179 – 8 May 2023

Investment Institute Macroeconomics

How Far to Diverge

- The Fed has probably hit peak policy rate, we expect two more 25bps hikes from the ECB
- Euro area core inflation may be stickier than in the US, but some "policy patience" may be warranted there

Last week's communication from the Fed and the ECB points to a divergence in the months ahead. We think the "soft hiking bias" the Fed retains is largely driven by a so far unsuccessful attempt to stop the market from pricing future rate cuts even more aggressively. The mention of an "additional firming" of monetary policy in the US no longer is the "statement of intent" it was last time, and there was enough in Jay Powell's comments to hint at a pause. On the other side of the Atlantic, Christine Lagarde's mention in the press conference that the ECB has "more ground to cover" told us that they are not "done". Our baseline is that the Fed has indeed reached the peak of its monetary tightening in this cycle, while we expect from the ECB two more 25bps hikes to a terminal rate of 3.75%, with a significant risk it goes to 4%. In our own forecasts core inflation in the Euro area will not decelerate markedly before the end of the summer, and this is clearly crucial in the ECB's current reaction function.

Yet, from a "normative" point of view – what we think the ECB should do, rather than predicting what it will do – we are worried. The ECB is taking the deterioration in credit origination seriously – this was key in their decision to opt for 25bps rather than 50 last week – but seems yet unconvinced this will have a serious enough impact on the real economy to take core inflation durably down. The saving buffers accumulated by the private sector since the pandemic may delay the transmission of tougher credit conditions to spending decisions, but this protection cannot be eternal. The US remains the epicentre of a "banking turmoil" which keeps on re-appearing, but the decline in credit demand from the private sector in the Euro area is a concerning signal. The shape of the yield curve in the Euro area has become very similar to the US one. The bond market may be signalling that if the US gets into recession, it will be difficult for the Euro area to avoid one. This brings a clear limit to the scope of policy divergence beyond the next few months. Sticky inflation in the Euro area may reflect a slower reaction to macro conditions than in the US, not necessarily a difference in the ultimate sensitivity to the cycle.

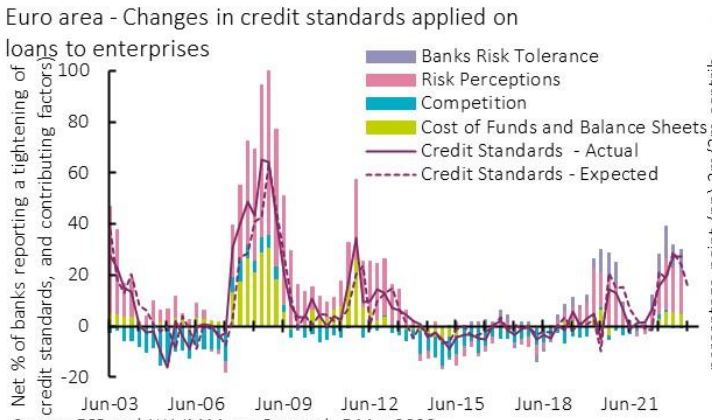
The ECB is taking the deterioration in credit seriously (as it should) …

Among many others, there was one moment in Christine Lagarde’s Q&A last week which we found particularly interesting: the explicit acknowledgement that the new batch of the Bank Lending Survey (BLS) had a meaningful impact on the Governing Council’s decision to slow down its hiking pace to a 25bps clip. It seems the European Central Bank (ECB) feels it can afford to proceed more slowly now that evidence is accumulating that its *“past rate increases are being transmitted forcefully to the Euro area financial and monetary conditions.”* **The Governing Council is finally reassured to see that its cumulative tightening is not operating “in a vacuum” but is having a tangible impact on banks’ behaviour.**

