Investment Institute Macroeconomics

The (welcome) Return of Boring

- British general elections on 4 July will see two mainstream economic propositions face each other, in stark contrast with a recent tendency in the West to put populist offers at the heart of the debate.
- We are tempted to treat the re-acceleration in negotiated wages in Q1 in the Euro area as a blip.

With little chance now that the Bank of England will ease quickly enough to create a "feelgood effect" in the second half of the year, there was little to gain for the Conservatives by holding off elections until the autumn. The general elections which will be held on 4 July will be very different from the ones in 2019, which pitched a hard-left statist vision with Corbyn against an essentially dirigiste and "hard Brexit" one with Johnson. In the economic realm, the two main parties now differ only by nuances within a general mainstream view. The most salient point on the economic agenda is likely to be the fiscal rules framework, with some not completely marginal issues on policy sequencing and coordination with monetary policy. This will however remain an essentially technical debate, with no space for fiscal adventures on either side. Another interesting point revolves around how a Labour administration could try to offset fiscal prudence with some re-regulation, especially on the labour market, but again, we do not expect big swings. The "elephant in the room" remains Brexit of course, and how a better trade relationship could be built with the EU, but none of the big national parties want to tackle it. All this may make for a relatively boring campaign and election outcome in the macroeconomic realm, but this would come as a nice relief considering how populist propositions have often been at the heart of the debate across the West in the last political cycle.

In the Euro area, suspense on the outcome of the ECB meeting on 6 June is close to nil, since even the hawks are openly making a rate cut then as a baseline. There is however some more debate on the trajectory after June, and the market has moved away, last week, from pricing three full rate cuts for this year – which remains our baseline. We suspect investors have been impressed by the unexpected re-acceleration in negotiated wages in Q1. We are however tempted to treat this print as a "blip" since a big one-off in Germany pushed the aggregate result up. Excluding Germany, negotiated wages visibly decelerated in Q1, and real-time indicators, as well as business surveys, continue to point to a continuation of the deceleration in Q2.

UK elections: various shades of mainstream

General elections will take place in the UK on 4 July. The Prime Minister could have waited until well into the second half of the year. The British press was speculating on the Conservative party betting on an imminent reversal in the Bank of England's stance to bring about some relief to mortgage holders – always a key issue in the UK, where adjustable rates dominate, especially given the importance of the house owners demographics to conquer the political centre. The inflation print for April, although still decelerating, came out too significantly above expectations – including ours – for the Monetary Policy Committee not to take notice. We have brought back our baseline for the first rate cut in the UK from June to August. The Prime Minister probably calculated that any relief would not be felt before late in the autumn, and that there was no point in dithering much longer (the absolute deadline was January 2025). His own position was not at risk – the various factions within the Conservatives, despite a drubbing in the recent local elections, chose not to push for yet another change of leader – but keeping his fractious cabinet together was increasingly arduous. The risk was that by the autumn the Conservatives would appear even more divided than today, with little capacity to push any relevant legislative agenda in the meantime. Ripping the band aid, despite polls putting Labour 20 points ahead, was probably, on the margin, the best thing to do.

So, it appears that the UK will be the first G7 country this year potentially changing government. However, **the UK is likely to provide a configuration which has become rare across the West: a race between two essentially centrist offers**, at least from an economic point of view – our sole remit. In the last political cycle – including in the UK – elections in many developed countries have revolved around the opposition between populist and mainstream propositions, or in some cases a battle between several strands of populism. The 2024 British general elections will be very different from the previous one in 2019. Then, electors had to choose between a hard-left statist offer with Jeremy Corbyn, and an essentially dirigiste proposal with Boris Johnson. Indeed, with his focus on bridging the gap between the North and South of England with state intervention (the "levelling up" agenda) and little time for the concerns of the business sector, added to his hard Brexit approach, Johnson's Toryism was very unusual by modern standards. Conversely, the country now faces in the economic policy realm two nuances of a mainstream approach. Of course, Rishi Sunak will campaign on low tax, but Keir Starmer pledged to "keep taxes as low as possible". While this formulation does not exactly exclude target tax hikes, Labour's traditional focus on funding public services is instead essentially based on "growth dividends".

