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Bad Timing (for everyone)

- The surge in US long-term yields is an unsurprising response to the prospect of an ill-timed fiscal stimulus.
- The UK is a clear victim of bond market contagion. Yet, we think the deterioration in the macro outlook will ultimately allow the BoE to provide more support than what the market is currently pricing.
- Contagion is more measured in the Euro area, but the ECB needs to take on board the tighter financial conditions.

More signs last week of the impressive resilience of the US labour market is the immediate cause of the additional surge in long-term US yields, but more fundamentally this heralds the fact that, unless the new administration radically changes course, adding more fiscal stimulus and another supply-side shock in the form of tariff hikes will come at a particularly bad time given the resistance of US inflation. We think there is still some space for one "last cut" in the first half of this year, with a low level of confidence, but we think a proper resumption of the Fed's descent to accommodative territory will not happen before 2026, when the economy starts deteriorating in response to the implementation of "Trumpnomics".

Higher yields, and a "stopped out" Fed are bad news for everyone. The UK has been a clear victim of bond market contagion. To the country's usual source of vulnerability – particularly its chronic current account deficit – one needs to add the fiscal expansion announced in last October's budget, and a "stagflationary" dataflow. This leaves the British government with only unpalatable solutions to deal with the effect of a rising debt servicing cost on its discretionary room for manoeuvre (cutting spending, hiking tax, or changing once again the fiscal rules). Still, we think the market is currently too timid on its expectations for rate cuts from the Bank of England. We think that the deterioration in the real economy will usher in a more convincing pace of disinflation, which will offer some capacity to offset the "bad winds" from the US bond market.

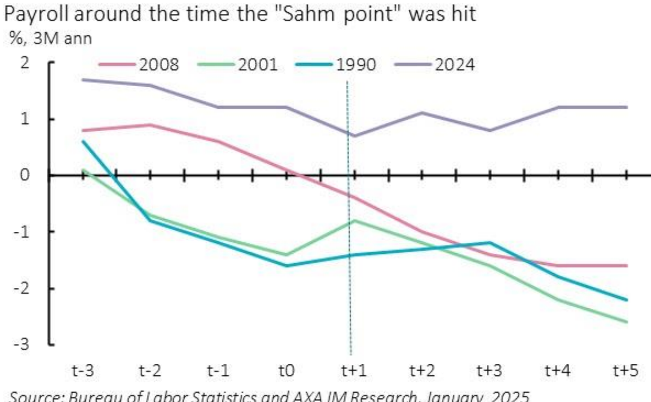
If contagion has been more measured in the Euro area, long-term rates have also been on the rise there and this goes beyond "self-inflicted damage" from member states and should be treated as a symmetric shock. This will add to the zone's difficulties, and the latest surveys are concerning. We think the ECB needs to take the tightening in financial conditions on board to move quickly to neutral, and then into accommodative territory.

US pressure cooker

When it comes to the market effect of big political shifts, the reward is often more in the waiting than in the delivery. **It may be that the "Trump trade" has started to erode on the equity side even before the inauguration of the 47th President**. At close last Friday, the S&P500 index was only 0.8% above the level it had reached the day of Donald Trump's election. A lot of the explanation lies in the new environment for interest rates. Since 5 November, the US 10-year yield has risen by 50 basis points (bps) to hit 4.76% last Friday, while the money market forward contracts suggest **the market is now pricing only a little more than one cut by the Federal Reserve (Fed) this year** (29bps by December 2025), down from between four and five two months ago. Investors are reconnecting with one simple truth: **the Republican candidate may have won because Americans think the economy is not doing well, but it is in reality doing fine, and the promised additional stimulus is ill-timed.**

