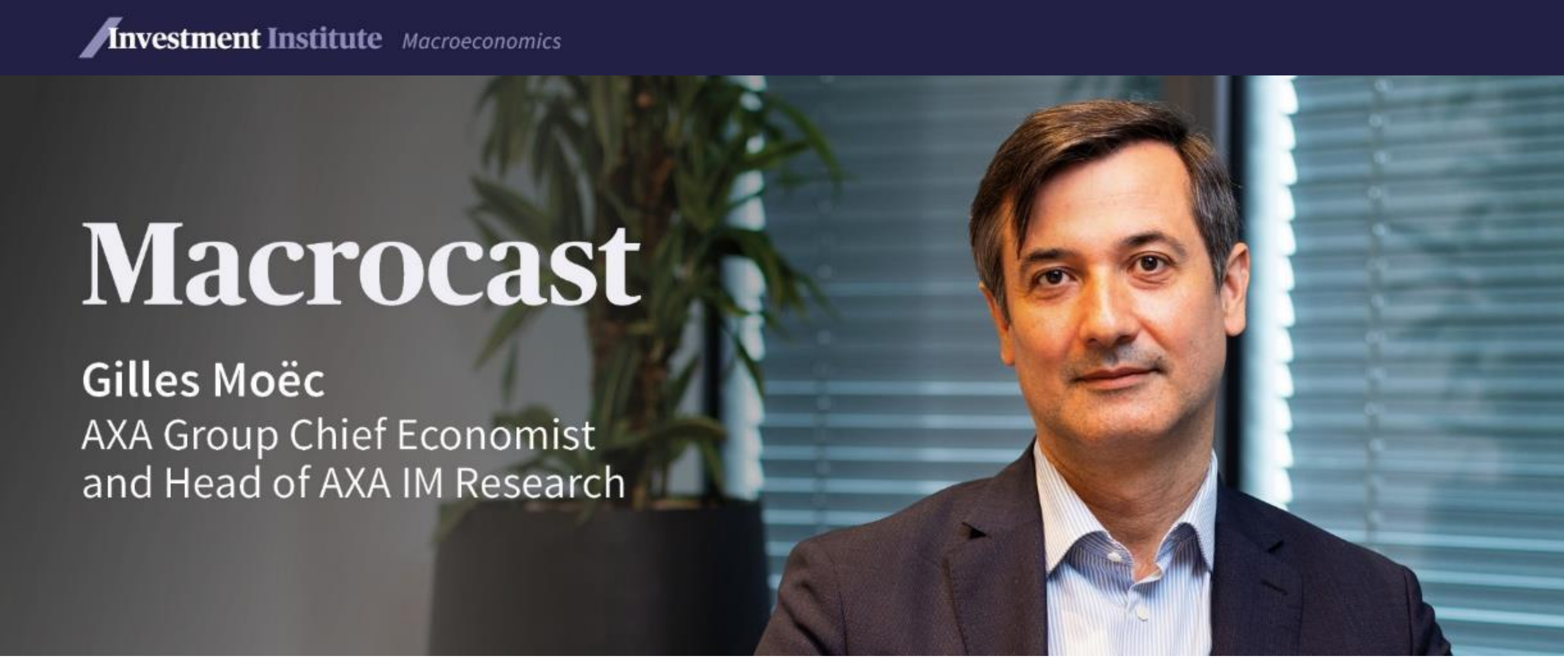
186 – 26 June 2023



Rebellion Weekend

- Some cautious lessons from the Wagner Group rebellion.
- The BoE "did its duty". Now the government needs to hold its fiscal nerve. We think it will.
- There's a lot going on for the hawks now, but evidence the economy is slowing down continues to pile up.

Even if the apparent resolution of the Wagner Group rebellion leaves Putin weakened but still in power, the episode should remind us that there is no easy scenario under which a peace settlement even remotely favourable to Ukraine could co-exist with stability in Russia, and that the most obvious alternatives to Putin are within the nationalist camp. The West is in "for the long haul" in the Ukrainian war and the management of its aftermaths.

Over the last few months, the Ukraine war had faded from the macroeconomic radar. For now, the chances of avoiding a replication of the extreme tension on energy prices later this year are substantial. The share of China in US exports of LNG has not picked up, leaving space to replenish European inventories. As of last week, the EU's gas reserves stood at 75% of storage capacity, 20 points more than at the same time last year.

