For professional clients only
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Research & Strategy Insights

Vaccine and stimulus: too much of a good thing?

Global Macro Monthly

Key points

- The virus is fading from a year-end resurgence in most areas of the globe. Vaccine rollout is also underway. Economies will ease COVID-related restrictions at different paces depending on circumstances. This will govern the speed of economic rebound.
- Additionally, the US appears set to unleash a powerful fiscal stimulus. This will boost economic activity this year and next, we forecast to 6.2% and 4.5%. It also looks set to close the US output gap by the end of this year, bringing closer a sustainable rise in inflation.
- Financial markets are reacting to this shifting outlook: government bond yields are rising in the US, but also elsewhere. This is leading to a pause in risk markets, although we remain positive in outlook at this stage.
- Unchecked, the rise in yields may be a problem in areas where growth is not recovering as quickly. Notably the Euro area, but also in some emerging markets.

Global Macro Monthly

Investment Strategy

Global Macro Monthly – US

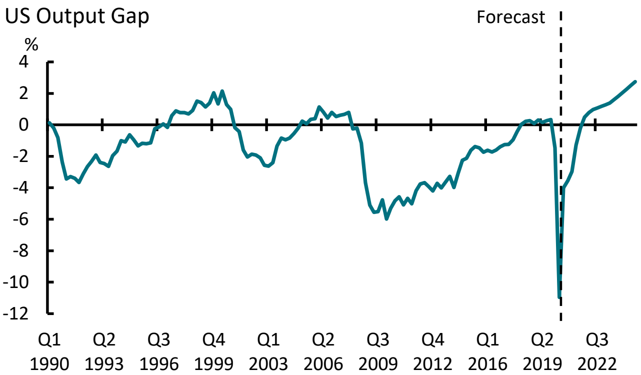
David Page,
Head of Macroeconomic Research,
Macro Research – Core Investments

An inflation-lite growth surge?

The US appears to have overcome the latest resurgence of coronavirus. Positivity rates are falling, new cases are at their lowest since end-Q3 and cases are only increasing in states representing less than 5% of GDP. As a result, many states have begun to ease COVID restrictions. This risks a further relapse, particularly with more contagious variants prevalent. However, the risk is mitigated by the vaccine rollout, which has now reached just under 20% of the population. While we will monitor the risk of a further outbreak, the US looks on track to materially ease restrictions into Q2, boosting activity.

At the same time, the administration is now focusing on delivering a fiscal boost to the economy. Former President Trump's impeachment trial was the shortest in history, with the 57-43 vote insufficient to convict. President Joe Biden will begin by passing another stimulus bill, proposed at $1.9tn (8.6% of GDP). With a bipartisan offer of just $0.6tn, the Democrat administration looks set to pass the bulk of this bill using the reconciliation process. Though we expect less than the full $1.9tn (and probably no minimum wage), it will likely be more than the $1tn we had assumed. While this will drive a quicker recovery, it may restrict a second bill that we expect in 2022, which should contain Biden's key manifesto pledges, particularly those on climate change[1] and inequality.

Exhibit 1: Fiscal stimulus and Biden's proposed top-up



Source: Congressional Budget Office, Bureau of Economic Analysis, AXA IM Research, Feb 2021

The primary fiscal boost to growth will come from supporting household incomes, particularly through extending unemployment benefits and additional direct payments of $1,400 to individuals below a given income level. In the first instance this should add to household excess savings, estimated at around $2.5tn (11% of GDP). As the economy re-opens, we expect some of these savings to be spent due to pent-up demand, fuelling consumption growth. However, with 1 percentage point (ppt) of GDP already estimated to have been used to pay down debt and 40% of savings in the hands of higher income households, we estimate this impact to be around 6% of GDP, spread uncertainly over two years.

The fading restraint of the pandemic, fiscal stimulus and pent-up demand should combine to deliver a surge in US growth. We edge our 2021 growth forecast higher to 6.2% – the fastest annual growth since 1984 – and forecast a similarly robust 4.5% in 2022. This outlook exceeds consensus expectations, which have also increased, to 4.8% and 3.6%.

This boost should reduce spare capacity faster than first estimated – we now expect the output gap to close by the end of 2021. This brings forward the point at which inflation should sustainably return to the Federal Reserve (Fed)'s target. 2021 is likely to see volatility in headline rates, with Consumer Price Index (CPI) likely rising to around 2.5% by mid-year due to base effects, before easing back below 2% by year-end. We forecast average inflation at 2% this year and 2.2% next; personal consumption expenditures (PCE) inflation should close around the Fed's target by the end of 2022. Thereafter, inflation should rise, but by how much depends additionally on the scale of future stimulus. A consensus assumption that inflation will remain as benign as during the previous decade should not be taken lightly. US excess demand looks on track to exceed anything seen since the 2008/09 financial crisis (Exhibit 1), and the Phillips curve could steepen, directly following minimum wage legislation and indirectly reflecting the Fed's efforts to raise inflation expectations.

The short-term monetary policy outlook is straightforward. The economy is a long way from the Fed's goals, particularly as it focuses on full employment and reducing labour market inequalities. The Fed has dismissed discussions of tapering asset purchases as "premature" and its forward guidance conditions for a rate hike look unlikely to be met before 2023 at the earliest. Continued monetary policy easing through 2022, despite a strong growth surge, would mark a distinct shift in reaction function – but by how much is unclear for now. We expect the Fed to announce plans to taper asset purchases in December, starting in January and concluding by the end of 2022. Yet with the economy gaining momentum over the coming years, we expect it to start tightening policy as soon as is consistent with its guidance. We estimate the first-rate hike in mid-2023, a little ahead of consensus expectations. The difficulty for markets will be in considering how much to price now for potentially significant future events that remain highly uncertain.

[1] Page, D., "How can President Biden tackle Climate Change", AXA IM Research, 21 January 2021.

