Banque Richelieu

Monthly Review
February 2024

Summary

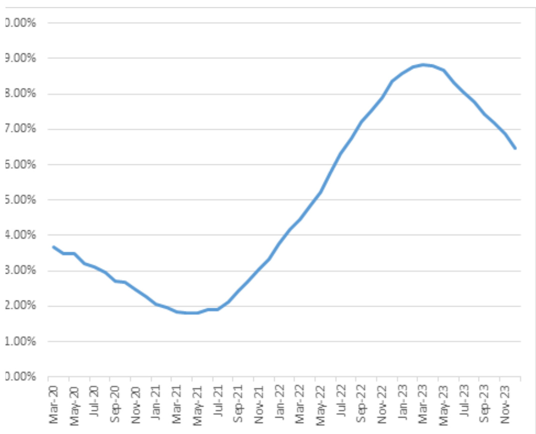
Better to delay a little than to retreat afterward...

For the next few weeks, the match between the European Central Bank and the Fed is eagerly anticipated to determine who will lower interest rates first. While the hesitation of governors will be present in all official speeches, restrictive conditions are no longer being discussed. Nevertheless, the stakes are quite different between the United States and Europe. In the United States, the economy has shown incredible resilience; in Europe, economic agents are just beginning to recover from historic interest rate hikes.

Annualized GDP US versus Eurozone

Sources : Bloomberg, Richelieu Group

Inflation on rents (primary residences)

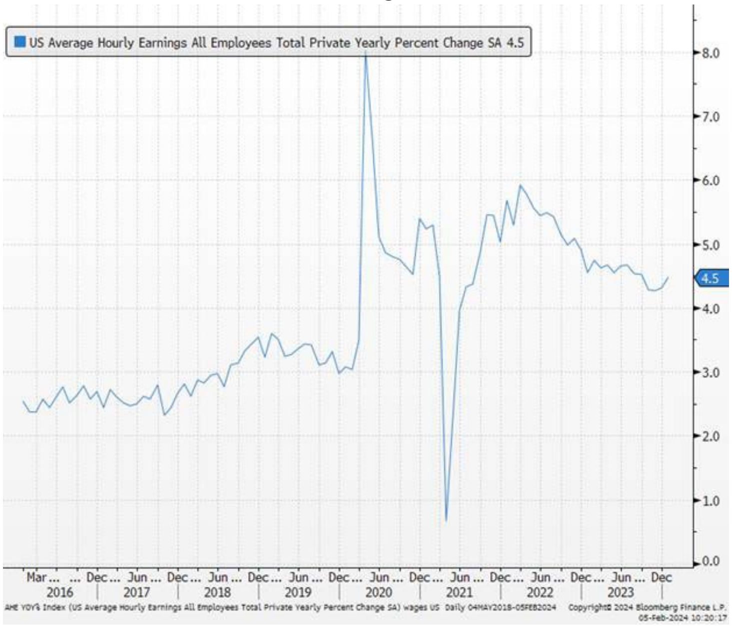


Sources : Bofa, Richelieu Group

In the United States, the GDP significantly exceeded fourth-quarter forecasts, posting a +3.3% on an annualized basis (compared to the anticipated 2%), mainly driven by household consumption. The Fed attempted to temper expectations of rate cuts during the month, deeming them too strong. C. Waller, a Fed governor, explains that the current policy is adequate in the face of disinflation and slowdown, particularly in employment. According to him, while avoiding excessive tightening is crucial, there is no need to rush things. **Inflation seems to be taking root but is expected to be reduced this year due to the resolution of supply-demand imbalances.** Housing remains a concern, with the unrealized hope for a relaxation of rents, as indicated by the latest CPI report showing their weight in December. It is premature to slow down the balance sheet reduction, but this discussion will become relevant considering its impact on market liquidity.

During its end-of-month press conference, the Fed clearly expresses confidence in the economy, waiting for more certainty before normalizing its policy. This confidence requires a decrease in inflation, especially concerning wages.

