AXA Investment Managers

Investment Institute Macroeconomics

Deferred Confidence

- Powell's Q&A and the payrolls put paid to expectations of quick cuts by the Fed
- Euro area January inflation – with concerning developments in services – may have done the same for the ECB

In December, Jay Powell had fuelled the already aggressive market pricing for quick rate cuts. Last week he chose to take the opposite posture and did so effectively. Beyond the explicit reference to March not being the FOMC's base case for the first cut, Powell's key point was the need to get further confirmation of the ongoing disinflation process to get the level of confidence needed to embark on cuts. While the FOMC chairman made it clear the Fed is not seeking a proper downturn of the labour market, seeing more normalisation there was on his shopping list. From this point of view, the strong payroll last Friday came as a strong warning signal.

Optimists will argue that if the reason beyond the resilience of the US economy is a positive supply-side shock pushing both employment and productivity higher, then one could be relaxed about the inflation risks. Still, the same configuration is also consistent with a higher equilibrium interest rate, while even the strong recent productivity gains could not fully offset the current wage momentum. We find similarities with the discussions at the Fed in the late 1990s when the New Economy narrative – at the time based on the impact of the new information technologies – convinced Alan Greenspan to "go easy" on monetary tightening. These decisions probably contributed to the build-up of imbalances ahead of the Great Financial Crisis of 2008. The risks are different today, of course, but this memory should be another reason for the Fed to be cautious.

Meanwhile, the Euro area does not have the luxury of discussing the possibility of a positive supply-side shock given the mediocrity of its latest GDP prints. We wrote last week that for the ECB to cut in April, a "perfect data flow" would be needed. The inflation print for January, with potentially concerning news for services prices, certainly does not qualify. All this leaves us comfortable with our baseline of the first cut coming in June on both sides of the Atlantic.

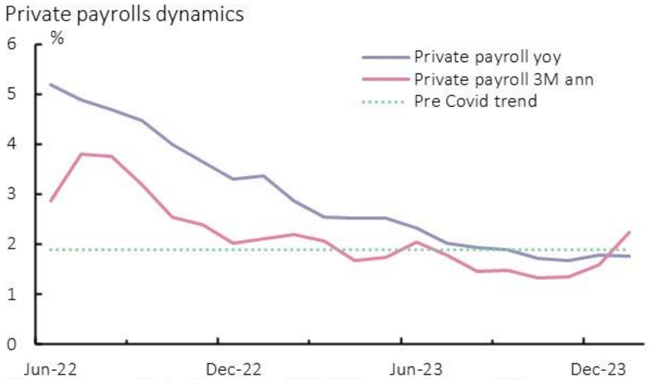
Powell – and the payrolls – pricked the balloon

We wrote last week in reaction to the market's still aggressive pricing for the Federal Reserve (Fed) that *"the very resilience of the economy should incentivise the Fed to take its time to shift to a more accommodative stance – what is the urgency?"* Jay Powell's words last Thursday have strengthened our view.

Indeed, while the Federal Open Market Committee (FOMC) statement and Powell's Q&A clearly indicated cuts "*at some point this year*" to quote him verbatim, there was no expression of any urgency to so. The key sentence in the statement was that idea that "*The Committee does not expect it will be appropriate to reduce the target range until it has gained greater confidence that inflation is moving sustainably toward 2 percent*". This point about the need to get confirmation that the good news on prices from the last 6 months continue was repeated many times during the Q&A. In answering incessant questions on what exactly would provide such confidence, Powell was careful, but fundamentally stated that this will depend on the balance between the real economy and the inflation dataflow. He said squarely that if the Fed were to see a proper correction of the labour market they would *"be inclined to cut faster"* but equally there remain issues on the inflation front which have not yet settled. He mentioned the contrast between falling goods prices and resilient services prices, an issue that will be familiar to habitual readers of Macrocast.

