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Ostrum
ASSET MANAGEMENT

Keys of the week

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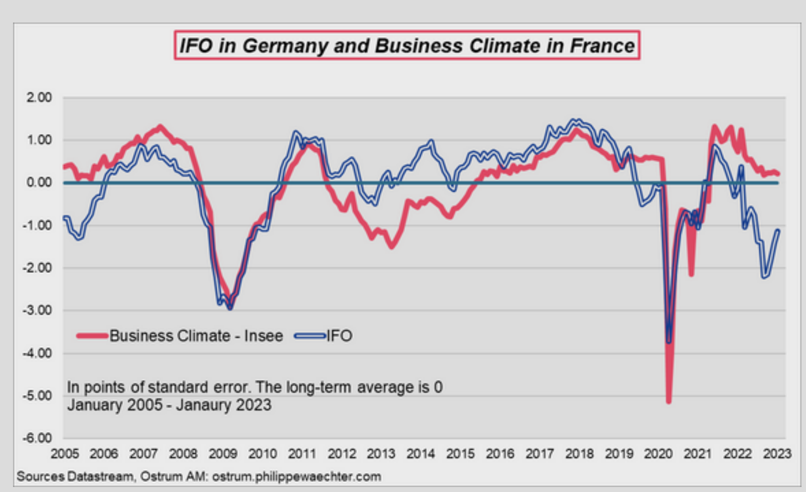
- This week - Corporate surveys SP Global, IFO and INSEE for January 23



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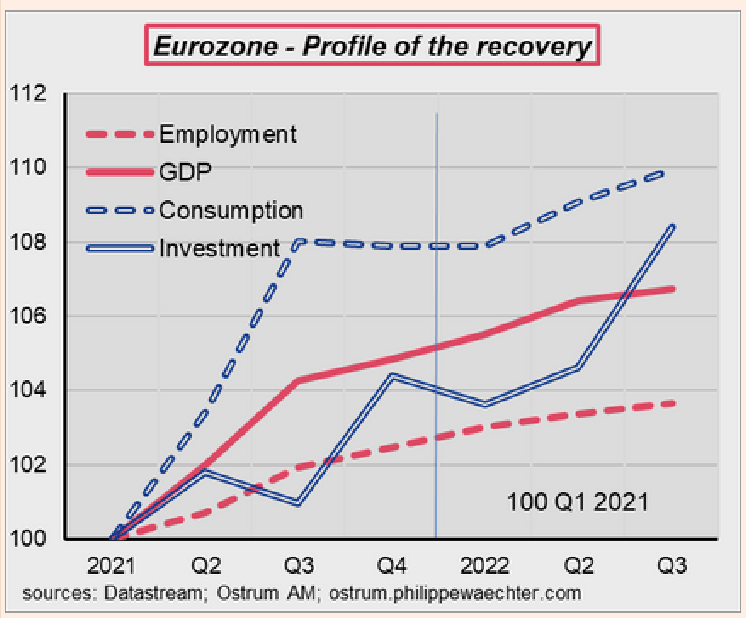
The risk of recession is receding...but...

The **energy shock** disrupted the economic cycle of European countries in 2022. Since the rapid rise in import prices could not be passed on to the export price, it was necessary to write it off internally. Consumers and businesses were on the front lines.

