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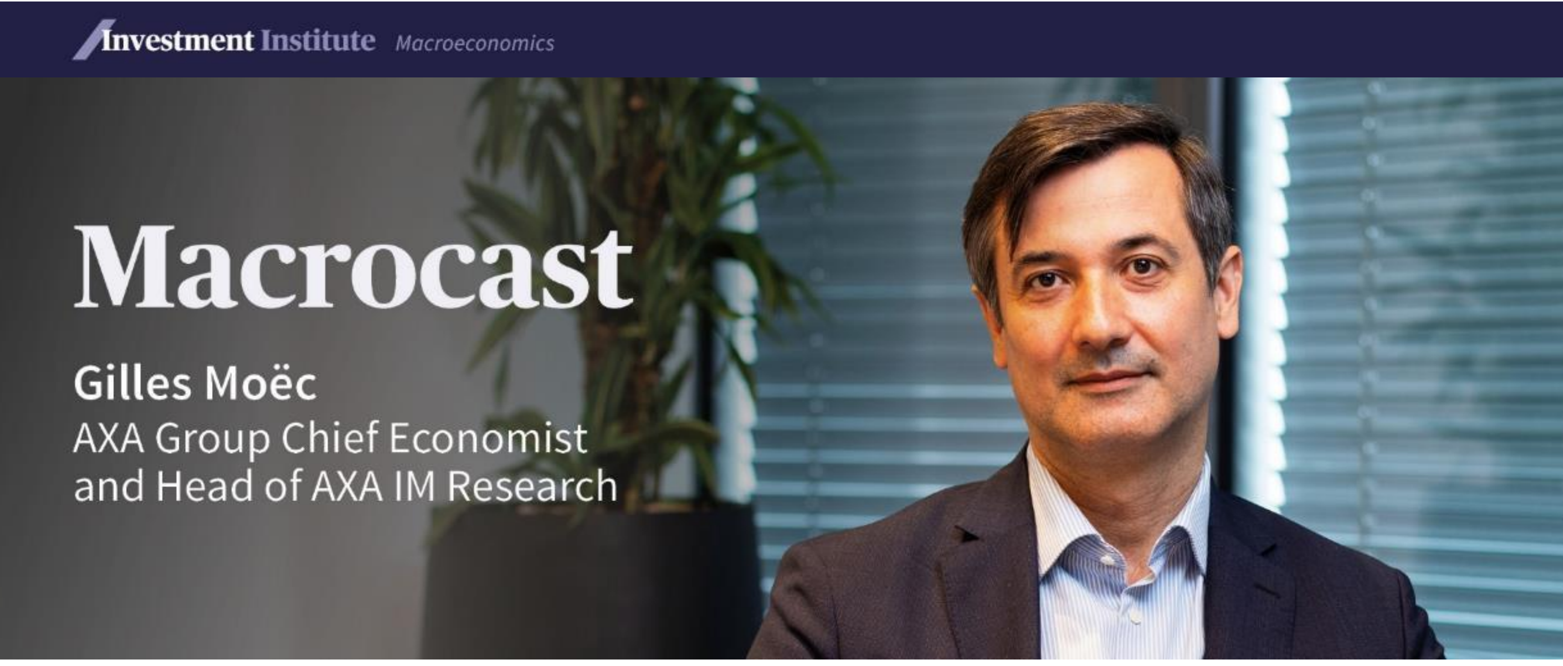


Watch the Tone

- Some change in tone from Washington on trade, but we remain prudent.
- Better-than-expected start of 2025 for Euro area GDP, but headwinds are simply blowing too hard.
- A further postponement of the financial liberalization of China is a casualty of the trade war.

We would not overstate the signal from the drop in the US GDP in Q1 – the imports surge to "beat the tariffs" should not hide the resilience of domestic demand, and job creation remains decent – and we continue not to expect any pre-emptive support from the Fed, which we think will affirm this week its "wait-and-see" mode. Yet, the awareness of looming economic damage weighing on an already souring public mood may play a role in the change of tone on the trade war front at the White House. More concessions were announced last week, and negotiations with China may finally start. Meanwhile, the EU has made an offer to the US in terms which could go some way towards fitting the US view on trade matters. Still, the starting positions across stakeholders are very far apart. We suspect it may take more tangible damage in the US – and/or more concessions from the rest of the world – before the landing zone is effectively in view.

