251 – 16 December 2024

Plotting a Skip

We wish our readers a great festive season – Macrocast is taking a break and will come back on 6 January 2025

- The ECB has resorted to a convoluted but ultimately reassuring forward guidance. Meanwhile, the SNB expressed its reluctance to return to negative rates: the familiar ghost of unconventional policy is haunting Europe again.
- The Fed will likely telegraph a slower pace of cuts next year with a new dot plot.
- We look again at parliamentary arithmetic in France now that a new PM has been appointed.

Forward guidance is very much the central banks' main issue as the year is drawing to a close. The ECB provided some, breaking away from a pure "data dependent" mantra, but in a convoluted way: the ECB no longer thinks monetary policy will need to remain "sufficiently restrictive" to bring inflation back to target, but considers that even after last week's cut, monetary policy is still restrictive; ergo, more cuts are in the pipeline. Christine Lagarde mentioned a range for the neutral rate (1.75% to 2.50%), lower than the estimate provided by Isabel Schnabel the week before. For our part, we think the ECB will ultimately have to go into properly accommodative territory, below the market's current pricing, at 1.5%, in 2H 2025. The SNB surprised the market with a 50bp cut, but their language expressed a reluctance to go back into negative territory if more is needed – which is highly likely. Given the specific situation of Switzerland, a return of substantial FX intervention is lurking.

This week, it will be the Fed's turn. Rather than the widely expected 25bp cut, focus will be on the new "dot plot". We think the Fed will point to a slower pace of return to neutral, beyond the "one cut per quarter" implied by the September forecasts, endorsing the market view that it will "skip" at least one of those quarterly cuts (we expect only one cut in 2025, in March). How Powell discusses "Trumpnomics" is another point of focus. While the Chairman does not need to explicitly comment on Trump's policies, he can re-use the Fed's approach of December 2016 and point to a more expansionary fiscal policy as an input in the new forecasts, as suggested by Bill Dudley.

France has a new Prime Minister, but the arithmetic of power has not changed. If a "pact" emerges where the government pledges to stop using the 49.3 procedure against a pledge by some parliamentary groups outside government not to support a motion of no confidence, a "proper" political agreement on the budget will be needed.

Complicated, but ultimately reassuring

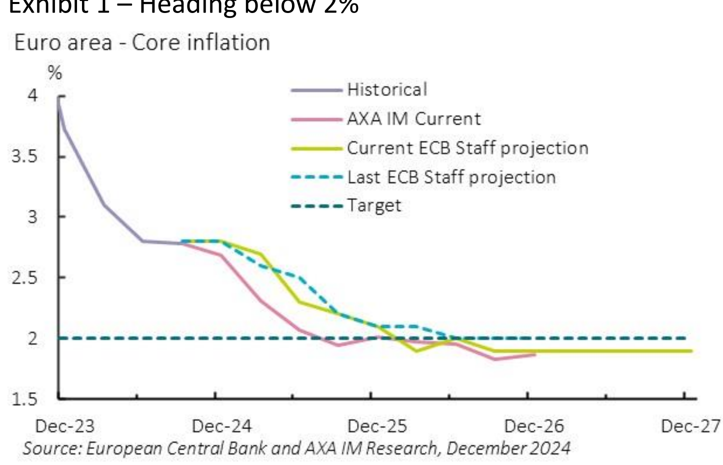
The European Central Bank (ECB)'s 25bp cut last Thursday was widely expected, so focus was on the next steps. **The ECB hinted at more rate cuts, but in a convoluted way, providing a two-step, complicated form of forward guidance.** Indeed, Christine Lagarde said unambiguously – reaffirming a point in the prepared statement – that even after bringing the deposit rate to 3.0%, monetary policy is still restrictive, while the prepared statement no longer contains the key point that monetary policy needs to be "*sufficiently restrictive for as long as necessary*" to bring inflation back to target. Putting the two together, the ECB signals it wants to cut further, but the message is not straightforward, probably owing to lengthy internal negotiations between hawks and doves.

