Investment Managers

271 – 26 May 2025

Investment Institute Macroeconomics

Macrocast

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Too Many Open Fronts

- A 50% tariff on EU products could precipitate the Euro area into a substantial recession, but the US may not be in as strong a position as the White House seems to believe, with the market – and possibly public opinion – reacting adversely to both the re-ignition of the trade war and doubts on the US fiscal trajectory.

After a few relatively quiet weeks on the trade front, Donald Trump chose to "up the ante" by announcing a 50% tariff on EU products from June 1st. European equities, understandably, did not react well, but what we find the most interesting in the market's response last Friday was the fact that, against economic theory, the dollar weakened versus the euro. This would reflect the fact that the entire policy stance in Washington is increasingly seen by the market as counter-productive for the US themselves, at a time when concerns about the US fiscal trajectory – fuelled by the House's approval of the "Beautiful Budget Bill" – would already be enough to inject a significant risk premium in US financial assets. It may well be that the White House has opened too many fronts simultaneously.

Of course, a 50% tariff on EU products could trigger a substantial recession in the Euro area – combined with the euro appreciation GDP could fall by 2% relative to baseline – but the impact on the US economy from European retaliations, albeit smaller, would still be tangible: the EU is a much bigger market for US producers than China. The resilience in US long-term interest rates may not have a large immediate impact on the financial position of US corporations – the fear of the "maturity cliff" has incentivized a lot of them into pushing the bulk of their refinancing needs to 2028-2029, but for households, high mortgage rates, combined with the tariff shock on purchasing power and hesitant equity prices, are not helping. The concessions on trade had allowed the US President's polls to stabilise in the last few weeks. This may change again with last Friday's announcement. All this may convince the Europeans that they should not "fold too quickly" and consider the latest threat as another ingredient in a negotiation which can continue under the initial deadline (9 July).

Still, there was at least one piece of good news coming from the US last week: the Supreme Court has explicitly protected the Federal Reserve from the risk of an early dismissal of Jerome Powell. This reduces the risks of the tariff-induced inflation shock turning persistent, at least until Powell's replacement in May 2026.

Here we go again

What the thought was the most striking aspect of the market reaction on Friday to Donald Trump's threats to impose a 50% tariff on EU products – enforceable from June 1st – is that the dollar continued to weaken. On Friday evening the euro stood at 1.1362 dollar, against 1.1283 on Thursday night. This goes against theory: for all their limitations and adverse side-effects, tariffs should still reduce a country's trade deficit, thus lifting its currency. We suspect that this market response reflects **a general distaste among investors for the constant bombardment of new, potentially far-reaching policy measures in the US which only add to the "risk premium" now associated with US assets**. After focusing almost exclusively on the trade front, the White House shifted to fiscal policy. But the combination last week of "big moves" on both trade and fiscal policy was too much to digest for investors. The usually robust relationship between the transatlantic spread on 2-year yields and the euro exchange rate continues to be broken: while the market continues to see – rightly in our view – more scope for the European Central Bank (ECB) to accommodate in the year ahead than the Federal Reserve (Fed), the dollar continues to weaken (see Exhibit 1).

