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"ELEVATED POLITICAL, GEOPOLITICAL AND ECONOMIC POLICY-RELATED UNCERTAINTY ACTS AS AN ECONOMIC HEADWIND. THERE IS A CLEAR URGENCY OF CREATING A PREDICTABLE POLICY ENVIRONMENT."

ECONOMIC RESEARCH

BNP PARIBAS

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world

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INTRINSIC INSTABILITY

The global economy faces a long list of uncertainties -growth, inflation, interest rates, political, geopolitical, tariffs, etc. When uncertainty is exceptionally high, as is the case today, the economic environment becomes intrinsically unstable and may evolve suddenly and drastically. This acts as an economic headwind because companies that are highly exposed to these sources of uncertainty may postpone investment and hiring decisions. This may weigh on household confidence, triggering a reduction in discretionary spending. Financial markets may also become more volatile because investors shorten their investment horizon. There is a clear urgency of creating a predictable policy environment.

When discussing the inevitable uncertainties of the economic outlook, central bankers or economic commentators in general, often refer to the balance of risks. ECB President Christine Lagarde stated in her press conference in December that risks to growth remain tilted to the downside.[1] In the US, Fed Chair Jerome Powell recently commented that the FOMC sees the risks to achieving its employment and inflation goals as being roughly in balance.[2] These statements are useful but they only tell us something about the risks that would tip the balance in one or another direction or that would keep each other in check. They do not convey information about a more fundamental question, which is the degree of uncertainty. Is it higher or lower than normal? At the current juncture, we can safely say that it is exceptionally high. The list of uncertainties is long: will the euro area see stagnation rather than subdued growth? Will inflation reaccelerate in the US due to measures taken by the Trump administration (tariffs, deportation of illegal immigrants, tax cuts)? Will the Fed hike rates this year instead of cutting them? Will US import tariffs be raised across the board or only on a selective basis? How will geopolitics influence the economic and market outlook? Will Wall Street continue to ignore the rise in Treasury yields?

Uncertainty is challenging because it forces us to take decisions without having all the relevant information. When uncertainty is abnormally high, the decision challenge increases exponentially. To illustrate this point, let us assume that economic growth depends on the level of inflation, long-term interest rates and the exchange rate. Suppose that when uncertainty is at a normal level, three outcomes can be considered for each variable. For growth, this implies that 27 (3^3) outcomes are possible, depending on the specific combinations of inflation/bond yields/the exchange rate. When uncertainty is higher than normal for each variable, the range of outcomes is wider. Suppose we now need to distinguish between five possible cases. That would imply that 125 (5^3) growth outcomes are possible. Admittedly, some or even many can be excluded (e.g. when inflation surprises to the upside, it is unlikely that bond yields would surprise to the downside). However, the feedback loops between the different variables mean that coming to grips with all the interconnections soon becomes excessively complex.

With this in mind, it is appropriate to label the current global economic environment as intrinsically unstable. To a large degree this is due to political, geopolitical and economic policy uncertainty.[3] An obvious example is the prospect of import tariff increases in the US and the retaliatory measures that other countries would take, which significantly increase the uncertainty that surrounds inflation and growth forecasts. Intrinsic instability does not imply that bad outcomes are inevitable. It simple reflects a situation that may evolve suddenly and change drastically. This uncertainty acts as an economic headwind because companies may postpone decisions that are irreversible -think of major investment projects-, preferring to wait until a clearer picture emerges. However, such caution comes with a cost because postponing a project means that the contribution to a company's profits will be missed -the opportunity cost of waiting- and there is also a risk of losing ground vis-à-vis competitors if the latter have implemented their investment plans. Clearly, the exposure to the source of uncertainty matters and in case of import tariffs, export-oriented companies will react differently than companies focusing on the domestic market. Geopolitical uncertainty also matters and empirical research shows it has a detrimental impact on US companies.[4] During periods of high macroeconomic uncertainty -which clearly is a broader concept than geopolitical uncertainty- US and European firms reduce hiring.[5] [6] Concerns about a worsening labour market and the risk of job loss may in turn weigh on household confidence and spending on a broad range of items such as health care, personal care products and services, recreation, holiday packages and luxury products.[7] Finally, in financial markets, investors may adopt a shorter investment horizon and show increased sensitivity to data surprises, implying an increase in volatility, which in turn also comes with an economic cost. To conclude, one couldn't agree more with the European Commission who, in a recent analysis of the consequences of uncertainty, stated that "ensuring a predictable policy environment and avoiding costly policy reversals are essential to foster a climate conducive to consumption and especially investment, ultimately enhancing the growth potential."[8]

