Investment Managers

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Investment Institute Macroeconomics

London lessons

- No costless political solution for the UK government now – putting the Bank of England (BOE) in a delicate position.
- The UK experiment suggests markets have no patience with “supply-side miracles” and “growth dividends” narratives.
- We don’t think Quantitative Easing (QE) resumption would be a “go to” solution elsewhere in case of liquidity accidents, but the European Central Bank (ECB) may think twice about launching Quantitative Tightening (QT) early.

The Bank of England has bought the government some time to re-think its plans, but volatility is likely to remain high. Reassuring markets by curbing spending to offset the permanent tax cuts is the government’s preferred course, but the political cost would be large. Funding the immediate relief package with a windfall tax on energy companies, or reversing the tax cuts are other options, but they also come with a potential cost in terms of political stability. There is a distinct risk the BOE is forced to intervene beyond 14 October. This would be another step into fiscal dominance. Action was unavoidable with a systemic crisis emerging in the UK pension industry but choosing bond purchases rather than channelling liquidity to pension funds - although operationally expedient – puts the Bank of England in a delicate position as it blurs the limits between pursuing financial stability and monetary policy.

We can draw some early lessons from the “British experiment”. As much as the market is still willing to look through the immediate fiscal cost of mitigating the energy price shock, there is no patience with governments embarking on large permanent tax cuts, and investors have very little time for “supply-side miracles” and “growth dividends” narratives in a context of rising interest rates. We have seen a flurry of comments presenting the BOE action as a harbinger of things to come across the G7. We are not convinced. True, financial accidents are likely in times of rapidly rising market interest rates but considering that a resumption of QE would be the “go to” solution misses the crucial point that a conflict of objective has now appeared. Pure liquidity solutions would probably be preferred. Where however the British experiment could contribute to alter the course of central banks it’s on the risk of launching Quantitative Tightening too early. The Bank of Spain has sent a clear warning to the ECB on this issue, albeit from a different angle. The probability of a QT announcement in October already has diminished in our view.

In the US – where we will focus on payroll this week – we note that Lael Brainard has mentioned the risk of the Federal Reserve (Fed) “going too far” … although it’s probably not for immediate consumption.

Questions on an intervention

The Bank of England had to intervene last week, that is undeniable. It could not possibly let a systemic crisis emerge in the United Kingdom (UK) pension industry which could have global ramifications. The form of its intervention however raises questions since it strengthens the suspicion that "fiscal dominance" continues to prevail.

The rise in UK market interest rates in reaction to the government's announcement of a permanent loosening of fiscal policy threatened to become a self-reinforcing, destructive spiral. Indeed, defined benefits pension funds, were facing calls for more cash as collateral as part of the derivative contracts in which they had entered to hedge themselves against the risk of a *fall* in interest rates. These pension funds – who hold roughly GBP 900bn worth of Gilts - were thus forced to sell assets in a rush to meet these cash requirements, thus exacerbating the market turmoil. This had to be stopped. To do this, the Bank of England had a choice to make between two technical options, with very different consequences from a macroeconomic point of view: either treat the pension funds' liquidity problem itself – i.e., making sure they could access cash more easily- or cap the rise in market interest rates by intervening directly on the bond market.

The first option runs against the fact that only credit institutions have direct access to central bank refinancing. We note however that during the extreme market turmoil of March 2020, central banks managed to create in a matter of days facilities allowing liquidity injection to "second circle" financial entities (e.g., with the Money Market Liquidity Facility by the Federal Reserve). The suddenness of the spike in rates last week might explain why the Bank of England could not put together a similar mechanism speedily enough, but it is a well-recognized "chink in the armour" of the central bank's financial stability framework, and we are surprised that even now there is no discussion – at least publicly – of setting up such facility as a potential successor to the temporary bond buying.

