206 – 11 December 2023

Investment Institute Macroeconomics

No Early Christmas Break for Central Bankers

- We expect Jay Powell and Christine Lagarde to push back against "early cuts" narratives
- The BoJ is preparing minds to normalisation, even if prudence still prevails. The global ripples could be significant

Even central bankers may want to believe in Santa Claus sometimes, and after four gruelling years – moving from another episode of extraordinary intervention to the steepest tightening in decades – they could be forgiven for hoping to descend slowly into the festive break torpor without having to say much in their December meetings. Alas, the world is not often kind to them, and their last policy communication of the year is taking place amid aggressive expectations from the markets for significant cuts quite early in 2024, at least for the Federal Reserve, the ECB, and the Bank of England, which they can't completely ignore.

We focus here on the first two institutions. Jay Powell will probably try to steer the market towards more prudence, in line with his last public statements. We think the Fed will use its updated "dot plot" to signal to the market that, indeed, cuts are coming, but not as many as what is currently priced. While a move in early spring rather than in June – our baseline – is gaining in plausibility, we fail to see what the upside for the Fed would be to give a nod to the current market pricing while the economy remains strong enough to keep inflation risks alive. The ECB does not have an equally simple communication tool at its disposal, and the big difference with the Fed is that the real economy in the Euro area is in a much worse state. We think Christine Lagarde will be able to use the new forecasts to signal that, while hikes are no longer on the table – even hawks such as Isabel Schnabel have given up on that option – it will take until 2025 to get inflation back to target, a prospect which does not warrant early cuts.

While the bond market in the US and Europe remains of course tuned to even minute change in the communication of the Fed and the ECB, potential moves by the Bank of Japan are getting increasingly relevant. The market is now considering that the BoJ meeting on 19 December could be "live". We stick to our view that the BoJ will wait until April as it will want to tread carefully amid mixed domestic data while it needs to take on board the ramifications of tightening when the western central banks would be about to cut. Still, the BOJ is indeed preparing minds.

Talking to the markets

The two most important central banks of the Western world were probably hoping they could glide gracefully into the festive season with a perfunctory, "nothing more to tell you" December meeting. Yet, while we do not expect any hard announcement from the Federal Reserve (Fed) and the European Central Bank (ECB) nor a massive change of communication, it will be difficult for Jay Powell and then Christine Lagarde to completely ignore the dramatic shift in the monetary policy trajectory now expected by the market. Some of the dataflow is undeniably lending itself to dovish expectations, and some measure of acknowledgement from the two central banks is warranted, but we still expect a pushback against the latest market pricing. **Managing communication will be perilous. We think however that Jay Powell's job will be easier than Christine Lagarde's.**

Let's start with the Fed. The latest public words from Jay Powell left little doubt on his preference for stable messaging from the Federal Open Market Committee (FOMC). On 1 December, the chairman of the FOMC stated that "*it would be premature to conclude with confidence that we have achieved a sufficiently restrictive stance, or to speculate on when policy might ease…We are prepared to tighten policy further if it becomes appropriate to do so*." That Powell was still ready to float the idea that the Fed is not "done" and could still hike further – which was still in the 1 November statement of the FOMC with its reference to "*additional policy firming that may be appropriate*"- should be seen as an attempt to steer the markets away from overly "brave" bets rather than a real possibility.

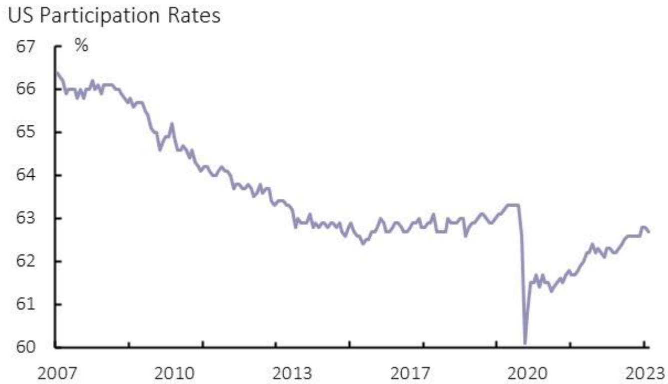
Given what all recent FOMC speakers have said recently however, the "one last rate hike" narrative has rapidly faded. When to cut is now the centre of the debate, and there is a point at which an empty threat becomes harmful to a central bank's credibility. Yet, **none of the speakers have argued for an *imminent* reduction in the Fed Funds rate**. Dropping the reference to further firming in the December statement would need to be balanced by firm rhetoric to avoid the market getting further into exuberant mode.

