Independence Wars Ahead?

- Good news on the US inflation side – and more signs the real economy may get softer.
- Odds that the Fed will be able to cut this year are rising again – but we explore how a conflict could brew between the next US administration and the central bank. The Fed's independence is less solidly protected than the ECB's.

In the US, core consumer prices have resumed their deceleration in April in year-on-year terms. Slower rents have helped, but even when controlling for this – and the pesky car insurance prices – the short-term momentum has flattened, in contrast with almost systematic re-acceleration since the second half of last year. It is only one monthly print though, and we need to be prudent. Yet, it is tempting to read this piece of good news on the inflation side in the context of a softer dataflow in the real economy. A disappointing number for retail sales out last week, together with the deterioration in consumer confidence, point to a more hesitant household sector.

In principle, this should trigger a divergence in the market reaction across asset classes, pushing the price of risk-free assets up, as the odds of Fed cuts are rising, but also weighing on the price of equity and credit as the economy would become less supportive. Such divergence did not materialise last week. It seems the market is pinning their hopes on a goldilocks scenario in which the Fed's loosening – and general improvement in financial conditions – would keep the real economy robust enough to minimise any significant deceleration in profits and deterioration in credit quality. The fact that no fiscal austerity is looming in the US also helps.

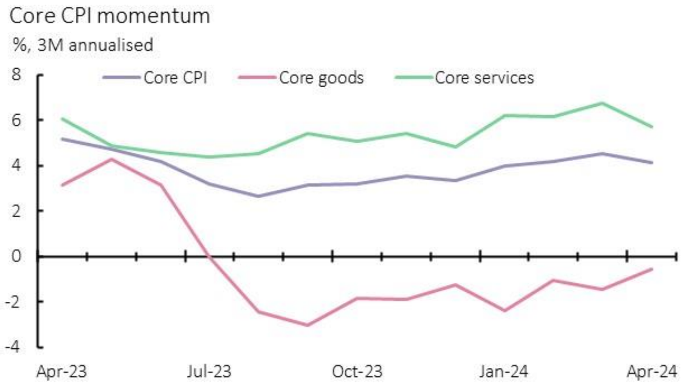
Still, we want to explore the possibility that, especially under a potential second term for Donald Trump, a conflict arises between a Fed opting for a very prudent removal of the restrictive stance and a US administration ready to provide even more fiscal support next year. This is not a theoretical concern. Trump was explicitly critical of Jay Powell during his first term, at least until the pandemic, and last week a former President of the New York Fed published an OpEd on the possibility to see the administration exert pressure on the central bank. The legislative process through which the Fed's status could be reformed would probably be cumbersome, but the institutional set-up of the Fed is quirky, and its independence is less solidly guaranteed than the ECB's.

A step in the right direction

The market has been hoping for a "smoking gun" in the dataflow which would allow the Federal Reserve (Fed) to start cutting rates. Last week did not bring such breakthrough, but still a step was made in the right direction. The core Consumer Price Index (CPI) came out in April in line with market expectations and decelerated in year-on-year terms (3.6% against 3.8% in March), resuming the slowdown which had come to a halt in February, and back to the lowest reading since April 2021.

