

ECOWEEK

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“ AS THE ECB APPROACHES ITS TERMINAL RATE, UNCERTAINTY WILL MIGRATE AND THE ATTENTION WILL SHIFT FROM WHAT WILL HAPPEN IN TERMS OF MONETARY POLICY TO THE ECONOMIC REPERCUSSIONS OF PAST RATE INCREASES. ”

ECONOMIC RESEARCH



BNP PARIBAS

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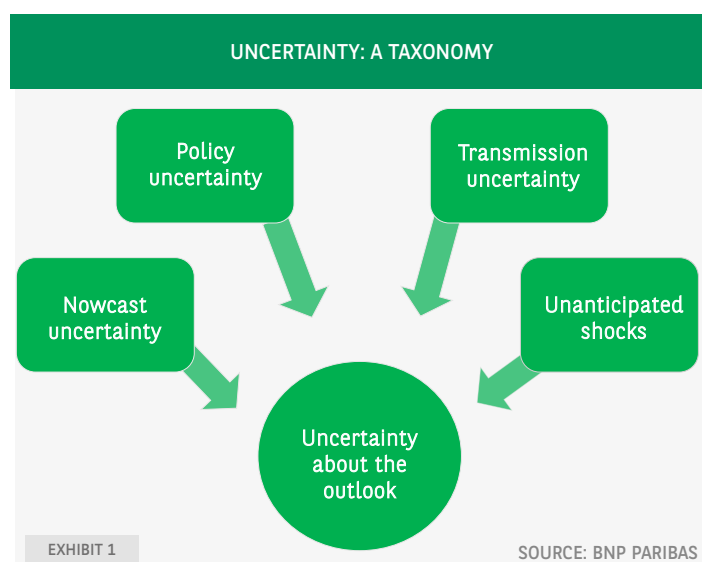
FROM INFLATION TO GROWTH: THE MIGRATION OF UNCERTAINTY

Recently, the word uncertainty has been frequently used by the Federal Reserve and the ECB in their communication. It is something they must take into account when taking policy decisions. Likewise, households, firms and investors face different types of uncertainty. That of not exactly knowing the current state of the economy, uncertainty about future economic policy and monetary policy in particular, uncertainty about the transmission of past shocks -including interest rate hikes- and the risk of events -geopolitical, climate-related, etc.- that would have economic repercussions. Every month, the European Commission asks firms and households how difficult or easy it is to make predictions about their future business or financial situation. The balance of opinions captures their economic uncertainty. It seems that, until recently, inflation has been the dominant source of uncertainty but going forward, economic growth should take over this role as the attention will shift to the delayed impact of past increases in official interest rates.

The word uncertainty is omnipresent in recent central bank communication. At the Federal Reserve symposium in Jackson Hole at the end of August, Fed Chair Jerome Powell said that *"there is always uncertainty about the precise level of monetary policy restraint"*, adding that the assessment of the appropriate monetary stance is *"further complicated by uncertainty about the duration of the lags with which monetary tightening affects economic activity and especially inflation."* Also, some shocks to supply and demand in this cycle have been unique and have introduced uncertainty about whether the ensuing dynamics will persist or not¹. ECB President Christine Lagarde mentioned uncertainty five times in her Jackson Hole speech, emphasizing that *"monetary policy should not itself become a source of uncertainty"* and that central banks should *"talk about the future in a way that better captures the uncertainty we face"* in order to maintain their credibility².

In summary, households, firms and investors face four different types of uncertainty (*exhibit 1*). The first one consists of not exactly knowing the state of the economy. Households may worry about the risk of losing their job, firms may wonder about the strength of customer demand, etc. We can call this 'nowcast uncertainty', i.e. the difficulty of producing a reliable assessment of the current state of the economic and business environment. A second type of uncertainty concerns economic policy, particularly monetary policy at the current juncture: will official interest rates be hiked further and, once the terminal rate has been reached, how long will they stay there? Closely related is the question about the lagged response of the economy to past shocks, monetary and other. The shocks caused by the pandemic, the war in Ukraine, the jump in inflation may still make themselves felt. The lags of monetary policy transmission are also long, variable and impossible to estimate with any precision. This underpins uncertainty about the outlook³. Fourth and finally, uncertainty is also influenced by the risk of shocks -geopolitical, climate-related, etc.- that would have economic repercussions.

