238 – 9 September 2024

Investment Institute Macroeconomics

Busy September

- Despite another weaker-than-expected payroll, we still expect the Fed to cut by 25bps "only" next week.
- The ECB is unlikely to provide much guidance beyond a widely expected 25bps cut this Thursday.
- We look at another policy dilemma for Beijing: how to expand a too-small tax base without shrinking consumption.
- The new French PM may need extra time to build a budget bill.

In the US, the employment report for August has confirmed that the labour market is cooling, but by historical standards this still retains all the features of a very soft landing: job creation remains positive, and wage growth remains robust. Still, this was enough to re-ignite the discussion in the market on the possibility the Fed resorts to a 50bp cut next week. We remain unconvinced. Starting the easing phase with such a big move would set the tone for the entire trajectory – in terms of market pricing – while we do not think the FOMC has made up its mind on the severity of the incoming downturn. Keeping to a 25bp cut while making it plain in the press conference that the Fed would not hesitate to cut "big" and/or "fast" should the need subsequently arise would be simpler in our view.

The ECB needs to decide before the Fed. While there is little suspense on cutting by 25 bps this Thursday, the market will focus on any hints of "forward guidance" on the next steps from Christine Lagarde. We think she will keep her cards close to her chest, since the debate at the Governing Council is still in full flow. The very latest dataflow plays in the hands of the doves though: the details of the Euro area national accounts for Q2 confirm that businesses are increasingly offsetting the push from labour costs by reducing their margins.

With poor demand in Europe and the beginning of a slowdown in the US, cyclical developments in China – as a potential "consumer of last resort" for the world economy – take a specific importance. We add to our generally cautious Chinese outlook an exploration of another policy issue for Beijing: the need to expand the tax base, now that land-use sales can no longer fund a large share of public investment, while household spending is already weak.

Finally, the appointment of a Prime Minister in France does not fully bring clarity to policymaking in Paris. The budget bill may have to be postponed by a few weeks to allow for delicate compromises to be drawn.

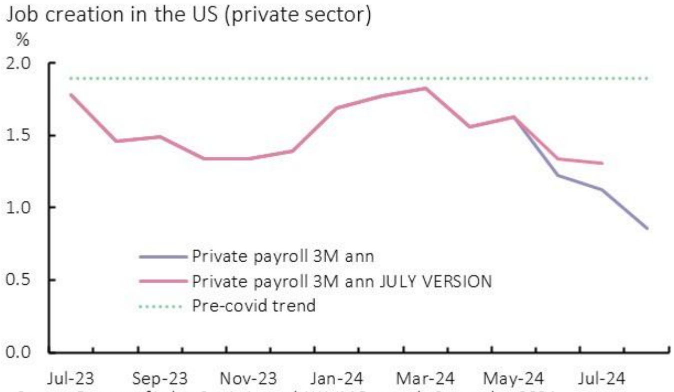
(Ever so) softly landing

In the US, the employment report for August has confirmed the message from July: the US labour market is now clearly softening, but without the markers of a "hard landing."

Beyond the below expectation monthly print for the Establishment survey (142K versus 165K), the downward revision of the previous two months has made the pace of decline visibly steeper (see Exhibit 1). The market initially read into the August print a significantly higher risk that the Federal Reserve (Fed) will have to contemplate "unusual action" to deal with the downturn, pricing up to 41bps worth of cuts next week, against 33bps before the release. Yet, expectations have been subsequently pared back, returning to 33bps as of Friday evening. We agree with the latter and consider that prudence should be maintained on the quantum of easing the Fed is prepared to provide in one go at this stage.

