
# Soft-ish landing (with luck)

# 134 – 9 May 2022

## Key points

- The Bank of England's hike accompanied by the forecast of a recession next year should be a warning for central banks elsewhere in their quest for a "painless tightening".
- We bring forward our call for the ECB lift-off to July, but we think the ECB won't be able to go very far into normalization. The absence of solution to fragmentation is a major issue, and Italy is already feeling some pain.

The UK often has to deal with exaggerated versions of the woes faced by all developed nations. The Bank of England's decision last week to hike its policy rate while revising down its GDP forecasts for next year in recession territory should be a warning to central banks elsewhere. The Federal reserve (Fed, upon hiking rates by 50 basis points and telegraphing more is to come is now talking about delivering a "soft-ish landing" for the economy. Maybe some doubts are creeping in at the Fed on its capacity to deliver the "race to neutral rate" without triggering an outsized slowdown, but it's still very tentative. The deterioration in hiring intentions reflected in the ISM surveys should however be taken seriously. A lot rests on the labor market.

Meanwhile, it seems that a growing number of the European Central Bank (ECB) Governing Council members want to accelerate the normalization of monetary policy. We explore here in some details a new speech by Banque de France Governor Villeroy de Galhau. Last week we mentioned the possibility that the first ECB rate hike would occur in July, but conditional on strong dataflow in the coming two months which we didn't – and still don't – believe is likely. However, given the flurry of new statements from the central bank, we are now making this our baseline. We reverse the "burden of proof". Instead of seeing a July hike only if the data in May and June is strong, we now think it would take an abysmally bad data flow for the ECB to wait any longer. Yet, while we bring the timing of the lift-off forward, we pencil in only two hikes this year, followed by a long pause once the depo rate is back to zero. We don't think the Euro area can escape much tougher macro conditions in the second half of the year which will ultimately stay the hand of the ECB.

A key issue in our view is that there is still no solution – neither on the central bank side, nor on the governments' via a deepening of debt mutualization – to fragmentation risks in the Euro area. We look with some concern at the elevation in the Italian sovereign spread and the rise in the absolute level of yields there. While 3.1% may not seem like much for an Italian 10-year yield given the history of the local bond market, the rise in the funding costs of the government may make it more difficult to respond to a further deterioration in the economy, especially if wholesale energy prices flare up again if a new sanction package is put together by the EU.

The Bank of England (BoE) managed the rare feat of delivering a 25 basis-point (bp)-rate hike last week while taking down its own GDP forecast for next year in recession territory. Coming the day after the Federal Reserve (Fed) delivered a 50bp hike and promised more of those while still conveying its confidence that it can tighten monetary policy without (entirely) jeopardizing the recovery, the BoE's warning – and predicament – may have echoes beyond the borders of the UK.

Governor Bailey – who at times seemed to apologize for hiking rates – found himself in the not great position of communicating the decision of a very divided Monetary Policy Committee (MPC). On the hawkish side, three members supported a bigger move of 50bps. On the dovish side, some members supported the idea that the Bank should refrain from signalling more hikes ahead – in essence, a minority considers that "peak tightening" has already been achieved. To be fair, the UK economy finds itself in a complicated position. Inflation is very high – the Bank now expects it to reach 10% towards the end of this year – and beyond the impact of the energy price shock, the UK has inflicted onto itself its own dose of supply-side tightness via Brexit, which has cut the flow of workers from the EU. The Bank's predicament stems from the fact that the "demand-led" component of inflation may warrant a tightening in monetary policy, but that there is at the same time enough of a "supply-led" push in consumer prices – on which the central bank has no control – to hurt purchasing power and hence bring the economy in contraction.

The hawks may consider that in this configuration, more monetary tightening is still needed to anchor inflation expectations, even at the cost of a contraction in economic activity. But doves will equally find reasons to stop hiking as we are getting near the point at which "inflation kills inflation", i.e. where the impact of the rise in prices on consumption ultimately forces core inflation to slow down. One could add – in support of the doves – that contrary to most Euro area countries, the fiscal authorities' commitment to mitigate the price shock on real income is minimal in the UK, while in contrast to the US, no massive stimulus from last year continues to push the economy up. This lack of fiscal stimulus should normally stay the hand of the central bank – unless the MPC considers that the very lack of government support will end up creating irresistible pressure on wages.

