Research & Strategy Insights

Starting with a bang

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Key points

- The Federal Reserve (Fed) started 2022 with a clear hawkish message. The market impact of a swift reduction in the Fed's balance sheet should not be understated.
- Italy and France open the debate on the reform of the European fiscal surveillance system.

Long-term interest rates started 2022 with a "bang", reacting – rationally in our view – to a surprisingly hawkish batch of Fed minutes pointing to an early beginning of the reduction of its balance sheet. It may well be that the US central bank was increasingly frustrated by the curve flattening which had been the main market reaction to the telegraphed series of Fed Funds hikes. The stubbornly low level of 10-year yields threatened to "drown" much of the Fed's intended monetary tightening.

Now that the market, a few days into the new year, has hit the interest rate levels we had been forecasting for the end of 2021, we want to question our forecast for the end of 2022 (2.0% for a US 10-year yield). We are not convinced we need to upgrade it. True, the latest data confirm the pace of wage growth is very high in the US, adding to the sense inflation is now largely endogenous over there, but with Biden facing more and more difficulties to achieve anything substantial on his latest tax and spend package – and the perspective of a Republican victory in the mid-terms – the US fiscal stance could turn quite sharply this year and next. In addition, while tapering is not necessarily the trigger of a correction of the equity market, a proper reduction in the size of the Fed's balance sheet could be much more detrimental to risky assets. Given the sensitivity of the US real cycle to wealth effects, this is not something the Fed could completely ignore. So all in all we are inclined to stick to 2.0% by the end of 2022 for US 10-year rates, but with a significant risk that yields follow this year a "bell curve" and exceed these levels at some point in the first half of the year, especially if the expected slowdown in inflation is delayed.

While the hawks at the European Central Bank (ECB) continue to express their concerns over inflation, we think that for now the "status quo" of December 2021 can be maintained there, with the "big decisions" on policy rates pushed into the end of this year and more likely into 2023. However, the ECB is tapering its Quantitative Easing (QE) programmes in 2022, which reduces the support for the most fragile bond markets. As governments start preparing their fiscal bills for 2023 this summer and the European fiscal rules kick-in again next year, questions around debt sustainability may start to be asked. In this context, we take a good look at the proposal from Mario Draghi's and Emmanuel Macron's economic advisors for a reform of the Stability and Growth Pact.

After the rush

The release of the December meeting minutes last week reminded the market of the depth of the Federal Reserve (Fed)'s "pivot" on inflation risks and hawkish dispositions as we start 2022. As we write, US 10-year yields are very close to the 1.75% level we had been forecasting for the end of 2021. 10-year Bund yields are also in line with the -0.05% we had been expecting. If confirmed, the Omicron wave would then appear to be a mere "accident" delaying our expected trajectory by only a few weeks. But we want to start this first Macrocast of 2022 by questioning our call for long-term rates at the end of *this* year. Is 2% by end-2022 for US 10-year yields, our baseline, still tenable despite the Fed's hawkishness?

We had been surprised in December that the US central bank would be ready to change so radically its discourse on the likely monetary trajectory in the midst of the Omicron wave. **Data, however, so far seem to support the Fed's gamble.** In South Africa, the number of infections has started to decelerate significantly, and faster than during the previous waves, while casualties remained very limited (see Exhibit 1). The apparent rise in the number of deaths recorded in the very last few days is the result of a "rescaling" after an audit of the South-African data, not a genuine spike. The US is much less advanced in this wave as infections continue to soar for now, and there was always some doubt as to the capacity of developments in South Africa to shed much light on how the variant would fare in more developed nations with an older population. Still, data from the UK continue to be reassuring: while on a national basis, infections continue to rise (but there are tentative signs of a slowdown in London), mortality has barely moved up (see Exhibit 2). The impact of the economy for now seems to be dominated by a shortage of workers due to the isolation rules which are being loosened in several countries. We are not out of the woods – the variant hit the younger generations first, and we need to check the healthcare systems continue to cope as it is now spreading across older people – but for now, the Fed's readiness to look through this new wave looks reasonable.

