AXA Investment Managers

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Investment Institute Macroeconomics

Price-Wage race

- More disinflation in the US – and that makes purchasing power resilient
- A 25-bps hike is probably "in the bag" for the February FOMC meeting, but the March one matters more
- As the labour market needs to land for disinflation to fully settle in, the anti-inflation consensus is likely to erode

The word "goldilocks" has appeared frequently in the market literature of the last weeks. Disinflation is emerging without a drastic deterioration in the real economy – for now – and indeed, the December batch confirmed the signals already visible in November: US inflation is declining. If one excludes rents, to avoid being "tricked" by their inherently sticky nature, core inflation is even falling very fast. Prudence is however of the essence. It's possible to see the current price configuration as a transitory "lull" where old, supply-driven inflationary forces are abating, and newer, demand-side forces, supported by a still robust labour market, have not peaked yet.

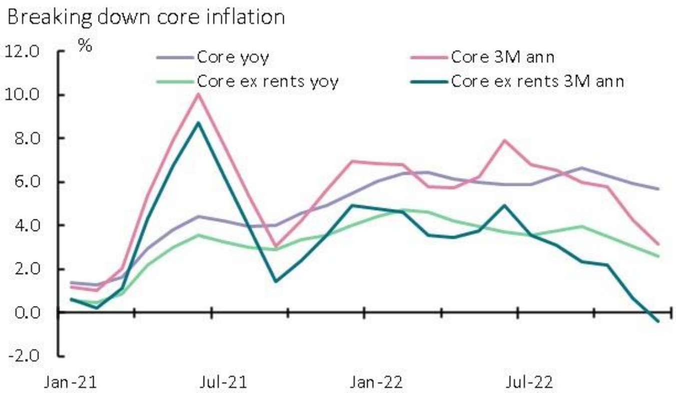
For now, the ongoing disinflation is meeting still strong wage growth. On a three-month annualized basis, weekly real wages have stopped declining in the US. We like to think about price/wage loop, with wages catching up with prices and fuelling further inflation. Here, a price/wage race might be a better description of the issue at stake. The resilience in purchasing power may delay the slowdown in consumption and economic activity needed to ensure that the labour market lands, and that a truly lasting disinflation sets up.

In any case, Fedspeak was clear enough last week to believe another slowdown in the pace of hiking is "in the bag" for the next FOMC meeting on 1 February to 25bps. Yet, it's probably the March meeting which is crucial, since it should coincide with a stark change of messaging from the Fed for the current market expectations – a terminal rate below 5% - to be vindicated. We still believe this will be too soon. We think central banks won't be able to stop before seriously impairing aggregate demand and cooling down the labour market, and we are unlikely to be there by the end of Q1. This will become a much more complicated moment for them. Some empirical findings suggest households' perceived well-being is more adversely affected by a rise in unemployment than by an acceleration in prices. The consensus around the "good fight" against inflation is likely to erode.

More disinflation in the US

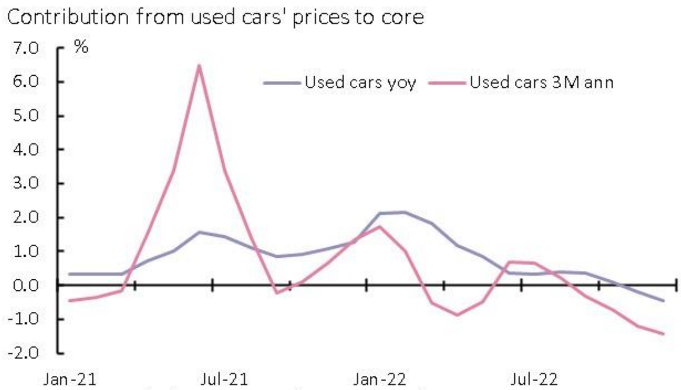
Before the Christmas break the November print provided the first tangible signal that disinflation is on its way in the United States (US) and the December batch confirmed the message, decelerating exactly in line with expectations for both headline and core. We have been scrutinizing a sub-component of underlying inflation, core excluding rents, noting that on a three-month basis, it had fallen close to zero growth in November. In December, it fell into negative territory (see exhibit 1). Analytically, this sub-component is relevant since rents are particularly "sticky", which given their weight in the index can create a false impression that inflation fails to respond to changes in cyclical conditions. We must be prudent though because the confirmed disinflation still owes a lot to one item: used cars. This was already the case in November, but it became even more pronounced last month. The contribution from the decline in used car prices on overall core inflation reached a half percentage point when looking at the year-on-change (in other words, core inflation would have stood at 6.2% instead of 5.7%) and a whopping 1.4% on a three-month annualized basis (see exhibit 2).

