AXA Investment Managers

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Investment Institute Macroeconomics

A Conversation about the Conversation

- We think the ECB will admit the conversation has started on cutting, but we do not expect a clear timeline. June is still our base case for the first cut.
- There might be green shoots of recovery in global manufacturing, but the signals from China remain uncertain.
- In the US, the January CPI worried us. The PCE version of core inflation did not reassure us.

Many members of the ECB Governing Council have already taken to the wires to opine on cutting rate, so it is unlikely in our view that Christine Lagarde will deny this week that the conversation has started internally. The council is however probably too divided – with varying degrees of patience – for her to embark on a precise discussion of the timeline. The recent dataflow did not send a clear signal. Core inflation fell less than expected in February and the three and six-month momentum suggests a re-acceleration may be ongoing. Yet, the doves can take comfort in the fact the negotiated wages decelerated in Q4 2023 for the first time since the spring of 2022, and they can easily point to the weakness in the real economy to argue against wasting time. The hawks however can argue that the credit impulse has improved lately. We expect the new forecasts to maintain ambiguity and we continue to think that the first cut will come in June.

The lack of momentum of the Euro area economy is to some extent a product of the weakness in the manufacturing sector at the global level. Even in the otherwise stellar US economy, the latest ISM index in manufacturing was deep in contraction territory. We look however to the recent rebound of export orders in Taiwan – still the world's key producer of chips - for early signals of a turnaround in global manufacturing. Still, we think that to solidify a proper recovery more Chinese traction would be needed. The cut in the 5-year LPR rate by the PBOC was an encouraging step, but how the central bank's signals will be transmitted remains uncertain.

Finally, we explore again the inflation dataflow in the US. Two weeks ago, we expressed our concerns over the January core CPI print. The PCE version did not reassure us. The "last mile" of disinflation is decidedly arduous.

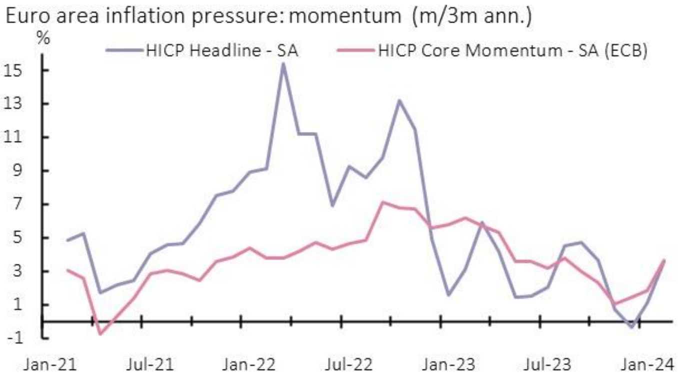
ECB: accepting a "conversation about the conversation"

An issue for Christine Lagarde this week is that the debate on cutting rates has already started in a very public form, with quite a few members of the Governing Council taking to the wires to air their views. This will make it very difficult for the European Central Bank (ECB) President to kick the ball in the long grass and completely refuse to engage in a "conversation about the conversation" which is needed ahead of the first rate cut. Yet, **the Governing Council is at this stage probably too divided for her to go beyond an admission that the internal debate has started and engage in a precise discussion on timing.**

In any case, the ECB conference is facing little immediate pressure from the market, which has withdrawn any expectation of a cut next week. Even the April meeting, which was seen as very much in play in the forwards pricing only a few weeks ago, is no longer seen as "live", as only about 5 basis points worth of cuts are now priced in, against a peak at 19bps on 7 February. **We wrote a month ago that a cut before June was not unthinkable but would take a "perfect" data flow to materialise, with crucially a steady decline in core inflation. The least we can say is that the dataflow is not helping in that regard.**

