New Year, Still Impatient Markets

- The ECB probably found itself vindicated by the core inflation data last week
- Market is now looking at the US economy as a glass half full. The Fed may take away the proverbial bowl of punch
- The House of Representatives finally getting a Speaker does not extinguish the US institutional fire

Another acceleration in year-on-year core inflation in December in the Euro area probably solidified the ECB's hawkish line unambiguously expressed in December. When controlling for base effects, the picture is a bit less concerning – on a 3-month basis, core inflation has decelerated from a peak in September – but the central bank is probably finding more reasons to continue hiking at a fast clip as surveys suggest the real economy is more resilient than feared. If the economy does not "slow down enough" on its own, as the Euro area is dealing better than expected with the end of Russian gas supply, then aggregate demand would need to be nudged further down by more monetary tightening to take inflation decisively down.

By contrast, the latest US surveys suggest the economy is softening quite fast over there. This probably contributed to the market choosing to ignore still robust job creation in December to focus on an unexpected slowdown in wages and the decline in working time. We continue to be uncomfortable with the market pricing though. Forwards have the Fed's terminal rate below 5% again for June 2023, and price 50bps worth of cuts, instead of 25 earlier last week. For now, signals of labour market softening are still indirect. The Fed is likely to focus on traditional indicators, such as the unemployment rate, which has just hit its lowest level in 53 years. Besides, the Fed may consider it is forced to "offset" the market's reluctance to respond to its signals by more actual tightening. Our simple Index of Financial conditions has already loosened by 75bps relative to a peak in late October/early November. Corporate spreads have declined. The Fed may consider that not enough of its monetary tightening is finding its way to the corporate sector.

Finally, we look at the US Congressional dysfunction, which is not put to rest by Kevin McCarthy finally winning enough votes to become Speaker of the House. We should brace ourselves for another debt ceiling drama this year.

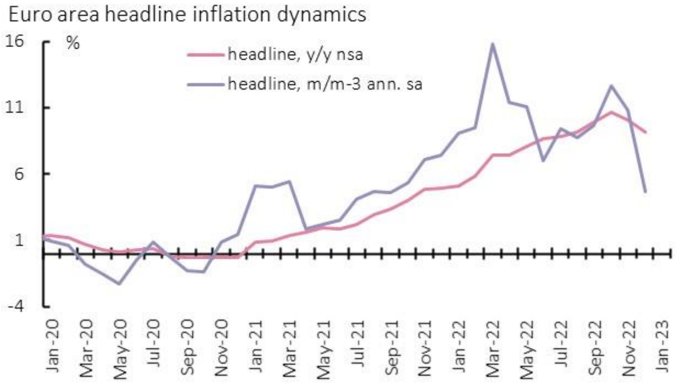
Stubborn core inflation in the Euro area

Disinflation can be a very choppy ride. While in the United States (US), the November print for Consumer Price Index (CPI) had brought unmitigated – albeit potentially temporary – pre-Christmas relief, as both headline and core inflation surprised to the downside, **the news flow on the European side starts 2023 with a still concerning message.** While the decline in headline inflation for December was steeper than expected (nearly one percentage point down relative to November, at 9.2%yoy), thanks to the significant drop in retail energy prices, core inflation accelerated from 5.0% to 5.2%, suggesting that price pressure continues to widen.

As usual, we like to vary the angles to avoid being tricked by base effects, and we look at 3-month annualized growth rates on top of the traditional year-on-year metric, using the European Central Bank (ECB)'s seasonally adjusted series (see Exhibits 1 and 2). **This sends a less worrying signal on core, with some visible deceleration in core inflation from a recent flare-up in late summer.** A peak was hit 7% in September, to fall back to 5% in December. Still, an ECB hawk would probably focus on the fact that core inflation has stood firmly above 4% for months, twice the central bank's target.

