Hawks don’t Hibernate

We wish our readers a great festive season – Macrocast is taking a break and will come back on 9 January 2023

- The Fed spoke even more clearly, but the market continues to price rate cuts next year.
- The ECB’s hawkish turn stunned the market and adds to the downside risks to the European economy and raises questions on fragmentation.

We’ve had quite an eventful week on the monetary policy front for this last Macrocast of the year, and this fits quite nicely in our general narrative for next year. Indeed, for us 2023 is likely to be the “mirror image” of 2022. Faster, broader, and more persistent inflation has defined 2022, but with remarkable resilience of the real economy. Conversely, we expect a significant disinflation for 2023, but with a heavy toll on activity, largely because for the first time this century, central banks on both sides of the Atlantic are not trying to accommodate the slowdown. Quite the opposite, they are ready to engineer it, as a painful but necessary condition to get inflation back under control.

True, the new Fed’s forecasts are still consistent with only a very shallow recession in 2023 “at worse”, but as we expected the new median terminal rate in the dot plot suggests the FOMC is ready to go very deep into restriction, and stay there for long, to get inflation back under control. Collectively, investors are still not listening though, as forwards continue to price a good 50 bps worth of cuts in the second half of next year. Even if we agree that some tangible signs of disinflation are now appearing in the US, this creates some uncomfortably large space for disappointment in the markets next year.

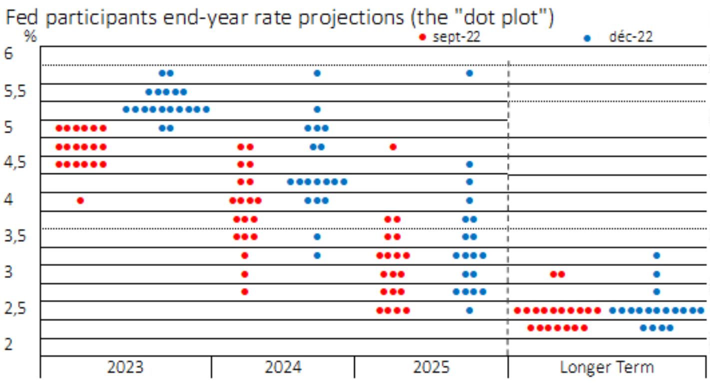
Meanwhile, the ECB gave us a proper “hawkish festival”. We now expect a terminal rate at 3.25%, well into restrictive territory, with risks tilted to the upside. It is tempting to read last week’s ECB communication as an adaptation to the Fed’s own hawkishness the previous day, with a desire to avoid a depreciation in the euro exchange rate which would impair the European disinflation. This is understandable, but it feeds into the “race to the top” setup lamented by M. Obstfeld a few months ago, which may ultimately bring about an excessive degree of aggregate monetary tightening in the global economy. Besides, with this hawkish tilt, beyond the fact it is adding to the already daunting headwinds blowing against the European economy, the ECB is taking risks with fragmentation in the Euro area. The ECB has given itself some space to recalibrate QT next June. This is wise but may not suffice.

The Fed speaks even more clearly, but the market shrugs

The Federal Reserve (Fed) left little space for interpretation when executing a hawkish gear-change to 50bps last week. The whole package was a powerful summary of what Jay Powell has been saying for months: the central bank is far from being done, and it would be wrong to expect a quick turnaround at any point in 2023. As we expected, the "dot plot" was the main channel of forward guidance. Beyond the move to 5.1% for the median forecast at the end of 2023 – in line with our own expectation for the terminal rate **– what we found striking is how homogenous the Federal Open Market Committee (FOMC) is on the year-ahead trajectory,** with only two members considering a policy rate below 5% could be appropriate, and only marginally so (see Exhibit 1). Predictably, projections become more scattered through the forecasting horizon, but we think **the market should take note of the fact that only *one* FOMC member believes that in 2025 the Fed could afford to bring its policy rate below the long-term level of 2.5% commonly seen as neutral in the US** (reflected in the dot plot's continued anchoring at this value for its long-term forecast).

