Investment Institute Macroeconomics

The Last One?

- Both Fed and ECB are highly likely to hike by 25bps this week, we think for the last time for the Fed, while we remain more in the "September peak" camp for the ECB, despite some soothing words from hawks.
- Spanish elections may not have brought much clarity, but the country's underlying situation is robust enough to help it deal with, potentially, some more months of uncertainty.

The Fed is highly likely to hike by 25 basis point this week, but focus will be on the next steps. In the absence of new forecasts, it should be relatively easy for J. Powell to keep his hands free for September. After all, the June statement was already quite non-committal. We think July will mark the end of the Fed's tightening cycle, but that remains conditional on the further accumulation of signs the US economy is slowing down.

We also think the ECB will hike by 25bps this week, but to move more convincingly into data dependent mode – now that even hawks don't want to take a September hike as a given - the central bank must alter its prepared statement to remove the notion that policy rate "will be brought" to sufficiently restrictive level. This would be taken as a major dovish shift by the market, and we think Lagarde will have to offset this by sending some hawkish messages in the Q&A. Looking ahead, there is still a key element missing for the Governing Council to stop hiking beyond July: an observable deceleration in core inflation, unlike in the US.

The BoE will have until August to decide on its next move. We must be cautious, but the better-than-expected inflation print for June could keep the next hike at 25bps "only" and reduces the risk the BoE steers a lonely and painful tightening course beyond the summer.

With near complete results on Sunday night, it seems the right-wing block failed to reach a majority in parliament. Pedro Sanchez could in principle cut a deal with regional parties to stay in power, but this would put him in a fragile position and another election in a few months is a real possibility. We review the country's underlying position and find it overall robust enough to deal with some months of uncertainty without too much market tension.

Fed: peak reached (hopefully)

A 25bps rate hike by the Federal Reserve (Fed) this week is a near-certainty – we suspect the central bank would have found ways to let the market know in advance it was having a change of heart – but **the real issue is whether and how the Federal Open Market Committee (FOMC) will want to give hints on the future trajectory**. Our view is that they will want to keep their hand as free as possible. From this point of view, the Fed is in a much easier position than the European Central Bank (ECB) since the Fed's policy statement in June was "properly data dependent", with a perfectly non-committal key sentence: *"In determining the extent of additional policy firming that may be appropriate to return inflation to 2 percent over time, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments"*. Keeping this unchanged would put them in the perfect set-up to assess the data flow for the remainder of the summer while keeping the market on its toes, thus avoiding a spontaneous loosening in financial conditions which could impair policy transmission.

In June, the "hawkish bias" came mostly from the new FOMC forecasts with the two additional rate hikes embedded in the dot plot. There is not going to be any update to the projections at this meeting. Jay Powell is likely to be bombarded with questions on the validity of the June dot plot, but we think he can easily beat them away by referring to their "data dependency" and asking everyone to be patient and wait for the next batch of forecasts in September.

However elusive Powell may be, observers are likely to pore over every minute qualitative change in the Fed's assessment of the current macro situation. In June, inflation was considered to be "*elevated*" and with core only marginally below 5%, we don't think the Fed will have changed its point of view on this. What would however draw attention is any reference to the better-than-expected June print in the statement, but on balance the FOMC is likely to maintain its warning that it remains "*highly attentive to inflation risks*". On the real economy side, the June characterization (activity expanding at a modest pace, robust job creation and low unemployment) also remains essentially valid. True, at long last the payroll number came out below expectations in June, but this is to some extent offset by the revision in Q1 GDP numbers.

Any major change of diagnostic in a dovish direction would in any case be difficult to reconcile with the fact that the Fed is highly likely to hike this week. This creates a limit to how far Powell's rhetoric can change. If he comes out as too dovish, the natural question he would get is "why are you hiking then?".

Now, on substance, what do we think the Fed will ultimately do in September? Habitual readers of Macrocast will know that we have been expecting for a while that **July would be the last hike of the current tightening phase**. We have at times been quite uncomfortable with this call given the robustness of the data, but the better news on the inflation front recently have made us more confident.

