Research & Strategy Insights

Keeping cards close to the chest

102 – 30 August 2021

Key points

- After the vertiginous growth of the first half of 2021, some "digestion phase" was always to be expected in the US but some macro indicators point to some "organic" downside forces as well, amid the resurgence of Covid concerns.
- In this configuration, the Federal Reserve (Fed)'s prudence, expressed by Powell in Jackson Hole, is warranted.
- The European Central Bank (ECB) is not in a hurry to clarify the ambiguities left by its revised forward guidance.

As the summer ends, economic growth is moving away from the "spectacular rebound" of the first half of the year to a more sedate pace as the reopening is being digested. The issue though is how much of the slowdown is mechanistic – activity cannot "catch-up" forever – and how much is "organic", to borrow a word from Philip Lane. The resurgence of pandemic concerns ranks first on the list of "organic forces", and on this front, it is the US which is the most problematic.

A puzzling development is that the break between the number of cases and hospitalizations – the immediate benefit of the vaccines - which has been observed in Europe is not happening in the US, despite a very decent vaccination rate. A possible explanation is that the number of cases in the US is largely under-estimated, since testing is now very low there. The generally lower stringency of sanitary measures over there relative to Europe may explain why the delta variant is spreading so quickly.

These concerns may explain the recent softness in some macro indicators in the US, as spending on services may start to be impaired by consumers self-restraining. While this constitutes a clear downside risk to growth, we need to keep a sense of perspective. Policymakers' appetite for wide-ranging restrictions is now very low, and we can see some European solutions to preserve economic activity – e.g., the sanitary pass launched in France and Italy – making their way in some of the key economic areas of the US, such as New York. We are facing a "dent" to the recovery, not a reversal.

Yet, the sanitary issues are clearly playing a role in the Fed's prudence. In Jackson Hole Jay Powell did not offer any spectacular announcement and kept his cards close to his chest. The general "direction of travel" is tapering this year, but the precise timing can evolve depending on the balance of risks. The ECB as well, which has communicated a lot last week, is not in a hurry to clarify the ambiguities left by its revised forward guidance.

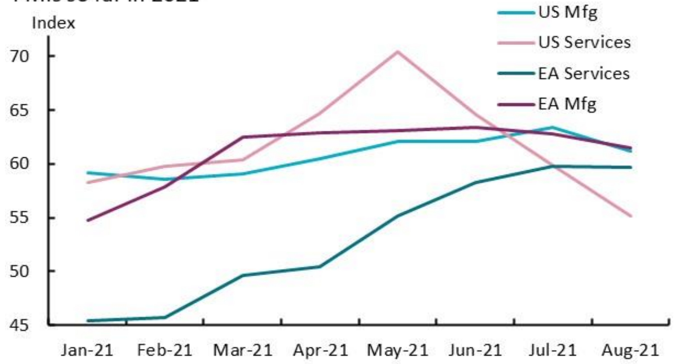
Beyond the "rubber band" economics

After the vertiginous improvement in macro data in the first half of the year, as the advanced economies were reopening, gauging the new "cruise speed" is not going to be easy. Three forces will rein in growth in the months ahead. First, catch-ups cannot last forever and are usually followed by some transitory digestion phase – the "rubber band economics". Second, while government appetite for even modest mobility restriction measures is now low, people may self-restrain their consumption of some services in reaction to the stubborn "delta wave". Third, the impact of lingering supply-side disruptions triggered by the pandemic across the global value chain could make it difficult for output to fully respond to existing demand. While the third force is problematic across the globe, the first two may be felt with specific strength in the US, where the catch-up started early and the rebound in the first half of (H1 2021 was particularly impressive given the magnitude of the Biden fiscal push which is now fading, now combining with concerning developments on the pandemic front.

So far in the pandemic crisis, t**he US economy had usually fared better than Europe. It is tempting to read in the very latest macro data the first signs of some reversal of this pattern.** Much ink was spilled last week when the services Purchasing Managers Index (PMI) for August dropped more steeply than in the Euro area (from 59.9 in July to 55.2, against a more sedate 1-point dip to 59.2).

