AXA Investment Managers

182 – 29 May 2023

Investment Institute Macroeconomics

Easy Does It?

- A deal has been struck to extend the debt ceiling at the cost of only a very manageable austerity turn.
- Germany's recession may look "technical" for now, but the tipping point for the labour market may not be far.

President Biden and House Speaker McCarthy have struck a deal to extend the debt ceiling by 2 years, in exchange for an austerity turn which looks quite manageable. Details were still missing as of Sunday night, but it seems that federal spending could be cut by only 0.3% of GDP in 2024 relative to the CBO's baseline. From a medium-term growth point of view, a key element is that the deal leaves the IRA untouched. The Democrats will have to stomach a limited extension of the obligation to work for some recipients of federal aid and a cut to the additional resources allocated to the Internal Revenue Service (IRS) to fight tax avoidance. Unsurprisingly, both parties will have to make do without their respective extreme wings to get this through the line. The timeline is tight, even with the "X date" pushed to 5 June, and we can expect some tense episodes, but Biden and McCarthy probably have the numbers to get it through Congress this week. We note however that the whole debate has focused on a very small fraction of US federal spending. The long-term drift in US public finances remains unaddressed.

The fiscal ramifications of this deal, if confirmed, are unlikely to move the Fed's macroeconomic outlook. The FOMC will however relish the prospect of not having to reverse course – even temporarily – on Quantitative Tightening (QT) to deal with a failure to agree, even if a catch-up in issuance may trigger some liquidity tension in the short run. Some recent data have put the "pause in June" scenario in doubt. We agree it's a close call, but some of the positive surprises, such as some signs of rebound of the housing market, look unsustainable. We still think the peak in policy rates has already been hit, even if some further moderation in the payroll data this week would help cement the pause.

Meanwhile, Germany is in recession. The German public may be forgiven for having failed to notice, since the labour market has, at first glance, remained impervious to the downturn. We argue however that the tipping point may not be so far away. More awareness of the deterioration in economic conditions would actually be welcome, as it could tilt the unions towards resuming their "jobs first, wages second" approach and help to tame inflation.

Towards a manageable debt ceiling deal

President Biden and House Leader Kevin McCarthy cut a deal which would extend the debt ceiling for two years – i.e., until after the next elections - on Saturday night. While everyone's baseline was that an agreement would be reached, given the potentially dramatic consequences of hitting the "X date", focus had shifted to the macroeconomic consequences of the fiscal concessions which the White House would have to offer to seal the deal. While there remain many missing details in the information we have at the time of writing on Sunday night European time– the United States (US) process is particularly cumbersome and we would wait for the Congressional Budget Office (CBO) assessment to get a full picture **– it seems the amount of fiscal retrenchment directly attributable to the deal is going to be minimal, likely to cause only a minor dent in the US growth trajectory for next year**.

The full content of the deal was still not available at the time of writing this note on Sunday night European time. Assuming what is finally passed through Congress – more on this later – is consistent with the overall sketch-out of the agreement which has been filtering through the press on Sunday, only non-defence discretionary spending would be submitted to a freeze in 2024. This is less restrictive than what had been aired last week about a freeze on the *entirety* of discretionary spending with a protection on defence, which would have mechanically forced significant cuts in non-defence items. We can use the latest long-term fiscal projections of the CBO (released last February) as a benchmark to work out some numbers: **keeping nominal non-defence expenditure at its planned 2023 level would result in a "real" cut of 0.3% of GDP in 2024.** If we assume a multiplier level of 0.7, this would reduce the GDP growth trajectory by only 0.2% next year relative to baseline. This would be quite manageable when compared with the 1.2% GDP growth rate for 2024 in the Federal Reserve's forecasts of March, although less comfortable when compared with our own forecast (0.5%). It seems the 2024 freeze would be followed by a cap of 1% to non-defence discretionary spending growth in 2025. Using again the CBO framework, this would result in a real spending cut of 0.45% of GDP relative to baseline, possibly impairing GDP growth by c.0.3%.

