MacroResearchBoard
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Independent Investment Strategy
WEEKLY
MACRO STRATEGY
November 8, 2024

Beware The Fat Tails

- The (apparent) Republican sweep in this week's U.S. elections will give President-elect Trump the executive and legislative capability to enact major fiscal, regulatory and other policy changes.
- For now, we are standing pat on our moderately pro-growth investment recommendations, as the U.S. economy currently has solid momentum and the global economic outlook will improve as DM policy rates continue to decline.
- The two key risk factors to monitor are: an upside breakout in Treasury yields and whether, in addition to the positive economic policy actions Trump has proposed, he will also resume trade wars and protectionism. Stay tuned.

The U.S. election delivered a jolt to global markets, as a buy "America" stampede followed the Republican sweep of the White House and Congress[1]. Uncertainty is bound to stay elevated for some time as the world waits to see if president-elect Trump will deliver on some of his more extreme proposed policies, both economically positive and negative.

The silver lining is that this uncertainty has arrived when the U.S. economy is on a solid growth path

[1] The House majority has not yet been confirmed, but it appears that the Republicans will maintain control.

and should be resilient awaiting upcoming policy changes. Meanwhile, the Fed is dovish and again lowered its policy rate this week (see page 9), which provides underlying economic and risk asset support.

As discussed below, Trump has proposed a number of sizable policy actions, some positive for growth and risk assets, and some that would represent headwinds to global growth and even to the U.S. economy, especially should any sizable protectionist actions actually take place (rather than merely being threatened). These are the "fat tails" associated with Trump that we have noted in our reports this year, and are now in play.

The "fat tails" associated with Trump are now in play

The implications of the election on the investment outlook were discussed in Wednesday's **MRB *Webinar*** (see page 14). Trump's surprisingly strong victory looks to be accompanied by a unified Republican government. That will give Trump the executive and legislative capability to enact major fiscal, regulatory and other policy changes.

Trump's pro-growth promises reinforce the risk-on climate in the near term, given the already strong U.S. economy

His pro-growth promises for major tax cuts and deregulation reinforce the risk-on climate in the near term given the already strong U.S. economy. Yet the sustainability of this pro-growth backdrop will ultimately be governed by whether he follows through on his proposals to hike trade tariffs and undertake mass deportations, both of which would undermine growth and boost inflation. And any major tax cuts beyond the extension of the 2017 tax cuts would add to upward pressure on bond yields and the associated term premium[2].

For now, we are standing pat on our moderately pro-growth investment recommendations, which will benefit from the ongoing uptrend in U.S. and global corporate earnings at a time when DM central banks are cutting interest rates. Monetary conditions tightened during the rate-hiking phase in recent years, but never became restrictive to the point where a recession was likely, and are now easing, which is positive for risk assets.

Since 2022, every upside breakout in Treasury yields has coincided with a de-rating phase and increased recession fears

U.S. assets have recently benefited from the perception that a Trump win will benefit the U.S. economy and asset prices, with the notable exception of the Treasury market where the budding uptrend in yields surged this week (**chart 1**). The ***positive*** tail risks under Trump include a laxer regulatory environment, lower taxes, and the likelihood that fiscal policy will remain expansionary, albeit these positive influences may already be mostly discounted.

[2] **MRB**: "***Absolute Return Strategy: The Return Of The Term Premium***", October 31, 2024

To this end, **chart 2** shows that U.S. equity market returns have far outpaced non-U.S. bourses for some time, especially recently as the odds shifted in Trump's favor. This outcome partially reflects the stellar outperformance of U.S. corporate profits. However, there also has been a huge re-rating in U.S. equities that did not occur elsewhere (panel 2).

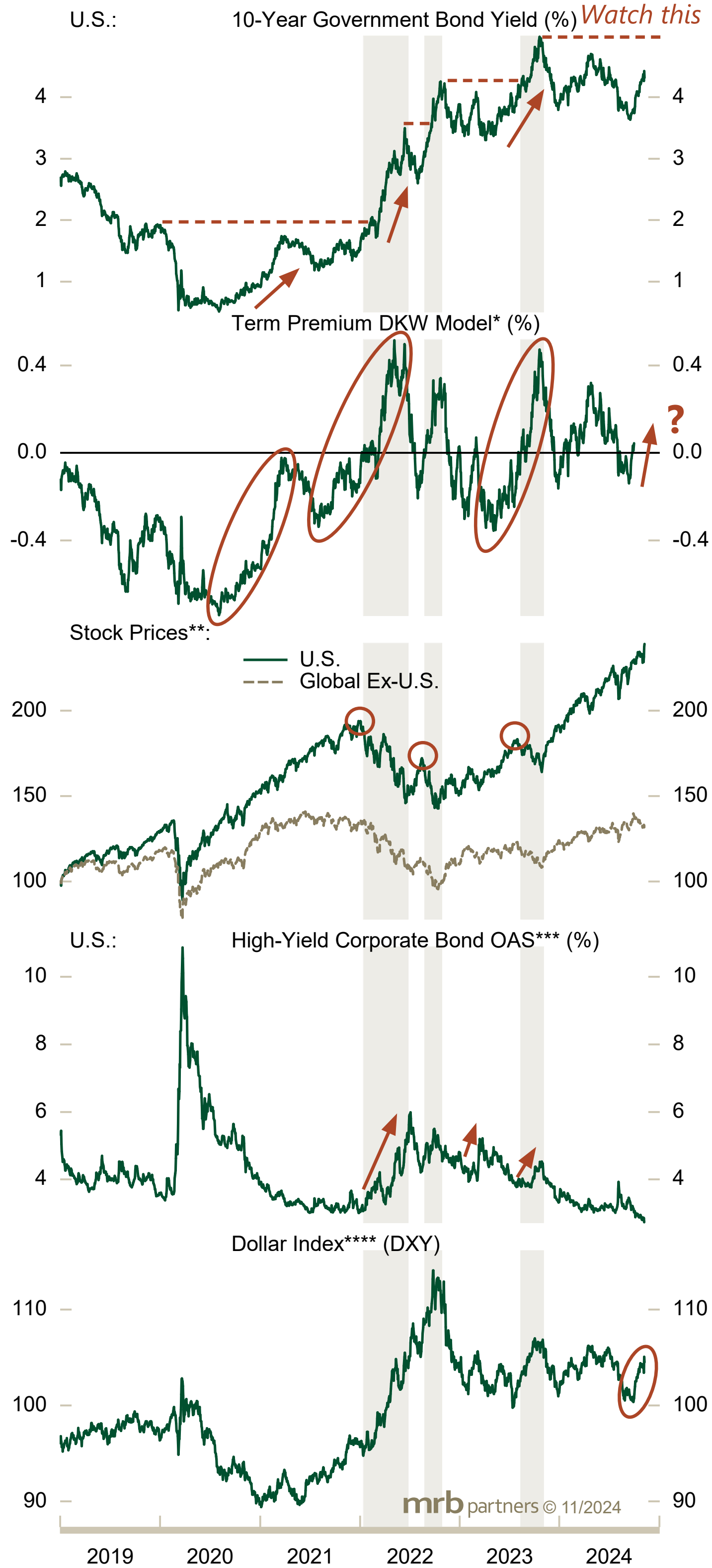
Trends in DM government bond markets, especially the U.S. Treasury market, will be critical for U.S. and global equity prices. Since 2022, every upside breakout in Treasury yields has coincided with both a de-rating phase and a perking up of recession fears. The latter never lasted long, because the U.S. economy has shown persistent solid momentum and bond yields never "overshot"; in the end, the Fed never delivered a monetary knockout blow.

