Investment Managers

# 234 – 22 July 2024

Investment Institute Macroeconomics


## Pushing the Walls

- Alternative Democratic candidates may not stray far from Biden on the economic agenda.
- The ECB was tight-lipped on its future trajectory.
- The new UK government will have to "push the walls" to get some policy space. Labour has a vested interest in incentivising the Bank of England (BoE) to cut fast.

The "big news" from the weekend was of course Joe Biden's decision to withdraw from the presidential race and endorse Kamala Harris. We would be surprised if any Democratic candidate would offer a significantly different economic agenda from Biden's. This suggests the most "disruptive" platform, from a market and macroeconomic point of view, remains Donald Trump's.

Last week's ECB press conference was to some extent a disjointed affair: while we found the macro narrative quite dovish, expressing a fairly robust confidence, disinflation will continue despite some gyrations in the monthly data, Christine Lagarde remained tight-lipped on the next steps. We suspect the Council is divided, and the political context in key member states – even if France was not mentioned by name – may trigger tactical positioning by some hawks who don't want to send to potentially spendthrift governments the signal that full-on monetary policy accommodation is just around the corner. Genuine concerns about the resilience in services prices adds to this reluctance. We still maintain our baseline of two more reductions in the policy rate this year (September and December).

In the UK, the King's speech, in which the government lays out its priorities, was quite prudent in the macroeconomic realm. We still think that the cabinet will need to "push the walls" to find enough policy space. The feedback loop from monetary policy to the fiscal constraints is particularly tight in the UK because of the Treasury's indemnification of the BoE for the QE-related losses. The UK government has a vested interest in maintaining a modest fiscal stance to maximise the chances the BoE will cut quickly.

In France, the left's failure to secure the Chair of the National Assembly confirms they are not in a strong position to secure the Prime Minister job, but finding a robust enough political solution remains elusive.

## Different names, same issues

The big news of the weekend was obviously Joe Biden's decision to withdraw his re-election bid and support Kamala Harris as the Democrats' candidate against Donald Trump. A party convention in August could be decisive. Many commentators have focused on Harris' favourite status beyond her Vice-President position because of the ease with which financial contributions to the Biden-Harris ticket could be transferred to Harris' own presidential bid. Republicans, as of Sunday, were already disputing the legal case for this. We note however that, according to the New York Times, the Biden campaign apparatus has already switched to working for Kamala Harris (this was at least the gist of a joint message from the chair and manager of Biden 's campaign). With Trump now the clear favourite in the polls, any strong challenger to Harris in the Democratic party could decide to "pass" the race this year and focus on 2028. At the time of writing these lines on Sunday night, two of the "natural alternative candidates", Josh Shapiro, Governor of Pennsylvania, and Gavin Newsom, Governor of California, chose to explicitly support Harris right away.

With so little time to organise before the convention, we will probably know very quickly if anyone with a winning chance will formally put their hat in the ring. Yet, beyond the name of Biden's replacement**, the key issue for us is how different the economic platform of Trump's challenger will be from Biden's. With limited time to produce a fresh agenda, and in any case a decent level of consensus across the Democratic party on economic issues, we would not expect much change**. We note that Kamala Harris herself, and most of the "natural alternatives" are either closely associated with Biden's administration or with the Democratic "mainstream".

On international trade, any Democratic candidate would probably push a quite muscular "anti-China" policy anyway. Biden did not repeal the special tariffs levied by Trump and with public opinion harbouring negative feelings on China – the Pew Centre's polls suggest more than 80% of US citizens have a negative opinion of the country – "rolling back" the Chinese export machine has become uncontroversial in Washington. The key difference with Trump would remain the treatment of imports from other suppliers, which in case of a Democratic victory in November would spare European exporters a smaller but still painful version of the trade war against Beijing.

