AXA Investment Managers

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Investment Institute Macroeconomics

Dies IRA?

- While the US IRA is getting lots of praise, we present here a short defence of the European net zero strategy.
- Just the right amount of improvement on the US bond market?
- The unemployment rate predictably rose in France in Q3 – consumers haven't noticed yet.

The seamless and apparently painless IRA, contrasting with the complex and carbon tax-heavy European net zero transition is contributing to the current narrative on the widening transatlantic performance gap. True, some aspects of the European approach should be reviewed, and its' easy to recognize the tangible effect the IRA is already having on US investment, but we continue to think that the US "all carrot and no stick" strategy could well end up being less efficient from a decarbonation point of view and more prone to counter-productive effects given its "adventurous" approach to fiscal sustainability. The current European strategy will probably continue to be challenged on the premise that it is less "pro-growth" than in the US, but we would highlight a recent quantitative work by the French Economic Analysis Council showing that with the right fiscal framework, even a sizable and generalised carbon tax, could be quite manageable in terms of employment impact.

Turning to more immediate considerations, the improvement of the US bond market is of course good news. Breaking down the US yield curve, we may have hit a "sweet spot": although correcting visibly from their recent peak, real long-term rates remain high enough to complement the Fed's action via its policy rates, while inflation expectations are low enough to help convince the central bank that enough has been done. There were still some concerning details in the otherwise encouraging CPI print for October, but the rebound in jobless claims confirms the message from the latest payroll data, pointing to more softening of the domestic sources of inflation ahead.

The unemployment rate rose in France by 0.2 percentage point in Q3 2023, exactly the quantum predicted by the pre-Covid relationship between GDP and unemployment. While this may not come as surprise from a macro point of view, surveys suggest that consumers have not yet taken the measure of the deterioration of the labour market. When they do, this could trigger more precautionary saving.

In Defence of Europe's net zero strategy

The Inflation Reduction Act (IRA) is one of the ingredients of the current resilience of the United States (US) economy – showing up for instance in the already visible rebound in manufacturing investment projects - in stark contrast with the increasingly dismal readings on the European economy. **There was nothing obvious there. Indeed, the European Union (EU) itself had been quicker than the US in engaging in its own green investment push**. After all, 37% of the EUR672bn to be funded under the Recovery and Resilience Facility is directed to climate objectives. There are three factors commonly discussed when explaining the actual and perceived larger impact of the IRA: one is the design of the package itself, which appears less bureaucratic, a second one is its uncapped nature, and finally the fact that the US approach to the green transition is "all carrot, and no sticks".

The first factor is probably valid. Since it involves a quite revolutionary approach to funding – the EU as a "federal" institution directly shoulders the debt issuance funding the Next generation package - a fairly complex implementation system making the gradual disbursements conditional on progress on a number of reforms agreed with each national government may have deprived the programme of some of its "shock and awe" potential. In addition, some key aspects of the European Commission's response to the IRA, notably the Net Zero Industry Act aiming at removing many of the administrative hurdles impairing the transition (for instance by mandating maximum instruction time for projects permitting), have yet to get through the other side of the legislative process.

Conversely, while we understand why **industrial investors may be favourably impressed by the financially uncapped nature of the IRA tax credits, this could down the road prove to be a self-defeating feature.** The IRA was initially presented as financially balanced since its funding seemed assured by some tweaks to corporate tax and a reduction in the government's social bill through more decisive action on the cost of medicines. Yet, the cost of the decarbonation incentives comes with no ceiling : an estimate of the tax credit take-up by the Congressional Budget Office was used as a reference value during the legislative process (USD370bn over 10 years), but enthusiasm for the package could push the figure much higher, up to USD1,200bn (some 5% of GDP) according to this paper by the Brookings. The IRA is not emerging in a vacuum. It cannot be detached from the growing focus on the medium-term fiscal trajectory of the US. **If the IRA ends up pushing federal debt even higher, it could add to the forces pushing long-term interest rates permanently higher, which would become self-defeating.** Indeed, decarbonation is a lengthy capital-intensive process which is of course affected by the level of funding costs. From a more political point of view, we are also concerned that, should the IRA trigger too much of a fiscal drift, the whole decarbonation/climate change mitigation agenda would come under even more partisan pressure than today in the US, further fuelling the backlash already at work.

