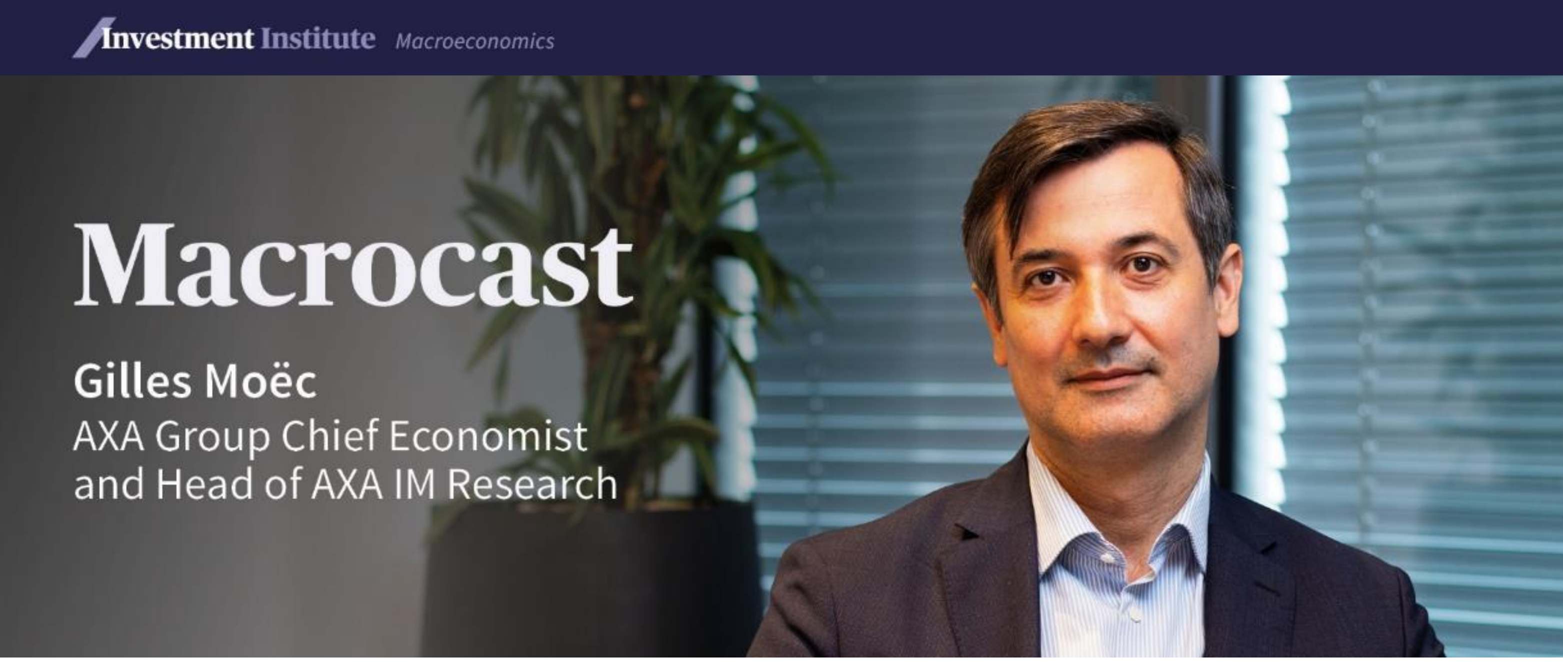
# 235 – 29 July 2024




## Is it just Haste?

- Bill Dudley called on the Fed to cut this week already. We don't think they will, but his points resonate.
- For both the BoE and BoJ a still hazy macro configuration will force them into "leaps of faith".
- The Chinese Plenum Communiqué did not signal any big strategy shift – mere rate cuts are no panacea though.
- The French economy is hurting… but we think the mediocre data flow in Germany should also call for attention.

Bill Dudley called on the Fed to cut its policy rate this week already, given the accumulating signs the US economy is landing, with cracks appearing in particular in the spending capacity of households towards the bottom of the income ladder. We agree that the latest PCE print should open the door wide to a proper shift in the Fed's policy stance – while we never believed in the market's enthusiasm until last winter for half of dozen cuts in 2024, we also rejected the "no cut this year" hypothesis – but the Q2 print for GDP was probably "too decent" to get the FOMC into emergency mode. In any case, Jay Powell can easily dispose of the "lateness critique" by telegraphing quite clearly that a cut will come in September, and that it would be start of a "restriction removal" process.

