Summer Breeze, Autumn Leaves

- Stellar Q3 GDP in the US puts the resilience theme even more in focus
- The ECB is now more cautious, but its "high for long" narrative will come under market pressure.

A bumper print for Q3, driven by private consumption, further demonstrates the resilience of the US economy to the monetary tightening. At the beginning of this year, we were expecting US consumers to run out of excess saving to spend at a time when the labour market would start to correct in earnest. It however appears that the combination of still robust job creation, strong nominal wage gains and disinflation is allowing more than decent purchasing power growth, while the savings rate fell again. Spending was particularly strong for durable goods, normally quite sensitive to interest rates. It seems US consumers are still happy to ignore the monetary stance.

The resilience of the US economy is likely to rank high in the questions Jay Powell will be asked this week. The likely continuation of the policy pause was telegraphed clearly by his speech at the New York Economic Club we discussed last week. The market-driven tightening in financial conditions will help the Federal Open Market Committee (FOMC) stay in monitoring mode despite the strong real economy data, and we count on the Employment Cost Index (ECI) for Q3, to be released ahead of the Federal Reserve (Fed) meeting, to confirm wages have started to decelerate.

In contrast, we think GDP stagnated last summer in the Euro area. This would further justify ex post the European Central Bank (ECB)'s cautiousness last week. While the press conference was uneventful, we would highlight the readiness of the Governing Council to explicitly acknowledge the impact the accumulated tightening is already having on inflation dynamics. The Bank Lending Survey confirms monetary transmission is operating "forcefully" in the Euro area – to quote directly from the ECB. While the financial position of the corporate sector provides a buffer, we are starting to detect some unease in some quarters of the Eurosystem. The idea that maybe the central bank has gone too far is gaining traction. We do not think rate cuts can be really within reach before the end of next spring at the earliest, but with base effects helping disinflation in the coming months, we expect the ECB to come under significant market pressure to accommodate well before that if, as we expect, the real economy displays more mediocrity.

Summer breeze

US growth was ebullient in the summer. A 4.9% annualized gain for GDP – 1.2% quarter-on-quarter (qoq) as these things are usually looked at in Europe –, more than 2.5 times the US usually accepted trend, would be considered as very strong in any circumstances. At a time when typical new mortgages come at a hefty 7.5% interest rates and the average investment-grade company needs to fork out north of 6.5% to fund itself with 10-year bonds, this is a gravity-defying result.

As usual, there is real danger in extrapolating too much from one quarterly reading, but **the most salient aspect of last week's release was the strength of consumer spending**, which contributed 2.7 percentage points to overall GDP growth in the third quarter (Q3). This has not been unusual recently (gains were similar in Q1 2023 and Q4 2021) but the least that can be said is that the much-awaited correction in consumption has not yet materialised. Digging into some of the details, what is striking is that the growth rate of spending on goods has exceeded that of services in Q3, and this is now true on a year-on-year basis as well. This would suggest that households have normalized their consumption pattern: the shift to services, which had characterized the post-reopening economy, is now leaving space to a nice rebound in spending on manufactured goods – which would help explain the new-found resilience in US business confidence in this sector. The year-on-year gain in spending on durable goods (4.9%) is remarkable since this component of consumption tends to be quite sensitive to interest rates in the US. **As of last summer, it seems American households were happy to ignore the new monetary regime.**

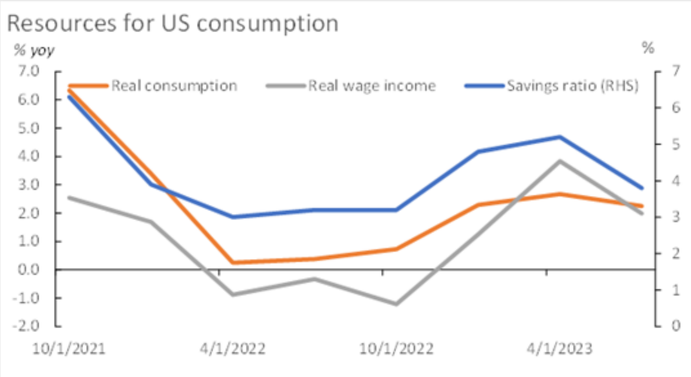
Taking another read at what we were writing on US household behaviour at the beginning of the year, the baseline was that gradually the excess savings accumulated during the pandemic would be eroded, both by actual spending and inflation, so that by the middle of this year consumer spending would have to rely essentially on the new income flows at a time when – we thought at the time – they would come under pressure as the labour market would have landed by then. The upside risk we were mentioning then was that **the exhaustion of excess savings could be offset by a rebound in labour income, triggered by still strong job creation, robust pay dynamics and enough deceleration in headline inflation. It seems that this risk is materialising.**

