Unfazed

106 – 27 September 2021

Key points

- The results of the German federal elections point to a lengthy negotiation process
- We use the Spanish and Irish real estate bubbles of 10 years ago to shed a light on China's options
- The Fed is unfazed by mounting uncertainty – the next two months could be volatile though

The first projections for the next Bundestag seem to leave three options open: "traffic light", "Jamaica" … and another "grand coalition" between SPD (Social Democratic Party) and Christian Democratic Union-Christian Social Union (CDU-CSU). No solution looks obvious, and this suggests Angela Merkel could still be Chancellor for some months in 2022. By the time a coalition agreement is struck, the French presidential campaign may have started in earnest. European Union (EU) affairs could be at a standstill until next summer.

While uncertainty is still high around the Evergrande case, we look at China's capacity to deal with its real estate bubble using the experience of Spain and Ireland 10 years ago. Contrary to the peripheral countries of the Euro area, China's central bank is fully flexible, its International Investment Position is positive, and its capital account is not fully liberalized. This allows China to choose the timing and pace of its real-estate overhaul. However, such "clean-up" is a condition to the further modernization of its macro management. Moreover, a lesson of the Spanish and Irish experience is that real-estate bubbles artificially inflate economic growth while deteriorating its quality through sub-optimal labour and capital allocation. Still, deflating the bubble comes with large transition costs.

Beyond telegraphing the beginning of tapering in November – unless the dataflow deteriorates significantly - the latest Federal Open Market Committee (FOMC) meeting was remarkable for the continuation of the "hawkish shift" on policy rates, although the Fed's economic outlook has barely changed relative to June. There was a similar move at the Bank of England last week as well. This, together with the "grumblings" at the European Central Bank (ECB) on inflation risks suggest the "tide is turning" on the global monetary stance, even if we can expect some volatility ahead – not least the extreme complications of the US fiscal process. Some "pause for thought" remains possible.

And the winner is…we don't know yet

Before getting into some brief speculations on the possible outcomes of the coalitions talks in Germany, our first reaction to the federal elections is that the mainstream parties control a larger share of the vote than in 2017. The two radical parties in parliament Alternative für Deutschland (AfD) and Die Linke garnered only around 15% of the votes between themselves, against more than 20% 4 years ago. This is another indication that, possibly counter-intuitively, the Covid crisis is not fuelling populism, at least not in electoral terms. It may reflect the fact that mainstream governments have responded to the crisis by implementing extraordinarily supportive economic policies, depriving populist parties from a large part of their platform. The real test has yet to come though. Policy normalization could be trickier for incumbents down the road. Still, for now, mainstream is in command.

As we write– but counting is still underway - the results of the federal elections leave three viable coalitions on the table, with around the same number of seats comfortably above the majority thresholds: "traffic light" (SPD, Greens, Free Democratic Party (FDP)), "Jamaica" (CDU, Greens, FDP) and GroKo (SPD, CDU). One option which according to the polls had long been on the table – "red-red-green" (SPD, Greens, Die Linke) – seems now to be out of reach, the left party hovering at c.5% (projections would put this option some 5 to 8 seats away from the majority threshold).

At this juncture, appetite for another "grand coalition" seems to be very limited – even if it's a valid fall-back plan, in 2017 this ended up being the only solution – which means **some measure of agreement would have to be found between two parties – the Greens and FDP – which have radically different ideas on key elements, in particular on the "debt brake" and tax hikes. This is the bridge that needs to be built for either "traffic light" or "Jamaica" to have a chance**. The FDP leader Christian Lindner made this explicit in the post-exit poll TV debate: he proposed that the Greens and his party have a closed negotiation first, before taking it to the two bigger parties (even if Lindner has also stated his preference for Jamaica, while the Greens so far have kept their own counsel).

We explored this in Macrocast two weeks ago. **Our contention is that delivering "net zero" by 2045 while reducing the deficit following a strict implementation of the "debt brake" and cutting tax is not feasible.** The line of "least resistance" in our view to reconcile these competing claims on public finances would be to find a financial engineering solution to circumvent the debt brake, for instance by funding key elements of the decarbonisation expenditure via an off-balance sheet vehicle. But this would probably call for some flexibility on the European fiscal surveillance Pact, which Lindner opposes.

