AXA Investment Managers

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Investment Institute Macroeconomics

Under Surveillance

- US core inflation is rebounding, and consumers are noticing – even those who lean Republicans.
- This should dampen enthusiasm for trade war, but for now the White House seems to be "doubling down".
- We look at potential outcomes of the German elections, with a focus on the ramifications for Europe.

US core inflation rose above expectations in January. Some residual seasonality may be at play, but the US has been experiencing a rebound in underlying price pressure since the end of last summer. Consumers are noticing: the upward shift in households' inflation expectations in the University of Michigan survey is striking. Political inclinations play a major role in how US consumers perceive the economy, but we find it interesting that confidence today is lower than at the beginning of D. Trump's first term even among Republicans. This would indicate that, even if political polls remain favourable to the President, the new administration is already "under surveillance". While this should call for more prudence on tariffs, the White House seems to be doubling down, with this notion of "reciprocal tariffs". We note however that the Department of Commerce has 6 months to evaluate such policy. This provides some space for de-escalation, even if uncertainty alone is probably already weighing on firms' decisions.

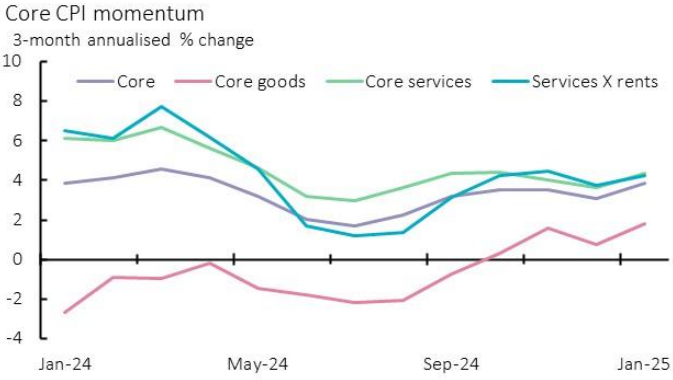
We take stock of the additional threats to globalization. The "clubification" of the world economy across clusters of countries sharing similar values or security concerns, with a few "connectors" linking those clubs, looked like a degraded but still workable version of the "world economic order". Yet, even these clubs are now proving unstable and connector countries may suffer from stricter rules of origin. It is however possible that a hybrid model emerges, with a loose alliance of countries still complying with the old multilateral rules co-existing with the rival blocks.

Blanchard and Pisani-Ferry call on the EU to take the lead of this alliance. Yet, the EU must first prove its internal solidity. The elections in Germany on 23 February will be a key test. The outcome remains uncertain, and we provide some illustrative scenarios. We remain doubtful that Berlin will be willing to take the EU to a deeper state of integration after the elections, while coalition negotiations will likely generate a transitory political vacuum at a time when Europe is for now excluded from peace talks on Ukraine which can have serious ramifications for its future.

Inflation is up, and Americans are noticing

We regularly write in Macrocast against falling prey to confirmation bias, and it is with this risk in mind that we looked at the US inflation print for January released last week. Given our strongly held view that the Federal Reserve (Fed) is "done", because inflationary pressure remains too high even before any impact from Trumpnomics, there was a strong temptation to run a victory lap when core US Consumer Price Index (CPI) unexpectedly rose by 0.4% mom – consensus was at 0.3% – accelerating from 0.2% in December. There are caveats though: there could be some "residual seasonality" in the early months of the year. At the beginning of 2024, a series of strong consumer prints convinced the Fed to delay the beginning of its cuts, before a deceleration came in the spring. We would not want to "cry wolf". Yet, when looking at the 3-month momentum, what in our view is striking **is the rebound in core CPI *since the end of last summer* which is fuelled by a broad array of components,** including services excluding rents on which the Fed usually focuses (see Exhibit 1). This started before the potentially seasonal re-acceleration kicked in. The January print only confirms it. Moreover, a quick look at the Cleveland Fed's Trimmed Mean alternative measure of core inflation (by stripping from the calculation the components with the most extreme changes) suggests that idiosyncratic developments in some obscure corners of the consumer basket cannot be blamed for the shift upward (the "trimmed mean" index also rose by 0.4%mom in January).

