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Research & Strategy Insights

Beyond the deal

56 – 27 July 2020

Key points

- Note to our readers: Macrocast is taking a summer break. Thanks a lot for your interest, support and suggestions so far. Next issue on 31 August.
- Comments may focus this week on a deeper recession in Europe than in the US in Q2, but the opposite picture is emerging for Q3. On the policy side as well, while in the US some "stimulus fatigue" may be appearing after the initial "overkill", the EU has managed to produce a deal on the Recovery and Resilience Fund (RRF). The deal is a strong signal, but a lot remains on the EU's plate still.

The US risk-taking on the pandemic front did not pay. While this week the first estimates for Q2 GDP will likely reveal a much deeper recession in the Euro area than in the US in the spring, in contrast the summer rebound looks more promising in Europe than in the US. The progression of the virus in some of the new US hotspots is slowing down, but it is now clear that the normalization of activity – from a too elevated circulation of the virus when the lockdowns were relaxed – was premature. The labour market is showing some signs of relapse as well. This creates a policy headache: the US government has already spent a lot, engaging in "overkill" support in our view, testing the patience of the fiscal hawks in the Republican party. The weekly 600 dollars top-up to unemployment insurance is expiring at the end of the week. Negotiations will run in overdrive in Congress this week. More stimulus is likely to come – given the electoral calendar -but we think it will be less generous.

In contrast, Europe "looks good". Of course, the EU has its issues as well. Even if the pandemic is in better control in Europe than in the US the recent flare-ups in several countries and the first signs of internal EU borders closing again are concerning – but it is managing to come up with policy solutions which may not move the dial much in terms of immediate macroeconomic support but at least send a positive signal to public opinion and investors. Given the complexity of the EU institutional set-up and how far apart the initial positions were, the agreement in the Recovery and Resilience Fund is very reassuring. Once again, the usual "existential concerns" about the future of the EU have been put to bed.

Still, many concessions have watered down the initial Franco-German proposal. Governance could be cumbersome and from a macroeconomic point of view the direct additional stimulus to expect from the RRF should not be overstated. Fundamentally, delivering on the EU's "own resources", on which a lot remains to be negotiated, will be key to determining whether a proper fiscal union is on the tracks. From a financial point of view, this will also be crucial to assess the chances of the EU to become a perennial major player on the bond market, turning the euro into a fully-fledged alternative to the dollar as a reserve currency.

A quick retrospective look

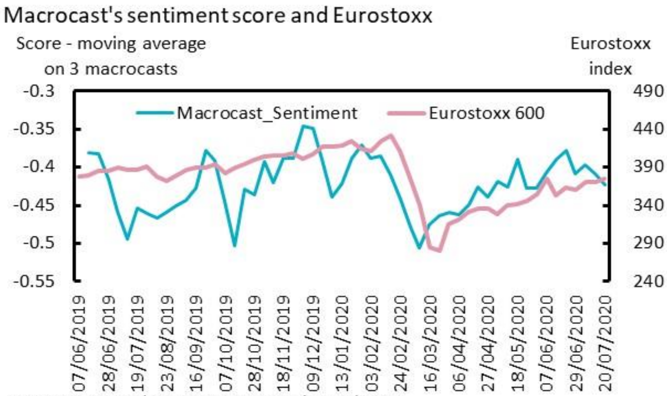
Macrocast is taking a breather in August. Before we take a last look at the economic news flow before September, it may be the right time, after a bit more than a year, to take a retrospective look at this product. Two young and very promising members of AXA IM Research macro team, Hugo Le Damany et Emmanuel Makonga, have recently published a topical research paper using Natural Language Processing (NLP) to "decode" the Fed's beige book and the Fed's statements. The idea is to filter those texts for key words and quantify precisely their optimism/pessimism tenor. They have been kind enough to submit the existing 55 issues of Macrocast to their filter.

The first lesson – which might not come as a surprise to habitual readers – is that Macrocast has been firmly in the bearish camp. Le Damany and Makonga's NLP index is normalised between -1 (most pessimistic) and +1 (most optimistic). Macrocast averages a properly grumpy -0.42. Biases are unavoidable, but they need to be acknowledged and if possible held constant. At least, your humble servant has been constant in his grumpiness.

