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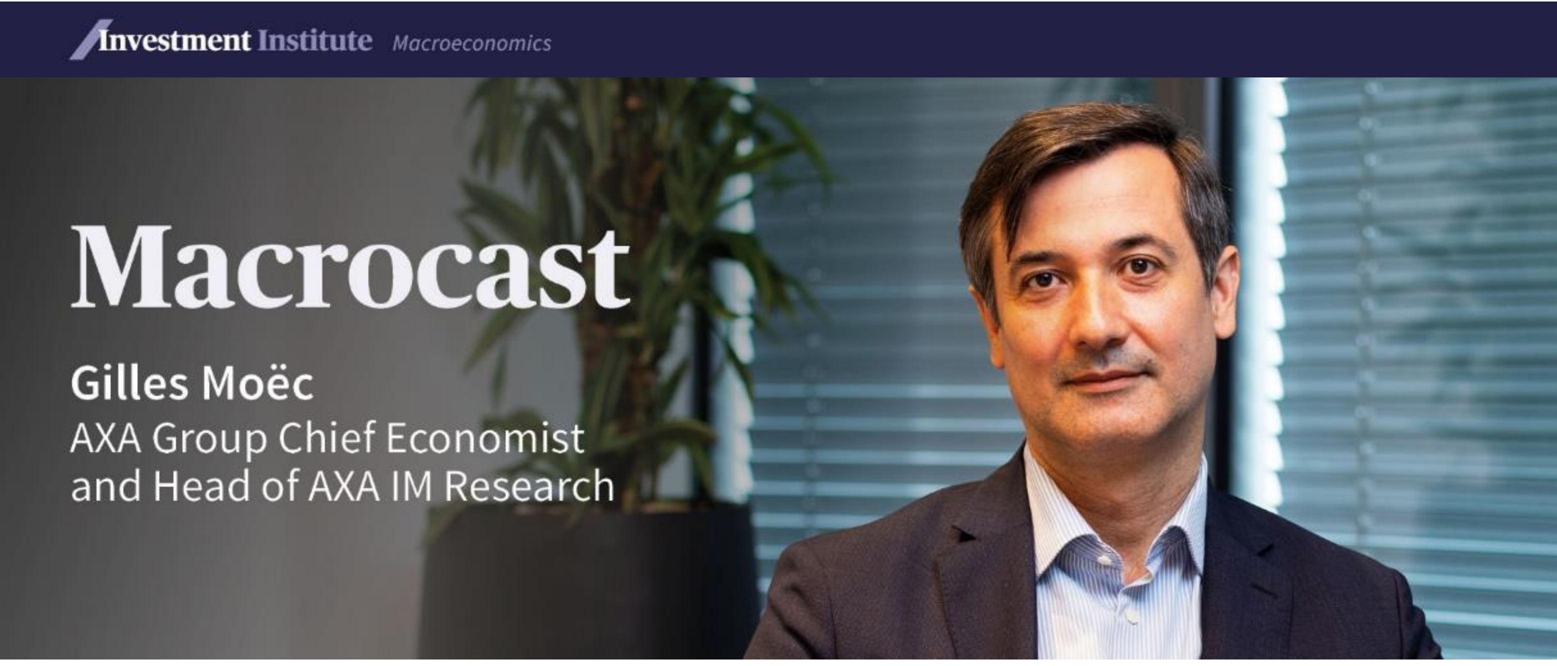


Revolutionaries vs. Realists

- Unclear if the White House followed a "revolutionary" or a "realist" approach last week.
- Berlin is definitely in "revolutionary" mode. The fiscal package is a game changer for Germany. The impact on Europe as a whole is still difficult to assess.
- The ECB needs to navigate between the adverse risk (US tariffs) and now a positive one (supportive fiscal stance).