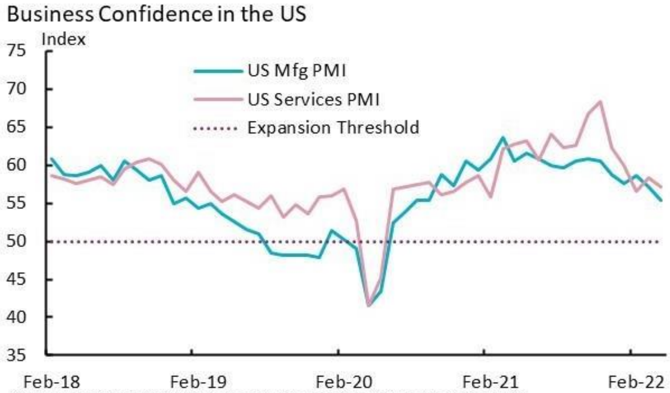
The UK's economy is now operating under a sort of exaggerated version of the woes faced by all developed nations, but the same stark choices will soon impose themselves on other central banks.

The Fed hawks – and at this precise moment it seems the entirety of the Federal Open Market Committee (FOMC) falls under that category – are probably seeing themselves in a comfortable position, because signs of overheating are obvious in the US. Business confidence has started to edge lower (Exhibit 1) but the absolute level is still comfortably in expansion territory. While the market initially welcomed the Fed's announcement last week– probably because the central bank chose to ignore the calls from Bullard for a 75bp move (Powell said it was not under consideration) – in truth Powell's concessions to any potential doves were very limited. Yes, he said that core inflation may be close to its peak and his messages were consistent with reverting to 25bp hikes after the summer, but it still seems that it would take a lot for the Fed to deviate from its "race to neutral rate" trajectory.

A lot rests on the behaviour of the labour market – it's its tightness which is the main factor behind the transformation of the supply-driven inflation shock into a demand-driven one. The April batch of "payroll data" did not send any clear directional signal. Job creation in the private sector came out slightly above expectations (406K against 390K) but the unemployment rate stabilized at 3.6% while the market was expecting another drop. The most interesting take-away from the payroll batch is probably the slowdown in wage growth month-on-month, to 3.6% annualized, down from 4.8% in March. 3.6%, while taking in consideration productivity gains, could be consistent with inflation settling back not far from 2%. But the series is extremely volatile, and we would not want to read too much in a single month's worth of data.

Still, looking at the payroll data for the Fed is akin to driving with the eye firmly set on the rear-view mirror, and one may want to focus more on business hiring intentions than on current job creation. The employment component of the ISM survey has been edging down (Exhibit 2) and contrary to the headline index, it is now dangerously close to contraction territory in manufacturing and marginally *inside* contraction territory in the services. This would suggest less stellar job dynamics in the second half of the year. True, the Fed may be able to argue that the unemployment rate is now so significantly below equilibrium that it could tolerate some labour shedding while still hiking rates, going all the way above 2% for the Fed Funds rate by year-end, which seems to be the FOMC's intent now. Still, we note that in the press conference, Jay Powell talked about the "good chance" to engineer a "soft-ish landing" rather than "a soft landing" for the US economy. Adding these 3 letters may illustrate the fact that maybe some measure of doubt is creeping in at the Fed.

Exhibit 1 – Headline ISMs down but nicely into expansion territory




Sources: Institute of Supply Management and AXA IM Research, 6 May 2022

Exhibit 2 – Hiring intentions close to or in contraction territory


Sources: Institute of Supply Manager and AXA IM Research, 6 May 2022

## ECB wants to accelerate

On the European side, there was quite a bit of substantial "ECB speak" last week. We were intrigued by comments by Isabel Schnabel and Francois Villeroy de Galhau. The former was quite bold by stating that the ECB should "*act on inflation and not just talk about it*". Given her usual positioning within the board it's probably not surprising. But Villeroy de Galhau is normally more "centrist" and his view that he would find it reasonable if the deposit rate exceeded zero by year end was striking. His tone on the inflation threat has changed decisively: *"The ECB is highly vigilant about second-round effects and wage developments, knowing that at times they can move quite abruptly. We also monitor inflation expectations closely, not only from market participants but also from households and firms. There are signs – including in Banque de France business surveys – that these expectations are becoming less and less anchored at 2%"*. We don't think that he chose the words "vigilant" and "closely monitoring" lightly, since these were the code words, during the Trichet era, which when used in the ECB's statements were laying the ground for rate hikes. In short, it seems that patience is deserting most Governing Council members.

