

Macrocast

Gilles Moëc

AXA Group Chief Economist



Postcard from Washington (and Letter from Paris)

- The IMF forecasts are now kinder to the US, but there was perceptible angst in Washington
- Latest data confirm Euro area trade is “squeezed” by the US/China rivalry
- The French government’s short-term survival does not solve a still daunting fiscal equation

While growth in China and India would decelerate in 2026, the IMF sees the current resilience in the US economy extend into 2026: GDP gains would continue to exceed potential. The tech-related investment boom – combined with easy fiscal policy – is clearly taken seriously by the Fund. Yet, the conversations in Washington last week, around the IMF meetings, were dominated by a series of concerns. The new flare-up of the trade war between the US and China is possibly the clearest one, but the over-reliance of both the market and the real economy, in the US, on the tech sector is another one. Finally, the emergence of “credit incidents” in corporate America is often seen as a warning call, especially in a situation where the valuation of financial assets – which has helped to power up consumer spending – is stretched. The decline in 10-year yields suggests that the appetite for safety trumps concerns about the US fiscal trajectory. This “generic nervousness” makes the outcome of the meeting between Donald Trump and Xi Jinping at the end of the month even more crucial. The US side has sent more conciliatory signals lately, but Beijing may think they have the upper hand.

Global trade patterns could fuel confidence in Beijing. Chinese exports have accelerated in September. Shipments to ASEAN and Africa are particularly strong...but the EU also is providing traction. For now, Chinese producers can offset their losses on the American market. Strong imports from China contrast with the weakness in European exports. Real time indicators from port activity suggests that the softness observed this summer is continuing into the autumn. Over time, this can only fuel protectionist temptations in Europe as well – and that is in the medium term a limit to China’s model, but in the short run, Beijing can afford to be tough.

In France, the government has survived two motions of no confidence, at the cost of suspending the 2023 pension reform. Focus is now on the budget discussion, which remains economically daunting and constitutionally complex. Adopting a budget bill would probably take additional concessions from the government, which will test again the country’s political stability. S&P chose not to wait and “pre-emptively” downgraded France.

The mood in Washington

In the autumn, trees lose their leaves and economists – including your humble servant – gather in Washington DC for the International Monetary Fund (IMF) meetings. On paper, there was cause to celebrate. Indeed, the IMF in its new World Economic Outlook (WEO) has revised up its economic forecast for 2025. World GDP is now seen as rising by 3.2% against 3.0% in the July update, reflecting an unexpected level of resilience to the trade war. Except for China, unchanged at 4.8%, all major economic regions are seen as growing faster this year, the Euro area and India gaining 0.2 percentage point (pp) relative to July, and the US 0.1pp. The IMF however did not extend this resilience into 2026, forecasting a – small – slowdown in world output to 3.1%, still below the pre-pandemic average (3.4% from 2007 to 2019). The deceleration would be quite visible in China (losing 0.6pp relative to 2025) and India (losing 0.4%).

Yet, beyond the general deceleration, a striking feature of the new forecasts is that the Fund now sees the US in slight acceleration in 2026 (2.1%, from 2.0% in 2025). Although the Fund insists on the fact that, compared with its forecasts from last year, before the re-launch of the trade war, US GDP growth would be lower, **a cursory reading of the new projections would lead to the conclusion that the victims of the trade war are to be found in the “global South”, while the US would manage to keep growing above potential – usually seen around 1.75%.** While the Fund also multiplies warnings on price pressure, the narrative on growth will probably be well received by the White House. The promise of the Artificial Intelligence (AI) revolution seems to play a major role in this optimistic view of the resilience of the US to its self-imposed twin supply-side shock (tariffs and immigration crackdown). To quote from the Fund’s Chief Economist foreword to the WEO, *“financial conditions remain very accommodative, with a dollar that has lost some of its strength. And [...] we are witnessing a strong boom in AI-related investment coupled with a modestly expansionary fiscal policy in 2026.”*

