AXA Investment Managers

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Investment Institute Macroeconomics

Tuesday's Grey and Wednesday Too

- After soft data, hard data are now also starting to point to a stagflationary scenario in the US
- The 25% tariff on cars is a first taste of what could come on Wednesday with the "reciprocal tariffs"
- So far, the bond market reaction to the German fiscal shift is consistent with a *wider* fiscal space for the country

This Wednesday 2 April, the release of the US "reciprocal tariffs" will herald the generalisation of the trade war. Yet, we can already see the signs of a stagflationary scenario for the US economy emerging with, for the first time last week, "hard data" and not just sentiment being hit. The steep upward revision in consumers' price expectations is making them effectively close their wallets. After the release of the personal spending figures for February, the Atlanta Fed's Nowcast estimate for Q1 GDP stands at -0.5%. The 25% tariff on cars and car parts alone could lift US core inflation by 0.6%/0.7%. This could be a short-lived shock, but labour market conditions could make it more persistent, and we keep an eye on the other negative supply-side shock about to hit the US: according to the Border Protection data, the crackdown on immigration is already triggering a very sharp decline in entries. This could keep wage growth high even if job creation starts to get wobbly.

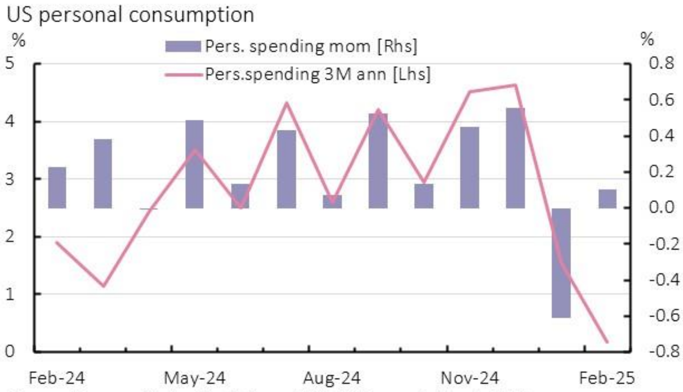
For Europeans, the tariff on cars gives a first taste of what is coming their way. Given Germany's particular sensitivity to car exports, this validates the new policy approach in Germany, with the focus on reviving domestic spending. Yet, in the short run, pain is likely to be intense. The likely retaliation from the EU, quite possibly via the Anti Coercion Instrument designed in 2023, will be part of the equation. European businesses and consumers will have to contend with uncertainty around the final level of the US "reciprocal tariffs", as negotiations will take time, while being unsure about the impact they will have on their own economy given the wide range for price elasticity estimates, as well as about the effect of any counter-measures the EU could take. This is a lot to take.

We extrapolate from the bond market reaction so far to the fiscal shift in Germany to investigate how fiscal sustainability conditions could change in the Euro area. For Germany, the fiscal space would *widen* – the fiscal push would thus be self-financed – as the likely gain in trend nominal growth exceeds by far the rise in long-term yields. The same does not hold for France or Italy. This illustrates again the need for more joint issuance in Europe.

