250 – 9 December 2024

Dry Powder: Ready to Fire, or Collecting Dust?

- We are uncomfortable with the notion of “keeping powder dry” which the hawks at the ECB are pushing
- Paris seems to be dealing relatively well with instability in the short run
- The US labour market remains resilient. The FOMC could find many reasons not to cut in December.

A 25bps cut by the ECB is widely expected for this Thursday, but focus is on the extent to which the central bank will accept to move from pure “data dependence” to some forward guidance, anchoring a regular descent of policy rates to neutral and possibly below. We think the ECB’s statement will explicitly point to a “restriction removal” process on the back of a downward revision of their growth and inflation forecasts, but without elaborating too precisely on the speed and magnitude of such process and maintaining, as always, conditionality.

The ECB hawks now seem to accept the need to cut, but they call for “keeping some powder dry” to deal with future shocks, and dispute how far the current level of policy rates is from a neutral level. We are uncomfortable with the notion of “dry powder”. This sends the signal the central bank could “run of powder” in the future, while part of its power lies in the market’s belief in its capacity to continuously find ways to support the economy and fight deflation risks. We do not think the ECB will have to use unconventional policy anytime soon but given the level of internal and external political instability the Euro area is facing now, the central bank appears as a rare source of reassurance. It is not the right time to send the signal some weapons in the arsenal will remain under lock and key. Of course, the Governing Council does not know yet to what extent the Trump administration will deliver on its trade war threats, nor how the political system in France and Germany will re-arrange itself. But uncertainty carries an immediate economic cost, which could further depress consumers’ purchasing plans and business investment.

We review the latest political developments in Paris. The country is heading towards a “special law” which will ensure budget continuity. There are some signals arrangements around a “minimal government” could be found, but of course the underlying public finance trajectory remains in jeopardy. We also look at the November Employment report in the US. We still need to wait for the inflation print, but although it is not our baseline, it is getting less and less difficult for the FOMC to decide that a pause in “restriction removal” is warranted in December.

Why keep some powder dry?

We expect the European Central Bank (ECB) to cut by 25 basis points (bps) its policy rate to 3% this Thursday. While we would not be surprised if the central bank had ultimately to resort to one or two 50bp cut(s) at some point next year, we do not think the threshold for such action has been hit yet: judging by their communication ahead of the "purdah period". **Even the doves seem to avoid appearing too "greedy" and seem comfortable with 25bp**s. This view is consistent with the market pricing of 27bps worth of cuts for this week, up from a peak at 38bps on 22 November.

Focus is however on the next steps. At her hearing at the European Parliament, Christine Lagarde stated that "*we still have a bit of work to do, but we are in sight of target and that would predicate that we begin looking forward more than we have in the last couple of years".* Accordingly, we expect the prepared statement to mention "*a gradual removal of restrictiveness provided data confirm the ECB's outlook*": a conditional path, but with the clear sense of direction which was missing so far.

Such shift will of course raise the role the forecasts – the "outlook" – play relative to the backward-looking dataflow. Supporting the "restriction removal" path, we think the ECB will revise down its forecasts for both GDP growth (from 1.3% to 1.1% in 2025) and inflation (2.1/2.2% for core, from 2.3%, in 2025). This will not be difficult to justify, given the recent message from the surveys, and simply carrying over the fact that inflation in the autumn of 2024 has already been noticeably lower than in the ECB's September forecasts (please see for more details our colleagues François Cabau and Hugo Le Damany's full preview note here).

Although we expect that a large majority of the Council will back the cut this week, the hawks are not surrendering easily, with the real battle moving to where the neutral rate is how quickly the ECB's policy rate should move there. Isabel Schnabel, in a recent interview to Bloomberg, set out her stall: in her view, the current rate may not be that far from where the ECB already is and moving too fast/too far is problematic as a lot of the reasons why the Euro area economy is struggling are structural and cannot be easily addressed by monetary policy. She warns against "*using valuable policy space that will be needed in the future when the economy is facing shocks that monetary policy can deal with more effectively".*

We do not dispute that many of the challenges facing the Euro area are of a structural nature. Some are old, others are newer: Germany's over-reliance on struggling export markets and overly concentrated sectoral specialisation, as well as excessive energy costs, have only recently become significant sources of impairment. Yet, logically, **if structural issues have become more of a hindrance for output, then *potential* growth has taken a hit**, **which would be consistent with a *lower* neutral interest rate**, in contradiction with Schnabel's view that the neutral rate has increased (she locates it between 2 and 3%).

