

Macrocast

Gilles Moëc

AXA Group Chief Economist
and Head of AXA IM Research



Policy Mixology: Finding the Right Dosage

- The articulation of fiscal and monetary policy in dealing with the inflation shock is crucial. We welcome a generalization of measures breaking the relationship between wholesale and retail energy prices. The United Kingdom (UK) may provide another “lab experiment” though: the market is ready to “cut some slack” for governments dealing with the current crisis, but visibility on the future fiscal consolidation is necessary.

In the absence of clear forward guidance, single data prints can make big differences to monetary policy decisions. Last week’s data flow came with divergent signals for the Federal Reserve (Fed) and the European Central Bank (ECB). In the United States (US), some tentative deceleration in wages and a rebound in labour market participation should steer the Fed towards a 50 basis points hike at the next meeting, rather than another 75-bps move, barring a nasty surprise on inflation next week. In the Euro area, another acceleration in core inflation in August may well have convinced the Governing Council to hike this week by 75 bps – our new baseline. They would “rip the band aid” and bring the policy rate faster in neutral territory.

The policy mix has become a key issue. Germany has announced another fiscal programme to mitigate the impact of the surge in energy prices. In our view, focusing fiscal action on breaking the relationship between wholesale and retail energy prices is the optimal avenue, since it allows some cooperation with the central bank: it may “artificially” dampen the actual inflation shock, but this may help keep inflation expectations anchored. From this point of view, what we know of the European Union (EU) plans on the electricity market reform is reassuring.

Meanwhile, the UK is providing another interesting “laboratory experiment”. Liz Truss – widely expected to have won the Tory leadership race – is for now focusing on general tax measures to mitigate the energy price shock after it occurs. More fundamentally, beyond short-term support, her fiscal plans are quite spendthrift. This is met with quite some market pressure, as investors expect the Bank of England to be forced into even more tightening to deal with the fiscal push. Markets are ready to “cut some slack” on governments for their immediate action, but they want to be convinced consolidation will be the priority when the crisis is over. In the EU, it’s the fiscal surveillance framework which is supposed to provide this visibility. We explore here a German proposal for its reform.

Still 50 for the Fed

Last week we reiterated our view that provided the next payroll and inflation prints “are not too red hot”, then the Fed would probably opt for a 50 basis points hike on 21 September rather than deliver another 75-bps move. There is still the hurdle of the Consumer Price Index (CPI) publication for August on 13 September to pass, **but the latest message from the labour market is likely to convince a majority of the Federal Open Market Committee (FOMC) that there is no pressing need for another unusual hike this month.** True, job creation continues at a very brisk pace, north of 3% annualized, but labour market pressure is abating. Last week we had singled out the re-acceleration in wages since the spring (on a three-month annualized basis). August finally brought a – tentative – deceleration on that front (see Exhibit 1).

The other positive piece of news from the Fed’s point of view is that **the participation rate has edged up in August** (see Exhibit 2). There again, it is still significantly below the pre-pandemic level, which suggests that supply constraints are still very much with us, but there’s progress. With more Americans returning to the job market, the unemployment rate rose as well, despite healthy job creation numbers, which is what’s needed to trigger a more visible deceleration in wages. The underemployment rate – which adds to unemployment proper those who seek more working hours – has stopped falling.

As we explored at length last week, this does not mean a “dovish pivot” is in the works at the current juncture. At a pace of c.5% annualized, wage growth remains very high and completely out of step with a quick return of core inflation towards 2% for any reasonable rate of productivity gains. **What we have in mind instead is the famous Churchillian line: “it is not the end of beginning of the end, but it may be the end of the beginning”.** The Fed has started to re-establish its inflation-busting credentials. There is no doubt that Fed Funds need to go into proper restrictive territory, but they can now do so without the sense of absolute urgency which prevailed in June and July.

In our opinion, **there is still some pain ahead for risky assets.** Given the “acquired speed” on consumer prices, the deceleration in wages – if confirmed – will result in more deterioration in real income and we’ve seen in the first half of the year already how consumers are less inclined than we hope to draw on their excess savings to protect their spending. A slower-than-feared pace of monetary tightening is still a tightening, and financial conditions will continue to get tougher. Recession is still by far the most likely scenario for the quarters ahead. Markets may want to “see through it”, but it’s not obvious that all the accompanying deterioration in profits has been fully priced in. Even our baseline of a slower pace of tightening is not straightforward. Payroll data is notoriously fickle and prone to revisions. The latest batch confirms our view that the looming recession could take care of the inflation spike relatively quickly, but we expect quite a few bumps on the road: the dataflow is rarely completely fully convergent and consistent.