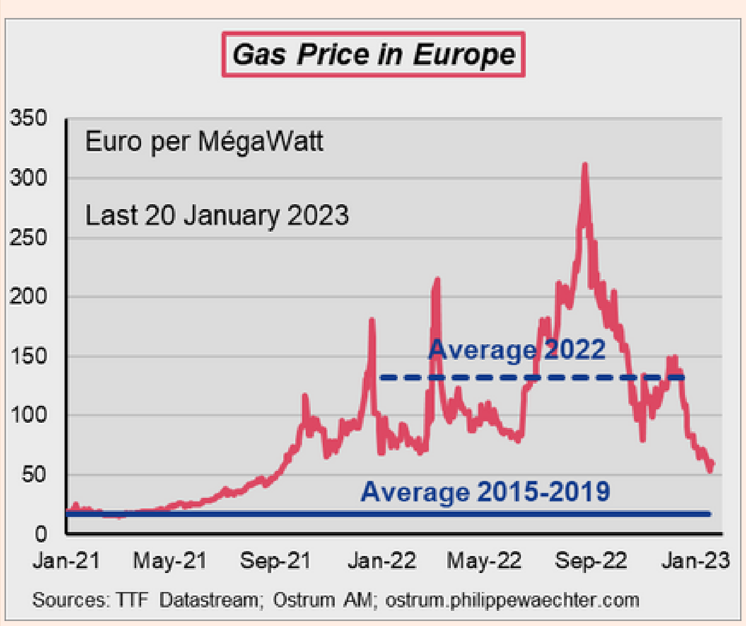
The fear was to see the **horrors of the 1970's reappear** during the first oil shock. This configuration had resulted in a lack of agility in the macroeconomic adjustment, as companies suffered a supply shock, the rise in the price of energy, an inflationary shock with wage indexation and a demand shock due to the uncertainty of the time which had resulted in a rise in the saving rate.

Since the invasion of Ukraine by Russia and the **rapid rise in gas and electricity prices**, economic policy has been very active in **pooling the shock** over time, so that neither households nor businesses have to adjust too abruptly, limiting therefore the risk of a recession.



This **countercyclical policy** has been far-reaching, as indicated by the work of DG Treasury and the Bank of France. This has notably resulted in large transfers from the State to households. On the graph, consumption is robust.

The other important point is that in the face of the energy shock, **companies have stayed the course** with an increase in **investment** and **employment**.
Businesses, on average, have not had to abruptly reverse their way of doing things.
The supply shock did not look as feared. This is the good surprise. Companies have been reactive to the shock.



The business climate has also changed because the **price of energy dropped dramatically**. The restrained behavior of businesses and households and the very favorable weather conditions have limited pressure on energy prices.
This situation meant that the available gas reserves were not drained, while at the same time **France** was once again **exporting electricity**, which also limited gas demand on a European scale. (France had been a net importer of electricity in 2022)
The **uncertainty has settled.** The Eurozone would be able to spend the winter in a certain comfort.

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The risk of recession is receding…but…

It is this triple dimension that has reduced the risk of recession in the Eurozone. States have pooled risk and businesses and households have been rather proactive, particularly on the corporate side.

Does this mean that the risks of a recession similar to that of 1975 are definitely going away?

During the **first oil shock**, the price quadrupled between **October 1973 and March 1974**. However, the **recession began in 1975**. The high oil price was permanent and it has had important consequences on behaviors. This mechanism helps to understand the delay between the price shock and the recession.

In the very short term, everyone adjusts his habits as if the change was temporary. As the oil price remained high, companies and households have adapted their behavior. The stronger the shock the more important is the change in behavior. But there is a delay that helps understanding the distance between the shock and the recession.

In the **current situation**, the energetic shock has been important from February to the beginning of fall. The uncertainty associated with this period has led to a **higher saving rate** and has **dampened households expenditures**. At the same time, as the demand momentum was low, **companies have accumulated inventories**.
This specific situation has been managed by governments with strong proactive economic policy in order to limit the impact of households' loss of purchasing power.
The last element inherited of this period is the tighter monetary policy due to the surge of the inflation rate.

In **coming months**, the economic business cycle remains fragile. The inflation rate will remain high, above the ECB target of 2% and wages purchasing power will continue to decrease leading to lower demand.
In that case, companies will reduce their inventories, pushing down production.
The situation will be tricky as the ECB will keep interest rates high and as governments will limit their plan to support internal demand.

In the short term, the risk of recession is lower but it has not disappear and may have simply been delayed.

This **risk of a recession will be lower if** the drop in the inflation rate is coming rapidly, reducing the loss in purchasing power. This means that no energy shock is expected. The risk will also depend on the strength of the Chinese recovery.
Lower inflation in the Eurozone will support domestic demand and the Chinese recovery will improve external demand.