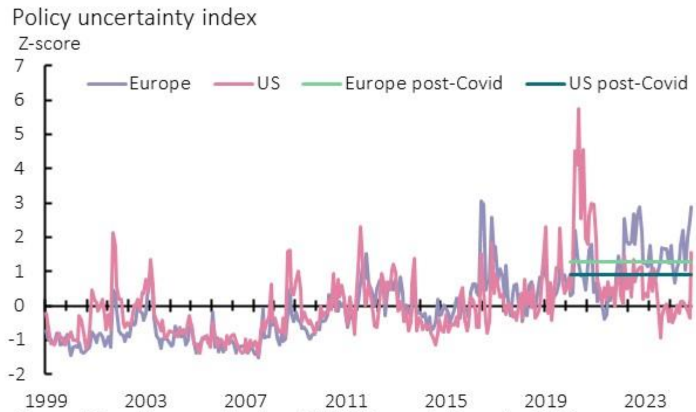
More generally, **we are uncomfortable with the general concept of "keeping some powder dry"**, abstaining from big, or fast moves today to preserve some policy room for manoeuvre in the future. We understand that in the current circumstances, as we do not know how quickly and how intensively the new administration in Washington DC can trigger a trade war with Europe, some ample policy capacity could come handy once we know more about Donald Trump's transformation rate from campaign promises to implementation. Yet, if "keeping some powder dry" means consciously maintaining current monetary conditions a bit too restrictive today to build up future intervention capacity, this creates a risk that the future shock hits **already deteriorated conditions, making it necessary to resort to an even bigger quantum of accommodation down the road. Another problem with "keeping powder dry" is that it can send the signal that the central bank is concerned with a risk of running out of powder later**, which can be a dangerous message. Isabel Schnabel is consistent, since in an earlier speech she expressed her reservations about some aspects of unconventional policy – such as Quantitative Easing – but we think it was a great source of progress – and credibility – that the ECB unambiguously proved that it could continue to provide much needed support even when it had run out of "conventional policy space".

To be clear, in our baseline we do not think the ECB will have to dig into unconventional territory again, but we consider that **it would be a mistake for the ECB to send the signal there is a limit to its policy capacity, at a time when Europeans are already dealing with an extensive power vacuum, with both France and Germany grappling with political instability** (more on this in the next section).

Of course, central banks cannot fully substitute themselves to governments, but **the ECB is in the current configuration the only power centre in the European Union (EU) which maintains strong, and fast decision-making ability, with time-proven efficient tools at its disposal**. Moreover, while Germany is now dealing with the realisation that its once successful growth model may no longer be appropriate, a lot of the current weakness in Europe can also be traced back to usual cyclical issues. We have been insisting for months in Macrocast on the continued rise in the savings' rate as a major concern for the European outlook. The rise in uncertainty cannot help.

We use in Exhibit 1 the news-based policy uncertainty index in the US and in Europe developed by Baker, Bloom and Davis. It is based on counting the occurrences of certain key words in national newspapers. The European index has both a higher average and a higher volatility than the US one, but here we normalise it into a z-score to make it easier to compare. For 20 years, uncertainty had evolved in a remarkably parallel way across the Atlantic, which is not necessarily intuitive: the Great Financial Crisis started in the US in 2008, but the ripple effect was visible immediately in the European perceptions. In the opposite direction, it is striking to see that the rebound in uncertainty in Europe during the peripheral crisis of 2011-2012 was echoed in the US index. This link has however changed drastically since the pandemic: Europe's sensitivity to the Ukraine war and the related energy shock has been specific. More recently, **while the US elections duly raised uncertainty on the Western side of the Atlantic, it is on the Eastern side that the recent spike has been the most visible**. On top of the risks the US administration is creating for Europe specifically (trade war, defence), Europe needs to deal with home-grown instability, with the demise of the government in France, the implosion of the coalition in Germany and the interrupted electoral process in Romania.

