AXA Investment Managers

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Investment Institute Macroeconomics

Monthly Op-ed

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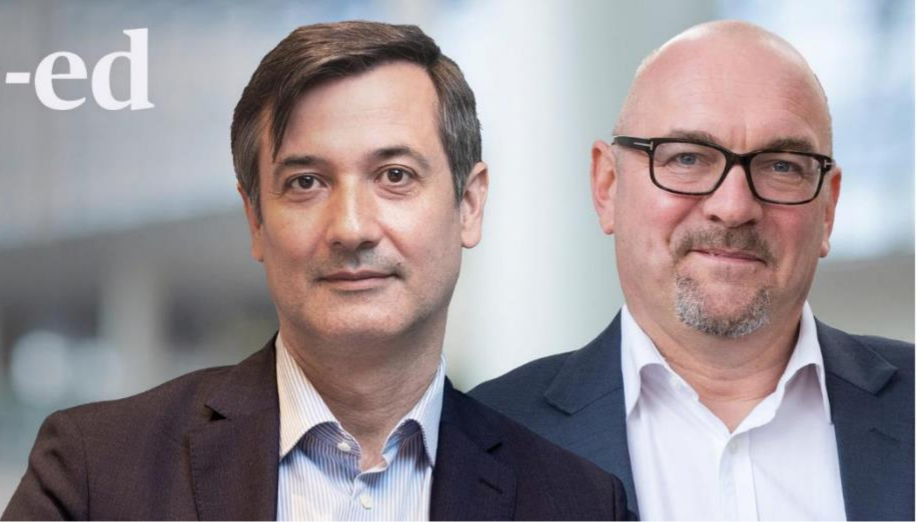


Stories for the summer

Key points

- The so far impressive resilience in economic activity across the Atlantic – which has played a major role in accelerating the central banks' tightening – is showing its first cracks.
- We present our revised "mid-year" macro scenarios. A manageable but still painful landing is our base case.
- Bond price stability necessary for broader market recovery
- Growth risks remain key challenge for equity investors
- Valuations improve across markets

Our mid-year macro scenarios

The economy's impressive resilience so far across the Atlantic has been a key ingredient in the central banks' willingness to toughen up their stance to fight the inflation spike. If the usual "self-stabilizing forces" – e.g., a deceleration in consumption brought about by rising prices – do not show up, then the Federal Reserve (Fed) and the European Central Bank (ECB) will feel even more the need to bring forward their rate hikes. However, it is precisely at the moment that this new resolve is communicated that signs of deceleration are appearing. The lower-than-expected PMI readings for June in both the US and the Euro area, together with a less concerning second estimate of US consumers' inflation forecasts in the Michigan survey for June have triggered a – rare – downward revision in the market's expectations for the Fed Funds trajectory. Besides, with no further Covid flare-up in China for now, the global economy may avoid another source of supply-side inflationary pressure through the price of manufactured goods. Finally, oil prices have moderated.

This gets us to where we stand on the balance of risks around our forecasts as we reach the middle of the year. A manageable but still painful landing is our base case, to which we ascribe a probability of 60%. We expect GDP to grow less in 2023 in both the US and the Euro than their two central banks currently expect (1.2% versus 1.7% Q4/Q4 for the US, and 0.7% versus 2.1% for the Euro area), as the market-led tightening in financial conditions and self-stabilizing forces (consumption impaired as real income is eroded by inflation) would kick in on top of the reversal of the monetary policy stance. These annual averages would be consistent with quarterly GDP into or on the verge of contraction at the turn of the year. The loss in growth dynamics would be sufficient to bring about a deceleration in core inflation without forcing the central banks to deliver all the tightening they have been communicating on lately. The Fed would be "stopped" at 3.25%, below the 3.4% by end 2022 and 3.8% by end 2023 which is in their current "dot plot". The ECB could leave its depo rate at the lower end of the "neutral range" (i.e. at around 1%). We would then see the US 10-year yield at 3.15% by the end of 2022, and 10-year Bund yield at 1.5%

We would see two symmetric risks around this baseline. First, as a kind of "extreme version" of our main forecasts, we cannot discard the possibility that the sum total of self-stabilizing forces, market tightening, and policy restriction triggers a "sudden stop" in demand so that 2023 GDP growth would be flat on an annual average basis. This, considering the base effects, would take a more severe quarterly contraction in GDP at the turn of the year. Long-term interest rates would then fall back below 3% by year-end (a fully inverted curve) in the US and below 1% for Bund yields, as core inflation would correct faster than what the central banks themselves are currently forecasting. In short, a painful, but relatively short-term correction.

