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MACRO MORNING BRIEFING

July 8, 2024

Policy Reality Bites Post-Politics

Expansionary shift in fiscal a new risk rate path

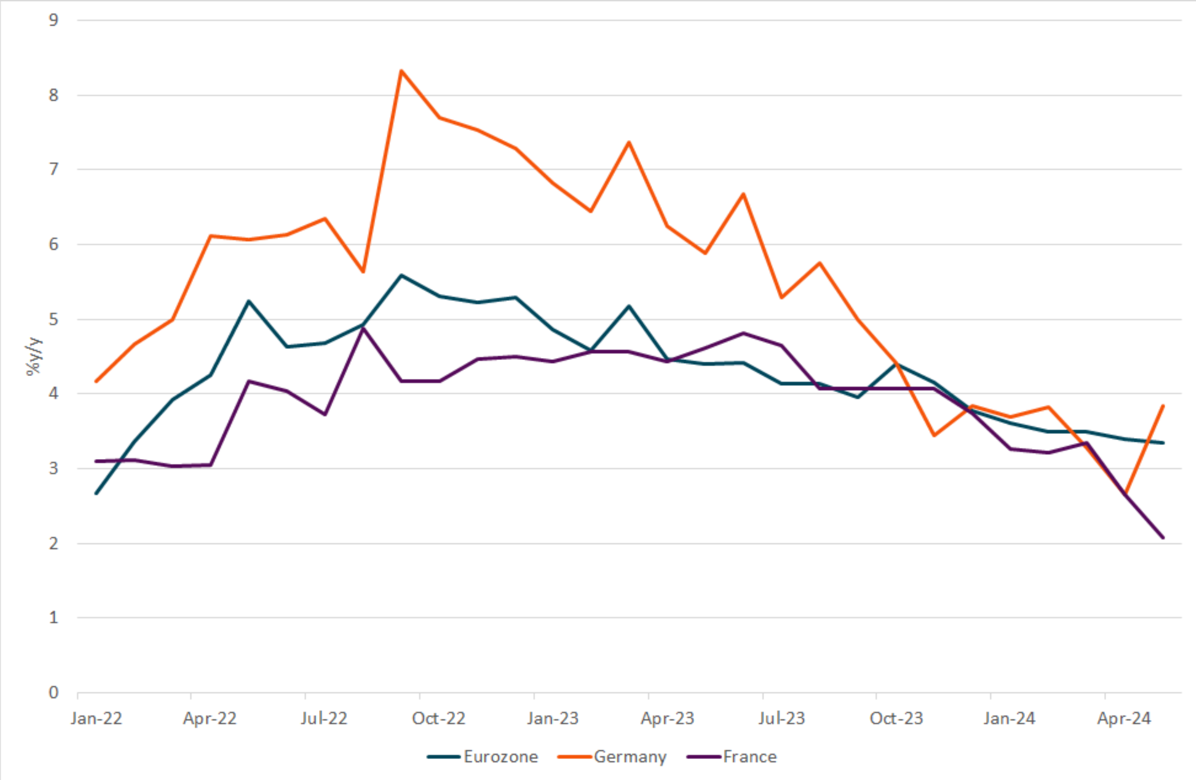
- Budget arrangements in the UK, France and Germany to test bond markets
- Wage growth is falling in Europe, but ECB and BoE will stay cautious
- Europe not out of the woods yet for fiscal premia

2024's electoral focus entering final phase in Europe

As the dust settles on the UK and French elections and new parliamentarians take their seats in London and Paris, markets can revert back to focusing on data and fundamentals to drive near-term asset allocation. With the US vote looming large, this phase will likely be short so any adjustments will be fiscal at best. Even so, the market's reaction to the US payrolls data on Friday underscores the prominence of wage developments in driving policy expectations, especially if the likes of the Bank of England and Federal Reserve are to start their own easing cycles in Q3. Meanwhile, the ECB may also follow up with their second cut in September, but ECB President Lagarde's Sintra speech underscored the risks from ongoing strength in labor markets.

