Investment Institute Macroeconomics

Causes and FX

- The Fed will need more time – even if a softer GDP print is the first ingredient in a resumption of disinflation.
- Despite some green shoots of recovery, we side with Panetta's view: the ECB will need to diverge from the Fed.
- No easy choice for the BoJ – weak FX is of course a concern, but does it make sense to try to "run after the dollar"?

Among the rich dataflow of last week in the US, the market focused squarely on the higher-than-expected print for core inflation. As of last Friday, only one-and-a-half rate cuts by the Fed remain priced in for this year. The details of the PCE release brought no more relief than the overall number: services inflation rose again, while manufactured goods inflation moved back in positive territory, on a 3-month annualised basis, for the first time since June of last year. We expect Jay Powell this week to make it plain that the Fed is in no position to cut soon. We still expect the Fed to cut this year though (twice, starting in September), on the assumption that the softer than expected GDP print for Q1– below potential growth for the first time in nearly two years – points to the beginning of a lasting slowdown which would help re-start the disinflation process, especially given the tightening in overall financial conditions, with 10-year yields returning to levels unseen since last autumn.

Still, another dollop of "higher for longer" in the US has serious implications for the rest of the world. While cutting rates in June seems now quite consensual across the Governing Council, hawks may point at the risk of stoking imported inflation in the Euro area via currency depreciation if the ECB diverges too much from the Fed. Banca d'Italia Fabio Panetta made a powerful case for decoupling last week, pointing to the overall tightening in financial conditions which a Fed on hold would trigger for the rest of the world, and we explore in some details a paper Panetta referred in his speech which quantifies the spill-over effects of US monetary policy. We side with him in considering that the optimal reaction of a central bank facing lower inflationary pressure domestically and challenging demand dynamics should be to offset contagion from the US by cutting policy rates. The Bank of Japan is already facing acute pressure on its exchange rate, which has fallen below the levels which had triggered a FX intervention in 2022. The latest inflation data however vindicates Ueda's cautious approach to policy normalisation.

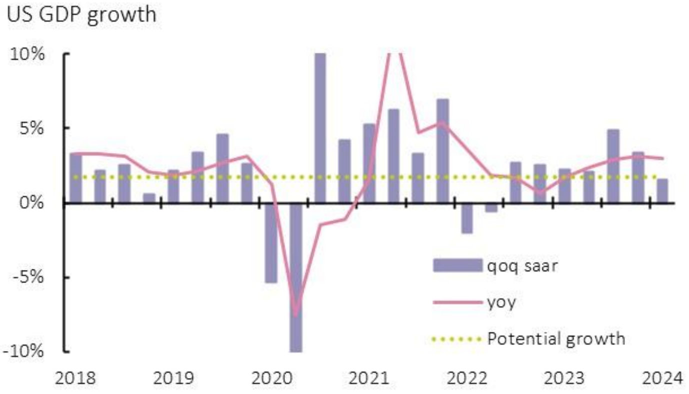
Too resilient inflation in the US – but the economy may be softening

The market reaction to the release of the first estimate of US Q1 GDP was unambiguous: focus was squarely on the additional bad news on the inflation front, as the core Personal Consumption Expenditure (PCE) deflator came out above expectations for the quarter (3.7% annualised against 3.4%).The not-insignificant miss on real growth (1.6% against 2.5%) was shoved aside. **Market pricing for the Fed trajectory jumped (again): only 35 basis points worth of cuts are now expected between now and the end of the year, against 44bps before the release.**

Core PCE rose by 4.4% on a 3-month annualised basis in March, the third acceleration in a row from a trough at 1.6% in December 2023. This can no longer be seen as a mere accident, the payback for faster than expected disinflation in the second half of last year. **The "race" between the price of manufactured goods finding its trough and services prices decelerating is being lost.** Indeed, services prices hit 5.5% on a 3-month annualised basis, the highest pace seen March 2023, while core industrial goods' prices returned their first positive reading in April since June of last year. Against this background, we agree that there is simply not enough time left, realistically, for the dataflow to provide the confidence the Federal Reserve (Fed) needs to engage in cutting in the near-future and we expect Jay Powell to make this clear at this week's press conference. He can simply draw on the points he made on 16 April: "*The recent data have clearly not given us greater confidence… it is appropriate to allow restrictive policy further time to work*".

