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Macrocast

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Postcard from Davos

- China's pitch to international investors collides with keen focus on supply-line diversification
- General optimism at the World Economic Forum (WEF) around economic prospects may understate the coming cost of further monetary tightening

The contrast between economists – generally pessimistic about the chances to avoid a recession in 2023 – and corporates' often upbeat expectations was very tangible in Davos. The gap may have to do with the fact that the ongoing monetary policy tightening, in a context of macro resilience, has not had much of an impact so far, while the reopening of China is seen as a significant boost to prospects for global demand – the potentially inflationary impact via commodity prices is expected to come only later. But beyond the lifting of sanitary restrictions, what we found striking at the World Economic Forum was how Chinese officials – who had been absent at the 2022 edition – endeavoured to reassure international investors on Beijing's commitment to a further strengthening of the private sector and protection of property rights. The question however is whether this effort is not coming too late. Indeed, the number of sessions dedicated to the diversification of supply lines – read "outside China" – was impressive.

The American "official sector" was discreet, with neither the US President, Vice President nor State Secretary making it to the Swiss alps. This may reflect quiet confidence in Washington DC. There was unanimous praise for the US new-found interest in industrial policy, epitomized by the Inflation Reduction Act (IRA). Despite the return of political dysfunction in Congress, there was not much PR the US needed to engage in. By comparison, the Europeans did not manage to present a united front. We will need to see if the Franco-German summit this weekend kick-starts more action.

Central bankers were popular in Davos. After some initial, unconfirmed dovish noises, the hawkish line held prominence, which gets us back to our first point. The tightening in monetary policy is not over. We've updated our index of financial conditions. Our concern is that, for the Federal Reserve (Fed) to stop early, it needs to be able to argue that real interest rates will continue rising amid falling inflation even if nominal rates remain unchanged, providing "spontaneous" demand dampening. The fact that risk-free, ex ante real rates are already falling is not helping.

China's "twin comeback" comes late

One the key underlying themes of this year's World Economic Forum was the "twin reopening" of China. Its most immediately salient aspect is of course the U-turn on sanitary restrictions which has convinced a majority of the attendees that global demand prospects can be revised up (more on this later), the other one is the parallel **effort by Chinese officials to make it plain that their country remains open to foreign investment and is serious about being part of the multilateral policy-making framework.** In other words, **the geopolitical rivalry with the United States (US) and more forceful intervention in key sectors of economic life should not be equated with isolationism**.

We would bring two pieces of evidence to substantiate this "China's comeback". The most visible one was of course Vice Premier Liu He's speech. The second macroeconomic priority he mentioned, after the need to deliver on growth, was that "we *must let the market play a decisive role in resources allocation (…) some people say China will go for the planned economy. That's by no means possible".* The points on protecting property rights and sound legal system were clearly directed to international operators in China who may have had some misgivings about the safety of their investments there. To nail a point home on the sense that China would not return to its pre-reforms days and espouse a more collectivist model, he stated that *"common prosperity is by no means a synonym of egalitarianism or welfarism (…) there will be equal opportunities, but no guarantee of equal outcomes".*

But another element may be a bit less obvious: **China's pledge to be fully involved in safeguarding international financial stability.** The country has become the biggest sovereign creditor of emerging and developing countries. The ongoing debt stress currently affecting some of these countries in the midst of the monetary tightening triggered in the North is a first test of China's response in "bad times", and its decisions will likely be crucial to the overall capacity to "sort out the mess". Indeed, China owns 67% of total official credit covered by the G20 Debt Service Suspension Initiative, and 17% of commercial loans. Until late last year, China was seemingly ploughing its own furrow on these matters, multiplying disagreements with multilateral and other sovereign lenders on how to "share the burden" and offering relief to some of its debtors on a bilateral manner without necessarily much transparency. However, on 15 December 2022 China accepted to join a "roundtable" of foreign creditors under the steering of the International Monetary Fund (IMF) to find common solutions. This was echoed in Liu He's speech in Davos: *"we stand ready to work with all parties to find solutions to the debt issues of some developing countries".*

The peak of "China optimism" in Davos may have been hit with Henry Kissinger's address in the middle of the week. Listening to the man who played such a pivotal role in the US-China rapprochement in the 1970s was of course quite topical. Asked about the Taiwan issue and more broadly the US-Chinese rivalry, he drew a parallel with the US/Union of Soviet Socialist Republics (USSR) co-existence in the second half of the cold war when both players realised that their confrontation, in unchecked, could become so destructive that it trumped any short-term gain. He sketched out a configuration in which both sides "agree to disagree", with the US "*not* doing" and saying enough to keep the "one China policy" nominally intact and China refraining from military gesticulations against Taiwan.

