242 – 7 October 2024

Investment Institute Macroeconomics

Best Laid Plans Go Awry

- The Fed will have to dial down on “jumbo cuts” given new evidence of resilience in the real economy
- The ECB is warming to the idea of “back-to-back” cuts
- Some central banks may have to resort again to unconventional policy – the SNB is a natural candidate

While they both converted to “restriction removal”, it seemed until last week that the Fed and the ECB had laid out different plans, the Fed opting for a decisive, pre-emptive path, while the ECB was choosing a more prudent, data dependent and meeting-by-meeting approach. Yet, the employment report released last week provided more evidence that the softening of the US economy is proceeding at a glacial pace, while Christine Lagarde’s latest testimony at the European parliament expresses a readiness to engage in back-to-back cuts, the Governing Council – even its hawkish wing – getting more concerned about the deterioration of the real economy.

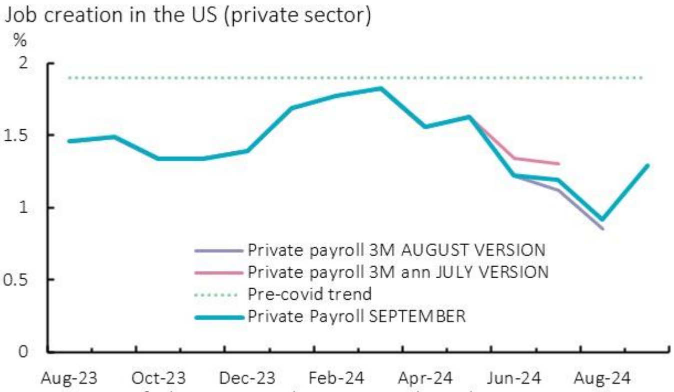
We think the payroll report for September “killed” the probability of a 50bp cut in November in the US. Still, given the FOMC’s willingness to act pre-emptively, even in the absence of glaring signs of an economic downturn, the most plausible scenario in our view is that the Fed continues to lower its policy rate by 25bp increments, while leaving the terminal rate above its long-term level, as long as inflation continues to behave. Yet, we also continue to think it remains very difficult to predict with any accuracy the Fed’s trajectory in 2025 before the US elections, given the binary nature of the policy proposals in terms of inflation risks. On the other side of the Atlantic, we think the most plausible trajectory for the ECB is to cut by 25bp increments at every Council meeting until June 2025 and the neutral rate, close to 2%, is hit. For the ECB to dip in properly accommodative territory, a “clear” recession would need to materialise. There is still a chance this can be avoided.

We also take a hard look at Switzerland. Indeed, while the ECB would still retain some decent room for manoeuvre to avoid having to resort again to unconventional monetary policy instruments even in case of full-blown recession, the SNB may not have that luxury. Another “balance sheet ballooning”, triggered by massive FX intervention, could be necessary there once the meagre room left for rate cuts is exhausted.

What a difference one release made…

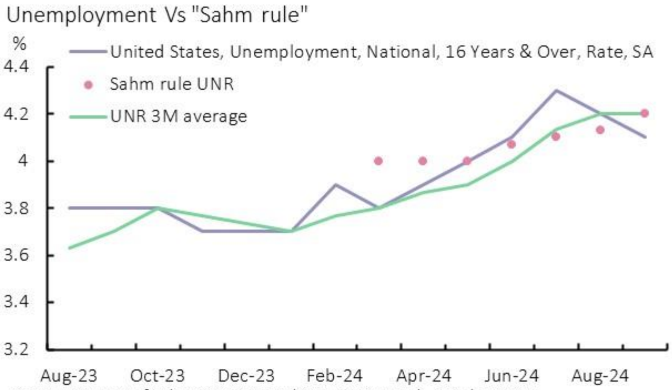
"Confirmation bias" is a common ailment among economic commentators, and while we endeavour to fight it, habitual readers of Macrocast may have detected some instances which your humble servant has fallen in that trap. That said**, we do not think we are wrong to find in the September payroll print some evidence that the Federal Reserve (Fed) has "jumped the gun" by inaugurating its easing phase with a 50bp cut**. We had already noticed the message from unemployment claims and business surveys, but it took the release of the employment survey for the market to re-assess its enthusiasm on the speed and depth of the Fed's accommodation. Job creation has rebounded, posting a 1.3% gain on a 3-month annualised basis (see Exhibit 1), but beyond this, what is striking is the overall – and unusual – consistent nature of last week's print: employment accelerated, the unemployment rate fell (by 0.1pp on the month) and wages re-accelerated (4.3% from 4.1% in August for hourly pay on a 3-month annualised basis).

