Powell's Curve

112 – 15 November 2021

Key points

- COP26: rendez-vous in Sharm El-Sheikh.
- For all the volatility in the US bond market, the Federal Reserve (Fed) is retaining its credibility. This is one of the reasons why Biden should re-appoint Powell.
- Watch the new Covid flare-up in Europe, as well as the EU's Eastern border.

COP26 left a lot of "unfinished business" and governments are now requested to produce new Nationally Defined Contributions to decarbonization, with a focus on 2030, by the next COP in Sharm El-Sheikh at the end of next year. Optimists will probably choose to focus on the fact that finally, fossil fuels and particularly coal are now explicitly targeted, but the contorted wording leaves a lot of room for interpretation. Yes, the general "direction of travel" is clearer, but attention should shift from "big international events" to closely monitoring implementation country by country.

For all the volatility of the last few weeks, we think a clear narrative is emerging from the US bond market. Investors believe the Fed will be forced into an "early rate lift-off" – that's the reading from 2-year yields - but judging by market-based inflation expectations, they also think this will be enough to avoid a persistent shift in the inflation regime above the Fed target. This explains as well why the 10 to 30-year segment of the curve has tightened these last few weeks. At the same time, judging by the strong showing of the equity market, investors don't believe pre-emptive rate hikes by the Fed would cost much in terms of economic growth. In other words, the Fed remains fully credible. As much as we think the market is both too aggressive in its pricing of the Fed and too sanguine about the possibility of a "bloodless monetary tightening", the Fed's credibility is one of the reasons why we believe it is strongly in Joe Biden's interest to re-appoint Jay Powell. Replacing him with a "true dove" would probably trigger a further drift in long-term interest which would be detrimental to the US government's borrowing costs, while stoking inflation fears in the population would not do much to help Biden's shaky polls. Meanwhile, the European Central Bank (ECB) is not demonstrating such a strong grip on the market, and the "mood music" coming from the hawks is being noticed by the market.

While the ECB is mulling its December announcements, the new flare-up of the pandemic in the North of the Euro area could alter slightly the short-term macro outlook. While we think that the response will be more conversion to the "Franco-Italian model" (strict enforcement of sanitary passes), which would avoid far-reaching and economically destructive lockdowns, some impact on consumption can emerge as worried households would self-restrain on their spending in the most affected areas. We also need to keep an eye on developments on the eastern European Union (EU) border, even though the latest statements by V. Putin have been reassuring.

COP: See you in Sharm El-Sheikh

COP26 finished late – as all COPs have – with three areas of focus in the conclusions. The first one is a "rendez-vous clause" in November 2022, coinciding with COP27 in Sharm-el-Sheikh, to update the countries' Nationally Defined Contributions (NDCs). This applies to those who haven't submitted one in time for Glasgow, but also *"requests Parties to revisit and strengthen the 2030 targets in their nationally determined contributions as necessary to align with the Paris Agreement temperature goal by the end of 2022, taking into account different national circumstances"*. **Members are thus given a "second chance" to produce NDCs consistent with keeping global warming to 1.5 degrees, a target which looks elusive on the basis of the current commitments**. Asking for more clarity for 2030 makes sense. While the relatively optimistic Melbourne University assessment of the post-COP26 temperature trajectory (1.9 degrees) last week took on board all pledges, including the furthest away ones, the Climate Action Tracker analysis came out last week with a darker picture (2.4 degrees) largely because of its focus on the normally more tangible but unfortunately still insufficient short-term measures.

The second key point is **the explicit inclusion of fossil fuel and particularly coal in the agreement. The wording is however quite contorted.** The text " *calls upon Parties to accelerate the development, deployment and dissemination of technologies, and the adoption of policies, to transition towards low-emission energy systems, including by rapidly scaling up the deployment of clean power generation and energy efficiency measures, including accelerating efforts towards the phase-down of unabated coal power and inefficient fossil fuel subsidies, recognizing the need for support towards a just transition".* There is an abundance of qualifiers which need to be analysed one by one.

