Taking another Look at Supply

- While demand remains key to the US inflation trajectory, the continuing improvement in supply conditions – assuming disruptions in China do not stand in the way – will provide some welcome, albeit volatile, help.
- The debate on a possible wage/price loop is gaining traction in the Euro area. We explore alternative data.

The "mini rally" which has started in response to the better-than-expected October inflation in the US remains overly dependent on a just a few data prints and can easily flip. This makes November inflation, to be released on 13 December, incredibly – and probably excessively – important, especially since it will come out just the day before the Fed meeting which is widely expected to put an end of the "jumbo hikes". The minutes of the last FOMC meeting make us believe a gear-change to a 50-bps hike in December is a very safe bet, but the market may have to deal with volatile inflation in the months ahead. There will be uncomfortable moments.

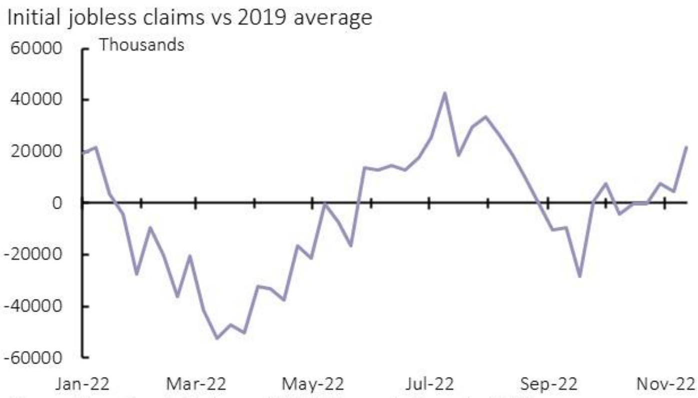
While the market attention had flipped to demand as the main source of US inflation, supply conditions were quietly improving. Supply lines are less disrupted, US import prices continue to decelerate, and the decline in delivery times and backlogs signals that production is no longer busy catching up with demand. Industrial goods prices should continue to decelerate in the US – this was the main driver of the better core inflation print last month. It's a very volatile variable though, so that upside surprises cannot be excluded. Potential disruptions in Chinese supply, amid protests against the "closed loop system" can also derail the general improvement. US services inflation needs to roll over as well for the Fed to start feeling inflation is definitely on the right track. The tentative softening of the labour market will help, but this will need to be confirmed in "hard data". The market cannot take too many strong payrolls on the chin.

The ECB's October message was also consistent with a slowdown in the pace of hikes but contrary to the FOMC the Governing Council needs to deal with a higher-than-expected inflation print. We continue to expect 50 basis points "only" in December though. Focus has moved to wages. We explore some of the alternative sources currently available to get a timely picture on that front. "Negotiated wages" – the ECB's usual preferred metric – may send a too conservative message, but equally, data based on job advertisement sites may over-state the pace of wage growth.

Waiting for 13 December

The United States (US) market eased into the Thanksgiving torpor without having given back much of the gains accumulated since the better-than-expected inflation print for October. This sustained bout of optimism – or of lesser pessimism – has been fuelled further by some of the data released since then. We have already covered in Macrocast the ambiguous message from the latest payroll, but the sense that the US labour market is about to turn was given some substance by the rebound in initial jobless claims which has now exceeded again the 2019 average for three weeks in a row (see Exhibit 1). This graph should however be a reminder that we have been "burned before", the late spring/early summer spike having corrected sharply in late August. **A market rally which is overly dependent on a few data prints can easily flip again, which makes the November inflation print, to be released on 13 December, incredibly – and probably excessively – important**, especially since it will come out just the day before the Federal Reserve (Fed) meeting which is widely expected to put an end to the "jumbo hikes".

