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Research & Strategy Insights

Gravity wins in the end

61 – 28 September 2020

Key points

- Traditional macro indicators are pointing to a relapse in Europe – but the situation in the US is also fragile.
- Market resilience depends on the capacity of monetary policy to be constantly re-calibrated. On this we take a special interest in ECB board member Panetta's speech last week, but we note that in EM some central banks are forced to give up on "all-out accommodation".
- Some positive "mood music" on the chances of a Free Trade Agreement between the UK and the EU.

The sense of disappointment on the state of the recovery is particularly acute in Europe, where the traditional macro indicators, such as the PMIs or the forward-looking components of the national surveys, are already pointing to a relapse in September, before most of the new restrictive measures taken to contain the second wave of the pandemic kicked in. But the situation in the US is also problematic. There, Initial jobless claims remain significantly higher than at any point during the Great Recession of 2008-2009. Beyond the economic data, markets need to consider the US election uncertainty, especially since Donald Trump's public refusal to commit to a swift transition if he loses.

September provided another natural experiment on the market's dependence on easy monetary policy. Equities – which are not touched by central banks – have lost 8% in the US. High-yield credit, only indirectly supported, suffered a bit, but investment grade credit, fully covered by the quantitative easing schemes of the Fed and the ECB, has barely moved. Still, this broad resilience of large segments of financial markets is dependent on the capacity of the monetary stimulus to be constantly re-calibrated to deal with new headwinds. From this point of view, we have been reassured by an important speech by ECB board member Fabio Panetta, who laid out what we think is the doves' proposal to the central bank's strategy review.

Not all central banks are equal. Credibility issues and compromised fundamentals pre-Covid act as "gravitational forces" which ultimately constrain monetary policy in some emerging markets to give up on their all-out accommodative stance. The central banks of Turkey and – to a lesser extent – Hungary have had to "break ranks" and hike last week. This may be positive for financial stability but of course won't help growth.

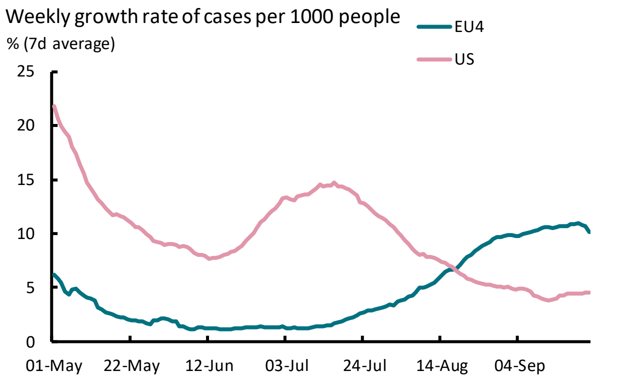
In this difficult environment, we take comfort in the positive developments in terms of political stability in Italy after the regional elections, as well as in the "positive mood music" in the British press on the chances of a Free Trade Agreement between London and Brussels.

Traditional data going soft

The S&P500 index lost 8% since its recent peak on 2 September. The index remains a bit above the 2019 close, but the recent loss of momentum is still telling. There are many headwinds to take on board. US election uncertainty goes beyond the usual questions on the future policy stance of the administration, as investors are increasingly focusing on the possibility of a contested outcome, fueled by Donald Trump's public refusal to commit to a swift transition if he loses. The political stress combines with the resurgence of the pandemic in key world economic regions to dampen "animal spirits".

