# 191 – 31 July 2023

*NB: The next issue of Macrocast will come out on 4 September. We wish our readers a great summer break.*

# If it's not a skip, it's probably a peak

- "Dovish hikes" across the Atlantic. The peak is there – or nearly there.
- Another strong GDP print in the US despite restrictive monetary conditions fuels the "soft landing" hypothesis. We are unconvinced – even more so in the Euro area case.

We have had "dovish hikes" from both the Fed and the ECB last week. We still see it as marginally likelier than not that the ECB Governing Council will add a last 25bps hike in September while we are more confident that we are already at the beginning of a long plateau at the Fed, but the gist is the same: both central banks will probably stop at some point in Q3 2023 having brought their policy rates at roughly twice the equilibrium level.

The juxtaposition of this high level of policy restriction with another strong US GDP growth print and tangible disinflation over there is fuelling hopes that a "soft landing" is all it will take to converge to the Fed's 2% target, and Peter Hooper has just offered a very cogent narrative on how a recession could be avoided in the US. We are unconvinced though. While the Fed has started tightening nearly 18 months ago – the usual transmission lag – it has reached restrictive territory in September 2022 only, and we think the bulk of the impact has not yet passed through. Peak impact could coincide with the exhaustion of the excess savings Hooper mentioned as one of the factors which could help avoid a US recession.

Some of the "protective factors" listed by Hooper can also be found in the Euro area – credible central bank, sound financial position of the private sector, specific nature of the Covid-triggered inflation wave – except for the labour market institutions which remain probably more conducive to second-round inflation effects than in the US and may force the ECB to inflict much more macro damage to "break the back" of inflation. In any case, it is already clear that the Euro area is underperforming the US, and we are concerned with how the monetary tightening is increasingly affecting so-far resilient member states such as Italy and Spain. So, as much as we would like to leave our readers with a rosy view before our August recess, in a nutshell we see an already "hardish" landing materialising in the Euro area, while the soft landing in the US, albeit more plausible, still looks far from certain in our view.

## From skip to pause, and from pause to peak

The Federal Reserve (Fed)'s communication last week was very much in line with our expectations detailed in the previous Macrocast. We thought that Jay Powell would seek to retain maximum flexibility on the future trajectory for rates after hiking by 25 basis points, and that keeping the soft forward guidance unchanged from June was the easiest way to deliver such optionality. This is what the Federal Open Market Committee (FOMC) did**. "*Additional firming*" of the monetary stance remains on the cards, but just like in June, it will remain strictly data dependent**. We also thought the Fed could afford to keep its assessment of the macro situation unchanged. This held for inflation – still qualified as "elevated" without any mention of the better-than-expected June print in the prepared statement– and we don't think the upgrade of the real economy pace from "modest" to "moderate" should be interpreted as a strong hawkish signal.

In June, it was the forecasts released at the same time as the prepared statement which made it plain the Fed had not reached its peak tightening, with two more hikes in the dot plot, but Powell's slip (inadvertently – or not - using the word "skip" during the Q&A before correcting himself) had also spilled the beans. What was communicated in June was a willingness to take more time between two tightening moves, not a hint at a lasting pause. There was no such voluntary or involuntary giveaway last week. **Powell in the Q&A took pains to paint a very balanced picture of the situation, strengthening the impression that the Fed is now fully in data dependent mode and has no pre-determined path in mind**.

Unsurprisingly, the Fed does not want to declare victory on a single inflation print, and to quote Powell in the Q&A the FOMC *"will be looking to see if the signal from June CPI is replicated"*. We also found interesting that the Fed has clearly an eye on the possibility the economy re-starts too briskly, which would then impair the chances to cover rapidly the last mile of disinflation. We think it is a key risk given the resilience of the labour market and the re-acceleration in real wages. Indeed, he mentioned that *"stronger growth over time could add to inflation and may require a policy response".* So, the "tightening bias" is still very much here, but equally the Fed is clearly starting to think that enough has been done. Powell's point on *"policy is restrictive, and more so after today*" was straightforward.

