185 – 19 June 2023

Investment Institute Macroeconomics

Towards a Busy Summer

- The Bank of England is under fierce criticism, but a lot is beyond its control.
- We now see the peak in the Fed tightening in July, while the "natural slope" now is probably that the ECB hikes one last time in September.

After the Fed and the ECB, focus is now turning to the Bank of England, which is widely expected to hike by another 25bps on Thursday. The British central bank is facing much criticism. It has appeared as more reluctant to tighten monetary conditions than its American and European counterparts, going as far as to warn the market against pricing too many rate hikes last November, only to be now compelled to possibly deliver even more than what had been expected at the time, amid stubborn wage pressure. We think the BoE is however having to deal with the product of political decisions and structural forces on which it has little control. In the bizarre configuration the UK is finding itself in – an overheating labour market which fails to create jobs – the shortcomings of the British healthcare system (nearly half a million people have left the workforce because of long-term sickness since 2019) and the limitations of the post-Brexit immigration system contribute a lot more than any traditional excess demand.

We review the Fed's decision last week: we feel the FOMC may have dangled the possibility to hike twice more to avoid a market-led softening in financial conditions which could have followed the pause. We have moved our baseline to one more hike in July, but we still think this will bring enough restriction as we expect the data to tell us within the next two months that the economy is indeed landing. For her part, Christine Lagarde absolutely refused to be dragged into a conversation about the post-July trajectory. This probably reflects the absence of consensus at the Council, which makes sense given the difficulty to form a precise diagnosis at the moment. One last hike in September is probably the "natural slope" now though, even if we think we need to take the latest hawkish forecasts with a pinch of salt. The ECB is focused on the labour market, and there may not be enough evidence it is about to land by the time the Council meets in September. This however makes us even more concerned that the ECB will end up "doing too much".

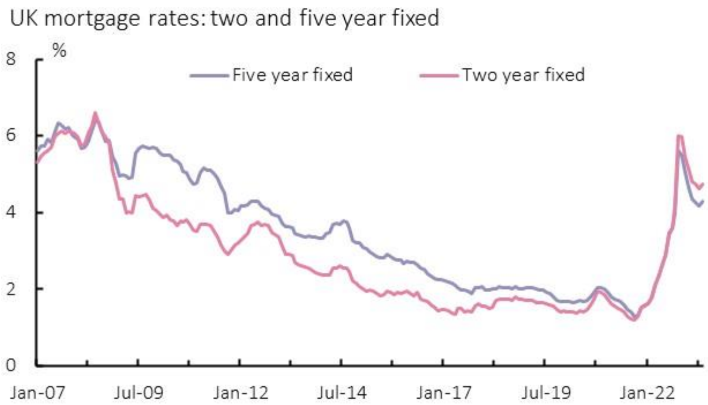
UK: Jobless overheating

While the Federal Reserve (Fed) and the European Central Bank (ECB) are pondering whether the right level of restriction has been reached or is about to be reached, at least the longer end of the yield curve has been range-bound for quite some time in the United States (US) and the Euro area. This is not the case in the United Kingdom (UK). Since a recent trough in early February 10-year yields in the UK have increased by 90 basis points, three times as much as in the US and five times more than in Germany. The 10-year interest rate on gilts is now only 20bps below the peak hit during the "silly season" of Liz Truss' experiment in the first half of October 2022. Only this time, **the market's distrust is not driven by an adventurous fiscal policy, but rather by doubts as to what it will ultimately take to bring inflation back under control.**

The Bank of England (BoE) has long appeared as a "reluctant hiker" among the Western central banks, even taking the unusual step in November 2022 to explicitly tell the market it was pricing in too much future tightening. This reluctance may have a twin explanation. First, once the central bank was reassured about the fiscal stance, the Monetary Policy Committee (MPC) probably considered that the removal of stimulus would quickly dampen domestic price pressure, especially since the market's re-assessment of the UK's trajectory after the demise of Liz Truss in October 2022 triggered a re-appreciation of the exchange rate which would help tame imported inflation. Second, the Bank of England is probably sensitive to the fact that monetary transmission in the UK can be swifter – and more immediately painful – than in the US or the Euro area given the dominance of adjustable-rate mortgages.

A bit more than 6 months after issuing this warning, the Bank of England is poised to end up doing what it was saying it would not need to do and possibly more. The market – including ourselves – is expecting a hike this week to 4.75% together with hints at more. We think they will only stop in August at 5.0%, only marginally below the peak the market was expecting in November 2022 (5.25%), but the balance of risks is tilted to the upside. This would put an end to the post-Truss correction in mortgage rates, which has already started to fade (see Exhibit 1).

