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MACRO MORNING BRIEFING

February 5, 2024

The Struggle To Tame Services Demand

Robust services demand lengthening 'last mile' of inflation battle

- Labour market tightness remains across global services industries
- Role of government spending in services wages difficult to target
- Global curves could re-steepen, depending on end-Q4 duration flow

Central banks wary of global services-driven price rebound

In the wake of last Friday's US January employment data, both market participants and central banks appear set for a rather tense quarter. On the one hand, the strong pushback against aggressive end-2023 pricing of early rate cuts seems justified, for now. The across-the-curve repricing has been orderly – no signs yet of the volatile bear-steepening episodes of last year repeating. Nonetheless, it remains uncertain where risk appetite goes from here, especially as the 'leaders' of risk have become increasingly narrow – a select group of US company equities is where the world apparently is shifting asset allocation, leaving the rest almost scrambling for crumbs. Weaker exchange rates against the dollar, weak equity valuations and bond yields refusing to come off means that financial conditions are still tightening passively elsewhere in the world. Consequently, we remain sceptical that any pushback in the Federal Reserve's easing schedule requires replication elsewhere.

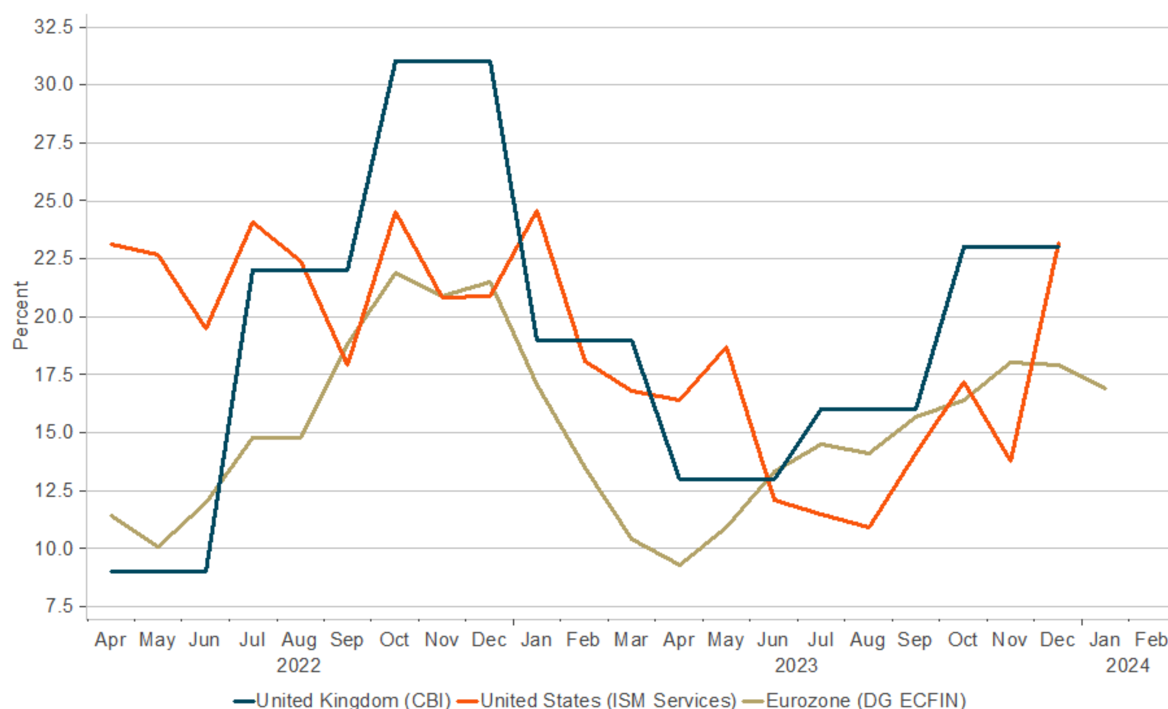
Central banks will likely continue to home in on the labour market, but also with an increasingly narrow focus on wage growth and its underlying drivers. Under normal circumstances, it would simply be a question of identifying core economic sectoral exposures and looking at the key leading indictors: manufacturing for export-based economies, and services for the rest. However, since the end of the pandemic, developed economies have persistently struggled to alleviate labour supply pressures in services.

