169 – 20 February 2023

Investment Institute Macroeconomics

The re-acceleration hypothesis

- The "dovish pivot" seems to be dead. Hawks should refrain from hasty moves though: even if the current data points to some re-acceleration in growth (at least in the US), history suggests that monetary tightening can hit the economy with a long lag.

At long last, markets have given up on the "dovish pivot". Expectations of the Fed's and the ECB's terminal rates have been revised up and – more crucially – there is now less than a 25-bp cut priced in for the Fed in the second half of the year. This results from the combination of many indicators pointing to continued resilience of the real economy – or even re-acceleration –and hawkish noises from policymakers.

Still, as much as we considered the market had been impatient in pricing an early return to the good old times of friendly central banks, we think we should be quite prudent on growth prospects for 2023. Looking at past episodes of Fed tightening, it often took about a year for the labour market to exhibit tangible signs of deceleration. This puts the current robust dataflow in perspective. There would be quite some damage for the Fed credibility if it chose to raise again the quantum of the hikes – as advocated by Bullard and Mester – just at the time the accumulated tightening finally makes its way to the real economy. This makes the approach by Barkin and Bowman quite reasonable: continue to hike, maybe for longer than expected, but by "cautious" increments of 25bps. We will however watch the dataflow for February with some trepidation to make sure this "middle way" can win.

Of course, higher rates in the US have their usual transmission effects on Europe, even though macro conditions differ. Yet, the debate emerging at the ECB resembles the Fed's, between those like Nagel and Schnabel who clearly want the continuation of the tightening at a fast clip, and those who argue for a more cautious, step by step approach, even if the direction of travel would still be up. But this is not for immediate consumption: the 50-bp move in March is in any case "in the bag" – it would take a proper catastrophe for the ECB's "intention" not to be acted upon at the next meeting.

Stubborn US dataflow

A key source of market volatility in the US is the fact that so much depends on just one variable – payroll data – which happens to be prone to significant revisions and short-term gyrations. Still, this time it seems **the jumbo job creation combined with strong wage growth reflected in the January batch is confirmed by a wealth of other data sources to paint a strong picture of the US economy as 2023 starts**. Earlier this month, the ISM in the services sector for January, with a bumper reading at 55.2, spectacularly extricated itself from contraction territory (49.6 in December). Retail sales have been stronger than expected and the latest business surveys convey a reassuring message: the Empire manufacturing survey was much more resilient than the downbeat ISM in the same sector.

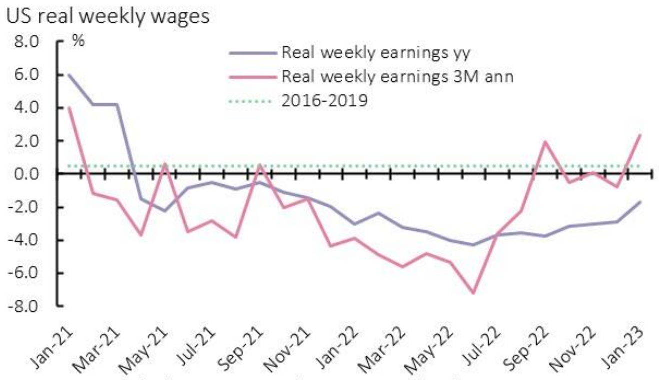
Good news on the real economy might have fed further the "goldilocks narrative" were it not for indications that disinflation is hitting some roadblocks – or to borrow from Jay Powell's lexicon a "bumpy road". CPI inflation duly slowed down again in January, but less than expected, landing at 6.4% year-on-year, down from 6.5% in December while the market was counting on 6.2%. Core inflation also refused to slow down in line with expectations, retreating by only 0.1 pp to 5.6%. Worse, on a 3-month annualized basis, core re-accelerated from 4.3% in December to 4.6%, despite another strong negative contribution from used cars. The federal Reserve (Fed) has been focusing recently on core services excluding housing: its' been flat at 2.7% year-on-year for three months in a row, while we suspect the central bank would want to see a proper deceleration in this key area which is probably the most sensitive to the domestic US cycle. Besides, what is in the pipeline does not look too good, with a much stronger than expected reading for producer prices.

