AXA Investment Managers

# 266 – 14 April 2025

Investment Institute Macroeconomics


# Low Visibility Navigation around Known Reefs

*Note to our readers: Macrocast is taking a pause this week. Next issue on 28 April*

- The latest information is still consistent with a brush with recession in the US in 2H 2025.
- The success of "Reaganomics" in the early 1980s is not the right precedent to think about today's US policy stance.
- Upon cutting by 25bps, we expect the ECB to express their readiness to adjust further if need be.

Sketching out more scenarios is a somewhat vain exercise in the highly volatile policy environment in the US. We can however adjust our previous assessment of the shock to the latest news. The temporary concessions on 9 April have changed the distribution of the shock for the rest of the world (less tariffs on almost everyone, but a much bigger one on China), but even after factoring in the reprieve on Chinese electronic goods (also only temporary), the overall magnitude of the inflation spike and GDP loss for the US is essentially unchanged: we still think the US will experience a brush with recession in 2H 2025. The size of the US shock – at a time when consumer confidence is already nose-diving – is likely to trigger more inflections in the White House's position in the months ahead and we suspect that the final tariffs will be smaller than those announced last week. Yet, sheer uncertainty alone, unless negotiations resolve very quickly, will take its toll on business capex, financial conditions and consumption.

We try to take some distance from the current news flow to explore a narrative which is apparently becoming popular in Washington: as disruptive as the current administration may seem, "Reaganomics" in the early 1980s were equally challenging to the received wisdom of the day but proved so successful that even after a "transitory recession", Ronald Reagan was comfortably re-elected in 1984. Republican lawmakers should thus "stay the course" today. Looking back to the 1980s though, "Reaganomics" were less divisive than often thought – the President passed his tax cuts with the help of a significant fraction of Democratic Representatives – and, crucially, the "misery index" – the sum of inflation and the unemployment rate – peaked *before* Reagan took office.

For all the instability, all the news flow points to faster disinflation in Europe and continuing for now to cut at a steady pace – while making it plain that the ECB will do what it must to deal with the changes in the Euro area's international environment – is probably the best course of action for the Governing Council given the uncertainty level.

## It is still too big!

The situation remains of course extraordinarily fluid but despite the concessions offered by D. Trump on most countries on 9 April, the shock to the US – and global – economy remains massive. Given the pain the US will experience within the 90 days allocated to negotiations, it is likely that the final average tariff on US imports will be lower than what has been announced on "Liberation Day". The White House's announcement over the weekend that computers, chips and mobile phones from China would be exempt from the tariff add-ons is another sign that, as the US becomes more aware of the damage, more compromise will come. However, given the role tariff revenue plays in the US administration's fiscal plans, a full "disarmament" is unlikely. In the meantime, the mere impact of uncertainty on investment decisions, added to the effect of the already-enforced custom duties, would still result in significant global GDP losses.

As we discussed last week, on 2 April, the uniform reciprocal tariff of 10%, with country-specific add-ons, combined with the measures already announced in February and March (e.g. 25% on metal and on c.50% of Canadian and Mexican products) would have brought the weighted average tariff to 22.5%, 10 times the "pre-Trump level". The suspension of the "add-ons" on 9 April for 90 days was more than offset by another hit at China, whose products (13% of US imports) faced a total tariff of 145%. The weighted average tariff was going to reach 27%, according to the same source for the aggregation (Yale Budget Lab). If we take out computers, phones and related products imported into the US from China, as per D. Trump's announcement on Saturday, this leaves out of the reciprocal tariff hike roughly one fifth of total Chinese shipments to the US, but they will still be subject to the 20% surcharge announced before "Liberation Day". **The shock is now distributed differently for the rest of the world but even after this weekend's additional concession, it remains in the same ballpark for the US economy as in the initial version.**

