AXA Investment Managers

Research & Strategy Insights

Santa is a hawk

117 – 20 December 2021

We want to thank our readers for their attention and feedback throughout 2021 and wish you the best possible festive season and a great year 2022. The next Macrocast will come out on Monday 10 January.

Key points

- More sanitary restrictions emerging as Omicron spreads.
- The Federal Reserve (Fed)'s resolve to tighten quickly in 2022 looks strong. The European Central Bank (ECB) has pushed the debate on its rate lift-off to very late in 2022 or more likely to 2023.
- Three issues on our radar for January: escalation in Ukraine, the risk of severe supply-side disruption in China because of the "zero Covid" policy, possibilities of political upset in Italy around the presidential elections.

Unfortunately, we cannot close this year without taking a hard look at the pandemic again. Confirming our concerns from last week, although more indications emerged that Omicron triggers less severe infections, in many advanced countries the speed of propagation coupled with the presence of a significant minority of unvaccinated individuals create such a threat to healthcare capacity that more severe sanitary measures are being implemented. This could make for a mediocre Q1 2022 in terms of economic activity.

Also in line with our expectations, central banks across the Atlantic reacted differently to the new threat. The Fed has been even more hawkish than we thought, penciling in three rate hikes next year. Yet, the market still believes this early tightening would "nip inflation in the bud" without having to go far into restrictive territory, and the Fed itself signals that throughout its forecasting horizon running until 2024 the actual policy rate could remain below the equilibrium level. Still, an "overkill risk", where the economy would slow down so much that inflation would in the medium run return to its below-target pace from before the pandemic, is clearly priced in by markets. We find evidence of this not just in inflation-indexed bonds but also in the relative performance of cyclical equities. The ECB is not in such a hurry and with its new "soft open-ended" quantitative easing (QE) has pushed the debate on its rate lift-off to very late in 2022 and more likely to 2023. We notice that their GDP forecasts are consistent with a positive output gap in 2023 and 2024, while they expect inflation to be below 2% by then. That reflects a strong belief at the central bank that, at least in Europe, the bar to exit from the pre-pandemic low inflation regime is high, for all the hawks' increasingly public concerns.

Ahead of the Christmas break, we sketch out the issues which will be on our radar in January: the possibility of an escalation in Ukraine, the risk that China's zero Covid policy triggers a significant disruption in supply over there if Omicron takes hold, which would add to the global bottlenecks, and finally scenarios for a political upset in Italy around the presidential elections.

Omicron news

We were very much hoping that for the last Macrocast of 2021 we would not have to comment on the pandemic again, but the challenge from Omicron is obviously key for the macro trajectory in early 2022. Last week we delved into the first large-scale study on the capacity of the Omicron variant to escape vaccines. The conclusions of the British Health Security Agency were sobering: the 2-doses regimen would provide little protection against symptomatic cases, and boosters would appear to be efficient but less so than with the previous version of the virus. At the same time, we turned to empirical data from South Africa, where the discrepancy between the rapid rise in cases and the stability of casualties suggested a low severity of Omicron infections. This week, new data from South Africa confirm that the variant is less aggressive.

According to an analysis by Discovery, an insurance company, of 78,000 test results attributed to the variant, the "basic severity", i.e. the probability to be hospitalized for someone infected with Omicron is 29% lower than for the first version after correcting for the vaccinal status. Two doses of Pfizer would provide 70% protection against hospitalization – while a 30% protection against symptomatic infections confirms the message from the UK data. The study does not explore the impact of boosters, but the logical conclusion is that this would move the protection level against hospitalization even higher.