Any Democratic candidate would probably maintain Biden's approach to industrial policy, with a continuation of the Creating Helpful Incentives to Produce Semiconductors (CHIPS) Act and the Inflation Reduction Act (IRA), with sustained support for the US transition to net zero. In fiscal matters, much of the savings any Democratic candidate would contemplate would stem from allowing some of the tax cuts implemented by Trump in 2017 to expire, at least those which benefit highly paid individuals the most. On immigration, any Democratic candidate will probably pledge to reduce inflows, but in any case, the impact on working age population dynamics would be smaller than if Donald Trump "hard agenda" prevails. Of course, the situation remains fluid, **but our baseline is that, even with Joe Biden out of the race, it is Donald Trump who would still come up with the agenda with the most tangible impact on markets**, given its inflationary aspects (brutal clampdown on immigration, generalised custom tariffs hikes, accommodative fiscal policy). In any case, the probability for any President from the Democratic party would also be enjoying a majority in Congress is small, which would reduce his or her capacity to steer the economy. The "Trump Trade", which recently has supported the dollar and put a floor under long-term interest rates despite expectations of rate cuts, is likely to remain "live".

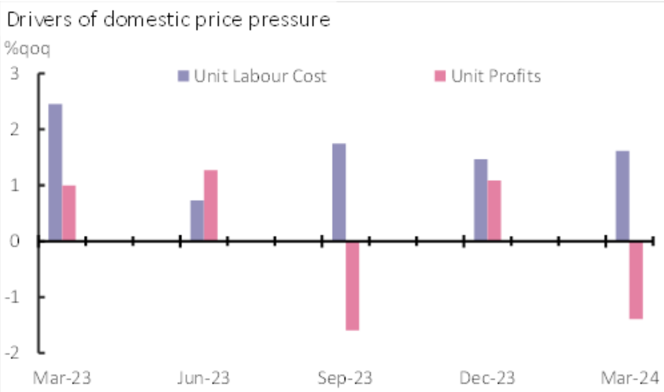
## Evasive ECB

It was a quite inconclusive European Central Bank (ECB) meeting last week: the overall macroeconomic analysis of the central bank, as it was laid out by Christine Lagarde, continues to point to another rate cut in September, but she maintained a strict data dependent mode, and called the September meeting "wide open". We thought the door would have opened more widely to describing a gradual "restriction removal process" but the crack has not been opened more visibly than in June.

We think this reflects some intense discussion internally between hawks and doves, which made it impossible for Lagarde to embark in any kind of forward guidance at this stage. Indeed, the cacophony was remarkably loud immediately after the meeting. On Thursday evening, Bloomberg put out an article mentioning "ECB sources" arguing that the Governing Council may not be able to cut more than once in 2024. Conversely, Banque de France Governor Villeroy de Galhau stated in an interview on Friday morning *that "seen from today, the market expectations look quite reasonable"*. The market still prices a substantial 78% probability of a cut in September, albeit down from 88% a week before, and a cumulative 89% probability of two rate cuts by December, in line with our own view.

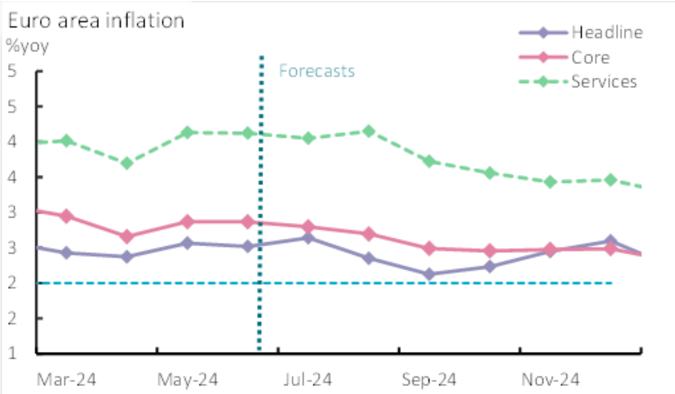
**Market pricing is consistent with the overall macro narrative presented by the ECB last week** because of their strong readiness to dismiss the "not great" signals on consumer prices – ascribed to one-offs and catch-up effects – and a growing confidence (based on surveys) that i) wage growth is going to moderate into the second half of this year and 2025 and ii) profit margins are being squeezed to absorb much of the ongoing wage catchup. This "WPP" triad (wages, productivity, profit) highlighted by Christine Lagarde is clearly at the heart of the central bank's deliberations. In the first half of 2023, unit profits and unit labour costs were still rising in sync, signalling that business margin behaviour was not at all offsetting the push from wages and poor productivity developments on prices. Fortunately, while Unit Labour Costs (ULCs) have maintained strong dynamics, unit profits have fallen in two of the last three available quarters (see Exhibit 1).