Exhibit 1 – Jobless claims turning…again



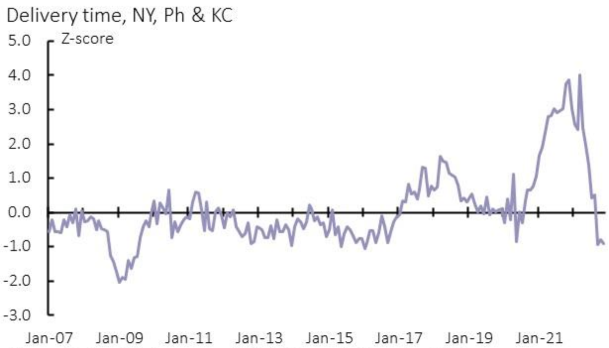
Source: Department of Labor and AXA IM Research, November 2022

While we are waiting for 13 December, we can at least prepare ourselves from what could be a series of difficult-to-interpret inflation prints. Olivier Blanchard in a tweeter thread last week sent an interesting warning: it's likely that inflation is going to continue receding, but the crux of the matter – at least for the Fed - is how endogenous such deceleration will be. Indeed, while inflation in the US has been primarily driven by excess demand at least since the beginning of this year, supply conditions also contributed. They may now take inflation down as the disruptions fade, but **the Fed will probably want to see the demand-driven component also contribute negatively to the overall price dynamics before considering it's definitely on the right track.**

As the world economy was reopening, focus was on the bottlenecks emerging on complex, internationalised supply lines. This is what justified for too long the notion that the price spike would be transitory, failing to take on board the mounting pressure from the labour market – but your humble servant confesses having made the same mistake at the time. **Market focus then logically shifted to excess demand, but meanwhile supply disruptions were quietly normalizing.**

We look at the "delivery times" component of the regional Fed surveys (timelier than the ISM survey since we already have data for November) in Exhibit 2. They have fallen back *below* their long-term average since September 2022. This confirms the message from the reduction in the backlog of works – it fell to 45.3 in October - in the ISM survey in manufacturing, hitting the lowest level since the reopening. **Production is no longer busy catching up with demand**. The normalization of supply lines is general across the world economy – reflected for instance in the plunge in the Baltic Dry Index which measures the price of shipping goods – combined with the steep appreciation in the dollar continues to take US import prices down, even when excluding the impact of oil (see Exhibit 3). The core import price index is now growing by only 3% year-on-year, significantly below domestic inflation.

Exhibit 2 – Time getting short



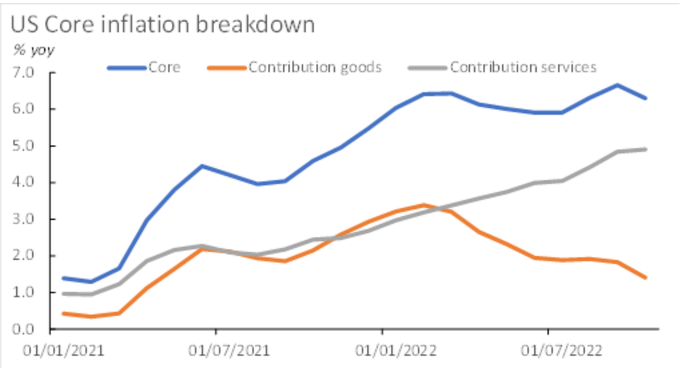
Source: Regional Fed surveys and AXA IM Research, November 2022

Exhibit 3 – Import prices continue to slow down

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

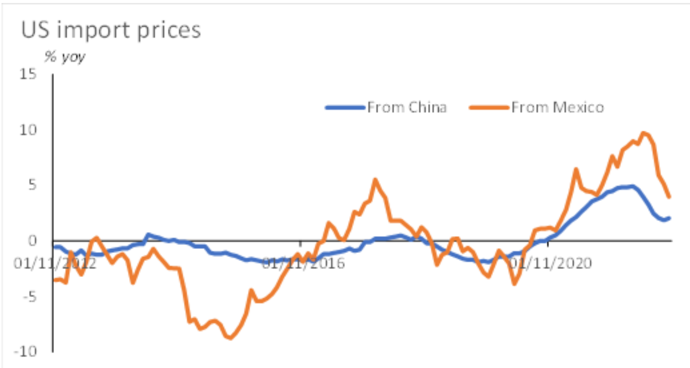
This makes us quite confident that we should see softer manufactured goods prices continue on trend to dampen core inflation. Services account for three quarters of the weights in the core Consumer Price Index (CPI) basket in the US. Yet. Despite the further acceleration in services prices in October (from 6.7% to 6.8% year-on-year), the deceleration in goods prices was large enough (declining from 6.7% to 5.1%) to more than offset it. To put things in perspective, core inflation has been roughly stable around 6% year-on-year since the end of the winter 2021/2022, with the deceleration in goods -despite their smaller weight in the basket – almost exactly offsetting the acceleration in services (see Exhibit 4). Even if services inflation continues to be robust, the disinflation in the core goods sectors would suffice to maintain overall core inflation on a broadly decelerating path.

