AXA Investment Managers

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Investment Institute Macroeconomics

Looking for some Glue

- Radical options removed in France, but finding a sense of direction remains tricky
- With inflation on a plateau and a resilient labour market, the ECB feels little pressure to accelerate the cuts
- The case for a September cut by the Fed is becoming even stronger

Although the ranking of the three blocks in the final round of the French elections came as a surprise relative to the first round and the polls (far-right RN ended in third position), the likeliest scenario we have been contemplating since the announcement – that none of the main groups would secure an absolute majority – has materialised. Another surprise though is that the most extreme factions taken together will not have the numbers to pass a motion of no confidence to stop a "central coalition" from governing. This is positive in terms of political stability for France, but forging such coalition is still likely to prove difficult. Numerically, the components of the left excluding hard-left LFI, together with the centrists may - just – get to an absolute majority but finding a political agreement would be tricky, as the left is starting from a quite demanding position on the economy. "Institutional glue" is in short supply in the traditionally adversarial political system of France. A minority, technical government is an option, to break the deadlock, but this would likely only focus on delivering "minimalist" policies – albeit crucially a budget for 2025.

With uncertainty lingering in France, and a far from shiny dataflow in Germany, the continuation of the removal of monetary restriction by the ECB would help. The June print for the Euro area CPI was not concerning – the momentum for services prices has improved – but inflation is on a plateau still visibly above 2% which we expect to continue until the autumn. In a context of labour market resilience (a point highlighted by Christine Lagarde in her speech in Sintra), the Governing Council is unlikely to accelerate the rate cuts (we still expect them for September and December).

In line with the points we made last week, the US dataflow continues to build a compelling case for a Fed cut in September, with the rise in the unemployment rate getting tantalisingly close to the "Sahm rule" threshold. There is still no sense of urgency there – New York Fed President Williams made it plain last week – but dithering too long could prove costly.

French elections Round 2

In contrast with the first round for which polls had been quite accurate, the second round came with a major surprise: while expected to emerge with the highest number of deputies – albeit probably short of an absolute majority – far-right Rassemblement National (RN) came out in the third position, behind the left alliance and a more resilient than expected Macronist "Ensemble" group as a close second. Centre-Right les Republicains (LR) also fared better than expected. Still, **the likeliest scenario after the first round – that no block would gain an absolute majority of 289 seats– has materialised**.

The French ministry of Interior published the results in the 577 constituencies. RN and its allies secured 143 seats, the left alliance Nouveau Front Populaire (NFP) 182, Ensemble 168 and LR, together with other centre-right candidates who had not allied themselves to RN, 60 seats. Even when adding the 6 "other centrists", the most often discussed potential coalition (Ensemble + the centre right) would be far away from the threshold with 234 seats. **So, we know now that the most radical policy proposals will not be implemented, but it remains unclear how France will be governed. However, another key difference with the projections before the second round is that the far-left La France Insoumise (LFI) and RN are also, when taken together, very far away from the absolute majority needed to prevent a "central coalition" from governing by voting a motion of no confidence. This removes a crucial risk. Yet, forging such coalition could prove difficult.**

Before briefly discussing the political dynamics, it is worth exploring the pure arithmetic. A key issue is the breakdown within the left alliance across the hard-left left (LFI), the socialists Parti Socialiste (PS), the Greens Europe Ecologie Les Verts (EELV) and the Communists. LFI (40% of the left alliance seats) immediately rejected any compromise outside the left alliance. The other groups expressed – often with a high number of internal nuances, for instance within PS – some willingness to contemplate a form of dialogue. However, even when adding all their forces to the left-wing independent deputies outside the alliance, Ensemble and various centrists, the majority threshold would be hit by only a very small margin (at the point of writing, the precise breakdown within the left was unavailable but we find a figure around 295). To solidify such already tricky potential coalition, adding the centre-right would be helpful (this would bring such block towards roughly 350 seats), but it would be even more difficult to find political agreements across such an even wider coalition, and LR spokespeople have not so far expressed any appetite for wide political arrangements.

Judging by the various statements on TV studios on Sunday night, it seems that the left-wing groups implicitly or explicitly "open to dialogue" – basically the components of the left which historically had direct government experience – want to start from a fairly maximalist position to possibly snatch significant concessions from the centrists on public spending, or on the recent pension reform, presenting the radical platform of the left alliance as the basis for discussion.

