Snowballing Away

- Weighing Iran's options, in the short and long term.
- In terms of fiscal sustainability, the US Senate efforts may not move the dial much on the "One Big Beautiful Bill" (OBBB).
- We look at the Swiss experience to explore the FX/deflation nexus.

The crisis in the Middle East has escalated further, with the direct involvement of the US. In the short run, the market reaction will be driven by the magnitude of Tehran's response. There is no palatable option for massive retaliation, and a rational calculation, on balance, would conclude to a limited reaction by Iran. Yet, the odds for the medium to long-term scenarios are much more widely distributed. Following Ilan Goldenberg's analysis in Foreign Affairs, Tehran can consider that the cost/benefit balance of the nuclear programme has changed and that it is time for a policy re-set entailing full cooperation with international institutions and détente with Israel and the US. In his pessimistic scenario though, the hardliners would win the argument and calculate that continuing the programme is the best chance of preserving the regime. This would likely force a lasting involvement of the US, i.e. a further break from D. Trump's isolationist preferences.

The first indications from the market on Sunday night pointed to some moderate strengthening of the dollar. We will want to see beyond the "knee-jerk" reaction and see if the pattern from last week – when US assets did not benefit from the usual "flight to safe haven" behaviour – holds. This could partly be the result of the market concerns about the US overall policy stance. The Senate has moderated the House's plans on some aspects – crucially on Section 899 – but it is far from clear at this stage if the final bill will differ much from the initial version in terms of fiscal sustainability.

Crossing the Atlantic, we explore Swiss monetary policy. A key point there, in our view, is that the resilience of exports to currency appreciation – a key Swiss asset – cannot justify benign neglect on FX issues, since even strong economies cannot shrug off deflation. The Euro area cannot even necessarily count on such export resilience. Actually, "real time data" based on seaports activity points to weak exports in Q2 already.

Extension and escalation

In the short-run, the magnitude of the market reaction to the US strike on Iran's nuclear facilities – which may not be over since the result on the ground still needs to be assessed – will depend on the extent to which Iran will retaliate. **In a rational calculation, Tehran should err on the side of caution**. The country's isolation on the international stage is plain to see, and hitting US military bases in the Middle East forcefully would probably trigger an even more forceful military reaction by the US, with potentially destabilising consequences for the regime. We continue to think that closing the Strait of Hormuz would be counter-productive for Iran: beyond the military response it would elicit, it would drastically reduce the country's financial capacity and would strain the relationship with China which heavily relies on Gulf oil.

Tehran could opt for the approach it had followed 5 years ago. On 3 January 2020, a US drone attack killed a key Iranian military leader in Iraq. In retaliation, Iran launched a limited missile strike on US bases in Iraq on 8 January. The attacks did not result in any US fatalities, the US did not respond back, and the Iranian leadership made it plain that it would not escalate further. Of course, this time the US hit the Iranian territory, and losing – or slowing down – the nuclear programme is a much bigger loss to Tehran than a single general, and the temptation to upgrade the response will likely be intense. But again, this is not what a rational calculation should conclude, and JD Vance's statement on Sunday suggesting that Washington had no strategic goal towards Iran beyond stopping the nuclear programme, should tilt the balance towards a moderate response in the short run. An issue of course is that even a limited Iranian counterstrike could result in larger US fatalities than the Iranian regime would expect – there is no perfect calibration in these matters – triggering strong US retaliation.

The latter point was made by Ilan Goldenberg (former special advisor on the Middle East to Kamala Harris and former Iran Team Chief at the Department of Defence) in an article in Foreign Affairs on Sunday. We were impressed by his very lucid comments on the Iranian crisis in other media in the run-up to the US involvement, and his views on the medium to long-term consequences of D. Trump's decision in the Foreign Affairs' piece are illuminating. Taking the risk of simplifying his very nuanced analysis, **two options would emerge for the Iranian leadership.**

In the **optimistic one**, Iranian policy circles would come to the conclusion that the cost/benefit trade-off of the nuclear programme has changed, and that dismantling it – with outside verification – would free up scarce resources for other domestic endeavours (at a time of internal social tension). Such process could however take time, and in any case, it could be difficult for Iran to come back swiftly to the negotiation table without losing face. Patience on all sides would be needed.

