# 154 – 17 October 2022

# Macroeconomic Suez

- Jeremy Hunt is launching a fiscal re-set in the UK, even if the full details won't appear before the end of the month
- The UK pension fund issue raises questions on potential sources of financial instability elsewhere
- The "reawakening of the doves" continues on both sides of the Atlantic, but it's not for immediate consumption

Market forces have proved too strong for the UK's supply-side, trickle-down experiment. The new Chancellor of the Exchequer has re-set British fiscal policy even if we will have to wait until the end of the month for full details. The next 2 weeks are thus crucial as investors wait for the final cut of the budget bill amid lingering political instability. The change of tone with the arrival of Jeremy Hunt may suffice to appease the "bond vigilantes" for now, allowing the Bank of England (BOE) to keep the tap off direct bond market intervention. If pressure lingers, the bar for a resumption of BOE intervention is now probably lower since the moral hazard issue is less acute.

The whole episode could be seen as the natural consequence of "hard Brexit", with unfunded tax cuts and supply-side reform the sole politically palatable option remaining given the cost of high trade friction with the European Union (EU), only to crash against financial reality. The Suez operation in 1956 is a "founding trauma" for modern Britain, as it discovered it was no longer a "Great Power". This month's fiscal drama could convince the UK authorities that their capacity to steer a lone path on economic matters is small. Perhaps the silver lining around this cloud is that a re-assessment of the UK's relationship with Europe could start. October 2022 may have marked "peak Brexit".

The issue with the UK pension funds is raising questions on the next potential sources of financial instability. The steep increase in corporate refinancing gaps must be monitored. Fortunately, businesses have taken advantage of the low interest rate period to lengthen the maturity of their debt, which gives time to absorb the shock. Yet, the tightening in broad financial conditions will hurt growth. Central banks are however ready to take risks to break the back of inflation. While the "reawakening of the doves" continues on both sides of the Atlantic, it is not for immediate consumption. For now, the signal from the current dataflow – e.g., the higher-than-expected United States (US) core inflation in September – is stronger than the more prudent message from the models.

## Gravity prevails in the UK - finally

**Market forces have proved too strong for the United Kingdom (UK)'s supply-side, trickle-down experiment.** While Liz Truss' short press conference last Friday seemingly kept the door open to maintaining some key aspects of her administration macroeconomic agenda – which triggered some further market trouble – the new Chancellor Jeremy Hunt's media round over the weekend made it clear that a completely different approach to fiscal policy is now going to be pursued. He explicitly mentioned the possibility of tax hikes on top of spending cuts, even if hammering out the details is likely to be painful.

Fiscal arithmetic points to bleak choices ahead**. The two policy reversals announced so far – keeping the 45% maximum tax rate and proceeding with the planned corporate tax hikes – would yield only c. GBP20bn out of a total shortfall standing at up to GBP72bn by 2027** (the upper figure coming from leaks in The Times on the assessment made by the Office of Budget Responsibility which will help shape the final budget bill scheduled on 31 October). News reports on Sunday pointed to postponing the planned 1 percentage cut in the basic income tax rate by a year, which would not move the dial much over 5 years. Removing the remaining obvious "chunky bit" in the original version of the package – the cut in the National Insurance contribution – would yield another GBP10bn but would come with a massive political cost.

Hunt will have to take his scalpel to public expenditure. An issue for the UK is **that there are not many "low hanging fruits" left to pick after the austerity drive of the 2010s.** At 45% of GDP, public spending there is significantly below the levels seen in the rest of Europe and only moderately above that of the US. Jeremy Hunt's own posture is going to be delicate. As a centrist within the Tory party, he is no "slash and burn" fiscal zealot. We suspect he will adopt a "probing approach", trying to find what is the minimum amount of effort on the expenditure side needed to keep the market comfortable. Still, as curtailed public spending will combine with the drag on personal income from higher interest rates, **the "growth equation" is also going to be difficult to square, with adverse consequences on the denominator of the public debt ratio.**

