AXA Investment Managers

23 February 2022
Research & Strategy Insights

Frozen Conflict

Global Macro Monthly

Key points

- Geopolitical developments appear to be worsening, risking the materialisation of downside risks to our growth outlook, and limiting expected central bank action.
- To date tensions have provided persistent pressure on energy markets, continuing to push 'transitory' inflation higher. But inflation is also broadening. And regions with tight labour markets face more persistent inflation.
- Most central banks now guide for tighter policy. In emerging markets, this has been the case for a while – some appear near the top of the cycle.
- The Federal Reserve looks likely to start to tighten in March, as does the Bank of Canada. We forecast the Bank of England to hike in May and the European Central Bank in December. In most cases, we forecast less tightening – certainly this year – than priced by markets.
- Higher inflation, tighter financial conditions and in some cases fiscal adjustments present challenges to real incomes and GDP. We lower our growth forecasts in several regions. This as supply conditions appear to be easing and the Omicron wave fades.

Global Macro Monthly

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Global Macro Monthly – US

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

'Transitory' persists, but medium-term builds

US inflation hit a 40-year high of 7.5% in January, while the 'core' CPI reached 6.0% for the first time since 1982. Another overshoot of expectations, once again, reflected factors which should prove transitory. Energy and fuel prices rose further, in part on geopolitical tensions in Ukraine. Used car prices also continued to increase despite vehicle sales picking up, while other indicators suggested weaker used prices ahead. Geopolitical events remain difficult to predict and would certainly result in further short-term inflation pressure if they deteriorate. However, an improving situation would see energy prices ease materially, and the easing supply chain pressure and improvement on the pandemic front should ease goods demand and improve labour supply; all short-term factors that should result in inflation falling significantly from around spring. Uncertainties from COVID-19 and geopolitics remain a risk to this outlook.

Yet inflation pressures are broadening. Owner-occupied rents account for one quarter of the Consumer Price Index (CPI) basket and rose to 4.1% from 2.4% six months ago. Broader services inflation also rose to 4.6% from 3.1% in July. This broadening is consistent with it shifting from a supply-driven shock to a more demand-based and persistent pressure. This is consistent with the tightening of the labour market that Federal Reserve (Fed) Chair Jerome Powell described as "remarkable" and has certainly exceeded our expectations. Although we still expect labour supply to rise, revisions now show jobs growth to have increased by 550k/month over 2021, with no deceleration in the past three months. With unemployment already at 4%, the labour market needs to slow to ease medium-term inflation pressures, reflected in wage growth in December rising by 0.7% on the month.

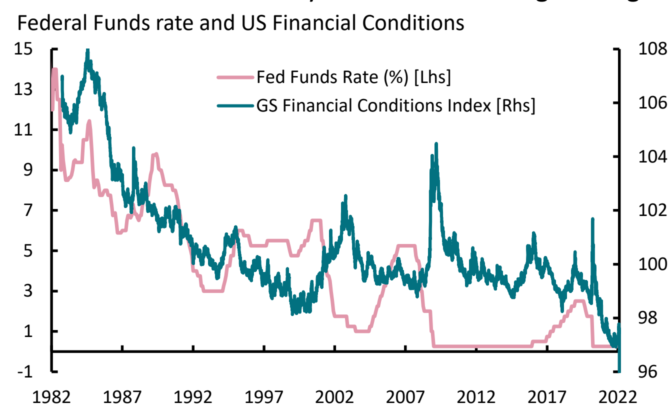
In need of a Hail Mary for economic touchdown?

It is this broader build-up of inflation pressures that we expect the Fed to focus on. The continued labour market improvement has brought a lift-off for rates nearer. We now expect the Fed to start a tightening cycle at its next meeting in March. High inflation has seen expectations soar in terms of how quickly the Fed will hike, with speculation of back-to-back hikes, a 50bp initial move and even an inter-meeting hike debated. Yet despite this febrile speculation, expectations for the cycle peak have only risen to 2.0%.

At January's policy meeting, Powell was mindful of tightening too abruptly, describing the Fed's approach as "steady", while others suggested "gradual". We believe the Fed would like to initiate tightening more conservatively. We continue to forecast quarter-per-quarter hikes initially. The Fed also looks set to deliver a faster pace of quantitative tightening (QT) than witnessed in the previous cycle. We expect this to be announced in June. Combined with an expected sharp fall in inflation in H2 2022, we expect the Fed will hike rates four times this year to 1.25%.

The Fed will require a further tightening in financial conditions to achieve a sufficient growth slowdown. We expect it to be patient initially and gauge the market response. However, if combined rate hikes and QT elicit an insufficient tightening in conditions, it will have to act further. The Fed will not want to repeat the early 2000s "Greenspan's conundrum" episode (Exhibit 1). On balance, we expect this to occur around the turn of the year. We forecast the Fed accelerating its hikes in H1 2023, before easing off again in H2 to leave the upper range of the Fed Funds target at 2.75% by end-2023; significantly above current market forecasts.

Exhibit 1: Estimated real yield reactions to tightening



Source: Federal Reserve Board (FRB), Bloomberg and AXA IM Research, 21 Feb 2022

Powell acknowledged a need to be "humble and nimble" in the outlook. Geopolitics, the pandemic, its aftermath and the endogenous response of financial markets will materially influence the final pace of tightening. For now, a risk of rising inflation expectations in the face of elevated headline rates skews risks towards quicker tightening.

At the same time, the Fed's objective is not easy. With current labour market momentum, unemployment is likely to be around 3% by year-end. The Fed is therefore aiming to slow growth and raise unemployment. But this is not something it has achieved with much success in the past. The Sahm Effect observes that every time unemployment has risen by 0.5 percentage points from its previous low, it has morphed into a sharper unwind and recession. The Fed is thus heading for a narrow landing strip and we think it will have to proceed carefully, even without the luxury of moving slowly. But a quicker pace of tightening should weigh on growth – we have lowered our GDP forecasts for this year and next to 3.2% and 2.0%, below the consensus 3.8% and 2.5%.

Global Macro Monthly – Eurozone

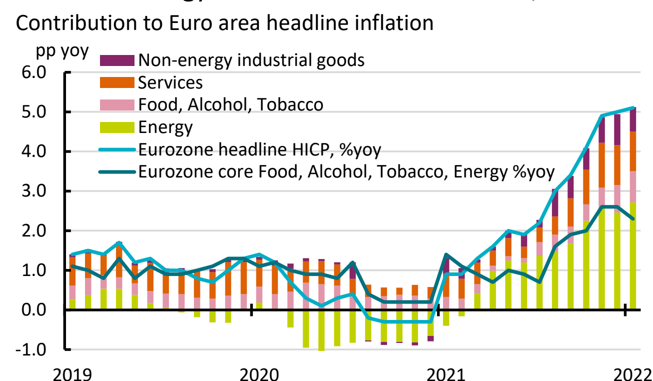
François Cabau and Hugo Le Damany,
Economists,
Macro Research – Core Investments

Before and after: January Inflation

What a shocker! The preliminary Eurozone Harmonised Index of Consumer Prices (HICP) inched up 0.1 percentage points (ppt) to a new record high of 5.1% year-on-year in January –consensus had expected a material drop to 4.4%, notably reflecting the German Value Added Tax cut dropping off the annual rate.

