Investment Managers

150 – 19 September 2022

Investment Institute Macroeconomics

Peak in the clouds

- The US inflation peak remains elusive, calling for another jumbo Fed hike this week (we expect 75bps)
- We discuss Maurice Obstfeld's call for a more internationally coordinated monetary policy
- The reaction of G. Meloni to the EU/Hungary spat needs to be watched carefully

The US inflation peak remains elusive. While the "exogenous factors" of inflation continue to abate – US import prices excluding oil are now growing by less than core consumer prices – domestic pressure continues to accumulate. The softening of the US labour market which had emerged in late spring has given way to impressive resilience. The decline in long-term inflation expectations should bring some comfort to the Fed, suggesting the central bank has regained its full credibility, but their research suggests that the still-elevated short-term expectations matter more for wage and price dynamics. All this calls for another jumbo hike this week. Some observers are now calling for 100 basis points (bps). It may well be an option, but even with a 7bp hike – our baseline – the policy stance will reach restrictive territory. This should call for a modicum of prudence.

The accumulation of oversized hikes creates the impression of "race to the peak" across central banks. Maurice Obstfeld's called for a more internationally coordinated monetary policy, to reduce the risk of excessive tightening. We agree in principle but in practice, such coordination would be truly efficient only if exchange rate management was part of the package. Even in a coordinated approach, the respective quantum of tightening would likely depend on the position of each economy in the cycle. Given the US overheating, in contrast with the Euro area, a significant rate differential would remain between the two currencies. The ensuing weakness in the euro, fuelling imported inflation, would still tempt the ECB into "hiking too much", jeopardizing any internationally pre-agreed pace of tightening. We are not holding our breath on the chance to see such grand bargain emerge any time soon.

Finally, we look into the EU Commission's recommendation to suspend part of the structural funds to Hungary. The reaction of the likely winner of the Italian elections this week casts a light on the possibility to see Rome aligning more with the "combative" Eastern member states. This won't help the Union make further progress.

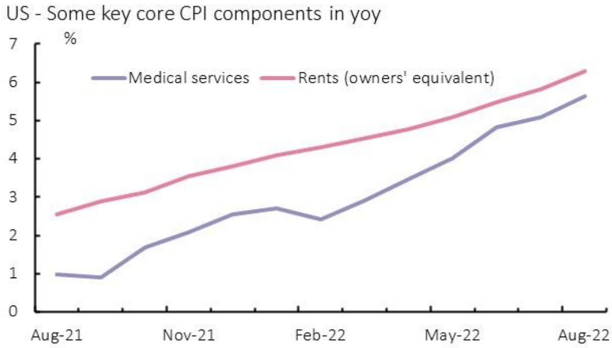
Inflation genie does not want to jump back in the bottle

After the July respite – a lower than expected print which had fuelled the short-lived summer rally – **the release of US inflation data for August put the last nail in the coffin of the "dovish pivot"**. Headline inflation continued to decelerate, thanks to lower energy prices, but core inflation unexpectedly gains further speed. Optimists – a rare breed these days – will want to focus on the slightly lower 3-month annualized change which helps to look through some of the base effects (Exhibit 1). Still, even with this metric, a core inflation on a 6% pace is more than enough to spook even the most dovish central bank. "Sticky components", such as rents, continue to accelerate to reach a 6% pace as well. Medical services are not far behind (Exhibit 2), possibly reflecting "third round effects", i.e., adjusting to the acceleration in wages (healthcare is a labour-intensive industry).

