AXA Investment Managers

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Investment Institute Macroeconomics

Risk Asymmetry

- Markets don’t budge on their aggressive pricing of the policy trajectory for the Fed and the ECB despite the absence of “lights flashing red” which would call for a quick reversal of the policy stance.
- While a “soft landing “is the baseline for the US and the Euro area when controlling for the difference in potential growth rates, the most plausible *alternative* scenario around this baseline is not the same in the two regions.

While so far in the new year the equity market has not kept up with its pre-Christmas exuberant mood, forward contracts suggest investors still believe that the ECB and the Fed will deliver quick and massive accommodation in 2024. We maintain our more cautious approach. The minutes of the December FOMC meeting strengthen our view that Jay Powell’s very dovish statements on 13 December should be taken with more than a pinch of salt, while the labour market softening continues to proceed by minuscule increments in the US. In the Euro area, headline inflation has rebounded in December, as expected. At the current juncture, no light is flashing red and forcing the Fed and the ECB to engage in cuts as early as March.

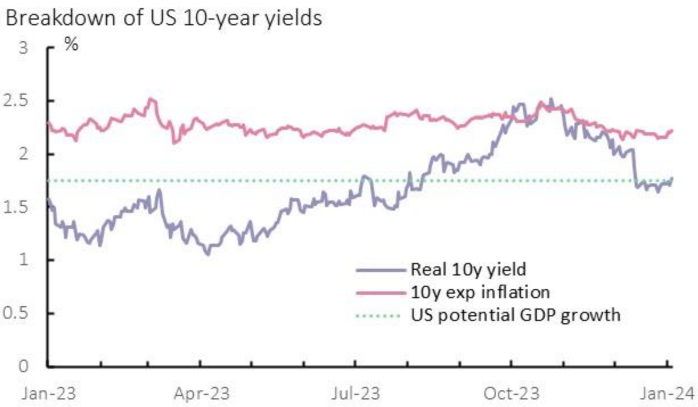
The fixed income market is resolutely positioned for a “soft landing” on both sides of the Atlantic and, when controlling for the difference in potential GDP growth between the US and the Euro area, it is also our baseline. However, when it comes to risks around such baseline, we feel there is too little thought given by the market on the possibility of some significant transatlantic divergence this year. The most obvious alternative scenarios revolve around the two classical policy mistakes: central banks may already have gone too far and engineered a “proper recession” which would ultimately take inflation below target. Conversely, they may have stopped their tightening too early making it impossible to bring inflation fully back to 2%. In our view, the Euro area is more at risk of falling in the first scenario, and the US in the second. Beyond the fact that the economy has recently been much more resilient in the US, a fundamental difference between the US and the euro zone is that in the latter the maximum effect of the tightening of monetary conditions, given the usual transmission lags, will coincide with the start of budgetary restriction. The asymmetric materialisation of these alternative scenarios would be quite damaging to the euro exchange rate and make the policymakers’ choices even more delicate.

Markets don't budge

We left for our Christmas break while the market was still extending its rally, betting aggressively on swift rate cuts on both sides of the Atlantic. In line with most of our peers we were more cautious. While accommodation is indeed what is next for the main central banks – with the notable exception of the Bank of Japan - we have been arguing that the fresh memory of the initial failing to spot how persistent the current inflation phase has been would make the Federal Reserve (Fed) and the European Central Bank (ECB) very cautious on the timing and magnitude of the cuts. Of course, Jay Powell's stance at his latest press conference fuelled the market's animal spirits, but we were inclined to read it as a communication mistake, suspecting the Federal Open Market Committee (FOMC) chairman did not accurately convey the message from the "median member" of his committee. The meeting's minutes released last week support this view. Yet, while the equity market has clearly taken a breather in this new year, in contrast with its pre-Christmas exuberance, expectations for monetary policy have barely changed since mid-December, which we find at odds with the data flow and the additional messages from the central banks.