Exhibit 1 – Watch the US services

PMIs so far in 2021

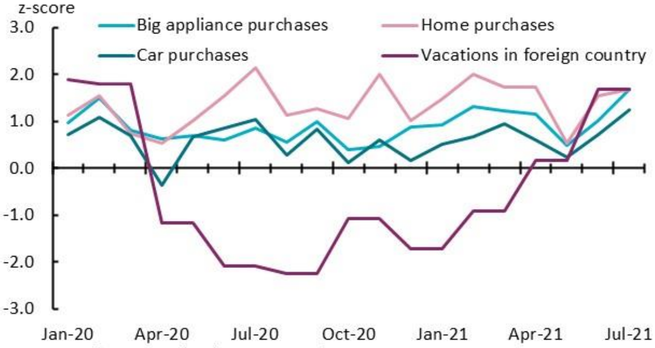


Sources: ISM, Markit and AXA IM Research, 27 August 2021

The July Conference Board survey suggested a still very high appetite to consume among American households (Exhibit 2), including on items which are very dependent on their assessment of sanitary conditions (i.e., foreign holidays). This may be about to change, however. We were impressed by a NBC poll, conducted between 14 and 17 August, according to which only 37% of respondents think the "worst is behind us" on the pandemic, against 42% saying "the worst is yet to come". This has flipped relative to April, when 61% believed the "worst was behind". This resurgence of Covid-related fears may already be reflected in US households cutting down their restaurant bookings slightly in the most recent data. Nothing spectacular relative to where they were at the beginning of the year, but they are now about 10% below normal again (Exhibit 3). So, while consumption on goods may still be strong, spending on services may be curtailed again.

Exhibit 2 – Still happy to consume apparently…

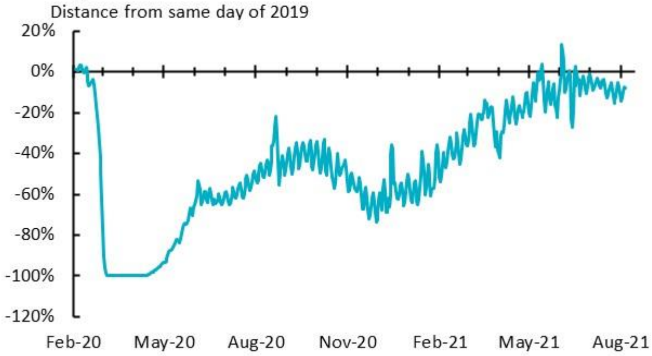
US consumer 6-month expectations



Sources: Conference Board and AXA IM Research, 26 August 2021

Exhibit 3 – … but watch signs of "crowd avoidance"

