AXA Investment Managers

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Investment Institute Macroeconomics

Probing the "Last Mile"

- Geopolitical risks re-emerge to potentially derail the dampening of global inflationary forces
- The US December inflation print was not all good news
- We count on margin behaviour to support further disinflation in the Euro area despite strong unit labour costs

The "macroeconomic fate" of 2024 will depend on whether the disinflation process which started last year can continue swiftly, allowing central banks to remove some of their restriction. Disinflation in 2023 was primarily driven by exogenous factors – the normalisation of supply lines and energy prices - and unfortunately, we are seeing the return of "polycrisis" risks which could derail the general slowdown in the price of tradables in the global economy. The recent developments in the Red Sea suggest that the inflationary impact of the Middle Eastern crisis could take a different form than the "usual' oil price shock, as supply lines are starting to be disrupted again. The election in Taiwan of a DPP President for the third time in a row forces us to confront again the possibility of another escalation of the Sino-American rivalry, with the potential to trigger another trade war.

Yet, we still see reasons to remain reasonably confident. The Red Sea disruption cannot be compared with the general seizure of supply lines when economies reopened after Covid. The fact that the Taiwanese President-elect did not secure a parliamentary majority, in a configuration in which China is not in the best position to take the risk to lose support from foreign demand, could help avoid tension between Beijing and Washington escalating too far.

Still, even if the exogenous inflationary forces are kept under control, the latest consumer prices print in the US suggests that the "last mile" of disinflation remains bumpy. On a 3-month annualised basis core inflation has been hitting a "resistance line" above 3% since September. The materialisation of the Bernanke-Blanchard sequence, where labour cost-driven inflation takes the lead while supply-driven shocks fade, cannot be ruled out yet. We are less worried about the Euro area, despite the continued decline in productivity there which pushes unit labour costs up, as we expect the deterioration in economic confidence to take margins down.

The return of the "polycrisis" risk

Another inflation shock remains the main potential channel through which the ongoing Middle Eastern crisis could affect the global economy, but it may materialise in an unexpected form. Indeed, observers - including your humble servant - are all bracing for a steep rise in oil prices if public opinions in Arab producer countries end up forcing their governments to use the energy weapon to incentivise the West and the United States (US) in particular to heap pressure on Israel, and/or if Iran threatens or effectively decides to blockade the Strait of Hormuz. This may still happen. Yet, the latest move a week ago by Saudi to cut the price of its exports relative to benchmark (apparently to support its market share within the Organization of the Petroleum Exporting Countries (OPEC)) is another sign that for now there seems to be a strong disconnect between the deteriorating situation in the Middle East and the oil market. In addition, we have always seen such a drastic move by Iran as an existentially dangerous "one shot gun" for this country. Indeed, by blockading the Strait, Iran would probably be unable to avoid a direct confrontation with the US while cutting itself from its main economic resource at a time of heightened social and political tension on the domestic front. However, **the attacks by the Houthi on ships cruising through the Red Sea have triggered concern over supply lines and freight costs. After all, 12% of world trade transits through this route**.

To get a sense of perspective on this particular risk **we look at the recent behaviour of the Baltic Dry Index (see Exhibit 1). The rebound has been visible, briefly exceeding 3,000 but reaching much lower levels than at the time of the post Covid reopening when it flirted with 6,000**, and possibly because market participants expect the ongoing military operation by the US and the United Kingdom (UK) against the Houthis to reopen the route, there has been a significant correction over the last few days, even though according to the Pentagon the group retains 70% to 80% of its (mostly mobile) capacity to strike. In addition, shipping tends to be more correlated to the manufacturing cycle and at the global level this segment of the economy is currently the weaker spot. This should help mitigate further spikes in shipping costs. In December, the indicator we favour to assess disruptions in supply lines - delivery times - stood 2 standard deviations *below* their pre-Covid long-term average. This provides quite some leeway to absorb future disruptions.