Note however that the deal seems to confirm that, irrespective of whether the Supreme Court will ultimately find the student loan relief mechanism pushed by Biden legit, loan repayments – which had been suspended during the pandemic – will resume later this year. This affects 45 million Americans, with monthly payments of between 200 and 300 dollars according to the Federal Reserve (Fed). This would probably have happened anyway, as part of the general post-pandemic normalization, but its combination with the debt ceiling drama may intensify the public perception of an austerity turn.

It could have been much, much worse. The initial starting position of the Republicans in this negotiation was very tough. A bill they passed in the House at the end of April (the Limit, Save, Grow Act) – albeit with no chance of being approved by the Senate – was estimated by the CBO as reducing federal spending by a sweeping 1.6% of GDP in 2023 already. This would have in all likelihood triggered a very significant recession in the US.

So, what happened? **There were three different "cursors" on which the two parties were going to play in this negotiation, two having to do with "ideological purity", one with purely economic growth considerations**. Let's start with "ideological purity" on fiscal policy. It's of course a caricature, but by and large Democrats are "pro-spending", and Republicans are "anti-spending". So, from this point of view, this rather "minimalist" deal comes across as a relative gain for the Democrats and the most conservative wing of the Republican caucus is already voicing their concerns. Now, when it comes to "ideological purity" in social affairs, Republicans have won the extension of the minimum work contribution from the recipients of the federal food aid. This comes with a measure of carveouts obtained by Biden, but this is likely to irk the most progressive wing of the Democrats. In the same vein, the Republicans have managed to impose a limited rollback on the extra funding the Internal Revenue Service (IRS) was going to receive to fight tax avoidance.

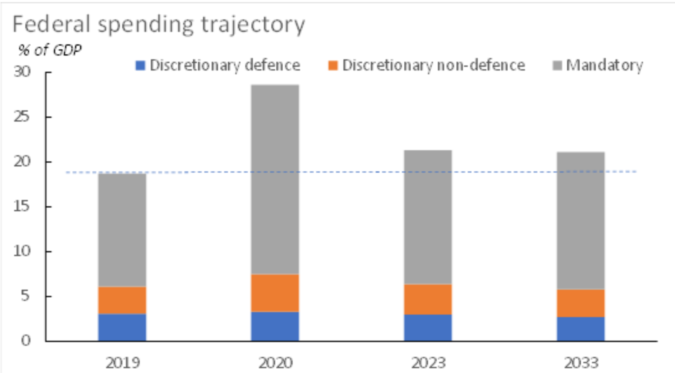
Finally, on short-term economic growth, the calculations of the Republicans were not obvious. Indeed, forcing more spending cuts to the point of tilting the economy into a recession next year could have been tempting for the Republican leadership since it would have significantly harmed Biden's chances at re-election. McCarthy may have however taken on board three points: one, that this would have meant crossing a red line for the White House, with a clear risk of failure to agree, since the cost in terms of immediate GDP loss of a deferment of non-interest payments in a no deal configuration relative to the cost of accepting large cuts would have diminished. Second, a Republican presidential platform heavy on spending cuts would have less chance to convince public opinion next year if people were already faced with the consequences of an actual dollop of deep fiscal austerity before the elections. Third, McCarthy may have concluded that in any case his extreme wing, the "freedom caucus", would have rejected almost any deal with Biden. His only chance to avoid a default then lies in cutting a deal which would be palatable to enough Democrats in the House to get it through the line.

But beyond these immediate considerations, what we find very positive in this deal is that **the Inflation Reduction Act (IRA) has been kept outside the scope of the debate. What is probably the most encouraging piece of legislation in the US in decades for potential growth is an object of consensus**. True, to protect the IRA it seems that Biden has had to accept some streamlining of the permitting process for energy projects – this is supported in the Senate by moderate Democrat J. Manchin – which would probably favour the fossil fuel industry. But the bulk of the push towards greening the US economy has seemingly survived the debt ceiling test. Also, in the field of structural issues, the push "from welfare to workfare" might on the margin help reduce the pressure on the US labour market which has been operating under severe supply constraints – the impact is likely to be limited though. Today, childless, able-bodied recipients of food stamps above the age of 49 must work at least 20 hours a week. This would be pushed to the age of 54. It's a political signal, not a structural transformation of the system.

