AXA Investment Managers

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Investment Institute Macroeconomics

Speaker's Cornered

- We look into the recent dramatic rise in long-term yields, focusing on the US. Beyond the cyclical issues, questions on the future trajectory for US public finances, amid political dysfunction, may play a role.

The US 10-year yield flirted with 5% last week, as the market continues to digest the Fed's warnings on the trajectory for policy rates amid a stubbornly resilient economy and massive net issuance of Treasuries. Yet, any data release – however flimsy - contradicting this hawkish narrative is still triggering some episodes of downward correction in yields, suggesting a fair degree of collective unease with the level long-term interest rates have reached. This is understandable. With the market now magnifying the impact of the policy tightening, the resilience of the real economy will be tested, which should make the Fed sensitive to the risk of engaging in "overkill". Last week's release of the payroll data for September was a case in point: after rising steeply as the US defied yet again gravity and created many more jobs than expected, yields retraced partly, possibly owing to the less scary elements of the release hidden behind the headlines. Indeed, wages decelerated further, to a pace which is consistent with a return to 2% inflation without having to make too heroic assumptions about productivity.

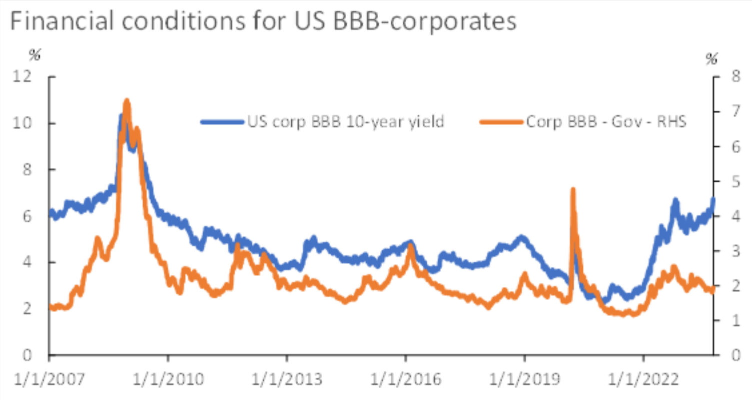
Still, the state of the US public finance is another source of fundamental concern for the bond market. In the short run, the ousting of Kevin McCarthy from the House Speakership and the lingering divisions within the Republican party may paradoxically help contain long-term yields if a shutdown cannot be averted, with its dampening impact on demand. Yet, what the current drama reflects of the difficulty to reach any bipartisan resolution on fiscal matters – or even full alignment within each party – does not bode well for the possibility to address the structural flaws of US public finances in the years ahead. There is probably no imminent danger. According to the CBO, under a no-policy scenario US federal debt would reach 118% of GDP in 2033, a level which has already become quite familiar in several European countries. Yet, such scenario is predicated on the partial expiry in 2025 of the tax cuts granted by Donald Trump, which of course is not a done deal if he returns to the White House. On the other side of the fence, we detect little focus on fiscal consolidation in Biden's platform for now. With socialised spending rising on trend in the US, hard choices will be needed, and political polarisation will not help.

US labour market still too hot – but wages are behaving

There is always a danger to discuss "the market" as if it were a sentient being torn between emotions and rational thinking – although we guess this is how a lot of finance professionals often picture it, subconsciously or not - but it provides commentators such as your humble servant with handy metaphors: it feels "the market" is at the moment unsure of, and surprised by, its own reactions. **The dramatic rise in long-term yields of the last few weeks looks fragile since any piece of data- even the least reliable ones - contradicting the hawkish narrative immediately triggers a yield correction**. We have had a clear illustration of this last week when the release of the ADP data which suggested a faster landing of the US labour market reduced the pressure in the bond market (the 10-year yield fell from 4.88% to 4.73% that day). ADP has not been a good predictor of payroll data for a long time, and this is normally well-known on trading floors.

