AXA Investment Managers

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Investment Institute Macroeconomics

Macrocast

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Revisiting the 1994 miracle

- Beyond the additional hikes in the US, UK, and Euro area this week, we don't expect a change of tone from the central banks.
- We take a hard look at the likelihood to see a replication of the "recession free" tightening of 1994. We are not optimistic.

A "central bank super week" is starting. The Fed, the ECB and the Bank of England all meet. Last week the Bank of Canada chose to buck the trend – or precede it for the optimists– by announcing a pause after its 25bps hike, although disinflation in Canada is still tentative, and it's going to be tempting for the market to read into the decision in Ottawa the harbinger for the long-awaited "dovish pivot" elsewhere. We don't think the time has come though. True, we expect a downshift to 25 basis points by the Fed this week, but their communication remains consistent with considering to pause only in Q2 – at best. The ECB for its part could not be further away from the BoC thinking at the moment. We expect the ECB to hike by more than the Fed not only this week, but also in March, which would solidify the recent rebound in the euro exchange rate. The Bank of England is – again – in a delicate position. A still tight labour market combined with still higher-than-expected core inflation call for a 50bps hike – out central scenario – but the Marginal Propensity to Consume (MPC) is clearly concerned by the risk of "overdoing it".

So far, the real economy has remained resilient despite the relentless rate hikes, to the point that the equity market may be counting on the replication of the "1994 miracle", the only episode of Fed tightening since the early 1960s which did not trigger even a shallow contraction in US GDP. Beyond the fact that the size of the cumulative tightening is already larger than in 1994, we note that it now applies to a more leveraged economy than then. In addition, in 1994, the Fed responded to "imaginary inflation": corporates did not have to deal with margin contraction and households' purchasing power was not eroded. Finally, supply-side conditions were much more favourable then. In the first half of the 1990s, the civilian workforce was expanding much faster than today, while "animal spirits" were probably spurred by the emergence of globalization, materialised very concretely in the US by NAFTA. Current resilience is welcome, of course, but we continue to dispute its longevity, especially with central banks "not being done".

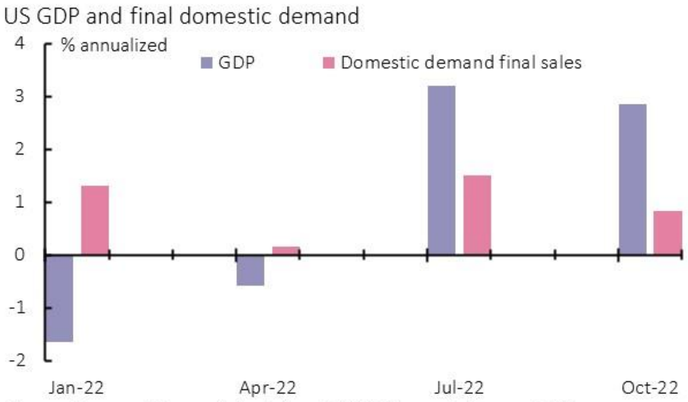
After a strong US GDP in Q4, what are the chances of a recession-free adjustment?

As the "central bank super week" comes, macro resilience continues to be a dominant theme. The rebound in the Euro area composite Purchasing Managers' Index (PMI) in expansion territory in January, albeit by a very narrow margin, is confirmed by a wide array of national surveys (INSEE in France and IFO in Germany) and some hard data for Q4 – Spanish GDP grew by 0.2% quarter-on-quarter, which combined with stagnation in Germany seriously lowers the risk GDP contacted at the Euro area aggregate level at the end of last year. We will get the first estimate for the zone as a whole on Tuesday this week. **US soft data has not been that supportive though**. The S&P composite PMI for January came out above expectations, but at 46.6 it remains firmly in contraction territory. Yet, for now the United States (US) continues to "dodge recession» by a very significant margin. Q4 GDP growth came out at 2.9% annualized, slightly above market expectations (2.6%) even if trackers such as the Atlanta Fed had been more optimistic.