Exhibit 4 – The goods vs services divergence



Source: BLS, AXA IM Research, November 2022

Exhibit 5 – China contributes to disinflation in the US



US department of commerce, AXA IM Research, November 2022

The "only" problem is that manufactured goods inflation tends to be quite volatile. Its standard deviation (calculated on the year-on-year percentage change) stood at 1% in the 20 years before the pandemic against 0.7% for services, and the gap has widened since the pandemic (if one includes the last 3 years, the standard deviations shoot up to 2.3% versus 0.9%). This suggests that we cannot be assured that in November, manufactured goods prices will again be able to take overall core inflation down again. Services inflation is stickier – especially in the US given the large weight of rents in the basket - which explains why the Federal Reserve is so focused on that component. Still, policymakers cannot completely dismiss the deceleration in goods inflation, if only because it can influence inflation expectations and hence the wage bargaining process. While they make up for only a quarter of the core basket and only a bit more than one fifth of the overall CPI basket, these purchases are often "big-ticket", memorable ones and may have a disproportionate impact on how households see prices in general. **The fact that their inflation expectations have stabilized, albeit at a too high level, when core goods inflation started to roll over may not be a coincidence**.

China is a key source of uncertainty in this respect though. Indeed, so far, the country has been able to continue acting as the world's first source of manufactured products despite its still drastic approach to the pandemic which lingers on there. The tentative relaxation in the "zero-Covid" policy just after the Communist Party Congress was seen by the market as a further guarantee to a sustained contribution from China to dampening the global inflationary shock. As Exhibit 5 illustrates, while there is a lot of discussion right now on shifting back some US supply lines from China to Mexico, from a pure pricing point of view – i.e., ignoring the geo-strategic imperatives – Chinese products remain more tempting. Yet, the tentative Covid policy relaxation has collided with a significant rebound in the circulation of the virus, with a re-emergence of lethal cases, which has forced a return to lockdowns of various intensity in Beijing, Shanghai, and Guangzhou. So far this year, Chinese authorities have been able to limit the impact of sanitary restrictions on industrial output by setting up the so-called "closed loop" system under which workers in critical businesses were kept on the location of their production sites. The protests against these arrangements may force a re-think.

Deep down the pandemic continues to be a public healthcare issue which outcome will be dependent on the degree of immunity of the population. As long as a significant percentage of elderly people are not at all or fully vaccinated, re-opening in the same way it has been done in the West will remain problematic. If the "closed loop" system becomes socially unacceptable, then the only remaining option for Beijing will be to accept more impact from the sanitary restrictions on economic activity, at least as long as comprehensive vaccination is not in sight.

Beyond the return of China-made uncertainty and its potential impact on the supply of manufactured goods, we need to see US service prices roll over as well, and this is to a large extent dependent on the labour market, and this makes next week payroll data quite crucial. Last month's message was ambiguous because of the divergent signal from the households and the establishment surveys. If the latter moves towards the former (which last month reported a net destruction of jobs), then the odds of a relatively quick turnaround in services inflation would rise. The Fed will have very little time to ponder, but in any case, they are probably in a more comfortable position now. The minutes of the last Federal Open Market Committee (FOMC) meeting released last week were consistent with the end of the "jumbo hikes". A *"substantial majority"* see the case for slowing hikes "*very soon*", even if "*various members*" saw a likelihood of a "*somewhat higher*" peak than before. Now that the stance is firmly restrictive, it will be easier for the Fed to tolerate "bad prints" in inflation without taking a big stick to it. **We continue to think the case for a 50-bps hike on 14 December remains very strong.**

Euro area: are wages taking off?

