AXA Investment Managers

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Investment Institute Macroeconomics

Warning Shots in the Dark

- Uncertainty and volatility may prevail, but the “Jackson Hole 2022 spirit” is crystal clear: risks can’t be taken with persistent inflation and more tightening is needed. 2023 may be a different story though.

We found it striking that a lot of discussions in Jackson Hole focused on the inordinate level of uncertainty central banks are facing right now while the policy conclusions – “keeping at it” on the monetary tightening – were crystal-clear. This reflects the profound change in how central banks view the distribution of risks. With higher probability of inflation turning persistent, they feel compelled to act forcefully, even if the macro environment is unusually volatile. This is the symmetric approach to what prevailed during the “great moderation” when it is the deflation risk which was calling for decisive accommodative action.

The dataflow is getting more ambiguous though – in the United sates (US) at least. Beyond the good news from the July consumer inflation print, import prices are now falling. Yet, the Federal Reserve (Fed) remains focused on the labour market, and with wages still accelerating, Powell’s hawkish tone is justified. The prominence of the 1970s/1980s period in the Jackson Hole debates suggests the Fed is concerned about making a policy mistake. There may also be a message to the US government. After all, it’s the excess fiscal stimulus of 2020-2021 which explains a lot of the current core inflation shock, and the central bank may be tired of being accused of having failed to address the acceleration in consumer prices. The “original sin” of the 1970s Fed was in its failure to resist government pressure to accommodate its spendthrift proclivities. Now, if the labour market starts struggling decisively, the shelf-life of the 2022 “Jackson Hole spirit” may not be that long. But there is always some inertia in the policy stance. Even if the dataflow deteriorates, the Fed will continue hiking for the remainder of this year, and as we argued before the August break, the market was too impatient in pricing in a dovish pivot.

The ECB-speak at Jackson Hole was also on the hawkish side. Still, we detect quite some differences in the analysis of Isabel Schnabel and Francois Villeroy de Galhau. This may not matter much before 2023 though. For now, hawks and doves are united on the need to bring policy rates back to neutral territory.

Jackson Hole takeaways

There was no significant surprise in Jay Powell's short speech in Jackson Hole. For all the hope in the market for a "dovish pivot" (more on this later), we agreed with most commentators' expectations of a Fed willing to "toe the line" on the continuation of tightening. Powell made it clear that the Federal Open Market Committee (FOMC) will need to see a confirmed downward trend in inflation before pausing, especially given the level at which policy rates are now. The current Fed Funds are in the neutral range, and they will need to be pushed to restrictive territory. Two sentences summarize these points: *"The lower inflation readings for July are welcome, a single month's improvement falls far short of what the Committee will need to see before we are confident that inflation is moving down" … "with inflation running far above 2 % and the labour market extremely tight, estimates of longer-run neutral are not a place to stop or pause"*.

In the short run, what the market was really focusing on is the *speed* and *extent* of this move into restrictive territory. Powell did not say anything clear on this front. Our best attempt at an interpretation of his words is that another 75-bps hike is possible in September, but it is not a done deal since it is clearly data dependent. The Fed boss was very explicit about the very next data prints being crucial for them to make their decision between 50 and 75. If they go for 75 next month, it would probably be the last time, but even that is not carved in stone: *"Our decision at the September meeting will depend on the totality of the incoming data and the evolving outlook. At some point, as the stance of monetary policy tightens further, it likely will become appropriate to slow the pace of increases"*. The general direction of travel is clear, but forward guidance is not what it used to be ….

What strikes us in the current policy debate is the twin interrogation on (i) the underlying message from the recent dataflow and (ii) the 1970s "high inflation" precedent – which figured prominently both in Powell's speech and in the more academic discussions in Jackson Hole. On the first issue, it's increasingly clear that it's the signal from the US labour market which will determine the central bank's trajectory. On the second, it seems that a topical take-away from the "Burns and Volcker times" for the current conversation may be the interaction between monetary and fiscal policy. We want to devote the bulk of this Macrocast on these two issues.