Exhibit 1 – Core inflation still too high



Source: Bureau of Labor Statistics and AXA IM Research, February 2025

Exhibit 2 – Consumers are starting to notice

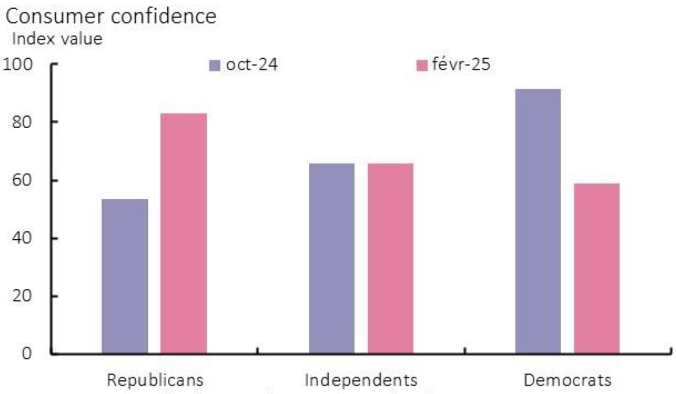
Source: University of Michigan and AXA IM Research, February 2025

Now, when assessing the dataflow, a good practice is to check if a "common message" is emerging from various sources. If the rebound in core CPI was an isolated phenomenon, we could choose to ignore it. But this is blatantly not the case. We reviewed last week the January Employment Report: when looking at job creation on a 3-month annualised basis, the profile is eerily resemblant of core inflation's: after hitting a trough last summer, a re-acceleration has been on course since the early autumn, only to gain even further momentum this winter. Wage growth continues to be strong and, with productivity gains edging back to 1% – probably for purely cyclical reasons – the pace of unit labour costs is no longer consistent with a convergence of services inflation back to 2%.

A concerning development is that consumers are taking notice. The University of Michigan survey for February came out with a shocker: US households believe inflation next year will hit 4.3%, one full percentage point higher than in January and its highest level since November 2023. Now, it can be a quite volatile series (see Exhibit 2), but interestingly, their long-term inflation expectations are also rising, reaching 3.3% in February, a pace they had not reached even at the peak of the peak of the post-pandemic inflation shock. As any economist trained in the 1980s – yes, your humble servant is *that* old – we would worry quite a lot if persistent signs of de-anchoring of inflation expectations were to materialise, given the risks of self-perpetuating wage/price loop. True, over the last few decades the academic consensus has moved away from such focus on expectations, but **the combination of higher expected inflation *and* a robust job market should raise the alarm at the Fed,** where quite a lot of people, after all, were also trained in the 1980s.

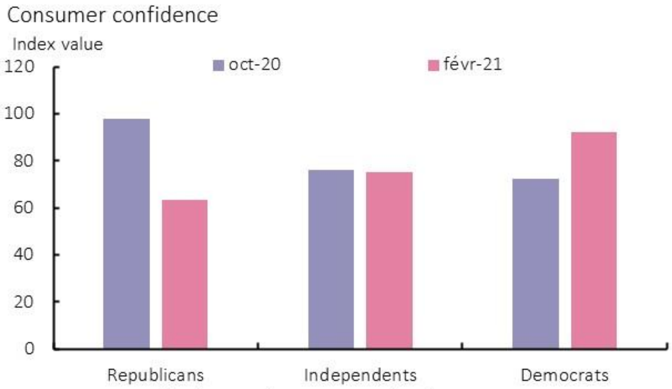
But beyond the consequences for monetary policy setting, **the latest slew of concerning data on the inflation front is also relevant to Donald Trump's policy platform**. If the persistent inflation of early 2025 cannot of course be blamed on him, consumers' sensitivity to this matter could force the new US administration to be more circumspect on key aspects of its agenda. Inflation expectations shooting up may be a pure extrapolation from the price developments which consumers observe, but we suspect that the warnings from many commentators – and the Democratic party, despite its current predicament – on the potentially inflationary effects of Trumpnomics may also play a role.

