



## Still waiting for the US cavalry

# 62 – 5 October 2020

### Key points

- As the US labour market is stalling, a new layer of fiscal stimulus is urgently needed. We are still waiting.
- In the Euro area deflationary risks are getting more material. Christine Lagarde's speech last week was dovish, very much in the Draghi tradition, but there was no "bridge" to current challenges hinting at imminent decisions. We expect PEPP to be extended in December.

The Payroll data for September confirmed that the recovery of the US labour market is stalling. The fact that employment failed to grow outside the hospitality sector suggests the difficulties go well beyond the direct impact of Covid-fighting restrictions. Labour income is also likely to stall and this is less and less offset by government transfers. The equity market rebounded last week on expectations of a deal between Democrats and Republicans in Congress on a new stimulus package which failed to materialize. The news of Donald Trump's illness, adding an extra layer of anxiety, may focus minds and negotiations are continuing, but the US economy is entering Q4 with little support. Beyond the immediate challenges, we explore the chances of accommodative fiscal policies after the elections. In our view a Biden victory would raise those odds, given a high probability for the Democrats to retain their majority in the House and the former VP's strong track record on reaching across the aisle to cut bi-partisan deals if the Republicans retain control of the Senate.

In the Euro area, focus is on deflation risks. The year-on-year change in consumer prices was negative in September for a second month in a row. There were some one-offs pushing prices down, but the trend is clear. Crucially, the balance of opinion on future price trends is now one standard deviation below its long-term average for households as well as for businesses. We are also concerned with the high preference for saving expressed in the confidence surveys. There could be a self-fulfilling mechanism settling in: precautionary saving, fuelled by a deteriorated labour market outlook, restricts consumption which depresses consumer prices further, in turn validating the preference for saving since it becomes rational to postpone spending.

In such an environment, the signals from central banks are crucial. Christine Lagarde last week shed some light on the ECB'S strategy review. We were reassured to see that Draghi's intellectual legacy lives on. All the central tenets of his macroeconomic approach were well defended in her speech. The "new Keynesian" conversion of the ECB is alive and well. However, what was lacking was a "bridge" to the current challenges, a sense of urgency. There is an aspect of "draghism" which seems to be missing in the new ECB: a readiness to "push" the Governing Council into bold decisions before a wide consensus is reached. We expect PEPP to be extended in December, but a more permanent shift in the ECB arsenal is difficult before the strategy review concludes.

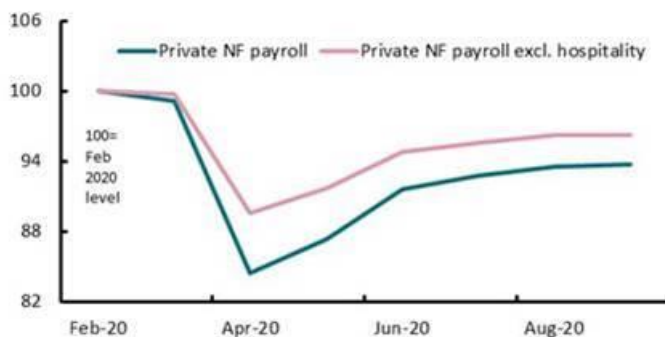
## US job recovery stalling

US weekly jobless claims can be very volatile but the message they had been sending through September was on the whole concerning, as they were plateauing far above the levels seen during the previous recession. The monthly Payroll data – which can be heavily revised but is still more reliable – released last week unfortunately confirmed this message. **The normalization of the US labour market is stalling** (employment grew by 0.3% in September after +0.8% in August in the private sector). Roughly half the jobs shed at the height of the first wave of the pandemic are still lost. What we find particularly concerning is that the inflexions are no longer mostly driven by the hospitality industry (see Exhibit 1). This industry – at the forefront of supply-side disruption issues - had contributed more than 60% to the overall decline in private employment in March and April, and symmetrically in May and June explained half of the rebound (although it accounts for only 10% of total headcounts). In September though, employment outside hospitality was flat and still 3.7% below the pre-pandemic level. This suggests that **the deterioration in the economic outlook and hence in labour demand has spread beyond the direct impact of the Covid-fighting measures which had to be re-imposed with the resurgence in the pandemic.**

**This labour market weakness is coinciding with political paralysis on the fiscal stimulus front.** As we write these lines (Sunday night), there is still no agreement found between Democrats and Republicans on another package. The House's vote on its own second stimulus plan above the quantum seen by the Republican Senators as a ceiling suggests positions are getting entrenched. **Personal income fell by a sharp 2.7% month-on-month in August.** It is still 2% above the pre-pandemic level (see Exhibit 2) but as the fiscal push is fading, total income is converging to the pace of labour income which recovery is going to be impaired by the slowdown in job creation. Excluding government transfers, income rose by 1.1% in August. With job creation stalling it will be difficult to repeat this in September.

