Life at the Peak

- We expect the BoE after one last hike to join the Fed and the ECB on having reached "peak rates"
- While the "Table Mountain" trajectory is less damaging to the economy than the "Matterhorn", this is not a riskless strategy, while in the months ahead we expect the central banks to continue to "talk hawkish"

After delivering a well-crafted dovish hike last week, we think the ECB has joined the Fed in having reached "peak rates", and we expect the Bank of England to apply to the club this week as well after one last 25bps hike.

Still, all three central banks will make it clear they remain data dependent and will not hesitate to hike again if need be. Even in the US where the deceleration in core inflation is more advanced, the Fed cannot ignore some faint but uncomfortable signals that price pressure remains too strong. Jay Powell this week will need to "speak hawkish" despite staying put, and we expect the FOMC to maintain one additional hike for 2023 in its "dot plot", even if we do not think they will need to act on it given our forecast of a quite mediocre end of year for US growth. There may also be some interesting changes in the FOMC's assessment of the "long-run" policy rate. All this would prolong the market's own moves these last few weeks with less cuts priced in for 2024. The market has not changed its pricing for the ECB by the end of next year, and we find the 50% probability of a rate cut already in March 2024 quite daring – we see the first rate cut there in June 2024 at the earliest (i.e., with a much lower than 100% probability).

In principle, a "high enough for long" approach should be less damaging to the economy than an "always higher" trajectory which would then probably need to be followed by emergency cuts (a "Table Mountain rather than Matterhorn," to use Huw Pill's striking image) but unfortunately it is difficult to assess in real time if a central bank has not already gone too far. Given how the two economies are currently faring, it seems to us the risk is higher in the Euro area than in the US.

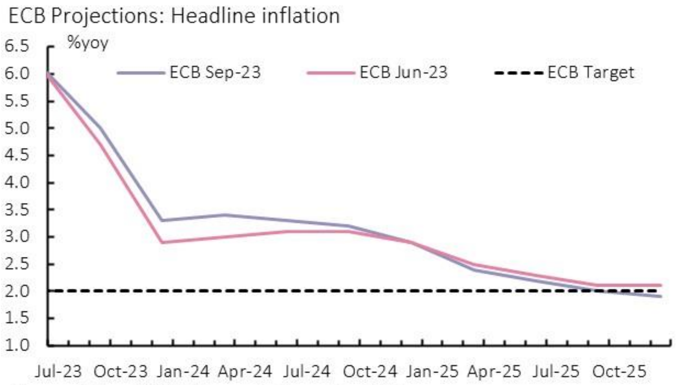
At the other end of the monetary spectrum, we expect the BoJ to continue to plough its own – very special – furrow with no change to policy or guidance this week.

The word that cannot be uttered

Monetary policy in the Euro area has shifted with one sentence from a state of unusual uncertainty – the market was split on whether the European Central Bank (ECB) would hike or not - to a high degree of clarity on the future trajectory. Indeed, the hawkish signal of yet another hike to 4%, twice what used to be accepted as the upper range for the equilibrium rate in the Euro area, was completely drowned by the clear message the Governing Council considers it has probably done enough (*"ECB interest rates have reached levels that, maintained for a sufficiently long duration, will make a substantial contribution to the timely return of inflation to our target"*). At 3.75%, the ECB feared it was not "quite there" to ensure a timely return of inflation to 2% - which justifies the "last" hike – but equally now sees monetary conditions as restrictive enough.