Exhibit 1 – US core inflation in the wrong direction

Source: Bureau of Labor Statistics and AXA IM Research, September 2022

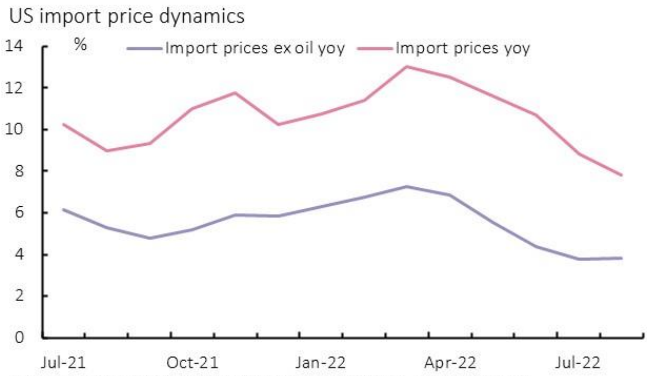
Exhibit 2 – It's getting even stickier



Source: Bureau of Labor Statistics and AXA IM Research, September 2022

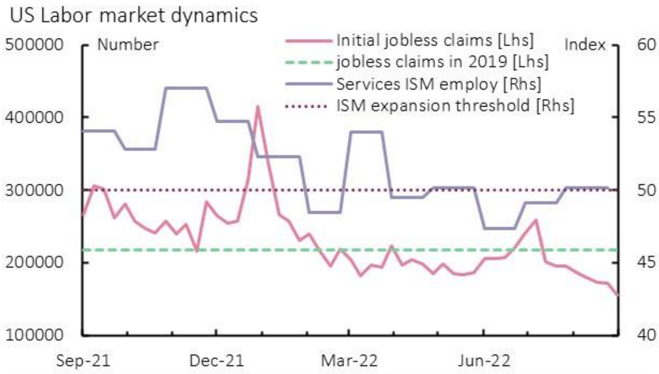
Taking a step back, the overall configuration for price pressure in the US is not very different from the one we were describing just before the August break. **Good news continues to accumulate on the exogenous inflation front.** Import prices in August continued to decelerate. Much of it is thanks to the drop in oil prices but import prices excluding energy are now growing more slowly than US core consumer prices (Exhibit 3), below 5%. The dollar strength clearly helps, but so is the fact that in some key suppliers of the US such as China, inflation has remained moderate (1.7%yoy in August). But precisely, **the very fact that US core inflation exceeds core import prices illustrates how the inflation problem is now enmeshed in domestic conditions**, with the persistent labour market tightness a key ingredient.

Exhibit 3 – Exogenous inflation pressure continue to abate



Source: Bureau of Labor Statistics and AXA IM Research, September 2022

Exhibit 4 – But the labour market is "too resilient"



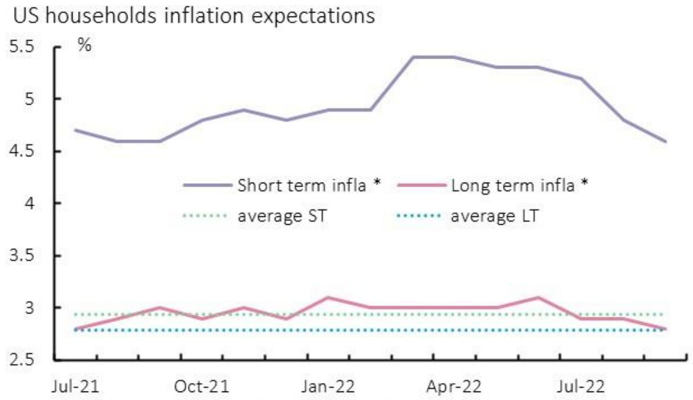
Source: Institute of Supply Management, Labor dept and AXA M Research, September 2022

In the early summer – and this also contribute to the market rally – the news flow was resolutely skewed towards a softening US labour market. In the crucial services sector, the "employment" component of the ISM survey had fallen in contraction territory, and jobless claims were rising, exceeding in late June the 2019 average. The picture is less concerning now, with the ISM employment component back to the expansion threshold – just – and jobless claims heading south again (Exhibit 4). In these conditions, wage pressure mounts further, and **the Federal Reserve (Fed)'s view is probably that slack, instead of growing, continues to diminish, adding to the urgency of moving the policy stance into solidly restrictive territory.**