Exhibit 1 – US labour market stalling

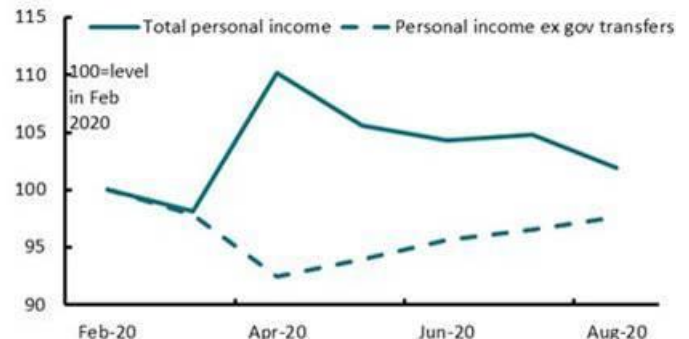
### US employment dynamics



Source: Macrobond, BLS, AXA IM Research, September 2020

Exhibit 2 – Stimulus fading

### US income dynamics



Source: Macrobond, BLS, AXA IM Research, September 2020

**Negotiations are continuing between Democrats and Republicans** – and given the current level of political tension in the US this may be a little miracle. The deterioration in the dataflow may help focus minds, especially if the equity market struggles. Indeed, the rebound in the S&P 500 last week was partly predicated on the expectation of some progress on the fiscal front. With the news of Donald Trump's hospitalization adding another layer of uncertainty, financial markets may find it difficult to find their footing again, which in the US tends to have a fairly quick impact on the real economy given the magnitude of wealth effects on spending behaviour. This could precipitate decisions. We note that Nancy Pelosi, the leader of the House, stated on Saturday that the President illness could "*change the dynamics*" of the negotiations. However, at the same time she hinted at the possibility of a much smaller stimulus targeted at the air transport industry, which can possibly be interpreted as a sign of her low confidence in the chances of a proper macro package.

**We may not get strong signals on the fiscal policy stance before the results of the elections, but we can engage in a bit of "war-gaming" on this.** Let's first assume that the situation in Congress does not change, so that after November 3<sup>rd</sup> the House remains controlled by the Democrats while the Republicans would hold on their majority in the Senate. If Biden wins, at first glance policies could remain as stuck as they are now. However, for all his

progressive electoral platform, the Democratic candidate is a moderate at heart with a strong record in cutting bi-partisan deals in the Senate. If Donald Trump is defeated – especially if the gap with Biden is wide – a part of the Republican caucus in the Senate may feel they have a wider room for manoeuvre to shift to a more bi-partisan stance, raising the chances of a swift stimulus into early 2020. The onus would probably be on a Biden administration to resist pressure from the left of the Democratic party so that the package would still be palatable to the moderate Republicans. **Now at the current stage the polls are consistent with a higher than even chance for the Democrats to win the Senate** (63% probability according to Nate Silver’s 538 Website), while their majority in the House looks solid. The most plausible scenario – albeit by a small margin – is thus that a Biden administration would control all the levers of fiscal decision-making.

**Conversely, the probability that the Republicans win back the House even if Donald Trump is re-elected is low. A Trump 2.0 administration would thus probably still have to deal with a divided Congress.** Given his divisive stance, we would be surprised if the Democrats opted for a conciliatory approach – especially if once again he wins thanks to a majority in the electoral college while still being behind the popular vote. Of course, if the economy continues to soften the pressure on the Democrats to compromise would increase so that at some point some bi-partisan consensus would be found, but it may take time, while in any case the Republican party would probably insist on keeping the next stimulus within tighter limits than the spring 2020 version.

For now, the US sovereign bond market is in “wait and see mode” – understandably given the level of uncertainty, not just on the final results but also on the capacity to know quickly who the winner of the elections will be amid Donald Trump’s “pre-contestation” of the election results. However, given our war-gaming above, **a Biden victory would ultimately be consistent with some rise in long term interest rates** : odds of a swift and large fiscal stimulus would allow the Fed to maintain its current stance, while in a Trump victory more monetary policy action would probably be needed to offset a slower and smaller fiscal push.

