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Research & Strategy Insights

Fed Hawk Down

Global macro monthly

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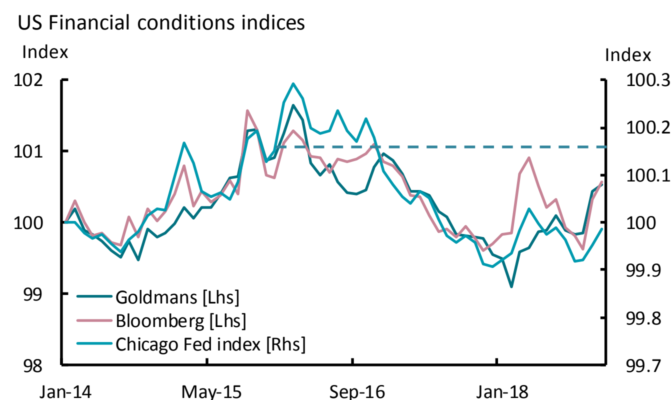
Key points

- The US Federal Reserve closed 2018 with its fourth interest rate hike of the year. However, its rhetoric wasn't exactly dovish, leading many to believe tightening will continue
- Despite further disappointing macro data, in line with our below-consensus forecasts, the European Central Bank expressed "continuing confidence"
- The European political backdrop remains dramatic – from Brexit to the Italian budget saga and France's "yellow vests". But compromises are still possible
- Japanese growth may rebound only modestly as net trade keeps weighing on the outlook
- China's macro news flow has disappointed but the Central Economic Work Conference confirmed more accommodative policies for 2019
- Similarly, indicators in other emerging markets pointed to a potential further economic slowdown ahead

The Fed tried and failed to deliver a dovish hike

As markets, and we expected, the US Federal Reserve (Fed) increased the Fed Funds Rate by 0.25%, to a range between 2.25% and 2.5% on 19 December. A unanimous Federal Open Market Committee vote came in line with expectations, despite financial market weakness in the previous weeks (Exhibit 1). In the accompanying statement, the Fed acknowledged the material tightening in financial conditions since its November meeting but maintained that "some" further gradual increases would likely be warranted. Similarly, the Summary of Economic Projections acknowledged a softer outlook, with lower GDP growth and inflation forecasts. And the "dots" also moved lower with the median estimate now consistent with the Fed hiking rates twice in 2019 and once more in 2020 (to 3%-3.25%).

Exhibit 1: US financial conditions tighten across metrics



Source: Federal Reserve Bank of Chicago, Bloomberg, Goldman Sachs and AXA IM R&IS calculations

In his press conference, Fed Chair Jerome Powell stressed the modest adjustment in the outlook for policy, in response to the tightening in financial conditions. Moreover, he emphasised that the Fed's macro outlook for next year was "positive" or "strong". If the Bank sought to provide reassurance that US activity was most likely to only slow modestly, the immediate market reaction suggested it failed, as equities resumed their steep declines and Treasury yields fell.

Movements in financial conditions will remain critical in terms of where interest rates go from here. We now believe there will be two hikes in 2019 and no change in 2020, with a

pause in March and the next rise in June 2019 (previously we forecast three rises in 2019 and one cut in late-2020). We are increasingly mindful of market-based recession indicators, pointing to a rising probability of a US recession within 12-months' time, which would reduce our rate outlook materially by end-2020.