The contrast between hard data and the surveys in the US may not be as stark as it may seem at first glance. **Underlying domestic demand has softened**. Final domestic sales – i.e., stripping GDP from the contribution from net trade and inventory movements – came out at only 0.8% annualized in Q4, down from 1.5% in Q3 (see Exhibit 1). True, the messages from the quarterly national accounts have been particularly hard to interpret in 2022. GDP fell in the first two quarters for mostly technical reasons as the economy was reopening (catch-up in imports as supply lines normalized and inventory drawdown to service the rebound in demand took GDP "artificially" down). Q3 can probably be seen as the first "normal" quarter from this point of view and decelerating from that basis should be taken seriously. The behaviour of consumption is quite telling. Q4 ended on a sour note on that front. We had already highlighted the mediocre numbers from credit card spending in December reported by Bank of America. This was confirmed in the aggregate numbers: real personal spending fell by 0.3% month-on-month in December.

Yet, **none of this changes the general assessment of the US economy: it is indeed slowing down – going "in the right direction" from the Federal Reserve (Fed)'s point of view – but at a quite leisurely pace**. Since this coincides with some disinflation, the hope that the US economy could land without going through the dreaded "recession phase", despite the ongoing monetary tightening, is getting some support. We continue to think that the probability of this happening is low, considering both historical precedents and the current characteristics of the US economy.

Exhibit 1 – Going slower…. slowly

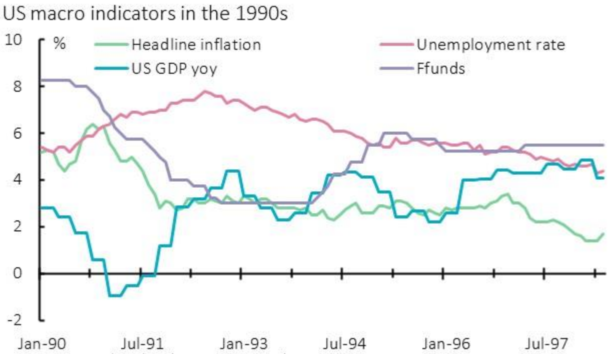


Source: Bureau of Economic Analysis and AXA IM Research, January 2023

Since the advent of "modern monetary policy" in the early 1960s, the US went through 10 episodes of Fed tightening. In 9 cases, a contraction in GDP ensued. It was not always dramatic – several shallow recessions did happen – and one can dispute causality in some cases (for instance when the rate hikes coincided with massive oil price shocks) but there is only one case of recession-free monetary adjustment. In 12 months from February 1994 the Fed raised its policy rate by 300 basis points. This had remarkably little apparent impact on GDP, which continued growing in a range of 2.5%-4%

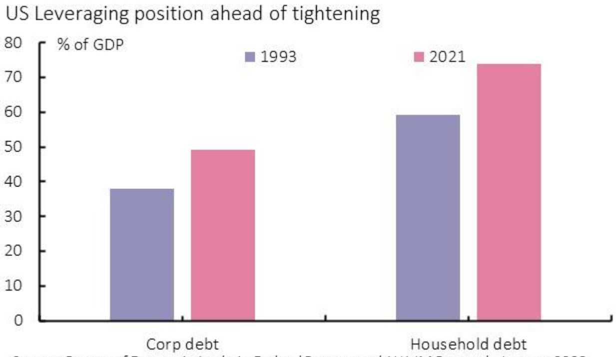
throughout 1994 and 1995, while the unemployment rate continued to fall, albeit at a slower pace (see Exhibit2). Can a repeat of 1994 lay ahead?

