October 25, 2023

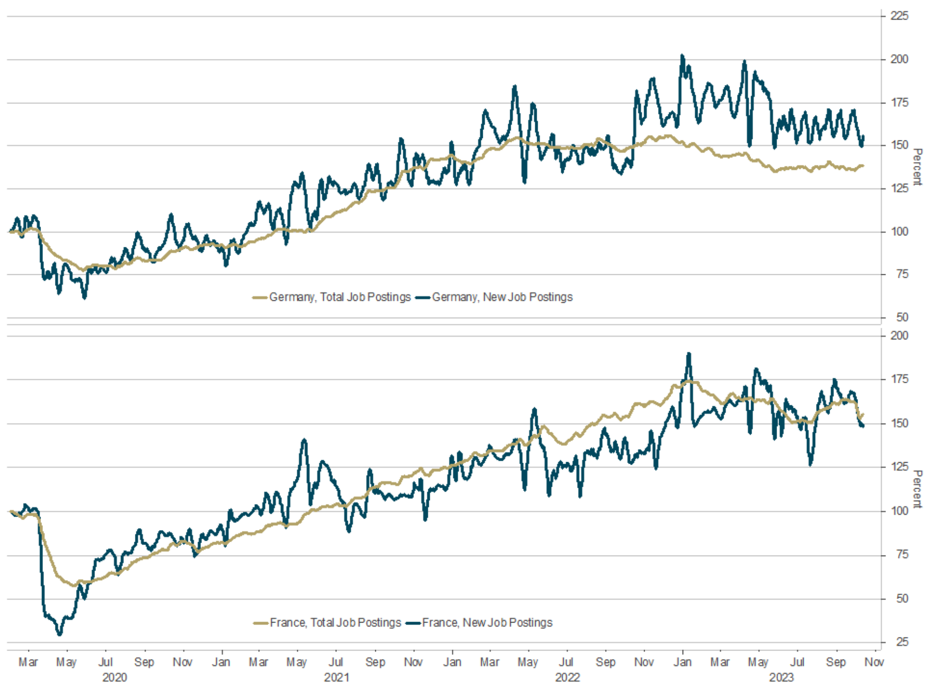
ECB Moving to Stability Phase

Barring any extreme last-minute surprises, we doubt market expectations for a decision by the European Central Bank (ECB) will shift materially. Since mid-September overnight Index Swaps (OIS) pricing have been virtually unchanged ahead of the 26 October monetary policy meeting.

The only injection of potential variability in the outlook comes from geopolitical risk. This is a matter well beyond the ECB's control and is unlikely to trigger any pre-emptive policy measures. The supply linkages from the Middle East crisis to European energy are not comparable to the impact of the Russia/Ukraine events in 2022. Additionally the labour market is no longer tightening aggressively to generate the compounding effect of a wage and input-price spiral.

Considering the importance of the labour markets input into inflation and ECB policy, we continue to parse through real-time data to look for signs of a loosening. Daily job openings in Germany and France appear to be stuck in a range. This will come as a relief for policymakers concerned about a short but potentially sharp round of elevated inflation expectations heading into the winter months.

Labour Market Openings



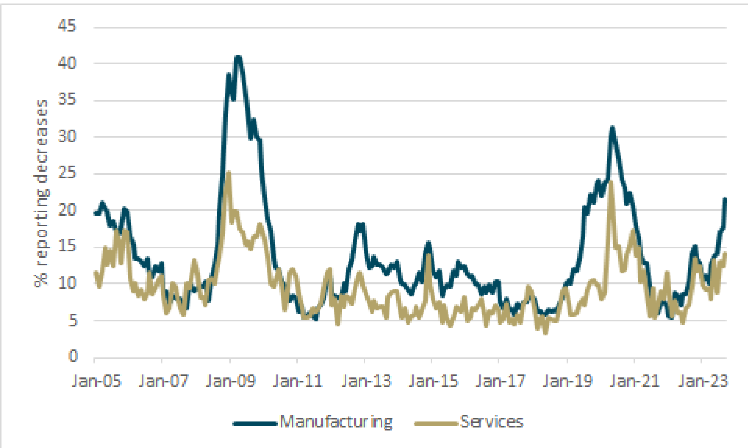
Source: Macrobond, BNY Mellon

Considering the ECB is a single-mandate central bank, the lack of movement in labour market strength suggests that not enough is being done to slow the economy, especially considering the level of tightening and rhetoric emanating from the Bank of England and the Federal Reserve. In the ECB's defence, July's speech in Sintra by Christine Lagarde suggested the employment strength generated in specific low-productivity sectors of the economy, such as services and construction, are less sensitive to interest rate tightening. Even if this remains the case, the guidance from monetary policy must also stick to a 'higher for longer' theme, as sectoral sensitivity to policy may also not be symmetric. In other words, tighter financial conditions may not slow job creation in service sectors but that doesn't mean looser financial conditions will generate a demand boost in the same sectors.

On balance, real-time data suggests Germany's labour market is in a weaker spot in absolute terms. As Purchasing Manager Indices (PMI) continue to point to a severe contraction in manufacturing, the signs this is clearly translating into labour market pressures is also becoming clear. Based on the employment components in Germany's monthly IFO survey, we can see that the number of firms reporting further declines in employment intentions is rising across both industry and services. The deterioration in employment conditions in manufacturing is also far stronger comparatively.

