AXA Investment Managers

172 – 13 March 2023

Investment Institute Macroeconomics

Rising Interest Rates Hurt – Who Knew?

- Strong US policy response to the demise of SVB – but watch the macro-financial transmission channels
- Central banks are less united on their stance. We see the ECB to hike by 50 while the Fed should stay at 25 – while the Bank of Canada chose to pause.

The US authorities took out the "big guns" and acted decisively before the market open to contain the spill over effect from the demise of SVB (now accompanied by Signature Bank) using a two-pronged approach. First, they will "make good" on these banks' deposits beyond the normal FDIC insurance limit. Second, the Fed has launched a new program ensuring access to 1-year liquidity at favourable terms: the par value, instead of the market value, will be used to assess collateral – providing relief against the shrinkage of the banks' bond portfolio - and no "haircut" will be imposed. This should stem a potentially disruptive migration of deposits from small to mid-size banks to large, systemic ones. Beyond the immediate financial stability issue, the SVB episode sheds a light on the not-so-straightforward impact on higher interest rates on banks, especially when variable rate liabilities collide with fixed-rate assets accumulated at historically low yields. This is another reason to be quite attentive to macro-financial developments as a potential harbinger of difficulties in the real economy. The SVB episode is also likely to trigger more prudence at the Fed in the field of monetary policy. In any case, there was just enough softness in the payroll data last Friday to stop the Fed from resuming "jumbo hikes". Unless this week's CPI comes noticeably above expectations, 25bps should remain the pace until a terminal rate which we see at 5.50% is hit in June.

We've been arguing for several weeks that the ECB should pay more attention to the collapse in the credit impulse, but our impression is that the Governing Council will remain focused on the message from core inflation in the definition of its trajectory. Even if Christine Lagarde may try not to elaborate too much on the quantum of the next moves after delivering this week the well-telegraphed 50bps hike, given the overt disagreements within the Council, the direction of travel is clear – and it's up. Since we expect robust core inflation over the entirety of the first half of 2023, a terminal rate at 4% would not surprise us much. The ECB would be at the hawkish end of the distribution. Other central banks, such as the Bank of Canada, also focused on the recent core inflation trend, are now pausing.

Hey, stop, what's that sound…again?

The market took the demise of Silicon Valley Bank (SVB) hard at the end of the last week. SVB looks like an idiosyncratic case: its focus on a single industry (tech) made it particularly sensitive to collective deposit drawdowns – especially in a situation where new venture funding is drying up and tech companies need to access their cash. Supervisors and regulators are not taking risks though. The United States (US) government – in the broad sense of the meaning – rushed to come up with firm commitments before the market open. Lessons from the Great Financial Crisis have clearly been learned.

The Treasury and the Federal Reserve (Fed) worked swiftly on emergency measures to provide more protection to SVB depositors than what the Federal Deposit Insurance Corporation (FDIC) deposit insurance scheme implies. There is normally a cap at USD250k per depositor, which makes sense to protect household deposits but is very small when dealing with mostly corporate accounts (according to press reports 85% of SVB deposits are above the FDIC threshold). As per the terms of the joint statement of the Treasury, the Fed and the FDIC issued on Sunday night European time, *"SVB depositors will have access to all of their money starting Monday, 13 March"*, invoking the "Systemic Risk Exception" which had been widely used during the Great Financial Crisis of 2008. This is not a bailout – no government protection for SVB bondholders for instance has been mooted – but the idea there is probably to avoid a potentially painful migration of deposits from other small to mid-sized banks (SVB's balance sheet stood at little over USD200bn) towards larger institutions, as well as nipping in the bud the emergence of a chain of liquidity and solvency issues in the tech sector. The sector was already particularly sensitive to the current macro configuration: since it combines high capital expenditure at the onset and in most cases yield profits only in the long run, it does not deal well with a rise in the risk-free interest rate. The demise of one of its sources of funding (SVB) is not going to help.