Thus, although we remain positive on equities, we also recommend keeping a close eye on anything that could: trigger either a breakout in Treasury yields or undermine what is still a solid U.S. economy and a gradually improving growth outlook outside the U.S.

The risk of ever-higher Treasury yields has been our top cyclical concern since the pandemic ended, and we remain positioned accordingly: underweight bonds and below-benchmark duration within multi-asset and fixed-income portfolios, and short Treasurys in absolute terms and relative to Bunds in our absolute return portfolio, the **MRB *TradeBook*.**

In terms of economic risks, the skies are still currently mostly blue with the ongoing exception of the global manufacturing sector. This week's PMI and ISM surveys for the major economies showed more of the same: generally positive-to-very-positive service sector readings, but with sub-50 manufacturing indexes. Fortunately, the former sector represents

Chart 1 **Treasury Yield Breakouts Spark Equity Market Corrections**



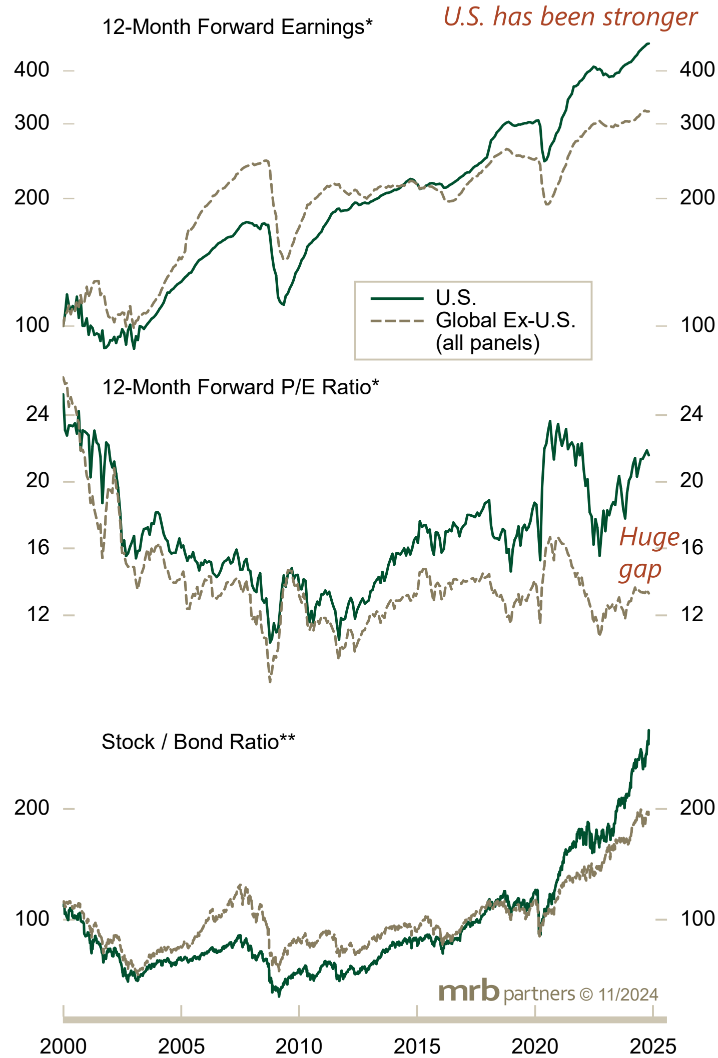
* D'Amico, Kim & Wei (DKW) No-Arbitrage Term Structure Model; source: U.S. Federal Reserve
** U.S. dollars; rebased; source: MSCI
*** Option-adjusted spread; source: BofA Merrill Lynch
**** Source: Bloomberg
Note: Shaded for equity sell-offs in 2022-2023

a much larger part of the DM economy, and thus overall activity is positive and labor demand has held at historically high levels (and DM labor markets generally remain tight).

In terms of one of the most worrisome potential ***negative*** tail risks, protectionism, one can look to Trump's first term and see evidence that steps taken then had a negative economic and asset market impact. Fortunately, Trump stopped escalating tariff action once the equity market tanked and the business sector started to cry foul.

Chart 3 shows a few key variables during Trump's first term. The U.S. economy had a solid head of steam when he was elected, and was given a further boost when taxes were cut in 2017. Moreover, the global economy was finally rebounding solidly after an historically poor first half of the decade, which included two recessions during 2008-2012 in the euro area and Japan, and subsequent painful deleveraging.

Chart 2 **U.S. Equities Have Been Massively Re-Rated**



* Source: MSCI
** MSCI stock market total return index divided by 10-year government bond total return; local currency; rebased
Note: Earnings are in local currency and rebased

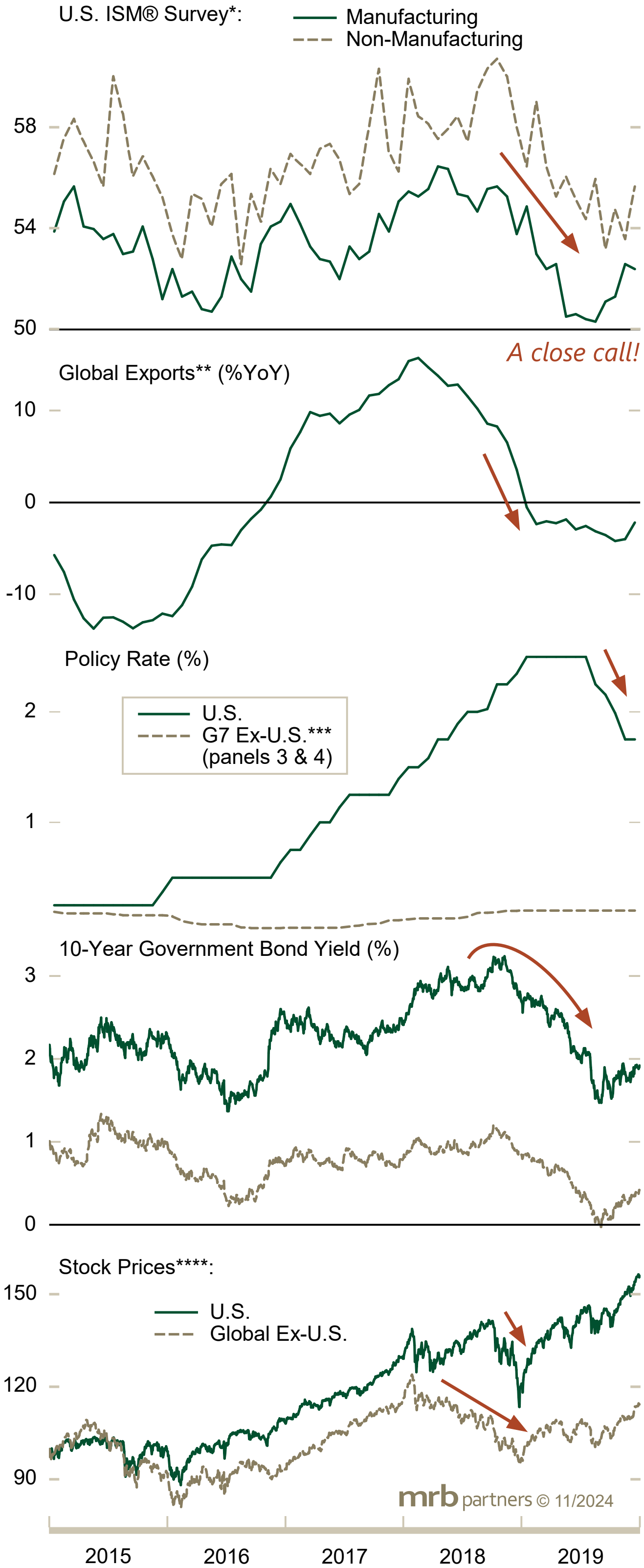
By 2018 it was becoming clear that economic risks were escalating, with equity prices down sharply, credit spreads widening, the U.S. economy cooled markedly and global trade contracted. Thereafter, the Fed was forced to pivot and cut rates, and bond yields fell meaningfully to provide some economic relief. Ultimately, Trump did not pursue his trade policies to the point of pushing the world into recession; rather, he stopped escalating the trade wars and even agreed to a new trade deal with Mexico and Canada.