More hints at stagflation in the US

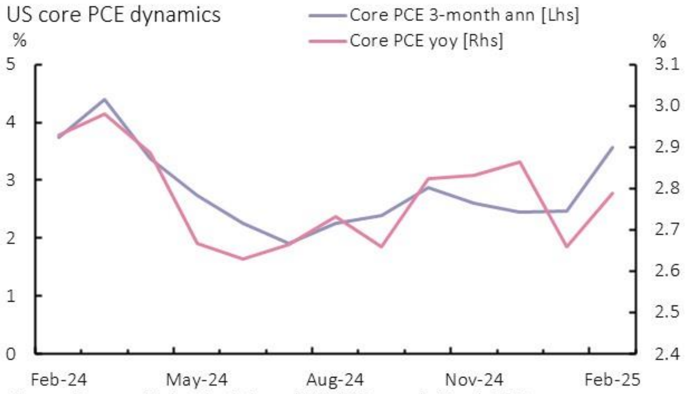
As much as we want to control our confirmation bias, evidence for – or at least hints at – stagflation continues to mount in the US, and this time it crossed the boundary between "soft" and "hard data." The personal consumption number for February was key for the market. The January plunge (-0.5%mom in the first estimate) could easily be explained away by weather conditions. A "mechanical rebound" would ensue. Still, consensus for February had taken on board some impact from the recent deterioration in consumer confidence, with expectations of only a 0.3% gain, not a full offset then. The actual number came out even lower, at a meagre 0.1% (with a downward revision to -0.6% of the January reading). On a three-month annualised basis, **US private consumption grew by only 0.2%, the worst result since December 2022** (see Exhibit 1). The Atlanta Federal Reserve (Fed) Nowcast now corrects for the massive imports of physical gold which had artificially taken down their GDP estimate, but after the data releases from last week, their figure remains negative for Q1, at -0.5%.

Exhibit 1 – Ooops, it's going down!



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

Exhibit 2 – Inflation momentum up



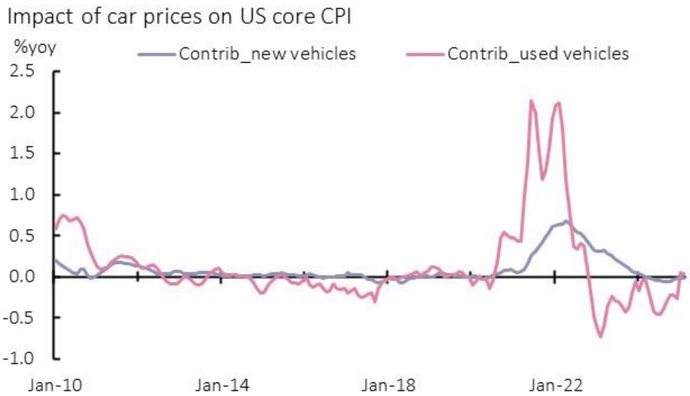
Source: Bureau of Labor Statistics and AXA IM Research, March 2025

Inflation allergy is more than a sentiment now, affecting actual spending decisions. The Fed's favourite gauge of inflation, core Personal Consumption Expenditures (PCE), also came out on the wrong side of consensus in February, rising 0.4%mom while the market was expecting 0.3%, unchanged from January. With more "accidents" along the way than the Consumer Price Index (CPI) measure, core PCE has quite clearly taken off from its summer 2024 lull (see Exhibit 2).

In such an environment, a trade war looks even more adventurous. Yet, even before the "reciprocal numbers" are released this week, the White House announced another sectoral tariff hike, with the 25% additional levy on cars, enforceable on 2 April for finished products, and from May onward on parts, thus further fuelling consumers' fears on the inflation outlook. According to the White House's own "Factsheet" accompanying the new Executive Order, imported cars account for about 50% of total car sales in the US, while the "import content" of cars manufactured in the US stands between 40 and 50%. The overall effect of the tariff hike on US domestic car prices is thus likely to be very significant, even if margins will absorb some of it.

The "budget lab" of Yale University estimates that overall, new cars' prices in the US could rise by 13.5% (see link here). We would expect some spillover to used ones (which the Yale study does not take in consideration). Indeed, beyond the direct "price channel," production disruption could emerge. In the short-run, US carmakers and car importers will try to offload their inventories, but as they try to chase the lowest "tariff intensity" of their production lines, carmakers may face delays in supplying new vehicles, resulting in demand diversion towards used cars. Such pattern was observed when the economy emerged from the pandemic, with massive impacts on overall inflation (see Exhibit 3). **Since new and used cars together account for 5% of the weights of the core CPI index, a hike of 13.5% would lift core inflation by 0.6-0,7%. The "transitory disturbance" in the US economy which the White House is now warning about may be quite significant if the car tariffs alone can visibly raise overall inflation.**