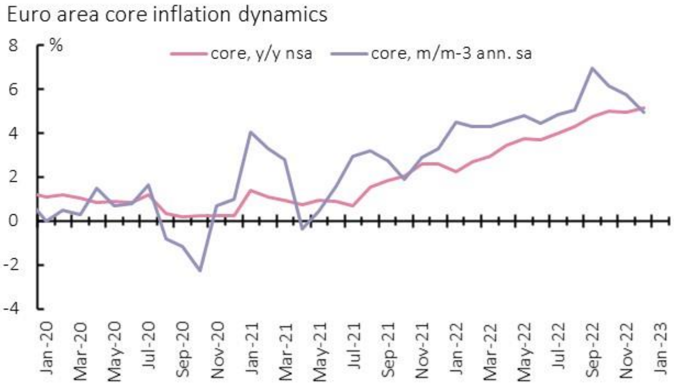
An optimistic reading of the European situation would take comfort in transmission lags. The energy- sensitive components of the core inflation basket may take time to respond to the drop in gas and electricity prices. We could thus expect a more significant slowdown into the first quarter of 2023, assuming of course weather conditions continue to hold wholesale prices down. This is not a done deal however, since some governments will reduce the scope of their energy price mitigation measures into the new year. Yet, even if energy prices continue to provide relief on core an element of concern lies on the fact that retailers appear to be still able to pass the rise in their energy costs to consumers, instead of absorbing it in their margins. This, together with some signals wages are accelerating – albeit moderately in most countries - would fit in the hawks' narrative of the necessity to curb aggregate demand further. Indeed, the new ECB mantra could be summarized as "if we are powerless to deal with (lower) supply, we can still take demand down to control prices". Not a great combo for growth, but to use an old saying by Jean-Claude Trichet, the ECB has "only one compass: price stability".

Exhibit 1 – Headline inflation down



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

Exhibit 2 – For core, it depends on the metric…



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

The hawkish ECB stance of the December meeting is thus likely to persist. The two 50bps hikes of February and March to 3% are probably anyway "in the bag". Given the clarity of the signals sent at the last press conference, it would take massive changes in the dataflow to alter the central bank's course. But what we found intriguing in the latest speech by Banque de France Governor Villeroy de Galhau – who so far has steered clear of the hawks' line – was his point about reaching the terminal rate "by summer". While his mention of avoiding "*getting fixated on overly mechanical rate hikes*" suggests some flexibility from the current 50bps quantum, his timeline could be as consistent with a 4% terminal rate as with the 3.5% priced in by the market and our own 3.25%.

The ECB is starting 2023 on a definitely hawkish footing. **Maybe this readiness to "talk tough" is a result of the resilience of the real economy**. Indeed, since the Euro area is dealing better than expected with the end of the Russian gas supply, the magnitude of the "spontaneous" slowdown in economic activity – which would help control inflation – needs to be revised down. The latest Purchasing Managers' Index (PMI) print would indeed point to a less dramatic Q4 2022, reaching 49.3 in December for the composite index, still in contraction territory but much less depressed than at the beginning of the autumn and hitting its highest level since August. **If the economy does not "slow down enough" on its own, then aggregate demand would need to be nudged further down by more monetary tightening.**

US economy finally softening…but how quickly can it sway the Fed?

The recent resilience in the Euro area real economy is all the more remarkable that surveys are pointing to a quite steep pace of deterioration in the US. The Markit PMI index is now lower in the US than in the Euro area in both services and manufacturing (see Exhibit 3 and 4). The US ISM index (which has a longer history than its Markit equivalent and is usually more commented) remains higher but is also now in contraction territory in both sectors in December – unfortunately it can't be directly compared with the European PMI. It seems that the US economy is – finally – softening, which should bring some comfort to the Federal Reserve (Fed).

