AXA Investment Managers

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Investment Institute Macroeconomics

Bad Peripheral Vision

- The reaction of Italian yields suggests the old constraints on the ECB's monetary policy are still there.
- The ECB seems to have stopped believing in the Phillips curve: it would take a lot of macro deterioration to change the monetary policy trajectory.
- The Fed will likely hike by 50bps this week. Check by how much the unemployment rate moves in their "dot plot".

The ECB's announcement of a 25bp hike in July and a likely 50bps one in September has merely solidified the market's expectation of seeing the policy rate at the lower end of the "neutral range" by end-2022. The most important immediate development was the reaction of the Italian bond market to the absence of granularity on the ECB's anti-fragmentation weapon. The new level of the Italian 10-year is higher than any reasonable estimate of trend nominal GDP growth there. Avoiding debt "snow-balling" would entail steady fiscal retrenchment which could be made difficult by shaky political conditions from next year. Even if pressure does not extend to the periphery beyond Italy for now, it seems the "old constraints" affecting the ECB's normal conduct of monetary policy are still with us. If no progress is made on the anti-fragmentation weapon or on further debt mutualization in the EU, disruptions on the bond market could affect confidence across the whole of the Euro area, ultimately forcing the ECB to stop before reaching its desired level for the policy rate. At this stage however it seems the central bank is ready to tolerate quite a lot of deterioration in the real economy to achieve its price stability mandate. In the adverse scenario embedded in the ECB's latest forecasts, a significant recession in 2023 leaving the unemployment rate 2 percentage higher than in the baseline in 2024 would leave inflation only marginally below 2%. The ECB has stopped believing in the Phillips curve. That's another shift away from the Draghi era.

The Fed is likely to hike by 50 basis points this week. Higher-than-expected inflation in May again is fuelling risks of a 75bp move, but we don't think the Fed will want to add to the current turmoil: there is enough market-led tightening in financial conditions as things stand. Focus is likely to be on the Fed's forecasts. Whether the "median" FOMC member puts the Fed Funds in restrictive territory by end 2022 (the latest market pricing) or by end 2023 will matter, but we will also take a hard look at the forecast for the unemployment rate. This could give us a sense of how much "macro sacrifice" the Fed is ready to trigger to get inflation back under control.

For the market, the ECB answered the wrong question

The European Central Bank (ECB) has committed to hike policy rates in July for the first time in 11 years. Given our usual proclivities (negative minds tend to focus on problems) we will focus on whether the ECB has managed to set itself free from the issues which have been weighing on the "normal conduct of monetary policy" since the onset of monetary union. And our answer is: "probably not". This raises the possibility that the central bank gets into another cycle of attempting to normalise its stance amid shaky cyclical conditions, to be forced to retreat before bringing its policy rate at its preferred level.

The market – and ourselves – may have been surprised by the clarity of the ECB's message last Thursday, but not by its substance. The Governing Council chose to "kill suspense" for the July meeting and pre-announced a 25-basis point (bp) hike. It has also been almost as clear on what it will do in September: unless the inflation outlook improves – which we suspect would entail an unlikely downward revision in the next batch of forecasts from the above-target 2.1% projected for 2024 – the ECB will raise rates by 50bps in September. But while the distribution of the hikes between July and September was still open to debate in the market, the overall tightening was priced in. Consequently, the market's expected trajectory for the ECB rates has not changed much after the press conference, merely "solidifying" another 25bp move in December (Exhibit 1).

The interpretation of the policy statement's point on "gradual but sustained path of further increases" after September is however not straightforward: "gradual" could be understood as reverting to a 25bp quantum, while "sustained" could mean the ECB is planning to hike at every meeting this year (i.e., July, September, October, and December). At this stage it's unlikely the Council has made up its mind as to the exact speed and quanta beyond the summer, but the market is clearly choosing an aggressive interpretation. Interestingly, **the expectation for the level of the deposit rate at the end of 2022, at 1%** (which entails one more 50bp hike after September) **would put it at the lower end of the range offered by Francois Villeroy de Galhau for the neutral rate in the Euro area. There would thus remain a gap relative to the US.** Indeed, on the other side of the Atlantic, the market now expects the Federal Reserve (Fed) Fund rate to hit 3.25% by the end of 2022, thus reaching restrictive territory (more on this in the last section of this note).