This is however conditional, beyond the confirmation of softer price pressure, on the further accumulation of signs the US economy is slowing down. The first estimate of Q2 GDP out this week is expected in the same range as Q1 (consensus at 1.8% annualized, after 2% in Q1) but by September this print will be a bit stale for the FOMC. The behaviour of consumption this summer will be crucial, and we see it as the net result of, on the downside, the rebound in the savings ratio and softer job creation, and on the upside the fact that real wages have been improving again. We find reassurance in the June print for retail sales. Although it is a less comprehensive indicator than personal consumption, the below-expectations 0.2%mom gain in June for the headline number confirms consumers are getting more cautious, even if the "control group" measure was more positive.

This is an area where **the tightening in financial conditions may be exerting some significant effect**. According to a Fed survey published early last week, the rejection rate for loan applicants rose to 21.8% in the 12 months to June 2023, the highest in 5 years, while credit applications themselves declined to their lowest level since October 2020. For auto loans, which are often essential to the inflexions in spending behaviour, the rejection rate was the highest since the survey started in 2013.

All in all, while it remains a close call, we think the "natural slope" is that the FOMC won't have to tighten further in September, insisting however on the need to keep monetary conditions restrictive for long.

Are ECB hawks relenting?

For the ECB, keeping options open after the also highly likely 25bps hike this week is going to be more complicated than for the Fed, since the June prepared statement contained a clear forward guidance about the next move: *"Our future decisions will ensure that the key ECB interest rates <u>will be brought</u> to levels sufficiently restrictive to achieve a timely return of inflation to our two per cent medium-term target*". Keeping this unchanged would telegraph another hike in September. Kilometres of research – including our own not-too-concise contribution – have highlighted the uncomfortable fact that such clarity of intent was hardly compatible with the data dependent mode in which the Governing Council claims to be in. Now that even hawks like Klas Knot went to the wires stating that a September hike was only "*a possibility*", we fail to see how the central bank could afford not to rephrase. The most non-committal approach to do this would be to move to something like *"the Governing Council's future decisions will ensure that the key ECB interest rates <u>are</u> sufficiently restrictive to achieve a timely return of inflation to the 2% medium-term target"*. If by September – and the next batch of ECB forecasts – more signs accumulate that monetary transmission is in full swing and that price pressure is abating, then the ECB would be justified in considering that enough has been done and start a pause. If conversely inflation fails to land, this would be proof for the Governing Council that the right degree of restriction has not yet been reached, warranting another hike.

Still, even such a non-committal change would likely be considered as a clear dovish signal from the market, which could trigger some spontaneous loosening in financial conditions running counter the central bank's willingness to cool the economy. To guard against this risk, **we would not be surprised if there were some hawkish overtones in Christine Lagarde's Q&A.** This is where re-using the notion of "ground to cover", reflecting a hiking bias, could come handy, even if we think that she will make it more explicitly conditional on the dataflow. Note however that the ECB is likely to wait for some key data releases next week before fine-tuning its communication on Thursday. The flash Purchasing Managers' Index (PMI) for July out on Monday will provide some guidance on the chance the Euro area extricates itself from the technical recession which started in Q4 2022 (the composite PMI fell in contraction territory in June). The price behaviour components of the index are also going to be scrutinized. Data on Wednesday on credit origination for June will give further indication on the state of policy transmission, with also the indications of the Q2 Bank Lending Survey.

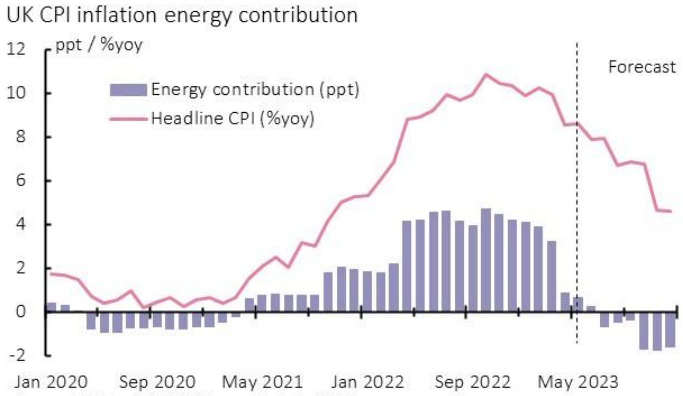
There is now undoubtedly a higher probability than last month that the ECB could be "done" by July already, stopping shy of bringing its policy rate to 4%. Beyond the comment by Klas Knot (and Joachim Nagel who also made a September hike data dependent), we can start being hopeful the disinflation observed at the global level is affecting the Euro area in a more tangible manner. **What is however missing, when we compare the European situation with the United States (US), is a proper deceleration of core inflation already apparent in the data**. Our own forecasts see that only for the last 4 months of the year. True, our projection was too high for June, but beyond the actual consumer prices prints, we continue to be impressed by the ECB's focus on wage development. As we have been repeating for some time, we find it hard to believe the ECB will pause before it's clear that wage growth has started decelerating, and that may only materialise *after* the September meeting. So, even if we recognize that it is a very close call, we remain more in the "September peak" camp.

