AXA Investment Managers

28 June 2023

Investment Institute Macroeconomics

A skip and a hop(e)

Key points

- Key event risk has faded: bank turmoil has stabilized and the US debt ceiling was resolved with little disruption.
- Focus returns to cyclical dynamics. Economic signals have been mixed. Eurozone history has been revised to a mild recession over the winter, but broadly, activity has been more resilient than we had expected.
- The outlook remains weaker: we expect mild recession in the US, and risks of downturn in the UK and even the Eurozone, although we expect firming activity in China.
- Headline inflation has fallen in most jurisdictions, but core inflation remains stickier, not least with labor markets continuing to suggest second round effects.
- Central banks are being forced into delivering more restrictive policy, even if data-dependency risks being myopic and risks sharper downturns ahead.
- Sovereign debt concerns also rise in advanced economies.

Global Macro Monthly

28 June 2023

A skip and a hop(e)

Global Macro Monthly Summary June 2023

David Page
Head of Macro Research
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Cyclical focus, structural causes

There is little evidence of any worsening of problems in the US – or global – banking system, for now anyway. Moreover, the US debt ceiling issue was resolved with far less disruption than we had feared; a deferral of the limit until 2025 in exchange for modest fiscal tightening, estimated to peak at around 0.25% of GDP next year. Moving beyond these key event risks, markets have refocused on cyclical dynamics.

We continue to expect a mild US recession with the first quarterly contraction possibly as soon as Q2, although we see the following quarter as more likely. However, data has been mixed, with surveys volatile, spending revised, aspects of housing rebounding, and the labor market posting a bewildering divergence of signals. The Eurozone, by contrast, has seen significant data revision – it now shows there was a mild recession over the winter. We expect expansion in Q2, but by the smallest of margins, and see growth remaining subdued into 2024. The UK economy has also avoided recession so far, but with a so-called ”mortgage time bomb” increasingly in the public mind, risks of a downturn are rising.

Yet these downbeat assessments focus on future growth; recent experience has typically been more resilient – even in the eurozone where we first considered a steep recession. Yet inflation remains sticky. In the US and eurozone, headline inflation has fallen sharply as energy shocks unwind – the lagged pass-through of energy has delayed this dynamic in the UK. But core measures of inflation remain stickier, slowly easing to 5.3% in the US and eurozone but rising to 7.1% in the UK.

This combination of elevated core inflation, tight labor markets, and still-resilient economic growth is forcing central banks to deliver more restrictive monetary policy. We have raised expectations for the Federal Reserve – following the ”skip” at its latest meeting – European Central Bank, and Bank of England (BoE), and we expect a policy tweak from the Bank of Japan in July. Other developed economy central banks have also tightened further.

We also consider to what extent structural issues are prolonging this phase at the top of the policy cycle.

Confusing labor market trends, including strong employment growth despite stagnant economic expansion, plausibly reflect structural developments. US unemployment jumped in part on recovering labor supply; falling eurozone hours worked reflects shifting employment composition; and recent strong UK jobs growth has been driven by rising self-employment.

These combinations are resulting in weaker productivity growth, contrary to hopes of improvement following the introduction of new technologies during the pandemic. COVID-19 and its aftermath, aging workforces and, in some cases, changing migration trends are impacting the ways labor interacts with the economy.

These structural shifts are underpinning concerns about stickier inflation and perplexing central banks. Most remain explicitly backward-looking – with a mantra of “data-dependency” – rather than relying on forward-looking forecasts. The BoE is so wary of its forecasts that it applies a risk-adjusted forecast to guide policy. This feeds our fears of eventual over-tightening and the prospect of a more meaningful correction when tightening finally gains traction.

We also monitor growing medium-term risks to advanced economies’ sovereign debt in this edition’s *Theme of the Month*. While the US successfully navigated the latest debt ceiling issue, the resulting Fiscal Responsibility Act has done little to change the longer-term, unsustainable path ahead. In the eurozone, Portugal, Ireland, and Greece have successfully improved their debt outlooks but rising interest rates will challenge others over the coming years against a background of the re-establishment of fiscal rules. Meanwhile, rising policy rate expectations have lifted longer-term UK borrowing rates back to the highs of the September fiscal crisis under then-Prime Minister Liz Truss – although sterling strength belies the view that this marks the same loss of confidence as back then. Several economies face a daunting task of achieving debt reduction. Many run the risk of seeing markets lose confidence in their fiscal strategy. This presents the risk of further yield increases over the coming quarters.