Exhibit 1 – Market expects "back to neutral" by end-22

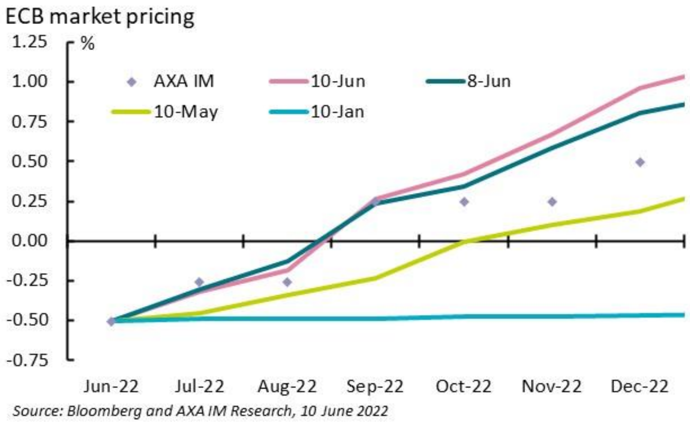
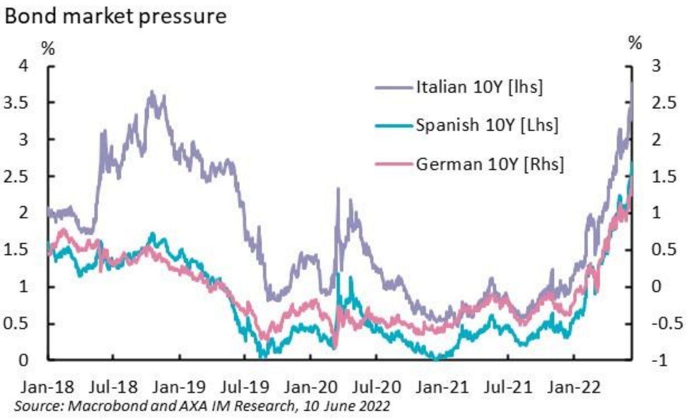


Exhibit 2 – Italy is paying the price of the ECB's normalization



The most notable market reaction came from the bond market and the widening of the Italian spread (+22bps over Bunds, see Exhibit 2). **This reflects disappointment over the ECB's failure to flesh out the "anti-fragmentation weapon"** to which Christine Lagarde reaffirmed the Governing Council's commitment. True, the spread remains significantly smaller than in the second half of the 2018 when populist parties formed a coalition in Rome, but the absolute level of the yield – and thus the actual pressure on the Italian government's funding cost – is similar.

The benefit of the anti-fragmentation weapon is that it would allow the ECB to fight spread widening while tightening monetary conditions for the Euro area as a whole at the same time (that's one of the reasons why Banque de France Governor, when discussing such instrument, mentioned the possibility to sterilize the purchases conducted under this framework). **So, logically, the more the ECB wants to push policy rates higher, the more they should make progress on this instrument.** Yet, the only concrete aspect of such tool on which the ECB is ready to elaborate remains the possibility to skew the Pandemic Emergency Purchase Programme (PEPP)'s reinvestments towards the most fragile signatures. It is not a massive tool, and investors – at least your humble servant – cannot help but suspect that the main reason the ECB does not want to "come clean" on this is quite simply because the Council is very far from an agreement on the political and technical aspects of a new programme. The Council probably considered that by going to "25 basis points only" in July, they would give themselves some time. Clearly, this has failed.

True, many things have changed relative to the dawn of the sovereign crisis of 2011-2012. No blatant case of macro mismanagement to the degree Greece had achieved by the end of the 2000s can be detected, and at the time the "periphery" had been accumulating massive external imbalances which have abated since the conversion to domestic demand rationing at the time of the crisis. The Spanish spread has barely moved (that's another takeaway from Exhibit 2). **Italy is the only country in the crosshair right now. This should however provide little comfort.**

Italy refinances roughly 15% of its debt every year. This means that a 100bp shock across the entirety of the curve shifts interest payments by a bit more than EUR3bn the first year, i.e., a bit less than 0.2% of GDP. Note that a quarter of Italian debt is held by Banca d'Italia as a consequence of the various quantitative programmes, which also means that a quarter of interest payments go back to the government down the road, at least as long as the proceeds of the programmes are re-invested. The devil is in the accumulation, i.e., in the medium-term trajectory.

