Fog on the Window

- We explore the risk the Fed cannot cut at all this year. We are not convinced
- We look at the potential ramifications for the ECB of the Fed postponing its first cut beyond June.
- The outcome of the wage negotiations opens the door wide to the BOJ normalisation.

The market has moved markedly from its exuberant expectations of massive cuts by the Fed to price barely three cuts in 2024. The mood music is that there is now a distinct risk the US central bank will be unable to cut at all this year because of a window for easing closing well ahead of the presidential elections. We agree that some key details in the latest prints of the consumer price index are concerning but we also think there are enough signals elsewhere for Jay Powell to continue to guide towards a gradual removal of some of the current restrictive stance. The revised data for January and the February print for wages have been reassuring, with a pace consistent with a return to 2% inflation given the US strong productivity performance. We also highlight a very recent paper by the Brookings suggesting that the much higher than expected net immigration in the US could explain why the US economy could continue to create many jobs without triggering further tension on wage. On the political constraints, we think it would be reputationally very dangerous for the Fed to allow the looming elections to influence its reaction function and choose inaction if the data warranted a monetary easing, and there is no obvious historical pattern to substantiate a strong influence of the pre-electoral context on Fed decisions.

We explore the consequences for the ECB of the risk the Fed would not cut in June. The only strong argument in favour of taking on board the Fed's attitude would be the potential impact on European inflation transiting through another depreciation in the exchange rate. Yet, we think that the current euro exchange rate level already takes on board a baseline in which the ECB cuts more than the Fed this year, and in any case the ECB's key focus now is domestic inflation, not the role of external forces.

There is quite some trepidation on the possibility the Bank of Japan could end its negative rate policy this week already. The results of the wage negotiations certainly fuel the BOJ's resolve to start normalising, but we still think moving in April presents some advantages. What really matters anyway is not whether the BOJ moves in March or April, but how it will handle the end of Yield Curve Control.

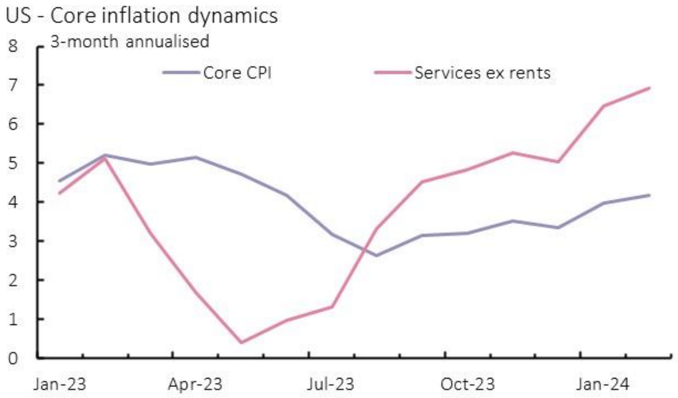
Now you see it, now you don't

The March Fed meeting was seen as just another step in an orderly communication strategy leading to a rate cut in June. After Jay Powell's latest testimonies to Congress, there was little doubt the Fed would continue to feel increasingly confident about disinflation while sanguine about a still robust real economy and pave the way for a policy reversal at a measured pace. Yet, **some key components of the dataflow continued to misbehave, and the latest "talk of town" on the market is the risk that the central will find itself unable to cut at all this year. For now, the market pricing is still broadly aligned with the December's Fed forecasts with three cuts by year end, but the level of conviction has been falling** and, as of last Friday, the market was pricing a probability of cutting in June only marginally above 50%, down from more than 80% just a few weeks ago, while only 72bps worth of cuts are now priced in by year-end. We find ourselves in a paradoxical situation: for months we have expressed our disbelief at what we thought were completely unrealistic expectations from the market (with a total easing this year peaking above 150bps), but equally we are now unconvinced by the current "no cut" mood music. While we fully acknowledge that the famous "last mile" of disinflation is proving arduous – a point we have often made these last few months – there are in our view enough underlying signals in the US dataflow to warrant 3 to 4 cuts this year.

