Note to readers: There won't be a Macrocast on Easter Monday. The next issue will be published on 8 April.

Plotting in the Open

- The Fed seems ready to tolerate accidents on the road to disinflation and maintains an easing narrative.
- We explore the possibility some broad-based monetary and currency disorder could be a consequence of another protectionist push in the US, with a succession of competitive devaluations.

Jay Powell steadied the Fed's narrative last week, and with the "dot plot" still pointing to three cuts this year, the market was reassured. It seems the central bank has a relatively wide tolerance margin for accidents on the road to disinflation. This dovish message for this year was somewhat offset by an upward revision in the policy trajectory for the next two years and the longer run. This adds to the sense that the Fed believes the neutral rate has increased. This is reinforced by Powell's point on the strength of the supply-side in the US, which allows disinflation to co-exist with a still very robust economy, an indication that potential growth has improved. The general impression that the global monetary stance is easing or about to ease was further fuelled by the Bank of England's dovish message last week, together with the Swiss National Bank's surprise cut.

Yet, beyond this convergence of central banks in the short term, we think there is a distinct risk of monetary and currency disorder as another trade war may be looming with the US presidential elections ahead. Even if they are not necessarily facing the same quantum of additional tariffs on their exports to the US, China and the Euro area may be tempted to allow their currencies to depreciate to maintain their competitiveness. This could be all the more tempting that spontaneously monetary policies could diverge from the Fed's, as cyclical conditions in the US are stronger than in most of their key trade partners, and levying additional customs duties would in any case lift price pressure on American consumers. Even within NAFTA, tension could rise. The central bank of Mexico has already chosen to cut without waiting for the Fed, as capital inflows attracted by the perspectives of near shoring could excessively raise the already appreciating peso exchange rate. A succession of disorderly competitive devaluations could ensue across large swathes of the world economy, potentially intensifying support for even more protectionist measures, both in the US and outside the US.

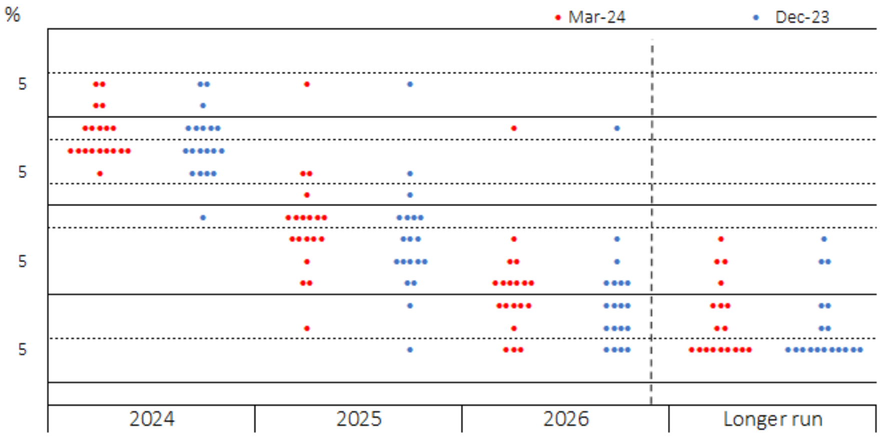
Powell steadies the narrative

There was quite some speculation in the market that the Federal Reserve (Fed) would react to the concerning details in the two latest inflation prints by dialling down its forecasts for rate cuts. However, **as we expected, Jay Powell and the Federal Open Market Committee (FOMC) stuck to their guns: the new "dot plot" has a median at three cuts in 2024, the same as in December** (see Exhibit 1). There was a noticeable shift, since only one member now expects more than three cuts, against five in December, while four instead of three now expect less than three cuts, but **three cuts are now more clearly the mode of the distribution, with 9 dots out of 19, against 6 out of 19 in December**. The resilient dataflow has probably dampened the enthusiasm of the doves for a significant easing this year, but equally, the market's growing concern about a complete inability to cut at all this year should be put to bay by the fact that only two FOMC members – the same number as in December – hold this view.