The penultimate draft of the "Glasgow pact" read "phase-out" rather than "phase-down" coal, before it was toned down at the last-minute request of India. In the final version, "*phase down*" would imply that any scaled reduction of the contribution of coal to the energy mix would suffice, without giving way to a complete disappearance. "*Unabated*" implies the possibility to mitigate the emission of coal generated Greenhouse Gas Emissions (GHGs) with carbon capture techniques.

"*Inefficient*" is ambiguous when applied to fossil fuel subsidies. It could be understood as any subsidy which would encourage wasteful consumption and impair the transition to cleaner energy (it's the definition used by the G20). But implementation could be "interesting". Canada for instance has already pledged to scrap all inefficient federal subsidies by 2025, but in a preliminary report found all its existing programmes efficient, either because they could help reduce the country's carbon footprint – e.g. supporting research in cleaning fossil fuel activity - which makes sense, or – and that's more debatable - because they had a "social" content (e.g. supporting access to affordable energy to some communities). If this interpretation is widespread, this would leave the door open to quite a lot of subsidy frameworks worldwide. Finally, the mention of "just transition" implies the recognition of the significant transitory damage to employment which could be triggered by abandoning coal. Of course, the general direction of travel for fossil fuels is clear, and that's probably progress relative to the Paris agreement (the International Energy Agency report on how to achieve net zero probably played a key role here) but the speed of the transition could remain low.

The third point is **a pledge to bring the developed countries' contribution to help emerging and developing states to mitigate climate change to USD100bn per annum by 2025, against 2020 in the Paris agreement. This is an unimpressive target.** The Organization for Economic Co-operation and Development (OECD) review of the pledges ahead of COP26 suggested that USD100bn could be reached by 2023. This will not help bridging the gap between "North" and "South" when it comes to the fight against climate change. We note that to justify their rejection of "phasing out" carbon, India's representative to the COP26 brought back the historical fairness argument , according to which developing and emerging countries should be granted a larger share of the remaining "carbon budget" – the quantum of CO2 which can still be emitted without pushing global warming above 1.5 degrees – given their minuscule contribution to global warming until the recent decades.

Finally, beside the "Glasgow Pact" proper **a deal was struck on the tricky interpretation of article 6 of Paris agreement covering carbon trading across countries**. Rules were defined on the centralised exchange, with in

particular a mandatory cancellation of 2% of the new credits issued – to better ensure a "net decarbonisation" – and 5% of the credits will have to be set aside to help developing countries adapt to climate change. These "safeguards" however won't apply on the bilateral agreement (such as the one which has already been concluded between Switzerland and Peru, whereby, in a nutshell, the former pays the latter to decarbonize). The "proof will be in pudding" though, as to exactly how these systems will work and how due scrutiny will be organized to avoid greenwashing. From this point of view, the fact that the agreement has allowed some "grand-fathering" of credits created under the Kyoto agreement (largely discredited in terms of real impact on global carbon emissions) into the new framework is not a great sign. Yet, as we argued last week, this may be an important step towards the emergence of a global price for carbon.

All in all, **COP26 probably ends up better than what could have been feared (we summarized last week early wins on forests and methane), but we expect another moment of tension next year around the new pledges**. We continue to think that attention is now likely to shift away from these "big moments" focused on pledges towards monitoring implementation at the national level. As things stand today, there are few "hard takeaways" for the private sector, apart from the methane deal which is going to have immediate consequences on the oil and gas industry.

Fed credibility test

Volatility on the US bond market has risen significantly recently, but a lot of the movement has been taking place on the front end of the curve. Since the beginning of September, most of the action has occurred on 2-year yields, while the 2 to 10-year segment of the curve has flattened significantly since mid-October, and the 10-30-year spread has tightened (see Exhibit 1). This flattening is best understood when looking at the market's inflation expectations. The 5 year-5 year rose in September and in the first half of October before plateauing in a 2.5/2.6% range since the beginning of October (see Exhibit 2). Since break-evens pay the change in the consumer price index, which tends to be 0.3 to 0.5% higher than the Fed's preferred measure of inflation (the private consumption deflator), this suggests that the market does not believe the Fed will ultimately lose control of inflation (see Exhibit 2). **So, in a nutshell what the market is pricing right now is an early, "pre-emptive" monetary policy tightening, which would not need to go very far to prevent inflation from becoming uncontrollable.**

Exhibit 1 – Flatter curve….

