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What to watch: An early pivot for the Fed would be costly, inventory glut to reduce Red Sea bullwhip effects, and the Eurozone getting its very own soft landing

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In summary

This week, we look at three critical issues:

- **The cost of the Fed's pivoting early.** While the FOMC is widely expected to keep rates steady next week, progress on inflation (despite the Red Sea tensions) has led some market participants to expect a pivot as early as March 2024, prompting an unusually large disconnect between the restrictive monetary stance of the Fed and easing financial conditions, particularly the buoyancy of the stock market. We estimate that a Fed rate cut in March could push up inflation by +0.5pp by the end of the year to 2.9%, potentially compromising the central bank's credibility. Against this risk of premature monetary policy easing leading to renewed bouts of inflation, we still expect the Fed to pivot only in June.

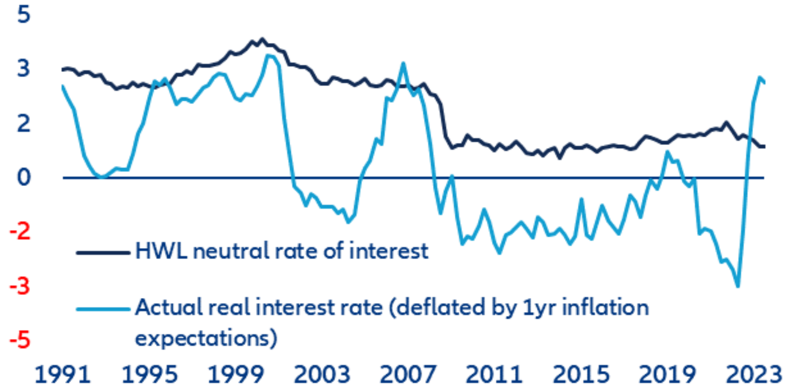
- **Read Sea 0 – 1 Inventory glut (except for the car sector).** With demand on the decline since 2022, most manufacturing sectors are struggling with an inventory glut, especially in Europe and China. On the one hand, slower inventory liquidation in Europe could provide a buffer against any potential supply-chain disruptions that could arise from a prolonged Red Sea crisis. But the automotive sector may not be so lucky: With a very low inventory-to-sales ratio, the sector is very sensitive to supply shocks stemming from the Red Sea crisis, and companies do not seem to have learned from the recent supply crisis. On the other hand, higher inventories are already eating into pricing power for both European and US companies, especially in the textiles, furniture, metals, paper and chemicals sectors. Cost absorption should be the norm in 2024.

- **The Eurozone is on track for its own soft-landing.** While private consumption and investment remain subdued, the labor market continues to be exceptionally strong and real incomes are on the rise, finally improving the outlook for private consumption. The output gap is now significantly negative, which gives room for a mechanical catch-up with potential levels. In addition, January PMI indexes suggest a limited additional recession force as business activity in the manufacturing sector has improved to the highest reading in ten months – albeit at still low levels. Price indicators reveal little upside risk for Eurozone's inflation outlook and with energy prices remaining stable, we continue to expect disinflation to gain traction and allow a first ECB rate cut in July. The latest ECB Bank Lending Survey shows that the most significant impact of the tightening has passed the peak.

The cost of the Fed's pivoting early

The FOMC is widely expected to maintain the restrictive status quo at its meeting next week, holding the Fed Funds rate in the 5.25-5.5% target range. This will mark the fourth consecutive meeting where the Fed has held its monetary settings steady, six months after its last policy move (increase in rates by 25bps in July 2023). The real Fed funds rate is currently 200bps above its estimated neutral level (Figure 1).

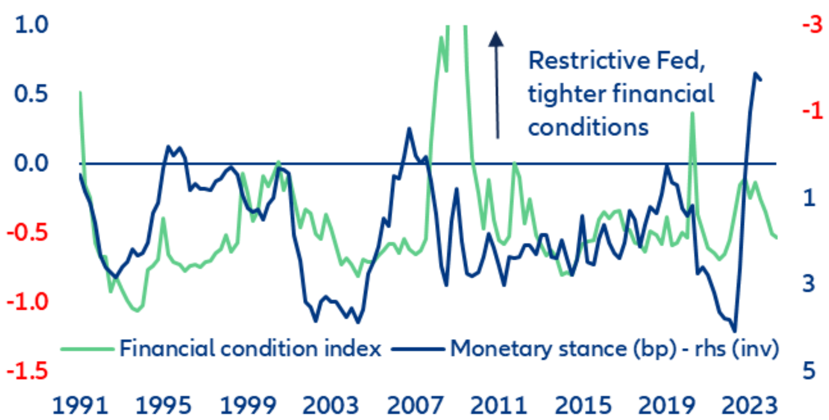
Figure 1: Neutral vs actual real Fed interest rate (%)



