Normalisation and Correction

Monthly Investment Strategy Oped

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Key points

- The Federal Reserve's relentless hawkish messaging is a game-changer for 2022
- The Fed was probably frustrated by the market response to its hints of policy normalisation.
- Equity market corrections in anticipation of higher rates
- Watch earnings growth forecasts
- Scope for re-setting of exuberance in parts of the equity market

Fed and market playing cat and mouse

With evidence accumulating that the Omicron wave is having a smaller impact on economic activity than the previous pandemic episodes, one could have expected a "nice start" to 2022 on the market. This however offset by the signals from the Federal Reserve (Fed) which has clearly decided not to take risk with inflation, probably spooked by the acceleration in wages and the stubborn weakness in labour market participation. Their change in tone over the last few months has been striking, and investors need to deal with a weekly (and sometimes daily) flow of hawkish comments from various Fed speakers. This relentless messaging may have to do with some frustration at the central bank about the lack of reaction of broad financial conditions. Late last year, while investors had perfectly understood the Fed's hints at a faster pace of rate hikes, reflected in the rise in 2-year yields, long-term interest rates did not move. If prolonged, this would have dampened the impact of the Fed's first rhetorical and then actual tightening. The central bank finally managed to get the long-end of the curve moving with its hints in the minutes of the December meeting that it could reduce the size of its balance sheet faster than during the last phase of monetary normalisation. Mortgage rates followed suit, but as of 24 January corporate bond were still surprisingly refusing to move in sync with treasuries. This may prompt additional hawkish comments from the Fed, clearly intent in lifting the funding costs of private agents to curb excess demand quickly.

A key issue though is to understand the reasons behind the market's first reaction to the Fed's hawkish turns. One can favour a "technical" explanation: the amount of liquidity created by quantitative easing is so large that "telegraphing" rate hikes has little impact on the market at large. This can be alleviated precisely by reducing the central bank's balance sheet. Unfortunately, there is also a darker explanation in terms of macroeconomic trajectory: investors may be reluctant to lift the long end of the curve because they believe that the Fed is in "overkill mode" and will trigger a significant economic slowdown which will, ultimately, bring inflation back to the below 2% pace which prevailed between the end of the Great Financial Crisis (GFC) of 2008-2009 and the beginning of the pandemic. This is one of the reasons why it is difficult to characterize the Fed as

being behind the curve: market-based long-term inflation expectations were not (and still aren't) particularly high when the central bank started signalling its readiness to tighten its policy. A lot of the current overheating in the US is still the product of the massive fiscal stimulus of 2020 and 2021. With growing signs of policy paralysis in Washington D.C. as it is getting more difficult for Joe Biden to pass his new fiscal packages, the fiscal stance will become less supportive. True, a lot of the past stimulus is still stored in the households' savings overhang, but this must be measured against the erosion in purchasing power triggered by the inflation spike (despite the recent acceleration, wage growth is slower than inflation). Still, while in our baseline a moderate tightening by the Fed would still be consistent with robust growth in 2022, the "cat and mouse" game between the markets and the Fed is however having one clear victim so far this year: equity prices.

De-rating

The narrative behind current financial market volatility has been in place for some time. Inflation has been rising for a year. Central banks are responding to that by moving towards tighter policies. The growth and inflation outlook has deteriorated, and COVID-19 is still acting as a disruptive force. To top it all, the geo-political situation in Eastern Europe poses a risk to stability in the region.

The pandemic is largely responsible for the increase in inflation since the spring of 2021. However, investors are not sure whether inflationary dynamics have moved beyond those generated by supply disruptions and backlogs. Wage growth has picked up and the global energy situation creates additional complexity. With unemployment rates in the major economies within a few tenths of a percentage point of their pre-pandemic lows and with inflation likely to remain elevated for the rest of this year, monetary tightening is warranted and inevitable. After two years of plentiful central bank generated liquidity and fiscal stimulus, markets became expensive. Bond yields fell in 2020 and are only now approaching pre-pandemic levels. Equity returns benefitted from surging earnings growth and higher ratings. What is clear now is that as the Federal Reserve and other central banks increase risk-free short-term interest rates, a valuation adjustment is taking place.

For equity markets, lower price-earnings multiples typically result from higher rates. In all recent monetary tightening cycles in the US, the market multiple has fallen to below the level it was at before the Fed started to hike rates. If this cycle was to repeat the pattern – and it seems to be doing so – we are talking about a potential decline in the price-earnings ratio for the S&P500 of 2-3 percentage points from current levels. Assuming earnings are stable, this suggests a decline in the forward ratio to between 18x and 19x – giving a market level of somewhere in the range of 4100-4300. On this simplistic logic there is perhaps another 5-7% downside risk to the index, which is already over 8% down from the all-time high reached in December 2021.

Such a correction would be consistent with what is still a relatively benign backdrop. The global economy is growing, and the amount of tightening priced in is relatively modest. Keep in mind that the Fed cut the policy rate by 150 basis-points (bps) in the space of less than two weeks in March 2020. Current market pricing has the Fed taking almost two years to hike by that much. If inflation does peak in the first quarter (Q1), as we expect, and the Fed gives no reason for markets to price in even more tightening, then some stabilisation in markets should be seen in the months ahead.