Our own expectations about the April batch of the BLS were so low that we found positive surprises in the data. That banks expect less tightening in lending standards in the months ahead, as if they were treating the last few weeks as a temporary situation, was not a given. We were also expecting a higher contribution of the banks’ own cost of funding to the tightening in lending conditions, while the primary driver has been a change in banks’ risk perception and risk tolerance, i.e., developments which are “external” to the banking sector itself – reflecting a change in the way they assess borrowers’ credit worthiness (see Exhibit 1). We thought that with the emergence of a premium on banks’ funding costs on both sides of the Atlantic since the demise of Silicon Valley Bank (SVB) and Credit Suisse, together with the usual effect of higher interest rates, a stronger impact on banks’ lending appetite would appear.

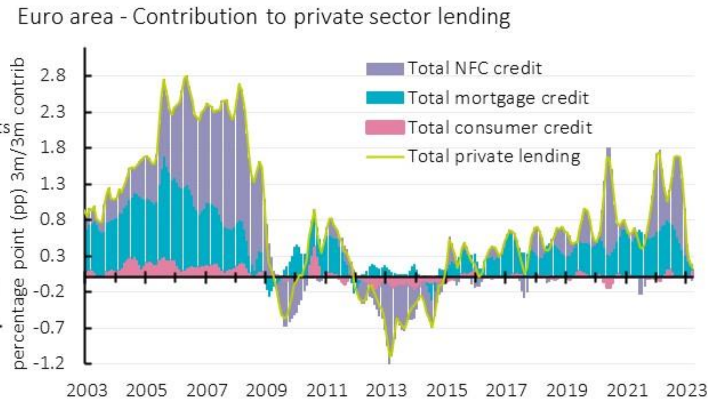
Yet, **what may be spooking the ECB even more than the last BLS could be the figures on actual loan origination for March, also released last week**. We have been drawing our readers’ attention on this ad nauseam since the beginning of the year: lending flows have been drying up in the Euro area months before the banking turmoil emerged in the United States (US). We usually focus on the credit impulse to gauge this, but this year-on-year change in loan flows metric may still be “polluted” by the aftermaths of the pandemic. To vary the angles, in Exhibit 2 we look at the contribution of each big component of credit to the overall lending to the private sector on a 3-month basis. The recent decline is plain to see – even if not as bad as during the Great Financial Crisis or the Euro area sovereign turmoil which followed it – and is generalized across sectors: the origination of mortgages and loans to firms has stalled.

Exhibit 1 – Risk perceptions drive tighter lending standards



Source: ECB and AXA IM Macro Research, 5 May 2023

Exhibit 2 – All components contribute to lower loan origination

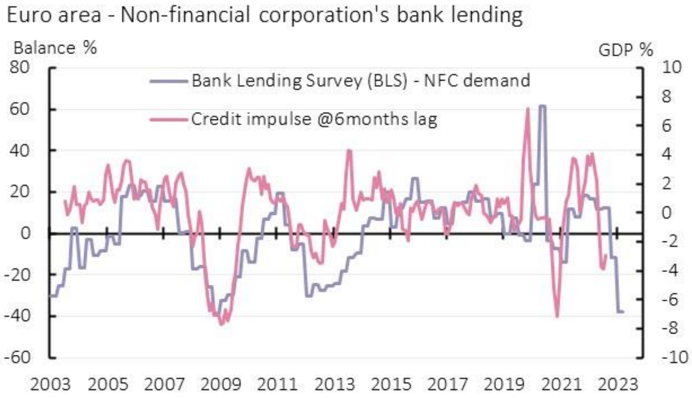


Source: ECB and AXA IM Macro Research, 5 May 2023

There is not much in the pipeline which could convince the ECB it is not a “blip”. Indeed, offsetting in our view the fact that banks are a tad less nervous about their credit standards in the months ahead, they are also – according to the BLS – convinced that demand for credit from the private sector is collapsing. This matters a lot. Indeed, it is probably tempting for many members of the ECB Governing Council to treat the banking turmoil as a “mostly American issue” with few ramifications for their side of the pond – Christine Lagarde reiterated in the Q&A her view that the structural features of the two banking systems differ significantly. However, **if demand for credit is falling, then even without the emergence of difficulties intrinsic to the Euro area banking sector the economy will slow down. This should be a serious source of concern**.

