214 – 19 February 2024

Investment Institute Macroeconomics

Pesky Data

- The Fed favours the PCE over the CPI, but the latter's January print strengthens the point that, at least in the US, the last mile of disinflation could be arduous.
- François Villeroy de Galhau implicitly offers a *quid pro quo*: an early start of rate cuts against a measured pace for the subsequent accommodation and a landing policy rate above the pre-Covid cruise level.

The market's pricing of the Fed has finally converged towards the FOMC's dot plot: there are now less than four full 25bps cuts priced in by the end of 2024. Even if that shift has been developing since the beginning of the year, last week's trigger was the release of a disappointing core CPI print for January. On a 3-month basis the re-acceleration since a trough in August was confirmed. True, the message from the core PCE – the Fed's favourite gauge – has diverged lately (no clear re-acceleration trend there) but some of the CPI resilience will likely find its way to the PCE this time. Indeed, fast-growing rents – which play a smaller role in the PCE – are not the only driver of robust price growth in the services sector. The dataflow needs to change quickly, otherwise there is a risk the market will take its shift further and "overtake the dot plot" to push the start of accommodation to very late, if at all, in 2024.

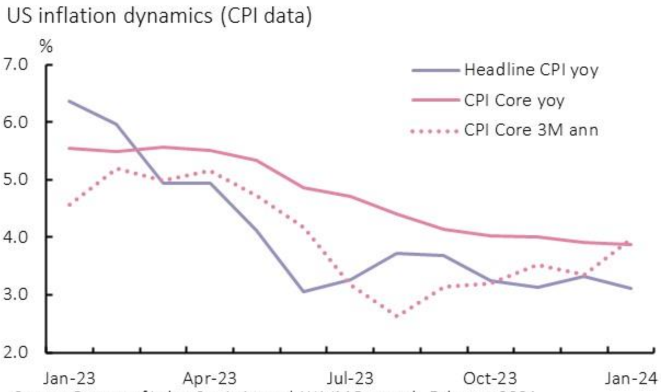
Meanwhile, the ECB Governing Council is busy discussing publicly which "policy mistake" is the most plausible. Isabel Schnabel and Joachim Nagel took a firm view: the risk of cutting too soon still dominates. We agree that the policy space at the ECB is now ample enough that failing to respond early to the deterioration of the real economy could be offset by deep and quick rate cuts down the line. Yet, we are concerned that the adverse consequences for the Euro area of a delayed monetary policy response could be compounded by the restrictive turn of the fiscal stance. Moreover, having the ECB slashing rates in an emergency mode after a late first cut would not do wonders to the central bank's credibility. BDF Governor Villeroy de Galhau is clearly preoccupied by the risk of cutting too late. We think his interview to L'Echo last week was implicitly an offer of a quid pro quo to the hawks: an early cut would be "offset" by a slow pace of subsequent loosening, and the final level of the policy rate would not be as low as what was seen between the Great Financial Crisis and Covid. This strengthens our view that there should be a floor to the overall quantum of rate cuts priced by the market this year, now significantly larger than for the Fed.

When data refuses to behave

A few days of peace and quiet on the data front had allowed us to focus on structural issues and explore productivity trends in our previous issue of Macrocast. The release of some market-moving indicators last week forces us to leave those lofty themes for a while and return to the nitty-gritty of cyclical analysis and monetary policy forecasting.

