167 – 6 February 2023

Investment Institute Macroeconomics

Jobs Hit Bulls

- The “dovish nuggets” in the Fed and the ECB’s communication last week were sparser than what the market reaction would suggest. The US payroll – rightly - put a dampener on the market enthusiasm.
- We are concerned by the steep decline of the “credit impulse” in the Euro area – but the ECB may believe wage bargaining will be slow to react to a deterioration in economic conditions.

For the “dovish pivot” to be imminent, two conditions need to be fulfilled. First, communication from the central banks need to change. Second, the dataflow needs to be consistent with inflation landing within an acceptable timeframe. There were some tentative alterations to the Fed and the ECB’s messages last week, even if we think they should not be overstated. In the Q&A, Jay Powell may have been too vague in the rebuttal of the market still pricing cuts. The ECB has acknowledged that the balance of risks around their inflation baseline scenario is now “more balanced”. But the market’s enthusiasm in seizing on these dovish nuggets crashed against the strong US labour market data coming out on Friday.

Christine Lagarde’s slight communication downshift was in our view heralding more a mere slowdown in the pace of hikes to 25 basis points after March than a pause, and we continue to think the risk to our unchanged central scenario – that the ECB stops after hiking to 3.25% in May – is subject to an upside, rather than a downside risk. While we think the market is too confident now on growth prospects in the Euro area – we are concerned by the steep decline of the “credit impulse” in deeply negative territory – we also believe the ECB is worried about the impact of some of the institutional characteristics of the European labour market in 2023: centralized wage bargaining systems can result in a delayed response of wage dynamics to a deterioration in economic activity, as past inflation plays a bigger role than in decentralized system, such as the one which prevails in the US.

In a nutshell, while in the US the issue is that the monetary tightening has not bitten enough yet to tame the labour market, in Europe it may be that the monetary is starting to work its way through the economy, but with only slow impact on underlying inflationary pressure. We would not bet on the patience of policymakers, however “less hawkish” they have sounded recently.

The US job machine roars on

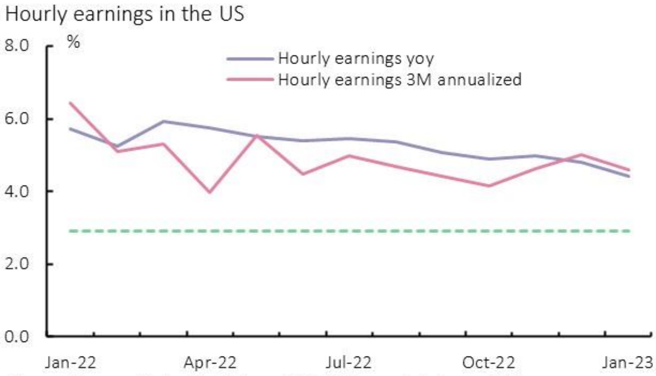
We noted in our previous issue of Macrocast that the word "goldilocks" was getting very popular again. Last week was initially believed to bring more fuel to that particular market engine. Indeed, Jay Powell was not as hawkish as feared (more on this later) and the payroll release for January was expected to close the week with a "not too hot, not too cold" message, with enough job creation and wage growth to keep the recession at bay, but not strong enough to tell the Federal Reserve (Fed) that more underlying inflationary pressure is in the pipeline. But what came out was very different. **Not only was the headline number for new jobs much stronger than expected – 517k jobs, significantly above the already robust average of 2022 at 400K - but the revisions to the data on employment and wages wiped out the sense that the labour market has really started its adjustment**. Both in year-on-year and 3-month annualized terms, headcount growth accelerated in January and moved further above the pre-pandemic trend (see Exhibit 1). On the wage front, it now takes the eyes of an eagle to detect a sense of deceleration (see Exhibit 2).

Revisions have been extensive, as often at the beginning of the year when the Bureau of Labor Statistics takes on board a new, extensive Census of Employment and Wages. Some downward adjustments were made to job creation in the spring of 2022 (-136K in April and May) contrasting with upward revisions in the second half of 2022 (+304k) which has affected the trend. Until the January release, it seemed US employment growth was steadily, albeit very slowly, softening. With the new data, while a deceleration trend still appears in year-on-year terms – reflecting the huge base effects from 2021 - on a 3-month annualized basis, the image that emerges is that job growth has been staying in a "tube" between 3 and 4% since the spring of last year (against less than 2% on average in the 4 years before the pandemic) without a clear overall direction.

