Still no smoking gun

94 – 7 June 2021

Key points

- More signs of supply-side tension on the US labour market, but still no sense of a permanent shift.
- The European Central Bank (ECB) will need to choose its words carefully on Thursday. Optimism on the reopening needs to be tempered while the latest pandemic developments in the UK are being assessed.
- The G7 agreement on global corporate taxation is another blow to the already ailing "Washington consensus".

More signals of supply-side tension in the US have emerged with the release of the labor market data for May. We focus on the strong rebound in the relative pay of low-skilled workers in the hospitality sector which is taking place even though the number of jobs of this type is still more than 15% below the pre-pandemic level. This would suggest that employers are consenting to significant pay rises to lure employees back. There is no clearer indication than last month on which explanation – childcare issues or over-generous unemployment benefits – dominates, and we may never know since those hurdles are likely to fade broadly at the same time. The ongoing reopening of the US is extending to schools, while nearly half of the states have decided to terminate the federal top-up of unemployment benefits ahead of schedule, in general by July (it could have continued until November). In any case, since those factors are both transitory, as such they cannot sway the Fed in one direction or another.

The ECB has communicated profusely ahead of its Governing Council this Thursday, which should insure us against anything revolutionary. Still, they will have to choose their words wisely to qualify the pace at which PEPP is continuing. We continue to think they will abstain from any significant rhetorical shift this time, waiting to see how the reopening of the European economy is shaping up. The Governing Council is probably taking a hard look at the latest pandemic developments in the UK. The rebound in hospitalizations is still very tentative over there, but it is already a reminder of a very simple truth: with aggressive variants, the threshold for collective immunity rises. Although the UK is among the most advanced countries on vaccination, there is still a "reservoir" of more than 4 million people above the age of 50 who have not been fully protected. This still leaves open the possibility to see more pressure building on the healthcare system.

The G7 agreed over the weekend on the "two pillars" of the strategy laid out by the OECD on global corporate taxation. It will still take a lot of work before any decision is implemented. Still, at this stage we can already add this piece of news to our already long obituary of the "Washington consensus".

None the wiser (yet)

The release last week of the US payroll data for May came out as a minor relief after the disappointing April print, but we are far from a very brisk recovery pace. Indeed, with 559K more jobs on the month, the reading was a welcome improvement from April (278k) but below the market's expectation (675k) and still leaving a very significant loss relative to the pre-pandemic level (4.6% below the December 2019 print for the private sector).

Employment is catching up much more slowly than GDP. Since no monthly GDP is available in the US, we proxied it by rebasing the New York Fed's Weekly Economic Indicator (WEI) – which is expressed in a way to fit the year-on-year change in GDP. Using this measure, **in May 2021, economic activity was already be above its pre-pandemic level** (by 1.4%), with the gap relative to employment growing (see Exhibit 1). It is not a perfect method – some labour market indicators contribute to the WEI construct - but our result is consistent with the fact that in Q1 already, US GDP was less than 1% below its Q4 2019 level, and the Atlanta Fed "nowcasting" currently puts GDP growth in Q2 2021 at 2.5% quarter-on-quarter, which would bring its level to 1.5% above Q4 2019.

That employment lags GDP in times of recovery is not unusual – employers always initially respond to a rebound in demand by using their existing workforce more intensively. During the previous recession, by the time US GDP had recouped its losses in Q3 2010, private employment was still 5% below its initial level. Consensus expectations for job creation before the April 2021 payroll print were probably over-optimistic. **The surprise comes from the fact that labour market pressure is already very high in the US very early in the recovery,** judging by the hiring difficulties (we use the small business survey in Exhibit 2).