Yet, **a key difference between today and the 1970s – which has become a frequent historical reference in the current Fedspeak – is that the central bank does not have to address a decade-long drift in inflation expectations**. Labour market institutions have also changed radically. Although we can see US how unions are becoming more active again, targeting the new industries (see their efforts at unionizing Amazon for instance), wage negotiations have become much more individualized than in the 1970s. These two elements should matter for the extent and duration of the monetary tightening the Fed will have to deliver in this cycle. Indeed, if high inflation expectations are not solidly embedded in their outlook, wage setters should be readier to react to downgrade wage settlements at the first signal of a deterioration of the labour market. Moreover, as many US employees still get their best shot at a pay increase by changing jobs, then a slowdown in economic activity should have a dampening effect on aggregate wages relatively quickly as vacancies dry up, even without a significant rise in unemployment.

The starting point today for inflation expectations is much more favourable than in the 1970s. The latest batch of the Michigan survey was released last week, and **long-term inflation expectations (beyond 5 years) fell back to their long-term average (2.8%) for the first time since July 2021**. There is thus no "de-anchoring" to speak of, and an optimist would probably argue that the decline in those long-term inflation expectations – which rise never was spectacular in the first place – in the last month could be the product of the Fed's recreating its credibility with its new, tougher message and action (the drop in gasoline prices may have played a role as well, but disentangling the two factors is next to impossible in real time). Yet, **there are reasons to believe that the Fed is going to focus on the short-term inflation expectations (one year horizon) which, although improving, remain very high by historical standards** (Exhibit 5).

Exhibit 5 – Unfortunately, it's the short-term inflation expectations which may matter more



Source: Michigan University and AXA IM Research, September 2022

A recent paper by the San Francisco Federal Reserve (find the link here to the short version) broke down the recent wage developments between the effect of (i) current headline inflation; (ii) the unemployment gap; (iii) the lagged value of wage growth and (iv) one year head inflation expectations – in practice a run-of-the-mill augmented Phillips curve specification. They find that **while short-term inflation expectations always had an impact on wage growth, the pass-through dramatically rose from 12% before the pandemic to 100% since the economy reopened**. **Moreover, this effect would appear to be more persistent than before**. The authors are not very explicit in their interpretation of the mechanisms at play, yet the main channel is probably a "threshold effect". In normal circumstances, when inflation is low, employees are less focused on protecting their real income. When current and expected inflation shoots up, demand for some form of wage indexation rises. An **unfortunate corollary of this finding is that a massive rise in unemployment would then be needed to bring inflation back under control and offset the impact of the elevated inflation expectations**, which would warrant on oversized monetary policy tightening.

Larry Summers opined last week that a 100bp hike could be warranted this week, and the market was pricing a 25% chance of this happening. Much as the Fed moved from an expected 50bp hike to 75bps in June as it was reacting to worse-than-expected inflation data, there can be a rationale in pushing from the expected 75bps to 100bps in September in response to further bad news on the data front to convince economic agents of its resolve.

We think the terms of the policy debate have changed though relative to the early summer. Indeed, **whether the Fed hikes by 75 or 100bps, this time Fed Fund rates will stand in what the Fed defines as "restrictive territory"**. To re-use the automobilistic analogy coined by the Banque de France Governor, until then, the Fed was only gradually lifting its foot from the accelerator. At the end of the week, it will start pushing the brake. In all logic, this should call for some measure of prudence on the quantum of hikes by now. Indeed, we tend to think of the feedback loop between monetary policy as a neat, gentle line. Yet, at the risk of boring our habitual readers to death with an argument we have used before, in true life, non-linearities abound and it's extremely difficult to predict when the economy "snaps" in one go in response to a policy signal after months of resilience. Once the stance is restrictive, the risk of reaching this "snapping point" rises. 75bps is already a big amount of tightening in one go by historical standards – and it will take months to know whether bringing the policy rate above 3% starts having a dampening impact on economic activity and price dynamics. We have revised our call from 50 to 75bps after the latest payroll and inflation print, but we still don't have 100bps as baseline.

