Data Refuses to Behave

- Stronger than expected job creation raises doubts on the Fed’s pause, while lower than expected Consumer Price Index (CPI) helps the ECB doves. We however still see the two central banks proceeding as planned at their June meeting.
- Super-low inflation in China should trigger an export-led recovery and help tame global price pressure, but geopolitics get in the way.

The stage had been carefully set for a pause at the Federal Open Market Committee (FOMC) meeting on 14 June, while a day later the ECB would deviate by hiking further. The recent dataflow is however raising some questions. In the Euro area a bigger than expected deceleration in core inflation in May is providing the doves with some arguments to proceed more carefully while in the US strong job creation is casting doubt on the pace at which the economy would finally land.

The details in the data are however consistent with the two central banks proceeding as planned at their next meetings. The inflation decline in the Euro area owes too much to one-offs and while we continue to think there is more evidence that the European economy is slowing down, there is also still too much acquired speed on the labour market for the ECB to feel relaxed about the risk of a wage-driven inflation second wave. However, we are marginally more confident with our baseline that July, and not September, will be the peak in policy rates for the ECB. In the US, job creation according to the Establishment Survey is contradicted by the Household Survey, while some wage moderation seems to be underway, especially when taking working time in consideration. Yet, the issue is less about June than about the possibility that the Fed resumes hiking in July. We are counting on more evidence of the downturn accumulating in the next two months to ultimately stay the Fed’s hand, but it’s a very close call. In any case, we welcome the fact that the market is now pricing a lower probability of rate cuts in the second half of the year, consistent with our long-held view that the Fed will not revert stance as swiftly as investors expected.

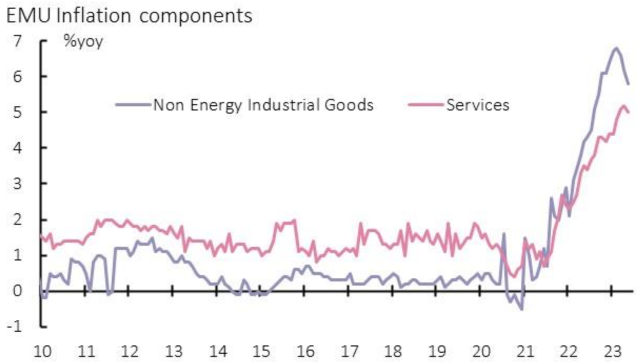
Finally, we look at the Chinese dataflow but rather than focusing on evidence that the recovery is now sputtering – it clearly is – we are more interested in the fact that inflation remains super low over there. In normal circumstances, the ensuing competitiveness gain would trigger an export-led recovery which would help tame inflation globally. Politics however are getting in the way, as the US is reducing its reliance on Chinese products.

ECB not about to lower its guard

Given the European Central Bank (ECB)'s insistence on "data dependence", the market may be forgiven for over-reacting to some key single data releases. **A rare event – inflation coming out below expectations in May – has triggered a visible repricing over the entirety of the European curve**, with the two-year and ten-year German yields losing 15bps and 18bps respectively. We want however to remain prudent. Whil*e on the margin* this has made us more comfortable with our baseline call the ECB will stop hiking after July rather than after September, we think this is a very fragile gain, and poring over Christine Lagarde's speech on 1 June, it's clear the ECB is still very much in a hiking mode, only a more cautious one.