Immediately available employee income in the economy (i.e., the number of employees multiplied by their monthly wages, without considering employers' contributions to pension and healthcare entitlements) has risen 5.7% year-on-year (yoy) in Q3 2023, exceeding inflation – 3.7%yoy for headline Consumer Price Index (CPI) – by a comfortable margin, even if the gap was less wide than in the first half of the year. We note incidentally, in connection with the points we made two weeks ago on the convergence of the US welfare state towards European standards, that social security payments (essentially state pension) are contributing more to overall gross disposable income (GDI) gains: they rose by 12% year-on-year in Q3 2023, equivalent to 10% of the total improvement in GDI.

Now, **pure income flows alone cannot explain all the stellar consumption in Q3. It also took another decline in the savings ratio**. It had rebounded in Q2 to 5.2% – from a trough at 3% in Q2 2022 – but fell again to 3.8% in Q3. Stronger remuneration of liquid assets, and the steep repricing of credit card lending did not convince households to continue raising their saving effort (see Exhibit 1). **The saving behaviour continues to play a powerful counter-cyclical role**: the savings ratio fell significantly in 2022, allowing consumer spending to remain in (marginally) positive territory despite an all-out decline in real labour income at the time, then rebounded when real wages re-accelerated strongly in the first half of 2023, and fell again in Q3 to offset a small deceleration in real wages.

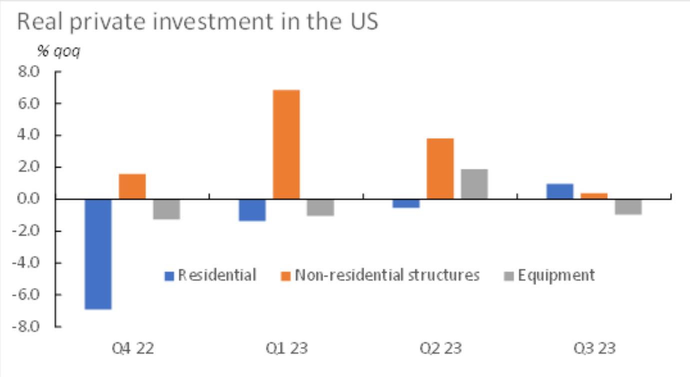
True, **while household spending was holding up very well, investment was disappointing in Q3** (it contracted in qoq terms for both non-residential structures and equipment, see Exhibit 2). We would however caution against interpreting this squarely as a sign the corporate sector is adjusting to the tighter financial conditions and revising down its capex projects. It may be the case, and habitual readers of Macrocast will be familiar with our view that miracles seldom occur so that "at some point" capex will have to go down given the level of real rates, now restrictive considering both expected and observed inflation. Yet, coming after a string of very strong prints, the Q3 result may just be a "breather" rather than the beginning of something sinister. Incidentally, the rebound in residential investment in Q3 may be indicative of how the improvement of the real income dynamics for households may partly offset the rise in interest rates, but again, it is a volatile series, and this could be accidental.

Exhibit 1 – Real labour income and savings help



Source: Bureau of Economic Analysis, AXA IM Research, October 2023

Exhibit 2 – Corporate investment taking a breather?