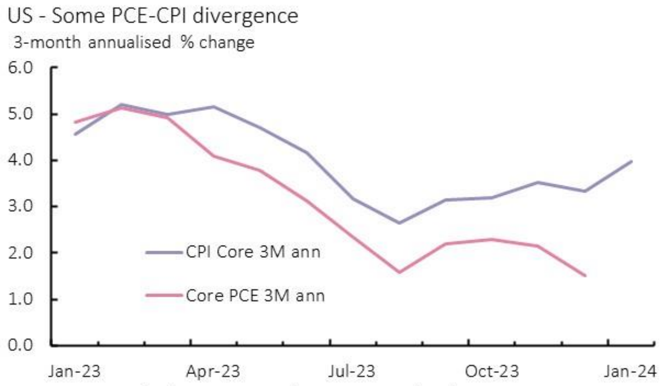
Jay Powell must congratulate himself for his cautious turn at the January press conference, since the first inflation print for 2024 confirmed that the Federal Reserve (Fed° has some good reasons to remain prudent on the timeline of rate cuts. The Consumer Price Index (CPI) fell less than the market was expecting, coming out at 3.1% yoy against a consensus at 2.9%. This is still down (3.4% in December) but such a pace had already been seen in June and November 2023 and observers focused on the bad news on core inflation, which stabilised at 3.9% yoy in January whereas the market was counting on another deceleration to 3.7%. As usual, we want to "vary the angles" to minimise the impact of old base effects. On a 3-month annualised basis, the picture that emerges is quite concerning. **Since hitting a trough last summer, core CPI has been on an upward trend, and stood in the three months to January of a pace twice as high as the Fed's target** (Exhibit 1). The much-derided notion that the last mile of disinflation may prove to be arduous is getting more and more support from the US data flow. **We are getting concerned that the Fed, instead on being pressed on quick cuts, could get under some pressure for not having yet "cracked it" and fully delivered the relatively painless disinflation which had become the dominant narrative**.

Exhibit 1 – Upward momentum for US core CPI



Source: Bureau of Labor Statistics and AXA IM Research, February 2024

Exhibit 2 – The gap with the Fed's preferred measure

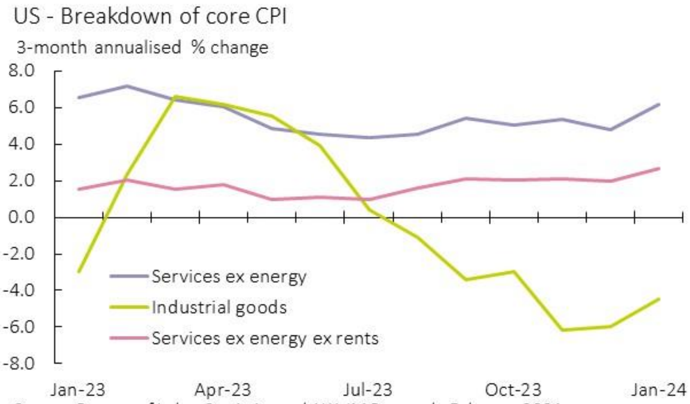


Source: Bureau of Labor Statistics and AXA IM Research, February 2024

The Chicago Fed President Austan Goolsbee was quick to hit the wires to downplay the significance of the January CPI. Beyond reminding everyone not to over-react to one print – although, given the trajectory since the autumn, we see it more as the confirmation of a series of adverse developments than as an isolated event – he brought attention to the fact that the Federal Open Market Committee (FOMC) cares more about the core Personal Consumption Expenditures (PCE) deflator than about the CPI. In the current circumstances, it is more than just a technical point. Indeed, as we show in Exhibit 2, **the two measures of core inflation – here on a 3-month annualised basis – have been sending quite a different message since the beginning of last year**. The PCE has inflected downward faster than the CPI, and while the PCE has hit a trough exactly at the same time as the CPI, it is difficult to argue that it has been on an upward trajectory since then. The picture which emerges with core PCE is more of a "plateau" at or just below 2% since September.

Now, there still should be some interesting lessons to draw from the January CPI print. As we usually do, we looked at behaviour of manufactured goods versus services (Exhibit 3). We remember that during the January press conference, Jay Powell mused about industrial prices rebounding "at some point" and that, by then, it would be up to the services sector to shoulder most of the continuation of disinflation. The first leg of that proposition may have materialised. While industrial prices continue to fall, they did so in the three months to January at a slower pace. Unfortunately, this was not offset by a deceleration in services prices, quite the opposite: they accelerated in the three months to January.