Volatile inflation components remain in the driving seat, though core inflation's momentum builds. Increased geopolitical tensions have pushed Brent crude oil prices higher – up around 27% year-to-date in euro terms – meaning the energy subcomponent alone accounted for more than 50% of Eurozone inflation. Together with food prices, they have combined to make up more than two-thirds of Eurozone inflation in January. Meanwhile, core (and especially services) inflation has also displayed upward momentum, standing at 2.6% on average in the past three months (Exhibit 2).

Exhibit 2: Energy and food account for most, core rising



Source: Eurostat and AXA IM Macro Research, 21 February 2022

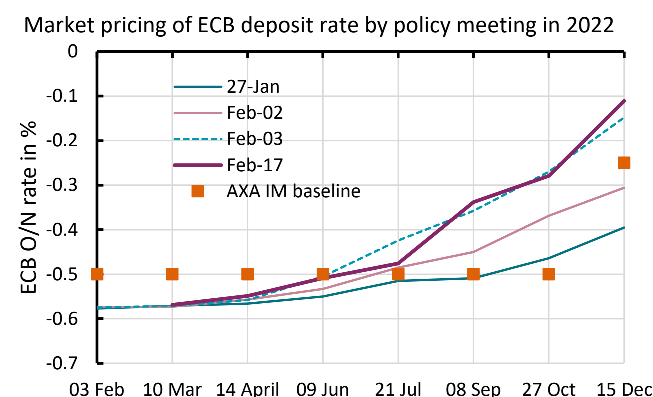
Full details of January inflation, released on 23 February, and the flash February HICP on 2 March will be key to assessing the persistence of strong core inflation in the context of a buoyant labour market. Preliminary employment estimates showed Eurozone jobs grew in the fourth quarter (Q4) by 0.5% quarter-on-quarter (faster than GDP growth, which rose by 0.3%qoq), coming slightly above pre-crisis levels. Business surveys continue to suggest disrupted growth in Q1, before picking up from Q2.

Owl soul searching

European Central Bank (ECB) President Christine Lagarde delivered a hawkish press conference on 3 February boosting market expectations for a rate hike (Exhibit 3). A sizeable minority within the Governing Council (GC) was reported to have pushed for the ECB to take action at the February meeting. After being legitimately skewed on the dovish side, underpinned by Chief Economist Lane's views, ECB President Lagarde's key challenge will be to lead the GC towards a consensus decision amid a large range of views, and to find a balanced tone for normalisation. In our view, a gradual and conditional approach – similar to the Pandemic Emergency Purchase Programme recalibration in 2021 – is most likely, given the high macro and geopolitical uncertainty, while emphasising the flexible role of quantitative easing (QE) reinvestment to avoid any abrupt unwarranted steepening of rate curves and widening in Eurozone government bond spreads. Updated inflation forecasts for the March meeting will be key.

In the wake of the ECB's press conference on 3 February, we have changed our baseline expectation to show an earlier increase in rates than previously expected. We think that the rate forward guidance will be amended at the March meeting, removing the downward bias in interest rates. Given that we do not foresee a change in the sequencing of monetary policy tools, the ECB needs to finish QE before hiking rates. We think the ECB's gradual approach implies the Asset Purchase Programme will end in October (removing the open-endedness) which would then pave the way for a first hike in December. While the ECB has so far refrained from communicating on the potential pace, we think two 25-basis-point hikes in December 2022 and March 2023, taking rates to zero, are likely before pausing. This makes us more prudent than market pricing as to the timing of the start of hikes and believe the ECB will not need to tighten as much as currently priced (Exhibit 3).

Exhibit 3: Short-end rate market likely ahead of itself



Source: Bloomberg and AXA IM Macro Research, 21 February 2022

Stakes will be equally high at the 10-11 March Extraordinary European Union (EU) Council meeting where France's President, is likely to press ahead with negotiations on the future of EU fiscal policy. Given the status quo at the helm of Italy resulting from the Presidential elections, President Macron will benefit from the support of PM Draghi in the wake of their joint op-ed in the Financial Times in December pushing for public investment favoured in future fiscal rules while implementing sensible reforms to curb public spending.

Global Macro Monthly – UK

Modupe Adegbembo,
Junior Economist,
Macro Research – Core Investments

Cost of living squeeze takes centre

Headline annual CPI inflation hit a 30-year high of 5.5% in January and is set to rise further. We now expect inflation to peak at over 7% in April, when the Office of Gas and Electricity Markets (OFGEM)'s energy price cap rises by 54%. We now expect inflation to reach 5.5% in 2022 (up from an earlier forecast of 4.5%) and 2.1% in 2023 (up from 2%). We expect inflation to fall in the second half of 2022 based on the path implied by energy futures. Consensus forecasts are for inflation to average 5.3% for 2022 and 2.2% in 2023.

Recent GDP reports have surprised to the upside, with December's -0.2% softer than the expected -0.5% decline. In 2021 UK GDP grew by 7.5% – the highest annual figure on record, going back to the Second World War – although following the historic 9.4% collapse in 2020 as the pandemic spread. Over the coming months, challenges to real incomes are likely to dominate, with increases in National Insurance and benefit reductions alongside energy price increases and broader inflation pressures. Income pressures are set to weigh on the consumer and provide a challenging outlook for growth. Some will be able to bolster consumption using savings accumulated over the pandemic. But these savings are not evenly distributed. Given the increased real income squeeze and expected tighter monetary policy that we now forecast (see below), we downgrade our estimate for UK growth in 2022 to 4.3% (from 4.9%) and to 2.1% (from 2.5%) in 2023. This compares to consensus forecasts of 4.5% and 2.2% respectively.

The labour market remains tight, but there are some signs of easing in the pace of tightening. In December unemployment remained at 4.1%, wage growth continued to slow (to 3.6% from 3.8% in the 3-months to December) and is set to soften further as base effects fall out.

The Bank of England raised rates by 25 basis points (bps) to 0.5% in February, with four members of the Monetary Policy Committee (MPC) voting for a 50bps hike. The MPC said it feared longer-term inflation expectations may become unanchored. Recent upside surprises in inflation and retail sales mean we cannot rule out a March hike. However, we expect the MPC to follow a more cautious path given the looming income squeeze and leave the Bank Rate unchanged at 0.5% in March, pencilling in the next hikes for May and August, bringing the rate to 1%, where we expect it to peak. This is lower than current market expectations, which currently price in rates close to 2% by end-2022.

Global Macro Monthly – Japan

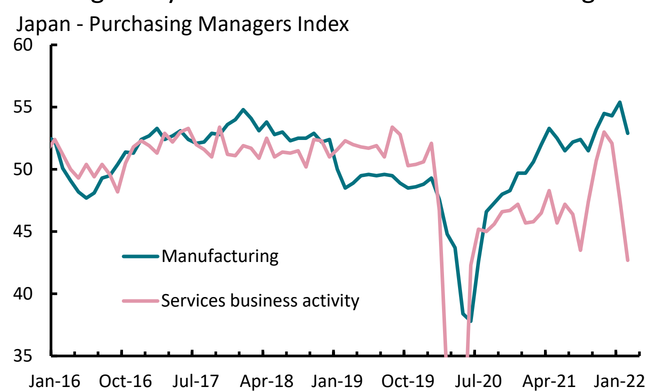
Hugo Le Damany,
Economist,
Macro Research – Core Investments

GDP roller coaster

Preliminary Q4 GDP growth bounced back by 1.3% quarter-on-quarter (qoq), boosted by strong support from private consumption (+2.7%) and net exports. On the other hand, public investment fell by 4.5% while capital expenditure was weak (0.2%).