Action to protect depositors is complemented by generous liquidity action directed at the small to mid-sized banks. The fact than another credit institution – Signature Bank, a bank roughly half the size of SVB which was heavily involved in crypto currencies– was also closed by its supervisor on Sunday could create the impression that another "domino series" could start. The new Bank Term Funding Program (BTFP) announced on Sunday will provide loans of up to one year in length to "*banks, savings associations, credit unions, and other eligible depository institutions pledging U.S. Treasuries, agency debt and mortgage-backed securities, and other qualifying assets as collateral. These assets will be valued at par"*. The notion that collateral will be accepted "at par" is very important: at a single stroke it means that banks' liquidity will be offered against financial assets which are going to be considered as not having been affected by the recent declines in prices, and without the "haircuts" that the Fed normally requests to reduce its own risk. In this case, it's a USD25bn "backstop" provided to the Fed by the Treasury which will do the risk mitigation.

With the US using the "big guns" quickly, market confidence might return equally swiftly, but maybe **more fundamentally, from a macro-financial point of view the SVB misadventure helps to shed a light on the not-so-straightforward relationship between the level of interest rate and banks' health.** Yes, in general – and in the medium run - rising interest rates benefit banks as it allows them to improve their margins, but profitability can be impaired if variable rate liabilities collide with long-term fixed-rate assets (e.g., government bonds and mortgages) accumulated at a low interest rate level. Beyond the profitability issue, banks can have a harder time complying with their regulatory capital thresholds in times of steep rise in interest rates (since 2013 in the Euro area, valuation losses on the banks' available for sale bonds count towards the calculation of the capital ratios).

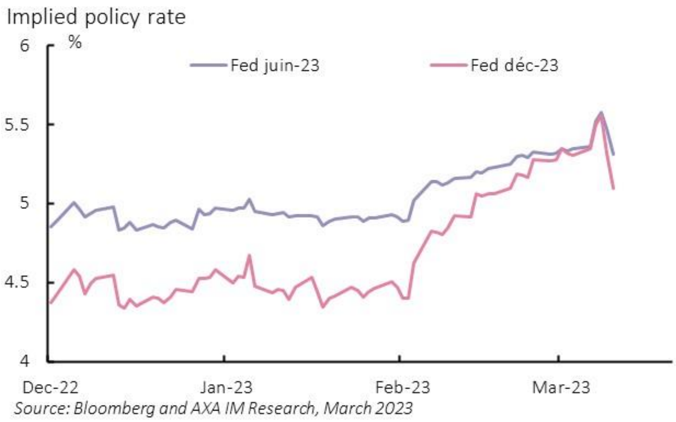
The European Central Bank (ECB) has been cognizant of that risk for a while now. In the May and November 2022 issues of its Financial Stability Reviews, they have taken a hard look at the banks' hedging of their interest rate risk. **The ECB's conclusion is reassuring, pointing at the intensification of bank hedging in the European swap market since 2021**. In the May 2022 Review, the ECB computed that "*by the end of 2021, the gross notional outstanding on interest rate swaps held by banks had increased to €128 trillion [from c.100tn a year before]*" and the November Review confirmed the continuation of the trend. Note that in Europe, deposits are considered to be very sticky and largely unaffected by interest rate movements. This is one of the reasons why Peter Hoffman, in an article in the ECB's research bulletin in 2019, downplayed banks' interest rate risk at the aggregate level in Europe, stating among other reasons that deposits *"ultimately behave like a long-term resource"*. In other words, European banks would not have to raise much the remuneration of deposits to keep them put. This has however never been tested against a quite steep rise in short-term rate from a negative starting point.

Even if we are not in systemic territory, we are gradually (re)learning that interest rates can hardly rise without triggering pain, and albeit idiosyncratic, the developments at SVB should remind us that the macro-financial channels should be the first to check – they are likely to be the harbinger of more difficulties reaching the real economy. In the very short run, it's going to be difficult for the Fed to ignore the SVB episode, even if in theory financial stability concerns should not affect monetary policy decisions. Fortunately, there was just enough softness in the payroll data last Friday to stop the Fed from resuming "jumbo hikes".