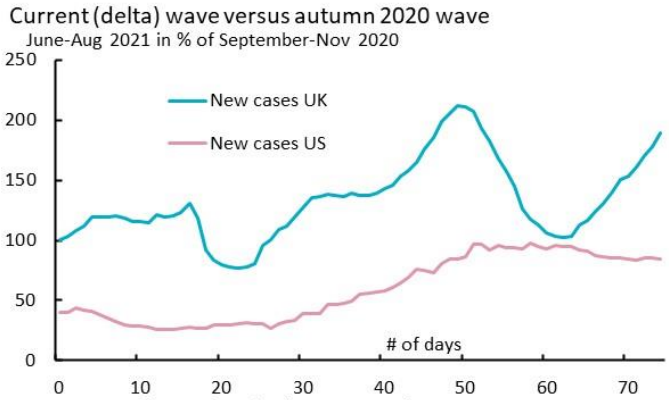
Bookings in US restaurants



Source: OpenTable and AXA IM Research, 22 August 2021

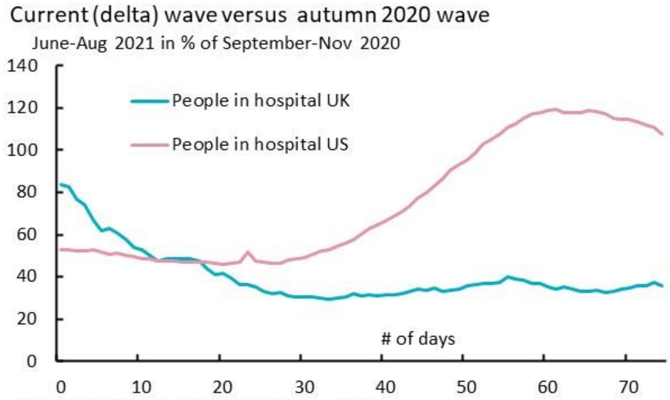
The US is no longer faring better than Europe when dealing with the pandemic, after the "miracle" of the first months of the vaccination campaign in the US, contrasting with the logistical issues experienced by the European Union (EU). **The most immediate benefit of the vaccines is to break the relationship between the number of cases and the level of pressure on the healthcare system**, allowing an economically beneficial lift-off of a wide array of sanitary restrictions despite still elevated virus circulation. The break is still very visible in the UK, which we continue to use a "forward-looking" indicator of developments in Europe in general, even if the continent is closing the vaccination gap quickly. In Exhibits 4 and 5, we compare the current "delta wave", which has started in earnest in June, with the last "pre-vaccine" wave, the one observed in the autumn of 2020. The aggressiveness of the delta variant is plain to see in the fact that the number of cases in the UK has been significantly exceeding the levels seen last autumn, with some recent gyrations probably connected to the European football tournament. But the efficiency of the vaccines is also plain to see, with the number of people in hospital in the UK standing at only a third of the autumn levels.

Exhibit 4 – Looking at cases…



Sources: Our World in Data (OWID) and AXA IM Research, 26 August 2021

Exhibit 5 – …makes less sense than looking at hospitalisations



Sources: OWID and AXA IM Research, 26 August 2021

The same "break" cannot be found in the US. Over there, while the number of cases has remained slightly lower than last autumn, hospitalizations have been significantly higher. The wedge between the two countries on hospitalizations (as a percentage of population it is now two and a half times higher in the US than in the UK) contrasting with a very similar infection rate (0.4/1,000 in the US, 0.5 in the UK) is puzzling. One possibility is that **the number of cases is massively under-estimated in the US.** Indeed, testing has collapsed over there in the last few months. As of the beginning of last week, the number of new tests stood at 10.9 per thousand people in the UK against only 2.6 per thousand in the US. **In other words, vaccines do work, in the US just as everywhere, but the underlying strength of the delta wave is much higher in the US than in Europe**.

A potential explanation here is that despite progress on vaccination European countries have in general maintained a higher level of sanitary restrictions than in the US. The "stringency index" designed by the Blavatnik School of Government stood at the end of June at 38.9 in the US against 51.4 in the UK and 47.2 in France. Obviously, there is a risk that heightened mobility during the summer period could trigger a more problematic acceleration in the circulation of the virus which would be reflected in healthcare pressure in Europe as well, but for now the problem is significantly more acute in the US.

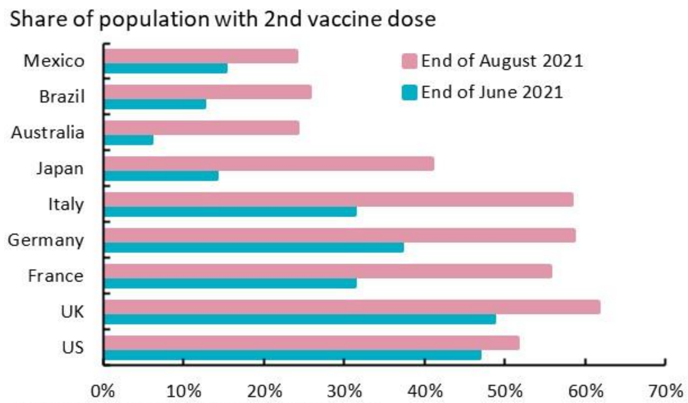
Still, **what we are discussing here is a relatively mild impairment to economic activity, relative to what was experienced last year.** Vaccines do provide protection, and there are more and more signs that companies and local authorities in the US look to the experience in some European countries – notably France and Italy – where mobility restrictions are determined by individuals' vaccination status. For instance, from 13 September onward, customers will need to prove they have received at least one dose to be able to dine indoors in New York, and the city has mandated its workers to either vaccinate or test on a weekly basis. This type of approaches will always remain patchier in the US, given its federal setup, than in unitary European countries, but there is a high chance that the main productive nodes of the world's biggest economy will be able to operate with a decent level of normality in the months ahead despite the delta wave.