Exhibit 1 – More uncertainty now in Europe than in the US

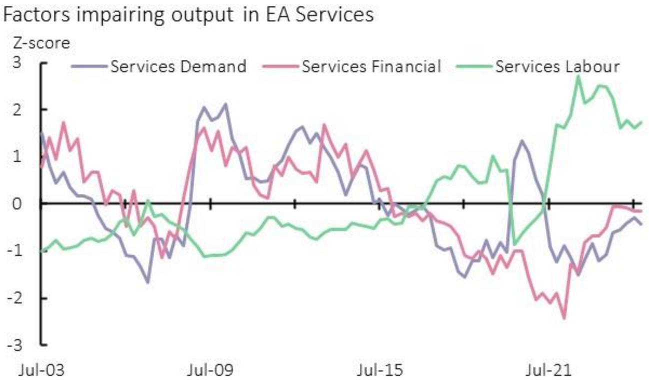


Source: Baker, Bloom and Davis and AXA IM Research, December 2024

The impact of uncertainty on the economy can be quantified, even if it is not directly measurable. According to a recent paper by the European Commission (see link here), **an average-sized exogenous shock to uncertainty reduces GDP growth by 0.45 percentage points (pps) over one year in the EU,** and the sensitivity of consumption and investment to uncertainty has increased when the estimates take the pandemic and post-pandemic period into account. This would suggest that it would be wrong for policymakers NOT to take uncertainty into consideration and wait until the full details of a looming exogenous shocks are known before making a move.

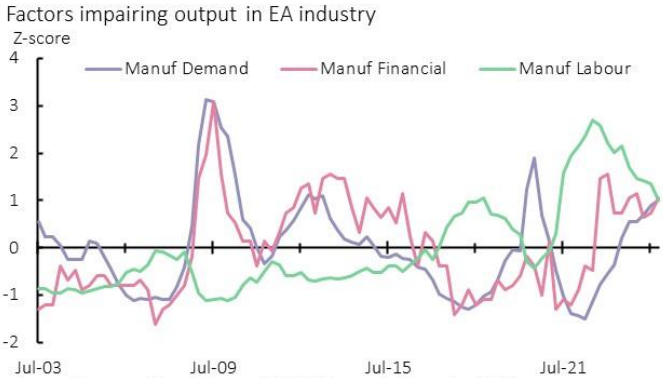
Another argument of the hawks is that there is no sign that monetary conditions are a particular source of hindrance for the real economy – which would be another sign that the current policy rate may not be very far away from the neutral level. When looking at the factors put forward by businesses to explain why they cannot raise production as much as they wish, it is true that the net percentage of them mentioning financial conditions is in line with its long-term average in the services (see Exhibit 2). This contrasts with 2021, when the net percentage fell to 2 standard deviations *below* the long-term average, but this would merely suggest a shift from "extremely accommodative" to "neutral" monetary conditions.

Exhibit 2 – Cyclical issues emerging again…



Source: European Commission and AXA IM Research, December 2024

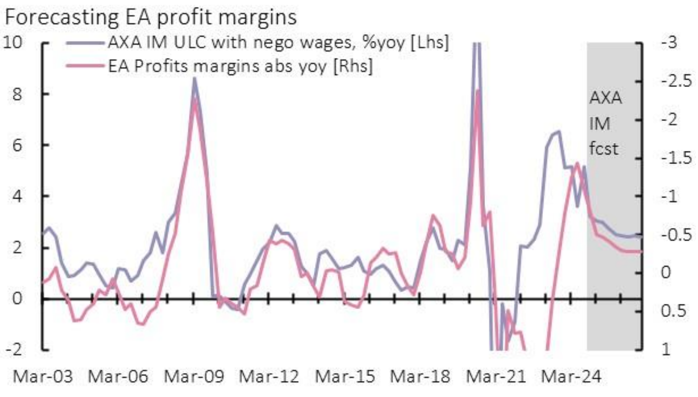
Exhibit 3 – …especially in manufacturing



