NB: Exceptionally, there will be no Macrocast publication on Monday 13 November. Next issue: Monday 20 November

Fever Breaking

- The Fed message, a tweak in debt issuance and soft payroll combined to take US long-term yields down. The fiscal trajectory remains a major hurdle though.
- Good news on inflation and bad news on growth and employment are playing for the doves at the ECB, but the hawks are not giving up.

10-year yields have significantly retreated in the US last week, in reaction to a near-perfect combination. The message from Jay Powell was that, while the Fed's tightening bias is still there, the bar for another hike is rising. The Treasury announced a tweak in the maturity distribution of its issuance in the next three months towards the front end of the curve. And, finally, the payroll data for October came out of the soft side, with below-trend job creation, a small rise in the unemployment rate and crucially, a further deceleration in wages.

While we might have seen the recent bond market fever breaking, there are limits to the yield retracement. Now that the Fed has explicitly acknowledged the impact of the market-driven tightening in financial conditions in the calibration of its own stance, symmetrically if market rates fall too fast or too far, then the probability the Fed is ultimately forced to hike again would rise. Of course, this would not be needed if the economy continues to soften – and Q4 may well come out as a mediocre quarter. Yet, beyond the cyclical factors, fundamental forces still need to be considered. The Treasury can momentarily ease the pressure on long-term yields by issuing more bills and 2-year notes, but the fact remains that the overall quantum of federal debt will continue to rise, without any clear perspective on a subsequent fiscal consolidation. The behaviour of Japanese investors also needs to be monitored in the light of yet another tweak in the BoJ's Yield Curve Control.

In the Euro area, the October print confirmed that disinflation is in motion, beyond the mechanical base effects on energy and food. The deceleration in the prices of both manufactured goods and services – albeit more timidly for the latter – is reassuring. The cost of this disinflation is getting plainer to see unfortunately: the labour market is softening, even if the deterioration remains contained for now. The ECB hawks have not given up though, and we review here Isabel Schnabel's latest speech.

The right combination

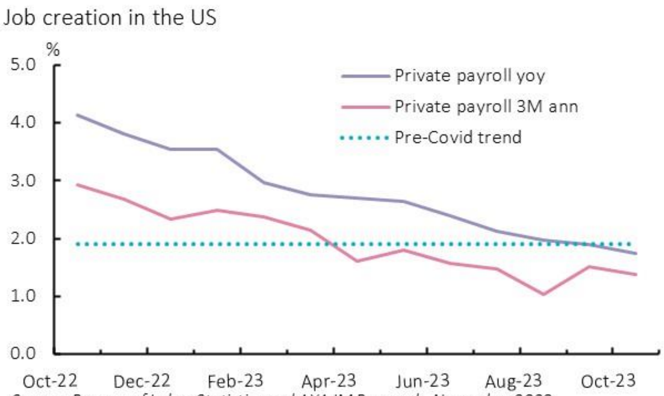
As the policy pause continues, the only major change in the Federal Reserve (Fed)'s statement last week, apart from qualifying economic activity as "*strong*" rather than "*solid*", was the mention of "*tighter financial conditions*" – and not just credit conditions – which made it plain the Fed is taking into consideration the recent steep rise in market rates in the calibration of its policy stance. This was made even clearer in Powell's Q&A. When asked about the September dot plot (which contained one more hike before the end of this year, so by now leaving only December in play), Powell's response on its efficiency "*decaying over time*" was quite telling. While the tightening bias is still there, it seems that the bar for the Fed to hike again is rising, which makes us comfortable with our call that the Fed Funds peak was hit last July.

Yet, in our view the phase of higher long-term yields would have to be durable enough to act as a proper substitute for more Fed Funds hikes. In other words, **the fate of the Fed's pause would be at least partly conditional on what the market does in the coming months**. This would in principle put a floor to a further substantial retracement of long-term rates after the rally of the last few days. If the Fed were to conclude that the market-led tightening is losing too much steam, it would not hesitate to hike further to bring financial conditions to the appropriate level. Since Powell made the point that a more visible economic slowdown – and a deterioration of the labour market – would likely be needed to make sure inflation is vanquished, the "only" question would be whether this landing is driven by market forces or directly by the Fed. We are still in a "no pain no gain" mode.

