187 – 3 July 2023

Hawkish Speeches, Weak Data

- Hawkish festival in Sintra.
- The central banks may get the contraction in aggregate demand they seem to wish for quite quickly now: European surveys are turning decisively south, and the end of consumption resilience is confirmed in the US. It will take a lot to stay the central banks' hand though.

Except for the BoJ, all central banks stroke a hawkish note last week in Sintra. Although they chose to remain evasive on the quantum and timing of the next hikes, they are sufficiently concerned by persistent inflation to warn the market against pricing rate cuts too soon after the tightening peak. Keeping monetary conditions restrictive over a long time will do some significant damage to the economy, but they have clearly reached the conclusion that there won't be such thing as a painless landing.

They may get the contraction in aggregate demand they probably see as necessary quite quickly now. The European Commission survey released last week confirmed the message from the PMIs: services are now following the manufacturing sector in the downturn. In Germany – which we think will be the key to the ECB's future trajectory – hiring intentions are falling, heralding a correction of the labour market which is needed to hold back future wage negotiations and convince businesses to absorb in their margins the rise in labour costs already in the pipeline. There is no "smoking gun" yet though, and the better-than-expected core inflation print for June is unlikely to stay the ECB's hand at the July meeting. We need a clearer softening in the dataflow, and more signs core inflation is starting to land, to avoid a hike in September.

In the US, the May print for core PCE was reassuring, but the Fed is likely to focus on signs that excess demand has not yet been plugged. The upward revision in Q1 GDP was a setback from this point of view. Yet, consumption has been virtually flat since February, primarily because the savings' ratio is rising. We don't think this is enough though to convince the Fed to turn the current "pause" into an indefinite standby. Just like the ECB, the Fed is currently focusing on the labour market. This puts this week's payrolls release in focus, but we suspect that even a lower-than-expected print would need to be sustained through the summer to reassure the Federal Open Market Committee (FOMC).

Sintra's hawkish slant

The major central banks of the developed world, gathered last week in Sintra, may all have their idiosyncrasies – and Governor Ueda stroke a lone, dovish tone, reaffirming that the Bank of Japan (BoJ) needs to see more evidence inflation has definitely taken hold before altering its policy stance – but **the message from the European Central Bank (ECB), the Bank of England (BoE) and the Federal Reserve (Fed) was remarkably convergent:** while the timing of "peak tightening" may vary, they all made it plain that past-peak – which has not yet been reached - none of them would be in a hurry to reverse gear and cut rates. In the "higher for longer" line, the latter component seems to matter more than the former. The market had already moved before the meeting in Sintra, finally giving up on pricing cuts in 2H 2023 for the Fed. From a macro point of view, the longer central banks are deep into restrictive territory, the bigger the damage. Still, it's precisely because central banks are now fully reconciled with the idea that some significant damage is needed to bring inflation down that their communication can be nakedly hawkish.

There were words of warning from "outsiders" though. While the substance of Gita Gopinath's speech was in general supportive of hawkish monetary policies, she made it plain that central banks could not completely ignore the financial stability risks arising from the monetary tightening, and explicitly mentioned that in some cases, a slower return to price stability could be warranted.

Little was said by policymakers on specifics. The Fed had already sent a precise message with the two additional hikes baked in its latest "dot plot", and Jay Powell was probably counting on the minutes of the last meeting, due for publication this week, to nail the point home. Governor Bailey did not elaborate on whether a 50bps increment could be their preferred approach in the near future. As she did at the press conference following the last Governing Council meeting, Christine Lagarde refused to commit to anything beyond the July hike. Yet, her speech was in our opinion slightly more hawkish, as it seems that the central bank's belief in a "second wave" of inflation, this time fuelled by labour costs, is getting more solid.

How central banks are going to manage their balance sheet in the near future was the "elephant in the room". The issue was tackled in the academic discussions, but studiously avoided in the policy forums. This may well be the "big issue" of the second half of 2023 though, beyond the debate on peak rates. The ECB is only halfway there on stopping the reinvestment of the securities bought during Quantitative Easing (QE), since for now the quantum purchased under the pandemic emergency scheme is exempt. There may be "pure" reasons to speed up the normalization of the balance sheet (e.g., to accelerate the transmission of the policy stance, or to replenish the ECB's capacity for action if and when deflationary forces were to re-appear) and "impure" ones, such as reducing the cost to the central bank of paying significant interest rates on inflated bank reserves and thus impair the dividend owed to the national governments. We are convinced the issue will be in full focus after the summer, but at this stage it appears that no decision has been made.