Focusing on observed core inflation is tempting…and possibly misleading

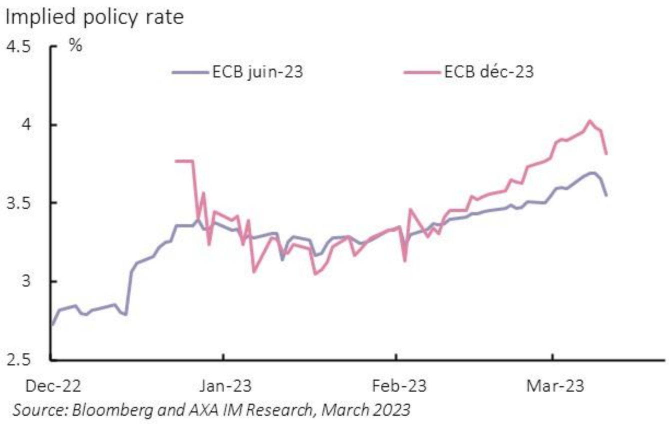
Volatility is a by-product of central banks moving away from forward guidance to focus on "data dependence". Indeed, every single bit of new information on the state of economy can trigger significant market shifts. Over the last few weeks, stronger than expected signals from the real economy and robust inflation prints had convinced markets to revise up their pricing for the ECB and the Fed on the level of the terminal rate, while for the Fed the market's long held hope for rate cuts by the end of this year had finally been shelved. Symmetrically, the nuanced picture of the US labour market painted by the payroll data released at the end of last week triggered another downward revision of the terminal rate and the re-emergence of Fed rate cut expectations (see Exhibits 1 and 2).

Exhibit 1 – Fed rate cuts pricing re-emerged post-payroll



Source: Bloomberg and AXA IM Research, March 2023

Exhibit 2 – Moderately lower terminal rate for the ECB



Source: Bloomberg and AXA IM Research, March 2023

We explore first the likely policy posture of the ECB ahead of this week's Governing Council meeting. At first glance it is in a more comfortable position than the Fed communication-wise, since another 50bps rate hike to 3% had in any case already been announced as an "intention" in February. **Yet, observers will focus on any hints on the shape of the further tightening beyond March which Lagarde may find it difficult to provide given overt disagreements within the Governing Council**. We noted last week how the positions of hawks such as Holzmann on the one hand – calling for three more 50bps hikes after this one – collides with those who, while supporting a tightening bias, warned against any automaticity or pre-commitment on how it should be delivered.

For our part, we are tempted to significantly revise up our expected trajectory for the ECB, from a terminal rate of 3.25% to 4.0%, with at least another 50bps hike (in May) as a pure reflection of a more persistent core inflation, which would not slow down decisively before the middle of this year. We will wait until the press conference to firm up this call change, but **our impression is that in the current "macro fog", *observed* core inflation is going to play a crucial –**

and probably disproportionate – role in shaping monetary policy decisions to the detriment of forward-looking, model-based approaches. This will increase the risk of going too far – failing to recognize that disinflation forces are already at work in the background – but we now consider this as unavoidable.

In a substantial and quite technical speech last week Philip Lane neatly distinguished three "inputs" in central bank decision-making. One is current core inflation. Another is the forecast for inflation over the next 1 to 3 years. The last one is the assessment of the transmission the previous policy decisions. An issue though is that items 2 and 3 are obviously uncertain, which in contrast makes the recent developments in core inflation more "tangible". Indeed, assessing how the accumulated monetary policy decisions so far are working its way through the economy entails first detecting signs that economic agents are responding to the central bank's signals. Habitual readers of Macrocast won't be surprised to read that we think this is already obvious in the macro-financial data, credit origination in particular. But gauging how much of the change in macro-financial conditions is producing the desired effect on aggregate demand in inflation is next to impossible in real time – which gets us back to the usual thorny issue of monetary policy setting: knowing precisely where the equilibrium interest rate stands. That's for the "rear-view" approach. The exploratory approach – the forecasts – is even more uncertain, and it's obvious the level of confidence of the Governing Council in the predicting capacity of its own services is particularly low.