The "high for long" narrative is easy to maintain in the United States (US). Indeed, while disinflation is progressing, the resilience of the real economy remains for now unabated. The labour market is softening, but still very gradually. We don't think last week's payroll release changes the scenario. Job creation rebounded in November on a monthly basis, but when controlling for the gyrations in the car industry due to the strikes, it was in fact stable. On a three-month annualised basis, employment growth continues to be below trend (1.3% in November against 1.9% on average between 2010 and 2019) but this is still very far from contraction. The unemployment rate fell back from 3.9% to 3.7%. Average earnings picked up a bit (3.3% annualised over three months against 3.0% in October).

Exhibit 1 – Still some way to go

Source: Refinitiv and AXA IM Research, December 2023

Exhibit 2 – They haven't all come back!



Source: Refinitiv and AXA IM Research, December 2023

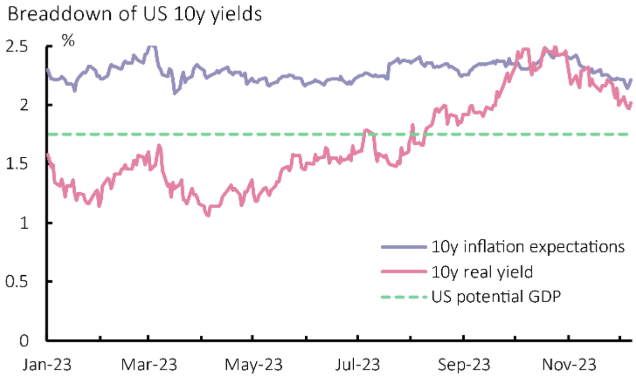
The market saluted the previous week's reduction in job openings to their lowest level in two years but when taking a step back, there is still more than enough underlying tension on the US labour market to justify some prudence from the Fed. The job openings and quits rate are only gradually converging back to the pre-Covid level, and while the participation rate continues to improve, it is still not fully back to a 2019 level which was already low by historical standards (see Exhibits 1 and 2). True, the rebound in productivity has taken unit labour costs down (-1.2% annualised in Q3 2023), and this augurs well for the continuation of disinflation, but we fail to see what the upside for the Fed in would be declaring victory just yet and prepare minds for an imminent change of stance. In any case**, the market rate last week had already withdrawn some of its most aggressive expectations**. At the beginning of the week, a 60% probability of a cut in March was priced in. This fell to 43% on Friday night.

There is still one big piece of information the Fed will have before meeting: the Consumer Price Index (CPI) print for November out on Tuesday. The market consensus expectation is to see core inflation stabilise at 4.0% year-on-year. If this materialises, the (temporary in our view) absence of further decline would help Jay Powell on Wednesday night. Indeed, we think **there is a strong case for the Fed to try to steer the market away from its most extreme pricing since broad financial conditions are on the brink of standing in the way of what the central bank has been trying to achieve.**

Since the beginning of the correction in US yields, we have been checking US broad financial conditions to assess whether the market-driven loosening was not getting so extreme that it would jeopardise the Fed's efforts at cooling down demand. In the middle of last week, US 10-year yields in real terms (using the market's inflation expectations) have moved marginally below 2% for the first time since September, closer to what is considered to be potential GDP growth in the US. There are still in restrictive territory, but only just (see Exhibit 3). Of course, real financing conditions are tougher for the business sector (3.7% on average on a 10-year bond issued by a BBB-rated corporate) but they are loosening as well, and the spread relative to the risk-free rate has been remarkably stable since the beginning of the year (see Exhibit 4).