In the context of its business and consumer surveys, the European Commission has developed an economic uncertainty indicator. To this end, survey participants are asked how difficult or easy it is to make predictions about their future business or financial situation⁴.



The charts show the evolution of the uncertainty indicators in recent years in different business sectors as well as for households. Unsurprisingly, the dynamics across industry, services, retail trade and construction are very similar. In 2020, the Covid-19 pandemic caused a jump in uncertainty, which subsequently declined. Last year, the war in Ukraine caused another jump, again followed by a reduction in uncertainty. Consumer uncertainty also increased in reaction to these events, but the biggest jump occurred in the latter part of 2022.

The European Commission surveys allow to explore whether the evolution of uncertainty is related to changes in the economic environment and outlook. To this end, the charts to the left compare the uncertainty indicator with the evolution of business/household confidence. *A priori*, one would expect a negative correlation. This is the case for households but for business, the correlation was negative when the pandemic struck and when the war in Ukraine started, whereas since the second half of last year, uncertainty has been declining alongside business confidence.

¹ Source: Inflation: Progress and the Path Ahead, Remarks by Jerome H. Powell, Chair Board of Governors of the Federal Reserve System at "Structural Shifts in the Global Economy," an economic policy symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, 25 August 2023.

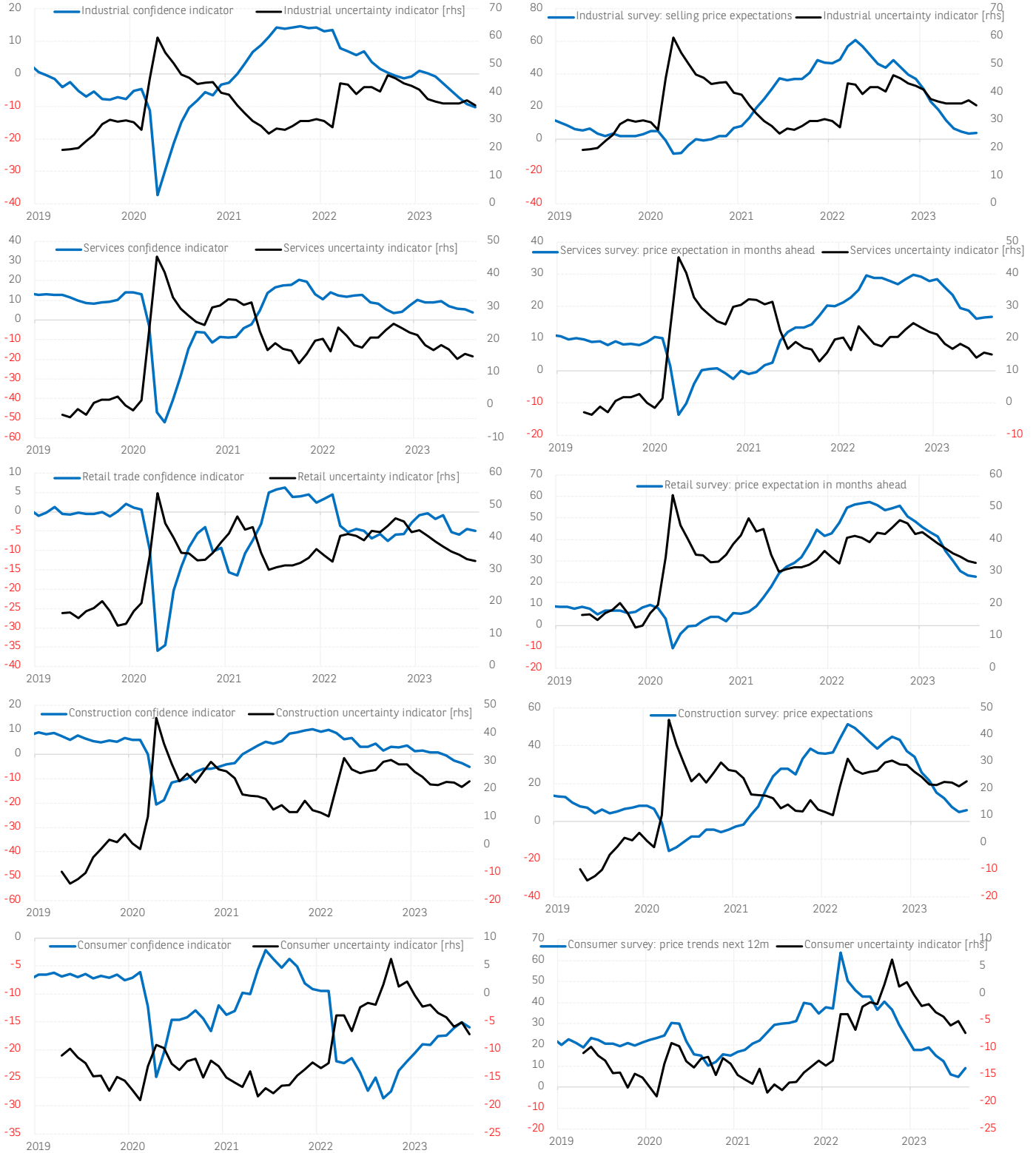
² Source: Policymaking in an age of shifts and breaks, Speech by Christine Lagarde, President of the ECB, at the annual Economic Policy Symposium «Structural Shifts in the Global Economy» organised by Federal Reserve Bank of Kansas City in Jackson Hole, Jackson Hole, 25 August 2023.

