Investment Managers

26 January 2022
Research & Strategy Insights

Omicron to a Russian Rubicon

Global Macro Monthly

Key points

- Omicron cases appear to be peaking in countries exposed early, but it is spreading more broadly. Hospitalisations have been relatively light, but disruption is still likely.
- Russia-Ukraine border tensions are rising and having a spillover effect in energy and risk asset markets.
- Inflation rose in several developed jurisdictions in December but should be near peak. Omicron and geopolitics to keep rates elevated over the coming months. Visible disinflation expected after the Spring.
- Elevated inflation and tight labour markets are resulting in developed market central banks tightening policy sooner than previously expected. We expect the Federal Reserve to tighten policy in March, but the European Central Bank to hold off into 2023.
- The growth outlook is softer in the short-term reflecting Omicron disruption and an income squeeze. We also lower our US growth outlook on faster policy tightening.

Global Macro Monthly

Investment Strategy

Global Macro Monthly – US

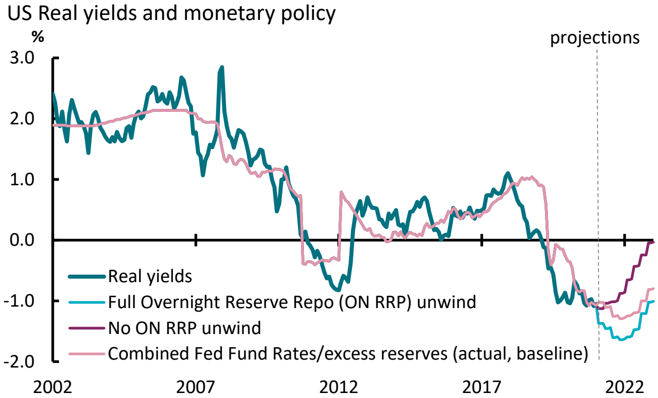
David Page,
Head of Macroeconomic Research,
Macro Research – Core Investments

A full tightening cycle imminent

Developments have led us to once again bring closer our expectation for the start of a full Federal Reserve (Fed) tightening cycle. The labour market has continued to tighten more quickly than expected. While this appears inconsistent with relatively soft payroll gains in the latest months (249k and 199k) it reflects a much stronger household survey, which recorded employment growth of 1090k and 650k respectively in the same months while unemployment fell to 3.9% and average earnings rose by 0.6% on the month in December. We see risks of the household survey reverting to the establishment survey over the coming months, but the labour market looks tight enough to merit a Fed reaction – even if it remains short of 'full employment'. Accordingly, a number of neutral-to-dovish Federal Open Market Committee (FOMC)'s participants have recently stated that they are "open to" a March hike, despite the disruption that the surge in Omicron cases looks set to deliver in the near term. We now consider this most likely.

While market expectations have become more febrile, including speculation around a 0.50% opening hike and a faster pace of tightening than in the last cycle, we remain more circumspect and forecast four hikes for this year (taking the Fed Funds Rate to 1.00-1.25%) and three for 2023 (1.75-2.00%). Different to markets, however, we do not think that this will be the peak of this cycle and expect the Fed to continue to tighten policy in 2024 closer to, and possibly exceeding, its 2.5% estimate of the longer-term funds rate.

Exhibit 1: Estimated real yield reactions to tightening



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

December's FOMC meeting minutes also announced the consideration of unwinding the balance sheet. Details have yet to be finalised, but minutes suggested quantitative tightening (QT) could come sooner after rates have started to rise and at a faster pace than in the last cycle. Several members have discussed after one or two hikes and we now expect the Fed to begin ramping up its unwind after mid-year. Last time, the Fed capped the maturities of its assets at $30bn in Treasuries and $20bn in Mortgage-backed securities (MBS) per month. This time, we estimate a pace of $60bn and $30bn, or just short. This would likely see a modest unwind this year, but close to $1tn next. The impact is uncertain – academic estimates quantifying the effects of QE are unlikely to apply symmetrically to QT. Moreover, around $2tn in excess liquidity remains on the Fed's balance sheet in the form of overnight reverse repos. These are likely to be unwound as the Fed withdraws liquidity, dampening the QT impact (Exhibit 1). Nevertheless, the Fed appears ready to deliver monetary tightening with both barrels.

