Dovish "Bivot"

We wish our readers a great festive season – Macrocast is taking a break and will come back on 8 January 2023

- We were expecting the Fed and the ECB to push back against the market's aggressive pricing. Only the latter did. The Fed may be too relaxed, and the ECB too worried, relative to the intensity of inflation risks in their constituencies.
- COP28 was a mixed bag, with some breakthroughs on green finance and a nice signal on fossil fuel, although implementation will remain, as usual, the crux of the matter.

After Jay Powell did not push back against market pricing last week, even more aggressive expectations for rate cuts emerged. Some FOMC members tried to "fine tune" the Fed's communication on Friday, with some effect on the market, but we suspect the verdict will come from the data flow. The Fed President – and the market – might get lucky and we could see the resumption of swift disinflation in early 2024, dissipating the ambiguous message from the November CPI print, but we prefer to maintain our expectation of only 75bps of cuts next year and brace ourselves for some volatility in the first few months of next year. Christine Lagarde, conversely, was very clear in her refusal to embark on any discussion of rate cuts, but her warnings largely fell on deaf ears at the end of last week, with the market still pricing massive accommodation. Some aspects of the central bank's forecasts could express a bias towards exaggerating the chances of a price drift ahead. In a nutshell, we think the Fed may be today too relaxed on the capacity of the current macro trajectory to bring inflation back to 2% swiftly, while the ECB may be overly cautious. This keeps us comfortable with our baseline that both central banks will ultimately wait until June 2024 to cut, although this may come too late for the ECB given where the Euro area stands in the cycle.

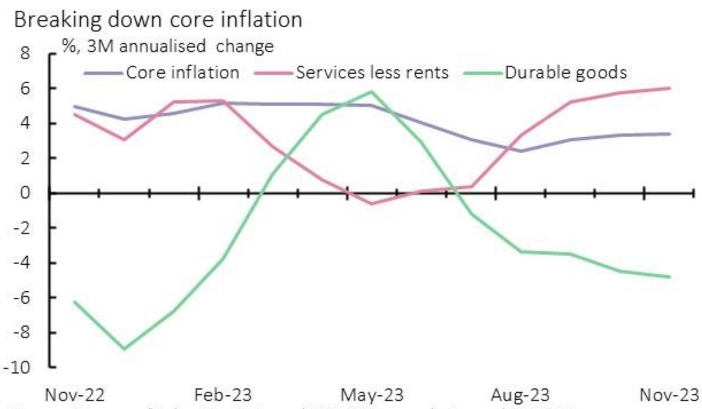
Expectations were low for the outcome of COP28, so the final version of the Stocktake agreed in the UAE last week – explicitly mentioning "transitioning away" from fossil fuels - probably is a positive surprise. The commitments taken at COP by 50 oil companies controlling 40% of the market were laudable but focus on scope 1 and 2 only. Scope 3 revolves around demand. It was probably illusory to expect much on that front in a global forum. We will now need to monitor the new pledges – and the means attached to them – in the next wave of NDCs by national governments. We note however that progress is now possible on key aspects of international green finance.

Not so secret Santa

We were wrong last week in expecting Jay Powell to push back against the market's aggressive pricing of rate cuts. By explicitly mentioning that the timing of cutting was now part of the Federal Open Market Committee (FOMC) discussions, he did nothing to protect the "high for long" approach he had publicly defended as recently as 1 December. He started on a familiar footing by stressing that they were still focusing on determining whether they "have done enough" – which is consistent with keeping on the table, albeit in an attenuated form, the possibility to hike rates further which was plainly mentioned in the prepared statement. He however "spoiled" this effect by immediately shifting immediate to the "other" question. We feel the need to quote him verbatim here: "*the other question, the question of when will it become appropriate to begin dialling back the amount of policy restraint in place, that begins to come into view, and is clearly a topic of discussion out in the world and <u>also a discussion for us at our meeting today</u>*.

