Falling into Place

NB: The next issue of Macrocast will come out on 2 September. We wish our readers a great summer break.

- The US economy is starting to struggle – even if we think the softness in the latest payroll should not be overstated. The market is reacting hard, with in addition a fading "Trump trade". The "bad winds" from America will matter of course for policy makers everywhere, making in particular the BoJ's latest move even bolder.

Since the beginning of the year, the most salient macro surprise had been the resilience of the US economy, especially its labour market. This phase seems to be closing now, with more and more signs that the forces of economic gravity cannot be defied for ever. Yet, just as much as euphoria was probably misplaced in the first half of this year, there are still reasons to expect a reasonably soft landing for the US economy. By the standards of the last two mild recessions in the US (1990 and 2001), the labour market is still in a better shape. Jay Powell's "measured dovishness" may seem conservative after the payroll print but there is an arguable case for the Fed not to move immediately into emergency action. Still, the market is in no mood to reserve judgement. If some over-reaction is probably at play – it's mid-summer after all - the macro and market configurations have fallen into place: "bad news is bad news", instead of being merely seen as the harbinger of rate cuts which would still support the equity market. We suspect that the current political state of play in the US – with Harris now in a 1.6ppt lead in the polls' average – is magnifying the impact of the macro news, as the "Trump trade" – consistent with higher long-term yields – is looking less alluring. Yet, we would call for caution: if the US data deteriorates too quickly, Harris, who cannot distance herself completely from the economic policy of the current administration, could be hit, while Trump's fiscal stimulus and protectionism would become more attractive to electors.

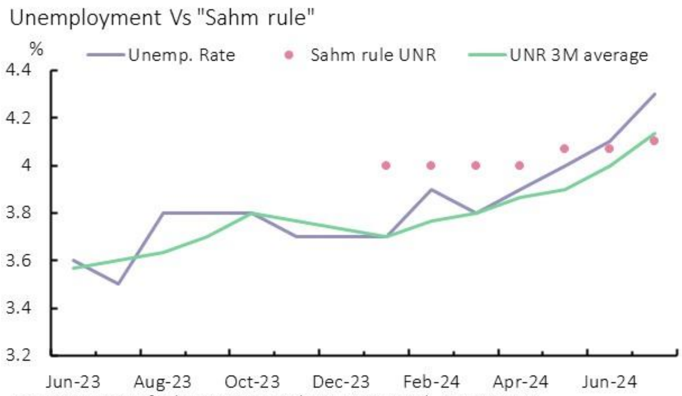
In the UK, BoE Governor Bailey must be happy he sided with the doves to cut rates last week given the "bad winds" blowing from America. By contrast, the BoJ's bold hike – and hawkish rhetoric – looks even bolder. The ECB has until September to make up its mind. The Euro area's dataflow has been inconclusive so far this summer, but with quasi-certainty now the Fed will cut, and mediocre prospects for external demand, we remain confident the ECB will cut again in September

Gravity is winning

The long resilience of the US labour market is no more… or is it? Given the prominence we have given to the "Sahm rule" in the last few issues of Macrocast, of course it would be difficult for us to dismiss the signal sent by the payroll report last Friday. With the unemployment rate hitting 4.3% in July, up 0.2 percentage point (ppt) in one month, while the market was expecting stability, to reach 4.1% on 3-month average, the "Sahm threshold" – a rise of more than 0.5% relative to the trough of the last 12 months – has been crossed (Exhibit 1). Historically, this has always predicted a recession.

