Walking and Talking

81 – 1 March 2021

Key points

- Fed speakers "talked dovish" but did not push back against the rise in yields, which unsurprisingly continued. The ECB is more pro-active.
- For now, the UK is the only G7 country where the rise in interest rates is used to justify concrete fiscal stabilization plans. The choice of the instrument may not be ideal though.

Although Jay Powell and other Fed spokespeople reiterated their intention to maintain an accommodative stance despite the looming fiscal push, US 10-year yields ended last week another 10 basis points higher, bringing the overall rise so far this year to more than 50 basis points. Real yields continue to drive the sell-off, market-derived measures of inflation expectations having peaked on 16 February. This market reaction is probably not surprising since none of the Fed speakers attempted to push back against the rise in yields, attributing it to the improvement in the macro outlook.

In the previous issue of Macrocast we opined that the ECB could not afford to be passive given the magnitude and speed of contagion on the European bond market from the US, at odds with the cyclical conditions in Europe. Governing Council members engaged in robust verbal intervention last week, explicitly weighing against an ill-timed tightening in market conditions. Brokers reported an increase in the pace of the PEPP, suggesting the ECB is "walking the talk". This is justified in our view. Everywhere in the developed world a rebound in the growth rate of new Covid cases is being observed, but in the Euro area this creates a specific risk given the slow start of the vaccination programme. There, the trough in economic activity may not have been reached. The case of Italy is telling. The country started to re-open on a regional basis last month, but the re-acceleration in the circulation of the virus is now triggering more stringent restrictions again in the economically crucial regions of Lombardy and Piedmont.

A key issue at the current juncture is whether the rise in market interest rates will force fiscal authorities to reconsider the magnitude of their stimulus programmes. There is no sign of this in the US. Although the Biden administration will probably be unable to get its steep rise in the minimum wage to USD15 per hour – some good news on the inflation risk side – it seems the package will not land too far from the administration's initial target of USD1,900bn. The UK is the only G7 country where the rise in interest rates is explicitly used to justify concrete fiscal stabilization plans, with in particular a significant albeit gradual hike in the corporate tax rate. We will monitor the market reaction to this first experiment. It is possible that investors will focus more on the country's overall macro strategy than on public deficit projections. Raising corporate tax might not be the most obvious choice for post-Brexit Britain.

Precedents and uncertain trajectories

The pandemic-driven crisis has no proper precedent, but understandably the market is looking for past events for guidance in our extremely uncertain environment. It may well be that **the memory of the "taper tantrum" of 2013 – when expectations of a quicker than expected reduction in the pace of Fed buying triggered a bond market sell-off – was a bit too overwhelming last week**. Your humble servant – as most macroeconomists – confesses having a quite dim view of "technical analysis" or using past market patterns to try to predict asset prices, but it's true that the graphical resemblance has been uncanny so far (see Exhibit 1, here for real yields). If the US bond market continues to replicate the 2013 trajectory, the 10-year real interest rate would touch zero by 10 March 2021.

2013 was driven by (mis)communication from the Fed and last week **Fed speak did not signal a strong intention to stop the market reappraisal in its tracks**. True, Raphael Bostic, who a month ago had sounded quite hawkish in his readiness to discuss normalization, stated last week that he was going to be *"very, very patient with monetary policy"*, but also said that the rise in yields was *"probably a good thing",* reflecting a better macro outlook. This line was also espoused by Bullard, who attributed higher market rates to "*reflecting 2021 optimism"* after reiterating that the Fed would take its time to normalize its stance. Both statements encapsulate the view that the Fed can hardly push back against higher yields given its own explicit tolerance of future inflation overshooting and is ready to tolerate some moderate increase in real yields.

We were surprised though that no one at the Fed chose to take a forward-looking approach and signal that there would be a point beyond which higher real interest rates would become too much of a burden for the US economy given its still fragile state. This leaves it up to the market, through a volatility-inducing discovery process, to test the central bank. In any case, this brings us back to two points we have already made several times in Macrocast. First, the debate at the Fed is solely between doing less – i.e., when and how to taper – or continuing with the current stance, the possibility to do *more* is not in scope. Second, no matter how often FOMC members repeat the "average inflation targeting" mantra and make it plain they will take their time to start raising Fed Funds rates – Powell, Clarida and Brainard did so last week - investors won't be in position to trust them 100%. If the labour market improves quickly in 2022 and asset prices remain strong, pressure will be massive on the central bank not to tolerate that many months of above 2% inflation before normalizing. Given the state of Fed communication, there is probably some more space for higher market rates.