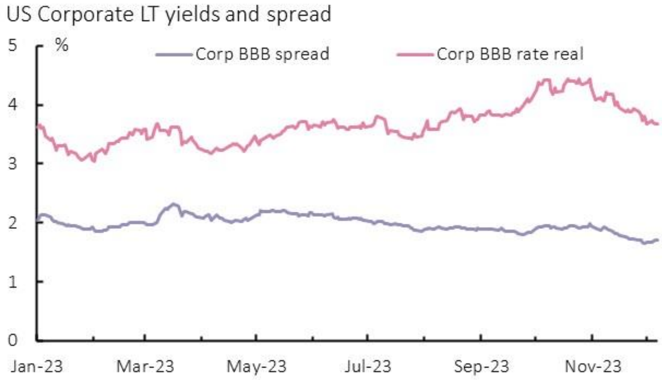
Some nervousness was perceptible on the US bond market on Friday as investors were focusing on the possible ramifications from the Bank of Japan (BoJ) normalising its policy faster than expected (more on this in the last section of this note) but **what we find striking is that a key market focus from one month ago – excess supply of treasury paper in a context of unaddressed fiscal deficits – has seemingly completely disappeared. The issue remains very much there though, and we continue to think this will put a floor to the current decline in long-term rates**. The Fed may not want to wait until the market "wakes up" though and is likely to send a signal to dampen animal spirits.

Exhibit 3 – Looser financial conditions



Source: Macrobond and AXA IM Research, December 2023

Exhibit 4 – even for corporates



Source: Macrobond and AXA IM Research, December 2023

The Fed has one handy tool at hand to signal a disagreement with the market. Of course, **the "extra hike" in the previous dot plot failed to materialise** (barring the mother of all policy surprise this week) **which will further undermine the credibility of these rates forecasts, but it remains a nice messaging device**. The September version had the Fed-Funds in the 5-5.25% range at the end of 2024, implying only a 50bps cut from the peak forecasted at the time. The Fed could maintain a "high for long" message by keeping the same change in the policy rate from the actual end-2023 level, hence bringing it down to the 4.75%-5.0% at the end of 2024. Since it is a collection of individual forecasts, precise steering is not always possible, but the crux of the matter is that there would still be a significant gap between the Fed's forecast and the market's expected trajectory.

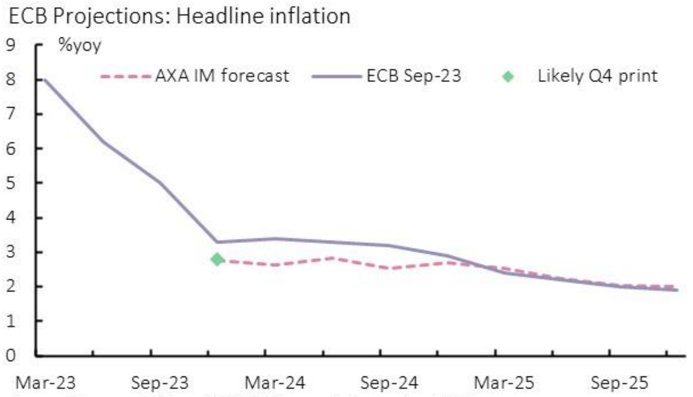
We have our doubts that the dot plot and prudent rhetoric from Powell will suffice to tame the market's animal spirits. Data will be key – starting with this week's inflation print – as well as news regarding the supply of government bonds. The fiscal projects of the candidates to next year's presidential elections will be scrutinised, as well as factors affecting demand, for instance the speed at which the Bank of Japan normalises its policy.

Acrobatic communication from the ECB

We noted last week that even Yannis Stournaras, the usually dovish Governor of the Greek central bank, chose to push back against the aggressive pricing of rate cuts by the ECB. Yet, a few days later, an interview by Isabel Schnabel – usually considered as the hawks' spokesperson at the board - fuelled the market's impatience further. Indeed, she plainly stated that she no longer thought further hikes had to be on the table. We don't think however that she has crossed the floor to a dovish stance. Rather, we think she has "cut her losses" as it was getting obvious that, given the dataflow, keeping the option of another rate cut was stretching credulity too far (her point on *"The most recent inflation number has made a further rate increase rather unlikely"*). This does not mean that she is ready to advocate quick rate cuts.