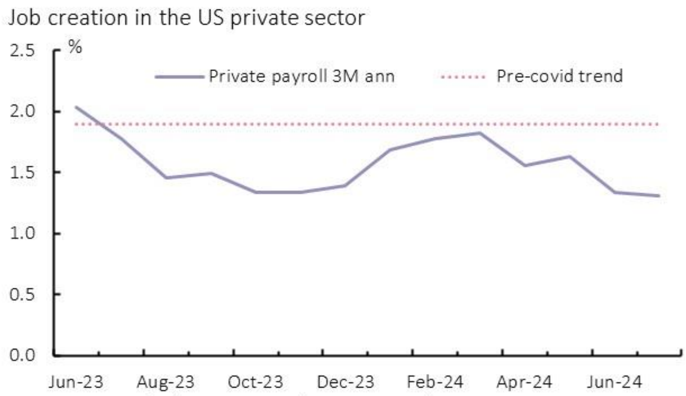
Now, it's equally important to listen to those who call for caution, notably Claudia Sahm herself, who made it plain that "this time it may be different", as she pointed to the resilience of real income as one of the forces which could still stop the US economy from falling into recession. Signals from the labour market are also more ambiguous than it looks. True, job creation in July fell well short of expectations (114K against 175K) but crucially it has remained in positive territory. Over the last 3-month, **job dynamics have continued to wallow below the pre-Covid trend, but at 1.3% in annualised terms this is by no means catastrophic** (Exhibit 2), even in comparison with previous mild recessions. For instance, **when the "Sahm rule" threshold was crossed in the autumn of 1990, as the US economy was dealing with the oil shock triggered by the first Gulf War, jobs were already being destroyed** to the tune of 1.0% on a 3-month annualised basis in September 1990. The same applies to the summer of 2001. When the Sahm rule level was hit in June 2001 – interestingly at a similar level as today – employment was falling at a more than 2% annualised pace.

Exhibit 1 – The "Sahm rule" threshold has been hit



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

Exhibit 2 – But the US economy continues to create jobs



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

This draws attention to the forces at work on the supply-side of the US labour market which put the rise in unemployment in a different light. Immigrants continue to push the number of available workers up. While this should add a good pinch of salt on the sense that the US economy is descending fast into a "pre-recession" state, **this is still a point which should move the Federal Reserve (Fed) in the direction of removing restriction.** Indeed, strong labour supply should reassure on the prospect of wage growth landing on a pace consistent with price stability.

What is at least undeniable is that the "forces of gravity" are finally winning, and the US economy is feeling the pinch of the monetary tightening. Given how far into restrictive territory the Fed Funds rate is, there is ample cover to start cutting without taking much risk. It may be easy to criticise the Fed for failing to react last week already – and we expressed our sympathy for Dudley's call for immediate action in the previous issue of Macrocast – but **in the great scheme of things, moving in July or September is unlikely to move the dial much in our view. Indeed, Jay Powell was sufficiently dovish last week to allow financial conditions to loosen significantly.** The debate is now shifting to how quickly monetary policy in the US needs to go all the way to accommodative territory. We do not think a straightforward answer will emerge before clarity is available on the US fiscal stance next year, and this will largely depend on the outcome of a presidential race which has spectacularly tightened.

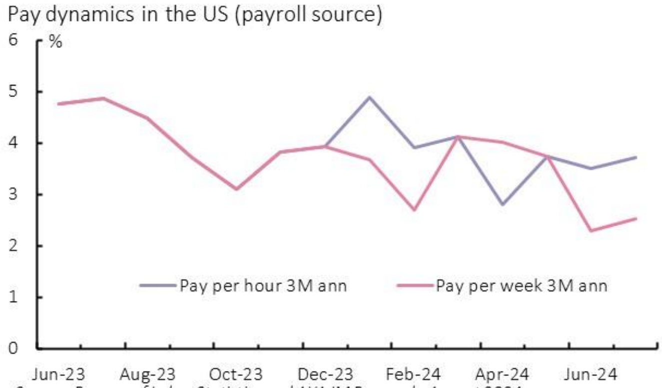
Powell's as dovish as he could realistically be… while Harris disrupts the "Trump Trade"

By stating that a rate cut was "on the table in September", Powell gave a strong nod to the market pricing of such outcome, while giving himself some wiggle room by reiterating that such move would still require "good data". **Coming before the release of the latest payroll report, this was as dovish as it could realistically be**, in our opinion, since the resumption of disinflation is relatively new and there is still quite a bit of data to flow before the next meeting. But Powell's insistence on the risks now being two-sided around the Fed's dual full employment/price stability mandate, although not new, was a strong hint at the imminent beginning of the removal of monetary restriction.