Exhibit 1 – Job creation in a 3 to 4% "tube"

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

Exhibit 2 – Can you *really* see a deceleration in wages?

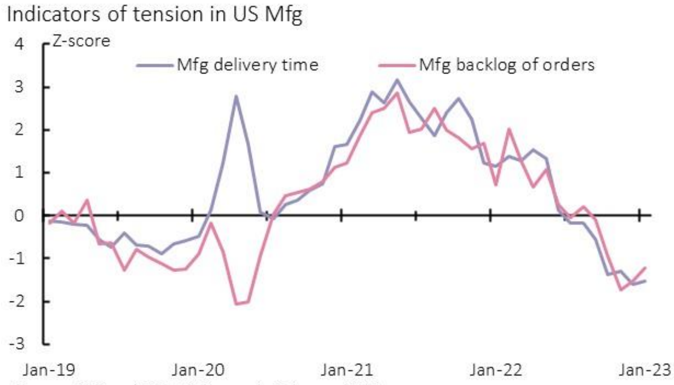


Source: Bureau of Labor Statistics and AXA IM Research, February 2023

There was really nowhere to hide from the payroll's headlines. We had noted a few months ago how a gap had been widening between the Establishment and the Household surveys, possibly reflecting the Bureau of Labor Statistics' difficulty in dealing with the net effect of disappearing and emerging businesses. Yet, the gap is now tightening again. **The household survey reported an even higher rise in employment (+894K) than the establishment survey in January.** True, eternal optimists will focus on the fact that – newly recalculated - seasonal adjustment may have pushed the payroll numbers too high, and a mild January coming after the snowstorms of December may have also helped, but even so, underlying job creation would have remained strong.

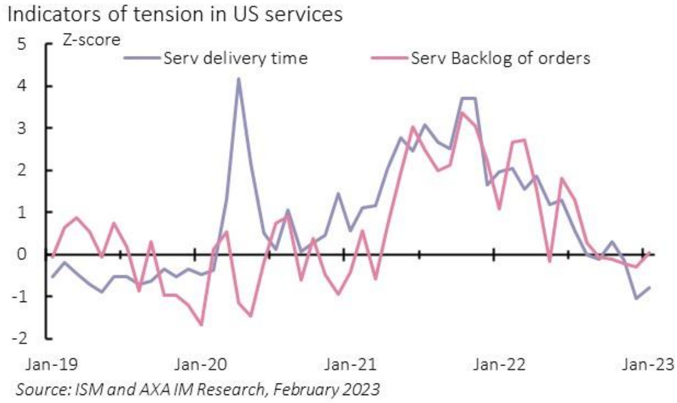
This resilience of the labour market is all the more remarkable that from many other angles, indicators of excess demand are improving. Before the Christmas break, we took a look at the balance of opinion on delivery time and backlog of works in the United States (US) to get a sense of how far the business sector was now on the absorption of the past disruptions in supply lines. Using this metric, **the manufacturing sector is already facing a clear demand deficit**: delivery times and backlogs of work are significantly below their long-term average (see Exhibit 3). Unsurprisingly, the change is less spectacular in services, as aggregate demand shifted from away from goods as the economy reopened, but it is nowhere near the acute levels of tension still seen at the beginning of last year (see Exhibit 3).

Exhibit 3 – US Manufacturing faces demand deficit



Source: ISM and AXA IM Research, February 2023

Exhibit 4 – Tension has significantly abated in US services



Source: ISM and AXA IM Research, February 2023

An issue of course is that**, as long as the labour market remains so strong, the US economy could still see a re-acceleration** – an outcome which the US economists of Bank of America are already considering - which would set the stage for core inflation remaining stuck far above the Fed target. We made the point two weeks ago that in real wages, over three months, were back in positive territory. With the upward revision in earnings, it's even more visible now. A mitigating factor was the decline in working time, which pointed to still some adverse pressure on real labour income, but this was corrected in January. Our expectation of visible weakening in GDP growth into 2023 is based on the exhaustion of the excess saving buffers, but of course if real income rebounds, this effect would be muted.

