AXA Investment Managers

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Investment Institute Macroeconomics

Labour Market Gap

- US labour market fuels the resistance of US interest rates, which is not making an already complex fiscal equation any easier.
- The European labour market is softening according to the ECB's own indicators: this should prompt more action.

The strength of the US labour market was confirmed last week: job creation is strong, wage growth is not consistent with a swift deceleration in services prices, while the high participation rate in the "belly" of the US workforce suggests the reserves of residents who could replace an interrupted flow of immigrants are scarce. The Fed is further validated in its decision to pause. None of this is great for the US bond market. Long-term (and short-term) rates remain higher than in the latest CBO forecasts for the US deficit, which adds to the risks of further drift. The White House has informally issued its tax plans: they are aligned with Donald Trump's electoral platform. We continue to think that solving the fiscal equation is going to test the new President's grip on his party. The disagreement between Senate and House Republicans on how to tackle the budget process is a warning shot. "Out of the box" ideas to provide the administration with some additional budgetary room for manoeuvre, e.g. playing on the Treasury's gold reserves, are a symptom of the depth of the fiscal conundrum the US is facing, and despite the 30-day reprieve granted to Canada and Mexico, we continue to expect some more substantial lift in overall US tariffs beyond the 10% levy on Chinese products, given the role tariffs' income plays in the fiscal plan of the administration.

Conversely, the latest quantitative and qualitative indicators released by the ECB suggest the European labour market is softening fast, and that a steep deceleration in wages is ahead. The latest ECB Corporate Telephone Survey also suggest European businesses consider – unlike the ECB hawks – that trade wars are deflationary, not inflationary. All this continues to push in the direction of more accommodation from the central bank, while the "EU leaders' retreat", at the beginning of last week, has not produced breakthrough decisions (at least not yet).

Last week, the Bank of England chose to cut by 25bps despite raising its inflation forecasts. One usually hawkish MPC member even sided with a dove to call for a 50bp cut. This is another sign that, outside the US, generic uncertainty is pushing central banks to focus on downside risks to growth, rather than on upside risks to inflation.

Plentiful US jobs

Signs of the enduring strength of the US economy continue to accumulate. True, on a purely monthly basis, job creation in January came out below expectations (143K versus 175K) but the revisions for the last two months (+100K relative to the December print) still suggest strong momentum. On a three-month annualised basis, job creation has accelerated nicely to 1.8% in January, from a recent trough at 0.6% in August of last year, and the rebound now appears much steeper when compared with last month's print (see Exhibit 1).

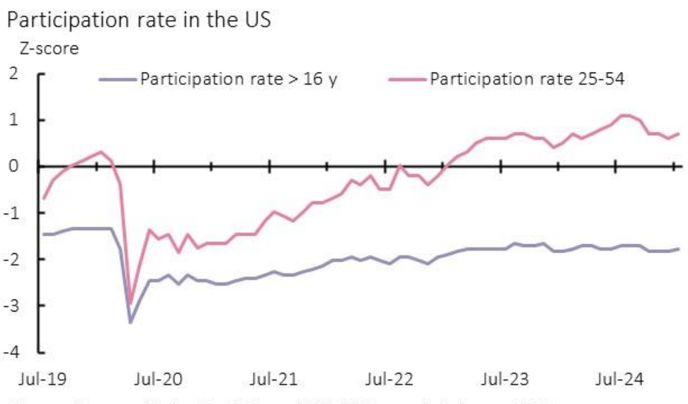
Against such a background, that wages still exhibit strong growth is not surprising: hourly pay rose by 0.5%mom in January, and the growth rate over the last three month was impressive (4.5%, up from 4.3% in December). We can tentatively translate this into unit labour costs dynamics. If one uses the Atlanta Fed's GDP nowcast for Q1 2025 (2.9%), a 1.8% gain in job creation – if sustained over the whole quarter – would be consistent with productivity growing by only 1.1%. Unit labour costs, assuming wage gains remain at 4.5% over Q1 – would then rise by 3.4%. This would be higher than in Q4 2024 (3.0% according to a preliminary estimate released last week), and inconsistent with the deceleration in services prices excluding rents – which are very sensitive to labour costs – which the Federal Reserve would want to see.