ECB expresses "continuing confidence with increasing caution"

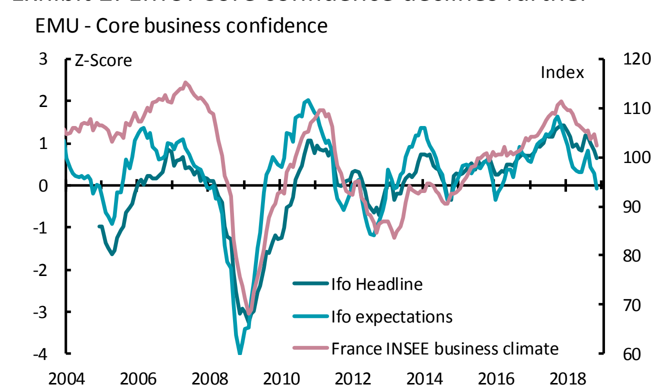
As widely expected, European Central Bank (ECB) President Mario Draghi confirmed the end of the institution's asset purchase programme at its December meeting. He left forward guidance on rates unchanged but the Bank enhanced its forward guidance on reinvestment, by switching from a state contingent, to a combination of state/date contingent guidance – a unanimous decision, which was emphasized by Draghi. Technical details revealed that the new ECB capital key will be progressively phased in, and that reinvestments will continue to adhere to the principle of market neutrality, via smooth and flexible implementation, in particular helped by the reinvestment horizon – distributed over a year instead of three months, as previously stated.

As such a change in portfolio composition and an "operation twist" (skewing reinvestments toward longer bond maturities) are out of the picture for now, in line with our expectations – as technical constraints are elevated, with a high ownership share of ECB's holding in some countries, such as the Netherlands Germany, Portugal, and the 33% issue/issuer limit. Regarding targeted longer-term refinancing operations (TLTROs), President Draghi said that they were mentioned but not discussed. We were not expecting any announcement on TLTROs at this meeting, as we did not think the ECB wanted to pre-commit but rather preferred to keep the facility open as an option. However our growth forecast is much more cautious than the ECB, where we expect 2019 GDP of 1.4% vs. the Bank's 1.7%. And given the challenges banks face in 2019, (having to repay TLTRO II loans, while TLTRO II will drop below a residual maturity of one year at the end of June 2019, thus becoming ineligible for Net Stable Funding under Basel III), we believe TLTRO funding will be rolled in some form in the first half of next year. We expect an announcement will potentially take place in March.

On economic activity, President Draghi acknowledged that growth has disappointed and that it was not only due to country and sector temporary factors, but also to more persistent components – growth is trending back to its potential. He blamed softer external demand and increased uncertainty, which led the ECB to revise down growth by 0.1 percentage point (pp) to 1.9% in 2018 and 1.7% in 2019, still above our and consensus forecasts for 2019. Draghi also mentioned that risks were broadly balanced but quite interestingly, that the balance of risks was moving to the downside. In our view, downward revisions are likely to occur again in March, for both growth and core inflation. Indeed, the latest activity indicators are not positively oriented (Exhibit 2), with December euro area composite Purchasing Managers Index (PMIs) falling to a four-year low, on a growing list of concerns including global trade, economic outlook, rising political uncertainty, Brexit, tighter financial conditions and auto-sector weakness.

At the country level, business surveys remained depressed with the December IFO disappointing on weaker expectations, while the French INSEE dropped to a two-year low owing to a seven-point correction in retail trade confidence. The latter was clearly related to the yellow vests movement, which we believe will weigh on growth, pushing the fourth quarter (Q4) GDP to 0.2% quarter-on-quarter (qoq). Incidentally, the French INSEE revised down Q3 GDP to 0.3%qoq in the final GDP estimate, from 0.4% previously, mechanically reducing our 2018 and 2019 growth forecasts to 1.5% and 1.3%, respectively (-0.1pp).

Exhibit 2: EMU: Core confidence declines further



Source: Datastrream and AXA IM R&IS calculations

Meanwhile in France, President Emmanuel Macron announced a series of fiscal measures to abate the "yellow vest" protests, including the extension of tax credits, which will provide a monthly boost of €100 for minimum wage earners, the detaxation of overtime and the cancellation of the 1.7% tax hike for pensioners with an income of below €2,000 per month. We estimate these measures will cost circa €11bn – including approximately €4.5bn from the cancellation of the fuel tax and various incentive schemes for the replacement of older cars and home boilers. This is likely to push the fiscal deficit to 3.4% in 2019, from 2.8% in the budget and 2.6% in 2018. Yet, the 2020 deficit should be back below the 3% threshold, as the 2019 deficit will also be boosted by a significant one-off boost with the transformation of tax credit CICE[1] into a permanent payroll tax cut, worth some 0.9% of GDP.