Exhibit 1 – The offsetting game



Source: Eurostat and AXA IM Research, as of July 2024

Exhibit 2 – No smoking gun on inflation this summer



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

With wage growth moderating and hopefully no more bad news on productivity, the continuation of disinflation looks like the most plausible scenario. ECB hawks have however been more focused on actual price developments rather than on the macroeconomic adjustment at work in the background. On this front, by the end of the summer the Governing Council may not get the "smoking gun" it would hope to settle the dispute. Indeed, in our forecasts, headline inflation will re-accelerate slightly in July, before heading down against in August but without a strong direction before the autumn. Services inflation, which clearly is on top of the Governing Council concerns, could remain elevated for several months (see Exhibit 2).

By the team they meet in September, the ECB won't have the detailed results for unit profits and unit labour costs for Q2**. The forecasts, which we think will play a strong role in the decision-making, will have, as often, to make a "leap of faith". On wage growth, canonical models should confirm a deceleration ahead,** reflecting with a lag the decline already observed in headline inflation, while the real economy is unlikely to be buoyant enough to warrant much margin expansion by the business sector.

**We suspect that the political context may on the margin add to the ECB prudence**. The reference to the EU's fiscal surveillance compact and calls for "speedy compliance" to it by member states, was strengthened in the prepared statement. This is obviously directed at the member states which have been put under "excessive deficit procedure" since the last ECB meeting in June, but France was probably high on the list when the Council sat last week. We note that a Financial Times article a few days before the meeting pointed to some hawks willing to exert pressure on Paris do "do the right thing" on fiscal policy by threatening to postpone rate cuts. This is a very dangerous game – and we fail to see why the monetary policy of the entire Euro area should be held hostage to some political games between the ECB and a so-far elusive government in France – but tactical positioning by some hawkish Governing Council members may have tilted the discussion towards not opening up more forcefully for an easing in September – which remains our baseline.

## UK: looking for some policy space

Sometimes, politicians can be lucky. The UK's new Prime Minister is coming to power on a "steady ship" platform, enjoying a massive parliamentary majority, when the European Union (EU) is still dealing with a populist push, France looking for an elusive government and the US being again tempted by a protectionist and isolationist adventure. The UK is thus emerging as a "safe haven" in these choppy waters, something that the rebound in the sterling exchange rate is reflecting. A defeat in the Euro football finals of course came as a disappointment, but cyclical data is helping the new British cabinet: the monthly estimate of GDP grew at twice the expected rate in May and over three months, the 0.9% growth is the highest in two years.

Now, luck is rarely enough, and steering the British economy remains a tough task. The country still needs to grapple with poor productivity, weak investment, and tough public debt dynamic. We will have to wait for a proper budget in the autumn to get details on the public finance strategy, but in the King's speech laying out its first priorities, **the new cabinet opted for prudence**, as expected: the speech mentioned a stronger role for the Office for Budget Responsibility (OBR), which will now have to produce new forecasts every time a "significant" change in spending and taxation is tabled. While this obviously targets the "Liz Truss episode", this will provide cover this autumn for a modest budget.