This appetite for **questioning the wisdom of the "big push" for higher for longer yields probably reflects an awareness among many investors of the self-defeating nature of such a configuration**: if overall financial conditions get too restrictive, magnifying the impact of the central banks' own tightening, then the probability of a soft landing diminishes. The credit spreads are not particularly high by historical standards – at 195bps on Friday, the spread between BBB-rated corporate 10-year bonds and govies was in line with the post-GFC/pre-Covid average – but habitual readers of Macrocast are familiar with our point that spreads are great indicators of market stress, but not necessarily of macro pressure on funding conditions, for which the *absolute* level of funding costs, compared with expected real growth and inflation, is a better proxy. BBB-rated bonds paying 6.75% is not something we have seen so far on this side of the Great Financial Crisis (GFC) (see Exhibit 1).

Exhibit 1 – Highest corporate funding costs since 2010



Source: Macrobond, AXA IM Research, October 2023

True, fortunately **there is little corporate debt which needs to be refinanced this year and next and this partly explains why there has been such resilience of the real economy so far, but what comes to refinancing is now facing massive gaps,** a point Federal Open Market Committee (FOMC) member Bostic – who turned quite hawkish in this cycle – was ready to acknowledge in his last public statement. Corporate bankruptcies have been on the rise in the first half of the year already, exceeding their pre-Covid average level in the US and making up for the pandemic-era freeze. They tend to affect smaller businesses than usual – which may explain why the issue is not attracting more coverage – but this is part of the "cracks" slowly appearing. On the household side, mortgage rates are also rising in a steep manner, exceeding 7% (for the key 30-year one) since 2 October. The behaviour of the residential market has been to some extent counter-intuitive so far, with new home sales holding up surprisingly well and even rebounding in the first 7 months of the year, as those having to move were forced to turn to that segment of the market as the rise in interest rates had "frozen" the existing house sales. **At 7% interest rates, even the new home sales are likely to be affected and the "bottoming out" of residential construction would be in jeopardy.**

Taking into consideration the likely after-effects of the current movements in yields was given a boost by Mary Daly, the boss of the San Francisco Fed, who stated that market developments *"diminish the probability the Fed has to hike further"*, even if she stuck to the view that such action may ultimately be needed if the labour market and inflation do not cool.

Given what could lay ahead if the current interest rates are sustained, it is maybe understandable – and reassuring – that **after a knee-jerk hawkish interpretation of last Friday's higher-than-expected payroll data (336K vs 170K), yields retraced partly as investors chose to focus on the soft elements in the release** (the 10-year yield shot up back to 4.88% in the minutes following the release to end the day at 4.80%). On the job creation front, at least when focusing as usual on the establishment survey, the sense of gradual deceleration reflected these last few months is no longer there (see Exhibit 2). On a 3-month annualised basis, employment growth had finally moved below the pre-pandemic pace since the beginning of the year, but this has been almost entirely wiped out by the September release (on top of the strong number for the month the release also came with some upward revisions to the recent past, 119K over two months). However, this "still hot" labour market is not reflected in wage data. Yet, **on a 3-month annualized basis, hourly earnings have decelerated further in September to 3.4%, which would be – just – consistent with a return of inflation to 2% without having to make too generous assumptions about productivity.**

What is also interesting is that last month's print confirms the recent trend on wage distribution. Indeed, at the beginning of the strong acceleration in nominal earnings, those of the bottom of the ladder (non-supervisory, production workers in Exhibit 3) were enjoying steeper gains than the average, possibly reflecting dire labour shortages in low-wage, labour-intensive sectors which saw a steep rebound post Covid, e.g., hospitality and recreational activities. This mattered for the overall health of the United States (US) economy since these were the workers who had accumulated the least "excess savings" during the pandemic. This premium seems to have disappeared for a few months. The contrast between strong payroll gains and some loss of momentum on wages gives some credibility to the hypothesis that the Establishment survey may be overstating job creation at the moment, while the Household survey points to much weaker employment growth. We must be careful with this because previous episodes of divergence between the two sources in this cycle have resolved in favour of the Establishment survey, but for now, it gives the market some reason to ponder.

