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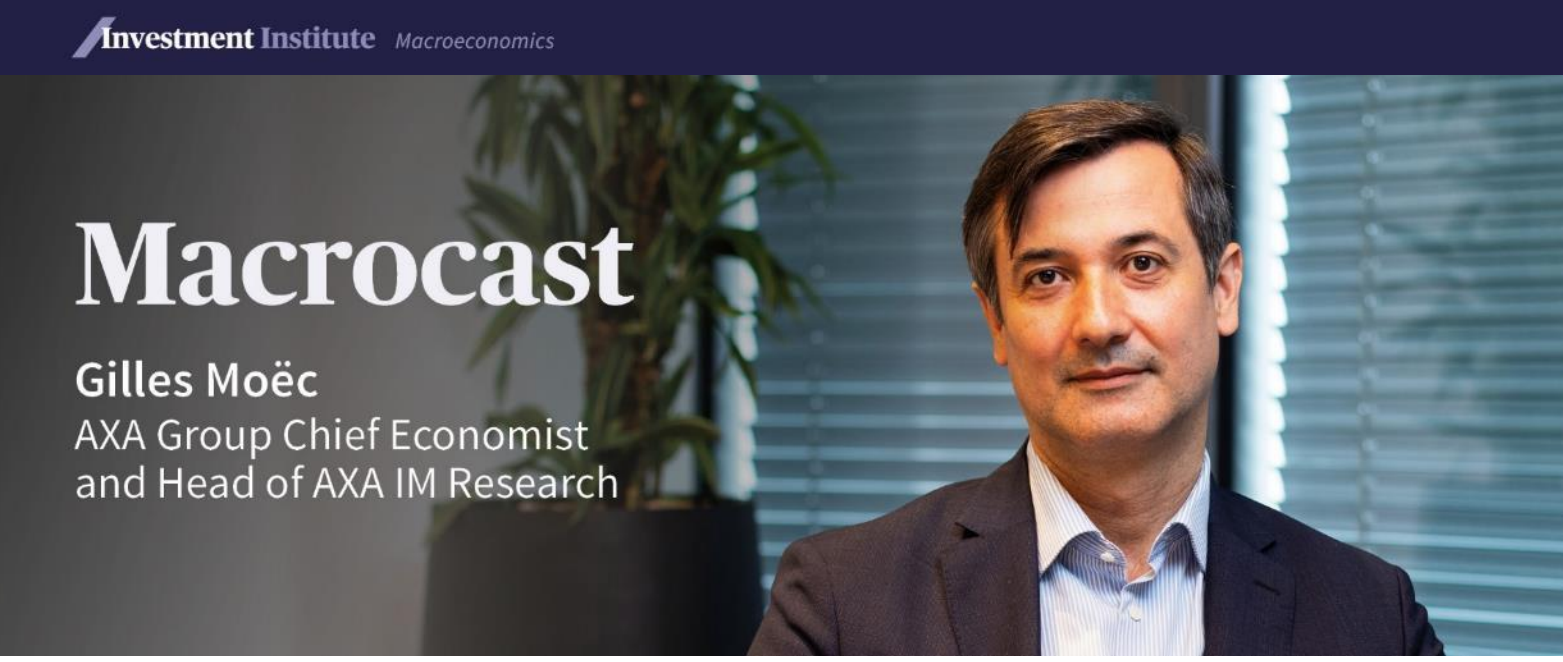
Investment Institute Macroeconomics



Another Mountain

- Taylor rules tell us the "tightening peak" was too low…but also that significant cuts could be needed in 2024.
- The Autumn Statement and the normalisation of the economic policy debate in the UK.

After endless debates on the right timing for the peak of the monetary policy tightening across the Atlantic, the discussion is naturally shifting to the timing and magnitude of the rate cuts in 2024. Of course, many surprises can derail the best-laid plans, but we can still look at what old policy rules would tell us about the possible trajectory for the Federal Reserve and the European Central Bank.