The absence of the "red-red-green" alternative makes Lindner's position stronger, and hence the chances of "Jamaica". If he chooses to stay out of government, he will also prevent the Greens from acceding to power (just like in 2017 the solution would be GroKo again). Yet, symmetrically, a key issue for the Greens is probably to choose the right solution from a future electoral point of view. "Jamaica", presumably under a CDU-CSU Chancellor, could be costly given the unpopularity of the current CDU leader, contrasting with Olaf Scholtz' strong personal standing in the polls (plus the fact that SPD came out first in the votes). Tagging themselves to CDU in these circumstances may be unappealing. If the Greens prefer SPD over CDU as senior coalition partner, then Lindner would have to accept it to – at long last – return to power. There is not easy solution, which is probably why quite a few observers on Sunday night were already expecting a GroKo solution in the end.

Last time negotiations took 5 months. As we wrote 2 weeks ago, it may well be that no new Chancellor will come out before the French presidential campaign is in full swing, which means that not much may move in the EU before the summer of next year. As governments in most member states are unveiling their budget bills for 2022, it is worth remembering that it is the last year they can do so outside the EU fiscal surveillance rules. If nothing is negotiated quickly next year in Brussels, they will face tight constraints on their 2023 budgets.

Spanish (and Irish) light on China's plight

Meanwhile, markets have regained their footing after being rattled by the Evergrande saga, in part thanks to the People's Bank Of China (PBOC)'s liquidity injection. Uncertainty continues to linger though. It seems Chinese local authorities are taking control of Evergrande's cash to protect ongoing operations, but payments to bondholders have been missed (although we are still in the "grace period"). But beyond the particulars of the Evergrande case, we want to return in more details to the specific features of real estate crises in the Chinese context, contrasting them with recent – and spectacular – ones which have plagued European countries such as Spain and Ireland 10 years ago.

In a timely piece, Michael Pettis **put the Evergrande issue in a wider macroeconomic perspective. Pettis as is customary for him slices Chinese economic growth in a "proper one" and what he calls "residual growth", the product of ever-expanding private sector debt, essentially directed to construction**. His point is that this "residual growth" is ultimately unsustainable given the debt servicing costs, with significant financial stability ramifications.

Read through our European lenses, **this is remarkably similar to the artificial "periphery boom" at the beginning of the 2000s.** When monetary union started in 1999, Germany was in a bad patch, digesting the aftermaths of unification. The convergence of nominal interest rates towards the level which prevailed in the system's centre (Germany) led to a swift drop in *real* interest rates in the periphery, in a complete reversal of the situation which had prevailed in the previous 10 years, when their local central banks had to maintain a very aggressive stance to get these countries to qualify for the euro. Thanks to the contribution of the real estate boom, Ireland and Spain enjoyed very strong GDP growth for nearly 10 years, exceeding by far the Euro area average. Observers at the time often failed to recognize the artificial nature of this out-performance. The European Commission's estimates of potential growth in these member states were very high at the time, with stark consequences on fiscal surveillance. Indeed, fast-rising tax receipts which were the by-product of this unsustainable "froth" were treated as structural, and debt sustainability projections were based on overly optimistic growth assumptions. These countries' policy space was thus significantly over-stated, which in turn fed complacency.

The Great Financial Crisis pricked that particular bubble, leaving the overly exposed Spanish and Irish banking sector in a dismal situation, exerting in turn massive pressure on their sovereigns, which were already dealing with a catastrophic fall in tax receipts, through the "presumption of bank bailout". These countries had to go through an extremely painful adjustment under surveillance of the EU and the ECB. Potential growth estimates plunged.

Let's indulge in a bit of economic alternative history there, to explore key differences between the current Chinese situation and these two "textbook cases" of real estate-induced recessions. What would have happened if Spain and Ireland had had fully independent central banks at the time? It's highly likely that they would have emulated the Fed's approach at the time and engaged in massive debt monetization via quantitative easing, providing their governments with "free" resources to bailout the banks.