Still, **while central bankers were "talking tough" in Sintra, the dataflow was signalling some – still tenuous – reduction in inflationary pressure, and weaker prospects for aggregate demand**. Not enough to stay their hands immediately, but we continue to think that there is still a chance no additional tightening will be needed in September.

Good surprise on Euro area inflation

The significant deceleration in Euro area consumer prices in June (from 6.1% in May to 5.5% year-on-year) is the product of **more good news on the "exogenous forces" – food and energy – and "less bad than expected" developments on core inflation**. The contribution from energy is now in significantly negative territory, while we seem to be past peak on food inflation (see Exhibit 1). There is normally a positive correlation, with a lag, between those two components, since energy is a key input in agricultural production, even if the vagaries of weather conditions could always trigger a rebound later this year. Yet, we know the ECB is more focused on core inflation these days, and of course the re-acceleration – from 5.3% to 5.4%yoy - is a setback at first glance, but the market was bracing for more (5.5%) given the disappearance of the one-off effect from the rebate on German train tickets.

Exhibit 1 – Food and energy down

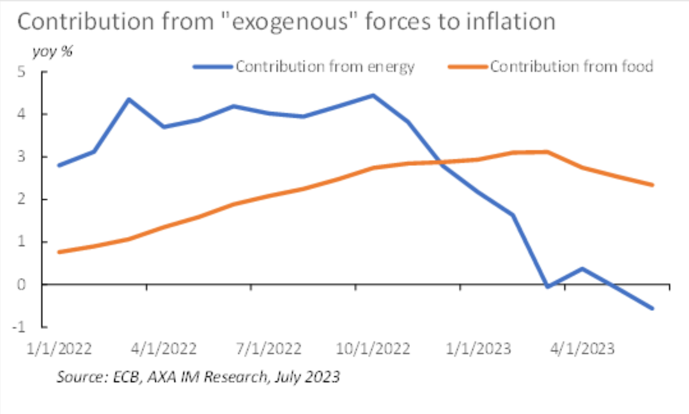
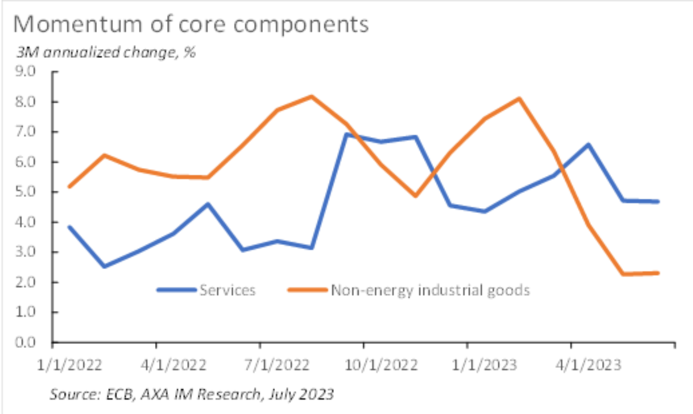
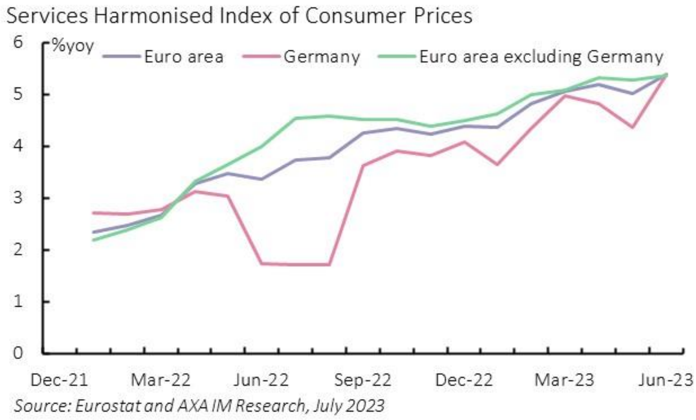