Last week's release of the employment report was particularly informative since it took on board, for the household survey thanks to which the unemployment rate is computed, **a revision in the population estimates**. It was significant: the civilian non-institutional population (non-institutional basically means people not in jail) was revised up by 2.8mn, but since the number of employed people was also revised up (by 2.0mn), the participation rate is now 0.1pp higher. The new population and labour force estimates are consistent with the data on immigration which suggested that the flows were large but with a particularly high employment intensity. This point deserves specific attention given the ongoing crackdown on immigration.

Exhibit 1 – Steeper rebound in job creation

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

Exhibit 2 – Not that much "workforce reserve"

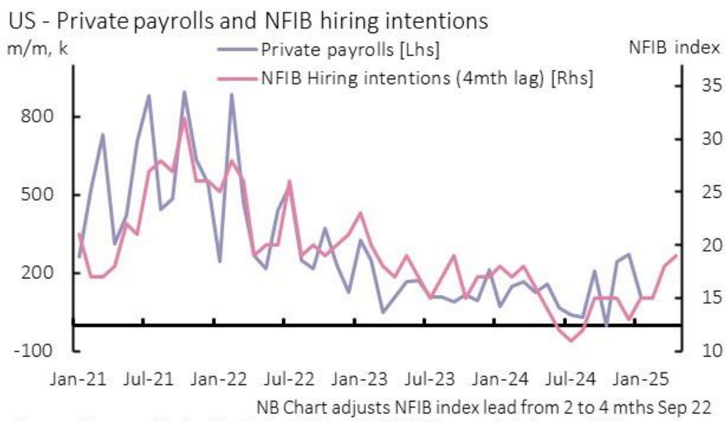


Source: Bureau of Labor Statistics and AXA IM Research, February 2025

In Exhibit 2, we look at the participation rate as a "z-score", with the 1990-2019 period as the basis for the long-term average. The aggregate participation rate continues to wallow nearly 2 standard deviations below this reference, but – and that is usually surprising for European readers – the US version of the participation rate uses the entire population above the age of 16. As the population gets older, naturally the participation rate, defined in this way, falls. This is why it is always more interesting to look at the developments in the "belly" of the US population distribution, people between the age of 25 and 54. It is the group which probably has the highest wage bargaining capacity. Their own participation rate has been standing above the long-term average since 2023.

This should put in question the idea that the US labour market is "on the whole" cooling. It is undeniable that job openings have been diminishing, while the "quit rate" has normalised, but this was against the background of rapidly expanding labour supply thanks – essentially – to immigration. **If immigration stops while job creation remains in the 1.5/2% growth area, it will probably take a sizeable increase in wages to lure more resident "non-workers" back onto the labour market**. Such scenario of tension resumption is supported by the latest business surveys. For instance, while the headline services ISM for January disappointed somewhat, the employment component rebounded strong, and the National Federation of Independent Business (NFIB) hiring intentions – which, if one corrects for month-to-month volatility, are good predictors of private payrolls – have taken off again (see Exhibit 3). All this keeps us comfortable with our call that the Federal Reserve (Fed) is already "done" for this year.

Exhibit 3 – More hiring ahead



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

But beyond the Fed trajectory, **the resilience of the US economy is also bad news for the US bond market**. After a few days of improvement, 10-year yields rose again after the Employment Report was released on Friday, gaining 7 basis points (bps) back to a whisker below 4.50%. Scott Bessent explained that his attention, as well as Donald Trump's, was focused on the long-end of the curve, rather than on the Fed's policy rates – which we took as an appeasement gesture at a time when concerns are mounting about a conflict between the US government and the Fed. He went on to say that if oil prices go down – a clear objective of the current administration, as per the President's direct call on Organization of the Petroleum Exporting Countries (OPEC) – inflation will normalise faster, allowing for a reduction in long-term interest rates. Yet, such rosy scenario ignores the domestic dynamics at play for prices, which are not going in the best direction. There could even be some knock-on effect of higher long-term interest rates on rents. Indeed, a steeper deceleration in rents, already suggested by real-time data, is one of the likely core inflation dampeners for 2025. But with mortgage rates stuck at a high level – they are only slightly below 7% now – more people could be forced into rentals, adding to the pressure on prices.