That would not have been enough however to protect financial stability in the periphery. Indeed, the boom years had been accompanied – and funded – by massive inflows of foreign capital which had left these countries with a deeply negative International Investment Position, with domestic banks acting as the "conduit" for this foreign indebtedness. Contrary to the US which can count on structural overseas demand for its debt given its reserve currency status, the combination of a real estate correction with "run-away" monetary policy in Spain and Ireland would probably have been accompanied by a significant depreciation in the currency and rapid capital outflows. Depending on the share of foreign-denominated liabilities, defaults could have occurred. The only protection in this configuration would have been capital controls.

To be clear, we are not advocating *ex post* that Ireland and Spain should have left monetary union. The cost of doing so would have by far exceeded the short-term benefit of keeping the real estate and banking sector afloat. But we think **these mechanisms shed a light on the magnitude of the options opened to China today to deal with its bubble: its central bank is fully flexible, its International Investment Position is positive, and its capital account is not fully liberalized.** This provides Chinese authorities with ample policy space.

True, the market has been fretting on the risks of offshore investors deserting the Chinese markets, triggering difficulties to roll-over existing foreign currency debt incurred by Chinese entities. The sharp drop in price on high-yield off-shore bonds suggest international investors are indeed getting cold feet, but we think a sense of perspective is needed here.

According to the State Administration of Foreign Exchange (SAFE) data, China's official FX reserves still stand at more than twice the total of Chinese external debt denominated in foreign currency. True, the ratio has deteriorated these last few years as the pace of reserve accumulation has abated, but meanwhile **the foreign currency coverage ratio of Chinese banks has improved**: their own foreign currency assets exceed again their foreign currency liabilities (see Exhibit 1). This does not mean that there can't be any market pressure or volatility, or individual incidents, but the potential an Evergrande-type issue could turn systemic for global markets is limited. So far this seems to be endorsed by the market: no contagion has been observed on the investment grade market from the spike in high yields (see exhibit 2).

Exhibit 1 – More than enough!

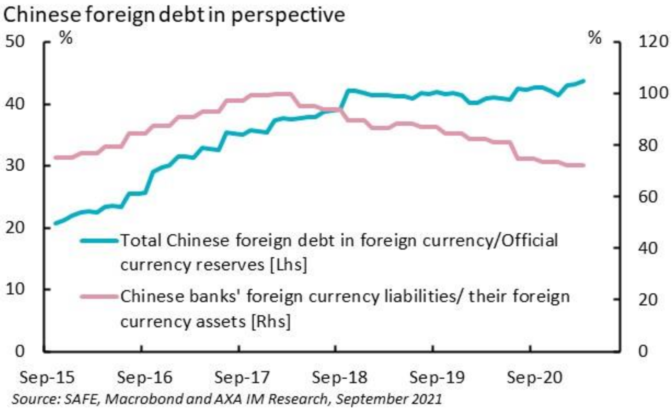
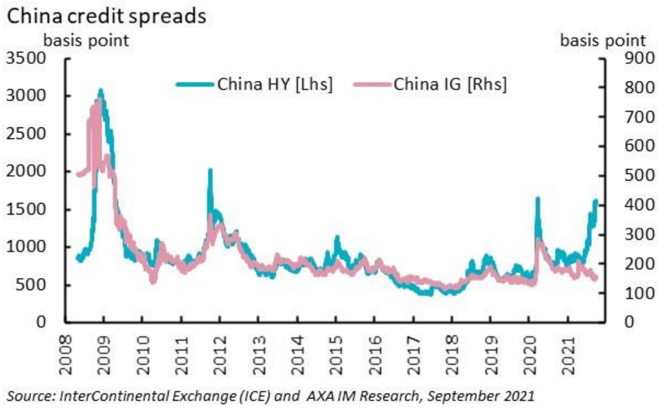


