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Fast and Furious?

- Republican "full sweep" would help Trump to "go fast" but institutional limits should not be understated
- The ECB will have to look through a not entirely spotless short term inflation outlook to help shore up confidence
- Hopes of a "fiscal thawing" in Germany are exaggerated in our view

It seems the Republican party is on course for a "full sweep" and control the White House and the two houses of Congress – Just. In addition, the new administration will be able to count on a sympathetic Supreme Court. This will incentivise the President-elect to try to deliver quickly on his platform. He has 22 months from his inauguration to the mid-term elections to act with a wide room for manoeuvre. He may still find some obstacles on his fiscal loosening path though: while a politically aligned Congress makes it easier to pass a budget through "reconciliation", keeping all the nuances of the Republican caucus together through this complex process will not be straightforward. This means Donald Trump may focus on areas on which he has more leeway through executive orders: immigration and tariffs. The market has reacted to his victory by expecting more inflation but also much more growth. If the fiscal sugar rush comes only after the potentially disruptive decisions on immigration and tariffs, perceptions may change. The market may be the main source of "check and balance" on the new administration's instincts.

The Fed's reaction will of course be a key ingredient in any market revision of its assessment of Trump 2.0. Jay Powell kept his cards close to his chest last week. Yes, the Fed cut by 25bps, but he refused to embark on any kind of forward guidance, even for the December meeting. Another 25bp cut next month is our baseline, but we think the Fed will stop at 4.25% in March, 50bps higher than what the market is currently pricing for the terminal rate.

The Euro area will find itself in a complicated position – and the underwhelming stimulus announced by Beijing last week will not help shore up confidence among European exporters. We think the ECB will need to look through a not entirely spotless short-term outlook for inflation and engage in a more forceful restriction removal path. The market briefly interpreted the political crisis in Germany as the promise of some fiscal loosening ahead. We think this will be a very uncertain and slow process. In the UK, conversely, a spendthrift budget is already impacting the central bank's trajectory.

Avenue open for 22 months

As we write these lines on Sunday evening, Republicans are on course to save their tiny majority in the House of Representatives: they are only 5 seats away from the 218 threshold, while the Democrats are still 15 seats away. There remain 19 seats to call. In 6 of those, the Republican candidate has a lead of 3% or more in the votes already counted, and a smaller lead in 3 more.

A full sweep is not so unusual in the US, but the Republicans would benefit this time from a much rarer configuration: on top of controlling the executive and legislative branches, they should also be able to count on a "sympathetic" Supreme Court, now clearly tilted towards the conservative camp since Donald Trump's appointments during his first mandate. **This enables Donald Trump to deliver on his platform – with some limits we will discuss – and incentivise him to it fast, i.e. before the mid-term elections of November 2026**. Indeed, even though it is now more likely than not that the Republicans will keep the House, their majority will be razor thin, and even a modicum of bad mood in the electorate would probably be enough to tilt the House towards the Democrats in two years. Also, immediately after the mid-terms, the Republican party is likely to fully focus on Donald Trump's succession, which will reduce the bandwidth for big policy moves and diminish the President's authority. From his inauguration to the mid-term elections, Donald Trump will have 22 months to sculpt his legacy. That is short.

In the runup to the election, Donald Trump was very vocal on the need to appoint loyalists to government posts. The "spoils system" is a traditional feature, but it seems the President-elect wants to go much further than usual. This probably reflects a willingness to avoid the "lull" at the beginning of the previous Trump administration, when his instincts were kept in check by seasoned Washington operators. **Controlling both houses will help Trump to expedite the – often gruelling – vetting process of the presidential appointees.**

Yet, even if the Trump administration "hits the ground running", and taking on board the US complex legislative process, which of the three central tenets of his election economic platform – tax cuts, immigration crackdown, trade policy – will Donald Trump prioritise? This may depend on the ease with which the projects can be pushed through the institutions.

The main benefit of controlling both Houses is that it makes using the "reconciliation process" easier to pass fiscal bills. Indeed, as of now, the normal legislative process still entails a "filibuster rule" which brings the normal majority threshold in the Senate to 60 (this can be rescinded by a single majority vote, but the leaders of the Republican caucus in Senate still favour this rule). "Reconciliation" brings the Senate majority threshold back to 50. The Republicans have been vocal about their willingness to use this conduit to pass their tax cut agenda. Yet, starting such a process requires getting both Houses to vote the same resolution instructing the budget committees of the two Houses to work on new parameters (see here for a more thorough exploration of reconciliation). Then the resulting bill needs to be approved by the whole House before it is passed to the Senate, which can amend it. It then goes back to the House which either endorses the Senate's amendments, or a joint committee is set up to converge before the bill is finally signed by the President.

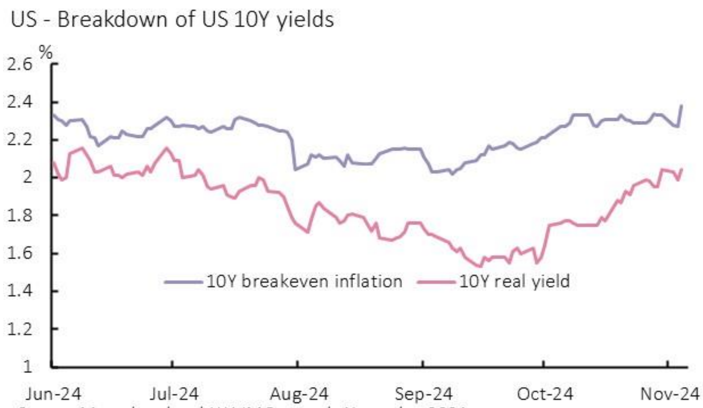
This suggests that **even when both Houses are politically aligned, reconciliation can still be a time consuming and complex process**. The Senate likes to take its time. In 2017, when the Tax Cuts and Jobs Act went through reconciliation, the Senate's final vote did not come before 20 December. This year however, a much quicker resolution would be needed if the Republicans decide to tag the extension of the debt limit to the new tax bill. Indeed, the current debt limit extension expires on 1 January 2025. The Treasury has some leeway to extend it technically further, but it could not wait until the end of the year. The two issues could be disjointed, but the debt ceiling issues should remind us that the Republican party is divided on fiscal matters. While Donald Trump's victory probably makes it less palatable to a lot of Republican Representatives to use the debt ceiling issue as a way to block the executive branch**, there are still some fiscal conservatives who would balk at a tax bill which, according to the Penn-Wharton Budget**

Model, would raise the deficit by 2% of GDP annually. With a razor-thin majority in the House, the leverage of these conservatives would be considerable. True, additional income from tariffs may help to soften them – even if realistically, the hikes will not fully offset the tax cuts – together with a thorough review of federal spending which Elon Musk is pushing, but the recent history of the Republican caucus in the House does not suggest we should expect a swift convergence.

This gets us back to a point we made in our "election preview" last week: **even with control of Congress, Donald Trump may focus first on the fields on which he has direct control via executive orders: international trade and immigration** – even if in the latter, some of his deportation programme would probably entail a significant rise in the financial resources of the Immigration administration, which itself would be tied to the success of the fiscal bill. In his first post-election interview, Donald Trump made it plain that he would want to deliver on its immigration platform and that there is "*no price tag attached to it*", meaning that the economic cost of such action is secondary.

We think such sequencing would matter for the markets and the macroeconomic reaction to Trump 2.0. Indeed, the market reaction since the election – and before that in the two weeks in which polls started turning in Trump's favour – reflects a belief in stronger inflation accompanied by even stronger growth. This is at least what the breakdown of 10-year US yields suggests (see Exhibit 1). **If the newsflow from the White House in the first months of 2025 is more about measures which would indeed lift inflation, but also probably restrain growth (immigration crackdown and trade tariffs) while the expected fiscal sugar rush takes time to materialise, the market reaction may change**.

