AXA Investment Managers

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Investment Institute Macroeconomics

Postcard from Davos

- A better managed US-China rivalry comes as a relief – but not enough to spur strong optimism
- The US elections as a key conversation topic
- Lagarde's warning on market pricing

Given the fraught geopolitical context, there were many reasons to worry for the participants to the World Economic Forum, but the atmosphere was lifted by a sense that the rivalry between China and the US is better managed. De-globalisation was however still high on everyone's mind. Discussions often revolved around whether the focus should lie on financial links rather than trade in goods. Yet, it may well be that Foreign Direct Investments strengthen, rather than mitigate, the reorganisation of the world economy across politically aligned "clubs".

The US presidential elections were the "elephant in the room". Beyond the additional geopolitical uncertainty that this could trigger, the notion that a Trump 2.0 administration could disrupt further the already fragile post-WW2 economic and financial order was pervasive. The EU would potentially be in a delicate position from a strategic point of view – revolving around the role of NATO – but also because its green agenda is conflated with its approach to international trade, which may lead to a confrontation with the US if they leave the Paris agreement again.

The highest number of sessions pertained to Artificial Intelligence, and its potential for lifting aggregate productivity. It is probably a sign of our troubled times that even when faced with a promising technology, attention tends to be more drawn towards its potential adverse effects, on employment stability and on how our democratic processes operate. We see this as another signal that the societal and political fragility of many countries looms large, at least in the West.

Christine Lagarde took the occasion of Davos to send a warning on the market expectations for the ECB trajectory – we expect this to be repeated this week at the press conference. We also explore intriguing statements by BdF Governor Villeroy de Galhau on the average level of the policy rate over the cycle.

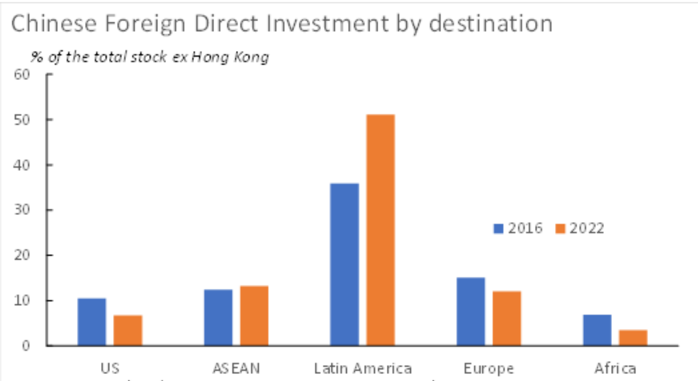
Some relief and many concerns (old and new)

Reading the World Economic Forum (WEF)'s Global Risk Report, Davos' participants might have been excused for feeling stressed. Even by your humble servant's pessimistic standards, it conveyed very few positive messages, identifying four daunting intertwined challenges (climate change, demographic bifurcation, technological acceleration, and geostrategic risks) which will make the global economy difficult to navigate. A majority – albeit small - of chief economists polled by the WEF expect the economy to weaken this year. Still, it was not all "doom and gloom" in Davos, even if capturing a generic mood in a sprawling event is not necessarily straightforward. **The decent level of confidence was fuelled in some part by a sense that the US-China rivalry is under better control**.

We discussed in last week's Macrocast how the elections in Taiwan could trigger another geopolitical flare-up, to conclude however on a rather optimistic note, on the assumption that in the current economic circumstances the Chinese leadership would probably avoid taking risks with alienating the West further. This was the general view in Davos. The fact that Beijing sent its Prime Minister (PM) Li Qianq to spearhead a massive delegation to the WEF meeting is another sign that China is taking the threats of decoupling seriously and seeks to convince Western corporations that the country remains open to foreign business (last year only the Vice-PM made the trip).