Exhibit 1 – Core excluding rents markedly down - again



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

Exhibit 2 – Still some key help from used cars



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

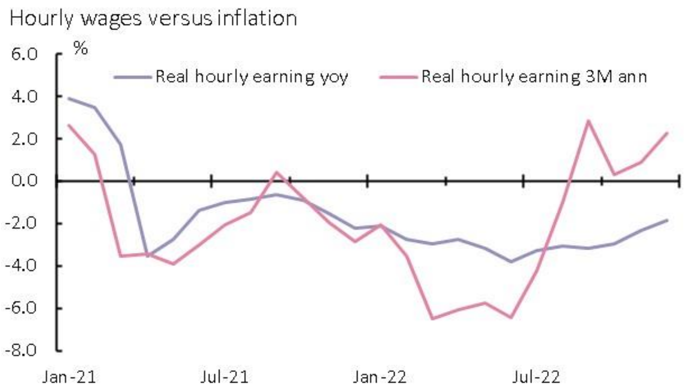
More fundamentally, even if "slicing" the consumer price basket helps analytically, it remains cumbersome as a predictive tool**. It's possible to see the current price configuration as a transitory "lull" where old, supply-driven inflationary forces, are abating, and newer, demand-side forces, have not peaked yet.** The decline in the price of used cars is one of the most obvious symptoms of supply-side normalization. A dearth of components had impaired the production of new cars, while rental companies had less vehicles to offload on the second-hand market after the pandemic, triggering the huge increase in used cars' prices. This effect is now absorbed. In a similar vein, albeit less spectacularly, the normalization of supply conditions in the world economy, combined with the appreciation of the dollar, has triggered a steep deceleration in the price of US imported manufactured products. But **the jury's still out on the fate of services prices since it can be argued that the still robust growth rate in wages – which we have discussed last week – has not yet fully passed through**. In our view, the net effect of these two opposing forces should be tilted to the "right direction" – we expect further disinflation overall – but not necessarily as quickly and as far as what the Federal Reserve (Fed) would like to see. This is why some proper deterioration in demand is needed. It's taking time, and in a way, some of the better news on the inflation front may actually delay the demand correction.

Disinflation, wage acceleration and consumption

So far, the equation for US consumption has been quite straightforward. Inflation was so high that even accelerating wages could not keep up and purchasing power was falling. Consumption could still resist relatively well because households could draw on excess savings, but it was only a matter of patience before households were forced to restrict their expenditure – and as we noted last week, there were signs of softness in the holiday season. However, if inflation slows down faster than wages, because of the supply-side components, then purchasing power will rebound, postponing the "day of reckoning" for consumption. Let's see where the data stands of this.

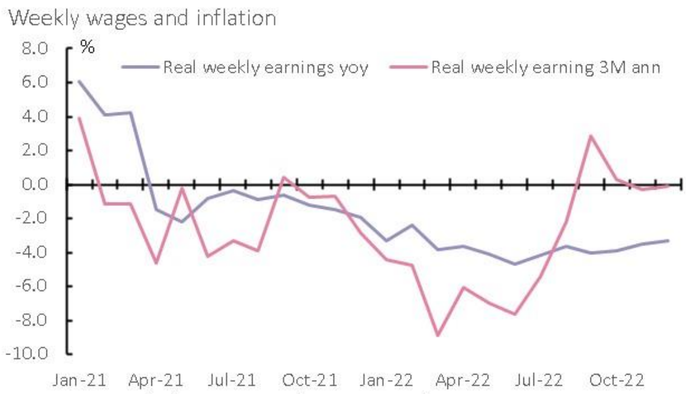
The worst of the contraction in real hourly wages was hit in June 2022 at -3.8% year-on-year. In December, it had eased back to -1.8%. On a three-month annualized basis – to try to capture the very latest inflexions – real hourly wages have rebounded back in positive territory since September 2022 and hit 2.3% in December (see Exhibit 3). However, to gauge the overall impact on households' spending capacity, we need to consider the impact of the decline in working time which we have identified last week as "phase 1" of the labour market correction. **On a tree-month annualized basis, real weekly wages have been flat since October (see Exhibit 4). This is however a significant change relative to the "bottomless pit" in which it had apparently fallen last spring.**