Decrypting the US reaction function has become even less straightforward last week. In a "revolutionary" reading of the administration, there would now be an acceptance of transitory pain – in the form of higher inflation and slower growth – as a trade-off against the overhaul of a global economic order which "has not served US interests". This however is contradicted by a new – partial – reprieve on tariffs levied on Canadian and Mexican products, as well as by Donald Trump's recommendation to DOGE to cut federal employment "with a scalpel" rather than a hatchet. Yet, while it may be that the administration is hesitating between the "revolutionary" and the "realist" approaches, there is a tangible risk that the market simply decides to "stop guessing" and conclude that uncertainty is simply too high and will erode growth and corporate earnings. The fact that the S&P500 did not immediately salute the rumours, and then the official announcement of the reprieve on Canada and Mexico is striking, in our view.

Where there is definitely a "revolutionary" mood, it's in Berlin. The announcement that the new coalition would seek to change the debt brake before the new MPs take their seats in the Bundestag was striking. The package is a game changer for the German economy. While it is undeniably a positive for Europe as a whole, it is however difficult at this stage to get a sense of the magnitude of the uplift. This will depend on the import content of the defence effort, whether the EU manages to pull through more joint issuance, and/or if national governments choose to use the spending leeway offered by the reform of the EU fiscal surveillance proposed by the Commission.

The ECB now needs to deal with two opposite risks: on the negative side, the still very tangible possibility the US will slap tariffs on European products. On the positive side the possibility the new fiscal stance in Germany – and maybe elsewhere – lifts growth and inflation. We are still inclined to think that the ECB will have to go lower than 2%, because the tariffs will likely come faster than the impact of the fiscal turnaround, but it has become a closer call.

What does Washington actually want?

A revolutionary could be defined as someone who accepts to inflict pain – even massive pain – to society in the short-run in exchange for a radically transformed and better long-term future, on the basis that the present is utterly unbearable. There is some evidence that the new US administration fits this definition. Scott Bessent – although himself a moderate in the cabinet – stated at the end of last week arguing that *"access to cheap goods is not the essence of the American dream".* **This sounds like the acceptance of some inflation pain**, in the name of overturning a global world order which, today, does not serve the interests of Americans pursuing "*prosperity and economic security*" to quote him verbatim. Incidentally, this is quite a U-turn from the focus, during the campaign, on curbing inflation, especially at a time when households are, again, getting very sensitive to the price issue, as we discussed last week. Such fatalism on the short-term costs of the White House's policies could also be found in Scott Bessent's points the next day on the fact that the US needs to "*detox*" from high public spending, and this may warrant a slowdown in growth.

Yet, **the evidence in favour of the "revolutionary hypothesis" is not overwhelming**. Understanding the ultimate policy objectives and reaction function of the new US administration has never been straightforward, but last week's developments have made the task even more difficult. The week began with the announcement that the 25% tariffs on Canada and Mexico would go through as planned at the end of a first one-month reprieve. This would have cemented the "revolutionary reading" of the US administration, since this would have had a very visible impact on the US economy (probably shaving GDP by half a point, and raising inflation by half a point), with the main adverse effects materialising in US manufacturing, the very sector the government is trying to shore up. Yet, 24 hours after they became enforceable, the White House announced another one-month suspension of the tariff hike on those North American imports which were covered by the USMCA trade agreement.

