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Investment Institute Macroeconomics

Beyond the Respite

- The dataflow has been kind last week, allowing for a respite on the bond market.
- We review Michael Pettis' paper on trade tariffs as a current account rebalancing tool.
- We also review Setser and Tortoir's proposal for a more muscular approach in Germany to Chinese competition.

Last week's dataflow has been kind to the global bond market. With US core inflation easing more than expected in December, what seemed like an inexorable march towards a 5% 10-year yield has stalled in the US, while in the UK the combination of a better inflation print with another weak monthly reading for GDP helped strengthen the expected capacity of the Bank of England to cut decisively in 2025, with some diffusion effects to the long-end of the curve. While this coincides with our baseline for the UK, we remain suspicious of the magnitude of the disinflation trajectory ahead of us in the US, even if we need to hear more precise signals from the new US administration to fully quantify the resistance line.

In this more benign market environment, and precisely as we wait for the first pronouncements from the 47th President of the US, we can pay attention to seemingly arcane macroeconomic issues which we think are relevant for the medium-term outlook for the world economy. First, we draw on an intriguing paper by Michael Pettis who argues that unilateral tariffs could be an acceptable current account rebalancing tool for the US, with the logical conclusion that the other regions – Europe and China – which present a structural, excessive current account surplus should not retaliate. While we think Pettis has a point, we also believe that he does not pay enough attention to the adverse long-term effects of tariffs, including in the US. Yet, we concur with the view that, in demand-deficit regions, retaliation, while tactically tempting, is not optimal.

This may be different in the case of the trade relationship between two surplus regions, and we also explore a paper by Setser and Tortoir proposing a roadmap for Germany towards a more muscular approach to Chinese competition. They take the precaution of laying out solutions which would still be consistent with the WTO rules. In the context of elections in Germany next month this is an interesting contribution.

Phew…

The beginning of 2025 had been taxing for the market, with in particular the sharp rise in long-term yields – hitting the UK badly – and near-cancellation of the gains made on the US equity market since D. Trump's election, and **the respite brought about by kinder-than-expected data last was more than welcome.**

The **US print for consumer prices in December was key**. Headline came out in line with expectations, at 2.9% year-on-year, accelerating from November (2.7%), but the core Consumer Price Index (CPI) finally broke the string of unchanged – and elevated – prints at 3.3% since August, to land at 3.2% year-on-year. This is still high, but the momentum is going in the right direction in a clearer way: on a 3-month annualised basis, core CPI retreated to 3.3%, down from 3.7% in November. The Fed's focus, the services excluding rents component, provided much of the impetus, losing 1 full percentage point on a 3-month annualised basis relative to November (see Exhibit 1). Now, **alternative measures of core inflation are not necessarily sending the same reassuring message**. Metrics designed by the Cleveland Fed to take out the effect of small components providing outsized contributions to the overall index indicate that either core inflation is slowing down but remains very high, close to 4% (median CPI) or has been flatlining since the late summer well above 3% (trimmed CPI, see Exhibit 2).