Exhibit 3 – Hourly real wages rebounding



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

Exhibit 4 – More muted for weekly wages, but still better



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

We like to think in terms of price/wage loop, with wages catching up with prices and fuelling further inflation. Here, a price/wage *race* might be a better description of the issue at stake. The resilience in purchasing power permitted by the deceleration in consumer prices may delay the slowdown in consumption and economic activity more generally which would in turn ensure that the labour market lands. This is a similar problem as to what we described last week with market conditions failing to completely transmit the tightening in monetary policy, which could ultimately force the Fed to talk and act more hawkish.

25bps probably in the bag for February - but it's the March meeting which is crucial

Yet, despite the resilience in the labour market and the loosening in financial conditions, we had enough statements from Federal Open Market Committee (FOMC) members at the end of last week to believe that, as we expected, the Fed should deliver a 25bps, rather than a 50bps one, at its next meeting on 1 February. Yet, this alone would not constitute a dovish pivot per se. Quite simply, the combination of a monetary stance now far enough in restrictive territory with the beginning of disinflation is giving the Fed enough assurance that it is no longer "behind the curve", allowing the FOMC to take a more leisurely pace towards the terminal rate it deems appropriate.

Given how entrenched expectations are**, we would define such "dovish pivot" as the Fed changing its communication to fit current market expectations of (i) not quite reaching 5% as a terminal rate and (ii) start cutting rates in the second half of the year, by around 50 basis point**s (see Exhibit 5). On the first component of the "pivot", there are not many FOMC meetings left to change the message. At a 25bps pace, the range for the Fed Funds rate should stand between 4.75% and 5.0% by the 22 March meeting, which would coincide with a new batch of forecasts. So basically, the current market pricing is consistent with the FOMC using its next "dot plot" to signal a "change of heart". This would make the meeting on 1 February relatively "uninteresting" – if indeed the 25bps hike is confirmed – with all the focus on the March one. Some market observers are already toying with the idea that the Fed could even signal as early as in February that it could "skip" the March hike.

As habitual readers of Macrocast know, we have our doubts that such a change in messaging could come so quickly – either in February or in March - given how resilient the economy – and especially the labour market – has been recently, which is why we are bracing ourselves for a moment of disappointment in markets. Yet, the ongoing market rally could have some legs while we wait for the Fed to re-affirm its views, unless no "accidents" materialize in the data flow. When it comes to this week, we would expect FOMC members to pore over new housing data for December. If the correction in the housing market stalls – hampering the expected deceleration in rents – the Fed may get further frustrated by the loosening in financial conditions.

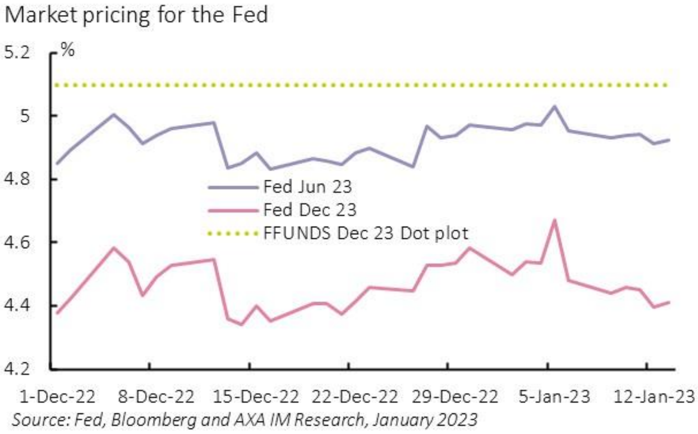
We will still need to keep an eye on US politics though. When we wrote about the debt ceiling drama last week, we had no expectation that it would make such an early comeback in official communication. Indeed, Treasury Secretary Yellen announced that her department would have to re-start "extraordinary measures" – such as postponing payments into the Federal employees' pension funds – from 19 January to give itself some capacity to deal with the absence of extension of the debt ceiling. This is pretty "standard warfare", and the Treasury has probably several months before exhausting these measures, but the political game has started.