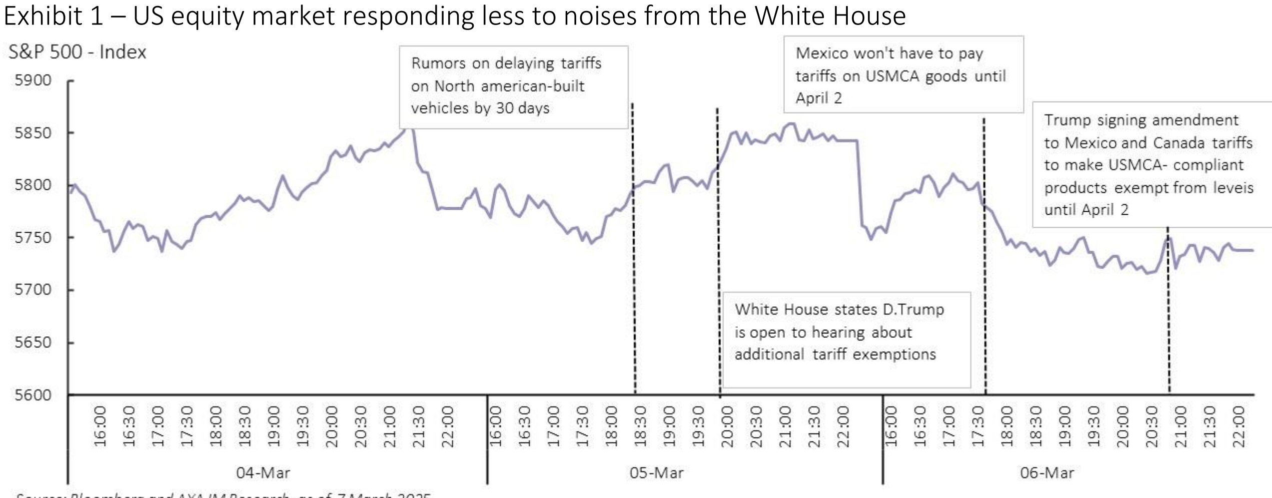
Since it is unclear what new concessions were extracted from Mexico and those two countries to warrant such an about-face in Washington DC, **a possible interpretation is that the "revolutionaries" gave way to the "realists"**. US industry representatives had been very vocal in their criticism of the North American tariffs. The equity market was souring. The new reprieve would then herald a shift in the US administration towards less strident policymaking. Another indication of such new trend would come from Donald Trump's recommendation – after a reportedly "robust" cabinet meeting – that Elon Musk's Department of Government Efficiency (DOGE) should proceed with "a *scalpel"* rather than a hatchet when reducing federal employment.

Another – and not exclusive – interpretation is that China has been the sole target since day one. According to this reading, pressure on Mexico and Canada had as underlying objective to force them to close their own doors to Chinese products, as a condition to maintain unfettered access to the US market. Beijing itself may have chosen to pre-empt these moves by announcing last week that Canadian agricultural products would be slapped with tariffs of up to 100% (e.g. on rapeseed oil). Beijing presented this as a retaliation against Canada's own tariffs on China's Electric Vehicles (EVs) and metal products, but the timing is intriguing: why wait until now to respond to a Canadian move from last August? It is very possible that Beijing is trying to nudge Ottawa towards a firm attitude vis-à-vis the US by showing them there would be a price to pay for any full alignment with the US approach to China (even though this threat is limited in our view, since Canadian exports to Greater China were last year 1/15th of its exports to the US...).

Yet, a natural question arising there is why the reprieve was granted to the North American partners before they show proof of a hardened stance towards China, while so far moving only gradually on Chinese products, the two 10% hikes being still very far from the 60% touted during the campaign. Besides, pressure on Mexico and Canada still comes with a high price tag for the US economy, even with the additional reprieve. Indeed, the concession on the products covered by the USMCA agreement is only a partial retreat. According to US officials quoted in the press, half of imports from Mexico (62% for Canada) would still be hit. Based on this breakdown, and taking on board the confirmed 10% tariff on Canadian energy and the two 10% hikes on Chinese products, the weighted average rise in tariff would still reach more than 6% (to add to the "starting point", 3.4% on average on all products for the US). Note that this calculation needs to be taken with a pinch of salt since there were reports last week on practical questions raised by importers on the precise scope of the new tariffs.

So, almost two months into the new US administration, and despite intense communication from the White House, decrypting their actual reaction function is difficult. A risk – which is already materialising to some extent – is that **investors collectively "give up" on trying to second-guess the US policy trajectory and take their distance from the US market in general, on the premise that uncertainty in Washington will erode the macro dynamics there and ultimately hit earnings**. We find it striking that last week the S&P500 index did not "salute" the concessions on North American trade: when tracking the price gyration hour per hour, there was no obvious reaction to the news flow (see Exhibit 1).