Let us start with the bad news. **The Consumer Price Index (CPI) release for February confirmed the concerning trend of the last few months**. On a year-on-year basis core CPI decelerated less than what the market was expecting (from 3.9% to 3.8%, consensus was at 3.7%), but more fundamentally the short-term momentum remains resolutely up. On a 3-month annualised basis the re-acceleration in core continued, and it cannot be ascribed to rents: services excluding rents are still moving up fast (see Exhibit 1). As was already the case in January, the fact that the pressure in the CPI goes far beyond rents suggest that the core Personal Consumption Expenditure deflator (PCE) on which the Federal Reserve (Fed) focuses will also be up (the share of rents is smaller in the PCE index)**. We think Jay Powell this week will stick to preparing minds to an easing trajectory, but to deliver this he will probably draw attention to what is "in the pipeline" for inflationary tension rather than on the observed outcome for consumer prices.** Fortunately for him, we think the recent dataflow can be more helpful on this front.

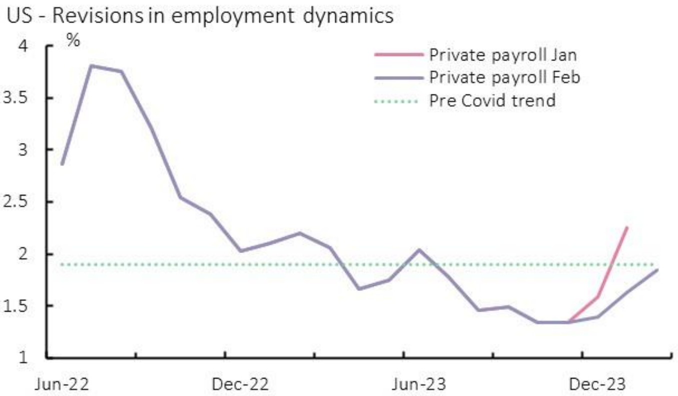
The labour market is of course key, and it remains an acute frustration that the flagship indicator on this front – the monthly payroll report – is so volatile and subject to revision. In the January batch, the momentum in job creation had significantly exceeded again the pre-pandemic trend. **The February batch however brought relief with a significant downward revision in the recent data and job creation was – marginally – still below trend**. The rebound itself is still there and it is of course surprising so far into the Fed's tightening cycle, but it now looks less acute (see Exhibit 2).

Exhibit 1 – Core CPI momentum up again



Source: Bureau of Labor Statistics and AXA IM Research, March 2024

Exhibit 2 – Significant downward revisions to job creation

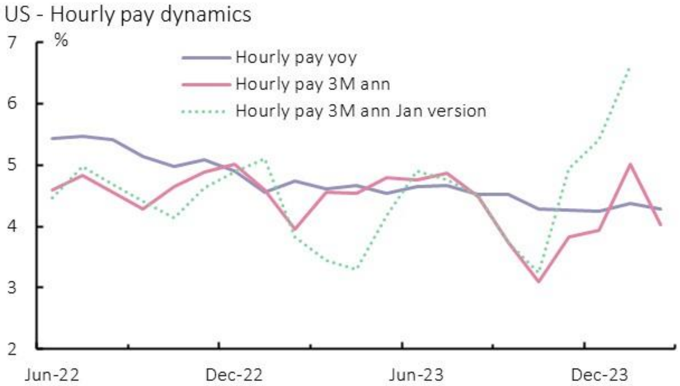


Source: Bureau of Labor Statistics and AXA IM Research, March 2024

The most reassuring aspect in the payroll batch for February was the steep downward revision in pay per hour. We have been highlighting the strong productivity gains in the US economy, but even above 3% they could not bring unit labour costs to a path consistent with a return to 2% inflation if the momentum in pay per hour, close to 7% on a 3-month annualised basis in January in the first estimate of the payroll, did not fade quickly. **The January momentum for**

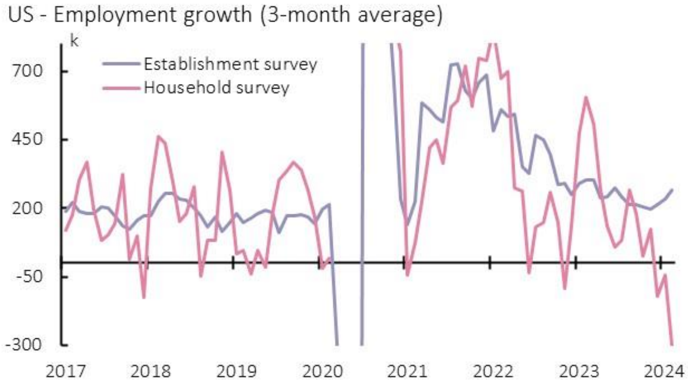
wages has however been revised down to a less scary 5%, followed by a notable deceleration to 4% in February, a pace which – assuming the strength in productivity is sustained – would be comfortably in line with 2% inflation (see Exhibit 3).

