
# The Bear and the Turtles

# 123 – 14 February 2022

## Key points

- We explore the macro constraints to a re-armament effort in Europe. Russia would struggle. It may be an acute awareness of these challenges ahead which explains Moscow's tough approach now.
- While this keeps us behind some prominent sell-side calls, we make the case for a cautious approach by the Federal Reserve (Fed) after the March lift-off.

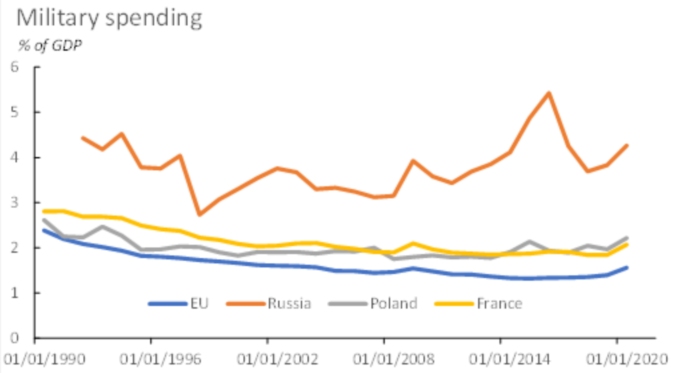
Judging by the public warnings of the US and UK governments, tension with Russia over Ukraine is not abating and may even get paroxysmic this week despite continuing diplomatic efforts. Beyond the impact a further escalation would have on the short-term European outlook, we explore the macroeconomic constraints around a likely re-armament race in Europe. While the current gap in military spending between Russia and the European Union (EU) looks glaring when expressed in share of GDP, it reverses when looking at the absolute levels. The likely demographic and economic trajectory in Russia will make it very hard for Moscow to keep up with the EU countries if, in a delayed reaction to Russia's assertiveness, they decide to bolster their own defence spending.  It might be Moscow's very awareness of these demographic and economic challenges ahead which may explain why Russia is ready to go quite far now to protect its influence in Ukraine, which is sees as crucial to the "strategic depth" which has traditionally been a focus of Russian military doctrine. In a nutshell, Moscow would rather have an indirect confrontation with the West before its economic vulnerabilities start impacting its defence capabilities again. Yet, by confronting the West now, Moscow may actually accelerate a re-armament race which it will have a very hard time winning.

Inflation surprised to the upside again in the US in January, but the reaction from the Fed has not been unanimous. While James Bullard called for raising the Fed Funds rate by 100 basis points by July, San Francisco Fed President Mary Daly expressed her support for a prudent approach after the March lift-off. We think the cautious approach makes sense. The very recent weakness in consumer spending may reflect the decline in purchasing power as the combination of strong job creation and robust wage growth is not fully offsetting the rise in consumer prices and the end of the income top-ups by the government. Hawks will probably argue that the release of excess saving  - mostly held in checking deposits - back into consumption would keep demand on an unsustainable pace without a significant and quick monetary tightening, but no model can properly explore these opposite scenarios because the US economy has never found itself in a similar position. This would argue for a prudent approach to the pace of rate hikes by the Fed, with a lot of the "learning by doing" which Mary Daly advocates to get the right quantum of tightening. For now, we keep our forecast of four 25 basis points hikes in 2022, which leaves us behind some prominent sell-side calls.

