Market Convictions – May 2023

Natixis Investment Managers | Solutions

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Outline

1 | Lower headline inflation, but bear in mind underlying pressures

2 | Rate hikes and QT to carry on

1 Inflation will remain way above central banks' target in 2023

Central Scenario: Headline Inflation Forecasts

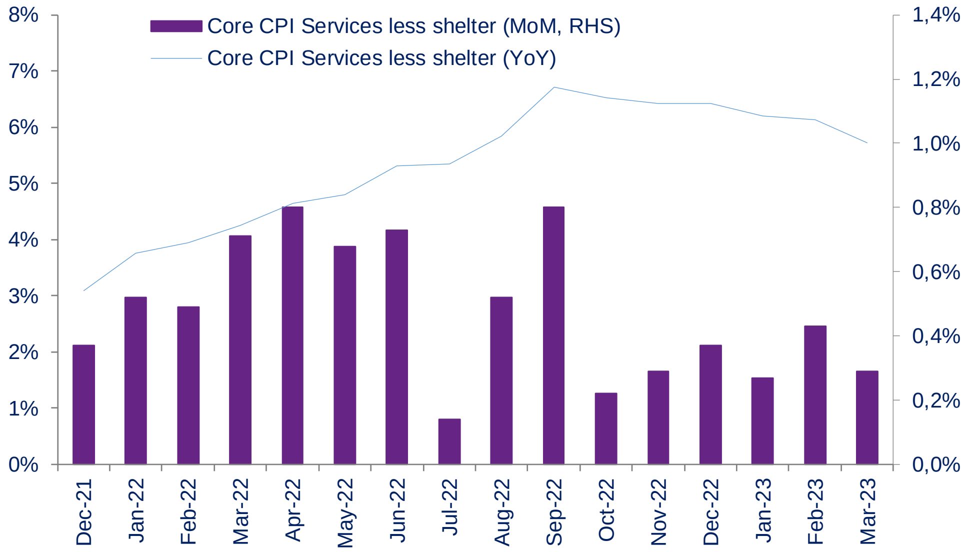
	2022*	2023*	2023 Consensus
World	**6.5%**	**4.2%**	**5.5%**
Advaned economies	**7.9%**	**4.7%**	**4.5%**
United States	8.1%	4.4%	4.1%
Euro Zone	8.7%	5.9%	5.6%
United Kingdom	9.1%	6.9%	6.5%
Japan	2.3%	0.6%	2.2%
Emerging Economies	**5.3%**	**3.8%**	**6.3%**

Sources: NIM Solutions & Bloomberg Yearly Average Consensus

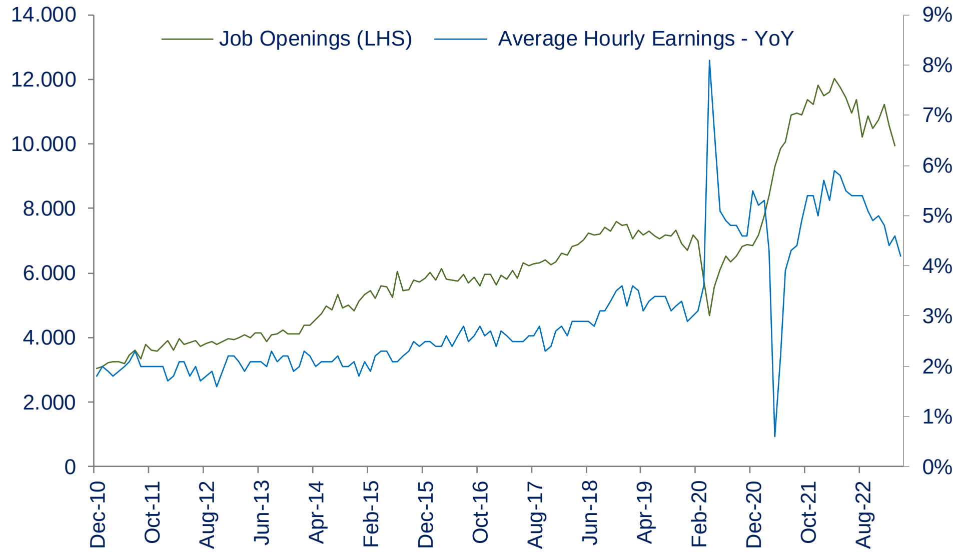
- **US**: we expect average headline inflation to decline significantly in 2023, from 8.1% in 2022 to 4.4% this year. However, our estimate remains higher than that of the consensus, which expects it to average 4.1% in 2023.
- **Eurozone:** we expect average headline inflation to decline significantly in 2023, from 8.7% in 2022 to 5.9% this year. However, our estimate remains higher than that of the consensus, which expects it to average 5.6% in 2023.
- **UK**: we expect average headline inflation to decline in 2023, from 9.1% in 2022 to 6.9% this year. However, our estimate remains higher than that of the consensus, which expects it to average 6.5% in 2023.
- **Japan**: we expect average headline inflation to decline significantly in 2023, from 2.3% in 2022 to 0.6% this year. Our estimate is lower than that of the consensus, which expects it to average 2.2% in 2023.
- **Emerging Economies:** we expect average headline inflation to decline in 2023, from 5,3% in 2022 to 3.8% this year. Our estimate is lower than that of the consensus, which expects it to average 6.3% in 2023.