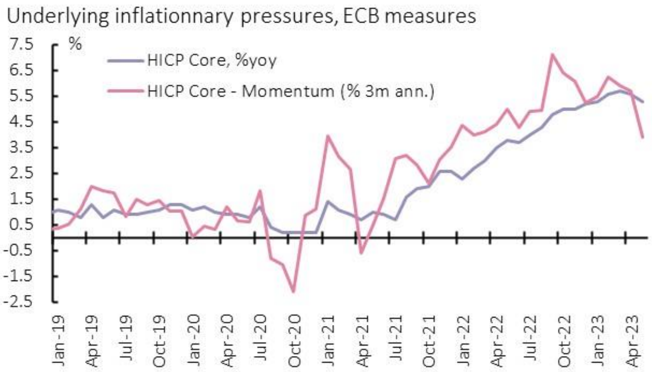
Headline inflation declined from 7.0% in April to 6.1% while the market was expecting 6.3%. The exogenous forces helped, with a decline in energy costs (from 2.4% to -1.7%yoy) and food prices decelerating further. But **core abated as well, falling from 5.6% to 5.3%, faster by 20bps than the market consensus**, with both services and non-energy goods going in the right direction. This matters. Core goods inflation had started to decelerate a few months ago, reflecting the lagged effect of the absorption of bottlenecks in the real economy and a correction in the global demand for durable goods after the hunt for "tangible products" during the pandemic. Yet, services prices were continuing to accelerate, fuelling fears of a "second wave" of the inflation shock, with unit labour costs becoming the main driver of the European price drift, counter-acting the deceleration in manufactured goods prices (see Exhibit 1). As small as it is, the 20bps decline in services inflation in May is very good news. Besides, also when we "vary the angle" to control for base effects, last week's data batch was encouraging **on a three-month annualized basis, core inflation has fallen below 4% in May, for the first time since December 2021** (see Exhibit 2).

Exhibit 1 – Both services and manufacturing heading down



Source: Eurostat and AXA IM Research, May 2023

Exhibit 2 – Core below 4% on a 3-mth annualised basis



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

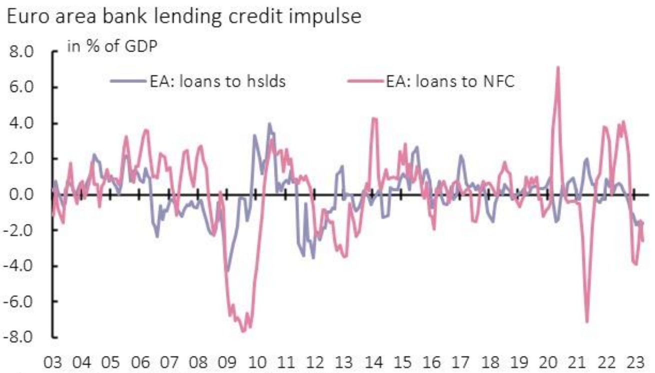
It's far too early to call this a "trend" though and we note that Christine Lagarde stated last week that *"there is not clear evidence underlying inflation has peaked"* in the Euro area. Germany has been a key contributor to the decline in services inflation in May thanks to the resumption in the rebate on train tickets which occurred in May instead of June last year. This base effect will however reverse in June since the rebate is this year much smaller than what it was in 2022.

More fundamentally, the ECB is likely to focus on what is in the inflation pipeline, rather than on observed data only. We have often described inflation dynamics as a race between on the one hand the absorption of the supply-side shocks – energy prices, global bottlenecks – and the emergence of domestically-driven second round effects via the labour market. **Earlier last week the ECB published the data for negotiated wages in Q1 2023. They came out at a robust 4.3% year-on-year, a significant acceleration from Q4 2022 (3.1%).** In a benign scenario, most of this wage pressure could be absorbed by the comfortable margins accumulated by the corporate sector since the beginning of the inflation shock, so that the final impact on consumer prices could be contained. But for this to materialise, lower demand is probably needed (if demand had not been plentiful, businesses would have been unable to raise their margins in the first place). Some of it should be spontaneous – the normal reaction of consumer spending to an elevation in prices – but arguably some additional policy action may be needed. Carefully reading Christine Lagarde's speech, **it seems the**

ECB is now reassured that its policy tightening is visibly being transmitted, but also remains on the whole convinced that monetary restrictions are not "restrictive enough", repeating the main message of the last press conference.