The key issue – from a purely macroeconomic and financial angle, which is your humble servant's remit – is whether this "Chinese come back" - and possible détente with the US - is not coming too late to change the new, more cautious attitude of the "corporate West" towards China.

Indeed, **the number of sessions in Davos dedicated to the diversification of supply lines – read "outside China" – was impressive.** The pandemic shock, roll-back on liberalization in some sectors and the expectation of further US pressure are still incentivizing businesses to reduce their reliance on China. It was a pure coincidence and hardly a surprise, but the announcement that Chinese population is now shrinking – first decline since 1961 - and is being overtaken by India came out to solidify the "China +1" option for supply lines, on the belief that the reservoir of global workforce may well be elsewhere. The transition costs associated with this diversification may be substantial, but that particular train may have left the station.

By contrast the American official sector were conspicuously absent, with neither the US President, Vice President nor State Secretary making it to the Swiss alps. Rather than neglect – and a busy domestic agenda – this may reflect quiet confidence in Washington DC. With a few dissenting voices – drawing attention to the capacity of the Republican-led House to disrupt the Implementation of the Inflation Reduction Act – there was unanimous praise for the US new-found interest in industrial policy. Despite the return of political dysfunction in Congress, there was not much Public Relation (PR) the US needed to engage in.

Conversely, **the Europeans were there en masse, but they did not convey a particularly united message.** Chancellor Scholtz' speech was remarkably "German-centric" and basically a strongly worded "defence and illustration" of the German industrial model. His point was to demonstrate that Germany remains an attractive production centre despite the rise in energy prices – note for instance his mentioning that energy prices were not among the lowest even before the Ukraine war and that did not impair Germany's capacity to remain competitive – and that being at the forefront of the green revolution could be the new driving force behind the continued expansion of German manufacturing. There was not much however on the challenges of potential de-globalization. On European matters there was nothing new. While Germany recognizes the need for another investment effort in the European Union (EU), the only practical solution mentioned in the speech was the usual combination of repurposing – without additionality – the unused Next Generation loans with a further relaxation of the state aid framework.

Intriguingly, Bloomberg had pointed on 11 January a draft proposal for a reform of the EU's financial architecture coming from Social Democratic Party of Germany (SPD), Scholtz' party, supporting another joint financial instrument to fund European-wide industrial policy. This was absent from Scholtz' speech, which would suggest difficulties within the coalition, especially with Lindner in the Finance Ministry. A more optimistic interpretation would have announcements of this nature kept in reserve for the Franco-German summit held this weekend. The joint statement issued after the common meeting of the two cabinets did not contain many details in the economic realm though. A deal on hydrogen was clearly reached – Berlin wants "green hydrogen" to be produced only from renewable sources, while Paris wants to open this to nuclear power, the statement calls for respecting each country's particular energy mix – but developing hydrogen is for the long-haul and on the other aspects of industrial policy, beyond the expected call for a loosening of competition rules and curtailing red tape, no new tangible instrument was offered. Details may take weeks to filter through though.

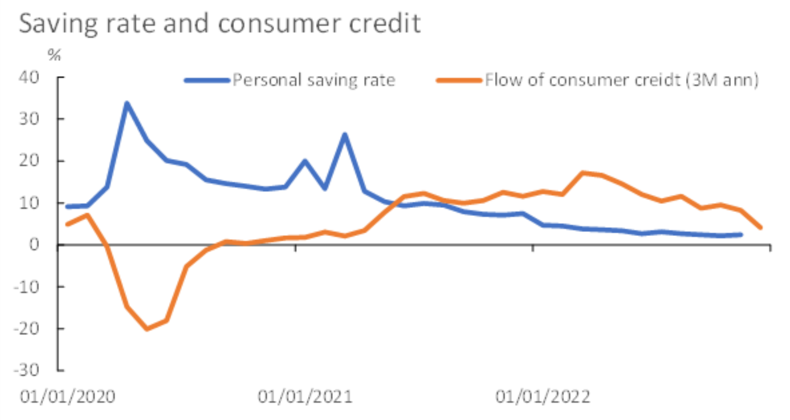
True, during the WEF officials from the EU institutions were hopeful that more mutualized debt could be raised, if governance problems could be solved. An idea would be to make additional mutualized debt only available to cross-European projects, rather than having its proceeds distributed to governments for national use – as is the case under the Next generation framework. It was unclear however how much of these ideas could be supported by the Council. It's possible that the European Investment Bank – mentioned in the Franco-German joint statement – could be at the forefront of this effort, but again, no details are available at this stage.

Upbeat corporates collide with stern central banks

We noted last week how the "absence of catastrophes" – in particular in Europe which is managed to avoid a sudden stop in energy supply despite a war in Ukraine which is overwhelmingly seen as protracted - is fuelling a relief in business confidence. Coupled with the reopening in China, this fed quite a bit of optimism of the growth prospects in Davos – at least much more so than last May. **There is a wide gap between the opinion of economists – two third of them see a recession as "likely" or "very likely" in 2023 according to the World Economic Forum pre-Davos poll – and the general positivity of corporates**. In truth, while surveys such as the Purchasing Managers' Index (PMIs) do not paint a very encouraging picture (another batch will be available this week), hard data continues to be resilient. Usually effective trackers such as the Atlanta Fed point to very decent US GDP growth in Q4 2022, also to be released this week, at 3.5% annualized (we are more conservative, but still comfortably in expansion territory, at 2.6%).

The contrast between surveys and hard data can be solved if one considers the gradual fading of powerful, but temporary sources of support. Exhibit 1 tracks the US personal saving ratio since the beginning of the pandemic together with the change in the flow of consumer credit. The decline, to near-disappearance, of the savings ratio in 2022 has cushioned the decline in consumption despite the adverse shock on purchasing power, supporting GDP, while recourse to consumer credit had been robust and accelerating until the summer of 2022. With the savings ratio now incredibly thin (2.3% of disposable income in November), and households now taming their leveraging, with an acute deceleration since October in a possible reaction to higher interest rates, these sources of support are now fading, which does not bode well for the first half of 2023, as already roughly half of the excess savings of the pandemic have been absorbed. While a rebound in Chinese demand would help Europe – although we continue to think that we need to wait until the Covid transmission peak is well behind us to gauge the solidity of Chinese demand in the short run – it would hardly move the dial in the US, which remains driven by its domestic engines.

Exhibit 1 – Non-income sources of consumption resilience fading in the US



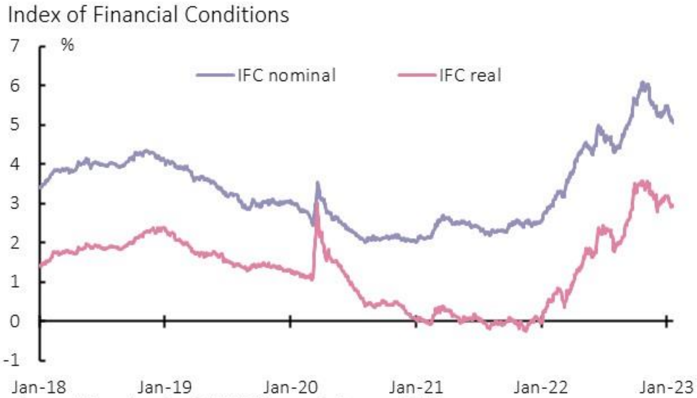
Source: BEA, Federal Reserve, AXA IM Research, January 2023

True, last week, we mentioned the fact that inflation was declining fast enough thanks to the normalisation of supply-side driven components that real wages were up again, which may postpone further the adjustment of private consumption, but precisely this is a configuration which is not conducive to inflation landing close to the central bank objective any time soon. We've been repeating this ad nauseam for some time now: the magnitude of what remains to be done in terms of monetary tightening is understated by the market, especially if financial conditions are felt to be too lenient by the central banks.

We have updated our simple "index of financial conditions" for the US in Exhibit 2. Relative to a peak in early November, it has loosened by 90 basis points. While this is still in restrictive territory – especially because of still elevated, albeit declining, mortgage rates - the Fed may feel the market is failing to transmit enough of its tightening to the real economy. The spread between US treasury yields and BBB-rated corporate bond yields has edged back below 2% on a 10-year maturity since 12 January, in line with the average level of 2019 (see Exhibit 3). True, the Fed speakers who took to the wires last week before the Federal Open Market Committee (FOMC) gets into "purdah" were in majority either implicitly or explicitly in line with a hike of only 25bps at the next meeting – our central scenario anyway – but the issue is not there. Rather, it's whether the Fed will stop soon (before reaching the 5/5.25% region for the Fed Funds' terminal rate it telegraphed in the latest dot plot) before reversing course in the second half of 2023 with rate cuts.

While we believe the Fed will stop before core inflation is back to 2%, **to justify this it will have to be able to argue that the lagged impact of the accumulated tightening will be large enough to cover the "last mile" and bring inflation back to 2%. The notion of real interest rate will become handy in these circumstances**. Indeed, in a situation where nominal interest rates stop rising but inflation expectations continue to decline, ex ante real interest rates will keep rising, thus further dampening aggregate demand, which would make more hikes useless. **A problem is that risk-free real interest rates are *already* declining**. Using market-based inflation expectations, 10-year treasury yields hit 1.25% at the end of last week, down from a recent peak at 1.74% in early November (see Exhibit 3). If this is where we are now even before the Fed has changed its guidance on rates, this does not bode well for financial conditions remaining restrictive enough to ensure a proper inflation landing. **All this is happening too soon**.

Exhibit 2 – Financial conditions loosening



Source: Macrobond and AXA IM Research, January 2023

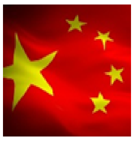
Exhibit 3 – Real risk-free rates down

Source: Macrobond and AXA IM Research, January 2023

The market is impatient in Europe as well. There was a significant pricing reaction after Bloomberg released a paper claiming the European Central Bank (ECB) was having second thoughts about hiking by 50 basis points in March 2023. True, technically, the March meeting is less "baked in" than the February one. In December Christine Lagarde's exact words were "*based on the information that we have available today, that predicates another 50-basis-point rate hike at our next meeting, and possibly at the one after that, and possibly thereafter".* But precisely**, we fail to see why the ECB would want to telegraph a slowdown in the pace of hiking in March already now, since it has the option to do so anyway within its existing guidance**. We note that Governing Council members who are not precisely hawkish such as Villeroy de Galhau chose to pour cold water from Davos on this Bloomberg release, while Klas Knot chose to explicitly argue in favour of continuing at 50bps in March.

We thought the ECB December forecasts were exceedingly skewed towards the upside risks to inflation, and some fine-tuning might occur in March already, but we don't expect a gear downshift to 25bps before the second quarter. When the ECB says it is data dependent, we think they are in fact mostly dependent on one piece of data: core inflation. While it has started to decline in the US, it has continued to rise in the Euro area. It's difficult to ascertain in real time whether this mostly derives from "mechanical" lagged effects from higher energy prices, or if it's already "bad inflation" stemming from higher labour costs, but we are dealing with a central bank which has decided not to take any risk. **They will need to see some convincing deceleration in core before lifting their foot from the brake, and we still expect solid, albeit decelerating, core inflation at c.4.5% in Q2.**