There was also **something odd in maintaining the possibility to hike further in the statement and devote so much space to discussing the risk attached to maintaining a restrictive stance for too long.** He did not merely mention it. He gave some prominence to this concern in his answer to a direct question on cutting rates: *"we're aware of the risk that we would hang on too long. We know that that's a risk, and we're very focused on not making that mistake".* Of course, he then moved to the symmetric risk (cutting too soon), but he did not elaborate as much there. While the expected words on "*refusing to declare victory*" on inflation were uttered, Jay Powell sounded resolutely relaxed on the capacity of the current macro trajectory to get us back to a pace of price growth which would allow the Federal Reserve (Fed) to start removing restriction quickly. Although we certainly agree on the substance of his point on starting to cut well before inflation has hit 2% to avoid overshooting risks, we fail to see what the urgency was in getting into that conversation now, when core inflation is still at 4% and the economy still resilient.

Exhibit 1 – Services and durable goods prices still diverging

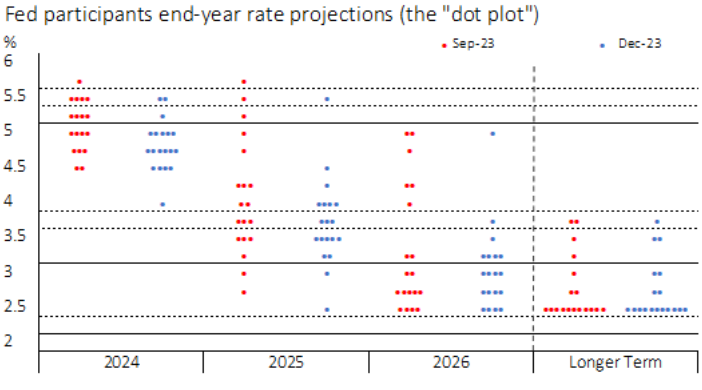


Source: Bureau of Labor Statistics and AXA IM Research, December 2023

We wrote last week that, should the consensus expectation materialise last week, and November core inflation merely stabilise instead of continuing to fall, Jay Powell would have the piece of evidence to steer market pricing away from its aggressive stance. This indeed materialised, but the November inflation print received little attention in the FOMC chairman's communication. When looking at dynamics on a three-month annualised basis, **we had another confirmation of the growing gap between falling prices for durable goods and another acceleration in services excluding rents** (see Exhibit 1). At the risk of boring our habitual readers to death with a point we have been making at nauseam, if too much of the ongoing disinflation remains driven by external forces – and the price of durable goods tends to follow global trends – without much contribution from the domestic forces, there is a case for prudence for a central bank. To be clear, we think that disinflation will continue, as domestic demand starts slowing down, but the signals are for now faint.

Fundamentally, our main source of surprise lies in the discrepancy between the dovish rhetoric and the FOMC's dot plot. The "median member" now forecasts three rate cuts in 2024 – which happens to be our baseline – which was already much smaller than what the market was pricing before Powell took to the stage, and which we would consider quite reasonable in a situation where 2% inflation would be hit only in 2026, a point reiterated in this forecast batch, even if there was a minor downward revision in the trajectory (2.1% in 2025 instead of 2.2% in the September version). The distribution of the dot plot matters at least as much as the median point. We find it striking **that only one member sees the Fed Funds rate as low as 4% at the end of next year (see Exhibit 2) …but that the average pricing of the market stood, by the end of the press conference, at 3.5%** (see Exhibit 3).

Exhibit 2 – A prudent path…



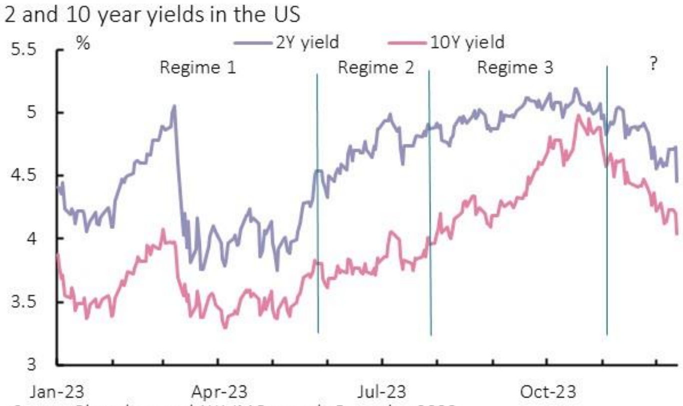
Source: Federal Reserve Bank and AXA IM Research, December 2023