Exhibit 1 – To be monitored, but well off-peak

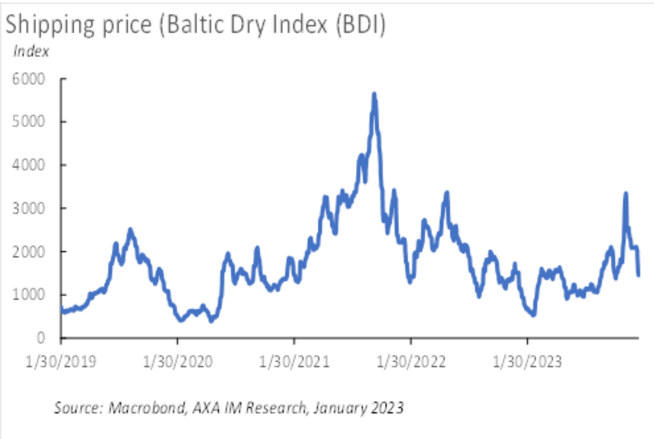
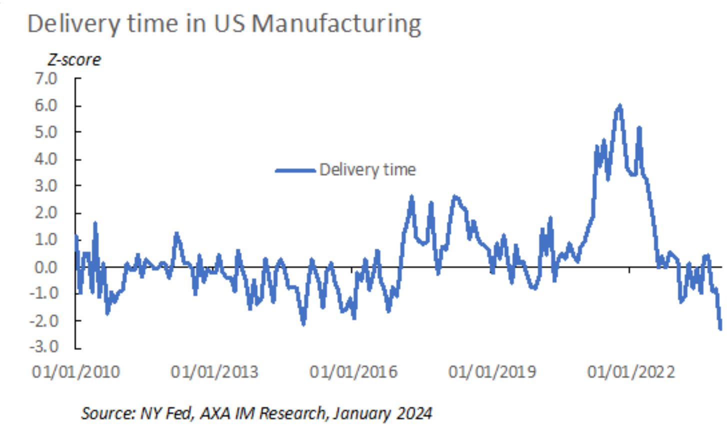


Exhibit 2 – Some leeway to absorb supply disruption



There is however another potential shock to global prices which we need to explore - once again: the risk that **another surge in the China-US rivalry, fuelled by the aftermath of the elections in Taiwan** last weekend, would trigger another episode of "trade war" between the two countries. Even though President-elect Lai (he will take office in May) has not explicitly advocated formal independence for Taiwan since 2017, he was seen in Beijing ahead of the election as even more reluctant to engage in concessions towards the People's Republic than his 2-term predecessor Tsai, hailing from the same party (he was branded as an "instigator of war" by an official from China's Taiwan Affairs Office at the end of December). In his victory speech he made plain his readiness to maintain dialogue with the continent, but his points on resisting *"intimidation"* were unambiguous. Although Lai received only 40% of the votes (Taiwan operates a "first past the post" electoral system), **the fact that his party, the Democratic Progressive Party (DPP) has been able to maintain**

its grip on the presidency for three mandates in a row may be analysed in Beijing as a sign that only stronger pressure will shift a reluctant Taiwanese opinion towards accepting unification which the People's Republic of China (PRC) called "unstoppable" again a few days ago. Fear among observers is that China would engage in economic action against Taiwan, eschewing a direct military intervention which would probably trigger a confrontation with the US, but resorting to a naval blockade. **Trade and financial sanctions against Chinese products would likely be the US response.**

A popular paper by the Peterson Institute released in 2022 on the impact of customs duties on Chinese products on US inflation concluded to a small effect, given that these products account for only 2.7% of the US Personal Consumption Expenditure deflator (PCE). Yet, this figure itself was based on research from the Federal Reserve using data from 2010. Since then, and despite some recent pullback, the share of Chinese imports in the US economy rose significantly. More fundamentally, **the "mechanical approach" focusing on the direct trade links does not take on board the overall reshuffling of supply lines which another step in the US/China confrontation would trigger**. As the paper from Laura Alfaro for last year's Jackson Hole conference made plain, there is a cost to decoupling from China since many substitutes may raise their export prices in exchange for stepping up production.