The Fed is clearly trying to calibrate how much additional tightening is needed, resorting to a more "probing" approach. Now that Fed Funds are ostensibly in restrictive territory, they can afford to take a more leisurely pace to their hikes, which makes their "forward guidance" more complicated. This may be how we can interpret Jay Powell's softness in his rebuttal of the market's pricing of the Fed trajectory. By construction, the more the Fed hikes, the higher the risk it goes too far and is subsequently forced to adjust down. Now, the policy statement itself was not particularly dovish, with in particular this explicit message that *"the Committee anticipates that ongoing increases in the target range will be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2 percent over time" and* noting that inflation has *"eased somewhat"* but *"remains elevated"* cannot be taken as the Fed taking a victory lap. However, **in the Q&A it's probably Powell's discomfort with being too precise on the terminal rate, a month before coming up with new forecasts, which has convinced the market the "dovish pivot" is on its way**.

Yet, a key takeaway for us however was his answer to a question on the balance of risk around revising up or down the current "dot plot", issued in December and consistent with the Fed crossing – just – the 5% limit. He elaborated on the *"risk to do too little"* and realise in a few months than they had been "close to do the job" and failed. This **reflects a central bank which is ready to be pragmatic and to be driven by data – as he repeated several times – which might get them to alter their dot plot and ultimately vindicate the market pricing, but nothing indicated last week that this is their natural slope.**

Of course, **the more the Fed is data dependent, the more every payroll print matters**. As we type, Mary Daly was the only Fed official who went to the wires since Powell's press conference with the payroll data date available and her reaction (her first word was "*wow*" …) was quite telling. We find it interesting that she said in no unambiguous terms that the December dot plot remains the best guide to the Fed's trajectory (*"a good indicator of where policy is at least headed"*), and she is no instinctive hawk. Miracles may happen and core inflation may come down more decisively without a softening of the labour market – Powell said it was "gratifying" that the disinflation seen so far did not entail weaker job dynamics – but they are not likely. There may be two conditions for a dovish shift in the "dot plot": one that core inflation falls further – and the jury's out so far on the component the Fed is explicitly focused on (services excluding housing). The other, that the labour market lands. Clearly, we are not there. We think the risk the Fed continues hiking in Q2 is higher than what the market is pricing now, and we continue to believe rate cuts are not on the horizon this year.

ECB to "stay the course"

Market enthusiasm after the Fed meeting probably coloured their response to the European Central Bank (ECB) the following day. Indeed, the rally looked to us excessive in respect to the very few changes to Christine Lagarde's communication. The ripple effect of the payroll numbers in the US put a dampener on these "animal spirits" – at least for now.

The ECB chose to "rip the band aid" and combined its 50bps hike with the explicit intention to do it again in March. This allows the central bank to claim it is completely consistent with the strong forward guidance contained in its December message. However – since there was little doubt it would reach 3.00% in March – focus was more on what lies ahead, and journalists had lots of pointed questions as to whether the ECB considers it will have reached its "terminal rate" by then. Lagarde was quite clear on this: *"what about after March? Does that mean that you have reached the pinnacle or the peak?' No. We know that we have ground to cover".* Yet, given her insistence on being data dependent and a downshift of the balance of risks for the inflation outlook to "more balanced"**, there are strong hints that a slowdown in the pace of hike(s) will come in Q2.**

This is also our interpretation of the key sentence in the statement about the trajectory post-March: *"we will then evaluate the subsequent path of our monetary policy"*. We see this as a sign the pace of tightening will fall, while the most enthusiastic observers in the market may have read this as a sign a pause was possible after the March move already. For our part, this makes us more confident that a 25bps hike in May will be the last before a pause – our central scenario – but we continue to think there is a risk the ECB stops only by the summer. Indeed, **we don't think the ECB has yet its desired level of comfort on price developments.**

