Research & Strategy Insights

Who's the Looser?

120 – 24 January 2022

Key points

- While the US overheating is undeniable, it's difficult to argue there is excess demand in Europe. But this cyclical gap is not replicated in relative financial conditions, which by reference to before the pandemic are not looser in the Euro area than in the US. This is another reason to expect significant policy divergence this year.
- We look into the "exclusion versus engagement" debate which is becoming prominent in sustainable finance.

The issue about inflation in the US now is less about a drift in expectations – surveys paint a reassuring picture on that front – and more about the actual effect of the current overheating. Re-anchoring expectations can often be done by the central bank merely "baring its teeth" but ultimately not doing too much in terms of actual tightening. Curbing excess demand, conversely, entails a proper rise in funding costs of the private sector. Since the Federal Reserve (Fed) has signaled its readiness to reduce its balance sheet faster than during the last normalization phase, mortgage rates have followed the rise in treasury yields. However, corporate bond yields seem to be lagging, remaining more than 1.5 standard deviations below their 2010-2019 average. This asset class normally plays a key role in monetary policy transmission. The Fed may have to toughen up its rhetoric further to get more reaction from that side of the market.

It is much harder to argue that the Euro area is characterized by excess demand, and even with the reasonably brisk growth pace in our forecasts we don't expect the output gap to close there before the end of this year. However, when taking as reference the pre-pandemic decade, financial conditions are not looser in the Euro area than in the US. This is another reason why we think it's wrong to qualify the European Central Bank (ECB) as "being late" relative to the Fed. On top of the cyclical gap between the two regions, there is simply less accommodation to remove in the Euro area than in the US.

The "engagement versus divestment" debate has become prominent in sustainable finance. We review an intriguing academic paper suggesting the current impact of exclusions on capital cost is very limited. While the paper is convincing about the current state of play, we are less sure about the implications for the future, as more pervasive carbon-pricing systems will affect the relative financial performance of highly carbonated businesses. Finally, while in our view engagement – and hence accompanying companies in their transition journey – is key to any successful sustainable investment strategy, divestment can in certain cases be necessary to protect the long-term interests of savers. A business which would not make any effort to adapt to a regulatory environment which is likely to be increasingly tough on environmentally harmful activities is a good candidate to become a "stranded asset".

Transatlantic cyclical gap at odds with relative financial conditions

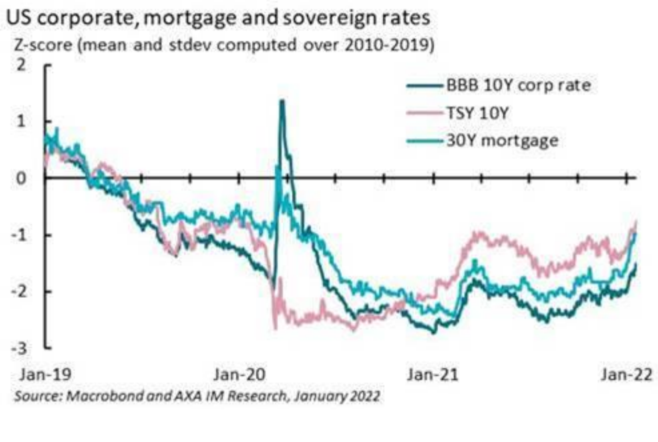
For economists of your humble servant's generation, the idea that anchoring inflation *expectations* is key to controlling *actual* inflation is an article of faith, and a legacy of the big pendulum swing of consumer prices in the 1970s and 1980s. The best way to stop an exogenous shock – say a steep increase in oil prices – from triggering persistent inflation is to convince employees and employers that inflation on trend will remain low in the future so that wage negotiations are not impacted. If the expectations channel dominates, then the central bank by merely "baring its teeth" and signalling its readiness to tighten policy can keep inflation low, without being forced into a lot of actual hikes.