Exhibit 3 – Down everywhere, but lower in the US

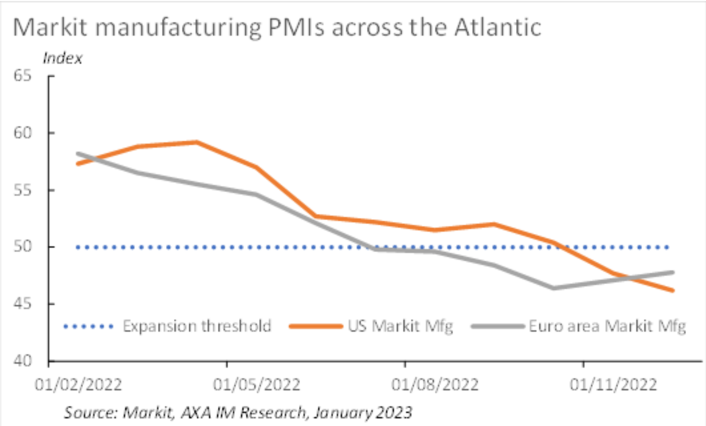
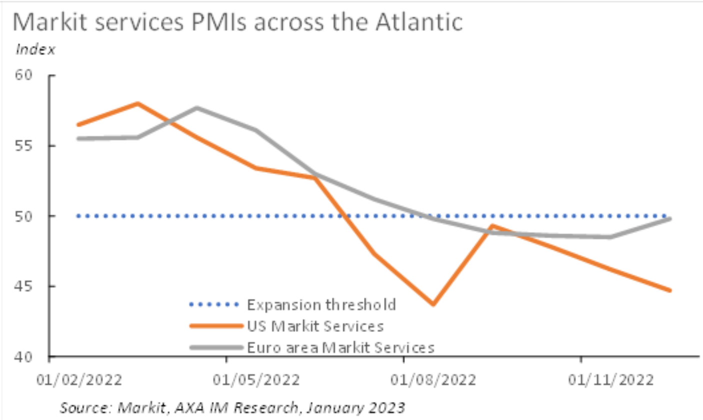


Exhibit 4 – Surprising services resilience in Europe



However, there does not seem to be much transmission of this weakness in economic activity to the labour market. With 220k job creation in the private sector in December 2022 according to the establishment survey, the pace remains robust within a gently downward trend (see Exhibit 5). Crucially, job creation, on a three-month annualized basis, was in December 2022 still above the pre-pandemic pace. Meanwhile, wage growth has surprised to the downside in December, continuing the slight deceleration seen since the spring, but again earnings are still growing faster than in the years before the pandemic (see Exhibit 6).

Exhibit 5 – Job creation slowing, but not enough

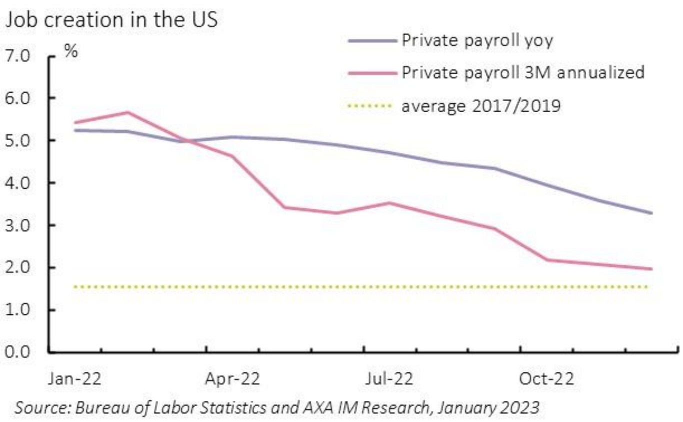
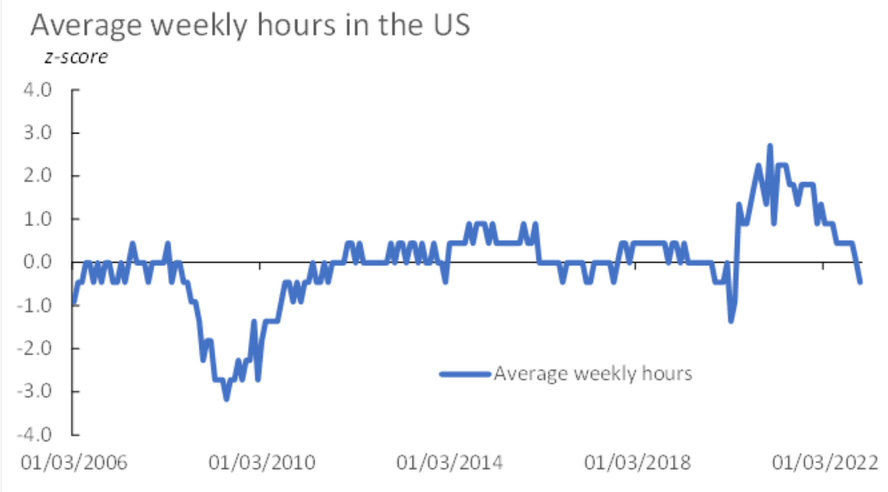


Exhibit 6 – Wages slowing as well…somewhat

Yet, last Friday the market chose to focus on the downside wage surprise and US long-term interest rates fell markedly. Forwards were pricing a terminal rate for the Fed above 5% in June 2023 (5.06% on Thursday afternoon), but they went back to 4.95% after the payroll release, while 50bps worth of cuts by the end of 2023 were priced again, up from 25bps only on Thursday afternoon, in direct contradiction with the clear messages sent by the Fed, affirmed last week again with the release of the minutes of the December meeting.

