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Investment Institute Macroeconomics

Roaring Fifty

- We expect a “twin gear-change” in the pace of tightening from the Fed and the ECB, both opting for 50bps, but also quite a lot of hawkish rhetoric.
- The EU has few politically, financially, or institutionally appealing solutions to deal with the US IRA challenge.

It’s a big week for central banks. Market pricing and analysts’ expectations have converged around a “gear-change” in the speed of tightening, with the Fed and the ECB both opting for “50 bps only” hikes. We concur, even if the risk of another jumbo hike seems to us a bit higher in the Euro area than in the US. Yet we also expect this slowdown in the tightening pace to come with a big dollop of hawkish rhetoric to make it clear that the central banks are “not done yet”. This is especially a challenge for the Fed, given how markets have been quite stubborn in pricing in rate cuts quite quickly. However, the Fed can use quite effectively its “dot plot” to send clear messages. When it comes to the ECB, it’s less the trajectory for policy rates which is likely to be the “piece de resistance” but the first indications on Quantitative Tightening. We don’t expect much granularity this week on this, but we believe the ECB won’t want to “rock the boat” and will proceed carefully. Even a very gradual reduction in reinvestment can have a visible market impact though. We expect the supply of government bonds net of ECB operations to double next year relative to 2022.

Still, beyond these crucial monetary policy decisions, we also wanted to take a bit of perspective and explore further a theme which we find is going to rank more and more prominently in the macroeconomic debate: the rebound in US competitiveness, especially when compared with Europe. The Inflation Reduction Act is crystallising European fears of losing out to the US in the potential next industrial revolution: the green transition. We explore the options for an EU reaction, but none of them looks ideal from a political, institutional, or practical standpoint. Rather than focusing on a form of “retaliation”, the most productive approach would consist in delivering a boost to green transition investment by launching a “Next Generation EU” 2.0 programme, but we fail to perceive much enthusiasm across member states for such an additional effort.

Circling around the airstrip

Expectations for this week's Federal Open Market Committee (FOMC) meeting are remarkably convergent, with the near-entirety of sell-side economists calling for a 50-bps hike – a call which is firmly priced in by the market, and which is also ours. The slowdown in the pace of tightening has been quite clearly telegraphed by Jay Powell – even if as usual he has given himself some wiggle room – and no other prominent speaker from the Federal Reserve (Fed) has publicly come out against it. Of course, there is still one key piece of data missing, the consumer price index to be released on Tuesday, the day before the Fed meeting, but it would take a massively higher-than-expected print to move the dial to 75 basis points. The big issue for this week lies more in the kind of "soft forward guidance" we can get from the Fed.

Updating the "dot plot" would be the main channel through which the Fed could provide some visibility on the trajectory. We expect the "median forecaster" to put the Fed Funds rate at 5-5.25% in 2023, some 50 basis points above the September batch. A technical issue though is that the members of the FOMC are not asked about where they see the "terminal rate", i.e., the peak in the current tightening phase, but more prosaically where they think is the appropriate level for the policy rate *at the end* of 2022, 2023 and 2024. The terminal rate implicitly targeted by the FOMC could be higher than the value they will provide for the end of next year if, emulating what the market has been pricing for some months now, the "median FOMC member" starts considering rate cuts in the second half of 2023. This would however bat odds with all the recent communication from the central bank, and in any case**, if the policy rate at the end of 2023 is even only marginally higher than what the market is currently pricing for the peak (4.9% in the spring of 2023 as of last Friday), the message will be quite strong: monetary conditions *throughout next year* would be tighter than what is currently pricing in** (forwards have Fed Funds at 4.53% in December 2023).

Another way for the Fed to communicate their readiness to get further than what the market has been pricing would consist in significantly downgrading their GDP growth forecasts for next year. The FOMC was still quite optimistic in September, with a 1.2% GDP gain next year, a full percentage point above current consensus. Converging towards consensus in this batch – which we expect – would signal powerfully that the Fed is ready to maintain a quite restrictive stance (5% for Fed Funds is twice the neutral rate) despite challenging macro conditions. A popular explanation behind the market's expected dovish pivot is that the Fed would be "forced" by the looming recession to change tack quite rapidly next year. If the Fed fully acknowledges in the December forecasts the recession as the "price to pay" to get inflation back under control while upgrading their interest rate trajectory, the market should normally cut the odds of a cyclically driven dovish trajectory, assuming however that the market really listens to the Fed's messages, which has not been obvious recently.