Exhibit 3 – It's not just about rents…



Source: Bureau of Labor Statistics and AXA IM Research, February 2024

How will this affect the core Personal Consumption Expenditures price index (PCE) measure for January, due out on 29 February only? There is a myriad of methodological differences between the PCE and the CPI, but a crucial one is the share of rents, which stands at about 40% of the weights in the core CPI against less than 20% in the PCE. Out of the overall 1.4 percentage points acceleration in the prices of core services between December and January (from 4.8% to 6.2% on a 3-month annualised basis), rents contributed exactly half. *Ceteris partibus* (rents are not the only source of divergence), the uptick in the PCE version will likely be smaller than in the CPI one of core inflation, but **even outside of rents, the trend is not exactly favourable**: there seems to be a "resistance line" at 2% on this sub-index since the autumn of last year. Some of this is likely to be reflected in the PCE measure.

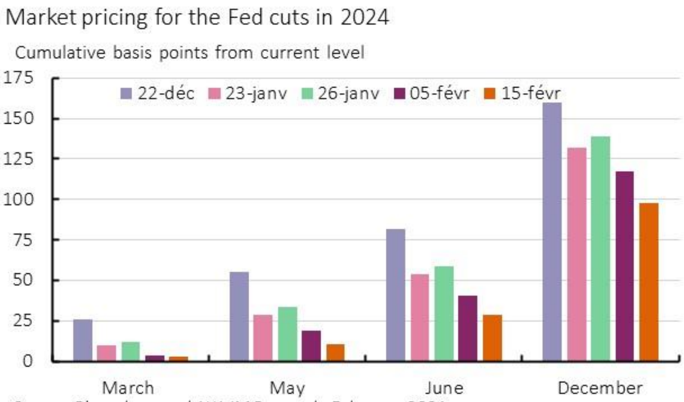
While we are aware those technical discussions can be a real bore, we think they matter a lot today. Indeed, a part of Goolsbee's dismissal of the CPI print was that there was a disconnect between a continuation of the acceleration in rents recorded in the index and data focusing on *new* rents – the consumer price index takes on board both existing leases and new ones – which point to the beginning of a correction which will gradually find its way to the inflation measure. **Yet, if half of the recent acceleration in services inflation cannot be explained by the "rent factor", then his argument becomes weaker.**

Beyond the message from the data releases themselves, what is striking is how the market is now reacting to them, reflecting a drastic change of mood. Before Christmas, Goolsbee's soothing words, combined with some less-than-spectacular real economy prints would probably have been enough to offset the impact of one disappointing CPI print on the expected Fed trajectory. Industrial production and retail sales came out below expectations last week. Yet, most comments were however quick to ascribe the poor showing of retail sales to a simple mean-reversion effect after strong consumption into the festive break, while a weakness in manufacturing has become less and less relevant for the entirety of the US economy. Before Christmas we suspect that such figures would have been quickly put in the "don't dismiss a hard landing" docket. Now, these releases are treated as "accidental". Unsurprisingly, since we were never in the "quick cuts camp", we are sympathetic to the view that indeed, we should not read too much into these real economy data points. Still, to get the Fed to cut in June, we think some measure of slowdown in the first half of this year will need to materialise. Indeed, as we have been arguing for a long time now, we don't think inflation can fully converge to the Fed's target without some descent into sub-trend growth.

The first "full" 25bps cut by the Fed is now priced for June – our baseline – but what we find even more interesting is the fact that overall quantum of accommodation priced by the market between now and the end of 2024 has fallen below 100bps (Exhibit 4). The market has almost entirely converged towards the FOMC's median forecast. Our baseline is that the US economy will show enough signs of relative weakness by June to allow the central bank to deliver on the FOMC's median trajectory for monetary policy, **but the dataflow needs to change fast now to avoid 360 degrees shift by the market which could start to "overtake the dot plot" and start pricing a much-delayed accommodation, and even a full absence this year.**