The issue however is whether the decoupling process can be arrested at this stage. China was not the only emerging country launching a charm offensive in the Swiss Alps. India renewed its efforts from last year in terms of presence on the ground, and the Gulf states stepped up their visibility quite noticeably. **The number of sessions dedicated to the reshuffling of global supply lines was still very high**. Evidence presented struck a consensus: the *direct* decoupling between the United States (US) and China is tangible, friend-shoring is taking place – benefiting countries such as Mexico and Vietnam. On whether we can talk about de-globalisation, the jury is however still out, with financial links in new focus instead of imports and exports of goods. In principle, China could continue to play a crucial role in Western supply lines by stepping up direct investment into the US new favourite suppliers. In Macrocast last summer we focused on a bifurcation within the "Global South" between those – e.g., Brazil or Chile – which have shifted both their import and export matrix towards China and those – e.g., Vietnam – which export to the West and import from China (the International Monetary Fund (IMF) labels them "connectors"). Connection can also take the form of acting as the recipient of investment from one "camp" to produce for another, and Vietnam has been increasingly receiving Chinese FDIs.

Exhibit 1 – Where do Chinese FDIs go?



Source: China's Commerce Ministry, AXA IM Research, January 2024

Yet, it also could well be that **investment links merely strengthen the bifurcation of trade lines across the two camps.** Focus usually lies on the how western companies have often stopped adding to their footprint in China. This is however symmetric, and we think equally important. Indeed, the US share in direct foreign investment (FDI) by Chinese entities – never particularly high – has fallen over the last few years (see Exhibit 1). The economic rivalry between the US and Japan in the 1980s was ultimately resolved when Japanese corporations started investing heavily in the US, thus providing jobs and "made in America" production. This is definitely NOT going down the same route with China – and with national security considerations mattering more and more, it is probably a dead end. We are currently in a configuration in which "*geopolitics contaminate economics*", to borrow from the economist Danny Quah's words in Davos, whereas under the happy globalization era "*economics contaminated geopolitics*" as tighter trade and financial links were expected to bring countries politically closer.

It is not obvious at all that China's strategy is to try to circumvent the "clubification" of the world economy by investing heavily in countries which have become key suppliers to the US. We have in any case our doubts as to the sustainability of such approach if the rivalry between the US and China continues to be entrenched. We heard participants from Southeast Asian countries explaining that they "can't afford to choose" between China and the US but it could become an increasingly difficult balancing act (for instance if the US were to make it harder to import products with a high made in China content or made by China-controlled firms). It seems that **Chinese companies have instead been stepping up their direct investments in countries which now primarily trade with China.** The share of Latin America in China's FDIs now exceeds 50%. Within this, the share of US-driven Mexico was puny in 2022 (0.3%).

Yet, to use the distinction put forward by Professor (and former assistant Defence Secretary) Graham Allison, **the structural causes of the rivalry remain there, but it appears to be better managed**, especially since the meeting between Joe Biden and Xi Jinping in November 2023 in San Francisco. Many pundits opined that the mere fact that a direct communication line was reopened between the military forces of the two countries illustrated the willingness, on both sides, to minimise the risks of incidents disproportionately flaring up.

This is not enough however to trigger very optimistic expectations about the quantum of traction the world economy can get from Chinese demand. The Chinese PM's speech did not mention any additional fiscal support measures. We would have been surprised that such an announcement would have come first in an international setting rather than at an event targeting a domestic audience, but this absence contributed to the further decline in the Chinese equity market last week. Quite often, data released during the "Davos week" take a specific salience and this time the news that the Chinese population had shrunk in 2023 for the second year in a row, with an accelerated decline (more than 2 million against 0.8 million in 2022), although hardly a surprise, came as a reminder that beyond the current difficulties with demand, on trend China is facing a wealth of structural hurdles.

November in January

In our "postcard from Davos" from last year we had focused on the general positivity surrounding the US outlook, thanks in particular to the Inflation Reduction and the Chips Acts. There is still quite some focus on the so-far successful implementation of the US new industrial policy, but **what many participants had on their mind – and what a few very well attended sessions focused on – was the likelihood of another Trump presidency**.