According to the Washington Post on Friday, **the Republicans in the House have drafted an emergency plan to avoid a default.** A resolution would require the Treasury to prioritize certain expenditure – defence, social security, Medicare, and veteran support – and redistribute the rest of federal income towards making good on the debt service. At first glance, this looks contradictory with the Republicans' pledge to use the debt ceiling issue to revisit "social entitlements", but the choice of priorities is probably dictated by a willingness to avoid antagonizing key electoral constituencies (senior citizens in particular). This would still result in (i) intense disruption (e.g., air traffic control or border control are not among the sanctuarised items according to the Post) and (ii) in any case a significant fiscal contraction with visible effects on domestic demand. As we wrote last week, an issue is that the two parties have a vested interest in pushing the drama to the brink. For now, the White House, via the President's press officer, communicated a refusal to negotiate with the Republicans on their terms.

Beyond the impact of such repetitive political dispute on the credibility of US debt, this is having some effects on underlying market dynamics, although in a very technical manner. Already in late 2022, the Treasury was reducing the cash buffer it holds at the Fed, as it was already slowing down debt issuance to delay a showdown on the debt ceiling. This will go further into the coming weeks – and possibly months – as long as there is no resolution in Congress. This means that for now the impact of the Fed's Quantitative Tightening on market conditions is muffled by lower-than-expected issuance. This could explain why the federal debt market could look eerily calm despite the political drama. Of course, symmetrically, once the debt ceiling is extended – and assuming the price to pay for this is not a significant reduction in funding needs – then issuance will accelerate significantly as the Treasury will endeavour to replenish its cash buffer.

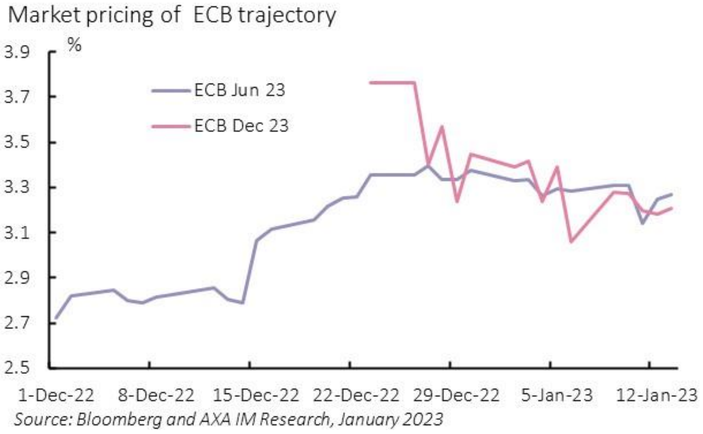
Meanwhile, on the other side of the Atlantic we note that the European Central Bank (ECB) will meet in March a good three weeks before what may be a crucial FOMC day, and this second meeting of the year should normally still be covered by the "automatic pilot" 50 bps hike apiece telegraphed in December. The hawks at the Governing Council can probably take comfort in the fact that the market is not expecting rate cuts at all at any point in 2023 (see Exhibit 6).

Exhibit 5 – Market still does not want to listen the Fed…



Source: Fed, Bloomberg and AXA IM Research, January 2023

Exhibit 6 – …but OK to believe the ECB



Source: Bloomberg and AXA IM Research, January 2023

As long as the market maintains its contrasted view of the probability of a "dovish pivot" at the ECB and the Fed, this should help sustain the current rebound in the euro exchange rate, which is probably a positive side-effect for now for most of the Governing Council given its impact on imported inflation.

Pick your poison

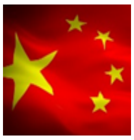
The word "goldilocks" has appeared frequently in the market literature of the last weeks. Disinflation is emerging without a drastic deterioration in the real economy. The world economy has not – yet – been hit with the usual, politically-tricky employment/inflation trade-off. **Back in the 1970s, the "misery index", originally crafted by Okun, became quite popular.** It works by simply adding the unemployment and the inflation rates. In a situation of stagflation, the misery index rises, as strong growth in consumer prices coexists with high unemployment. A persistently elevated misery index would suggest some adverse structural forces are at play in the economy, e.g., that the labour market is so rigid that even high unemployment does not trigger the expected slowdown in wages which would ultimately take consumer prices down. Conversely, today, the Fed is convinced – at least that's what it communicates publicly – that only a moderate rise in unemployment will suffice to bring about a return to price stability: the expected "sacrifice ratio" is modest. Beyond the question of whether this is the right assumption, an issue is in any case how even such small "excess unemployment" will be tolerated by public opinion.

