Investment Institute Macroeconomics

Postcard from Davos

- The US President's speech in Davos may have embodied "Peak Trump".
- With the European response still hindered by internal difficulties, the ECB, as usual, will have to provide a "bridge".

Although he only addressed the delegates by video link, Donald Trump dominated the week in Davos. His message to the world was crystal clear: he intends to build an extraordinarily attractive US economy, thanks to deregulation, low (fossil) energy prices and low tax, and those who choose not to produce on the US territory but still want to serve US demand, will face heavy tariffs. We may well have just witnessed "peak Trump", before the internal contradictions of his economic agenda start materialising, but for now the dominance of the US is striking.

Ursula Van der Leyen's speech in Davos was received as Europe's response to the US assertiveness. Her message was nicely balanced between an affirmation of European values – notably in favour of a multi-lateral approach to world affairs – and a recognition of the need to change how EU institutions deliver policies. We found her three-pronged offer attractive– completing capital market union, simplifying the regulatory framework, rolling out a new energy strategy – but the details of the policies will be unveiled only in the coming weeks. Moreover, we could not help noticing that the fiscal constraint, an internalised difficulty to bring about a new wave of jointly funded programmes, plays a prominent role in the ranking of the EU's priorities (CMU and simplification cost nothing to the public purse). We continue to think there should be space for ambitious joint action, for instance in the field of energy and defence. Yes, governments' debt is high in the EU, but it is smaller than in the US, and there are obvious economic gains from electrification and defence. It may well be that while EU institutions are well aware of the need for urgent action, the difficulty lies in national governments. It remains to be seen if the coalition agreement which will follow the German election will provide the necessary jolt, while political clarification remains elusive in France. In the meantime, it will be up to the ECB to provide the necessary "bridge". While this is not for immediate consumption – for now, cutting 25bps per meeting, just like this week, is likely to remain the ECB's baseline – Christine Lagarde's recognition that Europe is facing an "existential crisis" should be a good reason for the central bank to focus on downside risks to growth and, ultimately, go beyond "neutral" and bring its policy rate into accommodative territory.

Davos bookended by Trump

At a Davos session dedicated to the future of the US dollar, the moderator took a quick poll asking the audience which reserve currency would be dominant in 25 years. An absolute majority chose the dollar, a crypto came a decent second, the yuan drew a few votes, and no-one elected the euro. This in our view encapsulates **the atmosphere in Davos: striking dominance of the US combined with a focus on technological innovations, a relative marginalisation of China and a level of pessimism on the European outlook which we have never witnessed** (but we were not there during the peripheral crisis of 2011-2012).

Of course, **calendar effects magnified this sentiment**, the World Economic Forum (WEF) being almost exactly bookended by Donald Trump's inauguration and his own speech in remote to the delegates on Thursday afternoon. **To some extent, last week may well have marked "peak Trump"**. The 47th President of the US has started his mandate with a "bang", a series of executive orders which showcase his determination to act fast, while he can claim two very visible "quick wins" with on the foreign policy front his involvement in the ceasefire between Israel and Hamas, and the announcement of a massive investment in Artificial Intelligence (AI) in the US (the Stargate project). **The next steps may prove more difficult,** between the legal wrangling around his executive orders, tough negotiations with Congress on fiscal affairs, and the weight of the internal inconsistencies of his economic and foreign policy platform. It remains to be seen, for instance, how the US business community reacts if the federal government's crackdown on immigration proves too radical, or how the banking sector – currently generally enthusing about the prospect of deregulation, deals with a "stopped out" Federal Reserve (Fed). Our view is that this confrontation with the reality of policymaking will trigger more volatility rather than a market-friendly downward revision in the US President's ambitions.

Yet, the current "statement of intentions" can hardly be ignored. Donald Trump's speech on Thursday was in our view a very informative one. The message to the delegates of the forum – and to corporate decision makers across the globe – is simple: the US is going to be an extraordinarily attractive economy, offering low energy costs, low regulation, and attractive tax conditions – he repeated his pledge to cut the corporate rate further. Everyone is welcome to come and produce there. For those who would choose not to and still want to access the US market, tariff duties await.