William De Vijlder

Economic Adviser to General Management

1 Source: ECB, Press conference, Christine Lagarde, President of the ECB, Luis de Guindos, Vice-President of the ECB, Frankfurt am Main, 12 December 2024.
2 Source: Federal Reserve, Transcript of Chair Powell's Press Conference, 18 December 2024.
3 Christine Lagarde speaks about self-inflicted uncertainty: "*Uncertainty about the actual political evolution, depending on elections, appointments or whatever, in several member states. That is self-inflicted uncertainty that we have nothing to do with, but which is caused by the current political situations. Things will, again, probably come to resolution, and we will see better the economic consequences of those decisions.*" Source: see footnote 1.
4 Source: Dario Caldara and Matteo Iacoviello, Measuring Geopolitical Risk, American Economic Review 2022, 112(4): 1194–1225. For a broader overview, see: William De Vijlder, Global economy: the economic consequences of geopolitical uncertainty, BNP Paribas, Ecoweek, 30 October 2023.
5 Source: Uncertainty and Labor Market Fluctuations, Soojin Jo and Justin J. Lee, Federal Reserve Bank of Dallas working paper 1904, 2 July 2019.
6 Uncertainty and firms' labour decisions. Evidence from European countries, Marta Martínez-Matute & Alberto Urtasun, Journal of Applied Economics, 2022, pp. 220-241.
7 Source: The effect of macroeconomic uncertainty on household spending, Olivier Coibion, Dimitris Georgarakos, Yuriy Gorodnichenko, Geoff Kenny, Michael Weber, IZA – Institute of Labor Economics, discussion paper 14213, March 2021."
8 European Commission, The cost of uncertainty – new estimates, European Economic Forecast, Autumn 2024.

ECONEWS

Find our scenario and forecasts

EUROZONE

Rising inflation in December and drop in economic sentiment. According to Eurostat's preliminary flash estimate, harmonised inflation rose from 2.2% to 2.4% y/y in December, driven up by services (from 3.9% to 4.0%) and the exit from energy price deflation (from -2.0% to 0.0%). At the same time, household inflation expectations rose in November, both one-year expectations (0.1 pp to 2.6%) and three-year expectations (+0.3 pp to 2.4%). The European Commission Economic Sentiment Indicator (ESI) fell in December to its lowest level in five years. The unemployment rate in the eurozone remained more or less stable in November, standing at 6.3%, but the outlook for household unemployment is rising.

FRANCE

Household confidence contracted again in December from 90 to 89, after already losing 5 points in the previous two months, driven by prospects for growth of unemployment. Close to its historical average in October, this balance of opinion has gained 20 points in two months. As a result, households are more negative about the prospects for changes in living standards, which is expected to penalise consumption. Nevertheless, the proportion of respondents planning to buy a property within two years has risen (9.5% in December compared to 7% in June), and transactions are already on the up (+20% y/y in Q4 for the Century21 network).

ITALY

Deterioration. The European Commission ESI plunged in December (to 98.2, the lowest level since November 2023), driven down by the deterioration in industrial activity. Confidence in this sector has fallen back to its lowest level since November 2020, penalised by the deterioration in hiring expectations for the months ahead (-2.7). Although it had improved over the past three months, consumer confidence has fallen (-15.6, but above average since the beginning of 2023), due to the sharp rise in unemployment expectations (at their highest level for 2 years).