European Central Bank President Lagarde's Sintra speech last year has proved extremely prescient in identifying impending pressures in the policy cycle. She identified the "*relative*

weakness of manufacturing and long-term shifts towards employment in services”. Crucially, services continues to suffer from “*structurally low productivity growth*”, resulting in “*several years of rising nominal wages, with unit labour cost pressures exacerbated by subdued productivity growth*”. Although focused on the Eurozone economy, we think these words could be applied anywhere. For economies such as the US and UK, where structural demand for services is high, nominal wage pressures may be even stronger and so naturally could mean a low ranking in the ‘first-to-cut’ stakes within G10 economies.

On the face of it, services demand is in decline in the US and UK. In Exhibit 1, we compare the forward-looking business surveys for services and shares of respondents which indicated that hiring intentions will fall or employment levels will decline. While the share of respondents expecting a decline is rising in all three key economies shown, the trajectory is clearly more pronounced in the US and UK. On an absolute basis, however, services businesses through 2023 were not registering pessimism as strong as in 2022, corroborating the view that labour markets are not loosening at a fast pace.

Exhibit #1: Share Of Services Business Reporting Weaker Labour Demand



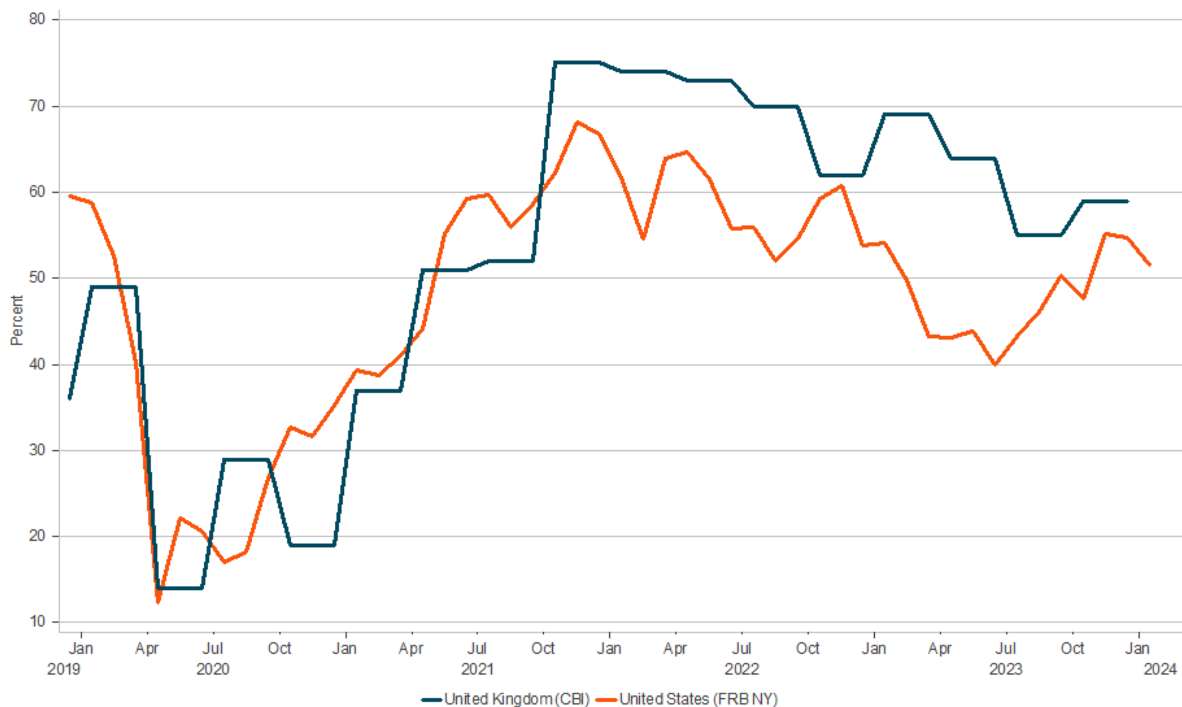
Source: Macrobond, BNY Mellon

Returning to President Lagarde’s speech, the warning that nominal wages would rise because of subdued productivity growth is still quite pronounced globally. Improved productivity can raise real earnings through cost reductions, rather than lean on the nominal, but there is scant evidence of cyclical productivity improvements at present, let alone on a structural basis considering demographic pressures and a global investment drag. We can see in Exhibit 2 that business surveys in the UK and US have both pointed to very high wage

pressures on an absolute basis. Given the nature of both of those economies, services demand is likely a crucial driver behind the results.

Friday’s payroll figures notwithstanding, wage risks appear to be escalating in the US after a prolonged period of decline to mid-2023. Based on the New York Federal Reserve Bank’s Business Leaders Survey, businesses indicating an increase in wages in future conditions are now back at late-2022 levels, a period when the Fed was struggling to anchor inflation expectations and had to rely on aggressive tightening.