Exhibit 3 – Seeing the economy through political lenses



Source: University of Michigan and AXA IM Research, February 2025

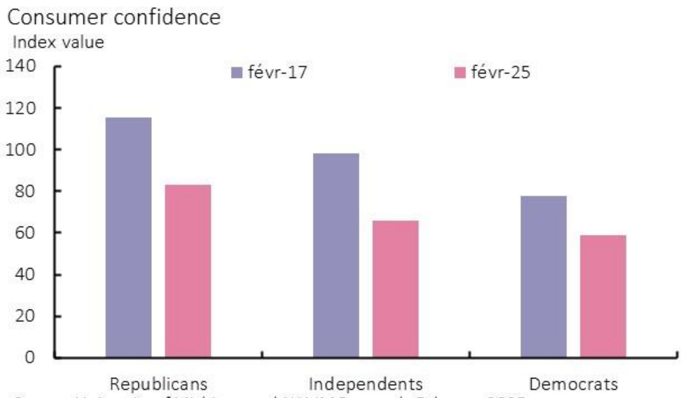
Exhibit 4 – A symmetric move



Source: University of Michigan and AXA IM Research, February 2025

Political polls have been kind to Donald Trump in the first weeks of his second presidency, but consumers' economic sentiment may be more useful to gauge the "risk appetite" of the Republicans who will increasingly be focused on how to maintain their razor-thin majority in the House in 2026. At face value, we are still in full "reverse causality" mode, where political preferences dominate economic perceptions. The Michigan index provides a breakdown in consumer sentiment by political leaning. The symmetric moves since before the elections are striking. Republicans dramatically revised up their assessment of the economic situation, while Democrats revised it down. Independent consumers' confidence barely moved (see Exhibit 3). Such polarisation is not new: the exact opposite had happened in late 2020/early 2021 when Joe Biden was elected (see Exhibit 4). Yet, beyond these "knee-jerk" reactions, what we find interesting is that **the *absolute* level of consumer confidence is significantly lower today across *all* political leanings than one month after Donald Trump's first accession to the Presidency** (see Exhibit 5). Moreover, the index has receded in February to 67.3 from 69.3 in January, now visibly down from a recent peak in November 2024 at 76.9. **Trumpnomics may already be "under surveillance"**.

Exhibit 5 – Even Republicans are less enthusiastic than in 2017



Source: University of Michigan and AXA IM Research, February 2025

The resilience in inflation – and consumers' noticing – could have two short-term effects. First, it will further fuel tension on the long end of the US yield curve. Last week, the strong Employment Report brought 10-year up by nearly 10 basis points (bps). The inflation print brought another 10bps. A mediocre print for retail sales, coming out at the very end of last week – which we think is essentially the product of mean reversion rather than the harbinger of something more sinister – brought yields slightly down again, but they are still markedly higher than in the Congressional Budget Office (CBO)'s baseline. This will continue to make the US fiscal equation more difficult, as we explored last week, with potential ramifications for what could become a thorny budgetary discussion within the Republican congressional caucus.

Second, **the realisation that inflation is proving stickier than hoped – and that households are noticing – should in principle make trade tariffs even less palatable. Yet, it seems that on this matter the White House is "doubling down" with the announcement of "reciprocal tariffs".** The idea – which was laid out in details in the Heritage Foundation blueprint for a Republican administration last year – is that products imported in the US should be subject to the same level of tariff which would hit US products entering the country of origin. This would be very material for India for instance, which still maintains high tariffs (18% on average according to the World Trade Organization, against 3.4% for the US). At face value, the European Union (EU) would be in a favourable position, since its average tariff of 5% is not so much higher than in the US, and since the EU exempts more US products from tariffs than the US exempts European products. However, the White House factsheet on the executive order makes it plain that the Treasury, when establishing the right "reciprocal duties" on the EU will have to look beyond tariffs per se but also take on board the value added tax (21.8% for the standard rate), which has therefore the potential to result in a massive shock on European competitiveness.

Now, the White House's factsheet makes it quite transparent that tariff threats are also there for leverage (the document explicitly recognizes the concessions offered by Canada and Mexico after the first tariff salvo), **and for now the only thing the White House's decision does it to mandate the Secretary of commerce to evaluate such policy *"within 180 days*"** (see the full text in the link here)**.** So, once again, it is next to impossible to know at this stage how far the US will take this in practice. It cannot be excluded that, should the focus on inflation gain in prominence in public opinion within those 6 months, these aspects of Donald Trump's platform would be quietly "de-prioritized". We would however argue that, irrespective of the final decision, **there will be a macroeconomic price to pay simply because of the uncertainty it creates**, with the usual adverse effects on investment.