There was no sense of alarm at the Fed though, as Powell read the latest labour market data in terms of "normalisation" rather than as the harbinger of something more sinister (i.e., a proper recession). This was in our view a way to bat away calls for an immediate cut in July. Of course, given what we now know on the state of the labour market, such position from the Fed may now sound overly conservative. Still, given Powell's insistence since the beginning of this year on the positive supply-side forces at work in the economy, his view may be further strengthened by the specific features of the labour market situation we discussed earlier.

It is of course possible that in the next few payroll prints, job losses will start piling up, prompting the Fed into emergency action, especially if the "recession narrative" starts dominating headlines to the point that it has actual effects over business and households' readiness to spend, but we are not there yet. To Claudia Sahm's point, there is still a lot of purchasing power gains in the US pipeline. The unemployment rate may be up, and this will likely dampen wage growth in the near future, but **for now workers' pay is rising faster than inflation** (Exhibit 3), even for weekly gains which suffer from a drop in working hours (2.5% against 1.5% Personal Consumption Expenditures (PCE) when taking the 3-month annualised change).

Exhibit 3 – It's landing but still decent



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

Still, the market is not ready to wait. The combination of weaker data last week with Powell's soft rhetoric solidified the market's expectations of rate cuts in the remainder of 2024. **September is now firmly anchored, and with 33 basis points (bps) priced in, investors are increasingly factoring in the possibility that the Fed would be forced into a 50bp move in one go**, and now expect a total of 86bps of cuts by December, a dramatic shift from the beginning of the week (68bps).

This has spread along the curve, and **US 10- yields have fallen below 4%. We suspect that the latest political developments have played a role there beyond the macro configuration**. Indeed, the "Trump trade" – which we discussed last week, consistent with a stronger dollar and higher long-term interest rates – is fading somewhat as Kamala Harris has managed to plug the gap with her Republican opponent. According to the 538 polling average, the Vice-President is now leading by 1.6ppt. It seems that, for now, Donald Trump – weighed down by a Vice-President candidate who is proving more controversial than expected – is finding it difficult to find the right angle against Harris. The Democrats' convention starting on 19 August will probably prolong Harris' surge in public awareness. **It is still early days though, and a risk to Harris' candidacy lies in the deterioration of the US economy.**

Most predictive models of US presidential elections suggest that voters make up their mind quite early about the state of economy. A few months ago, we showed that consumer confidence in the first quarter of an electoral year has a strong impact on the chances of success of an incumbent President. Yet, **since Harris cannot completely distance herself from the Biden's administration's management of the economy, a further increase in unemployment between now and November would probably hinder her chances**. It would also make Trump's platform more attractive to electors. Indeed, while his tax cut agenda looked difficult to defend in the context of a still robust US economy, it would be much easier to communicate against a background of weaker economic prospects.

The Bank of England's – cautious – leap of faith

This was a "low confidence call" on our part, but the Bank of England (BoE) chose to cut its policy rate last week as we were expecting. And what a close call it was since the status-quo lost by only one vote in the Monetary Policy Committee. We discussed the pros and cons of such move extensively in Macrocast lately. Ultimately, it was always going to be a "leap of faith", but given the bad winds blowing from the US, Governor Bailey must be quite happy that he tilted the decision towards an easing. In any case, last week's decision did not open wide the gates of policy accommodation**. The BoE almost explicitly closed the door to another cut at the September meeting** by stating quite candidly that *"we need to make sure inflation stays low and be careful not to cut interest rates too quickly or by too much*".