Exhibit 1 – Finally, some better news on core momentum

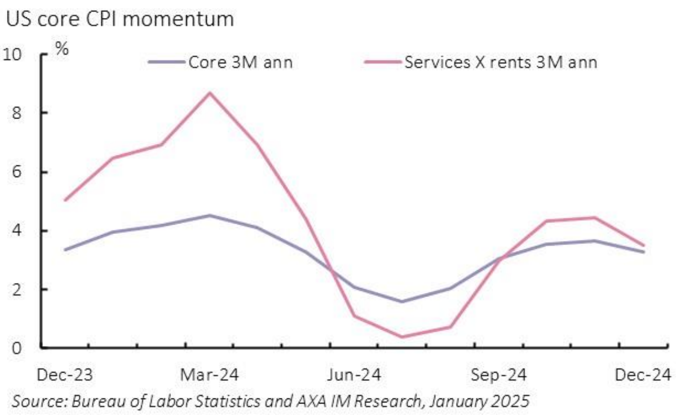
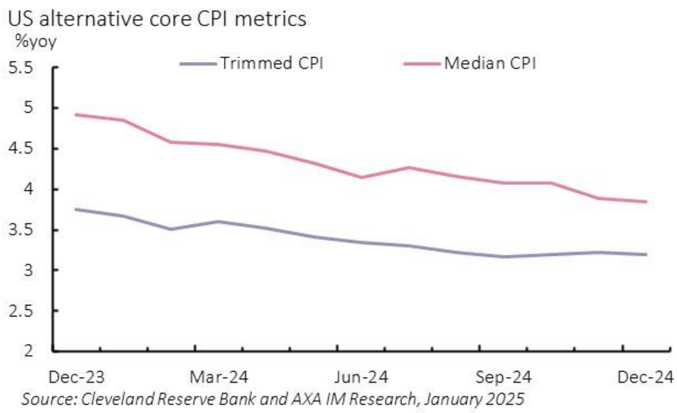


Exhibit 2 –Alternative core measures less supportive

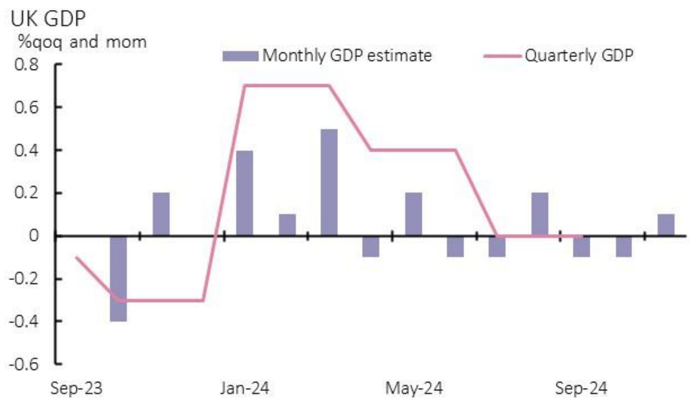


Still, these alternative metrics draw much less attention from the market, and **US long-term interest rates corrected nicely last week**, reverting to 4.62% at close on Friday, markedly down from a recent peak at 4.80% on 14 January. What had started to look like an inexorable march towards 5% – which would have happened in our view if the December CPI print had even slightly exceeded expectations – stalled. Yet, **this is hardly a complete erasure of the market's newfound concerns.** Forward contracts are still not fully pricing the Fed's own dot plot (consistent with two cuts in 2025), expecting only 37 basis points (bps) of cuts by December 2025. This is better than the "one cut and they are done" expectations from the beginning of the week, and the shift to "no cut at all" from some sell-side shops, but the level by year-end would still be firmly in restrictive territory. We find it interesting that the market has not moved that much despite some fairly dovish comments from Federal Open Market Committee (FOMC) members, such as Christopher Waller, who have often proved to be good guide to the Federal Reserve (Fed)'s policy. This may be that while the headlines on Bloomberg were encouraging – "fresh rate cut<u>s</u> possible in first half of 2024" (we highlight the "s" to "cuts"), his comments were conditional: this would happen "*if we continue to get inflation prints like this"*.

For our part, we discussed last week how we were maintaining one cut in 2025 as baseline, probably in March, with a low level of confidence. Our level of confidence is now higher, but we continue to think it will be difficult for the Fed to go much further than this, at least until the adverse effects of Trumpnomics materialise, while some of the policy announcements from the new administration could make the FOMC think twice about resuming swift restriction removal. While some of Scott Bessent's messages at his confirmation hearing were reassuring – notably on his respect of the Fed's independence, Donald Trump's pick for "border tsar" has announced that arrests of undocumented immigrants would start the day after the new President's inauguration. While the impact of reducing immigration on inflation will take time to show up, the vigour of implementation could still be a first indication of Trumpnomics "transformation rate".