Exhibit 1 – South Africa already on the other side

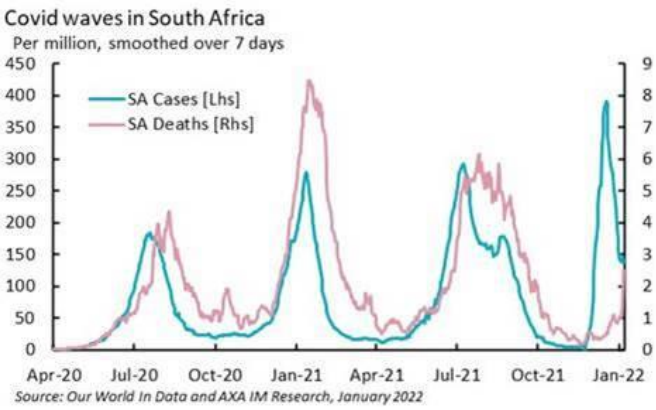
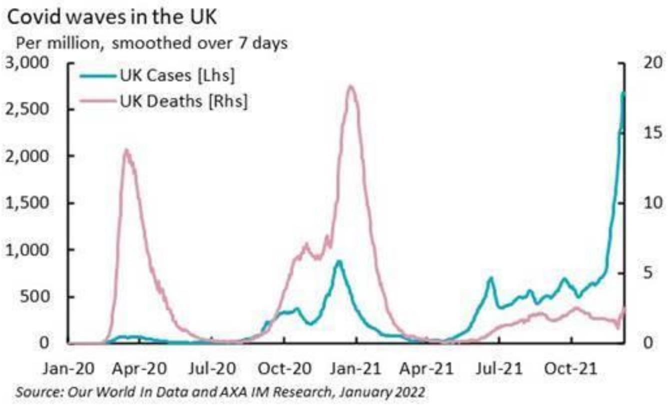


Exhibit 2 – Still reassuring news from the UK



Now, while in December Jay Powell had already mentioned a discussion on reducing the Fed's balance sheet, the focus then was squarely on the speed on the rates lift-off. The minutes send another – and much more hawkish message. During the last policy cycle, the central bank waited for nearly two years after the rate lift-off to start running down its balance sheet. Now, the Fed is considering reducing this lag: *"participants judged that the appropriate timing of balance sheet runoff would likely be closer to that of policy rate lift-off than in the Committee's previous experience".* The use of "participants" without any qualifiers ("a few" or "some") normally indicates that a fairly high level of consensus has already been achieved on this.

The reduction in the Fed's balance sheet appeared 26 times in the text, against none in the November version. The central bank wanted its signal to be heard "loud and clear" and the fact that the debate at the Federal Open Market Committee (FOMC) was preceded by a formal presentation by the Fed staff suggests that we are no longer in the realm of theoretical discussions, but into the exploration of the technical conditions of such a move. The points on the Standing Repo Facility – set up in July 2021 to address liquidity shortage on the money market – which could reduce the impact of the balance sheet run-off on aggregate liquidity suggest a high level of confidence at the central bank about the capacity to conduct a swift retreat from the bond market without triggering too much damage, even if "some participants" continue to be worried about the "vulnerabilities" of the market.

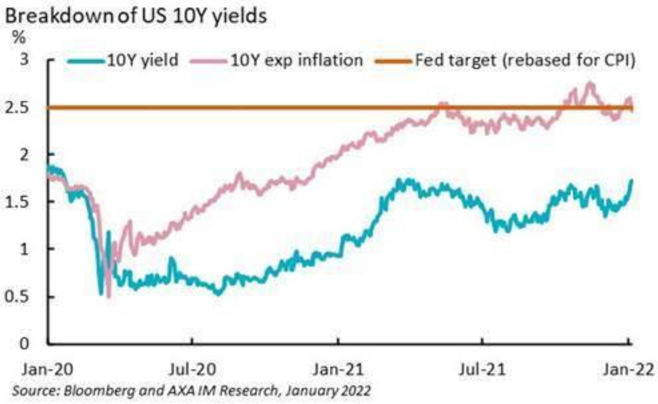
On top of the earlier beginning for the run-off, the Fed signalled that the balance sheet normalisation could proceed at a faster pace since, relative to the previous QE phase, the Fed has acquired bonds with lower maturities, so the same pace of reducing reinvestments would lead to a quicker correction in the portfolio size. This new-found sense of urgency is explicitly driven by the fact that (i) the overall size of the Fed's balance sheet is significantly higher than last time and (ii) inflationary tensions are more acute than in the mid-2010s.