However, what is striking - and most likely of immense frustration to the ECB - is that the fall in services employment is lagging strongly (though the October preliminary services PMI print for Germany suggests some relief is due). For example, during the 2008 cycle over 40% of manufacturing companies reported declines in their hiring outlook. During the initial stage of the downturn there was a correlated fall in services employment – almost one-for-one. Presently, there is a gap above five percentage points and momentum in employment losses in services appears to be far weaker. In inflation terms, this yet again means that services-based inflation, which is sticky and not subjective to productivity offsets, will likely drop at a much slower pace. This means the German economy may continue to drift towards stagflation. Policy initiatives there are few and far between – the external environment and managing a three-way coalition domestically comes with strong constraints.

IFO Employment Survey



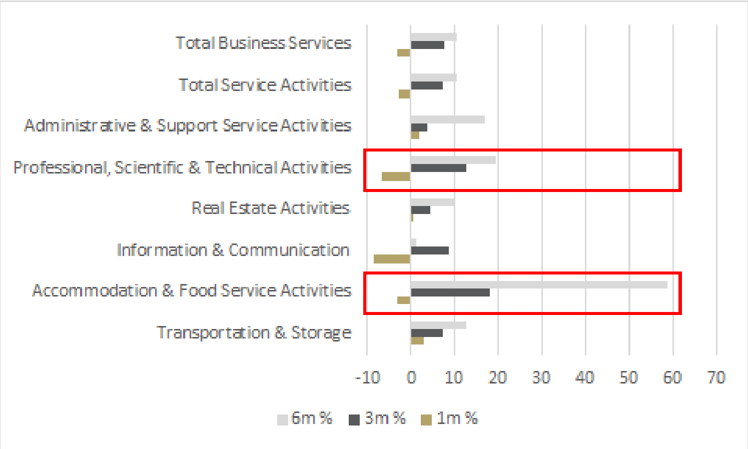
Source: Macrobond, BNY Mellon

Labour markets are often lagging wider trends in any economy. The latency can be particularly acute for economies such as Germany where entrenched collective bargaining processes plays an outsized role. Consequently, policymakers will need to be attuned to the realised data as much as the forward-looking surveys.

Maintaining our focus on the services industry, we can see that on a sequential basis momentum loss is finally coming through. The latest figures for July already point to greater declines on the month, but every single services category continues to indicate expansion compared to the beginning of the year. This likely explains why labour market indicators have not shifted towards outright contraction. We suspect some of the biggest declines will be needed in segments such as accommodation and hospitality, where even accounting for the decline in July, output levels remain up to 60% higher than six months ago. Again, we stress these are areas where monetary policy will likely have very little effect, meaning that a 'wait-and-see' approach is the likely path ahead.

'Higher for longer' is the main policy mantra within G10 economies at present and this is reflected in the behaviour of bond prices. However, there are clear risks of the monetary policy widening pre-existing imbalances. The immediate risk is further credit contraction in the manufacturing sector, which arguably will need more support from the banking system to prevent more severe job losses in a high value-added industry. It is the high loan exposures and lack of disintermediation in the Eurozone which could provide greater forbearance at this point.

Germany Services Activity Output

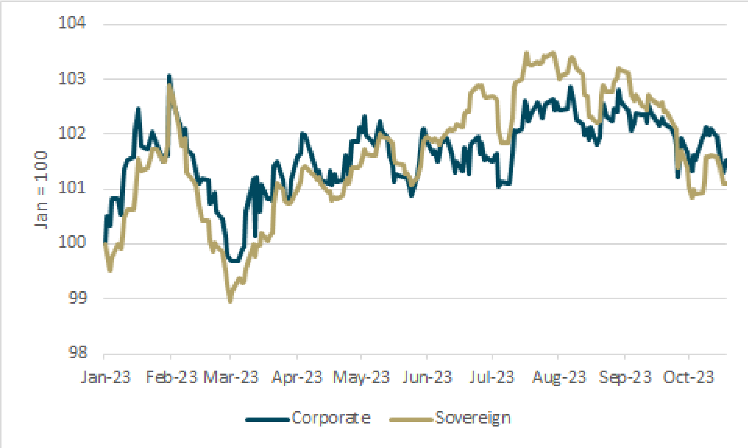


Source: Macrobond, BNY Mellon

What the Eurozone cannot escape is fragmentation risk. As the marginal effect of negative real rates starts to wear off on countries with high debt burdens, lack of growth and spread widening is moving up the agenda, especially for Italy. For now, though, in absolute terms, sovereign spreads over bunds are manageable but European paper is clearly no "safe haven".

Year-to-date, even from the perspective of Eurozone asset allocators, it is quite telling that the corporate aggregate has slightly outperformed its government equivalent. Considering the ECB is still quite active in limiting heavy supply into the market of sovereign bonds, the situation for Eurozone sovereigns could be a lot worse. This is something the ECB will need to consider as the burden of adjustment in financial conditions starts to shift towards its balance sheet and sovereign bond maturities. The status quo for policy at present is not ideal for the Eurozone, but its maintenance is the path of least volatility for the broader economy, especially in the absence of a broader growth and productivity strategy.

Total returns, Eurozone Sovereign vs. Corporate Credit



Source: Bloomberg, BNY Mellon

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