AXA Investment Managers

# 237 – 2 September 2024

Investment Institute Macroeconomics


## Pre-emptive vs Reactive

- The Fed is ready to act aggressively, but they may not have to.
- The Euro area recent dataflow helps with the September cut, but hawks are calling for a cautious approach.
- This week may be decisive for French politics.

The early August equity market shock may already feel like a distant memory, but some key market metrics have changed over the summer: the expected trajectory for the Fed is now much more dovish. Jay Powell in Jackson Hole chose not to stick to a cautious, gradualist approach, making it plain that the Fed has “ample” room for manoeuvre to act and will not necessarily wait for more obvious signs of a downturn to cut aggressively. Yet, while we know that the Fed is ready to support the economy decisively, it is still not obvious it will have to. The August payroll, out this Friday, will be important of course, but so far unemployment benefits claims remain tame, consistent with the notion that the ongoing rise in the unemployment rate is essentially driven by the supply-side, while the dataflow on economic activity in Q3 remains decent. We stick to our view the Fed will cut only twice this year, albeit with a significant risk of a third one. Meanwhile, Kamala Harris’ lead in the polls may have contributed to taking US 10-year yields under 4%, since her victory would probably usher in a less spendthrift fiscal policy than Donald Trump’s, and of course less tariff hike. It remains a very tight race though.

Paradoxically, while the ECB chose not to wait for the Fed and cut in June already, its messaging has become very cautious on the next steps since then. The latest dataflow should however make a September cut easier. Yet, we note how prudent some influential board members such as Isabel Schnabel remain. They have of course a point on inflation – the good news is very recent – but we are more concerned on the risks for growth than they are. For now, the nice rebound in purchasing power triggered by the wedge between wage growth and inflation is not being spent by households. If one adds to the mix slower global demand and the prospects of fiscal restriction, we think the ECB should not take too much time to bring the policy rate closer to neutral, but that is a normative view, and we need to pay attention to the hawks’ signals. We do not expect more than three 25bp cuts in total this year.

Finally, the political process in France may be finally moving on after a long summer break, but whatever the name of the new Prime Minister, policymaking is likely to remain delicate in Paris.

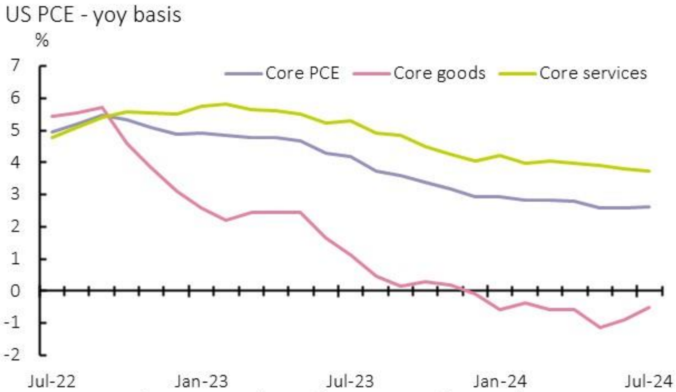
## Not all is forgotten

**The equity market has weathered its brutal drawdown of early August.** The S&P500 index was at the end of last week some 2.4% above the level it had reached at the end of July, before the combination of more hawkish than expected signals from the Bank of Japan (BoJ) and a big miss on the US payroll data on 2 August, triggered the sell-off. Very quickly, verbal intervention from the BoJ, through the voice of its deputy-Governor, expressing less enthusiasm for a swift further normalisation of monetary policy in Japan amid unstable markets, helped put "the end of the yen carry-trade" theme under control and market pricing for the BoJ trajectory fell back. Accordingly, after the massive re-appreciation from 155 to 142 against the US dollar between 30 July and 5 August, the yen eased back to 149 by mid-August.