Yet, **there is a third party to the current tango dancing between the Fed and the market: the data flow.** Indeed, if there is more tangible evidence that cracks are appearing in the so far resilient US economy, then both the market and the Fed could conclude that the accumulated combined tightening so far has gone far enough – or even possibly too far. The central bank could then "live" with long-term yields moving back significantly below the Fed Funds' level.

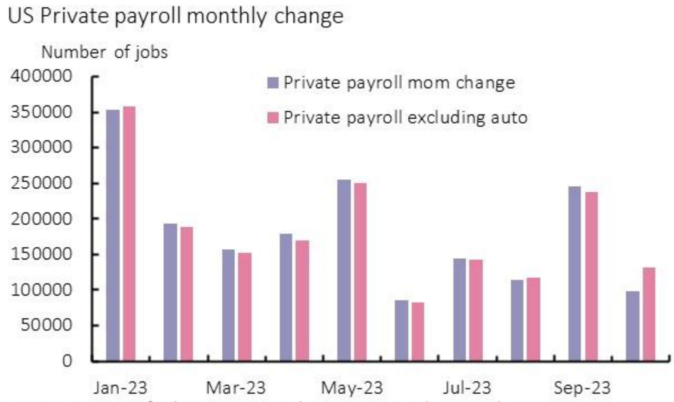
The payroll data for October released last week may have provided just what was needed. On a monthly basis, job creation moderated by more than what the market was expecting, and thanks to net downward revisions to the previous few months, it was back firmly into sub-trend territory (see Exhibit 1). Last month's numbers were to some extent affected by the strike in the auto industry (this sector explained almost the entirety of the job losses observed in manufacturing) but even when controlling for this factor, the deceleration is quite visible: when looking at the monthly changes, even if volatility is as usual massive on this series, a contrast has now appeared between the first and so far the second half of the year (see Exhibit 2).

Exhibit 1 – Below trend (again)



Source: Bureau of Labor Statistics and AXA IM Research, November 2023

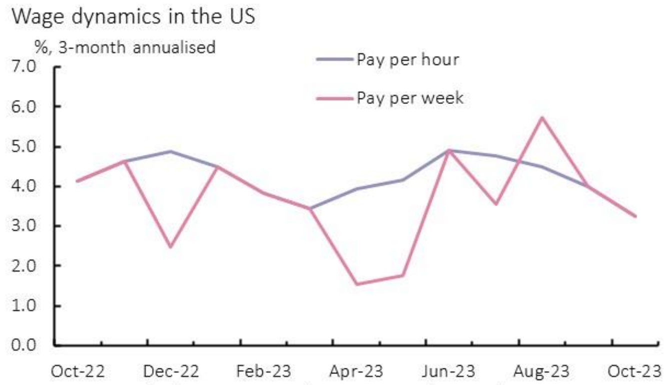
Exhibit 2 – The October softness was not just about cars



Source: Bureau of Labor Statistics and AXA IM Research, November 2023

All the other details of the payroll release pointed to a proper softening of the labour market. The unemployment rate rose 0.1 percentage points to 3.9%, while the market was expecting stability. It is a small move of course, but at least psychologically, the fact that the unemployment rate has increased by 0.5pp since the beginning of the year – a magnitude normally consistent with a recession according to Fed research – probably matters. Providing further support to the idea that the labour market has – finally – started to soften, wages also decelerated, both in hourly and weekly terms (see Exhibit 3).

