AXA Investment Managers

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Investment Institute Macroeconomics

Note to readers: There won't be a Macrocast on 22 April. The next issue will be published on 29 April.

Letter from China

- The ECB cemented a rate cut in June. Their stated tolerance to higher energy prices is welcome given the further escalation in the Middle East. Meanwhile, we have pushed our expectation of the first cut by the Fed to July.
- Looking back to other countries' policy choices when faced with a protracted real estate slump, we look at how China could offset the lack of support from residential investment without triggering more trade tension.

By explicitly introducing a reference to easing in their prepared statement, the ECB has cemented the market's – and ours – expectation of a rate cut in June. What we found particularly interesting in the press conference was a sense that the central bank would be ready to tolerate some pressure on energy prices – accepting "fluctuations" around their disinflation baseline – which is welcome given the recent escalation in the Middle East.

The disinflation narrative is clear in the Euro area, it is not in the US, and we had another disappointing print for the US CPI last week. Although producer prices brought some reassurance, we feel time is getting tight to get enough confidence for the Fed to cut by June and we have brought our expectation for the first easing to July.

The real estate slump continues in China, which is consistent with the past experience of other countries: these issues don't disappear fast. We draw on these episodes to look into China's overall macroeconomic strategy. The US reaction to the subprime crisis was to engage in policy "carpet bombing", with massive fiscal and monetary support. In contrast, some of the Euro area peripherals such as Spain which had to deal with a collapse in residential investment did not have the same policy space and had to resort to "internal devaluation": they owe the success of their adjustment to strong improvement on the export side. China's current fiscal position makes it difficult to expect there the same quantum of government support the US enjoyed after 2008. It is going to be very tempting to rely on exports to make up for the output lost to the real estate crisis. The sheer size of China in world trade makes it however difficult to expect an export-led strategy could be accepted without significant tension with trade partners. When looking for a solution to China's current predicament, we think that a key issue is how the proceeds of stronger productivity growth could be channelled towards higher real wages, rather than lowering further the price of Chinese exports, with looser monetary policy "greasing the wheels" of the adjustment.

The ECB cements a cut in June – tolerance on energy prices welcome

While the market was busy re-adjusting further its expectations for the Federal Reserve (Fed) trajectory given the bad news on US inflation (more on this in the next section) **Christine Lagarde last week solidified the consensus – which we share – around the once-heretic idea that the European Central Bank (ECB) will cut in June and will do so irrespective of what the Fed is likely to do a week later.**

First, the prepared statement contains the – new – explicit point that "it *would be appropriate to reduce the current level of monetary policy restriction*" if by the "*updated outlook"* (which we think is a transparent codename for "the June forecasts") the central bank can be more confident inflation is converging towards the target. It is still data dependent - the central bank will look at actual price and macro developments between now and the June meeting on top of its new set of forecasts - but the direction of travel is clear: the ECB is now explicitly biased towards cutting.

Second, Lagarde disclosed that "a few members" had argued for a rate cut already this week, as they felt confident enough that inflation is under control. Third, and that may be what we found the most striking, she was quite dismissive of some of recent concerning developments in some components of consumer prices. **When asked about the rebound of energy prices, she merely signalled that the ECB was expecting some "*fluctuations*" around the overall disinflation trend, thus expressing little preoccupation**. She was equally dismissive when asked about the resilience of service prices, indicating that they "would not wait for all components" to be aligned before changing their policy stance.

The issue of energy prices takes a particular prominence in the current configuration given the further escalation in the Middle East. We had always considered that, from a global macro point of view, via the oil prices channel, a direct involvement of Iran could be a game-changer. This is now obviously the case, with on top of it a direct involvement of the US (and other Western countries such as the UK and France) in the defence of Israel. In a message through its delegation at the UN, the Iranian government let it be known that after its drone and missile attack on Israel in retaliation against the strike on its consulate in Syria, "*the matter can be deemed concluded*", but also warned that if Israel "*makes another mistake*", Iran's response would be "*considerably more severe*". The key issue at this stage is whether Israel will consider that the large success of the defence against the drone attack can be seen as enough of a victory to make a significant counterstrike against Iran unnecessary. We would expect the US will exert pressure on the Israeli government to show some restraint, focusing instead of on joint western action in the diplomatic realm towards Iran. If that is the case the conflict could be stopped from spreading to the Strait of Hormuz – key to the quantum of destabilisation of the oil market which may yet arise.