"Trading" the shift to protectionism paid off in 2018-2019

Trump's "promises" on the election trail this year regarding tariffs and trade restrictions are far larger than what was enacted in the second half of the 2010s. In fairness, he has said that these are negotiating positions, and investors have focused more on this point than the risk of actually passing 1930s-type protectionist policies.

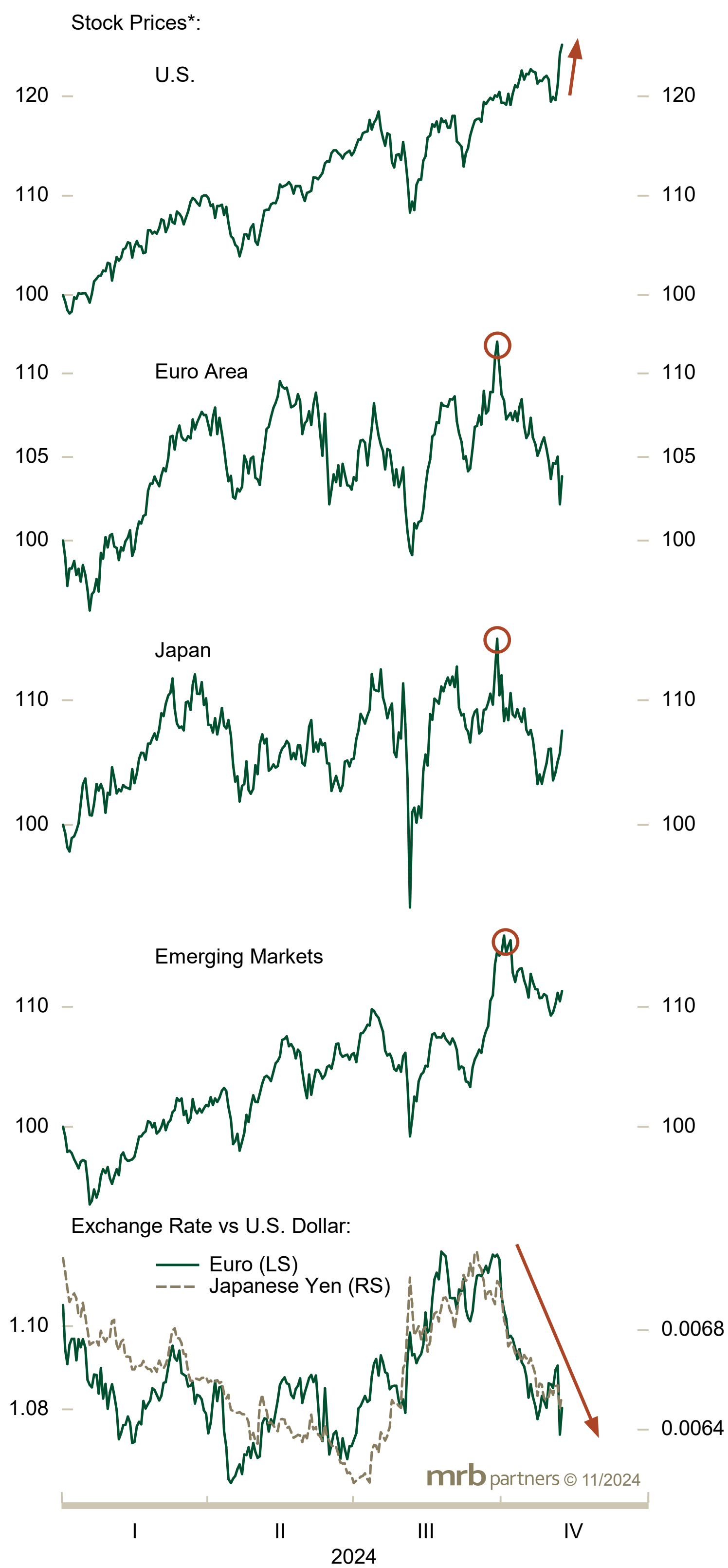
All we can conclude at this juncture is that we need to monitor trade policy issues and, if needed, be prepared to change our current positive view on equities and credit, as well as on the U.S. and global economic outlook. Still, "trading" the shift to protectionism paid off in 2018 (sell stocks) and 2019 (first by buying bonds, and

Chart 3 **Trump 1.0: Protectionism Came Close To De-Railing The Economy**



* Source: Institue of Supply Management®
** Source: Netherlands Bureau for Economic Policy Analysis
*** GDP-weighted aggregate
**** U.S. dollars; rebased; source: MSCI

Chart 4 **U.S. Equities Versus The Rest Of The World**



* U.S. dollars; rebased; source: MSCI

then buying equities once trade tensions eased), and may well do so again in Trump's second term – stay tuned.