Yet, it would be a mistake to believe "nothing has changed" over the summer in the US. Indeed, even if the extreme market positioning of early August, when up to 125bps of the Federal Reserve (Fed) cuts by the end of the year were being priced, expectations for the Fed trajectory have stabilised around 100bps of cuts by December, significantly more than by early July (65bps). Yet, for such a re-alignment to trigger a rebound in the equity market, **the underlying market assumption must be that the Fed will cut aggressively without a too profound deterioration in economic activity**, otherwise the benefit of the rate cuts on the valuation of risky assets should be offset by a downward revision in earnings' expectations. In clear, this would suggest that the Fed would pre-empt the risks of a recession and ease policy quickly without waiting for too negative signals on the real economy to accumulate, rather than merely gradually react to the materialisation of downside risks.

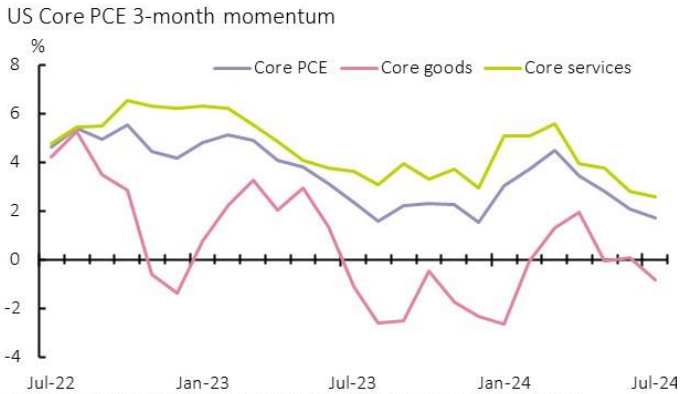
**Such assumption has been given credibility by Jay Powell's speech in Jackson Hole on 23 August.** Indeed, while most observers – including us – were expecting a "cautiously dovish" message, focusing on gradualism while acknowledging it was time to start removing some of the restriction, the Federal Open Market Committee (FOMC) chairman made it clear that the Fed could act decisively and pre-emptively. His point on his "*not seeking nor welcoming*" a further cooling of the labour market suggests that the central bank has received the July payroll batch as an already strong enough signal that "the time has come to adjust". We also receive Powell's point on the fact that the Fed would start from a high starting point in terms of restriction level and would therefore have "*ample room to respond (…) including to the risk of an unwelcome further easing of the labour market*" as an indication that he would not hesitate much to cut aggressively if the need arises.

Exhibit 1 – Steady it goes (down)




Source: Bureau of Economic Analysis and AXA IM Research, September 2024

Exhibit 2 – Very reassuring short-term momentum



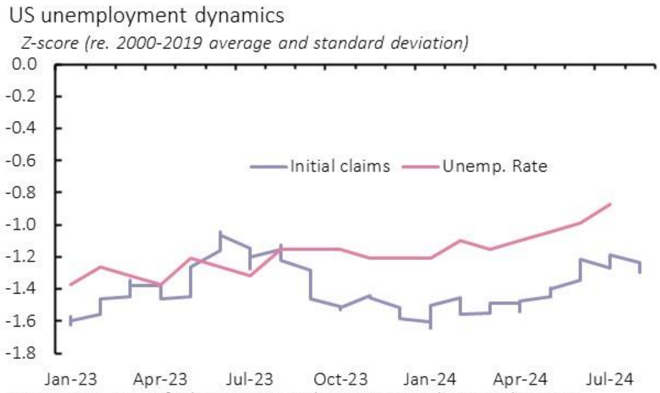

Source: Bureau of Economic Analysis and AXA IM Research, September 2024

**This readiness to cut of course comes from a sense of satisfaction on the inflation front,** and last week's data brought further confirmation that this battle in being won. The Core Personal Consumption Expenditure (PCE) index came out for July slightly below market expectations at 2.6%yoy (instead of 2.7%), the same pace as in June and May (see Exhibit 1). The short-term momentum is even more reassuring. Indeed, on a 3-month annualised basis, core Personal Consumption Expenses (PCE) in July fell again below the 2% mark (1.7%). The rebound in core inflation of the winter of 2023/2024, which had triggered a hawkish turn in the Fed's rhetoric, now appears as a mere bump (see Exhibit 2). Both goods and services contributed to the recent slowdown, the latter point being particularly important for the FOMC.

