Growing, (too) Fast and (too) Slow

- Markets had a "grumpy August". Bond yields rose in response to the US still growing too fast, while the confirmation of deflationary risks in China – and the lack of policy response - dampen investors' animal spirits.
- Euro area softness extends beyond Germany.

In our latest Macrocast on 31 July we had left our readers with a – probably typically – pessimistic note, describing the short-term outlook for the Euro area as a "hardish landing" and expressing doubts on a soft landing being all what it is going to take to tame inflation in the US. We don't feel chirpier after a few weeks' rest and unfortunately it now seems the markets are also looking somewhat downbeat. As of Friday 26 August, the S&P500 was down nearly 4% on the month while the Dax lost a bit more than 5%. Summer markets can be fickle, and there has already been some rebound from the lows hit around 20 August, but investors' caution could be justified as the world economy is having to deal with two unrelated headwinds. The confirmation of the resilience of the US economy is putting to rest the market's hopes of a swift reversal of the Fed's policy stance, which has pushed long-term yields further up, while the scenario of a "deflation trap" in China is getting more substantiated by the recent dataflow, with only timid policy response from Beijing so far. In a nutshell, economies are growing either "too fast" or "too slow".

There is not one single "paradigm" explaining cyclical conditions across the main economic regions now. For China, Rogoff's "debt supercycle" model is persuasive – but then the PBOC should react by engaging in more decisive rate cuts, to ease the pain of the balance sheet adjustment while structural reforms deal with the persistent imbalances in Real Estate. For the US, Charles Goodhart's focus on a reversal of the balance of power on the labour market provides an interesting model.

Europe finds itself faced with the double whammy of slower Chinese demand and some contagion from higher interest rates from the US which compound the ECB's tightening. A new concerning development is that business confidence is deteriorating markedly outside Germany, affecting countries which so far had been performing rather well, such as France.

Single paradigm failure

Together with excess pattern recognition – seeing regularities where there is only data randomness – **single paradigm belief in a very common affliction in the economic profession. We would define it as the urge to find a single, common explanation to a wide set of events.** This is particularly prevalent in the analysis of the global economic cycle and it's easy to understand: with trade and financial integration intensifying over the last five decades, and central banks all converging towards a similar reaction function, macro developments across nations should be more tightly correlated. This does not mean growth rates should necessarily be the same everywhere. GDP potential would still differ depending on the maturity and institutional features of each economy and various levels of policy space would allow for different degrees of mitigation of common shocks. Yet, broadly speaking, the world economy would still move according to the same "beat". **The pandemic and its aftermath should have provided a perfect example of such commonality**. Lockdowns differed in their intensity but were still imposed across all relevant economic regions. The reopening would come with an initial massive catch-up in economic activity amid still constrained supply, triggering a global inflation shock which should then be dealt with an equally synchronized monetary tightening, at the cost of a transitory phase of below-potential growth.

Things turned out differently. In the United States (US), inflation has started to fall – even if it has more ground to cover to get back to the Federal Reserve (Fed)'s target – but the steep tightening in financial conditions, with policy rates standing now at more than twice their equilibrium level, has not yet sent the economy below its potential growth rate. Conversely, at the other end of the spectrum, China is grappling with deflation and below-par economic growth, while still hesitating to engage in decisive monetary and fiscal stimulus**. Different paradigms may be at work simultaneously in the world economy.**

China and the return of the "debt supercycle" model

The latest Chinese dataflow has been particularly poor. Industrial production rose 3.7%yoy in July, down from 4.4% in June and below market consensus (4.3%). Exports fell by 14.5%yoy, more than in June (-12.4%) and by more than market expectations (13.2%). Soft data on business confidence are not more encouraging, with the composite Caixin Purchasing Managers' Index (PMI) declining to 51.9 from 52.5. Beyond the July print for consumer prices (-0.3%yoy), developments in the financial sphere point to deflationary pressure getting entrenched, with "narrow money" M1 aggregate gaining only 2.3%yoy from 3.1% in June, and Aggregate Financing coming out at only half of market expectations in July (CNY 520bn against 1,100bn). The adjustment to the correction of the property sector – which accounts for as much as quarter of Chinese GDP - is proving more painful than expected.