In other macroeconomic realms, the government is sending signals to its core electorate by re-regulating – mildly from the few details which have come out in the King's speech – the labour market (banning the infamous "zero-hour contracts") or the private rental market (abolishing the "no fault eviction" process). In a way, the fact that Labour won mostly because public opinion had come to massively reject the Conservatives, rather than because of any enthusiasm for a left-wing alternative, is helping Starmer: there is no huge popular appetite for radical reforms.

Yet, **the fiscal buffers will probably be tested to the limit**. Where there is a strong social demand, it's on the public health framework. While the new Health Secretary is touting structural changes rather than the usual approach consisting in pouring more cash into the system, population ageing will in any case continue to push spending up. The same holds for old age care. Government day-to-day operations could also be made more expensive by wage growth in the public sector to catch up with the inflation shock. According to "The Times", independent pay review bodies are recommending pay raises of 5.5% for teachers and public health staff. Besides, lifting productivity and hence potential growth is unlikely to rest solely on the private sector. Additional investment in infrastructure will be needed, coming on top of the cost of greening the economy, a key tenet of Labour's programme – and probably a political necessity for the government as well, since Labour has lost a few constituencies to the Greens, a very unusual occurrence in the UK. In such circumstances, getting all the possible help from monetary policy will be key.

Indeed**, in the UK the feedback loop between interest rates and the fiscal stance is tighter than in most other Western economies**. Beyond the usual debt burden channel, the UK has made a very peculiar choice when the central bank engaged in Quantitative Easing (QE): the losses incurred by the Bank of England are entirely covered by the Treasury.

Technically, Quantitative Easing in the UK was operated by a legally separated entity from the Bank of England, which purchased bonds with a loan from the central bank paying the policy interest rate. Initially, the entity was making gains, since the yields on the acquired bonds were higher than the near-zero BoE rate. This was always going to turn a loss at some point, when the central bank would raise its rate above the average bond yield and Quantitative Tightening would entail re-selling bonds below their purchasing price, and/or receiving a principal payment at maturity on bonds purchased well above par. Two main accounting options could have been considered. Either let the gains accumulate in preparation for the losses. Or turn the gains and subsequent losses into a deferred liability/asset on the Treasury. There would still be a long-term cost to the Treasury since the central bank will withhold transfers to the Treasury until the deferred asset is extinguished, but the losses would never trigger an effective cash transfer *from* the Treasury to the central bank. The latter is the approach chosen by the US Federal Reserve.

The UK initially chose the first avenue, but quite quickly, by 2013 the transitory gains were too tempting for a cash-strapped government, and a total of GBP124bn was remitted to the Treasury (5.5% of GDP). But symmetrically, now that the combination of higher Bank of England rates and lower bond prices is generating losses**, the Treasury is effectively bleeding**

**cash to the central bank (nearly GBP50bn between October 2022 and March 2024**). According to the OBR, based on data from March 2024, in their baseline scenario, the lifetime net loss to the Treasury would reach GBP104bn. That is roughly the equivalent of two years of public investment in the UK. No small change. Of course, the path for interest rates is a key source of uncertainty there. The OBR provides an illustrative scenario analysis. Moving the interest rate assumption by 100bps North or South of the baseline, the net cost to the Treasury could be as low as GBP46.6bn or as high as 156.9bn.