How to explain the perceptible angst in the Washington DC conversations then? We would list three interconnected reasons. First, the IMF’s new forecast was built under the assumption that the “trade war front” had stabilised. The flare-up between the US and China adds a new layer of uncertainty. Second, there was quite a lot of talk around the return of the “K-shape economy”, to describe an unusually stark divergence between industries in expansion and others in contraction. The resilience of the US economy owes a lot to tech – we discussed this two weeks ago, highlighting how, without Information Technology (IT) investment, GDP growth in the US would already be below potential – while the more traditional sectors are starting to struggle. If tech dynamics were in jeopardy, for instance because of China’s restriction of rare earths exports to the US, although this would affect far beyond tech, there would not be obvious alternatives to keep US GDP growth on a sound footing. Third, the recent credit accidents (e.g. First Brands’ demise) are adding to the concerns about a possible state of “excess exuberance” of the US financial markets in general. The massive valuation gains of financial assets have contributed to consumption resilience. If this support were to falter, there again there is no clear alternative source of traction, as the rebound in inflation is eroding purchasing power and employment is flat.

These risks are starting to be taken seriously by investors. True, recent statements by Donald Trump – explicitly confirming that the 100% additional on Chinese products he touted himself *“would not be sustainable”* – and Scott Bessent – who will negotiate with his Chinese counterpart directly this week – have reassured the market somewhat. Yet, relative to a month ago (just after the Federal Open Market Committee – FOMC – meeting) forward contracts are now pricing more cuts from the Federal Reserve (Fed) in 2026, in reaction to a more challenging macroeconomic outlook, even though investors still do not expect a steep descent into properly accommodative territory (see Exhibit 1). 10-year yields have also corrected, falling briefly under 4% on Friday. **It seems that the desire for the safety of government securities is trumping concerns over fiscal policy.** The transmission from the short-end to the long-end of the Treasury curve has visibly improved. We note however that this preference for safety has not yet triggered a significant re-assessment in corporate bond spreads (see Exhibit 2). Concerns are for now focused on private loans.

The new prudence on the market may push the US administration into maintaining its new, more conciliatory tone towards China ahead of the meeting between Donald Trump and Xi Jinping at the end of the month. According to a report by Bloomberg News, Scott Bessent has expressed a belief that the latest decisions by the Chinese authorities on rare earths controls had not been vetted by Xi Jinping before being communicated, and that Beijing will quickly see that

such a drastic approach could prove counter-productive by bringing other players, such as the European Union (EU), which are also concerned about losing access to processed rare earths, close to the US line. There is however a distinct risk, in our opinion, that in the eyes of the Chinese leadership, US market volatility, combined with the lingering shutdown, weaken the position of the US government to the point that China should be even more assertive. The very fact that US authorities have moved from confrontation to an appeal to reason in the space of a few days may convince Beijing that China has the upper hand. The US side should prepare to provide some substantial concessions in the future talks. This is not a posture which comes easily to the current administration.

Exhibit 1 – Market expecting (a bit) more Fed cuts

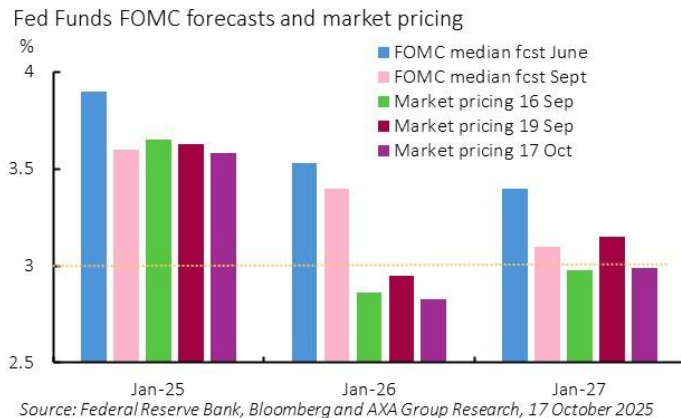
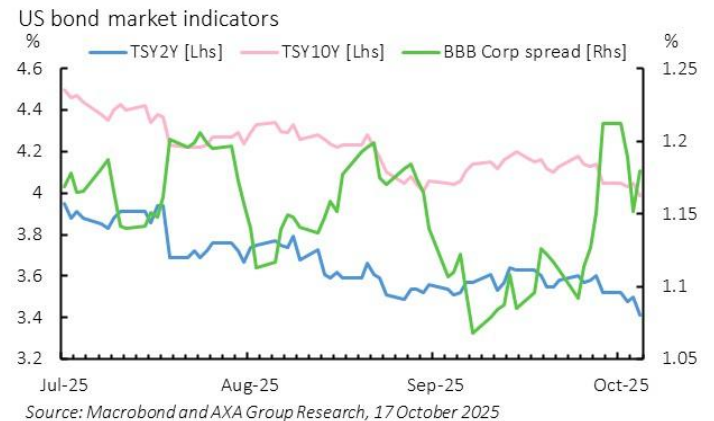


