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What to watch: And the Fed pivoted, BoE on pause, Poland's fiscal risks and what happens once the US yield curve disinverts

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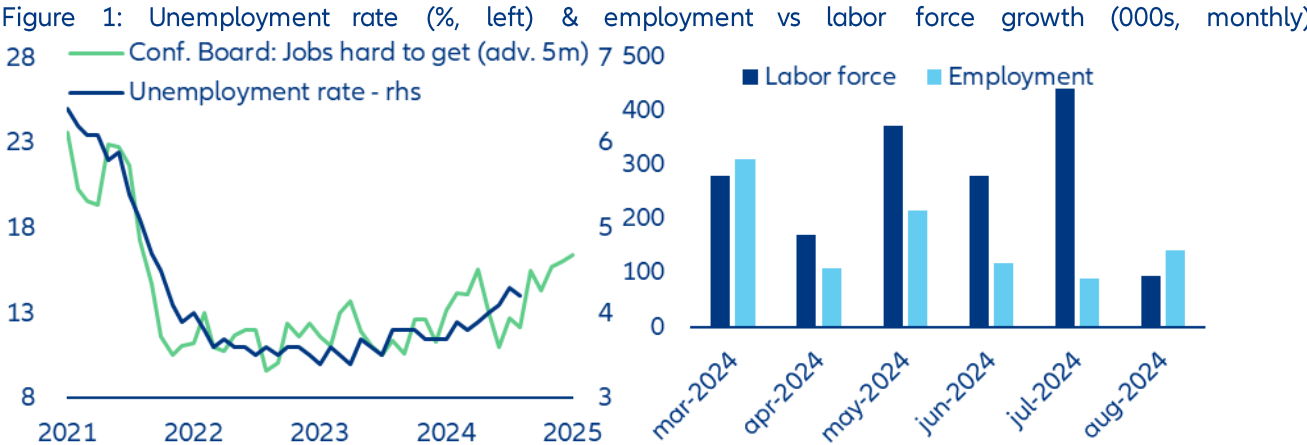
In summary

This week we look at four critical issues:

- **Fed: the pivot we've all been waiting for.** After the sharpest monetary tightening in decades, the Fed is set to cut interest rates by 25bps next week. The August CPI print indicated that inflation continues to soften while the unemployment rate is on a firm upward trajectory to 5% in the next months, from 4.2% in August. The US economy has remained remarkably resilient so far, helped by loose fiscal policy and strong immigration, as well as the strength of corporate balance sheets. Although recession risks have risen, we continue to expect a 'soft landing'. In this context, the Fed must tread carefully between the risk of being behind the curve and the risk of re-heating the economy. We expect a balanced approach of back-to-back 25bps interest rate cuts in each meeting starting next week, which would bring the Fed funds rate (upper range) down to 3.5% in July 2025 from 5.5% currently.
- **Bank of England (BoE): on pause amid solid momentum.** After delivering its first rate cut in August, we expect the BoE to pause its loosening cycle at next week's meeting as inflation is set to pick up again to +2.8% y/y in November on the back of unfavorable base effects and the Ofgem energy price cap increase by +10% in October. The inflation outlook should improve again from December onwards and we expect the 2% target to be reached sustainably before mid-2025. In this context, the BoE is likely to cut the bank rate by 25bps in November, skip December and then cut by 25bps in each meeting in 2025, stopping in September 2025 once it reaches 3.25%.
- **Poland: Favoring growth over fiscal consolidation carries risks.** Poland's economic growth should remain robust, driven by domestic demand on the back of expansionary fiscal policy (2024: +3%, 2025: +3.8%). However, the budget proposal for 2025 calls fiscal consolidation into question and harbors medium-term fiscal risks. We expect the government to begin to consolidate its budget from 2026 onwards, thereby stabilizing the public-debt-to-GDP ratio at around 56%. In a downside scenario with no fiscal consolidation, public debt would continue to rise and exceed 60% by 2027. In the short term, the Polish budget proposal poses inflationary risks and is likely to delay interest rate cuts until Q2 2025.
- **The end of the US yield curve inversion: what now?** After the longest inversion in history, the US yield curve has returned to a positive slope. Does this mean a recession is looming? Not quite as we still believe in a soft landing without a sharp sell-off in risky assets. Nevertheless, we prefer bonds over equities at this time. Historical evidence shows capital flows have typically moved in the opposite direction at this stage of the yield curve shift; hindsight reveals this was often not the optimal financial choice.