The – easing – direction of travel is however quite nicely telegraphed by the forecast update. Indeed, the modal Consumer Price Index (CPI) inflation forecast was revised down to 1.7% in two years' time – against 1.9% in the May batch – and to 1.5% in three years' time – from 1.6%, conditioned on Bank Rate falling to 4.87% end-24 and 4.09% end-25, as per the market's expectations at the time of building the projections**. We think there is space for one more cut this year, in November, to 4.75%.**

There are two major sources of uncertainty around this. First, we do not know if another hawk will replace departing Haskel (his mandate stops at the end of the summer). The arrival of another dove could of course tilt the balance towards two more cuts rather than just one. Second, we suspect quite a bit will depend on how the government will set the fiscal stance in its first budget unveiled on 30 October. Governor Bailey has already seemingly dismissed the nice 5.5% catch-up in wages offered to teachers and nurses in terms of inflationary impact. The issue lies in how much of the overall spending gap will be plugged. With government sources increasingly pointing to some tax increases, the BoE could be inclined to cut a bit faster in the knowledge that aggregate demand will be kept in check by a fairly restrictive fiscal stance.

The Bank of Japan's gamble

While the BoE sounded very cautious upon cutting rates, conversely the Bank of Japan (BoJ) appeared quite resolute when "ripping the band aid" and hiking by 15bps in one go, above the market's – and our – expectation. **The need to support the currency – beyond direct interventions which are rarely effective for very long without help from monetary policy "proper" – was quite transparent** in the BoJ's comments on the "attention required" by the rebound in import prices. The central bank's intention to continue normalisation was clearly conveyed by the message on the need to continue to adjust the level of monetary accommodation, while the impact on the real economy was seemingly dismissed by the reference to real interest rates remaining negative.

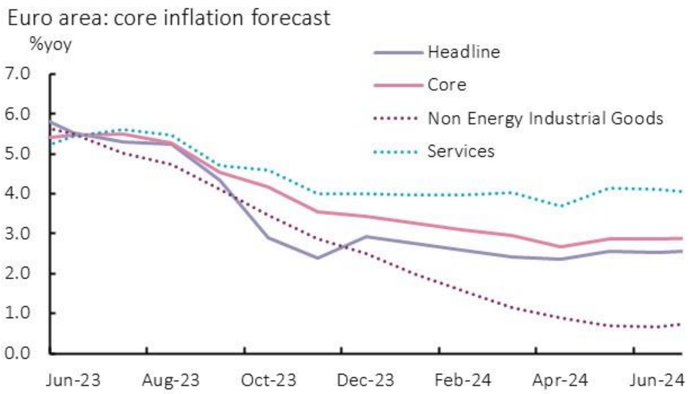
Since the central bank opted for a gradual pace of reduction in bond purchases – from ¥5.7tn today to ¥4.9tn at the end of this year and ¥2.9tn at the end of 2025 – there was possibly a sense that the risk to rattle the market with a meatier rate hike would be controlled. An issue though is that **this came out at the same time as the concerning news from the US and the resumption of significant Fed cuts expectations.** The yen re-appreciated substantially, hitting 146 against the dollar, from a trough at 162, hitting its best level since February. We noted in our BoJ preview that the manufacturing PMI, normally sensitive to export markets, was still very weak in Japan in the last few months despite the competitiveness advantage brought about by the currency depreciation. True, a recovery in consumer spending, triggered by the acceleration in wages, may more than offset the lack of external traction, but a lot will hinge on the saving behaviour of households. The BoJ has taken a bold step.

The Euro area's unconclusive inflation print

Inflation in the Euro area has been on a "plateau" for some months, and we are not expecting disinflation to resume in earnest before the autumn. Given those expectations, the July print did not surprise us much. Core inflation was completely stable, at 2.9%yoy, which was a bit disappointing. Yet, among the components, we knew that the European Central Bank (ECB) is focused on services – Isabel Schnabel made it plain again in her latest interview. From this point of view, there was a – small – improvement, with a deceleration from 4.1%yoy in May and June to 4.0% in July (looking at the second decimal, the delta is larger, with a decline from 4.12% to 3.96%). The absence of further drop in overall core came from industrial goods, which rebounded ever so slightly from 0.7% to 0.8% (Exhibit 4). When "varying the angle" and looking at the 3-month momentum, core rebounded after 3 months of decline, but overall, **the July print does not clearly invalidate the slight decline in services inflation of the last few months** (Exhibit 5).