US wages



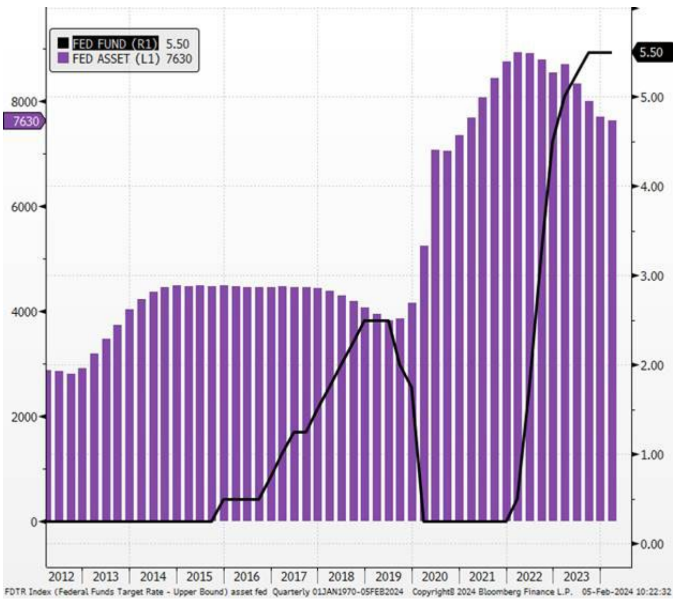
Sources : Bloomberg, Richelieu Group

The statement has evolved to mention a reduction in benchmark interest rates (as opposed to the previous mention of a possible additional tightening), while emphasizing that it is still too early to consider it.

The current momentum is positive for the institution, eager to confirm the trend of the last six months with more data on inflation and employment.

So, in our view, the interest rate cut cycle will begin in June, or even in May if the Fed has seen enough data in March (only one inflation report will be published between the two meetings). Our forecast for the first 25 basis points rate cut is in June 2024, followed by another in September and then in December, implying a total expected rate cut of 75 basis points this year. Regarding the balance sheet, there will be no slowdown in Quantitative Tightening (QT) until summer, which will exert additional pressure on inflation and allow for the initial interest rate cuts under optimal conditions.

Fed's assets



Sources : Bloomberg, Richelieu Group

The official statement now indicates: « the committee does not expect it to be appropriate to reduce the target range until it has greater confidence that inflation is on track to sustainably reach 2%. » The Fed is not aiming for inflation to reach 2% just once; « We want it to stabilize at 2%. We don't want inflation to drop below 2%.» J. Powell.

Source : X (formerly Twitter)

The essential question remains the concept of «greater confidence» according to the Fed !

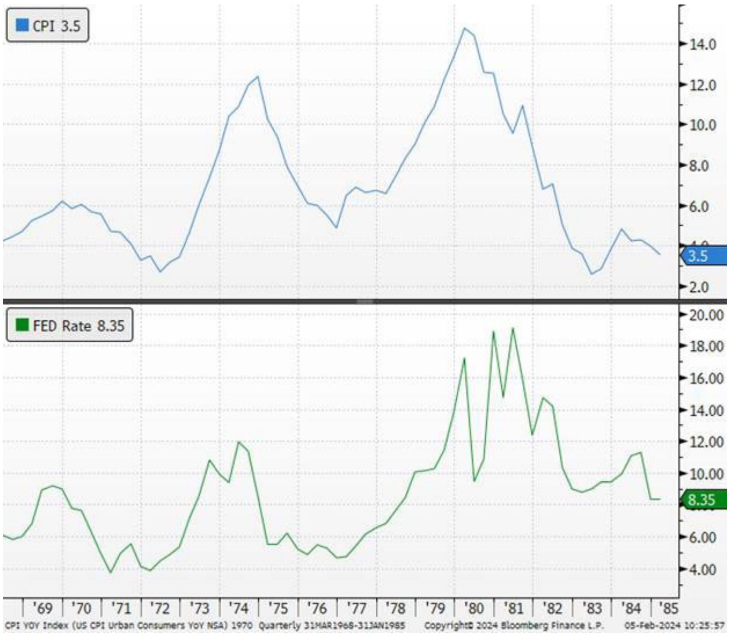
We believe this will require a further slowdown in wage growth to 3.5%. Beyond the official statement, President Powell reiterated his rather dovish stance during his press conference, emphasizing the Fed's intense commitment to achieving a « soft landing.» Mr. Powell stated, « We are not seeking to weaken the labor market » marking a notable shift from his previous statements that linked a higher unemployment rate to achieving the inflation target.