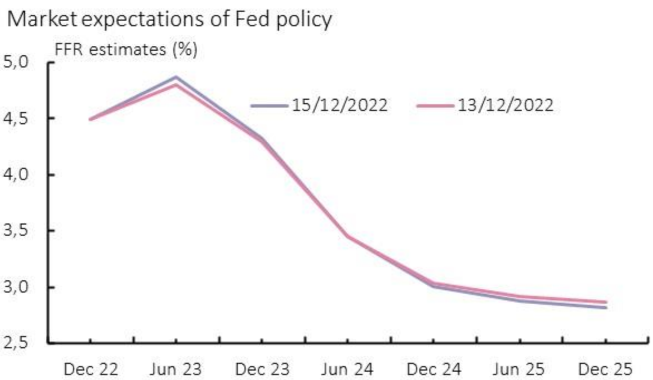
Such strong consensus within the FOMC on what needs to be done should normally convince the market that the Fed "means business" and trigger a swift re-appraisal of its views on the likely trajectory, but this did not happen. Exhibit 2 illustrates how the market expectations for the Fed policy derived from forwards barely moved after the December meeting. The collective, infinite wisdom of investors still expect rate cuts in the second half of 2023, with the Fed Funds finishing the year at 4.37%, more than 50bps below the "dot plot". **A possibility is that the market believes the Fed is "bluffing tactically",** in other words that, in a situation of elevated observed inflation and risks of inflation expectations de-anchoring, it makes sense for the central bank to "talk tough" and provision for the *risk* monetary policy will have to go deep into restriction, but without a high degree of conviction. This may be true, but the FOMC's unity pleads for a simpler explanation: the Fed and the market disagree on the macroeconomic trajectory next year.

Exhibit 1 – United in higher rates



Source: Federal Reserve Bank and AXA IM Research, 16 December 2022

Exhibit 2 – Market "ain 't bothered"



Source: Bloomberg and AXA IM Research, December 2022

Let's start with the macro rationale laid out by the Fed last week. The 50bps upgrade in the terminal rate relative to September is consistent with the revision in the inflation forecast, since the "median FOMC member" now projects core Personal Consumption Expenditures (PCE) to rise by another 0.4 percentage point in 2023. Such additional tightening required to get inflation to finally land will entail more pain for the real economy, and the FOMC has also revised down its projection for GDP growth, down from 1.2%yoy in Q4 2023 in September to 0.5% now. 0.5%yoy is an interesting choice, since from a purely arithmetical point of view it could either be consistent with near stagnation across next year, or with a shallow recession in 1H followed by a brisk recovery in 2H. **The Fed is thus still not convinced it needs to engineer a properly sinister contraction in activity to get inflation back to 2%** - even if it now projects the unemployment rate to raise by nearly one full percentage point next year.

This may be source of divergence between the market and the Fed. **Investors are counting on a deeper recession than what the central bank is still projecting, providing for a faster demise of inflation.**

More tangible signs of US disinflation

True, **this idea that the Fed is underestimating the looming deterioration in the real economy found some backing evidence over last 10 days,** which may have strongly contributed to keeping market expectations stubbornly dovish on the Fed's strategy despite Powell's clarity. The disappointing retail sales last week may only be an accident, but it's of course tempting to read it in combination with the latest signals that the United States (US) labour market is softening. But more crucially, it's probably the inflation print for November, the second downside surprise in a row, which may explain the market's doubts as to the Fed's capacity to deliver on its projected stance.

Exhibit 3 – It's getting slower

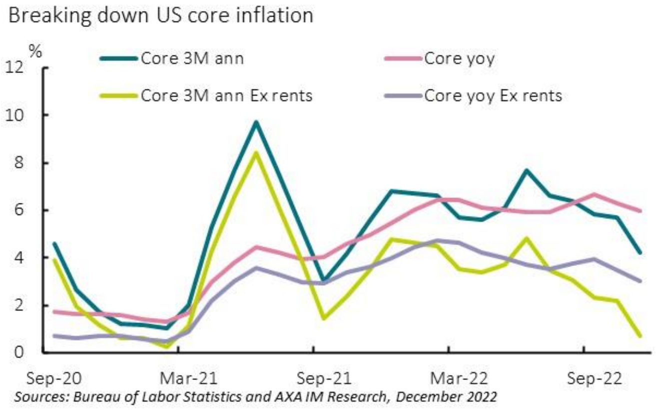
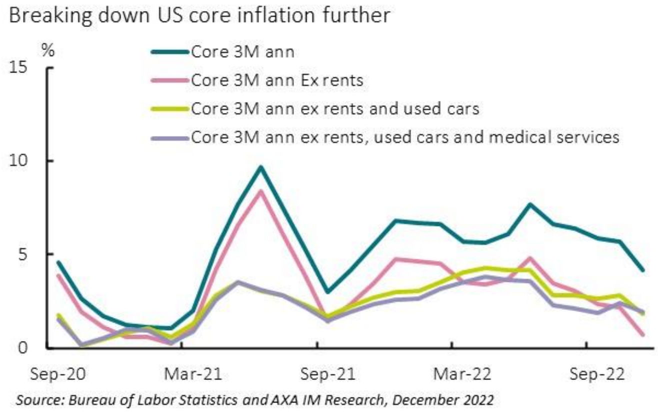