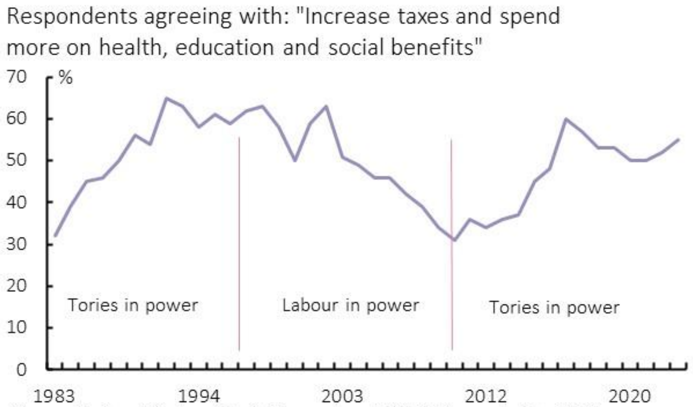
But before we explore these nuances, **what any continental observer will find striking is the fact that from an economic point of view, Brexit, or at least the UK's relationship with the EU, is the elephant in the room**. Daniel Finkelstein, an always extremely perceptive analyst of British politics, exposed this eloquently in his latest column in The Times: The Conservatives don't want to talk about it because they have little to show for their promise that Brexit would lead the country to pastures green. Labour does not want to talk about it because they do not want to alienate a segment of the blue-collar vote which had deserted them in 2019 to support Boris Johnson. In any case the party has already explicitly ruled out re-joining the single market or even a customs union – although the latter was not so long ago seen as a rather moderate attempt to reconcile compliance with the 2016 vote and the UK's economic self-interest. Even the arch pro-European Lib-Dems are keeping a low profile on the issue given their attempt to siphon out conservative votes in the affluent South of England. Europeans can probably count on a more favourably disposed administration in London in Labour wins – Keir Starmer is personally pro-European – but we would be surprised if anything major institutionally was to emerge. At least, given its extreme discretion on the subject, Labour would not have a strong democratic mandate to push for this after the elections.

If Brexit is excluded from the conversation, what we find interesting is that, precisely because none of the two main parties will stray too far away from what would be acceptable to a centrist voter and will avoid economic populism, the **British election will epitomise the sum of constraints which weigh on any reasonable government in the developed world.**

The Conservatives have already tested the limits of their tax cutting approach. As recently as last week, the International Monetary Fund (IMF), in its assessment of the UK economy, did not mince its words when criticising the decision by the current administration to cut the National Insurance contribution, even if the fund staffers recognized the positive effect it may have on labour supply. In a country where the IMF programme of 1976 is still brandished in political debates as the humiliating, lowest point of the country's post war difficulties, these criticisms matter. **The internal contradiction of the conservatives is that, especially after the disaster of the Thatcherite revival attempt by Liz Truss last year, the preference for low tax collides with the country's strong support for well-funded public services, including in their own ranks.**

The National Centre for Social Research has been surveying attitudes of the British population towards key policy proposals since the early 1980s. Back then – at the height of the Thatcherite revolution – only 32% of respondents supported "*increasing taxes and spend more on health, education and social benefits*". This rose to more than 60% by the time Labour won the elections in 1997, but fell again to 31% by 2010 – incidentally when the Conservatives came back to power in coalition with the Lib Dems. This has risen again to 55% in 2024 (see Exhibit 1). A thorny problem for the Conservatives is that the last demographic group where they command strong support – people above the age of 65 – are attached to the National Health Services and the country's socialised pension system (although it remains far less generous than in most continental countries). There is no political space left for a small government offer.

Exhibit 1 – Public opinion's big swings on a big issue



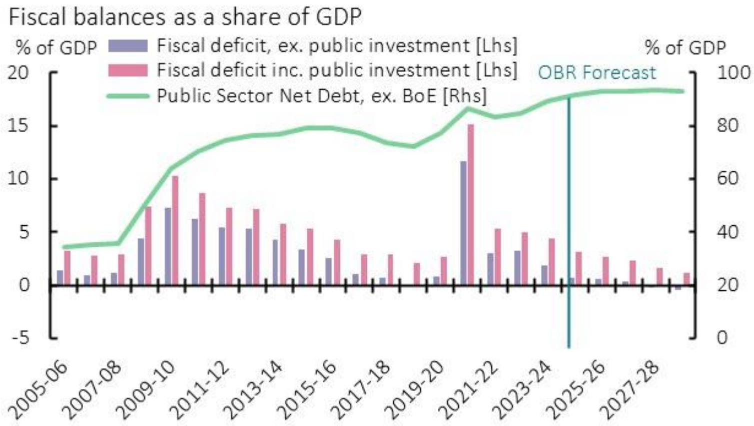
Source: National Centre of Social Research and AXA IM Research, May 2024

The constraints weighing on the Labour party are not much lighter. With the memory of the Corbynite era still fresh, the party's leadership needs to focus on rebuilding a reputation in sound macroeconomic management. Now that the fight has moved again to the centre-ground, advocating sweeping tax hikes to fund public services is not politically feasible. A majority of public opinion may be "in general" in agreement with this proposal today, but this could fade quite quickly when *actual* tax hikes take shape. Yet, Labour – which hasn't yet published its manifesto – needs to cater for its traditional electorate. Walking this tightrope will not be easy.