When consumer prices grow by close to double-digit territory as a result of external forces, e.g., higher oil prices, everyone agrees to hate inflation. The shock is bad for businesses – it erodes margins and complicates planning – and for consumers – it reduces purchasing power. Even if in those circumstances there is very little the central bank can do about the root cause of inflation, it's unlikely it is going to come under massive criticism if it tightens monetary policy. Governments may object to the resulting increase in its funding costs, but optically, the temporary decline in the debt to GDP ratio the shock triggers can reduce scrutiny on public finances. **The going gets tougher when inflation morphs into a lower, but persistent above-target pace as second-round effects stemming from the labour market take precedence**. Among households, those who are employed and benefit from a strong bargaining power can hope to maintain their purchasing power and tolerate a highish inflation rate much better than those relying on transfers which may be indexed on inflation with a lag. If the labour market "insiders" happen to be heavily indebted in the form of variable rates, their animosity against the central bank can develop. Governments facing constant social demand for indexation – as well as incurring diffusion effects from higher wages in the private sector on its own payroll – may increasingly resent a monetary policy tightening, and so do businesses squeezed between rising labour and funding costs.

Employment is supposed to be the great leveller. Once it becomes obvious to the labour market "insiders" that they are paying for the protection of their real wages by a higher probability to lose their job – either "spontaneously" because their employers' profitability deteriorates, or because the monetary tightening triggers a significant reduction in aggregate demand – then the social compromise can shift back to a preference for low inflation. The process may take time though, and an issue is that few people in the active population today have any direct memory of the pervasive effects of inflation on employment prospects.

It may be useful to turn to the United Kingdom (UK) for both some current and historical insights on these issues. As strikes are increasingly affecting the country, the government is developing a line of argumentation unused for decades: giving in to claims from nurses or train drivers would be triggering a lasting inflation detrimental to the entirety of the country's workforce. Judging by the recent polls, this line does not seem to cut much ice, at least for the moment. Once again if this gets us back to the 1970s**. Popular awareness of the toxic nature of an entrenched price/wage spiral took time to emerge.** The conservative government of Ted Heath at the beginning of the 1970s initially vowed to roll back on union power and break the inflation wave which had engulfed the UK even before the first oil shock. This had failed and even before Ted Heath lost power to Labour in the middle of the decade, his government had already given up the fight. What really caused the change in public attitude in favour of rigorous policies was the gradual recognition that the wage/inflation loop was negatively affecting welfare through the deterioration of the labour market, ushering in the Thatcherite revolution of 1979. In other words, **it took actual pain, and not the warnings against future pain, to alter the status quo**. Of course, history does need to repeat itself. The level of economic literacy is probably higher today than 50 years ago, and labour market institutions have changed profoundly, but counting – as the market is right now – on painless disinflation where no actual deterioration in the labour market would need to occur is very optimistic in our view.