In the **pessimistic one** – for instance if the most extreme wing of the regime wins the argument – Iran would consider that continuing the programme – which would entail refusing any external oversight – is the best chance of preserving the regime, calculating that D. Trump, given his non-interventionist inclinations, will not commit to the kind of direct involvement on the ground which may be needed to completely eliminate the Iranian threat. Goldenberg likens this to the situation in Iraq after the first Gulf War, when Saddam Hussein's regime was allowed to survive after its defeat in Kuwait but forced the US into constant monitoring (and ultimately to the second Gulf War). We note that the regime may be tilted in this direction if they think that a defiant stance towards the US could be a unifying social force in the country, transcending public opinion's growing dissatisfaction with the current policy setup.

Ultimately**, what the US strike may reveal – once again – is that keeping military intervention limited in time and scope can be difficult.** A long-term involvement with Iran could be politically costly for the Trump's administration since it would dent its isolationist creed – even if for now there does not seem to be any dissent of note within the Republican caucus in Congress. From a purely macro-financial point of view, what we will monitor in the coming days is whether some "safe haven" behaviour favourable to the US dollar and US risk-free asset can be observed. The "knee jerk" reaction as of Sunday night pointed to some strengthening of the dollar, towards 1.1470 from a Friday close at 1.1522 (and another push to oil prices of 8%, same as after the first Israeli strikes) but we want to see how the market reacts over the next few days. Indeed, we were struck last week how, contrary to previous episodes of tension in the Middle East, US treasuries and the US dollar did not rally in any tangible manner after the first Israeli strikes on Iran. A replication later this week would suggest that the market remains very concerned with the US overall policy stance, notably on trade and fiscal matters. Beyond the effect of the generic, policy-driven "negative risk premium", it may also be that higher oil prices, affecting only marginally core inflation, but raising the probability of a slowdown in the US real economy later this year, could be interpreted by the market as raising the chances of a resumption of Fed cuts, weighing on the dollar. To close the loop, adverse market reactions in the US could influence D. Trump's approach to Iran should the crisis linger.

Will the Senate save the budget?

While the discussions continue in Congress on the fate of the "Big Beautiful Budget Bill", the Congressional Budget Office (CBO) has produced new estimates of its impact, confirming the early assessments by academic centres just after the release of the version of the bill voted by the House of Representatives: **even when taking on board higher tariff revenues, the bill would lift the deficit by USD2.4tn over the coming decade.** A key issue of course is the extent to which the tax cuts will lift GDP and help keep US public finances sustainable. The CBO's "dynamic estimate," taking on board the macroeconomic effects, concluded to an increase in the public debt ratio of 7.1 % of GDP over 10 years. While GDP would indeed grow faster than in the baseline by 0.5% per annum on average, the "snowballing effect" stemming from higher interest rates weighing on an already high stock of debt would more than offset the positive effect on tax receipts. **The US could become a classic case of "debt snowballing."**

Hopes are now pinned on the possibility that the Senate would amend the text in a more prudent direction, but the discussion there is not necessarily supportive of that view. The Republican caucus is walking a tightrope. One of the expensive additional tax cuts (i.e. those which go beyond the mere prolongation of the Tax Cuts and Jobs Act (TCJA) from 2017) was an extension of the exemption threshold for SALT (State and Local Taxes) from the federal income tax. This is a key ask from "marginal Republicans," i.e. Representatives from affluent districts in Democratic-led States where resident pay high state and municipal tax on which only 10K were exempt of federal tax. The House's version of the OBBB brought this limit to 40K. This was crucial to sealing the deal among Republican Representatives (the bill passed by only one vote of majority). According to the Penn-Wharton Budget Model, this would raise the federal deficit by USD330bn over 10 years. The version of OBBB currently discussed in the Senate's budget committee brings it back to 10K. However, going in the other direction in terms of net effect on the deficit, the Senate Republicans want to soften the blow to the Inflation Reduction Act (IRA) subsidies to green energy projects, for instance by prolonging the "grade period" for those which are in the pipeline but have not started yet.