Exhibit 1 – Trade uncertainty rose further

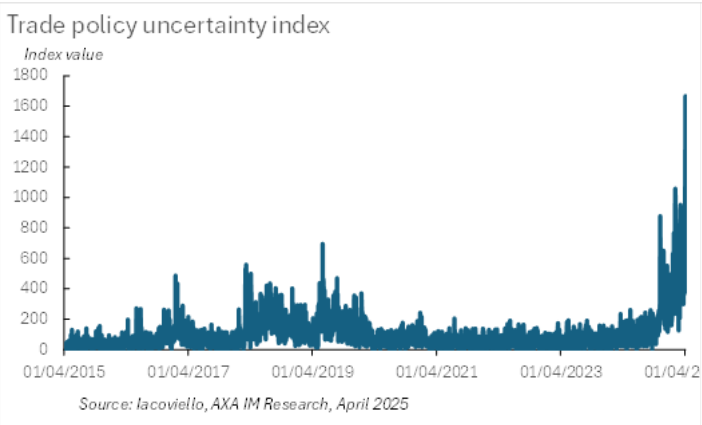
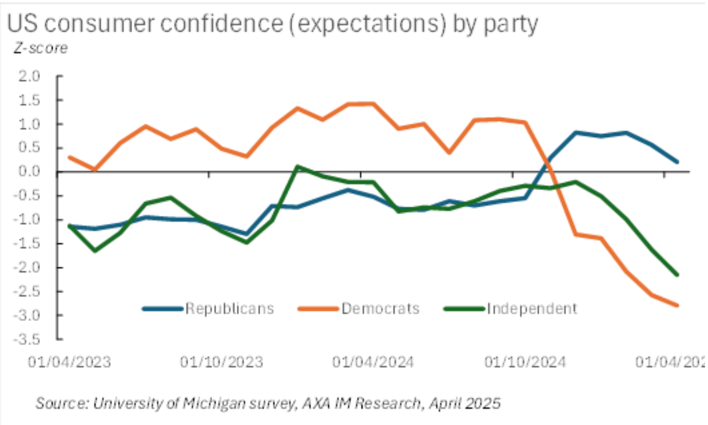



Exhibit 2 – US consumers are getting VERY morose

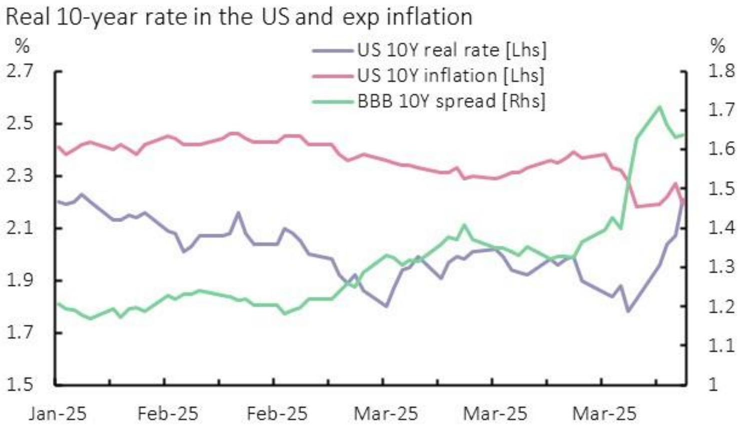



Mechanically, the tariff shock would still push US inflation up by more than 2%, hitting households' purchasing power and eroding business margins, compressing consumption (also affected by negative financial wealth effects) and investment. Some substitution away from foreign products will mitigate the blow, but domestic players may be inexistant or respond by raising their own prices. Oil prices will still offer some mitigation (they are down c.20% since inauguration day), and we pencilled in a 0.5% overall effect on US headline US inflation, but the overall price shock would still be enough to bring inflation to twice the Federal Reserve (Fed)'s target.

Now, while the "actual shock" may end up being lower than the headline figures suggested last week, **the daily "trade policy uncertainty index" – which now includes some "post Liberation Day" data – has skyrocketed** (see Exhibit 1). Even the reprieve on electronic products imported from China is deemed by the US administration to be "temporary" (the point was made explicitly by Commerce Secretary Lutnick on Sunday) while they are working on a general tariff on this type of products. Unless more progress is made rapidly on the negotiation front and some stability is found on communication, we are inclined to scale further up the uncertainty impact on business capex estimated by Matteo Iacoviello at the Fed during the first trade war on 2018-2019 by a factor 3, rather than the factor 2 we used last week, which would result in a reduction in business investment of 3-6% from baseline. The deterioration in consumer confidence continues at full speed. When looking at the expectations component of the Michigan University survey, what is striking is that even Republican-leaning respondents are reporting a decline in their level of confidence – even if it remains still slightly above its long-term average. **The plunge in Independents' confidence is very similar to the Democrats' (see Exhibit 2). The loss of optimism is now pervasive.** We note that the survey was conducted between 25 March and 8 April, so does not fully reflect the state of opinion after "Liberation Day". Actual spending is highly likely to fall. This may take a few weeks to emerge, as customers may try to "beat the tariffs" by stepping up their purchases while retailers still have inventories from "pre-tariff" times to offload, but over a few months at most, the direction of travel is obvious.