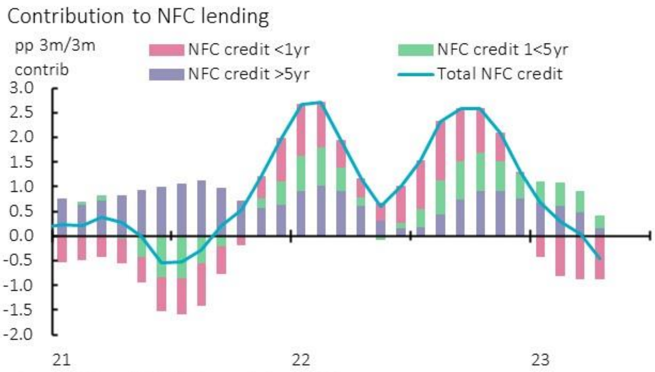
Last week also brought us the credit origination data for April. Although there is a lot of noise in these series, **the sharply declining trend in the credit impulse remains obvious** (see Exhibit 3), with maybe some stabilization in deeply negative territory for business loans offset by a continuing deterioration for loans to the household sector. This is clear evidence that, indeed, monetary policy is in restrictive territory. Looking at the behaviour in business loans per maturity, it seems the economic slowdown is getting more entrenched. Indeed, initially, short-term loans (i.e., with a maturity of less than one year) were the main drivers of the overall deterioration in the credit impulse. Then the reversal in loan dynamics hit medium-term, and more recently long-term maturities (see Exhibit 4). This would be consistent with the normal stages of a cyclical downturn, with inventories going down first (funding inventories is a key driver of short-term loan demand) before investment decisions also start being revised.

Exhibit 3 – Credit impulse continues to fall



Source: ECB and AXA IM Research, June 2023

Exhibit 4 – Long-term business credit now also hit



Source: ECB and AXA IM Research, June 2023

We also find interesting that **Christine Lagarde connected the current contrast in consumption dynamics between goods (heading down) and services (resilient) to the tightening in financial conditions**. Of course, she started from the premise that a lot of this is still a legacy of the reopening after the pandemic ("overspending" on durable goods during the lockdown is being corrected while there is some pent-up demand for services supporting aggregate consumption). But in continental Europe where consumer credit has never been as developed as in the United States (US) or the United Kingdom (UK), only purchases of durable goods tend to be funded through leveraging. Higher interest rates may have started to make consumers think twice. However, while the flow of new consumer credit has been small lately (between 2 and 3 billions a month), it's difficult to detect a clear trend. The bulk of household leveraging is in mortgages, and there the slowdown is tangible.

Yet, the ECB does not seem to be convinced that aggregate demand is correcting quickly enough in the Euro area, and it's true that **while the recession in Germany should send alarm bells rising, the overall dataflow for the real economy is confusing**, with in particular, at least according to the Purchasing Managers' Index (PMIs), a contrast between declining business confidence in manufacturing but a lot of resilience in the services sector. This may be about to change though. While still firmly in expansion territory, the PMI services edged down in May. The same message was conveyed by the European Commission (EC) survey, a bit more clearly even (see Exhibit 5). It's early days though, and pretty much as the PMI is still above 50, the EC confidence index is still above its long-term average.

We suspect that on the back of the recent dataflow **the debate within the Governing Council is less unambiguously dominated by the hawks, but there still should be enough to keep the market on its toes this summer**. We can't rule out a bad surprise in the June inflation print on the back of the base effect we discussed above, and the labour market is unlikely to react very swiftly to the signs of fading demand. Last week, when exploring the ramifications of the German recession, we mentioned that more awareness of the downturn was needed to tame wage negotiations. This could take time though. We expect wage growth to start slowing down, but only towards the end of 2023 (see Exhibit 6). The Governing

Council will receive the data for negotiated wages for Q2 2023 before its September meeting. Another acceleration – which we think is likely – will give the hawks ammunitions. We are convinced the Euro area economy is slowing down – to the point of falling in at least "near recession" in the second half of the year – but it would not take much for the ECB to continue hiking in September.

Exhibit 5 – Confidence in services turning as well?

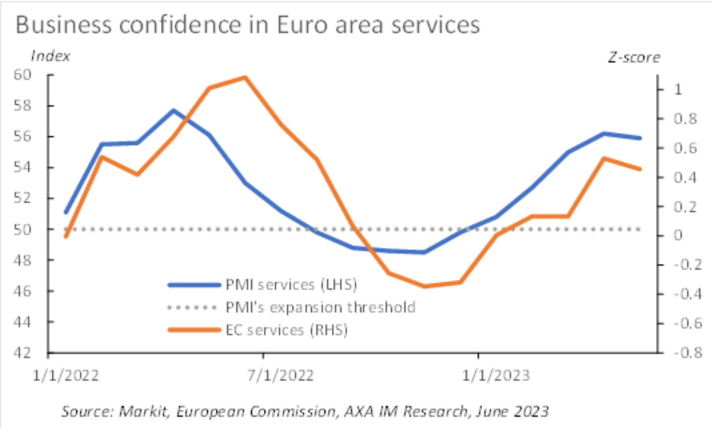


Exhibit 6 – Close to wage growth peak, but not just yet

US labour market – Have your pick!