There are however good reasons to believe such costly scenario could be avoided. First, Beijing may take comfort in the fact that Lai will be constrained in his domestic policies by the fact that the DPP has lost its majority in parliament. The nationalist Kuomintang (KMT) – favourable to a rapprochement with continental China - now holds one more seat than the DPP, without having secured a majority either. Lai will probably have to cut deals with KMT and a third party which has been taking a "middle way" between the two big rivals when it comes to the relationship with Beijing (note however that even KMT supported a further increase in defence spending during the campaign). Second, **the current domestic configuration in continental China is not conducive to taking the risk of another instalment of the trade war.** Deflation continued in December, with consumer prices falling by 0.3%yoy (from -0.5% in November). The situation is less concerning when stripping energy and food, but core inflation remains weak (service prices rose by only 1%yoy in December). This in our view reflects the persistence of significant slack in domestic demand – particularly consumption. Losing external traction in those circumstances would be "brave". Third, a purge took place in the Defence department at the end of last year, and according to US Intelligence briefings mentioned by Bloomberg (see article here), the Chinese leadership is taking the measure of corruption issues in the military, which may be another reason to avoid engaging in overly aggressive action.

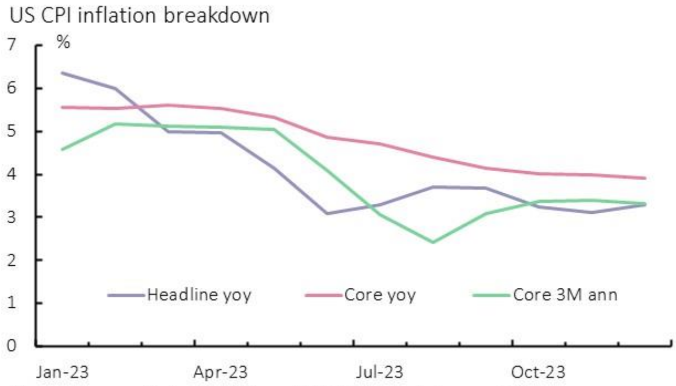
A polycrisis scenario – with higher energy prices, supply line disruptions and an escalation of the US/China trade war – would be particularly toxic because it is unclear how central banks could react in such configuration (both energy and core inflation would probably rise). Yet, for now we want to keep it as an alternative narrative, without altering our central scenario. Yet, the return of these issues should be another reason to be cautious on the future trajectory of inflation in the US, when some signs of downward resistance are emerging, and hence on how speedily monetary policy can start removing restriction.

US inflation starting to resist ?

In a paper in the Brookings from May last year Ben Bernanke and Olivier Blanchard explored the ongoing inflation shock and concluded that supply-side factors played the dominant role, rather than the push from labour costs despite the impact of massive fiscal stimulus on an already tight labour market. They however warned that, **while the supply-side cost push would gradually fade, labour costs could become the main driver of still excessive inflation**, which led them to the conclusion that the Federal Reserve (Fed) would have no other option but to cool down demand enough to normalise the labour market. This is not what the market is now expecting. Conversely, the "soft landing" narrative hinges on the hope that inflation will continue to converge towards 2% without any major loss of momentum in the economy, allowing the Fed to remove much of its restriction. **The data flow, however, keeps the Bernanke-Blanchard sequence very much in play.**