³ The latest account of the ECB's governing council reported that its members "felt that it was important to look for further evidence on whether the latest deterioration in the growth outlook reflected the impact of monetary policy measures or could also be due to residual effects of the pass-through of earlier shocks or longer-lasting structural issues weighing on the supply side." Source: ECB, Account of the monetary policy meeting of the Governing Council of the European Central Bank held in Frankfurt am Main on Wednesday and Thursday, 26-27 July 2023.

⁴ The indicator shows the balance of the answers. For more detail, see European Commission, The Joint Harmonised EU Programme of Business and Consumer Surveys User Guide, update January 2023.



EUROZONE: CONFIDENCE, INFLATION OUTLOOK AND UNCERTAINTY



CHARTS

SOURCE: EUROPEAN COMMISSION, BNP PARIBAS



Clearly, other factors must play a role. A possible candidate is the evolution of inflation. When inflation is rising fast and beating expectations, it fuels uncertainty. Firms will be concerned about the evolution of their costs and their possibility to raise prices. Households will be worried about the loss of purchasing power. Business and households may fear higher borrowing costs following the tightening of monetary policy. To explore this, the charts to the right show the evolution of uncertainty and price expectations⁵. For the different business sectors and for households, price expectations and uncertainty have been declining since the latter part of last year.

The decline of headline inflation seems to have reduced uncertainty of economic agents in the Eurozone. A growing feeling that the ECB is close to the terminal rate should bring more relief. With the risk of more rate hikes also disappears that of additional headwinds to growth. However, it will also shift the attention to the headwinds that have already been developing and that may still intensify. Uncertainty will migrate from what will happen in terms of monetary policy to that about the transmission of past rate increases. To put it differently: until recently, inflation has been the dominant source of uncertainty but going forward, economic growth will take over this role.

William De Vijlder



As the ECB approaches its terminal rate, uncertainty will migrate and the attention will shift from what will happen in terms of monetary policy to the economic repercussions of past rate increases.

⁵ The rationale for using price expectations is that they are available per economic sector. Moreover, the assumption is that uncertainty is forward-looking so it is preferable to use a forward-looking measure of prices rather than observed inflation, which is backward-looking.



MARKETS OVERVIEW

OVERVIEW

Week 29-09-23 to 2-10-23				
US CAC 40	7 230	↑	7 297	+0.9 %
US S&P 500	4 488	↑	4 588	+2.5 %
Volatility (VIX)	15.7	↓	15.1	-2.8 pt
US Corridor 3M (bp)	3.79	↑	3.77	-1.0 bp
US 10yr 3M (bp)	5.47	↑	5.88	+0.2 bp
US 10Y (bp)	3.88	↑	3.82	-4.3 bp
US Bond 30y (bp)	2.59	↓	2.52	-1.5 bp
US 10 Yr 30y (bp)	4.36	↑	4.30	-6.0 bp
US EUR VS USD	1.08	↑	1.08	+0.3 %
US Dollar (index)	1 000	↓	1 000	+1.8 %
US Oil (Brent, \$)	84.6	↑	88.6	+4.6 %