1 Inflation is softening in the US, but not yet cause for a Fed pause

US core consumer price index – Services sector less housing



US JOLT Survey and US Average Hourly Earnings



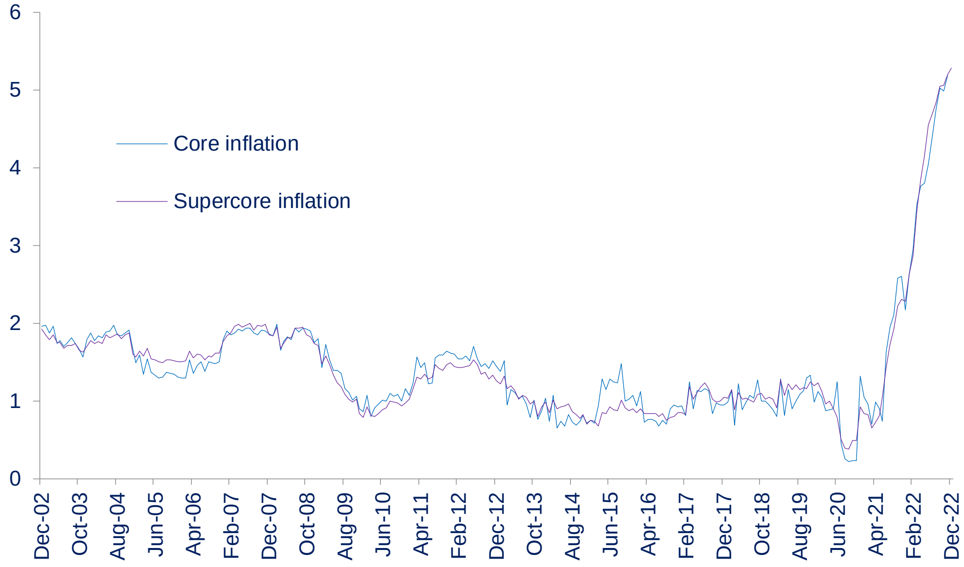
- US headline CPI came in line with expectations in March, easing to 5% YoY vs 6.0% the month before. Moreover, as we had expected last year, core inflation is stabilizing above the headline one, reaching 5.6% YoY, up from 5.5% the month before, with a 0.4% monthly increase – a still far too high pace for the Fed to pause. On the positive side though, Fed Chair Powell preferred inflation gauge, that is services core CPI excluding shelter, eased in March (see chart above) to 5.7% YoY, its lowest level since July 2022.
- The central bank needs to have greater reassurance that underlying inflationary pressures are on a solid downward trend, which is not yet the case. In fact, in his last statement J. Powell highlighted that the slow decline in underlying inflation is becoming a greater source of concern.

- Businesses, especially those in the services sector, keep reporting that their single most troublesome factor is wages growth, which is a byproduct of the shortages in the labor market still present. On this front, recent data have pointed in the right direction. US average hourly earnings increased 4.2% YoY in March, the slowest growth rate since June 2021. And US job openings declined 632,000 from the month before and currently stand at 9.9 million, the lowest level since May 2021 (see chart above),
- Overall, we expect this disinflation trend to continue as weakening demand eases upstream price pressures and labor hoarding. But we cannot rule out that wages and inflation growth could stabilize at higher levels compare to what we have seen over the last 20 years; the structural trend of inflation is now one of the key parameters to look monitor.

