AXA Investment Managers

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Investment Institute Macroeconomics

Stockholm Syndrome

- The February inflation data vindicates the European Central Bank (ECB) hawks. We remain however concerned with the "financial channel": the January batch for loans confirms the credit impulse in deeply negative.
- We look at Sweden and the UK as "canaries in the coalmine" when it comes to monetary policy transmission.

In the Euro area, the inflation figures for February vindicate the Governing Council's decision to signal its intention to deliver another 50bps hike on 16 March. The slowdown in economic activity is not yet having the expected moderating impact on price behaviour. We continue to think the monetary tightening has however started to work its way through the economy, even if it has not yet visibly impacted aggregate demand. The data for January has confirmed the steep decline in the credit impulse. The historical relationship with GDP with a lag of a quarter is relatively tight, even if base effects from the pandemic may have blurred the picture and ample liquidity buffers may delay the transmission to business and consumers decisions.

Cracks usually appear first in the most interest-rate sensitive sectors of the economy. The recent developments in Sweden are interesting from this point of view. Transmission should be swift there, given the dominance of variable rate mortgages and an extremely stretched housing market before the tightening began. GDP contracted significantly in Q4 there (-0.9%) amid sharp declines in house prices. The Riksbank is in a quandary. If it stops hiking rates, it risks fuelling the depreciation of the currency and hence imported inflation. Accepting a quite deep recession – and the collateral risks to financial stability – may be the only workable avenue there. The UK could be the "next shoe to drop". The recent dataflow is not as bad as in Sweden, but the housing market correction has started.

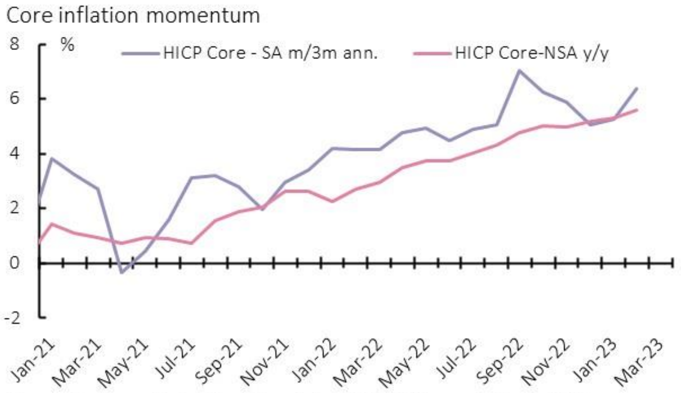
The ECB Governing Council is visibly tempted by additional tough moves beyond March, but we feel that the risk of a "double dip" scenario is also gaining ground. Transmission may be slower than in the UK or in Sweden because of structural features of the Euro area economy – with the dominance of conservative lending practices and fixed rate mortgages in many member states – but it does not necessarily mean that down the road the impact is smaller.

Stubborn inflation

In February, headline inflation failed to decelerate as much as expected in the Euro area, hitting 8.5% year-on-year, barely lower than in January (8.6%) and 20 basis points above expectations. Energy duly retreated but food prices continue to be a major issue at 15%. **Food prices have significant ramifications beyond their share in the index** (c.20% for the broader definition), as they trigger one of the most socially regressive effects – they disproportionately hurt those of the bottom of the income distribution – which may call for further costly fiscal treatment, and as frequent expenditure, their impact on overall price perceptions and hence expectations can be salient. Even if there is nothing central banks can directly do to deal with this sort of shocks – often driven by weather conditions or the lagged effect of energy prices since agriculture is one of the most energy-intensive activities- it's something they can't ignore from a forward-looking point of view.

This will compound the ECB's frustration with core inflation, which has accelerated in February, hitting 5.6%, year-on-year up from an already concerning 5.3% in January and coming out 30 basis points above expectations. There is no solace to be found in base effects: on a 3-month annualized basis, the acceleration is also visible (see Exhibit 1). There is no solace either in the sectoral breakdown. Prices in both non-energy industrial goods and services accelerated. The former is a puzzle in its own right. Given the normalization in supply lines and the end of the global shift in consumption towards goods, one could expect some deceleration there, as it has been happening in the United States (US). Two explanations can be brought forward: first, the lagged effect of the euro depreciation last year, which has affected import prices, and second the continuation of the pass-through from the energy price shock which has been stronger and more persistent than in the US. These effects are likely to gradually fade, but of course, the acceleration in services prices may reflect second-round effects from stronger wage growth, pointing to the beginning of a self-sustained process bringing further persistence.