Exhibit 3 – …no longer trodden by the market

Source: Bloomberg and AXA IM Research, December 2023

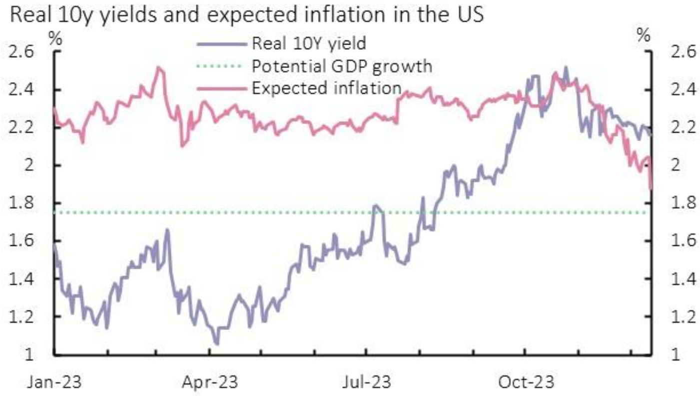
For sure, there is nothing in what Jay Powell said last week which would be contradictory with waiting until mid-2024 to start removing accommodation. Stating that you have started discussing the time is of course very different from making any decision. Yet, **given the gap between the dot plot and the press conference, one can legitimately wonder whether the chairman accurately conveyed the message from the "centre of gravity" of the FOMC.** We noted that John Williams, President of the New York Fed, hit the wires last Friday to pour some cold water on the market's exuberance. His point on "*we are not really talking about rate cuts right now*" sounded like a direct rebuttal of what Powell said. He nailed the point home by stating that "*it's just premature to be even thinking about a March rate cut*" and tried to put the focus on the fact that the Fed is still pondering whether they have delivered enough restriction. Rafael Bostic separately stated he had only pencilled in two rate cuts for 2024 and was not expecting any relaxation before the second half of the year. Unanimity is starting to break though, and we note that Austan Goolsbee added to the "dovish festival" on Friday.

Exhibit 4 – Where's the floor?



Source: Bloomberg and AXA IM Research, December 2023

Exhibit 5 – Expected inflation < 2%, really?



Source: Bloomberg and AXA IM Research, December 2023

In theory, the Fed could ignore market pricing and let investors to their own device when it comes to making sense of their communication. In practice, steering market expectations becomes crucial when actual financial conditions jeopardize the transmission of the monetary policy signals. We mentioned last week that bond yields were now falling so fast that the "sufficient level of restriction" the central bank is trying to maintain to bring inflation back to target was at risk. Of course, last week's events pushed this further (see Exhibit 4).

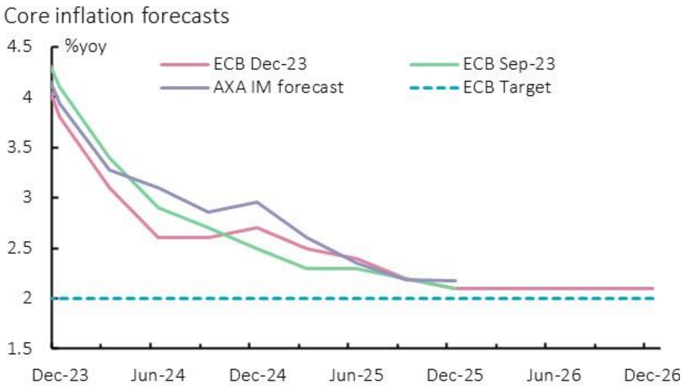
When breaking down the US 10-year yield, quite bizarre signals are emerging. For instance, on Thursday at close, break-even 10-year Consumer Price Index (CPI) inflation stood at 1.88% (so less than 1.5% when using the Fed's favourite consumer price gauge, the Personal Consumption Expenditures price index (PCE), given the usual wedge between the two measures). In other words, **market participants were by then collectively expecting the Fed to at the same time cut aggressively and massively overshoot its inflation target in the long run**. Anything is possible of course, but we would be ready to see all this as a signal that the market has started to get in inconsistent, unreasonable territory. True, the Fed – and the market – might get lucky and we could see the resumption of swift disinflation in early 2024, but **we prefer to maintain our expectation of the first rate cut to June and brace ourselves for some volatility in the first few months of next year.**

