140 – 20 June 2022

It's Getting Tighter

- Financial conditions are tightening very fast in the United States (US) and in the Euro area.
- The European Central Bank (ECB)'s anti-fragmentation tool is announced for July. We are worried about the implications of selling bonds from other issuers to offset the support to weaker signatures.
- France can operate with a relative majority in parliament, but the government will have to pick its battles.

The Federal Reserve (Fed)'s 75 basis points hike last week, combined with its projections bringing the policy rate well into restrictive territory by year-end, reflects a willingness to dispel accusations of being behind the curve and to "get on with the job" of taming inflation swiftly, allowing for some relaxation in a not-too-distant future (the projections include rate cuts in 2024). An issue though is that the Fed seems to think that its unusually fast pace of tightening will have only a small impact on unemployment, but that even this small deterioration will be enough to curb inflation decisively. The Fed may believe that merely reducing vacancies, without destroying many actual jobs, would be enough to put pressure on wages. What concerns us though is that financial conditions have already tightened considerably. The average cost of funding of US corporates is now the highest since the end of the Great Financial Crisis of 2008-2009. This will affect business spending decisions in the months ahead. We suspect the Fed is intentionally downplaying the amount of pain its tightening will entail.

In the Euro area funding costs on the corporate bond market are back to their highest level since 2012. The ECB seems to want to bring its policy rate in neutral territory by year-end, but financial conditions for the corporate sector have already hit that range. We always think in terms of the monetary impulse acting with lags, but right now, the expected tightening could transmit very quickly to the economy. Focus is however for now firmly on sovereign funding costs. Although the ECB has managed to pour some water on that fire last week, we reiterate our view that the market underestimates the difficulties faced by the looming anti-fragmentation tool. The implications of offsetting the purchases of bonds from fragile signatures with sales of bonds from other member states concern us.

Governments will have a hard time navigating the reduction in fiscal room for manoeuvre the market tightening will trigger. The French government losing its absolute majority in parliament comes at a delicate time, even if the Constitution helps to operate with a relative majority.

The Fed's intriguing forecasts

By hiking by 75 basis points, the Fed delivered last week what the market had been pricing since the inflation print for May – another upside surprise – had been released, departing from the 50-bps move (to be repeated in July) which had been communicated quite clearly to the market. Textbook central banking teaches that it's often wrong to step away from an intended trajectory in reaction to only one data point (the reason why we kept our call at 50). Yet, as we mentioned last week, the release of the Michigan household survey, reflecting a significant jump in 5-year ahead inflation expectations, probably tilted the Fed into more robust action to counter the pervasive impression that it had been "behind the curve" for some time. Now, more fundamentally, what may be more telling than the June hike itself is the combination of the stated possibility to move by the same quantum in July again – although Powell kept all options on the table with his "*From the perspective of today, either a 50-basis point or a 75-basis point increase seems most likely at our next meeting*" - with the message from the Federal Open Market Committee (FOMC)'s "dot plot". The Fed wants to "get on with the job" fast.

Indeed, **the median FOMC member now expects the Fed Funds rate to be firmly into restrictive territory by the end of 2022** (3.4%, against c. 2.5% for the "neutral rate') with a few further hikes into 2023 (3.8%). Moving by 300 basis points in 9 months would constitute a quick pace of tightening by historical standards. The post-Great Recession normalization between 2015 and 2019 had been particularly sluggish, but even during the mid-2000s tightening, it took a year and a half for the Fed to raise its policy rate by 300 basis points. We would need to go back to the 1990s to find a similar pace, but even then, it took a bit longer: the Fed Funds rate rose from 3% to 6% between January 1994 and January 1995, including, interestingly, a 75 basis points move in November 1994.

So, the Fed now wants to move fast – the March "dot plot" had only 175 bps worth of hikes for this year – which probably reflects a change of view on the sticky nature of the ongoing inflation shock as well as a tactical choice in the "apportionment of pain". The idea is that it's better to kill excess demand in one go and accept a noticeable immediate impact on growth and employment, rather than opt for a timid pace of tightening which could ultimately make an even more painful restrictive shift necessary in the future if inflation gets entrenched.