**So, as it's clearly not a "skip", then it is at least a pause, and more likely a peak,** in our opinion. Our belief that the pause will eventually morph into a long plateau before a first cut in early spring 2024 is predicated on the continuation of disinflation which, in our opinion, cannot be fully accomplished without further damage to the real economy – more on this in the central section of this note. This remains a fluid situation though and **we would be surprised if the Fed, in September or even later, will want to be absolutely clear on the next trajectory.** True, the market will always have the possibility to rely on the "dot plot" for guidance. Still, even the "dot plot" is data dependent. It is part of a comprehensive forecasting exercise, and whatever the "median FOMC" member's thinks about the likelihood of further monetary policy moves, it is conditional on their views on inflation and the real economy.

## ECB: properly data dependent (at last)

Upon hiking by 25 basis points to 3.75%, **the European Central Bank (ECB) changed its communication, as we expected, to become properly data dependent in the run up to the September meeting.** This was achieved by removing the notion that policy rates "*will be brought*" to sufficiently restrictive levels – which entails some action – to "*will be set*", which is truly non-committal. To nail the point home, Lagarde stated, when discussing the September meeting, *"it may be a hike, it may be a pause, what it's not going to be is a cut*", without being dragged into any elaboration on the respective probability. It's the data which will determine "*whether and how*" there is more ground to cover by the central bank.

**This makes sense against a complicated data background**. The ECB acknowledged that the real economy is struggling more, that monetary policy is operating (that was visible again in the latest lending data released earlier this week) and that the "external forces" of inflation are softening, but also that the "internal forces" continue to be strong, with a still robust labour market feeding into services prices.

**What do we expect for September then? It's hanging by a thread, but we think it's still slightly likelier than not that the ECB will hike one last time by 25bps**. In our own forecasts, core inflation would still be above 5.0%yoy in the August print – which is the last one the ECB will have before meeting again – and although that would be below peak, this would hardly qualify for the kind of sustained and timely convergence to 2% that the ECB would want to see. Moreover, while we can see some cracks appearing on the labour market, especially in Germany, available data in September on wage growth may still fail to reveal a proper deceleration.

**It's a close call though because we detect a lot of concern about the real economy in some sectors of the Governing Council.** The doves, who have been embracing a more forward-looking reaction function than the hawks who are more focused on observed data, should have an easier job when pointing at what's in the pipeline for the labour market – e.g., hiring intentions in the business surveys or real-time data from digital wage-trackers – at convincing their peers that they do not need to wait for confirmation in the hard data which, in the Euro area, comes out with a significant lag. The ECB's next batch of forecasts will be key from this point of view. The issue the ECB staff is facing however is that the June version (prepared by the National Central Banks) came out with a very strong labour costs assumption – one of the key ingredients in the hawkish inflation forecast. They may want to fade it – we think they should – but there may be limits to how much they can revise this scenario down in the space of three months with only scant additional data on this issue.

**The bond market reacted in a marginally dovish manner to the ECB meeting**, with the 2-year German yield falling by 8bps from the daily peak (the market was clearly positioned for a hawkish surprise this morning) but was on Friday back to its level from the beginning of the week. The 10-year Bund yield rebounded to 2.44% after falling as low as 2.40% in the middle of the press conference, also back to its early week level. **The reaction, especially on the long end of the curve, could have been stronger in our opinion given the clarity provided by Lagarde on the future of Quantitative Tightening (QT)**.

Habitual readers of Macrocast will know that we have been concerned recently by the noise around the cost to the ECB of rising interest rates in a situation of massive excess reserves. This could tempt the governing council in accelerating quantitative tightening in order to flush out this excess liquidity faster. Yet, **Christine Lagarde made it very clear at the end of the Q&A, when specifically asked about a potential trade-off between a pause in rate hikes and an accelerated QT, that the interest rate would remain their main policy tool**. The option of bringing forward the end of the reinvestment of Pandemic Emergency Purchase Programme (PEPP) – today still scheduled to continue "*at least until the end of 2024"* – may come back, but at least for now the Euro area bond market does not need to think too much of even more net supply to absorb.

