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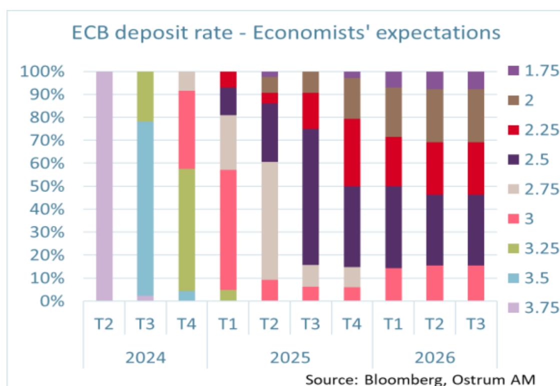
Topic of the week: Three risks to our 2024 scenario
by Zouhoure Bousbih, Aline Goupil-Raguénès & Axel Botte

- US protectionism, and to some extent European protectionism, has weighed on global trade since Donald Trump's election in 2016. Today, China's export capacity poses an existential threat to emerging industries related to the energy transition, such as electric vehicles, in Europe and the United States. Escalating protectionist measures would likely have significant implications for international trade and goods inflation;
- Recent wage negotiation data in the Eurozone raises concerns about the formation of a wage-price spiral that is incompatible with a sustainable return of inflation to the 2% target. Sustained additional inflation would challenge the ECB's ability to act, particularly with limited fiscal flexibility;
- The healthcare and social assistance sector has been a major job creator in the United States over the past two years. A reform of the ACA or a reduction in Medicaid funding could have significant consequences for healthcare spending and the labor market in general.

Market review: Is the ECB taking an unnecessary risk?
by Axel Botte

- ECB cuts rates by 25 bp whilst raising its inflation forecast for 2025;
- FOMC meets this week after another solid job report;
- T-note yields moving wildly between 4.30 % and 4.60 % over the past month;
- Equities on a positive note whilst sovereign and credit spreads remain stable.

Chart of the week



There is considerable uncertainty about the level of interest rates over the next two years. The survey of Bloomberg economists illustrates the distribution of ECB rate expectations collected before the ECB meeting on June 6th.

A large majority of economists are forecasting a cut in September, followed by one or two additional cuts in the fourth quarter. The deposit rate appears to be below 3% in all cases from the second quarter of 2025.

Figure of the week

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The market capitalization of Nvidia surpassed that of Apple by over 3 trillion dollars this week. At current prices, Nvidia, Apple, and Microsoft are worth more in the stock market than the entire Chinese market.

Source: Bloomberg

Topic of the week

Three risks to our 2024 scenario

In this note, we discuss three risks to our economic scenario of moderate slowdown in the United States, recovery in the Eurozone, and slightly higher inflation than central bank targets. A new round of protectionist measures against China's export power would weigh on global trade and fuel inflation. Additionally, the dynamics of wage formation in the Eurozone appear to be incompatible with stabilized inflation at 2%. Finally, the re-election of Donald Trump would reopen the issue of healthcare reform in the United States. This sector, which has been rapidly expanding for the past two years, would face a setback.

The risk of an escalation of trade tensions

The number of restrictive trade policies tripled in 2023 compared to 2019!

The increase in restrictive trade policies poses a major risk to global growth prospects. According to the International Monetary Fund, 3,000 new restrictive trade measures were imposed in 2023, triple the number of measures in 2019! China, the European Union, and the United States dominate global trade, accounting for 42% of global exports and imports combined. An escalation of trade tensions among the three dominant economies could therefore exacerbate international fragmentations and penalize global growth.

Protectionism made a strong comeback under the Trump administration. "America first" triggered protectionist responses against China and Europe by using tariffs to defend American interests. The Biden administration has continued in this direction, but has also increased subsidies to the American industrial sector through the Inflation Reduction Act (IRA), the largest investment program in American history! Like during the Trump era, the Biden administration did not concern itself with potential retaliation from China.

A new phase of confrontation has begun among the three economic powers.

However, China immediately responded that it was also ready to increase its tariffs on American and European imports, including a 25% increase in tariffs on automobiles. China is targeting the European Union with these threats, as the EU must make decisions following the investigation conducted by the European Commission on China's subsidies to its electric vehicle sector. In fact, the EU is also preparing to increase its tariffs on Chinese electric vehicles to 25-35% from the current 10% tax.