## The bear and the turtles: who would win a re-armament race in Europe?

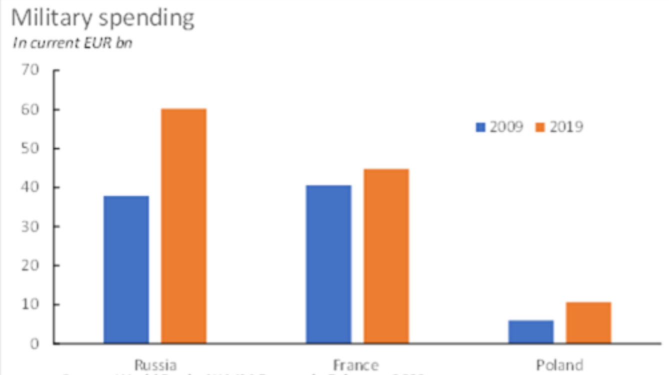
There is a dissonance in the West between Anglo-Saxon countries where Russian military intervention in Ukraine is seen as "very likely" and "imminent" to quote from the British Defence minister last Saturday, and continental Europe where the belief in the possibility of a diplomatic solution seems stronger. What is clear in any case is that this risk is not going away. Based on the recent behaviour of the natural gas market, **further escalation** (military action against Ukraine triggering economic sanctions against Russia, with reprisals on gas supply) **could easily lift the *overall* cost of energy in the Euro area by more than 10%** which could be enough to shave more than 1% off household purchasing power, subject to the mitigation action taken by governments to limit the transmission from wholesale to retail prices. Together with the generic drop in economic confidence triggered by the heightened geopolitical uncertainty, such escalation would have the potential to severely dent the European recovery. Still, beyond the relatively obvious channels through which such a crisis would affect the short-term outlook, we want here to focus on some underlying medium-term macroeconomic trends which could shape the relationship between Russia and the EU. Our point is that **the capacity of the EU to catch-up on defence spending is significant and that Russia would have a hard time engaging in a proper re-armament race in Europe.**

Exhibit 1 – The military spending gap looks huge…



Source: World Bank, AXA IM Research, February 2022

Exhibit 2 - …but less so in absolute terms



Source: World Bank, AXA IM Research, February 2022

One of the reasons ice melting is such a threat to polar bears is that even under perfect conditions they are already inefficient walkers and are constantly in "crisis mode" as they spend too much energy roaming the Arctic looking for seals to hunt. The same energy conservation issue may apply to Russia if the tension over Ukraine were to unleash a long-term build-up in military capacity in the European Union. Today, the discrepancy in defence expenditure looks spectacular when expressed as *a percentage of GDP*: it has been standing at 3 to 4% in Russia since the end of the cold war, while it fell to 1.5% in the EU in 2017 (see Exhibit 1) – much to the concern of the US, increasingly frustrated by their disproportionate contribution to NAT0. The discrepancy remains glaring even when comparing Russia with the member states which comply or nearly comply with the North Atlantic Treaty Organization (NATO) target of 2% (e.g. France and Poland). However, **what matters strategically is the *absolute* amount of money spent on defence, and from this point of view the gap is much smaller**, given Russia's limited economic size. In 2020 its GDP in nominal terms stood at less than 40% of Germany's alone, and was roughly in line with the sum of the Netherlands' and Belgium's. In billions of euros, in 2019 (last available comparable data in the World Bank source) **French and Polish military expenditure taken together matched that of Russia** (see Exhibit 2).

Of course, financial resources are only one aspect of the problem, and most Atlantic and Mediterranean-facing EU member states have shifted their military strategy away from focusing on a large-scale, terrestrial conventional conflict on the European theatre to develop smaller-scale overseas projection capabilities, more adapted to the emergence of asymmetric conflicts**. It would take time and money to shift back to the old 1980s strategy, but at least the economic capacity to do so exists.** The 2014 Crimean affair was already a wakeup call for many EU governments and the current Ukrainian crisis, irrespective of its conclusion in the short-run, is likely to trigger an acceleration in the catch-up in military expenditure and strategic decisions which had been delayed for years. As an example, Sweden, which with military spending currently at just 1% of GDP has been standing towards the bottom of the EU distribution, has decided last year to increase its defence budget by 40% over 2021-2025 and is now contemplating joining NATO. Most EU countries have been slow to react to Russia's assertiveness, trying for too long to capture the dividends of the end of the cold war and this ongoing defence re-think may take time to yield tangible results, but **a relatively small upward adjustment in the share of military spending in GDP would allow it to compete quite easily with Russia**. True, the EU is facing financial constraints to raise public spending, especially after the additional rise in debt incurred during the pandemic. Habitual readers of Macrocast may remember that your humble servant is in favour of exempting the part of military expenditure above the EU average from the scope of the Stability and Growth Pact to loosen the constraint for those member states who accept to shoulder a disproportionate share of collective defence. But still, the room for manoeuvre in the EU is ample when compared with the medium-term challenges Russia is facing.