Powell in his comments was emphatic that the recent consumer price prints *"do not terribly change the story"* of the continuation of disinflation, mentioning the possibility that seasonal factors may have blurred the picture, and insisting several times on how quickly consumer prices had decelerated in the second half of last year. The FOMC still wants to get more data to become "*fully confident that inflation is moving towards 2% sustainably*" but Powell explicitly said that the balance of risk was symmetric (cutting too soon and allowing inflation to remain too strong and cutting too late and cause unnecessary harm to the economy). Importantly, **the Fed Chairman stated that strong job creation by itself would not necessarily be a reason NOT to cut, because some of this current strength in the US economy may come from improved supply.** He explicitly mentioned in his introductory remarks the strong immigration flows, which we highlighted in our previous Macrocast, as contributors to the better balance between demand and supply on the labour market. This can explain why the Fed is comfortable with communicating that they can still telegraph the same quantum of easing this year while at the same time revising up its forecasts for GDP growth and employment. Unsurprisingly, Powell refused to engage in a conversation on the precise timeline for cuts, but his performance last week was consistent with our call that the first cut will still come in June.

Exhibit 1 – Still three in 2024 (just)

Fed participants end-year rate projections (the "dot plot")



Source: Federal Reserve Bank and AXA IM Research, March 2024

Beyond 2024, the dot plot has a 25bps upward revision in the Fed Funds in 2025 and 2026, as well as a 10bps bump to the "long-run" level to 2.6%. Powell did not elaborate much on this, but we think **this reflects a belief that the US equilibrium rate has increased**. Although he was clearly unwilling to sound conclusive on this, Powell made the point that his "*instinct would be that rates will not go back down to the very low levels that we saw*". The underlying narrative may also be that the Fed is ready to move from "very restrictive" to "somewhat restrictive" this year but will remain on its toes for a prolonged period before moving into outright accommodative territory.

Also of note, Powell said that the FOMC would "fairly soon" make decisions on slowing down the pace of Quantitative Tightening. The Fed chairman made it plain that this was detached from the monetary stance itself. The idea there is that a slower pace would allow to better address imbalances in the distribution of excess reserves across banks. We have been expecting an announcement on this in June, but Jay Powell's decision to hint at this last week already makes it possible a decision could be made in May already.

In the days ahead of the FOMC meeting the market had come to price less than a 50% probability of a cut in June. It has now moved to 69%. Symmetrically, while slightly less than three cuts were priced for 2024, the market is now expecting again between three and four by December (85bps). Further along the curve, 10-year yields have corrected from a four-month peak at 4.34% on 18 March to 4.19% on Friday. Powell's steady narrative has clearly been heard.

Protectionism and monetary disorder

The countdown to rate cuts is on well outside the US as well. The Bank of England (BoE) surprised – again – last week as it completely reversed its February hawkish tilt with a plainly dovish message last week. No Monetary Policy Committee member is now advocating further hikes (against two at their previous meeting), and Governor Bailey's statements conveyed a strong easing bias. He explicitly engaged in the "various shades of restriction" narrative which we explored last week, with his point that the *"stance of monetary policy could remain restrictive even if Bank Rate were to be reduced, given that it was starting from an already restrictive level".* While the Bank remains concerned with the strength of the labour market, the downward revision in the inflation trajectory – now seen as falling slightly below 2% in Q2 2024 on the back of the freeze in the fuel duty – has tilted us into pencilling in the first cut by the BoE in June instead of August.

