AXA Investment Managers

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BoE breaks ranks

- While the Fed is open to a higher terminal rate, the Bank of England (BoE) "dares to differ".
- Beyond a likely "fiscal paralysis" – which may not be entirely bad news given the state of the US economy – the mid-term US elections could herald some future headaches, even if another debt ceiling drama can be avoided.

Unless the data gets truly terrible on inflation next month, the Fed will probably go for 50bps "only" in December, but the key issue, as Powell said, no longer is how quickly but how far and for how long. While the Fed sought to control any overly dovish interpretation of their imminent shift to a more cautious pace of tightening by talking up the possibility of raising the terminal rate, the Bank of England chose to push the market to consider that it has been over-estimating the total amount of tightening needed to bring inflation back under control. This difference may stem from the BoE's awareness of looming fiscal austerity in the United Kingdom (UK), which would make the Marginal Propensity to Consume (MPC) ready to take a measured risk with the exchange rate by diverging from the Fed's rhetoric. Of course, if the United States (US) economy starts softening fast, any "policy gap" becomes easier to maintain. We look at the recent US labour market dataflow. It has become quite ambiguous, with signs of softness co-existing with persistent evidence of overheating. There is still no "smoking gun" there which could trigger a downward revision in the expected terminal rate.

The European Central Bank (ECB) President's speech last week was on the hawkish side in our opinion. The message on a shallow recession not being enough to tame inflation on its own is understandable "in substance", but the communication effect is quite striking: if a shallow contraction does not suffice, then a legitimate question to ask the ECB is whether it is actively seeking to engineer a deep recession by going far into restrictive territory.

If the Democrats this week lose the House, or both the House and the Senate, there are technical ways to avoid another "debt ceiling drama" if the Biden administration can make good use of the "lame duck session". Yet, the main consequence of the mid-term elections may lie in the intensification of the political confrontation in the US in the run-up to the presidential elections of 2024, in particular on voting procedures.

Fed: slower to higher

The 75-basis point (bp) hike by the Federal Reserve (Fed) last week was widely expected and the true focus was whether this would be the last "jumbo hike". On the basis of the prepared statement and Jay Powell's Questions & Answers (Q&A), this is now very likely, consistent with our call that the next hike in December would be at 50bps. However, as we discussed in the previous issue of Macrocast, **going slower does not per se indicate that the Fed is close to being done**. It just means it is more prudent, and Powell was very clear that there is still "*some ground to cover*", that "*any discussion of a pause was very premature*" and that, crucially, the terminal rate *"may be higher than previously thought".* It's reassuring from a financial stability perspective that the Fed is becoming more cautious, but risky assets are not out of the woods yet.

The statement was quite clear about the likelihood of an imminent slowdown in the tightening, with the notion that the calibration of the next hikes – still explicitly seen as appropriate – would consider the lagged effect of the previous tightening effort (echoing words we had heard from Christine Lagarde the week before), and Powell was quite emphatic in the Q&A that they would take into account the steep increase in market interest rates. Powell said explicitly that the time to "consider a slowdown" has come, even if he gave himself some wiggle room, mentioning decisions to this effect *could* come on this "as early as at the next meeting".

At the same time, the Fed is well aware of the fact that there remains a lot of excess demand to absorb, and the point about the resilience of the labour market is quite telling. Powell also mentioned the need to keep inflation expectations anchored. This probably explains his readiness to mention the possibility that the Fed may have to go further than expected, even if this point was immediately qualified by an Insistence that there remains wide uncertainty around this. We will need to see the dot plot in December to get details, but **Powell may have laid the ground for pushing the median terminal rate above the 5% line (4.6% in September).**

What is the net macro and market effect of the "slower but higher" trade-off? The immediate market reaction would suggest it is clearly negative. As forwards started pricing a terminal rate slightly above 5%, equities tanked. Yet, as we started discussing last week, there is a benefit in a more measured pace of tightening. Indeed, financial stability accidents tend to occur when market conditions move in a brutal way – for instance when large movement in interest rates suddenly trigger unexpected margin calls on derivative contracts. Moreover, the risk of over-restricting the economy decreases since the central bank has more time to assess the impact of its past policy stance. This is a reason not to necessarily believe what the Fed is saying now about the terminal rate. Beyond Powell's own careful qualifiers last week, it would be in the Fed's interest to communicate on an elevated terminal rate to help keep inflation expectations anchored and avoid a counter-productive market-led loosening in financial conditions which would otherwise be triggered by the end of the "jumbo hikes".

