Carefully Crossing

- Crossing the neutral rate seems harder for the ECB than we thought. We still think this will happen though.
- The US May Employment Report was no “smoking gun”
- The US “reverse Energiewende” – towards more oil and gas and less renewables – may not lift investment

The level of resistance at the ECB Governing Council against bringing the policy stance into accommodative territory, now that the policy rate has been lowered to 2%, is higher than we expected. That is our main takeaway from last week’s press conference. We note however that the latest forecasts and their long stretches of inflation undershooting leave very little space for additional shocks. We continue to think the ECB will cut deeper, but the burden of proof in terms of dataflow looks heavier. We now think the cuts will coincide with the next forecasts, in September and December, with the depo rate reaching 1.5%, 50bps higher than in our previous baseline.

Last week’s US Employment Report triggered a flurry of comments, with a debate arising between those who detect there the first proper “cracks” in the US labour market, which should make the Fed re-think its current wait-and -see attitude, and those who continue to think the slowdown is still too elusive to sway the central bank. We err towards the latter. True, some of the details of the report are problematic – we would highlight the reliance on only two sectors, healthcare-social assistance and leisure-hospitality, to provide most of the job creation in May – but this is not (yet?) the smoking gun the Fed needs to move out of its careful attitude. The tariffs are not yet stabilised, and their impact on prices and activity have not yet materialised. More time is needed, despite the pressure from the White House for pre-emptive cuts.

We also try this week to extract ourselves from the “tariffs and budget” diptych which has been dominating the US policy cycle since January by looking at the US energy sector. There, the White House is winning the battle on prices, but this means investment in the US oil and gas industry is stalling, as the Dallas Fed survey suggests. At the same time, the repeal of much of the IRA will hit investment in electrification and renewables. The US “reverse Energiewende” is not contributing to lifting the US overall capital stock.

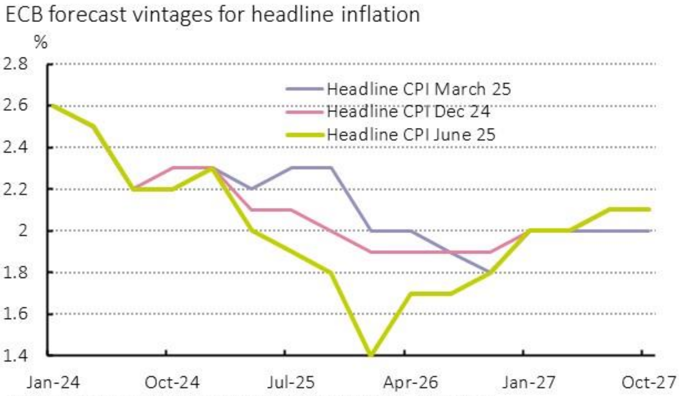
2% is a tough limit

The European Central Bank (ECB) meeting last week was more momentous than we expected. We thought that the perspective of crossing a policy rate at 2% – usually seen as the neutral level – would no longer constitute a critical limit triggering intense internal discussions. Yet, judging by Christine Lagarde's comments in the Q&A last week**, there is still some substantial resistance to contemplate shifting the policy stance in accommodative territory**. Continuing cuts beyond last week widely expected 25bp cut is still very much on the table given the ECB President's refusal to explicitly endorse the notion of "pause" or of "being done" but the notion of being now "*in a good position"* – a point she repeated several times – suggests that, on the basis of the ECB's updated macroeconomic outlook, the ECB would rather stay where it is today. **This may be tactical: if the hawks are resisting, the dataflow must be the "Justice of the Peace."** Rather than indicating now a bias towards providing accommodation, which clearly would be far from receiving unanimous support at the Governing Council, it is probably easier to state a preference for neutrality "for now", allowing the data flow, in time, to convince the hawks that this approach is untenable.

The pace of cuts would however need to change. With a higher burden of proof, **it will probably take further downward revisions in the forecasts to deliver this move into accommodation**. There would thus only be two windows of opportunity this year: September and December. Accordingly, although the level of uncertainty is of course massive – a point repeatedly made by Christine Lagarde – we now see as a baseline two more 25bp cuts in 2025 only (instead of 4), the deposit rate hitting 1.5% at the end of the year (the market pricing, according to forward contracts, was standing at 1.67% after the meeting).