We could think of it as a form of monetary delayed gratification. What could lend support to this view is the fact that the "dot plot" median now includes 40 bps of rate cuts in 2024. It might be technical – FOMC members would simply indicate a convergence to equilibrium after a restrictive phase without any strong conviction on the right timing for this – but this echoes a statement by James Bullard a few weeks ago who explicitly discussed the possibility to be tough now to allow some easing soon. He was seen as somewhat "fringe" in the committee, but since the Fed has effectively delivered on his call for a 75-bps hike (he was the first there), we would pay a lot of attention to his thoughts.

What we find surprising in the "dot plot" is however the very limited quantum of pain which is embedded in the labour market forecasts. We mentioned last week the point made by Governor Waller about an unemployment rate of 4.25% being the right level consistent with a deceleration in consumer prices back to the Fed target. The median FOMC member does not even expect this level to be reached in this cycle. The rise from the current 3.6% level would be very slow (3.7% at the end of 2022, 3.9% in 2023 and 4.1% in 2024). This gap could explain why the Fed does not expect core inflation to fully return to target at the end of the tightening cycle (median at 2.3% in 2024), which we could probably take as a nod to the Fed's new strategy – although it looks ancient by now – of tolerating some measure of overshooting. Yet, **obtaining almost 2 percentage points of reduction in core inflation at the cost of a rise in unemployment of only 0.4 percentage point would reflect a very strong belief in a steep Phillips curve** – the opposite of what the ECB is communicating now, as we discussed in Macrocast last week.

There are three possible interpretations of this message. First, Waller's point on the possibility to tame wage growth by merely reducing the unusually high vacancy rate without having to kill too many actual jobs is now probably consensual at the FOMC. Second, the Fed may consider that a significant chunk of the current pace of core inflation is not

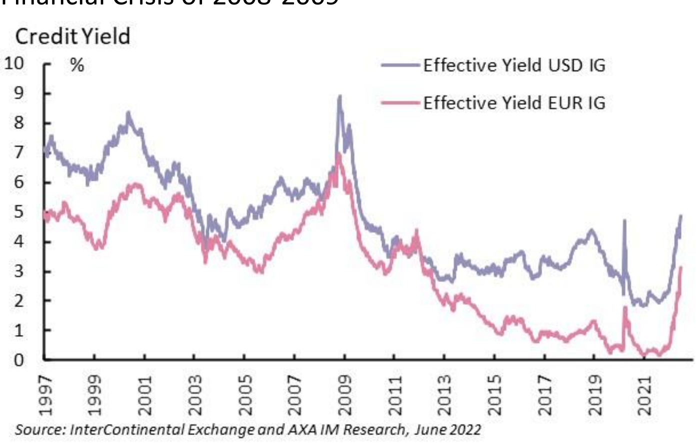
demand-led but reflects some supply-side pressure which will spontaneously recede over the forecasting horizon, leaving less ground to cover for demand rationing. A third and less benign interpretation is that many FOMC members are voluntarily submitting a rosy version of their expectations for the labour market to avoid adding to the ongoing gloom.

Gauging the market-led tightening

What is in any case undeniable is that the market reaction so far has not been consistent with a benign scenario. The market prices one more 25-bps hike by the end of 2022 than what the dot plot suggests. **True, the Fed's shifting gears reassures those worried that it would allow an upward shift in trend inflation**. The 10-year breakeven has receded from a peak at 2.76% on 10 June to 2.58% last Friday – in line with the Fed's target when taking into consideration the usual wedge between Consumer Price Index (CPI) and Personal Consumption Expenditures (PCE) price index. Yet, **the price to pay for this improvement in the central bank's credibility is the continuing deterioration of the performance of the credit market**, suggesting that a significant loss of macro momentum us being priced in, consistent with a rise in default rates.