Exhibit 1 – Mortgages under pressure again

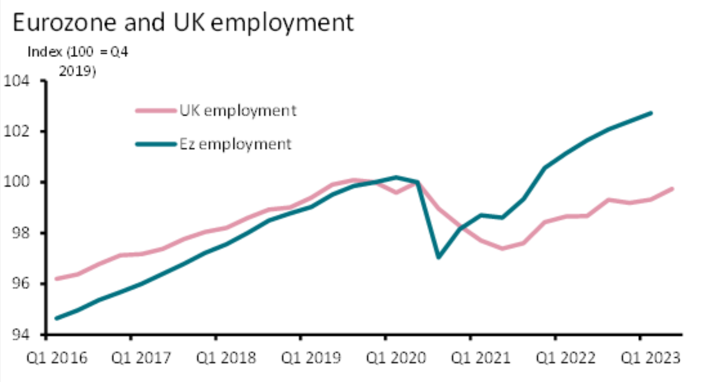


Source: Bloomberg and AXA IM Research, June 2023

The Bank of England's new stance is a response to the stickiness of inflation among very high and still accelerating wage growth (+7.2%yoy in April) while the unemployment rate unexpectedly declined to 3.8%. This week may unveil a lower reading for headline inflation in May but we are bracing ourselves for another possible move up of core inflation to 6.9%. Of course, it's tempting to lay the blame entirely on the central bank for having failed to curb aggregate demand enough to get the labour market to land, but we would be ready to find quite a few excuses for the BoE since a lot of this inflation-fuelling wage drift is the product of political decisions and structural forces on which monetary policy does not have much grip – at least not without inflicting a lot of additional misery to the economy.

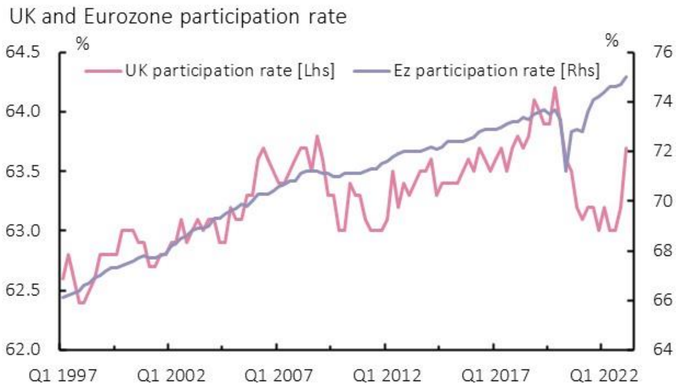
What is striking about the UK is that its labour market is overheating without even creating jobs. While headcounts have only just caught up with their pre-pandemic level in the UK, there are already more than 2% higher in the Euro area (see Exhibit 2). This "jobless overheating" is fuelled by a decline in the participation rate (the proportion of those of working age either in work or looking for a job). While in the Euro area it has swiftly resumed its upward trend when the economy reopened to gain more than one percentage point relative to Q4 2019, it is still roughly 0.5 point lower in the UK. The gap between the two regions has widened to a massive 11.3 percentage points in Q1 2023 (see Exhibit 3).

