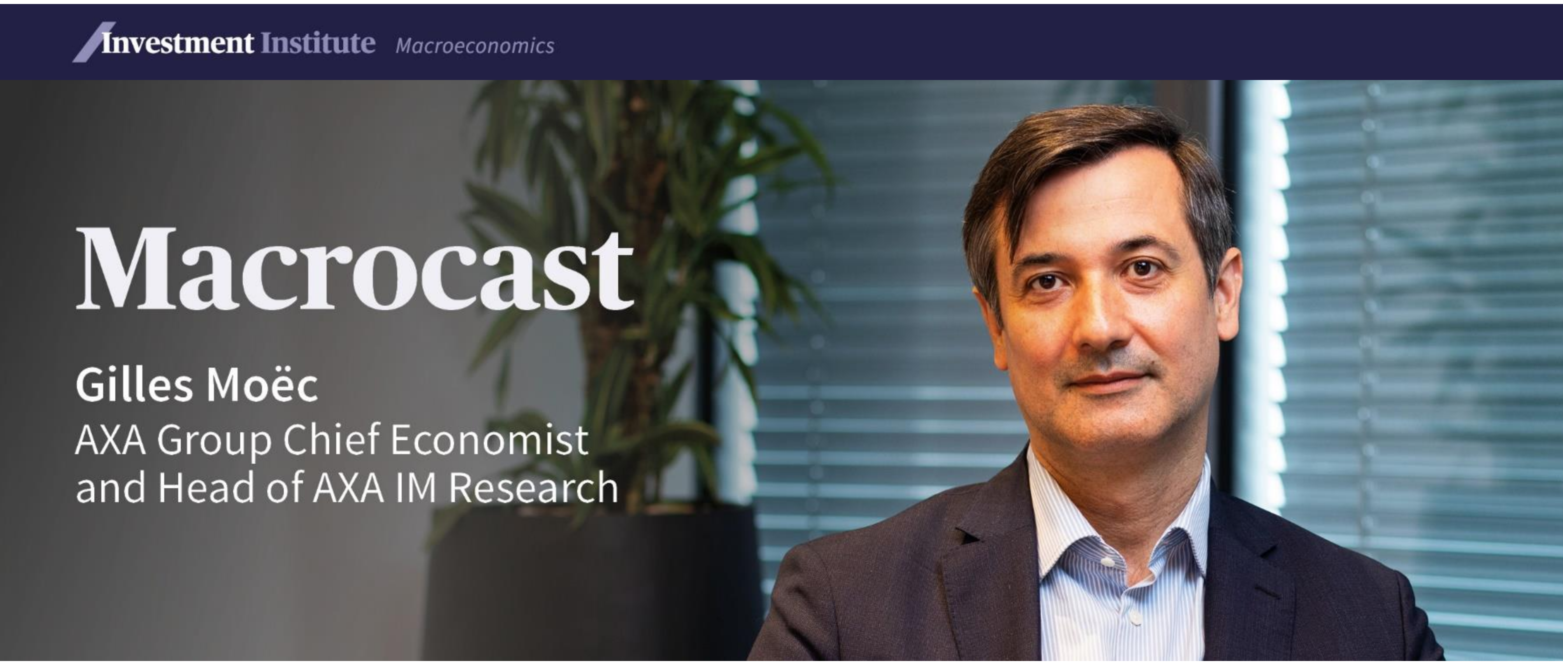
145 – 25 July 2022



Will Meloni Mellow?

- The European central Bank (ECB)'s Transmission Protection Instrument (TPI) is unlikely to help Italy. How the parties likely to win the elections on 25 September frame their economic agenda is key.
- There is inertia in the central banks' current hawkish stance, but signs of economic slowdown are accumulating on both sides of the Atlantic. This may affect the policy debate by the end of the summer.