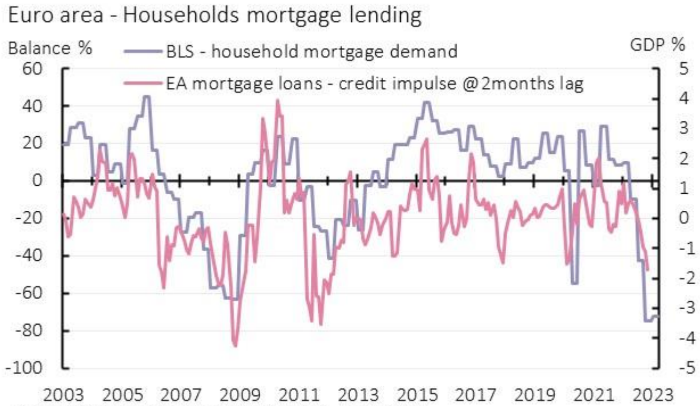
Indeed, based on the experience accumulated since 2003 – when the data became available – the demand component of the BLS has been a more than decent predictor of actual credit origination for both households and non-financial corporations (see Exhibits 3 and 4) with a few months lag.

Exhibit 3 – The BLS demand-side is a good predictor…



Source: ECB and AXA IM Macro Research, 5 May 2023

Exhibit 4 – … of actual loan origination



Source: ECB and AXA IM Macro Research, 5 May 2023

Yet, in the Q&A **Christine Lagarde introduced a key distinction between two "legs" of monetary policy transmission.** The first one goes from policy action to monetary and financial conditions – and that leg is working properly, judging by credit developments. The other leg goes from those developments in the "financial sphere" to the real economy. And this is where the ECB clearly considers that the "jury is still out". Habitual readers of Macrocast will be familiar with your humble servant's unhealthy obsession with "chained uncertainty": we never know exactly when the market starts reacting to policy signals, then we don't know how quickly market changes have an impact on economic agents' spending decisions, finally it's unclear how swiftly this change in spending decisions can impact inflation.

Re-reading carefully last week's prepared statement and Lagarde's Q&A, we were struck by the number of "fence-sitting" comments on the macroeconomic situation. The ECB saluted the strong showing of the business surveys, but also contrasted it with the less than cheerful message from the mediocre 0.1% GDP gain in Q1. In a similar vein, the ECB highlighted the strength of job creation and the continuing decline of the unemployment rate, but also mentioned that the average working time still has not returned to the pre-pandemic level. It seems the central bank is waiting to be certain the monetary tightening already visible in the credit data will show up in a meaningful deterioration in aggregate demand which will help get inflation durably down. "Fence sitting" may become very untenable in June when the ECB releases its next forecasts, but even then, recent episodes would suggest that the Council has come to take these projections with a very large pinch of salt.

We were surprised that there were no more questions during the Q&A on this disconnect between credit and aggregate demand. In our opinion, the fact that the ongoing monetary tightening is occurring against a background of comfortable liquidity buffers accumulated by businesses and households during the pandemic may delay the impact of a decline in new credit on aggregate spending. Yet, this would not be *permanent* and as such should not be a reason to necessarily continue hiking. This gets us back to the non-linearity theme**. If one waits for the buffers to be depleted to consider that monetary conditions are *"restrictive enough*", it may well be the point when they have actually become "too restrictive".**