Yet market optimism persists for now with financial conditions easing to levels not persistently seen since last summer. In part, this reflects equity market optimism as investors rush to price the impact of expected longer-term productivity gains from the implementation of artificial intelligence in different aspects of the economy. The impact and indeed timing of such an improvement remains perhaps the most uncertain of all the structural developments. But it is likely to be a topic to which we return to in the future.

Global Macro Monthly – US

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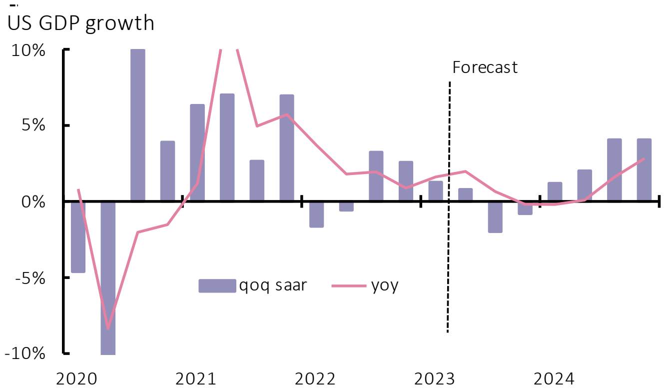
Mixed messages

Our concerns over a potentially difficult summer have not come to pass, at least not yet. The Fiscal Responsibility Act – the bill that deferred the debt ceiling restriction into 2025 – came with modest fiscal tightening over the coming years but removed a key summer risk. Admittedly, the Treasury is now planning to rebuild its cash buffer at the Federal Reserve (Fed), via the Treasury General Account (TGA), aiming to increase it to $425bn by the end of June. This could reduce liquidity over these traditionally quieter months and weigh on markets. However, the rebuild was initially outpaced by unwinding reverse repurchase agreement holdings, and net liquidity was broadly balanced between the two over the first three weeks of June.

Exhibit 1: US GDP growth projections



Source: US Bureau of Economic Analysis and AXA IM Research, 22 June 2023

As a result, the focus is firmly back on the broader economic cycle. Signs of recession remain mixed. The Empire State Manufacturing Survey's sharpest decline in a month, outside of the pandemic, was more than reversed in the latest month. Other surveys remain weak but not in recession territory. Car sales and housing starts have risen despite indications of tight credit conditions; the Atlanta Fed GDP tracker currently estimates growth of 1.9% annualized – about the long-term trend rate. Retail behavior has also been volatile: The latest sales "control" measure rose by 0.2% in May, but March's 0.3% contraction was revised lower to 0.8%, suggesting a contraction in retail spending over Q2. With a marked deterioration in the trade deficit to weigh on growth and an expected further inventory reduction, Q2's outlook remains uncertain. We forecast a modest 0.8% annualized rise, but a fall is possible.

The labor market has given out the most mixed messages. Payroll growth continues at a robust pace, with the 3-month average increasing in May to 283k (from 253k) – even if slower than over the last two years. Yet the household survey was weaker – employment falling by 310k, unemployment up 0.3ppt to 3.7%, and average hours worked falling to the lowest since the pandemic. Other measures of labor activity remain mixed, including a rise in the timely jobless claims measures, but the NFIB small business survey is broadly flat over six months.

Recession concerns to cap rate hikes

In total, broad recession indicators – sharp yield curve inversion and tight credit conditions – as well as weak survey evidence continue to lead us to expect a mild recession. However, its timing remains uncertain. We forecast contraction in Q3 and Q4 resulting in a downturn similar in scale to the early 1970s and 2000s (Exhibit 1). Yet significant uncertainty remains around household excess savings. We forecast growth of 1.0% this year and 1.1% next; a firmer 2024 outlook now with an expected inventory rebound next year.

Meanwhile inflation shows signs of progress. Headline CPI inflation fell to 4.0% in May; we expect it close to 3% in June then progress to stall over the second half with inflation remaining around 3-3.5%. Core CPI inflation has been slower to fall, now at 5.3% in May from the 6.6% peak in October. Recent core measures have been impacted by rises in used auto prices, which should reverse over the coming months. But broader risks to core CPI remain, with a still-tight labor market. We forecast CPI inflation to average 4.2% in 2023 and 3.1% in 2024. But with headline inflation closer to the Fed's mandate, it eases inflation expectations pressures for now.