Discussing the Obstfeld proposition

Maurice Obstfeld is one leading economist who share your humble servant's concern that monetary policy may end up in excessive, rather than insufficient tightening. His point in a note for the Peterson Institute (see here for the link) is twofold. First – and on this we unreservedly agree – he argues that much at present hinges on whether the Phillips curve has steepened or remained flat, i.e., whether wage growth has become more reactive to unemployment than during the "great moderation" phase. It may well be that under the current challenging conditions on the supply side, the curve is steeper than usual and a small decline in the unemployment rate triggers a large acceleration in wages. Yet, symmetrically, this could mean that a small rise in the unemployment rate could take wage growth markedly down – so that only a mild recession would suffice. Conversely, some key policymakers such as the European Central Bank (ECB)'s Isabel Schnabel argue that the curve is probably still flat – which explains why they argue in favour of a very significant monetary tightening. In all fairness, there is no way to know at this stage in which regime the economy will operate in the next few months which are crucial to the trajectory for monetary policy. We don't want to put words in Obstfeld's mouth, **but this would call for a "probing" approach to the monetary tightening**, with regular pauses to assess the impact of the hikes delivered so far, rather than continuing to raise rates at a fast clip once they are in restrictive territory.

Still, Obstfeld observes that **some "hawks" argue that even if the Phillips curve has steepened, it may well be that monetary policy needs to deliver massive tightening to curb demand speedily.** Indeed, "*the fact that it is often global rather than domestic slack that matters for price-setting reduces the sensitivity of the economy to interest rate changes on a much broader level*", to borrow from Schnabel's words. To clarify, the "global slack hypothesis" would mean that, since an individual central bank only affects domestic slack which has become less of a driver of domestic inflation – given the growing influence of global prices – the monetary policy tightening would need to be calibrated to obtain a correction of domestic demand large enough to offset the potentially countervailing effect of a global economy which would continue to overheat.

This gets Obstfeld to call for monetary policy coordination. Indeed, at the current juncture, most central banks – with the notable exception of the People's Bank of China – are hiking rates, often in large increments. Obstfeld argues that they may individually "go too far" by failing to take into account the effect on "global slack" of the hikes delivered elsewhere, which would ultimately result in an excessive *aggregate* tightening, taking global demand lower than strictly necessary to bring inflation back under control. This could be addressed by internationally coordinating the various monetary policy trajectories, rather than letting each central bank try to guess the future action of its counterparts to evaluate the ramifications for its own economy.

We agree in principle, but in practice, we are afraid the benefits of such coordination would be limited in the present circumstances given the reaction of exchange rates. Indeed, each country's position in the cycle would likely be the yardstick according to which the individual quantum of tightening would be apportioned in a coordinated approach. Among the key economies, the US presents the most clear-cut case of overheating after the excess of fiscal stimulus under the late Trump and early Biden administrations. It would thus be up to the Fed to deliver the biggest tightening, to obtain the largest correction in domestic demand. The Euro area – in which no blatant case of overheating can be observed – would be tasked with much less. We would end up with exactly the current explicit messages delivered independently by the Fed and the ECB, the former pushing its policy rate well into restrictive territory, the latter keeping rates in the neutral range. **Coordination could reduce the aggregate number of hikes since every central bank would explicitly take on board what the others would be doing, but it would probably not change the interest rate differential across the various regions.**

A coordinated approach would thus only validate what the market is already pricing for exchange rates… which ultimately could make the central banks deviate from any coordinated path. Indeed, the sensitivity of the US economy to external developments is lower than that of the Euro area. The strength of the dollar helps a bit the Fed to achieve its goals but impairs *much* the capacity of the ECB to deliver its own, fuelling the temptation of the ECB to emulate the Fed more than what its domestic conditions would warrant. This has certainly played a role in the ECB's decision to hike by 75bps at its latest Governing Council meeting. **To be successful, the international coordination Obstfeld is calling for would need to encompass some management of exchange rates**, which would entail the explicit possibility of coordinated exchange rate interventions on the markets. No such feat has been attempted since the late 1980s and Obstfeld does not explore this avenue, although he discussed the implications of various monetary policy paths for currencies. Now, since the whole world economy is dusting off its 1970s and 1980s classics, there might be a case for revisiting, at least intellectually, the "good old times" of the Louvre and Plaza agreements (we are not holding our breath though).

