Guns, Butter and Interest Rates

- ECB to cut again this week. We think easing will continue despite the hawks.
- Scaling up European defence spending is becoming even more pressing. Fiscal constraints are however daunting for many member states – we explore the French case. This calls for joint funding of the military effort.
- The macro mood is souring in the US. There's a difficult fiscal conversation brewing over there as well.

The ECB is meeting this week under inauspicious stars, amid domestic softness and sustained uncertainty over the trade relationship with the US. Another 25-bp cut is the widely expected outcome, but the conversation in the Governing Council is getting more difficult as the "neutral rate" range is now within sight. We continue to think that the balance of risks is now so blatantly skewed to the downside that the ECB will have to "cross neutral" and bring its policy rate to 1.5% by year end, but the central bank's forward guidance may become even softer.

With the risks of a US military withdrawal from Europe rising quickly, the EU must scale up defence spending. This will at the very least reduce the quantum of fiscal tightening which could have been expected, since there are limits to how much of that extra spending could be funded by spending cuts elsewhere or tax hikes given the populist push which many governments are facing. In principle, this should make the ECB more cautious in providing monetary accommodation, but the expectation of more defence spending is putting a floor to how low long-term interest rates could go. We think the central bank will have to take on board the net tightening in overall financial conditions when calibrating its policy stance, especially since the ongoing Quantitative Tightening is another source of "yield resilience". Yet, even with an "understanding" ECB, some member states are hitting limits to their fiscal space. This is another reason for us to think that joint funding of Europe's military effort is necessary.

While the US is a major source of disruption for Europe, domestic conditions over there could be souring faster than we thought. Consumer confidence is deteriorating, across almost all components: Americans are getting nervous about inflation, their job prospects and the financial market. The House's budget resolution was a breakthrough for the Republicans last week, but we note that it would not cover all of D. Trump's campaign pledges. A complicated fiscal conversation is looming in Washington DC as well.

Under Pressure

The European Central Bank (ECB) meets this week as Europe finds itself under massive external pressure. In the short term, while the market is increasingly taking the pronouncements from the White House on tariffs with a pinch of salt, the threat of a serious hike in custom duties on European products cannot be ignored. At least, while last year the Governing Council sounded quite torn on the impact US protectionism would have on prices – the prospects of a further disorganisation of supply lines were often mentioned as adding upside risks to European inflation – **a consensus has now seemingly emerged around the idea that US tariffs on imports from Europe would further slow down the Euro area economy and thus reduce rather than raise Euro area inflation**.

Exports of goods to the US stood last year at 3.1% of the Euro area GDP. Assuming a unitary reaction of volumes to tariffs (to be clearer a 1% increase in tariffs cuts the volume of imports by 1%), which is not far-fetched when looking at how Chinese exports to the US reacted during the first trade war, **customs duties at 25% as per Donald Trump's very latest statements concerning the European Union (EU) would mechanically reduce Euro area GDP by 0.8%, before second-round effects** via investment and employment. The old "rule thumb" for the sacrifice ratio (the relationship between the decline in GDP and lower inflation, usually seen at around 1, a figure recently supported by Bundesbank Research, see link here), would point to **a reduction in inflation of about 0.8% as well**.

Of course, the calculation changes for the central bank if one takes on board retaliation from the EU on American products imported into Europe. Yet, imports of goods from the US are comparatively small (2.0% of the Euro area GDP last year). In addition, given Europe's already shaky demand conditions, we would assume that a significant share of any EU tariff hike would be absorbed by margins. All in all, we think it would be difficult for even a 25% retaliatory tariff on *all* US products to bring about a significant *net* uptick in European inflation given the magnitude of the adverse shock on growth from the US strike. Finally, we would expect the Commission to opt for "smart" retaliatory measures, focusing on products which would inflict maximum pain to US exporters while minimising the inflationary impact for domestic consumers, rather than a blind "tit for tat" approach. For instance, we do not think the EU would levy tariffs on imports of Liquefied Natural Gas (LNG) from the US. This would be counter-productive domestically, especially if Europeans want to continue weaning themselves off Russian gas, without having any effect on US producers given the current overall pressure on LNG production capacity. In any case, while no calibration of the monetary policy response is doable before details emerge on the magnitude of potential tariffs on European products, at the very least **the mere threat should tilt the balance of risks to growth to the downside in the ECB's assessment, as uncertainty is probably already having an impact on investment and hiring decisions by European businesses.**