The European Union is caught between preserving its role as a defender of free trade and its economic interests.

The European Union is caught between preserving its self-proclaimed role as a defender of free trade and the fears of job losses and investment due to subsidy policies. The conclusions of the European Commission's investigation were expected to be announced on June 4 but have been postponed to June 10, after the European elections on June 9…

Trade tensions have also contributed to the reshaping of global value chains, resulting in a redirection of foreign investment flows benefiting emerging countries. These countries risk economic sanctions in the event of trade tensions escalation.

One thing is certain: regardless of the new occupant of the White House, trade tensions are

likely to continue among the three dominant economies.

The risk of Medicaid/ACA reform in the US

With the US unemployment rate below 4%, labor market conditions remain tight. Higher wage gains and domestic inflationary pressures have built up. After the initial broad-based recovery in employment, net hiring has increasingly been concentrated in a smaller set of industries. Only a small majority of sectors continue to add staff. Other sectors either face slower demand or must adjust to higher costs by boosting productivity and cutting positions.

Strong job growth in healthcare and social assistance industry.

Healthcare has been one such large purveyor of jobs. The reason is that US households had postponed medical care during COVID so that demand for medical services picked up noticeably in the past two years. Healthcare and social assistance employment has grown at a 4.2% annual rate since the end of 2021, adding a total of 2.1 million jobs. In the 12 months to April, almost half of net job creation is indeed traceable to the healthcare and social assistance sector. Furthermore, the job openings rate in the healthcare and social assistance sector has increased by 3 percentage points compared to 2019. However, a significant portion of the rise in employment is within the social assistance and nursing and residential care subsectors, where wages are below the average across the entire US economy.

Medical spending could slow if Medicaid/ACA gets defunded.

Household spending on healthcare has propped up the US economy but Donald Trump's re-election could eventually end the boom in demand for medical care. Many insurance companies have noticed a rise in their claims numbers as people just use their healthcare plans again. Expansion of the Affordable Care Act and Medicaid has also contributed to the strength in hiring. According to the Financial Times, ACA (Affordable Care Act also known as Obamacare) marketplace enrolment hit a record high of 21 million in January 2024, up from 11 million in 2020, driven by subsidies from the pandemic-era American Rescue Plan Act, and the Inflation Reduction Act. Meanwhile, 40 states and Washington DC have opted into the ACA's expanded Medicaid coverage for nearly all low-income individuals (up to 138 % of the Federal Poverty line set at $20,783).

If re-elected, would Donald Trump try to repeal ACA?

The November election also raises questions over the current level of healthcare funding. During his first term in office, Donald Trump unsuccessfully attempted to repeal the ACA and he has suggested he would be open to cutting Medicaid. A Trump presidency thus poses potential risks to healthcare despite his inability to implement major changes. Hospitals might be cautious and scale back hiring plans in 2025 to protect against possible Medicaid cutbacks. Additionally, work requirements for ACA recipients may be imposed in Republican states.

In sum, if Donald Trump returns to the oval office, a new Republican Administration may seek changes in the healthcare policy which could have far-reaching consequences for lower-income individuals. As per economy activity, employment could slow further as employment in the healthcare and social assistance sector has outpaced aggregate hiring in the US over the past few years.

The risk of maintaining high inflation in the Eurozone

The dissipation of the post-COVID effects and the energy shock is over.

After reaching a historical peak of 10.6% in October 2022, inflation in the Eurozone has significantly moderated to 2.4% in November 2023. This resulted from the dissipation of post-COVID effects and the energy shock. Inflation benefited from a strong negative contribution from energy prices, leading to a more moderate increase in food prices and non-energy goods. This was compounded by the cessation of disruptions in supply chains and lower demand, as Eurozone growth was almost stagnant in 2023. These effects have now ended, as evidenced by the energy prices' contribution becoming zero. Furthermore, Eurozone growth is picking up, albeit moderately, and should be supported by household consumption.

The continuation of disinflation depends on the evolution of prices in the services sector, which crystallize the wage pressures.

