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Research & Strategy Insights

Relative Speed

75 – 18 January 2021

Key points

- Accumulating signs of cyclical softness in the US may help Biden's massive stimulus through Congress, but some compromise will be needed. Powell has nipped in the bud suggestions of an early taper, but we think US long-term interest rates can still rise further. Europe meanwhile is enjoying "positive contagion" from the US: inflation expectations are up, but nominal yields barely moved, and equity is performing well.

Some very tentative signs of progress are emerging on the pandemic front in the Western countries. Lockdowns still work. However, the timing of the re-opening of the economy still depends on the relative speed of the virus propagation and of the vaccination programme. The UK perfectly exemplifies this. While inoculations are happening faster there than in any comparable country, a significant acceleration is still needed to reach the target of covering the most vulnerable segments of the population by mid-February, which the prevalence of a more contagious variant is making even more urgent. In continental Europe, the vaccination programme has not yet really taken off. We maintain our baseline that full normalization should not be expected before this summer.

Some Euro area countries such as Germany and Spain may have (just) avoided another contraction in GDP in Q4, but Q1 looks grim given the intensification in mobility restrictions. In the US, indications of labour market softness are accumulating, with a significant dampening impact on private consumption. This may help Joe Biden get his fiscal package through congress with some bi-partisan support, but we think the massive USD 1.9trn top up to the 0.9trn already agreed is an opening gambit by the incoming administration: necessary compromises will probably shrink the package. Yet, we still think a stimulus of c.10% of GDP this year is likely.

Jay Powell sought to nip in the bud speculations over a quicker than expected taper which would be justified by the stronger fiscal stimulus, but we reiterate our view: merely reassuring on the continuation of the current stance will not suffice to stop the rise in US long-term interest rates. However, Europe seems to benefit from "positive contagion" from the US. Inflation expectations have rebounded in Europe as well, but nominal yields have barely moved. The European equity market outperformed the US. ECB's Schnabel "pre-emptively dovish" interview last week may have helped. We expect similar comments from Christine Lagarde this week after the Governing Council meeting.

The ECB is probably monitoring very closely Italian politics. A "de facto" confidence vote in the government will take place on Tuesday in the Senate. Early elections remain unlikely at this stage, which probably explains the market's restrained reaction. The election of Armin Laschet as leader of the CDU, suggesting continuity with Angela Merkel's European stance, may help keep the peace on the Euro area's bond market.

Lockdowns (still) work

Over the last week, the first signs that the winter wave of Covid is abating somewhat have appeared. Among developed countries, we are currently focusing on the UK, given the prevalence there of a more contagious variant of the virus, potentially informing on the pandemic trajectory elsewhere if this new form of Covid were to take hold. It seems that with the usual lag, the strengthened lockdown is working: positivity rate has fallen (see Exhibit 1) and a tentative decrease in the number of new cases can be observed there in the very latest data (see Exhibit 2). It will take some time before pressure on the UK healthcare system starts easing – there is lag between infections and hospitalisations, and initially the inflow of new patients will significantly exceed the number of current patients being discharged, but there is a flicker of light.

Exhibit 1 – encouraging inflexion

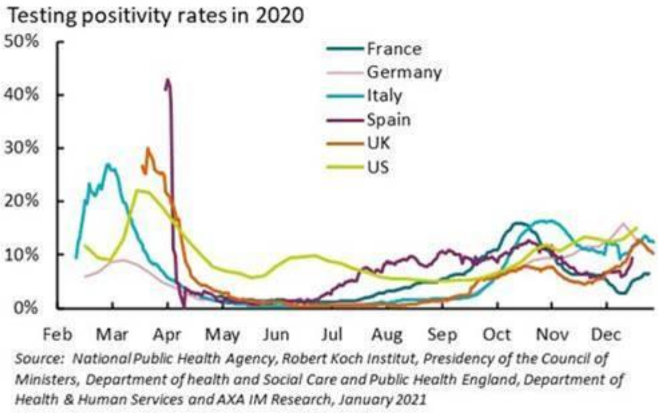
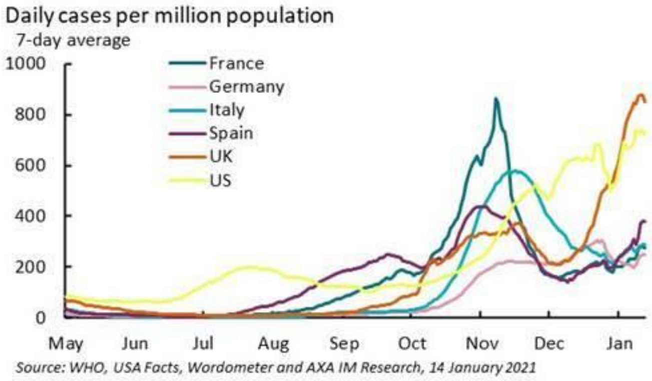


Exhibit 2 – Peak in infection speed just reached?