**At the same time, it is not yet obvious that the US real economy is about to go through a massive downturn**. The first estimate of Q2 GDP has been revised up from an already respectable 2.8% to 3.0%, and the Atlanta Fed "nowcast" is for now putting Q3 at 2.5%. A softer labour market should act as a dampener on household spending, but private consumption in July rose by a decent 0.4%mom, up from 0.3% in June. In our last Macrocast before the summer recess we pointed at the very unusual nature of the current rise in the unemployment rate in the US. Indeed, the last few times the "Sahm point" was hit, the US economy was already destroying jobs, whereas, at least for now, jobs continue to be created at a relatively fast clip. Of course, next week's release of the employment report for August could be a watershed moment, **but so far this summer, "initial claims" for unemployment benefits have remained quite tame.**

To gauge this, we look at the unemployment rate and the claimant count (the 4-week average version) in reference to their average and volatility observed between 2000 and 2019 (i.e. excluding the Covid phase). The former is now less than one standard deviation below its long-term level, but the claimant count is still 1.4 standard deviations below (see Exhibit 3). This, together with the fact the latest claims' prints fell again, adds to the sense that a lot of the current rise in the unemployment rate is driven by the improvement in labour supply, not necessarily a bad macro signal.

Exhibit 3 – Reassuring initial claims



*Source: US Bureau of Labor Statistics and AXA IM Research, September 2024*

**All in all, while the Fed looks ready to do a lot and do it quickly, it is still not obvious to us that they will end up <u>having to</u> do so.** For now, we maintain our view that the FOMC will cut only twice by 25bps this year, albeit with a significant risk that they will deliver three. Part of our prudence comes from the fact that financial conditions at large have already significantly loosened in the US, which makes the case for aggressive intervention by the Fed less compelling, but again, the very readiness of the central bank to do so is providing a level of insurance which can help explain the current positivity on the equity market.

## How to gauge Harris' lead?

Indeed, **another element which has not completely recovered from the "early August scare" is the level of 10-year yields in the US**. They have recovered from their low on 5 August at 3.78%, but at 3.90% as of last Friday they are still below the 4% level which we thought would act as a floor irrespective of the short-term trajectory for the Fed's policy rates given the ongoing reduction in the central bank's central sheet and the perspective of a further upward drift in the supply of government debt. We mentioned the hypothesis, in our last Macrocast before the summer recess, that the dip in yields could be connected to a decline in Donald Trump's probability of victory in November. Indeed, even if Kamala Harris can hardly be considered as a "fiscal conservative", she would still allow some of the 2017 tax cuts to expire, while avoiding a frontal "trade war".

Nate Silver's 538 weighted average of available polls – ranked according to the size of their sample, how recent they are and adjusted for any historical bias - currently puts Kamala Harris' national lead at 3.2%, with a noticeable advance in the swing states of the Great Lakes (2.6% in Michigan, 1.6% in Pennsylvania, 3.2% in Wisconsin) and a more marginal one in the West (0.2% in Arizona and 0.7% in Nevada). The swing states of the South are split, Harris leading marginally in Georgia (0.5%) and Trump in North Carolina (0.3%). The contrast with the situation which prevailed in the last days of Biden's campaign is stark.