Club membership not mandatory

While we wait to see whether and how far Donald Trump's threats will materialise, we think **we can take a step back and reflect on the current shape of what used to be called the world's economic order**. We have just produced a short op-ed for the World Economic Forum (see link here) on this very subject. Our story starts from the fragmentation of the world economy in mutually hostile blocks, replacing the omni-directional globalisation which started in the 1990s. This is not necessarily conducive to a contraction in cross-border trade. Rather than repatriating production capacity to the territories where the output is consumed, global companies could merely re-organise their supply-lines around "clubs" of countries which share similar values or security concerns. On top of these "clubs" and ensuring the continuation of some omni-directional trade "by stealth", the International Monetary Fund (IMF) popularized the notion of "connector countries" (e.g. Mexico, Vietnam), non-aligned players whose production centres would maintain links across the clubs. A degraded version of unfettered globalisation, but still a workable one. As long as the clubs would still offer a variety of development levels, unifying territories with low labour costs to countries with high spending capacity, the adverse consequences of fragmentation in terms of inflation and efficiency could be mitigated.

But **even this degraded version of globalisation is under threat**. "Connector countries" can easily be portrayed as "Trojan horses" allowing geopolitical rivals to still gain access to markets. Tighter rules of origin were a key win by the US administration during the negotiation of the USMCA agreement under Donald Trump's first term, to hamper the capacity of China to merely displace its production to Mexico to benefit from preferential access to the US market, and we suspect this will come back in the renegotiation of the Treaty, with leverage from US tariffs against Canada and Mexico. In a similar fashion, while a free-trade agreement between the US and the EU has always been considered as unrealistic, at least these two territories, unified by strong political and military links, offered stable trading conditions, with relatively low and crucially predictable bilateral tariffs. As we discussed in the previous section, this could change drastically. The "global North" is not the only block under internal pressure. The "global south" is also divided. While the BRICS are attempting to institutionalise their cooperation, old geopolitical and economic rivalries are getting in the way. The fraught relationship between China and India provides a good example. Beyond geopolitics, the temptation for India to present itself as a "China substitute" to the rest of the world is now irresistible. Besides, just like mature economies, some emerging countries are tempted to raise tariffs on Chinese products to protect their industry (e.g. Indonesia).

In a nutshell, this means that **global companies, when setting up their supply and distribution lines, cannot count of much stability from the "clubs" which looked absolutely solid and obvious just a few years ago**. Full-on fragmentation, with the uncertainty that it creates, is now a real risk, with adverse consequences in terms of global price levels and efficiency.

We would however argue that a hybrid model is also conceivable: **besides the two antagonistic "unstable clubs", one centred on the US, the other on China, a more traditional loose alliance of countries, still organised around the multilateral framework of the "old" globalisation, could survive**. We could find signs of this in the recent agreements concluded between the EU and the Mercosur, or the rapprochement between post-Brexit UK and the EU. This loose alliance and the two "clubs" would not be mutually exclusive: for instance, Canada and Mexico would remain in the US-dominated club but could at the same time pursue a tightening of their economic links with the EU and Mercosur. Such hybrid model would be more palatable than all-out fragmentation, even if to navigate it would require a lot of agility from global companies. Oliver Blanchard and Jean Pisani-Ferry are calling on the EU to take the lead of such "coalition of the willing" in a paper for the Peterson Institute (see link here).

Germany looking inward

Blanchard and Pisani-Ferry make the point that, to take such leadership, Europe would first need to overcome its own internal conflicts. In our view, it is less the EU institutional setup than the readiness and capacity to act in key member states which is at the heart of the current marginalisation of Europe. From this point of view, **the German elections on 23 February are likely to be an important test of the EU's capacity for revival.**

Exhibit 6 – Illustrating uncertainty

Germany election polls				
	Latest polls 04 Feb	Simulation A	Simulation B	Simulation C
	% of votes	% of seats in the Bundestag		
SPD	17	19.4	18.4	17.5
CDU/CSU	30	34.2	32.4	30.9
Greens	13	14.8	14.0	13.4
FDP	4	0.0	5.1	4.8
AfD	22	25.1	23.8	22.7
Die Linke	5	0.0	0.0	4.8
BSW	6	6.8	6.5	6.2
Independent	-	-	-	-