**What the ECB did instead was to stop paying the deposit rate on the mandatory reserves held by banks on its books. We had mentioned this possibility as the easiest, least disruptive but also least "profitable" solution from the ECB's point of view**. Indeed, as of 21 July, mandatory reserves stood at EUR 157bn, thus coming with an annual cost of EUR 6bn for the central bank with a DFR at 3.75%...but this is dwarfed by what's left on excess reserves, well north of EUR 3000bn, which will continue to be remunerated at the Deposit Facility Rate (DFR).

Just after the meeting Bloomberg reported that the ECB had discussed the possibility of raising the volume of mandatory reserves (in practice by moving up the coefficient linking those reserves to the banks' own quantum of deposits), which would have triggered a bigger saving to the Eurosystem. This would be a dangerous and unpredictable move in our opinion. Indeed, while the banking sector can easily take a EUR 6bn reduction in its income, a bigger move on reserves may have triggered another form of monetary tightening by incentivizing banks to further reduce their lending activity (credit origination begets deposits, which beget mandatory reserves). In the other direction, this could have dis-incentivized banks to offer decent remuneration to their clients on their own deposits. Monetary policy transmission works by raising the cost of borrowing, but also by favouring saving over consumption.

**The foreign exchange market reaction was more brutal**, the Euro losing more than a full figure against the dollar, trading as we write only marginally above 1.100 (down from 1.115 before the meeting). This may however reflect as much the upside surprise on US Q2 GDP, which came out at 2.4% annualized against 1.8% expected, as the ECB's communication shift. We continue to think the United States (US) economy will also start struggling later this year but for now the contrast with the Euro area is stark. This gets us to the discussion of the "soft" versus "hard" landing.

## "Soft" versus "hard" landing: a transatlantic reading

While the market was unconvinced – and the Fed was and still is very reluctant to admit it - it has been quite consensual in the economic profession that it will be next to impossible to bring inflation back to 2% in the US without help from a significant recession. So, when one of the most respected private-sector economists such as Deutsche Bank (DB)'s Peter Hooper, once a staunch supporter of the "recession solution", devotes a nearly 20 pages essay to the possibility that a "soft landing" may ultimately suffice, we should listen (your humble servant needs to disclose a potential bias: he had the pleasure of working with Peter a decade ago).

**Hooper mentions several reasons for which "this time it may be different", both because the Fed may have to do less, and because the economy is better equipped to deal with a hiking Fed**: (i) First, the specificity of the pandemic shock. Supply constraints played a key role in precipitating the inflation wave, and symmetrically the ongoing normalization in global supply may now bring about a good deal of spontaneous disinflation. (ii) Second, the Fed's credibility is much stronger than during the last episode of sustained inflation (in the 1970s), and since consumers' inflation expectations did not really dis-anchor, it may not take too painful an adjustment to bring actual inflation back to target. (iii) The financial position of the private sector is robust, which is unusual in times of monetary tightening (usually occurring after an episode of excess credit origination) and will help dampen the impact of higher interest rates. (iv) The labour market has profoundly changed since the 1970s, with in particular a massive drop in unionization (from a quarter to less than 5% of the working population). A relatively minor adjustment in vacancies, rather than a large increase in unemployment, may suffice to dampen wage growth (the "Waller argument" we've discussed before).

Hooper provides some empirical evidence of the impact of the institutional changes – both in terms of Fed's credibility and labour market organization – by estimating a Philips curve (how inflation reacts to unemployment) over two samples, one covering the 1970s, the other starting in 1985 only, after the Fed had restored its credibility under Volcker and organized labour had seen its influence diminishing drastically under the Reagan administration. Using the post-1985 Philips curve, a smaller rise in unemployment (to c.4.5%) would suffice to bring inflation back to target, against more than 5% using the full sample.