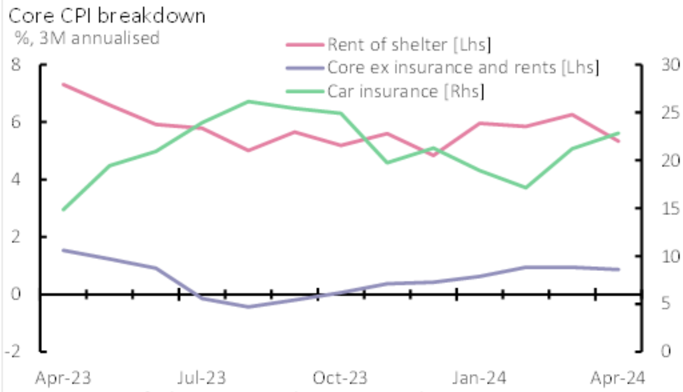
As usual, we want to vary the angle and get a sense of the recent momentum by looking at the 3-month annualised growth rate of core prices. What is reassuring is that, while core goods prices are no longer significantly falling – such stabilisation had been expected by the Fed – services prices decelerated enough to bring the overall core CPI momentum slightly down (see Exhibit 1). A slowdown in rents (a long-awaited development) was one of the factors behind this improvement, but this was to some extent offset by a further acceleration in car insurance prices – a component which idiosyncratic behaviour we had highlighted recently. Still, even when excluding these two "usual culprits", the 3-month annualised change in core inflation has flattened to a very weak 0.9% in April, the same pace as in March, breaking with the re-acceleration seen since the second half of 2023 (see Exhibit 2). This is reassuring: the good CPI outcome for April was broad-based.

Exhibit 1 – Services lead the April improvement



Source: Bureau of Labor Statistics and AXA IM Research, May 2024

Exhibit 2 – Removing the "usual culprits"



Source: Bureau of Labor Statistics and AXA IM Research, May 2024

Now, it would of course be wrong to shed all the concerns about the pace of inflation landing in the US just because we have just had a piece of good news on a single month. There was already a pause in the re-acceleration in core CPI in December which proved short-lived. Yet, **it is tempting to read the improved CPI reading in April in the context of an accumulation of signals of a general softening in the US real economy.**

We have already commented in Macrocast the latest disappointing prints for the ISM survey in both manufacturing and services, but last week also brought a significantly below-expectation retail sale number. The "control group" – the retail sales version which is closest to the aggregate personal consumption concept of the national accounts – declined in April by 0.1% against a consensus expectation of +0.2%. This seems to confirm the growing uneasiness of households reflected in the very weak reading in consumer confidence released on 10 May. **Even residential investment – a counter-intuitively powerful element of support to the broader US economy of late – is showing signs of weakness**. Building permits fell 3% on the month in April after already shedding 5% in March, and housebuilder confidence declined in May for the first time in 6 months. So far, the lack of turnover on the existing houses market, as households are reluctant to lose the benefit of low-interest rate mortgages contracted several years ago, has been driving those forced to move to the new-build market, but even on this segment mortgage rates above 7% may have finally taken their toll. The new and existing home sales data for April to be released this week will give us a fuller sense of the situation in this sector.

This gets us to the market reaction to the better news on inflation. We have been repeating for months that we did not believe in a completely pain-free resumption of disinflation. As we explained last week, it may not take that much of a deterioration of the labour market (something like the 2001 episode) to get inflation back to target, but it would still be incompatible, in our view, with GDP growth maintaining a pace above or near its potential pace. **This should in principle lead to divergent reactions across risk-free and risky assets.** The decline in long-term treasury yields makes complete sense, given the rising probability of Fed cuts, but the further positivity on the equity market is more questionable. In a nutshell, the positive effect of the reduction in the discount rate on equity valuations should be at least partly offset by the contraction in expected profit margins and rising delinquency which should normally accompany GDP growth moving below potential.

It seems the market is pinning their hopes on a goldilocks scenario in which the Fed's loosening – and general improvement in financial conditions – would keep the real economy robust enough to minimise any significant deceleration in profits. The fiscal stance is another term of importance in the US economy current equation. A key difference between Europe and the US is that in the latter there is no austerity turn looming. Quite the opposite, another helping of fiscal candy could be a result of the coming presidential elections. In a nutshell, the only two outcomes realistically on the table, at least for 2025 – there may be a day of reckoning later during the next presidential mandate – are either a broadly stable stance under Biden, with the continuation of the subsidies from the Inflation Reduction Act, or another push under Trump with the prolongation of the Tax Cuts and Jobs Act.