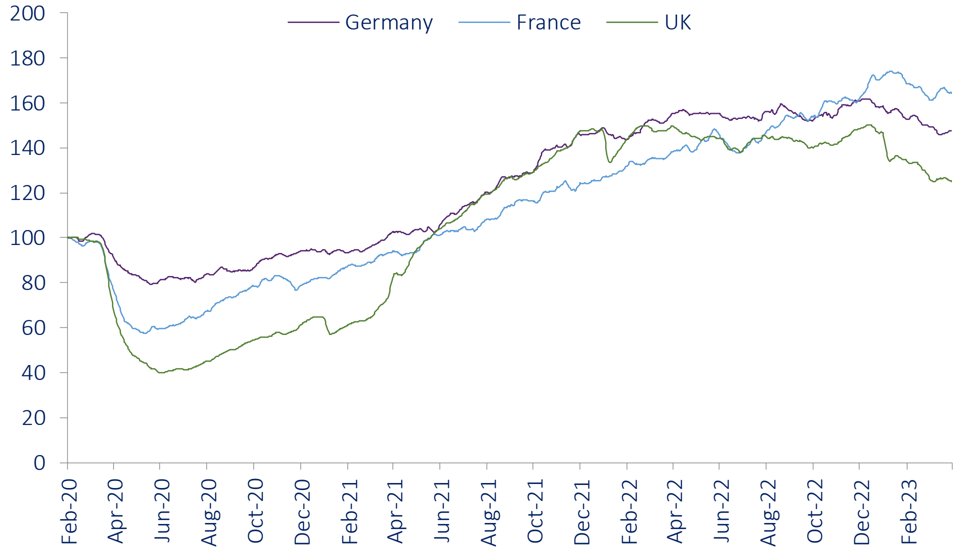
 SOURCES: REFINITIV, NIM SOLUTIONS

1 Underlying inflation dynamics in the Eurozone remain strong

Eurozone core inflation and ECB alternative measure -YoY



Percentage change in job postings in Europe – Indeed



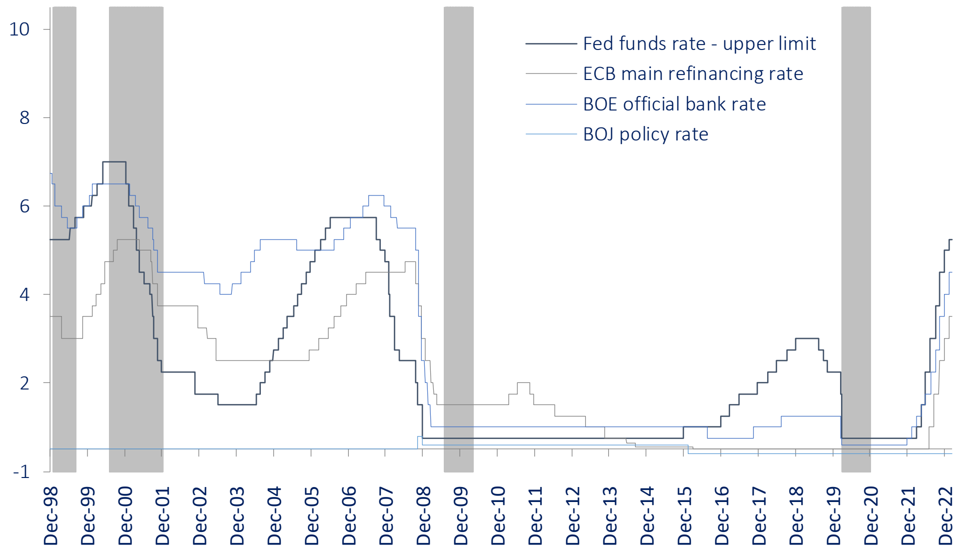
- Eurozone's headline inflation fell to 6.9% YoY in March and down from 8.5% the month before. However, core inflation reached 5.7%, a new all-time high. The same was the case with ECB's supercore inflation statistic, which captures items sensitive to the business cycle and with low exposure to imports, reflecting that underlying inflation dynamics remain strong (see chart above).
- However, our perception is that this is primarily resulting from the pass-through effect of previous energy price increases and less so from a persistent tailwind from the reopening. Moreover, Eurozone's PPI suggests a significant moderation in upstream price pressures. The latest print came in at 13.3% YoY, its 8th consecutive monthly decline, and down from 43.6% last August. Say a word about the mark-up effect