Finally, even if in the short-run, going "all carrot and no stick" can be quite appealing for the US, especially in the context of the current fight for industrial relocations amid a major global re-jigging of supply lines, we are concerned by obvious risks this could become counter-productive. Let's take a simple example: modernising and securing the national electric grid is one area of focus of federal government intervention. This could further reduce the already low cost of electricity for industrial consumers in the US. Without a "stick", i.e., a cost directly associated with the production of greenhouse gases, some of the decarbonation benefits of the push towards renewable power generation could be offset by the relocation on the American territory of carbon-intensive production centres. The hybrid nature of the IRA – a decarbonation and an industrial sovereignty project – makes it prone to adverse side-effects.

The European approach, which combines carrots (subsidies, albeit with precise quantitative limits) with a stick (carbon pricing), is in our opinion more balanced and more efficient than the American one. From a political economy point of view though, an obvious issue is that the IRA appears as more "pro-growth" – with the caveat we mentioned if it ends up taking interest rates up - adding to Europe's current feeling of losing ground. We suspect Europe's capacity to sell its decarbonation approach to its public opinion – and to external investors – lies largely in how it can affect job prospects. On this, we have recently had good news, in the form of thorough quantitative research by the French Council of Economic Analysis (CAE) (see link here).

The authors simulate the impact of a carbon tax worth EUR100/ton across the French economy (hence a magnification of the current trend towards an extension of the tradable carbon emission allowances to more sectors)**,** looking at both the aggregate and the sectorial outcomes. If the product of the tax is used to reduce public debt, the impact on GDP and employment would be tangible (a loss of 0.75% and 0.6% respectively). The tax receipts could however be entirely redistributed. In the simulation, the component shouldered by households would be offset by an income tax cut, while the one shouldered by the corporate sector would be compensated by a decline in the employers' social contributions rate. Then the impact on GDP and employment becomes marginally positive (+0.3%). This result is hardly surprising but conveys nonetheless a key message: in the current circumstances when governments are coming under more pressure to reduce the fiscal deficits, a recourse to carbon taxes can be very tempting. Yet, given the magnitude of the potentially adverse effect on growth and employment, this could quite quickly turn counter-productive and trigger in Europe – where public opinion so far has remained quite supportive to the fight against climate change – the kind of backlash already at work in the US.

But the sectorial results of the CAE study were in our view the most interesting ones. Even an entirely redistributed carbon tax would still affect sectors and businesses differently, depending on their current carbon intensity. The authors investigate the impact of the tax hike at a very high level of disaggregation for the French industry. One key conclusion is that, as energy mixes differ widely across businesses within the same sectors**, the impact of the tax itself on employment would vary more *within* sectors than *across* sectors**.

Why does it matter? We are tempted to connect this finding with a recent National Bureau of Economic Research (NBER) study by Brian Kovak and Peter Morrow (see link here), highlighted by the Peterson Institute, on how Canadian workers dealt with the disappearance of trade tariffs between Canada and the US under North American Free Trade Agreement (NAFTA) in the early 1990s. Suddenly, industries which had been protected by massive customs duties fell under the direct competition of larger US producers. Kovak and Morrow show, although NAFTA brought about quite a lot of labour re-allocation in Canada in the short-run, workers' long-term outcomes in terms of pay and capacity to remain employed were largely intact. One potential explanation is that tariffs varied enormously across products *within* sectors. This made it easier for people to transfer from one business hit negatively to another one without too much loss of skills.

The impact of the fight against climate change on employment is too often painted as a binary shock, with industrial jobs losing to services ones, which could trigger massive re-training issues. The CAE paper shows that this is far too simplistic. Industrial workers could move *within* the same sector, and hence transfer their skill set, from carbon-intensive companies to "greener" ones. The authors stop short of making this an explicit, "happy" conclusion, but their point on the overall reallocation effect they estimate (a total 4% of jobs would disappear and reappear) being much smaller than the usual employment turnover in France hints at an optimistic outlook.