The ECB chose to "rip the band aid" on negative rates and hiked by 50 basis-points (bps) despite fresh and unambiguous forward guidance in June that it would start with a 25bps. This may come with a permanent cost to credibility if the ECB decides in the future to offer forward guidance again. The Council probably saw the move as a worthy concession to the hawks to get unanimous backing for TPI, its new anti-fragmentation instrument. Still, while we see TPI as potentially powerful to offer protection to the rest of the periphery in case of contagion from Italy, we don't think the new weapon helps to deal with the Italian drama itself. Even TPI's "light conditionality" entails complying with some existing "contracts" with the EU which were at the heart of the tension within Draghi's coalition. The message to Italy's political circles is that for now, "they are on their own". How the parties likely to win the snap elections on 25 September amend their current manifestos will be key to curb any further spread widening. Giorgia Meloni – leader of Fratelli d'Italia, currently ahead in the polls in a right-wing coalition – has already toned down her Eurosceptic stance, but on tax and structural issues, radicalism still prevails.

The ECB is clear it wants to continue with normalization. We note however that for many economic agents in the Euro area, financial conditions are already restrictive – the latest Bank Lending Survey suggests lending standards are hardening fast. The flash Purchasing Managers Index (PMI) for July is consistent with a quick pace of deterioration in the real economy and the emergence of involuntary inventories may at last curb the current price dynamics. This may gradually offer some ground to the ECB doves, even if we think the next move in September will be at 50bps as well.

This week we expect the Federal Reserve (Fed) to hike by 75bps. There as well adverse signs on the real economy are accumulating, but in the US initial overheating was obvious, which is likely to keep the Fed on a quite hawkish path for now.

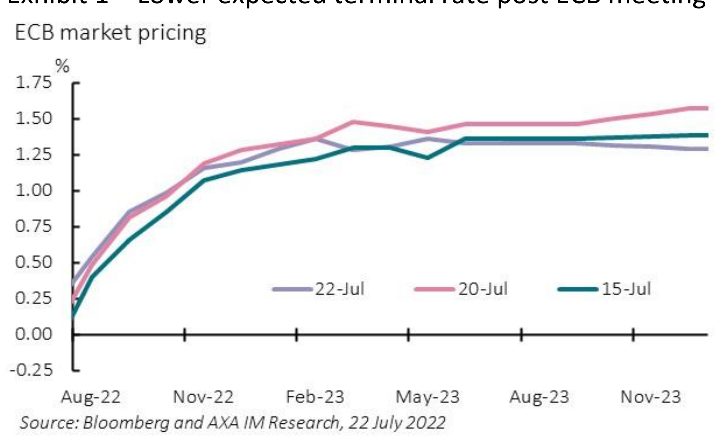
ECB rips the negative band aid – it hurts…

We were surprised by the European Central Bank (ECB)'s decision last week to hike by 50 basis points (bps), despite fresh and unambiguous forward guidance from last month that they would start with a 25bp move. Christine Lagarde provided two main explanations for this decision: first, that the central bank felt the need to respond to another higher-than-expected inflation print for June which lifted some measures of expected inflation; second, that setting up the Transmission Protection Instrument (TPI), their anti-fragmentation weapon, made the Governing Council confident the market could take a swifter normalization in the policy stance. We are not fully convinced by the second argument: when the ECB telegraphed a 25bp hike at the June meeting, they also communicated on their work towards such protection tool. Unveiling the TPI should not have been a game-changer, unless they were concerned at the time that they would ultimately fail to come up with anything convincing on anti-fragmentation.

We suspect that "ripping the band aid" and move the policy rates in positive territory in one go, rather than waiting for September, was the result of an internal compromise to get unanimous backing for the TPI. Including the hawks in the support to TPI was probably seen as a key ingredient in the instrument's credibility. This comes with a price though. Many major central banks in the last few months have delivered bigger than expected hikes, but none has done it after breaking a forward guidance which was not a mere hint, a somewhat coded message, but an indication which was explicitly embedded in what is the most official means of communication – here, the "policy statement" endorsed by the Governing Council. **Should the ECB feel the need to resume forward guidance in the future, it should not expect the same kind of swift transmission to the market**, which from now on will have a very good reason to take anything is said by the Governing Council with a pinch of salt.

