Investment Institute Macroeconomics

Macrocast

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Carbon divergence, Macro Convergence

- Biden’s capacity to circumvent Congress on his green agenda has taken a major hit. The contrast with the European Union (EU) is getting starker, especially after the parliament’s vote on the extension of the Emission Trading System.
- Europe and the United States (US) are converging on the macro slowdown and a less aggressive expected trajectory for central banks.

Until last week it seemed that Joe Biden could salvage his green agenda, despite his absence of majority in Congress on these issues, through his control of federal agencies. What law would not allow, delegated regulation could. This has been dealt a blow by the Supreme Court last week, which ruled that the EPA could not implement its “sweeping change” in power generation in the US without explicit Congressional authorization. Moreover, the Court invoking the “major questions doctrine” may jeopardize many other avenues the Biden administration could have used to circumvent Congress, including potentially on green finance, on which the Securities and Exchange Commission (SEC) had become increasingly involved. The contrast could not be starker with the EU, since the European parliament has voted in favour of the extension of the Emissions Trading System (ETS) and the implementation of a border carbon tax. The legislative process is not over yet – there are still differences with the Council’s positions made public last week- but at least, in Europe all the key political families support the fight against climate change and the need for a price of carbon to emerge. Without a similar level of consensus domestically, the US won’t be able to act as a leader on the world stage on this front. This will impair the chance of success of COP 27 in November.

While the US and Europe are drifting apart on the green agenda, they are converging on the macro data flow: signs of slowdown continue to accumulate, with US consumption showing in May its first clear sign of weakness, and the European Commission survey confirming the message from the Purchasing Managers’ Index (PMI) to suggest a sizeable deterioration in business confidence. The market took notice, with a downward revision in the quantum of policy rate hikes it expects by year end. Fed Funds are now priced under the Fed’s median forecast, and the European Central Bank (ECB)’s depo rate below the “neutral range”. The less aggressive pricing of the central banks’ trajectories is not helping all asset categories though. In fixed income, pressure eased up on investment grade names, but continued to rise in high yield. The impact of rising recession risks trumps the relief from less restrictive monetary policy. The “payroll data” this week will be key.

Carbon Supreme

When discussing COP 26 last year a nagging issue was the gulf between the decarbonation ambitions of the US and the lack of domestic tools to push the agenda through – the failure of Biden's investment plan, with its focus on energy transition, came out during the conference. **The reassuring argument at the time was that Biden still retained ample capacity to shape the US carbon trajectory through his control of federal regulatory agencies**, in particular the Environment Protection Agency (EPA). With CO2 added to the list of pollutants which the agency controls, a gradual shift away from the most damaging energy sources – coal ranking first – could be organized despite the absence of a Democratic majority in Congress. **This has been put in jeopardy by last week's Supreme Court ruling against the EPA**.

The Supreme Court's decision is worth a read given the complexity of the matter (see here, the "syllabus" at the beginning acts as a "non-technical summary"). On clean power issues the EPA acts via "Best System of Emissions Reduction (BSER)". Individual states are mandated to design their own programs towards achieving this BSER. The BSER is based on three building blocks. The first ("heat rate improvement") implies implementing best practices to minimize CO2 emissions from coal-fired power plants. Building blocks two and three however mandate a "power generation shifting" not at the level of individual power plants but for the entirety of the national electricity grid. In practice, building block 2 shifts coal to gas, which emits less CO2, and building block 3 push fossil-fuel capacity (both gas and coal) towards renewables. Invoking the "major questions doctrine", the Court found that such sweeping change in the energy mix could not be implemented without explicit Congressional authorization: *"Congress did not grant EPA in Section 111(d) of the Clean Air Act the authority to devise emissions caps based on the generation shifting approach the Agency took in the Clean Power Plan"*.