But also spooked enough by inflation to refuse to pause

Yet, **Christine Lagarde made no secret that the ECB intends – or at least expects – to continue hiking.** The first reaction of the market just after the policy statement was issued and before Christine Lagarde started speaking was dovish. Indeed, while the gear downshift from 50 to 25bps was the baseline – with a low level of confidence – investors were probably expecting this concession from the hawks to come with a bigger price tag in the form of an explicit forward guidance signalling more hikes ahead. There was one in fact, but it was probably more subtle than what the market was expecting. The key was there: *"Our future decisions will ensure that the policy rates will be brought to levels sufficiently restrictive to achieve a timely return of inflation to our two per cent medium-term target".* "Will be brought" supposes some additional action. Christine Lagarde was then more explicit in the Q&A by repeating several times that the ECB has "*more ground to cover*."

The ECB's hiking intentions – which contrast with the Federal Reserve (Fed)'s non-committal hiking "bias" we will discuss in the next section – are driven by the stubborn behaviour of core inflation. True, core inflation slowed down by 10bps in April but our preferred "core momentum" approach (looking at the 3-month annualized change) provides no comfort (see Exhibit 5). As long as there is no clear evidence underlying inflation is not decelerating durably, the ECB will not want to stop. This gets us back to a point we have made in the past weeks: given what is in the pipeline**, we don't expect core inflation to slow down in a tangible manner before the end of the summer (see Exhibit 6). This is what in our view "seals the deal" for two more 25bps hikes and a terminal rate at 3.75%,** with a significant risk 4% is hit.

Exhibit 5 – Still looking for a proper decline in core

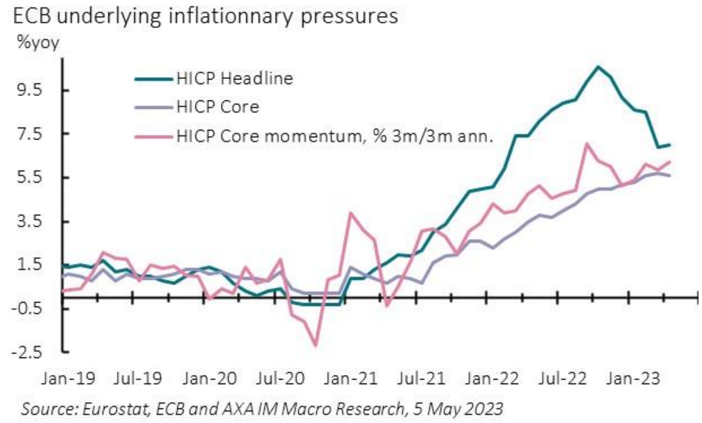
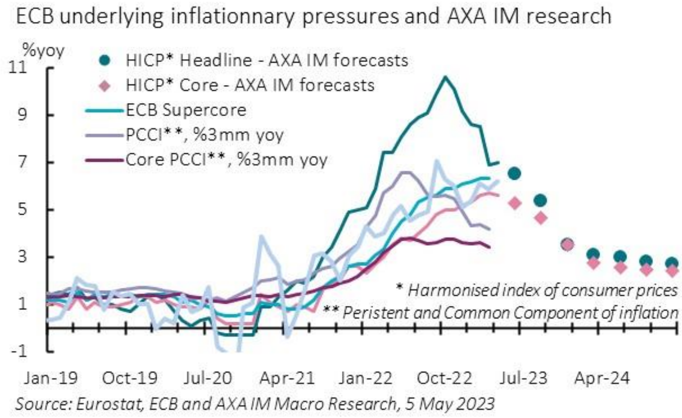


Exhibit 6 – We may have to wait until the end of summer



Christine Lagarde denied that the decision to combine an acceleration of Quantitative Tightening (QT) – Asset Purchase Programme (APP) reinvestments will stop in July – was a "deal" to secure 25bps against the hawks' push for a bigger move. It may be that doves and hawks are equally impressed by the resilience of the European bond market to the first phase of QT. We note however that the central bank chose to give itself some leeway in case market conditions were to deteriorate – possibly as a side-effect of an extension of US banking turmoil. Indeed, the ECB "*expects*" reinvestments to stop, which is less committal than "*intends*".