Exhibit 1 – Uncanny similarity

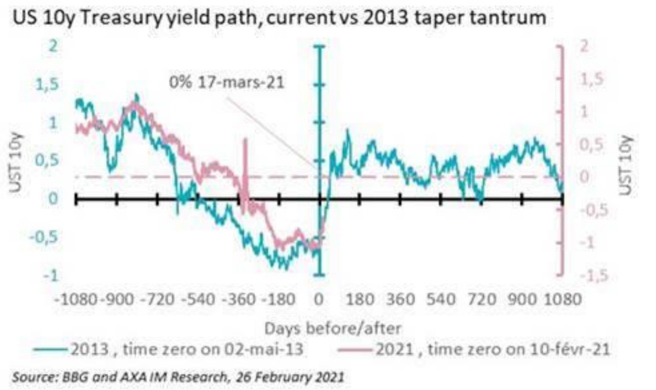
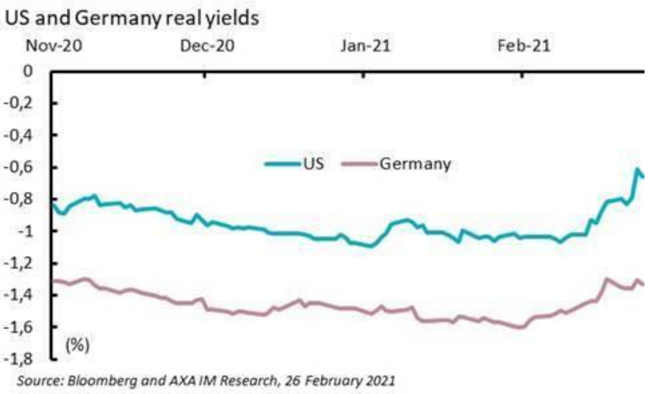


Exhibit 2 – Less abrupt in Europe



ECB walking the talk?

As we expected, the ECB is ready to take a more pro-active view. On Monday, Christine Lagarde used a tried and tested expression to signal concern and some readiness to act: the central is bank is *"closely monitoring the evolution of longer-term nominal bond yields*". We find it interesting she chose to focus on nominal and not real yields – despite the latter measure being singled out in the last Governing Council minutes as a key variable. Real yields started rising in the Euro area as well (see Exhibit 2) but were flatter last week. Lagarde's choice of words may reflect some caution at the ECB on the validity of the real-time breakdown between inflation expectations and real yields derived from market pricing. More generally, it may well be that the ECB does not want to send too subtle a message and is intent on nipping the rise in market rates in the bud.

Philip Lane added to the ECB's verbal intervention in a comprehensive interview with La Expansion. We would highlight two points he made. First *"it's important to remember that our pandemic emergency purchase programme (PEPP) will be used flexibly in response to market conditions. We have our regular monetary policy meetings, but our market operations can also be conducted in a flexible way between meetings, if necessary".* This is consistent with an immediate acceleration in purchases (the bit on "between meetings"), which according to brokers has already been done last week (we'll look for confirmation in the data released on Tuesday by the ECB) but also leaves open the possibility that the Governing Council could choose to step up the PEPP envelope itself should the need arise. This is also how we understand Isabel Schnabel's point on Friday that *"policy will then have to step up its level of support"* if the rise in real long-term rates is too abrupt. We concede that it is not very explicit – neither of them chose to discuss upfront another extension of the PEPP – but there is crack in the door.

There is no emergency on the PEPP envelope. We reiterate our point from last week: thanks to peaceful market conditions these last few months the ECB has been able to be economical with PEPP and there is plenty of dry powder to resist market pressure. The overall size of the programme is still comfortable. After the last top-up it probably could not be extended much beyond another EUR200bn without taking the risk of getting close to bringing the ECB holding to 50% of the eligible debt of some member states. If the main issue was fragmentation – sovereign spread widening – then the ECB could add space by focusing its purchases on peripheral signatures on which it is still quite far from the 50% limit. If it's about keeping general financial conditions supportive, then it would need to intervene on core bond markets as well. Still, keeping "live" the possibility of even a small additional top-up could be tactically interesting in the current uncertain environment. We note however that the Governing Council will be in "purdah" this week, ahead of the meeting on 11 March. If the bond market sell-off resumes verbal intervention will be difficult.

The second point we would highlight in Lane's interview is his insistence on the possibility to take the deposit rate further down: *"we always remind people in our policy statements that we retain the option to move the key policy rates lower. We remain confident that if we decided it was the correct decision to make, we could move interest rates*". Normally, ECB speakers toy with this instrument only in case of undue upward pressure on the Euro exchange rate, which has been broadly stable since the beginning of the year. Still, rekindling expectations of a further drop in the front end could also help to take the entire curve down.