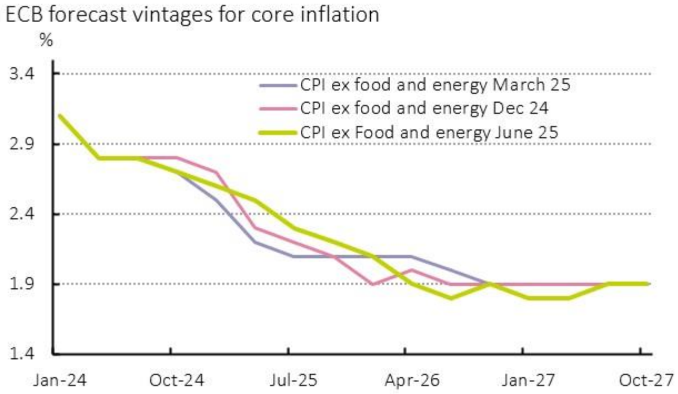
It will not take much to sway the Council though, in our view. Indeed, the new batch of forecasts released last week already has quite some "inflation undershooting" embedded, as we expected in last week's Macrocast. Indeed, headline inflation would fall to as low as 1.4% at the beginning of 2026 (see Exhibit 1). Yet, Christine Lagarde insisted last week on the fact that the new downward revision in the inflation projections essentially reflects exogenous forces, lower oil prices and stronger euro, without significant undershooting in "domestic inflation". They have services prices continuing to grow by more than 3% year-on-year until the end of 2025, to settle at 2.5% in 2026-2027. Consequently, core inflation would never stray too far below the ECB target (see Exhibit 2). There would however be a lot of "sailing close to the wind": core inflation would be as low as 1.8%yoy in Q3 2026, and again in the first half of 2027**. Even a relatively small shock to the ECB scenario would take inflation significantly below target, which would warrant proper accommodation.**

Exhibit 1 – Big headline undershooting in early 26



Source: European Central Bank and AXA IM Research, June 2025

Exhibit 2 – Not much space for shocks on core



Source: European Central Bank and AXA IM Research, June 2025

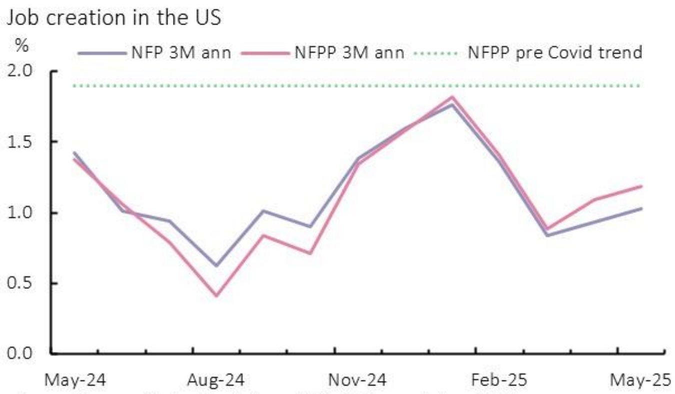
The ECB has explored one of those obvious exogenous shock: the intensification of the trade war. The central bank's baseline in this new batch of projections was a 10% average tariff on everyone (from almost zero) except for China which would be hit by a 20% hike on top of the "pre-Trump 2.0" 20%. **This is already quite optimistic in our view, since it would be by and large consistent with an extension of the current UK deal to everyone outside China** – including, crucially, to the European Union (EU) – while it seems to us that the agreement with the UK – which had been putting much effort for years in this, and which does not post a bilateral trade surplus with the US – would be the most favourable which could be realistically snatched from the White House at this stage. Now, in the "severe scenario," tariffs on European products would be lifted to 20%, which was the level announced on "Liberation Day" (10% basic + 10% EU-specific add-on). In this case, inflation in the Euro area would fall by 0.2% in 2027 relative to baseline (hence to 1.8%). **This looks rather conservative to us**, and indeed the Eurosystem economists explored, but without quantifying it, how an additional deflationary effect would probably materialise because of Chinese producers redirecting their efforts towards the European market. The ECB estimates that around 80% of products imported into large European countries could be supplied by China. We would add to this the fact that, under a severe scenario, since global growth would be seriously hit, energy prices could fall even further, adding to the deflationary pressure.