Exhibit 1 – FX no longer responds to spread

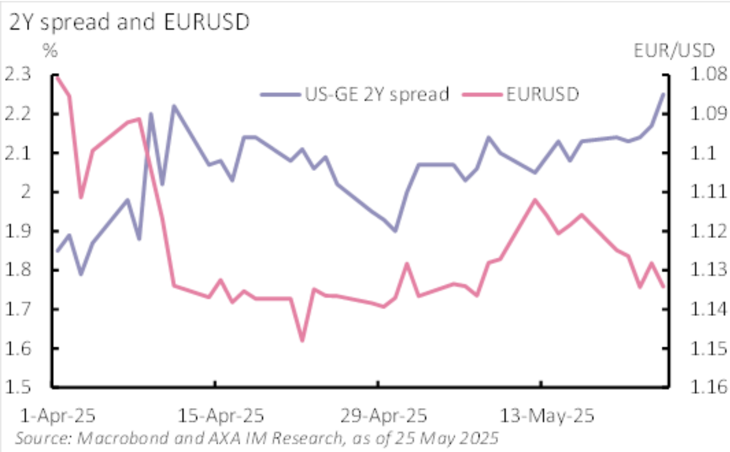
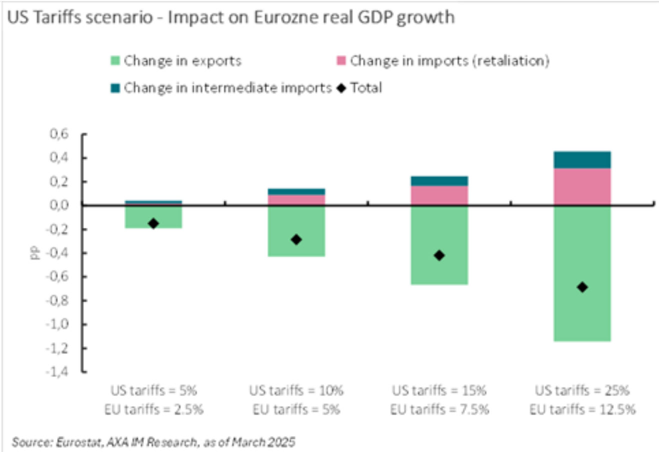


Exhibit 2 – Pushing the assumptions up



Of course, **a 50% tariff on EU products would have a significant impact on the European economy**. In the various iterations of the trade war scenario, we never considered a shock of such magnitude, but models are linear (see Exhibit 2). If this was the permanent state of play, and in a configuration where the EU would respond by imposing tariffs of 25% on US products (which would be sufficient to inflict damage to the US while limiting the side-effects for Europe), we estimate that GDP would fall by 1.6% relative to baseline in the Euro area. If we add to the mix a stronger euro – maintaining the 5% gain in trade-weighted terms observed since the beginning of the trade war – the GDP loss would reach 2%. In other words, a serious recession would ensue, given the already mediocre current dynamics.

Despite Donald Trump's comments on his lack of interest in future talks (*"I'm not looking for a deal – we've set the deal"*), it is still likely that the 50% tariff on EU products is intended as a negotiation ploy. Press reports suggest that the US were disappointed by Brussels' opening gambit in the talks, still targeting *mutual* tariff cuts rather than *unilateral* moves on the European side. Beyond the economic cost to the Europeans of taller trade barriers in the US, it may well be that the White House considers it has the upper hand and can easily win concessions: Europeans are still trying to convince Washington to remain involved in a peace process in Ukraine which puts them in an awkward position, and Donald Trump can use the deals – very provisional in China's case – he has struck recently to raise the pressure on the EU: indeed, a 50% tariff would put Europe at the same overall level as China (the new 30% "reciprocal rate" comes on top of the "old" 20% inherited from the first trade war) and much higher than the UK's.

While it may be asymmetric, the shock to the US economy of such a massive hike in custom duties levied on European products would however be large, bringing in alone a contribution of 9.3 percentage points to the weighted average tariff, given the EU's share in US imports (18.5% in 2024, versus 13.4% for China), which would take it back again above 20% (21.9% according to the Yale Budget Lab, see link here), enough to lift inflation by more than 2% (2.2% according to the same source). According to the Yale Budget Lab, if the 50% tariff on EU products was permanent – as well as all other tariffs currently in the pipeline – US GDP would be immediately 0.8% lower, with a long-run cost of 0.5%. Retaliations would also be painful for the US. Even if the US is a much less open economy overall than the EU, Europe is a much bigger market for American producers than China: the EU last year received 18% of US exports, more than twice the share of China (7%). In other words, **a 25% European tariff has the same overall effect on the US competitiveness as a 65% Chinese tariff.**

There is another dimension that the US side should take on board: the possibility that the EU responds on imports of services, especially digital ones, on which the US has been recording an increasing bilateral surplus. While Google, Apple, Facebook and Amazon (GAFA) do not routinely publish precise data on their turnover in the EU, it is significant. For instance, 29% of Alphabet revenue come from the EMEA region – Europe, Middle East, and Africa – in 2024, of which the bulk probably comes from Europe. The US are focused on seeing Europe "disarm" on the Digital Services Tax. Further escalation – even if of course it would not be in anyone's interest – raises the risk that the EU decides to go further in this direction, even if calls of this nature have been less loud in the last few weeks.