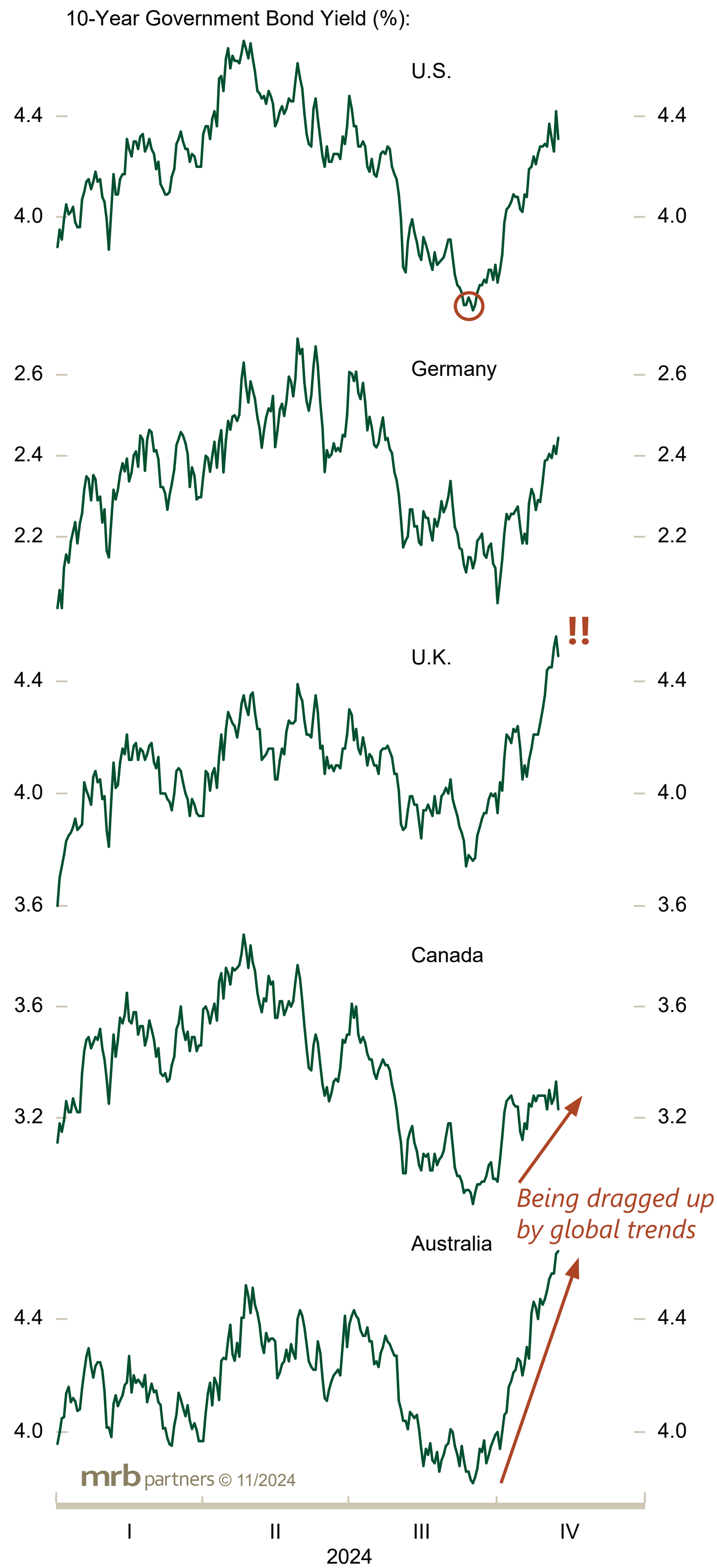
This week witnessed a further surge in the U.S. equity market's performance in both absolute and relative terms (**chart 4**, previous page). Having a better corporate earnings backdrop and a stronger overall economy have benefitted U.S. stocks. Part of the swing in relative equity performance was magnified by a rebound in the U.S. dollar over the past few weeks (panel 5). While these moves are starting to look exaggerated (the U.S. equity market is becoming overbought, especially in relative terms), it will take time to restore better equity market sentiment outside the U.S., despite much better valuations.

As noted, a close tracking of bond market trends will be critical to the equity market. **Chart 5** shows the recent abrupt rebound in DM bond yields, especially in the U.S., with the latter ironically closely timed to the Fed's first rate ***cut***. Investors are starting to become worried after ignoring budget deficits and soaring government debt levels in recent years.

Upward pressure on bond yields will steadily intensify if the global economic expansion rolls on, and the U.S. and other DM economies continue to run the largest budget deficits excluding the GFC and pandemic periods.

Fiscal concerns recently heated up in the U.K., which has seen a surge in Gilt yields this autumn despite another BoE rate cut yesterday[3]. The rise provided a reminder of a risk that has been near the top of our list of factors that could trigger the next recession, namely a snapping of the weak-link countries[4].

Chart 5 **DM Government Bond Yields: Higher And Higher**



[3] **MRB**: "*U.K. Policy: What You Need To Know About The Budget And Fiscal Outlook*", October 29, 2024

[4] The MRB weak link countries are: Australia, Canada, New Zealand, Norway, Sweden and the U.K.

This threat will increase meaningfully if these countries suffer much higher bond yields despite weak domestic economies, because of rising U.S. and global bond yields. The weak-link economies need ***lower*** borrowing rates to ease debt-servicing burdens that are choking their household sectors and to ease pressure on government deficits at a time of weak domestic growth.

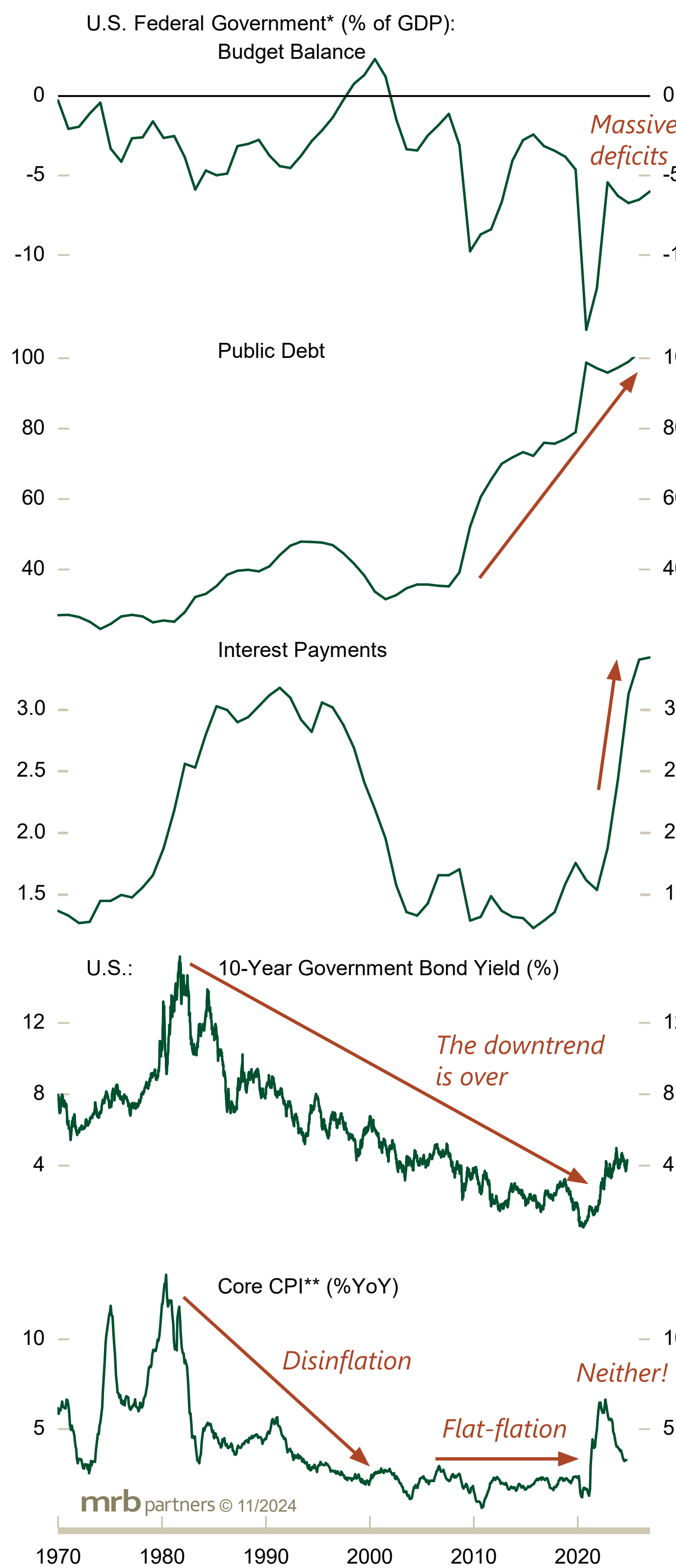
As discussed in last week's **MRB *Absolute Return Strategy***[2], budget deficits do matter, ***eventually***. This has generally not been an issue for bond investors, especially for the U.S. in recent decades.

