Mature Economies

Quarterly Cyclical Outlook

Quarterly – 2024Q3

Document completed on August 7th, 2024.

Table of Contents

Overall assessment 5

United States 9

Eurozone 15

United Kingdom 19

Japan 23

Overall assessment

Preliminary remarks on our interpretation of the August sell-off and its implications for the 2024H2-2025 scenario

The financial shock observed since the almost simultaneous increase in Japanese policy rates and lower-than-expected job creation in the US has suddenly raised prospects of a potential recession in the US and further financial meltdown related to the global unwinding of so-called Yen carry-trade. In parallel, US bond yields have tumbled, validating both a recession scenario and much larger cuts in Fed Fund rates in the very short term.

We believe that stock market adjustments are likely to continue and financial volatility to remain high, as our scenarios were already suggesting. However, the financial adjustment occurs in a context that so far precludes a severe adjustment in US and worldwide economic activity: it includes supportive disinflation, a pick-up in international trade despite protectionist measures, persistent public support to investment, and labor markets that are becoming softer but still much too robust to announce a recession.

Our persistent "macro soft-landing" scenario, in a financial context where uncertainty remains high and where herd behavior and sudden reversals become the norm, reinforces the need for (1) establishing clear long-term central and alternative scenarios, and (2) enhancing capabilities for corporate and investment flexibility (priorities by countries or asset classes, sectoral rotation, …).

G4 convergence of growth and inflation rates despite divergent cyclical dynamics

Our tools and analyses confirm a key point of our previous quarterly scenario, i.e., a progressive convergence among G4 (US, Eurozone, UK and Japan) for both GDP growth and inflation rates, as post-Covid transition factors have now broadly dissipated. Average GDP growth for G4 is estimated at 1.5% in both 2024 and 2025, with best/worst performances among countries shrinking to 1.6 / 1.2 in 2025 against 2.5 / 0.1 in 2023; similarly, average CPI inflation rate is projected at 2.7% in 2024 and 2.3% in 2025, with best/worst performances of 2.5 / 1.9 compared to 7.4 / 3.3 in 2023.

This convergence reflects however different cyclical dynamics and current position, with the US facing a soft landing while Eurozone, UK and Japan registering getting into a modest acceleration phase.

- In 2025, the US economy is projected to grow by 1.6% (from 2.5% in 2024), driven by softer private sector activity, cautious consumer spending as lower inflation is associated with higher real interest rates and a softening labor market. Inflation should ease to about 2.5% by end-2025, supported by weaker consumer spending and moderating wage growth. We continue to argue that the Fed will implement a gradual though resolute monetary easing, with two 25bp cuts in 2024 and an additional 100-150bp in 2025, responding to easing inflation and labor market conditions. Despite the recent market sell-off and associated worries, our complex modeling techniques continue to tell us that a much larger deterioration in labor conditions are required for a recession to be penciled-in (with a "threshold" computed at 75,000 job *destruction* per month, to be compared with the August 2 "panic trigger" of 115,000 *creation* of new jobs).

- The EUZ's growth is expected to accelerate to 1.4% in 2025 (from 0.8% in 2024), driven by higher real incomes, increased consumption, and stronger investment. Regional performance will vary, with Southeastern Europe seeing the highest growth due to robust wage increases and tourism, while Northern Europe benefits from trade recovery. Services inflation remains high but is likely to ease with slowing wage growth. The ECB is projected to cut rates further in late 2024, with a potential pause by mid- 2025 after another 100bp reduction.
- The UK economy is projected to grow by 1.3% in 2025 (from 0.8% in 2024), driven by increased household spending power from lower inflation. This boost will enhance consumer confidence and spending. However, past monetary tightening and ongoing fiscal constraints will moderate the recovery pace. The Bank of England is expected to cut rates by 100bp in 2025, following two 25bp cut in 2024.
- Japan's real GDP is expected to grow by 1.2% in 2025 (from 0.2% in 2024), supported by a rebound in automotive production and ongoing tourism. While improved real incomes from higher wages and easing inflation will boost consumer spending, limited global demand will restrain overall growth. Inflation is projected to decline to 1.9%, influenced by strong wage negotiations and rising electricity costs. The Bank of Japan may pursue its rate hike later due to persistent yen weakness pass through on inflation up to 1% Bank Rate.