Exhibit 2 – Good transmission through the yield curve



European producers are squeezed between the US and China

The Euro area is more and more clearly the collateral victim of the US/China rivalry. Given the usual noise on monthly readings, we prefer to look at the three-month average of trade data. In the three months to August – last available point – Euro area exports of goods fell by 0.1% year-on-year. The decline is large on the US market (-11.7%yoy). It is tempting to dismiss this as a pure payback for the swift acceleration in European shipments to the US ahead of the tariffs (+37%yoy in March 2025) rather than reflecting the direct effect of the tariffs on European competitiveness. Yet, the decline is also massive on some other markets (-11.3% to China, -5% to ASEAN countries). Unfortunately, the more recent period may not have brought much relief. We follow the IMF “portwatch” data for near real time indications on trade: in the first 10 days of October, port activity has fallen well below 1 standard deviation under the average (see Exhibit 3).

Exhibit 3 – No recent relief on European foreign trade

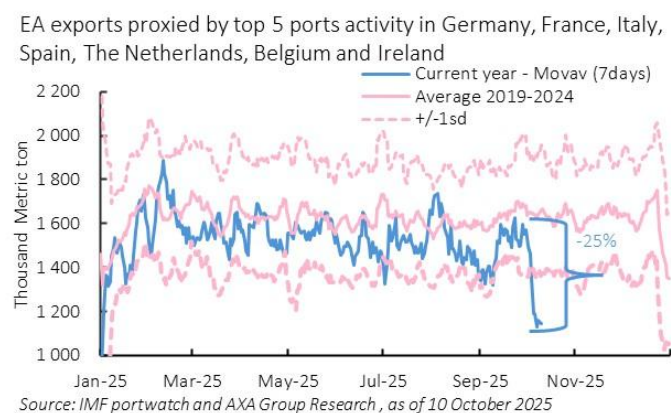
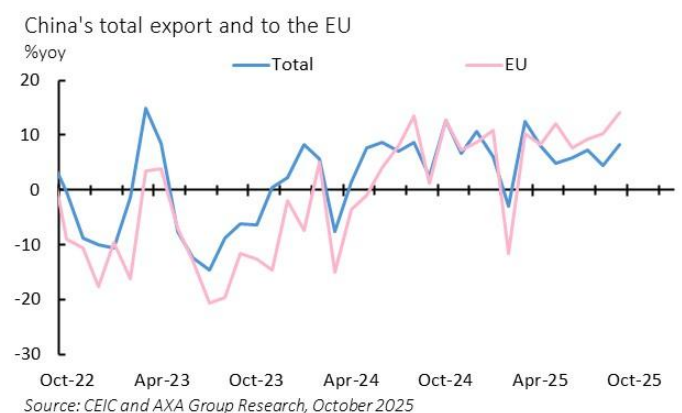


Exhibit 4 – Europe provides traction for Chinese producers



On the import side, what we had been concerned about since the trade war re-started is materialising: Chinese producers have re-directed some of their exports towards Europe. **Total Chinese exports accelerated in September 2025** from 4.4% to 8.3% year-on-year – another reason why Beijing probably considers it still is in a comfortable position relative to the US – **but the momentum for exports to the EU is even stronger** (+14.2%yoy in September

against 10.3% in August, see Exhibit 4). Europe is not China's main alternative to the US (the contribution from Africa and ASEAN is larger) but the dynamics are likely to strengthen the calls for a more protectionist stance in Brussels, as we discussed last week when we explored the EU's proposal to lift tariffs on steel. In the medium to long term, that is the limit of China's current economic model, but for now, Beijing probably considers it can brave more hostile moves from the US on trade to pursue its agenda on technological dominance.