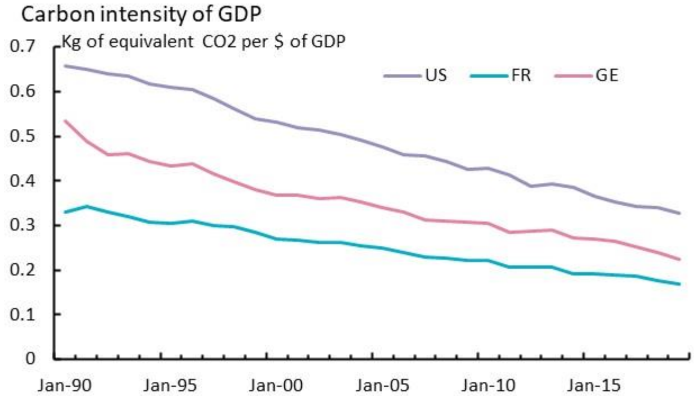
This leaves the EPA in limbo. The Court made it clear what the agency cannot do but did not state clearly what is still within its remit. There are already discussions of enforcing de facto limits to fossil-fuel based electricity generation by going after their by-products, such as sulphur dioxide or methane, but **the Court's resorting to the "major questions doctrine" can be a Trojan horse for any interest group intent on blocking many other environmental regulations. Congress is paralysed on these issues, because of the crucial role Senator Manchin, representing a coal-producing State, plays in the Senate to provide a majority in the Senate.** Most polls at this stage predict a Democratic defeat in the Mid-term in November, which would prolong the paralysis.

Sustainable finance is one of the areas to watch. Developing more stringent regulation on these matters via federal agencies is another way for the Biden administration to circumvent Congress to advance its green agenda. The SEC – which until Biden's access to power had been very reluctant to extend its supervision in this area – has become a key instrument. Habitual readers of Macrocast may remember that when we discussed this last year, we noted that the Republican members of the SEC board had come out publicly against such extension. **Given the Supreme Court's new attitude, it cannot be excluded that the lack of explicit Congressional authorization to the SEC could provide ground for litigation against any "sweeping decisions" on these matters as well.**

We've read some reassuring comments on the real impact of the Court's decision on the US decarbonation trajectory, focusing on the fact that even under the Trump administration, the carbon intensity of GDP (units of carbon emitter per unit of GDP) did not deviate from its decades-old downward trend in the US (Exhibit 1). Far-reaching efforts by economically key states such as California could offset the lack of implementation capacity at the federal level. Still, this optimistic view does not consider the fact that the US – still one of the most carbon intensive economies in the developed world – needs a proper change of dimension for its decarbonation strategy**. If GDP carbon intensity were to continue at the average pace observed over the 10 years before the pandemic, the US would not reach the *current* French level before 2052, and even a doubling of the decarbonation pace would bring this economy to "net zero" in the 2090s only, 40 years too late**. Strong – and potentially painful – strategies are needed in Washington DC. We are not getting any closer to the emergence of a carbon pricing framework at the national level in the US any time soon, and this is widely considered as a key instrument in nudging corporations towards a swifter decarbonation. The current institutional setup is not conducive to such overhaul and may not be for years. Received wisdom is that the US may be late in responding to a global issue, but once it starts addressing it, it tends to act more forcefully than other democracies. The election of Joe Biden was widely seen – including by your humble servant – as marking this "decisive moment". We may have to wait longer.

The accumulation of setbacks for Biden's agenda is bad news for the fight against climate change at the global level. The decarbonation pledges had been found wanting at COP26. COP 27 in Egypt in November 2022 was seen as an occasion to catch-up, as governments were invited to produce revised Nationally Determined Contributions. Given its difficulties at home, the US administration will not find itself in the best position to lean on other countries to improve their own decarbonation efforts.

Exhibit 1 – Lower, but not fast enough



Source: United Nations, World Bank and AXA IM Research, July 2022

The contrast with the developments in the EU could not be starker. Eight days before the US Supreme Court released its ruling, the European parliament, after rejecting a first version two weeks ago, managed to support a compromise on the extension of the Emissions Trading System (ETS). It will be extended to the shipping sector, while a bespoke framework will be implemented for buildings and road transport. In these two sectors, only "commercial use" would be hit in the first years. Private consumers would not be hit before 2029., probably as a nod to the pressure households are currently facing on their purchasing power Besides, a Social Climate Fund would be created, which would channel proceeds from the ETS to help vulnerable households cope with the ensuing rise in prices. Finally, the European parliament endorsed the "carbon border tax" which would address the "carbon leakage" issue by raising a levy on highly carbonated imports into the EU which are not sufficiently taxed in the producer country.