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The US business Cycle

Recent data for the **US economy** show a **weaker business cycle**.

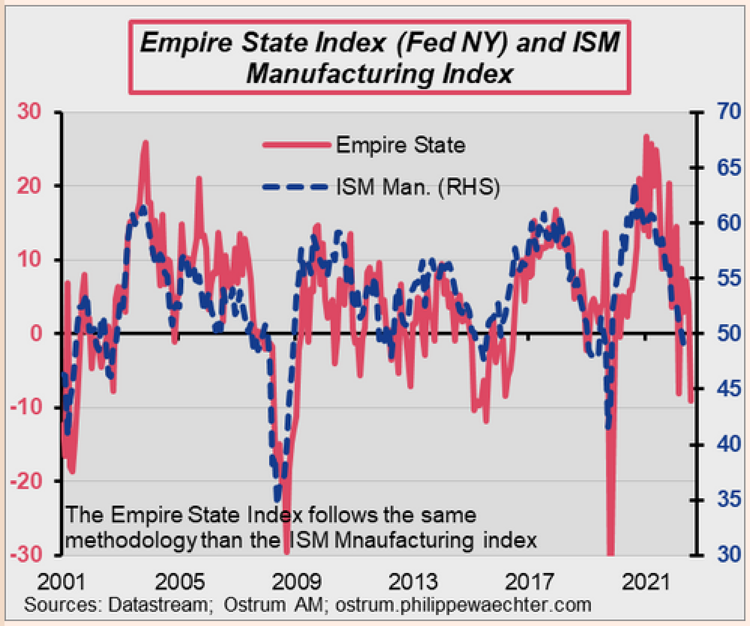
The global **ISM** (weighted average of manufacturing and non manufacturing indices) was below 50 in December and the recent New York Fed index, the **Empire State Index,** dropped dramatically in January. The point here is that its correlation with the ISM manufacturing index is high. May be can we expect a weaker ISM this month ? **Industrial production** now have a lower momentum. This is also the case for **retail sales**.

On the other side, the **labor market** remained tight. The ratio of vacancy rate to unemployment rate increased in December after a declining trajectory since May. Nevertheless, the labor market is a **lagging indicator** for the business cycle not a leading one. It may not represent the trend seen at the beginning of 2023. We note that even with a tighter labor market, the wage dynamics is a bit lower than in previous months.

This lower growth momentum reflects the impact of the **tighter monetary policy** and its consequences on behaviors notably on the real estate market (see next page).
But the risk of a recession is still low.

Beside these data on the business cycle, we notice a **downside risk on inflation**. In December, the inflation rate dropped to 6.5%. This is still high, higher than the Fed's target but the change in the price index from June to December is **0%**. A rapid deceleration.
Last week, **production prices** have shown a **similar pattern**. The yearly change was 6.2% compared to 11.2% in June. But from June to December the index was down -1.8% and the core production price index was up 1.9% at annual rate on the same period.

Therefore, the question is on the Fed's behavior. The lower business cycle momentum and a reduced inflation rate could be the recipe for a **more accommodative strategy on the Federal Reserve side.**



We mustn't have these expectations in minds
1- The Fed is committed to a tighter monetary policy after its December meeting. A higher fed funds rate is expected in January (50bp)
2 - Lael Brainard reminds this point last week.
3- It's too early to change its strategy for two reasons
  A - The inflation dynamics is complicated. In order to avoid a resurgence in coming months, the Fed must remain tight
  B - The most important is the long term interest rate. A credible Fed on inflation will reduce the inflation premium leading to lower long term rates. That's what is important.