**The next two weeks will be critical, as investors wait for the final cut of the budget bill amid lingering political instability (more voices are calling for another leadership challenge).** The change of tone with the arrival of the widely respected Jeremy Hunt may suffice to appease the "bond vigilantes" for now, allowing the Bank of England to keep the tap off direct bond market intervention. This however would imply that pension funds have been able to unwind most of the problematic derivative contracts which were at the root of the fire sales of UK government bonds. The Bank of England may count on the liquidity facility it put in place early last week (which is less controversial, in terms of "fiscal dominance") to deal with the residual pressure. We also think that the bar for more bond buying is lower now that the government has changed tack, even if Is and Ts still need to be dotted – the moral hazard issue is less acute.

**The central bank would not be off the hook though**. It still needs to calibrate its "normal" policy response for the next Monetary Policy Committee (MPC) meeting on 3 November. In his last interview Andrew Bailey made it clear that the tightening would have to go further than what the Bank was still expecting in August. Now, we suspect that the MPC will want to take on board what will remain of the net macroeconomic effect of the budget as well as where market conditions are settling. On the latter front, the "spontaneous" tightening so far has been so massive that the Bank of England could consider that there is little it needs to add to it and that a smallish hike – say 50bps – could suffice. **The weakness of the currency – and the UK's specific sensitivity to imported inflation – would however argue in favour of going harder**. The market may begin to feel reassured on the UK's fiscal trajectory, but it probably still wants its "pound of flesh" off the monetary side. 75bps could be the right "compromise point" in these circumstances.

**Beyond the vagaries of policy calibration, the whole episode should be seen, in our view, as the natural consequence of "hard Brexit".** Indeed, since 2016, at each bifurcation, the British government of the day chose the path of maximum divergence with the EU – these choices often forcing a change of political personnel. This is understandable from a pure political point of view: given Brexit was won on a "taking back control" platform, any remaining form of European influence over the UK's choices was problematic. Yet, **as the economic damage triggered by heightened trade friction**

**was becoming more obvious, only the "buccaneering Singapore on Thames" strategy remained appealing**. The UK would take advantage of the regulatory freedom offered by Brexit to offer the rest of the world a clear supply-side, free-market narrative which would attract investment and offset the cost of exit.

**The "only problem" in this economic strategy is that it is perpendicular to the preferences of the British population.** The 2021 issue of the survey of British Social Attitudes, a poll regularly conducted by the National Centre for Social Research, revealed that only 6% of the public supports "reducing tax and spending less on health, education and social benefits", against 52% supporting higher tax to allow for more spending. The fiscal package presented only two weeks ago by Kwasi Kwarteng was thus the only one which could come close to reconciling the "buccaneering strategy" with the electorate's preferences: cut tax without any commensurate reduction in spending, counting on some future "growth dividends" to solve the equation. The "second problem" is that against a backdrop of higher inflation and interest rates, it's next to impossible to please the population and financial markets at the same time.

Some countries have better chances than others to survive unfunded fiscal experiments. The US has been for years "living above its means" without any major financial stress. But this is thanks to the US "exorbitant privilege" as the issuer of the world' s reserve currency of reference. No such status is attached to Sterling. **When UK pension funds started disposing of their gilts in a rush for cash, there was no structural foreign demand for UK bonds ready to pick-up the slack, which left only the central bank as a backstop.**

The Suez operation in 1956 is a "founding trauma" for modern Britain, as it discovered it was no longer a "Great Power". The UK's partner in this operation was France. For Paris, the Suez episode was drowned into the more general – and protracted – drama of violent decolonization, but the conclusion drawn by the French elites of the time was that the country's future lies squarely in a more integrated Europe. British elites chose a "balanced" approach between Europe, their special relationship with the US and a nagging willingness to still "go in alone". This month's fiscal drama should convince them that their capacity to steer a lone path on economic matters is very small. **Perhaps the silver lining around this cloud is that a more profound re-assessment of the UK's relationship with Europe could start.** After 6 years, "Brexit fatigue" has settled and there is little appetite from the main opposition party to put the European issue back on the table, **but this month may have marked "peak Brexit**", giving way to, gradually, a better relationship between the UK and the EU.