Uncertainty on the trade front could linger well beyond 9 July, the normal term of the current talks between the US and the EU. Indeed, the announcement last week that Donald Trump and Xi Jinping had finally talked to each other and decided to prolong the trade talks – under Scott Bessent's leadership on the American side – suggests that there is some flexibility at the White House when it comes to deadlines. In the European case, the institutional difficulties in getting agreements would make it difficult in any case to get a swift decision. **In a configuration in which no hard news is available to the Governing Council on the trade front, "skipping" the July meeting and wait for the new forecasts of September would be appealing.**

Still too many jobs to sway the Fed

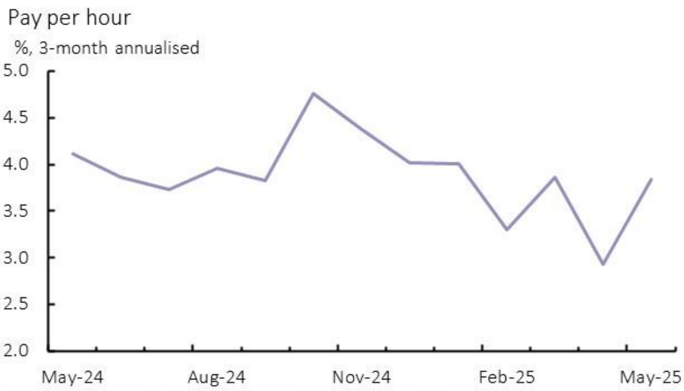
Given the high level of macroeconomic uncertainty, employers could be excused for pulling the brakes on hiring – and some surveys are pointing in this direction, notably the National Federation of Independent Business (NFIB), while the Federal Reserve (Fed)'s latest beige book reported that "*most districts described employment as flat*". Yet, The Employment Report came out better than expected in May, with non-farm payroll at +139K (market consensus at +126k) according to the Establishment Survey. Despite downward revisions to previous months, and cuts to federal employment, job creation is still decent - +1.0% on a 3-month annualized basis, against 0.9% in April. While the employment gains are markedly below the pre-Covid trend (1.9% on average between 2010 and 2019), this is still a very, very soft landing: the slowdown in job creation reflected by the Establishment Survey continues to be contained. True, payrolls are less strong than last winter, when they were within touching distance from the pre-Covid trend (1.8% in the three months to January), but the current pace according to the Establishment Survey is close to what was observed in the middle of last year (see Exhibit 3). The unemployment rate in May was unchanged at 4.2%. Meanwhile, the recent tentative and softening trend in pay per hour – amid wide volatility – stopped in May, with hourly wages hitting 3.8% on a three-month annualised basis (see Exhibit 4).

Exhibit 3 – Below par, but still decent



Source: Bureau of Labor Statistics and AXA IM Research, June 2025

Exhibit 4 – Wage growth remains robust



Source: Bureau of Labor Statistics and AXA IM Research, June 2025

Some details of the report are problematic though. Only two industries (Healthcare-social assistance, leisure and hospitality), with a share in total non-farm employment of only 22%, accounted for three quarters of all the employment gains in May (110K taken together). The market was bracing for a bad figure in leisure and hospitality as foreign tourism in the US is struggling, but more generally, this dependence on just two sectors is concerning. Industries more attuned to the economic cycle than Healthcare are not doing very well. This sectorial concentration of job creation in the Establishment Survey may help understand some of the contrast with the Household survey, according to which employment fell by 696K in May. Yet, the Household Survey, which is in any case more volatile than the Establishment one, has several times in this cycle (and as recently as the spring and autumn of 2024) pointed to an imminent job crash which did not materialize.