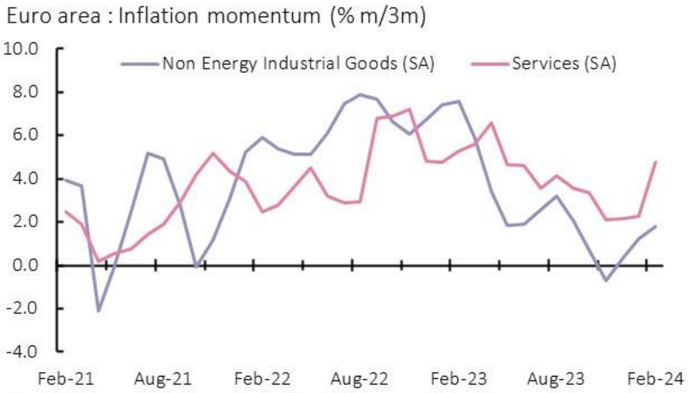
Core inflation fell further to 3.1% year-on-year in February against 3.3% in January, but the market was counting a much more convincing easing to 2.9%. On a 3-month annualised basis, core prices re-accelerated substantially to exceed again the ECB's 2% target (see Exhibit 1). Unfortunately, this cannot be ascribed to an isolated sector. Keeping the same 3-month annualised basis, the price of both services and goods re-accelerated (Exhibit 2). Although the ECB may not – and probably should not - have to wait until inflation goes back completely to 2% before accommodation comes, a re-acceleration would be much more difficult to condone.

Exhibit 1 – Price momentum up….



Source: European Central Bank and AXA IM Research, March 2024

Exhibit 2 – … in services and manufacturing



Source: European Central Bank and AXA IM Research, March 2024

Fortunately, it is not all bleak on the European inflation front. Negotiated wages in the Euro area slowed down in Q4 2023. Their pace remains too high of course – 4.7%yoy – especially in a region without any productivity gains and the deceleration from Q3 was small (0.2 percentage point) but this was the first easing since the spring of 2022. True, it is often the negotiation from Q1 which set the tone for the entire year and the Governing Council is likely to still want to see confirmation of this deceleration in real time indicators, if not in the negotiated wage index for Q1 which will come only in time for the June meeting. Yet, there is probably enough there for the ECB to muscle up further the assessment of the extent to which its policy is already working its way through the economy.

The latest print of the European Commission survey does not point to any improvement in the real economy of the Euro area. We like to focus on the forward-looking components. In the services sector, expected demand had started to rebound in the spring of next year. This has unfortunately stalled in January and declined markedly in February (see Exhibit 3). True, employment expectations have been more resilient, and their level is still significantly higher than their pre-Covid average (we use 2010-2019 as reference), but there might be the beginning of an erosion emerging. The picture for manufacturing is worse. One can find some comfort in the fact that orders have seemingly stabilised, but they have been standing below their pre-Covid average since the spring of 2023. Employment expectations in the sector continue to deteriorate and they crossed the 2010-2019 average line last summer (see Exhibit 4).

Exhibit 3 – Relapse in business confidence in the services

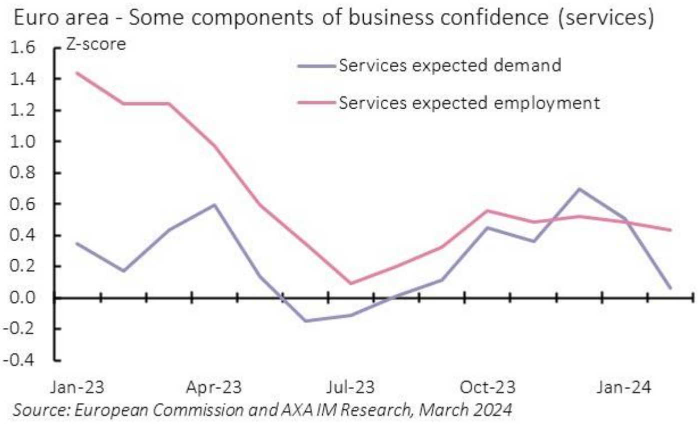
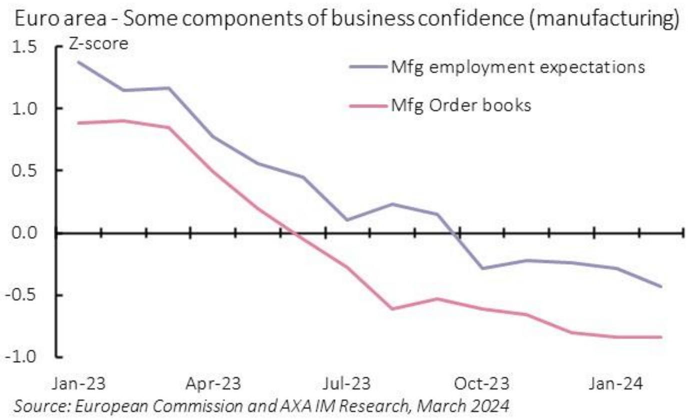
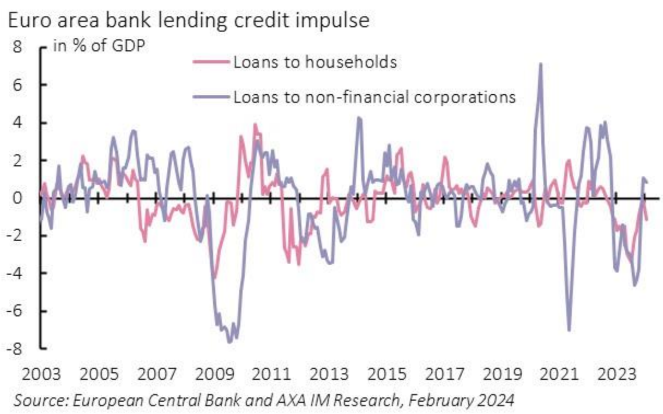