Global Macro Monthly – Eurozone

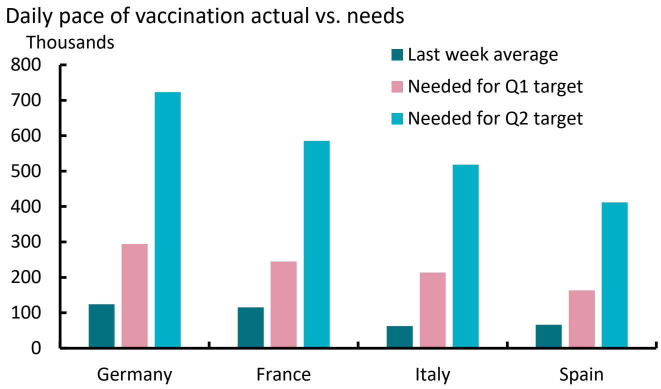
Apolline Menut,
Economist (Eurozone),
Macro Research – Core Investments

The V-race continues

Coronavirus developments have been relatively encouraging in the euro area, with new cases and positivity rates falling in Spain and Germany and broadly flat in France and Italy. But variants are spreading: the UK variant now accounts for around 36% of positive cases in France, up from 20 -25% last week, and most eurozone governments assume it will be the prevalent strain by mid-March. As such, governments remain very cautious. Germany has extended its lockdown until 7 March and set tougher targets for non-essential retail reopening (7 day-incidence of new Covid cases per 100k now below 35 vs. 50 previously), Italy has delayed the reopening of ski resorts and France has announced localised lockdown.

On the other side, the vaccination campaign has so far failed to accelerate. Weekly vaccination rates per million are broadly stable at circa 1,500 versus 4,500 in the US and 6,000 in the UK. Supply bottlenecks are partially to blame, with delayed deliveries of the Pfizer and AstraZeneca vaccines a constraint in Italy and Spain in early February. Positively, supply-side issues are due to recede in the second quarter (Q2) as the European Commission (EC) has secured 350 million more doses from Pfizer and Moderna, while Janssen and CureVac are expected to be approved in mid-March and late May. But logistics could still be challenging. The official guideline from the EC is to vaccinate a minimum of 70% of the adult population by September 2021. To get 50% vaccinated by the end of Q2, countries would need to deliver five times the current daily injections on average (Exhibit 2). We believe this is broadly feasible, and we continue to expect a gradual reopening in Q2, with growth momentum peaking in Q3.

Exhibit 2: A significant scale-up needed



Source: Our World in data (OWID) and AXA IM Macro Research, As of 21 February 2021

One key risk, beyond the logistical challenges, lies in vaccines' efficacy against mutations. In the near term, Q4 GDP data confirmed that economies are coping better with restrictions – euro area GDP shrank by just 0.6% on a quarterly basis – but activity indicators suggest the industrial contribution to growth is likely to fade in Q1. While this may be due to some temporary factors (for example, the VAT cut reversal in Germany and bad winter weather) this requires monitoring as our baseline assumes continued support from industry. Overall, we see euro area growth at 3.6% this year.

The Draghi effect

This is a far weaker estimate than the US, despite the euro area's larger 2020 contraction, and in part reflects the fiscal response. On average we see discretionary measures at just circa 3% of euro area GDP in 2021. Italy's new Prime Minister Mario Draghi has concentrated a lot of hopes on the fiscal front, and not only in Italy. Domestically, one of his priorities will be to optimise the use of the recovery fund (the catalyst for the collapse of the previous government), together with spurring stronger growth via the tax system, public administration, and justice reforms. In the near term a top-up and more efficient composition of the latest emergency decree (€32bn at some 1.9% of GDP) is due to be discussed.

But hopes are also high at the European Union level, where Draghi could steer the debate on fiscal rules. So far, governments have been lacking clarity beyond the likely extension of the escape clause in 2022; the EC is due to give its opinion in March. Draghi could be key in revamping the fiscal framework, but the timing is not so obvious, and he will need support from European partners. Meaningful progress before the German elections in September 2021 is unlikely, while the Italian Presidential election in February 2022 could also trigger further domestic political volatility. We hope for another 'Draghi effect', but the challenges are high.

ECB dragged into action

The European Central Bank (ECB) also faces quite a few challenges. Following US stimulus-based optimism, yield curves in the euro area have shifted higher and steepened. While we thought after the January meeting that clarification on the meaning of "preserving favourable financial conditions" would be welcome, we now think it is unavoidable. Not doing so by the March meeting would risk being further tested by markets, with a subsequent unwarranted tightening of financial conditions. The latest ECB meeting minutes were a first step towards clarification, emphasising that "what mattered from a monetary policy perspective was the evolution of real rates". Larger purchases under the Pandemic Emergency Purchase Programme (PEPP) in the coming weeks could help to calibrate the reaction function, but more explicit forward guidance will be needed as well.

Global Macro Monthly – UK

David Page,
Head of Macroeconomic Research,
Macro Research – Core Investments

Lockdown and vaccines open path to rebound

Despite new coronavirus cases exceeding 60k/day in January, the latest lockdown has supressed the virus. New cases have fallen by 25%wow since lockdown – a pace only briefly managed in Q2 2020. The latest new cases are below 10k for the first time since October. The vaccine programme has also been successful to date, delivering 15mn+ first doses (25% of the population). The UK remains in full lockdown, but a recent timetable envisages restrictions easing across Q2. Moreover, new evidence that vaccines reduce the spread of the virus increases the chances of the UK reaching herd immunity – and a more permanent removal of restrictions – in early summer.

The economy coped better with lockdowns in Q4 than expected. GDP contracted by 2.3% on the month in November (revised from -2.6%) and rose 1.2% in December. In total, Q4 GDP expanded 1% on the quarter, with services outperforming. Q1 will be worse, with a longer and stricter lockdown. We also expect an impact from new trading arrangements with the EU: this appeared to boost inventory and GDP in Q4, and should unwind this quarter, while UK exports to the EU appear to have been curtailed. In total, we expect Q1 GDP to record a sharp 3.5%qoq contraction.

Beyond Q1, restrictions should ease and growth rebound solidly. The modest firming in Q4 has led us to raise our 2021 outlook to 4.6%, with faster activity around mid-year helping drive 2022 growth higher still – we expect 7.5% GDP growth, even as quarterly rates normalise. Consensus forecasts have also dropped to 4.6% for 2021, and 5.5% in 2022.

The Bank of England (BoE) downgraded its growth outlook to 5% from 7.25% for 2021 and raised it to 7.25% from 6.25% for 2022 – now in line with our forecasts. It instructed the banking system to make operational preparations for negative policy rates, but stressed this did not signal any intention to adopt such a policy. Indeed, given the six months lead time – during which we forecast a strong rebound in activity – we persist in our expectations that the BoE will not adopt negative rates in this cycle. It also left its QE target unchanged at £895bn, with an intention to continue asset purchases until year-end. Yet the current QE envelope will require tapering asset purchases to around two-thirds of current levels from now, or to less than half current levels from mid-year. We do not expect the BoE to taper purchases so significantly ahead of other central banks and so expect a further expansion of QE by £75bn in May – despite a stronger growth backdrop.