MONEY & BOND MARKETS

Interest Rates	highest 23	lowest 23	yield (%)	highest 23	lowest 23
EUR	4.25	4.25	3.50	3.50	3.50
Emis	-0.53	-0.53	3.50	3.50	3.50
Corridor 3M	3.77	3.85	3.50	3.50	3.50
EUR 10Y LTM	4.00	4.39	3.50	3.50	3.50
FED	5.50	5.50	4.50	4.50	4.50
Libor 3M	3.00	3.40	4.75	4.75	4.75
Libor 12M	2.04	2.84	4.75	4.75	4.75
EUR	5.25	5.25	3.50	3.50	3.50
Libor 3M	5.50	5.80	3.87	3.87	3.87
Libor 12M	0.81	0.81	3.87	3.87	3.87

yield (%)	highest 23	lowest 23
AXO 3-7y	3.04	3.04
Bund 2y	3.04	3.38
Bund 10y	3.51	3.75
US 10y	3.82	3.23
Corp. BBB	4.58	4.77
Treas. 2y	4.33	5.18
Treas. 30y	2.19	4.95
High Yield	6.01	5.38
gilt 2y	4.88	5.52
gilt 10y	4.43	4.74

EXCHANGE RATES

EUR -	highest 23	lowest 23	2023
USD	1.00	1.00	+1.0%
GBP	0.80	0.80	-3.1%
CHF	0.94	0.94	-3.1%
JPY	157.81	158.36	+12.1%
AUD	1.47	1.47	+6.4%
CNY	7.85	8.08	+5.8%
BRL	5.33	5.29	-5.1%
RUB	103.97	130.48	+33.5%
INR	80.40	81.29	+1.1%

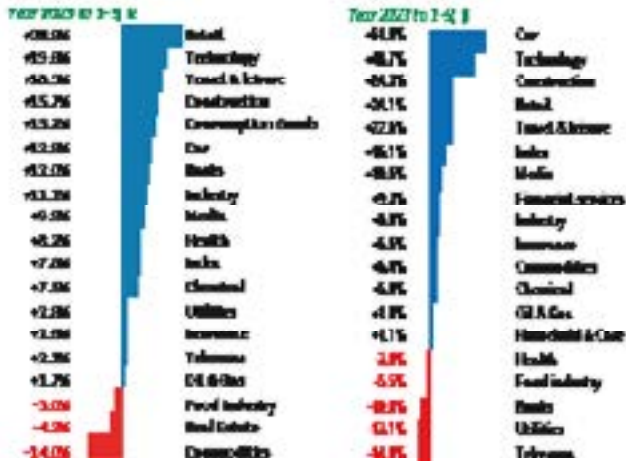
COMMODITIES

Spot price, \$	highest 23	lowest 23	2023 %Chg
Oil, Brent	88.6	88.6	+4.4%
Gold (ounce)	1 929	2 047	+5.0%
Metals, LME	3 770	4 404	-5.4%
Copper (ton)	4 479	5 328	+1.4%
Wheat (ton)	190	2.9	-13.4%
Corn (ton)	103	8.7	-3.0%

EQUITY INDICES

Index	highest 23	lowest 23	%Chg
World			
MSCI World	7 645	7 638	+1.4%
North America			
S&P 500	4 518	4 508	+17.0%
Europe			
Euro Stoxx 50	4 282	4 473	+10.8%
CAC 40	7 237	7 577	+1.3%
ASX 200	10 840	10 470	+13.8%
IBEX 35	9 470	9 894	+1.5%
FTSE 100	7 485	8 038	+0.0%
Asia			
Nikkei, J20	1 228	1 288	+1.3%
Nikkei	10 773	10 794	+3.4%
Emerging			
MSCI Emerging (excl)	688	5 073	+0.5%
China	80	75	-3.0%
India	829	835	+6.3%
Brazil	1 588	3 735	+1.8%

PERFORMANCE BY SECTOR (Euros Stoxx 50 & S&P 500)



SOURCE: REFINITIV, BNP PARIBAS

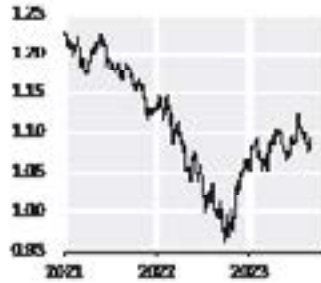


BNP PARIBAS

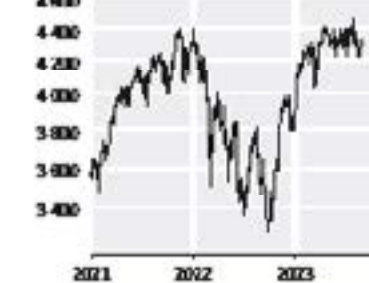
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MARKETS OVERVIEW

