AXA Investment Managers

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Investment Institute Macroeconomics

The end of the beginning?

- We expect a slower pace of tightening from December 2022 from the Fed and the ECB. Market optimism could however be curbed by the realization that a slower pace does not necessarily inform on the “terminal rate”. There will be more episodes of stress amid volatile dataflows.

The “end of the beginning” of the ongoing monetary tightening will be reached when central banks intend to continue hiking but decide they can take the risk of doing it at a less brisk pace. We expect both the Fed and the ECB to resort to a smaller quantum of tightening at their December meetings after delivering a last 75bp move, the Fed emulating the ECB this week. Yet, there is not direct link between slowing down and finding the right level of the policy rate which will be appropriate to return inflation back to 2%. The “terminal rate” remains elusive. It’s just that the risk of fuelling more overheating is now lower, so that the central bank can now move to a “probing strategy” rather than “catching up” in a hurry.

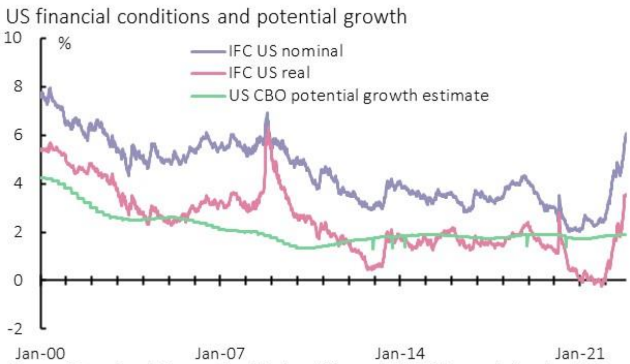
While the “probing” approach reduces the risk of policy mistakes – and from this point of view we can understand some of the market’s recent bout of optimism – if the resilience of the economy holds up into the coming months, the Fed may be forced to go further than the 4.6% median forecast of the FOMC members for Fed Fund in 2023. Still, for our part, we remain comfortable with being slightly below market expectations for the terminal rate given our forecast of a sizeable recession in the US driven in part by the ongoing steep deterioration in financial conditions, but we also expect more episodes of market stress in the months ahead every time the dataflow will not move down “fast enough”. Besides, investors need to accept more “macro pain” ahead before enjoying the benefits of a proper “dovish pivot” by the Fed. In the Euro area, a higher-than-expected inflation print for October released a day after a less “one-sided” Governing Council meeting may have wrong-footed the ECB. There remain strong reasons though to still expect a sizeable deceleration in inflation next year, converging to the central bank’s target. Yet, beyond the number and size of the next hikes (we now expect 50bps in December and 25bps in February) we suspect the bond market will become increasingly sensitive to the prospect of Quantitative Tightening, with a decision on this now scheduled for December. The Bank of England also meets this week. We stick to our view – and now the market’s – that 75bps would be a good “compromise hike”.

It's tough out there

Judging by the rebound in equity prices these last 10 days, one could be forgiven for thinking the world economy has properly turned a corner. Our contention however is that the worse is still to come, unfortunately. One of our key sources of concern is the continuation of the tightening in broad financial conditions. We have updated our simple "Financial Conditions Index" (FCI) for the US (unweighted average of 10-year treasury yields, 10-year yield on BBB corporate bonds and 30-year mortgage rate) and it continues to climb to levels which in the past were associated with funding restriction (Exhibit 1), and it is even more obvious if one factors in the decline in potential growth to gauge the distance from "neutral". Our FCI for the US is not easily replicable in the Euro area since disintermediated funding covers only a small part of corporate finance there. In Europe, the behaviour of banks is crucial, and the news flow on this is not uplifting. Indeed, the latest Bank Lending Survey (BLS) released by the European Central Bank last week (covering Q3) suggests that **lending standards for corporate loans are being tightened by more than during the early pandemic turmoil, and the balance of opinion has reached levels unseen since the sovereign crisis of 2010-2012**. Unsurprisingly in these circumstances, expected credit demand from corporations is down (Exhibit 2). The latest BLS may have informed the European Central Bank (ECB)'s more prudent message of the pace of future hikes last week (more on this later).