As usual with the EU's institutional process, the parliament's vote is not the last step of the legislative process but only opens the door to the "trilogue" with the Commission and the European Council. The Council has made its position public last week, and some sources of disagreement remain. The Council did not endorse the distinction between commercial and consumer use. Their approach to the "social transition" issue is to postpone the implementation of the extension for both categories: To quote directly from the Council's communication on 29 June, for buildings and road transport *"the start of the auctioning [of the emission permits] and surrender obligations will be delayed by one year compared to the Commission proposal (auctioning of allowances from 2027 onwards and surrender from 2028 onwards)".* The Council also wants to cap the Social Climate Fund to EUR59bn, while parliament wants its funding to go beyond this if carbon prices rise significantly.

The debate is thus not over, **but the big difference with the US is that in the EU parliament all the key political families agreed to support the deal** – the centre right European People's Party (EPP), the socialists, the greens, and the liberals. The consensus around the need to accelerate on the fight against climate change is strong, even if the debate around the extent to which the impact on consumer prices needs to be mitigated is understandably still fierce. Yet, the EU on its own will have a hard time mobilizing the international community on the energy transition. The absence of the US will be a major impediment.

Gravity calls

The "cracks" in the dataflow we explored last week are getting wider. The Federal Reserve (Fed) is probably focused on the behaviour of consumption, since "excess stimulus" during the pandemic had primarily boosted this component of GDP and a slowdown in personal spending is necessary to force producers and retailers to stop passing the rise in their input costs into final prices. Soft readings had already emerged for some months in retail sales, but their high intensity in goods, at a time when consumption has shifted to services, made them less accurate indicators of overall spending. **The release of the more comprehensive personal consumption data for May last week, with a first monthly decline since December 2021 (-0.4%), brought a first tangible sign that the impact of inflation on purchasing power is finally affecting household spending decisions**. The decline in real income is not new -it has been going on since the beginning of this year – but so far it had been offset by a decline in the saving rate, which in April came below the pre-pandemic level. This did not happen again in May, when the saving rate marginally rose on the month, albeit marginally, for the first time in 2022. If one takes a step back and look at the year-on-year changes, the picture which emerges is that of a slow normalization in consumption, as households have less and less appetite – or capacity for those at the bottom of the income distribution – to draw on the excess saving of the pandemic (Exhibit 2).

Obviously, we should be careful not to overstate a month worth of data. **For consumption to continue softening, the labour market probably needs to take a hit itself.** We mentioned last week that weekly jobless claims had normalized from their March trough, but it is still a very tenuous signal. Business surveys may tell us more. We confess having been a bit obsessed with the "employment" component of the ISM survey lately. The June batch for the manufacturing sector came out last week with another dip further in contraction territory, reaching, at 47.3 after 49.6 in May the lowest level since August 2020 (Exhibit 3) during one of the pandemic flare-ups. Next week's release of the same survey in the services sector will probably be more telling, and then of course the payroll data for June will focus attention, but the current speed at which signals of sharp deceleration in the US economy are piling up is remarkable.

Exhibit 2 – Less resilient consumers

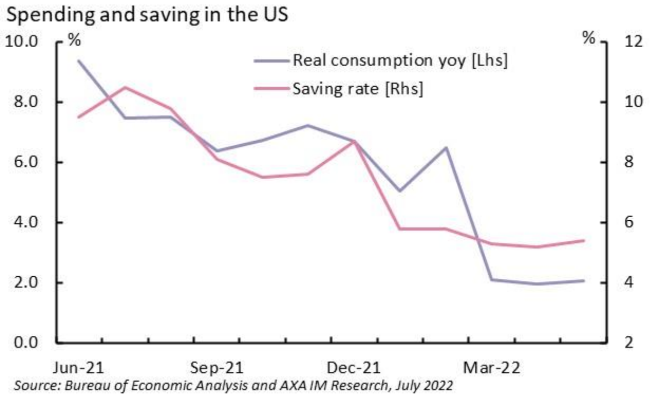
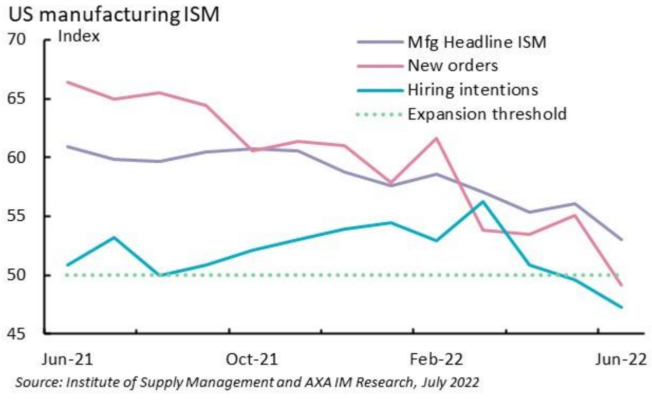