Exhibit 2 – Jury's still out on services



Delving more into core inflation developments and looking at 3-month annualized changes to get a better sense of momentum, the deceleration continues to be driven by manufactured goods (see Exhibit 2), reflecting the normalization in international supply-chains and the knock-on effect from lower energy prices. The trajectory for services – more tightly dependent on domestic conditions – is less clear since it's difficult to find a proper inflexion in the last few months. The gyrations in German train tickets do not help of course. The most honest point we can make with only the flash estimate for June – and thus incomplete data – is that excluding Germany, services inflation seems to have stabilized on a year-on-year basis (see Exhibit 3). This may not seem like much, but this is still bringing some comfort since it is in the services sector where we should now see the strongest underlying pressure, given its sensitivity to labour costs.

Exhibit 3 – Correcting for Germany's gyrations

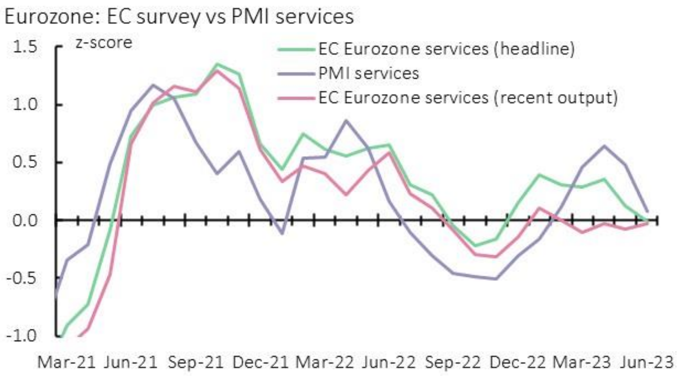


No tangible sign the Euro area is rebounding from technical recession

Yet, the signs of "proper" disinflation remain tenuous and to stay the ECB hand beyond July, the labour market needs to display some obvious signs of softness. Indeed, what Exhibit 3 also tells us is that we have been disappointed before on the services price front: excluding Germany we saw a long period of stability around 4.5% in the second half of 2022 which gave way to a concerning acceleration which contributed to the ECB's "muscling on" its tightening. We know from the recent negotiations that there is even more wage pressure in the pipeline, and we have already argued that, unfortunately, it's only when unions become aware that job prospects are deteriorating that they will accept to moderate their claims.

Still, despite this major source of uncertainty**, the doves may feel emboldened by more signs that the real economy is not clearly rebounding from its "technical recession" of last winter**. In the previous issue of Macrocast we had already highlighted the decline in the services Purchasing Managers' Index (PMI), while noting that its information content had been poor lately and that we would need to see confirmation from alternative sources. It came last week with the European Commission (EC) survey, which reported a significant drop in business confidence in the services sector (see Exhibit 4). When focusing on the "recent output" component of the EC survey, the stagnation, or "mild recession" scenario appears as the most plausible. True, consumer confidence continues to improve – see Exhibit 5 – but it's still well below its long-term average and we suspect the recent rebound is only a 'lull", a brief phase of reprieve as households are taking on board the detente on the inflation front without having, for now, seen any deterioration in their employment conditions.

Exhibit 4 – Activity softness in services confirmed



Source: Refinitiv and AXA IM Research, July 2023

Exhibit 5 – All components below their long-term average

Source: European Commission and AXA IM Research, July 2023

Habitual readers of Macrocast know that we are focused on **Germany as the key battleground**. Inflation has already receded significantly in some of the Southern countries – it fell below 2%yoy in Spain – and France never experienced the "raging inflation" seen in most of the Euro area. Inflation continues to exceed the Euro area average in Germany and wages are due to accelerate further in the coming quarters. Given its size, it's the fate of the wage/price nexus in this country which is likely to determine how far the ECB will have to go to tame inflation.

There is a lot of inertia in the wage bargaining process in Germany, since agreements usually cover more than one year – for instance the recent, very generous deal in the public sector will produce its maximum impact on wage growth in the spring of 2024 only – yet a deterioration in employment prospects in the coming months could still dampen *individual* pay rises beyond sector-wide agreements. We had already noticed that, while the internationally comparable International Labour Organization (ILO) measure of unemployment has remained stable for months around 3%, the national measure has been rising steadily, to hit 5.7% in June against 5.0% a year ago. Based on the historical relationship between unemployment and GDP, even the ILO measure should be on the cusp of deteriorating. This would be in line with the message from the soft data: **the IFO survey now has employment expectations below their long-term average for both the services and the manufacturing sector** (see Exhibit 6).