The solutions found to rein the deficit trigger strong internal opposition. For instance, some Republicans want to cut more into the overall cost of Medicaid by curbing "provider tax," an arcane system which incentivizes states to tax healthcare providers, which attract additional subsidies by the federal government…which are then often redirected towards the same providers. Yet, some other Republicans fear that curbing the system would result in lower healthcare provision in their states. All in all, it is not obvious at all that the version of the OBBB which will come back from the Senate – and will still need to be "reconciled" with the House's – would send the US deficit on a different trajectory than what the CBO projects.

There is however one area of the OBBB on which the Senate Republicans have pushed clearly in one direction, with a potentially significant impact on preserving the attractiveness of the US financial market: a **moderation of "Section 899"** which introduces a withholding tax on financial income generated in the US accruing to residents of countries which "treat US companies unfairly" according to the US administration. In a nutshell, the Senate has capped the tax to 15% – from 20% in the House's version – and delayed its enforcement to 2027, while making it explicit that "portfolio interests" (e.g. interests paid on US Treasury bonds held by overseas institutional investors) would be exempt. Also, crucially, it has removed the existence of a Digital Service Tax from the list of "unfair practices" which would automatically trigger the withholding tax. This essentially leaves the UTPR (Undertaxed Profits Rule) under the Organisation for Economic Co-operation and Development (OECD)'s pillar 2 framework (aiming at ensuring businesses operating across borders pay a minimum level of corporate tax) as the main trigger. This new setup of Section 899 would more easily open the door to negotiations with partners focusing on how UTPR would apply on US firms. This is an immensely technical issue and, of course, the final write-up of the Section in the OBBB will need to be carefully monitored.

Fed is in even less of a hurry to cut

While we are still waiting for definitive answers on fiscal policy, the general stance of monetary policy is relatively clear. **The reduction in uncertainty on tariffs – acknowledged by Jay Powell several times in the Q&A of last week's press conference, by which he probably means that the most extreme scenarios are now off the table – is not making the Federal Open Market Committee (FOMC) keener on resuming cuts quickly**. Quite the opposite: the dot plot shows more members supporting no cut at all this year, and the median Federal Reserve (Fed) Funds projection was revised up for 2026 and 2027. "Team transitory" still appears to be a relatively small minority at the committee.

There were only minor changes to the policy statement as the Fed, as widely expected, kept its rates unchanged. The central bank wants to remain data dependent, but the general message continues to be that the FOMC is in no hurry to resume cutting. We find the general message from the new forecast is hawkish on balance, even if the short-term trajectory for policy is (apparently) unchanged.

The FOMC's median forecast for GDP was revised down for 2025 and 2026. The change for this year, from 1.7% in March to 1.4% can be partly explained by the carry-over effect from the (artificially) negative print for Q1, **but GDP growth is now projected slightly below trend growth next year, at 1.6%, against 1.8% in March. Yet, this slower economy – itself probably triggered by the tariff-induced price shock – would not fully take care of inflationary pressure**: the forecast for core Personal Consumption Expenditures (PCE) was revised up from 2.2% to 2.4% in 2026 and, crucially, the FOMC is not sure it can be brought completely back to target in 2027, hitting 2.1% at the end of the horizon, from 2.0% in March. While the FOMC's median projection for Fed Funds has not changed for this year (2 cuts), we mentioned last week when previewing the Fed meeting that it is more 2026 and 2027 which would be of interest in this batch of forecasts. There, the message is hawkish: the median projection for Fed Funds was revised up for next year, with only 30 basis points (bps) worth of cuts against 50 in the March batch, and 20bps in 2027 against 30 in March. We find it striking that in the last year of the forecasting horizon, Fed Funds would remain 40bps about the committee's estimate for the long-run level (3.0%). In other words, **the FOMC does not seem to contemplate the need to bring the policy stance into accommodative territory, even quite late after the tariff shock.**

