A Feast of Data

- US data is consistent with Fed hiking by 25bps and hinting at a pause
- We expect the ECB to hike by 25bps, but with some hawkish complements. It is not "done".
- BoJ may be "taking one for the team" by opting for slow monetary normalization

Since monetary policy has moved towards data dependence – at least rhetorically – last week's "feast of data" was key, even if some crucial releases are still missing in the case of the ECB ahead of its Governing Council meeting.

US GDP grew less than expected in Q1 and, importantly, below its potential pace. Some of the details paint a less clear picture – a lot of the weakness came from an inventory drawdown, which can be interpreted in many ways – but even the apparent strength in personal consumption should not spook the Fed into thinking that excess demand is still very much here: a lot of it came from a jump in January, with much less momentum in the following two months. True, the Employment Cost Index for Q1 suggested that wage pressure remains strong but, combined with signals that the banking turmoil is not completely abating, there is probably enough in the overall data flow at the disposal of the FOMC to solidify a hike of "only" 25bps with hints that the rate peak may well have been reached.

GDP also grew by less than expected in Q1 in the Euro area. This removes one of the arguments of the hawks who are pushing for a 50-bps hike. Our baseline is that the ECB will deliver a 25-bps hike, as it seems that core inflation may – just – have peaked (national data from last week need to be confirmed) and because we expect the incoming Bank Lending Survey and credit origination data for March to show the monetary tightening is working its way. It is a close call though, and we think a 25-bps hike will have to come with some complements to keep the hawks on board, e.g., clear hints in Christine Lagarde's Q&A that the ECB is not done, or possibly some signals of an acceleration in QT after the end of June.

Meanwhile, the BoJ maintains its specific course. The policy review signals a willingness to start normalising policy in Japan as well, but without any haste. This is welcome from a global financial stability point of view.

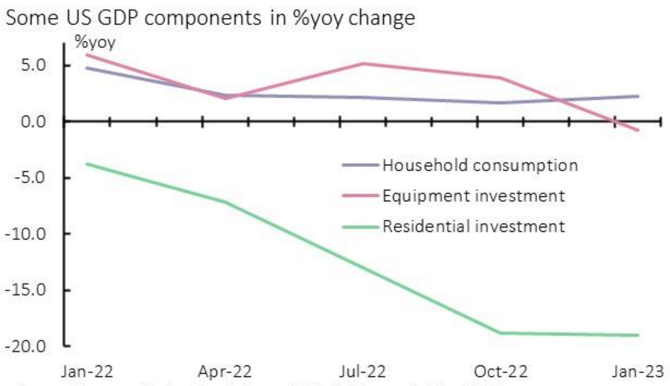
US GDP: the monetary tightening works in contorted ways

US GDP growth has fallen in the first quarter (Q1) 2023 below the widely accepted estimate of its potential pace (1.1% in annualized terms versus 1.75%) after strong gains – and hence a reduction in the output gap – in the second half of 2022. The market was counting on much more robust growth (1.9%) and the outcome is consistent with slack finally re-accumulating in the US economy, a fact which would add to the "evidence docket" suggesting inflationary pressure is starting to abate.

Looking in the details, the signals are less straightforward though. Indeed, **a lot of the GDP deceleration is attributable to a brutal reversal in inventories**, which brought a strongly negative contribution in Q1. This offset much of the stellar gain in private consumption (+3.7% annualised). Changes in inventories are the bane of macro analysts: it is a residual variable, prone to massive volatility and revisions, and any fundamental interpretation needs to be particularly prudent. In an optimistic view, the inventory drawdown would merely reflect a surprise at the strength of consumer spending. This would be positive for Q2 GDP, as it would support some additional output gains in the months ahead to replenish inventories. In a more pessimistic approach, the drawdown would reflect a deterioration in the firms' outlook for demand. **What is however undeniably negative is the behaviour of investment. Both equipment and residential investment fell in Q1.** For the latter it is the continuation of a contraction which started before the post-Covid reopening, but the decline is now massive, close to 20% year-on-year. For equipment investment it is newer and less steep (Exhibit 1).