In his most recent column in Project Syndicate, **Ken Rogoff proposed to look at China through the prism of his "debt supercycle" model. We find this quite persuasive. Indeed, we find many similarities with the patterns at work in the US or large chunks of the Euro area periphery during and immediately after the Great Financial Crisis of 2008-2009.** After years of financial excess – the emergence of debt-fuelled housing overcapacity in China today resemblant of Japan's speculative bubble of the 1980s, the US' sub-prime frenzy of 2005-2007 or Spain's regional banks' housing glut until 2010 – Beijing would have to accept a painful correction phase while over-leveraging is being absorbed, weighing on consumer spending, and fuelling deflation. Rogoff's historical analysis suggests that economic slowdowns materialising at the end of debt supercycles tend to last longer, cause more lasting damage and are harder to treat than contractions occurring without any previous build-up of over-leveraging.

Macro balance sheet corrections seldom come without a deeper adjustment of the economy than "mere" deleveraging. The US fifteen years ago may have been an exception from this point of view. Japan's woes of the last 35 years cannot be entirely explained by the correction of past financial excess. Rigid product and labour market institutions, adverse demographic developments made worse by brakes on female workforce participation and extreme prudence on immigration have also played a role. In Europe's southern periphery, the housing crash was only one facet of a much broader savings/investment adjustment after years of ballooning current account deficits and stagnating productivity. **Structural reforms are usually part of the policy response to a balance sheet correction**. In China today, it's the whole system of resource allocation which is probably in focus. The mixture of command and market economy, although undeniably successful in turning China into a global economic superpower, may be ill-fitted to overcome the country's "middle-income curse" – other Asian countries such as South Korea did not manage to break comfortably through the 10,000 USD/head GDP glass ceiling without going through major structural changes.

Yet, even if structural reforms probably need to be implemented in China, **we can't think of any episode of macro balance sheet adjustment which – at least ultimately – was not mitigated by significant monetary loosening.** This is what Ben Bernanke's Fed understood right away, embarking in extreme accommodation to deal with the brutal deleveraging brought upon by the banking crisis of 2008 and 2009. This was the Gordian knot of the European peripheral crisis: countries such as Spain, Ireland or Portugal needed supportive monetary conditions to keep their economies into a state of "bearable recession" while they were repairing their banking system and cleaning up the balance sheet of the private sector. This could not be fully provided by the European Central Bank (ECB) before Mario Draghi took command in late 2011.

This is where we find there is a limit to the currently frequent analogy made between China today and Japan at the beginning of its deflationary stagnation: so far there hasn't been any attempt to cure the Chinese deflation with a proper monetary stimulus, unlike in Japan. Monetary support may not be *enough* to lift China out of its current slump, but it's unlikely it can be merely *possible* without it. That should be the first test before concluding that China is truly affected by the "Japanese disease".

Bigger rate cuts may not be enough to spur China, but they would help

We have been arguing in Macrocast for some time that a policy stimulus targeting consumption is the textbook solution to China's current predicament, given the deflationary context and rising unused capacity – such as the increase in youth unemployment which, interestingly, Beijing has decided to stop measuring. The usual approach – asking local authorities to launch yet another wave of infrastructure projects – feels inappropriate when it is a dearth of demand, rather than a lack of supply, which is the main issue. Yet, for now, support has come out as timid. We have already commented on the lack of fiscal space if one considers the quantum of debt already accumulated by local authorities, but **monetary policy could be used more decisively**. On 21 August, Chinese banks disappointed the market by cutting their 1-year Prime Loan Rate by only 10bps (15bps were expected) but also by choosing to keep their 5-year Prime Loan Rate – which has a stronger impact on mortgage rates – unchanged.

We understand the authorities' reluctance to fuel more risk-taking in the real estate sector – the weight of this sector in the economy is clearly unhealthy – but **we fail to see how China can square its equation, squeezed between slower traction from the rest of the world and a necessary de-leveraging in the private sector, without significant cuts to policy rates, which are getting higher in real terms as deflation sets in**. Real Estate wealth accounts for more than two third of the wealth of urban Chinese households. It's probably too late to avoid an adverse wealth effect, but it's not too late to reduce the weight of the debt service on future income streams.

This is where China's unique economic structure could actually help: since the banking sector is state-owned and regulation is already quite intrusive, it should be relatively easy to turn monetary conditions generally accommodative while still avoiding that too much as this support is channelled again to real estate and delay the clean-up of this sector. After all, the correction started with the implementation of new finance-capping regulations (the "three red lines") in August 2020, before being relaxed again in 2022 when it became clear housing was sliding too fast and too far.