So, a resumption of bond buying it is. The Bank of England justified its intervention as a way to avoid an "unwarranted tightening in financial conditions". It is a very ambiguous formulation. We would argue that **a good share of the increase in market interest rates could not be considered as *"unwarranted"* since it reflected a perfectly rational reaction to a fiscal package which is widely seen as at odds with setting British public debt on a sound path**. This was backed by an official communication from the International Monetary Fund (IMF) and confirmed by the decision from Standard and Poor's to put the UK sovereign rating on "negative outlook" on Friday night. True, the second-round effects though the pension funds – flash sales of government bonds – would qualify for "unwarranted" market turmoil, but it's a thin line. In our view, the first option – channelling liquidity to ailing financial institutions – which would have reduced the pressure on bond yields solely by reducing the need for pension funds to engage in "fire sales – would have been "cleaner" than generic purchases on the market.

It's very difficult to defend the idea that the resumption of bond buying does not interfere with monetary policy. The purchases are not going to be sterilized, and while the annual quantum of Quantitative Tightening is unchanged, the beginning of its implementation has been postponed to the end of October. In the meantime, the Bank of England's balance sheet will continue to rise. Of course, all this is supposed to be temporary. The last purchase auction is scheduled for 14 October, but the point in the communiqué about "*the purchases will be unwound in a smooth and orderly fashion once risks to market functioning are judged to have subsided*" leaves more than just a crack in the door opens for more.

The Bank of England did not combine its intervention with an emergency policy rate hike. As we discussed in Macrocast last week the decision to hike by 50 basis points "only" on 22 September could be justified – at a stretch in our view – by the fact that the Bank did not know the full extent of the fiscal accommodation which was going to be announced by the government the day after. But precisely, "now they know". This should have warranted an immediate reaction and **combining a rate hike with intervention on the bond market would have gone a long way in dispelling suspicion of**

"fiscal dominance". In addition, as often, acting late ends up with having to act very tough later. Just after the government's announcement, an emergency hike by 100 basis points might have "done the trick". Today, the market's pricing 140 bps of rate hikes for the November meeting. Short of a jumbo hike, the ground re-gained on the currency over the last few days is very likely to be lost.

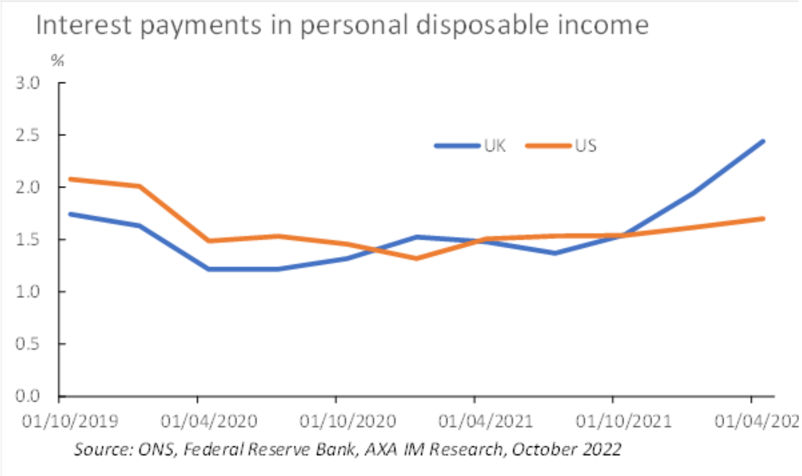
What the Bank of England has done last week was to give the government time to change its course. Liz Truss is already paying a significant price politically – the polls reveal a very significant surge for the opposition, now leading by a massive margin – but the immediate economic cost, in terms of funding rates for the Treasury, has been contained. The UK administration has been the source of the turmoil. A re-profiling of the fiscal package is deep down what is needed, and the market must be satisfied this is happening before the Bank of England terminates its intervention. There are three main avenues for the government. One is to keep the bulk of the announced tax cuts but offer on the other side a convincing plan of public spending reduction. Another is to change the burden sharing between energy companies and public finances of the short-term measures designed to mitigate the ongoing inflation shock – in clear emulate the European approach and "confiscate" some of the excess profits of the "infra marginals". The other is to scrap the tax cuts – or at least severely curtail them. As things stand today, it's clear the first option is preferred by the government, since it would be the only one fully in line with its ideological stance. The political consequences would be massive though, such approach being very much at odds with the general mood of the country – and the electoral manifesto on which the current parliamentary majority won in 2019.