Beyond these short-term challenges, **the ECB cannot ignore longer-term issues brought about by the new geopolitical configuration**. Scaling up defence spending is now obvious for all member states and will probably run counter to any significant fiscal tightening in the Euro area for the foreseeable future. While *some* of the defence effort might be offset by cuts in other areas (see for instance the decision by the UK to slash development aid to make space for an upward revision military spending), given the political incentives for governments to keep populists at bay, a net tightening in fiscal policy will be increasingly difficult to maintain. At first glance, this should make the ECB more cautious about cutting rates beyond "neutral". Yet, if the market reacts to this delay in fiscal consolidation by pushing long-term rates higher, then the ECB should take the whole picture on board and incorporate the tightening in financial conditions in its reaction function. In addition, as ECB board member Piero Cipollone stated two weeks ago, *"to strike the right balance, we should ensure that our rate decisions adequately compensate for the tightening induced by the reduction of our balance sheet"*. Quantitative Tightening blunts the impact of the ECB rate cuts. The resilience of Bund yields at around 2.4%, despite two years in a row of mild recession in Germany, should raise concerns.

In practice **for this Thursday, just like everyone else we expect a fifth consecutive 25-bp cut to 2.5% for the deposit rate**. **The difficulty will lie in how the Governing Council handles its soft forward guidance**, since the central bank is moving closer to the upper end of the range for the "neutral rate". Isabel Schnabel made the point that, given the measurement uncertainty, she *"cannot be sure"* monetary policy is still in restrictive territory and wants a discussion on where to stop. Yet, Bundesbank President Nagel was more open: he played up the recent good news on the consumer prices front and affirmed his expectation inflation will return this year to the central bank's target. The hawks may not be unified. While we think Christine Lagarde will likely want to keep her cards close to her chest and insist on how the central bank will react to the data, rather than following any pre-ordained path, we think she will maintain a general tone consistent with further cuts ahead.

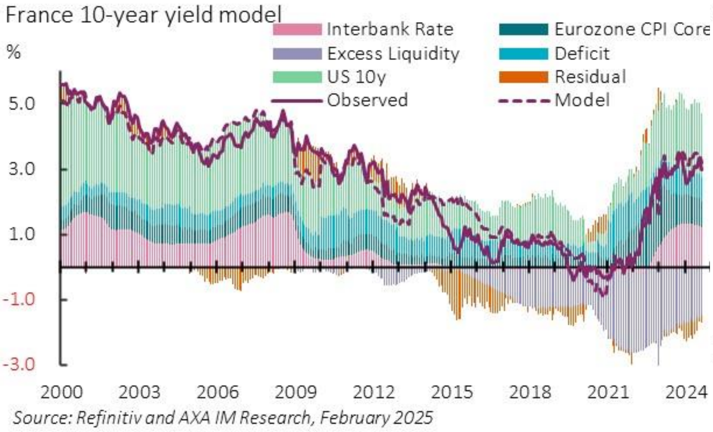
We think that the point on whether monetary policy would still be "restrictive" after this week's cut is becoming less crucial, since the right question for the ECB should be whether a mere neutral level is already inappropriate at this point, so that proper accommodation should now be the right stance. We expect the central bank to revise again its GDP forecast down, with this year to take the largest hit in the ECB's scenario (0.2pp) to only 0.9%, which would put it clearly *below* the consensus estimate for the Euro area's potential growth. In principle, and taking on board the lags of monetary policy, this should be consistent with a mildly accommodative stance.

The inflation side of the forecasts may however be less straightforward: energy prices (particularly for gas future contracts) rallied significantly right before the cut-off date for the forecasts. Overall, we expect a small upgrade on headline inflation for 2025/2026/2027 to 2.2% (+0.1pt) / 2% (+0.1pt) / 2.1% (unchanged) but crucially core should remain unchanged at 2.3% / 1.9% / 1.9%. But again, to return to our discussion of tariffs at the beginning of this section, **what will be key is the characterisation of risks around the baseline**, and with evidence accumulating of a steep deceleration in wages combined with harder-blowing headwinds on growth", we think the ECB will increasingly focus on the downside risks. We continue to think the ECB's policy rate will fall down to 1.5% by year end.