Risks include a possible reacceleration of inflation, although unlikely in the short term. The major risk is an inflationary stabilization incompatible with the mandate. Efforts are being made to avoid a new inflationary wave and the need to raise rates before 2025, steering clear of the mistakes of the 1970s.

This is positive and reflects the Fed's credibility with the markets. Regarding risks, a reacceleration of inflation is still possible but unlikely in the short term. The most probable risk is that inflation stabilizes at a level deemed incompatible with their inflation mandate.

We believe that everything is being done, both in speech and action, to avoid another inflationary wave and the necessity of raising rates before the end of 2025. Every effort is made to avoid the pitfalls of the 1970s. This is inherently good news and demonstrates a commitment to credibility with the markets over time.

Inflation and Fed rates in the 70s



Sources : Bloomberg, Richelieu Group

In the Eurozone, fourth-quarter GDP data pleasantly surprised with zero growth following a slight contraction in the previous quarter. The effects of monetary tightening and household purchasing power losses clearly weighed on domestic demand. Disparities remain significant, with Germany experiencing negative growth, France stagnating, and Italy, Spain, and Portugal accelerating. In terms of inflation, disparities are also evident among the countries. A growing gap is emerging between the struggling Franco-German duo and the rest of the Eurozone, which is rebounding, benefiting from falling inflation and household relief in terms of purchasing power.

PMI indicators in the main countries of the Eurozone

Sources : Bloomberg, Richelieu Group

The outlook should gradually improve in the coming months as consumption finds a new support factor with the increase in real wages, while the destocking phase in the industry is coming to an end. The Eurozone composite PMI is slightly up in January. The improvement in the manufacturing sector index is more significant than expected, but in services, there is a deterioration. The employment component stabilizes. Confidence is improving for the fourth consecutive month with better business activity prospects one year ahead.

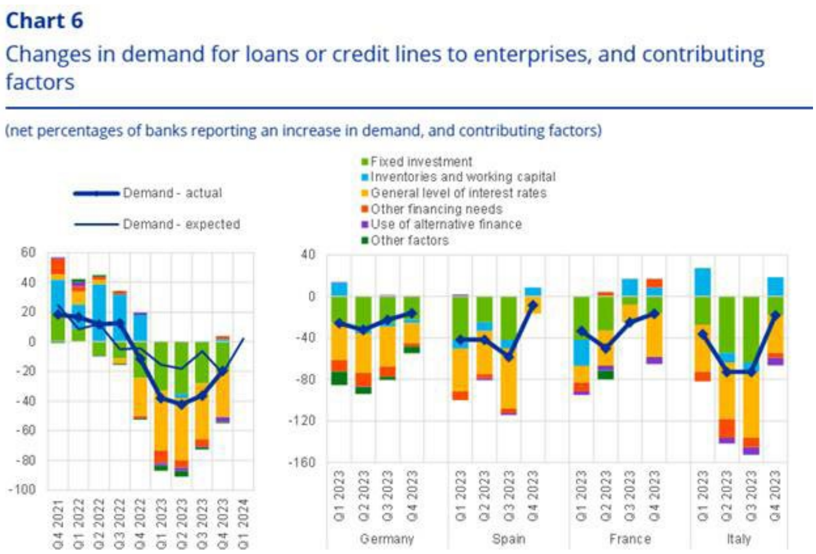
Consumer confidence in the Eurozone

Sources : Bloomberg, Richelieu Group

An improvement in activity is expected to occur in 2024, thanks to continued disinflation, including costs borne by businesses, and wage increases that more than compensate for inflation. This is aimed at supporting household confidence and reigniting domestic demand. On the business front, we should witness a recovery in industrial production thanks to the end of destocking. **However, the rebound in growth will remain very modest overall (+0.5% in 2024).**