Exhibit 4 – Further below trend in manufacturing



If you really feel ready to take a microscope and find some tiny traces of improvement on the real economy front, the flows of credit might be the only place to look. We use here the concept of "credit impulse" made popular by Deutsche Bank in the post-Great Financial Crisis days. For a long time after 2008 flows of new loans were still negative – the corporate sector was busy deleveraging and was paying back more debt than it took more loans – which was causing alarm. Yet, the second derivative, the *change* in these negative new loan flows became positive quickly (deleveraging was getting less intense), which was consistent with GDP growth turning up as well (GDP growth is also a "second derivative": it is the change in a *flow* of output). **Today in the Euro area, while the credit impulse for households is still negative, it has turned slightly positive for businesses** (see Exhibit 5). We would urge caution though. As our graph plainly suggests, the credit impulse can be very volatile, and we would be surprised that it would turn so rapidly after the last instalment of monetary tightening in September 2023.

Exhibit 5 – Credit impulse no longer collapsing



The piece de resistance of this week's ECB press conference may well be the revised forecasts. We expect them to lay the ground for a cut which we still expect in June, but with enough ambiguity left to keep options open on timing and offer enough space for a more straightforward macroeconomic message in the June batch. To be more precise, we expect a downward revision in the GDP forecast for 2024 by 0.2-0.3pp from 0.8%yoy in the December batch (getting closer to our own projection at 0.3%), but without much impact on the following years (the ECB was expecting 1.5% for 2025 and 2026, slightly above potential). The employment side of the projections will be key. We expect the ECB to still forecast poor productivity gains ahead, rather than a steep decline in employment, which will maintain upward pressure on unit labour costs. Consequently, **we do not expect a significant revision to the overall inflation trajectory beyond some downward adjustment to the projection for 2024**.

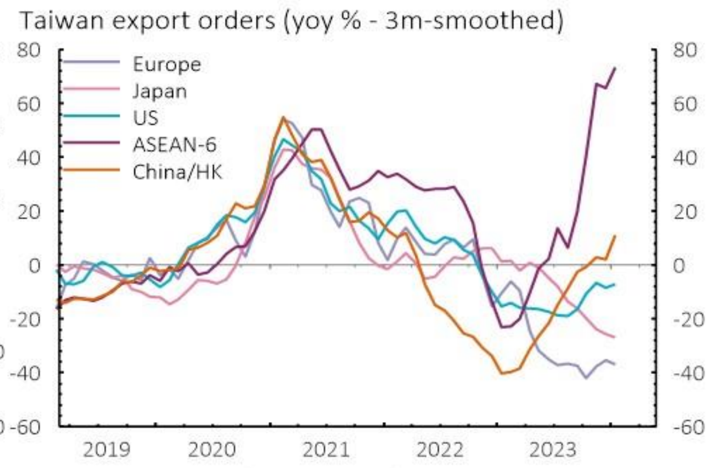
We think the big change on the macro narrative will more likely come in the June batch to coincide with the first rate cut. By then, the ECB will have received some key data. The March print for consumer prices – the only additional one the Governing Council will get when they meet again in April - could be artificially boosted by an unusually early Easter break this year. The April and May releases may be more reliable to gauge the chances of a swift return to 2%. This a strong reason in our view to expect the move in June only.