Second, a "persistent inflation" scenario – to which we ascribe a lower probability than to the previous alternative scenario - which would force even tighter monetary tightening, above the Fed's median forecast in the US for the policy rate (north of 4% in 2023) and into restrictive, rather than neutral territory in the Euro area (above 2%), resulting in a significant recession (-1%/-2%) in annual average in 2023). Long-term interest rates could be very volatile in this configuration, with inflation expectations de-anchoring, initially consistent with a steepening of the curve before the response from central bank would ultimately restore credibility and trigger a curve inversion. In short, a very painful, and protracted correction, with maximum damage for risky assets.

Still, the root cause of such persistence would likely be quite different across the Atlantic. In the US, an overheating labour market and spiralling wages would be the most obvious candidate. Core inflation would be the main source of overshooting, making the Fed's job simple, if painful. In the Euro area, it's more the exacerbation of the exogenous shocks, and particularly another steep rise in gas prices, which would be the natural trigger of the "persistent inflation" scenario. This would make the ECB's job much less simple.

The Euro area would find itself in the durable divergence between core and headline inflation . Hiking policy rates further to avoid a drift in inflation expectations would probably be the ECB's "natural slope", but we would then expect significant political tension within the monetary union. Indeed, in the "painful for longer" configuration, governments would be under intense pressure to further mitigate the shock with fiscal support and resent an ECB stance which would impair its funding conditions. Markets themselves would probably take notice of the deterioration in GDP growth and further drift in fiscal positions. It's probably in this "persistent inflation" scenario that the probability for the ECB to be forced to deploy its anti-fragmentation tool would be highest, but also where the capacity for governments to deliver on even light macroeconomic conditionality would be lowest.

Faints rays of light in bond markets

The baseline scenario of US growth slowing enough to allow the Fed Funds rate to peak just above 3.0% is a positive one for bond markets. It would suggest that long-term bond yields have risen enough and would allow interest rate volatility to decline. Investors would thus be more confident about adding duration to their bond exposures and total returns would start to turn more positive, after experiencing their worst drawdowns in living memory. Indeed, the bottoming of total returns is potentially already behind us. Average bond prices have fallen to extreme lows and the technical effect of "pull-to-par" should deliver positive returns going forward. Given how much bond yields have risen, there is also the return of fixed income as a potential hedge against equity weakness as a further reason to add exposure.

For credit markets the story is a little more complicated. Spreads have widened to levels that, in the past, have triggered a period of excess returns for corporate bonds relative to government bonds. Indeed, the rise in overall yields looks attractive in terms of future absolute returns too. The US investment grade corporate bond index yields 5% with equivalent benchmarks in Europe yielding 3%. Lower interest rate volatility and low average bond prices should make credit more attractive going forward. However, spreads are not at their widest levels. In previous periods of economic downturn or market stress, the spread between corporate and government bonds has been wider. Of course, we are not suggesting that spreads should approach anything like the levels seen during the global financial crisis but there is certainly room for spreads to go even higher should economic data or liquidity conditions really deteriorate over the summer.

However, the medium-term view would be more positive across fixed income assets. Even in high yield, where some increase in default rates is to be expected, these look to be low relative to other cycles. The gap between existing coupons and current market yields has widened, and that refinancing risk needs to be monitored. However, as far as we can tell, there is no huge re-financing wall ahead of us. Companies are probably more inclined to build cash levels to sustain their interest coverage as expectations on revenue growth and margins have deteriorated.

Higher yields in credit suggest that income should be a much more important determinant of total returns in bond portfolios going forward. Central bank intervention in markets in recent years has pushed yields down and bond prices up so capital appreciation has tended to dominate. Those days are over for now. Indeed, it should be noted that for most holding periods other than relatively short-term, income dominates the return to bond investors. Higher yields today mean higher income streams.