**We note that this would still qualify as a significant rise in unemployment relative to the current level**, and this would likely require a tangible slowdown in economic activity, if not a proper GDP contraction. Actually, Hooper makes it plain at the beginning of his paper that a recession still is his baseline. What he provided is a cogent alternative scenario explaining why it might not need to happen.

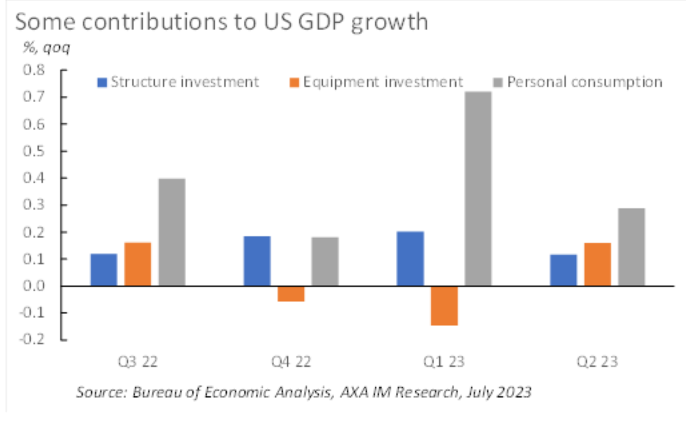
**The issue we want to explore here in some detail is how much of Hooper's reasoning would apply to Europe. We would argue that out of the four protective factors he put forward, the first three could easily be found in the Euro area as well**. First, pandemic-related restrictions were overall stricter there than in the US, which suggests that the Covid shock has been even more disruptive, with supply constraints playing a bigger role in the "inflation explosion", but also, symmetrically, helping more on the way down. Second, it's hardly disputable the ECB is at least as credible as the Fed on inflation-busting. While there was some initial hesitation, the two central banks resolutely embarked on a series of hikes which have brought policy rates to around twice the respective, commonly assessed equilibrium rates in the two regions. Survey-based measures of consumers' inflation expectations in the Euro area have less history and/or precision than in the US but they have not been pointing to any major dis-anchoring either. Third, while Europeans did not benefit from a fiscal stimulus of the magnitude seen in the US, their businesses and personal finances were in a sound position when the ECB started hiking.

**It's on the fourth factor – institutional changes on the labour market – that the transatlantic gap is probably the widest.** Unionization fell in Europe as well, but institutional features continue to favour collective bargaining, which in principle is more conducive to forms of lagged wage/price indexation, even if the system has not been tested for high observed inflation since the early 1980s. This creates an "acquired speed" in wage growth which would prolong second round effects on services prices. This may make the ECB impatient and prone to "overdo" its tightening, which in turn would trigger the rise in unemployment which would belatedly change unions' attitude in key countries such as Germany.

## For now, Europe is landing hard(ish) – and we remain cautious on the US

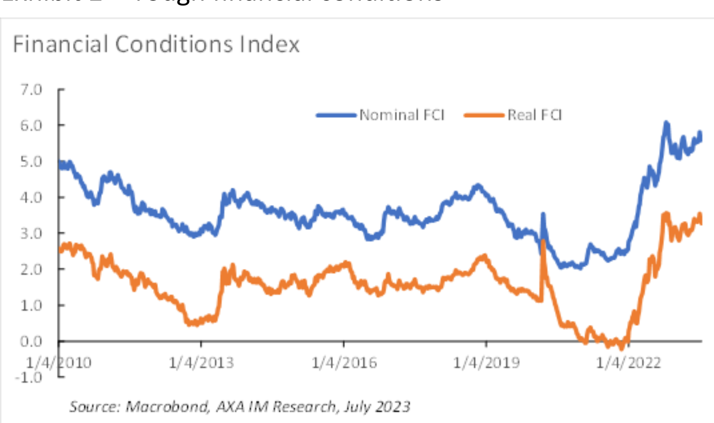
We suspect that **a lot of the interest in the US soft landing scenario is quite simply an attempt to rationalize the current resilience of the US economy**. We confess we do not have a "smoking gun" explanation for this, but we would still make a simple observation: true, the continued strength of consumption is a key driver of the current overall growth performance of the US economy, but we are more intrigued by the behaviour of investment. Indeed, the robust job market is providing some support to personal expenditure, while we would expect investment to struggle as interest rates are rising. Equipment capex had contributed negatively to GDP in Q4 2022 and Q1 2023 but rebounded in Q3. While this is difficult to prove empirically, this may reflect the first impact of the Inflation Reduction Act.