These confused economic signals resulted in similarly mixed messages from the Fed at its June meeting. It left the Fed Funds Rate unchanged at 5.25% as expected but in its Summary of Economic Projections participants raised end-year expectations by 50bps to 5.75%. Fed Chair Jerome Powell described this as a "skip" – with connotations of following up with a hike – although he subsequently corrected this terminology. He also stated the decision had been taken to continue to slow (not end) the process of tightening and twice stated the next meeting in July was "live." We believe the Fed was telling us it would hike next month, not simply forecasting a need. We have raised our expectation for a Fed peak to 5.50%. However, our expectation for more convincing deterioration of economic data over the coming months leads us to expect a further hike in September – much less November – unlikely. Markets remain even more skeptical, currently pricing a 70% chance of a July hike and only fully pricing one hike by November – short of the Fed's 5.75% projections.

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Global Macro Monthly – Canada

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BoC a bellwether, or more complicated?

The Bank of Canada (BoC) raised rates by 0.25% to 4.75% in June – a surprise but consistent with voiced concerns over persistent inflation. Q1 GDP added to this worry, rising more than expected (3.1% annualized). Strength was broad-based, particularly in consumer spending, up 5.6%. Inflation had also surprised; April's headline rate rose to 4.4% with underlying inflation down easing to 4.2%. The BoC concluded policy was "not sufficiently restrictive" and it would evaluate "whether the evolution of excess demand" is consistent with "target." This is less directional than April's rhetoric where it said it "remains prepared to raise the policy rate further if needed." Markets price another 50bp of tightening by year-end.

Yet developments in Canada will follow their own beat – in May disinflation recommenced. The headline rate fell to 3.4% and core below 4.0%. April's retail sales rose by 1.1% but by only 0.3% in volume terms. If May and June repeat this, volumes would fall in Q2, and broader consumption will likely be flat. We forecast soft Q2 GDP growth of around 0.5% (annualized) and expect growth of 1.2% this year and 1.0% next (consensus 1.0% for both). Employment fell 17k in May, with the second successive fall in full-time employment. While the BoC warned only a third of mortgage holders have seen any payment rise so far, it's wary of hiking too much before the full effects of previous rises bite.

Canada is unusual in that its growth reflects a surge in its now 40mn population, which rose by 1mn (or 2.7%) in 2022 alone. In May, the labor force rose by 17k and unemployment to 5.2%. This increased supply loosens the labor market and should dampen inflation pressures, even as headline growth remains firmer. That said, the population rise adds to persistent housing pressures, and Canada's targeted migration has eased pressures in some sectors – finance, education, and information services – but raised it for others.

The BoC must also take these dynamics into account. In its latest assessment, it stated the economy remained "clearly in excess demand," and rebalancing was "taking longer than expected." This maintains the risk of further tightening. On balance, we expect the BoC to hold in July. We also expect softer activity in Q2 and Q3 to dissuade it from further hikes, thereafter, leaving a 4.75% peak. But risks remain to the upside for the foreseeable meetings.

Global Macro Monthly – EM LatAm

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Disinflation progresses but core inflation lingers

Latin America's headline inflation is showing a sustained decline across major countries, even amid resilient economic activity. As inflation comes down, so should policy rates. However, the exact timing of monetary easing is unclear as core inflation remains stubbornly sticky.

In May, Mexico's inflation rate cooled to 5.8%, marking the lowest reading since September 2021 and falling below market expectations. The drop was mainly the result of lower electricity and gas prices. Meanwhile, core inflation continues to fall but at a slower pace and remains high at 7.4%. Despite these positive developments, the Mexican central bank is unlikely to consider any rate cuts until Q1 2024. In contrast, Chile may start easing as early as July, prompted by the persistent downside surprises in inflation, which reached 7.8% in May. The central bank's latest policy statement acknowledges the possibility of near-term rate cuts, reflecting Chile's rapid disinflation and sluggish economic performance.

In Brazil, headline inflation surprised to the downside in May, falling to 3.9%, the lowest reading since November 2020. However, inflation is expected to accelerate again in the second half of the year as tax cuts on fuels are gradually removed. Moreover, core inflation has been slow to fall due to a tight labor market and higher fiscal transfers. Inflation also came below expectations in Colombia reaching 12.4% in May, thanks to a moderation of food prices. Adding to the good news, the reduction in the country's current account deficit and reduced political risks are contributing to a strengthening of the peso, which should aid the disinflation process in the coming months.