Delegates were probably relieved that Donald Trump did not mention hard figures on such tariffs which, combined with the fact that none of his day-1 executive orders brought changes in this field. This is another indication that there may be some measure of negotiation on this. **That is in line with the transactional nature of Donald Trump's approach to policymaking**. As we have been arguing in Macrocast for some time now, tariffs are a "Swiss knife" in his platform. They could be used as leverage for anything ranging from protecting US companies from European fines (this was explicitly mentioned in the speech) to punishing Canada for allowing Fentanyl to cross its borders. **Tariffs are likely to be calibrated depending on the other countries' acceptance of US conditions on these "other issues", and this may take some time, but a corollary is that the US trade partners will never know if they are "out of the woods" on this issue:** the range of reasons for which a country could be slapped with tariffs is so long that there will always be a possibility that after a first round, another wave hits. On the US side, there are insistent noises around the idea that tariffs would be staggered over several months to minimise the adverse domestic effects – this would give companies some time to flip foreign suppliers for instance – but for those who export to the US, we are concerned by the lingering uncertainty all this would create. Global companies cannot know *where* they should locate their production centres, since it is impossible to guess at this stage *who* will be hit by tariffs. This of course raises the profile of the US territory itself as the only "safe" place from which to serve a US customer base, but generic uncertainty on supply lines is likely to foster a wait and see attitude on global investment.

In any case, irrespective of the concessions the rest of the world may be willing to offer, we are convinced tariffs *will* rise because (i) fundamentally, the US President deeply believes that his country's trade deficit is caused by a discrepancy between the tariffs and non-tariff barriers US producers face on their export markets and those the US impose on importers and (ii) because the revenue from tariffs is essential to square the Republicans' fiscal equation (Donald Trump mentioned "trillions of dollars", which is hyperbole but still indicative of what he expects from them).

This gets us to another piece of news which hit the WEF's participants**: the freeze of the Inflation Reduction Act (IRA)'s funding disbursements to renewable energy projects**. Whatever "ESG backlash" there is in the world, the World Economic Forum ploughs on with a substantial share of sessions dedicated to the fight against climate change. Yet, such freeze – combined with the US's second withdrawal from the Paris agreement – made the backlash very tangible, and possibly came as a surprise to some observers. Indeed, a popular view since President Trump's victory was that, since a lot of the IRA-funded projects emerged in Republican states, campaign trail pledges to stop them should not be taken at face value. Well, apparently not. There is still some wiggle room – federal agencies can still ask for permission to disburse on some projects to the Office of Management and Budget – but there again, **we think observers failed to spot the very simple fact that the Republicans "need the money"**: Donald Trump will have a hard time snatching from Congress the possibility to cut tax without offering some mitigation on the spending side, and the IRA is a good candidate for that.

At the same time, President Trump reiterated his pledge to lift fossil fuel output in the US – including "good clean coal" to quote him verbatim – to keep energy prices as low as possible as part of his strategy to attract AI investment projects – which happen to be incredibly energy-intensive**. One element of surprise in his speech was his very direct call on Saudi Arabia and Organization of the Petroleum Exporting Countries (OPEC) to lower the price of oil** – it was not enough for Riyadh to announce a substantial rise in their investment in the US, Donald Trump incidentally asked for even more on that front.

Lower oil prices could be a way to deal with some of the internal inconsistencies of the Republican platform…at the risk of creating new ones. It is very difficult to see how even a moderate implementation of President Trump's agenda could fail to fuel already resilient inflationary pressure in the US. In his speech Donald Trump renewed his call for lower rates, while this week's Federal Open Market Committee (FOMC) is highly likely to conclude to a "skip". The door will remain open for another cut in March, but we remain comfortable with our call that this would be the last one before 2026. Lower oil prices could help change that trajectory, even though the effect would be ambiguous (the Fed focuses on core inflation, and lower energy costs put more money in consumers' pockets, which can ultimately add to demand pressure on supply). Yet, even if it worked, an issue there is that US investment in fossil fuel capacity is of course dependent on high enough oil prices, hitting another key aspect of Donald Trump's pro-growth agenda.