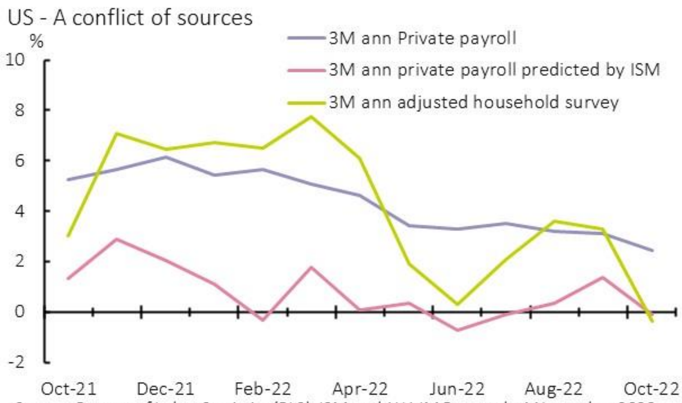
So, all in all, unless the data gets truly terrible on inflation next month, the Fed will probably go for 50bps in December, but the key issue, as Powell said, no longer is how quickly but how far and for how long. The Fed – and the world economy – has to deal with "twin uncertainty": we don't know how large the looming recession is going to be, and we don't know how, irrespective of the size of the recession itself, the labour market and crucially wages will respond to a softer economy. It's rational to consider that a terminal rate at 5% is now the Fed's natural slope but extrapolating from the current resilience of the economy may be wrong. Economists are trained to think in linear terms when macro variables gradually respond to policy signals. The natural reaction to such resilience so far consists in taking a "bigger stick" and tighten more. Alternatively, the absence of response could simply suggest that a certain policy threshold needs to be hit beyond which the economy "snaps" and corrects rapidly. That the Fed decides to proceed more cautiously could mean that such non-linearity is now on their mind. This won't necessarily bring unmitigated good news for risky assets though: to get the Fed to pause, and not merely slow down the tightening pace, they will need to stomach a recession with a significant drop in profits and a rise in defaults. No pain, no gain.

US dataflow still not turning – at least not clearly enough

For sure, the recent US dataflow remains overall too suggestive of "overheating" for the Fed to seriously reconsider the need to "cover more ground". Non-farm payroll came out last Friday above market expectations again, and the deceleration in the three-month annualized growth rate in private sector jobs – which should be more sensitive to the cycle than the broad measure encompassing government employees – still leaves job creation on a very healthy path: 2.4% in October versus 3.1% in September, markedly higher than the 1.3% average growth rate seen in 2019 before the pandemic.

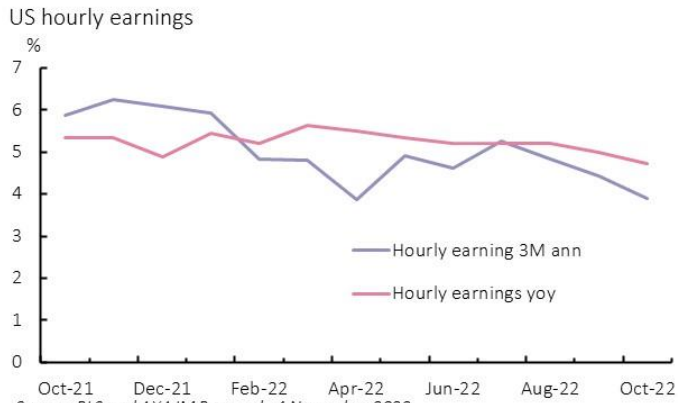
Yet, surveys point to a deterioration in hiring intentions. The employment component of the ISM survey for the services sector fell again in October below the expansion threshold, at 49.1. We must be careful not to read too much into this since the previous episode of decline last spring – which had fuelled the ill-fated "early summer rally" on the equity market - had been short-lived and was not accompanied by any actual cut in job creation. An issue all observers – including the Fed – are facing right now is that old established relationships between hard and soft data have deteriorated since the pandemic. The correlation coefficient between ISM-employment and the change in private payroll used to be strong (0.77 over 1997 to 2019). That during the pandemic the predictive power of the ISM survey fell given the enormity of the labour market gyrations at the time is not a surprise. But even since the reopening there remains a "bias", with the ISM-predicted payroll change systematically and significantly lower than the actual figure (see Exhibit 1). However, interestingly the ISM survey for October – using the pre-pandemic elasticity – predicted the same quantum of (marginal) job destruction as the Household survey, the source the Bureau of Labor Statistics use to compute the unemployment rate, which explains why it rose by 2 decimals to 3.7%. Gaps between the Establishment and the Household surveys are not uncommon. The former is normally deemed more robust because of i) a larger sample (130k businesses against 60k polled households) and ii) a "hard" criterion (how many employees the business paid wages to) rather than a "soft" declarative criterion (whether the polled household declares to be in employment). Yet, **the combination of the ISM and the Household surveys allow to at least raise the odds that the US labour market may be about to turn.**