When she was directly quizzed on the market's pricing, she expressed a good deal of distance from it *("Central banks are more cautious, and I would argue they have to be more cautious. After more than two years of above-target inflation, we need to err on the side of caution"*). We also think that her warning against predicting today what "*could happen in 6 months"* is directed at those in the Governing council who have explicitly mentioned the possibility to start cutting rates around the middle of 2024. Moving to proper "data dependence", i.e., deciding meeting by meeting, can be in itself a way to deflect investors' willingness to see the ECB validate the market pricing. We expect **Christine Lagarde to follow a similar approach this week: removing further hikes from the debate, but also calling for prudence in the face of impatient markets, stressing, as Schnabel did, that the next months' inflation readings may be less spectacular.**

Exhibit 5 – Lower starting point, same story



Source: Eurostat, ECB and AXA IM Research, December 2023

True, inflation is currently falling faster than in the September forecasts. In Exhibit 5, we have estimated the likely CPI print for Q4 2023 on the basis of the actual figures for October and November, to compare it with the ECB's projections. The gap is tangible, but the fact that the starting point for the inflation trajectory is lower does not necessarily mean that we should expect a much quicker pace of convergence towards the central bank's objective. We concur with the ECB that headline inflation is unlikely to decline much more in year-on-year terms in the next few months ahead, as most of the powerful favourable base effects are now fading. Still, **we expect some small downward revision to the inflation forecasts for 2025 to 2.0%, from 2.1%, which would be consistent with a central bank increasingly confident it has done enough, but still far enough into the projection horizon to call the market for prudence in its pricing of cuts**. In the characterization of the balance of risks around the new central scenario, we would expect the ECB to move to a more balanced view with less focus on upside risks, but we still expect Christine Lagarde to mention the labour market as a source of potential price drift, especially in connection with the abysmal productivity performance.

Isabel Schnabel echoed Christine Lagarde's earlier statement that Pandemic Emergency Purchase Programme (PEPP) reinvestments are likely to be discussed at the December meeting. The current market configuration, with very tame peripheral spreads, has opened a low-risk window for this. But the affirmation of yet another element of policy normalisation would also help send the message to the market that the ECB is not "panicking" in the face of adverse macro developments. Now, discussing it, and publicly saying it is being discussed, does not mean *deciding* it. We think that a heavy sovereign issuance outlook is likely to keep the ECB prudent. The Governing Council may well want to see how the market behaves early next year. We maintain our baseline of PEPP partial roll-off decision in March, with some significant risk of a January decision if market conditions allow. Technically, the ECB would likely to replicate what it did with Asset Purchase Programme (APP), with a partial roll-off to start with.

Our baseline for the first cut remains June 2024, but as we wrote last week the speed of disinflation – occurring faster than we expected – makes it plausible a cut intervenes earlier in Q2. Our point though is that we fail to see why the ECB would want to engage in this discussion right now. We think it is better off maintaining a "steady course". Coming to a consensus around cutting will not be easy within this Governing Council and Christine Lagarde is likely to need some more months to build a majority around this. **What keeps us tilted towards June is the hope, supported by some recent indicators such as the Purchasing Managers' Index (PMIs), that the Euro area may have found a cyclical bottom around stagnation/very shallow recession, rather than descending into "proper" contraction territory**. This is holding by a thread though, and we suspect that many at the ECB have some doubts on their "2024 recovery" scenario. Yet, again, what would be the point of acknowledging this now?