Financial decoupling needed

We think the communication divergence between the Fed and the ECB is fully justified. The ongoing cyclical decoupling between the US and the Euro area should be reflected in financial conditions.

Exhibit 3 – Services struggling in Europe…

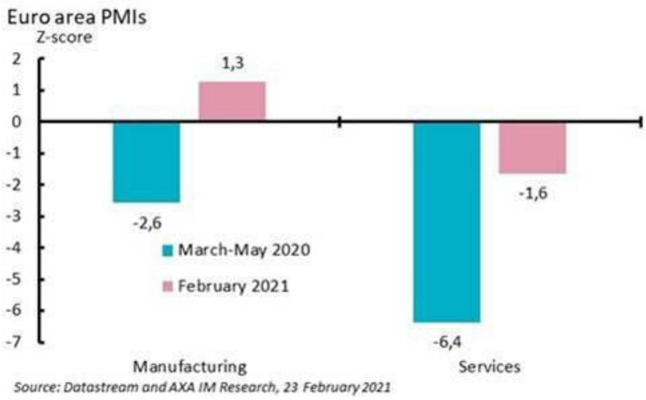
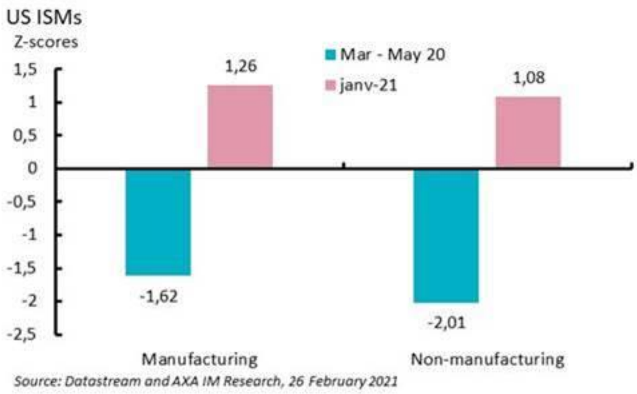


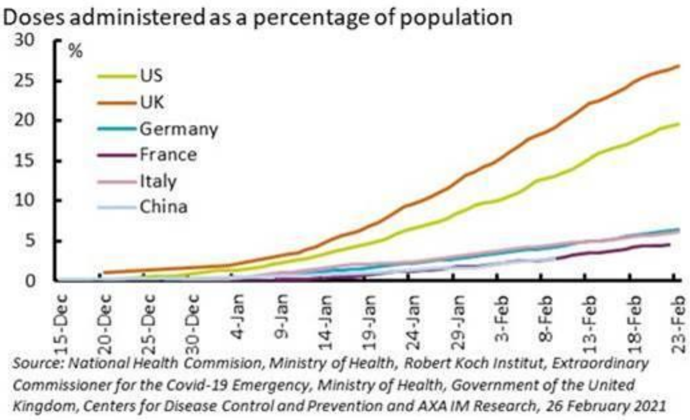
Exhibit 4 - …but still quite strong in the US



True, business confidence in the manufacturing sector is above its long-term average in both cases, but in the dominant services industry, the gap between the two regions is significant (see Exhibit 3 and 4). The macro trajectory for 2021 continues to be dependent on the pandemic and the US is now in a stronger position on that front than the Euro area. Everywhere in the developed economies the very latest developments in the rates of change in new cases have been concerning (see Exhibit 5), possibly reflecting the prevalence of the more contagious variants, but **the capacity to deal with a resurgence without taking drastic restrictive measures prolonging the "hibernation" of the economy is too a large extent conditional on the progress made on the vaccination front**. A deceleration in the flows of new inoculations continues to be observed in the US and the UK, but there a fifth and a quarter of the total population respectively have already received at least one shot, still between 4 and 5 times the levels seen in continental Europe. This would normally allow the US and the UK to take more risk with reopening.

Exhibit 5 – Another rebound

Exhibit 6 – Week after week the gap widens



It is therefore not clear if the Euro area economy has touched its trough in the current wave, while this is more obvious in the case of the US and the UK. It is symbolically telling that France, where the 7-day growth rate in number of new cases hit nearly 10% on 23 February, is contemplating toughening up the restrictive measures in one fifth of its territory on 6 March, just two days before the UK re-opens its school system.