Exhibit 1 – Up, not matter how you look at it



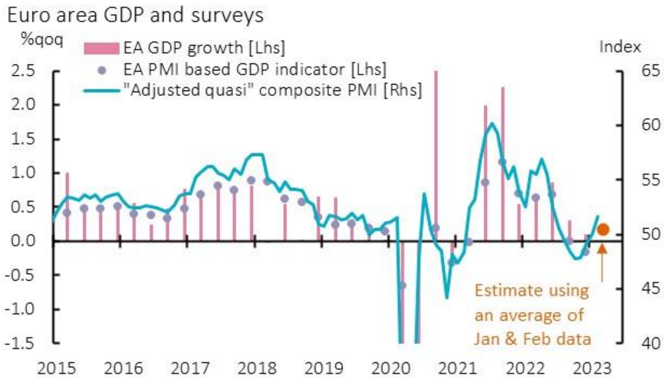
Source: European Central Bank, Eurostat and AXA IM Research, March 2023

Beware the macro-financial channel

In any case, **the slowdown in economic activity is not yet having the expected moderating impact on price behaviour, although it now emerges that GDP probably fell in the Euro area in the last quarter of 2022**. The 0.1 quarter-on-quarter gain reported in the first estimate had come as a positive surprise. Even if energy supply did not break in Q4, removing risks of a "sudden stop" in output in key sectors, business surveys were still consistent with a trip into shallow contraction (see Exhibit 2). Yet, the Euro area data had been pushed up by one of those regular bumper figures from Ireland, where GDP have first been estimated at 3.5 %qoq before being revised down by a factor 10 to 0.3%. In addition, **the drop in German GDP has been brought to -0.4%qoq in the second estimate, from -0.2% initially. All components of final domestic demand declined there**, and **the acute drop in household consumption (-1.0%) was the biggest on record since the Great Recession of 2009 if one excludes the lockdowns.** GDP did not fall into properly concerning territory in Germany at the end of last year only because inventories brought a positive contribution – which does not necessarily bode well for Q1 if a large share of this inventory build-up was involuntary – while imports crashed more than exports (-1.3% versus -0.9%), which is hardly reassuring either. The direct effect of these revisions in the two countries would send the Euro area print to -0.1%. It's not a massive difference in the great scheme of things – even if the psychological effect of hitting negative territory matters – but at least it rebuilds some trust in the relationship between the surveys and quarterly national account.

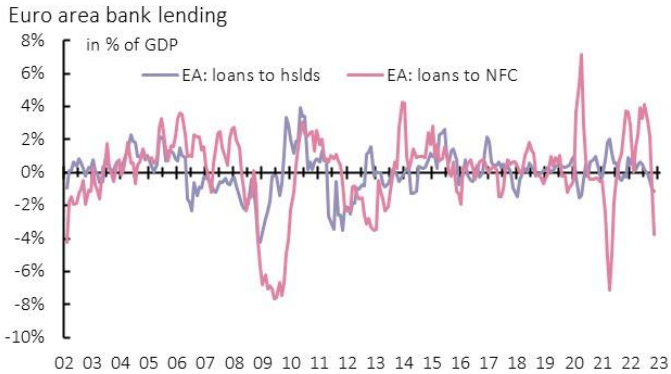
Of course, one could argue this is already "old history" and focus on the fact that technically, a recession – defined as two quarters of contraction in a row - is likely to be avoided anyway since the current dataflow is consistent with marginally positive growth in Q1 (0.2%qoq using our "adjusted PMI" relationship). Yet, we want to highlight that **the "financial side" of cyclical analysis would point to severe difficulties ahead**. We have updated with the January data our measure of the credit impulse – the year-on-year change in the flow of new loans to businesses and households. They confirm what we have already seen with the December batch: the decline in lending to corporations is very significant (see Exhibit 3).