Focusing on the recent message from core inflation is thus quite understandable, but it's also likely to produce only illusory comfort. True, there may be hard, observed data to pore over, but understanding the forces at work behind the latest core inflation prints is no easy feat – Lane's own complex and nuanced analysis of core inflation in the remainder of his speech amply demonstrates that. Indeed, he highlighted what is at the crux of the hesitations within the Governing Council. It still appears that much of the current resilience in core inflation is driven by the pass-through from energy prices, which would call for patience, but the contribution from labour-intensive components is rising, which suggests that there is still much more that monetary policy needs to do in a context of accelerating wages.

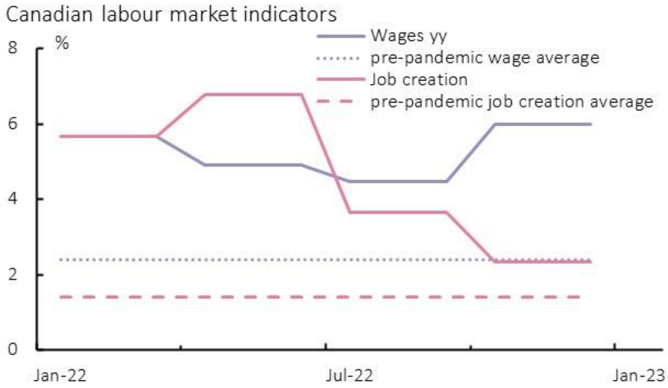
As things stand today, and taking on board our own short-term forecasts, core inflation is likely to remain very elevated for most of the first half of 2023 in the Euro area as the negative base effects from falling energy prices are likely to be balanced by positive base effects from rising services prices. **With core inflation still above twice the ECB's definition of price stability by the end of spring and only modestly receding from peak, the "natural slope" of the Governing Council is likely to continue to hike at a fast clip**, irrespective of how Christine Lagarde tries to keep her options open on Thursday.

Looking at the dissenters

Last week we focused on the "canaries in the coalmine", the countries where monetary policy transmission is swift and pain is starting to show, even if exchange rate issues still make it difficult to stop hiking if the Fed and the ECB continue to tighten. But there is at least one example of a central bank which has chosen to dissent. The Bank of Canada (BoC) in January had already warned that it was probably "done". In March, the BoC decided to deliver on that intention, despite still robust inflation (5.9%) and a tight labour market. The BoC's communication style is plain: they are quite simply expecting economic activity to continue to slow down, after a flat GDP in Q4 2022, and even if they took the precaution of maintaining a tightening bias – they explicitly signalled they would hike further if they realised that inflation is not slowing down enough – they are now counting on the lagged effects of their tightening so far, compounded by the continuation of Quantitative Tightening, to deliver the right disinflation path.

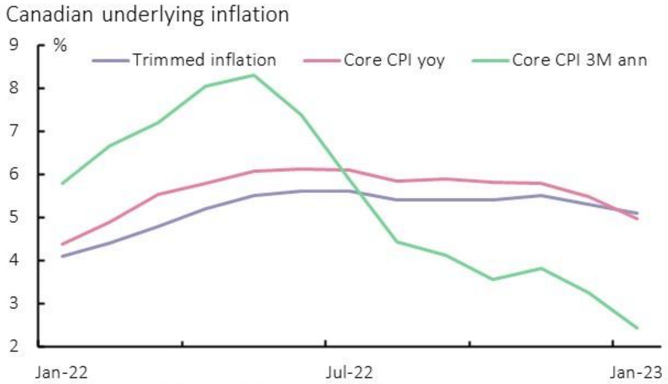
Philip Lane's "input tryptic" helps to shed a light on the BoC's decision. Given the dominance of variable mortgages in Canada, the central bank over there can be more confident about the transmission of monetary policy. They can't be that comfortable with their forecasts though given the tight labour market and wages still growing at nearly three time their pre-pandemic trend at the end of last year (see Exhibit 3), and the possibility of renewed imported inflation as the currency would suffer from the policy gap versus the US. Landing back to 2% is not that straightforward. But again, it's probably the message from *observed* core inflation which won the day (see Exhibit 4). When measured on a three-month annualized basis to vary the angle on base effects, core inflation in Canada is back in line with the BoC target.