So, in a nutshell, **this Employment Report, despite some less encouraging details, does not provide the "smoking gun" which could sway the Fed out of its current "wait and see attitude",** especially since wages continue to grow at a relatively healthy pace. If households start to re-think their spending decisions, as consumer surveys suggest, it is because their expectations, notably on inflation, are deteriorating, not because their current purchasing power is being squeezed (for now). The tariffs are not yet stabilised, and their impact on prices and activity have not yet materialised. More time is needed for the Fed, despite the pressure from the White House for pre-emptive cuts. it would take a tangible worsening of the hard data for the Fed to re-think its stance. We are not there.

The US own "Energiewende"

So far into Donald Trump's second term, the "policy space" has been almost entirely filled by trade and fiscal issues, with essentially adverse effects on the market given the likely impact on inflation and interest rates that the White House announcements and the Congress proceedings so far have triggered. But there is another side to "Trumpnomics" which many investors believe could lift growth and profitability: the promise of supply-side reforms. Appointments in major federal agencies – for instance at the Securities and Exchange Commission (SEC) and Environmental Protection Agency (EPA) – show commitment to deregulation, as a continuation of Trump 1.0 (the previous Republican administration duly delivered on its pledge to retire two regulations for any new one), even if it is still too early to seriously assess the scope of the new efforts. Yet, reinforcing the US economy's supply side takes more than deregulation. **Lifting and modernizing the country's stock of capital is another area of interest. In this realm, energy plays a crucial role.**

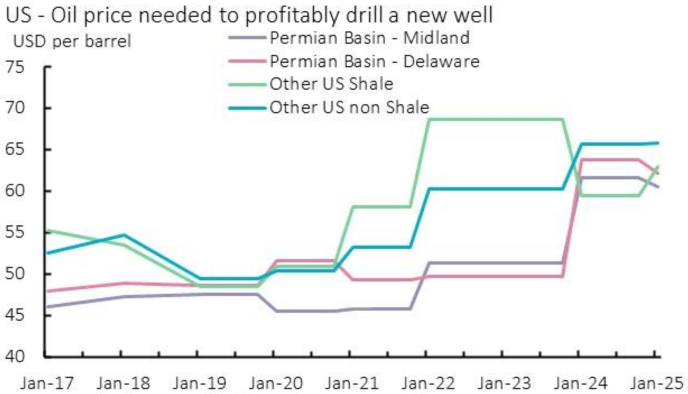
Cheap and reliable energy supply has for long been a key asset to the US economy, with strong potential to attract more manufacturing capacity on the territory. The Biden administration was intent on maintaining this advantage while reconciling this strategy with decarbonation. The new administration is instead focusing on securing the US position as a net exporter of fossil fuel and counts on cheap oil and gas to keep overall energy prices low, while putting a stop to federal subsidies to renewable energy. In a nutshell, **the US is pursuing a sort of mirror version of Germany's "Energiewende": a re-carbonisation of its energy mix.**

The price objective on oil and gas is currently being delivered, but without the expected rise in capacity which would have contributed to the expansion of the US capital base. There is an intrinsic contradiction between calling – quite successfully – for lower oil prices at the global level and lifting production in the US. Now that the US administration is acknowledging that the trade war will likely trigger a transitory inflation shock, keeping energy prices low is even more crucial, at least politically. But while the US has become the world's largest producer of fossil fuel, production costs there remain much higher than in the marginal suppliers in the Persian Gulf. **Once capital costs are put in the mix, raising output capacity for most US domestic producers is uneconomic at the current price**. Strategically, those Organization of the Petroleum Exporting Countries (OPEC) leaders have a vested interest in complying with the US call for a rise in production allowing lower prices as they can protect their market share.