Biden and McCarthy must now get the deal through Congress, and they are likely to lose their respective most extreme wings in the process. Kevin McCarthy announced he would give the House 72 hours to look into the deal, which would be consistent with a vote on Wednesday night. The "Freedom caucus" is likely to oppose it. They control around 40 votes, more than the Republican majority of 9 seats. On the Democrats' side, support from the 100 members of the progressive caucus is unlikely, but on paper at least that leaves enough votes to get the deal through (the House has 435 seats). On Sunday some moderate Democrats were already voicing their support.

Then the Senate must vote the House's text on the same terms. The Democrats are in control there, which should make things relatively swift, even if some "rear-guard action" by some hard-line Republicans will try to slow down the process. The fact that the "X date" has been pushed to 5 June gives just a tiny bit of flexibility. The very fact that the draft legislation takes so much time to be released probably indicates that both parties want to be sure to maximise support before dotting all the "I"s. An important point to check in the deal when the final text is available is whether it includes a rule which would automatically reduce spending – including defence programmes – if Congress fails to pass a budget later this year. This would be an "anti-government shutdown clause" (Republicans would probably balk at reducing the resources of the Defence sector). Some press reports mentioned such inclusion, as a key request from Biden to avoid being dragged into yet another fiscal face-off this year, but not all of them. This would be an important win for the Democrats.

Exhibit 1 – No planned return to pre-pandemic spending



Source: CBO, AXA IM Research, May 2023

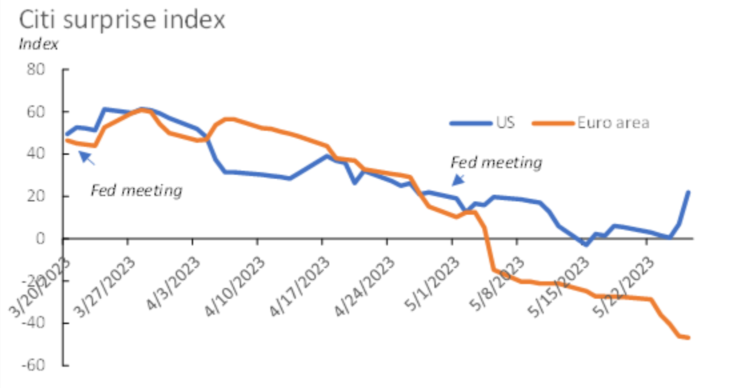
Now, if we take a bit of distance from the intense politicking and the immediate danger of a default, or a growth-stunting deferment in non-interest payments, a crucial issue in our view is that **all these discussions are zeroing in on a very small fraction of the US budget, which can't deal with the – daunting – challenges facing public finances**. In 2022, discretionary spending stood at a grand total of 6.4% of GDP. Since there is a bi-partisan agreement to leave defence spending outside the fiscal debate, what is left in the "discretionary bucket" amounts to only 3.5% of GDP. "Mandatory spending" stands today at 15.9% of GDP. **The current 10-year projections of the CBO suggest that by 2033, total federal spending would stand at 21.2% of GDP, still 2.3 percentage points above the pre-pandemic level.** The entirety of this "fiscal drift" would be attributable to the rise in mandatory expenditure, in a no-policy change scenario, reflecting the gradual impact of population ageing (see Exhibit 1). The "real debate" in the US should focus on how to reform these programmes to make them sustainable despite the demographic pressure, or on how tax receipts should be brought to a level consistent with the US desired level of social protection – if reducing the weight of these programmes is seen as politically undoable by both parties. We are clearly not there.

Is the Fed feeling that comfortable?

Assuming – as we do – that Congress passes the deal negotiated this weekend, the Federal Reserve would in principle find itself in a more comfortable position. As we discussed last week, crossing the "X date" would probably have made it necessary for the central bank to intervene – or at least to make it plain it was ready to intervene – to make sure the federal government would retain market access, suspending quantitative tightening temporarily. Given the manageable impact on GDP the deal would likely trigger, the Fed won't have to radically review its projections. While a rebound in federal issuance – to bring the Treasury's account in a more comfortable cash position – could trigger some temporary liquidity tension on the market, **the Federal Open Market Committee (FOMC) can on substance move back to a "business as usual" operating mode. The key question is whether the Fed's assessment on 1 May, consistent with a pause, remains the most likely "business as usual" trajectory.**