Fed: the pivot we've all been waiting for

After the sharpest monetary tightening in decades, the long-awaited pivot is finally here: The US Federal Reserve is set to cut interest rates for the first time since March 2022. Amid softening inflation and a weakening labor market, the Fed should kick off an easing cycle at its next meeting on 17-18 September. The August CPI print indicated that inflation is now firmly below 3% on a year-on-year basis (at +2.5%). Meanwhile, the unemployment rate is on a firm upward trajectory, and the Conference Board's "Jobs hard to get" survey suggests that it will rise further in coming months, close to 5% from 4.2% in August (Figure 1, left). Next week's cut will be the first after the Fed hiked interest rates aggressively between March 2022 and July 2023, keeping rates high since then. With the Fed Funds Rate increasing by +10pps since March 2022 in inflation-adjusted terms, this has been the fastest tightening cycle in history, far above the previous record-breaking years of 2004 and 1972 (Figure 1, left). Nevertheless, the US economy has remained remarkably resilient so far. In fact, apart from the softening labor market, the economy is still not showing signs of broad-based weakness, helped by loose fiscal policy and strong immigration, as well as the strength of corporate balance sheets. The ratio of net interest payments to after-tax profits has even been falling for non-financial corporates despite elevated interest rates, a diverging trend from past monetary tightening episodes (Figure 2, right)¹. Overall, we forecast US GDP growth at a solid +2.3% annualized in Q3 2024 (after +3.0% in Q2 2024).



Sources: LSEG Workspace, Allianz Research

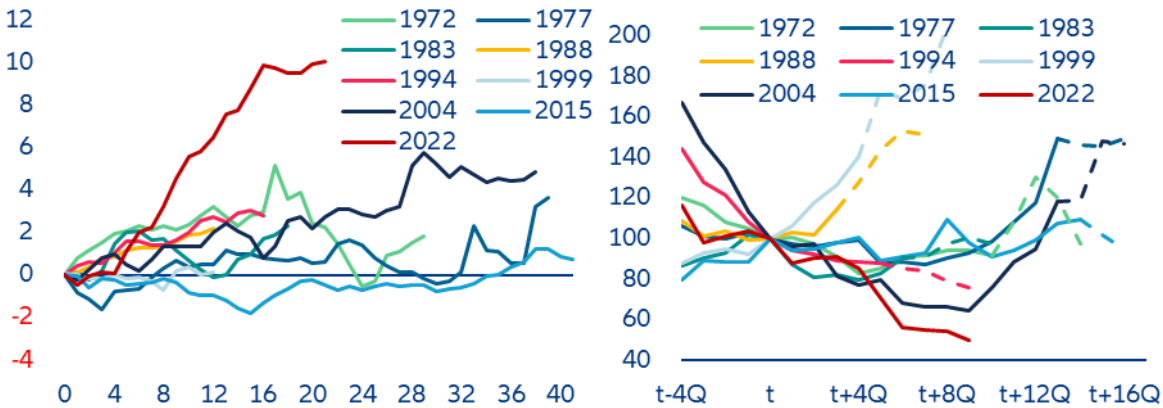
We expect back-to-back 25bps interest rate cuts in each meeting starting next week as the Fed balances out a softening labor market and a still-resilient economy. The Fed Funds Rate should reach 3.5% in July 2025. The softening labor market and lower inflation may prompt some FOMC officials to increasingly press for 50bps rate cuts rather than the 25bps that we forecast in each meeting through July 2025. However, the labor market is not as weak as it appears at first glance. The private layoff rate remains very low while weekly initial jobless claims are not particularly elevated (at around 230-250K) relative to 2023. In short, US companies are not laying off workers, which would be a concerning signal through negative confidence and lower spending effects. Furthermore, employment growth is soft but not outright weak, according to the establishment survey (Figure 1, right). And labor force growth² has been strong, in part fueled by the surge of immigration. This has contributed to push up the unemployment rate. All this suggests that the rising unemployment rate is mostly explained by new people joining the workforce rather than laid-off workers and weakening demand. In this environment, the Fed must tread carefully between the risk of being behind the curve (being restrictive for too long) and the risk of re-heating the economy and over-easing financial conditions in a context of solid corporate balance sheets by easing too rapidly. That is why we expect a