The ECB's stated tolerance on some impact from higher oil prices of inflation is welcome since the fiscal capacity to protect the European economy from another surge in energy prices is today close to non-existent, given the surge in public debt and the ensuing conversion of most governments to at least some measure of austerity. We think the Governing Council is fully aware of these new limitations. **The less an energy shock is accommodated by fiscal action, the lower are the chances it triggers persistent second-round effects on core inflation**. In the absence of fiscal support, an oil shock triggers a decline in aggregate demand which normally stops price contagion to other components of the Consumer Price Index (CPI) in its tracks.

There were plenty of questions to Christine Lagarde on the articulation with the Fed. She indicated how developments in the US could be an input in the ECB's overall assessment but also made the explicit point that the ECB is "not Fed dependent", and insisted on the fact that inflation dynamics are very different in Europe in the US, as well as the overall macro conditions.

There was nothing "ground-breaking" in Lagarde's messages, and market pricing barely budged, but this was to be expected since a June cut was already the market's baseline. As we mentioned last week, we find it quite telling that the euro has not significantly weakened further despite the change in the market's relative pricing of the Fed's and the ECB's trajectory. The drop last Friday from USD1.075 to USD1.065 was in our view more the reflection of the usual flight to the dollar in times of heightened geopolitical risk, as the world was bracing for more escalation in the Middle East, than an after-shock from the Governing Council meeting. A "quiet revolution", allowing the ECB to diverge relatively easily from the Fed when cyclical conditions are not aligned across the Atlantic may be in the making. Yet, before we conclude that all this amounts to a "declaration of independence" of the Euro area – as we read in some of the comments of the ECB's presser – we would need to remember that **we are talking here of the possible emergence of a *lag* between the two central banks more than a proper, lasting divergence, as the market's baseline remains that the Fed also will ultimately ease this year.**

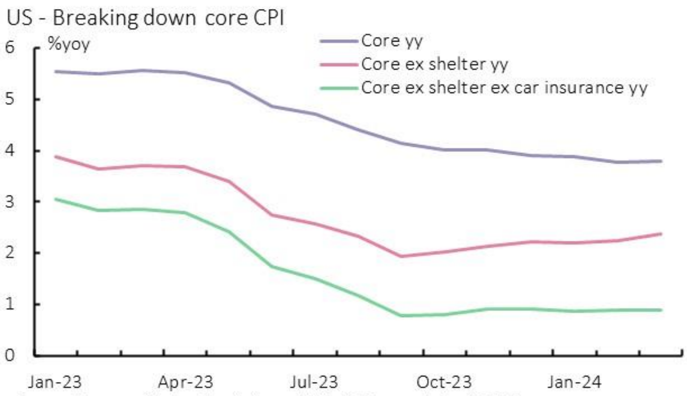
Besides, this would not necessarily entail that *overall* financial conditions could diverge. Indeed, although European disinflation is proceeding nicely, fiscal policy is getting restrictive in Europe and the ECB is expected to cut more than the Fed, long-term interest rates have not shifted downward on our side of the pond. Relative to early February, 10-year yields have risen by 28 basis points (bps) in Germany. This is less than the rise seen on US yields but may still reflect the dominance which the US bond market continues to exert.

New news on the last mile make us push our Fed call

Last week we had concluded our analysis of the latest payroll batch with the hope that the March print for the CPI would not be "too hot" so that a fairly fast start of the Federal Reserve policy shift could still be expected. This unfortunately did not materialise, and **core inflation came out 10bps higher than market expectations at 3.8% year-on-year (yoy), unchanged from February**. This cannot be ascribed only to the resilience in rents. Excluding this component, core CPI re-accelerated in March to 2.4%yoy, the highest pace since July 2023 (Exhibit 1).