Exhibit 2 – The miracle of 1994



Source: Macrobond and AXA IM Research, January 2023

Exhibit 3 – Debt matters



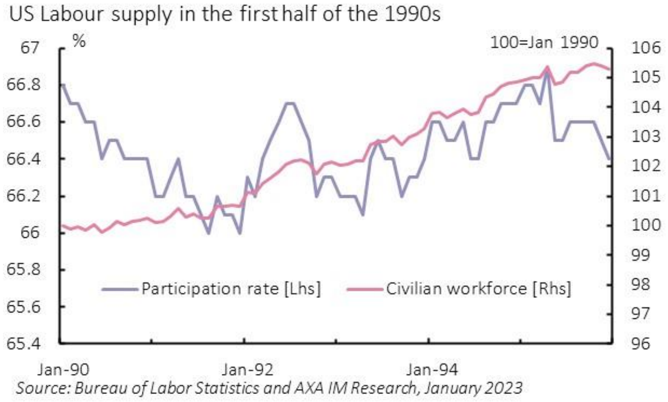
Source: Bureau of Economic Analysis, Federal Reserve and AXA IM Research, January 2023

Part of the answer may lie in the debt position of the US economy. To some extent, the impact of rate hikes on spending decisions is a function of the quantum of accumulated debt on which it applies. The debt ratios of US corporates and households the year before the Fed started tightening in 1994 were lower than where they were before the current adjustment started (see Exhibit 3). The magnitude of this effect should not be overstated though. Indeed, in 1994 and 1995, the Fed moves triggered a very significant rise in long-term interest rates, which would have magnified the effect of the tightening on the spending behaviour of private agents. The current reluctance of markets to fully pass the signals of the Fed – illustrated by the recent loosening in financial conditions we highlighted in the last few issues of Macrocast – is conversely dampening the impact.

The two main differences between today and the 1994 miracle pertain to the inflationary environment and supply-side conditions. In 1994, the Fed reacted to "imaginary inflation". Indeed, another striking feature of the early to mid-1990s, once the shock of the first Gulf war on energy prices had been absorbed, was the stability of inflation around 3% (this was before the Fed explicitly chose 2% as its target). The Fed under Greenspan was – for the last time – pre-emptive. Their approach followed a purely forward-looking neo-Keynesian analysis of the situation. As the economy was rebounding from the 1990-1991 recession, the unemployment rate was regularly converging back to 5% which was then widely seen as the "equilibrium level" below which wages and inflation would start accelerating again. The Fed hiked without any indication that inflation was actually *already* rising. US corporations and households did not have to deal with price pressure weighing on margins and purchasing power. This created a completely different configuration from today where the private sector needs to deal with *both* the consequences of the monetary tightening and those of the inflation shock. There are reasons to believe that these adverse forces are only starting to exert their influence now. As we have discussed last week, in most of 2022 the decline in purchasing power could be offset by drawing on excess savings from the pandemic, while it takes a while for a rise in interest rates to affect spending (recourse on credit card has started to decelerate in October only).

Supply conditions were also much more supportive in the mid-1990s than today. **Potential growth was on the way up then, while it is probably heading down today**. Indeed, the labour market participation rate fully recovered from the cyclical drawdown of 1991-1992. By late 1994, it was back to its January 1990 level. Moreover, this was still a time of swift gains in the volume of working age population. As a result, the civilian workforce rose by 1% per annum on average in the first half of the 1990s. The absence of aggregate labour scarcity at the time is a major explanation behind the absence of a significant wage drift despite a low unemployment rate (by this era's standards). Conversely, as is well known, the US is today grappling with a stubbornly low participation rate and a slower growth in working age population. As a consequence, the civilian workforce has risen by only 0.25% per annum since January 2019 (see Exhibit 4 and 5).

Exhibit 4 – Strong labour supply in the mid-1990s…



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

Exhibit 5 – …in stark contrast with today

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

True, arguably a strong potential growth could still have coincided with a recession in the mid-1990s if aggregate demand had softened in response to the monetary tightening. Something must have spurred the economy's "animal spirits to keep demand in synch with supply. We have already covered in Macrocast how, as tough as the 1990s could be from a cyclical point of view, between the shock of the Gulf war and the ramifications of German unification for monetary stability in Europe, at least some sources of hope for the future were also emerging. In the US, the advent of the North American Free Trade Agreement (NAFTA) in the mid-1990s probably constituted one of the most visible aspects of globalization, lifting growth prospects in the corporate sector. This is missing today. Arguably, the prospect of a significant acceleration in green investment thanks to the Inflation Reduction Act may play this role today, but it may come too late to allow the US economy to avoid a probably short trip into a shallow contraction in GDP within the next few quarters, especially **since the overall size of the monetary tightening this time is likely to dwarf that of 1994**. Then, the Fed hiked by a total of 300 basis points between February 1994 and February 1995 and started cutting only 18 months after its first hike. So far in this cycle, the Fed has already hiked by 425bps in 9 months, and we expect an overall effort of 500bps, with cuts coming only some 2 years after the first hike.