To get a better sense of how these developments fare in comparison with previous cycles, we look at them in z-score terms (i.e., expressed as a number of standard deviations around the average annual change calculated over the last 20 years). The drop in investment equipment does not look too sinister (half a standard deviation), but the correction in residential construction – the most interest rate sensitive component – comes out as very significant by historical standards. As of Q1 2023, the decline there has exceeded one and half standard deviations. In clear, **we must go back to the bad old days of the Great Financial Crisis to find similar rates of decline in the residential sector. This would suggest that the monetary tightening is working its way through the economy.**

Exhibit 1 – Investment down



Source: Bureau of Labor Statistics and AXA IM Research, May 2023

Exhibit 2 – Residential investment contraction steep by historical standards

Source: Bureau of Labor Statistics and AXA IM Research, May 2023

Consumption seems to be immune for now though, at least at first glance. It is quite striking to see that roughly half of the crucial contribution to GDP growth brought by household consumption in Q1 2023 came from one item – car purchases – which is normally very sensitive to credit conditions given the dominance of leasing solutions in the US. This could be a mere catch-up in response to supply-disruption in this industry since the pandemic, but also reflect that consumers are offloading their cash buffers into big-ticket purchases. In any case, the time-distribution of consumption across Q1 would suggest that a deceleration is already underway. The quarter-on-quarter jump is entirely attributable to a very strong January, while February and March have been flat to slightly negative.

On top of the disappointing GDP numbers for Q1, **last week the Federal Open Market Committee (FOMC)'s attention must have been drawn again to the banking turmoil.** First Republic – the Californian regional bank which has been struggling since the demise of Silicon Valley Bank (SVB) and Signature bank – has suffered a lot on the equity market as it published results for Q1 revealing a decline of 40% of its deposit base. According to Reuters, the Federal Deposit Insurance Corporation (FDIC) is actively trying to find a rescue buyer for the company.

The next Senior Loan Officer survey is likely to reflect another tightening in funding conditions. It will not be published this week, but the FOMC members are likely to have at least some preliminary results by the time they meet. What is already clear from the Federal Reserve (Fed)'s data and market pricing is that the banking industry is not returning to the *status-quo ante*. Although take-up is not as massive as in mid-March, banks' requests for Fed cash through both the discount window and the ad hoc Term Funding Programme (TFP) rose again slightly last week (see Exhibit 3). Given its long-term nature it is to be expected that the outstanding Fed loans through the TFP would not shrink fast, but the same reasoning cannot hold for the discount window. **The US banking sector's reliance on its central bank has not normalised**. Similarly, the premium which banks need to pay for funding on the bond market has receded from the peak of mid-March but is still 40 taken down by the re-implementation in Germany of a "cheap train ticket" operation, but a rebound could easily appear in June. On balance though – as long as a slower core CPI print for April comes with (as we expect) more credit tightening, even a small and fragile deceleration would probably be consistent with the Governing Council settling for 25 basis points (bps) higher in the US than before the turmoil started (see Exhibit 4).

If it was not enough, **concerns over the "debt ceiling" drama are starting to move markets** – at least at the short-end of the yield curve. The Fed finds itself walking on tightrope there: it needs to continue to downplay what Jay Powell called "rabbits out of a hat" to quote his words exactly – i.e., baroque solutions allowing the central bank to mitigate the impact of a technical default – to incentivize Congress to come to an agreement, without "spooking" the market too much. We may have reached the point at which uncertainty is already having an impact on some spending decisions in the private sector.

Exhibit 3 – US banks' reliance on Fed cash not normalized

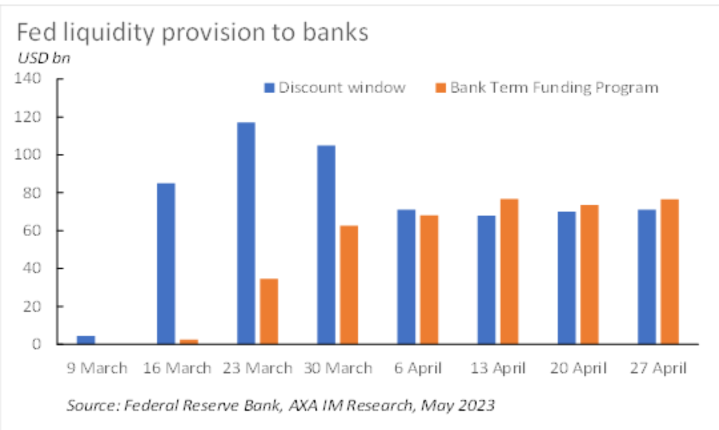
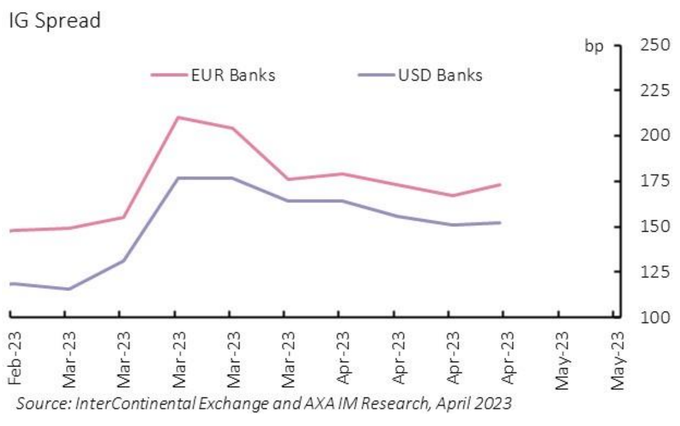