The convergence in inflation rates has brought core and headlines metrics much closer to central banks' targets, though they have remained (and will remain, in our central scenario) above such targets. While the dynamics in goods prices have reverted to pre-COVID negative y/y figures, the disinflationary base-effect for commodity prices and impact on energy / food components has dissipated and is expected to turn modestly upward in 2024H2 and early 2025. In parallel, easing labor cost pressures and a progressive-only exit from monetary tightness will limit firms' ability to pass-on cost increases to consumer prices. In the US, where rent constitutes a significant share of service prices (59%), their monthly deceleration is a clear positive signal for further disinflation. Our models project headline inflation to be at 2.5%y/y in the US, 2.3% in the UK and the EUZ, 1.9% in Japan by the end of 2025: performances would be closer but not yet at or below central banks' targets, with risks tilted to the upside, as the broader context includes potential rebounds in demand and ongoing uncertainties related to supply chains, tariffs, and commodity prices.

A potential upward risk for inflation with a new Trump presidency, bringing a more disruptive 2025 scenario.

The outcome of the upcoming US election is poised to significantly shape the macro perspectives and the monetary policy landscape. it will be not only the winning candidate but also the composition of Congress that will determine the future macro perspectives. The implementation of former President Trump's agenda, should he be elected with a Congressional majority, would differ significantly from that of Vice President Harris.

Should D. Trump secure a victory with a Republican majority in both Senate and House of Representatives, specifically designed quantitative models highlight that inflation would accelerate rapidly due to tariffs and migration controls. Assuming a still-independent Fed, monetary policy would become much more cautious in 2025, with potential spillover effects on other central banks. If the Fed were to respond according to "traditional" rules, a monetary tightening of approximately 100bp would be needed. In the medium term, as financial conditions tighten and concerns about fiscal stability

escalate, a larger shock on US economic growth would emerge (by 2026-2027, beyond our current scenario exercise), then prompting a reversal to rate cuts by the Fed.

On the other hand, the election of K. Harris associated with a split Congress would lead to a scenario close to our central case. Harris' fiscal policies (higher corporate taxes, ending of tax rebates for households) would create a moderate headwind to growth, to which the Fed would likely respond with quicker / larger monetary easing.

Need and difficulty of enhancing credibility of monetary policies

Restrictive monetary policies in G4 that started in-between end-2022 and mid-2023 have driven a gradual slowdown in global growth and declining inflation. Central banks in major economies have now to find the right balance between the opposite risks of plausible inflation stickiness and reversal before reaching official targets, and excessive / too-long monetary restriction leading to recessionary forces being set in motion.

Given the prevailing elevated levels of uncertainty and ongoing price pressures, particularly in domestic inflation, services inflation, and wage growth, central banks will continue with a policy stance that remains restrictive despite a persistent easing process. This approach means cutting policy rates (with a plausible combination of larger rate cuts / slowing the quantitative tightening / reduction in central banks' balance sheets) while keeping them above the inflation rate. The aim is to ensure that inflation performances do not revert too soon to acceleration while having started the policy easing; it is also required to keep central banks' credibility as intact as possible in a context of longer-term uncertainties. Central banks will keep a careful, data-dependent approach to determine the schedule and scope of monetary easing, though they are ready to revert to liquidity provision and / or market interventions if financial stability or banking systems were suddenly closer to systemic risk materialization.

This suggests that central banks will likely adjust their policies to transition from over-restrictive to neutral levels. Our augmented Taylor Rule suggests Fed Funds rate at 4% by mid-2025, ECB Deposit Rate at 2.5%, BoE Bank Rate at 3.5%, BoJ at 1.0% before entering a phase of stabilization. This phase of stabilization should be considered a pause in the conduct of monetary policy, dependent on future inflation trajectories.