The Federal Reserve of Dallas surveys the US oil industry very thoroughly. **Across all key production regions, the break-even oil price to justify new drilling has risen substantially over the last few years, to reach USD 60/bl and above** (see

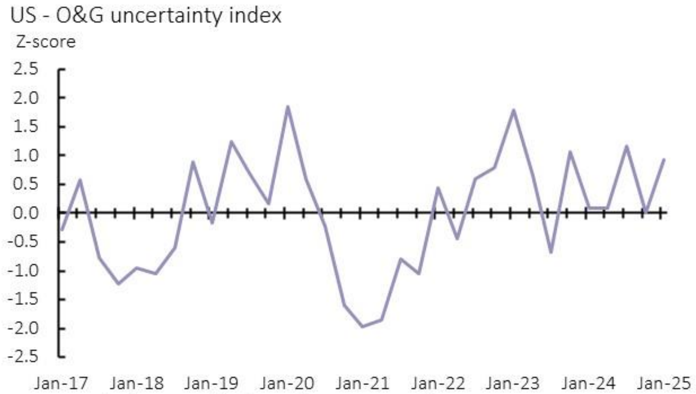
Exhibit 5). The oil industry, just like the rest of the economy, has been hit by the rise in interest rates. Note as well that this industry could be directly hit by the trade war. Indeed, among the reasons behind the rise in the "breakeven price" for oil, respondents to the latest Dallas Fed survey mentioned the cost of "steel tubular goods" which is going to be raised by the tariffs on steel imports (especially if they are lifted to 50% as per Donald Trump's announcement last week). Despite the reassurance from the new administration, the survey reflects a surprisingly high level of uncertainty in the oil industry (see Exhibit 6).

Exhibit 5 – Oil prices too low for new investment?



Source: Federal Reserve of Dallas and AXA IM Research, June 2025

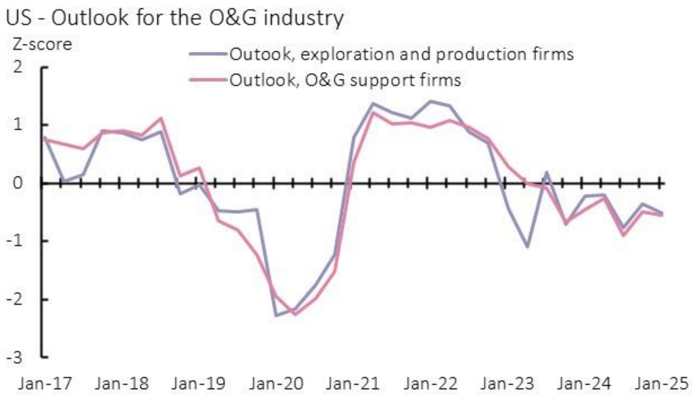
Exhibit 6 – Political reassurance does not suffice



Source: Federal Reserve of Dallas and AXA IM Research, June 2025

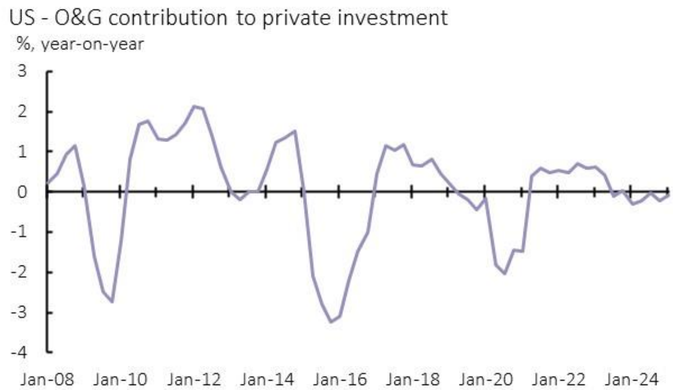
Beyond the lack of readiness to boost investment, the "general outlook" of the respondents to the Dallas survey remains below its long-term average (see Exhibit 7). Since the big push in domestic fossil production under Obama in the early 2010s, investment by this industry has at times provided a modest but visible contribution to overall investment in the US (see Exhibit 8), but it has been fading for several years, and the latter trend is unlikely to reverse in the foreseeable future, **and in the absence of additional capacity and improved oil prices, the net positive income the US economy currently benefits from as a net exporter of fossil fuel is unlikely to rise significantly.**