Source: European Commission and AXA IM Research, December 2024

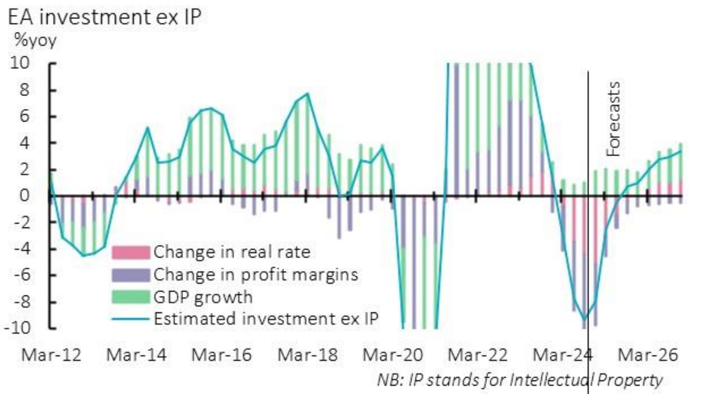
We note however that in the already struggling manufacturing sector, this net percentage in the October quarterly survey stood 1 standard deviation above the long-term average. In any case, we think that **the level of restriction of financial conditions – and hence the monetary stance – should be assessed when taking on board the underlying financial position of economic agents**. As Exhibit 4 illustrates, normally unit profits and unit labour costs move in opposite directions immediately. However, from 2021 to late 2023, a significant lag appeared: businesses were able to extend and then defend their margins for longer than usual despite the push from labour costs. This was specific to a phase of massive exogenous inflation shock, which allowed firms to "hide" their mark-ups behind the general rise in prices when consumers were particularly confused. This suggests that the beginning of the ECB's monetary tightening was easily absorbed by businesses as they could rely on a large cash buffer and did not need much external funding. As margins started falling eventually – and this began only in 2024 – then the pressure from higher rates gradually showed. With demand softening, we think margins will continue contracting, although not as spectacularly as over the first quarters of 2023. Irrespective of the uncertainty issue, this will continue to weigh on corporate investment (see Exhibit 5). In our baseline, we expect a moderate rebound in investment only because we forecast a proper accommodative stance from the ECB (we are below market pricing with a terminal rate, at the end of 2025, of 1.5%).

Exhibit 4 – No easy recovery for profits



Source: Refinitiv, ECB and AXA IM Research, December 2024

Exhibit 5 – Rate cuts crucial to re-start business investment



Source: Eurostat and AXA IM Research, December 2024

Still looking for political clarification in France…and Europe

We explored last week how – despite mounting risks of the government falling – the French sovereign spread did not move much out of its post-dissolution trading range, which we attributed to a solidification of the case for a proper accommodative stance by the ECB and the existence of a large domestic saving pool which could be easily tapped to replace nervous international investors. Accordingly, the further widening after the unambiguous success of the opposition's motion of no confidence triggering Michel Barniers' resignation was very short-lived, and as of last Friday at close the 10-year spread with Germany was down to 77bps.

The market may have found more reasons not to over-react in the fact that some potential additional bad surprises did not materialise. President Macron reiterated unambiguously that he intends to remain in place until the normal end of his mandate in 2027, which reduces the risk that another potentially binary presidential election is organised in the near future. Besides, some of the signals sent by mainstream opposition groups were reassuring on the possibility to form a "minimal government" into 2025. The socialists had already aired the possibility to strike a "non-aggression pact" with other political forces which would commit not to support another motion of no-confidence against a new cabinet. They have also accepted to meet with the President on Friday – as have the Greens who will see E. Macron on Monday – in contrast with the hard left LFI. It seems that the left-wing alliance – which had made it impossible to enlarge the previous government's support to the centre-left – is starting to show cracks.

There are several possible configurations ahead. In one, the Socialists and possibly the Greens would join the centrists and the centre-right into a new cabinet. We think this is difficult at this stage, given the obstacles to agree on a common platform across these forces and the electoral risk these centre-left parties would take if they openly exited from the alliance with the hard left. However**, a de facto support "from the outside" to a government which would agree not to cross a few "red lines" looks possible**. Such government's main task would consist in designing a proper budget bill for 2025.