Exhibit 1 – Contradictory messages on job creation



Source: Bureau of Labor Statistics (BLS), ISM and AXA IM Research, 4 November 2022

Exhibit 2 – Still robust wage growth



Source: BLS and AXA IM Research, 4 November 2022

But even if the labour market turns, it will be from a very high degree of tension, reflected in the hourly earnings data. As Exhibit 2 illustrates, the deceleration in wages remains tenuous and this is likely to keep the Fed on its toes. The 3-month annualized growth rate is still well into the 4 to 5% range which is hardly consistent with core inflation landing back to 2%. The Fed is getting more prudent, but there is definitely scope for "covering more ground" before hitting the terminal rate.

It's getting hard to follow the ECB (again)

We thought the European Central Bank (ECB) had nicely tied up some loose ends at its October, shifting to a more consistent form of soft forward guidance – indicating that more tightening is needed but without pre-committing to any number of hikes – which was making its pledge to be data dependent more credible. Yet, the message sent last week by Christine Lagarde in a speech in Tallinn remained clearly "one sided" in its approach to the inflation risk and could push the central bank in a communication corner. The key headline taken away from her speech is that *"even a mild recession will not tame inflation"*. This message is at odds with the ECB's own last batch of forecasts, which have inflation returning close to target in 2024 without even the slightest contraction in GDP. The ECB President may be laying the ground for a big uptick in the next forecasts to be released in December, but **this will unavoidably trigger the following question: is it a way for the ECB to signal it wants to engineer a deep recession as the sole practicable bridge towards its inflation target?**

The statement itself makes sense from an "academic" point of view. When inflation is primarily driven by an excess of demand, then removing said excess – which may not necessarily entail a deep recession - brings consumer prices back to target. When inflation is the product of a mix of supply and demand factors – the ECB is now communicating on a 50/50 breakdown – then yes, by construction, a "normal" recession driven by a demand correction would not suffice. But then the central bank has a choice. It can consider that the contribution from the supply-side factors will spontaneously fade so that no additional tightening is needed. Or, if the central bank sees the supply-side forces as persistent, it moves to a "fundamentalist" approach where demand needs to be driven to even more deeply negative territory to offset the inflation contribution from supply. Christine Lagarde in her speech was keen to highlight the number of reasons which would make the supply-side shock persistent – e.g., via the cost of the green transition – which would only strengthen a hawkish interpretation of her message. True, Lagarde's points need to be balanced by a speech by Fabio Panetta who made a rigorous defence of a "two-sided" approach to calibrate the next steps in the ECB's tightening, but it's difficult to get a sense of where the Council's centre of gravity is standing.

Maybe we are wrong to read too much into this speech. **Lagarde's hawkish overtones could simply reflect a willingness to avoid creating a sense of imminent transatlantic divergence after the Fed's message on its own terminal rate to minimize a further bout of depreciation for the euro**, which had taken another hit just after Powell's press conference, but this is a thin line.