The message from a Taylor rule is unambiguous: the peak in policy rate looks low in both the US and the Euro area. Now, if central banks have chosen to be prudent and refrained from pushing rates as far as what old policy rules would have suggested, this would normally call for time before taking the risk of cutting. However, a Taylor rule taking on board the forecasts for the output gap from institutions such as the CBO, the European Commission or the OECD would also call for significant cuts next year even if inflation is not quite back to target at the end of 2024, which makes the market's current pricing not so unreasonable. Central banks' voices are generally calling on markets not to get carried away. We are therefore more cautious in our own forecasts, but the "tide is turning". The debate on the right shape for the monetary policy trajectory was revolving around a Matterhorn versus Table Mountain analogy. We propose to add Mount Snowdon, the highest mountain in England and Wales, to the list: any pyramidal mountain can be strenuous to climb, but if it is reasonably low, the descent can be quick.

The Chancellor of the Exchequer delivered his Autumn Statement last week. Even if the "tax drag" goes on, we think that in terms of narratives it epitomises the normalisation of the British policy debate. It seems the UK is heading to next year's election with a quite traditional "battle of manifestos" to conquer the centre ground of British public opinion, between a centre-right defending a small government agenda, and a centre-left defending public services but while keeping an eye on balancing the books. Yet, one issue may move the UK debate more towards the current US mood: the political weaponization of the fight against climate change.

Matterhorn versus Table Mountain…or Snowdon

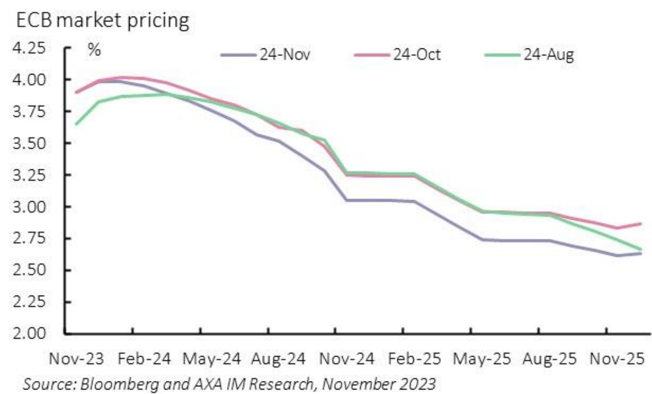
Mount Snowdon, the highest mountain in Wales and England, is almost as high as the flat-topped Table Mountain in South Africa (1,085 metres versus 1,087). Yet, while ascending can be strenuous and even dangerous, the descent from the pyramidal peak can be very quick. This Welsh summit may offer a better analogy than the Matterhorn vs Table Mountain image currently used to discuss the shape of the ongoing monetary policy trajectory.

The "Table Mountain" approach is at its heart a trade-off: once in restrictive territory, policy rates would not climb as high as feared, or perhaps necessary, offering some protection against adverse macroeconomic and financial consequences. However, to make sure that the inflation dragon is properly slain, the central bank would then leave interest rates unchanged for a long time. All major Western central banks are now using this narrative to different degrees. The "only" problem is that the market does not seem to believe them, at least not entirely.

Exhibit 1 – Fast descent priced in for the Fed…

Source: Bloomberg and AXA IM Research, November 2023

Exhibit 2 – …and the ECB



Source: Bloomberg and AXA IM Research, November 2023

The latest market pricing (we use Bloomberg data) suggests the market now expects the first cut for the Federal Reserve (Fed) to come in April 2024 (see Exhibit 1). There is more prudence regarding the European Central Bank (ECB) - the first full 25bps cut is priced for June 2024 only, which is our baseline – but this would be followed by a quick succession of further loosening. By the end of next year, the ECB rate would be back to 3%. It seems that **much of the ECB's "hawkish premium" – the belief in the market that the European central bank would always be more reluctant to cut than its American counterpart – has evaporated**, with a very comparable cumulative quantum of cuts by December 2024 priced across the Atlantic (95bps for the ECB versus 114bps for the Fed, a gap equivalent to a bit less than one "normal" policy increment).

