Investment Institute Macroeconomics

Note to our readers: the next issue of Macrocast will come out on 4 November

Policy Mixology

- The looming fiscal tightening in the Euro area should embolden the ECB to set a clearer path for its own policy
- The UK presents a very clear case of potential cooperation between the government and the central bank
- When looking into China's policy options, financial stability measures should not be confused with fiscal stimulus

Paradoxically, although it is now consensus that the Fed should have been more prudent in September, the market is now almost exactly aligned with the FOMC's dot plot. We have been warning against reading too much into such forecast given the imminent election in the US which could have some quite different effects on inflation. Such uncertainty does not exist in the Euro area. Of course, Europe has its own sources of political tension, but at least the fiscal stance for next year is clear: based on the government pledges in the three largest economies, the adjustment will reach 0.9% of GDP in the Euro area. This cannot be ignored by the ECB. Estimates of the impact of fiscal and monetary policy on GDP vary, but very few would argue that next year's fiscal austerity won't have some dampening effect on an already mediocre domestic demand. This should be among the reasons for which we think the ECB should depart from its "one meeting at a time" mantra, to which it stuck again last week. The fact that the Governing Council was unanimous in condoning a back-to-back cut which would have been very contentious just a few weeks ago is positive, but even if some measure of data dependence will of course remain, there is now enough clarity on the kind of internal risks to growth the Euro area is facing to warrant a less reactive approach.

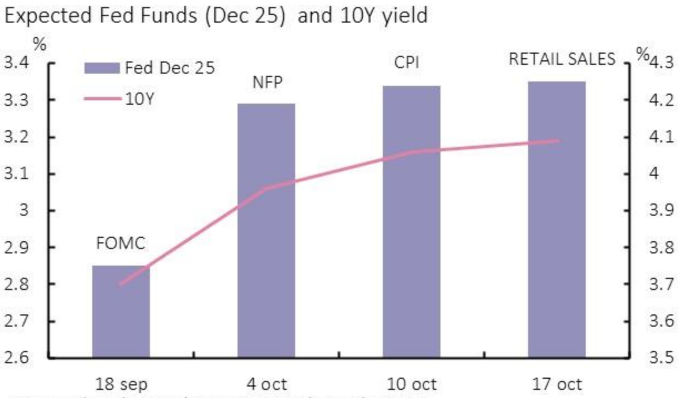
Next week in London the Chancellor of the Exchequer will unveil the budget for 2025. We think the UK presents a very clear case of potential cooperation between the central bank and the government, as a front-loaded fiscal adjustment is coming.

We continue to reserve judgement on China's fiscal stimulus as long as we do not get more precise information. We note that the market tends to react very positively to noises about a significant rise in central government debt issuance. If a large fraction is directed to a swap for local government debt, this may be positive in terms of financial stability, but the direct impact on activity could be quite limited.