While economic growth was substantially weakened at the end of 2023, leading indicators (Eurozone business climate in January) indicate stabilization or even the beginning of a rebound. Another positive sign comes from the distribution of bank credit. The message conveyed by the ECB's quarterly Bank Lending Survey shows the end of deterioration. The tightening of conditions for bank credit issuance is easing, and demand is deteriorating much less rapidly than in 2022 and 2023.

Evolution of the demand for loans
or lines of credit to businesses

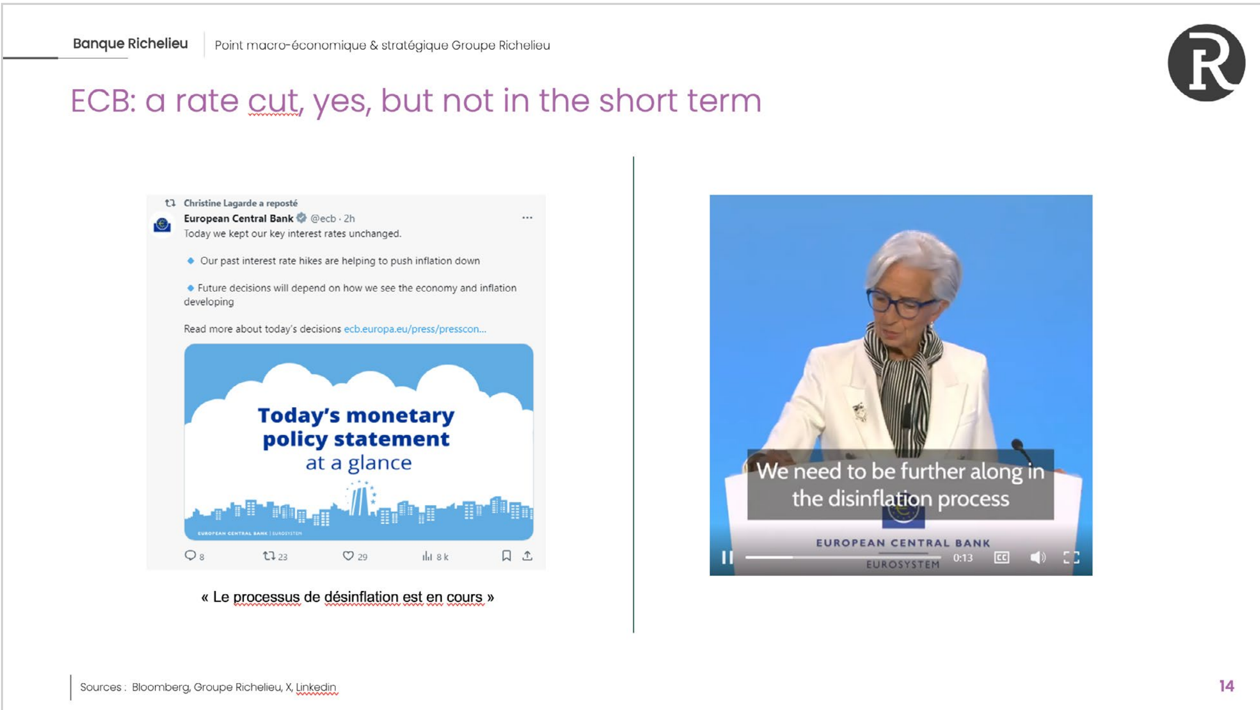


Source : ECB (Click here)

Banks anticipate, for the first time since 2022, a slight rebound in loan demand from both businesses and households, despite persistently tightened credit conditions. The main risk still lies in the inflation dynamics that could surprise with its resilience as oil prices rebound, and supply chain tensions reappear, largely linked to geopolitical issues in the Red Sea. The unemployment rate in the Eurozone remains at a historically low point of 6.4%, a factor that could be a potential source of concern regarding the pace of wage increases.