Timing issues at the Bank of Japan

While the ECB and the Fed are busy dealing with aggressive market pricing of cuts, the Bank of Japan is still unclear on the timing of its exit from negative policy rates. **Investors have reacted quite sharply last week to indications from the BoJ that this could come earlier than expected**. This is not the first time. Early in 2023 the market had similar shifts in expectations, sometimes indeed fuelled by communication from the BoJ, but we are now in December and, as much as the yield curve control policy has been made more flexible, the Japanese overnight rate is still negative. The remarks by Governor Ueda which triggered the market move were quite innocuous in our view. Saying that "*setting monetary policy will be even more challenging in 2024*" does not send any strong directional signal in our view, and in any case the market was already bracing for a change in the policy stance next year. For our part, our baseline is that the Bank of Japan will end eight years of negative interest rates with a 10-basis-point hike to 0.0% around April 2024, alongside an end to its yield curve control policy. The issue now is whether the change could come earlier than that, and in particular whether next week's policy meeting on 19 December could be "live".

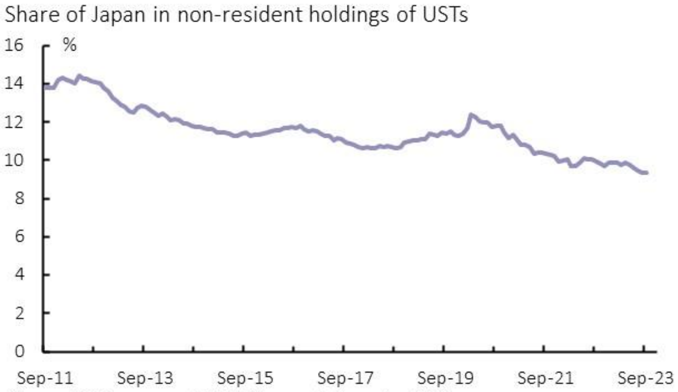
A speech by Vice Governor Himino, a few days before Governor Ueda spoke, was more informative in our view. Indeed, he started to sketch out what the conditions could be for an exit from the current stance, and crucially mentioned that the Japanese banking sector would withstand the shock from higher interest rates. This is not new – the BoJ released a working document on this topic in October – and would still call for some qualification. In their October assessment, the BoJ staff concluded that "over time" banks would do well, but also that regional banks – which are heavily invested in long-term bonds - could go through a bad patch. Yet, the fact that Himino was ready to gloss over this particular finding is probably an indication that indeed, the BoJ is getting ready to act.

Timing remains elusive though. Himino's comments on that aspect were prudent:" We'll *look at various factors, but there's never a moment when you see a green light flash for all of them. There's also never a moment where the lights all turn red… In reality, you have to make a call at some point amid a mixed batch of signals".* Indeed, a mixed batch it is! Headline inflation (3.3%yoy in October) has been above 2% systematically since April 2022. Core inflation has slowed down a bit in October to 4.0% from 4.2%, but that is still a high number. On the basis of the current price developments, maintaining negative policy rates is becoming increasingly odd. The picture for the real economy is looking however less than promising. Japanese GDP tends to be volatile, but the 0.7%qoq decline in Q3 was of course a bad signal. The narrative from the BoJ has been that they would be able to remove the economy's monetary "crutches" once wage growth would turn the current inflation surge into a durable anchoring around 2% in contrast with the deflation of near deflation of the last three decades. Of course, if sustained, such weakness of the real economy would make this unlikely.

This explains in our view Himino's point (the "red" and "green" lights) **on the impossibility for the BoJ to wait for all the stars to be perfectly aligned before making a move. A leap of faith will be necessary**. Even if it is likely that inflation will soon slow down (we are counting on headline and core to move back under 2% in 2025), the sheer fact that finally, some inflation took place in Japan, and some wage growth was visible would normally lift inflation expectations. We note that unions are starting the 2024 pay negotiation round with a 5% growth request.