France's fiscal constraints come back to the fore

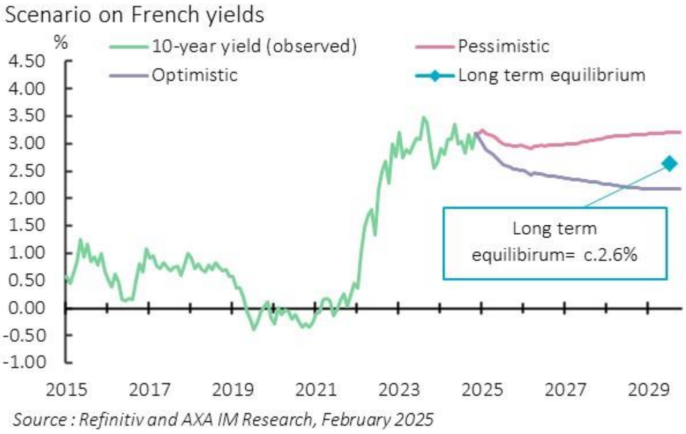
In some EU member states, scaling up defence spending is more a political and legal issue than a directly economic problem. Immediately after his victory in the German elections, Friedrich Merz opened the possibility to get parliament to vote on a "top up" to the special defence fund before the new Members of Parliament (MPs) take their seats on 25 March, thus circumventing the populists' blocking minority to the reform of the debt brake. It is still unclear whether this solution will ultimately be used, but merely mentioning this possibility – which is politically controversial, albeit legal (in 1998 it is an outgoing Bundestag which allowed Germany's participation to the bombing of Serbia) – is a symptom of the depth and speed of the strategic re-thinking currently underway in Europe. **France however has no fiscal space left to accommodate a further rise in its already significant defence effort**. The announcement by S&P last week that they put France's rating (which they had taken down to AA- in May 2024) on a negative outlook has put the French fiscal constraints back in focus.

Exhibit 1 – Our model for French 10-year yields



Source: Refinitiv and AXA IM Research, February 2025

Exhibit 2 – Two scenarios



Source : Refinitiv and AXA IM Research, February 2025

Our colleagues Eleonore Herfurth and Hugo Le Damany have recently published a note exploring the determinants of French long-term interest rates (see link here). Their first step was to estimate an econometric model explaining 10-year OAT yields with only fundamental variables. They include monetary policy signals (both policy rates and the changes in the ECB's balance sheet, captured by excess liquidity), inflation, an international contagion factor (US 10-year yields) and, crucially, the fiscal deficit. The model does a very good job, in retrospect, in fitting the inflexion points in French long-term interest rates, and over the most recent period, the "residual", i.e. the prediction error of the model, remained small (see Exhibit 1). This suggests that **beyond the purely political noise since June 2024, in any case the French 10-year yield would exceed 3%.**

Their note tackles many other issues (e.g. non-linearities in how yields respond to fiscal news), but one aspect of their work illustrates very well the constraints currently weighing on French fiscal authorities, and how they interact with the monetary policy stance. They build two scenarios (see Exhibit 2). In the optimistic one, France gradually adjusts its deficit to 3% of GDP by 2029, while benefiting from the ECB choosing not to reduce further excess liquidity after 2026 (leaving it at 20% of GDP). The model suggests the 10-year OAT yield would settle at around 2.2%. In a pessimistic one, they maintained the deficit in the 'red zone', only allowing a very gradual convergence from the current level to 5% of GDP by 2029, while the ECB would pursue its quantitative tightening policy, bringing excess liquidity down to around 10% of Eurozone GDP (a level comparable to 2017-2018). Then the model suggests the OAT 10-year yield would remain at its current level of around 3.2%. Such level is important because it is very close to trend nominal GDP growth in France. This means that, under the pessimistic scenario, the country would be forced into hard action on its primary balance since it would be facing "snowballing" debt dynamics (a point made by S&P to justify their moving France into "negative outlook").

This suggests that France could hardly push its defence effort much higher without either finding savings elsewhere or raising further a tax burden which is already very high. France is not the only member state in this situation. The European Commission's proposal to remove defence spending from the fiscal surveillance metrics would help only marginally for them, since it is market dynamics, rather than the European institutional setup, which would act as a brake. This is one of the reasons why **we think that *joint* issuance to fund military spending should be the way forward.**

Is the tide rapidly turning in the US?