Exhibit 2 – UK underperforming on headcounts…



Source: Office for National Statistics, Eurostat, AXA IM Research, June 2023

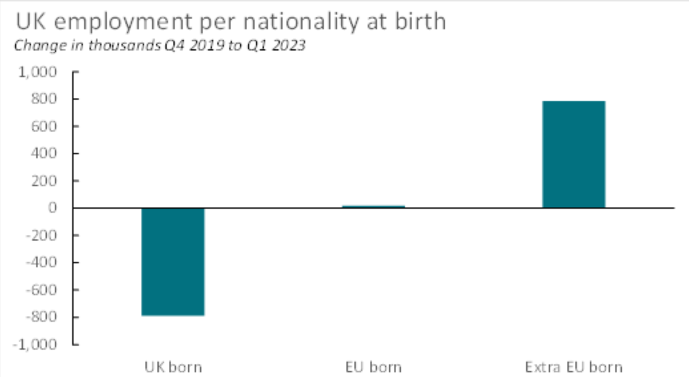
Exhibit 3 – …and participation



Source: Office for National Statistics, Eurostat and AXA IM Research, June 2023

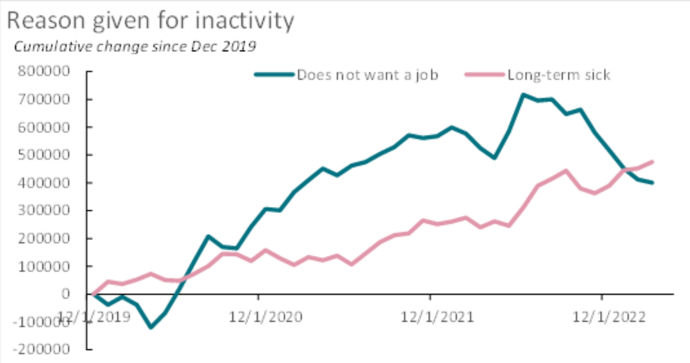
We were intrigued by a calculation made by David Smith, the Times' economics editor, in his latest column on Sunday: while overall UK employment has stagnated, it has fallen by nearly 800K for British born individuals relative to the pre-Covid level. Employment in the EU-born category has stagnated – a consequence of the termination of free labour mobility which is triggering net departures from the UK labour market – and the "slack" was taken by non-EU born workers (see Exhibit 4), reflecting the fact that while its composition may have changed, immigration has actually re-accelerated post-Brexit. Yet, the crucial question becomes: why has employment diminished so drastically for British-born individuals? A deterioration of the health status of the existing workforce may be a strong contributor. Indeed, when we look at the reason given for inactivity in the Office for National Statistics (ONS) data, it appears that in cumulative terms, individuals reporting long-term sickness has increased by nearly 500K relative to the pre-Covid level, overtaking those who simply stated they are not looking for a job. The latter number is now diminishing fast, which may reflect the need in many families to increase their participation to the labour market to offset the erosion of their purchasing power by inflation (see Exhibit 5).

Exhibit 4 – Change in employment composition



Source: ONS, AXA IM Research, June 2023

Exhibit 5 – Too ill to work



Source: ONS, AXA IM Research, June 2023

The rise in sickness leave since the pandemic has been observed across the developed economies, but at least in the Euro area it does not seem to be a strong enough factor to take the participation rate down (although it may reduce the total number of hours worked). **In the UK case, it is tempting to link the number of workers forced to withdraw from the labour market for health reasons to the magnitude of the bottlenecks observed in the National Health**

Service. We may have got to the point where the long queues for treatment – which have only been made longer by the pandemic – are not only a social issue but are now having a visible impact on the economy.

Of course, in theory adverse developments on existing workforce supply could be fully offset by more immigration so that overall wage pressure could be contained. However, we think that **even if absolute immigration numbers have not fallen post-Brexit, the new system is less conducive to a swift adjustment of demand and supply on the labour market.** Indeed, under the old free circulation of labour from the European Union (EU), many aspiring workers from Europe could come to the UK first and *then* look for a job on par with those already there. The new system is based on "pay thresholds" for new immigrants, and a government-run prioritization of some sectors deemed to be under specific tension. In other words, jobs need to be secured, at least in principle, before moving. This makes for a clunkier matching process.

Dealing with these structural issues affecting the British labour market will be extremely thorny politically. The usual answer to bottlenecks in the National Health Service (NHS) is to pour more money into the system, but the government's fiscal room for manoeuvre has shrunk, especially with the return of more expensive funding conditions. Some discussions on reforming the system structurally will emerge, but anything which looks like privatizing the health service, even remotely so, is usually very unpopular with the electorate and parties will tread carefully on that front. The immigration system is probably unfit for purpose, but reopening the issue is not palatable even for opposition politicians. It's thus likely that no decisive action will be undertaken any time soon, which will leave a particularly heavy burden to the Bank of England, which will be left with the unenviable task of setting aggregate demand low enough to match a structurally impaired supply.

This will be a very uncomfortable position for the BoE. It has already had to consent to an external review of its forecasting apparatus, while the principle of central bank independence has always been shakier in the UK than on the continent. For instance, when Gordon Brown granted the BoE the right to set policy rates independently in 1997, he chose to keep the right to decide on the definition of the inflation target for the government. While we would not expect the current administration to go as far as to change the status of the BoE – we don't think the Prime Minister nor the Chancellor of the Exchequer would want to take direct responsibility for setting rates in the current environment – **we expect quite a lot of "bickering" between the central bank and the government** which will want to lay the blame of a further painful rise in mortgage rates on the Bank's inability to keep inflation in control in the first place. Such bickering is unlikely to help mooring long-term interest rates.

