Beware of Contagion

- The Federal Reserve (Fed) is ready to go far to achieve its inflation goal. The cost to growth will be large.
- Contagion to the Euro area should make the European Central Bank (ECB) think twice before starting the Quantitative Tightening (QT), but the hawkish rhetoric remains strong.
- Predictably, the UK's adventurous fiscal package is met with market sanction.

The Fed's narrative is clearer: they want to see the labour market soften, and if that takes a recession, "so be it" – even if it's not their baseline still. The resilience of job creation calls for more tightening and the new peak in the "dot plot" is far into restrictive territory. Aggregate financial conditions are now back to pre-Great Financial Crisis levels, even after correcting for the new inflation expectations. Potential growth has diminished since 2008, which suggests that the actual level of financial pressure on the economy is already quite significant, even before the further 100 basis points (bps) in Fed Funds hikes which we expect. The cost to growth should not be understated.

The spillovers to the rest of the world are getting every day more problematic. We discussed last week Maurice Obstfeld's point on central banks engaging in a race which will end up in an excessive aggregate tightening. The European market reaction to the Fed's announcements last week is a case in point. Investors have revised further up their expectations for the ECB trajectory, probably considering the exchange rate issue will play an even bigger role in the central bank's reaction function in the coming months. To be fair, the latest communication from the ECB gave the market plenty of reasons to expect an even more hawkish stance. The bond market is also moving fast. As of last Friday, the Italian 10-year rate stood at 4.34%. This may act as a reminder to the new administration in Rome that its fiscal room of manoeuvre is going to be tight. In any case, we think the current state of the market – and further transatlantic contagion – should make the ECB think twice about moving fast on QT, even if the "noises" from Frankfurt are not reassuring on that front.

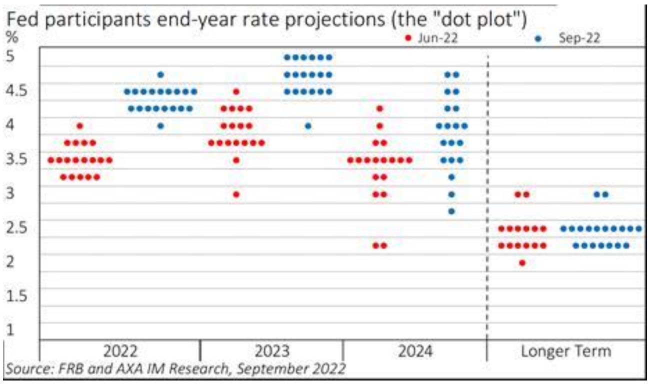
The Bank of England (BoE) was isolated in choosing not to do a "jumbo hike" last week. They may well have to deliver one very soon, That the market did not like the latest fiscal policy announcements in the UK is an understatement. We reiterate our view that it's a very adventurous package. The recipes of 1980 don't work well in the 2020s.

Blood, sweat and unemployment

Given the noise around a 100bp hike, delivering 75bps last week with a unanimous Federal Open Market Committee (FOMC) might be counted as relief, but that's only testament to how far the goalposts have moved on monetary policy. **The Fed is signalling very clearly that it still has far more to do to get the Fed Funds where it thinks they need to be**. The Fed now indicates via its "dot plot" that it expects to raise its policy rate to 4.6% in 2023 against a previous peak – in the June batch – at 3.8%. Much of that is supposed to come fast. There will be quite some effort to make in the remaining two meetings of 2022, with more than 100 bps between the new Fed Funds rate and the 4.4% by year-end suggested by the "dot plot". With the succession of "jumbo" hikes we knew that gradualism was gone, and even getting squarely into restrictive territory – which in principle should make them more prudent – does not seem to change the Fed's narrative much.