Exhibit 4 – Banks' risk premia not normalized



In such circumstances it is not surprising that at some point last week expectations emerged that the Fed would not hike at all in May. We see this as quite unlikely though. **While inflation is slowing down, it is going to be a long journey to get it back to 2%, and conditions on the labour market continue to fuel some underlying pressure**. The Employment Cost Index for Q1 – considered as a more robust indicator than the monthly wage data coming with the payrolls – surprised to the upside at 1.2%qoq (nearly 5% in annualized terms), accelerating from an upwardly revised 1.1% in Q4 2022. Even if adding one last 25bps to the Fed Funds this would not move the dial much in the grand scheme of things, keeping rates unchanged so soon, taking markets by surprise, would probably trigger additional expectations of a complete turnaround by the Fed – i.e., more price cuts being priced in. While the Fed is concerned with the additional tightening in financial conditions brought about by the banking turmoil, symmetrically too much additional decline in long-term interest rates could ultimately impair the transmission of monetary policy and leave aggregate financial conditions too loose to get inflation back under control.

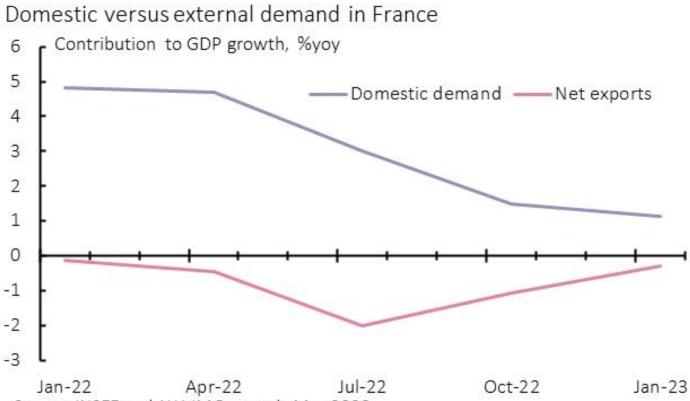
We continue to expect a 25-bp hike this week, with some clear hints that the Fed may have reached the peak of its monetary tightening. The simplest way to convey this would be to remove the point in the prepared statement that *"the Committee anticipates that some additional policy firming may be appropriate"* to leave room to a fully data-dependent, meeting by meeting decision function.

Euro area escapes recession – just

In Q4 2022, Euro area GDP contracted by 0.1%. This however felt almost miraculous given the concerns over energy supply disruptions. Since then, business surveys such as the Purchasing Managers Indices (PMIs) had painted a positive picture, and we gradually saw a significant upside risk to our forecast of only marginal GDP growth in Q1 which put us towards the bottom of the range. The preliminary estimate came out slightly below market median expectations and in line with ours, at +0.1%, with quite a wide distribution across member states. This is another contrast with the surveys which reflect a high degree of convergence within the Euro area. Two "clubs" emerged with, broadly, Germany and some of its neighbours on the brink of recession (Germany came out at zero, after a downward revised 0.5%qoq decline in Q4 2022, which brings the year-on-year change in Q1 2023 in negative territory at -0.1%, and Austria fell by 0.3% after stalling in Q4), while Southern Europe did very well (0.5% in Italy and Spain, 1.6% in Portugal). France was in the middle, with a 0.2%qoq gain.

