

Macrocast

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It's starting

- Cracks appearing in the resilience of the economy – precisely when central banks were getting impatient
- We revisit our macro scenarios at mid-year.

The economy's impressive resilience so far across the Atlantic has been a key ingredient in the central banks' willingness to toughen up their stance to fight the inflation spike. If the usual "self-stabilizing forces" – e.g., a deceleration in consumption brought about by rising prices – do not show up, then the Federal Reserve (Fed) and the European Central Bank (ECB) feel even more the need to bring forward their rate hikes. However, it is precisely at the moment this new resolve is communicated that signs of deceleration are appearing. The lower-than-expected Purchasing Managers' Index (PMI) readings for June in both the US and the Euro area, together with a less concerning second estimate of United States (US) consumers' inflation forecasts in the Michigan survey for June have triggered a – rare – downward revision in the market's expectations for the Fed Funds trajectory. Besides, with no further Covid flare-up in China for now, the global economy may avoid another source of supply-side inflationary pressure through the price of manufactured goods. Finally, oil prices have moderated.

Key releases are coming out this week to gauge the speed of the correction in growth, but as we revisit at mid-year our forecasts, a painful but manageable landing is our baseline. We expect lower GDP growth in the US and the Euro area than the two central banks, but it's precisely the reason why we think they won't tighten as much as what they are communicating, which may offer some relief to the markets by the turn of the year. Still, we need to keep an eye on an alternative "persistent inflation" scenario which would force more monetary policy action. We don't think it could take the same form across the Atlantic. In the US, inflation may be difficult to tame because wage growth remains too strong. The inflation drift would then come mainly from "core", which would make the Fed's job simple, albeit painful. In Europe, another exogenous shock such as a further sharp rise in gas prices – which have already moved up last week in reaction to Russia's move on supply – is a more natural candidate. The ECB would probably continue hiking moderately to anchor inflation expectations, but we would expect some tension between governments and the central bank, while the probability to be forced to deploy an "anti-fragmentation" tool would be high – although the governments' capacity to deliver on even light conditionality would be lower.

Cracks appearing (at last)

Market volatility last week can be explained by the juxtaposition of the continuation of some “tough talking” from central banks and signs that the so far remarkable resilience in the real economy is coming to an end on both sides of the Atlantic.

Jay Powell in his testimony to Congress was explicit in his acknowledgment that a recession was possible, but that the Fed would not be detracted from its mission to deliver price stability (their commitment is “unconditional”). **Such possibility is getting less theoretical as some “cracks” in the dataflow are appearing.** The market was expecting a deterioration in the Purchasing Managers Index for June in both regions, but the decline was more pronounced than expected, even if the level of the headline index remains in expansion territory in the US and the Euro area (see Exhibit 1). The forward-looking components (new orders) are now in contraction territory, pointing to a tougher second half of the year. As we have been arguing for some time, paradoxically we *need* to see such deterioration in economic activity so that endogenous price pressure is tamed, allowing central banks NOT to deliver the entirety of the tightening they have been telegraphing.

Another piece of data struck us last week: the US consumers’ inflation 5-year ahead forecasts for June were revised **down from 3.3% to 3.1%** (a fairly unremarkable level by historical standards) in the Michigan survey’s final results. We mentioned last week how the initial jump had played a significant role in the Fed’s decision to “up the ante” and resort to a 75-bps hike rather than the 50 bps one which had been telegraphed initially. There is still a lot to say about central banks thinking twice about changing course on the basis of a limited set of data.