However, for now, at least the ECB has re-created some internal consistency**. Forward guidance is for now suspended and the ECB moves to a "meeting by meeting" data dependent approach to decision-making**. The general direction of travel remains clear though. A "further normalization of monetary policy" is appropriate, towards "a neutral range" – which however Christine Lagarde refused to define, even in broad terms. The pace of such further normalization remains uncertain – Lagarde dropped the "gradual" qualifier**. This means the market needs to price the future moves using a combination of its own macro outlook and its now poorer understanding of the ECB's reaction function.**

Exhibit 1 – Lower expected terminal rate post ECB meeting



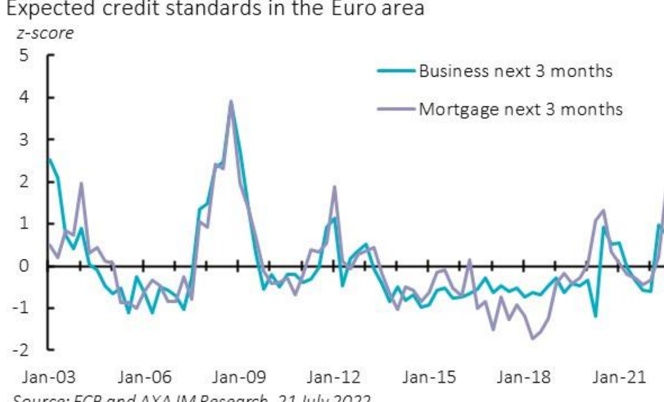
Source: Bloomberg and AXA IM Research, 22 July 2022

What we find interesting in the market reaction to the ECB's announcement is that it did not really take it on the "hawkish side". Using the forward rates, the "terminal rate" seen for the ECB is now lower than just before the Governing Council (Exhibit 1). In a week, the market has moved up its expectation for where the policy rates would be at the end of 2022 – reacting to the sense that the Governing Council wants to go "faster and harder" in the short run – but after that**, the ECB is seen as leaving rates close to the lower end of the "neutral range"** mentioned by Banque de France Governor Villeroy de Galhau (between 1% and 2%).

We could interpret this move in two very different ways. The first – which would bring comfort to the ECB – is that a "faster/harder" normalization pace would bring inflation back under control swiftly so that only a modicum of tightening would be ultimately needed. The second – more concerning – is that the market may be suspecting a "policy mistake" is in the making, and that the central bank is not paying enough attention to the signals which are accumulating of a significant deterioration in economic activity which will ultimately "stop out" the ECB irrespective of the inflation dynamics.

Habitual readers of Macrocast will know that **your humble servant has an issue with the "accommodative" and "neutral" qualifiers for the policy stance because what matters is not so much where the policy rate is, but how financial conditions react to the central bank's signals.** The ECB's bank lending survey, released last week, suggests that banks were already busy tightening their credit standards quite fast, for both businesses and households (Exhibit 2) before the ECB changed the rates. This is already being felt by businesses. To gauge this we can use the Rexecode survey. It covers only France but it provides a quick "snapshot" of the financial position of firms. The trend in "cash at hand" is now on a swift declining slope, while it is getting harder to secure external funding (Exhibit 3).