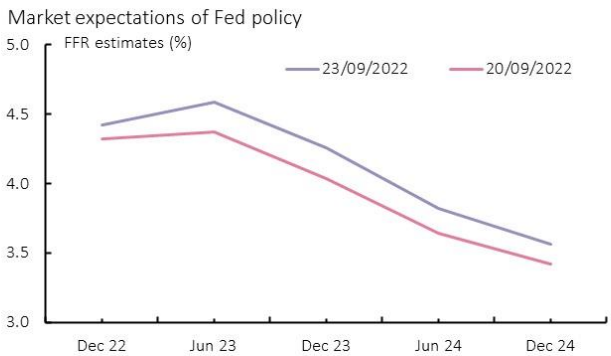
Beyond this abrupt tightening, Powell made it clear that it may take time for the policy change to get the desired impact on the economy and the inflation trajectory. At first glance, this message is not entirely corroborated by the "dot plot". Indeed, the median forecast for the Fed Funds for 2024 remains lower than for 2023, with a sharper decline from peak (70bps) than in June (40bps). Yet, levels matter. At still 3.9% in 2024, policy rates would still be higher than today and more deeply into restrictive territory than what the Fed was signalling before the summer break. Note as well that the distribution of the "dots" for 2024 is remarkably wider than in the June batch, in contrast with the convergence of views which occurred for 2022 and 2023 (Exhibit 1). Individual FOMC members' projections are so scattered for 2024 that we doubt we can extract any signal there. They are clearly focused on the immediate issue at hand, which is to regain control of inflation quickly, with little time to think about the shape of the future relaxation.

Exhibit 1 – Convergence upward



Source: FRB and AXA IM Research, September 2022

Exhibit 2 – Market still betting on 2023 cuts



Source: Bloomberg and AXA IM Research, September 2022

Beyond the signalling on the future policy trajectory, the narrative has altered as well. **A popular view at the Fed before the summer was that it may be possible to get the desired deceleration in wages, now the main engine of inflation in the US, without triggering a substantial increase in the unemployment rate**. Indeed, the imbalance between vacancies and available workers is so large that it is the labour market "churn" (workers leaving jobs for better paid ones) which is the key source of aggregate wage drift. Cooling down hiring intentions might suffice to reduce workers' bargaining power without much job destruction. **This "happy landing" scenario has been taken out from the forecasts**. Before the summer break FOMC members still had in mind a slow and limited deterioration of the labour market. In the June forecasts, disinflation was obtained at a barely visible cost to employment: the unemployment rate would peak at 4.1% in 2024, from 3.9% in 2023. They now expect a rapid, more substantial change, with the unemployment rate hitting 4.4% next year (from 3.7% in August 2022). The narrative was also clearer in the September Q&A**: the Fed wants to see a softening of the labour market, with as logical corollary the idea that it will likely continue hiking until it sees one**. To quote Powell, *"We have to get supply and demand back into alignment and the way we do that is by slowing the economy. Hopefully we do that by slowing the economy and we see some softening of labour market conditions"*. By promising more tightening, the Fed is adjusting to the resilience of the labour market which has so far made it impossible to curb wage growth.

Note that a 0.7 percentage point in the unemployment rate would still be a fairly small rise relative to what was seen in some of the "normal recessions" of the past (1991 or 2001. The Fed has become more straightforward in its communication about the pain disinflation will bring, but it is still erring on the side of optimism. This may explain why the market continues to "buy" the Fed's trajectory only partly.

Indeed, **while the market has revised up its expectation for "peak Fed Funds" after Powell's press conference, to a level consistent with the "dot plot", the beginning of the relaxation is still expected to start in the second half of 2023** (Exhibit 2). Our suspicion is that market participants are more pessimistic about the state of the economy in the next few quarters than the Fed. The central bank still refuses to have recession as a baseline, even if the possibility is now openly discussed (*"No one knows whether this process will lead to a recession or if so, how significant that recession would be"* to quote Powell). Their still positive 0.2% GDP growth expected for 2022 looks quite "brave" in our view. The market is thus probably betting on a bigger recession than the Fed which would impair the labour market more than what the Fed currently expects, bringing about a fairly quick deceleration in inflation.