Meanwhile, the Euro area started the year on a stronger footing than expected with a 0.4%qoq gain for GDP in Q1. We remain however convinced – and that is the message from surveys – that headwinds will push economic activity down, making forceful accommodation from the ECB necessary. Still, while Philip Lane opened the door to using 50-bp cuts, we think that the lingering price pressure in the services sector – manifest in the April CPI print – will make the central bank wait until the impact of the trade war materializes more clearly, or that the negotiations disappoint, before using this tool, keeping to a 25bp increment at the June meeting.

While we remain reasonably confident Beijing will choose a cooperative approach towards the rest of the world – outside the US – on trade issues, we think the trade war will in any case further diminish hopes of a financial liberalization in China. Financial repression will remain very tempting to deal with intensifying pressure on public finances as the fiscal stimulus is scaled up to make up for lost foreign demand.

Incentives to negotiate?

When reading the negative print for US GDP growth in Q1 2025 (-0.3%qoq annualised), optimists will focus on the resilience in "final domestic sales", which take out volatile components such as foreign trade and inventories which are currently subjected to intense gyrations, with businesses trying to "beat" the tariffs. Final domestic sales rose by a very solid 2.3%qoq annualised. The entourage of the US President will also probably point to another metric, "final domestic sales to private purchasers," which exclude government spending, which rose by an even more satisfying 3.0%. **The base of the US economy still looked solid in Q1.**

The better-than-expected Employment Report released last Friday was also reassuring on that front: on a three-month annualised basis, job creation according to the Establishment Survey rose by 1.3% in the private sector, a still decent pace when compared with the summer of 2024, when a series of concerning readings had contributed to the Fed's decision to start cutting rates (see Exhibit 1). Despite this resilience, the further deceleration in wages would be good news for the inflation outlook (see Exhibit 2), hourly earnings gaining only 2.6% on a 3-month annualised basis, the slowest pace since 2020, but of course, given the looming impact of the tariffs, the central bank is unlikely to take much comfort from there. In addition, we maintain the point we made last week: labour supply is now undergoing an adverse shock, with immigration coming to standstill, which could stand in the way of the continuation in the deceleration of wages. This may not have yet affected wage data, but dynamically this is something the Federal Reserve (Fed) cannot ignore. So, all in all, **the negative GDP print in itself is unlikely to prompt the Federal Reserve into pre-emptive action, and we expect J. Powell to affirm the Fed's "wait and see" mode this Wednesday.**