The readiness of investors to "bet against the Fed" probably stems from a fundamental difference of analysis on the state of the economy. At the end of last year, the chatter was focusing on the gap between the household and the establishment surveys to suggest that the headline payroll numbers were overstating the tightness of the labour market – we agree. This time the "variable of interest" is the data on weekly working time. Indeed, in December, Americans worked for the lowest number of hours (34.3) since April 2020. Working hours were half a standard deviation *below* their long-term average (see Exhibit 7). **Judging by this piece of data, the US labour market could be in "stage 1" of contraction, where businesses respond to an actual or expected decline in demand by reducing working time, before cutting headcounts.** Winter is coming, but not just yet.

Exhibit 7 – Americans have more time on their hands…



Source: Bureau of Labor Statistics, AXA IM Research, January 2023

This week, the market expects more good news in the form of another decline in core inflation, seen (according to Bloomberg consensus) as falling to 5.7% year-on-year in December, down from 6% in November. There was evidence of significant holiday discounts last months as retailers were trying to offload excess inventories (this would explain the 3.4% year-on-year decline in spending on typical holiday items recorded by Bank of America, using its credit card data). If this materialises, the bond market is likely to rally further.

The crucial question however is whether any of this would be enough to sway the Fed out of its current preferred trajectory. The first test would consist in reducing the quantum of hike at the next meeting, and while we expect another notch down to 25bps, we continue to be impressed by the hawkish noises coming from the Federal Open Market Committee (FOMC). As we have often argued in Macrocast, there is always a "psychological cost" to changing stance, especially if the central bank believes it has made a mistake in the recent past by mis-interpreting the inflation spike as a purely transitory phenomenon. The burden of proof is heavily tilted against the doves. Betting on significant cuts in the second half of this year is "brave" in our view.

For now, the data pointing to a significant decline in inflationary pressure is only *indirect.* **The Fed may be intrigued by the drop in working time, but it's highly likely that they remain impressed by the strength in the traditional variables – the unemployment rate in December reached its lowest level (3.5%) in 54 years** – and will want wage growth to fall back to a pace consistent with core inflation returning to 2%, and for this there is still a good percentage point to lose.

Another issue for us is that the Fed may consider it is forced to "offset" the market's reluctance to respond to its signals by more actual tightening. Early last year the central bank was visibly increasingly worried by the market's inability to tighten financial conditions in a way which would bring about the cooldown in demand it deemed necessary. This probably played a major role in the FOMC's decision to move to "brutal" hikes at the time. We could see something similar developing there. **Since a peak in late October/early November 2022, our simple Index of Financial Conditions has loosened by nearly 75 basis points**. Indeed, beyond the recent retreat in risk-free interest rates, the spread between 10-year Treasury yields and 10-year BBB-rated corporate bonds has declined from a peak at 255bps in mid-October to 213bps at the end of last week. **The Fed may consider that not enough of its monetary tightening is finding its way to the corporate sector.** This is one of the reasons which make us think that the market remains too impatient on the elusive "dovish pivot".

Congressional dysfunction – it's not over

Among the "issues of interest" for the bond market in 2023, the level of congressional dysfunction should probably rank relatively high. True, Kevin McCarthy was finally elected Speaker of the House, which allows for a resumption of the legislative process in the US, but more volatility could come. As part of the concessions to the right of the Republican caucus, the threshold to request another vote on the Speaker has been taken down from 5 Representatives in McCarthy's initial offer to only one (the current rule inherited from the former Democratic majority is that it takes half of the caucus of one of the parties to set up a motion to "vacate the chair"). This suggests that McCarthy – just like his two Republican predecessors – is going to be faced with the constant threat of losing his job and given the difficulty to agree on a replacement amid deep divisions within the party and the tiny majority it holds in the House, institutional paralysis could ensue.