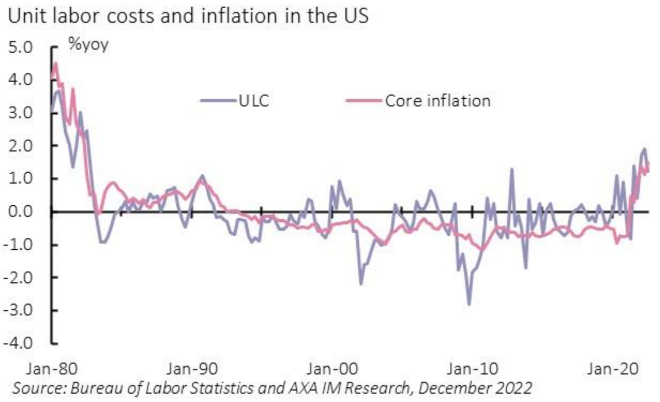
Beyond the message from the "dot plot", we expect Jay Powell to maintain the "triptych line" has been espousing for months now, making it clear that the market should not see a continuum between moving to small rate hikes and imminently pausing, before cutting rates quickly. **Our habitual readers will forgive us this aeronautical metaphor: the Fed is not ready to land. It is currently circling around the airstrip**, trying to see through a "data fog" if conditions are getting met before fully deploying the landing gear.

Indeed, the general disinflationary direction of the dataflow continues to materialise "on the whole", but the proverbial "smoking gun" is still missing. True, jobless claims released last week continued to rise, bringing more substance to the softening labour market we discussed in the previous issue of Macrocast. This held for both initial and continuing claims, the latter reaching their highest since February – yet the absolute level is still quite low by historical standards for a "pre-recession" configuration. In the same vein, the release of estimates of unit labour costs for Q3 came out with some comforting message, falling back to 5.4%yoy from 7.1% in Q2, both components going in the right direction. Productivity is still declining, but at a slower pace (from -2% to -1.3%yoy) and compensation for hour decelerated from 5% to 4%). A problem though, beyond the fact the sheer speed remains elevated, is that Unit Labour Costs (ULCs) tend to be very volatile, and while they are fundamental to price dynamics, distinguishing the signal from the noise is particularly arduous for this variable**. Exhibit 1 illustrates how generally inflation and ULC regimes coincide,**

but the latter can be quite erratic. It will take more than just one encouraging print for that series for the Fed to breathe more comfortably. We are all – understandably – focusing on detecting inflexion points, and it's undeniable in our view that most "second derivatives" are now going in the right direction in the United States (US) when it comes to the prospects for disinflation, but the peaks were so high that it's going to take time to land back not too far from 2% inflation.

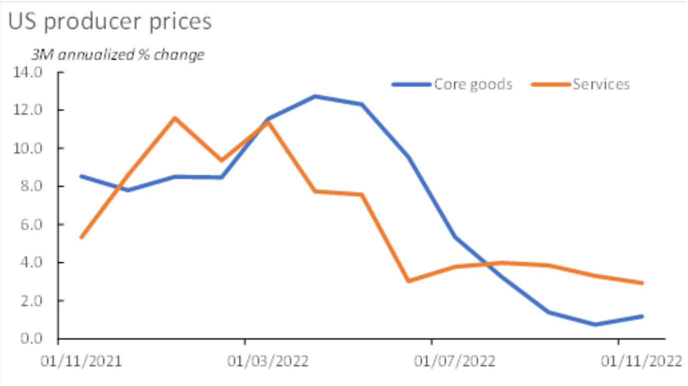
While indicators on the "demand side" of the inflation equation continue to be crucial, we keep an eye on the supply side in the "pipeline". We explored two weeks ago how a lot of the downside surprise on US inflation in October came from industrial prices, while they were still accelerating in services. We explain the disinflation in industrial goods as the materialisation of the general improvement in supply lines over the last few months. We also pointed out how the volatility in industrial goods prices could create some "accidents" in the data flow without necessarily suggesting the disinflation trend is jeopardized. The release of production prices for November last week was a case in point. The monthly change in the headline Producer Price Index (PPI) came out above expectations, and when looking at the data with a bit more perspective (our preferred 3-month annualized change) we've had a small rebound in core goods, which more than offset a deceleration in services prices (see Exhibit 2). The trends for both series are encouraging though: what is in the pipeline for US prices is definitely less scary than the picture from last summer, but it's going to take time to find its way to consumer prices.