The three major Western central banks would then move in synch. The Swiss National Bank (SNB) chose not to wait and delivered a surprise cut last week. Inflation in Switzerland was coming down fast (1.2%yoy for headline and 1.1% for core in February, systematically below 2% for the latter since May of last year) and we suspect the SNB did not want to take the risk to trigger further upward pressure on the Swiss currency if it appeared as a mere follower on the monetary easing. In trade-weighted terms, the French franc was still up by more than 7%yoy last month (and a whopping +30% over 10 years). In a similar vein, we are tempted to interpret Governor Ueda's very prudent comments last week upon "ripping the band aid" and finally hike the Bank of Japan (BoJ) policy rate as an attempt to avoid triggering an overreaction of the Yen on the back of overly enthusiastic expectations for rapid hikes down the line. **We think that exchange rate considerations are going to increasingly weigh on policymakers outside the US as the risk of a generalised trade war 2.0 is mounting.**

Joe Biden's administration did not reverse his predecessor's protectionist measures, and even extended them in some form under the guise of industrial policy under the Chips Act and the Inflation Reduction Act (IRA). We should however brace ourselves for an intensification of trade wars if Donald Trump is re-elected. Two weeks ago, we explored his former Trade advisor Peter Navarro's' proposals on tariffs. While China would still be a key target – Donald Trump has been floating a 60% custom duty on Chinese imports, or "even bigger" to quote him verbatim – tariff hikes would be deployed well beyond China, with a general rise of 10 percentage points on top of a retaliation against non-tariff barriers. Trade policy would not be solely the economic extension of geopolitical rivalry with Beijing, but the expression of a general desire to protect American producers against all competitors.

The reaction function of the US partners is often analysed solely in terms of their own trade policy. In this realm, they have only two options to mitigate the shock: either to offer to reduce tariffs on American products – possibly through a free-trade agreement – or to offset American barriers by developing alternative markets. The criteria for choice are often at least as much political – for example, the cost to European governments of greater openness to American agricultural products, or the dismantling of systems protecting cultural exception, as those would be two top US demands in any trade talks with the EU – as economic. Moreover, in the case of China, it is far from clear that engaging in "mutual trade disarmament", with Beijing dismantling its state aid framework for key exports and lowering tariffs on US products to convince Washington to give up on the trade war, would be necessarily successful. Since the US considers China as a systemic rival, there could be a reluctance on the American side to contribute to China's prosperity by allowing unfettered access to its domestic market even if it were matched by a greater access of the Chinese market.

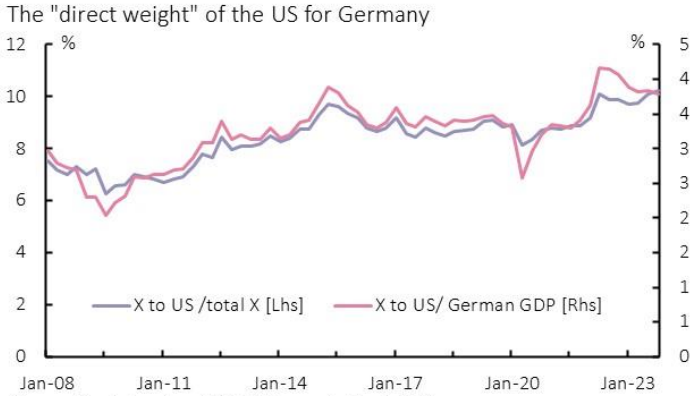
What is clear however is that "benign neglect" cannot be a response. Indeed, the macroeconomic impact of a large hike in US tariffs would be significant. A study by the Peterson Institute from last year (see link here) suggests that the elasticity of Chinese exports to the US to the 25% tariffs imposed as part of "trade war 1.0" was close to one (in other words, for the products subjected to these levies, shipments to the US fell by 25%). The share of the US market in total Chinese exports has been falling (gently until the trade war and then more significantly), but this is still equivalent to nearly 5% of China's GDP (see Exhibit 2). In other words, **if all Chinese products end up facing a 60% customs duty in the US, the cumulative direct impact could exceed 2% of GDP**. That is no small change.

European Union (EU) members would face a smaller shock – a 10% rise in the customs duty – but it would still be noticeable. The US market has become increasingly important to German exporters. German shipments of goods to the US stand at nearly 4% of German GDP (see Exhibit 4). If the use the same elasticity, **a "trade war" 2.0 could cost Germany directly 0.4% of GDP.** This would not go unnoticed in a country which has been teetering on the verge of recession for two years.

