Trouble in Small America

- Small US businesses are "feeling the pinch", even if they still want to hire
- Beyond its general commitment to a restrictive stance for long, the Fed is probably moving to a more cautious approach and the terminal rate is in sight, while the ECB hawks are very vocal

The IMF lowered its forecasts for the world economy in 2023 and 2024 and the consensus among economists – which we share – is that recession risks have notably risen given the pressure on bank lending, but the equity market still looks remarkably resilient. There is however a strong compositional effect. In the US the equity market is supported by the strong performance of the biggest names, with a particular concentration in Tech. Further down the "belly" of the equity index, the deterioration in valuations has been significant. This size effect can also be seen in economic confidence indicators. The NFIB small firms survey has moved in below-trend territory earlier and more deeply than the better-known, "generalist" ISM surveys. This is not a habitual feature of US cyclical downturns, and we are tempted to ascribe the current size effect to the better capacity of large companies to deal with the inflation shock. Looking ahead, small businesses are going to be particularly sensitive to the tightening in lending standards which we think is going to be a lasting consequence of the banking turmoil.

"Small America" is thus already feeling the pinch. Yet, the resilience of job creation is also visible in small businesses, with the "hiring plans" component of the NFIB survey still above trend. This adds to the sense that the labour market will be the "last shoe to drop", with an even longer lag than usual, postponing inflation landing and keeping the Fed in a "restrictive mood" for longer than the market is currently pricing, even if the terminal rate is now in sight.

At the ECB, the hawks have been very vocal lately, pushing for the continuation of "jumbo hikes" as they are frustrated by the continuing acceleration of core inflation. Our expectation is that the coming data flow - in particular the Bank Lending Survey and actual credit origination for March - will show that enough of the monetary tightening has already moved the dial to keep the May hike at 25 bps, but the general mood in Frankfurt looks uncompromising.

Looking beyond "Big Business" in the US

The general message from the International Monetary Fund (IMF) meetings is not particularly cheerful, with a downward revision in global GDP forecasts primarily driven, as per the Fund's Chief Economist communication, by the expectation of more prudent lending behaviour by the banking sector. Yet, exactly as the economist crowd gathered in Washington D.C. were voicing their concerns – which your humble servant shares – the US equity market ended a fourth episode of weekly gains in five weeks.

The relationship between equity prices and GDP is never straightforward. True, in theory, if the share of profits in GDP is stable, the overall change in corporate earnings should be tightly correlated with GDP growth. However, for some key sectors – and Tech in particular – it's more *expected* profits over the long-term, rather than actual ones, which move valuations (we quantified this in a note with our colleague Hugo Le Damany last year, see the link here). They can weather cyclical downturns if trend growth is not affected. Exogenous shocks can also have strong compositional effects. High energy prices push GDP down but raise profits in energy companies. The magnitude of the net effect on the index will depend on the relative weight of energy-producing companies versus energy-dependent ones. Interest rate sensitivity is another issue. If a looming recession is seen as triggering a monetary policy loosening, this can benefit companies which are very sensitive to the discount rate because their profits will emerge only in the distant future – Tech again.

To explore this, rather than slicing the Standard & Poor's (S&P) into sectors, **we can take the simpler and more radical approach of looking at performance per capitalisation size**. Indeed, there is a strong concentration of Tech companies in the "large cap" bucket. The smaller the companies, the more "traditional" they tend to be in terms of activity sectors. The message from Exhibit 1 is very clear: **over the last year, within the first 1,500 names in the S&P index (in its broad definition), there has been a strong positive relationship between the market size of companies and their performance**. While the top 10 names (with 8 of them in the tech industry, and one in energy) have managed to stay flat on average, the bottom decile in terms of size lost roughly a quarter of its value. In other words**, while the market has been kind to the top of the US corporate structure, down the ladder, in the "belly" of the US economy, market conditions have been tough.** The market is thus not blind to the macro risks. Compositional effects blur the signal when looking at the aggregate index.