However, **the macroeconomic reasoning behind the quicker-than-expected balance-sheet reduction is not very explicit in the minutes.** We think a key underlying factor is the Fed's concern with a stubbornly, "abnormally" low level of long-term interest rates. We have been highlighting this since the autumn of last year: the market's reaction to the Fed's increasingly hawkish signals has been to flatten the yield curve. This can create financial stability issues, and "a few participants" are quoted in the minutes as saying that a flatter curve would be detrimental to the banking sector. But more importantly, the Fed may be worried that stubbornly low long-term interest rates would "drown" the impact of Fed Funds hikes. In particular – although that point was not made in the minutes – long-term interest rates need to rise to affect the currently fast-flowing mortgage origination which contributes to keeping the economy in overheating territory.

Many members of the FOMC are probably quite happy to see 10-year yields finally moving away from the 1.5% range in which they had been wallowing before the festive break. The median FOMC member expects the long-term level of Fed Funds rate to stand at c.2.5%. It is tempting to ascribe the anomaly of having 10-year-yield standing *below* what is a good proxy of the Fed's estimate of the US natural interest rate to the size of the excess liquidity created by QE. Yet, there are intrinsic risks for any central bank in trying to anchor the long end of the curve without direct intervention. The minutes actually spell out clearly that Fed Funds rates are controllable while whatever happens further down the curve depends on market reactions, including over-reactions.

More profoundly, **the Fed needs to consider the reasons why long-term interest failed to react to the imminent series of Fed Funds hikes.** We've made the point several times in Macrocast over the last few months: the breakdown of 10-year yields between real rates and expected inflation suggests that the market believes a small number of hikes will be enough to regain control of inflation. 10-year expected inflation is still in line with the Fed's target (see Exhibit 3). We explored in our last Macrocast of 2021 the risk of "overkill". It should not be understated, especially given the recent news on the fiscal front.

Exhibit 3 – Unspectacular long-term inflation expectations



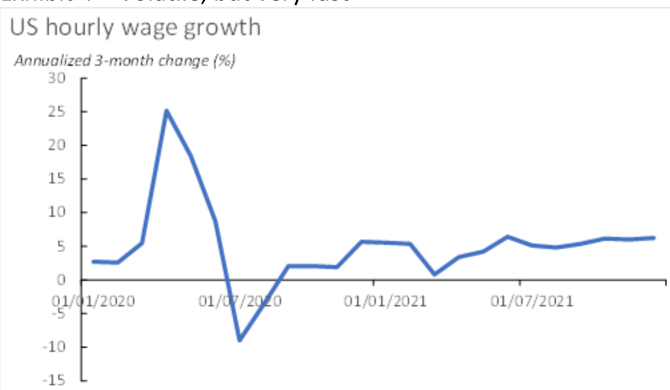
Negotiations are still ongoing but Senator Joe Manchin's opposition to the social and environmental package, even after its downscaling, at the end of last year, remains for now. The cumulative fiscal "over-stimulus" under Trump and in the first few months of the Biden administration explains the fact the US output gap turned positive so quickly into 2021. If the additional fiscal push is stopped in its track, and then the Democrats lose control of the

House in November 2022, the fiscal stance will turn neutral at best from next year onward. If this coincides with a quick tightening in financial conditions, the trajectory for US demand may have to be significantly downgraded.

For now, the Fed is clearly intent on responding to the accumulation of signals that inflation is getting entrenched, and last week's release of the payroll data for December has probably solidified their resolve. While job creation came out below expectations – and the coming months may well be even more disappointing as the labour market adjusts to the Omicron wave which is still likely to have a temporary impact on some sectors – the above-expectations' wage growth in December suggests second-round effects could now be driving consumer price dynamics in the US. As Exhibit 4 illustrates, wage growth has been very volatile since the start of the pandemic, but the 3-month annualized gain in hourly pay in December has hit 6%, an unavoidable cause of concern.

The jury's still out though on the exact timing of both the rate lift-off and balance-sheet reduction. The minutes made it clear it will still be "data dependent". The market has immediately reacted to the minutes by focusing on March 2022 as the rate lift-off date. We agree these odds have meaningfully increased, but labour market data may be difficult to read in the coming months while supply-side tension is receding. In November, supplier delivery time had improved in manufacturing but not in services. In the December batch, pressure was easing in both sectors (see Exhibit 5).

Exhibit 4 – Volatile, but very fast



Source: Bureau of Labor Statistics, AXA IM Research, January 2022

Exhibit 5 – Supply-side normalisation ahead?