Enthusiasm for non-market mechanisms should be tempered however, since there is a convincing argument that it is precisely the lack of autonomous allocation of resources in housing which is at the heart of the sector's imbalance.

A Working Document by the Peterson Institute argues that the Chinese housing market is divided between a too-hot segment in the already developed, large cities in the coastal areas and a too-tepid segment in the West of the country and small cities. The paper does not ascribe this to speculation on the coast's big cities, but on an inappropriate management of supply, with land release being rationed there while local authorities in other areas have stepped up their land sales. **In a nutshell, too little capacity is built where Chinese people want to live and too much where they don't want to stay.** Reforming town planning at the national level could be the best way to address the financial imbalances of the sector without triggering an overall decline in construction activity.

Yet, for now the policy response seems to be stuck in low gear. Protecting the banking sector's interest rate margins is mentioned as one of the reasons behind the People's Bank of China (PBOC)'s reluctance to engage in large-scale rate cuts, which we find is a non-obvious approach when faced with excess leveraging in the non-financial sector. Avoiding a further softening of the Chinese currency would be another one but given the lack of inflation at the moment we fail to see how the country could be faced with a conflict of objectives on this front. Whatever the motives, this hesitant pace is contributing to a profound revision of investors' opinion on the Chinese economic outlook, and probably does not help re-instilling confidence domestically.

Hesitations on the domestic side are all the more difficult to understand that no immediate relief can be expected from the outside world. We had our doubts on the effectiveness of the US "decoupling from China" strategy but trade data suggests this is now material. In June 2023 – last available data – figures from the US Census Bureau (see Exhibit 1) suggest that Mexico has now caught up with China as a supplier of manufactured products to the US (we take out food and energy from the trade in goods data to minimize the impact of the gyrations in import prices). Beyond the "near-shoring" favouring Mexico, the US has been able to diversify its suppliers in Asia. 10 years ago, US imports from Vietnam were 50 times lower than imports from China. Today, they are only 12 times lower (see Exhibit 2), not bad for a country whose GDP is 40 times smaller than China's. True, the US no longer plays the ueber-dominant role it commanded in the world economy 30 years ago when China started to emerge, but it still accounts for a bit less than a fifth of total world demand excluding China. Losing market shares in this country matters. Our contention is that as long as a decisive stimulus package is not put forward by Beijing, the current lack of enthusiasm for China's economy will persist.

Exhibit 1 – Mexico overtaking China in US imports

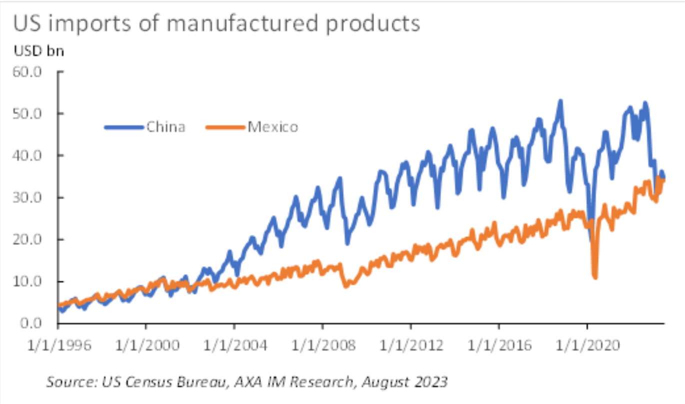
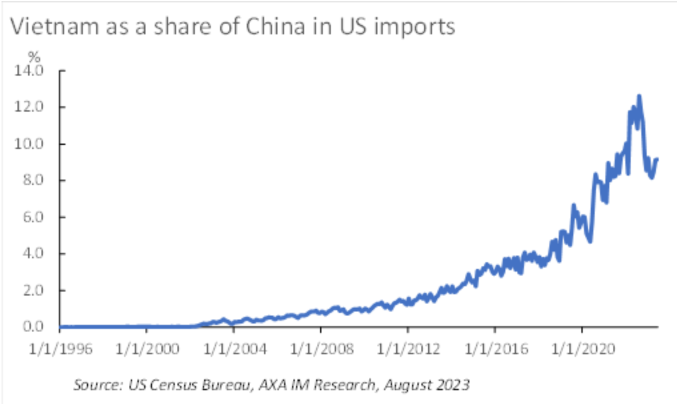


Exhibit 2 – US diversifying its Asian suppliers



The US Goodhart moment?