The British government is also benefiting from a welcome respite. The yield on 10-year gilts fell back to 4.66% – virtually on par with the US – last Friday, from a high at 4.90% on 13 January. There as well the December inflation print was the immediate cause of the market's relief trade: headline CPI fell to 2.5% year-on-year from 2.6% and the crucial services component dipped nicely from 5.0% to 4.4%, giving more weight to the Bank of England's signal of 4 rate cuts in 2025 – which is also our baseline. Swift monetary restriction removal is in order in the UK. We argued last week that the mediocrity of the real economy would incentivise the central bank to ease. The November estimate for monthly GDP has strengthened our view: GDP rebounded by a meagre 0.1%mom, below market expectations of 0.2%, following two months of contraction. It is a volatile series – see Exhibit 3 – but without a decent performance in December, GDP could contract over Q4, after stagnating in Q3.

Exhibit 3 – Sustained stagnation?



Source: Office of National Statistics and AXA IM Research, January 2025

This is a bittersweet relief for the British government. The bond market pressure abating gives them a bit of air, but yields remain significantly higher than in the Office for Budget Responsibility (OBR) forecasts, and the 2% GDP growth target looks even more elusive. This means that the Chancellor will still face a very complicated equation when presenting the new fiscal outlook in March, with a much-diminished discretionary room for manoeuvre. If Rachel Reeves opts for spending cuts – which on balance, we think is the likeliest – then bond market pressure will abate even more but at a dear price for GDP growth. The good news for the British equity market is that the constituents of its main index are much more sensitive to the global cycle than to the gyrations in purely British demand.

Tariffs and current account rebalancing

While the world is breathing a sigh of relief on the inflation front, we can revert back to finer points of economic analysis which may seem arcane – **can tariffs be the right tool to deal with excess consumptio**n – but may be more topical than usual as Donald Trump is being sworn in.

A short article by Professor Michael Pettis – a well-known China-based American economist – last month in Foreign Affairs (see the link here) made a point which, to our knowledge, is seldom made when discussing the Sino-American trade war: **if one considers that, deep down, the US chronic current account deficit is the reflection of structural excessive consumption, then precisely because they are ultimately paid by US consumers, tariffs may be an acceptable rebalancing tool**. He contrasted the current trade war with the infamous Smoots-Hartley tariff of 1930, which prolonged the Depression by taxing US consumers at a time when their expenditure was already too weak to absorb domestic production. Pettis argues that in the current "overheating" context of the US economy, tariffs could lift overall GDP – on top of lowering the share of consumption in GDP – since the higher pressure on domestic capacity stemming from "displaced consumption" away from imports could lift investment and output.

Conversely, C**hina's chronic current surplus is the product of a structural consumption deficit. This would imply that Beijing should not respond to US tariffs by raising its own,** since it would further depress consumer spending. A point which Pettis does not make but would logically ensue from his view is that the European Union (EU) – another chronic surplus region – should not retaliate. Ultimately, if one follows Professor Pettis to its natural conclusion, unilateral tariff hikes in the US would be a way to deal with global imbalances.

This gets us back to the early 2000s, when economists across the world were worried about a possibly painful correction of the US ballooning current account deficit. A massive devaluation of the US dollar was an option. Tariffs do not have exactly the same effect as a currency depreciation – they do not make exports more competitive and can even make them less competitive if other countries retaliate – but they still direct more spending towards domestic producers, away from imports. The overall effect is likely to be inflationary – precisely because more spending will go to domestic sectors which are in many cases less efficient than overseas suppliers, or already producing at full capacity – but this would be an acceptable cost to rebalance the economy. It would not necessarily be more painful than alternatives, such as engaging in restrictive fiscal and monetary policy as the US was constantly – and predictably fruitlessly – asked to do by foreign observers in the early 2000s.