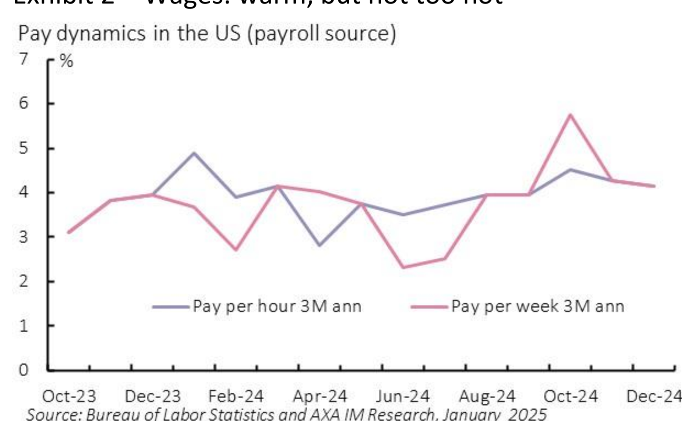
The labour market is the best sign of this. December payrolls surprised – again – to the upside, with 256k new jobs (consensus was on 165k), without any significant downward revision to the previous months. The unemployment rate fell marginally, to 4.1% from 4.2%, and it is getting more obvious every month that, although the recession-predictive "Sahm point" had been hit in July of last year, "this time should be different". We have updated again the graph in which we compare the current job creation performance relative to historical precedents when the Sahm point had been hit: the gap continues to widen (see Exhibit 1). On a 3-month annualised basis, employment in the private sector has gained 1.2% in December, staying in the same range since last year's late spring. For the Fed, which is pledging to care as much about downside risks to employment than to upside risks on consumer prices, the "skip" in the cuts telegraphed at the December meeting appears of course fully justified, but more profoundly the debate at the Federal Open Market Committee (FOMC) is now probably focusing on whether any additional "restriction removal" is warranted.

Exhibit 1 – This time it is *definitely* different



Source: Bureau of Labor Statistics and AXA IM Research, January 2025

Exhibit 2 – Wages: warm, but not too hot



Source: Bureau of Labor Statistics and AXA IM Research, January 2025

Now, **on the reassuring side, this robust showing is however not fuelling a re-acceleration in wages**. Both pay per week and pay per hour has decelerated in December on a 3-month annualised basis (see Exhibit 2). We note as well that although job creation is robust, it has stayed below the pre-Covid trend of 1.9%. If the Atlanta Fed's nowcast is correct, GDP in Q4 grew by 2.7% annualised. This would be consistent with productivity gains of c.1.5% at the end of last year. Against such a background, nominal wage growth at around 4% would still leave unit labour costs in the 2.5% range which is acceptable for a central bank targeting 2% inflation, especially if at the same time the strength of the dollar is likely to dampen any imported inflation (at least as long as tariffs are not hiked…). All in all, this still leaves some space for the Fed to deliver one last hike in the first half of this year – as has been our forecast since late November – but with a low level of confidence.

Where we disagree with the new market pricing it is on the timing of such "last cut". Forward contracts see this happening in September. A US economy being hit by the late summer – with an unusually long delay – by the restrictive monetary and financial conditions, would be a scenario consistent with such timing for the next cut. Yet, by

September, at least some of Donald Trump's platform will have been announced and possibly legislated, but the adverse consequences – on labour supply and inflation – are unlikely to materialise so quickly. In the months ahead, it is plausible that the "sugar rush" from some aspects of Trumpism 2.0 (deregulation, the promise of tax cuts) will still support consumer and business confidence. We think the Fed will resume cutting, but rather in 2026, when domestic demand will have weakened after responding to the *implementation* of Trumpnomics, rather than in the middle of series of policy announcements.

Only painful options ahead for the UK

When long-term interest rates rise on the world's dominant bond market, global financial conditions are usually impacted. **In the developed world, the UK is standing out in terms of contagion**. Long-term rates have increased everywhere, but the German 10-year spread relative to the US has narrowed by 29bps as of last Friday compared with the eve of Donald Trump's election. The spread compression has reached only 9bps in the UK.