Global Macro Monthly – Japan

Hugo Le Damany,
Economist (Japan),
Macro Research – Core Investments

Longer state of emergency but vaccination begins

The number of coronavirus cases has halved to reach November's level, but hospitals remain saturated. The government has extended the state of emergency (SoE) in 10 regions until 7 March. The vaccination campaign is also now underway, beginning with healthcare workers. The government has secured enough doses for a national campaign, but currently faces a shortage of syringes and people to administer the vaccine in some areas.

Fourth quarter (Q4) GDP surprised on the upside, expanding 3% quarter-on-quarter (qoq). Business investment rebounded strongly (+4.5%), exports accelerated following a solid recovery in Asia (+11%) and private consumption was robust (+2.2%). We have revised our outlook a little to take account of this upside surprise and the recent extension of restrictions. We now expect Q1 GDP growth to decline by -1.1%qoq, mostly due to a predicted -2.6% private consumption decline, equivalent to one-third of the shock seen during the previous SoE. We remain optimistic on the outlook, even if it will also depend on the vaccination speed. If the government manages current bottlenecks, GDP should rebound in Q2 and accelerate in Q3. Private consumption in services, investment and exports should be the engine of recovery.

The "new" core measure of CPI (excluding fresh food and energy) has declined substantially in recent months, from +0.4% year-on-year (yoy) to -0.4% in December. It rose slightly in January to +0.1%, but largely on temporary factors, including the suspension of the 'Go to' programme. We expect significant volatility over the coming months, reaching a trough around mid-year of -1.2%yoy, worsened by impacts from mobile phone charge reductions, exchange rate appreciation and the likely reintroduction of the 'Go to' discounts.

The Bank of Japan (BoJ) is scheduled to unveil the conclusions of its strategic review at its March meeting. As flagged by Governor Haruhiko Kuroda, the BoJ won't remove yield curve control or quantitative and qualitative easing, but we may hear some comments on the range around the 10-year target and how they intend to improve functioning in the Japanese government bond market. He has stated that the BoJ has no plans to "permanently reduce" its exchange-traded fund purchases, but we believe it can adopt a more flexible approach. Finally, we still expect some comments on negative interest rate policy, acknowledging that the BoJ can push the refinancing rate lower by deploying further measures to alleviate the cost for the financial sector.

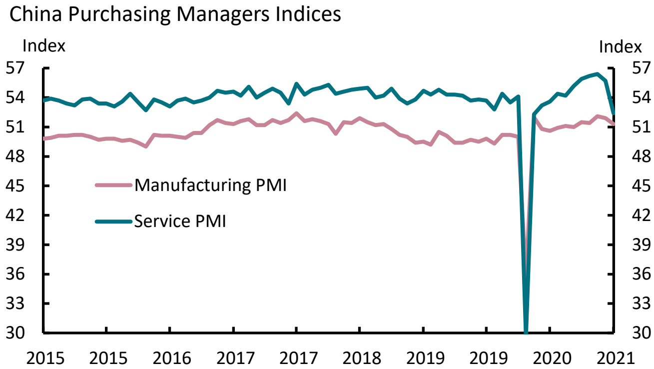
Global Macro Monthly – China

Aidan Yao,
Economist (China),
Macro Research – Core Investments

Growth moderates into the year of the Ox

Growth momentum moderated in early 2021 after the Chinese economy ended the Year of the Rat on a high note. A new wave of virus outbreaks hit the northern part of the country, creating heightened alerts and renewed social restrictions before the lunar Chinese New Year (LNY). Manufacturing and services sector growth weakened visibly in January, with Purchasing Managers' Indices (PMI) falling from multi-year highs (Exhibit 3). Nationwide transportation data showed that pre-holiday travel volumes were 76% below normal levels as migrant workers were encouraged to stay put while urban residents refrained from taking long-distance holidays. The renewed outbreak and the associated social restrictions are expected to hold back, albeit temporarily, the recovery in some service activities and household spending.

Exhibit 3: Manufacturing and services PMI ease



Source: CEIC and AXA IM Research, 19 February 2021

Some silver linings

However, the virus outbreak has not impacted all sectors equally. With migrant workers staying local for holidays, many businesses and factories were able to remain open during the LNY. Daily data on industrial activities, such as steel furnace operations and electricity generation, remained firm during the holidays. Even though inter-regional travel was curtailed by tighter restrictions, traffic congestion within major cities was at, or above, normal levels.

With people remaining in cities, urban consumption benefitted from a release of purchasing power during the holidays. Online retail, car sales and restaurant revenues all grew solidly relative to 2019. Despite ongoing capacity restrictions in cinemas, box office sales broke records, taking in over RMB7.8bn from 160 million movie-goers – up 23% from 2019. Anecdotal evidence from courier firms, which stayed operational because of labour availability, also showed a surge in orders due to increased online shopping and gift shipping. We expect these positives to offset the shock to tourism and transportation, limiting the overall negative impact of the virus resurgence on GDP growth.

Another reason for staying constructive is that the outbreak appears to have been short lived. Local cases fell to zero just before the Chinese New Year and have remained so ever since. Beijing ordered cities and provinces, which were subject to restrictions, not to impose any new measures before or during the holidays. With the situation now largely under control, the next step is to gradually roll back travel bans, allowing mobility to resume and the impacted sectors to return to normal. Overall, we don't expect the latest outbreak to change our full year growth forecast, which is deliberately placed slightly below the consensus to account for downside risks like this. However, this might alter the quarterly GDP profile relative to our previous expectations, with slightly weaker first quarter (Q1) growth followed by a rebound in Q2.

PBoC stays the course on policy normalisation

The brief interruption to the recovery is not expected to change the outlook on monetary policy. Despite a brief liquidity shortage scare prior to the LNY – driven largely by mismatched expectations between the market and central bank – investor sentiment calmed down subsequently after the People Bank of China (PBoC) injected liquidity into the system, driving interest rates back to more normal levels. January's credit data also showed no obvious sign of monetary tightening, with strong growth in bank loans offsetting weak local government bond issuance due to a lack of frontloading quota this year. Indeed, with muted inflation and the renminbi staying firm, there is little urgency for the PBoC to take a sudden turn towards monetary tightening.

