AXA Investment Managers

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Investment Institute Macroeconomics

Pain Ahead (for all)

- With the first wave of tariffs out, Donald Trump indicates he "means business." The impact on inflation will be visible, adding to the reasons why the Fed now wants to pause.
- The ECB will find more and more reasons to cut deep as credit standards tighten and credit demand erodes.

Those who had been hoping for a low "transformation rate" of Donald Trump's electoral platform into policies may have to revisit their opinion after this weekend's announcement of tariff hikes on Canada, Mexico, and China. True, the move on Chinese products was limited to 10%, and Europe has so far been spared, but we think this is just a first salvo, and the shock on US import prices will already be substantial. The message sent to all trade partners is that the US is ready to take some pain – the impact on US inflation is likely to be visible – to assert its dominance, and that no one, irrespective the tightness of the relationship with the US is, can consider themselves "safe" from US unilateral trade action. This will add to the Fed's reluctance to ease further, already obvious in Jay Powell's press conference last week before the tariff announcements, with ramifications for the long end of the curve. We do not think that rate cuts cannot materialise again without "Trumpnomics" going full circle, i.e. without a slowdown in GDP growth following the current "sugar rush," which would help absorb a re-acceleration in consumer prices which, after this weekend's announcement, is looking even more likely.

The ECB was largely on autopilot last week. Christine Lagarde did not have to deploy much creativity: the rate cut was telegraphed, and the change in forward guidance in December gave them cover to continue to bring their policy rate towards neutral. It is quite striking however that the market is now finding it absolutely normal that the ECB continues to ease while the Fed is pausing (likely for long). This is completely justified by the data divergence, but it is still interesting that the ECB has managed to assert its independence from its US counterpart without much market grumbling. We remain confident the ECB will break through neutral: if the ECB is already willing to go to neutral despite still officially believing in a recovery, then logically the continuation of the current stagnation – which we think is more plausible – should provide a strong reason to cut further. Moreover, we think the ECB will be increasingly spooked by the tightening in credit standards and erosion in credit demand, resulting in a descent in fully accommodative territory.

The opening salvo

Donald Trump acted on his threat and signed on Saturday an executive order levying a 25% tariff on goods imported from Canada and Mexico (with a carveout for Canadian energy, 29% of total Canadian exports to the US, at 10%), and 10% on Chinese products (see here for the White House's official factsheet). These three countries were in 2023 the source of 34% of total US imports, and **the shock on these three countries' products alone would lift the *average* US tariff by 6.4 percentage points** (if we assume no change to the products exemptions), **to compare with a shock of "only" 2 percentage points during the first trade war.** This is *very* significant.

The" choice of victims" for this first salvo in "trade war 2.0" is interesting. Donald Trump chose to place the greatest shock on two friendly countries, Canada, and Mexico, with which the US is linked by a free-trade arrangement, and whose production is tightly intertwined in US value chains, with therefore a significant feedback effect on the US economy. The shock on China is smaller – even if the 10% is added to already very high levels of customs duties since the first trade war, averaging 19% – and non-existent for now on Europe. The message this could send is threefold, in our opinion.

First, the magnitude of the hike – which incidentally kills the notion that the US could proceed by relatively small increments to mitigate the impact on their own industry, allowing some time to re-jig supply lines – signals to all the trade partners of the US that the US is ready to suffer relatively heavy domestic repercussions to achieve its goals of rebalancing its trade and assert its dominant economic status. In a nutshell, "Trump means business".

Second, going after the members of the USMCA – the version of North American Free Trade Agreement (NAFTA) which Donald Trump himself revamped during his first term – which was due for renewal in 2026 suggests that no one, irrespective of the tightness of political, economic or security links, should feel "safe": the US trade interests supersede any other foreign affairs' consideration.

Third, the relatively moderate move on Chinese products – initially the main trade adversary in Donald Trump's campaign rhetoric – may suggest that, as he expressed in Davos, **the US President really wants to reach a peace agreement on Ukraine and is counting on Chinese pressure on Russia to get there**. We however suspect that he will not hesitate to hit China harder if this manoeuvre fails. It is his leniency towards Europe – for the moment – that may seem most surprising. This however could simply reflect a consistency concern: the justification for this first round of tariffs is the Fentanyl traffic and immigration – this is clearly expressed in the White House's factsheet – and on these two aspects it is difficult to incriminate Europe. Given Donald Trump's insistence on how the EU has "mistreated" the US, any European relief is likely to be short-lived, in our opinion.