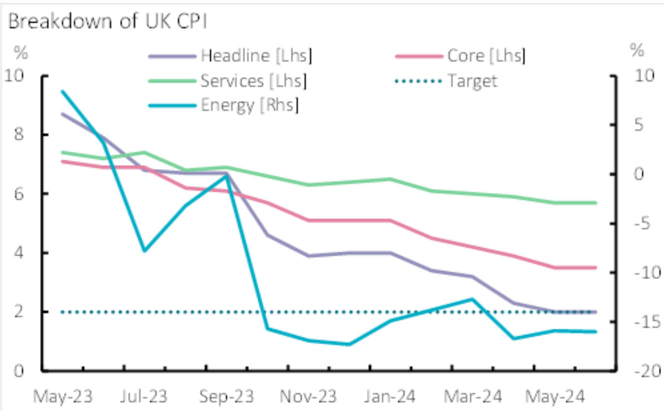
True, in the long-run the two options are not different in terms of accumulated cash-flow: cash transfers today from the government to the central bank will bring forward the moment when the central bank will be able to pay a dividend to the Treasury again. **But timing matters**. The government is cash-strapped now, at a time when social demand for public spending is high. An article in the Financial Times last week argued that "the market" would not necessarily react negatively if the new British government chose to change the accounting system again and stop the cash transfers to the Bank of England. This avenue has however been repeatedly formally closed by the new Chancellor of the Exchequer Rachel Reeves, who wants to project a sense of fiscal rectitude.

Still, if changing the accounting rules is unpalatable, the government has a vested interest in getting the central bank to cut its policy rate as fast as possible, to minimise the cash transfers. This may partly explain why Rachel Reeves is so prudent on the fiscal stance: **the less the Bank of England will be tempted to respond to excess demand triggered by expansionary fiscal policy, the quicker monetary policy could ease,** thus freeing up more capacity to find extra resources without being forced into tax hikes.

**In the short run, the new British government may not be that lucky**. Indeed, although headline inflation has hit 2.0%yoy for two months in a row in May and June, too much of that disinflation continues to stem from a decline in energy prices which positive base effects will fade (see Exhibit 3). Services inflation – the most sensitive to endogenous developments in the domestic economy – has been decelerating at a frustratingly slow pace for months. The market has been pushing its expectation for a first rate cut, with now only 12bps priced in for August, hence a slightly less than 50% probability, against 16bps before the release of the latest inflation numbers.

The Monetary Policy Committee (MPC) of the Bank of England, was already divided in June, and Huw Pill, the Bank's Chief Economist, sounded – uncharacteristically – hawkish in his latest public speech. **We suspect there may be some tactical thinking around the timing of the BOE's move relative to the other major central banks**. Indeed, the UK economy is usually very sensitive to exchange rate movements. The "Britain as a safe haven" trade has pushed the sterling exchange rate up lately. Delaying the monetary easing – in particular waiting for the Fed to start its own process, we think in September – may be alluring: a further sterling appreciation could help get even more goods disinflation, at a time when the real economy is doing well enough to withstand a bout of deterioration in price competitiveness.

