Saved by Supply

- "Interim meeting" for the ECB, with no decision expected. The dataflow still points to a June cut.
- In the US, strong supply conditions continue to help contain inflation pressure despite strong job creation.

No decision is expected from the ECB this week. Last month, Christine Lagarde had hinted at action in June, but of course the Governing Council will have the occasion this Thursday to report on an "interim assessment" of the Euro area's macroeconomic situation. The central bank's decision to revise down its inflation forecast appears to be vindicated by the March print for CPI: disinflation continues at a faster clip than the market expected. The resilience in services prices remains a sore point though. The message from the surveys on firms' price future price behaviour, and still anaemic domestic demand, are however reassuring for the quantum of inflationary pressure still in the pipeline. It seems the European economy is for now stabilising in low gear. True, acquired speed in nominal wages, contrasting with slower headline inflation, will support purchasing power, but fiscal headwinds are accumulating before the impact of the monetary tightening fades. We continue to think the ECB will not wait until inflation has fully converged to 2% and will cut in June, even if the Fed dithers.

The possibility of a lag between the ECB and the Fed is now the market's baseline. While we maintain June as our baseline for the first Fed cut as well, it is undeniable that the dataflow is less clearly supportive of a monetary policy reversal in the US than in the Euro area. Job creation remains robust and its re-acceleration since the autumn of last year was confirmed again in the March batch of the payrolls. We note however that pay growth has stabilised at a pace which, assuming current productivity gains are sustained, should be consistent with a return to 2% inflation. Strong supply conditions, driven in particular by large net immigration, are helping. That the recent "Fedspeak" has turned remarkably prudent makes sense, but we still consider Kashkari's hints last week at "no cut" at all in 2024 as an extreme scenario. That however the ECB cuts before the Fed is absolutely within our "plausibility range". We note that the Euro exchange rate has barely softened despite a reversal in market expectations on policy rate differentials (still in early February the consensus was for more hikes by the Fed than by the ECB). This should embolden the ECB to take the right decisions for the Euro area irrespective of what the Fed ultimately does.

What more do they know?

At the March meeting Christine Lagarde started laying the ground for a rate cut at the end of spring by stating that the European Central Bank (ECB) would "*know a bit more in April and a lot more in June*". It's thus fair to explore what that "*bit*" of additional information may be.

The new ECB forecasts unveiled in March reflected a belief in a faster convergence of inflation towards target, with a significant downward revision relative to December for Consumer Price Index (CPI) in 2024 and an earlier landing to 2% in mid-2025. It's early days of course but the latest print vindicates this choice. Both headline and core inflation decelerated more sharply than the market expected in March, falling by 20bps from February in both cases (the consensus was for only 10bps) to 2.4% and 2.9% year-on-year respectively. It would however be too hasty to sound the "all clear". Echoing the developments already seen in the US, the price behaviour of core goods and services continues to diverge. On a year-on-year basis, services prices growth stabilised at a high mark in March, while the price of manufactured goods continues to decelerate at a brisk pace. When taking a long-term perspective, inflation in core goods is back within the pre-Covid, below 2% range, while for services inflation is still above the peaks seen at the beginning of monetary union (see Exhibit 1). Normalisation is not complete. When focusing on the short-term momentum (annualised 3-month change) the contrast is even more striking: services prices have re-accelerated further in March, confirming the break in January (see Exhibit 2).

Exhibit 1 – Inflation in a long-term perspective

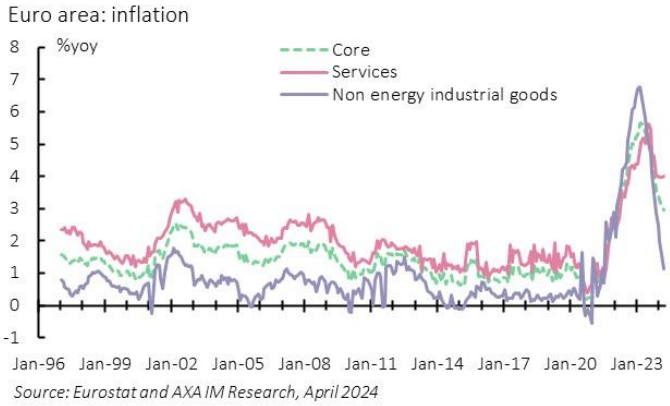
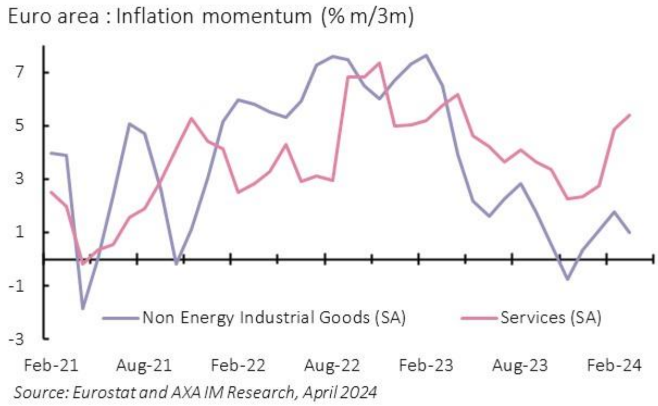