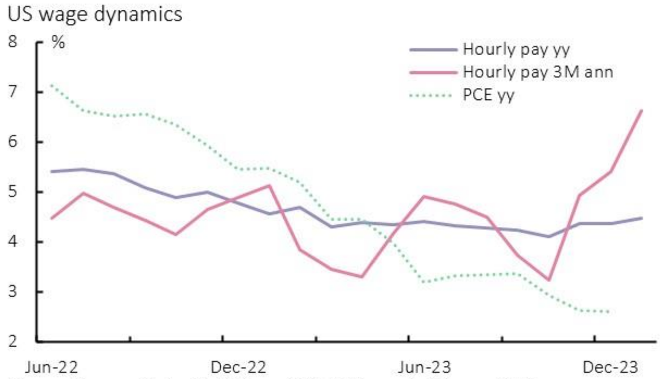
Quite simply, the FOMC considers that they have some time to cut as long as the economy remains strong (which incidentally is their base case). When asked precisely about a cut in March, Jay Powell answered candidly that it was "*probably not the most likely or what we would call the base case*." It is not an all-out dismissal, but it is still a strong message. This makes us comfortable with our long-held view that the first cut will come in June only. We cannot exclude the possibility it comes in May already – to which the market on Friday afternoon was still ascribing a probability of 80% - but for this to materialise the dataflow would probably have to be "truly perfect", with a slowdown in wages and some easing of services prices. Given the payroll release last Friday, the US dataflow is not going this way. We would thus still see a much lower probability for a May cut than what the market is betting on.

Exhibit 1 – From "soft" to "no landing"…



Source: Bureau of Labor Statistics and AXA IM Research, February 2024

Exhibit 2 – …both for jobs and wages



Source: Bureau of Labor Statistics and AXA IM Research, February 2024

Beyond the strong headline monthly number for job creation in January (+353K when the market was expecting 185K), the upward revisions to the past months have, once again, altered the picture we could form of the US labour market to the point that **the very notion of "landing" does not seem to apply**. We have updated our usual payroll graph (see Exhibit 1) in which we compare the current momentum to the 2010/2019 trend for employment growth. The gap which appeared in the second half of last year is now very small – job creation never fell, in the revised data, below 1.3% on a 3-month annualised basis, and over October-January period, **job creation re-accelerated steeply to exceed trend again**. Precisely because this series is so often profoundly revised, we do not want to draw definitive conclusions from only one print, but **taken at face value, we are dealing with a "no landing", not a "soft landing", which would run counter some of the arguments laid out by Powell last week.**

Indeed, as much as he wanted to give himself time, Powell was also quite insistent that the data – including what pertains to the labour market – was "going in the right direction", consistent with the overall easing bias espoused by the FOMC since December. The entire January payroll release, from the Fed's point of view, cannot be taken as a step in the right direction. Indeed, beyond strong job creation. Wages jumped much higher than expected as well, and the momentum is getting truly impressive, getting very close to 7% on a three-month annualised basis (see Exhibit 2). This strengthens the **self-reinforcing nature of the current resilience of US demand. It is no longer primarily supported by the fiscal push and the readiness by households to draw on their excess savings but increasingly by strong real income growth. This additional demand fuels in turn more job creation.**

The events of last week have shaken the market expectations. Goldman Sachs and Bank of America have pushed back their forecast for the first cut to June – our long-held baseline – and forward contracts by Friday night no longer had a full 25bps cut priced in for the May meeting (rather an 80% probability). Moreover, the market is also changing its mind on another issue which probably matters even more: the overall quantum of accommodation we are likely to get this year. Indeed, it is now a grand total of 124bps worth of cuts which is priced in until December 2024, a small five "normal size" cuts, against more than six for most of January. Including 1 May, there will be 6 FOMC meetings left this year. In other words, the market is no longer sure the Fed would cut at *every single meeting.* We think it is much more reasonable, even if in our baseline the Fed would cut by even less (four times).