Chart 6 shows the trends in the key variables for U.S. government debt. Bond vigilantes rioted in the 1970s, and kept real bond yields high throughout the 1980s. U.S. politicians eventually were forced to deal with chronic large deficits and rising debt levels, culminating in the 1990 budget deal that likely cost President George H.W. Bush the 1992 election. Thereafter, bond vigilantes faded from the scene and were eventually replaced with bond zealots.

Disinflation (1980s-1990s) and then flat-flation (2000s-2010s) allowed nominal U.S. bond yields to steadily decline to near zero, which helped in terms of lowering government interest payments (and therefore reduced budgetary pressures), as well as boosted economic activity. Not surprisingly, most bond investors tended to downplay the importance of budget deficits in driving bond market trends. ***The powerful secular decline in yields overwhelmed periodic concerns over excessive government borrowing***.

However, the current picture for U.S. government deficits, debt and interest payments is now worse than in the 1970s. If inflation was ***not*** an issue, then perhaps the U.S. could gradually work its

Chart 6 U.S. Government Debt/Deficit Trends Are Alarming



* Includes 2024 projection; source: Congressional Budget Office
** Excludes energy and food

way out of this fiscal hole, albeit only if it took the politically-risky step of reducing the deficit (which did not work out well for Bush in 1990!).

Instead, our view is that inflation will remain sticky, especially if economic growth holds up as we expect. Neither U.S. political party proposed a platform of fiscal restraint this year, and Trump shows no inclination to want to deal with it, outside of vague claims that he will massively reduce government waste.

Perhaps Trump will succeed where all others have failed. If not, then the risk of an eventual overshoot in bond yields will grow, as will the likelihood of a risk-off phase. Huge budget deficits at a time of solid economic growth are worrisome (i.e. this is the time when the budget should be in surplus if debt is to be stabilized), especially given today's starting point of record high public sector debt and sticky inflation.

Neither U.S. political party proposed a platform of fiscal restraint this year

Ignoring this issue increases the probability that fiscal excesses will once again contribute to the return of bond vigilantes. And this is not just a U.S. problem, but also exists in many DM economies.

There are other tail risks that could yet trip up the global economy and risk asset markets. Notably, geopolitical tensions have significantly worsened this decade. Oil prices currently remain calm and are near the low end of their range, and thus are supportive for the global economy. However, history shows that this could yet flip given the instability in the Middle East (and in Ukraine).

Huge budget deficits at a time of solid economic growth are worrisome

To sum, U.S. equity valuations in particular leave no cushion for any negative shocks. A risk-off phase looms if Treasury yields were to decisively breakout, as occurred in 2022-2023 (see **chart 1**). While it is a bigger concern in the better-performing U.S. asset markets, the higher level of bond yields and overall global risk asset valuations today imply greater price downside if bond yields climb meaningfully and/or the corporate earnings outlook darkens.

Final Word: *Bonds will be the governor on how far the current risk-on phase can run, but we doubt that higher yields will be a threat until the U.S. 10-year Treasury yield tests the 5% peak hit in October 2023. If yields decisively breach 5%, then investors likely will worry that the ceiling for yields is open ended, which would almost certainly cause an equity de-rating and mounting concerns whether the current positive backdrop for corporate earnings will deteriorate.*

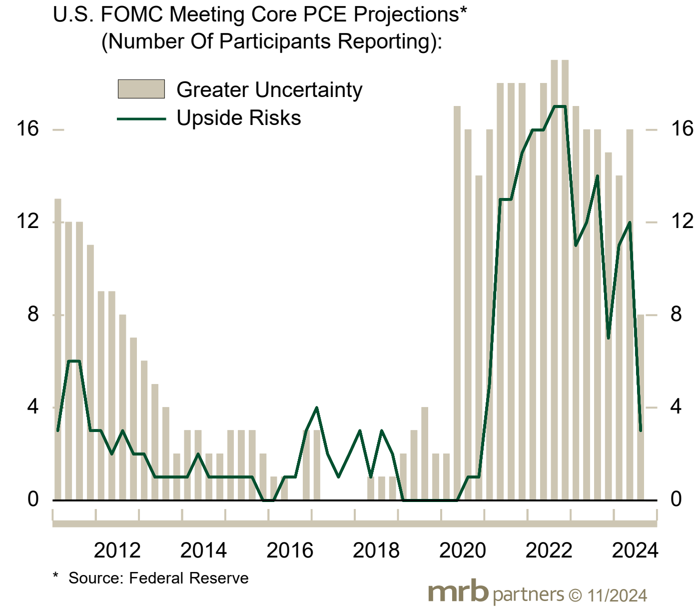
We doubt that higher bond yields will be a threat until 10-year Treasury yields test the 5% peak hit in October 2023

Policy

A Uneventful Fed Rate Cut, A Less Certain Policy Path

As expected, the Fed cut the policy rate by 25 bps at yesterday's FOMC meeting to 4.5%-4.75%. Fed Chair Powell refrained from giving clear forward guidance for next month's policy meeting or the next iteration of the dot plot, but noted "*a sense of some of the downside risks to economic activity having diminished*" since the last Fed meeting, and indicated "*feeling good about economic activity*". Powell also highlighted that the last inflation report "*wasn't terrible, but a little higher than expected*".

Chart 7 The Fed Has Become Too Complacent On Inflation



MRB's view is that the Fed is still likely to cut the policy rate by another 25 bps rate at next month's FOMC meeting, but the more important question is what the Fed is likely to do next year and beyond, especially in view of the results of this week's U.S. elections.

In September, the median Fed participant had a highly dovish policy rate outlook, projecting a percentage point of easing next year, and an additional 50 bps easing in 2026, taking the policy rate to the Fed's estimate of the neutral rate of 2.9%. Our view at the time was that the dot-plot path was unrealistic, that the Fed had become too complacent on inflation, and had set itself up for a dovish policy mistake in September by signaling such an extended rate cutting cycle[5] (**chart 7**).

The Fed will cut by less than the bond market has been pricing in, or as indicated in the September dot plot

The disinflationary drag from immigration and pandemic-related distortions will eventually fade. At the same time, The Fed's uber-dovish pivot means that the future cyclical inflationary impulse will strengthen ahead, as real GDP growth continues to meaningfully outpace the economy's potential growth rate. Core inflation will ultimately remain well above the Fed's target, in a 3%-plus range rather than around 2%.