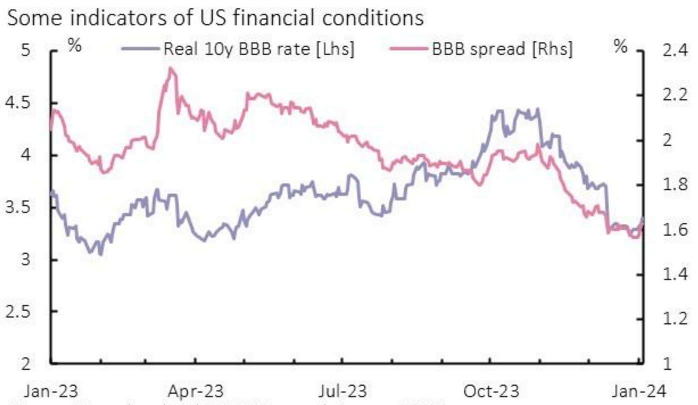
The challenge for the Fed at this juncture is not to discuss whether accommodation is on the table for 2024 – the market has been past this for a long while – but whether it could come quickly and in size. Jay Powell's December Q&A could have suggested that this was already the FOMC's central scenario. **The minutes suggest however that the members are still very prudent in their assessment of the United States (US) situation**. While there seems to be a broad consensus around the notion that the labour market will continue softening (*"participants generally judged that, in 2024 (…) the rebalancing of the labour market would continue*"), the "data dependent" mood still prevailed on both the diagnostics (where the economy is going) and on the policy prescription. The notion that "*participants generally perceived a high degree of uncertainty surrounding the economic outlook*" echoes the qualifier on the members' baseline for rate cuts in 2024 ("*Participants also noted, however, that their* [interest rate] *outlooks were associated with an unusually elevated degree of uncertainty and that it was possible that the economy could evolve in a manner that would make further increases in the target range appropriate*"). This is not necessarily consistent – to say the least - with the state of mind of a central bank which is readying to cut rates in three months' time.

Exhibit 1 – No longer clearly restrictive



Source: Macrobond and AXA IM Research, January 2024

Exhibit 2 – US Corporate spreads down



Source: Macrobond and AXA IM Research, January 2024

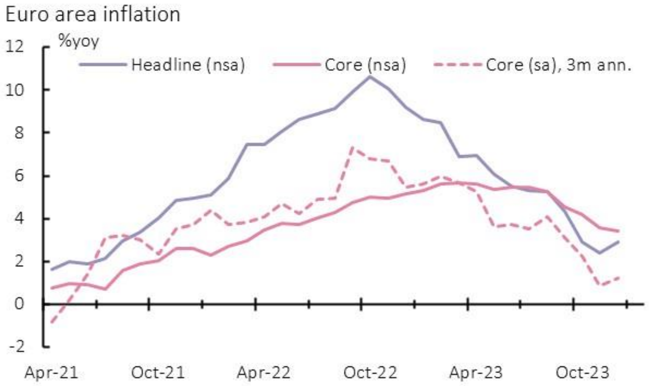
We also found an explicit mention of a point we have been focusing on since the market rally began: *"participants observed that, after a sharp tightening since the summer, financial conditions had eased over the intermeeting period. Many participants remarked that an easing in financial conditions beyond what is appropriate could make it more difficult for the Committee to reach its inflation goal".* Habitual readers of Macrocast will be familiar with Exhibits 1 and 2 which we have updated again. In real terms, the yield on US 10-year treasury bonds has been back in line with the canonical estimate of potential GDP growth since the day of the Fed's latest press conference, which puts a question mark on the level of restriction currently in the system (the distance between real rates and potential growth can be a simple but useful proxy for restrictiveness). The premium corporations have to pay above the Treasury to fund themselves has also continued to fall these last few weeks. **It is getting more difficult to argue that the Fed's stance is fully transmitted to the real economy by the financial system.**

The release of the payroll data for December is unlikely to fully reassure the Federal Reserve. In itself, that the employment growth on the month was higher than expected is not necessarily crucial, as it comes after a significant downward revision for the previous two months. What we think is key is the fact that, **when taking a bit of perspective – e.g., our preferred 3-month annualized change – the undeniable softening in employment continues to take place at an extraordinarily slow pace** (+1.0% for the private sector against 1.1% in November). The message on wages was also muddled. While a drop in the average working time – which might reflect some deterioration in cyclical conditions – took weekly gains down to 3.1% on a 3-month annualized basis from 3.6% in November, **hourly pay accelerated** to 4.3%, up from 3.6%.