Exhibit 2 – Services prices continue to misbehave



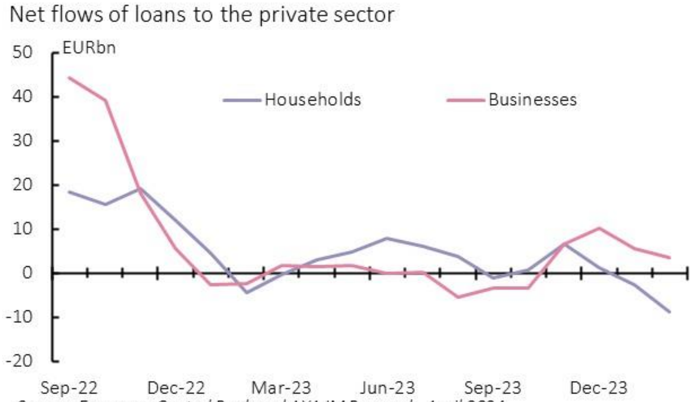
What additional data will the Governing Council have on what is on the pipeline for services prices? They already knew about the deceleration in negotiated wages in Q4 when they last met, but they may find **additional comfort in the latest European Commission business survey in the services sector.** Indeed, after a concerning rebound in January to 1.8 standard deviations above its long-term average, the balance of opinion on expected prices fell back to 1.1 in March. Still elevated but moving again in the right direction.

On the real economy, signs of stabilisation at a low pace have accumulated. The commentariat has made much of the upward revision of the composite Purchasing Managers' Index (PMI) for March to 50.3, back in expansion territory for the first time since May 2023. We do not think however that this necessarily heralds a strong recovery.

Indeed, it is not obvious that the Euro area economy is already past the peak impact of the monetary tightening. True, a trough has seemingly been hit on business loans last autumn and the net new flows have been positive again on a three-month average basis since last November, but this rebound has been more than offset by **a relapse in contraction territory for loans to households** (see Exhibit 3), driven by the continuing decline in mortgage production. Housing activity continues to be seriously impaired across much of the Euro area and we would not count on a proper recovery in this sector before interest rates visibly fall.

Besides, even if the impact of the monetary tightening on cyclical conditions will probably start fading later this year**, the reversal of the fiscal impulse in the Euro area is likely to emerge gradually in the domestic demand data.** We have already commented in Macrocast the untimely fiscal tightening in Germany. The fiscal turnaround is now being confirmed in France. The realisation that the deficit for 2023 was higher than targeted (from 4.9% to 5.5% of GDP) has quite understandably triggered additional pledges by the government to rein in spending in 2024 and 2025 (with cuts of “at least” EUR20bn pencilled in for 2025 – 0.7% of GDP – coming after EUR10bn already legislated for 2024) which will add to the impact of the already planned removal of the last provisional support measures enacted to deal with the energy crisis**. Beyond the direct effect the cuts themselves will have on domestic demand, the media focus on the fiscal issue may weigh on business and consumers’ decisions to spend.**

Exhibit 3 – Bank lending still timid



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

In other member states, the main issue is not necessarily the new fiscal measures, but quite simply the disappearance of massive sources of government support. **France was not the only country experiencing a sizable revision of its 2023 deficit. It was much larger in Italy** (from an estimate in October 2023 at 5.3% of GDP to 7.2%) essentially because the cost of the “superbonus” – a very generous government subsidy for home improvement – was revised up from 1.8% of GDP to a whopping 3.7%. The measure has now been quite rightly terminated, but the key question now for Italy is how domestic demand will maintain its current decent pace without this fiscal support.