Exhibit 1 – More jobs, more wages, but slower

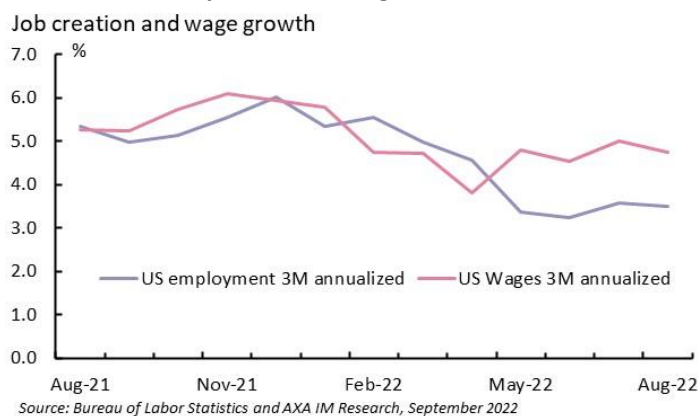
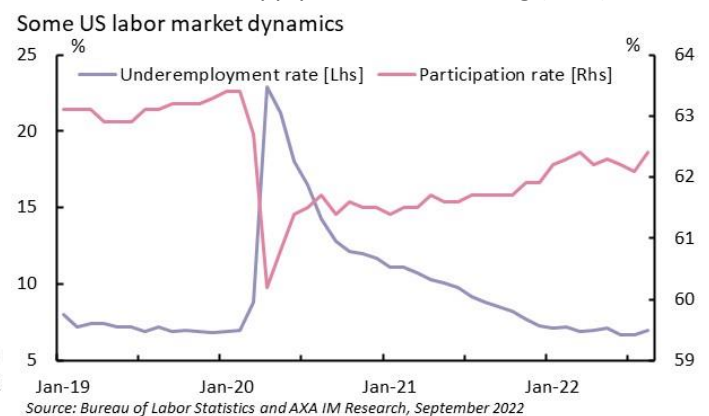


Exhibit 2 – Labour supply constraints easing (a bit)



75 now for the ECB

While the data was going in the Fed’s way, the opposite was happening for the ECB. The August print for consumer prices added to the long list of upside surprises, with as the most toxic element another acceleration in core inflation, suggesting the widening of inflationary pressure is not relenting. Even before the print, Reuters and Bloomberg were reporting that several members of the Governing Council were pushing for a 75-bps hike next week. Philip Lane’s call for a steady pace of tightening has been a lone voice so far, and the fact that we haven’t heard much from what remains of the dovish wing after these hawkish reports came out suggest opposition is weak. Accordingly, we have changed our call and expect a 75 bps move next week. In the same vein of our discussion of the ECB-speak in Jackson Hole last week, it seems **a consensus is relatively easy to form on “ripping the band aid” and bring the policy rate to neutral quickly**. We also believe that with the weakness in the euro exchange rate lingering, and hence additional pressure on imported inflation, it may be quite tempting for the Governing Council to deliver a hike which could be bigger than the Fed’s.

The deterioration in the dataflow is plain to see, but without any clear indication that underlying inflationary pressure is abating. The spread between orders and inventories of finished goods in the Euro area manufacturing sector is thinning quickly, which signals a steep contraction in output is very likely in the months ahead. Yet, expected selling prices, even if they have moderated somewhat from their peak in early spring, remain two standard deviations above their long-term average (see Exhibit 3). The same applies to services: expected demand fell in August below its long-term average and hiring intentions, although still above the “flotation line”, are heading south. Yet, expected prices have only tentatively climbed down from their historically high level. Given its mandate, the ECB can’t but focus more on the latter. Quite simply, if supply capacity is more constrained than usual – and there are very good reasons to think it’s still the case – then it also takes a bigger-than-usual decline in demand to bring price pressure back to an acceptable level. In clear, **a recession may not be seen in Frankfurt as the mere side-effect of the necessary monetary tightening, but as the only solution to deliver on the target**.

Exhibit 3 – Steep output correction ahead...