The second lesson is that there has been some predictive content in Macrocast since the beginning of the pandemic crisis. Nothing spectacular, but we turned more pessimistic a few weeks before the market properly reacted and rebounded from peak pessimism a bit before the market (Exhibit 1). On the real economy side, Macrocast turned more pessimistic before the Euro area's purchasing managers' index started free-falling with the pandemic, and symmetrically turned more optimistic before the rebound in the PMI (Exhibit 2). Careful observers will have noticed that Macrocast has taken another pessimistic turn in the last few weeks – albeit to much lesser degree than in March – in contrast with the market's continued optimism. This reflects our concern with the relapse of the pandemic in the US and spillover effect on economic activity which so far, the market has chosen to shrug off.

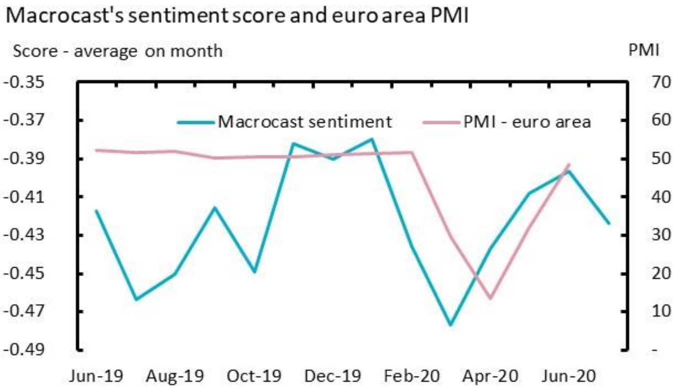
Of course, now that your humble servant has been made aware of all this by the NLP approach, there is a possibility that the predictive power of Macrocast could suffer. Upon reading Emmanuel and Hugo's findings, I could not stop thinking about a character in a novel by David Lodge who has his fiction submitted to a computerised analysis, revealing to him all his writing idiosyncrasies. The result was a permanent writer's block. You should not be so lucky though, dear reader. Before I rest my pen for a few weeks you will still need to endure a bit more of depressing prose.

Exhibit 1 – Some predictive power over equity market inflexions during the Covid-crisis…



Sources: STOXX and AXA IM Macro Research, 21 July 2020

Exhibit 2 - … as well as on economic indicators



Sources: Markit and AXA IM Macro Research, 21 July 2020

Relapsing US labour market

We have made intensive use of the new "real time data" since the beginning of the pandemic, to try to capture the signal within the noise of traditional macroeconomic surveys which are less reliable in times of extreme movements in activity, while "hard data" – e.g. industrial production – tend to be available only with a fairly long lag. **This does not mean these new sources, such as Google or Apple mobility reports, are perfect**. Far from it. A key issue for us as we advance into the summer is that they are not corrected for seasonal factors. For instance, in the case of Google, these datasets show how visits and length of stay at different places change compared to a baseline which is defined as the median value, for the corresponding day of the week, during a 5-week period in January and early

February 2020. In other words, **we are now looking at summertime activity by reference to a winter baseline.** We tried to deal with this by calculating the average across the different components of the indicators to capture aggregate activity – e.g. in the summer we would expect activity in parks and recreation to rise and workplace activity falls – but at some point, we want to cross-check these new indicators with more traditional ones.

We have been highlighting the relapse in activity in the US for some weeks, revealed by those real-time indicators. This is now being confirmed by one piece of "hard data" which comes with only a short lag: the weekly jobless claims. 1.416 million Americans applied for unemployment benefits in the week to 18 July (seasonally adjusted) against 1,307 million the week before. We must be cautious though because the seasonal correction was significant (without the correction jobless claims would have fallen on that week) and the series is volatile, but this was the first weekly rise since the end of March. So, it seems that the relapse in activity reflected in the mobility indices is now being translated in a slower pace of "re-hiring" of laid-off workers.

This relapse is a policy headache. We made the point in Macrocast that policy support in the US was in "overkill mode", triggering as of May 2020 (latest available data) a *rise* in aggregate income relative to the pre-pandemic level**. An issue now is that while the US economy is missing on its V-shape recovery, the government has already spent a lot, testing the patience of the fiscal hawks in the Republican party.** As things stand at the time of writing this note (on 26 July), the federal "top up" of USD600USD per week boosting the states' unemployment benefits schemes will expire on 31 July. The Republicans are proposing to replace this blanket top-up with a means-tested differential subsidy which would guarantee 70% of pre-pandemic income (a replacement rate close to the Europe levels). A problem though is that in many cases the states do not seem to able to get their systems in order to make this differential premium technically possible quickly. A compromise solution would be to lower the blanket top-up to USD200 per week. There is very little time to come to a bi-partisan deal.