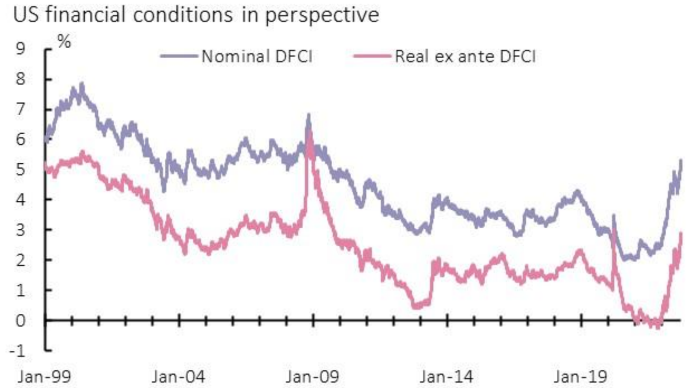
We also consider the Fed's GDP forecast as too optimistic. While the very recent dataflow has often surprised on the upside – especially when it comes to labour market developments – we expect a significant deterioration in Q4. Accordingly, we expect the Fed to revert to 50bp hikes in both November and December, but contrary to what the market is pricing right now – and below the Fed's dot plot – **we see this 4.25% reached at the end of the year as the peak rate. However, we are reserved on the chances to see the Fed cut rates in 2023 already from this level**. While it's difficult for any central bank to keep on hiking in the midst of a confirmed recession, it will be equally difficult for the Fed to lower its guard while inflation would still be above 3%, which is unfortunately likely to be the case through 2023 despite the deterioration in economic conditions, given the "stickiness" of a lot of the current price pressure.

What's "normal"?

The state of financial conditions in the US is among the reasons which make us more pessimistic than the Fed about the short-term. When gauging the impact the monetary stance will have on the real economy, looking at Fed Funds rates won't suffice – it's a point Powell himself made in the Q&A last week. We need to take into consideration how the Fed signals are transmitted through the financial system at large. Remember that the Fed at the beginning of its policy normalization was frustrated that market interest rates were not responding. Second, "restriction" needs to be compared to some "normal", or equilibrium level. If we take the FOMC's median forecast for the Fed Funds' rate in the long run, which may be used as a proxy for where the central bank sees the equilibrium rate, stability prevails: it's still 2.5%, with very little dispersion around this level. So the Fed is already 50 to 75bps into restriction. However, it's impossible to precisely nail where equilibrium is in real time. As bizarre at it may sound, equilibrium moves, especially in times of massive supply-side shocks. An acceptable second best is to take a historical perspective on this. To explore this, we start by building a very simple proxy for aggregate domestic financial conditions for the US.

We compute the unweighted average of the 10-year Treasury yield, the 10-year yield on BBB-rated corporate bonds and the 30-year mortgage rate. By doing so we try to proxy financial conditions as they are perceived by the government, the corporate sector and households. For the purpose of any valid historical comparison, we need to take on board changes in expected inflation. Indeed, we want to look at *ex ante* real financial conditions to gauge the likely impact on current economic decisions. We subtract from our nominal financial conditions metric the 10-year breakeven. Again, it's only a proxy – market-derived expectations may differ from households' for instance – but it should still help us to capture big changes in the inflation regime.

Exhibit 3 – Today's "restrictive" is pre GFC "normal"



Source: Macrobond and AXA IM Research, September 2022

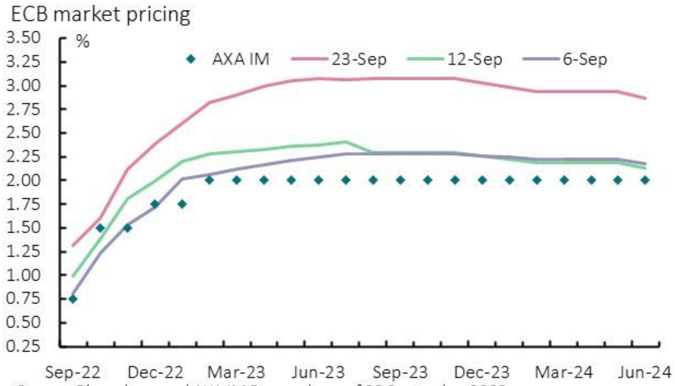
The day after the Fed's hike, real financial conditions in the US were the tightest since the Great Financial Crisis (GFC) of 2008-2009 if one excludes the short market meltdown in March 2020 on the onset of the pandemic (Exhibit 3). True, **today's "restrictive" level is only the "normal" level of the pre-GFC universe**. Indeed, our real financial conditions index stands at 2.9% as of last Friday, only marginally above the average of 2003-2005 when the Fed was past its "dot come bubble busting" tightening of 1999-2000 and not yet into the quick fire "GFC-triggering" series of hikes of 2006-2007). This comparison would however fail to consider the lasting decline in potential growth the GFC has ushered in. Consensus estimates of US potential have fallen by about 0.75%-1% after 2008 and failed to recover since then. When economic agents make decisions involving the state of financial conditions, they form anticipations on trend real growth – which will drive the return on their investment – not just on inflation. **Considering the current state of potential growth in the US – probably around 1.75%, as per the Congressional Budget Office – there should be no doubt that the US is already facing truly restrictive financial conditions**, even before the additional series of hikes the Fed is already preparing. This quantum of restriction may well be what's needed to curb inflation, but the price to pay in terms of growth and unemployment will be large.