On the other side of the Atlantic the ECB has been quite discreet since Christine Lagarde's press conference, but we would still highlight Isabel Schnabel's interview in the Sueddeutsche Zeitung (SZ) on 22 December. Unusually, we think the questions were more interesting than the answers. Indeed, that the journalists from the SZ – which is not the most hawkish newspaper in Germany – chose to ask why the ECB should not force the level of prices down to completely offset the inflation shock of the last two years for consumers, instead of "merely" targeting a return to 2%, is a useful reminder of the pressure the ECB can get from some quarters. Schnabel's terse response that "*people would not be better off if we plunged the economy in years of recession"* is often lost to public opinion in Germany. Central bankers are not there to please the crowds, but they are not there either to please market participants betting on swift rate cuts.

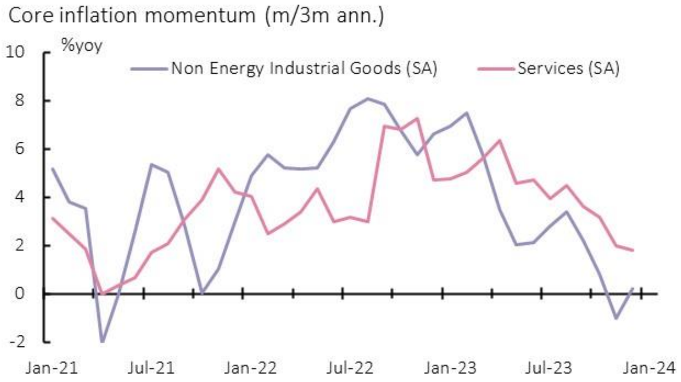
The expectation of an imminent rebound in year-on-year inflation was one of the points highlighted by Christine Lagarde last month in her vigorous pushback against imminent rate cuts. This materialised in the Consumer Price Index (CPI) release for December. There was nothing dramatic there, and we absolutely don't think this heralds a concerning, durable re-acceleration in consumer prices. What is very reassuring is that – as expected – most of the rebound can be traced back to the mechanical payback from the German government having massively subsidized energy bills in December 2022. Core inflation continues to fall in year-on-year terms (3.4% from 3.6% in November). True, there was a marginal rebound in core in the 3-month annualized measure (see Exhibit 3), but the pace is now very slow (1.2%, well below the ECB's target). This reflects a small rebound in industrial prices marginally in positive territory, while the momentum of services prices continues to soften (see Exhibit 4). This matters, since the ECB hawks have been focusing on the latter component of inflation – the most sensitive to domestic conditions. Yet, **psychologically, the fact that yoy headline CPI rose again (to 2.9% from 2.4% in November) after seven straight months of decline cannot be completely discarded as a non-event.**

Exhibit 3 – Disinflation (momentarily) stalls



Source: AXA IM Macro Research, as of January 2024

Exhibit 4 – It's not about the services



Source: Eurostat and AXA IM Research, as of January 2024

Our point is that, although there is no major reason to doubt headline inflation will in a few months' time resume its normalisation, **there is no "light flashing red" for the ECB at the moment which would force the Governing Council into a quick turnaround which would materialise in a rate cut in March,** to which the market continues to ascribe a probability of 50%. The real economy is of course very weak, but if anything, the latest Purchasing Managers' Index (PMIs) – although still in contraction territory and indicative of a shallow recession – might have found their trough.

The same applies to the Fed: there does not seem to be any development at this stage in the US which would warrant quick accommodative action by the Fed. Consequently, **we continue to be baffled by how aggressive the market continues to be in its expectations for both the ECB and the Fed** (see Exhibits 5 and 6). There has been some measure of repricing for the Fed's expected trajectory for 2025, but relative to the pricing on the day of the last Fed press conference, almost nothing has changed for 2024. Of course, three months can be a long time, but the anchoring around March for the first rate cut on both sides of the Atlantic is "brave" in our view.