We need to talk about tax (and financial engineering)

Stubbornly high interest rates are also bad news for the US fiscal trajectory of course. The Congressional Budget Office (CBO)'s latest forecasts, based on their economic outlook incorporating data up to 4 December 2024, assume Fed Funds rate falling to 4% in 2025, and 10-year yields descending to 4.1% on average in 2025. We use a 2020 paper from the CBO (see link here, table 2.3) to estimate the effect of the entire curve moving up by 50 basis points relative to baseline. The deficit would rise by USD30bn in 2025 (0.1% of GDP), and USD90bn (0.3% of GDP) in 2026. Not a huge drift – although one needs to remember that the baseline would already put the deficit at a chunky 6.2% of GDP in 2025 without any impact from the new administration's policies. Besides, **this would be enough to wipe out the federal income boost from what remains of the tariff hikes announced on Saturday 1 February by Donald Trump**. Indeed, the 10% additional duties on Chinese products are all that is – for now – left of the first salvo, given the reprieve granted to Canada and Mexico. A back-of-the envelope calculation (i.e. without taking on board likely substitution effects) would put the additional income for the US federal purse at c. USD50bn. The 25% tariffs on steel and aluminium "pre-announced" on Sunday would not either "move the dial".

This gets us back to one of our familiar points: **in the new US administration's plan, tariffs are not there only to rebalance US trade, but they are also part of the fiscal equation**. Without this source of income, getting the tax cuts through Congress becomes more difficult. We can see how the Republicans are currently hesitating on the best course of action, with a gap appearing between the House and the Senate. The leader of the House is acutely aware of the lack of unity of the Republican caucus. He is therefore betting on one sweeping package mixing all the key elements of the Trump's platform in the hope that, for instance, fiscal hawks would accept unfunded tax cuts because of their interest in securing a much tougher immigration policy. The Senate Republicans however would prefer to move in two steps: first get a spending package providing the President with the Congressional approval on c. USD300bn towards some of his priorities – i.e. securing the border – and then only get into a proper budgetary discussion. We cannot help but suspect that Senators view this as a nice way to dampen the administration's enthusiasm for sweeping, but unfunded tax cuts, a view that is echoed by some of the fiscal hawks in the House's Republican caucus. We already mentioned in Macrocast how the refusal of nearly 40 House Republicans to grant the new administration a 2-year extension of the debt ceiling suggested the fiscal hawks "mean business".

The White House disclosed last week its tax plans: they fully align with the electoral platform: beyond the prolongation of the Tax Cuts and Jobs Act (TCJA) – which alone has been costed by the CBO at more than 1% of GDP in additional deficit every year – the government wants to eliminate income tax on social security benefits, reduce the corporate tax rate (in a way which would favour "made in America" production, which still remains to be defined), as well as raise the State And Local Tax deduction cap (SALT). The latter deserves some exploration. Before Trump's first mandate, Americans avoided double or triple taxation of the same income by the three layers of income tax authorities (municipal, state and federal). This was often seen – especially in Republican circles – as creating the wrong incentives for spendthrift states, which could raise their own level of income tax without hurting too much their constituents who ended up paying less federal tax. Low taxation states would ultimately subsidize the spendthrift ones since their own constituents would end up paying a higher share of federal tax. A cap at USD10,000 on SALT was introduced in 2017 as part of the TCJA, one of the very few components of the act which had the effect of *reducing* the deficit. This has however backfired as a fair number of Republicans now push for the removal or at least a substantial increase in the cap. According to the Penn-Wharton budget model, a full repeal would lift the federal deficit by 0.4% of GDP permanently.

Given this already difficult political and economic configuration, the efforts by Elon Musk's Department of Government Efficiency (DOGE) to cut into "day to day" government spending obviously come in handy – even if the ex-ante constraints (the big social programs are "off limits") make it unlikely massive savings could ensue. But even without these reservations, legal obstacles are mounting, with federal judges stalling DOGE's decisions.