Source: Politico polls of polls and AXA IM Research, February 2025

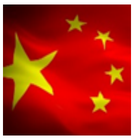
Our colleague Francois Cabau has just published a very thorough note on the elections (see link here).We stole from his work Exhibit 6 here, which presents three simulations for the possible outcomes for the distribution of seats in the Bundestag based on the same voting intentions in the polls. Indeed, three parties – the centre-right FDP, and the two movements of the hard left, Die Linke and the Sahra Wagenknecht Alliance (BSW) – the latter having however moved to the right on immigration issues – are all close to the 5% threshold below which they could not enter the Bundestag (unless they win 3 seats in the direct constituency votes). There is a myriad of potential scenarios, but we have come up with three illustrative outcomes. In scenario A, where among the three small parties only BSW makes it to 5%, a two-party alliance between CDU and SPD could suffice to provide a coalition with a parliamentary majority, while the populist parties would be unable to reach the 33% of the seats they would need to block any constitutional reform, e.g. the removal or alteration of the "debt brake" which caps the fiscal deficit to 0.35% of potential GDP. In scenario B, where both FDP and BSW make it to parliament, a "simple" SPD-CDU alliance might still command a majority, but FDP – traditionally hawkish on fiscal issues – could side with the populist parties to sink a reform of the debt brake. In scenario C, all three small parties make it to the Bundestag. Then, the alliance of the mainstream parties would probably need to extend to the Greens or the FDP, which could prove quite dilutive in terms of policy decisions, while a blocking minority would have ample space to stop any constitutional reform.

What really matters is to find a decisive enough policy package which could revive the fortunes of the EU's biggest economy. **The parties likely to enter coalition talks will all come to them from a spendthrift starting point, which in our opinion makes it likely that some agreement on a reform of the debt brake will emerge** – without necessarily having the parliamentary majority to make it happen. Yet, a thorny discussion on the budgetary priorities which would benefit from such an extension of the country's fiscal space would be unavoidable. While during the campaign CDU leader Friedrich Merz expressed some openness to relaxing the debt brake to fund investment, cutting tax – especially corporate tax, but also income tax by abolishing the "solidarity surcharge" and raising the threshold of the highest bracket – is the gist of his party's manifesto. The two centre-left parties also favour some tax cuts, but in favour of those at the low end of the income ladder and/or to accelerate the economy's decarbonation.

Besides, **some of the key macroeconomic challenges facing the German economy are barely discussed, and if they were would probably prove toxic to the stability of the future coalition**. High energy costs, and the absence of a clear energy policy contribute to the current predicament of Germany. Yet, on this issue, the gap between Merz – who floated the idea of prolonging the lifespan of the remaining nuclear plants – and the centre-left is wide. The position of the future German government on international trade – e.g. on the response to the US protectionist push, or the attitude towards China – is also difficult to predict from the current debates.

A key issue for us is that the electoral campaign in Germany has largely "looked inward", with a focus on domestic matters which did not leave much space to European projects. Our hunch is that if some easing of the *national* policy stance can be expected after the elections, Berlin is unlikely to push for the extension of the big European programmes – a Next Generation EU 2.0 for instance. The fact that Next Gen funds have not yet been fully spent plays of course a role, while it may already prove so difficult to overcome a reluctance of a big part of German public to part with fiscal frugality at the national level that any attempt to load German taxpayers with more guarantees to joint EU issuance would be judged as unsellable. But **we also suspect that a difficulty in setting up more European programmes also lies in strategic disagreements across member states**. Defining a clear, common energy strategy across the EU is not straightforward, and the same probably holds for common defence projects, with differences for instance on which share of joint military spending should go to European producers and which to US contractors, the latter seen as a way to placate Donald Trump.

Coalition talks could last long before a full-fledged federal government is up and running in Berlin. This will create a de factor power vacuum at a time when Europe needs to get its voice heard on the peace talks on Ukraine. The European equity market has reacted positively to the start of talks between the US and Russia. This probably reflects a belief that European firms will benefit from Ukraine's reconstruction, while the European economy could access relatively cheap Russian gas again. While we acknowledge that a removal of sanctions on Russian exports would likely be a key demand from Moscow in any peace talk, it is not obvious to us whether the Europeans *collectively* would want to subject themselves again to energy dependence from Russia, even if the Financial Times last week reported such temptation among some member states. We also note that Washington has been explicit in its demand for more American Liquefied Natural Gas (LNG) imports from the EU as part of any trade negotiations. Down the road, the test the European project will go through on the occasion of these peace negotiations – from which the EU has so far been excluded – is whether the concept of "strategic sovereignty" will become consensus, with necessary ramifications in terms of joint defence projects, as a response to both a persistent Russian threat and the perspective of an American disengagement from Europe (a point made explicitly by US representatives at the Munich Security Conference last week).