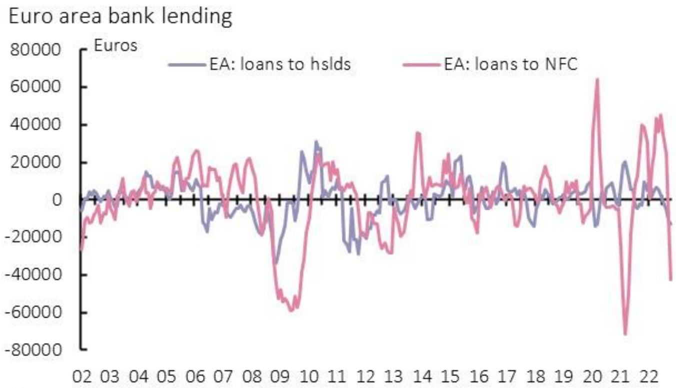
Poring over the substance of the ECB's analysis, it's quite clear that underlying price pressures are at the forefront. We would highlight this extract: *"price pressures remain strong […] Wages are growing faster, supported by robust labour markets, with some catch-up to high inflation becoming the main theme in wage negotiations. At the same time, recent data on wage dynamics have been in line with the December Eurosystem staff projections*" which were very significantly upgraded in December – the ECB's forecast for compensation per employee was raised by 0.4ppt and 0.5ppt to 5.2% and 4.5% in 2022 and 2023 respectively, with respect to the September batch. That aspect of the ECB's projections was a key contributor to the hawkish message that even by 2025, inflation would not be quite back to target (as per the market's expectations for interest rates at the time). So, **while the ECB is explicitly less worried about inflation than in December, it is still only a very subtle change**. Importantly – and this may have been lost in the first interpretation of Lagarde's Q&A, that the balance of risks around the inflation baseline is "more balanced" also came with the warning that *"we don't think there is a symmetry of risks*". With core inflation still refusing to decelerate – unless the inclusion of a proper German number in the January print triggers a revision next week – the ECB does not want to lower its guard. But the ECB's job is probably easier than the Fed's in terms of communication since the market is not pricing rate cuts in the Euro area this year. This possibly made Christine Lagarde less keen on "overdoing it" in her messaging.

Past monetary tightening starting to bite?

Another element which may have fuelled the market's positive reaction to the ECB's Governing Council is the lack of triumphalism on the state of the real economy. Of course, Christine Lagarde acknowledged the better-than-expected data flow recently – what we call the "absence of catastrophe" – but it was a qualified appraisal: "*While above the December Eurosystem staff projections, this outcome [positive GDP growth in Q4] means that economic activity has slowed markedly since mid-2022 and we expect it to stay weak in the near term. Subdued global activity and high geopolitical uncertainty, especially owing to Russia's unjustified war against Ukraine and its people, continue to act as headwinds to euro area growth*". Beyond the recognition of these adverse forces, **we were struck by the frankness of the ECB's assessment of financial conditions in the Euro area, which is largely under its direct control**.
The paragraph on financial and monetary conditions in the prepared statement came in stark contrast with the December version which was more cursory and mentioned that "*bank lending to firms remains robust*", with this key

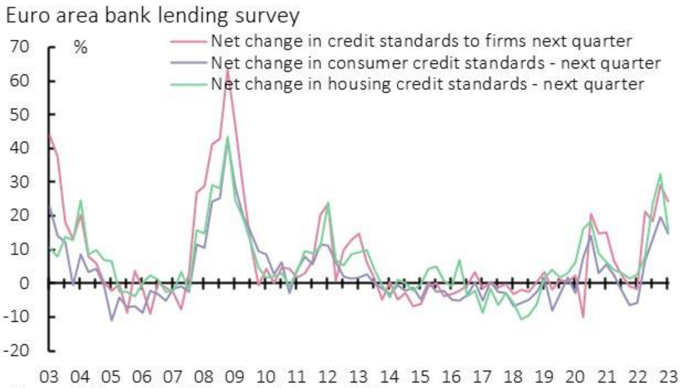
point on "Bank lending to firms has decelerated sharply over recent months". Indeed! We like to look at these developments using the concept of "credit impulse". Indeed, lending is often measured as the year-on-year change in the *stock* of loans. However, the metric closest to a change in GDP (which is a change in an output, a *flow*) is the change in *new* credit. An issue with this approach is that it can be quite volatile, as we illustrate in Exhibit 5. Yet, it still captured the main inflexions of the European cycle: positive impulse in the years preceding the Great Financial Crisis, massive drop in 2009, short-lived rebound in 2010 stopped by the advent of the sovereign crisis in 2011-2012, and then mostly flat developments from the end of the sovereign crisis to the pandemic, reflecting a mediocre growth performance. The Covid crisis of course triggered wild gyrations, but **we think the latest dive in the credit impulse is genuine**. Indeed, it correlates well with the ECB's bank lending survey (BLS) which points to lending standards now tighter than at the beginning of the pandemic and during the sovereign crisis (see Exhibit 6).