Exhibit 2 – Short trip in contraction in Q4 2022



Source: Refinitiv and AXA IM Research, March 2023

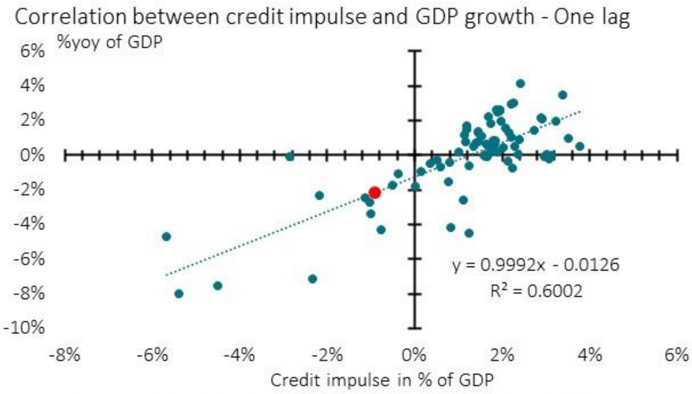
Exhibit 3 – Deeply negative credit impulse



Source: European Central Bank and AXA IM Research, March 2023

In general, the relationship between the credit impulse (summing the CI for households and businesses) and GDP is quite tight if one corrects for some volatility and exclude the pandemic period. In Exhibit 4 we compare the average over two quarters of the credit impulse (CI) with GDP growth in the next quarter from Q1 2002 to Q4 2019.

Exhibit 4 – Usually quite a decent relationship



Source: European Central Bank, Eurostat and AXA IM Research, March 2023

The fit is quite satisfying – we can explain 60% of the variance – and the elasticity is very close to 1. On the basis of this historical elasticity, GDP would fall by 2% year-on-year at the beginning of 2023 (the red "dot" on Exhibit 4). Given the carry-over it would take an unrealistic collapse in output in the coming months to get there. As things stand today, the relationship is probably noisier. Even if the bulk of the pandemic impact on credit came in 2020 and early 2021 – with the impact of the government-guaranteed schemes - base effects may still reduce the information content of the most recent values of the credit impulse. Moreover, the credit impulse focuses only on the liability side of the balance sheet of non-financial agents.

We have already suggested in Macrocast that the unusual level of liquid assets in the non-financial sector -itself a legacy of the pandemic – may blunt the effect of the tightening in financial conditions and credit contraction on spending decisions.

Yet, beyond the data noise, it is an important warning to keep in mind, and in any case what we think is clear from these figures is **that it is only at a stretch that the central bank can argue that it has brought interest rates "barely" in restrictive territory.** To quote exactly from the latest ECB minutes: "*any assessment of what level of rates could be seen as excessively restrictive was complex and uncertain, although it was generally felt that concerns of "overtightening" were premature at the present".* A risk, as always, is that "nothing happens" until the economy snaps brutally, and this data from the macro-financial channel could be a harbinger of painful developments ahead.

Housing is often the first shoe to drop – and then it hurts!

Now, it might be possible to track some more early warnings from the macro-financial channel by looking harder at the industries which are traditionally more sensitive to financial conditions. Real estate is the most obvious candidate. **We can already see cracks appearing in the countries where the housing market was particularly vulnerable before central banks started to tighten their policy, with some transmission effects over the rest of the economy.**

This may be part of the explanation behind the steep decline in GDP observed in Sweden in Q4 2022 (-0,9%) and the persistence of weak surveys in early 2023 – in contrast with the rebound seen in the Euro area. The Swedish manufacturing Purchasing Managers' Index (PMI) remained stuck at 47 in January and February and fell sharply in contraction territory in the services sector in February (45.7). The housing market there has been characterized by fast rising prices for years and a very high share of variable rate mortgages (at the end of 2022, 80% of leveraged households had a remaining rate fixation period of 2 years or less according to the Riskbank). House prices have already fallen by 16% in only 9 months, and activity in the real estate sector has plummeted (investment in construction fell by 4.8% quarter-on-quarter in Q4 2022). The economy is hit from both the direct impact of the rising interest rates on purchasing power – which compounds the effect of inflation – and the contraction of real-estate related activity.