The European Union (EU) was also kept busy in December with its budget negotiations with the Italian government. A

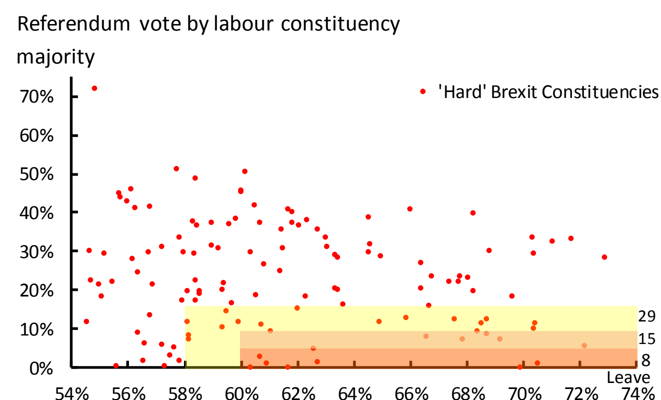
[1] Tax credit for employment and competitiveness

deal was struck, as the Giuseppe Conte Government accepted to amend its budgetary plans, lowering its deficit target to 2.04% of GDP, instead of 2.4%. The lower deficit target is mainly a result of additional consolidations measures worth 0.6pp of GDP, while on the other side the European Commission (EC) agreed to use the "flexibility clause" for exceptional infrastructure spending on 0.2pp of GDP spending, i.e. it will not be included in the computation of the structural deficit. Altogether this implied that the EC will not open an so-called excessive deficit prodecure, or EDP, against Italy. In our view, this represents a political compromise, aimed at reducing anti-EU rhetoric, ahead of the European elections.

UK and Europe: The final countdown

Despite having reached a Withdrawal Agreement with the EU, Prime Minister Theresa May, refused to table this before Parliament for fear of a hefty defeat – of more than 110 Members of Parliament (MPs). Subsequently, May faced and survived a challenge from within her own Tory party. She has so far escaped an expected challenge to her government from the opposition Labour party, with leader Jeremy Corbyn adopting a non-binding no confidence vote in the PM, and not the wider government. Meanwhile May has been attempting to garner more political support from EU members, in the form of reassurances of the temporary nature of any backstop arrangement. However the EU has made clear re-negotiation is off the table.

Exhibit 3: Can some Labour MPs rescue PM May's deal?



Source: UK National Statistics and AXA IM R&IS calculations

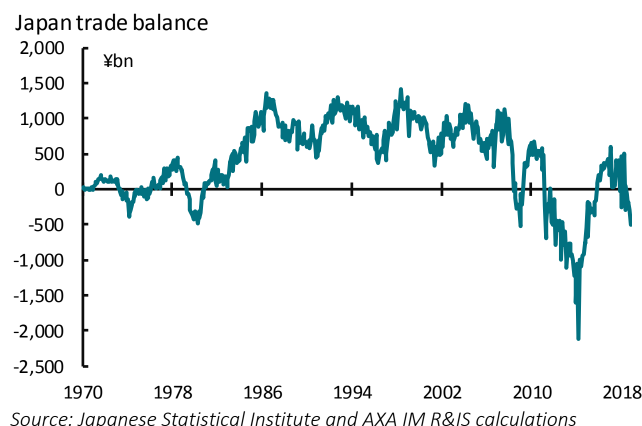
Even though we are now in the final three-month countdown, with a no-deal Brexit still the default option (in case no proactive choice is made), we maintain our baseline scenario of a non-disruptive outcome for two reasons. First, May's deal may receive more backing from Labour supporters – 129 of whom come from constituencies, where more than 55% voted to leave the EU (Exhibit 3). This support may become more apparent if Labour fails to force an early election as we expect. Second, the European Court of Justice's decision that the UK can unilaterally revoke Article 50 reduces the probability of a hard Brexit, as MPs could "stop the clock" and reassess the best strategy.