Tighter policy impacts macro-outlook

A quicker tightening of monetary policy would be designed to impact the outlook for growth and prices. The GDP outlook for Q4 has continued to evolve. The sharp drop in December's retail sales (-1.9% on the month), confirmed our expectations that October's flurry of spending marked an earlier start to the shopping season, rather than a stronger season overall. We retain our outlook for Q4 GDP growth of 4.8% (saar) but note that the Atlanta GDPNow tracker has retreated to 5.0% from a high of 9.7% at the start of December (consensus 6.0%).

In our Outlook 2022 we forecast GDP growth to be 3.5%. That was lower than the consensus of 4.0%, which has since crept lower to 3.8% (with some forecasts going lower still). To our minds, the quicker adjustment in monetary policy should reduce the GDP outlook for this year and next. We lower our GDP forecasts to 3.3% and 2.5% on the back of a firmer Fed outlook. This assumes that the Fed manages to slow the economy smoothly. A more exaggerated reaction with tighter financial conditions could result in a sharper growth reaction.

Inflation rose to 7.0% in December – another upside surprise and a 40-year high – driven once again by used car prices and rents. A peak should be close, with auctions suggesting second-hand car prices are easing, oil inflation fading on base effects and Producer Price Index (PPI) inflation dipping. Further final increases could emerge as geo-political tensions push oil higher, winter freezes spike energy prices and Omicron adds fresh disruption to supply chains. However, barring major deterioration in geo-politics (Ukraine) and supply chains (China), inflation should fall sharply from the spring.

We have raised our 2022 Consumer Price Index (CPI) inflation outlook to an average of 4.6% (from 4.1%). But we still expect inflation to fall sharply over the year and now see Personal Consumption Expenditure (PCE) price index inflation touching 2.0% early in 2023. We forecast CPI to average 2.6% in 2023, down from our previous 2.9% forecast again reflecting the impact of an expected quicker monetary policy tightening.

Global Macro Monthly – Eurozone

Hugo Le Damany,
Economist,
Macro Research – Core Investments

Brighter days on the horizon

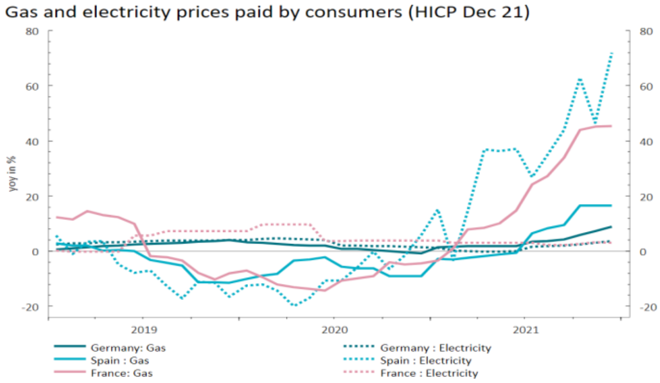
The worst of the Omicron wave is probably behind us. Cases are easing in several countries, while hospitalisations have remained at a manageable level. Restrictions are likely to remain for a few extra weeks but should ease thereafter. While Q4 GDP estimates are yet to be released, indicators show more resilient economic activity than initially feared when Omicron emerged. We continue to forecast 0.4% quarter-on-quarter growth in Q4 which would push GDP above its pre-pandemic level.

In January, surveys have been mixed. In Germany, both manufacturing and services PMIs surprised on the upside but slightly declined in France. Business climate also slightly deteriorated while consumer confidence was broadly flat. We believe there is downside risks to our Q1 GDP forecast which currently stands at +0.6%. We continue to anticipate some improvements, especially on restrictions, but such a rebound is more likely to be seen in Q2 data.

However, there are two large downside risks to the outlook for 2022. