MyStratWeekly
Market views and strategy

Ostrum ASSET MANAGEMENT

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Topic of the week: The ECB facing domestic tensions on prices

- **Christine Lagarde and Isabelle Schnabel insist on the need for the ECB to remain cautious and not lower rates prematurely;**
- **Inflation in services has stabilized at 4% for 3 months, reflecting the persistence of domestic tensions linked in particular to wages;**
- **The ECB forward-looking tracker of negotiated wages in eurozone does not show signs of a slowdown in wages in 2024;**
- **In a context of low productivity growth, even a slight decline, the evolution of profit margins will be decisive in absorbing the sharp increase in labor costs;**
- **Salary negotiations and unit profits for the 1st quarter will be decisive in judging the continuation of disinflation;**
- **The ECB is not expected to lower its rates before June.**

Market review: Towards the Fed scenario

- **Repricing of Markets' expectations of Fed rate cuts;**
- **Outperformance of European stock markets;**
- **Resilience of Euro zone peripheral spreads;**
- **Credit is resilient.**

Chart of the week

The price of cocoa in New York literally soared from last summer to reach a historic high of $6,000 per tonne on February 13, compared to $3,000 at the start of June 2023. This surge is linked to poor climatic conditions in Ghana and Ivory Coast, main cocoa producers (nearly 70% of world production).

After being affected by a disease linked to flooding, the cocoa pods suffered from the drought following the passage of El Nino. This increase in prices has also been amplified by speculators who force cocoa producers to cover their short positions. This spectacular increase in the price of cocoa should result in an increase in the selling price of chocolate.

Figure of the week

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Source : Transitions & énergie

In 2023, the United States became the world's leading exporter of liquefied natural gas, ahead of Australia and Qatar. Exports were 91.2 million tons, mainly destined for the Netherlands, the United Kingdom and France.

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● Topic of the week

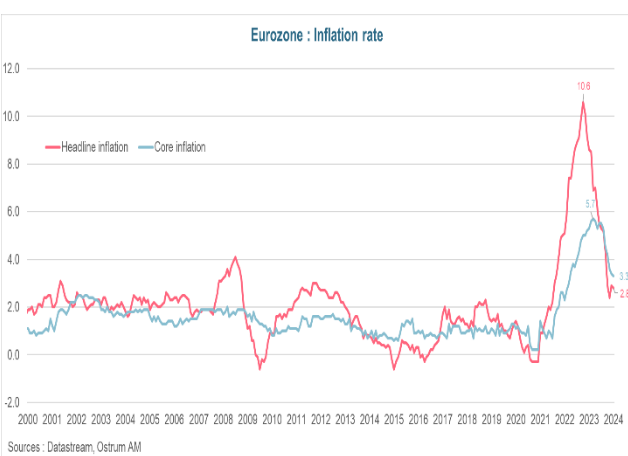
The ECB facing domestic tensions on prices

Christine Lagarde and Isabelle Schnabel reiterated last week that the ECB must be cautious and not lower rates prematurely. Inflation in services has in fact stabilized at a high level for 3 months, reflecting the persistence of tensions on domestic prices linked in particular to wages. To better understand their development over the coming quarters, the ECB has just published a forward-looking wage tracker, based on the results of wage negotiations. The latter does not show any sign of moderation in 2024, quite the contrary. In a context of low productivity growth, or even decline recently, the evolution of profit margins will be decisive in helping to partially absorb the increase in wage costs and allowing inflation to return to the 2% target of the ECB.

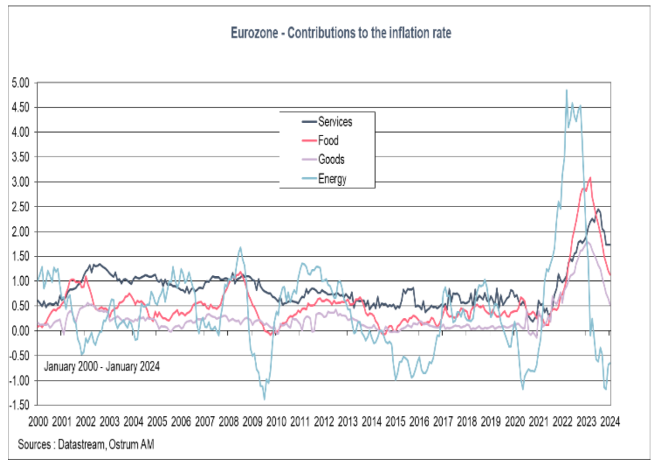
Persistence of tensions on domestic prices

The strong post-covid recovery then the consequences of the war in Ukraine resulted in a clear acceleration of inflation in the Eurozone from the start of 2021 to the summer of 2022.

The main factor was the sharp rise in energy prices and its spread to all sectors, particularly in the food sector. There were also the effects of disruptions in supply chains.



After reaching a historic peak at 10.6% in October 2022, inflation slowed significantly to return to 2.8% in January 2024. The faster-than-expected disinflation is mainly linked to energy prices, which are down from a year ago (-6.3% against +41.5% in October 2022). Energy prices therefore have a negative contribution to inflation as shown in the following graph. Food price inflation also moderated but still remain elevated (5.7% compared to a peak of 15.5% in March 2023).



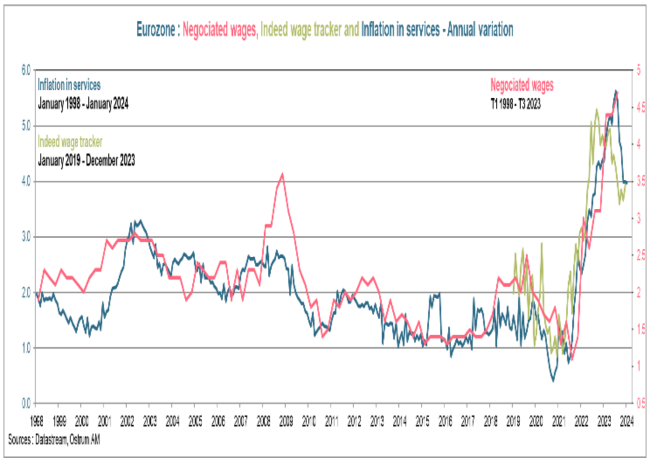
Core inflation (excluding food and energy) peaked later, at 5.7% in March 2023, before returning to 3.3% in January 2024. This moderates to a slower pace than overall inflation. The slowdown in the rise in prices of goods other than energy was the main reason. The prices of industrial goods excluding energy increased by 2% in January compared to 6.8% in February 2023. This reflects the consequences of the fall in energy prices, the end of disruptions in supply chains and lower demand. The restrictive monetary policy pursued by the ECB has tightened credit conditions and weighed on the lending dynamic of households and businesses. Inflation in services, on the other hand, moderated to a much smaller extent. After reaching a peak of 5.6% in July 2023, it has stabilized at 4% since November.

The continued slowdown in inflation towards the ECB's 2% target will depend above all on the evolution of prices in services. Indeed, the negative base effect on energy prices will soon be over and prices of food and industrial goods excluding energy have already slowed markedly.

No sign of moderation in negotiated wages

Negotiated wages and Indeed index

The service sector is labor intensive and thus crystallizes the impact of salary increases since 2022. Negotiated wages (in pink in the graph below) accelerated sharply to record an increase of 4.7% over one year in the 3rd quarter of 2023, a historic high, compared to an average of 1.7% between 2010 and 2019.



Households have negotiated wage increases to recoup part of the losses in purchasing power linked to the sharp acceleration in inflation. In addition, certain sectors are facing labor shortages, which also contributes to wage pressures.

The Indeed wage tracker (in green on the graph) concerns online job offers and thus gives a measure of the evolution of salaries for new contracts. The index has moderated since April, going from 4.9% over one year to 3.9% in December 2023. It nevertheless continues to progress at a sustained pace and has even tended to firm up slightly over the past 3 months.