Exhibit 3 – Wages in the right direction



Source: Bureau of Labour Statistics and AXA IM Research, November 2023

We would however remain prudent. Payroll releases are particularly frustrating because they tend to move the market markedly although **it is one of the most revised – and volatile – macroeconomic series in the US**. We also note that while according to the payroll data wages had already started to decelerate in Q3, the normally more reliable Employment Cost Index (ECI), which controls for the composition changes in the workforce, indicated an acceleration.

In any case, **the decline in US long-term yields – with some significant spill-over on European markets – started ahead of the payroll release, and we suspect that technical factors pertaining to bond supply also played a significant role**. We have explored before how we think investors have become more sensitive to the United States (US) fiscal trajectory and this often materialises in visible reactions to any news on bond supply. The Treasury released on 1 November its Quarterly Refunding Plans, with as usual precise data on issuance per maturity. For the November 2023 - January 2024 period, the US federal government is planning to issue a total of USD917bn in bonds, against USD821bn between June and August, but with a clear skew towards the short-end of the curve (75% of the rise would come from paper with a maturity between 2 and 5 years. Issuance of 10-year bonds would increase by only USD6bn). From a cash-flow management, it makes sense for the Treasury to alter its maturity distribution if it considers that interest rates have peaked: it would make little sense to “lock” too much federal debt for 10-year and beyond at a nearly 5% nominal interest rate. From the market’s point of view, a supply which would grow less than feared on the long end of the curve could indeed trigger some rebound in bond prices on this segment.

We would however note that **such redistribution across maturities of debt issuance does not change the fact that the overall borrowing needs of the federal government remains out of control**, and as we have been arguing for some time, the perspectives on this remain grim given the US political situation.

The behaviour of Japanese investors in response to the Bank of Japan (BoJ)’s tweaking of its policy also deserves to be monitored closely. The central bank continues to move in small increments, but the decision 10 days ago to allow 10-year yields to move “around” 1% instead of enforcing a hard ceiling – while it amounts to a very limited tightening in Japan, considering the recent inflation prints and a still decent real economy – could make the very end of the curve quite attractive to domestic investors when considering the cost of hedging bonds denominated in foreign currencies. True, Japanese entities have been reducing their exposure to the US government bond markets for years. Their share in foreign holdings of Treasuries fell first below that of China during the Great Financial Crisis and then below that of the Euro area a few months ago, but it still stands at 15%, not an unsubstantial number.

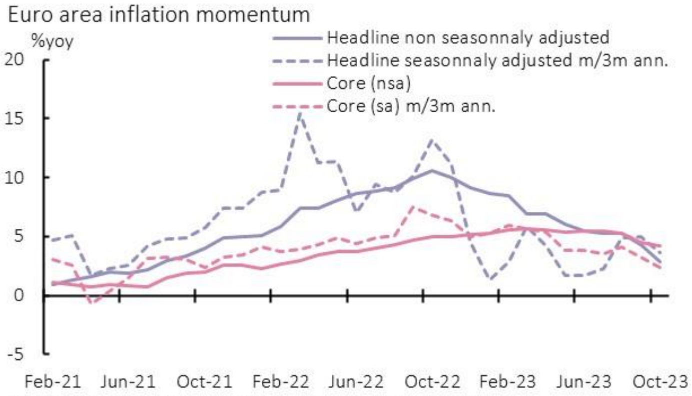
The ECB hawks more resilient than the data

The September inflation print – which already pointed to some tangible deceleration in core inflation - may have helped to tilt the European Central Bank (ECB)’s Governing Council into a more dovish tone at the last meeting. Now, **the October print confirmed – and amplified – the message: disinflation has come in earnest to Europe, which ex post vindicates the ECB’s new-found prudence** we discussed last week.

Base effects are of course helping on the year-on-year comparison, but the momentum is also going in the right direction when looking at the 3-month annualised change for both headline and core (see Exhibit 4). Amid the details provided by Eurostat and the ECB, we would highlight the fact that momentum is fading for both the non-energy industrialised goods and the services components of core (see Exhibit 5). Manufactured goods disinflation started last winter, reflecting the normalisation of supply lines, the overall decline in demand for this type of products since the reopening and quasi-deflation in China, but the good news is that the euro's depreciation is not hampering the process of "imported disinflation" too much, even if it is (logically given the strength of the dollar) more advanced in the US where manufactured goods' prices have been falling for several months.