The minutes of the May FOMC meeting released last week made it plain that the participants, while having taken on board the mediocre GDP print in Q1 and the impact the tightening in lending conditions is likely to have on growth and inflation, want to "retain optionality" on the next moves. **On the basis of the minutes alone, a pause in June – our baseline – looks like the "natural slope"** since only *"some participants"* considered that a further tightening *"would likely be appropriate*" while "*several participants*" stated that this would not be necessary (assuming "several" - is higher than "some"). It's a fine line though and even those in favour of a pause make it explicitly conditional on the economy continuing to perform in line with their outlooks. This makes the ongoing dataflow crucial. While the FOMC members' outlooks may be different from the market consensus, it may be instructive to look at how data releases have been faring relative to expectations lately (see Exhibit 2).

Exhibit 2 – "Surprise, surprise"

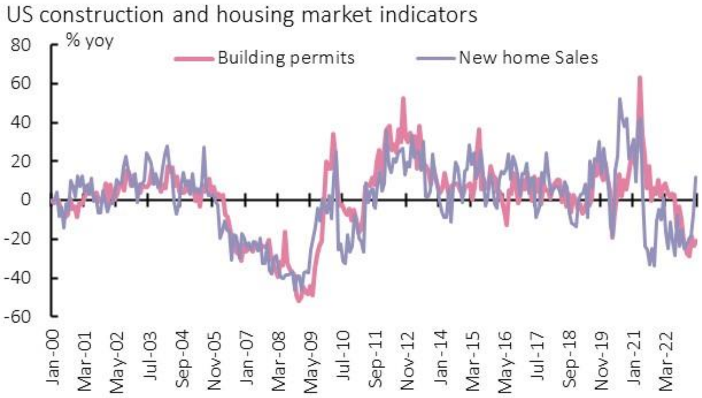


Source: Citibank, Macrobond, AXA IM Research, May 2023

The Citigroup's surprise index has continued to be in positive territory in the US– i.e., actual data releases have painted a more positive picture of the economy than what the market was expecting – in contrast with the Euro area, but the gap had been regularly narrowing since the March FOMC meeting. The very latest batch however has pointed to the re-emergence of positive surprises.

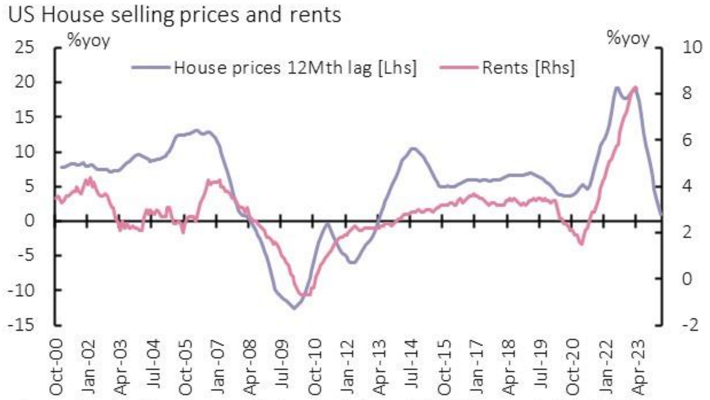
One area of specific interest, in our view, should be the housing market. Indeed, an unexpected rebound in new home sales took place in April (see Exhibit 3). Historically, they have been in synch with building permits, and lately they have been signalling a steep decline in activity in housing, close to the lows seen during the Great Financial Crisis of 2008-2009. The continuation of the correction in housing is key to the Fed' strategy. Indeed, recently the central bank has been focusing on the "services excluding rents" inflation indicators since they can provide a more forward-looking signal than core inflation as a whole, given the long time it takes for a decline in house selling prices to filter through rents – the "best fit "can be had with a 12-month lag (see Exhibit 4).