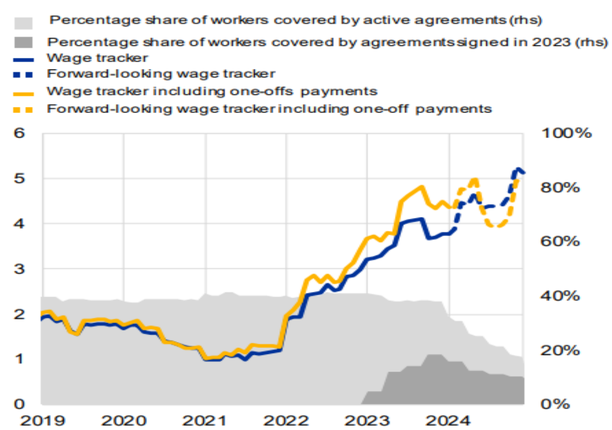
The Indeed index is a different measure of negotiated salaries which concerns not new recruits but employees present on the labor market and whose salary is fixed within the framework of wage negotiations. The problem is that this relevant index for monitoring the evolution of wages in the Eurozone is only known with a delay. The latest available data is that of the 3rd quarter of 2023.

ECB “wage tracker”

To remedy this, the ECB has built a leading indicator of negotiated wages: “wage tracker”. It is based on the results of salary negotiations in 7 countries: Germany, France, Italy, Spain, the Netherlands, Austria and Greece. Wages in the Eurozone are mainly determined through collective negotiations. In the 5 main countries, collective bargaining concerns 75% of employees (including 100% in France, Italy and Belgium). The 7 countries covered represent almost 90% of salaries in the Eurozone. This indicator tracks the evolution of negotiated wages published by Eurostat.

Given that wage negotiations cover a period which can range from one year (as in Austria and France generally) to several years (2 years in Germany and 3 to 4 years in Italy and Spain), the results of the latest salary negotiations provide advanced indications of wage developments over the coming quarters.

ECB « wage tracker »



Source : ECB

The blue curve in the previous graph represents the “wage tracker” published by the ECB and, in dotted lines, its expected evolution taking into account the latest wage negotiations. After a slight moderation in the 4th quarter of 2023, this index suggests a more rapid increase in salaries in 2024, according to the results of the latest negotiations. Negotiated wages would increase by around 4.5% on average over the coming quarters compared to 3.7% on average in 2023. This would mainly be the case in Germany.

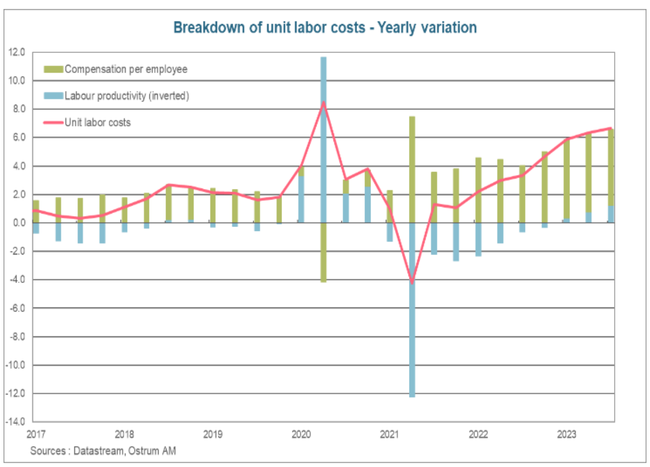
The yellow curve includes one-off payments. These have been significant recently in order to compensate for losses in purchasing power. After a drop in the 1st half of 2024, due to negative base effects, negotiated wages including one-off payments should start to rise again in the 2nd half of 2024. They would increase on average by 4.5% in 2024 compared to 4.2% in 2023.

