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Economic Strategy & Analysis

ENTX on Bloomberg
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Dexterous Robots Amplify Looming AI Impact, Oil Glut and Basket Updates

'"We know that we're starting this year with subdued growth, some good news on the labor market, but increasing concern on the downside risks caused by geopolitical tensions, and especially what is happening in the Red Sea," Economy Commissioner Paolo Gentiloni told reporters ahead of a meeting of euro-area finance ministers in Brussels on Monday. ***This "is not for the moment apparently creating consequences on energy prices and inflation, but we think that it should be monitored very closely because these consequences could materialize in the coming weeks,"*** *he added. ECB Council member Joachim Nagel suggested summer may be an appropriate juncture to begin to consider lowering borrowing costs, highlighting that it remains premature to discuss the issue now.* ***"Maybe we can wait for the summer break or whatever but I don't want to speculate,"*** *the Bundesbank chief told Bloomberg Television, highlighting that officials will remain data-dependent. "I think it's too early to talk about cuts."* ***President Christine Lagarde has said rate reductions will begin once policymakers are convinced inflation is headed back to the 2% goal*** *— something Nagel embraced. Most say that means waiting for crucial data on wages that are only likely to come around May, making June the earliest meeting at which the deposit rate could be lowered from its current level of 4%.* ***Chief economist Philip Lane echoed that sentiment, saying that lowering borrowing costs isn't something the ECB will be discussing any time soon, and that recalibrating rates too quickly can be "self-defeating****." Markets disagree. They're pricing six quarter-point moves in 2024, starting as early as April.'* From [Bloomberg]

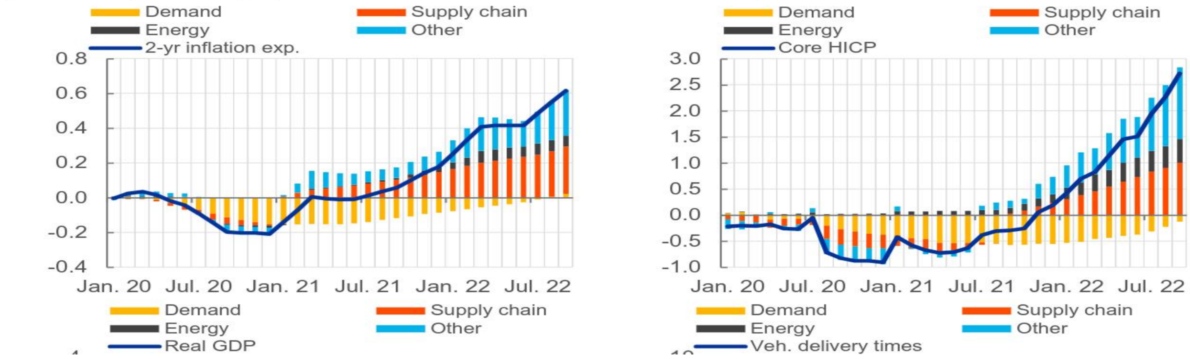
*'****The ranks of struggling companies have been swelling because of Germany's economic stagnation, combined with high interest rates, rising wages, elevated energy prices and a government budget squeeze. This is expected to push insolvencies up by between 10 and 30 per cent this year****, experts* ***warn, taking them above pre-pandemic levels.*** *One such company is 85-year-old wooden toymaker Haba. Delivery failures caused by "wrong decisions" on IT systems at Haba's online children's clothing operation compounded the "heavy burden" the company was already enduring from the soaring cost of energy and wood, according to spokesperson Ilka Kunzelmann. Steffen Müller, head of bankruptcy research at the Halle Institute for Economic Research, said* ***the monthly rate of German insolvencies it tracks, which excludes unregistered companies that have few employees, has risen since last summer above the pre-pandemic average for the first time. In December, it hit its highest level for at least seven years.*** *"For the next two to three months we will definitely see higher insolvency numbers, you can see that from the early filing numbers," said Müller.* ***"The government gave a lot of aid to firms that had low productivity before the pandemic. That prolonged their lives. But now they have to repay the aid and many are struggling to do so."****.'* From [The FT]