Since November 2023, inflation has not moderated. It has fluctuated between 2.9% and 2.4%, settling at 2.6% in May 2024. The continuation of disinflation depends on the evolution of prices in non-energy services, which have continued to increase at a sustained pace. After reaching a peak at 5.6% in July 2023, they stabilized at 4% for five consecutive months between November 2023 and March 2024. Their decline to 3.7% in April was followed by an acceleration to 4.1% in May. The services sector is more labor-intensive and thus crystallizes the wage pressures that have been at play since 2022. In order to make up for the loss of purchasing power resulting from the sharp acceleration of inflation, households are negotiating higher wages and bonuses to compensate. Negotiated wages in the Eurozone have therefore increased significantly, reaching a historical rise of 4.7% over the year in the third quarter of 2023 and the first quarter of 2024.

Stronger-than-expected wage increases would delay the return of inflation to the ECB's 2% target.

The risk is that wages continue to increase rapidly for a longer period than anticipated in order to compensate for the loss of purchasing power. This is occurring at a time when the unemployment rate is at a historic low in the Eurozone (6.4% in April) and business leaders, through surveys, indicate their intention to increase their workforce to meet rising demand. The environment is therefore favorable to employees.

The monetary policy would remain restrictive for a longer period, thus stifling the ongoing recovery.

The risk of maintaining high inflation in the Eurozone would be that stronger-than-expected wage increases, in a context of low productivity growth, would lead to higher unit labor costs for companies. Unless they absorb these costs within their margins, the result would be a more significant increase in prices, particularly in services, and higher-than-expected inflation. This would delay the return of inflation to the ECB's target of 2%. During its decision to make its first interest rate cut last Thursday, after 9 months of status quo, the central bank emphasized the importance of upcoming data to decide on the evolution of its rates. In the event of higher-than-expected inflation, the ECB would be forced to maintain its restrictive monetary policy for longer to weigh on domestic demand and allow inflation to moderate. In a context of limited budgetary leeway for governments, particularly in France and Italy, the consequence would be to stifle the Eurozone's recovery.

Conclusion

The American election is likely to be decisive for the economic cycle and financial markets. Firstly, US and European protectionism against China is expected to intensify, posing a risk of weakening global trade and increasing inflation. Additionally, wages

continue to adjust slowly to the rise in prices. The endogenous increase in labor costs fuels inflation in services and could force the ECB to maintain high interest rates longer than anticipated, potentially leading to a downturn in economic activity. Finally, in the event of Donald Trump's election in November, the ACA or Medicaid funding could be called into question. The healthcare and social assistance sector has grown significantly in the aftermath of the COVID crisis. A reduction in spending resulting from a cut in medical coverage would lead to a significant slowdown in job creation in this sector.

Zouhoure Bousbih, Aline Goupil-Raguénès & Axel Botte

Market review

Is the ECB taking an unnecessary risk?

The ECB lowers its deposit rate to 3.75%. The increase in its inflation forecasts revives uncertainty about its policy. The FOMC meets after a positive employment report.

The ECB made an initial 25 bp rate cut last week. This move, which had been anticipated for several weeks by central bankers, seems to go against the grain of data indicating an economic upturn in the Eurozone and the institution's inflation forecasts for 2025. In the United States, the FOMC will have to contend with price inertia and the initial signs of weakening labor market. The Bank of Canada took the lead by lowering its rate by 25 bps. In this context, volatility remains significant in the bond markets. The Bund fluctuates around 2.50%, while the T-note has come down from 4.62% at the end of May to 4.30% currently. Spreads, however, remain directionless in both sovereign and corporate debt spheres. Stocks are responding positively to central bank actions. The electoral calendar (Mexico, South Africa) is generating high volatility in emerging market currencies.

Christine Lagarde had a challenging communication task to accomplish. The 25 bp rate cut in June seems, in hindsight, incompatible with the data. Inflation rose to 2.6% in May. The ECB's forecasts are also revised upwards to 2.2% for 2025. Wage pressures (+5.1% in Q1) are expected to fuel an acceleration in demand in the second half of the year, which should alert central bankers to the internal risks of price instability. Moreover, the Fed's actions cannot be ignored. Job creation remains strong according to the business survey (+272k in May, including +229k in the private sector). However, the unemployment rate continues to rise steadily to 4% (May), and other surveys (QCEW, ADP) paint a less favorable picture than BLS data. Like the Eurozone, the hourly wage rate in the US has risen to 4.1% over the year. In Canada, employment and wages also cast a shadow after the BoC's initial move, which seemed to hint at more to come.