Our models for 10-year bond yields suggest a time-sequence for 2024 and 2025: (1) an initial downward trend on long rates up to the moment when central bank easing expectations are fully anticipated and anchored, excepted for Japan where the BoJ repricing of liquidity forces an upward movement for JGB yields, towards 1.5%. Elsewhere in mature economies, our models point to neutral-range levels for 10-year sovereigns around 3.75% in the US, 2.25% in Germany and 3.75% in the UK, for most of 2024H2 and early 2025. As evidenced by the market turbulences of early August, this phase is likely to be accompanied by bouts of higher market volatility, as the macro-transition to slowing macroeconomic performances and inertia in service inflation comes along with policy questions and political / geopolitical uncertainties. (2) During 2025, a form of equilibrium in bond yields is expected to emerge, a result of an unstable balance between, on one side, a continuous (though limited) disinflationary trend and associated cuts in policy rates, and, on the other side, progressively rising prospects of cyclical recovery and higher medium-term price pressures (including potential increase in tariffs, geopolitically-driven trade fragmentation), issues about central banks' credibility (with inflation not back to below targets despite the cyclical trough), and fiscal considerations. and expected macro recovery. The equilibrium point

suggested by our quantitative tools are around 25bp higher than the neutral levels computed for 2024H2.

Central scenario of economic convergence subjected to substantial risks

Overall, our 2024-2025 macro scenario point to a volatile late-cycle phase with lower inflation momentum and upcoming policy easing. This scenario, by construction, cannot take into consideration the (plausible) materialization of sudden shocks, whether they are caused (1) by a deep misunderstanding between policy makers (monetary, but also fiscal) and market participants with very large swings in markets' valuation and reemergence of systemic risks in financial institutions, or (2) by political factors (US elections, European uncertainties), or (3) by geopolitical crises (extension of conflict in the Middle East with a massive spike in energy prices, a Chinese blockade of Taiwan creating huge havoc in supply chains, expansion of Russia's destabilizing policy vis-à- vis Europe), or (4) by climate-related disasters (with implication on both food prices, trade and fiscal spending). Each of these different EBUs (Expected But Unpredictable events), except the first one (financial meltdown and systemic risks) would have a substantial dual effect of cutting rapidly economic growth and pushing up inflationary pressures, hence with increase conflicts of objectives for policy makers).

The key strategic challenge for industrial companies as well as financial investors is therefore to prepare for such EBUs (alternative scenario construction, stress-tests…) in order to make the corporation more agile in fast-response capabilities, while using the central scenario as a sort of anchor for medium-term decisions and enhancing timing / early-warning tools.

Exhibit 1 – Real GDP growth forecasts (Avg y/y, in %)

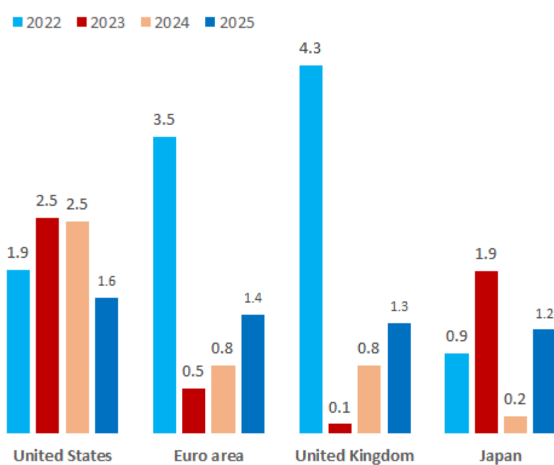
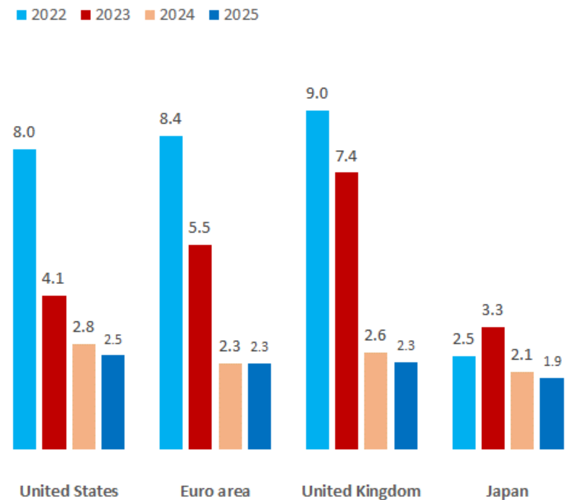


Exhibit 2 – Headline inflation forecasts (Avg y/y, in %)



Source: TAC ECONOMICS Datalab

Japan

- An economic recovery supported by domestic demand is expected for both 2024 and 2025.
- A disinflation is underway with an underlying question regarding whether wage hikes will broaden and drive-up prices in the services sector.
- Our interest rate scenario continues to indicate further rate hikes, but to a limited extent contingent upon the domestic demand's ability to support activity momentum.