Exhibit 1 – Digging into the last 12-month equity performance: size matters

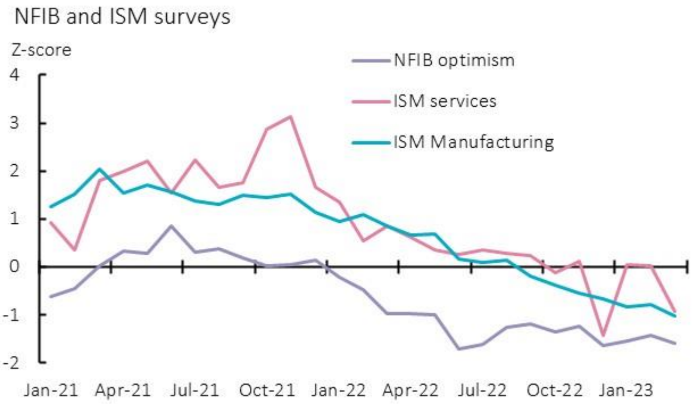
Source: Datastream and AXA IM Research, April 2023

We explore this "big" versus "small" approach beyond pure market developments by looking at business confidence data. In Exhibit 2, we compare the survey on "economic trends" in small companies conducted by the National Federation of Independent Business (NFIB) – with the more frequently used, all-encompassing ISM surveys. The difference is striking. Economic confidence has been standing below its long-term average in the NFIB survey since the beginning of 2022, roughly a year before it happened in the ISM surveys, and the level in March 2023 is much more deeply negative, at 1.6 standard deviation below average. **"Small America" has been in trouble for a while.**

We looked at previous episodes of economic slowdown in the US. Such divergence between the NFIB and the ISM survey is not a permanent feature. For instance, in 2008 the ISM survey "saw the recession coming" earlier than the NFIB. We are tempted to attribute the currently strong size effect to the inflation shock. The input price structure of the Tech industry is more dependent on "intangibles" – e.g., the regular amortization cost of R&D – than in more traditional sectors. More generally, size is normally positively correlated with market power. Large companies on average are probably in a better position to impose a transmission of their input costs to their final prices, or more simply have more capacity to swiftly re-organize their production patterns to dampen the impact of the rise in their input costs.

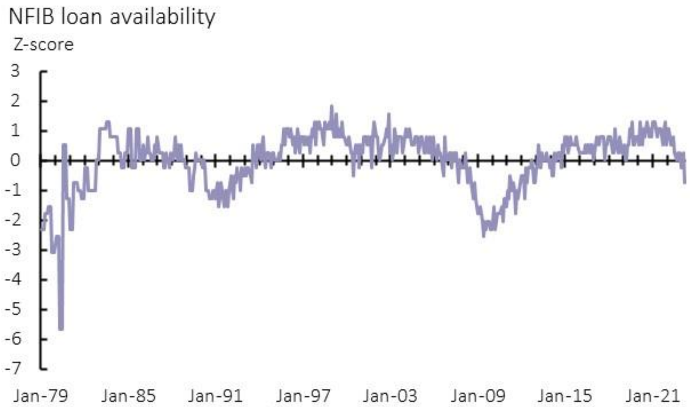
Whatever the underlying reason, **the fact that smaller businesses are currently in a more fragile position than what aggregate indicators would suggest takes a particular salience in the context of the looming tightening in credit conditions**. True, the latest Federal Reserve (Fed)'s weekly data suggest that the banking turmoil is under control in the US, with less recourse to central bank refinancing. The peak in banks' borrowing and hoarding cash came in the week of March 15. We remain however convinced that the issues which have emerged in regional banks and a generic aversion to risk in the banking industry will have a lasting impact on banks' appetite to lend. This will have a disproportionate impact on small companies whose access to direct market funding is limited. We note that the "availability of credit" component of the NFIB survey has already fallen below its long-term average (Exhibit 3). This component is already lower than at any point during the "mini-recession" of 2001 and in line with what was observed during the early 1990s recession.

Exhibit 2 – If you're smaller you're lower



Source: National Federation of Independent Business (NFIB), ISM and AXA IM Research, April 2023

Exhibit 3 – Small businesses already feeling the credit pinch



Source: NFIB and AXA IM Research, April 2023

Still, there is an area in which small and big businesses are converging: employment resilience. While the NFIB headline confidence indicator has fallen markedly below trend, hiring plans remain robust, standing in March 2023 roughly half a standard deviation *above* their long-term average. For small businesses as well, labour hoarding seems to be rife. Despite "feeling the pinch" and feeling more pessimistic about future demand trends, they are still raising headcounts. To get a sense of the disconnection between the assessment of the economic situation and hiring intentions, we created a "predicted path" for the hiring plans in the NFIB survey using the strong historical relationship, estimated over 1980 to 2019, between the "headline" and the "hiring plans" components. This shows where hiring intentions by small businesses "should be" given their assessment of the economy. The spread with actual hiring intentions is massive (Exhibit 4).