Goldilocks scenarios are always fragile by nature, as they hinge on the optimal balance of various forces which have no reason to be closely coordinated. While we are confident the Fed will start cutting before the US elections – September is our baseline – **we are concerned about a potential conflict between the central bank and the US government, the latter pushing for a quick downscaling of policy rates, the former becoming even more reluctant to engage in an accelerated removal of restriction if the US economy is faced with an inflationary combination of higher trade tariffs and "larger for longer" fiscal deficit**s. The relationship between Donald Trump and the Fed had soured in 2018. The brewing conflict disappeared from the radar as the pandemic struck, but we see some ingredients for a re-match if the Republican candidate wins next November.

How solid is the Fed's independence?

For all the accusations of dogmatism which have been hurled at them since their general re-conversion to monetary orthodoxy in the early 1980s, **central banks have been crucial in ensuring the very survival of the western economies since the beginning of the century**, first to mop up the consequences of the Great Financial Crisis of 2008, and then during the pandemic. Arguably, their recourse to unconventional tools also allowed the near-deflation phase of the mid 2010s not to turn into a protracted global recession. Now that they have returned to their default mode to fight inflation head-on – even if they might have been initially slow to spot the issue – central banks should be basking in popular gratitude. This is however not what surveys suggest, at least in the US.

Gallup has been polling the American public on their support for the Fed Chair since the early 2000s. What we find paradoxical is that Alan Greenspan, who bears in our view a strong responsibility in the build-up of the imbalances which led to the 2008 crisis, remains the most popular Chair. Bernanke, who can be credited for saving the US economy's bacon at a particularly grim time, never saw a majority of the respondents declare they had trust in him. Closer to us, **Powell was lauded at the height of the Fed's action to mitigate the macro-financial impact of the pandemic, but he fell below 50% of approval quite quickly as the inflation shock emerged and he did not benefit – quite the opposite – from the Fed's shift to restriction afterwards** (see Exhibit 3). Jay Powell's popularity is squeezed by the twin effect of persistent inflation – the surveys suggest that the price level remains a key driver of the ongoing deterioration in consumer confidence – and the decline in mortgage affordability in the context of the Fed's restrictive stance. In last available survey, conducted in April 2024, Powell's ratings rebounded slightly from 2023, but he remains at the lows hit by Bernanke and Yellen before him.

Exhibit 3 – Powell is unpopular

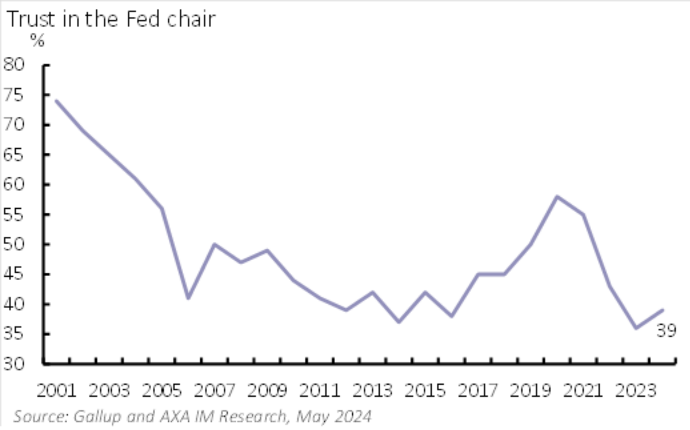
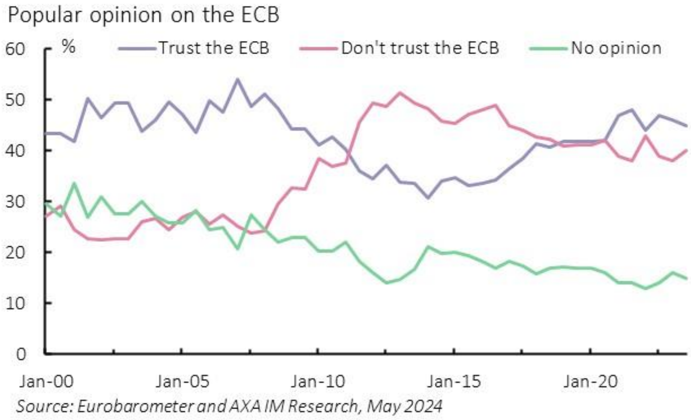