**The stagflationary risks still embedded in the White House's policies are not lost to the market, as the risk premium on US corporate debt has soared, as it should when the likelihood of a recession rises**. As of last Friday, 10-year rates on BBB-rated corporate debt in the US stood at 6.09%, 50bps higher than the day before "Liberation Day". The uptick in real rates on US treasury yields, rather than reflecting, as it often does, an improvement in the growth outlook, is merely an indication that investors are now also demanding a higher risk premium for holding government securities (see Exhibit 3). The – rather hesitant – rebound of the equity market after the concessions can be seen as a "relief trade" now that it has been established that Donald Trump can backpedal in case of intense market pressure. Yet, as we discussed, redistributing pain in the rest of the world does not necessarily reduce pain in the US. This administration is still expressing a readiness to contemplate a lot of "transitory turbulence".

Exhibit 3 – US corporate funding getting more expensive




*Source: Macrobond and AXA IM Research, April 2025*

**The communication from the Fed last week strengthened our view that, while ultimately the Federal Open Market Committee (FOMC) will offer accommodation once the damage on the labour market materialises, monetary policy will not "rush to the rescue" of the real economy, even if the Fed stands ready to protect financial stability.** The Fed has for now chosen an approach similar to what the Bank of England adopted during the "Liz Truss episode" of 2022: readiness to provide liquidity if financial stability is seriously impaired, but in a way that would be disconnected from monetary policy "proper". This is at least how we understood the statement by Boston Fed President Collins last week. Indeed, while she stuck to the customary, reassuring line that "*markets are continuing to function well*", she made it plain that the Fed "*has the tools to address concerns about market functioning*", but she also stated clearly that "*the core interest rate tool we use for monetary policy is (…) probably not the best way to address challenges of liquidity or market functioning*". Separation between safeguarding financial stability and delivering on the dual goals of monetary policy – price stability and full employment – is still there. The Fed's reluctance to offer "easy support" is another reason to believe the Trump administration will have to continue to offer concessions. We still think that the Fed will end up cutting by more than 100bps, but also continue to think there is little reason for the FOMC to start the process quickly.

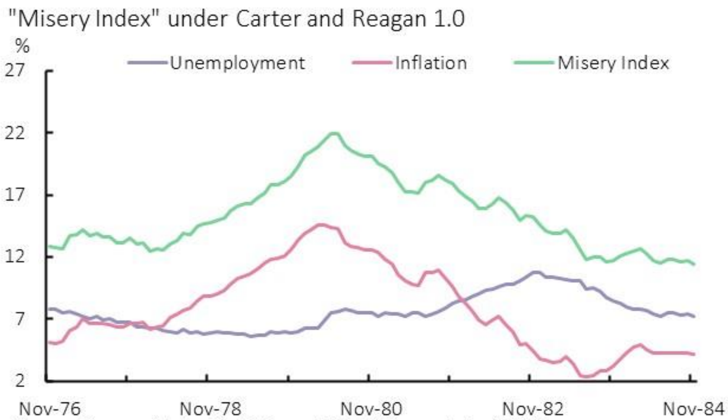
## Trumpnomics versus Reaganomics

**What may be surprising at this stage is how timid the reaction of the Republican Party still is to the Executive's actions.** True, a few Republican Senators mounted a bipartisan attempt at snatching back authority on trade from the White House, and some of them were very transparent in their criticism – Ted Cruz for instance. This probably played a role in D. Trump's decision to offer some concessions. Still, the Republicans had a great occasion to exert their leverage on the Presidency by dithering further on the budget, but their caucus last week managed to rally their thin majority to make further progress on the "reconciliation process".

Donald Trump's popularity among Republican activists probably plays a role in this state of affairs, but fundamentally**, a narrative has emerged around a replication of Ronald Reagan's impressive achievement in his first mandate**. Reaganomics were decried in the early 1980s as violating the economic wisdom of the time (George Bush senior famously labelled the project of his victorious opponent in the 1980 Republican primaries "voodoo economics"). Reagan presided over a nasty recession in the early days of his presidency, which resulted in an enlargement of the Democrats' majority in the House in the mid-terms of 1982. However, his supply-side "bitter medicine" worked to re-start the US economy. The ensuing recovery allowed him to win comfortably a second term in 1984. **For Republicans today, the parallel is appealing: "hang tight", embrace the new economic thinking, and just like in the early 1980s, reward will come despite short-term "turbulence".**

The parallel with today has however its limits. First, Reaganomics benefited from intense discussions in Academia throughout the 1970s, and **Keynesians had been losing the intellectual battle long before Reagan was elected**. Milton Friedman received his Nobel Prize in 1976, and he was a prominent public intellectual, regularly featured in the mainstream press and on TV. The production of economists in the current administration (e.g. Miran or Navarro) is nowhere close to the current centre of gravity of academic discussion.