We continue to focus more on the difficulty for the Fed to continue cutting in 2025 if D. Trump is elected. The US presidential race has tightened, and although we don't expect economic issues to rank very high in the next three months' debates, the outcome will matter enormously in the global economic sphere. In this context, we review the China's Communist Party's Plenum communiqué which in our view confirmed Beijing's focus on the supply-side of the economy. We continue to think domestic demand remains China's weak point, and we are struck by how more and more countries – even in the Global South – are taking measures against imports of Chinese products.

The BoE and the BoJ meet this week amid unclear macro conditions at home. On balance, we think the BoE will cut by 25bps, but it is a close call as the MPC is likely to be divided. The BoJ needs to normalise its stance faster to support the currency, but the economy continues to be mediocre. We think combining a massive reduction in the quantum of bond purchases – straight to 3 trillion a month – with a rate hike would be too daunting.

Finally, we look at the recent business confidence surveys in the Euro area. In France they confirm a wait-and-see attitude has taken hold of the corporate sector amid still high political uncertainty, but we draw attention to the softness of German indicators. This should help ECB hawks accept not to stand in the way of a cut in September.

## Hearing Dudley's call?

**When Bill Dudley, formerly President of the New York Federal Reserve (Fed) Bank and Vice-Chair of the Federal Open Market Committee (FOMC), changes his mind, it's a good idea to listen intently**. In his latest column for Bloomberg, he came in favour of cutting rates "now" – i.e., at this week's meeting – after considering for some time that there was no point in hurrying. Dudley is no starry-eyed dove. He criticized the Fed's new "Flexible Average Inflation Targeting Model" introduced in August 2020, which in effect called for waiting until the economy is "red hot" before moving to monetary restriction, as ill-fitted to spot inflation shocks in time and had been calling for rate hikes in 2021 (the first one came in March 2022).

His line of argumentation is simple: on the real side of the economy, while wealthy individuals can still sustain a high level of spending, "cracks" are appearing for those at the lower end of the income ladder as higher interest rates hurt via car loans and credit cards bills. Construction is finally being hit by high mortgage rates. Jobs are still being created but at a slower pace, and Dudley – as we did in Macrocast three weeks ago – pointed to the "Sahm rule" to argue that the recent rise in the unemployment rate called for attention. In those circumstances, given the good news on the inflation front, why wait to start removing accommodation?

Exhibit 1 – September cut now seen as "done deal"

Probability of a Fed cut in September 2024

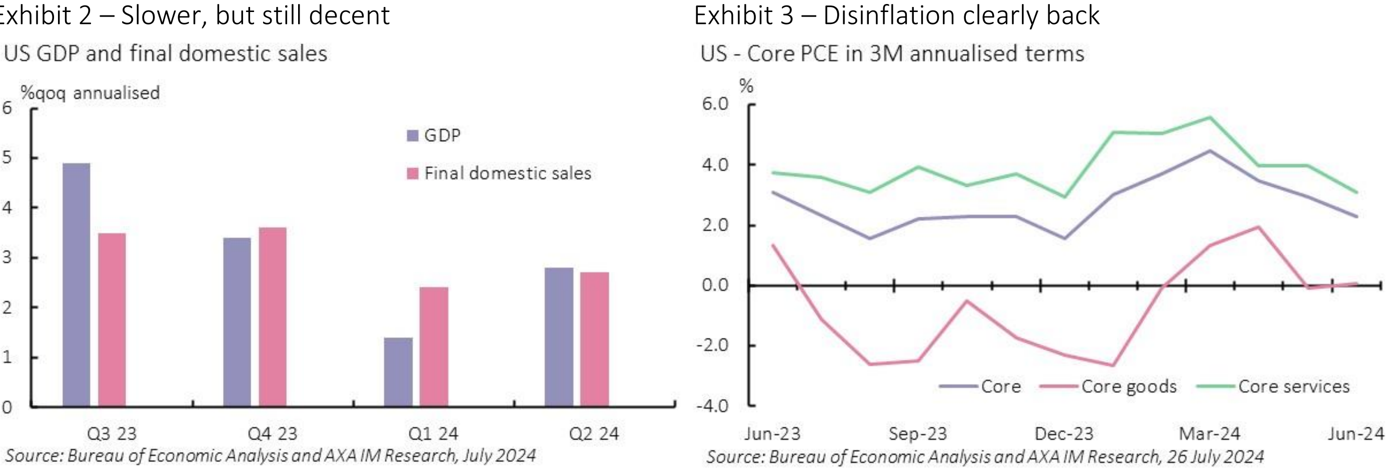
%
120
100
80
60
40
20
0
51
88
63
75
108
105
May 1
May 6
June 6
June 24
July 16
July 26