Exhibit 4 – The ECB now in a better position



The European Central Bank (ECB) finds itself in a better position (see Exhibit 4). The question is less personalised than for the Fed (it's about trust in the institution, not in the Chair) and unsurprisingly, the proportion of "don't knows" was massive at the time of its inception in 1999. Opinions became much more polarised after the sovereign crisis which followed the Great Financial Crisis of 2008 – the proportion of "don't knows" fell abruptly, and those distrusting the ECB were the clear majority. Yet, after several years of divorce with public opinion, the ECB has regained almost all the lost ground, and the inflation shock and the restrictive shift did not visibly affect trust in the European Central Bank, at least by the second half of 2023 which is the latest data point we have.

The Fed has a "popularity issue" at a time when the jury's still out on its capacity to bring inflation back to target this year. Central bankers are not there to be popular and arguably, too strong popularity could even be a bad thing for them, for instance if it reflected a tendency to "please the crowds" by running on overly accommodative policy. There is a reason why central bankers are not elected officials**. Low popularity can still be an issue though if the central bank is about to embark into one of the confrontations with the federal government which have peppered the life of the institution since its inception in 1913**. The Fed may be the most important central bank in the world, but its legal status and independence is far from being the most solid. If public opinion has a poor opinion of the Fed, Congress may be quickly sympathetic to a push by the US President to curtail the independence of the Fed or at least to help him populate the board with people who would be inclined to make sure monetary policy supports the administration's overall targets.

For those who think your humble servant is engaging here in particularly hairy political fiction, a cursory look at the debates around whether the President had the authority to remove Jay Powell in 2018 should act as a reality check. Bill Dudley, a former President of the New York Fed, feels sufficiently worried about such prospect that he made it the heart of his OpEd on Bloomberg last week.

The institutional arrangement governing appointments at the Federal Reserve dates back to the 1930s. For those who relish getting into the US legal nitty-gritty, we advise to take a look at this piece from the Brookings (link here) but we provide here a quick overview. In a nutshell, the President of the United States (POTUS) chooses the chair of the Federal Reserve among the governors of the board. By law, POTUS can also fire that person from the chairmanship, but only "for cause", and most scholars opine that a policy disagreement would not qualify as such. But POTUS could probably <u>not</u> fire him or her from the board of seven governors who are also appointed by POTUS but with a very long mandate of 14 years. Those governors, together with the President of the New York Fed and a rotating subset of Presidents of the regional Feds, form the key Federal Open Market Committee (FOMC) which determines monetary policy. An interesting institutional quirk is that it is only by convention that the Chair of the Fed board is also the Chair of the FOMC. Technically, any member of the committee can be chosen by his or her peers as Chair. **An outcome openly discussed in 2018 was that Powell could continue to steer the FOMC even after being demoted by Trump.**

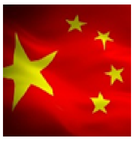
While the political leaning of the regional Presidents is not always clear, within the board Democrat-leaning appointees are currently in a slight majority (4 out of 7) and none of them is facing imminent mandate expiry (the earliest due for renewal is in January 2026). This could result in a – not great – situation where there would be two heads of the Fed: the chairman of the board, chosen by the US President, and the chair of the FOMC, chosen by his or her peers.