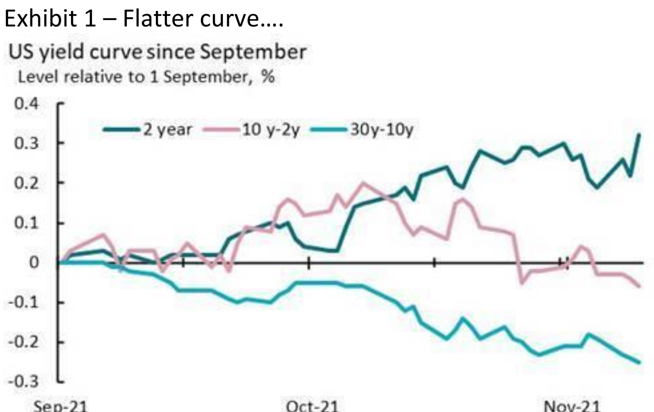
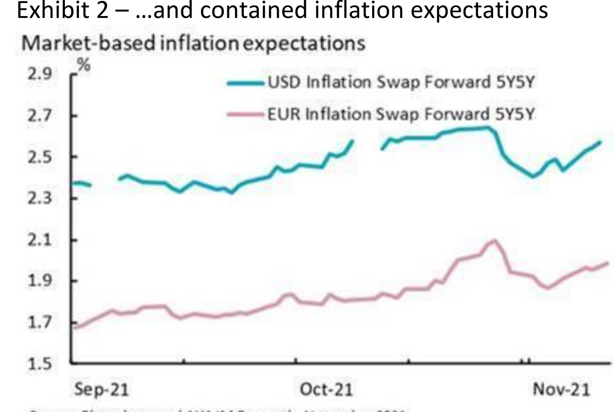


Exhibit 2 – …and contained inflation expectations



The latest US dataflow is supporting case of those who believe the Fed is going to be forced to bring forward its rate lift-off. Inflation has exceeded expectations in October again, with core inflation beating its recent May 2021 peak to stand at 4.6% year-on-year. We updated our usual breakdown of the US Consumer Price Index (CPI) and what is concerning is that beyond the "accidental buckets" (micro-chip and catch-up related items) the acceleration in persistent factors such as rents continues, while the upward drift in the "other components" (the 40% of the core price index which neither "accidental" nor "rents") suggests that the inflation shock is spreading to more and more sectors. **We continue to highlight the misleading role of base effects though**. When looking at year-on-year changes we are still comparing "post vaccine" prices with "pre-vaccine" ones, and on a three-month change basis core inflation for October is under 4% annualised, against a peak above 10% annualised in June 2021,

but even with this metric the acceleration in rents and "other components" is visible (see Exhibits 3 and 4). The jury's out, but hawks can find enough in the data to justify their views.