Beyond Survival

The French government has survived two motions of no confidence, one tabled by hard-left La France Insoumise (LFI) and the other by hard-right Rassemblement National (RN), thanks to its explicit suspension of the 2023 pension reform which has convinced most socialist deputies not to support the motions. **Focus is shifting away from immediate government survival – although the issue could return quickly – towards the substance of the budget bill for 2026 and the medium-term trajectory for French public finances.**

Since the government has pledged not to use the 49.3 procedure, the budget bill will take the unusual form of a “work in progress” through the 70 days of parliamentary process, and will require an ad hoc majority to pass, involving mutual concessions across political families, without any certainty of success. The budget bill sent to parliament on Tuesday last week – largely the preparatory work of the previous government under Francois Bayrou – should thus not be taken at face value, but it provides an interesting basis to gauge where the French deficit could land after the parliamentary discussions.

The target is to bring to the deficit to 4.7% of GDP in 2026, from 5.4% in 2025. This requires quite an effort. Indeed, the rise in interest payments would in any case spontaneously add to the deficit to the tune of 0.2% of GDP. In addition, the government is counting on fairly mediocre growth (more on this later) of 1.0% in 2026 and mediocre “spontaneous” tax receipts. In total, all this means that **the government needs to find savings and tax measures of 1.2% of GDP in 2026 to deliver on its target.** In light of France's historical record, this would be ambitious. **But even after such effort, public debt would rise again, by 2% of GDP, to hit 117.9% of GDP in 2026.**

In 2025, according to the High Council for Public Finance, the entirety of the structural effort of 0.8% of GDP is coming from higher taxation. For 2026 however, the effort would be almost equally split between savings and taxes. On the expenditure side, apart from defence, austerity would be demanded from government departments, but **the most salient feature – and the thorniest one – is likely to be the freeze in nominal terms of social spending, including pensions.** In addition, the target for healthcare spending is very ambitious. It is intended to rise by 3.6% in 2025 – which may turn out to be quite optimistic already – and would decelerate to 1.6% next year, partly via an increase in co-payments (healthcare is largely free in France with some minor participation from individuals and a larger one from non-profit seeking cooperatives).

On the tax side, the key rates – VAT, income tax, corporate tax – would be kept unchanged, but the freeze in nominal terms of the brackets will result in an income boost for the government. The better-off pensioners would also be hit by a cap on the deductions for the calculation on their income tax. It would be a mixed bag for corporates. In this initial version of the bill, the business sector in general would be hit by the reprofiling of the rebates on social contributions for lower-paid workers, but the special add-on on corporate tax for big companies introduced last year – EUR8bn in 2025 – would be cut by half in 2026. Besides, the corporate sector would benefit from a cut in the tax on output (CVAE) to the tune of EUR1bn.

As usual, the macroeconomic assumptions will be key to the realism of the budget target. **The 1.0% GDP growth forecast of the government is only slightly more optimistic than consensus (0.9%), but we do not think that most forecasters took on board such a large fiscal adjustment** – with its adverse short-term impact on domestic demand – when they produced their projections. Adding to the difficulty, some of the measures in the budget bill have never been tested before. The logic of the macroeconomic narrative behind the initial budget bill is that the decline in purchasing power of pensioners would have little impact on their consumption because recently they have saved most of the nominal income boost from the price indexation, but we do not know – because it has never happened before – how they will respond to the freeze.