Lagarde fight back – market is deaf

Christine Lagarde delivered the pushback we expected, and more. She was extraordinarily clear on the fact that the Governing Council is not ready to discuss rate cuts – which was echoed by all members who took to the wires afterwards, even if Francois Villeroy de Galhau made it plain that a cut was indeed likely to be the next move, but after a "plateau" on which he chose to not to elaborate. Lagarde's point on "*not lowering the guard*" left no room to ambiguity. We suspect that her tone was possibly even starker than she had initially intended it to be because she was informed by the market's reaction to Jay Powell's press conference the previous day. **To avoid a market stampede on pricing even more rate cuts, we think she felt the need to be possibly more "one-sided" than what remains a complicated macro configuration for the Euro area would have warranted.**

As we also expected last week, the new European Central Bank (ECB)'s forecasts were undoubtedly aligned with a very prudent pace of policy loosening. True, the projections for inflation are now lower for 2024, but any other trajectory would have been very difficult to conjure up since disinflation has been proceeding faster these last few months than what the ECB was forecasting in September. In terms of signalling, this is in our opinion more than offset by the upward revision for 2025. **For core inflation, the ECB is now counting on a long plateau at c.2.5% from mid-2024 to mid-2025, instead of the regular deceleration forecasted in September** (see Exhibit 6).

Exhibit 6 – A long plateau for core inflation



Source : European Central Bank and AXA IM Research, December 2023

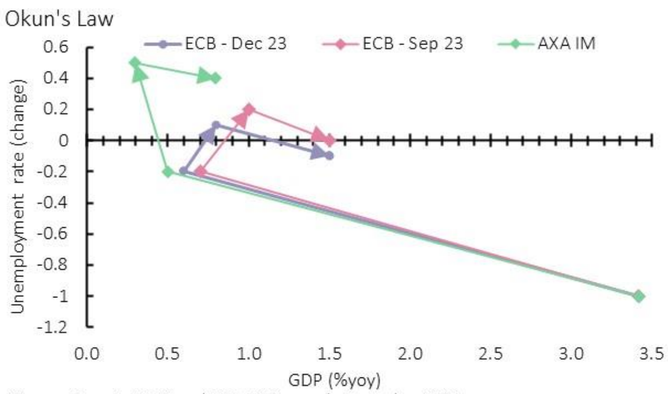
Exhibit 7 – Lagarde's warnings fell on deaf ears

Source: Bloomberg and AXA IM Research, December 2023

This is a signal the market should normally take seriously since the technical assumptions for interest rates in the ECB projections come from the market pricing at the cut-off date (23 November), a point on which Lagarde insisted at the very beginning of the Q&A session. In other words, **the trajectory the market was expecting for monetary policy a month ago would not be fully consistent with a quick return to 2% inflation**. Yet, the market continues to be deaf to this combination of tough rhetoric and slow-converging inflation forecasts. As of Friday, last week, **the market was expecting to see the ECB's policy rate at 2.25% at the end of 2024, below the low-end of the range of "Taylor rates" we computed for the Euro area.** If sustained for another three months, this would become the technical assumption for the March ECB forecasts, with the risk of making it very difficult for the central bank to telegraph a swifter disinflation scenario without which, precisely, the early rate cuts priced in by the market will not materialise.