Fed: the "skip" is hard to follow

Last week the Fed gave us a "hawkish hold" with the upward revision in the dot plot implying two more hikes - more than what the market was bracing itself against - and maintaining a "tightening bias" in the soft forward guidance on the prepared statement *("determining the extent of the additional firming that may be appropriate*"). In a nutshell, this reflects a belief at the Federal Open Market Committee (FOMC) that monetary conditions may not be restrictive enough against a background of resilient labour market. This seems to be absolutely key in the current thinking of the FOMC judging by Jerome Powell's Q&A. In practice, this probably means the Fed won't "stop for good" until payrolls unambiguously deteriorate. And it may take more than one batch to be convinced. A soft reading ahead of their July meeting may not be enough to stay their hand.

Still, delivering two more hikes as per the dot plot seems like a lot to us as inflation - both headline and core - has started to recede, and real economy indicators are heading down. While we made the point last week that there is quite a thick "data fog" at the moment, the direction of travel for growth – or the absence thereof – and inflation seems to be tilted towards the downside. **We feel we may be in a situation where the Fed "says two to get one in the end".** The hawkishness of the dot plot would be largely a ploy to move the market away from triggering a spontaneous softening of financial conditions which would delay the landing of the economy. From this point of view, the Fed has already been successful in getting the market to push further its expectation of rate cuts. For the FOMC, making sure monetary conditions remain restrictive for long enough to firmly bring inflation back into its box may matter more than triggering even more restriction.

So, in response to the messages of last week we have moved our call for the peak in rate in July, at 5.25-5.50%, but we still don't want to go further than that given our expectation of more bad news on growth and good news on inflation in the coming two months.

ECB: towards a busy summer

There was not much surprise in the ECB's decision to hike again by 25 basis points, nor in the pre-announcement of another one in July. What investors were most interested in was any hint at what the trajectory could be from the second half of summer onward.

The new forecasts released last week are indicative of more than just one additional hike. The widening of the deviation from the inflation target for 2025 was a clear indication in our view. With core inflation at 2.3% in 2025 (from 2.2% in March), it was obvious the ECB feels more tightening would be needed. True, the technical assumption for short-term rates in 2024 stood at only 3.4%, which means that the actual "excess inflation" is smaller than what is already implied by the stated policy intentions by July (3.75%), but a 35bps difference would unlikely be large enough to reduce inflation by 30bps by 2025. Using a recent presentation by Philip Lane, even the most "generous" macroeconomic model used by the ECB would have inflation down by only c.0.1% for that magnitude of additional tightening.

Still, during the Q&A Christine Lagarde was clearly intent on refusing to engage into any conversation on what could be the steps after July, which explains why the market retraced most of its initial hawkish interpretation of the ECB's prepared statement. "ECB sources" after the meeting indicated – according to Bloomberg news – that the council was bracing for a tough conversation this summer about the need to keep on hiking after July.

We should take the guidance offered by the forecasts with a large pinch of salt. The June and the December batches are prepared by the Eurosystem – the National Central Banks' individual forecasts are a major input – while the March and September ones are conducted by the ECB staff "centrally". It's possible that **the contributions from the National Central Banks (NCBs) faced with significant domestic inflation challenges and where "hawkish proclivities" dominate may have pushed the average significantly up**. But votes at the Council are not weighted by the size of each member state. There can be a wedge between the result of the aggregation of the national projections and the reality of the debate at the Council.

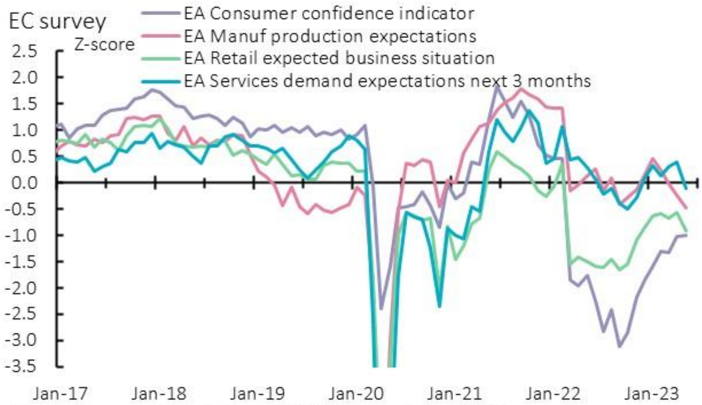
The Bundesbank's own forecast, also released last week, is quite interesting from this point of view. The German central bank expects still very solid wage growth in 2024 (5.2% after 6% in 2023), keeping inflation high (3.1% in 2024 and still a whopping 2.8% in 2025 for core), but crucially on the "real side" the Bundesbank is quite optimistic, with enough of a robust rebound in activity to keep employment growth positive and avoid any rise in the unemployment rate. For a country which has just gone through 2 quarters of decline in GDP cumulating to 0.8%, we think this is "brave".