Sources: NY Fed, LGSE Datastream, Allianz Research

Encouraged by progress on inflation, markets have surged since the beginning of the year and some participants now expect a pivot as early as March 2024. But significantly easing financial conditions should help the Fed stay the course. So far, the Red Sea crisis has not increased inflation expectations, with early January US business surveys for the manufacturing sector (Empire State, Philly Fed) showing no evidence of accelerating prices. In this context, some market participants expect that the Fed could start its easing cycle in March 2024. However, this has led to general financial conditions significantly easing since mid-2023 despite the ever-increasing restrictiveness of the Fed's policy. While such a discrepancy has happened before during prior tightening episodes (1994-95, 2005-06, 2018-19), it has never been this large (Figure 2). These loosening financial conditions could become a pressing problem for the Fed if they lead to higher inflation by boosting spending, especially in a context where inflation has become more responsive to aggregate demand amid low unemployment relative to vacancies (i.e. the Phillips curve is steeper, Figure 3).

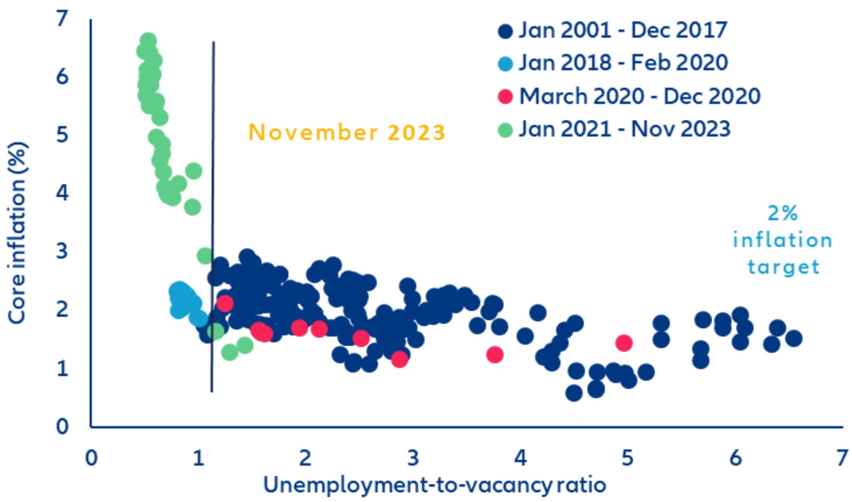
Figure 2: Fed's monetary stance & financial conditions



Sources: Chicago Fed, LGSE Datastream, Allianz Research. Note : The monetary stance is measured as the difference between the HLW neutral rate and the actual real (deflated by the Cleveland Fed's 1yr ahead inflation expectation measure) Fed funds rate.