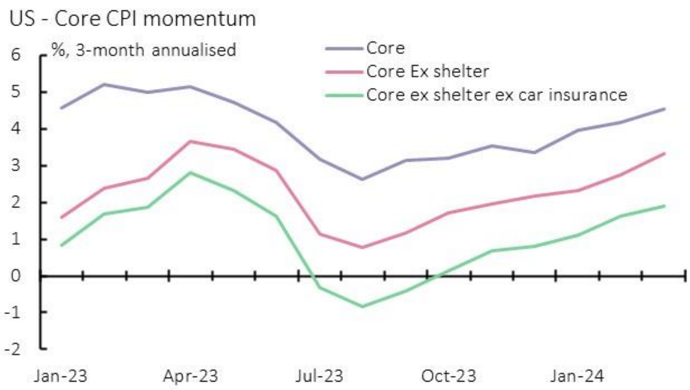
We have already mentioned in Macrocast how idiosyncratic developments in some small components of the index, without any connection to the broad macroeconomic environment, could bring some disproportionate contributions to core inflation. This happened again in March with car insurance prices rising by 22.2%yoy, up from already whopping 20.6%yoy in February. When excluding this item as well, core inflation has remained roughly flat at c.1%yoy since the autumn of last year. There are two limits to seeking this sort of reassurance though. First, removing items after items in the inflation basket ultimately makes the result insignificant (we keep only 40% of the weights in core inflation when taking shelter and car insurance out). Second, **even this "narrow measure" has been showing some stronger momentum when looking at a three-month annualised basis** (Exhibit 2).

Exhibit 1 – It was not about rents



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

Exhibit 2– Momentum is up



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

A better-than-expected print for producer prices in March provided some measure of reassurance last week – some of the PPI components are directly used to compute the personal consumption deflator (PCE) which the Fed favours as the right indicator for inflation – but we are afraid time is getting tight to get the right messages from the dataflow which will allow the Fed to start cutting in June. **We have thus pushed back our baseline to the first easing coming in July.**

Lessons from past real estate crises

Your humble servant had not had the opportunity and pleasure to visit China since the pandemic until last week. The trip has been the occasion to look deeper in the Chinese economy and refine our outlook, more precisely on what could be a workable growth model for the country which would not trigger more tension with the rest of world.

There was a very interesting graph in the International Monetary Fund (IMF)'s latest in-depth review of China (Exhibit 3), comparing the current housing correction in China with well-known precedents. Their main purpose was to suggest **that housing slumps tend to be protracted and deep**. The share of residential investment in GDP drops by several points and stays significantly lower than at pre-Crisis for years after the initial shock. Based on these multiple episodes, the market should thus not expect a quick turnaround – there is no point in being "disappointed" every time another piece of data signals the continuation of housing trouble in China. For now, the correction is following the usual model: first only the most fragile housing markets were hit, but since last year residential prices have been falling even in tier1 cities (Exhibit 4). If the Chinese residential slump follows the usual pattern also on the way ahead, this means that **Beijing must find policy solutions which will boost other sectors of the economy on a lasting basis.**

Exhibit 3 – China's real estate issue in perspective

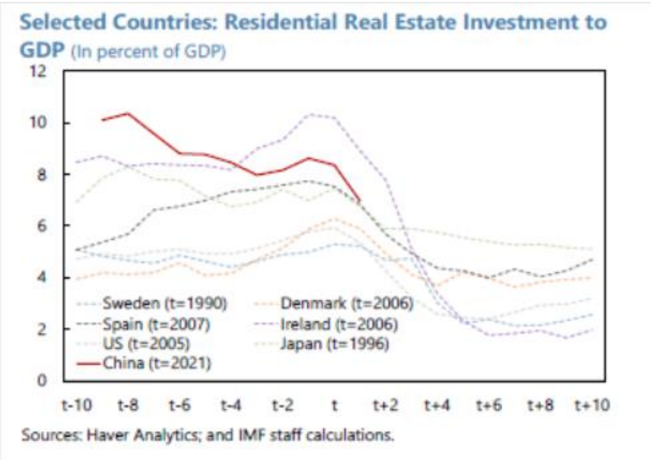


Exhibit 4 – The usual pattern

Source: CEIC and AXA IM Research, March 2024

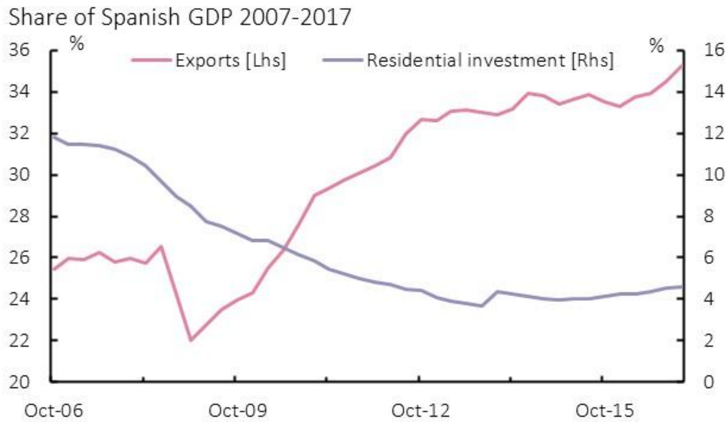
We think that **we can prolong this observation by the IMF by looking at the typical policy choices made by other countries when they faced their own protracted housing bubble bust to draw potential lessons for China**. We will focus on two polar cases: the US after subprime, and Spain in the Euro area crisis. The first is a case of intense "policy carpet bombing", based on massive use of monetary and fiscal supports; the second of structural adjustment taking the – painful – form of an internal devaluation.