Fed and ECB meeting in the middle

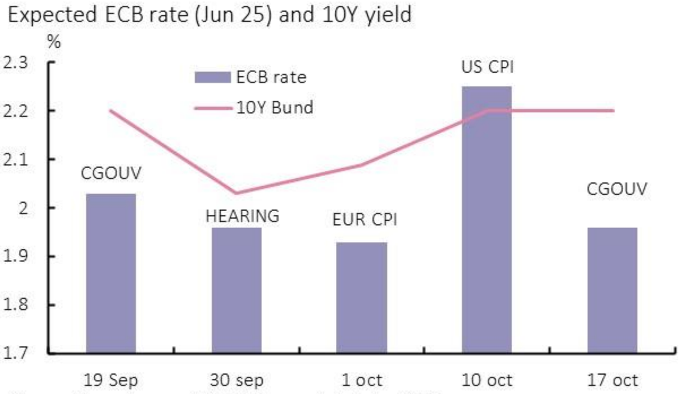
The usual "dance" between the market and the central banks has taken different forms across the Atlantic since the end of the summer break. In Exhibits 1 and 2, we look at how the market reacted to some key announcements and data releases for the expected monetary policy trajectory and how it transmitted through the yield curve. After the September Federal Open Market Committee (FOMC) meeting, investors were expecting to see Fed Funds hit in December 2025 already the level the Federal Reserve (Fed) itself, through its dot plot, did not forecast to reach until the end of 2026 (2.9%). We argued at the time that the Fed starting its monetary easing with a 50-basis point (bp) cut fuelled overly ambitious expectations. Subsequently, **the release of the employment report on 4 October was the key shock.** The above-consensus prints for Consumer Price Index (CPI) and retail sales only marginally strengthened the market's conviction that the Fed would have to steer a more prudent path. Since the beginning of October, the market has brought its expectations for December 2025 almost exactly in line with the dot plot (3.4%). Interestingly, the transmission to 10-year yields was almost 1 for 1, and for the long-end of the curve as well the "jolt" came from Non-Farm Payrolls (NFPs). Jay Powell may find himself in a delicate position, as a wide consensus has formed around the idea that he "pushed the envelope" too far at the September meeting, but perhaps paradoxically, the market is now completely aligned with what the FOMC's "median member" forecasts – against which we have been repeatedly cautioned given how binary the outcome of the US elections can be for the inflation outlook.

Exhibit 1 – The NFP release was the jolt



Source: Bloomberg and AXA IM Research, October 2024

Exhibit 2 – Market counted on an ultimately dovish ECB anyway



Source: Bloomberg and AXA IM Research, October 2024

The story is different for the European Central Bank (ECB). Even on the evening of the September meeting – which was not particularly dovish, despite the 25bp cut, with a forecast still nodding visibly to upside inflation risks – the market was expecting the ECB to cut at every meeting until June 2025 despite hints at a more measured pace (e.g. the insistence of quarterly forecasts). Lagarde's subsequent dovish hearing at the European parliament on 30 September moved the market's expectation down by only 10bps. Interestingly, the only moment over the last month when the market revised up the ECB's trajectory coincided with the release of higher-than-expected inflation in the US, as if investors took on board higher-than-expected Fed Funds in their assessment of the future ECB moves. As the market's view of the ECB did not change much, 10-year yields also remained more stable than in the US. It seems that **investors have made up their mind on the – concerning - European outlook and the subsequent policy response, irrespective of what the ECB expresses. Perceptions are more fluid on the US side.**

Yet, even if it does not shake the market, at least the ECB is now expressing a readiness to act more decisively. "*We are not blind".* This was in our view the key statement by Christine Lagarde at the October meeting. There was little suspense around the actual move – the market was pricing a 99% probability for a 25bp rate cut. But while in the ECB only marginally revised down its growth forecast in September; Christine Lagarde made it plain last week that the central bank was ready to respond quickly to a deviation from their baseline scenario.

Christine Lagarde made no mystery of the ECB's concern over the real economy in her Q&A, and the prepared statement added one element to the list of downside risks to growth: the possibility that a lack of consumer and/or business confidence throws a spanner in the wheels of the recovery which the central bank continues to expect, at least officially. This was clearly a nod to some recent behavioural developments. While some rebound in purchasing power is materialising, since wage growth, albeit decelerating, is still outperforming declining inflation, the rise in the savings ratio is leaving consumer spending virtually flat. On the corporate side, the deterioration in profit margins – although conducive to faster disinflation – contributes to the ongoing contraction in investment.

As we expected**, there was no return to forward guidance**. The statement and Christine Lagarde's pronouncements were still consistent with data dependent, one meeting at a time decision-making. Still, we can sense how **a significant revision of the forecast can be expected for December, and as we argued two weeks ago it may be the right occasion to send a more decisive message on the future trajectory for policy rates**. We agree with the market pricing of one 25bp cut at every meeting until June 2025, with the deposit rate hitting 2%, i.e. the upper end of what is commonly seen as the neutral level in the Euro area. We do not exclude the possibility that, on this path, the ECB resorts to one 50bp cut if the dataflow deteriorates faster. The market is already pricing a more than 50% probability of such action at the December meeting (see Exhibit 3).