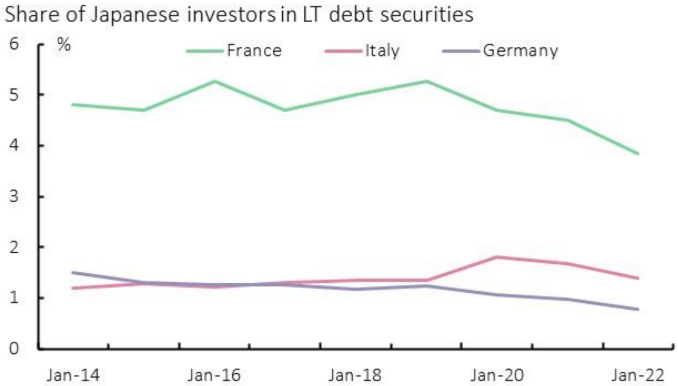
An issue though for the BoJ is that **it needs to balance an increasingly visible willingness to normalise policy with (i) keeping the financial stability risks to a minimum and (ii) avoid an overreaction of the exchange rate**. 60% of Japanese mortgages are floating. The end of yield curve control would naturally raise questions on the path for fiscal consolidation in Japan. The combination of rate hikes in Japan with rate cuts in the US could trigger a brutal appreciation of the yen with all its adverse consequences on competitiveness while possibly dampening import prices to the point that Japan could drift back into near deflation. The necessity for the BoJ to tread very carefully in this environment is the reason why we stick to our baseline timing, even if we acknowledge that there might be some impatience in Japanese policy circles to "rip the Band-Aid".

Exhibit 6 – Slowly down, but still big



Source: US Treasury and AXA IM Research, December 2023

Exhibit 7 – Japanese investors matter for the French market



Source: Bank of Japan, Eurostat and AXA IM Research, December 2023

In any case, when the normalisation of Japanese monetary policy comes, the ripples should not be understated. While the share of Japanese investors in foreign holdings of US federal bonds has been falling over time, it is still a chunky 10% (see Exhibit 6). Even if hedging costs of holding positions in US bonds would fall somewhat as the policy rate differential between the Fed and the BoJ would shrink, it would be unlikely that they would change enough to stop the repatriation of Japanese savings from the US to their domestic market if rates in Japan were to rise. This is one of the reasons, beyond the continuation of strong supply from the US Treasury, which makes us think that there is a relatively high floor to the current decline in US long-term rates. But some European markets could also feel the pressure. We have crossed the data from the Japanese balance of payments on holdings of long-term debt securities per country with the national financial accounts compiling the stock of public and corporate bonds issued in the three biggest European Union (EU) economies. The two concepts may not coincide perfectly, but they should give a broad indication of the role Japanese investors play in these countries' bond markets. France comes out with the highest reliance on Japan, with almost 4% of its debt securities held by Japanese investors (see Exhibit 7).