That the recession will morph from "technical" to a "proper one" is becoming a consensus view inside Germany. The three main economic institutes are not expecting any tangible rebound from the contraction in GDP observed in Q4 2022 and Q1 2023, and all have a decline in GDP in annual average for 2023, with IFO at the bottom of the distribution (-0.4%, the ifW is at -0.3% and DIW at -0.2%).

Exhibit 6 – Hiring intentions down in Germany

Interestingly, instead of triggering some additional fiscal accommodation – which would well be in Germany's capacity given its low debt level –the coalition has spent the best of last month negotiating, somewhat acrimoniously, how to find additional savings to the tune of EUR20bn, to plug the projected shortfall in tax receipts (the government was still counting on GDP growing by 0.2% this year in the stability programme published in May). Some of the deterioration in economic activity in Germany can already be directly traced back to monetary policy – e.g., the decline in residential investment – but the ECB can be reassured that, at least in the Euro area's biggest economy, the government is not going to stand in the way of the dampening in aggregate demand which disinflation is calling for.

It is not yet too late to stop the "second wave of inflation" which is clearly the ECB's chief concern at the moment. Even if the deterioration of the labour market may take too long to percolate through wages, at least **slower demand could convince businesses to absorb the rise in unit labour costs in their currently ample margins.** This pattern may be now at work in the United States (US).

Consumption struggling in the US

The release of the US Personal Consumption Expenditure (PCE) deflator data is rarely an exciting affair since it comes well after the Consumer Price Index (CPI) data for the same month, but it is the Fed's preferred gauge of inflation, and it would be a mistake to ignore it. **The May print came just as expected, with headline falling below 4% year-on-year (3.8% precisely) for the first time since April 2021. Core decelerated a bit more than expected**, to 4.6% from 4.7%. What is still missing though is a clear inflexion point: both the year-on-year and the three-month annualized measures have been pointing to a relatively stable trend since the beginning of the year (see Exhibit 7).

Delving deeper into the breakdown, **the Fed may find causes for concern in the counter-intuitive behaviour of non-energy industrial goods prices** which – on a three-month basis – have been rebounding recently (see Exhibit 8) **while services inflation is only slowly receding**. Note however that although the weight of actual and imputed rents in the basket is lower in the PCE than in the CPI, the inertia in rent growth (8.0% year-on-year in May) continues to push the services PCE up. According to a Bloomberg computation, excluding rents, services inflation has hit its lowest monthly pace since July of last year in the PCE.

So, prices are going in the right direction, but the gap relative to the inflation target remains wide, and **in the Fed's forward-looking approach, there could remain far too much excess demand in the system for a "safe landing" to materialise**. Bringing inflation from 4% to 2% can be much more painful than bringing it from 6% to 4%. From this point of view, the additional upward revision in the GDP print for Q1 could have sent alarm bell ringing. The earliest estimate stood at 1.1%. It then crept up to 1.3%, but this was still below potential GDP growth in the US – widely seen as close to 1.75%. But with 2% growth, the latest estimate, the positive output gap rises again.