## Financial pain…but where exactly?

Your humble servant had the pleasure to be in Washington for the International Monetary Fund (IMF) annual meetings last week and can report the mood was not upbeat. A note of caution here: the crowd at the annual meetings tends to be formed of professional worriers – your humble servant included – so it's difficult to remember one session from which anyone could come back optimistic. Still, even after controlling for this bias, nervousness was obvious. When not playing at the very popular "where is the Chancellor of the Exchequer" game, most of the people there were asking each other **where, after the British pension fund Liability-Driven Investment (LDI) debacle, the next financial stability issue lies.**

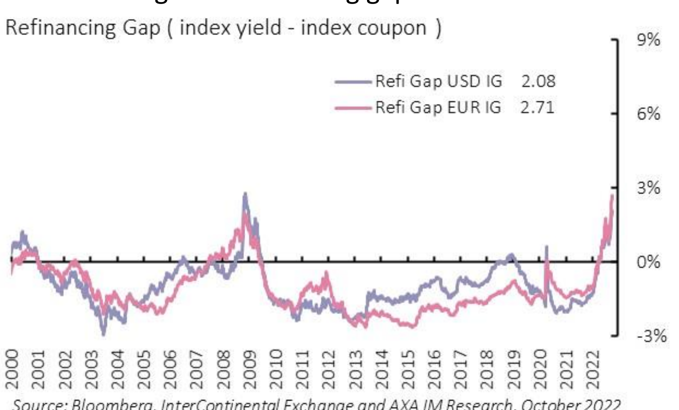
No obvious candidate emerged from the conversations. Consensus is that banks have been submitted to such a barrage of regulation since 2008 that there are probably in a strong position to absorb any rise in defaults triggered by the steep repricing of interest rates. Outside the banking system, countries with large pension funds were naturally submitted to scrutiny. In the Euro area, the Netherlands stands out from this point of view (it's the biggest pension system in the world as a percentage of local GDP and is dominated by "defined benefits" schemes). However, what is lacking there is the initial "spark" in market interest rates which triggered the deleterious spiral in the UK. Dutch yields have been rising as everywhere, but at a quite sedate pace. A quite timely note by Rabobank shed some light on the issue. A key fact is that the funds' liabilities are sensitive to 6-month EURIBOR curve, a Euro-wide money market index, while the size of the Euro area swap and repo markets is a multiple of that of the UK, which would make it easier to absorb a Dutch-specific problem.

Concerns have been raised over the state of corporate finance. Corporate bond yields have been increasing at a fast clip recently (see Exhibit 1) and the contrast with the ultra-low funding costs of the last few years is stark, resulting in **the highest "refinancing gap" since the Great Financial Crisis of 2008 in both the US and the Euro area** (Exhibit 2). Still, companies have taken advantage of the Quantitative Easing (QE) times to significantly lengthen the average maturity of their debt. In the high-yield space, redemptions will not peak before 2029 in the US and 2026 in the Euro area. This suggests that the impact of the current rise in interest rates will be a "slow grind" rather than a sudden shock in 2023.

Exhibit 1 – Steep increase in corporate funding costs

Source: InterContinental Exchange and AXA IM Research, October 2022

Exhibit 2 – Highest refinancing gap since the GFC




Source: Bloomberg, InterContinental Exchange and AXA IM Research, October 2022

Yet, while this may be generally reassuring from a financial stability point of view, the tightening in financial conditions constitutes a key ingredient in the looming recession which nearly everyone in Washington considered to be unavoidable.

