Research & Strategy Insights

The narrow path

130 – 11 April 2022

Key points

- Despite one of the best economic performances through the pandemic and swift action against the fallout from the Ukraine war, many French voters still opted for radical solutions. Left-wing voters are key to round 2.
- The European Central Bank (ECB) hawks are not "reading the room" in their criticism of the fiscal support of income.
- Judging by the current dataflow, the US seems capable to take a "fast and hard" monetary tightening but we think we can see the first cracks.

The polls conducted on the day of the first round suggest the French presidential elections remain tight into the second round on 24 April. None of the two candidates can win without some support from voters who chose left-wing candidates last Sunday. Marine Le Pen has focused so far on purchasing power issues, and she will probably try to maintain that line. Emmanuel Macron will probably have to invest more in these issues in the coming two weeks, if only to offset his pledge to push retirement age to 65 – a red flag for left-wing voters – with a robust defence of the French welfare state. This will contrast with 2017, when Emmanuel Macron emerged as a "supply-side reformer".

France has had one of the best GDP performances across member states through the pandemic. The unemployment rate there is lower than before Covid struck. Household income has been powerfully supported by fiscal policy and business failures kept to a minimum. Retail energy prices have risen in France by less than any other large Euro area country thanks to swift government action. Yet, a large proportion of French voters opted for radical solutions. This illustrates the depth of the demand for economic protection from governments, and we suspect this goes beyond France. It's the ECB which has made this protection possible for the last two years. The central bank is however clearly less and less keen to play that role, while social pressure on public finances continues to be intense. We explore here the last speech by Isabel Schnabel, who developed a "purist" hawkish approach to the European policy-mix.

Meanwhile, in the US, the accumulation of hawkish signals from the Federal Reserve (Fed) is relentless. The Fed's willingness to normalize "fast and hard" continues to be fuelled by a strong dataflow, in particular on the labour market. Powell's narrative – the US economy is currently growing so much faster than potential that it can easily take a significant monetary tightening – is being strengthened. Still, we think we can see the first signs of what could end up being a quite abrupt slowdown towards the end of this year. The gap between sunny business confidence and consumers' gloom cannot continue for much longer, and the Fed's communication and action has started to affect the housing market.

The battle for the left-wing voter

After spending 2020-2021 trying not to practice too much cod epidemiology, and for the last month avoiding to excessively verse into polemology, your humble servant now needs to navigate the pitfalls of psephology. We will firmly focus on what is our remit: how the last phase of the French presidential elections can shape economic policy, for France and Europe, in the next 5 years.

The second round looks like a re-run of 2017, but the similarities should not be overstated. The two remaining candidates gathered c.51% of the votes in the first round as we write (28% for Emmanuel Macron, 23% for Marine Le Pen), against 45.3% in 2017. This mechanically means that their "reserves of votes" are smaller for the second round, unless turnout rises significantly on 24 April, and they are spread very differently from 2017. Five years ago, candidates from the left-wing (Jean-Luc Melenchon) and the centre-right (Francois Fillon) had gathered roughly the same share of the vote in the first round. This time, the centre-right has collapsed below 5% of the votes, while Jean-Luc Melenchon improved his score to exceed 20%. The behaviour of left-wing electors will thus be more crucial than in 2017. Marine Le Pen has more "natural partners" (the 7% of the votes which went to far-right Eric Zemmour can be easily claimed by Marine Le Pen, as well as the 2.1% which went to the sovereigntist Dupont-Aignan) but none of the two candidates can win without attracting some voters from the left.

Marine Le Pen probably owes a lot of her qualification to the second round to her decision to focus her campaign on purchasing power issues (see on this the very thorough note produced by our colleagues last week, which remains largely valid with the first round results in). She will probably maintain this approach to try to attract as many left-wing voters as possible, or at least paint her opponent as "anti-social" to convince this segment of the electorate to abstain massively. In response, while Emmanuel Macron will probably insist on the spendthrift nature of her plans, he will have to focus on social and economic themes as well, if only to "offset" his decision to advocate pushing back to 65 the retirement age – a "red flag" for many left-wing voters – with a robust defence of the French welfare state, a point he has already made in his speech on Sunday night.