What we have learned from the sovereign crisis of 2011-2012 is that markets are prompt to extrapolate from recent macroeconomic developments and change their view on debt sustainability. The risk is that the *current* interest rate level (3.76% on a 10-year as of Friday night) is used as a new floor and is then compared to the likely trend for *nominal* GDP growth. If the ECB is credible, inflation will re-converge to 2%. Potential growth will depend to some extent on the success of the current reforms triggered by Mario Draghi with the help of the Next Generation EU programme. However, it would be very "brave" to assume Italy could bring its potential real GDP growth – now routinely seen as barely in positive territory - to 1.8% so that trend nominal growth at c.3.8% would match the current level of 10-year yield. As usual, if the "snow-balling" effect is not under control, the only remaining lever is the primary surplus, entailing a constant effort on non-cyclical income and/or expenditure to shore up public finance. This is where the looming general elections (by next spring) become crucial, with polls suggesting a strong showing from populist parties raising questions on the political capacity to implement the required fiscal retrenchment.

We never believed in the ECB's capacity to be granular on anti-fragmentation at last week's meeting and we think many investors underestimate the complexity of such an instrument. Yet, we might have come back to a quite depressing feature of the market/ ECB relationship: the temptation for at least some investors to "test the ECB's resolve" and discover the point at which it will be ready to "crack". But precisely, the fact that the ingredients for a "wholesale peripheral crisis" beyond Italy are not there can make the ECB comfortable with delaying the response on anti-fragmentation. This would be consistent with further spread widening. The ECB will probably try to deal with the situation with some verbal intervention first, e.g., by highlighting that the market is "over-reacting". This never worked. The market wants to know not just *if* some bazooka could be deployed but *what* is the definition of said bazooka.

The Governing Council could end up in a very complicated position: if its inability to come up with a quick response on fragmentation persists – which is unfortunately likely – then there is a point at which the possibility of returning to the bad old days of the sovereign crisis will affect economic confidence for the whole of the Euro area. The most obvious option will then be to stop the normalization in policy rates before the "neutral level" is reached. Once again.

It is an iron law of policymaking in Europe that the only way to "free" monetary policy from being constantly "polluted" by debt sustainability issues is to strengthen the institutional set-up so that a good measure of debt mutualization keeps sovereign spreads under control. If governments can't come up with an extra-layer of mutualization, then it has to be provided by the ECB. If the ECB fails to convince market it has a political and technical solution at the ready, then it's the monetary stance – the trajectory for rates – which needs to change. The alternative to this "cascade" is the return of an existential questioning of monetary union.

Is the Phillips curve dead to the ECB?

It will likely take a lot of macro deterioration to convince a majority of the Governing Council to change tack. We found it striking that in the June batch of forecasts, the inflation forecast associated with the ECB's adverse scenario, which entails a deep recession in 2023 (GDP would fall by 1.7%), stands at 1.9% in 2024, only marginally below the 2.1% projected in the central scenario. This suggests that the ECB – or the Eurosystem to be more precise, since the June batch takes on board the contributions from all national central banks – believes the "Phillips's curve", which normally links the unemployment rate to inflation but more generally encapsulates the impact of the economic cycle on inflation, is extraordinarily weak. In the adverse scenario, the unemployment rate in 2024 would be 2 percentage points higher than in the baseline.

This could be read as another piece of evidence in the "ECB has returned to the pre-Draghi era" docket. Indeed, a key input of Draghi during his time at the helm of the central bank was his general belief in the "new Keynesian synthesis" where "slack" in the economy is a key driver of inflation. We note that from his vantage point as Italian Prime Minister, Mario Draghi said last week that as consumption in the Euro area remains below its pre-pandemic level, *"there is still spare capacity in the economy".* Yet, if the ECB now believes that a deep recession would barely bring inflation back below its target, then the message it is sending is that it will tolerate a lot of bad data in order to achieve price stability. We cannot but remember that Draghi reversed the 2011 hikes in his first months at the ECB as the economy was tanking.

It's not going to help that the dataflow on the real side of the Euro area economy is likely to remain quite difficult to read until late into 2022. Q1 GDP was significantly revised up from a first estimate of 0.3% quarter-on-quarter to 0.6%. The upward revision owes a lot to Ireland's contribution (GDP there rose by 10.8%) which is traditionally erratic, but more fundamentally, Italy's performance was revised up from an initial -0.2% to +0.1%, leaving France as the only big country in contraction territory (-0.2%). By the time the ECB makes its decisions in September, Q2 results will be available. In principle, this is when the impact of the fallout from the Ukraine war should show very clearly, but this could be dampened by the lagged effect of the re-opening on services activity, in particular tourism, which could lift GDP for the Mediterranean countries. It's only after the summer that the "extent of the damage" may clearly show.