- Having said that, wage growth is the key issue in determining the future path of core inflation. Collective bargaining during 2022 led to an aggregate wage rise of 4.7% for this year, and this is playing a strong role in core inflation: wage-sensitive items contributed only around 0.5 percentage points to core inflation before the pandemic, that contribution has more than doubled in recent months (Christine Lagarde's speech on March 22, 2023).
- Overall, while the increase seen in consumer prices and the tightness of the labor market are likely going to keep wage growth under upward pressure, we believe that the weakening of demand will slow underlying inflationary pressures as well as labor demand (see chart above). Nevertheless, Philipps and mark-up effects are being monitored by the ECB to determine the inflation origins and decision they have to make in consequence.

 SOURCES: REFINITIV, NIM SOLUTIONS

2 Most rate hikes have taken place, but not yet a done job

Key rates of the main central banks



Monetary Policy Forecasts - NIM Solutions

	Apr-23	May-23	Jun-23	Jul-23	Aug-23	Sep-23
Fed Funds Rate Range	**[4.75% - 5.00%]**	[5.0% - 5.25%]	[5.0% - 5.25%]	[5.0% - 5.25%]	[5.0% - 5.25%]	[5.0% - 5.25%]
ECB Main Refinancing Rate	**3.50%**	3.75%	4.00%	4.00%	4.00%	4.00%
ECB Deposit Rate	**3.00%**	3.25%	3.50%	3.50%	3.50%	3.50%
Bank of England	**4.25%**	4.50%	4.75%	4.75%	4.75%	4.75%
Bank of Japan	**-0.10%**	-0.10%	0.00%	0.00%	0.00%	0.00%

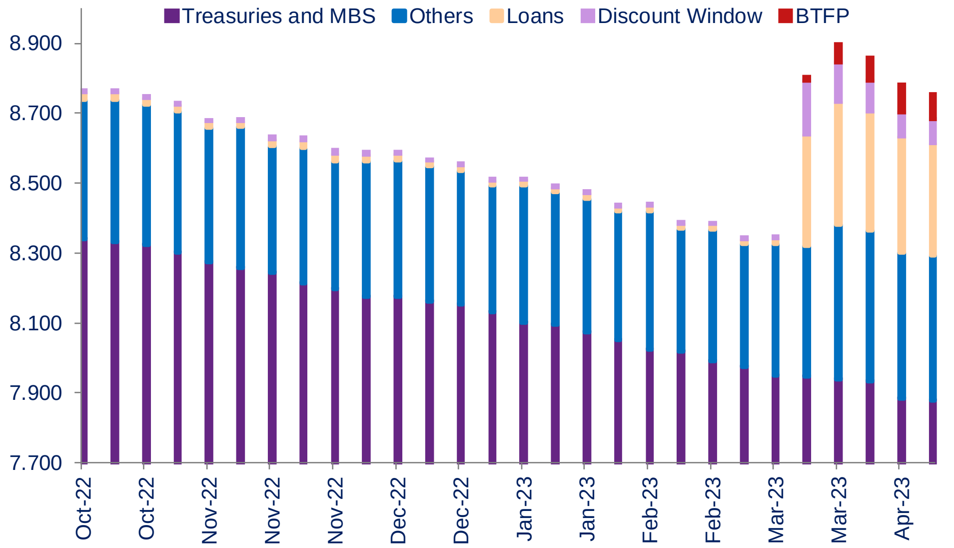
- At their march policy meetings, the FED raised its policy rate by 25bp to 4.75%-5.0%, the ECB raised its policy rates by 50bp to 3.0%-3.5%, the BOE raised its policy rate by 25bp to 4.25%. Throughout this tightening cycle, the FED has increased its rated by a cumulative 475bp, the ECB by 350bp, and the BOE by 415bp.
- The rate hikes implemented in March were put in place without causing any additional stress to the financial system. That said, it is unclear to what extent the stress in the banking system will weigh on economic activity.