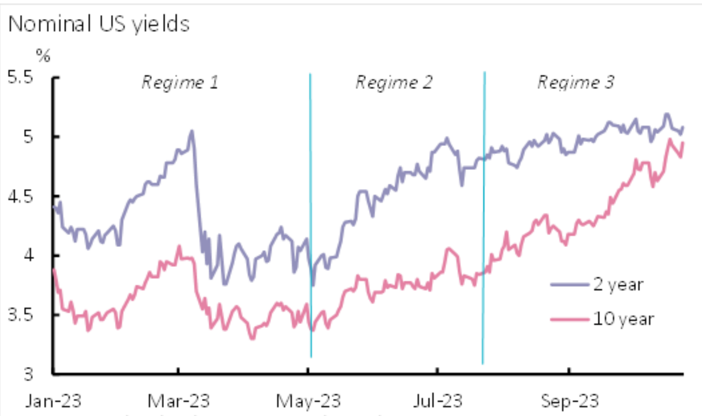


Source: Bureau of Economic Analysis, AXA IM Research, October 2023

The market was remarkably non-plussed by the release, while another dollop on tension on bond market could have been expected. This may merely reflect the fact that the market had already made up its collective mind. Even GDP grew more than expected, investors were in any case already bracing themselves for another exuberant print far above the US potential pace.

Still, **it adds to the "higher equilibrium rate" narrative we succinctly explored last week**. When looking at the 2 to 10 year spread – under the assumption that the 2-year yield essentially reflect the market's understanding of the current signals from the central bank – we can find three successive "regimes" this year. Last winter 10-year yields were reacting almost 1 for 1 to quick changes in perceptions around the Federal Reserve (Fed)'s strategy. Then, last spring, investors finally understood the central bank "meant business" and 2-year yields rose but without taking 10-year yields with them. This is the typical configuration when the market takes on board the impact of the ongoing monetary tightening on the real economy (i.e., consistent with a recession down the road).

Exhibit 3 – Three "macro regimes" for the US 2-10y spread



Source: Macrobond and AXA IM Research, October 2023

We have been in a third regime since this summer, when the data resilience makes the market bet on long-term yields remaining close to the current level of policy rates, as if believed that the economy can "take" a higher level of interest rates permanently, or – which has the same effect – that it is only if financial conditions remain at their current tight level "forever" that inflation will be tamed.

Pre-purdah Fedspeak was clearly indicative of the central bank staying "pat" this week. Focus is likely to be on how Jay Powell will balance his answers to two obvious questions: how the sustained resilience in the US data fits with their current stance, and how the Fed takes the current market-led tightening in financial conditions into consideration. His speech at the New York Economic Club we think provides an easy template for his press conference this week: precisely, the market moves to some extent "offset" the dataflow and allows the Fed to remain in monitoring mode. On Tuesday, the release of the Employment Cost Index for Q3 – a measure which tends to be more reliable than what comes out of the payrolls – could help Powell justify the continuation of the pause if it confirms that the resilience in job creation is accompanied by the beginning of a slowdown in wages, especially if the JOLTs number (out the same day as the FOMC meeting) points to more easing of the tension on the labour market.

Autumn leaves

We will have the first estimate for Q3 GDP in the Euro area this Tuesday which we don't think will be a match for the US print. Indeed, we expect a flat number, after a paltry 0.1% qoq gain in Q2 (revised down from a flash estimate at 0.3%). As usual, there may be some adjustment to make when the release comes out, given the propensity of huge output gyrations in Ireland to affect the whole-area reading.

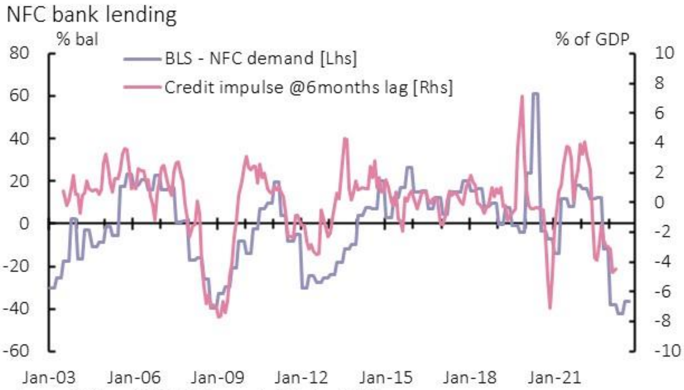
A mediocre reading would bring further justification to the European Central Bank (ECB)'s new-found caution. Indeed, while there was no surprise in the gist of the (absence of) decisions and general narrative by the ECB last week, as per our and everyone else's expectations, **the ECB continues to alter qualitatively its reading of the Euro area's economic trajectory**. The word "weak" appears 13 times in the ECB's transcript of the October press conference, up from 10 in September and 9 in July. The balance of risk for growth – tilted to the downside – has not changed but there was more elaboration on the labour market weakness than in September: *"there are signs that the labour market is weakening. Fewer new jobs are being created, including in services, consistent with the cooling economy gradually feeding through to employment*".