Now, beyond the political message we need to investigate the macroeconomic ramifications. We generally use the model developed by the Peterson Institute (the "McKibbin model") to quantify these issues – although we have some misgivings about some features of the model (notably how international flows of capital affect interest rates). With 25% customs duties on their exports to the US, Canadian GDP would be 1.3% lower than in the baseline after 2 years (see here). The shock would be of a comparable magnitude to Mexico in the short term, but would be more lasting, which we assume derives from the greater substitutability of Mexican products (New England cannot do without Hydro Quebec's electricity easily, even with a 10% tariff), which means that the shock could reach 2 points of GDP by the end of the decade.

We think these estimates are very conservative for three reasons. First, they cannot fully capture the negative effect that customs duties will have on foreign investment in Canada and Mexico as a "base" to serve American demand, which will magnify the overall dampening effect on domestic capital expenditure. Second, they do not consider the effects of internal "friction" on companies which for years have been considering the three North American countries as a single market and will have to reorganize. Third, Canada has already announced retaliation with 25% tariffs on 30%

of Canadian imports from the United States (therefore an effective shock of 7.5%) and Mexico has mentioned this possibility without being as detailed as Canada as we write. **These retaliations (not considered in the McKibbin model's scenario exploring a 25% tariff) will result in increased domestic inflation in these countries, which will further hamper the ability of monetary policy to limit the shock on demand.** True, a central bank should be able to look through such shock, especially if a contraction in demand makes it impossible for the relative import price shock to morph into an overall rise in the price level. Yet, with an already weakening currency, a full conversion to all-out accommodation may not be a palatable option to the Canadian and Mexican central banks, especially if this adds to the wrath of the US – accusations of currency manipulation could quickly justify additional trade tariffs. **Escaping recession for the two North American partners of the US will be difficult**. **Conversely, the impact on Chinese GDP of the 10% additional duties on the Chinese economy would be quite limited** (0.2 ppt of GDP after 2 years, including Chinese retaliation, according to the McKibbin model). Of course, this will not help at the current juncture, given the already difficult domestic situation, but this should remain manageable, as long as the 10% hike is not a mere introduction to a long salvo (a replication of the approach "in waves" during the first trade war).

The impact on the United States would be visible. The McKibbin's model estimates the effect of tariffs on Canadian and Mexican products on US GDP at 0.3% after 2 years without considering the effects of retaliatory measures. The impact of the additional 10% on China would be much more limited (a little less than 0.1% of US GDP after two years, therefore a 0.4-0.5% range could be expected in total. This is manageable given the current "acquired speed" of the US economy, but **the effect on US inflation would be significant: more than 0.5% additional inflation in 2025 already. In a context where the Fed is already worried about the resilience of inflation, this weekend's announcements are for me the "nails in the coffin" of the continued reduction in key rates in the US this year, with spillover effects on long-term rates.**

As far as overall market dynamics are concerned, last Saturday's announcements on tariffs may herald the end of the "good Trump trade". Since November, the market has generally taken a benevolent view of Trumpnomics 2.0, overweighting its positive aspects on American growth (deregulation in particular), and underweighting its negative aspects (increased inflation, budgetary drift). Even if Europe and partly China are spared for the moment, this weekend's announcements should lead investors to revise the polarity of their reading of US policies, unless they consider that Donald Trump could quickly reverse these tariffs, but at this stage we cannot see Canada and Mexico will be able to offer more, at least in the short term, to trigger such a turnaround in Washington. The good news of January was the decoupling of the US and European stock markets. The absence of tariffs on Europe at this stage could prolong this movement a little in the very short term, especially since European exporters to China should be partially relieved (Chinese demand should not be too badly affected), but again, we view this move on North America and China as only an "opening salvo".

Fed: resigned to a collision course

The Federal Reserve (Fed)'s press conference last week may now appear as their last take on the US economy "pre-tariffs," but we do not think the messages from Jay Powell are already obsolete. Quite the opposite: if it was already increasingly visible that the US central bank considered itself as "stopped out" *before* the announcement of the tariffs, then the chances of additional easing by the Fed have fallen to zero, at least until the toxicity of the new trade and – possibly – fiscal stance materialises into a deceleration in the real economy which will ultimately absorb the short-term additional inflationary push.