## Deflation winds are howling

**In Europe, after a focus on concerning news on the state of the real economy two weeks ago, attention was drawn again on deflation risks.** The harmonized consumer price index fell by 0.3% year-on-year in September in the Euro area, the second negative print in a row. Of course, one should avoid drawing too many conclusions from one or two months of data, especially since a change in the date of sales in several countries, as well as the VAT rate cut in Germany in July are affecting the data. But the trend is clear. Beyond those accidents, core inflation has slowed down after the pandemic crisis (see Exhibit 3). This has been our belief from the start that the ongoing shock is more deflationary than inflationary, but we are still surprised by the speed and the magnitude of the deceleration in prices. We were expecting some sectors to experience supply-chain issues which would have offset some of the demand-side weakness. This is hardly visible.

Exhibit 3 – Beyond the volatility, trend is down

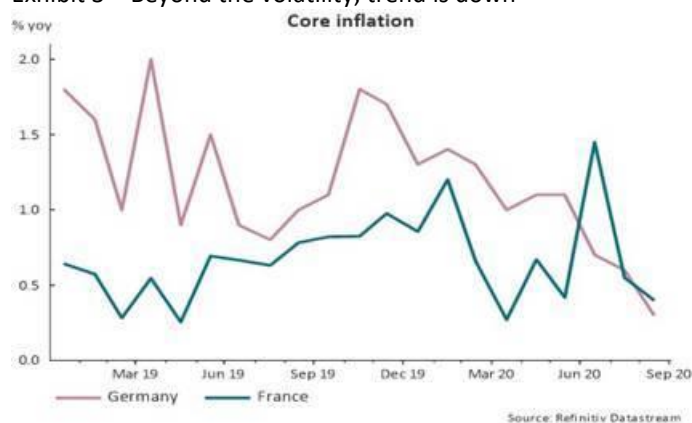
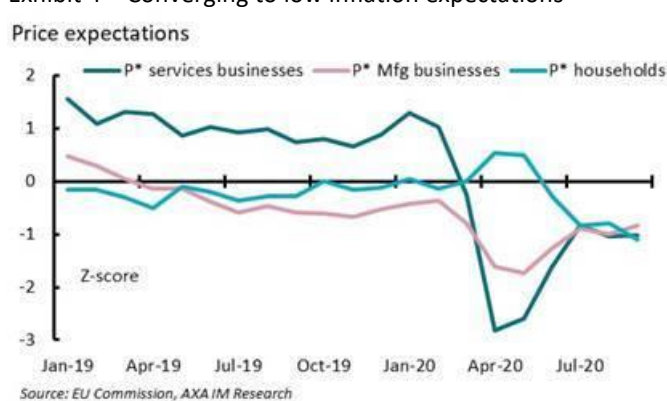


Exhibit 4 – Converging to low inflation expectations



To some extent it is a statistical artefact. An issue with consumer price index is that the weights assigned to the various products in the reference basket are not adjusted in real time. The price of air transport is plummeting (-14% year-on-year in August), contributing negatively to the overall price index based on a weight (0.85%) which does not take into account the plunge in consumption of air transport in 2020. In a nutshell, prices which “matter less” at the moment fall, while those which “matter more” continue to rise (e.g. internet provision services, which has been posting a positive growth since February in contrast with the c.4% decline seen in 2019).

However, despite this potential source of conflict between perceived and measured inflation, households in the Euro area are now in a “disinflationary mood”. Indeed, **what we find striking at the current juncture is the convergence of inflation expectations across economic agents.** Judging by the confidence surveys of the European Commission, the balance of opinion on future price trends is roughly one standard deviation below its long-term average for households as well as for services and manufacturing businesses (see Exhibit 4). The lagged response of households – in the spring surveys they briefly expected consumer prices to accelerate - is not surprising. Adverse economic shocks, even when they are ultimately consistent with lower inflation, often trigger expectations of higher price increases by families, possibly reflecting concerns over future supply – which also explain hoarding behaviours which are common in times of stress. In any case, this knee-jerk reaction is now over and households’ view on future inflation is now aligned with that of the corporate sector.