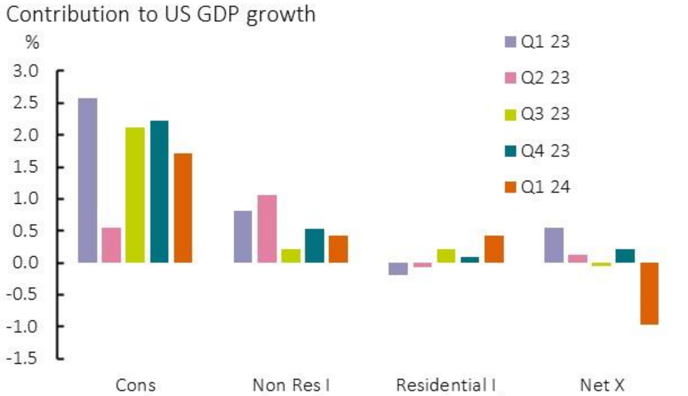
We would however note that at least the first ingredient in the usual sequencing for a policy reversal has showed up. Indeed, we would expect disinflation to come *after* a slowdown in economic activity. With GDP growth massively above trend in the second half of 2023, the conditions for swift disinflation in the first half of 2024 were probably not met. **For the first time since the beginning of 2022, GDP in Q1 has grown below the potential pace (1.75%)** which was consensus before the recent acceleration in productivity suggested it should be upgraded. The heat under the "pressure cooker" which the US economy has become could start to dial down (see Exhibit 1). Supply has been doing well lately – in particular thanks to strong immigration flows – and some softer demand could change the picture quite dramatically.

Exhibit 1 – Slightly below potential



Source: Bureau of Economic Analysis and AXA IM Research, April 2024

Exhibit 2 – Net exports did the trick



Source: Bureau of Economic Analysis and AXA IM Research, April 2024

Non-residential investment softened, following up on its fairly regular weaker trend since the beginning of last year. Consumption was softer than expected, even if the gains remain robust (see Exhibit 2). What could make the Fed more comfortable about the pass-through of the monetary tightening is the fact that household spending on durable goods – normally quite sensitive to monetary conditions – fell by 1.2% in Q1, by far the biggest quarterly decline since the end of the pandemic. A possible explanation would be that while there are more than enough flows of purchasing power to maintain strong spending on "day to day" services, there may be some harder thinking going on before committing to big ticket purchases which often entail some recourse to credit.

Monetary policy transmission remains questionable though, or to be more precise is taking some counter-productive forms. Indeed, residential investment – normally one of the most interest rate-sensitive component of GDP – surged in Q1 and has been on a fairly regular upward trend since the beginning of last year, despite typical mortgage rates exceeding 7% in the US. This probably continues to reflect a dearth of supply on the re-sale market, households preferring to hold on to their current property and the attached low interest-rate mortgages. Transactions in existing homes continue to languish around the 4 million marks, close to the lows seen during the Great Financial Crisis. Those who absolutely need to move are forced onto the new home market, where transactions remain in line with the historical average.

GDP growth would have remained comfortably above potential in Q1 without the **significant drag from net exports, which brought a negative contribution of 1% annualised, the worst performance since Q1 2022.** The strength of the dollar may finally be hurting significantly. This matters as well for monetary policy. True, the US is a less open economy than the Euro area for instance and it usually takes a lot for exchange rate considerations to start making their way to the Fed thinking, but that point may be close to being reached.

Still, all this remains too tentative. As usual **it is difficult, on the basis of a single quarterly print, to distinguish between pure "mean reversion" after two very strong quarters in a row and "proper" underlying deceleration in economic activity.** The first Atlanta Fed "nowcast" for Q2 – which of course needs to be taken with an even bigger pinch of salt than usual given its large miss in Q1 (the nowcast for last quarter settled at 2.7%) – came out at a very strong 3.9% annualised last Friday.

Nowcasting is very fragile so early in the quarter, with very few of the indicators counting towards the Atlanta Fed's estimate being already available. **The first "big piece of data" which will attract the market scrutiny on the underlying strength of the US economy this spring is going to be the payroll release this Friday**. As usual, surprises cannot be excluded with this heavily revised and volatile series but based on the weekly data for unemployment insurance claims, even with some mean reversion from the March bumper reading for job creation, a quite robust print is to be expected (the market is set on 250k, only moderately down from 303K in March).