Another aspect of the Canadian "natural experiment" dissected by Kovak and Morrow is that information was plentiful at the time of NAFTA. It was relatively straightforward to work out whether a specific business would lose or win because of the disappearance of the customs duties. This might explain – the paper mentions this only as a conjecture – why Canadian workers dealt with the NAFTA shock better than with the competition from Chinese products, which was less straightforward to comprehend. The CAE authors also call for a high level of information dissemination on the carbon intensity at the sectorial and business level. **One of the benefits of carbon pricing – especially if market volatility can be minimised - is that it helps planning and allow stakeholders to design coping strategies.**

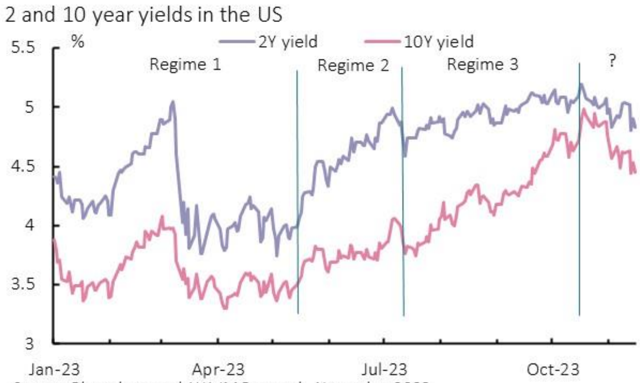
Of course, it is always possible to dispute the parameters of the authors' models, or point out that France already is a fairly low-carbon economy by the standards of developed nations, which would suggest the impact of carbon taxes of this magnitude could be higher elsewhere in the EU or in the US, but we found it important to highlight this paper in order to bring some nuance to the current "euro-pessimistic" mood. These findings help us to remember that the often-overstated economic cost of mitigating climate change is always smaller than the cost of allowing climate change to "run its course".

A sweet spot for the market

Now, getting back to more immediate considerations, the US bond market continues to recover from its bout of fever. The better-than-expected inflation print for October, and probably the market taking on board the feedback loop from its own action (too elevated bond yields would ultimately trigger the very recession investors had stopped believing in), led to a correction in 10-year yields of more than 50bps from the recent peak, exceeding the small re-assessment of the Federal Reserve (Fed)'s expected stance crystallised in the decline in the 2-year rate (see Exhibit 1). In a nutshell, we are now witnessing the opposite of the dominant pattern seen last summer when 10-year yields were rising despite a stabilisation of the market's outlook for the Fed.

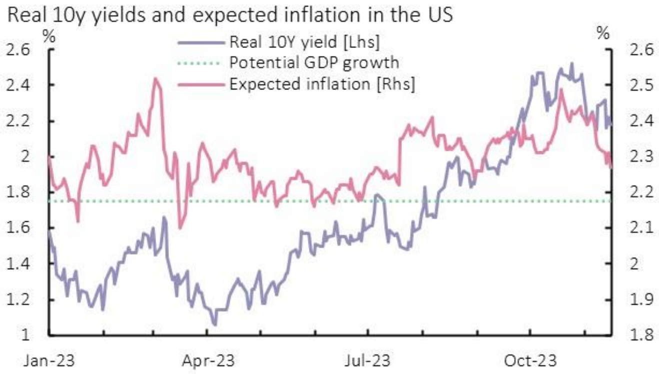
Explicitly taking into consideration overall financial conditions in the calibration of the monetary policy stance was the main innovation in the Fed's communication on 1 November. This made a lot of sense given the level of restriction brought about by the market-driven tightening. The distance between real rates *across the entirety of the curve* and potential GDP growth can be a good yardstick. What was striking in the summer/early autumn of this year was how 10-year yields deflated by the market's own 10-year inflation expectations had started to exceed 1.75%, the widely accepted estimate of potential growth in the US (see Exhibit 2). Despite the correction observed over the last few weeks, this is still the case: real 10-year yields stood at 2.16% on 17 November, albeit down from a recent peak at 2.52% on 25 October.

