AXA Investment Managers

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Investment Institute Macroeconomics

NB: The next issue of Macrocast will come out on 5 September. We wish our readers a great summer break.

Mid-summer blues

- The United States (US) is not yet in a "proper recession" - yet. The labour market is key there, and the Federal Reserve (Fed) will want to see clear signs of deceleration in wages before lowering its guard.
- The Euro area's Q2 upside surprise is fragile. At 20% of capacity, the flows of gas through Nord Stream 1 create a massive risk, raising key questions for the European Central Bank (ECB).

With US GDP falling in Q2 for a second quarter in a row, discussions on the definition of recessions have been rife. Our view is quite simple: while indeed, the sources of contraction in 1H 2022 may be too narrow to qualify as a "proper recession", underlying signals – in particular fading support from consumption – are concerning. Yet, significant job losses should be a key ingredient in a recession. This is missing for now – despite some early signals from jobless claims. This is key for the Fed. They have not given up on the neo-Keynesian approach. The Federal Open Market Committee (FOMC) still believes in the Phillips curve, and they want to see a deterioration in the labour market trigger a deceleration in wage growth. This will make the next few payroll prints crucial, possibly leading to significant volatility. While the market has for now decided to look through the Fed's tightening phase, the Fed won't want to lower its guard easily.

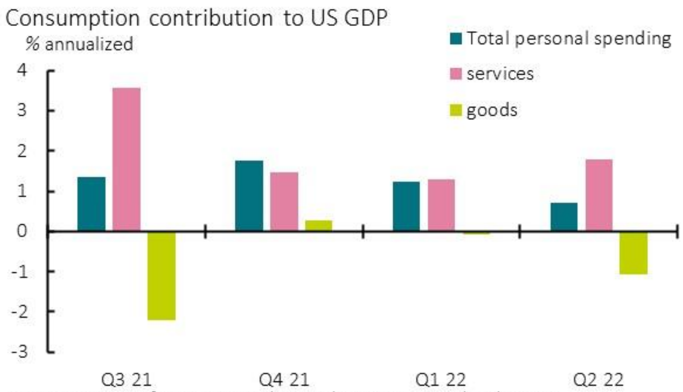
A stronger than expected GDP in Q2 in the Euro area came out in sharp contrast with the US. Still, the details of the upside surprise suggests that the underlying position of the Euro area remains extremely fragile. The post-reopening catch-up started later in Europe than in the US. Once this effect dissipates, we expect GDP to contract in the Euro area as well, the depth of it depending on the quantum of Russian gas flowing to the European Union (EU). In our calculations, if Russia maintains the flow of gas through Nord Stream 1 at 20% of capacity, Germany and Italy would not be able to go through the winter without rationing, the quantum of which – and hence of the associated recession – would depend on some resource-pooling at the EU level. Unfortunately, the 20% trickle may be the optimal level from Moscow's point of view, allowing Russia to retain massive pressure on the West and decent hard currency receipts given the rise in prices. The behaviour of the ECB in a recession triggered by gas rationing would be key. For now, it seems their natural slope would be to hike further. It may take time for the hawkish rhetoric to be toned down, but the market is impatient.

By the time you know for sure what a recession is, you already are in recession

US GDP fell in Q2 again (-0.9% annualized after -1.3% in Q1). While in most parts of the world this would technically qualify as a recession, the US approach relies on the pronouncements by the National Bureau of Economic Research (NBER) which takes a more “holistic view” (see here for a complete description). A key input for them is the breadth of the contraction. From this point of view, the first half of 2022 would not qualify. In Q1 the decline was essentially driven by net trade, as imports were catching up as the economy was reopening. In Q2, it comes from the change in inventories (without its negative contribution, GDP would have increased by 1.1% annualized). Still, even if the US was not in recession (yet), underlying signals are concerning.