UNITED STATES

Vigorous activity and downward revision of monetary easing expectations. December's ISM Non-Manufacturing Index surprised on the positive side by gaining 2.0 pp to 54.1. The Business Activity sub-component is at a particularly high level at 58.2 (+4.7 pp). It should also be noted that the input price index jumped to 64.4 (+6.2 pp), the highest since February 2023. **A positive surprise also seen in terms of the creation of non-agricultural salaried jobs**, which reached the highest level since March at +256k compared to a consensus of +135k. At the same time, the unemployment rate fell -0.1 pp to 4.1%, and wage growth slowed both in monthly terms (+0.3%) and in annual terms (+3.9%). Nevertheless, employment is still falling in goods production, by more than 80k over 2024. The University of Michigan preliminary survey reports a **drop in the consumer sentiment index** in January (-0.8 pt, to 73.2), ending 5 months of progress. In particular, inflation expectations rose to +3.3% over a 1-year and 5-10-year horizon, a record not seen since 2008 in the latter instance. The minutes of the December FOMC meeting and the more recent communications from its members confirm that the Fed now considers it necessary to proceed cautiously with its monetary easing.

BOND MARKETS

Strong rise in yields driven by the United States and affecting the United Kingdom in particular. Yields required by investors to buy 10- and 30-year US and UK bonds hit highs not seen for several decades last week, as growth expectations in the US were revised upwards and the Fed's policy easing tapered. European interest rates and spreads were also driven up, pushing France above 80 points once again.

ERMERGING COUNTRIES

Significant slowdown in industrial activity. In December 2024, around 2/3 of manufacturing PMI indices fell compared to the previous month. The index is below 50 for half of the countries. The deterioration reflects much more the downturn in domestic demand than in export orders.

Brazil: Capital flight. Preliminary data from the Brazilian Central Bank (BCB) show that net sales of financial assets by non-residents (including portfolio investments, direct investments, derivatives and other investments) totalled almost USD 29 billion in December 2024, helping to explain the large currency pressures over the past several weeks. This marks the largest monthly net outflow since 1982. Another historic milestone - oil became the country's main export item in 2024.

China: Pessimism on the financial markets fuelled by concerns about economic growth. The stock market correction has continued since the beginning of the year; yields on Treasury bonds are at historically low levels (10-year rates: 1.63% on average since 1st January), and pressure on the yuan has intensified. These movements reflect market concerns about low inflation (CPI: +0.1% y/y in December) and growth prospects. Since 6 January, the USD/RMB spot exchange rate has remained at 7.33, sticking to the upper limit of the permitted fluctuation band.

COMMODITIES

Oil prices continued to rise this week against the backdrop of pressure on crude supply. Some Asian operators are limiting their oil imports from Iran, anticipating a tightening of US sanctions on Iranian crude exports. This has led to an increase in total barrels exported to Asia by some Gulf countries. In addition, better compliance by OPEC+ members with production quotas is putting more pressure on crude supply. Also, the United States has significantly tightened its sanctions on the Russian oil sector, potentially affecting 1/3 of Russian oil exported by sea. Conversely, in Europe, the absence of pressure on gas supply, despite the end of Russian exports via Ukraine, has meant the European TTF benchmark has fallen by more than 10% this week.

MARKETS OVERVIEW

Bond Markets

Bond Markets	in %	in bps			
	10-janv.-25	1-Week	1-Month	Year to date	1-Year
Bund 2Y	2.30	+11.7	+30.2	+23.5	-62.3
Bund 5Y	2.34	+14.3	+40.7	+22.4	+17.0
Bund 10Y	2.57	+14.1	+45.1	+20.4	+35.5
OAT 10Y	3.34	+12.2	+53.0	+21.3	+68.6
BTP 10Y	3.66	+16.9	+56.5	+23.6	-3.2
BONO 10Y	3.22	+15.3	+49.9	+20.3	+8.9
Treasuries 2Y	4.38	+10.1	+20.3	+13.3	-4.9
Treasuries 5Y	4.59	+17.1	+47.0	+20.3	+60.2
Treasuries 10Y	4.77	+16.8	+54.0	+19.4	+72.7
Gilt 2Y	4.30	+10.9	+21.4	+15.1	+6.7
Treasuries 5Y	4.56	+17.0	+39.6	+21.0	+91.4
Gilt 10Y	4.84	+24.6	51.5	+26.7	+93.3