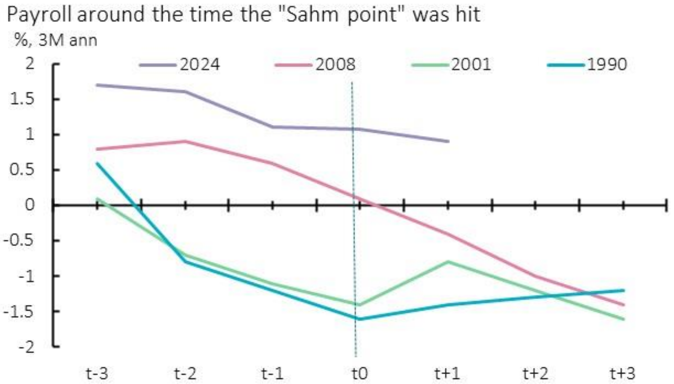
True, some of the initial market reaction may have been magnified by the interview of Fed Governor Waller, who after the payroll release expressed his openness to "larger cuts", and mentioned the possibility to cut fast, i.e. at every meeting, if need be. Yet, cutting by 50bps is still a big step in our view, in a situation where available data still do not suggest a hard landing is underway. Indeed, we reiterate the point we made before the summer recess: the ongoing labour market adjustment remains very soft by historical standards. True, in August, the "Sahm point" was hit again – just: over the last 3 months, the unemployment rate has averaged 4.2% (4.13% in July), 0.57 points above the lowest point of the last 12 months (3.63% in the three months to August 2023). This would normally be a strong predictor of recession, but **every time in recent history the "Sahm point" had been hit, job creation was much weaker than what is being currently observed** (see Exhibit 2 – we took away the Covid period from the graph otherwise the scale of the shock would make any reading of the "ordinary recessions" very difficult). The labour market has turned a corner, that much is clear, but it is still a very soft adjustment. In addition, while job creation is slowing down, there is still quite a bit of acquired speed on wages. Indeed, hourly earnings rose by a stronger-than-expected 0.4% on the month, and by 3.8% on a 3-month annualised basis.

Exhibit 1 – More visibly down



Source: Bureau of Labor Statistics and AXA IM Research, September 2024

Exhibit 2 – Still a very soft landing by historical standards



Source: Bureau of Labor Statistics and AXA IM Research, September 2024

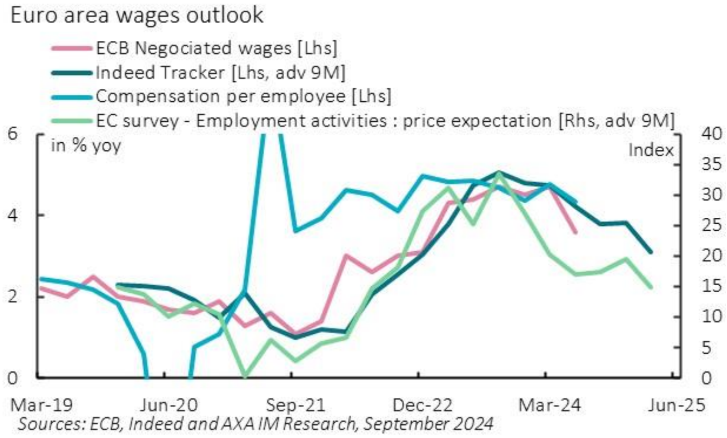
When poring over the details of Governor Waller's interview, it is not obvious that his openness to "big moves" necessarily applies to the September meeting already. What makes us still favour a 25bp cut next week, rather than 50bps, is that opening the easing phase with a big step down would probably set the tone – at least in terms of market pricing – for the entirety of the trajectory, and such signal could be difficult to alter down the road. The level of confidence to do this would need to be high. In our view, such approach works only if one considers the Federal Open Market Committee (FOMC) has already made up its mind about the *slope* of the macroeconomic downturn, which we do not think is obvious given the recent dataflow. **It would be easier, in our view, for the Fed to cut by "only" 25bps next week while making it plain that the FOMC would not hesitate to raise the quantum of cuts at the next meetings and/or adopt a "quick fire" pace of cuts if the dataflow indeed starts pointing to a harder landing**. This approach would in our view encapsulate Waller's points on cutting at "consecutive meetings" or "larger cuts" if it is appropriate, informed by the dataflow. But for now, we would borrow verbatim from Waller's comments: *"Based on the evidence I see, I do not believe the economy is in a recession or necessarily headed for one".*

Is there life after September?