Ultimately, with the elections looming, we are convinced that more stimulus will be agreed on, but the combination of disappointing data and conflictual politics is not helping the US at the moment, which by contrast puts Europe in a much better light. Of course, next week as the first estimates for Q2 GDP will be released in both the Euro area and the US, the latter may look good (we think the US GDP fell by 7% quarter-on-quarter against 13% for the Euro area) but for now Q3 looks more promising in Europe than in the US. **The EU has its issues as well** – as we discussed last week, even if the pandemic is in better control in Europe than in the US the recent flare-ups in several countries and the first signs of internal EU borders closing again are concerning – **but it is managing to come up with policy solutions which may not move the dial much in terms of immediate macroeconomic support but at least send a positive signal to public opinion and investors.**

RRF: *habemus* deal!

A deal on the Commission's "Next Generation" proposal – heavily drawing on a Franco-German initiative – finally came through last week. After four days of tough negotiations, the mere existence of an agreement is probably what matters in the short run from a market perspective, since once again the usual "existential concerns" about the future of the EU have been put to bed.

Initial positions were very far apart. Issues pertaining to the very principles of the union were raised. But **ultimately a deal was done and some important taboos – in particular debt mutualisation – have been broken. In the year of Brexit, it is reassuring**. We note that some seasoned observers who have through much of their career been very sceptical about the monetary union are changing their mind. For instance, Stephen S. Roach in a column for Project Syndicate on 22 July, wrote that *"like many, I have long been critical of Europe's Economic and Monetary Union as a dysfunctional currency area (…) there was always a critical leg missing from the EMU stool: fiscal union (…). Not anymore".*

Now, **beyond the powerful symbols, from a macroeconomic point of view, the package is less ambitious than the initial Franco-German proposal, and is laden with future difficulties**, given its complex governance and the negative financial spillover effects on other areas of EU expenditure.

The overall figure of EUR750bn was protected in the end, but the grants (the key item) are reduced from an initial EUR500bn to EUR390bn. Since the negotiation focused on a round figure of 400bn (anything below was unacceptable to France and Germany, anything above unacceptable to the "frugals") a "trick" was found: it is 390bn "at 2018 prices". So, with a bit of inflation it will end up above EUR400bn in current euros.

The "frugals" wanted a "veto right" on the way money is used by the member states. They failed to secure it, which would have been a deal-breaker for the most fragile states, but the governance process is going to be cumbersome.

The "recovery and resilience programme" produced by each member state describing their planned use of the resources will need to be endorsed by the EU council at a qualified majority on a proposition from the Commission which will take macroeconomic issues into consideration. **This may open the door to the sort of macroeconomic conditionality the peripheral countries did not want.** Expect the populists in the South to focus on this to denounce the deal, even if so far, we note that Matteo Salvini was unusually low-key in his criticism of what the Italian government got from the negotiations in Brussels. We suspect he is biding his time until the process starts in earnest.

Then, if one member-state considers another one is not delivering on the program's targets, it can refer the matter to the next EU council. Ultimately the European Commission seems to have the final word, but it will still have to take on board the discussions at the Council. In practice, if only one member-state objects, odds are the Council will ultimately reject its concerns. Yet, it seems that the deal offers the possibility for the "frugals" to slow down the process and potentially trigger some volatility – a dissuasive weapon. Separately, the rebates to the frugals' contributions to the EU budget are significantly increased and enshrined in the deal. This was expected but again likely to play in the hands of the populists in the south.