Christine Lagarde did not endorse such "lack of patience" in her interview with Delo on 7 May. While she made it clear that *"judging by the incoming data, [her] expectation is that net asset purchases should be concluded early in the third quarter"* she maintained the sequencing intact : *"adjustments to the key ECB interest rates will take place sometime after the end of net purchases and will be gradual"*. Still, she also mentioned that the Governing Council would *"take decisions on the path of monetary policy"* at the next meeting on 9 June, informed by the new set of forecasts. Announcing on 9 June a termination of the Asset Purchase Programme (APP) effective in the first days of July and delivering a rate hike at the 21 July meeting would comply with the set sequence.

Last week we mentioned the possibility that the first ECB rate hike would occur in July, but conditional on strong dataflow in the coming two months which we didn't – and still don't – believe is likely. However, given this flurry of new statements from the central bank, we are now making this our baseline. We reverse the "burden of proof". Instead of seeing a July hike only if the data in May and June is strong, we now think it would take an abysmally bad data flow for the ECB to wait any longer.

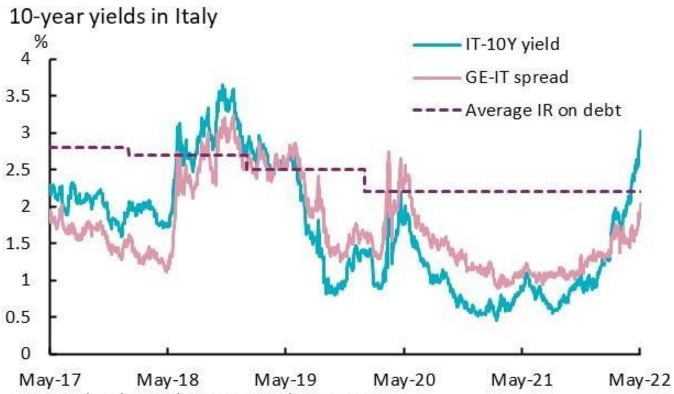
The timing of the lift-off is one thing. Its intensity is another matter. Villeroy de Galhau gave an indication on where the neutral policy rate might stand in the Euro area: between 1 and 2%, 100pbs below the US level. He seems to advocate a regular pace of hikes until the ECB approaches this neutral range, followed by a more "judgemental" approach. We would highlight a point in his speech: "*gradualism shouldn't mean excessive caution or inertia: if, in* *the case of persistent shocks, the central bank reacts too cautiously, inflation expectations are likely to increase putting higher upward pressure on inflation*". This could be read as indicating that the bar to stop the ECB from regularly moving to the neutral rate could be quite high – which is remarkably similar to the message we are getting from the Fed. For our part, we would apply to the Euro area what we expect for the US and what seems to already be the BoE's baseline: a tough second half of the year for economic activity which would "stay the hand" of the central banks. Starting early does not mean adding more hikes on the trajectory. We thus bring the return to zero for the depo rate forward, with a second 25bp hike in September, but then followed by a long pause. We don't think the ECB will have the right conditions for delivering a third hike in December.

## How tough is 3%?

Fragmentation risks are a specific source of headwind for the Euro area economy. In his speech, Francois Villeroy de Galhau made plain his belief in a complementarity of the normalisation of the policy and the creation of an anti-fragmentation weapon. He however mentioned that the ECB did not need to *"get in the technicalities"* of such a weapon – even if he discussed two of them, the sterilization of the purchases and a specific timeframe for the resale of the bonds – but as we explored in Macrocast two weeks ago, the reluctance to be open about the specifics of a new anti-fragmentation weapon may betray more a difficulty to agree within the Governing Council, rather than a tactical decision to create a surprise effect down the road. We note that in her own statements, Isabel Schnabel seemed to conflate a "new programme" with skewing the reinvestments of the APP and the Pandemic Emergency Purchase Programme (PEPP) towards the fragile signatures, something which we think would fail to impress the market much.