- The available data for Q1.23 has continued to surprise, with stronger growth and job creation than expected. The bottom line is that labor markets remain tight and core inflation prints have either moved sideways or increased since the start of the year.
- Therefore, while central banks will carefully monitor financial conditions going forward, they need to tighten their policy further and leave it tight for a substantial period of time (see the next two slides for our specific views on central banks next steps).

 SOURCES: REFINITIV, NIM SOLUTIONS

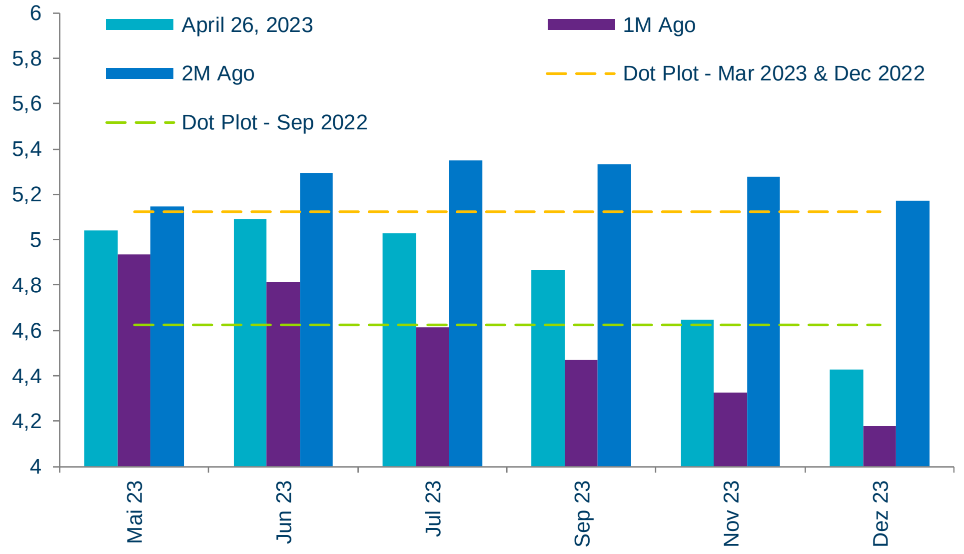
2 After the banking hiccup, Fed's balance sheet is decreasing again Rate cut expectations to come at odds with the Fed

Fed total balance sheet - USD Billions



- Following the tremor in the banking sector and the emergency funding that was put together afterwards, the Fed's balance sheet has now been declining for three straight weeks. The usage of the Bank Term Funding Program (BTFP), which is the newly created emergency lending facility to ensure liquidity to help banks meet deposit outflows, fell for the first time since its creation, down USD 7.1 billion to USD 71.8 billion. Similarly, 58% of the usage of the Fed's discount window has now been unwound.
- Overall, we expect net USD liquidity to decline in the short-term due to the easing of the Fed's emergency lending and the continuation of the regular QT program.