This gets us to another point we made last week: among the reasons we listed why the Fed should stick to a 50-bps hike we mentioned the fact that the market was "taking care" on its own of a large share of the tightening in financial conditions which is needed to put an end to the US overheating phase. This has gone even further after the Fed's decision. **Corporate yields have risen further to exceed the peak seen during the pandemic-induced turmoil in March 2020 to hit the highest level since the end of the Great Financial crisis of 2008-2009 (see Exhibit 1).**

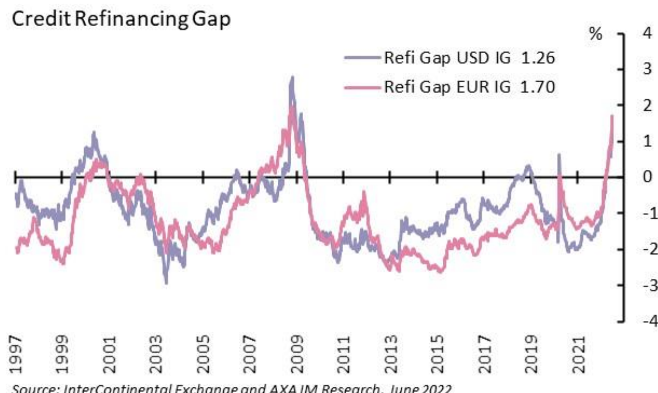
Exhibit 1 – Highest corporate funding costs since the Great Financial Crisis of 2008-2009



True, paying 5% - the average cost of new debt for investment grade corporate issuers in the US may still seem historically low, especially when taking on board current inflation (the *ex post* real interest rate remains solidly negative). **Yet, the *ex-ante* real yield – i.e., the nominal yield on corporate bonds minus expected inflation – has increased significantly,** considering 2.5% CPI trend inflation is still the assumption most businesses would use when contemplating new investment projects. Current inflation is also somewhat misleading when trying to gauge the pressure from funding conditions. Indeed, so far businesses have been able to pass the increase in the cost of their inputs in selling prices, leaving margins at comfortable levels. Preserving profitability is going to become harder as demand – which has so far been protected by the capacity to draw on the excess savings accumulated during the pandemic – will gradually erode.

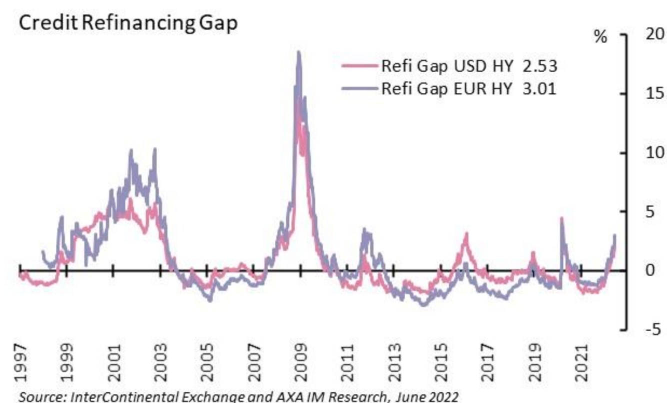
This squeeze on profitability from tougher price pass-through will be compounded by the rise in business financing costs. Indeed, **the refinancing gap has turned positive in the corporate sector to a degree unseen since 2009.** In other words, the cost of refinancing exceeds the current average interest rate paid on existing debt (see Exhibits 2 and 3).