Exhibit 27

Japan economic outlook

	24Q1	24Q2	24Q3f	24Q4f	25Q1f	25Q2f	25Q3f	25Q4f	**2023**	**2024**	**2025**
Real GDP (y/y, %)	-0.8	0.6	0.8	1.1	1.7	1.3	1.0	0.9	**1.9**	**0.2**	**1.2**
Real GDP (q/q, %)	-0.5	0.8	0.6	0.4	-0.1	0.4	0.3	0.3			
CPI inflation (y/y, %)	2.6	2.6	2.7	2.4	2.4	2.1	1.8	1.7	**3.3**	**2.6**	**2.2**
Bank rate (eop*, %)	-0.1	0.0	0.25	0.5	0.75	1.0	1.0	1.0	**-0.1**	**0.5**	**1.0**
10-year gov. bond (%)	0.8	0.9	1.1	1.2	1.4	1.5	1.6	1.7	**0.6**	**1.0**	**1.5**

Source: TAC ECONOMICS / *eop=end of period

Expected GDP growth resurgence supported by higher consumer spendings.

Japan's GDP contracted by -0.5% in Q1 2024 compared to the previous quarter (-0.8% year-on-year), related to weaker private consumption (-0.7% q/q), which has decreased for the fourth consecutive quarter, impacted by inflation. Foreign trade also negatively impacted growth by 0.3 pp. In June 2024, real household consumption and real wages both remained in contraction, decreasing by -0.7% and -1.4% y/y, respectively. This ongoing contraction is influenced by persistent inflation while the pass-through of wage increases negotiated during the Shunto 2024 to private consumption has been slower than expected, partly due to weakened consumer sentiment from Q1 2024's economic downturn and heightened inflation expectations (88% of households anticipate rising inflation over the next 12 months).

However, retail sales showed growth (+3.0% y/y and 1.7% m/m in May), suggesting some resilience. Additionally, the BoJ's survey of small and medium-sized enterprises (SMEs) indicates that labor shortages are seen as persistent, with businesses acknowledging the need for continued wage increases. SMEs typically experience slower wage growth compared to larger firms. The conditions for establishing a virtuous cycle of wages and prices are expected to develop over the year.

Despite the competitive advantage from the past yen's depreciation, Japan's manufacturing PMI has remained weak in recent months, reflecting sensitivity to export markets. The July Manufacturing PMI fell from 50.0 in June to 49.1, with both new orders and export business contracted (in decline since 14 and 29 months, respectively). Weaker domestic and international demand led to reduced output levels, though the overall decrease in production was slight. Industrial production fell -3.6% m/m in June, affected by specific disruptions caused by auto safety scandals. The auto industry experienced a notable drop in output, with car production falling -

4.8% after rising for three months. Other major industries, including machinery and petrochemicals, also reported declines.

The logic behind our GDP growth projections assumes faster wage growth able to boost consumer spending and help counteract weak external demand. Improved consumer sentiment might trigger a positive cycle, supporting the central bank's policy adjustments. Loose monetary policy and rising wages are expected to drive consumer spending and overall economic activity. While the yen may strengthen later in the year, it is unlikely to return to pre-pandemic levels, mitigating potential headwinds in international trade. Therefore, our growth projections suggest a rebound in growth from 0.2% in 2024 to 1.2% in 2025.

Towards confirmation of the wage price loop

Headline CPI inflation remained steady at 2.8% y/y in June (+0.1% m/m). Core inflation (i.e., excluding fresh food, closely monitored by the BoJ) accelerated to 2.6% y/y in June from 2.5% in May and 2.2% in April. The most notable increase was in utilities, which rose by 7.5% following the end of an energy subsidy program. On a monthly basis, core inflation increased by 0.3% m/m in June, down from 0.5% in May, with goods prices rising by 0.4% and services by 0.2%. The weakened yen is contributing to supply-side pressures, while strong wage growth is driving demand-side pressures. The government plans to reinstate energy subsidies from August to October to mitigate the effects of the summer heatwave. While this may temporarily ease overall inflation, it is unlikely to significantly influence the BoJ’s policy in the near term.