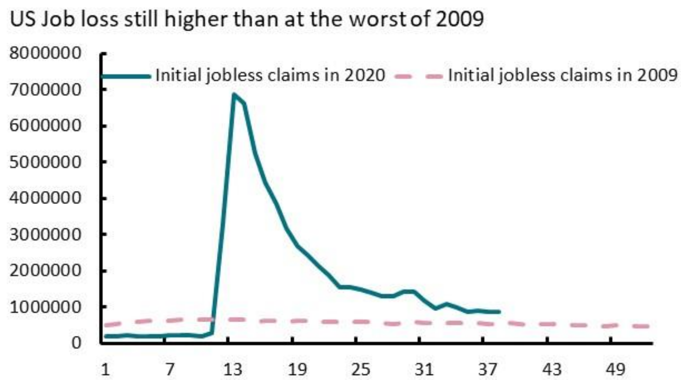
While the Covid relapse in Europe is quite rightly drawing attention, we should not lose track of the US developments: the weekly infection growth rate there has been lower than in the four largest members of the Euro area taken together since mid-August, but for the last three weeks it has remained stuck at about 4.5%, still significantly higher than the pace at which the European countries had managed to bring it down at the end of the spring (see Exhibit 1). We discussed last week the approach chosen by New York and how it may allow the city to avoid the fate of many European countries upon re-opening its economy more broadly from next week onward. Still, many parts of the US did not take the New York line of stringent measures and deployment of massive track-and-trace capability early enough and will now be forced into some protracted, if mild, restrictions to activity.

Exhibit 1 – EU still ahead, but US infection rates plateauing



Source: John Hopkins, AXA IM Research, September 2020

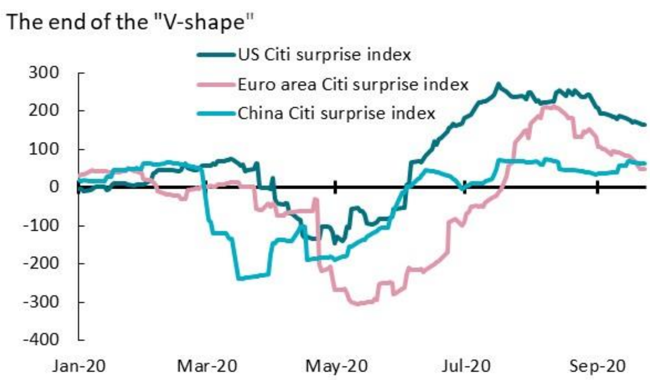
Exhibit 2 – Putting the 2020 figures in perspective



Source: Macrobond, AXA IM Research, September 2020

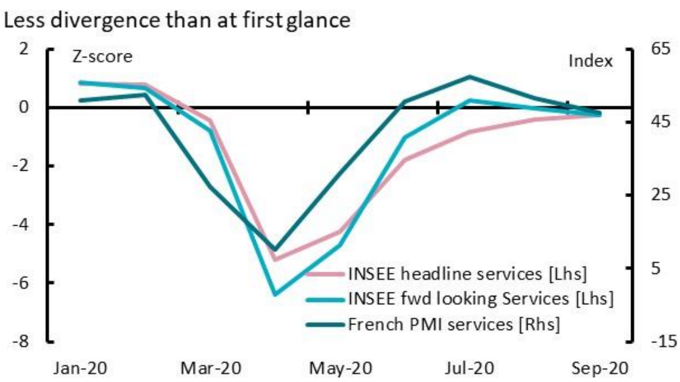
Last week's release of the new (higher than expected) jobless claims was a reminder of how fragile the situation is in the US. An issue with looking at economic data now is that compared with the massive gyrations seen between March and June, the latest numbers may look good, but it's an "optical illusion". **That US job losses have been plateauing since late-August slightly below 1mn a week looks great relative to the March/April numbers, but they are still significantly higher than where they were at the worst of the last recession in 2009** (see Exhibit 2).

Exhibit 3 – Euro-euphoria did not not last long



Source: Macrobond, AXA IM Research, September 2020

Exhibit 4 – PMIs and national surveys are not contradictory



Source: INSEE, Markit and AXA IM Research, September 2020

Yet, it is fair to say that the sense of disappointment in the data is more acute on the European side of the pond. Citigroup's surprise index has been getting less stellar in the US over the last month and half, but the change of tack has been much clearer for the Euro area's data flow, which enjoyed a much shorter euphoric phase (see Exhibit 3). Unfortunately, we believe it may only be the beginning.

The resumption or intensification of restrictive measures to stem the pandemic second wave in large swathes of Europe will hit the recovery in the coming months. The effect may be more difficult to gauge with real-time mobility indicators than last spring. Indeed, in many cases governments are opting for targeted measures – for instance early closing time for restaurants and bars – rather than blanket prohibitions. The Google mobility index for workplace suggests the general "back to work" movement was continuing last week across most of Europe. Some of the worst effects on the hospitality industry for instance may not fully materialize before the half-term holidays in October and early November.