Still, we do not want to be overly pessimistic about the Euro area economy in 2024. **Among the potential tailwinds for domestic demand, real wages are now a strong candidate.** Indeed, even if we think wage growth will continue to fade in the months ahead, the “acquired speed” is likely to hover around 4% for quite some time, nicely above headline inflation, providing some impetus to purchasing power even if we cannot count on much help from job creation to boost consumption (employment grew by only 0.3%qoq in Q4 2023 and the latest surveys are not pointing to much momentum). There are also some tentative signs that the global manufacturing cycle may be finally turning – we discussed a few weeks ago the rebound in export orders in Taiwan, often a forward-looking indicator of industrial activity worldwide. This should benefit some of the most export-driven countries of the Euro area, Germany in particular.

Our main point though is that the net effect of these positive forces against the monetary and fiscal policy headwinds is consistent with **economic growth remaining mediocre, even if risks of outright recessions have faded. This would not be enough to get much demand pressure to push consumer prices up by incentivising businesses to raise their margins,** thus allowing the ECB to remove some of the restriction without waiting for inflation to have fully converged to target, counting on an ulterior deceleration in services prices.

The ECB would have to proceed carefully though. Until a few days ago the oil market had been remarkably unfazed by the crisis in the Middle East. Yet, last week, Brent prices exceeded USD90/bl for the first time since October 2023. In year-on-year terms, the change in oil prices has turned positive again and given the low levels seen in the spring of

2023, the base effects are going to push year-on-year inflation up in the months ahead if market prices stay where they are. This is likely to be contained – gas and electricity prices remain tame for now – but **we could see the fate of inflation this year as depending on a "race" between the beginning of a re-deceleration in services prices and a re-acceleration in energy costs.**

All in all, we believe the dataflow has been supportive of the ECB's shift to pre-announcing a stance reversal and we expect Christine Lagarde to continue to gently steer towards a June cut this week. The questions at the press conference will probably focus on two issues.

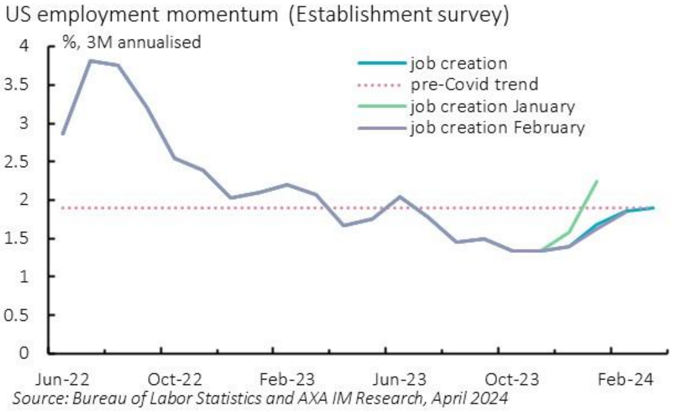
First, what would be the shape of the trajectory beyond June. On this, we continue to think that there is no upside for the central bank in pre-committing to any particular path. Missing the recovery that the ECB still forecasts would warrant quicker cuts. Sustained resilience in services prices coupled with the return of some pressure from energy prices would warrant a more cautious approach. Our own view – given our doubts on the strength of any rebound in the real economy – is that the three cuts currently priced in by the market, and our long-held call, will materialise, but we would be surprised to get any endorsement of market expectations by the ECB this week.

Second, could the ECB cut if the Federal Reserve (Fed) dithers. Christine Lagarde already answered positively to this question in March, and we explored this in some details two weeks ago. The only channel through which the Fed stance would have a bearing on the ECB's decisions is through the exchange rate. A divergence could trigger a further depreciation in the euro exchange rate, adding to inflationary pressure. However, the main inflation risk is today on the domestic side – services prices – and in any case, **a lag between the Fed and the ECB is now the market's baseline**. Indeed, the forward contracts imply only a 49% probability of a cut in June by the Fed as of 5 April, against a 95% probability of such move by the ECB. There is now a gap of one full 25bps cut between the ECB and the Fed priced in for the end of this year. And yet, the euro's exchange rate has not eroded much, down only 0.3% from 1 February when the market was pricing more cuts by the Fed than by the ECB.