Exhibit 3 – 50bp cut in December in play for the market

Source: Bloomberg and AXA IM Research, October 2024

We found it quite telling that Christine Lagarde chose *not* to brush away the possibility of such move when she was asked directly about this during the Q&A. She reported that a 25bp cut had been the option put on the table by the ECB's Chief Economist – in charge as usual of the policy proposal at the beginning of each Governing Council – which naturally focused the discussion, but that is a minimalist rebuttal. The important fact is that the decision to cut by 25bps was unanimous, while it came certainly faster than a lot of Governing Council members expected in September. **If *everyone*, including the most extreme hawks, are condoning back-to-back cuts, the bar to get to 50bps in one go may not be that high.**

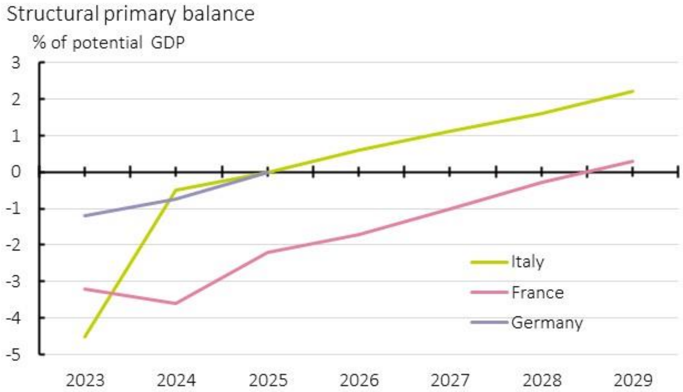
One may ask what effect a more explicit monetary policy trajectory by the ECB beyond December could have, since the market is already expecting "systematic easing. We would argue that **the central bank still needs to reach beyond the market participants and trigger a positive confidence effect for consumers and businesses.**

Exploring the 2025 policy mix

The ECB as usual at the end of the prepared statement called on governments to "*make a strong start*" in the direction of lower deficits and debt in their medium-term plans, but we have often complained about the central bank's reluctance to – at least explicitly – take the fiscal impulse on board in their own policy reaction. Christine Lagarde last week pointed to a clear "division of labour": *"the fiscal authorities will do what they have to do in fiscal terms and while* *the authorities will do what they have to do in structural reforms, we will do our part by maintaining price stability".* Yet, she immediately added "*of course we are interested in what they do, because everyone has to play their part".* We do not want to over-interpret this remark – this is a common affliction among central bank watchers – but this may be a subtle hint at some evolution here.

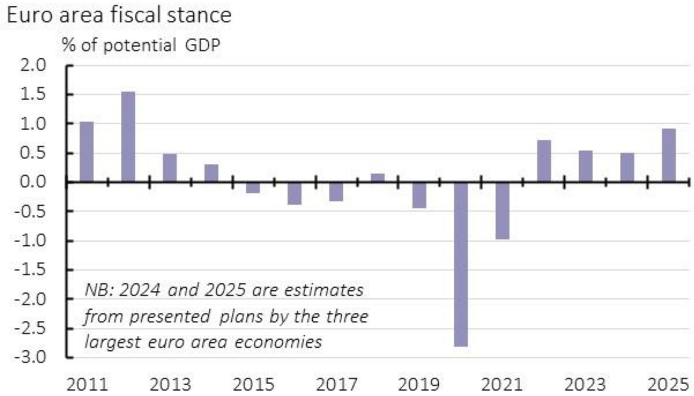
We discussed last week how the French fiscal adjustment for 2025 would have some adverse effect on aggregate demand, but we now want to extend this to the Euro area as a whole. Information is still patchy, but the fiscal stance – **the change in the primary government balance – will be restrictive in all three larger economies of the Euro area (see Exhibit 4) next year and beyond**. The massive step in Italy in 2024 reflects the end of the "Superbonus", and the subsequent further tightening will – just like this year – be at least partly offset by the funds flowing from Brussels, but Germany, complying with its national "debt brake" provisions, is planning a reduction in its structural deficit of 0.75% of GDP next year.