The Fed's optionality

The Fed was in a more comfortable position to hint at a pause since core inflation has started to recede. The mediocre GDP reading for Q1, combined with lingering difficulties in regional banks, sealed the deal in our opinion. Yet**, it is a very considered "pausing signal" which we got from the Fed**. Indeed, the Federal Open Market Committee (FOMC) did not remove entirely the mention that "additional firming of monetary" may be needed. It downgraded it, made it optional, a possibility which may or may not be used depending on the data flow, rather than the statement of intent it was at the previous meeting. To quote their exact words, the Fed will determine *"the extent to which additional policy firming may be appropriate"*, by taking "*into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments*". We think there are fundamental and tactical reasons behind the choice of retaining a "tightening bias" even if it is a soft one.

Fundamentally, the Fed cannot be certain that the current improvement seen in the inflation data is durable given the pressure which is still plain to see on the labour market. Employee earnings surprised to the upside again in the April payroll data released last week and reaccelerated (see Exhibit 7). Coming after the acceleration in the Employment Cost Index released the week before, there is probably enough to keep the FOMC on its toes. Maintaining the idea that a pause is not a given thus makes sense given the balance of risks.

However, wage growth tends to be an even more lagging variable than headcount. Even if the headline number for employment growth in April also surprised to the upside last week, **when smoothing the data over several months, it is quite clear that hiring is slowing down, finally converging to the pre-pandemic trend** (see Exhibit 8). From this point of view, we could say that the US might now be more advanced than the Euro area in the "second leg" of monetary transmission we discussed earlier. It's still tenuous, but if the job market continues to weaken, the Fed could simply count on the lagged impact of the accumulated monetary tightening to deliver the inflation landing it seeks. Maintaining the current level of monetary tightness for long, rather than raising it further, is probably appropriate. But **explicitly announcing a pause could trigger a market-led loosening in financial conditions which could jeopardize the effect of policy action.**

This is where tactical considerations probably get into play. Maintaining a "soft tightening bias" may reflect the Fed's willingness to convince markets to stop pricing more rate cuts in the second half of the year. This has failed so far though: money market forwards are now already pricing a rate cut as soon as July. What the market is thus counting on is a very swift turnaround in monetary policy, in a space of just a few months, at odds with the usual practice of the Fed. The resumption of the banking turmoil, with more regional banks struggling in the equity market, is probably a key ingredient in this aggressive pricing.

Exhibit 7 – Wages aplenty in US

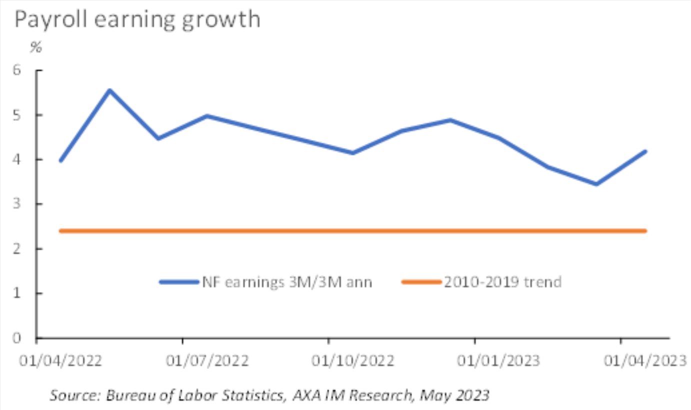
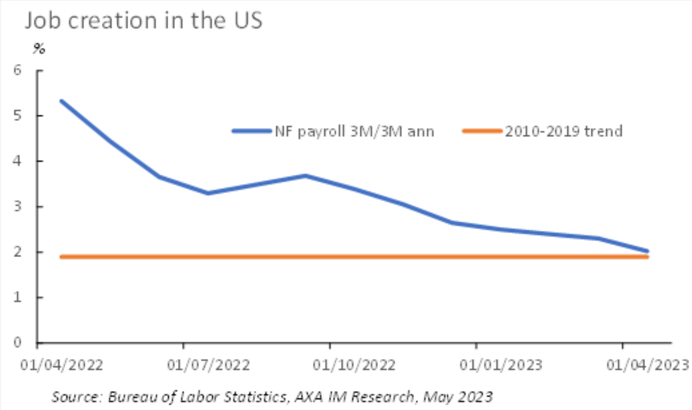