Exhibit 2 – Landing aborted

Source: Bureau of Labor Statistics and AXA IM Research, October 2023

Exhibit 3– But wages continue to slow down

Source: Bureau of Labor Statistics and AXA IM Research, October 2023

US policy dysfunction: looking beyond the Speakership drama

Yet, even if the week ended on this less concerning note, the background music on the bond market remains hawkish. We have been struck by how **discussions on the long-term fate of US public finances – with of course ramifications for Europe – have flared-up in the last few weeks**, possibly because the government shutdown has refocused attention on the state of the federal budget.

We briefly explored last week the consequences of Kevin McCarthy choosing to strike a bi-partisan deal to avoid a government shutdown at the last minute, providing us with a respite until mid-November. An optimistic narrative could see this as the first symptom of the return of a more pragmatic and less ideological approach to policymaking in the US. We were unconvinced and noted that **the recent "laws of gravity" defining the functioning – or rather dysfunctioning - of the Washington machine were inconsistent with any lasting bi-partisanship**. We had more than our share of vindication last week. The Democrats refused to lend the votes to McCarthy which would have allowed him to face down the challenge from his caucus' right-wing. Officially, the reason is that the Democrats could not save at the last minute a Speaker who had so far conceded so much to his extremists. We however suspect that it plays into their current narrative to allow the Republican party's divisions to simmer further and get more media exposure.

The idea mulled by some Republicans to call on Donald Trump to act as a temporary Speaker might seem baroque but reflects how deep the sources of dysfunction are. In the meantime, of course, while the Republicans are trying to find a solution, **precious time is wasted instead of trying to find a more permanent solution to the budget dispute beyond the mid-November deadline**. The arithmetic is quite simple: without support from Democrats, any Republican candidate can afford to lose at most 5 members of his own caucus to win the Speakership. 8 Republicans voted against McCarthy last Tuesday, and 90 against the bipartisan motion aimed at averting a shutdown the week before. It is a very narrow path.

Arguably, a higher probability of a government shutdown could help dampen the rise in bond yields since it would weigh on the real economy and probably convince the Federal Reserve (Fed) not to hike in the remainder of 2023 (there is no impact on the probability of default since the debt ceiling deal reached in June provides cover until 2025). Yet, we suspect that a growing number of investors are starting to look under the bonnet of the US deficit trajectory. There is a lot of US federal paper to absorb this year, especially as the Fed is reducing its balance sheet, but the years ahead do not look particularly propitious. As Lawrence Summers loves to say – although he is incredibly bleak on the magnitude of the necessary fiscal efforts down the line – **the US has "some time" to deal with its budget issues. But time becomes scarce when there is no visible political pathway, in the current configuration which may get us to 2028, for the kind of overhaul which will be needed.**

While Trump may have shed a lot of the tenets of the Reagan-era pro-market Republican party – in particular a belief in free-trade - one key element still featured prominently in his policy choices: a willingness to cut taxes. It is not yet clear what he will push in his platform for next year's election if he wins the primaries, but his action in power should be a guide. The Tax Cuts and Jobs Act (TCJA) of 2017 reduced the income tax rate by between 1 and 4 percentage points across the brackets, together with a steep cut to corporate tax, producing an impact on public debt estimated by the Congressional Budget Office (CBO) at USD 1.9tn cumulatively over 2018-2027. **Some of the provisions of the TCJA are due to expire in 2025, and this is a key assumption in the CBO's 10-year scenario. Yet, even with the TCJA expiring, federal debt would still reach 118% of GDP by 2033 (from 97% in 2022).** Of course, if Trump wins the next elections, and assuming the Republicans can regain full control of Congress, the probability the TCJA is prolonged would substantially rise. This could be offset by decisive action on the expenditure side, but given the Republicans' new demographics, rolling back on the age-related federal healthcare and pay-as-you-go pension may not be an easy sell (more on this later).