ECB to hike by more than the Fed

Last week the Bank of Canada (BoC) delivered the kind of message which the market is hoping to get soon from other central banks and the Fed in particular. Indeed, upon hiking again by 25bps its policy rate to 4.50%, the BoC signalled its intention to pause explicitly, stating that *"if economic developments evolve broadly in line with the forecast we published today, we expect to hold the policy rate at its current level while we assess the impact of the cumulative 425-basis-point increase in our policy rate. We have raised rates rapidly, and now it's time to pause and assess whether monetary policy is sufficiently restrictive to bring inflation back to the 2% target".*

Although it had been expected, it is still a big decision. Indeed, the signals from the Canadian economy are ambiguous. Core inflation has stabilized at around 5% but without demonstrating so far the visible downshift seen for the past two months in the US (at least in year-on-year terms). The softening of the labour market is no longer as clear as it was in mid-summer, when the unemployment rate rose to 5.4% - it has fallen back to 5% in December. This probably explains why the BoC's pause is a conditional one: they explicitly "reserved the right" to resume hiking if the inflation landing they now expect does not materialise.

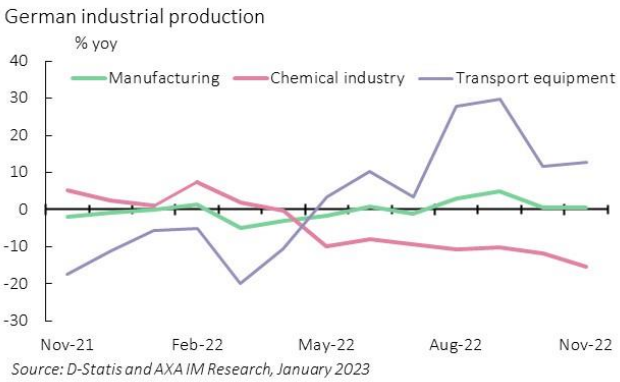
Yet, in any case **the BoC has created an interesting precedent, or model case, for central banks entering a new phase of their policy journey,** which is all the more relevant since it has not been a particularly dovish central bank so far in the tightening phase (it did not hesitate to hike by a full 100bps last June). Arguably, with disinflation signals clearer in the US than in Canada, one could wonder why the Fed is not preparing to take the same attitude. It's a judgement call, boiling down to finding the glass half-empty or half-full on the disinflation process. A key point however for us – which we discussed at length last week – is that with financial conditions easing over the last two months, there is a risk that merely keeping policy unchanged would result in less tightening down the road, which puts in doubt the notion that "enough has already been done" to bring core inflation further down.

There was a lot of market interest in Federal Open Market Committee (FOMC) member Waller's comments last week as he joined those who would favour a 25bps hike only – our central scenario - at this week's meeting given his usually hawkish proclivities. But the most interesting part of his comments, in our view, was what he said about the next steps: *"Beyond that, we still have a considerable way to go towards our 2 per cent inflation goal, and I expect to support continued tightening of monetary policy*". In clear he is not advocating "one last hike" before a pause, as the BoC has just delivered**. That monetary policy needs to be tightened further into this year seems to remain quite consensual at the Fed, beyond the downshift in the quantum of hikes**. We expect this message to be reiterated this week. In any case, we think that any significant change in communication cannot come before the March meeting, given the prominence of the "dot plot" in the Fed's arsenal, and we would be surprised if by March 22 the data flow had changed so much as to give them confidence to alter their view of the terminal rate, which would be consistent with the last hike to come in Q2, without hinting at rate cuts for the second half of the year.