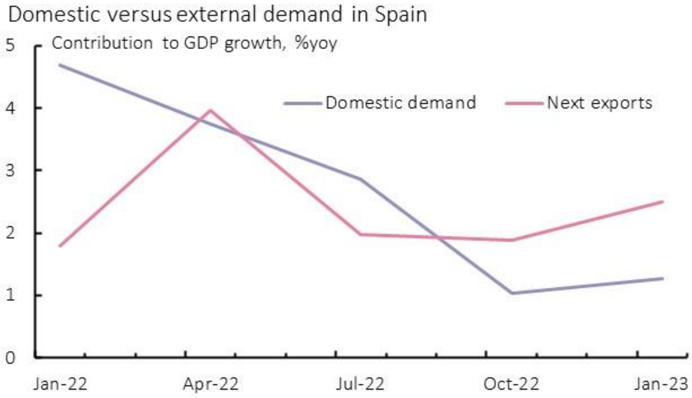
As usual, the level of details varies a lot across countries. Interestingly though, in the two large economies for which we already have a full GDP breakdown (France and Spain), some common traits are emerging: **external traction is improving, while domestic demand is losing steam** (Exhibits 5 and 6). The qualitative comments from D-Statis suggest household consumption fell in Germany in Q1, with exports doing much of the traction (investment improved though).

Exhibit 5 – French domestic demand slowing further



Source: INSEE and AXA IM Research, May 2023

Exhibit 6 – Spanish GDP supported by net exports



Source: Instituto Nacional de Estadística and AXA IM Research, May 2023

This will on the margin help the doves in the run-up to Thursday's decisions. Excess demand was never really the Euro area's problem in this cycle, but it is getting even harder to argue now. Yet, we think most of the debate will focus on the inflation and credit-related data that will be released just before the Governing Council meets.

ECB: beyond the rate hike

Before the European Central Bank (ECB) went into "purdah" – and before the GDP estimate for Q1 was released **–** two last interviews by board members often considered as representing the proverbial "hawkish" (Isabel Schnabel) and "dovish" (Philip Lane) camps made it plain that the ECB is extremely likely to hike again this week. This unsurprising indication leaves quite a bit to fine tune though. We suspect the conversation at the Governing Council will revolve around three issues: (i) the calibration of the hike itself (25bps vs 50bps); (ii) whether to indulge in hard or soft forward guidance on the continuation of the tightening; (iii) whether action on policy rates could already be complemented by signals on the pace of quantitative tightening after the end of June. The outcome is more difficult to predict since key data releases this week may still sway the Council: the first estimate of April inflation, the Bank Lending Survey (BLS) and actual credit origination for March.

A 50-bp hike is on the table – Isabel Schnabel made it clear in her interview. Our impression though is that this is the hawks' "initial negotiating position" rather than a firm conviction: while making the case for more tightening Schnabel was very guarded on the precise outcome of this week's meeting. **50bps is however what we would get if all data releases align this week to paint the picture of still rising inflationary pressure combined with only limited pass-through of the accumulated monetary tightening and banking turmoil:** in clear, another upside surprise to core inflation, a rebound in credit origination (contrasting with the decline in the credit impulse seen since the end of last year) and a stabilization – or even a loosening – in lending standards. **Conversely, we think 25bps is the likely outcome – and our baseline - if core inflation slows down from March's 5.7% year-on-year (yoy) reading, the BLS reveal an additional tightening in credit conditions and actual credit origination continued to fall in March.**

Our own top-down forecast for April core inflation stands at 5.6%yoy, the smallest possible deceleration from March. We think this is consistent with the national data released last week, yet with a significant margin of uncertainty given the lack of details in some of the country estimates. There would of course be two ways to look at it. Isabel Schnabel said in her Politico interview that the point was less whether Euro area inflation has already peaked, but rather how wide the gap to the ECB's target is. Doves would however be reassured by an end to the stubborn *acceleration* in core inflation over the last few months, as well as the favourable developments in some alternative measures of underlying inflation last month already.

This is likely to be a very fragile deceleration. The base effect on package holidays due to the earlier Easter break helped in April, May will be taken down by the re-implementation in Germany of a "cheap train ticket" operation, but a rebound could easily appear in June. On balance though – as long as a slower core CPI print for April comes with (as we expect) more credit tightening, even a small and fragile deceleration would probably be consistent with the Governing Council settling for 25bps. We would be far from the *sustained* deceleration of core inflation to a significantly narrower gap to 2% which Isabel Schnabel would consider enough to warrant a pause, but the hawks may be ready to accept 25bps once core inflation has at least started to decelerate.