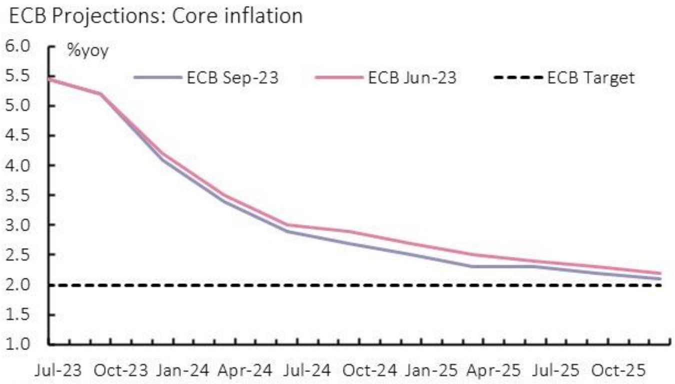
Of course, optionality is still there. Taken at face value, a "*substantial contribution*" leaves the possibility that more will still need to be done, and the statement, as well as Lagarde's answers in the Q&A, still insist on the central bank being in a "data dependent" mode, but we should read this in combination with the new ECB forecasts. In the June version, even by the very end of the projection horizon, headline inflation was not expected to be exactly where it should be, at 2.1% in Q4 2025. While the ECB has revised up its inflation scenario for this year and next, it now expects only 1.9% for the end of 2025, just below the "magic threshold" of 2% (see Exhibit 1). Interestingly, this does not extend to core inflation, which the ECB still sees at 2.1%, albeit lower than in June (2.2%, see Exhibit 2). In other words, the central bank believes that a bit of luck – i.e., the behaviour of exogenous forces on which it has no control, such as energy and food prices – will be needed to deliver the target. We are still on a knife edge. Yet, **the overarching message we got last week is that the ECB no longer feels compelled to signal a further tightening to err on the side of caution**.

Exhibit 1 – Back to target by end 25 on headline



Source : ECB and AXA IM Research, September 2023

Exhibit 2 – but not completely for core

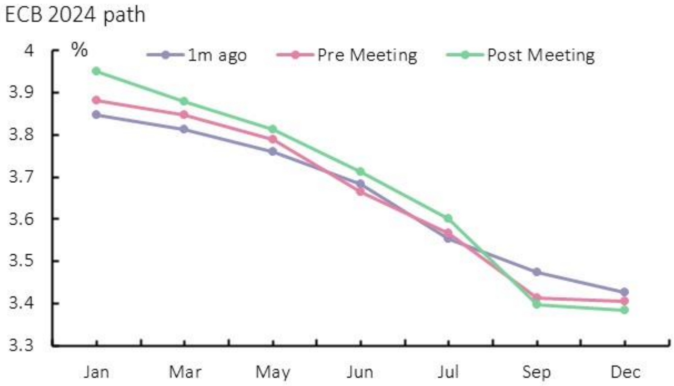


Source : ECB and AXA IM Research, September 2023

A key difference between the Federal Reserve (Fed)'s "median inflation forecasts" and the ECB's projections is that the latter are based on the market pricing of interest rates, rather than on the policymakers' own expected trajectory for monetary policy. The ECB's September batch assumes an average 3-month rate at 3.40% in 2024 on an annual average basis (computed from market pricing before the cut-off data on 22 August), down from a current level of 3.91%. So even under the assumption of rate cuts, the ECB considers it can deliver on the inflation target.

Even if Christine Lagarde stated in no uncertain terms that the word "*cut*" had not even been uttered during the Governing Council meeting, it's only natural that this is what the market is likely to focus on this issue from now on. The ECB is trying to push the "high for longer" instead of the "higher still" trajectory. Christine Lagarde refused to elaborate on what a "sufficiently long duration" meant in practice, but the market is impatient. As Exhibit 3 illustrates, the current pricing is consistent with a 50% probability of a 25bps cut in March 2024 already, which moves up to 100% for June 2024, followed by another one in September. We are uncomfortable with this distribution of probability. We would be surprised to see the ECB even contemplate a rate cut before June, which is for us the earliest it can be reasonably expected, so far from a 100% probability.

Exhibit 3 – The market is impatient on cuts



Source: Bloomberg and AXA IM Research, September 2023

In any case, **for rate cuts to materialise as early as Q1 2024, it is obvious to us that the ECB's baseline for the real economy could not materialise**. Indeed, Christine Lagarde explained in the Q&A that three quarters of the downward revision in the GDP forecast for next year (from 1.5% to 1.0%) was attributable to the adverse base effect of the current sluggish patch, and that a recovery would follow suit in 2024. We find it unlikely that the ECB would choose to cut early if at the same time cyclical indicators are bottoming out, especially with inflation – as they expect – still at or above 3% for both headline and core. Our own expectation of a first cut in June 2024 at the earliest is predicated on a significantly weaker – and below consensus - growth outlook than the ECB's (0.3% against 1.0%).