Exhibit 2 – US demand still matters to China…

Source: Macrobond and AXA IM Research, March 2024

Exhibit 3 – …and matters more and more to Germany



Source: Bundesbank and AXA IM Research, March 2024

Chinese exporters could be tempted to by-pass the US tariffs by directing their efforts at third countries which would minimally transform their products and ship them to the US, incurring "only" the 10% hike. This has already materialised, with Vietnam in particular playing the role of intermediary: 30% of the country's exports go to the US, while 35% of its imports are sourced from China. This would still represent a net loss for Chinese producers, since Vietnamese re-exporters would probably pass the 10% rise in US tariffs which they would face themselves, on top of the "intermediation margin" they would probably demand.

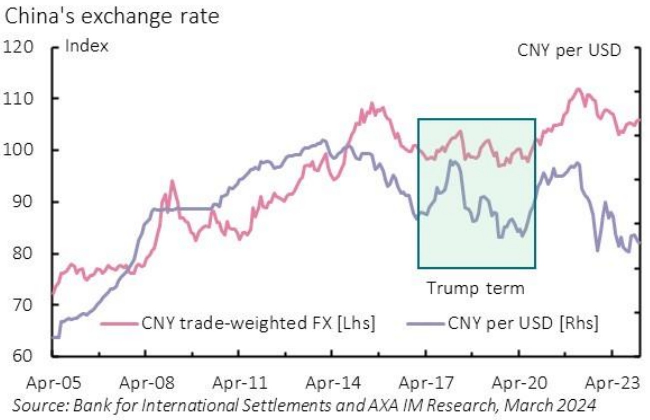
Shifting more production to centres located in the US – or within NAFTA – would be another solution to by-pass tariffs. It is far from certain that this option could be open to Chinese operators on a large scale, both out of concerns in China about having too much direct capital exposure in a systemic rival – much like Beijing has been gradually reducing its exposure to US debt securities – and because of mounting concerns in the US about allowing significant settlements of Chinese-owned industrial facilities on the US territory in strategic sectors. Such approach would likely be more a temptation for EU-based businesses. Combining an avoidance of higher customs tariffs with the benefits of lower energy prices would probably lure many EU companies to the US. This would still come with some significant drawbacks: a loss in domestic capital expenditure and employment.

There is, however, another, indirect option: **allowing the exchange rate to depreciate against the dollar to offset the impact of tariffs.** This temptation is all the stronger given the spontaneous evolution of economic policies. Indeed, the United States is currently in a more advantageous cyclical position than many of its trading partners – certainly the eurozone and China. **It would be rational for the European Central Bank (ECB) and People's Bank of China (PBoC) to pursue a more accommodating monetary policy than the Fed, which would lead to a depreciation of the euro and renminbi**. At the same time, the Federal Reserve could itself be induced to tighten, or at least to tone down its more accommodating stance in response to a new protectionist shock. Indeed, a general increase in tariffs would most likely result in higher inflation in the US, especially as this could be offset by tax cuts to cushion the deterioration in household purchasing power (an option explicitly put forward by Donald Trump).

On the other hand, the "backlash" on inflation from US partners opting for monetary accommodation and exchange rate depreciation would probably be manageable, especially for the European Union. Indeed, even if the dollar's appreciation would result in a higher energy bill, a joint depreciation of the euro and the renminbi would limit the impact on the price of manufactured goods traded between these two players. Since the Renminbi would probably have to depreciate also relative to the euro because Chinese products would face higher tariffs in the US, the net effect could even be *disinflationary* for Europe. The risk of some positive price reaction would be higher for China than for Europe, but since the former is currently facing deflationary pressure, this would probably a risk worth taking.