In the wake of the ECB December meeting, we flagged that depo rate could go as high as 3.50% by June – our baseline is terminal reached at 3.25% in May. Not only could this 3.50 level materialise sooner (e.g., May), but the risk to terminal rate is also skewed to the upside in our view.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Retail sales (Dec) fell sharply, ex autos and gas -0.7%, with downward revisions to November • Industrial production (Dec) -0.7%mom and worse than expected, November revised lower • Empire State survey (Dec) falls sharply to -32.9 – a recession level. Philly Fed improved • Fed goes into purdah after two suggest 0.25% hike • PPI inflation (Dec) falls to 6.2%yoy and (5.5% core)	• GDP (Q4, 1st est). Now trackers suggest 3.5% (saar), we estimate softer 2.6% (as consensus), but more solid than we had previously forecast • PCE inflation (Dec) exp'd to fall to 5.0% and 4.4% core • Saving rate (Dec) low rate in Oct and Nov suggests sharp unwind of excess saving supported spending • Adv trade (Dec) watch for outperformance in exports to help explain Q4 GDP strength
	• Euro area "flash" December HICP was confirmed in final release, core increasing to 5.2%yoy from Nov • Improved optimism reflected in Jan ZEW survey • Euro area finance ministers focused on short term energy crisis financial support. Discussions on future budget rules yet to properly start • ECB speakers struck hawkish tone, fighting rates market rally reinforced by unnamed ECB comment	• Jan EMU business and consumer surveys key to gauge growth momentum recovery and composition (PMIs, INSEE, IFO) • Spain Q4 "flash" GDP print. Significant upside risks to our -0.4%qoq projection
	• CPI falls further from peak to 10.5%yoy, core holds at 6.3% as declines in core goods offset by strong increases in services inflation • UK labour market data (Nov/Dec) confirmed labour market remains tight with robust wage growth • Retail sales (Dec) slumped unexpectedly -1%mom	• Public finance data (Dec) borrowing expected to continue to rise, in part due to rising • Flash PMIs (Jan) expected to improve from Dec 31-month low seen in manufacturing • Producer Price Index (Nov/Dec) following delayed publication due to statistical errors
	• BoJ delivered a dovish surprise to markets. BoJ made no change to YCC and doubled down on its defense of its target; but risks of early removal remain • CPI (Dec) rose to 4.0%yoy, the BoJ's preferred core measure (ex-energy and fresh food) rose to 3.0%	• Further sign of market dysfunction and pressure on 10y JGBs • Details on candidates for the BoJ's leadership • Flash mfg PMIs (Jan)
	• Q4 GDP growth falls to zero, beating market expectations. Full year growth collapses to 3%, the second lowest since the 1970s • December activity data much stronger than expected, although some strength could be questionable • Mobility indicators continue to improve	• Markets close as China celebrates the lunar new year
	• CB: on hold in Turkey (9%) dovish statement, paused in Malaysia (2.75%), +25bp in Indonesia (5.75%) • Inflation (Dec) softened in South Africa (7.2%), Malaysia (3.8%), accelerated in Saudi Arabia (3.3%) • Q4 GDP in Taiwan (-1.1%qoq) below expectations	• CB: hikes expected in Colombia (+100bp), Nigeria, South Africa (+50bp), Thailand (+50bp), rates on hold in Hungary, Chile • Q4 GDP in Korea and the Philippines to be released

Upcoming events	US:	Tue: Manf. & Services PMI (Jan) ; Thu: GDP (Q4), Core PCE (Q4), Weekly jobless claims (21 Jan), Durable goods order (Dec), Goods trade balance (Dec), Wholesale inventories (Dec), New home sales (Dec); Fri : PCE & Core PCE (Dec), Personal income & spending (Dec), Michigan consumer sentiment (Jan), Pending home sales (Dec)
	Euro Area:	Mon: EU19 Consumer Confidence (Jan); Tue: EU19 Composite, Manf. & Services PMI (Jan), Ge Composite, Manf. & Services PMI (Jan), Fr Insee business confidence (Jan), Fr Manf. & Services PMI (Jan) ; Wed: IfO Business Climate Indx (Jan); Thu: ISTAT business & consumer conf. (Jan), Sp unemployment (Q4); Fri : EU19 M3 Money Supply (Dec), Fr Insee consumer conf. (Jan), Sp GDP (Q4)
	UK:	Mon: PSNB (Dec), Composite, Flash & Services PMI (Jan), CBI Industrial Trends survey (Jan); Wed: PPI input & output (Dec); Thu: CBI Distributive Trades Survey (Jan)
	Japan:	Tue: Manf. PMI (Jan), Leading index (Nov)

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