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Research & Strategy Insights

Peak hawkishness reached? Give it a bit more time

Monthly Investment Strategy Oped

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Key points

- Central banks' hawkish rhetoric continues to get more intense despite the state of the financial markets.
- The Federal Reserve no longer tries to talk up a "painless tightening" and acknowledges that pain is in the pipeline for inflation to be brought back under control. Yet, there is a readiness to "look a recession in the eye".
- This creates a difficult configuration for markets. We think that in the second half of this year, the deterioration in the dataflow will make it impossible for monetary policy to deliver all the tightening that is currently priced in, but before such a change in mood at central banks is effective, the economy needs to slow down more.

Giving up on "painless tightening"

We wrote last month that the monetary policy hawks found themselves in a "sweet spot", as inflation continued to move higher – and in the case of the Euro area spread to more sectors – while the data flow on the real side of the economy was still on the whole decent despite the fallout from the Ukraine war. Jay Powell could comfortably argue that there is so much overheating in the US that the economy can take a quick return to the Federal Reserve (Fed)'s neutral rate – the Fed's central tendency between 2.3% and 2.5% – without triggering a significant slowdown. Meanwhile, signs that the European Central Bank (ECB) is willing to accelerate its own lift-off are accumulating fast, with usually centrist Governing Council members such as Villeroy de Galhau explicitly reconciled with seeing the ECB's policy rate in positive territory by the end of the year (we now expect the first hike for July). It is a "static" view though. We signalled last month our belief that the second half of 2022 was going to become much harder to navigate, and accordingly since then some of the forward-looking component of business confidence surveys – i.e. hiring intentions in the US – have started to move South, while disappointing GDP prints in Euro area countries in the first quarter (Q1) suggest that economic activity was already sub-par before the brunt of the Ukraine war had hit. Markets are already taking a dim view of the months ahead, pricing in a deterioration in corporate turnover and profits.

This new configuration begs the question of whether "peak hawkishness" has been hit, to the point that central banks would need to reconsider the pace of their normalization trajectory. It's clear that the Fed's confidence in its capacity to engineer a "painless tightening" is rapidly eroding. After downgrading the soft landing of the US economy into a "*soft-ish*" landing in his baseline, Jay Powell has been candid enough to concede that the unemployment rate may have to *"move up by a few ticks"* but Neel Kashkari was more blunt – and in our view more realistic – when he put forward the key question

"*if we really have to bring demand down to get inflation in check, is that going to put the economy into recession? And we don't know".* He is not a voting Federal Open Market Committee (FOMC) member this year, but his readiness to utter the "r" word is probably telling of the general attitude at the Fed. Yet, acknowledging that policy normalization will inflict significant pain does not mean that the Fed is ready to give up on delivering said normalization. At this stage, it seems that quite a few members are ready to take the risk of a recession, and the generalization of statements supporting the possibility to bring the policy rate *above* the neutral rate – endorsed by Powell himself last Tuesday – suggest that the need to re-take control of inflation trumps any other consideration, at least for now.

True, while headline and core inflation for April exceeded market expectations in the US, at least the index decelerated relative to March. Still, there are unfortunately signs that price pressure continues to widen. Used cars – which stand for only 5% of the basket for core – have been the bane of US inflation watchers since the exit from the worst of the pandemic given the wild gyrations in their price (the year-on-year changed peaked at a whopping 45% in June 2021). Excluding this item from the calculation, no deceleration has appeared yet.

For now, Biden's anti-inflation policies seem to focus on areas where he is unlikely to gain support from Republicans. The US President expressed an openness to reverse trade tariffs slapped on Chinese products by the previous administration. He called on Congress to pass the Clean Energy and vehicle tax credits, as well as fixing what he called "glitches" in the Affordable Care Act and allowing Medicare to negotiate drug prices, all issues on which Republicans – and some moderate Democrats – are likely to mount a stubborn resistance. In a way, resolving inflation in the US may come less from what the Biden administration will do than from what it won't. Indeed, at least the "demand-side" component of the current inflation spike can be alleviated by allowing the fiscal stimulus from the last few years to "die down", which would magnify the impact of the Fed tightening.