Some rare, good news in the UK

The Bank of England will have the luxury of waiting until August before making its own decisions. Given the somewhat "panicky" tone the Monetary Policy Committee (MPC) struck in June, it's very hard to imagine it would not hike again next month. Yet, it is now more likely that they will opt for 25bps rather than 50 now that **inflation has – a rare feat – come out below expectations in June.**

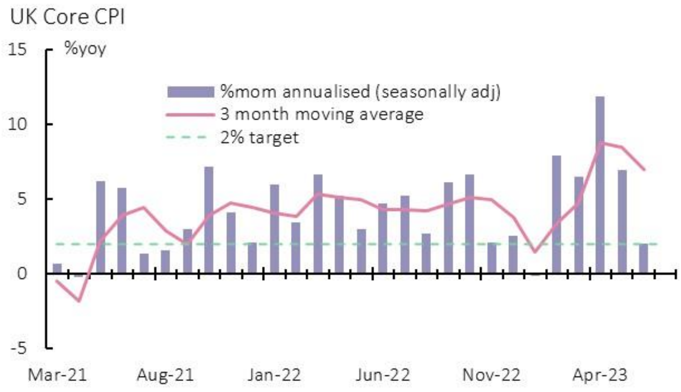
The overall pace remains dizzying: 7.9% year-on-year still puts the United Kingdom (UK) firmly in the upper range among developed nations. Yet, given the growing fear that the country is facing run-away inflation, a decline from 8.7% in May is good to take, especially since the market was bracing for a smaller deceleration (8.2%). The correction in energy prices remains a key contributor (see Exhibit 1) and we will see further drops in July and October as the regulator revises its caps, but **core is now also decelerating**. The market was expecting a mere stabilisation at 7.1% year-on-year, but core slowed down to 6.9%. In annualized terms, the June monthly print was particularly low (see Exhibit 2). We must be careful though because we have had some false dawns already (in January for instance) but then the deceleration was triggered by volatile components such as airfares, while the recent one looks broader based. The fact that the change in core producer prices is now in negative territory is a strong signal.

Exhibit 1 – More help from lower energy prices



Source: ONS and AXA IM Research, July 2023

Exhibit 2 – Low core print – but we've been there before



Source: ONS and AXA IM Research, July 2023

Habitual readers of Macrocast will know that the UK is one of the developed nations for which the idea that the monetary tightening would peak by Q3 of 2023 is the least solid in our opinion. Too many structural issues – mostly pertaining to the labour market – can make it very difficult to cover the "last mile" of disinflation towards the central bank target. Yet, on the basis of the very latest dataflow, we can probably be more hopeful that the Bank of England (BoE) won't have to steer a lonely and painful path beyond September.

Stuck again in Spain?

Spanish politics used to be simple, organized around two behemoths, PSOE on the centre-left and PP on the centre-right, with a sizeable but marginalized far-left, no far-right to speak of, and a smattering of regional parties torn themselves between centre-right and centre-left. Things started to get more complicated in the last 10 years, with the emergence and then complete disappearance of a centrist party intent on fighting regional nationalism (Ciudadanos), the emergence of the far-right (Vox) competing with PP and a far-left (Podemos and now Sumar) competing with Partido Socialista Obrero Espaňol (PSOE), combined with a dramatization of the national question in Catalonia. In such configuration, it's probably not that surprising that achieving political stability has become tougher. **In 2019, it took two general elections in six months to finally allow the incumbent Socialist-led administration some measure of parliamentary majority. Based on the near-complete results available as we write on Sunday night, we may have to go through the same process this year.**

