Investment Managers

200 – 23 October 2023

Investment Institute Macroeconomics

Snake Oil

- Powell's cautious words did not tame the bond market
- These days, high oil prices come with a strong dollar. That's a double whammy for European inflation
- We expect a quiet ECB Governing Council

Despite Jay Powell's cautious words last week, US long-term yields were at the end of last week still close to 5%. Even if the Fed Chairman's words triggered a downward revision of market pricing for Fed Funds for the remainder of this year, the long end of the curve seems to be increasingly detached from the expected short-term trajectory for monetary policy. The market may have taken on board the notion that the US neutral rate is now higher. This would reduce the capacity of the Fed to influence long-term yields.

The resilience of the US economy now extends to how it reacts to international energy shocks. Of course, higher oil prices affect US consumers, but since the US has turned into a net exporter of fossil fuel, contrary to the Euro area this does not result in a deterioration in the terms of trade. This has contributed to the reversal of the correlation between oil prices and the dollar exchange rate. It used to be negative – rising oil prices coincided with a weaker dollar. It is now positive: the US dollar thrives despite elevated oil prices. This adds to the constraints weighing on Europe: a stronger dollar adds to the inflationary pressure triggered by energy costs.

The risk of another push in oil prices would affect the Euro area at a moment when its energy-intensive sectors have not yet recovered, their output still below the level seen before the pandemic, unlike in the US. This highlights the need to provide consumers with more visibility on energy costs. The deal on the reform of the EU electricity market last week brings some progress on this front.

We do not expect much from the ECB Governing Council meeting this week. A pause had been clearly telegraphed after the 25bps hike in September and given heightened uncertainty the ECB is unlikely to want to "rock the boat", including on balance sheet issues, even if we don't exclude a small move on mandatory reserves.

Powell not fanning the flames was not enough for the bond market

Jay Powell sounded very cautious at the New York Economic Club last week, calling as is now customary for him for "humility" in how policymakers proceed in the current uncertain environment. There was enough said on the magnitude of the accumulated monetary tightening and on the need to monitor data holistically to confirm that the Federal Reserve (Fed) is very unlikely to move again in November. The market extended its understanding of Powell's message to also reduce its pricing for a December hike. But Powell was still clear on a very simple fact: there is not enough evidence that the tightening is producing the expected dampening impact on the economy which is still "*doing just fine*" to quote him directly. So, the tightening bias stays there, even as a mere option: *"additional evidence of persistently above-trend growth, or that tightness in the labour market is no longer easing, could put further progress on inflation at risk and could warrant further tightening of monetary policy"*.

A very interesting line of argumentation in Powell's speech was his point on **some divorce between long-term interest rates and the market pricing of the Fed's future path**. We had another example of this at the end of last week actually. 10-year yields rose although the market "depriced" the expected Fed-funds rates. Powell echoed some his colleagues' earlier points that the market-driven tightening could "*in principle*" (the qualifier matters) reduce the need for more action by the Fed, but fundamentally **this could simply reflect a belief in the idea that the neutral rate has moved up** in the United States (US). There is a long list of potential explanations for that. One – which is probably gaining traction now given the parliamentary standstill in Washington DC which does not bode well for fundamental action on public finances – is that unchecked fiscal deficits will absorb a growing share of savings. We were surprised that the "median Federal Open Market Committee (FOMC) member" in September did not revise their forecast for the level of Fed Funds in the long run, but Powell had made it clear then that there could be a difference between what is in the dot plot and where the Fed thinks the neutral rate is.

If this "higher neutral rate" narrative holds, **there could be lasting limits to how the Fed can influence the long end of the curve:** soothing words from FOMC members on the next few policy moves would not be enough to move the dial. The neutral rate is not observable, and we would expect the current shift towards a higher estimate to be stopped in its track as soon as evidence of a proper economic slowdown emerges, but for now things are "just too fine" for the bond market to change tack. Geopolitical uncertainty may be rising, but US treasuries do not benefit from any rush to "safe haven" assets.