The US could not be further away from a "debt supercycle" situation. Quite the opposite, it's the absence of excess leveraging in the private sector before the Fed embarked on its hiking spree which is one of the key reasons why – at least so far – tighter monetary conditions haven't had any massive adverse impact on the US economy. This does not mean all is fine over there. The composite PMI for August was barely above the expansion threshold (50.4, down from 52.0 in July) and job creation in July came out slightly below expectations (187k against 200k), but these are only relative signs of weakness. The unemployment rate remains historically low at 3.5% and retail sales were solid.

To a large extent, the US current problem is that it is still growing "too quickly" to make it obvious that the "last mile" of disinflation, back to 2%, is likely without further monetary tightening, or at least maintaining the current level of tightness for longer than the market had been expecting until recently. Indeed, while the price of energy and manufactured goods would be kept in check by low Chinese demand, services prices could continue to grow too fast to allow aggregate consumer prices to finally behave. **It's the resilience of the labour market – highlighted again in his Jackson Hole speech by Jay Powell last Friday – which continues to be the source of surprise over there**. It may be Charles Goodhart's focus on the balance of power between employers and employees which could provide the key.

A profound change in labour market conditions is only one aspect of Goodhart's overall narrative of a persistent return of inflation, but it's the one which may be the easiest, or the earliest to spot in the dataflow. With a slowdown in aggregate labour supply, due in Goodhart's framework to the "big retirement" of the baby-boomers, the prolonged phase of wage moderation which started in the 1980s – aided and abetted by globalization and the integration in the global labour force of China and the former Eastern bloc - must come to an end. The twin surprise is that the US comes out as the large economy where the issue of labour scarcity is materialising first, although it is by no means the most demographically challenged one in the West, and also that the drop in participation was noticeable also in the "belly" of the age distribution and not just among baby-boomers. Yet, **while the US is undeniably facing a labour supply issue which contributes to keeping wage growth high, what is also striking is the resilience of labour demand.** The annual rebasing of the payroll data revealed that job creation had been slightly overstated last year, and that consequently productivity was a bit better than initially computed, but the 0.2% change did not really move the needle.

Jay Powell has provided very few new "nuggets" in his Jackson Hole speech relative to his pre-summer recess communication**. The hiking bias is still there – the Fed is explicitly open to raising further the policy rate if need be – but so is patience, i.e., a willingness to give time to the accumulated tightening to finally trigger a landing of the US economy consistent with a return to 2% inflation**. This – assuming we continue to see more signs of deceleration in the US economy, for instance in the August payroll report due at the end of this week - is still consistent with our view that the post-July pause is in fact a plateau and that the peak has been reached.

Yet, in our view the most important point in Powell's speech was the insistence on the need to maintain monetary conditions tight for a long period of time to make sure the Fed has broken the back of inflation. This is not new, but for some reason, this is only now percolating through the market, with **US bond yields noticeably rising through August** (see Exhibit 3). 2-year yields have risen somewhat, but the most striking change has affected the longer-end of the curve, with the 4% threshold being hit again by 10-year yields. The breakdown is quite telling in our view: inflation expectations have barely moved, it's real rates which are on the rise (see Exhibit 4). One possible interpretation is **that investors now believe that while they have little doubt on the Fed's resolve to keep inflation in check, this will entail permanently higher interest rates, given the emergence of structural inflationary forces.**

Exhibit 3 – High for longer

Exhibit 4 – No big inflation concern: it's all in real yields

The market-led tightening in financial conditions may contribute to the Fed's readiness not to hike in September. This would also support our belief that, ultimately, even the "red hot" US economy cannot eternally remain immune to higher funding costs once they are properly transmitted through the economy.

Europe's Double Whammy

The Euro area finds itself in a specific position. It's difficult to defend the idea that a "debt supercycle" is at play there given the balance sheet clean-up observed in the periphery after the sovereign crisis and the persistence of a sober funding model in key countries such as Germany. There may be some signs of a "Goodhart moment", with the labour market also proving resilient and wages accelerating steeply – at least in some member states. This makes the ECB nervous and is raising questions on the future trajectory of monetary policy. But where in the US strong wage gains have provided protection against a sharp economic slowdown – so far – in the Euro area the dataflow is more concerning.