We don't have that many precedents for full policy cycles in the Euro area but the c.9-month interval currently priced by the market for the Fed and the ECB between the last hike and the first cut would be within the United States (US) historical range (in line with the 2000-2001 stance reversal for instance). **Such a turnaround would however seem to be at odds with the insistent "high for long" mantra which has been maintained by the two central banks** - with even some suggestions that the tightening is not necessarily over yet. We can either deplore the market's deafness or check whether there may be some perfectly valid macro reasoning behind these expectations.

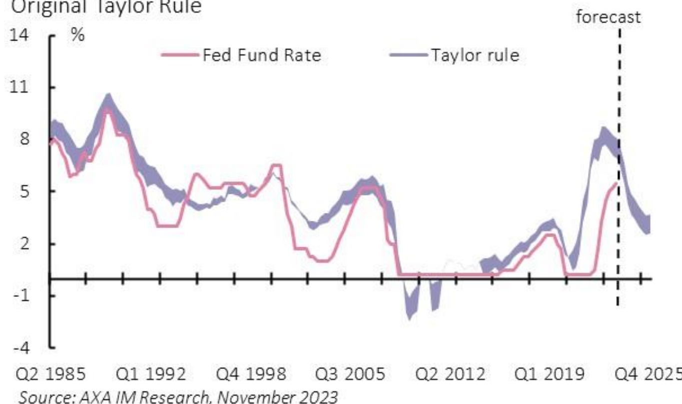
We start by assessing the level of the peak policy rate against the Taylor rule. We focus first on the US because the Taylor rule was designed to fit US monetary policy. The rule's premise is simple and intuitive, even if there are different ways to calculate it (the Fed in its own presentation of the policy rule comes up with 5 versions, see here for the formulas): the Fed's policy rate should be driven by GDP's deviation from trend (the output gap) and inflation's deviation from the Fed's target. These two "moving parts" are added to a more stable component, the neutral rate, R*. It is an elegant and convincing framework, but in practice quite uncertain. Indeed, we don't know where the neutral rate is in real time, and there can be a wide range of estimates for the output gap. And of course, this approach neglects the impact of unconventional monetary policy instruments, such as Quantitative Easing (QE) and Quantitative Tightening (QT).

To build our own Taylor rates, we use the output gaps from three different sources (Congressional Budget Office (CBO), International Monetary Fund (IMF), and Organisation for Economic Cooperation and Development (OECD)) together with the canonical Laubach-Williams estimate of the R*. Out of the 5 examples of Taylor rule used by the Fed, we run the first two – the original one, and the "balanced" one (which raises the weight of the output gap versus inflation relative to the original version). For the forecasts, we use the output gap projected by the three institutions, and our own view for inflation.

The two variants of the Taylor rule send the same message: the Fed Funds rate peak was too low, after having reacted too slowly (see Exhibits 3 and 4). Even in the balanced version which comes with a wider range of estimates for the Taylor rate (a mechanical effect of affecting a higher weight to the range of output gaps), the bottom of the range was still some 100bps above the policy rate when it hit its peak in July 2023. It could be tempting to ascribe the gap between the Taylor rate and the actual Fed Funds rate to a too high estimate for the neutral rate, which is a theoretical, unobserved concept, but to close the gap the neutral rate consistent with the actual policy rate would have to stand at zero, which is not credible in the current circumstances.