Exhibit 5 – Euro area credit impulse now sharply negative



Source: ECB and AXA IM Research, February 2023

Exhibit 6 – Tight lending standards

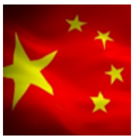


Source: ECB and AXA IM Research, February 2023

Of course, there is an element of circularity in the BLS. Banks tighten their lending standards when they expect the economy to deteriorate, as the probability of default rises. With a better-than-expected European winter, banks could become less concerned – and actually there was a very tentative improvement in the "expected lending standards" component of the BLS for next quarter, but the absolute level is still very high**. This is probably the first indubitable sign that the ECB's monetary tightening is starting to bite, and the speed of the contraction in the credit impulse may come as a concern to some members of the Governing Council.**

Yet, **we suspect part of the discussion at the ECB is on the probability that the underlying deterioration in the Euro area's cyclical conditions will rapidly tame inflationary pressure given the specific institutional features of the European labour markets**. A very topical study by Erwan Gautier from Banque de France looked in detail at collective wage bargaining in France last year. While he took the precaution of stating that his paper could *not* substantiate the existence of "price/wage loop", his findings have the immense merit of showing how in practice, collective wage scales have been pushed up (in mostly two rounds) in France in 2022 in reaction to the price shock, for instance via the second-round effects from the mandatory hikes in the minimum wage. The French system has its idiosyncrasies, but wage bargaining is in general more centralized in Europe than in the US. This matters for the inflation outlook in 2023 and 2024. In a decentralized system, wages respond fairly quickly to cyclical conditions as job opportunities dry up, making it much harder for employees to negotiate individual raises. **In centralized system, there can be a delay between the deterioration in the labour market and a deceleration in wages** since past inflation plays a central role in the discussions, even if de jure price/wage indexation mechanisms have disappeared from most Euro area countries (Belgium being a well-known exception).