If after revision much of the fiscal package ends up being "growth neutral" – the expansionary impact of whatever remains of the tax cuts offset by austerity on spending – then the Bank of England could consider that it does not necessarily need to respond with such a significant tightening in monetary policy. This may explain the Bank of England's reluctance to engage in an emergency tightening before taking on board the "final" decision of the government. But this means the central bank was ready to give the new administration the benefit of the doubt. Coming after allusions by the new Prime Minister during the leadership campaign on a possible revision of the status of the Bank of England, this puts the central bank in a delicate position.

The timeline is going to be problematic. The government has an option to change tack as early as at the Tory party conference which has started this Sunday, with the Chancellor of the Exchequer scheduled to speak on Monday and the Prime Minister on Wednesday. Yet, for now the full presentation of the fiscal package – including now a macroeconomic assessment by the independent Office for Budget Responsibility – is still scheduled on 23 November…which is 20 days after the next meeting of the Bank of England's Monetary Policy Committee. **Significant volatility can thus be expected in the weeks ahead**, the market reacting to what could be several iterations in the British government's decision-making process on the issue, especially if no clarity is obtained by the last bond market intervention on 14 October. Noises about a fraction of the Tory party ready to cooperate with the opposition in parliament to "kill" at least some aspects of the fiscal package were gaining strength over the weekend. Still, **irrespective on the final decisions by the government and the central bank, financial conditions are unlikely to return to the status quo ante, with an already significant macroeconomic price to pay.** Interest rate shocks propagate through the economy at a very fast pace in the economy, notably via the dominance of short-term mortgage contracts.

We can illustrate this by comparing the speed at which interest payments change as a percentage of household gross disposable income in the United States (US) – where fixed-interest mortgages dominate – and the UK. As of Q2 2022, interest payments had barely started to move in the US at 1.7% of disposable income, still below the pre-pandemic level of 2.1%, whereas in the UK they had already risen by nearly one full percentage point in two quarters and already stand visibly above the pre-pandemic level (see Exhibit 1). Note that the difference cannot be explained by a divergence in the leverage pattern: US households have added more to their debt than their British counterparts since the beginning of the pandemic. The current market volatility makes any projection of the final further adverse effect on purchasing power – and the housing market – difficult (the current market expectation of the Bank of England being forced to hike up to 6% may well be an overreaction) but there is no doubt that the impact will be sizeable.

Exhibit 1 – It's already showing



What lesson for the rest of the world?

The first lesson to draw from this "British experiment" is a confirmation that as much as the market is still willing to look through the further rise in fiscal deficits triggered by the mitigation of the energy price shock, there is zero patience with governments embarking on large permanent tax cuts. Perhaps more interestingly, the market reaction suggests that **investors have very little time for narratives driven by "supply-side miracles".** The British government surprise at the market reaction stems from the belief in the fraction of the Conservative party currently in charge that a replication of a Thatcherite set of policies would naturally get the market on their side. We made the point last week that in an already highly deregulated economy such as the UK there is not obvious structural reform which can move the dial. More broadly, we think the market is going to be prudent around any fiscal plan which would be too dependent on "growth dividends" in a general environment of higher interest rates.

There may be a message for Italy here. Draghi's macro strategy as Prime Minister was convincing as he could back the promise of lifting Italian potential growth – hence ensuring the long-term sustainability of public finances without need for the endless austerity which the country delivered after the mid-1990 – with the financial support of the European Union (EU) via the Next Generation programme combined with a precise set of structural reforms negotiated with the European Commission. Unlike in the UK, there is a series of supply-side measures which can move the dial there, but the market is not going to be placated by vague commitments. **Scrupulous delivery of the pact with the EU is key here.** The first days of Georgia Meloni since the right-wing victory last week suggest that prudence will be her motto on economic issues. Still, what also helped Draghi was the low level of interest rates worldwide when he designed his "good versus bad debt" approach. **When assessing debt sustainability, markets will always consider "growth dividends" together with the expected level of interest rates. This means that the path for Meloni's future administration will be narrower than for Draghi's**.