In the US, the slowdown in goods price, fuelled by the currency appreciation and normalization in supply lines came too late as services prices were already accelerating fast amid massive wage pressure. **The sequence of events is very different in the Euro area. There, the prices of goods and services both continue to accelerate**. For the former, some responsibility can be ascribed to the depreciation of the euro, but in both sectors, **the diffusion effect from the steep rise in energy costs – much more pronounced than in the US – continues to play a major role**. This is one key point made by European Central Bank (ECB) Chief Economist Philip Lane in a very comprehensive blog post published last week. In both goods and services, the energy-intensive sub-sectors provide a larger contribution to the overall drift in prices than the others. En passant, this is a reminder that the distinction between core and headline inflation is not as tight as commonly thought. Removing energy and food items from the basket – the approach to computing underlying inflation indices – cannot deal with the transmission effects of higher energy and good prices to the other items (e.g., on the price of restaurant and road transport services).

Ideally, we would simply need to be patient and wait for the stabilization of food and energy costs, but the risk there is to miss a potential persistent effect from wages catching up, and Philip Lane spends a large section of his blog post to explore this. He starts from a familiar point: while in the US, wage dynamics can be captured with limited latency – even if they are less precise than the quarterly Employment Cost Index, the average earnings accompanying the payroll data are quite timely – in the Euro area the latest comprehensive data on wages effectively paid to employees dates back to the second quarter of 2022. The ECB has been focusing on its indicator of negotiated wages, based on the outcome of collective bargaining, but it comes with only a quarterly frequency at the Euro area level. This indicator has been gradually accelerating recently, but the Q3 print – 2.9%yoy – was still unremarkable in the sense that it is consistent with where wage growth should be on trend given 2% medium term inflation and allowing for productivity gains. Yet, there can be significant gaps appearing between negotiated and actual wages, usually dependent on the cyclical position: when the labour market is tight, employers will be tempted to grant individual pay rises over the "tariff" derived from collective bargaining. **The lack of timeliness of traditional wage data has triggered a search for alternative sources, and recently wages published on digital hiring sites – *Indeed* in particular – have become a key focus.** The ECB is explicitly looking into them and the central bank of Ireland published a research paper on the topic.

The signal this tracker sends is quite worrisome, with an acceleration to 5.2% in October for the Euro area as a whole. It is however far from being a perfect instrument either. By construction it captures the wages offered to new hires, while wage statistics are collected over the entire stock of workers. In times of labour market tightness employers will offer "over par" conditions to secure additional workforce, exceeding the targets set by collective bargaining. There may also be a structural bias in the data: employers are going to be incentivized to publish wage targets to attract candidates with the skills which are the most in demand, while they can choose not to communicate wage targets for jobs which are less "red hot" (a high proportion of job offers posted on *Indeed* do not come with a wage indication – 90% in the case of Germany). This would distort the data to the upside. Finally, data being available since 2018 only, an econometric verification of the information content of the tracker is impossible.

Beyond the methodological limits, **ultimately, the impact of the wage increases granted to these "marginal workers" on aggregate labour costs will depend on the extent of "churn", i.e., the percentage of workers changing jobs or arriving on the labour market**. While there may have been changing recently with the "great resignation wave", turnover is significantly lower in Europe than in the US. The average tenure of workers in a company exceeds 10 years in all major economies of the Euro area according to the Organisation for Economic Co-operation and Development (OECD) in 2021, twice the level observed in 2020 in the US according to the Bureau of Labor Statistics. **In a nutshell, negotiated wages may be too conservative, and the *Indeed* tracker too aggressive, with the reality probably somewhere between the two.** Philip Lane mentioned the ECB's experimental dataset capturing the change in wages for 2023 implied by the latest agreements signed within the collective bargaining framework. The deals from Q3 2022 (last available data) point to wage increases of 3.5% next year. We note that the ECB's September forecasts – which project an inflation rate of 2.3% in 2024, down from 5.5% in 2023 – assume wage growth to hit 4.8% in 2023.