Exhibit 3 – Rare sales/permits divergence in April



Source: Census Bureau and AXA IM Research, May 2023

Exhibit 4 – Waiting for rents to respond – they are always slow



Source: Freddie Mac, Bureau of Labor Statistics and AXA IM Research, May 2023

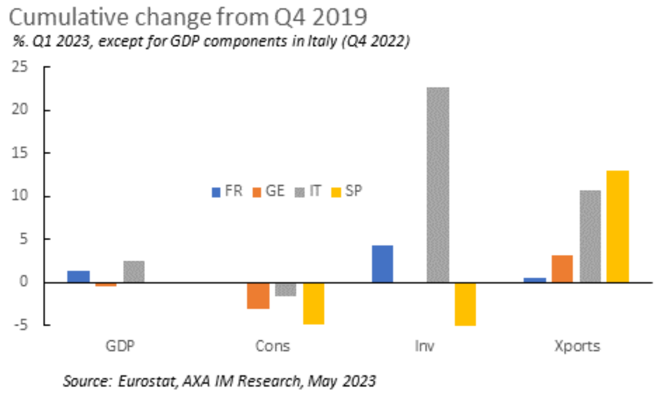
If the housing market is no longer correcting, then the mechanics of the core inflation landing would be jeopardized. We are very much tempted to treat the rebound in new home sales as a statistical accident. Indeed, mortgage rates are still hovering around 7% which is positive in real terms even when looking at realized inflation, and very much into positive territory when considering consumers' long term inflation expectations (only a touch above 3% according to the latest Michigan University survey). The downward pressure on housing remains significant enough to trigger the right deceleration in rents in due time. Yet, since the Fed has taken a forward-looking "gamble" when hinting at a pause in June, FOMC members could be forgiven to be jumpy when data goes the other way. This makes this Friday's payroll release key to cement – or further jeopardize – the notion that the Fed's tightening is "done".

Germany in recession

In the Euro area the dataflow, lately, has been less difficult to read, with the surprise index ploughing further into negative territory. Given the disappointing dataflow for March which materialised after the first estimate's flat reading, we were expecting a downward revision in Q1 GDP in Germany. It materialised and it was deeper than we thought, at -0.3%qoq. **By the definition usually retained in Europe, the biggest economy of the Euro area is in recession** (two consecutive quarters of contraction). The cumulative loss since Q4 (-0.8%) is of course smaller than what would have happened if energy rationing had been forced upon the country last winter, but it is still a weak result, coming after a quite mediocre performance since the post-pandemic recovery. Germany is, among the 4 biggest economies of the Euro area, the one with the smallest catch-up to the GDP level of Q4 2019.

There is not one single source of underperformance (see Figure 5). To summarize it in one sentence, **Germany did worse than France and Italy on consumption and investment (but better than Spain) and did worse than Italy and Spain on exports (but better than France).** It thus appears that Germany is facing both domestic and external challenges.

Exhibit 5 – Breaking down GDP across the Euro area's "Big4"



It's tempting to explain away the strong investment growth in Italy to the New Generation programme. The rebound there began however before the Recovery and Resilience funds started to be disbursed. Immediately upon reopening from the lockdown capital expenditure rose very fast, reacting to the national incentives and the general confidence boom which coincided with Draghi's tenure as Prime Minister. Yet**, the biggest surprise may come from the fact that in the two Southern European countries, exports are now more than 10% above their Q4 2019 against only 3.2% in Germany** (France's underperformance is more in line with its own trends). This North/South gap emerged without any major divergence on export prices (see Exhibit 6). Germany may have been specifically hampered by supply-side shocks which weighed on some of its traditionally strong industries, such as car manufacturing (16% of total German exports before the pandemic struck). The number of passenger cars exported has only just caught up with the levels seen at the end of 2019 – which were already weak by historical standards (see Exhibit 7). Beyond the supply-line disruptions (e.g., issues with securing enough semi-conductors), difficulties with facing new local competitors – e.g., Chinese carmakers on the Electric Vehicles (EV) segment- are a cause for medium-term concern.