Exhibit 3 – Canadian wages still very strong



Source: StatCan and AXA IM Research, March 2023

Exhibit 4 – But core inflation heading down



Source: StatCan, BoC and AXA IM Research, March 2023

All this points to a reversal of the expected sequence. In theory, one should first focus on the macroeconomic conditions for inflation, i.e., whether demand is rising in excess of supply, with labour market developments a key input there, *before* looking at actual price behaviour, with the former potentially over-riding the message from the latter, in a proper forward-looking manner. Instead, **both the ECB and the Bank of Canada are currently focusing on recent prints of core inflation, with – understandably - completely diverging consequences for their trajectory.**

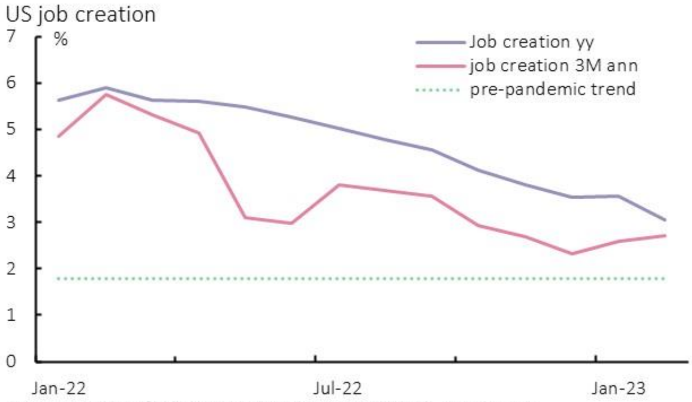
Some tentative signs of labour market softening in the US

Where does the Fed stand there? The configuration in the US is unique in the sense that i) unlike in the Euro area, US core inflation has started to decelerate, although more slowly than in Canada and ii) the labour market is still too hot but there are now tentative signs it is starting to cool down. In terms of policy transmission, it should also be in an intermediate position: fixed-rate mortgages dominate in the US, just like in the Euro area, but with disintermediated finance standing for a much bigger share of corporate funding one could expect some swifter monetary policy transmission US side. **The Fed could then follow a "median way" between the Bank of Canada's pause and the ECB maintaining a fast pace of hikes, to settle on a few additional 25 basis points hikes to reach the terminal rate within the next few months** (we now expect the Fed Funds peak at 5.50% in June).

Over the last few weeks, very strong data had revived the hawks' interest in resuming 50bps clips and Powell himself – with some "fine tuning" across his two latest Congress hearings – expressed his openness to the idea, mentioning in his final pre-purdah statement that the Fed could resort to 50bps hikes again if the "totality of the data" warranted this. This put even more focus on the two major data releases left before the Federal Open Market Committee (FOMC) meets on 22 March: payroll and Consumer Price Index (CPI) for February. Fortunately, the release of the employment data last Friday brought some relief.