Exhibit 4 – Peak misery came before Reagan took over



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

By the time Ronald Reagan came to power, there already was a strong consensus in mainstream policy circles that "something radical had to be done" to get the US economy out of its stagflationary torpor. Two facts illustrate the change in consensus. First, Reagan was able to get his radical fiscal plans (including sweeping tax cuts for the wealthy) through Congress without a Republican majority in the House. Democrats still had a majority of 51 seats after the November 1980 elections, but a significant fraction of them sided with the Republicans on economic issues. Second, Paul Volcker – who was already knows as an "inflation hawk" was appointed by Jimmy Carter, and it is the Democratic administration of the late 1970s which initiated the first deregulation efforts. Yes, Ronald Reagan's popularity nosedived in 1982 as the recession took hold. Yet, he did not "start" it – the unemployment rate began to rise again in the autumn of 1980, he came to power in January 1981. A popular concept in those days was the "misery index", the sum of inflation and the unemployment rate (see Exhibit 4). **"Peak misery" was hit in June 1980, 5 months before Reagan was elected. Carter lost because the economic situation of the US was *objectively* bad. Biden lost because** *perceptions* **of an actually sound US economy were deteriorated**, as the memory of the post-Covid inflation shock was still too fresh, more than offsetting the strength of the labour market. As we discussed in the previous section, the consumer surveys of the last few months indicate that, as much as they were already morose in 2024, Americans are now getting downright depressed. We may get to a new phase where the objective economic situation and perceptions will converge – on the pessimistic side.

**There is another element of Reagan's legacy which we think is also often overlooked: while his supply-side policies contributed to re-starting the economy, they failed to rebalance the federal budget.** The deficit in 1984, when he was re-elected, was nearly twice as large in percentage of GDP as Carter's last year in office in 1980. "Trickle down" economics, where steep tax cuts for those at the upper end of the income ladder "pay for themselves" by eliciting a strong enough growth in the tax base did not materialise. It was not a major issue at the time given the low level of US federal debt (41% of GDP in 1984) and any impact on the bond market was drowned by the decline in inflation which allowed the Fed to cut and reduced the premium on long-term yields. A failure of "trickle down" economics this time would be much more detrimental to the public debt trajectory. We suspect that some of the "counter-intuitive" resilience in long-term Treasury yields since Liberation Day can be traced back to the thorny fiscal equation which the US now needs to solve.

## At least, it's easier for the ECB to cut

In our first take after the 2 April announcements, we had pencilled in a brush with recession in the Euro area as well. European Union (EU) exports to the US are equivalent to only 3% of GDP, but with economy already barely in expansion, a 0.6 to 0.8% loss in GDP – the mechanical effect of the decline in US demand – would be enough to bring GDP into negative growth by mid-year, and uncertainty of course is also an issue for Europe. **The concessions on 9 April remove some of the downsides for Europe. Beyond the removal of the tariff add-on, there is now a level playing field across US suppliers except for China**: European products' competitiveness is hit only relative to US producers. However, Europe will still be hit by the second-round effects, i.e. the impact of the US recession on world demand, and particularly slower growth in China, which will suffer even more than in the 2 April version of US tariffs. There is also a risk that China will try to offset its de facto exclusion from the US market by "dumping" its products on the European market, displacing domestic production. We are thus inclined to maintain the view Europe will also have a brush with recession in 2H 2025.