The only problem with this is that there is not much in terms of "excess inflation expectations" which needs to be curbed in the US, judging by consumer surveys at the moment, as we have been repeatedly arguing in Macrocast. Wages in the US are not accelerating because Americans have decided that trend inflation has increased, and they need to protect their purchasing power. They are accelerating because there are simply too many job offerings for a pool of potential employees which has shrunk with the drop in participation. **The only realistic way to curb inflation is then to reduce excess demand**, i.e. to bring the quantum of job offerings down to the available workers' pool, **and this may take a bit more than a bit of "teeth baring".**

Besides, beyond the change in the overall stance of the Fed, the instruments and the transmission channels of the imminent tightening also need to differ from the experience of the last two years. At the worst of the pandemic, the main role of central banks was (i) to avoid a market seizure which would have added to the deterioration in aggregate demand and (ii) to make the necessary massive fiscal support financially doable by keeping interest rates to a minimum across the entirety of the curve. Injection of liquidity to non-financial agents through quantitative easing (QE) was thus the appropriate instrument. Now that the inflation spike in the US is driven by endogenous factors, the only way to "put the genie back into the bottle" is to make sure the Fed's monetary tightening will *directly* affect demand.

The current US overheating – actual GDP has started to exceed its trend level around the middle of last year – is to a large extent the product of several waves of massive fiscal stimulus. Of course, over time the removal of quantitative easing can nudge the US administration towards less profligacy, but politics, rather than the level of treasury yields and its knock-on effect on fiscal space, will seal the fate of future stimulus. In the meantime, it's the behaviour of businesses and households which needs to change, which means that their effective cost of funding needs to rise. What happens to the treasuries is second order from this point of view. **We need to see some proper transmission of the current increase in risk-free interest rates to corporate and mortgage rates**.

Exhibit 1 – Still quite some catch-up need on corporate bond yields



Before the pandemic, treasury yields, BBB-rated corporate bond rates and mortgage rates were within the same distance from their post-Great Financial Crisis (GFC) average (see Exhibit 1). With the pandemic came significant divergences. A massive spike in corporate and mortgage rates occurred at the beginning of the pandemic, as aversion to risk peaked, but this was quickly brought to a stop by the Fed's action, purchasing treasuries and mortgage-backed securities, and then for the first creating a (finally unused) capacity to intervene on the corporate bond market. What we find striking at the current juncture is that while treasuries and mortgage rates have reacted to the recent statements by the Fed in a similar fashion, now standing less than one standard deviation below their 2010-2019 average, **corporate bond yields remain more significantly below their long-term average (more than a 1.5 standard deviation below their 2010-2019 average**).

Raising the cost of refinancing for leveraged business is however a key transmission channel to curb excess demand. The corporate bond spread accounts for 40% of the Financial Conditions Index developed by Goldman Sachs, whose weights are determined by the impact of each component on GDP. They have the same weight as government yields, with equity prices and the exchanging providing much smaller contributions. We opined two weeks ago that fighting the curve flattening observed at the end of last year was one of the reasons why the Fed was so keen on quickly discussing a reduction in the size of its balance sheet. There may still be an ingredient missing: a more reactive corporate bond market. Without this, the Fed's efforts would be dampened. **This may prompt the Fed to be even more hawkish in the weeks and months ahead, until the market "gets it" and reprice the cost of funding for businesses**. This would take the form of tougher rhetoric, since, unlike treasuries and mortgage backed securities, the Fed has no direct impact on corporate bonds.

Exhibit 2 – Omicron is much less of a drag

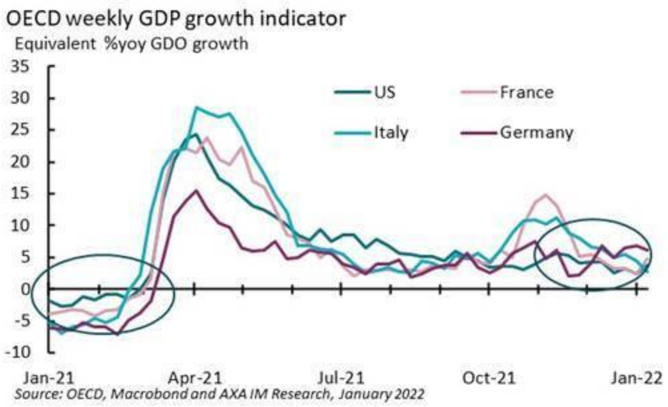
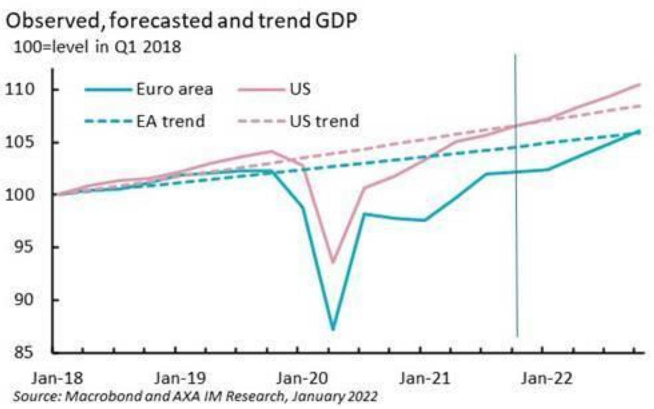


Exhibit 3 – similar growth rates, different output gap

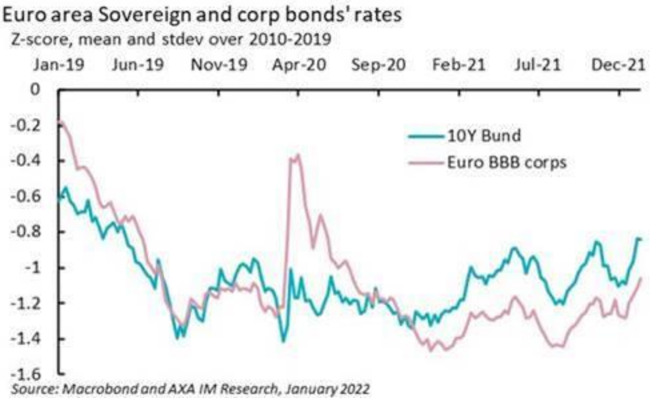


We think some of the overheating will spontaneously recede in 2H 2022, but the Fed is clearly getting impatient. To some extent, the ECB finds itself in the opposite situation. **Even the most hawkish members of the Governing Council would probably have a hard time convincing themselves the Euro area has an excess demand problem**.

The ongoing Omicron wave is having very manageable impact on demand in both the Euro area in the US alike, judging by the Organisation for Economic Co-operation and Development (OECD) weekly index (see Exhibit 2), which leaves us on the whole comfortable with our GDP forecasts. Still, while we expect a slightly higher GDP gain in 2022 in the Euro area than in the US (3.9% against 3.5%), this would not exhaust the cyclical differential accumulated since the beginning of the pandemic. Using an in-consensus potential growth rate of 1.75% in the US and 1.2% in the Euro area, and assuming a similar output gap in 2018 to start with (as per the OECD's estimate), even at our fairly robust forecasted pace **GDP in the Euro area would be back to its trend level only at this end of 2022 only, roughly a year and a half after the US** (see Exhibit 3). In any case, the "proof" of overheating lies in actual endogenous inflation pressure, and for now, wage growth in the Euro area has remained tame, amid improving participation rates, in contrast with the US.

Given these cyclical differences, a healthy gap in financial conditions across the Atlantic could be expected. This is not happening. Last week, 10-year Bund yields were 0.8 standard deviation below their post-GFC average, the same distance as for 10-year treasuries. BBB-rated corporate bond yields are closer to their average in the Euro area than in the US, and sovereign and corporate bond yields in the Euro area are now higher than in the second half of 2019 (see exhibit 4). This gets us back to the issue of the transatlantic policy gap before the pandemic started. Indeed, the ECB had re-started QE in September 2019, while the Fed had "only" reduced its policy rate from 2.5% in July 2019 (post-GFC peak) to 1.75% in October. In other words, **the Fed could hike by 150 basis points the Fed Funds rate from their current level before returning to the pre-pandemic stance, whereas the ECB would return to its pre-pandemic stance by simply doing what is *already* contained in its forward guidance for October 2022 (an Asset Purchase Programme (APP) at EUR20bn per month, same as in November 2019).**

Exhibit 4 – Euro area financial conditions already stricter than before the pandemic



In addition, when comparing the overall level of monetary and financial conditions across the Atlantic, one needs to factor in a major difference in the structure of the two economies: while market funding dominates in the US, bank intermediation still prevails in the Euro area. Judging by the Fed's Senior Loan Officer survey and the ECB's Bank Lending survey, **credit standards are currently *easier* in the US than in the Euro area** (by historical standards).

It would be tempting to consider that the weakness of the euro vis-à-vis the dollar offsets these "not so loose" domestic financial conditions, but the euro's trade-weighted exchange rate has actually *appreciated* by 3% relative to December 2019 (using the JP Morgan index).

Exhibit 5 – Loose credit standards in the US

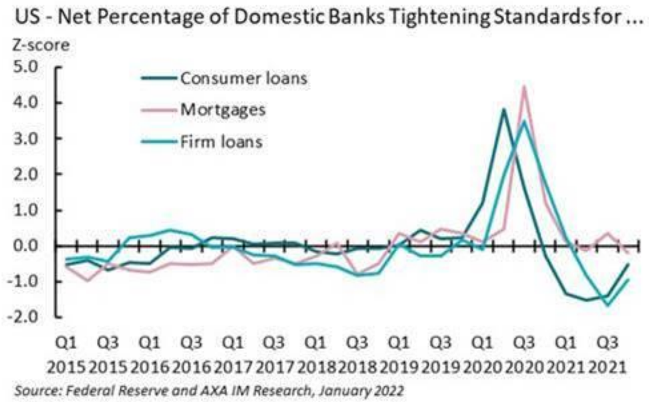
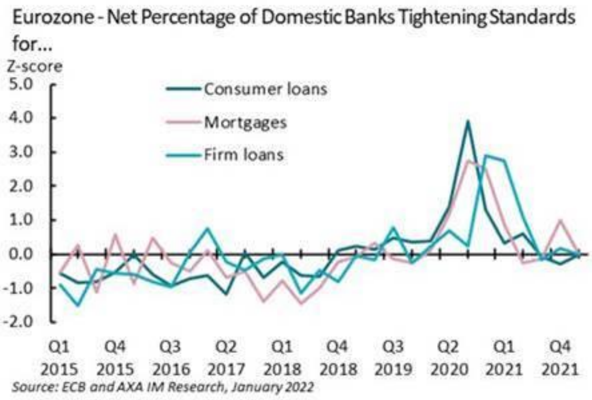


Exhibit 6 – Not so much in the Euro area



The cyclical gap between the US and the Euro area is thus clearly at odds with the policy gap. This justifies a very significant policy divergence in 2022 across the two sides of the Atlantic. Of course, **some hawks may argue that the ECB's policy stance of 2H 2019 – explained at the time by the return of deflation concerns – is not the right point of reference now that the Euro area is experiencing a painful inflation spike**. We note that the possibility that inflation, while remaining in line with the ECB target, would however in the coming years shift from the "below par" inflation regime which had been prevalent between 2012 and 2019, was prominent in the account of the ECB's latest Governing Council meeting released last week. This alone would be consistent with more stringent financial conditions today than in 2H 2019. Still, it is a possibility, not a done deal, and the account made it clear there is not yet a consensus at the central bank on this.

Ultimately, it's the labour market and more precisely wage growth which will tell the ECB whether such change in the inflation regime is happening. For now, nothing has appeared in the data which would substantiate this, but this clearly an area on which the ECB will focus hard. This was encapsulated in this paragraph in the account: *"It was seen as paramount to pay close attention to timely signals emerging from the real economy, notably those from firms and wage-setters, rather than relying mostly on models and past patterns (…) In this context, it was also reiterated that higher inflation in the medium term was unlikely to come about without dynamic wage growth".*

While the ECB waits for the verdict of the labour market – with a forward guidance consistent with taking the entirety of 2022 for such assessment, we think it's wrong to qualify the ECB as "being late" relative to the Fed. It's not just because there is a cyclical gap, it's also because **there is less accommodation to remove – when taking the 10 years before the pandemic as a reference – in the Euro area than in the US.**

Divestment, impact and stranded assets

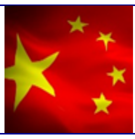
The "exclusion versus engagement" debate has become a prominent theme these days in sustainable finance. This is pushed by practitioners (e.g. Larry Fink in his latest letter to CEOs), but there has also been a flurry of interesting academic papers focusing on this issue. Zingales and alii (see here) are making the case for a larger impact of engagement (e.g. voting in shareholders meetings to change the business strategy) than divesting in terms of effecting actual changes in collectively harmful practices. Their paper is highly theoretical and not for the fainthearted. Published just before the festive break, an intriguing paper by Jonathan Berk and Jules Van Binsbergen titled "the impact of impact investing" (see here) is more accessible and backed by empirical observations. Their main conclusion is also that "impact investment" based on exclusions and hence divestments has very limited capacity to move the dial.

The paper by Berk and Van Binsbergen is methodologically rigorous and based on a very large data sample collected on the US market. **The authors come up with a very simple and elegant formula for calculating the impact of "divestment" on the cost of capital**. It combines three factors: (i) the weight of Environmental, Social and Governance (ESG) investors in the total financial wealth, (ii) the size of the "excluded scope" – the share of market capitalization which the ESG investors will exclude - and (iii) the correlation between the performance of "dirty" and "clean" companies. The role of the first two factors is straightforward: in principle, with a high number of ESG investors committed to far-reaching exclusions, "non-ESG" investors would need to tweak their own capital allocation significantly to absorb the slack created by the divestments, probably demanding a significant premium for that. The third factor is however key. Indeed, if the financial performance of "clean" and "dirty" companies happens to be similar, then such reallocation towards "dirty companies" would have little effect on the risk/return profile of the portfolio of those non-ESG investors, thus limiting the premium (and thus the rise in the cost of capital) "dirty" companies would have to pay.

Their most striking result is undoubtedly that **the share of total financial wealth held by "ESG" investors (defined as those excluding about half of the US market capitalization from their portfolio) should rise to 80% (against 2% today on the American market) so that the cost of capital of "dirty" companies increases by 1%.** They estimate the current impact as a third of one basis point. It is undeniable that more and more investors are converting to these practices, especially in Europe, and this is one of the areas where the paper is biased because of its systematic reliance on US data. It is however true that it's possibly utopian to believe that the conversion would be so general worldwide that there would not be enough savings in regions which not very interested in ESG themes to compensate for an additional "push" in Europe and the United States.

Still, **the paper is possibly overly "static", and it is not obvious to us if its conclusions could necessarily hold for the coming decades.** For their third parameter, the authors use a correlation of 97% between "dirty" and "clean" returns, based on a comparison between an American ESG index and the general index over 5 years. Such magnitude would allow non-ESG investors to increase their exposure to "dirty" equities without significantly altering their overall risk profile, and consequently compensate for the exclusions of ESG investors without asking from issuers a significant performance premium. This is a key input into their conclusion that it would take a near complete conversion of the investor base to ESG and/or a broadening of the exclusion scope to move the dial. Yet, we **think it is very likely that the performance correlation between "clean" and "dirty" companies will deteriorate in the years to come** because of regulatory changes, at least in Europe. Between the increase in the price per ton of carbon on the Emissions Trading System (ETS) market and its scheduled extension to more sectors, possibly combined with the implementation of a carbon tax at the border (one of the priorities of the French Presidency of the EU), the most carbon-intensive companies will gradually have to reckon with a significant impact on their margins, and this effect will be integrated into their stock market valuations. This should create a wedge between “clean” and “dirty” names.