¹ Most US corporates have been able to term out their pre-Covid-19 debt with long maturities and fixed interest rates, while their large holdings of cash have been invested in high-yielding assets such as US government T-bills. In net, their interest expenses have thus declined substantially.

² We look at a "corrected" version of the labor force which sums up employment from the establishment survey with unemployment from the households survey, because of the latter's recent undercounting of the immigration surge in the employment data.

balanced approach of back-to-back 25bps interest rate cuts in each meeting starting next week, which would bring the Fed funds rate (upper range) down to 3.5% in July 2025³.

Figure 2: Inflation-adjusted Fed Funds Rate (left) & net interest payments/profit after-tax (right)

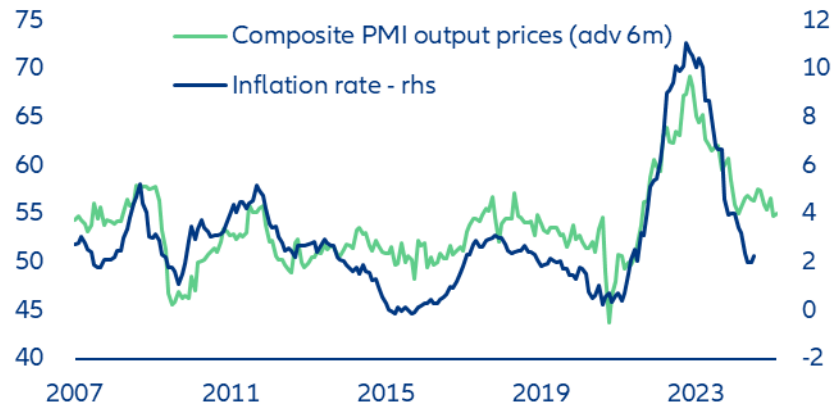


Sources: LSEG Workspace, Allianz Research. *Left chart: 0 = month of the first interest rate hike, real interest rate deviation in pp; Right chart: t = quarter of the first interest rate hike, indexed at 100, Net interest payments ratio deviation. Dotted lines show the variable past the tightening cycle (when the Fed begins to cut interest rates).

Bank of England: on pause amid solid momentum

After delivering its first rate cut in August, we expect the Bank of England (BoE) to pause its loosening cycle at next week’s meeting as inflation is set to pick up again. The BoE lowered the bank rate by 25bps to 5% in August on the back of moderating inflationary pressures, with year-on-year (y/y) CPI inflation hitting the 2% target in both June and July, and wage growth continuing to ease. However, the Bank also cautioned against the risk of reigniting inflation in the medium term and the decision was a close one, with a narrow majority of five MPC members voting for the bank rate cut against four voting against. In the coming months, we expect annual inflation to tick up to around +2.8% y/y in November as i) unfavorable base effects will continue to play out in the last months of 2024 and in early 2025 and ii) the Ofgem energy price cap will increase by +10% (from GBP1,568 to GBP1,717 a year) in October. This outlook is in line with business surveys of output prices (Figure 3).

Figure 3: UK CPI inflation & composite PMI output prices



³ This is close to our estimate of the neutral interest rate, which is probably much higher than during the 2010s because of i) higher inflation volatility, ii) larger government deficits and iii) solid private sector balance sheets.