To some extent, **this higher sensitivity of British financial conditions to bad winds coming from the US reflects structural issues.** First, the UK has been exhibiting a chronic current account deficit (2.5% of GDP in the first three quarters of 2024, from 2.2% in 2023). The Euro area, conversely, is a surplus region. This means that the UK must constantly attract international investors to balance its books, whereas the Euro area – when taken as a whole – can relatively easily replace departing non-resident investors, who constantly compare interest rates and return probabilities across various markets, with more captive domestic saving. Second, British domestic investors are getting less keen on sovereign bonds because of the changes in the pension industry. Defined contribution pension funds dedicate only 4% of their assets to government bonds, against 70% to overseas equity. They are gaining ground in terms of total assets relative to bond-intensive defined benefits funds.

Yet, **contingent issues are making these structural flaws more problematic. The fiscal stance is the first problem**. Rachel Reeves, Chancellor of the Exchequer, surprised in October by designing a budget consistent with an increase in expected borrowing, some 0.9% of GDP higher than in the March forecast, according to the Office of Budget Responsibility (OBR), despite raising tax such as social contributions on wages. This contrasts with the generally tighter orientation of public finances across Europe.

Second, the current British dataflow is not favourable. Core inflation remains high, hitting 3.5% year-on-year in November, up from 3.3% the month before, even if the November print came 0.1 percentage point (pp) below expectations. This does not help the market in pricing a swift continuation of the Bank of England (BoE)'s "restriction removal". Forward contracts suggest a bit less than 2 cuts by the end of this year, half of the quantum Governor Bailey alluded to in his interview to the Financial Times at the beginning of December. At the same time, while inflation is resilient, GDP is stagnating. This raises the risk that tax receipts will rise far less than what the October budget forecasted (a quite ambitious 2% GDP gain in 2025 was the budget's underlying assumption, provided by the OBR). This "stagflationary" combination is not supportive for the British bond market.

The next big rendez-vous for British fiscal affairs will come on 26 March, when Rachel Reeves is scheduled to present new fiscal forecasts with the Spring Statement. She had downplayed the possibility to use this moment for new, hard announcements, but with higher interest rates and likely lower GDP projections courtesy of the OBR, she may not have the luxury to wait until October to correct course.

There are only three choices for her, all unpalatable. She could acknowledge the drift in the projected deficit and revise down the spending programme – which would probably trigger quite some commotion in her party, which has already reacted with some impatience to her perceived fiscal prudence. She could balance the books by hiking tax further, but coming after some already unpopular announcements last October, this would be quite toxic for Labour's already struggling popularity, on top of possibly eroding the UK's attractiveness. She could "plough on" and change the fiscal

rules again – unlike in Europe, this can be done very swiftly in the UK – but she had already tweaked them in October to allow more space to public investment. A second shift in less than 6 months could send the wrong signal to the market. She has seemingly rejected this possibility by stating last Saturday that *"the fiscal rules laid out in the budget are non-negotiable".*

An additional risk for the UK is that its economy's sensitivity to interest rates is high, which indeed supports a hawkish government communication. Mortgage rates are not directly indexed on gilts' yields, but follow swap rates, which however cannot completely de-correlate for long with them. They have already moved higher recently (see Exhibit 3). A decline in mortgage rates will not free up as much disposable income as expected – if market conditions do not change. Tax receipts would then continue to fall below expectations.

Exhibit 3 – Beware the feedback loop from mortgages

Source: Bloomberg and AXA IM Research, January 2025

Yet, **we put some faith in the Okun law – which links GDP growth to unemployment – and the Phillips curve – which links unemployment to inflation – to usher in some loosening of the pressure on British long-term yields in the months ahead.** By the Office of National Statistics' own admittance, the flagship employment survey is today unusable for policy calibration, but alternative labour market data suggests that, unsurprisingly, the deterioration in aggregate demand is now triggering some job destruction, which itself will take inflation more decisively down. To be clear, we think that the rise in labour costs caused by the hike in social contributions, in a context of slow demand, will result in more job losses than price pressure down the pipeline**. We think the market's expectations of only two BoE cuts in 2025 is too timid. We stick to four**. If we are right and the Fed is "stopped out" by the end of this quarter, the gap on the short end of the curve should have some effect on the quantum of contagion from the US to the long end of the UK curve, provided the government in London does not give up on fiscal prudence.