The further dip in the PMI and the Ifo surveys in Germany in August confirm that this country continues to face major difficulties to extricate itself from the recession/stagnation mode of the last three quarters (see Exhibit 5). The current level of these two indicators is consistent with a contraction in GDP in Q3. There, specific sensitivity to the global manufacturing cycle – and particularly to low traction from China – may provide a good explanation to the poor performance, but more structural issues may also play a role, with sliding competitiveness in key sectors such as the car industry. **What is newer – and thus probably more concerning – is that countries which so far had been doing relatively well are also feeling the pinch.** French GDP surprised on the upside in Q2 with a 0.5%qoq gain. The latest, significantly below expansion territory PMI print, further supports the idea that a lot of this springtime resilience was attributable to one-offs, even if the INSEE survey, although also deteriorating, is less concerning (see Exhibit 6).

Exhibit 5 – Germany sinks deeper

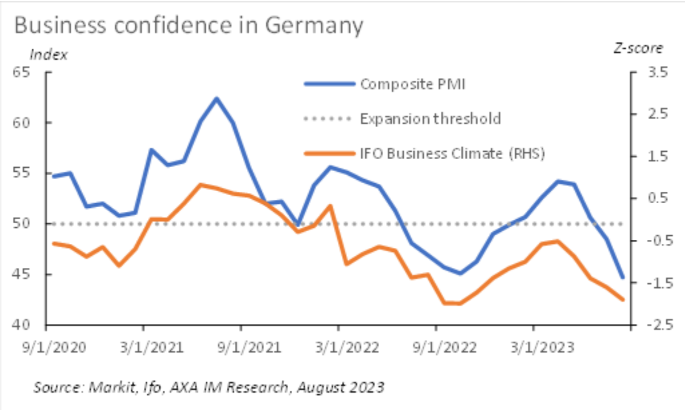
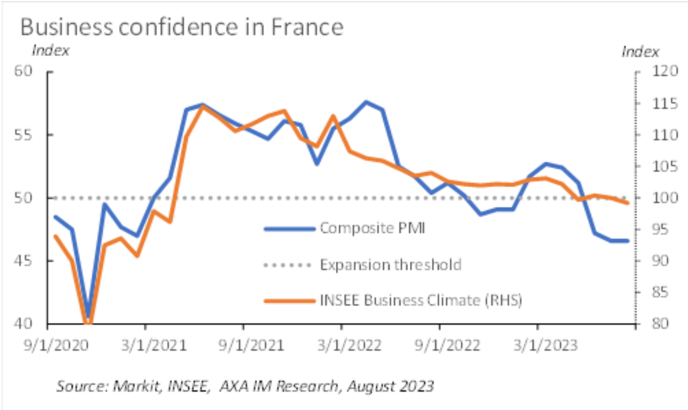
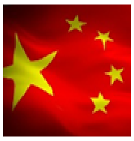


Exhibit 6 – France is relapsing



The Euro area may be faced with a double whammy given its more externally driven growth model, it is more sensitive than the US to slower Chinese demand, and given the strong transatlantic bond market correlation, it is also importing from the US more upside pressure on interest rates which compounds the impact of the ECB's tightening.