Partido Popular (PP) was the polls' favourite and needed to achieve two goals: (i) reduce the influence of far-right Vox which in the last elections came only 37 seats below them, to regain undisputed leadership on the right; (ii) win a parliamentary majority, if need be, with Vox, together with its usual regional allies (centre-right regional parties in the Canary Islands and Navarra). PP delivered on the first. As we write Vox lost nearly 20 seats down to 33, while PP improved notably from 89 to 136. It failed however on the second one, since the right-wing block in total could command at most 171 seats, 5 shy of the majority threshold in the lower house. The left-wing block (PSOE+Sumar) is even further away at 153, but it is ideologically more amenable to negotiations with nationalist parties in Catalonia, the Basque country and Galicia, which as we write should together control 25 seats. This would not be a walk in the park though. Catalan and Basque nationalists are divided between different parties, and any coalition would be very fragile, assuming Pedro Sanchez to stay in power would be ready to pay the price some of these parties would request (e.g., another independence referendum in Catalonia). **Three options are thus still on the table after these elections: the continuation of a fragile left-leaning coalition, a shift to a fragile, minority right-wing coalition, or new elections in a few months to hopefully get a clearer message.**

It is a (good) sign of the times that no particular market tension – nor even much curiosity – emerged in the run up to the general elections in Spain. Ten years ago, the peripheral crisis was still in full swing, and minute political changes were scrutinized by investors. **The fact that Spain's economic health is currently not a major concern of course helps.** Inflation has just fallen below 2% - courtesy of strong base effects from energy and food prices and the country is currently avoiding the contraction in GDP in which Germany has fallen in Q4 2022 and Q1 2023.

This is all the more remarkable that Spain was among the hardest hit by the economic effects of the pandemic, with GDP falling by more than 10% in 2020, twice as much as the Euro area average. The subsequent recovery has however been powerful, although the country has only just filled the gap relative to the pre-pandemic GDP level, later than the Euro area (see Exhibit 3). Another source of reassurance for the market is that despite the higher-than-average cumulative GDP loss, Spain's primary deficit should land in 2023 very close to the zone's average according to the latest European Commission forecasts (see Exhibit 4).

Exhibit 3 – More deeply down, but recovering fast

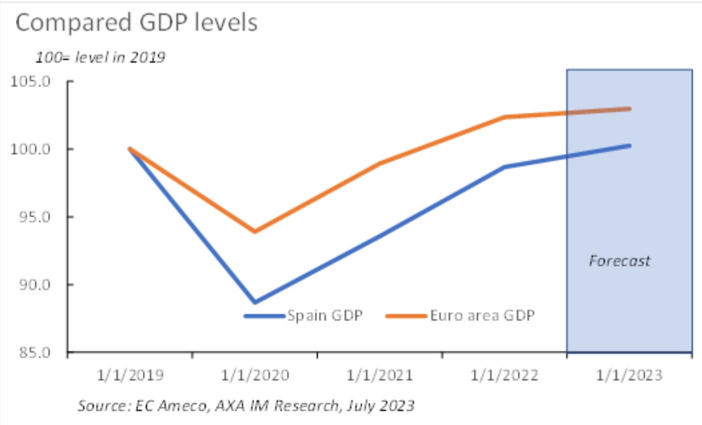
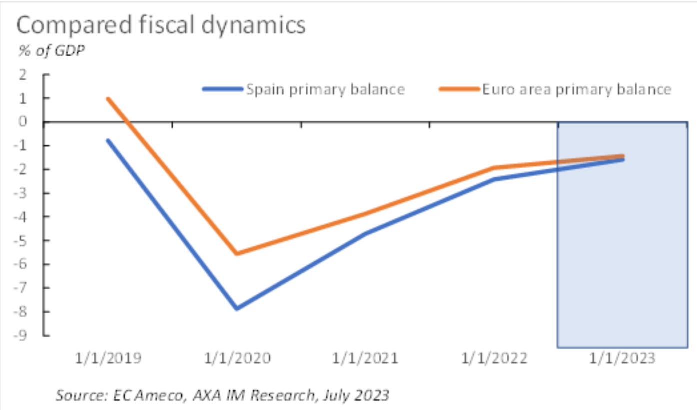