GDP growth is expected to be extremely weak in Q1. Services have once again been impacted by Omicron as a result of government restrictions and cautious consumer behaviour (Exhibit 4). The industrial sector can limit losses but as communicated by some automakers, Omicron is also disrupting production chains. We have thus slightly softened our short-term GDP forecast for Q1 to +0.3%qoq from +0.4%. But the outlook is brighter. Expectations in services surveys remain robust while semiconductor shortages appear to be having less of a negative impact on activity.

Exhibit 4: Purchasing Managers' Indices (PMIs) show heterogeneity across services and manufacturing



Source: HIS Markit, AXA IM Macro Research, as of February 2022

The Bank of Japan: Resisting or resigning?

The 10-year Japanese government bond yield has briefly reached the upper limit set by the Bank of Japan (BoJ)'s yield curve control, of 25 basis points (plus or minus) around 0%. A range extension was adopted in March last year, but the BoJ added that it would introduce "fixed-rate purchase operations for consecutive days" as a powerful tool to set an upper limit on interest rates if necessary. On 10 February, the BoJ warned markets that it would intervene from 14 February, for an unlimited amount. Recent speeches by Governor Haruhiko Kuroda strengthen this position, arguing that a rate rise was not justified by Japanese economic fundamentals, but reflected spillovers mostly from the US.

Global Macro Monthly – China

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

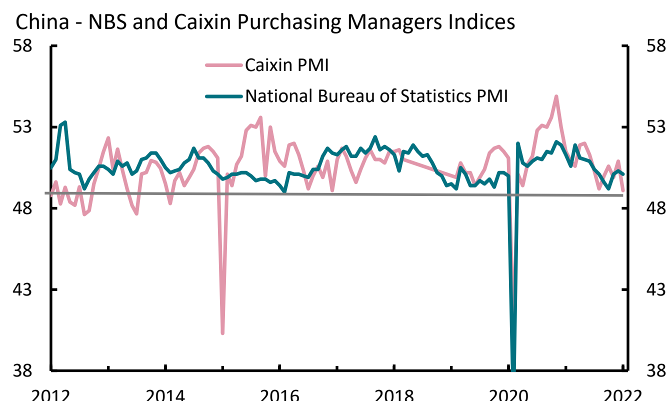
A soft start to the year

After staging a decent recovery in the final quarter of 2021 China's economy got off to a rocky start in the year of the Tiger. Official activity data for January and February will be released together in the middle of March to smooth the lunar new year (LNY) effect, leaving the market 'flying blind' when it comes to gauging the economic pulse. To fill the data void, we rely on high-frequency, third party indicators, which showed a mixed picture of the economy so far in 2022.

Starting with the bad news – the housing market is still in dire straits. Property sales in 30 major cities declined by 30% year-on-year in January partly due to a high base and an earlier LNY. However, households' purchase intentions also remained weak as people stayed on the side-lines waiting for prices to drop further. While banks have started to ease mortgage restrictions by expediating loan approvals and cutting interest rates, these acts have so far failed to spur a notable rebound in credit growth. Long-term lending to households – mainly in the form of mortgages – was the weak spot in an otherwise stellar credit print for January.

The weak property market has continued to take its toll on industrial activity, with conditions exacerbated by another COVID-19 outbreak. Both the official and Caixin manufacturing Purchasing Managers' Indices (PMIs) fell in January (Exhibit 5), with the latter dipping below the 50 mark. Operating rates at various steel blast furnaces also fell, reflecting partly the LNY effect and possibly pollution controls ahead of the Winter Olympics. Looking ahead, the fading of these transient forces should set production on course for a rebound, particularly if the property market stabilises and infrastructure-related stimulus kicks in.

Exhibit 5: A soft start to the year



Source: CEIC and AXA IM Macro Research, 18 February 2021

News on the consumer side was mixed. On the one hand, passenger traffic volumes during the LNY rebounded strongly, rising 37% from the same period last year. Despite suffering from another outbreak, Beijing's more lenient management under its 'dynamic zero-COVID' strategy appears to have struck a better balance between social mobility and virus control than in 2021. That said, the absolute levels of passenger flows and traffic congestion remained significantly below those of pre-pandemic years.

Despite making more trips, consumers were reluctant to open their wallets. Tourism revenue during the LNY declined modestly relative to last year, while cinema box office sales were flat despite hitting their second highest figure on record. On a brighter note, the closing of international borders led shoppers to fill the stores in Hainan's offshore duty-free zone, pushing LNY sales up 151% year on year. Auto sales at both retail and wholesale level also improved sequentially. Overall, there does not appear to be a clear direction with consumer spending following the very weak retail sales last December.

Policy cycle turns in earnest

In contrast to the clouded economic picture – given the limited data, the policy outlook has become crystal clear. The need to foster stability in the economy has been communicated loud and clear in recent policy meetings. And Beijing is making efforts to deliver on that pledge. Since last November, the People's Bank of China has lowered reserve requirements and interest rates, and guided banks to speed up lending. As a result, new bank loans and total social credit both reached a record high in January, significantly beating market expectations. Granted, the details of the data were not as strong as the headline figure suggests, with the latter boosted by banks' short-term lending. But the fact that liquidity is starting to penetrate in the economy should help dampen concern about Beijing's willingness to put a floor under growth.

Fiscal policy is also doing more heavy lifting. The State Council has just announced a top-up to the CNY1.46tn (RMB) special bond quota with another CNY328bn in general bonds to be issued before the National People's Congress (NPC) in March. This, combined with the carry-over fiscal funds from last year, should support infrastructure investment in the coming months. Outside of countercyclical policies, property market curbs have also been relaxed, with easing restrictions on developers' escrow accounts – which store their pre-sales funds – being the latest example.

These actions suggest Beijing is serious about supporting the economy ahead of the leadership reshuffle at the 20th Party Congress. But achieving this goal against the lingering pandemic and a weak property market will require more policy heavy lifting. We expect further easing measures to be announced at next month's NPC.

Global Macro Monthly – Canada

David Page,
Head of Macro Research,
Core Investments

Bank of Canada to join the tightening party

COVID-19 has flared up again. Canada's public health authority called a peak in cases on 21 January, and daily cases are now around one fifth of that level, however the impact is still being felt. There have been protests over vaccine mandates and lockdown restrictions in Ottawa and at the Ambassador Bridge – a gateway to the US that handles a quarter of US-Canadian goods trade. Payrolls fell by 200k in January – the first drop in seven months, with accommodation and food (-113k) and retail (-26k) bearing the brunt. Ontario and Quebec, where restrictions were the tightest, saw the steepest drops. Unemployment rose to 6.5%, its first increase since April.