The issue remains that in the US and some European countries there is still a significant minority of adults who have so far refused all vaccinations. Even if they "flip" now it will take until well into 2H 2022 to provide them with the highest level of protection. This, combined with the astonishing speed of propagation of the new variant (in the UK, which has extensive sequencing capacity and can thus follow the variant quite precisely, the number of cases is doubling every 1.5 days in some regions) suggests that **some "circuit breakers" in the form of even tougher mobility restrictions will need to supplement the booster programme in the next few weeks**. So far, the tightening in Germany has been barely visible in real-time activity indicators such as the Google mobility index, but the "direction of travel" is for even tougher decisions. The Netherlands' decision to return to lockdown is a clear warning. Even beyond the government measures, which are increasingly severe and are already affecting the travel industry in many European countries, businesses are often "taking things into their own hands" and reverting to working from home including in US cities which have not mandated this (e.g. in New York City). Less footfall will probably affect consumption. **This could make for a mediocre Q1 GDP.**

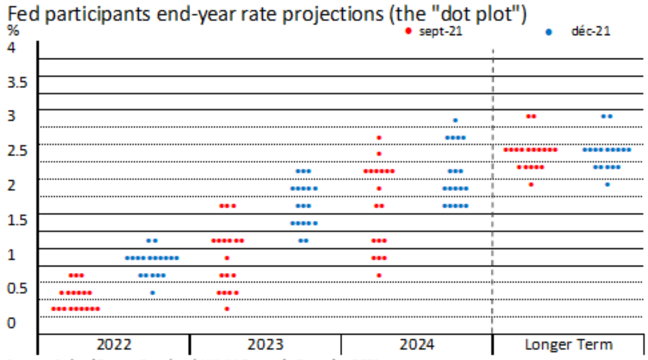
The Fed has flipped

The Fed has surprised on the hawkish side last week, not so much with the acceleration of tapering which had been well telegraphed but with the new "dot plot" showing the median Federal Open Market Committee (FOMC) member now expecting three hikes in 2022 - consensus (and your humble servant) were expecting two. We thought the new tapering pace would be there to create space for the possibility of rate hikes in the first half of 2022, but the shift in the dot plot suggests we have left the realm of possibilities to the realm of intentions.

Making this announcement despite the emergence of the Omicron variant is bold, but probably reflects a belief at the Fed that the US will respond to the new pandemic wave with their customary tolerance to high casualties and hence with minimal economic damage. This is balanced against **inflation dynamics which the Fed clearly sees as increasingly driven by the endogenous working of the economy rather than by the initial "reopening shock".** The better news on upstream inflationary pressure – e.g. the tentative improvement in delivery times and backlog of orders in US manufacturing and the correction in oil prices – were not even mentioned in the introductory statement, which focused instead on the strong growth in wages, compounded by the persistent weakness in the participation rate: *"we are attentive to the risks that persistent real wage growth in excess of productivity could put upward pressure on inflation".* The latter point is encapsulated in Powell's discussion of "full employment". He seems to believe that in the short-term, lingering Covid-related issues may have pushed the *natural* rate of unemployment higher, which means that the Fed would need to strike at a still fairly high level of *observed* unemployment.

The shift relative to September is quite spectacular (at the time, one single hike in 2022 was not even fully anchored). Interestingly, in the dot plot the Fed rate in 2024 would still be marginally below the "long-term" value which we think reflects the FOMC's assessment of where the US equilibrium rate is (see Exhibit 1). This sends the message that **the looming tightening would still leave monetary conditions quite accommodative**. The rationale behind the acceleration in the lift-off combined with a still lowish interest rate level probably is that the Fed – as well as the market – believes in the capacity of an early tightening next year to "nip inflation in the bud", reducing the risk of being forced into an ultimately bigger tightening later if it chose to dither for too long.