Exhibit 1 – Not much margin left before contraction

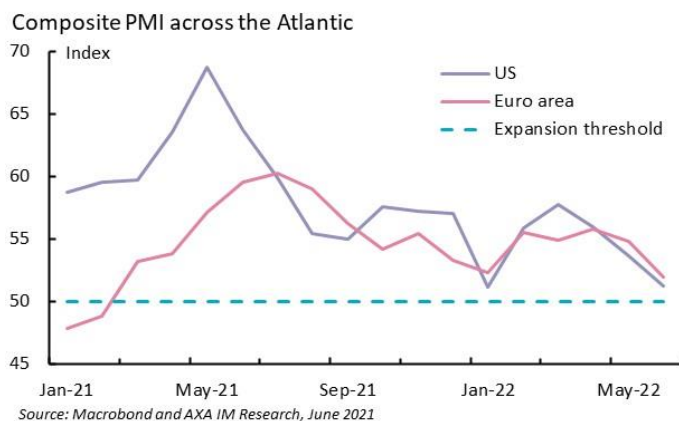
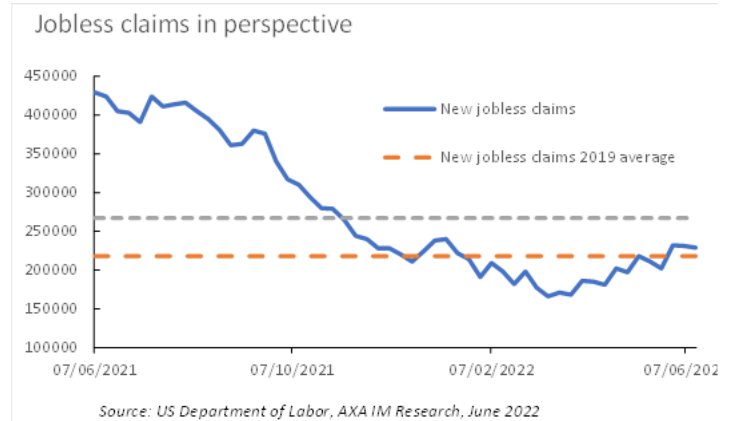


Exhibit 2 – US jobless claims moving slightly higher



The combination of the decline in the PMI and revision in the Michigan survey was enough to trigger a visible downward revision in the market’s expectations of the quantum of tightening the Fed would have to deliver. On Friday 17 June, the market saw the Fed Funds at 3.56% at the end of the 2022. A week later, this had come down to 3.40%, exactly in line with the Fed’s median forecast in the latest “dot plot”.

Habitual readers of Macrocast will remember that we don’t think the Fed will be able to deliver on this median projection – we have the Fed Funds at 3.25% at the end of 2022 and staying there in 2023 (the dot plot has it at 3.4% and 3.8% respectively). For our call to materialise, the labour market needs to react faster than what the Fed has in mind. Evidence for this is still scarce. **New jobless claims seem to have hit a trough at the end of March 2022 at 168k. It has been staying above the 200K systematically since the second week of May and caught up with their pre-pandemic level (230K in the first 2 weeks of June 2022 against 218K on average in 2019).** The amazingly strong health of the US labour market may finally be succumbing to gravity, **but it is still a low level by historical standards:** on average between 2013 (i.e., after the worst of the Great Financial Crisis was absorbed) and 2019, new jobless claims had stood at 267K per week (see Exhibit 2).

In clear, this means **that the Fed is unlikely to be terribly impressed by the first signs of softness on the labour market just yet**, even if prudence may creep in and already stay their hand on yet another 75-bps hike in July to opt for a more traditional 50, but there is another layer of uncertainty which pertains to the sensitivity of wages to the beginning of a deterioration of labour prospects, especially in a context of continuing pressure on energy and food prices. We discussed how the Federal Open Market Committee (FOMC)'s latest "dot plot" reflects a belief that only a few upward ticks in the unemployment rate could bring about a deceleration in core inflation. The nature of the current wage acceleration is very different from the 1970s. Today, most of the aggregate pay rises stem from the fact people are willing to change jobs to get better wages, rather than press for an upgrade in their current job, either individually or collectively via unions. A slowdown in economic activity triggering even a moderate reduction in job vacancies could stop this inflationary "churning" process. **The question though shift to whether employees could then revert to "traditional" in-job wage pressure since inflation is currently affecting non-discretionary items of their consumption (car transport and food in particular).**

Further pieces of data are coming out this week which could be key to keeping yields on the more benign levels they have reached last week. The message from the Markit PMI last week needs to be confirmed by the "old" Institute of Supply Managers index – and we will focus on the new orders and hiring intentions components. Personal consumption for May will also be released. We've had some "warning shots" on the resilience of US consumer spending with lower-than-expected retail sales but they are skewed towards goods while what is crucial now is demand for services. We will also have durable goods orders for May. Investment was already hit in Q1 GDP. If this continues into Q2, this would be another piece of evidence in the "significant slowdown" docket.