At first glance there is some room though from the current price, close to USD75/bl: the breakeven price for developing shale projects is now probably around USD40/bl, reaching USD60 for offshore projects. Yet, **the calculations of oil operators, both outside and inside the US, can stand in the way of D. Trump's plan**. First, OPEC members are well aware of the medium-to-long term risk of being squeezed between (i) more supply from the US and (ii) lower structural demand for oil from Europe and China. In such configuration, maximising current income, to speed up their transition to a post-oil economic model, makes a lot of sense, and this goes against accepting Trump's call to cut prices now. In a similar fashion, it is not clear if US operators would necessarily engage in a massive investment splurge domestically. The US already is the world's biggest oil producer (outpacing Saudi Arabia by 2mn barrels a day in 2023). Oil is a rent activity, and just like all rents, expanding output is not necessarily the best profit-maximising solution. The oil market is understandably hesitant. West Texas Intermediate (WTI) lost nearly 2 dollars after D. Trump's speech but retraced roughly half of this dip on Friday.

In any case, an interesting point was the explicit link the US President made in his speech between oil prices and the war in Ukraine, laying some of the blame for the continuation of hostilities to OPEC's refusal so far to cut oil prices. Coming on top of Trump's earlier comments on his readiness to tighten sanctions against Russia signals his intention to heap pressure on Vladimir Putin to get to a peace settlement. **We were struck by how prominent Ukraine was in the President's speech**, as well as the emotional choice of words. It was quite clear that he wants results there, possibly as he starts to think about his legacy. The fact that he is starting from a "tough position" on Russia (which incidentally is forcing Orban to revisit his opposition to new EU sanctions) will likely reassure the Europeans…but they won't be that easily off the hook: he reiterated his demand for a military spending to GDP ratio of 5%, when a lot of European members are still struggling to get to 2%.

Europeans have their back against the wall

Since Trump's intentions were dominating the conversation, the response of the other regions was of course on the menu. China was relatively discreet in Davos this year. Beijing sent – like last year – the vice Prime Minister who delivered the same message, i.e. that China is open to business and willing to cooperate, but the general view is that the government will wait to see what actual moves would come from Washington DC to calibrate its own response. Also, we found it interesting that **China did not figure prominently in Donald Trump's speech**. He had to be prompted by a question at the end of the session to discuss the country. While he repeated that China was treating the US unfairly in the realm of trade and implicitly laid responsibility for Covid to Beijing, he also touted his good personal relations with Xi Jinping while alluding to the possibility of joint pressure from DC and Beijing onto Moscow to speed up peace in Ukraine.

On Europe, Donald Trump had few good words, even if he declared his "love" for the region, and on top of his shopping list in Brussels on trade and defence, he did not mince his words on the mediocrity of the European economic models. His words echoed – albeit in their own, unmistakenly blunt way – the general mood in Davos every time Europe was discussed: a region plagued by low productivity gains, poor technological choices, and an increasingly unbearable regulatory burden.

Ursula Van der Leyen's speech in Davos came before Donald Trump's address, but it was very much received as an implicit response to his inaugural speech in Washington DC. The gist of her points is that, while the European Union (EU) will remain faithful to its values – e.g. support for social cohesion, commitment to the fight against climate change and a cooperative approach to global affairs – it needs to take on board the failure of the 1990s version of globalisation – which is closely associated to the "Brussels consensus". **European policies must change, become more precise in their support to a rebound in the economy. She enumerated three priorities**: the completion of the capital market union, which would help with the recycling of plentiful European savings into European investments, the simplification of regulation, mentioning a far-reaching effort on non-financial reporting and the possibility for firms to opt for a single regulatory regime across the EU, and finally a clean energy programme. On trade, she presented the EU as a reliable partner – insistence on Brussels' compliance with the "rules of the game", a clear barb at the US – and clearly invited Beijing to a dialogue on these issues, setting the Electric Vehicle (EV) problem aside.

This reflects a growing awareness of the need to act decisively in Brussels, but the speech was often criticized as remaining too thin on implementation details, falling to go beyond the European tendency to focus its energy on establishing pessimistic diagnostics rather than on action. To be fair, there was a timing issue on which Van der Leyen had no control: the Commission strategy – with we assume a much better level of details – will be disclosed in the next few weeks. She could not "spill the beans" last week.

Yet, while we think the three priorities make a lot of sense, **the sum of the constraints weighing in the EU is clearly implicitly embedded in these policy choices**. It is quite telling that the first two items – capital market union and simplification – are "free" from a fiscal point of view: they would not cost one euro to the public purse. There is an internalisation of the budgetary constraint facing the EU, as if there was no possibility to extract another round of "federal funding" after the Next Generation EU programme. For our part, we would put the third item – the energy program – at the top, with a big joint investment price tag on it, and combine this to a joint defence spending instrument. We have already discussed in Macrocast how the EUR500bn by 2030 the Commission believes is the investment needed to bring the European electric grid up to scratch could be money well spent.