Exhibit 3 – It's spreading

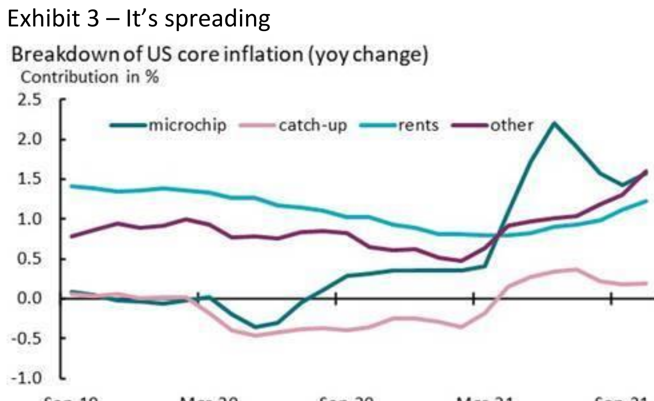
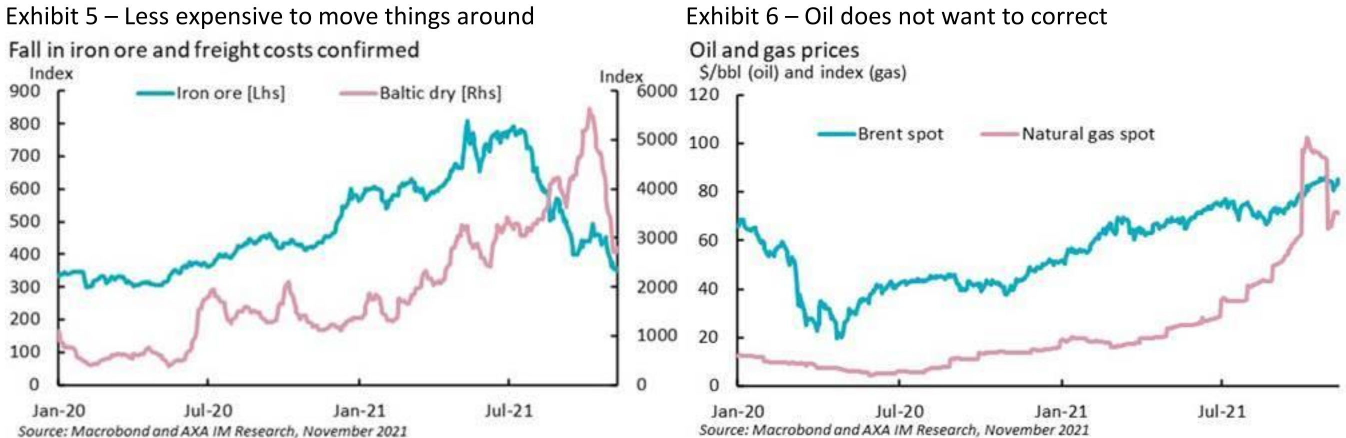


Exhibit 4 –Less spectacular when controlling for base effects

Last week we praised Powell's capacity to retain optionality for next year, but we also shifted our baseline to a hike in December 2022, from March 2023. We remain less gun-ho than the market pricing though, which sees the lift-off in September. **As spectacular as the upswing in consumer prices is now, we think that due attention is needed to some reassuring developments in "upstream" inflation developments**. Three weeks ago, we noted in Macrocast the tentative correction is some key international prices, but since then the improvement has become even more visible. The ongoing decline in the Baltic dry index would suggest that at least some of the global supply-side disruptions are starting to ease (see Exhibit 5). On the energy side, oil staying stubbornly above USD80/bbl and Organization of the Petroleum Exporting Countries (OPEC)'s refusal to lift output are of course a source of concern, but at least some loosening has taken place on the gas market (Exhibit 6). Of course, it may be that these "upstream" forces will materialise too late and that by that time endogenous inflation has taken hold in the US via the labour market, but it is far from a done deal.

Exhibit 5 – Less expensive to move things around

Exhibit 6 – Oil does not want to correct



Still, judging by the developments on the equity market, which is still doing remarkably well despite a pricing of a Fed which sees the lift-off as imminent, **investors may be a bit too sanguine about the possibility that such an early monetary tightening could nip inflation in the bud without triggering a significant economic slowdown**. Indeed, in the pre-emptive tightening the market is pricing, the Fed would be dealing with a level of demand at or just above trend hitting a still constrained supply – taking for instance the form of a "rationing" in available workers due to the continuation of the current deficit in labour participation. So, we are not talking about the usual "taking off the froth" from excess demand to engineer a soft landing. **Under the current conditions, the monetary tightening would have to take demand into quite a lot of compression to elicit a return of core inflation to 2%.** Although it would probably look "elegant" at first glance to envisage a small, early tightening to insure the US against a persistent upward shift in the inflation regime, we would be worried that the central bank would face a second credibility issue in rapid succession if (i) immediately after having ditched average inflation targeting it could not

quickly obtain a visible deceleration in consumer prices thanks to its small hike or conversely (ii) the Fed "inadvertently" triggered a significant economic slowdown so fast after the pandemic recession.