Exhibit 4 – Fiscal gap filled



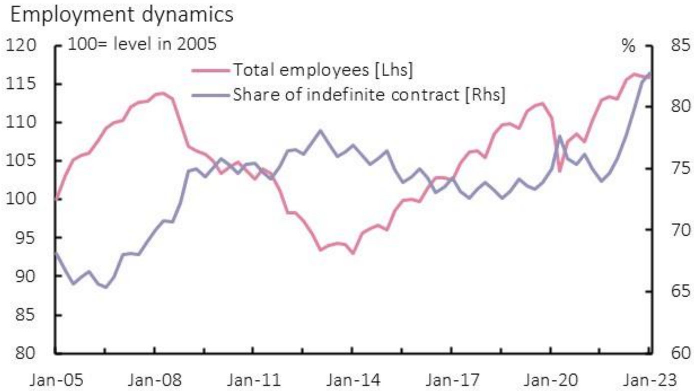
The incumbent administration had not much space and time to make its mark on macro. Due to the circumstances of Sanchez' accession to power, his mandate was more political – appeasing the country's structural institutional issue after the Catalan referendum drama – than economic. As a condition to support the centre-left in parliament in 2018 – which precipitated PP's Rajoy demise – the centre-right Basque nationalists ensured that the new Socialist PM would endorse the budget bill proposed by his predecessor. After several months of near paralysis amid two general elections, the administration had to deal with the pandemic crisis and more recently the energy crisis triggered by the Ukraine war.

Sanchez' approach on macro issues could have been defined by a willingness to correct some of the adverse social effects of the painful adjustment the country went through under his two predecessors, without jeopardizing its success. The post-2010 reforms combined with the wage moderation unions ultimately accepted put an end to what had been the root cause of the country's demise in 2010: a significant decline in competitiveness as the economy was overheating in response to the sudden decline in interest rates permitted by the monetary union. Rather than looking at "price measures" of competitiveness such as relative unit labour costs, we think it makes more sense to look at a country's capacity to lose or win market shares by comparing actual exports with external demand (the weighted average of the clients' import growth). **After the massive decline of the pre-sovereign crisis phase, Spain has been able to maintain its market share.** The decline of the pandemic years is of course due to the country's specialization in services exports, and the performance since the recovery is in line with the previous trend. It seems that the benefit of the crisis-led adjustment lives on (see Exhibit 5).

Exhibit 5 – Stable competitiveness for 15 years

Source: OECD and AXA IM Research, July 2023

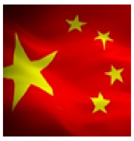
Exhibit 6 – More jobs, better jobs



Source: INE and AXA IM Research, July 2023

There is however one area in which Sanchez has had time to impose his mark: the employment reform. The extreme dualism of the Spanish labour market between those with indefinite contracts and those alternating fixed-term contracts and periods of unemployment has been for decades a structural weakness of the Spanish economy, often seen as responsible for the country's mediocre productivity performance (firms don't see the point in investing much in the training of a higher proportion of non-permanent workers, people with fixed-term contracts see little point/have little opportunity to improve their human capital). Last year's reform combined incentives and regulation to shift more fixed-term workers to move to indefinite contracts, while still preserving firms' capacity to deal with demand fluctuations through a recourse on temporary redundancy programmes – widely used during the pandemic. The latest data point to an overall rebound in job creation coupled with a significant rise in the share of indefinite contracts (see Exhibit 6).