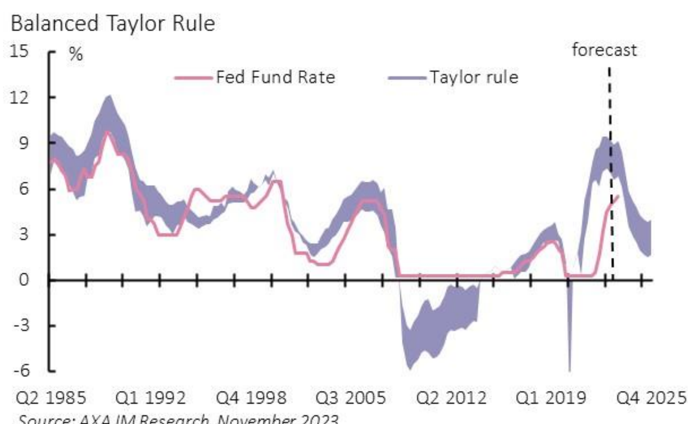
Yet, even if the policy rate was "too low" relative to the Taylor rule, the reversal in 2024 could be very steep. While the upper bound of our Taylor range would still have the Fed Funds at 5% at the end of 2024 (if using the IMF's forecast of the output gap), the other two projections would be consistent with fairly low rates, 2.5% with the input from the CBO and 3% with the OECD's. Note that the latest CBO forecast came in July and that 2023 GDP will come out higher than expected at the time, which would probably lift the output gap for 2023 and 2024 by a good 0.8%, but this would still leave the Taylor rate at only 3.25% at the end of 2024. Note as well that our forecast for inflation is not particularly "dovish": we have core Personal Consumption Expenditures (PCE) at 2.4% at the end of 2024, still above the Fed's target.

Exhibit 3 – Peak policy rate < Taylor rate…



Source: AXA IM Research, November 2023

Exhibit 4 – …but Taylor rate would fall quickly



Source: AXA IM Research, November 2023

That the peak policy rate is lower "than it should have been" would be fully consistent with the Fed being engaged on a Table Mountain approach, but then the logical conclusion is that this should be followed by a lengthy phase of "overshooting" with policy rates remaining above what would be consistent with the Taylor rule when the economy and inflation finally lands. Yet, **it is not the first time that the Fed failed to bring its policy rate in line with what the Taylor rule would prescribe, and this did not always make it "slow on the way down".**

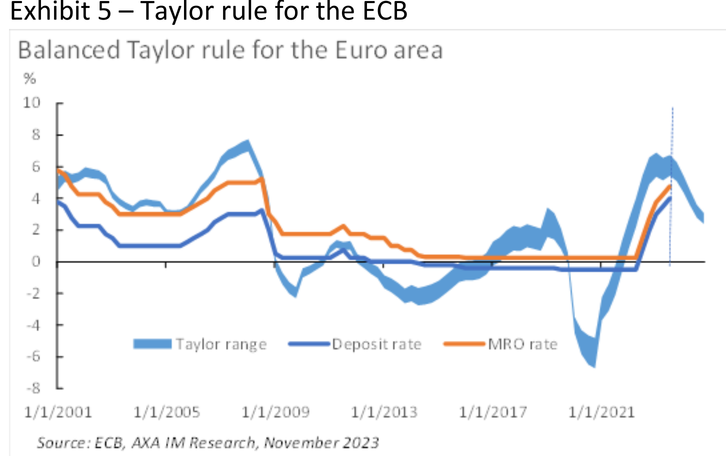
This was the case in the mid-2000s, when the Greenspan-led Fed was counting on the "New Economy" (inflation-busting productivity gains triggered by the digital revolution) to allow a more accommodative policy stance than what the dataflow was normally calling for. When signs of economic weakness started accumulating in 2007, the Fed started to cut rates exactly when and by the magnitude prescribed by the Taylor rule. This was no "panic cutting" as the first cut pre-dated by a year the emergence of the Great Financial Crisis with the demise of Lehman Brothers. The Fed started cutting rates in Q3 2007, one quarter *before* the recession materialised. There was no "remorse policymaking" then. In a nutshell, **what the market is currently pricing does not look unreasonable given a plausible macro outlook and the *past* reaction function of the Fed.**

Indeed, the market pricing for the Fed Funds at the end of 2024 (4.3%) is within the range of our three estimates for the Taylor rate, but above their average (3.75% when re-scaling the CBO input).

Now, we think we need to be extra-careful because the current circumstances are unique. The Fed in 2007 was not exiting from a phase of extremely high inflation as it is now. There is thus more of a case for a "remorse policymaking" which would make the Federal Open Market Committee (FOMC) delay the beginning of the policy reversal. We thus expect Fed Funds to still stand at 4.5% at the end of 2024. But we are ready to accept that the balance of risk lies more to the South of that value.