Indeed, even if Obama operated a fiscal turnaround in his second mandate, government support was crucial in the immediate aftermath of the sub-prime crisis. The structural budget deficit rose by 5.4% of GDP between 2007 and 2010 and did not start to decline significantly before 2013 according to the Congressional Budget Office (CBO)'s estimates. Budgetary profligacy was aided by a quick recourse to unconventional monetary policy tools by the Fed. Quantitative easing (QE) started in November 2008 with the massive purchases of mortgage-backed and other securities (the Fed held a whopping USD1.7 trillion of MBS, bank debt and treasury notes by March 2009). On top of its direct impact on activity, the ultra-loose monetary stance powerfully helped to deal with the financial stability consequences of the housing slump, for instance by compressing the cost of servicing the initial over-leveraging and allowing ample liquidity to dampen the rise of defaults.

These options were not open to Spain. The ECB was for long very reluctant to roll-out the ultimate weapons in its unconventional arsenal QE started only at the very end of 2014, and policy rates were hiked in November 2011). Without such unconditional monetary support, fiscal policy had to shift to austerity, after a very brief expansionary phase. The structural deficit started falling again as early as 2010, and the overall correction exceeded 6% of GDP by 2013 from peak, to address a massive rise in the risk premium on the bond market. Potential "Federal" support from the EU belatedly came when the European Stability Mechanism was set up, but running orthodox fiscal policies was the price to pay to benefit from the support of the newly created European financial solidarity frameworks.

Given these constraints on the policy-mix, combined with the absence of relief via currency depreciation, **Spain resorted to the only other avenue still open: "leveraging" the steep deterioration of the labour market to rebuild competitiveness thanks to weak wage growth**. Even if the country could not rapidly regain the output lost at the beginning of the crisis, exports started rising as a share of GDP, filling some of the hole left by the slump in residential investment. In 2007, at the peak of the residential frenzy, residential investment stood at 12% of GDP. 10 years later it had fallen to less than 5%. Meanwhile, the share of exports rose from 22% to 35%. Of course, Spain took advantage of its already developed tourism industry (foreign tourism receipts are treated in national accounts as an export of services) but the rise in the exports of goods explain two third of the overall gain in the export share of GDP.

Exhibit 5 – How Spain did it



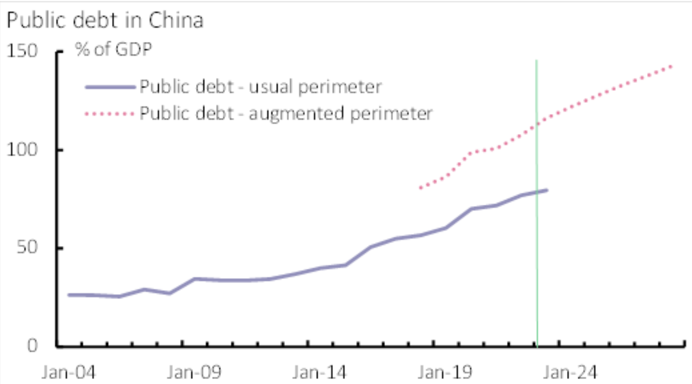
Source: Instituto Nacional de Estadística and AXA IM Research, April 2024

How does China today fit with these two polar models? **A key difference between the US in 2008 and China in 2024 is the level of public debt**. Even without the support of ultra-accommodative monetary policy, there was little question at the time on the sustainability of US federal debt which stood at 35% of GDP in 2007 (97% last year). China's public debt, as recalculated by the IMF, stood last year at more than 100% of GDP when integrating the liabilities of local authorities which over the last few years have shouldered most of the weight of the various stimulus programs, and the Fund is expecting a further drift in the years ahead (Exhibit 6). In addition, since China has escaped the global inflation shock, it has not benefitted from the reverse "snowball effect" when nominal GDP growth rate exceeds the interest rate. This has contributed to the drift in the Chinese public debt to GDP ratio – now exceeding the US level – contrasting with the slight decline seen elsewhere (Exhibit 7). The decision by the central government to curtail additional infrastructure spending by local government at the end of last year is an unsurprising reaction to this deterioration in the overall fiscal position.