January 23, 2023

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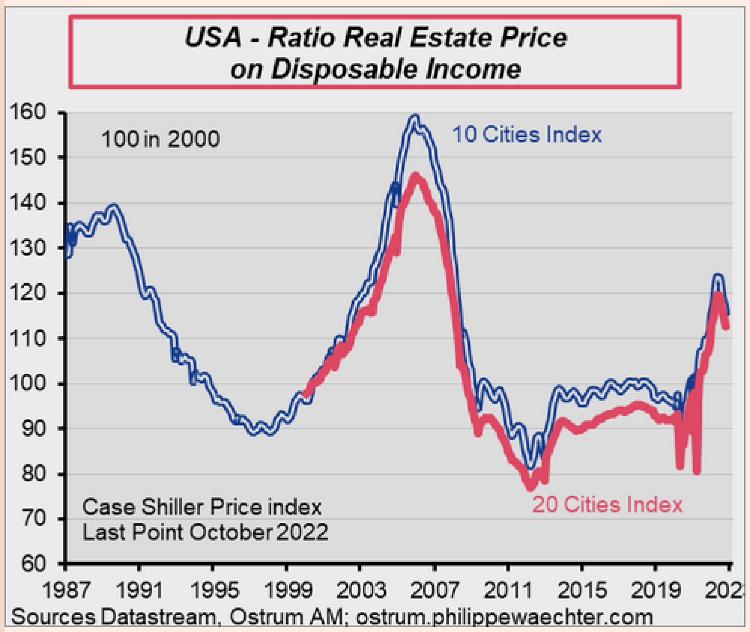
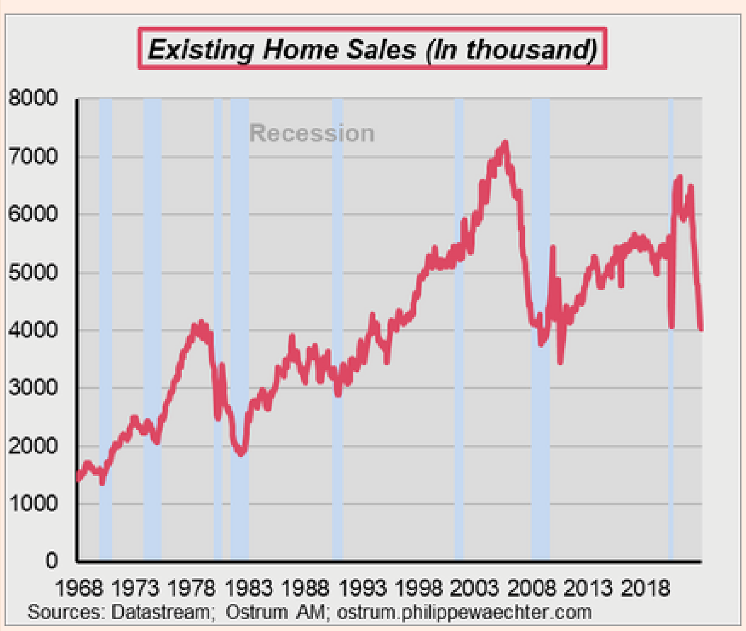
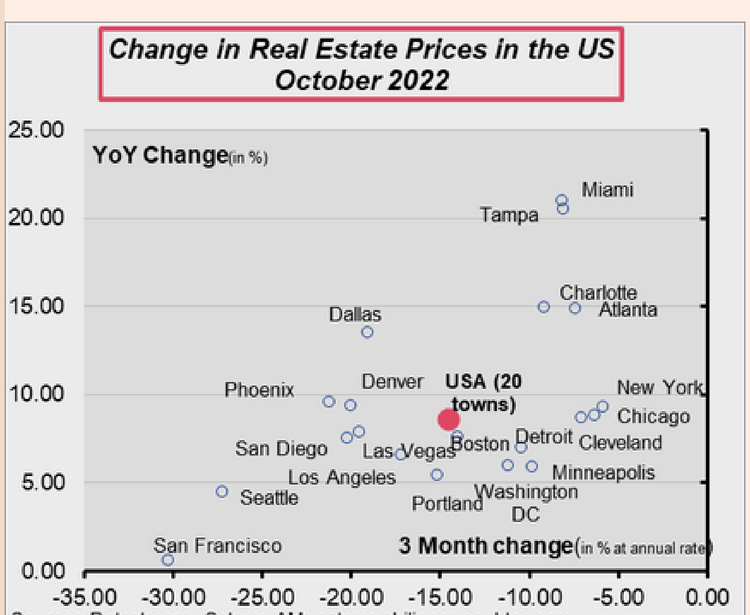
Real Estate in the US – A source of Upheaval







A **lower real disposable income**, **higher mortgage rates** and **high real estate prices** have tumbled the **real estate market** since the beginning of the year.
The upheaval on the labor market has also been a source of explanation.