Meanwhile, the Bank of England's meeting on 20 December was expectedly uneventful with the Bank Rate kept at 0.75%, the asset purchase facility at £435bn and the corporate bond purchase programme at £10bn – all of which came via a unanimous vote. The focus was on Brexit uncertainty and the softening in the global outlook. We still expect that the next hike will happen May, assuming the UK avoids a "no deal" Brexit, with another raise later in November.

Japan: Modest rebound, net trade weighing

In Japan, the Q3 GDP second estimate declined sharply (-2.5%qoq annualized instead of -1.2% published earlier), mainly due to a downward revision to capex and higher natural disaster damages. But a large rebound for Q4 is expected even if the most recent data has disappointed, especially industrial production and shipments: -1.1% and -2.1% month-on-month (mom) in November against +2.9% and +3.5% the previous month. The activity should reach 2%qoq annualized, meaning that GDP growth for 2018 should average around 0.7%. Looking at the beginning of 2019, the government declared that growth should "pick up moderately". But we believe growth will still be challenged by net trade. (Exhibit 4)

Exhibit 4: Trade still weighing on Japanese growth



Source: Japanese Statistical Institute and AXA IM R&IS calculations

On the price front, "new" core inflation remained low at 0.3% in November and we do not expect a rebound in December. With inflation expectations anchored at this low level, we see "new" core inflation remaining around this level over the first half of 2019, at least.

At its meeting on 19 December, the Bank of Japan left monetary policy unchanged and strengthened the forward guidance on lower long-term interest rates. Yield curve control (YCC) and its tolerable band for 10-year yields has been maintained, the long-term Japanese Government Bonds (JGB) purchases guidelines (increasing the net holding at a

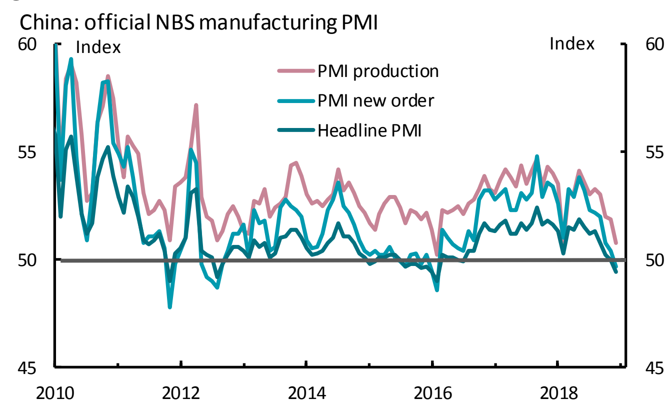
pace of about ¥80tn a year) and risk assets (Exchange-Traded funds) did not change.

China: Further weakness, further policy supports

After a tumultuous 2018, with external and internal shocks creating powerful headwinds for the economy, the latest Chinese data (manufacturing PMIs, industrial production and corporate profits) has shown little sign of abating pressure (Exhibit 5).

The good news is that the policy cycle has already turned, and should become more accommodative in 2019, as foreshadowed by the Central Economic Work Conference (CEWC), the most important (annual) economic event in China. Last month, it confirmed a definitive shift in macro policies towards striking a better balance between short-term growth supports and long-term structural reforms.