Exhibit 1 – Equipment Capex rebounded in Q2




Source: Bureau of Economic Analysis, AXA IM Research, July 2023

Exhibit 2 – Tough financial conditions




Source: Macrobond, AXA IM Research, July 2023

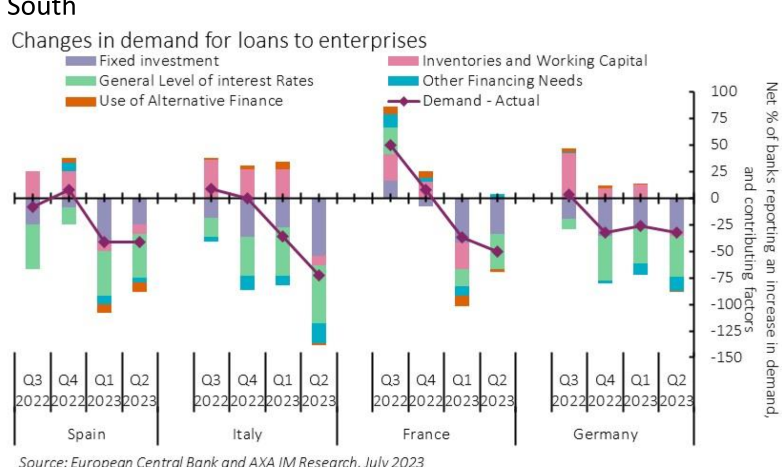
**We still believe patience is of the essence on this issue**. True, we should now be in the "policy relevant horizon" where, a bit less than 18 months after the Fed's first hike in March 2022 – the upper end of the range for policy transmission – it is probably surprising to find that GDP growth is still exceeding its potential pace. Yet, **Fed Funds moved into restrictive territory, above the 2.5% level which the FOMC considers is its "long term level", only in September of last year. This in our view is one element which is often lacking in the current optimistic reading of the US: a recognition that monetary conditions were extraordinarily accommodative to start with**. Even though the Fed has been proceeding with gusto between the end of last year and the spring of 2023, there was a lot to catch up on. Domestic financial conditions (we have updated in Exhibit 2 our simple index, the average of 10-year treasury yields, 10-year interest rates on BBB corporate debt and 30-year mortgage rates) have now been standing for the last six months at their highest post-Great Financial Crisis, even when considering higher expected inflation. We continue to think the bulk of the impact has not yet filtered through. This could coincide with the moment the excess savings Hooper mentioned as one of the drivers of the resilience would start to fade. Of course, as we have discussed before, the rebound in real wages could become the next source of support of consumption, if nominal wages don't slow down, but then we fail to see how services inflation could easily glide back to a pace consistent with 2% core inflation.

We don't deny that the US is not for now outperforming the Euro area. Eurostat has revised its estimate for Q1 GDP from -0.1%qoq to zero in the Euro area, which means that technically the zone is no longer in recession, but the contrast with the US remains stark. True, French GDP growth in Q2 surprised on the upside and was similar to the US print (0.5% against 0.6% in quarter-on-quarter terms), and Spain was not too far behind (0.4%), but the first estimate for Germany came out at

zero, after two quarters in contraction. **If the largest economy of the Euro still cannot extricate itself from recession, this does not bode well for the next quarters in the rest of the monetary union given the high level of trade integration.** Besides, we note that domestic demand was down again in France.