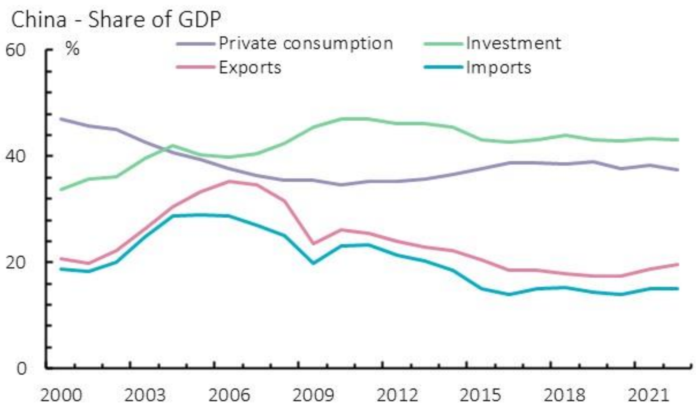
True, China did not use this weapon on a massive scale during the "first trade war" in 2017-2019, during which the depreciation of the Yuan was moderate (see Exhibit 4). However, at the time domestic objectives were not aligned with a general policy of weakening the Chinese currency. Today, with a struggling domestic demand, low interest rates and a weakening exchange rate would be an attractive combination. While the share of exports in GDP had been falling in China from a peak in 2007 to 2017, it has stabilised since then (see Exhibit 5), illustrating that the conversion to a fully domestically driven economy is far from complete.

Exhibit 4 – No massive CNY depreciation under Trump



Source: Bank for International Settlements and AXA IM Research, March 2024

Exhibit 5 – Exports share in Chinese GDP no longer down



Source: CEIC and AXA IM Research, March 2024

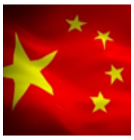
Foreign policy considerations have often affected China's exchange rate policy. To establish the Renminbi as an international reserve currency rival to the dollar, offering attractive returns to foreign investors, and not seeking a weakening of the parity against the US currency has recently been a cardinal principle for Beijing. However, in a configuration where US trade policy could push more emerging countries to decouple from any economic dependence on the US, the political calculus in China may conclude that it is possible to let the Renminbi depreciate without any significant threat to its international status.

A key problem for the Euro area is of course that there cannot be an exchange rate policy per se, since the issue is according to the treaty shared between the Council and the ECB. Also, from a practical point of view, the euro exchange rate is truly free-floating whereas the Renminbi is managed. At the very least however, the possibility that

Europe faces a US tariff hike next year should be another reason for the European Central Bank not to delay easing monetary policy, even if the Fed is late in that game, and should not hesitate to cut more deeply than the Fed. Another European issue is that a large currency depreciation in China – even if it would be helpful to mitigate inflationary pressure in the Euro area – would raise the competitiveness of Chinese products on the European market, at a time when governments are increasingly concerned with the risk of losing out to China in strategic sectors such as the car industry.

An "exchange rate response" to US tariffs would never be a panacea. We would see a distinct possibility that this would trigger spiralling competitive devaluations and protectionist pressure outside the US. Even within NAFTA, tensions could easily flare. In the latest reform of the trade agreement, Washington managed to impose stricter rules of origin to counteract the possibility that non-North American producers would shift too much production to Mexico to by-pass tariffs, but this is not the only pressure point. The central bank of Mexico last week did not wait for the Fed to start cutting rates, possibly to stem the significant appreciation of its currency (+7%yoy against the US dollar in February 2024), at least to some extent the product of actual or expected entries of foreign capital into the country under the "near-shorting" theme. Monetary and currency disorder could be generalised.