In this context, we expect one rate cut in November and a terminal rate of 3.25% to be reached by September 2025. The outlook for inflation should start to improve again from end-2024/early-2025 and we expect the 2% target to be reached sustainably from March/April 2025. Notably, wage growth has eased substantially recently, with the three-month moving average of weekly earnings cooling to +4.0% y/y in July, down from +4.6% in June. Furthermore, at +5.2% y/y in July, services inflation remains too elevated from the BoE’s liking, but business surveys indicate that companies’ selling-price expectations have hit their historical range; services inflation is expected to normalize fast through end 2024 and the first half of 2025 as demand for consumer services should continue to slow down. Overall, economic momentum has been solid this year (after a weak 2023), buoyed by the recovery of the construction sector and higher business confidence (Figure 4). Indeed, financing conditions eased ahead of the BoE starting the easing cycle. The credit impulse, which measures the change in flows of private credit and has a year-long lead over GDP growth, has started to recover, turning positive since April for the first time since March 2021. Lastly, the BoE will certainly be cautious about the outlook for wage growth, given the recent series of above-inflation public sector pay rises agreed by the government over the summer. Against this backdrop, we think the BoE will adopt a slow loosening cycle, balancing normalizing inflation and the risk of over-heating financial conditions. We expect it will cut the bank rate by 25bps in November, skip December and then cut by 25bps in each meeting in 2025, stopping in September 2025 once it reaches 3.25%, which is the financial market-based measure of the UK’s neutral rate (Figure 5).

Figure 4: Allianz Research’s UK Nowcast GDP and components

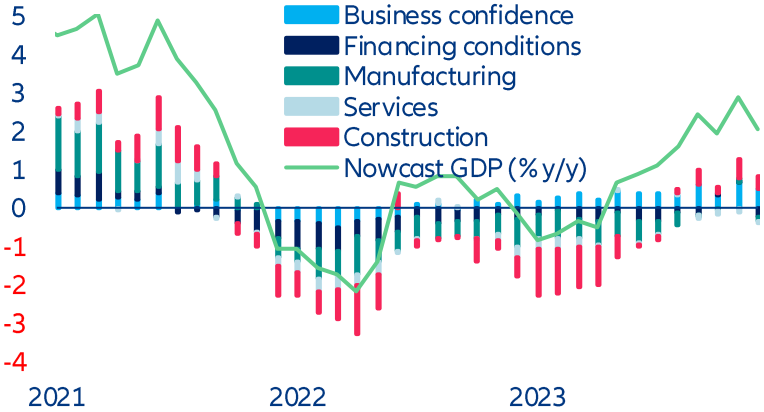
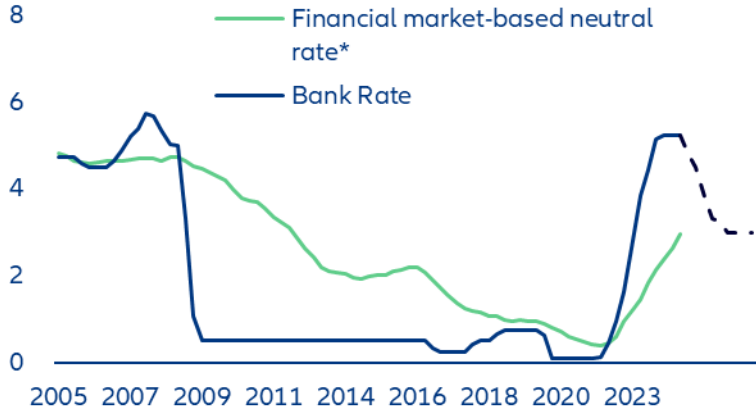


Figure 5: Allianz Research’s bank rate forecasts (%)



Sources: LSEG Workspace, Allianz Research. * three-year moving average of three-year forward, one-year rate

Poland: Favoring growth over fiscal consolidation carries risks

Economic growth is expected to remain robust in the coming quarters after a surprisingly strong recovery in the first half of the year, driven by domestic demand on the back of expansionary fiscal policy. Poland’s real GDP growth accelerated to +3.2% y/y in Q2 from +2% in Q1. Government spending has become a key growth driver in recent quarters, surging by almost +11% y/y in the first half of the year (H1), partly thanks to a rise in public sector wages. The latter, together with a generally strong labor market and falling inflation, boosted consumer spending growth to an average of +4.7% in H1. Meanwhile, the contribution from net exports turned negative in Q2, reflecting continued weakness in the Eurozone, especially in Germany. On the other hand, the fall in new orders has reduced the drawdown in inventories, thereby decreasing their negative impact on overall growth (Figure 6). Looking ahead, we expect the momentum in domestic spending to continue in the coming quarters. In addition, investment growth should pick up as the Polish government aims to spend all of its previously frozen EU funds over the next two years. And exports should gradually improve from the end of 2024, thanks to a moderate recovery in the Eurozone. Overall, we have raised our full-year real GDP growth forecasts to +3% in 2024 and +3.8% in 2025.