*Source: Bloomberg and AXA IM Research, 26 July 2024*

The market seems to hear Dudley only partly. As we illustrate in Exhibit 1, while the market is now firmly expecting the Fed to cut at the September meeting, the "105% probability" on that date suggests that investors see the chances of a Fed move at this week's meeting already as only marginal (5%).

Exhibit 2 – Slower, but still decent

Exhibit 3 – Disinflation clearly back




*Source: Bureau of Economic Analysis and AXA IM Research, July 2024*

*Source: Bureau of Economic Analysis and AXA IM Research, 26 July 2024*

Interestingly, the probability for July cut fell a bit, from 8% from last week. We suspect this is the result of the GDP print. **We wrote that the only thing which could tilt the Fed into cutting in July already would be a "truly horrendous" GDP print for Q2. Instead, GDP surprised to the upside again, at 2.8% against 2.0**%, double the Q1 pace and exceeding the US potential growth rate (usually seen at c.1.75%). To eliminate a usual source of gyrations – stock building – and get a sense of the current domestic dynamics of the US economy, we can look at domestic final sales, i.e., GDP minus the change in inventories and net trade. The message is that the pace has abated from 3%+ in the second half of 2023 to 2%+ in the first half of 2024. The US economy is landing, but only very slowly (Exhibit 2). This does not seem to call for emergency monetary support.

True, focusing too much on GDP triggers the risk of driving while gazing too much at the rearview mirror. We have already highlighted in Macrocast how the surveys – in particular the ISM – pointed to some difficulty in sustaining such decent growth rates into the second half of the year. **Recent earnings reports by consumer goods' businesses in the US also lend credibility to the thesis that households spending is starting to get soft.**

Besides, GDP was not the only interesting data print last week in the US. The Personal Consumption Expenditure (PCE) deflator for June, the Fed's favoured gauge of inflation, largely confirmed the message from the Consumer Price Index (CPI) earlier in the month. **On a 3-month annualised basis, core PCE is now very close to target at 2.3%.** The re-acceleration of last winter now seem to have completely faded. Perhaps more importantly, the ongoing deceleration cannot be attributed to core goods, which are now flat, but essentially came from services, the most reflective of the macro dynamics at work in the US domestic economy (Exhibit 3).

Unfortunately, the Fed won't have the payroll data for July before making their decision. Yet, another important point to consider as well in the current calibration of the Fed's stance is that the current level of the policy rate is high relative to any realistic estimate of the equilibrium level. To avoid having to embark in a quick succession of rate cuts down the road – never a credibility-affirming option – to reach safe accommodative territory, starting the process early enough would be an asset. **Jay Powell can however shake most of the "lateness critique" this week by telegraphing sufficiently clearly the September cut – and crucially that it would only be the beginning of a series of cuts**. This would entail making it clear that the June "dot plot" is obsolete. Yet, given Powell's very prudent handling of the dot plot then, this should not be too much of a hurdle.