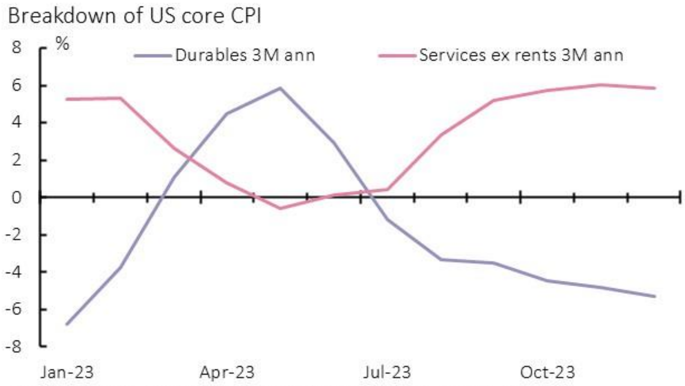
US headline Consumer Price Index (CPI) inflation came out a bit stronger than expected for December, and more importantly – at least psychologically – re-accelerated to 3.4% year-on-year from 3.1% in November, the first positive second derivative since July. Reassuringly however core inflation continued to decelerate – slightly – to hit 3.9%yoy, the first foray below 4% since August 2021 – even if the slope is getting flatter (see Exhibit 3). This looks a lot like what we had in the Euro area and commented last week. **The US inflation momentum remains however strong, and much stronger than in Europe** where 3-month annualised core inflation is comfortably below 2%. Indeed, on the same 3-month annualised basis, core inflation stood at 3.3% in the US, slightly lower than in November but still higher than the recent trough at 2.4% in August. What remains also crucial for us is that the contrast between the largely exogenously-determined manufactured goods prices and services prices remains stark (see Exhibit 4). When looking at the details of the services sector, price momentum is broad and cannot be reduced to "statistical accidents" such as the change in the way medical insurance costs are computed. Another issue is that rents also seem to be quite resilient. They have been decelerating from their peak in March 2023 when they hit 8.3%yoy, but at 6.2%yoy in December they continue to provide a significant contribution to the overall consumer price resilience. The domestic engines of inflation are still switched on.

Exhibit 3 – Still some momentum on core



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

Exhibit 4 – Services/goods contrast still there



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

True, owing to the methodological differences between the CPI and the PCE, the latter may come out slightly better and this would normally be more relevant to the Federal Reserve. But **what continues to strike us is how insensitive the market has become to a data flow which remains at least ambiguous, as well as to a Fedspeak that remains cautious**. The market may choose to disregard Loretta Mester's clear misgivings about cutting soon (she reacted to the December inflation print by saying that *"it shows there is more work to do, and that work is going to take restrictive monetary policy")* as last summer she was one of the vocal advocates of continuing to hike beyond July, but all the speakers – including the usually "centrist" New York Fed President Williams - did not seem to be in a hurry to cut when they took to the wires for the first time in 2024. Still, as of Friday 12 January, the forward market was back pricing a 78% probability of a rate cut in March, up from 60% the day before.

The ULC-profits tango

While the market seems to us a bit over-enthusiastic about the continuation of swift disinflation in the US, **there is at least one element which we did not discuss and which could foster a nearly "painless disinflation" in 2024, and that's productivity**. As of Q3 2023, productivity per hour stood at 5.3% above its pre-Covid level in the US, and after a slow patch in 2022, gains have accelerated in 2023 to reach 1.8%yoy in Q3. This has allowed unit labour costs to start decelerating, hitting 3.1%yoy in Q3 2023 against a peak at 7.2% at the end of 2022. **Unfortunately, none of this is happening in the Euro area**, where conversely productivity in the summer of last year (last available data point) is barely above its pre-Covid level and has started to decline again (see Exhibit 5), falling by 1.2%yoy in Q3. **This explains a lot of the European Central Bank (ECB)'s nervousness when it comes to the inflation trajectory ahead.** Indeed, the Euro area is dealing with a twin problem: wage growth continues to be very robust, and the institutional features of the European labour market could make it more prone to lengthy price/wage catch-up behaviour, while the decline in productivity would further add to the inflationary pressure by lifting unit labour costs even faster than wages.