The canonical empirical analysis of the inflation/employment trade-off from the point of view of households came up in 2001**. A study by di Tella, McCulloch and Oswald in the American Economic review looked at how unemployment and inflation affect perceived "life satisfaction".** The authors started from the Eurobarometer survey over 1975 to 1991, based on answers from 264,000 respondents in 12 European countries. They first "filtered" the data using the microeconomic characteristic of the respondents (life satisfaction is positively correlated with income, being employed etc…). They then estimated the impact of inflation and unemployment rates on the component of life satisfaction which cannot be captured by these microeconomic variables. The results are statistically significant. Yes, both inflation and unemployment adversely affect life satisfaction, but crucially, an increase in the rate of unemployment by 1 percentage point diminishes life satisfaction more than twice as much as an increase in the inflation rate by 1 percentage point. In other words, the "misery index" – with its equal weighting – does not capture the true impact of these two key macro variables on households' happiness, and hence preferences. People care more about unemployment than inflation. Of course, this paper is now quite old, and it may be that the relative weights have changed, but these findings should focus attention on the looming "allocation conflict" around the current fight against inflation which Olivier Blanchard mentioned in the twitter debate he launched over the festive break. Central banks have had an easy ride, so far.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• US CPI (Dec) fell to 6.5%, it's lowest since Oct 2021, and first monthly fall since May 2020. Gas -12%, core rose 0.3%mom • Fed Harker suggested 25bps Fed rate hikes could be "appropriate" • House begins business under McCarthy • NFIB survey (Dec) fell to 89.8, around mid-year lows	• Retail sales (Dec) expected weaker in real terms. Consumption still contributes to solid Q4 GDP outlook • Fed's Beige Book • Empire and Philadelphia Surveys (Jan), watch for convergence • Housing data (Dec), inc starts and sales to gauge effect on this rate sensitive sector
	• Nov EMU industrial production (IP) increased by 1%mom after -2% in Oct. Ge IP up by 0.6%, strong rise in Fr at 2.1% but mostly a catch up due to strike in Nov, It down by -0.3% • Nov EMU unemployment rate very resilient and flat at 6.5% • Dec final HICP unchanged in Fr at 6.7%yoy, slightly lower in Sp: 5.5% (-0.1pp)	• Details from Dec final HICP across EMU countries. • Jan EMU and Ge ZEW surveys • Dec producer prices in Germany • Nov current account data should continue to point to improvement (stronger EURUSD, lower energy prices) • ECB speeches: Lagarde twice, Schnabel, Villeroy and Knot
	• GDP (Nov) rose 0.1% above cons -0.2%, could see UK avoid a recession in 2022 • Talks between gov and unions failed to settle disputes, with more strikes planned for coming months • BoE fully unwound £19.3bn long-dated gilts bought in wake of Sept 'mini-budget'	• Labour market data (Nov/Dec) will be watched closely for signs of slackening and wage pressure • CPI inflation (Dec) we expect to remain at 10.7% (cons 10.6%), risks to the downside • Retail sales (Dec) likely to rise pre-Xmas • GfK cons conf (Jan)
	• Tokyo CPI (Dec) rose to 4.0% above cons 3.8%. Indicates strong momentum for upcoming nationwide figures • Leak in Yomiuri suggests BoJ set to review side effects of YCC at upcoming MPM	• MPM (17-18 Jan) we see no change to YCC in base case, but risk of end of YCC high as market dysfunction increases • CPI (Dec) expected to rise with core ex energy and fresh food expected to rise to 4.0%
	• Credit growth disappoints due to lower government and corporate bond issuance. Bank lending to businesses surprises on the upside • Export and import growth declines less than expected. Trade surplus widens • Price pressure remains muted, with CPI inflation edging a touch higher	• Q4 GDP to show economy in distress due to "reopening-pain" • Growth contraction likely deepens in December as COVID wreaks havoc • Mass travelling ahead of the lunar new year underway. Investors will watch mobility indicators to assess the level of activity recovery and signs of COVID spreading to rural areas
	• CB: +25bps in Korea to 3.50%, Romania to 7.0%, Peru to 7.75% • Industrial production (November) weakened in Turkey and Hungary • Annual inflation (Dec) slowed in India • (5.7%), Mexico (7.8%), Brazil (5.8%). It rose in Hungary (24.5%) albeit below expectations	• CB: 25bps hikes expected in Indonesia and Malaysia, policy rate unchanged in Turkey (9%) but more regulatory measures • Annual inflation (Dec) data in Malaysia and South Africa • Q4 GDP in Taiwan to be released

Upcoming events		
	US:	Tue: Empire state manufacturing survey (Jan); Wed: Retail sales (Dec), PPI (Dec), Industrial production (Dec), Business inventories (Nov) NAHB housing market index (Jan), Beige Book, Long-term investment flows data (Nov); Thu: Weekly jobless claims (14 Jan), Philadelphia Fed index (Jan), Housing starts (Dec), Business permits (Dec); Fri: Existing home sales (Dec)
	Euro Area:	Tue: IT & GE HICP (Dec), GE CPI (Dec), GE ZEW survey (Jan) ; Wed: EU19 CPI (Dec) ; Thu : ECB Meeting account (15 Dec) ; Fri : GE PPI (Dec)
	UK:	Tue: Labour market data (Nov/Dec); Wed: CPI (Dec), RPI (Dec); Thu: RICS housing survey (Dec), BoE Bank liabilities and credit conditions survey (Q4); Fri: GfK consumer confidence (Jan), Retail sales (Dec)
	Japan:	Tue: Private 'core' machinery orders (Nov); Wed: Industrial production (Nov), Trade balance (Dec), BoJ policy announcement; Thu: CPI (Dec)
	China:	Tue: GDP (Q4), Industrial production (Dec), Retail sales (Dec), Fixed asset investment (Dec); Fri: Loan Prime Rates

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