Exhibit 5 – Euro is strengthening

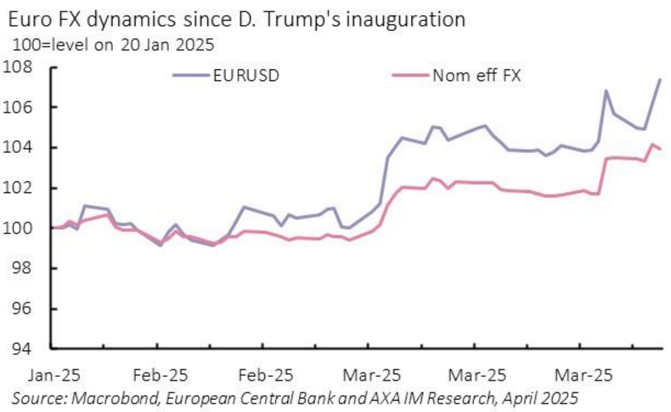
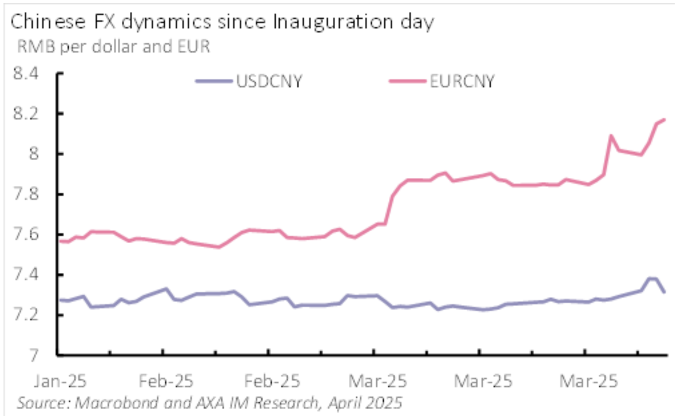


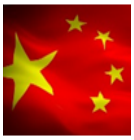

Exhibit 6 – Watch the yuan…




However, **since all factors are pointing in the direction of more disinflation in Europe (slower activity, lower oil prices, stronger euro), we think the European Central Bank (ECB) will provide fast and large support to the economy:** unless the trade negotiations resolve quickly and positively, we expect its policy rate to fall to 1% by year-end (1.50% before "Liberation Day"). The euro strength for us is becoming a crucial issue for the ECB. The Euro has appreciated by nearly 8% against the US dollar since Inauguration Day and most of the move has taken place after the cutoff date for the ECB's March forecasts. In trade-weighted terms, the euro has gained nearly 4% (see Exhibit 5). Using the ECB's own elasticities, derived from the alternative scenarios they add to their forecasting scenarios, this would be enough to reduce inflation by 0.3 to 0.4%. We have seen many commentators devote a lot of energy to analyse the minute changes in the People's Bank of China (PBoC)'s daily "fixing" of the yuan/dollar exchange rate, and possibly, the marginal depreciation of the last few days is a message to the US, but what we think is more directly relevant for Europe is how the Euro has gained 8% relative to the Chinese currency (see Exhibit 6), at a time when Beijing could be tempted to "dump" the products it can no longer offload on the US market to the EU. Chinese authorities seem for now to focus on their domestic stimulus, and the EU's move on Chinese Electric Vehicles (EVs) last year may convince them to avoid negative sum games, but even without any organized strategy by China, the mere depreciation of the Yuan against the euro adds to the zone's difficulties.

The market on Friday was pricing a 95% probability of a 25-bps cut this Thursday. We concur. As usual, the key elements of the prepared statement will be scrutinised for clues on the future trajectory. For our part, **we think that many "points of attention" in the ECB's communication have become obsolete**. The market is likely to focus on whether the ECB changes their characterization of the current level of the policy rate after the cut: *"monetary policy is becoming meaningfully less restrictive"*. The easiest for the Governing Council would consist in leaving this sentence unchanged – "less restrictive" would convey the sense that it is still on the restrictive side despite having hit 2.25%, thus leaving space for further cuts down the road. Yet, in our view the real issue is that, given the abundance of downside risks and the softness in the European dataflow even before the trade war started, the ECB should contemplate taking its policy stance in *accommodative* territory. Finessing around the level of restrictiveness has become largely irrelevant in our view.

This does not mean that we expect a "dovish festival" on Thursday. There is little to gain for the ECB in being too prescriptive given the level of uncertainty. Warm words around being "open to doing what it takes to respond to changes in the macro situation" would probably suffice at this stage, especially since Christine Lagarde is likely to highlight how the financial markets in Europe have so far dealt quite well with the bad winds blowing from the US.