Exhibit 1 – More inflation, but even more growth (for now)



Source: Macrobond and AXA IM Research, November 2024

Ultimately, possibly more than the narrowness of the Republican majority in the House, it is the market response which may be the "balancing force" which would convince the Trump administration to revise down its ambitions in the macroeconomic realm.

Powell prepares for the fight

As widely expected, **the Federal Reserve (Fed) cut its policy rate by 25 basis points (bps) last week.** While the economy remains strong – a point Powell made several times during the Q&A – the Fed Chair argued that the labour market has cooled enough to get the point it is "*now less tight than just before the pandemic*" and "*no longer a source of inflationary pressure*". This allows the central bank to remain on a path of gradual restriction removal "*towards a more neutral stance*". There was an initial flutter among Fed watchers as the notion that the Federal Open Market Committee (FOMC) has "*gained greater confidence that inflation is moving sustainably towards 2%*" was removed from the prepared policy statement, but Powell made it clear during the Q&A that reaching such confidence threshold was a "test" to start the restriction removal process back in September. They don't need to repeat this now the process is ongoing.

None of this was surprising. **Hints about the future trajectory, and how the US elections could affect it, were really what journalists were focused on during the Q&A. They did not get much on that front**. Powell repeated that the FOMC is not on any pre-set course and will take decisions one meeting at a time. He was also very clear that the Fed would not pre-empt any policy decisions the President or Congress could take: "*we don't guess, we don't assume*". Of course, Powell stated that when policies are properly laid out, they will be analyzed by the Fed staff and will be used as an input on the FOMC's decision function, among "a million other things" given their impact on the economy, but as long as the timing and substance of these policies are not defined, the Fed will not speculate.

Powell's explicit refusal to engage in forward guidance extended to the December meeting. He was careful not to rule out anything. He reiterated that, on their general path of restriction removal, they can modulate the pace and "*find neutral (…) carefully, patiently".* Powell noted that since the September meeting the dataflow on the real economy had been generally stronger than expected, while the inflation print for September was "*not terrible, but a little higher than expected*". He made it plain that the Fed would take a good look at the inflation and employment report prints which will be released by the December meeting. There were several questions on the recent rise in long-term interest rates – presumably to gauge the Fed's appetite to offset a tightening in overall financing conditions – but in line with the point we made in the previous section of this note, Powell insisted that so far this indicated more an upward revision in growth expectations rather than a drift in expected inflation, and that in any case the Fed takes these moves on board only when they are persistent, sending the message that a temporary bump in 10-year yields in the aftermath of the elections would not necessarily spook the FOMC.

All in all, we think a 25bp cut in December – our baseline – is still probably the Fed's "natural slope", but our level of confidence is lower after this press conference. It would not take much in the next inflation and employment data to put the FOMC on pause. In any case, if the FOMC cuts in December, we expect a pause in January and under our central scenario for the implementation of Trump's policies, we think the Fed will stop at 4.25% in March. This could of course antagonize the incoming Republican administration, leaving the FOMC open to accusations of partiality after their 50bp cut of September. It seems Jay Powell is readying for the fight though. When asked if he would go if the President asked him to, he simply but forcefully answered "no". When asked if the President could remove a member of the Fed board, he answered that *"it is not permitted under the law*". **The test for the future relationship between Trump and Powell may be coming very quickly: we will see if, and how, the President-elect chooses to respond to Powell's statements.**

The market is now pricing Fed Funds at 3.77% for December 2025, still below our baseline, without any major change on the day of the Fed's press conference between the release of the statement and the end of the Q&A (FX also barely moved while Powell was speaking). Fed Funds pricing is still 12bps higher than before the election results, but given that the market started pricing a Trump victory in earnest since polls began to turn around 20 October, we think that to gauge a "Trump premium" currently at work in the pricing we need to look at the change from 19 October (there was no major data release after that, since the October payroll was too noisy to really affect markets) **: Fed Funds pricing for December 2025 moved up by 40bps. We think this is conservative**. In any case, the market is in no better position than the Fed: Trump's platform has the potential to strongly affect inflation and employment in 2025, but as long as we don't have precise information on the timing and content of the actual decisions, volatility will probably remain elevated.