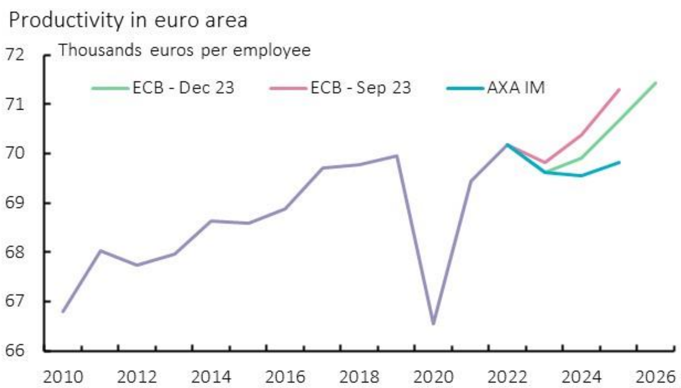
Now, it may well be that the market disagrees with the ECB on the assessment of inflation risks. While we share the ECB's view on a slow convergence to 2%, **there are some aspects of the central bank's latest forecasts which could be seen as the expression of a bias towards exaggerating the chances of a price drift** in 2024 and 2025. The ECB forecasts that GDP will gain 0.8% in 2024. We think this is still too optimistic – we expect 0.3% - but the new forecast is 0.2 points below the September batch. Yet, conversely, **the ECB has now a rosier outlook for the labour market**, with an unemployment rate for 2024 0.1% lower than in September, with employment higher by 0.2pp. When looking at the Okun relationship between the change in unemployment and the change in GDP, the ECB now expects only a marginal and short trip into labour market deterioration territory (see Exhibit 8). The central bank continues to see a quite "employment-rich" growth ahead, with the rebound in productivity postponed further relative to September (see Exhibit 9). For our part, we do not even see any recovery on productivity over our forecasting horizon, but some of this is due to our dim view of the denominator (GDP). **The ECB's sombre scenario for productivity, despite decent growth, allows it to come up with some concerning developments on unit labour costs beyond the impact of still robust nominal pay rises expected for next year.**

Exhibit 8 – The ECB's rosy view of the labour dynamics



Source: Eurostat, ECB and AXA IM Research, December 2023

Exhibit 9 – Delaying the productivity rebound



Source: Eurostat, ECB and AXA IM Research, December 2023

Christine Lagarde explicitly stated last week that risks of another labour cost drift play a major role in the ECB's cautious attitude. We made the point earlier that, given the scarcity of real-time, tried and tested data on wages in the Euro area, this played against expecting cuts as early as March or April (only data for Q4 will be available by then). Yet, nothing prevents the central bank from being forward-looking. Last Friday, the Purchasing Managers Index (PMI) for December fell again in the Euro area, denting the hope that a floor for the cycle had been found in the autumn. Interestingly**, the employment component deteriorated further, hitting a three-year low (in contraction territory) of 49.6 for the composite index**. Yet, for now, the "Saint Thomas" approach to monetary policy when it comes to labour costs (believing only what one sees) continues to prevail in Frankfurt. This makes us more comfortable with our call that the ECB will wait until June to cut for the first time and will deliver "only" 75bps worth of accommodation next year, although from a normative point of view we are concerned with the risk the central bank waits too long amid a quickly deteriorating economy.

Where however we think the ECB erred on the side of supporting the Euro area' s economy it's on their patience with ending the reinvestment of Pandemic Emergency Purchase Programme (PEPP). The Governing Council "ripped the band aid" and chose to announce the schedule last week already, but the news that for the first half of 2024 reinvestments would not be touched, with a gradual roll-off in the second half of the year only, has brought comfort to the bond market in peripheral countries.

COP and beyond

That a COP chaired by a minister from an oil-producing country managed to produce a final version of the Global Stocktake explicitly mentioning *"calls on Parties to contribute to the following global efforts [including] Transitioning away from fossil fuels in energy systems, in a just, orderly and equitable manner, accelerating action in this critical decade, so as to achieve net zero by 2050*" probably exceeds expectations. **"*Transitioning away*", at least in our book, means ultimately replacing fossil fuels as a source of energy, which is a stronger signal than the "*phasing down*" painstakingly achieved at COP27**, and is in our understanding similar to "*phasing out*", even if the latter implies a timeline which is here missing. Indeed, the final text is – unsurprisingly – vague on implementation and intermediate objectives. The change in spirit is however significant enough.