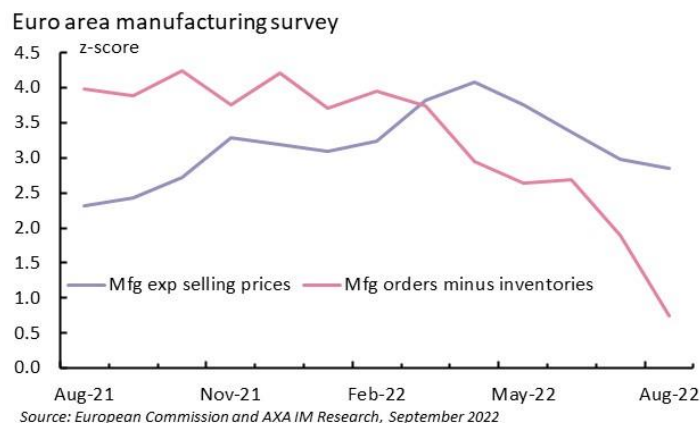
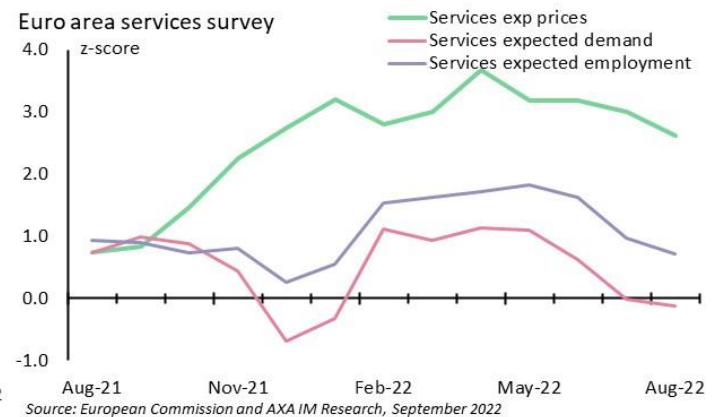


Exhibit 4 – ...but business expected prices still too high



Another narrative may be on offer though. Since monetary policy operates with lags – which may be quite long in the Euro area given the somewhat contorted policy transmission (dominance of fixed-rate mortgages in many countries, central role of banks in funding the business sector), focus may not be on the immediate effect of the tightening but rather on the signal it sends for inflation expectations. **It’s not so much that monetary needs to “engineer” a recession in the next few months – this would be more appropriate for an economy in clear overheating such as the US - but rather that it should not try to mitigate a recession which will be triggered by mostly exogenous forces – the explosion in gas prices – in order to keep long-term inflation expectations anchored**. The message to price setters – employers and unions in particular – is that beyond the current economic slowdown, the ECB would not hesitate to restrict demand in the medium term if an acceleration in wages turns the current shock into a persistent new regime.

Then there might be space for the continuation of some implicit cooperation between the fiscal and the monetary authorities. The ECB should not be put off by governments trying to mitigate the depth of the looming recession as it would dampen the “cyclical disinflation” but see this as an optimal “burden sharing”: governments keep demand afloat now, while the economy is facing the most pressing challenging, and the central bank keeps inflation expectations anchored for the medium run.

Policy mixology

There are three major avenues for governments to mitigate a sectoral price shock such as the current rise in energy costs. The first consists in offsetting it with a *general* indirect tax measure, such as a VAT cut. This approach has the merit of leaving relative prices unchanged (if the move is symmetric across all product classes), which may help spur a change in behaviour: the *relative* price of energy would rise by as much as without any tax mitigation, which may trigger some energy-saving decisions. A major drawback is that, for political reasons, it may be difficult to normalize the VAT rate once the energy shock is gone, so that over time the cost to the public purse is higher than it should be. Moreover, this policy is not necessarily socially equitable. Indeed, the share of energy in individual consumption is negatively correlated with income. While on *aggregate* it may be possible to calibrate the VAT cut to offset the average rise in retail energy prices, people at the bottom of the income distribution – who also have often the least capacity to save on energy, as they tend to live in energetically inefficient housing – are unlikely to be made whole.

These social concerns explain the appeal of targeted measures supporting real income *after* the price shock has hit. It can take the form of direct payments to those at the bottom of the income distribution to help them cope with the rise in their energy bills. We see two major drawbacks there if they are the only form fiscal action takes. First, the macroeconomic mitigation effect – supporting overall consumption – may be limited if only a small minority of households receive this support while the bulk of the population is left out of the programme. Second, this deals with the consequences of the price shock but has no or a small effect on measured inflation. This then raises the risk that second round effects appear via wage negotiations. Cooperation with the central becomes more difficult. Fiscal mitigation may be offset by more monetary tightening.