That being said, there should be no illusion that last year's ultra-accommodative policy stance will not last forever. The PBoC has made its desire to normalise policy abundantly clear, with recent official speeches and the creation of a 'tight balance' in interbank liquidity via Open Market Operations (OMO). In its first OMO after the LNY, the central bank wasted no time in withdrawing RMB260bn of excess liquidity injected prior to the holidays. All of these suggest that the central bank is willing to look through the short-term disruptions caused by COVID-19 and is staying the course on exiting emergency policy settings.

Overall, we see the latest developments reinforcing our view that monetary policy is on a steady path to normalisation. The PBoC will manage this process carefully to avoid a policy cliff. We expect no reserve requirement ratio or interest rate hikes this year, but targeted tightening to rein in financial imbalances and leverage growth – in, for instance, the property market – could be increased.

Global Macro Monthly – EM

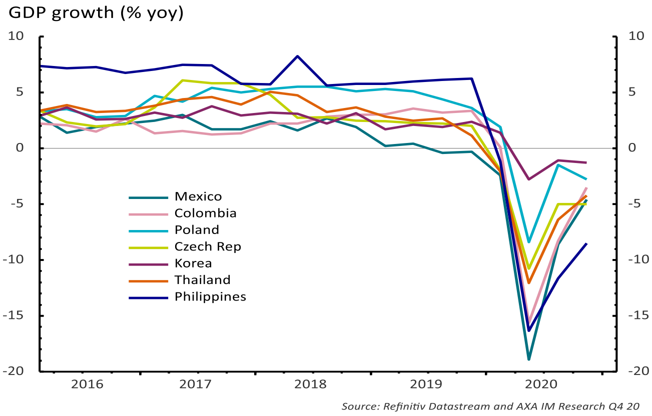
Irina Topa-Serry,
Senior Economist (Emerging Markets),
Macro Research – Core Investments

Shirley Shen,
Economist (Emerging Asia),
Macro Research – Core Investments

Activity better than expected in Q4 2020

Fourth quarter (Q4) GDP data released to date has generally surprised on the upside, showing activity held up better as the world appears to be learning how to live with coronavirus and its restrictions (Exhibit 4). Recovery in Asia seems to be progressing well, with quarterly GDP growth improving across the region. Headline Purchasing Managers' Indices (PMI) show a rather mixed picture, however. Following a strong finish in December, activity started to slow in some markets in 2021. Malaysia and Thailand posted a contraction, in part due to surging COVID-19 cases as well as tighter restrictions. Others saw strong expansion, such as Taiwan and Korea which are still benefitting from a solid electronics sector.

Exhibit 4: Q4 GDP growth overall above expectations



Source: Refinitiv Datastream and AXA IM Research, Feb 2021

In Central Europe, the latest wave of the virus resulted in renewed lockdowns, curtailing the recovery experienced in Q3 2020. Consequently, flash PMI estimates depicted weaker growth in Q4, but the region showed increased resilience in facing these restrictions. As a less open economy, Poland stood out, with growth recording just -2.7% on average in 2020, versus -5% for Hungary or -5.7% for the Czech Republic. Early Q4 GDP data reported in Latin America have also been reassuring, even if overall 2020 still recorded a very deep recession with GDP contracting by 6.8% in Colombia, 8.5% in Mexico and 11% in Peru.

2021 under better auspices?

With activity recovering quicker than expected into year-end, 2021 growth expectations benefit from a better carry-over effect. Ultimately, the strength of the recovery remains intimately linked to developments on the pandemic front and vaccination campaigns allowing for a faster lifting of the restrictions in place. So far, vaccination programmes have had a relatively slow start in developing countries, though undeniably there are huge divergencies within the pool of nations. Aside from Israel, which remains by far the best performer in terms of absolute numbers of citizens vaccinated, Central and Eastern European countries outperform most developing – as well as advanced – economies so far. Latin America broadly lags, but the pace has stepped up very recently in Chile and Brazil thanks to the supply of the Sinovac vaccine.

As long as some form of restrictions continue to be in place, additional fiscal support is needed, and we have argued that the room for manoeuvre varies greatly across economies this year. As governments unveil budget proposals, we will be able to fine-tune our assumptions. The Indian budget presented last month retained a focus on growth, pursuing an expansionary fiscal policy to support economic recovery. The government announced a larger-than-expected fiscal deficit for FY21 - 9.5% of GDP (the consensus expectation was 7.5%) and FY22 at 6.8% of GDP (consensus 5.5%). Given the stronger-than-expected fiscal impetus, we have revised higher our FY21 growth forecast to 8.5% from 8.0%.

Latin America is experiencing divergent policy and reform momentum. In Brazil, the central bank independence bill, aiming at decoupling the governors' mandates from election cycles, has passed Congress. The focus now turns to the Budget approval and administrative and tax reforms. Another emergency aid package is likely to be approved and it will be particularly important to see whether the fiscal emergency reform introduces triggers to curb mandatory spending to meet the spending cap. While there is undeniably a positive momentum for reform in Brazil, the timeline is narrowing given the upcoming 2022 presidential elections, while President Jair Bolsonaro's approval ratings are declining.

Meanwhile, in neighbouring Mexico, with mid-term elections in sight on 6 June, President Andrés López Obrador is accelerating his 'Fourth Transformation' programme. This could bring increased state interventionism through plans to overhaul the electricity industry law, by conferring preferential treatment to the state-owned utility company, modifying the current outsourcing scheme to dissuade its use, and consolidating regulatory agencies. Constitutional challenges as well as breaches of international treaties are likely, while if these laws were passed, they would likely further dampen private investment.

Investment Strategy – Cross-assets

Greg Venizelos,
Credit Strategist,
Research – Core Investment

Inflation expectations to the fore

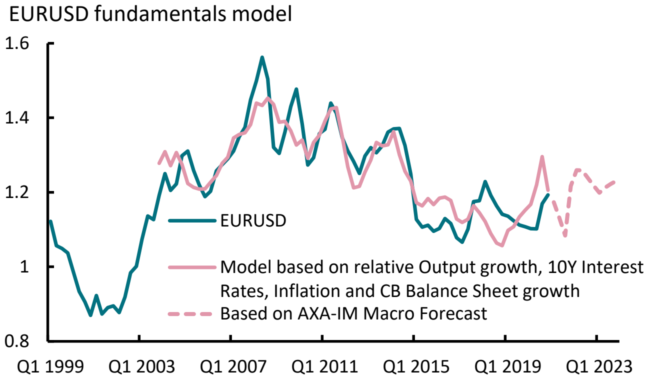
Policy support and post-COVID-19 growth expectations have been the key drivers of equity markets for months. That support may be fading as markets adjust to the next phase of the recovery. In the US that means adjusting to a shift in inflationary expectations and what that implies for the Fed. It also means on the recovery side, we are getting there, at least in the US. Forthcoming GDP numbers should be impressive, but the 'slope' of expectations has been steep and may start to flatten. Combined with higher yields, equities may take some time to adjust. The narrative points to a potential rise in volatility and perhaps less impressive returns for a while.