**The demographic situation in Russia is quite concerning**. Its population peaked in 1992 at 148.5 mn. According to the United Nations (UN) estimates it stood at 144 mn in 2020 and will fall under 140 million at the beginning of the next decade. Beyond the general adverse impact on economic dynamics, population ageing is unavoidably going to be a growing source of pressure on public finance while military spending already absorbs more than 11% of total central government expenditure. The 2018 demonstrations against the planned pension age reform, which coincided with a steep decline in Vladimir Putin's standing in the polls, are a reminder that there are limits to the sacrifices the Russian population is ready to accept to fund the country's status as a military superpower. Beyond ageing, the entire growth model is also problematic. **The country has so far been unable to seriously diversify away from exports of fossil fuels.** Although they naturally vary with gas and oil prices, exports of mineral products have always stood at between half and two third of total Russian exports since the breakup of the Soviet Union**.** While for now it is putting Russia in a position of strength given the price level, **this is going to be a source of vulnerability as the more developed economies gradually reduce their demand as part of their journey to net zero**. Even if gas operates as a bridge away from coal during the transition, the very fact that Moscow is using it as a channel to exert strategic pressure over the EU is already making at least some European governments look elsewhere – in particular towards US liquefied gas – for their supply.

**It might be Moscow's very awareness of these demographic and economic challenges ahead which may explain why Russia is currently ready to go quite far *now* to protect its influence in Ukraine**, which is sees as crucial to the "strategic depth" which has traditionally been a focus of Russian military doctrine. In a nutshell, Moscow would rather have an indirect confrontation with the West *before* its economic vulnerabilities start impacting its defence capabilities again. **Yet, by confronting the West now, Moscow may actually *accelerate* a re-armament race which it will have a very hard time winning.**

## US: Inflation awakening versus sleeping money

Last week brought another piece of evidence to the already thick "persistent US inflation" file. The headline Consumer Price Index (CPI) for January exceeded expectations again at 7.5%yoy from 7% in December, with the same quantum of acceleration for core CPI (from 5.5% to 6.0%), with pressure continuing to broaden to more sectors. Interestingly though, it seems that the reaction at the Fed was not unanimously hawkish. True, while James Bullard came out last Thursday calling for hikes totalling 100 bps by July, the United States (US) press was reporting significant pushback at the Board against a knee-jerk monetary reaction. **We will know more about the policy options under discussion at the Fed this week with the release of the minutes of the last Federal Open Market Committee (FOMC) meeting**. At this stage, it seems the need to start raising rates in March is now consensual, but there is still a strong case in favour of proceeding cautiously in our opinion. This has been expressed quite candidly by San Francisco Reserve Bank President Daly on Sunday*: "what I would favour is moving in March and then watching, measuring, being very careful about what we see ahead of us".*

The Michigan consumer survey has been under focus over the last year mainly because of its inflation forecast component as the market – and the Fed – are trying to gauge how much the current price spike is affecting long-term expectations. Last week' release was unremarkable on that front since US consumers' 5 to 10 years forecast for inflation remained at 3.1% in February, which is somewhat elevated relative to its 20-year average (2.8%) but in line with levels seen several times in the mid-2000s. Actually, what is probably surprising is that the household forecast is not moving more given the very elevated recent prints and media focus in the price issue. **The "new**

**news" in the release was in the overall consumer confidence index, which fell to 57.4 for the "forward-looking component", the worst level since 2011**. The relationship between confidence and actual spending can often be loose, but the deterioration in household sentiment could herald a persistent slowdown in consumption beyond the weakness reflected in the very latest indicators which observers were prone to attribute to the Omicron wave. Purchasing power is being eroded by the stubborn inflation spike. Excess demand could then start to correct "spontaneously", with less to do in terms of tightening by the Fed.