In this backdrop, the election of Donald Trump as the next U.S. President, and the Republican Party gaining majority in both houses of Congress, implies higher odds of inflation surprising on the upside, next year and beyond.

MRB's view has been that firmer, persistently above-target inflation will force the Fed to rethink its policy path in 2025; eventually the Fed will cut by less than the bond market has been pricing in, or as indicated in the September dot plot. The election

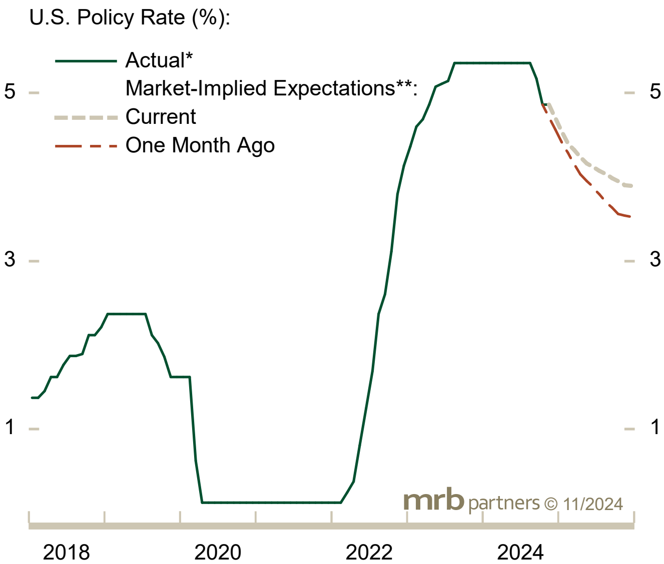
[5] **MRB**: "*U.S. Fed Policy: The Makings Of Another Dovish Error*", September 19, 2024

outcome further cements our view that the Fed will ease less ahead than it had anticipated earlier.

The election outcome also adds more upward pressure on long-term bond yields, from a fiscal policy standpoint, as well as from greater uncertainty, which would impact the term premium[6]. The Fed will be watching long-term bond yields closely ahead, as persistently higher yields would counteract rate cuts.

Admittedly, there is considerable uncertainty around the potential magnitude of the election's impact, and depends on how/whether the Trump administration pursues tariffs/trade wars, halts or reverses the flow of immigrants, and pushes for tax cuts and deregulation[7].

Chart 8 **The Forward Market Is Reining-In Its Rate Cut Outlook**



* Source: Federal Reserve
** Source: Bloomberg

For the time being, Fed Chair Powell predictably steered clear of discussing the election results at yesterday's press conference, noting that "*in the near term the election will have no effects on our policy decisions... we don't know what the timing and substance of any policy changes will be. We therefore don't know what the effects on the economy would be*".

We expect the Fed's dot plot and forward guidance to change only gradually. The forward market is pricing a percentage point of easing next year, which is less dovish than a month ago, but we expect that expectations will come in further as the coming year unfolds (**chart 8**).

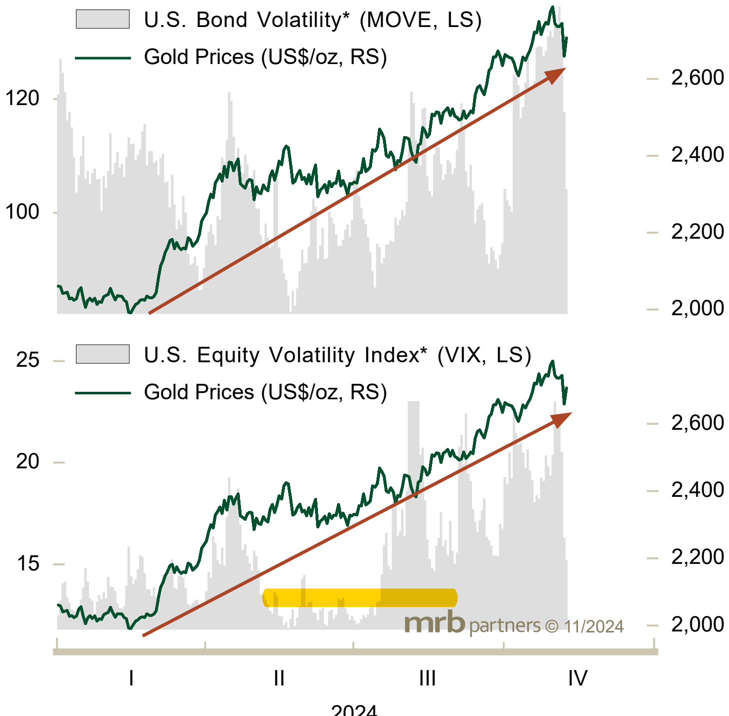
While the potential policy changes of the new Administration and Congress are still uncertain, the risks to inflation are tilted to the upside

Final Word: *The Fed cut the policy rate by 25 bps yesterday as expected, and Powell presented a generally upbeat assessment of the economy. Economic uncertainty has increased as a result of the outcome of the U.S. election. While the potential policy changes of the new Administration and Congress are still unknown, we think that the risks to inflation are tilted to the upside. Consequently, we continue to believe that the Fed will ease by much less than its last dot plot showed, and less than the forward market is discounting.*

[6] **MRB**: "***Webinar – U.S. Post-Election Discussion: Q & A With MRB***", November 6, 2024

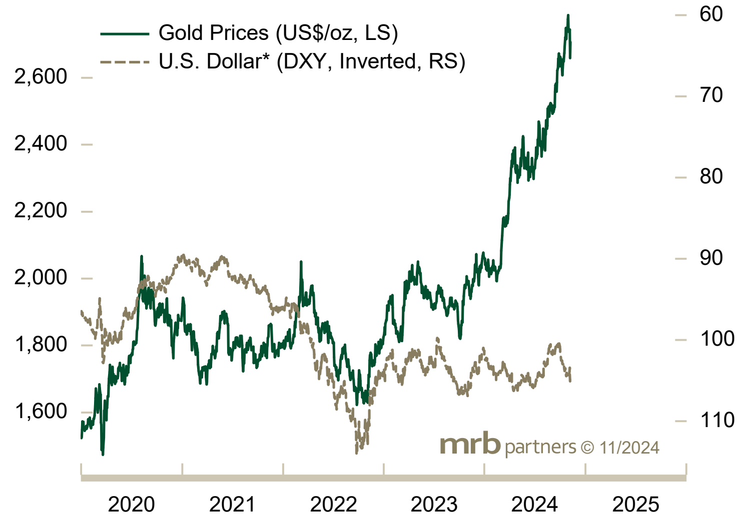
[7] Some of these alternatives could boost growth in the near term.