Exhibit 8 – But hiring is gently but regularly softening



We think the Fed has reached the peak of its tightening in this cycle, consistent with our view that, when taking the macro ramifications of the ongoing banking turmoil, a mild recession by the middle of the year is very plausible. It may however take time for the Fed to explicitly acknowledge it has entered a pause, and we continue to think the market is too impatient in its pricing of rate cuts.

Bond markets call a re-convergence of US and European monetary policy within a year

Christine Lagarde sounded non-plussed when asked during the Q&A about the diverging trajectories of the Fed and the ECB. The Governing Council seems to be comfortable with this, and the market is indeed – for the short-term – convinced that the two central banks will indeed diverge, at least when looking at forward contracts on the money market. In contrast with the US where rate cut pricing has gone in overdrive since last week, in the Euro area, a terminal rate between 3.50 and 3.75 for July followed by stability until the end of the year is expected.

This pricing is in our view completely justified by the signals coming from the ECB, and we mentioned in the first section of this note our own baseline of two more 25bps hikes. But this is the result of our predictive analysis – what we think the ECB *will* do. From a normative point of view, what we think the ECB *should* do, we are circumspect about the absolute need of pushing policy rates higher, and we take the risk that they go too far seriously.

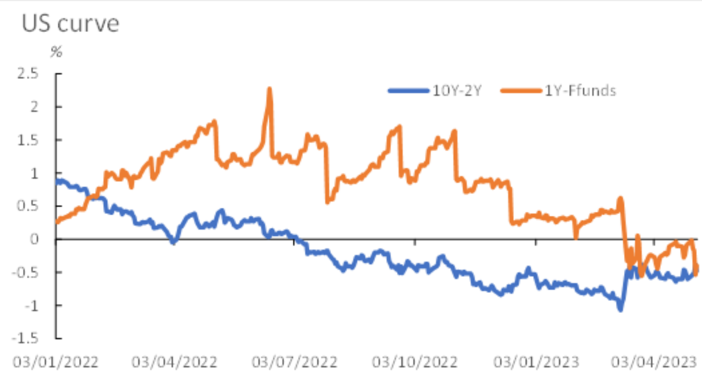
True, even if the ECB hikes up to 3.75%, the overall rise in policy rates from trough would be smaller (4.25%) than in the Fed's case if it stops here (5%). Yet, evidence of excess demand is more plentiful in the US than in the Euro area, which for instance is not dealing with a lingering labour supply deficit – the participation rate *rose* there – and was more measured in its fiscal stimulus efforts. A significant gap thus looks legitimate. A popular view considers that, given the ECB's extremely accommodative starting point – while the Fed never ventured into negative rates – it's normal that it would still have more "ground to cover". Our view on this has always been quite simple: the difference in potential GDP growth between the US and the Euro is routinely estimated at 0.5 percentage point (c.1.25% versus c.1.75%), which would be consistent with a gap in the equilibrium interest rate of also 50bps. That at the worst of the deflation risk the ECB's policy rate stood at -0.5% against 0-0.25% for the Fed would thus stand to reason and did not reflect a particular "dovish bias" at the time by the ECB which would need to be offset now.