The choice of language opens a broad set of possibilities: if the direction of travel is clear, the path and the landing zone remain uncertain. Removing the need to keep monetary policy "sufficiently restrictive" can be understood by the hawks as a signal that bringing the policy rate to neutral will suffice, and by the doves that nothing prevents the ECB from taking it squarely into accommodative territory.

However, **the concession to the hawks is not massive**. We commented last week on Isabel Schnabel's estimate that the neutral rate stands in a range of 2.0% to 3.0%. Yet, Christine Lagarde said forcefully that restriction is still here, which means that she (and a majority of the Governing Council) considers the neutral rate stands lower than in Isabel Schnabel's view. Towards the end of the Q&A, she mentioned a research paper by the ECB staff which estimates the range for the neutral rate at 1.75%-2.5%. True, she was cautious on the number, and she has created some wiggle room by announcing that the central bank will "*debate in due course*" these estimates, but her point on "*we will see when we get there*" , and not "if", was another stone in the garden of those who think that the monetary stance has already hit the upper end of the neutral rate range, as well as another way to signal more cuts are in the pipeline.

In any case, **this leaves 50bps of cuts before the central bank gets to the staff paper's upper estimate**. Our baseline is that they get there in two 25 basis points (bps) increments, but Christine Lagarde's reference to some Governing Council members put a 50bp cut on the table at the December meeting already suggests that the door is not completely shut, depending on the data and news-flow by January.

Exhibit 1 – Heading below 2%



Source: European Central Bank and AXA IM Research, December 2024

Precise decisions are not made – Christine Lagarde maintained the "data dependent, meeting by meeting" mantra – and probably cannot and should not be made: the ECB – just like all stakeholders – is grappling with unusually high uncertainty, but at least there is no a priori rejection of the possibility the ECB will have to dig deep into its policy space. Indeed, risks on the inflation trajectory are "*two-sided*" around a new, slightly lower inflation forecasts. The change was marginal numerically, but symbolically important: core inflation would hit 1.9% in 2026, against 2.0% in the September batch (see Exhibit 1). A crucial point – on which the economists of Bank of America zeroed in – is that **this**

downward revision was obtained despite a lower assumption for policy rates – the ECB uses market pricing – at 1.8% in 2026. In other words, the ECB accepts that hitting its inflation target could be consistent with quite a few additional cuts, possibly down to the bottom of the research paper's range for the neutral rate.

We continue to think that mediocre data on the real economy and lower inflation – below the ECB's updated forecast – will ultimately force the ECB to cut down to 1.5% by the end of the next year, i.e. into accommodative territory if one uses the 1.75.2.0% range for neutral. We feel more confident about our below market call after the ECB's Governing Council meeting. We note that the market reaction is more subdued, with a 10bp rebound in the forward-based pricing of the deposit rate last Friday. We are tempted to ascribe this to the quite complex nature of the ECB's change of language.

Groundhog Day at the SNB

The Swiss National Bank (SNB) may have a new President in Martin Schlegel, but it is tormented by the same forces and facing the same dilemmas each time the "global monetary stance" turns to accommodation – or restriction removal. Switzerland is one of the very few cases where inflation is undershooting the central bank's target (0.7%yoy in November). The country owes it essentially to its safe haven status, which pushes the currency even further in times of global uncertainty (see Exhibit 2). So far in this cycle, the SNB has endeavoured – in vain – to discourage currency appreciation by moving ahead of other major central banks, especially the ECB. **It is now running out of conventional policy space.**

Exhibit 2 – Strong currency, weak inflation

Source: BNS, Macrobond and AXA IM Research, December 2024

Last week, SNB surprised the market by resorting to a "jumbo" 50bp cut (only 30 were priced in), leaving its policy rate at a meagre 0.5%. Yet, by disposing of its previous forward guidance pointing to further rate cuts in its press release – replaced by a less precise reference to "policy adjustments" – it sent the signal that it is very reluctant, to say the least, to cross again the zero bound and bring its policy rate into negative territory. Martin Schlegel explicitly said that moving by 50 bps last week reduced the probability of having to resort to negative rate has come down. This is however not the only unconventional tool in the SNB's arsenal. **The CHF exchange rate softened a bit (losing 0.6% on the day) but we suspect this has more to do with the market jumping to the conclusion that substantial FX intervention would ultimately need to be reinstated, rather than reacting to the surprise drop in the policy rate.**