We are readying ourselves to a pretty boring debate around fiscal rules. The current government rule is based on a limit to the deficit of 3% of GDP – oddly reminiscent of the European Stability and Growth pact – and public debt falling as percentage of GDP by the end of a 5-year period – also quite similar to the new version of the European fiscal framework. Shadow Chancellor Rachel Reeves – who would very likely become Chancellor in a Labour cabinet – in March 2024 presented her own set of rules. **"Day to day" spending would need to be balanced by income, but a Labour government would reserve the right to borrow to fund the investment component of public spending**. She would however retain the need to bring the public ratio down after 5 years. All in all, it comes out as a "constrained golden rule".

This may not necessarily change from the current actual approach. Public investment in the UK has been hovering between 2 and 3% of GDP since the Great Financial crisis (see Exhibit 2). So, a balanced "ordinary budget" would still offer space, within the confines of Reeves' proposed framework, to bring public investment towards the upper end of the range while still respecting the 3% overall deficit cap in principle currently operational. The limit to the investment effort would in effect come from the public debt target. In principle public investment could "pay for itself" if the return – by how much it could boost GDP – at least matches the additional deficit. This is highly debatable however, and lags matter. The GDP-boosting effect on the denominator would not necessarily accrue within the 5-year horizon of the debt limit. The calculation is also highly sensitive to the interest rate assumption. So, **ultimately the debt target would instil prudence on the quantum of public investment effort.**

Exhibit 2 – Reasonable stable public investment



Source: the OBR and AXA IM Research, May 2024

A key issue though is how strong the new rules framework will be. Indeed, fiscal rules have changed 9 times in the UK since the late 1990s and the obvious time inconsistency of the current one is a strong limitation (deficits are today, debt reduction is for tomorrow). The "golden rule" introduces its own new avenues to circumvent the framework. Indeed, the distinction between public consumption and public investment is clear in the national accounting handbooks, but it could be blurred on purpose in the scope of the fiscal rule to provide some leeway, with actually some conceptually sound reasons (e.g., by adding education spending – mostly teachers' pay – in the perimeter of investment). In her speech, Rachel Reeves hinted at a stronger compliance mechanism, again similar to some European dispositions, where the package could not be altered unless the independent Office for Budget Responsibility declared a state of exceptional circumstances. There could also be an interesting variation in whether the 5-year rule is "rolling", as it is today (every new budget pushes the horizon) or if it becomes fixed (in effect meaning that public debt would have to fall by the next general elections).

Sequencing could be an area of focus. Rather than wait until the end of the 5-year period to deliver the bulk of the austerity efforts (which would come at the same time of the general elections), a Labour administration could choose to start with austerity. This would allow the Bank of England to proceed with its own accommodation faster. Such configuration would have the twin benefit of protecting aggregate demand from much of the fiscal tightening, and lower interest rates and thus hold public debt back (in the UK, because of the way the financial relationship between the Treasury and the Bank of England was negotiated during the heady days of Quantitative Easing, the lower the interest rate, the lower the cost to the Treasury of indemnifying the Bank of England). All this would allow the government to embark on a more generous second phase of its mandate.

This could be delicate for a Labour administration though, which would have to hold off from offering "red meat" to its hard-core supporters for a few years. We suspect the magnitude of the majority Labour could win in July would be an important parameter. A wide one would allow Keir Starmer to stare down any rebellion from what remains of Labour's left wing. But we also suspect that a Labour administration would be tempted to offset some of its fiscal prudence with some left-of-centre markers on regulation. The party has been working on a reform of labour law. Today, most workers accrue some level of protection after two years in employment. A Starmer government could extend the existing protection from day 1 of the working contract. In the same vein, a Labour government could stamp down on some "zero-hour contracts" seen as overly advantageous to employers.

We do not think that such focus on regulation – here off-shoring social policy to the business sector – when the fiscal space is constrained will be limited to the UK. But in the specific British case the overall welfare cost could be higher because of Brexit. Indeed, with the loss of unfettered access to the EU single market, the UK's attractiveness as a production centre has taken a hit. High labour market flexibility – when compared to most other continental countries – remains an advantage for the UK. Aligning social regulation on the continental benchmark without at the same time improving significantly the quality of the trade relationship is risky, which gets us back to our earlier point on Brexit remaining the "elephant in the room". True, a Labour government may hope that removing some of that flexibility will force companies to invest more in their workforce and thus lift productivity, which has performed poorly in the UK for years – a strategy which is showing some tentative signs of success in Spain – but these effects could take time to materialise.