Exhibit 7 – Below par expectations



Source: Federal Reserve of Dallas and AXA IM Research, June 2025

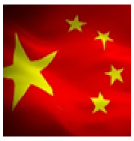
Exhibit 8 – Not that big a contribution to investment



Source: US Bureau of Economic Analysis and AXA IM Research, June 2025

At the same time, **the latest fiscal decisions by the White House, endorsed so far by the House of Representatives in the "Big Beautiful Budget Bill" will adversely impact investment in renewables**. True, some projects already in construction would still qualify for the existing incentives, but new projects won't. For instance, the "clean electricity credits" put in place under the Inflation Reduction Act (IRA)would be revoked for projects that start construction more than 60 days after the One, Big, Beautiful Bill (OBBB) enactment or go into service after 2028. In contrast with the oil and gas industry, which is individualised in the US national accounts, it is not straightforward to quantify the contribution from the "clean energy" sector to the US economy. A lot of estimates come from pro-decarbonisation think tanks, for instance a widely quoted study by the Climate Advocacy Lab warning that the termination of the IRA would result in almost 800K fewer jobs in the US by 2030 may be seen as overly partisan. Yet, we would highlight a study published by Goldman Sachs in 2023, estimating that the IRA would generate investment to the tune of USD290bn annually, some 1% of GDP, *"more than twice the total investment in the Shale revolution".* This should be symmetric: if most of the IRA is repealed, then this additional capacity will not emerge.

So, for now, on the energy investment front, the positive supply side shock is elusive, even if US consumers will of course benefit from lower prices. Despite a more sympathetic administration, the oil and gas industry is hesitant to commit to additional capital expenditure given the low level of oil prices, while the repeal of the IRA is likely to significantly harm what could have been a promising source of investment in the years ahead. Some Republican Senators, elected in states which were among the biggest beneficiaries of the IRA tax credits, are trying to soften the blow as the "Big Beautiful Budget Bill" is now under scrutiny in their own committees, but we always come back to the same issue: since the budget proposal is already inconsistent with debt stabilisation, protecting the IRA – which was a very expensive piece of legislation to start with – would require significant cuts elsewhere, or giving up on some of the tax cuts. Reconciling the "structural" and the "fiscal" aspects of Trumpnomics is difficult.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Non-farm payrolls (May) increased by 139k, below April's revised increase of 147k, and unemployment steady at 4.2% • NFIB hiring intentions (May) remain weak • ISM mfg PMI down slightly to 48.5 in May but new orders edged up to 47.6. Services index fell to 49.9 (down 1.7 points) and first time in contractionary territory since mid-2024 • Vehicle sales in May dropped to 15.65m (SAAR) from 17.25m in April with steep pull-back after pre-tariff surge	• NFIB bus optimism index to stay subdued, after 95.8 in April • Inflation in May see a firmer print, at 0.4% from 0.2% in April; rise in core inflation may be less than in headline • PPI in May could rebound some along with commd prices • Michigan consumer sentiments (prel) in June likely to recover some from 52.2 in May • Key to watch Fed's Quarterly Financial Accounts
	• ECB cut depo rate to 2.0% but stated it was well positioned under current conditions. Barring new shock, pause in July is acted. Further rate cuts are conditioned to weakness in growth and inflation. We change our call and see the ECB cutting rates only twice by year end (Sep and Dec) at 1.5% • Euro area May flash HICP came below 2% with huge deceleration in Svcs after Easter. Inflation to continue decelerating in coming months • Q1 GDP upgraded to +0.4%	• Need to monitor ECB governors' speeches after surprising comments made by the GC on the fact that under current circumstances (ECB baseline scenario) they are comfortable with current level of interest rates
	• BoE mortgage approvals (Apr) fell to 60.5K, from 63.6K • BoE consumer credit (Apr) rose to £1.6bn, from £1.1bn • Nationwide house prices (May) rose by 0.5%mom • Comp PMIs (May) increased to 50.3, from 48.5 • Construction PMI (May) rose to 47.9, from 46.6	• Labour market (Apr/May) PAYE data likely to drop again. AWE ex. bonus set to edge down • BRC Retail Sales (May) set to drop back after Easter boost in April • Monthly GDP (Apr) potential for mom decline • RICS House Price (May) likely to hold broadly steady
	• Comp PMIs (May) fell to 50.2,from 51.2 • Capital spending (Q1) up 6.4%qoq after a weak Q4 • Cash earnings (Apr) unch in yoy terms at 2.3% • HH spending (Apr) dropped by 1.8%mom • Leading Eco Index (Apr) fell to 103.4, from 107.6	• Final GDP (Q1) look for any upward revision to HH consumption • ECO Watchers Survey (May) look for small rebound • PPI (May) likely up 0.2%mom
	• Caixin manufacturing PMI drops to 48.3 in May, from 50.4 in April, and lowest since September 2022	• CPI and PPI (May) expected to edge up a little, given the Geneva deal and firmer oil prices • Exports (May) likely to rebound, esp. to the US. Strong exports to ASEAN to continue • Imports (May) may improve a touch from April's contraction
	• CB: Poland (on hold 5.25%), India (50bp cut to 5.5%) • GDP (Q1 yoy): Romania (0.3%) • CPI (May yoy): Thailand (-0.6%), Philippines (1.3%), Indonesia (1.6%), Peru (1.7%), South Korea (1.9%), Czech Republic (2.4%) • Industrial production (Apr yoy): Brazil (-0.3%), Hungary (-2.3% wda)	• CB: Peru (on hold 4.5%) • CPI (May): Brazil, Colombia, Hungary, India, Mexico, Poland, Romania • Industrial production (Apr): Colombia, Malaysia, Mexico, Turkey