The immediate reactions on the EU side were not indicative of an intention to "fold" too easily, even if an open attitude towards the US continues to prevail. A common calculation in Washington is that Europe's negotiation position can be easily undermined by playing member states against one another. Still, based on the various statements of the weekend, there does not seem to be any visible cracks in the European resolution. We find it interesting that the Dutch Prime Minister Schoof – who in early April was calling for restraint on the EU's handling of the trade war – merely stated after Donald Trump's announcements *"this is all part of the negotiation; we will look calmly at the proposals and respond robustly and firmly".* EU trade commissioner Maros Sefcovic – who had a call with the US Trade Representative after the White House's announcements – stated that the Commission *"remains ready to work in good faith (…) EU-US trade is unmatched and must be guided by mutual respect, not threats. We stand ready to defend our interests".* Scott Bessent's point on Friday on the 50% tariff "*lighting a fire under the Europeans"* would be another reason for the EU to consider they are still in the early days of the talks with the Americans, rather than facing a negotiation failure. This may be the substance of Ursula Von der Leyen's statement on Sunday night, after a call she qualified as "good" with Donald Trump. She mixed signs of openness *("advancing trade talks swiftly and decisively")* with a request to comply with the scheduled timeline – the 90 days negotiation phase ending on 9 July.

The US side complains about the difficult decision-making process in Europe, but precisely because a high level of consensus would be needed, obtaining swift concessions may not be that easy. So far, the EU had "chosen not to choose" in its general attitude towards negotiations, between the UK's "immediately conciliatory" approach and China's "hard, immediate retaliation" stance. Threats of 50% tariffs could tilt the European council towards a more Chinese attitude, if there was a sense that this is, ultimately, the most efficient approach to obtain concessions from the US.

The Europeans may also count on the feedback from financial markets to mollify the US stance. Indeed, outside the trade realm, the White House cannot ignore the increasingly difficult financial environment that its policy stance is contributing to create domestically. The bond market gets regularly upset when the US fiscal outlook becomes uncertain, e.g. when the extreme polarisation of the US political system results in policy paralysis. This time however, the market is getting upset precisely because investors now have good reasons to believe the US is going to follow a well-defined path. It is just that it is a path they do not like.

An adventurous fiscal path

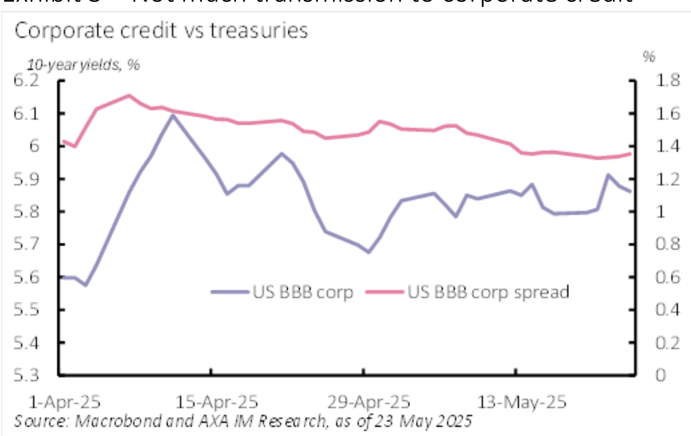
We explored last week the implications of the "OBBB" (One Big Beautiful Budget Bill) on the US fiscal trajectory. To summarize, if all the measures it contains become permanent – and there is a decent chance they would, since precisely the OBBB prolongs the 2017 Tax Cuts and Jobs Act (TCJA) tax cuts – **the deficit would hit 8% of GDP by the end of the decade according to the Yale Budget Lab**. Even with the support of trade tariff revenues, the deficit would stay at its current level, i.e. 6% of GDP, which in any case is not consistent with long-term debt sustainability. The negotiations within the Republican caucus resulting in the ultra-tight victory in the floor vote “moved money around” but without changing the overall deficit impact of the package: to appease the fiscal hawks, federal spending on health care will be cut a bit further, but to keep the Representatives from marginal districts in affluent areas of New York State and New Jersey, the deduction cap on state and local tax for the calculation of federal income tax was raised.