Given this data flow, we need to consider the "re-acceleration hypothesis" seriously. Just before the Christmas break, we looked at ex post real wages, noting that thanks to the decline in headline inflation colliding with robust nominal earning gains, real wages were rebounding. We update this with the January data for consumer prices and the revised history for earnings which came with the latest payroll batch (Exhibits 1 and 2). While the base effects continue to take the year-on-year change in negative territory, on a 3-month basis the rebound is significant, and this time this holds for the weekly measure as well. Indeed, late last year average working time had started to decline, which we saw as the first phase of the labour market adjustment. It's a volatile series, but working time rose again in January, taking real weekly earnings above the contraction line again. This all adds up to favourable developments for purchasing power. **There are more people at work in the economy, and they are better paid, including when taking inflation into consideration**. Expectations for a significant slowdown in consumer spending is predicated on the gradual exhaustion of excess savings. This effect will probably materialise – since most of the gains were made at the upper end of the income distribution, it's likely that a large share of these buffers will not be spent – but it is being seriously counter-acted by the rise in real income.

Exhibit 1 – Real wages continue to rebound…

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

Exhibit 2 – … also when controlling for working time



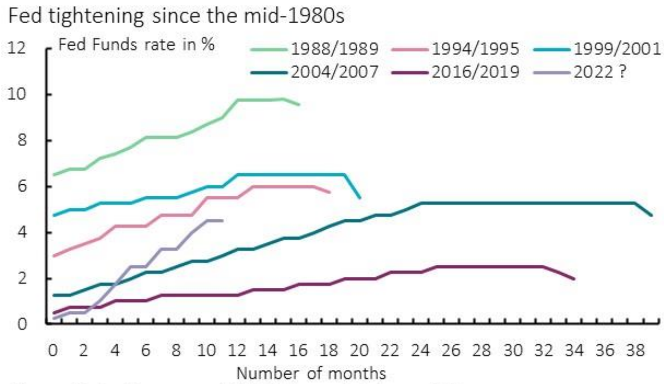
Source: Bureau of Labour Statistics and AXA IM Research, February 2023

Further resilience in consumer spending – going beyond last week's surprising strength in retail sales for January – could be fuelled by the fact that the wage growth is particularly high for "production and non-supervisory workers", hence employees with the lowest propensity to save and the most likely to have exhausted their excess cash holdings from the pandemic. For this segment of the workforce, nominal weekly pay in January has increased by 5.4% year-on-year, against 4.7% on average.

Unsurprisingly, the recent dataflow is triggering a wealth of hawkish comments from Fed officials to the point that a recalibration of the next hikes to 50 basis points (bps) is now on the cards, as it was explicitly discussed by James Bullard and Loretta Mester. As long as the US economy was sending signs it was about to land, however gently, the Fed could move to a "probing" approach, lowering the quantum of hikes since the risk of "not having done enough" was receding. It is no longer as obvious. An issue however is how much of the accumulated tightening is already reflected in the data. After all, taking the FOMC's estimate of the "long-run policy rate" as a proxy of the equilibrium rate, the Fed has passed the restrictive threshold in September only. So, **could it be a case of the Fed hawks being too impatient to see results, colliding with an equity market too ignorant of the looming effect of past tightening?**

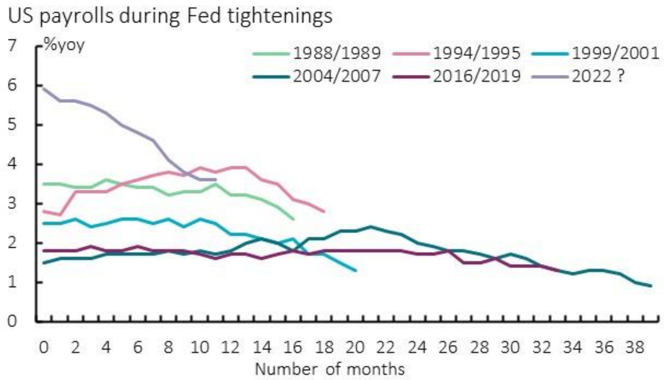
There is no easy way to gauge the time it is going to take for the impact to materialise. We can only look into precedents. In Exhibits 3 and 4, we show the shape of each monetary tightening since the mid-1980s (from the first hike to the first cut) together with the profile of private payrolls during each of those phases. The reaction of the labour market has often been slow to appear. **In three cases (1988-1989, 1994-1995 and 1999-2001), a deceleration in job creation started to emerge only after roughly a year into the hikes** (in the two other cases before the current episode, no reaction to speak of was discernible, but those were very slow normalization phases). This would suggest that the current resilience is not necessarily such an outlier: it seems to be a fairly regular feature of the US economy that the labour market "breaks" only shortly before the central bank reaches its terminal rate. True, one could expect a faster-than-usual response given the unusual steepness of the current tightening episode, but equally this may be offset by the fact that it started from an unusually low base.