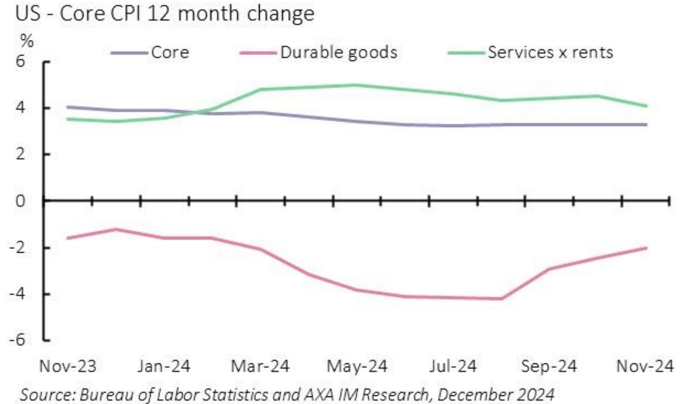
True, the SNB's "introductory remarks" to the press conference stated that "*policy rate cuts continue to be our main instrument should monetary policy have to be eased further"* but with only 50bps left before hitting zero, market participants would be excused if they paid more attention to the following sentence: *" At the same time, we remain willing to intervene in the foreign exchange market as necessary"*. This is certainly not new, but it takes more prominence now.

An interesting issue in our view is whether the SNB is the "canary in the coalmine" pointing to a more generalised recourse to unconventional monetary policy elsewhere in Europe. Switzerland is a very specific case, because of the exchange rate pressure and below-average inflation prints. As we discussed in the previous section, the ECB still has some substantial policy space before thorny questions emerge, and so has the Riksbank. Yet**, the situation in which the SNB finds itself today should act as a reminder that it may be unwise to *ex ante* rule out dipping again in conventional territory**. Central bankers are generally reluctant to deploy the "weird arsenal" – the Riksbank Governor provided in 2020 a simple but effective talking point on negative rates *("people find them weird*"). Still, expressing too much confidence in the fact that deflation will never return could come back to bite central bankers down the line.

US inflation bad news

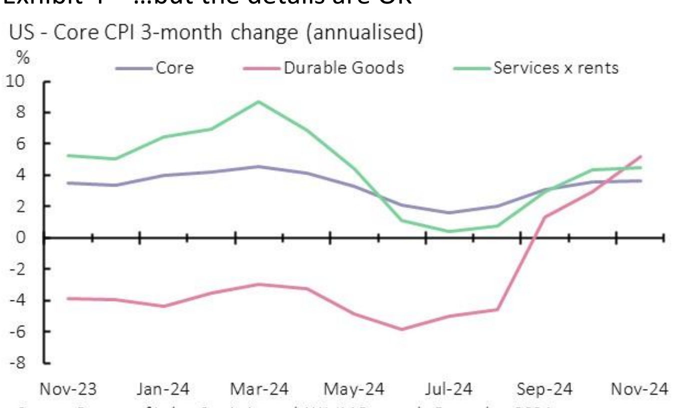
While Europe may have to brace itself for inflation undershooting, **the US is not out of the woods when it comes to bringing inflation back to target from the upside, even before Donald Trump's policies start to be implemented**. We wrote last week that, should the Federal Open Market Committee (FOMC) decide to pause their "restriction removal process" at the December meeting, they could easily find some good reasons, between more signs of resilience of the labour market and concerning signals in the latest inflation prints. There were however enough reassuring elements in the details of the November Consumer Price Index (CPI) data to justify another rate cut next week, as per our baseline, even if the headline numbers were not great. Still, while Fed Funds are still in restrictive territory, we expect the FOMC to telegraph a slowdown in the pace of cuts.