Figure 6: Real GDP growth (% y/y) and contributions (pps)



Sources: Statistics Poland, Allianz Research

Poland’s budget proposal for 2025 calls into question fiscal consolidation and harbors medium-term fiscal risks. Next year, fiscal policy is set to be more expansionary than previously forecast. A draft budget announced by the Polish government at the end of August envisages a fiscal deficit of -5.5% of GDP in 2025, and the estimated deficit for 2024 has been revised upwards to -5.7% of GDP. This compares with our August forecasts of -4.3% and -5%,

respectively (which were slightly below consensus). Generous social spending to support consumer spending and an increase in defense spending to 4.7% of GDP in 2025 (up from 3.3% in 2023 and an estimated 4.2% in 2024)⁴ are the main reasons for the widening deficit. The proposal still needs to be endorsed by Parliament and signed off by the President but it is likely to be broadly approved. The market reaction to the announcement was very muted, perhaps reflecting the view that sovereign debt risk is likely to remain moderate in the near term. However, policymakers and investors are underestimating the medium-term fiscal risks as public debt is now set to rise from 50% of GDP in 2023 to around 55% in 2025, and would exceed 60% by 2027 without future consolidation (Figure 7). In this context, it should be noted that Poland has a comparatively short maturity profile for its sovereign debt (with government bonds maturing at over 8% of GDP on average in 2024-2025, compared to an emerging market average of 4.4%) and an interest-to-revenue ratio of around 5%. The initiation of the Excessive Deficit Procedure against Poland by the European Commission in June, even before the budget proposal, means that the country will need to commit to a deficit-reduction path. Our baseline scenario therefore assumes that Poland will begin to consolidate its budget from 2026 onwards. As a result, the public-debt-to-GDP ratio is likely to level off at around 56% after 2026 (Figure 7). However, this scenario also deprives the government of any significant room for fiscal maneuvering in the event of a potential economic shock occurring after 2025.

Figure 7: Public finances (% of GDP) scenarios

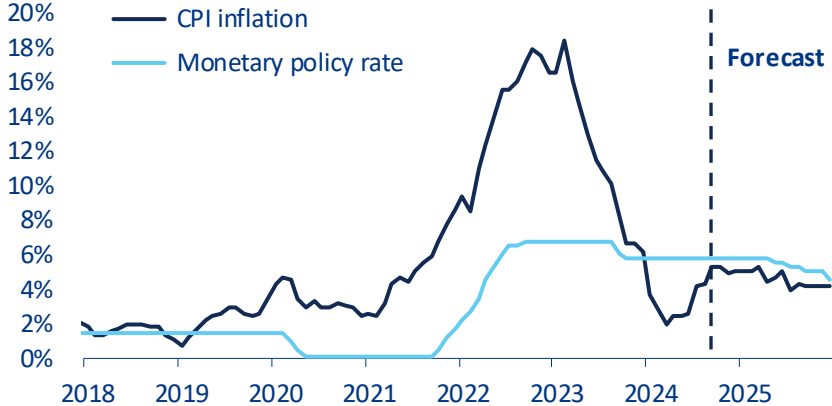


Sources: Eurostat, Polish Ministry of Finance, Allianz Research

In the short term, the Polish budget proposal poses inflationary risks and is likely to delay interest rate cuts. Headline inflation has risen from a recent low of 2% y/y in March 2024 to 4.3% in August, driven by rising food and energy prices. Taking into account the additional inflationary pressure from the now planned increases in child benefits, pensions and public sector wages, we have raised our average annual inflation forecasts to 3.8% in 2024 and 4.5% in 2025 (from 3.6% and 3.8% respectively in June). We also expect the Polish central bank, which has kept its key policy interest rate unchanged at 5.75% since October 2023, to postpone its next rate cut to Q2 2025, compared with our previous forecast of a cut in December 2024 (Figure 8).