Bank of England draws takes issues with market pricing

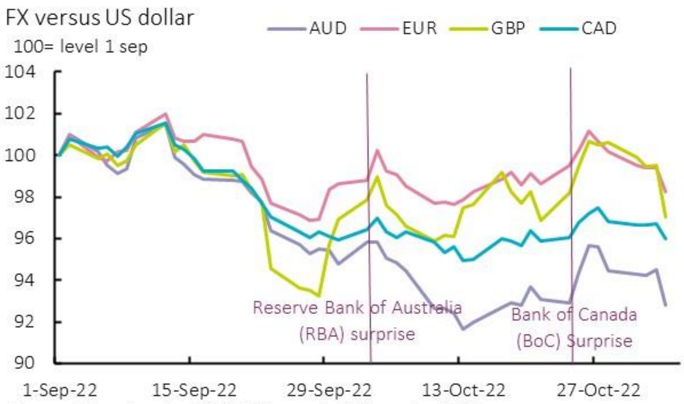
As expected, the Bank of England hiked its policy rate by 75bps to 3% - there was probably little choice there given the fragility of Sterling exchange rate – but the salient point of the November Monetary Policy Report, highlighted by Governor Bailey during the press conference – was the vigorous pushback against market pricing a terminal rate for the BoE in excess of 5%. Indeed, the BoE projections based on a policy rate at 5.2% see inflation well below target and falling – Consumer Price Index (CPI) inflation is forecast at 1.5% at the end of 2024, falling further to 0% at the end of 2025, in the midst of a significant recession, GDP falling by 1.5% in 2023 and by another percentage point in 2024. In other words, **delivering what the market was still pricing two weeks ago – it had already come down between the time the Monetary Policy Rate (MPR) was built and published – would result in "overkill", pushing the British economy back into deflation**.

We found the "constant interest rate" projection equally telling. Under this assumption, a recession into the next two years would remain unavoidable (-1% and -0.25% in 2024), and inflation would not be so far from target at 2.6% at the end of 2024, ending the forecast horizon at 1.2%. While the Bank of England made it plain that "further increases [in the policy rate] may be required", these projections signal that **we are now closer to the terminal rate than what the market was initially expecting. We expect it to be reached in March 2023 at 4.25%.**

While the Fed – and to a large extent the ECB – sought to control any overly dovish interpretation of their imminent shift to a more cautious pace off tightening by talking up the possibility to raise the terminal rate, the Bank of England chose to push the market to consider the possibility that the total amount of tightening may end up on the low end. A key difference between the UK on the one hand and the US and the Euro area on the other is the "direction of travel" on fiscal policy. The Bank of England – even if as usual it was "agnostic" in its MPR on the content of the fiscal plan to be released on 17 November beyond the direct measures already announced to mitigate the rise in energy prices – can be certain that an austerity drive is on its way in the UK. For now, Euro area governments are still raising their level of support to the economy, while in the US the Fed will have to wait for the dust to settle on the mid-term elections to know for sure where the fiscal stance is likely to be (more on this in the last section).

Fiscal austerity is normally consistent with a currency appreciation (primarily because it improves the current account position). The Bank of England may be counting on this effect to offset its dovish message on the terminal rate and avoid an intensification of imported inflation pressure. **The immediate reaction of the foreign exchange market to the MPR last week was not entirely comforting though. There is a price to pay for "breaking ranks" with the Fed.** The Australian dollar has taken a hit after the Reserve Bank of Australia (RBA) was the first central bank to surprise with a lower-than-expected hike on 4 October (see Exhibit 3). The Canadian dollar did not suffer too much from a similar move by the Bank of Canada (BoC) a month later – but the currency had already weakened more that the euro and sterling in the weeks before.

Exhibit 3 – The FX price to pay to diverge from Fed



Source: Macrobond and AXA IM Research, 4 November 2022

The economics of the US mid-term elections

Judging by the scenarios run by Nate Silver's 538, aggregating and adjusting polls, the Democrats are expected to lose the House with a probability of 82%, while the Senate remains very open, with only a marginal advantage for the Republicans (53% probability to win). Even assuming the two houses change hands, this would not hand the Republicans a free hand on legislation, since they would still be very far from the super-majority threshold needed to overturn presidential vetoes. But even losing the majority in one of the two assemblies would seriously impair Biden's capacity to act, while there would be a significant risk of returning to well-worn "theatrics" around the debt ceiling and government shutdowns. This would hardly be a new situation in the US. The question is however how such a well-known configuration could make our current macroeconomic woes even more difficult to address.