The BoE's 50bps hike, coming on the heels of yet another upside surprise on inflation, is an attempt at restoring its credibility. A key question for the UK now is how the government – present and future – will handle social demand for fiscal support to offset the pain of a recession which will be the natural result of the BoE's latest decisions. We think PM Sunak and Chancellor Hunt will resist this temptation however, and we would be surprised if the Labour opposition took liberties with fiscal rectitude in its electoral manifesto next year. The UK is now under strict market surveillance, but a steadfast fiscal stance should help avoid a more significant drift in yields.

Hawkish talking by the Fed, the resumption of "jumbo hiking" in the UK and the end of the pause in Australia and Canada are creating the impression that a large wave of additional tightening is coming in the global economy, defeating hopes that the "peak" is in sight. However, we continue to see more cracks appearing in aggregate demand. The latest slump in the Euro area PMI in another piece of evidence.

What's the signal in the Russian noise?

The rebellion of the Wagner Group in Russia has seemingly fizzled out after a mediation by the President of Belarus. It was not obvious Prigozhin had the military and political capacity to topple Putin's regime – most of the political experts we follow on Russian issues were unconvinced – but that he is able to seek refuge in Belarus without being punished – at least not immediately - still leaves the Russian "strong man" unusually weak. In the space of three years economists have been forced to dabble into epidemiology and then polemology. We do not want to take another over-stretching risk to Kremlinology, especially in the currently extremely fluid environment. We will thus limit ourselves to just two generic observations before getting to **what remains in our view the main conduit of the war's macroeconomic ramifications for rest of the world: the behaviour of energy prices**.

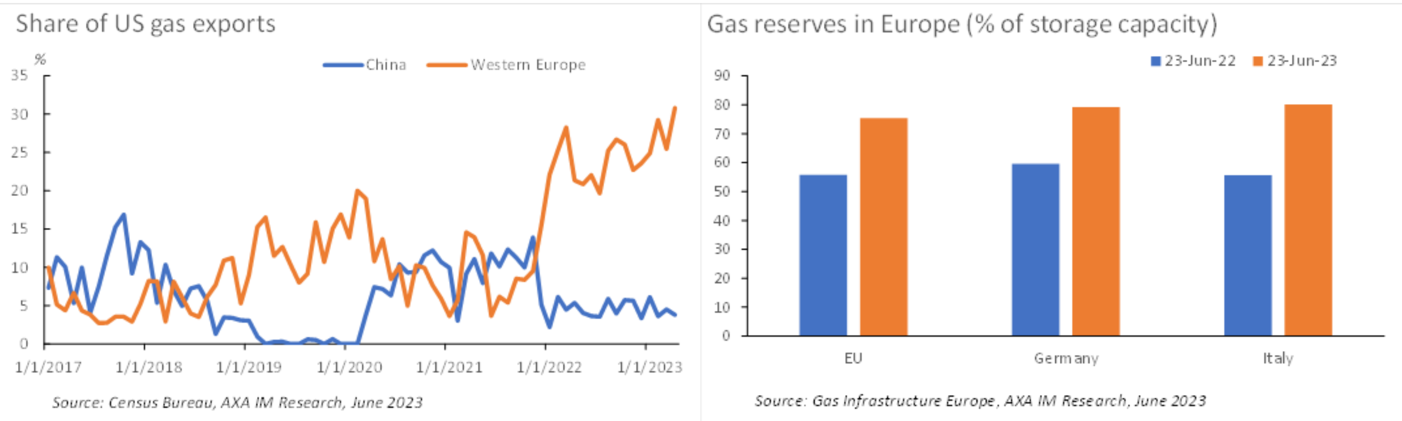
First, the Wagner episode suggests that **there is probably no scenario in which Russia is defeated militarily in Ukraine, or at least forced into massive concessions, without significant political instability in Moscow**. In his address to the nation on Saturday morning Putin has renewed his commitment to what he sees as a patriotic war. The "special operation" against Ukraine is increasingly presented as a pre-emptive move within the larger scope of a western aggression against Russia. To some extent, the current regime is now finding itself in the situation many governments found themselves at the peak of World War I (WWI): even if the cost of the war is getting increasingly unsustainable, the very magnitude of the accumulated losses makes it more difficult to make any realistic peace compromise politically acceptable domestically. The natural slope is do "double down" and seek a military victory which will ultimately justify the sacrifices endured by the population. But over time a failure to deliver such victory would make the political survival of the regime very difficult. It's of course difficult to see through the current information fog, but some movements of sympathy from the civilian population toward the Wagner Group could suggest that Russian public opinion still supports the war but is increasingly frustrated by the ongoing inability to win it.