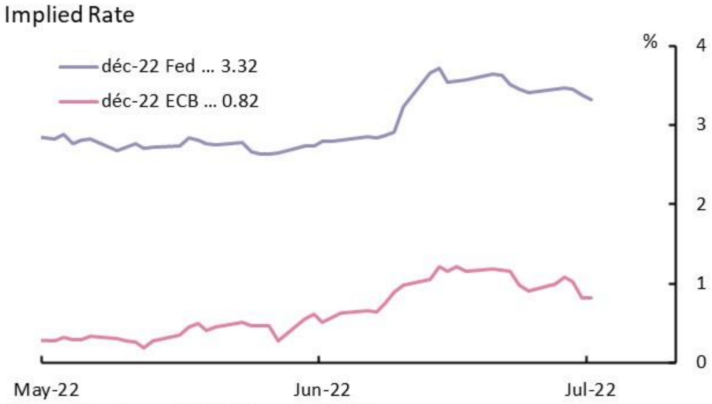
Exhibit 3 – Hiring intentions down



This has not been lost to the market of course. Equities have dipped further, as the risk of recession keeps on rising, but at the same time, **the first doubts are emerging on the Fed's need to deliver all the tightening they have been liberally communicating**. The market, using Bloomberg's measure based on overnight futures, was seeing the Fed Funds' rate at 3.32% at the end of 2022 as of last Friday (see Exhibit 4), under the Fed's Federal Open Market Committee (FOMC) members' median forecast (3.4%). There is something quite intriguing in the market now revising down its expectations for the Fed's trajectory after last week's hawkish statements in Sintra. Jay Powell repeated there his readiness to tolerate a recession to deliver price stability. He may get there sooner than he expected.

In the Euro area as well, investors are taking notice. Despite another higher-than-expected inflation print last week, **the market has revised down its expectations on the ECB's trajectory, with a depo rate now seen below 1% - the lower end of the range for the neutral rate – at the end of 2022.** It seems that the decline in business confidence reflected in the European Commission survey last week, especially in the services sector when focusing on the forward-looking components, confirming the message from the PMI the week before, has convinced investors that a significant slowdown in economic activity is on its way. The quantum of tightening the ECB will have to deploy to get inflation back under control may end up smaller than what the central bank is currently hinting at.

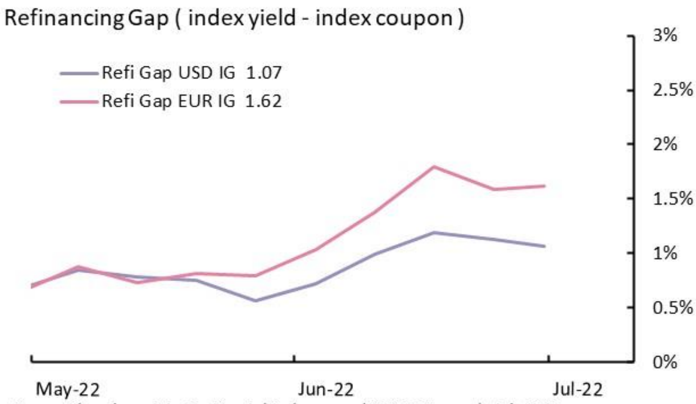
Exhibit 4 – market reconsidering the hawkish rhetoric