While there were relatively few discussions of the direct macroeconomic and financial ramifications – we will not bore again our readers with our concerns about the US fiscal developments - the biggest questions were revolving around the geopolitical and environmental consequences. The consensus view was that a second term could be more disruptive than the first. There are two all-out wars which may still be raging by November, and while Biden has been predictable in his handling of these crises the same could not apply to Donald Trump. Another reason is that in 2016, when dealing with a fairly unprepared Trump team, the traditional Republican apparatus was still able to shape government. By the time Donald Trump took his distance from the old "safe pairs of hands", he had lost control of the House, which blunted some of his operational capacity. US political pundits in Davos were however readier to predict a Republican victory in the Senate than in the House, should Donald Trump win the presidential elections, which could hamper his fiscal agenda. Yet, the Senate is the centre of decision for public service appointments, and this could become a source of noise in the global markets. The swift return of an "anti-globalist" personnel to manage the US diplomatic, defence and trade relationships, as well as the climate change agenda, could be an early manifestation of a Trump 2.0 administration.

The European Union (EU) would find itself in a delicate position. Beyond the uncertainty around how a Trump administration 2.0 would deal with Ukraine, pressure on North Atlantic Treaty Organization (NATO) funding would probably reappear. Some of the European member states have already engaged in a swift reinforcement of their military spending (for instance, the French "loi de programmation militaire" will bring the financial effort to 2% of GDP from 2025 onward) but some of the announcements have already lost some their initial shine. The "special fund" of EUR100bn carved out of the general debt brake system by Germany is being slowly eroded. According to this IFO paper, as of mid-2023 only EUR 1.2bn of the fund have been spent. The interest payments on the extra debt (included in the EUR100bn package from the start) are rising much faster than initially expected given the new monetary policy environment, leaving less space for actual spending. The EU would also find itself in difficulty on the trade/green agenda nexus. A Trump administration, upon leaving the Paris agreement for the second time, could go aggressively at the EU on the Carbon Border Adjustment Mechanism.

There was in general little enthusiasm on European themes. The announcement that Germany GDP fell by 0.3% in annual average in 2023 did not help. In a repeat of last year, the US success with the Inflation Reduction Act (IRA) – for that matter we continue to be surprised that its potentially huge fiscal cost is not more discussed – was contrasted with the EU's complex implementation of the Next Generation Pact, even though the European leaders there were insistent on Europe's technological innovation, combined with more financial integration.

Finally, if one assesses the message from Davos according to the number of sessions organised on a specific theme, then the rise of Artificial Intelligence (AI) certainly wins. Beyond its increasingly demonstrable capacity to concretely affect business operations, the attraction of this technology to a Davos audience owes a lot to a general willingness to move away from the fundamentally depressing "secular stagnation" narrative which has become dominant since before Covid after years of poor productivity gains. Beyond sector-specific sessions, from a macro point of view the debate revolved around "scalability" – how far and how quickly the applications could move the dial on aggregate productivity – and regulation, with many voices (often coming from AI scientists themselves) calling for more scrutiny on the potential implications of the technology for democracy and the fabric of our societies. The WEF meeting coincided with the release of a thorough IMF paper of the subject which was quite blunt on the potential macroeconomic disruption the diffusion of this new "general purpose technology" could trigger, with the "flagship number" of 40% of jobs potentially affected in the global economy**. It is probably a sign of our troubled times that even when faced with a promising technology, with the potential to lift the world economy, attention tends to be more drawn towards its potential adverse effects**, in particular its social consequences. We see this as another signal that the societal and political fragility of many countries looms large in the global discourse, at least in the West.

Is it still falling on deaf ears?

Davos can also be a great occasion for central bankers to send messages to markets and the main event from that point of view was Christine Lagarde's foray into the likely timeline for the European Central Bank (ECB)'s monetary loosening. At the December press conference, she had already pushed back against the market's aggressive pricing. She took things a big notch further by indicating in an interview, in response to a question about her opinion on other Governing Council members' mentions of a likely rate cut this summer, that she "*thinks it's likely too*". Unsurprisingly, this came with a wealth of conditions and qualifiers – the ECB remains data dependent – but **she confronted current market pricing for an early spring cut head-on**, stating that *"they are not helping our fight against inflation, if the anticipation is such that they are way too high compared with what's likely to happen".* Klas Knot expressed this even more forcefully, stating that *"the more easing the markets have already done for us, the less likely we will cut rates, the less likely we'll add to it"*.