As usual Italy is the "nerve point", and the very latest developments are getting concerning. 10 year yields there have broken 3% last week, to hit 3.14% at close on Friday. This reflects both the general expectation of higher rates across Europe and the increase in the country's specific risk premium, evidenced in the widening of the spread vis-à-vis Germany. It is still significantly below the levels seen in the middle of 2018, but then there were actual developments inside the country – the electoral victory and then the formation of a "coalition of the populists" – which could easily explain the rise in the risk premium. For now, under Draghi's leadership Rome is delivering on the reform "milestones" negotiated with the European Union in exchange for the disbursements of the Next Generation EU funds. The ongoing spread widening is more easily explained by the *anticipation* of a less favourable political setup after the elections of 2023 (they must be held no later than 28 May) combined with a termination of QE which is unmitigated by a clarification of the anti-fragmentation weapon.

Exhibit 3 – It's moving fast



*Sources: Bloomberg and AXA IM Research, 6 May 2022*

True, 3.1% on a 10-year *Buoni del Tesoro Poliannuali* (BTP) may not seem much given the history of the Italian bond market, but we would warn against any "benign neglect". The dotted line in Exhibit 3 illustrates the decline over time of the average interest rate paid by the Italian sovereign on its accumulated debt, as the high-yielding bonds issued at the time of the sovereign crisis 10 years ago are being replaced by much lower-yielding bonds benefiting from quantitative easing (QE). This explains why in 2021 debt-servicing costs were maintained at 3.4% of GDP – the same level as in 2019 – although public debt had increased by a whopping 20% of GDP. This was crucial to understand the complete change in Italy's fiscal policy during the pandemic and – until now – in response to the fallout of the war in Ukraine.

For nearly 30 years – starting in the early 1990s – the successive Italian governments have been running on the whole prudent fiscal policies, reacting to the reduction in policy space triggered by the steep rise in debt servicing costs which was "siphoning out" the rest of public expenditure. In the economic realm, this contributed powerfully to the decline in the country's potential growth as spending on public investment – infrastructures in particular - was the main victim of sustained austerity. In the political realm, it may well be that the lack of "return on taxation" – since an abnormally high share of taxes had to be spent on servicing the debt, the quantity and quality of public services received by taxpayers suffered – played a big role in the emergence of populist movements. Still, by the time the pandemic struck, debt servicing had fallen significantly, re-creating policy space for the governments and keeping the "bond vigilantes" at bay.

Draghi's success owes a lot to his government's capacity to spend its way out of the pandemic recession. In addition to benefitting from the patient re-creation of some national policy space, the Next Generation funds have insulated Italy against market pressure – the cost of the loans part of the framework are disconnected from national yields. However, Italy had "maxed out" its capacity to draw on the Next Generation funds before the fallout of the Ukraine war materialised. Arguably, the steady flow of disbursements over the next few years will provide continued support, but there is no additional "pocket of money" coming Italy's way, despite a cyclical situation which is already deteriorating. We were a bit surprised that this did not generate more comments when the data was released, but GDP fell (by 0.2%) in Q1 2022, before most of the fallout from the Ukraine war materialised. In net terms, any additional public deficit that Rome would incur to deal with the Ukraine crisis – and we will see this week how wholesale energy markets react to another sanctions package by the EU – will add to Italy's "ordinary liabilities", i.e., won't be mediated by the EU, nor accommodated by the ECB, but covered by ordinary, profit-seeking bond holders.

Despite unveiling on 2 May, a new package of EUR14bn, coming on top of the 15.5bn one launched in the first quarter to help the economy with rising energy prices (to a total of 1.6% of GDP), the Italian government stated its intention to stick to the overall deficit target for 2022 it had committed originally – 5.6% of GDP, down from 7.2% in 2021. Some of the extra spending will be covered by a toughened-up windfall tax on energy companies (EUR6bn) and better than expected tax receipts. But there are of course limits to windfall taxes – especially at a time when costly investment may be needed to reduce the country's reliance on Russian gas – and positive surprises on tax income would not survive a protracted contraction in GDP.