In our opinion, we are entering new phase in which the "spontaneous" headwinds – chiefly the erosion in purchasing power triggered by an inflation shock which in the US remains larger than the acceleration in wages – are going to combine with the emerging impact of the more restrictive policy stance. There may still be some "reserves of growth" – for instance in the excess savings of the pandemic – but they are being depleted fast.

Exhibit 1 – More and more restrictive market conditions



Source: Macrobond, Congressional Budget Office and AXA IM Research, October 2022

Exhibit 2 – Tough time ahead for intermediated funding

Source: European Central Bank and AXA IM Research, October 2022

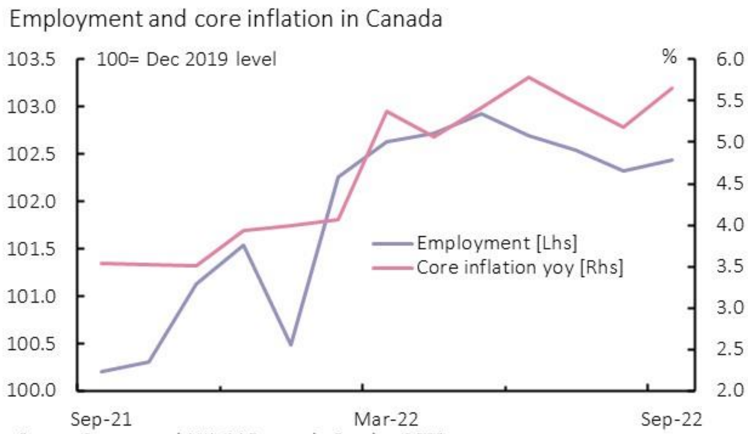
The Canadian Canary in the Coalmine?

The "end of the beginning" of the ongoing monetary tightening is reached when central banks intend to continue hiking but decide they can take the risk of doing it at a less brisk pace. The Bank of Canada (BoC) has already reached this point at its October meeting. We should thus look into some key aspects of the Canadian dataflow to gauge the probability that the same inflexion points will be reached by the Federal Reserve (Fed) at the end of this year.

The BoC has been very "hardy" on the speed of its tightening so far, even resorting to a 100-basis point (bp) hike. The market was still expecting a "chunky" move by 75 basis-points (bps) at the October meeting, but the central bank surprised by delivering "only" 50bps. Governor Macklem made it plain that they were not done with hiking – the statement explicitly calls for more – but the central bank is reassured to see that the quantum of tightening so far has started to have a visible effect on the economy. To quote directly from the opening statement *"the economy is still in excess demand – it's overheating …[but] higher interest rates are beginning to weigh on growth. This is increasingly evident in interest-rate-sensitive parts of the economy, like housing and spending on big-ticket items".* We found another "nugget" in the statement: *"we are trying to balance the risks of under and over-tightening".* That the very existence of the two-sided risk is acknowledged is significant in our view, and contrasts with the current message from the Fed.

A key input into the BoC reasoning may have been the deterioration of the labour market. Exhibit 3 plots Canadian employment relative to the pre-pandemic level. The peak was hit this spring, but relative to May the economy has now destroyed jobs. The softening of the labour market may have convinced the BoC that some subsequent deceleration in wages would follow, allowing for a softer pace of tightening, even though observed inflation remains too high and in the case of core has not started to decelerate.

Exhibit 3 – Bank of Canada's forward-looking approach



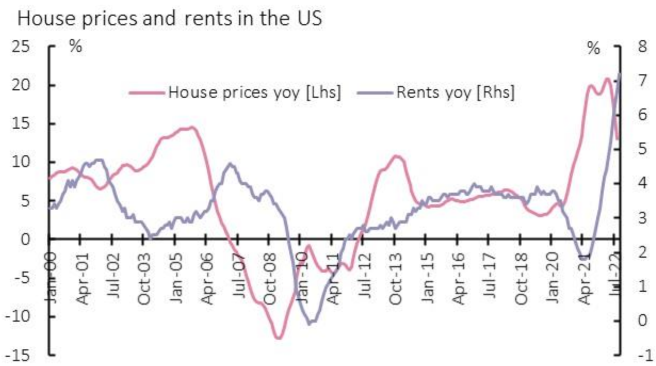
Source: Statcan and AXA IM Research, October 2022