**Irrespective of the diffusion effect from Germany's economic weakness, we are concerned by how the monetary tightening is increasingly affecting the Euro area member states.** Among all the elements which have convinced the ECB Governing Council last week to become non-committal on future hikes, the latest Bank Lending Survey probably played a significant role. The most striking message in our view came from the assessment of credit demand. It is seen as falling further, and it is as, or even more depressed, in the Southern European countries which have so far eschewed recession than in Germany. The main factor behind this decline is the rise in interest rates – proof that the ECB's policy is being transmitted – but also a downward shift in investment and, to a lesser extent, inventories and working capital. This does not bode well for a recovery GDP growth in the Euro area as a whole in the second half of the year.

Exhibit 3 – Credit demand down, even in the so-far resilient South




So, as much as we would like to leave our readers with a rosy view before our August recess, in a nutshell we see an already "hardish" landing materialising in the Euro area, while the soft landing in the US, albeit more plausible, still looks far from certain in our view.

## One step in Japan's slow convergence to monetary normalization

We have been suspecting for several months that **the Bank of Japan would wait until the other major central banks would have reached their tightening peak before moving itself, since this would minimize the global financial stability risks.** We were thus expecting some "fine tuning" of Yield Curve Control last week, but we thought the Bank of Japan (BoJ) would operate by targeting a lower tenor (e.g., 5-year yield). Instead, the BoJ opted for a shift which was not necessarily easy to communicate, nor to understand quickly by the market, but which in a nutshell means that although 0.5% remains in principle the target for 10-year yields, in practice the BoJ will tolerate moves up to 1%. The market reaction was brutal by Japanese standards, with 10-year yields jumping by 12bps, but the level itself remains very close to the "old" limit at 0.55%. Besides, the BoJ's economic assessment and forecasts remain dovish, the central bank still expecting inflation to fall back below 2% next year.

Yet even this rather timid step towards normalization should remind investors that, **although the peak in policy tightening has been reached or is close to be in the US and Europe, there is little reason to see long-term interest rates fall back significantly**. Central banks continue to shrink their balance sheet, and with Japanese savers less tempted to ship their liquidity overseas, pressure will rise.

## Bank of England: buckle up!

We cannot leave for our summer break without saying a word about the Bank of England. As we wait for their decision this week, we can only repeat what we wrote last week: a lower-than-expected inflation print for June probably allows the central bank to move by 25 basis points only, and the British economy may have reached the tipping point at which the labour market starts softening and wages shift away from their currently unsustainable growth rate, but it is for the UK that we are least confident that the tightening peak is being reached, given the magnitude of the structural headwinds which will impair the normalization of inflation.