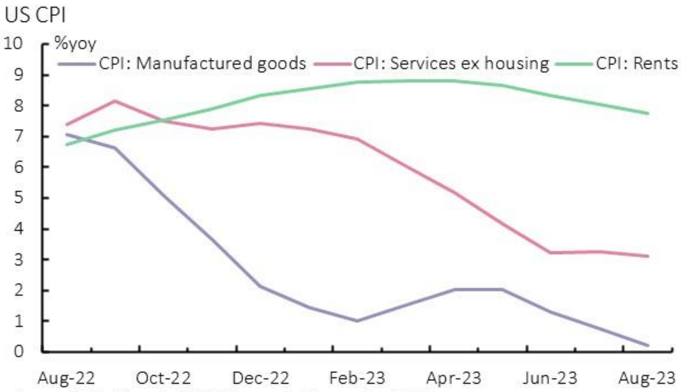
None of this is for immediate consumption and for the coming months, barring a significant accident, we expect the ECB to be as non-committal as possible in its assessment of the macro situation which may make for uneventful Council meetings. Another interesting signal we got from the ECB last week is that **they are in no rush to discuss the balance sheet again**. Christine Lagarde was unambiguous on these matters: *"we have not discussed the Pandemic Emergency Purchase Programme (PEPP), the reinvestment and the forward guidance. PEPP is our flexibility instrument, as you know, and is the first line of defence if we want to defend a proper transmission of our monetary policy. We have not discussed any kind of Asset Purchase Programme (APP) outright sales*". This is a relief since there was always the outside risk that the end of the hikes could be "supplemented" by stronger resorption moves on past unconventional action.

Some – measured – sources of unease for the Fed

The euro exchange rate weakened further on Thursday as the ECB's message was unveiled. We came across some scathing interpretations in the economic commentators' sphere, for instance the possibility that the market was "punishing" the euro as hiking rates in a near recession configuration would further add to the region's woes and attractiveness. While we agree that the ECB should tread carefully as the "overkill risk" is significant in Europe, our own interpretation is that the main driver of the market reaction was the much stronger than expected signal that the ECB is likely "done" and that the transatlantic interest rate differential would not narrow much. Besides, **it "takes two to tango" and the softness of the euro exchange rate is also the product of some potentially uncomfortable developments for the Fed which may force the US central bank to "speak more hawkish"** and thus lift the probability distribution around its rate trajectory.

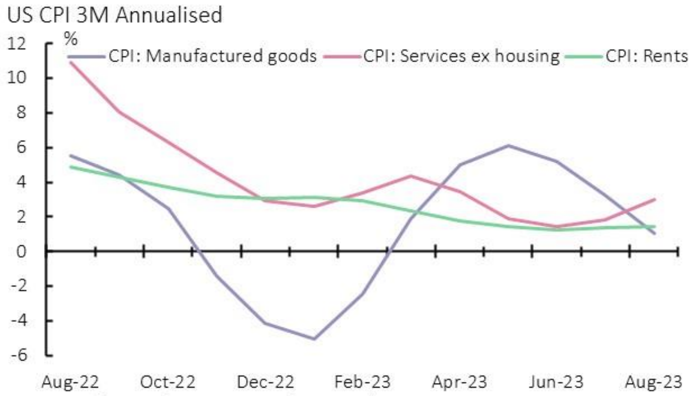
The headline consumer price index came out slightly above expectations in August, at 3.7%yoy against 3.6%, re-accelerating from July (3.2%). True, the July print was a bit "too good to be true", with an annualized monthly gain of 2.4%, within the Fed's target range given the usual wedge between the Consumer Price Index (CPI) and the Personal Consumption Expenditures (PCE). The Fed was certainly not expecting such swift progress (the June Federal Open Market Committee (FOMC) forecasts had headline PCE at 3.2% only at the end of this year). The central bank will likely tolerate quite a few "accidents" on the way, especially if they are essentially driven by exogenous forces (a rebound in fuel prices in August) and core inflation continues to make progress, as it did last month, declining to 4.3% year-on-year from 4.7% a month earlier. Yet, there were some faint warnings in the underlying data. **The price of services excluding rents – the Fed's focus, since this is the component which is normally the most attuned to the domestic cycle – may have hit a "line of resistance" slightly above 3% in year-on-year terms** (see Exhibit 4). Looking ahead, there should be enough decelerating contributions from rents and manufactured goods prices – the latter being now barely in positive territory – to offset such "resistance" and allow for a continued convergence of overall core inflation towards 2%, but the re-acceleration in services prices when measured on a three-month basis (see Exhibit 5) still deserves to be monitored.