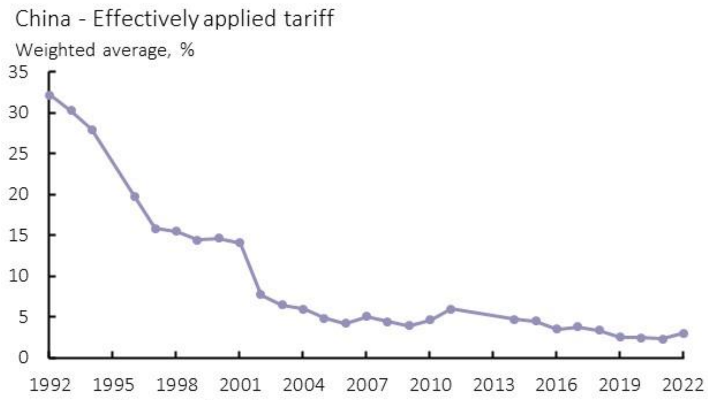
Maybe not more painful, but still painful, and we think Professor Pettis is looking at the whole situation with pink-tinted glasses. Tariffs do not offer a free lunch, and they are not a socially neutral policy tool. We could think of tariffs as a big VAT hike: it raises prices in a proportional manner, for everyone, irrespective of where they stand on the income ladder. It may not be by complete chance that the decline in the share of custom duties in total government income – which in the US was well above 50% in the 19th century – coincided with the rise in progressive income tax. This can help to explain why the conservative camp in the US is now tolerant of tariffs: this is equivalent to a "flat tax". Pettis also conveniently ignores the long-term adverse effect of protectionism on productivity, by favouring domestic players underperforming the global efficiency benchmarks.

Now, **the damage goes beyond equality and long-term productivity concerns**. Just like currency depreciations tend to be repeated, the effect of tariffs on the current account can be short-lived: inflation goes faster than in the rest of the world (if there is no retaliation) which erodes competitiveness and, down the road, the current account starts deteriorating again. Besides, other countries can allow their currency to depreciate, which would add to the pressure on exporters. The risk then is that a country could not easily resort to one isolated tariff hike, and just like with "competitive devaluations", would be forced into regular "top-ups" to the new tariff level.

Another issue is how such a "rebalancing" tariff could operate if it is not articulated with the whole policy stance. A tariff might be a substitute for a fiscal tightening, but if it is accompanied by fiscal loosening – as could be the case this year – then the net effect on the current account may be zero or turn negative if the consumption stimulus is larger than the adverse effect of tariffs on households' purchasing power. Scott Bessent, Donald Trump's pick for Treasury Secretary, insisted on the necessity to prolong the 2017 tax cuts to avoid "an economic calamity". Most of these cuts went to those at the top end of the income ladder, so the direct effect on consumption – and ultimately inflation – is likely to be weak but this is not the case of another aspect of Trump's fiscal plan: the exemption of social security pensions from income tax.

Yet, for all its limits, the paper by Pettis is a reminder that the macroeconomic impact of tariffs cannot be analysed in isolation. **His argument on the counter-productive effects of retaliating for regions plagued by a deficit of demand is precious** – readers familiar with Macrocast will know that this has been our position as well. Tactically, if the US trade war is an opening gambit for negotiations with partners, it is understandable that the threat of retaliation should be used, but if this were the endgame, this would make the whole sequence even more of a negative-sum game. China has been reducing the overall level of tariffs since it has joined the World Trade Organization (WTO). Critics will argue – with more than some evidence – that this is offset by non-tariff barriers, but as Exhibit 4 suggests, a reversal may be underway, even if the rebound in the last available year (2022) is small. More retaliation would erase much of the progress.

Exhibit 4 – Progress in jeopardy?