Second, the episode should remind us that **the most significant political competition to Putin comes from within the nationalist camp, not from a still elusive liberal opposition**. True, some liberal voices expressed their support to the Wagner rebellion – G. Kasparov for instance – because in the current circumstance they would welcome *any* challenge to the status quo which could, ultimately, pave the way for the advent of a democratic Russia, but at least transitorily – and non-democratic transitions have a bad habit of lasting very long in Russia – another nationalist, potentially even more extreme leader could control the Kremlin if Putin were to lose power. All this suggests that the West is in "for the long haul" in the Ukrainian conflict and its aftermaths. An unstable Russia would prolong the security concerns of European nations. Helping Ukraine win militarily will not be the end of the West involvement in containing Russia. We think this will make the conversion to higher military spending durable, especially if the European Union (EU) takes on board the possibility of a return to power of Donald Trump.

Yet**, it's undeniable that the war in Ukraine has faded from the economic debate**. This is a result of last winter's "miracle" when western Europe in general and Germany in particular managed to deal with the disappearance of Russian gas without significant disruption. This would have been impossible without mild weather conditions though, and **until a few months ago focus was firmly on a possible replication of supply and price tension next winter**, especially if the rebound in Chinese demand were to trigger more competition for scarce Liquefied Natural Gas (LNG) resources. From this point of view, the fact that the recovery in China is sputtering may be seen as positive, reducing the risks on the commodity price front.

In Exhibit 1, we calculated the share of China and western Europe in the exports of United States (US) LNG since 2017. A substantial part of the supply effort consented by the US to Europe was made possible by the drop in Chinese demand last year. The latest data we have cover the month of April. As of two months ago, **the share of China had not started to rise again in US gas exports. This leaves space to replenish European inventories**. According to the Gas Infrastructure Europe website, **gas reserves in the European Union are already 75% full as of 23 June 2023**, versus 56% at the same time in 2022. Reserves in Germany and Italy – the large economies the most historically dependent on Russian gas – are at 80% of storage capacity (see Exhibit 2).

Exhibit 1 – Low Chinese demand offers space for Europe   Exhibit 2 – Europe is refilling quickly



The weakness of Chinese imports of US LNG does not solely reflect the difficulties of Chinese aggregate demand, but also a choice to diversify its supply to avoid making itself dependent on its geopolitical rival (Russian gas is not yet arriving en masse). Beijing has just sealed a second deal to participate – and partly fund – Qatar's expansion in LNG capacity, which is planned to grow from 77 million metric tons per annum to 110 by 2027. The rise in gas production capacity at the global level is reducing, on trend, Russia's leverage. But even in the short-run, Europe is better protected against a protracted war in Ukraine resulting in a lasting disruption in Russian gas supply. It's always possible that the gas markets could take fright at the prospect of political instability in Russia, but the immediate impact on energy supply would be much more manageable than last year.

The Bank of England fights back

The inflation print for May released last week spurred the Monetary Policy Committee (MPC) into more decisive action than expected. What we find striking is not just the upgrade to a 50-basis points quantum, but also the fact that the number of dissenters remained small (only two members advocated no change, no one supported 25bps). **We interpret this as a collective reaction against the Bank of England (BoE)'s loss of credibility**. Other central banks may have shared the BoE's tardiness in spotting the persistence of inflation, but only the BoE showed so little enthusiasm for the tightening once it had started. There remains some of the BoE's apologetic tone in hiking in the recognition by Governor Bailey of the pain to what is going to be inflicted to households, but this was immediately justified by the need to act decisively now to avoid having to do even more damage in the future. The Bank is now living by the Shakespearian "being cruel to be kind" approach favoured by many public-school headmasters of yore (French readers may be more familiar with the parental "you will thank us later" line).