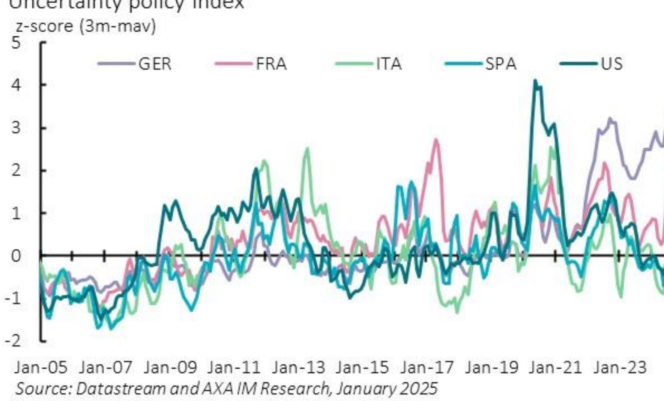
In a nutshell**, we do not think long-term interest rates can fall in the UK without a further deterioration in the economy. This is a bitter-sweet conclusion for the government**. Reforming the economy's structures to raise potential growth would of course provide an uplifting aspect to a current set of British macro policies which lacks "positivity," and the Chancellor has pre-announced a train of measures, focused in our understanding on deregulation. Yet, our usual gripe – for our habitual readers – is that inordinate political energy is being spent in the UK on finding new ways to make the country more attractive from an investment point of view while the most obvious solution – bringing the UK closer to the European Union (EU) single market – is still considered as taboo across policy circles, even though poll of after poll suggests that a clear majority of the British public now considers that Brexit was a bad idea. London is getting closer to the EU on crucial non-economic matters, e.g. on defence, but the notion that the UK could negotiate a special treatment in Washington DC on trade issues looks far-fetched to us.

More needed from the ECB

While the contagion to German yields from higher US interest rates has been measured – despite some expectations in the market that fiscal policy in Berlin could take a much more expansionary direction after the elections, which we do not hold as a baseline – **the trouble with global bond markets remains a problem for Europe**. The French spread has moved somewhat upward in the last few weeks, averaging 84bps so far in January against 80bps in December, but the key issue lies in the *absolute* level of yields. France paid last week 3.4% to fund itself with 10-year bonds. This exceeds France's trend nominal GDP growth (around 3.2%, a combination of 1.2% potential GDP gains and 2% inflation), which is mechanically bad news for the long-term public debt trajectory. The issue however goes beyond France. Italy is now paying 3.77% on 10-year bonds, 58bps up in one month, while its trend nominal GDP growth is even lower than France's.

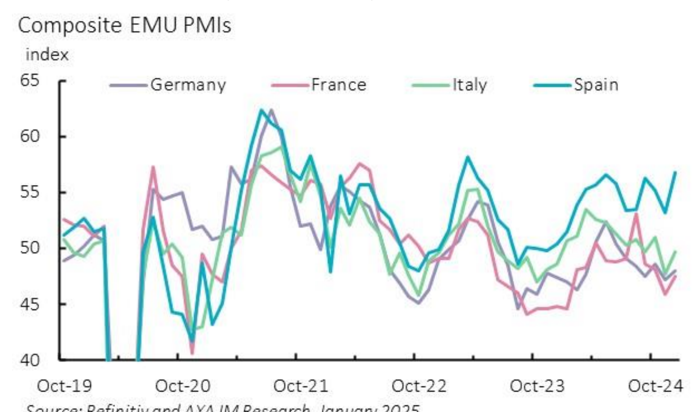
While we do not expect the European Central Bank (ECB) to start targeting the yield curve any time soon, we think the Governing Council cannot ignore the tightening in overall financial conditions at a time when the economy continues to struggle. While there is no justification for monetary policy response for an isolated, self-inflicted drift in yields in one or the other member state, we think they should now treat the rise in long-term interest rates as a symmetric shock affecting the zone as a whole.