- As covered back in the 11th December note, despite the pushback above on implied market expectations, central bank 'rhetoric' is now predictably shifting decisively dovish, and researchers are setting up intellectual alibis for the U-turn. The ECB has released [a working paper] blaming the inflation surge mostly on supply chain disruption (and to a lesser extent the energy shock), **while the demand component is barely positive.** That's hardly a surprise to anyone outside the bank but to quote: *"The dynamics of core prices and inflation expectations are instead mostly explained by supply chain disruption shocks and to a lesser extent by adverse energy supply shocks"* **Unlike the US, excess demand has been a minor factor in the inflationary cycle in the Eurozone**, justifying a much more nuanced policy response.
- Near term, while global **shipping costs have spiked on Red Sea/Panama Canal disruption, the wider inflationary feedthrough will be limited unless oil rebuilds a $15/bl+ geopolitical risk premium,** and the reaction to 'kinetic action' last week was remarkably muted, reflecting the perceived glut through at least Q1 covered below. A shooting war with Iran would change all that, but Tehran's provocations so far have been carefully calibrated and at China's diplomatic prodding it has made peace with Saudi. For now, if the slower container delivery

times drag through Q1 and create retail shortages, it makes a Fed cut in March even less likely…but if the ECB does wait until the summer, the credit stress now clearly apparent in Germany will broaden.

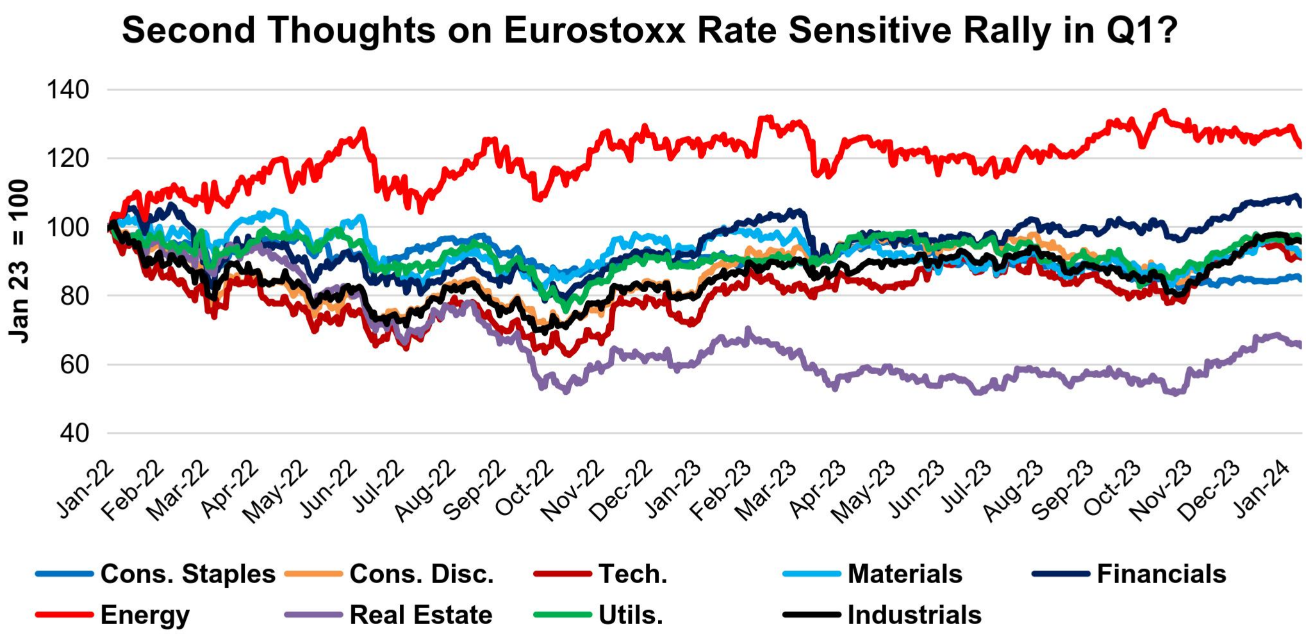
ECB Belatedly Accepts That Unlike US, Inflation Wasn't Excess Demand Led…

Figure 8: Historical Decomposition of Shocks during the Pandemic Period
(percent, percentage points, deviation from stochastic trend)