The BoE's decision was met with much criticism in political circles though. From a purely economic point of view, we don't think there's anything interesting in the rear-guard debate on whether the Bank is forced into extraordinary harshness now because of its past mistakes, but tactically this is a tempting line for the government: blaming the Bank of England for the current inflation deflects attention from the structural inflationary forces we explored last week, for which the current administration bears at least some responsibility. But **the crucial issue now is if and how fiscal policy will change in response to the additional tightening since this in our view will ultimately shape the market reaction to the BoE's new stance.**

The opposition and some segments of the Conservative party are calling on the government to soften the blow of higher rates for mortgage holders. Returning to the tax deductibility of interest payments would be an easy solution (albeit socially regressive). This could be quite politically tempting since mortgage holders – although a minority of the population now, since older owners have paid up and most young households have been de facto excluded from home ownership – are concentrated in the middle-class which is going to be a key battleground in next year's general elections. The Chancellor however has been very clear he was not prepared to go down this route, invoking the risk of further stoking inflation but – we think – probably more concerned with the additional cost on already shaky public finances.

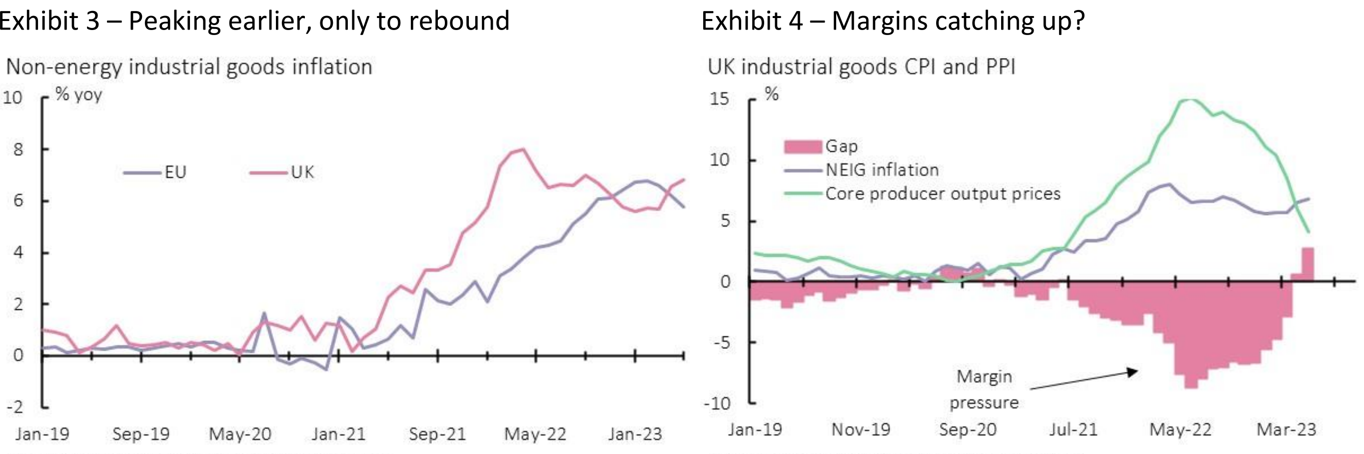
Now, the issue goes far beyond the fate of mortgage holders. With policy rates at 5% and strong hints at more, the BoE has probably reconciled itself with the sad realization that short of a quite nasty recession, the United Kingdom (UK) will not be able to take consumer prices back under control. **Pressure on the fiscal authorities to deliver more support will only rise in the next few months.** The market was clearly increasingly spooked by the persistence of inflation in the UK and the tepid response from the BoE. Last week's 50bps hike is likely to reassure investors, and the ensuing decline in 10-year yields probably reflects both a higher perceived risk of recession but also an improvement in the British "risk premium". But it was a small decline, and **we think that – especially with the memory of the Truss episode still fresh – British fiscal policy is under surveillance.**

Prime Minister (PM) Sunak and Chancellor Hunt are aware of this risk, and we expect them to hold fast to their "small government" ethos. This is not just because this is these two politicians' ideological leaning in the first place, but also because the coming 12 months will define the battle lines within the Conservative party for its future in likely opposition (general elections need to take place by January 2025 at the latest, but an earlier date, somewhere in 2024, is widely expected). Indeed, since the Brexit referendum the Tory party had veered very far away from its usual market-friendly, fiscally prudent stance, to espouse more populist views. Sunak and Hunt are probably convinced that a recession is coming anyway, and that their chances to win the next elections, already weak, are now close to nil. Demonstrating fiscal rectitude in their last year in office, and the possibility that the UK will be out of recession – just – before the elections take place would put them in a good position to win the ensuing succession war in their party.