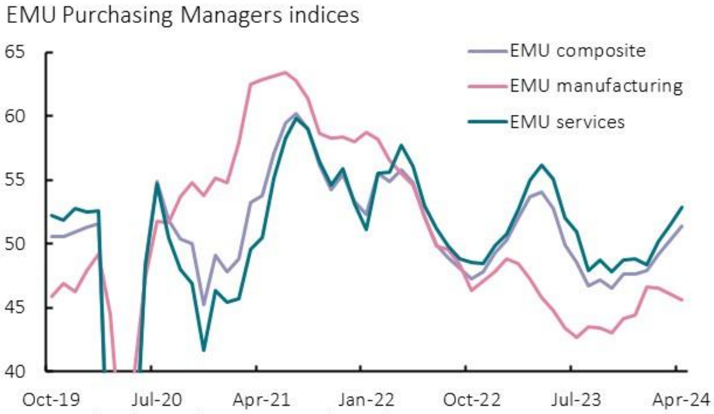
We will however focus less on employment numbers and more on wage developments, given their more direct information content for consumer prices. Robust job creation is coexisting with an easing in hiring difficulties when considering the continuing normalisation in vacancies. Together with the April print for hourly pay in the payroll release, we will take a hard look at the Employment Cost Index for Q1 2024, released this Monday, a "purer" gauge of labour cost dynamics. The market consensus has it slightly accelerating, from 3.6% annualised in Q4 to 4% in Q1. Although 4% wage growth, given strong productivity gains, is not far from being consistent with a return to 2% core inflation, Federal Open Market Committee (FOMC) members are likely to be more sensitive to changes in speed and would probably want to see a deceleration.

Yet, **on the assumption that Q1 GDP points to the beginning of a lasting slowdown in the US, we still expect the Federal Reserve to be able to cut in September** and provide another one before year-end. The longer the Fed maintains its current restrictive stance, the higher the probability it will exert enough pressure on aggregate demand to produce the required reduction in inflation, especially if markets properly transmit the Fed's signals. From this point of view, 10-year yields climbing back to levels unseen since the autumn of last year is positive. This is a point we made repeatedly when the market was overly enthusiastic about the quantum of rate cuts we could expect from the Fed this year: there is a feedback loop between market pricing and policy reaction, since too favourable aggregate financial conditions stand in the way of the landing of the real economy necessary to bring about disinflation. This may be changing. Yet, the consequences for the rest of the world of another dollop of "higher for longer" are likely to be significant, especially for those who are not enjoying the same positivity in their real economy.

Is the Euro area finally perking up?

True, **some "green shoots of recovery" are emerging in the Euro area**. The composite Purchasing Managers' Index (PMI) rose to 51.4 in April, the second month in a row in expansion territory after 8 months of contraction (see Exhibit 3). Services are leading the way. This would vindicate the European Central Bank (ECB)'s belief in what would be essentially a domestically led recovery. In a way, Europe would now benefit from some of its rigidities, i.e., the stickiness of wages. Indeed, while nominal wages have started to decelerate – this was the message from negotiated wages in Q4 2023 and real-time indicators suggest this has continued into the beginning of this year – they are now outgrowing consumer prices, freeing up purchasing power and lifting consumption.

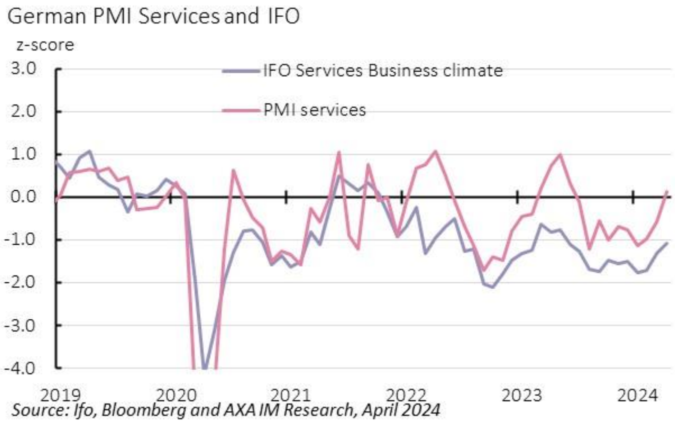
Exhibit 3 – In expansion territory twice in a row