For decades, the US welfare state has been slowly expanding, with more people covered by the federal healthcare programmes and social security pension, which is largely a consequence of demographic change, but also political inertia – the last major reform of social security dates back to the early 1980s. The US social protection system was getting increasingly resemblant to what is commonly found in European countries, but without the tax receipts needed to avoid a slow drift in deficits. The US is faced with a rather simple choice: either reduce the generosity of social programmes, or boost taxation levels. The current majority in Congress has clearly erred towards the former, but without providing any relief on the overall financial imbalance of the federal government: beyond prolonging TCJA, the House has offered income tax cuts to senior citizens, on top of the exemption of tips and overtime.

The fiscal equation is moving even more forcefully towards a deterioration in the long-term debt trajectory because one of the paradoxes of the current administration: while it is treading a generally isolationist path on foreign affairs – the loss of interest in a peace settlement in Ukraine is one of its manifestations, or the insistence on burden sharing with the European on North Atlantic Treaty Organization (NATO), **military and security spending will continue to rise**. According to the Congressional Budget Office (CBO)’s preliminary assessment of OBBB, over 2025-2034, the House’s proposal for the armed forces budget would lift the federal deficit by USD143bn cumulatively, to which USD67bn would be added by Homeland Security. There would be no “peace dividends.” In his recent speech in Riyadh, while Donald Trump put the final nail in the neo-conservative agenda’s coffin, by voicing his opposition to any regime-changing or nation-building goals for the US foreign policy, he also made it plain that the US military dominance would remain an objective of his administration.

Beyond the OBBB, investors may be concerned by the recent dynamics in government spending. The Penn-Wharton Budget Lab has developed an interesting real time tracker of the federal budget (see link here) based on the daily statement by the US Treasury Department. **As of 22 May 2025, federal spending was 5.3% higher, even after adjusting for inflation, than during the corresponding period of 2024**. The efforts of the newly created Department of Government Efficiency (DOGE) have not yet been fruitful. For now, this is more than offset by robust gains in tax receipts (+9.6%) as the economy is still doing well, and the revenue from customs ‘duties will help, but this is likely to change as the impact of the tariffs on consumers’ purchasing power and business profits start materialising.

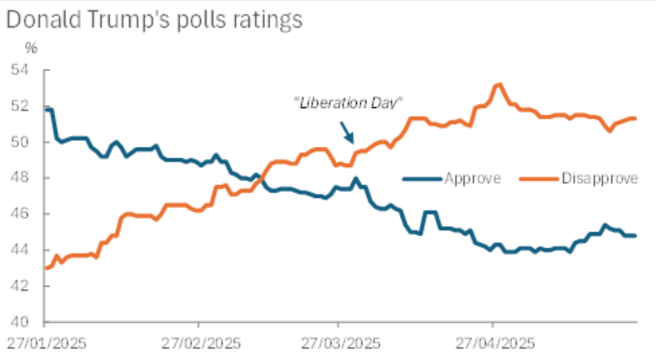
Exhibit 3 – Not much transmission to corporate credit



