AXA Investment Managers

211 – 29 January 2024

Investment Institute Macroeconomics

Exploring a Miracle

- In the US, strong growth combined with further disinflation has raised the credibility of a very rare occurrence: a painless landing. In the Euro area, Christine Lagarde's press conference last week may reflect a greater readiness to alter the course of monetary policy in the face of a deteriorating real economy. We remain cautious in both cases.

In our first post-Christmas Macrocast we wrote that the distribution of risks was not symmetric across the Atlantic in part because the most plausible policy mistake is not necessarily the same in the US and the Euro area. The belief in the capacity of a "soft landing" to bring inflation under control may convince the Fed to cut rates too soon, allowing a resilient economy to ultimately keep the pace of consumer prices above target. Conversely, a backward-looking approach to monetary policy by the ECB may make them cut too late, precipitating a deep recession which would force inflation below target. Yet, two developments last week might have reduced these two risks symmetrically: the combination of strong GDP growth in the US with on-target core PCE adds credibility to the "painless disinflation" hypothesis, while Christine Lagarde's unexpected reluctance to push back market expectations last Thursday may reflect a greater readiness to alter the course of monetary policy rapidly in the face of deteriorated conditions in the real economy.

Unsurprisingly, these pieces of news have fuelled further the market's already aggressive expectations for swift rate cuts across the Atlantic. Still, we maintain our cautious approach – our baseline is still that cuts start in June for both central banks. In the US, although we agree a case for bringing the cuts forward is getting easier to make, the very resilience of the economy should incentivise the Fed to take its time to shift to a more accommodative stance – what is the urgency? – while still keeping alive the possibility that, although the recent data flow on consumer prices has been reassuring, a line of resistance above 2% may still emerge. For an early cut by the ECB, we think that the dataflow would have to be "perfect" in the coming months.: inflation would have to recede flawlessly, more "bad data" would have to come on the real economy and the real-time indicators on wages would have to point to a proper slowdown. This is not impossible - an April cut is now part of our "plausibility range" for the ECB – but data rarely comes without ambiguity.

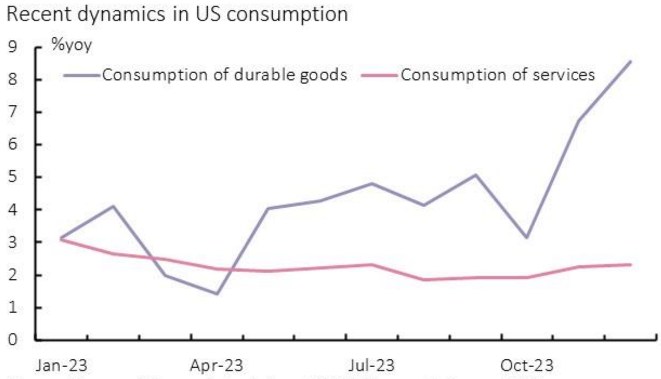
US Teflon economy

US GDP growth exceeded expectations again in Q4 2023. The consensus range was between 1% and 2.5%. At 3.3% in annualized terms, it stood almost at twice the commonly received estimate for potential growth. Given how fast GDP had risen in Q3 already (4.9%), it would have been natural to expect some measure of mean reversion. Even more intriguingly, this exuberant growth rate is not ushering in a rebound in inflation. The first estimate for the Core Personal Consumption Expenditure (PCE) price index – the Federal Reserve (Fed)'s favourite measure of inflation - for December came out slightly below expectations, falling below 3% year-on-year for the first time since March 2021.

Last year we opined several times that miracles do happen, but that it would be brave to peg one's macroeconomic baseline to one of them. Monetary tightenings normally trigger significant downturns. We are forced to consider such rare event may be materialising in the US. **The Q4 GDP performance must be measured against a policy rate which itself stands at more than twice the Fed's own estimate of its "cruise level".** It is increasingly difficult to resort to explanations focusing on "transmission lags". Fed Funds rates have been in restrictive territory – using this "cruise level" as a yardstick – since the autumn of 2022. This should have started to bite by then.