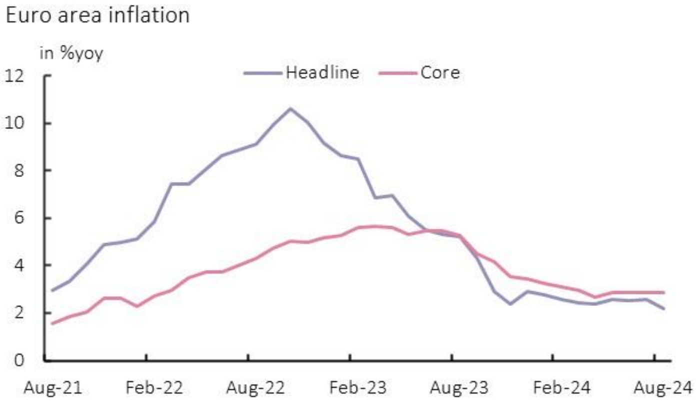
This however may not be the most relevant reference. **Harris has benefitted from massive media exposure at the Democrats' convention in Chicago. At the same period of 2020, Joe Biden was enjoying a national lead of 7.1% over Trump**, and in 2016 Hilary Clinton also emerged from the conventions' season with a substantial lead. Note as well that Harris' lead in 538's weighted poll average has eroded slightly in the last few days, from a peak at 3.6% on 28 August. Her TV interview on CNN – her first major occasion to lay out her platform to the public at large after the very scripted convention speeches – did not appear to have moved the dial further. **This remains a very tight race**, and the debate next week between the two candidates could play a major role.

## ECB: from pre-emptive to reactive?

The European Central Bank (ECB)'s rate cut in June was "brave" in the sense that when the Governing Council delivered the decision which it had largely telegraphed at the previous meeting, the dataflow was not necessarily completely supportive. Services inflation was resilient, "hard data" on wage growth was not yet going in the right direction. The June cut therefore appears as an example of forward-looking policy, but the ECB's extreme cautiousness in July on the future trajectory may, to some extent, have reflected a sense of "retrospective unease" in the council. **The latest dataflow should conversely make a cut in September an easy discussion.**

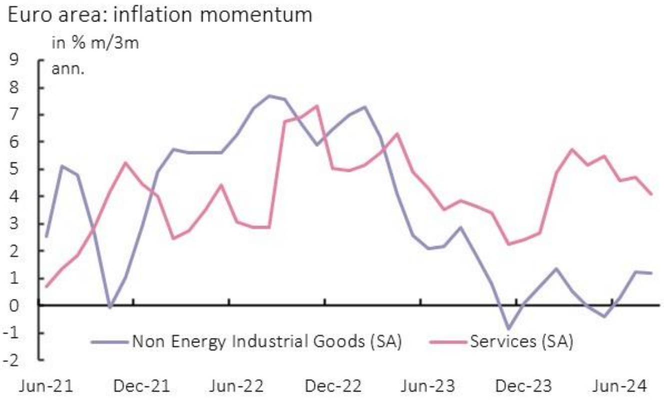
Headline inflation fell to 2.2%yoy in August in the Euro area, tantalisingly close to the ECB target, from 2.6% in July, with core decelerating slightly from 2.9% to 2.8% (see Exhibit 4). This is still high of course, and services inflation was relatively hot, but the latter may have been temporarily boosted by the Olympic games in France (services prices rose there by 3.0% in August, up from 2.6% in July). More fundamentally, the short-term momentum is definitely going in the right direction. While core goods' inflation has been moving within a perfectly manageable -0.5-to-1.5% range on a three-month annualised basis since last winter, services inflation has been gradually correcting from its unwelcome rebound of early 2024 (see Exhibit 5).

Exhibit 4 – Steady core in year-on-year terms




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

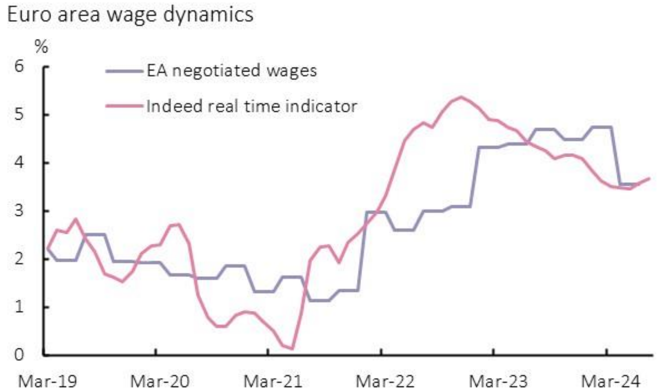
Exhibit 5 – Reassuring short-term momentum




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

News up the "inflation pipeline" was also reassuring, with negotiated wages finally coming down in Q2, at 3.6%yoy from 4.7% in Q1. To be fair, since we insisted on the lagged impact of generous pay deals struck 18 months ago in Germany to downplay the resilience in Q1, equally the magnitude of the deceleration in Q2 was exaggerated by this base effect, but **the crux of the matter is that the message from the new real-time indicators of wage dynamics – e.g. the indeed index – which had been pointing to a deceleration since last year was finally vindicated** (see Exhibit 6).