But anyway, **at least for now, the key point is that the market believes "Powell could do it" without triggering massive output loss and that's a net positive**. That the Fed remains credible – i.e. as long as inflation expectations remain close to its target - helps to contain any market-led tightening in financial conditions while we wait for observed inflation to finally fall.

As a corollary, we think that Joe Biden should re-appoint Biden rather than bring a seemingly more dovish chairperson to the Fed. While we already discussed in Macrocast what would be the *political* rationale for making someone like Lael Brainard the next Fed boss – it would send an olive branch to the left of the Democratic caucus in Congress which has some reasons to resent Biden's latest decisions in the fiscal realm. But in the economic realm, it could be counterproductive.

Let's consider two symmetric cases. In the first, the new Fed boss is *genuinely* more dovish than Powell, i.e. would tighten monetary policy less/later than Powell for any given level of inflation. If his or her preferences are obvious, then the market would be right in pricing a steepening of the curve, with long-term interest rates rising fast to take on board higher expected inflation. From the point of view of the US administration, this would be double-whammy with higher – unpopular – inflation and fast-rising borrowing costs on a public debt above 100% of GDP. It's only if Powell successor were to re-instate Quantitative Easing (QE) to control the entirety of the yield curve that the treasury could be protected, but this would be far-fetched even for the most dovish potential candidates to the seat.

In the second case, the reaction function of the supposedly more dovish new Fed boss is in *reality* not very different from Powell's (that's our suspicion for Brainard), but the mere fact that he or she would have been chosen to replace Powell would be seen by the market as an indication policy would remain loose for longer. Then, he or she could be strongly incentivised to establish its credentials by hiking faster than what Powell would have done, with of course the risk of severe damage to the recovery.

Considering the conclusions of these two simple thought experiments, we are confident that Biden's rational choice, despite the short-term political cost, should be to re-appoint Jay Powell. Press reports see the decision for just after Thanksgiving (25 November).

Noisy Frankfurt

The respite we noted last week did not last long, and the market has come to price the ECB's first 10 basis point hike for the summer of 2022 again, at the same time as the Fed's first 25 bps move (see Exhibit 7). It is getting difficult to follow the gyrations in the communication from some members of the Governing Council. Holzmann two weeks ago came out to talk down overly aggressive market pricing of the ECB rate lift-off but chose last week to comment that quantitative easing could stop in the autumn of 2022. We are concerned that some members are engaging in a form of "reverse engineering": if policy rates can't be raised before quantitative easing is over, then it becomes crucial for the most hawkish members to obtain an early exit from QE.

Board member Isabel Schnabel provided a clear rebuke to the possibility to reverse the sequencing : "*in raising policy rates before ending net asset purchases, central banks would be willingly accepting losses on their balance sheets that would ultimately lead to losses for the average taxpayer"*. We are not certain this is the strongest hurdle from a macroeconomic point of view (we would be more focused on the credibility loss, since this would entail doing the opposite of what the current forward guidance says) but in countries focused on fiscal discipline it is probably a powerful argument. Yet, Schnabel also commented on the distributional impact of quantitative easing – benefiting the wealthiest individuals – with a twist via the rise in house prices. The "mood music" coming from some quarters of the ECB points to a "trickle" of QE next year, and the market is taking notice (10-year Italian yields has come close to 1% again). As often, it may unfortunately some further market movements to make the hawks reconsider and support a higher Asset Purchase Programme (APP) for longer (our baseline is EUR40bn/month continuing into the entirety of 2022 "at least").