Exhibit 1 – Breaking with the summer pattern



Source: Bloomberg and AXA IM Research, November 2023

Exhibit 2 – 10-year real rates above potential growth



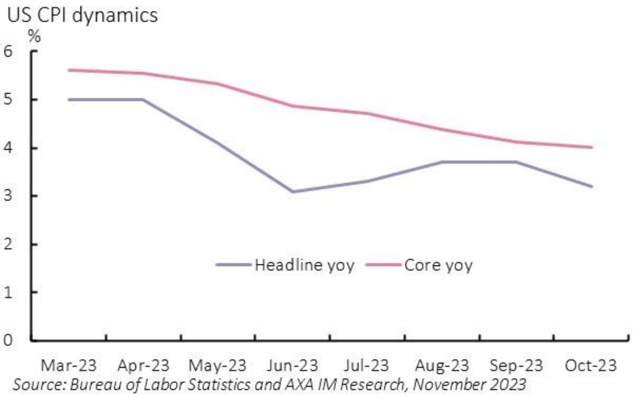
Source: Bloomberg and AXA IM Research, November 2023

Even if there may be good reasons to believe potential GDP is accelerating in the US, for instance because of the innovation spur brought about by artificial intelligence and/or the investment push triggered by the IRA, the impact is probably more in the range of a few decimals – especially in the short-run - than of a massive re-set. **2.16% on a 10-year real rate, still some 40bps above the central value for potential GDP growth, thus offers some "safety margin"** against a possible adverse reaction of the Fed we warned about two weeks ago. Indeed, taking into consideration overall financial conditions should go both ways: if the market retraces too far, bringing real rates back into neutral or accommodative territory, then – considering that the job on getting inflation durably to 2% is unfinished – the central bank would be justified in delivering more hikes.

The other source of comfort is brought by **market-based inflation expectations**. Indeed, although they have been more stable than real rates – fortunately for the Federal Reserve's credibility – they have been receding recently. They fell from a recent peak at 2.49% on 19 October to 2.28% on 17 November, hence fully consistent with the Fed's definition of price stability given the usual gap between Consumer Price Index (CPI), the reference for inflation-linked bonds, and Personal Consumption Expenditures (PCE)**. In a nutshell, real long-term rates remain high enough to complement the Fed's action via its policy rates, while inflation expectations are low enough to help convince the central bank that enough has been done.** This is not a too bad configuration for the market.

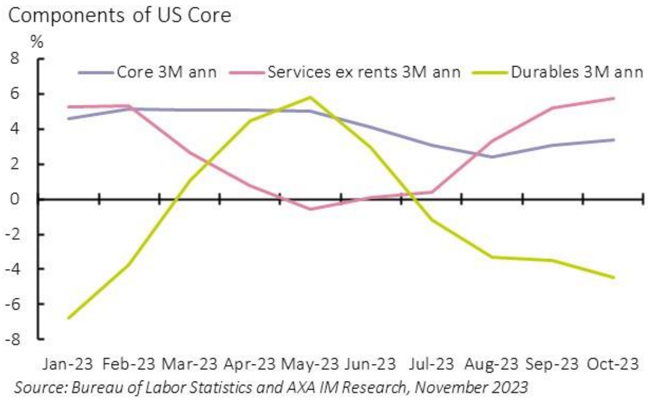
While it's always tempting to be dismissive of market-based long-term inflation expectations given their tendency to react too much to recent price prints, in the present case their correction started *before* the release of better-than-expected inflation numbers for October last week, even if the decline intensified afterwards. Headline inflation fell to 3.2%yoy in October from 3.7% in September, thanks to a decline in energy costs, but the most reassuring development was the continuation – albeit at a very gradual pace – of the deceleration in core prices to 4.0%yoy, down from 4.1% in September (the market consensus was on an unchanged yoy). This was the slowest rate of core inflation since September 2021 (See Exhibit 3).