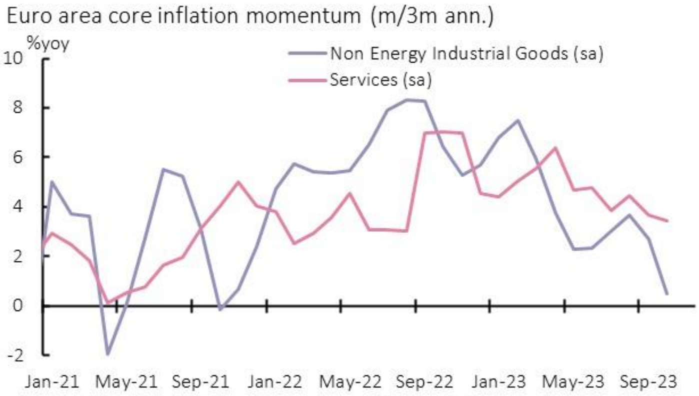
But more fundamentally, **it is the more recent deceleration in services prices which should really move the dial on the ECB's assessment of inflation risks.** This summer, the move could be seen as merely mechanical payback for the rebound seen in the spring, but the slowdown is continuing into the autumn and on a 3-month annualised basis, the growth rate of services prices has hit its slowest pace (3.5%) since August 2023. "Home grown" inflation – on which monetary policy has the most direct impact – is falling.

Exhibit 4 – It's not just about base effects



Source: Eurostat and AXA IM Macro Research, as of October 2023

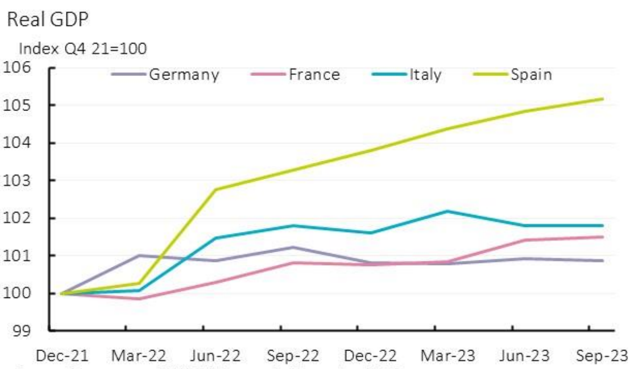
Exhibit 5 – It's no longer just about manufactured goods



Source: ECB and AXA IM Macro Research, as of October 2023

Of course, the current disinflation does not preclude the possibility that a "line of resistance" would be found well above the ECB's target. Yet, the confirmation that the Euro area was flirting with recession last summer reduces this probability. Of course, that GDP fell, albeit marginally (-0.1% quarter-on-quarter) in Q3 is psychologically important, but more fundamentally what we find striking is that over one year, the region has been basically stagnating (0.1% year-on-year). Optimists would argue that it is a decent and unexpected performance given the magnitude of the energy shock slapped at the Euro area. Pessimists - and habitual readers of Macrocast will know in what bucket your humble servant would fall – would focus instead on the fact that months after the peak in energy prices, no sign of recovery has emerged, quite the opposite. Except for Spain which continues to defy gravity, the big economies of the Euro area have all "stalled" by now, even if stagnation has started much earlier in Germany than in France and Italy (see Exhibit 6).