The contagion issue: ECB needs to think twice about QT

What the Fed is doing is perfectly understandable from the point of view of the US economy but **the spillovers to the rest of the world are getting every day more problematic**. We discussed last week Maurice Obstfeld's point on central banks engaging in a race which will end up in an excessive aggregate tightening. The European market reaction to the Fed's announcements last week is a case in point. The anticipated trajectory for the European Central Bank spiked again after the Fed's hawkish signals (Exhibit 4). It may well be that market participants have increased the weight of exchange rate considerations in their understanding of the ECB's reaction function and consider that any upgrade in the Fed's trajectory needs to be matched by its European counterpart to protect the currency and curb imported inflation.

To be fair, the ECB-speak has given plenty of ammunitions since the last Governing Council meeting for the market to expect an even more aggressive monetary policy in Europe. Christine Lagarde in a speech last week has re-stated the point she had made in Sintra that the central bank would be inclined to treat a persistent energy shock as a permanent negative shock to supply which would logically demand more robust action on demand to control inflationary pressure: "were we to conclude that ongoing supply shocks had durably lowered economic potential, we would have to ensure that demand remains aligned with supply". We add that since the first part of her speech was dedicated to showing the energy shock would have more lasting consequences than previous ones, there is little doubt the ECB has already reached that conclusion. The ECB President also expressed her doubts as to the capacity of the looming recession – still not their baseline – to significantly dampen inflation, since the root of such recession would lie in the supply side. Finally, her discussion of the fiscal response to the energy crisis came with an element of warning: "*it will make a* *difference whether fiscal policy focuses mainly on public consumption and transfers – which may add to inflationary pressures – or on public investment and debt sustainability*".

Exhibit 4 – Market sees the ECB emulating the Fed



Source: Bloomberg and AXA IM Research, as of 23 September 2022

Beyond the message from the ECB, in any case the European bond market would be affected, as usual, by the changes in US long-term interest rates, and **yields have shot up last week in the Euro area**. As of Friday, Italian 10-year rates had hit 4.34%. This may act as a reminder to the new administration in Rome that its fiscal room of manoeuvre is going to be tight. But equally, these developments on the European bond market should make the ECB think twice about resorting quickly to QT (leaks just after the latest Governing Council suggested decisions as early as at the October policy meeting). Just like in the US, we need to take a holistic view of financial conditions. We have already highlighted in Macrocast the tightening in bank lending standards. Large rises in long-term interest rates could make the ECB's discussion on "neutral versus restrictive" futile.

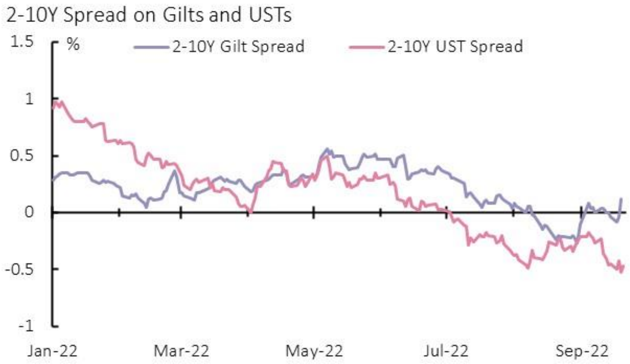
Policy mix-up

The market was bracing for an "adventurous" budget bill in the UK. It came out even more so than expected (see here our colleague Modupe Adegbembo's timely note for details). Beyond the further decline in the GBP exchange rate, we think the movements on the yield curve provide quite a lot of insight in the market's negative reaction to the announcements.