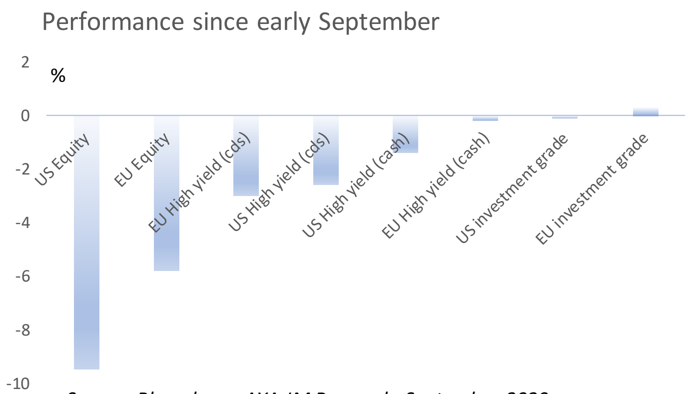
Still, the traditional macroeconomic data is already suggesting a significant deterioration in activity in some sectors. The flash Composite PMI index for the Euro area in September remained just above the threshold between expansion and contraction, at 50.1, still sharply down from 51.9 in August and 54.9 in July. But within the PMI batch it is the contraction in services activity (47.6) which caught attention. This was widespread across the region, with both the French and German readings below 50, as well as the implied level in the rest of the Euro area.

Some observers focus on the divergence between national surveys and the PMIs, pointing at better resilience in the INSEE and IFO data. This is not unusual, especially when it comes to detecting inflexion points. However, **when we look at the forward-looking components of the national surveys, the loss of momentum is also manifest.** The "business expectations" index of the IFO survey edged down in September in the [i]services and retailing sectors. The same pattern was seen in the details of the INSEE release. While the overall services index continued to improve slightly, the "expected activity" component has started to relapse (see Exhibit 4).

The ECB doves' opening gambit

The market, again, needs to decide what to focus on, either the mounting downward risk to the recovery, which is negative for earnings and pushes corporate default risks up, or the resulting policy push and the liquidity wave that it triggers. September has provided us with another natural experiment. The distribution of the market correction across asset prices has followed the level of protection from monetary policy. Equities are untouched by central banks and they have been hit the hardest (see Exhibit 5). High yield credit is only indirectly protected, and there was some contagion there. Investment grade credit – fully integrated in the Fereral Reserve (Fed)'s and the European Central Bank (ECB)'s emergency quantitative easing programmes – barely moved. In the Euro area, peripheral sovereign spreads are the key test. The generally favourable outcome for the ruling coalition of the Italian regional elections and referendum supported the local bond market, but even for Spain, currently faced with the worst pandemic resurgence in Europe and where the political situation is tense, the sovereign spread has been firmly under control.

Exhibit 5 – Market correction across asset classes



Source: Bloomberg. AXA IM Research, September 2020

Of course, this broad resilience of large segments of financial markets is dependent on the capacity of the monetary stimulus to be constantly re-calibrated to deal with new headwinds. We have already discussed in Macrocast how, given our belief in the centrality of fiscal policy in the current configuration, the ECB would be forced to increase in size and extend in time its Pandemic Emergency Purchase Programme (PEPP) by year end. But we also noted that it would be difficult for the Governing council to make this approach explicit, for mainly political reasons. This would leave the ECB at a disadvantage relative to the Federal Reserve which has already changed its strategy in a more dovish direction. However, it seems that "history is accelerating" and that some of the doves at the ECB are ready to explicitly lay out a bold strategy. **Board member Fabio Panetta's speech last week could well be the beginning of the ECB's response to the Fed's Average Inflation Targeting (AIT)** – **assuming it is embraced by the rest of the Governing Council**.

The Fed's move is based on the notion that it is easier to allow inflation to overshoot in the future amid decent cyclical conditions than to lift inflation amid the currently adverse cyclical conditions. A pledge to overshoot tomorrow is thus credible and could lift inflation expectations today, reducing long term interest rates in real terms. A drawback of AIT though is that it can send a signal of powerlessness today, or even justify a certain immobilism in the short run, which we would summarize bluntly as "since we promised something for the future, don't ask us to do more today".