True, if it lands north of 4% in December 2024, the Fed Funds rate would still remain above the Fed's own estimate of its "long-term level" and thus arguably in restrictive territory, but the new market expectation is at least converging to the message from the FOMC In December, when the median member expected only three cuts – a point Powell chose to mention the Q&A last week.

More profoundly, **the current configuration should raise questions on where the equilibrium rate (R*) is now standing in the US**. Indeed, if the US economy continues to show very little sign of slowing down despite Fed Funds north of 5% - even after allowing for transmission lags – then the possibility that the equilibrium rate has risen must at least be considered. It is a wild goose chase to quantify it in real time, and it is also possible to blame the lack of response of the real economy to the monetary signal on impaired transmission. From this point of view, a less aggressive market (10-year yields have moved up slightly above 4% again last Friday) may do the trick, but if the US economy is currently benefiting from a positive supply-side shock – a broad-based sustained elevation in productivity triggered by accelerated innovation – then the case for a higher R* becomes stronger. The same holds for the savings ratio: by bringing back their savings ratio to low levels unseen since the run-up to the Great Financial Crisis, US households' behaviour may signal that rates still need to be elevated for long.

Yet, as often, the macroeconomic conclusions can be ambiguous. If the US economy is benefitting from a permanent positive supply-side shock lifting productivity, then wage-inflation could be easier to manage, and truly, the recent fast productivity gains have helped keep unit labour costs in check. Yet, **as favourable as they are, those robust productivity numbers are still no match for a near 7% pace for wages.** We would thus expect more cost-push inflationary pressure in the US in the months ahead in the labour-cost driven services sector, which may increasingly offset the decline in durables goods' prices, unless the labour market corrects fast. This was by the way one of the risks mentioned *en passant* by Jay Powell in his Q&A. Indeed, "at some point" global manufactured goods prices will find a floor and the continuation of disinflation in the US will hinge on some deceleration in services prices. For now, we fail to see how it could easily materialise – we would add to the wage pressure the fact that, amid strong growth, businesses will have little incentive to compress their margins.

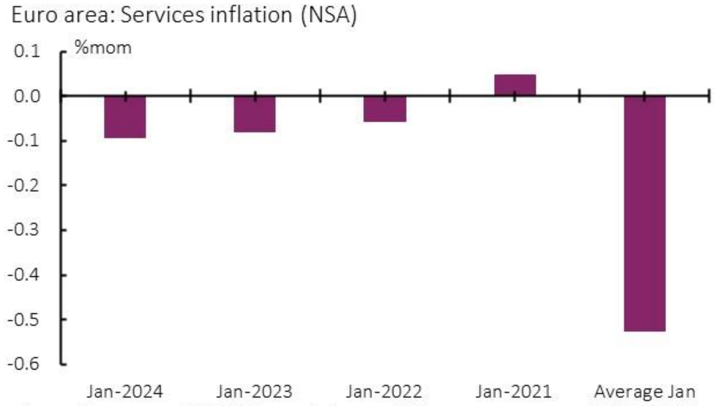
These debates are not as arcane nor as new as they may seem to be. We find some similarities with the late 1990s when the Fed under Alan Greenspan was hesitating on the way to deal with the "New Economy" – a surge in productivity triggered by the diffusion of information technology. The choice by the Fed at the time was ultimately to allow rates to remain lower than they should have been based on what the unemployment rate and the actual inflation rate would have prescribed under the old "Taylor Rule" – what Blinder and Yellen at the time called the Fed's forbearance. While it has been an ongoing academic dispute ever since, the Fed's enthusiasm for the recognition of a positive supply-side shock at the time – resulting in lower than usual policy rates – is often seen as one of the factors which contributed to the build-up of financial imbalances in the run-up to the crisis of 2008. Focus is today more on the behaviour of goods and services prices than on asset prices, but this memory could well make the Federal Reserve think twice before making the "leap of faith" we mentioned last week and remove monetary restriction before it is absolutely clear the economy has landed.