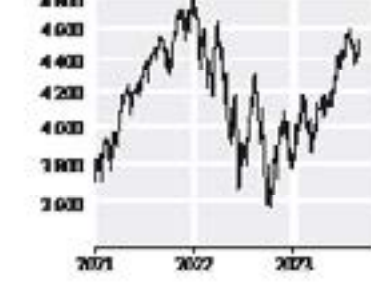
EURO-DOLLAR



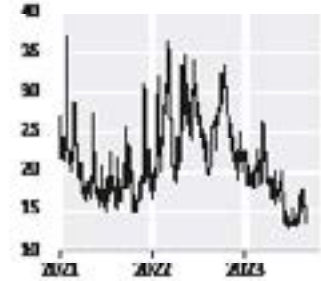
EUROSTOCK50



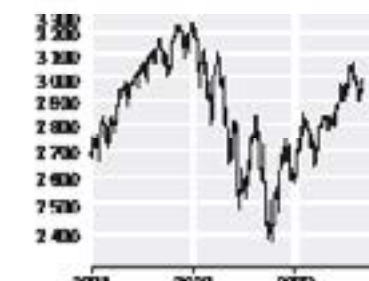
S&P500



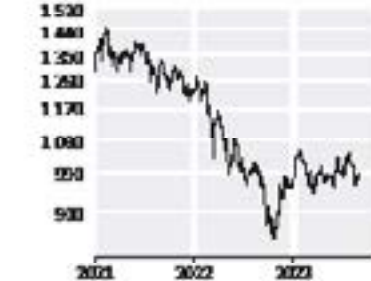
VOLATILITY (VIX, S&P500)



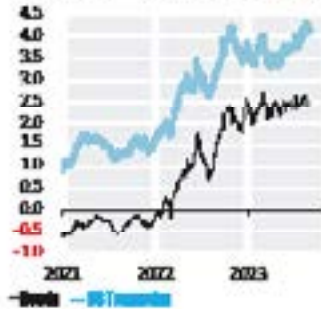
MSCI WORLD (USD)



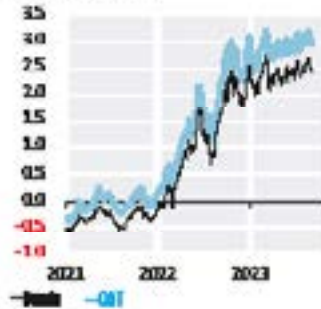
MSCI EMERGING (USD)



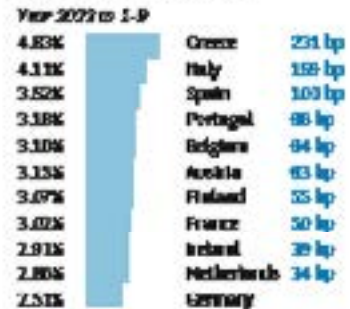
10Y BOND YIELD, TREASURY VS BUND



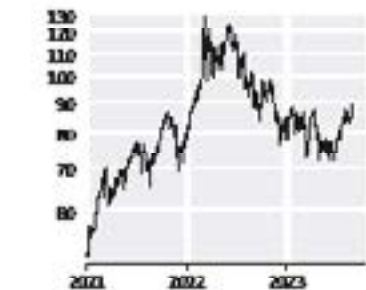
10Y BOND YIELD



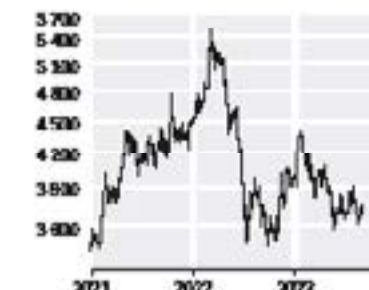
10Y BOND YIELD & SPREADS



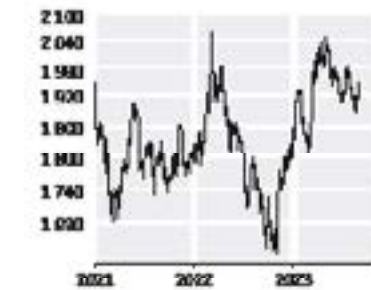
OIL (BRENT, USD)



METALS (LME3, USD)



GOLD (OUNCE, USD)