Exhibit 6 – Not a price competitiveness problem

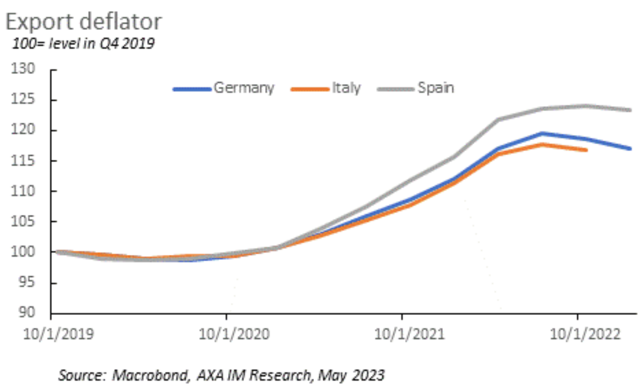
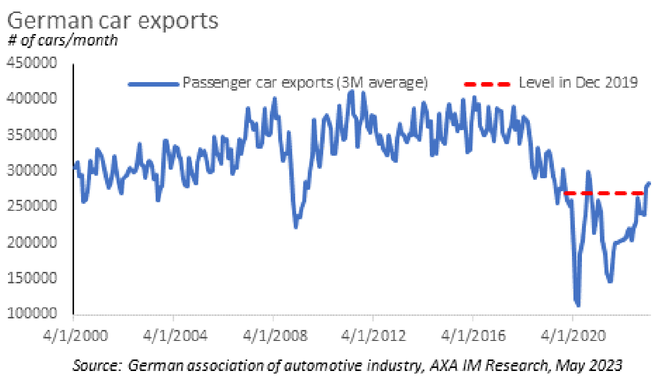
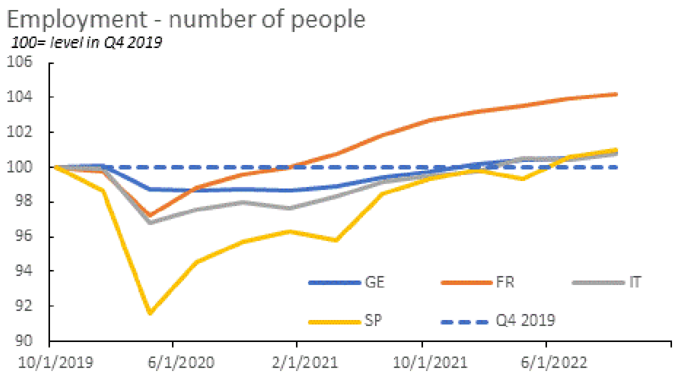


Exhibit 7 – A specific problem with cars



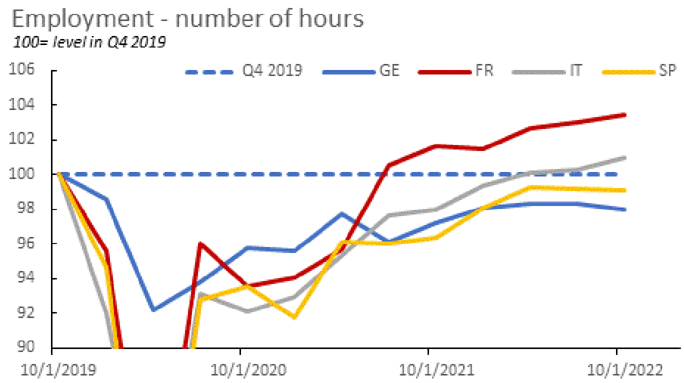
The consumption gap between France and Germany can be largely explained by the inflation differential (10.3% against 15.1% in cumulative terms since Q4 2019) and hence the purchasing power gap between the two countries. But **we also need to look at employment dynamics**. In terms of headcount, Germany has done roughly the same as the Southern European countries in bringing jobs marginally above their pre-pandemic level (see Exhibit 8), but France outperformed quite spectacularly. When focusing on hours worked in the economy however, Germany finds itself at the bottom of the distribution (see Exhibit 9), underperforming the two Southern countries, which suggests that the sense of "excess demand" in the German economy may be overstated. According to the German Federal Employment Agency, unfilled job vacancies hit a peak at 871K in May 2022. They have come down to 786K in April 2023, converging towards the 2019 average of 774K.