Currencies & Commodities

Currencies & Commodities	Level	Change, %			
	10-janv.-25	1-Week	1-Month	Year to date	1-Year
EUR/USD	1.02	-0.4	-2.4	-1.0	-6.5
GBP/USD	1.22	-1.4	-4.0	-2.4	-4.0
USD/JPY	157.58	+0.1	+3.6	+0.3	+8.2
DXY	111.99	+7.9	+11.5	+10.5	+6.1
EUR/GBP	0.84	+1.0	+1.6	+1.4	-2.7
EUR/CHF	0.94	+0.2	+1.3	+0.1	+0.6
EUR/JPY	161.51	-0.3	+1.1	-0.8	+1.1
Oil, Brent ($/bbl)	78.85	+3.3	+8.6	+5.5	+1.8
Gold ($/ounce)	2692	+1.8	+0.1	+2.5	+32.8

Equity Indicies

Equity Indicies					
World					
MSCI World ($)	3678	-1.6	-3.6	-0.8	+16.3
North America					
S&P500	5827	-1.9	-3.4	-0.9	+21.8
Dow Jones	41938	-1.9	-5.2	-1.4	+11.3
Nasdaq composite	19162	-2.3	-2.7	-0.8	+28.0
Europe					
CAC 40	7431	+2.0	+0.5	+0.7	+0.1
DAX 30	20215	+1.6	-0.6	+1.5	+21.1
EuroStoxx50	4977	+2.2	+0.5	+1.7	+11.4
FTSE100	8248	+0.3	-0.4	+0.9	+7.8
Asia					
MSCI, loc.	1410	-1.7	-1.4	-1.6	+11.5
Nikkei	39190	-1.8	-0.5	-1.8	+13.8
Emerging					
MSCI Emerging ($)	1057	-1.5	-4.9	-1.8	+6.9
China	60	-4.4	-8.3	-6.4	+15.0
India	1000	-3.8	-7.2	-2.8	+8.0
Brazil	1181	+0.7	-9.5	+0.3	-32.4

Performance by sector

Eurostoxx600

Year 2025 to 10-1, €

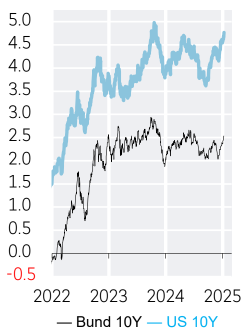
+4.4%	Oil & Gas
+2.3%	Health
+2.3%	Technology
+1.3%	Banks
+1.2%	Industry
+0.8%	Index
+0.5%	Commodities
+0.2%	Telecoms
-0.1%	Media
-0.3%	Consumption Goods
-0.4%	Automobiles
-0.6%	Insurance
-1.3%	Construction
-1.9%	Chemical
-2.0%	Food industry
-2.4%	Utilities
-2.9%	Travel & leisure
-3.6%	Real Estate
-3.8%	Retail

S&P500

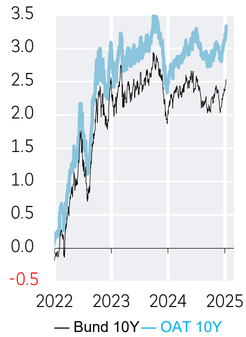
Year 2025 to 10-1, $

+2.9%	Energy
+2.5%	Healthcare
+2.2%	Retail
+1.3%	Media
+0.8%	Pharmaceuticals
+0.5%	Semiconductors
+0.2%	Bank
-0.1%	Consumer Discretionary
-0.2%	Utilities
-0.4%	Commercial & Pro. Services
-0.7%	Capital Goods
-0.9%	Index
-1.0%	Materials
-2.5%	Automobiles
-2.8%	Insurance
-3.2%	Consumer Services
-4.2%	Tech. Hardware & Equip.
-4.3%	Real Estate
-4.6%	Food, Beverage & Tobacco
-4.9%	Telecoms