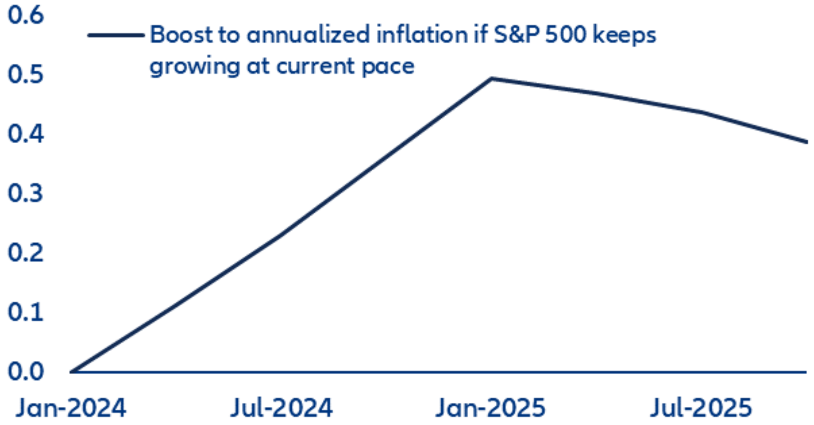
We find that an early rate cut in March could push up inflation by +0.5pp by the end of the year, getting it close to 3% on average. In this context, we still expect the Fed to pivot only in June. Assuming that the S&P 500 grows at the same pace (around +1.5% year-to-date, i.e. roughly 5% on quarterly basis) – buoyed by the prospect and then the realization of a Fed cut in March – we calculate the impact on inflation using our in-house financial conditions index and an estimated (steep) Phillips curve. We estimate that, relative to a baseline, annualized inflation would be around 0.5pp higher by end 2024-early 2025. Relative to the latest FOMC economic projections, that would mean inflation would be at +2.9% instead of +2.4%. Monetary policy operates with a lag on economic activity and inflation. As a result, even if forward-looking indicators still point to softening inflation in the next six months or so, there is clearly a risk that inflation picks back up further down the line. In this context, we expect FOMC officials to push back against market bets for a March rate cut – something that Fed Governor Waller already did last week in a speech (''no reason to move as quickly or cut as rapidly as in the past'') – to avoid acting prematurely and having to back down if inflation picks back up.

Figure 3: Phillips curve: core inflation vs unemployment-to-vacancy ratio



Sources: LGSE Datastream, Allianz Research

Figure 4: Boost to inflation if S&P 500 keeps growing at current pace (pp)



Sources: LGSE Datastream, Allianz Research

Read Sea 0 – 1 Inventory glut (except for the car sector)

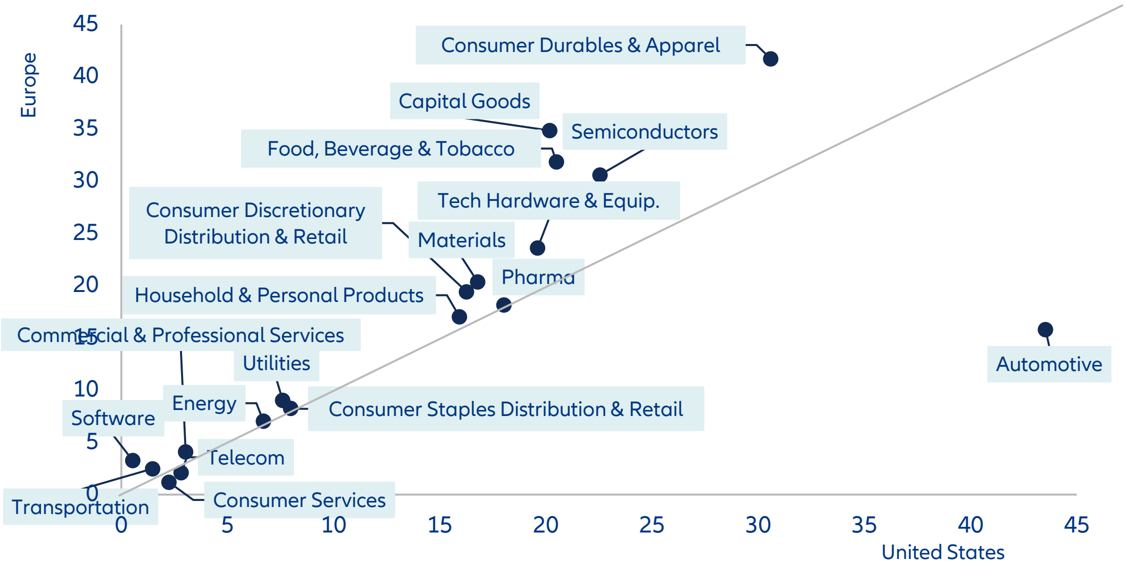
With demand on the decline since 2022, most manufacturing sectors are struggling with an inventory glut, especially in Europe and China. The loss in real purchasing power has been a significant drag on consumer demand for goods, making it difficult for companies to reduce high inventories inherited from the post-pandemic rush to "just-in case" stockpiling. While new orders have been outpacing inventory levels (Figure 5) in the US and some emerging economies (such as India, Mexico and the Asean), manufacturing companies in Europe are clearly struggling to reduce surpluses. In 2023, the rise in the inventory-related costs equaled two days of turnover (days inventory - DI) for Western European countries for all sectors on average, against close to 0 in the US, with chemicals, computer & telecom, construction, machinery & equipment, metals and transport equipment most affected. Overall, companies in the US have an inventory-to-sales ratio of 12.9 on average, lower than the Western Europe average of 20.6. This suggests that European firms are liquidating their inventory slower and are therefore operationally less efficient, which could put margins at risk, particularly in the current context of increasing shipping rates, as we believe most firms will have to absorb a large part of these increases if they want to destock quicker.