Exhibit 4 – Southern Europe still quiet…



Source: Datastream and AXA IM Research, January 2025

Exhibit 5 – …But Spain the only resilient one

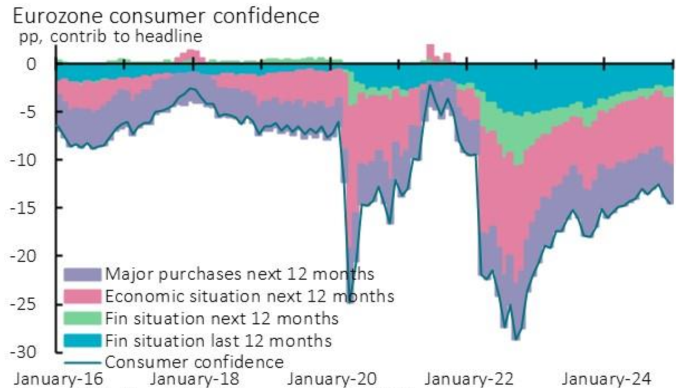


Source: Refinitiv and AXA IM Research, January 2025

The policy uncertainty index – an indicator of "generic gloom" – is very high in Germany (fuelled by ruminations about the country's growth model) and France (driven by political instability and fiscal difficulties) while it is still barely above its long-term average in Spain and Italy. However, when looking at the composite Purchasing Managers' Index (PMI) – and the message would be confirmed by the European Commission survey – Spain **is the only big country in the Euro area where business confidence remains strong.** It is sliding in Italy as well, which suggests that even when the political environment is stable and where – by historical standards – the recent growth performance has been decent, the outlook is deteriorating. Higher long-term interest rates will not help, if only by forcing larger discretionary action on the fiscal balance to offset a higher debt service.

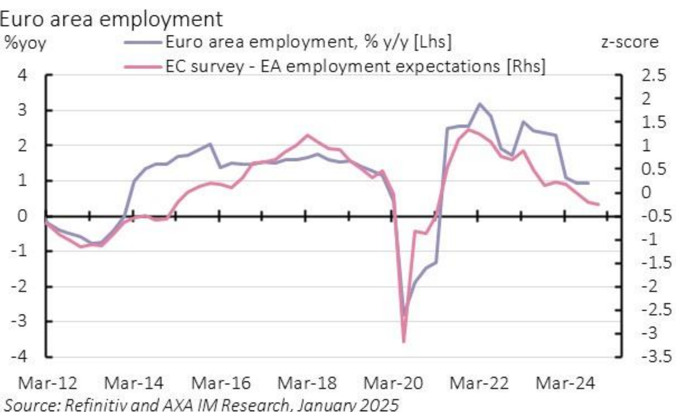
A steady improvement in consumer confidence had been a rare positive development in the Euro area since the pandemic, even if it remained markedly below its long-term average. This may be changing though, with two months of back-to-back deterioration since November 2024 (see Exhibit 6). The generic component "economic situation over the next 12 months" which usually reacts to the policy/political news flow has visibly moved down, but intentions to save have also risen again, while the opinion on future unemployment is deteriorating. This echoes developments in the business sector. **Hiring intentions are now only marginally above their long-term average**. Actual employment growth remains in positive territory on a year-on-year basis, but beyond the series' volatility, we have now the right ingredients for the beginning of some proper job destruction in the Euro area (see Exhibit 7).