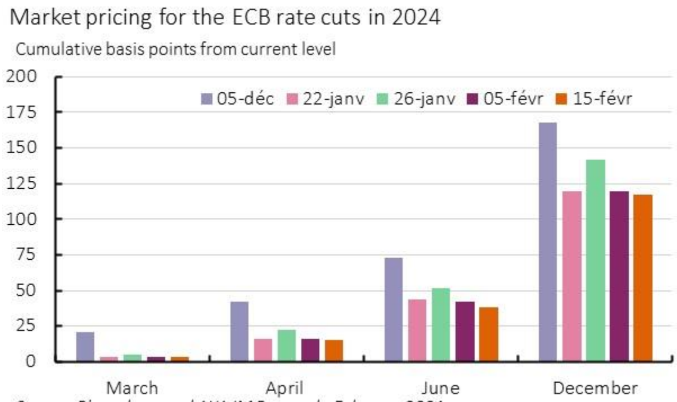
Another interesting development from last week is the fact that the market is now expecting the European Central Bank (ECB) to cut more than the Fed by the end of 2024. This probably reflects the widening gap between the US and the Euro area when it comes to the real economy, even if – as we explored two weeks ago – some of the concerning issues in the details of US inflation, in particular the resistance of services prices, can now also be found in Europe. As often here we are torn between our normative approach – what we think the central bank should do – and the predictive one – what we think the central will end up doing. From a normative point of view, there is little doubt in our mind that given the state of the economy, the ECB can afford to take a "leap of faith" and cut by more than 100bps this year already. From a predictive point of view though, the terms of the debate between hawks and doves – now laid out very publicly – make us think the ECB will refrain from offering more than three cuts this year.

Exhibit 4 – Back to the "dot plot"



Source: Bloomberg and AXA IM Research, February 2024

Exhibit 5 – ECB now seen to cut more



Source: Bloomberg and AXA IM Research, February 2024

Discussing policy mistakes

Christine Lagarde's refusal at the last press conference to explicitly rule out an "early cut", i.e. anything before June, which is now the market's baseline – as it has been ours for a long time – was probably motivated by a higher level of concern at the deteriorated state of the real economy in the Euro area, which for now is not producing any early shoots of the recovery the ECB has been counting on in its own – optimistic – forecasts. Such prudence also seems to reflect an **absence of consensus within the Governing Council**, as more and more members are taking to the wires to air their opinion.

The key debate ultimately hinges on the cost of a policy mistake. Joachim Nagel and Isabel Schnabel recently focused on the "mistaken early cut" scenario – where the central bank jumps the gun and eases too early before being forced to hike again later as inflation proves persistent. Both used historical precedents to support their view, but Schnabel was the most explicit: she recalled the mid-1970s error, when the Fed chose to cut when the price impact of the first oil shock appeared to have started to fade, while the economy had been in recession and was moving fast away from full employment. Inflation failed to fully normalise after that, even before the second oil shock of 1979 and this sowed the seeds of the extreme policy stance which Volker had to resort to in 1980 to finally kill inflation.

While habitual readers of Macrocast may be surprised to find your humble servant come up with more arguments in favour of the hawkish school of monetary policy – we are on the record having opined that the September 2023 was not "absolutely necessary" – we think there is another reason why **the ECB could think it is a relatively comfortable position right now and does not need to hasten the moment of the first cut: there is quite a lot of policy space today.**

Indeed, when the economy is on the brink of deflation and policy rates are already close to zero, failing to react quickly to signals that the economy is weakening can have dramatic consequences. It can be difficult to exit spontaneously from a "deflation trap" as this is often self-perpetuating. Indeed, if households expect price to fall in the future, they can choose to delay their consumption, which adds to the weakness of the economy and reduces price pressure further. In addition, if there is already little space left for conventional monetary policy because rates are close to their lower bound, then central banks, when they finally react, may have no other option but to use unconventional instruments such as quantitative easing, which can be difficult to calibrate or are politically sensitive, as it is the case in the Euro area.