Arguably, Jay Powell did not have much to do last week: the Federal Open Market Committee (FOMC) had nicely prepared minds to a "deceleration in the pace of restriction removal" at the December meeting, with their new dot plot announcing a restrictive monetary policy stance until the end of the forecasting period: indeed, by the end of 2027, the "median forecaster" at the FOMC was then expecting Fed Funds to stand at 3.1%, still marginally higher than their upwardly revised estimate for the policy rate's "long-run level". Yet, the Fed **wanted to cross a few "Ts" and dot a few "Is" last week**. The changes to the statement were blunt, and hawkish: inflation is no longer "*making progress*" towards the Fed's target, while it is still qualified as "*somewhat elevated*". The unemployment rate is now "*stable at* *low level*" rather than "*moving up but remains low*". The latter is pure observation of the December employment report, but it is interesting that the Fed chose not to salute the better-than-expected core Consumer Price Index (CPI) print for the same month.

The FOMC is clearly in observation mode, and the pause could last long since, clearly, they are comfortable with the current state of affairs. Jay Powell stated it squarely: "*With our policy stance significantly less restrictive than it had been, and the economy remaining strong, we do not need to be in a hurry to adjust our policy stance".* Given the neutral balance of risks between more inflation and less growth, on the pure basis of the introductory statement, the Fed's next move could go either way. This is a strong posture.

The reaction by Donald Trump came quick and loud: the Fed's pause, coming less than a week after the US President reiterated in Davos his appetite for lower rates, was not welcome. **Now, we do not think this can have a tangible impact of the Fed's decision-making until Jay Powell's mandate ends next year.** We also note that the FOMC was unanimous on the decision to pause, which in itself is a strong signal. Jay Powell spent a great deal of time during the Q&A to dispel the impression the central bank is pre-empting the effect of yet still undetailed government policies, but we think this is just him picking his battles: there is no upside for Powell in engaging in a shouting match with the White House on fiscal, trade or labour policies, and he probably prefers to focus on preserving his institution's independence: the less he lashes out on Trump's policies, the easier it will be for him to defend the Fed's stance in the court of public opinion.

Exhibit 1 – market still pricing c. 2 rate cuts this year

Source: Bloomberg and AXA IM Macro Research, 31 January 2025

Given all this, **we are surprised that the market's expected trajectory for Fed Funds in 2025 has not changed more. As of Friday, close of business, forward contracts were still pricing nearly two 25bp cuts this year, one in Q2, the other in Q4.** We have already discussed the timing issue. For the Fed to resume "cautiously cutting", inflation would need to fall more decisively in the months ahead while the economy would soften. But conversely, the impact of Donald Trump's policy should first elicit more inflation pressure and only subsequently negatively affect growth. There will be two more Employment reports and CPI prints before the FOMC meets again in March, and it was still entirely possible before last weekend's announcements on tariffs that by then another deceleration in the price of services excluding rents – before the impact of Trumpnomics starts showing – could sway the Fed into consenting to "one last cut" for this year. This had been our baseline so far, but given Powell's words last week, and the announcement of the tariffs on Canada, Mexico, and China, we think the Fed is probably already "done". We would not be surprised if the forwards point to a lot less cuts when the market reopens this Monday.

Then, it is only when Trumpnomics have gone full circle – i.e. first triggering a temporary resumption in inflation and then an inflation-busting slowdown in economic activity – that cuts will resume. Our baseline is that it is unlikely to happen before 2026, which incidentally would coincide with the changing of the guards at the Fed, even if we cannot exclude that the negative feedback loop from the tariffs to the economy materialises faster.