Exhibit 1 – Job creation rebounds



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

Exhibit 2 – Barely at the "Sahm point"



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

The unemployment rate stabilised on a 3-month average basis, which means that it now barely hits the "Sahm point" (see Exhibit 2), and the overall message of the payroll print is that of ongoing resilience of the US economy. Given the decline in headline inflation**, the gains in wages should provide some protection against an abrupt correction in consumer spending.** True, it is always a risk to draw too many conclusions from one payroll print given the propensity of this indicator to be sometimes massively revised, but the September report is likely to be "cleaner" than the October one which will be released a week before the Federal Open Market Committee (FOMC) meets again on 6-7 November, given the noise from the strikes at Boeing and on US docks.

The market has immediately revised down its expectations for the FOMC meeting in November, pricing as of Friday evening a 99% probability of a 25bp cut, from a 75% probability of a 50bp cut at peak on 24 September. Since we were not comfortable with the first 50bp cut in the first place, we think the market movement makes a lot of sense.

The real question now is how much of a complete revision in the Fed's trajectory is warranted. We remember that the Fed's decision in September was aimed at *avoiding* a hard landing *ahead*, instead of taking the risk of unwittingly triggering one by maintaining monetary conditions too restrictive for too long, which suggests they do not necessarily need glaring evidence the economy is softening before acting. There seemed to be a wide consensus in the FOMC around the fact that policy had been overly tightened anyway – we may get more colour on this this week with the release of the minutes of the meeting. In addition, while job creation has rebounded, its growth rate remains visibly below the pre-pandemic trend. We think **the most plausible scenario is that the Fed continues to lower its policy rate by 25bp increments, while leaving the terminal rate above its long-term level, as long as inflation continues to behave** (the September print for the CPI out this week will deserve some attention). In any case, we continue to think that it is next to impossible to correctly predict the Fed's course next year before the US elections, given the binary nature of the policy proposals when it comes to inflation risks.

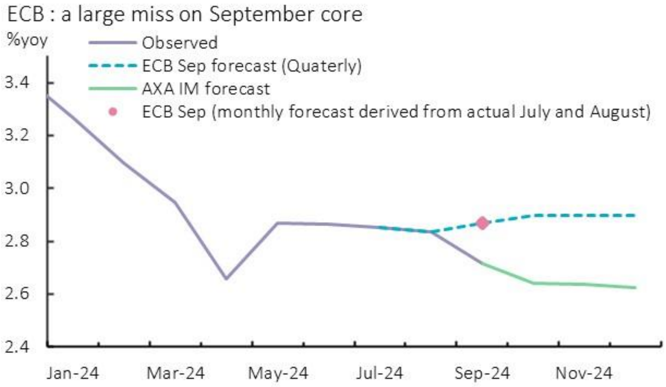
ECB hawks are mellowing

We wrote last week that, given how pressing the market had become in its expectation of a rate cut at the October meeting, European Central Bank (ECB) spokespeople would have to take to the wires before the purdah period to send a clear indication of what the Governing had in store. Christine Lagarde did speak, and we do not think she could have been more straightforward in her message. By mentioning the Council would have to take into account the latest better-than-expected inflation print at the next meeting, **the ECB President in her introductory statement to her European parliament hearing made it plain that they would not wait until a new full set of forecasts comes out before dialling down again on restriction.** A back-to-back 25bp cut at the October meeting is now quasi certain.

This is a lesson in pragmatism, suggesting that **the central bank is taking a symmetric approach to forecast errors**. During the phase when inflation repeatedly exceeded the ECB's own forecasts, the central bank explicitly distanced itself from their still benign message – sometimes very bluntly – and hiked rates decisively. It is reassuring to see that "on the way down" the ECB is also ready to detach itself from even a very recent inflation outlook (it is less than a month old). Christine Lagarde mentioned again the ECB is driven by three criteria: developments in underlying inflation, inflation outlook and monetary policy transmission. The three elements do not need to be fully aligned for a decision to be taken. Actual developments can trump projections.