Exhibit 3 – Looking at past tightening episodes…



Source: Federal Reserve and AXA IM Research, February 2023

Exhibit 4 – …from the job creation angle



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

So, is it only a matter of time? **One could add to the dovish case for not over-reacting to the current rebound in some variables that some of the usually interest-rate sensitive sectors of the economy have started to react**. Even if typical US mortgage rates have receded from their November peak, the correction of the housing market is underway, with housing starts and building permits continuing in January the slide which started in the second half of last year. Last week we highlighted the fall of the European credit impulse in negative territory in response to tighter lending standards, but the Fed's Senior Loan Officers' survey also points to a restriction of credit supply in the US – even if the macro impact is likely to remain smaller than in Europe given the dominance of disintermediated funding in the corporate sector.

Patience could thus be warranted, especially since the Fed has been very clear that they intended to keep on hiking. **There would be something quite credibility damaging for the Fed if it chose to raise again the quantum of the hikes just at the time the accumulated tightening finally makes its way to the real economy**. This need for patience is implicitly acknowledged in the Fed's monetary policy statement: *"in determining the extent of future increases in the target range, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity* *and inflation, and economic and financial developments".* Yet, consistency is also part of a central bank credibility. They argued the calibration of the next moves would be data dependent*: "the Committee's assessments will take into account a wide range of information, including readings on labour market conditions, inflation pressures and inflation expectations, and financial and international developments"*. It's difficult to argue that the data flow has not materially changed relative to the last meeting. **The statements last week from two other Fed officials, Michelle Bowman and Thomas Barkin may reflect the central view of the FOMC in the current configuration: no need to hasten the tightening by resuming 50-bps hikes but preparing markets for a longer-than-expected string of 25-bps moves which could get us to June.** We will however watch the data batch for February with some trepidation. Another series of upside surprises and Bullard and Mester could win the argument.

What about market expectations?

In any case, **the market has profoundly re-thought its monetary policy expectations.** The Fed's terminal rate is now seen at 5.25% in June – up 10bps in a week and 35bps since 3 February – and less than 25bps worth of a rate cut is now priced for the end of 2023, with a Fed Funds rate seen slightly above 5% in December 2023. Habitual readers of Macrocast may not be surprised to discover that we see this new trajectory as much more rational and likely than the previous feverish bets on an increasingly elusive "dovish pivot" which looks dead by now – or at least in a deep coma. On the positive side, this market repricing suggests a better transmission of the monetary policy signals to broad financial conditions, which may convince the Fed it does not need to re-accelerate its tempo. The absence of market reaction could even have triggered the emergence of a debate on a quicker unwinding of the Fed's balance sheet.

There is also a somewhat new market trajectory for the European Central Bank (ECB). In the Euro area, there was no expectation of rate cuts in the second half of the year to eliminate, but the terminal rate is now priced significantly higher, hitting at some point 3.65% on Friday morning for December 2023, before easing back to close the week at 3.55%. That is still a full 25-bp additional hike priced in for the year since the beginning of February, and also 25 bps above our forecast for the terminal rate. The peak on Friday morning probably reflected reactions to yet another hawkish interview by Isabel Schnabel, who warned the market about being overly optimistic about the pace of disinflation. There was nothing particular in last week's European dataflow to warrant such a change in market pricing. The combination of Schnabel's speech with Bundesbank's Nagel's remarks on the Euro area monetary conditions not yet being in restrictive territory probably did the trick.