Exhibit 4 – Still hiring though

Source: National Federation of Independent Business (NFIB) and AXA IM Research, April 2023

This gets us to a simple point: **the labour market is likely to be the "last shoe to drop" in this current, atypical cycle.** Employment is always a lagged indicator, but the transmission delay between firms perceiving a decline in demand and acting on headcounts could well be longer than usual. There is no doubt in our view that the monetary policy tightening is working its way through the economy, triggering *en passant* some unpleasant episodes of financial instability. If one looks beyond the US' biggest corporations, mood is souring quite quickly. But we haven't yet reached the point when hiring is materially affected, which will delay inflation landing. This is consistent with the Fed remaining reluctant to "lower its guard" too quickly despite the accumulation of dark clouds.

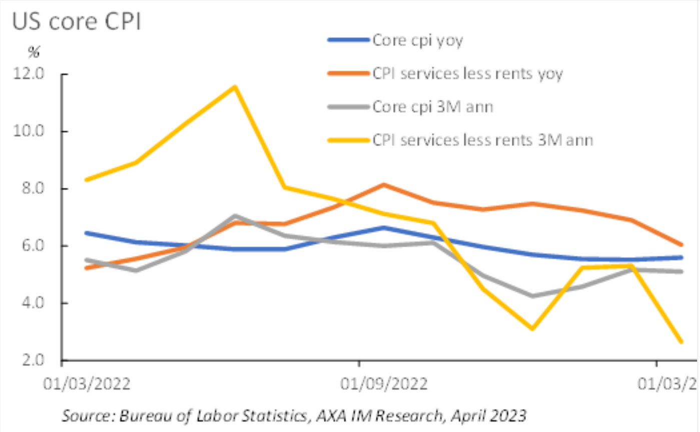
Some head-scratching at central banks

Now, even if the general commitment to a restrictive stance is unwavering, it is obvious that there is new sense of "hesitancy" at the Fed on the next steps. The Minutes of the last FOMC meetings, released last week, suggest that the impact of the banking turmoil is taken very seriously by members. Yet – and for us it is a crucial – to some extent the macro damage triggered by the banking turmoil is part of what they probably see as necessary to get inflation to land. To quote from the Minutes, *"with inflation remaining unacceptably high, participants expected that a period of below-trend growth in real GDP would be needed to bring aggregate demand into better balance with aggregate supply and thereby reduce inflationary pressures"*. The market-led tightening in financial conditions removes some of the pressure on the central bank to add many more policy rate hikes, but it does not mean – at least at this stage – that the central bank is ready to counter-act it with a monetary loosening.

There is only limited additional data the FOMC will be able to pore over before its next meeting on 2 May. Q1 GDP will be released on 27 April but short of a massive surprise, there is little they will be able to infer that that reading – the Fed is probably more interested in how the economy deals with the aftershock of the banking stress from Q2 onward. The next "payroll" batch will come only after the meeting, and so will the next CPI print. The release of the Employment Compensation Index (ECI) for Q1, normally more accurate than the monthly earnings data, may confirm one of the few insights which could be gained from the March payroll – that wage growth may have started to moderate. Quite a few data on the housing market coming out in the coming two weeks will help gauge the impact of the accumulated monetary policy tightening on what is the most interest-rate sensitive sector of the economy, but that's about it.