Exhibit 2 – Steep tightening in lending standards



Source: ECB and AXA IM Research, 21 July 2022

Exhibit 3– Much less easy financial conditions for corps

Source: Rexecode and AXA IM Research, 21 July 2022

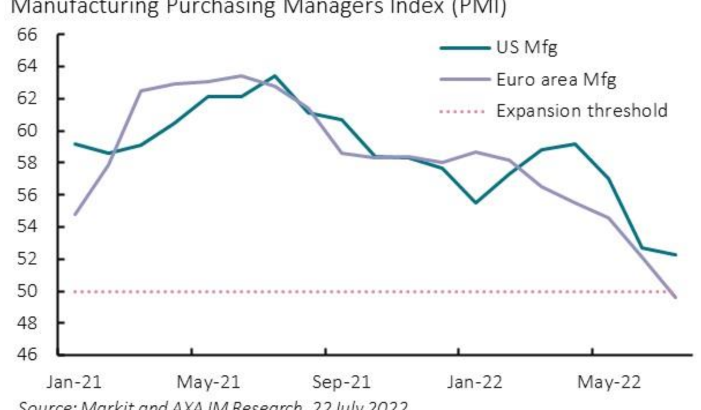
Of course, the ECB's "single compass" if inflation, and it will always gauge its policy stance according to how prices are *reacting* to a set of supply and demand conditions, rather than to these conditions themselves, but still, we may be at a tipping point when underlying price pressure could start abating.

The release of the Markit PMIs for July last week was a shocker, suggesting the slowdown in the global economy is gaining momentum. In the US, it's the services component of the PMI which went into contraction territory, while in the Euro area the decline was driven by manufacturing (Exhibits 4 and 5). What we find particularly interesting in the qualitative details provided by Markit is the emergence of "involuntary inventories "in the Euro area: *"this steep reduction in input buying by factories in turn reflected a large rise in warehouse inventories of inputs and **the largest build-up of unsold finished goods ever recorded by the survey**, often linked to lower than anticipated sales to customers and weakened order books".* Coupled with the fact that *"average suppliers delivery times lengthened in July to the least extent since October 2020"*, reflecting easing supply-line disruptions, this could be the signal that price pressure "up the pipeline" is finally abating. Indeed, so far producers haven't had any difficulty in passing the rise in their input prices to the final consumers amid strong demand. From now on, **those left with unexpected inventories may finally be forced to curb their asking price to normalize them.**

True**, Europe has for now escaped the "worst case scenario" in which Russia chooses to turn the tap off its supply of gas**. Deliveries have re-started last Thursday at the end of the 10 days "maintenance period". Pressure is not disappearing entirely though, as Moscow continues to warn against possible disruptions ahead, e.g., by demanding more concessions on the sanction regime to allow more gas-related equipment to be shipped back to Russia. This will

continue to cloud the horizon and is unlikely to instil much confidence in the Euro area business community, especially in Germany where the decline in the PMI has been particularly acute: it was still in expansion territory in the France for the manufacturing sector, while it was in contraction for both manufacturing and services in Germany.

Exhibit 4 – Euro area manufacturing in contraction



Source: Markit and AXA IM Research, 22 July 2022

Exhibit 5 – US services in contraction

Source: Markit and AXA IM Research, 22 July 2022

This gets us to our forecast for the ECB's next move. In our baseline, given the ECB's choice to remove the word "gradual" from the policy discussion, and still chunky inflation prints over the summer, we expect the central bank to hike by another 50bps in September. The issue however is how to weigh the balance of risks around this central scenario. Given the speed of the deterioration in the data flow, we think there's a significant probability that the Governing Council finally opts for 25bps**. Now that the ECB's rates constellation is in positive territory, the terms of the debate may have changed.**

Indeed, some Council members of a dovish disposition never liked negative rates in the first place, in particular because of their potentially counter-productive impact on the banking industry and hence on policy transmission. Now that this "anomaly" has been corrected, they might be in a better position to argue against a quick pace of tightening, even in the face of still strong inflation prints, if they can make the case that underlying price pressure is moderating in line with the slowdown in economic activity. September may be too early for this line to win the debate at the Governing Council, and we suspect some hawks, well aware of the deterioration in the real economy, may conversely insist on bringing rates as high as possible "while they still can". The conversation may have to wait until the October meeting.