We have discussed at length in previous issues of Macrocaster the risks of deflationary spirals settling in, as economic agents extrapolate the recent inflation trend and revise their expectations accordingly. Surveys suggest the risk is real. We would add another layer here, as saving behaviour can contribute to such spirals. **A particularly nasty feature of deflation is that it then becomes rational for economic agents to postpone spending.** Indeed, as long as they can protect the nominal value of their accumulated wealth (which they do if they hold it in capital-protected financial assets, or in currency), the purchasing power of their saving will rise with time.

To be clear we do not think that the immediate cause of the current spike in saving is the decline in inflation expectations. Rather, the root cause is very likely to be the deterioration in the employment outlook which is triggering some precautionary behaviour. But **there could be a self-fulfilling mechanism settling in: precautionary saving restricts consumption which depresses consumer prices further, in turn validating the preference for saving.**

Exhibit 5 – It’s not about German over-saving!



**This is why we think that the saving behaviour of households is key to gauge the trajectory of the economy in the coming months.** Among the many indicators which support the “precautionary saving” hypothesis there is the fact that in Germany, which is having a “good covid crisis” relative to most other developed countries, the shift towards saving in the consumer confidence survey has been subdued relative to France, where the deterioration in employment prospects has been very significant (see Exhibit 5).

The ECB is clearly concerned with these developments – even if they don’t explicitly make the connection between the higher preference for saving and the deflation risks. In a box in their latest Economic Bulletin they acknowledged the role households’ unemployment expectations have on the saving ratio. However, they still



concluded that the bulk of the rise in the saving rate in Q2 2020 was due to “forced saving”, i.e. the physical impossibility to spend. The European economists at Bank of America Merrill Lynch in their latest weekly pushed the analysis further, by introducing in the model other measures of “macro stress” than households’ labour market outlook, which are i) the European Market Volatility Index (VIX) and ii) the Economic Policy Uncertainty Index (which measures the frequency of “stress words” in the press). **With the modified model, more than half of the saving rate spike of Q2 could be explained by these broader precautionary motives.**

This result matters. Indeed, this is another reason why monetary policy should provide more reassurance in our uncertain times. Reducing market volatility and providing visibility on economic policy seem to have a measurable impact on households’ saving behaviour, and hence on the chances to sustain the current economic recovery and avoid adding to the deflationary risks. **Dealing with market stress is not just a way to safeguard the swift transmission of monetary policy impulses. It is in itself a source of support to the real economy sustaining inflation dynamics.**

### **The conditions of Draghism without Draghi**

This makes the communication of the ECB even more crucial. Christine Lagarde gave a wide-ranging speech at the ECB Watchers Conference last week, shedding some light on key aspects of the central bank’s strategy review to be released next year. Given the Fed’s shift to Average Inflation Targeting (AIT), pledging to allow some inflation overshooting in the future, understandably most observers were keen to hear whether the Europeans were also ready to move in this direction. Lagarde expressed an openness to consider the concept, stating that the *“usefulness of such an approach could be examined”*.

Habitual readers of Macrocast know that we are not completely enthusiastic about AIT, so our focus in this speech was different. Since it was Lagarde’s first proper discussion of the overall intellectual framework of the ECB, **we wanted to understand whether she would stay in line with Draghi’s legacy and his thorough transformation of European monetary policy.**

**From this point of view, the message was clear. All the central tenets of Draghi’s conversion of the ECB to the new-Keynesian approach, away from the monetarist legacy he found in 2011 were present in Lagarde’s speech.** Lagarde is clearly moving towards making the ECB’s target properly symmetric (i.e. removing the notion that inflation should be *below* but close to 2%), a point which Draghi often asserted in his speeches without making it – for lack of time? – explicit in the ECB’s doctrine. On the implementation front, unconventional policy is here to stay, a permanent weapon in the central bank’s arsenal.

**One crucial aspect in our view of Draghi’s legacy is scepticism about the “structural decline” in inflation.** In our view this debate is tainted by strategic considerations on the monetary policy stance. To be clear, a “dove” may well come to the conclusion that there are some good reasons to think “trend” inflation has fallen, e.g. because of technological change - better and quicker price comparability is often mentioned as a factor. Your humble servant, despite dovish proclivities which by now are probably obvious to habitual readers, is inclined to think so. However, this does not necessarily mean that a central bank should be satisfied with a durably low inflation rate, given the risk of i) mistaking the impact of structural forces for a “run of mill” effect of economic slack and ii) falling in deflationary traps (if structurally inflation is closer to zero then the “safety margin” is smaller). This made Draghi very uncomfortable with *acknowledging* such structural shift, for fear it would be used as a weapon by hawks to generate a tighter monetary policy.