In terms of distribution of opinions within the FOMC, it seems that "team transitory" – those, such as Governor Christopher Waller, arguing that it is more likely than not that the tariffs won't trigger a persistent inflation drift – are still a relatively small minority: only 5 members see Fed Funds below 3% in 2027, unchanged from March. Conversely, the group in favour of maintaining a wait-and-see attitude for long, not planning to cut at all in 2025, is getting stronger (7 members in June against 4 in March).

Of course, Jay Powell in the Q&A made it plain that those projections and rate paths should be taken with precaution given the still elevated level of uncertainty – although the Fed now sees that uncertainty on the magnitude of tariffs is past its peak. Yet, the analysis of the US economy he has offered was very much skewed, in our opinion, towards elevated concern over the looming inflation shock. He acknowledged that so far, aggregate consumer prices do not indicate much pass-through from tariffs, but he also indicated that this was likely the result of precautionary behaviour by producers and retailers, and the central bank is definitely bracing itself for the shock to materialise in the coming months.

On the transitory versus persistence issue, Jay Powell did not take sides – and acknowledged a diversity of views within the FOMC – but also made it plain that the Fed would need to form its opinion cautiously. In the meantime, the Fed is still "in a good position" to wait, with the monetary stance "modestly restrictive" in his qualification.

The September meeting will be key, as Jay Powell mentioned that they are expecting to get more clarity on the tariff pass-through within the summer. Two cuts by year-end – remaining the FOMC's, and the market's baseline (46bps priced in, without much change as Jay Powell was talking – is still probably the likeliest path, but a proper softening in the economy will need to materialise in the second half of the year to get us there. The Fed is still clearly not in a pre-emptive mood. A key quote from J. Powell was that "*the labour market is not crying out for a rate cut*."

Swiss pain

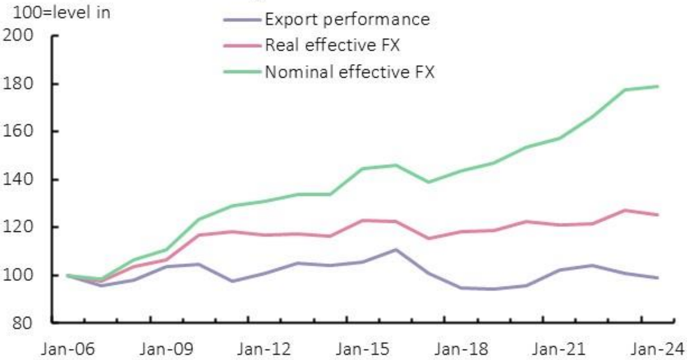
On the other side of the spectrum, monetary accommodation remains firmly on the menu, with the central bank of Norway and the Swiss National Bank (SNB) cutting rates last week. We focus here on the SNB, given the high risk that it has to move into "unconventional territory" again, in clear, bringing its policy rate in negative territory (from 0% as of last week) and/or engage in large scale FX intervention.

The SNB's statement routinely mentions the possibility to resort to exchange market intervention (*"we remain willing to be active in the foreign exchange market as necessary"*) but the SNB leadership also openly discussed the possibility that the policy rate may have to turn negative, choosing a balance approach: recalling how negative rates had been *"an important instrument for ensuring price stability between 2015 and 2022 (…) in an exceptional phase",* but also making it plain that they "*are also aware that negative interest can have undesirable side-effects and presents challenges for many economic agents."* We note that under the specificities of the Swiss monetary policy framework, some Swiss banks will already de facto have to shoulder a negative interest rate on their holdings at the central bank: indeed, once sight deposit exceed 18 times their minimum reserve requirement, banks are "remunerated" at 25bps below the policy rate, which means – 25bps under the new stance.