News from the global manufacturing cycle

The weakness of the global manufacturing cycle has been a key hurdle for the Germany economy, with diffusion effects to the rest of the Euro area. This was partly a normal mean reversion after the massive shift of global consumption towards manufactured products during the pandemic and as such, just as mechanically, some rebound is due. Yet, from existing business surveys in the developed world, it is difficult to detect any green shoot of recovery – the ISM index for the US industry released last week does not point to any more positivity than the European Commission survey we commented earlier in this note. **Still, we turn our attention to factory orders in Taiwan to get a sense of whether some improvement is in the pipeline.** Indeed, as the world's still biggest producer of chips, increased shipments from Taiwan to the rest of the world could be a forward-looking indicator of a rebound in global manufacturing activity. The series can be noisy, but after a year and a half of contraction, it seems that export orders have started to normalise (see Exhibit 6). For now, most of the traction comes from intra-ASEAN demand (see Exhibit 7).

Exhibit 6 – Finally turning positive?

Exhibit 7 – ASEAN demand the key contributor



While these very green shoots of recovery are good news, we think that **for a proper turnaround of the global manufacturing cycle, a decisive rebound in continental Chinese demand is necessary**. The geographical breakdown of Taiwanese export orders suggest traction from the continent is getting slightly positive but remains very far from having fully recuperated from last year's deep decline.

Habitual readers of Macrocast will be familiar with our view that such decisive rebound is unlikely without a significant shift in the People's Bank of China (PBOC)'s monetary policy stance against a background of increasingly entrenched deflation. From this point of view **the central bank's decision on 20 February to cut by 25bps its 5-year Loan Prime Rate (LPR) is a step in the right direction**. At 3.95%, its level remains high in regard of the decline in consumer prices (-0.8%yoy in January), but what makes the move striking is that the PBOC chose at the same time to keep its 1-year LPR rate unchanged at 3.45%.

A willingness to protect banks' interest margin is often mentioned among the explanations to the PBOC's reluctance to engage in all-out accommodation. By construction, this asymmetric move is going to weigh on banks' transformation margins. This would be a positive development in our opinion since we have always considered that the financial position of banks should not be a key factor to ponder when loosening monetary policy. We also find it positive that the PBOC chose to add another layer of accommodation while the exchange rate was already under renewed downward pressure (the rebound of November and December was already losing momentum in January. In a state of deflation, allowing the currency to weaken is part of any textbook prescription and it is probably a favourable development for domestic demand that the central bank chooses to sacrifice at least temporarily its long-term objective of offering FX stability to cement the Yuan's role as a reserve currency.

Exhibit 8 – Questions about transmission

Source: CEIC and AXA IM Research, February 2024

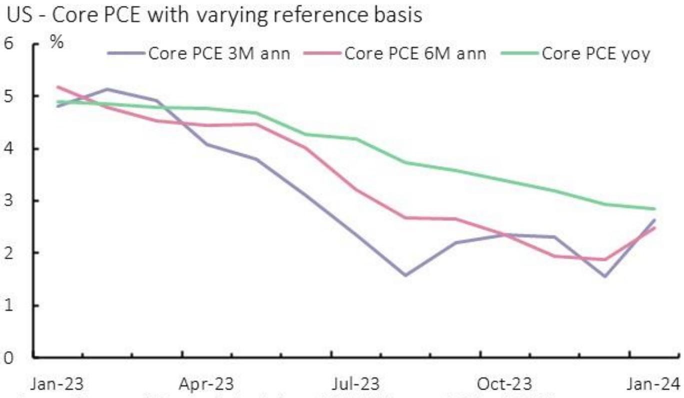
The 5-year LPR is widely used as an anchor for mortgage rates and the 1-year rate for lending to corporations. We have our reservations on tailoring the monetary impulse across sectors, but in the current circumstances in China, boosting the property market makes a lot of sense. **Transmission however could be the issue.** In Exhibit 8, we compare the LPR rate with actual mortgage rates (i.e., measured at the point of retail). We could not find up to date data beyond 2021 for the latter, but the rebound in mortgage rates in 2021 despite the stability of the monetary policy stance at the time illustrates that there is not necessarily a mechanical transmission of the PBOC signals. We will monitor very closely the housing-related dataflow in China in the months ahead for evidence that accommodation is effectively working its way through the economy.

US PCE not more reassuring than CPI

When the concerning US Consumer Price Index (CPI) print for January came out – the quite regular decline in core inflation had stopped even in year-on-year terms – Chicago President Austan Goolsbee stated that a lot of those concerns would disappear once the Personal Consumption Expenditures (PCE) version of core inflation – favoured by the Federal Reserve (Fed) – would come out. We had our doubts, and we think the details of the PCE release vindicate us.