Exhibit 6 – Stalling's the word (except in Spain)



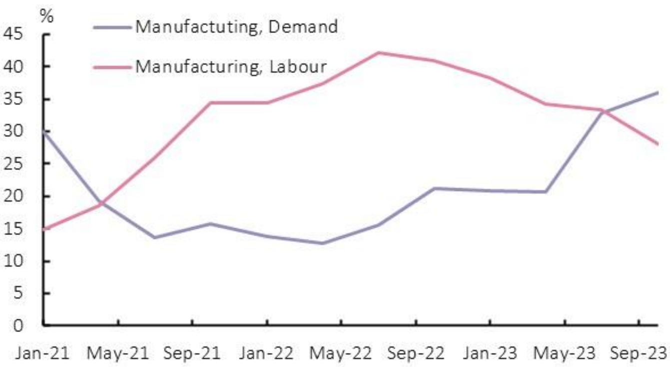
Source: Eurostat and AXA IM Research, November 2023

Eurostat has released last week the unemployment rate for the whole Euro area for September which has risen 0.1pp to 6.5% - just as for the US the market was expecting stability. We would hesitate to read anything in the release though: the unemployment has been oscillating between 6.4 and 6.5% since the beginning of the year. **Our focus is more on Germany, since it is in this country that the "labour market battle" is crucial**, given the recent trends in wage growth there and the status of the Bundesbank as the natural leader of the hawkish camp at the ECB. The October data for joblessness by the Employment Agency in Germany (a different measure from the ILO-consistent one which is used by Eurostat to compute the EU unemployment rate) confirmed that the labour market is not immune to the general malaise in the economy. In seasonally adjusted terms, the number of unemployed people rose by 30K month-on-month, and 165K over one year. The "unemployment halo", adding people loosely attached to employment, rose by 191K year-on-year. The Employment Agency mentioned that the inflow of Ukrainian refugees contributed 69K to this rise in the "halo", which still leaves quite a lot of space to more endogenous force. With employment prospects deteriorating, wage pressure should gradually diminish.

The evolution in employees' bargaining power can be proxied by looking at how demand and labour shortage affect production. In manufacturing, there is now no ambiguity: the latest European Commission quarterly survey (October) shows that for the first time since 2021, the impact of deteriorating demand prospects on production is outweighing that of hiring difficulties (see exhibit 7). The gap has not yet closed in the services sector, which has been better protected from the worst of the headwinds facing the Germany economy, but it has been narrowing (see Exhibit 8).

Exhibit 7 – Supply/demand lines have crossed in manufacturing

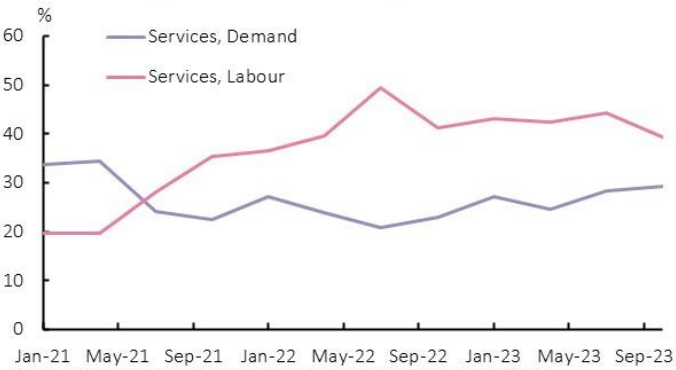
Factors limiting production in Germany



Source: European Commission and AXA IM Research, November 2023

Exhibit 8 – Gap is closing in services

Factors limiting production in Germany



Source: European Commission and AXA IM Research, November 2023

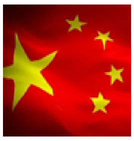
Two weeks ago, Christine Lagarde batted away any question of rate cuts, but we suspected that this issue would now dominate the debate. We did not have to wait for long. National Bank of Greece Governor Stournaras was the first to openly discuss it, to the point that he provided a tentative and conditional timing – the middle of next year (which is our baseline) – provided inflation stabilises by then "below 3%". This implicitly advocates a forward-looking version of monetary policy which takes lags into consideration to calibrate its stance. In clear, waiting for inflation to reach 2% before cutting rates would be "overkill".