Source: Bloomberg and AXA IM Research, April 2024

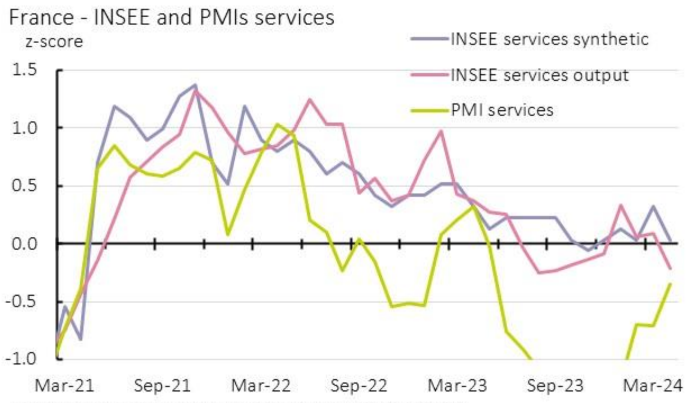
Prudence is of the essence though, as the PMI survey's recent performance in predicting GDP growth has been poor. For Germany, cross-checking the PMI message with the IFO survey provides some reassurance, since both indicators point to an improvement, but the level of activity remain depressed in German services according to IFO, with a reading for April still one standard deviation below the long-term average (see Exhibit 4). For France, the message is even divergent. The PMI points to a sharp rebound from depressed territory – the latter at odds with still positive GDP growth in the second half of last year – while the INSEE survey, which had remained close to its long-term average in the services sector, has softened in April.

Exhibit 4 – Same direction, different levels



Source: Ifo, Bloomberg and AXA IM Research, April 2024

Exhibit 5 – Divergent message



Source: INSEE, Bloomberg and AXA IM Research, April 2024

We agree with the scenario of a continuation of the improvement in purchasing power, which effect on consumption will be compounded by the resilience in employment prospects helping to avoid another hike to the savings ratio. Yet, we think **the current surveys do not yet take the full account of the more restrictive fiscal stance which is taking hold**

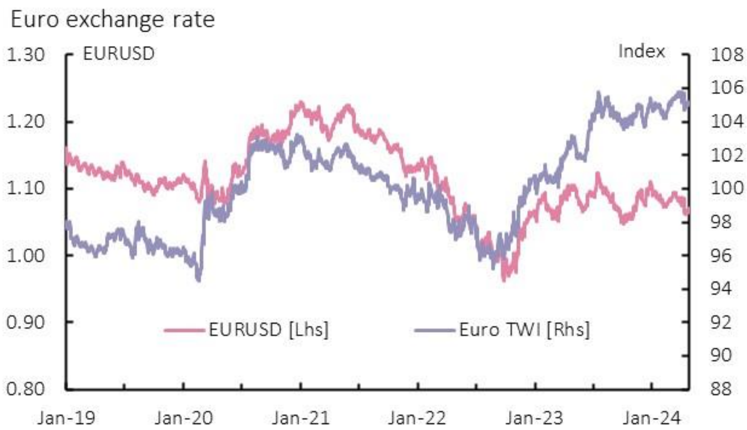
across the Euro area. GDP growth for Q1 will be released this week and we expect a slightly positive reading (0.1%qoq), but we are reserved as to the extent of any subsequent acceleration.

True, those fiscal, domestic headwinds may be offset by an improvement of external demand as the global manufacturing cycle turns. Bundesbank President Nagel in a speech last week expressed his confidence in such outcome, and better than expected readings for industrial production at the beginning of 2024 in Germany may be indicative of a turnaround. We explored in Macrocast a month ago the encouraging signs coming from orders to Taiwan – the world's biggest producer of chips, and hence a leading indicator of global activity in manufacturing – and more generally it may simply be that the payback from the surge in spending on manufacturing during the pandemic has finally run its course.