Exhibit 1 – Higher, faster, but still below the "natural interest rate" in 2024



Sources: Federal Reserve Board and AXA IM Research, December 2021

Technically, the Fed can claim that it is not shifting away from its "average inflation targeting" framework (AIT). The Fed pledged to tolerate inflation above target while the economy was making progress towards full employment. Their point now is that inflation has been indeed above target – and spectacularly so – "for a while" and that FOMC members expect full employment to be hit in 2022. However**, we would argue that some of the objectives of AIT have not been met**. Indeed, a justification of AIT was that allowing observed inflation to overshoot for a while would allow long-term expected inflation to move higher, so that the subsequent increase in *nominal* yields could be offset by a stability in *real* yields. What is happening in the market right now is different: long-term nominal yields are not rising, but equally, 10-year expected inflation has now fallen back *below* the Fed's target. In other words, **at least some investors are concerned that the early tightening would go too far and could trigger an economic slowdown, bringing inflation back to the sub-par pace seen between the end of the Great Financial Crisis and the pandemic.**

Exhibit 2 – "Overkill risk" already on the market radar

Sources: MSCI, Refinitiv and AXA IM Research, December 2021

This is also reflected in the equity market, when going beyond headline indices and looking into the sectors (see Exhibit 2). There has been a tight relationship this year between expected inflation and the relative performance on the equity market of cyclicals versus defensives. The "overkill risk" is thus also taken in consideration by equity investors. However, we believe the Fed's resolve is strong and we expect the Fed to act on its intentions and deliver three hikes in 2022, starting in June with the distinct possibility the lift-off could start even earlier.

ECB: pushing the hard decisions to 2023

The ECB is having a hard time reconciling many different objectives beyond price stability, as well as maintain a decent level of consensus at the Governing Council. Indeed, the urge to scale down quantitative easing is in our opinion not so much the product of immediate concerns over inflation – the labour market tension argument is completely missing in the Euro area – than the expression of a growing unease about the financial stability impact of massive asset purchases. We also suspect that for some Governing Council members, keeping the tap on for too long would incentivize governments to play fast and loose with fiscal policy, sowing the seeds of either another sovereign crisis, or of a future "capture" of the central bank by fiscal authorities. At the same time, a majority of the Council is perfectly aware that "weaning the market off" QE too quickly could trigger another bout of "fragmentation" – read sovereign spread widening – potentially rekindling concerns over a sovereign crisis in the periphery. Finally, while even the hawks are in no rush to press for a debate on hiking policy rate in 2022, they want some room to be able to do so in 2023, which means that the ECB's forward guidance should at least be consistent with that mere possibility. **Last week's announcements are possibly the best possible compromise between these different constraints.**

Asset Purchase Programme (APP) is scaled up to EUR40bn initially in Q2, dampening the impact of Pandemic Emergency Purchase Programme (PEPP) termination, before moving down to 30bn in Q3, and back to EUR20bn from October 2022 onward without any limit in time beyond this, but conditional on a necessity to do so to (*"as long as necessary to reinforce the accommodative impact of our policy rates")*. We thought the ECB would not commit on a tapering trajectory but would instead opt for a pace of EUR40bn per month until the end of 2022 "in principle" but subject to revision every quarter. The pre-committed downward slope can be seen as a concession to the hawks. However, we think the decision on APP is overall balanced between the views of the hawks and the doves, who get the potential continuation of an open-ended form of QE.

Since the sequencing is explicitly that APP would continue until *"shortly before"* the first hike, the new forward guidance entails the technical possibility of a rate hike in December 2022 at a stretch – it would be a very short "shortly" and Lagarde in the Q&A re-stated her view that a hike next year would be *"very unlikely"*- but symmetrically, since APP could continue into 2023, the council has bought itself quite a lot of optionality, or to put it in a less favourable light, it has decided to push the policy rates issue to later. **We suspect the September and December ECB forecasts will be crucial**. At that stage, an upside revision of the 2024 core inflation projection to 2% would be normally consistent with putting a quick end to APP and prepare for an imminent hike. Equally, maintaining a below-target inflation projection would kick the rate hike into the long grass.

Exhibit 3 – A bigger hump, but still a hump shape

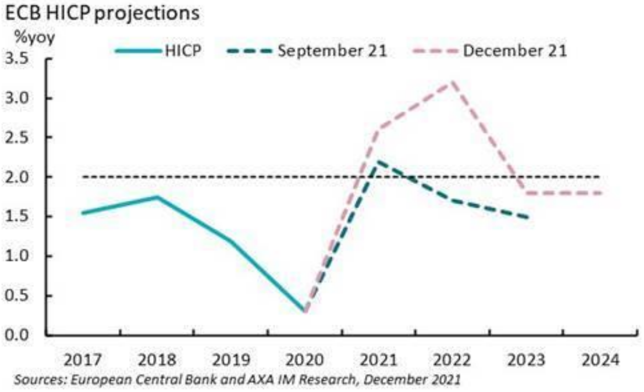
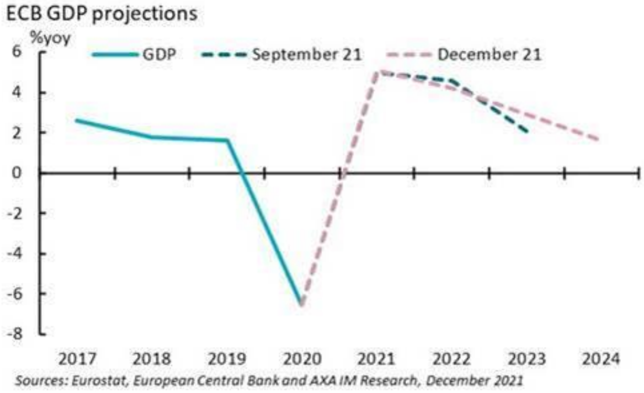


Exhibit 4 – slow descent towards potential growth



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For now, though, the forecasts are consistent with "low for longer". The ECB has significantly revised up inflation for 2022, but it's still a hump, only a bigger one (see Exhibit 3). 2023 is also revised up but at 1.8%, it's still below the new definition of price stability, and crucially its economists do not expect an acceleration in 2024. The underlying message seems to be that past the immediate impact of the pandemic, the Euro area would not manage to exit its pre-2019 sub-par inflation regime. Indeed, although the ECB has revised slightly down its GDP forecast for 2022, 2023 was revised up (see Exhibit 4) and, crucially, economic growth would remain above potential for the entirety of the projection (1.6% in 2024). Even assuming a nice "bump" to potential growth from faster adoption of digital technology and the improvement in labour participation to 1.5% from the consensus 1.2/1.3% of 2019, **the ECB GDP forecast would be consistent with a positive output gap (the difference between actual and potential GDP) in 2023 and 2024**. Despite reaching a state of "overheating" of the real economy at the end of the forecast horizon, the ECB still sees inflation below target.

In line with our expectations, the ECB is going to deal with the fragmentation risk by using the reinvestments of PEPP, which are extended to 2024 from 2023, and whose flexibility can be used to deal with "monetary policy transmission stress" (read : spread widening). In practice this means the reinvestments can move away a lot from the capital key if a particular constituency needs helps (and this will explicitly apply to Greek bonds). It's of course a positive message, but some observers had been expecting more, in the form of a "third programme" between PEPP and APP which would have been at the ready in case of problematic market movements. Habitual readers of Macrocast will know that we were sceptical on this possibility, but it's true that the quantum of reinvestments which could be used – between 10 and 15 billion euros per month – is much smaller than PEPP at its peak. There is a weakness there.

In other aspects, the ECB will "assess" how Targeted Longer-Term Refinancing Operations (TLTROs) can help, as well as the tiering system alleviating the cost of the negative rates for banks. As we expected they did not make a firm announcement on this, but they certainly did not close the door.

The ECB is probably relieved it has been able to announce the end of PEPP without triggering any immediate adverse market reaction. It was in our opinion the best possible compromise across factions – but the decisions were not unanimous, and several hawks made their dissenting views known immediately after the press conference. **The central bank has given itself another 9 to 12 months to check whether inflation is indeed temporary**, but positions are getting entrenched and if the macro outlook is not clear cut at the end of 2022, decisions will be difficult.

What's on our radar for the coming weeks?

At least we now have quite a lot of visibility of the big central banks' attitude into 2022. But new sources of uncertainty have emerged lately and could well trigger significant market volatility early next year. Our habitual readers will by now be familiar with our long-held concern with Turkey. For now, **what we feared, i.e. that Ankara would move even further away from macroeconomic mainstream despite extreme market pressure, is materialising.** The central bank continues cutting rates aggressively, and the government is adding to the exogenous inflationary shock triggered by the steep depreciation in the currency by hiking the minimum wage by 50%. We will continue to monitor this looming crisis, but outside Turkey – which has been problematic for several months - many other sources of turbulence are be on our radar. We will focus here on three risks.

Risk #1: supply-side disruption in China

The recent Peoples' Bank Of China (PBOC) decision to loosen monetary policy was reassuring on Beijing's resolve to put a floor on the current slowdown in Chinese demand, which is good news for world GDP. A key concern for us though is more on the Chinese supply-side.

Indeed, Beijing has in November reaffirmed its commitment to the "zero covid" policy, which entails very severe mobility restrictions in the cities where clusters are found. By Western standards, the recent number of cases in China is extremely low, even though the tally on 17 December (125) was the highest since August. Still, given Omicron's capacity to spread very fast – and the generally lower quality of the vaccines used in China – the continuation of the same sanitary strategy could have a very significant impact on China's productive capacity. This would be difficult to manage for foreign countries – in particular the European Union (EU) and the US – which have become even more dependent on it since the start of the pandemic (see exhibit 5), fuelling further "stag-flationary" forces.

Risk #2: Ukraine crisis (mutually assured pain)

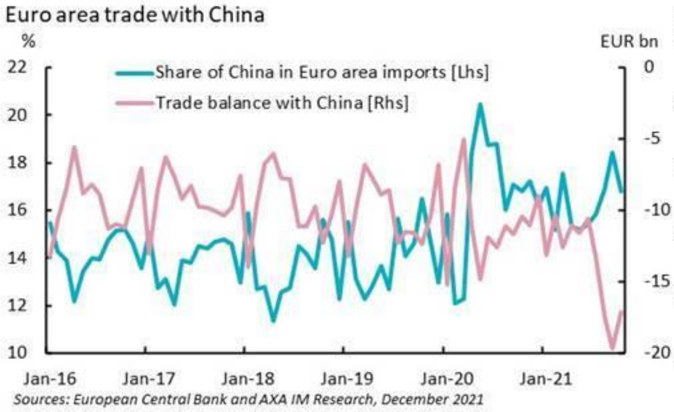
Avoiding Ukraine's anchoring to the West via EU and/or North Atlantic Treaty Organization (NATO) membership is a key tenet of Russia's focus on "strategic depth". The West has been clear - and so far, united - on the magnitude of economic sanctions Russia would face in case of military action further west into Ukraine. The arrival of the Greens at the German Foreign office solidifies the EU's resolve on that matter. However, **from a purely financial point of view, Russia's capacity to deal with Western sanctions looks quite high**: reserves now exceed its external debt (see exhibit 6).

Yet, these reserves would be of limited use if the West cuts Russian banks access to Society for Worldwide Interbank Financial Telecommunication (SWIFT), the dominant transnational payment system. Transactions with the rest of the world – and some internal ones as well – would be severely curtailed, with a potential knock-on effect on political stability in Russia, where the middle-class is increasingly disgruntled and would probably resent being technically unable to buy foreign products. There is a precedent: in 2012 at the time of the dispute on its nuclear programme, Iran was cut from SWIFT, and the threat was already made in 2014 to Russia at the time of the first crisis in Ukraine.

The 2014 threat has played a major role in **the development of a Russian alternative payment framework, the System for Transfer of Financial Messages (SPFS).** According to the Russian central bank, SPFS in 2020 handled 20% of Russian domestic transfers and had 23 foreign banks in its membership, including in the EU (e.g. in Cyprus). Still, access to SPFS by western banks, undermining a SWIFT disconnection, could be terminated as part of a sanction package. The Russian banking sector would need to set up a system of "correspondents" between SPFS and foreign entities outside the control of the West. The conclusions of the latest high-level meeting between the Chinese and Russian governments last week mentioned "developing shared financial structures" and China's Global Times newspaper covered the issue of escaping SWIFT thoroughly last Friday. **If Russia could be "plugged" onto China's own large financial transactions framework, this would go an extra step in the establishment of two parallel and competing financial systems in the global economy.** We note as well that the central bank of Russia is launching the pilot phase of its own digital currency.

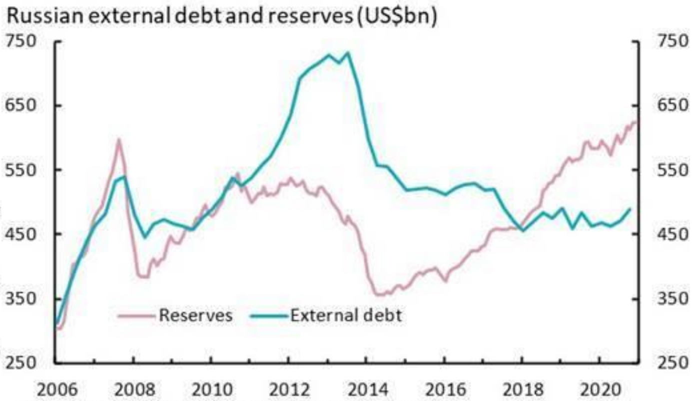
Beyond these macro-financial considerations, it is likely that the first effect of the institution of tougher sanctions on the European side would be another steep increase in gas prices which would come at a delicate time for purchasing power.

Exhibit 5 – The world has become dependent on Chinese supply



Sources: European Central Bank and AXA IM Research, December 2021

Exhibit 6 – Russia seems to be in a favourable financial position



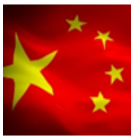
Sources: Datastream and AXA IM Research, 17 December 2021

Risk #3: political upset in Italy

Italy has had a good year 2021, benefitting from massive ECB support - materialised in the extent to which PEPP has diverged from the capital key in the case of the Italian bond market - and taking full advantage of the EU's Next Generation framework. Mario Draghi's capacity to herd a very composite parliamentary majority to support a convincing investment and reform package is playing a major role in shoring up this institutional support and keeping private investors on board. **It is thus unsurprising that the possibility that Mario Draghi would leave his current job to become President of the Republic is generating some nervousness.**

On 4 January, the speaker of the lower house will start the process of electing a new President, a complex affair in the hands of about 1,000 parliamentarians and representatives of the regions. Interestingly, they don't have to vote for declared candidates but can write in anyone. The first three rounds require a two third majority, reduced to simple majority from the fourth round on. Dozens of potential candidates have been mentioned in the Italian press, but **Draghi has not officially declared himself…. But nor has he publicly ruled himself out** as some former political heavyweights have done (e.g. ex PM Romano Prodi). The most prominent politician who has declared himself is Silvio Berlusconi, even though he would reach the age of 92 at the end of the mandate. Although he is supported by his own party and by Lega, at this stage he probably would not command a majority.

The main reason for Draghi to run for President – a ceremonial role most of the time, but a crucial role in times of political crisis – is that if he doesn't now, he would miss this opportunity for 7 years (he is 74 years old). An option would be to ask current President Mattarella to run for a second term, which he has ruled out so far, to serve only until after the 2023 general elections, thus then allowing Mario Draghi to succeed him. The hope is that after these general elections a functional majority could emerge to support a "political" rather than a "technical" government, allowing Draghi to leave the day-to-day political arena. There is one precedent of a President (Napolitano) finally persuaded to run again as the 5th round had failed to produce a majority. From a market point of view, this would probably be the best option, but the road to get there can be sinuous.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• The FOMC meeting took a hawkish turn. Taper was quickened as expected, but Fed members now see three rate hikes next year, as do we • Congress addressed debt ceiling, raising by $2.5trn taking it beyond the midterm elections • Retail sales (Nov) slowed to just 0.3% from 1.8% • Philadelphia Fed survey (Dec) dropped to 15.4 • Housing starts (Nov) rose by 11.8% on month • President Biden acknowledged Build Back Better Act likely only in 2022	• GDP (Q3, revision) expected unchanged at 2.1% (saar, p) • PCE inflation (Nov) expected to rise to 5.7%, which would be a 40-year high • Any final progress on BBB Act • Michigan 5-10 yr inflation expectations (Dec,f) • Personal spending (Nov), watched in light of softer retail sales. We expect 1.5% Q4 qoq • New and existing home sales (Nov) • Durable goods order (Nov,p) • PPI inflation (Nov) exp'd higher at 9.2%, core stable at 6.8%
	• The ECB confirmed the end of PEPP in Mar 22, reinvestment policy extended until end of 2024. APP increased to €40bn per month in Q2, but only €30bn in Q3 and €20bn from Oct 22. 2022 HICP up to 3.2% (+1.5pp)/2024: 1.8% • EMU Mfg flash PMIs (Dec) is flat/down in Svcs • Dec Fr Bus climate stand well but Ge Ifo fell	• EMU consumer confidence flash (Dec) is expected to decline for the 3rd consecutive month and go back to the level of April 21 • Monitoring Spanish Q3 GDP growth revision after disappointments on private consumption
	• MPC voted 8-1 for hike to 0.25%, in line with our expectations though markets expected delay due to Omicron concerns • Unemployment (Oct) dips to 4.2% as end of furlough fails to ease labour market pressures • CPI (Nov) rises to 5.1% - a new 10-yr high	• Watch for further increases to Covid cases and changes in restrictions after highest ever cases are recorded for two consecutive days • Q3 GDP (Nov, f) expect little revision; p, 1.3% • PMIs (Dec, f) – expect some softening as Omicron weighs on activity (p, 53.2)
	• The BoJ extended the end of the extraordinary loan program until Sept 22 • Other measures are broadly unchanged • Tankan surveys up in non mfg sector and flat in Mfg. Dec Mfg PMI flash down to 54.2 (-0.3)	• CPI is expected to increase with higher contribution from energy but its reading will remain strongly distorted by mobile phone charge that remove approx. 1.5pp from the index
	• November activity data suggests futher slowing of the economy • The CEWC confirms to pursue policy easing to combat growth slowdown	• Given subdued domestic growth picture, we expect government to continue to roll out policy easing going forward
	• CB: Chile hiked +125bps to 4.0%, Mexico +50bps to 5.25% & Hungary +30bps to 2.4%. Indonesia & Philippines stood on hold at 3.5% & 2.0%, respectively. Turkey cut -100bps to 14.0% • Inflation (Nov) accelerated in South Africa (5.5%) & India (4.9%)	• CB: Thailand is expected to stay on hold at 0.50%. Czech Rep. could hike +75bps to 3.50% • Reaction to the presidential runoff in Chile (Sunday) • Inflation figures (Nov) for Singapore, Malaysia, & Korea • IP numbers (Nov) for Poland, Russia & Taiwan

Upcoming events		
	US :	Mon: Leading indx (Nov); Tue: Current account (Q3); Wed: GDP (Q3), Conf Bd cons conf (Dec), Existing home sales (Nov); Thu: PCE price indx (Nov), Personal income & spending (Nov), jobless claims (18 Dec), Durable goods orders (Nov,p), Michigan consumer sentiment (Dec), New home sales (Nov)
	Euro Area:	Tue: EU19 Cons conf (Dec,p); Thu: It ISTAT business & consumer confidence (Dec), Sp GDP (Q3)
	UK:	Mon: CBI Industrial Trends Survey (Dec); Tue: PSNB (Nov), CBI Distributive Trades Survey (Dec); Wed: GDP (Q3), Business investment (Q3), Private consumption (Q3), Current account (Q3)
	Japan:	Thu: Leading indx (Oct), CPI (Nov); Fri: Housing starts (Nov)
	China:	Mon: 1-yr and 5-yr loan prime rates

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