But the key point for us is the readiness of the ECB to link the softness of the real economy and the improvement in inflationary pressure to the impact of its policy. In the paragraph on the fall in core inflation, we would highlight the mention of "*the impact of tighter monetary policy on demand and corporate pricing power*". In our prior discussions of what it would take for the ECB to stop hiking, we focused on two tests: first whether the central bank's signals were appropriately transmitted by the financial sector to corporates and households – this was obvious already last spring, and second whether such transmission was effectively starting to alter the inflation trajectory. The latter is now acknowledged by the ECB, which was not the case last month. A potential impact of stronger policy transmission on price behaviour was only discussed in the "risk" part of the statement.

In September, all three major western central banks hesitated – explicitly – between a pause and a hike, but the ECB was the only one which ultimately chose to tighten further. What probably tilted the decision in this direction – and the reason why we were at the time, on margin, expecting a hike – was the absence of tangible decline in observed core inflation, in a configuration where the Governing Council has been reluctant to engage in forward-looking policy "bets" (i.e., was downplaying the role of lags). Now that core has started to decelerate – and did so more clearly than expected in September – while the outlook for the real economy is mediocre at best**, we think the commentariat is likely to focus on the possibility the ECB went too far**. This is not a purely theoretical conversation between "captains hindsight" discussing what should have been done with the benefit of new data rather than what was decided. **Any accumulating evidence the ECB tightened too much would fuel a reprofiling of rate cuts expectations.**

The ECB reiterated that monetary policy transmission was being "forceful", and **the latest batch of the Bank Lending Survey (BLS) has probably played a major role in the central bank's prudence.** The tightening in lending standards continued, and rejection rates continue to rise for both non-financial corporations and households, but what is also striking is how demand for loans has plummeted, even if the pace has marginally improved in Q3. This will likely fuel a further decline in actual loan origination, down to flows last seen during the Great Financial Crisis (GFC) given the strong predictive power the survey has (see Exhibit 4).

Exhibit 4 – Gloomy BLS



Source: ECB and AXA IM Research, October 2023

Exhibit 5 – There has been some resilience though

Source: ECB, Eurostat and AXA IM Research, October 2023

There are however good reasons to believe the impact of the financial tightening is not going to be as dramatic as during the GFC. Actual corporate investment is still doing much more than what the demand for investment loans reflected in the BLS would suggest (see Exhibit 5), in contrast with the well-established correlation. We think this reflects the strong aggregate financial position of the corporate sector – and in particular the comfortable margin buffers – which allows businesses to fund internally a larger share than usual of their capex. Yet, as demand falters, as noted by the ECB, maintaining those margins is likely to be increasingly difficult and the pressure from higher rates and tougher lending standards should become more intense.

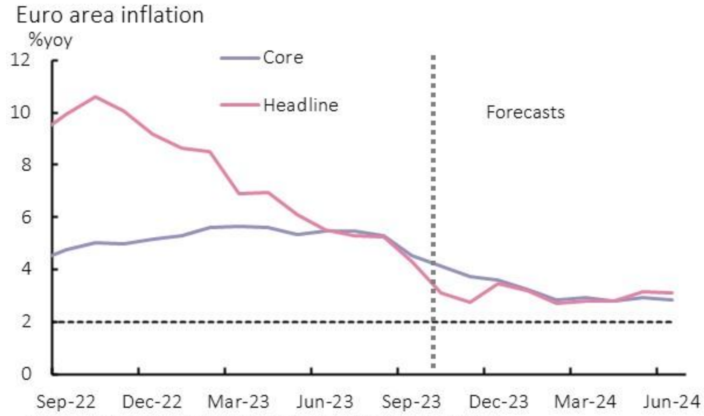
The general sense of real economy weakness conveyed by the ECB has received additional support with the release of jobless numbers in France for Q3. So far, we have been focusing more on Germany as the first major economy where we would expect the "employment shoe to drop", given the state of stagnation/shallow recession prevalent there since the end of last year, but tentative adverse developments are emerging in France as well, despite its much better growth performance so far. The number of people registered with the government employment agency has increased by 0.4%qoq in Q3 (some of them having a part-time job but seeking a full-time one). The number of those registered while having no professional activity at all rose 0.7%qoq. The details show that this does not reflect a rise in dismissals, but essentially that a growing number of workers on "atypical contracts" (interim, time-defined contracts) are facing more difficulties to find another position when their current contract expires. It's often the first signal that demand for labour is falling.