Exhibit 5 – No re-think during the Christmas break..

Source: Bloomberg and AXA IM Research, January 2024

Exhibit 6 – ...neither in the US, nor in the Euro area

Source: Bloomberg and AXA IM Research, January 2024

Central banks' postures and constituency risks misaligned

The market is thus still positioned for a soft landing triggering such swift disinflation that the central banks will provide equally swift accommodation this year. The first leg of this proposition is widely shared in the economic profession. The consensus for 2024 is remarkably convergent across the Atlantic. True, forecasters generally expect stronger GDP growth in the United States (0.9%) than in the euro zone (0.6%), but if we correct for the gap between potential GDP growth between the two regions (around half a point), in both cases it would be a relatively painless landing, without going through a phase of deep recession, allowing for an incomplete but promising return towards the 2% inflation objective. This is also our central scenario, even if we are a bit above consensus for the US (1.1%) and a bit below for the Euro area (0.3%).

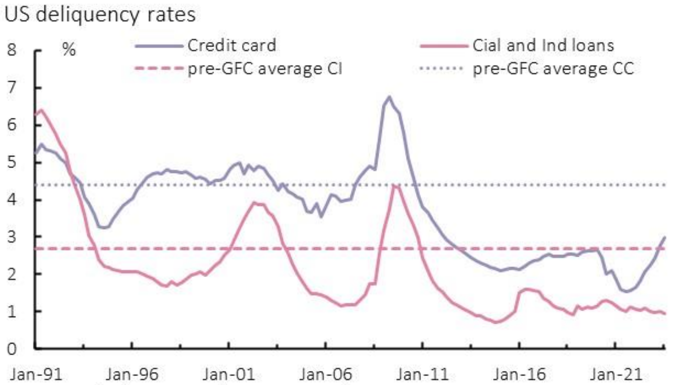
Where economists and market participants differ is that for the latter these convergent macroeconomic scenarios would be consistent with rapid and massive rate cuts in 2024. For our part, we expect only three 25bps cuts by the Fed and the ECB by the end of 2024. We however share the market's view, in our central scenario, that the two major Western central banks will move synchronously. But for us the most plausible *alternative* scenario would not necessarily be the same on both sides of the Atlantic, and beyond the disagreement on the quantum and timing of rate cuts, **we feel there is too little thought given by the market on the possibility of some significant transatlantic divergence in the monetary policy trajectory this year.**

The risks surrounding the "benign" central trajectory are quite easy to lay out and revolve around the usual policy mistakes. On the one hand, it may be that central banks have in fact already gone too far, that growth stalls and that, due to a significant downturn of the labour market, inflation falls back below the target of the central bank, returning to the quasi-deflation regime which prevailed before Covid (alternative scenario A). On the other hand, central banks may have stopped the tightening of financial conditions too early, letting demand prance above its potential pace, causing inflation to hold up above their objective (alternative scenario B). The euro zone seems to us a more plausible candidate for scenario A, while the United States seems to us to be more at risk of falling into scenario B.

The resilience of the American economy remains impressive. True, employment growth has fallen below its trend rate since the spring of 2023, but the United States is still far from destroying jobs. Inflation-adjusted labour income continues to grow robustly, helping to protect consumption from the erosion of excess savings accumulated during the pandemic. The maximum impact of the Fed's rate hikes should show up in 2024, and this is the essential reason why the consensus of forecasters is forming around slower growth, but as we noted in the first section of this note the transmission of the monetary policy may no longer be as effective. **It still takes a "leap of faith" in the US case to be fully confident disinflation will continue without major hurdles.**