Monthly GDP surprised in November, rising by 0.6% on the month despite flooding. December's flash estimate was "around flat", leaving the fourth quarter (Q4) GDP around 1.5%, modestly firmer than we expected, with 2021 as a whole up 4.6%. We forecast a drop in January and a more subdued 0.4% rise in Q1 but expect the impact of COVID-19 (and protests) to fade quickly. We maintain our 3.5% forecast for 2022 GDP. However, our expectation for a faster tightening by the US Federal Reserve (Fed) presents downside risks to 2022's outlook and we have lowered our 2023 forecast to 2.8% from 3.1%.

The Bank of Canada (BoC) left policy unchanged in January, as we forecast. Yet it acknowledged that "slack has been absorbed" and removed its forward guidance adding that it "expects interest rates will need to increase this year". We expect it to hike by 0.25% at its next meeting in March and again in April. Governor Tiff Macklem has subsequently added that quantitative tightening (QT) – an end of balance sheet reinvestment – could follow in "fairly short order" after the first interest rate move. This looks likely for the second half (H2) of 2022, when nearly 10% of holdings will mature – and could be announced in April.

The BoC expects inflation to remain around 5% over H1 2022, although we see scope for an earlier easing. Average earnings slowed in January to 2.4% but we suspect the BoC's concern includes the quality as well as quantity of labour market development. Productivity growth remains subdued and unit labour costs elevated, suggesting a need for monetary tightening. That said, a QT announcement and a faster Fed should tighten financial conditions more quickly. We continue to expect fewer hikes than markets at four for this year, to 1.25%, and two for next, to 1.75%.

Global Macro Monthly – EM

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

Geopolitics + inflation = volatility… and (mostly) rate hikes

Emerging markets (EM) are going through a difficult period with geopolitical tensions between Russia, Ukraine and Western countries centre stage. The door may still be open for a diplomatic solution – but that solution has yet to be found. For the time being, Russia remains concerned with any North Atlantic Treaty Organization (NATO) expansion towards its borders, while the US and its European allies continue to warn Russia of serious sanctions should it invade Ukraine. Tension remains high along the Ukrainian boarder and financial markets echo the volatility of the diplomatic talks and military troop movements.

Commodity prices thus remain elevated, which has so far supported the sovereign bonds of EM commodity exporters. However, the longer commodity prices stay high, the more they feed into the other components of inflation. The GDP-weighted EM excluding China proxy inflation rate, which aggregates data from the biggest 20 developing countries accounting for 28% of global GDP, reached 9.2% year-on-year in January (4% excluding Turkey), versus 7.5% in the US. Turkey's latest inflation rate reached 48.7%.

Inexorably, policy rates increased again last month by 150 basis points (bps) in Chile and Brazil, 100bps in Russia, Ukraine and Colombia, 75bps in the Czech Republic, 50bps in Mexico, Peru, Poland and Hungary, and 25bps in South Korea and South Africa. Some central banks indicated that most of the heavy lifting has probably been done and that future policy fine-tuning will be data dependent.

Turkey continues to stand out with unorthodox monetary policy. The central bank left the policy rate unchanged at 14% despite soaring prices and seems to have no appetite for further rate hikes. The recently introduced currency-protected deposit scheme has so far been successful in stabilising the Turkish lira and temporarily halting further dollarisation of the economy. Sales tax cuts and targeted price controls have seen fiscal policy supress price increases. Turkey is also limiting its external financing needs by increasingly subsidising loan programmes to exporting sectors, which have benefited from a weaker currency. The collapse in purchasing power is nonetheless pressuring President Recep Tayyip Erdoğan, who announced a 50% rise in the minimum wage, pensions and civil servants' salaries – just compensating for inflation. Yet private sector discontent is palpable and seen in the increasing number of strikes and Erdoğan's weak approval ratings.

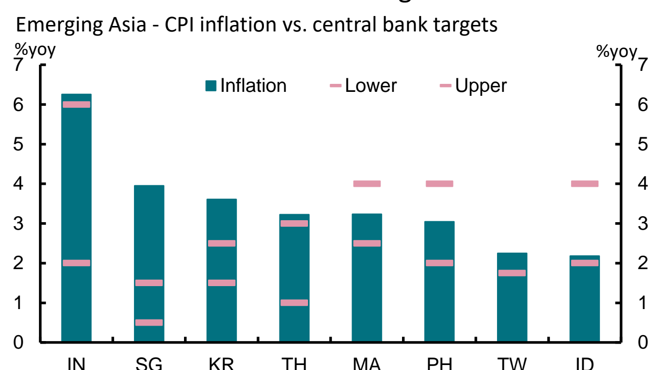
Global Macro Monthly – EM Asia

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

Inflation rising, but Asian central banks in no hurry to hike

Inflation in Asia has continued to rise, and for some economies has already surpassed upper target bands (Exhibit 6). Given Asia's relatively healthy external balances, and much of the inflation overshoot reflecting base effects and one-off supply shocks, central banks have to date shown flexibility around inflation targets and more stability in monetary policy.

Exhibit 6: Inflation has been rising



IN: India; SG: Singapore; KR: South Korea; TH: Thailand; MA: Malaysia; PH: Philippines; TW: Taiwan; ID: Indonesia
Source: CEIC and AXA IM Macro Research, 18 February 2021

Most central banks are yet to increase policy rates from their pandemic lows, with only three Asian central banks so far making a shift towards a hawkish stance. Bank of Korea was one of the first to hike in the region and has already raised its policy rate three times (+75bp to 1.25%) since August 2021. The Monetary Authority of Singapore also recently announced an off-cycle increase in the Singapore dollar nominal effective exchange rate slope following its hawkish move in its October meeting last year. And Bank of Indonesia kept its seven-day reverse repo rate on hold but has laid out a series of reserve requirement hikes to absorb excess liquidity.

Historically, Asian rates have closely tracked the US Federal (Fed) Funds Rate. With the Fed now expected to tighten more quickly than previously envisaged, we believe this will likely encourage Asian central banks to raise policy rates. However, unlike some G10 and emerging market economies, which have pivoted towards outright tightening following the Fed's sharp hawkish turn, we believe that Asian central banks are likely to have more autonomy in this policy cycle and envisage only a gradual normalisation process. For most of Asia, domestic growth recovery will remain the key focus throughout 2022.

Global Macro Monthly – LatAm

Luis Lopez Vivas,
Economist (Latin America),
Macro Research – Core Investments

Inflation surprises pile up in Latin America

Despite tighter monetary conditions, the region has registered significantly higher-than-expected inflation in the last two months. Global factors like supply bottlenecks and energy price increases, as well as domestic drivers, are behind this. On average, annual inflation in the region was 0.3 percentage points (ppt) above market expectations in December and 0.2 ppt higher in January. The situation is particularly worrisome in Colombia and Chile. Upside surprises were more limited in Brazil and Mexico, where the economy is in recession and inflation already peaking.

In Colombia, inflation reached 6.9% year-on-year (yoy) in January, the highest since 2016. The reading was well above the central bank's 3% target and market consensus of 6.4%. While food inflation continues to be the biggest contributor to headline Consumer Price Index inflation, the largest price increases came from services. Services inflation will likely continue to accelerate as restrictions are lifted. In this context, we believe that Colombia's central bank will need to speed up the pace of rate hikes in March to 125 basis points.