Exhibit 6 – the dollar is strong; the euro is not historically weak

Source: JP Morgan and AXA IM Research, 21 July 2022

In any case, **another striking point from last week's surprise move by the ECB is that the exchange rate is the small effect it had on the euro exchange rate, which remains stuck dangerously close to parity.** This is surprising given the

consensus view – which we share – that having policy rates in negative territory had a non-linear effect of the exchange rate. There is no cause for alarm in our view. While the depreciation has been swift over the last few months, in trade-weighted terms, the level of the euro is nowhere near a historical low, while the dollar has reached a historical peak (Exhibit 6). **Today's problem is the strength of the dollar, not the weakness of the euro.** There is no reason to rush to "systemic conclusions" for Europe there. Still, in the short run, the depreciation of the euro has of course magnified the impact of the rise in international commodity prices on European inflation. We suspect a good share of the "absence of rebound" in the euro exchange rate over the last few days reflects some generic concerns over the macro-political outlook for the Euro area, triggered by the Italian political drama, which the ECB's TPI is unlikely to address.

Will Meloni mellow?

As we expected, **the TPI conditionality is "light" in the sense that it would not entail a specific "contract" between the sovereign faced with market pressure impairing the "singleness" of the ECB's monetary policy, and the central bank or any other European institution**. Rather, on the basis of existing frameworks – complying with the EU fiscal surveillance rules (e.g., not being under Excessive Deficit Procedure) or delivering on the "milestones" already agreed with the European Commission against the disbursement of the loans and transfers for the Next Generation Fund – the ECB will make up its own mind, adding to the mix debt sustainability analysis. **This addresses one of the major flaws of the set-up so far: while Outright Monetary Transactions (OMT) has been there as a potential solution since 2012, they require a formal request by a government and an ad hoc negotiation**. This made this instrument quite cumbersome to use in "real life" when market pressure can change at short notice. Here, the ECB will have the possibility to start the programme at any time, on its own initiative, while lowering the "political cost" threshold for the governments at the receiving end.

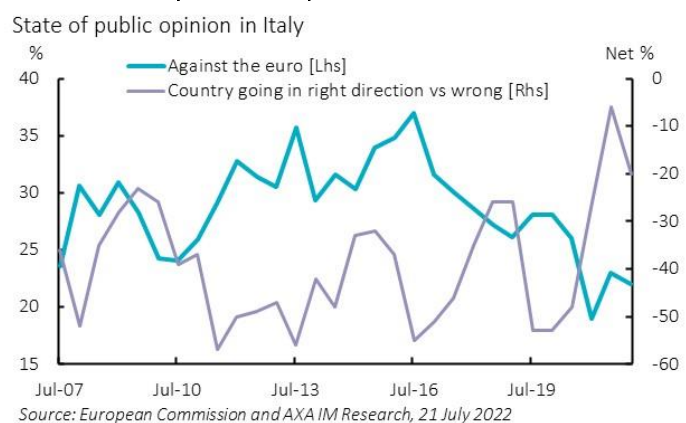
This is undeniably progress, but **there are features of TPI as unveiled last week which leave us with some concerns**. It is completely understandable that the Governing Council retains maximum discretion on the "rules of engagement" of the new instrument, but some more technical elements could have been detailed from the get-go. Habitual readers of Macrocast may know that your humble servant has a bit of an obsession with the conditions for the sterilization of additional purchases of bonds in the fragile countries, outlining two possibilities: either selling – or reinvesting less in – bonds from sovereigns which are not benefiting from the new purchases, or pumping some excess liquidity from the banking sector. The wording used by the ECB on this is quite ambiguous and leaves the two options open**. If the Governing Council could not agree with these technical, but crucial features of the programme, maybe this signals a deeper lack of agreement on the overall scope of the TPI**. As Lagarde herself said during the Q&A, the central bank very much hopes it will never have to activate TPI. Doves and hawks may have agreed not to get too deep into the technicalities of the instrument because a more precise conversation could have open glaring rifts.