In contrast to other countries in the region, Peru has experienced slow disinflation. Inflation reached its peak at 8.8% in June last year and has only declined by one percentage point since then to 7.9% in May. This slow progress reflects adverse weather and politically related shocks that the country has endured since the start of the year. As such, the easing cycle will likely be postponed until Q4 of this year.

Despite the region's progress in disinflation, inflation remains above target in most countries. In addition, risks for the inflation outlook remain biased to the upside due to potential price shocks from the global economy, and the effects of El Niño which could exacerbate flood inflation.

Macro forecast summary

Real GDP growth (%)	2022		2023*		2024*	
	AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
World	3.4		2.7		2.8	
Advanced economies	2.7		0.9		0.9	
US	2.1	2.1	1.0	1.1	1.1	0.6
Euro area	3.6	3.2	0.4	0.7	0.5	0.9
Germany	1.8	1.8	-0.5	0.1	0.3	1.1
France	2.6	2.6	0.6	0.6	0.5	0.9
Italy	3.7	3.8	1.2	0.8	0.4	0.9
Spain	5.5	5.5	2.0	1.6	1.0	1.6
Japan	1.1	1.0	1.5	1.0	1.3	1.1
UK	4.0	4.0	0.2	-0.1	0.3	0.8
Switzerland	2.1	2.1	0.7	0.7	1.0	1.4
Canada	3.4	3.4	1.3	0.9	0.9	1.2
Emerging economies	3.9		3.8		3.9	
Asia	4.3		5.0		4.6	
China	3.0	3.0	5.3	5.8	5.0	4.9
South Korea	2.6	2.6	1.5	1.1	2.0	2.1
Rest of EM Asia	6.0		5.0		4.4	
LatAm	4.0		1.5		2.3	
Brazil	2.9	2.9	1.0	1.2	1.5	1.6
Mexico	3.1	3.1	1.2	1.8	1.8	1.7
EM Europe	0.9		1.5		2.3	
Russia	-2.1		1.7		1.3	1.3
Poland	4.9	4.9	1.0	0.7	2.9	3.1
Turkey	5.6	5.6	2.1	2.2	3.1	2.6
Other EMs	4.9		3.1		3.7	

Source: Datastream, IMF and AXA IM Macro Research – As of 27 June 2023
**Forecast*

CPI Inflation (%)	2022		2023*		2024*	
	AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	7.4		4.7		2.7	
US	8.0	8.0	4.3	4.2	3.0	2.6
Euro area	8.4	8.5	5.6	5.5	2.8	2.4
China	2.1	2.0	2.3	1.8	2.5	2.4
Japan	2.5	2.5	2.7	2.6	1.3	1.4
UK	9.1	9.1	7.1	6.7	2.5	2.8
Switzerland	2.8	2.8	2.4	2.5	1.5	1.5
Canada	6.8	6.8	3.9	3.6	3.0	2.2

Source: Datastream, IMF and AXA IM Macro Research – As of 27 June 2023
**Forecast*

These projections are not necessarily reliable indicators of future results

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Forecast summary

Central bank policy Meeting dates and expected changes (Rates in bp / QE in bn)		Current	Q3-23	Q4-23	Q1-24
United States - Fed	Dates	5.25	25-26 Jul 19-20 Sep	31-1 Oct/Nov 12-13 Dec	30-31 Jan 19-20 Mar
	Rates		+0.25 (5.50)	unch (5.50)	-0.25 (5.25)
Euro area - ECB	Dates	3.50	27 Jul 14 Sep	26 Oct 14 Dec	25 Jan 7 Mar
	Rates		+0.50 (4.00)	unch (4.00)	unch (4.00)
Japan - BoJ	Dates	-0.10	27-28 Jul 21-22 Sep	30-31 Oct 18-19 Dec	Jan Mar
	Rates		unch (-0.10%)	unch (-0.10)	unch (-0.10)
UK - BoE	Dates	5.00	3 Aug 21 Sep	2 Nov 14 Dec	1 Feb 21 Mar
	Rates		+0.25 (5.25)	unch (5.25)	unch (5.25)
Canada - BoC	Dates	4.75	12 Jul 6 Sep	25 Oct 6 Dec	Jan Mar
	Rates		unch (4.75)	unch (4.75)	unch (4.75)

Source: AXA IM Macro Research - As of 27 June 2023

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