These constraints probably explain why we have observed a re-emergence of "out of the box" ideas to give the US administration more fiscal air. One of them focuses on the fact that the Treasury's gold reserves are valued at one fiftieth of the current market price for gold in the government's accounts (no revaluation since 1971). Re-revaluing those reserves to their market price could lift the "debt ceiling" by USD500bn (c. 1/3 of the current deficit). Note however that if such manoeuvre could help deal with some of the political obstacles facing the White House, this would not change the dynamics on the bond market, as the supply of debt would continue to rise, while such financial engineering would be unlikely to reassure investors on the capacity of the US to fundamentally address its fiscal issues.

ECB hawks are losing their last argument

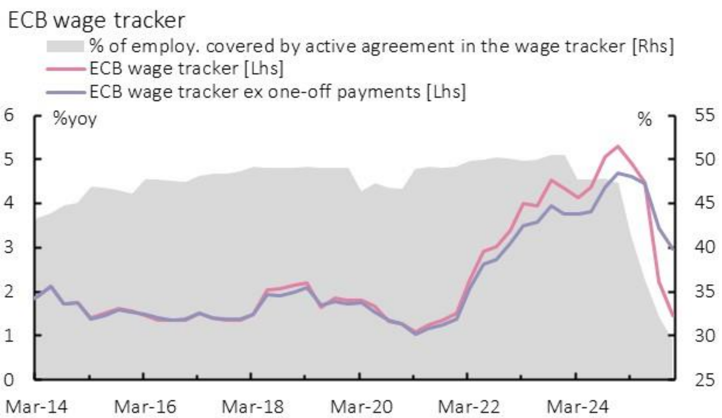
Europe has so far been spared by the first salvo of US tariffs. It seems however that **national governments and European institutions are already expecting to be "next on the list"**. We will need to see how the "reciprocal tariffs" mentioned by Donald Trump at the end of last week would work, but our baseline is that some tariffs will indeed be levied on European products. We confess we were somewhat surprised by the candid statement by Bernd Lange, the chair of the European Union (EU) parliament's trade committee, as reported by the Financial Times over the weekend: irrespective of their substance, his offer of reducing tariffs on US cars (actually on all imported cars irrespective of their origin), on top of raising European purchases of US Liquefied Natural Gas and military equipment *before* any precise threat is made by Washington DC may not the best move from a tactical point of view. Even if, from a fundamental point of view, we agree that tariff retaliations are counter-productive, they can come handy, at least as threats, in a negotiation. If Washington uses tariffs as leverage, the risk is that the American side will simply "pocket" the offer to demand more down the line.

Now, in the EU institutional set-up it is the Commission which oversees negotiating trade deals, not the EU parliament. The Council is however ultimately involved, and disagreements across member states are likely to emerge on the concessions which could be offered to the US. The "informal EU leaders' retreat", on 3 February, did not end up with firm conclusions (see the EU's official page here), but before the meeting France was reported to argue against a too high share of the planned additional EU spending on defence going to US contractors. We note on this issue that a report by Bruegel last year highlighted the fact that even the US defence industry is dealing with significant production bottlenecks, with delivery delays mounting (see the link here). This suggests that the US are not necessarily the right answer to Europe's need to rapidly scale-up its defence capabilities.

In any case, **uncertainty on the tariff front remains massive**. The reprieve for the North American countries triggered some hope that the final shock would be less disruptive than feared, but we cannot know what the US final decision will be on Canada and Mexico after the 30 days, nor when, and how, the tariffs threats on Europe will be voiced. The concessions offered by Canada and Mexico were not particularly onerous, but this may not be the end of the negotiation. A potential 25% tariffs on steel and aluminium will add to the sense that the trade conflicts are only starting.