| Country/Region | What we focused on last week | What we will focus on in next weeks |
|---|---|---|
|  | • The S&P plunged 11% after reciprocal tariffs; USTs initially dropped 25bps drop, but then rose 65bps. Financial turmoil prompted tariff reversal (a 90d pause) to 10% everywhere, except for China where they were raised to 145%<br>• CPI inflation (Mar) headline and core softer than expected at 2.4% and 2.8% the latter a 4yr low<br>• PPI inflation (Mar) core slips to 3.3% from 3.5%<br>• Fed minutes (Mar) lower output, higher prices | • Retail sales (Mar) – gauging scale of pre-tariff bump outside autos<br>• NY Fed 1yr inflation expectations (Mar) watch for increases similar to survey evidence<br>• Empire and Philly Fed indx (Apr) signs of weakness<br>• Industrial production (Mar) final main inputs to gauge Q1 GDP<br>• Jobless claims have remained low, watch worsening<br>• Housing starts (Mar) to decline from firm level |
|  | • EU is imposed c.12% average US tariffs during the 90-day pause<br>• French government revised down its 2025 growth forecast by 0.2ppt to 0.7% | • We expect a dovish 25bps rate cut by the ECB taking the depo rate to 2.25%<br>• All eyes on EU-US trade talks as well as possible measures against China<br>• Italian PM to visit the White House on 17 April<br>• Euro area bank lending survey, final March inflation |
|  | • RICS Residential Market Survey (Mar) prices balance dropped to +2%, from 11%<br>• Monthly GDP (Feb) surprised to the upside. Mom growth of 0.5%, compared to 0.1% expected by markets, 3m/3m 0.6%. IP, construction and services all boosted | • BRC Retail Sales (Mar) look for signs of slowdown amid tariff uncertainty<br>• Labour market (Feb) further signs of a slowdown likely. Wage growth looks set to remain broadly unch.<br>• CPI inflation (Mar) headline set to edge back to 2.7%, from 2.8%. Core to remain unch at 3.5% |
|  | • Av. cash earnings (Feb) rose to 3.1%, from downwardly-revised 1.8%<br>• Eco watchers survey (Mar) outlook dropped to 45.2, from 46.6<br>• Consumer confidence (Mar) dropped to 34.1, from 34.8<br>• PPI (Mar) up 0.4% on the month | • IP final (Feb) small rise on the month after strong Jan. Machinery orders (Feb) look for small uptick<br>• Exports (Mar) look for further strength in build up to tariffs<br>• CPI inflation (Mar) look for small rise in headline rate. Core set to remain broadly unch. |
|  | • CPI (Mar) recorded another decline of -0.1% from -0.7%<br>• PPI (Mar) extended the fall to -2.5% from -2.2% | • Credit numbers for (Mar), key to watch HH and small business credit demand<br>• Exports and imports (Mar), watching for wider impact on tariffs<br>• GDP (Q1) likely to come in strong<br>• Monthly output (Mar) to watch retail sales recovery and tariff impact on industrial production |
|  | • CB: India (25bp cut to 6.0%), Philippines (25bp cut to 5.5%), Romania (unch 6.5%), Peru (unch 4.75%)<br>• CPI (Mar, yoy): Chile (4.9%), Colombia (5.1%), Czech Republic (2.7%), Hungary (4.7%), Indonesia (1.0%), Mexico (3.8%), Romania (4.9%), Taiwan (2.3%)<br>• Industrial production (Feb, yoy): India (2.9%), Malaysia (1.5%), Turkey (-1.9%) | • CB: South Korea (unch 2.75%), Turkey (unch 42.5%)<br>• GDP (Q1): Malaysia (advance estimate)<br>• CPI (Mar): India, Poland<br>• Industrial production (Feb): Colombia |

| | | |
|---|---|---|
| Upcoming events | US: | Tue: Empire state survey (Apr); Wed: Business inventories (Feb), NAHB index (Apr), Long-term investment flows (Feb); Thu: Philadelphia fed index (Apr), Housing starts (Mar), Building permits (Mar), Initial jobless claims (w/e 12 Apr) |
| | Euro Area: | Tue: Fr HICP (Mar), Ez IP (Feb), Ge ZEW surveys (Apr); Wed: It, Ez HICP (Mar); Thu: Ge PPI (Mar), ECB announcement |
| | UK: | Mon: BRC retail sales (Mar), Unemp (Feb), Avg earnings (Feb); Wed: CPI (Mar), CPIH (Mar), RPI (Mar) |
| | Japan: | Wed: Private 'core' machinery orders (Feb); Fri: CPI (Mar) |
| | China: | Mon: Exports (Mar), Imports (Mar), Trade balance (Mar); Wed: GDP (Q1), IP (Mar), Retail sales (Mar), Fixed asset investment (Mar) |

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*As at the end of June 2024, including non-consolidated entities.
** As at the end of December 2023.

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