Exhibit 6 – Negotiated wages validate real-time indicators




*Source: ECB, Indeed and AXA IM Research, September 2024*

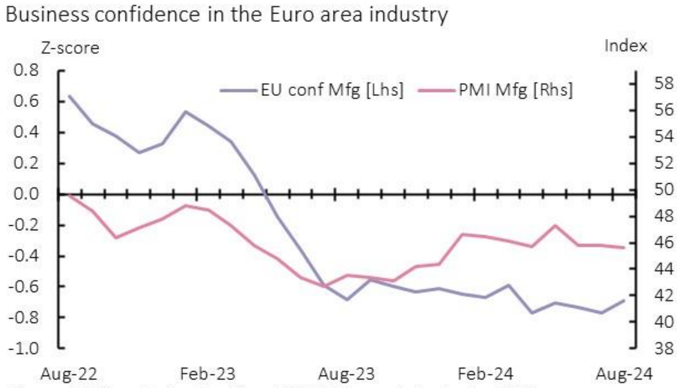
Yet, despite this recent dataflow, **some of the most influential policymakers at the ECB want to maintain a very cautious approach to the speed and magnitude of easing.** Last week's speech by Isabel Schnabel, delivered after the inflation data for August was released, makes the point eloquently: *"the earlier monetary policy shifts in response to forward-looking signals, the more cautious and gradual it can afford to be on the way back to (an unknown) neutral".* In clear, precisely because the ECB chose not to wait and started cutting in June, it has built a "buffer" and can now afford to take its time. There were enough nods to disinflationary forces elsewhere in her speech to still make the September cut relatively easy to snatch from the hawks – she acknowledged the deceleration in wages and supported the view businesses will absorb much of the rise in unit labour costs by reducing their margins – but we don't think we should revise our baseline scenario that the ECB will cut only twice more (September and December) this year.

Where **we disagree with Isabel Schnabel's characterization of the current macro configuration is on the balance of risks.** She focused in her speech on alternatives to the baseline scenario which would see inflation remaining more resilient, because unit labour costs would be "higher for longer" (notably if productivity continues to disappoint), or because the pass-through of wages to services prices would be higher than expected. Even the global protectionist risk – which we think may take inflation *down* in the Euro area, given its dependence on export markets, as it would slow down the real economy – is presented in Schnabel's speech as an inflationary outcome (via the return of global supply lines disruptions). All this may well materialise, but equally we are struck by her dismissal of the possibility the Euro area faces a "hard landing".

True, even if they are slowing down, there is enough "acquired speed" in nominal wages to produce decent purchasing power gains given the drop in inflation. This could elicit enough consumption support to keep Euro area growth around the "flotation line", i.e. not too far from its estimated 1.1/1.2% potential. Yet, this will materialise only if households decide to spend these gains, while **generic anxiety about their prospects could tilt them into raising their saving effort further**. This is what happened in France in Q2 2024, where the savings' ratio rose from an already very elevated 17.6% in Q1 to 17.9%, as per the details of Q2 national accounts released last week. Given the uncertainty created by the outcome of the parliamentary elections – more on this later – we are not holding our breath for a significant correction in Q3, beyond possibly some short-term "feelgood effect" from the Olympics. Personal consumption fell by 0.2%qoq in Germany in Q2, another signal that the generous pay deals are not being transformed into stronger spending. Of course, these mediocre developments in France and Germany are partly offset by better metrics in the South, but if the two largest economies of the Euro area are not doing well, we fail to see how the rest of the region could maintain their current momentum for much longer.