Source: Institute of Supply Management and AXA IM Research, January 2022

The Fed may also be forced to consider developments on financial markets before making up its mind. In November we [published a note](#) quantifying the impact of the change in the Fed's balance sheet on US equities, distinguishing IT names from the rest, with a model in which fundamentals (corporate profits), interest rates and market stress (the VIX volatility index) also intervene. At the time, our main point was to suggest that tapering itself would not necessarily trigger a decline in equity prices. But reducing the size of the Fed's balance sheet would.

Exhibit 6 – Fed balance sheet matters for equity

Source: Bureau of Economic Analysis (BEA), CBOE, Fed, S&P and AXA IM Research, Dec 2021

Exhibit 7 – Exploring policy scenarios

	S&P 500 excluding IT					
(in %yoy)	Scenario 1	Scenario 2	Scenario 3a	Scenario 3b	Scenario 4a	Scenario 4b
Q4 2021	21.6%	unch.	unch.	unch.	unch.	unch.
Q1 2022	15.4%	14.2%	unch.	unch.	unch.	unch.
Q2 2022	12.2%	8.4%	4.5%	1.1%	2.4%	-0.9%
Q3 2022	7.2%	3.4%	0.9%	-2.4%	-1.1%	-4.4%
Q4 2022	1.6%	-0.5%	-1.6%	-4.2%	-3.6%	-6.2%

Source: BEA, CBOE, Fed, S&P and Calcul AXA IM Macro Research, Dec 2021

Our model suggested plainly how the previous phase of balance sheet shrinking explained much of the mediocre performance of the S&P index in 2018-2019 (see Exhibit 6). We use the same model to simulate a few scenarios on the Fed's policy choices of 2022 (see Exhibit 7).

In scenario 2, the Fed hikes three times in 2022 but delays its balance sheet reduction until 2023. Under the assumption of corporate profits growing in line with trend, and VIX at its long-term average, the S&P index excluding IT would be roughly stable in year-on-year terms in Q4 2022. In scenario 4a and 4b, we added to the three hikes a balance sheet reduction starting in Q2 2022, at two different speeds. In 4a, the Fed would opt for the gradual pace seen in 2018. In 4b, for the faster pace of 2019. Even the latter would possibly be too conservative given the minutes' insistence on a quick normalization. Accordingly, the decline of more than 6%yoy in equity prices excluding IT by the end of 2022 in scenario 4b would then probably be also too conservative.

The correction could be steeper for two additional reasons. Indeed, there are some interactions between some of our model's explanatory variables. The abrupt removal of liquidity may trigger a rise in the VIX. The tightening in financial conditions together with looming fiscal paralysis could affect corporate profits. IT equity is less sensitive to realized corporate profits but their elasticity to interest rates and changes in the Fed's balance sheet is even higher than for the rest of the index. While some members of the FOMC may be happy to see some "froth" taken away from an exuberant equity market, **the Fed could not completely ignore the feedback loop to the economy from a correction in equity prices** given the magnitude of wealth effects on consumption.

All in all, we remain comfortable with our end 2022 forecast for US yields, despite the change of tone from the Fed. However, **we take on board a serious risk that before finally settling to 2% in Q4 2022, US 10-year interest rates could first exceed this level, following a "bell-shaped" trajectory,** especially if the deceleration in inflation – in which by the way FOMC members continue to believe according to the minutes – is delayed.

European public debt: finding benign ways to offload the ECB's balance sheet

An interesting lesson from the market's reaction last week is that the euro exchange rate did not weaken much, despite the hawkish turn of the Fed. This strengthens our view that the euro has found a floor in late 2021. This should help keep the exchange rate issue away from the monetary policy equation of the ECB. Last year's depreciation has obviously pushed imported inflation higher, but it was a second-order problem relative to the energy price shock and supply-side disruptions. If the euro does not weaken further, that's one less argument for the hawks, protecting the status quo encapsulated in the ECB's announcements in December 2021. While the "mood music" from some of the hawks on the board suggests a growing concern over domestic inflationary pressure – but often more because of the impact of higher carbon pricing than because of second-round effects from the labour market – for now the ECB has given itself 2 or even 3 more forecasting rounds before settling on a course for policy rates in 2023.

Yet, before the decision is made on policy rates, the quantum of support for fragile bond markets will be markedly lower in 2022 after the ECB's decision on Pandemic Emergency Purchase Programme (PEPP) and Asset Purchase Programme (APP). We believe that this will gradually put the question of fiscal sustainability on the table this year. **The budget bills for 2023 may herald the beginning of fiscal retrenchments in the Euro area – although the implementation of the Next Generation EU framework will soften the blow – exactly at the moment the US could have to deal with fiscal paralysis.** The extent of this shift in the fiscal stance is likely to be at least partly dependent on the kind of peer-pressure which national governments will have to face in the EU.