Source: World Integrated Trade Solution and AXA IM Research, January 2025

A plan for Germany

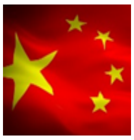
It's with these limitations of a simplistic understanding of tariffs in mind that we read **the very timely paper by Brad Setser and Sander Tortoir for the Centre for European Reform** (see link here) providing a roadmap for Germany in its response to Chinese competition. Their main point is that Germany has only recently – or at least later than other countries – felt the brunt of the emergence of China. Indeed, the first Chinese expansion on export markets focused on sectors – e.g., low-value added electronics and consumer goods in general – which were far from Germany's trade specialisation, while the ensuing massive capex need in China, coupled with the emergence of a wealthy class of entrepreneurs, triggered strong demand for German products. For years, while the US and a growing number of EU member states were calling for a more muscular approach, Berlin could afford to choose benign neglect.

According to Setser and Tortoir, the political "reflexes" acquired then – standing in the way of any European protectionist temptation against Chinese products become however counter-productive in the second wave of export emergence, when industries where Germany excels came under direct competition from China. The authors do not limit themselves to the often-discussed car industry. They also point to industries contributing to the green transition as another sector where Germany is increasingly facing direct Chinese competition. They suggest that **traditional crisis mitigation tools deployed in Germany will not work in the face of a structural shift.** Germany has developed a generous system of "Kurzarbeit" under which the government takes in charge a significant share of employees' pay in times of low activity while maintaining the existing contract with the employer. This would in effect slow down the transition of workers from sectors under threat to more protected industries. A more offensive approach would be needed.

The authors try to distance themselves from all out protectionism by insisting on the fact China does not comply with the rules of the game, so that countervailing duties, offsetting state subsidies in the exporting country, are acceptable under WTO rules, for instance the granular tariffs levied by the EU on Chinese Electric Vehicle (EV) producers, which the German government unsuccessfully opposed. Basically, what Setser and Tortoir advocate is an alignment on a more "French" approach to international trade issues. They make the interesting point that traditional "free traders" such as Denmark and the Netherlands have already made this choice. Germany is increasingly isolated.

We sympathise with Setser and Tortoir's arguments, but we would add that politically a delicate balance would need to be maintained between a specific, WTO-compliant rollback approach to China, and the temptation to gradually extend this to international trade in general. We would also add that such strategy would need to be coupled with some fiscal loosening by Berlin, so that Germany makes gradual progress towards a more balanced economic model, less reliant on exports.