Influencing the Fed within the current institutional framework would thus be quite cumbersome – possibly one of the reasons for which Donald Trump did not follow on his hints about firing Jay Powell during his first term. **There are however some proposals for a revamp of the legal framework governing the Fed.** The Manhattan Institute, a conservative Think Tank, released a very precise report on this matter in March (see link here). It revolves around two simple ideas: first, *"shortening board member terms and clarifying that members serve at the will of the U.S. president"* – that would take care of the current potential impasse of removing the Chair of the board without any possibility to remove him or her from the board itself – and second *"heightened presidential control over the board should be balanced by increasing the influence of the Reserve Banks, whose boards of directors should be chosen by state governors in each district"*. Today, the boards of the regional Feds are mostly chosen, through a complex process, by the commercial banks in each district.

We fail to see how the second element could with any level of certainty constrain the power of POTUS. Indeed, this would politicize the selection process within the whole Federal Reserve system even more than today. There is currently a majority of Republicans among state governors. This would allow the Republican party, in case of a presidential victory in November, to effectively control most appointments at such a revamped Fed.

All this would entail an act of Congress, and anyone remotely familiar with the US institutional process would know that **getting a new Fed status through would be immensely complicated**. The Senate Cloture rule, which makes it impossible to pass any significant new legislation on most topics – outside the budget process – without the support of 60 Senators, would be a significant hurdle. Yet, we note that as part of the 2024 campaign, Democrats themselves are calling for a reform of the "rule of 60" for key issues such as reproductive rights. This sheds light on the technical fact that it would not take much – actually a single vote in the Senate at a simple majority – to change this supermajority rule, through a process known as "reform by ruling". It is indeed possible to end "supermajority" with a simple majority vote (more details on this for the legally-minded here) and this would be open to the Republicans should they secure a majority in the Senate after November, which is the most plausible outcome at this stage given the message from the polls (even though incumbent Democratic Senators seem to be more resilient than Joe Biden in the current surveys). There would be something quite paradoxical in the White House gaining control over the Fed to push for a monetary accommodation of tax profligacy when the conservative call for a reform of the central bank ultimately reflects a fundamental disagreement with what they see as a phase of over-dovishness by the Fed (this is the line of the Manhattan Institute). Yet, the general discontent in the Republican party around unconventional monetary policy tools, often referred to as "currency debasement" would offer strong political leverage for a Donald Trump 2.0 Presidency to set the process in motion should he choose to.