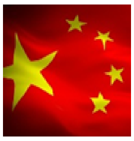
True, most of Biden's legislative agenda has been exhausted by now – or proved to be unsellable even with a Democratic majority in the two houses - but there is again some chatter about the possibility of another "debt ceiling drama" getting us back to the 2011 crisis under the Obama administration which had triggered a downgrade of US debt, even if a last-minute agreement had been reached. According to the Washington Times, McCarthy had to toughen up his stance on the debt ceiling to finally get enough holdouts to support him.

These concerns have resurrected the "14th amendment issue". Indeed, one of the provisions of the amendment ratified in 1868 in the context of the post-Civil War reconstruction stated that *"validity of the public debt of the United States, authorized by law, including debts incurred for payment of pensions and bounties for services in suppressing insurrection or rebellion, shall not be questioned."* Some scholars have argued that this gives cover to the President to ignore the debt ceiling if Congress fails to agree on another increase in the leveraging limit of the US. This would offer an exit from a potential constitutional quandary. Indeed, the only alternative to default would be to switch off payments on other items of federal expenditure to make good on debt – probably triggering a massive adverse shock to economic growth - but by doing so, the President would then fail to discharge his duty to execute spending bills duly voted by Congress. It's a hotly discussed view in academic circles, and your humble servant would not dare to venture into the merits of the various positions. But we can look for precedents.

Previous US Presidents faced with this issue have taken different views. President Clinton indicated in 1997 that he would not hesitate to instruct the Treasury to continue borrowing, basically defying the Republicans to challenge him in Court. President Obama took a different view, his press secretary explicitly noting at the time that there is no firm ground for the Executive branch to ignore a "decision" by Congress not to extend the debt ceiling. Yet, the concessions that Obama was forced to offer to the Republicans to get a compromise left a bitter taste among Democrats – and Biden must count with his own hardliners on the left of the Democratic party. **Given the starting point of some of the Republicans – demanding cuts to historic welfare programmes such as Social Security and Medicare in exchange for another rise in the debt ceiling – negotiations would be tough.**

Sadly, the two sides probably have to allow the drama to climax and get us to the brink before finding a deal. Former Republican Speaker Boehner's "method" to deal with his party's dysfunction was to ostensibly put the right wing's positions on the agenda, until he could prove they would never reach a majority, before moving to a more moderate and politically realistic line. There was only so far, he could go however with that approach. The fact that he had to ultimately resign from his position is ominous for McCarthy, and so is the fate of Paul Ryan – who replaced Boehner: he left politics altogether despite his presidential ambitions. Meanwhile, the Democratic side has a strong interest in painting their opponents as extremists who take risks with financial stability. After all, they managed to expand their majority in the Senate and lose the House by only a small margin by getting the support of many centrist voters put off by the hardliners in the GOP ("Grand Old Party" – Republican Party's nickname). This is not going to incentivize them to cut deals too quickly. The Treasury has not provided clear guidance as to when the debt ceiling issue could come back in 2023, but press reports converge towards the middle of the year for yet another showdown.