Exhibit #2: Share Of Businesses Reporting Higher Wages



Source: Macrobond, BNY Mellon

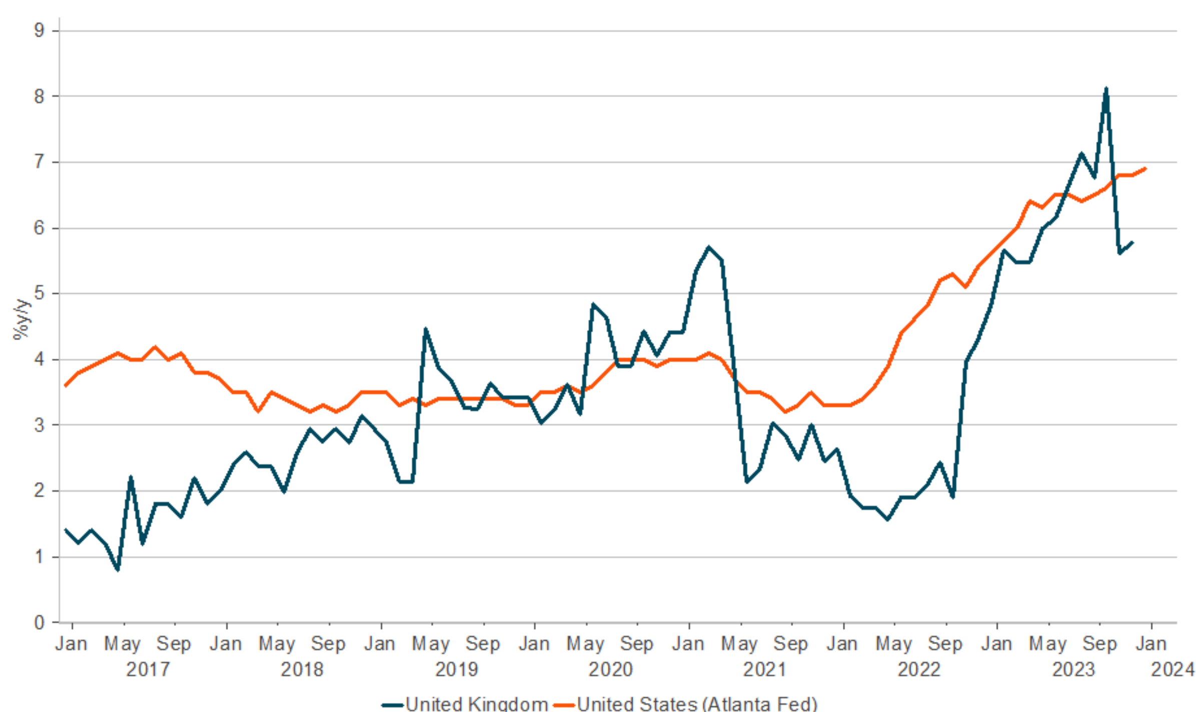
We have in the past expressed concern over the ECB’s narrow focus on wage inflation in services because the Eurozone economy is far more dependent on manufacturing; wages in that sector are certainly not facing the same pressures as in services. Even if services has become far more dominant in aggregate wage formation, monetary policy should also be adopted under the assumption that it is effective in generating sufficient restraint to slow inflation. For example, tighter policy needs to be capable of slowing demand in the relevant sectors, i.e., those that are generating labour demand.

President Lagarde in her Sintra speech said that the demand is being generated in the construction and public sectors. Globally, the former is slowing sharply; commercial real estate-related risks have been well-documented. The public sector is a completely different issue and comparatively far less sensitive to monetary policy. Even if global risk premia rises through higher yields, sovereign bonds to fund fiscal spending will likely be first in line for purchases. US, UK and Eurozone sovereigns also remain reserve assets which almost have

guaranteed buyers. If services demand and wage growth is being generated by public-sector spending and not at all sensitive to monetary policy, then central banks may need to revisit their current stances, lest rate-sensitive sectors get hollowed out.

Exhibit 3 shows public-sector wage growth rising strongly in the US and UK. Both show no sign of fiscal retrenchment in the near future. If current monetary policy is de facto trying to bring down public-sector wages, then the Fed and Bank of England risk fighting losing battles while creating economic collateral damage elsewhere. During their tightening cycles, central banks in Latin American and Central/Eastern Europe were vociferous about the need for fiscal restraint. It remains to be seen whether this is possible in developed economies.