Exhibit 6 – Indeed tracker continues to accelerate in Germany

Source: Bundesbank, Indeed and AXA IM Research, November 2022

Exhibit 7 – While in decelerate in Italy

Source : Istat, Indeed and AXA IM Research, November 2022

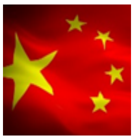
An interesting take-away from the latest *Indeed* data is the divergence across countries, with offered wages already slowing down in Italy while they continue to accelerate in Germany. This can contribute to harden divergent views on the appropriate monetary policy trajectory, with German policymakers finding more reasons to worry about a wage-price loop – especially in the context of the additional sizeable fiscal push in Berlin – while Southern Europeans worry more about the looming contraction in economic activity and potential pressure on their sovereign's refinancing costs.

A debate among the hawks?

The minutes of the October ECB Governing Council meetings confirmed that the hike's quantum of 75 bps had not been unanimously supported, even if even those advocating a 50-bps move were on board with signalling that further tightening would be needed. The market - and ourselves - took Christine Lagarde's Q&A on the dovish side, reading it as consistent with a gear shift back to 50 bps at the December meeting, even if the forceful message on a terminal rate in restrictive territory was not lost - in a nutshell, a very similar combo to what we had from the Fed.

A key difference with the Fed though is that the ECB needs to deal with another upside surprise on inflation, which given its pledge to be "data driven" on a "meeting by meeting" approach is problematic. In our view, bringing the deposit rate to 2.25% - hence in a range widely seen as above neutral - in one go in December would be risky in a particularly uncertain environment. The minutes created a distinction between the likely policy trajectory if a shallow recession occurs - continuing to tighten - and a deep recession case - explicitly mentioning the possibility of a pause in this configuration (interestingly, cuts don't even make it to the mental landscape of the ECB, even in really bad circumstances). Even if better news on the energy supply side have tilted the balance of risks towards a shallow contraction, it would be adventurous to continue proceeding with the tightening at the 75-bps pace, especially since 50 basis points would still qualify as a chunky move by historical standards**. We were relieved to hear Bundesbank Governor Nagel make this point. To quote him verbatim: "*even 50 basis points is a strong rate move*". This should "seal the deal" for a 50 bps hikes "only" on 15 December**, even if this may not be a unanimous view among German members of the Governing Council. We note that Isabel Schnabel in a speech last week stated that *"Incoming data so far suggest that the room for slowing down the pace of interest rate adjustments remains limited, even as we are approaching estimates of the neutral rate".*