Exhibit 3 – Cars matter for overall price dynamics sometimes



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

Of course, **we need to contemplate the other side of the equation: the possibility to see a significant increase in foreign investments in the US to circumvent tariffs** (but only partly, because they would still need to source at least some parts from outside), lifting aggregate domestic capex and thus offsetting the adverse effect on consumption. The announcement by Hyundai that it will invest USD21bn in the years ahead in the US to produce steel and cars came at the right time for the White House. Still, this effect needs to be balanced against the deterioration in profits which the hike will trigger for US carmakers, which will make their investment effort more difficult (General Motors and Ford invest together roughly USD20bn annually).

We also need to take into consideration the possibility that the Fed accommodates the shock. The tariffs' impact should take the shape of a one-off price level shock – a "transitory" effect to re-use the word exhumed by Jay Powell two weeks ago. Transitory inflation has a nasty habit of turning persistent, but it takes specific conditions for this. The supply-side shock of the post-Covid reopening had a persistent price effect because pent-up demand could rely on massive cash reserves forcibly accumulated during the lockdowns and lingering fiscal support. If indeed US households continue to respond to the return of price pressure by closing their wallets, as they have been doing since the beginning of this year, the shock should be short-lived – at the cost of significant GDP growth impairment. Yet, **the tariff effect is going to combine with another negative supply-side shock: the rapid decline in immigration.**

According to the US Border Protection statistics (link here), **in the first two months of 2025 their officers have made 110,000 "encounters" (i.e. came into contact with would-be immigrants) against nearly 500,000 in the corresponding period of 2024 and 425,000 in 2023**. Deterrence seems to be working. While this down the line also impacts GDP adversely, it could add to US pressure on wages, possibly on a lasting basis. The Fed asserts that the US labour market is currently broadly balanced, neither adding nor subtracting to inflationary pressure. If job creation starts decelerating in earnest – which for now has not happened – the Federal Open Market Committee (FOMC) will still need to take on board the decline in labour supply to gauge the chances inflation duly falls after the one-off effect of the tariffs fade. In our view, **while the Fed may be forced to resume cutting earlier than we thought until recently, this will have to be a reactive move – coming after the damage materialises – rather than a pro-active one.**

More uncertainty within uncertainty

Even before the European Union (EU) "number" is disclosed, **the White House's decision on cars last week is making one clear European victim, Germany, which accounts for three quarters of the cars shipped to the US from the EU**. German car exports to the US stood in 2024 at EUR34bn, hence 0.8% of GDP. Given the high import content of cars, the "true" figure in terms of macroeconomic effect is closer to 0.5% – which by the way suggests that quite some pain will be felt in Central and Eastern European countries where the bulk of suppliers of German carmakers are located. If the price elasticity is unitary – a 1% price increase triggers a 1% decline in volume – the direct effect on GDP of a 25% tariff hike on cars would be visible, but not "crushing". Unfortunately, this assumption is a strong one.

There is a profuse academic literature on estimates of "Armington elasticities," which measure the degree of substitution in demand between similar products produced in different countries**. A meta-analysis of existing literature from 2020 (see link here) found a range of 2.5 to 5.1, with a median of 3.8.** Illustratively, if one applies this median to the current shock, the near entirety of German car exports to the US would be wiped out (without absorption in margins). There is no strong reason to think *car* imports display a lower elasticity than the average. In a less comprehensive study of Armington elasticities, research from the US International Trade Commission (see link here) found for transport equipment in general a range between 2.2 and 7.6.

Since the "reciprocal tariffs" will usher in a negotiation phase, uncertainty will still be a key channel through which the trade war will affect growth in Europe, but the "hard" 25% tariff on cars – there does not seem to be room for negotiation on this one, at least for now – will give us a first taste of the impact transiting through the price channel, and it is likely to be already quite painful.