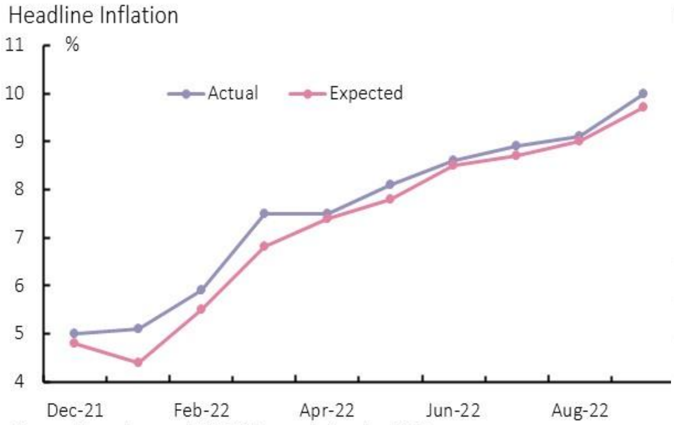
The Bank of England response brings the second lesson. We were intrigued to find in the British central bank's communiqué last week some of the same words the ECB used to describe its Transmission Protection Instrument (TPI) – in particular the notion of "unwarranted market dynamics" – and we are certain the BOE experiment with its new bond buying will be scrutinized in Frankfurt**. A key difference between the BOE and the ECB's instrument is that the latter comes with de facto policy conditionality,** with the need to comply with the EU's fiscal surveillance framework while support can only be brought after a debt sustainability analysis has been conducted. True, the ECB retains wide discretion in its appreciation of the conditions for triggering TPI, but **if anything, the British event strengthens our view that the European instrument could not be used if the immediate source of market movement was a policy decision by a member state**, or that at least the threshold for intervention would be very high. We have seen a flurry of comments over the last week presenting the BOE action as a harbinger of things to come across the G7. We are not convinced. True, what has happened to the British pension funds acts as a reminder that accidents are likely in times of rapid tightening in monetary policy and rising market interest rates. Yet, **considering that a resumption of QE – as temporary as it may be – would be the "go to" solution for central banks facing similar events misses the crucial point that a conflict of objective has now appeared.** In March 2020, monetary policy and financial stability objectives converged – inflationary pressure was falling. Today, they are likely to diverge. This calls for developing liquidity channelling solutions, rather than using a blunt instrument such as QE.

Inflation seals the October ECB hike, while a dove speaks out (finally)

Still, what the Bank of England experience may instil in other central banks – and particularly the ECB – is a sense that one should think twice before complementing "traditional" action on policy rates with Quantitative Tightening. This is the crucial debate now in Frankfurt.

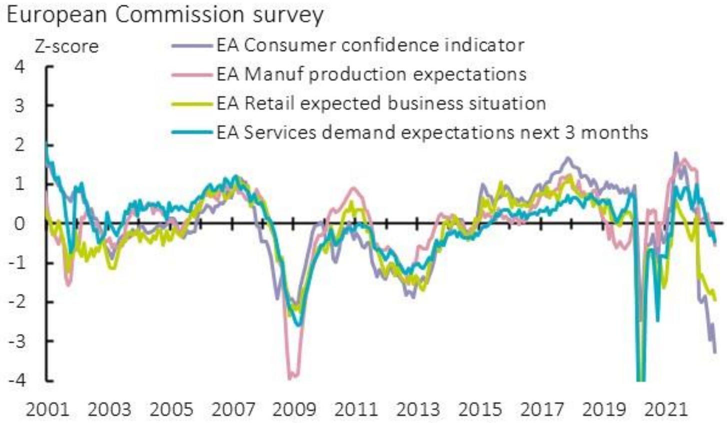
On policy rates, **we were already expecting the ECB to hike by 75 basis points on 28 October and the release of yet another higher-than-expected inflation print for September (see Exhibit 2) has in our view "sealed the deal".** True, there was a lot of noise in the data (the higher than expected print in Germany was driven by the temporary halt in measures implemented to mitigate the energy price shock) and the announcement by Berlin last week of yet another package to curb the transmission to retail from wholesale energy prices could seriously dampen headline inflation in the coming month (assuming no rebound in oil prices triggered by a larger than expected reduction in oil supply is decided at the Organization of the Petroleum Exporting Countries (OPEC) meeting this Wednesday). The agreement in Brussels around the possibility to levy windfall taxes will probably trigger more measures controlling retail energy prices across the Euro area. Yet, the ECB will probably focus instead on the further acceleration in core inflation. Moreover, just as the Fed has been frustrated lately by the absence of reaction of the labour market to the deteriorated economic outlook, the ECB may be surprised by the contrast in the surveys between the abysmal decline in confidence of households (back to Great Financial Crisis or early pandemic levels) and a business sentiment which, in manufacturing and services – excluding retail – has softened but by a much lower quantum (see Exhibit 3). A recession is still not the ECB's baseline, and they may consider that one needs to wait on which "side"- households or businesses - the economy turns in the coming months before changing its view.