Exhibit 3 – January pay was not so scary after all



Source: Bureau of Labor Statistics and AXA IM Research, March 2024

Exhibit 4 – The return of the survey divergence



Source: Bureau of Labor Statistics and AXA IM Research, March 2024

The divergence between the Establishment and the Household survey in the payroll report adds to the current "data fog". It is not the first time in this cycle that the household survey points to job destruction while the headcount reported by the Establishment survey remains more than decent (see Exhibit 4). It would have been wrong in 2022 and early 2023 to make monetary policy decisions based on the household survey, which has been distinctly erratic since the post -pandemic reopening, but the gap between the two surveys may still provide some information on labour market dynamics. **It is possible that the current divergence reflects the impact of the ongoing rebound in immigration in the US,** which the Household survey can capture only with a lag when the results from the sample are adjusted for new population estimates. The Establishment survey has its own issues – a difficulty to account for the net flow of disappearing/newly created businesses – but at least it should be less disturbed by population dynamics.

The Brookings Institution came up this month with a very elegant paper looking into this issue (see link here). **In 2019, just before the pandemic, the Congressional Budget Office forecasted net immigration would hit 1 million in 2023. Its new estimate stands at 3.3 million (c.1% of the resident population).** The authors of the Brookings paper estimate that this has raised sustainable employment growth – the number of new jobs reported in the establishment survey which can be added to the economy without triggering inflationary pressure - to 160k-240K/month in 2023, still below actual numbers but by a much smaller margin than the usual estimates (60-130K). The immigration flows – with newcomers' bargaining power being on average lower than the incumbents – help to understand how the US machine could at the same time keep on growing relatively fast without triggering too much additional tension on wages and, subsequently, inflation. These findings by the Brookings may fuel the already hot political debate on migration in the US and make Joe Biden's position even more difficult, but from a purely macroeconomic point of view, this could reassure the Federal Reserve.

Another signal which we think could help Jay Powell maintain his message on a gradual easing trajectory comes from the real economy. The resilience in US GDP growth so far has been essentially reflecting the strength of consumer spending (investment has been softening since mid-2023). The disappointing January print for retail sales was initially dismissed as an accident. The "control group" component – closest to the national accounts' broader version of consumer spending – fell by 0.3% on the month, against a consensus forecast of +0.2%. The market was duly expecting a rebound in February (+0.4%mom) which did not materialise (the control group was flat). Private consumption may finally have started to soften. This would be consistent with the sobering message from the Fed's latest beige book, the qualitative assessment of economic activity by the regional Reserve Banks' local branches: "*Economic activity increased slightly, on balance, since early January, with eight Districts reporting slight to modest growth in activity, three others reporting no change, and one District noting a slight softening. Consumer spending, particularly on retail goods, inched down in recent weeks.*" The sense that, at long last, US economic growth is no longer stellar would of course support the case for not waiting too long before starting to remove some of the current monetary policy restriction.

We expect the distinction between "accommodation" and "lesser restriction" to inform Jay Powell's statements this week. Indeed**, if the "median Federal Open Market Committee (FOMC) voter" maintains three cuts this year as baseline – which is our central case – the projected policy rate would remain well into restrictive territory by the end of the year**. The equilibrium rate may well have risen above the 2.5% long term level for the policy rate retained so far in the "dot plot" but arguing it is now above 4% would be very far-fetched in our opinion. There is of course a risk that the "dot plot" would be revised to only two cuts for 2024, but in terms of credibility risks for the Federal Reserve the gain would be very limited: the market is no longer expecting any cut before June. This gives the FOMC some time to assess the data carefully before having to significantly alter its message.