Yet, exchange rate issues will likely continue to loom large in central banks' decisions – outside the US. **This week's rate move by the Bank of England may be a case in point**. The decision by the new British administration to finally opt for a direct intervention on energy retail prices has triggered a downward revision in inflation forecasts and the market is expecting the Bank of England to hike by "only" 50bps this Thursday. This would however "look small" relative to the recent and expected moves by the Fed and the ECB, unlikely to help shore up sterling. Given the high sensitivity of the British economy to "imported inflation", we suspect this has become a key issue in debates at the Monetary Policy Committee (MPC), and on balance we still expect a 75bp move this weekend. Beyond this month decision, given the adventurous nature of the UK's medium-term fiscal plans beyond the mitigation of the energy shock this winter, ultimately the Bank of England may not have other choice than bringing it policy rate very close to the Fed's.

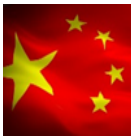
European complications

So far in this crisis European unity has been solid, even if we continue to be disappointed by the absence of progress on another instalment of debt mutualization. The energy shock triggered by the war in Ukraine would qualify for another exercise in financial resource pooling – after the pandemic effort – beyond the solidarity in gas supply currently in preparation (France announced last week that the interconnection with Germany is now technically viable, which would allow for some gas transfers from the autumn onward). However, **some political cracks are appearing within the EU, starting in the East but with immediate ramifications in the South, which are not going to help with the overhaul of the whole fiscal set-up.**

The European Commission has recommended on 19 September to suspend one third of the cohesion funds allocated to Hungary (EUR7.5bn until 2027) as long as Budapest does not address the corruption issues raised by the EU institutions. This is the first test of the new “rule of law” framework painfully negotiated with the European parliament in 2021. The outcome of parallel negotiations between the Commission and the Hungarian government on the “Next Generation” funds could further raise the bill for the Orban administration.

As often with European processes, there will be many occasions to resolve the crisis. The Hungarian government now has two months to present new remediation measures before the European Council votes on the matter (at a qualified majority of 15 member states representing at least 65% of the EU population). Yet, the issue is already having some impact on the political situation in Italy. Indeed, two days before the Commission issued its recommendation, the European parliament voted a resolution calling Hungary an “electoral autocracy”. This brought some comments from Giorgia Meloni, who according to all the available polls will win the Italian general elections on 25 September. She stated that “Hungary is… a democracy”, while the Members of the European Parliament (MEPs) from her party voted against the resolution in Brussels. This raises the possibility that Italy votes down the sanctions later this year once Meloni’s coalition is in power in Rome.