Yes, **EUR500bn over 5 years is a lot of money, but that is 3% of the EU's annual GDP, i.e. equivalent to one year of the income the EU transfers to the rest of the world to pay for the fossil fuel it imports**. Yes, public debt has increased in the EU, but in 2023 it stood at 82.1% of GDP, across all levels of government, well below the US level (97.8% of GDP for the sole central government). Yes, a difference between the US and Europe lies in the former's capacity to easily attract capital from the rest of the world to plug its funding needs at a low cost, but that is precisely one the reasons Europe needs to complete its capital market union. Yet, **to offer the world – and domestic savers – an integrated, deep, and**

liquid financial market, a reasonably plentiful "federal", risk-free asset of reference is a key contribution. This is the role bonds issued by the European budget, jointly guaranteed by the member states, should play. European electrification, and/or defence, would be natural candidates for such joint-liability bonds, on top of the Next Generation issuance which will in any case dry up in the coming years.

This gets us to our next point on the European state of play. **As much as there seems to be a new urgency at the EU level, it is the behaviour from member states which could be the main problem**. Mainstream governments find themselves in a situation in which they avoid new European commitments for fear this would fuel more populist backlash. A risk, down the line, is that this attitude adds to accusations of inaction at European institutions, ultimately fuelling populist forces further. At several points in her speech Ursula Van der Leyden praised the trade agreement between the EU and Mercosur as an exhibit of Europe's continued support for free trade. The deal is being blocked, at this stage, by several member states.

ECB to provide a "bridge", as usual

Maybe the elections in Germany will provide the "jolt" the EU needs right now, at the national level, to get the machine working again. We think it will take time, unfortunately, if only because a full political clarification does not seem imminent in France. In the meantime, **it is the European Central Bank (ECB) which, as often, will have to offer a "bridge" to the European economy, as the only institution with ample political and technical capacity for action**.

In the short run, it should not be very difficult for the ECB to provide Europe with some rays of light, removing restriction at every meeting. We expect another 25bp cut this week with the promise of more ahead. A slightly higher momentum for core inflation in December – driven by services prices – combined with a better-than-expected print for the Purchasing Managers' Index (PMI) in January probably brings to zero the probability the ECB would announce an acceleration of this pace this week (in clear, opening the door to 50bp cuts). Yet, **we find it sadly reflexive of the current level of gloom in Europe that a pitiful 50.2 level for the composite PMI is treated with such fanfare**.

This Thursday, there is little doubt Christine Lagarde will face a wall of questions on how Trump 2.0 is affecting her thinking. We have equally little doubt that she will deflect by stating that the Governing Council needs to see actual decisions, not vague threats, to calibrate a response. But **in Davos, she recognized Europe is facing an "*existential crisis*". This should be a strong enough reason for the ECB to focus on the downside risks to growth, rather than on any residual upside risks to inflation, in its decision-making**. Even if it is not for immediate consumption and we do not expect any major change of tone from the ECB this Thursday, we continue to think – unlike the market which has revised up lately its expected trajectory for European monetary policy – that the central bank will move its rates squarely into accommodative territory, hitting 1.5% by the end of this year (the market's baseline is at 2%).