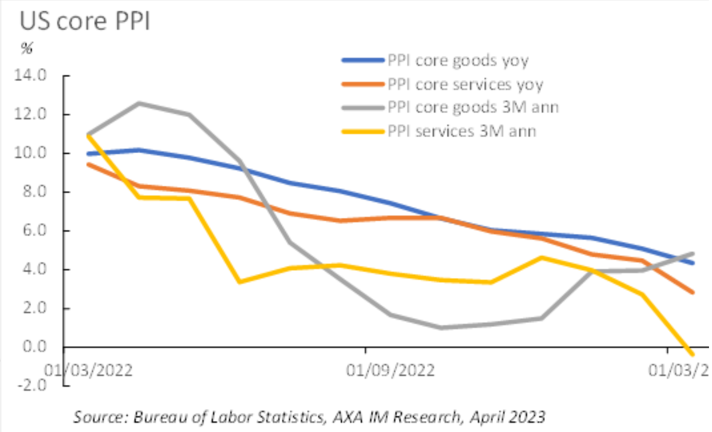
The March CPI print did not bring about any decisively new messages. There was some better news on services excluding rents, which we know is a key variable of interest to the Federal Open Market Committee (FOMC), with the 3-month annualized change coming very close to 2% (Exhibit 5). Yet, overall core inflation still came out stronger than expected in year-on-year terms. There was a slight deceleration on a 3-month annualized basis but remaining in the obviously too-hot 5% area. The producer prices index (PPI) came with a more hopeful message on the kind of inflationary pressure, which is now in the pipeline, with a significant deceleration in March, even when excluding the impact of energy. Yet, while the FOMC may relish the fall in negative territory of the producer prices in the services sector on a 3-month annualized basis, the parallel re-acceleration in core goods was disappointing (Exhibit 6).

Exhibit 5 – Still a mixed bag on consumer prices



Source: Bureau of Labor Statistics, AXA IM Research, April 2023

Exhibit 6 – Clearer disinflation in producer prices

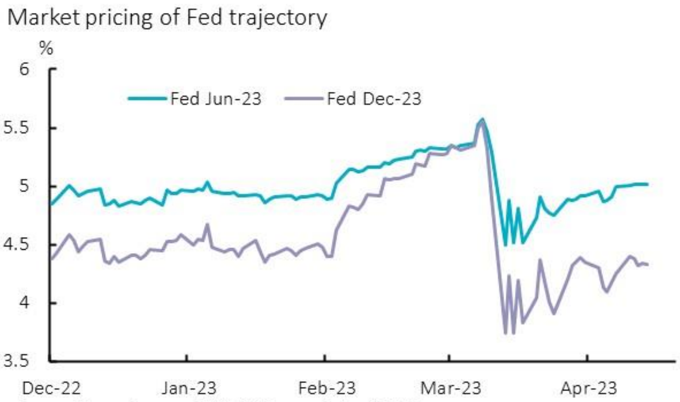


Source: Bureau of Labor Statistics, AXA IM Research, April 2023

The notion of "balance of risk" is likely to play a major role in the Fed's thinking in May. The configuration has become much murkier than the obvious combination of resilient real economy and inflation running on all cylinders of the winter. The banking turmoil "may" trigger a faster and deeper economic slowdown, and inflation "may" have started to turn, which certainly calls for much more prudence in the central bank's next steps. This is consistent with proceeding with caution – i.e., avoiding jumbo hikes, and the terminal rate is now in sight. The Minutes released last week made it plain that the banking turmoil has convinced a majority of members to pencil in a lower rate trajectory than what they would have done on the sole basis of available data.

For the immediate future, the market pricing is consistent with a "still stern, but flexible" Fed, and expectations for one more 25 basis-point (bp) hike have come back after the knee-jerk reaction of mid-March, leaving the terminal rate below the levels seen in early March (Exhibit 7). This is in line with own expectations. Yet, what remains more controversial is the return of two rate cuts being priced for the second half the year.

Exhibit 7 – 50 bps worth of cuts priced in for the Fed



Source: Bloomberg and AXA IM Research, April 2023

Exhibit 8 – ECB's terminal rate re-priced higher

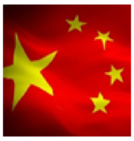
Source: Bloomberg and AXA IM Research, April 2023

It seems **the market is currently believing in what would ultimately amount to a policy mistake, with a Fed "forced" in a matter of months to completely change tack on its stance after having gone "too far"**, in contradiction with the central bank's message about the need to maintain restrictive conditions for long, to ensure inflation lands correctly. This probably reflects a sense that the economy, rather than linearly and slowly responding to the monetary tightening, would "snap" at some point, bringing about a faster-than-expected decline in inflationary pressure.