Exhibit 4 – Still some impact from used cars



As usual, rather than obsessing on the month-on-month or – on the other side of the spectrum – the year-on-year change, we prefer to "vary the angles" and look at the 3-month annualised rate to check for potential inflexions. Using the latter, the message on core inflation becomes quite clear, with the slowest gain of the year at 4.3% in November, and a regular deceleration since the end of the summer. Things become even more interesting when taking away some of the stickiest components of inflation, rents in particular. Indeed, excluding rents, the drop in core inflation becomes truly spectacular, reaching a meagre 0.6% in 3-month annualized terms, unseen since January 2021 (see Exhibit 3).

Of course, one needs to be prudent when slicing the consumer price index as precision is gained to the detriment of relevance – excluding rents, only 60% of the core index remain. Yet, we think such approach is warranted in the current configuration because we can count on a slowdown in rents in the course of 2023 with a high level of confidence: house selling prices have already started to decelerate as a result of the rise in mortgage rates, and rents follow purchasing prices with a quite reliable lag of 6 to 9 months. It would be tempting to consider that "cyclical" inflation has been vanquished, and that "all" the Fed would now have to do is sit tight and wait for rents to decelerate.

But digging further in the details, more complexity arises. We made the point two weeks ago that with a large chunk of the ongoing inflation being explained by the sharp slowdown in industrial goods prices, "accidents" would probably happen in the coming months given the high volatility of this component of the Consumer Price Index (CPI). In November, the price of used cars – which has been the bane of US forecasters for two years given its extremely erratic movements – crashed and on a three-month annualized basis, they fell by nearly 25%. This mechanically means that without this shock, core inflation decelerated to "only" 2% in November in 3-month annualized terms. There was also quite a lot of market chatter on the drop in medical services prices, but while they helped with taking the monthly change down, over 3-Month it does not change the picture (see Exhibit 4). Our point here is that we may not be able to count on many repeats of such a slide in used cars in the months ahead, so extrapolating too much from the November print is risky.

Yet, since core inflation seems to be back to 2% annualized when excluding the impact of rents and used cars, **many observers will still be tempted to call the near end of the US inflation spike.** That's the message we get from the inflation-indexed bonds, since the 2-year breakeven has fallen to 2.13% last Friday – hence less than 2% once the wedge with PCE is taken away, down 15 basis points in 10 days. **This would however ignore the possibility to see more second round effects in 2023**. Indeed, slicing the consumer price index makes sense to explain the recent changes in inflation, but consumers react to inflation as a whole, and do not really care what drives the spike. Wage earners want to protect their purchasing power from the inflation shock irrespective of its origin, and this gets us back to our discussion from three weeks ago. Given the Fed's doubts on the reality and/or magnitude of the labour market softening, their readiness to go further on their tightening makes sense.

All in all, we think the current market pricing creates some uncomfortably large space for disappointment next year. For the market to be right on rate cuts in 2H, a quick and significant downturn needs to happen in the real economy, which we don't think the equity market – and possibly the corporate bonds market – has completely priced. If the market is wrong and the Fed is on hold in 2H 2023, the real economy may fare better than investors expect in 2023, but the relief in the form of lower rates will take time to materialise, while persistent inflation may trigger a readjustment in the risk premium on the long end of the curve. We cannot either exclude a third, properly problematic scenario cumulating the two downsides, where the real economy contracts severely into a significant recession without producing enough disinflationary forces, forcing the Fed to maintain a very hawkish stance throughout the year, going beyond 5% for the terminal rate.