RIBAS



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ECONOMIC SCENARIO

8

UNITED STATES

After a strong second half of 2022 (+0.7% q/q on average per quarter), US activity decelerated only slightly in the first half of 2023 (+0.5% q/q on average per quarter), thanks to the resilience of household consumption and the strength of nonresidential investment. The impact of the tighter monetary policy on lending standards is strong but still limited on activity and employment growth. We still expect a shallow recession but shorter than before considering that growth no longer should be modestly positive in Q3 this year. While the peak in inflation was reached in mid-2022, core disinflation remains gradual and headline inflation should not approach the 2% target before the end of 2024. The slow pace of disinflation argues in favor of keeping monetary policy in restrictive territory, despite the expected start of the easing cycle in spring 2024. This should limit the recovery in 2024.

CHINA

Economic growth, which was sluggish and unbalanced in 2022, started to accelerate in early 2023 following the end of the zero Covid policy. However, the post-Covid recovery has lost momentum very rapidly. Export momentum has stalled due to weak global demand and tensions with the US. Domestic demand remains held back by a significant loss in consumer and investor confidence. The crisis in the property sector is persisting, with the continued fall in sales, new defaults of developers and growing difficulties of certain financial institutions. The government and the central bank implement new policy stimulus measures, which yet remain of moderate magnitude. The weak financial situation of local governments should constrain public investment.

EUROZONE

The euro zone came close to technical recession at the turn of 2022-2023. After a slight contraction in GDP in Q4 2022, growth is now estimated to be zero (rather than slightly negative) in Q1 2023. There was a technical rebound in Q2 (+0.3% q/q) that masked a disparate performance between Member States, which tends to weaken the overall result. France and Spain have been doing well, but Germany, Italy and the Netherlands are struggling. The negative effects of monetary tightening should intensify causing growth to fall back. After three quarters of stagnation, a limited recovery would follow. Although it is expected to decline throughout 2023, inflation would remain elevated and well above the 2% target at the end of this year and still a bit above at the end of 2024, forcing monetary policy to remain in restrictive territory.

FRANCE

French growth surprised on the upside in Q2 2023, with activity accelerating more than expected (+0.5% q/q, after two quarters at +0.1%). While household consumption and investment remain depressed, this rebound has been supported by business investment and, above all, exports. A negative correction is likely in Q3. Inflation keeps falling but slowly so (5.1% y/y according to the harmonized measure in July, down 2.2 points from its February peak). Because of rising interest rates, household demand should remain subdued in 2023, weighing on our GDP growth forecast (0.8% in 2023, compared to 2.6% in 2022).

RATES AND EXCHANGE RATES

In the US, after having skipped the June meeting, the Federal Reserve proceeded, as expected, to a further 25bp rate hike in July. This increase would be the last in our view, but uncertainty remains given the still elevated core inflation and the resilience of the labour market to date. In any case, these factors argue against a rate cut before the beginning of 2024. The residual uncertainty on the policy rate peak is reflected in long-term rates, which remained on an upward trend at the end of August. As inflation falls further and the prospect of monetary easing in 2024 rises, long-term rates should resume their decline soon.

Unlike the Fed, the ECB did not pause in June but, like the Fed, it increased its key rates by 25bp in July (deposit rate at 3.75%, refinancing rate at 4.25%). We are of the view that this increase would mark the end of the ECB's tightening cycle, considering the effects of the monetary tightening already underway. But it is not yet certain that it will be the last, given the absence of a tangible fall at this stage of core inflation. As part of its

monetary tightening, the ECB also announced a complete halt, starting in July 2023, of its reinvestments under the APP. European long-term rates move in line with US rates, but in a more muted way: their slight rise in late August should not last long and be followed by a gradual decline, fueled by the expected fall in core inflation which should step by step become more visible.

On 27 July, the Bank of Japan (BoJ) adjusted its yield curve control policy (YCC) by allowing a wider fluctuation in 10-year sovereign interest rates around the target of 0.5%. Further adjustments to the YCC cannot be excluded, given that the country currently faces the fastest rate of inflation since the early 1990s. Nevertheless, the BoJ is unlikely to increase its policy rates this year, but a rise is expected in 2024.

We expect the dollar to weaken somewhat versus the euro. The dollar's valuation is expensive and next year the Federal Reserve should ease earlier and more than the ECB. We expect the yen to remain around current levels in the near term before strengthening versus the dollar based on the expected monetary divergence between the Fed and the BoJ in 2024.