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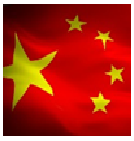
Country/Region	What we focused on last week	What we will focus on in next weeks
	• Employment (Nov) rose by 199k in Nov, unempl fell to 3.7% and average hourly earnings rose 0.4%mom • JOLTS survey (Oct) showed vacancies fell to 8.73m its lowest since March 2021 • ISM services (Nov) beat expectations to rise to 52.7 from 51.8, new orders remained at 55.5	• FOMC (Dec) no change in policy expected, FFR at 5.50%. Press conference likely to say "too soon to consider cuts". Dots to show cuts expected in 2024 • CPI inflation (Nov) headline expected to soften further on weak oil; core rate likely unchanged at 4% • Retail sales (Nov) quantification of post-Thanksgiving sales, anecdotal surveys positive
	• Sentix index (Dec) improved 1.8pt to -16.8 • Ge industrial data (Oct) were on the weak side: orders fell by 3.7%mom, production by 0.4%. Fr IP (Oct) also declined by 0.3%mom • EMU retail sales (Oct) is back in positive territory for the 1st time since June at +0.1%mom. Heterogeneity across countries is huge Fr: -1%mom, Ge: +1.1% • Q3 EMU final employment is up +0.2%qoq and GDP unch. at -0.1% despite priv consumption up to +0.3%	• The ECB GC should maintain the status quo on DFR, indicate they remain data dependant and try to convince market that cut priced for March is too early, but remains open for a move later in 2024 • Ge ZEW indices (Dec) to improve slightly, both on current conditions and outlook • EMU Industrial Production (Oct) • Flash PMIs (Dec) should marginally improve but remain in contraction territory • Eurozone wages and labour cost (Q3)
	• BRC (Nov) like-for-like sales stay at 2.6%yoy in value terms, -ve in real terms • Services PMI (Nov, f) revised higher to 50.9 from 50.5 – now highest since July	• BoE meeting (Dec) policy on hold at 5.25%, Bank to stress too early to consider cuts • Labour market report (Oct/Nov) including experimental statistics. Expect earnings to slow • GDP (Oct) weaker growth after solid 0.2% in Sept.
	• GDP (Q3) was surprisingly revised down after priv. consumption finally declined by -0.2%qoq • CPI Tokyo (Nov) came down at 2.6%yoy (-0.7p), core inflation is flat at 2.7% • Final Mfg PMIS (Nov) has been revised up to 48.3 (+0.2p) while Svcs is down to 50.8 (-0.9p) • Household spending (Oct) is depressed (-0.1%mom)	• Tankan surveys (Q4) are key to assess ongoing sentiment across companies. We should have small improvements but nothing spectacular • Flash PMIs (Dec) • Machinery orders (Oct)
	• Caixin PMI Services increased more than expected to 51.5 in Nov (Oct: 50.4) • Exports grew for the first time in six months by 0.5%, from a decline of 6.4% in Oct. Imports edged down by 0.6% in Nov, from an increase of 3% in Oct. • FX reserves rose to $3.17tn in Nov (Oct: $3.10tn)	• Sat (9 Dec): CPI & PPI (Nov) • 11-18 Dec: Nov credit stats (Total social financing, M2 supply, new loans) • Fri (15 Dec): Nov monthly output stats (Fixed asset investment, Industrial production, retail sales)
	• CB: India (6.5%) & Poland (5.75%) stood on hold • Q3 GDP (%yoy) lost steam in Brazil (2.0%) & contracted in South Africa (-0.7%). It accelerated in Romania to 1.1% • Inflation (%yoy) fell in Chile (4.8%), Colombia (10.2%), Hungary (7.9%), Korea (3.3%), Taiwan (2.9%) & Philippines (4.1%). Inflation rose in Turkey (62.0%) & remained steady in Mexico (4.3%)	• CB: India (6.5%), Mexico (11.25%), Philippines (6.5%) & Taiwan (1.875%) to stay on hold. Brazil to cut -50bps to 11.75% & Peru -25bps to 6.75% • Q3 GDP: Brazil, Romania & South Africa • Nov CPI: Czechia & India • Oct industrial production: Colombia, India, Malaysia, Mexico, S. Africa & Turkey • Oct economic activity index: Brazil & Peru

Upcoming events	US:	Tue: NFIB small business optimism (Nov), CPI (Nov); Wed: PPI (Nov), FOMC announcement (Dec); Thu: Retail sales (Nov), Weekly jobless claims, Business inventories (Oct); Fri: Empire State manf survey (Dec), Industrial production (Nov), Manf & services PMI (Dec), Long-term investment flows (Oct)
	Euro Area:	Tue: Ge ZEW Survey: current situation & economic expectations (Dec); Wed: EA Industrial production (Oct), Ge Current account (Oct); Thu: EA ECB announcement (Dec), Sp HICP (Nov); Fri: EA Composite, manf & services PMI (Dec), Ge & Fr Manf PMI (Dec), Fr & It HICP (Nov)
	UK:	Tue: ILO Unemp (Oct), Average earnings (Oct); Wed: Monthly GDP (Oct), Construction & manf output (Oct), Index of services (Oct), Industrial production (Oct), Total trade balance (Oct), Trade in goods (Oct); Thu: RICS Housing survey (Nov), MPC announcement (Dec); Fri: Gfk consumer confidence (Dec), Manf, services & composite PMI (Dec)
	Japan:	Tue: Tankan large manf index (Q4); Wed: Priv core machinery orders (Oct); Thu: Industrial production (Oct); Fri: Manf PMI (Dec)
	China:	Fri: PBoC announcement (Dec), Fixed asset investment (Nov), Industrial production (Nov), Retail sales (Nov)

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

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