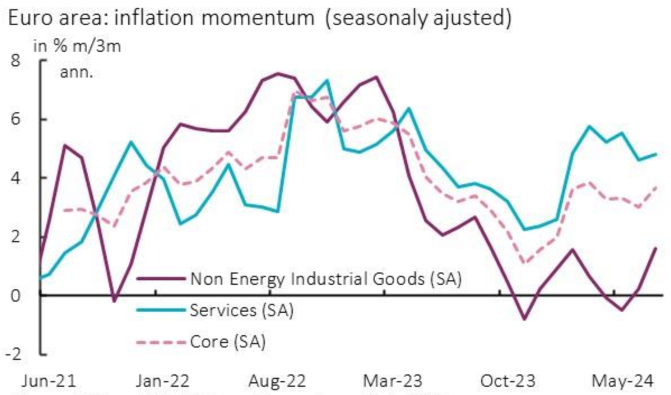
All in all, a rather inconclusive data release which with the right spin could play in the hands of both doves and hawks at the Governing Council. Earlier in the week, the GDP print for Q2 came out as equally ambiguous. Hawks can of course argue that with annualised gains in Q2 of 1.2% – i.e., within the range of potential growth in the Euro area – there is no strong reason to remove monetary restriction quickly. Yet, the poor showing of consumer spending in France for several quarters now, and the relapse in negative growth in Germany are hardly signs of robustness, especially with business surveys, in the two largest economies of the Euro area, continuing to deteriorate into Q3.

Exhibit 4 – Stable core CPI in yoy terms



Source: Eurostat and AXA IM Macro Research, as of July 2024

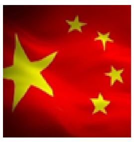
Exhibit 5 – Not much more to see in the 3-m momentum



Source: ECB and AXA IM Macro Research, as of July 2024

With inconclusive data in the summer, the focus will of course be on the outlook embodied in the September forecasts of the ECB. This is a limit of data dependence: a judgemental call will be needed. On the price outlook, as long as real time indicators continue to confirm wages are now decelerating, and assuming the details of Q2 GDP, when they come out, do not invalidate the ECB's stated expectation to see business margin behaviour offset much of the push in unit labour costs, **we think the central bank's economists should confirm the disinflation path, especially with a mediocre narrative for world demand**. The ECB's positivity on the real economy was based on i) a rebound in consumer spending as disinflation frees up purchasing power and ii) decent external traction. On the first element, at least in France and Germany it seems clear that households do not seem that enthusiastic about reopening their pockets, while the news from China and the US is not particularly encouraging for the second one.