A proper minority government, or a technical government, could be another solution to break the deadlock. While LR and significant parts of the left beyond LFI would not have to formally approve bills – in particular, the budget for 2025 – they could accept NOT to table a motion of no confidence and thus allow the legislative process to remain operational. This would however likely require a form of "minimalist" policymaking, avoiding making too big decisions to avoid triggering the opposition of any of the camps. This would minimise disruption, but without providing much clarity on the French macroeconomic trajectory, at a time when fiscal action is called for, as we have already discussed in Macrocast.

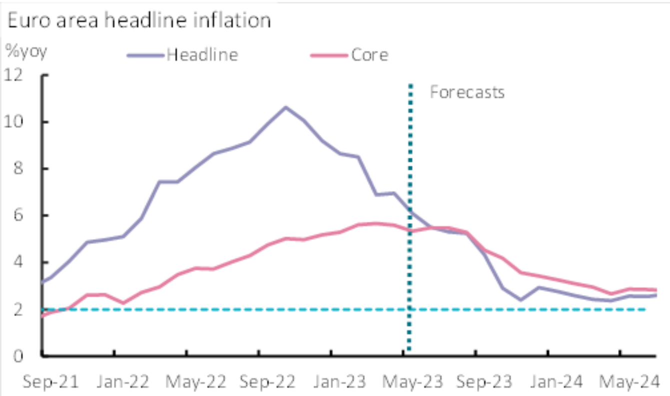
A key immediate issue is how France will maintain some government continuity while a political solution is found. Incumbent Prime Minister Gabriel Attal announced on TV on Sunday night that he would tender his resignation to the President on Monday but at the same time expressed his readiness to remain at his post in the current busy context for France with the Olympic games. Technically, in France a "resigning government" continues to operate until a new cabinet is formed, managing "current affairs" although no new significant measures can be implemented. French Courts allow for some leeway to deal with "urgent matters" – especially anything having to do with public order – but they have become increasingly restrictive over time. Still, nothing forces the President to accept the Prime Minister (PM)'s resignation, and Gabriel Attal could be formally re-appointed. As we explained two weeks ago, a Prime Minister does not need to request a vote of confidence in the National Assembly – which will reconvene on 18 July. We maintain our view that elaborating the budget bill – which needs to be transmitted to parliament in early October at the latest – is the real deadline for a political solution to emerge.

Discussing European inflation

As clarity may not emerge quickly in France, a wait-and-see attitude may continue to hamper growth there (the decline in the Purchasing Managers' Index (PMI) survey for June was a first indication of the damage), although the setback for the most extreme policy options may put a limit to uncertainty. Yet, **the dataflow has not been kind to the Euro area outside France either**. Industrial production fell badly in Germany in May by 2.5% on the month after a paltry gain of 0.1% in April, leaving the carryover for Q2 at -1.1%qoq after +0.4% in Q1. This is getting concerning since a general rebound in the global manufacturing cycle would normally be favourable to the German economy. Given the general commitment to fiscal restraint – albeit now with a question mark on France – this makes the continuation of the reversal of the monetary policy stance even more urgent in the Euro area. There was not much however in the consumer prices print for June to speed up the process.

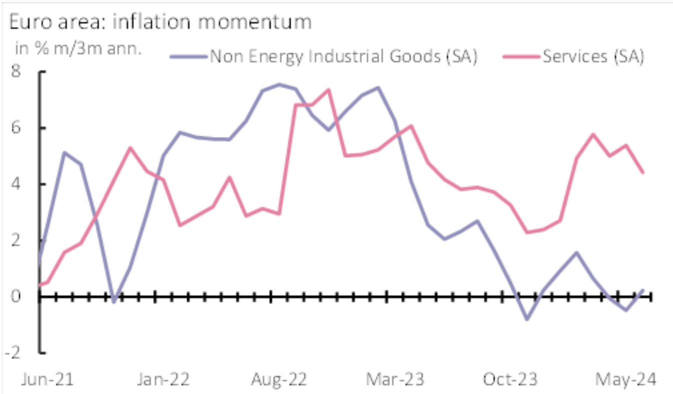
Headline inflation was in line with market expectations, at 2.5%yoy, receding from May (2.6%). However, core inflation came out slightly above expectations (2.9%yoy against 2.8%), unchanged from May. This confirms that **European inflation is currently on a plateau, and because of base effects we do not expect a resumption of a visible decline before this autumn** (see Exhibit 1). The picture looks however brighter when looking at the 3-month annualised changes: the crucial services prices decelerated in June (see Exhibit 2), even if they remain on a high pace by historical standards.