Just before the festive break, **President Emmanuel Macron and Prime Minister Mario Draghi informally but ostensibly launched the negotiations on the reform of the European fiscal surveillance system by co-signing an Op-Ed in the Financial Times**. The issue needs to be addressed with some measure of urgency. The "escape clause" suspending the implementation of the Stability and Growth Pact normally ends in 2022. If nothing changes, in 2023 member states would need to start consolidating their public finances to the tune of 1/20th per annum of the distance between their actual debt to GDP level and 60%. In the case of Italy, this would force a debt reduction of

5% of GDP per year, with the potential to break the recovery which could propel the Euro area into the same sort of destabilising spiral as in the aftermaths of the Great Financial Crisis of 2008-2009.

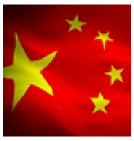
Just after the joint Op Ed by Draghi and Macron, a much more detailed and technical approach appeared in a 13 pages paper co-authored by their economic advisors (which you can find here). The paper is largely of an academic nature and may not exactly reflect the two governments' official position, but it is a useful starting point. They make two interlinked propositions. First, transferring the sovereign debt acquired by the ECB during the pandemic to an EU mutualised fund such as the European Stability Mechanism (ESM). Second, allowing for a milder fiscal retrenchment than under the current rules by imposing different paces of debt reduction according to the nature of debt.

The benefit of offloading the pandemic debt from the ECB's balance sheet would be twofold. First, it would immediately "re-load" the ECB's capacity to engage in quantitative easing should the need arise. Indeed, by the end of PEPP/APP the ECB is going to be very close to the limit it has imposed onto itself in terms of the share of any member state's debt that it would be willing to hold. It would be reassuring to know that a fresh capacity would be at hand without having to go through the legally and politically fraught process of getting the ECB to change its position on the limits. **Second, the "pandemic debt" would be de facto "sterilized" permanently, removing the risk of market volatility when the ECB finally decides to emulate the Fed and reduce the size of its own balance sheet.** Indeed, Giavazzi, Weymuller and their co-authors' view is that after the transfer, the ESM would constantly hold on its balance sheet a share of each member states' debt equivalent to the one accumulated during the pandemic. This is an interesting alternative to the solution which so far had been envisaged by most observers – including your humble servant – in which it's the ECB which would "kindly" accept to re-invest over possibly decades the bonds acquired under PEPP.

In addition, the authors propose to carve out from total debt a "slow reduction bucket" made of (i) the liabilities incurred during the pandemic and (ii) the debt incurred as part of "spending for the future", for instance green transition-related expenditure. This bucket would need to be corrected at a pace of 2% per annum, against 5% per annum for ordinary debt. The combination of these two paces would define a "spending ceiling" for national governments. Ultimately, these two variables (debt reduction pace and spending ceiling) would be the sole constituents of the new European fiscal surveillance mechanism, which would be a welcome simplification from the currently extremely esoteric system. We note that the German coalition agreement called for a simpler framework.

We confess that we find this architecture quite elegant. It has the merit of not pursuing solutions – such as any form of debt cancellation – which are non-starters in Europe from a political point of view. In a similar way, such a framework would still reward "good behaviours" since a country with low accumulated ordinary debt to start with would still benefit from much wider fiscal space than a formerly profligate one. There are a few areas in the proposition which would need to be made more precise or revised. For instance, the authors propose to create a national contribution to the common fund calculated as the difference between the ESM's funding cost and the country's growth rate, applied on the quantum of national debt held by the fund. This could have the effect of depleting national governments' resources in times of recession. The impact of the debt transfer system on member states' cash flow is also not obviously positive. Indeed, today the interest they pay on the debt held by the ECB is largely returned to them through the dividend of their national central bank. If they paid them to the ESM, it would no longer return – at least not directly – to the national treasuries.