Figure 5: Inventories versus new orders by country in Q4 2023

Source: S&P Markit PMI, Allianz Research

On one hand, slower inventory liquidation in Europe could provide a buffer against any potential supply-chain disruptions that could arise from a prolonged Red Sea crisis. But the automotive sector is facing major challenges. High inventory levels mean that European firms can withstand longer delivery times – at least for a few months. For instance, consumer durables & apparel is highly dependent on shipping from Asia but it also has the highest inventory-to-sales ratio (41.7) in Europe. As a result, companies in this sector could be spared the effects of supply-chain disruption, though they will not be able to pass on higher transportation costs to consumers to remain cheap enough for destocking. However, the European automotive sector may not be so lucky. With a very low inventory-to-sales ratio (15.7, below the European all-industry average of 20.6 and well below the US automotive average of 43.5), the sector is very sensitive to potential supply shocks stemming from the Red Sea crisis. And European automakers do not seem to have learned from past experience: Despite the 2020 crisis, companies have not properly rightsized their short-term production needs, with some original equipment manufacturer (OEMs) even being forced to halt production due to supply delays resulting from the conflict in the Middle East. At a time when US and Chinese OEMs have been reducing vehicle prices (notably for electric vehicles), European players are unlikely to be able to sit out the price war as losing market share is not an option. In this context, we expect European automakers to absorb a large part of the increase in transportation costs rather than passing it to the final consumer.

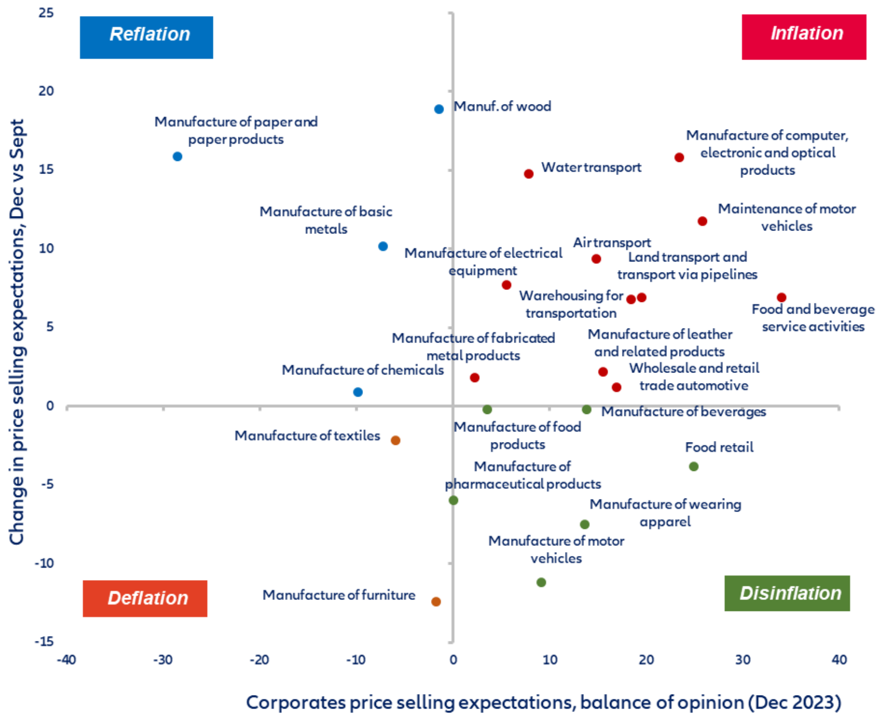
Figure 6: Inventory to sales ratio, Western Europe (Y axis) and US (X axis)



Sources: Bloomberg (average by sector, only listed companies, last 12 months data as of 23 January 2024), Allianz Research