Our baseline scenario for the US economy is that, thanks to the acquired speed from 2024 and a "sugar rush" from deregulation and tax cuts projects, GDP would still exceed potential on an annual average basis in 2025, before falling below potential in 2026 as the toxic aspects of Donald Trump's policies would start materialising from the second half of 2025 onward**. This scenario could however "accelerate": the White House's hyper-activity may bring the toxicity forward. This is at least what consumer sentiment suggests.**

We have already discussed in Macrocast the deterioration in consumer confidence reflected in the University of Michigan survey, highlighting the fact that even among Republican-leaning respondents, mood was souring from the end-2024 levels and never improved as much as it had at the beginning of Donald Trump's first term. The Conference Board survey for February released last week does not provide a political breakdown, but the deterioration in sentiment across the board was plain to see. When focusing on expected conditions, the post-election surge has been completely offset, returning to one standard deviation below the long-term average (see Exhibit 3). In the Michigan survey, the upward shift in inflation expectations had been striking, moving back close to the historical peak. The movement was in the same direction for the Conference Board but still within ranges seen in the recent past (see Exhibit 4).

Exhibit 3 – Headline consumer confidence down

Source: Conference Board and AXA IM Research, February 2025

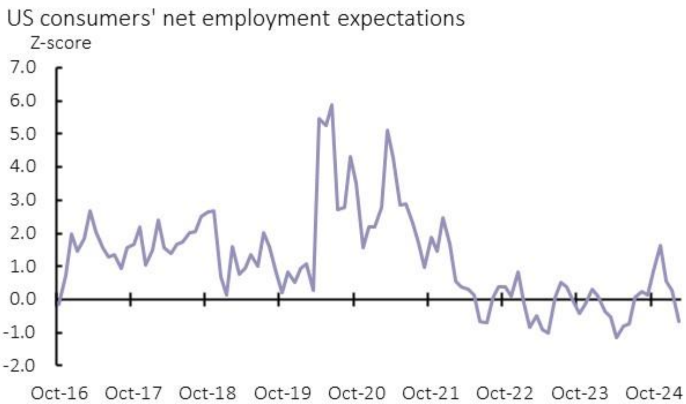
Exhibit 4 – Consumers' inflation expectations up

Source: Conference Board and AXA IM Research, February 2025

Beyond inflation resilience, **US consumers seem to be increasingly worried about the labour market**, with the balance between those expecting more, rather than less jobs ahead turning negative in February (0.7 standard deviation below the long-term average) for the first time since June of last year (see Exhibit 5). **The divorce between labour market expectations and objective conditions on the ground is striking**. Employment Reports suggest job creation remains robust and has even re-accelerated lately to reach 1.8% in annualised terms. Job openings are normalising, which may weigh on households' perceptions, but they are still in line with their long-term average, and as we discussed two weeks ago, the employment rates in the belly of the US workforce are historically high. This disconnect is consistent with the signals from the Citigroup's surprise index – which tracks gaps between the market's expected value for key macro indicators and their actual releases. It has deteriorated much more on "soft" indicators (i.e. surveys) than on "hard" ones.

The risk however, as usual, is that this "generic grumpiness" becomes self-fulfilling if consumers start reining in their spending. This is not certain. After all, their job expectations were already slightly depressed in the first 10 months of 2024, and households still maintained a strong consumption effort. There is however a new development: **households are no longer counting on a decline in interest rates and are getting more cautious on the prospects for the equity market** (see Exhibit 6). Given the sensitivity of US consumption to wealth effects, such revision in expectations cannot be taken lightly.

Exhibit 5 – More worried about jobs



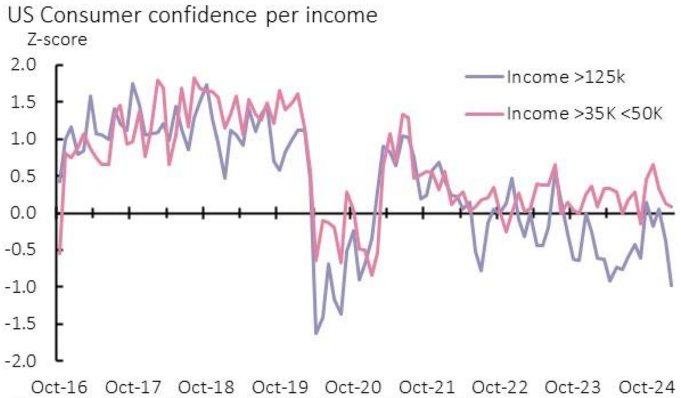
Source: Conference Board and AXA IM Research, February 2025

