AXA Investment Managers

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Investment Institute Macroeconomics

Monthly Op-ed

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Meeting in the middle

Key points

- The Fed is likely to be more prudent on the pace of removal of its restrictive stance.
- Symmetrically, the ECB is readying to act more decisively to avoid inflation undershooting its target.
- This combination has supported the US dollar against the euro. The dollar has also gained versus the yen, with BoJ policy tightening prospects moving out. The shift in US election sentiment has provided a further boost.
- Fiscal policy in the US also looks set to remain more expansive, particularly than in the Europe where measures are being enacted to rein in excessive deficits.
- In the US fiscal issues are for now being over-looked, except in widening long-end swap spreads.

ECB concerned (finally)

Last month we wrote about the risk that the Federal Reserve (Fed) ends up "doing too much", providing too much accommodation too fast to a still very resilient US economy, while the European Central Bank (ECB) would stick for too long to its restrictive stance, failing to realise that the speed and depth of the deterioration of the real economy could usher in inflation undershooting in the Euro area. The recent dataflow may have forced both central banks to reconsider, and they could "meet in the middle", the Fed becoming more prudent, refraining from resorting again to "jumbo cuts", while the ECB sounded more atuned to the need to accelerate the removal of restrictive policy as inflation is falling faster than in its own recent forecasts.

In the US, a much better-than-expected employment report for September suggested the Fed may have overreacted to the rise of the unemployment rate at the beginning of the summer. The consumer price index for September, released last week, did not provide much respite to the doves at the Fed. Indeed, the Core Consumer Price Index (CPI) rebounded slightly in year-on-year terms to 3.3% from 3.2%, while the market was expecting an unchanged reading. Beyond the monthly volatility, what is emerging is a general stabilisation – or in a more pessimistic fashion the emergence of a "line of resistance" – of core inflation above 3% since late spring, a still uncomfortable pace relative to the Fed's target; given the usual gap between the CPI and the Personal Consumption Expenditures (PCE), the Fed's target measure of inflation, 2.5% on core CPI would be consistent with target. The short-term momentum is not very reassuring either, with the second acceleration in a row on the 3-month annualised rate.

The Fed had communicated on its tolerance of still robust gains in rents, whose weight in core CPI exceeds 40%, given the favourable trend in real-time indicators of new leases, but the acceleration in "services less shelter" has been steep in September (from 0.7% on a 3-month annualised basis in August to 3.0%). "Explaining away" the September print is not straightforward.

The Federal Open Market Committee (FOMC) members who have recently taken to the wires have acknowledged the recent dataflow and expressed a preference for proceeding at a measured pace with the continuation of the monetary easing. For 2025, a continuation of cuts, stopping well above the Fed's estimate of the neutral rate as proxied by its forecast of the long-term level of the Fed Funds rate (2.9%) is our baseline, but with a high level of uncertainty, as we have been arguing for months, given the impact the outcome of US elections could have on fiscal and trade policy.

While the Fed is sounding more prudent, the ECB is already acting more decisively. "*We are not blind*". This was in our view the key statement by Christine Lagarde at the October meeting. There was of course little suspense around the actual move – the market was pricing a 99% probability for a 25-basis point (bp) rate cut after her dovish hearing at the European parliament. We had been surprised in September by the fact that the ECB, upon releasing a new batch of forecasts, had only marginally revised down its growth forecast for the Euro area and kept the list and qualification of the downside risks unchanged. Christine Lagarde made it plain that the central bank was ready to respond quickly to a deviation from their baseline scenario.

Christine Lagarde made no mystery of the ECB's concern over the real economy in her Q&A, and the prepared statement added one element to the list of downside risks to growth: the possibility that a lack of consumer and/or business confidence throws a spanner in the wheels of the recovery which the central bank continues to expect, at least officially. This was clearly a Federal nod to some recent behavioural developments. While some rebound in purchasing power is materialising, since wage growth, albeit decelerating, is still outperforming declining inflation, the rise in the savings ratio is leaving consumer spending virtually flat. On the corporate side, the deterioration in profit margins – although conducive to faster disinflation – contributes to the ongoing contraction in investment.

As we expected, there was no return to forward guidance. The statement and Christine Lagarde's pronouncements were still consistent with the data dependent, one meeting at a time decision-making. Still, we can sense how a significant revision of the forecast can be expected for December, and it may be the right occasion to send a more decisive message on the future trajectory for policy rates. We agree with the market pricing of one 25bp cut at every meeting until June 2025, with the deposit rate hitting 2%, i.e. the upper end of what is commonly seen as the neutral level in the Euro area. We do not exclude the possibility that, on this path, the ECB resorts to one 50bp cut if the dataflow deteriorates faster.