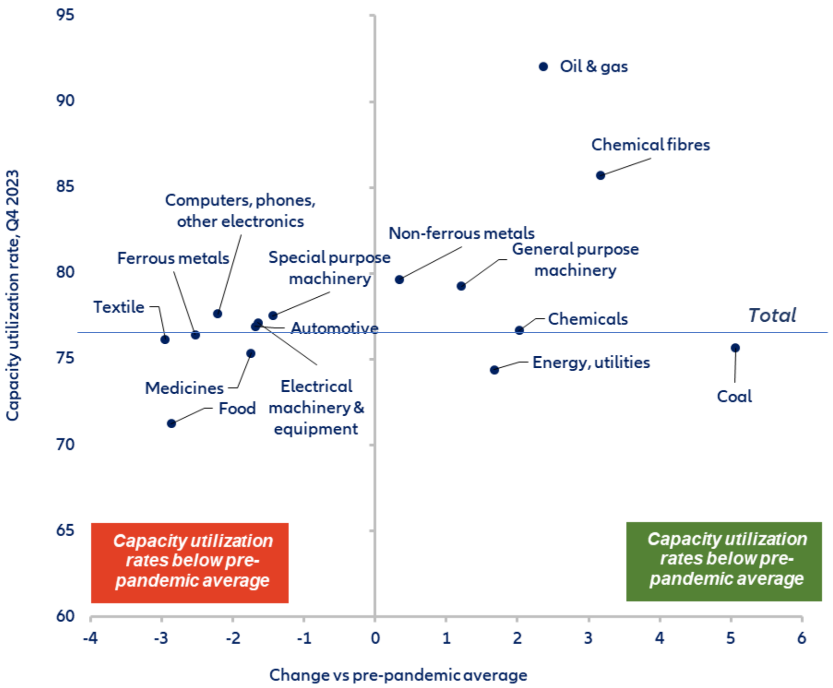
On the other hand, higher inventories are already eating into pricing power for both European and US companies, especially in the textiles, furniture, metals, paper and chemicals sectors. Cost absorption should be the norm in 2024. Higher inventories mean higher storage and maintenance costs (where inflationary pressures remain high), leading in parallel to an increase in working capital requirements and subsequently to a reduction in profit margins. Moreover, companies are losing pricing power in a context of faltering demand. Comparing companies' selling-price expectations between September and December 2023 (Figure 7), we find that while most manufacturing and services sectors remain in a slightly inflationary environment, with the balance of opinion still positive, several have entered a deflationary phase. In China, surpluses have already pushed exporters to decrease their prices since last fall to boost volumes. We expect this trend to continue, notably for goods in sectors where inventories are high (Figure 8) particularly as we approach the Lunar New Year festivities that should boost consumption, which will limit the impact on overall selling prices – at least over the next few months. Looking at corporates' capacity to absorb the increase in costs throughout 2023 – measured by the ratio of output-prices growth to input-prices growth – we find that Chinese and US companies stand out, with high and rising cost absorption while other markets (Asean) stand at comfortable but decreasing levels (Figure 9). In contrast, most European companies absorbed less than 50% of the increase in input prices. To protect market shares, more efforts will be needed in 2024.

Figure 7: Price selling expectations by sector, December 2023 (level) and change since September 2023



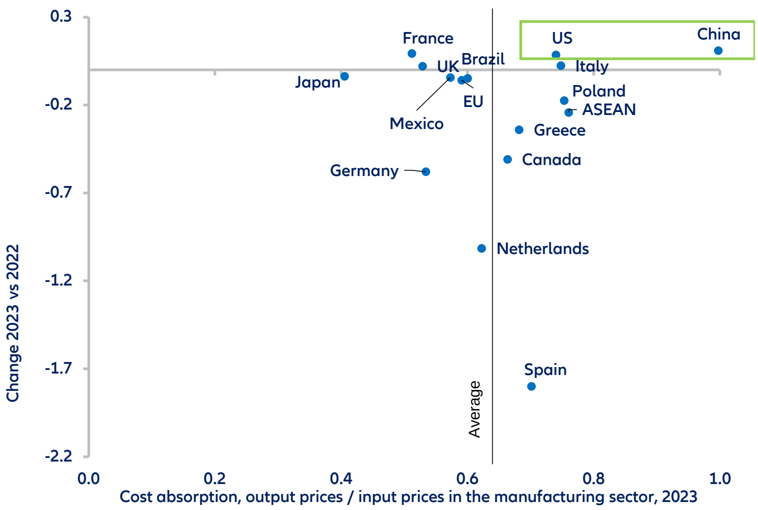
Sources: European Commission, Allianz Research