While we expect the Fed to be quite clear on the generic "direction of travel" after its first hike, even if it will make it conditional on data, **we are not confident we will get a lot of clarity on that front from the European Central Bank (ECB) upon delivering a second 25bp cut on Thursday**. While the cut itself makes little doubt – the forward contracts were pricing a probability of 99% to such outcome as of last Friday night – we would expect the market to focus on even the slightest traces of forward guidance in Christine Lagarde's speech and Q&A. We explored last week how the hawks are maintaining a very prudent view of the macroeconomic developments in the Euro area, which would make it difficult for Christine Lagarde to be straightforward on the trajectory.

However, **we think the very recent European dataflow has added more evidence that the ECB *should* sketch out a "decisive easing" trajectory**. There was indeed a lot to mine in last week's new estimate of Q2 GDP. The key point for us was not the downward revision from the first estimate (from 0.3%qoq to 0.2%), even it confirmed the Euro area is still not emerging from its spell of economic mediocrity. We were more interested in the details of the quarterly accounts on the wage and profit behaviour.

Exhibit 3 – More evidence wages are heading down



Sources: ECB, Indeed and AXA IM Research, September 2024

We already knew that negotiated wages had – at long last – finally slowed down in Q2, but last week confirmed that **"actual" wages per head decelerated as well**, to 4.3%yoy from 4.8% in Q1, hitting their slowest pace since the end of 2021 (see Exhibit 3). This may not look like much, but interestingly this was lower than in the ECB's latest forecasts (5.1% in Q2). Now, nominal wages alone do not necessarily say much about the domestic inflation pipeline. **It is the "wage, productivity and margin" nexus which matters – as Christine Lagarde made it plain during the July press conference. But we think on that front as well the news is getting better.**

Taken at face value, it is very difficult to extract any signal from the quarter-on-quarter changes in unit labour costs (wage growth minus productivity gains) and unit profits, given their extreme volatility (see Exhibit 4). Still, when averaging them over four quarters, we think the picture gets quite clear: **while unit labour costs have only started to slow down – and remain at a high pace – unit profits are now starting to contract**. Businesses are now doing the opposite of the "greedflation" of 2022 and they are offsetting the labour cost push by lowering their margins. Incidentally, beyond the favourable impact this is having on inflation, the contraction in profits helps explain the deterioration in corporate investment which was confirmed in the new GDP estimate for Q2 – another reason for the ECB, in our view, to embark on a clear easing process.

Exhibit 4 – Noisy unit labour costs and profits

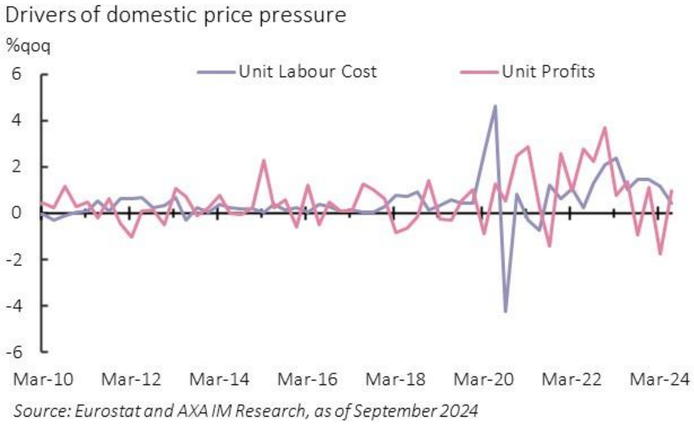
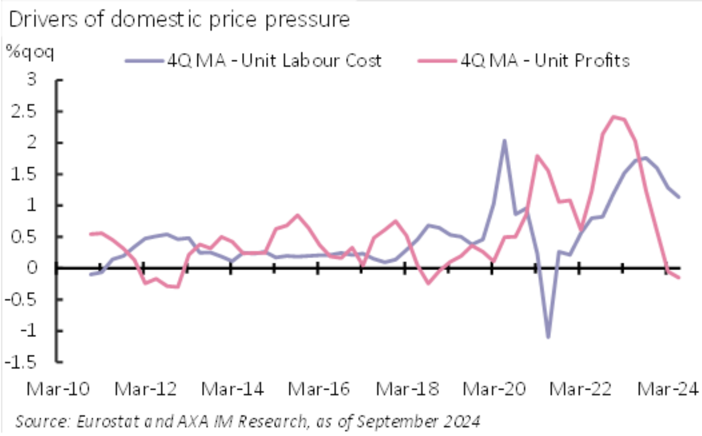