In case of an intensification of the fallout from the Ukraine war, Rome would have to choose between two potentially "bad solutions". First, responding by setting up yet another mitigation package and let the deficit drift, at the risk of pushing investors into demanding a premium on interest rates which would then reduce the policy space down the road. "At some point", the ECB may react by launching its anti-fragmentation weapon, but the Italian government will not know for sure which "pain threshold" would trigger such action. Second, giving up on providing immediate relief to consumers and businesses to keep the market "on Italy's side". This is precisely what could fuel support for populist parties ahead of next year's elections, raising the risk of losing market support – only later – especially if the delivery of the "milestones" agreed with the European Commission within the Next Generation framework then grinds to a stop.

Mario Draghi is trying to find a balance between (i) taking a principled approach to the Ukraine war despite his country's reliance on Russian gas – see for instance his warning that Italians may have to choose between "peace and air conditioning" – (ii) while arguing for a deepening of the EU fiscal support scheme, what he called "pragmatic federalism" in a recent speech to the European Parliament ("*We need pragmatic federalism, encompassing all areas affected by the ongoing transformations – from the economy to energy and security")*. Anne-Sylvaine Chassany's very thoughtful piece in the Financial Times on Sunday contrasted his strategic approach with Scholtz' hesitations. However, down the road, It's Olaf Scholtz who holds the key to the EU's coffers.

| Country/Region | What we focused on last week | What we will focus on in next weeks |
|---|---|---|
|  | • The Fed increased rates by 0.50% to 1.00% - first 50bps since 1994 – and signalled 50bps for next 2 meetings. Also announced QT from 1 June.<br>• Non-farm payolls (Apr) rose 428k; unemployment inched higher to 3.6% and monthly earnings slowed to 0.3%. Some slowdown, not enough.<br>• ISM indices (Apr) both slipped further, indicating softness in new orders and employment.<br>• Vehicle sales (Apr) rose to 14.3mn, above consensus, improving from Sept lows | • US CPI inflation (Apr) – lower gasoline should see inflation retreat from 8.5% peak in March.<br>• US PPI inflation (Apr) – lower oil prices should see headline PPI dip, focus on core.<br>• U Mich 5-10y inflation expectation (May, p) – will these remained unch at 3.0% (as last year)<br>• Michigan consumer sentiment (May, p) – April's figure rose a little, expect reverse<br>• Jobless claims have trended higher from mid-March low – will this trend persist |
|  | • EC survey showed stabilised confidence for consumer and retail at low levels in April, while services' continues to hold well<br>• Noticeable fall in German IP in March | • Member states final HICP for April<br>• Euro area industrial production likely to record a marked fall in March |
|  | • MPC hiked to 1%, with 3 voting for bigger 50bps on tight labour market. We now expect hikes in June & August bringing rates to 1.5%.<br>• May MPR sees growth "slowing sharply" and inflation peaking over 10% in Q4 2022<br>• UK final PMIs (Apr) were revised upwards | • BRC sales (Apr) likely to show moderation as consumer confidence fell<br>• RICS house price balance (Apr) house price indices point to easing in house price balance<br>• UK monthly GDP (Mar) expected -0.1% (cons) with wind down of Covid services contributing |
|  | • Cons confidence (Apr) stable at 33 (+0.2pp)<br>• As expected, core Tokyo CPI (exc fresh food) (Apr) surge to 1.9%yoy (+1.1p) while headline rose to 2.5%. Contributions from lower phone charges ended while food and energy rose | • Final Svcs PMI (Apr)<br>• Households spending detail (Mar) to fine tune Q1 GDP forecast.<br>• Economy Watchers Poll (Apr) |
|  | • Politburo reiterates supports for the economy and signals less regulatory pressure for the tech sector | • Trade data to show impact of Shanghai's lockdown; CPI inflation to print higher reflecting supply chain disruptions |
| <br> | • CB: Brazil hiked +100bps to 12.75%, Chile +125bps to 8.25%, India +40bps to 4.40% & Poland +75bps to 5.25%<br>• April CPI (%yoy) rose in Korea (4.8%), Peru (8.0%), Philippines (4.9%) & Turkey (70%). It slowed in Thailand (4.7%)<br>• Apr exports slowed to 12.5%yoy in Korea | • CB: Mexico (6.5%), Peru (4.5%) & Romania (3.0%) are expected to hike +50bps. Malaysia to hike +25bps to 2.0%<br>• Q1 GDP (%yoy) likely picked up in Indonesia, Malaysia and the Philippines<br>• The Philippines will hold presidential elections on May 9. Ferdinand Marcos Jr leads the polls |