⁴ Since 2023 Poland has had the highest defense spending in relation to GDP among NATO member states.

Figure 8: Inflation and interest rate outlook



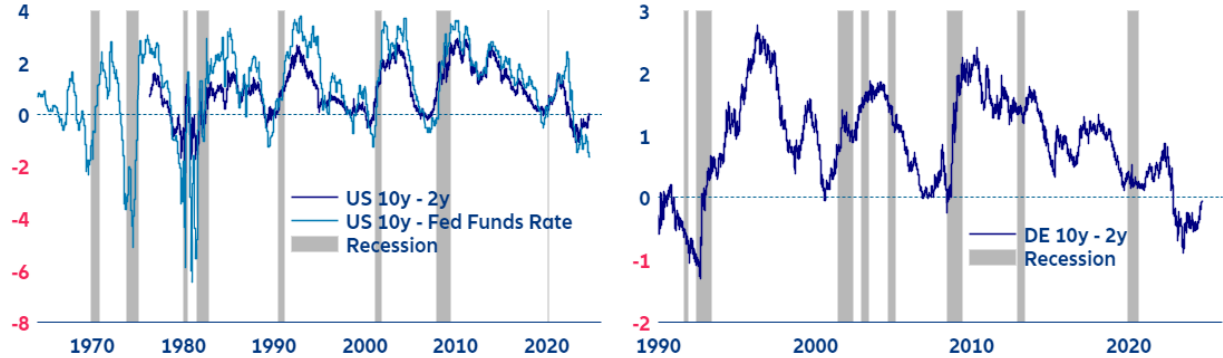
Sources: LSEG Datastream, Allianz Research

The end of the US yield curve inversion: what now?

The US yield curve has finally returned to its “normal” positive slope after being inverted for more than two years – the longest period in history. Faced with the highest inflation rate in decades, the Fed was forced to increase its policy rate (overnight) massively in 2022, thereby lifting short-term interest rates (2y) along with it. Longer-term interest rates (10y) rose as well but less so as investors expected an economic downturn at some point that would have led to lower policy rates further down the road. As a result, until last week, the reward for lending money to the government over the longer-term was lower than in the short term, leading to an inverted yield curve. But now the difference between US 10y yields and 2y yields (2y10y), the most closely watched yield-curve measure, has switched again from negative to positive, implying that investors get a higher reward for lending money to the government if they invest for the longer term.

Historically the end of an inversion marks the beginning of a recession – at least in the US. The yield curve inversion has been a good predictor for recessions in the US (Figure 9). However, analysts began to doubt the pattern in this cycle as the yield curve remained inverted for a prolonged period with no recession in sight. To be fair, in the past, a recession would arrive only once the yield curve ended its inversion, which would be right now. Hence, the yield curve oracle has not been proven wrong yet. However, as outlined in the first story of this report, we are not expecting a recession to materialize in the US. Outside of the US, the prediction power is lower. In Germany, for instance, where the curve remains inverted, the previous recessions were not clearly indicated by the yield curve. However, Germany is of course a special case as long-term and short-term yields are mingled by factors inside and outside of Germany (ECB, Europe, safe-haven demand).

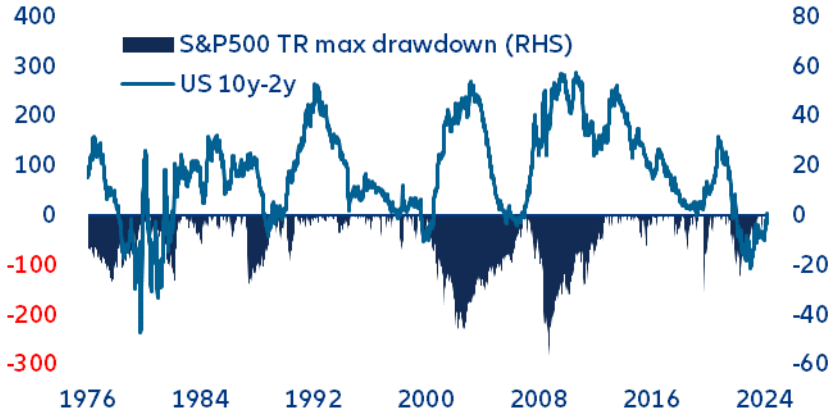
Figure9: US and German yield curves (2y10y) and recessions