Beyond the US case

In our view, **the biggest new challenge which has emerged on the pandemic front over the summer comes from several studies pointing to some relatively quick time decay of the immunity provided by the vaccines**. [A large-scale study in Israel] following 2,653 people having received two Pfizer doses and 4,361 unvaccinated people who had been previously infected suggested that after six months 16% of those in the first group had experienced a decline in antibodies below a threshold "generally considered as protective", a higher proportion (9.4%) than for those who had been previously infected (10.8%).

Some countries are already working on some booster programmes. This would entail a constant "churning" of vaccines. Not a medical, but a logistical issue, given the already high pressure on vaccine production capacity. **This also adds a new constraint on the speed of the current vaccination programmes.** Indeed, if progress is too slow, a large share of those who have been inoculated first – in general the most-at-risk groups – will become more prone to infection again even before any kind of "collective immunity" is reached, recreating pressure on healthcare capacity. This means that countries would have to embark on "permanent vaccination campaigns". This may not be too much of a challenge for advanced economies – even if we note in Exhibit 6 that some of them, such as Japan and Australia, continue to lag significantly behind Europe which has now taken the lead – but less fortunate countries, already dealing with significant logistical or political hurdles (e.g., Mexico and Brazil) will have a hard time delivering the necessary effort.

Exhibit 6 – Still wide dispersion



Sources: OWID and AXA IM Research, 27 August 2021

All this paints **a complicated picture for the world economy in which the probability of disruptions at one segment or another of the global value chain remaining high**, as Covid "flare-ups" triggering localised but significant curtailments to mobility – e.g., the current developments in Australia – would still accompany us into 2022. While we remain quite positive on services output in the advanced economies in general, given the absence of generalized lockdowns – the much more globalised manufacturing sector could continue to face supply difficulties, with potentially more pressure on prices.

No wonder the Fed is keeping its options open

Since the end of Ben Bernanke's tenure, the Federal Reserve has been trying to dial down the heat on the immediate policy content of the Jackson Hole conference. It makes sense, given the ambiguity of the configuration. Indeed, it is unclear whether on such an academically oriented conference, the Fed chair speaks in a personal capacity or reflects the majority of the Federal Open Market Committee (FOMC). If the committee is particularly diverse in its views – and judging by the dispersion of the "dot plot" and recent communication, this is definitely the case right now – then it's preferable to communicate big changes only after a formal meeting.

Accordingly, in his speech Jay Powell did not to stray away from the latest "official communication" of the majority of the committee, choosing a mere restatement of a known majority position when it came to the crucial paragraph on the future policy stance: *"at the FOMC's recent July meeting, I was of the view, as were most* *participants, that if the economy evolved broadly as anticipated, it could be appropriate to start reducing the pace of asset purchases this year".* The addendum to this was finely balanced*: "the intervening month has brought more progress in the form of a strong employment report for July, but also the further spread of the Delta variant. We will be carefully assessing incoming data and the evolving risks"*.

The Fed does not see reasons to ditch its positive outlook from the early summer and is still heading towards the beginning of a roll-back of its unconventional policy tools but does not want yet to tie its hands to any precise schedule. The general direction of travel is clear, but the timing is open. Given the developments on the pandemic front we sketched out in the previous section of this note, this makes sense, especially given the latest developments on the inflation front.

Indeed, **Jay Powell was able in his speech to make again the case for the transitory nature of the current inflation spike with more evidence to support his view**. The very latest data suggests that some of the items which had pushed core inflation towards a three-decade high have started to stabilise (used cars for instance) while the latest Michigan survey – released as the Fed chairman was speaking – confirmed that although consumers do expect a continuation of the current quick inflation pace in the year-ahead, their forecasts over a longer horizon remain in the historical range.

