March 2nd market briefing

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"Interests In The Sky"

Market briefing

- ➡️ Back in 2008 the ECB benchmark reference rate started to fall and today it is at 0%.
- ➡️ During the last seven years the ECB has struggled to put inflation at its desired level.
- ➡️ Markets are desperately looking for signals of when the next interest rate hike will take place.

Not long ago I was watching the 2015 movie "Eye in the sky" which, for those of you who haven't seen it, is about a US Army Colonel (Helen Mirren) who is commanding an operation with drones aimed at killing terrorists in Kenya. Despite the surgical weapon at hand, tension escalates when a young girl appears on the military screens. This girl is a local who not only lives next to the terrorists' house, but who also decides to establish next to the targets' house wall a makeshift point of sale for making some money of the bread her mother bakes at home. The dilemma then becomes if waiting for the girl to leave, with the risk that the terrorists may leave too, or to fire a missile immediately securing the mission but risking the life of the innocent, and kindly portrayed, girl. For most of the movie it reminded me situation faced nowadays by the monetary authorities in Europe.

Both the FED and the ECB do face a critical decision: To hike or not to hike?

Both the ECB officials and the US Army Colonel do have very specific missions. The ECB must keep the inflation rate just below 2% while on the other hand the US Army Colonel must kill terrorists. Also both, despite having a very clear objective, must take care of not messing things up during their attempts to succeed. Or, in other words, the two must minimize the "collateral damage" of their actions. Usually if nobody is watching they can go away with any unnecessary damage caused as part of their missions, but if stakes are high because others are watching or because of the context within the decision is being taken then pushing the button can become complicated. Very complicated. While in the movie the problem starts when the soldier piloting the drone refuses to shoot after seeing the young girl, triggering the whole argument of the story, in the real world both the FED (although it shall be independent of politics) and the ECB the dilemma is triggered when people is watching, when politicians have doubts, and/or when stakes are high. What variables are now on the screen? Well, Dutch and French General Elections are around the corner while in Germany's will take place in September. Italy will follow early next year. Politicians may be tempted of fighting populism with its own weapons, and monetary illusion is one at hand as long as the ECB does not take too serious its mission.

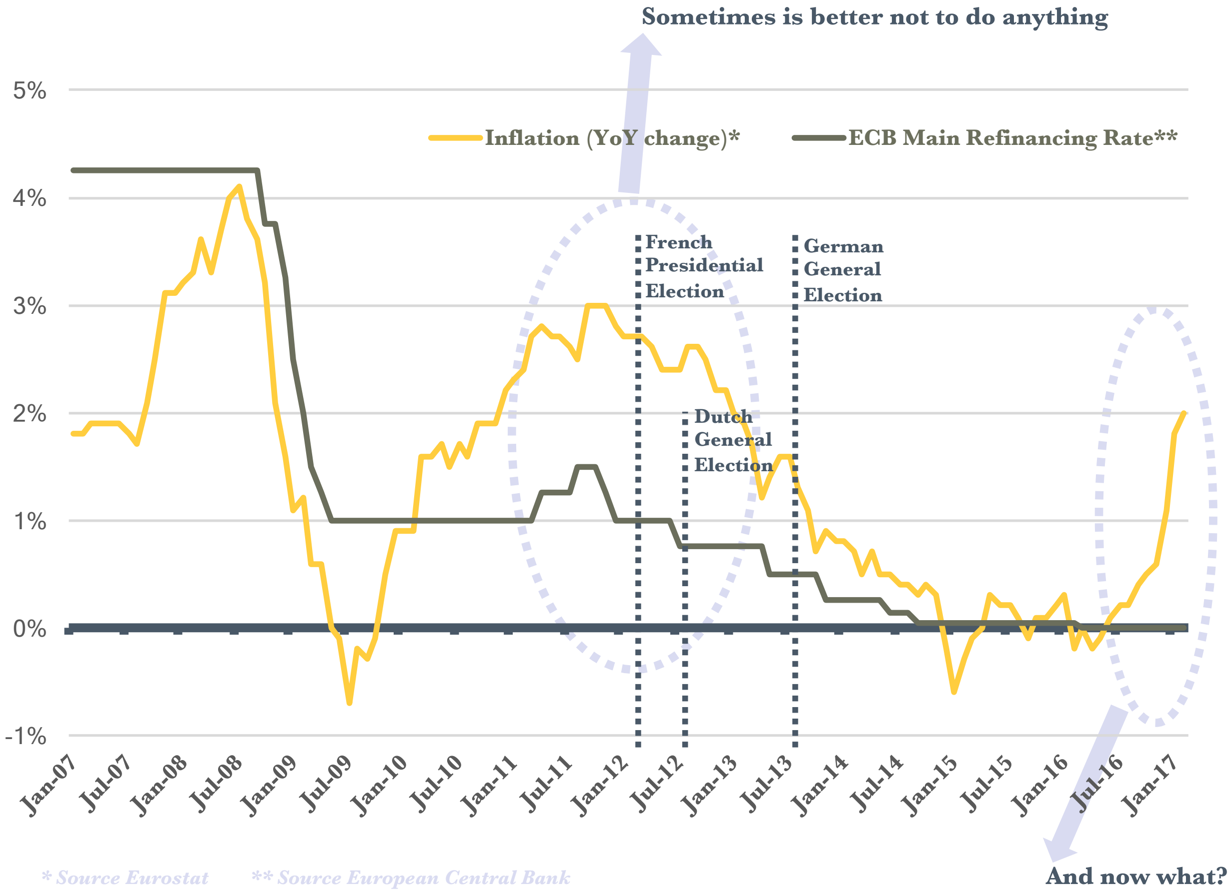
Decision making has gone away from pure economics shifting towards politics.