An issue though is **how much of such general turnaround would benefit production based in the Euro area**. Some of the losses in market shares suffered by Germany-based producers at the peak of the surge in energy prices have not reversed – the off-shoring flows by German companies towards locations offering lower energy prices have been adding to this. We discussed two weeks ago how the "New Productive Quality" strategy unveiled by Beijing could lead to another rise in the share of China in world trade. We think this is one of the aspects of the conversation currently emerging on the degree of divergence between the ECB and the Fed which could be acceptable, given the knock-on effects on the exchange rate and competitiveness.

Indeed, **while cutting in June now seems to be a matter of consensus across the Governing Council, the debate has moved to the speed of accommodation after this first step**, with doves and hawks in explicit disagreement. The latter focus on the rebound in imported inflation which an excessive divergence from the Fed would bring about through the exchange rate. Yet, as Exhibit 6 makes it plain, while the bilateral euro exchange rate against the dollar has been on the weak side, in trade-weighted terms the European currency has been for some time well above its pre-Covid level. In other words, it is the dollar that is strong (against virtually every other currency), not the euro that is particularly weak. **A weaker currency is precisely what the Euro area needs now to foster its recovery and avoid falling back into too low inflation.**

Exhibit 6 – The euro is not that weak actually….



Source: Macrobond, Bank for International Settlements and AXA IM Research, April 2024

In a speech last week, **Banca d'Italia Governor Fabio Panetta – often a spokesperson for the doves on the council – made a powerful point**: *"If markets expect interest rates to drop but the Fed keeps them unchanged (for instance on the back of strong inflation data), the rest of the world faces an unexpected monetary tightening. And a tightening in the US has a negative impact on inflation and output in the euro zone*". He referred to a paper by Degasperi, Hong and Ricco (see link here) which provides a very useful quantification of the potential effects of US monetary policy for the rest of the world.

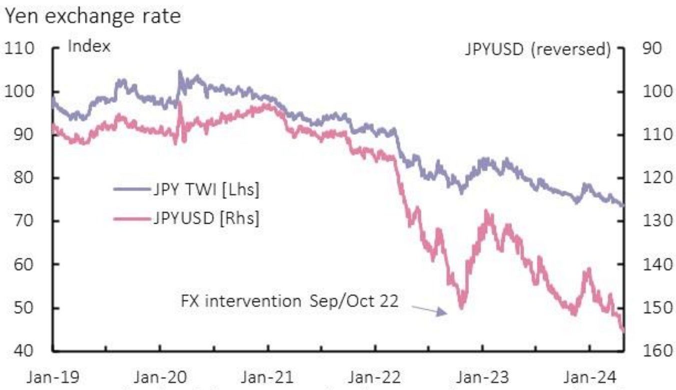
One of the usual channels through which Fed hikes can affect other economies is the contraction in US demand, lowering exports elsewhere. The adverse demand channel is normally at least partly offset by the depreciation of the foreign currencies, which in turn lifts their price level, but this can be thwarted by reactionary monetary tightening outside the US. The paper suggests an overall sensitivity of 0.3 of foreign central banks to Fed's moves – in clear, on average, foreign central banks lift their policy rate by 30bps for every 100bps hike by the Fed. The authors also integrate in their analysis the global balance sheet rebalancing which would ensue, following Helene Rey's famous framework from 2015. To quote them directly, "*the US monetary policy shock also moves the long end of the foreign economy's yield curve, which reduces the effectiveness of domestic monetary policy*". This is the usual financial contagion effect. **When taking all these channels together, in their model a monetary policy shock of 100bps in the US would lower industrial production by 1.5% on average in Organisation for Economic Co-operation and Development (OECD) countries outside the US**. We note that such shock would not be different in size from the current revision in market pricing from 6 to 2 cuts in 2024.

Of course, one would have to consider the reasons behind such revision: if the Fed ultimately cuts less – or not at all – than previously expected at least partly because economic activity in the US is proving more resilient, then the adverse effects through the trade channel would be limited. Yet, the contagion effect through the longer end of the curve would remain. Then, **the optimal response from a foreign central bank facing fading domestic pressure on inflation and challenging conditions on the real economy would consist in offsetting the drift in long-term yields with cuts on the short end of the curve**. Our baseline remains that, while we have pushed our expectations for the stance reversal by the Fed, the ECB should still cut three times this year.