Exhibit 1 – ULCs far more volatile than core inflation



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

Exhibit 2 – Good news from the "producer price pipeline"



Source: Bureau of Labor Statistics, AXA IM Research, December 2022

All in all, it seems to us that the Fed now has good reasons to believe that the quantum of tightening it has already delivered this year is having an impact on inflationary pressure, but also that the gap relative to its target is still too high to warrant complacency. We thus expect the slowdown to 50bps to be accompanied by plenty of hawkish noises, both in terms of qualitative comments as well as in the main takeaways from the new forecasts. While the Fed has for now refrained from emulating the Bank of England – which we also expect to hike by 50bps this week – in directly commenting and contradicting market expectations, we think the recent market rally is being met by quite some frustration at the FOMC. Indeed**, if broad financial conditions continue to loosen, impairing the transmission of the policy tightening, the chances to see inflation landing relatively quickly will diminish.** Powell may be tempted to shake the market out of its current complacency. This could make for a still "rhetorically hawkish" Wednesday night.

ECB: let QT begin (although not just yet…)

We also expect a gear-change to 50bps from the European Central Bank (ECB) this Thursday. It is less clear than for the Fed though, since some prominent members of the Council such as Isabel Schnabel made publicly the point that the space for a slowdown in the tightening pace is limited. Still, we stick to the point we made last week: if the central bank is truly in "data dependent mode", then it should be symmetric. Higher than expected inflation prints played a key role in pushing the ECB into 75bps territory. Then the lower-than-expected November release, however flimsy, should play against the temptation to deliver yet another super-size hike.

Another – more fundamental – reason may be that 2% (where the deposit rate will be if the ECB chooses a 50bps hike) is an important threshold. Indeed, even if Christine Lagarde has been at pains recently to avoid any precise quantification of the "neutral rate", 2% is widely seen as its upper limit. Moving in one go by 75bps would push the deposit rate squarely in restrictive territory, something which in Christine Lagarde's communication recently was still presented as an option, but not a certainty. We expect the ECB to eventually cross that Rubicon in the first quarter (we have the terminal rate at 2.5%), but no without a "proper conversation" within the Governing Council.

Still, **just like the Fed, the ECB may well be frustrated by the recent market moves which have lessened the tightening in broad financial conditions, which would make them want to "offset" the gear-change with a good dollop of hawkish comments.** The new macroeconomic forecasts would be an obvious channel to achieve this, but the technical constraints of the projection exercise may complicate matters for the hawks. Indeed, the use of forward pricing for energy can be quite problematic in the current circumstances. The September batch was based on a price of natural gas for 2023 at a whopping EUR235/Mwh, markedly up from EUR168/Mwh in 2022, resulting in the continuation of a strong positive contribution from energy to headline inflation next year. The state of the market has dramatically changed since then (the 1-year ahead TTF contrast currently stands at EUR 121.5/Mwh), which should be consistent with a *decline* in the contribution from energy to headline in the projections.

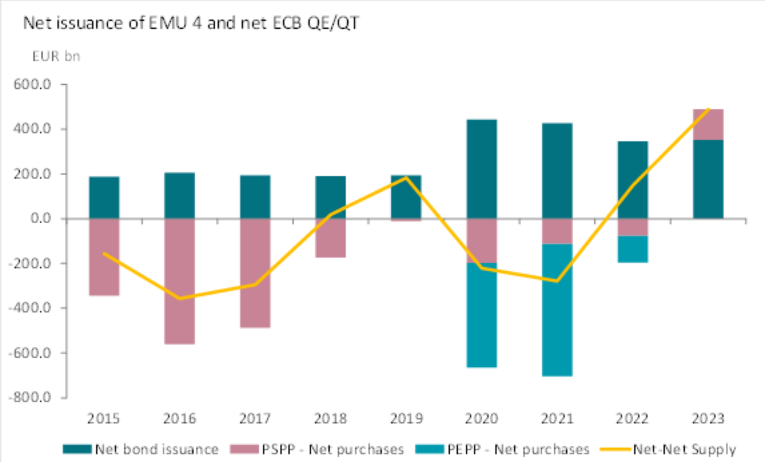
True, the ECB is likely to be tempted to offset a slower headline inflation with an upward revision to its scenario for core, but the room for manoeuvre for this is not that wide either. Observed core inflation has continued to accelerate since September, but not by massively more than what the central bank was expecting already. Indeed, the change in annual average for 2022 core Consumer Price Index (CPI) stood at 3.8% in the September batch. With the data from October and November in, and assuming a stabilisation at 5.0%yoy in December, the annual average is likely to settle at 3.9%: not a large difference in the starting point to help justify an uptick over the entirety of the forecasting horizon. The ECB is ostensibly more worried about wage developments now than three months ago, and they could justify an upward revision of core inflation this way, but they had provisioned an already quite chunky acceleration in wages in 2023 (4.8%) in the September batch. Finally, another problem is the interest rate assumption. While the FOMC members indicate what they think is the "appropriate policy rate", the ECB wants to take an "agnostic view" and builds its forecasts on the basis of the observed forward rates. In September, this resulted in an assumption for short-term rates at 2% in 2023. This is likely to have moved to close to 3% in the December batch given how market pricing has evolved. Having core inflation accelerating significantly despite short-term rates moving in sharply restrictive territory might be difficult for the central bank, communication-wise.