Chart 9 Higher Bond And Equity Volatility Has Supported Gold Prices This Year



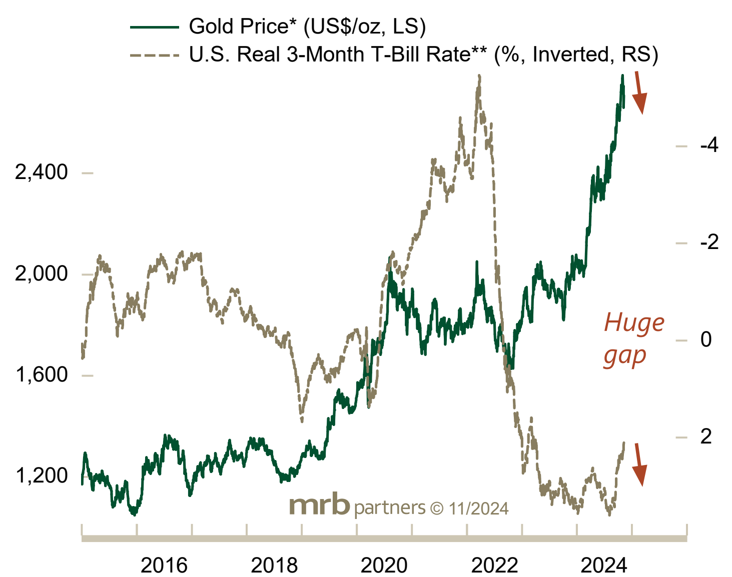
* Source: Bloomberg

Chart 10 The U.S. Dollar Influences Gold Prices, Albeit This Year's Move Has Been Disproportionate



* Source: Bloomberg

Chart 11 There Is Now A Massive Gap Between Real Rates And Gold Prices



* Source: Bloomberg
** 3-month T-bill rate minus 1-year CPI swap rate; source: Bloomberg

Commodities

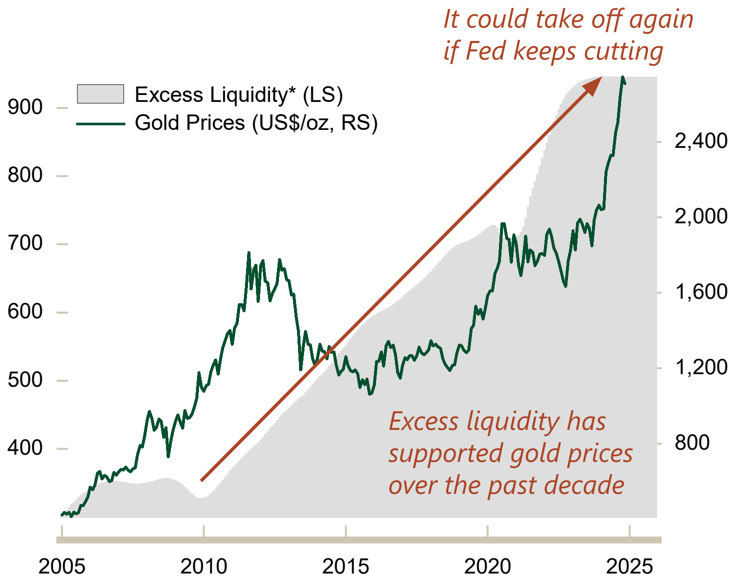
Gold Is Primed For A Consolidation

Gold prices have rallied strongly in the past year reflecting both market and geopolitical factors (**chart 9**). While the first wave of strength from October 2023 to mid-February was on the back of a broader risk-on rally, we would attribute the ongoing durability of the rally to heightened investor anxiety associated with the situations in the Middle East/Ukraine, as well as mounting concerns that policymakers in the developed world are underestimating the stickiness of inflation.

Indeed, the precious metal traditionally receives support from elevated equity and, especially, bond volatility, as well as persistent geopolitical risks (**chart 9**). That said, we have articulated in previous research reports that the two dominant cyclical market drivers are the level of bond yields and the trend in the U.S. dollar, given that gold is priced in U.S. dollars[8]:

[8] **MRB**: "*Gold: Does The Gold Rally Still Have Legs?*", October 28, 2020

Chart 12 **Excess Liquidity Has Supported Gold Prices**



* Proxied by cumulative gap between U.S. nominal GDP growth & Fed funds rates

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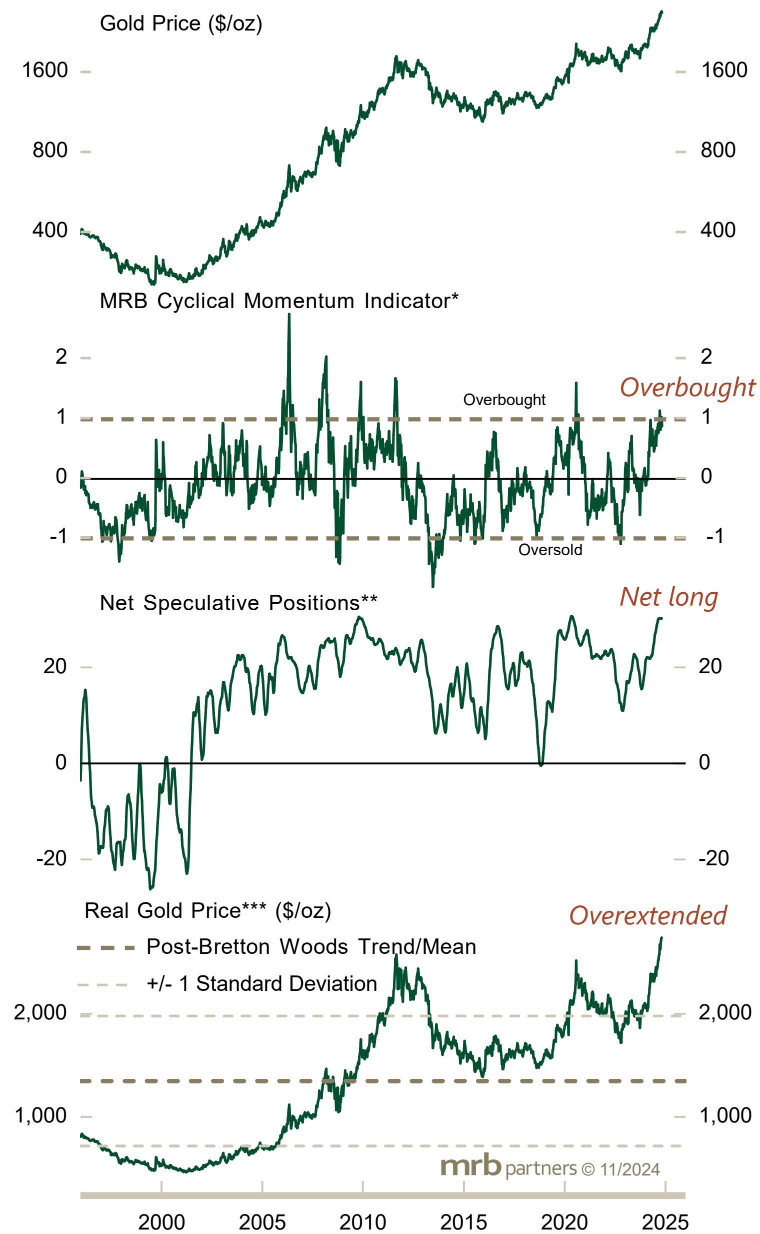
Chart 13 **Gold Prices Are Stretched**



* Standardized
** Total long positions minus total short positions divided by open interest; smoothed; source: Chicago Mercantile Exchange
*** Deflated by U.S. headline CPI inflation
Note: Panel 1 shown in log scale

- The dollar has been within a trading range this year, which, on balance, has helped put a floor under gold prices. However, this week's U.S. election results sparked broad-based U.S. dollar appreciation, which has weighed on the precious metal (**chart 10**, previous page).