The European Central Bank (ECB) seems to be even further away from any dovish pivot. We discussed last week how the signals in Davos were overall consistent with 50bps both at the February and March meetings, with the better-than-feared developments in the real economy emboldening the central bank into more demand dampening action. Truth is, the absence of catastrophes does not mean economic activity is in a great shape. We would summarize it with Exhibit 6: the good news is that at the same time as industrial production in Germany has been falling in the energy-intensive sectors (e.g., chemicals), some less energy-intensive industries (e.g., car manufacturing) have been benefiting from the absorption of the supply disruptions triggered by the pandemic. But the net result is still a *stagnation* of output. And this is the situation before the bulk of the ongoing monetary policy tightening has had time to filter through the real economy. Yet, we need to take the ECB's words seriously. They have repeatedly expressed doubt as to the capacity of a shallow economic recession to trigger a swift return to 2% inflation. Logically, this suggests that they judge the current resilience as even less conducive to achieving their targets.

Our impression is that – and the contrast with the Bank of Canada could not be starker – **the ECB is refusing to engage in a proper forward-looking analysis of the situation, or to be precise has seemingly decided to be one-sided in its approach to risks.** The Governing Council probably continues to worry about the emergence of a price/wage spiral, although even the real-time indicator Indeed tracker – which we think is heavily skewed to the upside – has been losing ground recently (see Exhibit 7). We continue to think the ECB is not going to change its message before core inflation effectively declines for several months in a row. There is a real risk in our view that the print for January, to be released this week, points to a stabilization to 5.2%, further delaying any proper re-assessment by the ECB (note that the re-weighting of the index with the new year can trigger some volatility).

Exhibit 6 – The energy divide in German output



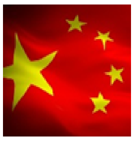
Source: D-Statis and AXA IM Research, January 2023

Exhibit 7 – The Indeed wage tracker is losing some ground

Source: ECB, Macrobond and AXA IM Research, January 2023

In a nutshell we don't expect any significant change of tone this week accompanying the widely expected 50bps additional hike. **For the first time in this monetary cycle the ECB is likely to hike by more than the Fed, and we expect a repeat of this feature in March. This will solidify the recent rebound in the euro exchange rate.** In isolation this should make the ECB less concerned about inflationary pressure, but the central bank will likely read this within the context of renewed tension on some dollar-denominated commodities. Even converted into a stronger euro, the price of a barrel of oil has increased by 11% since a trough on 8 December (+14% in dollars).