Given the prevalence of the variant, the UK needs to proceed as fast as possible with its vaccination program, which is already ahead of all comparable countries (see Exhibit 3). At the latest count, the UK was vaccinating 0.3% of its population per day, i.e. c. 200k. However, even if the country has had a very strong start relative to its counterparts, a further acceleration would be needed to get to the government's target, i.e. covering 15 million most vulnerable people by February 15th (a near doubling of the current daily rate to 380K). This is all the more problematic since **the emergence of the variants raises the bar for achieving "collective immunity" and protecting the healthcare system.** Indeed, if Covid becomes more contagious, the probability of the virus meeting a non-vaccinated host rises for any given rate of vaccine coverage in the population, especially since it is still unclear whether the vaccines also prevent transmissions and not just the development of the disease.

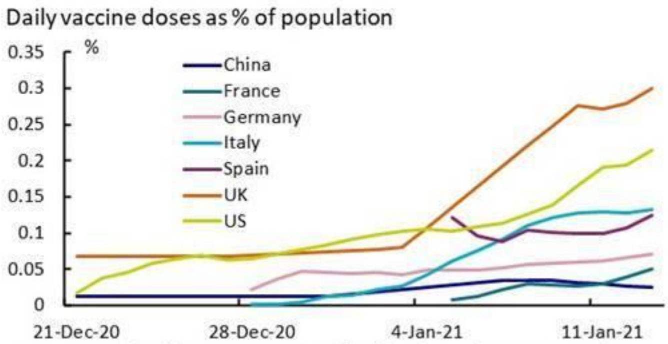
The same reasoning applies to treatment capacity. The idea that full-on normalization could proceed once the most vulnerable – and hence the most prone to severe Covid cases requiring hospitalization – are covered is wrong if the virus reproduction rate significantly rises. According to the US Centre for Disease Control data, in the first half of 2020 (i.e. before the variants were detected), people below the age of 55 accounted for only 7.3% of total Covid related deaths. However, assuming illustratively that everyone above the age of 55 is vaccinated and no one below, if the total number of cases is multiplied by 15 after 2 months (which is what would happen if no restriction hampers a rise of the reproduction rate by 0.5 – see our Macrocast from last week on this), then the total number of casualties would return to the pre-vaccination level: the rise in the number of infections would offset the fact that on average the non-vaccinated part of the population is more resistant to the virus.

This is a very crude calculation since it ignores a lot of variables of interest: thankfully, a lot of the younger people have already developed immunity, those with co-morbidity will have priority on vaccination and the "flip-side" of a more contagious disease if that it exhausts faster its reservoir of potential hosts. Still, the latest pandemic developments continue to point to serious challenges beyond the end of the first quarter of 2021. Our baseline – no full normalization before the summer – is holding.

Also, worth watching is the re-emergence of clusters in China, in the Hebei province. While the number of cases looks paltry there relative to current levels in Western countries, this can be a cause of concern ahead of the mass mobility of the lunar year holiday. More fundamentally, the constant "flare-ups" in many different regions and the emergence of variants may prolong the challenges to the tourism and international transport industry at the global level. Indeed, as long as governments everywhere will be forced to act cautiously in the face of new forms of the virus – and give themselves time to check if they are responding to the existing vaccines – full normalization of travel will be difficult to achieve.