In his TV address last week, E. Macron announced that a "special law" rolling over the 2024 budget into 2025 would be submitted to parliament. We went through the mechanics of this approach in our previous issue, and concluded that, when compared with the latest version of the budget bill offered by Michel Barnier, the difference in terms of overall deficit in 2025 would likely be small. An option which has been discussed in the French press last week consisted in amending the special law to index the tax brackets on inflation, which would result in a slightly higher deficit. However, the consensus among constitutional law specialists is that amendments would not be possible: the government will be bound by the tax configuration as it currently exists and will be able to spend only within the stipulations endorsed by parliament last year, i.e. only in nominal terms (with an exception for pensions which will be indexed on inflation).

While, as we have been expecting all along, this takes away risks of a government shutdown (most opposition groups have pledged to support it) and reduces the risks of another deficit drift next year, the fundamental concerns over the overall trajectory of French public finances remain. In the short-run, French businesses will escape the rise in corporate taxes and social contributions which were the few key elements of the Barnier budget which had survived the parliamentary process until the motion of no confidence. Yet, given the temporary nature of the "special law" (a nominal freeze in spending and tax brackets is likely to be immensely unpopular and technically difficult), **it is likely that indeed, a "proper" budget will have to be agreed at some point in 2025, even before any new elections can be organised**. If the new government's parliamentary support skews to the left with the addition of Socialists and possibly Greens – even as "silent partners" – these measures may become tempting again. But deep down, it remains to be seen if the kind of constant, multi-year effort which the fiscal adjustment requires can be achieved without a broader political clarification which may not be within the grasp of the current parliamentary configuration.

An agreement around a "minimal government" in Paris is unlikely to provide a clear sense of political direction at the European level, especially at a time when Germany is waiting for new elections. There are initiatives emerging in Europe to address the challenge from the new US administration and give a new sense of purpose to the EU. The Financial

Times last week reported on a project to apply the "Next Generation EU" blueprint to boosting defence spending. A club of member states – but with possible extension outside the EU to the likes of the UK and Norway – would issue EUR500bn of jointly backed securities, with the technical help of the European Investment Bank (administering the special vehicle) which would go towards funding the re-armament effort across member states. This is promising, but as much as it seems that Christian Democratic Union (CDU), the likely victor of the February elections in Germany according to the polls, is warming up to a change in the fiscal rules at the national level**, it is unclear at this stage if the change in mood across the political spectrum in Berlin on fiscal issues encompasses the European level**, and this is absolutely necessary to get these "reviving Europe" plans across the line.

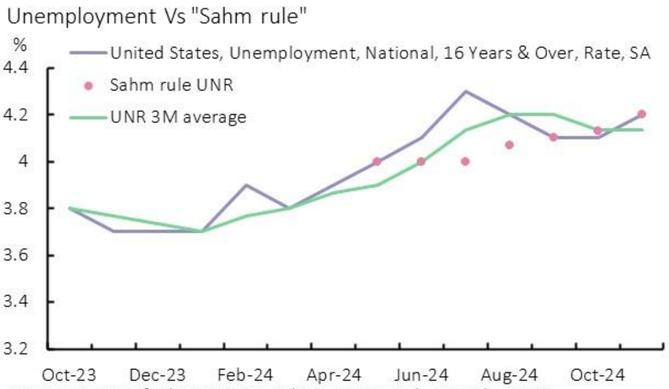
Still holding on

The Federal Reserve (Fed) will have one more week than the ECB to make up its mind on its next policy move. The dataflow on the inflation front has not been reassuring for the last two months, but of course, now that the Federal Open Market Committee (FOMC) is paying equal attention to its price stability and full employment objectives, the employment report for November, after the heavily "disturbed" October batch, was always going to be crucial.

After the October dip mostly due to a hurricane and strikes, job creation rebounded slightly above market expectations (227k vs 220k) and taking on board a net positive revision over the last two months of 56K, the overall picture of a resilient labour market is still very much here. However, **the signal from the Establishment survey was to some extent contradicted by a worse-than-expected Household Survey which put the unemployment rate at 4.25%, up from 4.1% in October**, while the market consensus was on a stabilisation. This number probably explains why the market was pricing on Friday an 85% probability of a rate cut at the December meeting, against 64% the day before the release of the Employment Report.