Exhibit 2 – No contagion so far

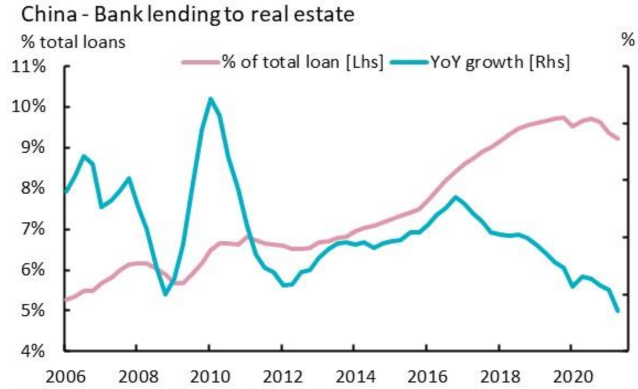


… but it can't go on like this eternally

The parallel with the European periphery can be seen from another viewpoint**. If it is impossible for a permanent real estate bubble to co-exist with a fully liberalized current account and a monetary policy entirely driven by price stability, then "cleaning up" the real estate sector is a condition to a further modernization of China's macro management**. The current set-up allows Beijing to choose the timing and pace of such clean-up, but it needs to take place at some point if the country wants to liberalize its financial structures and institutions further.

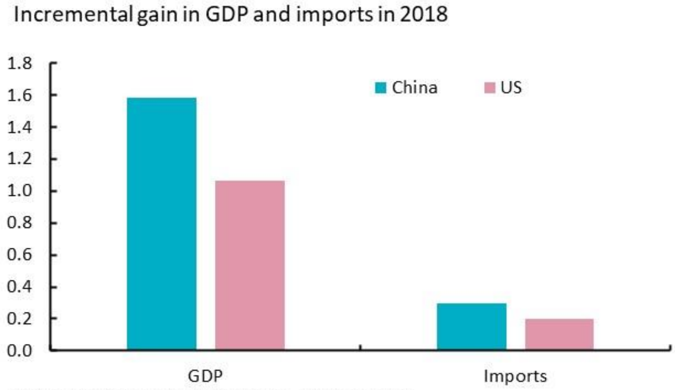
Another lesson from the peripheral crisis is that lasting real estate bubbles are bad for potential growth, since they trigger a sub-optimal allocation of capital and labour. Still, re-allocation towards more productive sectors comes with friction, and the transition is usually painful for aggregate growth. These are not theoretical musings: while the world is focusing right now on the imbalances on the Chinese real estate market, the push-back on over-leveraging in this sector has already started in earnest (see exhibit 3). The impact of the "three red lines" (liability to asset ratio below 70%, no earing ration below 100%, cash reserves above short-term debt) is already showing.

Exhibit 3 – Real estate crackdown already showing



Source: CEIC and AXA IM Research, September 2021

Exhibit 4 – How crucial to world demand China has become



Source: Worldbank and AXA IM Research, September 2021

If China loses Pettis' "residual growth", or "froth", then the rest of the world needs to revise down the speed at which the country can provide, year in, year out, ever-larger traction. True, China will remain central to exporters everywhere though. A Chinese economy growing at 4% "only" today would provide as much demand as when it was growing by 8% a year 10 years ago when it was only half the size it is today. China's GDP growing at 2.5% per annum would yield the same contribution to world GDP as the US growing at their potential rate usually estimated at 1.75% per annum (using a spot FX conversion of their GDP). But betting on 5%+ China growth forever would be mistaken, in our view.

Another point to consider is the likely change in GDP composition looking ahead. Indeed, a less capital-intensive growth model, moving towards a consumption-led economy could be problematic for exporters heavily specialised in investment goods. We reiterate the view we expressed two weeks ago in our survey of Germany ahead of this weekend elections: counting on the Chinese market as the main industrial engine of one's economy is going to be less rewarding than expected. From our point of view, this is the main takeaway from the Evergrande episode, which we see as a manageable short-term symptom of the necessary changes in the Chinese economy.