Now, "**data cocktails" really come out with a single flavour**. Judging by the developments of the last few months, an upside surprise on inflation is in our opinion likelier than some improvement on the lending side. We could thus have stubborn core inflation combined with concerning credit data. What would then be the Council's inclination? The doves would probably want to focus on what is in the pipeline – credit developments would provide evidence that the monetary tightening is working its way through the economy and that the ECB can thus afford to be patient and proceed more cautiously (this is our interpretation of Philip Lane's argumentation in his interview to Le Monde). It is a very fine line but even the doves have been increasingly put off by the seemingly unstoppable acceleration in core prices and based on our perception of the current balance of power between doves and hawks, in this configuration 50bps would probably win the day.

Compromises could be found between the calibration of this week's hike and forward guidance, as well as the discussion on the pace of quantitative tightening (QT) in the second half of the year. "Hard" forward guidance – i.e., indications on the future path of monetary policy in the ECB's prepared statement would be at the very far end of our expectations. ECB Vice-President de Guindos in an interview last week said that forward guidance would not make a return "soon". Yet, "soft" forward guidance – e.g., plain indications that a "further tightening may be warranted" at the beginning of Christine Lagarde's Q&A session – is going to be tempting, especially if the Governing Council has opted for a "25-bp only" move.

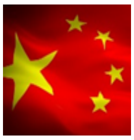
Indicating a likely acceleration of Quantitative Tightening after June is going to be another temptation. Pierre Wunsch explicitly advocated it weeks ago during the IMF meetings. There are two ways to interpret Isabel Schnabel's points on this issue in her politico interview. One is to focus on her use of the word "predictable", which could be read as a sign that the ECB does not want to "rock the boat" on QT and would be happy to maintain an unchanged pace after June. The other is to focus on her description of how the market has very easily absorbed QT. If QT has so far proceeded seamlessly – and did not prevent some episodes of declines in long-term German yields, combined with very well-behaved peripheral spreads – the ECB may feel emboldened to accelerate the pace somewhat, or even to stop reinvestment altogether after June, as an extreme possibility. It is a decision they could leave to the June meeting though. Rather than an explicit announcement, indications that a "discussion has started" on this matter could suffice to appease the hawks' misgivings about a too slow normalisation of the ECB's balance sheet.

The Fed's decision, coming just ahead of the ECB Governing Council meeting, is another source of uncertainty. While our call for "one last 25bp hike" is well within the market's pricing, the degree of dovishness of Jay Powell remains unclear. A very dovish Powell could send the euro soaring further. While the ECB at this juncture is probably quite happy to see the exchange rate dampen imported inflation, too brutal a further rise may convince a majority of Governing Council to "ease up on the divergence" with the Fed. This is another reason to believe 25bps should be the preferred port of call, but uncertainty abounds.

Is the Bank of Japan "taking one for the team"?

Some investors have repeatedly bet on a very quick stance reversal by the Bank of Japan (BoJ) coinciding with the appointment of Governor Ueda – noises around the possibility that Governor Kuroda would pre-announce the end of Yield Curve Control (YCC) before the end of his mandate had even emerged. It seems the central bank wants to steer a more predictable course. That the BoJ wants to normalize its policy as inflation is finally returning was obvious in last week's announcements even though the policy rate and YCC were kept unchanged, between the removal of the commitment to keeping rates unchanged or taking them to a lower level in the prepared statement and the decision to start a "strategy review" - but what is equally clear is that it is not a hurry.