Exhibit 5 – But on trend we think the message is clear



Even if the state of the debate within the Governing Council suggests Christine Lagarde will not want, on Thursday, to elaborate too much on what could come next, **her diagnosis on the current macro situation in the Euro area – informed by these latest data points – could err on the dovish side in our view**. Another key input obviously will be the ECB's new forecast batch. The ECB is likely to forecast marginally lower headline inflation in 2024's annual forecast to 2.4% (-0.1pt), but we see risks of an 0.1 percentage point upside revision to 2.8% for 2024 core inflation forecast. For 2025 and 2026, the ECB should account for lower momentum in oil prices (-6% in average), and stronger euro (+2%). This should result in important revision for headline inflation to 1.9% in 2025 (-0.3pp) and 1.7-1.8% (from 1.9%) in 2026, while core inflation revisions should be much more limited - expected at 2.1% (-0.1ppt) in 2025 and unchanged at 2% in 2026. Not a very strong signal, but the signal the ECB believes in a slightly faster convergence towards its target would still indicate a readiness to ease faster in 2025.

Taxing China

As we are readying for slower US demand in the short run (the magnitude of such deceleration is still debatable, but not the direction of travel there) it is natural to look for alternative sources of traction in the world economy. Europe "does not do demand", so China would normally be the "natural candidate" to pick up the tab. Yet, habitual readers of Macrocast will be familiar with our reserved Chinese outlook. **We explore here another side of the complex policy equation for Beijing: the collision of a structural need to expand the tax base with the necessity to reduce the saving ratio of households.**

Indeed, what is striking in China is the low level of tax receipts as a percentage of GDP at less than 14% in 2022 according to the International Monetary Fund (IMF). Tax ratios are normally a positive function of the degree of economic maturity of a given country, but even when compared with similar countries in terms of GDP per head or trade openness, China is close to the bottom of the distribution (the average in comparable countries stood at 19% (see link here https://www.elibrary.imf.org/view/journals/002/2024/050/article-A002-en.xml)and its tax ratio has been declining from a peak at 18% of GDP in 2011. Such thin tax base co-exists with a high public debt (around 100% of GDP).

One of the reasons taxes could be kept low despite increasingly active fiscal policies is that a significant share of local government revenue – at the forefront of the country's public investment effort – comes from land-use sales (30% of their total income in 2022 according to the Peterson Institute – see link here). As long as China has been deploying an extensive growth model, such approach was seemingly virtuous. Local authorities would fund infrastructure spending by selling land at a rising price, and the very extension of the electrical grid, roads, sewage network etc... would mechanically raise present and expected land values. Moreover, local authorities do not forfeit the entirety of their property rights (legally, transfer of ownership of state-owned land is prohibited): they sell "land usage rights" to developers for a maximum of 70 years. The value of the asset side of the local authorities is not only boosted by the rising price of future land-use sales, but also by the long-term gains on the existing operations. In such a configuration, looking at gross debt could be misleading. **The**

local governments' liabilities should be compared with the rising value of their fixed assets. Looking at net debt is tempting … as long as demand for land grows.

In the "extensive" growth model, urban population rises as country dwellers flock to the cities, which can transitorily offset overall demographic dynamics which have been mediocre for a long time. But what happens once those reserves get exhausted, or when the general upgrade of the housing stock has been completed? Exploring land rent issues has been one of the first endeavours of economic science. The verdict is straightforward: pouring more capital (e.g. infrastructure) into land when demand is structurally falling amid declining population will simply result in diminishing, and soon negative returns: at some point, the cost of capital will exceed the value of the land. Land-related revenue of local government has been falling since 2022.