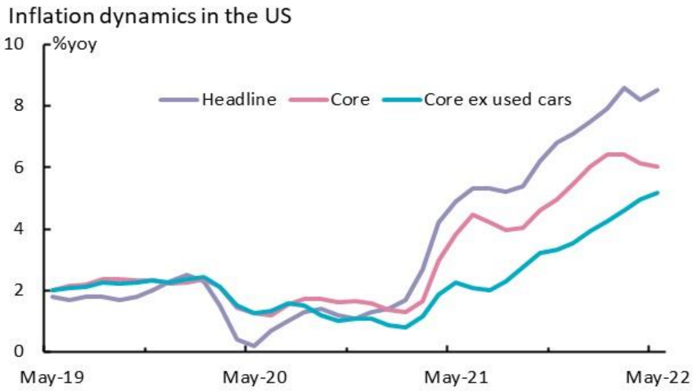
We remain less aggressive than the market on the overall quantum of hikes beyond September, but we recognize it's a close call. There is a real risk that "momentum wins" and the ECB indeed brings its policy rate to neutral territory (at least at the lower end of the range, i.e., 1%) by December. We would argue that such haste would end up forcing the ECB into a retreat at some point in 2023, since a neutral stance would by then appear too restrictive in the face of a negative output gap, stopping second-round inflation with a deterioration in the labour market. We expect the debate in Frankfurt to revolve around these issues – whether "doing too much too quickly" could ultimately derail the normalization trajectory – throughout the second half of the year.

Bad US inflation – Fed on the warpath

The ECB has been quite focused on the exchange rate channel lately, and the latest newsflow from the US is not going to make it any less "hawkish". Indeed**, with inflation surprising on the upside in May again, the Fed's tough stance is being further justified.** This week's decision Jay Powell's press conference is unlikely to calm the market down in our view, pushing the dollar further up.

US headline inflation came out 0.3 percentage points above the market consensus gathered by Bloomberg, beating the peak hit in March to reach 8.6% year-on-year. **Core inflation decelerated again, but by less than expected** (from 6.2% year-on-year in April to 6.0% in May, market was counting on 5.9%). We submitted the Consumer Price Index (CPI) to our usual "used cars test", and unfortunately, excluding this component, core inflation continues to accelerate (Exhibit 3). The first "green shoots of disinflation" which we flagged last week (in particular the fact that wage growth stood at 3.6% in annualized terms for two months on a row) are not yet having any impact on observed consumer prices. What's more, the Michigan University survey released the same day came out with the highest 5 year ahead inflation expectations since 2008, hitting 3.3% from 3.0% last month. We had often highlighted in Macrocast how long-term inflation expectations had remained contained since the start of the consumer price spike. It might be over.

Exhibit 3 – Core inflation still accelerating when controlling for "used cars"

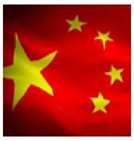


Source: Bureau of Labor Statistics and AXA IM Research, 10 June 2022

A Federal Reserve faced with both higher observed and expected inflation will feel under obligation to move hard and fast, especially if the real economy continues to fare relatively well. The market has begun toying with a 75bp hike this week since this "inflation shocker" but we are reasonably confident the Federal Open Market Committee (FOMC) will judge that sticking to the widely telegraphed 50bp hike this month – and another one in July – is the best course of action. **With market rates rising sharply and the price of risky assets falling further, there is enough "market-led" tightening in financial conditions going on right now for the Fed not to go beyond what is already a quite tough trajectory.**

Focus may be elsewhere, and in particular on the forecasts and the "dot plot". Jay Powell has been distancing himself from "merely returning to neutrality" to discuss the possibility the Fed would have to go into properly restrictive territory. This would be consistent with the median forecast moving to 2.50-2.75 for end 2022, and 3.0-3.25% for end 2023. The market is now more impatient than that, as mentioned in the first section, with Fed Funds priced as exceeding 3% at the end of this year already, but the May inflation numbers may have come too late to alter the members' views for 2022 already.