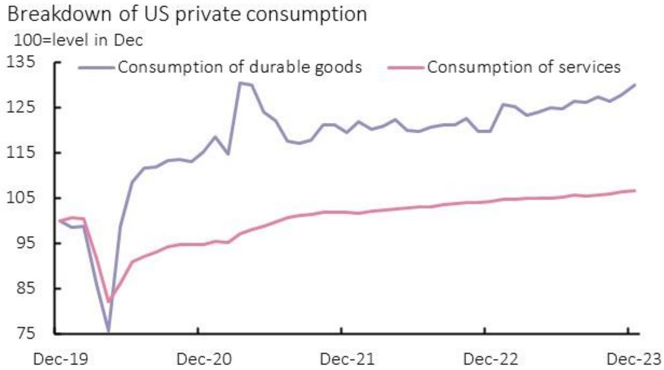
What we find the most striking in this Q4 GDP data is **the resilience of some of the very components which should be the most sensitive to interest rates**. Households' spending on durable goods has in fact accelerated significantly over the last two quarters (see Exhibit 1), to gain more than 8% year-on-year in December 2023. It is a relatively small share of total consumption (13%), but it comes with a wide variance and often drives the overall spending dynamics.

Exhibit 1 – Unstoppable splurge on durables



Source: Bureau of Economic Analysis and AXA IM Research, January 2024

Exhibit 2 – And it's been going on for a while



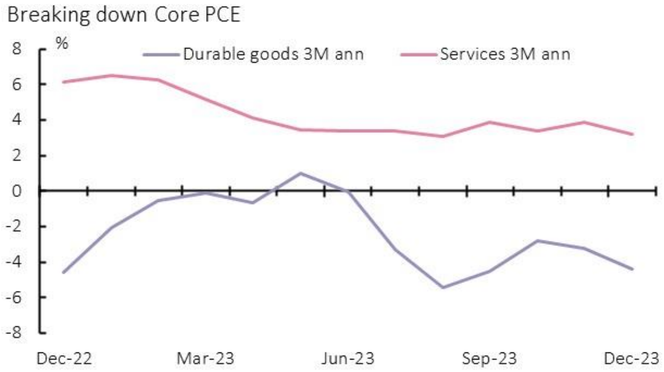
Source: Bureau of Economic Analysis and AXA IM Research, January 2024

This resilience is all the more surprising that US households have been busy accumulating a lot of durables since Covid (see Exhibit 2). Indeed, after the completely understandable splurge during the lockdowns – people diverting to this component what they could not spend on high-contact services – the subsequent pause was quite short, and spending rose again significantly to the point that it stands today nearly 30% above its pre-pandemic level.

In 2021, a quite astute paper by the Cleveland Fed attempted to disentangle the "lockdown effect" from the "income boost effect" from the fiscal stimulus at the time of Covid in explaining the splurge in durable goods spending. A side result of their analysis was to suggest that the marginal propensity to spend additional income was twice as large for durables than for non-durables. We suspect this may provide an explanation for what is going on in the US. While consensus – and yours truly – thought that most of the consumption dynamics in 2023 would come from people drawing on their accumulated savings – with diminishing effects on aggregate spending – **the big "new news" of last year was the rebound in real labour income, with the combined effect of brisk job creation and strong nominal wages growth exceeding inflation, which replaced the fiscal stimulus**. We suspect that, for now at least, this income factor trumps the rise in interest rates in convincing households to continue to splash.

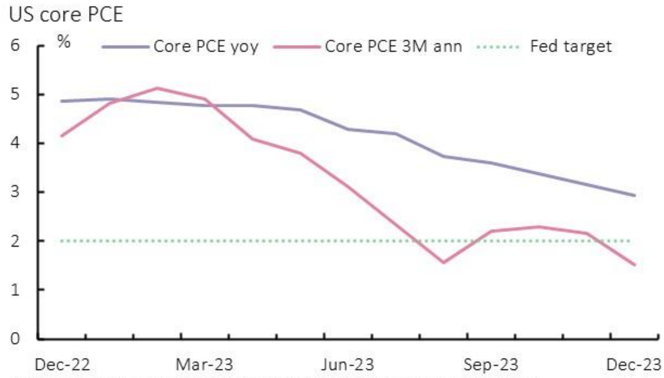
This does not help to solve the other mystery though: how is it possible that such strong consumption dynamics co-exists with diminishing inflation? One partial answer is going to be familiar to readers of Macrocast. The price of consumer durables is largely determined by global, and not domestic conditions. [A San Francisco research paper from 2019] concluded that a third of the consumer durables included in the PCE are imported. The paper also gives interesting examples of how "made in America" goods can onboard significant foreign inputs. For instance, 17`% of the cost of a Jeep Patriot manufactured in Illinois goes to parts made in other countries. Since activity in manufacturing is in or near-contraction globally, to which the strength in the dollar and the Chinese deflation add, it is no surprise that the price of consumer durables falls in the PCE measure (see Exhibit 3).