Movements in personal income have been particularly erratic since the start of the pandemic, but with the last big fiscal boost now nearly a year old, it's getting easier to get a sense of the underlying trend (see Exhibit 3). Since the spring of 2021, corrected for inflation, disposable income has been almost constantly contracting. The combination of the very robust job creation and strong wage increases has not fully offset the impact of the price shock and the disappearance of the federal income top-ups. **Consumption has held up quite well though**, with a contribution in Q4 to GDP of 2.3% quarter-on-quarter annualized (out of an overall growth of 6.9%), but **this was made possible only by the decline in the savings' ratio** (see Exhibit 4). An issue though is that the savings ratio, after having tripled at the peak of the pandemic is now close to the post-Great Financial Crisis average (7.9% in December 2021 against 7.2%). The room for manoeuvre to cushion the impact of the inflation spike on spending by reducing the saving ratio further is getting limited. We note that the 3-month change for real consumption has turned negative in December 2021.

Exhibit 3 – Real household income has been falling

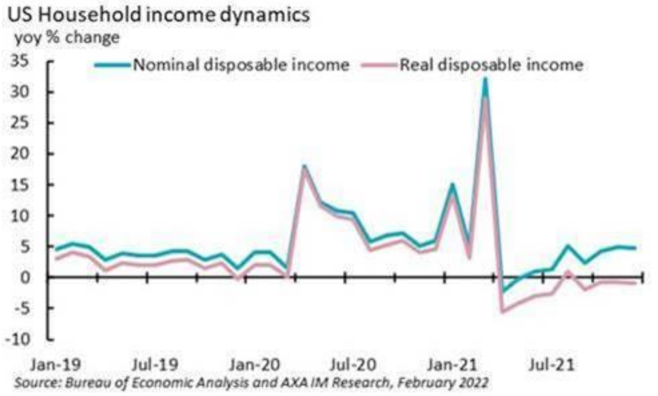
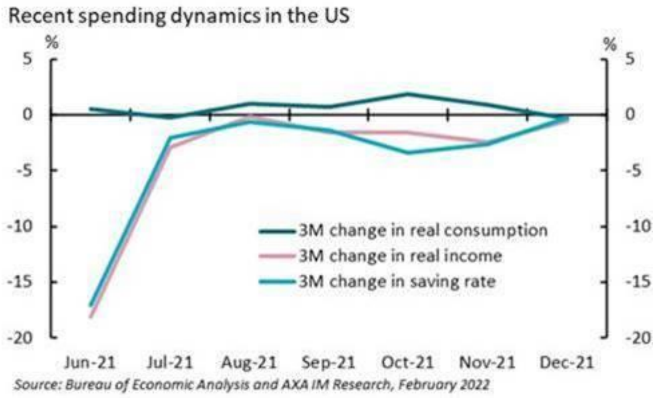



Exhibit 4 – Consumption saved by drop in savings ratio




It may however be wrong to think in terms of "flows only" here. **What becomes of the "stock" of excess saving accumulated since 2020 is as crucial**. We have updated our proxy for "cumulated excess saving" in Exhibit 5. Technically, we compute it by summing all the saving above the post-GFC average rate. As of December 2021, this stood at 17.6% of the total consumption of 2019. Of course, this accumulated saving has been somewhat eroded by the inflation spike, but even after taking this effect into consideration we are still left with an excess saving of 16% of a normal year's worth of spending.