Exhibit 1 – A significant employment gap remains…

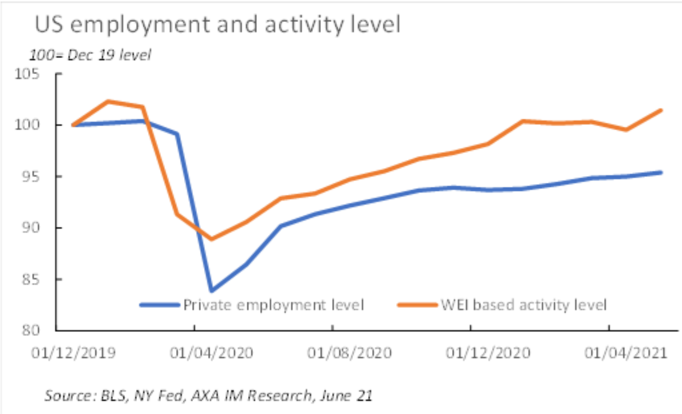


Exhibit 2 – …but hiring difficulties are mounting

A sector-specific focus may help shed some light on the dynamics at play here. As of May 2021, the leisure and hospitality sector, which normally accounts for c.13% of total private employment in the US, still contributed 40% to the overall job loss relative to December 2019.

Last month we looked at some compositional effects in this industry, noting that during the pandemic the destruction of low-skilled jobs had been massive relative to "supervisory jobs" (-16.5% for the former, -2% for the latter), which may have "artificially" lift average wages during this period. Yet, what is now striking is that hourly earnings for low-skilled workers in leisure and hospitality have accelerated markedly these last two months, so that their wage gap relative to the more skilled employees, which had widened in the first half of 2020, and then again during the second wave, has now i*mproved* relative to the pre-pandemic level (see Exhibit 3): the relative pay of low-skilled workers in May 2021 was 6% higher than in December 2019. **This would strongly suggest that the number of unskilled jobs being created at the moment in the hospitality sector is below what employers would want it to be optimally, which is forcing them to offer significant pay rises to lure employees back to work.**

We still need to fully understand what the cause of this supply-side "rationing" of jobs is, which is now being dealt with via wage increases. There is no "smoking gun" allowing us to choose between Yellen's favourite explanation - childcare difficulties impairing a return to work as many schools remained closed or partly closed in the US – and the Republican held view which indicts Biden's overly generous unemployment benefits. We may never know for sure. In both cases, these hurdles should fade, and possibly at the same time. Indeed, continued progress on the pandemic side should rapidly allow more schools to fully reopen, while **a rising number of states (24 since the beginning of May, all Republican-held) are getting ready to terminate the payments of the unemployment benefit "top ups"** before the end of the federal scheme in November (it will be effective in general between the end of June and the end of July). Some states are even mulling one-off bonuses to people taking back a job. This could actually provide us with an interesting natural experiment in the coming months: it will be quite telling if those states experiment a quicker "return to work" than in those where the federal top-up is maintained, of course controlling for employment composition and local demand conditions.

Exhibit 3 – While lots of low-skilled jobs are still lost, their relative pay is rising

In any case, this "payroll batch" is unlikely to sway the Fed in one direction or another. The US central bank has a dual mandate: price stability and full employment. With private sector jobs still 4.6% below their pre-pandemic level, it is difficult to argue full-employment has been achieved, unless one considers that those supply-side issues – reflected in pay and hiring difficulties – constitute an upward shift in structural unemployment. Since, at least for now, those supply issues can be related to temporary factors – and here it's irrelevant whether they are the product of policy decisions or sanitary conditions – **it would be very brave to conclude that the Non-Inflation Accelerating rate of Unemployment (NAIRU) has moved up for good**.

The Fed's message – including from its centrists – was changing subtly before the latest labour market indicators came out. "Talking about thinking of tapering", which used to be a hawks' preserve, is going mainstream at the FOMC. This issue remains however strictly disconnected from the timeline for Fed Funds normalization. Tapering is on its way, to start at the end of 2021 or early 2022 at the latest, but we don't think the Fed's message on its policy rates will change any time soon, unless inflationary pressure continues to build up once the transitory factors disappear, which is going to take at least until the end of this year.

ECB to choose words carefully

The ECB Governing Council is meeting this Thursday, but there has been enough communication from its members recently not to expect any earthquake. Yet, **the central bank will still have to think hard about its choice of words when it comes to characterizing its pace of purchases under the Pandemic Emergency Purchase Programme**.