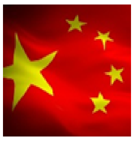
For more precise commitments, the relevant text may well be the "Oil and Gas Decarbonation Charter" (OGDC), signed by 50 national and international oil companies which together account for 40% of total world production. Under the OGDC, signatories would commit to reach net zero by 2050, but this would be limited to companies' operations (i.e., scope 1 and 2), while ending routine methane flaring by 2030 and reaching "near zero" upstream methane emissions. **In a nutshell, it leaves scope 3, which account for roughly 90% of the sector's emissions, out of the framework.**

If we want to see the glass half full in keeping with the Christmas spirit, this may well be the top of what could be expected from a worldwide effort at this juncture. Indeed, ultimately Scope 3 emissions are driven by demand. **Embarking the world on a coordinated programme to gradually wean global consumers off fossil fuels would require a level of political convergence and technical consensus which we think was never within reach in the current configuration.** We will need to see in the next batch of the member countries' National Contributions (NDCs) in 2025 by how much and through which means government expect to trigger a faster decline in the final demand for fossil fuel. Ideally, this would require precise commitments in terms of carbon pricing and deployment of alternative solutions. Among the key regions, the European Union (EU) is probably the closest to this – even if many Ts still need to be crossed there. Some serious catch-up from the other key players is needed.

Where however more tangible progress was made is on the financial aspects of the transition, starting with the operationalisation of the Loss& Damage fund which was the necessary condition to make it work. This is the framework under which the most vulnerable nations would receive financial assistance. The World Bank will host it for a 4-year interim period. More is needed though, as the $792mn financial commitments made still fall short of the amounts required – between 160-340 bnUSD per year by 2030.

This should however pique the interest of Fixed Income investors, especially in the emerging world, who will keep on their radar as well what comes out of the Task Force on Credit Enhancement for Sustainability-Linked Sovereign Financing. New commitments include the use of climate-resilient debt clauses (CRDCs) allowing debt service to be paused to provide breathing space when countries are hit by climate catastrophes. The first meeting on this matter will be held in January 2024 and will define the role of key members such as the major multilateral banks including the Asian Development Bank, the Inter-American Development Bank and United States International Development Finance Corporation. Of note, **credit rating agencies such as Fitch Ratings indicated their intention to consider revisions to credit rating criteria for loans to ensure use of CRDCs does not impose an additional burden for borrower countries**.