Italy is going to be very informative given the decision there last month to partly re-open on a regional basis. There, the 7-day growth rate in new cases has turned positive again since 21 February to reach a 2-digit pace on 23 February for the first time since 10 January. Three more regions, including economically crucial Lombardy and Piedmont have just been upgraded to "yellow status" from Monday, triggering a full closure of bars and restaurants, and two regions (Basilicata and Molise) have been moved to "red", in effect a stringent lockdown. If the re-acceleration continues in the weeks ahead, this could act as a general warning for Europe against lifting restrictions too early. For now, the concerns we have been expressing since the emergence of variants – that we would have to "write off" the entirety of the first half of 2021 in terms of growth – are being confirmed in the Euro area. Restrictions will continue to significantly hamper economic activity into Q2 in continental Europe. We remain circumspect on the prospects of full normalization in time for the crucial summer season.

European governments can contain much of the ensuing scarring effects on the economy by prolonging their support measures, and this is what they have done, in particular thanks to the extension in the part-time unemployment schemes, but the longer activity is curtailed, the higher the risks of significant damage to the financial position of the corporate sector. Most of the lending spree of the first wave has been used by businesses to build cash buffers, so that low demand for more credit these last few months is neither surprising nor concerning. But of course, the proportion of those buffers which will need to be "burned" will rise the longer businesses cannot normalize their activity. This is a key variable to consider for the ECB and fully justifies their willingness to preserve easy financing conditions.

Any evidence of "policy feedback loop"?

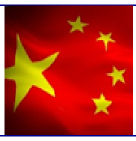
Intuitively, in the US at some point the rebound in market interest rates coupled with decent cyclical conditions even before the Biden package hits could make it more difficult for the US administration to pass the entirety of the plan. However, **for the time being, there is no evidence Biden is ready to compromise**. On Saturday the US

President called on Congress to deliver fast ("*there is not time to waste*"), following the House's endorsement of the full package (without bi-partisan support), echoed by Secretary Yellen in a tweet. Although still rejected by the entirety of the Republican caucus as it stands, the stimulus is very popular, with even Republican-leaning voters supporting it at 47% according to a Quinnipiac poll.

A setback for Biden though is that the gradual increase in the federal minimum wage to USD15 per hour – contained in the House bill – cannot find a majority in the Senate, since two Democratic Senators, Manchin and Sinema, are opposed to it. In any case, the Senate has ruled that this specific measure could not be subject to the "reconciliation process" which would allow for a simple majority pass. This means that this flagship item of the Democratic platform will have to be sacrificed for the rest of the stimulus to be implemented, which is quite urgent since the December bi-partisan intermediate package had prolonged the federal top-up to unemployment benefits only until March. Whether or not the US economy would have to deal with such a big increase in low-skilled wages was crucial in our assessment of the package's capacity to spur inflation beyond a transitory overheating phase. Still, our opinion at this stage is still that **the US fiscal package in the strict sense of the meaning – i.e., without the minimum wage which had been tagged on the House bill – will be significant and land close to Biden's opening gambit**. We also note the noises from Washington that the medium-term public investment plan, coming on top of the "emergency" fiscal stimulus, could be pushed through Congress this spring already.

It may be outside the United States that the rebound in market interest rates is already having an impact on fiscal policy decision. **The UK's budget bill, to be unveiled this week, is the first concrete "deficit roll-back" strategy which has been put forward in the G7 so far.** The Chancellor of the Exchequer Rishi Sunak had already made noises of this nature before but until now he had been stopped by the Prime Minister. Not this time. According to the British press over the weekend, Tory MPs will be forced by the party whips to support projected tax hikes. The need to contain the rise in market interest rates is explicitly mentioned by Sunak in defence of his plan. Two measures stand out. First, the UK would levy a stealth inflation tax by freezing in nominal terms the income tax brackets (in effect shifting more taxpayers into higher tax rates as income adjusts on consumer prices). Second, corporate tax would gradually rise from 19% to 25%. This would not be a full-on austerity drive though. Most of the support schemes are being prolonged for now, and the government is planning to guarantee some categories of mortgages to boost the housing market. Still, talking about tax hikes so early is "brave".

The British government may be spooked by the sensitivity of the gilt market to the general sell-off. Since the beginning of the year the UK 10-year yield has increased by 10bps more than in the US. The policy debate in London is influenced by the opinion of Andy Haldane, the Chief Economist of the Bank of England, who believes a post-Covid return of inflation may force central banks into a quicker than expected normalization. Still, the choice of instrument in this fiscal plan is surprising. One might have expected that post-Brexit the British government would try its utmost to keep the UK as attractive as possible as a global place of business and hiking the corporate tax rate is probably counter-productive from this point of view. In any case, we will be monitoring closely the market reaction to this first foray into fiscal consolidation by a G7 country. On Friday, UK yields did not fall back, unlike in the US and the sterling exchange rate gave back some of the recent gains reaped following the planned reopening of the economy thanks to the success of the vaccination programme. If this is confirmed in the coming weeks, this could signal the market is more sensitive to the overall macro strategy in London than to "austerity gestures".