Exhibit 4 – Services disinflation on services stalled



Source: Refinitiv and AXA IM Research, September 2023

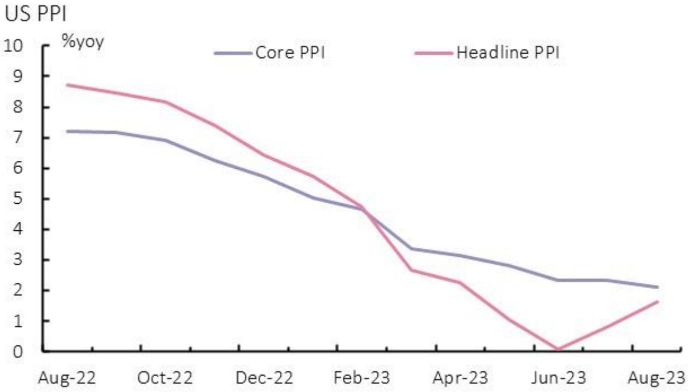
Exhibit 5 – Even more concerning on a 3-month basis



Source: Refinitiv and AXA IM Research, September 2023

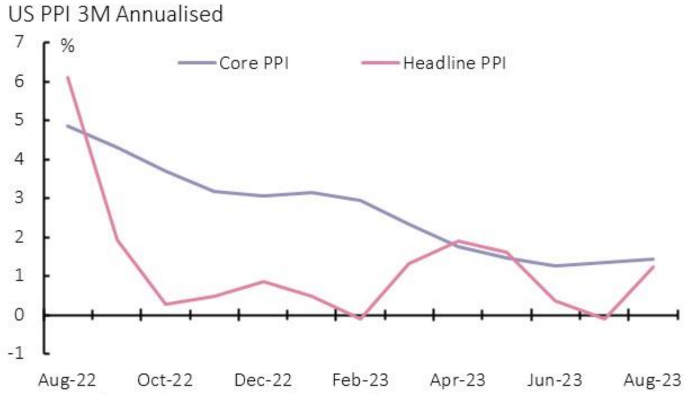
Further up the inflation pipeline, some measure of caution is also warranted. The rebound in energy prices is also easily observable in producer prices (see Exhibit 6). When looking at the recent momentum, for which we like to focus on three-month annualized changes, what is also somewhat concerning is that core Producer Price Index (PPI) has stopped decelerating (see Exhibit 7), which would suggest that what is currently seen on consumer prices is no mere "accident" imputable to the data's randomness, but may also reflect proper downward inflation resistance, which would not be entirely surprising given the resilience in the real economy, even though "analytical prudence" is of the essence since some of the strength in PPI came from small, financial industry related components.

Exhibit 6 – Energy prices fuelling pipeline inflation



Source: Refinitiv and AXA IM Research, September 2023

Exhibit 7 – Core PPI stops decelerating on a 3-month basis



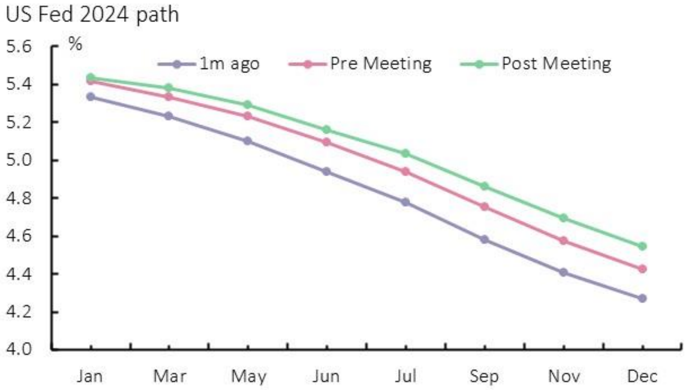
Source: Refinitiv and AXA IM Research, September 2023

The recent dataflow continues to send a quite positive message on the health of the US economy which of course heightens the risk of inflation resilience. Jobless claims, for instance, remain consistent with an extremely soft landing of the labour market. The wage/inflexion nexus should get more attention over pay and benefits in the car industry – which we had commented on in our post-summer recess note – has been confirmed. Most commentators focus on the impact it may have on GDP through lower production and argue that even a strong pay rise as the outcome of the strikes would have limited impact on inflation (carmakers have been able to rebuild inventories and any generous pay deal would cover only 0.1% of total employment in the US). While we agree that US labour market institutional features are very different from Europe's and US unionisation levels are low, we still look at the strike in Detroit's "big 3" as a symptom of lingering concerns over purchasing power which could still ignite some additional catch-up in pay.