In Chile, January inflation came in at 7.7%yoy, which was 0.7 percentage point above market expectations. More worryingly, core inflation reached 7.1%. These results came despite Chile's central bank hiking its policy rate by 500 bps since last July. Considering the ongoing normalisation of activities and the upcoming summer season in Chile, inflation will likely not let up until June, after which base effects should allow for some gradual easing. Like Colombia, Chile's central bank will likely deliver a larger hike at its March meeting.

Peru is the region's only major country to surprise to the downside. January inflation (5.7%yoy) came in below market consensus (6.0%), likely reflecting weaker economic activity. The country's monthly GDP indicator has decelerated for three consecutive months. Nevertheless, inflation is still considerably above the midrange target of 2.0%. We believe that the central bank will maintain its gradual tightening pace as it juggles inflation pressures and a slowing economy.

Given the region's recent inflation surprises and the Fed's hawkish pivot, Latin American central banks will need to prolong (and in some cases accelerate) the current hiking cycle. While long term expectations remain well-anchored, short-term expectations are high. In this sense, central banks will need to keep a watchful eye and avoid inflation becoming entrenched.

Investment Strategy – Cross assets

Greg Venizelos,
Credit Strategist,
Research – Core Investment

Central banks against the inflation wall

The monthly increase in the US Consumer Price Index (CPI) has averaged 0.2% over the past 20 years and less than 0.6% most of the time. US CPI rose by 0.6% in January – a monthly increase that would sustain annual rates above 7% for 2022. Even monthly increases of 0.4% to 0.6% would allow inflation to fall, but not as swiftly as previously hoped. This suggests a more aggressive Federal Reserve (Fed) and an increasing risk of a possible recession, which could translate to at least a 2.5% yield in US Treasuries and a 20% correction in stocks.

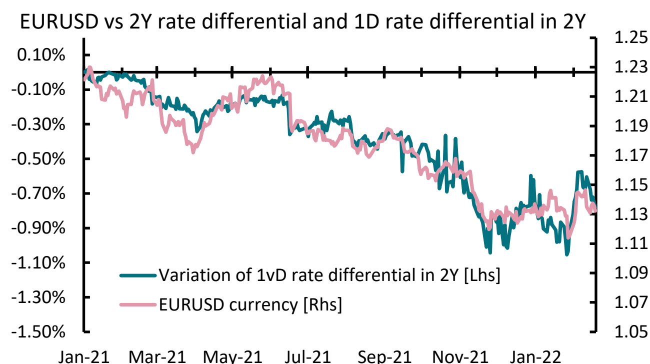
Investment Strategy – FX

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

False start for the euro

A hawkish turnaround by the European Central Bank (ECB) at its February meeting triggered a sharp rebound in the euro/US dollar rate to slightly below 1.15. We were expecting such a rebound, albeit later, conditional on signs of growing inflation pressures for Europe too. Despite the sizable surprise, the move did not reflect signs of a larger repositioning towards a euro/dollar fair value of 1.25. It simply reacted to the central bank terminal rate differential (the one-day rate in two years' time), as has been the case since 2021 (Exhibit 7).

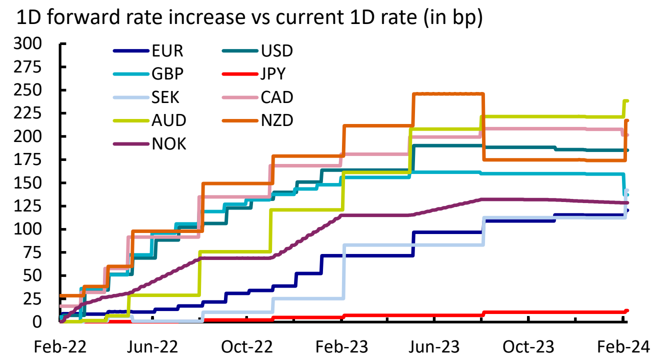
Exhibit 7: Euro/dollar tracking terminal rate differential



Source: Bloomberg and AXA IM Research, 21 February 2022

Indeed, the close relationship with terminal rates skews the outlook for the euro/dollar rate to the downside in the near term. The ECB did not push back against possible rate hikes in 2022 and markets proceeded to price more than four hikes over a two-year horizon, which we find excessive (Exhibit 8). At the same time, the Fed terminal rate is under-priced in our view. An adjustment between the two could push the euro/dollar rate back towards 1.10. Longer term, if wages in the European Union (EU) start rising more persistently, pushing the EU terminal rate higher, the euro/dollar rate could move towards 1.20.

Exhibit 8: 'Grate' expectations for most central banks (Bank of Japan the exception) …



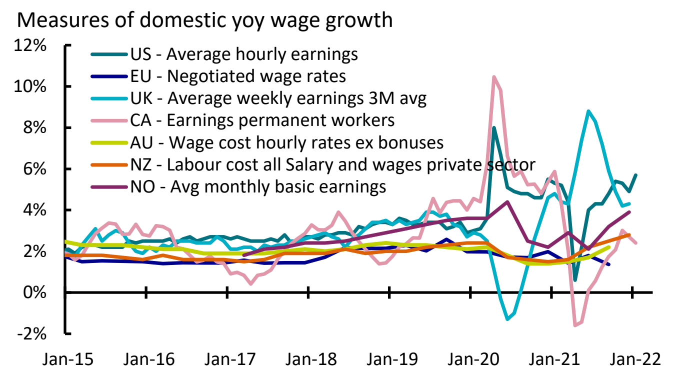
Source: Bloomberg and AXA IM Research, 21 February 2022

Fed, Norges and New Zealand to keep ahead

Currently wages are a key driver of central bank expectations. In the EU, they have risen, but not accelerated (Exhibit 9). Neither are they rising notably in Canada or Sweden, and both the Bank of Canada and the Riksbank have been surprising dovish side in their latest meetings. There are signs of rising wages in Australia but still not at the 3% target where the Reserve Bank of Australia would consider normalising policy. However, wages are rising to relatively high levels in Norway and New Zealand, making the case for both central banks to be hawkish more credible. In addition, house price inflation has surged in New Zealand and remains elevated in Norway. GDP in both economies had also rebounded well above pre-COVID-19 levels.

US and UK wage growth is strong and supports central bank hawkishness. But in the UK, this appears vulnerable in the medium term, as GDP is still below pre-pandemic levels and the key sources of inflation pressure, (lack of) migration and energy, are weighing on potential growth.

Exhibit 9: … despite uneven wage inflation pressures



Source: Bloomberg and AXA IM Research, 21 February 2022

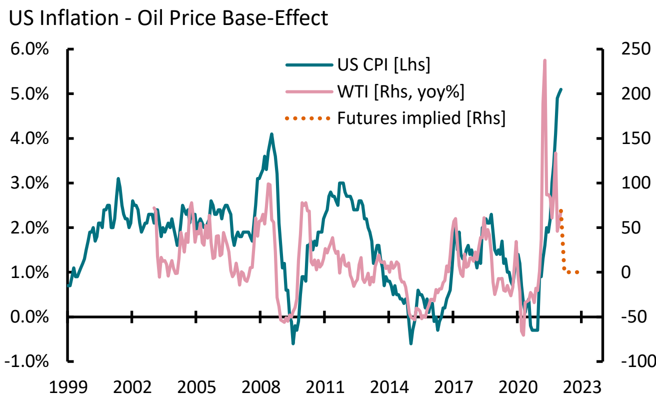
Investment Strategy – Rates

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

Policy, inflation and the term premium

Understandably, inflation expectations are an essential variable in virtually every inflation model. Central bankers allocate a large share of their attention to the evolution of these forecasts, which often motivate policy decisions on the back of the risk of so-called positive feedbacks from inflation expectations to measured inflation. This was the case in the Eurozone in 2011, with controversial rate hikes, and in 2015, when the European Central Bank entered the quantitative easing (QE) arena. It is common practice to observe both market and survey-based inflation expectations.