## The central banks' winter games

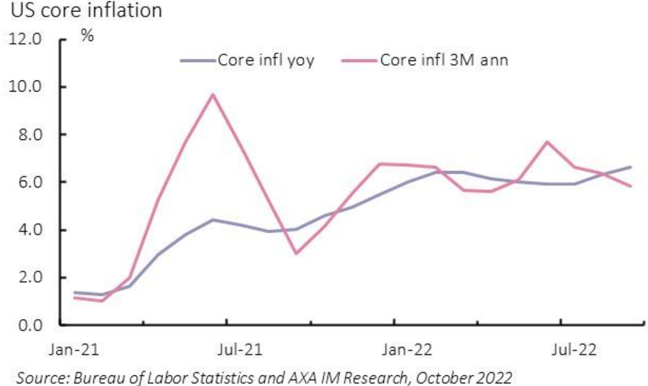
At this stage of the tightening, we are torn between our normative view – what we think the central banks should do – and our predictive one – what we think they will do. On a normative angle, our general contention is that the Federal Reserve (Fed) has more room for manoeuvre to take the time to assess the macro situation now that its stance is clearly in restrictive territory – which is even more obvious when looking beyond the level of the policy rates to take on board broad financial conditions. Irrespective of the current data flow – which is the product of the policy stance from 6 to 9 months ago given the transmission lags - this would call for smaller hikes already – 50bps to start with – with a pause at the beginning of 2023, when we think the economy has slowed down enough to take out the labour market froth. But this collides with what we hear from the Fed and a sense that we will deal with a good measure of "policy inertia". Indeed, in any committee there is always a cost in changing views which combined with the sense the Fed needs to compensate for its recent mistake in taking the measure of the inflation shock, will make the central bank overshoot responding to the dataflow while ignoring the lags.

This doesn't mean there is no debate at the Fed, as this excerpt of the minutes of the September Federal Open Market Committee (FOMC) meeting illustrates: *"Several participants noted that, particularly in the current highly uncertain global economic and financial environment, it would be important to calibrate the pace of further policy tightening with the aim of mitigating the risk of significant adverse effects on the economic outlook*" and "*several participants observed that as policy moved into restrictive territory, risks would become more two-sided, reflecting the emergence of the downside risk that the cumulative restraint in aggregate demand would exceed what was required to bring inflation back to 2 percent".* But this still a minority view, and the minutes' main message may rather lie in this sentence*: "Many participants emphasized that the cost of taking too little action to bring down inflation likely outweighed the cost of taking too much action".*

So, **it seems that the doves have woken up at the FOMC, but they are fighting an uphill struggle and none of these calls for prudence are for immediate consumption**. The think the debate will start in earnest this winter with practical consequences over the policy stance before the beginning of next week. For the time being, the Fed will continue to

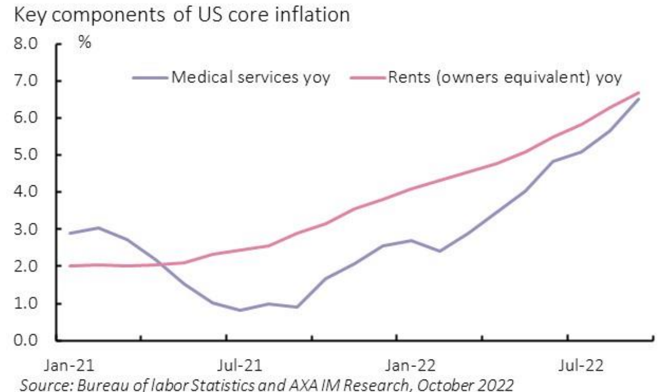
respond vigorously to the dataflow, and the signals from there are concerning. We wrote last week that after the strong payroll numbers for September it would take a reassuring Consumer Price Index (CPI) print to avoid a 75bps hikes at the next meeting. The CPI print was anything but reassuring. Core inflation surprised again to the upside and seems to have settled around a far too high 6% pace, even when controlling for the base effects (see Exhibit 3). Moreover, the acceleration in the "sticky components" (rents, medical services) continues (see Exhibit 4), which does not bode well for a quick turnaround of the inflation trend. 75bps is thus our central call now (predictive angle).