In our opinion, the market-loosening in financial conditions is more an issue for the US than for the Euro area – given the poor real economy developments on the Eastern side of the Atlantic – but the very fact that ECB speakers are explicitly criticising the market pricing should be seen as a strong warning. Ancient market wisdom has it that "you don't win against the central bank". **Whatever one thinks of the soundness of the current ECB message – and we have our doubts – not listening at all to an increasingly consistent and explicit message is "brave".**

We were also intrigued by some comments made by Banque de France Governor Villeroy de Galhau. He pushed back against the notion that the "last mile of disinflation" would be necessarily harder. He used the image of a "symmetric Consumer Price Index (CPI) Christmas tree" but added that this did not entail that the evolution of policy rates would be symmetric too, i.e., that they could return to their "subnormal levels" of 2015-2022. He was quite candid at what this could mean for the level of interest rates, mentioning 2% on average in nominal terms over the cycle – consistent with real rates at zero and no longer negative as it was the case during the "subnormal phase".

This gets us to what the market is currently pricing. Focus usually is on the start of the trajectory, with endless discussions on the starting point of accommodation. What we find interesting is that **over a longer horizon – the end of 2025 – market pricing (see Exhibit 2) is not very different from the average level mentioned by Villeroy** (between 2 and 2.25%). So, it seems that market participants have fully understood the profound change which has affected monetary policy post-Covid. We are inclined to take an even more precautionary view on the "landing level" for the ECB in 2025 (we have 2.75%) but the debate in our view is more on the shape of the return to this average level. We are warming – as an alternative scenario - to the narrative laid out by the economists from Bank of America for some time that the first cut(s) may take longer than the market expects, but precisely because the ECB will have taken too long to start cutting, it will be forced into accommodating fast once it reaches that point. Yet, for now the market, and probably the ECB's Governing Council, are firmly focused on finding the right timing for the start of the cutting phase. **We expect Lagarde this week to stick to the views she expressed in Davos and continue to push back against the market pricing.**