We have been arguing for a long time that green finance can be a key contributor to the transition, but also that crucial decisions, in particular on the energy mix of each country, remain squarely within the purview of political actors. The financial industry has made itself increasingly "battle ready". COP28 came up with some breakthroughs in this field, but the crux of the matter remains defining binding, precise and technically realistic plans to overhaul energy generation. The principle is now agreed. Implementation and timeline is not.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• FOMC left FFR on hold. Powell said at or near peak. Rate forecast 75bps lower end-2024. Markets priced bigger 150bps drop after Powell press conference • CPI inflation (Nov) dipped to 3.1% (core unchanged at 4.0%) in line with expectation • Retail sales (Nov) stronger than expected 0.3%mom • Jobless claims around 2023 lows	• GDP (Q3, f) expected unch at 5.2% (saar) • PCE inflation (Nov) expected 2.8%, core 3.4% • Saving rate (Nov) Oct's 3.8% remains very low • Conf Bd Cons conf (Dec) expectations component best guide to spending. It rose in Nov to 77.8 • Philly Fed idx (Dec) remained subdued but improving • New homes sales (Nov), H1 pick-up has faded
	• The ECB kept its policy rates unchanged. Made an earlier-than-expected decision on PEPP roll-off, though content was very close to our expectation. Policy stance well summarised by "we should absolutely not lower our guard" • Euro area flash composite PMI output edged down to 0.6 points to 47.0. Both manufacturing and services reported further steep falls in new orders	• Euro area final HICP prints for November, and most crucially details within services • German Ifo and French INSEE business confidence for December
	• BoE meeting (Dec) policy unch at 5.25%. Minutes said decision to 'hold or hike' finely balanced • GDP (Oct) fell 0.3%mom, below expectations. May have been impacted by storm. Risks fall in Q4 • Labour market (Nov/Oct), average earnings fall sharply (7.2% 3m yoy) in otherwise patchwork data	• CPI inflation (Nov) further falls expected, services watched for any unwind of erratic disinflation • Retail sales (Nov) expect avoids fourth monthly fall in volumes in five months • GDP (Q3, f) expected unch at 0.0%qoq • Current account (Q3) narrow from wide Q2 -£13bn
	• Tankan surveys (Q4) improved, both in big companies and smallest but also in mfg and non-mfg sectors. This is a positive signal of recovery after weak Q3 GDP. Flash PMIs (Dec) were mixed with better Svcs (52, +1.2p) but weaker Mfg (47.7, -0.6p) • Machinery orders (Oct) is firm at +0.5%mom after +1.4% last month	• The BoJ is likely to keep the status quo on rates but should send some signal that they are closer to the end of negative interest rate policy. They will reiterate that wages and GDP outlook are key • CPI (Nov) is expected to decline with core reaching 2.5%yoy
	• CPI & PPI (Nov): -0.5% & 3.0%yoy (Oct: -0.2%; -2.6%) • New TSF (Nov): 2.45tn RMB (Oct: 1.85tn RMB) • FAI (Nov): 2.9%yoy ytd (Oct: 2.9%) • Retail sales (Nov): 10.1%yoy (Oct: 7.6%) • Industrial production (Nov): 6.6%yoy (Oct: 4.6%)	• Wed (20 Dec): Loan Prime Rate 1Y and 5Y (Dec) • Wed (27 Dec): Industrial profit (Nov) • Sun (31 Dec): NBS PMI manuf & non manuf (Dec) • Tue (2 Jan): Caixin PMI manuf (Dec) • Thu (4 Jan): Caixin PMI services (Dec)
	• CB: India (6.5%), Mexico (11.25%), Philippines (6.5%) & Taiwan (1.875%) stood on hold. Brazil cut -50bps to 11.75% & Peru -25bps to 6.75% • Nov inflation (%yoy) fell in Czechia (7.3%), Romania (6.7%) & S. Africa (5.5%). It rose in India (5.6%)	• CB: Chile is expected to cut -50bps to 8.50%, Colombia -25bps to 13.0%, Czechia -25bps to 6.75% & Hungary -75bps to 10.75%. Turkey to hike 250bps to 42.5% & Indonesia to stay on hold at 6.0% • Reaction to Chile's vote on a second draft of a new constitution (Sunday 17) • November trade data in Indonesia & Malaysia

Upcoming events	US:	Mon: NAHB Housing market index (Dec); Tue: Building permits (Nov), Housing starts (Nov); Wed: Current account (Q3), Conference Board consumer confidence (Dec); Thu: GDP (Q3), Core PCE (Q3), Philadelphia Fed index (Dec), Weekly jobless claims (16 Dec); Fri: PCE & Core PCE Price index (Nov), Durable goods order (Nov), Personal income & spending (Nov), Michigan consumer sentiment & inflation expectations (Dec), New home sales (Nov)
	Euro Area:	Mon: Ge Ifo business index (Dec); Tue: EA CPI (Nov); Wed: EA Consumer confidence (Dec), Ge PPI (Nov); Thu: Fr Insee manf confidence (Dec); Fri: Fr Insee consumer confidence (Dec), It ISTAT business & consumer confidence (Dec), Sp GDP (Q3)
	UK:	Tue: CBI Industrial Trends survey (Dec); Wed: CPI (Nov), CPIH (Nov), RPI (Nov), PPI Input & Output (Nov); Thu: PSNB (Nov), CBI Distributive Trades survey (Dec); Fri: GDP (Q3), Business investment (Q3), Priv consumption (Q3), Current account (Q3), Retail sales (Nov)
	Japan:	Tue: Trade balance (Nov), BoJ announcement; Thu: CPI (Nov)
	China:	Wed: PBoC announcement: 1y Loan Prime Rate (LPR) & 5y LPR

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