There is no excessive concern about the moderation in inflation, given that both headline and core figures remain well above the BoJ’s 2% target, combined with the likelihood of sustained core prices linked to higher wages, higher commodity prices pushing up both headline and core inflation.

A shift in the BoJ's focus from economic activity to inflation

The BoJ surprised by unexpectedly raising interest rates by 15bp in its July meeting, surpassing both market expectations and our own projections. The BoJ's emphasis on the need to address the rebound in import prices highlighted its intention to support the currency, recognizing that direct interventions alone are insufficient without corresponding adjustments in monetary policy. The BoJ conveyed its commitment to continuing the normalization process, indicating the necessity of further reducing monetary accommodation while downplaying the impact on the real economy by noting that real interest rates remain negative.

The BoJ’s monetary policy meeting also includes decision toward a gradual reduction in bond purchases, decreasing from ¥5.7 trillion currently to ¥4.9 trillion by the end of this year and further to ¥2.9 trillion by the end of 2025. This approach appears designed to manage market reactions cautiously. However, the combination of this unexpected adjustment by the BoJ, along with a stream of below-expectation indicators in the US, triggered a sell-off.

The BoJ’s recent communication suggests a shift towards a more rapid adjustment than previously anticipated. While our initial view was that the BoJ might take a gradual tightening approach given the subdued economic outlook, recent communications point to a faster pace of adjustment. This aligns with models forecasting a terminal refi rate around 1%, implying several incremental hikes of 25bp. Consequently, the projections for 10-year Japanese government bond yields have been revised upward, with expectations now set for a gradual increase towards 1.5 in 2025.

Key Japan data charts

Exhibit 28 - Japan GDP Growth Projections (Q/Q, in %)

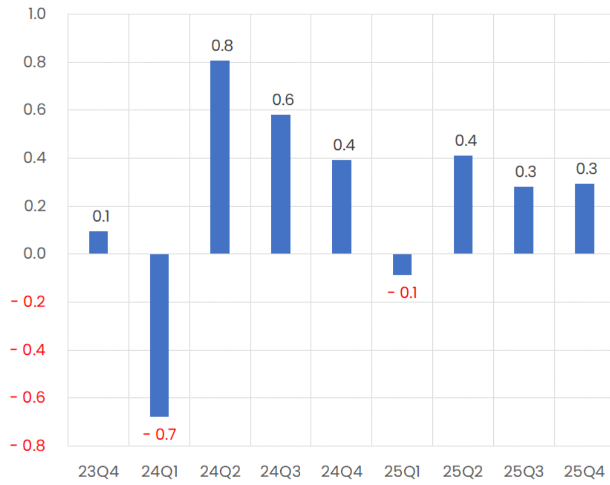


Exhibit 29 – Japan headline infl. projections (Y/Y, in %)

Exhibit 30 – BoJ monetary policy reaction function (in %)

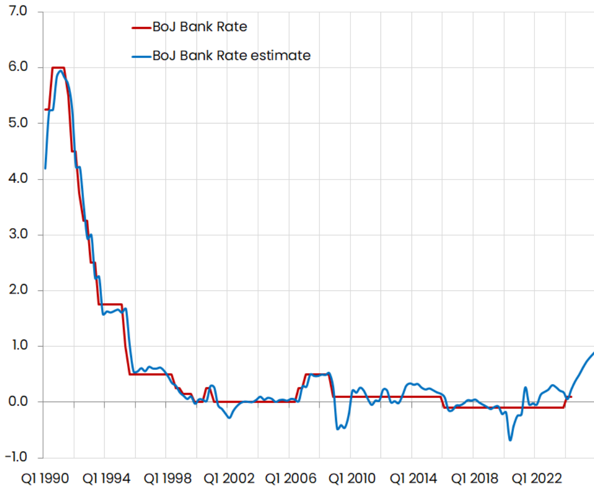
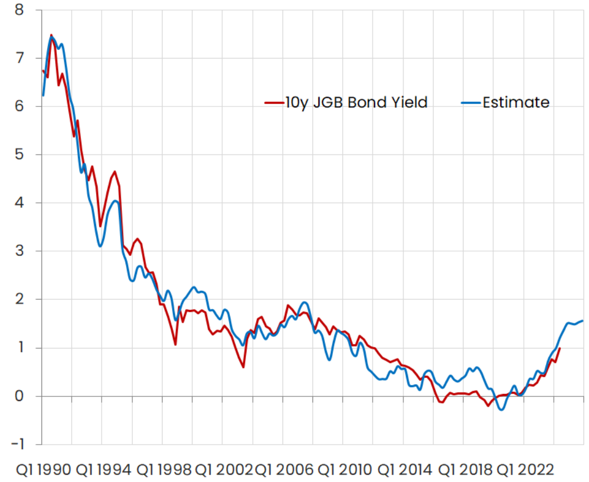