In the Euro area however, the quantum of fiscal support is currently rising, rather than falling, as governments are mitigating the impact of higher energy and food prices on real income. Some hawkish members of the ECB board – such as Isabel Schnabel – explicitly criticized this approach as "fuelling the inflation fire". The more fiscal support there is, the more the ECB will feel comfortable about normalizing monetary policy to fight the risk of seeing inflation expectations de-anchoring. In addition, the Fed' relentless hawkish rhetoric continues to push the dollar higher, and the euro's weakness will add to the inflation pressure, pushing the ECB towards tougher rhetoric and action.

It can't be better before it's worse first

So, it seems central bankers are ready to "look a recession in the eye" given their concerns over inflation. Still, there is always a difference between entertaining the idea of tolerating a *potential* recession and dealing with an actual one. Yet, we suspect that it will take more than a deterioration in soft data – such as business surveys – to stay their hand. A decline in hard data, with probably a focus on the labour market given the focus on wage dynamics – to be clear, some significant rise in the unemployment rate – may be needed to trigger a re-consideration of the quantum of tightening needed. This is likely to take some time. In Europe, specifically, one factor which may trigger a change of mood at the ECB would be a return of acute sovereign spread widening, since the development of the "anti-fragmentation weapon" they said they were ready to deploy if need be is fraught with political and technical complications. If fragmentation gets very bad, then it's the overall ECB stance which will have to change. But there again, it may take time (the proximity of general elections in Italy in 2023 may however make this a burning issue towards the end of 2022).

This does not create a great configuration for markets in the immediate future, in the sense that worse news needs to hit the headlines before a significant downward revision in the quantum of central bank hikes being priced in can start. To get the monetary policy "put" into action, the economy – and profits – need to hurt more.

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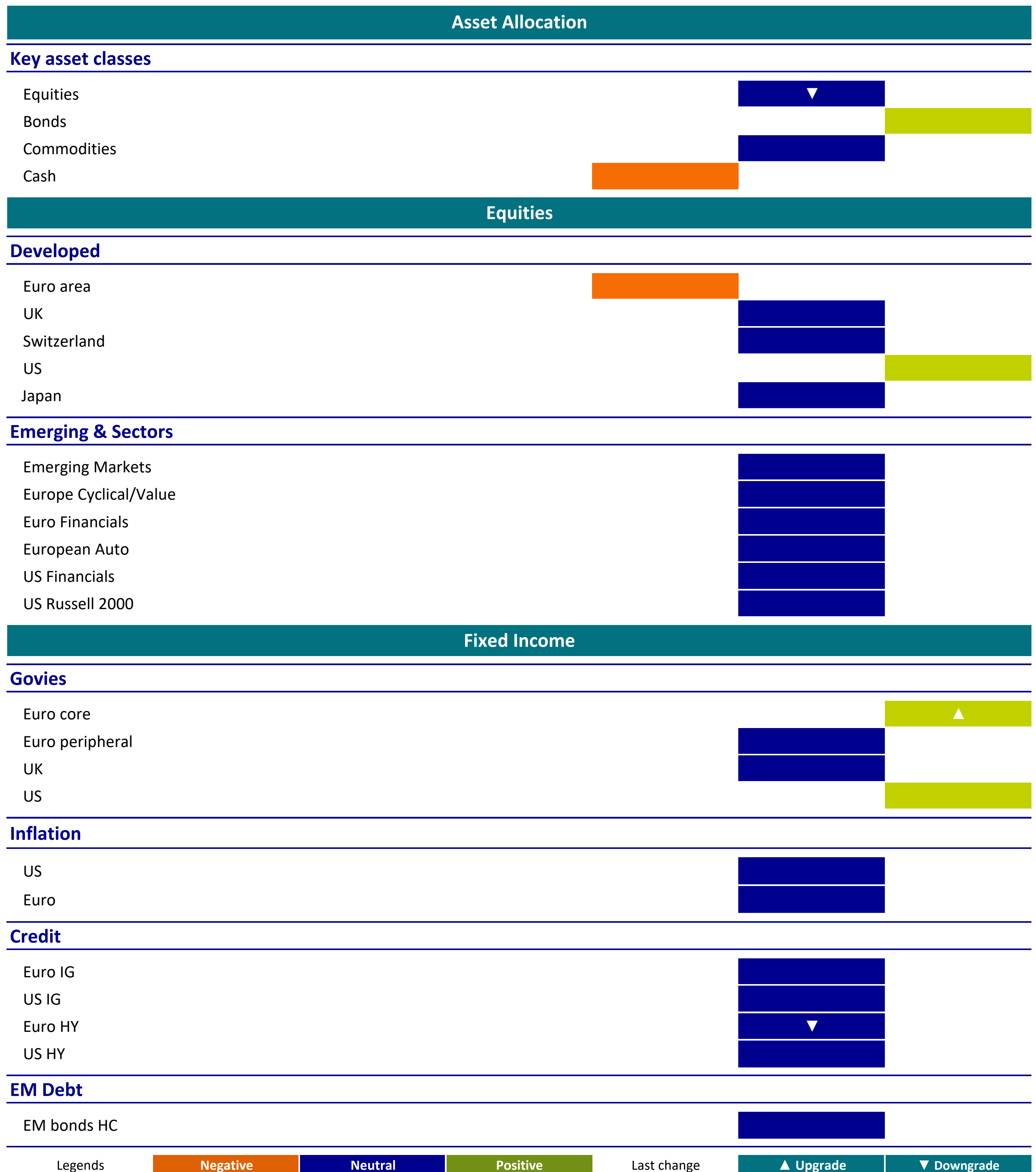
Recommended asset allocation