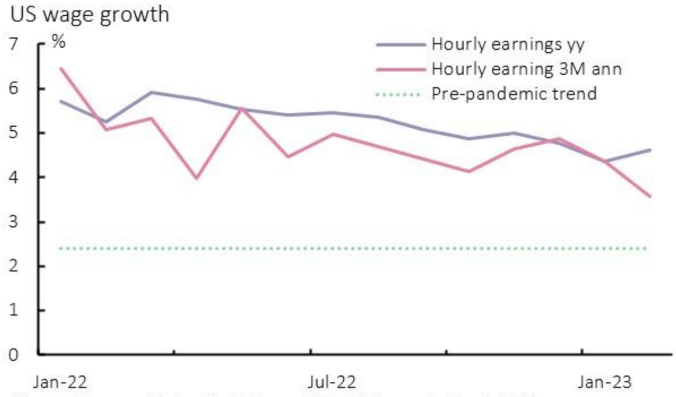
Job creation remains very strong, and another upside surprise came out on this front. When looking at the 3-month annualized metric, employment re-accelerated in February (see Exhibit 5). However, wage growth rose by less than expected and decelerated on a 3-month basis (see Exhibit 6), close to 3.5%, which may be a "magic number" when it comes to achieving 2% inflation, if one considers a trend growth in productivity of 1.5% (although such have not been seen in a long time on a sustained basis).

Exhibit 5 – Still strong employment…



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

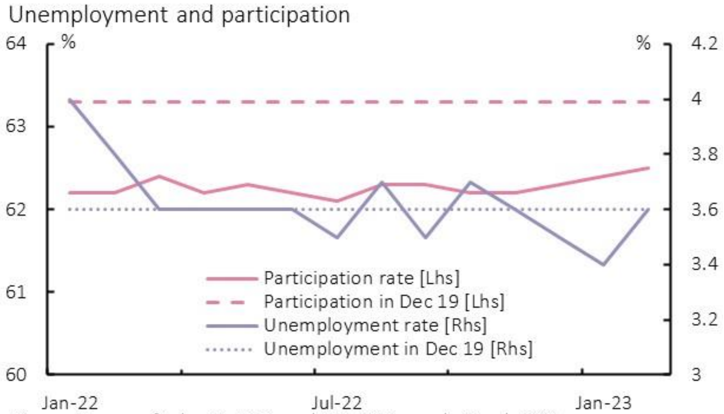
Exhibit 6 – … but some wage deceleration



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

We must be cautious because payroll data can be heavily revised and we have been there before, when "data accidents" suggested the labour market was already softening last year. Yet, the FOMC should be soothed by the small rebound in the unemployment rate and a marginal improvement in the participation rate (see Exhibit 7) which, albeit still one percentage point below the pre-pandemic level, point at some of the acute tension felt on the labour market being relieved (earlier last week, the fall in the "quit rate" reflected in the Job Openings and Labor Turnover Survey (JOLTS) data was another symptom).

Exhibit 7 – A step in the right direction in February



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

In any case, now that the Fed has already brought its policy stance in restrictive territory, there should be more tolerance on "taking one's chance" with the dataflow going – for once – in the right direction for inflation. Irrespective of the additional sense of prudence that the SVB episode should instil, this should strengthen the "Barkin/Bowman line" at the FOMC, according to which, rather than resuming jumbo hikes, the Fed should focus on providing more visibility to the market by advocating a higher terminal rate held for longer. Assuming this week's CPI is in line with market expectations (6.0% year-on-year from 6.4% in January) and consistent with another – small – deceleration in core inflation (market counts on 5.5% year-on-year from 5.6%), a 25bps hike at the 22 March meeting is the likeliest, in our view.