While we do not think any of this will trigger any additional action from the Fed - we stick to our view that the tightening peak has been hit - we also think there is enough in the data to expect some hawkish overtones from the FOMC this week. The "data dependent" mode is likely to be maintained – which would allow the Fed to "reserve the right" to hike again if need be – but probably more importantly, we expect the "median FOMC member forecast" for the Fed Funds trajectory to be unchanged from the June batch for the end of this year, implying another hike. Indeed, the June forecast came out with *two* additional hikes, consistent with "skipping" some meetings but still indicating a preference for a further visible tightening. One was delivered in July, one remains – and we expect the Fed to keep it to send the signal the Fed is not lowering its guard.

We think that from a tactical point of view, removing the last hike from the dot plot could send an overly dovish message to the market. We do not believe the maintained presence of one last hike for 2023 in the Fed forecasts would come as a surprise to the market, but this would validate, and possibly exacerbate on the margin the changes in pricing over the last few weeks. We have replicated in Exhibit 8 for the Fed the graph on market pricing we built for the ECB in the previous section. In the Euro area, the expected slope of the monetary policy trajectory has moved over the last month but the "landing zone" for the end of 2024 has barely changed at c.3.5%. Conversely, for the Fed the expected landing zone has shifted upward. A month ago, **the market was pricing Fed Funds rates at 4.26% by December 2024, to lift it to 4.54% as of last Friday** (there was another move up between Wednesday and Friday which we think is completely disconnected from the ECB announcements but simply reflected a reaction to yet another strong jobless claims number and a better-than-expected print for retail sales).

Exhibit 8 – Market expecting less Fed cuts



Source: Bloomberg and AXA IM Research, September 2023

The FOMC's forecast of the long-term level of the Fed Funds – routinely used as a proxy of where the equilibrium interest rate lies in the eyes of the central bank – could be another area of interest this week. Indeed, there can be a legitimate debate on whether this should be lifted. Interestingly, before Covid struck, the FOMC had been regularly revising its estimate down. It had fallen just below 3.0% in early 2018, down from 4.25% when the Fed started publishing its "dot plot" in 2012. It declined further to 2.5% in December 2019 just before the pandemic struck and still stood there in June 2023. There are kilometres of sophisticated research on why, while falling over the first two decades of the century, the equilibrium rate may well have risen again, but beyond theoretical considerations on demography or the preference for saving, the current configuration quite simply provides a telling "natural experiment": the US economy is still doing relatively well and inflation is still quite far above the Fed target although policy rates are already at more than twice the current FOMC's proxy for "neutral". The very fact that the economy can "take" a 5% policy rate without softening much would indicate that the neutral rate is indeed higher than previously expected.

Still, as we have argued before, it's only when inflation has truly converged back to 2% that we will know what degree of pain in terms of growth and employment has been necessary and by how much the central bank needed to tighten to deliver. The economy may look strong for now, but it may only be a matter of time before the impact of the accumulated tightening finally catches up. In other words, **we have our doubts as to whether the equilibrium rate can be properly assessed *ex ante*,** which makes it a very uncertain guide to actual monetary policy decisions. Yet, tactically, in the face of current macro resilience, it may be very tempting for FOMC members to raise their estimate, which would normally have the effect of maintaining some upward pressure on long-term yields, another ingredient in the overall tightening in financial conditions which will ensure the US economy lands.