In 2017, Emmanuel Macron could be considered as a "moderate supply-side reformer". He turned into a "Keynesian by accident" because of the pressure from the pandemic and now the fallout of the war un Ukraine. Our contention is that the new electoral configuration will prolong this shift. This will also make him even more vocal in the European arena in arguing for further fiscal integration and debt mutualization. So far however progress has been slow on that front. It's possible the risk of victory for Le Pen would "focus minds" in the European council. We would not expect any hard decision before the second round, but some "nice words" to this effect from Berlin would be welcome.

Multiple forces could however pull in different directions within the "Macronian constellation". While winning a second term will be dependent on wooing enough left-wing voters, a small-margin victory on 24 April (the two polls conducted on the day of the first round we saw have Emmanuel Macron winning by either 2 or 8 points, much less in any case than in 2017) would not put La République En Marche (LREM) in a strong position to secure a majority in the parliamentary elections in June. For this, the presidential party may need more support from centre-right splinter groups. Producing a consistent set of policies could thus become more difficult in the 5 year ahead.

If Marine Le Pen wins, the focus will very quickly shift to the general elections and securing a victory for her party alone in June would be difficult, with much less "established partners" in parliament than for Macron. This – together with a likely strong opposition of the Constitutional Court to some of her most controversial projects – could quickly trigger institutional paralysis. The same may occur in the European arena: while Marine Le Pen no longer advocates "Frexit", some of her policies – e.g. unilaterally reducing France's contribution to the European Union (EU) budget – would trigger a backlash from the other member states, and at the very least, more progress on fiscal integration would become unrealistic. Somewhat paradoxically, Marine Le Pen's political view of the European Union would make her national economic platform even more difficult to implement. Indeed, she advocates large-scale tax cuts and spending boosts with no clear financing. This would come to the market's attention – and the recent widening of the French spread would only be a foretaste. If this coincides with policy paralysis and divisions at the European level, Paris could not count on EU solidarity to deal with market pressure.

Are the ECB hawks reading the room?

Mario Draghi used to joke that there was always one election going on in the Euro area and that the ECB could not take these political events in consideration. Still, that the central bank does not directly react to elections is one thing, but elections do shape the policy-mix and the institutional architecture of the EU and from this point of view, they exert an influence on the ECB. France has had one of the best GDP performances across member states through the pandemic. The unemployment rate there is lower than before Covid struck. Household income has been powerfully supported by fiscal policy and business failures kept to a minimum. Yet, a large proportion of French voters opted for radical solutions. This illustrates the depth of the demand for economic protection from governments (we note that the first chapter of Marine Le Pen's manifesto is titled "the protection duty") and we suspect this goes beyond France. It's the ECB which has made this protection possible for the last two years. The central bank is clearly less and less keen to play that role, while social pressure on public finances continues to be intense.

The shift in the ECB's general approach since the end of 2021 lies in how the majority of the Governing Council sees the balance of risks. The possibility that the current inflation spike morphs into something more persistent carries a high weight in the Governing Council view, while the symmetric possibility – that the current deterioration in confidence and real income ultimately depresses core inflation – is now seen as negligible. This asymmetric approach to risks explains why the ECB's communication has been much more firmly focusing on the need to gradually normalize than on the need to prepare for another "existential moment" for the monetary union. However, Christine Lagarde in her latest communication stated that the central bank was exploring the possibility to launch a new programme in case of renewed fragmentation, without getting into any details. We considered that the bar for this was high, but the mere fact that the President of the ECB would even mention it was reassuring.