Country/Region	What we focused on last week	What we will focus on in next weeks
	• President Trump inaugurated as 47th President. Raft of Executive Orders, focused on migration and de-regulation for energy and tech. Lighter start on tariffs, but not convinced this rings all clear for the coming four years • Jobless claims (initial and continuing) rise, most from California, which we expect reflects LA fires	• FOMC meeting (Jan). Expect FFR on hold at 4.50%. Likely to keep March cut on table. Press conf only • GDP (Q4, p) we forecast 2.8% (saar) to deliver 2.8% for 2024 as a whole. Market similar 2.6% for Q4 • PCE inflation (Dec) headline expected higher to 2.5% (from 2.4%), core stable at 2.8% • Consumer conf (Jan) headline and particularly expectations retraced sharply in Dec.
	• ZEW (Ge) was quite neutral, the flash PMIs more incisive with a positive surprise in both Mfg (45.3; +2.4pt) and Svcs (52.5; +1.3pt). Too soon to call it a rebound • Fr bus climate and flash PMIs were mixed and remains in depressed territory confidence • Flash consumer conf (EMU) improved in Jan at -14.2 (+0.3pt), Composite PMIs is back in expansion territory (50.2) but remains weak	• The ECB should cut its interest rates by 25bps and signal more to come • Ge Ifo (Jan), Fr consumer conf (Jan), It mg bus conf • Flash EMU GDP growth for Q4. We forecast +0.1%qoq of which Ge: +0%; Fr: +0%; It: +0.1%; Sp: +0.6% • EC surveys (Jan) with a focus on economic sentiment and selling price expectations • Inflation data for Jan with forecasts for Ge at 3%yoy, Fr at 2% and Sp at 2.6%. Uncertainties prevail with taxes adjustments, new weights, sales period
	• Labour market (Nov/Dec) showed unemp. rate rose to 4.4%, from 4.3%. Total pay rose to 5.6%, from 5.2%, above expectations • Public finances (Dec) showed PSNB overshot OBR expectations again • GfK cons conf (Jan) fell to -22, from -17 • Flash comp. PMIs (Jan) up 50.9, from 50.4	• BoE consumer credit (Dec) likely will remain weak • Mortgage approvals (Dec) look set to weaken slightly in the face of higher borrowing costs • Nationwide house prices (Jan) likely will edge down on yoy basis due to base effects
	• IP (Nov) fell by 2.2%mom, yoy down by 2.7% • Exports (Dec) up 2.8%yoy • Inflation (Dec) up 3.6%; core core unch at 2.4% • BOJ (Jan) hiked by 25bp to around 0.50% • Flash composite PMI (Jan) up 51.1, from 50.5	• Leading economic indicator (Nov) likely edged down • Cons conf (Jan) likely will remain subdued • Tokyo CPI (Jan) looks set to edge up; core core to edge up to 1.2%, from 1.1% • Retail sales (Dec) on trck to remain broadly unch.
	• LPR January unchanged at 3.1% and 3.6% for 1-year and 5-year respectively	• NBS mfg PMI and non-mfg PMI (Jan) • Caixin mfg PMI (Jan)
	• CB: Malaysia (3%) on hold, Turkey 250bp cut to 45% • CPI (Dec): Malaysia (1.7%), Singapore (1.6%), South Africa (3%) • GDP (Q4 qoq): South Korea (0.1%), Taiwan (0.5%) • Economic Activity Index (Nov yoy): Argentina (0.1%), Colombia (0.4%), Mexico • Industrial production (Dec yoy): Poland (0.2%), Singapore (10.6%), Taiwan (20%)	• CB: Hungary (6.5%) and Chile (5%) on hold, Colombia 25bp cut to 9.25%, and Brazil 100bp hike to 13.25% • GDP (Q4): Czech Republic, Hungary, Mexico, Philippines • Industrial production (Dec): Thailand

Upcoming events	US:	Mon: New home sales (Dec), Building permits (Dec); Tue: Durable goods orders (Dec, p), FHFA house price indec (Nov), Conference Board consumer confidence (Jan); Wed: Goods trade balance (Dec), FOMC announcement; Thu: GDP (Q4, p), PCE price index (Q4, p), Initial jobless claims (w/e 25 Jan), Pending home sales (Dec); Fri: PCE price index (Dec), Personal income and spending (Dec), Emp cost index (Q4)
	Euro Area:	Mon: Ge IfO business index; Tue: Sp Unemp (Q4); Wed: Sp GDP (Q4, p), Ez M3 supply (Dec), It ISTAT business confidence (Jan); Thu: Fr, Ge, It, Ez GDP (Q4, p), Sp HICP (Jan, Q4), Ez, It Unemp (Dec), Industrial confidence (Jan), ECB announcement; Fri: Fr HICP (Jan, p), Ge Unemp (Jan), Ez ECB consumer inflation expectations (Dec), Ge HICP (Jan), Ge CPI (Jan)
	UK:	Tue: BRC Shop Price Index (Jan), Thu: Nationwide house price index (Jan), Mortgage approvals (Dec)
	Japan:	Thu: Unemp (Dec)
	China:	Mon: Official mfg PMI (Jan), Official non-mfg PMI (Jan); Fri: Caixin mfg PMI (Jan)

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