Understanding the US dataflow: a tale of two pipelines

Powell's speech in Jackson Hole may well have been the "nail in the coffin" of the early summer market rally. After a peak in June, US long-term interest rates started falling back quite significantly, while equities rebounded nicely (see Exhibit 1). This might have been the pinnacle of the "bad news is good news" phase: as signs of weakness in the US economy were piling up, investors had started "de-pricing" the quantum of tightening the Fed would deem necessary to bring inflation back under control.

Exhibit 1 – The summer rally that came and went

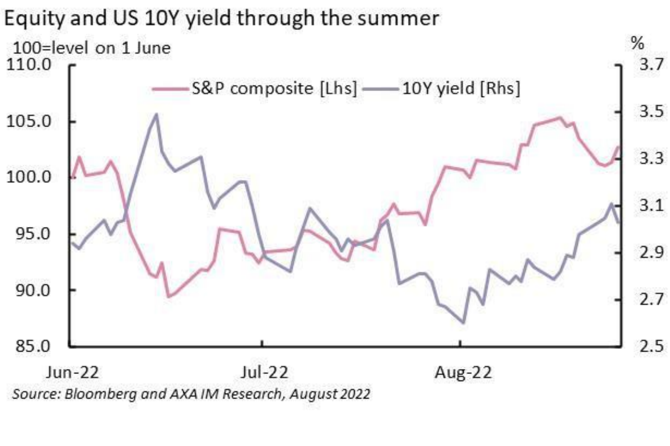
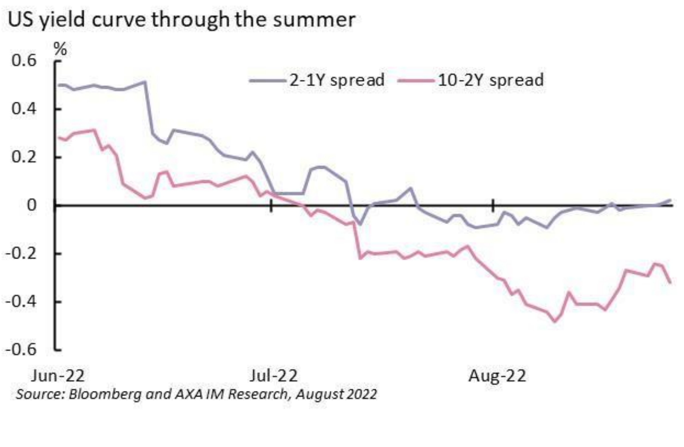


Exhibit 2 – Looking hard at the curve inversion



Indeed, the shape of the yield curve was quite telling. As usual in "pre-recession" times, 10-year rates fell markedly below 2-year yields, but the curve also reverted between the 1- and 2-year maturities (see Exhibit 2), reflecting a growing belief in the market the Fed's tightening phase would be short-lived and that policy rate cuts would become necessary by the end of next year.

This pattern started changing in August: long-term yields rebounded, equities started edging down again and the 1-to-2-year spread moved back to – marginally – positive territory. All this occurred before Jay Powell's speech (we stopped the sample in exhibits 1 and 2 to the day before the start of the Jackson Hole conference). It's the dataflow which produced this change. The early summer equity rally had been bolstered by the release of the US inflation numbers for July, and it's undeniable that they came up with – at long last – some good news. Habitual readers of Macrocast are familiar with your humble servant's obsession with base effects and cleaning core inflation from the volatility in used cars prices. Both the year-on-year and the 3-month annualized change in core inflation fell in July, and the first break in what had so been an uninterrupted acceleration in core inflation excluding used cars this year finally appeared (see Exhibit 3 and 4).

