June 3, 2024

Diverging Reaction To Europe Services Strength

Services inflation persistence evident in Europe

- ECB rate caution over services inflation still excessive
- SNB may have over-reacted; BoE to focus on household cashflow
- Election results in key emerging markets to test carry resilience

Policy response only needed if wage growth also resilient

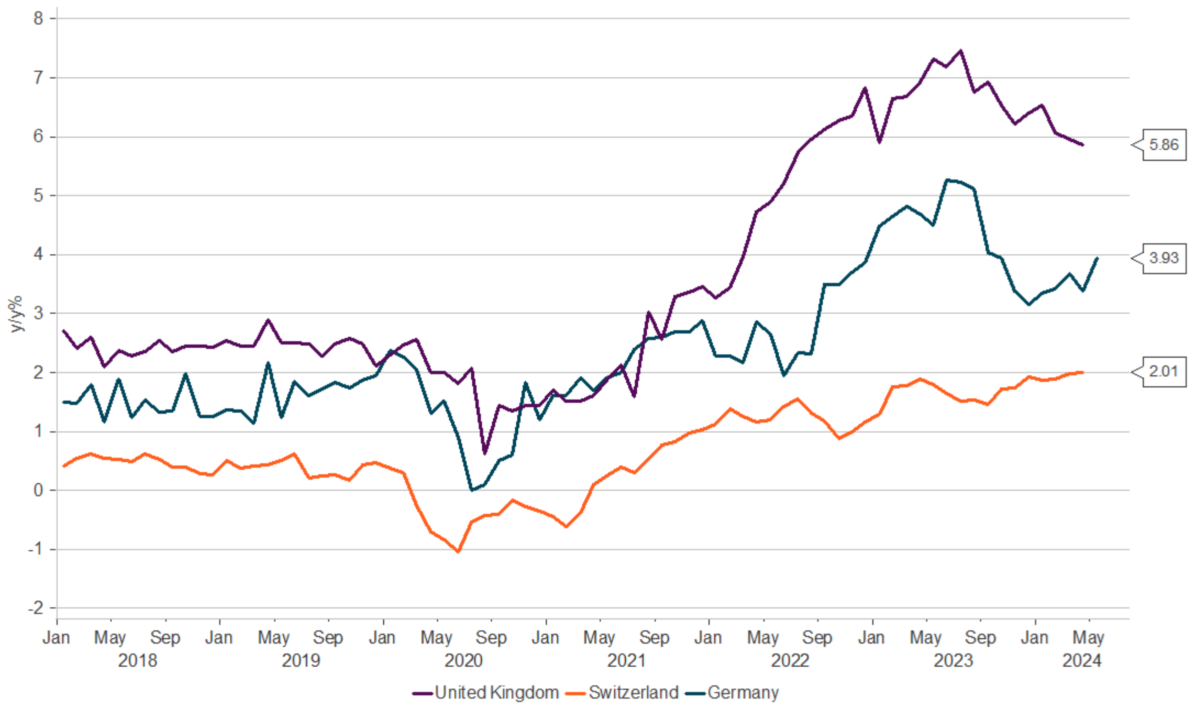
The European Central Bank this week kicks off a key round of policy decisions across Europe. A rate cut is expected but much of the market sees the prospect of a 'hawkish cut', with only one additional move fully priced through year-end. Although European policymakers have been clear in their respective capacities to diverge from the Federal Reserve's decisions and ease ahead of it, some similar policy dilemmas are starting to arise.

US household and labour market resilience, manifested through strength in services sector demand, has repeatedly pushed back policy expectations – even though the manufacturing sector has continued to struggle despite ever-growing fiscal support. Since the beginning of 2022, non-manufacturing ISM has signaled contraction for only two months. The manufacturing equivalent registered just one month in expansion during the same period.

Similarly, Europe's manufacturing sector may be facing severe cyclical and structural challenges due to the lack of industrial policy. Germany's manufacturing PMI has been in contraction since July 2022 and trends in Switzerland have been similar. However, as household demand is generally weaker on the continent, we believed it was going to be difficult for services growth to remain robust as households would be affected by declines in the highest value-added sector of the economy. By extension, labour demand for services would likely soften and gradually generate faster declines in inflation, as labour remains the core component in services costs. This was the basis for the Swiss National Bank's surprise cut in March: its assessment of the economy was “the services sector expanded again, while value added in manufacturing stagnated”. However, price momentum then had fallen at a pace where the SNB materially lowered medium-term inflation forecasts due to “lower second-round effects”, i.e., central bank parlance for a price-wage spiral.