True, in Europe economy goes well and confidence is high. But it is also true that the Greek crisis is still there (that nobody talks about it anymore doesn't mean it has disappeared). Moreover we can't forget that political pools show a worrying bias towards the right (well, maybe far too right) which among other things is a symptom that people is discomforted with "traditional" center oriented politicians. Needless to say that even if unemployment in the euro zone (now just below 10%) is at an eight-year low, it is still above the 2000 - 2008 period levels. And what about too-big-to-be-saved countries like Italy which from time to time are on the verge of a rescue? The list keeps going but I guess the picture starts to be clear. There are potential collateral damages in the screen, some of them just too close to the impact area, just like the movie. And nobody wants to bear the guilt is something goes wrong.

In Europe things are improving but no interest rate hike is in sight.

**** On the other side of the atlantic ocean politics seem to be random (i.e.: unpredictable) hence any anaylisis is worhtless.***

In the graph below we can see different behavior patterns. First, in the period that goes up to mid 2008, interest rates were steady at historically high levels while inflation reached a 4% level jumping within a year from a level just below the target of 2%. Then, in the second period which also covers 12 months - from mid 2008 to mid 2009 - inflation went down sharply and entered into the so feared negative zone (deflation). The ECB reacted by lowering the reference rate at a fast pace down to 1%, a level that remained for almost two years which we identify at the third period. Within this period inflation picked up again (went above the 2% target). Nothing was done by the ECB until, and here begins the fourth period, it decided to hike rates a little bit. What happened? Well, it didn't impede inflation to touch the 3% level just before going, slowly, back to the negative zone again.



** Source Eurostat* *** Source European Central Bank*

Looking at what actually happened it may seem that somebody pushed the button too early. What followed the attempt to control inflation (which is what ECB officials are paid to do) was an unstoppable downward trend that ended up in the so feared deflation zone. Shortly after firing the weapon, the ECB started to undo its decision and lowered the reference interest rate. It trailed a falling inflation rate without much effectiveness. Timidly trying not to reach the 0,00% level the ECB went down to 0,15%, then to 0,05% and finally, sacrificing spare capacity, it reached the bottom and fixed its control variable at zero where it has remained until nowadays. With inflation below 0,5% there are no doubts about what can happen but now, after the YoY price index grew at a 2% in February 2017, questions started to being asked about what the ECB will do.

True, the 2% YoY change rate is mostly a consequence of the rise in energy prices. Otherwise it would have been a much less worrying 1,2% according to the ECB. It is also true that we are leaving behind winter in Europe which, all other things equal, should ease the pressure in energy prices during the coming months.

If inflation keeps growing the ECB should act. That is what its mandate imposes. Problem is that the last attempt didn't go as expected and mistakes, much more than in the military, do have political consequences. In the movie (*spoiler*) the Colonel asks for data that validates her intention of firing the missile. She even asks for reports that support her decision. She ends up asking for estimations she knows are not accurate. She had a mission and she wanted to accomplish it. At the end, the young little girl dies being carried on by her desperate parents after the expansion wave of the explosion caused severe wounds on her. Would the Colonel shoot again under the same conditions if she face the same situation? Would the ECB rise interest rates again after the last experience? We don't think so. More evidence of no collateral damages is needed for the ECB to fire this time.

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