Mighty greenback

Bond markets have adjusted to the expected path of US interest rates since the release of September's employment report. At the same time, the ECB has cut its key deposit rate again. Market pricing has the gap between the Fed Funds Rate and the ECB deposit rate remaining between 150-175bps through the next year. If the market is more cautious on the path of US rates – because of service sector inflation persistence, a labour market that may not be that weak, and fiscal policy uncertainty related to the election – one result may be a continued strengthening of the dollar.

Indeed, it is difficult to see which currencies might challenge dollar hegemony for the foreseeable future. The Japanese yen strengthened through the summer as the Bank of Japan (BoJ) announced its second policy rate hike at the end of July. However, there has been no further policy tightening. Markets currently have another 25bps or so priced in for the BoJ over the next year – hardly a rate profile that makes holding yen that interesting. Interest rates in the US will still be well over 300bps higher than in Japan next summer, on the basis of current market forward pricing. In real terms, short-term US rates should still be around 1% while short-dated Japanese rates will remain negative by about the same amount.

From a relative interest rate differential point of view, only sterling looks set to hold its own versus the dollar. The Bank of England (BoE) has been the least dovish of the major central banks. We expect rates to fall in the UK, not least because the Labour government is likely to err on the side of restrictiveness in its October budget. However, core inflation remains at 3.2% (headline inflation fell to 1.7% in September) and it is unlikely the BoE will cut rates more aggressively than the Fed. Sterling may not be able to keep pace with the dollar but it may outperform the euro and the yen, especially if the government is able to stress long-term growth plans in its fiscal statement.

Broad dollar strength

The US has well documented long-term fiscal issues. The Congressional Budget Office (CBO) sees the federal deficit remaining above 6% of GDP in coming years with the debt-to-GDP ratio rising above 120%. The difference between the US and Europe is how this plays out politically. In the current election campaign, there has been little discussion about how to rein in federal spending and improve the longer-term fiscal profile. Indeed, taken at face value, many of the policies espoused by the two presidential candidates are likely to lead to more borrowing, rather than less. That is even more likely under a Donald Trump presidency. His bias is towards lower taxes and less regulation. Meanwhile in Europe, as highlighted by the proposed fiscal tightening in France, getting borrowing under control is more of an immediate political priority. The European Union policy framework demands that governments set out credible plans to keep budget deficits at agreed targets. This means that US fiscal policy is likely to remain more expansionary than in Europe. Coupled with what looks likely to be a tighter monetary stance, this is a classic recipe for a stronger currency.

At some point, fiscal largesse might become an issue for markets. There is evidence across government bond yield curves of an increased risk premium at the long end. Measured by the difference between government bond yields and interest rate swap levels, bonds have cheapened in the US, UK and France this year. By contrast, on the same measure, corporate spreads are close to their narrowest, suggesting markets are not demanding a particularly large credit risk premium for corporate debt, particularly high quality. Eventually, a higher fiscal risk premium will have some systemic implications, but not yet – and markets are more focused on the fiscal-growth nexus than sovereign creditworthiness. On this basis, the dollar continues to win.

Trade policy will also be important

Ahead of the election, there has been a market narrative of being positioned for a Trump victory via bets on a strong dollar. Expectations of an aggressively protectionist trade agenda are one factor behind this. If the US does impose additional and significant tariffs on Chinese and European imports, then one response would be for currencies to weaken against the dollar to offset the impact of the tariffs. There is also likely to be a negative growth shock on countries that export to the US having their trade volumes impacted by US policy. Hence, the dollar could strengthen against currencies like the Chinese renminbi and Mexican peso. While it is hard to pick all the winners and losers from gradually rising protectionism – arguably, everyone loses in the end – it is clear that the US dollar would be a beneficiary.

US dominance

We are potentially heading to a more volatile time for markets given the uncertainties around the US election. However, the backdrop is that the US continues to stand out as the strongest economy in the world with the most buoyant financial markets. Early indications from Q3 earnings are positive, with banks and technology companies likely to lead the way in terms of surprises. The most recent data has poured doubt on the view that weakness in the labour market will undercut consumer spending. Companies and households have strong balance sheets, buffered by large cash holdings and those firms that need to borrow are able to do so at lower costs than for most of the last two years. Bonds and equities are expensive – based on current credit spreads and price-earnings multiples relative to the history of the last 10 to 20 years – but this is a sign of strength more than potential risk at this point in time. The narrative on other economies is not as bullish. China is trying to construct a large enough policy package to boost growth but details are sketchy and unconvincing so far. Europe is struggling with low productivity and a competitive challenge in key sectors, like automobiles, which are themselves being met with trade restrictions rather than structural reforms to boost productivity. Currencies are like share prices for a country, and it is hard to argue against the US currency being more in demand than its competitors given the current macro backdrop.