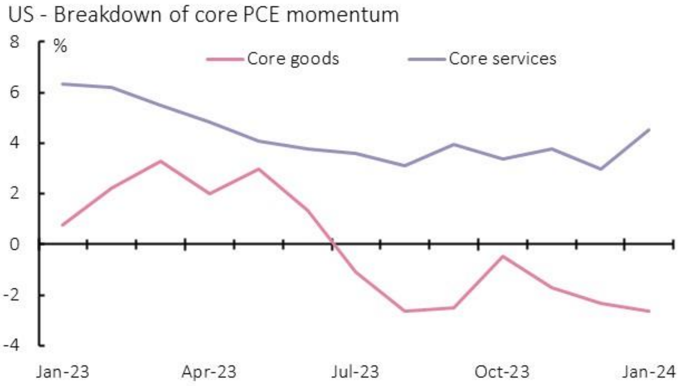
True, **core PCE slowed down further in January in year-on-year terms (from 2.9% to 2.8%), but when controlling for base effects from early 2023, a more problematic image emerges**. In Exhibit 9, we compute the change in the core PCE on a three and six-month annualised basis on top of the usual year-on-year. Those two "alternative" measures both rose in January. It was tempting to dismiss the CPI reading because of the strong contribution from rents, which have a much smaller weight in the PCE. Yet, rents were only part of the story and when looking at the short-run momentum, services PCE accelerated in January, as we expected (see Exhibit 10). We do not want to over-state one monthly reading, but this is another reason for the Federal Open Market Committee (FOMC) to take its time before embarking on accommodation.

Exhibit 9 – Momentum up for core PCE



Source: Bureau of Economic Analysis and AXA IM Research, March 2024

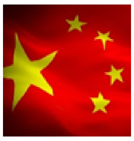
Exhibit 10 – Re-acceleration in services prices



Source: Bureau of Economic Analysis and AXA IM Research, March 2024

The main risk we see is that the market goes "all the way" and stops believing in any rate cut at all in 2024. As much as we disagreed with the "quick and massive" cuts priced in by the market until the Christmas break, **we are getting concerned with the fact that even the June cut is no longer strongly anchored** (only 17bps priced immediately after the PCE release). In our view, for the Fed not to accommodate at all this year, the US economy would have to remain so "red hot" that inflation pressure would remain completely unabated. We think there may be good reasons to think that trend growth has improved in the US thanks to strong productivity gains, but this will not fully protect cyclical conditions from the impact of policy restriction. "At some point" the monetary tightening should still work its way to domestic demand, even if businesses have lengthened the maturity of their debt during the long phase of low interest rates.

This may not have yet materialised – the latest real time data on the labour market remains decidedly upbeat – but at least **the less than stellar start of the year for consumer spending may help keep market expectations geared towards some accommodation**. Indeed, private consumption fell by 0.1% month-on-month in January, driven mostly by a steep decline in purchases of durable goods (-2.1%mom). It probably was mere data randomness – consumers already took breathers, with spending contracting twice in 2023 on a monthly basis, without breaking the still strong trend, but anything in the current configuration acting as a reminder that this incredibly elongated upswing with find its limits is probably welcome. Last Friday the release of the ISM survey for February in manufacturing also helped. New orders fell below the expansion threshold at 49.2, down from 52.5, and the employment component fell further into contraction, down to 45.9 from 47.1 in January. We are unimpressed because we want to see the much more relevant services sector also softening – the ISM for this sector will come out on Tuesday – and for now the market still expects a reading in expansion there. Still, by Friday night the forwards were back to pricing a nearly full 25bps cut in June (24bps to be precise).