The latest inflation numbers across Europe (exhibit #1) may now be leading to a reassessment of whether services inflation is proving far more persistent than previously expected. On an annualised basis, Germany inflation has increased by almost 1ppt year-to-date. Swiss inflation is not showing any sign of coming down either and this week’s numbers may yet point to more decisive break above 2.0% y/y. In the UK, where growth value-added has far stronger services exposure, inflation in that sector is falling, but from a far higher level compared to peers in Europe. However, the pace of declines is not nearly fast enough for the Bank of England to have full confidence in commencing an easing cycle. The BoE's MPC will likely continue to focus on household cashflow erosion generating a stronger demand drag for services, but again, the process has likely been slower than expected.

Exhibit #1: Europe Services Inflation

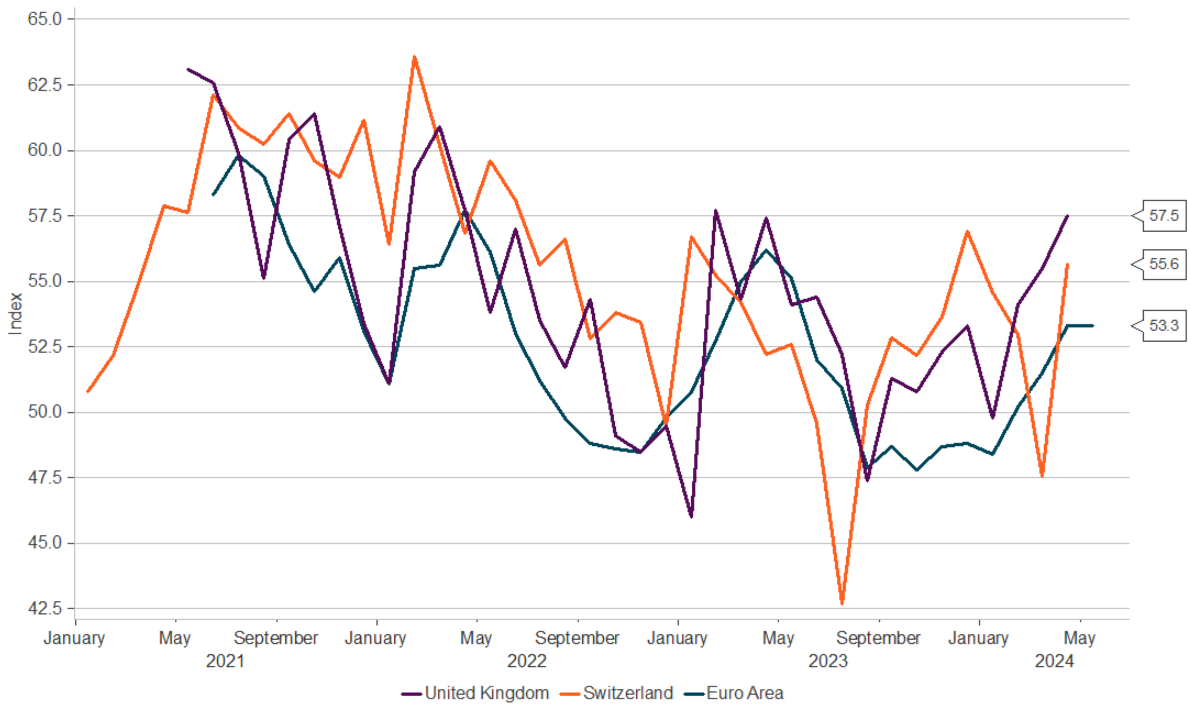


Source: Macrobond, BNY Mellon

Recent services PMI numbers across Europe do not make for comforting reading: expansion is particularly strong in Switzerland and the UK, and the Eurozone’s figure is comfortably holding in expansion. SNB President Jordan’s recent comments about inflation risk have centred around franc weakness, but if the March assessment of second-round effects in inflation held, then inflation would have been less sensitive to shorter-term fluctuations in the currency. However, Jordan also said in a recent speech that there were reasons to believe the natural rate of interest in Switzerland “has increased somewhat” and that this also represented a “small upward risk” to inflation. A higher natural rate implies greater medium-term inflation risk, but this would also be incongruent with the March assessment, where the inflation forecast through 2025 and 2026 was barely above 1%. The data point to an important risk for economies with high levels of savings generated through manufacturing value-added: it is possible that services inflation persistence can endure despite weakness in the highest value-added sector. In turn, wage growth will also likely persist, too.