The SNB's language last week suggests that the decision of effectively bringing the policy rate below zero would not be taken lightly, but **the central bank's outlook is only one relatively small shock away from outright deflation** (while the May print was already negative in yoy terms). Indeed, even at the end of the bank's forecasting horizon (Q1 2028), and assuming the policy rate remains at zero, inflation would reach only 0.7%.

Exhibit 1 – Resilient export despite CHF appreciation…

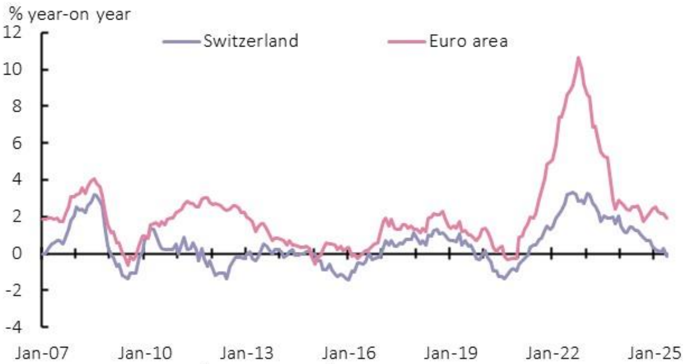
Swiss exports and exchange rates



Source: OECD, Bruegel and AXA IM Research, June 2025

Exhibit 2 – …with strong contribution from inflation gap

Headline CPI in the Euro area and Switzerland



Source: SNB, Eurostat and AXA IM Research, June 2025

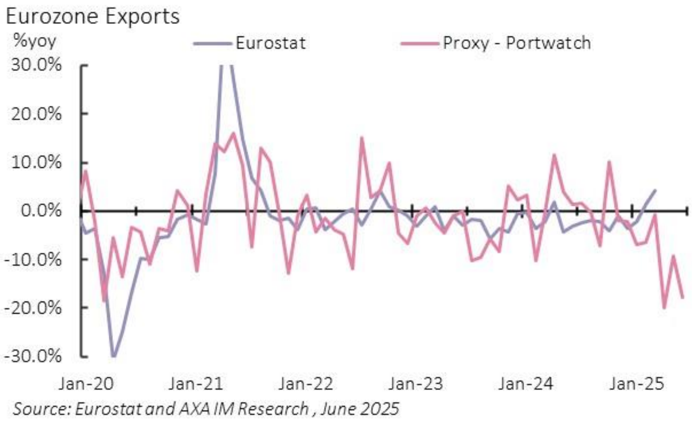
One aspect of the "Swiss miracle" is the country's capacity to maintain strong exports despite the appreciation of the currency. In Exhibit 1, "export performance" is the ratio (calculated by the OECD) between the volume of exports of goods and services and the world demand specifically addressed to the country (so that a rising ratio means exporters are gaining market shares). Over the last 20 years, the Swiss franc has appreciated by 80%, although the Swiss export performance has remained stable. This is routinely ascribed to the low price-sensitiveness of a lot of Swiss exports (for instance pharmaceuticals). This undoubtedly plays a part, but what has also been crucial is the fact that Swiss inflation has on trend been significantly lower than in most of its trade partners: the *real* effective exchange rate has appreciated by only 20% since 2025 and has been almost stable for the last 15 years. We can illustrate this in Exhibit 2, looking at the inflation gap between the Euro area and Switzerland. This inflation gap is itself – in part – a result of the currency appreciation, which strongly contributes to keeping prices low in the small, open economy that Switzerland is.

The limit of this mechanism though is that the country is constantly at risk of falling into proper deflation, and even a strong economy cannot shrug off deflation, if only because of the adverse effect it has on the real burden of debt – mortgage debt for instance for households. In other words, the strength of the Swiss export market does not mean the country can engage in "benign neglect" when it comes to its currency.