However, in Europe – where excess demand was absent to start with – **the latest news-flow seems to be bad enough to avoid the replication of the US pattern and the ECB opting for a bigger hike in July than the 25-bps which has been communicated in no ambiguous terms at the latest Governing Council meeting.** ECB Vice-President Guindos described the central bank's guidance for July as "*firm*". The market may however be less interested in the quantum of hike than in any elaboration on "anti-fragmentation". Not much has come out on this last week, apart from Mario Centeno's point on "no explicit spread" being targeted. This is different from Ignazio Visco's willingness to indicate 200 basis points as a possible reference value for the Italian spread. We don't think the ECB's reflexion on these matters is finalized. In the meantime, they are benefitting from the general retreat in risk-free yields which is now helping to keep spreads under control.

Catastrophe averted in China (for now)

A major source of supply-side inflationary pressure is of course the possibility that China cannot play its role of "producer of last resort" of the world economy if drastic sanitary restrictions continue to impair output, thus adding to the already visible pressure on the price of manufactured goods globally. **The latest news on this is fortunately reassuring.** The number of new cases has returned to its pre-spring barely visible level (see Exhibit 3). and it seems the country's "industrial machine" is still in a decent shape. True, the latest Caixin PMI for the manufacturing sector is still in contraction territory, but it has rebounded in May. Also reassuring is the fact that exports accelerated in year-on-year terms (see Exhibit 4). None of this should detract us from the fact **that demand conditions remain shaky in China, with a level of policy stimulus which remains subdued, but from the point of view of global inflation, what is crucial is that "China Inc" remains open for business.**

For the time being, it seems to be the case, even if of course the risk of further Covid flare-ups will continue to be a major source of uncertainty. Yet, one of the reasons why China cannot easily move away from the drastic "zero Covid" policy is the relatively low rate of vaccination among the elderly. The more time without flare-up, the higher the capacity to boost the level of immunity and the lower the need for severe sanitary measures next time. **The "absence of a catastrophe" in China has probably helped curb the most pessimistic inflation forecasts in the market and contributed to the correction in the expected trajectory for monetary policy.**

Exhibit 3 – Covid in China: tamed for bow

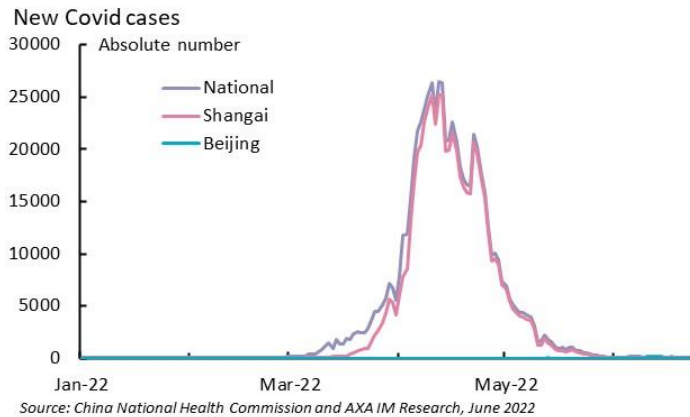
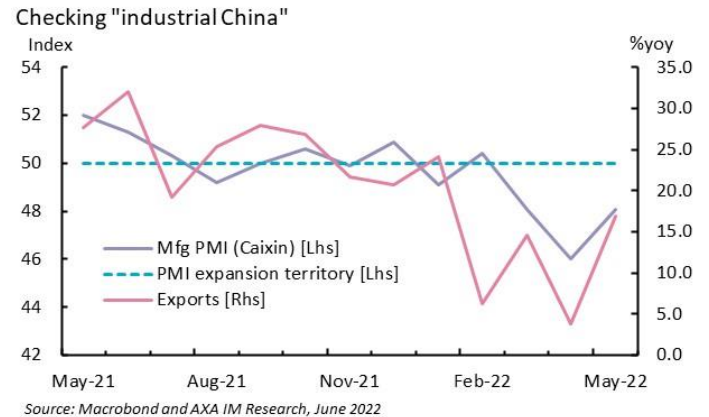