The latest wording is the following: *"the Governing Council expects purchases under the Pandemic Emergency Purchase Programme (PEPP) over the current quarter to continue to be conducted at a significantly higher pace than during the first months of the year".* We highlighted last week Banque de France Governor Villeroy de Galhau's words: *"any hypothesis of a reduction of purchases partly for Q3 or the following quarters is purely* *speculative "*. It would be thus very surprising in our view if the new statement on Thursday hinted at a reversal of the substance of that stance, i.e., buying more than in Q1. There is a discussion among sell-side houses however as to the precise quantum of purchases in the months ahead, whether it could be lower than the recent EUR 80bn average, even if it remained above the Q1 pace. Still, crucially, the exact quantum is only known ex post. Investors will look at even subtle changes of wording from Christine Lagarde to get some indication.

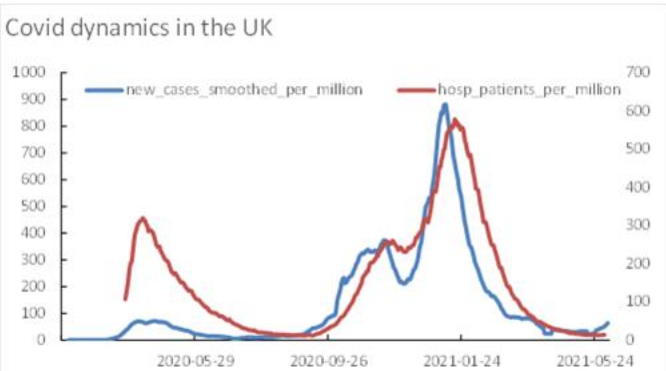
The easiest approach for the ECB would be to keep the language completely unchanged. This would still provide the Council with some leeway. No one has ever defined what "significantly higher" than in Q1 meant, so there would be space for the ECB to "dial down" a bit from the current 80bn euros if financial conditions could be kept benign this summer without the need for large central bank intervention, especially when taking on board seasonal factors. Alternatively, the text could also remove the "*significantly*" qualifier, which would be more binding: it would signal the intention of the ECB to *effectively* dial down, this would no longer be a mere option. For our part we fail to see what the purpose of this would be, since it would reduce the ECB flexibility in a still uncertain summer, and it would be interpreted as a sign the "hawks" are winning the argument. The central bank is likely to announce an upgrade to its forecasts on Thursday as well, saluting the ongoing reopening, but we would expect this to come with many words of caution. Our baseline remains that the Governing Council will choose to push back any strong decision on PEPP until the end of the summer.

News from the British lab

In all our recent discussions we have always made sure to make the point that the entire conversation on overheating/inflation/policy normalization is largely moot if the pandemic forces a delay in the reopening of our economies despite the growing success of the vaccination programmes, especially in the Western developed nations. This is no rhetorical flourish from our part. We are not out of the woods yet, and the situation in the UK needs to be closely monitored, as the potential harbinger of similar developments in other developed countries.

With the "Delta" variant now dominant in the UK according to Public Health England, together with the expected spike triggered by the lift off of major restrictions, new Covid cases have rebounded to 64.7 per million in the 7 days to June 5, the highest pace since late March, nearly tripling from a trough at 22.3 per million in the 7 days to May 19. Obviously, the focus no longer is on the number of cases but on the speed at which it could re-create significant pressure on the healthcare system despite the well-advanced vaccination programme. Hospitalizations have started to tentatively rebound, from a trough at 12.77/million on May 27 to 14.03 on June 2 but it is such a small move that it is barely visible on a graph (see Exhibit 4). Fatalities have not started to re-accelerate (yet).

Exhibit 4 – Going up again, but it takes good eyes (for now)



Source: OWID, AXA IM Research, June 21

Exhibit 5 – Very few severe cases among the fully vaccinated as of the end of May

Breakdown of "Delta Variant" cases in England

	Total	Unvaccinated	2 doses
Total cases since 1 Feb	9427	5172	267
A&E visits	364	233	12
O/N hospitalisation	89	59	3

Source: PHE, AXA IM Research, June 2021

Assuming the government sticks to its current deadline and dismantles the bulk of the remaining restrictions on June 21 – a timeline to which it is less and less committed – the impact of allowing the delta variant to "roam freely" would depend on how aggressive it is in terms of transmissibility and lethality, how fast the vaccination programme can be completed and finally how protective the vaccines can be against the variant.