Exhibit 10: Positive base effects into the summer



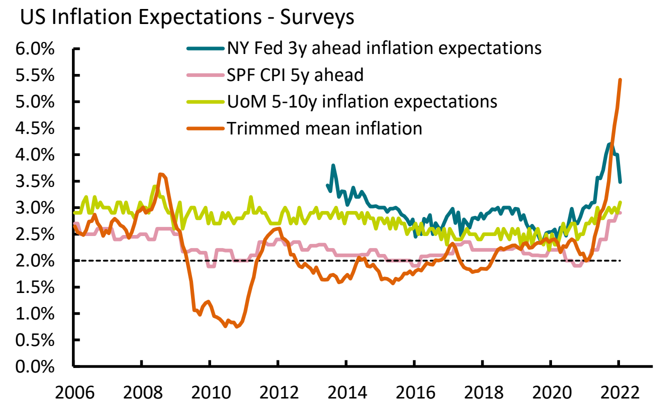
Source: Bloomberg and AXA IM Research, 18 February 2022

Market-based expectations have the obvious advantage of being readily available for several economies around the world. The flipside of the coin has to do with the tight relationship between crude oil prices and inflation expectations, across the entire breakeven curve. Somehow, inflation traders tend to follow oil prices very closely when it comes to inferring inflation over different time horizons.

Looking at Exhibit 10, this shouldn't surprise us, as there seems an evident relationship between year-on-year changes in West Texas Intermediate (WTI) oil prices and the US Consumer Price Index. According to WTI oil price futures, oil is set to pull US inflation lower starting in July of this year. While this information is well internalised in the inverted shape of the Treasury Inflation-Protected Securities breakeven curve, we should keep in mind the volatile nature of oil futures prices – and that these are not necessarily good predictors of actual future prices, which means those expected base effects can change abruptly - and at short notice.

To avoid being overly skewed toward one source of information, central bankers also consult surveys to assess inflation expectations. Exhibit 11 shows the relative stability of longer-term survey-based expectations, as well as the somewhat worrying rise in shorter-term measures of expectations in the aftermath of COVID-19.

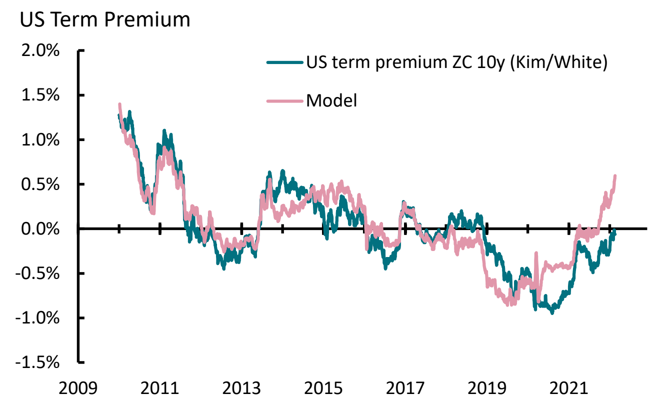
Exhibit 11: Surveys point at sustained inflation



Source: Bloomberg and AXA IM Research, 18 February 2022

Inflation expectations' trajectory is most likely a key driver behind Federal Reserve (Fed) policymakers' changing narrative. The preferred policy option appears to be a tightening of monetary conditions, which is well priced in by the curve. On the other hand, several economists have warned against hiking rates in the wake of supply bottleneck-driven inflation. This dichotomy and the related increase in Fed's policy uncertainty, especially after over a decade of QE, has contributed to a significant increase in bond market volatility.

Exhibit 12: Term premium is lagging



Source: Bloomberg and AXA IM Research, 18 February 2022

In addition to interest rate and inflation expectations, we should not underestimate the term premium's contribution to both the level and shape of the yield curve. In our framework, both bond price volatility and the shape of the forwards space contribute to explain the term premium (Exhibit 12). In a hiking cycle scenario characterised by increased policy uncertainty, it is fair to assume the term premium will have a positive contribution to the level of Treasury yields.

Investment Strategy – Credit

Gregory Venizelos
Credit Strategist
Research – Core Investments

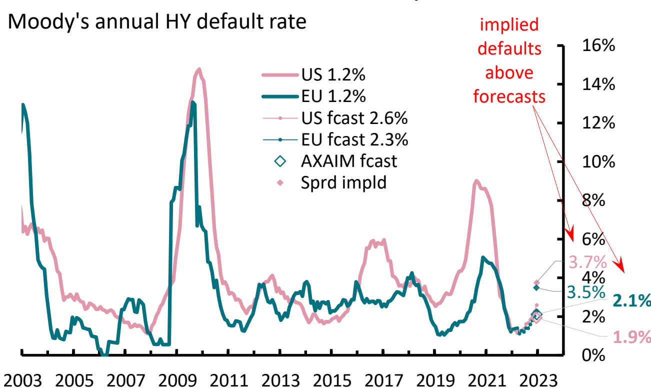
Modify your duration

High yield (HY) credit has outperformed both equities and investment grade (IG) credit in 2022, albeit with a 3% drop. For its part, global IG is down 4% while credit is off 5%. Returns across credit indices (the degree of drawdown, to be precise) continue to scale according to index duration, with the longest duration markets bearing the brunt of the rise in government bond yields. Moreover, HY spreads have outperformed in beta-adjusted terms, having widened relatively less than IG spreads – a pattern of bearish compression which is not atypical ahead of a hiking cycle.

Til defaults do us part

Above-trend growth and healthy earnings should continue to underpin HY credit fundamentals. Furthermore, default cycle indicators are currently very benign, adding to the tailwinds. Indeed, the COVID-19 default cycle has come to an end after a default peak that has been the highest since the global financial crisis. The subsequent decline in the default rate has been swift and, currently, realised annual defaults are at levels not seen since before the 2008/2009 crisis (Exhibit 13). An uptick from low levels is almost inevitable, but default rates over the next 12 months are likely to remain below historic averages at circa 4% and 3% for US and European HY respectively.