Exhibit 31 – Japan 10-year bond yield projections (in %)



Sources: Datastream, TAC ECONOMICS

Exhibit 32 – Quarterly economic data

	2022Q3	2022Q4	2023Q1	2023Q2	2023Q3	2023Q4	2024Q1
GDP (y/y, %)	1.6	0.8	2.5	2.3	1.4	1.1	-0.8
Household Consumption Expenditure (y/y, %)	3.9	1.0	3.0	0.2	-0.1	-0.6	-2.1
GFCF (y/y, %)	0.9	0.5	3.5	2.4	0.2	1.4	-1.8
Government Consumption Expenditure (y/y, %)	0.4	2.1	1.6	0.4	0.4	-0.3	-0.2
Change in inventories (% GDP)	0.5	0.6	0.6	0.9	0.1	0.0	0.1
Goods & Services Balance (% GDP)	-5.2	-4.0	-3.4	-1.1	-0.9	-0.6	-1.1
Exports of Goods & Services (y/y, %)	6.1	7.7	2.1	3.7	2.3	4.4	1.5
Imports of Goods & Services (y/y, %)	10.8	9.9	3.7	-1.4	-5.0	-2.4	-4.3

Source: Cabinet Office Japan

Exhibit 33 – Monthly data

	2023M12	2024M01	2024M02	2024M03	2024M04	2024M05	2024M06
Industrial Production (y/y, %)	0.1	-3.1	-6.8	-3.1	-4.2	0.3	--
Consumer Prices (y/y, %)	2.6	2.1	2.8	2.7	2.5	2.8	2.8
Producer Prices* (y/y, %)	0.3	0.3	0.7	0.9	1.2	2.6	2.9
Interest Rate - ST (3 months, %)	0.7	0.6	0.7	0.7	0.8	1.0	1.0
Interest Rate - LT (10 years, %)	0.1	0.1	0.1	0.2	0.3	0.3	0.3
M4 (y/y, %)	2.3	2.5	2.4	2.5	2.2	1.9	1.5

* PPI for manufactured goods

Source: Bank of Japan, Statistics Bureau

Exhibit 34 – Survey data

	2024M01	2024M02	2024M03	2024M04	2024M05	2024M06	2024M07
Consumer Confidence Index	38.1	39.0	39.5	38.3	36.2	36.4	--
Industrial Conf. (Nikkei PMI Manuf.)	48.0	47.2	48.2	49.6	50.4	50.0	49.2
Industrial Confidence (Reuters Tankan)	6.0	-1.0	10.0	9.0	9.0	6.0	11.0

Source: Statistics Bureau

Disclaimer

These assessments are, as always, subject to the disclaimer provided below.

This material is published by TAC ECONOMICS SAS for information purposes only and should not be regarded as providing any specific advice. Recipients should make their own independent evaluation of this information and no action should be taken, solely relying on it. This material should not be reproduced or disclosed without our consent. It is not intended for distribution in any jurisdiction in which this would be prohibited. Whilst this information is believed to be reliable, it has not been independently verified by TAC ECONOMICS and TAC ECONOMICS makes no representation or warranty (express or implied) of any kind, as regards the accuracy or completeness of this information, nor does it accept any responsibility or liability for any loss or damage arising in any way from any use made of or reliance placed on, this information. Unless otherwise stated, any views, forecasts, or estimates are solely those of TAC ECONOMICS, as of this date and are subject to change without notice.

Your contacts at TAC ECONOMICS

Technical questions / hotline

TAC ECONOMICS team is available for any economic, financial, technical questions and requests at the following e-mail address: hotline@taceconomics.com

Customer relation

For any question relative to your subscription, please contact us by e-mail at taceconomics@taceconomics.com

Tel +33 (0)299 39 31 40

Web: http://www.taceconomics.com