The market could in principle remain sceptical on fiscal rectitude in the UK precisely because the current government is unlikely to win the next elections – at least judging by the current polls. However, **the Labour party has been trading very carefully on its budgetary plans**. Starmer has managed to side-line his party's left wing, and he is campaigning resolutely on the centre. The shadow Chancellor has dropped expensive plans on funding the green transition the minute the first criticism appeared in the press. We consider it very unlikely that investors would become particularly nervous on the fiscal stance as the next elections approach.

Exhibit 3 – Peaking earlier, only to rebound

Exhibit 4 – Margins catching up?



Source: Refinitiv and AXA IM Research, June 2023

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Still, assuming market pressure remains limited, the big issue is how far the BoE will have to go to tame inflation. Of course, another acceleration in the price of services (from 6.9%yoy to 7.4%) was a key contributor to the bad news in the May inflation print, but another specific area of concern was the relapse in non-energy industrial prices. Inflation in this sector had peaked in the spring of 2022, at a much higher pace than in the Euro area, but since then it had been on a declining trend, falling below the Euro area's pace at the end of 2022 (see Exhibit 3). This was suggesting that offsetting part of the domestic "overheating" we discussed last week, the UK was benefitting, just like the rest of the world, from the absorption of global production bottlenecks. This has however reversed in April and then again in May, while this component continued to decelerate in the Euro area. In April we were ready to dismiss it as pure noise in a quite volatile series, but with two prints in a row, a pattern is emerging. We are tempted to read this as a consequence of business margin behaviour. **A simple comparison of**

producer and consumer prices suggests that businesses had to consent to a massive contraction in margins last year. This is now being reversed (see Exhibit 2).

This gets us back to a point we made several weeks ago about the debate on the sources of inflation: ultimately, whether inflation is "margin-pushed" or "cost-pushed" does not matter much for monetary policy. Ultimately**, if business can expand their margins, unless non-competitive behaviour is emerging, it means that there is enough demand to absorb the higher prices. Central banks are then brought back to the usual limits of their action: they have little grip on supply, but they can get aggregate demand down by taking monetary conditions into more restrictive territory**. Of course, it can appear strange to detect excess demand in the UK in the current juncture, with GDP in effect stagnating (+0.2%yoy in Q1 2023) but the tightness of the labour market is an important piece of evidence. Potential growth – here understood as *non-inflationary* growth – is likely to be extremely low in the UK right now, a consequence of the structural impairment of labour supply we described last week. **This could mean that getting GDP growth below potential requires in effect a recession. This is what is now in the pipeline.**

Another piece of evidence in the Euro area recession docket

Hawkish talking by the Federal Reserve (Fed), a resumption of "jumbo hiking" in the UK combined with the end of the pause in Australia and Canada are creating the impression that a large wave of additional tightening is coming in the global economy, defeating hopes that the "peak" is in sight. These central bank moves – triggered by persistent observed inflation, or lingering pressure in the pipeline (such as the stubborn robustness of the US labour market) – need to be however put in the perspective of global demand. More signs of slowdown are emerging in the real economy at the global level, and even if the lags between these real economy signals and disinflation can understandably fuel central banks' frustration, there are nonetheless undeniable.

The flash Purchasing Managers' Index (PMI) survey in the Euro area for June is the latest indicator going south. The composite PMI was only marginally in expansion territory at 50.3, sharply down from 52.8 in May and markedly below expectations (52.5). The recent behaviour of the index suggests that the usual pattern of manufacturing acting as a forward-looking indicator of the direction of the whole economy is being observed again: the services PMI's resilience, contrasting with the deep deterioration in business confidence in industry, has come to a halt (see Exhibit 5). In a sense, what is surprising is that the PMI was not lower earlier, since after all the Euro area has been in "technical recession" since Q4 2022. Still, the message from the PMI is that any rebound is likely to be modest – if it emerges at all.