Measuring the windows

In a nutshell, it is possible that it takes more time than we thought for price data to prove "beyond reasonable doubt" that full convergence to the Federal Reserve (Fed)'s target is materialising, but there are in our opinion enough signals that the real economy is starting to soften to keep the Fed in an easing mood. **What is however starting to create concern in the market is the sense that there is only a limited "window of opportunity" for the Fed. This is often expressed in the blunt statement that if the Fed has not cut by June, or by July at a stretch, it will not be able to cut at all before the very end of the year, if at all in 2024.**

The case for this is driven by "pure" and "impure" political reasons. Let us start with the pure ones. The logic is that if by the end of spring the economy is still too strong to warrant a rate cut, it may become rational to wait until there is a clear signal on fiscal policy post-elections to calibrate the monetary response, even if some faint signals of deterioration in the dataflow materialise in the autumn. Indeed, if Donald Trump wins and Republicans regain full control of Congress, tax cuts are likely to follow, possibly in combo with inflationary trade tariffs (the Republican candidate last week stated that he would offset the impact of his 10% trade tariff on real income with tax cuts). The impure one is that the Fed would prefer to avoid cutting too close to the elections for fear of being accused of pro-Biden bias.

We scoured the behaviour of the Fed since the advent of modern monetary policy in every election year when an incumbent President was running again and over this small sample no pattern emerges. True, **the stakes are particularly high this time because we are talking about a full monetary stance reversal - cutting after a series of hikes - and not just the continuation of an already settled course.** There is only one modern example of such reversal in an election year featuring an incumbent. In 2004, as George Bush Junior was running for his second term, the Fed ended a long phase of low interest to start hiking in June. It refrained from hiking again immediately before the election to resume tightening in November 2004 a few days after the elections, but it had hiked September. It is possible that this 2004 episode explains the current focus on June as the "last possible time" for a policy reversal on an election year, but turning a general rule out of only one precedent looks far-fetched to us. When no incumbent is running, the 2016 elections is often singled out since the Fed waited until just after the elections to hike after 12 months of stability … but it merely replicated the move of the previous year (a 25bps hike in December 2015 after a long phase of near-zero interest rate).

Our long-held opinion on this is that there is no upside for the Fed in overthinking its behaviour around elections. The best course of action - both from a macro and reputational point of view - is to do exactly what the data and the usual reaction function would tell the FOMC to do. Beyond the need to protect its reputation against accusations of political bias**, making monetary policy decisions (and sometimes not moving is a decision) on a guess of what the election outcome will be and the impact it could have on the fiscal stance would put the central bank on a slippery road, in effect pre-empting democratic decisions.**

For those who believe that your humble servant is becoming far too naive and overly optimistic on human nature, we would observe that the Fed decisions are made collectively and that if a member - be it the chairman - appears as overly interested in his chances of landing another term to the point it colours his or her monetary policy view, the other FOMC members –

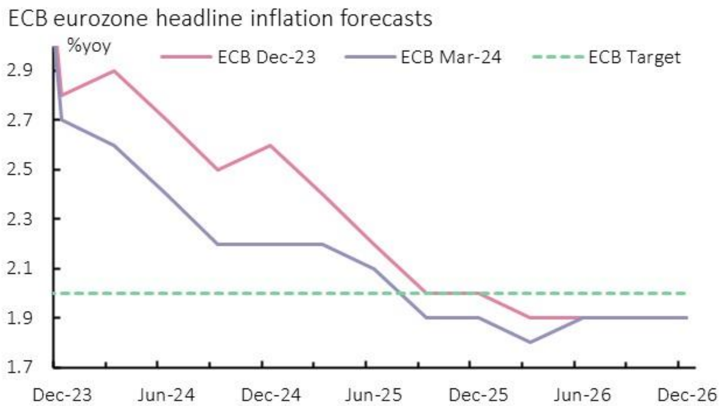
a quite diverse bunch politically - should be able to keep him or her in check. Obviously, there is a margin of appreciation, and we agree that moving right before the election could be contentious, but there is no meeting between 18 September and 6 November.

How should the ECB navigate Fed uncertainty?

The risk that the Fed would cut later than expected – or not all – takes a particular resonance for the European Central Bank (ECB), since the possibility of cutting independently was raised in a question to Christine Lagarde at the latest press conference. We thought she was unambiguous in her answer about the need for the ECB to do what is appropriate for the Euro area, but the issue will probably linger until at least the June meeting. The Governing Council will this time meet one week before the FOMC on 6 June. By then, they may have strong indication from Fed speakers on the likely result of their US counterpart's deliberations, but if the debate between hawks and doves at the Fed is lively, the ECB may still have to "shoot in the dark".