Exhibit 1 – Still decent job creation

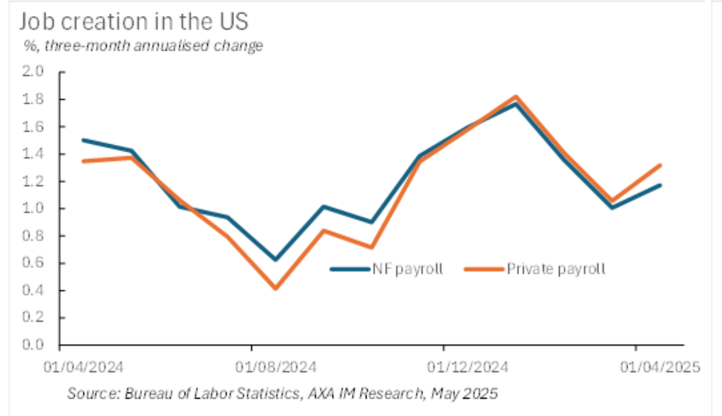


Exhibit 2 – Wages continue to slow down

Yet, some details of the GDP print are concerning. While business investment remained truly bullish, private consumption was not particularly strong in Q1. The 1.8% gain was the softest since Q2 2023, despite a strong incentive to try to beat the tariffs and bring some purchases forward. The deterioration in consumer confidence, which pre-dates the tariffs announcements, has seemingly taken its toll. The surge in imports (a whopping +41.3%) which was the main factor behind the negative GDP reading will give way to a severe contraction in Q2, but such mechanical support to GDP may be offset at the same time by a major drawdown in inventories. Indeed, the change in inventories contributed 2.25% to GDP in Q1, the highest level since the post-Covid reopening in 2021. Businesses are highly likely to heavily draw on those inventories from now on, rather than stepping up production, given the rise in input costs triggered by the tariffs. If at the same time consumer spending weakens further, as a reaction to the price shock**, Q2 GDP may also come out on the soft side. The domestic configuration for the US administration is thus uncomfortable: it cannot count on quick support from the "Fed cavalry," while the outlook for the economy is deteriorating.**

This may explain the change in tone, and practice, by the US administration over the last few days, on trade issues. The additional concessions on automobile tariffs offered in an Executive Order on 29 April suggest that the White House is

not completely deaf to the criticisms coming from the US business sector. Carmakers assembling in the US will be reimbursed for tariffs paid on imported auto parts, up to 3.75% of a vehicle's retail price in the first year (relief will then gradually fall), and the administration made it plain that the 25% tariffs on steel and aluminium would not be compounded with the tariffs paid on car parts. The Executive Order also clarifies that auto parts imported from Canada and Mexico which comply with USMCA remain exempt. Possibly more fundamentally, given the current state of de facto mutual embargo, proper negotiations between the US and China, without a prior direct conversation with Xi Jinping, which for weeks had appeared as a key condition for Washington, may now start, at least in how it is now being presented by Secretary Bessent, which may reflect a more realistic approach to trade policy. The Chinese de facto embargo on exports of rare earths to the US – which could trigger serious disruptions in industrial production in the US – may have also played a role in the US softening.

Beijing has quietly exempted last week some US products from its own retaliation tariffs (e.g. on 8 types of microchips made in the US). The Chinese government has acknowledged the fact that negotiations on a technical level could now start, even if nothing has been revealed on their content. This is still a very "conditional welcome" though: Beijing words were still defiant, the Commerce Ministry's communiqué stating *that "if the US wish to talk, they need to show sincere willingness and stand ready to correct their erroneous practices and cancel unilateral tariffs."* We also think that we should not overstate the latest Chinese exemptions: the motive there is squarely to protect strategic sectors of the economy from the brunt of the trade war, not to wave on olive branch to the US. It might be the end of the beginning of the trade war, but it is not yet the beginning of the end.

Still, **while the substance of such Sino-American talks is still elusive, we find it interesting that the European Union (EU) has laid out a precise "initial offer" to the US in terms which would go some way towards fitting the current US administration's view of trade matters**. Indeed, trade commissioner Maros Sefcovic offered to raise EU purchases of Liquefied Natural Gas (LNG) and soy by EUR50bn. This figure was explicitly calculated as the "delta" needed on trade in goods to produce a balanced bilateral trade relationship when adding the US surplus on services. "Net zero" bilateral balances are the stated objective of the US administration, even though, so far, the White House has taken only trade in goods in consideration. This may be progress, but this is only a first step. Indeed, as a condition for such deal, according to the EU Commission, the US would have to give up the 10% "basic" tariff on European products already enforced, not just renounce the "reciprocal add-on" of another 10% which has been suspended for 90 days. This is a big ask, in our view, given our strong belief that tariffs cannot easily go back to the status quo ante, as the income they will generate is crucial to the success of the administration's fiscal plans.