The 15 year mortgage rate was at 2.1% in September 2021 and is at 5.3% in January. It's ore expensive to have a credit to purchase a real estate product.
The **price to income ratio was at 124** in the graph. It was lower then in January 2006 (145) but the pace was very rapid after the lockdown period.

Change in the interest rate has been a major source of this upheaval. It is usually the case as it change long term view on the profitability of the real estate product.

Therefore, the **rationality is to reduce transaction** first and that's what has been seen since the beginning of the year.
The peak on **New Home Sales** were in May 2022. In December, transactions were **23% lower**.
The peak in **Existing Home Sales** were in January 2023 and in December, transactions were **38% lower**.
At the same time, the **National Association of Home Builders index** is at **35** in January which is in the contraction area. The peak was at **84 in December 2022**.

The second step of the adjustment is the drop in prices. In the last graph we see that **every city witness lower prices**. This has started last spring mainly in the states of the west, it is now the case everywhere. The market is ready for a crisis.

Such a crisis would have a **negative impact on consumers' behavior**. It's a **negative wealth effect** that lead to lower households expenditures. This is a usual link between real estate and recession.
The **good news is low inventories**. Households limit their sales as interest rates are clearly higher now than when the product was bought. It's an incentive not to move.

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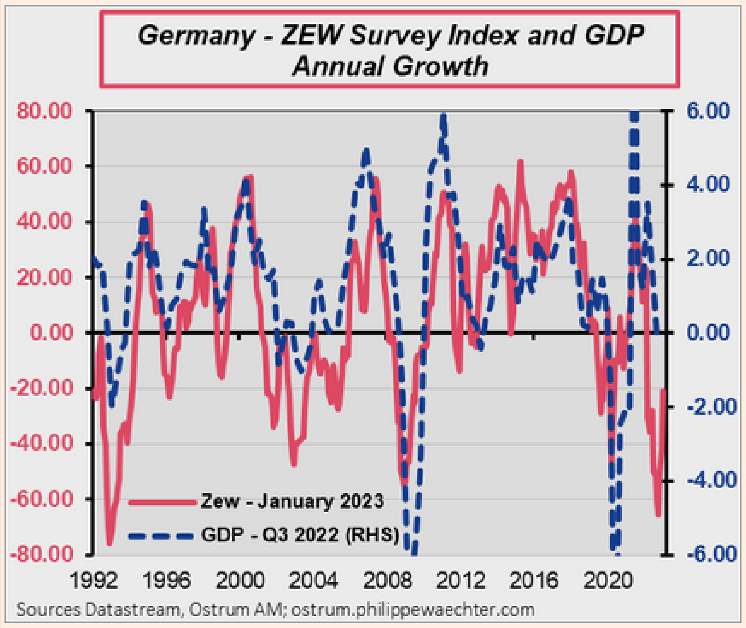
Germany, China and regional Employment in France