Chinese swap

Timing is everything, and it was tempting to read the announcement by Beijing of a support package for local authorities to address their hidden debt problem as a reaction to Donald Trump's victory. Yet, the spokespeople from the Finance Ministry hinted at another stimulus "later". It may well be that the Chinese authorities want to get a better sense of the magnitude of the tariffs coming their way to calibrate their response. Still, the market was underwhelmed by last week's announcement. We were not surprised: we argued a few weeks ago that investors, in their enthusiasm about the looming Chinese stimulus tended to confuse financial stability measures – shoring up the balance sheet of over-leveraged local authorities – with an injection of additional spending in the system.

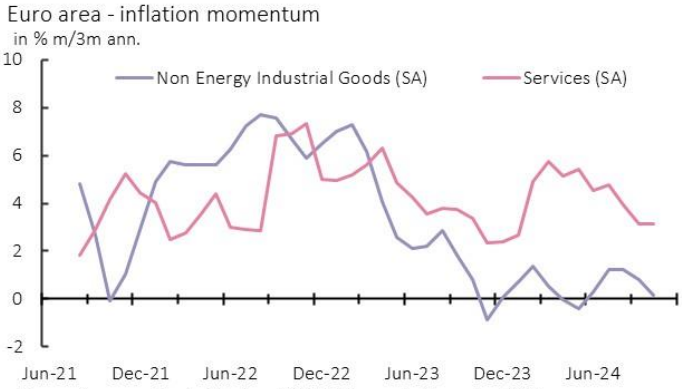
From a financial stability point of view, it is reassuring to see that the local governments' will be authorised to issue more traditional debt with which they will be able to refinance their existing off-balance sheet debt issued by special vehicles set up to fund infrastructure and housing projects. The announced amount of additional debt issuance (RMB 10tn, or USD1.4tn) is close to an estimate by Goldman Sachs of the risky part of the special vehicles' debt. Since the interest rate on traditional bonds is in general lower than that weighing on hidden debt, local authorities will see some improvement in their cash flow position, but, as far as we understand at this stage, nothing will alter the basic fact that local governments can no longer easily cover their ordinary spending with land sales as long as the real estate correction. **Since the central government still controls most of tax receipts, only a significant cash transfer to the local authorities would really change the overall fiscal impulse. Financial engineering is not substitute for proper active fiscal policy.**

Meanwhile, in the EU

We have been arguing that a 10% tariff hike on all US imports would be manageable for the rest of the world as long as monetary policy would be allowed to play its stabilisation role. In principle, a 10% uniform tariff would not affect any exporter more than any other. They would have to care only about competition from US-based producers, which could be rebalanced at least partly by the reordering of currencies which would naturally ensue from the Fed turning more hawkish while the other central banks would turn more dovish. From a recent peak this summer at 1.1192, the euro has already lost 4.2% against the dollar**. For the depreciation to continue, the European Central Bank (ECB) must of course be in position to diverge more from the Fed**, and this will of course be function of how confident the Governing Council is that inflation can continue to converge in a timely manner to its target.

We found it quite reassuring that the Governing Council decided *unanimously* to deliver a back-to-back cut in October, suggesting that even hawks are revising their macro outlook. Yet, **in the run-up to the December meeting, the dataflow will of course matter**. The stronger-than-expected GDP growth estimate for Q3 (+0.4%qoq, 1.6% annualised) in itself was not decisive in our view, given the exceptional contribution from France thanks to the Olympics and another outsized Irish number. Controlling for these two factors, GDP growth was closer to 1% annualised, barely in line with potential.