The ECB reads the riot act, and market gives up

The fact that the Fed had been "predictably" hawkish last week may also explain while its message fell flat on the market's ears. After all, most economists were expecting a strong message from the Fed accompanying their gear-change, and Powell did not go substantially further than those expectations. Conversely, **the European Central Bank (ECB) delivered an unexpected "hawkish festival" last week**. We thought the ECB would also offset its gear-change with a big dollop of hawkish rhetoric, but we got much more than we thought on that front, as most other observers. It may be this element of surprise – completely missing in the Fed's case – which may have triggered the strong market reaction in Europe when it comes to central bank pricing.

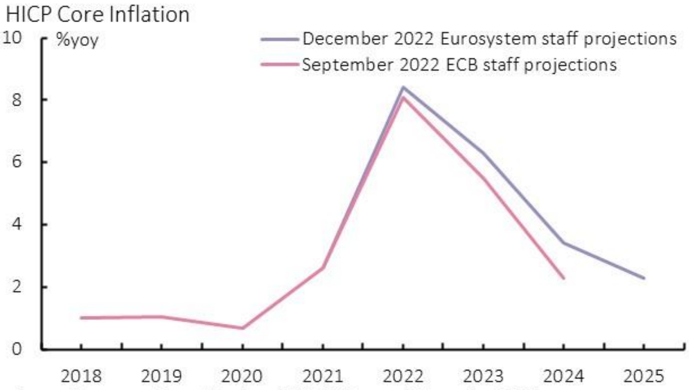
Governing Council Holzmann came up with a great summary of last week's council meeting: they hesitated between 50bps and 75 and chose to produce the most hawkish 50bps hike they could think of, by making it absolutely plain that the central bank is far from its terminal rate. Indeed, t**he ECB has rarely been clearer on its likely short-term path for policy rates than since they have officially buried forward guidance**. The key sentence in the prepared statement was *" interest rates will still have to rise significantly at a steady pace to reach levels that are sufficiently restrictive to ensure a timely return of inflation to our two per cent medium-term target",* but Christine Lagarde was even more specific in the Q&A*: "Based on the information that we have available today, that predicates another 50-basis-point rate hike at our next meeting, and possibly at the one after that, and possibly thereafter, but everything will also be determined by the review of data. So don't assume that it's a one-shot 50; it's more than that. I don't know how many more times".*

Our expectation was that, once the ECB hits the upper end of the "neutral rage" – which is now the case with the deposit rate at 2% - it would take a "proper discussion" – which we thought would take place in Q1 – on the modalities and pace of going into restriction. We thought they would eventually make that decision, but allowing for more data to become available, something which is consistent with the notion that the ECB would be data dependent, a point Christine Lagarde made again last week. It seems the central bank considers that it has enough data already to cross the Rubicon of restriction – and by some margin – without much more debate. **We think the ECB is now less dependent on the dataflow than dependent on its own forecasts.** Over the last decade they have spectacularly over-estimated inflation. Then over the last two years they have spectacularly under-estimated it. This – reasonably – made the ECB quite prudent in its handling of projections over the last few months. It seems however that this time, for 2023, they have decided to tie themselves to *one* macro scenario.

Indeed, digging into the macroeconomic rationale, the key sentence in the Q&A was the point that the market pricing of the ECB's policy rate trajectory – before last week's meeting – was too low to be consistent with a return to 2% inflation within the appropriate timeframe. Since market pricing had the terminal rate at 2.9% in the ECB's forecasts' technical assumptions, this suggests the ECB wants to go significantly above 3%. 50 basis points in both February and March thus seems to be in the bag, and that is now our baseline.

We were surprised by the magnitude of the upward revision in the inflation forecasts, and the "landing point" in 2025 remaining so significantly above target (2.4% for core, see Exhibit 5). We find it striking that the ECB expects inflation in more than 2 years to be roughly at the same level in the Euro area and the US. European inflation has been on trend lower than in the US, and there was no obvious situation of excess demand in the Euro area – a big difference with the US – before the Ukraine war struck.