At this stage, our assessment of the global manoeuvring around trade talks is that foreign governments are readying offers which could be ultimately accepted by the US – and presented as a victory for Donald Trump on the domestic front – if and when the deterioration in the US economy makes the current maximalist position of the US side untenable. **Unfortunately, it may take more tangible damage in the US – and/or more concessions from the rest of the world – before the landing zone is effectively in view. We would thus tread very cautiously on the equity market's rebound.**

Intriguing consumer confidence numbers in Europe

Relative to the US, and judging solely by the headline GDP numbers, the Euro area started the year well. Indeed, GDP there rose by 0.4%qoq in Q1, 1.6% annualised, doubling the pace of Q4. As often, volatile Irish numbers need to be taken out, but excluding Ireland, GDP still grew by 1.2% annualised, in line with the region's potential growth rate. This is a strong achievement given the headwinds facing Europe. Yet, we do not think we should extrapolate much from the Q1 reading. Indeed, according to the European Commission survey, expectations in the business sector are markedly below their long-term average in all three sectors (manufacturing, services, and retail), with a further deterioration in April (see Exhibit 3).

Exhibit 3 – Weak across the board

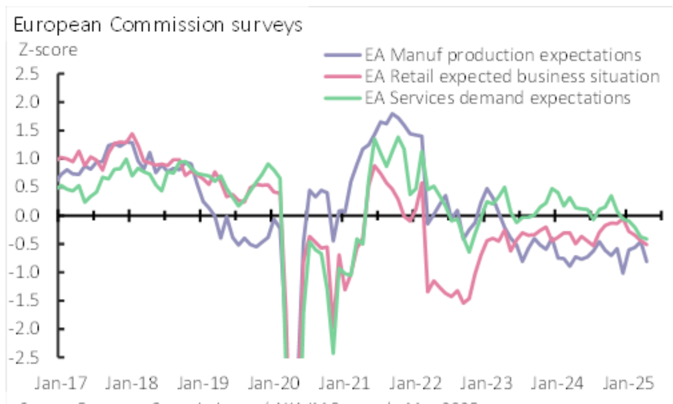
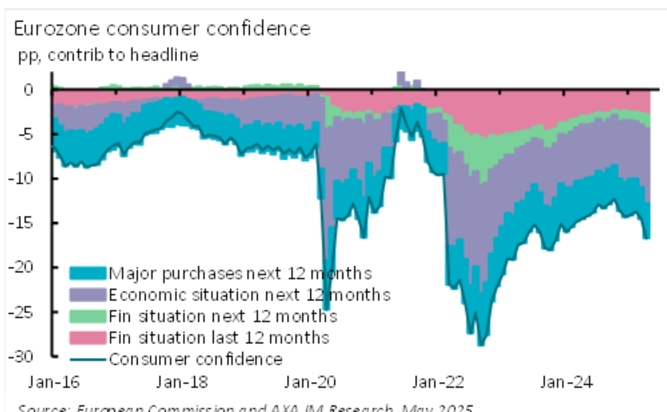
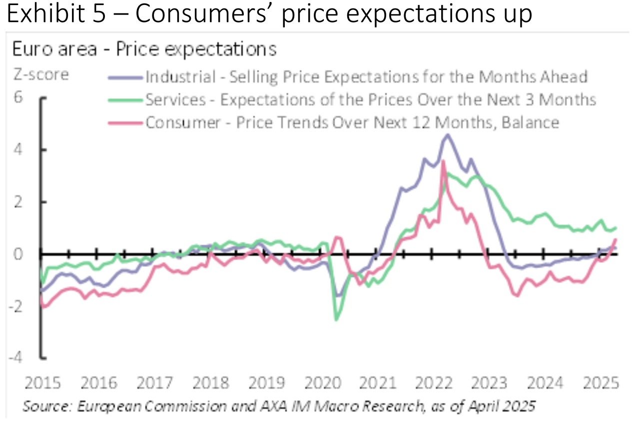