Exhibit 2 – Bump on the disinflation road



Source: European Central Bank and AXA IM Research, November 2024

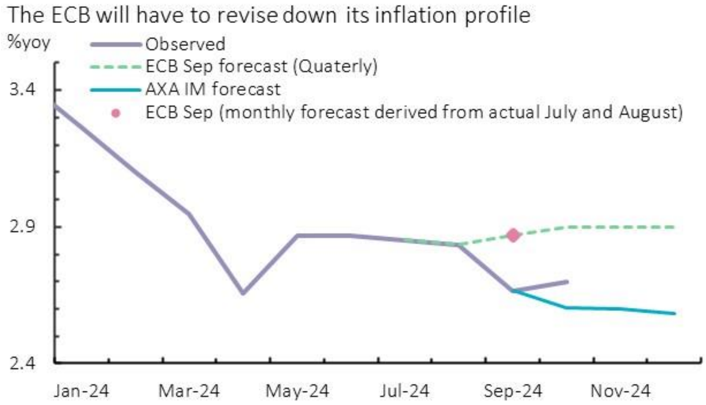
Exhibit 3 – Services price behaviour still not normalised

Source: European Commission and AXA IM Research, November 2024

The inflation print for October was to some extent disappointing: the core Consumer Price Index (CPI), contrary to expectations, failed to decelerate further from September, staying at 2.7%yoy. The momentum shows that the deceleration in services prices has paused (see Exhibit 2). The business surveys suggest that the price behaviour in this sector still has not fully normalised, with selling price expectations still two standard deviations above their long-term level (see Exhibit 3). The road to disinflation was always going to be bumpy, and we should not overstate the significance of one month worth of data. The October print was still closer to our inflation forecasts than to the ECB's (see Exhibit 4). Still, while at the end of October, the market was pricing a 40% chance of a 50bp cut, rather than a 25bp one, at the December meeting, the recent dataflow has changed the picture (only a 20% chance as of last Friday).

25bps is also our baseline, but we continue to think that a bigger cut may still be in the table if the months ahead if inflation prints are convincingly back on the decelerating path and if confidence surveys suggest the European corporate sector is reacting very strongly to the US elections.

Exhibit 4 – The ECB's inflation forecast still too high



Source: Eurostat, European Central Bank and AXA IM Research, November 2024

In any case, what is at stake a t the December meeting is, in our view, less the quantum of that month's cut, but **how clear the ECB will be on a trajectory of restriction removal which would get monetary conditions back to neutral**. It would be dangerous not to be pre-emptive here. Waiting for *actual* decisions in Washington on levied on European and Chinese products (we think the latter matter more) to react may keep financial conditions in Europe unduly restrictive. Indeed, **just the threat of another trade war could be enough to trigger a wait-and-see attitude in the European corporate sector**, uncertain for instance on how the Chinese economy would take a 60% tariff hike.

Moreover, **we continue to think the ECB cannot ignore the fact that fiscal policy is unable to provide any meaningful protection in the Euro area at the moment.** It is another clear manifestation of the Zeitgeist that a day after the US elections brought the next administration a likely "full sweep", the German coalition collapsed. **We now have the two larger economies of the European Union (EU) operating with minority governments with an unclear path to finalising the budget bill**. There was a brief moment of positivity in the market, as the exclusion of the fiscally conservative Free Democrats was interpreted as the promise of more active budgetary policy ahead. This was fuelled by Scholz' announcement that he had proposed another *suspension* of the "debt brake" for 2025. Yet, as things stand today, it is unclear if the Chancellor could find a majority to support such move, and how much of a revision in the fiscal impulse 2025 this could yield.

Taking things further, **it is not obvious the elections**, probably taking place in late March (at time of writing, this was still the timeline favoured by Scholz, despite pressure from the opposition for quicker resolution), **would necessarily bring a clarification on Germany's fiscal stance.** To go beyond that a suspension – which requires only a simple majority – disposing entirely of the Debt Brake constitutional rule, or at least substantially reforming it, entails a two-thirds majority in both Houses of parliament. According to the latest polls, populist parties from the right and the left are now attracting more than a quarter of the electorate, and the official position of CDU-CSU, the likely winner of the general elections, is still to support the Debt Brake. In any case, polls suggest that another two or three-way coalition will need to be formed after the elections, which will (i) delay the clarification further and (ii) make negotiations around the fiscal stance tricky. While one can "sense" that the macro debate is shifting in Germany's policy circles, **we do not think we should count on swift fiscal support from the Euro area's biggest economy in time to stem a further deterioration in business confidence.**