BoE and BoJ also to meet this week

The Bank of England (BoE) has been the clearest in shifting focus from further hikes to keeping them high enough for long enough (the Banks's Chief Economist Huw Pill has proposed a geophysical image which is likely to take hold: "less Matterhorn and more Table Mountain"), even if this has yet to make it to the central bank's policy statement (the ECB has beaten them to it on substance). Despite still strong inflation, **the BoE can now point at how the United Kingdom (UK) labour market is faring to push against too high market expectations of the terminal rate.** The unemployment rate rose further to 4.3% in the three months to July (4.2% in June), above the pre-pandemic level, as the economy destroyed 207K jobs in the same period (-66K in June). While GDP growth remained in positive territory in the three-month to July (0.2%), the probability of an outright recession is rising in the UK. The "only" problem the BoE is still facing is that there is quite a lot of inertia in the wage data: average pay excluding bonus rose by 7.8% year-on-year in July, and this cannot be solely attributed to the one-off generous deals in the public sector which the government has been forced to concede amid acute social tension: private sector pay rose by 8.1%yoy, only marginally declining from 8.2% in June. **The "compromise solution" for the Monetary Policy Committee (MPC) would be to emulate the ECB and deliver "one last hike" this week to 5.50%,** still making it clear that under the expected sombre path for the economy, the right level of restriction has been reached, provided it is kept at this level for long.

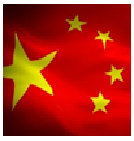
The market has several times been too prompt to call the imminent end of the Bank of Japan (BoJ)'s negative rate policy and yield curve control, but they could be forgiven for the latest episode given the words Governor Ueda used in his interview to Yomiuri: *"it's not impossible that we will have enough by the end of the year to anticipate [wage hikes going forward]".* Indeed, the central bank has been arguing that it needed to see the stronger inflation path better reflected and anchored by faster wage growth before shifting the policy stance. Given the seasonality of pay deals in Japan, this would have meant waiting for the middle of next year before getting the right information. That the BoJ would be ready to take a "leap of faith" on this indeed would normally constitute a strong message…until "BoJ officials" took to the wires to signal that there was a discrepancy between the market reaction - the yen had appreciated following Ueda' interview - and the substance of Ueda's statement. We have been convinced for some time that the BoJ would not move before it was obvious the other major central banks were "done" tightening before moving, to avoid disrupting the global bond market with a too sudden shift back of Japanese investors towards their domestic market. The window of opportunity is now opening, but it seems the BoJ still want to remain cautious. We expect no change in rates, Yield Curve Control (YCC) or guidance this week.

Life at the peak may not be that comfortable

Choosing a "Table Mountain" approach should reduce the risks of triggering an abrupt recession down the line by pushing rates too high, which would then need to be accommodated by potentially an equally exaggerated quantum of rate cuts - if for instance inflation ended up undershooting the central bank target as a result of the contraction of the real economy. There are several long-term benefits to reducing macro volatility. First, a deep recession, even if swiftly addressed with a good dollop of monetary loosening, can depress trend growth by damaging human capital - e.g., through a loss of skills – as unemployment rises, and depress the capital stock as businesses cut their capex too far. Second, a "soft landing" would strongly enhance the credibility of central banks by demonstrating their capacity to "fine tune". The "Table Mountain" approach is based on the recognition of the sometimes-long transmission lags, as monetary policy should stop hiking before all indicators of inflation have started blinking green.

Still, much in the same vein as we don't think the equilibrium rate can be easily assessed ex ante, **we are not sure central banks can easily spot whether they have already unwillingly engaged on a painful trail on the Matterhorn.** We can only notice that it is more likely the Fed has stopped before going too far, given how strong the real economy still is, than the ECB which may have to face a recession very soon. Now, it is also understandable why the ECB is taking this risk: the signs of a softening inflation are harder to spot in the Euro area than in the United States (US).