Conversely, Panetta's insistence on another kind of asymmetry focuses on the here and now. The theoretical premise is similar to that of the Fed's AIT but with a twist: since it's harder to lift an economy out of entrenched deflation than to curb inflation once it's back (the old "Mishkin rule"), a central bank must do all it can *before* a deflationary spiral sets in. The ECB should therefore throw everything it has at the economy, even at the risk of doing too much, since there would always be time to correct this in the future if the monetary push is too successful and inflation expectations get out of control. AIT could be part of the package, but our impression is that Panetta is more focused on more policy moves soon – probably in the form of another recalibration of QE. Indeed, the key question is *how* the ECB could throw more at the economy. Panetta's speech is consistent with moving the limits of QE further, either through a bigger/longer PEPP or extending to PSPP (the "ordinary" Public Sector Purchase Programme) the relaxation in the "limits" already implemented on PEPP.

Panetta pre-empted objections on the "diminishing returns" on monetary policy by highlighting the role of fiscal policy. The key sentence in his speech on this is *"by restoring the proper functioning of financial markets, we have removed a major obstacle to expansionary fiscal policies*". Here, Panetta did not go through the convoluted wording often used by ECB spokespeople who prefer to speak in terms of dealing with fragmentation to avoid a pro-cyclical market-let tightening in financial conditions. He did not beat around the bush: keeping sovereign spreads in check is a necessary condition to obtain an (implicitly much-needed) fiscal push. Panetta concluded this key paragraph by nailing the point home: *"insofar as monetary policy empowers fiscal policy and increases confidence, it also empowers its own effectiveness".*

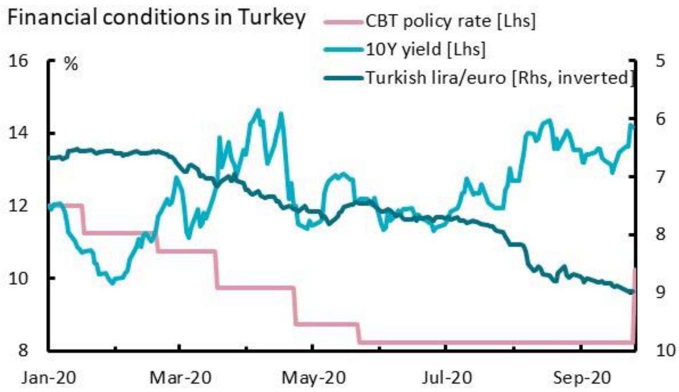
We welcome Panetta's focus on the "here and now" and fiscal easing since in our view the impact of AIT can be quite limited despite its undeniable intellectual appeal and we argued two weeks ago that at the moment making a fiscal policy stimulus financially possible may well be monetary policy's most efficient transmission channel. We noted anyway in a speech by Banque de France Governor Villeroy de Galhau released on Friday a suggestion that in its communication over the last few years the ECB has de facto taken on board some elements of AIT, meaning that the difference of approach between the Fed and its European counterpart on the monetary policy strategy is not that wide.

The key question of course is whether a majority of the Council is ready to "walk the talk" and move quickly either to expand the PEPP again to help deal with the unavoidable further increase in government funding needs next year or extend to the ECB's "normal" quantitative easing programmes the flexibility from the "limits" found for PEPP. The battle is only starting it seems. One of board's hawks, Yves Mersch, dismissed last week's Financial Times article according to which such a debate had already started as PEPP is under review *("I saw the article, but as a member of the Executive Board I am not aware of such a development").* Yves Mersch is leaving the ECB on 14 December, but he will still be voting on the crucial 10 December. Governing Council meeting. Our baseline is that such extension will be granted at that meeting, but maybe without the full clarification on the central bank's strategy that Panetta (and others) seem to be pushing for.