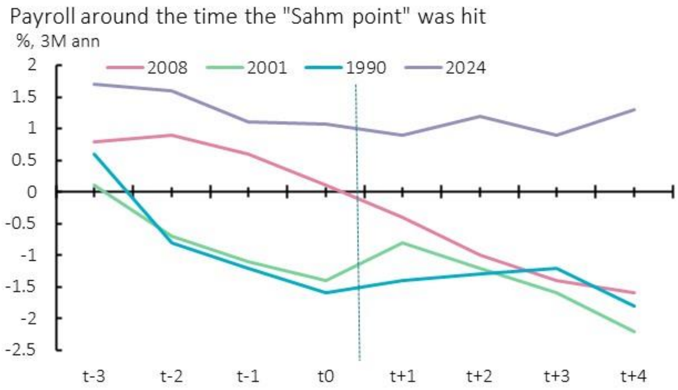
Still, the Household Survey tends to be volatile, and has already sent many wrong signals in this cycle. On a three-month average basis, it is difficult to be particularly concerned (see Exhibit 6). The US may still be close to "Sahm territory" – historically predictive of a recession – when looking purely at the unemployment rate, but evidence continues to accumulate that "this time may be different". On a 3-month annualised basis, job creation has been remarkably stable over the last 6 months in a 1 to 1.5% range. We are now 4 months after the "Sahm point" was hit for the first time in this cycle in July, and the difference with the dynamics in job creation with the previous episodes of recession is getting ever more striking (see Exhibit 7).

Exhibit 6 – Around the "Sahm territory"



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

Exhibit 7 – Still very different from previous episodes

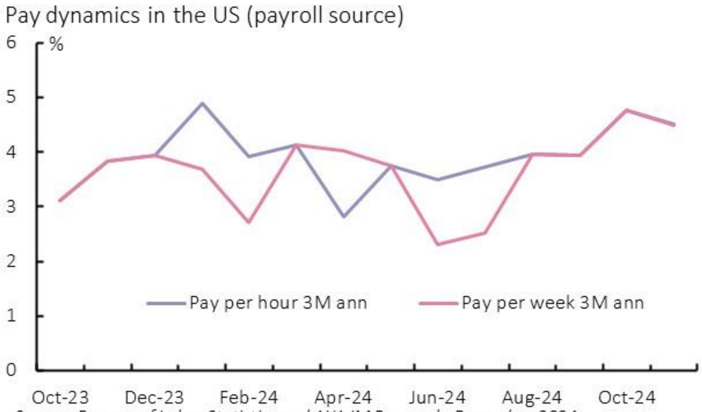


Source: Bureau of Labor Statistics and AXA IM Research, December 2024

In a nutshell, there is enough in the recent dataflow for the FOMC to justify keeping the policy rate unchanged at the December meeting, especially since pay growth remains above the range normally consistent with a convergence to 2% inflation (see Exhibit 8). We noticed the comment by Ben Hammack, the President of the Cleveland Fed, last Friday

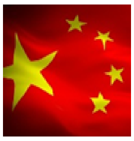
"*I believe we are at or near the point where it makes sense to slow the pace of rate reductions"*. A 25bp cut in December is our baseline, but our level of conviction is low. It may require some deceleration in core inflation in the November print this week to "lock it".