Finally, another reason a "currency war" is not an optimal solution is that it could lead to a protectionist spiral in the United States. Beijing's decision in 2015 to depreciate the Renminbi (after years of appreciation) was one of the factors behind the hardening of US policy (accusations of currency manipulation by Beijing were rife under Obama). This is another aspect of the counter-productive nature of trade barriers. Unfortunately, economic rationality is not always aligned with political passions.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• FOMC left FFR unch at 5.50%. Dots kept 3 cuts for this year, next reduced to 3 (from 4). Powell said QT tapering announced "fairly soon" • Existing home sales (Feb) surge 9.5%mom, but made (and then unwound) similar move last Feb. • Philadelphia Fed survey (Mar) +3.2, index appears to be trending higher, contrary to Empire survey	• PCE inflation (Feb), core expected to rise 0.3%mom • Personal income and spending (Feb), watch real consumer spending and level of saving • Conf Bd consumer conf (Mar) monitor expectations for further drop • GDP (Q4) final revisions, current est 3.2% (saar) • New home sales (Feb) watch for further gains
	• Euro area composite PMI output edged up 0.7 points to 49.9 in March led by services • Euro area final headline and core HICP were unrevised at 2.6% and 3.1%yoy respectively	• Eurozone member states' flash March HICPs. We project euro area flash headline and core HICP unchanged at 2.6% and 3.1%yoy respectively • European Commission March survey
	• MPC voted to keep Bank Rate unchanged at 5.25%, vote split (0-8-1) vs. Feb. (2-6-1) • CPI Inflation (Feb) fell to 3.4%, from 4.0% in Jan, below the MPC's expectations, 3.5% • Retail sales (Feb) 0.0%mom after Jan surge	• GDP (Q4 final) expect no material change to the first estimate, -0.3% • UK current account (Q4) modest widening expected
	• The BoJ hiked its policy rate to 0-0.1%. No guidance for further tightening. YCC on 10y yield abolished, but BoJ to keep purchases to avoid sharp sell off • PMIs flash Composite (Mar) rose to 52.3 (+1.7p), boosted by services (54.9; +2p) • CPI (Feb) surged to 2.8%yoy (+0.6p) (base effects)	• Tokyo CPI (Mar) expected flat vs February • Employment data with unemployment rate; jobs/applicants' ratio (Feb) • Retail sales (Feb) to see if we see first signs of improvements • Industrial production (Feb)
	• Fixed asset investment (Jan-Feb): 3.2%yoy (Dec: 3.0%) • Industrial production (Jan-Feb): 7.0%yoy (Dec: 6.8%) • Retail sales (Jan-Feb): 5.5%yoy (Dec: 7.4%) • LPR 1Y & 5Y for March remained unchanged at 3.45%yoy and 3.95%yoy respectively	• Industrial profit (Feb)
	• CB: Turkey surprised markets by hiking +500bps to 50%. Taiwan also hiked +12.5bps to 2.0%. Brazil cut -50bps to 10.75%, Czechia -50bps to 5.75% & Mexico -25bps to 11%. Indonesia stood on hold (6%) • Q4 GDP slowed to 0.1%qoq in Chile • Industrial production (yoy): Czechia (Jan: 0.0%), Colombia (Jan: -4.3%) & Poland (Feb: 3.3%)	• CB: Hungary is expected to cut -75bps to 8.25% & South Africa should stay on hold at 8.25% • CPI: Malaysia (Feb) & Poland (Mar) • Feb Industrial production: Korea, Taiwan & Thailand • Feb unemployment: Brazil, Colombia & Mexico

Upcoming events	US:	Mon: New home sales (Feb); Tue: Durable goods order (Feb), Case-Shiller HPI (Jan), FHFA HPI (Jan), Consumer Board consumer confidence (Mar); Thu: GDP (Q4), Weekly jobless claims (23 Mar), Chicago PMI (Mar), Michigan consumer sentiment & inflation expectations (Mar), Pending home sales (Feb); Fri: Goods trade balance (Feb), PCE price index (Feb), Personal income & spending (Feb), Wholesale inventories (Feb)
	Euro Area:	Tue: Sp GDP (Q4): Wed: Ez Business confidence (Mar), Fr Insee consumer confidence (Mar), Sp HICP (Mar); Thu: Ez M3 money supply (Feb), Ge Unemp (Mar), It ISTAT business confidence & consumer confidence (Mar); Fri: Fr consumer spending (Feb), Fr&It HICP (Mar)
	UK:	Mon: CBI Distributive Trades survey (Mar); Wed: BoE publishes Financial Policy Summary; Thu: GDP (Q4), Current account (Q4), Business investment & private consumption (Q4), Nationwide HPI (Mar)
	Japan:	Mon: Leading index (Jan); Thu: Unemp (Mar)
	China:	Wed: Industrial profits (Feb), Sun: Official mfg & non-mfg PMI (Mar)

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