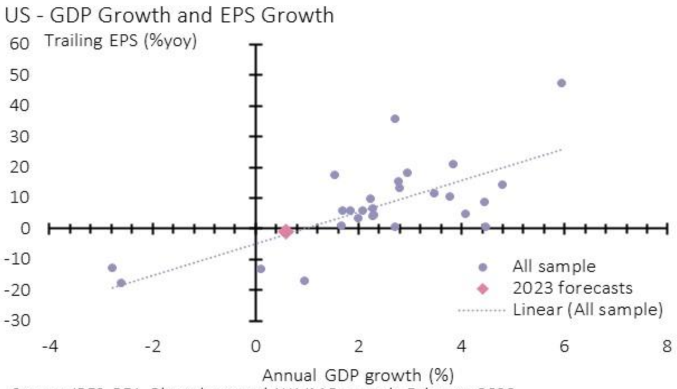
But doves and/or centrists may have contributed as well. As usual, Fabio Panetta made the "dovish case" in a remarkably cogent manner. He called for patience by reminding us that *"core inflation cannot turn on a dime"* and a delay is normal before the decline in energy prices gets transmitted to the energy-sensitive components of services and industrial goods. He also explored the possibility that the ongoing acceleration in wages is more a *"one-off rebalancing of in the income distribution between workers and firms*", rather than the beginning of a proper price/wage loop, as employees have so far *"borne the brunt of the "Putin Tax".* But still, **his speech also shows how far the goal posts have moved in a few months at the ECB.** The doves used to argue for some QT versus rate lift-off trade-off. Now they merely plead for not committing to any pre-set course for the number and quantum of future hikes, without denying that more tightening is likely to be needed.

Banque de France Villeroy de Galhau warned against "excessive volatility » of the market's pricing of the ECB's terminal rate, but as much as he also defended a cautious, "one step at a time" approach to the continuation of hikes now that the policy rate is in restrictive territory (something he explicitly stated, so a direct rebuttal of Nagel). Yet, his point about the possibility to reach the terminal rate by the summer – which he said, *"ends in September"* opens the door to quite a few additional moves from the 3% already "bagged in" for March, even if he took the precaution to say that *"there will be no obligation to act automatically at each Council meeting"*. In a nutshell, **doves and centrists are willing to give time to the lagged effect of the cumulative tightening to finally exert its effect on the economy and get inflation to land and resist pre-committed hikes, but even for them the direction of travel for policy is still up.**

In those circumstances – with the terminal rates being revised up and chances of rate cuts falling – it is not surprising to see the whole curve move up. In the US, the 10-year yield has hit 3.90% on Friday morning, before retreating somewhat to 3.81% in the afternoon, but still up nearly 50 bps from a tough in early February. The German 10-year has briefly exceeded 2.5% before retreating to 2.44% the same day. What is more puzzling is why the equity market remained so resilient. There was some movement downward last week, but over 30 days the S&P500 is still up 2%, 2.3% for the DAX and 4% for CAC40.

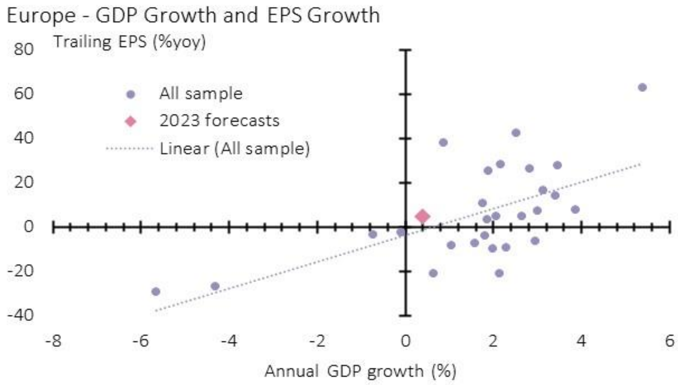
Expected earnings are not that exuberant though. The relationship between GDP growth and earnings per share is never very tight – we explored this in detail last year, taking on board the difference in sectoral weights between the equity indices and GDP – but there is still a loose positive correlation. Current earnings expectations (we took the data from late January) are not particularly "off" the consensus for GDP growth in 2023 as collected by Bloomberg (see the pink dot in Exhibits 5 and 6), on both sides of the Atlantic. **On the basis of the historical relationship, those expectations are consistent with "near stagnating" GDPs this year, which is not far from our own baseline.**