Of course, when the Fed increases rates and its balance sheet strategies become more perceptible there will be concerns about the growth outlook and corporate earnings growth. The fourth quarter earnings season on the US has seen some disappointments already and equity analysts forecasts for earnings-per-share levels in 2022 and 2023 have started to be modestly revised lower. This has been most pronounced regarding growth stocks with the Nasdaq composite price index down over 14% from its highs. As the pandemic recedes and the global economy normalises spending patterns will shift again amongst consumers to the relative detriment of those companies that benefitted from lockdown and restrictions on social mobility. Yet earnings in aggregate need not fall materially given the upside for spending on clearing production backlogs, ramping up output in industries like electronic vehicles and semi-conductors, and accelerating green investment. For several reasons, the extreme growth exuberance evident in some parts of the market is not likely to return. Yet elsewhere different dynamics can become drivers of returns.

Markets outside of the US have less relative downside given that valuations have not been so stretched. The Euro Stoxx index, for example, was recently on 2022 earnings multiple of 15x compared to the 30x earnings the Nasdaq composite was on. Interest rate increases in Europe will lag those in the US while economic growth looks solid. So far, European equity indices have outperformed the US and there are reasons to expect this to continue until the rate and earnings picture in the US

stabilises. It is likely that Europe emerges from the Omicron wave sooner than the US and elsewhere, which should provide additional impetus to consumer spending and investment.

A decline in global infection rates and a peak in inflation in Q1 hold the key to a more positive outlook for bond and equity markets. Some commentators are already questioning whether the Fed needs to hike rates as much as is being anticipated but even if the market is spot on, the tightening is unlikely to detail the global economy. What investors need to come to terms with is a valuation adjustment in global markets. This is most obviously needed in the frothier parts of the stock market and appears to be underway as we wait for the first hike in rates since 2018. There will be some significant stock specific losses and reversals of the more exuberant investment themes that have coloured the last year or so. However, the good news is that earnings overall can provide some offset to lower ratings and our earlier expectation of global equity returns in the high single digit range remains feasible even after a poor start to the year.

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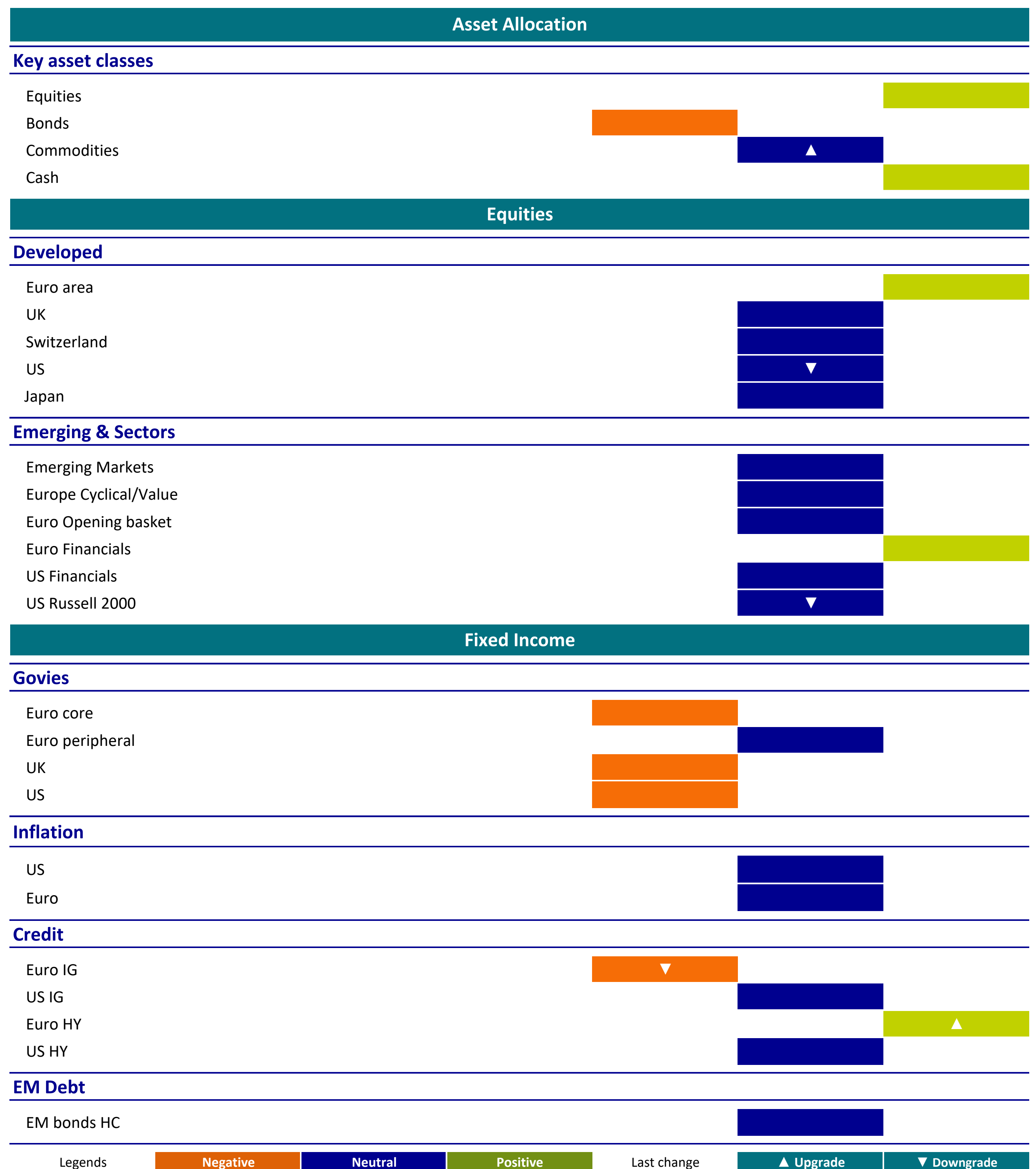
Recommended asset allocation