Market expectations for Fed Funds effective rate in 2023 & FOMC Dot Plots

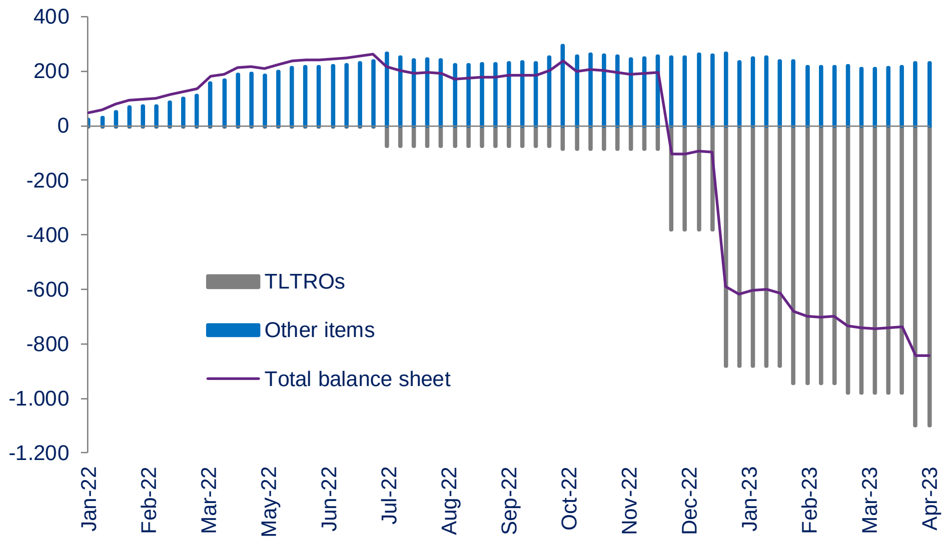


- Moreover, market expectations for the future path of the Fed Funds rate have been remarkably volatile this year. This dynamic is a clear reflection of the highly volatile macroeconomic cycle we are witnessing; one that continues to be affected by the series of exogeneous shocks that started with the pandemic back in early 2020.
- Policy rate expectations have gone from pricing a peak north of 5.25% (at least +25bp from where we are now) and no cuts in 2023 before the banking turmoil, to price 75bp of rate cuts in the middle of the turmoil, starting as soon as in June, to again price in +25bp in May. With economic data continuing to come in stronger than expected, the bar for the Fed to pause rate increases, and more so to cut rates, is increasingly higher.

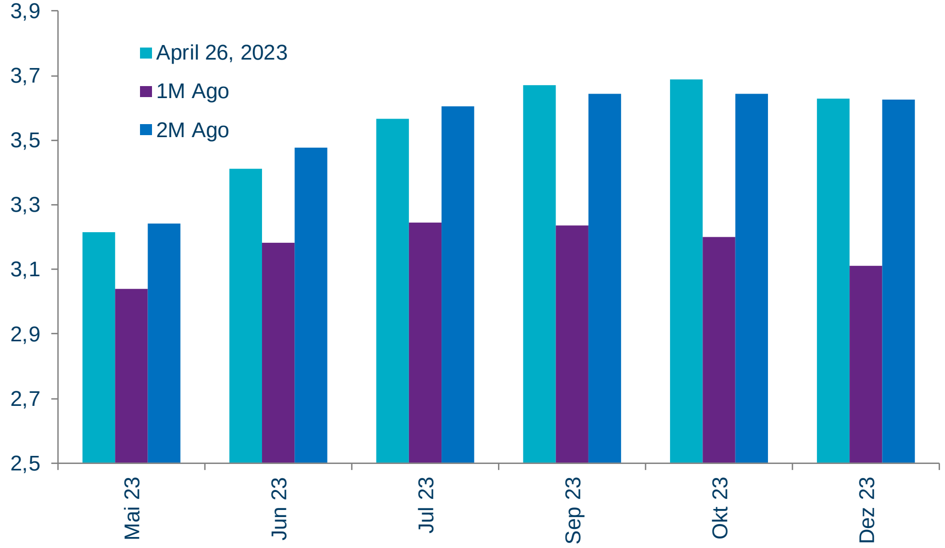
 SOURCES: REFINITIV, NIM SOLUTIONS

2 ECB quantitative tightening to proceed unchanged beyond Q2.23 Rate expectations in Europe are closer to ECBs intentions

Cumulative change in ECB balance sheet - EUR Billions



Market expectations for ECB deposit rate in 2023



- Even before ECB's QT program started at the end of March, the balance sheet size had already been reduced by about EUR 1.1 trillion since its peak in June 2022. This decline has been entirely led by the early repayments of TLTRO funding by commercial banks (see chart above). TLTROs are expected to be paid in full by the end of this year, meaning that even before accounting for the ECB's QT program, the ECB balance sheet is expected to fall by EUR 2.2 trillion by the end of 2023.

- On top of that, since the end of March the ECB has started to normalize its APP holdings: the central bank seeks to reduce bond re-investments by EUR 15 billion per month until the end of the Q2.23. If this pace were to continue throughout 2023, it would amount to about half of the EUR 350 billion of APP redemptions expected for this year.

- Moreover, market expectations for ECB's policy rates better reflect the central banks' intentions: higher for longer. After the stress in the banking sector, futures rates are not only back to where they were before, but they are now even slightly more hawkish. The ECB deposit rate is expected to increase 75bp more and reach 3.75% by September (implying a main refinancing rate at 4.0%).

- Overall, we expect the ECB to continue increasing rates for a few more policy meetings, however, we do not expect it to increase the pace of its QT program beyond Q2.23, especially following the recent banking tremor. It is in the ECB best interest to proceed at a more gradual pace, but underlying inflation pressures remain too strong and are the biggest concern for ECB policymakers.

 SOURCES: REFINITIV, NIM SOLUTIONS

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