Investment Strategy – FX

Romain Cabasson,
Head of Solution Portfolio Management,
Multi-Assets – Core Investments

US Dollar enjoying near term tailwinds

Exhibit 5: Relative growth a short-term risk for EUR/USD

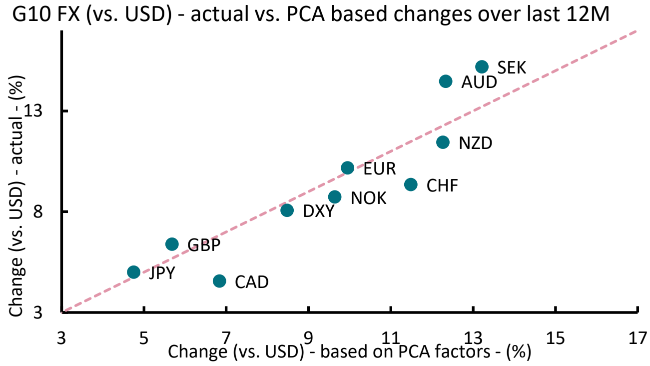


Source: Bloomberg and AXA IM Research, February 2021

The large US fiscal package announced by President Joe Biden is pointing to significant US growth outperformance. This is also supported by a big push on the vaccine front that should allow for a faster reopening of the economy, while still-stringent restrictions and a lagging vaccine rollout weigh on our euro area outlook for the first half of 2021 (Exhibit 5). The net growth differential suggests near-term dollar strength, as FX becomes a proxy for unconventional monetary policy unwind from ultra-low interest rates. Longer term, the structural factors for dollar weaknesses remain in place – the loss of carry advantage; the Fed's commitment to an inflation overshoot; dollar overvaluation not fully unwound, and a lack of safe-haven flows amid a global growth rebound.

Speculation over an earlier Fed tapering has pushed US rates higher. In contrast to late 2020 when this was driven by inflation expectations, real rates have picked up too. This has led to a pause in dollar depreciation near term, especially versus the euro – which has appreciated close to fair value – as well as the yen. A persistent rise in US yields as real rates start moving higher along with inflation expectations could push the dollar/yen rate yet higher. But between the euro and the yen, the euro is our preferred funding leg, as it is closer to fair value compared to the more undervalued yen. Plus, Japanese investors might also turn to currency-hedged long-term US assets, where the steep US dollar curve offers better carry. As a historical comparison, the fiscal push after the 2016 US election triggered a 50bps rise in 10-year US real rates and a 12% appreciation in the dollar/yen rate. What may cap yen deprecation this time is that the yen remains more undervalued than the euro and the carry of unhedged dollar short-term positions is much less attractive. Japanese investors could potentially achieve a better carry and volatility profile in long-term currency-hedged US assets.

Exhibit 6: NOK and CAD lagging other High Beta currencies



Source: Bloomberg and AXA IM Research, February 2021

Burning hot reflation trade

The repricing of the global growth rebound has not yet run its course. Currencies with a higher commodity exposure degree have more room to rise. So far, positioning in such currencies is only marginally positive. Sterling is attractive as it remains largely undervalued, while the vaccine rollout continues to point to an earlier reopening of the UK economy than the European Union's (EU). As Brexit has occurred, it allows investors to reassess their appetite for sterling exposure, and the Bank of England has dismissed negative rates, for now.

The Canadian dollar and Norwegian krona have lagged in the reflation repricing until now, while the Australian dollar and Swedish krona have run a bit ahead of themselves (Exhibit 6). Soaring Australian export prices justify some extra premium, but both the latter central banks are unlikely to turn hawkish, as inflation was below target pre-COVID-19 and Sweden's output is at risk from lagging EU demand. Canada could benefit from US fiscal stimulus spillover while the Bank of Canada and Norges Bank could react more to an overheating housing market, better growth outlook and rebounding oil.

Investment Strategy – Rates

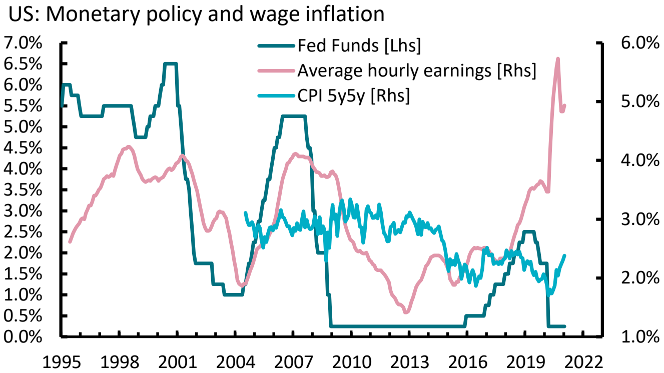
Alessandro Tentori
AXA IM Italy CIO and Rates Strategist
Research – Core Investments

Inflation, monetary policy and inequality

Tweaking the approach to monetary policy is not a big issue per se, if well telegraphed to, and digested by, markets. However, complications may arise both endogenously – for instance if communication is left intentionally vague – and exogenously. In this latter case, market setup can shift to a new equilibrium, for example as the economy moves from a disinflationary to inflationary setup, and sometimes sharply.

The US Treasury market has undoubtedly started the year on a weak footing with a 46 basis points rise in 10-year yields year-to-date, and we might be facing a combination of these two factors. The overall outcome is likely to be a regime of heightened uncertainty, as investors realise the disconnect between inflation and the central bank's agenda (Exhibit 7).