Exhibit 3 – Finally some good news on core inflation…

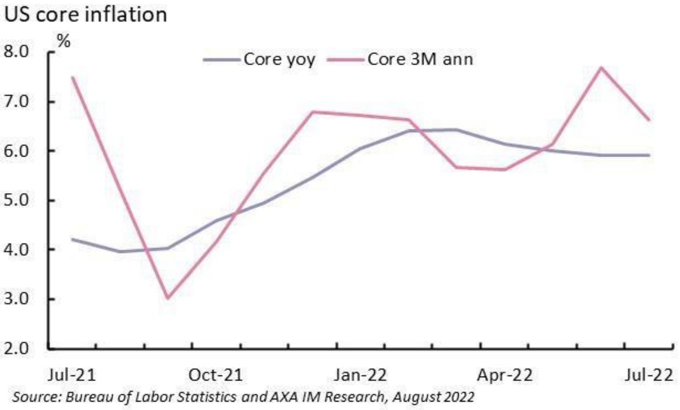
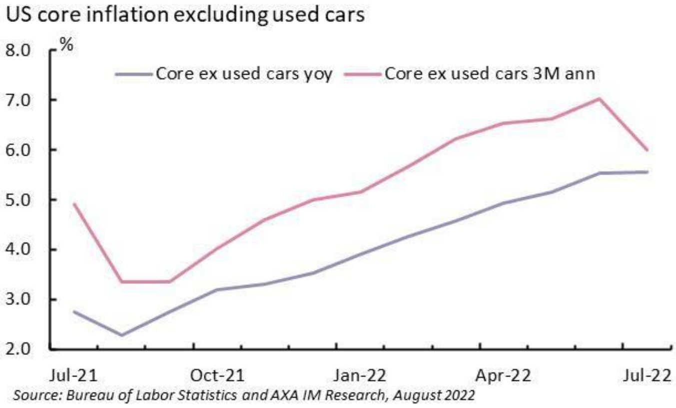


Exhibit 4 – …even when controlling for used cars



But what matters is less where observed consumer prices are now than what is in the pipeline, and some contrasting messages have come through lately. The exogenous sources of inflation seem to be abating. This goes beyond the decline in oil prices. Excluding petroleum products, import prices have finally started to decelerate. This may reflect some resorption in the key bottlenecks which have been plaguing the world economy, in a context of slower demand (see exhibit 5).

Exhibit 5 – Import prices finally decelerating swiftly…

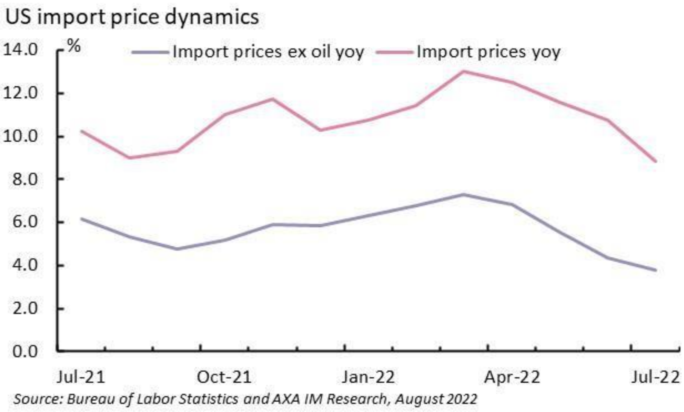


Exhibit 6 – … but US wages keep accelerating

The thorny issue for Jay Powell and the Fed is now firmly on the domestic side of the equation. Despite some tentative signs that the US labour market has finally started to ease – we have discussed at length before the summer break the new trend in jobless claims – July payroll data suggests job creation remains brisk, and probably more fundamentally, supply-side constraints remain problematic (labour market participation fell again). Even though wage developments are the product of cumulative lags (it takes time for job creation to react to a slowdown in economic activity, and even more before wages respond to a less buoyant labour market), the Fed can hardly ignore the message from the latest data on that front. The deceleration in hourly earnings is tenuous in year-on-year terms – and in any case inconsistent with a quick return to 2% for core inflation – and the dynamic on a 3-month basis is going in the wrong direction (see exhibit 6). This is the data point which "spooked the market" and killed the rally.

Powell chose to avoid the "recession debate" and talked about "below trend growth" (*"Reducing inflation is likely to require a sustained period of below-trend growth"*). Yet, it's also clear to us that the Fed needs to see some pain to change tack, and as long as the labour market is doing well, the Fed is unlikely to consider that enough pain has been inflicted to make sure inflation is "back in its box". This could come any moment now, though, at least this is what the employment components of the business surveys tell us, so we would not bet on a very long shelf life for the Fed's stern message in Jackson Hole. Yet, as we wrote in our last Macrocast before the summer break, the market was getting ahead of itself in betting on a quick turnaround by the summer.