While the market has read the recent Euro area dataflow in a dovish way, in the US it has decided to shrug off the very robust – and massively exceeding expectations – job creation in May for the June meeting**, still pricing a "pause", but has also solidified its expectations for a last "insurance" hike in July. This is understandable given the ambiguity in the data.**

The most watched component of the release, private payrolls from the Establishment Survey, defeated expectations with a net gain a 283K (168K expected), up from a significantly upwardly revised April improvement of 294k. **On a three-month annualised basis job creation was up 2.1% in the private sector, moving again above the pre-pandemic, post-GFC average of 1.9%, casting doubt on any actual landing of the US labour marke**t (see Exhibit 7). This was however offset by a higher unemployment rate, hitting 3.7% from 3.4%, despite a stable – and still below pre-pandemic level – labour participation rate. Job destruction according to the Household survey (-310K) solves the mystery from a purely statistical point of view – the unemployment rate is calculated using the Household survey - but **we are, not for the first time in this cycle, faced with conflicting messages on the real state of the US labour market.**

What may have swayed the market into maintaining only a 30% probability of a rate hike in June was probably the good news on the wage growth side, with "only" a 0.3% monthly gain in hourly earnings, in line with expectations. True, on a 3-month annualized basis, at 4.2% this is still far too high and no longer decelerating, but this is offset by a decline in working time. On a weekly basis, wage growth has declined substantially (see Exhibit 8), which would suggest that "froth" in the US labour market is abating, albeit slowly, but this is not confirmed by other sources, such as job vacancies.

A pause is usually seen as a way to signal that the right level of monetary conditions tightness is in sight. However, in the current circumstances, it could merely be the result an inability to process a conflicting dataflow in a convincing directional way. No-one at this juncture can be sure the "right" level of monetary conditions has been reached, and there may not be enough signal amid the data noise to make a decision. In the early part of the monetary tightening, it made sense to err on the "hawkish side" when faced with uncertainty, since monetary conditions were unambiguously overly accommodative. Now that they are restrictive, taking time to gather more information makes sense.
Still, in this case, **keeping rates unchanged in June would not necessarily tell us much as to the ensuing trajectory for the Federal Reserve (Fed)**. The market is now pricing an 80% probability of one last 25bps hike in July. We are still unsure this will prove necessary, as we expect further evidence of an economic downturn within the next two months.

Yet, what may be more interesting is what is now expected for the remainder of the year. As we have been repeating ad nauseam in Macrocast for months now, we think expecting rate cuts in the second half of 2023 is "brave" given how inflation would probably still be above target by year-end, especially in a situation where the Fed is probably not too happy with how it missed the beginning of the inflation wave. We are more comfortable with the market pricing now that it is expecting only one 25bps cut instead of two, even if it's in our opinion still one cut too far.

Exhibit 7 – That plane refuses to land

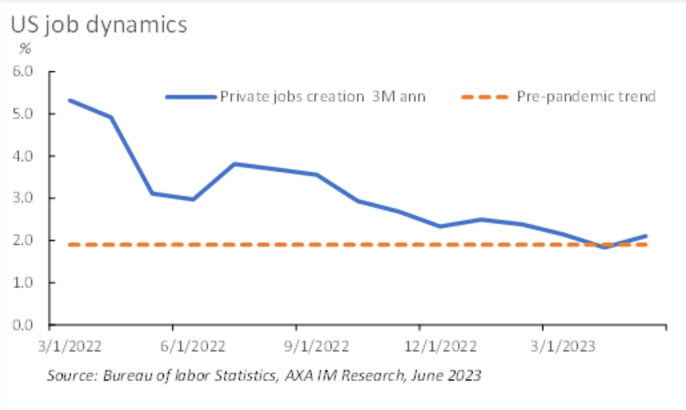
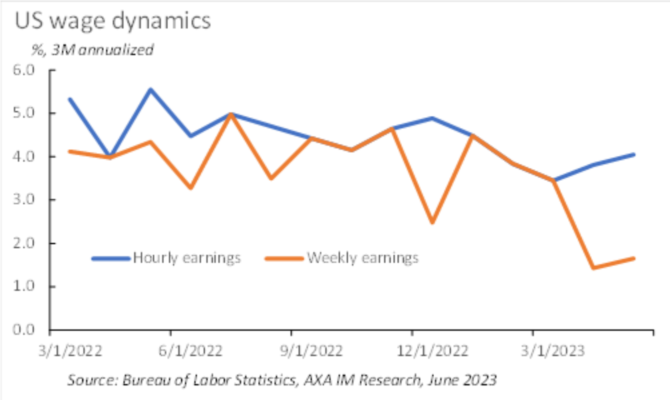