The minutes of the **last Riskbank monetary policy meeting made it very clear the central bank is concerned about the financial stability consequences of its own action** – mentioning a rise in corporate defaults, notably in the real estate complex, potential payments difficulties for households, and the banking sector's excessive exposure to highly leveraged commercial real-estate companies. At the same time, upon delivering a 50bps hike at its last meeting, the central bank signalled the continuation of the monetary tightening, with at least another 25bps hike inQ2 implied in their forecast (to c.3,25%). This may not be enough to stem inflation though. A specific issue for Sweden has been the weakening of its currency – and the Riskbank made it plain that shoring up the kronor is one of the key reasons behind the continuation of the monetary tightening despite accumulating signs of steep deterioration in the real economy. It's a dynamic system though: if all major central banks revise up the quantum of tightening, they each need to deliver, the Riksbank will be forced to step up its own efforts to support the currency in the "zero sum" race which Maurice Obstfeld deplored a few months ago.

What is missing in the Swedish equation – and that is a general feature across the developed world – is the response from the labour market. Unemployment is quite volatile there, but Statistics Sweden produces a "smoothed, seasonally adjusted" metric which, at 7.2% in January 2023, continues to decline gently. A risk is that wage moderation – which would offset imported inflation – does not emerge before the economy is "very far gone", forcing in between the central bank to go even deeper in restrictive territory and take more risk with domestic financial stability.

There are some lessons for the UK there. True, the recent dataflow has not been as clearly awful as in Sweden. GDP merely stalled in Q4, while the Bank of England was expected a shallow contraction, but the housing market is not in a good shape. According to the Nationwide house price index, no price contraction has yet materialised in year-on-year terms, even if the deceleration has been impressive, but **the RICS survey – normally a robust predictor with a 6-month advance – is consistent with a proper fall to the region of 5% by the middle of this year** (see Exhibit 5). By historical standards, house prices are currently responding fairly quickly to the Bank of England tightening (see Exhibit 6). The knock-on effect from higher interest rates on consumers' purchasing power is probably slower to materialise than in Sweden ("only" 52% of borrowers needed to refinance within 2 years at the end of 2022 in the UK) but it will still show up nonetheless.

Exhibit 5 – UK House prices to fall

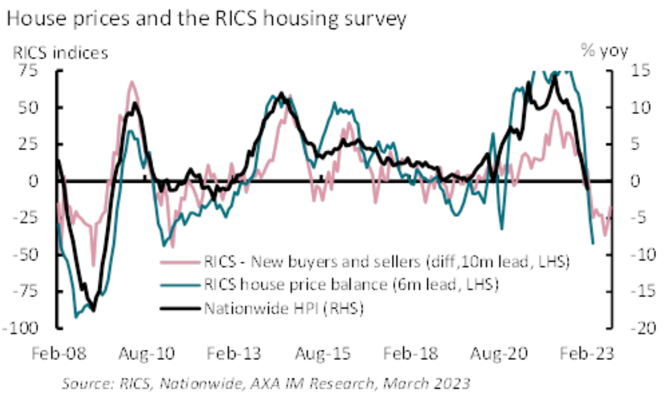
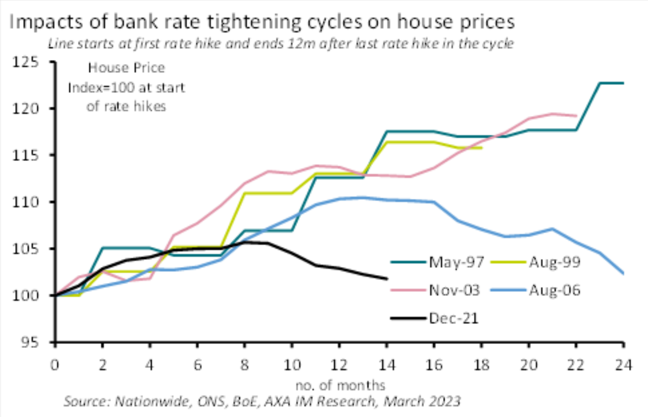