Exhibit 4 – Consumer confidence further down



Consumer confidence also continues to soften. Optimistic readers will probably take some comfort in the fact that, within the confidence index, it is the "generic component" ("economic situation in the next 12 months") which is still providing the biggest contribution to the decline in the headline number, while more "personal" components – e.g. major purchases intentions – are less depressed (see Exhibit 4). This would suggest that an improvement of the mood music on trade could still change the picture rapidly. Yet, we are concerned – and puzzled – by a development we had not seen coming: consumers' inflation expectations are rebounding. Indeed, households' expectations for prices 12 months ahead are now back above their long-term average (see Exhibit 5). True, the flash estimate for Consumer Price Index (CPI) inflation for April came out slightly above expectations (2.2% against 2.1% according to the Bloomberg consensus), but the pace is still slow compared with recent experience, and energy prices – a component to which households are usually very sensitive – continue to fall markedly (-3.5%yoy in April, from -1.0% in March). We are tempted to attribute this rebound in consumers' inflation expectations in the Euro area to the bombardment of news on trade tariffs. While we do not think that retaliation tariffs on the EU side would move the dial on European inflation, given the marginal role US products play in the consumer basket, the "mood music" may be impacting European public opinion.

Exhibit 5 – Consumers' price expectations up



The rebound in services prices in April is however real, pushing core inflation to 2.7%yoy in April, from 2.5% in March. Business surveys in the services sector (see Exhibit 5 again) suggest that, while price expectations have not increased further recently, they remain stubbornly above their long-term average. The Governing Council has however made it plain that it could tolerate "accidents" and temporary deviations from the general trend towards the European Central Bank (ECB)'s inflation target. Our core view has not changed: we think the central bank will have to bring its policy rate well into accommodative territory this year – possibly down to 1% – which could entail "jumbo cuts". Our view was further strengthened by a speech delivered by ECB Chief Economist Philip Lane on 24 April. He stated that *"there is no reason to say we are always going to do the default 25 basis-point (bp) interest rate move"*. We however think that, given the residual pressure on services prices, the ECB would wait until the trade war materialises more markedly into

the real economy, and/or that negotiations with the US disappoint, before resorting to a 50-bp cut. By the time of the next meeting, in June, we think the Governing Council will keep to a 25-bp increment.

Postponing further China's financial opening

The disappointing reading for the manufacturing Purchasing Managers' Index (PMI) in China in April, falling below the expansion level and losing 1.5 percentage points (ppt) over one month to 49.0, suggests that after a "pre-tariff" surge in US demand for Chinese products last winter**, the dreaded but fully expected adjustment to the new trade course in Washington is taking its toll on the second biggest economy in the world.** Indeed, when averaging over three months, Chinese exports to the US had re-accelerated to a double-digit pace in January 2025 to hit 11.9% year-on-year, markedly up from 5% in October 2024, before D. Trump's re-election. The pace fell back to 5% in March, the latest available data, and shipping metrics suggests the drop in bilateral trade in April was already steep.

Martin Wolf in the Financial Times last week expressed his confidence in the capacity of China to withstand the shock, betting conversely on a future policy turnaround in the US as the damage of protectionist policies get more obvious. We have sympathy for this view (see the first section of this note). Yet, as much as we think Beijing can and will deploy its "policy reserves" to mitigate the external blow and thus keep economic growth on a decent pace despite vanishing US demand**, we also believe that such support will at the same time keep China further away from fully converging towards a "Western style" of macro management and reinforce a reluctance to completely open up its economy, at least in the financial realm.** We do not think this will primarily reflect a political or ideological choice but will instead stem from an awareness that the magnitude and features of the policy stimulus would make it more difficult to submit the Chinese financial system to the degree of pressure usually associated to unconstrained international financial flows.

Habitual readers of Macrocast will be familiar with our focus on the "augmented" Chinese fiscal deficit now routinely calculated by the International Monetary Fund (IMF), which on top of the official number adds the off-balance sheet activities of the special financing vehicles of the local authorities. Then **the overall deficit is well over 10% of GDP (13.2% in 2024 in the Fund's latest "article IV" report on China), and public debt well above 100% (124% in 2024). Such levels – and an additional fiscal push to support domestic spending – are easily sustainable only if Beijing can continue to effectively direct abundant private savings towards funding the general government.**