What about the ECB? The Frankfurt institution has never shown any enthusiasm for rule-based monetary policy. To be fair, neither has the Fed, but the fact remains that the Taylor rule has been working pretty well in the past in the US. The twin reference to the output gap and the inflation gap is more attuned to the Fed's dual mandate – even if one can see the output gap more as a forward-looking gauge of underlying inflationary pressure than as a proxy for a deviation from full employment. In the less theoretical realm, an issue for fitting any rule on the ECB is of course that it is a young institution, operational only since 1999. Another is that the policy rate of reference has shifted at the ECB: the Main Refinancing Operations (MRO rate) has given way to the deposit rate since the central bank moved to unlimited liquidity provision mode. We can however still try to apply the same approach we used for the Fed. For the Euro area output gap, we take the estimates and forecasts from the OECD and IMF and substitute the European Commission to the CBO source. We take the value for the R* from the latest Holston, Laubach and Williams' update, since the New York Fed team is kind enough to calculate it for the Euro area as well (see here). Note that to add a twist, we used in our computations the ECB's own forecasts for inflation (the September batch).

Exhibit 5 – Taylor rule for the ECB



Source: ECB, AXA IM Research, November 2023

Just like for the Fed, the ECB's peak policy rate would appear to be "too low" with a gap between the bottom of the range of our "Taylor rate" and the actual deposit rate of about 100bps. Yet, **the deterioration in macro conditions coupled with a relatively quick pace of disinflation – although still above the ECB's target – would be consistent with a quick descent in policy rates next year**, with a range between 2.5% and 3% for Q4 2024. This would make the current market pricing of 3% reasonable, even if we are a bit more prudent than that (we expect 3.25%).

Governing Council member Simkus stated last week that the market pricing for the ECB next year was overly optimistic, and Banque de France Governor Villeroy de Galhau, upon stating that "barring a surprise" the tightening phase is over, called for patience. The dialogue between the ECB and the market may be less about the overall magnitude of the rate cuts in 2024 than about their starting date, and the "Taylor rule" is rarely precise enough for this. The output gap is not directly observable, and most institutions provide only an annual estimate for it (we have linearly "quarterlized" the data from our sources). For our part, we think the forecast in June 2024 should provide the central bank with the right narrative to cut for the first time.

A more traditional policy debate in the UK

Between the Brexit referendum in 2016 and the ill-fated "Truss experiment" a year ago the UK strayed further and further away from mainstream policymaking. **We noted at the time of Jeremy Hunt's nomination as Chancellor of the Exchequer, followed very quickly by Rishi Sunak's ascent as Prime Minister, that the policy debate was about to normalise**, especially since at the same time Keir Starmer, Leader of the Opposition and Prime Minister in waiting if one extrapolates from the current polls, has been busy marginalising the old Corbynite left in the Labour party and pledged not to engage in a tax spree upon coming to power. **The "Autumn Statement" unveiled by Jeremy Hunt last week solidifies this view.**

Of course, there were some "smoke and mirrors" aspects. The 2-percentage point cut in the main rate of National Insurance contribution and making permanent "full expensing" of capex from corporate tax hides a further rise in the overall taxation burden, as the "inflation drag" continues. Indeed, contrary to most continental countries where the thresholds of the income tax brackets are revised in line with inflation every year, they will remain unchanged in the United Kingdom (UK) until 2028, dragging more and more individuals into higher taxation levels. But fiscal policy is also a matter of narrative, and the shift there from the "big government" choices of the previous Tory administration is plain to see.