If the avenue of fiscal stimulus is impaired, then it is quite logical that the temptation to rely on exports to provide lasting impetus to the economy re-emerges. In a way, even though China – unlike Spain 10 years ago – still can exert direct control over its exchange rate, it finds itself in a similar position in terms of "internal devaluation". Indeed, the country is going through a phase of deflation when virtually everyone else is still struggling with the aftermath of the global inflationary shock. This puts Chinese products in a very strong competitive position.

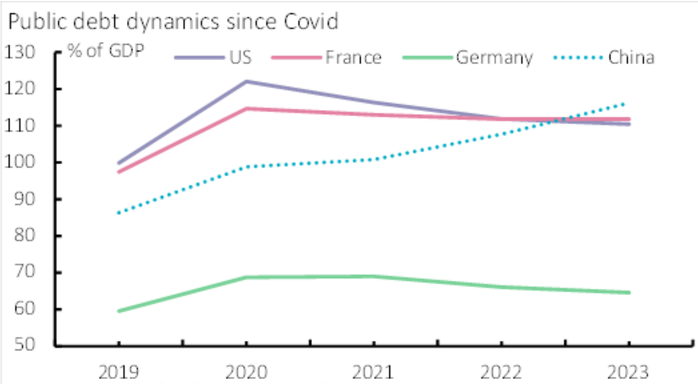
There are however three major differences with Spain 10 years ago: size, access to a large free-trade zone, and underlying saving/investment balance. When Spanish exporters started snatching market share after the sovereign crisis, there was little reaction in other countries since the overall share of Spanish exports in world trade remained small. Today, the sheer size of the *Chinese* export machine means that a rise in the Chinese export to GDP ratio to offset the lasting drag from residential investment would necessitate a further increase in its share in world trade which would not occur without significant losses for others. Moreover, even if the European partners of Spain had resented the new competition, there was nothing they could do in the configuration of the European single market. China cannot count on such "automaticity". Even regions which so far have not been vehement in their criticism of China's surge in world trade, the EU in particular, are uncomfortable with yet another rise in China's share of world exports. Finally, the Spanish crisis was the product of a massive imbalance between investment and saving. Turning a current account deficit to a surplus was simply rebalancing to a net saving position. Conversely, China's starting point is of a dearth of internal spending. Focusing even more on exports would leave the excess saving question untouched.

Exhibit 6 – Diminishing fiscal firepower



Source: International Monetary Fund and AXA IM Research, April 2024

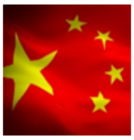
Exhibit 7– A specific trend



Source: Macrobond and AXA IM Research, April 2024

China's **"New Quality Productive Forces" strategy could be mutually beneficial if its proceeds were channelled to domestic expansion**. Indeed, more focus on innovative industries should trigger a rise in aggregate productivity in China. There is no automaticity in seeing these productivity gains primarily employed to raise the competitiveness of Chinese products on international markets. **Higher productivity could create space to raise real wages, thus supporting faster growth in personal consumption, instead of merely keeping export prices low. This would be a healthier way to sustain domestic demand than using, directly or indirectly, massive fiscal stimulus.**