Exhibit 3 – Services/durables gap in PCE



Source: Bureau of Economic Analysis and AXA IM Resarch, January 2024

Exhibit 4 – Annualised 3-Mth core PCE < 2% (again)



Source: Bureau of Economic Analysis and AXA IM Resarch, January 2024

However, services inflation continues to be quite brisk, even if it has decelerated in December, to hit 3.2% on three-month annualised basis, oscillating between 3 and 4% since May 2023. This is not yet "normal": on average between the Great Financial Crisis of 2008-2009 and Covid, services prices rose by 2.1% annually. Spending on services has been less exuberant than on consumer durables, but its pace is perfectly decent. If there is a "last mile" of disinflation, this is where it could be the hardest to run.

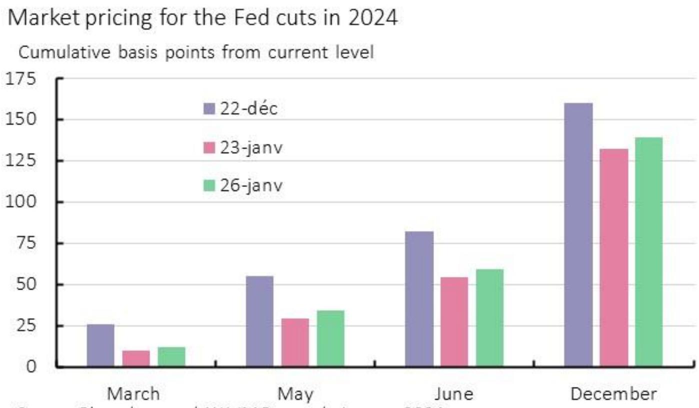
In any case, it is no surprise that this "no landing" scenario accompanied by lower inflation is being saluted by the market. The most positive aspect of the December PCE print is that on a 3-month annualised basis, core inflation has fallen below 2% (1.5%, see Exhibit 4). It has happened already once on this side of the Covid crisis in August 2023 (1.6%), so prudence should be of the essence but in the current context of speculation on the imminence of a rate cut, this fuels the market's exuberance.

At the end of last year, we were ranting on the market's aggressive expectations for swift rate cuts. Since then, investors have become much less sure about March as the starting point (12bps priced last Friday – i.e., a nearly 50% probability - against a peak at 26 on 22 December), but after the inflation print last week the May hypothesis has gained even more traction, with 34bps priced in.

We continue to be unconvinced by the quantum of cuts being priced in. We still expect the start to come in June only, and by that time the market is now pricing more two 25bps cuts (52bps). What is getting us to this? In a nutshell, the main reason for prudence should be the very resilience of the real economy. In terms of balance of risks, **what would be the point in hurrying to cut since there is no urgency to support the economy and boost employment?** True, not all is great in the US real economy. Investment continues to be under pressure. Equipment capex failed to rebound significantly from the decline in Q3 (+1% after -4.4% annualised). Investment in "structures" – plants and offices – also did poorly in Q4, after stellar prints since the end of 2022. We should be careful not to read too much into a single print, but this may be the sign that the stimulus provided by the US new industrial policy – Inflation Reduction Act (IRA) and chips act – may now be past its peak. But it remains a minor gripe in an otherwise very solid growth print. Even net exports – rarely a strong point in the US growth pattern – has just recorded its seventh quarterly positive contribution in a row, suggesting the US economy is coping very well with a strong dollar.

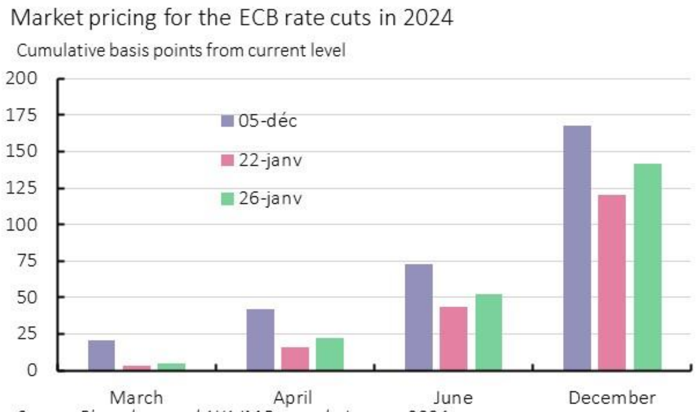
As long as the US real economy continues to be boosted by "genuine factors" – strong labour income growth – it is going to be reasonable to focus on the possibility that a line of resistance duly emerges on core inflation, even if the dataflow to support this might have been elusive recently. Jay Powell's words will be scrutinised this week. He could hardly come up as more dovish than he did in December. Now that he has clearly indicated that the Fed is thinking about cutting, he can afford to introduce more qualifiers on the exact timing. If he errs on the dovish side, we suspect this could take the form of lengthy comments on the improvement in the supply-side of the US economy – elaborating further than he did the last time. Productivity gains are the "Deus Ex Machina" which could allow the US to sustain strong growth, full-employment, and low inflation. We have not seen this in a meaningful and durable manner since the 1960s, and more briefly in the late 1990s, which again should push for prudence.

