Don’t read after dark!

- As expected, no forward guidance from the ECB.
- The Draghi report is not for the faint-hearted. The gap between what needs to be done and what is politically realistic is wide.
- It’s a close call, but we still expect the Fed to cut by 25bps “only” this week.

As expected, the ECB did not engage in any meaningful forward guidance beyond the rate cut it provided last week. We consider that keeping the list and characterisation of the downside risks to growth and upside risks to inflation largely unchanged relative to July could be easily challenged given the dataflow over the summer. This “steady boat” approach reflects in our view a difficulty to bridge disagreements across the Governing Council. In these circumstances, we are surprised to see that the market is still pricing 11bps worth of a cut in October. We stick to our guns and do not expect this before December. True, if the dataflow turns even more concerning – a distinct possibility in our view – the hawks at the Governing Council may have to “capitulate”, taking the ECB to a more decisive path. Yet, it seems to us that, as much as we think that, indeed, a clearer easing outlook is now warranted, the bar to get there remains high.

While the European short-term outlook does not look very promising, the same can be said about the long-term prospects according to the Draghi report released last week. This is not a reading for the faint-hearted – and not just because it stretches along 400 pages of compact macro. His point about the risk of a “slow death” of the EU is clearly intended as a wake-up call, but the report may add to a sense of helplessness by drawing attention to Europe’s difficulties with swift decision-making. The policy recommendations themselves make a lot of sense, but Europeans have known for a long time what needs to be done. The key issue is political appetite at the national level. In our view, the “European machinery” aspects are secondary.

While Europeans look to the US economic performance with envy, locally the focus of the policy debate is squarely on how to mitigate an impending slowdown. The market is hesitating between pricing 25 or 50bps for this Wednesday’s cut by the Fed. We still maintain our view the Fed will choose 25, even if it is close.

Que sera sera…

As we expected, **last Thursday Christine Lagarde refused to elaborate on the likely trajectory for the European Central Bank (ECB) beyond the widely expected second 25bp cut they delivered**, maintaining a "data dependence" mode encapsulated in her use of the quite fatalistic expression "que sera, sera…". The "crumbs" left for ECB watchers were sparse. Her answer to a question on whether the central bank would receive enough additional information by the October meeting – *"a short period of time relative with other intervals we've had in the past"* – combined with an insistence that data dependence is not "*dependence on data points*" was for us indicative of a **preference for waiting for another full set of forecasts, in December, before cutting again – as per our baseline.**

In general, **we detect no sign of elevated concern at the ECB over the state of the economy**. The downward revision to GDP growth in the new forecast was very limited (0.1% each year from 2024 to 2026). When looking into the details, we were surprised by the upward revision in the assumption for world GDP growth for 2025 and 2026 – thus helping to keep Euro area exports relatively healthy – given the recent news in the US and China. On the domestic side, we note that the ECB is now expecting a smaller quantum of fiscal tightening across 2025-2026 than in June, which we think is a difficult assumption to make since the budget plans in key member states (and not just France) have yet to be finalised.

At the same time, the inflation projection was left unchanged, despite a dampening impact from new technical assumptions (price of energy) since core inflation was revised slightly up. The latter point is surprising, as if the central bank has chosen not to alter its underlying view since the June forecasts despite the dataflow which brought good news on this front. Indeed, while the ECB duly took into account the deceleration in wages per head reflected in the Q2 data, revising them down by 0.3 percentage point for 2024, this was then partly offset by revising them *up* for 2025. The same happened to the projection for unit labour costs. In Exhibit 1, we "colour code" some of the main elements of the ECB's September forecast in comparison with June. A "mixed picture" emerges.