Even if their role has expanded over the last few years, only a tiny fraction of Chinese public debt is held by overseas investors (c.3%). Within the domestic creditors of the Chinese governments, Chinese banks account for roughly 2/3 of the total (still using IMF data). **China operates under a circuit where financial repression drives the bulk of consumers' savings towards low-yielding deposit accounts at banks, which stands as the counterpart on the banks' liability side of the exposure on their asset side to the domestic sovereign risk.** A liberalisation of the capital account could trigger savings outflows to the rest of the world, until savers are satisfied that the level of remuneration of their investment, risk profile and protection of property rights domestically is equivalent to what they could secure externally. **The "circuit," and hence a smooth funding of the sovereign without a painful rise in interest rates, could be maintained only if domestic banks raise the interest rate that they serve on the deposit accounts AND accept a decline of their own profit margins when continuing to invest in government debt.** Such approach would be inherently dangerous, from a financial stability point of view, and would be inconsistent with banks management shifting completely to profit-seeking.

The need to maintain low interest rates on public debt in a phase of additional fiscal support would provide a new justification to financial repression. Before the dominant thinking in global economic circles shifted in the 1970s and 1980s against financial repression, development models popular in the 1960s were very supportive of such approach. The rationale was simple: capital productivity in developing economies tends to be high, because the initial stock of capital is low. This means that the "natural" interest rate is also high, relative to mature economies. By artificially maintaining the effective interest rate on domestic saving low, and by making it difficult for domestic saving to invest overseas, local investment intermediated by state-controlled banks can take off, expand rapidly and remain very

profitable as the spread between the return on capital (a function of capital productivity) and funding costs is wide, while capital controls prevent overseas savers from taking advantage of local investment opportunities.

Gradually, once the developing country has expanded its capital base, the return on investment converges towards levels seen in more mature economies and private consumption becomes the main engine of growth, capital controls can be gradually lifted, which incidentally helps with addressing some of the drawbacks of financial repression, such as capital misallocation towards unproductive sectors. China is precisely at this stage of its development: the real estate crisis is a clear symptom of the limits of financial repression: artificially low interest rates on liquid savings combined with limited financial investment solutions trigger excess allocation into "bricks and mortars." Yet, given the need to maintain domestic funding conditions accommodative given the current international challenges, lifting capital controls, and allowing a full opening of the Chinese financial system is probably much less palatable.