The policy review may take "*one to one and a half year*" to complete. Besides, the macroeconomic forecasts issued last were quite telling. Although it has revised up its forecasts for inflation in 2023 and 2024, for fiscal year 2025, the end of its projection horizon, **the BoJ still expect core inflation to remain below 2%, seeing it at 1.8% and highlighting the considerable uncertainty around these figures.** This does not convey any sense of alarm around compliance with the price stability target. This prudence strengthens our case for a very gradual normalisation of Japanese monetary policy, which would probably be a positive development for the global economy. Any repatriation of Japanese investments on overseas markets to take advantage of higher rates domestically may be less disruptive if it occurs once the Fed and the ECB are "done" with their own tightening and the market is solely preoccupied with the timing of the first policy rate cut.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• GDP (Q1, p) headline softer than expected at 1.1%. Inventory dragged headline lower, despite strong consumer, government and export spend • Renewed concerns around US banking health • ECI (Q1) rose by 1.2%qoq, quicker than Q4. Cleanest view of wage growth suggests mild acceleration • PCE inflation (Mar) slowed to 4.2%, core to 4.6% • Personal spending (Mar) 0.0%mom, from lower -0.2%. Adds to softer sentiment outlook for weaker Q2	• FOMC (May). We forecast FFR increase of 0.25% to 5.00-5.25%. Expect no explicit statement of pause, but no guidance for further hikes • Labour Market Report (Apr) expect signs of softening payroll growth • JOLTS (Mar) watching for further falls in vacancies and Challenger Job cuts (Apr) to stay high • Senior Loan Officers Survey (May) to gauge impact of banking concerns on credit conditions
	• EMU Q1 GDP came in line with our below consensus forecast at +0.1%qoq pulled up by net trade • Similar to PMIs, EC business confidence edged up in April led by services • German HICP came in line with our below consensus, edging down to 7.6%yoy in April	• We forecast EMU "flash" April headline HICP to increase to 7.1%yoy, while core to edge down 0.1pp to 5.6%yoy • EMU March M3 and ECB Q1 Bank Lending survey to gauge any ramifications from banking sector stress. • ECB May meeting. Our baseline is for a 25bps hike to 3.25%. Hawkish compromise to remain
	• Flash PMI signals continued pickup in services whilst manufacturing remains subdued • PSNB ex (Mar) was 21.5bn, FY borrowing stands at £139.2bn (5.5% of GDP), 13.2bn less than OBR f'cast • Rate setter Ramsden pointed to further rate rises arguing BoE must "stay the course"	• Nationwide house prices (April) further slowing in prices expected • Local elections in England (Thu) heavy Tory losses expected – could provide insight to upcoming GE • BoE household lending data (Mar) • BoE Decision Maker Panel (Apr)
	• BoJ MPM (Apr), BoJ stood pat leaving all policy tools unchanged at Gov Ueda's first meeting at helm. BoJ announced policy review and tweaked guidance • BoJ forecasts BoJ core CPI reaching 1.8% in FY 25 • Tokyo CPI (Apr) headline reaccelerated to 3.5% and core picked up to 3.5% above expectations	• Monetary base (Apr) • Consumer confidence index (Apr)
	• China continues to see economic activity recovery, with risks of another wave of COVID infections high heading into Labour Day holiday • State Council announced plans to boost employment, particularly for new graduates and young people	• Headline PMI to remain resilient for both Caixin and NBS manufacturing PMIs
	• CB: Hungary (13%), Russia (7.5%) & Turkey (8.5%) kept policy rates unchanged • Q1 GDP (yoy%) eased 0.8% in Thailand & contracted in Taiwan by -3.0% • Thailand export growth fell 4.2%yoy • CPI (April) fell to 14.7%yoy in Poland	• CB: Brazil (13.75) & Malaysia (2.75%) to stay on hold • CPI (Apr): Colombia, Korea, Indonesia, Peru, Philippines, Turkey & Thailand • Q1 GDP data in Indonesia • PMI numbers across EM region

Upcoming events	US:	Tue: Manf. PMI (Apr), ISM manf index (Apr); Tue: Factory orders (Mar), JOLTS Job openings (Mar); Thu: Weekly jobless claims (29 Apr), Trade balance (Mar), Non-farm productivity (Q1), ULC (Q1); Fri: Non-farm payrolls (Apr), Unemployment (Apr), Ave earnings (Apr), Ave weekly hours (Apr)
	Euro Area:	Tue: EU20, Ge, Fr, It & SP Manf PMI (Apr), EU20 ECB Bank Lending Survey (Q1/Q2), M3 money supply (Mar), CPI 'flash' estimate (Apr), It HICP (Apr); Wed: EU20 ADP employment chg (Apr), Services PMI (Apr), ISM non-manf index (Apr), FOMC announcement; Thu: EU20 Composite & Services PMI (Apr), PPI (Mar), ECB announcement; Fri: EU20 Retail sales (Mar), Ge New manf orders (Mar), Fr Ind prod (Mar)
	UK:	Tue: Nationwide house price index (Apr), Manf PMI (Apr); Wed: BRC Shop Price index (Apr); Thu: Local elections in England, SMMT new car reg (Apr), Composite & Services PMI (Apr), Mortgage approvals (Mar), Net mortgage lending (Mar), Consumer credit (Mar), M4 money supply (Mar); Fri: Construction PMI (Apr)
	Japan:	Mon: Consumer Confidence index (Apr); Tue: Monetary Base (Apr)
	China:	Thu: Caixin manf PMI (Apr); Fri: Caixin services PMI (Apr)

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