Exhibit 8 – Weekly earnings down



Can the world shun Chinese disinflation?

The commentariat has been focusing recently on the disappointing dataflow in China, epitomized by a further dip in contraction territory in the manufacturing official PMI and some weakening in the so far resilient services PMI. It seems that China, upon reopening, has been eschewing what we thought was the biggest risk – a rebound in the pandemic given the low vaccination rates in the elderly population – only to wallow again almost immediately in old issues – e.g., the correction of the housing market. Beijing has made it plain it was readying some stimulus capacity, but so far, Chinese traction has not been as decisive as expected for the rest of the world – in particular for Germany, as we have been discussing last week. Yet, we think **the current price developments in China should be discussed more thoroughly. The extreme weakness in consumer prices growth looks set to continue when looking at what is in the pipeline on the producer prices front** (see Exhibit 9).

Inflation is close to zero, which is another indication that the economy over there continues to operate below capacity. But under normal circumstances, this should be a tremendous opportunity for China. It's the only large economy which is for now avoiding the global return of inflation – even Japan seems to be finally extricating itself from its deflation trap. The ensuing competitiveness gain should support world demand for Chinese products and trigger an export-led recovery. Given the size of the Chinese export machine and its dominance in many manufactured goods, this would powerfully contribute to taming global inflationary pressure.

Exhibit 9 – Chinese disinflation continues

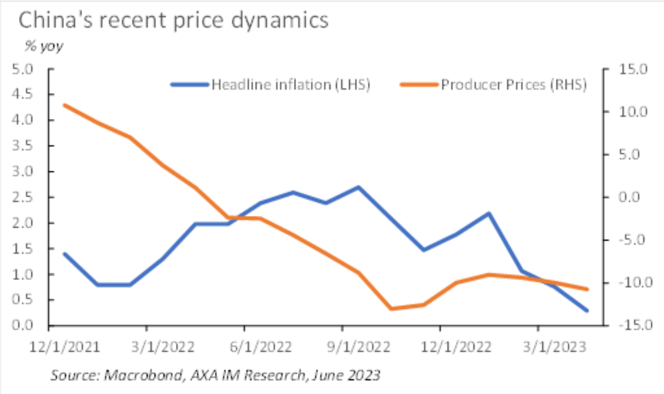


Exhibit 10 – The US is indeed moving away from Chinese products

Chinese exports have rebounded with the reopening (+8.5% year-on-year in April) but this could collide with the general diversification away from Chinese supply led by the US. In February 2023 – last available data from the Census Bureau – Chinese products accounted for only 16.2% of the US total imports of manufactured goods, below the trough seen at the peak of the trade war under the previous administration (see Exhibit 10). Some of this may be attributed to the disruptions which were lingering three months ago but looking ahead it would be surprising if the impressive legislative arsenal deployed in the US against China-sourced products (e.g., the rules of origin for the inputs in the Electronic Vehicles (EV) batteries in the Inflation Reduction Act (IRA) package) would not end up having a tangible impact on the volume of Chinese exports to the US.