The results of wage negotiations for the 1st quarter of 2024 will be important to be better able to measure salary tensions given the significant proportion of contracts requiring renegotiation (gray area on the graph).

Importance of profit margins

Sharp rise in unit labor costs

Compensation per employee has increased significantly since 2021, growing at a rate of 5.3% year-on-year in the 3rd quarter of 2023. At the same time, productivity gains have been low, unable to offset the sharp increase in wages. Labor productivity growth even became slightly negative in 2023 (-1.3% in Q3). It is shown in blue on the following graph, and on an inverted scale. This resulted in a sharp increase in unit labor costs: +6.7% year-on-year in the 3rd quarter of 2023.



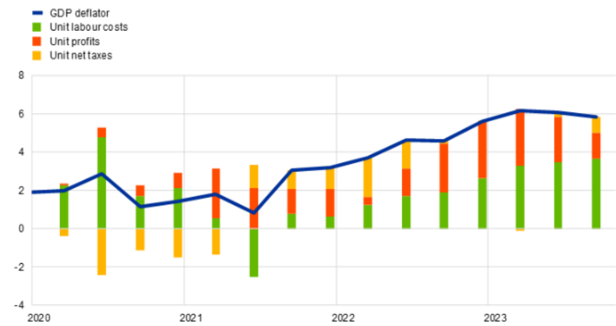
In a context of low productivity gains, the risk is that companies will partly pass on the sharp increase in their wage costs to consumers. Isabelle Schnabel clearly pointed this during her speech on February 16.

Significant increase in profit margins in 2021 and 2022

The GDP deflator makes it possible to measure pressures on domestic prices. It can be broken down into contributions from unit labor costs, unit profits and taxes per unit produced. As shown in the following graph, corporate margins played a major role in the acceleration of inflation in 2022. The contribution of unit profits to the GDP deflator increased sharply while that of unit labor costs has progressed more moderately.

Breakdown of the GDP deflator

(annual percentage changes; percentage point contributions)

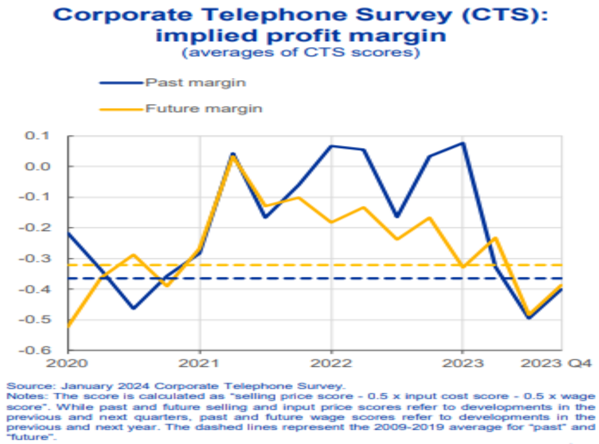


Sources: Eurostat and ECB calculations.

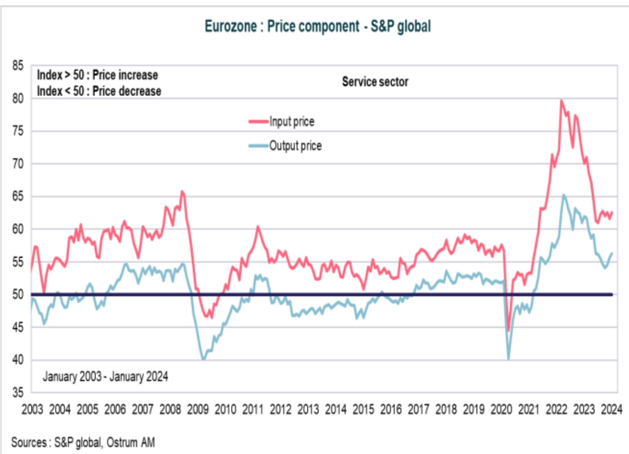
The sharp increase in demand following the reopening of the economy, once health restrictions were lifted, in a context of a sharp increase in the price of inputs, allowed companies to significantly increase their margins.