Exhibit 5 – Inflation higher for longer



Source: European Central Bank and AXA IM Research,December 2022

Exhibit 6 – Market duly revised its pricing

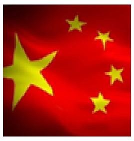
Source: Bloomberg and AXA IM Research, December 2022

The strong upgrade on inflation is to a large extent driven by a relatively positive view on the state of the real economy, with a GDP forecast at +0.5% for the 2023, which crucially does not entail any significant decline of the labour market. Importantly, they expect a very significant acceleration in wages - 5.2% next year. Beyond the assumption on wages itself, it is worth noting passthrough from compensation per employee to core seems very strong (+0.5pp upside revision in 2022 relative to the September batch and +0.4pp in 2023 for compensation and +0.8pp for core). The central bank has clearly made many technical choices to produce this stark message on the direction of travel. We are however tempted to think a less-than-rosy dataflow on the real economy in the coming months will ultimately stay the ECB's hand. We thus converge with the market pricing – see Exhibit 6 – to expect a terminal rate at 3.25%, the central bank finishing with a single 25bps hike in May, before pausing when the June forecasts come out. The risk around this call – significantly revised up from our initial 2.5% given the stark communication from the ECB - is however clearly tilted to the upside, with a significant risk the ECB gets to 3.5%.

Beyond the purely macroeconomic rationale, it is tempting to read last week's ECB communication as an adaptation to the Fed's own hawkishness the previous day, with a desire to avoid a depreciation in the euro exchange rate which would impair the European disinflation. When the Fed merely has to revise up its stated terminal rate to send a signal, the ECB has to resort to a more contorted approach: proceeding by "reverse engineering" by arguing that existing market pricing will not suffice and nail the point home by commenting directly on the next moves. In a way, the Fed's "forward guidance by construction" embedded in the "dot plot" makes it difficult for the ECB not to provide *any* forward guidance, at least as long as it seeks to exercise influence over the exchange rate. This is understandable, but it feeds into the "race to the top" setup lamented by M. Obstfeld a few months ago, which may ultimately bring about an excessive aggregate degree of monetary tightening in the global economy.

Besides, with this hawkish tilt, the ECB is clearly ready to take risks with fragmentation in the Euro area, with the Italian 10-year spread moving back above 200bps and reaching the highest level since the beginning of November. Unsurprisingly, the Italian government was very vocal last week in its direct criticism of the central bank. The natural slope for Rome would be to become more assertive in its discussions with Brussels on some repurposing of its Next Generation funds, arguing that the monetary policy tightening is creating some specific pressure for Italy. There are limits however to how far G. Meloni's administration can go there, given the market's sensitivity to any sign of strain between the country and the European institutions. Still, **the magnitude of the market reaction last week calls for a lot of prudence on Quantitative Tightening (QT).**