Exhibit 4 – Weak, but rebounding industry



News from the “black stuff

In addition, for those who like to focus on “green shoots”, **the decline in oil prices last week – despite a partial rebound on Friday – is another positive.** It may be an illustration of the fact long-term divergence between headline and core inflation is rare. This is usually seen from the adverse angle – ultimately wage earners care about total inflation, not whether it comes from endogenous or exogenous forces and revise up their wage claims accordingly – but there is also a more cheerful angle. If central banks are clear in their resolve to take the risk to curb excess demand to tame inflation, this should also affect commodity consumption and down the road commodity prices. **An issue though is that supply capacity in the energy sector might already be at such a high level of tension that lower demand would not necessarily trigger a large price correction.**

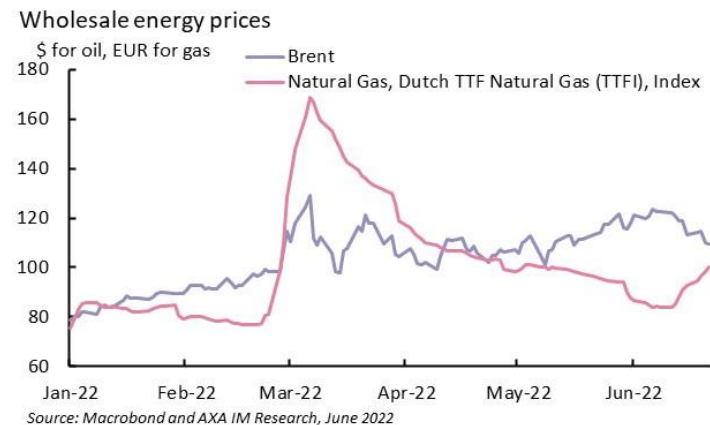
Data from the US oil industry can provide some interesting insights. According to the influential report by Baker Hughes Co, the number of US oil rigs in operation – a forward indicator of output - rose by 10 in the week to 24 June to reach its highest level since March 2020. Progress has been steady – the count has been up for 7 quarters in a row, the longest streak for a decade – but the crux of the matter remains that this would not be enough to bring production above pre-pandemic level. According to the US energy agency, domestic production is likely to reach 11.9 million barrels per day, against 12.3 million in 2019.

US oil operators are faced with two headwinds: first, they tend to be highly leveraged, and the recent spike in corporate funding costs which we explored last week will hit them. Second, the current US administration is lukewarm at best when it comes to further development in domestic oil capacity. The combined effect of the two is that operators have a low incentive to invest and expand capacity, while they can use their current improvement in income to pay down debt as fast as possible. Discounted Russian oil can help keep a lid on aggregate oil prices, but the below par recovery in US production capacity still puts us in a configuration in which the producers with the widest room for manoeuvre – Saudi Arabia in particular – are unlikely to boost production much further after the concession they offered a few weeks ago on bringing forward and extending a schedule output boost.

In any case, any short-term relief from lower oil prices is likely to be offset, for European consumers, by the rise in wholesale natural gas prices (see Exhibit 5). This is the logical consequence of Russia “upping the ante” on its supply to Europe. Given the role of gas in electricity generation in Europe and the technical limitations to finding alternatives to Russian supply, the Euro area remains faced with a very unpleasant dilemma: allow public deficits to rise further by mitigating the impact on consumer income or allow headline inflation to continue rising.

Unfortunately, **we cannot thus exclude that we could soon face a rare occurrence of a sustained disconnect between headline and core inflation.** While the latter would be gradually curbed by the deterioration in economic activity engineered by the policy tightening, the former would remain far above the central bank target as the succession of supply shocks to energy and food would not cease. Second round effects via wages would be contained by the deterioration in employment prospects.