By contrast, Isabel Schnabel's speech last week read like a "purist" hawkish reading of the outlook, leaving very little space for contingencies. What struck us is actually less her points on monetary policy – she had made them in a way or another before – than her remarks on fiscal policy. While she acknowledged that some fiscal response was needed to deal with the fallout of the Ukraine war, she argued that the bulk of it should go towards investing for the future, rather than protecting income immediately, to avoid a risk that fiscal policy "*adds to the inflationary risks*". This could be understood as an implicit criticism of the attitude of most EU governments so far : they seem to have all read from the same textbook, both in terms of the size of the emergency support and its content (see Exhibit1)

Exhibit 1 – Everyone in Europe reads the same fiscal textbook

Country	Date	Measures	Cost (bn€)	% of GDP (total)
Germany	Fall 21	- 43% reduction in renewable surcharge (EEG) in Jan 2022. EEG will be reduced to zero in Jul 22 - Support for households (tax releif, heating subsidies)	16	0.9%
	March 24	- 3 months rebate, 30c for gasoline and 14 cents for diesel - taxpayers will receive a one time payment of 300€ - one-off boost to child support of 100€ - a monthly ticket for public transport at 9€	15	
France	Fall 21	- Temporary caps on regulated energy price hikes (gas price frozen since Oct 1st, electricity price capped at 4%) - social bonus for energy bills (100€) for 5.8mn households - Means-based €100 transfer to 38mn in Dec 21 and early 22	23	1.2%
	March 16	- fuel rebate of 18c until end of June 22 and ask oil companies to make another effort of 10c - targeted measures for heavily exposed companies such as transport, agriculture, fishery...etc (state guarantee loans, delayed taxes, extension of part time working scheme) - new fiscal incentives to accelerate energy transition	7	
Italy	Fall 21	- Reduction in natural gas and electricity renewable charges, natural gas VAT reduction to 5%, social bonuses for 3mn HH - Tax credit for all energy intensive companies (20% of the cost of energy consumed in Q1 2022), reduction of system charges and taxes for large users	16	1.2%
	March 18	- Fuel rebate of 25c until end of April - number of vulnerable low income households for which rise will be capped rose to 5.2mn (from 4) - Excess profits tax on some energy companies - specific interventions for firms in transport, agriculture, fishing	6	
Spain	Fall 21	- Tax cuts to VAT, electricity generation tax and excise tax on electricity - caps on gas prices and minimum supply garantee of electricity to 1.5mn of HH - Social bonus for electricity bill Mar 31 for 1.2mn HHs, thermal bonus (€90 per beneficiary)	5.3	1.3%
	March 29	- Lower VAT on electricity and taxes for electricity generator until end of June - oil rebates (20c) until end of June - State guarantees (10bn)	16	

While in principle we agree that fiscal policy should promote investment to boost potential GDP growth, we disagree with the notion that protecting income in the current circumstances would add to the inflationary risks.

Isabel Schnabel herself acknowledges that so far, wage dynamics have remained tame in the Euro area. One of the explanations she puts forward is that, contrary to the US, working time in Europe has not normalized: *"those working reduced hours are unlikely to bargain for higher wages".* So, for now, Europeans are suffering from a decline in real wages. Without fiscal support to their immediate income now, logically, they would ask for even more compensation from their employers in the months and years ahead, if indeed we end up with the delayed but protracted rise in wages which Isabel Schnabel seems to see as a given. To avoid a nasty "wage catch-up backlash" in the near future, it is strategically more useful to offset some of the decline in real income *today*.

Of course, fiscal accommodation of the price shock is not without risks if markets perceive the additional stimulus as jeopardizing debt sustainability in the long run. Still, this would bring the ball back in the ECB's camp, but precisely another thing we note in Schnabel's speech is the fact that she did not even consider the possibility that "anti-fragmentation" action could be mounted by the central bank. Pushing this logic to its extreme point, income-supporting fiscal policies should be avoided not so much – or not only – because they could add to the inflationary pressure, but also because in the current circumstances, the ECB would not accept to make it financially workable as it did during the pandemic crisis. This is a principled approach, but also precisely the kind of reasoning which made the sovereign crisis so hard to manage 10 years ago.

Fed: towards a "return of the doves" in 2H 2022?