The ECB's clear preference for continuing to raise rates is deeply rooted in the absence of clear signs of deceleration in core prices, in contrast with the US. **The root cause of the divergence in inflation dynamics across the Atlantic should however matter for monetary policy setting. Price stickiness can mean very different things.** In one configuration, "sticky prices" reflect a *low sensitivity* of prices to changes in macroeconomic conditions. In another, they simply reflect a *slow adjustment speed* (in clear terms, it takes a while, but we will finally get there). The latter could merely be due to different modes of organization of consumer goods markets, or to the transmission lags of monetary policy.

In the first case, the policy recommendation is straightforward: monetary policy needs to be tougher, to bring about a large enough deterioration in aggregate demand which will finally bring inflation where it should be. This would be consistent with Christine Lagarde's message on monetary conditions not being restrictive enough yet. The second case simply calls for patience, at least as long as long-term inflation expectations are not de-anchored. Deciding between the two cases is difficult in real time, but it seems that for now the ECB is more focused on case 1 than case 2.

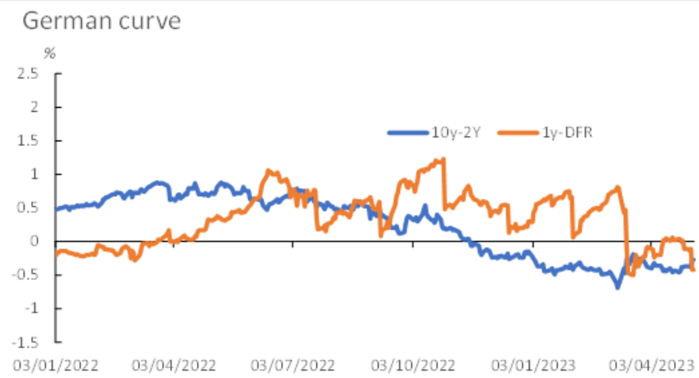
The ECB is worried, which makes it impatient, but if it's only a matter of time before core inflation slows down, then the risk of policy overshooting is high. This is what the bond market may already be pricing. If instead of looking at forward contracts on the money market to gauge the market pricing of the next central banks' decisions, we look at the bond market, then the gap between the yield on a one-year government bond and the ECB's and Fed's policy rate is intriguingly close, at c.50 basis points. **It may come a bit later, but ultimately the market's collective wisdom signals that the ECB will be forced to cut rates in a context of recession.** Further into the curve, we note that the 10-year to 2-year spreads has also become very similar across the Atlantic. This is normally associated with the market pricing a recession.

Exhibit 9 – The shape of the yield curve…



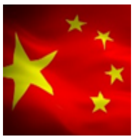
Source: Macrobond, AXA IM Research, May 2023