There is no doubt in our mind that the current dataflow is clearly favouring the doves, but **the hawks are far from having given up the fight. Isabel Schnabel's latest speech probably "sets the stall" for their line of argumentation** in the months ahead.

Beyond a discussion of the inflation risks – focusing on the possibility of second-round effects from wages – the most interesting aspects of her paper were, in our opinion, her approach of monetary transmission and the sensitivity of the economy to the ECB signals. While Isabel Schnabel acknowledged how banks have swiftly transmitted the central bank tightening to their own clients, she also highlighted the fact that – until recently – term premia had remained modest on the bond market, while credit spreads had not widened significantly. She also pointed to the shift of the economic structure of the Euro area away from capital-intensive industries, which are by construction very sensitive to interest rates, to more labour-intensive sectors. Using data from the ECB's telephone survey of the non-financial survey, she highlighted that only a quarter of the businesses in the services sector consider that the ongoing financial tightening has already had an impact on their activity level. This may call for a higher quantum of tightening to walk the "last mile" and bring inflation back to 2%.

We are not convinced. As much as a lack of "broad" monetary policy transmission – i.e. encompassing non-bank funding, with a focus on corporate bonds – would be problematic in the US, in the Euro area the "narrow" channel should be sufficient there, given the dominance of intermediated credit, to bring about the right magnitude of tightening to the whole economy – and the recent data on this issue points to significant adverse developments on credit flows. The decline in sensitivity to interest rate changes is a more powerful argument in our view. Yet, the signs that the whole of the Euro area economy is softening – and not just the manufacturing sector – are now plain to see. True, the weakness in consumption may not – yet – essentially reflect the monetary tightening, but what matters is that, irrespective of the underlying reasons, it should gradually force businesses into reducing their margins.

Of course, we cannot exclude that once Euro area inflation has reached 3%, it will prove difficult to get much further, but equally, we do not see the logic in deciding *now* that the monetary stance needs to get even tighter. This in our view is a discussion for well into next year. For now, evidence points to the ECB having done enough – and possibly even too much already.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• FOMC left policy unch, FFR at 5.25-5.50%, Powell suggested data-dependent, meeting-by-meeting • Labour market (Oct), payrolls 150k from 297k, unemp rose to 3.9% and earnings rose 0.2%mom • ISM mfg (Oct) 46.7 from 49.0, new orders 45.5 • Conf Bd cons conf (Oct) 102.6 – lowest since May • Yields fell sharply from 4.93% after Fed meeting	• Michigan survey (Nov, p) consumer sentiment likely to weaken, SR inflation expect's have been volatile • Consumer credit (Sep) August saw a fall, watch for gains to help explain Sept's consumer spending • Jobless claims have risen in latest weeks although overall level remains low
	• Headline inflation (Oct) dropped to 2.9%yoy with huge energy and food base effects. Core also dropped but was more resilient (4.2%yoy, -0.3pp) • EMU GDP growth (Q3) turned slightly negative (-0.1%qoq). Ge and It performed poorly (-0.1% and +0%). France has done slightly better (+0.1%) • EC surveys (Oct) are stable but remain depressed	• German industrial output and orders (Sep) • EMU Retail sales (Sep) • Final HICP data. Worth to watch details on French and Italian services prices (which were respectively on rise and flat) and gas/electricity prices in Germany
	• BoE held rates at 5.25% and signaled an extended hold. Nov MPR kept upside skew to inflation forecasts and saw growth broadly flat to end 2024 • PMI (Oct) remains weak 48.7(comp) in line with flash • CBI industrial trends (Q4) signals continued weakness in manufacturing sentiment	• BRC Retail sales monitor (Oct) • RICS residential market survey (Oct) housing market remains weak, but has shown signs of stabilization • Monthly GDP (Sep) likely to post a decline leaving Q3 flat overall • Trade balance (Sep)
	• BoJ once again loosened YCC, now seeing 1% yields as a loose reference, rather than firm cap. • PM Kishida announced ¥17tn ($113bn) stimulus of which ¥13tn to be funded by a supplementary budget	• Flash PMIs (Oct) • HH spending data (Sep) • Reuters Tankan Index (Nov) • Current account/ trade balance (Sep)
	• NBS PMIs (Oct): Mfg 49.5 (Sep: 50.2); Non-mfg 50.6 (Sep: 51.7) • Caixin PMIs (Oct): Mfg 49.5 (Sep: 50.6); Services 50.4 (Sep: 50.2)	• Tue (7 Nov): Exports & Imports (Oct) • Thu (9 Nov): PPI & CPI (Oct) • 10-17 Nov: Credit data (TSF, M2 supply, new loan, FDI) (Oct)
	• CB: Colombia (13.25%), Czechia (7.0%) & Malaysia (3.0%) stood on hold. Brazil cut 50bps to 12.25%. • October inflation (yoy) fell in Peru (4.3%), Poland (6.5%) & Turkey (61.4%). It rose in Korea (3.8%) & Indonesia (2.6%) • Q3 GDP (yoy) gained steam in Taiwan (2.3%). It decelerated slightly in Mexico (3.3%) & contracted in Czechia (-0.6%)	• CB: Mexico (11.25%) & Romania (7.0%) are expected to stay on hold. Peru to cut -50 bps to 6.75% & Poland to cut -25bps to 5.5% • Q3 GDP data in Indonesia & Philippines • Inflation (Oct): Chile, Czechia, Hungary, Mexico, Taiwan, Thailand, Philippines & Poland • Industrial production (Sep): Hungary, India, Malaysia, Mexico & Turkey