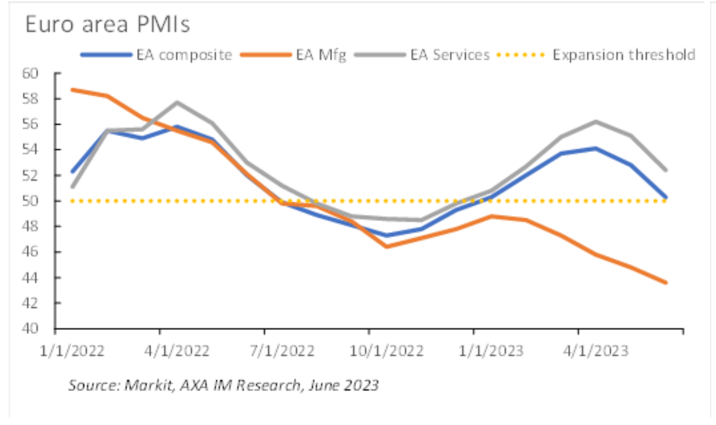
The country distribution of the June PMI surprised us though. Indeed, in France the services component of the PMI fell in contraction territory, while it remains high – albeit declining - in Germany (see exhibit 6). If one looks at the indicator since the middle of last year, it seems it has "got it wrong", failing to reflect the quite deep GDP contraction in Germany contrasting with some resilience in France. It will be interesting to compare the message from the PMI with the European Commission survey to be released this week.

We will also look for corroboration of the signal on prices. Indeed, to quote directly from Markit, the producer of the PMI survey, "*average prices charged for goods and services rose at the slowest rate for 27 months in June, having been on a broad easing trend over the past year but showing an especially large drop in momentum in June".* The combination of prolonged challenges to the real economy and easing inflationary pressure will come as a boon to the doves at the European Central Bank (ECB) Governing Council who are reluctant to see the central bank "sleep-walk" into yet another hike in September.

It will be an uphill struggle for the doves though, since there could be bad news in the June inflation print to be also released this week. Between surveys hinting at some disinflation to come and hard numbers on higher realised inflation, so far in this cycle the central bank has been more focused on the latter. As we have already discussed 4 weeks ago, a lot of the slowdown in consumer prices in May could be traced back to a one-off – the timing of the rebate on train tickets

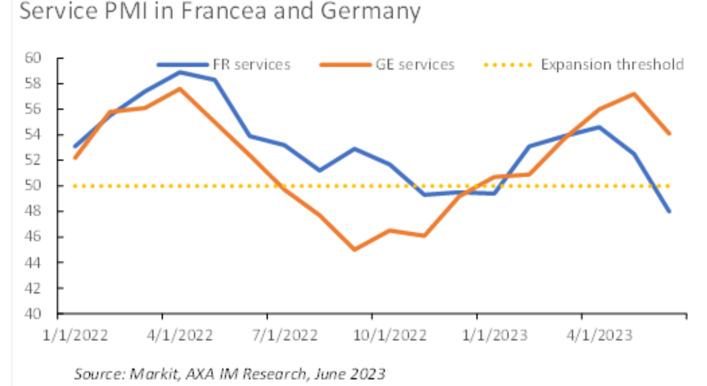
in Germany – which will be offset in June. Still, the underlying narrative on the state of the European economy is slowly becoming a bit tougher to manoeuvre for the hawks. It may not be clear enough by September – especially if the labour market holds tight – which makes September our baseline for peak tightening, but we still think it's a closer call than it looks.

Exhibit 5 – Services converging to manufacturing?