Exhibit 5 – Significant excess saving …

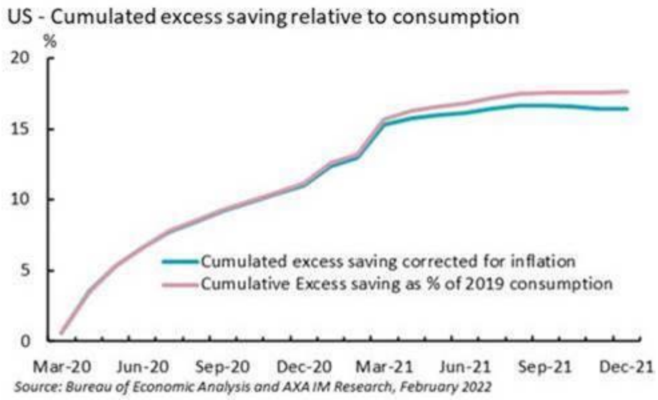
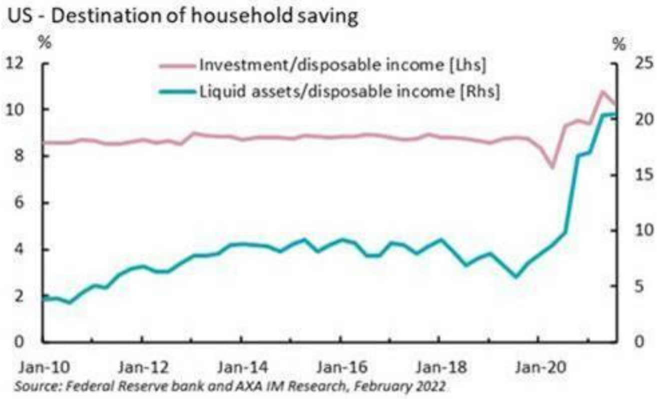



Exhibit 6 - …mostly stored in liquid assets



**This provides a significant buffer against the deterioration in purchasing power, and this plays in the hands of the hawks at the Fed**. Indeed, if households put this buffer to use, it would then be wrong to count on any "spontaneous correction"of the US economy towards a more sedate growth rate any time soon. Doves are likely to insist on the fact that the distribution of the excess saving is very unequal across income levels. A large part of it is probably held by the wealthiest households, whose propensity to spend is low. Yet, how this extra saving has been stored also matters.

Savings is what's left of disposable income after consumption. It can be used either to invest in physical assets – in housing in the case of households – or in financial assets. Exhibit 6 suggests that some of the saving windfall of the pandemic has been directed to residential investment, helping to explain the robust housing price dynamics. It is normally a very stable share of household disposable income except for the last two years when it rose by more than 2 percentage point. Yet, most of this excess saving has taken the form of an accumulation of "currency and checkable deposits" in the Fed's terminology, which now stand at 20% of disposable income against 5% before the pandemic. **The "saving overhang" is still held mostly in readily available cash. It has not found its way to the less liquid assets.** The rise in household wealth in shares and bonds since the beginning of the pandemic is essentially attributable to the valuation effect, not to new flows. The recent financial markets developments are unlikely to trigger much enthusiasm for such a transfer now.

Uncertainty on consumer behaviour is thus massive. Either households consider that the current erosion in purchasing power is just a fairly short-term problem and decide to draw down on their expanded checking accounts to maintain their level of spending (the hawks 'view), or households start getting nervous about the possibility of a significant downturn triggered by the imminent monetary tightening which would affect their employment prospects and decide to maintain their current cash buffers full as a measure of precaution. No model can properly explore these scenarios because the US economy has never found itself in a similar position. **This would argue for a prudent approach to the pace of rate hikes by the Fed, with a lot of the "learning by doing" which Mary Daly advocates to get the right quantum of tightening.** For now, we keep our forecast of four 25 basis points hikes in 2022, which leaves us behind some prominent sell-side calls of up to seven hikes this year.