The two most influential central banks, the Fed, and the ECB, are unlikely to make policy moves for the next 9 months, but we are convinced they will have to go through some uncomfortable moments during this long wait.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Fed comments start to coalesce on pause in Sept., but still more mixed beyond • CPI inflation (Aug) rose to 3.7%yoy on higher gas costs, core slowed to 4.3% from 4.7% • Retail sales (Aug) rose 0.6%mom, > 0.1% expected. Ex cars & gas +0.2% vs -0.1%, with 0.3ppt prior rev. • House politics raise stakes in government shutdown risk even as McCarthy backed impeachment • Empire State Mfg (Sep) rose back to 1.9 from -19.0	• Jobless claims for signs of persistent strength • FOMC meeting. FFR expected on hold at 5.5%, likely the peak. Markets to watch dot plot, which may still suggest one more hike. Also watch LR FFR estimate • Housing data (Aug). Existing sales likely still weak; NAHB and housing starts could re-soften • Philadelphia Fed survey (Sep), volatile but likely corrects lower • PMIs (Sep, p) watch for further softening in services
	• ECB hiked by 25bps. Door open for further hike, but data dependant. We see ECB done and debate to move to balance sheet in coming months • ZEW surveys remain depressed • Industrial production (Jul) came at -1.1%mom • Fr, Ge and Sp, It HICP final data (Aug) are unchanged	• Final HICP EMU data (Aug) • Business climate in France (Sep) and flash consumer confidence across euro area (Sep) • Flash PMIs (Sep). Monitoring to see if strong August declines persist. We are only partially convinced that PMIs catch well current economic activity
	• Unemployment (Jul) rose to 4.3%, employment dropped by 207k, but dominated by self-employed, average earnings hit 8.5% 3m yoy, (7.8% ex-bonus) • GDP (Jul) contracted by 0.5%mom on rain & strikes • RICS survey (Aug) fell to -68% lowest since 2008-09	• BoE decision. We forecast 25bps hike to 5.50%, which we consider peak. No press conference. Minutes to keep options open for further hikes • CPI (Aug) expected to rise on oil, watching core • Retail sales (Aug) expect rebound from wet July
	• BoJ Gov Ueda comments in w/e press led markets to consider end-year policy change. BoJ back-tracked • Industrial production (Jul, f) -1.8%mom, slightly firmer than -2.% prelim estimate • M2 money supply (Aug) stable 2.5%yoy	• BoJ decision. No change expected and no forecast updates, policy and guidance steady • CPI inflation (Aug) headline expected to slow to 3% from 3.3%, core, core stable at 4.3% • Trade (Aug) exports and imports expected to slow
	• CPI (Aug): +0.1%yoy (Jul: -0.3%) • TSF (Aug): 3.12tn RMB (Jul: 528bn) • New yuan loan (Aug): 1.36tn RMB (Jul: 346bn) • Industrial production (Aug): 4.5%yoy (Jul: 3.7%); retail sales (Aug): 4.6%yoy (Jul: 3.7%) • Fixed asset investment (Aug): 3.9%yoy (0.26%mom) (Jul: +1.2%yoy, -0.16%mom)	• Wed (20 Sep): 1Y LPR and 5Y LPR (Sep)
	• CB: Peru cut 25bps to 7.50%. Russia hiked +100bps to 13.0% • July industrial production (yoy%) accelerated in India, Malaysia, Mexico & Turkey. It contracted in Hungary & Romania • Aug inflation (yoy%) fell in Czechia & India. It rose in Brazil & remained steady in Romania	• CB: Indonesia (5.75%), Philippines (6.25%), S. Africa (8.25%) & Taiwan (1.875%) to stay on hold. Brazil to cut 50bps to 12.75% & Turkey to hike 500bps to 30% • July econ activity index: Brazil, Colombia & Mexico • July retail sales: Mexico, S. Africa & Poland (Aug) • Aug inflation: Malaysia & S. Africa • Aug industrial production in Poland

Upcoming events	US:	Mon: NAHB housing index (Sep); Tue: Building permits (Aug), Housing starts (Aug); Wed: FOMC announcement; Thu: Current acc (Q2), Philly Fed index (Sep), jobless claims (16 Sep), Existing home sales (Aug); Fri: PMI (Sep, p)
	Euro Area:	Tue: EA CPI (Aug); Wed: Ge PPI (Aug); Thu: EA Consumer confidence (Sep), Fr Manf confidence (Sep); Fri: EA, Ge, Fr Manf & services PMI (Sep), EA Composite PMI (Sep), Sp GDP (Q2)
	UK:	Wed: CPI (Aug), CPIH (Aug), RPI (Aug), PPI input and output (Aug); Thu: PSNB (Aug), MPC announcement; Fri: Gfk consumer confidence (Sep), Retail sales (Aug), Manf, composite and services PMI (Sep), CBI Industrial trends survey (Sep)
	Japan	Wed: Trade balance (Aug); Fri: CPI (Aug), Manf PMI (Sep), BoJ announcement
	China:	Wed: Loan Prime rate (Sep)

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