Exhibit 5 – Another Transatlantic divergence

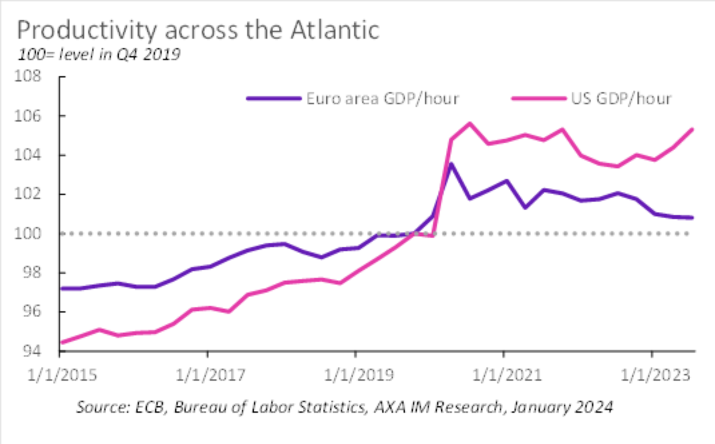
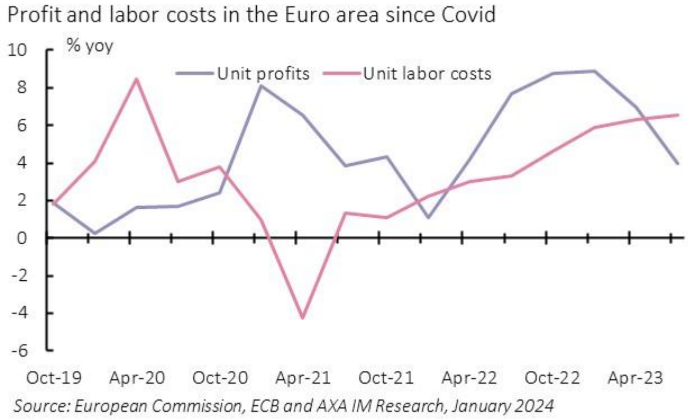


Exhibit 6 – The ULC/profits tango



The ECB highlighted how the margin behaviour of firms played a major role in the inflation shock of 2022. Indeed, at the time unit profits rose much faster than unit labour costs and ended up playing the dominant role in the overall acceleration in the GDP deflator at the time. We were at the time unconvinced that laying the blame on corporate margins was necessarily a great tactical move by the ECB. Indeed, beyond the point that communication from central banks has little direct influence on margin behaviour – it is the product of a myriad of decentralized decisions, unlike wage bargaining which in Europe tends to be quite centralized – any focus on rising profits could only fuel employees' claims for a wage catch-up. In any case, unit profits subsequently decelerated (see Exhibit 6), but then unit labour costs continued to accelerate, growing by 6.5%yoy in Q3 2023.

At first glance, we could simply wait for the ongoing slowdown in economic activity in the Euro area to drive the labour market down enough to triggering a swift deceleration in wages. This however ignores the fact **that in the short-run ULCs tend to be counter-cyclical: they rise faster when the economy slows down**. In Exhibit 7, we plot the year-on-year change in unit labour costs (ULC) against the European Commission's Business Climate Index (over 1995 to 2019). The relationship is fuzzy but still statistically significant, and *downward* sloping.