Some concerning details in European inflation

On the usual year-on-year basis, Euro area inflation decelerated again in January for both the headline and underlying measures (2.8% and 3.3% respectively), but less so by one decimal than what the market was expecting. European statisticians are having a hard time with consumer prices now, between a strong reallocation of spending across categories which is triggering a larger-than-usual annual recalculation of the index' weights, and strong gyrations in prices at the beginning of the year during the pandemic. As we write those lines, the European Central Bank (ECB) still has not – and that is an unusually long lag – computed the seasonally-adjusted version of the Consumer Price Index (CPI) for January, except for the non-energy industrial goods and the food components. Consequently, we need to be even more prudent than usual in the assessment of the monthly print, but **the developments in services could warrant attention**.

In general, non-seasonally adjusted services prices tend to fall quite significantly on the month in January (by an average of 0.5%). This pattern was disturbed during the pandemic and the subsequent inflation surge. Given the recent disinflation trend, one could have hoped that in January 2024 some pattern normalisation would reappear. This did not happen: services prices fell by 0.1% only, in line with the reading for January of last year (see Exhibit 3). The impact of a VAT rate change in Germany explains some of this, but services were also resilient in other countries.

Exhibit 3 – Still abnormal pattern in services prices

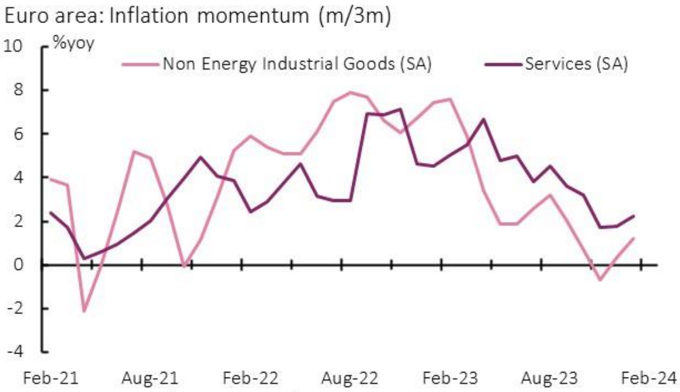


Source: Eurostat and AXA IM Research, January 2024

So far, the absence of resilience of services prices in the Euro area – in sharp contrast with the US situation – has been a key element in our general optimistic view on the continuation of disinflation on this side of the pond. It is too early to draw definitive conclusions from only one print, but January matters more than any other month. There is some very convincing research (see here for instance) which suggests that 14.5% of all prices are revised in the first month of the year (against 8.5% per month on average). **To some extent, January "sets the tone" and this year the tone may not be the one that the ECB is hoping for.**

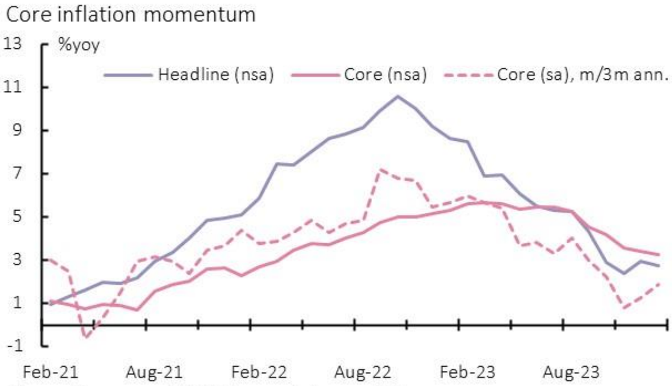
Last month, the resilience in services prices coincided with a rebound into positive territory of industrial goods' prices, when measured on a 3-month annualised basis (see Exhibit 4). if in a non-seasonally adjusted terms the monthly change in services prices was the same as in January of last year, we may assume that it will not be too different in seasonally adjusted terms. We will need to re-do the calculation once we have the figures from the ECB, but with this assumption, **services inflation would have re-accelerated on a 3-month annualised basis**. Under the same assumption, total core inflation also rose again in January, hitting 1.9% from 1.2% in December (see Exhibit 5).