Given data outcomes over the past few months, G10 central banks which have not yet moved may choose to err on the side of caution on services inflation and associated wage pressures. But it's a balancing act considering the structural factors affecting labour supply.

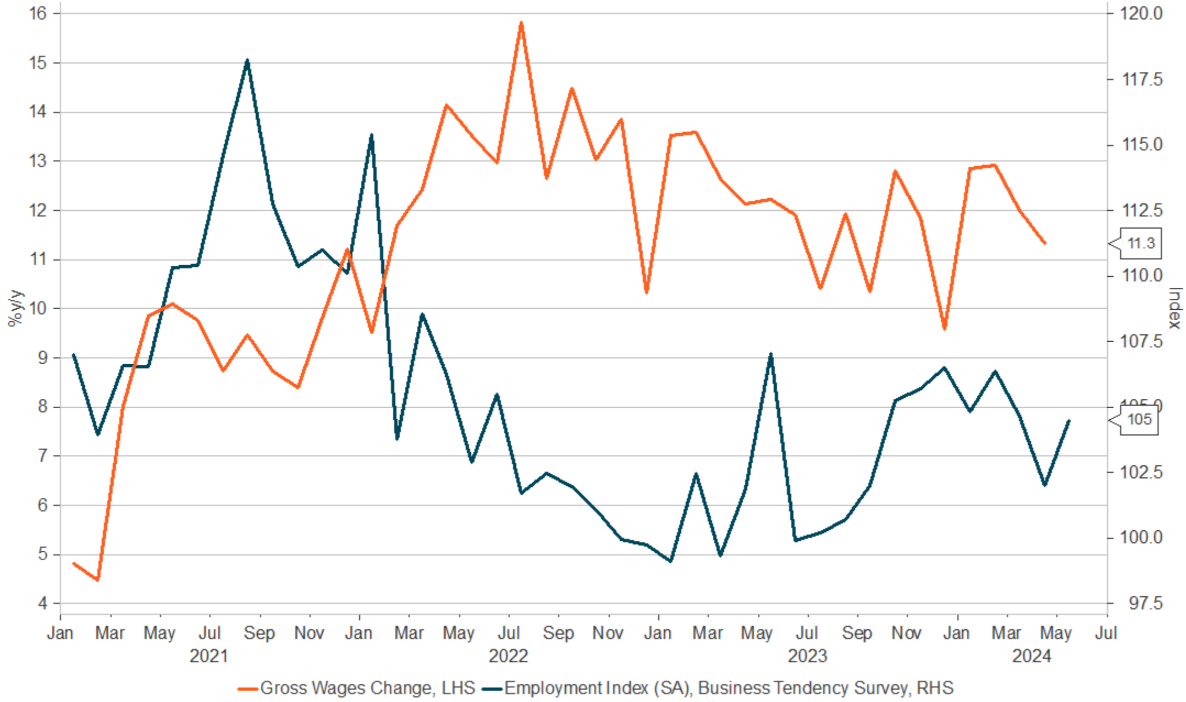
Exhibit #2: Europe Services PMIs



Source: Macrobond, BNY Mellon

Although policy globally is set to conform to ‘higher for longer’, the outlook for the carry trade is still mixed. Markets will likely remain highly selective on the carry legs considering risk:reward is still high in continuing to run with dollar longs. The National Bank of Poland (NBP) decision this week looks set to solidify the zloty as one of the best-performing carry currencies, and quite frankly the only remaining such name in Europe. The NBP’s resolve regarding maintaining high real rates is quite clear. Inflation persistence risk amongst Poland's key trading partners is heavily restricting policy space, especially through the exchange rate. Furthermore, after a material slowdown during the second half of 2023, there are similar signs of a recovery in labour demand – while outright wage growth remains in double-digits on an annualised basis (exhibit #3), albeit with very high volatility.