All in all, we expect only a minor change in the inflation forecasts, and most of the "soft forward guidance" to be qualitative. Christine Lagarde could for instance focus on the balance of risk for inflation still being clearly tilted to the upside to signal the continuation of rate hikes into the beginning of 2023.

The "piece of resistance" next week is however likely to be the indications the ECB intends to give us on the shape of "Quantitative Tightening" in 2023. Most sell-side houses are not expecting much more than general principles and a tentative timeline. We agree. **We think the central bank will re-affirm that the policy rate is the main instrument of monetary policy in the current circumstances**. This would send the signal that the pace of Quantitative Tightening (QT) will be fairly predictable and will not be fine-tuned too often to try to shape financial conditions "in real time". We expect the implementation to start only in Q2 2023, a timing which is likely to loosely coincide with the ECB reaching its terminal rate. Some hawks – in particular the Bundesbank President Joachim Nagel – have been arguing for starting in early 2023, but we suspect it is mostly "tactical positioning" and that there is a consensus to proceed carefully in an already complicated bond market. Our expectation is that the ECB will not proceed to "net sales" in 2023 and will focus on gradually reducing the pace of reinvestment of the maturing bonds it holds, with "zero reinvestment" coming in Q4 2023 only.

Note that even such prudent approach would not be riskless. Between 2015 and 2021, "net net" supply of government bonds (net issuance minus ECB purchases via its various Quantitative Easing (QE) programmes) was – briefly and marginally – positive only in 2018/2019. In 2020 and 2021, massive purchases brought net net supply into deeply negative territory again, despite massive issuance by governments funding the mitigation of the pandemic. **Supply turned positive again in 2022, and on the basis of the forecasts from sell-side houses and using our own expectations for ECB reinvestment, it would more than double in 2023 to nearly EUR500bn**. It is a significant change, and one of the reasons why we remain circumspect on the idea that long-term interest rates have reached their peak in the Euro area. On the US market, investors know what the Fed intends to do, and it's probably already largely priced in. The same does not hold in the Euro area.

Exhibit 3 – "Net net" supply of European government bonds to double in 2023



Sources: Barclays, Deutsche Bank, Goldman Sachs, ECB and AXA IM Macro Research, as of Dec 2022

IRA adding to the European headaches

While this week is going to be dominated by monetary policy, we also wanted to take a bit of perspective and explore further a theme which we find is going to rank more and more prominently in the macroeconomic debate: the rebound in US competitiveness, especially when compared with Europe. The Inflation Reduction Act is crystallising European fears of losing out to the US in the potential next industrial revolution: the green transition.

With the Inflation Reduction Act (IRA) – which in reality is a Green Transition Act – the US administration means business, even if the package is smaller than what Biden had presented in his electoral platform. USD369bn (1.5% of GDP) in tax incentives and direct subsidies is still significant. The package is mostly geared towards the renewables/electric vehicles (EV) industries, and it is funded via ordinary, general tax receipts (no recycling of any carbon tax). The IRA comes with a strong « buy American » component, either via eligibility for subsidy (e.g., access to the USD 7,500 grant to consumers purchasing EVs) or access to federal procurement. For instance, for EVs, final assembly must be performed in North America, and 40% of minerals for batteries need to be extracted or processed in a free trade partner by 2024, moving to 80% in 2026. Besides, no content from « foreign entity of concern » (e.g., Russia, China) will be allowed. Beyond the minerals, batteries as a whole will need to have 50% North American content by 2024, 100% by 2028.