Exhibit 5 – Earnings expectations vs. GDP look OK…



Source: IBES, BEA, Bloomberg and AXA IM Research, February 2023

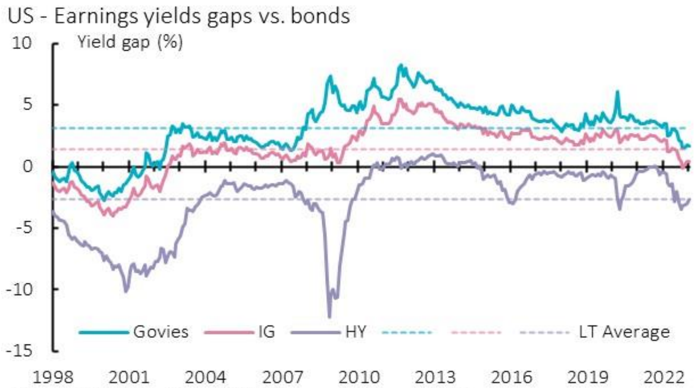
Exhibit 6 – … in the US and Europe



Source: IBES, Eurostat, Bloomberg and AXA IM Research, February 2023

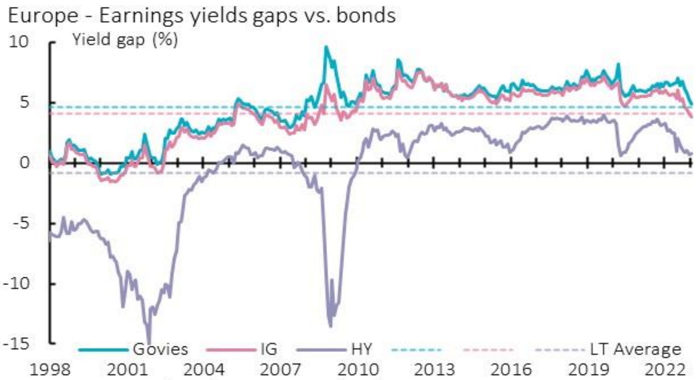
It's when expected equity earning yields are compared with fixed income yields that the puzzle returns, at least in the US. The difference between the two is a way to measure the risk premium. In the US, it has fallen well below the long-term average when compared with government or investment grade corporate bonds (Exhibit 7). This gets us back to the point made by our colleague Chris Iggo in his own weekly on Friday: today's credit spreads offer healthy returns without the quantum of volatility attached to equity.

Exhibit 7 – US equity: Where's my risk premium?



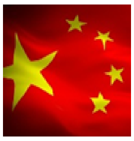
Source: IBES, ICE BofA and AXA IM Research, February 2023