Let's start with fiscal policy. **If anything, a neutral fiscal stance, resulting from the impossibility for the Republicans and the White House to significantly "move the dial" on tax and expenditure, would probably be a good thing in the present cyclical conditions.** Indeed, Biden's activist fiscal policy in the first months of his mandate, coming on top of Trump's massive stimulus, certainly played a role in the advent of the current inflationary shock. From this point of view, "doing nothing new" on the fiscal front may be exactly what the US economy needs right now. **However, over the**

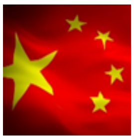
entire 2022-2024 period, a state of "fiscal paralysis" could become a problem if the Fed gets its calibration wrong and sends the economy into a deeper than necessary recession or triggers a financial stability accident which would require government intervention. Your humble servant may for once err on the side of optimism though on this issue, considering that moderates from both sides of the political divide would in these circumstances manage to patch up differences and provide the necessary response, even if the absence of alignment between the White House and Congress would still probably slow down the process.

Let's then consider the "debt ceiling circus". Republicans have recently returned to their fiscally hawkish roots, probably because they sense that focusing solely on "culture wars" would not necessarily put them in a favourable electoral position. They are on safer ground when attacking the Biden administration for allowing inflation to drift – an issue which now regularly topping polls surveying the preoccupations of American families. Many voices in the Republican caucus want to make their support to another rise in the debt ceiling – thus avoiding a situation of default – conditional on a reduction in "entitlements", in particular pushing back the age at which free healthcare provision via Medicare is provided. The hawkish shift is not mere posturing. Six Republican-led states are currently trying to stop Biden's student loan forgiveness programme, which is hardly a popular move, especially in the segments of the US population (young college-educated) in which the Republicans have fared badly recently.

However, **it seems that the Biden administration is already laying out plans to defuse the debt ceiling bomb by using the "lame duck session**" – i.e., before the new Senators and Representatives are sworn in – to pass "prophylactic measures". One option would be to pass in the next few weeks a large enough debt ceiling extension to cover the entirety of the next two years, either by striking a deal with the Republicans in the Senate or by using again the "reconciliation" process to avoid filibustering.

Financial and military support for Ukraine is also a question mark. The Republican leader in the House Kevin McCarthy has stated that he did not want a "blank cheque" for Ukraine – while some members of the left wing of the Democrats have called on the US to push for a "negotiated solution". There are however probably enough moderates in both parties to maintain support for Kyiv. Reducing help to Ukraine would probably be seen as sign of US weakness by China, while the "geopolitical rivalry" with Beijing is a policy goal shared by the two parties in Washington DC. If the military conditions continue to improve for Ukraine, there may come a time for some pressure from DC to nudge Kyiv towards concessions, but the US is likely to want to do this from a position of strength.