This is very different from the current configuration. Indeed, while inflation has been fading it remains significantly above the central bank's target. When Joachim Nagel says that he sees little risk of "undershooting", we think it comes in reference to the large buffer that exists between current inflation and a state of deflation. If indeed the ECB concludes that the economy is set on a too weak trajectory which, ultimately, would put its inflation target at risk "from below", it would have ample time to correct course. Moreover, once it decides to correct course, since policy rates are now high by historical standards, it has ample space to provide accommodation before hitting the lower bound and be forced to contemplate re-starting unconventional tools.

It is not a bullet-proof approach though. Monetary policy does not operate in a vacuum. When the central bank started hiking rates fiscal policy was accommodative. The fiscal stance is now shifting to restriction. By the time the subsequent cuts start lifting the economy, **much damage could have already been inflicted by the combination of the lagged impact of the ECB tightening and the effect of the fiscal restriction**.

We note that the "policy space" argument has been seldom used by the ECB hawks. We suspect this boils down to a concern over credibility. Indeed, **if the ECB is seen as delaying the first cut, the fact that eventually it could offer accommodation at a fast clip would likely be seen as a demonstration its assessment of the economic situation was wrong in the first place rather than as a reassuring awareness of its rebuilt firepower**. This would get the central bank to the painful episode of 2011 when the ECB chose to hike rates before being forced into emergency cuts immediately afterwards.

We suspect it is with the ECB's credibility in mind that last week Banque de France Governor Villeroy de Galhau argued for a "pragmatic approach" to monetary policy while quite explicitly calling for not keeping monetary policy too restrictive for too long. Indeed, he stated that delaying the first cut for too long was "*at least as much*" a risk as cutting too early. We note also that he made the recovery dependent on some rate cuts. ECB speakers routinely rely on disinflation – and its positive impact on consumers' purchasing power – to explain why a recovery is their baseline. Villeroy de Galhau added to the reasoning the fact that rate cuts would naturally follow disinflation and help re-start domestic demand. We take this as a significant message to his more hawkish peers at the Council: they cannot at the same time argue for patience as a recovery is on its way and deny the need to start accommodating.

In his view, there are three levers the central bank can use at this stage: the timing of the first cut, the pace of the subsequent cuts, and the final level of the policy rate. In a nutshell, we think **the Banque de France Governor is offering the hawks at the Governing Council a compromise. In exchange for an early cut – i.e. before June**, we noted his points about looking into forward-looking indicators on the degree of tension of the labour market rather than waiting for late spring and the first hard data for 2024 on wage dynamics – **the ECB could set on a slow pace of cuts, and indicate that the final level of the policy rate would not come back to the lows of the post sovereign crisis phase**. Villeroy de Galhau's reference to an equilibrium interest rate at 2% was not there by chance in our opinion.

Of course, if the hawks accept such compromise, they could find themselves in the situation of the doves two years ago. Indeed, the doves accepted the end of QE and the first hikes probably on the belief the tightening would not go as far as it did, and they were then gradually drawn into more and more hikes. If the hawks accept an early cut, they would probably demand in exchange explicit forward guidance on a slow pace of further cuts and a "highish" landing level.

All in all, we remain comfortable with our call for a first cut in June, even if there is a significant risk the ECB moves in April already. Yet, if that happens – and assuming the economy remains mediocre, rather than turns truly catastrophic – we would still expect the central bank to stick to a slow pace of accommodation. This should put a floor on the market's expectations for the overall quantum of cuts.