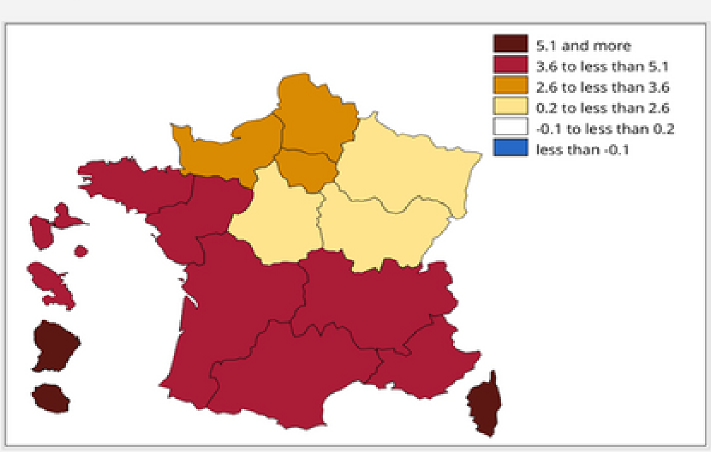


Expectations are improving in **Germany**. This explains the rebound of the **ZEW** indicator in January.
While the current conditions indicator remains low, the Germans are more optimistic. **The economy has adapted to a deteriorating environment** and inflation is falling.

The indicator (average of the two components) nevertheless remains in a degraded zone and **the risk of recession remains strong in Germany.**

Growth in China was **3%** in 2022. Expectations for 2023 are between 4% and 5% depending on the shape and speed of the Chinese recovery.
The consumer will be at the heart of the system. Real estate will also be important in the dynamics of the Chinese cycle.
For the moment, the recovery is expected while short term data remain weak.
Expectations on sales in the new year are high but the risks of contamination are high. In coming weeks, the situation will be conditioned by the sanitary environment.

Change in payroll employment (regions) between the end of December 2019 and the end of September 2022 (in %)



The **employment momentum** is strong everywhere in **France**. Employment is higher in the third quarter than in 2019 in all French regions.
This momentum is also evident in the short term as this upward movement continues into the third quarter of 2022.
The evolution by department is sometimes more contrasted.
The unemployment rate follows a comparable profile. It is falling everywhere compared to 2019 by major regions.
The territorial improvement of employment is a very positive signal. It reduces uncertainty and **promotes the distribution of activity on the national territory**.