Christine Lagarde, during her latest press conference, has already identified the issue and is expected to maintain a cautious stance. **We anticipate three interest rate cuts this year (far from the 7 or 8 expected by the market)**. Similar to the diverse situation in Eurozone countries, increasing divergences are emerging regarding the timing of the first reduction in benchmark interest rates. The Portuguese governor, Mr. Centeno, who is among the more « dovish », stated yesterday that the ECB should start lowering its benchmark rates sooner rather than later. In contrast, the Slovak governor P. Kazimir (accompanied by Martins Kazaks from Latvia on Friday or Klaas Knot from the Netherlands,) belonging to the 'hawkish' camp, continues to express concerns about the risks of an early reduction in benchmark rates. **The upcoming economic indicators will be crucial in determining the speed of disinflation and the rebound in economic activity.**

Excerpt from the macroeconomic presentation of Groupe Richelieu on January 30, 2024



Source : Richelieu Group

A downward trend in inflation will need to become widespread across the entire Eurozone to allow the central bank to lower benchmark interest rates, even if it maintains a cautious bias. In our view, wage data will be the triggering factor for the first rate cut. One thing remains certain, as emphasized by the governor of the Bank of France, François Villeroy de Galhau: **a reduction in benchmark interest rates will take place this year, and now all options will be on the table at each meeting.**

Speech by François Villeroy de Galhau

MENU BANQUE DE FRANCE EUROSYSTÈME | Nous contacter | Nous trouver | Language : FR | Rechercher

Accueil > Intervention Gouverneur > La Tribune Dimanche : « L'inflation revi...

Discours

Gouverneur | + 1

La Tribune Dimanche : « L'inflation reviendra à 2 % d'ici 2025 au plus tard »

Les intervenants

François Villeroy de Galhau, Gouverneur de la Banque de France

28 Janvier 2024

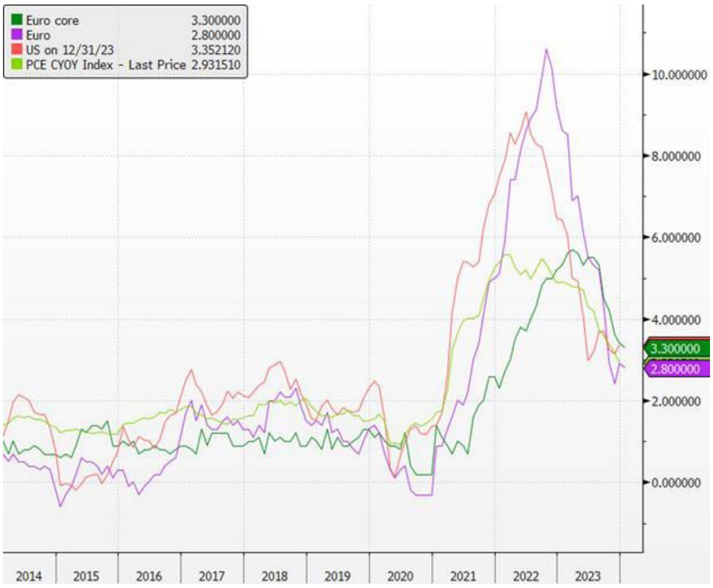
LA TRIBUNE DIMANCHE- L'inflation recule, la plupart des pays de la zone euro ont échappé à la récession en 2023. Quel regard portez-vous sur l'économie européenne en ce début d'année ?

FRANÇOIS VILLEROY DE GALHAU- Sur la seule conjoncture économique, les incertitudes ont plutôt tendance à un peu diminuer. Nous avons d'ailleurs très peu modifié nos prévisions entre septembre et décembre. Il y a un ralentissement de l'activité, en France comme en Europe. Et, plus positivement, un net recul de l'inflation.