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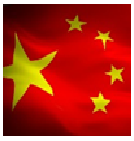
Country/Region	What we focused on last week	What we will focus on in next weeks
	• CPI inflation (Jan) firmer than expected at 3.1% (core 3.9%), services ex-shelter accelerated further • Retail sales (Jan) -0.8%mom (control -0.4%), below expect's. Weather a factor, but fits slower outlook • Empire & Philly surveys (Feb) both rise > expect's • Industrial output (Jan) -0.1%mom (mfg -0.5%) • CBRE Q4 results: optimistic worst over for CRE	• FOMC minutes (Jan) add to cautious easing narrative • Existing home sales (Jan) expected to show signs of pick up in broader housing • PMIs (Feb, p) confirm continued growth • Jobless claims, continued signs of stability in jobs market
	• GDP 2nd estimate was unchanged at 0%qoq, employment data up by +0.3% (EMU, Q4) • Industrial production (EMU, Dec) up by +2.6%mom, +0.3% if we exclude Ireland • ZEW surveys (Ge, Feb) much better on expectations • Fr and Sp final HICP (Jan) unchanged at 3.4% /3.5%	• Flash consumer confidence (EMU, Feb) should continue to improve as disinflation continue. Protests across Europe can dampen a bit the improvement • Bunch of surveys with flash PMIs in Fr, Ge and EMU, INSEE business climate in Fr, Ifo in Ge. No major improvements to be expected • Final HICP (EMU, Jan), ECB seasonally adjusted measure for services inflation • GDP detailed for Germany (Q4)
	• GDP (Q4) -0.3%, confirms technical recession • CPI inflation (Jan) unch 4.0% (core 5.1%) • Labour data (Dec), unemp falls to 3.8% despite recession, pay +5.8% (3myoy), higher on Nov rev's • Retails sales (Jan) +3.4%, rebounds from Dec drop	• PMIs (Feb, p) particularly services watched for ongoing signs of pick-up into Q1 • GfK consumer confidence (Feb) – at near 2-year high as inflation falls and hopes of rate cuts rise • Public finances (Jan) last update before 6 Mar Budget
	• GDP first estimate (Q4) has surprised (again) to the downside, declining by 0.1%qoq (cons: +0.3%). Private cons. declined for the 3rd quarters in a row. Exports are the only bright spot but have been boosted by intellectual property (one-off)	• Flash PMIs (Feb) even if they have been poor to predict GDP recently, in particular for Svcs • Machinery orders (Dec) • Reuters Tankan non-Mfg (Feb) • Exports and imports (Jan)
	• *(Data release pause due to Chinese New Year)*	• 20 Feb: Loan Prime Rate 1Y and 5Y. Currently at 3.45% and 4.2%, respectively
	• CB: Philippines (6.5%) & Romania (7.0%) on hold • Jan CPI (yoy): Czechia (2.3%), India (5.1%), Poland (3.9%) & Romania (7.4%) • Q4 GDP (yoy): Malaysia (3.4%), Romania (-0.4%), Hungary (0.0%), Poland (1.0%) & Colombia (0.3%) • Defense Minister Subianto leads in early unofficial results for Indonesia's presidency as voting ends	• CB: Korea (3.5%), Indonesia (6.0%) & Turkey (45%) are expected to keep rates unchanged • CPI (Jan): Malaysia, Singapore & South Africa • Q4 GDP: Mexico (final), Peru & Thailand

Upcoming events		
	US:	Tue: Leading index (Jan); Wed: FOMC minutes; Thu: Weekly jobless claims (17 Feb), Composite, mfg and services PMI (Feb), Existing home sales (Jan)
	Euro Area:	Tue: Ez Negotiated wages (Q4); Wed: Ez Consumer confidence (Feb); Thu: Ez Composite PMI (Feb), Ez, Ge, Fr Mfg and services PMI (Feb), Ez CPI inflation (Jan), ECB publishes Monetary policy account from Jan meeting, Fr Insee mfg confidence (Feb), It HICP (Jan); Fri: Ge GDP (Q4), Ge IFO business climate index (Feb)
	UK:	Wed: PSNB (Jan), CBI Industrial Trends survey (Feb); Thu: Composite, mfg and services PMI (Feb); Fri: Gfk consumer confidence (Feb)
	Japan:	Tue: Trade balance (Jan); Thu: Mfg PMI (Feb)
	China:	Tue: Loan Prime Rate decision

Our Research is available online: www.axa-im.com/investment-institute

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