Habitual readers of Macrocast will be familiar with our point that it's the Fed's trajectory for 2025 which is more uncertain given the radically different possible macroeconomic outcomes of the US presidential elections. According to the few polls conducted after Joe Biden decided to step aside, **Kamala Harris has been able to tighten the race significantly, even if most polls still put Donald Trump in the lead.** Looking carefully at the data, it seems she has been able to bring back Democratic-leaning voters who did not want to be squeezed in a repeat of the 2020 race (support for the Green candidate Jill Stein – a natural refuge for some Democrats – fell). It is early days though. **We are not readying ourselves to a "economy-intensive" debate.** Kamala Harris needs to distance herself from Biden's tenure on that front – even if fundamentally he delivered some important measures to lift the country's growth potential – given public opinion focus on inflation. She is not going to send anyone's blood racing by pledging a fairly prudent approach on fiscal policy by allowing some of the Jobs Act of 2017 tax cuts to expire. She is likely to focus on women reproductive rights, while Trump will attack her on immigration and law and order.

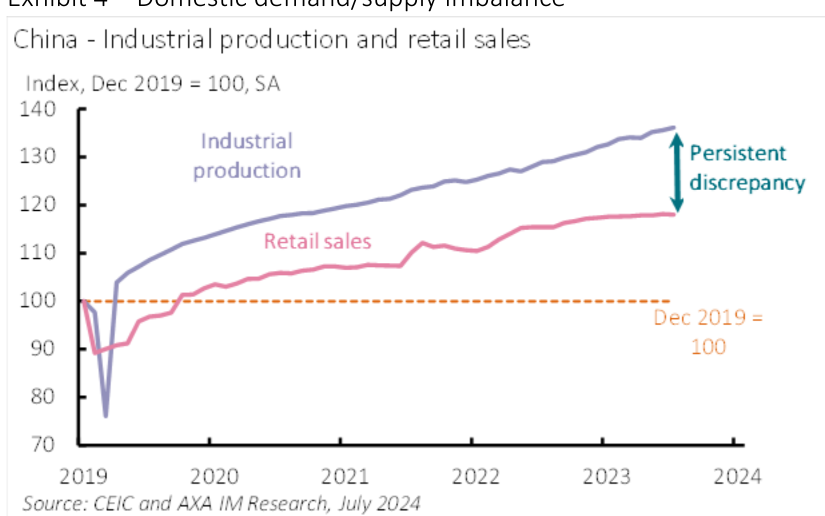
Yet, **the "Trump Trade" is real**. Our colleague David Page has just put a topical note out (see link here) on the US elections, illustrating how the **gyrations in the polls do have some explanatory power over the residuals of canonical models predicting US yields and the dollar exchange rate**. Higher odds of a Trump victory do push 10-year yields and the dollar up. That the presidential elections are not fought on the economy does not mean they won't have a significant impact on the economy.

## China's strategy dilemma

This goes obviously well beyond the United States. Harris would probably emulate Joe Biden in maintaining the current tariffs against Chinese products, but she would be unlikely to intensify the trade war, unlike Donald Trump. The latter outcome would come at the wrong time for China.

It's of course too simplistic, but a good way to characterise the current economic choices in China consists in simply looking at retail sales – proxy for consumer spending – against industrial production (Exhibit 4). The discrepancy is massive. Another "twin figure" may help get into the nitty gritty: **in Q2 2024, domestic sales of cars fell by 5.4%yoy in China, while automobile production rose by 6.1%. In other words, foreign absorption is vital to China's industry**.

Exhibit 4 – Domestic demand/supply imbalance



Source: CEIC and AXA IM Research, July 2024

We have already discussed in Macrocast the EU's – provisional – decision to impose tariffs on imports of Chinese EVs, but **what we also find increasingly problematic for China's export machine is the fact that the alarm over unbalanced trade relationships with China has spread to key countries in the "Global South".** On 28 June, Indonesia's Trade Minister announced his country would impose tariffs on some key Chinese imports of between 100% and 200%. Indonesia stands for only about 2% of total Chinese exports, but this should still be a source of concern for Beijing: **substituting "South-South" trade to the old "South-North" pattern is not going to be straightforward.**

Two weeks ago, **the Plenum of the Central Committee of the Chinese Communist Party released a detailed policy paper. There was no hint at a change in the overall economic strategy**. The word "consumption" appeared only 5 times in the 48 pages-long text, including twice in relation to energy, while "investment" came out 28 times. China is still intent on focusing on the supply-side. The document contains a defence of traditional "trickle down" through which the development of high productivity industries – under the "new quality production" model – spearheads GDP growth. Still, we maintain the view that, historically, maturing economies found a "second breath" only when they increasingly directed productivity gains towards expanding domestic consumption via higher real wages. The policy document mentions "*putting in place systems to effectively boost the incomes of low-income earners, steadily expand the size of the middle-income group, and properly regulate excessive incomes*", but there was no explicit mention of the link between productivity and salaries.