Exhibit 7 – Only slow core inflation decline

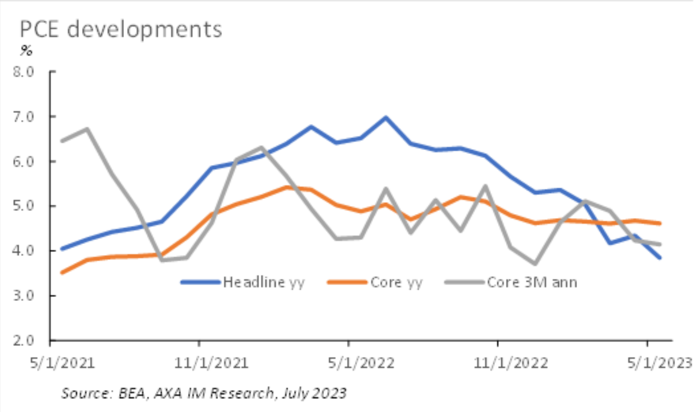
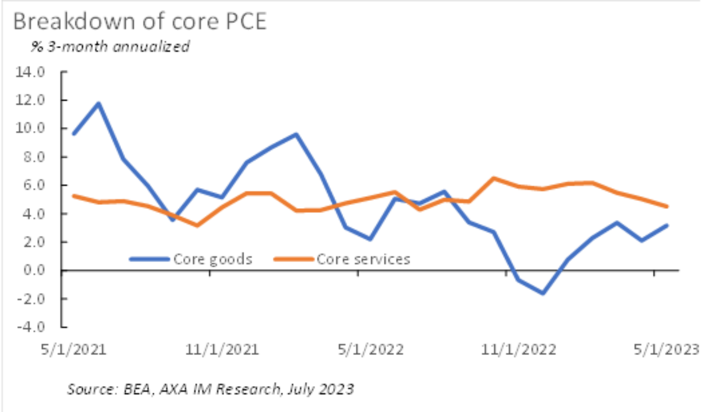


Exhibit 8 – Services slightly down, NEIG rebounding



Yet, the Fed may be focusing more on the behaviour of consumption than GDP at large, given how crucial developments in the services are for the whole inflation trajectory. The entirety of the consumption gain observed in Q1 GDP materialized in January. Since then, personal consumption has been virtually flat – this was confirmed last week in the data for May (see Exhibit 9). This might be counter-intuitive against a background of robust job creation and real wages no longer falling. The explanation comes from the savings ratio. After hitting a post-pandemic trough last summer, it has steadily recovered to return to its early-2022 level (see Exhibit 10).

Exhibit 9 – US consumption has been flat since February

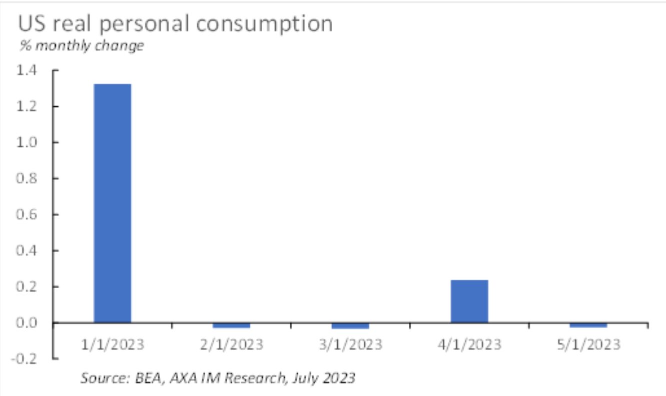
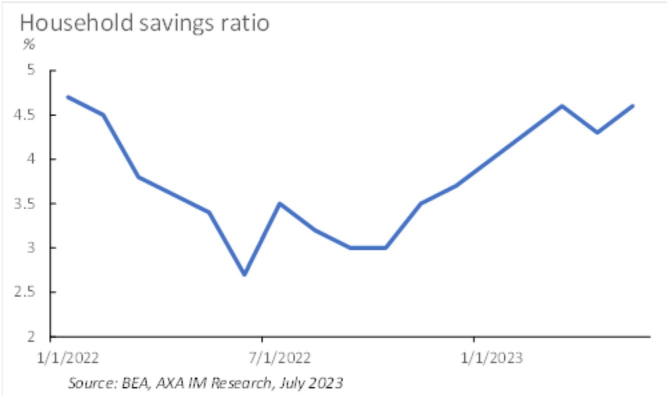
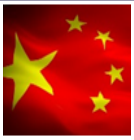