Incidentally, were China to allow domestic saving to move freely out the country, a steep depreciation of the currency would probably ensue. Paradoxically**, it would be precisely when Beijing would give up controlling its capital account, normally an ingredient in what the US Treasury considers as "currency manipulation," that the Renminbi would fall to levels even more threatening to the US bilateral balance with China.** So, as much as we believe it is in Beijing's interest to pursue a cooperative strategy with partners outside the US in the realm of international trade, we do not think this can easily extend to the financial system. The trade war will prolong the relative closeness of Chinese markets.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• GDP (Q1, p) -0.3% (saar) first fall in 3yrs, driven by weaker trade; cons and bus firmer than f'cast • Labour market (Apr) payrolls rose a solid 177k; unemp stayed at 4.2% and earnings softened to 0.2%mom. NFIB suggests worsening outlook • Employment cost index (Q1) stable +0.9%qoq • Cons expect's (Apr) lowest outside of recession • ISM mfg index (Apr) 48.7 vs 49.0 • Vehicle sales (Apr) solid 17.3m vs 17.8m	• FOMC meeting. No change in policy expt'd and no forecast update. Powell to keep 'no hurry' as Fed judges worsening in labour and inflation outlooks • ISM svcs index (April) expect weakening as PMI and Philly indices lower, but watching scale • Jobless claims rose last week, watch for unwind • NY Fed 1yr inflation expects (Apr) further gains? • Consumer credit (Mar) watch for rise after strong end qtr spending
	• EMU flash prelim GDP (Q1) came at +0.4%qoq, Ge (0.2%), Fr (0.1%), It (0.3%) and Sp (0.6%). Prelim details showed exports didn't benefit from front loading purchases, domestic demand still weak in core countries but stronger in periph • EMU flash inflation (Apr) should average 2.1% in Apr (-0.1pt from Mar) after EMU-4 releases came broadly in line. Core should rise to 2.5% but biased by timing of Easter	• The blackout in Spain and Portugal mechanically removes 0.4% of annual GDP (1 to 2 working days), even if the impact should be lower because a large part of it is simply postponed • Final PMIs (Apr) • Retail sales (EMU, March) • Ge Industrial output and exports (Mar)
	• Nationwide house prices (Apr) fell by 0.6%mom • BoE consumer credit (Mar) edged lower to £0.9bn, from £1.3bn • Mortgage approvals (Mar) fell to 64.3K, from 65.1K, as SDLT boost subsides • Final Manu. PMI (Apr) up at 45.4, from 44.9 • Local Elections: Reform pick up 1 seat and 1 mayoral position	• Final composite PMI (Apr) upward revision on back of manu PMI • Construction PMI (Apr) likely to remain well below the 50.0 mark • BoE rate decision & MPR: look for a 25bp cut with Dhingra voting for 50bp cut. CPI inflation forecasts and growth to be revised lower • RICS (Apr) likely to show further slowdown
	• Retail sales (Mar) fell 1.2% on the month. IP (Mar) down 1.1%mom, after 2.3% rise in Feb. • BoJ rate decision and Quarterly Outlook Report: rates on hold, downward revisions to growth and CPI inflation. Wage/price spiral still intact • Cons. conf. (Apr) plunged to 31.2, from 34.1	• Final composite PMI (Apr) unlikely to see any material revisions • HH spending (Mar) look for fall after strong Feb. • Av. cash earnings (Mar) to remain broadly unch. • Eco Watchers Survey (Apr) look for drop in sentiment towards next 12 months
	• NBS mfg PMI fell back to contraction territory at 49 in April from 50.5 in March; while Caixin mfg PMI dropped more mildly to 50.4 from 51.2 in March • NBS non-mfg PMI edged down to 50.4 from 50.8	• Caixin services PMI (Apr), watch for deterioration • Export and import (Apr) will see 'reciprocal tariff' bite
	• CB: Chile (unch 5.0%), Hungary (unch 6.5%), Thailand (25bp cut to 1.75%), Colombia (25bp cut to 9.25%) • GDP (Q1 yoy): Taiwan (5.4%), Czech Republic (2.0%), Mexico (0.8%), Hungary (0.0%) • CPI (Apr yoy): Poland (4.2%), Indonesia (1.95%), South Korea (2.1%) • Industrial production (Mar yoy): South Korea (5.3%), India (3.0%), Thailand (-0.7%)	• CB: Brazil (75bp hike to 15.0%), Czech Republic (unch 3.75), Poland (50bp cut to 5.25%), Malaysia (25bp cut to 2.75%) • GDP (Q1): Indonesia, Philippines • CPI (Apr): Brazil, Chile, Czech Republic, Hungary, Mexico, Taiwan, Thailand • Industrial production (Mar): Brazil, Czech Republic, Hungary

Upcoming events		
	US:	Mon: Composite PMI (Apr), ISM non-mfg index (Apr); Tue: Trade balance (Mar); Wed: FOMC announcement; Thu: Non-farm productivity (Q1, p), Unit labour costs (Q1, p), Initial jobless claims (w/e 3 May)
	Euro Area:	Mon: Ge coalition agreement to be signed; Tue: Fr IP (Mar), Sp Svc PMI (Apr), Ez Composite PMI (Apr), Ez PPI (Mar); Wed: Ge New mfg orders (Mar), It Retail sales (Mar), Ez Retail sales (Mar); Thu: Ge, Sp IP (Mar); Fri: It IP (Mar), Ge Moody's credit rating review
	UK:	Tue: Composite and Svc PMI (Apr); Wed: Construction PMI (Apr); Thu: RICS Housing Survey (Apr), Halifax house price index (Apr), MPC announcement
	Japan:	Wed: Composite PMI (Apr)
	China:	Tue: Caixin services PMI (Apr); Wed: Foreign exchange reserves (Apr); Fri: Exports (Apr), Imports (Apr)

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*As at the end of June 2024, including non-consolidated entities.
** As at the end of December 2023.

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