Exhibit 7 – No more Fed-ECB lag (again)

Market pricing of first rate hike

Fed 25bp · ECB 10bp · BoE 15bp

Nov-24, Apr-24, Oct-23, Mar-23, Aug-22, Feb-22, Jul-21

Sep-21, Oct-21, Nov-21

Source: Bloomberg and AXA IM Research, November 2021

Euro-Covid

While the governing council is squabbling over the next steps of monetary policy, the short-term macro outlook may be slightly altered by the return of pandemic concerns in key economies in the Euro area. The Netherlands have returned in "partial lockdown" over the weekend, and all eyes are now on Germany. However, despite the new spectacular flare-up in cases (see Exhibit 8), casualties remains low relative to past peaks (see Exhibit 9), even it is creeping up towards the elevated – by European standards – level seen in the UK which has been tolerated for months now without much action from the government. The ongoing negotiations towards a new coalition don't make it easy to make "hard decisions" in Berlin either. Our baseline though is that the "Franco-Italian" model – strict enforcement of sanitary passes – will gain more traction in the countries in Northern Europe which had so far been reluctant to use this strategy, allowing to avoid massive, indiscriminate lockdowns. This would limit the economic impact of the ongoing flare-up, even if we would not exclude some visible effect on consumption, with some measure of "self-restraint" in spending in the most affected areas.

Exhibit 8 – Spectacular rise in cases in Germany

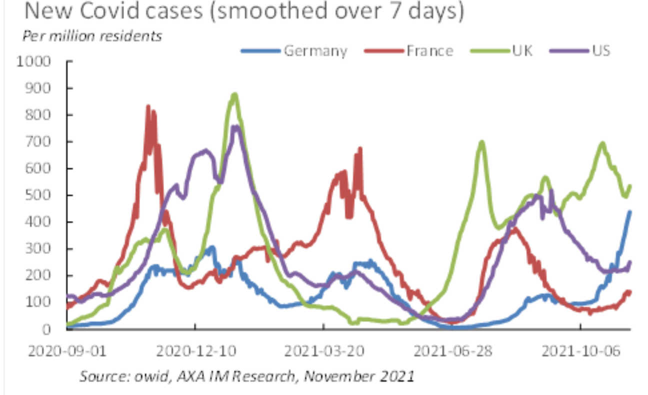
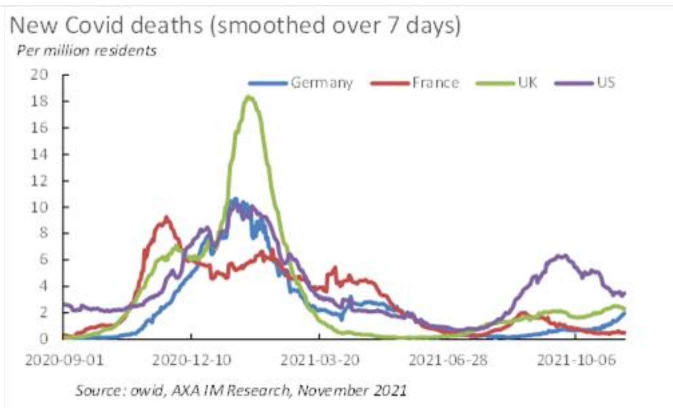


Exhibit 9 – Casualties remain low



What's new on the Eastern front?

We need to keep an eye on the situation on the Eastern border of the EU. **We were reassured on Sunday though by some appeasing words from Vladimir Putin.** He made it plain that Moscow would consider a move from Belarus to turn the tap off gas to the EU as a "breach of contract" with Russia, and that he had rejected a defence ministry proposal to hold snap Black Sea military drills in response to North Atlantic Treaty Organization (NATO) activity *"because [he] doesn't want to escalate tension in the region"*. Maybe with the legislative elections in Russia now behind him (with little visible protests after the results despite widespread allegations of electoral fraud) and the presidential ones still quite far away (2024), there is no need, at least immediately, to stoke geopolitical tension for domestic gain.