## European Central Bank (ECB) in communication fine-tuning mode

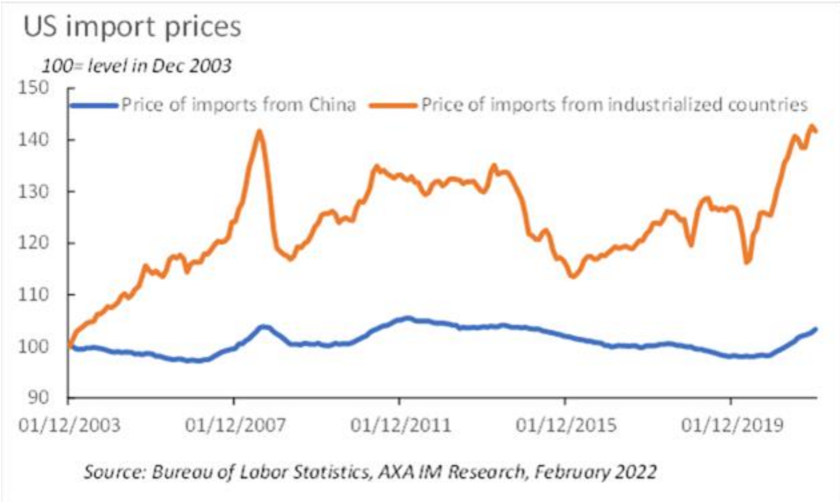
The Fed is not the only central bank which needs to fine tune its communication ahead of the "big decisions". While after the Governing Council meeting earlier this month we brought forward our baseline for the ECB's rate lift-off to December, we were still behind the market which had started pricing a move in June already. Since then, ECB speakers have come out quite clearly in favour of a much slower move. Christine Lagarde herself has repeated the word "gradual" frequently enough in her post-press conference statements to convey this message, but it may be Gabriel Maklouf, Governor of the Central Bank of Ireland, who came out with the clearest line in an interview with the Financial Times last weekend. In his opinion, the central bank could stop its net purchases of securities *"in June or in some months after that"* and then hike rates only after that. In his latest blog post Philip Lane took a quite relaxed view of the bottlenecks currently pushing inflation higher in the Euro area and set out to substantiate the contrast with the US.

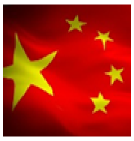
## China's inflation exception

While discussing the shape and form on the monetary tightening is at the centre of the economic debate in the whole developed world and in large swathes of Emerging Markets (EM), the People's Bank of China (PBoC) has eased monetary conditions. **For now, China is completely escaping the general tendency towards higher inflation**. Headline inflation stood at only 1.3%yoy in December 2021. This is to some extent explained by exceptional factors which have not much to do with the endogenous workings of the economy. While in general food prices have been rising globally, this has not affected rice prices much, while pork prices have been correcting after the absorption of the swine flu crisis of 2018. However, **the absence of any excess demand after Beijing's cautious approach to supporting the economy throughout the pandemic probably plays a significant role as well**. China thus finds itself in the opposite situation to many industrialized countries: both exogenous and endogenous sources of inflation are quite tame in China.

**This matters for the fate of inflation at the global level.** Indeed, in our view one key difference between today and the last periods of persistent, very high inflation is the level of integration of the world economy. In the 1970s, with foreign trade at a fraction of what it is today as share of GDP, economic agents located in countries where domestic prices were rising fast had limited capacity to call on alternative goods produced in countries with less inflation pressure. The emergence of new global producers, offering significantly lower prices, in the 1990s has been a major contributor to the overall moderation in inflation. A key issue of course if that over time this effect wanes as, in principle, prices in less advanced countries rise faster than in more mature economies. Now that China has established itself as a key supplier of manufacturing goods across the world, and as solidified this position since the pandemic, the speed of the price level catch-up there has become crucial. Fortunately, for now**, it seems that China is not on the cusp of "exporting inflation" to the rest of the world,** even if accessing Chinese products has become more difficult given the transportation bottlenecks. **China's moderating effect on price dynamics in advanced economies persists**. This can be illustrated by the slow growth rate of the price of products imported from China into the US, when compared with those coming from the more mature economies (see Exhibit 7).