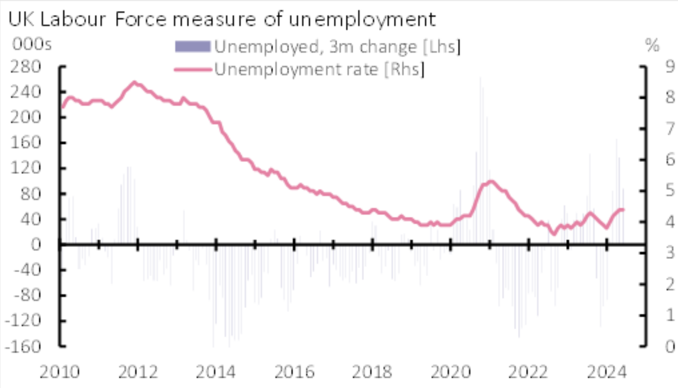
Exhibit 3 – Pesky services



Source: ONS and AXA IM Research, 17 July 2024

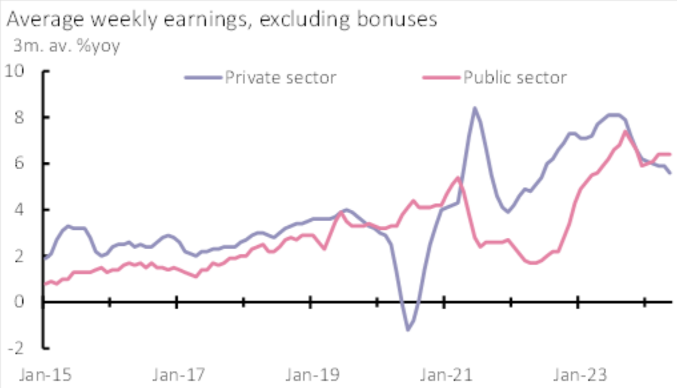
Yet, **pressure seems to be abating down the "macro pipeline".** The unemployment rate in the three months to May remained at 4.4%, still well above a recent trough at 3.8% (see Exhibit 4), as well as crucially slightly above the BoE's forecast released in May. Wage growth in the private sector – excluding bonus – remains high at 5.6%yoy (see Exhibit 5) but is on the right decelerating path (the overall figure continues to be propped up by the public sector). Ultimately, as often it will be a close judgment call for the MPC, balancing "not so great" current price data against what is probably a favourable outlook. We expect a close 5-4 decision in August for a 25bps cut, with a low level of confidence. The British government is trying to "push the walls" to find some policy space. It may take some more months before the coast starts to clear. In all likelihood, by the time the budget discussion starts, Rachel Reeves will be in position to make a fully informed call. In the meantime, she is probably right to keep her cards close to her chest.

Exhibit 4 – Unemployment rate off-trough




Source: Office for National Statistics and AXA IM Research, July 2024

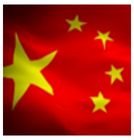
Exhibit 5 – Wages still fast, but decelerating




Source: Office for National Statistics and AXA IM Research, July 2024

## Lessons from the French National Assembly votes

The "Olympic truce" is about to start, but we suspect French political leaders will remain busy as an institutional solution is not yet within sight. T**he election of the Chair of the National Assembly brought some light to "what cannot be" without providing much clarity as to "what can be".** The failure of the left-wing alliance to secure the position, despite maintaining discipline within their ranks in all the three rounds it finally took to elect the Chair, and their defeat to an implicit alliance between the Centrists and the Centre-right, strongly suggests that the left's pledge to fill the Prime Minister's job – and thus steer France's policy-making – is unlikely to be successful. Yet even though the Centrist/centre-right coalition probably is the President of the Republic's optimal choice to build a government majority, it would probably remain too tight to survive long to motions of no-confidence and pass a budget. Indeed, in the third round for the election of the Chair of the National Assembly, a simple majority suffices. Getting a budget through requires being able to avoid a motion of no confidence being supported by the absolute majority of the lower house. Passing that "National Assembly Chair Test" was not enough. We maintain our view from last week that much more "politicking" needs to happen.