Exhibit 1 – The ECB did not bring forward the moment its inflation target is hit

ECB Macroeconomic Projection update September 2024 staff projections								
	Real GDP growth	Unemployment rate	HICP	HICP Core	Unit labour costs	Compensation per employee	Labour productivity	Unit profits
2023	0.5	6.5	5.4	4.9	6.2	5.3	-0.9	5.7
2024	0.8	6.5	2.5	2.9	4.5	4.5	0.0	0.2
2025	1.3	6.5	2.2	2.3	2.6	3.6	0.9	1.6
2026	1.5	6.5	1.9	2.0	2.1	3.2	1.1	1.6
Signal from last exercise		Hawkish	Dovish					

Source: ECB and AXA IM Research, September 2024

There is therefore no sense of urgency at the Governing Council, and this was reflected in the "balance of risks" in the prepared statement. The characterisation of the downsides to growth was left virtually unchanged from the July version, just like the neutral balance of risk on inflation. In such circumstances, we are surprised to see that the market is still pricing 11bps worth of a cut by October, and cumulatively 40bps by December. This may reflect a belief by market participants that with the dataflow turning even more concerning the hawks at the Governing Council will have to "capitulate", taking the ECB to a more decisive path. Yet, **as much as we think that, indeed, a clearer easing outlook is now warranted, it seems to us that the bar to get there remains high**.

The Grim Report

Christine Lagarde repeatedly praised the report on European competitiveness released by her predecessor Mario Draghi last week. For a central bank, any message which draws attention to the need of structural reforms to lift growth – away from short-term demand management and hence debating the monetary policy stance – is welcome. **Draghi's report provides a precise – and sombre – diagnostic of the current state of the European economy.** Draghi's statement on Europe losing ground and risking "a slow death" to quote him verbatim is backed by irrefutable data. The productivity gap with the US is widening, as well as the innovation gap. The EU fares badly on disruptive technologies, and its old grip on incremental innovation – i.e. improving existing products, e.g. in the car industry – is deteriorating. Over-regulation is rife. Moreover, Europe's long-held advantage on education quality is eroding, with Asia outperforming. This all combines into falling competitiveness. Finally, demographic dynamics are worse than in the US.

Such grim outlook calls for massive action – encapsulated in a call for a large investment effort – but paradoxically **Draghi's report runs the risk of drawing attention to Europe's difficulties with swift decision-making, adding to the send of gloom**. Indeed, on the side of policy recommendations, while the report has the benefit of compiling a lot of common-sense solutions, its impact may be blunted by (i) the impossibility to discuss national policies within its scope; (ii) the fact that it is coming after Letta's report; (iii) the internalised political limitations.

A number of key issues raised in the report are institutionally outside the scope of the European Union (EU). Education for instance is almost exclusively a national competence. The EU can of course improve its research framework (the report explores for instance a reform and extension of the Important Projects of Common European Interest) but this is action "at the end of the chain", which does not treat the root cause of the problem. The same holds for the report's recommendations on energy. The massive difference in electricity prices across the Atlantic is of course a key competitiveness hurdle, but **the report's recommendation to reform further the integrated European electricity market cannot deal with the key underlying issue: counter-productive political choices in key member states**, e.g. Germany's "Energiewende".

While the report rightly explores means to reduce the regulatory burden created by EU institutions, **a blind spot in the explanation of the gap with other large economic regions is the role of national regulations, e.g. on the labour market**. There is a well-established link in the academic literature between the flexibility of the labour market and the speed of implementation of innovation and ultimately productivity gains. A very interesting 2022 paper by the European Commission's Joint Research Centre (see link here) makes the point that there exists a strong complementarity between making labour regulation less stringent and raising higher education attainment in boosting productivity. Reforming the labour market, just like education, is the preserve of national governments. Conversely, **the focus on investment could reinforce the current "Zeitgeist", increasingly favourable to raising fiscal spending (despite the lack of room for manoeuvre in this field) and less and less interested in changing structures**. The last "big wave" of labour market reform in Europe came in the South – especially Spain and Portugal – during the sovereign crisis of the early 2010s. Since then, it seems that European governments have internalised the difficulty to sell any deep structural reform in this realm to public opinion.

The proposals in the financial sphere are similar to those put forward by Enrico Letta in his earlier report. **The points on fostering securitization in the EU – given the wide gap with the US – were already made. They make sense – shifting risk away from banks' balance sheet could incentive more lending –** and Draghi was more comprehensive in his analysis and recommendations. He calls for a reduction in prudential requirements, and the introduction of a first-loss government guarantees on some products. But these ideas have been floating in the European policy sphere since the sovereign crisis of 2011-2012, and the approach in our view misses a key reason why securitisation is so widespread in the US: the political choice to make long-term, fixed interest rates mortgages dominant. Indeed, the implicit government guarantee of mortgage- backed securities via Fannie Mae and Freddie Mac is there to promote fixed-term lending to households by banks. There is no political consensus in Europe around the type of mortgages which should be the norm (from fixed term in France to fully floating in Spain). There is some reverse engineering here: the EU would create a securitisation market "ex nihilo", while securitisation emerged in the US because there was an identifiable, politically consensual investment to fund.