Exhibit 1 – In the middle of the plateau



Source: Eurostat and AXA IM Macro Research, as of July 2024

Exhibit 2 – Still some good news on the services side



Source: ECB and AXA IM Macro Research, as of July 2024

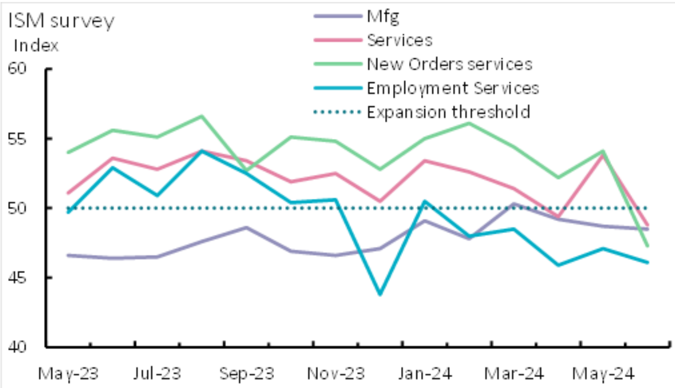
Still, **disinflation proceeds at too slow a pace to move the dial in favour of an accelerated removal of monetary restriction by the European Central Bank (ECB)**. In her speech at the central bank's annual conference in Sintra, Christine Lagarde's main point – from a policy setting point of view – was a specific feature of the current cycle: the combination of a decent real economy, with in particular no marked deterioration of the labour market, with a monetary tightening which initially proceeded at a fast pace. We would highlight this extract: *"The strong labour market means that we can take time to gather new information, but we also need to be mindful of the fact that the growth outlook remains uncertain"*. This, combined with a disinflation plateau, is in our view indicative of a central bank which is obviously preparing to cut more, but which can afford to do so at a measured pace. This strengthens our view that the next cut will come in September, and then in December.

Where the sky is clearing maybe faster than the ECB has been fearing over the last few months on the FX side. Indeed, even though the Governing Council proved in June that it could act without waiting for the Federal Reserve (Fed), there could be limits to the magnitude of the removal of restriction on the European side if a persistent standstill on the American side triggered a significant depreciation of the Euro, beyond the effect of a "risk premium" linked to the French elections. Such scenario of lasting divergence in the policy stance of the Fed and the ECB is now looking less likely.

More signs the US is landing – at last

The market is now taking more and more seriously the possibility the Fed cuts its policy rate in September – our baseline – pricing in as of last Friday a 75% probability of such move, against 55% a week before, as the dataflow continues to point to a landing of the US economy which albeit probably soft, would still be consistent with removing some of the current monetary restriction sooner rather than later. The ISM survey was one key input. We have already mentioned in Macrocast the disconcerting gyrations in its services component, but after an unexpected rebound in May, it joined again the manufacturing sector in contraction territory in June. Moreover, the forward-looking "new order" component in services fell in contraction territory for the first time since the post-Covid reopening. Hiring expectations continued to wallow below 50 as they have been doing since the autumn of 2023 (see Exhibit 3).

Exhibit 3 – Services and manufacturing contracting again



Source: Institute of Supply Managers and AXA IM Research, July 2024

There has been some disconnect lately between the surveys and actual job creation as reflected in the Establishment survey of the payroll report. In the private sector, job creation, after falling significantly below the pre-Covid trend in the summer of 2023 when measuring it on a 3-month annualised basis, started a recovery in the autumn of last year. This has however been reversing at the end of Q1 2024, with a more significant slowdown in June (see Exhibit 4): true, the headline payroll number came out again above expectations in June (206K versus 190K) but April and May were significantly revised down (111K) and the contribution from government hiring – which is largely disconnected from the fundamental dynamics of the economy – boosted the June print by 70K.