Fed unfazed

Given the uncertainty in China and a less than stellar recent dataflow in the US, the Federal Reserve could have been forgiven for being elusive on its intentions. Yet, even if the central bank retains some wiggle room, the last FOMC meeting is now quite clear on the policy trajectory. **Powell's statement last week was consistent with a formal announcement of tapering at the November meeting, with a strong likelihood it could start to be implemented the same month instead of waiting until December and last for only 6 months.** Of course, this remains conditional on "progress continuing broadly as expected" but the bar for revising the timeline looks high. In the Q&A Powell made the point that a "reasonably good" payroll report for September (out on 8 October) would be enough. Note that any interpretation of the September batch is going to be made difficult by the disturbance from hurricane Ida. Still, beyond the payroll release the FOMC will have a wealth of additional indicators by the time they meet on November 2. This suggests that, should the payroll release be uninformative, every single indicator published in the following three weeks could trigger some significant market volatility.

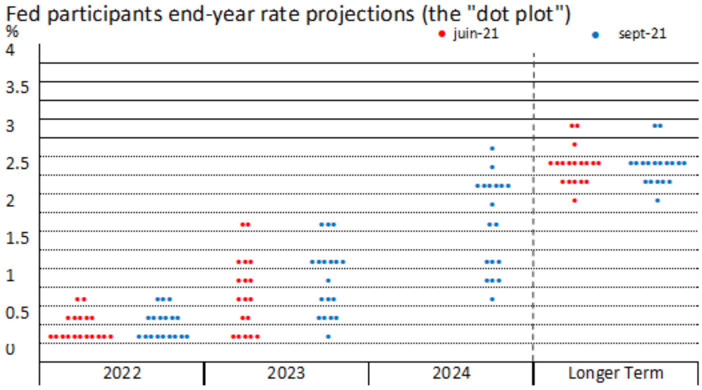
Beyond the clear signal on tapering, **the latest FOMC meeting was remarkable for the continuation of the "hawkish shift" on policy rates**. Nine members now expect a rate lift-off next year already - they are now evenly split - against 7 in June, and it's moving up as well for 2023 (9 members have Fed Funds above 1%, against only 5 in June). What is maybe equally interesting is the fact that the **"doves are giving up".** Indeed, in June 5 members were still advocating keeping the policy rate where it is today in 2023. Only one is holding out this time (see Exhibit 5).

This shift is occurring without any major change to the Fed's macroeconomic outlook beyond 2021: while the Fed takes on board the higher-than-expected current inflation spike, expecting 3.7% core inflation this year (3.0% in June), the inflation forecasts over the rest of the horizon remain consistent with only moderate overshooting, just like in June (2.2% in 2022 and 2023 and 2.1% in 2024 (from 2.1% in 2022 and 2.2% in 2023 in the June forecasts).

The "hawkish shift" is thus probably the product of a change in the balance of risks, and the attitude towards the risk inflation gets out of hand.

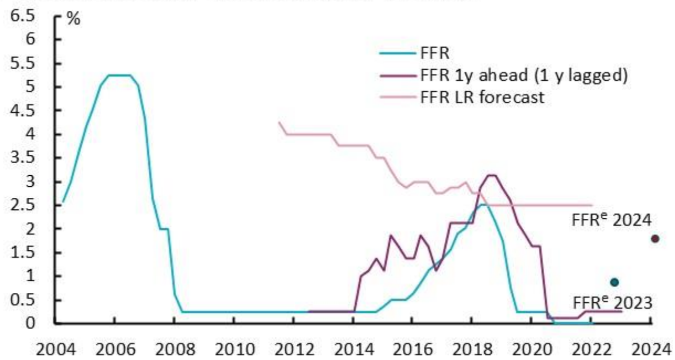
All this makes Powell's pledge to "decouple" the end of quantitative easing from policy normalization "proper" less convincing, but he can argue – and he did last week – that under the median projection of the FOMC, Fed Funds rate in 2024 would still be some way away from the "longer-run" level of the dot plot (1.8% against 2.5%), which can be used as an estimate of where the Fed sees the equilibrium interest rate for the US (see Exhibit 6). From this point of view, monetary policy would remain accommodative.

Exhibit 5 – Doves are giving up



Source: Federal Reserve and AXA IM Research, September 2021

Exhibit 6 – Still accommodative by 2024



Source: Federal Reserve and AXA IM Research, September 2021

Yet, **the current level of long-term interest rates is still looking at odds with the FOMC message** despite the rebound in the US 10-year yield to 1.45% at the end of last week. Even if our baseline remains that the Fed will wait until 2023 to hike, the perspective of the Fed terminating net buying in mid-2022 should continue to lift market rates. We still expect 10-year yields to hit 1.75% by year-end.