Exhibit 5 – Still a lot priced in…



Source: Bloomberg and AXA IM Research, January 2024

Exhibit 6 – …although March looks "dead" in the ECB case



Source: Bloomberg and AXA IM Research, January 2024

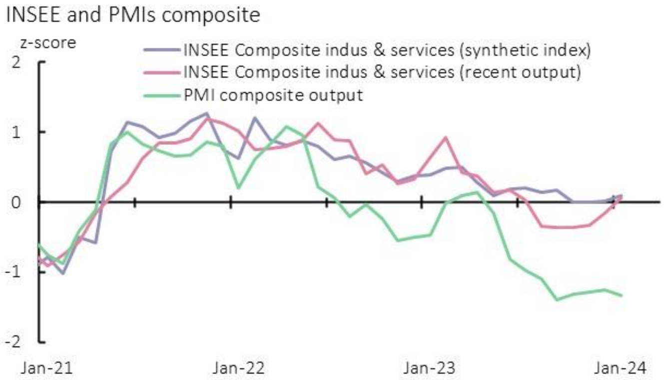
Is the ECB getting worried?

There is no such thing as a completely uneventful European Central Bank (ECB) meeting. Very little was expected last week, neither in terms of actual decisions nor in terms of communication alterations. Christine Lagarde's Bloomberg interview in Davos, very much in line with the stark tone of the December meeting, left little doubt that she would push back again against the market pricing for the timing of the first rate cut. As it happened, her pushback was much weaker than expected. Arguably, there was a bit less to push back on. Before the Governing Council meeting in December, the market was pricing an 80% change of a rate cut in March. Just before last week's meeting, the probability had fallen to 10%. However, there was still a 60% probability for a rate cut on 11 April (see Exhibit 6). We thought – along with nearly all observers – that even this would prove too much for the central bank, especially after Lagarde's point in Davos about market expectations "not helping". Actually, by the end of the Q&A, the market was pricing an 80% probability of a cut for April. And we understand why the market reacted the way it did.

Indeed, **Christine Lagarde was given plenty of opportunities to directly comment on the market pricing. But when she was explicitly asked about an April cut, her response was only "weakly dismissive",** answering that more progress is needed on the inflation front to make them confident inflation is back towards a 2% trajectory ("*we need to be further along in the disinflation process so that we are confident enough the inflation target is reached in a timely manner*"). **The general impression we had from Christine Lagarde is that they are *genuinely* in data dependent mode, more worried than in December about the state of the real economy and more comfortable about inflation.** Even unit labour costs, their "bête noire", sounded less dangerous in her assessment last week, as she mentioned some signs wages may be decelerating, while expressing more comfort in the capacity of firms' margin behaviour, in a context of slow demand, to absorb a lot of the pressure from the labour market (a point we have explored extensively here two weeks ago).

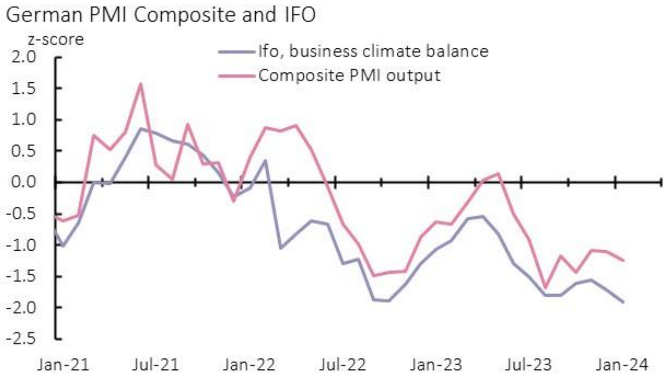
It may be that the central bank may start to be quite concerned about the deterioration in cyclical conditions in the Euro area, despite Christine Lagarde's insistence on their recovery scenario into 2024. The "R" word `(recession) was uttered during the Q&A, albeit in some dismissive way – the ECB President implicitly expressed sympathy for the US definition of a recession, which entails, beyond the usual "two quarters of negative GDP growth in a row" a more comprehensive deterioration, affecting in particular the labour market. We suspect however the central bank is in "performative rhetoric" mode and wants to reassure public opinion. Indeed, the dataflow is concerning. Purchasing Managers' Index (PMIs) must always be taken with a pinch of salt, and they are probably too low in France, an economy which has so far eschewed a proper contraction in GDP, and this is confirmed by the less depressing message from the tried and trusted INSEE survey (see Exhibit 7) but in Germany, the signal from the IFO survey is just as negative as the one from the PMIs (see Exhibit 8). The usual engine of European growth is still switched off.