On Sunday the British Health Minister stated that "the latest advice" he had on the matter was that it was "40% more transmissible" – which we understand as meaning the R coefficient is 1.4 times higher than the December version of the virus. 91.2% of people above the age of 60 have been vaccinated with two doses as of the end of May, and 79.4% of those above the age of 50. This still leaves a "reservoir" of more than 4 million people who as of last week were not vaccinated among those most at risk of severe forms of Covid because of their age.

To this we need to add the fact that preliminary estimates released two weeks ago suggested that two doses of Astra Zeneca – by far the dominant vaccine in the UK – provided a protection of only 60% against the variant for symptomatic cases, but crucially without providing data on the severity of the affection. **As of May 31st, since the delta variant was detected, non-vaccinated people accounted for 55% of the declared cases, against only 2.8% for those having received two doses.** Those with 2 doses accounted for 3.1% of the cases which made an overnight stay at the hospital necessary. The absolute numbers are still extremely low (see Exhibit 5), which suggests that indeed the vaccines provide good protection at least against severe cases, which explains the British government's priority at the moment: accelerating the programme, especially in the hotspots.

Still, the latest developments should act as a reminder that the emergence of aggressive variants pushes the threshold for collective immunity higher. This makes the "vaccine resistance" in some segments of public opinion more problematic, even if it is only a small minority. We reiterate a point we have made in Macrocast several times: there seems to be a "vaccination fatigue" settling in many countries once 50% to 60% of the population is inoculated – we have seen that in the US already.

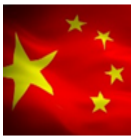
Tax deal trade-off

Your humble servant confesses not having systematically checked the communiques from the G7 in his career, but of course due diligence was needed this time. Indeed, an agreement has been found on global corporate taxation. The wording is remarkably concise but effective: "We *commit to reaching an equitable solution on the allocation of taxing rights, with market countries awarded taxing rights on at least 20% of profit exceeding a 10% margin for the largest and most profitable multinational enterprises. We will provide for appropriate coordination between the application of the new international tax rules and the removal of all Digital Services Taxes, and other relevant similar measures, on all companies. We also commit to a global minimum tax of at least 15% on a country-by-country basis"*. The two pillars of the OECD approach are endorsed: there will be space for local profit taxation on the point of consumption, on top of a minimum tax rate everywhere.

As usual with negotiations, we need to dig into the various actors' motives. One is common to all the G7 players: an interest in limiting a "race to the bottom" to allow them some capacity to tax corporate profits without fearing relocations. This is particularly pressing for two members which have concrete plans to raise their own corporate tax rate, the UK and the US, but we suspect all of them are interested in more room for manoeuvre on this source of government funding. Local taxation of profits is more ambiguous.

Indeed, the EU has been displaying a current account surplus which is now probably structural, contrasting with the US persistent deficits. **As a successful "export machine", the EU has a less clear interest than the US in having the foreign activity of firms taxed locally.** An issue for Europe however is its weakness in the production of hi tech, while being a major consumer of this type of services. The possibility to tax a share of the GAFA's profits originating from European sales is very tempting. This is why the articulation with the "digital services tax" mentioned in the communique is so crucial. The US offers the local taxation capacity as a way to bury the DSTs which had become popular in Europe. Instead of a device targeting one particular activity on which the US leadership is for now unrivalled, local taxation would hit a broader array of industries. The positive reaction from some of the GAFAs spokespeople over the weekend are possibly an indication of the trade-off at play here. Still, some uncertainty lingers: the Europeans don't want to give up on their DSTs before the US Congress endorses the deal on global taxation, while the US wanted the EU to abolish them immediately. “Appropriate coordination” on the subject, to quote from the communique, may take some efforts on both sides.

Anyway, the G7 agreement will need to be confirmed at the G20 in July, and then negotiated even more broadly under the aegis of the OECD. The level – 15%, while Biden had opened with 21% - makes it possibly more digestible to the low-tax countries such as Ireland (its own tax rate is at 12.5%), which would make a generalized deal easier. Still these countries will probably consider that once the principle of a minimum tax is agreed, then there is a significant likelihood the rate would gradually rise (the communique reads “at least 15%”), but it will take time and immense technical work before actual changes are implemented. The French Finance Minister Bruno le Maire mentioned “2 to 3 years” on Sunday. Still, this is part of the general “funerals of the Washington consensus” theme which is becoming every day more pervasive.