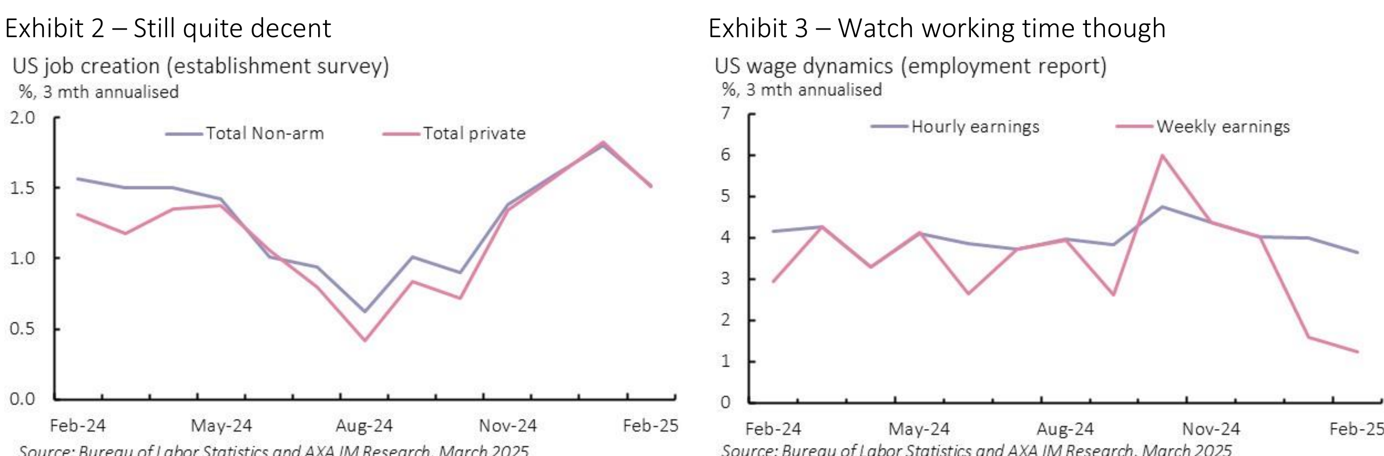
Exhibit 1 – US equity market responding less to noises from the White House



At this stage, **the depth of the "mood change" on the US is such that there is tendency to over-interpret any signs of softness**. While we agree with the fact that consumer confidence is deteriorating, which will increasingly weigh on spending, and that many businesses are probably adopting a wait-and-see attitude to investment, we think that the "acquired speed" of the US economy remains high. The number of headlines in the press on February payrolls missing expectations last week is an illustration of this mood swing, but a 10k miss is insignificant given the usual volatility of the series. On a 3-month annualised basis, job creation remains decent (1.4%) and still well above the recent trough seen in the early summer of last year (see Exhibit 2).

Exhibit 2 – Still quite decent

Exhibit 3 – Watch working time though



If one really wants to see bad omens in the February employment report, it is in the continuation of the decline in working time, which can be easily seen in the gap between pay per hour and pay per week (see Exhibit 3). Lower working hours can often be a first symptom of lower labour demand. Yet, between the volume of job creation and gains in weekly pay, the overall wage bill maintains a decent growth. **The issue for us is not so much the weakness of income generation but the growing reluctance to spend incom**e – at least for now. But we do not think we are on the brink of a recession in the US, despite the Atlanta Fed Nowcast continuing to dig deep into negative territory (-1.8% for

Q1 as of 6 March, the latest update, before the Employment Report was released). Jay Powell's reiteration after the payrolls that the Fed is in "*no hurry to cut*" is consistent with this view… but precisely, the Fed's caution is not helping the US market's revival.