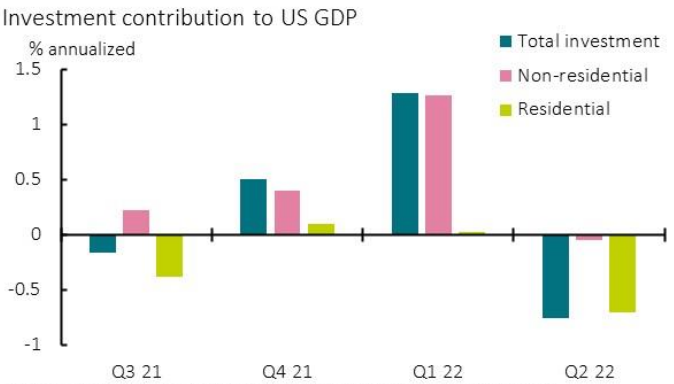
Consumer spending is contributing less to growth, as households have less appetite – or capacity – to offset the deterioration in real income by drawing on their excess savings (which are themselves eroded by inflation). The impact on the domestic economy is limited for now, since the bulk of the slowdown in consumption affects spending on goods while services expenditure remains decent (Exhibit 1), but the trend is unlikely to reverse in Q3. Another adverse development is the weakness in investment in Q2. Non-residential investment stalled in Q2, while the decline in residential investment shaved 0.7% off GDP (Exhibit 2). True, this may be some mere “mean reversion” after the strong Q1 showing, but the high-frequency data already available on the real estate sector so far this summer suggests that construction is likely to continue falling into Q3, largely in response to the tightening in financial conditions. Non-residential investment is unlikely to pick up again against a background of fast-deteriorating business confidence.

Exhibit 1 – Fading consumption support



Source: Bureau of Economic Analysis and AXA IM Research, July 2022

Exhibit 2 – Investment contracted in Q2



Sources: Bureau of Economic Analysis and AXA IM Research, July 2022

So, in a nutshell, while the GDP contraction of the first half of the year may not constitute a recession, the mere prolongation of the current trend in final domestic demand would create the conditions for one in the second half, possibly as early as Q3.

Now, **a key ingredient in the NBER framework is the behaviour of the labour market** –payroll data explicitly is in their decision matrix. Significant job losses are needed for a “proper” recession to be called. In the recent weeks we have been increasingly focusing on jobless claims. Last week’s initial claims marginally fell, but relative to upwardly revised data for the previous week, which keeps the number well above the 2019 average level. This is no “smoking gun” though. Payroll data for July will be released at the end of this week. A weak number would probably seal the deal on a recession. We would have to be prudent though. What is always frustrating about this market-moving variable is that it is immensely volatile and prone to large revisions. It may be too early in any case for the ongoing slowdown in activity to elicit a large decline in jobs. We may have to wait at least until the August release. This could trigger some significant market volatility.

Fed: still guided by the Phillips curve

Employment is not just a key ingredient for the NBER is assessing recessions. It's also at the heart of the Fed thinking at this juncture. Indeed, while the FOMC acknowledged in the policy statement last week that the real economy has been softening, immediately afterward came a point **on the resilience of the labour market as a key justification behind the 75-bps hike**. The Fed did not change its communiqué much on the inflation narrative, but this focus on the labour market was probably there to signal that, by and large, the central bank continues to believe in the" Phillips's curve": the Fed wants to see less buoyant job creation put the brakes on wage growth, so that underlying inflation is finally curbed.

However, while this suggests that the Fed has not changed its essential "software", **the central bank monitoring is facing three imbricated lags**. Lag 1 goes from the decline in economic activity to the labour market. Lag 2 goes from the drop in job creation to softer wage growth – which may take longer than usual as employees are probably particularly sensitive to their loss in purchasing power over the last few months and may maintain high wage claims despite a deterioration in job prospects. The latest available data suggests that wages were still on a very strong trend last spring. The Employment Cost Index (ECI) grew by 5.2% annualized in Q2. That is slightly less rapid than in Q1 (5.6%) but still well above a pace consistent with core inflation returning to 2%, even when being generous with productivity assumptions (we need to see annualized ECI growth move below 4%). Lag 3 goes from a deceleration in wages to slower core inflation, which may be disturbed by the gradual "feeding through" of supply-line disruption to final prices.