In any case, yours truly must confess that he finds it particularly reassuring that for once writing about a national election entails getting into this sort of macroeconomic nitty-gritty, rather than on having to explore extreme scenarios. As a final **point, this promise of political stability and long-term fiscal planning is precisely what domestic and foreign investors alike have lacked for much of the last decade** – something that has reduced the UK's weight in global asset allocation. A return to assessments of the nitty-gritty from the two main parties may ultimately bring that long-prized outcome of increased international investment and with it domestic productivity gains. This may be something that follows this election but judging by recent performance in sterling and UK equities, it may already be underway in anticipation. UK politics may have become boring again, but probably, boring is good.

Wage blip?

Meanwhile, in the Euro area, the policy debate has moved from whether the European Central Bank (ECB) will cut on 6 June – even hawks such as Joachim Nagel openly take this as a baseline in their communication – to the pace of easing. Isabel Schnabel warned that investors should not expect a back-to-back cut in July, and Nagel said the ECB should wait until September, but what we find interesting is that in any case the market was not at all expecting another cut in July was already anchored on September as the next one before they both took to the wires. Still, last week the market pricing of the ECB's trajectory became a bit hesitant beyond September, and last Friday only 58 basis points (bps) of cuts were priced for December, against 70 10 days earlier. The very latest data on negotiated wages may have contributed to the new hesitation. Indeed, the market was expecting a continuation of the deceleration seen in Q4 2023 and had to digest a re-acceleration to 4.7%yoy after 4.5%. Combined with the Euro area's very mediocre productivity developments, this would hardly be consistent with a swift return of inflation to 2%, at least not without a serious margin contraction effort by the business sector. Since the Euro area seems to be doing a bit better on the real side – with in particular a decent Purchasing Managers' Index (PMI reading for May (the composite index rose to 52.3 from 51.7), such effort may look less obvious now.

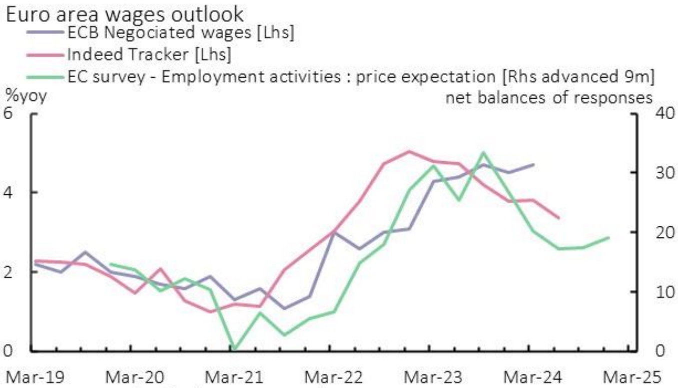
The Euro area aggregate reading owes however a lot to one-offs in Germany (with catch-up payments to civil servants). Excluding Germany, negotiated wages decelerated from 4.7%yoy in Q4 2023 to 4.0% in Q1 2024 (see Exhibit 3), the weakest print since the end of 2022. **In addition, a real time indicator such as the Indeed tracker, which is based on pay details for new job offers posted on a website, continues to a slowdown into** Q2 (down to 3.4%yoy, lowest since Q1 2022). We also look at the price expectations in the employment business from the European Commission survey (hat tip to Frederik Ducrozet on this one), also pointing to decelerating wages (see Exhibit 4).

We are therefore tempted to treat the data flow from last week in the Euro area as an accident and see no strong reason at the stage to change our baseline of three cuts by the ECB this year.