Meanwhile, the unemployment rate ticked higher to 4.1% in June, the highest level since November 2021. It is getting tempting to test this against "Sahm rule", proposed by Fed economist Claudia Sahm as a way to identify the start of a recession in "almost real time", i.e., well before it is called by the National Bureau of Economic Research (NBER). It is based on the very simple observation that, in every case over the last 7 recessions, the 3-month average of the unemployment rose by more than 0.5 percentage point above its low of the last 12 months three months after the recession started – which would still give much headway since it takes the NBER between 4 months and nearly 2 years to retroactively identify a recession. **The "Sahm threshold" currently stands at 4.07%, which is tantalizingly close to the 4% average observed over April-June** (see Exhibit 5).

Exhibit 4 – Still creating jobs, but more slowly

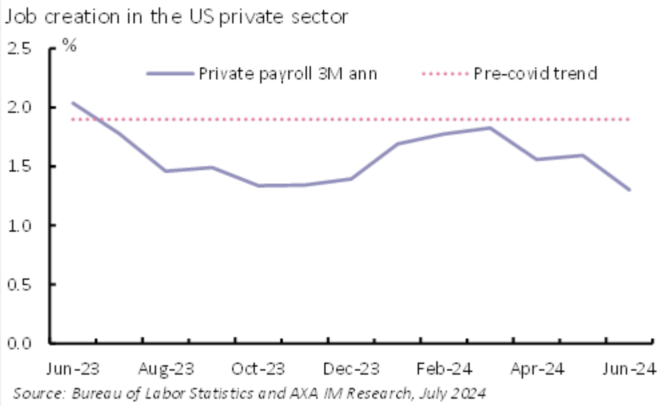
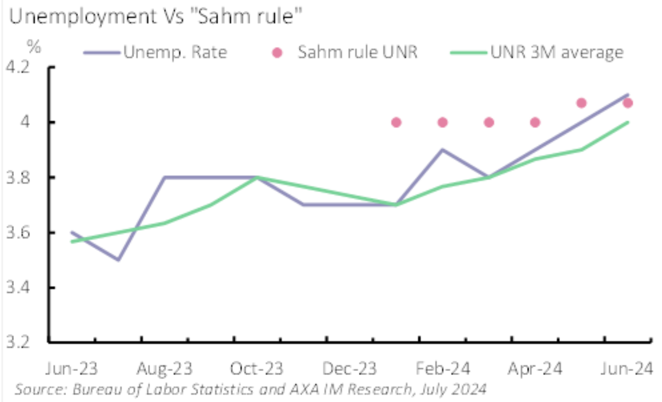
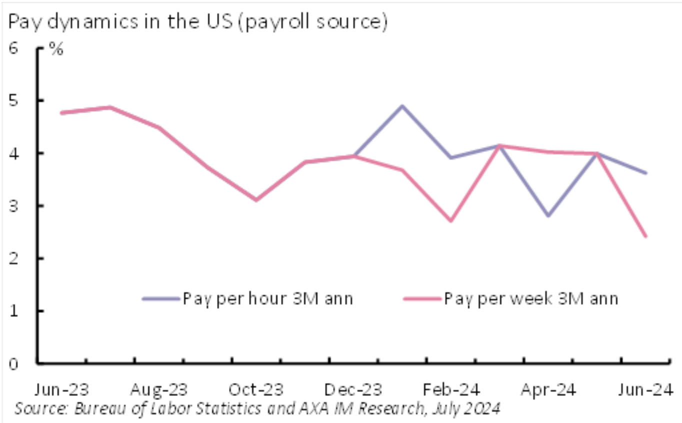


Exhibit 5 – On the brink of hitting the "Sahm rule"

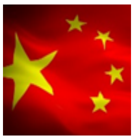


Now, it may well be that 2024 would be the first year the Sahm rule would fail to be predictive. Indeed, the labour market has been subjected to such massive shocks since 2020 that the ongoing rise in unemployment might be better described as a return to normality rather than heralding a proper contraction in activity. Still, we argued a few weeks ago that "it would not take much" in terms of magnitude of an economic slowdown to bring inflation back to 2%. Using a simple model inspired by Bernanke and Blanchard mixing households' price expectations and "under-employment rate", we calculated that a rise in the latter of less than 3 percentage points, so even smaller than what was observed during the mini recession of 2001, would suffice. We are not there, but **the slowdown of the US hiring dynamics seems to be already cooling wages down.** The 3-month change in pay per hour has been somewhat erratic recently, but it now seems anchored below 4% (see Exhibit 6), which would be consistent with a gradual return to 2% inflation given the recent trend in productivity.