**Again, on this Lagarde is siding with Draghi. We found it telling that in her discussion of the long-term forces shaping inflation she mentioned the possibility of *upside risks* and not only the diminishing trend everyone is focused on.** This is not that frequent. The key sentence there is *“structural forces need not be net deflationary, particularly in the aftermath of the COVID-19 pandemic. While globalisation and digitalisation have tended to pull in the same direction over the past 20 years, it is conceivable that they might now pull in opposite directions”*. This matters in our view. Indeed, if despite these potential upside forces inflation remains low in the aftermath of the Covid crisis, there would be a very strong case for monetary policy to provide even more accommodation, since it

could signal that capacity underutilization remains massive. We note that Lagarde's speech also "saves" the Phillips curve, the key mechanism at work in the new Keynesian model of monetary policy according to which slack still governs inflation dynamics, at least if one accepts a sophisticated version of underutilization: *"research supports such a role for "hidden slack". Since 2011, studies that assume that the output gap has been much larger have, in general, outperformed those that use traditional estimates"*.

In the same vein, we are always suspicious when the ECB focuses too much on inflation measurement issues – a key item in the strategy review. It is reassuring to read in Lagarde's speech that this is not intended to "move the goalposts".

Finally, Lagarde also embraced the notion of mutual enhancement of monetary and fiscal policy: *"when central banks have to use balance sheet policies extensively, there is an inevitable strengthening of the interplay between monetary and fiscal policies. This interaction works both ways"*. She was even more explicit than Mario Draghi used to be on these topics, for instance in her point according to which *"one explanation for the superior inflation performance of the United States relative to the euro area in recent times is that monetary and fiscal policies were more aligned"*.

**Still, we were expecting towards the conclusion of the speech, following Draghi's practice, a "bridge" between these conceptual points and the concrete issues currently in focus. It did not come**, despite the recent deterioration in the global and European dataflow. What was lacking in Lagarde's speech is the sense of urgency conveyed in Fabio Panetta's latest speech. This is from this point of view that the ECB seems to be departing from Draghi's legacy.

Indeed, **beyond his intellectual contribution to a complete re-shaping of the ECB, Draghi also excelled in "pushing" the Governing Council into new directions** without necessarily waiting for a complete consensus to emerge. It was probably unavoidable that after his mandate the Council would opt for a more collegial approach and possibly felt the need to re-group. Unfortunately, the ECB is faced – yet again – with a deep and multi-faceted economic crisis which requires a lot of flexibility. Their decisions since March have been remarkably swift, but by "setting aside" the existential questions on monetary policy to a necessarily lengthy strategy review, the European central bank is getting late in reformulating its narrative relative to the Fed.

We have already explored in Macrocast the options currently open to the ECB on its next layer of accommodation – which in our view is only a few months ahead of us given the softness of the recovery. The default approach would be extending in size and time the Pandemic Emergency Purchase Programme (this is our baseline, with an announcement in December).

A more fundamental – and more powerful in our view – option consists in extending to the "normal" Asset Purchase Programme the relaxation in the limits to quantitative easing already implementable with the PEPP (e.g. on the capital key). Massive QE would then become a permanent weapon in the ECB's arsenal, possibly only bound by the interpretation of the European Court of Justice's decision on QE according to which the ECB could not hold more than 50% of the public debt of a member state. This could be made even more powerful by the announcement of a very long reinvestment period for the debt purchased during the pandemic crisis. **It may be difficult to make such a decision, which would permanently affect the ECB's framework, before the strategy review is concluded.**

As often, the pressure of events may precipitate such a far-reaching decision. In this case the ECB would end up making a big decision without a new comprehensive intellectual framework, while the Fed has been able to draw attention to its additional dovishness purely by changing its framework *without* making any new decision.