Indeed, even if "politicking" always plays a role in budget decisions, especially a year ahead of the next general elections (at the latest), from a fundamental point of view the onus on governments usually is **on balancing cyclical stabilisation goals with structural reforms**. This is what Jeremy Hunt can claim to have achieved this time. While liberating some purchasing power quickly would help the UK deal with the current stagnation**, the country needs a lift in its potential GDP growth, and ignoring changes in multi-factor productivity, this takes driving more people onto the labour market and boosting capital expenditure**. Permanently allowing businesses to "expense" their capex will help on the latter. From an electoral point of view, Hunt could have chosen to cut the income tax – which hits a larger share of the electorate, including pensioners who are traditionally a strong constituency for the Tories – rather than the National Insurance (NI) contribution which affects only those in work, but this targeted cut should help boost labour supply (complementing the focus, in the realm of social policies, on tougher action on people on long-term health benefits to go back to the labour market).

Still, from a debt stabilisation point of view, the government could have avoided cutting the NI rate altogether, since according to the new projections from the Office of Budget Responsibility there is almost no space to address bad surprises on the road to a decline in public debt (only attained at the end of the projection horizon in 2028 to reach 92.8% of GDP). Arithmetically, the solution chosen by the government lies in planning massive pressure on public spending outside the Healthcare and – to a lesser extent – Defence department (-3.4% annually in real terms for England and Wales in those "unprotected departments" until 2028-2029, according to the well-respected Institute of Fiscal Studies, see here).

This creates some difficulties for Labour, increasingly squeezed between its reluctance to contemplate sweeping tax hikes and acute social demand for more public spending. But in a nutshell, **it seems the UK is heading to next year's election with a quite traditional "battle of narratives" to conquer the centre ground of British public opinion**, between a centre-right defending a small government agenda, and a centre-left defending public services but while keeping an eye on balancing the books. **This is miles away from the race to populism, on both sides of the political divide, which had characterized the first post-Brexit years.**

Two issues may however complicate this traditional equation. One is immigration. The Office of National Statistics has revised its estimate for the number of people immigrating in the UK in 2022 from 606k to 740K, thus exceeding the symbolic threshold of 1% of the UK's population. This puts the Conservatives in a difficult situation given the competition on its right from the Reform party. A business-friendly cabinet can hardly push for more constraints on entry given the corporate sector's gripes with the end of free-circulation of labour from the European Union (EU) since Brexit (most of the newcomers are from outside the EU). The Labour party itself is calling for a higher bar on the minimum wage to attain to receive a work visa.