Exhibit 4 – Both services and goods prices rebounding?



Source: Eurostat and AXA IM Research, January 2024

Exhibit 5 – The momentum for core may be up



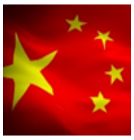
Source: Eurostat and AXA IM Research, January 2024

Last week we wrote that although Christine Lagarde had refused to push back explicitly on market pricing, an early rate cut – coming in April already – would require a "perfect dataflow". A firmer and broad-based further deceleration in consumer prices for January would have been part of such perfect narrative. This did not materialise. The market has responded by reducing the probability of a rate cut in April, pricing in 18bps "only" last Friday against 23 the day before. The June meeting continues to be our baseline for the first cut.

"Team transitory" should refrain from claiming a belated victory

Of course, it is possible to see these latest pieces of data, both in the US and the Euro area, as mere "hiccups". Yet, although we continue to think that a continuation/resumption of disinflation is the most plausible scenario for 2024, they should act as a call to prudence. Martin Sandbu in his newsletter last week laid out a number of conclusions on the current inflation shock. His most salient one was that as it was essentially supply-side driven, it was now spontaneously disappearing within an acceptable timeframe (2 years or so) with little contribution from monetary policy, and that it would be a mistake to maintain an unduly restrictive stance. We sympathise to some extent with this view, but we would still add that **while demand-side factors may not have played a big *so far*, the persistence of strong growth and tension on the labour market – at least in the US – makes it still possible that they could kick-in *in the near-future.***