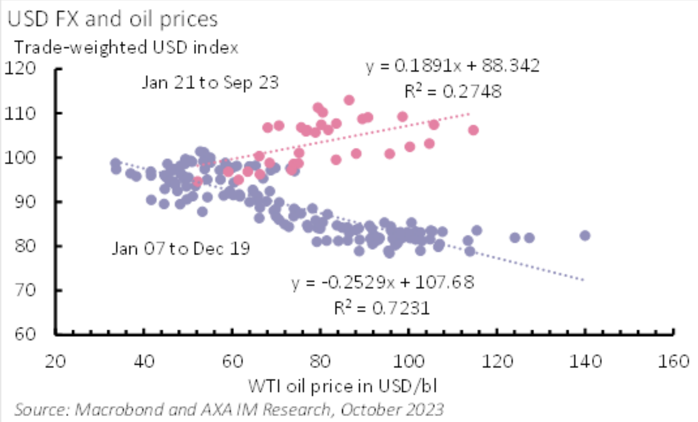
Oil bites from more than one channel

The crisis in the Middle East drives us to revisit the transatlantic asymmetries around an oil shock. Higher oil prices – as long as they are allowed to pass through by the fiscal authorities - trigger a deterioration in consumers' purchasing power everywhere. Yet, for those who do not have to import oil, this amounts to an *internal* income transfer, while for those who are pure consumers, this results in a deterioration in the terms of trade: import prices rise more than export prices, which in a nutshell is equivalent to a country losing its purchasing power over the rest of the world. Europe typically finds itself in this position, while the US, now a net exporter of oil (and gas) has escaped it.

There used to be a mitigant for the consumer countries: historically, the US dollar exchange rate used to depreciate when oil prices were rising. This could be ascribed to two, non-exclusive chains of causality. When the dollar happens to be weak, oil producers – paid in dollars – must deal with a decline in their own purchasing power over the rest of the world (they sell in dollars but tend to buy in euros). This incentivises them to raise the price of oil in dollars to restore their position. Alternatively, when oil prices are high, the US current account deficit used to deteriorate further, fuelling a depreciation in the US currency. Of course, these two channels could reinforce each other. Ultimately, thanks to the relief from a weak dollar, third countries, including the Euro area, would benefit from a smaller subtraction from their national income expressed in local currency to pay for oil and could offset some of this cost with competitiveness gains.

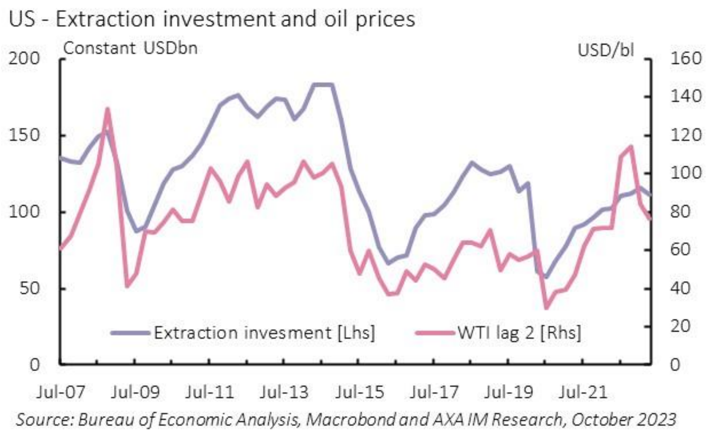
[An intriguing paper by the Bank of International Settlements](#) established that the correlation has inverted: these days, high oil prices can go hand in hand with a strong dollar (see Exhibit 1). Two potential explanations stand out. One, of course, is that strong oil prices no longer deteriorate the US current account (the correlation reversal coincided with the emergence of unconventional oil in the US). Second, it may well be that Organization of the Petroleum Exporting Countries (OPEC) countries are less inclined to let the price of oil remain high even when their purchasing power over the rest of the world is bolstered by a strong dollar, because they are trying to extract as much rent while they can.