Upcoming events		
	US:	Tue: Trade balance (Sep); Wed: Wholesale inventories (Sep); Thu: Weekly jobless claims (4 Nov); Fri: Michigan consumer sentiments & inflation expectations (Nov)
	Euro Area:	Mon: Ge New manf orders (Sep), Ge,Sp,It,Fr & EA Services PMI (Oct), EA Composite PMI (Oct); Tue: Ge & Sp Industrial production (Sep), EA PPI (Sep); Wed: Ge HICP (Sep), EA Retail sales (Sep)
	UK:	Mon: SMMT new car reg (Oct), Constructions PMI (Oct); Tue: BRC Retail sales monitor (Oct); Thu: RICS Housing survey (Oct); Fri: Monthly GDP (Sep), Construction output (Sep), Index of services (Sep), Industrial production (Sep), Manf output (Sep), Quarterly GDP (Q3), Business investment (Q3), Private consumption (Q3), Trade balance (Q3), Trade in goods (Sep)
	Japan	Wed: Leading index (Sep), Current acc balance (Sep), Trade balance (Sep); Thu: Economy Watchers survey (Oct)
	China:	Tue: Exports (Oct), Foreign exchange reserves (Oct), Imports (Oct), Trade balance (Oct); Thu: CPI (Oct); Fri: M2 Money supply (Sep), New yuan loans (Sep)

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

About AXA Investment Managers

AXA Investment Managers (AXA IM) is a responsible asset manager, actively investing for the long-term to help its clients, its people and the world to prosper. Our high conviction approach enables us to uncover what we believe to be the best global investment opportunities across alternative and traditional asset classes, managing approximately €840* billion in assets as at the end of June 2023.

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.

At end of December 2022, AXA IM employs over 2,600 employees around the world, operates out of 24 offices across 18 countries and is part of the AXA Group, a worldwide leader in insurance and asset management.

** Includes the contribution from Architas and AXA IM Prime, net of intercompany elimination.*

Visit our website: http://www.axa-im.com
Follow us on Twitter: @AXAIM & @AXAIM_UK
Follow us on LinkedIn: https://www.linkedin.com/company/axa-investment-managers
Visit our media centre: www.axa-im.com/en/media-centre