Exhibit 2 – Higher than expected, again



Source: Bloomberg and AXA IM Research, October 2022

Exhibit 3 – Who's right, households or businesses?



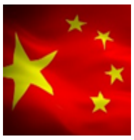
Source: European Commission and AXA IM Research, October 2022

Yet **the main issue now is not the quantum of hike – as long as the ECB remains in the "neutral range" but whether Quantitative Tightening should start**. Bank of Spain Governor de Cos delivered a very astute speech last week, which may represent the first big "counter-offensive" of the doves since the early summer. His point is twofold. First, he considers that the market is currently pricing a level for the ECB policy rates which is too high to bring inflation back to target given the particular macro conditions of the Euro area. He suggests – based on models developed at the Bank of Spain – that the "right" level should be towards 2.25%-2.50%. That is slightly higher than the upper boundary of the neutral range described by Villeroy de Galhau – and thus consistent with being in restrictive territory - but below the 3% currently priced in. But perhaps more fundamentally, he argues in favour of taking a "holistic view" of financial conditions were the ECB to launch QT. Quite simply, he suggests that QT would trigger a further rise in long-term interest rates which would need to be considered when calibrating the optimal level of the policy rate. In other words, his message to the "hawks" is that they "cannot have their cake and eat it", i.e., they cannot push for bringing policy rates to 3% AND launch QT at the same time. This is resemblant to the debate last spring on whether the ECB could stop QE before hiking rates. De Cos also adds in the mix the fact that Targeted Longer-Term Refinancing Operations (TLTROs) will gradually run-off, which will mechanically reduce the size of the ECB's balance sheet and should be taken into account in the calibration.

The debate is clearly raging. Last week, Christine Lagarde's audition at the European Parliament was not – in our view – consistent with QT starting quickly, given her point on exhausting the normalization of the traditional policy instrument first (De Cos justified this in his own speech by stating that a central bank has a much better understanding of how a rate hike works relative to quantitative action), in contrast with Nagel's call for early action. **This makes us less concerned about the October meeting**. Reuters had reported that decisions on QT could be announced then. The conversation does not seem ripe enough.

Debate at the Fed

The Fed is still in "data dependent" mode and this week's payroll release will be another "key piece of evidence" for the next steps. We and the market expect a softer number of job creation, even though the latest data on jobless claims makes this call uncertain. Beyond the dataflow, we can see some debate re-emerging at the Fed though. While Lael Brainard warned the market against pricing in a relaxation of US monetary policy too soon – a point we made in Macrocast last week – she has clearly taken on board concerns expressed among others by Maurice Obstfeld and mentioned explicitly the risk for the Fed to "go too far at some point" as well as the need to take on board the spill over effects of the global monetary tightening currently underway. A bit like for the ECB and QT we don't think her remarks are for immediate consumption, but they lay the ground for the difficult debate of late 2022/early 2023: once the signs of proper economic slowdown are there, should the tightening continue?