We are not there yet in the US. The September data suggested the US economy was still adding jobs at a very respectable rate. There are forward-looking signs that momentum is fading. Job openings – new positions being advertised – and resignations ("quits") have seemingly rolled over (Exhibit 4), but from such an elevated level that these phenomena are unlikely to be already moving the dial on wage settlements. The Employment Cost Index (ECI) for Q3– usually considered as a better gauge of wage pressure than the more frequent earnings released with the payroll – is decelerating only marginally (5.0% annualized in Q3 2022, 5.4% in Q2 and 5.8% in Q1) and remains inconsistent with a swift return to 2% core inflation. As usual the market will focus this week on the release of the payroll data for October – and expects a slowdown to 190k new jobs, down from 263K in September – but for now the dataflow has not deteriorated enough, in our view, to shift the Fed away from delivering another 75bp-hike this week.

Exhibit 4 – The right direction, only very slowly

Source: Bureau of Labor Statistics and AXA IM Research, October 2022

Exhibit 5 – Patience needed on rent inflation



Source: Macrobond, Bureau of Economic Analysis and AXA IM Research, October 2022

Yet, after the November meeting, the debate may change within the Federal Open Market Committee (FOMC). Even if the impact does not appear immediately, the Fed will have to increasingly take on board the ramifications for the real economy and hence inflation of the rapid deterioration in financial conditions. **The Fed's "chief dove", Lael Brainard, was the first at the FOMC to raise the "lags issue", i.e., the risk of overreacting to the current dataflow when not considering the time it takes for the past monetary policy decisions to affect it. This issue will become more prominent.** The housing market provides an interesting example. There usually is a lag of nearly a year between the inflexions of house prices and those of rents (Exhibit 5). House prices have started to decelerate, but this is unlikely to appear in the Consumer Price Index (CPI) rent data before mid-2023. Yet, given the role rents play in the Fed's preferred measure of inflation – it's roughly one third of the core consumer prices basket – the central bank cannot completely ignore the fact that, based on historical patterns, the contribution from rents to overall inflationary pressure should diminish well within its "policy horizon" (real-time data using new leases advertised on digital platforms are already pointing at a slowdown).

This change of attitude should convince the Fed to opt for a smaller hike – 50bps – in December, while making it clear this would not be the last. Indeed, while there may be tentative signs that "things are going in the right direction", the central bank is likely to consider that without further restriction, inflation would still remain unacceptably high. To use the BoC's wording, excess demand may start to be absorbed, but it remains in excess. This is one the reasons which make us quizzical of the equity mini rally of the last 10 days. Indeed, **while we do expect the quantum and then the pace of rate hikes to diminish after November, the level of the terminal rate will remain elusive**.

There is not direct link between slowing down and finding the right level of the policy rate which will be appropriate to return inflation back to 2%. It's just that the risk of fuelling more overheating is now lower, so that the central bank can now move to a "probing strategy" rather than "catching up" in a hurry. The "probing" approach reduces the risk of policy mistakes – and from this point of view we can understand some of the market's bout of optimism – but if the resilience of the economy holds up, the Fed may be forced to go further than the 4.6% median forecast of the FOMC members for Fed Fund in 2023. For our part, we remain comfortable with being below market expectations for the terminal rate given our expectation of a sizeable recession in the US, but we also expect more episodes of stress in the months ahead every time the dataflow will not move down "fast enough".

Less one-sided ECB betrayed by data?

Christine Lagarde loosened the forward guidance last week upon delivering the widely expected 75bp-hike. While the policy statement makes it plain that policy rates will still be "raised further", the central bank crucially dropped the notion it would continue for "several meetings". As we discussed last week, keeping the plural would have made hikes into 2023 certain. This would have been a problem for those – like the Banque de France Governor – who are arguing for a pause once the upper end of the neutral range is hit (in December likely). We thought the hawks would be dominant enough in the Council meeting to keep the language unchanged, but it seems the "doves re-awakening" which we have been observing for several weeks has been productive. News emerging after the meeting that three members of the Governing Council favoured a 50-bp hike last week would confirm that.