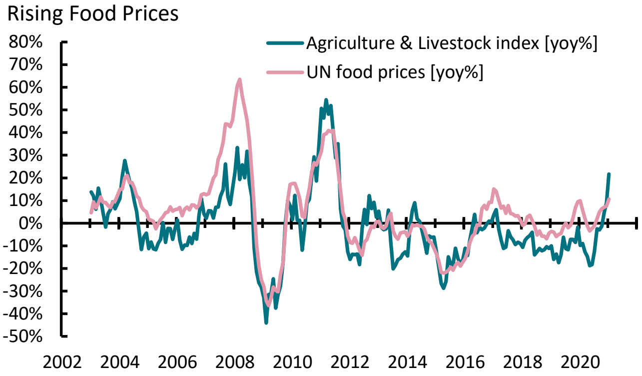
Exhibit 7: A tolerant Federal Reserve



Source: Bloomberg and AXA IM Research, 22 February 2021

Two aspects of inflation are worth examining in our view. The first is related to the intrinsic 'unfairness' of inflation, particularly when the inflation source is focused on basics like food and energy. Our economy is permeated by severe wealth inequality, which creates redistributive effects from changes in the price level. However, according to Oxfam, the world's richest 1% have more than twice as much wealth as 6.9 billion people. Furthermore, almost half of humanity is living on less than $5.50 a day. The implications of a rapid increase in soft commodities on social cohesion are rather obvious. And in fact, key food commodities like soybeans (+55%yoy) or corn (+46%) are showing price increases that resemble the 2008-2009 food crisis. In aggregate, the protracted rally observed in agricultural and livestock commodities implies a rapid increase in food prices (Exhibit 8). Adding the appreciation of oil prices to the equation suggests – based on the 2008 experience – a potential negative shock to middle- and low-income economies.

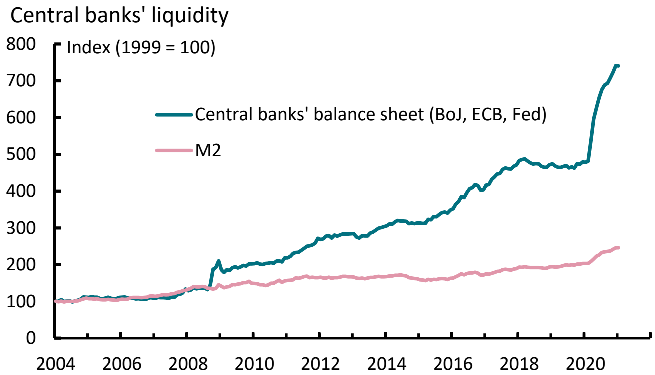
Exhibit 8: Inflation-driven inequality



Source: Bloomberg and AXA IM Research, 22 February 2021

The second important variable in assessing the potential impact of inflation on fixed income valuations is the size of existing monetary accommodation. Exhibit 9 depicts the combined size of the Bank of Japan, European Central Bank and Federal Reserve balance sheets (indexed to 1999's level) together with their respective M2 money supply. At first sight, the chart highlights simply the liquidity in excess of what is needed for elementary purposes like transactions.

Exhibit 9: Quo Vadis excess liquidity?



Source: Bloomberg and AXA IM Research, 22 February 2021

Nonetheless, the chart above also supports the frequently advanced narrative that current asset prices are mainly a reflection of excess liquidity, thus explaining the significant deviation from so-called fundamentals-based valuation. The implications are not immaterial: If the scenario turned out to be inflation and not just reflation, then asset valuations – fixed income in particular – would need to be reassessed.

With almost 22% of global bonds still trading at negative yields, the interplay between higher inflation expectations and expectations about tighter monetary policy (perhaps in the form of tapering) might eventually evolve into a self-reinforcing feedback loop, where expectations reinforce the outcome, which subsequently triggers a revision of expectations and so on. Such a process would almost certainly result in a double whammy for bond holders.

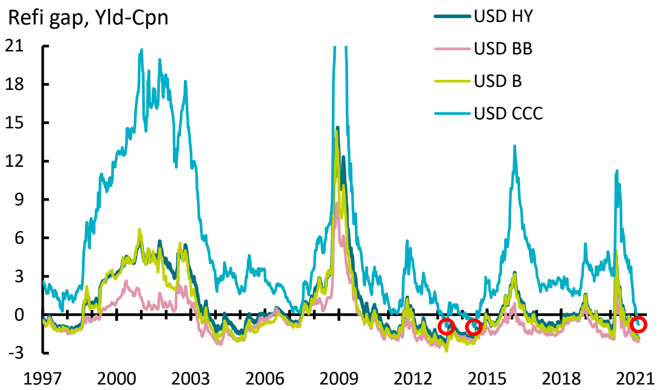
Investment Strategy – Credit

Gregory Venizelos
Credit Strategist
Research – Core Investments

The asymmetry in credit risk premia

The profound impact of global excess liquidity on risk premia has inevitably raised concerns about the asymmetry of risk-reward amid risk assets. Credit spreads are a central part of this concern, along with equity market levels. A case in point in credit is the strength of the rally in CCC-rated spreads, the riskiest part of high yield (HY) markets. As a result of this rally, the refinancing gap has become negative (namely the credit index yield falling below the credit index coupon) for CCCs too, reaching a level seen only twice before – in May 2013, pre-taper tantrum, and in June 2014, pre-Janet Yellen's verbal intervention on excessive HY market leverage (Exhibit 10, red circles). In both instances the market correction that followed was not overly dramatic, yet the optics of the chart aptly demonstrate the current asymmetry versus historical credit risk premia. And while this may does not foretell a significant spread correction near term, it does highlight that 2021 returns depend on carry income rather than price gains.

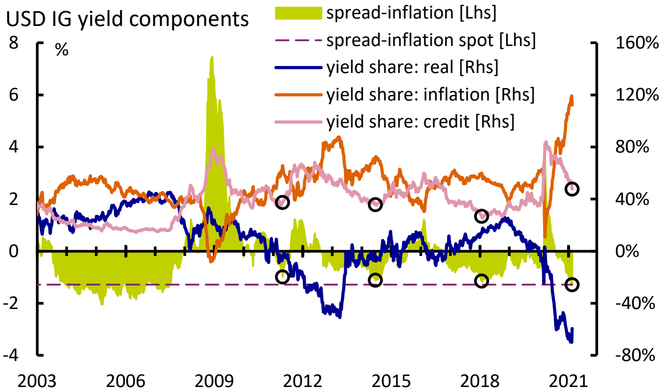
Exhibit 10: Refinancing gap in CCC-rated US dollar credit at a level only seen twice before in 25 years



Source: InterContinentalExchange (ICE) and AXA IM Research, February 2021

Another case of asymmetry in risk premia is the differential between the credit and inflation components within credit yields (Exhibit 11, green area). In US dollar investment grade (IG) credit, the all-in yield of 2% comprises circa -1.2% in real yield, 2.2% in inflation breakeven and 1% in credit spread. So, the inflation component is paying more than twice as much as the credit component, bringing the 'spread to inflation' differential to a low not seen since the global financial crisis. Prior lows in this differential post-crisis, in 2011, 2014 and 2018 (Exhibit 11, black circles), were followed by spread widening to a greater (2011) or lesser (2018) degree. What differs this time, however, is that the low in the spread-inflation differential has been driven by the unprecedented rise in the inflation component (Exhibit 11, orange line) rather than a low in the spread component (Exhibit 11, pink line). This suggests the credit component is not that overextended as a result and thus not that vulnerable to a correction risk near term.