While the Bank of England is still grappling with the accuracy of UK wage data, high-frequency indicators in the Eurozone are pointing to a clear downtrend in wage growth (exhibit 1), though not at a pace which would support consecutive cuts by the ECB yet. If there is one final "sting in the tail" from last week's political developments, it is the prospect of new changes in fiscal dynamics which could introduce additional volatility to wage data, and consequently affect policy intentions. In all likelihood, the UK and France's new legislatures will approve budgets which are considered fiscally expansionary. This could work both ways: public investment to boost productivity will be a welcome development for most central banks as real wages can continue to rise without inflation; on the other hand, if the immediate impulse is to boost public-sector salaries or other forms of "blunt" demand injection, the short-term consequences could be a reversal of recent wage trends. In this respect, industrial relations will require close monitoring as there could be a perception of a shift in bargaining power in favor of labor. In contrast, Germany's latest budget is unlikely to generate strong tailwinds due to strong fiscal rules, but as Vice-Chancellor Habeck said the total package could add 0.5% to Germany's growth rates, the ECB may need to exercise additional vigilance due to the country's economic impact on aggregate figures.

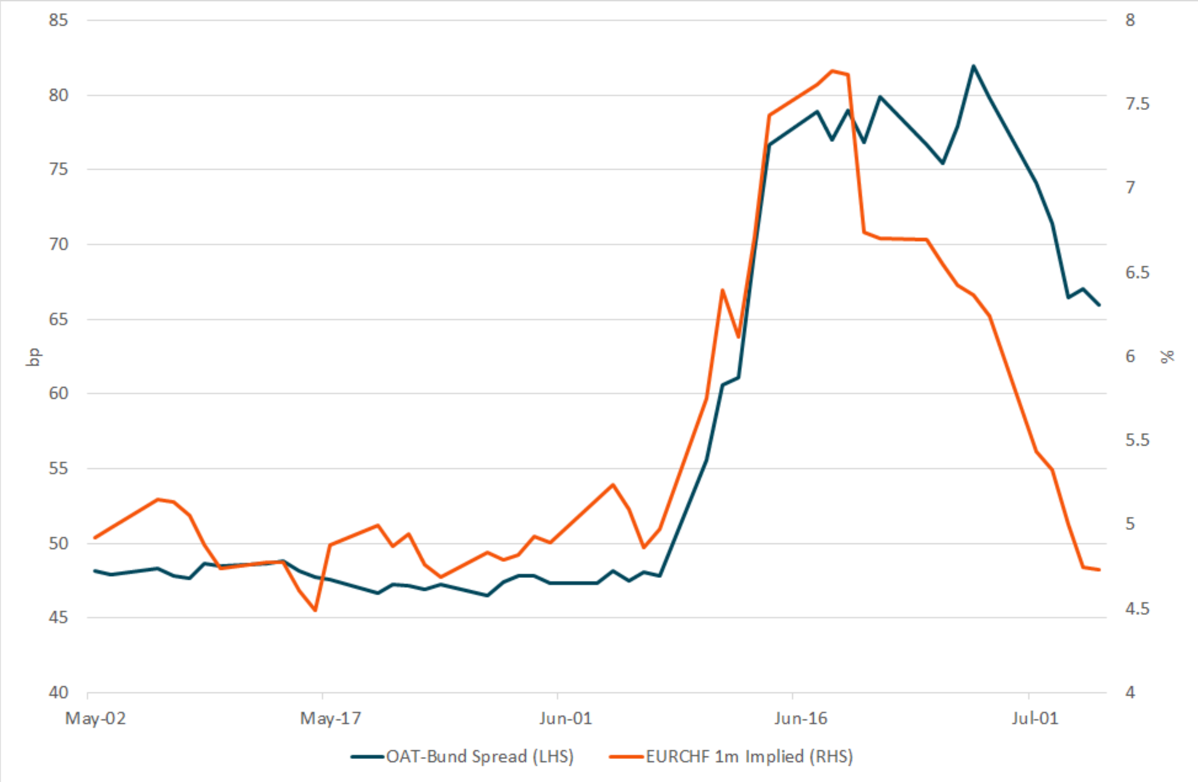
Exhibit #1: German and US manufacturing PMI



Source: Bloomberg, BNY

For now, though, it appears that the market is willing to adequately price out spillover risk from electoral results. The UK elections barely caused a ripple, while risk gauges for France had declined - they will be sorely tested in light of the left's strong showing on Sunday. During the initial widening phase of OAT vs. Bunds, we highlighted that short-dated implied volatility in EURCHF also increased materially. The franc is often one of the first ports of call to express a view on Eurozone sovereign risk and we believe that the risks directly contributed to the SNB cutting rates and doubling down on their inflation outlook – which, based on last week's figures for May, appear justified. While CHF valuations are still rich, EURCHF implied volatility has normalized (exhibit 2), even though the 10-year OAT vs. Bund spread has settled at above pre-European Union election levels. This indicates that markets still wish to reflect a new political settlement in France, but not in an excessive manner which could generate cross-asset spillover risk.