The revolution can be painless – for some

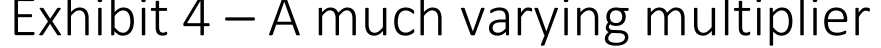
While we cannot decide at this stage whether revolutionaries or realists will win within the US administration, there is definitely a "revolutionary mood" in Europe. **The reaction from EU institutions and national governments to the American challenge is quicker and more powerful than expected**. True, the Defence package presented by Ursula von der Leyen remains sketchy at this stage, since we have not seen much "proper" new money in what has been put on the table so far, more a re-purposing of existing schemes (forthcoming summits may provide some clarity there). Still, the offer of taking out military spending from the scope of the European fiscal surveillance framework would have been unthinkable just a few weeks ago. As we discussed last week, the issue now is whether national governments have the readiness, and capacity to make full use of this new leeway given already shaky fiscal positions and markets "on the lookout". But **there is one country where the "revolution" can be relatively painless, it is Germany, given the width of its fiscal room for manoeuvre**. Last week we mentioned the possibility to pass a constitutional amendment to circumvent the "debt brake" without waiting for the new Members of Parliament (MPs) to take their seats in the Bundestag as an intriguing option, but Friedrich Merz, together with SPD, had made it plain he will act on it. The Greens will need to join CDU-CSU and SPD in Bundestag for the amendment to pass with the necessary 2/3 majority. As we write this note they haven't made their position clear but given their long-held critical view of the debt brake, they are expected to back the move ultimately.

There are two aspects to the package. One which came with a precise financial envelope: EUR500bn to fund infrastructure, education, digitalisation and energy over a decade. That is 11.6% of today's GDP, i.e. around 1% of extra spending per year on average for 10 years. That is serious money. The other one still needs to be quantified: from now on, defence spending above 1% of GDP will be excluded from the calculation of the deficit limit in the "debt brake" mechanism. In other words, this opens the door to a significant add-on to existing military spending, but what we do not know for now is how much of that extra leeway will actually be used. This may take the finalisation of the coalition agreement between CDU-CSU and SPD (an agreement in principle was announced this weekend, but the details still need to be fleshed out).

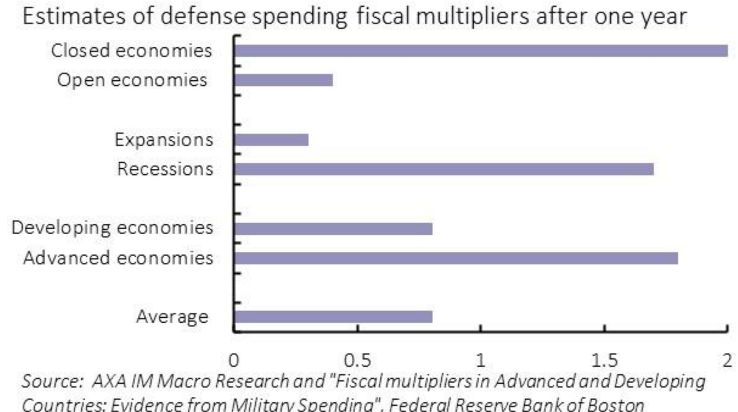
The key issue if of course the magnitude of the multiplier effects this extra spending will have on GDP, both in Germany and in Europe. We are tempted to ascribe a high multiplier – close to 1 – on the EUR500bn package: most of the spending will probably be recycled domestically (the import content is likely to be low on this type of spending) and any adverse effects (e.g. the "crowding out" of private spending via higher interest rates) are likely to be offset by positive externalities : for instance, scaling up the electricity grid would contribute to reducing the cost of energy *in fine*. Mechanically, given the size of the German economy in the Euro area, lifting German GDP growth by nearly 1% would raise European growth by c.0.2-0.3%.