This does not mean the ECB won't hike in 2023, but this at least opens the door to a proper debate on this rather that tightening on "robotically". In connection with the points we made in the previous section, it seems that the ECB is shifting to a "probing" approach instead of "catching-up". Christine Lagarde was clear that there is still ground to cover for the central bank to bring its policy rate at the appropriate level to bring inflation back to 2%, but the ECB is now ready to do this on a proper "data dependent" basis. Yet, just as with the Fed, the terminal rate remains elusive. In our view, the absence of clear overheating in the Euro area would call for the ECB to go much less far in restrictive territory than the Fed, just how far remains in discussion. The model-based proposals by the Governor of Bank of Spain and the ECB staff – 2.25/2.50% – look reasonable to us. We thus expect the ECB to hike by 50bps in December and deliver a final move of 25bps in February, putting the deposit rate at 2.25% (slightly up from our previous forecast of the terminal rate at 2.0%).

Of course**, if the ECB is truly data dependent, then every single inflation prints matters, and what came out the day after the Governing Council meeting is clearly not going in the right direction.** Flash estimates for inflation in October came out above expectations in Germany (11.6% against 10.9%), France (7.1% against 6.5%) and Italy (12.8% against 9.9%). Spain was the only big member state where inflation came out below expectations (7.3% versus 8.1%). A higher-than-expected contribution from energy and food played a significant role in the drift in the first three countries, but core inflation seems to also go in the wrong direction, which obviously is going to be a particular concern for the ECB.

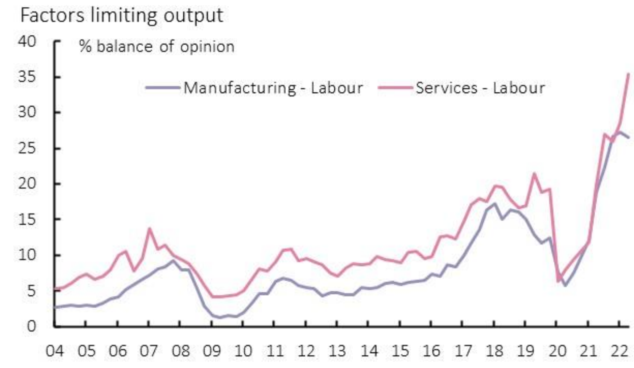
Still, **we think there are four factors which should help bring inflation gradually back to a pace more consistent with the central bank's target.** First, even if the current steep decline in spot wholesale gas price is in all likelihood only provisional – reflecting the fact that storage is at or near full capacity while the weather has been remarkably mild – we should still see base effects on energy prices go in the right direction. One-year forward contracts have European gas prices at EUR139/megawatt hour (Mwh), a still extraordinarily high level historically (it was EUR45/Mwh at the beginning of 2022), but this would still produce significant negative base effects in 2023. Second, more governments are introducing additional measures to dampen the transmission between wholesale and retail energy prices (Germany and the Netherlands). This would not necessarily help deal with the current acceleration in core inflation. However, a third factor needs to be considered. If – as we expect – the Euro area falls into recession, with a decline in the *volume* of consumption, the corporate sector will be forced to squeeze its margins, thus dampening the transmission from inputs to final prices. The final fourth element revolves around the wage/inflation loop.

So far, wage growth has been remarkably subdued in the Euro area, with even a deceleration in the latest batch of "negotiated wages" (Exhibit 6). A nagging issue is that negotiated wage data tends to come quite late (Q2 is the last available point). However, the news flow from the countries which publish timely monthly wage data is quite reassuring. In September wages grew by 2.6%yoy in Spain at a paltry 1.1% in Italy. The wage tracker set up by the ECB which tries to capture the latest developments in real time sends a reassuring message. To quote verbatim from the ECB itself, *"the experimental ECB wage tracker pointed to a gradual acceleration in wage growth over the coming quarters. Recently concluded wage agreements included increases of around 3%, on average, in the euro area for both 2022 and 2023. However, in the agreements concluded in the third quarter, wage increases for 2023 were slightly lower than in the agreements concluded in the second quarter. So far there had not been an accelerating trend in the data".* This may come as a surprise since the business surveys have been reporting intense hiring difficulties (Exhibit 7). Yet, in Europe the crux of the problem is an acute demand/supply mismatch in some sectors, but without the decline in the overall quantum of labour supply which has been plaguing the US economy (the percentage of the population between the age of 16 and 64 which either work or is actively seeking work is rising in the Euro area and is now exceeding the level seen in the US).