Exhibit 7 – Economic slowdowns push ULCs up…

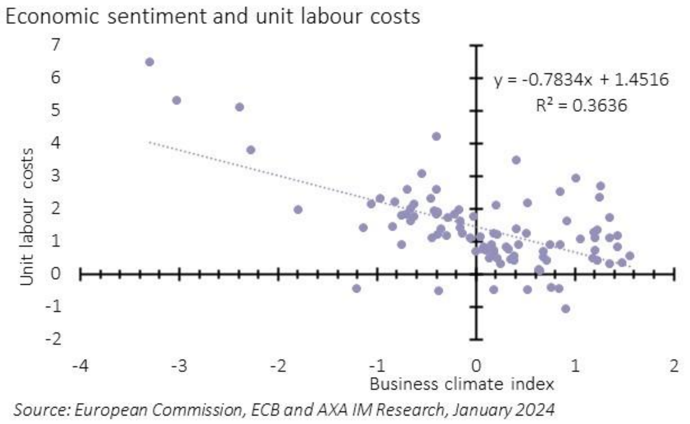
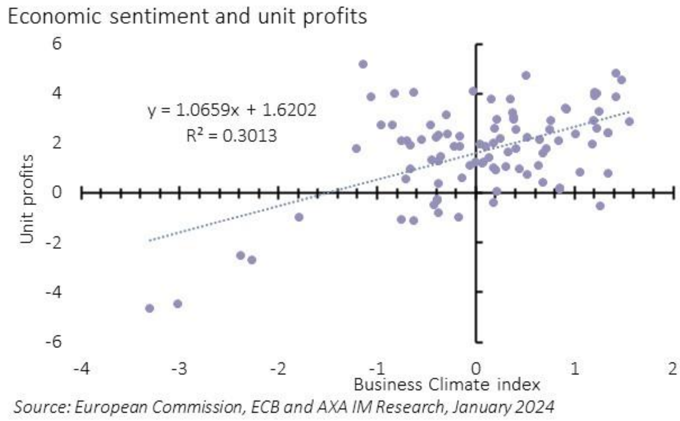
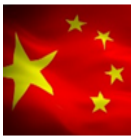


Exhibit 8 – …and pull profits down



This probably reflects the dominance, in ULC behaviour, of changes in productivity, which tends to decline when the economy is going down since businesses cannot/will not immediately adjust their workforce to the level of demand. This effect trumps the deceleration in wages which the decline in demand should trigger, which takes a while to materialise. Given our expectation of next to zero GDP growth in the Euro area this year (we forecast 0.3%) we would expect more upside pressure on unit labour costs. Still, as we suggest in Exhibit 8, **there is an equally fuzzy but statistically significant relationship between unit profits and economic sentiment, but it is *upward* sloping**. This is quite intuitive: strong demand offers more space for businesses to increase their mark-up. Note that the coefficient is similar in both relations: a 1-point decrease in economic sentiment lifts unit labour costs by 0.8% and shaves unit profits by 1.1%.