The ECB won't have the luxury to wait until September to start making up its mind, since the current version of the forward guidance embedded in the policy statement, if kept unchanged at the July meeting, would strongly signal a further rate hike to 4% (the bit on "*policy rates <u>will be brought</u> to a sufficiently restrictive level"*). The doves will probably push for an alteration of this element to allow for optionality at the September meeting. The simplest way to do this would be to skip the bit on the restrictive level and move directly to the point on data dependence. Such a drastic change would however likely be interpreted by the market as a signal the ECB is "done", which means that Christine Lagarde would have to "talk hawkish" during the Q&A to keep the option of finally hiking in September "live". On this – as with almost all the issues facing the ECB – there is no easy choice.

Is there going to be a "killer release" in the next 6 weeks which would tilt the Council in a direction or another on the alteration of forward guidance? The inflation print for June will likely be crucial. For all the enthusiasm about the larger-than-expected decline in core inflation which emerged in May, a lot of it was due to some one-offs which will reverse in June (e.g., the timing and magnitude of the rebate on train tickets in Germany). At the same time, the Governing Council will have another month worth of credit origination and business confidence data, which are likely to signal the economy continues to struggle as the monetary tightening is being transmitted. Still, in balancing observed inflation going in the wrong direction with signals demand may be contracting and ultimately tame inflation, we think we know there the Governing would fall: hinting at further hikes.

Yet, maybe paradoxically, with such a hawkish forecast in June the ECB has given itself a potential excuse for not hiking, ultimately, in September, which makes us believe that **even if in July the Council hints a yet another hike later, this won't be carved in stone**. Indeed, the ECB's baseline for inflation is predicated on a quite robust recovery from the current technical recession. Given the poor carry-over observed today, the strikingly above-consensus 1.5% GDP growth projected for 2024 is conditional on "*solid growth*" (to use the ECB's own expression) from mid-2023 onward. This is predicated on the ECB's narrative on the positive effect from disinflation on purchasing power and the continued removal of production bottlenecks. Maybe. But that's definitely not what the surveys are saying right now on the direction of the Euro area economy in the months ahead (see Exhibit 6). Business confidence – according to the European Commission survey – is now below its long-term average in all sectors of the economy, including in the so far resilient services.

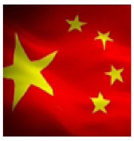
Exhibit 6 – Not looking good…



Source: European Commission and AXA IM Research, June 2023

We continue to question how the ECB takes into consideration the feedback effect from its own policy decisions. While monetary conditions may not be restrictive enough, the Governing Council now acknowledge that they are restrictive. Combined with a turnaround in the fiscal stance which is explicitly expected by the central bank in the narrative of its forecasts (the staff expects most of the decline in the overall deficit in 2024 to come from the discretionary component – in clear a push to austerity – rather than from a cyclical improvement in government receipts) we fail to see how GDP growth could exceed potential (commonly estimated at c.1.2/1.3%), as the ECB expects. **A new batch of more cautious forecasts in September could help avoid hitting a peak in policy rate at 4%.**