The good news is that at least the developed economies are getting better at dealing with the mobility restrictions. D-Statis stated last week that German GDP "roughly stagnated" in Q4 2020. Even if the national statistical institute struck a note of caution since there is still very little data for December, when the latest round of lockdown hit, at worst it seems Germany went through only a marginal contraction at the end of last year. We had similar noises from Spain, where the finance minister stated last week that the country "had avoided a contraction in Q4", while in the UK, the contraction in activity in November may not be enough to take the whole fourth quarter into negative territory. **Still, we think it is going to be difficult to repeat the same feat in Q1 2021, with restrictions on the whole intensifying on the whole continent.**

Exhibit 3 – Continental Europe lagging behind



Source: National Health Commision, Ministry of Health, Robert Koch Institut, Extraordinary Commissioner for the Covid-19 Emergency, Ministry of Health, Government of the United Kingdom, Centers for Disease Control and Prevention and AXA IM Research, 14 January 2021

Biden's initial offering

In the US as well the number of new cases seems to be tentatively about to plateau, but the damage to the economy is getting more obvious. The unexpected net drop in payroll employment in December two weeks ago was an eye opener, but we have been warning against the underlying softness of the US labour market since the summer. The December batch was no accident, and the higher than expected jobless claims for the week to January 9th – at 965k reaching their highest level since July 2020 - is providing further evidence of this. Consumers are taking notice, and the "control group" for retail sales fell for the third month in a row in December.

This raises the chances of Joe Biden's emergency stimulus package, unveiled last Thursday, to find a majority in Congress, even though his USD 1.9trn "delta" looks like an opening gambit to us, not the final number on which the fiscal push will land. Indeed, topping up the USD900bn already agreed between the two parties, the overall envelope of USD2.8trn is probably too high to bring many Republicans onboard, and some of the more moderate Democrats are likely to balk as well. Biden is openly seeking bi-partisan support for his plan, which would chime with his general goal to lower the political temperature and foster a more consensual approach to policymaking. Avoiding the "reconciliation process" to get the stimulus through would be a gesture of goodwill towards the Republicans. In our view, Biden chose to aim very high at the start of the discussions with Congress to give himself some space to compromise while still retaining a very significant overall quantum of fiscal stimulus in the end.

Biden's offer (the American Rescue Plan, ARP) adds to the December package a crucial element which in our view was indeed missing: additional support to municipalities and states, to the tune of USD 350bn. We discussed this in Macrocast before. Given the "golden rules" which in effect prevent most states and municipalities from running deficits, the drop in tax receipts triggered by the recession would mechanically force a fiscal tightening from this layer of government of c.1.5% of GDP. From a purely political point of view, this will please the Democrats who had been forcefully requesting this, even if we would expect some thorny debates on the allocation key to get as many Republicans on board as possible. Probably paradoxically, allocating the federal funds according to the local GDP per capita would favour democratic strongholds, while using the proportion of the population under the poverty line would favour local authorities run by Republicans. Still, there seems to be growing support on the Republican side for more action for the states and municipalities which are the frontline public authorities dealing with the pandemic (Senator Cassidy from Louisiana has warned that emergency personnel would have to be fired soon without cash transfers from the federal government).

The other big item is the extension of the direct payments to individuals from USD600 to USD2,000. This had become increasingly consensual. Initially an idea from Trump's White House, it had been seconded by the Democratic leadership in Congress. There would probably be enough Republicans to rally around this to deal with the misgivings of some Democrats – e.g. Joe Manchin – who would want it to be more means-tested. In a public letter to the President-elect last Tuesday, Republican Senator Marco Rubio pledged his support in advance to such a measure (another Republican, Sen. Hawley from Missouri, expressed his support). We have serious doubts about the efficiency of such windfall measures, but we see this as an important bargaining chip for Biden in his quest for bi-partisan cooperation.

Still, we would highlight an interesting bit in Marco Rubio's letter to Biden: *"please do not allow direct payments (…) get caught up in the normal political games by adding a wish list of far left or other unrelated priorities to this legislation".* This is probably a warning against using the consensual direct payment as a "Trojan horse" to get bi-partisan support for more controversial measures, such as raising the federal minimum wage to USD15 per hour or raising unemployment benefits.

We thus need to brace ourselves for a quite contorted negotiation in Congress, while Biden will also need to deal with the maximalists in his own party. From this point of view, the latest opinion piece by Nobel prize Paul Krugman in the New York Times, if it truly reflects the mood in the liberal policy circles, was a tad concerning. He proposed to Biden four rules to follow on macroeconomic issues. "*First, don't doubt the power of government to help (…). Second, don't obsess about debt (…). Third, don't worry about inflation (…). Fourth, don't count on Republicans to help govern".* While we share the view that the policy stance should remain accommodative beyond the pandemic peak, Krugman's rules might have gained by coming with a few qualifiers, such as stating the necessity at some point to think about a credible exit strategy. But it's the fourth "piece of advice" which could be the most problematic soon. As we discussed at length last week, the US institutional operating system is no friend to slim majorities. Refusing cooperation with the Republicans, beyond the fact that it would prolong the toxic atmosphere in US politics, could ultimately lead to paralysis.