Source: Markit, AXA IM Research, June 2023

Exhibit 6 – Surprising country ranking though



Source: Markit, AXA IM Research, June 2023

Country/Region	What we focused on last week	What we will focus on in next weeks
US	• Jobless claims remained elevated at 262k • Fed Chair Powell testimony. Statements repeated June FOMC guidance that a further 2 hikes were likely this year. Repetition added to market acceptance • Housing starts (May) surged 22%, but existing home sales rose 0.2%. Discrepancy lays in new home sales • Jobless claims remain higher at 264k • President Biden called China's President Xi a "dictator", which threatened positive developments from Secretary of State Blinken's latest China trip	• PCE inflation (May) expected to drop, similar to CPI, but core forecast unchanged at 4.7% • Personal spending (May), modest rise expected but watch for downward revisions following retail sales • GDP (Q1, final), prelim estimate at 1.3% (saar) • New home sales (May) likely firmer than existing given low levels of new home inventory • Chicago PMI (Jun) – early guide to ISM next week • Conference Bd consumer confidence (Jun)
Euro Area	• EMU Flash PMIs (Jun) deteriorated at 43.6 for Mfg (from 44.8). New businesses are now in contraction territory at 48.3 while output continue to fall (44.6). Svcs sector also came below expectations at 52.4, from 55.1. Employment remains resilient, standing at 54.1, albeit lower than May's 54.6 • French Business climate (Jun) flat at 100 • EMU consumer confid (Jun) is up to -16.1 from -17.4 • May overnight stays (Sp) at record level for this period	• Flash HICP (Jun) with core very likely to rebound, boosted by services prices and base effect from cheap Ge train ticket implemented in Jun-22 • EC surveys (June) • Ge retail sales and Fr consumer spending (May) • EMU unemployment rate (May) • TLTRO repayments (mandatory and voluntary) to the ECB will reach €506bn (477+29) • New round of parliamentary elections in Greece
UK	• MPC hikes Bank Rate by 50bp following upside surprises to inflation and wage data • CPI inflation (May) remained at 8.7%. Services and core CPI continued to rise to 7.1% • Retail sales (May) rose 0.3%mom supported by additional bank holiday and warmer weather	• BoE household lending data (May) • National accounts (Q1) to watch for potential revisions to 0.1% initial estimate and income data • Current account (Q1) • Nationwide house prices (Jun) expected to moderate as mortgage slowdown picked up
Japan	• CPI (May) headline continues to ease, but core CPI rose further to 3.2%yoy • BoJ minutes: some discussion of YCC revisions • PMIs (Jun) fell to 52.3 from 54.3 • Yen slid to 143 per dollar close to 146 level that trigger intervention in Sep 2022	• Tokyo CPI (Jun) to be watched for clues on nationwide CPI • Industrial output (May) • Further FX moves following recent yen weakness and potential of intervention
China	• China lowered its 1yr loan prime rate to 3.55%. This was the first drop since Aug 2022 and in line with market expectations. The 5yr LPR also fell by 10bps to 4.2%	• NBS PMIs (Jun) to gauge underlying activity in Q2 • Current account (Q1) • Industrial profits (May)
Emerging Markets	• CB: Turkey hiked its policy rate +650bp to 15%. Brazil (13.75%), Chile (11.25%), Czechia (7.0%), Mexico (11.25%), Indonesia (5.75%) & Philippines (6.25%) kept rates on hold • May headline inflation fell in South Africa (6.3%) & Singapore (5.1%). It rose in Malaysia (2.8%) • Brazil's economic activity indicator rose more than expected in April (0.56%mom)	• CB: Colombia is expected to stay on hold at 13.25% • May industrial production: Korea, Taiwan, Thailand, Russia & Singapore • June flash CPI in Poland • May current account and trade data in Thailand

Upcoming events		
	US:	Tues: Durable goods orders (May), Case-Shiller & FHFA HPI (Apr), Conference Board consumer conf. (Jun), New home sales (May); Wed: Goods trade balance (May); Thu: GDP (Q1), Core PCE price index (Q1), Weekly jobless claims (Jun 17), Pending home sales (May); Fri: PCE & core PCE (May), Personal income/spending (May), Chicago PMI (Jun), Michigan consumer sentiment (Jun)
	Euro Area:	Mon : Mon-Thurs ECB Sintra Conference, Ge IfO business climate index (Jun); Tues: It ISTAT business/consumer confidence (Jun); Wed : EU20 M3 money supply (May), Fr Insee consumer conf. (Jun), It HICP (Jun); Thu: EU20 Business confidence (Jun), Ge CPI & HICP (Jun), Sp HICP (Jun); Fri : EU20 HICP (Jun), EU20 Unemp. (May), Ge Unemp. (Jun), Fr Consumer spending (May), HICP (Jun)
	UK:	Mon: CBI Distributive Trades survey (Jun); Tues: BRC Shop Price index (Jun); Thu: Mortgage approvals (May), Net mortgage lending (May), Consumer credit (May); Fri: GDP (Q1), Business investment (Q1), Current account (Q1)
	Japan:	Thu: Consumer confidence (Jun); Fri: Industrial production (May)
	China:	Wed: Industrial profits (May); Fri: Official manf & non-manf PMI (Jun)

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