Figure 8: Capacity utilization rates in manufacturing sectors in China, %



Source: National sources, Allianz Research

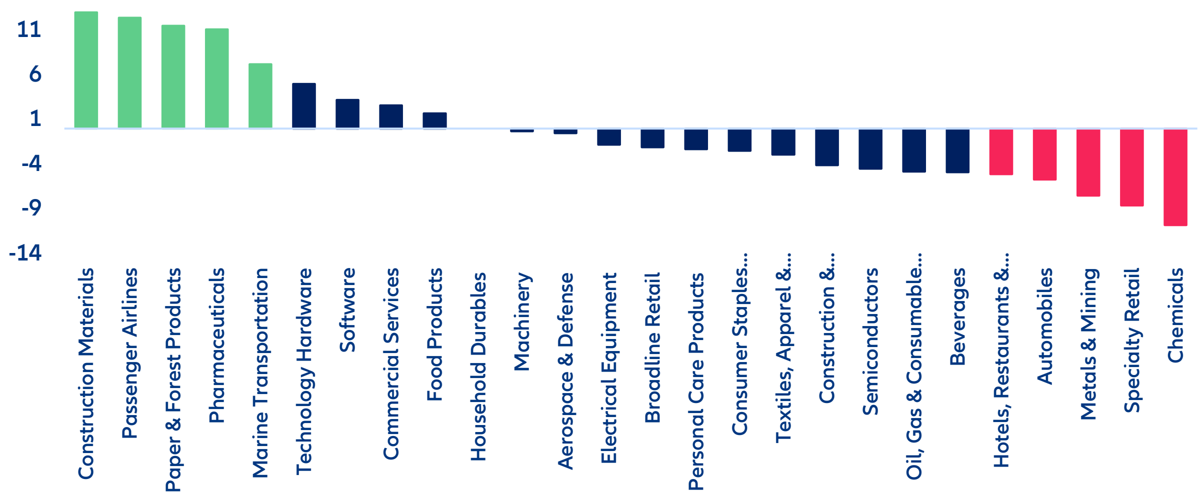
Figure 9: Cost absorption capacity for corporates in specific countries, %



Sources: S&P Markit PMI, Allianz Research

Market expectations confirm a margin squeeze ahead for many sectors in Europe. 16 out of 26 sectors in Europe have seen their earnings per share (EPS) expectations revised downwards (Figure 10) compared to the levels of three months ago. This suggests that these sectors will not have the capacity to pass on increased transportation costs and therefore no significant improvement in profitability can be anticipated in the current context. Chemicals suffered the largest downward revision (-10.8% versus October 2023) amid fears of supply delays and increased costs for an energy-intensive sector that is highly dependent on Asia and was already weakened by the consequences of the conflict in Ukraine. The automotive sector also saw a significant downward revision (-5.7%). Conversely, earnings estimates have been recently upgraded for nine sectors, including shipping (+7.2%) as global freight rates continue to climb (world composite index: +127% ytd and +82% y/y).

Figure 10: Earnings (EPS) analysts' revisions, today versus three-months change (%), Europe