Our colleague Yingrui Wang has just released a comprehensive paper on the state of Chinese banking (see link here). One of her key findings is that **the banks' main problem in the current real estate correction may not be developers' loans or mortgages, but rather their exposure to the special financing vehicles set up by local governments**, which account for 13% of their balance sheet in 2022, against 3.8% for "direct" real estate operations. It is thus a crucial matter of general financial stability in China that the central government – or the central bank – support the local authorities.

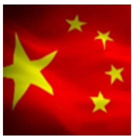
Still, whatever "financial engineering" is put in place to mitigate the impact of the current real estate correction on financial stability in the short run, ultimately**, what needs to happen is a proper overhaul of government income in China, substituting "ordinary taxation" to asset sales**. A difficulty there is that "ordinary" government revenue would need to rise while households maintain high savings ratio to build up reserves for their retirement in the absence of a comprehensive public pension system. Currently, because of a large basic exemption, 70% of Chinese households do not pay any income tax, and although facially the top rate for income tax stands at 45% – a level seen in many mature countries – the average income tax rate is below 5.5%. **Squeezing further an already anaemic consumption could be the net result of such overhaul.**

Beijing could simply to postpone any large tax reform, and then simply accept to curtail public investment to adjust to the decline in land price. Either way, these issues make it very unlikely China will be in position to contribute massively to world demand.

France: delay into October?

The suspense is only partly over now that Michel Barnier has been appointed Prime Minister. Indeed, **the "mother of political battles" remains the budget bill for 2025**. Technically, it normally needs to be transmitted to parliament on 1st October, but Pierre Moscovici, Chair of the French Audit Court and Public Finances High Council, in an interview over the weekend indicated that he could see a delay until mid-October. This may reflect some "backward counting" from the Constitutional rules. Indeed, the budget needs to be approved by 31 December, and parliament has 70 days to examine it. Thus, 20 October could be, from a practical point of view, the longest possible delay.