All this probably already weighs on business decisions in Europe, at a time when investment is already soft. As we wait for a proper EU strategy, with Paris and Berlin currently unable to push through decisive packages themselves, **businesses could do with any kind of reassurance available**. We have been hammering the idea that swift accommodation from the European Central Bank (ECB) is the only candidate at this stage. Fortunately, we think the hawks are definitely losing the battle at the ECB. Their last argument was the still strong rise in wages, which could further delay the normalisation of services prices. The release last week of the ECB's own "wage tracker" has put that concern to bay, in our opinion, with a projected gain – based on available deals – of only 1.5% by Q4 2025 (see Exhibit 4). The deceleration in wages was confirmed by another source, the ECB's Corporate Telephone Survey, released on 31 January, which also painted a dim picture of the labour market in general: *"many manufacturing firms were laying off staff, while others had adopted a cautious approach to hiring. Employment placement agencies reported another quarter of declining business in most countries and sectors as well as a low rate of conversion of temporary contracts into permanent ones. "*

Exhibit 4 – Steep wage deceleration ahead



Source: European Central Bank and AXA IM Macro Research, February 2025

We were also quite interested in the qualitative comments in the Corporate Telephone Survey on the impact of potential US tariffs. As we suspected, European businesses are more concerned about the diversion effect of US tariffs on China than on the direct effect of US tariffs on their own products, but **the message to the ECB hawks who had been arguing a trade war could be inflationary, by disrupting trade lines, is straightforward: European businesses see the trade war as deflationary.**

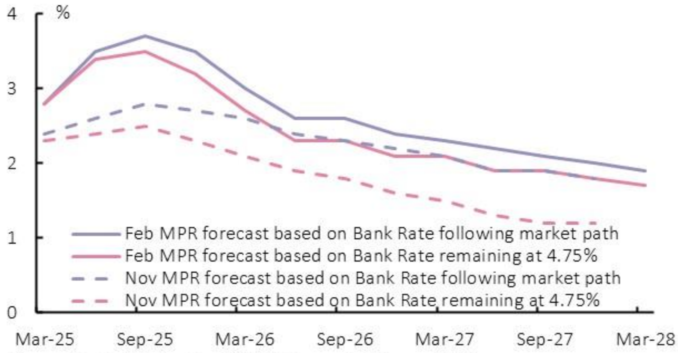
There was nothing revolutionary in the ECB staff research published last week on the neutral rate: the mid-point for the range is still 2%. So, there was little practical information there. But all the news-flow is in our opinion going in one clear direction: the ECB must break through neutral and bring its policy squarely in accommodative territory. We apologize to our readers for being so repetitive on this issue!

Bank of England cuts – and will continue cutting (we think)

That central banks *outside* the US should focus more on downside risks to growth than to upside risks to inflation takes a particular resonance in the UK since the best characterisation of the current situation there is “stagflation”. Yet, what we found the most striking in the Bank of England (BoE)’s decision last week is not so much the coexistence of another 25bp cut with an *upward* revision in the inflation forecasts (see Exhibit 5), but the fact that two members of the Monetary Policy Committee voted in favour of a 50bp cut. One of them is Catherine Mann, who certainly cannot be considered as a habitual dove. However, Catherine Mann has in the past expressed doubts about the wisdom of gradualism in rate setting. Her view is – possibly – that even if inflation is still sticky, the “writing is on the wall” on the real economy, which will ultimately force prices to decelerate.

Exhibit 5 – Inflation forecasts revised up

Bank of England CPI forecasts



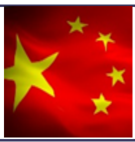
Source: Bank of England and AXA IM Research, February 2025