In our view, the most likely trajectory for the Fed's next steps would be a formal "warning" at the 22 September meeting that "tapering" is on its way, with a full announcement at the November 3 meeting – including the crucial speed of the process, for implementation from the 15 December 15 meeting onward. Still, there is much fluidity around this, and we expect the Fed to monitor financial market conditions, as well as the "balance of risks" on growth and inflation, to precisely tailor its schedule.

Before the summer break we were still expecting US 10-year yields to get close to 2% by the end of the year, with some of the technical factors holding them down (e.g., the unwinding of the Treasury General Account and domestic banks recycling their plentiful deposits) fading, and the Fed starting the reduction in its purchases. However, with the market being reassured on the inflation side and taking on board the aggressiveness of the Delta wave in the US, we are now looking for a less ambitious 1.75%.

Ambiguities confirmed at the ECB

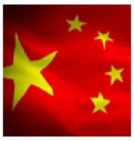
The ECB broke its "summer recess" with the publication of the minutes of its July meeting and a wide-ranging interview by its Chief Economist, Philip Lane, to Reuters. In these two instances, their message came out raising more questions than providing answers.

Let's start with the minutes. The discussion of forward guidance contained an interesting message*: "forward guidance on interest rates, if credible, should reduce the extent to which other instruments needed to be deployed"*. That reads like a trade-off with the hawks. In July, the ECB went further than the market expected on the dovish side, with its new forward guidance putting heavy emphasis on hitting the inflation target "well ahead" of the end of its forecasting horizon before tightening rates. Yet, market focus now is not so much on rate policy but rather on the magnitude and duration of the two quantitative easing programmes. Technically, forward guidance on quantitative easing (QE) is linked to that on rates, since the ECB has maintained in the July press release the pledge to only stop the Asset Purchase Programme (APP) *"shortly before it starts raising its policy rate"*. Yet, during the press conference Christine Lagarde had stated that the revised forward guidance applied only to rates. The idea expressed in the minutes that by being "generous" on low rates the central bank – if that was enough to lift inflation back to target – could do less on the unconventional side is another indication that some "decoupling" between the two aspects of the ECB's monetary policy is underway. This was confirmed further into the minutes by the point that *"there was general agreement to defer the discussion on the APP forward guidance to a future meeting"*. So, in a nutshell, **the link between APP and policy rates is hanging by a thread,** dependent on a decision which is not yet scheduled.

We note that **the decoupling between QE and policy rates seems to be a common theme across the Atlantic**. Indeed, in his speech in Jackson Hole, Jay Powell took great care to distinguish as clearly as possibly the discussion on tapering from any discussion on the rates lift-off. A key difference though is that the Fed is operating in a configuration in which the US output gap has probably already been plugged, so that taking time to lift rates after "tapering" QE is consistent with triggering some inflation overshooting. The Euro area is lagging on this front and given the structural fragility of its fragmented bond market, removing QE is likely to be thorny. Yet, the hawks' pressure is showing.

We may not see any clarification on the European QE front any time soon, judging by Philip Lane's interview. On terminating Pandemic Emergency Purchase Programme (PEPP), he made the point that since this would not be a brutal end of QE for the ECB – since APP would continue – the ECB does not necessarily need to announce a timeline to "prepare the market" very long before the "soft deadline" of March 2022 This suggests no announcement of this type would be made at the September meeting, consistent with our view that me may have to wait until December to get that. In the meantime, the conversation will focus on the calibration of PEPP. Philip Lane made it clear it is dependent on underlying market conditions. They have been benign lately, so a reduction in the quantum could be on the table for September, although, given the news flow on the delta variant outside Europe, there again December may be a better time to reduce the pace.