All this gets us to the third approach, and you may have to forgive your humble servant’s bout of French arrogance: the solution found in Paris, which focuses on **blocking as much as possible the transmission of higher wholesale energy prices to the consumer level, is probably optimal**. The French Finance Ministry has released an estimate of the cost of its “tariff shield”: EUR 24bn in 2022, i.e., roughly 1% of GDP. Independently, INSEE has released an estimate of its impact on consumer prices: without it, French inflation – significantly lower than the Euro area average – would have been 3 percentage points higher in Q2 2022 in year-on-year terms. A GDP elasticity of 0.3 to inflation would thus make it financially worthwhile.

Quite often governments will “pick and choose” across the various options. Germany’s announcement of a new package of EUR 65bn over the weekend (1.8% of GDP) combines them. Vulnerable households – students, pensioners, and people on welfare – will get direct payments (EUR200, 300 and 500 respectively), the subsidized train tickets scheme will be prolonged and a brake on “prices for electricity used for basic consumption” will be implemented. Crucially, **the German government took the occasion to support the EU’s initiative to introduce some limits to wholesale electricity prices**. This could further dampen the inflation shock.

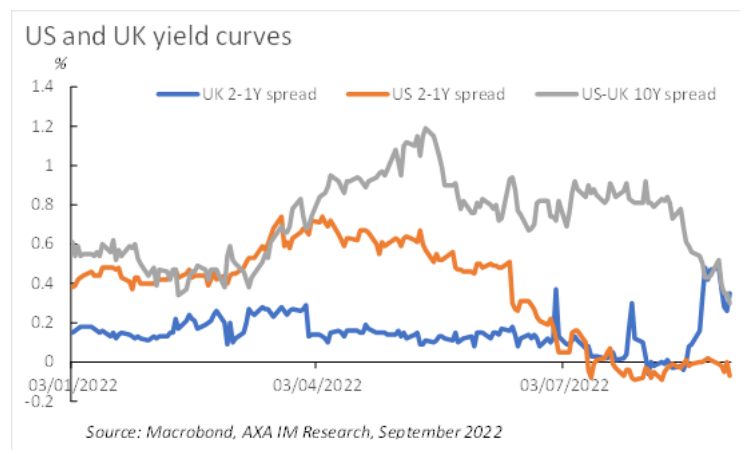
Few details are currently available on the EU’s projects there, but leaks have appeared in Euractiv ([see the “non paper” here](#)). One intriguing aspect is the idea to **cap prices for “infra-marginal” electricity suppliers**: those using renewables or nuclear power, whose production price is significantly below that of those who rely on gas – the latter currently driving the wholesale price of electricity in the EU since they are the “marginal providers”. These “infra-marginals” would in our understanding have to relinquish part of the spread between the wholesale price and their own production cost. The proceeds could be used “to lower the price of electricity at the consumer level”. It may take weeks to get this all through the European process, but this could help reduce inflation pressure by the end of the autumn and this winter.

Of course, **the duration and degree of the crisis are important parameters here**. The higher wholesale energy prices go, and the longer the pressure gets, the higher the risk the ensuing further drift in public finances starts triggering some questions in the market. The implicit calculation by European governments at this juncture is that the winter 2022-2023 is critical and that an easing of price pressure on energy can be expected afterwards. Perennial diversification measures away from Russian gas may be available by next year – e.g., the construction of a Liquefied Natural Gas (LNG) terminal in Germany - while some of the domestic difficulties – e.g., closure for maintenance of half of France’s nuclear reactor – would be resolved. This would reduce Russia’s capacity to put pressure on the EU, especially if the “price cap” on Russian oil pushed by the G7 can be implemented by then. Moscow would have to make do with significantly lower external funding. There is of course no certainty that we could count on an easier geopolitical configuration by next year – this is to a large extent dependent on current military developments in South Ukraine - but it seems that for now the market is ready to “cut some slack” to governments on their fiscal trajectory, with one major exception: the UK.