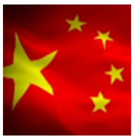
Exhibit 6 – Swift response to policy tightening this time



The Bank of England (BoE) officials are probably more confident than their counterparts on the continent that "winter is coming" and that the economy is going to significantly soften soon, which would start eroding wage-based inflation, given what is already in the pipeline. This has prompted them to publicly disagree with the market's pricing of its future trajectory. Governor Bailey's latest message – although convoluted in its formulation – was quite explicit about the possibility the Bank of England might already be "done", by stating that *"I would caution against suggesting either that we are done with increasing bank rate, or that we will inevitably need to do more"*.

To continue with the Swedish "laboratory experiment", an issue though is that, if the Bank of England decides to steer its own course and keep policy rates unchanged while the Federal Reserve (Fed) and the ECB continue into mid-2023, further bouts of GBP weakness are probably unavoidable, which may fuel imported inflation further and prove ultimately unsustainable. Compared with January 2022, the British currency is down 11.3% against the US dollar, almost twice as much as the euro (-6.6%). After Andrew Bailey's statement Sterling fell below 1.20 against the dollar again. **The Bank of England may be counting of the dataflow turning sour in the rest of Europe and the US in the second half of the year to give them cover** (for our part we expect the BoE to cut before year-end) so that policy divergence would only be temporary. This would be a rational consequence of considering that the United Kingdom (UK) – like Sweden – are the "canaries in the coal mine": monetary policy transmission may be swifter, particularly because of the structure of the housing market there, and pain will be felt earlier, but ultimately, the global tightening will end up affecting everyone in the global economy.