The lower-than-expected US GDP print for Q4 may convince some observers that the FOMC is driving with the eye firmly on the rearview mirror and that removing restriction is getting more urgent. We would however note that, first, GDP growth in Q4 remained above the most widely accepted estimate of potential growth (2.3% versus 1.75%) and, second, that the change in inventories brought a very large negative contribution to GDP (-0.9% annualized). Inventories are a complicated beast. Inventory compression can suggest businesses are getting nervous about their demand prospects and prefer to service clients by drawing on existing stocks rather than by expanding production…but it can all the same reflect a positive surprise in current demand which planned production could not immediately meet. Besides, this is one of the most volatile components of GDP, and the next estimate of GDP could be quite different. In any case, the resilience in consumer spending continues – this was one of the best quarterly gains for private consumption since the post-pandemic reopening – and the savings' rate fell again. In the short run, it is the pressure exerted by consumption on supply which matters for inflation. This is precisely what could morph the one-off relative import price shock triggered by the tariffs into a long-lasting drift in overall the price level.

ECB: Rinse and Repeat

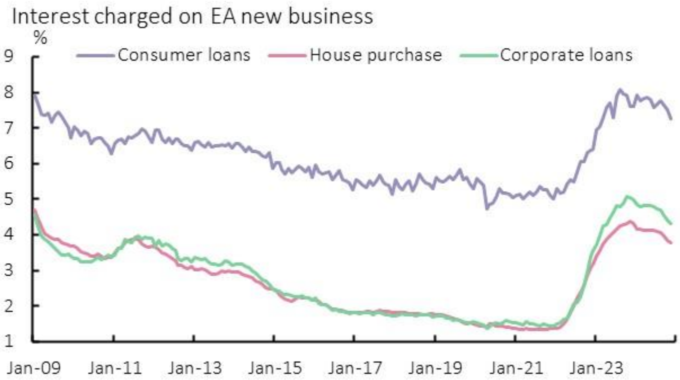
Just like the Fed, the European Central Bank (ECB) had said enough in December not to be forced in a major demonstration of creativity last week, but contrary to the Fed, the ECB chose to merely repeat what it had said at the previous meeting. Yet sometimes "boring is good": good deeds speak for themselves**. It may seem all natural and easy, but seeing the ECB cutting again, and almost explicitly promise more cuts ahead, the day after the Fed announced a potentially long pause should be quite an event in its own right!**

The deposit rate is now below 3% – the upper bound of the range for the neutral rate Isabel Schnabel was still talking about in early November – and Christine Lagarde made it plain that monetary conditions are still restrictive, which is the strong indication that the ECB will follow suite with another 25bp cut in March. By then, the upper bound of the range for the neutral rate the ECB President mentioned herself will be hit, at 2.50%. The conversation will then become more difficult: Christine Lagarde stated that the Governing Council had not yet decided whether stopping at the neutral rate would be enough. To make things even more complicated, she announced that the ECB would release new research with a new range for the neutral rate.

For our part, we continue to be confident the central bank will ultimately "cross the neutral rate" and bring the deposit rate to 1.5% by the end of this year. Maybe paradoxically, we find in the ECB's very willingness to contemplate the possibility of a recovery of the Euro area a strong reason to believe that a lot more accommodation will be needed. Indeed, the ECB's pronouncements last week on the current state of the Euro area sounded quite disconnected from the latest dataflow. We may be guilty of over-interpretation here, but **if the ECB is willing to go to neutral despite still officially believing in a recovery, then logically the continuation of the current stagnation or quasi stagnation – which we think is more plausible – should provide a strong reason to go below neutral.**

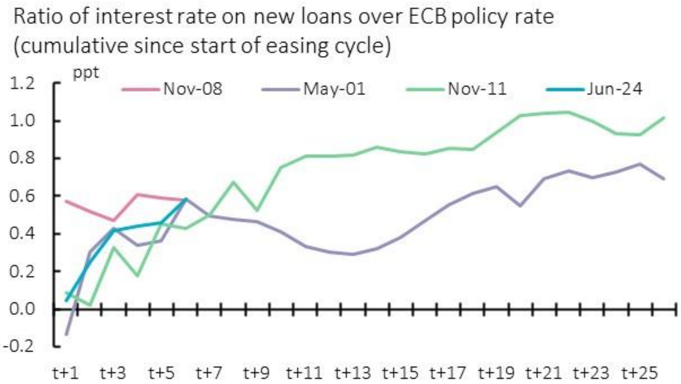
The ECB recognized that the decline in the savings rate, which was key to their rosy baseline for the Euro area's real economy in 2025, is not materialising, and this is impairing the necessary rebound in consumer spending. **But we would also pay attention to a criterion explicitly listed by the ECB in its decision-making framework: the quality of policy transmission**. Last Thursday, Christine Lagarde insisted on the fact that, responding to the ECB's restriction removal, interest rates on new loans to corporations and households have started to recede (see Exhibit 2), and we note that the transmission from the ECB's policy rates to actual lending rates has been following a perfectly usual pattern, with roughly 60% of the accommodation transmitted so far (see Exhibit 3).