The Fed does not seem to be ready to buy the notion that the economy is close to "snapping". The staff now *"includes a mild recession starting later this year"* in the March batch of its forecasts, but it did not come out from the Minutes as a major move from "*subdued real GDP growth*" trajectory it had been anticipating previously. The FOMC still agreed on a message explicitly open to "*additional firming*" of the monetary stance in the full awareness of this deterioration in the outlook. In any case, **we think there is no upside for the Fed in communicating a potential stance reversal** – in clear explicitly hinting at rate cuts – given the current market configuration. Validating the market pricing would probably trigger a further inversion of the yield curve and reduce the pressure on risky assets, while in our view some measure of market-driven tightening is precisely what the central bank wants to see to be confident aggregate demand will be tamed enough to bring inflation *durably* down. It may be that privately FOMC members see a plausible scenario in which they would be forced to cut, if indeed the economy "snaps", but why would they make it explicit?

A sense of hesitancy is also plain to see at the European Central Bank (ECB), but while at the Fed it seems that most FOMC members, irrespective of their general hawkish or dovish proclivities, are in "reflexive mode", I the Euro area the lack of clarity of the overall message stems from the fact that the usual "camps" at the Governing Council are getting further apart. Hawks – such as Pierre Wunsch – have been very vocal in the run-up to the IMF meetings, explicitly considering a 50-bp hike at the May meeting. They are rattled by the continuing acceleration in core inflation, and right now this seems to be their only compass: monetary policy needs to be tightened at a fast clip – and large increments – as long as core does not at least stabilize. Doves do not necessarily call for a pause, the time to take into consideration the legacy of the banking turmoil but seem to at least want to open the debate to that possibility, probably aiming at 25bps without explicit forward guidance to more tightening as an acceptable compromise.

There are some crucial data points which will become available to the Governing Council by the time they meet in May. There will be another inflation print, while the Bank Lending Survey and actual credit origination data for March may help gauge the degree of progression of the accumulated monetary tightening. We continue to expect a 25-bps hike "only", based on our belief in a further decline in the credit impulse and more tightening in the credit standards reflected in the BLS, but our level of confidence is low. The political equilibrium at the ECB is tilted towards those who are unwilling to allow for long transmission time. Given how "battle lines" are drawn at the Fed and the ECB, the currently bullish market view on the euro exchange rate makes a lot of sense. Yet, we are concerned that the risk of "going too far" is now much more firmly visible in Europe than in the US, with potentially some significant price to pay in terms of economic activity by the end of the year.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• FOMC minutes (Mar) suggested 'some' members would have voted for 50bps in absence of banking concerns. Staff now expect "mild recession" this year. • CPI inflation (Mar) fell to 5.0% from 6.0% – its lowest since May 2021. Fall driven by oil, core rose to 5.6%. • Retail sales (Mar) fell by 1% headline, with 'control' down 0.3% – raises question for spending in Q2. • PPI inflation (Mar) dropped to 2.7% from 4.9%. • Fed emergency lending (wk 7 Apr) fell by $5.6bn.	• Empire and Philly Fed surveys (Apr) both were at levels only worse during recession in March. • Continuing jobless claims – risen by 500k in the last 6 months and often harbinger of broader loosening. • Home sales and housing starts (Mar), judging if strong gains in February reflected favourable weather or an easing in longer-term rates. • Manufacturing and services PMIs (Apr, p) will add to gauges of activity after March bank shocks fade.
	• EMU retail sales (Feb) fell for the 2nd consecutive month (-0.8%mom after -1%), leaving the Jan-Feb 0.4%qoq below the Q4 level. • EMU IP surprisingly rose by 1.5%mom, pulled up by recovery in energy intensive and supply-chain sensitive sectors (cars). Ge up by 2.1%, Fr: +1.1% • Final HICP data (Mar) are unchanged for Ge and Sp, slightly higher for France at 6.8%yoy (+0.1pp)	• EMU Final HICP (Mar) is key to monitor pressure in services and some goods. Ge PPI (Mar) also matters to calibrate price deceleration in goods • German ZEW (Apr) is expected to improve after banking turmoil in March. We also have Fr business climate (Apr) and EMU Flash cons confidence (Apr) • EMU Flash PMIs (Apr) are expecting to remain strong. Please note they will be the most recent surveys on activity before the ECB meeting in May.
	• GDP (Feb) remained flat as strikes hit output, revisions to previous data sees GDP back at pre-pandemic level • BoE credit conditions survey (Q1) – lending and credit availability remain stable but does not fully capture the fallout post banking turmoil • Megan Greene to replace Tenreyro on MPC from 5 July	• Labour market data (Feb) focus will be on strength of earnings and slowing in employment growth • CPI inflation (Mar) expected to resume declines to 9.6%yoy, but services inflation likely more sticky • Retail sales (Mar) expected to retrace -0.2%mom • GfK cons conf (Mar) measure likely to remain low
	• 4th round of Shunto points to 3.7% hike in pay of which 2.2% base pay. Final round expected in July • CA surplus (Feb) widens on narrower trade deficit • Consumer and business sentiment (Mar) rose • Inbound tourism up sharply (Mar) to 1.9mn – 68% the figure for March 2019	• Trade data (Mar) expected to widen as imports pick up • CPI inflation (Mar) headline expected to continue moderating, signs of firmness in core to be closely watched • Flash PMIs (Apr)
	• Price pressures further weakening for both CPI (+0.7%yoy) and PPI (-2.5%yoy) in March • Strong exports (+14.8%yoy) and imports (-1.4%yoy) in March • Strong aggregate financing figures for March	• Q1 2023 GDP expected to show recovery from 2.9%yoy in Q4 2022 (consensus at 3.8%yoy) • March macro data (retail sales, IP, FAI) to guide for the strength of the current economic recovery • PBoC expected to keep 1Y LPR unchanged (3.65%)
	• CB: Korea (3.5%), Peru (7.75%), Singapore on hold • March CPI (%yoy) in Czech Rep. (15%), Hungary (25.2%), Romania (14.5%), India (5.7%) and Taiwan (2.4%) show inflation rate slowing across the board at various speeds • IP (Feb) weaker in Turkey (earthquake), resilient in Colombia, Mexico, India	• CB: Indonesia (5.75%) to stay on hold • March CPI: South Africa • IP (Feb): Brazil