| Upcoming events | | |
|---|---|---|
| | US: | Mon: Wholesale inventories (Mar); Tue: NFIB small business optimism (Apr); Wed: CPI (Apr); Thu: PPI (Apr), Weekly jobless claims (7 May); Fri: Michigan consumer confidence (May,p) |
| | Euro Area: | Tue: Ge ZEW survey (Mar), It Ind prod (Mar); Wed: ECB's Lagarde speaks, Ge Inflation (Apr); Thu: Ge Current account (Mar); Fri: Ind prod (Mar), Fr & SP HICP (Apr) |
| | UK: | Mon: MPC's Saunders speaks; Tue: BRC retail sales monitor (Apr); Thu: RICS housing survey (Apr), GDP (Q1,p), Business investment (Q1,p), Private consumption (Q1,p), GDP (Mar), Indx of services (Mar), Ind prod (Mar), Mfg & construction output (Mar), Trade balance (Mar), Trade in goods (Mar) |
| | Japan: | Mon: BoJ minutes; Wed: Leading indx (Mar,p); Thu: Trade balance (Mar), Current account balance (Mar), Economy watchers survey (Apr) |
| | China | Sat: Forex reserves (Apr); Mon: Imports & exports (Apr), Trade balance (Apr); Wed: CPI (Apr); Expected during the week: Total social financing (Apr), New yuan loans (Apr), M2 (Apr) |

DISCLAIMER

This document has been issued by AXA Investment Managers Asia (Singapore) Ltd (ARBN 115203622) ("AXA IM Asia"). **AXA IM Asia is exempt from the requirement to hold an Australian Financial Services License and is regulated by the Monetary Authority of Singapore under Singaporean laws, which differ from Australian laws.** AXA IM Asia offers financial services in Australia only to residents who are "wholesale clients" within the meaning of Corporations Act 2001 (Cth).

**This document and the information contained herein are intended for the use of wholesale clients only and should not be relied upon by retail clients or investors.** They have been prepared and issued for private informational and educational purposes only at the sole request of the specified recipients, and not intended for general circulation. They are strictly confidential, and must not be reproduced, circulated, distributed, redistributed or otherwise used, in whole or in part, in any way without the prior written consent of AXA IM Asia. They are not intended for distribution to any persons or in any jurisdictions for which it is prohibited.

To the maximum extent permitted by law, AXA IM Asia makes no warranty as to the accuracy or suitability of any information contained herein and accepts no responsibility whatsoever for errors or misstatements, whether negligent or otherwise. Such information may be subject to change without notice. The data contained herein, including but not limited to any backtesting, simulated performance history, scenario analysis and investment guidelines, are based on a number of key assumptions and inputs, and are presented for indicative and/or illustrative purposes only.

The information contained in this document is not an indication whatsoever of possible future performance and must be considered on this basis. Where information, contents or materials are provided by or quoted from any third party ("Third Party Information"), AXA IM Asia does not accept any responsibility or liability for such Third Party Information, and cannot and does not provide, and shall not be taken to provide, any warranty as to the accuracy, suitability, completeness or correctness of such Third Party Information. Any views, opinions or recommendations (if any) that may be contained in such Third Party Information, unless otherwise stated, do not reflect or constitute views, opinions or recommendations of AXA IM Asia.

This document has been prepared without taking into account the specific personal circumstances, investment objectives, financial situation or particular needs of any particular person. Nothing contained within this document shall constitute an offer to enter into, or a term or condition of, any business, trade, contract or agreement with the recipient or any other party. This document shall not be deemed to constitute investment, tax or legal advice, or an offer for sale or solicitation to invest in any particular fund. If you are unsure about the meaning of any information contained in this document, please consult your financial or other professional advisers. The data, projections, forecasts, anticipations, hypothesis and/or opinions herein are subjective, and are not necessarily used or followed by AXA IM Asia or its affiliates who may act based on their own opinions and as independent departments within the organization.

Investment involves risks. You should be aware that investments may increase or decrease in value and that past performance is no guarantee of future returns, you may not get back the amount originally invested. Investors should not make any investment decision based on this material alone.



AXA Investment Managers