In such a configuration, it makes sense for the ECB "not to rock the boat" and the Governing Council's pause extended to not signalling action on the two options currently on the table to shrink the balance sheet faster. Neither bringing forward the end of the PEPP reinvestment nor raising the mandatory reserves rate were even "*discussed*" as per Christine Lagarde's explicit statement last week. The market might have preferred a longer commitment. She could have batted away the two issues by referring to the ECB's big rethinking of its operational framework scheduled for next spring. Yet, if it is not even "discussed" now, it may be too early to make any hard announcement on this in December, which alone would be a relief in the current environment.

Finally, we detected the same prudence in Christine Lagarde's discussion of a potential oil shock, which of course remains a plausible scenario, especially now that ground operations have started in earnest in Gaza. Indeed, the ECB President stated that another steep increase in energy prices would apply "*to a completely different economy today and an economy which has had an episode of very high inflation, an economy where the interest rates (on the deposit* *facility) are at a very high level of 4%, and an economy that has strong employment and which is weakening".* Clearly, this suggests the central bank's tolerance threshold would be higher and it would not necessarily jump to yet another string of hikes to keep headline inflation under control. We remain a bit circumspect on this though, given the point we made last week on the fact that an oil shock would probably trigger another depreciation in the euro which would filter through *core* inflation. This would make the hawks quite uncomfortable, but Lagarde's cautiousness is still reassuring.

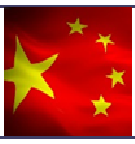
While the ECB President made it plain the Governing Council is very far from discussing rate cuts, we think it's going to be increasingly difficult for them to avoid the issue. In the coming months – and this already applies to the October CPI print this week – base effects from energy and food prices will help disinflation, hence the discrepancy between core and headline until the beginning of 2024 in our forecast (see Exhibit 6), even if both components should go in the right direction (we expect headline at 3.1%yoy for October, against 4.3% in September, and core at 4.1%, down from 4.5%).

Exhibit 6 – Base effects will help in the coming months



Source: Eurostat and AXA IM Macro Research, October 2023

This could of course be completely offset by a steep rise in oil prices, but for now the central scenario remains that inflation will continue to fall quite significantly in the months ahead, even if it will remain visibly above the central bank's target. We don't expect the ECB to start discussing rate cuts in earnest before they have confirmation wages are properly decelerating – and this is unlikely to come before next spring, which possibly puts some weight on the June 2024 batch of forecast to be the key ingredient to a change in stance. Yet, much before that, if the current dataflow for the real economy does not improve – and we expect mediocrity "at best" for the coming quarters **– the questions on the ECB's wisdom in hiking in September and maintain a "high for longer" stance will be relentless.**