The main – and possibly only – reason the ECB should care about the likely move by the Fed is because this could alter the European inflation trajectory via the exchange rate ramifications. Of course, if the ECB starts cutting – we expect them to start in June as well – while the Fed stays put would probably take the euro exchange rate further down. We do not think this effect should be overstated though. First, the market has been pricing for several weeks that the overall quantum of cuts by the ECB would exceed that of the Fed this year (91 against 71bps as of last Friday) and this should already be taken on board in the current level of the exchange rate. Second, avoiding a depreciation of the currency makes a lot of sense when external forces are dominant in the overall behaviour of inflation. This is hardly the case now in the Euro area. True, the price momentum for – often imported – manufactured goods has been up lately in the CPI but coming from a very low base, and Christine Lagarde was very explicit on the ECB's current focus on *domestic* inflation. In any case, the central bank's latest forecasts interestingly project some slight undershooting of inflation (see Exhibit 5) in 2025: this would provide a buffer for some return of imported inflation if the euro were to depreciate. **Our conviction is that domestic conditions permitting, the ECB would still cut in June even if the Fed chose to postpone its own move**.

Exhibit 5 – Some buffer for 2025



Source: European Central Bank and AXA IM Research, March 2024

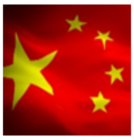
The BoJ's window is opening

Looking at snapshot of the Japanese economy, it is at first glance far from obvious why the Bank of Japan (BoJ) should alter its policy stance and hike imminently. Technically, **Japan is no longer in recession since the first estimate for Q4 GDP was revised up to +0.1% after a dismal reading in Q3 (-0.8%) but the real economy still looks wobbly**. Inflation is too high but headline – including tax effects – was back to 2.2%yoy in January 2024 from a peak at 4.3% in January 2023, while core has been decelerating since August of last year. **The decisive development however is that inflation dynamics look now more entrenched in the economy, with the crucial "wage-price loop" re-emerging at long last.**

Indeed, last Friday the leadership of Rengo, Japan's biggest union, announced that as a result of the negotiations with the employers' federation its affiliates would receive a pay bump (including seniority effect) of 5.3% on average, 0.5% less than the union's initial request which had surprised on the upside and the largest since 1994. Such half point bid/ask difference is not particularly large (the gap in the 2023 round stood qt 0.7%). This outcome is fuelling **speculations that the central bank would exit negative policy rates at this week's meeting, rather than wait until April as per our baseline**.

We are still unconvinced the BoJ will announce the policy shift this week already. Moving in April would coincide with the new set of forecasts prepared by the central bank's staff. In addition, moving as early as this week could give way to too much market expectation of a swift normalisation pace from then on, whereas for months the BoJ has been preparing minds for a very gradual process. We do not expect another 10bps hike before Q4 of this year – in a still uncertain environment for the Japanese economy.