Sources: LSEG Datastream, Allianz Research

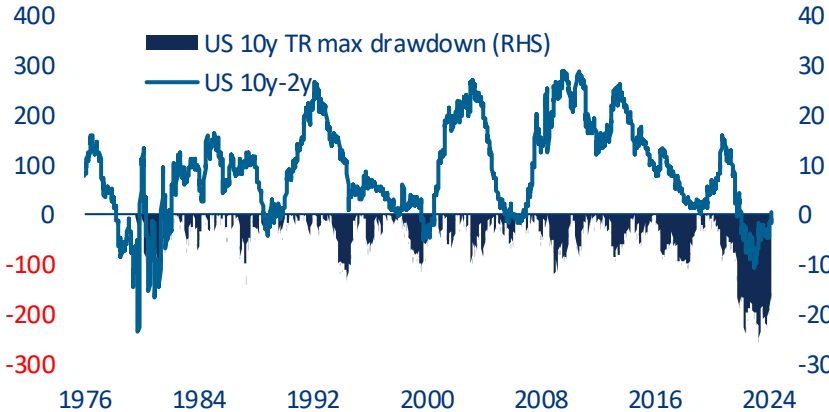
For investors, the end of a yield curve inversion has historically signaled caution for risky assets. Given current high valuations, we see no reason to challenge this warning. Figure 10 shows the maximum drawdowns that investors experienced by investing in equities. During most of the last normalizations of the yield curve, including the dotcom bubble and the great financial crisis, equity markets experienced significant losses. Other asset classes, such as government bonds or corporate bonds, were comparatively less prone to such drawdowns and might be a good alternative investment at this stage (Figure Z311). Such predictions should be taken with care as the number of observations is not sufficient to make a statistically significant assertion. Nevertheless, given the relatively high valuations in US equity markets and still attractive government bond yield levels, the normalization of the yield curve is yet another argument for increasing the weight of bonds at the cost of equities in a mixed portfolio at this stage.

Figure 10: US yield curve and maximum drawdowns for equities, bps (LHS), % (RHS)



Sources: LSEG Datastream, Allianz Research

Figure 11: US yield curve and maximum drawdowns for 10y government bond total returns, bps (LHS), % (RHS)