Exhibit 2 – Lending rates falling



Source: European Central Bank and AXA IM Research, February 2025

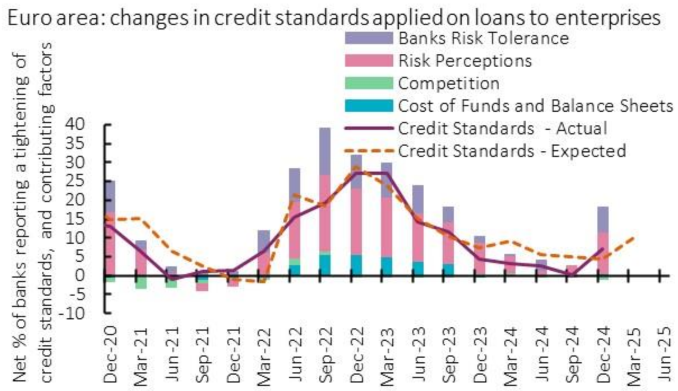
Exhibit 3 – Policy transmission looks OK on interest rates



Source: European Central Bank and AXA IM Research, February 2025

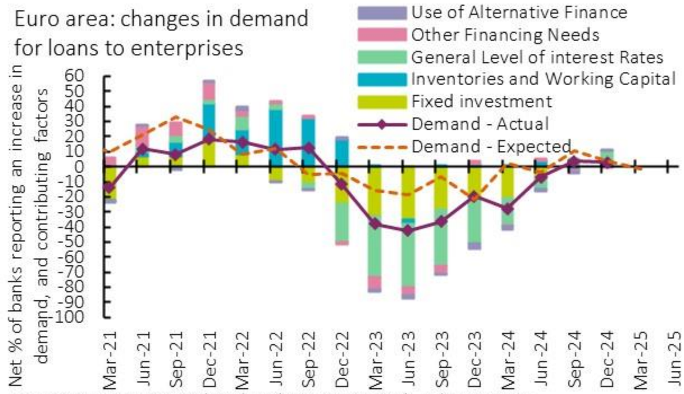
Yet, the price of loans may matter less than the actual availability of funds, and from this point of view the latest Bank Lending Survey sent a clear warning: credit standards are tightening again, as banks' perception of risk is deteriorating (see Exhibit 4). Demand for credit by the corporate sector is also softening (see Exhibit 5**). If the impulse of monetary policy to lending is faltering, despite the drop in lending rates, then mechanically more decisive policy easing is needed to achieve the right stance.**

Exhibit 4 – Lending standards tightening



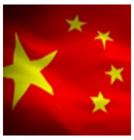
Source: European Central Bank and AXA IM Research, February 2025