Exhibit 6 – Market is now very timid on the BoE

Market path underpinning BoE forecasts

Source: Bank of England and AXA IM Research, February 2025

Indeed, the bulk of the upward forecast revision for inflation comes from higher energy prices – largely dependent in the UK to government decisions and their timing – with little second round effects. With now accumulating evidence the labour market is deteriorating, underlying inflationary pressure will abate. We continue to think that the market’s outlook for the Bank of England – with only one more cut by the end of this year – is too timid. We continue to expect three more cuts this year, one per quarter.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• US imposed 10% tariffs on China, but deferred 25% on Canada and Mexico for 30 days • Labour report (Jan) payrolls +143k, but with net 100k increase to previous two months. Unemp dipped to 4% and earnings rose 0.5%mom • ISM indices (Jan) mfg rose to 50.9 (from 49.2) 28 month high, services dropped to 52.8 (54.0) • Vehicle sales (Jan) fell to 15.6m (from 16.8m), reversing impetus for strong Q4 consumption	• CPI inflation (Jan) headline and core rates expected stable, but upside risk from residual seasonality • PPI inflation (Jan) oil could push headline higher, but core expected to slow • Retail sales (Jan) weak headline expectations belie rising value – volumes to fall, driven by auto sales • Industrial production (Jan) expected to rise after strong year-close, suggesting some improvement
	• Euro area headline and core inflation came a tad higher than expected at 2.5% (+0.1ppt) and 2.7% (unch) in January, respectively • ECB wage tracker showed significant deceleration ahead • ECB staff estimates EMU nominal neutral rate c.2% (1.75%-2.25%) • France passed its 2025 budget	• Euro area industrial production (December) • Euro area Q4 24 employment growth
	• BoE rate decision & MPR (Feb) 25bp cut to 4.50%, with the vote split (0-0-7-2). CPI inflation revised up to 3.7% peak in Q3 • Final PMIs (Jan) rose to 50.6, from 50.4. Fastest pace of jobs shedding since GFC, ex. covid • Car sales (Jan) down 2.5%yoy	• BRC Retail Sales Monitor (Jan) likely will tick down from 3.1% in Dec. • RICS House Price Balance (Jan) looks set to remain strong in the run up to the SDLT change in April • GDP first estimate (Q4) we look for no change but risks are to the downside
	• Comp PMI (Jan) rose to 51.1, from 50.5, on the back of rise in services PMI to 53.0, from 50.9 • Cash earnings (Dec) up 4.8%yoy, from 3.9%. A fall had been expected • Household spending (Dec) up 2.3%mom • BoJ Tamura signalled more hikes this year to 1%	• Current account (Dec) look for a slight narrowing • Eco Watchers Survey (Jan) look for improvement in the outlook • PPI (Jan) look for further increase on the back of weaker yen
	• Caixin mfg PMI eased to 50.1 in Jan from 50.5; services PMI dropped to 51 from 52.2	• CPI and PPI (Jan), likely distorted due to CNY holiday • Total social financing numbers for Jan, expecting sharp rise due to CNY holiday effect
	• CB: 25bp cuts in Czech Republic (to 3.75%) and India (to 6.25%), Mexico 50bp cut to 9.5%, and Poland on hold (5.75%) • GDP (Q4 yoy): Indonesia (5.0%) • CPI (Jan yoy): Indonesia (0.8%), Thailand (1.3%), South Korea (2.2%), Taiwan (2.7%), Philippines (2.9%), Turkey (42.1%) • Industrial production (Dec yoy): Brazil (1.6%), Hungary (-5.3%), South Korea (5.3%)	• CB: Philippines 25bp cut to 5.5%, Peru (4.75%) and Romania (6.5%) on hold • GDP (Q4): Poland, Romania • CPI (Jan): Argentina, Brazil, Czech Republic, Hungary, India, Poland, Romania • Industrial production (Dec): Colombia, India, Mexico, Romania, Turkey

Upcoming events	US:	Wed: Budget statement (Jan), CPI (Jan), Thu: PPI (Jan), Initial jobless claims (Feb/06); Fri: Retail sales (Jan), Export prices (Jan), Import prices (Jan), Retail sales (Jan), IP (Jan), Business inventories (Dec)
	Euro Area:	Tue: Fr Unemp (Q4); Wed: It IP (Dec); Thu: Ez IP (Dec); Fri: Ge Wholesale prices (Jan), Ez GDP (Q4), Ez Emp (Q4, p)
	UK:	Tue: Retail sales (Jan); Thu: RICS House price balance (Jan), GDP (Q4, p), GDP (Dec), Business investment (Q4, p), Goods trade balance (Dec), IP (Dec), Mfg production (Dec)
	Japan:	Mon: Current account (Dec)
	China:	Mon: New Yuan Loans (Jan)

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** As at the end of December 2023.

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