BoJ between a rock and hard place

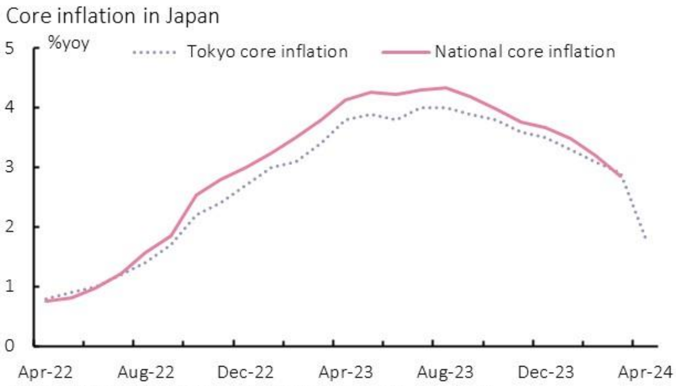
The ECB is not the only central bank having to address these interactions with the Fed. **The Bank of Japan (BoJ) last week came into focus as it delivered a cautious message about the speed of its ongoing monetary policy normalisation.** While Ueda last week indicated that the BoJ could bring back its policy rate to a neutral level – estimated at c.1% in nominal terms according to research by the central bank itself – in 2025, higher than what the market is currently pricing, this message was drowned in the overall prudence he displayed on the macro outlook. While the recent agreement on negotiated wages (the most generous deal since 1994) confirmed it was time to start normalising, the BoJ still wants to monitor how it will materialise in actual pay developments and further down the pipeline to consumer prices. Separately, the BoJ did not explicitly mention again a quantum of purchases on the bond market, but since it refers to last month's statement, the message remains that the central bank wants to maintain some control on the long end of the curve.

Exhibit 7 – JPYUSD below past intervention level



Source: Macrobond, Bank for International Settlements and AXA IM Research, April 2024

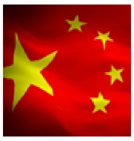
Exhibit 8 – Negative surprise on inflation



Source: Japan Statistics Bureau and AXA IM Research, April 2024

Unsurprisingly, such cautious overall message contrasting with the Fed's change of tone triggered another decline in the yen exchange rate below 152 against the dollar, a level hit just before FX intervention by Japan in September and October 2022 (see Exhibit 7). A difference though with 2022 is that inflation was on its way up then (see Exhibit 8). Now, the additional bout of exchange rate weakness coincided with core inflation in the region of Tokyo, coming out before the national index, falling much more than expected. The decline in inflation in April in Tokyo was to some extent the idiosyncratic product of a change in school fees, but this one-off cannot explain all the deceleration. This vindicates Ueda's prudence on whether inflation is now indeed well anchored around the central bank's target.