The immediate impact on the financial stability of the corporate sector from the resilience in long-term interest rates is likely to be manageable though. Yields on corporate debt continue to be much higher than before D. Trump’s electoral victory became likely (+52bps for 10-year BBB credit relative to early September), but the spread relative to treasury bonds has not widened overall. Since "Liberation Day," there has even been some compression in the corporate spread (see Exhibit 3). Back in 2022, in the face of the rise in corporate funding rates after the Fed-led compression of the pandemic, the market was intensively discussing the "refinancing cliff" which would hurt firms' financial position when the bulk of corporate debt would need to be rolled over in 2025 and 2026. Fear can be a good guide sometimes: **businesses have made significant efforts to refinance early**, especially in the high yield and leveraged loans spaces. According to a timely paper by Nelson Jantzen for JP Morgan published last week, maturities expiring in 2025 fell by USD148bn for high yields relative to what was expected in 2022 (USD234bn for loans), with a similar drop for 2026. This would leave only USD84bn of high yield bonds expiring in 2026, with the "cliff" pushed to 2029 when USD363bn would need to be refinanced.

Yet, **the current level of interest rates is clearly a hindrance for investment projects, and households in particular may become increasingly sensitive to elevated mortgage costs:** on average, the interest rate on a typical 30-year, fixed-rate mortgage has moved up again above 7.0% on 22 May. Real estate transactions remain stuck in a 4 million a month range (5.5 million before the pandemic) and they have fallen by 2%yoy in April 2025. This, together with the price shock and the hesitant dynamics of the equity market, is likely to fuel popular discomfort about the current policy stance. According to the New York Times' polls aggregator, Donald Trump's ratings deteriorated faster after "Liberation Day" on 2 April, to reach a net negative level of 9 points on 28 April. The announcement of concessions on trade, and the ensuing improvement in the markets, provided a respite and the net negative rating has fallen back to 6 points last week (see Exhibit 4). It is plausible that a relapse will materialise in the next few days.

Exhibit 4 – Will the stabilisation last?

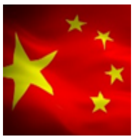


Source: New York Times average of polls, AXA IM Research, as of 25 May 2025

The ball is now in the Senate's camp, at least on the fiscal front. The White House will still be walking a very fine line, even after its victory in the House. Indeed, the fact that the package went through by a margin of only one vote after intense negotiation offers very limited leeway to accommodate any modification by the Senate when the bill comes back to the House. **The adverse market – and possibly popular – reaction may embolden Republican Senators to write in more saving measures and/or reduce the scope of the tax cuts.**