The multiplier on defence is much more difficult to pin down. We show in Exhibit 4 the estimates from a fairly recent Federal Reserve of Boston's research paper (see link here) based on the experience from 129 countries with various characteristics and at different stages of the cycle. **The variation around the average multiplier (0.75) is huge**. As usual with estimates of fiscal effects, the multiplier is much bigger in times of recession than in times of expansion (a common explanation is that the supply constraints are lower in the first case, as the economy is not a full capacity). Given the current state of the German economy – mild recession – the effect could thus be significant. However, the multiplier conversely comes out as very low (0.26) in the case of open economies. The threshold used by the authors is that any country where the sum of imports and exports exceeds 60% of GDP qualifies as an open economy. This would cover all four biggest economies of the Euro area. The weaker multiplier stems from the usual "leakage" to imports from any type of fiscal stimulus, but also of course from the import content of military spending itself. At the German level, the issue then is how much of the effort will go to German firms. At the European level, how much of German purchases will go to European firms, and whether the signal from the European Commission on the surveillance framework – and Germany's own decisive approach – will spur more spending in other member states.

Exhibit 4 – A much varying multiplier



Estimates of defense spending fiscal multipliers after one year



Source: AXA IM Macro Research and "Fiscal multipliers in Advanced and Developing Countries: Evidence from Military Spending", Federal Reserve Bank of Boston Working Paper Series and, February 2019

All in all, **while the whole package is definitely a "game changer" for the German economy, it is not yet clear if we should expand this conclusion across the entirety of the Euro area.** This will depend on the extent to which joint-issuance programmes help all member states scale up their own spending projects and – should most the effort continue to rely on national public finances – whether the market would allow such an additional extension of deficits. The latter is to some extent conditional on the European Central Bank (ECB)'s own behaviour, but it is a two-way street: the ECB will also need to factor in the possibility of a fiscal expansion in its own reaction.

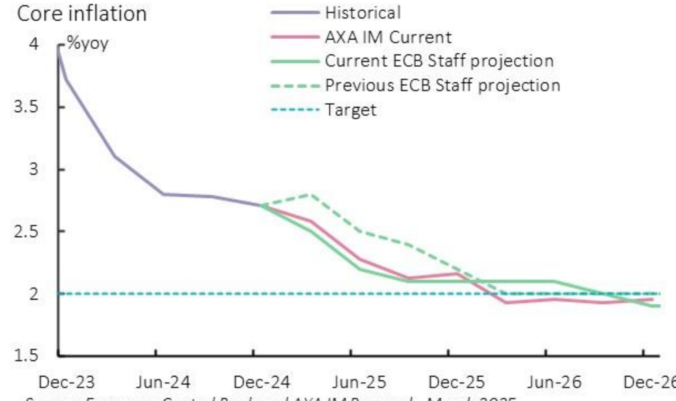
The conversation on slowing down has started at the ECB

The ECB is faced with a dual form of uncertainty: on the negative side, since it remains difficult to understand where US trade policy goes next, the risk of tariffs is tangible, but not a "done deal". On the positive side, while the central bank can be near-certain that German GDP will grow significantly more than expected, the ramifications for the Euro area as a whole are less obvious.

Highlighting the inordinate level of uncertainty, **as we expected Christine Lagarde played her cards even closer to her chest upon announcing the fifth cut in a row, at least on the timing of the next moves**. Adding the point that monetary policy has become *"meaningfully less restrictive*" is clearly a nod to the hawks like Isabel Schnabel who are getting concerned about the risk the ECB is going too far in its easing effort, but by definition, "less restrictive" implies it is still restrictive. That the central bank is not "done cutting" remains straightforward in our view.

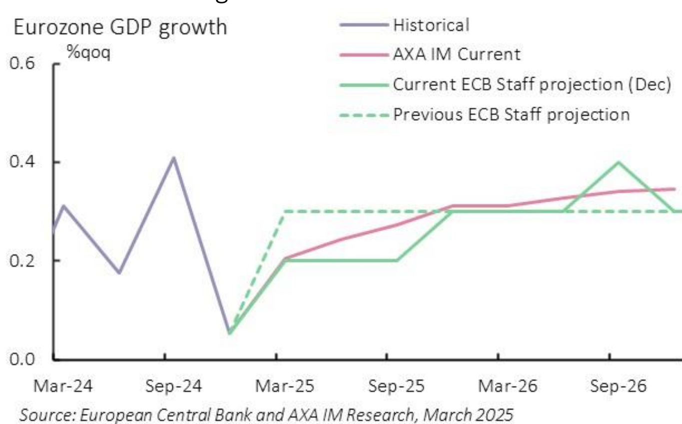
Supporting this view are the changes in the ECB forecasts: **they now expect took core inflation to converge to 2% visibly faster than in December** (see Exhibit 5), supporting Christine Lagarde's stronger confidence – expressed several times during the press conference – that they will deliver on their target. She went further by stating during the Q&A that, given the latest developments on energy prices since they froze the assumptions for the forecasts, their new headline inflation projections are already probably too high. The ECB also expects a softer recovery in the real economy than in December, GDP returning to 0.3% gains per quarter only at the end of 2025 only, rather than early in the year (see Exhibit 6).