Exhibit 4 – Restriction ahead in the EA-big3



Source: European Commission and AXA IM Research, October 2024.

Exhibit 5 – Most restrictive stance since 2012



Source: European Commission and AXA IM Research, October 2024.

When averaging the national pledges, we find that the overall fiscal tightening would reach 0.9% of GDP in 2025, assuming of course governments stick to their plans. This would be the largest effort since 2012 (see Exhibit 5). To be fair, technically this would not be a major breakaway from the recent trend: according to the European Commission's data, restriction has been ongoing since 2022. Still, the first years were about removing the extraordinary support which the pandemic – and then the war in Ukraine – made necessary. As private spending was normalising, removing the government impulse was largely neutral for aggregate demand. This is changing: **the fiscal tightening will materialise while there is no "catching up" left to do in private spending.**

Getting the right level of the fiscal multiplier is key. It was, famously now, for having resorted to too-low estimates of the multiplier that the US and the Euro area countries triggered a "double dip" in the early 2010s when choosing to close quickly the deficits left by the Great Financial Crisis. The reference at the time was a series of papers by Alesina and Perotti in the 1990s and early 2000s, concluding to multiplier *well below* 1 in Organisation for Economic Co-operation and Development (OECD) countries. Conversely, the academic literature which came after the early 2010s mistake concluded to a much higher multiplier, teetering on levels at which a fiscal tightening becomes self-defeating (the impact on growth, and hence tax receipts, is so negative that it sends public finances into a deficit spiral). What is at least consensus now is that multipliers are state-dependent: there is no absolute value, **the impact of the fiscal tightening will depend on a range of contingent conditions, among which the monetary policy stance and broader financial conditions**.

With monetary policy moving away from restriction, the multiplier should be reasonable, somewhat below 1. We are not at all in the situation European peripheral countries found themselves after 2010. But this cuts both ways. A research paper by the ECB in 2015 (see link here) suggested that, even if the multiplier was high, countries faced with massive financial pressure were still better off resorting to front-loaded, large fiscal consolidation, since they could reduce spreads and thus loosen financial conditions and ultimately cushion the blow for domestic demand. Financial pressure is moderate in the Euro area. Indeed, policy rates are still restrictive now, but 10 years yields are still in line with trend nominal GDP growth. **Fiscal restriction today is necessary to *avoid* moving bond yields into restrictive territory by reassuring the market on debt sustainability, but it probably won't *reduce* them much. This leaves much of the stabilisation effort to the central bank.**

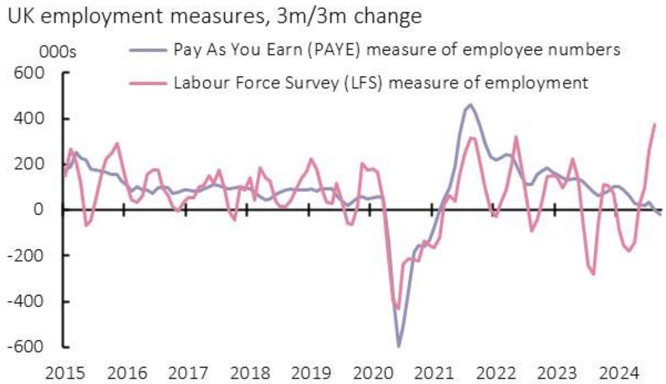
If we retain as a "reasonable assumption" a multiplier of 0.7 in the Euro in the current conditions, a restrictive fiscal impulse of 0.9% of GDP in 2025 would hit GDP by 0.6%. How much of a reduction in interest rates would be needed to offset such fiscal shock? Elasticities vary wildly. In Philip lane's own presentations on the matter in October 2022 (see link here), the reaction of GDP to a 100-bps change in policy rates after two years would vary from 0.2% to 1.0% across three models. If, as we and market expect, the ECB brings its deposit rate to 2% by June 2025, the overall loosening from peak would lift GDP by between 0.4% and 2%. This is a wide margin of uncertainty, but the good news is of course that even in the worst case – the outcome of the ECB's "base model" – about two-third of the adverse impact of the fiscal tightening could be offset. Yet, we note that such offsetting effect would come only slowly. In the "base model" there would not be anything visible the first year. Conversely, the reaction to the fiscal impulse tends to be quick….and a multiplier of 0.7 may prove too optimistic.

