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Analysis: 'New shock' for European markets as gas price spike fuels inflation fears

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4 minute read



Flames from a gas burner on a cooker are pictured in a private home in this illustration picture taken June 27, 2022. REUTERS/Stephane Mahe/Illustration/File Photo



Euro zone, UK inflation and rate expectations soaring

Sudden gloom contrasts with earlier hopes for peak

Investors say divergence with U.S. is growing

LONDON, Aug 24 (Reuters) - Another dramatic spike in natural gas prices appears to have ended any hopes that Europe's inflation battle is set to ease, with financial markets now bracing for higher prices, a faster pace of interest rate hikes and a deeper economic downturn.

Just a few weeks ago, signs that inflation in the United States - which tends to lead world economic shifts - might be peaking boosted stocks and lowered government borrowing costs. Investors bet central banks would now pay more attention to slowing economies, with a peak in the rate-hiking cycle nearing.

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Instead, this week began with a forecast from U.S. bank Citi that UK inflation would rocket to a near half-century high of 18.6% by January, a prediction that dominated

British newspaper front pages on Tuesday.

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That landed as another explosive rise in natural gas prices showed little sign of slowing, with Russia signalling further squeezes on exports and European buyers scrambling for supplies before winter.

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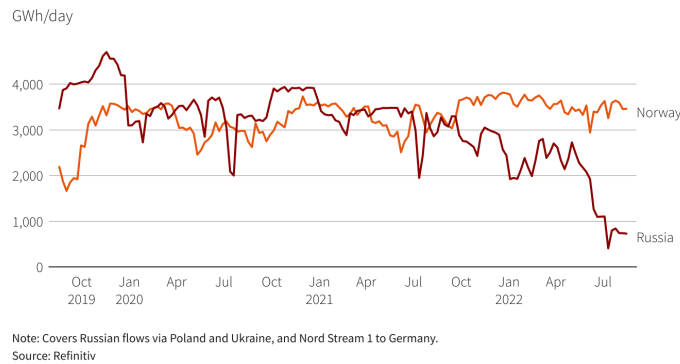
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Gas prices have surged almost 40% in August and nearly 300% this year.

"The key is energy, energy, energy. There is an energy crisis, let's be honest about that, electricity prices are 10 times pre-COVID levels, that is a shock to the system," said Thomas Costerg, senior economist at Pictet Wealth Management.

"The U.S. and Europe are on different paths. We all knew that the Achilles' heel of Europe is foreign energy and now they are paying the price for that," he said, referring to European reliance on Russian gas.

Pipeline gas supplies to Europe



Reuters Graphics

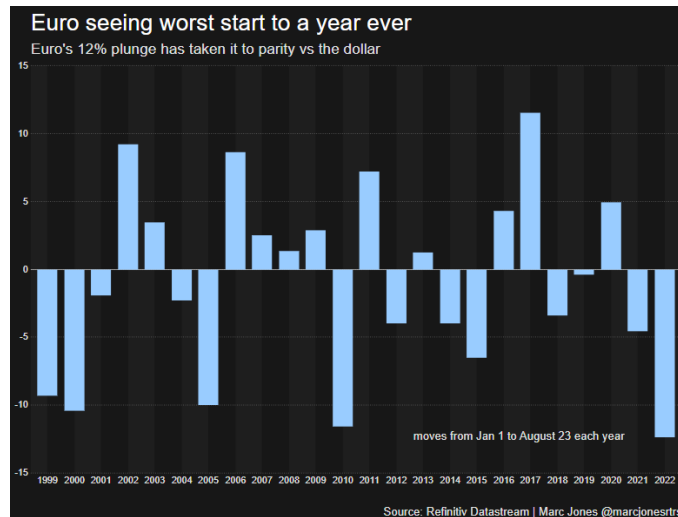
'COMPLETELY REVERSED'

So it's no surprise the mood has soured fast. World stocks ([.MIWD000000PUS](#)) have shed 4.3% from a 3-1/2 month high last Tuesday, the euro has pushed back below \$1 and U.S. 10-year Treasury yields are back at 3%.

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Monica Defend, head of the Amundi Institute, predicts a fall in the euro to \$0.96 by December because of Europe's weak economy.



Euro trashed

Concern is growing that central bankers, gathering at this week's Jackson Hole symposium, are laying the ground for more aggressive rate hikes than previously expected. Without some certainty about when the hiking will end, investors are nervous.

"The market was increasingly confident that recession is going to be the dominant theme, that central banks were going to be more conciliatory or relaxed in their policy tightening," said Richard McGuire, head of rates strategy at Rabobank. "Since the beginning of last week that has completely reversed."

HIGHER INFLATION

Just take a look at market-based measures of inflation expectations. Short-term gauges in the euro zone and Britain jumped to record highs this week. ,

One long-term gauge watched by the European Central Bank (ECB) in the euro zone rose to 2.24% on Tuesday, after falling below the ECB's 2% target in July. .

ECB policymaker Isabel Schnabel warned last week that inflation expectations may be getting "de-anchored", central bank speak for a loss of trust in the bank's willingness to deliver on its mandate. [read more](#)

Societe Generale strategist Kenneth Broux called Schnabel's comments a "seminal moment", with central bankers concerned inflation won't ease fast enough.

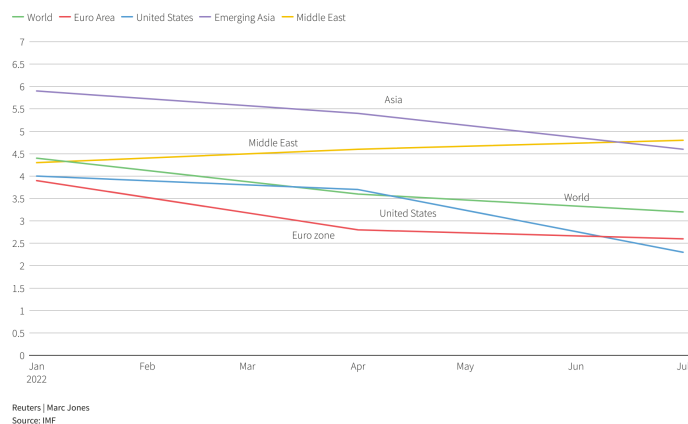
In Britain, a similar inflation gauge rose to 3.82% this week, from 3.4% in late July.

Two-year British government bond yields, trading at their highest since 2008, saw their biggest weekly jump since 2010 after data last week showed inflation hit 10.1% in July. Investors on Tuesday were betting the Bank of England would not stop hiking until June 2023 and rates are around 4.2%. Before the inflation reading, they expected a peak of 3.25% in March.

Euro zone markets have also raised where they think ECB rates will peak next year, by about 50 basis points to around 2%, Refinitiv data shows.

Recession bound?

IMF has downgraded its 2022 world economic forecasts twice since Russia invaded Ukraine



Reuters Graphics

Craig Inches, head of rates and cash at Royal London Asset Management, said the rise in market-based inflation gauges showed markets were now focused on "the next round of inflationary impact". Causes range from a European drought, to the gas crisis and pandemic-related supply constraints in China.

"There seem to be numerous stories that can point to more entrenched, embedded inflation," he said, adding markets were now asking themselves "how high do interest rates need to go"?

Inflation expectations are rising in the United States too, but the outlook for Europe looks much gloomier.

"Inflation in Europe was expected to rise in the fourth quarter but the scale of the rise we're now facing is a new event because of the renewed surge in gas prices," said Holger Schmieding, chief economist at Berenberg.

"That is a new shock that was not foreseen a few weeks ago."