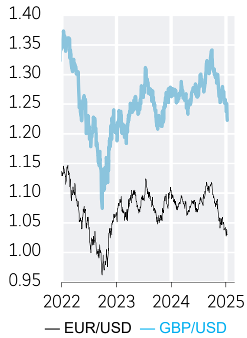
Bund 10Y vs US Treas. 10Y



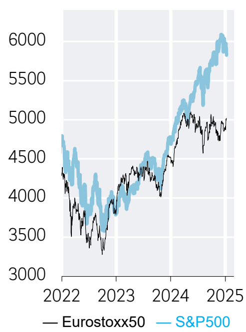
Bund 10Y vs OAT 10Y



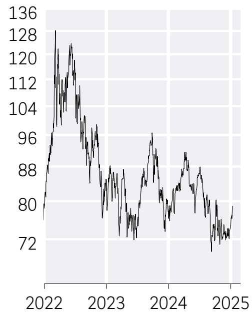
EUR/USD vs GBP/USD



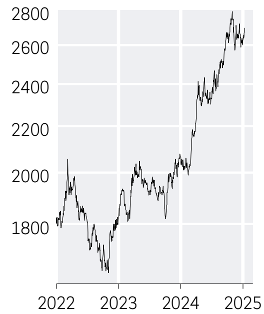
EUROSTOXX 50 vs S&P500



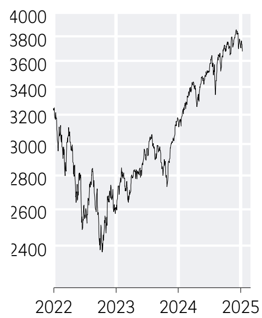
Oil, Brent ($/bbl)



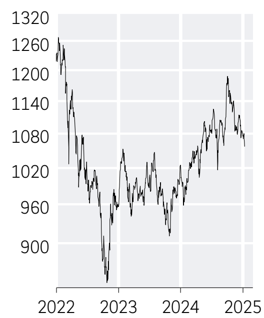
Gold ($/ounce)



MSCI World ($)



MSCI Emerging ($)



SOURCE: LSEG, BLOOMBERG, BNP PARIBAS

FURTHER READING

Has households' purchasing power returned to its pre-inflation level?	Chart of the Week	8 January 2025
Happy new year?	EcoWeek	7 January 2025
Is extending loan maturities an effective way to improve access to home ownership?	Chart of the Week	23 December 2024
Bank of England: no change, but more fears about economic activity	EcoBrief	20 December 2024
United States | FOMC: End of the cutting cycle?	EcoBrief	19 December 2024
FED-ECB: 2025, the great decoupling?	EcoTV	19 December 2024
How different will 2025 be from 2024?	EcoPerspectives	18 December 2024
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Bi-annual Conference | The economic consequences of Donald Trump's return	Special Edition	18 December 2024
How different will 2025 be from 2024? | Also in EcoPerspectives this week	EcoWeek	17 December 2024
Customs duties, how effective?	EcoTV	13 December 2024
Eurozone: The ECB's gradualist approach	EcoBrief	13 December 2024
French Economy Pocket Atlas - December 2024	French Economy Pocket Atlas	13 December 2024
Private debt in emerging countries: averages are misleading	EcoWeek	9 December 2024
The eurozone is exporting its savings. But is it investing them advantageously?	Chart of the Week	9 December 2024
To fragment or not to fragment (the global economy), that is the question	EcoWeek	2 December 2024
November 2024 issue	EcoPulse	29 November 2024
Inflation Tracker - November 2024 | Service prices are holding up	EcoCharts	28 November 2024
The COP29 in Baku: neither a game changer, nor a dead end	Chart of the Week	28 November 2024
Endgame for "Basel 3 Endgame" in the US?	EcoTV	28 November 2024

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