Uncertainty is high on the duration of each of these lags. This would justify a prudent approach to the future trajectory of monetary policy, in contrast with the recent past when the Fed had to quell accusations of being "behind the curve" and exit quickly from an accommodative stance which was clearly at odds with observed and – until recently – expected inflation.

Accordingly, Jay Powell kept his cards close to his chest during his press conference last week. While the Fed is clear that further hikes are needed, he was remarkably non-committal on their quantum. Continuing with 75 bps instalments is not off the table, but he also recognized that the time may have come for a slower pace of tightening. We expect a 50 basis points hike in September and 25 bps in October, assuming the real economy continues to soften and payroll data, if not in July, then a least in August, start showing signs of response.

Working through the gasworks

The contrast between a contraction in the US and a higher-than-expected GDP print in the Euro area in Q2 goes against the grain of the dataflow of the last few months. Still, the geographical and sectoral distribution of the Q2 upside surprise suggests that the underlying cyclical position of the Euro area remains extremely **fragile. While in the US a lot of the post-reopening catch-up has already taken place, it started later in Europe. Once this effect dissipates, we expect GDP to contract in the Euro area as well, the depth of it depending on the quantum of Russian gas flowing to the EU.**

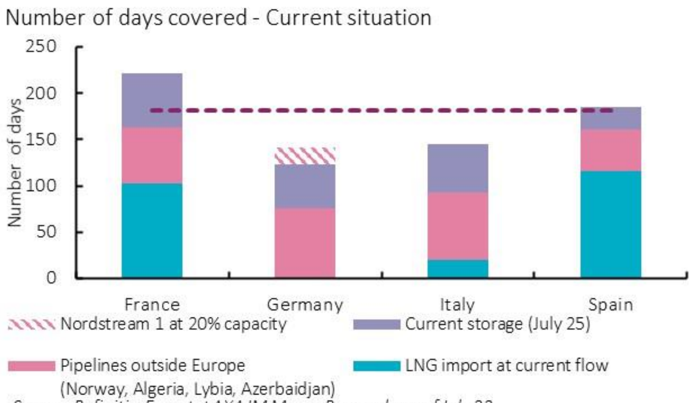
Let's start with France, where the level of details in the preliminary reading is high. GDP grew by 0.5% quarter-on-quarter, coming out 20 bps above our expectations (and 30 bps above consensus) and more than offsetting the contraction in Q1 (-0.2%). **Sources of growth were however extremely concentrated**. Four fifths of the 0.5% gain came from net trade, and Institut National de la Statistique et des Etudes Economiques (INSEE) highlighted the strong contribution of travels and tourism to the improvement in services exports. Looking at GDP from the production angle confirms the major role played by the normalisation of tourism in the first quarter completely free of sanitary restrictions: **output in the hotel and restaurant industry rose by 6.7%** quarter-on-quarter, and by 3.8% in the transport industry. On the more concerning side, consumer spending fell for the second quarter in a row (-0.2% after -1.3%), despite the magnitude of fiscal support against the impact of rising energy prices on purchasing power.

Consumption was not a source of weakness in Spain in Q2 – despite the bigger toll the rise in energy prices had on income over there – but we suspect a lot of the improvement came from post-reopening normalisation (output in "recreational activities" rose by 12%). There are no details on the contribution from the various components to the strong GDP gain in Italy, but **the contrast with stagnation in Germany is quite stark**. This would be consistent with the "reopening narrative". Indeed, during the pandemic, sanitary restrictions have been milder overall in Germany than in Southern Europe, and the fabric of the economy makes it less sensitive in any case to reopening. Indeed, GDP in France, Spain and Italy is more intensive in personal services than Germany. In the latter, the lacklustre performance of exports probably reflects the weakness in world demand, which cannot be fully offset by the depreciation in the euro.