Exhibit 6 – It is noisy, but generally in the right direction



Given past disappointments on the disinflation path, the Fed is likely to maintain a very prudent messaging. New York Fed President Williams set the – balanced – tone last week, stating that "*inflation is now around 2-1/2%, so we have seen significant progress in bringing it down. But we still have a way to go to reach our 2% target on a sustained basis*". This is certainly not a central bank which sounds ready to take action – leaving the July meeting as an occasion to gently alter communication – but if the dataflow does not suddenly deviate from the course set over the last few weeks, refusing to cut in September will be difficult to justify.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Payrolls (Jun) dropped to 206k, down from downward revised 218k in May (from 272k), unemp rose to 4.1% and AHE up +0.3%mom • ISM indices (Jun) mfg dipped to 48.5, but non-mfg dropped to 48.8 – a 4-year low • JOLTS (May) vacancies surprise +221k to 8.14m • FOMC minutes (Jun) repeated 'further confidence' before cuts, added focus on labour market	• President Biden's performances with growing doubts over his ability to run in November elections • CPI inflation (Jun) soft headline and core expected again to add to Fed's confidence for later easing • Fed Chair Powell semi-annual monetary testimony to Senate and House • PPI inflation (Jun) to round detail for PCE price view • Continuing jobless claims have been on rising trend
	• German industrial production fell 2.5% mom in May. • EMU flash inflation (Jun): 2.5%yoy for headline, 2.9% for core, small upside surprise due to goods	• French parliamentary 2nd round result. The RN fared much worse than what the polls predicted and came out third. No easy majority can emerge quickly though.
	• General Election. Labour win (412 seats at the time of writing). But vote share remains broadly unchanged at under 40% • BoE credit conditions survey (Q2) consistent with BoE cut in Aug. • BoE lending (May) • Services PMI eases slightly in Jun, from May	• BRC total sales likely rose to 1.0% in Jun, from 0.4% in May • Monthly GDP likely ticked up by 0.1%mom in May • RICS house price balance looks set to hold broadly steady at -17%
	• Tankan survey (Q2), large mfg index up at +13, from +11 – non-mfg unch at +33 • PMIs (Jun, f) services revised down to 49.4, from FE 49.8 • Leading indicator (May, p) up at 111.1	• Av, cash earnings – expected to ease slightly • PPI set to rise 0.4%mom in Jun; yoy up at 3.0%, from 2.4% • Machinery orders set to rise 1.5%mom in May, after a 2.9% drop in Apr.
	• Caixin Mfg PMI edged higher to 51.8 in May from 51.7 in April • Caixin services fell to 51.2 in May from 54.0 in April	• 10-17 July: Credit data (June) including total social financing, M2 money supply, new loans & FDI • 10 July: CPI & PPI (June) • 12 July: Trade data (June)
	• CB: Poland is stood on hold at 5.75% • June CPI (%yoy): Indonesia (2.5%), Korea (2.4%), Taiwan (2.4%), Peru (2.3%), Philippines (3.7%), Thailand (0.6%) & Turkey (71.2%) • May industrial production (%yoy): Brazil (-1.0%) & Hungary (-5.2%)	• CB: Korea (3.5%) & Malaysia (3.0%) are expected to stay on hold. Peru should cut -25bps to 5.50% • June CPI: Brazil, Colombia, Czechia, Hungary, India, Mexico, Romania & Russia • May industrial production: Czechia, India, Malaysia, Turkey & South Africa

Upcoming events		
	US:	Tue: NFIB survey (Jun), Fed Chair Powell semi-annual testimony to Senate; Wed: Fed Chair Powell semi-annual testimony to House Financial Services committee; Thu: CPI (Jun), Weekly jobless claims; Fri: PPI (Jun), Michigan consumer sentiment and inflation expectations (Jul, p)
	Euro Area:	Wed: It Industrial production (May); Fri: Ge Current account (May), Fr, Sp HICP (Jun)
	UK:	Tue: BRC Retail Sales Monitor (Jun); Thu: RICS Survey (Jun), GDP and monthly output (May), Trade (May)
	Japan:	Mon: Current account and trade balance (May); Thu: Private 'core' machinery orders (May)
	China:	Wed: CPI (Jun), Trade balance (Jun)

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