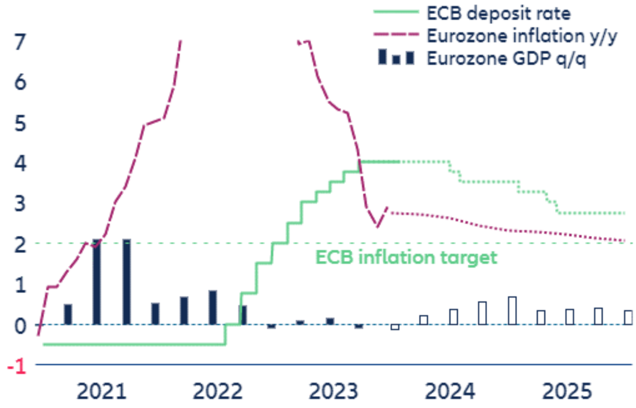


Sources: Bloomberg as of 23 January 2024, Allianz Research

The Eurozone is on track for its own soft-landing

A likely technical recession in the second half of 2023 does not derail our forecast of a slow rebound in 2024. Next week, Eurozone Q4 GDP data is expected to show another decline, likely confirming a technical recession as it follows a -0.1% dip in Q3. Moreover, it signifies a concerning trend as the region will have stagnated for five consecutive quarters by then. Private consumption and investment remain subdued, heavily impacted by high interest rates and the continued strain of diminished real wages. However, we do not see a stronger recession ahead but rather stick with our outlook of a soft rebound in economic activity in the course of 2024. First, the labor market continues to be exceptionally strong, with unemployment at a record low 6.4%. On top of this, real incomes are about to rise as disinflation continues, finally revitalizing private consumption (see our last weekly). Secondly, the output gap is now significantly negative. As we do not see a change in potential growth, output needs to mechanically catch up with its potential level at some point. Finally, the ECB is likely to cut rates in summer amid ongoing disinflation, providing some tailwind in the second half of this year (Figure 11).

Figure 11: Eurozone economic outlook



Sources: LSEG Datastream, Allianz Research

The latest Bank Lending Survey (BLS) released earlier this week already brought some positive news despite overall conditions remaining tight. The Q4 aggregate BLS conditions improved to their best level since the ECB began raising rates in summer 2022, hinting that the most significant impact of the tightening might now be in the past. The net balance of banks reporting tighter standards for firms fell from 12% previously to 4% and for housing loans from 11% to 2% – the lowest number for both since early 2022.

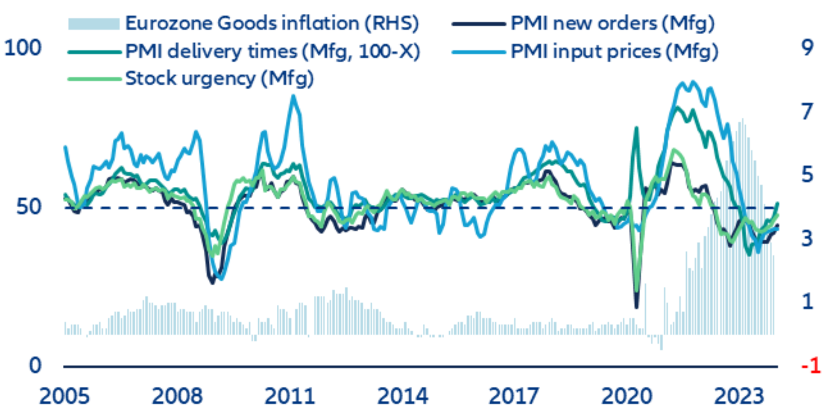
Similarly, PMI releases for January suggest a limited additional recession force as business activity in the manufacturing sector has improved to the highest reading in ten months – albeit at still low levels. The improvement of the manufacturing PMI by slightly more than 2 points to 46.6 for the Eurozone aggregate suggests a moderation in the contraction of activity. This comes along with an improvement of new orders to 44.6 and new export orders to 45.1. Despite remaining in contractionary territory, these are the highest levels recorded since April 2023. While business activity in the service sector has not improved (48.4, down 0.4 points from December), a simple model using manufacturing and services PMI numbers as inputs indicates that the trough in economic activity should be behind us (Figure 12).