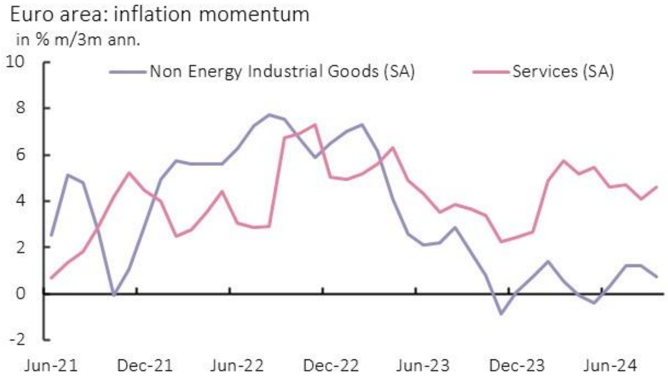
The "inflation miss" for core inflation in September was significant (0.2%, see Exhibit 3). We find it interesting that the ECB President did not choose to overstate some of the details in the print which could have painted a less favourable of the recent disinflation pattern. Indeed, when focusing on the short-term momentum, the price of services re-accelerated in September (see Exhibit 4). We **suspect the strong hint at bringing forward the next cut also reflects a growing unease at developments in the real economy**. We were surprised that the ECB did not revise significantly down its forecasts for GDP in the latest batch, nor qualitatively change the list of downside risks. Even if the depth of the slowdown in activity differs across surveys, especially in the tertiary sector, the recovery scenario to which the ECB continues to pay lip service is getting evermore elusive.

Exhibit 3 – Inflation falling faster than the ECB thought



Source: Eurostat, ECB and AXA IM Macro Research, as of October 2024

Exhibit 4 – even if the September print was not perfect



Source: European Central Bank and AXA IM Macro Research, as of October 2024

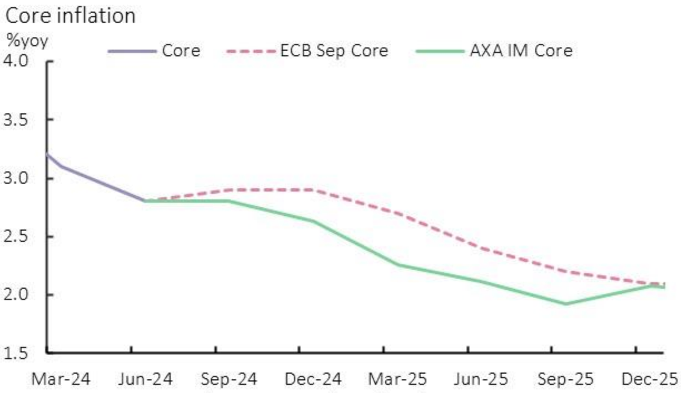
The change of tone goes beyond Lagarde's own communication. In her speech last week, Isabel Schnabel expressed what felt like an endorsement of the message sent by the ECB President at the European Union (EU) parliament. The key sentence, strategically positioned in the speech's conclusion, was *"we cannot ignore the headwinds to growth. With signs of softening labour demand and further progress in disinflation, a sustainable fall of inflation back to our 2% target in a timely manner is becoming more likely, despite still elevated services inflation and strong wage growth"*. **The concerns over the inflation trajectory are still there, but she no longer sees them as daunting enough to jeopardize the overall disinflation process.**

We also found interesting that she spent a large part of her speech explaining that the monetary tightening did not play a key role in the current difficulties in Germany. She made it plain that the financial structures of Germany – e.g. low leveraging and the dominance of fixed-rate mortgages – made the Germany economy, ultimately, less sensitive to higher interest rates than the Southern countries. Instead, she insisted on the fundamental reasons – e.g. excessive reliance on a few key exports – which explain Germany's current predicament**. It is unusual that a German policymaker feels the need to justify a restrictive monetary stance to a domestic audience** (the speech was given in Freiburg). This probably reflects the depth of the current doubts in Germany about the future of its economic model. While she made it plain that monetary loosening would be not alone solve Germany's issues, of course, removing some of the restriction can only help.