The Governing Council will meet on 12 September, a week before the Fed. Yet, we think the ECB will now have enough indication that its counterpart in the US will initiate its own "restriction removal process", to proceed with another rate cut without taking too much risk on the foreign exchange front.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• FOMC meeting. No chg in policy rate. Powell signals likelihood of Sept -0.25% • Payrolls (Jul) increased by 114K in Jun (consensus 175K). May revised down to 179K, from 206K Unemp up at 4.3%, from 4.1%. AHE well behaved • ISM mfg index (Jul) dips to 46.8 in Jul, from 48.5 • Official confirmation of Harris and announcement of running mate (1-7 Aug)	• ISM services index (Jul) watch for rebound in headline after weak June, and prices paid • Snr Loan Officer's survey (Aug) details of lending conditions • Trade deficit (Jun) advanced trade suggests improvement on rising exports • Jobless claims, watch trend in continuing claims for further direction for labour market
	• Flash EMU Q2 GDP came at +0.3%qoq, boosted by Spain (+0.8%); France and Italy at decent levels (+0.3% and +0.2%) while Germany fell by -0.1% • EMU inflation (July) was slightly above expectations at 2.6% for headline and 2.9% for core, with upside surprise on goods due to lower rebate during sales period in Italy. Services came at 4% (-0.1pt) • EC surveys (Jul) confirmed signals from PMIs and INSEE/Ifo with less momentum in services and weak industrial sector	• Final PMIs (July) • Sentix (Aug) • EMU Producer prices (June) must be monitored as good prices to consumers surprises on the upside in July. It seems to be located only in Italy during sales but worth checking input cost evolution if it can represent a risk in medium term
	• Mortgage approvals up 61K in Jun, from 59.9K in May. Cons. credit down at £1.2bn in Jun • Nationwide house price growth up 2.1%yoy in Jul • BoE cut Bank Rate by 25bps to 5% with 5:4 vote split. Cautious tone, but further cuts probable	• Final serv. PMI likely to remain unch from at 52.4 • BRC total sales likely up 1.5%yoy in Jul • Construction PMI likely up 52.9 in Jul, from 52.2 • RICS house price balance likely increased to -14% in Jul, from -17%
	• Unemp. rate ticked down to 2.5% in Jun, from 2.6% • IP likely fell by 7.3%yoy in Jun; retail sales up by 3.7%yoy • BoJ hiked key short term policy rate to around 0.25%, from 0% to 0.1% and announced bond purchase tapering	• BoJ Monetary Policy Meeting minutes released • Serv. PMI and comp. PMI likely unch from flash reading • Av. cash earnings to rise in line with results from Shunto negotiations • HH spending data, watch to see if it recovers
	• Industrial profit grew 3.5%yoy in H2 2024 (Jan-May: 3.4%) • NBS mfg PMI (Jul) edged down by 0.1ppt to 49.4; non-mfg PMI dropped 0.3ppt to 50.2 • Caixin mfg PMI (Jul) declined 2.0ppt to 49.8	• 5 Aug: Caixin Services PMI (Jul) • 7 Aug: Exports and imports (Jul) • 9 Aug: PPI and CPI inflation (Jul)
 	• CB: Brazil unch at 10.5%, Chile at 5.75%, Colombia -50bps to 10.75%, Czechia -25bps to 4.5% • Q2 GDP yoy: Czechia (0.4%), Hungary (1.5%), Taiwan (5.1%), Mexico (2.2%) • July CPI yoy: Indonesia (2.1%), Korea (2.6%), Peru (2.1%), Poland (4.2%)	• CB: expected on hold in India (6.5%), Romania (6.75%), Peru (5.75%), possible 25bp cut in Mexico to 10.75% • Q2 GDP: Indonesia, Philippines, Russia • July CPI: Thailand, Philippines, Taiwan, Turkey, Hungary, Brazil, Chile, Mexico, Colombia, Uruguay

Upcoming events	US:	Mon: Services PMI (Jul), ISM non-mfg index (Jul), SLOOS publication; Tue: Trade balance (Jun); Thu: Weekly jobless claims (Aug 3rd), Wholesale inventories (Jun)
	Euro Area:	Mon: EU20 composite PMI (Jul), EU20, Ge, Fr, It, Sp Services PMI (Jul), EU20 PPI (Jun); Tue: EU20 Retail sales (Jun), Ge mfg orders (Jun); Thu: Ge IP (Jun); Fri: Ge Moody's credit rating review, Fr ILO unemp rate (Q2)
	UK:	Mon: SMMT new car registrations (Jul), Composite and services PMI (Jul); Tue: BRC monitor (Jul), Construction PMI (Jul); Thu: RICS survey (Jul)
	Japan:	Wed: Leading index (Jun, p); Thu: Current account and trade balance (Jun), Economy watchers survey (Jul)
	China:	Mon: Caixin services PMI (Jul); Wed: Exports (Jul), Imports (Jul), Trade balance (Jul), Foreign exchange reserves (Jul); Fri: CPI (Jul)

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