Exhibit 2 – A sharp rise in the refi gap for IG by historical standards…



Source: InterContinental Exchange and AXA IM Research, June 2022

Exhibit 3 – …for HY it's less pronounced



Source: InterContinental Exchange and AXA IM Research, June 2022

The magnitude of the market-led tightening in financial conditions is a key reason for us to expect the Fed to be "stopped out" before delivering all the restriction they are currently signalling. **We expect Fed Funds to hit 3.25% at the end of 2022 and stay there in 2023, i.e., staying a good 50 basis points below the median forecast from the FOMC released last week**. Our contention is that domestic demand will hurt much more than what the central publicly expects to deliver the required slowdown in inflation. We expect US GDP to grow by only 1.2% in 2023 against 1.7% according to the Fed. We fully agree with the characterization offered by Ethan Harris, Chief Economist of Bank of America: The Fed shifted from *"falling behind the curve to playing a dangerous game of catch-up"*. Where we differ with him is that we think the Fed ultimately won't have to go as far as they currently say to deliver said catch-up (he sees Fed Funds above 4%). But that is only because we expect a very significant deceleration in economic activity teetering on recession to tame inflation in time, not because we believe the US central bank would give up on fighting the ongoing price spike.

Anti-fragmentation: if there are winners, losers will be needed

We discussed at length last week how the ECB failed to answer the most relevant question the market wants to be addressed: how to deal with fragmentation, i.e., widening sovereign spreads across the monetary union as the ECB terminates quantitative easing and starts to hike policy rates. Yet, before we get (again) to the shape the anti-fragmentation weapon could take, we want to explore what in our view is an equally concerning development**: the steep tightening in financing costs for European businesses**.

Indeed, what we find striking in the three exhibits we used to discuss the Fed is that the rise in funding costs has been even faster for European corporate issuers than for their US counterparts. True, there remains a difference in the absolute levels across the Atlantic, but **on average investment grade corporates in the Euro area are now paying above 3% for funding for the first time since June 2012**, and the interest rate has doubled in less than 3 months. Considering a trend inflation of 2% and potential GDP growth a bit above 1% for the Euro area as a whole, this suggests that **financial conditions have already reached a neutral level for the best signatures of the corporate sector.** Markets have a habit of anticipating the signals from monetary policy. This needs to be carefully taken in consideration by the ECB Governing Council in their future deliberations. **The normalization of the monetary stance that the ECB is planning to reach by the end of the year, or the beginning of 2023 is already a reality for the business sector. We suspect that rising funding costs for a corporate sector which – possibly even more than in the US – is going to be squeezed on its profitability will become a crucial point of focus ahead.**

Yet, for now the Council's energy is squarely focused on catching up on anti-fragmentation. Those who like to see their glass half full relish the fact that it took only a week of market action to trigger an emergency meeting of the Council and come up with the announcement that Pandemic Emergency Purchase Programme (PEPP) reinvestment flexibility would be implemented – that was the basic minimum in our view – and that that the ECB's committees were tasked

with coming up with a new tool "for the consideration of the Governing Council" – we assume for decision at the next meeting in July. **The same optimists will point at the compression in the Italian spreads over the last few days**. We would however observe that (i) the meeting took more than three hours to reach conclusions which we did not think were particularly far-reaching given the circumstances – which may point to a significant level of unease within the council – and (ii) that a lot of the improvement on the Italian market came after the Governor of Banca d'Italia stated that "*a 10-year spread over 200 basis points would be unjustified".* Accordingly, the Italian spread duly moved back slightly below 200 basis points. But we would be more reassured if this had come from a Northern European central banker rather than from Banca d'Italia, and more fundamentally**, this would point to a form of explicit yield control which we have always thought would be quite problematic for the ECB given its institutional features.**

But before we get to the nagging issue of the quantitative limits to the ECB action, we need to explore some of the consequences of some of the likely technical aspects of fighting fragmentation. A paper by Bloomberg over the weekend asserted that Christine Lagarde had sketched out to the European finance ministers a framework where new purchases of bonds would be triggered when some spread thresholds would be hit. Whether or not these thresholds would be made public is moot: the market will discover it for itself. However – and that echoes the point about sterilization we made last week – **purchases of bonds from member states under attack would be offset by sales of bonds from other countries to leave the total quantum of liquidity unchanged.** This would be the condition for dealing with fragmentation while tightening monetary conditions for the Euro area as a whole. In practice, this could lead to some "interesting" discussions within the council and possibly trigger quite some debate across governments.