There is something (hawkish) in the air… but events could still get in the way

A common explanation of the spike in US yields last Friday – there was little initial reaction to the Fed - was contagion from the UK market following hawkish Bank of England (BoE) minutes published the day before. If the taps of liquidity are being turned off on several key markets at the same time, even the world's dominant bond market – the US – will take notice.

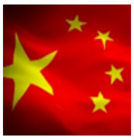
The fact that two members of the Monetary Policy Committee of the Bank of England voted to terminate the quantitative easing (QE) programme now instead of the end of the year was already significant, but the minutes also made it plain that concerns over inflation are piling up to the point a rate hike could be envisaged *before* the end of QE (technically, this would mean the November meeting is live). Note that the BoE has "tightened its hands" on the trajectory for reversing quantitative easing and engage in quantitative tightening: when policy rates reach 0.5%, the central bank will stop reinvesting the maturing bonds, and will consider selling its stock of bonds back into the market when it reaches 1%. The impact on the bond market of a change in the expected timeline for the rates lift-off is thus very high.

Now, just like the Fed the Bank of England stated that is monitoring employment developments very closely before making any decision, and just like in the US the current picture of the labour market is blurry: in the UK, the end of the "furlough scheme" could trigger a transitory spike in unemployment. **Another major source of uncertainty – beyond the various supply-side issues impairing the recovery – is the direction of fiscal policy.** We have already discussed in Macrocast the willingness of the British government to experiment with a quick conversion to fiscal tightening. The first instalment will come in April 2022, in a very visible manner for consumers and businesses, in the form of a 1.25% hike in national insurance contribution for both employees and employers. We think the BoE will wait until the summer of 2022 before hiking.

Fiscal policy could be a headache for the Fed and the market even faster. This Monday, the Democrats will try to pass in the Senate a continuing resolution (CR) to push the spending bill to December 2021 and the debt ceiling to Dec 2022, after having passed it in the House. This would require some Republican support to be successful, which is unlikely given the Republicans' willingness to force their opponents to take responsibility for the debt ceiling extension alone. A solution would then be to pass the spending bill only, to avert a painful government shutdown next week. But this would leave the debt extension issue open.

Yet, **according to the Treasury, money will run out "sometime in October".** The market's relative calm on these issues can probably be explained by the fact that investors know the Democrats can always tag a debt ceiling extension to their reconciliation package, but there are difficulties on this. The moderate Democrats in the Senate have expressed their concern about its size and are working hard to shrink it. A possibility is that radical Democrats in the House then decide to torpedo the bi-partisan 1.3tn investment package – which has passed the Senate only.