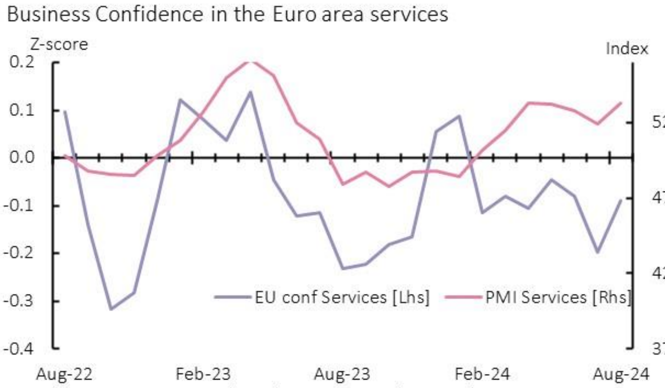
**Business surveys at the Euro area level are sending contrasting messages**. Manufacturing continues to suffer a lot: the EU Commission survey has confidence in this sector at 0.8 standard deviation below its long-term average, and the Purchasing Managers Index (PMI) there is well into contraction territory (see Exhibit 7). According to the PMIs, the situation is less dire in the services sector, but this reassuring message is contradicted by the Commission survey, which still has confidence in this sector slightly below its long-term average (see Exhibit 8).

Exhibit 7 – Manufacturing is struggling



*Source: EU Commission, Markit and AXA IM Research, September 2024*

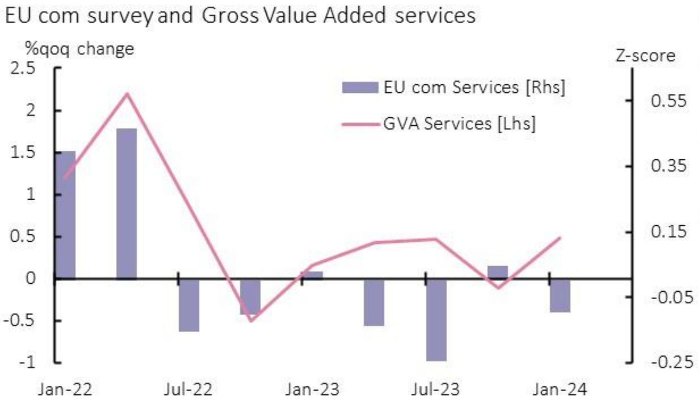
Exhibit 8 – Contrasting message on services



*Source: EU Commission, Markit and AXA IM Research, September 2024*

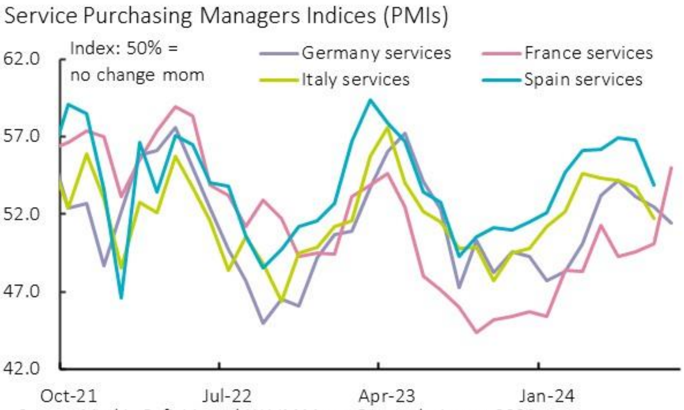
True, the EU Commission survey has recently painted a slightly too morose picture of the services sector, which has not performed too badly recently when looking at gross value-added growth – hence its contribution to GDP (see Exhibit 9). We note however that the relatively nice print for the Euro area services PMI in August was largely driven by France (see Exhibit 10), which may simply reflect the short-term boost from the Olympics.

Exhibit 9 – Services output and surveys



*Source: Eurostat, EU Commission and AXA IM Research, September 2024*

Exhibit 10 – The August rebound: an Olympics effect?