Indeed, if the ECB used the flexibility of its reinvestments, **some signatures in the middle of the Euro area pack would already receive less support than they were supposed to get to direct more reinvestments towards the South. In addition, they would have to face sales of bonds currently held by the ECB to offset new purchases of Italian bonds**. Your humble servant is convinced all this is going to go down very well in the French and Belgian Finance Ministries. Of course, the framework could protect those "middle of the pack" sovereign issuers by limiting the offsetting sales to the strongest signatures, in particular German yields. But then this could unduly lift the level of the interest rate of the reference asset in the Euro area. In any case, if helping the periphery comes with a refinancing cost to the other partners, this is likely to make the debate on conditionality quite tough. The easiest would be to provide the ECB with a "de facto conditionality" which would give it ample room for manoeuvre to trigger purchases without having to wait for a member state request. The already existing per-set milestones (often expressed in the form of structural reforms) could be used as an "umbrella" for ECB action. Member states contemplating a rise in their own refinancing cost because the ECB would sell their bonds to buy more fragile ones may request a tougher safeguard than this.

Beyond potentially fractious discussions on the definition of the weapon itself, we always come back to the same old issue: to defend a pre-set spread threshold, by construction the central bank needs to be ready to purchase as many bonds as needed – and the market needs to believe it. The ECB faces constraints on this, with the usual interpretation of the European Court of Justice on the Outright Monetary Transactions (OMT) programme seemingly limiting to 50% the share of any national public debt the Eurosystem can hold on its balance sheet. This has been a nagging issue since the start of unconventional policy, and we don't think the ECB is closer to provide answers on this. As of the end of last week, the market seemed to take a quite positive view of what could come up from Frankfurt on anti-fragmentation. We think there is some under-estimation of the political and technical difficulties on this.

French parliamentary elections: navigating with a relative majority

Governments will have a tough job in the months and years ahead, navigating between near-infinite demand for policy action from a public opinion which has decisively moved away from the concept of "small government" on one hand, and a contraction in its fiscal room for manoeuvre in a context of tightening financial conditions on the other. In such environment, strong parliamentary majorities are an asset, and from this point of view the parliamentary elections in France have restrained Paris capacity to steer domestic policy, the President's party losing its absolute majority by a significant margin.

"Ensemble" – Macron's coalition – secured 240 seats, coming up with the largest group but 49 seats below the absolute majority threshold. Arithmetically, an agreement with the centre-right Republicans (61 seats, to which 12 independent centre-right Members of Parliament (MPs) could be added) would generate a majority. It's early days but listening to the TV debates on Sunday night it seemed the best Ensemble can hope would be a "case by case" readiness to support bills in parliament, rather than a formal deal. Ensemble could also try to lure some of the more moderate members of the left-wing coalition to support some bills, but there a formal deal looks even more difficult to obtain.

The French Constitution provides powerful weapons to a government forced to make do with a relative majority in parliament, through its article 49.3 which allows the executive to get a bill through parliament without vote, provided the opposition fails to coalesce around a motion of no confidence winning an absolute majority in the lower house. However, the Constitution was reformed under President Sarkozy to allow only one procedure of this nature for an ordinary bill per parliamentary session, on top – and that's key – of budget bills which can always be adopted though 49.3. This means that **the worst possible form of political paralysis (incapacity to pass a budget) can be avoided, but otherwise, a government controlling only a relative majority needs to choose its battles carefully.**