From the 2nd quarter of 2023, the contribution of unit profits to the GDP deflator has become less significant. It was 1.4 percentage points (pp) in the 3rd quarter compared to 2.4 pp in the second. The contribution of unit labor costs remained almost unchanged at 3.6 pp compared to 3.5 pp. This tends to show that corporate margins absorb part of the increase in unit labor costs.

According to a survey carried out by the ECB among companies, this trend continued at the end of the year, on a slightly more moderate scale, as shown in the next graph. According to this same survey, business leaders anticipate continued sustained wage growth in 2024: 4.4% on average over the year compared to 5.3% in 2023.



The latest survey carried out by S&P Global among business leaders nevertheless calls for caution. This reveals a stronger increase in sales prices in the



services sector for 3 months (blue curve in the graph) while the increase in input prices has stabilized at a high level. This could signal an increase in profit margins at the start of the year.

In addition, tensions in the Red Sea, following attacks on ships by Houthi rebels, are disrupting global maritime trade by forcing fleets to take longer routes. This results in an increase in the cost of maritime freight and an extension of delivery times likely to weigh on prices.

Conclusion

The leading wage indicator developed by the ECB does not show signs of moderation in 2024, quite the contrary. In a context of low productivity growth, company margins will have a major role to play in absorbing the expected sharp increase in unit labor costs. The persistence of tensions on domestic prices is a reason why the ECB should not rush to lower its key rates. It should wait until June, to observe the data on negotiated wages and unit profits for the first quarter of 2024 and better understand the evolution of tensions on domestic prices.

Aline Goupil-Raguénès

Market review

Towards the Fed’s scenario

The repricing of market expectations of Fed rate cuts penalized US equity markets, which underperformed for the first time since the start of the year.

US inflation was higher than expected in January, removing the possibility of a rate cut in March, but domestic pressures which strengthened at the start of the year led the markets to consider the first rate cut in the Fed in June. A total of 90 bp of rate cuts are now expected for the whole of 2024 compared to 160 bp anticipated in December 2023. The real US 10-year interest rate reached 2%, the highest since Jerome Powell's speech in December. The S&P 500 index therefore underperformed the European and emerging market equities for the first time since the start of the year. The Nikkei index reached its highest level since 1989, owing to the weakness of the yen benefiting exporters.

The inversion of the US sovereign yield curve on the 2/10s segment increased to 38 bp led by the sharp rise of the two-year interest rate (+23 bp). European sovereign rates held up better thanks to sovereign auctions which were well absorbed and the “risk-on” environment. The spreads of so-called peripheral countries have tightened, like the Italy-Bund spread falling below 150 bp and France-Germany below 50 bp. Fitch is expected to update its sovereign rating on Belgium currently at AA- with a negative outlook, indicating a risk of rating downgrade. The credit market remained resilient, reflecting an attractiveness for the asset class.

The repricing of expectations of Fed rate cuts supported the greenback against G10 currencies. The yen returned to 150 against the dollar, leading the Japanese authorities to intervene verbally to slow down the depreciation of the Japanese currency. The Japanese economy entered recession in Q4, linked to weak domestic demand held back by negative real wages. The wage negotiations, “shunto” in mid-March will be decisive in reviving Japanese consumption. The European currency rebounded from its support of $1.07 supported by a “risk-on” environment. Crude prices remained firm, at more than $80 per barrel for Brent, linked to tensions in the Red Sea. Maersk has indicated that it does not expect an end to the conflict before Q3.

The string of economic indicators published this week in the United States should not call into question Jerome Powell's decision not to lower rates in March. Inflation slowed from 3.3% in December to 3.1% in January, but core inflation remains persistent at 3.9% since October. Inflation for non-housing services increased sharply to 4.4% yoy compared to 3.9% in December, reflecting domestic tensions which strengthened at the start of the year. Retail sales fell in January by 0.8%mom after increasing by 0.4% in December (revised downward). The control group's retail sales, contributing to the GDP calculation, are down -0.4%mom. New trend or weather effect? However, we can note positive signals from US manufacturing activity which seems to be stabilizing, as shown by the regional surveys in Philadelphia and New York. Weekly unemployment claims are lower than their 2019 pre-Covid average.