Exhibit #3: Poland Labour Market Dynamics

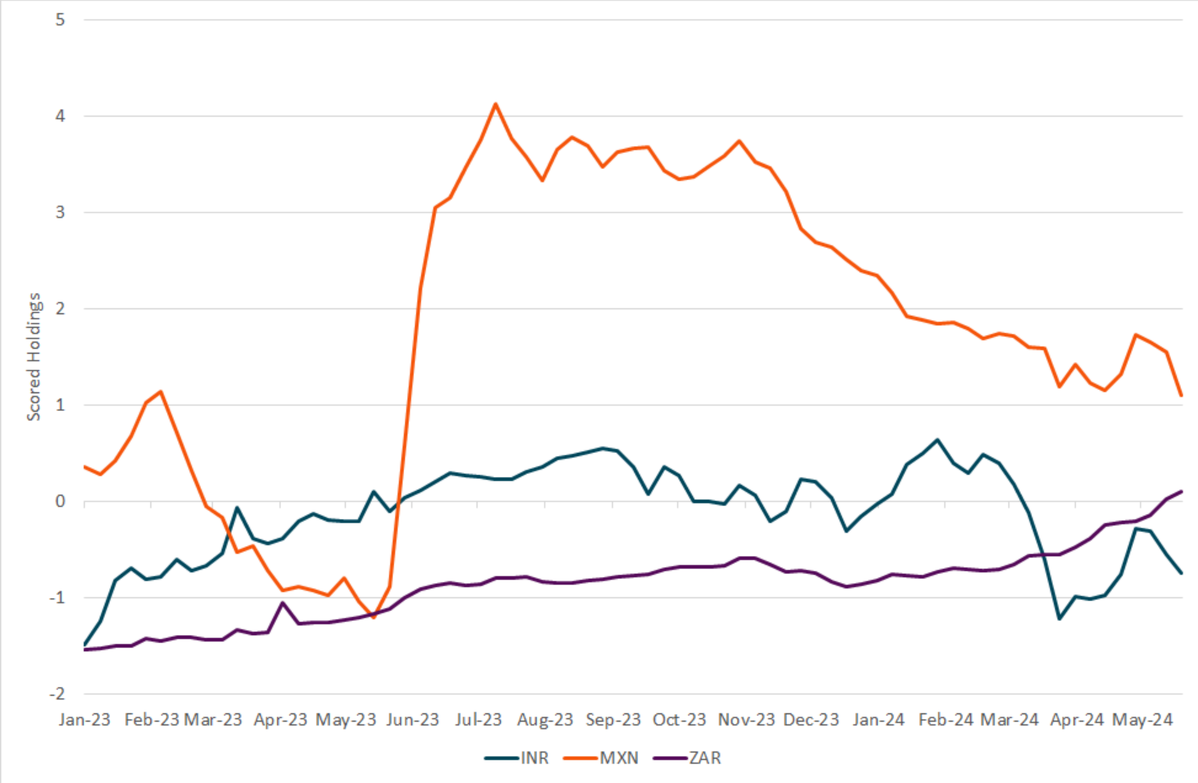


Source: Macrobond, BNY Mellon

Perhaps more so than monetary policy, the week ahead will provide a stern test of how political trajectories impact carry trades. The unique confluence of votes across the world this year means that the market will be able to assess the results of elections in South Africa, Mexico, and India in short order – three critical emerging markets for asset allocation and the carry trade. Currently, MXN and ZAR are positively held, indicating very little sign of politics-related stress. INR was also overheld through most of Q1 this year. ZAR has seen a good run of form heading into the elections, and as of last Thursday had returned to positively held for the first time since November 2021. Admittedly, some of the improvement in exposures would likely be due to unwinding of hedges upon outflow of underlying assets, and price action in the spot market on Friday pointed to some near-term stress.

All three currencies have benefited from their central banks maintaining credible inflation focus via positive real rates. However, various degrees of potential idiosyncratic risk could result in commensurate re-rating or even de-rating. Incoming governments would do well to avoid steps which could trigger the latter in a 'higher for longer' environment for dollar rates.

Exhibit #4: INR, ZAR & MXN Holdings



Source: BNY Mellon

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