In the same vein, changing regulation to promote infrastructure investment by insurance companies and pension funds were also laid out in the Letta report, as well as the shift to a single supervisor for the financial industry beyond the banking sector. The idea of skewing institutional investors' asset allocation has been floating in policy circles for years. **An issue here, when thinking about using capitalised pensions to bridge the investment gap with the US is that pension assets stand at only 32% of GDP in the EU, against 142% in the US**, and 62% of those holdings in Europe are located in only three countries (Netherlands, Denmark, Sweden) as per the report itself. A logical consequence is that to get any meaningful impact on "risky investment" a very significant share of the pension funds' assets would need to be shifted away from safer investments to the point that the security offered by those schemes to existing and future pensioners could be put in question. The alternative is to expand the overall size of pension funds, but ultimately this would get us back to national preferences: fostering the development of pillar 2 and 3 pensions usually entails reducing the generosity of PAYGO systems – households and businesses can hardly raise contributions to start the funds while maintaining the same level of support for existing PAYGO arrangements. This would be explosive in many member **states.**

Draghi's report highlights some of the institutional limits of the EU. **Commentators have often focused since the publication on his call for more "joint issuance" at the EU level, but it is only thinly sketched out in the report, internalising the opposition of key member state**s (Germany's Finance Minister Christian Lindner made his rejection very clear). In any case, some issues around the existing NGEU framework would need to be sorted out. Only roughly a third of the total financing capacity has been spent so far. This may be at least partly explained by the fact funding transits through national governments, instead of being allocated directly by the EU through a single point of selection and delivery – a key difference with the US IRA programme. This comes from the fact that Next Generation EU (**NGEU) was a hybrid project, with two objectives: beyond fostering more investment in digital and environmental projects, funding was distributed unevenly across member states to provide protection to the most fragile ones** (e.g. Italy). Such "equalisation" target can conflict with the goal of narrowing the productivity gap of the whole EU versus the rest of the world. The same applies to the "geo-return principle" which governs joint European programmes – such as Ariane (this guarantees European Space Agency (ESA) members that 85% of their contributions to programs will be returned in the form of contracts to companies located in those nations).

The report falls short of calling for a treaty change, probably taking on board the unfavourable political conditions in member states. However, what it calls for – using the full scope of the existing treaty to extend the qualified majority rules to more aspects of EU policymaking instead of unanimity and promoting "enhanced cooperation" i.e. "carveouts" within the EU, or even intergovernmental treaties, may not be much less daunting.

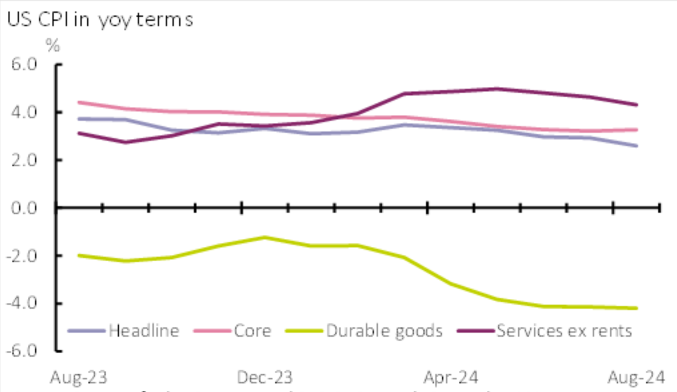
In conclusion, **the policy content of the report makes a lot of sense, but Europeans have known for a long time what needs to be done. The key issue is political appetite at the national level**. In our view, the "European machinery" aspects are secondary. Within the package, what may be realistically achievable is what is the most technocratic and least obviously controversial from a domestic political point of view, e.g. capital market union. Still, the projects with the most obvious direct impact on investment – additional joint funding in a streamlined distribution framework – would need much maturation by national public opinions. Historically, this has been do-able only in times of "overt crisis", e.g. in 2011-2012 when the very existence of the monetary union was under threat. In a "boiling frog" configuration, which probably best describes our current situation, this is probably out of reach.