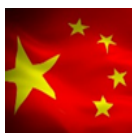
The initial budget bill is built on the assumption that the aggregate household savings ratio will recede slightly in 2026. This was already the expectation for 2025, but it is another rise which came out in the data for the first half of the year. A lot of this further elevation in the saving rate could be attributed to the high level of policy uncertainty in France. We have argued before in Macrocast that a convincing path for fiscal consolidation, going beyond one-off “freezes” but improving public finances, would not necessarily trigger that much adverse consequences for domestic demand, thanks to a decline in the savings rate precisely because it could reduce uncertainty. Yet, it is unlikely that such clear strategy, benefiting from stable political commitment, can emerge anytime soon in France, at least not without a political “re-set”. The ongoing budget discussion itself could generate even more noise than the recent political episodes. **In net terms, even if the final budget bill, after the concessions from the government, may end up having a smaller direct impact on aggregate demand, the lack of a clear direction may trigger a further rise in savings.**

The Prime Minister has already announced he would be open to some drift in the deficit target to 5.0% of GDP. However, even with this room for manoeuvre, the parliamentary process is likely to be very tough. The socialists have already announced that they would demand more concessions beyond the suspension of the pension reform. We suspect they will focus on the freeze in nominal terms of pensions and other social benefits, as well as the rise in co-payments on healthcare. In practice, this means that the tax treatment of corporations could end up tougher than what is in the government’s initial version of the budget bill. But keeping the whole of the mainstream political families together (from the centre-right to the socialists) will be difficult.

The suspension of the pension reform is likely to remain a bone of contention. Indeed, the government cannot unilaterally choose not to implement a reform which is currently the law of the land, deemed to be approved by parliament in 2023 through the 49.3 procedure. The very notion of “suspending the pension reform” is less clear than it looks at first glance. The government has chosen to implement it by adding an article in the Budget bill. This would make the suspension dependent on the budget bill being formally adopted by parliament. Yet, if parliament gets “bogged down” in the procedure – and if the government tries to slow it as much as possible – so that it has not been able to complete it in 70 days, then the government could invoke article 47 of the Constitution and implement the budget bill by “ordonnances” (basically decrees). There is a debate among constitutionalists on whether it is the initial version of the budget bill – e.g. without the amendment suspending the pension reform, and/or other concessions offered during the debates – or whatever the government chooses to keep from the parliamentary process, which would be implemented by “ordonnances”. Some other solutions are currently in discussion – such as formally rectifying the *initial* budget bill to take on board the reform suspension, but the socialists have already warned that, should they consider that the government is “dragging its feet” in search of the “ordonnances” option, they would support a motion of no confidence. **In short, despite the major concession of the pension reform, political stability is still far from ensured in France.** This is precisely what has prompted S&P to downgrade France last Friday ahead of the normal review schedule.

If a budget fails to materialise by 31 December, for instance if the government falls again, or if parliament is dissolved, France will likely revert to a “loi spéciale”, replicating the 2025 budget (this is what already happened last year at the demise of the Barnier government). The timeline of any dissolution would however need to make it possible for parliament to be operational again before 31 December, precisely to vote such “loi spéciale”.

The market reacted well to the survival of the government last week, despite the concession on pensions, with the spread falling slightly below 80 basis points (bps). That reflects the market’s focus on avoiding early elections, which could bring to power parties with radical fiscal plans. Yet, the recent events have deteriorated further the already challenging underlying position of French public finances. If the 2023 pension reform is entirely scrapped, this would lift the French deficit by 0.3% per annum by 2030. In any case, the reform was not expected to suffice to balance the finances of the pension system – by 2030 there would remain a deficit of 0.2% of GDP. This cannot be addressed by mere political expediency.