Country/Region	What we focused on last week	What we will focus on in next weeks
	• GDP (Q4, r) revised to 3.2% (saar) from 3.3%, but firmer consumption offset weaker inventory • PCE inflation (Jan) slowed to 2.4% from 2.6% (core to 2.8% from 2.9%), but core mom a 12m high • Personal income (Jan) surprised, up 1.0%, spending soft 0.2%, but saving rate still low 3.8% (from 3.7%) • Conf Bd cons expects (Feb) fell back below 80	• President Biden State of Union address • Super Tuesday – 15 US State Primaries • Powell semi-annual testimonies to Congress • Payrolls (Feb) to slow after strong Jan. Broader emp to recover. AHE after strong +0.6%mom gain in Jan • JOLTS (Jan) expect vacancies to fall after last 2 gains • Fed's Beige Book – underlying growth trends
	• Euro area inflation decelerated less than expected in February to 2.6%yoy, notably owing to increased momentum across core subcomponents • European Commission survey suggested eurozone broad stagnation to continue	• ECB meeting is likely to be decision free – depo rate to remain at 4%. Following sharp market repricing towards our expectation of a rate cut in June, we expect President Lagarde to strike a broadly neutral, data-dependent tone • Eurozone Final Q4 GDP revision and employment details
	• Mtg apps (Jan) rose to 55.2k – a 15m high – but mtg lending fell £1.1bn – sharpest in 9m • Natwd HPI (Feb) +0.7%mom in Jan & Feb • Manu PMI (Feb, f) revised up to 47.5 (from 47.1) • BRC price index (Feb) fell to 23m low	• Budget. Chx expected to extend fuel duty freeze and cut personal tax rates in bid to boost govt approval ratings. Overall finances outlook bleak • RECS/KPMG jobs survey (Mar), in lieu of official stats • Services PMI (Feb, f) – solid prel reading of 54.3
	• CPI inflation (Jan) 2.2% (from 2.6%), ex fresh food & energy to 3.5% (3.7%), less decline than expected • Industrial production (Jan, p) -7.5%mom • Unemployment (Jan) dips to 2.4% from 2.5%	• Tokyo CPI (Feb) guide to Feb national measure • Capital spending (Q4) outturns and broader national aggregates of company sales and profit • Leading index (Jan, p)
	• NBS mfg PMI (Feb): 49.1, down by 0.1ppt from Jan, affected by the lunar new year holiday break; Non-mfg PMI: 51.4, up by 0.7ppt • Caixin mfg PMI (Feb): 50.9, up by 0.1ppt from Jan	• 5 Mar: Caixin non-mfg PMI mfg (Feb) • 7 Mar: Exports and imports (Feb) • 9 Mar: CPI and PPI (Feb)
	• CB: Hungary cut -100bps to 9.0% as expected • Feb CPI (yoy): Indonesia (2.8%) • Q4 GDP (yoy): India (8,4%), Taiwan (4.9%) & Turkey (4.0%) • Jan industrial production (yoy): Russia (4.6%), Taiwan (16%) & Thailand (-2.9%)	• CB: Malaysia (3.0%) & Poland (5.75%) are expected to stay on hold. Peru to cut -25bps to 6.0% • CPI (Feb): Chile, Colombia Hungary, Mexico, Turkey & Philippines • Q4 GDP: Romania & South Africa • Industrial production (Jan): Brazil, Korea & Hungary

Upcoming events	US:	Tue: Super Tuesday (15 State Primaries), services PMI (Feb, f), ISM non-mfg (Feb), factory orders (Feb); Wed: Powell semi-annual testimony to House, ADP survey (Feb), JOLTS survey (Jan); Thu: Powell testimony to Senate, jobless claims, trade (Jan), productivity (Q4, r); Fri: President Biden State of Union address, labour report (Feb).
	Euro Area:	Tues: Services PMI (Feb, p), EZ PPI inflation (Jan), Fr IP (Jan), It GDP (Q4, r); Wed: EZ retail sales (Jan); Thurs: ECB announcement and press conf, Ge mfg new orders (Jan), Sp IP (Jan); Fri: EZ GDP (Q4, r), EZ employment (Q4), Ge IP (Jan), Ge & It PPI inflation (Jan)
	UK:	Tue: BRC retail sales (Feb), services PMI (Feb, f); Wed: Budget, construction PMI (Feb); Fri: RECS/KPMG labour surveyjapan
	Japan:	Mon: capital spending (Q4); Tue: Tokyo CPI inflation (Feb); Wed: services PMI (Feb, f); Fri: leading indicator (Jan, p)
	China:	Tue: Caixin non-mfg PMI (Feb), start of NPC; Thu: Exports and imports (Feb); Sat: CPI and PPI (Feb)

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

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AXA Investment Managers (AXA IM) is a leading global asset manager offering a diverse range of global investment opportunities in both alternative and traditional asset classes. Through our products we aim to diversify and grow portfolios, while delivering long-term investment performance and value for clients.

AXA IM manages approximately €844 billion in assets, of which €480 billion are categorised ESG-integrated, sustainable or impact as at the end of December 2023. We are committed to reaching net zero greenhouse gas emissions by 2050 across all eligible assets, and to integrating ESG principles across our business, from stock selection to our corporate actions and culture.

Part of the AXA Group, a worldwide leader in insurance and asset management, AXA IM employed over 2,700 employees and operates from 23 offices in 18 countries globally at end of December 2023

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