Calibration issues

While Europe is obsessing – rightly in our view – about its widening gap with the US, over there it seems that the focus is squarely on the downside risks to the outlook even in the absence of a "smoking gun" in the data flow. The Atlanta Fed nowcast sees GDP growth in Q3 at a still more than decent 2.5%, yet the only issue now for the market is whether the Federal Reserve (Fed) will opt to open the easing cycle with a "bang" (cutting by 50bps) or more prudently with a run-of-the-mill 25bps (our baseline). As of Friday night, market participants were evenly split, forward contracts pricing in 37bps of cuts for this week as of last Friday.

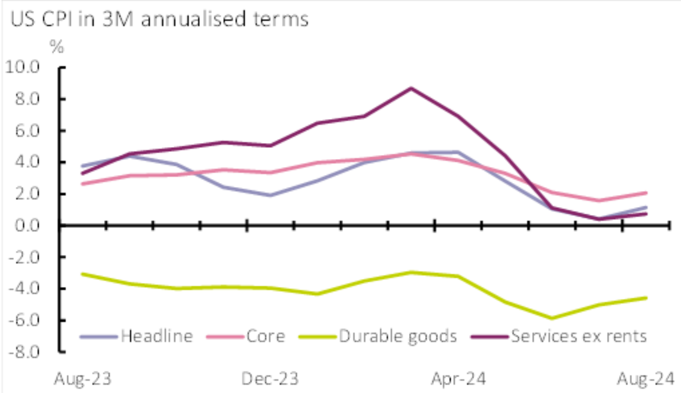
For our part, **we find some additional reasons in last week's data flow to stick to our 25bps (close) call**. Indeed, while the headwinds on the real side of the economy still seem quite contained in our view, risks of inflation undershooting remain limited. Headline inflation came out as expected at 2.5%yoy in August, down from 2.9% in July, but core inflation remains high (3.2%yoy), and the monthly gain was higher than expected (0.3% versus 0.2%). "Nothing to write home about" at first glance since services ex rents continue to decelerate gently in year-on-year terms (see Exhibit 2). On a 3-month average though, a rebound emerges, visible on most sub-categories of the index up (see Exhibit 3). That is no reason to postpone the cut in our view, but this could give a valid argument to those who oppose a "big move" at this week's meeting.

Exhibit 2 – Slowly improving in yoy terms



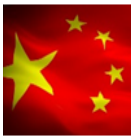
Source: Bureau of Labor Statistics and AXA IM Research, September 2024