Exhibit 5 – BoE seen as tightening more for longer

Source: Bloomberg and AXA IM Research, September 2022

Exhibit 6 – The absence of curve inversion is not necessarily good news



Source: Bloomberg, Datastream and AXA IM Research, September 2022

The 1-to-2-year spread indicates that the market expects the BoE to be forced into a significant and protracted tightening to offset the stimulative effect of fiscal policy and the rise in imported prices triggered by the currency depreciation (Exhibit 5). From this point of view, **we can question the wisdom of the BoE's decision to hike by only**

50bps last week. The "direction of travel" on fiscal policy was hardly a secret, and the Bank could have come up as pre-emptive rather than facing now a flurry of demands from various commentators for an "emergency hike". In any case, given the specificities of monetary policy transmission in the UK – in particular the high sensitivity of households' purchasing power to interest rate changes given the prominence of mortgages fixed for only two to five years – such monetary policy trajectory will affect growth quite quickly.

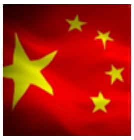
Towards the long end of the curve, news is not necessarily better. The 2-to-10-year spread is not inverted in the UK while it is – by a large quantum – in the US (Exhibit 6). This could be read as the consequence of decent growth prospects. It is however more likely that it reflects growing concerns over the dominant macro narrative in the UK, with investors bracing for a substantial and protracted rise in UK debt issuance and should thus be read as a rise in the country's risk premium.

The fiscal gamble is indeed huge, with a combination of higher expenditure and lower tax worth more than 4% of GDP each for this fiscal year and next. Using the latest Office of Budget Responsibility quantification as basis – there was no new set of macroeconomic assessment to coincide with the Chancellor's announcements last week – this would bring the deficit to nearly 8% of GDP this fiscal year and above 6.5% in 2023. As we have already argued in Macrocast, the market so far has been ready to give a "pass" to government responding to the ongoing energy crisis with a temporary increase in deficit, but **the new policy stance in London is also about permanent changes**. The Chancellor's argument is that the extra growth his supply-sides reforms will trigger will compensate for the higher spending/lower taxation. It is a very risky gamble and we have already made the point in Macrocast that the recipes of the early 1980s Thatcher/Reagan strategy are unlikely to be as successful in the current configuration.

Some of the supply-side reforms announced last week make perfect sense, such as reforming the planning system – which may free up some residential and non-residential investment projects – or reducing the "stamp duty" on most house purchases, which may help "unclog" the housing market and support geographical mobility in the UK. Still**, the key issue for us is that, quite simply, contrary to the early 1980s, there is no obvious "big structural reform" which would clearly move the dial on British potential growth.** The OECD index of Product Market Regulation and Employment Protection is already significantly lower in the UK than the average in the developed world. Last week's announcement on corporate tax is a decision not to hike – the previous plan was to raise corporate tax – rather an actual cut. Besides, corporate tax rate was already significantly lower in the UK than in its main European competitors, although its investment rate has remained stubbornly below the OECD average.

It's likely that more reforms will be announced, e.g., a further loosening in immigration rules (this is in part connected to a tough negotiation for a free-trade agreement with India), while the combination of the abolition of the top income tax rate and liberalization of bonuses in the financial industry probably reflects a willingness to strengthen some of the UK's current strong points (the City of London). The elephant in the room is however Brexit – which is no longer even discussed in political circles. The structural reforms currently launched or in preparation may partly offset some of the adverse consequences of leaving the EU (e.g., loosening immigration rules to offset the end of free movement of labour within the Union), but they can hardly trigger the kind of acceleration in trend growth which the Chancellor is currently discussing (while possibly triggering quite some political anger in the country, since a lot of people who voted for Brexit are not particularly open to immigration nor sensitive to the plight of those working in the City).