GDP GROWTH AND INFLATION

%	GDP Growth*				Inflation**			
	2021	2022	2023 e	2024 e	2021	2022	2023 e	2024 e
United-States	5.9	2.1	1.9	0.3	4.7	8.0	4.1	2.5
Japan	2.2	1.0	2.0	0.9	-0.2	2.5	3.2	2.3
United-Kingdom	7.6	4.1	0.5	0.1	2.6	9.0	7.5	2.9
Euro Area	5.3	3.4	0.5	0.6	2.6	8.4	5.7	3.0
Germany	2.6	1.9	-0.2	0.4	3.2	8.6	6.2	2.9
France	6.8	2.6	0.8	0.6	2.1	5.9	5.7	2.7
Italy	7.0	3.8	0.9	0.8	1.9	8.7	6.2	2.3
Spain	5.5	5.5	2.4	1.5	3.0	8.3	3.6	3.1
China	8.4	3.0	5.3	4.8	0.9	2.0	0.5	2.0
India***	8.7	7.2	6.1	6.5	5.5	6.7	5.5	4.5
Brazil	5.0	2.9	2.5	1.8	8.3	9.3	4.7	4.0

Source : BNP Paribas (e: Estimates & forecasts)

Last update: 25 August 2023

*** Fiscal year from 1st April of year n to March 31st of year n+1

INTEREST AND EXCHANGE RATES

Interest rates, %

End of period		Q3 2023	Q4 2023	Q4 2024
US	Fed Funds (upper limit)*	5.50	5.50	3.75
	T-Note 10y **	3.90	3.85	3.55
Eurozone	deposit rate*	3.75	3.75	3.00
	Bund 10y **	2.45	2.20	2.00
	OAT 10y	3.00	2.72	2.50
	BTP 10y	4.70	4.45	3.80
UK	BONO 10y	3.55	3.30	2.90
	Base rate*	5.50	5.50	4.00
Japan	Gilts 10y **	4.40	4.25	3.80
	BoJ Rate	-0.10	-0.10	0.25
	JGB 10y**	0.50	0.65	0.80

Exchange Rates

End of period		Q3 2023	Q4 2023	Q4 2024
USD	EUR / USD	1.10	1.12	1.18
	USD / JPY	133	130	123
	GBP / USD	1.25	1.27	1.34
EUR	EUR / GBP	0.88	0.88	0.88
	EUR / JPY	146	146	145

Brent

End of period		Q3 2023	Q4 2023	Q4 2024
Brent	USD/bbl	83	81	86

Sources: BNP Paribas (Market Economics, Interest Rate Strategy, FX Strategy, Commodities Desk Strategy)

Last update: 31 August 2023



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FURTHER READING

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Jackson Hole 2023: the fight against inflation is not over	EcoTV Week	1 September 2023
France: August's inflation figure reminds us that disinflation will remain gradual	EcoBrief	31 August 2023
July 2023: the hottest month ever measured	Chart of the Week	30 August 2023
Climate neutrality: the race has begun	EcoConjonture	29 August 2023
Global economy: the long wait	EcoWeek	28 August 2023
Greenflation: how inflationary is the energy transition?	EcoFlash	28 August 2023
Spain: strong job creations to support growth	EcoBrief	27 July 2023
Central America: How climate variability impacts human mobility?	Chart of the Week	27 July 2023
Eurozone: Inflation through the lens of business surveys. The case of services.	EcoWeek	24 July 2023
OECD: Economic pulse of June 2023	EcoPulse	24 July 2023
The Caribbean: Trouble in Paradise	EcoTVWeek	21 July 2023
United States: Money market funds reallocate their assets outside the ON RRP facility	Chart of the Week	19 July 2023
Eurozone: Inflation through the lens of business surveys - The case of industry	EcoWeek	18 July 2023
Is Chili a leader in energy transition?	EcoTVWeek	13 July 2023
Transport, France's main source of greenhouse gases emissions	Chart of the Week	12 July 2023
Eurozone: "have money, will travel"	EcoWeek	10 July 2023
Japan: After Price Inflation, Time for Wages?	EcoBrief	7 July 2023
Central banks: sobering Sintra	EcoTVWeek	7 July 2023
Inflation tracker July 2023	EcoCharts	6 July 2023
OECD: A limited economic turnaround, on both the downside and the upside	EcoPerspectives	5 July 2023



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ECONOMIC PULSE

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Tarik Rharrab

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