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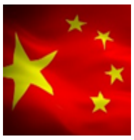
Country/Region	What we focused on last week	What we will focus on in next weeks
	• Fed Chair Powell's testimony to Congress warned of 50bps hike in March, but decision not made yet • Payrolls (Feb) rose by 311k – above consensus – but unemployment rose to 3.6% and earnings rose by just 0.2%mom – the softest increase in a year • Markets reacted to banking sector concerns as the impact of rate increases bit • JOLTS (Jan) vacancies fell to 10.8m - still high. Challenger job cuts up 400%+ - in recession territory	• CPI inflation (Feb) expected to be sticky and add to calls for Fed to tighten more in short-term • Retail sales (Feb) watched following Jan's surge • PPI inflation (Feb) should ease again in annual terms • Empire & Philadelphia Fed surveys (Mar) – have alternated which signals recession in latest months • U Mich consumer sentiment (Mar,p) – direction? • Housing starts (Feb) to see if more positive signs from sales have impacted starts
	• EMU Q4 GDP was revised down 0.1pp to 0.0%qoq, displaying weak domestic demand across the board • EMU retail sales edged up 0.3%mom in Jan, very far from cancelling 1.6% drop in December, pointing to ongoing weak consumption momentum in goods • GER industrial output surprised to the upside, rising 1.8%mom in January led by energy intensive sectors	• ECB to decide another 50bps rate hike in March. Hawkish tone to provide guidance for further significant rate increases to come • EMU IP should moderately increase in January • Final HICP should confirm headline and core inflation at 8.5% and 5.6%yoy respectively in February
	• GDP (Jan) rose 0.3% as services rebounded from Dec impacted by strikes and less Premier League fixtures • Halifax house prices (Feb) up 1.1%mom moving in opposite direction to recent data on house price falls • RICS Housing survey (Feb) house price balance fell to -48 from -46 with declines stabilising	• Spring Budget (Wed) – Chancellor expected to extend cost of living support and uplift to public sector pay with £30bn lower borrowing. Medium term prospects likely to remain constrained • Labour market data (Jan/Feb) u/rate expected to rise to 3.8%. Wage number will be closely watched
	• BoJ MPM last under Gov Kuroda, all policy tools left unchanged in handover to Ueda regime • Q4 GDP revised down to 0.1%qoq ann. from 0.6% prior as private consumption revised down • Current conditions DI up in February 2023 for first rise in four months	• Trade data and balance (Feb) expected to see deficit narrow • Chain store sales (Feb) • Industrial production data (Jan, f) • Tertiary sector index (Jan)
	• Feb. TSF supported by corpo/gov issuance • Feb. inflation slowed from +1%yoy, PPI to -1.4%yoy • 2023 economic target with GDP growth "at around 5%" versus "above 5%" expected appears conservative, pragmatic policy focus	• Jan-Feb. macro data with retail sales, industrial production and fixed asset investments to assess the strength of the early phase of the reopening, indicators expected to show strong recovery in line with latest PMI surveys
	• CB: Hungary (13%), Malaysia (2.75%), Poland (6.75%) & Peru (7.75%) stood on hold • Q4 GDP (%yoy) moderated in South Africa (0.9%) • Feb CPI (%yoy) eased in Chile (12%), Hungary (25.4%), Korea (4.8%), Mexico (7.6%), Philippines (8.6%) & Thailand (3.8%). It was stable in Colombia (13.3%)	• CB: Indonesia (5.75%) & Russia (7.5%) expected to stay on hold • Feb CPI: India, Nigeria, Romania & Poland • Jan Econ activity index: Colombia & Peru • Jan Ind. Production: Colombia, India, Malaysia, Mexico & South Africa

Upcoming events	US:	Tue: NFIB small business optimism (Feb), CPI (Feb); Wed: Retail sales (Feb), PPI (Feb), Empire State manf. survey (Mar), Business inventories (Jan), NAHB housing market indx (Mar), Long-term investment flows (Jan); Thu: Philly Fed indx (Mar), Housing starts (Feb), Building permits (Feb), Weekly jobless claims (11 Mar); Fri: Ind. prod. (Feb), Leading indx (Feb), Michigan consumer sentiment & inflation expectations (Mar)
	Euro Area:	Tue: It Ind. Prod. (Jan), Sp HICP (Feb); Wed: Ind. Prod. (Jan), Ge Current account (Jan), Fr HICP (Feb); Thu: EU20 ECB announcement, It HICP (Feb); Fri: EH20 CPI (Feb), Hourly labour costs (Q4)
	UK:	Tue: Unemployment (Jan), Average earnings (Jan); Wed: Chancellor to deliver budget; Thu: OBR briefing on Budget
	Japan:	Wed: Trade balance (Feb), Private 'core' machinery orders (Jan); Thu: Ind. prod. (Jan)
	China:	Wed: Ind. prod. (Feb), Retail sales (Feb), Fixed asset investment (Feb); Thu: New home prices (Feb)

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