Still, in our view **there is still a step the ECB has chosen not to cross in its recent communication: indicating clearly that it has engaged in a proper process of restriction removal in the way the Fed has**. Indeed, in the introductory statement to the hearing, Christine Lagarde maintained the "data dependent, one meeting at a time" line. This is now likely to be the market's main focus at the next press conference. A non-committal solution for the Governing Council would consist in hinting at the December forecasts as a key input in a deeper change in how the future policy rates could be communicated.

Indeed, beyond the recent "miss", it is the entire ECB inflation forecast for 2025 which looks too high to us (see Exhibit 5). In our discussion of the September batch, we focused on the strong wage trajectory at the heart of the ECB scenario, which in our view largely ignored the deceleration in negotiated and actual wages per head in Q2, as well as the message from the surveys and the real-tine indicators (see Exhibit 6). A downward shift would be fairly easy to justify. Hitting the 2% inflation target earlier in the new forecast would be a strong signal that the ECB is likely to continue cutting at a relatively fast quick pace after December.

Exhibit 5 – Towards 2%, faster



Source: Eurostat, ECB and AXA IM Research, as of October 2024

Exhibit 6 – Message from the labour market

Source: ECB, Indeed and AXA IM Research, as of October 2024

Of course, **a strong element of data dependence would remain**. The environment is probably too uncertain to engage in "full fat forward guidance", and the need to look at potential external risks makes it in any case impossible – as usual – for the ECB to fully pre-commit to any particular path. So far, heightened tension in the Middle East has had only a limited impact on oil prices. Despite the current escalation, with direct Iranian strikes on Israel, oil futures throughout 2025 are still below the level they had hit when the ECB took them as key assumptions in their inflation forecasts. While this, for now, creates an additional risk the current ECB inflation forecasts are too high, the ECB will need to remain alert to this geopolitical concern.

A 2% Rubicon for the policy rate?

At the end of last week, the market was pricing 23 bps of cut at the October meeting, against less than 10 bps after the September meeting. If the ECB takes the opportunity of the December meeting to cut again – as we now expect, bringing the deposit facility rate to 3% – and sends a more forceful "restriction removal" message for the trajectory ahead on revised forecasts, the question of course will shift to the speed of such removal and the terminal rate.

It will be tempting to use the Fed's approach as a blueprint for the ECB. As we discussed in the first section, the Fed's explicit strategy consists in cutting fast and deep enough so that the US avoids a hard landing, so that it would have to bring its policy rate in properly accommodative territory : in the September dot plot, the "median FOMC member" expects the Fed Funds rate in 2026 to merely converge to their stated "long-term level" (2.9%) at the end of 2026. The ECB does not explicitly communicate on its interest rate trajectory, but if the Governing Council resolves to bring forward its next cut, it should be relatively straightforward to continue cutting until the policy rate hits 2%, commonly seen as the neutral rate in the Euro area. This would mean cutting by 25 bps at every meeting until June 2025. This is close to what the market was pricing at the end of last week (2.1%). Perhaps unusually, we are aligned with the market's view.

Beyond June 2025, the market is not expecting much more in terms of cuts (1.97% for the September contract). This is fully understandable in our view. Even the descent to 2% may not be straightforward. While at the beginning of the process, if the data is sufficiently scary, even one 50bp increment probably cannot be excluded, but there is no absolute value for the neutral rate and, if the economy stabilises towards the spring of 2025, we can easily see how the hawks would start arguing against going too deeply down once the 2.5% mark is hit. Our baseline is that wages will continue slowing down, and that some of the most recent signals pointing to a pause there are merely noise, but hawks will react to any persistence in labour market tightness. Calculations by JP Morgan on what negotiated wages could look like in Q3, based on available national data, suggest a rebound could be seen, driven by base effects in Germany (this is the "dot" at the end of the line for negotiated wages in Exhibit 6).

Breaking 2% for the policy rate is probably unimaginable without a proper recession gripping the Euro area. We could be lucky. Countries which are traditionally sensitive to interest rates, and which are already doing quite well, such as Spain, could get even better thanks to the monetary easing. The outperformance of the South may suffice to offset weak developments in France and Germany. It will take a lot though. We have already explored last week how France is currently particularly vulnerable to the kind of fiscal retrenchment which is looming for next year (we will comment of the precise content of the budget bill when it is fully disclosed this week – for now too many details are still sketchy) but lower rates may help. Germany could indirectly benefit from stronger external traction from China if the stimulus there proves efficient. So, 2% as a floor for the ECB may be a plausible forecast for now, but we see a distinct possibility the central bank has to do more.