Exhibit 3 – Seemingly stuck at 6%




*Source: Bureau of Labor Statistics and AXA IM Research, October 2022*

Exhibit 4 – Stickly components continue to accelerate




*Source: Bureau of labor Statistics and AXA IM Research, October 2022*

**The behaviour of these "sticky components" may become problematic next year when interpreting the direction of inflation**. Indeed, since they react with a specifically long lag to cyclical deterioration and largely have a "life on their own" they will likely continue to contribute powerfully to the aggregate core inflation prints into next year even though the more cyclically sensitive components start to edge lower. That is another reason to be concerned with the possibility the Fed over-shoots.

**We mentioned last week that the doves were awakening at the European Central Bank (ECB) as well. This continues.** In our last issue of Macrocast, we highlighted a speech by the Bank of Spain Governor calling for a "terminal rate" between 2.25% and 2.50%. Last week some ECB staff work, apparently presented to the Governing Council with a "mixed reception" on 8 October, concluded that the central bank's terminal rate would stand in the current circumstances at 2.25%, significantly lower than the market's pricing (above 3%) – thus close to our own, dovish forecast. Finally, at a speech at Columbia University last week, Banque de France Governor Villeroy de Galhau reiterated his view that once the policy rate hits the upper end of the neutral range – which he still sees as between 1 and 2% - then careful deliberation will be needed to decide on the next steps, based on the information brought by current and future inflation (the latter derived from models and market pricing), cyclical conditions and finally the degree of tightening which he proposes to gauge with medium-term real forward rates. To be clear, this does not mean he advocates stopping at 2% - which he thinks as we do that it will be reached at the end of this year – but that a debate will be needed then, replacing the fairly "automatic" approach adopted these last few months.

**For now, although the debate is getting less one-sided, for the majority of the central bankers in the US and in the Euro area, the message from the actual data flow is clearly stronger than what can be inferred by the models** – or to borrow from Villeroy de Galhau's taxonomy, the "empiricist" approach is defeating the "academic" one. The market needs to be patient before that tide turns and should brace itself for pain in the meantime. To finish on a more positive point though, we note that Villeroy mentioned that Quantitative Tightening could start "before 2024" in the Euro area, which leaves quite some leeway relative to the imminent announcement which Reuters reported as likely just after the ECB's September meeting. Klas Knot, a leading hawk, said in Washington *"Once we will have reached neutral territory with our policy rate, it makes sense to consider the roll-off of asset purchases by limiting reinvestments*". He does not seem to be in too much of a hurry himself. This could be another positive fallout from the British bond market turmoil.