Not all is rosy in Spain. The public deficit may be under control, but public debt will probably reach 111% of GDP this year, while the rise in interest rates will make the fiscal equation harder to solve in the years ahead. Yet**, even if last week's elections may not have brought that much stability to the country, its underlying position is probably robust enough to help it go through some more months of uncertainty** if, for instance, new elections need to be organized. In any case, there was no chasm between the economic projects of PSOE and PP in the campaign. Unsurprisingly, the former was more focused on the growth dividends brought by the disbursement of the Next Generation funds while the latter was more focused on some tax cuts, but nothing revolutionary was on the table. We have many reasons to be worried about Europe right now, but Spain may remain some way away from the top ranks of our concerns.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Retail sales (Jun) headline rose by 0.2%mom, but control up 0.6%, consumer spending likely 1% in Q2 • Empire and Philadelphia Fed Surveys (Jul) both fell modestly, suggest mfg weakness, but not recession • Industrial production (Jun) second successive 0.5% drop in monthly output • Existing home sales (Jun) -3.3%mom, housing starts (Jun) -8.0%mom – sector remains weak.	• FOMC decision. Fully expect 0.25% hike to 5.5%. No forecast updates, but press conference watched for Sept outlook. We forecast 5.5% peak, cut from Mar. • GDP (Q2, p) consensus 1.8% and Atlanta Fed tracker at 2.4%. We see risk to downside, watch composition for implications for Q3 output • Conf Bd cons sent (Jul) rising stocks and falling gas prices could see modest boost • PMI (Jul,p) for manufacturing and services
	• EMU June final core HICP was slightly revised up 0.1pp to 5.5%yoy. Headline was confirmed at 5.5%yoy • EMU flash consumer confidence improved by 1 point to -15.1 in July, though continues to remain well below long-term average • France INSEE business confidence remained broadly stable at 100 at its long-term average	• We expect the ECB to increase its depo rate by 25bps to 3.75%, maintaining an hawkish stance but increasingly data-dependent ahead of its September meeting • Key releases to come out ahead the ECB meeting: flash PMIs for July, ECB Q2 bank lending survey, and June monetary aggregates • Preliminary Q2 GDP for France (AXA IM: 0.2%qoq), Spain (AXA IM: 0.3%qoq) and July EC survey • Flash July HICP in France, Spain and Germany
	• CPI inflation (Jun) falls to 6.9%yoy with broad-based easing with core and services CPI falling back • Tories defeated in two out of three by-elections • PSNBx (Jun) £18.5bn, better than expected trend • Mixed data on strength of consumer - retail sales (Jun) up 0.7%mom, GfK cons conf (Jul) edges lower	• Flash PMI (Jul) • CBI Quarterly Survey (Jul) – gauge manufacturing • Nationwide house prices (Jun) expected -0.5% as rise in mortgage rates bite
	• CPI (Jun) – core measure (ex-fresh food and energy) slowed to 4.2% from 4.3% • Trade data (Jun) trade balance in surplus for first time in 23 months, real exports up 4.8%mom • Reuters Tankan Non-mfg index (Jul)	• BoJ MPM (Fri) and Quarterly Outlook Report. We expect shortening of YCC tenor or target to 5Y from 0Y. Inflation projections likely to be revised up to 2% • Tokyo CPI (Jul) for clues for next month's national fig • Flash PMIs (Jul)
	• GDP (Q2: 6.3%yoy, 0.8%qoq) (H1: 5.5%yoy), signs of economic slowdown • Retail sales (Jun) 3.1%yoy • Fixed Asset Investment (Jun) -17.1%yoy • Loan Prime Rates unchanged in July (1Y: 3.55%, 5Y: 4.20%)	• Politburo meeting (Jul): potential fiscal stimulus packages • Industrial profit (Jun)
	• CB: South Africa (8.25%) on hold. Russia hiked +100bp to 8.5%. Turkey hiked +250bps to 17.5% underdelivered vs expectations • Inflation (June) fell in South Africa (5.4%) • GDP accelerated to 0.7% in Q2 in Singapore	• CB: Chile to start easing cycle -50bp to 10.75%; NBH in Hungary to cut O/N rate by another 100bp to 15%, keep repo rate unchanged at 13%; Indonesia expected on hold at 5.75% • Q2 GDP first estimates in Korea & Taiwan • July CPI indications for Brazil, Malaysia & Mexico

Upcoming events	US:	Mon: S&P manf, comp and services PMI (Jul); Tue: C-S HPI (May), Consumer confidence (Jul); Wed: New home sales (Jun), Fed funds rate, Fed Int on excess reserves; Thu: Durable goods (Jun), GDP (Q2), PCE consumption (Jun), PCE & Core PCE price index (Jun) Initial jobless claim (17 Jul), Pending home sales (Jun); Fri: Michigan consumer sentiment (July)
	Euro Area:	Mon: Sp Overnight stays (Jul), Fr Ge and EU20 comp, manf & services PMI (Jul); Tue: Ge Business climate (Jul), Ge Ifo Current conditions and expectations (Jul); Wed: Fr Consumer confidence (Jul), Fr Unemployment (Jun); Thu: Sp Unemployment rate (Q2), Sp Retail sales (Jun), It Consumer confidence (Jul), EU20 ECB refinancing and deposit rate (Jul): Fri: Fr GDP (Q2), Fr HICP (Jul), Fr PPI (Jun), Sp GDP (Q2), SP HICP (Jul), Ge HICP (Jul)
	UK:	Mon: Manf, comp and services PMI (Jul); Tue: CBI trends (Jul), CBI business optimism (Q3); Thur: CBI distributive trades (Jul); 27-31 Jul: Nationwide house prices (Jul)
	Japan:	Mon: Comp, manf and services PMI (Jul); Tue: Chain store sales (Jun); Wed: Services PPI (Jun), Leading indicator revised (May)
	China:	Politburo meeting (Jul): economic planning with potential stimulus packages

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