Country/Region	What we focused on last week	What we will focus on this week
	<ul style="list-style-type: none"> <li>President Trump testing positive for Covid</li> <li>Government avoids shutdown, but House passes \$2.2tn stimulus package making compromise deal less likely</li> <li>Presidential TV debate predictably unedifying</li> <li>US saw September payrolls rise by just 661k, less than expected, the jobless rate at 7.9%</li> <li>PCE inflation rose to 1.4% (1.6% core) in Aug</li> </ul>	<ul style="list-style-type: none"> <li>Health of President</li> <li>Stimulus discussion conclusion</li> <li>Vice President TV debate Pence and Harris</li> <li>September FOMC minutes</li> <li>ISM non-mfg index for September</li> <li>Jobless claims in latest week</li> <li>August's trade figure provides some of last data ahead of Q3 GDP release</li> </ul>
	<ul style="list-style-type: none"> <li>EA HICP fell to -0.3% in September, with core dropping to a new record low of 0.2%yoy</li> <li>German retail sales surprised to the upside at 3.1% mom in August, likely helped by VAT cut</li> <li>France consumer spending up 2.3%mom, on the back of delayed summer sales</li> <li>EC surveys headlines were positive, but expectations are stalling at best</li> </ul>	<ul style="list-style-type: none"> <li>ECB minutes to provide colour on whether a discussion on future action has already started at the September meeting</li> <li>National industrial production data to show continued but slowing improvement</li> <li>Final services PMIs with Spain in the focus given virus developments</li> </ul>
	<ul style="list-style-type: none"> <li>Tighter restrictions, r at 1.1 from 1.7 end-Aug</li> <li>UK-EU trade talks final week described "constructive" but not in the final stages yet.</li> <li>BoE officials cast doubt on -ve rates, Gov Bailey stressed not "reached a judgement"</li> <li>Q2 GDP revised to -19.8% q/q from -20.4%</li> <li>House price gains fastest since 2016</li> </ul>	<ul style="list-style-type: none"> <li>Aug monthly GDP growth, we forecast +7%, also IP, services, construction and trade.</li> <li>UK-EU trade talks, with Gove addressing Parliament on status on Weds</li> <li>Services PMI (Sep, final)</li> <li>Conservative Conf (Chx Mon, PM Tues)</li> <li>BoE's Financial Policy Comm meeting record</li> </ul>
	<ul style="list-style-type: none"> <li>August IP rose on a monthly basis but remain -12.6% below last year level.</li> <li>Retail sales improved: -1.9%yoy from -2.8%</li> <li>Tankan surveys improved from Q2 but point to a sluggish recovery</li> <li>August Urate rose by 0.1ppt to 3% while jobs /applicant ratio declined to 1.04 from 1.08</li> </ul>	<ul style="list-style-type: none"> <li>Despite some improvements, September Services PMI should remain in contraction territory (below 50).</li> <li>September Economy watcher polls should highlight either a small expansion or a stabilisation.</li> </ul>
	<ul style="list-style-type: none"> <li>Better than expected September PMIs point to continued expansion in the manufacturing and services sectors</li> </ul>	<ul style="list-style-type: none"> <li>Expect data to show strong spending in Golden Week holiday</li> </ul>
	<ul style="list-style-type: none"> <li>Last week, BSP decided to maintain policy rate unchanged at 2.25%, they acknowledge that current data flow asses that prevailing policy setting remain appropriate.</li> <li>PMI Mfg surveys show idiosyncratic developments in EM; the slight improvement is mainly driven by external demand.</li> </ul>	<ul style="list-style-type: none"> <li>Central bank meetings: India, Peru</li> <li>Inflation in Korea, Taiwan, Brazil (Sep)</li> <li>Exports in Taiwan (Sep)</li> <li>PMI in Korea, Russia, Brazil, India (Sep)</li> </ul>
<b>Upcoming events</b>	<p><b>US :</b> Mon: Serv PMI (final), ISM non-mfg PMI; Tue: TB, JOLTS Job Openings; Thu: Vice Presidential debate</p> <p><b>Euro Area:</b> Mon: EZ Comp Serv PMI (final), Eurogroup meeting, Ge, Fr Serv PMI (final), It, SP, Serv PMI; Tue: EU Ecofin meeting, Ge new mfg orders; Wed: Ge, IP; Thu: Ge CA, TB; Fri: Fr, It IP</p> <p><b>UK:</b> Mon: Comp, Serv PMI (final), Chx CPC; Tue: Cons PMI, PM CPC, Wed: Halifax House Price Index, UK-EU trade talks; Thu: RICS housing surv, FPC meeting summary; Fri: Monthly GDP</p> <p><b>China:</b> Wed: Leading index (prel.); Thu: CA balance, TB, Economy Watchers Survey</p> <p><b>Japan:</b> Thu: FX reserve; Friday: Caixin Serv PMI</p>	

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