On the other side of the Atlantic, the accumulation of hawkish signals from the Fed is relentless. When she was in the frame to replace Jay Powell as Fed chair, she was seen as a "moderate dove" on the Federal Open Market Committee (FOMC). The fact that it's precisely she who spectacularly re-started the conversation on the reduction of the central bank's balance sheet last week is another illustration, in our view, of the magnitude of the shift within the Fed towards a "fast and hard" approach to regain control of inflation. Habitual readers of Macrocast will remember that we see the balance sheet instrument – through its direct impact on the quantum of liquidity in the financial system and ramifications over the whole yield curve – as even more impactful on risky asset prices than hikes in the Fed Funds rate. While Brainard did not get into the technicalities, she hinted at a start in May at a "more rapid pace" than in 2017-2019. The minutes of the FOMC which were released just one day after Brainard's speech signalled that the Fed is inkling towards a balance sheet reduction of USD 95bn per month, just shy of twice the 2017-2019 quantum. All this has been in the pipeline for several months now, but so far in generic terms. With "possible" dates and figures now communicated, the Fed's lift-off is acquiring even more of a "shock and awe" flavour.

The Fed's hawkishness continues to be fuelled by a strong dataflow, in particular on the labour market. Powell's narrative – the US economy is currently growing so much faster than potential that it can easily take a significant monetary tightening – is being strengthened. Still, we think we can see the first signs of what could end up being a quite abrupt slowdown towards the end of this year.

The contrast between business and consumer confidence is unusually stark. Even in the services sector – where the relationship should be tightest – the gap is massive. The services Institute for Supply Management (ISM) has retreated somewhat from its heights at more than 3 standard deviations above its long-term average of late 2021 as the economy was under the twin boost of the reopening and Biden's fiscal push but remains at a comfortable level. Meanwhile, headline consumer confidence, as measured by the Michigan survey, has collapsed to nearly two standard deviations below its long-term average by March 2022 (see Exhibit 2). The deterioration in consumer confidence is predominantly driven by the rise in inflation, as real income is increasingly eroded by consumer prices. While nominal wages have accelerated significantly, in real terms the deterioration is striking (see Exhibit 3). While wage growth above 5% for now is putting a high floor to where inflation could decelerate from the current 7% pace, earnings are still lagging prices, not driving them. This is a key difference with the inflation spiral of the 1970s when real wages were in positive territory outside recession years.