On balance, we remain confident a total fiscal package of c.USD 2trn – including the initial USD 900 bn – will be worked through Congress. Biden may not reach the threshold of 60 Senators to back it and avoid filibustering, but the political message sent by using the reconciliation process to unlock the stimulus would not be the same if the package is supported by a few Republican Senators. Yet, **we probably need to brace ourselves for some market volatility following the gyrations of the US political debate.**

Powell Speaketh (and so doth Schnabel)

We argued in our previous Macrocast that the rise in US long-term interest rates would force the Fed to intervene verbally. We did not expect it so soon, but Jay Powell's remarks in Princeton, although reassuring on the Fed's resolve to be patient with their extraordinarily supportive stance, are not in our view enough to prevent yields from pushing further, after the small retrenchment observed in the last few days which in our opinion have more to do with the deterioration on the cyclical and pandemic fronts than with the chairman's intervention. Powell was essentially responding to Raphael Bostic – President of the Atlanta Fed – who last Monday argued that, depending on how the pandemic and the vaccination programme go, the central bank could slow down its quantitative easing programme. Dallas Fed President Kaplan was even clearer when he stated that "*later this year, my own view is that we should at least be having an earnest discussion about when it's appropriate to taper".* Kaplan won't be voting at the Fed's Open Market Committee this year, but Bostic will. After strong dovish rebukes from Clarida and Brainard on Tuesday, Powell in turn sought to hose down the impending fire and stated that "*now is not the time to be talking about an exit".*

What we continue to focus on though is not so much that the Fed is not on the brink of changing its stance – there is absolutely no reason to do so – but rather that the possibility to "do more" is no longer discussed, whereas it was still an option Powell explicitly mentioned at the policy panel at the ECB's virtual "Sintra" conference last September. Biden's fiscal policy changes drastically the balance of supply and demand on the US bond market. The Fed is buying US federal securities to the tune of USD 960bn p.a, one trillion less than the debt issuance needed to fund the total fiscal push of USD 2trn which we expect this year. The point we raised last week remains valid after Powell's statement: there is no readiness from the Fed to stand in the way of a market-led tightening in financial conditions triggered by a larger-than-expected fiscal stimulus.

Of course, global liquidity is ample, but we noticed the emergence in the market of a conversation of "thresholds" which US yields would need to cross for international buyers to come "en masse" to mop up additional issuance and stop the rise in yields. The behaviour of Japanese investors – the largest foreign source of purchases of US treasuries again, since China's retreat from the US bond market – may be key. Hedging costs have fallen thanks to the drop in Fed Funds, which could incentivize them to raise their holdings of USTs further as their yields have become more attractive, but given the volatility of the last few days and their reluctance to engage in "back and forth" trades, they may stay on the side line for a while, waiting for yields to push higher. We note that Goldman Sachs has just revised its forecast for 10-year US yield from 1.3% to 1.5% by year-end.

Other central banks have also been busy communicating. In an interview with "Der Standard" on January 12th ECB board member Isabel Schnabel sent a pre-emptively dovish message, dismissing the likely "hump" in inflation looming in 2021, with the exogenous shocks of 2020 fading, as unworthy of a monetary policy reaction, and concluding that *"we must be careful not to start consolidating too soon. That would be the biggest economic policy mistake that could be made – tightening monetary and fiscal policy too soon".* Contagion from the US onto European yields is the last thing the ECB wants to see at this juncture. While there was some debate on the calibration of the extension in quantitative easing in December, as reflected in the minutes released last week, the overall commitment to maintain an accommodative stance in the midst of the pandemic, in particular the flexibility of the Pandemic Emergency Purchase Programme (PEPP), is largely shared among the Governing Council. We expect Christine Lagarde to comment on those lines after this week's Governing Council meeting, at which no decision nor strong message is expected. The strategy for 2021 was framed last month. The real test will come later, once the economy will have been normalizing for several months, when the ECB will have to decide how to cushion the impact on the market of the removal of PEPP.