Exhibit 3 – Down and down it goes (albeit slowly)



Source: Bureau of Labor Statistics and AXA IM Research, November 2023

Exhibit 4 – Services/manufactured goods gap widening

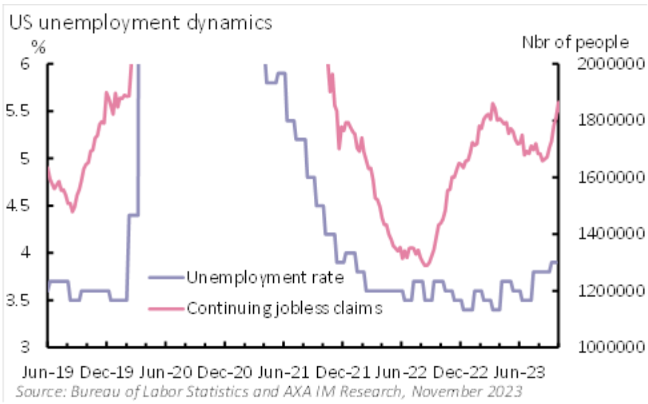


Source: Bureau of Labor Statistics and AXA IM Research, November 2023

There were however some concerning details in the CPI release. For two months we have been focusing on the divergence between the behaviour of manufactured goods' prices, which have been declining in reaction to normalising supply conditions globally, the dollar appreciation and the general softness in demand for this type of products since the reopening, and services prices excluding rents. The gap widened again in October (see Exhibit 4). There were technical factors at play in October, notably around the Bureau of Labor Statistics' (BLS) accounting for the cost of medical insurance, but the recent trend is worrisome. The purely domestic engines of inflation have not switched off yet.

Still, there may be some "domestic disinflation" in the pipeline via the labour market. We have already commented the payroll print for October, which was obviously a key ingredient, especially the rise in the unemployment rate, but we can cross check this with the weekly jobless data: their decline between April and September was a key sign of the resilience of the labour market, which played a role in the bond yields' "fever" last summer. This has now reversed (see Exhibit 5), with a gradual rebound in continuing claims back to the levels seen at the beginning of this year.

Exhibit 5 – Jobless claims rising again



Source: Bureau of Labor Statistics and AXA IM Research, November 2023

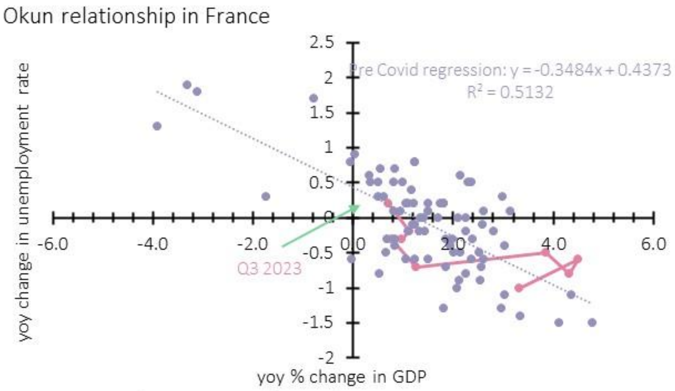
None of this is truly alarming for the state of the US economy (yet). Retail sales for October were always going to draw attention given the expected impact of the resumption of student loans' repayment on purchasing power. The market was bracing for a negative reading. In reality, ex-auto sales rose by 0.2% on the month. We are still in a situation where, even if the labour market is softening, there is still enough job creation, combined with decent nominal wage growth and sharply decelerating headline inflation, to provide a floor to purchasing power.

More (bad) news on the French unemployment front

Two weeks ago, we mentioned with some concern data pointing to a slowdown in hiring in France and a rise in registered unemployment. This has been confirmed with the increase by 0.2 percentage point (to 7.2%) of the unemployment rate in Q3. This should not come as a surprise, given the slowdown in economic activity over the last few months.