In any case, **we don't think the TPI can be the solution to Italy's current predicament**. Christine Lagarde had many occasions last week during the Q&A to send a warning to those in the market tempted to "short" Italy but managed to not even use the word "Italy' in her answers. There may be a good reason for this. As we wrote last week, even the light conditionality attached to the TPI could be problematic for Italy given its current political issues. While the EU's fiscal surveillance framework is suspended for now, delivering on some of the NextGenerationEU (NGEU) milestones was at the heart of a tension emerging within Draghi's collation.

We find it interesting that in the Q&A, when asked about the possibility for the ECB to control sovereign spreads, the ECB President chose to mention OMT as one of the instruments in the arsenal. This may be a message to Italy. Since the current spread widening there is "home grown", i.e., triggered by a political crisis which could jeopardize the country's macro trajectory, the ECB may not be comfortable to act without an explicit and detailed contract with Rome, which would be better achieved via OMT. TPI would however be the weapon of choice to provide help to the rest of the periphery should contagion from Italy appear.

Being in full control of "anti-fragmentation" could end up being a double-edged sword for the ECB though. Now that a new instrument exists, it is going to be very tempting for Italian politicians to clamour for its activation if the spread continues to widen, and then accuse the central bank of partiality against Italy if it refuses and sends the country to an OMT solution. We may be back to the complicated days of 2010, when the ECB was exerting pressure on Rome – e.g., via the famous letter from Jean-Claude Trichet and Mario Draghi, then Governor of Banca d'Italia, to Silvio Berlusconi, demanding specific action on fiscal issues – which ultimately triggered a backlash from Italian public opinion.

Exhibit 7 – Italy's Eurosceptics have lost a lot of traction



What the Italian parties best positioned to win the snap elections on 25 September say on their projects is going to be key. Reading the polls, the likeliest scenario would be a victory by far-right Fratelli d'Italia (FdI) in coalition with Lega and Forza Italia. FdI's leader, Giorgia Meloni, has become less vocal against the EU lately – even if the official manifesto of her party, still mentions "*shifting to a confederation of sovereign states*" rather than the current *"federalist project"* which has "*become France and Germany's playground*". She has also publicly stated that Italy under a FdI Prime Minister would still send weapons to Ukraine, to placate concerns over the other coalition parties' pro-Russian leanings. Meloni is adjusting to the current mood of the Italian electorate. Support for the monetary union has increased significantly over the last three years, and Italians' opinion on their country's outlook has improved a lot (Exhibit 7). Draghi's exit was the product of a parliamentary manoeuvres, while public opinion was still quite supportive of him. This may inform Meloni's approach to the election campaign.

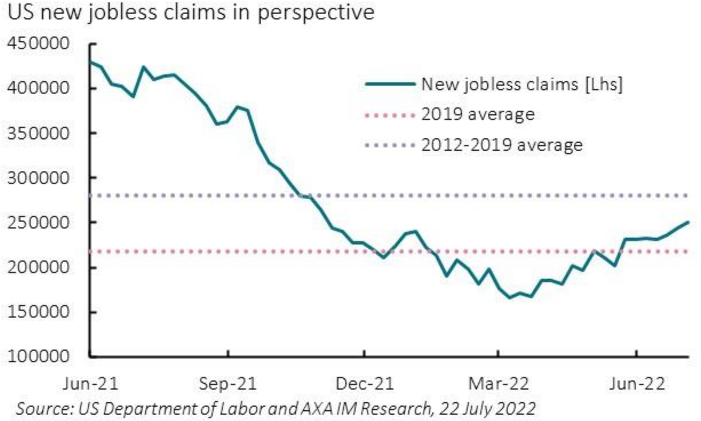
Yet, what remains unclear is how FdI's views have changed on the economy. Their manifesto remains radical on tax issues – they support massive tax cuts which at least in the short run would probably inflate Italy's deficit – and quite reluctant on key structural issues (for instance FdI is against limiting the use of cash in transactions which has been a crucial weapon in fighting tax evasion). This would send Italy on a collision course with Brussels. As we wrote last week, it's entirely possible Meloni will choose to focus her campaign on societal issues – e.g., fight against immigration – and go "mainstream" on economic questions, but so far, the move has not materialised, and a question mark would remain as to her actual behaviour once in power.