Our baseline remains that the Fed will hike by 50 bps at the next meeting on 21 September, assuming we get another deceleration in the August Consumer Price Index (CPI) and the next payroll print released at the end of this week is not too "red hot". We think the "terminal rate" in this tightening cycle will stand between 3.25% and 3.50%, slightly below the Fed's current communication (latest "dot plot" has the peak at 3.8% in end 2023), as the looming recession will take out a lot of the current froth on the labour market beyond policy action. Yet, Powell speech insisting on the need to continue tightening confirms that the market rally in the early summer was probably too impatient. On equity in particular, our opinion since July is that it was difficult to believe in a sustained rally triggered by lower rate expectations since a proper recession, with its usual adverse effect on corporate earnings, is likely to be what it's going to take to stay the Fed's hand.

Powell does not want to be Burns, so that he can avoid becoming Volcker

What was striking in Powell's short address is how prominent the reference to the 1970s/1980s was. A key takeaway there is the relative cost of pausing the tightening too early, which would eventually make even bigger hikes necessary, at an increased cost to GDP. This – which harks back to the decision by the Fed under Burns in 1975 to loosen its stance again before inflation had been properly killed, which ultimately forced Volcker into the growth-busting hikes of 1980 - is standard fare for any central bank accused of fuelling recession risks, but in the current configuration it comes handy as a direct rebuttal of the market expectations of a quick "dovish pivot". But this return to the 1970s/1980s is more profound than that. Powell is clearly keen to demonstrate that the Fed's hand "will not shake", that he won't fall in the same trap as Burns who considered that the general social, political, and doctrinal environment of the 1970s made it impossible for the Fed to take the required action to nip inflation in the bud. This message may not be solely addressed to the private sector, as a reminder that any "collusion to inflate" between employers and employees would be met by enough monetary tightening to make it unpalatable, but also to the government. What the Fed is implicitly telling the Biden administration – and the entirety of the US political circles – is that the Fed will not blink and allow easy fiscal policy to continue by keeping financial conditions loose. As we have already discussed often in Macrocast, Burns' original sin at the time may well have been his refusal to antagonize the Johnson administration and its spending plans.

An academic paper by Bianchi and Melosi tackling these issues, presented in Jackson Hole, is making the rounds. It argues in a nutshell that a monetary policy tightening can fail to take inflation back under control if the government is not at the same time committed to public debt stabilization. The authors are basically dusting off Sargent's view of inflation as "ultimately, always a fiscal phenomenon", a neo-classical rebuttal of Friedman's monetarist view according to which inflation is always ultimately a monetary phenomenon. The mechanism goes this way: if corporations and households are convinced that the government will continue to run unsustainable policies, which can ultimately be addressed only by an "inflation tax" to erode public debt, a restrictive monetary policy alone could not lower their inflation expectations. The economy then settles on a debt-fuelled stagflation. Even a massive rate hike, which would raise the fiscal deficit through the decline in tax receipts the ensuing recession would trigger, would not be able to alter inflation expectations, since it would further undermine public debt sustainability. The authors argue that Volcker – although he had been appointed by Jimmy Carter and started hiking rates under his administration – could not have been successful without Reagan's pledge to reduce the deficit in the 1980s. Fast-forwarding to today, their conclusions are even more sombre. In the early 1980s, public debt was low. Today it is massive, which makes the inflation erosion "solution" even more palatable, and thus realistic to corporations and households when forging their inflation expectations. Central bankers facing accusations of having "fallen behind the curve" and failed to address the inflation shock could find some solace is hearing from academics that, ultimately, it's the government which matters.

We have quite a few issues with the paper. First, we are surprised that, although they focus on "private sector beliefs" about the future inflation regime, the authors did not integrate in their model direct measures of inflation expectations. True, they have increased over the last two years, but only marginally above the Fed's target, which would seriously undermine the claim that the private sector is seriously betting on a fiscally driven high inflation regime. Second, we would dispute some aspects of their analysis of "Reaganomics", which initially allowed a significant drift in fiscal deficits. True, the rhetoric was "hawkish", but the practice certainly wasn't. We are always surprised when big believers in rational expectations consider that economic agents are more sensitive to words than facts.