Where does this leave the ECB? In the very short run, the inflation figures for February vindicate the Governing Council's decision to signal its intention to deliver another 50bps hike in March. The minutes of the February meeting revealed some disagreement around this, with some members pointing at some signs that core inflation was slowing down – even if eventually the decision was "consensual". The doves' calls for prudence are very likely to be ignored. Next week, we will cover in more details what we expect from the next ECB meeting, but it's already clear that our call for a terminal rate at 3.25%, even with 3.50% as a substantial upside risk, looks optimistic. Yet, with the Governing Council tempted by additional tough moves – e.g., keeping a 50bps quantum in May and signalling further hikes well into the second half of the year – we feel that the risk of a "double dip" scenario is also gaining ground. We continue to see the latest developments in the macro-financial channel as clear signs that the tightening is getting its way through the economy, even if it has not yet hit aggregate demand and inflationary pressure in a spectacular fashion. While transmission may be *slower* than in the UK or in Sweden because of the structural features of the Euro area economy – with the dominance of conservative lending practices and fixed rate mortgages in many member states – it does not necessarily mean that down the road the impact is *smaller*.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Yields rise with 10-yr and 30-yr yields exceeding 4%, 2-yr yields approach 5% • ISM index (Feb) rises to 47.7, new orders much firmer at 47.0. Chicago PMI weakens to 43.6 • Vehicle sales (Feb) fall back to 14.9m from 15.7m • Consumer confidence (Feb) headline falls to 102.9, important expectations index heads to last June's lows • Pending home sales (Jan) bounce 8.1%mom, recent mortgage applications fall 3rd consecutive week	• Labour market report (Feb) – following a blow out 517k in January, figure scrutinised for any revision or payback. Average earnings also watched • Fed Chair Powell semi-annual statements to Congress for clues to policy outlook • JOLTS survey (Jan) vacancies recorded a surprising rise in Dec, in contrast to other measures which fell • Factory orders (Jan) headline expected to fall • Monthly budget statement (Feb)
	• Flash EMU headline HICP (Feb) slightly declined, reaching 8.5%yoy (-0.1pp), but above expectations. Food and core prices (5.6%, +0.3pp) remain strong • Loans to households and NFC (Jan) eased again • Whole set of EC surveys (Feb) is broadly stable after improvement observed in Jan. Selling prices substantially declined. Final PMIs (Feb), slightly lower than flash, producer prices (Jan) down by -2.8%mom	• EMU Retail sales (Jan) should rebound but worth having a look at revised Dec value too as the drop was significant • Ge and Sp industrial production (Jan) after a downside surprise in Fr (-1.9%mom in Jan, driven down by mostly all components). France may be an exception there as energy cost surge occurred in Jan and months after the others
	• Windsor framework unveiled – new NI protocol deal • Housing market continues to slow, Nationwide house prices -1.1%yoy (Feb) and mortgage approvals down • Gov Bailey speech viewed by markets as dovish – signalling further tightening not forgone • BRC shop prices rose in Feb, with food up 14.5%	• Further developments on Windsor framework and DUP response to the deal • GDP (Jan) expected to rise 0.1% following improvement in activity indicators • Halifax house prices (Feb) • RICS Housing survey (Feb)
	• Tokyo CPI (Feb) core (ex frsh food) slowed sharply to 3.3% from 4.3% as expected as gvm't subsidies kicked in. But ex-energy core still rising (to 3.2% from 3.0%) • Retail sales (Jan) rose 6.3%yoy above expectations and consumer sentiment edged up in Feb • IP (Jan) fell by a steep 4.6%mom	• BoJ MPM (Thu-Fri) last under Gov Kuroda, all policy tools expected to be left unchanged • Current account and trade balance (Jan) • Q4 GDP figures could be revised down due to weaker capex highlighted in MoF survey • PPI (Feb)
	• PMIs (Feb) rebounded sharply underscoring tepid recovery in both manufacturing and services sectors • PBoC press conference reiterated policy to remain growth supportive	• Feb. aggregate financing • Feb. inflation data expected to show slowdown post CNY holiday effect; last prints CPI +2.1%yoy, PPI -0.8%yoy • National People's Congress to kick off on Mar-5, Beijing will announce 2023 economic targets and policy focuses, new Premier and economic team to be sworn in
	• CB: Hungary stood on hold at 13.0% • Q4 GDP (%yoy) moderated in Brazil (1.9%), India (4.4%) & Turkey (3.5%) • Feb CPI (%yoy) eased in Malaysia (3.7%) & Turkey (55.2%). It was stable in Peru (8.7%) & rose in Indonesia (5.5%) • Feb PMIs: Mixed results in CEE and overall improvement in EM Asia	• CB: Malaysia (2.75%), Peru (7.75%) & Poland (6.75%) expected to stay on hold • Feb CPI: Chile, Colombia, Egypt, Hungary, Korea, Mexico, Philippines, Taiwan & Thailand • Q4 GDP: Romania & S. Africa • Jan Ind. Production: Hungary, India & Turkey

Upcoming events	US:	Mon: Durable goods order (Jan), Factory orders (Jan); Tue: Fed Chair Powell's semi-annual testimony; Wed: ADP employment chg (Feb), Trade balance (Jan), JOLTS (Jan), Fed's Beige Book (Jan); Thu: Weekly jobless claims (4 Mar); Fri: Non-farm payrolls (Feb), Average earnings (Feb), Average weekly hours (Feb)
	Euro Area:	Mon: EU20 Retail sales (Jan); Tue: Ge New manf. orders (Jan), Sp Ind. prod. (Jan); Wed: EU20 GDP (Q4), Ge Ind. prod. (Jan); Fri: Ge HICP (Feb), Ge CPI (Feb)
	UK:	Mon: SMMT new car registrations (Feb), Construction PMI (Feb); Tue: BRC Retail Sales Monitor (Feb), Halifax HPI (Feb); Thu: RICS Housing Survey (Feb); Fri: Monthly GDP (Jan), Indx of services (Jan), Ind. prod. (Jan), Manf. & Construction output (Jan), Trade balance (Jan), Trade in goods (Jan)
	Japan:	Tue: Current account balance (Jan), Trade balance (Jan); Wed: Economy Watchers Survey (Feb), Leading indx (Jan), GDP (Q4); Fri: BoJ policy announcement
	China:	Tue: Trade balance (Feb), Exports & Imports (CNY) (Feb), Foreign exchange reserves (Feb); Thu: CPI (Feb)

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