Country/Region	What we focused on last week	What we will focus on in next weeks
	- NFIB business optimism survey (Sep) edged down to 98.8 from 100.8 - NY fed mfg (Oct) surprised at 10.7 from -8.7 - Philly Fed business index (Oct) dropped sharply to -12.8 from 23.2	(* = Due to US govt shutdown, data release delayed) - Non-Farm payrolls (Sep)*, expected to remain weak, likely close to the 3m ma of 29k; unemp rate to stay at 4.3%; average earnings to stay at 0.3%mom - CPI (Sept) to stay little changed from Aug's 0.4%mom - PPI final demand (Sep) to see recovery from -0.1% - Retail sales (Sep)* to ease from 0.6% in Aug - Industrial production (Sep)* to stay stable around 0.1%
	- PM Lecornu presented France's draft 2026 budget. He already survived to two confidence votes, one with a narrow margin - Euro area industrial production fell by 1.2% in August. Euro area goods' trade surplus improved in August owing to a bigger fall in imports than in exports - Euro area final September core inflation was revised up 0.1pp to 2.4%yoy, while headline was confirmed at 2.2%yoy	- Many ECB speeches ahead of the 30th of October Governing Council meeting - INSEE and PMI surveys for October
	- BRC Retail Sales Monitor (Sep) slowed to 2.0%, from 2.9% - Labour market (Aug/Sep): Payrolls dropped by 10K reversing 10K rise in August. Unemployment rate rose to 4.8%, from 4.7%. AWE ex. bonus edged down to 4.7%, from 4.8%. Inc. bonus rose to 5.0%, from 4.8% - Monthly GDP (Aug) rose by 0.1%, offsetting 0.1% decline in July. IP rebounded, services flatlined	- Public finances (Sept): should show borrowing broadly in line with OBR forecasts - Inflation (Sep) look of increase in headline rate to 4.0%, from 3.8%. Core set to rise to 3.7%, from 3.6% - GfK consumer confidence (Oct) likely to edge lower in run up to Budget - Retail Sales (Sep) look for modest 0.3% increase - Flash PMIs (Oct) look for signs of Budget impact
	- IP final (Aug) fell by 1.5%mom drop, revised down from flash estimate -1.2% - Machinery orders (Aug) fell by 0.9%mom, following 4.6% drop in July	- Exports (Sep) look for any further impact of tariffs. - Inflation (Sep) both headline and core set to rise to 2.9%, from 2.7% - Flash PMIs (Oct) likely to edge lower given political situation
	- Total social financing (Sep) down by another 6.2%yoy after 15.4% decline in Aug; New loan growth (Sep) down by another 18.9% after 34.4% fall - Exports (Sep) rose 8.3% from 4.4%; imports up to 7.4% from 1.3% - CPI inflation (Sep) up to -0.3% from -0.4%; PPI improved to -2.3% from -2.9%	- LPR 1y and 5y (Oct) to stay unch at 3% and 3.5% respectively - Q3 GDP to slow from Q2's 5.2% - Monthly output (Sept) to slow modestly across the board including retail sales, fixed asset investment and industrial production
	- CB: Singapore (unch) - CPI (Sep yoy): Romania (9.9%), India (1.5%), Argentina (31.8%) - Industrial production (Aug yoy): Romania (-1.1%), Colombia (1.0%), Malaysia (4.9%) - GDP (Q3 yoy): Singapore (2.9%), Malaysia (5.2%)	- CB: Hungary (unch at 6.5%), Korea (unch at 2.5%), Indonesia (25bp cut to 4.5%), Turkey (150bp cut to 39%) - CPI (Sep): Malaysia, South Africa - Industrial production (Sep): Poland, Taiwan, Singapore - Elections in Argentina (Oct 26)
Upcoming events	US: Thu: Chicago Fed National Activity Index (Sep), Initial Jobless Claims*, Existing Homes Sales (Sep)*; Fri: CPI Inflation Rate (Sep), Michigan Consumer Sentiment Final (Oct), Building Permits Final (Sep)*, New Homes Sales (Sep)* Euro Area: Mon: EA Current Account (Aug); Thu: EA Consumer Confidence Flash (Oct); Fri: EA HCOB Flash PMIs (Oct) UK: Tue: Public Sector Net Borrowing (Sep); Wed: CPI Inflation Rate (Sep); Fri: GfK Consumer Confidence (Oct), Retail Sales (Sep), S&P Flash PMIs (Oct) Japan: Wed: Balance of Trade (Sep); Fri: CPI Inflation Rate (Sep), S&P Flash PMIs (Oct) China: Mon: GDP (Q3), Industrial Production (Sep), Retail Sales (Sep), Unemployment Rate (Sep), Fixed Asset Investment (Sep)	

*Note: These US data releases are delayed as the government shutdown continues. A new updated schedule will be published by the respective government agencies once the shutdown has ended. US CPI will be released on 24 October as announced by the Bureau of Labor Statistics.



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