Exhibit 6 – Consumer confidence turning



Source: Refinitiv and AXA IM Research, January 2025

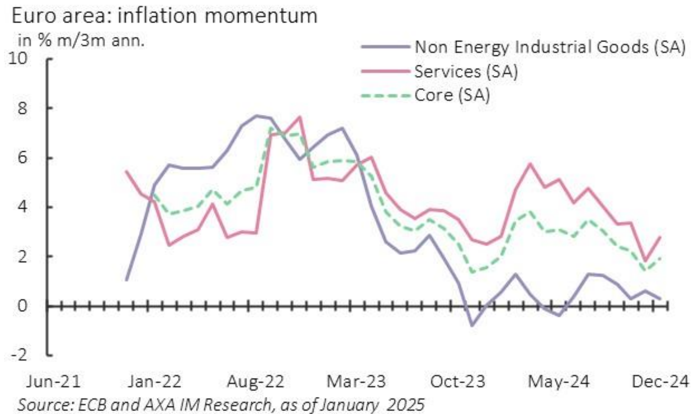
Exhibit 7 – Employment losing steam



Source: Refinitiv and AXA IM Research, January 2025

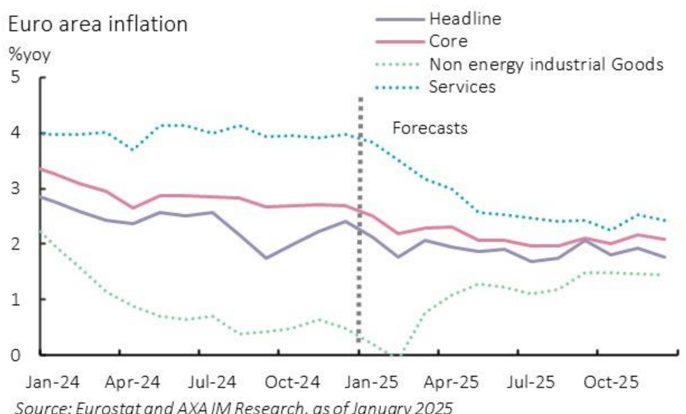
True, the news flow on inflation has not been immaculate in the Euro area lately, as core failed to fall further in December on a year-on-year basis (2.7%). On a three-month annualised basis, there was even a slight rebound, driven by services (see Exhibit 8). Yet, such developments had been anticipated by the market, and the ECB has already expressed some tolerance for some “noise” around their expected declining trend. Given the poor prospects on the real economy side, we are even more comfortable with our scenario for a resumption in the deceleration of core prices in the Euro area (see Exhibit 9): even if the depreciation of the euro could continue to push industrial prices up, we fail to see how services prices could resist long to the absence of domestic demand momentum.

Exhibit 8 – A rebound in core inflation momentum



Source: ECB and AXA IM Research, as of January 2025

Exhibit 9 – But we remain confident on disinflation ahead



Source: Eurostat and AXA IM Research, as of January 2025

The ECB is currently communicating on a return of policy rates to their neutral level. We think a descent in properly accommodative territory will be needed. **Our baseline is for a terminal rate at 1.5%, but we think there is a downside risk to this as the Governing Council should take on board the tightening in overall financial conditions.** As a result of this ECB’s action, if governments outside Germany stick to their current fiscal tightening stance, and if, as we expect, the new coalition in Berlin will usher in only a moderate re-orientation of fiscal policy, in a context of inflation further falling, we think some – modest – correction in long term yields from their current levels could be seen within the next few months.