Sentiment is already low in the Euro area judging by the European Commission surveys released last week. True, business confidence in manufacturing edged up again in March – possibly reflecting some early impact of the fiscal announcements from the German government – but it remains markedly below its long-term average, while confidence in services continued to deteriorate (see Exhibit 4). Consumer confidence also dipper lower in March. Interestingly, inflation expectations have been going up sharply over the last few months, despite favourable developments in observed consumer prices. The prospect of European retaliations may not help on that front (see Exhibit 5).

Exhibit 4 – Business confidence lower in services

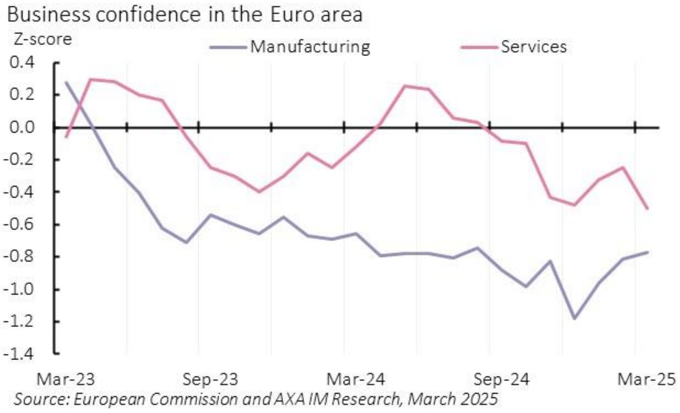
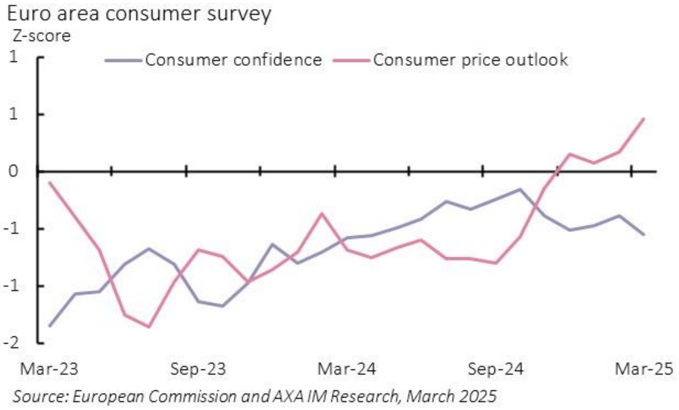


Exhibit 5 – Worried consumers



In an interview last week, Mario Draghi urged Europeans not to focus on tariff retaliation but instead concentrate on their own pro-growth agenda. Indeed**, in principle, Europeans could simply let the US tariffs be their own punishment**, given the adverse effect they should have on growth and inflation over there. Why should the Europeans add their own negative supply shock – in the form of higher inflation triggered by tariffs on US products – to the already painful negative demand shock on their exports? Yet, noises from Brussels and European capitals point to a "muscular reaction." There may be two rational explanations here. First, a game theory approach: the threat of retaliation can be an asset in the negotiation that the release of the "number" will trigger. Second, a political economy argument: retaliation would be another way to cement Europeans' renewed readiness to unify politically.

The first wave of retaliation could be almost instantaneous since it merely entailed reactivating countermeasures launched during the first trade war which had been suspended, rather than properly terminated. To go further and respond to a more generalised trade war after 2 April, **the Anti Coercion Instrument (ACI) offers a wider array of possibilities for retaliation:** beyond trade tariffs "proper," its most relevant aspect lies in the option to restrict services access to the European market, especially in the tech realm. As we discussed in our "Bretton Woods 3.0" piece a month ago, the EU's large bilateral surplus on trade in goods over the US does not put it in a great position to negotiate with the US a "tariff disarmament", but the EU's large bilateral deficit on trade in services is a reflection of how crucial the European market is for US tech: this is where the balance of power changes.