Swiss Squeeze

While we discuss whether the ECB will ultimately have to take the deposit rate below neutral, at least **there is ample space in the Euro area to provide plenty of accommodation before having to resort to unconventional measures which the Governing Council would probably be *very* reluctant to implement again. Yet, other European central banks, often quite constrained by the ECB's stance, do not have that luxury**. We rarely comment on the Swiss National Bank in Macrocast – probably because our pessimistic mind has trouble focusing on countries which go "too well" – but it presents a very interesting case in the current circumstances.

The Swiss National Bank (SNB) was early in cutting rates in this cycle, choosing not to wait for the ECB. They cut again in September while providing clearer forward guidance than their neighbour: in the press conference, the Governor stated that more cuts in the coming quarters may prove necessary. Since the SNB has already brought its policy rate to 1%, the conventional room for manoeuvre still available is of course quite limited. The market "does not want to believe" the SNB will bring rates in negative territory again, stopping marginally positive at the end of 2025 (see Exhibit 7). The market is thus anticipating a narrowing of the ECB/SNB spread from around 250bps to c.175bps in a year from now. The strength in the Swiss franc (see Exhibit 8) is completely logical then.

Exhibit 7 – The ECB/SNB spread to narrow

Source: Refinitiv and AXA IM Research, October 2024

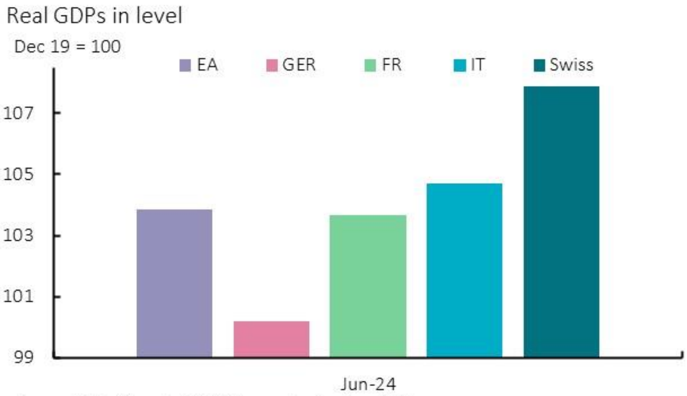
Exhibit 8 – A stronger CHF is not surprising

Source: Refinitiv and AXA IM Research, October 2024

In its monetary policy statement, the SNB squarely mentioned the CHF strength as a key source of disinflation in Switzerland which prompted the cut and the announcement of more to come, and also reaffirmed the possibility to intervene in the FX market, an option which the SNB now considers as a normal part of its monetary policy toolkit. FX intervention is the SNB's form of unconventional policy. Given the very open nature of the fairly small Swiss economy, inflating the balance sheet by purchasing foreign rather than domestic assets – as the Fed, the ECB or the Bank of England (BoE) did – is a more natural approach.

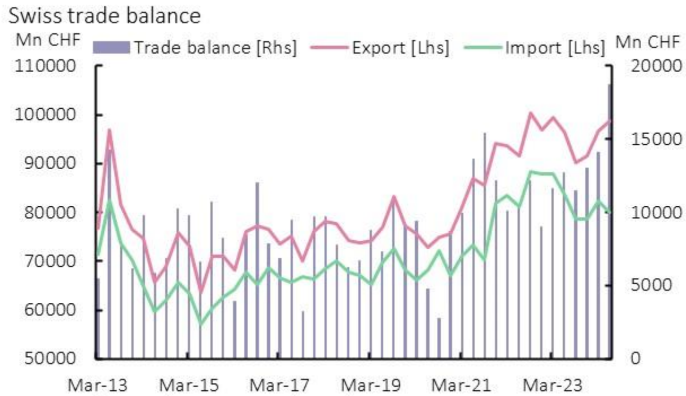
Yet, despite massive intervention before this year, the SNB has not been able to fully control the currency. This has however not seriously impaired Swiss growth dynamics, with a sizeable outperformance relative to Euro area countries since the pandemic (see Exhibit 9). This was not primarily driven by the resilience of domestic demand: the Swiss trade balance has even improved during the phase of acute currency appreciation (Exhibit 10).