Exhibit 5 – Oil and gas prices in a pincer movement



Two versions of a “persistent inflation” scenario

This gets us to where we stand on the balance of risks around our forecasts as we have got to the middle of the year. **A manageable but still painful landing is our base case.** We expect GDP to grow less in 2023 in both the US and the Euro area than what their two central banks are currently expecting (1.2% versus 1.7% for the US, and 0.7% versus 2.1% for the Euro area), as the market-led tightening in financial conditions and self-stabilizing forces (consumption impaired as real income is eroded by inflation) would kick in on top of the reversal of the monetary policy stance. These annual averages would be consistent with quarterly GDP into or on the verge of contraction at the turn of the year. The loss in growth dynamics would be sufficient to bring about a deceleration in core inflation which would help keep a lid on long-term interest rates. We would thus see the US 10-year yield at 3.15% by the end of 2022, and 10-year Bund yield at 1.5% - i.e., stabilizing at a level close to the one observed at the end of last week. We would see two symmetric risks around this baseline.

First, as a kind of “extreme version” of our main forecasts, **we cannot discard the possibility that the sum total of self-stabilizing forces, market tightening, and policy restriction triggers a “sudden stop” in demand** so that 2023 GDP growth would be flat on an annual average basis. This, considering the base effects, would take a more severe quarterly contraction in GDP at the turn of the year. Long-term interest rates would then fall back below 3% by year-end (a fully inverted curve) in the US and below 1% for Bund yields, as core inflation would correct faster than what the central banks themselves are currently forecasting. In short, a painful, but relatively short-term correction.

Second, a **“persistent inflation” scenario** which would force even tighter monetary tightening, above the Fed’s median forecast in the US for the policy rate (north of 4% in 2023) and into restrictive, rather than neutral territory in the Euro area (above 2%), resulting in a significant recession (-1%/-2%) in annual average in 2023). Long-term interest rates could be very volatile in this configuration, with inflation expectations de-anchoring, initially consistent with a steepening of the curve, before the response from central bank would ultimately restore credibility and trigger a curve inversion. In short, **a very painful, and protracted correction, with maximum damage for risky assets.**

Still, the root cause of such persistence would likely be quite different across the Atlantic. In the US, an overheating labour market and spiralling wages would be the most obvious candidate. Core inflation would be the main source of overshooting, making the Fed’s job simple, if painful. In the Euro area, it’s more the exacerbation of the exogenous shocks, and particularly another steep rise in gas prices, which would be the natural trigger of the “persistent inflation” scenario. This would make the ECB’s job much less simple.

The Euro area would find itself in the durable divergence between core and headline inflation which we discussed earlier in this note. Hiking policy rates further to avoid a drift in inflation expectations would probably be the ECB’s “natural slope”, but we would then expect significant political tension within the monetary union. Indeed, in the

“painful for longer” configuration, governments would be under intense pressure to further mitigate the shock with fiscal support and resent an ECB stance which would impair its funding conditions. Markets themselves would probably take notice of the deterioration in GDP growth and further drift in fiscal positions. It’s probably in this “persistent inflation” scenario that the probability for the ECB to be forced to deploy its anti-fragmentation tool would be highest, but also where the capacity for governments to deliver on even light macroeconomic conditionality would be lowest.