Probably more profoundly, we notice that the authors did not touch upon possible sanctions in the system. An obvious "stick" would be to exclude new purchases of debt of a member state (as part of the constant reinvestment aspect of the debt transfer aspect) which would not comply with the rules. We suspect the authors would rather leave this for future negotiations. For now, we haven't seen any official reaction from Germany, but there is a substantial Franco-Italian offer on the table.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• FOMC minutes (Dec) - discussions re balance sheet unwind earlier and faster than expected • Fed's Bullard suggests hikes from as early as Mar. • Payrolls surprised markets rising by just 199k in Dec, unemp fell to 3.9%, participation rose to 61.9%. Average earnings slowed to 4.7% • Resistance from Sen Manchin (D) puts broader Build Back Better agenda in greater doubt • ISM (M&S) indices (Dec) fell from highs, remain elevated. Signs of supply disruption easing	• CPI inflation (Dec) expected to rise further (consensus) 7.1%, but headline around peak? • PPI inflation (Dec) expected to rise from 9.8% from 9.6% in previous month • Retail sales (Dec) expected soft again – around flat – Q4 consumption still faster than Q3 • Omicron cases surged last week, look for signs of slowdown • Fed's Beige Book to provide anecdotal evidence of economy
	• HICP rose to 5% while core stands at 2.6%yoy. Ge, Fr, It reached respect. 5.7%, 3.4% and 4.2% but Sp surprised on the upside (6.7%) • Nov retail sales were strong at 1%mom / Dec final consumer conf fell to -8.3 from -6.8 • Services sentiment declined to 11.2 (from 18.4) while industrial rose to 14.9 (from 14.1)	• New hospitalisations trend in Fr, Sp and It • Nov euro area IP should disappoint after Ge and Fr data came respectively at -0.2% and -0.4%mom and this despite strong rebound in auto production • Final December HICP in France and Spain • Nov euro area U-rate should decline to 7.2%
	• Covid cases continued to surge, with weekly cases (to 6th Jan) reaching 1.3mn • Final PMIs posted growth in Dec – 57.9 (Mfg) and 53.6 (Serv) • House price pressure continues with Halifax HPI shows 9.8% rise in avg house value in 2021	• Monthly GDP (Nov) expected to rebound to 0.4% (cons) following weak growth in Oct (0.1%) • IP and Mfg Prod (Nov) expected at 0.2% (cons) • Signs of slowdown following surge in Covid cases
	• Dec Mfg PMI stands well at 54.3 (+0.1pp) while Svcs already declined to 52.1 from 53 • CPI Tokyo rose to +0.8%yoy, its highest point since Nov19 and without strong distortion from mobile phone charges	• New cases should surge after first Omicron cases. Watching new restrictions • Jan Reuters Tankan surveys for Non-Mfg indices are likely to confirm Dec prints: decline in Svcs and some robustness in Mfg
	• Activity in manufacturing sector improves in December thanks to strong external demand and fading power shortages	• Export growth may moderate due to raging Omicron and PPI inflation to subside as foreshadowed by the PMI
	• CB: Poland hiked +50bps to 2.25% & Peru +50bps to 3.0%. Israel stood on hold (0.1%) • Inflation (Dec) surged in Turkey to a 19-year high of 36.1%yoy (Nov:21.3%) • Asia export tracker shows continued moderation in export momentum, though chip shortage concern eased slightly	• CB: Korea is expected to hike +25bps to 1.25%, & Romania +50bps to 2.25% • Inflation figures (Nov) for Argentina, Hungary, Poland, Russia, Israel and Egypt • IP numbers (Nov) for Mexico, South Africa, Turkey, Malaysia & India

Upcoming events		
	US :	Mon: Wholesale inventories (Nov); Tue: NFIB small business optimism (Dec); Wed: CPI (Dec); Thu: PPI (Dec), Weekly jobless claims (8 Jan); Fri: Retail sales (Dec), Ind prod (Dec), Business inventories (Nov), Michigan consumer sentiment (Jan,p)
	Euro Area:	Mon: EU19 & It Unemployment (Nov); Tue: Sp Ind prod (Nov); Wed: EU19 Ind prod (Nov); Thu: It Ind prod (Nov); Fri: Ge GDP (2021), Fr & Sp HICP (Dec)
	UK:	Tue: BRC Retail Sales Monitor (Dec); Thu: RICS Housing Survey (Dec), Credit Conditions & Bank Liabilities Survey (Q4); Fri: Monthly GDP (Nov), Indx of Services (Nov), Ind prod (Nov), Manufacturing & Construction output (Nov), Trade balance (Nov), Trade in goods (Nov)
	japan:	Tue: Leading indx (Nov,p), Current account balance (Nov); Wed: Economy Watchers Survey (Dec);
	China:	Wed: CPI (Dec); Fri: Exports & Imports (Dec), Trade balance (Dec)

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