Exhibit 5 – It was complicated, it will remain complicated

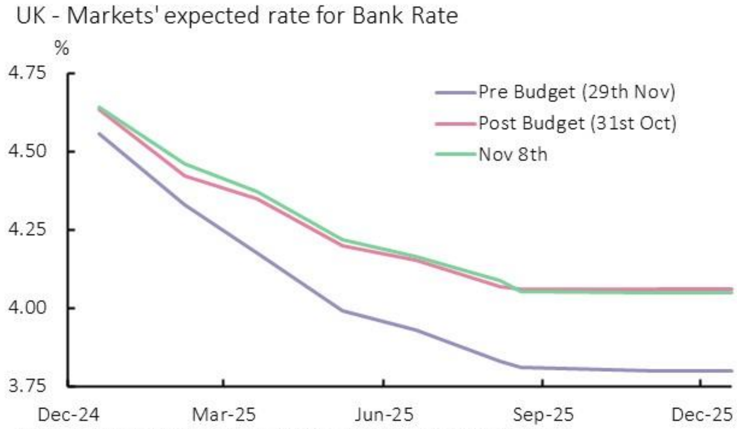
German parliamentary seat breakdown, and latest polls	Sep-17 Election		Sep-21 Election		Nov-24		Latest polls - 4 Nov
	Seats	%	Seats	%	Seats	%	%
SPD	153	20.5	206	25.7	207	28.2	16
CDU/CSU	246	32.9	197	24.1	196	26.7	32
Greens	67	8.9	118	14.7	117	16.0	10
FDP	80	10.7	92	11.4	91	12.4	4
AfD	94	12.6	83	10.4	77	10.5	17
The Left	69	9.2	39	4.9	28	3.8	3
BSW	-	-	0	0	10	1.4	7
Independent	-	-	1	-	7	1.0	
			736		733		89

Source: polls of polls and AXA IM Macro Research, 4 November 2024

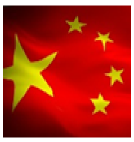
Bank of England cuts but hints at a slow pace ahead

On the need to build a cooperative policy-mix, the UK is clearly bringing a pure counterexample, contrary to our expectations after the latest elections. Indeed, upon cutting its policy rate by 25bps again last week, the Bank of England (BoE) revised up its forecasts for both GDP and CPI inflation in the wake of the Budget, with a 0.5% boost in the headline rate of inflation at its peak in 2025. The Bank still expects inflation to drop below its 2% target over the forecast horizon, though, suggesting further cuts are on the horizon, but the Monetary Policy Committee (MPC)'s preferred approach will likely be more gradual than we hoped just a few weeks ago. The market's pricing of the BoE's trajectory barely moved after the MPC meeting though. This is simply because **the "damage was done" when the budget was unveiled on 30 October (see Exhibit 6). If the market is right, the more spendthrift than expected bill is worth about 40bps in forfeited policy rate cuts.**