EM policy divergences appearing

While the Fed and the ECB are busy finding ways to be more accommodative, in emerging markets the stance is getting more disputed. We have highlighted before in Macrocast how – in contrast with the Great Financial Crisis of 2008-2009 – central banks in emerging markets unambiguously emulated their counterparts in developed countries and eased their policy stance without hesitation to protect their economies instead of focusing on financial stability issues and defending their currency. Cracks are appearing though. We had highlighted Turkey as one key candidates for a full-blown current account crisis, given the speed at which it was spending its currency reserves, and speculated that its central bank would ultimately be forced to reverse its stance and hike rates. This was done last week with a very significant 200 basis points hike (see Exhibit 6).

Exhibit 6 – Turkish monetary policy bowing to the inevitable



Source: Macrobond, AXA IM Research, September 2020

Gravity won in the end. The accommodative stance of the central bank of Turkey (CBRT) was offset by the rise in market interest rates, amid massive capital outflows and despite quantitative easing, while the depreciation in the Turkish Lira was triggering financial stability concerns given the high proportion of domestic loans denominated in foreign currency. The CBRT had already tightened "by stealth" since the summer by raising actual funding costs for liquidity significantly above the official policy rate but last week's move still sends an important message given the political pressure exerted on the central bank by the Turkish government to avoid any tightening (Recep Erdogan has often been very explicit about this). **The central bank of Hungary also tightened its monetary policy last week**, lifting its one-week deposit rate (the de facto policy rate at the moment since it anchors the local money market) by 15 basis points (bps) to 0.75%, reacting to the gradual acceleration in inflation: the core consumer price index had accelerated to 4.7%yoy from 4.1% before the pandemic.

This is by no means a general trend has emerged across all emerging markets. The central bank of Mexico cut rates by 25bps last week to 4.25% . But we note that there the pace of easing is decelerating (so far in the crisis it had reduced rates by instalments of 50 basis points). Banxico may be reluctant to bring its policy rate in real terms into negative territory (inflation is hovering at c.4%). As the pandemic crisis drags on, conflicts of objective are appearing. This is acute for central banks with limited credibility and/or for open economies where inflation is very sensitive to exchange rate developments.

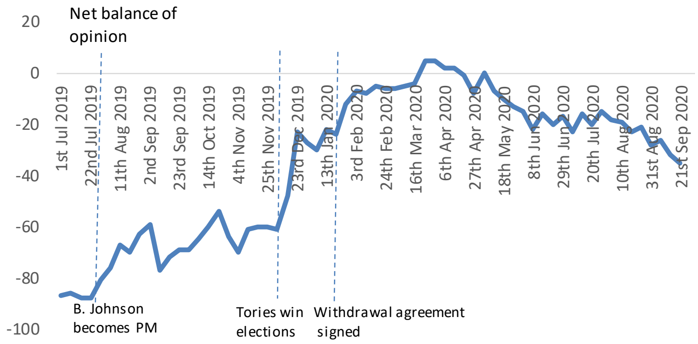
Positive mood music on a Brexit deal?

After the stress brought about by the UK's threat to unilaterally void the Withdrawal Agreement signed in January 2020, against all principles of international law, **there finally seems to be some "positive mood music" on Brexit**. A piece by Tim Shipman in the Sunday Times out on 27 September suggests there is a willingness in the British government to come to an agreement on the principles of a Free Trade Agreement by the end of this week, which would allow negotiators at a technical level to enter the so-called "tunnel" which could bring forth a full Treaty text for consideration at the EU summit on 15 October, well in time to get through the parliamentary endorsement process. Tim Shipman has been wrong before, but he is very close to the Brexiteers in command in 10 Downing Street and in this case, we think he is acting as a messenger. Moreover, the substance of his piece was echoed – with some more caution – in the Remainer-leaning Financial Times the same day.

A few weeks ago, we were concerned that Boris Johnson's U-turns over the last few months on many aspects of his policies and his handling of the pandemic would make him less flexible in his negotiations with Brussels. Yet, at this stage he could probably do with some good news. Last week the first polls putting Labour in the lead came out and public anger at the government's handling of Brexit is rising again (see Exhibit 7). In addition, a no-deal Brexit would play in the hand of the Scottish nationalists while more and more polls north of the border suggest they would win an independence referendum this time.