Figure 12: Eurozone GDP growth and PMI model fitted growth

Sources: LSEG Datastream, Allianz Research

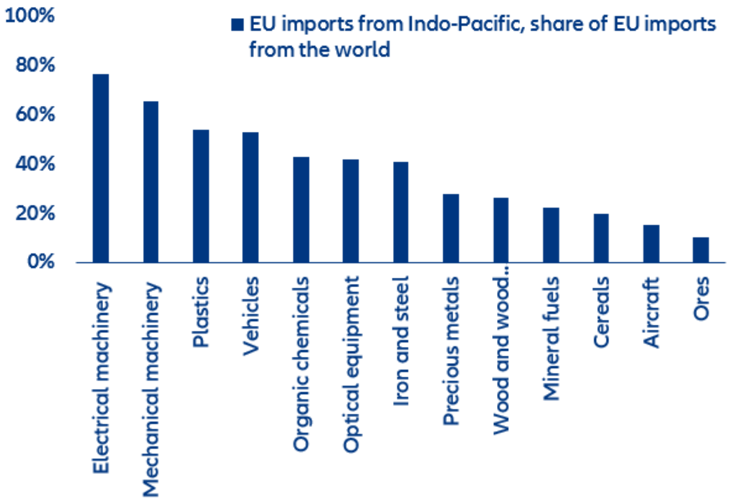
Price indicators also reveal little upside risk for Eurozone's inflation outlook despite rising freight costs following the escalation in the Red Sea conflict. As ships from Asia to Europe still need to take the detour around Africa, freight rates continue to climb. The price tag for a container from Shanghai to Rotterdam has increased by +372% since the beginning of November and by +38% ytd to levels not seen since October 2022. Surprisingly, this development has not translated into price increases, according to the latest PMI release. Even though delivery times are now increasing again for the first time in a year, a majority of companies report further decreasing input prices as the relevant PMI component remained stable at 42.3 (Figure 13). Similarly, the output prices component fell by -0.3 points to 48.6. Part of the explanation is that 2024 is in many ways different to 2022, which was marked by skyrocketing inflation in the Eurozone. Back then, the economy just emerged from the Covid-19 crisis with demand surging and inventories depleted. Today, aggregate economic demand in the Eurozone is much weaker and order books are empty. This should cap upward inflation risks, especially considering that goods represent only 26% of the total CPI index. However, some sectors that are more exposed to trade with the Indo-Pacific region could find it more challenging to handle the Red Sea situation if it lasts longer than expected. Within goods, clothing, electronical and mechanical equipment have the highest import intensities when it comes to trade with Asia (Figure 14).

Figure 13: PMI subcomponents and Eurozone Goods inflation in %



Sources: S&P Markit PMI, LSEG Datastream, Allianz Research.
Note: Stock urgency is defined as quantity of purchases – stock of purchases + 50.

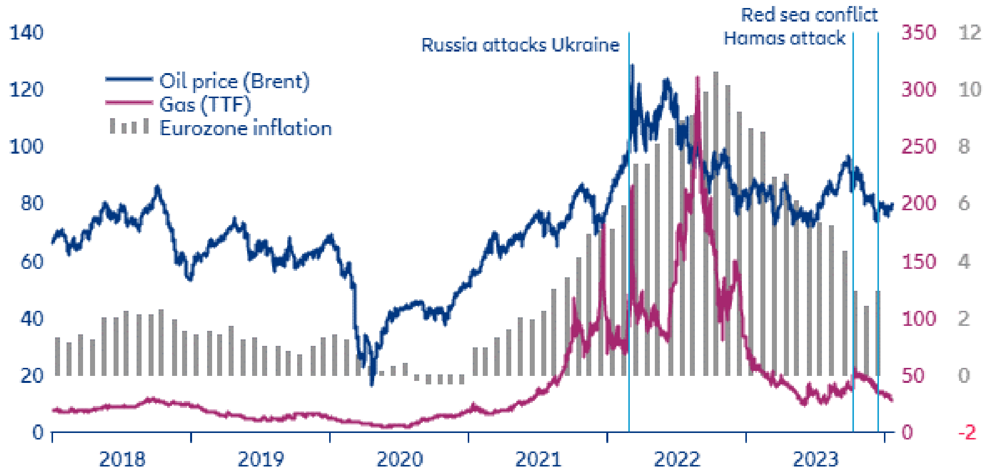
Figure 14: EU sector dependency on the Suez Canal



Sources: LSEG Datastream, Allianz Research

Moreover, with energy prices remaining stable, a key factor driving the 2022 inflation surge remains absent so far, supporting our outlook for ongoing disinflation and potential monetary easing – albeit at a slower pace than current market pricing. Figure 15 illustrates the initial impact of rising oil and gas prices in Europe in 2021, exacerbated by the Russian invasion of Ukraine causing significant gas supply disruptions. However, since the Hamas attack on Israel on 7 October 2023, oil and gas prices have continued to drop – even after Houthi attacks in the Red Sea have altered shipping routes. While the Red Sea conflict will slow the disinflation process, it will not stop it, making us confident of forthcoming monetary easing further supporting the European recovery in the second half of 2024.

Figure 15: Oil and gas prices versus Eurozone inflation in %



Sources: LSEG Datastream, Allianz Research

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