Country/Region	What we focused on last week	What we will focus on this week
	• Fed Chair Powell testimony to Congress reinforced Fed's dovish forward guidance • UST yields rise, 10-year reached 1.60%; real yields up (breakeven fell) as markets question Fed • PCE inflation (and core) rose to 1.5% • House vote to pass Biden's $1.9bn stimulus • Initial jobless claims surprise to downside, at 730k – the lowest since November (825k expected) • Housing posts first retreats as rates rise	• Further increases in UST rates • Fed speakers further verbal guidance, ahead of purdah before FOMC meet • US payrolls figures expected to post gains as some states eased restrictions • ISM manufacturing and non-manufacturing indices • Fed releases Beige Book, anecdotal evidence on broader economies
	• German IFO surprised to the upside, with multi-year manufacturing expectations • France announced localised lockdown, while Italy extended mobility restrictions until 27 March • Eurostat revealed new 2021 HICP weights (i.e. hotels & restaurants fell to 75 per 1000 from 101) • Q4 GDP revision Ger: +0.3% +0.2p | Fr: -1.4% -0.1p	• Feb HICP flash is expected to remain at current level (1%yoy) • European Commission to unveil proposals on fiscal rules on March 3rd- expect general escape clause to be extended to 2022 • January retail sales to gauge the impact of restrictions
	• Govt announces contingent plans to ease COVID restrictions from 8 March to 21 June • Sharp employment fall of 114k in Q4 20, unemp edges up to 5.1% still supported by furlough • Pace of virus decline slows to -10% w/w, vaccine pace softens a little to 2.4m • BoE to review pace of QE purchases in March	• Chx Sunak announces Budget. Much focus on extension of support measures, broader questions on additional stimulus or any plans to address large deficit • Mortgage lending and housing data. Applications could soften ahead of stamp duty expiry
	• Q4 GDP growth was robust at +3%qoq with a strong rebound in capex (+4.5%), an acceleration in exports (+11%) and robust consumption +2.2% • February Tokyo CPI rose to -0.3%yoy from -0.5% • Jan industrial production accelerated by 4.2%mom, converging to pre-crisis level (-1.9%yoy) • As expected, January retail sales declined by 2.4%yoy, impacted by recent restrictions	• Jan U-rate and jobs/applicants ratio should be flat at 3% and 1.06 respectively • Feb Services PMI is likely to remain in contraction due to the state of emergency • February consumer confidence is expected to remain weak
	• China maintains zero local case and starts to remove social restrictions, which allows mobility to pick up strongly after the lunar new year	• National People's Congress will reconvene next week to discuss 2021 economic priorities and long-term development plan for the next five years
	• Bank of Korea kept the base rate unchanged at 0.5%, in line with expectation. At the same time Governor Lee hinted no near-term policy action • Korea's first 20-day export growth rose 16.7% in Feb from 10.5% in Jan on the back of continued strong tech exports	• Malaysia central bank decision likely to stay on hold • Headline PMI figures for Asia to show some mixed picture

Upcoming events	US :	Mon: ISM mfg PMI, new orders (Feb); Wed: ISM non-mfg PMI, new orders (Feb); Thu: Initial jobless claims; Fri: Nonfarm payrolls (Feb), Unemployment rate (Feb), US Federal Budget
	Euro Area:	Mon: EA, EU4 mfg PMI (Feb), It, Ge HICP (Feb); Tue: EA HICP (Feb); Wed: EA serv, comp PMI (Feb), Sp, Fr serv PMI, It serv, comp PMI (Feb); Thu: EA unemployment rate (Jan)
	UK:	Mon: Mfg PMI (Feb), mortgage approvals (Jan); Wed: Budget, Serv, comp PMI (Feb); Thu: Construction PMI (Feb); Fri: Halifax house price index (Feb)
	China:	Sun: mfg PMI (Feb); Mon: Construction orders (Jan), Unemployment rate (Jan); Tue: Serv PMI (Feb); Thu: Household confidence (Feb)
	Japan:	Sun: Comp, mfg, non-mfg PMI (Feb), Caixin mfg PMI (Feb); Tue: Caixin serv, comp PMI (Feb)

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