Exhibit 6 – Not much to see on European wages…

Source: European Central Bank and AXA IM Research, October 2022

Exhibit 7 – …despite rife hiring difficulties



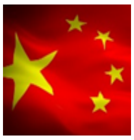
Source: European Commission and AXA IM Research, October 2022

Of course, these considerations pale in comparison with spectacular inflation print, but the debate between "empiricists" – those who focus on the current data flow - and "academics" – those who put their trust in models – may have started to shift towards the latter.

In any case, one should not overstate the change of tack from the ECB last week. **President Lagarde reported that the reduction of Asset Purchase Programme (APP) holdings was not discussed at the October meeting, but that discussion was scheduled for December, with a decision expected then.** This is sooner than we initially expected (announced in Q1 2023), even if the central bank could of course delay the start of the implementation proper. We think this aspect of the ECB policy will become more crucial in 2022. True, the decision to retroactively alter the terms of the Targeted Longer-Term Refinancing Operation (TLTRO) 3 – which we think could prove counter-productive in terms of credibility for the ECB if one day they have to use this instrument again – will "liberate" some much needed collateral, possibly relieving some of the pressure on the bond market… but this is likely to be more visible around the 1-3 year segment of the curve. On the longer end of the curve, lower reinvestments, then net sales, in a context of higher issuance, are going to be problematic.