*Source: Markit, Refinitiv and AXA IM Macro Research, August 2024*

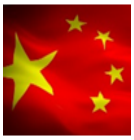
More fundamentally, **we are concerned with the lack of obvious source of traction for the Euro area in the months ahead if consumers remain "on strike".** Indeed, even if we are not convinced the US will soon experience a hard landing, demand there is likely to become less stellar than in 2023. The Chinese dataflow continues to be hesitant, and we reiterate the points we made before the summer recess on the policy stance in Beijing: powerful action is needed to re-start consumer spending, but neither the finance ministry, nor the central bank seem to be ready to take aggressive action in this regard. Such combination is unlikely to spur a rebound in Euro area exports. On the domestic European side, it is highly likely that the fiscally restrictive stance made necessary by market pressure and the resumption of EU surveillance will contribute to impairing demand. We do not think the central bank can afford to ignore those policy developments. From a predictive point of view, we think the ECB will be gradual in its approach to easing. From a normative point of view, we do not think this is necessarily the right strategy.

## Politics knocking on the door again

Of course, France remains at this stage a key uncertainty for the overall fiscal stance in the Euro area in 2025, since as we write these lines on Sunday no new Prime Minister has been appointed and no draft budget bill has been drafted. There seems to be some acceleration in the institutional process though. The French press over the weekend was abuzz with the possibility that Bernard Cazeneuve, who already served as PM at the end of Francois Hollande's mandate, could be the right "compromise personality" who could manage to set up a cabinet without immediately being torpedoed by a motion of no confidence.

He will meet with Emmanuel Macron on Monday 2 September. The President will also meet his two predecessors, Nicolas Sarkozy, and Francois Hollande the same day. We could read this as a sign that Emmanuel Macron may count on them to lean on their respective centre-right and centre-left camps to make sure a Cazeneuve solution would be at least given "the benefit of the doubt" in parliament.

At this juncture, there is absolutely no certainty Cazeneuve will be appointed, even if we note that key supporters of the current President of the Republic have these last few days praised him in the media. He left the Socialist party in 2022 as he opposed the alliance with the far-left, which makes him attractive to the centrists and acceptable to the centre-right, but because of this he may not be able to bring along the entirety of the socialist caucus in parliament, which would make his position fragile. Fundamentally, in terms of policy setting, we note that even his supporters within the moderate wing of the socialist party would need some key signals of a break from the Macronist approach to come onboard. Freezing the latest pension reform appears as a key condition there. Of course, this would raise additional hurdles to square the fiscal equation, possibly making some tax hikes unavoidable, in turn making it more difficult for the centre-right to tolerate – they seem to have rejected participating to a government outright – a Cazeneuve cabinet by refusing to support a motion of no confidence. The institutional process seems to be finally moving up, but policymaking in Paris still looks very delicate.