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Latest version of tariffs: reciprocal, based on other countries tariff and non-tariff barriers • Trump conversation with Putin over Ukraine • CPI inflation (Jan) rose to 7m high of 3%, core 3.3%, services rise may reflect seasonality issues • PPI inflation (Jan) firmer, but PCE relevant components assuaged market CPI concerns • Retail sales (Jan) -0.9%, possible snowstorm hit	• FOMC minutes (Jan) to determine range of views around "no hurry" for further cuts • Further developments in US policy towards Ukraine peace resolution • PMIs (Feb, p) mfg improving trend and close to 2yr highs, svc fell in Jan – temporary snowstorm impact? • Empire and Philadelphia Fed surveys (Feb) first estimates for Feb, but wildly divergent trends
	• Euro area industrial production fell by 1.1%mom in December, leaving Q1 25 carry over at -0.6% • Euro area Q4 24 GDP was revised up +0.1pp to 0.1%qoq. Employment grew by a similar amount, leaving labour productivity growth close to zero • EC President to allow member states to invoke escape clause to fiscal rules to increase defence spending	• Business and consumer surveys for February (INSEE, PMIs) • Final HICPs giving full extent of weights update • Follow-up comments post security conference in Munich
	• GDP (Q4, p) rose 0.1% above estimate, but driven by govt and inventories. Watch revisions • BRC Retail Sales Monitor (Jan) showed sales were up 2.5%yoy • RICS hse price index (Jan) fell to 22% (26%), fwd indicators much weaker ahead of Apr's tax chg	• Labour market (Dec/Jan) look for further softening • CPI inflation (Jan) headline to tick up to 2.6%, services to rebound • Retail sales (Jan) look for partial rebound • GfK cons. conf. (Feb) look for further weakness • Flash PMIs (Feb) look for signs of weakness
	• Current account (Dec) narrowed to ¥1bn • Eco Watchers Survey (Jan) outlook fell to 48.0, from 49.4 • PPI inflation (Jan) quickened to 4.2%yoy (from 3.9%)	• GDP (Q4) to rise by around 0.4%qoq • Exports (Jan) look for impact from yen fluctuations • CPI inflation (Jan) look for pick up in ex. energy and food to 2.6%, from 2.4 • Flash PMIs (Feb) look for signs of weakness in manu.
	• CPI edged up to 0.5%yoy, 0.7%mom on seasonality (Dec: 0.1%; 0%). PPI unchanged at -2.3%yoy • New loan rose to RMB 5.13tn; and total social financing up to RMB 7.06tn in Jan due to LNY, from RMB 0.99tn and RMB 2.86tn in Dec.	• House prices in Jan likely to show some further stabilisation in tier-one cites, but key to watch the development in lower-tier cities
	• CB: Philippines (5.75%), Peru (4.75%) and Romania (6.5%) on hold • GDP (Q4 yoy): Malaysia (5.0%), Poland (3.2%), Romania (0.7%) • CPI (Jan yoy): Brazil (4.6%), Czech Republic (2.8%), Hungary (5.5%), India (4.3%), Poland (5.3%), Romania (5.0%), Taiwan (2.7%) • Industrial production (Dec yoy): India (3.2%), Mexico (-2.7%), Romania (-3.4%), Turkey (8.0%)	• CB: Indonesia on hold at 5.75% • GDP (Q4): Colombia, Mexico, Thailand • CPI (Jan): Malaysia • Industrial production (Jan): Poland

Upcoming events		
	US:	Tue: Empire state mfg survey (Feb), NAHB housing market index (Feb), Long term investment flows (Dec); Wed: Housing starts (Jan), Jan FOMC meeting minutes publication; Thu: Philadelphia Fed Index (Feb), Initial jobless claims (w/e 15 Feb); Fri: Mfg, Svc and composite PMI (Feb, p), Michigan consumer sentiment and inflation expectations (Feb)
	Euro Area:	Tue: Fr HICP (Jan), Ge ZEW survey (Feb); Thu: Ge PPI, Ez consumer confidence (Feb, p); Fri: Fr Insee mfg confidence (Feb), Fr, Ge, Ez mfg and svc PMI (Feb, p), Ez composite PMI (Feb, p), It HICP (Jan)
	UK:	Wed: CPI (Jan), CPIH (Jan), RPI (Jan), PPI (Jan); Fri: PSNB ex-banking groups (Jan), GfK consumer confidence (Feb), Retail sales (Jan), Composite, mfg, svc PMI (Feb, p)
	Japan:	Tue: Private 'core' machinery orders (Dec); Thu: CPI (Jan); Fri: Mfg PMI (Feb, p)
	China:	Thu: Loan Prime rate

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