Exhibit 8 – Headcounts slightly above pre-pandemic level



Source: ECB, AXA IM Research, May 2023

Exhibit 9 – Hours worked still missing

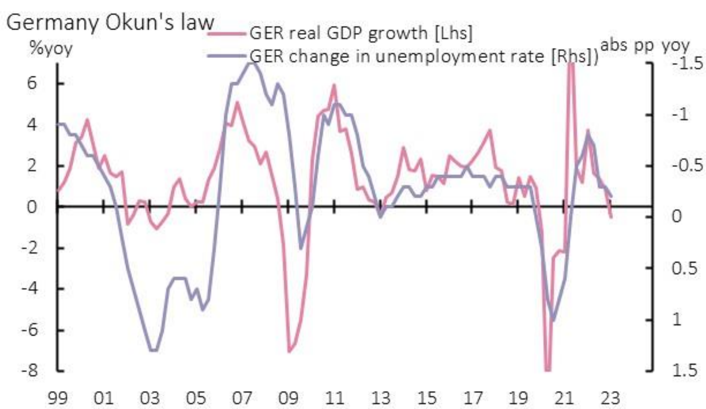


Source: ECB, AXA IM Research, May 2023

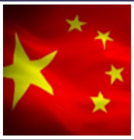
Yet, while Germany is in recession in the European sense of the word, it's likely that it would not – yet – satisfy the criteria the National Bureau of Economic Research (NBER) sets in the US to "declare a recession". A key ingredient missing is a much more tangible weakening of the labour market, materialised in a rise in unemployment, and the German public could be forgiven to ignore the GDP data. **But it's precisely some awareness of the deterioration of the economy which would be welcome in the current circumstances to tame wage negotiations and convince the unions to resume their old "jobs first, wage second" approach, thus contributing to the return of inflation towards the ECB target.**

We may not be that far however from the tipping point. Exhibit 10 provides the Okun's curve for Germany, i.e., the relationship between the change in GDP and the change in the unemployment rate (here in year-on-year terms). With GDP now in decline over one year in Q1 GDP, the unemployment rate may not be far from rising again, albeit from its currently extraordinarily low level (2.9% using the ILO compliant concept). True, the historical relationship is far from perfect. There seems to be an asymmetry at work: the peaks in unemployment look low relative to the troughs in GDP growth. We suspect this reflects the operation of fiscal stabilisers, such as the "Kurzarbeit" mechanisms triggered in times of cyclical storms. There is however very limited appetite at this stage to use the fiscal tools in policy circles in the present circumstances, the coalition being seemingly more focused on how additional savings may be needed to still deliver the significant fiscal retrenchment for 2024 we discussed next year. The European Central Bank (ECB) may soon get better signals – from a price stability point of view – from the Euro area's biggest economy.

Exhibit 10 – Unemployment soon to rise?



Source: Refinitiv and AXA IM Research, May 2023

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Debt ceiling debate predictably more difficult to nail down than optimism had suggested • FOMC minutes (May) "several" thought further hikes "may not be necessary" vs "some" that it would • GDP (Q1) revised up modestly to still soft 1.3% (saar) • PCE inflation (Apr) rose to 4.4% from 4.2% on firmer gasoline prices, core inflation rose to 4.7% • Personal spending (Apr) +0.8%, but smaller rise in real spending. We expect subdued 0.5% Q2, vs 3.7% Q1	• Debt ceiling resolution. Deal needed by early this week to allow legislative enactment by 1 June • Labour market releases (May). Expect payrolls growth to soften to around 150k, unemployment to rise to 3.5% and JOLTS vacancies to fall. Challenger job cuts and jobless claims also monitored • ISM mfg index (May), likely to remain soft • Vehicle sales (May) rose in April despite loan cost • Conf Bd Cons Conf (May), key guide to spending
	• Flash PMIs and national business surveys edged down in May. Bifurcation between manufacturing and services continue • Germany Q1 GDP was revised down to -0.3%qoq from 0.0%qoq indicating Germany did experience a technical recession during the winter, led by private consumption	• We project euro area "flash" headline HICP to drop 0.8pp to 6.2%yoy in May, while core would also fall but only 0.3pp to 5.3%yoy • European Commission business surveys for May • Eurozone M3 & bank lending for April
	• CPI inflation (Apr) declined to 8.7% as energy base effects drop out but core picked up sharply to 6.8% • PSNBx (Apr) up £25.6bn above market expectations • Sharp repricing of UK rates. 10-yr gilts rising to 4.37% and markets now see rates peaking around 5.5% • Retail sales (Apr) rebounded 0.5%mom following Mar drop and benefits uplift	• Nationwide House Prices (May) expected to rebound slightly following stabilised sentiment after seven consecutive declines • BoE household lending data (Apr) • BRC shop price index (May) • Fitch reviews UK credit rating (Fri)
	• Core machinery orders (Mar) down 3.9%mom • Flash PMIs (May) signal continued recovery in services (56.3) and pick up in manufacturing (50.8) • Reuters Tankan (May) showed sentiment on the rise • Tokyo CPI (May) signals strong momentum in inflation. Core CPI (ex-fresh food and energy) rose to 3.9%	• Labour market data (Apr) • Industrial output (Apr) expected to rise 1.5% • Retail sales (Apr) • Business capex (Q1) • Monetary Base (May)
	• 1Y loan prime rate unchanged at 3.65%	• NBS manufacturing and Caixin manufacturing PMI for month of May
	• CB: Korea (3.5%), Hungary (13.0%), Indonesia (5.75%), Turkey (8.5%) on hold. Hungary -100bp 1-day deposit rate to 16%. South Africa hiked +50bps to 8.5% • Korea's May first 20D export down (-16.1%yoy) • April CPI eased in Malaysia (3.3%) & South Africa (6.8%) & picked up in Singapore (5.7%) • Q1 GDP contracted 0.4%qoq (+0.4%yoy) in Singapore & Peru 1.1%qoq (-0.3%yoy)	• CB: Thailand (1.75%) expected to hike by 25bp • CPI (May): Poland, Korea, Brazil, Peru • Industrial production (April): Korea • Q1 23 GDP Korea, India, Turkey, Czech Republic, Poland, Hungary, Brazil • PMI (May) across regions • Turkey Presidential elections run-off