Exhibit 7 – PMIs too low in France…



Source: Refinitiv, S&P Global and AXA IM Research, January 2024

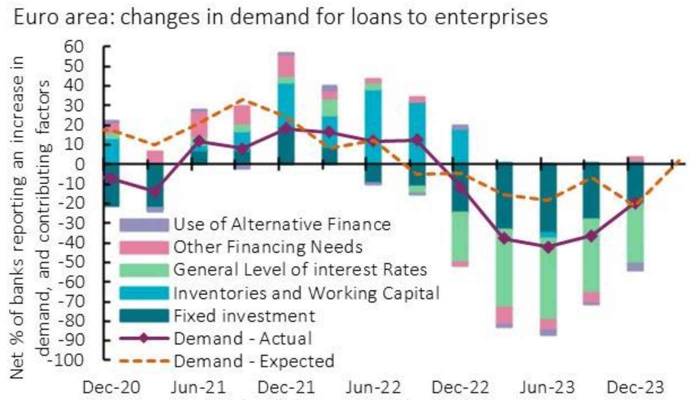
Exhibit 8 – But harder to argue for Germany



Source: Refinitiv, S&P Global and AXA IM Research, January 2024

The ECB's forced optimism on the recovery is predicated on the continuation of disinflation, supporting consumers' real income. But a lot of this disinflation, according to the central bank, would come from a compression in margins. **The key question for 2024, in our view, is whether firms can sustain a decline in their profitability without reducing their workforce?** So far, the European labour market has been resilient, but this cannot be taken for granted. If this stops, it is not obvious to us that much of the new-found real income would find its way to spending.

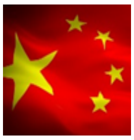
Exhibit 9 – Could banks be wrong again on expected demand?



Source: European Central Bank and AXA IM Research, January 2024

What we also find interesting is that **there was no qualifier in Christine Lagarde's characterisation of monetary policy transmission in the Euro area**, the ECB still considers as "forceful". She could have taken comfort in the latest Bank Lending Survey, which suggests banks expect the end of the deterioration in credit demand from the corporate sector (see Exhibit 9). This may not however bring that much relief given the poor predictive power of this component of the survey: last year, effective demand for loans systematically ended up significantly lower than what banks had been expecting the previous quarter.

All in all, Christine Lagarde's communication last week made a cut "by the summer" – making April Governing Council (GC) meeting very much live - more likely than "if not in the summer" (the two possibilities were in the question she answered in her interview with Bloomberg on 17 January. Yet, for an April cut, we think that the dataflow would have to be "perfect" between now and the March forecasts, as well in the few weeks until the 11 April meeting: inflation would have to recede flawlessly, more "bad data" would have to come on the real economy and the real-time indicators on wages would have to point to a proper slowdown. Our baseline is unchanged with rate cuts to start in June, coming at a pace of 25bps a quarter. Negotiated wages have yet to decisively turn, while labour productivity is persistently weak. PMIs confirmed ongoing service price pressures, pushing overall output prices at the steepest rate since last May. But indeed, an April cut is now firmly part of our "plausibility range".