In order to protect as much as possible the share of the grants which will go to the member states directly, the share of the grants going to the EU-wide funds is reduced relative to the previous proposals (Exhibit 3). This will hurt for instance the Just Transition Fund which was intended to help deal with the social consequences of the green transition in the regions. **This is likely to be hard fought by the European Parliament (EP).**

Exhibit 3 - Look beyond the total

EU instruments (EUR bn)	EC proposal	Final agreement
Recovery and Resiliency Facility	560.0	672.5
of which loans	250.0	360.0
of which grants	310.0	312.5
ReactEU	50.0	47.5
Horizon Europe (Research)	13.5	5.0
InvestEU	15.3	2.1
Rural Development	15.0	7.5
Just Transition Fund (Green)	30.0	10.0
RescEU	2.0	1.9
External Action	10.5	3.5
Others (Solvency Support Instrument, Strategic Invetsment Facility, Special Humanitarian Aid...)	53.7	-
Total	**750**	**750**
of which grants	500	390

Source: European Commission and AXA IM Macro Research, July 2020

Members of the European Parliament (MEPs) from the centre-right, the centre-left, the Liberals and Greens backed a resolution stating that they do not accept the terms of the agreement, intertwined with the 2021-2027 budget framework. On top of the disappointment on the cuts to the horizontal programmes, the "rule of law" conditionality on the RRF – which was bitterly resisted by Hungary and Poland – has been watered down and the compromise is drawing criticism from many members of the key parliamentary groups. Contrary to what the British Eurosceptics have been arguing for years, the EU institutional set-up has been increasingly ticking the boxes of what is widely seen as constitutive of parliamentary democracy: the European parliament can reject the budget.

Our baseline is that the EP will ultimately endorse the deal, given the absence of credible alternatives (chances of achieving a better outcome in the European Council are slim). But there will be noise. The Green parliamentary group will probably play a key role on this (the old "centre-right and socialist" condominium, even extended to the

Liberals, no longer controls a majority of the EP). The fact that the Commission managed to protect the pledge that 30% of the spending through the RRF will need to contribute to the green transition may help keep them on board. Still**, for now, the deal is another sign of the dominance of the inter-governmental, rather than "federal" nature of the EU**: The Commission has been largely side-lined. The power broking capacity is firmly in the European Council, with a key role for its President, and in the national governments. The EP is presented with a "fait accompli".

Is it really fiscal union?

The deal is probably more important from a political and symbolic point of view than from the chances to affect cyclical conditions quickly. We are talking about a quantum of expenditure for the grants below 0.4% of the EU GDP per annum until 2027, with a slow build-up. It can't be a full substitute to national fiscal efforts, far from it.

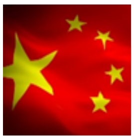
On the key issue of the allocation of the funds, 70% will be allocated (although not actually disbursed) in 2021 and 2022 following the Commission's initial proposal: the lower the GDP per head and the higher the unemployment rate before the pandemic the bigger the share of each country, so a very favourable allocation for the peripherals. From 2023, the unemployment criteria will be replaced by the actual post pandemic GDP loss. This is another reason why the actual disbursements will be slow.

A key question is whether this is only a "first step" on which the EU could build a more proper federal budget. It is not obvious. The conclusions of the council make it crystal clear that it is a one-off, and since the new scheme is enmeshed in the EU's multi-annual budget process – covering 2021-2027 – no further push is likely before the end of this round.

A crucial test on this front will come from the rise in the EU's own resources. On this it is worth looking at the exact words of the Council agreement: *"The Union will over the coming years work towards reforming the own resources system and introduce new own resources. As a first step, a new own resource based on non-recycled plastic waste will be introduced and apply as of 1 January 2021. As a basis for additional own resources, the Commission will put forward in the first semester of 2021 proposals on a carbon border adjustment mechanism and on a digital levy, with a view to their introduction at the latest by 1 January 2023. In the same spirit, the Commission will put forward a proposal on a revised ETS scheme, possibly extending it to aviation and maritime. Finally, the Union will, in the course of the next Multiannual Financial Framework (MFF), work towards the introduction of other own resources, which may include a Financial Transaction Tax"*.

In a nutshell, the plastic waste is the only new common resource for "immediate consumption". The rest needs to be worked on and probably more importantly negotiated across member states. The border tax – basically a modulation of customs duties according to the carbon footprint of imports – can be very tricky, since it is a source of trade tension with both the US and China whose carbon intensity is much higher than the EU's. It is probably tactically astute to wait until after the presidential elections in the US to become more concrete about this, but the issue could easily fester, irrespective of who sits in the oval office come January. Moreover, while the extension of the carbon exchange trading system is welcome, but we remember that the very existence of the Emissions Trading Scheme (ETS) was put in question by Eastern member states.