Fed hiking again mid blowing headwinds

Now that we know where the ECB stands (kind of…), **we need to focus again on the Fed this week**. We expect another 75bp hike. There as well the deterioration in the real economy is spectacular, judging by the latest PMIs, but the Fed is faced with a clear legacy case of excess demand and won't want to "lower its guard" too early. Troye, the labour market is getting visibly less buoyant. *Initial* jobless claims continue to rise and are now significantly above their 2019 level (Exhibit 8) and the very latest development is that *continuing* jobless claims have stopped falling (Exhibit 9), which suggests that those losing their job have a harder time finding a new one. However, these indicators remain at a comfortably low levels by historical standards and the Fed is likely to want to see more "pain" before being satisfied

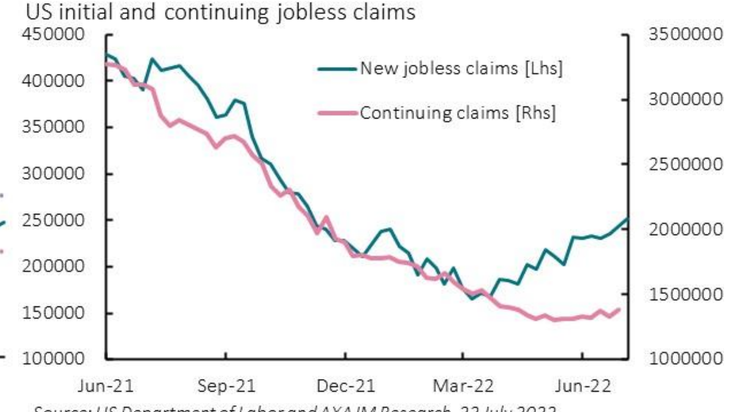
that it can reduce its pace of normalization. In addition, a number of interesting data points will be released only after the Fed's decision, in particular the latest print for the Personal Consumption Expenditures (PCE) and probably more interestingly – since we know since the release of the Consumer Price Index (CPI) that underlying inflationary pressure is still far from decelerating – GDP (out of Thursday) and the labour cost index (out on Friday) for Q2 2022. In a way, we are going to be more interested in the "Fedspeak" after these data points are released. It has been our call for some time that the Fed will not be able to bring its policy rate by year end at the level it has been communicating on via the "dot plot". The "evidence docker" of the doves is filling, but it might not impact actual policy decisions before the end of the summer.