Globalization is normally conducive to disinflation, since consumers can more easily source supply from countries which are not faced with an upward price shock. This has been a key ingredient in the "great moderation" which started in the 1990s. The current contrast between deflationary forces at work in China and the inflation wave in the developed world should be at least partly solved by more demand for Chinese products. Politics is however standing in the way. **The search for economic sovereignty is of course understandable, but it comes with a cost, which we think is already getting tangible**.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Congress raised the debt ceiling through to January 2025, with modest fiscal tightening and little fallout • Fed speakers intervened before purdah period as markets started to price >50% chance of a June hike • Payrolls (May) leapt to 339k, far above expectation. But unemployment rose to 3.7% and earnings slowed to 0.3%mom. JOLTS vacancies (Apr) rose to 10.1m. • ISM mfg (May) stable 46.9, new orders fell 3pt to 42.6 • Vehicle sales (May) fell more than expected to 15.1m	• Market expectations will focus on following week's FOMC meeting, but with no Fed commentary • ISM services index (May) edged higher last month from post-SVB lows, still lower than before, but not at recession levels like mfg index • HH net worth (Q1) latest estimates to underpin consumer strength looking forwards
	• Euro area "flash" HICP dropped 0.9pp to 6.1%yoy, while core HICP edged down to 5.3% in May in line with our expectations • EC business survey showed further moderation in growth momentum • Bank lending in April continued to decelerate at a modest pace	• Member states' industrial production and eurozone retail sales for April • Final euro area GDP and employment for Q1
	• Nationwide house prices (May) -0.1%mom and -3.4%yoy. Mortgage approvals (Apr) dropped to 58k • Net mortgage lending (Apr) down by £1.4bn lowest on record excl the pandemic • Mfg PMI (May) down to 47.1. Output remains high as producers work through backlogs but likely to fade	• BRC Retail sales monitor (May) likely to signal weak consumer outlook • RICS Housing survey (May) to provide an indication of the housing market outlook following disappointment seen in recent official data
	• Possibility of a June dissolution of lower house for a snap election in July remains • U/rate down 0.2ppts to 2.6% • IP (Apr) down 0.4% compared to expectations of a rise of 1.5%, but influenced by volatile elements • Retail sales (Apr) down 1.2%mom driven by a decline in car sales	• Further information on potential for early elections • Household spending data (Apr) • Second estimate Q1 GDP. Markets expect slight upward revision to initial 0.4% • Current account balance (Apr)
	• NBS PMI (May) weaker with mfg falling to 48.8 from 49.2 and services to 54.5 from 56.4 • Caixin mfg PMI (May) beats expectation rising to 50.9 from 49.5	• CPI and PPI inflation (May), CPI expected stable around 0.1%, but PPI expected weaker • Caixin services PMI (May) expt'd to slow from 56.4 • Trade data (May) export growth expected to fall
	• CB: Thailand hiked its policy rate by +25bps to 2% • Korean exports declined 15%yoy in May • April CPI eased in Korea (3.3%) & Peru (7.9%) • Q1 GDP (yoy) picked up in Brazil (4.0%), India (6.1%) & Turkey (4.0%). Czechia contracted 0.4% • PMI rose in Korea, India & Poland. It fell in Taiwan, Hungary & South Africa	• CB: India (6.5%), Peru (7.75%), Poland (6.75%) & Russia (7.50%) are expected to stay on hold • CPI (May): Brazil, Colombia, Chile, Mexico, Hungary, Indonesia, Philippines & Thailand • Industrial production (April): Malaysia, Hungary & Turkey • Q1 GDP: South Africa & Romania

Upcoming events		
	US:	Mon: Services PMI (May), Durable goods orders (Apr), Factory orders (Apr), ISM non-manf. index (May); Wed: Trade balance (Apr); Thu: Weekly jobless claims (3 Jun), Wholesale inventories (Apr)
	Euro Area:	Mon: EU20 Composite & Services PMI (May), PPI (Apr), It, Fr, Sp, Ge Services PMI (May); Tue: EU20 Retail sales (Apr), Ge New manf. Orders (Apr), Sp Ind prod (Apr); Wed : Ge Ind prod (Apr); Fri: It Ind prod (Apr)
	UK:	Mon: SMMT new car reg. (May), Services PMI (May); Tue: BRC Retail Sales Monitor (May), Construction PMI (May); Wed: Halifax HPI (May); Thu: RICS Housing Survey (May);
	Japan:	Wed: Leading index (Apr); Thu: GDP (Q1), Current account & trade balance (Apr), Economy Watchers survey (May)
	China:	Comments updated comment Comments updated comment Comments updated comment Comments updated comment

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