Yet, even if the ACI was designed in 2023 with a "rapid reaction" aspect in mind, due process is not absent. The European Commission first must examine the existence of a "coercion case" within 4 months. Importantly, the Commission does not need the coercion measures by a third country to be enforced before starting the process: mere "intentions" suffice. Then comes the determination phase, where the European Council takes the lead. Within 8 to 10 weeks, the Council needs to form an opinion on the case, at a qualified majority. The Commission then engages in consultations with the country accused of coercive measures against the EU collectively or individual member states. The implementation of the anti-coercive measures is supposed to come only in last resort.

While the examination phase is likely to be short – that the US is using trade tariffs to exert pressure on the EU is explicit in their own communication – the determination phase may take a bit of time. Indeed, while there seems to be a generic consensus across EU capitals around some sort of retaliation, the discussions are likely to be more complicated when precise measures are put on the table given member states' differing sensitivities to the US own measures (e.g. cars for Germany, food, and luxury goods for France). In addition, it is highly likely that Washington will try to play EU members against each other by skewing the product distribution of their own tariffs across the various member states' product specialisations.

In a way, the ACI process is a good fit for what the US is trying to achieve with the "reciprocal tariffs" in the sense that it explicitly provides for a negotiation phase. Yet, it also adds to general uncertainty. Indeed, **European businesses – and consumers – need to contend with uncertainty around the final level of the US "reciprocal tariffs", while being unsure about the impact they will have on their own economy given the wide elasticity range, as well as about the ramifications of any counter-measures the EU could take. This is a lot to take**, on top of existing domestic softness, fuelled by excess savings.

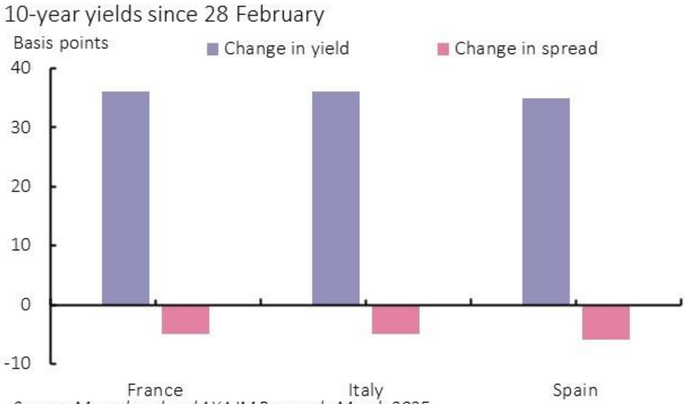
One – crucial – element still missing in the European response

Still, at least there is one "upside risk" for Europe which was still missing at the beginning of the year: the now very tangible German plan for defence and infrastructure spending, which could cushion some of the adverse effect of trade-related uncertainty. Still, we think that the EU response is quite imperfect because it opens asymmetries across member states.

The bond market has treated all big European signatures in roughly the same way since the fiscal shift in Germany: spreads have barely moved (c. 5bps across France, Italy and Spain), with absolute long-term interest rates moving up by c. 35-40bps homothetically (see Exhibit 6): **the upward revision in German yields, fuelled by expectations of more Bund supply in the years ahead triggered a general re-assessment of yields across the Euro area without much discrimination across signatures, despite the fact that *only* Germany has announced a significant change in its fiscal trajectory.**