Meanwhile, engagement – nudging companies in which one is invested to “do the right thing” – is essential to any proper impact policy, and AXA IM for one believes in accompanying businesses into their transition as the central plank of its sustainability strategy. Still, opposing engagement to divestment is possibly slightly misleading. **Exclusion is not only about impact – changing the behaviour – but should also be understood as a manifestation of “fiduciary duty” vis-à-vis savers.** A business which year after year would fail to read “the writing on the wall” and prepare its transition to net zero would expose itself to the risk of obsolescence and ultimately failure. Reducing exposure to such companies protects the long-term return of the portfolio, even if the impact on the immediate environmental behaviour of divested companies is minor.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• UST yields touched 1.90% as Fed speculation rose, but equities sold off sharply • Continued diplomacy with Russia over Ukraine • Empire & Philly Fed surveys (Jan) – diverged sending mixed messages over Omicron impact • Jobless claims rose unexpectedly to 286k suggesting an omicron effect in labour market • President Biden failed to pass voting rights bill, focus to move to slimmed spending package • Home sales (Dec) -4.6% m/m as mtg rates rise	• FOMC meeting, no change in policy expected, but Powell to lay groundwork for March hike • GDP (Q4, p) we estimate softer 5.0% (saar) vs 6.0% consensus • Employment cost index (Q4) expect softening from 1.3%qoq elevated rise in Q3 • PCE inflation (Dec) expected to edge modestly higher to 5.8% from 5.7% • Jobless claims - gauge scale of omicron impact • Consumer conf (Jan) measures hit by inflation
	• Eurozone consumer confidence flash (Jan) only declined by 0.1pp at -8.5 (cons: -9) • Fr business climate (Jan) down to 107 from 110 but industrials up to 112 from 111 / GE ZEW eco sentiment (Jan) surged to 51.7 • Euro area CPI (Dec, f) confirmed 5.0%yoy, Ge PPI up to 24.2%yoy	• It Presidential elections • EA, Ge and Fr Flash PMIs (Jan), Ge Ifo, Fr consumer confidence to gauge the state of the economy following peak of the Omicron wave • Jan EC sentiment surveys and business climate • Fr and Ge GDP flash (Q4) (AXA IM forecasts: Ge: +0.2% / Fr: +0.6%qoq)
	• CPI inflation (Dec) rose to 5.4% – a 30yr high – with rises in food and clothing driving the beat. Inflation still set to peak in Q2 2022 • Unemployment fell to 4.1% from 4.2%. Wage growth slowed to 3.6%yoy • Retail sales (Dec) incl fuel fell sharply by -3.7%	• Gray Report expected – key next stage in determining whether PM Johnson will remain, amidst rumours of a no confidence vote • UK flash PMIs (Jan) to gauge impact of omicron • UK public finances for Dec • Nationwide house price index for Dec
	• The BoJ kept the status quo and Gov Kuroda excluded any premature normalisation as rising inflation is not yet transmitted to wages • CPI inflation (Dec) rose to 0.8%yoy (+0.2pp) • machinery orders (Nov) up again to 3.4%mom • Industrial production (Nov, f)	• Monitoring Mfg PMI flash (Jan) and the impact of supply disruption, other components are likely to remain robust • CPI Tokyo (Jan) • COVID cases and government's reaction
	• Better Q4 GDP cannot mask persistent underlying weakness in the economy, which prompts the PBoC to cut rates	• Further policy easing could be rolled out as talks of growth stabilisation have ramped up significantly lately
	• CB: Several EMs kept their rates on hold: Malaysia (1.75%), Indonesia (3.50%), Turkey (14.0%) & Hungary (4.0%) • Inflation (Dec yoy %) picked up in Romania to 8.2% and in South Africa to 5.9%. It remained stable in Poland (8.6%) and Hungary (7.4%) • Retail sales (Nov yoy %) lost steam in Colombia (7.4%) and contracted in Brazil (-4.2%)	• CB: Colombia is expected to hike +75 bps to 3.75%, Chile +100 bps to 5.0% & South Africa +25 bps to 4.0% • Retail sales numbers for Mexico (Nov) & Poland (Dec) • GDP figures (Q4) for South Korea, the Philippines & Taiwan • Inflation (Dec) for Singapore

Upcoming events	US:	Mon: PMI (Jan,p); Tue: CS & FHFA house price indx (Nov), Conf Bd consumer confidence (Jan); Wed: trade (goods) (Dec), New home sales (Dec), FOMC announcement; Thu: GDP (Q4,p), Durable goods orders (Dec,p), Pending home sales (Dec); Fri: PCE (Dec), Personal income/spend (Dec), ECI (Q4), Michigan consumer confidence (Jan)
	Euro Area:	Mon: EU19, Ge, & Fr PMI (Jan,p), It Presidential election; Tue: Ge Ifo business climate indx (Jan); Wed: Fr Insee cons conf (Jan); Thu: Sp Unemp (Q4); Fri: EU19 M3 (Dec), EU19 Business confidence (Jan), Fr & Sp GDP (Q4,p), Fr Consumer spending (Dec), It ISTAT confidence (Jan)
	UK:	Mon: PMI (Jan,p); Tue: PSNB (Dec), CBI Industrial Trends (Jan & Q1); Thu: CBI Distributive Trades (Jan); Expected during the week: Nationwide house price indx (Jan)
	Japan:	Mon: Manufacturing PMI (Jan,p); Wed: Leading indx (Nov)
	China:	Thu: Industrial profits (Dec); Sun: Manufacturing PMIs (Jan)

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