Country/Region	What we focused on last week	What we will focus on in next weeks
	• FOMC delivered a 75bps hike in FFR to 1.5-1.75%, its biggest since 1994. Guided 50/75bps next month. Dots suggest 3.4% median in 2022 and 3.8% by end 2023. We forecast 3.25% peak by year-end • Retail sales (May) headline down 0.3%, control 0.0% in nominal terms, steep drop in real terms • PPIN inflation (May) broadly stable on month • Housing starts/permits (May) -14.4%/-7.0%mom • Empire and Philly Fed surveys (Jun) fall vs expected	• U Mich (Jun, f) 5-10yr inflation expectations watched after prelim jump to 3.3% • Existing and new home sales (May), both watched for ongoing signs of falling housing transactions • Jobless claims – trending higher for last 3-months • Current account deficit (Q1) widening expected on wider trade deficit in part reflecting unwind of port blockages • Manu and servs PMIs (June, p)
	• Ad-hoc ECB Governing Council meeting deciding to deploy PEPP reinvestments flexibly to rein in bond market fragmentation. ECB committees to accelerate design of new antifragmentation instrument.	• Last EU Leader Summit under French Presidency. • ECB "hawks" indicating preferences on anti-fragmentation instrument design • Business confidence (PMIs, INSEE, Ifo) for June • Second round of French parliament elections
	• MPC hiked by 25bps to 1.25%. Guided they will "act forcefully" to indicators of more persistent inflation, leaving door open for a 50bp hike in Aug • GDP (Apr) fell to -0.3% as test and trace activity fell, we now expected softer Q2 -0.3% from 0% • Unemployment (Apr) inched up to 3.8% from 3.7%	• CPI (May) expected to rise to 9.2% (cons) we see risk to downside • Public finances (May) margins narrow as rates rise • Flash PMIs (Jun) likely to show slower momentum • GfK Cons conf (Jun) may slip under price pressures • Retail sales (May) expected to fall
	• The BoJ maintained the status quo, arguing insufficient recovery and medium-term inflationary pressure still below target. On recent ¥ weakness, the BoJ stated it needs to be monitored. • Tankan mfg/non-mfg indices (Jun) at 13 (flat)/ 9(+4) • Machinery orders (Apr)	• Mfg PMI Flash (June) may progress after China reopening. Svcs PMI should continue to recover • CPI (May) is expected to slightly rise on the back of energy prices rebound and growing demand on some services)
	• Sequential growth recovered after April's slump, but challenges to a sustained recovery remain significant	• Market will pay attention to how Beijing navigates its COVID flare-up and further policy easing from Beijing
	• CB: Brazil hiked +50bp to 13.25%, Hungary +50bp to 7.25% & Taiwan +12.5 bp to 1.5% • May CPI (%y/y) slowed in India (7.0%) and remained unchanged in Poland (13.9%) • Q1 GDP (%yoy) in Russia decelerated to 3.5% • Most of Asia sees continued improvement of Covid cases. However, cases remain elevated in Taiwan	• CB: Mexico is expected to hike +75bp to 7.75%, Philippines +25bp to 2.50%. Turkey (14.0%) & Indonesia (3.50%) to stay on hold • Reaction to the presidential runoff in Colombia (Sunday) • May CPI (%yoy) should pick up in Malaysia, Singapore & South Africa

Upcoming events		
	US:	Tue: Existing home sales (May); Thu: Weekly jobless claims (18 Jun), Current account (Q1), Mfg & services PMI (Jun,p) Fri: Michigan consumer sentiment (Jun), New home sales (May)
	Euro Area:	Sun: FR 2nd round assembly elections; Mon: Ge PPI (May); Wed: EU19 Consumer confidence (Jun,p); Thu: EU19 Ge & Fr Mfg & services PMI (Jun,p), EU19 Composite PMI (Jun,p), Fr Insee mfg confidence (Jun); Fri: Ge IfO business climate indx (Jun), It ISTAT business & consumer confidence (Jun), Sp GDP (Q1)
	UK:	Mon: MPC's Mann speaks; Tue: CBI Industrial Trends survey (Jun); Wed: Inflation (May); Thu: PSNB (May), Composite, mfg, & services PMI (Jun,p), CBI Distributive Trades survey (Jun); Fri: GfK consumer confidence (Jun), Retail sales (May)
	Japan:	Thu: Mfg PMI (Jun,p); Fri: CPI (May)
	China:	Mon: 1-year Loan Prime Rate

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