For Japan as well a "feedback loop" between the relative monetary stance, the exchange rate, and the inflation/growth trade-off is at work. The latest cyclical indicators point to decent economic activity – the composite PMI is in expansion territory there as well – but some of the recent improvement comes from a strong performance of exports (+9.3%yoy in March 2024) which probably at least to some extent can be explained by the depreciation of the yen's trade-weighted index. While obviously the weakness of the yen versus the dollar adds to the country's energy and raw material bill, Japan remains probably ambivalent when it comes to intervening directly on the FX market if the Fed continues to find itself in a very peculiar position relative to the other G7 central banks. We would also highlight the role of China here: given how central this market has become for Japanese producers, paying exclusive attention to the Fed in a situation in which Beijing would choose to decouple and let its own currency weaken, could be very detrimental to the Japanese recovery. Of course, if the depreciation gathers such speed that financial stability in Japan would come under pressure, intervention will become unavoidable, but its chances of success would be limited given the strength of the *fundamental* reasons which put the US currency in a very strong position now.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• GDP (Q1, p) slows to 1.6% (saar) weakest since H1 2022, although final domestic sales firmer • PCE inflation (Mar) +0.3%m/m (& core); Jan revisions see Q1 firmer overall as flagged in GDP • PMI (Apr, p) mfg and services both weaken • New & pending home sales (Mar) +8.8% and 3.4%mom, explains 14% (saar) rise in Q1 resi investment	• FOMC meeting. No change in FFR policy and no tangible guidance to next move in absence of forecasts. Expect QT announcement in June • Payrolls (Apr) Mar's was v strong, expect sub-250k consensus but trend has been upside surprise • ISM (Apr) mfg has had rising trend, services softer • Conf Bd cons conf (Apr) last two reports weakened
	• Euro area composite PMI output gained 1.1pts to 51.4 in April suggesting improved activity momentum at the beginning of Q2 • Meanwhile, eurozone flash consumer confidence remained stuck at low level in April (-14.7)	• We forecast euro area Q1 GDP to grow by 0.1%qoq in Q1 • We forecast headline and core HICP to come at 2.4% (unch.) and 2.6%yoy (-0.3pp) respectively • European Commission monthly (April) & quarterly business survey (Q2)
	• The composite PMI rose to 54.0 in Apr., from 52.8 in Mar., above expectations 52.6 • PSNB ex. banks was £11.9bn in Mar., higher than the expected £10.2bn, but £4.7bn below Mar. 2023 • GfK consumer confidence up to -19 in Apr., from -21 in Mar.	• House purchase mortgage approvals likely ticked up to 61K in Mar., from 60.4K in Feb. Consumer credit looks set to increase by £1.5bn in Mar. $ • Nationwide house price growth likely fell by 0.7%yoy in Apr. but that reflects base effects
	• The BoJ made no changes to policy at April's meeting. Cautious stance about policy adjustments maintained • Tokyo CPI inflation dropped to 1.6% in April, below expectations of a fall to 2.2%. Not all weakness reflects waving of student fees	• USDJPY fell to 156.77 following the BoJ last week. Growing likelihood gov. intervene • Unemp. rate likely ticked down to 2.5% in Mar. • IP looks set to rise 3.5% mom. In Mar. • Retail sales likely fell to 2.2% on a yoy basis in Mar, from 4.6% in Feb.
	• PBoC held the 1Y and 5Y LPR unchanged for April, currently at 3.45% and 3.95% respectively	• 27 Apr: Industrial profit (Mar) • 30 Apr: NBS manufacturing PMI and non-Mfg (Apr) • 30 Apr: Caixin manufacturing PMI (Apr)
	• CB: Indonesia hiked +25bps to 6.25% & Turkey (50%) stood on hold. Hungary cut -50bps to 7.75% • Q1 GDP accelerated to 3.4%yoy in Korea • March industrial production (yoy): Poland (-6.0%), Russia (4.0%) & Taiwan (4.0%) • March inflation steady in Malaysia at 1.8%yoy	• CB: Czechia expected to cut -50bps to 5.25%. Colombia to cut 50bps to 11.75% • Q1 GDP: Czechia, Hungary, Mexico & Taiwan • April inflation: Indonesia, Korea, Poland, Peru & Turkey • PMI figures across countries

Upcoming events		
	US:	Tue: Employment cost index (Q1), Case-Shiller HPI (Feb), FHFA HPI (Feb), Chicago PMI (Apr), Conference Board consumer confidence (Apr); Wed: ADP emp change (Apr), ISM mfg index (Apr), JOLTS Job openings (Mar), FOMC announcement; Thu: Non-farm productivity (Q1, p), Trade balance (Mar),Unit labour costs (Q1, p), Weekly jobless claims (27 Apr), Factory orders (Mar); Fri: Non-farm payroll (Apr), Unemp (Apr), Average earnings (Apr), Average weekly earnings (Apr), Services PMI (Apr), ISM non mfg index (Apr)
	Euro Area:	Mon: Ez Business confidence (Apr), Ge&Sp HICP (Apr,p); Tue: Ez, Fr, It HICP (Apr,p), Ez,Ge,Fr,It,Sp GDP (Q1,p); Thu: It&Sp Mfg PMI (Apr); Fri: Ez Unemp (Mar), Fr Industrial production (Mar), Fitch reviews Italy's credit rating
	UK:	Tue: Post-Brexit physical checks on some imports to come into effect, BRC SPI (Apr), Mortgage approvals (Mar), Net mortgage lending (Mar), Consumer credit (Mar), M4 money supply (Mar); Wed: Mfg PMI (Apr); Thu: Local & mayoral elections and Blackpool South by-election; Fri: Composite & services PMI (Apr)
	Japan:	Tue: Unemp (Mar), Industrial production (Mar, p)
	China:	Tue: Official non-mfg & mfg PMI (Apr), Caixin mfg PMI (Apr)

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