Exhibit 5 – To 2% faster



Source: European Central Bank and AXA IM Research, March 2025

Exhibit 6 – Lower growth momentum in the short-run



Source: European Central Bank and AXA IM Research, March 2025

Now, Christine Lagarde also said that the Governing Council has become even more “data dependent” and she opened the door to a pause at the next meeting(s) if the “data warrants it”, which indicates **a readiness to change the pace of rate cuts**. We thought this conversation would start in earnest only at the end of Q2, when the 2% level would be reached, but the positive news from Berlin may explain some of the new caution. Beside the timing issue, the big question is whether the ECB would decide to move beyond 2% – the market’s baseline.

As we expected in our preview, Christine Lagarde downplayed the question of where the neutral rate is, to focus on a more “*evolutionary*” approach of monetary policy. Indeed, the question is less normative – whether the stance is restrictive or accommodative – than adaptative – whether the dataflow calls for more easing or not. In our view, determining whether the ECB will have to cut into the second half the year and below 2% depends essentially on whether European Union (EU) products will ultimately be hit by tariffs in the US, and how much progress is made on the European fiscal support side**. Our inclination remains that the sequencing will justify more than more cuts this year,** because we continue to think tariffs play a big role in the White House’s fiscal projects, which makes a shock on Europe likely in the next few months, while the impact of the additional public spending will be slow to materialise. Still, we acknowledge that the mere psychological effect of the new stance in Berlin may suffice to lift business and consumer confidence in the short run, staying the ECB’s hand. It has become a close call.

Yet, **we also think that the bond market – and exchange rates – could tilt the ECB into more accommodation than the market currently expects**. True, when asked about the rise in 10-year Bund yields, Christine Lagarde said that *“the ECB is not going to change its stance because of 24 hours of market movement”* and she pointed at the stability of intra-Euro area spreads. At face value, this means the ECB does not want to stand in the way of the ongoing rise in yields, as they probably think they mostly reflect a stronger growth outlook. However, even if spreads stay where they are, **we are convinced that, if the rise in *absolute* yields continues, even in countries where it is not yet obvious a fiscal stimulus in the sight, then we think the ECB would have to take into consideration the tightening in overall financial conditions and go further on policy rate cuts**. The same applies to the exchange rate: with the euro now appreciating against the dollar, it should open more space for monetary policy to ease.