**If no major policy shift is foreseeable for the near-future, Chinese demand could be supported by short-term "fixes".** On Monday last week, the People's Bank of China (PBoC) cut the 7-day reverse repo rate by 10bps. Shortly after, the market rates Loan Prime Rate (LPR) for 1-year and 5-year were reduced by 10bps, to 3.35% and 3.85%, respectively. Then the PBoC surprised the market again on Wednesday with a 20bp cut to the 1-year medium-term lending facility (MLF) rate, reducing it to 2.3%. They also injected RMB200bn via MLF facilities, resulting in the first positive monthly net injection (RMB197bn) since February**. It is rare for the PBoC to act so quickly and frequently.**

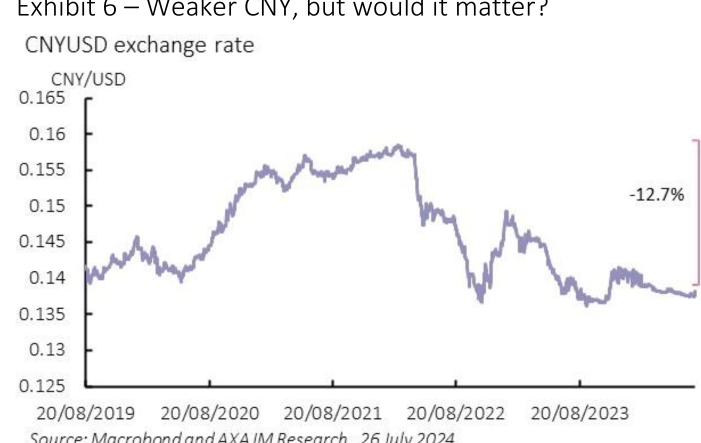
**Now, we continue to find it striking that policy rates have been reduced by only 100bps or so from peak (Exhibit 5) in a country which has been flirting with deflation. The** PBoC may this time have been emboldened by the relative stability of the CNY these last few months (Exhibit 6), in a context when the market is pricing rate cuts from the Fed again. In

our view, loosening monetary conditions in China is justified by the need to revive domestic demand. At the same time, **if an acceleration in the PBoC cuts is confirmed, this could trigger more acerbic comments in the US, given the frequent accusations of "FX manipulation" against China, which have been revived in the current presidential campaign as Donald Trump has seized on the "strong dollar" issue**, linking it to labour market difficulties. Note however that the CNY depreciation from the peak in early 2022 (12.7%) would be small beer relative to the effect a 60% tariff would have on Chinese shipments to the US, while it could exacerbate protectionist tendencies in the "Global South" and the EU. These "short fixes" are no panacea.

Exhibit 5 – Down, but slowly

*Source: People's Bank of China and AXA IM Research, 26 July 2024*

Exhibit 6 – Weaker CNY, but would it matter?




*Source: Macrobond and AXA IM Research, 26 July 2024*

## The BoJ dilemma

The Bank of Japan (BoJ) is the other major central bank meeting this week. The market is torn on what to expect: as of last Friday, it was pricing a rise in the policy rate of 5bps, basically half the new "usual quantum" for a rate hike by the BoJ. We are similarly torn. Of course, we notice that the commentariat is increasingly presenting a hike this week as a done deal – reflected in the shift upward in the market pricing over the month, **but we are concerned about the combination of a rate hike with the expected announcement of the quantum of reduction in BoJ purchases of bonds in a difficult macro context for Japan**. Indeed, while a further normalisation of the BoJ stance would of course help support the currency, and hence dampen the ongoing steep acceleration in import prices, the central bank needs to deal with a deteriorating economic outlook. Indeed, the Japanese PMI in the manufacturing sector, which is supposed to benefit most from the yen depreciation, fell back in contraction territory again in July. Moreover, inflation in the Tokyo area which comes out ahead of the national index slowed down in July, with core at 1.5%yoy, down from 1.8% in June.