Source : Banque de France (Click here)

We remain in line with November 1st, when Jerome Powell sounded the death knell for rate hikes. As long as there is no reversal in the disinflation process in Europe and the United States, markets will have confidence in a gradual normalization of monetary policies and a loosening of credit conditions.

Core and overall inflation in the United States and the Eurozone



Sources : Bloomberg, Richelieu Group

Although we are adopting a slightly more cautious stance than the consensus regarding the timing of the first rate cuts by central banks (expected in June by the ECB and the Fed, according to our view), we believe that, for now, the cautious attitude of central bankers is rather good news. Indeed, it demonstrates the willingness to avoid, as much as possible, a reversal in the face of price stability that is not truly committed. The key is the commitment to maintaining credibility in monetary action and sustaining moderate economic growth to prevent inflationary pressure. **Therefore, we remain positive on equity markets in this environment for the coming weeks.**

Regarding equity markets, barring an exogenous shock, we continue to believe that the situation remains favorable for companies, which should contain the decline in their margins.

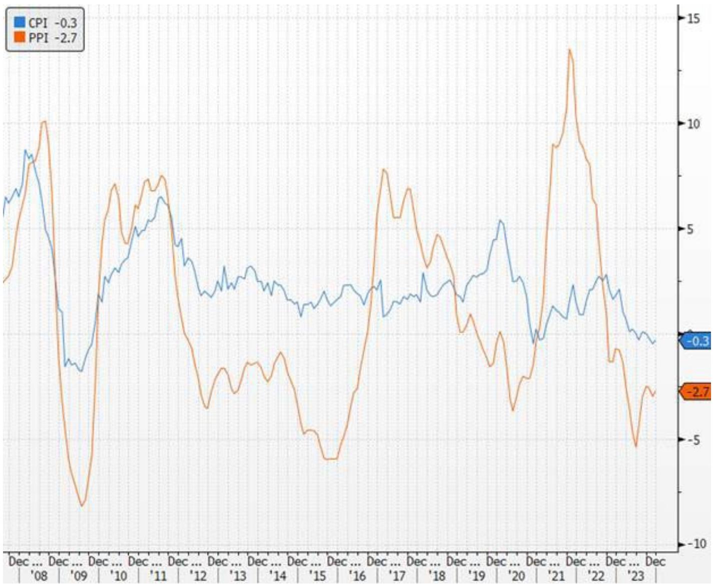
Stock indices since November 1st

Sources : Bloomberg, Richelieu Group

EMERGING COUNTRIES

The rate cut should be favorable to emerging assets, mainly in countries that have managed to stabilize their inflation. China will remain highly volatile compared to other nations. The government's initiatives, while reminiscent of the support efforts in 2015 or 2008, seem insufficient to spur a sustainable resurgence of investor confidence, due to the persistent structural issues in the Chinese economy. Contrary to expectations, China has not capitalized on the post-Covid enthusiasm. We believe this confirms Beijing's attempt to reassure (similar to the U-turn made earlier in the year on new regulations in the online gaming segment, announced on December 22), but it will be insufficient to significantly and sustainably revive their appetite for Chinese indices, despite their discount. In an environment marked by weak private sector demand and prolonged deflation, it is challenging to be enthusiastic about the revenue and profit growth prospects of Chinese companies.

Consumer and producer prices in China



Sources : Bloomberg, Richelieu Group

EUROPE

European assets will benefit from the recovery in Europe and the distribution of credit. Even though the recovery remains sluggish, this aspect tends to suggest that the improvement in economic growth is underway. Consumption is expected to rebound due to the rise in real wages and restored confidence in the face of inflation that is currently under control. Earnings prospects for 2024 are still moderate (+6% according to consensus). Additionally, in the coming week, the market may anticipate a rate cut by the ECB before the Fed, which could initially weaken the single currency and benefit exporting companies. **Valuations remain reasonable given the outlook for interest rates.** The improvement in credit conditions should finally benefit small and medium-sized enterprises that have suffered significantly from liquidity drying up for almost 2 years.