# 154 – 17 October 2022

| Country/Region | What we focused on last week | What we will focus on in next weeks |
|---|---|---|
| | • CPI inflation (Sep) eased to 8.2% from 8.3%, core rose to 6.6% and new 40-year high<br>• PPI inflation (Sep) lower at 8.5% and 7.2% (core)<br>• FOMC minutes (Sep) noted economy not responding much, inflation easing slowly. We raise our Fed Funds rate call to 4.00% in Nov and expect 4.75% in 2023 | • Latest housing data (starts, existing sales and NAHB survey) to gauge slowdown in this market<br>• Empire and Philadelphia Fed Surveys (Oct) to gauge momentum of industry<br>• Jobless claims have risen in past two weeks<br>• Fed publishes latest Beige Book |
| | • ECB speeches arguing terminal rate closer to 2.25%, discussion already happening on QT<br>• Euro area industrial production edged up in August to 1.5%mom after large fall in July (-2.3%) | • Oct Ge ZEW indices are expected to deteriorate further<br>• EMU Oct HICP figures to refine our view on current energy passthrough to on NEIG and food and how service prices are reacting to demand<br>• Ge Producer price. Stabilisation at very high level expected |
| | • Kwasi Kwarteng sacked as Chancellor, with Jeremy Hunt named as his replacement<br>• BoE long-dated gilt purchases come to an end after BoE upped limits £10bn a day and included linkers<br>• Employment fell 109 over the quarter, despite this u-rate fell to 3.5% on declining participation<br>• GDP (Aug) fell by 0.3% on weak IP and services | • Further announcement on government policy as reports suggest PM considering further U-turns<br>• Gilt market moves following end of gilt purchase programme next week – more disorder could see BoE be forced to extend<br>• CPI inflation (Sep) expected to rise to 10.0% (cons) we expect price rises to be broad based ahead of Oct peak<br>• Retail sales (Sep) expected to show further weakness |
| | • PPI Inflation (Sept) rose sharply to 9.7% could signal greater price pass-through to customers<br>• Yen falls back below ¥145.90 per dollar level that prompted intervention last month<br>• BoP (Aug), current account surplus continues to fall to Y58.9bn, smallest on record for August | • Trade balance (Sep) expected to have narrowed from all-time lows on higher exports and lower oil prices<br>• CPI (Sep) headline expected to fall to 2.9%. Japan's core CPI (excl fresh food) is forecasts to continue to rise to 3%<br>• Whether MoF intervenes in currency markets as Yen weakens |
| | • People's Daily runs three articles to stress the importance of sticking with the Dynamic Zero COVID policy<br>• US announces a sweep ban on the sales of semiconductors and advanced chips to China<br>• Sept credit growth strongly beat market expectations<br>• Golden Week tourism activity disappoints | • Q3 GDP to show a sequential rebound in growth after Q2's contraction due to Shanghai lockdown<br>• September monthly activity could be mixed, with faster growth in industrial activity and infrastructure investment while retail sales and services suffering from COVID flare up<br>• The 20th Party Congress kicks out on Sunday and will last a week |
| | • CB: Hungary hiked its upper end interest rate corridor +950bp to 25% to reign in FX weakness. Chile +50bp to 11.25%, Korea +40bp to 3.0%. Singapore tightened by re-centring the mid-point of the FX band<br>• Sep inflation (yoy) accelerated in Hungary (20.1%), India (7.4%) & Romania (15.9%)<br>• Aug ind prod (yoy) picked up in Malaysia & Mexico | • CB: Indonesia is expected to hike +25bp to 4.5% while Turkey should cut again by 100bp to 11.0%<br>• Ind production (Aug) for India, Malaysia, Mexico & Turkey<br>• Monthly econ activity data (Aug) for Brazil, Colombia & Peru<br>• Korea first 20-day export to show continued weakening<br>• Headline inflation (Sep) should accelerate in Malaysia & South Africa |

| Upcoming events | | |
|---|---|---|
| | US: | Mon: Empire State manf. Survey (Oct); Tue: Ind prod (Sep), NAHB Indx (Oct), Long-term investment flows (Aug); Wed: Housing starts (Sep), Building permits (Sep), Beige Book published; Thu: Philly Fed Indx (Oct), Weekly jobless claims (15 Oct), Leading indx (Sep), Existing home sales (Sep) |
| | Euro Area: | Tue: Ge ZEW Survey: current situation & economic expectations (Oct); Wed: EU19 CPI (Sep); Thu: Ge PPI (Sep), Fr Insee manf. confidence (Oct) |
| | UK: | Wed: CPI, CPIH, PPI and RPI (Sep); Fri: GfK consumer conf. (Oct), Retail sales (Sep), PSNB (Sep), S&P and Moody's review UK credit rating |
| | Japan: | Thu: Trade balance (Sep), Fri: CPI and National 'core' CPI (Sep) |
| | China: | Sun: 20th National Congress begins; Tue: GDP (Q3), Ind prod (Sep), Retail sales (Sep), Fixed asset investment (Sep); Thu: 1-year Loan Prime Rate |

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