Exhibit 10 – Savings up



None of these developments – neither on the inflation nor on the cyclical front – are providing a “smoking gun” yet, but gradually the case for turning the pause in an indefinite “standby” after July is building up. An inflexion in the payroll could accelerate the process. For next week, the market is expecting only some moderation in job creation in June, with a still solid 225K, from 339K. It will be an interesting summer.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• GDP (Q1) raised to 2.0% (saar) on consumer & trade • Personal spending (May) rose by 0.1%, April was rev'd to 0.6% from 0.8%, the saving rate rose to 4.6% • Conf Bd Consumer Confidence (Jun) rose to 109.7 highest since Jan 2022, with increase in expectations • PCE inflation (May) 3.8% from 4.3%, core dip to 4.6% • New homes (May) +12.2%mom; pending sales -2.7% • Fed Chair Powell reiterated Fed could hike at least twice more, back-to-back hikes not ruled out	• Payrolls (Jun) expected fall in payrolls outright and with convergence to softer HH survey • Other labour indicators: JOLTS (May) important; jobless claims distorted by annual auto shutdowns • FOMC minutes (Jun) will repeat most see two hikes • ISM (Jun) further softness to suggest recession • Vehicle sales (Jun) measure of cons strength, balancing tighter financing vs excess saving • Trade balance (May) likely drag to Q2 GDP
	• Flash headline HICP (Jun) eased to 5.5%yoy, pushed down by strong negative base effect in energy. Core is up to 5.4% but momentum in services prices is weaker • Ge retail sales and Fr consumer spending (May) rose respectively by +0.4% and +0.5%mom • EMU unemployment rate (May) stable at 6.5% • Center right ND party and its leader Mitsotakis (PM) won the absolute majority in Greek parliament	• Final PMIs (June) • Industrial production (May) in Spain, France and Germany (new orders as well) • Retail sales (May) • EMU producer prices (May)
	• GDP (Q1, f) unrevised at 0.1%qoq • Business investment (Q1) revised up to 3.3% (from 0.7%), firms use closing super-deductibility • Mortgage lending (May) falls £0.1bn even as approvals stabilize around 50k. M4 money supply 0%yoy • Nationwide house prices (Jun) -3.5%yoy	• PMI indices (Jun, f) preliminary estimates showed weak manufacturing and slowing services • Decision Makers Panel (Jun) price expectations • New car registrations (Jun), were rising by 16.7%yoy in May
	• Tokyo CPI (Jun) broadly stable at 3.1%yoy (-0.1pp) defying energy base effect • Industrial output (May) was down by 1.6%mom • Finance minister warns against excessive yen weakening as it approaches 145 against the dollar	• Tankan surveys (Q2) to confirm the good momentum on economic activity • Household spending (May) • Final PMIs (June)
	• NBS PMIs (Jun) manufacturing improved slightly (49 from 48.8) and services at 53.2 (from 54.5) • Industrial profits down 18.8% YTD (May) from -20.6% previous month	• June Caixin PMI survey for manufacturing and services
	• CB: Colombia on hold (13.25%) • June prelim. inflation in Poland 11.5% (13%) • Brazil COPOM opened the door for rate cuts, CMN reiterated inflation target at 3% ±1.5% for 2024-2026	• CB: Malaysia (3%), Romania (7%), Poland (6.75%) expected on hold • CB: Chile, Mexico, Colombia's central banks' minutes • June CPI in Indonesia, S.Korea, Philippines, Thailand, Taiwan, Turkey, Hungary, Peru, Uruguay, Chile, Mexico, Brazil • June PMI survey across the regions

Upcoming events		
	US:	Mon: Manf PMI (Jun), ISM manf index (Jun); Wed: Factory orders (May), FOMC minutes; Thu: ADP emp change (Jun), Weekly jobless claims (Jul 1), Trade balance (May), Services PMI (Jun), ISM non-manf index (Jun), JOLTS job openings (May); Fri: Non-farm payrolls (Jun), Unemployment (June), Average earnings & weekly hours (Jun)
	Euro Area:	Mon: EU20 Manf PMI (Jun), Ge manf PMI (Jun), Fr manf PMI (Jun), It manf PMI (Jun), Sp manf PMI (Jun); Wed: EU20 PPI (May), EU20 Composite and services PMI (June), Ge services PMI (Jun), Fr industrial production (May), Fr services PMI (Jun), It services PMI (Jun), Sp industrial production (May), Sp services PMI (Jun); Thu: EU20 Retail sales (May, Ge new manf orders (May); Fri: Ge Industrial production (May)
	UK:	Mon: Manf PMI (Jun); Wed: SMMT new car reg (Jun), Composite and services PMI (Jun); Thu: Construction PMI (Jun); Fri: Halifax HPI (May)
	Japan:	Mon: Tankan large manf index (Q2), Manf PMI (Jun)
	China:	Mon: Caixin manf PMI (Jun); Wed: Caixin services PMI (Jun); Fri: Foreign exchange reserves (Jun)

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