Country/Region	What we focused on last week	What we will focus on in next weeks
US	• US payrolls (Dec) surprised with a 256k gain, taking unemployment to 4.1%. Hourly earnings slowed to 3.9%yoy • Other labour market indicators, JOLTS, jobless claims and challenger, still firm • FOMC minutes recorded "a number" added assumptions for future govt policy • Services ISM (Dec) 54.1 (52.1), prices nr 2yr high	• CPI inflation (Dec) core expected stable at 3.3%, even as oil edges headline closer to 3% from 2.7% • PPI inflation (Dec) watched to complete PCE outlook • Retails sales (Dec) banks recorded credit card activity points to another firm report • Empire and Philly Fed surveys (Jan) volatile and divergent lately, ISM suggests stable but soft mfg • Fed's Beige Book for broader economic assessment
Euro Area	• Svcs final PMIs and EC survey confirmed no major gains in December. Q4 GDP growth should be around +0.2%qoq • EMU "flash" HICP (Dec) came at +2.4%yoy for headline and 2.7% for core. Fr and It figures were weak but Ge, Sp and Be surprised to the upside • EMU retail sales (Nov) rose by +0.1%mom, below expectations but Oct figures was revised up to -0.3% from -0.5%	• Final HICP (Dec) and details for services prices • Industrial production (Nov)
UK	• New car sales (Dec) down 0.2%yoy • Final composite PMI (Dec) edged down to 50.4, from 50.5 • BRC retail sales (Dec) points to rebound • Construction PMI (Dec) fell to 53.3, from 55.2 • BoE DMP survey (Dec) small uptick in inflation ex.	• CPI inflation (Dec) should tick down to 2.5%, from 2.6%, on the back of a drop in core • RICS house prices (Dec) look for any signs of weakness due to higher borrowing costs • Monthly GDP (Nov) look for a 0.1%mom increase • Retail sales (Dec) look for a partial rebound
Japan	• Final comp. PMI (Dec) rose to 50.5, from 50.1 • Consumer confidence (Dec) edged down to 36.2, from 36.4 • Av. cash earnings (Nov) up 3%yoy, from 2.6% • Household spending (Nov) up 0.4%mom • Leading indicator (Nov) down at 107, from 109.1	• Eco watchers Survey (Dec) look for signs of weakness in the outlook • PPI (Dec) looks set to rise by 0.3%mom • Reuters Tankan (Jan) look for signs of improvement
China	• CPI inflation rose 0.1%yoy in Dec, down from 0.2% in Nov; core CPI rose to 0.2% from 0.1% previously • PPI inflation improved to -2.3% in Dec from -2.5% in Nov	• Possible release of December M2 and lending data
EMERGING MARKETS	• CB: Peru 25bp cut to 4.75% • CPI (Dec, yoy): Colombia (5.2%), Mexico (4.2%), Philippines (2.9%), Taiwan (2.1%), Thailand (1.2%) • Industrial production (Nov, yoy): Brazil (1.7%), Czech Republic (-2.7%), Hungary (-4.2%), India (5.2%), Taiwan (10.3%), Thailand (-3.6%)	• CB: Poland (5.75%), Romania (6.5%) and Indonesia (6%) on hold, South Korea 25bp cut to 2.75% • CPI (Dec): Argentina, Czech Republic, Hungary, India, Poland, Romania • Industrial production (Nov): Colombia, Malaysia

Upcoming events		
	US:	Tue : NFIB small business optimism (Dec), PPI (Dec); Wed: CPI (Dec), Empire state mfg survey (Jan); Thu: Retail sales (Dec), Philadelphia Fed Index (Jan), Initial jobless claims (w/e 11 Jan), Business inventories (Nov), NAHB Housing index (Jan); Fri: Housing starts (Dec), Building permits (Dec), IP (Dec)
	Euro Area:	Tue: It IP (Nov); Wed: Fr, Sp HICP (Dec), Ge GDP (2024), Ez IP (Nov); Thu: Ge, It HICP (Dec); Fri: Ez HICP (Dec)
	UK:	Wed: CPI (Dec), CPIH (Dec), RPI (Dec), PPI (Dec); Thu: RICS (Dec), GDP (Nov), Index of services (Nov), IP (Nov), Mfg output (Nov), Construction output (Nov), Total trade balance (Nov)
	Japan:	Sun: Private 'core' machinery orders (Nov)
	China:	Mon: Exports (Dec), Imports (Dec), Trade balance (Dec); Fri: GDP (Q4), IP (Dec), Retail sales (Dec), Fixed asset investment (Dec)

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