We might see a replication of the spring pattern in Q3, with the continuation of a sharp contrast between Southern Europe and Germany, although the further normalisation in tourism will start from a higher point, possibly providing a less spectacular contribution to GDP. But in any case, **we fail to see what alternative engines of growth could switch on by Q4, for which we have been expecting a contraction in GDP at the Euro area level. Things could be much worse however than in our shallow recession call, depending on the developments on the energy front.**

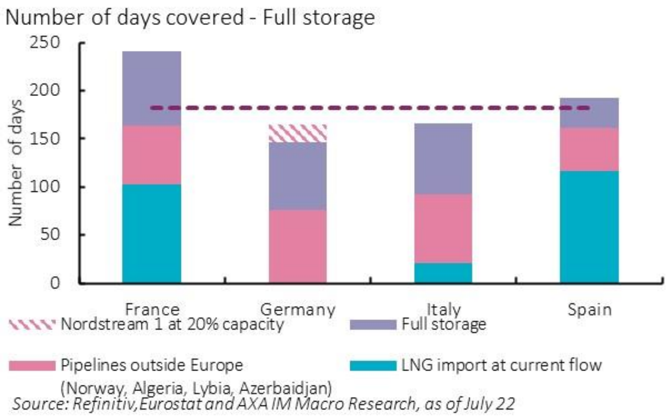
In Exhibits 3 and 4, we provide **a tentative assessment of the possibility for the major economies of the Euro to deal with Russia turning the tap off gas.** We were forced to use a long list of assumptions, so we would warn against taking the conclusions too literally. In particular, we have fixed at their current level the flows of Liquefied Natural Gas (LNG) and natural gas coming through the pipelines which are not controlled by Russia. The former can be overstated by the fact that low demand from China recently has allowed exporters to shift towards Europe (something which may obviously change), while the latter can be affected by developments affecting the producing countries (e.g., the recent strike in Norway which impacted the flows, or Spain's difficulties with Algerian gas transiting through the pipeline via Morocco, triggered by the Western Sahara issue). We were forced to make simplifying assumptions on the consumption side as well. Our main focus is how Europe can go through the next winter period, so we looked at the average consumption of gas over the last 5 years over the October 1st- March 31st. Of course, an exceptionally cold or mild winter would change the results significantly (e.g., consumption fell by nearly 6% between the autumn/winter of 2016-2017 and 2019-2020 in Germany).

Exhibit 3 – France and Spain already in the clear



Source: Refinitiv, Eurostat AXA IM Macro Research, as of July 22

Exhibit 4 – Picture does not change much if storage at max



Source: Refinitiv,Eurostat and AXA IM Macro Research, as of July 22

With those caveats in mind, what our simulations suggest (with a big thank you to Hugo le Damany in our team who has put together the calculation matrix) is that Germany, and Italy by a smaller margin, could not make it through the winter without rationing and/or receiving pooled resources from other member states. It suggests as well **that the Russian decision to reduce the flows through Nord Stream 1 at only 20% of its capacity is rational from their point of view.** In our calculations, with this quantum of gas coming from Russia, Germany would still be unable to secure enough gas to get through the winter at average consumption levels, even if it found a way to maximize its storage capacity by October, **thus allowing Moscow to maintain massive political pressure while still generating significant**

financial resources, the rise in price partly offsetting the loss in volume. We do not doubt the Russian government has more sophisticated capacity than we do to develop this kind of models, but in our calculations, it seems that sending gas through Nord Stream 1 at 20% of its capacity is the "optimal level" – with a safety margin – from Putin's point of view. In other words, it seems that **some resource-pooling at the EU level is the only practical solution**. True, there are some technical limitations there. The intra-European gas grid is not designed to send gas to Germany. Yet, lower consumption in "gas rich" countries could free up non-Russian supply from outside the EU. In practice, if Spain imports less gas from Algeria, then Algeria has more gas to send to Italy. If France imports less from Norway, there is more Norwegian gas for Germany, etc…

Still, as we have discussed last week, this leaves the EU member states in a quandary. It may be difficult for governments outside Germany and Italy to explain to their public opinion that they need to reduce domestic consumption to allow for shipments there, and the "European solidarity" deal last week came with a long list of caveats. **From a purely economic point of view though it should be a no-brainer.** The idea that any country in the Euro area could "shelter" itself behind its plentiful gas storage and non-Russian imports to avoid a gas-rationing induced recession is an illusion: **given the level of trade integration of the Euro area, and the weight of Germany and Italy in its GDP, a profound contraction in these two countries would trigger a significant recession in the rest of the zone anyway.** Yet, it may be a complex message to send, and besides, other political issues complicate the matter. A popular view outside Germany is that Berlin can only blame itself for the situation in which they are now. So, concessions should be extracted from the German government in exchange for gas. Attention is of course turning to Next Generation EU (NGEU), but the political development in Italy provides those with a negative view of enhanced debt mutualization in the German coalition the perfect argument to stand still.