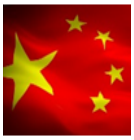
Exhibit 7 – British public opinion getting impatient

How well is the UK government handling Brexit



Source: YouGov, AXA IM Research, September 2020

An issue though is that the British press tends to ignore the EU side of the equation and focuses only on the noises from the "Westminster bubble". Still, we should probably take these articles as signs that the British government is now broadly united around getting a deal. Difficulties abound though. **The UK side will have to give some way on the level-playing field on state aid, while Boris Johnson will need some sort of optical victory to save face and get the endorsement of the ultra-Brexiter component of his majority** – possibly on fishing rights or on customs controls between Northern Ireland and the British mainland. We expect an interesting and volatile week on the Brexit front.

Country/Region	What we focused on last week	What we will focus on this week
	• Continued slide in US equities as Fed warns of protracted recovery, US dollar rebounds • US House passed bill to avert shutdown • CBO long-term projections, debt projected at 195% by 2050 (from 146% last year). • Republican plans to nominate replacement Supreme Court judge • Trump does not commit to peaceful transfer	• First TV election debate (29 Sep 21.00 EST) • US September payrolls release, particularly unemployment after sharp drop to 8.4% • Personal spending (Aug) to add to outlook for Q3 GDP (currently expect 20% ann) • Any further signs of moving towards compromise on US stimulus package • ISM index for September
	• EA Consumer confidence failed to improve • EA Flash Services PMIs fell sharply in September, pointing to contraction (47.6) and growing country divergence • IFO and INSEE edged up, reassuring a bit after the poor PMIs. But forward looking components signal further loss of momentum going ahead	• Euro area inflation to remain affected by distorted sales seasonality and German VAT cut, with headline at -0.4%yoy and core at 0.2%yoy. • EC surveys to complement the flash PMIs and provide details on savings intentions and employment prospects • Check ECB Watchers Conference
	• UK enacted additional social restrictions to reduce spread of virus • Chancellor Sunak announced further fiscal support, including new Jobs Support program • August's public finances showed borrowing this financial year has risen to £173.7bn	• Virus spread • Brexit negotiations to continue amidst concerns over Internal Markets Bill • National accounts for Q2, including household income breakdown • House price and mortgage lending data to gauge scale of UK housing acceleration
	• Flash September composite Markit PMI was largely unchanged rising by 0.3pt. The index level remains below 50 at 45.5pt in September due to a stronger fall in manufacturing output and a continued fall in new orders inflows.	• August Industrial Production is expected to weaken compare to July figures. • September CPI Tokyo usually leading nationwide level. • August Unemployment rate should be stable.
	• FTSE Russel announces the inclusion of China in its World Government Bond Index	• September PMI to show continued expansion in the manufacturing sector
	• Last week, Turkey raised its one-week repo rate by 200bps to 10.25%, in an attempt to contain higher than expected inflation. Hungarian MNB unexpectedly hiked deposit rate by 15bps to 0.75% reacting to recent HUF depreciation. Egypt cut rates by 50bps to 8.75% on the back of declining inflation	• Central bank meetings: Philippines, India • Inflation in Brazil (Sep) • Trade Balance in Turkey (Aug) • PMI in Indonesia, India, Russia, Turkey, Poland (Aug)

Upcoming events		
	US:	Tue: Goods TB, cons conf; Wed: First presidential debate, GDP (final), Core PCE price index; Thu: Perso spending, mfg PMI (final), ISM index; Fri: Unemp, Non-farm payrolls, Aver earnings
	Euro Area:	Tue: EA cons conf, Ger, Sp HICP, Fr cons conf; Wed: ECB Watchers Conference, Ge Unemp, Fr Cons Spending, HICP, It HICP; Thu: Ez, Fr, It, Sp Mfg PMI (final), Ez unemp; Fri: HICP 'flash' est
	UK:	Mon: EU-UK joint meeting; Tue: mortgage approvals, net mortgage lending, consumer credit, M4 money supply; Wed: GDP (final), business investment (final), current account; Thu: mfg PMI (final)
	Japan:	Wed: Industrial production (prel.); Thu: mfg PMI (final), unemployment
	China:	Wed: NBS PMI: mfg/non-mfg, Caixin mfg PMI

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