Interestingly, the IRA abolished former limits to EV subsidies. There used to be a « production cap » per carmaker beyond 200k vehicles, which effectively blocked further investment by US-centric producers (e.g., GM and Tesla had hit the limit). Removing the limit has the potential to trigger a quick catch-up in the US, where EVs/PHEVs account for only 6.2% of cars, against 11% in the European Union (EU).

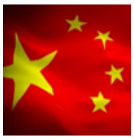
The Europeans' less than enthusiastic reaction is understandable. The IRA can trigger an adverse shock to EU exports: the US is now the main external market for EU carmakers, with a share in their total exports of 20.1%, against 17.1% to the UK and 16.7% to China. In addition, the IRA could result in a loss of competitiveness versus producers covered by Free Trade Agreements with the US, such as South Korea. Beyond the export issue, the EU is concerned about medium-to-long-term dampening effect on domestic investment since manufacturers of cars and products for renewables are incentivized to move production centres to the US.

We can list 4 possible responses from the EU, none of them looking ideal. "Carve out" would be the first – and probably least problematic. This would entail obtaining from the US an extension to Europe of the exemptions for batteries, vehicles, and renewable production capacity. This was Emmanuel Macron's approach during his state visit to the US. There were some positive noises from Joe Biden, but he has lost control of the House, which makes it more difficult to refine the legislation, even if some limited "interpretative leeway" could be found in the implementation of the rules by the federal agencies.

Escalating the issue to the World Trade Organization (WTO) is of course an option, but a quick resolution is unlikely. While the current US administration is much less openly critical of multilateral institutions than the previous one, there has not been no tangible progress on a major factor behind the WTO's current state of near paralysis. The Trump administration had blocked the appointment of US judges to the WTO's appellate body, and this issue remains locked. A fundamental problem as well is that the EU might find itself in a complicated position at the WTO because of its own "border tax" project (in practice levying customs duties matching the difference between carbon price in the EU and carbon price in the country of origin of imported goods). This is a "grey area" – the appellate body in 2007 in a ruling on a Brazilian measure found that wide flexibility should be granted when integrating environmental goals in trade policy, but there could be long discussions on the notion on "non-discrimination" of foreign products.

Of course, even if this would fall in the category of "lose lose" approach given the Responding with own discriminatory approach to foreign-made Evs/Renewable production capacity. We would however expect disagreement across member states over the principle of moving away from the EU's overall commitment to free trade, especially in a dispute with the US. The EU is not in the best position right now to engage in a full-fat trade war with the US given its dependence on US energy/strategic support.