Exhibit 6 – Adverse financial conditions are expected

Source: Conference Board and AXA IM Research, February 2025

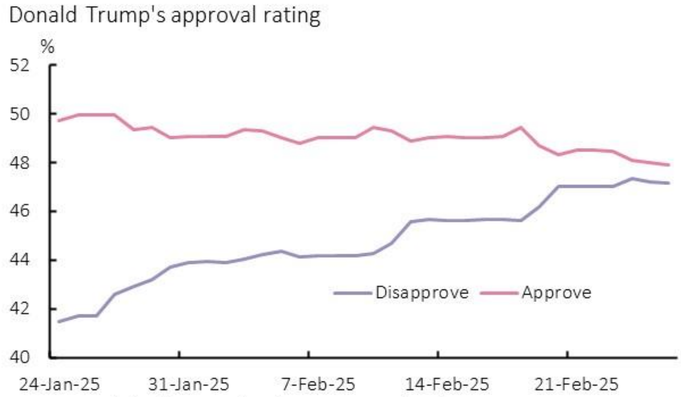
It is difficult to evaluate the precise contribution of the White House's various announcements to the general deterioration in consumer confidence, but we think an indication lies in the distribution across income levels: mood has soured much more swiftly for those making more than USD125K a year than for those closer to the bottom of the income ladder (see Exhibit 7). The highest earners are probably among those who are the most attuned to the policy news flow. Interestingly, the prospect of the prolongation of the TCJA tax cuts under Donald Trump's does not seem to lift their spirits. The constant bombardment of news pertaining to tariffs may weigh on mood. This may help explain the deterioration in Donald Trump's approval ratings (see Exhibit 8).

Exhibit 7 – The well-offs are unhappy



Source: Conference Board and AXA IM Research, February 2025

Exhibit 8 – It's moving – quite fast



Source: 538 (all polls average) and AXA IM Research, February 2025

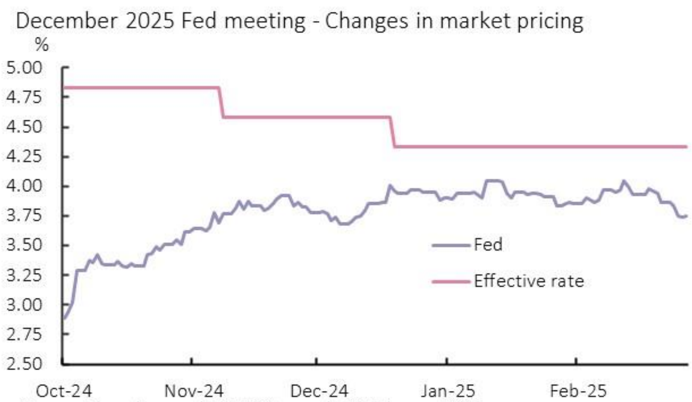
In addition, some "hard indicators" are now starting to come out on the wrong side of consensus. Personal consumption expenditure fell 0.5%mom in real terms in January, the biggest monthly decline in 4 years. Specific factors – extreme cold conditions in particular – may explain some of that underperformance, as well as possibly some random mean reversion after a string of very strong readings, but of course this data release adds to the risks of a proper deceleration in the US economy. This reading, on top of disappointing trade data released earlier, had a strong effect on the Atlanta Fed Nowcast, which now sees GDP growth in negative territory for Q1 2025 (-1.5%qoq annualised), from 2.3% – same pace as in Q4 – a week before. In one takes out a strongly negative contribution from changes in inventories, Q4 GDP was very strong, so, there again, some payback in Q1 could be expected without necessarily pointing to an underlying weakness, but the sky over the American economy is no longer uniformly blue.

Grumpiness has seemingly extended to financial markets. We routinely use the breakdown in US treasury 10-year yield between expected inflation and the "real interest rate", which is in principle more sensitive to growth expectations, as a way to capture the market's assessment of the US policy stance. The recent decline in the real rate is remarkable, while 10-year inflation expectations edged slightly further up (see Exhibit 9). The ugly "stagflation" word is becoming popular again.