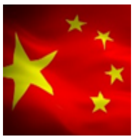
Exhibit 2 – Still expecting a lot

Source: Bloomberg and AXA IM Research, January 2024

Exhibit 3 – Look at 2025

Source: Bloomberg and AXA IM Research, January 2024

There was no equally forceful message from the Federal Reserve (Fed) in Davos, but Federal Open Market Committee (FOMC) members still took to the wires last week and **the key statement came, in our view, from Christopher Waller**. While his point on US inflation being "*within striking distance of the target*" could be seen as dovish – habitual readers of Macrocast will be familiar with our misgivings on some sectorial aspects of the US CPI – but his general tone was not suggesting the FOMC was in the mood for an imminent cut – and doing so on 20 March would qualify as "imminent" in our view, saying that the fact the economy *"is still doing well gives us the flexibility to move carefully and methodically"* and that *"The worst thing we'd have is it all reverses after we've already started to cut"*. We don't think it is *unthinkable* that the Fed ends up cutting in March (the market was pricing a probability of 46% for this last Friday, down from 83% on 12 January), but for this the next two batches of inflation and payroll would have to be "perfect" – with broader core inflation decline and less exuberant wage growth, which leaves us comfortable with our long-held call for June.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Iowa caucus. Trump wins with 51% • Congress passes another temporary spending bill averting shutdown, new deadlines 1 & 8 March • Retail sales (Dec) up 0.6%, up 4.0% ann in Q4 • Empire Survey (Jan) posts sharpest fall since 2020, Philly Fed rises to -10.6, +22pt new orders bounce • Jobless claims hit 17-month low • Fed's Waller adds to doubts about March cut	• GDP (Q4, p) now tracker to points to >2% (saar) gain, following outsized 4.9% Q3. Little signs of slowdown • New Hampshire primary. Likely closer than Iowa, but without big opposition win, Trump on track • PCE inflation (Dec) headline expected steady • Personal spending (Dec) upside risk after solid retail sales, watch income developments • PMIs (Jan, p) focus on services index
	• Final HICP (Dec) was unchanged at 2.9%yoy, core at 3.4%. ECB SA measure for services prices are not far from 2% momentum • ECB speakers (Lagarde, Knot, Lane) pushed back against early rate cuts, foreseeing late Spring at the earliest, relying on wages data	• The ECB will keep the status quo on rates and reiterates pushback against current market pricing • Flash PMI (Jan). Svcs and Mfg indices should slightly improve but remain in contractionary territory, Svcs not too far from 50. We also have business climate in Fr, Ifo in Ger and EMU consumer conf (Jan)
	• Retail sales (Dec) plunged by 3.2%, wiping out November's Black Friday +1.4%. Risks Q4 GDP fall • CPI inflation (Dec) edged higher to 4.0% (from 3.8%), core stable at 5.1%. Mostly noise • Labour market (Nov/Dec) pay growth slows to 6.5% (3m yoy) from 7.2%, unemployment rate 4.2%	• PMIs (Jan, p) Dec's services rise to 53.4 anomalous with most recent hard data, watch for persistence • GfK cons conf (Jan) edging towards year highs • CBI 1/4ly trends (Q1) business optimism has eased back, good guide for broader activity • Public finances (Dec)
	• Headline CPI (Dec) declined to 2.6 (-0.2p); core at 2.3% (-0.2p) • Reuters Tankan Svcs index (Jan) improved to 29 (+3p), the 2nd highest level since COVID period	• The Bank of Japan holds its monetary policy meeting but should keep the status quo on interest rates as there is no new developments on wages negotiations, which are key for inflation outlook • Flash PMI (Jan), CPI Tokyo (Jan), also key next week
	• GDP (Q4): 5.2%yoy, 1.0%qoq; the year as a whole increased by 5.2%yoy, in line with our forecast • Fixed asset investment (Dec): 4.1% (Nov: 2.9%) • Industrial production (Dec): 6.8%yoy (Nov: 6.6%) • Retail sales (Dec): 7.4%yoy (Nov: 10.1%) • FDI (2023): -8.0% (2022: +6.3%)	• Mon (22 Jan): 1Y & 5Y LPR for January. Market expects both rate to stay on hold • Sat (27 Jan): Industrial profit (Dec)
	• CB: Indonesia stood on hold at 6.0%, as expected • Malaysia's GDP (%yoy) accelerated slightly in Q4 to 3.4%, but it was below expectations of a 4.1% rise • Nov Retail sales (%yoy) contracted in Colombia (-3.4%) & South Africa (-0.9%), while they accelerated in Brazil (2.0%)	• CB: Malaysia (3.0%) & South Africa (8.25%) are expected to stay on hold. Turkey should hike by +250bps to 45.0% • Dec CPI: Malaysia, Singapore & South Africa • Dec industrial production: Singapore & Taiwan

Upcoming events	US:	Mon: Leading indicator (Dec); Tue: New Hampshire Primary; Wed: PMIs mfg & servs (Jan, p); Thu: GDP (Q4, p), durable goods orders (Dec, p), weekly jobless claims, new home sales (Dec); Fri: PCE inflation (Dec), Personal income & spending (Dec), pending home sales (Dec)
	Euro Area:	Tue: ECB bank lending survey, Ez cons conf (Jan, p); Wed: Ez, GE, Fr PMIs mfg & servs (Jan, p); Thu: ECB announcement, Ge IfO survey (Jan), Fr Insee business survey (Jan); Ez M3 money supply (Dec), Fr cons conf (Jan), Sp unemp (Q4)
	UK:	Tue: public finances (Dec); Wed: PMIs mfg & servs (Jan, p), CBI Quarterly trends survey (Jan); Fri: GfK consumer confidence (Jan)
	Japan:	Tue: BoJ announcement; trade balance (Dec); Wed: PMIs mfg & servs (Jan, p); Thu: Tokyo CPI (Jan)
	China:	Mon: 1y and 5y loan prime rate announcements

Our Research is available online: www.axa-im.com/investment-institute

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