Yet, for the ECB to take that turn, a further deterioration in the real economy indicators and a re-deceleration in core inflation in the August CPI print may not be enough. The Governing Council's growing concern about the labour market was evident last Thursday, and the only piece of news which at this stage would single-handedly stop further tightening would be a deceleration in wages. This gets us back to the point we made two weeks ago: while in Germany we may not be far from an inflexion point on the employment front, it may take a few months for this to percolate to the wage bargaining process. At the Euro area level, we expect the peak in wage growth to come only in Q3 2023, with a release only after the September meeting. This gets us to the conclusion that the baseline should now be that we get yet another rate hike in September, but this remains a very close call, and in any case, from a "normative" point of view, our usual concern that the ECB could end up going too far than what is strictly necessary is now stronger.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• The FOMC left rates unchanged at 5.25%, but Powell described this as a "skip" and the Committee signalled an additional 2 hikes this year. We expect 5.50% peak • CPI inflation (May) fell back to 4.0% - its lowest reading since March 2021 – core fell to 5.3% • Retail sales (May) rose by 0.3%, the control also rose by 0.2%, but March was revised to -0.8% from -0.3% • Philly Fed survey (Jun) eased lower to -13.7, but Empire bounced strongly to 6.6 – very volatile • Jobless claims remained elevated at 262k	• Housing starts (May) have been firmer in recent months, but softer sales could weigh • Existing home sales (May) had also bounced, but retraced sharply in April • Current account (Q1) expected to widen in Q1, but trade data suggests a bigger drag on GDP in Q2 • Jobless claims – will these continue to rise? • PMIs (Jun, P) additional survey information
	• The ECB hiked interest rates by 25bps and signalled its willingness to do the same in July but did not commit thereafter, waiting for data during the summer. Inflation update is clearer with core upgraded by 0.5pt in 2023 and 2024. We changed our call and added another 25bps hike in Sept (reaching 4%) • Final May HICP confirmed at 6.1%yoy, core at 5.3% • EMU IP (Apr) fell by 1%mom (+0.2% including Ireland) • EMU Labour cost (Q1) rose to 5%yoy, wages at 4.6%	• Flash PMIs across euro area (June). Worth to look at absolute levels for Svcs and Mfg, divergence between them and details on output levels, prices and employment expectations • French Business climate (Jun) • EMU consumer confidence flash (June) • Overnight stay in Spain (May) as a proxy for coming summer holidays. Nights in April were already higher than average of 2018/2019
	• Previous drop in payrolls reversed (up to 7k from -142k). Unemployment rate (Apr) dipped lower to 3.9% as employment rose despite labour supply bump • GDP (Apr) up 0.2%mom as services output expanded. • Trade balance (Apr) narrow to -£12.3bn driven by a larger fall in imports than exports	• CPI inflation (May) fuel prices to support decline in headline to around 8.5% with slight slowdown in food. We think core could edge higher to 6.9% • PPI inflation (May) expected to continue to ease • Retail sales (May) to be supported by additional May bank holiday
	• BoJ left all policy tools unchanged at its June meeting. Little change to communication on inflation outlook • PM Kishida ruled dissolving the lower house for early elections • Trade balance (May) narrows	• Further reports around early elections • CPI inflation (May) headline to continue to moderate, but services rises to be closely watched • Flash PMIs (Jun) expect to continue improvement seen in recent surveys
	• May's monthly data (yoy) weak - industrial production (3.5%), retail sales (12.7%), fixed invest (4%) and unemployment rate (5.2%) • Agg financing (May) lower after soft April • PBoC cut OMO reverse repo rate by 10bp to 1.9%	• 1yr lending rate expected to follow the recent policy decision with 10bp cut and more to come if economic weakness not reversed
	• CB: Taiwan (1.875%) kept policy rates unchanged • ECJ meeting confirmed AG's opinion for CHF mortgage treatment in Poland – higher provisions likely to weigh on loan activity into the year • April CPI yoy eased in India (4.3%) & Czech (11.1%)	• CB: Indonesia (5.75%), Philippines (6.25%), Czech (7%), Mexico (11.25%) and Brazil (13.75%) expected on hold, Hungary (12.5%) to continue to cut 1-day repo rates (16%) by another 100bp, Turkey (8.5%) to engage in massive policy normalisation with rate hike towards 25%

Upcoming events	US:	Mon: NAHB housing market index (Jun); Tue: Housing starts (May), Building permits (May); Thu: Weekly jobless claims (17 Jun), Current account (Q1), Leading index (Jun), Existing home sales (May); Fri: Manf. & Services PMI (Jun)
	Euro Area:	Tue: Ge PPI (May); EU20 Consumer conf. (Jun), Fr Insee manf. confidence (Jun); Fri: EU20 Composite, Manf. & Services PMI (Jun), Ge & Fr Manf. and Services PMI (Jun), SP GDP (Q1)
	UK:	Wed: CPI (May), CPIH (May), RPI input & output & output 'core' (May), PSNB ex-banking groups & PSNB (May), Car reg. (May), CBI Industrial Trends Survey (Jun); Thu: MPC announcement; Fri: GfK consumer conf. (Jun), Retail sales (May), Composite, Manf. & Services PMI (Jun)
	Japan:	Tue: Ind. prod. (Apr); Fri: CPI & CPI 'core' (May), Manf. PMI (Jun)
	China:	Tue: PBoC rate decision

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