Upcoming events	US:	Tue: C-S house & FHFA price index (Mar), Conference Board consumer confidence (May); Wed: Chicago PMI (May), JOLTS (Apr), Fed's Beige Book; Thu: ADP employment chg (May), Weekly jobless claims (27 May), Non-farm productivity (Q1), ULCs (Q1), Manf PMI (May), ISM manf index (May); Fri: Non-farm payrolls (may), Unemp (May), Average earnings (May), Average weekly hours (May)
	Euro Area:	Tue: EU20 M3 (Apr), Business confidence (May), Sp HICP (May); Wed: EU20 ECB Financial Stability Review, Ge Unemployment (May), HICP & CPI (May), Fr & It GDP (Q1) & HICP (May); Thu: EU20 Manf PMI (May), CPI (May), Unemp (Apr), ECB Account of May meeting, Ge, Fr, It & Sp Manf PMI (May), It Unemp (Apr); Fri : Fr Ind prod (Apr)
	UK:	Tue: BRC shop price index (May); Thu : Mortgage approvals (Apr), Net mortgage lending (Apr), Consumer credit (Apr), M4 (Apr), Manf PMI (May); Fri : Fitch credit rating review
	Japan:	Tue: Unemployment (Apr); Wed: Ind. prod. (Apr), Consumer confidence (May); Thu: Capital spending (Q1)
	China:	Mon: Official manf & non-maf PMI (May); Thu: Caixin manf. PMI (May)

Our Research is available online: www.axa-im.com/investment-institute

About AXA Investment Managers

AXA Investment Managers (AXA IM) is a responsible asset manager, actively investing for the long-term to help its clients, its people and the world to prosper. Our high conviction approach enables us to uncover what we believe to be the best global investment opportunities across alternative and traditional asset classes, managing approximately €824 billion in assets as at the end of December 2022.

AXA IM is a leading investor in green, social and sustainable markets, managing €489 billion of ESG-integrated, sustainable and impact assets as at the end of December 2022. We are committed to reaching net zero greenhouse gas emissions by 2050 across all our assets, and integrating ESG principles into our business, from stock selection to our corporate actions and culture. Our goal is to provide clients with a true value responsible investment solution, while driving meaningful change for society and the environment.

At end of December 2022, AXA IM employs over 2,600 employees around the world, operates out of 24 offices across 18 countries and is part of the AXA Group, a worldwide leader in insurance and asset management.

Visit our website: http://www.axa-im.com
Follow us on Twitter: @AXAIM & @AXAIM_UK
Follow us on LinkedIn: https://www.linkedin.com/company/axa-investment-managers
Visit our media centre: www.axa-im.com/en/media-centre