Exhibit 13: The COVID-19 default cycle has ended

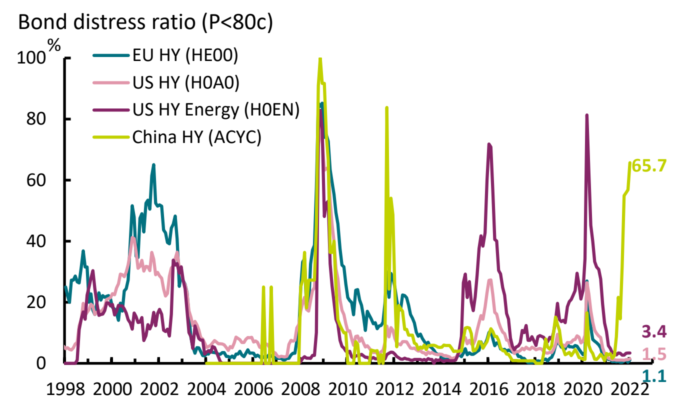


Source: Moody's, InterContinental Exchange (ICE) and AXA IM Research, Feb 2022

Default predictors: No alarms and no surprises

Typical default predictors like HY bond distress ratios – the share of bonds trading below a certain price or above a certain spread – and bank lending standards remain very well-behaved despite the recent uptick in market volatility. The exception is China HY, which is dominated by its troubled property sector (Exhibit 14). The commodity price rally is a strong factor here, given that energy is the largest sector within US HY. Similarly, bank lending standards remain near their historic lows and in easy territory (Exhibit 15). Combining these two default predictors with the appropriate lags in our model we can derive default expectations for the next 12 months. These are 2.1% for US HY and 1.9% for European HY for the Moody's cohorts (Exhibit 13), again below historic averages.

Exhibit 14: HY distress ratios at rock bottom, ex. China

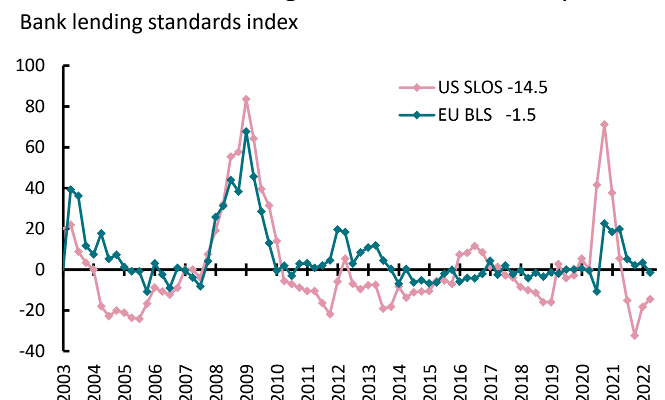


Source: ICE and AXA IM Research, Feb 2022

HY spreads cheap versus default expectations

HY markets screen cheap compared to default expectations, as the spread-implied default rate is currently above the model forecasts (Exhibit 13). The Moody's US HY cohort has an estimated spread of 525 basis points (bp) and screens cheap by some 200bps given the gap of 1.6% between default rates; implied of 3.7% and forecast of 2.1%. It would take a deterioration in the distress ratio to 5% (currently 1.5%) and in bank lending standards to 0 (-14.5%) for the default forecast to rise by 1.6% and wipe out that 200bp valuation. Again, while an uptick in defaults from the current low levels is likely, it is expected and manageable for HY credit. The risk to this view is that overeager central bank policy tightening alters the macro trajectory towards recession, driving a major repricing higher in equity and credit premia.

Exhibit 15: Bank lending standards remain easy



Source: Fed, ECB and AXA IM Research, Feb 2022

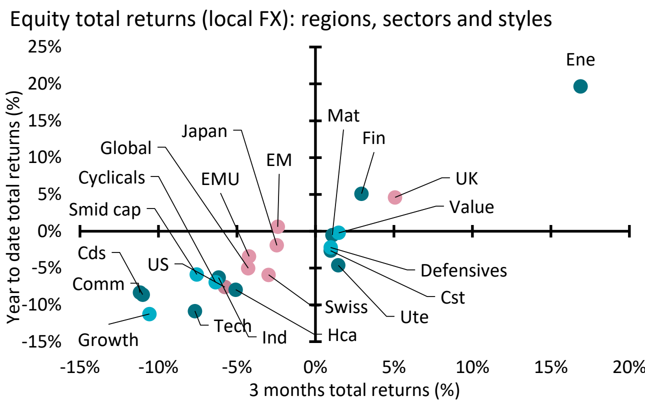
Investment Strategy – Equity

Emmanuel Makonga,
Investment Strategist,
Research – Core Investments

Some room to breathe

Stock market performance is suffering from a negative news flow. In the past month, global equities have contracted by 5%, although the UK has delivered 5% growth. Sector wise, energy is the standout (+20%), driven by rising commodity prices (Exhibit 16). Long duration equities are having a tough time (-11%) as the upward momentum in interest rates erodes the value of future cash flow. In this context, the rotation from growth to value has continued.

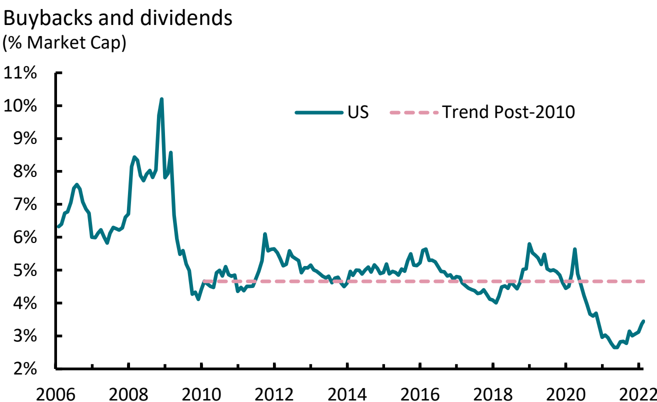
Exhibit 16: Energy as an outlier... again



Source: Datastream and AXA IM Research, February 2022

Monitoring cash revenues – US capital returns remain well below pre-pandemic levels relative to market capitalisation (Exhibit 17). We can observe such a gap in Europe too, albeit a narrower one. As buybacks and dividends lag earnings by two to three quarters, we expect cash returns to be a significant element in the performance of the 2022 equity market.

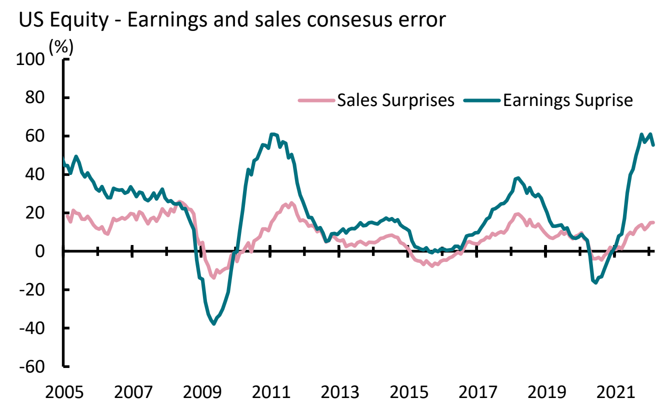
Exhibit 17: Buybacks and dividends should trend higher



Source: Bloomberg, Datastream and AXA IM Research, February 2022

Gauge the margin of error – The earnings season continues in the same tone. Most surprises are positive with 77% earnings per share (EPS) beating expectations in the US, and 65% in Europe, but negative earnings surprises are being punished by markets. Moreover, in the US, the labour market continues to tighten, adding to wage pressures which in turn erode profit margins. Tighter US monetary policy is also starting to create more complicated financing conditions for companies. Supply bottlenecks cut both ways – while they exert upward pressure on prices, forcing central bankers towards policy hikes, simultaneously higher producer prices correlate positively with margins as companies pass these costs on to consumers. Overall, the outlook for profit margins remains challenging.