This would remain a tough game to play though. While the EU could offer to Washington DC the possibility of a united front against Chinese trade, we do not know at this stage if the Trump administration would accept to treat Europeans more favourably in exchange for such alignment. Tariffs often appear in D. Trump's communication as a "Swiss knife" policy tool, not just as a way to contain China. German policy circles could choose to focus on a double jeopardy risk: losing much of their remaining market access to China in case Beijing retaliates, while facing at the same time more trade barriers in the US. Yet, another benefit of the "rollback", which the authors do not mention, is that this would further solidify monetary union. Indeed, beyond the fact that trade policy is squarely an EU competence, a lesser reliance on the Chinese market could also convince German businesses that, even if the growth potential there is not stellar, European markets remain crucial to Germany, and the last thing its exporters need right now, is a collapse in European demand, or doubts as to the solidity of the Euro.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• 10-yr USTs reverse <4.60% from 4.80% in part reflecting data, in part seasonality • Tsy Sec confirmation hearings – Bessent reassured 'safe hands' with few commitments • CPI (Dec) headline rose to 2.9% from 2.7%, core dipped to 3.2% (3.3%) below expectations • PPI (Dec) 3.3% vs 3.5% expct'd, suggests soft PCE • Philly Fed idx (Jan) 44.3 - biggest gain since 2020	• Inauguration day. A round of Executive Orders expected to follow return of Trump, inc on tariffs, migration and regulation • PMIs (Jan,p) both watched with marked volatility in other mfg indices, but persistent strength in services • Weekly jobless report, initial claims remain low, continuing claims easing back • Philly Fed (services) ind (Jan) any echo of mfg gain
	• Eurozone IP (Nov) stays at weak level (-1.9%yoy) • French PM survived a motion of confidence by promising some measures to the socialist party. Budget adoption is not a done deal yet • Latest polls in Ge see only four parties entering the parliament: CDU/CSU (31%), SPD (15%), Greens (11%) and AFD (18%) • Ge flash 2024 annual GDP growth estimated at -0.2%, deficit at 2.6% of GDP	• ZEW (Ge), Business climate (Fr), consumer confidence flash (EMU) and PMIs (Ge, Fr, EMU) to provide a first signal for 2025
	• CPI inflation (Dec) fell to 2.5%, from 2.6%; services fell to 4.4%, from 5% • RICS house prices (Dec) rose to a 2yr high of 28 • Monthly GDP (Nov) rose by 0.1%mom, below expectations for a 0.2%mom rise • Retail sales (Dec) fell by 0.3%mom, below expectations for a 0.4% rise	• Labour market (Nov/Dec) should broadly show looser conditions • Public finances (Dec) look for further overshoot of the OBR forecasts • GfK cons conf (Jan) to remain subdued • Flash PMIs (Jan) look for any weakness in services
	• Eco watchers Survey (Dec) outlook balance fell to 48.8, from 49.4 • PPI (Dec) rose by 0.3%mom, in line with expectations • Reuters Tankan (Jan) rose to +2, from -1	• IP (Nov) looks set to fall after 2.8%mom jump in Oct. • Exports (Dec) likely will rise on weaker yen • Inflation (Dec) looks set to tick up to 3%, from 2.9% • BOJ (Jan) we look for a 25bp hike to 0.5% • Flash PMIs (Jan) looks set to tick up
	• Exports up by 10.7% on robust external demand in Dec; imports up 1% in Dec (Nov: 6.7%, -3.9%) • Q4 GDP grew 5.4%yoy (Q3: 4.6%). 2024 GDP rose 5%, achieving target • Industrial production up 6.2%yoy in Dec (Nov: 5.4%); Retail sales up 3.7% in Dec (Nov: 3%); Property price declined -5.3%yoy (Nov: -5.7%)	• LPR 1Y and 5Y decision for January, likely unchanged at 3.1% and 3.6% respectively
	• CB: Poland (5.75%), Romania (6.5%) and South Korea (3%) on hold, Indonesia 25bp cut to 5.75% • CPI (Dec): Argentina (2.7%mom), Czech Republic (3%yoy), Hungary (4.6%yoy), India (5.2%yoy), Poland (4.7%yoy), Romania (5.1%yoy) • Industrial production (Nov): Malaysia (3.5%yoy)	• CB: Malaysia (3%) on hold, Turkey 250bp cut to 45% • CPI (Dec): Malaysia, Singapore, South Africa • Industrial production (Dec): Poland, Singapore, Taiwan • GDP (Q4): South Korea, Taiwan • Economic Activity Index (Nov): Argentina, Colombia, Mexico

Upcoming events	US:	Mon: Presidential inauguration; Thu: Initial jobless claims (w/e 18 Jan); Fri: Mfg, services & composite PMI (Jan, p), Michigan consumer sentiment & inflation expectations (Jan), Existing home sales (Dec)
	Euro Area:	Mon: Ge PPI (Dec); Tue: Ge ZEW surveys: current situation & economic expectations (Jan); Thu: Fr Insee mfg confidence (Jan), Ez consumer confidence (Jan, p); Fri: Fr, Ge & Ez mfg & services PMI (Jan, p), Ez composite PMI (Jan, p)
	UK:	Tue: Unemp (ILO) (Nov), Avg earnings (Nov); Wed: PSNB ex-banking groups (Dec); Fri: GfK consumer confidence (Jan), Composite, mfg & services PMI (Jan, p)
	Japan:	Thu: CPI (Dec); Fri: Mfg PMI (Jan. p), BoJ announcement
	China:	Mon: PBOC announcement (Loan prime rate)

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