Exhibit 10 – …is getting very similar across the Atlantic



Source: Macrobond, AXA IM Research, May 2023

What the bond market may be simply reflecting is that if a recession is now very plausible in the US, it would be very difficult for the Euro area – which has become even more reliant on net exports these last two quarters – to avoid one as well. With a US recession, global disinflationary forces will be at work – e.g., on the energy front – helping to dampen domestic inflationary forces in the Euro area.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• FOMC raised FFR 0.25% to 5.00-5.25%, removed "additional tightening likely", but did not state pause. • Banking stresses re-emerged in the wake of First Republic failure. S&P banks index -13% wk to Thurs. • Labour market data (Apr). Payrolls growth rose to 253k, from a revised 165k. Unemployment dipped to 3.4%. Earnings rose by 0.5%mom. JOLTS (Mar) fell to 9.6m. Challenger job cuts eased to 176%yoy. • Vehicle sales (Apr) rose to 15.9m (ann) – a 2 year high.	• CPI inflation (Apr) headline expected unchanged at 5.0% in part on rebound in gasoline, core f'cast to dip to 5.4% from 5.6% • Senior Loan Officers Survey (May) to see scale of credit conditions tightening after Powell comments. • Fed's H.8.1 bank deposit release for signs of stability • PPI inflation (Apr) annual disinflation should persist • U Mich sentiment (May, p) 5-10yr inflation expectations rose in Apr adding to pressure on rates
	• The ECB delivered a hawkish 25bp rate hike as we expected, guiding towards further rate hikes in line with our baseline terminal rate at 3.75%. APP reinvestment to be stopped from July. • Euro area "flash" core inflation edged down 0.1pp to 5.6%yoy in April in line with our forecasts but 3m/3m momentum shows no signs of rolling over.	• Final April HICP inflation releases for member states. • March industrial output for member states. • Governors' speeches in wake of last week's ECB decision.
	• Early results for Local elections in England suggest heavy Tory losses. • Nationwide house prices (Apr) rise 0.5% following seven consecutive months of declines. • BoE lending data (Mar) M4 down 0.6%mom but cons credit growth and mortgage approvals picked up.	• BoE May meeting – we expect 25bp hike to 4.5% where we expect MPC to pause. • May MPR to provide updated economic projections, to be watched amidst recent strength in inflation. • GDP (Mar/Q1) we expect growth to remain flat, with risks to the upside (cons 0.1%).
	• IMF warned of "uncertainty" over the direction of Japan's monetary policy and the potential spillover to global markets. • Monetary base (Apr) down 1.9%yoy • Consumer confidence index (Apr) continues to rise amidst continued recovery	• Economy watchers survey 9 Apr) • Leading index (Mar) • Household spending data (Mar) • Current acct and trade balance (Mar)
	• Headline PMI retreated in April for both Caixin (49.5) and NBS (49.2) manufacturing PMIs, below the 50-threshold	• CPI and PPI for April to remain weak(er) • Exports growth to slow in April, as suggested by PMI export orders, from strong March reading post CNY • Slower activity in April yet acceleration on yoy for IP, retail sales, FAI due to supportive base effects
	• CB: Malaysia surprised markets hiking +25bps to 3.0%. Brazil kept its policy rate unchanged at 13.75% • Q1 GDP (%yoy) remained stable at 5% in Indonesia • CPI (April) fell in Korea (3.7%), Indonesia (4.3%), Thailand (2.1%), Turkey (43.7%) & Peru (8.0%) • Korea exports growth (%yoy) fell further to -14.2%	• CB: Chile (11.25), Peru (7.75%), Poland (6.75%) & Romania (7.0%) to stay on hold • CPI (Apr): Brazil, Chile, Czechia, Hungary, India, Mexico & Romania • Q1 GDP data in Malaysia & the Philippines • Ind prod (Mar): Brazil, Colombia, Mexico & Turkey

Upcoming events		
	US:	Mon: Wholesale inventories (Mar), SLOOS; Tue: NFIB small business optimism (Apr); Wed: CPI (Apr); Thu: PPI (Apr), Weekly jobless claims (6 May); Fri: Michigan consumer sentiment & inflation expectations (May)
	Euro Area:	Mon: Ge Ind Prod (Mar); Wed: Ge HICP (Apr), CPI (Apr), It Ind prod (Mar); Fri: Ge Current account (Mar), Fr HICP (Apr), It Fitch review of Italy's rating, Sp HICP (Apr)
	UK:	Tue: BRC Retail Sales Monitor (Apr), Halifax house price (Apr); Thu: RICS Housing Survey (Apr), MPC announcement and MPR; Fri: GDP (Q1), Business investment (Q1), Private consumption (Q1), Monthly GDP (Mar), Index of services (Mar), Ind prod (Mar), Manf output (Mar), Construction output (Mar), Total trade balance (Mar), Trade in goods (Mar), BoE MPR
	Japan	Wed: Leading index (Mar); Thu: Trade balance (Mar), Current account balance (Mar), Economy Watchers Survey (Apr)
	China:	Tue: Exports (Apr), Imports (Apr), Trade balance (Apr); Thu: CPI (Apr)

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