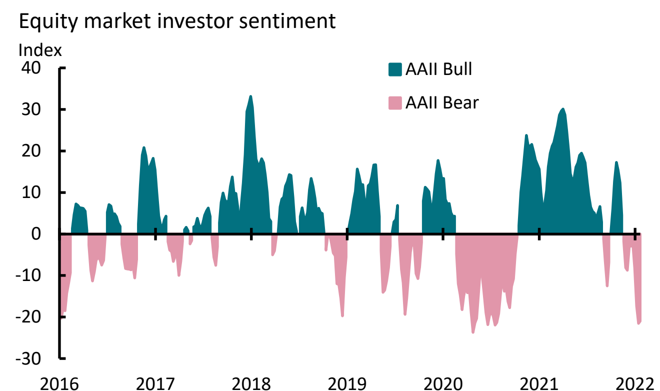
Exhibit 18: Concerns over margins may be too overdone



Source: IBES and AXA IM Research, February 2022

Cloudy environment – Exhibit 18 shows earnings currently being well supported by profit margins, given that sales surprises are high, yet not at record highs. Earnings are likely to become less impressive in the coming quarters, reducing equity market support. Negative corporate guidance also complicates the trajectory of margins in the coming quarters. In addition, the end of central bank accommodation and the risk of escalation of the Russia/Ukraine conflict are weighing on investor sentiment (Exhibit 19). In this environment, we are neutrally positioned in the asset class, favouring European auto manufacturers which are benefitting from an improvement of fundamentals and market preference for value.

Exhibit 19: Sentiment at its lowest on equities



Source: American Association of Individual Investors (AAII) and AXA IM Research, Feb 2022

Recommended asset allocation

Asset Allocation	Negative	Neutral	Positive
Key asset classes			
Equities			■
Bonds		▲	
Commodities		■	
Cash	▼		
Equities			
Developed			
Euro area			■
UK		■	
Switzerland		■	
US		■	
Japan		■	
Emerging & Sectors			
Emerging Markets		■	
Europe Cyclical/Value		■	
Euro Financials		▼	
European Auto			▲
US Financials		■	
US Russell 2000		■	
Fixed Income			
Govies			
Euro core		▲	
Euro peripheral		■	
UK		▲	
US		▲	
Inflation			
US		■	
Euro		■	
Credit			
Euro IG	■		
US IG		■	
Euro HY			■
US HY		■	
EM Debt			
EM bonds HC		■	

Legends: Negative | Neutral | Positive — Last change: ▲ Upgrade | ▼ Downgrade

Source: AXA IM Macro Research – As of 22 February 2022

Macro forecast summary

Real GDP growth (%)	2020	2021*		2022*		2023*	
		AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
World	**-3.1**	**5.8**		**4.0**		**3.5**	
Advanced economies	**-5.0**	**5.0**		**3.4**		**2.1**	
US	**-3.4**	**5.5**	5.6	**3.2**	3.9	**2.0**	2.6
Euro area	**-6.7**	**5.2**	5.1	**3.4**	4.0	**2.1**	2.5
Germany	**-4.9**	**2.8**	2.7	**2.9**	3.7	**2.7**	2.5
France	**-8.0**	**7.0**	6.6	**3.9**	3.8	**2.4**	2.0
Italy	**-9.0**	**6.5**	6.3	**3.8**	4.2	**1.9**	2.2
Spain	**-10.8**	**5.0**	4.7	**5.9**	5.6	**3.0**	3.6
Japan	**-4.9**	**1.7**	1.8	**2.9**	3.1	**2.2**	1.5
UK	**-10.0**	**7.2**	7.0	**4.3**	4.3	**2.1**	2.2
Switzerland	**-2.5**	**3.5**	3.5	**3.0**	3.0	**1.6**	1.9
Canada	**-5.2**	**4.4**	4.7	**3.5**	3.9	**2.6**	3.0
Emerging economies	**-1.9**	**6.4**		**4.4**		**4.3**	
Asia	**-0.8**	**6.8**		**5.1**		**5.2**	
China	**2.3**	**7.9**	8.0	**5.0**	5.0	**5.3**	5.3
South Korea	**-0.9**	**4.0**	4.0	**2.6**	3.0	**2.1**	2.5
Rest of EM Asia	**-4.6**	**5.8**		**5.4**		**5.3**	
LatAm	**-7.0**	**7.0**		**2.6**		**2.6**	
Brazil	**-3.9**	**5.1**	4.7	**1.2**	0.6	**2.0**	2.0
Mexico	**-8.5**	**6.0**	5.6	**2.6**	2.5	**2.2**	2.3
EM Europe	**-2.0**	**6.6**		**3.8**		**2.8**	
Russia	**-2.7**	**4.7**	4.2	**3.2**	2.6	**2.0**	2.2
Poland	**-2.5**	**5.8**	5.3	**4.9**	4.7	**3.8**	4.0
Turkey	**1.8**	**11.4**	9.9	**3.6**	3.0	**3.0**	3.4
Other EMs	**-2.1**	**4.2**		**3.9**		**3.9**	

Source: Datastream, IMF and AXA IM Macro Research – As of 21 February 2022 * Forecast

CPI Inflation (%)	2020	2021*		2022*		2023*	
		AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	**0.7**	**3.2**		**4.0**		**2.2**	
US	**1.2**	**4.7**	4.6	**5.0**	4.8	**2.9**	2.6
Euro area	**0.3**	**2.6**	2.5	**4.0**	3.1	**1.7**	1.6
Japan	**0.0**	**-0.2**	-0.2	**1.2**	0.8	**0.7**	0.7
UK	**0.9**	**2.6**	2.5	**5.5**	4.6	**2.1**	2.5
Switzerland	**-0.7**	**0.5**	0.5	**0.6**	0.9	**0.7**	0.6
Canada	**0.7**	**3.4**	3.4	**3.1**	3.4	**2.3**	2.2

Source: Datastream, IMF and AXA IM Macro Research – As of 21 February 2022 * 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	**Q1-22**	**Q2-22**	**Q3-22**	**Q4-22**
United States - Fed	Dates	0-0.25	25-26 Jan 15-16 Mar	3-4 May 14-15 June	26-27 July 20-21 Sep	1-2 Nov 13-14 Dec
	Rates		+0.25 (0.25-0.5)	+0.25 (0.5-0.75)	+0.25 (0.75-1)	+0.25 (1-1.25)
Euro area - ECB	Dates	-0.50	03 Feb 10 Mar	14 April 9 June	21 July 8 Sep	27 Oct 15 Dec
	Rates		unch (-0.50)	unch (-0.50)	unch (-0.50)	+0.25 (-0.25)
Japan - BoJ	Dates	-0.10	17-18 Jan 17-18 Mar	27-28 April 16-17 June	20-21 July 21-22 Sep	27-28 Oct 19-20 Dec
	Rates		unch (-0.10)	unch (-0.10)	unch (-0.10)	unch (-0.10)
UK - BoE	Dates	0.25	3 Feb 17 Mar	5 May 16 June	4 Aug 15 Sep	3 Nov 15 Dec
	Rates		+0.25(0.5)	+0.25 (0.75)	+0.25 (1)	unch (1)

Source: AXA IM Macro Research - As of 21 February 2022

These projections are not necessarily reliable indicators of future results

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