Exhibit 3 – A German one-off tipped the scales in Q1

Source: ECB, National Statistical Agencies, Eurostat and AXA IM Research, May 2024

Exhibit 4 – Alternative measures less concerning



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

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Country/Region	What we focused on last week	What we will focus on in next weeks
	• FOMC minutes (May), neutral but various members stated willingness to tighten further if necessary • PMIs (May, p) mfg 50.9 vs 50.0, but services 54.8 vs 51.3 – a 1-year high – but employment still soft • New & existing homes sales (Apr) fell by 4.7% and 1.9%, the former much bigger than expected • Jobless claims continue to unwind seasonal effect	• GDP (Q1, revision) watch for revisions to erratic contributions to Q1 softness • PCE inflation (Apr) both measures expected at 0.3%mom, but 0.2/0.3% looked close call from CPI/PPI • Personal spending (Apr) expt'd softer after Mar • Conf Bd Consumer Confidence (May) expectations idx • Fed's Beige Book – noted consumer softening last
	• EMU Flash PMIs Composite rose to 52.3 (+0.6p) driven this time by rebound in Mfg (47.4; +1.7p) in particular from Ger (+2.9p). Fr Svcs was disappointing (49.4; -1.5p) • EMU flash consumer confidence (May) rose to-14.3 • Business climate (Fr, May) was flat at 99 • Q1 Ger GDP confirmed at +0.2% but domestic demand was weak and only driven by net trade	• Flash inflation (HICP, May). Focus on services inflation that should increase a bit due to base effect after an already upside surprise in April • EC surveys are expected to slightly improve. Key to monitor the reconvergence between mfg and svcs and prices expectations • Ifo (Ger, May) to confirm or not the improvements seen in PMIs • Final GDP data (Fr, Q1) • Loans to households and companies (Apr)
	• CPI inflation fell to 2.3% in Apr (consensus 2.1%). Core ticked down to 3.9% (consensus 3.6%) • The flash composite PMI fell to 52.8 in May, from 54.1 in Mar. • Retail sales dropped by 2%mom in Apr. • GfK cons. conf. rose to -17 in May, from -19.	• Consumer credit likely rose by around £1.4bn in Apr, broadly in line with the average this year • Mortgage approvals probably held broadly steady at around 61K in Apr.
	• Machinery Orders rose by a further 2.9%mom in Mar. following a 7.7% rise in Feb. • Exports rose 8.3%yoy in Apr, up from 7.3% in Mar. • Composite PMI steady at 52.4 in May (52.3 in Apr) • CPI inflation fell to 2.5% in Apr., from 2.7% in Mar. Ex food and energy CPI, 2.4%, from 2.9%	• Unemp. rate likely unch at 2.6% in Apr • Tokyo CPI inflation likely rose to 2.2% in May, from 1.8% in Apr. • Retail sales look set to rise 2.0%yoy in Apr. • Industrial production likely up by 1.5%mom in Apr.
	• PBoC kept LPRs unchanged in May, 1Y: 3.45%; 5Y 3.95%	• 27 May: Industrial profit for Jan-Apr • 31 May: NBS mfg PMI and non-mfg PMI for May
	• CB: Chile cut -50bps to 6.0% & Hungary -50bps to 7.25%. Indonesia (6.25%), Korea (3.50%) & Turkey (50%) stood on hold • April inflation (%yoy): Malaysia (1.8%) & South Africa (5.2%) • Q1 GDP slowed to 1.5%yoy in Thailand	• CB: South Africa is expected to stay on hold at 8.25% • Industrial production (Apr): Korea, Thailand & Russia • Q1 GDP: Czechia, India & Turkey • General elections in South Africa • May inflation in Poland

Upcoming events	US:	Tue: Case-Shiller HPI (Mar), FHFA HPI (Mar), Conference Board consumer confidence (May); Wed: Federal Reserve issues Beige Book; Thu: GDP – 2nd estimate (Q1), Core PCE price index (Q1), Goods trade balance (Apr), Weekly jobless claims (25 May), Wholesale inventories (Apr, p), Pending home sales (Apr); Fri: PCE price index (Apr), Personal income & spending (Apr), Chicago PMI (May)
	Euro Area:	Mon: Ge IfO business climate index (May); Wed: Ez M3 money supply (Apr), Ge CPI (May, p), Ge HICP (May, p), Fr Insee consumer confidence (May), It ISTAT business & consumer confidence (May); Thu: Ez Business confidence (May), Sp HICP (May, p); Fri: Ez, Fr,It HICP (May), DBRS reviews Germany's credit rating, Fr Consumer spending (Apr), Fr,It GDP (Q1), S&P reviews France's credit rating, Moody's reviews Italy's credit rating, DBRS reviews Spain's credit rating
	UK:	Tue: BRC shop price index (May), CBI Distributive Trades survey (May); Fri: Mortgage approvals (Apr), Net mortgage lending (Apr), Consumer credit (Apr), M4 money supply (Apr), Nationwide HPI (May)
	Japan:	Wed: Consumer confidence (May); Fri: Unemp (Apr), Industrial production (Apr, p), Housing starts (Apr)
	China:	Mon: Industrial profits (Apr); Fri: Official mfg & non-mfg PMI (May)

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

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