Exhibit 3 – Core inflation flat …



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

Exhibit 4 – …but the details are OK



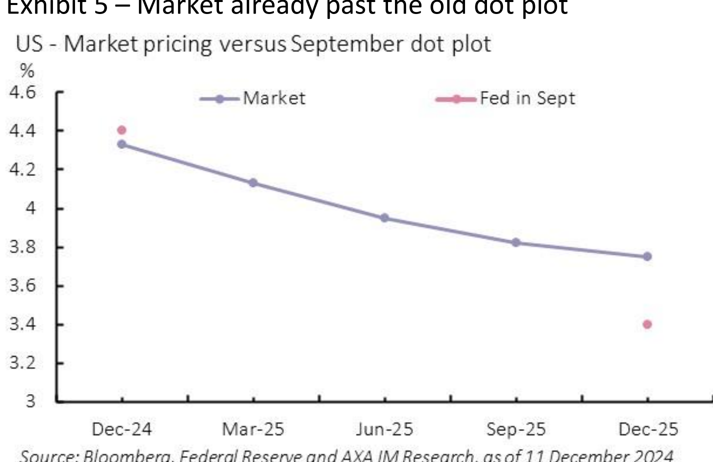
Source: Bureau of Labor Statistics and AXA IM Research, December 2024

On the face of it, the November CPI print could fuel even more concerns over the chances to see inflation properly hit the Federal Reserve (Fed)'s target next year. Indeed, as expected, headline inflation moved up in year-on-year terms, from 2.6% to 2.7%, while core remained stuck at 3.3%yoy, the same pace for four months. However, **the subindex on which the FOMC is the most focused, services excluding rents, decelerated to 4.1%yoy, the slowest pace since February 2024** (see Exhibit 3). In terms of momentum, on a 3-month annualised basis core CPI continues to grow too fast relative to target (3.7%) but at least the acceleration from October (3.6%) was not as steep as what had been observed in the previous three prints (see Exhibit 4). It is at best a "bottle half full" overall picture which emerges, but **given the Fed's habitual communication practices, we think that a message would have already come out if the FOMC was set on "skipping" December.**

Still, **if the cut this week is widely expected – a probability of 94% of a 25bp cut was priced as of last Friday – what the market is going to be focused on (much like for the ECB last week) is any message on the future trajectory.** The Fed cannot avoid providing some forward guidance since it will release a new set of forecasts, including a "dot plot". The one from September – with 4 cuts in 2025 – is old news, and the market is already less greedy than that, expecting only three (see Exhibit 5). A complication is that the FOMC communicates on a rate level at the end of each year, not on a proper trajectory, but **the September batch was consistent with once cut per quarter**. In principle, this would already

fit the message from several FOMC members who over the last few weeks have stated that the central bank is near the point when it needs to slow down the pace of "restriction removal". Yet, taking on board the resilience in the economy, the latest inflation prints, and quite simply where the market expectations pricing already is, **we think the FOMC raise its rate forecast by the end of 2025 by 25bps at least**. We would expect them to maintain a downward path subsequently but hitting their forecasted long-term level for Fed Funds (currently 2.9%), a good proxy for the "neutral rate", in 2027 instead of 2026. In other words, we expect the Fed to telegraph that it intends to "skip" at least one quarter in their descent to neutral and move more cautiously in this direction. Another way for the Fed to telegraph a more prudent attitude towards easing would consist in raising – once again – their estimate for the long-term level of Fed Funds in the forecast.

Exhibit 5 – Market already past the old dot plot



Source: Bloomberg, Federal Reserve and AXA IM Research, as of 11 December 2024

Of course, the "dot plot" is heavily conditional and in the past has not been a good predictor of actual decisions. It is at best a "statement of intention" associated to a baseline for inflation and growth which, by construction, cannot take on board future shocks. **An issue however this time – and journalists are likely to zero in on this during the Q&A – is that the materialisation of one future shock is quasi-certain, even if its intensity is unknown: the policy change the Republican administration will bring about from late January 2025 onward**. So far, the Fed's communication has held the line that the central bank cannot "pre-empt" decisions from the administration. Yet, we agree with former New York Fed President William Dudley in his Op Ed in Bloomberg on Friday that the *"we don't assume, guess or speculate"* line by Powell is untenable since the change in fiscal policy is largely predictable – at least the bit about prolonging the 2017 tax cuts – and expected by the market.