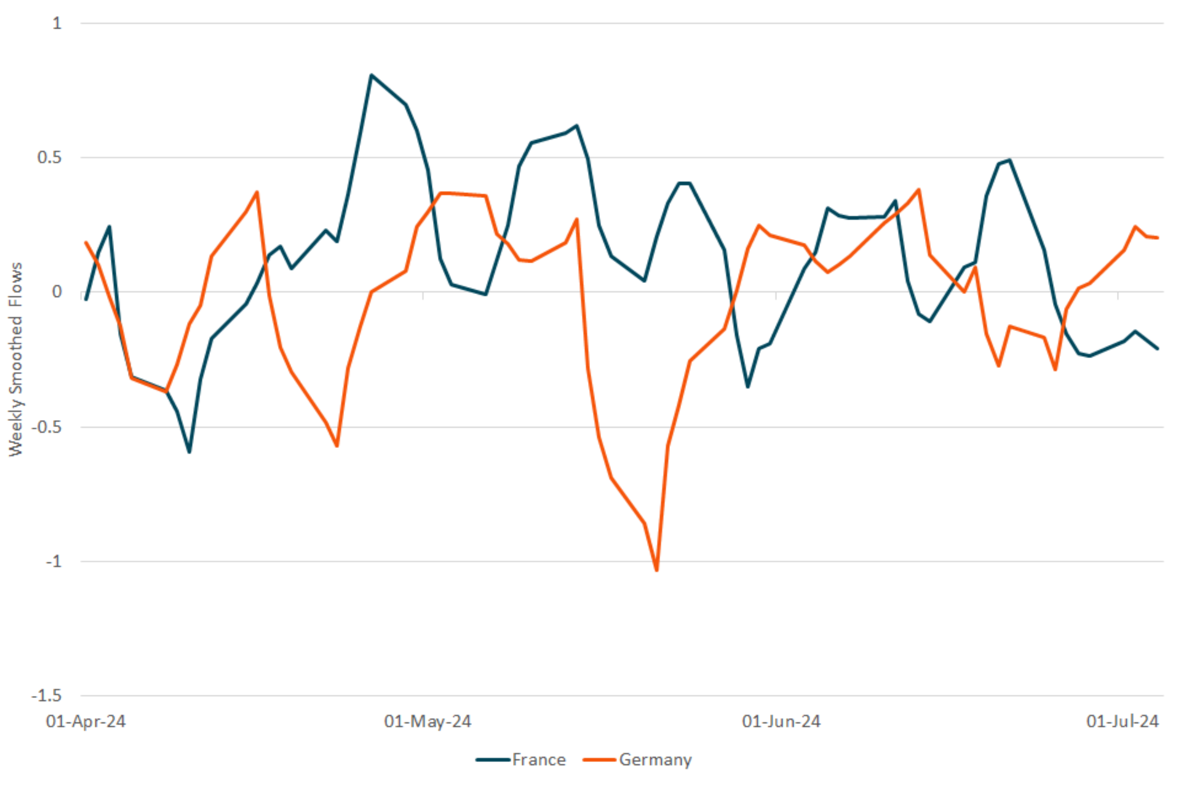
Exhibit #2: EURCHF implied volatility vs. OAT/Bund spread



Source: Bloomberg, BNY

Following the initial OAT moves in June, we noted that one of the reasons behind the widening in yields was the previous heavy positioning in OATs relative to Bunds. Favorable yields and liquidity in France contributed to the buildup, and there is no indication yet that there was strong liquidation in subsequent weeks. Bund flows have recovered well in June compared to April and May, but its flow average remains below French equivalents (exhibit 3). On the one hand, this shows that global fixed income investors are generally comfortable with current pricing and are not seeking mass rotation flows. Incremental flows had been seen in US Treasurys, but Washington D.C. has its own fiscal pressures to deal with. On the other hand, if there are additional fiscal surprises further down the line, a repeat of the volatility in Eurozone sovereign markets in June is possible, and with renewed spillover risk into other asset classes.