Exhibit 8 – Wage growth still robust



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

From January 2025 onward, the Fed's decisions are increasingly going to take on board the decisions of the Trump administration. The timeline remains vague but given the speed at which Donald Trump has been announcing the key appointments in his team – in sharp contrast with 2016 – we should brace ourselves for quick decisions. We expect only two more 25bp cuts by the Fed, one in December and another one in Q1. Even a partial delivery of the Trump platform would in any case, in our view, make it difficult for the Fed to cut more. If the FOMC does not deliver in December, then we could end up with only one cut left in this cycle.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Payrolls (Nov) 227k bounceback in payrolls vs 215k expectation. Unemployment 4.2% from 4.1% in Oct. Earnings growth stabilises at 0.3%mom • JOLTS (Oct) rises to 7.7m; jobless claims fall • ISM indices (Nov) mfg edges up to 49.7 (48.8), but services drops to 52.1 (56.0) • Vehicle sales (Nov) 16.5m (saar) – 3½yr high	• CPI inflation (Nov) headline expected higher and core expected +0.3%mom, unch at 3.3%yoy • PPI inflation (Nov) watch for fuller PCE forecast • NFIB small business survey (Nov) expected to make further gains • Continuing jobless claims have edged lower again in recent weeks
	• Final PMIs (Nov) were unch excepted for Svcs (49.5;+0.3pt) which remains in contraction terr • Oct Ge and Fr IP are down; EMU retail sales as well (1.9%yoy from 3%) • Euro area Q3 GDP confirmed at +0.4%qoq, employment at +0.2% • French 2025 budget was rejected and government stepped down after the parliament adopted a vote of no confidence	• (12 Dec) The ECB should deliver a 25bps rate cut, adopting a dovish tone but maintaining its gradual approach • President Macron to appoint a new Prime Minister • Final HICP (Nov) • Industrial production across euro area (Oct)
	• Nationwide House Prices (Nov) up 3.7%yoy • BRC retail sales (Nov) fell to -3.4%, from 0.3% • Composite PMI (Nov) fell to 50.5, from 51.8 • Construction PMI (Nov) rose to 55.2, from 54.3, on the back of new work • New car sales (Nov) down 1.9%yoy	• RICS Residential Market Survey (Nov) should point to ongoing recovery, as demand is buoyed by the upcoming changes to the SDLT threshold changes • Monthly GDP (Oct) set to rise by around 0.2%mom, but that follows a 0.1% decline in September
	• Composite PMI (Nov) rose to 50.1, from 49.6, but consistent with modest growth only • Wage data (Oct) showed average cash earnings fell to 2.6%, from 2.8%. But regular workers' scheduled earnings came in at 2.8%yoy, highest since 1994 • HH spending (Oct) was down 1.3%yoy	• Final GDP (Q3) look for any downward revision to growth in final consumption • PPI (Nov) look for impact from currency swings • Tankan survey (Q4) look for impact on manufacturing side from global uncertainty • Final IP (Oct) no reason to expect material change
	• NBS mfg PMI edged up to 50.3 in Nov from 50.1; non-mfg PMI dropped marginally to 50 from 50.2 • Caixin mfg PMI improved to 51.5 in Nov from 50.3; while services PMI declined to 51.5 from 52	• CPI inflation for Nov likely to stay weak; PPI deflation likely to extend the decline • Exports expected to continue the strong momentum while imports to stay weak, reflecting soft consumption
	• CB: India (6.5%) and Poland (5.75%) on hold • CPI (Nov yoy): Indonesia (1.6%), Korea (1.5%), Philippines (2.5%), Taiwan (2.1%), Thailand (1.0%), Turkey (47.1%) • GDP (Q3): Brazil (4.0%yoy) • Industrial production (Oct): Hungary (-0.2%yoy)	• CB: Brazil 75bp hike to 12%, Peru (5%) on hold • CPI (Nov): Brazil, Czech Republic, Hungary, India, Mexico, Poland, Romania • Industrial production (Oct): Czech Republic, India, Malaysia, Mexico, Turkey

Upcoming events		
	US:	Tue: NFIB small business optimism (Nov), Non-farm productivity (Q3), Unit labour costs (Q3); Wed: CPI (Nov); Thu: PPI (Nov), Initial jobless claims (w/e 7 Dec)
	Euro Area:	Tue: Ge HICP (Nov), Ge CPI (Nov), It IP (Oct); Thu: Ez ECB announcement; Fri: Fr, Sp HICP (Nov) , Ez IP (Oct)
	UK:	Thu: RICS housing survey (Nov); Fri: GfK consumer confidence (Dec), Monthly GDP (Oct), Index of Services (Oct), IP (Oct), Mfg output (Oct), Construction output (Oct), Total trade balance (Oct)
	Japan:	Thu: Tankan large mfg index (Q4); Sun: Private 'core' machinery orders (Oct)
	China:	Mon: CPI (Nov), PPI (Nov); Tue: Exports (Nov), Imports (Nov), Trade balance (Nov)

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** As at the end of December 2023.

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