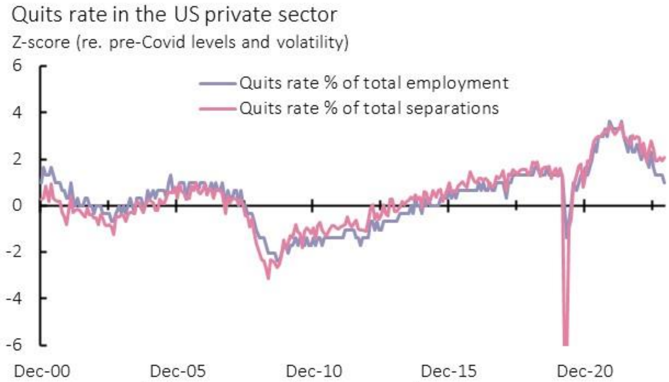
A simple way to gauge the impact of the ongoing monetary tightening is to look at loan delinquency. Credit card delinquency has hit last summer its highest level since the Great Financial Crisis (GFC), and the rebound since the Fed started rising rates has been steep...but when compared with the ratio that was habitual *before* the GFC, there is still little reason to be alarmed (see Exhibit 7). Note as well that, since banks' capital position has been massively shored up after the GFC, the impact of rising delinquency today on the supply of credit should be smaller. Meanwhile, there has been no sign so far of any rebound in commercial and industrial loans delinquency, which remains also significantly below the pre-GFC levels. Judging by this metric, "corporate America" seems to be dealing quite well with the monetary policy tightening. The same issue can be raised with the indicators of labour market tension. If one focuses on the *change* in metrics such as the quits rate, the labour market is indeed normalising, but if one compares its current level with the pre-Covid trend, as we did in Exhibit 8, there is still quite some pressure in the cooker.

Exhibit 7 – Focus on the level or on the change?



Source: Federal Reserve and AXA IM Research, January 2024

Exhibit 8 – Glass half-empty or half-full?



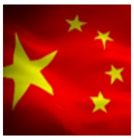
Source: Bureau of Labor Statistics and AXA IM Research, January 2024

In the Euro area the situation remains gloomier. Since the end of 2022 the region has been oscillating between low-intensity recession and stagnation. The job market is starting to be affected and the unemployment rate is rising in France and Germany. In the latter country, the correction of gas and electricity prices has still not caused a restart of the energy-intensive sectors, which suggests that lasting losses of market share have appeared.

A fundamental difference between the United States and the euro zone is that in the latter, the maximum effect of the tightening of monetary conditions, given the usual transmission lags, will coincide with the start of budgetary restriction. Even Germany, which could have largely escaped the general movement towards moderate austerity, must fall in line because of the decisions of the Supreme Court in Karlsruhe. In the United States, the pre-election context obviously does not lend itself to the slightest effort to reduce the deficit.

It seems to us that respective posture of the ECB and the Fed does not seem necessarily aligned to the most plausible risk in their region. Jay Powell was explicitly worried about the risk of falling into scenario A in its latest press conference, with some insistence on the FOMC's awareness of the risks of having gone too far, while the ECB's rhetoric rather reflects a concern to avoid scenario B. This could bode well for a lot of volatility at the start of the year. If market participants begin to anticipate the materialization of risk A in the euro zone – which would then justify their expectation of swift rate cuts, but also weigh on equity prices as profits would be dampened - and risk B in the United States, which would force a significant upward repricing of the Fed's trajectory, then strong downward pressure on the euro exchange rate would ensue.