In a nutshell, while in the US the issue is that the monetary tightening has not bitten enough yet to tame the labour market, in Europe it may be that the monetary is starting to work its way through the economy, but with only slow impact on underlying inflationary pressure. The degree of patience of policymakers is of course key in this configuration. Judging by their recent comments, we don't think this degree should be overstated, however "less hawkish" they may have sounded.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Fed hiked by just 0.25% to 4.5-4.75% as expected. Statement pointed to “ongoing increases”, but Powell explained this depended on path of inflation • Labour report (Jan). Payroll growth leapt to 517k, unemp hit 3.4% a 53-yr low, earnings +4.6% 3m ann • Employment Cost Index (Q4) slow to 1.0%qoq • JOLTS (Dec) vacancies rose to 11m from 10.5m • Vehicle sales (Jan) rose to 15.7m – highest since H1 21 • House prices (Nov) fell, S&P Case-Shiller now 6.8%yoy	• Fed Chair Powell speaks Tuesday – fine tune mssg? • Jobless claims trending lower this year, defying weaker jobs market view, but question seasonals • U Mich sentiment (Feb, p) recent gains questioned as oil stabilises, 5-10yr inflation exp monitored • Trade (Jan) – recent readings improved on imports • Budget Statement (Jan) to be watched in more detail with debt limit now reached and little near-term progress on raising it. Crunch time in summer
	• The ECB increased all its policy rates by 50bps and intends to do the same in Mar before “reevaluating future pace in regard to inflation dynamics” • Euro area headline HICP (Jan) dropped by another 0.7pp to 8.5%yoy, core unchanged at 5.2%yoy, upside risk for Final HICP (see next week release details) • EMU GDP Flash Prelim came above consensus at +0.1%qoq. Ge: -0.2%; Fr: +0.1%, It: -0.1%; Sp: +0.2%	• Few ECB speakers this week: Visco and Holzman • Ge Prelim HICP (Jan). Eurostat projected Ge HICP at around 8.7%yoy. Our own forecast and Consensus, respectively at 9.7% and 10% imply EMU headline HICP cool be boosted by [+0.2/0.4pp]. EMU core inflation should be unchanged if Eurostat has been consistent with recent momentum • Ge industrial orders and IP (Dec) across EMU-4
	• BoE MPC hiked Bank Rate by 50bp to 4.00%, signalled a ‘watchful’ peak – with further hikes dependent on sign of persistence in data • Feb MPR projects shallower recession and faster decline in inflation with risks skewed to upside • Nationwide house prices (Jan) 5th cons fall -0.6%mom and mortgage approvals fell to 2.5yr low	• GDP (Q4) expected flat – we see risks to the downside from disruptions caused by strikes • UK trade balance (Dec) • BRC Retail sales monitor (Jan) • RICS housing survey (Jan)
	• BoJ Gov contender Nakaso takes role in APEC advisory council - seen by some a sign of dropping out of race • Continued recovery in consumer spending with retail sales (Dec) up 1.1%mom • Final PMIs (Jan) down 0.1p to 50.7 (comp), services down 0.1p to 52.3	• Households spending (Dec) likely to support the continued rise in spending real figures may post slight decline amidst pressure from rising inflation • Current account balance (Dec) expected to remain in surplus 98.4bn (cons)
	• NBS PMI rebounds to expansionary territory reflecting improved activity post reopening • Services PMI surges even more to 52.9 on Caixin’s measure and 54.4 on NBS measure reflecting strong recovery of consumer spending • Health expert suggests China has passed the peak wave with 80% of the population infected of COVID	• Loan data (Jan) likely to show a sequential recovery in credit growth due to stepped-up support and seasonality • CPI inflation (Jan) expected to edge higher while PPI to narrow yoy decline
	• CB: Czechia (7.0%), Egypt (16.25%) & Brazil (13.75%) stood on hold. More hawkish tone in CZ & Brazil • Q4 GDP grew 0.4%qoq in Mexico. Full-year growth reached 3.0% in 2022 • Jan inflation accelerated in Korea (5.2%) & Peru (9.0%). It fell in Turkey (57.7%) & Indonesia (5.3%)	• CB: India to hike +25bp to 6.5%, Mexico +25bp to 10.75%, Peru +25bp to 8.0%, Romania +25bp to 7.25%. Poland (6.75%) & Russia on hold (7.5%) • Q4 GDP in Indonesia & Malaysia • Jan CPI in Brazil, Colombia, Hungary, Mexico, Russia, Thailand, Philippines & Taiwan

Upcoming events		
	US:	Tue: Trade balance (Dec); Wed: Wholesale inventories (Dec); Thu: Weekly jobless claims (4 Feb); Fri: Michigan consumer sentiment (Feb), Michigan inflation expectations (5-10y) (Feb)
	Euro Area:	Mon: EH20 Retail sales (Dec), Ge New manf. orders (Dec); Tue: Ge & Sp Ind. prod. (Dec); Fri: Ge Current account (Dec), It Ind. prod (Dec)
	UK:	Mon: SMMT new car reg. (Jan), Construction PMI (Jan); Tue: RBC Retail Sales Monitor (Jan); Thu: RICS Housing Survey (Jan); Fri: GDP (Q4 & Dec), Private consumption (Q4), Business investment (Q4), Index of services (Dec), Ind. prod. (Dec), Manf. & construction output (Dec), Total trade balance (Dec), Trade in goods (Dec)
	Japan:	Tue: Leading Index (Dec), Current Account balance (Dec), Trade balance (Dec); Wed: Economic Watchers Survey (Jan)
	China:	Tue: Foreign exchange reserves (Jan); Fri : CPI (Jan)

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