We are thus faced with two potential issues. First, the Democrats could be tempted to "play for time" and ramp up the possibility of a default to raise the pressure on Republicans well into October to get a full bi-partisan deal on debt extension – accepting to "cave in" and go alone only at the very last extremity, which could end up rattling the market. Second, and it is more fundamental, **the FOMC may have visibility on the US fiscal stance into 2022 and beyond only shortly before it meets on 3 November.** In a configuration in which the bi-partisan package is held up by the House, while the Democrats can only pass a fraction of their 3.5tn long-term fiscal overhaul in the reconciliation package, the net contribution from fiscal policy to US demand in 2022 could be much smaller than expected. The bar seems to be high for a change in trajectory at the Fed, and a November start for tapering is our baseline, but some "pause for thought" remains possible.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• FOMC meeting. Fed indicated a November taper announcement, over by mid-2022. Dots consider 50/50 hike in 2022 • Hse passes CR to avoid shutdown/debt ceiling, but Senate unlikely to follow through • Housing starts rebound somewhat in August, total sales down on month • Jobless claims rise in latest week • Weekly cons conf dipped 2nd successive week	• Spending bill to avert govt shutdown (Fri). Senate unlikely to pass Hse CR (Mon?), but second CR later. Debt ceiling to run into October. And delay to bi-p bill from 27 Sept. • PCE inflation (Aug), watch for softening in pace of core, similar to CPI • GDP (Q2, final), 6.6% preliminary est • Personal spend (Aug) expect rebound after retail sales. Income to slow from 1.1% (Jul) • ISM (Sep) modest dip from 59.9 in Aug.
	• Sep EC consumer confid progressed to-4 (-5.3) • EMU Flash Composite eased to 56.1, with both Svcs (56.3) and Mfg (58.7) down by 2.7 points. Svcs decline in Ger is striking (-4.8), Fr (-0.3p) • IFO bus climate fell by 0.6p, driven by current conditions (-1p) and bus expectations by -0.2p	• German election result and the first reactions to assess the most feasible coalition • EC sentiment surveys (ind,svcs,bus climate) should soften, in line with recent PMIs decline • EMU Sept inflation data should rise around 3.3%, Germany likely to go above 4%
	• BoE meeting. MPC left policy unchanged, but 7-2 vote to end QE early. More hawkish tone, raised CPI outlook, but still expected transitory • Gas price increases add to inflation angst • PMIs (Sep, p) retraced in manu and services • MPC lifted outlook for CPI in the near-term due to gas price pressures and considers this spike to be 'transitory'. Public fins higher in Aug, ytd < OBR outlook	• Revision of GDP (Q2, 2nd est) – no change expected to prev estimates (4.8%). Focus on Q3 outlook, our est 2%qoq • Update of Manufacturing PMIs (Sep, f) • Housing market data releases, watch for further reductions post stamp duty holiday • Gov Bailey speaking at Soc of Prof Economists • Mfg PMIs (Sep, f), pre lest 56.3 vs 60.3 (Aug) • BoE net lending (Aug) further softening post Stamp Duty holiday. Nationwide HPI also expected to begin to soften from elevated rate
	• The BoJ didn't modify its monetary policy but unveiled details on its climate financing prog • Aug CPI core is flat at 0%yoy, strong transitory pressures: lodging price (+), mobile charges (-) • Flash Mfg PMI softened to 51.2 (-1.5pp)	• LDP elects the new PM on Sept 29. Kono leads in national polls and Kishida within the party • Aug IP should decline as auto product struggles • Q3 Tankan surveys to gauge business confid in recovery as well as investment expectations
	• Fears of an imminent default by one of China's largest real estate developers send markets into a tailspin	• Investors will stay alert on how the Evergrande saga develops
	• Argentina Q2 GDP qoq contracted (-1.4%qoq) for the first time in a year as a result of a new COVID-19 wave • CB: Philippines, Taiwan and South Africa stood on hold; Hungary +15bp to 1.65%; Brazil +100bps to 6.25%; Turkey delivered a surprise 100bps cut to 18%	• PMI figures for September across EM countries • CB: Mexico (+25bps expected to 4.75%), Colombia (+25bp expected to 2%) Thailand (on hold at 0.5%) • CPI (Sept): Indonesia, Poland • IP (Aug): Taiwan, Korea • Q2 GDP - Russia final figure

Upcoming events	**US :**	Mon: Durable goods (Aug); Tue: trade (goods) (Aug), CS & FHFA HPI (Jul), Conf Board cons conf (Sep); Wed: Pending home (Aug); Thu: GDP (Q2,f), jobless claims, Chicago PMI (Sep); Fri: PCE
	Euro Area:	Sun: Ge election; Mon: M3 (Aug); Tue: ECB Forum- Sintra, Fr cons conf; Wed: Business conf (Sep), Sp inflation (Sep,p); Thu: EZ unemp (Aug), Ge unemp (Sep), Ge Fr & It inflation (Sep,p), Fr
	UK:	Mon: BoE's Bailey speaks; Wed: BRC shop price indx, BoE lending data; Thu: GDP (Q2,f), Current account (Q2); Fri: Manu PMI (Sep); During week: Nationwide house price indx (Sep)
	Japan:	Thu: Industrial production (Aug,p); Fri: Tankan large manu indx (Q3)
	China:	Tue: Industrial profits (Aug); Thu: Official manu & non-manu PMIs (Sep), Caixin manu PMI (Sep)

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