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Monthly Macro Insights

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The global economy started the year on a firmer note than feared. Yet, core inflation is still stubbornly high while banking sector woes make it clear that the most aggressive tightening cycle in decades is taking its toll. Correspondingly, central banks will have to balance the risks between price and financial stability.

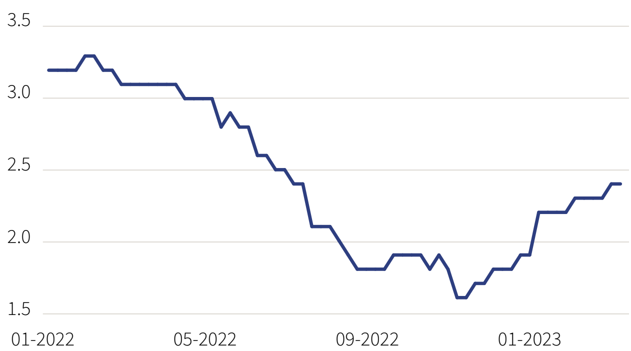
Stronger activity in early 2023

Survey indicators have strengthened from the troughs seen in late 2022. Consumer confidence has started to improve on the back of robust labour markets and the decline in headline inflation which has boosted purchasing power. Business survey indicators have rebounded from the November low, especially in the services sector, explained in part by the fading of pandemic-related supply dislocations. Regionally, China's reopening bounce is gathering some steam – although at a more moderate pace than expected – alongside a European rebound from its energy price shock.

However, investors' sanguine economic outlook is being challenged by higher-than-expected core inflation readings and continued tightness in labour markets, forcing central banks to keep rising interest rates. What's more, the drags from monetary tightening on credit are building alongside the lifts from fading supply shocks, and the banking sector stress now unfolding in the US and Western Europe will likely magnify the drag.

World – 2023 growth forecasts

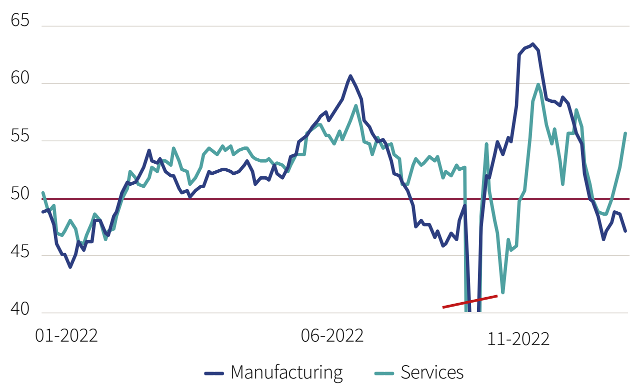
In %, JP Morgan



Sources: JP Morgan, Rothschild & Co Asset Management Europe, April 2023.

Eurozone – Business confidence

S&P Global



Sources: Macrobond, Rothschild & Co Asset Management Europe, April 2023.

Will the high-for-longer be challenged by rising financial stability concerns?

Most central bankers have insisted that policy rates will have to stay elevated for some time in order to restore price stability, and while financial stability risks have risen, they are unlikely to relinquish their inflation target. Indeed, banks are globally much better capitalised than they were in 2008 and the quality of their loan books, especially the case for mortgages, is stronger.

Still, the recent events in the financial sector might morph into a credit squeeze, especially as bank lending standards, which tend to lead credit growth, were tightening even before the latest turmoil. In the US, the need for smaller banks to preserve liquidity in the face of deposit flight, rising funding costs, and increased regulatory scrutiny will only exacerbate this trend.

While recognising the risk of an adverse credit shock, markets are signalling that the recent stress on US and European banks is contained and limited by policymakers' actions. In fact, it almost seems like the most pronounced and swift global monetary tightening in at least four decades will only have a marginal impact on economic activity, prompting some investors to go as far as to foresee a "no landing" scenario, with global growth barely softening in 2023.

Are monetary policies ineffective?

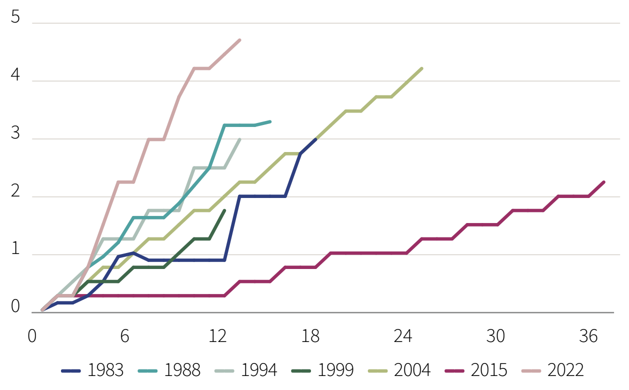
The basic idea with tighter monetary policies is that higher interest rates will slow overall demand in the economy, which will in turn reduce inflationary pressures. In fact, there are several channels by which monetary policy influences the economy. The level of interest rates influences credit demand, and the bank lending channel impacts the availability of bank credit and the conditions that are applied. The risk-taking channel works through changes in prices of financial assets and the willingness of borrowers, investors and banks to take risks, which influence capital markets-based financing.

However, the transmission is generally thought to have long and variable lags, changing over time in response to cyclical and structural changes in the economy. A large body of research tells us it can take up to six quarters or more for tighter monetary policy to materially affect inflation.