On this, the ECB announcements were a bit of a mixed bag. Unsurprisingly interest rates are to remain the primary tool to fight above target inflation in the medium run. President Lagarde specified during the press conference that unwinding the bond portfolio should not provide an indication of "policy stance". Asset Purchase Programme (APP) holdings will decline from March at a measured and predictable pace: EUR15bn per month until the end of Q2 - roughly 50% of assets will not be reinvested - a bit more aggressive than our baseline at EUR10bn from April, EUR20bn from July, EUR30bn from October. Yet, the central bank has given itself some leeway to recalibrate the pace for the second half of the year. This will allow them to gauge the market reaction and potentially minimize volatility. This may not be enough though. Christine Lagarde had a question on the Transmission Protection Instrument (TPI) last week. It may not be the last if pressure continues on the Italian bond market.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• FOMC raises rates by 0.50%, unanimously - in line. Dots signal further and more persistent hikes than market envisages. Market posts little reaction • CPI inflation (Nov) - headline and core 0.1ppt softer than expected. Goods falling, core services persistent • Retail sales (Nov) fall after downward revised Oct • Congress passes one-week bill to avert shutdown	• Congress continues to balance passing omnibus spending bill for next financial year, or another short-term pass to negotiate in Rep majority House next year • PCE inflation (Nov) expected to soften after CPI • GDP (Q3) – final estimates expected unchanged • Housing data (Nov/Dec) to gauge scale of slowdown in sales and building
	• ECB hikes interest rates by 50bps, very hawkish speech, we revised up terminal rate to 3.25%, APP reinvestment to be halved from Mar onwards • Dec Flash EMU PMIs still in contraction but closer to 50, Svcs at 49.1 (+0.6pp), Comp Output at 48.8 (+1pp). Ge slightly better, Fr weaker, in contradiction with business climate that came at 102 • Final EMU HICP at 10.1%yoy (0.1pp vs flash) • EMU October IP fell by 2%mom	• Ge Ifo should mirror Ge PMIs • Ge and It Nov producer price is expected to decline again on the back of lower oil prices and stabilisation of gas prices. But focus must be on food and goods PPI to catch any pivot from the supply side of inflation • Q3 EMU wages to see if it matches recent large upgrade from ECB Dec macro projection (4.5% in 2022) • Dec consumer flash across EMU • Belgium CPI
	• MPC meeting: +50bp hike to 3.50%. Three-way split w/ two votes for a pause seen dovishly by markets • Monthly GDP (Oct) rose 0.5% (cons) pushed higher by rebound from additional Sept bank holiday • CPI inflation (Nov) confirm inflation past peak with a decline to 10.7% on fall in fuel prices and core goods • U/rate (Oct) rose to 3.7%, wage growth was firm	• UK public finances (Nov) • National accounts (Q3) expected to be revised little from -0.2%, savings ratio figures will be watched closely • Current account (Q3) expected to continue to narrow from Q2's 33.8bn (5.5% of GDP) • Further industrial action across sectors including postal workers and train workers
	• BoJ Tankan (Dec): Results point to recovery driven by non-manufacturing sectors • Travel boom continues, inbound visitors rise to 980k in Nov from Oct's 540k • Exports (Nov) rose 1%mom up for 2nd month in a row • Mfg PMI down to 48.8, 9th consecutive month of declines	• BoJ meeting (Mon/Tues): expect all policy tools to be left unch • CPI inflation (Thu) expected at 3.7%yoy with 'Core' CPI (ex fresh food) expected at 3.6%yoy • Leading index (Oct)
	• November's activities data continues to signal weakening momentum. Infrastructure investment edged higher, but retail sales and industrial output were markedly weaker • COVID cases surge across China, although official statistics no longer produced. Beijing sees marked drop in activity • Beijing delayed CEWC on surging COVID cases	• Markets to continue to stay focused on Beijing's COVID outbreak and the spread to the wider country • Meanwhile authorities persist with policy changes, and we watch for possibly further relaxation of more COVID-19 related measures
	• CB: Mexico hiked +50bp to 10.50%, Taiwan +12.5bp to 1.75% & Philippines +50bp to 5.50% • Annual inflation (Nov) fell in Brazil (5.9%) & South Africa (7.4%). It rose in Czech Rep (16.2%) • Chile will try to draft a new constitution for a 2nd time • Peru announces early elections for April 2024	• CB: Indonesia is expected to hike +25bp to 5.50%. Turkey (9.0%), Czech Rep. (7.0%) & Hungary to stay on hold (13.0%) • Annual inflation (Nov) data in Korea, Malaysia & Singapore • Industrial prod. (Oct) figures in Singapore & Taiwan

Upcoming events		
	US:	Mon: NAHB housing market indx (Dec); Tue: Housing starts (Nov), Building permits (Nov); Wed: Current account (Q3), Conference Board consumer conf. (Dec), Existing home sales (Nov); Thu: GDP (Q3), Core PCE (Q3), Weekly jobless claims (17 Dec), Leading indx (Nov); Fri: PCE & Core PCE (Nov), Personal income & spending (Nov), Durable goods orders (Nov), Michigan consumer sentiment & inflation expectations (Dec), New home sales (Nov)
	Euro Area:	Mon: Ge IfO business climate indx (Dec); Tue: EU19 Consumer conf. (Dec), Ge PPI (Nov); Fri: It ISTAT business & consumer conf. (Dec), Sp GDP (Q3)
	UK:	Mon: CBI Industrial Trends survey (Dec); Wed: PSNB ex-banking groups (Nov), PSNB (Nov), CBI Distributive Trades survey (Dec); Thu: GDP (Q3), Business investment (Q3), Private consumption (Q3), Current account (Q3)
	Japan:	Tue: BoJ announcement; Thu: Leading indx (Oct), CPI (Nov)
	China:	Tue: Loan Prime Rates

About AXA Investment Managers

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