Exhibit 11: Credit risk component within credit, normal historically, while real rate and inflation at extremes

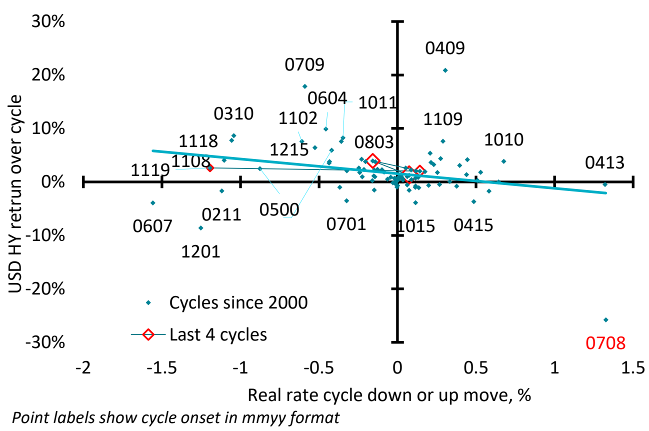


Source: ICE, Bloomberg and AXA IM Research, February 2021

The risk to credit from rising real rates

The mirror image of the unprecedented rise in the inflation component within credit yield is the unprecedented collapse in the real rate component (Exhibit 11, blue line). This begs the question of what happens to credit returns when real rates start to rise, as has been the case last week? To that effect we have looked at the total return of US dollar HY during US real rate cycles (Exhibit 12). The key observation here is that while the trendline appears negative sloping, it is highly influenced by the large 2008 outlier (red label) and most lie above the line of zero return. In the six years of negative real rate returns since 2000 (2005/2006, 2008, 2013, 2015 and 2018) three were negative for HY (2008, 2015 and 2018) but only one of those due to a rate/policy-related risk-off (2018).

Exhibit 12: US dollar HY returns over US real rate cycles negative sloped albeit biased by the large 2008 outlier



Source: ICE, Bloomberg and AXA IM Research, February 2021

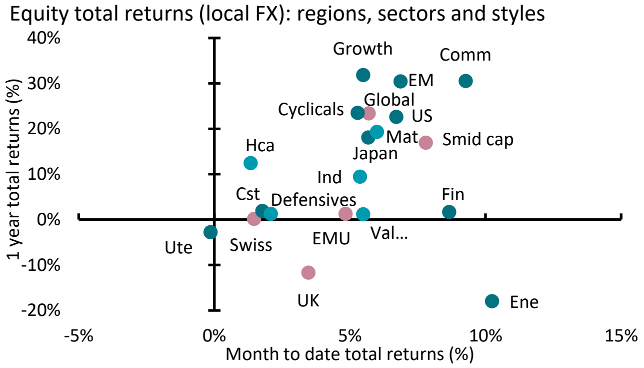
Investment Strategy – Equity

Emmanuel Makonga,
Investment Strategist,
Research – Core Investments

A good month despite a few cloudy days

Global equities rallied in February as vaccine optimism overcame some virus mutation concerns. At the time of writing, global equity market performance is 6.2% month-to-date, with the US up 5.5%, Japan ahead 8.8% and emerging markets up 8.3% in local currency terms. As fundamentals improve, cyclicals (+7.2%), small-mid cap (+7.1%), value (+6.1%) and growth (+6%) outperformed defensives (+2.7%). Volatility has partly normalised but remains above the 20 level in the CBOE Volatility Index, or VIX. Energy still leads among sectors, returning 12% month-to-date, thanks to higher oil prices in 2021 (Exhibit 13).

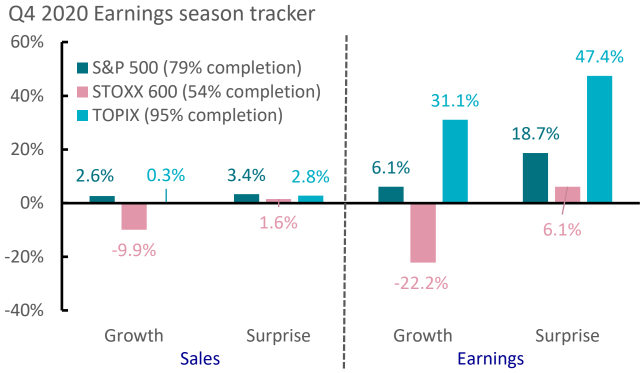
Exhibit 13: Global equity strong 2021 start continues



Source: Datastream and AXA IM Research, February 2021

Fourth quarter (Q4) earnings have sustained an upbeat tone, with positive sales and earnings surprises in the US, the Eurozone and Japan (Exhibit 14). Across the board, earnings visibility keeps improving, with analyst revisions in positive territory. Consensus expectations for global earnings per share (EPS) growth in 2021 have risen to 28.9%, in line with the strong economic activity recovery expected.

Exhibit 14: Encouraging earnings season



Source: Bloomberg, IBES and AXA IM Research, February 2021

Recent weeks have witnessed concerns over the potential impact of rising bond yields on equities. This year-to-date rise in US bond yields has been driven by both the breakeven inflation and real rate components, a reflection of optimism for future economic developments. Examining previous real rate and breakeven movements and corresponding equity performance since 1998 reveals some interesting results. Since 2009 (Exhibit 15), rising breakevens are linked with US equity gains (+0.83%) while rising real yields are linked with US equity losses (-0.39%). In the context of currently elevated equity valuations, rising yields should not be a problem if driven by breakevens (as forward earnings would also implicitly improve) but could prove problematic if driven by real rates. Without doubt, the evolution in real rates warrants some vigilance over the coming months.