At least, the Fed is protected

One element however which could make the market less concerned – at least in the short run – about a persistent inflation scenario is the fact **that the Supreme Court, upon approving the dismissal of the chairs of two independent authorities by Donald Trump, explicitly made the point that such ruling could not apply to the Fed**. Indeed, the Court "*disagreed*" with the notion that the legal challenges mounted by the two chairs "*necessarily implicate the constitutionality of for-cause removal protections for members of the Federal Reserve's Board of Governors or other members of the Federal Open Market Committee*" and went on to state that the Fed "*is a uniquely structured, quasi-private entity that follows in the distinct historical tradition of the First and Second Banks of the United States"*. Jerome Powell is safe, and the issue of future stance of the Fed is pushed to the appointment of his successor in May 2026.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• 30-yr UST yields rose to 2023's 16-yr highs as Moody's downgraded US debt to Aa1 from Aaa and House moved to approve the fiscal bill. • Trump threatens 50% EU tariff from 1 June • PMIs (May, p) 52.3, mfg (50.2) and svc (50.8) • Philly Fed svc indx (May) remained at -42, its lowest on record barring COVID • Existing home sales (Apr) -0.5%mom after -5.9% in Mar, defied hopes for rebound	• GDP (Q1, r) watch for revisions to volatile trade and inventory components, prelim reading -0.3% (saar) • PCE inflation (Apr) 0.1% expt'd rise in head & core • Personal spending (Apr) gauge softening after strong Mar • Conf Bd Cons Conf (May) watch for any rebound in expectations index after tariff pause/stock rebound • FOMC minutes (May) any in favour of pre-emption? • Adv goods trade (Apr) how soft imports post-tariffs
	• The EC downwardly revised its growth forecast to 0.9%/1.4% from 1.3%/1.6% for 2025/26. • May surveys suggest weakening growth in Q2 led by services. • German Q1 growth was revised up 0.2ppt to 0.4%, led by improved domestic demand. • Euro area Q1 negotiated wage growth dropped 1.8ppt to 2.4% in Q1 25	• May EC surveys, member states' flash May HICP • Last ECB speeches ahead of the 5 June GC meeting • ECB April inflation expectations • German May labour market report, France & Italy final Q1 GDP estimate.
	• CPI inflation (April) rose to 3.5% from 2.6%, in part on expt'd utility and admin changes, in part due to seasonal volatility • Public sector borrowing (Apr) rose £20.2bn vs £18bn expected. • PMIs (Apr, p) mfg edged lower, svcs rise to 50.2 • GfK cons. conf. (May) small rise to -20, still weak • Retail sales (Apr) +1.3%mom on weather/Easter	• BRC shop price index (May) will guide expectations of CPI softening next month • Lloyds business barometer (May) signs of business softening after firmer Q1
	• Trade (Apr) exports soften post tariff rise, but imports fell by less than expected. • Machinery orders (Mar) +13%mom. • PMIs (May, p) mfg stable at 49.0, svcs fall to 50.8 from 52.4 • CPI inflation (Apr) headline stable at 3.6%, core, core edges higher to 3.0% highest since Feb 24	• Tokyo CPI inflation (May) give forward looking guide to national inflation • Industrial production (Apr, p) expected drop after tariff increases • Retail sales (Apr) partial rebound expected after sharp 1.2% drop in Mar • Unemployment (Apr) expected steady at 2.5%
	• Retail sales slowed to 5.1%yoy in April from 5.9%; investment dropped to 3.5% from 4.3%; industrial output down to 6.1% from 7.7% • House price improved to -4%yoy from -4.5% • LPR 1Y and 5Y down by 10bps to 3% and 3.5%, following the policy rate cut	• Industrial profit for April will show tariff impact • NBS mfg PMI and non-mfg PMI (May) to see sentiment improvement after China-US preliminary trade deal
	• CB: Indonesia (25bp cut to 5.5%) • GDP (Q1 yoy): Chile (2.3%), Thailand (3.1%), Singapore (3.9%), Peru (4.7%) • CPI (Apr yoy): Singapore (0.9%), Malaysia (1.4%) • Industrial production (Apr yoy): Taiwan (22.3%)	• CB: Hungary (on hold 6.5%), South Korea (25bp cut to 2.5%) • GDP (Q1): Brazil, Czech Republic, India, Turkey • Industrial production (Apr): India, Singapore, South Korea, Thailand

Upcoming events	US:	Tue: Durable goods orders (Apr, p), S&P House Price Index (Mar), FHFA house price index (Mar), Conference Board consumer confidence (May); Wed: FOMC meeting minutes; Thu: GDP (2nd estimate) (Q1), PCE price index (2nd estimate) (Q1), Core PCE price index (2nd estimate) (Q1), Initial jobless claims (w/e 24 May), Pending home sales (Apr); Fri: PCE price index (Apr), Personal income & Spending (Apr), Goods trade balance (Apr, p), Michigan consumer sentiment & inflation expectations (May)
	Euro Area:	Tue: Fr Industrial confidence (May); Wed: ECB consumer inflation expectations (Apr), Fr GDP (Q1), Ge Unemp (May); Thu: IT ISTAT business confidence (May); Fri: EZ M3 money supply (Apr), EZ, It, Ge HICP (May, p), Sp HICP (May, p) It GDP (Q1)
	UK	Tue: BRC shop price index (May)
	Japan:	Fri: Unemployment (Apr), Industrial production (Apr, p)
	China:	Sat: Official mfg PMI (May), Official non-mfg PMI (May)

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

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