Exhibit 1 – The biting snake: correlation reversal



Source: Macrobond and AXA IM Research, October 2023

Exhibit 2 – US shale respond to oil prices in 6 months



Source: Bureau of Economic Analysis, Macrobond and AXA IM Research, October 2023

This is not a straightforward calculation for oil producers. Indeed, raising oil prices too high can ultimately reduce OPEC's control of the market, by lifting production capacities outside the cartel (e.g., in the US) or incentivising consumer countries to accelerate the reduction of their reliance on oil – in which they are already engaged given their net zero commitments. US oil production capacity is very quickly responsive to the price signals: the best fit we obtain for the relationship between West Texas Intermediate (WTI) prices and investment in extraction activities (nowadays dominated by shale) is two quarters, and despite the steep unwinding of shale projects in 2014-2015 when oil prices plummeted– which left quite a few financial backers bruised – there was no noticeable change of regime when extraction activity re-accelerated as oil prices firmed again (see Exhibit 2).

Irrespective of how geopolitical conditions evolve in the Middle East, **we can see three reasons behind Saudi Arabia's current "bet" that it should still constrain oil supply and leave elevated prices for long**. First, the higher level of interest rates may this time dampen the responsiveness of shale investment (shale projects tend to be highly leveraged). Second, there may be a calculation in Riyadh that the oil consumers can hardly go much faster on their decarbonation efforts given the technical and financial constraints. Third, and that may be the dominant factor, Mohammed Bin Salman may need to front-load oil income to fund his transformative plans – e.g., the NEOM project, which was initially scheduled to be terminated by 2025 at a total cost assessed at USD500bn, equivalent to one and half time the country's total oil income of last year – while continuing to maintain generous redistribution to the Saudi population at a delicate moment politically.

Assuming the current configuration persists, and the Euro area is forced to deal for longer with a strong dollar and an elevated oil price, what would be the consequences for its macroeconomic trajectory? The impact on GDP goes in opposite direction: **a higher oil price depresses growth, while a stronger dollar boosts growth (by lifting competitiveness).** We used the European Central Bank (ECB)'s "alternative scenarios" vintages to help us quantify the net effect. Indeed, the ECB uses several models to submit its forecasts' baseline to various sources of stress, quite often a different path for the exchange rate and oil prices (although not necessarily for the same batch). We derived elasticities from these exercises. The slope of the relationship is much steeper for the exchange rate (see Exhibit 3). It takes a 30% rise in oil prices to move the baseline for GDP down by 0.1%. The same quantum of dollar appreciation lifts GDP by 1.2%. In other words, **a small depreciation of the euro relative to the dollar by a few percentage points would**

suffice to offset a shift in oil prices above USD 100/bl. To put precise numbers on this – but one should take these model-based elasticities with a large pinch of salt – the adverse impact on growth of a barrel at 100 dollars (22.6% above the ECB assumption for 2024 in the September batch) could be wiped out by the dollar rising by only 2%....which it has already done, and more (the ECB's assumption for the euro/dollar exchange rate for 2024 stood at 1.09).