Upcoming events	US:	Tue: NFIB small business optimism (May); Wed: CPI (May), Core CPI (May); Thu: PPI (May), Core PPI (May), Initial jobless claims (w/e 7 Jun), Continued claims (w/e 31 May); Fri: Michigan consumer sentiment (Jun, p), Michigan inflation expectations (Jun, p)
	Euro Area:	Wed: ECB wage tracker; Fri: GE HICP (May, p), GE CPI (May, p); FR HICP (May, p); SP HICP (May, p); EZ industrial production (Apr)
	UK:	Tue: BRC retail sales monitor (May), Unemployment ILO (Apr), Average earnings (Apr), Private sector regular pay (Apr); Thu: RICS housing survey (May), Monthly GDP (Apr), Index of services (Apr), Industrial production (Apr), Mfg output (Apr), Construction output (Apr), Trade balance ex-precious metals (Apr), Trade in goods headline (Apr), Trade in goods ex-precious metals (Apr)
	Japan:	Mon: GDP (Q1, p)
	China:	Mon: CPI (May), PPI (May), Exports (May), Imports (May), Trade balance (May)

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

About AXA Investment Managers

AXA Investment Managers (AXA IM) is a leading global asset manager offering a diverse range of global investment opportunities in both alternative and traditional asset classes. Through our products we aim to diversify and grow portfolios, while delivering long-term investment performance and value for clients.

AXA IM manages approximately €859 billion in assets*, and has €480 billion of ESG-integrated, sustainable or impact assets**. Our purpose is to act for human progress by investing for what matters. As a responsible asset manager, we are committed to integrating ESG principles across our business, from stock selection to our corporate actions and culture.

Part of the AXA Group, a worldwide leader in insurance and asset management, AXA IM employs over 2,800 employees and operates from 23 offices in 18 countries globally**.

*As at the end of June 2024, including non-consolidated entities.
** As at the end of December 2023.

Visit our website: http://www.axa-im.com
Follow us on Twitter: @AXAIM & @AXAIM_UK
Follow us on LinkedIn: https://www.linkedin.com/company/axa-investment-managers
Visit our media centre: www.axa-im.com/en/media-centre

Issued in the UK by AXA Investment Managers UK Limited, which is authorised and regulated by the Financial Conduct Authority in the UK. Registered in England and Wales No: 01431068. Registered Office: 22 Bishopsgate London EC2N 4BQ

In other jurisdictions, this document is issued by AXA Investment Managers SA's affiliates in those countries.