True, the market has become somewhat "blasé" when it comes to those Congressional shenanigans, since "in the end" a solution has always been found. The fact that Joe Biden has 50 years of experience of dealing with Congress – and displayed his tactical skills in the first two years of his tenure – probably is a source of comfort, and yes, the baseline should be that, as usual, a solution will be found. Still, while habitual readers of Macrocast will know that your humble servant is quite positive on the long-term economic prospects of the US, its Achilles heel lies squarely in its entrenched institutional dysfunctions.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• US labour report (Dec), payrolls rose by 223k and unemployment fell to 3.5%. Earnings were revised lower in Nov and up 0.3%mom in Dec. • FOMC minutes (Dec) repeat hawkish end-yr meet. CPI may not fall enough; no members expect cuts in 23 • House sets post-civil war record to elect new speaker • ISM mfg (Dec) fell to 48.4, around cyclical lows of last two decades, excluding outright recessions	• CPI (Dec) – another soft print expected as energy eased further, but more focus on pace of core deceleration • House speaker necessary for usual functioning of government: new speaker will start from weak position • U Mich consumer sent (Jan, p) continued gains as inflation and particularly gasoline costs fall • NFIB survey (Dec) expected to remain subdued
	• Flash Dec EMU headline HICP at 9.2%yoy (-0.9pp from Nov), driven down by reimbursement of German Dec gas bill and lower wholesale energy prices. Core HICP at 5.2%yoy (+0.2pp) could fuel hawkish comments • Final PMIs upgraded for Svcs (49.8 from 49.1), Comp Output too (49.3 from 48.8). Dec EC surveys report rising economic sentiment in both Mfg and Svcs, and lower consumer inflation and selling price expectation	• Nov EMU industrial production (IP). Ge IP is expected to be flat (weakness of energy intensive companies probably compensated by other sectors such as cars). Worth to see how other countries are coping with this • Nov EMU Urate is expected to be flat at 6.5%, highlighting the resiliency of the economy • Details from Dec final HICP across countries
	• Widespread strikes, particularly rail, led to disruption • PM Sunak and Lbr's Starmer gave New Year speeches including alternative means to manage strikes • Services PMI (Dec) 49.9 – close to prelim (50.0) • BoE mtg approvals (Nov) slumped to 46.1k, a 2011 low excluding the pandemic	• GDP (Nov) expected to weaken after post-Queen's funeral bounce of +0.5% in October • Monthly output across sectors – energy output may be key bright spot • BRC sales monitor (Dec), first read of Xmas consumer spending, expected soft
	• BoJ' comments remain scrutinized after surprising move to widen YCC to [+/-0.5%] • Dec final PMI Mfg flat at 48.9 (-0.1p from Nov), Svcs above 50 threshold at 51.1 (-0.6p) • Dec consumer conf rose for the 1st time since Aug	• Dec CPI Tokyo is a good leading indicator for nationwide. We expect another rise in Dec, driven by robust core and rising food prices
	• PMIs show a further deterioration of growth momentum in December • COVID wave appears to have passed the peak in some regions, leading to a recovery of social, mobility and economic activities • Markets continue to look pass the near-term struggles and trade on future recovery	• CPI (Dec) to show muted price pressure while factory-gate prices continue to fall on a yoy basis • Both exports and imports (Dec) expected to decline on waning external and domestic demand • Credit growth should accelerate in December reflecting policy easing
	• CB: Poland kept its policy rate on hold at 6.5% • Annual inflation (Dec) fell in Poland (16.6%) & Turkey (64.3%). It rose in Indonesia (5.5%), Colombia (13.1%), Peru (8.5%), Philippines (8.1%) & Taiwan (2.7%) • Asian PMIs contracted in export-oriented countries while it rose in India, Indonesia & Philippines. CEE PMIs increased but remain in contractionary territory	• CB: Korea is expected to hike +25bp to 3.50% & Romania +25bp to 7.0% • Annual inflation (Dec) data in Brazil, Czech Rep, Hungary, Mexico, India, Romania & Taiwan • Industrial prod. (Nov) figures in Hungary, India, Malaysia, Mexico, Turkey & S. Africa

Upcoming events		
	US:	Tue: NFIB small business optimism (Dec), Wholesale inventories (Nov); Thu: CPI (Dec), Weekly jobless claims (7 Jan); Fri: Michigan consumer sentiment & inflation expectations (Jan)
	Euro Area:	Mon: EU19 Unemployment (Nov), Ge Ind. prod. (Nov), It Unemployment (Nov); Tue: Fr & Sp Ind. prod. (Nov); Fri: EU19 Ind. prod. (Nov), Ge 2022 GDP, Fr HICP (Dec), It Ind. prod. (Nov), Sp HICP (Dec)
	UK:	Tue: BRC Retail Sales Monitor (Dec); Fri: Monthly GDP (Nov), Indx of services (Nov), Ind. prod. (Nov), Manf. output (Nov), Construction output (Nov), Total trade balance (Nov), Trade in goods (Nov)
	Japan:	Wed: Leading indx (Nov), Trade balance (Nov), Current account balance (Nov); Thu: Economy Watchers Survey (Dec)
	China:	Thu: CPI (Dec), PPI (Dec); Fri: Exports (Dec), Imports (Dec)

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