Exhibit 3 – Calculating the effect for GDP…

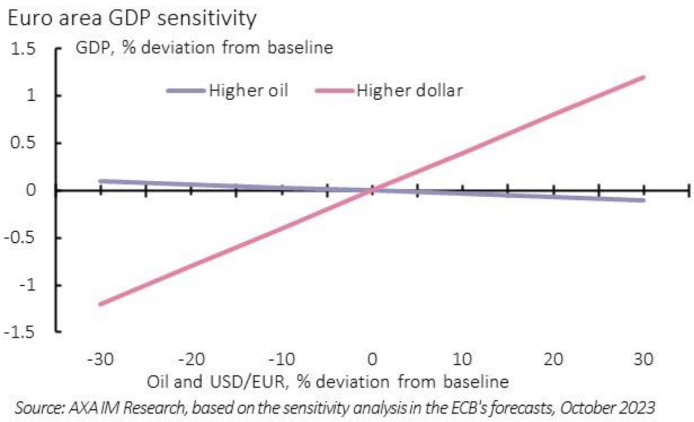
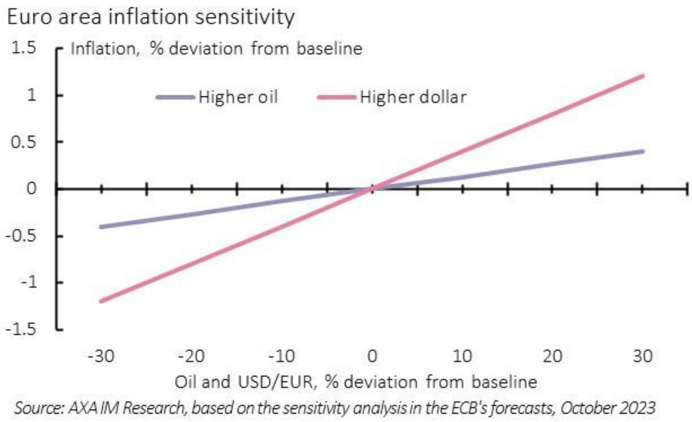


Exhibit 4 – …and inflation



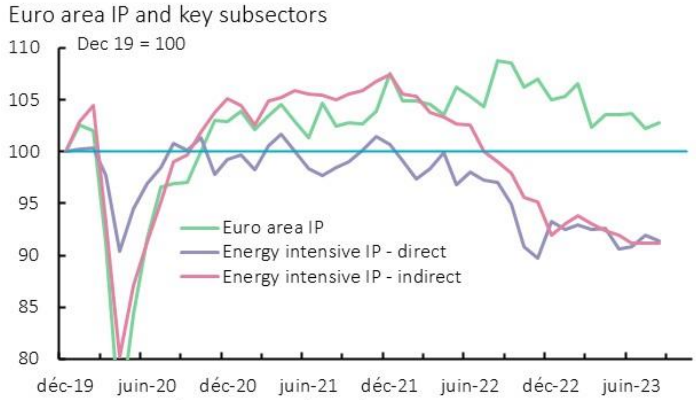
Conversely, **the impact on inflation goes in the same direction.** There again, the slope is steeper for the exchange rate (see Exhibit 4). A 10% rise in the dollar has the same boosting effect on Euro area inflation as a 30% increase in oil prices. **Using again the ECB's baseline for reference, with a barrel at 100 dollars and the exchange rate kept at its current level of 1.06, inflation would drift by more than 0.5 percentage points in 2024. If the exchange rate were to move to parity, the drift would reach nearly 1 percentage point.**

This may matter for monetary policy in 2024. As much as a central bank should normally be tolerant – at least initially – to additional price pressure from oil – imported inflation is more pervasive since it mechanically hits core prices via manufactured goods. In principle, the ECB should determine its path independently of the Fed, yet **the pressure from the exchange rate could make the Governing Council hesitate to cut rates ahead of its US counterpart, irrespective of domestic conditions**. External constraints weighing on the ECB are significant, and to some extent contradictory: the dominance of the US bond market is materialising once again in contagion to European long-term rates, which could result in too-tight financial conditions in the Euro area, at least for some of its member states, while the weakness of the exchange rate adds to its inflation concerns.