Exhibit 9 – Swiss outperformance



Source: Refinitiv and AXA IM Research, October 2024

Exhibit 10 – Trade balance impervious to FX appreciation



Source: Refinitiv and AXA IM Research, October 2024

A naïve reading of the favourable trade developments would attribute it solely to an extremely high non-price competitiveness of Swiss products, based on quality and specialisation. This certainly played a role, but another explanation deserves to be explored. While in nominal terms, the trade-weighted exchange rate of the CHF has appreciated much more than for the euro or the dollar (see Exhibit 11), when taking on board the inflation differential, the CHF has actually been very competitive (see Exhibit 12).

Exhibit 11 – Massively up it seems…

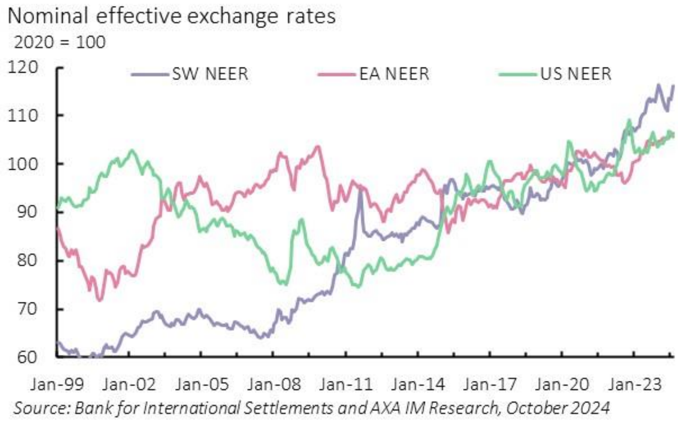
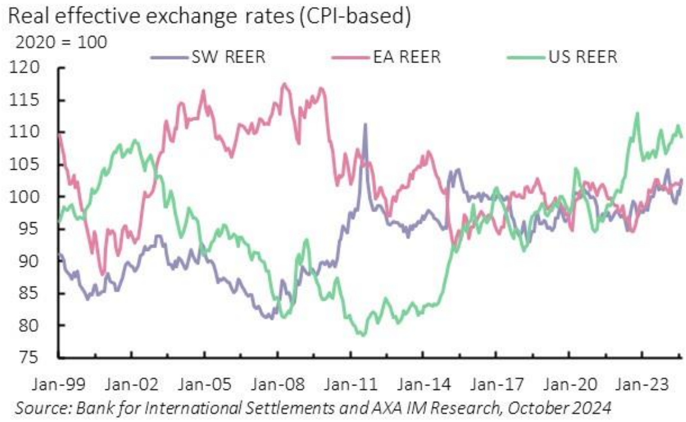


Exhibit 12 – But not when taking on board relative inflation



Yet, just as with fund management, in macroeconomic matters "past performance may not be a good predictor of future performance". **An issue ahead for Switzerland is that with inflation in its main competitors moving back to 2%, maintaining competitiveness in the face of nominal currency appreciation would entail accepting domestic deflation**, which comes with all sorts of ills (e.g. raising the real value of accumulated debt and triggering a "wait and see" attitudes by consumers). It is thus in our view perfectly plausible that the SNB will have to buck the trend and engage in another ballooning of its balance sheet at a time when all other central banks are reducing theirs. Unconventional policy is not dead, at least not everywhere….