Exhibit 9 – Real yields down – resilient expected inflation

Source: Macrobond and AXA IM Research, February 2025

Exhibit 10 – Market a bit more optimistic about Fed cuts



Source: Bloomberg and AXA IM Research, 27 February 2025

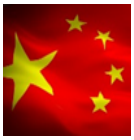
Still, despite the market's inflation outlook, **forwards still point to two cuts by the Federal Reserve (Fed) this year, in a clearer way than just two weeks ago** (see Exhibit 10). Habitual readers of Macrocast know that we think the Fed is "done" for this year. We recognise however that the signals of deterioration on the real side of the economy could precipitate one more cut, for instance at the June meeting, but for now the labour market has not showed signs of deterioration, which should be key to the Federal Open Market Committee (FOMC) given their current insistence on their dual mandate, while there is no evidence such softening in the real economy – which needs to be confirmed anyhow – is having any dampening effects on inflationary pressure. Yet, naturally, in this more uncertain environment, any "accident" on the Employment Report (there is one at the end of this week) would have a strong market effect.

The beginning, not the end, of a complex fiscal story

Between the "grumpiness" of households and a Fed on pause, the US administration needs good news. The prospects of an even more accommodative fiscal policy have improved on the margin with the passing of a budget resolution by the House last week. Given the Republicans' razor thin majority, this was no small feat. The process remains complex though. Since the Republicans want to use the "reconciliation" approach, the exact same resolution needs to be supported by the House and the Senate, and what we had last week was only the bare bones of a proper budget, with a lot of details on how spending cuts would be apportioned still in need of clarification, opening the door to much intra-Republican bickering. More fundamentally, t**he House's resolution, while significantly raising the primary deficit in the decade ahead, would still not offer enough space for the entirety of Donald Trump's tax plans announced in the campaign.**

The House's resolution would cut tax revenues by USD4,500bn over the coming decade, only partly offset by some USD1,700bn of net mandatory expenditure cuts (the 2,000bn "headline" spending cuts do not consider the USD300bn in additional spending towards border security and defence). This would result in an additional primary deficit of c.0.8% of GDP annually across the decade, when using the Congressional Budget Office (CBO)'s latest forecasts for nominal GDP. This would send the overall federal deficit to around 7% of GDP from slightly more of 6% today. Yet, as a note by the Penn Wharton Budget project made it plain last week (see link here), this would not cover much of Donald Trump's current plans. Indeed, the mere prolongation of the Tax Cuts and Jobs Act (TCJA) dispositions which were supposed to expire from this year onward would result in an overall decline in tax revenues of USD4,000bn. **Other promises, such as exempting social security pensions from income tax (USD1,100bn) or eliminate income tax on overtime (USD600bn) could not be funded within the parameters set by the House**. According to the Penn-Wharton's model, it's roughly half of the electoral promises which would need to be dropped.