Country/Region	What we focused on last week	What we will focus on in next weeks
	• US GDP (Q4, p) +3.3% (saar) upside surprise, consumer still solid, but inventory surprises posing risk for correction ahead • New Hampshire primary: Trump (55), Haley (44) • PCE inflation (Dec) unch at 2.6%, core dips to 2.9% • New & pending home sales (Dec) rise on month • PMIs (Jan, p) both manu & serv's rose to 50.3 & 52.9	• PCE inflation (Dec) headline expected steady • FOMC. No change in policy at 5.5%, no forecasts. Watch Powell for March hints, priced 50-50 • Labour report (Jan) payrolls f'cast in line with 3m trend (165k), watch HH emp and unemployment • JOLTS (Dec) other key guide to labour mkt loosening • ISM index (Jan) other mfg surveys have been weak
	• The ECB meeting was more dovish than expected. We keep our call for a first 25bps rate cut in June but April cannot be ruled out • Activity indicators points to diverging fate across countries. No meaningful improvement at the euro area level	• We highlight downside risks to our +0.1%qoq Q4 GDP forecast. Spain to continue to outperform the euro area • EA Flash HICP (Jan). Another limited fall in headline and core inflation is on the cards
	• PMIs (Jan, p) mfg and servs rose further on month (47.3 and 53.8), services towards mid-2023 highs • Public finances (Dec) borrowing £5bn lower than expected, Chx Hunt hits at tax cuts in Budget • GfK cons conf (Jan) rose to -19 highest since Jan 22	• BoE announcement (Feb). No change in policy (5.25%), Monetary Policy Report to update forecasts. Will inc assessment of Nov fiscal easing • BoE lending (Dec) mort apps to continue rise • Nat'wide HPI (Jan) – prices expected to remain flat
	• BoJ stood pat in January. We keep our call for a first hike in April • Both nationwide headline and core CPI edged down 0.2pp to 2.6%yoy and 2.3%yoy respectively	• Dec industrial production , retail sales • January consumer confidence
	• LPR 1Y & 5Y for Jan stayed unchanged at 3.45% and 4.2% respectively • RRR cut by 50bps to 10.0%, effective from 5 Feb • Re-lending and re-discount interest rates for rural sector and small firms cut by 25bps to 1.75%, effective from 26 Jan	• Sat (27 Jan): Industrial profit (Dec) • Wed (31 Jan): NBS Mfg and non-mfg PMI (Jan) • Thu (1 Feb): Caixin Mfg PMI (Jan)
	• CB: Malaysia (3.0%) & South Africa (8.25%) on hold as expected. Turkey hiked by +250bps to 45.0% signalling the peak • Dec CPI (yoy): Malaysia (1.5%) Singapore (3.7%) & South Africa (5.1%) • Mexico's economic activity index (Dec) contracted -0.5%yoy, surprising to the downside	• CB: Hungary (10.75%) expected to cut 75-100bp, Colombia (13%) to cut 25-50bp & Chile (8.25%) to cut 75-100bp. Brazil should cut 50bp to 11.25% • CPI: Peru (Dec), Indonesia (Jan) & Korea (Jan) • Jan PMI manufacturing survey across countries • Q4 GDP: Mexico, Taiwan, Philippines, Poland, Czech Rep, Saudi Arabia

Upcoming events		
	US:	Mon: Treasury supply estimates for Q1 & Q2; Tue: FHFA HPI (Nov), Case-Shiller HPI (Nov), Conference Board consumer confidence (Jan), JOLTS job openings (Dec); Wed: ADP emp change (Jan), Employment Cost Index (Q4), Chicago PMI (Jan), FOMC announcement; Thu: Non-farm productivity (Q4,p), Unit labour costs (Q4, p), ISM manf index (Jan), Weekly jobless claims (27 Jan); Fri: Non-farm payrolls (Jan), Unemp (Jan), Average earnings (Jan), Average weekly hours (Jan), Michigan consumer sentiment & inflation expectations (Jan, f)
	Euro Area:	Tue: Ez Business confidence (Jan), Ez,Ge,Fr,It,Sp GDP (Q4, p), Sp HICP (Jan, p); Wed: Ge CPI (Jan, p), Ge,Fr HICP (Jan, p); Thu: Ez HICP (Jan, f), Ez Unemp (Dec), It,Sp Manf PMI (Jan), It HICP (Jan, p); Fri: Fr Industrial production (Dec)
	UK:	Tue: BRC Shop price index (Jan), Mortgage approvals (Dec), Net mortgage lending (Dec), Consumer credit (Dec), M4 money supply (Dec); Wed: Housing starts (Dec); Thu: Manf PMI (Jan), MPC announcement & MPR; Fri: BoE Chief Economist Huw Pill speaks at National Agency briefing
	Japan:	Tue: Industrial production (Dec, p)
	China:	Wed: Manf & non-manf PMI (Jan); Thu: Caixin manf PMI (Jan)

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Our Research is available online: www.axa-im.com/investment-institute

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