These few weeks of grace could indeed come handy since the political conditions around the budget remain delicate. Michel Barnier comes from the centre-right and his appointment could suggest that the business sector would be protected as much as possible from tax hikes which look increasingly unavoidable. Yet, he has also pledged to "put back on the table" some aspects of the latest pension reform, which has been a target of both the left and the Rassemblement National. Since the left has already announced they would stand in clear opposition to the new government – announcing they would table a motion of no confidence – the attitude of the Rassemblement National will be key. While they made it clear they would not "torpedo" the Barnier government immediately, they would probably call for a protection of public spending on strategic issues for them (security in particular), and they have already pledged to support consumers' purchasing power in the budget, which would in principle make it impossible to cut social transfers or lift social contributions, VAT or income tax. Solving this political equation while still producing a budget bill consistent with the European surveillance framework – and the rating agencies' expectations – will be extraordinarily delicate.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Payrolls (Aug) expect headline payrolls rose to 142k from 114k in July. Unemp at 4.2%. Recession concerns should start to ease • JOLTS (Jul) fell to 7.7m after stable few months • ISM indices (Aug), mfg 47.2 (+0.4pt), but new orders fell. Svc 51.5 (+0.1pt) • Fed's Beige Book, activity flat or declining in most • Vehicle sales (Aug) up 15.1m, lowest since January	• US Presidential TV debate on Tuesday evening. First pairing of Harris vs Trump. Will consider polling in the wake of this for steer for November • CPI inflation (Aug) headline rate to drop, core likely more stable. Justifies focus slipping from inflation • PPI inflation (Aug) headline likely to fall. Details watched for impact on PCE inflation • Household worth (Q2) to explain strong spending
	• Q2 final GDP revised down to +0.2%qoq due to Ireland but overall domestic demand (priv. cons + investment stays weak). Employment rose by +0.2%qoq, wages decelerated to 4.3%yoy (-0.5pp) and profits to +0.9%yoy (-0.3pp) • July EMU retail sales rose by +0.1%, Q3 still negative • Far right confirmed polls in state elections in Ge (Th and Sax) but CDU should lead coalition negotiation. Gov coalition (SPD+Greens+LDP) faced another blow	• The ECB should announce a 25bps rate cut as recent data broadly matched its outlook, but they should refrain to commit to any other rate cuts in the near-term as the cost to do so is higher under current uncertainties (domestic inflation, US elections) • E. Macron has appointed M. Barnier next PM but he needs the support of RN to avoid a confidence motion. His opening speech, the appointment of ministers and budget negotiations are expected to take place next week
	• BRC retail sales monitor (Aug) gains from Q2 weakness, suggests solid ~0.5% monthly sales rise • PMIs (Aug, f) Mfg unch at 52, svcs rev'd to 53.7 from 53.3. Construction dips to 53.6 from 55.3 • New car registrations (Aug) fall 1.3%yoy	• Labour market (Jul/Aug) watch for further easing in pay, strengthening in emp/fall in unemp seen less reliable • REC/KPMG jobs report (Aug) better guide to trends • Monthly GDP (Jul) and other output
	• PMI indices (Aug, f) mfg 49.8 (+0.3pts); svcs 53.7 (-0.3pt) • Household spending (Jul) +0.1%yoy from -1.4% • Earnings (Jul) cash slowed to 4.8% from 5.1%	• GDP (Q2, f) prelim est of +0.8% (saar), with consumption and business invest +1.0% • PPI inflation (Aug) expected modest dip to 2.8%yoy • Eco Watchers survey (Aug) recent months have been subdued for outlook
	• NBS mfg PMI (Aug): 49.1 (Jul: 49.4) • NBS non-mfg PMI 50.3 (Jul: 50.2) • Caixin mfg PMI (Aug): 50.4 (Jul: 49.8) • Caixin service PMI (Aug): 51.6 (Jul: 52.1)	• 7 Sep: FX reserves (Aug) • 9 Sep: PPI and CPI inflation (Aug) • 10 Sep: Exports and Imports (Aug) • 14 Sep: August monthly output (retail sales, investment, industrial production etc.)
	• CB: on hold in Malaysia (3%) and Poland (5.75%), 25bp cut in Chile (from 5.75% to 5.5%) • Q2 GDP: India (+6.7%yoy), Korea (-0.2%qoq), Turkey (+0.1%qoq), Brazil (strong +1.4%qoq) • Aug PMI survey – manufacturing slightly better but still contracting in CEE • Turkey MTP presented	• CB: Peru • CPI (Aug): Czech, Hungary, Mexico, India • Industrial production (Jul): India, Malaysia

Upcoming events		
	US:	Tue: NFIB small business optimum (Aug); Wed: CPI (Aug); Thu: PPI (Aug), Initial jobless claims (31 Aug), Continued claims (24 Aug); Fri: Michigan consumer sentiment and inflation expectations (Sep, p)
	Euro Area:	Tue: Ge CPI (Aug), Ge HICP (Aug), Es, It IP (Jul); Thu: Sp HICP (Aug), Ez ECB announcement; Fri: Fr HICP (Aug), Ez IP (Jul), Sp S&P and Moody's credit rating review, Ge Fitch credit rating review
	UK:	Mon: Unemp (ILO) (Jul), Avg earnings (Jul); Tue: Monthly GDP (Jul), Services Index (Jul), IP (Jul), Mfg output (Jul), Construction output (Jul), Total trade balance (Jul), Trade in goods (Jul); Thu: RICS survey (Aug); Fri: BoE/Ipsos inflation expectations (Aug)
	Japan:	Mon: GDP (Q2)
	China:	Mon: CPI (Aug), PPI (Aug); Tue: Exports (Aug), Imports (Aug), Trade balance (Aug); Sat: Fixed asset investment (Aug), IP (Aug), Retail Sales (Aug)

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

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