Such asymmetric materialisation of risks could also put the Euro area policymakers in a complex position. Indeed, if the real economy and the Euro exchange rate plunge at the same time, the ECB could choose to proceed cautiously on rate cuts for fear of fuelling imported inflation, while public finances would not benefit from much relief on their funding side, given the usual contagion effects from the United States to the euro zone bond market. This in turn could prolong the pain in the real economy.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Employment report (Dec) payrolls rose 216k, unemp remained at 3.7% and earnings rose by 0.4%mom. Lbr market appears stable, but not weakening • FOMC minutes mixed with balanced concerns, rates "at or near peak" – not as dovish as Dec press conf • JOLTS (Nov) 8.79m, Oct rev'd higher to 8.9m (8.7m) • ISM mfg (Dec) 47.4 up from 46.7, stable all 2023	• CPI inflation (Dec) headline expected higher to 3.3% on weak base effect, core 3.8%. Rate enthusiasm associated with painless disinflation – this a test • PPI inflation (Dec), weak base expt'd to lift annual rate, mom expected subdued 0.2% • Jobless claims – at around 200k no indication of lbr market weakening
	• EMU headline inflation (Dec) rebounded to 2.9%yoy (+0.4p), mostly due to strong base effects in Ge (3.8%; +1.5p). Core inflation eased to 3.4% (-0.2p) • Both final Mfg and Svcs PMIs have been upgraded but remain in contraction (resp. at 44.4 and 48.8) • German retail sales (Nov) abruptly fell by 2.5%mom	• Ge and Fr data for industrial orders, production and trade (Nov) • Eurozone retail sales (Nov) • Eurozone unemployment rate (Nov)
	• Services PMI (Dec, f) rev'd higher to 53.4 (52.7 (p), strongest since June and suggests stronger growth • Mortgage approvals (Nov) and consumer lending both picked up, mortgage lending still stagnant • Construction PMI (Dec) 46.8 from 45.5 • Retailers warn heavy rain could affect sales	• GDP (Nov) and sector output. Oct's -0.3% leaves Q4 fall plausible and prospect of technical recession • RECS jobs report (Jan), in absence of fuller official data a key guide to jobs market • BRC sales report (Dec) first guide to Christmas spending season
	• A powerful earthquake struck central Japan on Jan 1st. A lot of buildings and infra have been destroyed • Retail sales (Nov) increased by 5.3%yoy (+1.1p) • Final PMIs were revised up for Mfg (47.9; +0.2p) and down for Svcs (51.5; -0.5p). Signal unchanged	• Tokyo CPI (Dec) should continue to decelerate (consensus at 2.5%yoy; -0.1p)
	• NBS Mfg PMI (Dec): 49.0; Non-Mfg PMI (Dec): 50.4 (Nov: 49.4 and 50.2 respectively) • Caixin PMI Mfg (Dec): 50.8 (Nov: 50.7) • Caixin Services PMI (Dec): 52.9 (Nov: 51.5), the highest reading in five months	• Sun (7 Jan): FX reserves (Dec) • Fri (12 Jan): PPI and CPI (Dec) • Fri (12 Jan): Exports and imports (Dec)
	• Dec inflation (%yoy) fell in Thailand (-0.8%), Philippines (3.9%), Poland (6.1%) & Taiwan (2.7%). It rose in Turkey (64.8%)	• CB: Korea (3.5%), Poland (5.75%) & Romania (7.0%) are expected to stay on hold. Peru to cut 25bps to 6.5% • Industrial production (Nov): Chile, Hungary, India, Malaysia & Turkey • Inflation (Dec): Brazil, Chile, Colombia, Czechia, India & Romania

Upcoming events	US:	Tue: NFIB small business optimism (Dec), Trade balance (Nov); Thu: CPI (Dec), Weekly jobless claims (6th Jan); Fri: PPI (Dec)
	Euro Area:	Mon: EA Business confidence (Dec), EA Retail sales (Nov), Ge New manf orders (Nov); Tue: EA & It Unemp (Nov), Ge Industrial production (Nov); Wed: Fr Industrial production (Nov); Thu: ECB publishes Economic Bulletin, Ge Current account (Nov), It & Sp Industrial production (Nov); Fri: Fr Consumer spending (Nov), Fr & Sp HICP (Dec)
	UK:	Tue: BRC Retail Sales Monitor (Dec); Fri: Monthly GDP (Nov), Index of services (Nov), Industrial production (Nov), Manufacturing output (Nov), Construction output (Nov), Trade balance (Nov), Trade in goods (Nov)
	Japan:	Thu: Current account balance (Nov), Trade balance (Nov); Fri: Economy Watchers Survey (Dec)
	China:	Fri: CPI (Dec), Exports (Dec), Imports (Dec), Trade balance (Dec)

Our Research is available online: www.axa-im.com/investment-institute

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AXA IM is a leading investor in green, social and sustainable markets, managing €489 billion of ESG-integrated, sustainable and impact assets as at the end of December 2022. We are committed to reaching net zero greenhouse gas emissions by 2050 across all our assets, and integrating ESG principles into our business, from stock selection to our corporate actions and culture. Our goal is to provide clients with a true value responsible investment solution, while driving meaningful change for society and the environment.

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