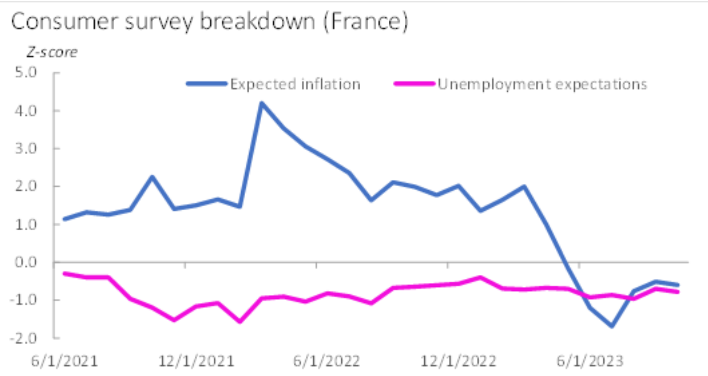
What strikes us in fact is how sadly predictable it was. We estimated the Okun relationship – how the unemployment rate reacts to GDP movements – over the 20 years preceding the Covid pandemic (the blue dots and the regression line in Exhibit 6). Unsurprisingly, the relationship broke completely during the pandemic – employment was protected by massive government intervention while GDP was plunging – but we looked at how the Okun law played out since mid-2021 (the red "path" in Exhibit 6), when the bulk of the pandemic volatility was absorbed. After a "horizontal phase" during which the unemployment rate seemed to be immune to the deceleration in GDP, the relationship normalised, and **the 0.2 percentage point rise in the unemployment rate over one year observed in Q3 is *exactly* what the pre-Covid Okun law would have predicted**. There was always a hope that the rise in hiring difficulties would push employers towards labour hoarding, thus blunting the elasticity of employment to changes in aggregate demand. This does not seem to be material.

Exhibit 6 – Predictable rebound in French unemployment



Source: INSEE and AXA IM Research, November 2023

Exhibit 7 – People have not noticed yet

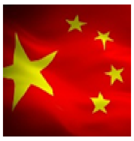


Source: European Commission, AXA IM Research, November 2023

While this might not be a surprise from a macroeconomic point of view, this may still come as a shock to consumers. Indeed, France has been enjoying for some years a downward trend in unemployment, and the government's own objective is "full employment", defined as an unemployment rate around 5% which, while ambitious, did not seem to be out of reach given the recent performance. While 7.2% remains historically low in France, the rebound is casting doubt on this perspective. Looking at the components of the European Commission's consumer sentiment survey, it's obvious that while French households have reacted to the recent disinflation and significantly revised down their expectations for inflation over the next 12 months, which are now below their long-term average, they haven't (yet) responded to the deterioration in the job market (see Exhibit 7).

Since it is likely that the public is more sensitive to news around dismissals than on slower hiring, the very recent rebound in the unemployment rate may not have significantly altered their perceptions. Most of the pick-up is due to the non-renewal of short-term contracts, rather than on the termination of the typical indefinite contracts. There is however usually a progression, from non-renewals to dismissals. **We are concerned that once French consumers take the measure of the deterioration in their employment prospects, they respond with a hike in precautionary savings, even though their accumulated savings, and the current savings rate, are already high.** The rebound in consumer spending was the silver lining to an otherwise paltry Q3 GDP (consumption rose by 0.7%qoq, GDP by 0.1%). We also believe the latest developments on unemployment are bad news for the already struggling residential investment. The combination of high mortgage rate with compromised job prospects is the usual recipe for a proper “buyer strike” on the housing market.