Source : Bloomberg and AXA IM Research, July 2022

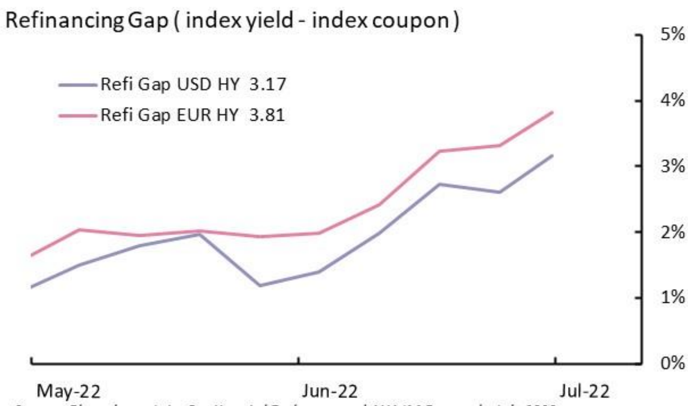
A key issue however is that even in the fixed income realm, not all assets are benefiting from this tentative revision in the Fed's expected path. Investment grade corporate bonds are faring better, with a "refinancing gap" (the difference between the average cost of existing debt and the current cost of raising funds) which has eased up last week (see Exhibit 5). Conversely, high-yield names are continuing to face rising pressure (see Exhibit 6). For now, at least**, the expected impact of the looming economic slowdown – which hurts disproportionately the weaker signatures, through a rise in default probability - trumps the relief brought by marginally lower expected policy rates**. And this makes sense: the decline in the expected level of Fed Funds may be impressive (50 basis points in less than 3 weeks) but would still leave it in restrictive territory by year-end. There may be two interpretations here. First, the collective wisdom of investors may believe that a recession or near-recession alone would not be enough to spontaneously address the inflation risk so that an effective monetary tightening – albeit a more moderate one than envisaged a few weeks ago – would still be necessary. Second, investors may collectively think that despite a recession which might be able to kill inflation on its own, the Fed will "follow its momentum" and deliver in the end more hikes than what would be strictly necessary.

Exhibit 5 –Strong signatures under less stress



Source: Bloomberg, InterContinental Exchange and AXA IM Research, July 2022

Exhibit 6 – High yield still under pressure



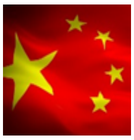
Source: Bloomberg, InterContinental Exchange and AXA IM Research, July 2022

It may be too soon to discuss this, but we would not be surprised to observe disagreements within the FOMC as we get close to the end of the year if the economy continues to decelerate. The members of a dovish disposition may be tempted to argue that the lags attached to monetary policy need to be taken in consideration. If by the end of 2022, core inflation has started a tangible deceleration, then additional rate hikes into 2023 may be seen as “overkill”. Conversely, hawks may argue that the inflation flare-up has been so spectacular that an “extra safety margin” should be carved up by moving further into restrictive territory next year. Habitual readers of Macrocast won’t be surprised to read that your humble servant’s sympathies go to the former, and that seems to be market’s majority opinion at this stage, considering the futures pricing.

There is more “wiggle room” for the ECB at this stage since the current forward guidance covers in a semi-precise manner the July and September meetings only. The “gradual and sustained” path towards the neutral rate can be elongated at will according to circumstances. There was no major shift from the current rhetoric at the ECB’s annual conference in Sintra.

In the short run, we believe the market is still more focused on the “fragmentation issue”. Reuters reported that the ECB was dividing member states between “receivers” (fragile countries who could benefit from extra purchases/re-channelling of reinvestment), “donors” (strong countries which would face a drop in the reinvestment in their sovereign bonds and/or sales of bonds bought under the Pandemic Emergency Purchase Programme), and finally “neutrals”. This piece was not confirmed by the ECB (we would not expect it) but this would suggest the central bank is leaning towards a “sterilization” via the bond market rather than via reverse repos with banks. We continue to be puzzled by this choice given the political risks it entails. We note that Fabio Panetta in a speech last Friday seemed to provide a justification for this. He stated that in case of outright fragmentation, *“the least vulnerable countries would experience capital inflows that would compress yields, resulting in financing conditions that would be too loose and inflation that would be too high compared with our intended monetary policy impulse*”. Selling the bonds of these strong countries could counteract this “flight to safety effect”.