Upcoming events	US:	Mon: Empire State manf. survey (Apr), NAHB housing market index (Apr), Long-term investment flows (Feb); Tue: Housing starts (Mar), Building permits (Mar); Wed: Fed's Beige Book; Thu: Weekly jobless claims (15 Apr), Philly Fed indx (Apr), Leading indx (Mar), Existing home sales (Mar); Fri: Manf & Services 'flash' PMI (Apr)
	Euro Area:	Mon: It HICP (Mar); Tue: Ge ZEW survey: current situation & economic expectations; Wed: EU20 CPI (Mar); Thu: ECB monetary policy account, Consumer conf. (Apr), Ge PPI (Mar), Insee manf. confidence (Apr); Fri: EU20 Composite, Manf. & Services 'flash' PMI (Apr), Ge Manf & Services 'flash' PMI (Apr), Fr Manf & Services 'flash' PMI (Apr)
	UK:	Tue: Unemployment (Feb), Average earnings (Feb), CBI Industrial trends (Apr); Wed: CPI (Mar), CPIH, RPI, PPI input & output, PPI output 'core' (Mar); Fri: Credit rating review, GfK consumer conf (Apr), Retail sales (Mar), Composite, Services & Manf. 'flash' PMI (Apr), CBI Distributive Trades survey (Apr)
	Japan	Fri: CPI (Mar), National 'Core' CPI (Mar), Manf. 'flash' PMI (Apr)
	China:	Tue: GDP (Q1), Ind. prod. (Mar), Retail sales (Mar), Fixed asset investment (Mar); Thu: Loan Prime rate (Apr)

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AXA IM is a leading investor in green, social and sustainable markets, managing €489 billion of ESG-integrated, sustainable and impact assets as at the end of December 2022. We are committed to reaching net zero greenhouse gas emissions by 2050 across all our assets, and integrating ESG principles into our business, from stock selection to our corporate actions and culture. Our goal is to provide clients with a true value responsible investment solution, while driving meaningful change for society and the environment.

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