Europe's energy-intensive industry still struggling

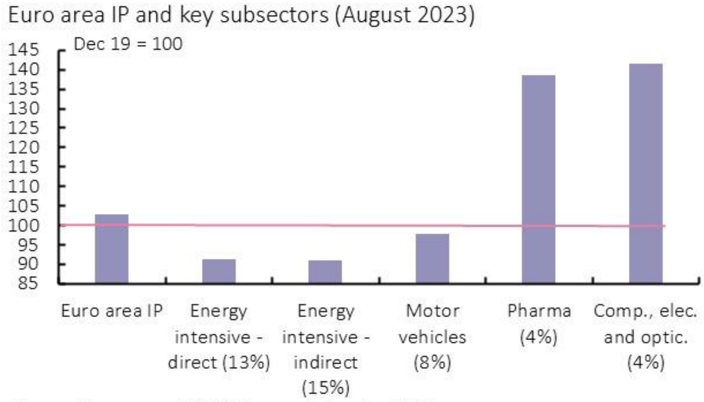
Still, **gas rather than oil has been a key ingredient in Europe's underperformance on growth, and fortunately, at least for now, the correlation between the prices of these two fossil fuels has been limited**. As of last Friday, Brent stood at 7 dollars above its early January 2023 level, while spot gas prices (using the TTF reference) were still down 31 euros. The ramifications of an oil shock for Europe are now less pervasive as a gas shock, given the impact the latter has on electricity prices and industrial costs in general. Yet, despite the decline in gas prices, European energy-intensive sectors continue to struggle, without any tangible sign of recovery (see Exhibit 5). Their output remains significantly below the pre-Covid level. It cannot be all attributed to the general shift in demand away from manufactured goods, back to services, triggered by the post-pandemic reopening. Indeed, some manufacturing sectors are doing well, with electronic components for instance up 40% relative to December 2019 (see Exhibit 6).

Exhibit 5 – Energy-intensive sectors still struggle



Source: Eurostat and AXA IM Research, October 2023

Exhibit 6 – Production barbells



Source: Eurostat and AXA IM Research, October 2023

Moreover, this seems to be specific to Europe. Focusing on the chemical industry, which is by far the most energy-intensive sector (except of course for the direct energy suppliers), output in Germany in August 2023 was still 8% below the December 2019 level, while in the US it was 3.2% *above*. We cannot exclude the possibility that this absence of recovery in Europe may reflect a loss of market share at the peak of the energy shock which is proving hard to recoup today.

Providing visibility on energy costs to producers should thus be a prime objective of European policymakers. **We have already alluded several times in Macrocast to the reform of the European electricity market, highlighting the divergence of Interests between Paris and Berlin on this topic. Fortunately, an agreement has been eked out last week**. To (over)simplify the issue, the main problem was the extent to which contracts for difference (CFD) could be used to secure future electricity capacity by prolonging the existence of power plants rather than creating new ones, when state aid is involved. In a CFD, electricity producers are guaranteed a floor price, protecting them from some of the effect of market price gyrations over the lifetime of their investment, while a ceiling price forces them to return to the state excess profits when market prices rise markedly above their own production costs, which then can be channelled back to consumers and/or further investment. Germany – and other countries – were concerned that this would allow France to "lock in" the benefit of its past investment in nuclear power. It seems the compromise was built last week around the idea that such CFDs would not be available *indefinitely*, but this looks like a limited concession from the French side. Of course, a lot will depend on the implementation of such system – once the negotiations with the European Parliament are through – and where exactly the strike price for the CFDs is going to be fixed, under surveillance of the European Commission, relative to the producer prices (taking into consideration the investment needed to prolong the existing capacity).

Still, at least **this "new electricity model" should provide a more predictable protection for consumers against wild spikes in energy prices**. It will not put public finances off the hook – state coffers will continue to shoulder the cost – but governments won't have to invent emergency intervention mechanisms as they go along. So, this is progress…yet it does not address Europe's root problem: the persistence, at least across most of the Euro area member states, of a "price-taker" position when it comes to energy, a structural difference with the US.