Exhibit 8 – Initial jobless claims continue to rise



Source: US Department of Labor and AXA IM Research, 22 July 2022

Exhibit 9 – Those losing their job have a harder time finding another one



Source: US Department of Labor and AXA IM Research, 22 July 2022

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Philadelphia Fed survey (Jul) fell to -12.3 – lowest since 2011&12. Major declines in prices paid and received and delivery times. • Jobless claims reached 251k – a 4-mth rising trend • June's existing home sales (-5.4%) and housing starts (-2.0%) both fell by more than expected • President Biden failed to call a Climate Emergency after talks with Manchin failed. Announced $2.3bn package (0.01% GDP), far short of proposed $450bn	• FOMC meeting. We expect 75bp hike and Powell to warn markets of more while inflation remains elevated. • GDP (Q2) estimate 1% (saar) with inventory and trade key uncertainties, cons 0.5%, Atlanta -1.6% • PCE inflation (Jun) expected to test 6.6% March high, 'core' expected 4.8% vs 5.3% in Feb • Employment cost index (Q2) f'cast 1.1% in line with consensus
	• ECB finally opted for a 50bp rate hike due to worries on inflation (short and long term) as well as an agreement on anti-fragmentation tool (TPI) • Draghi era comes to an end, President Matarella calls for legislative election due on 25 Sep. • Gas flow resumes (NS1), fears of cut unchanged • EMU cons conf dived to -27 (-23.8), aggregated PMI in contraction (49.6) dragged down by Ge	• Ge Ifo data is likely to confirm the contraction already shown by PMIs. At the euro area level, EC surveys (July) should also highlight broader signs of deceleration. Price expectations to be monitored • Most EMU countries will unveil Q2 GDP growth • We believe preliminary EMU HICP will reach 8.8%yoy in July, up by 0.2pp from June (cons: 8.7%). Sales period can distort the reading
	• Labour market data (May) saw wage growth pick up – we now expect +50bps in August MPC • HMRC payrolls (Jun) pointed to softening employmt • CPI inflation (Jun) rose to 9.4% above expectations as food and fuel drove the rise • Retail sales inc fuel (Jun) rose -0.1%	• Conservative leadership election, with televised debate between final two, Sunak and Truss (Mon) • BoE household lending data (Jun) • Nationwide house prices (Jul) • Business indicators and surveys – CBI Business trends survey and Lloyd's business barometer (Jul)
	• BoJ meeting no policy change as expected. Gov Kuroda: "no intention at all of raising rates" • Flash PMI (Jul) fell to 50.6, with Services PMI falling on recent rise in COVID cases • CPI (Jun) rose to 2.4% on rising import costs	• Tokyo CPI (Jul) expected to rise to 2.4% • Labour market data (Jul) • Retail sales (Jun) rise expected to slow to 0.2% • Industrial production (Jun, p)
	• COVID cases have risen over the past week, prompting authorities to reactivate restrictions, although no city-wide lockdown yet	• Market will continue to pay attention to COVID development and what appears to be spreading the risk in the real estate sector
	• CB: South Africa hiked +75bps to 5.50%. Indonesia (3.50%) and Turkey (14.0%) kept their policy rates unchanged. Russia cut 150bps to 8.0% • Annual inflation (June) accelerated in Malaysia (3.4%) and South Africa (7.4%) • Taiwan's June export order growth edged higher on easing supply disruptions	• CB: Hungary is expected to hike +75bps to 10.5% and Colombia +125bps to 8.75% • June CPI (yoy) in Singapore and July CPI in Poland • Q2 GDP figures in Korea, Mexico and Taiwan • June Industrial production data in Korea, Russia, Singapore, Taiwan and Thailand • Unemployment numbers in Brazil and Mexico

Upcoming events		
	World:	Tue: IMF July 2022 World Economic Outlook Update
	US:	Tue: Case-Shiller & FHFA house prices (May), Conf Bd cons conf. (Jul), New home sales (Jun); Wed: Durable goods orders (Jun), Goods trade (Jun), Pending home sales (Jun), FOMC announcement; Thu: GDP (Q2), Weekly jobless claims; Fri: PCE inflation (Jun), Personal income/spending (Jun), Employment cost index (Q2)
	Euro Area:	Mon: Ge IfO Index (Jul); Wed: EU19 M3 money supply (Jun), Fr Insee consumer conf. (Jul), It ISTAT business and cons conf. (Jul); EU19 Business conf. (Jul), Ge HICP (Jul); Fri: EU19 GDP (Q2, p), CPI estimate (Jul, p), Ge unemp (Jul), Ge GDP (Q2), Fr GDP (Q2), Fr Cons spending (Jun), Fr HICP (Jul), Sp GDP (Q2) and HICP (Jul)
	UK:	Mon: CBI Ind. trends survey (Jul); Fri: BoE lending data (Jun), Money supply – M4 (Jun)
	Japan:	Fri: Unemployment (Jun), Ind prod (Jun), Consumer conf. (Jul)
	China:	Wed: Ind. profits (Jun); Sun: Official manufacturing and non-manufacturing PMU (Jul)

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