Exhibit 3 – A rebound on a 3-month annualised basis



Source: Bureau of Labor Statistics and AXA IM Research, September 2024

True, the Consumer Price Index (CPI) print will not be the last piece of data the Federal Open Market Committee (FOMC) will have before making the decision. Retail sales for August, out on Tuesday, could sway the committee in one way or the other, but we think it would take a very bad reading for such print to play a decisive role given the resilience so far of consumption numbers. More fundamentally, the best argument in our view for a 50bp cut this week is that the Fed has pushed its policy rates very high relative to any reasonable estimate of the neutral rate. This gives the Fed ample room for manoeuvre to "cut big" – thus sending a reassuring message to the market and economic agents at large about its readiness to stand in the way of a nasty downturn – without taking a big risk of rekindling inflationary pressure. This makes our call for Wednesday a close one, but we stick to our view **that inaugurating the easing phase with 50bps would send a difficult-to-control ultra-dovish message, sending market pricing even further down for the whole Fed trajectory**, even if the FOMC tries to offset this by pencilling in a comparatively small number of additional cuts in the new "dot plot". Indeed, the gyrations of the dot plot – and ultimately limited predictive power – over the last year should have convinced market participants to take it with a healthy pinch of salt.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Harris performs well in TV debate. CNN poll suggest 67% thought she bested Trump • CPI inflation (Aug) falls to 2.5%yoy lowest since 2021. Core CPI stays at 3.2%, up 0.3%mom • PPI inflation (Aug) slows to 1.7% and core 2.4%, in line after Jul revisions, but mom above expectations • NFIB survey (Aug) dips to 91.2, still close 2yr highs • Jobless claims stable around 230k	• FOMC meeting. Expect 25bps cut, despite 35% chance priced for 50bps. SEP rate projections likely to show 2/3 cuts this year and 4 next • Retail sales (Aug) headline expected to slip on weak autos, core rise expected 0.3%, solid • Empire and Philly Fed surveys (Sep) • Manufacturing output (Aug) weakness expected • Housing starts/home sales (Aug)
	• The ECB implemented a 25bps rate cut and refrained to pre commit to any particular rate cut pace. Barring major macro shock, October meeting should be uneventful • Industrial production (Jul) fell by -0.3%mom after 0% in June (revised up from -0.1%)	• French PM Barnier is expected to unveil his government this week. Interesting to watch any potential insights on the future budget as deadline is approaching fast • Labour costs (Q2) detail • German ZEW surveys, Fr INSEE bus climate and EMU consumer confidence (Sep) • Final inflation data (Aug)
	• Labour market (Jul/Aug) unemp. fell to 4.1% but data are unreliable. Other measures point to looser conditions. Pay growth ex. bonuses slowed to 5.1% • Monthly GDP (Jul) was unchanged in July. 3m/3m growth slowed to 0.5%, from 0.6%	• CPI inflation (Aug) to rise due to energy. Services to rise due to base effects, but in line with BoE exp. • BoE to keep rates on hold at 5.25% (7-2 split). QT decision for next 12 months to be announced • Retail sales/GfK, watch for evidence of HH spending
	• GDP (Q2, f) revised down to 0.7%, prelim est of +0.8%, with consumption (0.9%) and capex (0.8%) • PPI inflation (Aug) dipped to 2.5%yoy, from 3% • Eco Watchers survey (Aug) improved, but still weak	• Trade (Aug) look for whether exports were hit by stronger yen • Machinery orders (Aug) expect a small monthly rise • CPI inflation (Aug) look for whether ex-food and energy continues to ease
	• FX reserves ticked up to 3.288 tn USD in August (Jul: 3.256tn) • CPI (Aug): 0.6%yoy, 0.4%mom (Jul: 0.5% and 0.5%) • PPI (Aug): -1.8%yoy (Jul: -0.8%) • Export rose to 8.7% from 7% in July; imports slowed to 0.5% from 7.2% in July	• 14 Sep: August monthly output (retail sales, investment, industrial production etc.) • 20 Sep: LPR 1 Year and 5 Year (Sep)
	• CB: Peru 25bps cut to 5.25% • CPI yoy (Aug): India (3.7%), Czech (2.2%), Mexico (5.0%), Hungary (3.4%), Colombia (6.1%), Brazil IPCA (4.2%), Romania (5.1%) • Industrial Production yoy (Jul): India (4.8%), Malaysia (5.3%), Czech (-1.9%)	• CB: Indonesia (6.25%), Taiwan (2%) and Turkey (50%) are expected to stay on hold, S.Africa expected to cut 25bp from 8.25%, Brazil (10.5%) meeting under the risk of a hike • Q2 GDP: Argentina, Mexico, Peru • CPI (Aug): South Africa

Upcoming events		
	US:	Mon: Empire state mfg (Sep); Tue: Retail Sales (Aug), IP (Aug), Business inventories (Jul), NAHB housing market index (Sep); Wed: Housing starts (Aug), Building permits (Aug), FOMC announcement, Long-term investment flows (Jul); Thu: Current account (Q2), Philly Fed Index (Sep), Initial jobless claims (w/e 9th Sep), Existing home sales (Aug)
	Euro Area:	Tue: Ge ZEW survey (Sep); Wed: Ez HICP (Aug); Fri: Ge PPI (Aug), Fr Insee mfg confidence (Sep), Ez consumer confidence (Sep, p), Ge S&P credit rating review, Fr DBRS credit rating review
	UK:	Wed: CPI (Aug), CPIH (Aug), RPI (Aug), PPI (Aug); Thu: MPC announcement; Fri: GfK consumer confidence (Sep)
	Japan:	Wed: Private ‘core’ machinery orders (Jul), Fri: CPI (Aug), BoJ announcement
	China:	Mon: PBoC loan prime rate announcement

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