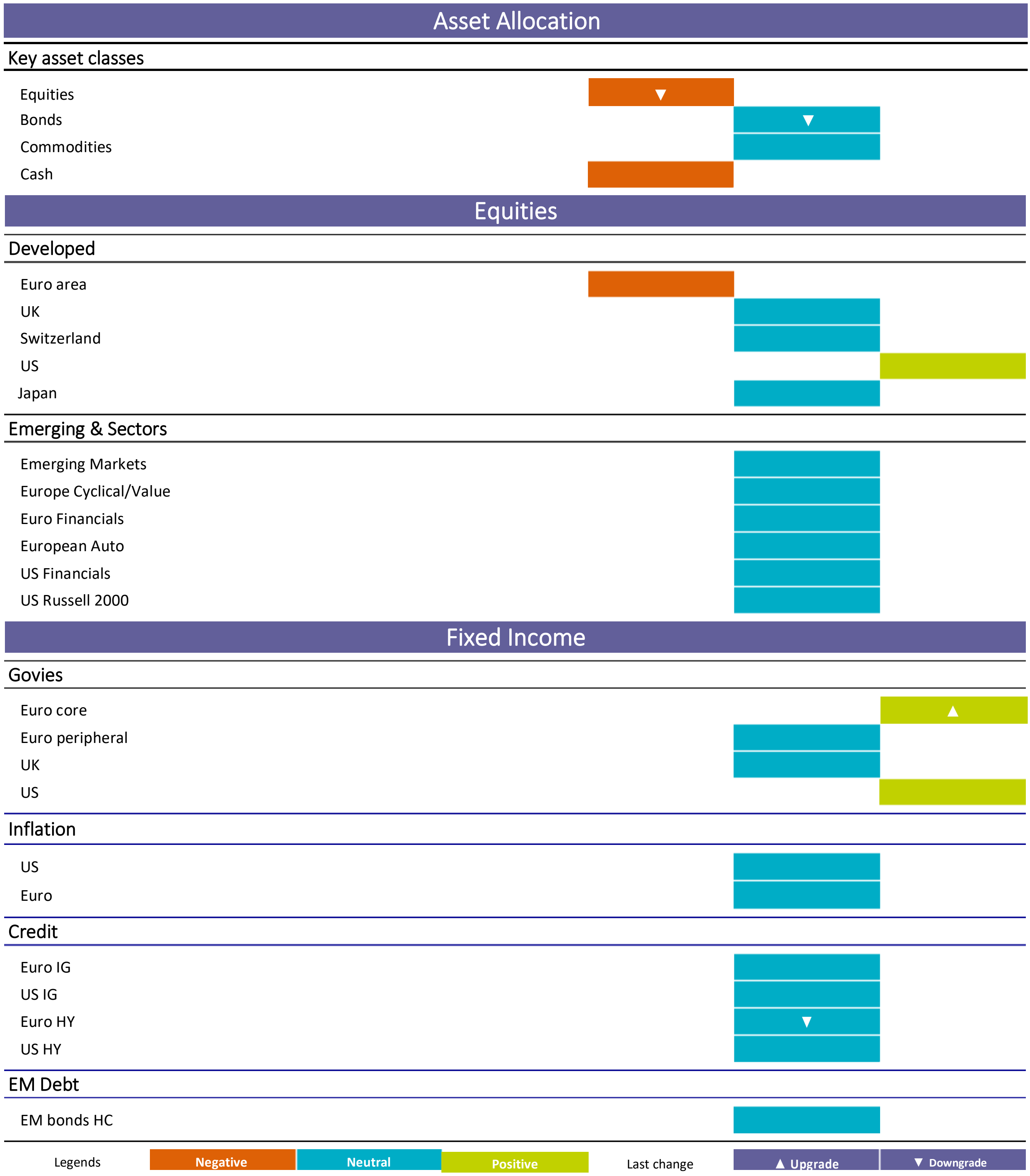
The macro environment remains challenging, that is for sure. For equity investors a decline in interest rate volatility and a stabilisation of bond yields will reduce the need for stocks to further de-rate aggressively. We note that the decline in forward price-earnings ratios has already been significant. At face value, the COVID-era, liquidity driven boost to equity valuation has been reversed and, in some sectors, and markets it has gone beyond that. Even areas where valuations rose to extreme levels, like technology and broader growth stocks, have seen a significant reduction in valuations.

Rising interest rates, particularly real yields, have hit equity valuations and more stable rates should mean less need to de-rate. In which case the key driver of equity returns will be earnings. Earnings forecasts were revised down around the time of first quarter releases but the consensus still sees almost 10% growth in earnings-per-share over the next year for both the US and European equity markets. This could be optimistic given the risks to growth. Any disappointment in second quarter earnings, and by this we mean going beyond consumer related sectors that have already guided lower, could be met with weak equity performance over the summer months.

However, many equity indices are displaying “bear market” corrections from the highs they reached last year, so valuations are more attractive. Compared to bond yields, markets in Europe and Asia look more attractive than the US. However, Europe continues to face risks on the energy side as well as concerns about fragmentation risks as the ECB increases interest rates. It could well be that the US, where generally valuations are richer, is able to recover first, driven by a scenario of the Fed pausing later this year and the economy avoiding a significant downturn.