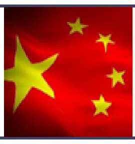
The ECB and "war economics"

While European governments have been warning against limits to their capacity to mitigate the impact of yet another inflationary shock – which would come with severe recessionary aspects if gas is effectively rationed – in practice, it may be difficult for them not to engage in more fiscal treatment. We also note that **rationing would entail even more direct state intervention in the economy,** a central authority deciding who, how and when would get access to the remaining gas supply. As we have been arguing for a while in Macrocast, there is a "habituation process" at play there. Governments have got used to unusual intervention in the economy with Covid. Gas rationing would prolong this trend, in stark contrast with the general "state retreat" observed when the "Washington consensus" was dominant.

All this is consistent with the concept of "war economics", when free-market economies, for the duration of a crisis, convert to strong government intervention. **Yet, an ingredient may be missing today for this conversion to be complete: central banks' willingness to set aside their usual anti-inflation target to create easy financial conditions for the governments.** While this may not have been the most commented part of the ECB's latest policy statement, we think the following sentences were clear warning sent to the member states: " *The risks to the medium-term inflation outlook include a durable worsening of the production capacity of our economy, persistently h high energy and food prices, inflation expectations rising above our target*" which in our view allude quite directly to a gas-rationing situation, coupled with "*temporary and targeted [fiscal] measures should be tailored so as to limit the risk of fuelling inflationary pressures. Fiscal policies in all countries should aim at preserving debt sustainability, as well as raising the growth potential in a sustainable manner to enhance the recovery*". The natural slope of the ECB, in case of a gas-triggered crisis this winter generating additional fiscal accommodation, would thus be to tighten further.

Last week, the market markedly revised down its expected trajectory for the ECB – forwards pointing to a depo rate at 0.87% by December 2022 at close on Friday after hitting 1.2% for a few hours when another higher-than-expected inflation print came out above expectations again for the Euro area in July (8.9%yoy from 8.6% in June for headline, 4.0% after 3.7% for core). As we have already pointed out last week, this may reflect either an expectation that the looming recession will ultimately "kill inflation" or that the ECB will "blink" and refrain from hiking much further in the face of massive macro difficulties for Europe. The latter is definitely likely – habitual readers of Macrocast know that we expect the ECB to be stopped out at the lower end of the "neutral range" but for now it's not the message we get from the ECB, and it may take time for the hawkish rhetoric to be toned down.