Exhibit #3: Public-Sector Wage Growth



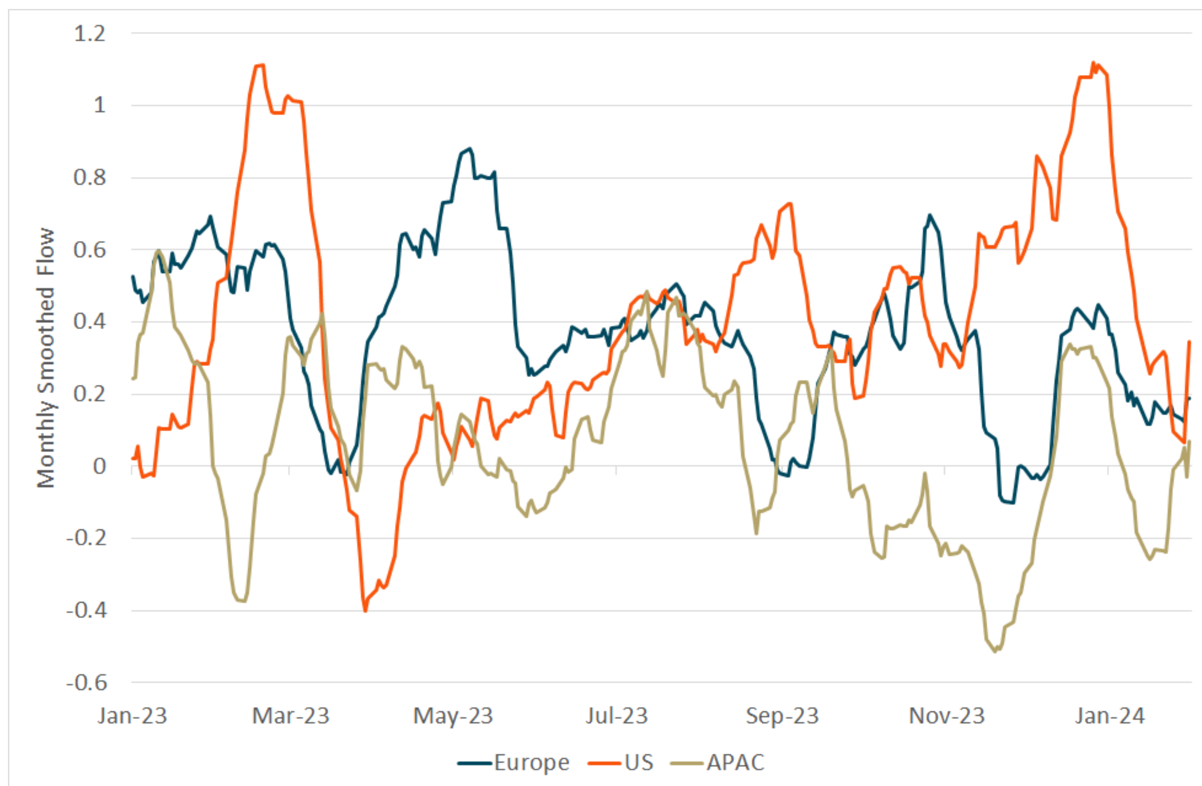
Source: Macrobond, BNY Mellon

As most G10 central banks have completed their first policy rounds of 2024, bond markets will have time to readjust to the March round. Considering re-emerging inflation risks, asset allocation may impulsively favour renewed bear steepening or largescale exits from duration. We would advocate treating such strategies with caution, however. Exhibit 4 illustrates smoothed monthly flows in the 10y+ space of sovereign flow over the past year and shows that in many markets, there were strong corrective flows already in January. US monthly smoothed flow is now close to neutral, while European duration (UK and Eurozone combined) is still showing declines in interest. APAC flow is neutral at best and, as opposed to US and European duration, never really got going towards the end of 2023.

With January apparently having brought a correction of the extreme flows in duration through November and December 2023, the risk now may be that there needs to be a ‘correction of the correction’. Everything remains data-dependent, of course, and the risk of a wage-based

reflation snapback is possible. Nonetheless, with iFlow indicating that the starting point for bond sales now is not as attractive as at the beginning of the year, a more measured approach to any corresponding positions would seem required.

Exhibit #4: Smooth Monthly Flow Into 10y+ Sovereign Bonds



Source: BNY Mellon

Please direct questions or comments to: iFlow@BNYMellon.com

Geoff Yu

EMEA MACRO STRATEGIST

CONTACT GEOFF

bnymellon.com

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