Country/Region	What we focused on last week	What we will focus on in next weeks
US	• CPI inflation (Oct) rose to a 30-yr high of 6.2% as gas, but domestic elements inc rents added. Prices set to rise more in months to come. • US PPI inflation unchanged at 8.6% (yoy), core 6.8% suggesting signs of easing external shock • Fed members (Bullard, Clarida) discuss prospect of 2022 rate hike • Mortgage delinquencies and foreclosures continued to normalise in Q3	• President Biden suggested Fed Chair decision by Thanksgiving - expect Powell for 2nd term • Retail sales (Oct) expected strong. Building on Aug and Sept rebounds, Q4 outlook more solid than Q3 – to support GDP rebound • Industrial output (Oct) and Empire State and Philly Fed indices (Nov) watched for supply-chain improvement • Presidents Biden and Xi to hold virtual summit
Euro Area	• Nov ZEW economic sentiment fell on current conditions but expectations improved strongly • Sept IP for Italy was flat at +0.1%mom, but above final EMU IP (-0.2%mom) • Oct final HICP confirmed for Ge at 4.6%yoy but slightly revised down for Sp to 5.4% • Ge exports down by 0.7%mom, imports flat	• Final HICP (Oct) for Fr and Italy and aggregated EMU • Q3 employment figures should point to a rapid recovery of the labour market • Q3 Fr unemployment rate • Oct car registration to assess any rebound especially in Germany
UK	• Q3 GDP +1.3% in line with our forecast/softer than consensus. Sep GDP +0.6%, firmer than expected, reflecting downward revision to Aug • Mfg and IP fell m/m by -0.1% and -0.4% • UK renews Art 16 threat of NI Protocol • BoE announces consultation on CBDC- Bitcoin	• PAYE payrolls (Oct) – first post furlough labour market release. Unemployment (Sep) • CPI inflation (Oct) – consensus 3.8% as 12% Ofgem price cap rise bites – see upside risk • Retail sales (Oct) consensus for 0.5% mom rise, despite households income squeeze struggle
Japan	• Nov Reuters Tankan Mfg fell to a 7-month low while non-Mfg index slightly rose • Oct Economy Watchers Poll strongly increased to 55.5 from 42.1 • Corp goods price surged to 1.2% mom(8%yoy)	• Prelim GDP figures (Q3) should be slightly neg (AXAIM: -0.1%qoq /cons: -0.2%) as domestic demand has been weak and supply shortages impacted key industrial sectors • CPI (Oct)
China	• Inflation pressure continues to build thanks to higher fuel and food prices • Total credit growth stays at 10%, but there are signs of cycle bottoming	• Monthly data to show some sequential improvement in activity, but overall growth remains weak
Emerging Markets	• Rate hikes in Mexico (+25bp to 5%), Peru (+50bp to 2%) and Romania (+25bp to 1.75%) • Q3 GDP slowed in Poland (5.1%), Philippines (7.1%) and Indonesia (3.5%). It contracted in Malaysia (-4.5%), impacted by lockdowns • Inflation (Oct) accelerated across the board in LatAm and CEE	• CB: Rates should stay on hold in South Africa (3.5%), Philippines (2.0%) and Indonesia (3.5%). Hungary should hike +20bp to 2.0% • Q3 GDP numbers for Bulgaria, Chile, Colombia, Hungary, Slovakia, Thailand and Romania • Inflation (Oct) figures for Bulgaria, Israel, Saudi Arabia, Slovakia and South Africa

Upcoming events

US :	Mon: Empire State survey (Nov); Tue: Retail sales (Oct), Ind prod (Oct), Business inventories (Sep), NAHB Housing indx (Nov), Long-term investment flows (Sep); Wed: Housing starts (Oct), Building permits (Oct); Thu: Weekly jobless claims (12 Nov), Philly Fed indx (Nov), Leading indx (Oct)
Euro Area:	Tue: EU19 GDP (Q3,p), Fr & It HICP (Oct,f); Wed: EU19 CPI (Oct,f); Fri: Ge PPI (Oct), Fr ILO Unemployment rate (Q3)
UK:	Tue: Unemployment (Sep), Average earnings (Sep); Wed: Inflation (Oct); Fri: GfK consumer confidence (Nov), PSNB (Oct), Retail sales (Oct)
Japan:	Sun: GDP (Q3,p); Mon: Ind prod (Sep,f); Tue: Trade balance (Oct), Private 'core' machinery orders (Sep); Thu: CPI (Oct)
China:	Mon: Ind prod (Oct), Retail sales (Oct), Fixed asset investment (Oct)

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