Yet, for all their methodological limits, these discussions in Jackson Hole have the merit of highlighting the difficulties of the global "policy mix" ahead, although we would take it with a different angle. A crucial point which we think is missing in Bianchi and Melosi's paper is the feedback effect from monetary policy onto fiscal policy choices. Indeed, it's precisely because the Fed did not dare to stand in the way of the US government in the 1970s that spendthrift policies were allowed to continue at no immediate cost. One could argue that one of the reasons why fiscal policy ultimately turned conservative in the US in the 1980s, beyond Reagan's ideological preferences, is quite simply because the new monetary stance imposed by Volcker made it necessary. Governments cannot ignore forever financial sustainability conditions. This could become the big issue for 2023, which may be the point at which governments will be forced by the rebound in interest rates and their own awareness of the toxic trajectory for public debt to move to a significant tightening exactly at the time the monetary stance is at its most restrictive. True, that is the combination which may "kill inflation", but at a cost to growth which the market has yet to price in.

European Central Bank (ECB)'s direction of travel impervious to recession – for now

The hawkish tilt was not the preserve of the Fed in Jackson Hole. Eurosystem representatives speaking there also came with some stern warnings, even if ECB-speech still come in different flavours.

Isabel Schnabel has for some time appeared as the most eloquent spokesperson of the hawkish persuasion at the ECB board, and she stuck to this line last week. She made a consistent case to extricate the current policy debate from the "demand versus supply side shock" issue. At the risk of over-simplifying a complex speech, one of her main points was that once there is a tangible risk inflation becomes persistent, it becomes irrelevant whether the source of the acceleration in consumer prices stems from an economy that is overheating (demand-led inflation) or from exogenous shocks (for instance a disruption in supply lines). Inflation expectations need to be tamed, and this requires "robust action" from the central bank – even more robust than in the past since she argues the economy has become less sensitive to interest rates. She did not hide the fact that this could result in significant pain. Indeed, if the Phillips curve has become flatter – which helps to explain why inflation had been so low during the pre-pandemic "Great Moderation" – then symmetrically this would suggest that a significant deterioration in the labour market may be needed to curb inflation now that it is running dangerously close to 2-digit territory. There are many points there which we would dispute – in particular the notion that the economy has become less sensitive to interest rates – but in terms of message to the market, things are clear: yes, the ECB is facing lots of uncertainty as macroeconomic volatility has risen, and yes, a recession may be looming, but the direction of travel for monetary policy is towards more tightening.

Banq ue de France G ove rnor Ville roy de G alhau' s spee ch caught observers' attention with his direct warning: *"have no doubt that we at the ECB would if needed raise rates further beyond normalization*" – which carries some weight given the ECB's insistence recently on reaching the *neutral* range – a point which he had been the first to make explicitly. Yet, he also stuck to the "non-linearity" in the policy discussion he has been supporting for several months: until the neutral range is hit – between 1% and 2% - for the policy rate, the tightening pace can be sustained without much debate. Going for restriction would however take another thorough discussion at the Council, and we note that on some key issues, his views seem to differ quite clearly from Schnabel's. He mentioned the possibility that the Philips curve may have re-steepened and takes a more quizzical approach to the message from inflation expectations.