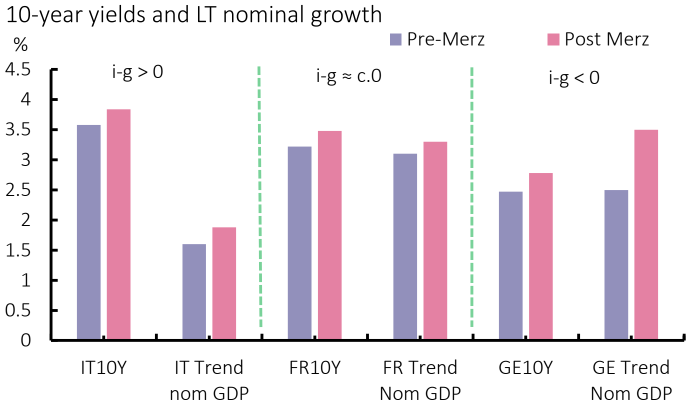
In Exhibit 7, we transpose this market reaction to long-term fiscal sustainability conditions across the Euro area. Using a multiplier of 0.7 for infrastructure and 0.3 for defence, a very tangible acceleration in German nominal GDP "trend" growth by a full percentage point may even be conservative (we put "trend" between quotation marks because this would not necessarily mean that underlying labour and capital supply, as well as productivity, would accelerate). Under these assumptions, **the fiscal space defined by the difference between nominal growth and interest rates would *widen* for Germany**, if the c. 40bps rise in 10-year Bund yields seen this month is the right "premium" on German funding costs. In other words, **the fiscal shift could be self-financed in Germany.** Nominal GDP growth would also rise a bit in France and Italy, because of the spillover from the tangible acceleration in demand from Germany, but even with some modest national defence efforts, we would be surprised to see "trend" GDP accelerate by more than a quarter-point (in the German case, it's the infrastructure effort which dominates in the growth impact). This would leave sustainability conditions unchanged for these two countries, with Italy still forced to maintain high primary surpluses, which does not sit well with any additional military spending, while France would see no additional space appear.

Exhibit 6 – Homothetic upward yield revision



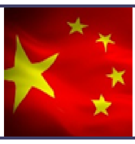
Source: Macrobond and AXA IM Research, March 2025