Ultimately, in a hazy macro configuration, we think the BoJ will try to find a compromise. The market's baseline is that the BoJ will reduce its bond purchases from the current monthly pace of ¥5.7tn to ¥4tn, and further cut it to ¥3tn in the second year, with a possibility to "jump" to the latter pace immediately. If the latter option were to be chosen, we think combining this with a rate hike would be too daunting.

**The Bank of England (BoE) will also meet this week.** We have already covered this in the previous issue of Macrocast. Ultimately, as often it will be a close judgement call for the Monetary Policy Committee (MPC), balancing "not so great" current price data against what is probably a favourable outlook given the beginning of a deterioration of the labour market. We expect a close 5-4 decision in August for a 25-bp cut, with a low level of confidence.

## The Euro area's "soft patch" goes beyond France

**There was little doubt that the snap elections in France would have a significant impact on business confidence. The INSEE survey confirmed it**, with a sharp decline in both the manufacturing and services sector (Exhibits 7 and 8). In the

latter, there was however a complete divergence between the message from the Purchasing Managers Indices (PMIs) and from INSEE. This is not exactly new (the PMIs drew a particularly gloomy picture of the French economy in the second half of 2023, contradicted by mediocre but still positive GDP prints). But we suspect that in July the gap comes from a difference in the timeline of the surveys. Indeed, INSEE collected responses mostly between 27 June and 12 July, when political uncertainty was at its peak, while Markit collected data for the PMI from 11 July to 22 July, when the most radical outcomes had already been taken off the table. Yet, we have little doubt Q3 GDP will be mediocre in France, despite the usual boost from the Olympic games.

Exhibit 7 – At least the same direction

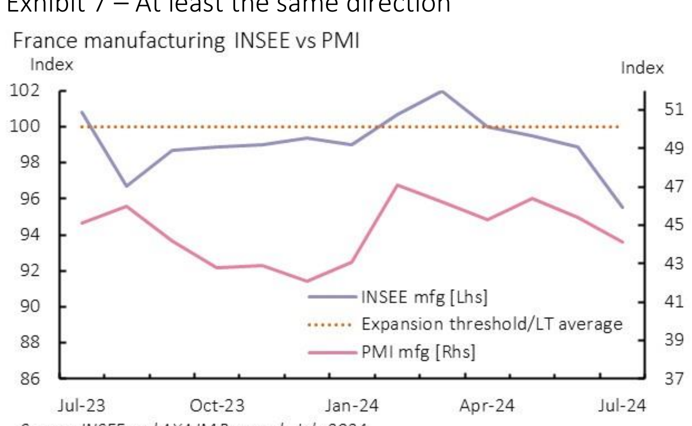
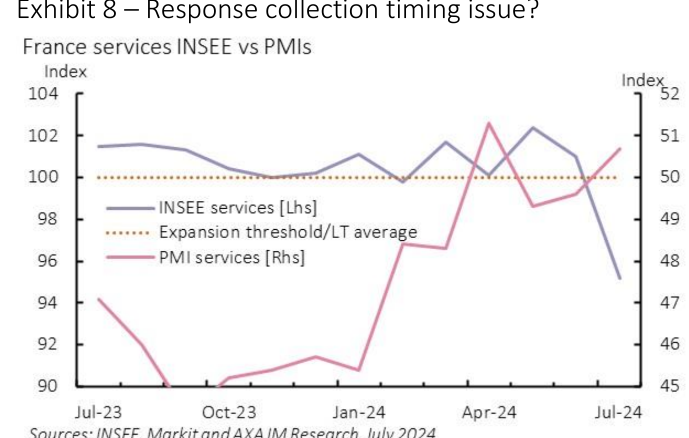



Exhibit 8 – Response collection timing issue?




**France is however not our point of focus. We are more interested in the developments in Germany,** where no “exogenous event” should be disturbing the macro dynamics. There, while there are differences in level, the PMIs and the IFO surveys send the same message: the economy is not recovering (Exhibit 9 and 10).