Rescued by supply

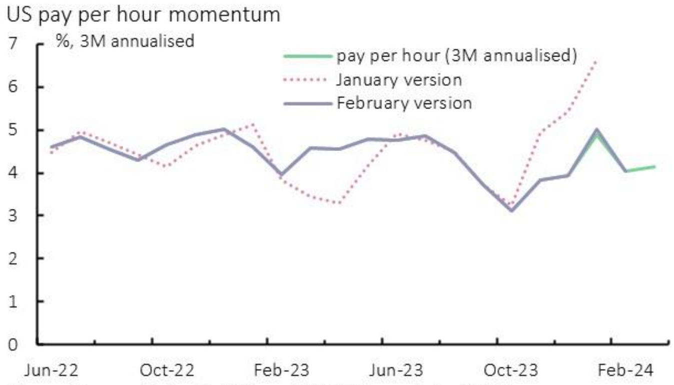
The market's uncertainty on the June cut was fuelled to some extent by another strong payroll release. Private payrolls rose by 232K, against a market expectation at 170, and contrary to what had happened last month, there was no massive downward revision to the previous data (only 20K for February). Also, contrary to the message from last month, there was no discrepancy between the Establishment and the Household survey which nicely rebounded from its significant decline in February.

Exhibit 4 – Job creation back to trend



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

Exhibit 5 – Pay growth broadly stable



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

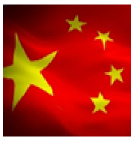
As usual in Exhibit 4, we focus on the momentum of the Establishment survey – here, the gains on a three-month annualised basis. The reacceleration from a trough in the middle of last year is confirmed, even if it stays mercifully below the scary surge reported in the first estimate of the January batch, and job creation in the US is now fully back to the pre-Covid trend. Hardly overheating, but also clearly not in "landing mode".

The market was already on "high alert" with the "no cut in 2024" theme gaining in popularity. **This "no landing" message was the last straw and the first full 25bps cut is now priced only in September, even if July remains very much in play (23bps expected)**. We are still inclined to keep our baseline for a first cut in June unchanged. This decision was largely fuelled by the behaviour of wages. Indeed, although the monthly data from the payroll has a lower quality, to properly gauge the US pay dynamics, than the quarterly Employment Cost Index (ECI), we think there is valid information there, and on this metric, momentum is still contained, with pay per hour hitting 4.1% on a three-month annualised basis in March, barely up from 4.0% in February (see Exhibit 5). What is key is to compare this pay momentum with productivity gains. Assuming productivity per hour sustains its current acceleration from its pre-Covid trend and settles at c.2%, wage growth hovering around 4% would be consistent with unit labour costs rising by 2%, itself consistent with consumer price inflation returning to 2%.

We had singled out in Jay Powell's latest Q&A session his insistence of the strong performance of the supply-side of the US economy. Supply developments are indeed coming to his rescue. The participation rate has inched up further in March, and we have already discussed in Macrocast how strong net immigration may help to reconcile robust job creation with stable wage growth. According to the Congressional Budget Office in its latest review of the macro outlook in February, net immigration may have hit 3.2mn people in 2023, most of them in the working age bracket, against an average of 0.9mn per year between 2010 and 2019. A piece of evidence supporting the immigration narrative is that wages of the "production and non-supervisory workers" – which concentrate a higher-than-average proportion of incoming migrants – are now rising slightly slower than the average (3.8% on a 3-month annualised basis in March), while over three months' pay per hour in the hospitality and leisure industry – a particularly migrant – intensive sector – has fallen slightly. Now, sector-based data tends to be quite volatile, and we must be prudent not to push to conclusions too fast, but there is now at least a case to make against the belief that general hiring difficulties would keep wage growth at a high pace permanently. We would add on the demand side that the employment component of the services ISM remained in contraction territory at 48.5 in March.

Note that **some of the most striking aspects of the current resilience in services prices are not currently directly linked to the state of the labour market**. The weight of car insurance in core inflation stands at only 3.8% in the CPI measure, but this item alone contributed 0.7%yoy to core inflation in February 2024. This is a lagged reflection of the rebound in car prices and spare parts, but also of a rise in the number of accidents (2022 saw the highest number of pedestrians killed in the US since 1981). Some of these effects are likely to gradually fade (if only because the big jump in mileage in 2023, as the economy fully reopened, will disappear from the base).