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Q3 GDP remains strong up 4.9% saar. Personal spending (Sep) up 0.7%mom above expectations • PCE inflation (Sep) core fell to 3.7%yoy easing in line with CPI measure • Durable goods orders (Sep) up 4.7%mom • Michigan infl expect's (Oct, f) 1yr revised up to 4.2% • PMIs (Oct, p) services remained firm at 50.9	• FOMC meeting. Pre-purdah comments suggested November pause, focus on Powell press conference • Labour market report (Oct) if this repeats a strong Sept report, end-year Fed hike expectations will rise • JOLTS survey (Sep), lower vacancies after Aug rise • ISM mfg and non-mfg (Oct), services watched most • ECI index (Q3) to confirm signs of easing wages
	• EMU flash consumer conf (Oct) remain depressed, negatively impacted by rising energy prices and resurgence of security issues • EMU, Ge and Fr Flash PMIs (Oct) remain largely in contraction territory. We agree with the signal, less with the amplitude. Employment is stabilising. Ifo (Oct) slightly increased but remain in contraction too • The ECB is "on hold" on rates and didn't discuss PEPP, neither remuneration of excess reserves	• Inflation (Oct) is likely to drop again on the back of huge energy and food base effects. Headline should reach 3.1% (-1.2pp vs Sep) while core deceleration would remain slow and gradual (4.1%yoy, -0.4pp) • EMU GDP growth (Q3) should be flat (+0%qoq) with risks on the downside as Germany and France are currently performing poorly. Spain was in line with our expectations at +0.3%qoq • EC surveys (Oct) with bus climate, price selling
	• ONS experimental data (Aug); suggested unemployment at 4.2% vs LFS 4.3% and 82k fall in employment. Estimates very uncertain • Flash PMI (Oct) moved sideways to 48.6 from 48.7 • CBI business optimism (Q4) drops to -15 from 6	• BoE MPC meeting (Thu) November pause expected; vote likely to remain close. Comes alongside publication of Nov MPR • Final PMIs (Oct)
	• Flash PMIs (Oct) dropped into contraction territory 49.9 from 52.1 as services expansion slows • Tokyo CPI (Oct) rose to 3.3% unexpectedly as internet subsidies were ended • Chain store sales (Sep) up 2.8%yoy	• BoJ MPM and MPR (Tues) all policy tools expected unchanged • Labour force data (Sep) • Industrial output (Sep) • Retail sales (Sep)
	• Industrial profit (Sep): +11.9%yoy (Aug: +17.2%)	• Tue (31 Oct): NBS Mfg PMI, non-mfg PMI (Oct) • Wed (1 Nov): Caixin Mfg PMI (Oct) • Fri (3 Nov): Caixin Service PMI (Oct)
	• CB: Hungary cut -75bps to 12.5%. Hawkishness across the board with Chile cutting by 50bps to 9.0% but stopping FX purchases; Turkey continued to hike, +500bps to 35%, an unexpected hike in the Philippines, +25bps to 6.5%, after 6 months on hold • Korea Q3 GDP +0.6%qoq, 1.4%yoy (after +0.6%qoq and 0.9%yoy in Q2) supported by net exports and somewhat by consumption, investment lagged	• CB: Malaysia expected on hold at 3%, Colombia expected on hold at 12.5%, Czech on hold at 7%, close call on the timing of the first 25bp cut, Brazil to continue cutting (50bps) to 12.25% • CPI (Oct): Indonesia, Korea, Turkey, Mexico, Brazil, Peru, Poland • PMI (Oct) across countries • Q3 GDP data in Taiwan, Czech, Mexico, Peru

Upcoming events		
	US:	Tue: Employment cost index (Q3), Case-Shiller HPI (Aug), FHFA HPI (Aug), Conference Board consumer confidence (Oct); Wed: ADP emp change (Oct), ISM Manf index (Oct), JOLTS Job openings (Sep), FOMC announcement (1 Nov); Thu: Non-farm productivity (Q3), Unit labour costs (Q3), Weekly jobless claims (28 Oct); Fri: Average earnings (Oct), Non-farm payrolls (Oct), Unemp rate (Oct), Comp PMI (Oct), ISM Non-manf index (Oct)
	Euro Area:	Mon: EA Business confidence (Oct), Sp,Ge HICP (Oct); Tue: EA CPI (Oct), EA,Fr,Ge,It GDP (Q3), Fr,It HICP (Oct); Thu: EA,It Manf PMI (Oct), Ge Unemp (Oct); Fri: EA Unemp (Sep), It Unemp rate (Sep), Fr Industrial production (Sep)
	UK:	Mon: Mortgage approvals (Sep), Net mortgage lending (Sep), Consumer credit (Sep), M4 Money supply (Sep); Tue: BRC Shop price index (Oct); Thu: MPC announcement & MPR (2 Nov); Fri: Services & comp PMI (Oct), Nationwide HPI (Oct)
	Japan:	Mon: Unemp (Sep), Industrial production (Sep); Tue: BoJ announcement (31 Oct)
	China:	Tue: Manf & non-manf PMI (Oct); Wed: Caixin Manf PMI (Oct); Fri: Caixin services PMI (Oct)

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