| Country/Region | What we focused on last week | What we will focus on in next weeks |
|---|---|---|
|  | • VP Harris first candidate interview. She leads in most marginals now, but will honeymoon persist?<br>• US GDP (Q2) revised up to 3.0% (saar) (from 2.8%) driven by consumption, revised up to 2.9% (2.2%)<br>• PCE inflation (Jul) stable at 2.5%; market focus on spending, up 0.5% and saving rate dipped to 2.9%<br>• Conf Bd cons conf (Aug) expectations hit 1-yr high<br>• Weekly jobless claims remain subdued at 231k | • Payrolls (Aug) expect headline payrolls to rise to 150k, expect -ve revisions to July. Unemp to remain at 4.3%. Overall to ease concerns about recession.<br>• JOLTS (Jul) expect drop to 8.0m after Q2 stabilised<br>• ISM index (Aug) expects around 46.8, stable around subdued level as global mfg faces headwinds<br>• ISM services (Aug) expect rise from 51.4, as PMI<br>• Fed's Beige Book, expect signs of softening outlook |
|  | • EMU inflation came at 2.2%yoy in Aug from 2.7% but Scvs rose to 4.2%, impacted by Fr Olympics.<br>• EC surveys didn't really improve at EMU aggregated level. Spain is still buoyant, core countries heavily skewed to industrials continue to struggle.<br>• Mixed credit lending (Jul) with a small rise to households at +0.5% (+0.2p) and a decline for non - fin corporates (+0.6%; -0.1p) | • Q2 Final GDP, employment, wages and profits data at EMU level<br>• EMU retail sales (July)<br>• In Fr, negotiations to appoint a new PM have been extended to non-political personalities, a decision is expected soon<br>• German state elections in Thuringia and Saxony with a likely huge progression from the AfD (far right) |
|  | • Mortgage approvals up 62K in Jul, from 60.6K in Jun<br>• Cons. credit up at £1.2bn in Jul, from £0.9bn in Jun<br>• Nationwide house price growth up 2.4%yoy in Aug | • Final manu. PMI likely to remain unch from at 52.5<br>• BRC total sales likely up 0.8%yoy in Aug<br>• Final serv. PMI likely to remain unch from at 53.3<br>• Construc. PMI likely down 54.5 in Aug, from 55.3<br>• Private car sales set to stay below 2019 level |
|  | • Unemp. rate ticked up to 2.7% in Jul, from 2.5%<br>• IP rose by 2,8%mom in Jul; retail sales up 0.2%mom<br>• Tokyo CPI inflation up at 2.4% in Aug, from 2.2%. Ex food and energy, up at 1.6%, from 1.5% | • Manu PMI likely unch from flash<br>• Serv. PMI and comp. PMI likely unch from flash<br>• Av. cash earnings to edge down following one off payments in Jun<br>• HH spending data, watch to see if it recovers |
|  | • Industrial profit grew 3.6%yoy ytd in July 2024 (H2 2024: 3.5%) | • 31 Aug: NBS PMI mfg and non-mfg (Aug)<br>• 2 Sep: Caixin mfg PMI (Aug)<br>• 4 Sep: Caixin Services PMI (Aug)<br>• 7 Sep: FX reserves (Aug) |
|   | • CB: Hungary unch at 6.75%<br>• Banxico inflation report | • CB: on hold in Malaysia (3%) and Poland (5.75%), 25bp cut expected for Chile (from 5.75% to 5.5%)<br>• Q2 GDP: India, Korea, Turkey, South Africa, Romania, Brazil<br>• Aug CPI: Indonesia, Thailand, Philippines, Taiwan, Turkey, Brazil, Peru, Chile, Colombia, Uruguay<br>• Aug PMI survey across countries<br>• Brazil 2025 budget proposal, new Mexican Congress may push for Constitutional reform |

| | | |
|---|---|---|
| Upcoming events | US: | Tue: ISM mfg (Aug); Wed: Factory orders (Jul), JOLTS (Jul), Beige Book publication; Thu: ADP emp change (Aug), Initial jobless claims (w/e 26 Aug), Continuing jobless claims (w/e 19 Aug), Non-farm productivity (Q2), Unit labour costs (Q2), ISM non-mfg (Aug); Fri: Non-farm payrolls (Aug), Unemp (Aug), Avg earnings (Aug) |
| | Euro Area: | Mon: Sp, It, Ez mfg PMI (Aug), It GDP (Q2); Wed: Sp, It, Ez services PMI (Aug), Ez Composite PMI (Aug), Ez PPI (Jul); Thu: Ge new mfg orders (Jul), Ez retail sales (Jul); Fri: Ge, Fr IP (Jul), It retail sales (Jul), Ez GDP (Q2) |
| | UK: | Mon: Mfg PMI (Aug); Tue: BRC Retail sales (Aug); Wed: Composite and services PMI (Aug); Thu: Construction PMI (Aug); Fri: Halifax house price index (Aug) |
| | Japan: | No data releases |
| | China: | Mon: Caixin mfg PMI (Aug); Wed: Caixin services PMI (Aug); Sat: Foreign exchange reserves (Aug) |

## Our Research is available online: www.axa-im.com/investment-institute