Exhibit 7 – Chinese products are still holding inflation back



| Country/Region | What we focused on last week | What we will focus on in next weeks |
|---|---|---|
|  | • CPI inflation (Jan) beat expectations at 7.5% a fresh 40-year high (core at 6.0%). Transitory factors weighed, but inflation has broadened<br>• Fed expectations shifted with more considering 50bps/back-to-back or intermeeting hikes, also after Bullard comments of FFR at 1% by July<br>• US 10-y reached 2.0% - first time since mid-2019<br>• US discussions with China over China's missed commitments on "Phase One" trade agreement<br>• US reiterates sanctions warnings to Russia | • Minutes of Jan FOMC meeting watched for signs of scale of Fed rate hikes discussed for March and details around QT design<br>• Ongoing diplomacy with Russia around Ukraine<br>• Retail sales (Jan) expected to rebound from Dec drop, but risks that volumes disappoint<br>• Empire & Philly Fed surveys (Feb) to gauge further easing of supply conditions<br>• Existing home sales, housing starts and permits (Jan) – are rate expectations slowing housing? |
|  | • ECB President and Governors softened communication on premature policy rate hike<br>• German final CPI and HCPI (Jan) unchanged at 4.9%yoy and 5.1%. Core CPI at 2.9%<br>• New HICP weights for energy rose to 10.9% from 9.4%, food decreased to 20.9% from 21.8<br>• Sp and It declined (resp -2.6%mom and-1%) | • Ger Zew (Feb) should rise again<br>• Final HICP (Jan) to assess the recent surprise and HICP weight update across countries<br>• EA IP (Dec) should decline after emu-4 releases<br>• EA flash consumer confidence (Feb) may slightly rise but higher prices should weigh<br>• Q4 GDP 2nd estimate and Q4 employment |
|  | • GDP (Dec) fell 0.2%mom due to omicron (0.5% cons) and Q4 GDP up 1.0% (1.1% cons)<br>• UK GDP grew 7.5% in 2021, fastest since WWII<br>• BRC shop price index (Jan) up 8.1%yoy<br>• RICS House Price Index (Jan) hit a new six-month high but momentum could soon fade | • ILO employment (Dec) and HMRC PAYE (Jan), unemployment expects to stay at 4.1% (cons)<br>• CPI (Jan) prices expected to edge higher to 5.5% (cons) from 5.4% in Dec.<br>• Retail sales (Jan) forecast to rebound by 0.9% from Dec drop of -3.7% |
|  | • Households spending (Dec) were below expectations while current account fell due to higher nominal energy imports. Risks are tilted to the downside for Q4 GDP growth forecast<br>• Jan corp goods price rose by 0.6%mom-8.6%yoy | • Q4 GDP (prelim) should rebound sharply (+1.3%qoq after -0.9%) but Dec data have been weak so we can't exclude a neg surprise<br>• Reuters Tankan Mfg and non-Mfg surveys (Feb)<br>• Nationwide CPI headline should rise again |
|  | • Credit growth recovers in January as policy easing starts to kick in | • Inflation is expected to ease at both factory-gate and consumer levels |
| <br> | • CB: +50bps in Mexico (6.0%), Peru (3.5%), Poland (2.75%), Romania (2.5%), +100bps in Russia (9.5%). Indonesia (3.5%), India (4.0%) & Thailand (0.5%) on hold<br>• Jan inflation accelerated in TH TW RS CB MX BZ and stabilised in PH, KO<br>• Malaysia (3.6%qoq) Indo (5%yoy) GDP rebounded in Q4<br>• PMIs weak in EM across the board in Jan | • CB: Philippines (2%) Turkey (14%) expected to keep rates on hold<br>• Q4 GDP in Romania, Hungary, Poland, Colombia, annual 2021 estimate in Russia<br>• CPI figures in India, Romania, South Africa, Argentina (Jan) |

| | | |
|---|---|---|
| Upcoming events | US : | Tue: PPI (Jan), Empire State survey (Feb), TIC data (Dec); Wed: Retail sales (Jan), Industrial production (Jan), Business inventories (Dec), NAHB housing indx (Feb), FOMC minutes (26 Jan); Thu: jobless claims, Philly Fed indx (Feb), Housing starts & permits (Jan); Fri: Existing home sales (Jan) |
| | Euro Area: | Tue: EU19 GDP (Q4,p), Ge ZEW survey (Feb), Sp HICP (Jan); Wed: EU19 Industrial production (Dec); Fri: EU19 Consumer confidence (Feb,p), Fr ILO unemployment rate (Q4), Fr HICP (Jan) |
| | UK: | Tue: ILO Employment (Dec), Average earnings (Dec); Wed: Inflation (Jan); Fri: Retail sales (Jan) |
| | Japan: | Mon: GDP (Q4,p); Tue: Industrial production (Dec); Wed: Trade balance (Jan), Private 'core' machinery orders (Dec); Thu: CPI (Jan) |
| | China: | Wed: CPI (Jan) |

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