Country/Region	What we focused on last week	What we will focus on this week
	• Non-farm payrolls report for May. April's 266k disappointed, markets expect 600k with unemployment dropping back to 5.9% - release is key to set tone for Fed's meeting in June • ISM manufacturing and services reports (May), manufacturing 61.2, serv 64.0 • Fed published its Beige Book and hights moderate pace of expansion, faster rate than prior period • Total vehicle sales (May), 17m	• US CPI inflation (May) – April reached a 2008 high of 4.2%, we expect further rise in May to exceed 4.5%, but likely set the peak of this cycle • Michigan 5-10-year inflation expects's – as important as headline rate – currently at 2011 high of 3.1% • JOLTS job openings survey – reached 8.1m (Mar) and key indicator of demand for labour • US trade balance fell to record $74.4bn deficit in March, expect further widening as retail rebounds further
	• EA May headline inflation surprised slightly to the upside at 2%yoy on strong energy base effects, while core edged up to 0.9%yoy • EC extended the general escape clause: fiscal rules won't apply in 22, but will be back in 23 • Very strong Services PMIs in Italy and Spain • EU to issue €80bn of EU bonds in 2021	• ECB to modestly upgrade its inflation and growth forecasts and refrain from tapering in Q3 (pace of purchases might still slow due to seasonality) • Watch IP details: supply bottlenecks impacts? • German Saxony Anhalt state elections results might exert pressure on CDU/CSU Laschet
	• Wary of continued spread of Indian variant, monitoring hospitalisations • Final M & S PMIs (May), 65.6 and 62.9 • BoE lending data (Apr), look to scale of ongoing support for housing market • Nationwide HPI (May), 10.9% • G7 Finance Ministers meeting in London	• Monthly GDP for April, Mar surprised with 2.1% rise, we expect around 1.5% again • Output data for key sectors for April • UK trade (Apr), mar deficit rose from modest surplus in Jan, expected further widening • BRC retail sales monitor – to confirm any retracement in consumer spending rebound
	• Japan has extended the state of emergency until mid-June in major cities • May services PMI declined to 46.5 from 49.5 • April industrial prod turned positive but was under consensus at +2.5%mom	• Acceleration in vaccination campaign • GDP revisions can be important. We can expect a slight revision on the upside • May economy watchers poll should remain subdued following recent restrictions
	• Manufacturing and services PMIs suggest steady growth momentum in May • The PBoC raises the reserve requirement on foreign currency deposits to manage FX liquidity and rein in RMB appreciation	• Export growth should remain buoyant thanks to the continued recovery in external demand • CPI and PPI to show intensified price pressure due to rising commodity prices
	• May manufacturing PMI survey shows different speed activity across regions/sectors, supply-side shortages and price pressures. Largest declines in India, Thailand, Malaysia, Turkey, strong rebound in CEE • Q1 GDP final release in Brazil Turkey India – upside risks for FY2021 forecasts • CB in India (4%) on hold	• CB meetings: Poland, Chile, Peru (on hold) Russia (+25bp) • May CPI in Chile, Brazil, Mexico, Taiwan, Russia • April IP in Mexico, India, Malaysia, Hungary, Turkey, SA • June 6 elections: mid-terms in Mexico (Morena expected to lose super majority), 2nd round in Peru presidential elections (tight polls)

Upcoming events	**US :**	Tue: NFIB small busi op (May); Wed: Wholesale inventories (final, Apr); Thu: CPI (May); Fri: Michigan consumer sentiment (prel., June)
	Euro Area:	Mon: New mfg orders (Apr), Sp IP (Apr); Tue: EA GDP (final, Q1), Ge ZEW survey: curr situation (June); Thu: ECB meeting (unch), Fr, It IP (Apr); Fri: Sp HICP (final, May)
	UK:	Mon: Halifax house price index (May); Tue: BRC Retail Sales Monitor (May); Thu: RICS Housing Survey (May); Fri: GDP (Apr), IP (Apr), Total trade balance (Apr)
	Japan:	Mon: Leading index (prel., Apr); Tue: GDP (final, Q1)
	China:	Mon: Trade balance (May); Wed: CPI (May), PPI (May)

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