From a debt sustainability point of view, this would be a better outcome – although a deficit permanently hovering around 7% of GDP would still remain daunting. Yet, investors who believed in the Republican "sugar rush" may be disappointed, as could some segments of Donald Trump's political base. If most of the fiscal space offered by the House of Republicans goes to prolonging the TCJA – the 2017 cuts – then most of the benefits of the new administration's fiscal policy will benefit those at the upper end of the income ladder. His blue-collar supporters, who were going to be the main beneficiaries of the "new" cuts (those pertaining to social security pensions and overtime) may object. This creates the conditions for a difficult conversation as the ball now goes to the Senate.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Pres Trump suggested 25% tariffs on EU; 25% on Ca & Mx from 4 March. No longer reciprocal? • PCE inflation (Jan) headline and core up 0.3%mom, less than CPI boost • GDP (Q4, r) unchanged at 2.3% (Saar) • HH spending (Jan) -0.2%mom – first fall in 22m • Conf Board cons conf (Feb) expectations fell to 72.9 (from 82.2) sharpest sustained fall in 2½yr • Jobless claims picked up to 242k highest in 2m	• Labour report (Feb). Payrolls expected around 150k softer pace; watch labour supply falls to keep unemp around 4%; AHE monthly pace elevated in Jan. • ISM indices (Feb). Mfg has improved. Watch svcs to see if follow weakness in PMI • Vehicle sales (Feb) Jan contb'd to sharp retail sales drop that month, a rebound expected this • Fed's Beige Book to provide anecdotal evidence on economy
	• CDU/CSU and its leader Merz won the election and should form a coalition with the SPD. Despite a blocking minority formed by far left (Linke) and far right (AfD) there is room to reform debt brake, but it could be more challenging to raise defence spending, unless it is an EU response • EC surveys (Feb) improved with industrial sector, consumer conf while svcs was slightly weaker • EMU loans rose to 1.3%yoy (+0.2pt) for households, +2% for non fin companies (+0.5pt)	• The ECB should deliver a fifth successive 25bp rate cut while communication should remain broadly unchanged, unless they decide to comment the level of restrictiveness. Such discussion will likely occur during the Q&A • After inflation released in Sp (flat at 2.9%), Fr (0.9% (-0.9pt)), Italy (flat at 1.7%) and Germany (flat at 2.8%), the aggregated eurozone should reach 2.3% • Retail sales (Jan), employment (Q4), 2nd estimate GDP (Q4)
	• Nationwide House Prices (Feb) rose by 0.4% month-on-month	• Consumer credit (Jan) likely to remain weak • Mortgage approvals (Jan) should remain elevated in the run up to the SDLT threshold change in April • Final services PMI (Feb) no material change expected. Construction PMI (Feb) look for a rebound
	• Tokyo CPI (Feb) edged down to 2.2%, from 2.5%. Ex food and energy ticked down to 0.9%, from 1% • Retail Sales (Jan) up 0.5% mom; 3.9%yoy. • Industrial production (Jan) up 2.6%yoy.	• Unemployment rate (Jan) should continue to show a tight labour market • Final services PMI (Feb) no material change expected
	• *No data released in the past week* • Trump imposed another 10% tariff on China, expected to be effective in early March	• NBS & Caixin mfg PMI (Feb), watch for tariff impact • NBS non-mfg & Caixin services PMI (Feb), check for recovery in services • Trade numbers for (Feb) useful for evaluating damage of tariff hike in Feb
	• CB: Thailand 25bp cut to 2.0%, South Korea 25bp cut to 2.75%, and Hungary (6.5%) on hold • GDP (Q4 yoy): Czech Republic (1.8%), India (6.2%), Turkey (3.0%) • CPI (Jan): Singapore (1.2%), South Africa (3.2%) • Industrial production (Jan yoy): Singapore (9.1%), Taiwan (5.1%), Thailand (-0.9%)	• CB: Malaysia on hold (3%), Turkey cut by 250bps to 42.5% • GDP (Q4): Brazil, Romania, South Africa • CPI (Feb): Colombia, Czech Republic, Indonesia, Mexico, Philippines, South Korea, Taiwan, Turkey • Industrial production (Jan): Argentina, Hungary, South Korea

Upcoming events		
	US:	Mon: ISM Mfg Index (Feb); Wed: ADP emp change (Feb), Composite PMI (Feb), ISM Non-mfg index (Feb), Factory orders (Jan), Beige book publication; Thu: Trade balance (Jan), Non-farm productivity (Q4), Unt labour costs (Q4), Initial jobless claims (w/e 1 Mar); Fri: Non-farm payrolls (Feb), Unemp (Feb), Avg earnings (Feb)
	Euro Area:	Mon: Sp, It, Ez Mfg PMI (Feb); Ez HICP (Feb); Tue: It, Ez Unemp (Feb); Wed: Fr IP (Jan), Sp, It, Ez Svc PMI (Feb), Ez composite PMI (Feb), It GDP (Q4), Ez PPI (Jan); Thu: Ez Retail sales (Jan), ECB Announcement; Fri: Ge new mgf orders (Jan), Sp IP (Jan), Ez GDP (Q4)
	UK	Mon: Mfg PMI (Feb), Mortgage approvals (Jan), Consumer credit (Jan); Tue: BRC Shop price index (Feb); Wed: Composite PMI (Feb), Svc PMI (Feb); Thu: Construction PMI (Feb); Fri: Halifax house price index (Feb)
	Japan:	Mon: Mfg PMI (Feb)
	China:	Mon: Caixin mfg PMI (Feb); Fri: Foreign exchange reserves (Feb), Exports (Feb), Imports (Feb), Trade balance (Feb); Sun: CPI (Feb), PPI (Feb)

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