Still, beyond these technicalities and the state of opinion within the public at large and the Republican party, the political cost of abolishing the Cloture rule is not trivial. "Reform by ruling" is commonly referred to as the "nuclear option". Republicans would have to ponder what the removal of the supermajority rule would offer them against the risk it would create for the survival of existing legislations which are important to them the day a Democratic majority returns. Ultimately, we think **all this would depend on a cost/benefit analysis for the Republicans should Trump win in November: the significant political capital to spend on a Fed reform would be weighed against the cost of a "reluctant Fed" refusing to accommodate a profligate fiscal policy**. Before any reform starts being wheeled into Congress, rhetorical tension would probably have to rise first between the President and the Fed. This may not be a "day 1" issue. Our point though is that **the guarantees of the Federal Reserve Independence are much weaker than those the European Central Bank can count on**. Indeed, as the independence principle is enshrined in the EU Treaty, which is extraordinarily difficult to reform, it has made its way to the constitutional order of the Euro area member states. Such "elevation" has not been contemplated in the US.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• CPI inflation (Apr) rose by 0.3%mom headline and core, services slowed markedly driven by ex-shelter • PPI inflation (Apr) rose 0.5%mom in headline and core, above f'casts, but mixed in terms of CPI impact • Retail sales (Apr) stagnated in line with our view – weaker than expectation – signs of softening mount • Empire and Philly Fed surveys (May) both fell back	• FOMC minutes (May) watch for divergence from Powell's calm tone and for hints of consumer concern • New and existing home sales (Apr) these markets had diverged, but watch in light of sharp drop in starts • Durable goods orders (Apr, p) monitor ex-transport for signs of ongoing acyclical support • Jobless claims still a touch higher over last 2 weeks
	• Final HICP (Apr) was unchanged at 2.4%yoy, core at 2.7% • EMU employment rose by +0.3%, GDP 2nd estimate confirmed at +0.3%, meaning flat productivity • EMU industrial production (Mar) rose by +0.6%mom after +1% in Feb but distorted by Ir (+12.8%). EMU-4 is negative • ZEW surveys (Ger, May) continues to signal economic recovery going forward	• Flash PMIs for euro area, France and Germany (May). Services to remain in expansion territory while mfg sector should remain weak, well entrenched in contraction • Euro area consumer confidence flash (May) • Business climate (Fr, May) • GDP detailed (Ger, Q1)
	• Labour market data to show the unemployment rate ticked up to 4.3% in Mar. • AWE ex. bonuses held steady at 6.0%, but the private sector AWE ex bonus measure ticked down to 5.9%, from 6.0%	• CPI inflation looks set to fall to 2.1% in Apr, from 3.2% in Mar. • The flash composite PMI likely ticked down to 53.5 in May, from 54.1 in Apr. • Retail sales look set to fall by 0.3%mom in Apr. • GfK cons. conf. likely rose to -17 in May, from -19
	• Broad money supply rose by 2.14T in Apr. • Corporate goods price index rose by 0.9%yoy in Apr., up from 0.8% in Mar. • GDP fell by 2% annualised in Q1, more than the expected 1.5%	• Machinery Orders look set to drop by 2.2% in Mar., following a 7.7% rise in Feb. • Exports likely rose by 11.1%yoy in Apr., up from 7.7% in Mar. • Composite PMI likely rose to 52.5 in May, from 52.3 in Apr.
	• TSF flow (Apr): -200bn RMB, a record low. Outstanding loan grew by 9.6%, same as in March • M2 money supply (Apr): 7.2% (Mar: 8.3%) • Industrial output (Apr): 6.7% (Mar: 4.5%) • Retail sales (Apr): 2.3% (Mar: 3.1%) • FAI (Jan-Apr): 4.2% (Q1: 4.5%)	• 20 May: LPR 1Y and 5Y for May • 27 May: industrial profit for Jan-Apr
	• CB: Romania (7.0%) & Philippines (6.5%) stood on hold • Q1 GDP (%yoy): Colombia (0.7%), Malaysia (4.2%), Poland (1.9%) & Romania (0.5%) • April CPI (%yoy): Czechia (2.9%), India (4.8%) & Romania (5.9%)	• CB: Chile is expected to cut -50bps to 6.0% & Hungary -50bps to 7.25%. Indonesia (6.25%), Korea (3.50%) & Turkey (50%) to stay on hold • April CPI: Malaysia & South Africa

Upcoming events		
	US:	Wed: Existing home sales (Apr), FOMC minutes; Thu: Weekly jobless claims (18 May), Mfg & services PMI (May, p), New home sales (Apr); Fri: Early close for US markets (2pm EDT) for Memorial Day, Durable goods order (Apr, p), Michigan consumer sentiment & inflation expectations (May)
	Euro Area:	Mon: Ge PPI (Apr); Ez, Ge, Fr Mfg & services PMI (May, p), Ez Composite PMI (May, p), Ez Negotiated wage rates (Q1), Ez Consumer confidence (May, p); Fri: Ge GDP (Q1), Fr Insee mfg confidence (May)
	UK:	Tue: CBI Industrial Trends survey (May); Wed: CPI (Apr), CPIH (Apr), RPI (Apr), PPI input & output (Apr), PSNB (Apr); Thu: Mfg, services & composite PMI (May, p); Fri: Gfk consumer confidence (May), Retail sales (Apr)
	Japan:	Wed: Private 'core' machinery orders (Mar), Trade balance (Apr); Fri: CPI (Apr)
	China:	Mon: PBoC Loan Prime rate announcement (1y & 5y)

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