Exhibit 4 – "Positive contagion" from the US to Europe

	Post Biden - Capitol	Capitol -	Combined
	3 Nov to 5 Jan	5 Jan to 14 Jan	3 Nov to 14 Jan
Market	Return	Return	Return
US equity	10.6%	1.8%	12.7%
US credit HY	5.3%	0.3%	5.6%
US credit IG	2.5%	-0.7%	1.8%
EU equity	14.5%	2.6%	17.5%
Italy govt	1.3%	-0.7%	0.6%
Spain govt	0.5%	-0.2%	0.3%
EU credit HY	5.0%	0.2%	5.2%
EU credit IG	1.2%	0.0%	1.2%

	Post Biden - Capitol	Capitol -	Combined
	0 Jan to 0 Jan	5 Jan to 13 Jan	0 Jan to 13 Jan
Market	Change	Change	Change
US Treasury 10y	0.06	0.17	0.23
US breakeven 10y	0.29	0.03	0.35
German Bund 10y	0.04	0.03	0.07
EU breakeven 10y	0.24	0.04	0.29

Source : Bloomberg and AXA IM Research, 14 January 2021

So far, the decoupling of the European and US bond market has been rock solid, the rebound in Bund yields remaining marginal and peripheral spreads barely moving since the US elections (see Exhibit 4). **It seems that the Euro area is enjoying "positive contagion" from the US.** The stability in European nominal yields is quite striking given the rebound in inflation expectations. Indeed, judging by 10 year breakeven, the recent reappraisal in the long-term inflation outlook is very similar across the Atlantic. Unlike in the US where ex ante real interest rates have started to rise since the Democrats' victory in Georgia (nominal yields rose more than inflation expectations since January 5th), in Europe real interest rates fell. This would suggest that the ECB is credible: investors expect the ECB to what it takes to keep financial conditions unchanged, even in the face of an improvement in the inflation outlook. Positive contagion also applies to the European equity market, which has outperformed its US counterpart since Biden's victory, both before and after the change in majority in the Senate. Given the sensitivity of European names to the global cycle, a stronger general outlook for the world economy, supported by a "full-fat" American stimulus, could indeed be consistent with a reappraisal in their earnings' potential once the economy gets out of the lockdowns.

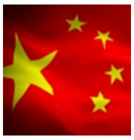
Political developments in Germany offsetting Italy's

Italy is on the radar again with the government crisis triggered by Matteo Renzi's decision to withdraw his party's ministers from cabinet. Although his movement, Italia Viva, is currently polling at only 3%, he controls enough seats in the Senate (18) to deprive the coalition from a majority (they currently have a margin of only 8 seats). Prime Minister Conte will address the lower house on Monday and the Senate on Tuesday, with each time an indicative vote which will act as a de facto confidence motion.

As we write on Sunday it is still possible that Renzi will ultimately allow the coalition to survive in the crucial vote on Tuesday. Indeed, Renzi's popularity, already low, could suffer another blow if he is seen as triggering an arcane political crisis in the midst of the pandemic. Two members of Italia Viva in the lower house have already announced they would vote in support of the government. Besides, some centrists outside the coalition might also provide temporary support. Still, it may be that Conte will lose the vote on Tuesday and resign. Several options would be opened then, such as re-starting the coalition with a different Prime Minister or enlarge it to some centrists to re-create a stable majority. **New elections seem to be least palatable option**. They would have to be organized before July, amid significant Covid-related friction. The two main coalition partners (PD and 5star) would engage in the campaign in a position of weakness (together they have been systematically polling below the opposition) and Italia Viva itself has very little incentive to compete in elections now (given where they are in the polls they may lose their parliamentary representation entirely).

This benign view seems to be very consensual, which may explain why the Italian sovereign spread has barely moved, but the substance of the political dispute is interesting from a macroeconomic point of view. Indeed, Renzi's disagreement with the Prime Minister came from the management of the Recovery and Resilience Funds. Conte wants a strong central control over their use directly from his office, while Renzi would want a more collegial apportionment. What the ongoing political squabbling in Italy may trigger is more delays in the effective disbursements of the new European facility.