Country/Region	What we focused on last week	What we will focus on in next weeks
US	• Tariffs raised on China (10ppt) and Cn & Mx (25ppt), then Cn & Mx pared back • Labour report (Feb) payrolls rose 151k, public rose by just 11k, unemployment rose to 4.1% and earnings growth slowed to 0.3%mom • ISM services (Feb) rose to 53.5, PMI rev'd up to 51.0 from 49.7 (p); mfg ISM dip to 50.3 from 50.9 • Vehicle sales (Feb) 16.0m, rebound from Jan drop • Beige Book (Jan) activity up slightly	• CPI inflation (Feb), headline and core expected to ease, watching services which were elevated in Jan • JOLTS survey (Jan) vacancy rate back to pre-COVID • PPI inflation (Feb) details primarily to determine PCE inflation, which has been softer than CPI • Michigan cons sent (Mar, p) monitor signs of further fall in sentiment or rising inflation expectations • Jobless claims for any sign of labour deterioration • NFIB survey (Feb) signs of small bus sentiment drop
Euro Area	• The ECB cut the depo rate by 25bps to 2.5% as expected. Way forward is more uncertain beyond April, highly dependent on likely upcoming US tariffs decision • Euro area headline and core inflation dropped 0.1pp to 2.4% and 2.6% in Feb respectively • CDU-CSU and SPD disclosed agreement to swiftly amend the constitution to generate historic fiscal loosening, including infrastructure and defence spending • EU Council endorsed EC (EU-Rearm) proposal for increased defence spending across the EU – mainly to be nationally financed	• Eurogroup and Ecofin to lay out details of EC Rearm plan • Increased defence spending intentions by member states • ECB speak post decision
UK	• Consumer credit (Jan) jumped to £1.7bn, from £1.1bn • Mortgage approvals (Jan) remained solid despite edging down to 66.2K, from 66.5K • Final services PMI (Feb) edged up to 51.0, from 50.8. Construction PMI fell to 44.6, from 48.1	• BRC Retail Sales (Feb) signs of weaker demand • RICS House Prices (Feb) look for stabilisation • Monthly GDP (Jan) activity likely will increase by 0.2% month-on-month
Japan	• Unemployment rate (Jan) edged up to 2.5%, from 2.4% • Consumer confidence (Feb) broadly unch at 35.0 from 35.2 • Services PMI (Feb) up at 53.7, from 53.0	• Av. cash earnings (Jan) base effects mean likely to slow to around 3.5% • Final GDP (Q4) look for revisions to private spending and investment • HH spending (Jan) look for small monthly drop
China	• NBS mfg PMI up to 50.2 (Feb) from 49.1; non-mfg edged up to 50.4 from 50.2 • Caixin mfg PMI rose to 50.8 from 50.1; services PMI up to 51.4 from 51 • Exports (Feb) slowed to 2.3% from 10.7%; import dropped sharply by -8.4% from +1%, driven by fell in energy imports	• CPI and PPI for Feb, likely to fell back from Jan as coming out of holiday season • Credit number for Feb. Loan growth and total social financing are expected to drop after highs fuelled by LNY holiday
Emerging Markets	• CB: Malaysia unch at 3%, Turkey cut 250bps to 42.5% • GDP (Q4): Brazil (3.6%), Romania (0.7%), South Africa (0.9%) • CPI (Feb): Czech Republic (2.7%), Indonesia (-0.1%), Mexico (0.3%), Philippines (2.1%), South Korea (2%), Taiwan (1.6%), Turkey (39%) • Industrial production (Jan): Hungary (-3.9%), South Korea (-4.1%)	• CB: Poland (5.75%, unch), Peru (4.75%, unch) • CPI (Feb): Colombia, Hungry, Poland, Brazil • Industrial production (Feb): Argentina, Turkey, Brazil, Malaysia, India, Mexico • South Africa to announce fiscal budget for tax year 2025-26

Upcoming events		
	US:	Tue: NFIB small business optimism (Feb), JOLTS Job Openings (Jan); Wed: CPI (Feb); Thu: PPI (Feb), Initial jobless claims (w/e 8 Mar); Fri: Michigan consumer sentiment and inflation expectations (Mar)
	Euro Area:	Mon: Ge IP (Jan); Thu: Ez IP (Jan); Fri: Ge, Fr, Sp HICP (Feb), Ge CPI (Feb), It IP (Jan), Fr Fitch credit rating review, Sp S&P credit rating review
	UK:	Tue: BRC Retail sales monitor (Feb); Thu: RICS Housing survey (Feb); Fri: GDP (Jan), Index of services (Jan), IP (Jan), Mfg output (Jan), Construction output (Jan), Total trade balance (Jan)
	Japan:	Mon: GDP (Q4), Current Account (Jan), Household spending (Jan)
	China:	Sun: CPI (Feb), PPI (Feb)

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** As at the end of December 2023.

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