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 Opening basket		■	
Euro Financials			■
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 26 January 2022

Macro forecast summary

Real GDP growth (%)	2020	2021*		2022*		2023*	
		AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
World	**-3.2**	**5.7**		**4.1**		**3.6**	
Advanced economies	**-5.0**	**4.9**		**3.6**		**2.4**	
US	**-3.4**	**5.5**	5.6	**3.3**	4.0	**2.5**	0.0
Euro area	**-6.7**	**5.0**	5.1	**3.9**	4.2	**2.1**	0.0
Germany	**-4.9**	**2.6**	2.7	**3.5**	4.0	**1.9**	0.0
France	**-8.0**	**6.7**	6.6	**3.6**	3.8	**2.0**	0.0
Italy	**-8.9**	**6.2**	6.3	**3.7**	4.3	**1.9**	0.0
Spain	**-10.8**	**4.3**	4.7	**5.5**	5.8	**3.0**	0.0
Japan	**-4.9**	**1.5**	1.8	**2.9**	3.2	**2.2**	0.0
UK	**-10.0**	**7.2**	7.0	**4.9**	4.7	**2.5**	0.0
Switzerland	**-2.5**	**3.5**	3.5	**3.0**	3.0	**1.6**	0.0
Canada	**-5.3**	**4.4**	4.7	**3.7**	4.0	**2.6**	0.0
Emerging economies	**-2.0**	**6.2**		**4.4**		**4.3**	
Asia	**-0.8**	**6.8**		**5.1**		**5.1**	
China	**2.3**	**7.9**	8.0	**5.0**	5.1	**5.3**	0.0
South Korea	**-0.9**	**4.0**	4.0	**2.6**	3.1	**2.1**	0.0
Rest of EM Asia	**-4.6**	**5.8**		**5.5**		**5.3**	
LatAm	**-7.1**	**6.2**		**2.6**		**2.5**	
Brazil	**-4.1**	**5.1**	4.7	**1.2**	0.9	**2.0**	0.0
Mexico	**-8.5**	**6.0**	5.6	**2.6**	2.8	**2.2**	0.0
EM Europe	**-2.1**	**5.9**		**3.8**		**2.8**	
Russia	**-3.0**	**4.5**	4.2	**3.2**	2.6	**2.0**	0.0
Poland	**-2.7**	**5.1**	5.3	**5.0**	4.8	**3.6**	0.0
Turkey	**1.8**	**9.5**	9.9	**3.6**	3.1	**3.0**	0.0
Other EMs	**-2.4**	**4.2**		**4.1**		**3.9**	

Source: Datastream, IMF and AXA IM Macro Research – As of 24 January 2021 * Forecast

CPI Inflation (%)	2020	2021*		2022*		2023*	
		AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	**0.7**	**3.2**		**3.1**		**2.1**	
US	**1.2**	**4.7**	4.6	**4.0**	4.2	**2.7**	0.0
Euro area	**0.3**	**2.6**	2.5	**2.7**	2.6	**1.8**	0.0
Japan	**0.0**	**-0.2**	-0.2	**0.9**	0.7	**0.7**	0.0
UK	**0.9**	**2.6**	2.5	**4.5**	4.1	**2.0**	0.0
Switzerland	**-0.7**	**0.5**	0.5	**0.6**	0.8	**0.7**	0.0
Canada	**0.7**	**3.4**	3.4	**3.1**	3.3	**2.3**	0.0

Source: Datastream, IMF and AXA IM Macro Research – As of 24 January 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	Q1-22	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	20 Jan 10 Mar	14 April 9 June	21 July 8 Sep	27 Oct 15 Dec
	Rates		unch (-0.50)	unch (-0.50)	unch (-0.50)	unch (-0.50)
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		unch (0.25)	+0.25 (0.50)	unch (0.50)	+0.25 (0.75)

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

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