Whether the BoJ moves in March and April is a second order issue in our mind – in any case we would expect the bank to lay the ground for a move next month if it does not hike this week – relative to **how the BoJ will manage its intervention on the bond market from then on**. We think the BoJ will put an end to yield curve control and give up on any explicit target for the 10-year yield, but while still "reserving the right" to act and modulate its purchases of bonds if the bond market is too volatile and triggers an inappropriate tightening in financial conditions. This matters well beyond Japan's borders, given the impact a massive repatriation of Japanese savings away from the US and European markets could have.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• CPI inflation (Feb) firmer than expected at 3.2%yoy (3.8% core), but likely on erratic components • PPI inflation (Feb), also firmer at 1.6%yoy (2.0% core), but not in components that add to PCE • Retail sales (Feb) +0.6% on gas, Jan revised to -1.1%. Control 0.0% after -0.3%. First signs of weaker sales • Empire State idx (Mar) drops to -20.9, still -ve trend	• FOMC meeting. FFR expected unch. Focus on dots, we expect 3 cuts still signalled, but risks of shift to 2 • Existing home sales (Feb), watch for continued recovery in sales & housing starts and permits (Feb) • Philadelphia Fed idx (Mar), pullback as in Empire? • PMIs mfg and servs (Mar, p)
	• Euro area IP fell by a marked 3.2%mom in January, consistent with -2% Q1 carry over, casting early downside risks to our +0.1%qoq eurozone Q1 GDP forecast	• Euro area final HICPs for February • Euro area flash March PMIs & German Ifo
	• Labour market (Jan/Feb) slack starting to emerge; emp. down 21K in 3m to Jan. unemp. rate up to 3.9% from 3.8%. Ex-bonus measure of AWE fell to 6.1%, from 6.2% (consensus 6.2%) • GDP (Jan) likely out of recession. GDP up 0.2%mom in Jan, after 0.1% decline in Dec.	• MPC meeting, policy expected unch at 5.25%, vote to remain split 3 ways. Soft CPI may shift vote dovish • CPI inflation (Feb) expected to edge lower, BoE expect 3.5%, from 4%. Consensus at 3.6% • Flash composite PMI (Mar) to remain well above 50
	• Q4 GDP revised up after capex finally rising by 2%qoq. Priv. consumption remains subdued (-0.3%) • Japan's biggest companies agreed to raise wages by 5.28% for 2024 (base pay and seniority), the heftiest pay hikes in 33 years	• (BoJ meeting). The end of NIRP and YCC is a done deal but will be implemented only in Apr. The trick is to communicate this quite clearly while refraining market participants to anticipate too many rate hikes in the near future to maintain an accommodative bias • PMIs flash (Mar) and CPI (Feb) (cons: 2.8%yoy)
	• CPI (Feb): 0.7%yoy, up from -0.8% in Jan. PPI (Feb): -2.7%yoy down from -2.5% in Jan. • 70-city new house price (Feb): -0.36%mom, second-hand house price (Feb): -0.62%mom • 1Y MLF (Mar) held unchanged at 2.5% • TSF (Feb): 1.56tn RMB from 6.5tn Jan; new loan: 1.45tn RMB, down from 4.92tn in Jan. M2 supply stayed at 8.7%yoy, same as in Jan.	• 18 Mar: Jan-Feb combine monthly output data including industrial output, fixed asset investment, and retail sales. It is the first monthly output release of the year and critical to evaluate the efficacy of the policy measures
	• Feb CPI (yoy): Brazil (4.5%), Czechia (2.0%), India (0.2%), Romania (7.2%) & Russia (7.7%) • Jan industrial production (yoy): India (3.8%), Malaysia (4.3%), Mexico (2.9%), Romania (-3.9%) & Turkey (1.1%) • Jan Retail sales: Brazil (4.1%), Czechia (2.4%) & Indonesia (1.1%)	• CB: Indonesia (6.0%), Taiwan (1.875%) & Turkey (45%) are expected to stay on hold. Brazil to cut -50bps to 10.75%, Czechia -50bps to 5.75% & Mexico -25bps to 11.0% • Jan Industrial production: Czechia, Colombia, Poland & South Africa • Q4 GDP figures in Chile

Upcoming events	US:	Mon: NAHB housing index (Mar); Tue: Building permits (Feb), Housing starts (Feb); Wed: FOMC announcement; Thu: Current account (Q4), Weekly jobless claims (16 Mar), Mfg & services PMI (Mar), Existing home sales (Feb)
	Euro Area:	Mon: Ez CPI (Feb); Tue: Ge ZEW survey: current situation & economic expectations (Mar); Wed: Ez Consumer confidence (Mar), Ge PPI (Feb), It Industrial production (Jan); Thu: Ez,Ge,Fr Mfg & services PMI (Mar), Ez Composite PMI (Mar); Fri: S&P reviews Germany's credit rating, Ge IFO business climate index (Mar), DBRS reviews France's credit rating
	UK:	Wed: CPI (Feb), CPIH (Feb), RPI (Feb), PPI input & output (Feb); Thu: PSNB (Feb), Mfg, services & composite PMI (Mar), MPC announcement; Fri: Fitch reviews UK credit rating, Gfk consumer confidence (Mar), Retail sales (Feb), CBI Industrial trends orders (Mar)
	Japan:	Tue: BoJ announcement; Thu: CPI (Feb)
	China:	Mon: Fixed asset investment (Feb), Retail sales (Feb), Industrial production (Feb); Wed: Loan prime rate decision (1y & 5y)

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