This is another reason why the ECB, even if it starts sending clearer messages on the overall trajectory past December, will have to remain data dependent in the sense that it will have to stand ready – beyond the external shocks – to take on board a powerful reaction to the fiscal tightening in 2025, which may force to descend into properly accommodative territory (i.e. below 2%). Of course, luck can be on the ECB's side and the reaction of the economy to its monetary loosening can come out at the upper end of its models' range, but precisely: such reaction has a higher probability to materialise if the ECB is more forceful on its messaging, by lifting confidence.

The UK is a good case for monetary and fiscal policy cooperation

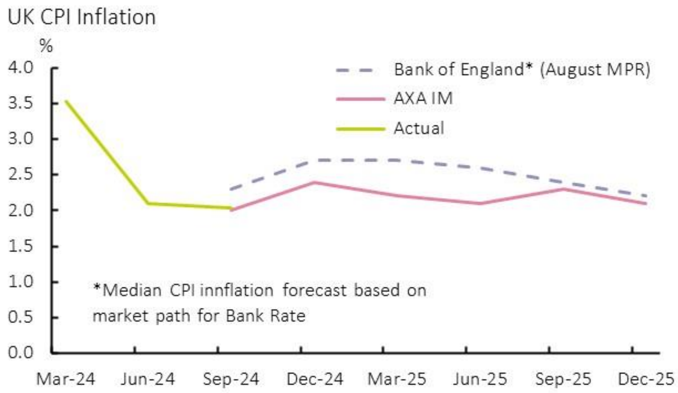
The UK is another example where considerations regarding the policy-mix could take centre-stage in the months ahead. The Bank of England has joined the "restriction removal" band and there as well we think an acceleration in the pace of easing is due, especially since the government is about to embark on a front-loaded fiscal consolidation effort (Rachel Reeves will present a budget for the next fiscal year on 30 October).

Exhibit 6 – Data is confusing, but it's loosening



Sources: Office for National Statistics and AXA IM Macro Research, Oct 2024

Exhibit 7 – Obsolete inflation forecasts



Sources: Bank of England, the ONS and AXA IM Macro Research, October 2024

The Monetary Policy Committee needs to deal with a tricky data flow, since the Office of National Statistics itself is publicly warning about the accuracy of its Labour Force Survey. Gauging the degree of tightness of the labour market is of course crucial to calibrate the monetary policy stance, and the rebound in the official employment date in the latest print would in principle be a strong argument against another policy loosening. Yet, when using alternative data, such as the number of employees registered for the pay-as-you-go income tax system, which we think is more reliable at the moment, the picture which emerges is that of an economy now *destroying* jobs, albeit marginally (see Exhibit 6). Moreover, just like in the Euro area, **the Bank of England (BoE)'s latest inflation forecasts were off from the start**. The CPI decelerated markedly in September, to 1.7% year-on-year, below market expectations of 1.9% and the BoE's forecasts at 2.1%. Services prices – key to get a sense of the domestic inflationary forces – slowed down to 4.9% from 5.6%. Our own forecasts are much closer to the inflation target than the central bank's (see Exhibit 7).