Such combination of higher interest rates and low economic momentum is making Europe's fiscal equation even more difficult. Italy's planned "exceptional" contribution on bank profits had to be quickly downscaled given the market's reaction, but for us it is the symptom of a broader malaise in many Euro area economies: governments try to balance the need to start their financial consolidation against the risk of dampening domestic demand further and look for apparently "painless" solutions to fill their coffers. We remain convinced that tax hikes are the "path of least resistance" for European fiscal policy in the years ahead.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Fed Chair Powell delivers keynote at Jackson Hole • First Republican primary debate features 8 candidates, ex-Trump who posted mugshot on X • Durable goods orders (Jul) -5.2%mom (after cum 11.% in recent months), ex-transport solid +0.5% • New home sales (Jul) +30k mom (from downward revised -13k); existing home sales -70k • Jobless claims +230k, following rise to 250k • Annual payrolls revisions (Apr 22-Mar 23) est -306k	• Labour market report (Aug) signs of deceleration expected to continue even after July's surprise • JOLTS survey (Jul) further falls likely in vacancies • ISM index (Aug) headline still expected weak, but watch new orders index for signs of bounce • PCE inflation (Jul) expected to rise following CPI increase (to 4.4%), core exp 4.2% from 4.1% • Consumer spending (Jul) expected strong • GDP (Q2, 1st revision), no change expected
	• Eurozone flash PMIs (Aug) are below 50 for both Mfg and services. Germany and France are particularly weak. Employment is stalling. Input cost picked up in services sector due to wages • Ifo (Aug) sent similar signals on German weak economy than PMIs • Eurozone flash consumer confidence (Aug) fell, ending an uninterrupted improvement since Sep 2022	• Flash HICP (Aug). We anticipate another small deceleration for headline but watch for any impact from higher oil prices. Core inflation should also experience a first decline is likely to stay above 5% • Credit data (Jul) are likely to remain weak, in line with low demand triggered by higher interest rate and lower supply as banks are seeing higher risk for economic activity • EC surveys (Aug) will provide more in-depth details
	• GfK cons conf rose to -25 (Aug) from 3m low in July, driven by easing in inflation but level remains weak • Flash PMIs dropped below 50 for both mfg and services. Composite falls to 31-month low • PSNB rose £4.3bn (Jul) leaving borrowing this FY below £11.3bn f'cast by OBR in March	• BoE HH lending data (Jul) • Nationwide house prices (Aug) expected -0.2% as rise in mortgage rates bite
	• China bans seafood exports from Japan, following Fukushima wastewater release. Seafood exports to China and HK made up 0.2% of total exports in 2022 • Tokyo core CPI (ex frsh fd and energy) was unchanged at 4.0%yoy. But core (ex fresh food) slowed to 2.8%yoy (+3.0% in Jul) as energy prices fell	• Retail sales (Jul) • Industrial production (Jul) • Labour market (Jul); u/rate expected to remain at 2.5%
	• TSF and New Loans slumped (Jul) to RMB528bn and 346bn RMB, far below expectations • PBoC enacts small rate cuts in past 2 weeks: 15bps cut to MLF (2.5%), 10bps cut to 7-day repo (1.8%), 10bps cut to 1Y LPR (3.45%), 5Y LPR unch (4.2%)	• Sun (27 Aug): Jan-Aug industry profit, which had a 16.8% decline in the first seven months of the year vs. same period of 2022 • Thu (31 Aug): NBS Mfg and non-Mfg PMI (Aug) • Fri (1 Sep): Caixin Mfg PMI (Aug)
	• CB: Turkey policy rate raised more than expected (+ 750bp) to 25.0% • Bank of Korea unch (3.5%), Bank Indonesia (5.75%) • India & Mexico CB minutes err on hawkish side • GDP Q2 in Thailand (+1.8% yoy, weaker-than-expected), Peru (-0.5% yoy, marginally stronger) • CPI (Jul) fell in Singapore to 4.1% yoy (Jun: 4.5%)	• CB: Mexico CB quarterly inflation report, Hungary policy rate on 29 Aug (unch. exp.:13%) • GDP (Q2): India, Turkey, Czech Rep • CPI (Aug): Malaysia, Indonesia, Peru, Brazil • PMI across EM countries

Upcoming events		
	US:	Tue: Case-Shiller HPI (Jun), FHFA HPI (Jun), JOLTS (Jul), Conf Bd cons conf (Aug); Wed: ADP (Aug), GDP (Q2), goods trade balance (Jul), Thu: PCE inflation (Jul), Jobless claims (26 Aug), Chicago PMI (Aug); Fri: Non-farm payrolls (Aug), Mfg PMI (Aug, f), ISM mfg index (Aug)
	Euro Area:	Mon: EA M3 (Jul); Tue: Fr cons conf (Aug); Wed: EA, It bus conf (Aug), Ge, Sp HICP (Aug); Thu: EA CPI (Aug), EA, Ge, It Unemp (Aug), EA ECB, Fr GDP (Q2), Fr, It HICP (Aug), Fr cons spdg (Jul); Fri: It GDP (Q2), EA, Ge, Fr, It, Sp Mfg PMI (Aug, f)
	UK:	Tue: BRC Shop price index (Aug); Wed: Mortgage approvals/lending (Jul), M4 (Jul); Fri: Mfg PMI (Aug)
	Japan:	Tue: Unemp (Jul); Thu: Industrial production (Jul)
	China:	Thu: Non-Mfg PMI (Aug); Fri: Caixin mfg PMI (Aug)

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