Exhibit 9 – Weak German manufacturing

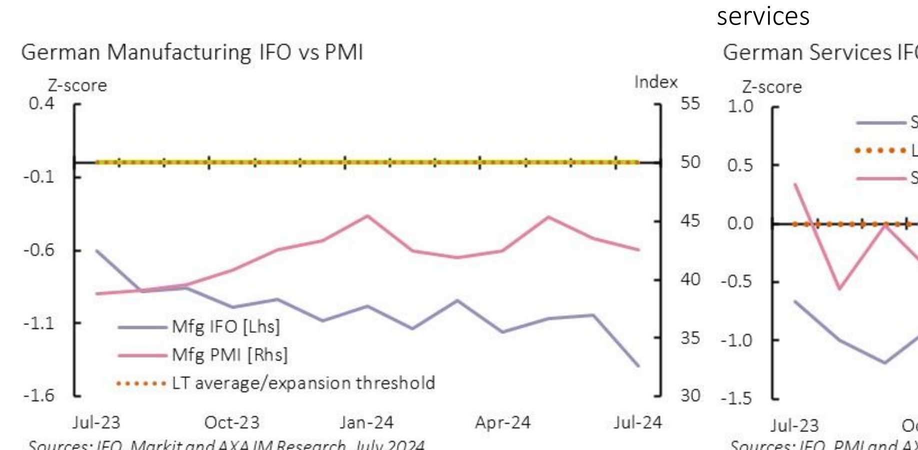
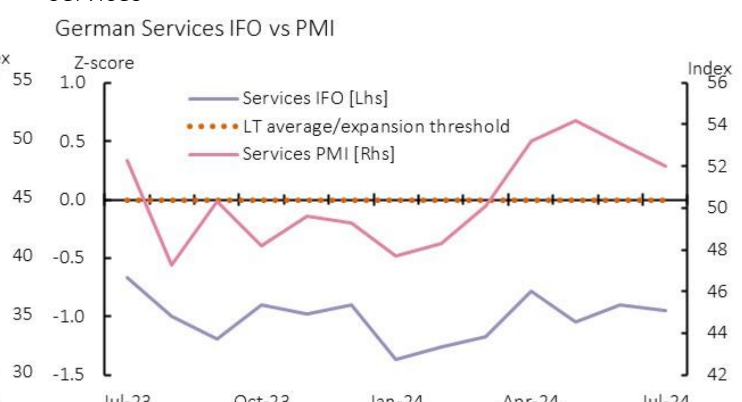
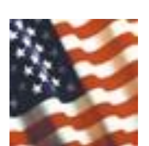
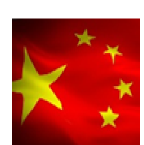
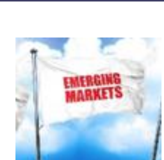



Exhibit 10 – Even the optimistic PMI is getting softer in services




**This should make the European Central Bank (ECB) hawks less reluctant to embark on the removal of monetary accommodation come September.** Indeed, it is in Germany that wage developments have been the most concerning, from a price stability point of view. Even if so far the state of “quasi recession” has had only a limited impact on the labour market, we should gradually see the labour movement take the macro situation on board and accept a return to wage moderation.