Asset Allocation	View	Last change
Key asset classes		
Equities	Neutral	▼ Downgrade
Bonds	Positive	
Commodities	Neutral	
Cash	Negative	
Equities		
Developed		
Euro area	Negative	
UK	Neutral	
Switzerland	Neutral	
US	Positive	
Japan	Neutral	
Emerging & Sectors		
Emerging Markets	Neutral	
Europe Cyclical/Value	Neutral	
Euro Financials	Neutral	
European Auto	Neutral	
US Financials	Neutral	
US Russell 2000	Neutral	
Fixed Income		
Govies		
Euro core	Positive	▲ Upgrade
Euro peripheral	Neutral	
UK	Neutral	
US	Positive	
Inflation		
US	Neutral	
Euro	Neutral	
Credit		
Euro IG	Neutral	
US IG	Neutral	
Euro HY	Neutral	▼ Downgrade
US HY	Neutral	
EM Debt		
EM bonds HC	Neutral	

Legends: Negative | Neutral | Positive — Last change: ▲ Upgrade | ▼ Downgrade

Source: AXA IM Macro Research – As of 23 May 2022

Macro forecast summary

Real GDP growth (%)	2020	2021*		2022*		2023*	
		AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
World	**-3.1**	**6.1**		**3.2**		**3.0**	
Advanced economies	**-5.0**	**5.1**		**2.5**		**1.5**	
US	**-3.4**	**5.5**	5.6	**2.5**	3.2	**1.4**	2.2
Euro area	**-6.7**	**5.4**	5.1	**2.1**	2.8	**1.2**	2.3
Germany	**-4.9**	**2.8**	2.7	**1.2**	2.2	**1.7**	2.5
France	**-8.0**	**7.0**	6.6	**2.7**	3.1	**1.0**	1.8
Italy	**-9.0**	**6.5**	6.3	**2.3**	2.7	**0.6**	1.9
Spain	**-10.8**	**5.0**	4.7	**3.5**	4.6	**1.6**	3.3
Japan	**-4.9**	**1.7**	1.8	**1.8**	2.1	**2.1**	1.8
UK	**-10.0**	**7.2**	7.0	**3.8**	3.9	**0.9**	1.4
Switzerland	**-2.5**	**3.5**	3.5	**2.0**	2.6	**1.3**	1.8
Canada	**-5.2**	**4.4**	4.6	**3.9**	3.9	**2.3**	2.8
Emerging economies	**-1.9**	**6.7**		**3.6**		**4.0**	
Asia	**-0.7**	**7.1**		**4.8**		**5.1**	
China	**2.2**	**8.1**	8.0	**4.5**	4.9	**5.2**	5.1
South Korea	**-0.9**	**4.0**	4.0	**2.0**	2.8	**2.0**	2.5
Rest of EM Asia	**-4.2**	**6.2**		**5.5**		**5.2**	
LatAm	**-7.0**	**6.8**		**2.6**		**2.6**	