While we agree with the market’s general view that Meloni’s coalition will refrain from decisions in the domestic economic realm which would immediately antagonize the European institutions – at least in its first months in power - the market may be under-estimating the impact an alignment of Italy on the “combative” approach to European integration popular in the East could have on the capacity of the block to make further progress.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• CPI inflation (Aug) eased to 8.3%, but 'core' rose unexpectedly to 6.3% from 5.9% • Retail sales (Aug) weaker than expct'd, Jul rev'd down • Empire and Philly Fed surveys (Sep) mixed, Philly fell to contractionary territory • Fin conditions tightened on sharper Fed move expcts	• Fed meeting (and SEP f'casts). Following surprise 'core' inflation we increase our forecast to 75bps rise this time. Expect 'dot plot' to rise for this year and next • Housing data (starts & sales) (Aug) expect to show continued declines in activity • Jobless claims continue to fall
	• EC presented emergency measures to soften burden from energy prices. They are enshrined at the national level • Euro area IP fell in July reflecting further stress on energy intensive sectors	• Business surveys for Sept: watching out for further drops in services confidence joining manufacturing weakness
	• GDP rose by 0.2% (Jul) – risk of technical recession in Q3 higher w/extra bank holiday for Queens funeral • Labour market continued to tighten as u/rate fell to 3.6% but vacancies fell as demand moderates • CPI inflation (Aug) dipped to 9.9% as fuel prices fell • Retail sales fell sharply by 1.6%mom as price rises weigh on consumer – largest drop this year	• BoE MPC meeting (Thurs); we expect +75bps given additional stimulus, but risk of a smaller 50bp hike remains • Fiscal Event (Fri) Chancellor Kwarteng to set out cost of Energy Price Guarantee Scheme and additional fiscal policies • Public Finances (Aug) • Consumer Confidence (Sep) expected to rebound from lows
	• BoJ conducts rate check, a precursor to intervention in currency markets in escalation of verbal warnings from Finance Minister Suzuki • Trade deficit (Aug) rose to a record ¥2.8tn as yen weakness pushes import costs higher • Gov to ease border controls faster to boost tourism	• BoJ meeting (Thurs); we expect no change to key policy parameters. BoJ may adjust lending programme. Gov Kuroda conf will be key amidst continued yen weakness • CPI (Aug) expected to push higher to 2.9% (cons)
	• August data surprises on the upside, with growth strengthening across all major sectors • Retail sales mark the biggest upside surprise, with growth in both goods and services sales improving despite a worsening of the outbreak • CNY/USD flirts with 7, with offshore RMB CNH rate already crossing the line	• Further policy easing is possible as Beijing surprises by cutting the bank deposit rate for the first time in years • SEC officials will arrive HK to start audit inspection on the first batch of Chinese ADRs • CNY/USD crossing 7, if it happens, could trigger some response (explicit or verbal) by the PBoC
	• CB: Russia cut the policy rate by 50bps to 7.50% • Aug inflation (yoy) picked up in India (7.0%), Romania (15.3%). It decelerated in Czech Rep. (17.2%) • Aug retail sales (yoy) lost steam in Colombia (7.7%) & Turkey (2.0%). Sales contracted 5.2% in Brazil • Aug unemployment increased in Peru to 7.3%	• CB: Indonesia is expected to hike +25bps to 4.0%, Philippines +50bps to 4.25%, Taiwan +12bps to 1.62%. Brazil (13.75%), Hungary (11.75%) & Turkey (13.0%) should stay on hold • Aug CPI (yoy) in Malaysia, Singapore & South Africa • Q2 GDP data in Argentina • Retail sales figures in Mexico (Jul) & Poland (Aug)

Upcoming events		
	US:	Mon: NAHB housing market indx (Sep); Tue: Housing starts (Aug), Building permits (Aug); Wed: Existing home sales (Aug), FOMC announcement; Thu: Current account (Q2), Weekly jobless claims (Sep), Leading indx (Aug); Fri: Manufacturing/Services 'flash' PMI (Sep)
	Euro Area:	Tue: Ge PPI (Aug); Thu: EH19 Consumer conf. (Sep), Fr Insee manufacturing conf. (Sep); Fri: EU19 & Fr & Ge Composite/Manufacturing/Services 'flash' PMI (Sep), Sp GDP (Q2); Sun: Italian general election
	UK:	Wed: PSNB (& ex-banking groups) (Aug), CBI Industrial Trends survey (Sep); Thu: MPC announcement; Fri: Gfk consumer conf. (Sep), Composite/Manufacturing/Services 'flash' PMI (Sep), CBI Distributive Trades survey (Sep), Chancellor Kwarteng gives fiscal statement
	Japan:	Tue: CPI & national 'core' CPI (Aug); BoJ announcement
	China:	Tue: One-year Loan Prime Rate

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