Download the full slide deck of our October Investment Strategy

AXA Investment Managers

23 October 2024

Macro forecast summary

Real GDP growth (%)	2023	2024*		2025*	
	AXA IM	AXA IM	*Consensus*	AXA IM	*Consensus*
World	3.1	3.2		3.1	
Advanced economies	1.7	1.6		1.5	
US	2.5	2.7	2.6	2.0	1.7
Euro area	0.5	0.7	0.7	0.9	1.3
Germany	-0.1	-0.1	0.0	0.5	0.8
France	1.1	1.1	1.1	0.6	1.1
Italy	1.0	0.8	0.8	0.8	0.9
Spain	2.7	2.9	2.5	2.1	2.0
Japan	1.9	0.0	0.0	1.1	1.2
UK	0.1	1.1	1.0	1.4	1.2
Switzerland	0.8	1.2	1.4	1.3	1.5
Canada	1.2	1.1	1.1	1.7	1.8
Emerging economies	4.0	4.2		4.1	
China	5.2	4.8	4.8	4.4	4.4
Asia (excluding China)	4.7	5.4		5.2	
India	6.5	6.9	6.9	6.5	6.7
South Korea	1.4	2.5	2.5	2.4	2.1
Indonesia	5.0	5.1	5.1	5.1	5.1
LatAm	2.3	2.0		2.5	
Brazil	2.9	3.0	2.7	2.0	2.0
Mexico	3.2	1.1	1.6	1.2	1.5
EM Europe	3.1	3.1		2.5	
Russia	3.6	3.2	3.6	1.5	1.7
Poland	0.2	3.1	3.0	3.7	3.8
Turkey	4.5	3.1	3.2	2.8	2.8
Other EMs	2.5	3.1		3.4	

Source: Datastream, IMF, Bloomberg and AXA IM Macro Research – As of 22 October 2024
**Forecast*

CPI Inflation (%)	2023	2024*		2025*	
	AXA IM	AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	4.7	2.6		2.2	
US	4.1	2.9	3.0	2.6	2.2
Euro area	5.5	2.4	2.4	1.9	2.0
China	0.2	0.5	0.5	1.6	1.3
Japan	3.3	2.5	2.5	1.8	2.1
UK	7.3	2.5	2.6	2.1	2.4
Switzerland	2.1	1.3	1.2	1.3	1.0
Canada	3.9	2.4	2.6	1.8	2.1

Source: Datastream, IMF, Bloomberg and AXA IM Macro Research – As of 22 October 2024
**Forecast*

These projections are not necessarily reliable indicators of future results

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Forecast summary

Central bank policy Meeting dates and expected changes (Rates in bp / QE in bn)		Current	Q4-24	Q1-25	Q2-25	Q3-25	Q4-25
United States - Fed	Dates	5.00	6-7 Nov 17-18 Dec	28-29 Jan 18-19 Mar	6-7 May 17-18 Jun	29-30 Jul 16-17 Sep	28-29 Oct 9-10 Dec
	Rates		-0.50 (4.50)	-0.25 (4.25)	-0.25 (4.00)	unch (4.00)	unch (4.00)
Euro area - ECB	Dates	3.25	17 Oct 12 Dec	30 Jan 6 Mar	17 Apr 5 Jun	24 Jul 11 Sep	30 Oct 18 Sep
	Rates		-0.50 (3.00)	-0.50 (2.50)	-0.50 (2.00)	unch (2.00)	unch (2.00)
Japan - BoJ	Dates	0.25	30-31 Oct 18-19 Dec	23-24 Jan 18-19 Mar	30 Apr - 1 May 16-17 Jun	30-31 Jul 18-19 Sep	29-30 Oct 18-19 Dec
	Rates		unch (0.25)	+0.25 (0.50)	unch (0.50)	unch (0.50)	unch (0.50)
UK - BoE	Dates	5.00	7 Nov 19 Dec	6 Feb 20 Mar	8 May 19 Jun	7 Aug 18 Sep	6 Nov 18 Dec
	Rates		-0.25 (4.75)	-0.25 (4.50)	-0.25 (4.25)	-0.25 (4.00)	-0.25 (3.75)
Canada - BoC	Dates	4.25	23 Oct 11 Dec	29 Jan 12 Mar	16 Apr 4 Jun	30 Jul 17 Sep	29 Oct 10 Dec
	Rates		-0.50 (3.75)	-0.50 (3.25)	-0.25 (3.00)	unch (3.00)	unch (3.00)

Source: AXA IM Macro Research - As of 22 October 2024

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

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

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