| Country/Region | What we focused on last week | What we will focus on in next weeks |
|---|---|---|
|  | • Trump at Republican Convention after failed assassination attempt, appoints JD Vance as VP<br>• Retail sales (Jun) firmer than expected with control group +0.9%mom; May's sales revised higher<br>• Beige Book reports flat or falling activity in 5 of 12 districts (from 2), consumers more price sensitive<br>• Philly Fed index (Jul) rises to 13.9, around 2-yr high<br>• Williams, Waller, Daly all rpt "good" developments | • As pressure mounts on Biden we watch for signs of him stepping aside before Democrat Convention<br>• GDP (Q2, p). We forecast 2.0% (saar), recent firmer activity lifted Atlanta GDP to 2.7%<br>• PCE inflation (Jun) expt'd 2.5%yoy, core 2.6% - staying at 3-yr low<br>• New & existing home sales (Jun), new to rebound from steep May drop, existing to retrace further |
|  | • ECB: no policy change, "wide open" decision for Sept. Our call is unch with likely Sept rate cut<br>• Ez IP (May) dropped 0.6%mom, "bridge" days in May is only part of the explanation<br>• Ez inflation (Jun, f) headline and core unch (2.5%; 2.9%)<br>• Ge ZEW survey (Jul) expectation fell but by less than expected while "current state" improved | • Flash PMIs in France, Germany and Eurozone. French political turmoil should still have an impact on sentiment, German industry may be again exposed to weak Chinese data. EMU should be better with peripherals still outperforming<br>• Business and consumer confidence (Fr), Ifo (Ge) to complete the picture for the beginning of the Q3 |
|  | • CPI inflation was unch at 2.0% in Jun, but services inflation remained sticky at 5.7%<br>• Unemp rate unch at 4.4%. AWE ex. bonuses dropped to 5.7% in May, from 6%<br>• Retail sales down 1.2% in June<br>• GfK cons. conf. edged up to -13 in July, from -14 | • Flash composite PMI likely edged up in July, from 52.3 in June, due to a post-election boost |
|  | • Trade bal. shifted into surplus in June. Exports up 5.4%yoy, imports up 3.2%yoy<br>• CPI inflation was unch at 2.8% in Jun, core rate rose 2.6%, from 2.5%. Ex. food and energy edged higher to 2.2%, from 2.1% | • Flash PMI to hold broadly steady<br>• Tokyo CPI inflation rate to rise to 2.5% in July, from 2.3% in June. Core likely edged up to 2.3%, from 2.1%. Ex. energy and fresh food, up at 1.6%, from 1.4% |
|  | • Q2 GDP slowed down to 0.7%qoq from 1.5% in Q1; GDP for H2 grew by 5.0%yoy<br>• Industrial production (Jun): 0.4%mom, 5.3%yoy<br>• Fixed asset investment (H2 2024): 3.9%yoy<br>• House prices (Jun): -4.9%yoy for new homes; -7.9% for existing homes<br>• Retail sales (Jun): -0.1%mom, 2.0%yoy (May: 0.2%mom, 3.7%yoy) | • 22 Jul: LPR 1Y & 5Y (July): expect stay unchanged at 3.45% and 3.95% respectively<br>• 27 Jul: Industrial profit (Jan - Jun) |
|  | • CB: Indonesia (6.25%) & South Africa (8.25%) stood on hold<br>• Monthly economic activity (May) slowed in Brazil (1.3%yoy), Colombia (2.5%yoy) & Peru (5.0%yoy)<br>• Export growth (June) lost steam in Malaysia (1.7%yoy) & Indonesia (1.2%yoy) | • CB: Hungary (7.0%), Russia (16%) & Turkey (50%) are expected to stay on hold<br>• Q2 GDP: Korea & Malaysia<br>• June CPI: Malaysia & South Africa<br>• May retail sales: Mexico & Poland |

| Upcoming events | | |
|---|---|---|
| | US: | Tue: Existing home sales (Jun); Wed: Goods trade balance (Jun), Wholesale inventories (Jun, p), Mfg and services 'flash' PMI (Jul), New home sales (Jun); Thu: GDP (advance) (Q2), PCE (advance) (Q2), Durable goods orders (Jun, p), weekly jobless claims; Fri: PCE inflation (Jun), spending & income (Jun), Michigan consumer sentiment (Jul, f) |
| | Euro Area: | Tue: EU20 consumer confidence (Jul); Wed: EU20, Ge, Fr mfg and services 'flash' PMI (Jul), Thu: EU20 M3 supply (Jun), Ge IfO index (Jul); Fri: Fr Insee consumer confidence (Jul), It ISTAT (Jul), Sp Unemp (Q2) |
| | UK: | Wed: Mfg and services 'flash' PMI (Jul); Thu: CBI Industrial Trends (Jul) |
| | Japan: | Tue: Mfg 'flash' PMI (Jul); Fri: Leading index (May) |
| | China: | Mon: PBoC to set 1 Year and 5 Year LPR for July; Sat: Industrial profits (Jun) |

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