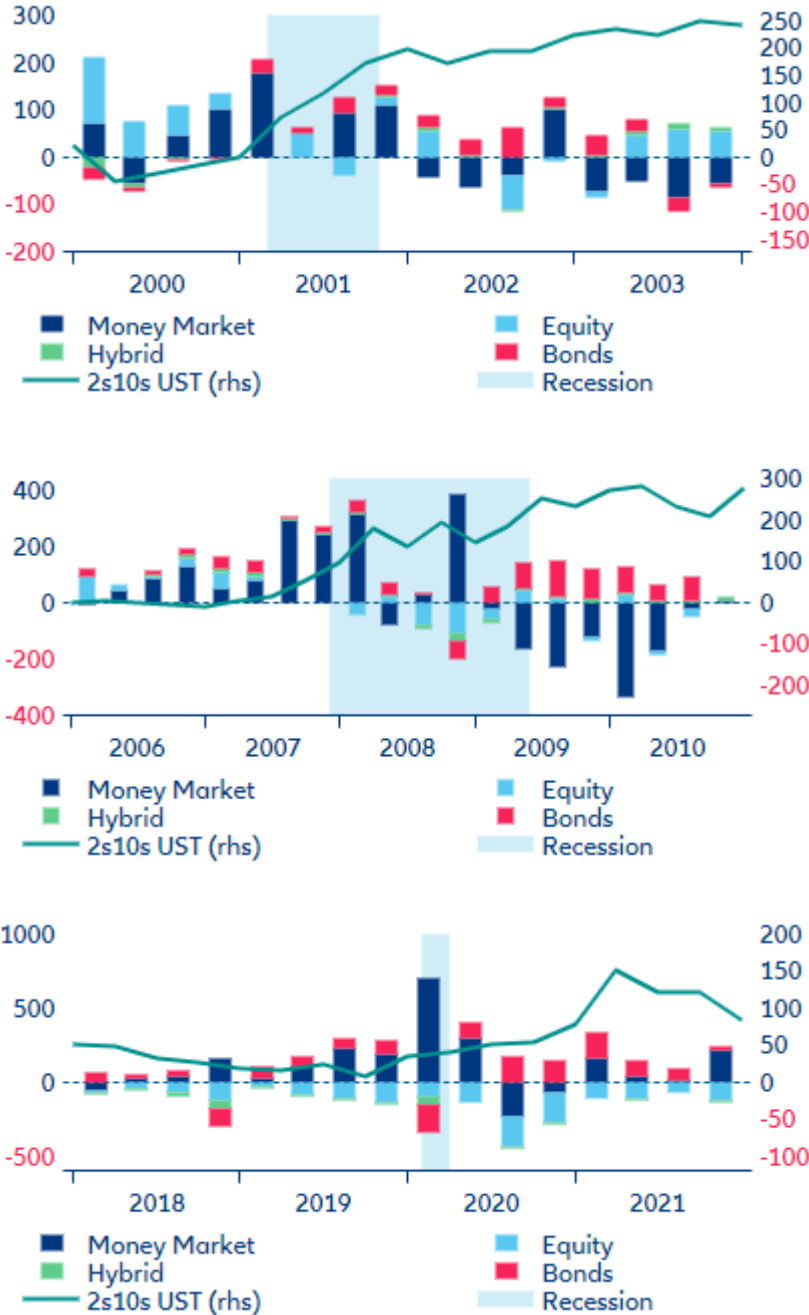


Sources: LSEG Datastream, Allianz Research

Capital flows evidence suggests that investors tend to be pro-cyclical and thereby have struggled to make optimal decisions in hindsight. Capital flows across markets — whether in equities, money markets or bonds — tend to reflect the pro-cyclical behavior of investors, especially when the yield curve begins to dis-invert. During a curve inversion, we often see significant inflows into riskier assets like equities (Figure 12-14). However, as the curve normalizes and a recession unfolds, investors quickly shift gears. Their risk appetite diminishes, leading them to move capital into safer investments, such as money market funds or short-duration bonds. This shift is driven by fear and consequently the desire to move towards safe short-term government bonds. As the economic downturn begins to stabilize and markets sense that the worst is over, we see a partial reversal of these risk-averse flows. Investors, though still cautious, start to extend the duration of their bond portfolios. In this phase, capital begins to flow not only into government bonds but also into high-grade corporate bonds, as they are seen as relatively safe and offer a premium over their governmental counterparts. However, despite this bond buying, investors remain hesitant to

make strong moves back into higher risky assets such as equities, reflecting a lingering reluctance to embrace risk at this stage of the cycle. Finally, as the economic recovery gains momentum, portfolios tend to shift towards a more balanced risk profile. This re-risking phase includes adding equities and lower-rated corporate bonds, reflecting growing confidence in the broader recovery and future growth potential (Figure Z4-Z6). However, these moves usually come after price gains have already passed by and are, in hindsight, of course not optimal. This time, however, the scenario may unfold differently as we anticipate a soft landing of the economy and therefore a more moderate version of the typical fund flow cycle. Investors may reallocate some funds from money market instruments into longer-term bonds to lock in attractive yields. But we do not expect a substantial or prolonged shift away from equities and corporate bonds.

Figure 12 – 14: US net new cash flow of mutual funds vs US yield curve (bn USD – different periods)



Sources: LSEG Workspace, ICI, Allianz Research

These assessments are, as always, subject to the disclaimer provided below.

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