Exhibit 8 – Not as clear in Europe



Source: IBES, ICE BofA and AXA IM Research, February 2023

All in all, habitual readers of Macrocast may not be surprised to read that we are much more comfortable with the levels of US and European long-term rates than we were in January when we thought the market was too impatient do declare victory over inflation and consider that the good old times of friendly central banks could return. Equally, they won't be surprised to find us still concerned with the macro environment for the remainder of 2023.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• CPI inflation (Jan) decline to 6.4% above, pace of decline to slow as energy costs rose and increases in food and clothing accelerated • Retail sales (Jan) up 3%mom boosted by car sales and restaurants following Dec slump • Empire & Philly Fed Surveys (Feb) paint mixed messages on status of US economy • Housing starts (Jan) decline by 4.5% in Jan, marking longest stretch of declined since 2009	• FOMC minutes (Feb) likely to reiterate more hikes and longer restrictive policy message • GDP (Q4) any revisions to preliminary 2.9% (saar) • PCE inflation (Jan) further declines expected after CPI, but watch for pace of 'core' decline • Personal spending (Jan) watched after solid retail sales, also monitor use of excess saving • PMI surveys (Feb, p) have been weaker than ISMs – particularly services – and point to contraction
	• ECB tone remained skewed on the hawkish side. Massive repricing of EUR short-end, mainly US driven • EMU industrial production declined by 1.1%mom in December, Q1 23 carry over is -0.3%qoq • Results of Italy's regional election further reinforced PM Meloni (Brother of Italy) lead in Italian political landscape	• EMU February business confidence ("flash" PMIs, INSEE, IFO) • German "flash" HICP for February as well as full details of January release • EMU January final HICP likely to be revised up (0.1pp) to 8.6%yoy • Details of Q4 GDP prints
	• CPI inflation (Jan) surprised on the downside at 10.1% with falls seen across core (to 5.8% from 6.3%) which was supported by weight update and services CPI • Labour market shows further signs of moderating, vacancies continue to fall and participation picked up • Nicola Sturgeon resigns as Scotland's First Minister	• Public finances (Jan) expected to show strain of energy price scheme on finances • Flash PMI (Feb) have recently shown output remains solidly in contraction territory will be watched for any deterioration • GfK consumer confidence (Feb)
	• Kazuo Ueda former professor and BoJ policy board member nominated as new BoJ Gov, Shinichi Uchida and Ryozo Himino as deputy governors • GDP (Q4) surprises to downside 0.2%qoq weighed down by volatile inventories but private consumption remains strong up 0.5%qoq	• Nominees to speak at lower house of Diet Feb 24, will be watched closely for clues on Ueda's policy stance • Flash PMIs (Feb) • CPI inflation (Jan) expected to continue to rise after earlier Tokyo CPI figures
	• CPI (Jan) inflation edges up to 2.1% from 1.8% in line with expectation • PPI (Jan) deflation deepens, falling 0.8% lower than expected • High-frequency data generally shows continued improvement in mobility and services activity, while house and auto sales remain weak	• Credit (Jan) growth to grow strongly on seasonality and strong policy support • MLF rate to stay steady • House price (Jan) to show some improvement in large cities
	• CB: Philippines hiked +50bps to 6.0%. Indonesia stood on hold at 5.75% • Weak Q4 GDP yoy growth prints in Colombia (2.9%), Hungary (0.4%), Malaysia (7.0%), Thailand (1.4%) & Poland (2.0%) • Jan inflation accelerated in India (6.5%), Poland (17.2%) & South Africa (6.9%); slowed in Romania (15.1%)	• CB: Korea is expected to stay on hold at 3.5%. Turkey could deliver a cut (current rate: 9.0%) • Jan inflation data in Malaysia & Singapore • Q4 GDP in Nigeria & Peru • Jan Industrial production figures in Colombia, Russia Singapore & Taiwan Nigeria election • Presidential election in Nigeria on Feb 25

Upcoming events		
	US:	Tue: Manf. & Services PMI (Feb), Existing home sales (Jan); Wed: FOMC minutes; Thu: GDP (4Q S), Core PCE (4Q S), Weekly jobless claim (18 Feb); Fri: PCE & Core PCE (Jan), Personal income & spending (Jan), Michigan consumer sentiment (Feb), New home sales (Jan)
	Euro Area:	Mon: EU20 Consumer conf. (Feb); Tue: Composite, Manf. & Services PMI (Feb), Ge Manf. & Services PMI (Feb), Ge ZEW surveys (Feb), Fr Manf. & Services PMI (Feb); Wed: Ge HICP & CPI (Jan), IfO business climate indx (Feb), Fr Insee manf. Confidence (Feb), It HICP (Jan); Thu: CPI (Jan); Fri: Ge GDP (Q4), Fr Inset consumer conf. (Feb)
	UK:	Tue: PSNB (Jan), Composite, Manf. & Services PMI (Feb), CBI Industrial Trends survey (Feb); Thu: CBI Distributive Trades survey (Feb); Fri: GfK consumer conf. (Feb)
	Japan:	Tue: Manf. PMI (Feb); Thu: CPI & Core CPI (Jan)
	China:	Mon: Loan Prime Rate

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