Exhibit 7 – "Sustainability inequality" even higher now



Source: Macrobond and AXA IM Research, March 2025

This gets us back – again – to the need to go further on joint funding of the defence efforts. While the material effects would be slow to emerge, more ambition on this side of the European equation would come at the right time to shore up business and consumer sentiment in Europe when "peak uncertainty" and the first tangible real effects of the tariffs already enforced is just ahead.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Personal spending (Feb) +0.1% after -0.6% in Jan, rebound cushions Q1 fall, but likely still soft • PCE inflation (Feb) headline +0.3% and core +0.4%, suggesting stickiness even before tariffs • Q4 GDP (r) up to 2.4% (saar) from 2.3% • Conf Bd Cons Conf (Mar) fell again with expect's lower suggesting spending weakness in Mar • Housing activity rose in Feb, but mort apps weaker in Mar as uncertainty impacts	• Labour market report (Mar) expect steady employment around 150k and unemp at 4.1% - no sign of deterioration expected • JOLTS survey (Feb) alternative take on labour mkt • ISM indices (Mar) mfg likely weaker given variety of other indices; services could rise after PMI higher • Vehicle sales (Mar) key consumer barometer – expected to remain solid above 16.0m
	• Trump announced 25% tariffs on auto. Ge, It, and other auto/component producers run a huge risk of their growth being significantly reduced • Flash PMIs (Mar) and EC surveys (Mar) point to lower sentiment in Svcs, small uptick in Mfg. We believe it is still consistent with growth at around +0.2%qoq in Q1 • Consumer confidence fell in several countries • Flash inflation in Sp and Fr (Mar) were lower than expected	• Trump administration releases their report on reciprocal tariffs (Apr 2). New tariffs could be implemented or used to negotiate. EU could potentially retaliate (in response to US tariffs on auto) • EMU inflation (Mar) to continue its disinflation trend, likely to secure an April cut for the ECB • EMU unemployment rate (Feb)
	• Flash composite PMI (Mar) rose to 52.0, from 50.5, though manu. dropped to 44.6, from 46.9 • CPI inflation (Feb) fell to 2.8%, from 3.0%. Core CPI fell to 3.5%, from 3.7%. Services unch at 5% • Spring Budget: £14bn gap in public finances made up for with spending cuts. OBR growth forecasts still too punchy • Retail sales (Feb) up by 1.0%mom; 2.2%yoy • Final GDP (Q4) 0.1%qoq rise. Savings rate jumped to 12.0%, from 10.3% in Q3	• BoE consumer credit (Feb) look for a drop back to £1.3bn, from £1.7bn • BoE mortgage approvals (Feb) look for a further drop back now the SDLT threshold changes are approaching • Nationwide house prices (Mar) look for a slowdown in year-over-year prices • S&P final surveys (Mar) no reason to expect material change • S&P construction PMI (Mar) look for further weakness
	• Flash composite PMI (Mar) fell to 48.5, from 52.0, driven by services (49.5) and manu. (48.5) • Leading eco indicator (Jan) rose to 108.3, from 107.9 • Tokyo CPI (Mar) up 2.9% (Feb, 2.8%). Core up 2.4% (2.2%.) Ex. food and energy 1.1% (0.8%)	• Retail sales (Feb) weaker mom rise. IP (Feb) rebound likely after January dip • Unemp rate (Feb) to stay broadly unch at 2.5% • Tankan (Q1) signs of broad-based weakness • HH spending (Feb) look for rebound after weak Jan. • Final PMIs (Mar) no reason to for material change
	• Industrial profit for Jan-Feb dropped to -0.3%yoy from +11% in December last year, partly due to holiday seasonality	• NBS mfg PMI (March), important to see tariff impact • NBS non-mfg PMI (March) watch for early sign of recovery in consumers • Caixin mfg PMI and services PMI (March)
	• CB: Hungary (6.5%, unch), Czech Republic (3.75%, unch), Mexico (50bp cut to 9.0%) • Industrial production (Feb): Singapore (-1.3%), Taiwan (+17.9%), Thailand (-3.8%)	• CB: Colombia (-25bps to 9.25%), Poland (unch 5.75%), Philippines (unch 5.75%) • CPI (Mar): Poland, South Korea, Brazil, Turkey, Philippines, Thailand, Peru • Industrial production (Feb): Chile, Brazil, Hungary, South Korea (watch exports for impact of tariff) • Trump's tariff announcement on 'Liberation Day', key event for many countries in EM

Upcoming events		
	US:	Mon: Chicago PMI (Mar), Dallas Fed mfg index (Mar); Tue: ISM mfg PMI (Mar), JOLTS job openings (Feb), ISM mfg emp (Mar); Wed: ADP emp (Mar), Factory orders (Feb); Thu: Balance of Trade (Feb), Exports (Feb), Imports (Feb), Initial Jobless claims (Mar/02), ISM svc PMI (Mar); Fri: Non farm payrolls (Mar), Unemp (Mar), Avg earnings (Mar)
	Euro Area:	Mon: Ge Retail sales (Feb), It, Ge CPI (Mar); Tue: Sp, It mfg PMI (Mar), It, Ez Unemp (Feb), Ez CPI (flash, Mar); Wed: Sp Unemp (Mar); Thu: Sp, It Svc PMI (Mar); Fri: Ge factory orders (Feb), Fr IP (Feb), It Retail sales (Feb)
	UK:	Mon: Consumer credit (Feb), Mortgage approvals & lending (Feb); Tue: Nationwide housing prices (Mar); Thu: S&P global construction PMI (Mar)
	Japan:	Mon: IP (Feb, p), Retail sales (Feb); Tue: Unemp (Feb), Tankan mfg index (Q1); Fri: Household spending (Feb)
	China:	Mon: Mfg PMI (Mar), Non-mfg PMI (Mar); Tue: Caixin mfg PMI (Mar); Thu: Caixin Svc PMI (Mar)

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