Exhibit 2 – Unusual contrast

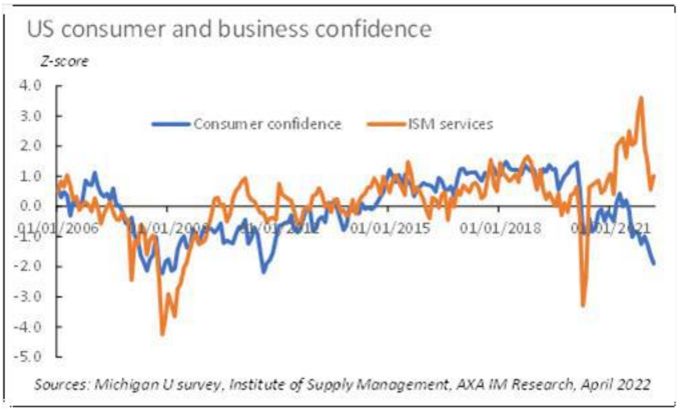


Exhibit 3 – US real wages are down – markedly so

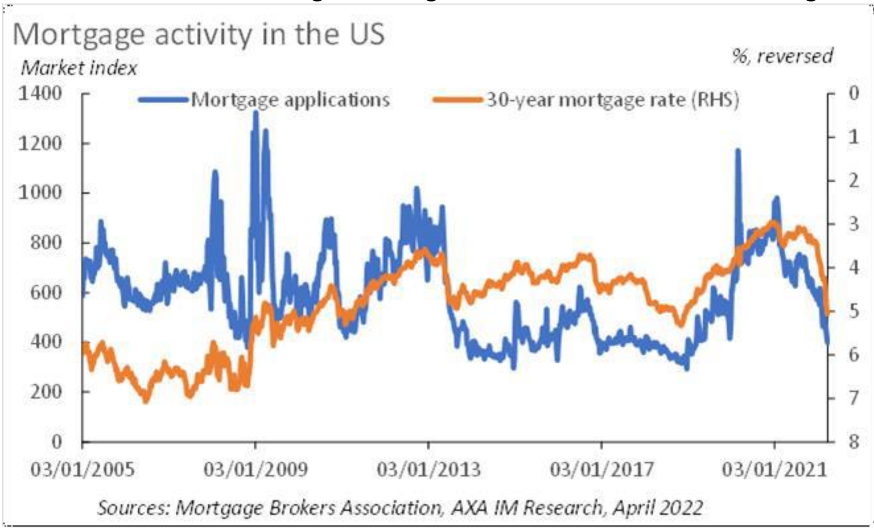
We don't think such a confidence gap between businesses and consumers can last much longer. So far, businesses have been reporting an unusual ease in passing the rise in their input costs to their final consumers. In March 2022, the New York Fed business leaders survey had "prices paid" (inputs) at 2.1 standard deviations above the long-term average, while "prices received" (outputs) stood at 2.5 standard deviations above the long-term average. With consumer confidence heading south as real income is being hit, this pass-through capacity will erode, resulting in slower consumption and dented margins.

To this "self-stabilizing" mechanisms, we would add the effects of the Fed policy. Lael Brainard devoted a part of her speech to the behaviour of mortgage rates observed since the Fed's communication started focusing on normalization. Earlier this year we noted in Macrocast that, as the long-end of the curve failed to react much to the imminence of the policy-rate lift-off, the Fed was probably frustrated by what it probably views as an essential transmission channel. This is no longer the case. 30-year mortgage rates have crossed the 5%-line last week, for the first time since November 2018, rising by 140 basis points since the beginning of the year. Even though in "instantaneous" real terms (i.e. when comparing the interest rate with the current inflation rate) mortgages still look very attractive, households probably prefer to compare those yields with what they expect their nominal income growth to be over the lifetime of the loan. Surveys have repeatedly suggested that consumers believe in a "hump shape" inflation shock: while their 5-year ahead inflation expectations have moved up relative to the pre-Covid level, they expect prices to settle on a 3-3.5% trend. "Ex ante" real mortgage rates are thus firmly in positive territory.

In those circumstances, it is not surprising to find that mortgage applications have declined very significantly (see Exhibit 4). A cooling-off housing market would add to the "tailwinds" which we think will blow in the US in the second half of the year, given its various ramifications for activity – through residential investment of course, but also consumption, given the size of the housing-related wealth effects.

Gauging ex ante how far the ongoing monetary tightening will dampen growth in the second half of the year is going to be very difficult – the specificities of the post-pandemic phase can prove the usual models wrong – but our baseline is that by the end of 2022 the Fed will need to slow down its normalization pace to take stock of the new cyclical conditions. This is where Lael Brainard is showing her "moderate dove" colours. Indeed, in her speech she was very careful on the Fed trajectory beyond 2022: *" I expect the combined effect of rate increases and balance sheet reduction to bring the stance of policy to a more neutral position later this year, with the full extent of additional tightening over time dependent on how the outlook for inflation and employment evolves*". While for now nothing much is going to distract the Fed from a quick normalization approach, divisions within the FOMC are likely to re-emerge once the signs of a cyclical slowdown start accumulating. Call us stubborn, but our baseline continues to be that US long-term yields will recede from their current levels to move back towards 2% by the end of this year.

Exhibit 4 – Who would have guessed higher rates would cool down housing?