- In terms of bond yields, U.S. Treasury yields peaked in Q4 2023 and trended lower for much of this year on expectations of imminent Fed interest rate cuts. While yields have backed up since the Fed finally cut rates, further Fed (and other central bank) easing should continue to provide support for gold prices (**chart 11**, previous page).

Heading forward, we believe that gold could continue to receive support for ***as long as there is relatively easy money being provided by central banks***. In other words, gold should remain well bid ***if*** excess liquidity conditions persist in the global economy (**chart 12**).

Also, another contributor (***albeit*** from a longer-term perspective) is the expanding fiscal deficit in the U.S. and in most of the DM world. This is a much more structural driver of gold's performance, but it certainly has helped sentiment in favor of gold prices since bond vigilantes are still in short supply. Ultimately, the growing U.S. fiscal deficit is U.S. dollar bearish[9], which will help put a floor under gold prices over the longer term.

On balance, while there is no evident headwind for gold in the near term, the precious metal is due for a consolidation phase as markets further unwind Fed rate cut expectations and bond yields climb further. Also, gold prices are one standard deviation overbought according to our *MRB Cyclical Momentum Indicator* and real gold prices are even more stretched, which warrants caution at this juncture (**chart 13**, previous page).

Gold prices are one standard deviation overbought according to our MRB Cyclical Momentum Indicator, and real gold prices are even more stretched

Final word: *While there is no imminent catalyst for a reversal in gold prices, the precious metal is quite overbought and likely to at least consolidate in the coming months. The likely catalyst for a consolidation/correction will be a more definitive jump in Treasury yields and/or a stronger U.S. dollar, **albeit** we are not expecting U.S. dollar strength to prove durable in the longer term.*

MRB *TradeBook Update*

Protecting Profits

The outcome of the U.S. presidential election benefited several positions in the **MRB *TradeBook*** and we are taking this opportunity to tighten some stops, and added a new position:

- **Long U.S. Financials Stocks Vs Broad Market:** This equity pair trade has gained further strength on the back of the outcome of the U.S. election (up 5%). We expect further relative upside, but will take this opportunity to tighten stops to protect 3% of the current gain.

- **Short U.S. 10-Year Government Bonds:** Bond yields have surged since mid-September benefiting our short position (up 4%). While macro forces should keep the underlying trend in bond yields pointed up, a consolidation phase is possible. In turn, we recommend staying short but tightening stops to protect 3% of the current gain.

While macro forces should keep the underlying trend in bond yields pointed up, a consolidation phase is possible

- **NEW POSITION:** Short U.S. Move 1-Month Bond Volatility Index: There has been a material decrease in bond market volatility (albeit from very high levels) over the past couple of days, as the bond market digests the recent spike in yields. In turn, the stop-short on our short U.S. MOVE 1-Month Bond Volatility Index was triggered (up 19%) and will set the exit point to protect 10% of the current gains. To be clear, we

[9] **MRB**: "***U.S. Dollar: Risks Are Skewed To The Downside***", July 30, 2024

expect bond volatility to remain more elevated than in the 2010s, given the new economic and political environment that will require bond investors to adjust their expectations to an era of more elevated inflation, a higher neutral Fed funds rate, and much larger government debt. Until this capitulation process has been completed, bond volatility is likely to remain elevated. Nonetheless, there will be periodic tactical opportunities to trade the extremes in bond volatility Note that if stopped out of our current position, will continue the strategy of setting a 5-point trailing stop-short to capture any future declines. Conversely, if the MOVE index were to decline substantially, we would consider taking the opposite bet. Stay tuned.

This Week's Research

Watch Now

U.S. Post-Election Discussion: Q & A With MRB

MRB strategists Phillip Colmar, Peter Perkins and Salvatore Ruscitti hosted a live webinar on Wednesday that addressed investor questions about the U.S. election results and implications for capital markets and investment strategy.

Key issues addressed included:

- What does Trump's win and a unified Republican government imply for the U.S. economy and capital markets?
- Is there a risk that Trump will interfere with Fed policy?
- Initial market reaction was higher stocks and higher bond yields. Will those persist?
- Which areas of the U.S. equity market are potential underappreciated beneficiaries of the election outcome?
- What are the implications for non-U.S. economies and markets?

Access MRB's research on the implications of the U.S. election on the economy and investment strategy here: "U.S. Election 2024"

Euro Area Economy: Under Pressure, But More Resilient Than Perceived

Aggregate euro area economic activity has been held back by a sick and stagnating German economy. However, four southern euro area countries (SEU-4, which includes Greece, Italy, Portugal and Spain), which together have roughly the same economic importance as Germany, are enjoying a much more vibrant expansion of nearly 5% real GDP growth. France's economy is in between and currently sluggish, largely due to a household sector that is reluctant to spend.

ECB policy cannot simultaneously satisfy the different needs of all member nations

Yesterday's report added to this theme by focusing on the ***structural*** outlook for the euro area. Key highlights included:

- The rigidities of a unified currency and single central bank within the euro area means that ECB policy cannot simultaneously satisfy the different needs of all member nations. This causes economic divergences in every cycle, which can persist until they become secular trends and result in significant imbalances, and eventually trigger a crisis.

Chart 14 **Euro Area: France Holds The Key To Unlock Growth**

* Truncated at 10 and -10; source: National Source
** GDP-weighted aggregate of Germany, Greece, Italy, Portugal and Spain
Note: Shaded for Center for Economic Policy Research-designated euro area recessions

- It is encouraging that the ***cyclically*** vulnerable parts of the region from the last decade are now those that have the strongest ***structural*** supports. This provides a long runway before structural forces will again dominate over cyclical dynamics. It also provides more stability for the regional economy and a substantial firewall to fend off recessionary forces.

Deleveraging has now tapered off, and the SEU-4 economies are experiencing a more vibrant cyclical economic expansion

- Many of the southern euro area members' economies faced stiff household deleveraging last decade, which was painful but eventually reduced structural imbalances. Deleveraging has now tapered off, and these economies are experiencing a more vibrant cyclical economic expansion, supported by consumer spending.

- Germany has the current weakest cyclical growth backdrop in the region due to drags from its large manufacturing sector that is struggling with a lack of global competitiveness and a weak overall demand backdrop. However, Germany has among the strongest structural foundations in terms of household and government sector balance sheets, and has accumulated the greatest amount of household excess savings since the pandemic, which mutes contractionary forces.

The French consumer sector (rather than German manufacturing) will be key to tilting the entire euro area economic growth profile

- France has comparatively high household and government sector debt levels relative to GDP (thereby increasing its longer-term vulnerabilities). However, households in France also have underspent since the pandemic, providing some cyclical firepower. France's economic expansion is also broadly in line with the aggregate euro area, making this member nation and its consumer sector (rather than German manufacturing) the key in tilting the entire regional economic growth profile (**chart 14**, previous page).

- On balance, as the ECB tries to shore up activity in the currently sick German economy, it should provide a boost for France (and the healthy economies). Better growth in France would meaningfully improve the growth prospects for the aggregate euro area.

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