| Country/Region | What we focused on last week | What we will focus on in next weeks |
|---|---|---|
| | • FOMC raised the FFR by 0.25% to 5.25-50%. Powell reluctant to give forward guidance, said Fed data dependent. We think Fed peaked, cuts from Q1<br>• GDP (Q2, p) rose 2.4% (saar), above expectation buoyed by consumer, investment and inventory. Slowdown fully expected in H2<br>• PCE inflation (Jun) fell to 3.0% (from 3.8%) and core to 4.1% (from 4.6%)<br>• ECI (Q2) rose by 1.0%qoq – too firm for LR Fed goals | • Labour report (Jul) trend slowdown in employment to continue, but surveys warn of upside volatility. Earnings expected to soften monthly pace<br>• SLOOS (Q3) Powell suggested tight and tightening<br>• JOLTS (Jun) fell in May, expected below March low<br>• ISM indices (Jul) watch pick-up in mfg, following PMI rise, services watched for any signs of softening<br>• Vehicle sales (Jul) rose close to 2-year high in June, should fall in coming months from tighter finance |
| | • ECB rose its DFR by 25bps to 3.75% as expected. Next decisions now "properly" data-dependent<br>• Flash July PMIs edged down further below the 50-breakeven. Weakening picture across both manufacturing and services<br>• France Q2 GDP surprised to the upside growing by 0.5%qoq, overperforming Spain (0.4%qoq). Meanwhile, Germany Q2 GDP was flat | • Euro area flash July HICP. We expect core inflation broadly unchanged from June, to remain above May low of 5.3%yoy<br>• Italy (AXA IM: +0.3%qoq) and euro area Q2 GDP (AXA IM: +0.1%qoq) |
| | • Flash PMI (Jul) falls to 50.7 weaker than expected as sentiment and output weakens across the board<br>• CBI Quarterly Survey up to -9 from -15<br>• BoE expect APF losses (from sales and cash flow) of £150bn up from £100bn estimated in April | • BoE MPC meeting (Thu) we expect 25bp hike to 5.25%, and publication of Aug MPR with updated inflation and growth projections<br>• BoE HH lending data (Jun)<br>• Nationwide house prices (Jun) expected -0.2% as rise in mortgage rates bite |
| | • BoJ tweaks YCC further allowing 10-year yields to rise to 1%<br>• Tokyo CPI rose more than expectedto 3.2% and core (ex food and energy) up to 2.5%<br>• Flash PMIs (Jul) Mfg edge lower to 49.4 from 49.8 | • Retail sales (Jun)<br>• Industrial production (Jun)<br>• Labour market (Jun); u/rate expected to decline 2.5% |
| | • Politburo meeting (Jul 24): Eyes on property market, unemployment, local government debt, and domestic consumption, yet no specific measures announced on the day<br>• Industrial profit (Jun) -16.8% ytd yoy, up from -18.8% ytd yoy in May | • 31 Jul: PMIs Mfg and non-mfg for July, both NBS and Caixin measures. Watch for signs of further softening in activity |
| | • CB: Chile cut rates for the first time since March 2020; NBH in Hungary cut O/N rate by another 100bp to 15%, kept repo rate unchanged at 13%; Indonesia on hold at 5.75%<br>• GDP Q2 in Korea (+0.6%qoq) & Taiwan (1.7%qoq)<br>• Inflation fell in Malaysia (2.4%) & Singapore (4.5%) | • CB: Brazil to cut 25bp to 13.5%. Colombia (13.25%) & Czechia (7.0%) to stay on hold. Thailand to hike +25bp to 2.25%<br>• CPI (July): Indonesia, Korea, Peru, Poland, Philippines & Turkey<br>• PMI across EM countries |

| Upcoming events | | |
|---|---|---|
| | US: | Mon: Chicago PMI (Jul); Tue: PMI (Jul), ISM mfg index (Jul), JOLTS (Jun); Wed: ADP survey (Jul); Thu: Jobless claims (29 Jul), Productivity (Q2), ISM services (Jul), services PMI; Fri: Non-farm payrolls (Jul), SLOOS bank lending |
| | Euro Area: | Mon: EA, Ge, It GDP (Q2), EA, It CPI (Jul,p); Tue: EA mfg PMI (Jul), EA, Ge, It unemp (Jul/Jun), EA services PMI (Jul), EA PPI (Jun), Fri: EA retail sales (Jun), Ge New mfg orders (Jun), Fr, It, Sp Ind prod (Jun) |
| | UK: | Mon: Mortgage approvals (Jun), Net mortgage lending (Jun), Consumer credit (Jun); Tue: BRC Shop price index (Jul), mfg PMI (Jul); Thu: services PMI (Jul), MPC and Monetary Policy Report (3 Aug); Fri: Construction PMI (Jul) |
| | Japan: | Mon: Industrial production (Jun), Housing starts (Jun); Tue: Unemp (Jun) |
| | China: | Mon: Mfg and non-mfg PMI (Jul), Tue: Caixin mfg PMI (Jul), Thu: Caixin services PMI (Jul) |

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