An interesting point of focus could be the forecast for the unemployment rate. Indeed, if the Fed goes into restrictive territory, one will logically expect the unemployment rate to move higher. This would in turn give us an interesting "value of reference" to gauge the Fed's likely further steps later in 2022 and next year. In March, the median forecast for 2023 had the unemployment rate flat at 3.5% (3.6% in May). A recent speech by Governor Waller implied that the Fed should bring the unemployment rate to 4.25% to bring the labour market back to the degree of tightness of 2019 (considering the change in vacancy rates). This would be a quite small move, consistent with Jay Powell's point on the unemployment rate "having to move by a few ticks". The usual problem with this sort of yardstick is the lagged effect of monetary policy moves: the unemployment rate of today is affected by the monetary stance several quarters back. This means that once the unemployment rate has reached its "desired level", odds are it will continue to move higher as the lagged effect of the last dollops of monetary tightening are still working their way through the economy. Waller said that bringing unemployment to just 4.25% would be a "masterful performance". Indeed. Odds are unfortunately that unemployment will have to rise more significantly in this tightening phase.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• CPI inflation (May) annual rate 8.6%yoy, above market expectations of an 8.3% rise. Month-on-month inflation also beat consensus reaching 1.0% • Trade deficit (Apr) dropped to $81.7bn from $107.7bn in part reflecting passing port backlog • Jobless claims resumed the noisy trend higher to 229k, from mid-Mar low suggesting softening labour market • Mortgage applications fell sharply again	• FOMC meeting. Expect 0.50% hike in FFR. Press conference likely hawkish with threat of 0.50% hike in Sept. • Retail sales (May) expected to fall in real terms on a headline and ex autos & gas basis • PPI inflation (May) boosted by oil prices • Empire and Philadelphia Fed surveys (Jun) watched for signs of further deceleration • Industrial production (May)
	• June ECB meeting was hawkish. Possible sequence of larger than 25bp rate hikes. Further periphery funding pressure likely needed for ECB to deploy (and uncover) anti-fragmentation tool(s)	• Euro area April industrial output • Final HICP prints for May. Core to monitor closely • Parliamentary elections in France (12-19 June)
	• Services PMI (May, f) revised higher to respectable 53.4 from 51.8 (p). Construction slowed to 56.4 from 58.2 • RICS reported falling new housing buyer enquiries • BRC monitor (May) suggested weak spending	• BoE meeting. Expect +0.25% hike, minutes watched for signs of guidance shift • GDP (Apr), watch for further contraction as utility hit and track & trace wind-down persist • Labour market (Apr/Mar) – softer employment likely
	• GDP (Q1) revised up to -0.1%qoq (from -0.2%), thanks to better priv consumption • Corp goods price (May) was flat (0%mom) • Gov and the BoJ released a joint statement on yen, stating "all options were on the table".	• BoJ meeting. Status quo is expected as Kuroda recently excluded any changes. Comments on current inflation will have to be monitored • Tankan mfg/non-mfg monthly indices (Jun) • Machinery orders (Apr)
	• Trade data surprises on the upside, with export growth likely bolstered by easing supply chain pressure and filling backlog orders	• May data to show a sequential recovery but activity to remain significantly below pre-outbreak levels
	• CB: Chile hiked +75bp to 9.0%, India +50bp to 4.9%, Peru +50bp to 5.5%. Poland (6.0%) & Thailand (0.5%) stood on hold. Russia cut 150bp to 9.5% • May CPI (%y/y) picked up in Hungary (10.7%), Romania (14.4%), Thailand (7.1%) & Taiwan (3.4%). It fell in Brazil (11.7%), Colombia (9.1%), Mexico (7.6%) & Russia (17.1%)	• CB: Brazil should hike +50bp to 13.25% & Taiwan +25bp to 1.625% • 2nd round presidential elections in Colombia (June 19). Polls show Petro & Hernandez in a technical tie • Q1 GDP growth in Russia should accelerate slightly to 3.6%yoy

Upcoming events	US:	Tue: NFIB small business optimism (May), PPI (May); Wed: Retail sales (May), Empire state mfg survey (Jun), Business inventories (Apr), NAHB housing market indx (Jun), FOMC announcement, TIC Long-term investment flows (Apr); Thu: Weekly jobless claims (11 Jun), Philadelphia Fed indx (Jun), Housing starts & building permits (May); Fri: Ind prod (May), Leading indx (May)
	Euro Area:	Tue: Ge Inflation (May), Ge ZEW survey (Jun); Wed: EU19 Ind prod (Apr), Fr HICP (May); Thu: It HICP (May); Fri: EU19 CPI (May)
	UK:	Mon: GDP (Apr), Indx of services (Apr), Ind prod (Apr), Mfg & construction output (Apr), Total trade balance (Apr), Trade in goods (Apr); Tue: Employment data (Apr); Thu: MPC announcement
	Japan:	Tue: Ind prod (Apr); Wed: Private 'core' machinery orders (Apr); Thu: Trade balance (May); Fri: BoJ announcement
	China:	Wed: Ind prod (May), Retail sales (May), Fixed asset investment (May); Thu: House prices (May)

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