Dudley referred in his Op-ed to the Fed's approach to Trump 1.0 when he was a member of the FOMC. Indeed, the minutes of the December 2016 FOMC meeting make plenty of references to the elections and their likely result on fiscal policy. The minutes for instance made it plain that *"about half of the participants incorporated an assumption of more expansionary fiscal policy in their forecasts"*. The median FOMC member lifted its trajectory for the Fed Funds in 2017 from 2 to 3 hikes. Yet, there was no explicit reference in the statement issued at the time, and in her press conference that day Janet Yellen minimised the message contained in the change in the dot plot even if she stated that new assumptions about fiscal policy had played a role. Powell could follow a similar approach this week. "Skipping" January – at least – will give the FOMC time to evaluate the first policy announcements by the incumbent administration. For our part, we think the combination of "spontaneously" resilient inflation and quick decisions from the Trump administration in the field of international trade and immigration will ultimately allow the Fed to cut only once in 2025, in March.

France: some stability, but still very complicated

The appointment of centrist veteran Francois Bayrou as Prime Minister in France leaves the arithmetic of power unchanged in France, at a time when Moody's decision to downgrade the debt of the French sovereign acts as a reminder that, as much as the "special law" soon to be voted by parliaments protects against a US-style shutdown exercise, the fiscal challenges remain daunting. The new Prime Minister, in his acceptance speech, made it plain that addressing France's fiscal situation was his first priority. How he will endeavour to deliver remains uncertain at the stage.

The good news is that, with the rollover of the 2024 budget into 2025, the new government will have a bit of time to design and negotiate with political factions a "proper" budget. Michel Barnier only had a few weeks to deliver a budget bill, with the result that the negotiations – which ultimately failed – had to take place while the parliamentary process, which is confrontational by nature (at least in France), had already begun.