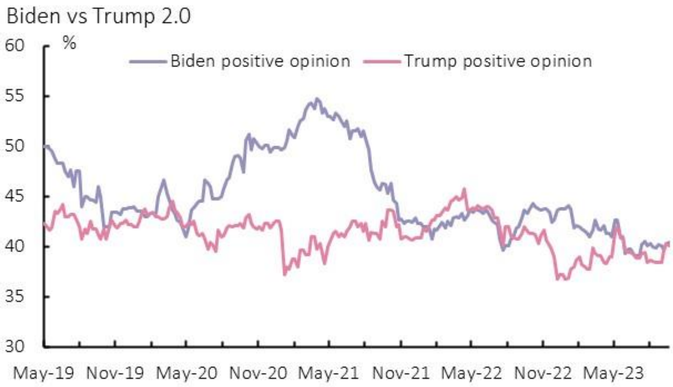
On the other side of the political fence, **Biden has a comprehensive and internally consistent economic plan for America, but it does not entail fiscal consolidation as it stands.** He holds the economics of his political diagnosis of the US. Doing away with the New Deal coalition of minorities and blue collars was what precipitated the Democrats' demise, in his view. Bill Clinton broke with his party's usual dim view of free trade and embraced globalization, epitomized by North American Free Trade Agreement (NAFTA). This triggered – or rather accelerated – the exodus of the blue-collar votes to the Republicans. Meanwhile, the Democrats may have become dominant in the more educated segments of the US population, but the intricacies of the American electoral system make it difficult for a Democrat to win without the blue-collar states.

Biden's endorsement – minus the tone – of Trump's trade war against China morphed into a generalized policy aimed at fostering a re-birth of manufacturing on American soil, embedded in the IRA legislation. He made a very visible gesture two weeks ago when visiting the picket line organised by the unions on strike in Detroit on a dispute with the car industry. In 2020 Biden was well ahead in the national vote, but he only became President because he managed to win – by a small margin – in key states of the Rust Belt**. In this re-industrialisation agenda, "pump priming" by the government plays a crucial role**.

Hopefully, over time the boost to trend GDP growth triggered by the productivity gains will help push tax receipts upward and contribute to keeping public debt sustainable, but it is difficult today to predict the overall impact the IRA will have on trend growth. At least the Inflation Reduction Act (IRA) is not expected to directly increase the deficit. It came with some hikes on corporate tax, closing some income tax loopholes and revision to drug pricing which explain why the CBO concluded that the act would ultimately improve the federal balance by some USD90bn cumulatively over 10 years. Yet, **a Biden administration would be very reluctant to act on the major federal social programmes**. This would collide with his general pledge to bring back the Democrats on what would be essentially labelled a social-democratic platform by European standards. Biden's insistence, ultimately unsuccessful, to make permanent cuts to accumulated student debt suggests that his "pro spending" outlook – already quite apparent in the additional fiscal stimulus he launched upon getting to power – is still very there.