The Bank of England – also meeting this week - seems to be hesitant on the quantum of additional tightening needed. An upward revision of its growth forecasts is now widely expected given the further decline in market interest rates since last meeting and coupled with still strong core inflation and a tight labour market, this should deliver another 50bps hike this week – our central scenario. Our level of confidence is not very high though, given the Bank of England's obvious concern with the risk of "overdoing" the necessary tightening, which puts a 25bps option on the table.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• US GDP (Q4) rose by a solid 2.9% (saar), a little firmer than our 2.6% forecast. Investment fell sharply, household spending was solid, but broader strength reflected factors we consider temporary • PCE inflation (Dec) fell to 5.0% from its peak 7.0% in June, core also fell to 4.4% from a peak 5.4% in Feb. • HH saving rate (Dec) up to 3.4%, upward revisions • Initial jobless claims fell to lowest since Sep at 186k	• FOMC meeting. We f'cast 0.25% hike, along with consensus, and peak in March at 5%. Powell tone critical: close to pause – like BoC, or concerned about easing financial conditions. We lean to the latter • Labour report (Jan). We join market looking for first sub-200k payrolls since 2020. Unemp to remain at 3.5%. Watch earnings which were volatile in Dec. • Non-mfg ISM (Jan) – rebound from sharp Dec low?
	• Euro area business and consumer sentiment edged up further in January but remain at low levels by historical standards pointing to weak growth ahead at best • Spain Q4 GDP surprised expectations growing by 0.2%qoq supported by net trade and services activities	• We expect the ECB to hike all its policy rates by 50bps in Feb., as widely expected. Unfazed rates market amidst better-than-expected news on the growth front likely to fuel continued (more on the margin) hawkish narrative • We forecast euro area headline HICP to drop by another 0.3pp to 8.9%yoy, core unchanged at 5.2%yoy in January. We see risks skewed to the downside and upside respectively. Again this year, change in item weights to generate high(er) than usual uncertainty
	• Public finance data (Dec) borrowing rose above expectations w/ highest Dec on record (£24.7bn) • Flash PMIs (Jan) posted sharpest drop in 2 years driven by declining services – underlying indications showed signs of recovery • PPI (Nov/Dec) fell by more than expected	• BoE MPC meeting (Thu) and Feb Mon Policy Report. We expect 50bp hike though risk of 25bp remains. Forecasts likely to signal a shallower downturn with a faster return to target, but more risks of persistence • BoE household lending data (Dec) • Nationwide house price index (Jan)
	• Flash PMIs (Jan) rose 1.1pts to 50.8 suggesting stabilisation in activity • Tokyo CPI (Jan) saw core (ex-frsh food and energy) rise 3%yoy up 0.5%mom with the upturn from the end of policy related factors	• Industrial production (Dec) • Retail sales (Dec) • Labour market data (Dec) • Final PMIs (Jan)
	• The average number of passenger trips in the first 19 days of the LNY travel rush increased 50.8% relative to the same period in 2022, but remains 47% below the pre-pandemic level • Movie box office sales surpasses 2019 LNY period • Outbound flight bookings quadruple compared to 2022, but house and car sales dip	• Onshore markets will likely rise when they resume trading in the Year of the Rabbit in reaction to gains in global markets • Investors will pay attention to full LNY consumer spending and travelling data in addition to mobility indicators
	• CB: bold +100bp in Nigeria, below consensus +25bp in South Africa (7.25%), +25bp in Thailand (1.5%), on hold in Hungary but tweaks to the liquidity framework, on hold in Chile (11.25%), more regulation measures in Turkey • Q4 GDP in Korea (-0.4%qoq) Philippines (+2.4%qoq)	• CB: rates on hold in Brazil (13.75%) and Czechia (7%) • Jan CPI in Indonesia, Korea, Turkey, Peru, Uruguay • Jan PMI survey to be released across region • Q4 GDP in Mexico to be released • Turkey's opposition coalition the Table of Six to present electoral platform on Jan 30

Upcoming events		
	US:	Tue: ECI (Q4), C-S & FHFA HPI (Nov), Chicago PMI (Jan), Conference Board consumer conf. (Jan); Wed: ADP employment chg (Jan), ISM manf. indx (Jan), JOLTS Job Openings (Dec), FOMC announcement; Thu: Weekly jobless claims (28 Jan), Non-farm productivity/ULCs (Q4), Factory orders (Dec); Fri: Non-farm payrolls (Jan), Unemp. (Jan), Ave. earnings (Jan), ISM non-manf. indx (Jan)
	Euro Area:	Mon: EU20 Business conf. (Jan), Ge GDP (Q4), Sp HICP (Jan); Tue: EU20 GDP (Q4), Ge Unemp. (Jan), HICP (Jan) Fr GDP (Q4), Consumer spending (Dec), HICP (Jan), GDP (Q4); Wed: EU20 Manf. PMI (Jan), CPI (Jan), Unemp. (Dec), Ge, Fr, It & Sp Manf. PMI (Jan), It HICP (Jan); Thu: EU20 ECB announcement; Fri: EH20 PPI (Dec), Fr Ind. Prod. (Dec), It & SP Services PMI (Jan)
	UK:	Tue: Mortgage approvals (Dec), Net mortgage lending (Dec), Consumer credit (Dec); Wed: BRC Shop Price indx, Manf. PMI (Jan); Thu: MPC Bank rate; Fri: Composite & Services PMI (Jan)
	Japan:	Mon: Ind. prod. (Dec)

About AXA Investment Managers

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