Since precisely monetary policy has not yet had a significant dampening impact on the economy – although this case is easier to make in the US than in the Euro area – it makes perfect sense for the central bank to take its time, especially in a situation where the equity and bond markets have already responded powerfully to the perspective of rate cuts. Your humble servant – just like Martin Sandbu - was a card-carrying member of "team transitory" at the beginning of the inflation shock. As much as we would love to feel vindicated, we think it makes sense to err on the cautious side right now – with the proviso that the buffers available to deal with the adverse effects of a too stubbornly restrictive monetary stance are much bigger in the US than in the Euro area.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• FOMC left FFR unchanged at 5.25-50% as expected. Powell pushed back again rate cut hopes for March • Employment (Jan) +353k, above expectations. Unemp at 3.7% and earnings jumped to 0.6%mom • JOLTS (Dec) vacancies rose unexpectedly to 9.0m • ISM index (Jan) rose to 49.1, new orders to 52.5 • NY Comm Bancorp raised broader bank concerns	• ISM servs (Jan) gains as in mfg and servs PMI? • Senior Loan Officers Survey gives breakdown of lending conditions, watch for further loosening • CPI revisions – were meaningful last year • Jobless claims sharp 2-week pick-up, but low overall • Trade (Dec) has been narrowing on post-pandemic improvement and rising exports
	• EMU GDP growth (Q4) was flat (0%qoq): Ge: -0.3%; Fr: +0%; It: +0.2%; Sp: +0.6%. Preliminary details point to weak private consumption • Limited fall for EA Flash HICP (Jan). Headline came at 2.8% (-0.1p from Dec), core at at 3.3% (-0.1p). Svcs prices flat at 4%yoy for the 3rd consecutive month • EMU unemployment rate (Dec) flat at 6.4% • EC surveys (Jan) broadly stable, no rebound yet	• Hard data with EMU retail sales (Dec), German industrial production (Dec) • EMU Producer prices (Dec)
	• BoE meeting (Feb) left policy unchanged with 2-6-1 vote split. Bailey said now how long, not how high • Mortgage apps (Dec) edged higher, lending fell by £0.8bn • Nationwide HPI (Jan) +0.7%mom (-0.25yoy)	• ONS to publish labour market updates (to Nov 23) • Services PMI (Jan, f) to confirm strong 53.8 (p) • BRC sales (Jan) good indicator of weak sales in Dec • RICS survey (Jan) best forward-looking housing guide • RECS jobs survey (Feb) useful in lieu of official data
	• Industrial production (Dec) rebounded by 1.8%mom, retail sales (Dec) decelerated to 2.1%yoy • Tokyo CPI came below expectations at 1.6% (-0.8 p from Dec), signalling that the momentum is slowly fading at national level • Unemployment rate fell further to 2.4% (-0.1 p)	• Current account data (Dec) • Household spending (Dec)
	• Industrial profit (Dec): 16.8%yoy (Nov: 29.5%) • NBS Mfg PMI (Jan): 49.2 (Dec: 49.0) • NBS non-mfg PMI (Jan): 50.7 (Dec: 50.4) • Caixin Mfg PMI (Jan): 50.8 (Dec: 50.8)	• Mon (5 Feb): Caixin service PMI (Jan) • Thu (8 Feb): CPI and PPI (Jan)
 	• CB: Hungary -75bp (10%), Colombia -25bp (12.75%), Chile -100bp (7.25%) & Brazil -50bp (11.25%) • Jan CPI (yoy): Indonesia (2.6%), & Korea (2.8%) • Q4 GDP: Mexico (0.1%qoq, 2.4%yoy), Taiwan (5.1%yoy), Philippines (2.1%qoq, 5.6%yoy), Poland (2023 0.2% average), Czech Rep (-0.2%qoq, 0.2%yoy) • Jan PMI manufacturing remained weak across EM, better in Latam, relatively unchanged in Asia	• CB: expected on hold for Mexico (11.25%), India (6.5%), Poland (5.75%) and Thailand (2.5%), 25bp cut in Peru (6.5%), 25-50bp cut in Czech (6.75%) • CPI (Jan): Colombia, Chile, Mexico, Hungary, Turkey, Thailand, Korea, Philippines, Taiwan • Q4 GDP: Indonesia • Reaction to general elections in El Salvador (Sunday)

Upcoming events		
	US:	Mon: Services PMI (Jan), ISM non-manf index (Jan), Fed's SLOOS survey; Wed: Trade balance (Dec); Thu: Weekly jobless claims (3rd Feb), Wholesale inventories (Dec)
	Euro Area:	Mon: Ez,Ge,Fr,It,Sp Services PMI (Jan), Ez PPI (Dec); Tue: Ez Retail sales (Dec), Ge New manf orders (Dec), It ISTAT bus & cons confidence (Jan); Wed: Ge,Sp Industrial production (Dec); Fri: Ge Moody's credit rating review, It Industrial production (Dec)
	UK:	Mon: LFS data updates to Nov 2023, SMMT new car registrations (Jan), Services PMI (Jan); Tue: BRC Retail sales monitor (Jan), Construction PMI (Jan); Thu: RICS Housing survey (Jan)
	Japan:	Wed: Leading index (Dec), Current account balance (Dec), Trade balance (Dec); Thu: Economy Watchers Survey (Jan)
	China:	Mon: Caixin services PMI (Jan); Wed: Foreign exchange reserves (Jan); Thu: CPI (Jan); Fri: Public holiday – Chinese New Year (day 1/7)

Our Research is available online: www.axa-im.com/investment-institute

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AXA IM is a leading investor in green, social and sustainable markets, managing €489 billion of ESG-integrated, sustainable and impact assets as at the end of December 2022. We are committed to reaching net zero greenhouse gas emissions by 2050 across all our assets, and integrating ESG principles into our business, from stock selection to our corporate actions and culture. Our goal is to provide clients with a true value responsible investment solution, while driving meaningful change for society and the environment.

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