True, headline inflation is likely to rebound somewhat in the next few months, essentially because of how wholesale energy prices are transmitted to final consumers in the UK, and the pace of services inflation, albeit abating, can still be considered as concerning. Yet, **we think the BoE can easily take the risk of bringing forward restriction removal, cutting again in November already, given the looming fiscal tightening**.

We have argued when the new government came to power in London that **there are strong arguments for front-loading the fiscal adjustment in the UK.** Politically, Keir Starmer can still blame the need for painful fiscal measures on the legacy of the Tory administration – this argument will fade soon. Economically, front-loading can convince the BoE to accelerate the cuts, given the immediate dampening on demand and hence inflation. Given the UK's strong sensitivity to interest rates – and the speed of monetary policy transmission there – a lot of the adverse effect of the fiscal tightening could be offset by the monetary stance.

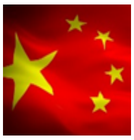
Rachel Reeves is coming under criticism from within the Labour party for trying to push a too austere budget. Yet, beyond the mitigating role BoE cuts could have, **there is a lot the Treasury could quickly save from lower long-term interest rates** – and this is a key difference with the Euro area countries**.** The memory of the "Liz Truss incident" is still fresh, and 10-year yields in the UK are still a good 100 bps above the levels seen in France, even though the latter has been under a lot of scrutiny recently – especially in the British press – for its fiscal difficulties. There is still quite some space for lower long-term interest rates in the UK if a strong, reassuring message on debt sustainability comes out.

To be clear, **we are not advocating here any curtailment of central bank independence**. This would be counter-productive since markets could question the central bank's commitment to price stability and hence push term premia higher. Still, **when central banks say "they are not blind", we think this should extend to the clear signals from fiscal policy when calibrating their own stance.**

China: chase the money

Over the last few weeks, the equity market has reacted positively every time a stimulus announcement by Beijing seems to be imminent. Some aspects of policy support already announced are substantial – e.g. the monetary policy loosening from the People's Bank of China (PBOC) – but on the fiscal side they remain hazy. The hesitations in Beijing may be linked to the uncertainty over the US elections given their potential impact on bilateral trade, but the "shock and awe" psychological effect of big stimulus announcements may have already been missed.