European pain

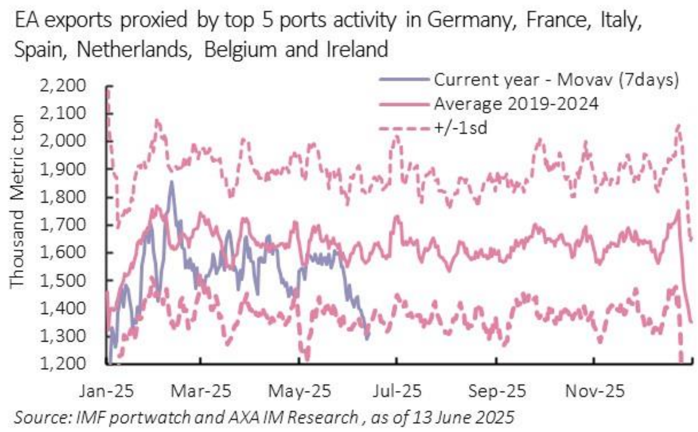
While some key aspects differ – size and openness for instance – we think there is some food for thought for the European Central Bank (ECB) in the current Swiss predicament. Assuming oil prices do not rise further as a result of a long-lasting Iran crisis, the risk of undershooting the inflation target is not negligible in the Euro area. If the dollar fails to regain its safe-haven status, the appreciation of the euro will continue to weigh on European price dynamics, especially if Chinese exporters choose to focus more on this market in response to higher US tariffs. But the overall narrative could be even more sombre for the Euro area since the resilience of its exports is less assured. True, some countries and some sectors tend to enjoy low price sensitivity, but it is not true across the entirely of the European economy. **In the short term, we are concerned about a potential lack of momentum in Euro area exports.** Trade data often comes quite late, but Hugo le Damany in our team has been using activity data from the top 5 seaports in 7 Euro area countries to get an approximation of European trade until mid-June. There is of course quite a bit of volatility, and since we have only 6 years of data – with the disturbances triggered by COVID in the middle – estimating a seasonal adjustment is not possible. Yet, exhibit 3 suggests that this indicator tends to reflect relatively well the message from the "hard data". What we find disappointing is that those "real time exports" were not particularly strong in April and May – when normally the US would have been stockpiling to "beat the tariffs" while they were quite low in June, hitting one standard-deviation below the 2019-2024 average (see Exhibit 4).

Exhibit 3 – A decent proxy for "hard" export data



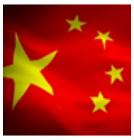
Source: Eurostat and AXA IM Research , June 2025