We think lower interest rates in China could "grease the wheels" of such strategic turnaround. Indeed, this would make the continuation of the required investment effort towards the productive upgrade easier while protecting the firms' financial position in a way which would allow them to direct more resources to lift wages. At the same time, lower interest rates alleviating the rise in debt servicing costs would help avoid a restrictive shift in fiscal policy, allowing space to develop a more comprehensive system of collective protection against key "life risks", which would help consumers direct less of their income towards savings. In such configuration, the rest of the world would be better disposed towards tolerating some softness in the Chinese currency since it would merely be a by-product of an internally directed expansionary monetary policy rather than a direct intervention on the exchange rate.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• CPI inflation (Mar) headline rose to 3.5%yoy, core held steady at 3.8%. We now expect 3 cuts this year, starting in July • PPI inflation (Mar) rose to 2.1%yoy and core PPI inflation to 2.4%yoy • FOMC minutes (Mar) confirm Committee seeks further evidence of inflation softening before cut • NFIB survey (Mar) drops to 11-year low of 88.5	• Retail sales (Mar) recovery after weak start to year • Business inventory (Feb) important for GDP outlook • Empire and Philadelphia Fed surveys (Apr), diverging trends to Mar, with Philly suggesting mfg recovery • Existing home sales (Mar) scale of retracement after 9.5%mom bounce last month • Fed's Beige Book, last noted softer consumer outlook
	• ECB Governing Council maintained depo rate at 4%. Communication from March meeting is unchanged. Bar seems very high to not cut in June • ECB Q1 Bank lending survey showed a lower share of banks reported a tightening in credit standard for both firms and households. But loan demand declined for firms, broadly stable for households	• Final HICP data (Mar) to assess dynamics within services prices and whether it provides from Easter period or is broad based • Industrial production (Feb) is expected to rebound (Cons: +0.8%mom, after -3.2% in Jan) • German ZEW (Apr)
	• BRC total sales picked up to 3.2%, pointing to a small pick-up in retail sales in March • RICS house price balance rose to -4, from -10 • GDP increased 0.1%mom in Feb., Jan revised up to 0.3%, from 0.2%. GDP on course to rise by 0.3%qoq in Q1	• Labour market data to show unemp. rate ticking up to 4%. AWE ex. bonuses to dip to around 5.8% • CPI inflation likely will fall to 3.1%yoy in March, with core falling to 4.3%yoy • Retail sales likely held broadly steady on the month again in March, though risks are slightly to the upside
	• Consumer confidence ticked up to 39.5 in March • PPI rose by 0.2%mom pushing up the headline rate to 0.8%yoy • Gov. Ueda stated the weak yen would not lead to a hike by the BoJ; emphasised broader drivers of CPI	• USDJPY broke through the 152 mark this week and is now at a 34-year high of 153.2, fuelled by repricing of later FED cuts. Growing likelihood gov. intervene • CPI to remain unchanged at 2.8%yoy, ex. fresh food and energy to edge down to 3%yoy
	• CPI (Mar) fell quicker than expected, grew by 0.1%yoy (Feb: 0.7%) • PPI (Mar) deflation worsened to 2.8%yoy from 2.7% • Exports dropped by 11.4% in Mar (Feb: +2.9%); imports declined by 2.8%, after a fall of 8.4% in Feb • M2 supply grew by 8.3% in March (Feb: 8.7%) • Bank lending grew by 9.6%; TSF rose by 8.7%	• 16 Apr: Q1 GDP • 16 Apr: March monthly output data (fixed asset investment, retail sales and industrial production)
	• CB: Korea (3.5%), Philippines (6.5%) & Thailand (2.5%) stood on hold. Peru cut -25bps to 6.0% • Inflation yoy (Mar): Brazil (3.9%), Chile (3.2%), Czechia (2.0%), Hungary (3.6%), Mexico (4.4%), Russia (7.7%), Romania (6.6%) & Taiwan (2.1%) • Korea's liberal opposition wins legislative elections	• March inflation in South Africa • Economic activity index (Feb): Brazil, Colombia & Peru • Q1 GDP in Malaysia • Retail sales (Feb): Colombia, Mexico & South Africa

Upcoming events		
	US:	Mon: Empire State mfg survey (Apr), Retail sales (Mar), Business inventories (Feb), NAHB Housing market index (Apr); Tue: Building permits (Mar), Housing starts (Mar), Industrial production (Mar), IMF releases April 2024 World Economic Outlook; Wed: Fed publishes Beige Book, Long term investment flow – TIC (Feb); Thu: Weekly jobless claims (13 Apr), Philadelphia Fed index (Apr), Existing home sales (Mar), Leading index (Mar)
	Euro Area:	Mon: Ez Industrial production (Feb); Tue: Ge ZEW Survey: current situation & economic expectations (Apr), It HICP (Mar); Wed: Ez CPI Inflation (Mar); Fri: Ge PPI Inflation (Mar)
	UK:	Tue: ILO Unemp (Feb), Average earnings (Feb); Wed: CPI (Mar), CPIH (Mar), RPI (Mar), PPI input & output (Mar); Fri: S&P to review UK's credit rating, Retail sales (Mar)
	Japan:	Mon: Private 'core' machinery orders (Feb); Wed: Trade balance (Mar); Fri: CPI Inflation (Mar)
	China:	Mon: PBoC 1y MLF rate announcement; Tue: GDP (Q1), Industrial production (Mar), Retail sales (Mar), Fixed asset investment (Mar), House prices (Mar)

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

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