This gets us to a simple conclusion: **while we understand why the ECB is concerned about the risk of a labour cost-driven second wave of inflation, there is an equal force which may play in the other direction: the dampening impact of the mediocre demand-side conditions on profits**. The ECB is more focused on the first than on the second because they expect an economic recovery at some point in 2024. We are more circumspect. Our point there is that, as we laid out last week, **we are less concerned with inflation risks in the Euro area than in the US, precisely because we expect mediocre growth in Europe**. From a normative point of view this would make us sympathetic to the March cut view….but from a predictive point of view, given the analytical choices made by the ECB, we still don't expect such move before June.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• CPI inflation (Dec) up to 3.4% (3.9% core) from 3.1% (4.0%). Inflation likely stickier in coming months • PPI inflation (Dec) up to 1.3% (2.0% ex f&e) from 0.9% and 2.0% • US leads international strikes in Yemen in response to Houthi attacks on shipping in Red Sea • Fed's Mester: March likely too soon for first rate cut. A voter this year, she leads pushback on cuts pricing	• Iowa caucus. Start of Republican primaries. Trump holds strong lead, Haley polled moving into second • Retail sales (Dec) a solid real increase expected. Coupled with IP also this week should finalise Q4 GDP outlook which now looks solid >2% • Fed publishes Beige Book • Empire & Philly Fed surveys (Jan), both soft in Dec • U Mich sent (Jan,p) – see how consumer starts 2024
	• EMU EC surveys show a small rebound across all sectors (industry up to -9.2(+0.3p); Svcs up to 8.4 (+2.9p), bus climate improving to -0.45 (+0.06p) • Industrial data (orders and production) were mixed in Ge, good in France • EMU Nov retail sales fell by 0.3%mom, driven by Ge • EMU Urate (Nov) fell to 6.4%, helped by It & Sp	• Final HICP (Dec) will be key to be monitored, in particular momentum in svcs prices excluding package holidays, small rebound in NEIG momentum (sa measure) • Last ECB speeches before meeting scheduled on Jan 25
	• GDP (Nov) rose by 0.3%, above expectation, but Sept revision left 3m/3m lower. Flat GDP in Dec would see -ve quarter and technical recession • RECS jobs report (Dec) a rise in placements and salaries after drop in November, vacancies still fall • BRC sales (Dec) suggests volumes fell in December	• Labour market (Jan/Dec) ONS to revive unemployment rate, but questions over reliability • CPI inflation (Dec) – headline, core and services all expected to fall further, outpacing BoE forecasts • PPI inflation (Dec) further monthly falls expected • Retail sales (Dec) risk of sharper fall than priced
	• Tokyo CPI (Dec) came at 2.4%yoy (-0.3p), broadly in line with the consensus. Core measure is flat at 2.7%	• We expect headline CPI (Dec) to match Tokyo decline, but core inflation to edge down at the margin • Reuters Tankan Svcs index (Jan) • Machinery orders (Nov)
	• CPI inflation (Dec): -0.3%yoy, from -0.5% in Nov • PPI inflation (Dec): -2.7% in Dec, from -3.0% in Nov • Export rose by 2.3%yoy in Dec, up from 0.5% in Nov • Import grew by 0.2%yoy in Dec, overturned from -0.6% in Nov • FX reserves registered at 3.24tn in Dec (Nov: 3.17tn) • New loan edged down in Dec to 10.6%yoy with M2 supply grew by 9.7% (Nov: 10.8% and 10.0%)	• Wed (17 Jan): Q4 2023 GDP • Wed (17 Jan): December monthly output data including: investment, industrial output, and retail sales
	• CB: Korea (3.5%), Poland (5.75%) & Romania (7.0%) stood on hold. Peru cut 25bps to 6.5% • Dec inflation (%yoy) fell in Brazil (4.6%), Chile (3.9%), Colombia (9.3%), Czechia (6.9%), Hungary (5.5%), Romania (6.6%) & Taiwan (2.7%). It rose in India (5.7%) & Mexico (4.7%)	• CB: Indonesia is expected to stay on hold at 6.0% • Reaction to Taiwan's presidential elections (Saturday) • Q4 GDP data in Malaysia • Retail sales (Nov): Brazil, Colombia, Mexico & South Africa

Upcoming events		
	US:	Mon: 2024 election event - Republican Iowa Caucus; Tue: Empire state manf survey (Jan); Wed: Retail sales (Dec), Industrial production (Dec), Business inventories (Nov), NAHB housing market index (Jan), Federal Reserve issues Beige Book; Thu: Building permits (Dec), Housing starts (Dec), Philadelphia FED index (Jan), Weekly jobless claims (13 Jan); Fri: Existing home sales (Dec), Michigan consumer sentiment & inflation expectations (Jan), Long term investment flows (Nov)
	Euro Area:	Mon: EA Industrial production (Nov), Ge Full year GDP (2023); Tue: Ge CPI (Dec), Ge & It HICP (Dec), Ge ZEW survey: current situation & economic expectations (Jan); Wed: EA CPI (Dec), ECB President Lagarde speaks at the World Economic Forum in Davos; Thu: ECB releases Monetary Policy accounts from December meeting; Fri: Ge PPI (Dec)
	UK:	Tue: ILO Unemp (Nov), Average earnings (Nov); Wed: CPI (Dec), CPIH (Dec), RPI (Dec), PPI Input & Output (Dec); Thu: RICS Housing survey (Dec), BoE publishes Credit Conditions survey for Q4 2023; Fri: Retail sales (Dec)
	Japan:	Wed: Private 'core' machinery orders (Nov); Thu: National 'Core CPI' (Dec)
	China:	Mon: 1Y MLF announcement; Wed: GDP (Q4), Industrial production (Dec), Retail sales (Dec)

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