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Employment report (Sep) payrolls significant increase up to 254k from 142k, unemp stable at 4.2%. Average earnings unch at 0.4% • Jolts survey vacancies (Aug) rebound to (8.04mn) following July's dip (7.6mn) • ISM indices (Sep), mfg unch, but prices paid has biggest fall since May 2023. Svc 54.9 (+3.4ppt) • Vehicle sales (Sep) rebound (+4%) following Aug dip	• CPI inflation (Sep) headline expected to fall further as weak oil lowers gasoline costs • FOMC meeting minutes (Sep) to gauge breadth of views around 50bps cut in Sept and ahead • PPI inflation (Sep) energy costs expected to weigh • Consumer sentiment (Oct, p) to watch for ongoing support from consumer • Trade (Aug) deficit has continued to widen
	• EMU inflation (Sep) was 1.8%, in line with consensus, but core inflation fell to 2.7%, 0.2 points lower than the ECB forecast, which with the dovish signal of Ms Lagarde during a hearing in the EU parliament forced us to add another rate cut in October • We now anticipate back-to-back rate cuts at each meeting until June 2025 (2%) • EMU Unemployment rate was flat 6.4% (Aug) • Fr industrial output was strong at +1.4%mom in August and revised higher to +0.2% in July (+0.7pt)	• French PM Barnier unveiled the main objectives of the 2025 budget, of which a deficit targeted at 5% in 2025, around 1pt of GDP of which less spendings (2/3) and more revenues (1/3). Some arbitrages are still ongoing and the budget draft will arrive at the Parliament on 9 October before being debated • EMU retail sales (Aug)
	• Final GDP (Q2) revised down to 0.5%qoq, from 0.6%. Saving ratio increased • BoE cons. credit (Aug) up at £1.3bn, from £1.2bn. Mortgage approvals (Aug) rose to 64.9K, from 62.5K, just below 2015-to-19 av. 66.5K • Bailey said cutting cycle could be more aggressive	• BRC Retail Sales (Seo) look for signs of stronger consumer spending • RICS Residential Market Survey (Sep) should show improvement due to lower mortgage rates • Monthly GDP (Aug) look for growth after two flat months in Jun and Jul
	• IP (Aug) down 3.3%mom offsetting Jul. rise • Retail sales (Aug) up 0.8%mom Cons. conf. (Sep) up slightly but still weak • Tankan survey (Q3) manu. remains weak. Services show slight improvement	• Average cash earnings (Aug) will tick down due to end of one off payments • HH spending (Aug) will likely be subdued • PPI (Sep) look for impact a stronger yen on prices • Reuters Tankan (Oct) look for weak manu.
	• NBS mfg PMI (Sep) up to 49.8 from 49.1 in August; non-mfg PMI down to 50 from 50.3 in August • Caixin mfg PMI (Sep) dropped to 49.3 from 50.4; services PMI down to 50.3 from 51.6	• Money supply and credit demand for September • Foreign direct investment ytd in September could extend the decline further from -31.5% in August
	• CB: Poland on hold (5.75%), Colombia 50bp cut (10.25%) • CPI yoy (Sept): Philippines (1.9%), Korea (1.6%), Indonesia (1.8%), Poland (4.9%), Turkey (49.4%) • EM PMI surveys (Sep): weaker both in manufacturing (49.8) and services (51.7)	• CB: Peru (5.25%) and Korea (3.5%) expected to cut by 25bp, India (6.5%) expected on hold • CPI (Sept): Taiwan, Thailand, Taiwan, Colombia, Brazil, Mexico, Hungary, Czech, Romania • IP (Aug): Czech, Turkey, South Africa, India, Malaysia

Upcoming events		
	US:	Tue: Balance of trade (Aug), Exports (Aug), Imports (Aug), NFIB business optimism (Sep); Thu: CPI (Sep), Inflation rate (Sep), Initial jobless claims (w/e 5 Oct); Fri: PPI (Sep), Michigan consumer sentiment
	Euro Area:	Mon: Ge mfg new orders (Aug), Ez Retails sales (Sep), Fr foreign exchange reserves (Sep); Tue: Ge IP (Aug), Fr Balance of trade (Aug), Fr current account (Aug); Wed: Ge balance of trade (Aug), Ge Exports (Aug); Thu: It IP (Aug); Fri: Ge Inflation rate (Sep)
	UK:	Mon: Halifax house price index (Sep); Tue: BRC retail sales (Sep); Thu: RICS house price balance (Sep); Fri: GDP (Aug), Goods trade balance (Aug), IP (Aug), Mfg production (Aug)
	Japan:	Mon: Foreign reserves (Sep); Tue: Current account (Aug), Household spending (Aug); Thu: Reuters Tanken Index
	China:	Sun: Inflation (Sep), PPI (Sep), Balance of trade (Sep), Exports (Sep), Imports (Sep), New Yuan loans (Sep)

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