Exhibit 4 – Disappointing message recently



Source: IMF portwatch and AXA IM Research , as of 13 June 2025

If confirmed by hard data, this would suggest that external traction is currently weak for the Euro, while the impact of the combined shock of tariffs and currency appreciation will likely emerge more forcefully in the months ahead. This week, a flurry of surveys (PMIs, European Commission) will help to get a more accurate picture of the Euro area economy as it prepares for summer.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Fed fund target rate unch at 4.5% in June as expected, general tone is hawkish on balance. FOMC's median GDP forecast revised down for 2025 and 2026. Sept meeting will be key – we expect cutting to resume • Headline retail sales weakened to -0.9%mom from -0.1% in April • Industrial production softened to -0.2%mom in May from +0.1% • Housing starts lagged in May, annual number down to 1.26mn from 1.36mn • Philadelphia Fed mfg business outlook (Jun) disappointed, stayed unch at -4.0	• Both existing and new home sales in May expects minor softening • Conference board consumer confidence in June to stay stable • Q1 GDP final may see an upward revision to -0.2% saar, from -0.3% in the second estimate, yet stronger headwinds expected in H2 • PCE prices for May, expect to be unch at 0.1%; same for core PCE price • University of Michigan consumer sentiment final for June may see minor downward revision from 60.5
	• Final May HICP confirms headline at a weak 1.9%yoy, most recent update does not point to major deviation despite energy prices jump as partially compensated by stronger euro and still weak momentum in core inflation going forward	• Flash PMIs (Jun) after resilient mfg activity and surprising weaker svcs • To be confirmed with Ifo, INSEE flat signal last week and European Commission surveys (Jun) • Inflation (Jun) in Fr and Sp
	• CPI inflation (May) fell to 3.4% in May. But error in April means it was technically unch. Core fell to 3.5%, from 3.8%; services to 4.7%, from 5.4% • BOE rate decision: held rates but dovish vote split (6:3) and minutes • GfK cons. confidence (Jun) rose 2pts to -18 • Retail sales (May) plunged by 2.7%mom	• Final GDP (Q1) no reason to expect a material change • Flash PMIs (Jun) look for signs of ongoing weakness. Employment balance in spotlight • Various BoE speakers inc. Bailey and Ramsden
	• BoJ rate decision: held rates at 0.50%. Statement slightly dovish, but uncertainty was key message • Exports (May) down 1.7%yoy, from +2% in Apr. • CPI inflation (May) headline down 10bp at 3.5%. But core rose to a 2yr high of 3.7%, from 3.5%	• Flash PMIs (June) look for small rebound • BoJ Summary of Opinions. Look for any hawkish signals • Labour market (May) unemp rate to stay low • Tokyo CPI (Jun) look to see if core remains above 2%
	• Retail sales rebound to 6.4%yoy in May from 5.1%; industrial production edged down to 5.8% from 6.1% in the year, monthly change rose to 0.6% from 0.2% in April; fixed asset investment was sluggish, down to 2.7% from 3.5% on the year • House price for new home softened -0.22% in May from -0.12% on the month, while annual decline narrowed to -4.1% from -4.6% • LPR 1Y and 5Y unch at 3% and 3.5% respectively	• Industrial profit (May) to watch whether "price war" pressures on corporate profit • NBS mfg PMI (June) may rebound some as impact of tariff truce • NBS non-mfg PMI (June) watch for sign of softening as holiday impact fades
	• CB: Philippines (25bp cut to 5.5%), Indonesia (unch 5.5%), Chile (unch at 5%), Taiwan (unch at 2%), Turkey (unch at 46%), Brazil (25bp increase to 15%)	• CB: Czech Republic (unch at 3.5%), Thailand (unch at 1.75%), Hungary (unch at 6.5%), Colombia (unch at 9.25%), Mexico (50bp cut to 8%) • CPI (May): Malaysia • Industrial production (May): Taiwan

Upcoming events		
	US:	Mon: Mfg, Svc, composite 'flash' PMI (Jun), Existing home sales (May); Tue: Current account (Q1) S&P and FHFA house price index (Apr), Conference Board consumer confidence (Jun); Wed: New home sales (May); Thu: GDP (Q1), Core PCE index (Q1), Durable goods orders (May, p), Goods trade balance (May, p), Initial jobless claims (w/e 2 June), Pending home sales (May); Fri: PCE price index (May), Personal income (May) Michigan consumer sentiment and inflation expectations (Jun)
	Euro Area:	Mon: Fr, Ge, Ez mfg and svc 'flash' PMI (Jun), Ez composite PMI 'flash' (Jun); Tue: Ge IfO business climate index (Jun); Wed: Fr Insee consumer confidence (Jun), Sp GDP (Q1); Fri: Fr, Sp HICP (Jun), Consumer spending (May), It ISTAT business confidence (Jun), Ez industrial confidence (Jun)
	UK:	Mon: Mfg, Svc, composite 'flash' PMI (Jun); Thu: CBI Distributive trades survey (Jun); Fri: GDP (Q1), Business investment (Q1), Private consumption (Q1), Current account (Q1)
	Japan:	Mon: Mfg 'flash' PMI (Jun); Fri: Unemp (May)
	China:	Fri: IP (May), Current account (Q1)

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