Exhibit #3: OAT vs. Bund flow

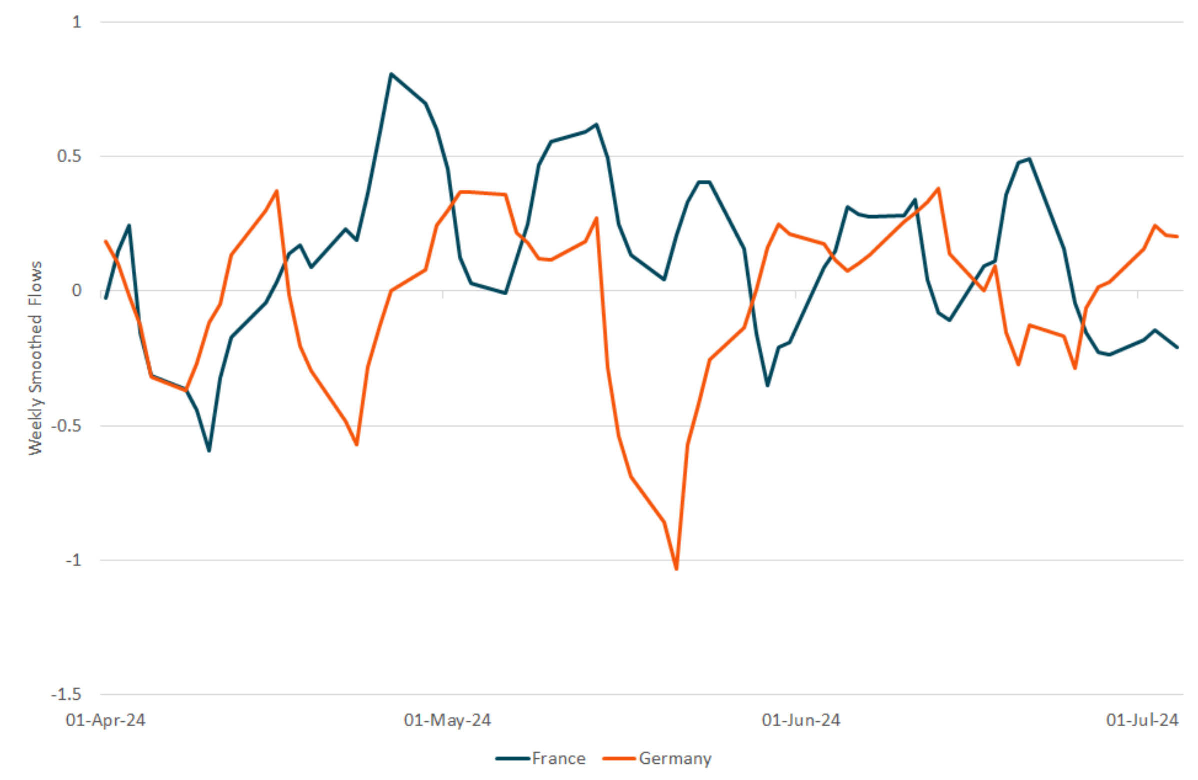


Source: BNY iFlow

Finally, the only G10 central bank decision this week is the Reserve Bank of New Zealand (RBNZ). No changes are expected, and the central bank will probably continue to err on the hawkish side due to domestic constraints. Based on current market pricing, we are fairly confident that the RBNZ will have the highest nominal policy rates among G10 economies by Q4 as the Fed cuts rates. However, as we have seen with recent performance of NOK and AUD, having a hawkish central bank with a view to keeping rates unchanged for the rest of the year is no guarantee of currency performance. There are idiosyncratic reasons behind the lack of interest, but NOK and NZD struggle with liquidity constraints. The past few weeks have also seen event-based risk aversion dominate price action, and smaller currencies often lose out in such conditions, no matter how large the savings buffers are (Norway's current account surplus stands at 17% of GDP) or the level of nominal and real rates.

New Zealand and Australia both have high exposures to Asia-Pacific growth, and this is where China's upcoming plenum could also come into play to trigger a broader rotation back into Asia-Pacific assets. In addition, NZD could benefit from both yield status and improvement in terms of trade. However, we don't see using monetary policy to support the NZD to generate pass-through as a major policy priority. The country's tradables inflation is clearly on sequential decline (exhibit 4), having fallen negative over the past two quarters. Even if terms of trade improve further the marginal benefit to returning to the inflation target is limited. In contrast, there is no sign that non-tradables inflation – especially in wages – is trending lower. Q1 wage growth, at 0.8%q/q, is the lowest quarterly sequential print in two years but still well above levels which could persuade the RBNZ to countenance a change in bias. We have highlighted that New Zealand is the only country at present whose government has a clearer program of fiscal restraint to complement efforts to restrain demand. Six months into the new government and its program, clear disinflationary results remain elusive. This will be a lesson to other new governments about to start their mandates around the world, as many of them were elected with a mandate to tackle the costs of living.

Exhibit #4: New Zealand inflation decomposition



Source: Macrobond, BNY

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