It is very important that the taboo of debt mutualisation is finally broken and that in the end member states managed to come to a deal providing concrete financial solidarity. This will help keep the sovereign spreads in check. But **we would be a bit more cautious than Stephen S. Roach about the emergence of a proper joint European liquid and large reference asset, susceptible to make the euro a fully-fledged alternative to the dollar as the world's reserve currency**. True, EUR 750bn of issuance will turn the EU into a large player on Europe's bond market (about EUR1.1 trillion worth of Bunds circulate), but a key to investors in the long term will be whether this issuer is a "master of its own destiny" when it comes to repaying its debt. Again, the fate of the EU's own resources is central.

Country/Region	What we focused on last week	What we will focus on this week
	• New virus cases appear to be peaking, particularly in the larger US states • Jobless claims rose in the latest week to 1.42mn, but reflected poor seasonals • Fiscal stimulus talks resumed – stimulus unlikely before August, we expect ~$1.5tn • Biden recorded second 15pt lead in polls	• US GDP Q2 estimate, we expect -31% (saar), marginally better than -34% consensus • US FOMC policy meeting – no change to policy but look for details of monetary review • Employment cost index Q2 • PCE inflation rate for June
	• EU Council agreement on the EUR750bn Recovery package, including 390bn of grants • July EA Flash Composite PMIs surprised to the upside at 54.8, driven by a sharp rebound in services confidence • EA consumer confidence failed to increase further in July, details to be released next week will be interesting	• Focus on the Q2 GDP preliminary estimates: expect euro area growth down -13.1%qoq. • German IFO and European Commission survey to edge higher in July. • June credit data to give insights on credit needs after the sharp rise over the past 3 months • July Flash HICP to increase to 0.5%yoy
	• UK cash borrowing in Q1 20/21 recorded a record £173.5bn. • UK June retail sales recorded 13.9% rise in retail volumes on the month, 10.2% in May. • UK-EU negotiations continue – no obvious signs of progress • CBI Bus Opt index rose to -1 from -87	• Pick-up in consumer lending in June from depressed May • GfK consumer confidence
	• Exports remain depressed (-26.2%yoy from -28.3% in May) while imports improved slowly (-14.4% from -26.2%). • June CPI was flat at 0%. • Manufacturing PMI flash is still far from 50 at 42.6, +2.5 points from June. • June chain store sales improved by 3.4%yoy.	• June unemployment rate is expected to rise again. Job/applicants ratio should point to a tightening of labour market. • June IP is likely to improve. • Household confidence is expected to rise again, but beware of the impact on the resumption of the pandemic in Tokyo.
	• Sino-US relations take another turn for the worse, with two sides ordering each other to close consulates • President Xi urges efforts to promote entrepreneurship	• Upcoming politburo meeting should reinforce the need for more pragmatic and targeted policy easing
	• Q2 GDP in Korea contracted -2.96%yoy in 2Q20, notably worse than consensus due to major external sector shock • Korean first-20 days exports in July -12.97%yoy (after -7.98% in June) • Rates on hold in Turkey and Ukraine, cuts in Hungary, South Africa and Russia	• July CPI in Poland, June CPI in South Africa. • Aïd al-Adha celebration (several markets closed)

Upcoming events	US:	Mon: durable goods orders; Tue: Case-Shiller HPI, Conf Bd cons conf.; Wed: goods trade, pending home sales, FOMC meeting; Thu: Q2 GDP, core PCE, weekly jobless; Fri: personal income, spending
	Euro Area:	Mon: Ge IfO index; Tue: Sp unemployment; Wed: Fr INSEE cons conf.; Thu: Ez business conf., Ez, Ge, It unemployment, Ge CPI, HICP, Q2 GDP, Sp HICP; Fri: Ez, Fr, It, Sp Q2 GDP, Ez CPI, Fr, It HICP
	UK:	Tue: CBI distributive trades survey; Wed: mortgage approvals, net mortgage lending, consumer credit, M4 money supply; Thu/Fri: Nationwide HPI
	Japan:	Mon: all industry activity index; Fri: unemployment, industrial production, housing starts, consumer confidence
	China:	Mon: industrial profits; Fri: official mfg., non-mfg. PMIs

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