It is always difficult to be constructive on markets when the macro-economic and political outlook is so uncertain, as it is today. There are clear downside risks still, not least of which could come from any escalation of the conflict in the Ukraine. However, if we stick to assessing the business cycle and how the global economy is still re-balancing in the wake of the pandemic, then there are some faint rays of light on the horizon. Central banks, led by the Fed, have set out their stall and started acting. Inflation should respond and with it there will be relief on the rate side. Given how far bond prices have fallen this year, investors should get some reward from focussing on where things go from here. A recovery in market wide bond prices can happen even if yields and rates remain higher than when central banks started to talk tough. That in itself is a re-requisite for a better performance from credit and equities. It will come, but the short-term outlook remains rocky.

Recommended asset allocation



Source: AXA IM Macro Research – As of 28 June 2022

Macro forecast summary

Real GDP growth (%)	2020	2021*		2022*		2023*	
		AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
World	-3.1	6.1		3.1		2.9	
Advanced economies	-5.0	5.1		2.6		1.2	
US	-3.4	5.5	5.6	2.4	2.8	1.2	2.1
Euro area	-6.4	5.3	5.1	2.8	2.7	0.7	2.2
Germany	-4.6	2.9	2.7	1.5	2.0	0.7	2.4
France	-8.0	6.8	6.6	2.3	2.9	0.8	1.7
Italy	-9.0	6.6	6.3	2.7	2.5	0.2	1.8
Spain	-10.8	5.1	4.7	4.2	4.4	0.6	3.0
Japan	-4.9	1.7	1.8	1.6	2.0	1.9	1.9
UK	-10.0	7.2	7.0	3.7	3.8	0.9	1.0
Switzerland	-2.5	3.5	3.5	2.5	2.6	1.0	1.8
Canada	-5.2	4.4	4.6	3.5	4.1	1.7	2.6
Emerging economies	-1.9	6.7		3.5		3.9	
Asia	-0.7	7.0		4.3		5.0	
China	2.2	8.1	8.0	3.6	4.7	5.2	5.1
South Korea	-0.9	4.1	4.0	1.5	2.7	1.6	2.4
Rest of EM Asia	-4.2	6.1		5.5		5.2	
LatAm	-7.0	6.8		2.4		2.1	
Brazil	-3.9	4.6	4.7	0.9	0.8	1.6	1.4
Mexico	-8.2	4.8	5.6	1.5	1.7	1.0	2.2
EM Europe	-2.0	6.7		-0.8		0.4	
Russia	-2.7	4.7		-6.0		-3.5	
Poland	-2.5	6.0	5.3	6.0	4.2	2.0	3.2
Turkey	1.6	11.5	9.9	4.6	2.2	2.0	2.8
Other EMs	-2.5	5.4		4.2		3.7	

Source: Datastream, IMF and AXA IM Macro Research – As of 24 June 2022 * Forecast

CPI Inflation (%)	2020	2021*		2022*		2023*	
		AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	0.7	3.2		6.7		3.4	
US	1.2	4.7	4.6	7.8	7.2	4.5	3.3
Euro area	0.3	2.6	2.5	7.4	6.8	3.1	2.6
China	2.5	0.9	0.9	2.1	2.2	2.3	2.3
Japan	0.0	-0.2	-0.2	2.2	1.7	1.0	1.1
UK	0.9	2.6	2.5	7.7	7.8	3.6	4.3
Switzerland	-0.7	0.5	0.5	2.0	2.1	1.0	1.0
Canada	0.7	3.4	3.4	6.7	5.7	3.4	2.9

Source: Datastream, IMF and AXA IM Macro Research – As of 24 June 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	Q3-22	Q4-22	Q1-23	Q2-23
United States - Fed	Dates	1.50-1.75	26-27 July 20-21 Sep	1-2 Nov 13-14 Dec	31-1 Jan/Feb 21-22 Mar	2-3 May 13-14 Jun
	Rates		+1.00 (2.50-2.75)	+0.5 (3.00-3.25)	unch (3.00-3.25)	unch (3.00-3.25)
Euro area - ECB	Dates	-0.50	21 July 8 Sep	27 Oct 15 Dec	2 Feb 16 Mar	4 May 15 Jun
	Rates		+0.75 (0.25)	+0,75 (1.00)	unch (1.00)	unch (1.00)
Japan - BoJ	Dates	-0.10	20-21 July 21-22 Sep	27-28 Oct 19-20 Dec	Jan Mar	May Jun
	Rates		unch (-0.10)	unch (-0.10)	unch (-0.10)	unch (-0.10)
UK - BoE	Dates	1.00	4 Aug 15 Sep	3 Nov 15 Dec	Feb Mar	May Jun
	Rates		+0.50 (1.75)	+0.25 (2.00)	unch (2.00)	unch (2.00)

Source: AXA IM Macro Research - As of 24 June 2022

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