The discussion on the future of APP was quite open in Lane's interview. On the crucial issue of transferring to APP the flexibility of PEPP, Lane did not close the door, making the point that the ECB should not set itself "too many red lines" when it comes to policy implementation, but (i) Lane has been sitting among the "moderate doves" of the Governing Council, so it's unclear whether his open attitude is widely shared and (ii) Lane mentioned the legal framework, which implicitly takes on board the jurisprudence of the European Court of Justice which can be interpreted as preventing the ECB from holding more than 50% of a member State's public debt. A key point though on these issues is that Lane stated his belief they *"have plenty of time to think about all this"*. Ambiguities have a great future.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Fed Chair Powell speech from Jackson Hole speech suggests Fed poised between Nov and Dec announcement to taper. • House passed Budget resolution allowing for $3.5tn reconciliation bill by end-Sept • Kabul bomb attack kills at least 60 Afghans and 13 US troops as evacuation continues • GDP revised to 6.6% (saar) in Q2 (from 6.5%) • PCE inflation (Jul) rose to 4.2%, core at 3.6% • Home sales rose faster than expected in July.	• August employment report – expected slower payroll gains than 943k in July – pace to affect market views of Fed taper timeline • ISM manu (Aug) likely to dip following decline in most Fed regional surveys • Conf Board cons confidence (Aug) – weekly measures regained highs post-delta dip • House prices (Jun) to remain firm • Vehicle sales (Aug) watched for signs of easing of chip shortage supply constraints
	• German Q2 GDP has been revised higher to 1.6%qoq thanks to stronger priv consumption • EMU Flash PMIs in both mfg and services have slightly declined but remain strong around 60 • Delta variant impacted EMU cons confid for the 2nd month in a row to -5.3 (from -4.4)	• EC sentiment surveys probably peaked in July but figures should remain high and consistent with a persistent recovery especially in services • Aug CPI is likely to increase to 2.5%yoy after +2.2% in July. Strong base effect from energy. • Final Q2 GDP figures for EMU-4 / Jul retail sales
	• New virus cases rise to 38k. Case load rising again having retraced from Euros spike and with schools on holiday. • PMIs lower (Aug, p). Manu modestly to 60.1 (from 60.4), services to 55.5 (from 59.6). Along with drop in July retail sales, consistent with our view of much slower Q3 GDP growth.	• BoE lending data (Jul) to suggest still elevated housing demand, despite imminent Stamp Duty exemption expiry • Nationwide HPI (Aug) – prices stabilising • BRC shop price index (Aug) watched after unexpected dip in CPI inflation • Final PMIs
	• Extension of state of emergency until mid-Sept • Jul CPI has declined substantially to -0.3%yoy from 0.2% following a methodology update • Aug Mfg PMI flash declined slightly but remains in expansion at 52.4 (from 53).	• Retail sales has probably peaked in July before renewed state of emergency • July IP has probably slowed due to chip shortages • Aug cons confidence has probably declined due to COVID resurgence.
	• Local virus case counts fall to low single-digit, prompting governments to unwind travel and social restriction	• PMIs may show manufacturing growth stalled and service activity weakened in August
	• Korean retail sales accelerated in June to 13.1%yoy, lost steam in Mexico to 17.7% from 29.7% in May. • Korea hiked policy rate from 0.5% to 0.75%, becoming the first major Asian to raise interest rates since the start of the pandemic. • BI/MOF announced IDR215tn of direct bond buying in 2021 and IDR224tn in 2022	• Q2 GDP growth expected to pick up pace in Brazil and India. • PMI figures for August across EMs. • A 25bp hike is expected in Chile (current policy rate: 0.75%).

Upcoming events		
	US:	Mon: Pending home sales (Jul); Tues: Case-Shriller & FHFA HPI (Jun), Conf Bd Cons conf (Aug); Thu: Jobless claims (Aug), ULC & productivity (Q2) , Factory orders (Jul); Fri: Payrolls Report (Aug)
	Euro Area:	Mon: Business confidence (Aug), Ge & Sp HICP (Aug,p); Tues: Ge Unemp (Aug), Fr & It GDP (Q2), Ez, Fr & It HICP (Aug,p), Fr Cons spending (Jul); Wed: Ge, Fr & It Manu PMI (Aug), Unemployment; Fri: Fr, Ge & It Servs PMI (Aug)
	UK:	Mon: Bank Holiday; Tue: BoE Lending data (Jul), M4 (Jul); Wed: Manu PMI (Aug, f); Fri: Servs PMI (Aug, f)
	Japan:	Tue:Industrial production (Jul, p)
	China:	Tue: Manu & Servs PMI (Aug), Caixin Manu PMI (Aug); Fri: Caixin Servs PMI (Aug)

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