Country/Region	What we focused on last week	What we will focus on in next weeks
	• US GDP revisions (Q2), headline remained at -0.6% (saar), consumption a touch firmer • PCE inflation dipped further to 6.2% from June high of 6.8%, core edged higher to 4.9% from 4.7% • Firmer figures with new home sales +29%mom, jobless claims <200k and confidence rising	• Payrolls report (Sep) expects further signs of softening, watch payrolls closer to 200k than 300 and mom wage growth • JOLTS (Aug) – expect modest increase in vacancies • ISM (Sep, mfg and non-mfg), both remain in solid territory despite dip in broader surveys • Vehicle sales (Sep) more signs lower gas prices a boost
	• EMU flash HICP surprised to the upside, gained 0.9pp to 10.0%yoy in September. Core (+0.5pp to 4.8%yoy) was main driver of the headline uptick • EC survey confirmed picture from PMIs that EA economy is already flirting with recession in Q3	• Industrial production for August across member states • ECB speeches in wake of new record inflation print • Italian government formation talks
	• Last week's fiscal event prompted huge sell off in UK assets with GBPUSD falling to all time low of $1.03 • BoE steps in to support liquidity in gilt markets ready to buy up to £5bn a day in long dated gilts until Oct 14 • Q2 UK GDP revised up to 0.2% from -0.1% delaying expected start of recession • Q2 CA deficit fell to 5.5% GDP on revised Q1 7.2%	• Chancellor Kwarteng speaks at Tory Party conf (Mon) will be key to expected policy path, PM Truss speaks Weds • Further repricing in UK assets and how BoE intervention progresses – currently do not expect an intermeeting hike • MPC members Mann and Ramsden speak (Mon and Fri) for clues on how the MPC plan to respond • Final PMIs (Sept)
	• U-rate (Aug) edged down to 2.5% as expected • Industrial production (Aug) continued to post solid gains 2.7%mom marking third cons rise on the month • PMI (Sept) rose to 50.9 with strong bounce in services up 2.4ppt to 51.9	• BoJ Q3 Tankan Survey likely to show stronger business conditions • Tokyo CPI (Sept) expected to rise to 2.9% as weakening yen weights on imported food costs • HH spending (Aug) expected to accelerate on base effects and robust summer travel
	• Despite declining COVID cases, Beijing advises the public to stay local ahead of the National Day • PBoC verbally intervened, warning of excessive speculation, after the CNY/USD rose above 7.2 • Mixed news from September PMIs – the NBS measure returns to expansion, while small firms struggle as reflected by the decline in Caixin survey	• Further actions from the PBoC are possible if RMB depreciation continues on a steep path • Holiday-related activity is likely to stay subdued as COVID controls deter the public from travelling • Caixin PMI to show services activity may have weakened in September due to COVID flare up
	• CB: Colombia hiked +100bp to 10.0%, Hungary +125bp to 13.0%, India +50bp to 5.90%, Mexico +75bp to 9.25% & Thailand +25bp to 1.0% • Aug inflation (yoy) edged higher in Malaysia (4.7%) and remained stable in Singapore (7.5%) • Ind prod (Aug) picked up in Taiwan & Thailand	• CB: Peru is expected to hike +25bp to 7.0%, Poland +25bp to 7.0 % & Romania +50bp to 6.0% • Aug inflation (yoy) in Colombia, Indonesia, Korea, Mexico, Peru, Philippines, Russia, Taiwan Thailand & Turkey • Reaction to general elections in Brazil (Sunday) • PMI figures across EM countries

Upcoming events		
	US:	Mon: Manf. PMI (Sep), ISM manf. Indx (Sep); Tue: Factory orders (Aug), JOLTS Job Openings (Aug); Wed: ADP employment chg (Sep), Trade balance (Aug), Services PMI (Sep), ISM non-manf indx (Sep), Weekly jobless claims (24 Sep); Fri: Non-farm payrolls (Aug), Ave earnings & weekly hours (Aug)
	Euro Area:	Mon: EU19, Fr, It, Ge, Sp Manf. PMI (Sep); Tue: EU19 PPI; Wed: EU19 Composite & Services PMI (Sep); Thu: EU19 Retail sales (Aug), ECB monetary policy account, Ge new manf. Orders (Aug), Ind prod (Aug); Fri: Ge Ind. prod & retail sales
	UK:	Mon: Chancellor Kwarteng speaks, Manf PMI (Sep); Wed: SMMT new car reg. (Sep), Composite & Services PMI (Sep); Ge, Fr, It, Sp Services PMI (Sep), Fr Ind Prod (Aug); Thu: Construction PMI (Sep); Fri: Halifax HPI (Sep)
	Japan:	Mon: Tankan large manf indx (Q3), Manf. PMI (Sep)
	China:	Fri: Fx reserves (Sep); Sat: Caixin Services PMI (Aug)

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