Brazil	**-3.9**	**4.6**	4.7	**0.9**	0.6	**1.9**	1.5
Mexico	**-8.2**	**4.8**	5.6	**2.4**	1.7	**2.2**	2.2
EM Europe	**-2.0**	**6.5**		**-0.2**		**1.0**	
Russia	**-2.7**	**4.7**		**-7.0**		**-3.0**	
Poland	**-2.5**	**5.7**	5.3	**4.2**	3.9	**3.3**	3.4
Turkey	**1.8**	**11.0**	9.9	**3.9**	2.1	**3.4**	2.7
Other EMs	**-2.5**	**5.4**		**3.0**		**3.0**	

Source: Datastream, IMF and AXA IM Macro Research – As of 23 May 2022 * Forecast

CPI Inflation (%)	2020	2021*		2022*		2023*	
		AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	**0.7**	**3.2**		**6.4**		**3.0**	
US	**1.2**	**4.7**	4.6	**7.6**	7.0	**4.0**	3.2
Eurozone	**0.3**	**2.6**	2.5	**6.6**	6.5	**2.4**	2.4
Japan	**0.0**	**-0.2**	-0.2	**2.2**	1.6	**1.0**	1.0
UK	**0.9**	**2.6**	2.5	**7.6**	7.2	**3.5**	3.9
Switzerland	**-0.7**	**0.5**	0.5	**2.0**	2.0	**1.0**	0.9
Canada	**0.7**	**3.4**	3.4	**6.2**	5.2	**3.4**	2.5

Source: Datastream, IMF and AXA IM Macro Research – As of 23 May 2022 * Forecast

These projections are not necessarily reliable indicators of future results

Forecast summary

Central bank policy Meeting dates and expected changes (Rates in bp / QE in bn)		Current	Q2-22	Q3-22	Q4-22	Q1-23
United States - Fed	Dates	0.75-1.00	3-4 May 14-15 June	26-27 July 20-21 Sep	1-2 Nov 13-14 Dec	Jan Mar
	Rates		+1.00 (1.25-1.50)	+0.75 (2.00-2.25)	+0.5 (2.50-2.75)	unch(2.50-2.75)
Euro area - ECB	Dates	-0.50	14 April 9 June	21 July 8 Sep	27 Oct 15 Dec	Feb Mar
	Rates		unch (-0.50)	+0.5(0.00)	unch (0.00)	unch(0.00)
Japan - BoJ	Dates	-0.10	27-28 April 16-17 June	20-21 July 21-22 Sep	27-28 Oct 19-20 Dec	Jan Mar
	Rates		unch (-0.10)	unch (-0.10)	unch (-0.10)	unch(-0.10)
UK - BoE	Dates	1.00	5 May 16 June	4 Aug 15 Sep	3 Nov 15 Dec	Feb Mar
	Rates		+0.5 (1.25)	+0.25 (1.50)	unch (1.50)	unch(1.50)

Source: AXA IM Macro Research - As of 23 May 2022

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