Not giving up on monetary tightening even in times of recession when inflation expectations are out of control, or at least under threat, is a key lesson from the 1970s. Now, in the European context, **the latest episode we may have in mind is not so much the 1970s but the early 1990s**. The Bundesbank at the time was responding to a particular case of supply-side, inflationary shock: German unification. The set-up of the European monetary system at the time meant that all other central banks had to align themselves to the Bundesbank's stance and hike, repeatedly, into a recession. Your humble servant had just graduated from university at the time, and it was not the best time to be on the job market, for a long while actually. Our habitual readers may not be surprised to see this last Macrocast before the summer recess end on negative note.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Fed hiked by 75bps. Powell said could do 75bps again, but mkt saw Fed as softening in tone • Q2 GDP surprisingly fell by 0.9%, mainly driven by inventory, but also sharp fall in residential invest • PCE inflation (Jun) rose to 6.8% (core to 4.8%) • Senate Democrats agree $433bn of spending ($739bn revenues). Senate passed chip bill • Biden and Xi have "candid" 20 min phone call as tensions rise over Pelosi's planned trip to Taiwan	• Payrolls (Jul) for signs of softening, watch difference between payroll and household job measures. Also watch for any improvement in labour supply • JOLTS survey and initial claims also watched as have shown signs of softening since March • ISM ind. (Jul) watched for sign of corroboration of US recession • Vehicle sales (Jun) watch mix of supply constraints vs demand reduction
	• EMU HICP reached 8.9%yoy, core rose to 4% (+0.3pt for each). All components progressed excepted energy as fuel prices slightly declined • Q2 GDP Flash estimates came stronger than anticipated (0.7%qoq), driven by outperformance from Fr (+0.5%qoq), It (+1%) and Sp (+1.1%), helped by tourism. GE is flat (0%) • EC and Ifo surveys point to contraction risk in Q3	• Next week's data should help refine the reading of the surprise GDP growth in Q2 • Final PMIs across EMU (June) • Unemployment rate in EMU, Italy (Jun) • International tourist arrival in Spain (Jun) • EMU retail sales (June) • Euro area producer prices (June) • Industrial production and orders in EMU (June)
	• Conservative leadership election: Truss maintains lead over Sunak in polls • BoE household lending data (Jun) • Factory output slowed, but price pressures have fallen from peak – CBI Business trends survey (Jul) • IFS estimates that c.100k workers sick w/ long covid	• BoE MPC meeting (Thurs) we expect 50bp hike and announcement on active gilt sales • Monetary Policy Report to update BoE forecasts • Further debates between Truss and Sunak as postal ballots are sent out to party members • Nationwide House price index (Jul)
	• Tokyo CPI (Jul) rose to 2.5% above 2.4% (cons) • Retail sales (Jun) and cons sentiment (Jul) fell • COVID-19 cases on the rise – local governments given power to issue declarations to curb spread • IP (Jun, p) bounced back 8.9%mom • Dollar-yen dropped 5% from mid-July high to 134	• Household spending (Jun) expected to increase for the first time in four months • Final PMIs (Jul) • Vehicle sales yoy (Jul)
	• The Politburo downplayed the growth target but pledged to keep growth in a reasonable range, signalling more policy support to come	• Eyes will remain on the COVID situation, the property market and geopolitical headlines
	• CB: Hungary +100bps to 10.75%, Ghana unexpectedly on hold at 19% • CPI yoy upside surprises in Malaysia (3.4%), Singapore (6.7%), less so in Brazil on tax cuts • Q2 GDP: Korea +0.7%qoq, Czech +0.2%qoq, Mexico +1.0%qoq Taiwan -0.7%qoq • Philippines Presid. speech signals policy continuity	• CB: RBI expected to hike 25-50bps, Brazil +50bps to 13.75%, Romania +100bps to 5.75%, Czech Rep +25bps with risk to stay on hold • July CPI in Brazil, Colombia, Uruguay, Peru, Turkey, Indonesia, Korea, Thailand, Philippines, Taiwan • Q2 GDP data for Indonesia • July PMI survey results through EM

Upcoming events		
	US:	Mon: Mfg PMI (Jul), ISM mfg index (Jul); Tue: JOLTS survey (Jun); Wed: Services PMI (Jul), ISM non-mfg index (Jul), Factory orders (Jun); Thu: jobless claims, Trade balance (Jun); Fri: Labour report (Jul)
	Euro Area:	Mon: EU19 mfg PMI (Jul), unemp (Jun), Ge Retail sales (Jun), It unemp. (Jun); Wed: EU19 Services PMI (Jul), PPI (Jun), Retail sales (Jun), Ge Trade balance (Jun); Thu: Ge new mfg orders (Jun); Fri: Ge, It, Fr, Sp Ind prod (Jun)
	UK:	Mon: mfg PMI (Jul); Tue: Nationwide house price index (Jul); Wed: Services PMI (Jul); Thu: SMMT new car reg. (Jul), Construction PMI (Jul), MPC announcement and Monetary Policy Report
	Japan:	Mon: mfg PMI (Jul)
	China:	Sun: mfg and non- mfg PMI (Jul); Mon: Caixin mfg PMI (Jul); Wed: Caixin services PMI (Jul)

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