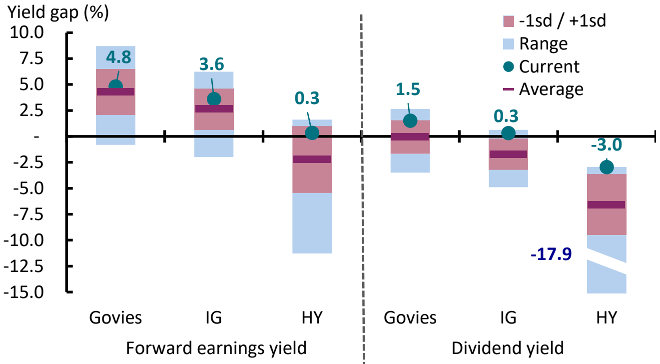
Exhibit 15: US equities tend to move more with breakeven

	Rising		Falling	
	Breakeven	**Real yield**	**Breakeven**	**Real yield**
Average (bps)	**2.61**	**3.36**	**-2.63**	**-3.2**
S&P500				
All sample (%)	0.33	0.19	-0.27	-0.16
Since 2009 (%)	0.83	-0.39	-0.83	0.02
Since March (%)	0.42	0.06	-0.33	-0.13

Source: Datastream and AXA IM Research, February 2021

Overall, the most recent developments in the pandemic situation combined with ongoing policy support keeps us of the view of a supportive backdrop for equity markets – an expected economic recovery coupled with dovish central bank stance. We remain overweight in equities in our multi-asset framework, given a projected bounce-back in profit margins and sales growth, combined with attractive relative value compared to fixed income assets (Exhibit 16). Within the asset class, we keep our exposure to emerging markets and China and have upgraded our green economy and cyclicals/value sectors in both Europe and US. In that context, the global vaccine rollout and fiscal and monetary support remain the key macro developments to monitor.

Exhibit 16: Equities remain in a good stance relative to bonds



Source: IBES and AXA IM Research, February 2021

Recommended asset allocation

Asset Allocation			
Key asset classes			
Equities			■
Bonds	▼		
Commodities			■
Cash	■		
Equities			
Developed			
Euro area		■	
UK			▲
Switzerland		■	
US		■	
Japan		■	
Emerging & Sectors			
Emerging Markets			■
Green Basket			■
Europe Cyclical/Value			■
US small caps		■	
US Cyclical/value			■
Global semiconductors			■
Fixed Income			
Govies			
Euro core	▼		
Euro periph		■	
UK		■	
US	▼		
Inflation			
US		■	
Euro		■	
Credit			
Euro IG		■	
US IG		■	
Euro HY		■	
US HY		■	
EM Debt			
EM bonds		■	

Legends	Negative	Neutral	Positive	Last change	▲ Upgrade	▼ Downgrade

Source: AXA IM Macro Research – As of 24 February 2021

Macro forecast summary

Real GDP growth (%)	2020	2021*		2022*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
World	**-3.7**	**5.4**		**4.1**	
Advanced economies	**-5.5**	**5.2**		**3.6**	
US	**-3.4**	**6.2**	3.7	**4.5**	
Euro area	**-6.8**	**3.6**	5.3	**3.2**	
Germany	**-5.3**	**2.4**	4.4	**3.1**	
France	**-8.3**	**5.5**	6.7	**3.0**	
Italy	**-8.9**	**4.4**	5.3	**3.2**	
Spain	**-11.0**	**4.5**	6.7	**4.3**	
Japan	**-4.9**	**3.5**	2.5	**2.3**	
UK	**-10.0**	**4.6**	5.7	**7.5**	
Switzerland	**-4.8**	**2.5**	3.7	**3.0**	
Emerging economies	**-2.7**	**5.5**		**4.5**	
Asia	**-1.4**	**7.1**		**5.1**	
China	**2.3**	**8.0**	7.9	**5.5**	
South Korea	**-1.0**	**3.5**	3.2	**3.0**	
Rest of EM Asia	**-6.0**	**6.4**		**4.7**	
LatAm	**-7.3**	**3.6**		**2.8**	
Brazil	**-4.0**	**3.0**	3.2	**2.3**	
Mexico	**-8.3**	**3.2**	3.7	**2.5**	
EM Europe	**-2.5**	**3.1**		**3.6**	
Russia	**-2.8**	**1.8**	3.1	**2.5**	
Poland	**-2.7**	**3.3**	4.2	**4.6**	
Turkey	**1.2**	**4.5**	4.6	**4.6**	
Other EMs	**-3.7**	**3.3**		**4.1**	

Source: Datastream, IMF and AXA IM Macro Research – As of 24 February 2021

* Forecast

CPI Inflation (%)	2020	2021*		2022*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	**0.8**	**1.3**		**1.4**	
US	**1.2**	**2.0**	2.0	**2.2**	
Euro area	**0.3**	**0.8**	0.9	**1.1**	
Japan	**0.0**	**-0.4**	0.0	**0.6**	
UK	**0.9**	**1.8**	1.5	**1.5**	
Switzerland	**-0.7**	**0.0**	0.2	**0.2**	

Source: Datastream, IMF and AXA IM Macro Research – As of 24 February 2021

* Forecast

These projections are not necessarily reliable indicators of future results

Forecast summary

Central bank policy Meeting dates and expected changes (Rates in bp / QE in bn)		Current	Q1 -21	Q2-21	Q3-21	Q4-21
United States - Fed	Dates	0-0.25	26-27 Jan 16-17 Mar	27-28 Apr 15-16 Jun	27-28 Jul 21-22 Sep	2-3 Nov 14-15 Dec
	Rates		unch (0-0.25)	unch (0-0.25)	unch (0-0.25)	unch (0-0.25)
Euro area - ECB	Dates	-0.50	21 Jan 11 Mar	22 Apr 10 Jun	22 Jul 9 Sep	28 Oct 16 Dec
	Rates		unch (-0.50)	unch (-0.50)	unch (-0.50)	unch (-0.50)
Japan - BoJ	Dates	-0.10	20-21 Jan 18-19 Mar	26-27 Apr 17-18 Jun	15-16 Jul 21-22 Sep	27-28 Nov 16-17 Dec
	Rates		unch (-0.10)	unch (-0.10)	unch (-0.10)	unch (-0.10)
UK - BoE	Dates	0.10	4 Feb 18 Mar	6 May 24 June	5 Aug 23 Sep	4 Nov 16 Dec
	Rates		unch (0.10)	unch (0.10)	unch (0.10)	unch (0.10)

Source: AXA IM Macro Research - As of 24 February 2021

These projections are not necessarily reliable indicators of future results

Download the full slide deck of our February Investment Strategy

Our Research is available on line: http://www.axa-im.com/en/insights

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