Source: Recent ECB working paper No. 2884

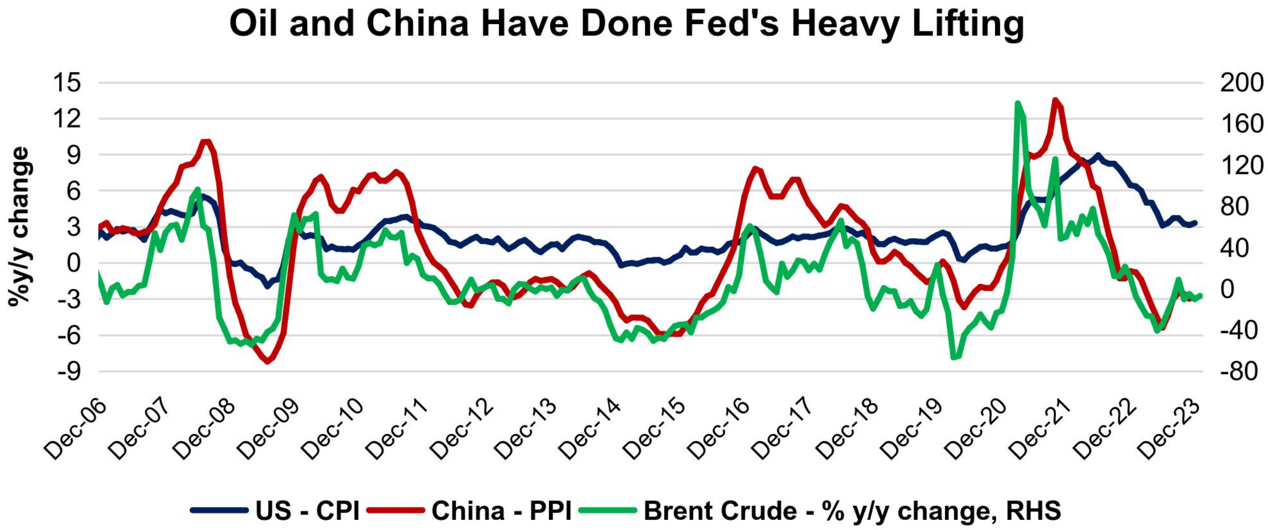
- Of course, this is all a relatively minor irritation so far versus the chaos down to factory staffing level in 2021 and supply chains have broadly normalized. With global energy supplies ample, the **ECB is justified in moving faster and harder than the Fed** in easing given the divergent fiscal paths, particularly as the US Congress is debating another $70-80bn in household tax cuts through next year. They need to get a move on - **German industry continued its decline in November with output now almost 15% below its pre-pandemic peak** (~€100bln in lost potential output in real terms) and **rate sensitive construction is now falling off a cliff.**



Source: Entext, Eurostoxx 600

- Despite the sharp DAX rally since October, **much of this largely reflects secular German deindustrialization**, as **sectors from autos to chemicals lose global competitiveness (feeding into the insolvency spike above).** The growth/inflation tradeoff implications for the ECB are clear – if it wasn't for Denmark (Novo's appetite suppressing pills) and Ireland (US tech multinationals) the overall industrial output and export picture would look grim.

- **One big positive is that France is generating more than 50 GW of power and ~70% of its consumption from nuclear (with the 6 new plants planned now potentially 14),** a crucial turn-around by EdF after its maintenance crisis in late 2022 that's helping to ease electricity prices across Europe. Meanwhile, Germany with its Green coalition having recklessly abandoned nuclear, is burning coal to generate 25GW when the windmills stall…
- The **consensus for the S&P in 2024 is forecasting ~5% revenue growth with 140bps of margin expansion to get low double digit EPS growth** – as highlighted in the last note, half that looks more likely as nominal growth slows so we have that earnings reset to get through in H1. However, **just as important beyond mid-year will be marginal asset allocation as rates fall - money markets fund assets have hit a record above $6trn,** or about 2x average levels in the five years pre pandemic. The number 4 will matter in coming months - that the 75% probability assigned to the first hike in March is inconsistent with FOMC participant guidance is obvious, but equity markets are concluding the hiking cycle is done (which it clearly is) and time to increase cyclical exposure.



Source: Entext

Without an unemployment rate above 4% and average hourly earnings growth dropping sustainably below ~4%, 10-yr nominal Treasuries are unlikely to remain much below 4% and/or the Fed is unlikely to reduce the policy rate to 4%, a level that will end yield curve inversion and incentivize the bank credit growth channel. Right now, the latest NFIB small business survey suggests ongoing difficulty in hiring – laid off tech workers can't fix plumbing or drive a truck.

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