| Country/Region | What we focused on last week | What we will focus on in next weeks |
|---|---|---|
|  | • Biden makes way for Harris as Democrat nominee<br>• GDP (Q2, p) firmer than expt'd 2.8% on cons spdg & inventory, but still slowing overall from H2 2023<br>• PCE inflation (Jun) slowed to 2.5%yoy, core 2.6%<br>• Home sales (Jun) existing -5.7% and new -0.6% after -14.9% previous month<br>• Regional mfg indices (Jul) falling consistently, presenting some risk to ISM | • FOMC meeting. No chg in policy rate. Powell to signal likelihood of Sept -0.25%<br>• Payrolls (Jul) watch for drop in headline towards 100k and revision to June. Unemp watched for Sahm rule breach. AHE remain well behaved.<br>• ISM mfg index (Jul) expect main index to dip<br>• Official confirmation of Harris and announcement of running mate (1-7 Aug) |
| | • The Paris Olympic Games begin. We do not project a huge impact on real GDP, small uptick on inflation.<br>• Flash PMIs were "very" weak in Fr, Ge, slightly better for other countries as shown by EMU surveys<br>• INSEE business and consumer confidence (Fr), Ifo (Ge) were on the same side. Weak start for Q3 GDP | • Q2 GDP flash. We have below consensus view for EMU at +0.1%qoq (cons: 0.2%; ECB: +0.4%)<br>• EMU inflation (July) expected at 2.5%yoy for headline and 2.8% for core, broadly in line with consensus. Focus will be again on services inflation that we anticipate flat at 4.1%<br>• EC surveys (Jul) to provide a more detailed view of the current weakness across countries and sectors |
| | • Flash composite PMI at 52.7 in Jul (53.2 in Jun); services at 52.4 (52.1); manufacturing at 54.4 (53.3) | • Mortgage approvals set to rise to 61K in Jun, from 59.9K in May. Cons. credit likely at £1.4bn in Jun.<br>• Nationwide house price growth likely up 1.5%yoy<br>• BoE to cut Bank Rate by 25bps to 5% with 5:4 vote split |
| | • Flash composite PMI at 52.6 in Jul (49.7 in Jun)<br>• Tokyo CPI inflation rate ticked down to 2.2% in July, from 2.3% in June. Core edged up to 2.2%, from 2.1%. Ex. energy and fresh food, down at 1.5%, from 1.8%. | • Unemp. rate to hold steady at 2.6% in Jun<br>• IP likely fell by around 0.5%mom; retail sales up by around 0.5%<br>• BoJ to keep rates on hold at 0% to 0.1%, but will announce bond purchase tapering |
|  | • 10bp cut on 7-day reverse repo rate to 1.7% on 22 July, market rates (1- and 5-year LPR) followed shortly with a 10bp cut to 3.35% and 3.85%<br>• 20bp cut on MLF to 2.3% on 25 July, with a positive net liquidity injection of RMB197bn, the second OMO operation of the month – a rare event | • 27 Jul: Industrial profit (Jan-Jun)<br>• 31 Jul: NBS mfg and non-mfg PMI (July)<br>• Caixin mfg PMI (July) |
|  | • CB: Hungary cut -25bps to 6.75%. Turkey stood on hold at 50%<br>• June inflation (yoy): Malaysia (2.0%) & South Africa (5.1%)<br>• Q2 GDP (yoy): Korea (2.3%) & Malaysia (5.8%) | • CB: Brazil is expected to stay on hold at 10.5%. Chile to cut -25bps to 5.5%, Colombia -50bps to 10.75%, Czechia -25bps to 4.5%<br>• Q2 GDP: Czechia, Hungary & Taiwan<br>• July CPI: Indonesia, Korea, Peru & Poland<br>• PMIs across EM countries |

| Upcoming events | | |
|---|---|---|
| | US: | Mon: Treasury funding schedule (Q3 & Q4); Tue: FHFA and Case-Shiller HPI (May), JOLTS job openings (Jun); Wed: Emp cost index (Q2), Pending home sales (Jun), FOMC announcement; Thu: Unit labour costs (Q2, p), Weekly jobless claims (Jul 27), mfg PMI (Jul), ISM mfg index (Jul); Fri: Labour market report (Jul) |
| | Euro Area: | Mon: EU20 Business confidence (Jul), EU20, Ge, Fr, It, Sp GDP (Q2, p), Ge HICP (Jul, p), Fr consumer spending (Jun); Wed: EU20 HICP (flash) (Jul), Ge unemp (Jul), Fr, It HICP (Jul, p); Thu: EU20, Ge, Fr, It, Sp mfg PMI (Jul), EU20 unemp (Jun); Fri: Fr, It IP |
| | UK: | Mon: Mortgage approvals and lending (Jun), Consumer credit (Jun), M4 (Jun), CBI distributive trade (Jul); Tue: BRC index (Jul), Thu: Mfg PMI (Jul), MPC announcement and MPR, MPC vote split |
| | Japan: | Wed: IP (Jun, p), BoJ announcement |
| | China: | Wed: Mfg PMI (Jul), Non-mfg PMI (Jul); Thu: Caixin mfg PMI (Jul) |

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