Moreover, while we wait for some more concrete measures, **we are struck by how the market is reacting positively to noises around a significant rise in debt issuance by the central government**. Indeed, in the current configuration in China, more debt issuance is not necessarily the reflection, or a promise of more fiscal stimulus. If a significant fraction of such additional debt is used to merely back a "swap" with real-estate related debt currently sitting on the local authorities' balance sheet, the effect of activity will depend on (i) how much such a swap could shore up sentiment in China and (ii) incentivise local authorities to be more active on "ordinary" (i.e. non-real estate related) spending. We recommend our readers take a good look at the note published last week by our colleague Yingrui Wang (see link here) on the intricacies of Chinese local authorities' finance. Given the relative underlying financial strength of the central and local government, a "swap" would probably be positive from a financial stability point of view, but for now, we continue to reserve our judgment on the overall fiscal stimulus in China.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Retail sales (Sep) up 0.4%mom, strong given gasoline weakness, control group +0.7% • Empire and Philly Fed surveys (Oct) Empire dropped to -11.9, but Philly rose to +10.3 • Jobless claims dipped to 241k, still a little elevated but concentrated in hurricane impacted areas • Industrial production (Sep) -0.3%mom, mfg -0.4%mom, but Q3 GDP overall likely solid	• Housing data (Sep) existing home sales likely posted small gain after Aug drop, new homes likely not • PMIs (Oct, p) ongoing focus on services which has remained solid since mid-year • Federal Reserve Beige Book – watch for any anecdotal signs of softening activity
	• The ECB cut its depo rate by 25bps to 3.25% as widely expected. No changes to rate guidance were made. Worries on growth and downside risks to ECB's inflation outlook made the meeting sound dovish • Euro area final September headline inflation was revised down -0.1pp to 1.7%yoy from the flash estimate. Core was unrevised at 2.7%yoy	• Business confidence for October: PMIs, INSEE, Ifo • Moodys credit rating decision on France • National Parliaments to discuss 2025 draft budgetary plans in France and Italy
	• Labour market data (Aug) showed a further decline in private sector wage growth to 4.8% • CPI inflation (Sep) undershot the BoE's expectations by a whopping 40bps • Retail sales (Sep) unexpectedly rose by 0.3%mom – a decline of 0.3% had been expected by markets	• Public finances (Sep) should show borrowing overshot the OBR's forecast again • Flash PMIs (Oct) likely will drop, given heightened uncertainty in the run up to the Budget • GfK consumer confidence (Oct) probably will remain subdued due to the Budget
	• IP (Aug, final) fell by 3.3%mom, more than offsetting the previous 3.1% rise • Exports (Sep) fell 1.7%yoy • CPI inflation (Sep) ex. fresh food and energy ticked up to 2.1%, from 2% in August	• Flash PMIs (Oct) look for further weakness in manufacturing • Tokyo CPI (Oct) looks for any signs that the virtuous wage/price spiral is taking hold • Elections – LDP should remain largest party
	• GDP grew 4.6%yoy in Q3, beating mkt exp of 4.5% • Retail sales rose 3.2%yoy in Sept from 2.1% in Aug • FAI increased 3.4% in Sept from 2.0% in Aug • House prices dropped by 0.7% (new) and 0.9% (existing) in Sept, same pace as in Aug • Exports slowed to 2.4%yoy in Sept from 8.7% • CPI inflation slowed to 0.4%yoy in Sept from 0.6	• 21 Oct: LPR 1-year and 5-year for October expect 20bps cut following the policy rate cuts in Sept • 27 Oct: Industrial profit for September
	• CB: Chile (5.25%), Thailand (2.25%) and Philippines (6%) cut by 25bps, Indonesia (6%) and Turkey (50%) on hold • CPI yoy (Sept): India (5.5%), Poland (4.9%) • Q3 GDP: Singapore (4.1%yoy) • IP (Aug): Colombia (-1.9%yoy), Uruguay (0.7%yoy)	• CB: Hungary (6.5%) on hold • CPI (Sept): Malaysia, South Africa • Q3 GDP: Malaysia, Korea • IP (Sep): Singapore, Taiwan • Economic activity index (Aug): Argentina, Mexico

Upcoming events	US:	Wed: Existing home sales (Sep), Beige book publication; Thu: Initial jobless claims (w/e 19 Oct), Mfg, services and flash PMI (Oct), New home sales (Sep); Fri: Durable goods orders (Sep, p), Michigan consumer sentiment and inflation expectations (Oct)
	Euro Area:	Mon: Ge PPI (Sep); Wed: Ez consumer confidence (Oct, p); Thu: Fr Insee mfg confidence (Oct), Fr, Ge, Ez mfg 'flash' PMI, Fr, Ge, Ez services 'flash' PMI (Oct), Ez composite 'flash' PMI; Fri: Sp Unemp (Q3), Ez M3 supply (Sep), Ez ECB inflation expectations (Sep), Ge IfO index (Oct), Fr Moody's credit rating review, It DBRS credit rating review
	UK	Mon: PSNB ex-banking groups (Sep); Thu: Composite, mfg and services 'flash' PMI (Oct); Fri: GfK consumer confidence (Oct)
	Japan:	Thu: Mfg 'flash' PMI (Oct)
	China:	Mon: PBoC announcement (Loan Prime rate)

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

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*As at the end of June 2024, including non-consolidated entities.
** As at the end of December 2023.

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