Exhibit 5: Contracting PMIs in China confirm weakening growth momentum



Source: CEIC and AXA IM R&IS calculations

For one, the authorities have grown more concerned about the deteriorating trend in the economy and were cognizant of the sharp market reaction to external shocks. The CEWC reiterated the importance of preserving stability in six areas, including employment, trade, finance and investment. With the growth trend unlikely to reverse anytime soon, we think Beijing is on course to deliver more policy supports in the coming months.

Second, to strike a better balance between speed and quality of growth, the CEWC has revealed some key departures in the current stimulus from those of the past. Compared to monetary policy, fiscal policy will do more heavy-lifting this time, with stimulus through household tax cuts, export tax rebates and corporate VAT/fee reductions already hitting the ground. On the flipside, monetary stimulus will be conducted with more caution, as Beijing promises to continue "structural deleveraging".

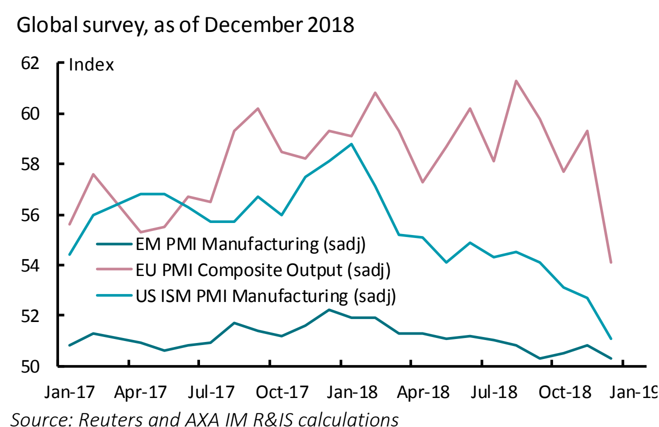
Finally, the CEWC's emphasis on structural reforms came as another reflection of Beijing's intention to strike a policy balance. Some of these reforms are consequences of the Sino-US conflicts, which are forcing China to be more liberal and open, and try to level the playing field for foreign and domestic enterprises. Beijing also vowed to speed up the restructuring of state-owned enterprises (SOEs) via mixed ownership and a better segregation of ownership and operating functions of the companies. If implemented properly, this will represent a leap in China's all-important SOE reforms.

Emerging markets: Further slowdown on its way

The latest PMIs point to a continued soggy outlook for emerging markets (EM) in Asia. In particular, Korea, Taiwan and Malaysia's indices have fallen below the waterline for at least two consecutive months. For the region's export barometers, Taiwan's PMI registered its lowest reading since Q3 2015, while Korea's number ticked up only slightly following November's significant decline. These reflect a particularly grim picture on the external side, with new export orders deteriorating across the board. On the brighter side, Indonesia and Thailand saw a pickup in headline PMIs, with some of these positives attributing to stronger domestic demand. This confirms our view that the domestic engine could be a key offset to external weakness for EM Asia this year.

December leading indicators were rather lacklustre in EM Europe as well, with the exception of Hungary where surveys still point to strong activity. Elsewhere, sharp falls were reported in Poland and the Czech Republic, with more moderate falls in Russia and Turkey, albeit after a recovery seen in November.

Exhibit 6: Global surveys pointing to growth deceleration ahead



Source: Reuters and AXA IM R&IS calculations

Latin America remained nevertheless rather steady; Mexico's PMI was unchanged in December, albeit still slightly below the 50-threshold while Brazil's came in at 52.6. Last month, the newly elected Mexican President Andrés Manuel López Obrador – or AMLO – took office and presented his 2019 economic plan which eased recent concerns, as it contained reasonable fiscal targets. Neigbouring Brazil saw its newly

elected President Jair Bolsonaro take office with a strong set of measures from day one. His primary aims are to crack down on crime, as well as shrinking the size of the state in the economy through privatisations, while offering additional power to the Agriculture Ministry for indigenous land claims.

The reformist ambition needed to restore Brazil's debt sustainability will however face a very fragmented Congress (Exhibit 6).

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