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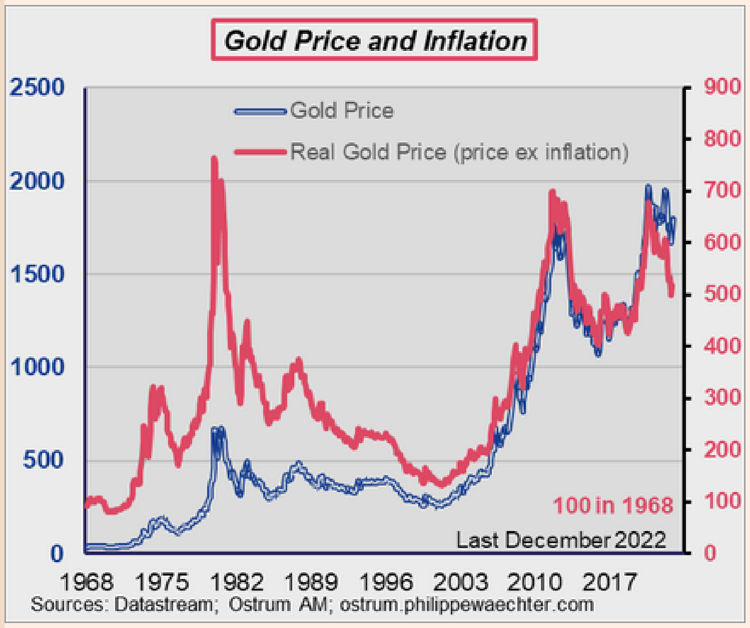
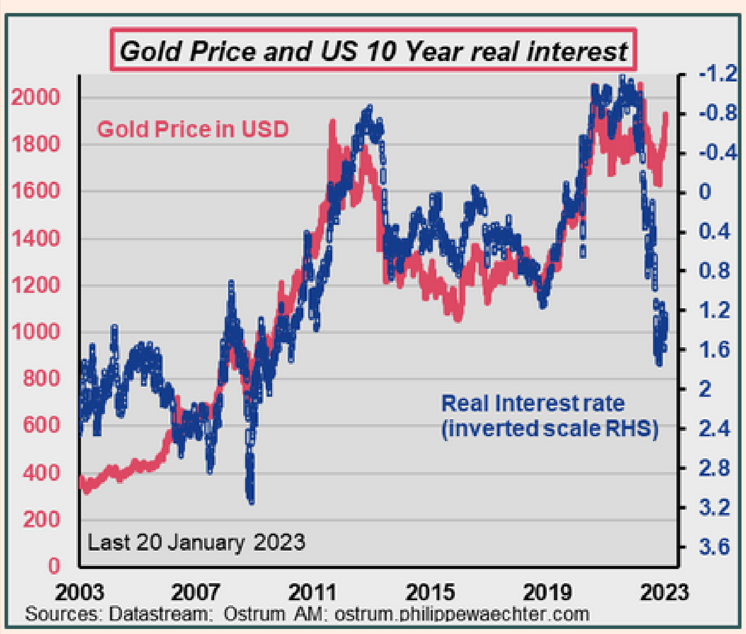
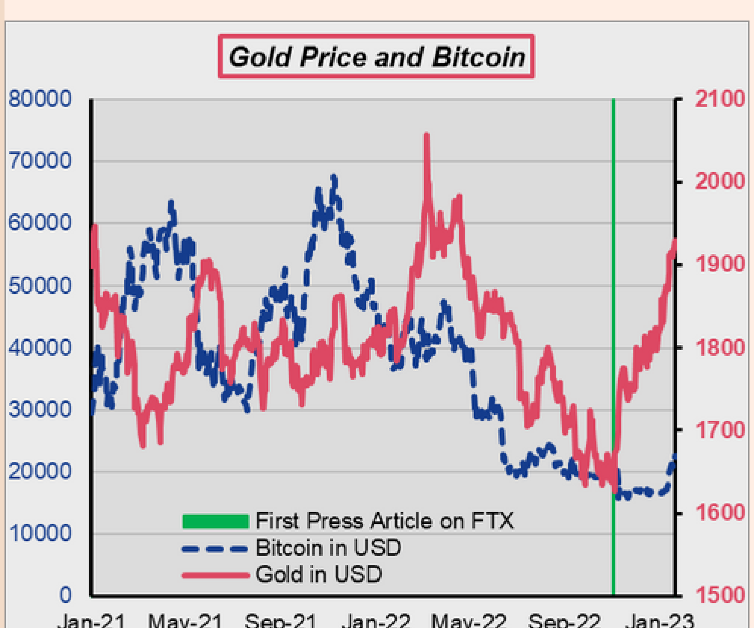
Gold Price – The recent months enigma







The price of **gold** today is very high a little **above 1900** dollars an ounce. It is close to the March 2022 highs, just over $2,000.
The **strength** of the gold price **may seem surprising** at a time **when inflation expectations are less strong**. If precious metal is a bulwark against currency depreciation, its attractiveness should diminish.

This being said, beyond the current episode, gold is a very bad way to guard against inflation. If this were the case, its real value (excluding inflation) should be rather stable. This is clearly not the case.
The price of the deflated ounce of gold fluctuated very/too much over long periods to be a reference anchor.

Generally, the **attractiveness of the precious metal is observed when the real interest rate on US government bonds becomes negative** (measured on inflation-linked bonds).
Gold does not yield anything while holding a negative real return bond is penalizing and therefore rationally induces to hold gold.

However, over the **recent period**, this correlation no longer works. The real interest rate has frankly gone up again, well above 1.%. This should translate into a decrease in the price of an ounce of gold. That is not the case.

To understand this episode on gold, the **bitcoin** is important.
There is no strong correlation between the two. But on November 2 the first article on the bankruptcy of the cryptocurrency broker FTX is published.
Cryptocurrencies as gold were supposed t be the instrument in the case of an upheaval on the financial and monetary system. The end of cryptocurrencies means a strong gold. This is an epiphenomenon and gold will soon settle on arbitrage with the real interest rate. The current movement is just a pipe dream.

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