Country/Region	What we focused on last week	What we will focus on in next weeks
	• FOMC minutes (Mar): balance sheet unwind of \$60bn UST and \$35 MBS from May; "many" saw "one or more" 0.50% hikes could be appropriate • St Louis Fed's Bullard called 3.5% FFR by year end • Jobless claims fell back to 166k – the lowest level since records began in 1968, suggesting few signs of labour market deceleration yet • MBA mortgage apps falling heavily since mid-Jan • US announces more sanctions on Russia • House Speaker Pelosi plans visit to Taiwan	• CPI inflation (Mar) – expected to rise to new 40-yr high of 8.5%. Should be around peak, but will recede more slowly in advent of war • Retail sales (Mar) expected to rise in nominal terms, but as in Feb expected to fall in real terms, signalling consumer pressure • Empire State survey (Apr) after sharp fall • U Mich sentiment survey (Apr, p) focusing on 5-10y inflation expectation anchoring • Inventories (Feb) strong build continuing
	• ECB minutes felt hawkish, revealing significant disagreement over path of inflation among Governing Council members • Macron came first in the first round but the race remains tight	• French presidential election: watch how the second round campaign develops, in particular the TV debate • ECB: we expect no decisions but potentially a more hawkish tone
	• UK energy strategy plans to generate 95% of electricity by low-carbon sources by 2030 • March PMIs revised down 59.7 as business activity is impacted by War • MPC's Cunliffe sees risk of inflation undershoot in Ukraine War	• GDP (Feb) expected at 0.3%mom (cons) • CPI inflation (March) expected to reach 6.7% (cons) as fuel price rises weigh and peak nears • ILO employment (Feb) and HMRC payrolls (Mar) likely to show further dip in unemployment to 3.8% from 3.9%
	• Consumer confidence (Mar) fell for the 3rd consecutive month to 32.8 from 35.3 • Economy Watchers poll (Mar), survey of services workers surged to 47.8 from 37.7 • Final Mfg and Svcs PMIs (Mar) revised up	• Reuters Tankan Mfg and Svcs indices (Apr) • Corporate goods price (Mar) is expected to remain at Feb level (9.3%yoy). Positive surprise is likely • Machinery orders data (Feb)
	• PMIs suggest growth contraction in March in light of tightened COVID restrictions. Supply chain hiccups can have global implications	• March activity data to show broad-based deterioration in the growth momentum last month
	• CB: Poland hiked +100 bps to 4.5% & Romania +50 bps to 3.0%. Russia cut 300 bps to 17.0% & India (4.0%) kept its policy rate unchanged • March CPI (yoy%) up in Colombia (8.5%), Indonesia (2.6%), Korea (4.1%), Mexico (7.5%), Philippines (4%), Thailand (5.7%) Turkey (6.1%) • Lower PMI in Russia/Turkey/CEE/Asia but broadly stronger in Latin America	• CB: Israel is expected to hike +15 bps to 0.25%. Korea (1.25%) & Turkey (14.0%) to stay on hold • March CPI (yoy%) to accelerate in India, Romania & Taiwan. To moderate in Nigeria • Industrial production figures for India, Malaysia, Mexico & Turkey • Q1 GDP (yoy%) to decelerate in Singapore

Upcoming events		
	US :	Tue: NFIB small business optimism (Mar), CPI (Mar); Wed: PPI (Mar); Thu: Retail sales (Mar), Weekly jobless claims (9 Apr), Business inventories (Feb), Michigan consumer sentiment (Apr,p); Fri: Empire state mfg survey (Apr), Ind prod (Mar), TIC Long-term investment flows (Feb)
	Euro Area:	Sun: Presidential election: first round; Tue: Ge Inflation (Mar), Ge ZEW survey (Apr); Wed: It Ind prod (Feb), Sp HICP (Mar); Thu: ECB announcement; Fri: Fr & It HICP (Mar)
	UK:	Mon: GDP (Feb), Index of services (Feb), Ind prod (Feb), Mfg & construction output (Feb), Trade balance (Feb), Trade in goods (Feb); Tue: BRC Retail sales monitor (Mar), ILO Employment data (Feb); Wed: Inflation (Mar); Thu: RICS Housing survey (Mar), BoE credit conditions & bank liabilities surveys
	Japan:	Wed: Private 'core' machinery orders (Feb)
	China:	Mon: CPI (Mar); Wed: Imports & Exports (Mar), Trade balance (Mar); Expected during the week: Total social financing (Mar), New yuan loans (Mar), M2 (Mar)

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