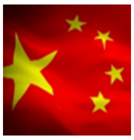
ECB to stand pat on rates – monitor any noise on the balance sheet

It's probably a telling sign that we start looking into this week's ECB meeting only in the last section of this issue of Macrocast. Given the heightened uncertainty, the Governing Council must be quite happy a pause was telegraphed in no ambiguous terms last time after a 25bps hike which felt as possibly the last one in this cycle. It makes sense to have the least eventful council meeting as possible.

Indeed, the key element at the September meeting, was this notion in the prepared statement that the Governing Council "*considered that ECB interest rates have reached levels that maintained for a sufficiently long duration, will make a substantial contribution to the timely return of inflation to the target*." **What's new since then? The Middle East crisis of course, but it's going to be far too early for the ECB to have any strong sense of the impact it will have on its overall trajectory**. Of course, it is likely that Christine Lagarde will have to mention this as an additional risk, but it was already there in September. In the Q&A last time she said that the *"price of oil is obviously something that we need to be attentive to*", combining it with other sources of external uncertainty such as the macro situation in China. At the same time, **the September print for inflation came out better than expected**, so this should bring a measure of comfort to the ECB. In a nutshell, we think that any significant change in the ECB's rhetoric will have to wait until the December meeting, with will come with a new set of forecasts covering 2026 for the first time, and even then, we are unconvinced the Governing Council will have a much clearer picture of the situation. In a recent interview, ECB chief Economist Philip Lane highlighted the timing of next spring when 2024 wage settlement data will be available.

True, **focus has recently been less on policy rates and more on balance sheet instruments**. The recent episode of tension on the Italian bond market will trigger a salvo of questions on the ECB's future moves on Pandemic Emergency Purchase Programme (PEPP) reinvestments as well as its Transmission Protection Instrument (TPI) during the press conference. We think the ECB President is likely to keep to her previous script – no discussion during the meeting, and unchanged forward guidance. We continue to think that the decision to end PEPP reinvestment is likely to come in December at the earliest. We see little reason for the ECB to touch its first line of defence against financial fragmentation at a time of budget discussions underpinned by limited fiscal consolidation and optimistic growth forecasts, while there is still no prospect for an agreement on future euro area fiscal rules. There is no point in fanning the flames, and we think the Governing Council will heed the Hippocrates oath: "first do no harm".