The Bank of England's calibration

The Bank of England (BoE) needs to decide on the quantum of its own hike on Thursday. The government has decided to push back to November 17 the full disclosure of its new fiscal plans, which might make the BoE's calibration more delicate, but the overall message is clear: the adventurous "mini budget" is properly extinct, and the UK's fiscal stance is moving towards austerity. This should normally push the central bank to opt for a smallish tightening, but at the same time financial conditions – albeit still much tougher than before the "mini budget" – have continued to ease back last week, which would go in the opposite direction for the Bank of England. This makes us comfortable with our call for a "compromise hike" of 75bps, in line with market expectations, still "chunky" but nowhere near the 100+bps the market considered as necessary just three weeks ago. In terms of balance of risks, we would not discard the possibility the Monetary Policy Committee (MPC) opts for an even smaller hike – 50bps – but that would create a risk for the still fragile rebound in the GBP which is vital for the UK to curb imported inflation.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• US GDP (Q3) rose to 2.6% (saar), firmer outurn than previously expected driven by trade. • PCE inflation (Sep), core PCE picked up to 5.1%yoy. below cons forecasts 5.2% and headline held at 6.2%. • Employment cost index (Q3) eases to 1.2% from 1.3% • New home sales (Sep) down 10.9%mom	• FOMC meeting. We expect Fed to hike by 0.75% but signal a smaller 0.5% hike next month. • Payrolls (Oct) expect further deceleration in employment growth but watch labour supply for impact on jobless. • ISM indices (Oct) expect indices to soften further, watch forward-looking components for signs of downturn
	• PMIs dig further in negative territory. Manuf weakness is spreading to services. Employment still robust. Fr remains above 50 threshold • Prelim Ge GDP came at +0.3%qoq (axa im: -0.4%), Fr at +0.2% (=) and Sp weaker at +0.2% (axa im: 0.8%) • HICP: major upside surprise in Ge (11.6%yoy), Fr (7.1%), It (12.8%) mostly driven by energy. Sp fell to 7.3%	• After surprise on inflation almost everywhere, there is upside risk to our EMU HICP (9.8%yoy, cons: 9.6%) • Italian Prelim Q3 GDP (AXA IM: +0.1%qoq) • Final PMIs • Unemployment rate should stay at 6.6%, it is too soon to see job destruction • Ge and Fr IP and orders, Sep producer prices details
	• Rishi Sunak confirmed as leader of Tory party and New UK Prime Minister. • Fiscal update now due on 17 Nov w/ cuts and tax increases of c£50bn currently expected • PMIs (Oct) dip further w/ sharp declines across sectors • CBI Industrial survey (Oct) signals steep drop in business optimism falling to -48 from -21	• BoC MPC meeting (Thurs). We expect MPC to hike by 0.75% with risks of 50bp as MPC still lack clarity over fiscal plans • BoE MPR forecasts likely to show sharp downgrades to growth on market rates. • BoE household lending data (Sep). • Nationwide House Prices (Oct).
	• As widely expected, BoJ kept all policy tools unch • BoJ raised core inflation forecasts to 2.9% in FY2022 from 2.3% and marked down growth to 2.4%. • Gov finalises package ¥29tn central gov spending • Further signs of intervention to yen on Monday • Tokyo CPI (Oct) pushes to 3.5% above cons forecast	• Industrial Production (Sep) expected to decline -0.8% (cons) following manufacturing disruption caused by Typhoons • Flash PMIs (Oct) • Retail sales (Sep)
	• 20th Party Congress concluded, with a new leadership line-up announced at the First Plenum • President Xi secured a third term as the leader of the Party, state and military • Four new members were promoted to the Politburo Standing Committee, with Li Qiang expected to succeed Li Keqiang as the Premier of the State Council	• Manufacturing and services activity might have deteriorated further in October due to tighter COVID restrictions • After Shanghai announcing a booster shot campaign using inhaled vaccines, markets will watch for signs of other regions following suit • Markets will also pay attention to concrete policy changes to prove or disprove the bearish initial reaction to the Congress
	• CB: Vietnam hiked +100bps to 6.0%. Brazil (13.75%), Hungary (13.0%) & Russia (7.50%) stood on hold. • Q3 GDP accelerated to 3.1%yoy in Korea • Annual inflation (Sep) fell in Malaysia to 4.5% & remained stable in Singapore at 7.5% • Sep Unemployment fell in Brazil (8.7%), Mexico (3.3%) & Singapore (2.0%)	• CB: Malaysia is expected to hike +25bps to 2.75%. India's central bank will hold an additional unscheduled meeting • PMI figures across EM countries • Annual inflation (Oct) data in Korea, Indonesia, Thailand, Philippines, Turkey & Peru • Unemployment (Sep) data in Mexico, Peru & Singapore • Q3 GDP %yoy should accelerate in Taiwan & Mexico

Upcoming events		
	US:	Tue: Manf. PMI (Oct), ISM Manf. Indx (Oct), JOLTS job openings (Sep); Wed: ADP employment change (Oct), FOMC announcement; Thu: Trade bal. (Sep), Non-farm productivity / ULCs (Q3), Weekly jobless claims (29 Oct), Services PMI (Oct), ISM non-manf. Indx (Oct), Factory Orders (Sep); Fri: Non-farm payrolls (Oct), Unemp. (Oct), Average earnings (Oct)
	Euro Area:	Mon: EU19 GDP (Q3), CPI 'flash' estimate (Oct), It GDP (Q3); Wed: EU19, Ge, Fr, It & Sp Manf. PMI (Oct); Thu: Lagarde to speak, Unemployment (Sep); Fri: EU19 Composite / Services PMI (Oct), ECB Lagarde speaks, PPI (Sep), Ge New manf. orders (Sep), Fr & Sp Ind. Prod. (Sep), EU4 Services PMI (Oct)
	UK:	Mon: Mortgage approvals (Sep), Net mortgage lending (Sep), Consumer credit (Sep); Tue: Manf. PMI (Oct), BoE begins active gilt sales; Thu: Composite / Services PMI (Oct), MPC announcement, Bank rate vote & Catherine Mann to speak; Fri: SMMT new car reg. (Oct), Construction PMI (Oct), BoE Huw Pill speaks
	China:	Mon: Official manf. and non-manf. PMI (Oct); Tue: Caixin manf. PMI (Oct); Thu: Caixin services PMI (Oct);

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