We think that the argument is sound. We are however concerned with the reaction in some of the countries on this “donor list” (where France for instance would sit, according to Reuters). Public opinion in Germany may not balk at higher rates at home. It may be a different story in France. Panetta discusses in his speech the need to go further on debt mutualization – a theme dear to your humble servant. Maybe a side-effect of this “penalization of the strong ones” could constitute an incentive for them to move faster on this issue. Now, it seems to us that the reluctance came from Berlin, not from Paris.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Recession risks. Fed Chair Powell confirmed possibility of contraction at ECB conference; markets saw falling equities, yields and dollar • GDP (Q1) revised lower to -1.6%, but consumption lower and inventory higher, risking softer Q2 • Consumption in May lower than expected and Apr revised lower, reducing outlook for Q2 GDP • Richmond Fed index (Jun), lowest since pandemic • Consumer confidence (Jun) expect's at 9-year low	• FOMC minutes (Jun). These can have more contemporaneous than historic feel. Some members voted for, or hinting, at 0.50% July hike • Payrolls (Jun) jobs growth has remained robust, markets expect softer +250k, while GDP suggest lower still. Earnings growth has softened since Feb • JOLTS (May) – fell in April, should continue in May • Non-mfg ISM (Jun), softer, but solid overall – watch employment component
	• June EC survey confirmed activity softness coming through, notably in the services sector • ECB's Sintra delivered a(nother) clear hawkish bias • EA HICP reached new historical high at 8.6%yoy (+0.5ppt) led by volatile components	• Member states May industrial output, Eurozone retail sales • ECB speeches ahead of 21 July Governing Council meeting, especially on anti-fragmentation tool. Minutes of June ECB meeting
	• Bailey at ECB's Sintra confirmed that 50bp move in Aug is a possibility dependent on data • Nationwide House price index (Jun) cooled to 0.3% lowest rate in 9 months • UK CA deficit (Q1) widened sharply to 8.3% of GDP • Mortgage approvals (May) edged up from April	• Final PMIs (Jun), likely to be revised downwards from 53.1 following Mfg weakness • SMMT new car registrations (Jun) • MPC members Mann, Pill and Cunliffe to speak will be watched for clues on whether 50bp in Aug is likely
	• IP (May) was down massively (-7%mom due to supply-chain issue) /Q2 Tankan Mfg fell to 9 (-5) but forward-looking index is stable, Svcs up to 13 (+4) • Retail sales were resilient in May, cons confidence (Jun) a bit less (-2p), CPI Tokyo flat at 2.3% (-0.1p)	• Final Services PMI (Jun) • Economy Watchers poll (Jun) • Household spending (May)
	• PMIs rebounded back to expansionary territory, although surprisingly services activity recovered faster than manufacturing activity	• Market will focus on the implementation of COVID policy changes and further policy easing for the economy
	• CB: +185bps above-expectations hike in Hungary, +150bps in Colombia • Korea consumer sentiment fell with inflation and interest rate expectations hitting decade high, exports contracted sharply (likely further accentuated by road freight workers' strikes)	• CB: Malaysia (+25bp), Israel (+50bp), Poland (+50bp), Romania and Peru (+50bp) • Taiwan exports for June • June CPI (%yoy) in Indonesia, Philippines, Taiwan, Thailand, Turkey, Hungary, Russia, Colombia, Mexico, Brazil, Chile • PMI survey results

Upcoming events		
	US:	Mon: Independence Day; Tue: Durable goods orders (May), Factory orders (May); Wed: Services PMI (Jun), ISM non-mfg indx (Jun), JOLTS Job Openings (May), FOMC minutes (15 Jun); Thu: ADP employment change (Jun), Jobless claims (2 Jul), Trade balance (May); Fri: Non-farm payrolls (Jun), Employment data (Jun)
	Euro Area:	Mon: EU19 PPI (May); Tue: EU19 Composite PMI (Jun), EU19 Ge Fr It Sp Services PMI (Jun), Fr Ind prod (May); Wed: EU19 Retail sales (May), Ge New mfg orders (May), Sp Ind prod (May); Thu: ECB meeting account (9 Jun), Ge Ind prod (May); Fri: It Ind prod (May)
	UK:	Tue: SMMT new car registrations (Jun), Composite & services PMI (Jun), BoE Financial Stability Report; Wed: Construction PMI (Jun); Thu: Halifax house price indx (Jun)
	Japan:	Fri: Trade balance (May), Current account balance (May), Economy Watchers Survey (Jun)
	China:	Tue: Caixin services PMI (Jun); Thu: Forex reserves (Jun); Sat: CPI (Jun), PPI (Jun)

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