The RRF is a major political concession from Germany to the rest of the EU given the usual reluctance in Berlin towards fiscal mutualisation. If national allocation processes become tainted by political games, it will become more difficult to extract more financial solidarity from Germany in the future. **Against this background, the victory of Armin Laschet as leader of CDU probably is a positive signal for the peace and tranquillity of the European sovereign bond markets.** Indeed, he embodies continuity on European matters with Angela Merkel's stance. A comprehensive strategy for the future shape of the European Union may still be lacking in Berlin, but the current German administration has repeatedly, in times of stress, ultimately always moved towards more economic integration. Laschet may not become the next Chancellor – that is still dependent on an agreement with CSU, which may have an interest in the job – but the signal from the "middle managers" of Germany's biggest party who voted in this leadership race is consistent with continued progress on EU matters, even if it usually takes the form of emergency responses to crises, rather than pre-emptive decisions.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• POTUS-elect Biden proposes an additional \$1.9tn (8.6% GDP) stimulus package • Trump impeached. Timing of Senate trial uncertain, McConnell considers his vote. • Fed Chair Powell tightened communication on taper, “not the time” for that discussion. • US new case numbers trend higher this week • Fed’s Beige Book, some areas stagnating	• POTUS Biden inauguration, FBI warns of organised demonstrations in most capitals. • Continued rise in COVID cases • Initial jobless claims to reverse severe seasonal surge, but watch underlying trend • Philadelphia Fed survey (Jan) • Existing home sales, starts and NAHB survey to gauge ongoing housing strength
	• France extended 6PM curfew • Renzi's Italia Viva left the government, meaning the current Italian coalition no longer holds a majority in both chambers • EA November IP rose by 2.5%mom, distorted by strong Irish numbers • German GDP shrank by 5.3%yoy in 2020, and deficit was better than expected at 4.8%	• Italy: snap elections remain a tail risk • ECB may get questions on politics/PEPP/€ • January Flash PMIs, French INSEE to have a relatively low information content • ECB Bank Lending Survey worth watching to see if extension of monetary and fiscal support is keeping in check credit standards tightening
	• GDP fell by 2.6% in Nov, much less than expected putting Q4 decline in doubt • New virus cases eased from peak, positivity rates dip – tentative signs of lockdown biting • BoE Gov Bailey “a lot of issues” with -ve rates, joined Dep Gov in broader push-back • RICS survey sees solid house price trends	• CPI (and PPI) inflation (Dec), CPI headline expected to rise to 0.5%yoy from 0.3% • Retail sales (Dec) see some downside risk to +0.5% expectation for ex-auto fuel. • Prelim PMIs for January • CBI Quarterly Industrial Trends survey to gauge underlying manufacturing activity
	• December bank lending remains supportive: +6.2%yoy after +6.3%. • Dec Economy Watchers poll fell to 35.5 from 45.6 due to the resurgence of the pandemic • January IPSOS Consumer sentiment index declined to 34.8 (-3.5 points)	• The BoJ holds its meeting on 20-21 and should adopt the status quo. GDP outlook should be revised down for FY2020 (up for 2021), traducing the state of emergency. • Exports probably accelerated in December • Dec CPI is expected to decline to -1%yoy
	• Trade data beats expectations, suggesting external demand remains resilient and domestic activity continues to recover	• Q4 GDP growth is expected to print at around the trend rate, featuring a faster recovery in consumption and strong trade contribution
	• BOK on hold, no expected near-term action. BRCP on hold adding further liquidity injection operations. India announced a 14-day reverse repo auction (INR2tn) as a first step towards policy normalization. • India CPI decelerated to 4.6% after breaching the upper target band of 6% for the past 8 months. • Brazil IPCA inflation 4.52% (Dec) above BCB’s inflation target (4.25%) on the back of electricity bills increase (+9.3%)	• Malaysia, Indonesia, South Africa, Turkey and Brazil central bank meetings. BNM is likely to start the year off with a 25bps rate cut to 1.5% but we don’t expect any change in policy for the others.

Upcoming events		
	US:	Tue: LT investment flows (Nov); Wed: Presidential inauguration; Thu: Building permits (Dec), Housing starts (Dec), Phili Fed Index (Jan); Fri: Mfg, Serv PMI (prel., Jan), Existing home sales (Dec)
	Euro Area:	It: HICP (final, Dec); Tue: Ecofin meeting, Ge ZWE survey: curr situation (Jan); Wed: EA HICP (final, Dec); Thu: ECB ann.,;Fri: EA Comp PMI (prel., Jan), Serv, Mfg PMI (prel., Jan)
	UK:	Wed: CPI (Dec); Thu: CBI Industrial Trend Survey (Jan); Fri: PSNB ex-banking groups (Dec), Retail sales (Dec), Comp, Mfg, Serv PMI (prel., Jan)
	Japan:	Mon: IP (final, Nov); Wed: TB (Dec); Thu: BoJ announcement, CPI (Dec); Fri: Mfg PMI (prel., Jan)
	China:	Mon: GDP (Q4), IP (Dec), Retail sales (Dec), Fixed asset investment (Dec)

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