One school of thought suggests that the lags may have shorten in part because of policy guidance and central banks' credibility that, in effect, allows financial markets to react to policy before it is implemented. Correspondingly, financial conditions in the marketplace began changing in anticipation.

US – Policy rate evolution

In % per month after the first hike



Sources: Macrobond, Rothschild & Co Asset Management Europe, April 2023.

France – Wages

In %, y/y

Sources: World Bank, Rothschild & Co Asset Management Europe, April 2023.

Conversely, there are two factors that, by themselves, are likely to have lengthened the time it takes for monetary policy to affect the economy. First, the high share of fixed-rate credit in the economy is contributing to impede monetary policy *via* its effect on the cash flows of borrowers. For instance, in the housing sector, mortgage payments for variable-rate borrowers have risen alongside increases in policy rates, whereas fixed-rate borrowers face a large and delayed jump in their mortgage payments, depending on the term of their fixed-rate loan. Therefore, the high share of fixed-rate loans is adding an extra delay to the pass-through to outstanding mortgage rates.

Yet, as those fixed-rate loans reset at a higher interest rate, borrowers will be faced with a sizeable jump in their required mortgage payments. This reduction in borrowers' free cash flows will place pressure on their budgets and require an adjustment of their spending behaviour. More broadly, higher interest rates are making it more attractive to save, more costly for firms to invest and will impinge on households' willingness to spend, all of which will ultimately slow the growth of aggregate demand and bring down inflation, but with a lag.

Secondly, labour markets are tight in most countries, as evidenced by the sharp rise in vacancies and vacancies-to-unemployment ratios. Reduced labour force participation has shrunk the pool of available job seekers, making it harder to fill vacancies. Barriers to returning to work, changing worker preferences away from certain types of jobs, and sectoral and occupational job mismatch have also contributed to the phenomenon.
In this environment, businesses are very reluctant to lay off workers as, two years after the onset of the COVID-19 pandemic, the hiring process is challenging and costly. Therefore, the labour market is less flexible with businesses slower to respond to weaker demand, and cooling it off might require a higher-than-expected level of policy rates.

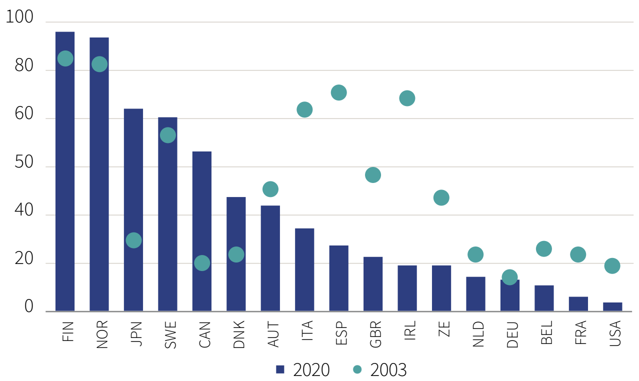
Meanwhile, tight labour market conditions, together with the extended period of high inflation, have put upward pressure on nominal wage growth. Although the pace of wage increases has started to level off, wage growth in most countries remains at rates that, if sustained for some time, would be inconsistent with inflation returning to target given weak underlying productivity growth, unless corporate profit margins contract.

Overall, the lags might have lengthened, but there are few reasons to think that monetary policy has become inoperative.
As such, the full – negative – impact of the synchronized tightening is likely to be felt in the coming months, which seems to have only been internalized by the sovereign bond markets.

Completed writing on 3 April 2023

World – Mortgage rates

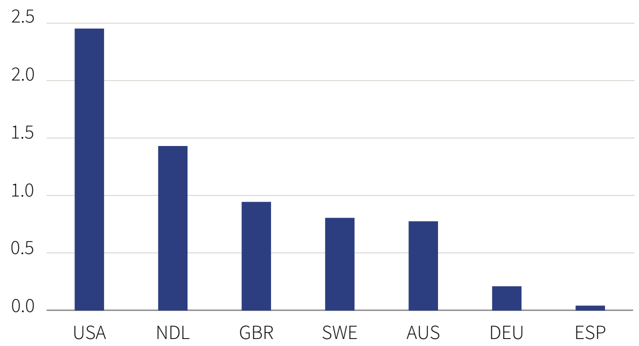
In %, share of adjustable-rate in new issuance



Sources: OECD, Rothschild & Co Asset Management Europe, April 2023.

World – Job vacancies

In pp, share of labor force relative to Dec-19



Sources: Macrobond, Rothschild & Co Asset Management Europe, April 2023.

Performance of the indices and interest rate levels

	Price as of 31/03/2023	1 month % change	2023 % change
Equity markets			
CAC 40	7 322	0.7%	13.1%
Euro Stoxx 50	4 315	1.8%	13.7%
S&P 500	4 109	9.8%	7.6%
Nikkei 225	28 041	2.2%	7.5%
Currencies			
EUR/USD	1.08	2.5%	1.3%
EUR/JPY	144.09	0.1%	2.6%

Interest rates	Price as of 31/03/2023	1 month bp(1)	2023 bp(1)
3 month			
Eurozone	2.81%	10	105
United States	4.69%	-8	35
10 years			
Eurozone	2.29%	-36	-28
United States	3.46%	-46	-41

(1) Basis point.

Source: Bloomberg. data as of 31/03/2023. Performances in local currency.

Past performance is not a reliable indicator of future performance and is not constant over time.
Index's performance is calculated on the basis of net dividend reinvested.

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