Yet, these differences probably matter for 2023 only. For now, hawks and doves can be united on bringing policy rates at least into neutral territory. This would suggest that beyond another 50 basis points hike in September, the "natural slope" would be a continuation of the tightening towards 1.25% by year-end.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Powell delivers Jackson Hole speech spelling out need for ongoing Fed tightening • GDP (Q2) revised higher to -0.6% (saar) from -0.9% • PCE inflation (Jul) retraced to 6.3% from June's 6.8% high, core to 4.6% from 4.8% (5.3% peak Feb) • 73% of NABE survey now expect US recession	• Labour report (Aug) watch for convergence of payrolls and alts measure of employment • JOLTS – latest vacancy figures in labour turnover • ISM (Aug) mixed signals in surveys, but PMI weak • Conf bd confidence (Aug) watch for further falls • Vehicle sales (Aug)–rising supply or falling demand?
	• Business surveys edged further down in August, implying euro area flirting with activity contraction in Q3. • ECB speakers as well as minutes from July GC meeting confirm hawkish bias despite dwindling growth prospects.	• We project euro area "flash" headline HICP to remain unchanged at 8.9%yoy in August from July. We look for core inflation to gain 0.3pp to 4.3%yoy. • Nordstream 1 shutdown from 31 August for 3 days of maintenance, how much gas to flow afterwards. • ECB GC speeches ahead of upcoming meeting.
	• UK utilities regulator Ofgem announced energy price cap set to rise by 80% in Oct to £3,564 from £1,971 • Business surveys point to manu weakness, flash manu PMI dropped to 46 from 52.1 and CBI industrial trends survey remains weak • Services remain resilient	• Final PMI estimates (Aug) • Nationwide house prices (Aug) • BoE/Ipsos inflation expectations (Aug) • BoE household lending data – mortgage approvals (Aug) expected to moderate • BRC like-for-like sales (Aug)
	• Flash PMI in Services and Mfg fall into contraction territory 49.2 and 48.9 on resurgence of COVID-19 and weakening external demand • Services PPI rises remains at 2.1%	• Tokyo CPI (Aug) expected to rise to 2.7% (cons) • Jobless rate expected to hold steady at 2.6% (cons) • IP (Jul,p) expected to decline -0.5% (cons) • Retail sales (Jul) expected to pick up modestly 0.3%mom after -1.3% drop as Covid resurged
	• China cuts the loan prime rates to alleviate resurge in the housing market • State Council announces a raft of measures to support the ailing economy • China and the US are reportedly approaching an agreement on audit inspection for listed ADRs	• The PMI to show manufacturing activity remained weak amidst COVID restrictions and power shortages • Further actions from the authorities are expected to alleviate the impact of power shortages in some provinces
	• CB: Indonesia hiked +25bps to 3.75% & Korea +25bps to 2.50% • Annual inflation (July) picked up in Singapore (7.0%) & South Africa (7.8%) • Korea's first 20-day exports weakened on slower Shipments to China	• CB: Hungary is expected to hike +100bps to 11.75% • Q2 GDP data for Brazil, India & Turkey • Aug CPI (yoy) figures in Indonesia, Korea, Malaysia, Peru & Poland • Unemployment (July) numbers in Brazil, Colombia, Mexico & South Africa

Upcoming events		
	US	Tue: C-S&FHFA HPI (Jun), JOLTS (Jul), Conf Bd cons conf (Aug); Wed: ADP employment chg (Aug), Chicago PMI; Thu: Weekly jobless claims (27 Aug), Mfg PMI (Aug); Fri: Non-farm payrolls (Aug), Factory orders (Jul)
	Euro Area:	Tue: Ge & Sp HICP, Ge CPI (Aug); Wed: CPI 'flash' estimate (Aug), Ge Unemp. (Aug), Fr GDP (Q2), FR & It HICP (Aug); Thu: EU19, Ge, Fr, It & Sp Mfg PMI (Aug), EU19 & It Unemp (Jul), It GDP (Q2); Fri: EU19 PPI
	UK:	Tue: Mortgage approvals & net lendings (Jul), M4 (Jul); Wed: BRC Shop Price Indx (Aug); Thu: Mfg PMI (Aug)
	Japan:	Mon: Lending index (Jun); Tue: Unemp. (Jul); Wed: Ind prod. (Jul), Consumer conf. (Aug); Wed: Ind. prod. (Jul), Consumer conf. (Aug)
	China:	Wed: Official mfg and non-mfg PMI (Aug); Thu: Caixin mfg PMI (Aug)

About AXA Investment Managers

At end of December 2021, AXA IM employs over 2,460 employees around the world, operates out of 23 offices across 18 countries and is part of the AXA Group, a worldwide leader in insurance and asset management.