Recent "Fedspeak" has in general sent a message of prudence these last few weeks, but Kashkari's hint at "no cut" at all in 2024 should be taken with a pinch of salt. He has erred on the hawkish side since the Fed embarked on a restrictive stance, and he is not a voter in the Federal Open Market Committee (FOMC) this year. For now, we maintain our baseline that the first cut will still come in June but a "not too hot" reading for the March core CPI, due this week, would help.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• US payrolls (Mar) up 303k, with 22k upward revision to prior months. Unemp dipped to 3.8% on strong labour supply. Average earnings rose 0.3%mom • JOLTS vacancies (Feb) 8.76m, stable since Oct • ISM (Mar), mfg rose to 50.3 – first >50 since Sep 2022; services dip to 51.4, prices lowest since 2020 • Vehicle sales (Mar) 15.5m stable since start of 2023	• CPI inflation (Mar) headline expected higher on oil; focus on services after firmer Jan/Feb. • FOMC minutes (Mar) watch for doubts over rates, but also timing of QT deceleration • PPI inflation (Mar) will inform PCE inflation outlook • U Mich consumer sentiment (Apr, p) watch for signs of softening
	• Euro area flash March headline and core HICP came below expectations, edging down 0.2pp to 2.4% and 2.9%yoy respectively • Final PMIs showed significant increased momentum in both Italy and Spain coming from services	• ECB Governing Council to maintain depo rate at 4%, expect no change of communication from March meeting. We continue to expect first cut to occur in June • ECB Q1 Bank lending survey to be released
	• Mortgage approvals rose to a 17m. high of 60.4k in Feb. above expectations of 56.5k. Consumer credit was a tad weaker at £1.4b, from £1.8b • Comp. PMI down at 52.8 in Mar. from 53.0 in Feb. but still points to a pick up in qoq growth in Q1 • Construction PMI rose to 50.2 in March, from 49.7	• BRC Retail Sales Monitor likely to point to a small pick up in retail sales in Mar. after a wet Feb. • RICS housing survey should continue to point to a recovery in the housing market • Monthly GDP data likely to point to a further small rise of 0.1%mom in Feb. after a 0.2% rise in Jan.
	• Tankan surveys (Q1) was mixed: less favourable for Mfg, slightly better for Svcs, capex estimate rose for big companies, lowered for SMEs • Final Svcs PMIs reduced to 54.1, still very robust • Households spendings (Feb) rose by 1.4%mom	• USDJPY remains at high level at 151.4, fuelled by repricing of later FED cuts. The government can increase its verbal warning
	• NBS manuf PMI (Mar): 50.8, up from 49.1 in Feb; non-manuf PMI recorded 53.0, up from 51.4 in Feb. • Caixin manuf and services improved marginally in March to 51.1 and 52.7 respectively, (Feb: 50.9 and 52.5)	• 11 Apr: CPI and PPI for March. CPI expected to decline from Feb's reading, which was supported by favorable seasonality • 12 Apr: exports and imports for March
	• CB: Chile cut -75bps to 6.5%. India (6.5%), Poland (5.75%) & Romania (7.0%) stood on hold • Inflation yoy (Mar): Korea (3.1%), Indonesia (3.0%), Peru (3.0%), Philippines (3.7%), Poland (1.9%), Thailand (-0.47%) & Turkey (68.5%)	• CB: Korea (3.5%), Peru (6.25%), Philippines (6.5%) & Thailand (2.5%) are expected to stay on hold • CPI (March): Brazil, Chile, Colombia, Czechia, Hungary, India, Mexico & Taiwan • Industrial production (Feb): India, Malaysia, Turkey & Mexico • Q1 GDP in Singapore

Upcoming events	US:	Tue: NFIB small business optimism (Mar); Wed: CPI inflation (Mar), FOMC minutes (Mar); Thu: PPI inflation (Mar), Initial jobless claims (6 Apr); Fri: Michigan consumer sentiment & inflation expectations (Apr, p)
	Euro Area:	Mon: Ge Industrial production (Feb), Ge Trade balance (Feb); Tue: Ez ECB publishes Bank Lending Survey; Thu: ECB announcement, It Industrial production (Feb); Fri: Ge,Fr,Sp HICP (Mar)
	UK:	Tue: BRC Retail sales monitor (Mar); Thu: RICS Housing survey (Mar), BoE Credit conditions survey (Q1); Fri: Monthly GDP (Feb), Index of services (Feb), Industrial production (Feb), Mfg & construction output (Feb), trade balance (Feb)
	Japan:	Mon: Trade balance (Feb), Current account balance (Feb), Economy watchers survey (Mar); Tue: Consumer confidence (Mar)
	China:	Thu: CPI (Mar); Fri: Exports & Imports (Mar), Trade balance (Mar)

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