US

The US markets are highly dependent on the « Magnificent Seven » , but the trend remains positive. The results of these companies have been generally positive so far. The highlight will be on February 21st with the results of NVIDIA, which may have been the most significant market catalyst in 2023. **There is no questioning of the rate cut despite the resilience of the economy.** The dollar should be a positive factor for performance in euros. Valuations remain high in the face of very optimistic profit growth expectations for the year. Considering the excellent performance of the consumer, recent easing of financial conditions, and announced levels of stocks and capex, we remain constructive. Regarding capex, improved financial conditions and regained confidence in the macroeconomy should support investment in 2024.

Magnificient 7 versus S&P (equal-weighted)

Sources : Bloomberg, Richelieu Group

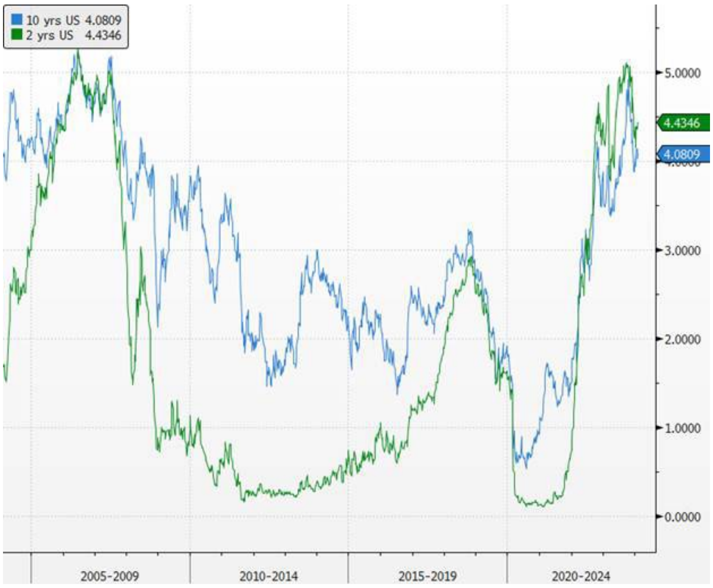
As for interest rates, we still do not believe in a pronounced recession. As central bank rate cuts become clearer, we should see a steepening of the yield curve in the US and Europe, particularly on the long end of the curve. If inflation stabilizes and makes slight progress, long-term rates should rise. Carry remains the predominant source of value. Concerning US high yield (HY), caution is warranted given the recent reports from US regional banks, especially those exposed to commercial real estate, and the expected acceleration in risk costs.

Spread high Yield US & Euro

Sources : Bloomberg, Richelieu Group

We continue in line with the previous month regarding macroeconomic factors. We are convinced that in the short term, it is the Fed that sets the tone. The potential for a decline in 10-year sovereign yields will remain constrained by the absence of a recession but also by the caution of the Fed. The continued reduction of the Fed's balance sheet will accentuate the portion of US debt that will need to be absorbed by investors.