Habitual readers of Macrocast may be surprised by how focused we are on labour developments in a single member state of the Euro area and ascribe this to your humble servant’s undeniable Frenchness, but we think the latest developments in France are very relevant for the European Central Bank (ECB). While one could – at a stretch – explain Germany’s weakness as purely “externally” and “supply-side” driven (a mixture of specific sensitivity to Chinese demand and production bottlenecks), the softer economic trends in France are clearly demand-driven. This should act as another warning to those at the Governing Council who consider that not enough pain has been doled out.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• CPI inflation (Oct) retraced to 3.2% (core 4.0%), modestly below expectations as gas prices fell • Retail sales (Oct), fell by 0.1% (control +0.2%), softening post a strong Q3, but not yet weak • UST yields fell sharply post-CPI to 2-month low • Presidents Biden & Xi met. Xi keen on improved business relation, military comms resumed	• FOMC minutes (Nov) to gauge range of views of further hikes, and resistance to cuts • Existing home sales (Oct) expected under continued pressure given recent mortgage rate increases • Jobless claims, rising on a continuing basis. Watch seasonal distortions, but monitoring further gains • PMIs (Nov, p) particularly any weakening in services
	• 2nd estimate of GDP growth (Q3) was unchanged at -0.1%, employment surprised on the upside, growing by +0.3%qoq • German ZEW Economic sentiment (Nov) improved to 9.8 (from -1.1) • EMU Industrial production (Sep) fell by 1.1%mom • EMU inflation (Oct) was unchanged at 2.9%yoy for headline and 4.2% for core	• EMU flash consumer confidence (Nov) • November economic surveys from INSEE business climate in France, Ifo in Germany and flash PMIs for EMU, Fr and Ge • German detailed GDP (Q3) to assess ongoing consumption weakness • ECB minutes (Oct meeting)
	• CPI inflation (Oct) fell more than expected to 4.6% from 6.7%, lowest rate since • Labour market (Sep), exp unemployment unch at 4.2%, earnings slowed to still high 7.9% (3m yoy) • Retail sales (Oct), further decline across most sectors as households feel squeeze	• Autumn Statement expected to see little change to fiscal stance, focus on investment incentives • Public finances (Oct) in light of OBR projections • Consumer confidence (Nov) watch for any rebound in light of falling inflation • PMIs (Nov, p) watch for signs of weakening
	• Preliminary estimate for GDP (Q3) largely surprised on the downside, in particular consumption (0%qoq) and capex (-0.6%). A rebound was expected but they go deeper in contraction	• CPI (Oct) is likely to rise to 3% (+0.2pp), matching recent increase in Tokyo prices. Core inflation would drive the rise this month • Flash PMIs (Nov)
	• Exports (Oct): -6.4%yoy (Sep: -6.2%); Imports (Oct): 3.0%yoy (Sep: -6.2%) • CPI (Oct): -0.2%yoy (Sep: 0.0%); PPI (Oct): -2.6%yoy (Sep: -2.5%) • TSF (Oct): 1.85tn RMB (Sep: 4.12tn) • Industrial production (Oct): 4.1%yoy (Sep: 4.0%) • Retail sales (Oct): 7.6%yoy (Sep: 5.5%) • Fixed asset investment (Oct): 1.2%yoy (Sep: 2.4%)	• Mon (20 Oct): Loan Prime Rate (1Y & 5Y)
	• CB: Peru (7.0%) & Philippines stood on hold (6.5%) • October inflation (yoy) fell in Brazil (4.8%), Hungary (9.9%), India (4.9%) & Romania (8.1%). It rose in Czechia (8.5%), Poland (6.6%) & Russia (6.7%) • Q3 GDP (yoy) contracted in Colombia (-0.3%), Hungary (-0.4%) & Peru (-1.3%). It accelerated in Poland (0.4%) & Russia (5.5%)	• CB: Indonesia (6.0%) & South Africa (8.25%) are expected to stay on hold. Hungary to cut -75bps to 11.5%. Turkey is poised for a hike, but the magnitude remains uncertain • Reaction to the presidential runoff elections in Argentina (Sunday) • Q3 GDP data in Chile, Mexico & Thailand • Industrial production (Oct): Poland & Taiwan

Upcoming events		
	US:	Mon: Leading index (Oct); Tue: Existing home sales (Oct), FOMC minutes (Nov); Wed: Durable goods order (Oct), Weekly jobless claims (18 Nov), Michigan consumer sentiment & inflation expectations (Nov); Fri: Manf & services PMI (Nov)
	Euro Area:	Mon: Ge PPI (Oct); Wed: ECB publishes Financial Stability Review, Consumer confidence (Nov); Thu: Fr Insee manf confidence (Nov), Fr, Ge,EA Manf & services PMI (Nov), EA Composite PMI (Nov), ECB publishes Monetary policy account for October meeting; Fri: Ge GDP(Q3)
	UK:	Tue: PSNB (Oct); Wed: Chancellor Hunt announces the Autumn Statement, CBI Industrial Trends survey (Nov); Thu: Manf, composite & services PMI (Nov); Fri: Gfk consumer confidence (Nov), Nationwide HPI (Nov)
	Japan:	Thu: CPI (Oct), National ‘Core’ CPI (Oct); Fri: Manf PMI (Nov), Leading Index (Sep)
	China:	Mon: PBoC Announcement (Nov)

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