Exhibit 6 – The budget is worth 40bps of forfeited rate cuts



Sources: Bloomberg and AXA IM Macro Research, 8 November 2024

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Donald Trump will be the next US President, in a quicker than expected result, he won the popular vote. Republicans have also won majority control of the Senate. They are on track to keep the House. • The FOMC cut rates by 0.25% as expected, noting some loosening in the labour market. We expect a further 0.25% cut in December. • ISM services (Oct) rose to 56.0 and a 28m high	• CPI inflation (Oct) expected to rise on oil rebound, services ex-shelter watched for another strong read • PPI inflation (Oct) also expected higher on oil, monitored for read-through to PCE inflation • Retail sales (Oct) several strong recent gains, but watched as gas prices rise • Industrial output (Oct) still seen falling • Empire State survey (Nov) dropped sharply last
	• O. Scholz fired Lindner, his finance minister (FDP - liberal party), ending the current coalition. He has called for a vote of confidence on 15 January that should trigger snap election by end of March 2025 • GE industrial output fell by 0.9%mom but orders rebounded by +4.2%, (Fr: -0.9% and It: -0.4%) • EMU producer prices (Sep) stayed neg at -3.4%yoy • EMU retail sales (Sep) rose +0.5%mom after August being revised up as well to +1.1%	• Ge ZEW (Nov) • EMU employment and GDP 2nd estimate (Q3) • Final inflation data (Oct) in Ge, Fr, It and Sp
	• BRC Retail Sales (Oct) dropped to 0.3%, from 1.7%. Consistent with yoy retail sales easing back • Construction PMI (Oct) fell to 54.3, from 57.2. Final composite PMI revised up to 51.8, from 51.7 • BoE cut Bank Rate to 4.75%, split 8:1. Revised up its growth and inflation forecasts on back of Budget, but continued to signal gradual cuts	• RICS Residential Survey (Oct) recovery likely to stall • Labour market (Sep) unemp. rate likely to edge up. Pay growth ex. bonuses to continue ticking down • Monthly GDP (Sep) set to rise by 0.1%qoq; stronger IP offset by weaker services • GDP (Q3) we look for a 0.2%qoq increase, down sharply from H1
	• Final comp. PMI (Oct) revised up to 49.6, from flash est. 49.4, remains below 50 • Wage data (Sep) show scheduled cash earnings for regular workers picked up to 2.9%yoy, from 2.8% • HH spending (Sep) was down 1.3%mom, leaving yoy rate down 1.1%	• Eco Watchers (Oct) look for signs the outlook is improving • PPI (Oct) look for evidence the weaker yen is passing through to costs • GDP (Q3) growth set to slow as temporary boosts in Q2 fade and HH spending remains sluggish
	• Caixin mfg PMI rose to 50.1 in Oct from 49.8; services PMI up to 52 from 50.3 in September • Exports rebound to 12.7%yoy in Oct from 2.4%; imports down to -2.3% from +0.3% in September	• CPI for October likely to stay weak at 0.4%, while PPI may narrow the deflation • October monthly output likely to stay at similar level from September, with potential improvement in retail sales
	• CB: Poland (5.75%) and Malaysia (3%) on hold, Peru (5%) and Czech Republic (4%) cut by 25bps, Brazil 50bp hike to 11.25% • Q3 GDP: Indonesia (4.95%yoy), Philippines (5.2%yoy) • IP (Sep): Mexico, Colombia	• CB: Mexico 25bp cut to 10.25% • CPI (Oct): Czech Republic, Hungary, Poland, India, Argentina, Chile, Colombia • Q3 GDP: Colombia, Hong Kong, Malaysia, Peru

Upcoming events	US:	Tue: NFIB small business optimism (Oct), SLOOS publication; Wed: CPI (Oct); Thu: PPI (Oct), Initial jobless claims (w/e 9 Nov); Fri: Retail sales (Oct), Empire state mfg survey (Nov), IP (Oct), Business inventories (Sep)
	Euro Area:	Tue: Ge HICP (Oct), Ge CPI (Oct), Ge ZEW surveys (Nov); Wed: Fr ILO unemp (Q3), Ez IP (Sep); Thu: Sp HICP (Oct), Ez GDP (Q3); Fri: Fr, It HICP (Oct)
	UK	Tue: Unemp (Sep), Avg earnings (Sep); RICS Housing survey, Fri: GDP (Q3, p), Business investment (Q3, p), Private consumption (Q3, p), Monthly GDP (Sep), Index of services (Sep), IP (Sep), Mfg output (Sep), Contruction output (Sep), Total trade balance (Sep)
	Japan:	Thu: GDP (Q3, p)
	China:	Fri: IP (Oct), Retail sales (Oct), Fixed asset investment (Oct)

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** As at the end of December 2023.

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