The other is the fight against climate change. This used to be a cross-party commitment. Theresa May managed to get parliament to vote the principle of reaching net zero by 2050 after merely 90 minutes of debate in 2019. The consensus is evaporating. PM Sunak has pushed back the mandatory changeover from combustion to electric engines for cars by 5 years and is re-launching oil drilling in the North Sea. Labour is for now committed to a GBP28bn investment plan to attain net zero. This is where the UK may be veering more, and not less, towards the current political mood in the US, where climate change mitigation is weaponised politically. We need to see if the UK remains an exception in Europe on this point, or – as often – policy debates in London can be seen as a laboratory for Europe as a whole.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• FOMC minutes (Nov) confirmed Fed to proceed cautiously, would view data over coming months • Durable goods orders (Oct) -5.4%mom after +4.0% last month, ex-transport 0.0% from 0.2% • Existing home sales (Oct) -4.1% following -2.2% market still weak • U MIch 5-10 yr inflation expects (Nov) 3.2%	• GDP (Q3, r) expt'd 5.0%, watch for inventory revision • PCE inflation (Oct), continued disinflation expected, watch for bigger health insurance pick-up • ISM mfg index (Nov), unwind of surprise Oct drop • Preliminary Black Friday shopping results in broader assessment of consumer strength • Conf Bb consumer conf (Nov) signs of stabilisation?
	• EMU flash consumer confidence (Nov) slightly improved to -16.9 (+1p) • Fr business climate overall (Nov) (-1p to 97) and flash PMIs have not improved. For Ge, Ifo and flash PMIs are slightly better but remain very weak • German detailed GDP (Q3) is confirmed at -0.1% of which priv. consumption: -0.3%qoq and GFCF: +0.6%	• Inflation data (Nov). We forecast another important decline, around 2.4-2.5% for EMU. Energy base effects will continue to drag down headline, but core should also decline to 3.7-3.8%, probably distorted by Ge package holidays. Say otherwise, no trend extrapolation possible with November print • Loans to households (Oct) and EC surveys (Nov) on sentiment, price expectations, business climate
	• Autumn Statement delivered 0.5ppt fiscal easing, earlier than expected, main measures inc fall in NICs and permanent business expensing • Public finances (Oct), larger deficit on debt interest • PMIs (Nov, p) mfg 46.7 vs 44.8, servs 50.5 vs 49.5 • Gfk cons conf (Nov) -24 vs -30, unwound sharp fall	• BoE lending data (Oct), focus on mortgage approvals and consumer credit • Nationwide HPI (Nov), gains in last month • BRC shop price index (Nov) ongoing stabilization in high street prices
	• CPI (Oct) rose to 3.3%yoy (+0.3pp), above consensus measure exc. food and energy up to 2.9% (+0.1p) • Flash PMIs (Nov) were mixed with Mfg sector worsening in contraction territory (48.1, -0.6p) while services was flat but still in expansion (51.7, +0.1p)	• Retail sales (Oct) • Labour market data (jobs/applicant ratio; unemployment rate)
	• Loan Prime Rate (Nov): unchanged from Oct at 3.45% (1Y) and 4.2% (5Y)	• Mon (27 Nov): Industrial profit (Oct) • Thu (30 Nov): NBS PMI Mfg & composite (Nov) • Fri (1 Dec): Caixin PMI Mfg (Nov)
	• CB: Indonesia (6.0%) & South Africa (8.25%) stood on hold as expected. Turkey hiked +500bps to 40% • Annual inflation in Malaysia remained steady at 1.9% in October • Q3 GDP (%yoy) lost steam in Thailand (1.5%) while it recovered in Chile (0.6%) after three consecutive negative prints • Oct Industrial production (%yoy) contracted in Taiwan (-2.3%) & accelerated in Poland (1.6%)	• CB: Korea (3.5%) & Thailand (2.5%) are expected to stay on hold • PMI figures across EM countries • Q3 GDP data in India, Poland, Taiwan & Turkey • Industrial production (Oct): Brazil, Chile, Korea & Russia • Nov inflation in Indonesia, Peru & Poland • Oct retail sales in Korea & Russia

Upcoming events		
	US:	Mon: New home sales (Oct); Tue: Case-Shiller HPI (Sep), FHFA HPI (Sep), Conference board consumer confidence (Nov); Wed: GDP second estimate (Q3), Goods trade balance (Oct), Federal Reserve issues the Beige Book; Thu: PCE (Oct), Core PCE (Oct), Weekly jobless claims (24 Nov), Chicago PMI (Nov), Pending home sales (Oct); Fri: ISM Manf index (Nov)
	Euro Area:	Mon: ECB's Lagarde speaks in the European Parliament; Tue: EA M3 money supply (Oct), Fr Insee consumer confidence (Nov); Wed: EA Business confidence (Nov), Ge CPI (Nov), Ge&Sp HICP (Nov), It ISTAT consumer confidence (Nov); Thu: EA,Fr,It HICP (Nov), EA Unemp (Oct), Ge Unemp (Nov), Fr consumer spending (Oct), Fr GDP (Q3), Fr&It HICP (Nov); Fri: EA,Ge,Fr,It,Sp Manf PMI (Nov), Fr S&P review of France's credit rating, It GDP (Q3)
	UK:	Mon: CBI Distributive Trades survey (Nov); Wed: BRC Shop Price index (Nov), Mortgage approvals (Oct), Net mortgage approvals (Oct), Consumer credit (Oct); Fri: Fitch credit rating review, Manf PMI (Nov), Nationwide HPI (Nov)
	Japan:	Wed: Industrial production (Oct); Thu: Unemployment (Oct)
	China:	Mon: Industrial profits (Oct); Thu: Manf & non-manf PMI (Nov); Fri: Caixin manf PMI (Nov)

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