A (very British) laboratory experiment

The name of the new leader of the Tory party – and hence the new Prime Minister - is announced on Monday 5. All observers expect Liz Truss to be the winner of the contest. It’s no exaggeration to say that her economic platform is met with quite some suspicion by the market. In the current state of her proposals, there would be no direct effort to curb the price of energy. The shock would be mitigated by “ex post” general measures – such as a cut in the VAT rate or reversing the recent hike in social security contributions, but more fundamentally, the entire philosophy of the new administration would be based on permanent tax cuts while expenditure – in particular on defence – would rise. It appears as **an attempt to re-enact the early 1980s Thatcher/Reagan compact**, counting on the boost to economic growth that the fiscal stimulus would supposedly trigger to ultimately “balance the books”. **Unsurprisingly, this is fuelling expectations of a protracted monetary tightening to offset the additional impact it would have on already massive inflationary pressure.**

Exhibit 5 – Market is worried about the UK policy course









We have been increasingly focusing on the shape of the yield curve between 1 and 2 years. In the US case, this spread has narrowed considerably, even inverting in some instances over the last two months, suggesting that the market is increasingly convinced the Fed’s tightening may have to be “brutal”, but should be short-lived. Conversely, in the UK, 2-year yields have increased significantly relative to 1-year yields over the last few weeks, as Liz Truss’ chances to become the next UK Prime Minister were rising. **The market is thus expecting the Bank of England to be forced into even more tightening as fiscal policy loosens.** At the same time, the so far large positive 10-year spread between the US and the UK has narrowed a lot (see Exhibit 5).

Now, the leadership race is very particular: the candidates need only two members of the Tory party who tend to be more supportive of tax cuts than the average British voter. Once in power, Liz Truss may well take some distance from her current economic manifesto. In addition, while she is likely to win the party members' vote, she came second in the votes of the Members of Parliament, who favoured the less unorthodox Rishi Sunak. **The constraints of her parliamentary majority may also force her to dampen the agenda.** Still, the current market developments in the UK may produce some useful lessons for all governments. Investors may be patient with the timing of the fiscal consolidation, but they still need to be convinced that when the economic situation gets less dramatic than today, deficits will be reduced.

A (very) German opening

In the EU, the fiscal surveillance framework is normally there to make sure that “at some point” fiscal prudence will prevail again. Yet, its current form is widely seen as unfit for purpose and reform proposals abound. France and Italy had come up with a quite detailed joint offer last year. Germany had been silent, but in late August, in a quite discreet fashion, a proposal coming from the Green-controlled Economy Ministry came out ([follow the link here](#)). We find it quite close to a French Treasury paper by Agnes Benassy-Quéré last February. The most potentially toxic component of the current system, the obligation for heavily indebted countries to reduce their excess debt ratio by 1/20th per annum would be kicked into the long grass. Rather than focusing on the deficits themselves, surveillance would pay more attention to expenditure benchmarks, and more space would be allowed to protect public investment. Yet, at the same time the short paper devotes quite some time to a “clarification of the rules”, in particular on how the surveillance package could be suspended to respond to crises, and in this regard the German Economy Ministry proposes to make the European Fiscal Board independent from the European Commission. So, we could summarize the German offer as “we accept looser rules, but we demand more certainty and clarity on how they would be implemented”. Fair enough.

Yet, **what we find the most interesting in the German paper is what's not in it.** The Franco-Italian paper last year was predicated on a deepening of the debt mutualization process which the Next Generation Pact had for the first time brought about in the EU. We think it is the crucial issue. Cynically, the market may not care very much about the changes in the surveillance framework operate, given how inefficient it has been so far. The market focus is on the solidity of the monetary union “come what may” and independently of what the ECB does – and debt mutualization certainly resonate with this concern. The German paper does not address this at all. Optimists will see it as a first step, with Berlin, tactically, choosing not to open this discussion for now but well aware that further mutualization will have to be the landing zone. Pessimists will consider that this reflects a lack of consensus on the issue in Germany itself: the Free Democrats-controlled Finance Ministry may have different views on European fiscal surveillance. True, for 2023, the existence of the paper probably suggests that Germany will not be very vocal in demanding swift progress on fiscal consolidation from its partners, but we also see it as only a very tentatively positive step towards properly addressing the structural flaws of the monetary union.