The fourth option would consist in Intensifying the EU's own efforts towards investing in the Green Transition. The EU Next Generation programme is smaller and less focused than the IRA – 37% of the EUR750bn are ear-marked to "climate action" – and funded by debt which is supposed to be partly paid back by new "own resources" for the EU, including proceeds from the carbon Emissions Trading System (ETS) and the "carbon border tax". Very much to our surprise and dismay, no agreement right now on a Next Generation EU (NGEU) 2.0 has been emerging. The EU Commission President has expressed her support to reforming state aid rules further in this field, but if funding comes from member states individually, rather than from a "federal" effort, the financial and psychological effect is likely to be small.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• PPI inflation (Nov) fell to 7.4% (6.2% core), disappointing hopes for a sharper drop in both • Continuing jobless claims rise to highest since Feb • Services ISM (Nov) rises to 56.5, PMI falls to 46.2 • Trade deficit (Oct) widens to $78.2bn from $74.1bn • US eases restrictions of Chinese chip use in final bill • Senator Sinema (D) leaves party to act as Independent	• FOMC meeting. We expect Fed to raise FFR by 0.50%. Expect still hawkish tone and 'dots' raised to 5% for end next year. Question of whether markets believe it • CPI inflation (Nov), concur with consensus 0.3%mom rise in core, energy may drag headline a little lower • Retail sales (Nov) expected weakness after solid Oct • Empire and Philly Fed Surveys (Dec)
	• Final EMU PMIs unchanged at 47.8 for Composite output and 48.5 for Services • EMU October retail sales fell by 1.8%mom • Ge IP slightly decline (-0.1%mom). Auto production compensated for lower production in intensive energy sector. Industrial orders rose by 0.8%mom • Q3 GDP and EMU employment revised up to 0.3%qoq (+0.1pp)	• Final HICP data will provide a refined view on underlying pressure but should confirm it remains strong as most of the decline come from energy prices • Ge December ZEW surveys should display a more resiliency German economy after most recent data • EMU October IP is expected to weaken as energy prices remain high and demand is fading • Fr December business climate should stabilize at 100
	• Halifax house prices (Nov) down 2.3%mom, with RICS balance suggesting declines set to continue • BRC sales monitor up 4.1% mom in nominal terms, but real deflated sales continue their decline • Industrial action across sectors in the UK with rail workers, nurses, teachers planned • REC survey (Nov) signals weakening in labour market	• MPC meeting (Thurs): we expect +50bp hike to 3.50% as BoE closes in on expected peak of 4.25% • Monthly GDP (Oct) expected to rise 0.4% (cons) pushed higher by rebound from additional Sept bank holiday • CPI inflation (Nov) set to confirm inflation peaked with a decline to 10.9% (cons) • Labour market data (Oct/Nov) likely to see u/rate rise
	• Q3 GDP revised up to -0.8% (saar) from -1.1% mainly due to inventories • Trade balance (Oct) at record levels as yen weakness weighs and Current account drops into deficit • Tankan index (Dec) shows manufacturing sentiment up despite global slowdown first rise since Aug	• Exports and imports (Nov) expect to show imports increase amidst rising energy and imported cost • Flash PMIs (Dec) • Tertiary Index • Chain store sales (Nov)
	• Beijing announces another 10-point plan to further relax COVID restrictions and reopen the economy • Export growth declines amid falling external demand; imports also disappoint as the economy struggles against surging COVID cases • Politburo meeting hints a pro-growth agenda next year, with discussions on COVID and property reflecting recent policy shifts	• November activity data to show the economy suffers from the latest COVID wave • Credit growth (Nov) to reflect increased policy support • Central Economic Work Conference to confirm a shift in policy priority from controlling COVID to stabilising growth • Markets to stay focused on Beijing's COVID policy changes
	• CB: India hiked +35bp to 6.25% & Peru +25bp to 7.50%. Brazil (13.75%), Chile (11.25%) & Poland (6.75%) stood on hold • Q3 GDP growth (yoy) picked up in South Africa (4.1%) • Annual inflation (Nov) rose in Chile (13.3%) & Hungary (22.5%). It fell in Korea (5.4%), Mexico (7.8%) & Turkey (84.4%) • Peru's Pedro Castillo was impeached and arrested	• CB: Colombia is expected to hike +100bp to 12.0%, Mexico +50bp to 10.50%, Philippines +50bp to 5.50% & Taiwan +12.5bp to 1.75%. Russia on hold at 7.50% • Annual inflation (Nov) data in India, Romania & S. Africa • Industrial prod. (Oct) figures in Colombia, India, Malaysia, Turkey & Mexico • Q3 GDP in Argentina & Russia

Upcoming events		
	US:	Tue: NFIB small business optimism (Nov), CPI (Nov); Thu: Retail sales (Nov), Weekly jobless claims (10 Dec), Philadelphia Fed Indx (Dec), Empire State manf. indx (Dec), Ind. prod. (Nov); Fri: Manf. and Services 'flash' PMI (Dec)
	Euro Area:	Tue: Ge HICP (Nov), ZEW: Current situation/expectations (Dec), It Ind. prod (Oct); Thu: ECB announcement, Fr HICP (Nov) & Insee manf. confidence (Dec); Fri: EU19 Composite/Manf/Services 'flash' PMI (Dec), CPI (Nov), Ge & Fr Manf. and Services 'flash' PMI (Dec)
	UK:	Mon: Monthly GDP (Oct), Indx of services (Oct), Ind. prod. (Oct), Manf. & Construction output (Oct), Total trade balance (Oct), Trade in goods (Oct); Tue: Unemployment & Employment (Oct), Ave. earnings (Oct), BoE Financial Stability Report; Wed: CPI, CPIH, RPI & PPI input and output (Nov), Ind. prod. (Oct), FOMC announcement; Thu: MPC Bank rate; Fri: GfK consumer conf. (Dec), Retail sales (Nov), Composite/Manf/Services 'flash' PMI (Dec)
	Japan:	Tue: Private 'core' machinery orders (Oct), Tankan large manufacturers indx (Q4); Fri: Manf. 'flash' PMI
	China:	Thu: Ind. prod (Nov), Retail sales (Nov), Fixed asset investment (Nov)

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