We noted in our previous issue of Macrocast that some "cracks" were appearing within the left-wing group. This is being confirmed: while hard left La France Insoumise (LFI) has already announced it will table a motion of no confidence, the other groups of the left alliance are maintaining the possibility of a "pact" through which, in exchange for the government's respect of some "red lines" and pledge not to use the 49.3 procedure, they would refrain from supporting a motion of no confidence. The situation remains fluid, but we can explore some ramifications. By construction**, if the government does not use 49.3 to get a budget bill through without a vote, it means that it will need to get enough "ordinary" support for such bill.** If Rassemblement National (RN) and the hard left vote against it, the government will need to find more than 211 deputies to vote in favour of the bill. The centrist alliance has 163 votes. With the centre-right – which was part of the previous government block and is expressing interest in staying on board – it can get to 210. **With the help of a few non-aligned deputies, the government could overcome the hard left and RN opposition…but only if the other groups of the left abstain.** This needs to secure "at least" the abstention of the centre-left would probably tilt the budget bill towards an adjustment relying more on tax hikes than spending cuts.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• CPI inflation (Nov) in line at +0.3%mom, but important services components softer • PPI inflation (Nov) rises to 3.0% from 2.4% • NFIB survey (Nov) jumps 10pts, same as after 2016 election • Household net worth (Q3) up $4.8tn, continued strong gains underpin consumer spending	• FOMC announcement (Dec) expect 0.25% rate cut. Fed likely to signal slower easing in 2025. Dot plot to see fewer cuts in 2025, watch long run FFR est • Retail sales (Nov) expected to resume solid gains after dip in control group last month • Empire & Philly Fed indices (Dec), diverged in Nov • PCE inflation (Nov) headline & core expected higher
	• The ECB cut its interest rate by 25bps, removed its forward guidance *"it will keep policy rates sufficiently restrictive for as long as necessary to achieve 2%"*, opening the door to further rate cuts until the neutral rate is reached. Debate will shift to the neutral and whether the ECB could go into accommodative territory at some point • EMU ex.Ireland (Oct) came at -0.6%mom • E.Macron appointed the centrist Bayrou as PM	• December Flash PMIs, Ifo and ZEW in Ge, INSEE business climate in Fr, Istat Business confidence in It, industrial sales (Oct) • EMU consumer confidence flash (Dec) • EMU final HICP (Nov)
	• RICS Residential Market Survey (Nov) pointed to an uptick in prices, demand and supply • Monthly GDP (Oct) fell by 0.1%mom, after a similar 0.1% drop in Sept. We now see growth of just 0.1%qoq in Q4 • GfK cons conf (Nov) slight rise after pre-Budget lows, but still weak by past standards	• Flash PMIs (Dec) look for slight improvement • Labour market (Oct) look for further signs of loosening in vacancies and PAYE data • CPI inflation (Nov) look for further uptick to 2.5%, due to tax changes and fading energy drag • BoE (Dec) Bank Rate unch at 4.75% (8:1 split) • Retail sales (Nov) look for further monthly drop
	• Final GDP (Q3) revised up to 0.3%qoq, from 0.2% • PPI (Nov) further 0.3%mom increase • Tankan survey (Q4) large manu. up +14, from +13, but outlook fell to +13, from +14. All industry up at 11.3%, from 10.6%	• Flash PMIs (Dec) look for slight increase • Exports (Nov) look for signs currency swings are boosting exports • BoJ (Dec) look for a hike to 0.5% • Inflation (Nov) to rise to 2.5%
	• CPI inflation edged down to 0.2% in November from 0.3%. Core CPI rose to 0.3% from 0.2% • PPI deflation improved to -2.5% from -2.9% • Exports slowed to 6.7% in November from 12.7%; imports worsened to -3.9% from -2.3%	• Money supply for November • November monthly production output including fixed asset investment, retail sales, industrial and production
EMERGING MARKETS	• CB: Brazil 100bp hike to 12.25%, Peru (5%) on hold • CPI (Nov): India (5.5%), Romania (5.1%), Brazil (4.9%), Poland (4.7%), Mexico (4.6%), Hungary (3.7%), Czech Republic (2.8%) • Industrial production (Oct): India (3.5%), Malaysia (2.1%), Czech Republic (-2.1%), Mexico (-2.2%), Turkey (-3.1%)	• CB: Hungary (6.5%), Indonesia (6%), Thailand (2.25%) and Taiwan (2%) on hold, Philippines 25bp cut to 5.75%, Mexico 25bp cut to 10%, Colombia 50bp cut to 9.25% • CPI (Nov): Malaysia • Industrial production (Oct): Colombia • GDP (Q3): Argentina

Upcoming events		
	US:	Mon: Empire state survey (Dec), Mfg, svc & composite 'flash' PMI (Dec); Tue: Retail sales (Nov), IP (Nov), Business inventories (Oct), NAHB index (Dec); Wed: Current account (Q3), Housing starts (Nov), FOMC announcement; Thu: GDP (Q3), PCE price index (Q3), Philadelphia Fed index (Dec), Initial jobless claims (w/e 14 Dec), Existing home sales (Nov); Fri: PCE price index (Nov), Michigan consumer sentiment and inflation expectations (Dec)
	Euro Area:	Mon: Fr, Ge, Ez mfg & Svc 'flash' PMI, Ez composite PMI, Ez Eurostat labour costs and wage growth (Q3); Tue: IfO business climate index (Dec), ZEW survey (Dec); Wed: Ez HICP (Nov); Thu: Fr Insee mfg confidence (Dec); Fri: Ge PPI (Nov), Ez consumer confidence (Dec, p)
	UK:	Mon: Composite, mfg, svc 'flash' PMI (Dec); Tue: Unemp (ILO) (Oct), Avg earnings (Oct); Wed: CPI (Nov), CPIH (Nov), RPI (Nov), PPI input & output (Nov), Thu: MPC announcement; Fri: PSNB (Nov), Retail sales (Nov)
	Japan:	Mon: Mfg 'flash' PMI; Thu: BoJ announcement, CPI (Nov)
	China:	Mon: IP (Nov), Retail sales (Nov)

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