Financial volatility remains focused on interest rates. The yield on the T-note dropped below 4.30% before a surge of over 10 bps following the employment statistic, which tempered expectations of a slowdown and associated rate cuts. This delays the reinvestment of the roughly $5.5 trillion parked in US money market funds. Nonetheless, the Fed's bias will remain accommodative, making a return to 5% on the 10-year seem unlikely. The Bund appears more vulnerable to a potential false start in the monetary cycle. German bonds are back at the 2.60% level. The swap spread is tightening (26 bps at 10 years). Both credit and sovereign spreads are still ignoring risk-free rate volatility. High-quality European credit is trading at 79 bps against the swap. High yield (308 bps) is also stable despite stretched valuations in historical metrics. Credit spreads compensate for the deleterious inversion of yield curves. The asset class continues to attract flows according to JP Morgan.

Stocks are up by around 1.5% in the United States, following Nvidia's market cap surpassing $3 trillion. American technology has gained 3.6% for the week. TSMC's sales also benefit the sector, including in Europe. The decline in oil prices eased at the end of the week but penalized the energy sector. Banks are closely linked to long-term rates.

Axel Botte

Main market indicators

G4 Government Bonds	10-Jun-24	1wk (bp)	1m (bp)	2024 (bp)
EUR Bunds 2y	3.08%	+5	+11	+68
EUR Bunds 10y	2.65%	+7	+13	+63
EUR Bunds 2s10s	-41.9bp	+3	+3	-5
USD Treasuries 2y	4.89%	+8	+2	+64
USD Treasuries 10y	4.46%	+7	-3	+58
USD Treasuries 2s10s	-41.7bp	+0	-5	-6
GBP Gilt 10y	4.3%	+8	+14	+77
JPY JGB 10y	1.05%	-2	+2	-25
€ Sovereign Spreads (10y)	**10-Jun-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
France	55bp	+8	+8	+1
Italy	141bp	+10	+9	-27
Spain	77bp	+5	+4	-20
Inflation Break-evens (10y)	**10-Jun-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
EUR 10y Inflation Swap	2.27%	+2	+2	+14
USD 10y Inflation Swap	2.56%	-3	-2	+15
GBP 10y Inflation Swap	3.75%	-3	+3	+21
EUR Credit Indices	**10-Jun-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
EUR Corporate Credit OAS	109bp	+1	-3	-29
EUR Agencies OAS	55bp	+0	-3	-15
EUR Securitized - Covered OAS	57bp	-1	-6	-22
EUR Pan-European High Yield OAS	331bp	-3	-28	-68
EUR/USD CDS Indices 5y	**10-Jun-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
iTraxx IG	53bp	+1	+0	-6
iTraxx Crossover	296bp	+5	-3	-18
CDX IG	50bp	0	-1	-6
CDX High Yield	334bp	-1	-2	-22
Emerging Markets	**10-Jun-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
JPM EMBI Global Div. Spread	386bp	+6	+14	+2
Currencies	**10-Jun-24**	**1wk (%)**	**1m (%)**	**2024 (%)**
EUR/USD	$1.076	-1.121	-0.074	-2.5
GBP/USD	$1.272	-0.477	1.541	-0.1
USD/JPY	JPY 157	-0.599	-0.783	-10.2
Commodity Futures	**10-Jun-24**	**-1wk ($)**	**-1m ($)**	**2024 (%)**
Crude Brent	$80.0	$1.6	-$2.4	5.0
Gold	$2 295.3	-$53.9	-$65.2	11.3
Equity Market Indices	**10-Jun-24**	**-1wk (%)**	**-1m (%)**	**2024 (%)**
S&P 500	5 347	1.32	2.38	12.1
EuroStoxx 50	4 996	-0.16	-1.76	10.5
CAC 40	7 851	-1.84	-4.48	4.1
Nikkei 225	39 038	0.30	2.12	16.7
Shanghai Composite	3 051	-1.15	-3.27	2.6
VIX - Implied Volatility Index	13.10	-0.08	4.38	5.2

Source: Bloomberg, Ostrum AM

Additional notes

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