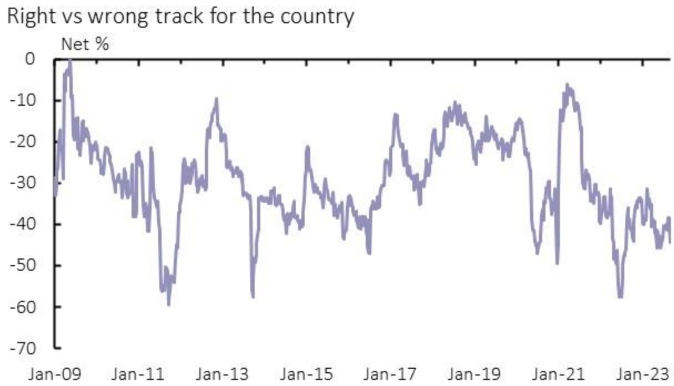
Where a Biden administration 2.0 would probably be keener to address the US fundamental fiscal issue than a Trump 2.0 one is on the readiness to hike tax, even if we would be surprised if it made it explicitly to the platform. A familiar quip in the United Kingdom (UK) is that British people would like Sweden's welfare state with American tax rates. Yet, arguably the collective preferences of the American population are equally dissonant. With an ageing population, a rising proportion of Americans will find themselves with a similar or even better level of social protection as many Europeans. The *average* social security pension in the US (available from the age of 62 at a discount, and full retirement age set at 66) stood last August at USD 1,705 per month, significantly higher than the *maximum* state pension in the UK (USD 1,059 per month at today's current exchange rate and USD 1,300 using the Organisation for Economic Co-operation and Development (OECD)'s Purchasing Power Parity), while part-free healthcare through Medicare is granted to the over-65s. Nearly a fifth of the US population is already a recipient of Medicare (an additional 21% is under Medicaid, the healthcare programme for people on low income). Arguably**, if collective preferences for those socialised programmes do not change, it will make sense to raise the level of taxation accordingly**. The political configuration to achieve this is elusive though. It would probably take one of those rare configurations where the White House and the whole Congress is under control by one party, and even this would probably necessitate some bipartisan efforts, since even Democrats would likely lose some members' votes on such a sensitive issue.

Exhibit 4 – A close race as things stand today



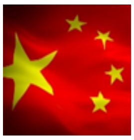
Source: RealClearPolitics and AXA IM Research, October 2023

Exhibit 5 – Americans are in a bad mood



Source: RealClearPolitics and AXA IM Research, October 2023

In any case, **the market is going to start following US politics even more closely as the electoral year is getting near.** Assuming we get a replay of 2020, the two candidates seem to be polling very close to one another (see Exhibit 4). The inflation wave has not been kind to Biden. The net percentage of those thinking that the country is heading in the wrong direction, although off its highs, remains quite elevated (see Exhibit 5). This is probably surprising in a situation where inflation is now receding, and the labour market is still doing remarkably well by historical standards. It would however be a mistake to extrapolate from the current state of play. A year before winning a second mandate, Obama was exactly in the same situation, with tight personal polls and a net percentage of Americans thinking the country is on the wrong track very close to the current one. The market wants some peace and quiet. It is unlikely to get it from US politics in the near future.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• US 10y Tsy yields reached a post GFC high of 4.88% • Payrolls (Sep) surprised up 363k with +119k revisions. Unemp steady at 3.8%, AHE up 0.2%mom • JOLTS (Aug) vacancies up to 9.6m, LinkUp fell in Sept. • ISM surveys (Sep): mfg +1.4pt (49.0), serv -0.9 (53.6) • House Speaker McCarthy ousted in 216-201 vote, first time in 260 years	• CPI inflation (Sep) headline seen stable, core lower • FOMC minutes (Sep) unlikely to add much to dots • New House Speaker vote: will this resolve problem? or next stage in House Republican dysfunction? • PPI (Sep) further modest headline gains on oil • NFIB small bus idx (Sep): weak, but hiring plans rise • Consumer sentiment (Oct, p) watch for further falls
	• Goods' consumption remains under pressure with retail sales dropping 1.2%mom in August, consistent with a -0.8% carry over for Q3. Aside from France, new car registrations were mixed at the end of Q3	• Germany, Euro area industrial production for (Aug) • Final September HICPs • Mid-Oct is the deadline by which governments must send their draft 2024 budgets to the Commission
	• Nationwide house prices (Sep) flat on the month but Halifax index down 0.4% – its sixth consecutive fall • BoE DMP survey points to easing inflation expectations and a cooling in the jobs market • Sharp decline in services PMIs (Sep, f) revised away; 49.3 from 47.2 vs 49.5 (Aug)	• UK monthly GDP (Aug) expected up 0.2%mom • BRC Retail sales (Sep) • RICS housing survey (Sep) • BoE's Financial Policy Committee quarterly summary
	• PM Kishida reveals broad outline of economic stimulus package likely to total ¥20tn - ¥30tn • Tankan survey (Q3) sentiment improving driven by non-mfg. Inflation expectations edge lower • Per-capita wages (Aug) up 1.1% below expectations	• Current account balance (Aug) • Reuters Tankan survey (Oct) • Machinery orders (Aug) • Corporate good prices (Sep)
	• NBS PMI mauf and non-mauf CORP (Sep): 50.2 and 51.7 respectively (vs. 49.7 and 51.0 in Aug) • Caixin PMI manf and services (Sep): 50.6 and 50.2 (vs. 51.0 and 51.8 in Aug)	• Sat (7 Oct): FX Reserves (Sep) • Fri (13 Oct): CPI, PPI (Sep) • Fri (13 Oct): Exports, imports (Sep) • 10-17 Oct: Total social financing (Sep), M2 supply (Sep), new yuan loan (Sep)
	• CB: India (6.5%) & Romania (7.0%) stood on hold. Poland & Peru cut 25bp to 5.75% & 7.25%, respectively • Sep inflation (yoy) rose in Korea (3.7%), Philippines (6.1%), Taiwan (2.9%) & Turkey (61.5%). It fell in Peru (5.0%) & Thailand (0.6%) • Asian PMIs (Sep) improve but still stuck in contractionary territory	• Elections in Ecuador & Poland on 15 October • Sep CPI in Brazil Czechia, Hungary, India, Mexico, Poland, Romania & Russia • Industrial production (Aug): Colombia, India, Malaysia, Turkey & Mexico • Q3 GDP data in Singapore • Aug retail sales in Colombia