2-year and 10-year yields

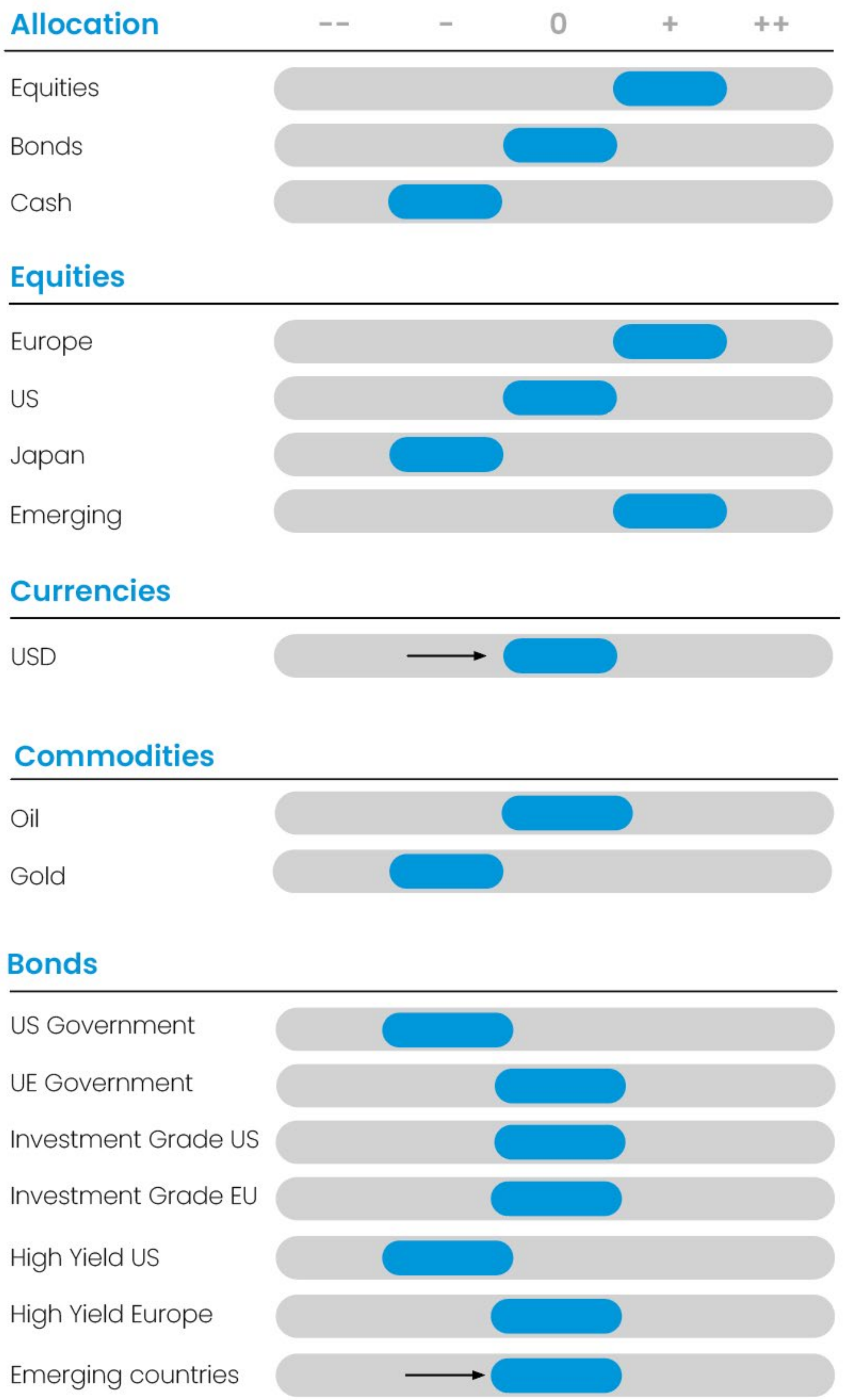


Sources : Bloomberg, Richelieu Group

Regarding the dollar, we have changed our short-term view during the month. The dollar could appreciate in the short term as the prospects of rate cuts in the United States diminish. The Fed continues to try to realign expectations. The latest releases show strong resilience in the US economy, whether on the real estate or employment side. We expect a correction in rate cut expectations and, consequently, for the dollar to find some support in the 1 to 3-month horizon. A stronger dollar in the early months of 2024 seems more likely, leading to a decline in EUR/USD towards 1.05. Although we maintain a bullish forecast for EUR/USD towards 1.15 by the end of the year, downside risks will likely prevail in the short term.

Euro versus dollar

Sources : Bloomberg, Richelieu Group



PREFERENCES

Yield / Innovation
Corporate Hybrid Bonds
Euro Crossover Bonds

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