Country/Region	What we focused on last week	What we will focus on in next weeks
	<ul style="list-style-type: none"> Fed Chair Powell testimonies to Congress described “unconditional” focus on restoring price stability and “possibility” of recession Commentators increased probability of US recession, few have this as base case Existing home sales (May) -3.4% on month Jobless claims remain on rising trend, 229k latest Manu & serv PMI (Jun, p) both fall sharply President Biden meets with oil & gas industry 	<ul style="list-style-type: none"> PCE inflation (May) headline & core watched to see if set new highs again following CPI Personal spending (May) watch for how much spending on services offset weakness in goods ISM manufacturing index (Jun) still expected solid GDP (Q1, final) no large revision to -1.5% (prelim) Consumer confidence (Conf Bd) (Jun) – has been more resilient than other measures to date Durable goods orders (May) guide to Q2 GDP
	<ul style="list-style-type: none"> Business and consumer surveys have surprised to the downside dropping noticeably in June, especially the former. Forward looking components suggest more downside to come. 	<ul style="list-style-type: none"> June EC survey, member states consumer confidence for June. France May consumer spending Flash HICPs for June. For euro area, we look for a new high to 8.4-8.5%
	<ul style="list-style-type: none"> CPI inflation (May) rose to 9.1% on higher food prices which likely have further to go Retail sales incl fuel (May) fell by 0.5% on weaker April figure revised down to 0.4% from 1.4% GfK Cons conf (Jun) slips to -41 – a new low Conservatives lose both seats in key by-elections 	<ul style="list-style-type: none"> UK national accounts (Q1) little revision expected to provisional Q1 figure of 0.8% BoE Household lending data (May) Nationwide House price index (Jun) may begin to show signs of moderation MPC’s Bailey to speak at ECB Forum (Weds)
	<ul style="list-style-type: none"> Mfg PMI Flash (June) fell to (-0.6pt). All components were down (output, new orders, stocks) excepted delivery time and employment that have improved Svcs PMI is up for the 4th consecutive month at 54.2 CPI (May) eased (+0.2%mom -0.2p), flat at 2.5%yoy 	<ul style="list-style-type: none"> On demand driven indices, we will have retail sales (May) and consumer confidence (Jun) IP (May) is expected to stay weak (-0.3%mom) Tankan surveys (Q2) to gauge companies’ outlook Jun CPI Tokyo may slightly rise after energy pick up
	<ul style="list-style-type: none"> House sales in 30 major cities recover in June, although it is not clear how sustainable this is 	<ul style="list-style-type: none"> Market will pay attention to further policy changes by Beijing and news of potential tariff reduction by the US
	<ul style="list-style-type: none"> CB: Mexico +75bp (7.75%), Philippines +25bp (2.5%). Turkey (14%) & Indonesia (3.5%) on hold May CPI (%yoy) higher in South Africa (6.5%), Singapore (5.6%) Gustavo Petro elected President of Colombia (watch for upcoming appointments of Cabinet) 	<ul style="list-style-type: none"> CB: +50bp expected in Hungary, +150bp expected in Colombia Q1 GDP in Russia, Kenya, Egypt June CPI (%yoy) in Poland, Peru, Indonesia PMI survey results
Upcoming events	<p>US: Mon: Durable goods orders (May,p), Pending home sales (May); Tue: Goods trade balance (May), Wholesale inventories (May,p), Case-Shiller & FHFA house price indx (Apr), Conference Board consumer confidence (Jun); Wed: GDP (Q1), Core PCE (Q1); Thu: PCE (May), Personal income & spending (May), Weekly jobless claims (25 Jun), Chicago PMI (Jun); Fri: Mfg PMI (Jun), ISM mfg indx (Jun)</p> <p>Euro Area: Mn: ECB forum on Central Banking; Tue: Fr Insee consumer confidence (Jun); Wed: EU19 M3 (May), EU19 Business confidence (Jun), Ge & Sp HICP (Jun,p), Ge CPI (Jun,p); Thu: EU19 & It Unemployment (May), Ge Unemployment (Jun), Fr HICP (Jun,p), Fr Consumer spending (May); Fri: EU19 mfg PMI (Jun), EU19 CPI (Jun)</p> <p>UK: Wed: BRC Shop Price indx (Jun); Thu: GDP (Q1), Business inventories (Q1), Private consumption (Q1), Current account (Q1); Fri: Lending data (May), M4 (May), Mfg PMI (Jun)</p> <p>Japan: Mon: Leading indx (Apr); Thu: Ind prod (May,p); Fri: Tankan large manufacturer’s indx (Q2)</p> <p>China: Mon: Industrial profits (May); Thu: Official mfg & non-mfg PMI (Jun); Fri: Caixin mfg PMI (Jun)</p>	

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