Upcoming events	US:	Tue: NFIB small business optimism (Sep), Wholesale inventories (Aug); Wed: PPI (Sep); Thu: CPI (Sep), Weekly jobless claims (7 Oct); Fri: Michigan consumer sentiment (Oct), Michigan inflation expectations (Oct)
	Euro Area:	Mon: Ge Industrial production (Aug); Tue: It Industrial production (Aug); Wed: Ge CPI (Sep), Ge HICP (Sep); Thu: EA Monetary policy account published; Fri: EA Industrial production (Aug), Fr, Sp HICP (Sep), Ge Current account (Aug)
	UK:	Tue: BoE's FPC Quarterly summary, BRC Retail sales (Sep); Thu: RICS Housing survey (Sep), Monthly GDP (Aug), Manf & construction output (Aug), Index of services (Aug), Industrial production (Aug), Trade balance (Aug), Trade in goods (Aug), MPC member & Chief Economist Huw Pill panellist on macro policy; Fri: Bailey speaks at Finance Membership Meeting
	Japan:	Tue: Current account balance (Aug), Trade balance (Aug), Economy watchers survey (Sep); Thu: Private 'core' machineary orders (Aug)
	China:	Fri: CPI (Sep), Exports & Imports (Sep), Trade balance (Sep), M2 Money supply (Sep), New yuan loans (Sep)

Our Research is available online: www.axa-im.com/investment-institute

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AXA Investment Managers (AXA IM) is a responsible asset manager, actively investing for the long-term to help its clients, its people and the world to prosper. Our high conviction approach enables us to uncover what we believe to be the best global investment opportunities across alternative and traditional asset classes, managing approximately €840* billion in assets as at the end of June 2023.

AXA IM is a leading investor in green, social and sustainable markets, managing €489 billion of ESG-integrated, sustainable and impact assets as at the end of December 2022. We are committed to reaching net zero greenhouse gas emissions by 2050 across all our assets, and integrating ESG principles into our business, from stock selection to our corporate actions and culture. Our goal is to provide clients with a true value responsible investment solution, while driving meaningful change for society and the environment.

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