Country/Region	What we focused on last week	What we will focus on in next weeks
	<ul style="list-style-type: none"> • Payrolls (Aug) rose by 315k, unemp at 3.7% and earnings + 0.3%mom. Adds to 50bps Sept Fed call • JOLTS (Jul) unexpectedly rises to 11.2m • ISM index (Aug) stays at 52.8, but prices paid falls to just 52.5 from 60.0 in July • Fed messaging remains hawkish. Mester calls for 4% 	<ul style="list-style-type: none"> • ISM non-mfg index (Aug) – watch for similar drop in price paid and gains in employment index • US trade balance (Jul), watch for signs of easing of import outperformance from H1 2022 • Jobless claims – have fallen in last couple of weeks, watch to see if any more than seasonals
	<ul style="list-style-type: none"> • Headline EMU HICP came at 9.1%yoy, slightly above our 8.9%; core at 4.3% in line with our projection. Peak still ahead of us (Sep) • July Fr consumer spending declined by 0.8%mom • Aug EC surveys pointed to another deterioration of economic and sentiment environment across eurozone 	<ul style="list-style-type: none"> • ECB: we expect GC to hike DFR by +75bps as well as announce measure(s) to tackle excess reserves remuneration • German July industrial production print • How much gas to flow after maintenance period is over
	<ul style="list-style-type: none"> • Cable continues to dive lower, currently trading below \$1.16 adding to inflation risk • Market now expects rates to peak at 4.25% • Nationwide house prices rose 0.8% (Aug) • ONS ruled £400 energy rebate will be classed as an income adjustment not impacting CPI/RPI 	<ul style="list-style-type: none"> • New PM to be announced 5 Sept. Truss remains the clear frontrunner and we expect will be pushed to provide more details on cost-of-living support • RICS House Price Balance (Aug) • MPC's Mann to speak (Mon) and MPC attending Treasury Select Committee
	<ul style="list-style-type: none"> • Dollar strength sees the Yen reach a fresh 24-year low against the dollar trading around 140¥ • IP (Jul,p) beat fears of a decline rising by 1% • Modest rise in retail sales (Jul) and consumer sentiment as the number of Covid cases continues to fall 	<ul style="list-style-type: none"> • Final Q2 GDP estimates – MoF corporate survey suggests Q2 GDP may be revised up from 0.5% • BoP Current Account and Trade balance (Jul) • Final PMIs (Aug) • Households spending yoy (Jul)
	<ul style="list-style-type: none"> • Manufacturing and services PMIs point to sluggish activity amidst another COVID wave • The spread of the outbreak to major cities is worrying, with Shenzhen and Chengdu tightening COVID curbs significantly • National mobility softened, especially inter-city trips 	<ul style="list-style-type: none"> • Credit growth likely rebounded sequentially in August due to policy easing and official guidance • Export growth likely weakened in August, while reduced domestic demand hampered imports
	<ul style="list-style-type: none"> • CB: Hungary hiked +100bps to 11.75% • EM PMIs weaken • Q2 GDP (%yoy) accelerated in India (13.5%), Turkey (7.6%) & Brazil (3.2%) • Annual inflation (July) moderated in Korea (5.7%) & Indonesia (4.7%). It picked up in Malaysia (4.4%) 	<ul style="list-style-type: none"> • CB: Chile is expected to hike +100bps to 10.75%, Malaysia +50bps to 2.50% & Poland +50bps to 6.75% • Q2 GDP data for Romania, Russia & South Africa • Aug CPI (yoy) figures in Hungary, Thailand, Taiwan, Turkey, Philippines & Russia
Upcoming events	<p>US: Tue: Services PMI (Aug), ISM non-manf. Index (Aug); Wed: Trade balance (Jul), Beige Book release; Thu: Weekly jobless claims (3 Sep), Powell speaks at Cato Institute; Fri: Wholesale inventories (Jul)</p> <p>Euro Area: Mon: EU19, Fr, It, Ge, Sp Services PMI (Aug), EU19 Composite PMI & Retail sales (Aug); Tue: Ge New manf. orders (Jul); Wed: EU19 GDP (Q2), Ge Ind. Prod. (Jul); Thu: EU19 ECB announcement; Fri: EU27 Energy Ministers meet, Fr Ind Prod (Jul)</p> <p>UK: Mon: SMMT new car reg. (Aug), Services & Composite PMI (Aug), MPC member Mann speaks, Prime Minister announcement; Tue: Construction PMI (Aug); Wed: Halifax indx (Aug) Thu: RICS survey (Aug);</p> <p>Japan: Wed: Leading indx (Jul); Thu: GDP (Q2), Trade & current account balance (Jul), Economy Watchers Survey</p> <p>China: Mon: Caixin Services PMI (Aug); Wed: Exports (Aug), Imports (Aug), Trade balance (Aug), Foreign exchange reserves (Aug); Fri: PPI and CPI (Aug)</p>	

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