Exhibit 5 – The end of the rebound in credit demand



Source: European Central Bank and AXA IM Research, February 2025

We are thus confident that the ECB will ultimately cut by more than what the market is currently expecting (we see 1.5% by the end of 2025, against 2% according to the forwards), and even more so if the Euro area is among the victims of the US's next round of tariff hikes.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• The US enacted 25% tariffs on Canada and Mexico and 10% on China, threatening major disruption • FOMC (Jan) left policy on hold. Powell stated "no hurry" for further cuts, we drop March cut view • GDP (Q4, p) rose 2.3%, softer than 2.8% expt'd, consumer +4.2%. GDP up 2.8% for 2024 as whole • PCE inflation (Dec) rose to 2.6% (2.4%), core 2.8% • Administration axed Federal grants only to rescind the order in the face of legal challenge	• Labour report (Jan) payrolls expt'd +150k from post-hurricane 256k in Dec. Unemp rate to fall to 4% with weak supply. But revisions could see material shift • JOLTS (Dec) vacancies climbed since Sept low, expected to remain around 8m • ISM indices (Jan) mfg to maintain firmer tone; services watched for storm/fire impact as in PMI • Vehicle sales (Jan) Q4 sales key part of Q4 consumer strength underpinning solid, see if maintained
	• The ECB cut its DFR by 25bps to 2.75% for a fourth consecutive time. A similar move in March is very likely • Euro area GDP stagnated in Q4, owing to disappointing Germany, France and Italy outturn • EC survey point to moderate growth momentum at best	• We project euro area headline and core inflation at 2.4% (unch.) and 2.6% (-0.1ppt) in January • Final PMIs for January • ECB to publish wage trackers (5 Feb)
	• BoE consumer credit (Dec) rose to £1.0bn, from £0.9bn; still weak by recent standards • Mortgage approvals (Dec) ticked up to 66.5K, from 66.0K • Nationwide house prices (Jan) +0.1%mom, annual rate slowed to 4.1%, still rising before April Stamp Duty change	• BoE rate decision & MPR (Feb) we see a 25bp cut to 4.50%, with the vote split (0-1-8). MPR to spell disinflationary expectations beyond 2025 • Final PMIs (Jan) no reason to expect a material change from the flash estimate • Car sales (Jan) still set to remain subdued by past standards
	• Leading economic indicator (Nov) edged down to 107.5, from 109.1 • Cons conf (Jan) fell to 35.2, from 36.2 • Tokyo CPI (Jan) rose to 3.4%; but ex fresh-food and energy edged up to 1.9%, from 1.8% • Retail sales (Dec) -0.7% after strong 1.9% in Nov.	• Final PMIs (Jan) no reason to expect a material change from the flash estimate • Cash earnings (Dec) look for further evidence of impact from higher wage settlements • Household spending (Dec) look for signs of weakness as inflation remains elevated
	• Industrial profit declined 3.3% in 2024, the third year of contraction • NBS mfg PMI dropped to 49.1 in Jan from 50.1, driven by weaker exports orders • NBS non-mfg down to 50.2 in Jan from 52.2	• Caixin mfg and services PMI (Jan), likely to edge down • CPI and PPI (Jan), maybe distorted due to holiday celebration
	• CB: Hungary (6.5%) and Chile (5%) on hold, Brazil 100bp hike to 13.25% • GDP (Q4 yoy): Czech Republic (1.6%), Hungary (0.4%), Mexico (1.1%), Philippines (5.2%) • Industrial production (Dec yoy): Thailand (-2.1%)	• CB: 25bp cuts in Czech Republic (to 3.75%), Mexico (to 9.75%) and India (to 6.25%), Poland on hold (5.75%) • GDP (Q4): Indonesia • CPI (Jan): Chile, Colombia, Mexico, Indonesia, Philippines, Thailand, South Korea, Turkey • Industrial production (Dec): Brazil, Hungary, South Korea

Upcoming events		
	US:	Mon: S&P global mfg PMI (Jan), ISM mfg PMI (Jan), ISM mfg emp (Jan); Tue: JOLTS (Dec), Factory orders (Dec); Wed: Trade balance (Dec), S&P global composite & services PMI (Jan), ISM Services PMI (Jan); Thu: Initial jobless claims (Feb/01), Nonfarm productivity (Q4, p), Unit labour costs (Q4, p); Fri: Non-farm payrolls (Jan), Unemp (Jan), Avg earnings (Jan), Michigan consumer sentiment (Feb, p)
	Euro Area:	Mon: Sp Unemp (Jan), Sp, It, Fr, Ge & Ez HCOB mfg PMI, Ez & It inflation (Jan, p); Wed: Fr IP (Dec), Sp, It, Fr, Ge, Ez HCOB services PMI (Jan), It, Ge, Ez composite PMI (Jan), It Retail sales (Dec); Thu: Ge factory orders (Dec), Ez Retail sales (Dec); Fri: Ge, Fr trade balance (Dec), Ge IP (Dec)
	UK:	Mon: S&P global mfg PMI (Jan); Wed: S&P global services PMI (Jan); Thu: BoE interest rate decision; Fri: Halifax house price index (Jan)
	Japan:	Mon: Jibun Bank mfg PMI (Jan); Wed: Jibun Bank services PMI (Jan); Thu: Household spending (Dec)
	China:	Mon: Caixin mfg PMI (Jan); Wed: Caixin services PMI (Jan); Sun: Inflation (Jan), PPI (Jan)

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