protocol in the Brexit trade agreement.

However, what we have heard most recently is somewhat more encouraging for markets: that Truss believes in the independence of the Bank of England, and that her government is preparing to provide \$170 billion in fiscal stimulus to help alleviate the pain being caused by rising energy prices to consumers and small businesses. This stands in contrast to previous statements articulating a preference for tax cuts over aid — although tax cuts may also remain in the mix. Sterling has weakened significantly this year, although against the backdrop of US strength against most major developed and emerging market currencies. Sharpening clarity on Truss' policies could see sterling reverse some of its losses.

That said, such a strong effort at fiscal support — which may be necessary given the cost-of-living crisis — would take place amid super-tight labor markets (UK unemployment is in low single digits; supply challenges due to the energy crisis, Brexit, labor shortages; and inflation already in the double-digits; and enlarged budget and external current account deficits). This substantial fiscal stimulus could mean the Bank of England may have to tighten more than otherwise and may have difficulty bringing inflation back down towards target. Sterling and UK domestic-facing assets could continue to underperform other major markets as a result.

4. China stimulus

China's latest COVID wave has led to greater stringency, including some forms of lockdown, in cities such as Chengdu and Shenzhen. So far, the impact to economic activity seems much smaller than what we saw in the first half of the year as policymakers try to balance economic considerations along with virus control.

While the risk of another economic downturn has risen, so have stimulus measures. We anticipate more pro-growth policies could be announced as we get closer to the Party Congress, and we expect that could lead to a Chinese stock market rally.

5. The yen

The Japanese yen has fallen below 140 per US dollar for the first time in nearly 25 years.⁷ This is mainly a result of the strong US dollar. However, the Bank of Japan (BoJ) has been steadfast in not raising rates, as central banks around the world have been tightening monetary policy (the Reserve Bank of Australia just raised rates by 50 basis points⁸). Financial firms' forecasts for the yen are being revised down, as more erosion is anticipated. This seems likely to be reversed only if BoJ officials were to signal a change to policy, and that seems unlikely at this juncture given what Governor Haruhiko Kuroda has communicated thus far. In addition, there are certainly some benefits to Japan's economy from a weaker currency.

6. Bank of Canada decision

The Bank of Canada (BoC) meets this week for the first time since its somewhat shocking decision in July to raise rates by 100 basis points.⁹ Despite high inflation, Canada's economy is quite strong — far less vulnerable than the eurozone or UK economies — and so a substantial rate hike is likely to be well tolerated, in my view. Consensus expectations are for a 75 basis point rate hike, and that seems appropriate given conditions in Canada, as well as BoC governor Tiff Macklem's desire to "front load" rate hikes.⁹

Hiking 175 basis points in two months is a lot, however, and given that the goal is “front loading,” I can’t help but wonder if the Bank of Canada will make a “subtle pivot” to a less aggressive path in subsequent meetings. We can look for clues coming out of this meeting, especially a focus on being more data dependent.

7. Copper prices

Finally, I think “Dr. Copper” has historically been a relatively reliable leading indicator of slowdowns, recessions, and expansions. Copper prices have been falling since their recent peak last March, under pressure because of reduced demand from China and a general tightening of financial conditions globally. If copper prices continue to decline, it could signal a major global slowdown is in the offing (although it is worth noting that any drop in commodity prices can also be a positive in this environment given that it can alleviate inflationary pressures.) We will want to follow prices closely for clues on the magnitude of the economic slowdown.

With contributions from Emma McHugh, Tomo Kinoshita, Arnab Das and David Chao

Notes

¹Source: Reuters, Sept. 3, 2022

²Source: S&P Global, “EU gas storage reaches November target early as Gazprom cuts flows,” Aug. 31, 2022

³Source: Eurasia Group, Aug. 25, 2022

⁴Source: The Guardian, “Thousands gather at ‘Czech Republic First’ rally over energy crisis,” Sept. 4, 2022

⁵Source: Bloomberg, as of Sept. 2, 2022

⁶Source: S&P Global, “S&P Global Eurozone Manufacturing PMI,” Sept. 1, 2022

⁷Source: Japan Forward, “Japanese Yen Drops Below 140 to the US Dollar for First Time in 24 Years,” Sept. 6, 2022

⁸Source: CNBC, “China stocks close 1% higher; Australian central bank hikes rates by half a point,” Sept. 6, 2022

⁹Source: Bank of Canada, “Bank of Canada increases policy interest rate by 100 basis points, continues quantitative tightening,” July 13, 2022

Important information

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

All investing involves risk, including the risk of loss.

Past performance does not guarantee future results.

Investments cannot be made directly in an index.

Tightening is a monetary policy used by central banks to normalize balance sheets.

A basis point is one hundredth of a percentage point.

An Overnight Index Swap (OIS) is an interest rate swap agreement based on a published index of a daily overnight reference rate.

The Harmonised Index of Consumer Prices (HICP) is used to measure consumer price inflation in the euro area. It is “harmonised” because all the countries in the European Union follow the same methodology. This ensures that the data for one country can be compared with the data for another. Headline inflation includes food and energy prices. Core inflation excludes them.

Gross domestic product is a broad indicator of a region’s economic activity, measuring the monetary value of all the finished goods and services produced in that region over a specified period of time.

The Northern Ireland protocol is a post-Brexit arrangement that regulates trade between Northern Ireland, which is part of the UK, and the Republic of Ireland, which is an EU member state.

The International Monetary Fund is a global organization of 190 member countries that supports economic policies that promote financial stability and monetary cooperation.

The reserve requirement ratio is the percentage of depositors’ balances banks must have on hand as cash.

The “Party Congress” refers to the upcoming National Congress in China, a political gathering that takes place every five years.

Doctor Copper is a slang term describing the price of copper as an indicator for the overall health of the economy.

The opinions referenced above are those of the author as of **Sept. 6, 2022**. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.