The main consequence of the mid-term elections may lie in the intensification of the political confrontation in the US in the run-up to the presidential elections of 2024. Together with the federal elections, the gubernatorial and state legislature races will have an impact on the possibility to see more changes to voting procedures in states which were crucial in November 2020. The arrival of some "election deniers" in positions of influence over voting in 2024 could make the outcome even more tense than it had been in the last presidential elections. This is not for immediate consumption of course, but this week could come with a sobering reminder of the degree of hysterization in US politics.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• FOMC meeting, hiked rates 75bps to 3.75-4.00%. Signalled likely slower pace going forwards, but peak likely higher. We shifted outlook to 5.00% peak in March. • Payrolls (Oct) rose by a stronger than expected 261k, but unemployment rose to 3.7%, wages fell to 4.7% • ISM rpts (Oct) down: mfg 50.2 (50.9), non-mfg 54.4 (56.7)	• Midterm elections. Republicans likely take control of House, Senate closer. Republican sweep raises future shutdown risks and could hamper fiscal reaction to recession. • CPI inflation (Oct) headline expected to slip from 8.2%, but more focus on 'core' expected stable at 6.6% • 5-10yr inflation expectations from U MIch Survey
	• Euro area flash October HICP surprised significantly to the upside climbing to 10.7%yoy. Pushed ECB Governors towards more hawkish narrative • Euro area Q3 flash GDP came in line with consensus at 0.2%qoq, decelerating from +0.8%qoq	• Eurogroup meeting on 7 November. • Further ECB speeches to guide towards December decision. • Policy orientation details of Italian 2023 budget. • Final German HICP details explaining the surge in October to 11.6%yoy. • September IP print across countries.
	• MPC hiked rates 75bps to 3.00% and firmly pushed back on aggressive market pricing of rates. We see peak of 4.25% in Q1 2023 and pencil in a cut to 4% in Q4 2023. • Nov MPR sees growth slowing sharply and inflation falling below target on both market and constant rates • Nationwide house prices down 0.9%mom	• BRC sales (Oct) • RICS Residential Survey (Oct) • GDP (Sep) expected to fall back sharply following additional bank holiday to mourn the Queen's death • Trade balance (Sep) expected to continue to narrow • MPC's Tenreyro, Pill, Haskel speak
	• Gov finalises package ¥29tn central gov spending. Key measures set to reduce impact of rising electricity prices • Recovery in consumption remains strong, retail sales (Sep) surprised to the upside at 4.5%yoy • IP (Sep) declined 1.6% mom due to distortions in autos but outlook weakening as external demand slows	• Tankan survey (Nov) • Current Account (Sep) likely to remain weak as currency extended losses • Producer Price Inflation (Oct) expected to rise further to 8.8%yoy
	• COVID cases continue to rise, prompting some regional governments to step up containment • Rumours of Beijing setting up a "reopening" committee and planning to ease quarantine arrangements for foreigners boost markets. No official response to the speculation yet. • PMIs drop below 50 for manufacturing and services	• Markets will stay attuned to news on COVID policy changes • Trade growth (Oct) should weaken further on softening external and domestic demand • Inflation pressure (Oct) should stay muted • Credit growth (Oct) to remain robust on policy support
	• CB: Colombia hiked +100bps to 11.0% & Malaysia +25bps to 2.75% • Q3 GDP (yoy) accelerated in Mexico (4.3%) & Taiwan (4.1%) • Annual inflation (Oct) picked up in Philippines (7.7%) & Turkey (85.5%). It fell in Indonesia (5.7%) • PMIs edged down in Asia due to weaker demand outlook	• CB: Mexico is expected to hike +75bps to 10% & Peru +25bps to 7.25% • Annual inflation (Oct) data in Mexico, Russia, Taiwan & Thailand • Q3 GDP figures in Indonesia, Malaysia & Philippines • Unemployment rate in Korea • Industrial production numbers in India & Mexico

Upcoming events	US:	Tue: NFIB small business optimism (Oct), Midterm elections; Wed: Wholesale inventories (Sep); Thu: CPI (Oct), Weekly jobless claims (5 Nov); Fri: Michigan consumer sentiment & inflation expectations (Nov)
	Euro Area:	Mon: ECB Lagarde speech, Ge Ind. prod. (Sep); Tue: EU19 Retail sales (Sep); Thu: It Ind. prod. (Sep)
	UK:	Mon: BoE Huw Pill Q&A; Tue: BRC Retail Sales Monitor (Oct), BoE Huw Pill speaks @ UBS conf.; Thu: RICS Housing Survey (Oct); Fri: GDP (Q3), Business investment (Q3), Private consumption (Q3), Monthly GDP (Sep), Indx of services (Sep), Ind. prod (Sep), Manf. Output (Sep), Construction output (Sep), Total trade bal. (Sep), Trade in goods (Sep)
	Japan	Tue: Leading indx. (Sep), Trade bal. (Sep), Current account bal. (Sep); Wed: Economy Watchers Survey (Oct)
	China:	Mon: Exports (Oct), Imports (Oct), Trade balance (Oct), Foreign exchange reserves (Oct); Wed: CPI (Oct)

About AXA Investment Managers

At end of December 2021, AXA IM employs over 2,460 employees around the world, operates out of 23 offices across 18 countries and is part of the AXA Group, a worldwide leader in insurance and asset management.