The Euro zone once again escapes recession with the final publication of its Q4 GDP at 0.1%qoq, indicating sluggish growth. However, the European labor market remains robust, reflecting job creation which increased by 0.3%qoq. The year 2024 promises to be more difficult. The European Commission has revised downwards its growth forecast for 2024 from 1.2% to 0.8% and 1.5% for 2025. Inflation in the euro area will only converge towards its target in 2025 at 2.2%.

Chinese markets were closed all week, but early data on consumer spending during the Lunar New Year festivities showed signs of strengthening household consumption. Rail traffic has reached a 5-year high, i.e. +60% compared to 2023.

Zouhoure Bousbih

Main market indicators

G4 Government Bonds	19-Feb-24	1wk (bp)	1m (bp)	2024 (bp)
EUR Bunds 2y	2.79%	+10	+6	+39
EUR Bunds 10y	2.39%	+3	+5	+37
EUR Bunds 2s10s	-40.5bp	-7	-1	-2
USD Treasuries 2y	4.64%	+17	+26	+39
USD Treasuries 10y	4.28%	+10	+16	+40
USD Treasuries 2s10s	-36.5bp	-7	-10	+1
GBP Gilt 10y	4.1%	+5	+17	+57
JPY JGB 10y	0.74%	+1	-7	-12
€ Sovereign Spreads (10y)	**19-Feb-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
France	47bp	-3	-3	-6
Italy	147bp	-7	-9	-20
Spain	90bp	-6	-3	-6
Inflation Break-evens (10y)	**19-Feb-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
EUR 10y Inflation Swap	2.19%	-1	+3	+5
USD 10y Inflation Swap	2.53%	+6	+3	+12
GBP 10y Inflation Swap	3.59%	+2	+6	+5
EUR Credit Indices	**19-Feb-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
EUR Corporate Credit OAS	125bp	-5	-15	-13
EUR Agencies OAS	64bp	-3	-5	-6
EUR Securitized - Covered OAS	71bp	-3	-4	-8
EUR Pan-European High Yield OAS	353bp	-23	-33	-46
EUR/USD CDS Indices 5y	**19-Feb-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
iTraxx IG	56bp	-1	-4	-2
iTraxx Crossover	312bp	-4	-19	-2
CDX IG	53bp	0	-2	-4
CDX High Yield	346bp	+3	-11	-10
Emerging Markets	**19-Feb-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
JPM EMBI Global Div. Spread	383bp	-8	-13	-1
Currencies	**19-Feb-24**	**1wk (%)**	**1m (%)**	**2024 (%)**
EUR/USD	$1.077	0.009	-1.147	-2.4
GBP/USD	$1.261	-0.135	-0.716	-0.9
USD/JPY	JPY 150	-0.380	-1.201	-5.9
Commodity Futures	**19-Feb-24**	**-1wk ($)**	**-1m ($)**	**2024 (%)**
Crude Brent	$82.6	$0.6	$4.5	7.4
Gold	$2 019.5	-$0.6	-$10.0	-2.1
Equity Market Indices	**19-Feb-24**	**-1wk (%)**	**-1m (%)**	**2024 (%)**
S&P 500	5 006	-0.42	3.42	4.9
EuroStoxx 50	4 750	0.08	6.77	5.1
CAC 40	7 738	0.62	4.96	2.6
Nikkei 225	38 470	4.26	6.97	15.0
Shanghai Composite	2 911	6.61	0.60	-2.2
VIX - Implied Volatility Index	14.68	5.38	10.38	17.9

Source: Bloomberg, Ostrum AM

Additional notes

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