We think the same line of reasoning will apply on mandatory reserve requirements. While we cannot rule out a limited adjustment though (e.g., an increase from 1% to 2%), which would have only a marginal impact on the ECB's profit-and-loss account (and banks') – the July drop to zero of the remuneration of mandatory reserves came without much warning – any more significant moves (e.g., the 5 to 10% coefficient advocated by Holtzmann) would have so potentially dangerous distributional consequences across the Euro area (with some adverse effects on the profitability and regulatory positions of banks in the periphery) that we think the Council will avoid "rocking the boat" in the present circumstances. In any case the ECB has planned for a comprehensive reserve management review around the end of next Spring. It makes sense to wait.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Retail sales (Sep) rose by 0.7%, with July revised to 0.8%, no signs of slowing in real terms • Fed Chair Powell before FOMC purdah, suggested Nov pause, high yields could deter further hike • Empire and Philly Fed surveys (Oct), subdued outlook but both above H1 lows • Existing home sales (Sep) 3.96m (ann) a 2010 low	• Personal spending (Sep) upside risks to spending following retail sales and focus on saving rate • PCE inflation (Sep) core disinflation expected to continue in line with CPI measure • Durable goods orders (Sep) expect ongoing strength • Michigan inflation expect's (Oct, f) watch revisions • PMIs (Oct, p) services watched for further declines
	• Final headline HICP (Sep) was confirmed at 4.3%yoy (-1p vs Aug), core HICP 4.5% (-0.8p). We believe core deceleration path is well engaged until year end, at least • French business climate (Oct) slightly declined at 98 (-1p) but ZEW Econ sentiment (Oct) improved by 10.3 to -1.1	• EMU flash consumer conf (Oct) should be negatively impacted by ongoing conflict in Middle East, rising energy prices and resurgence of security issues • Flash PMIs (Oct) in EMU, Ge and Fr should remain depressed. Ifo (Oct) likely to confirm PMI signal • ECB Gov Council no change on rates but may start debating about the future of PEPP reinvestments
	• CPI inflation (Sep) remained at 6.7% as falls in food and furniture offset by rise in fuel and hotels • Wages ex bonus (Aug) held at 7.8, but 3m ann rate fell to 5.3%. LFS publication delayed by 1 week • Retail sales (Sep) drops 0.9%mom • GfK cons conf (Oct) falls sharply to -30 from -21	• Delayed LFS data (Aug); employment expected to fall back sharply by 198k • Flash PMI (Oct) • CBI industrial trends survey (Q4)
	• Exports (Sep) continued to rebound up 5.2%mom • Core CPI (ex-fresh food) inflation (Sep) fell to 2.8% from 3.1%. BoJ core (ex-fresh food and energy) remains elevated at 4.2% (4.3% in Aug) • New report that Rengo is targeting wage hikes of at least 5% in upcoming spring wage negotiations	• Flash PMIs (Oct) • Tokyo CPI (Oct) expected to ease marginally • Chain store sales (Sep)
	• GDP (Q3): 4.9%yoy (Q2: 6.3%), 1.3%qoq (Q2: 0.5%) • Industrial production (Sep): 4.5%yoy (Aug: 4.5%) • Retail sales (Sep): 5.5%yoy (Aug: 4.6%) • Fixed asset inv't (Sep): 3.1%yoy ytd (Aug: 3.2%) • Urban unemp't rate (Sep): 5.0%yoy (Aug: 5.2%) • Housing prices (Sep): -0.1%yoy, (Aug: -0.1%) • Loan prime rate (Sep): unch (1Y: 3.45%; 5Y: 4.2%)	• Fri (27 Oct): Industrial profit (Sep)
	• CB: Indonesia unexpectedly hiked +25bps to 6.0% while South Korea stood on hold at 3.5% • Sep inflation (yoy) rose in South Africa (5.4%) & fell in Malaysia (1.9%) • The US lifted sanctions on Venezuela for six months, allowing energy sector transactions and removing the ban on secondary trading of Venezuelan debt	• CB: Hungary is expected to cut -75bps to 12.5% & Chile -50bps to 9.0%. Turkey to hike +250bps to 32.5% & Russia to stay on hold at 13% • Reaction to elections in Argentina (Sunday) • Industrial production (Sep): Russia, Singapore & Taiwan • Q3 GDP data in Korea

Upcoming events		
	US:	Tue: Manf & services PMI (Oct); Wed: New home sales (Sep); Thu: GDP (Q3), Goods trade balance (Sep), Wholesale inventories (Sep), Weekly jobless claims (21 Oct), Pending home sales (Sep); Fri: PCE Price Index (Sep), Personal income & spending (Sep), Michigan consumer sentiment & inflation expectations (Oct)
	Euro Area:	Mon: EA Consumer confidence (Oct); Tue: EA Composite PMI, EA, Ge, Fr Manf & services PMI; Wed: EA M3 money supply (Sep), Ge IFO business climate index (Oct); Thu: ECB announcement, Sp Unemp (Q3); Fri: Fr, It Consumer confidence (Oct), It Business confidence (Oct), Sp GDP (Q3), Fr Fitch review France's credit rating, It DBRS review Italy's credit rating
	UK:	Tue: Unemp (Aug), Manf, services & composite PMI (Oct), CBI Industrial Trends survey (Q4); Thu: CBI Distributive trades survey (Oct), Nationwide HPI (Oct)
	Japan:	Tue: Manf PMI (Oct); Wed: Leading index (Aug)
	China:	Mon: Shanghai Stock Exchange closed, Fri: Industrial profits (Sep)

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