Yet, Nagel also reiterated his preference for starting Quantitative Tightening (QT) in "early 2023". The "policy rate versus QT trade-off" may well be the focus of the conversation at the Governing Council ahead of the 15 December meeting. We remember that Banque de France Governor Villeroy de Galhau in his speech at Columbia University in October mentioned the possibility to start reducing the quantum of Asset Purchase Programme (APP) reinvestment "earlier than 2024". Our base case is that the ECB will wait until Q2 2023 to implement the gradual unwinding of APP, but even this may not be enough for the hawks. Hopefully, agreeing to announce a timeline at the December 2022 already, even if implementation is slightly delayed, may be enough.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• FOMC minutes, "substantial majority" see case for slowing hikes "very soon", "various" saw likelihood of "somewhat higher" peak than before • Continuing claims rose again to 1.55m – an 8mth high • New home sales (Oct) rebound 7.7% from 10.9% drop • PMI (Nov,p) – surprise fall to 47.6 (manu), 46.1 (serv) • Rejection of WH deal threatens US rail strike in Dec.	• Fed Chair Powell (Weds) for pushback against easing in financial conditions on Fed expected peak and cut • Payrolls (Nov) expected to slow from 261k, and divergence with HH survey watched with wage growth • JOLTS (Oct) declines expected after unexpected rise last month • PCE inflation (Oct) and 'core' exp'd lower after CPI • ISM index (Nov) expected flat, in contrast with PMI
	• Business surveys marked a pause in their deterioration in November but stayed a very low levels. Flash consumer also confidence edged higher • German Q3 GDP was revised up slightly to +0.4%qoq, with private consumption offsetting for net trade and inventories negative contributions • ECB minutes reveal continued hawkish bias	• We forecast euro area headline inflation to edge down to 10.5%yoy (-0.1pp, consensus: 10.4%yoy) but core inflation to increase to 5.1%yoy (+0.1pp, consensus: 5.0%yoy) in November • Continued flurry of ECB speakers including: Lagarde, Lane
	• Supreme court verdict that Scottish independence 'indyref2' requires Westminster's approval • BoE's Ramsden argued that whilst he expects rate hikes in near-term, he sees potential for rate cuts • Public finances data yet to show full impact of energy support. PSNB ex BoE (Oct) rose £13.6bn (cons £20bn) • Flash PMIs (Nov) rebounds to 48.3 just above Oct lows	• BoE household lending data (Oct) likely to show continued moderation in mortgage approvals • Nationwide house price index (Oct) expected to continue to decline amidst mortgage rates • BoE Chief Economist Pill to speak • BRC Shop price index (Oct)
	• Flash PMIs (Nov) unexpectedly dropped into contraction territory (49.4 down from 51.8) driven by falling mfg output, services remained constant • Department store sales (Oct) • Tokyo core CPI (Nov) rose to 3.6% just above consensus expectations of a 3.5% rise	• Labour market data (Oct) • Retail sales (Oct) expected to continue expansion as demand continues to recover • Industrial Production (Oct) • Business Capex (Q3)
	• COVID situation deteriorates with case numbers spiking to levels not seen since Shanghai lockdown • Governments in some major cities tighten COVID restrictions, weighing on economic activity • More easing for property market, with banks asked to support home demand and developers' financing • State Council signals a RRR cut forthcoming	• PMIs (Nov) likely show further weakening in manufacturing and services activity • Markets will stay focused on COVID and Beijing's policy changes • A RRR cut could be announced in the coming days
	• CB: Korea hiked +25bps to 3.25% & South Africa +75bps to 7.0%. Turkey cut 150bps to 9.0% • Q3 GDP growth (yoy) lost steam in Peru (1.7%) & Singapore (4.1%). GDP accelerated in Thailand (4.5%) • Annual inflation (Oct) fell in Malaysia (4.0%) • Anwar Ibrahim becomes Malaysia's new PM	• CB: Thailand is expected to hike +25bp to 1.25% • Annual inflation (Nov) data in Indonesia, Korea, Poland & Peru • Q3 GDP in Brazil, Czechia, Hungary, India & Poland • October industrial prod. & retail sales data in Chile • PMIs across EM countries

Upcoming events

US:	Tue: Case-Shiller house price index (Sep), Conference board consumer confidence (Nov); Wed: ADP employment (Nov), GDP 2nd estimate (Q3), Core PCE 2nd estimate (Q3), Goods trade balance (Oct), Chicago PMI (Nov), JOLTS Job Openings (Oct), Pending home sales (Oct), Federal Reserve Beige Book; Thu: PCE price index (Oct), Personal income/spending (Oct), ISM manufacturing index (Nov), Non-farm payrolls (Nov), Unemployment (Nov), Average earnings (Nov), Average weekly hours (Nov).
Euro Area:	Mon: Money supply – M3; Tue: Ge & SP prelim HICP (Nov); Wed: GE unemployment (Nov), Fr & IT final GDP (Q3), FR & IT prelim HICP (Nov), FR consumer spending (Oct); Thu: EU19, GE, FR, IT & SP manufacturing PMI (Nov); Fri: EU19 PPI (Oct).
UK:	Mon: CBI Distributive Trends survey (Nov); Tue: BoE household lending data (Oct); Wed: BRC Shop Price Index (Nov); Thu: Manufacturing PMI (Nov).
Japan:	Mon: prelim Industrial production (Oct).
China:	Mon: Official manufacturing PMI (Nov); Tue: Caixin manufacturing PMI (Nov).

About AXA Investment Managers

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