The press was reporting over the weekend quite a bit of unease in the Tory parliamentary party (remember that Liz Truss was not the MPs first choice). A rebellion to change the policy course just weeks after finding a new leader looks unlikely though, especially with only two years before the next general elections. The "course correction" may have to come from market pressure.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Fed raised rates by 75bps to 3-3.25%. It raised its end year projections to 4.4% and next year's to 4.6%. We raise our peak expectation to 4.25%, risks for higher • Housing starts (Aug) surprised with a 12%mom rebound, but existing home sales fell again • Jobless claims rose, ending 5 consecutive declines	• PCE inflation (Aug), echoing CPI, expectations for further ease in headline but core rate to rise • GDP (Q2) final estimates, watch revisions and composition • House price (Jul) and new home sales (Aug) releases for state of housing activity • Durable goods orders (Aug) add to Q3 GDP outlook
	• EMU Flash PMI in contraction territory (Comp Output at 48.2 and Svcs at 48.9), pulled down by Ge (indices below 50 for a 3rd straight month). Fr flash Svcs and Output are more resilient, respectively at 53 and 51.2 • EMU flash consumer conf at -28.2, lowest since 2008	• Ge Ifo surveys should confirm very gloomy picture painted by PMIs last week. EC surveys to provide some details on prices expectations • Sep EMU HICP: 9.6%yoy (+0.5p), cons at 9.6%. Ge: 10.3% (+1.5p) ; It: 9.3% (+0.2p) ; Fr: 6.4% (-0.2p) ; Sp: 9.9% (-0.6p)
	• BoE hiked rates by 50bp to 2.25% with 3 MPC members voting for a 75bp hike • Chancellor Kwarteng set out the government's 'Growth plan' including £160bn over five years. Energy price support set to cost £60bn this FY • We now expect Bank Rate to reach 4.00% in March • Consumer confidence declined further to -49	• BoE household lending data (Aug) • UK national accounts (Q2, F) little revision expected from -0.1%. Income breakdown of GDP will be closely watched where we expect a continued decline in the savings rate • Current account (Q2) deficit expected to decline from record levels in Q1 • Nationwide house price index (Sep)
	• BoJ kept all policy rates unchanged as expected. Gov Kuroda briefed rates and guidance would not change over coming years • MoF conducts intervention in Yen market for the first time since 1998 pushing yen from lows • CPI (Aug) rose to 3% above expectations	• Labour market data (Aug) jobless rate expected to decline to 2.5% as summer travel season supported hiring • Industrial production (Aug) likely to slow on weaker external demand • PMI data (Sept)
	• COVID case counts continue to drop, with Chengdu exiting 'static management' • High-frequency data points to renewed weakness in early September after better-than-expected August • CNY/USD crosses 7 for the first time since 2020; offshore CHN rate continues to match higher on dollar strength	• Industrial profit growth likely decelerates further amidst COVID restrictions • Manufacturing and services activity likely struggle against tightened virus controls in September • Further rapid RMB depreciation may prompt verbal reaction from the PBoC to sooth market concerns
	• CB: Indonesia hiked +50bp to 4.25%, Philippines +25bp to 4.25%, South Africa +75bp to 6.25% & Taiwan +12.5bp to 1.625%. Turkey cut 100bp to 12% & Brazil stood on hold at 13.25% • Korea's 1st 20 day exports (Sep) fell 8.7%yoy • Colombia's economic activity (Jul) slowed to 6.4%yoy	• CB: Mexico is expected to hike +75bp to 9.25 %, Thailand +50bp to 1.25% & India +50bp 5.90% • Aug inflation (yoy) in Malaysia & Singapore • July economic activity figures in Mexico & Argentina • Aug unemployment numbers in Brazil, Mexico & Colombia • Aug industrial production data for Korea & Singapore

Upcoming events		
	US:	Tue: Fed Powell speaks, C-S&FHFA HPI (Jul), Cons. conf (Sep), New home sales (Aug); Wed: Goods trade bal. (Aug),, Pending home sales (Aug); Thu: GDP&Core PCE (Q2), Weekly jobless claims (24 Sep); Fri : PCE&Core PCE (Aug), Personal income & spending (Aug), Michigan sentiment & inflation expct. (Sep)
	Euro Area:	Mon: Ge IfO index (Sep); M3 (Aug); Wed: Fr cons. conf. (Sep), It bus conf. (Sep); Thu: EU19 bus conf. (Sep), Ge&Sp HICP (Sep, p), Fri: EU19, Fr, It CPI (Sep, p), EU19, Ge unemp, Fr cons. spending (Aug)
	UK:	Tue: BoE Pill speaks; Thu: BoE lending data (Aug), M4 (Aug), Fri: GDP (Q2), Business investment (Q2), Private consumption (Q2), Current Account (Q2)
	Japan:	Mon: Mfg 'flash' PMI (Sep); Fri: Ind. prod (Aug)
	China:	Tue: Industrial profits (Aug); Fri: official manf & non-manf PMI

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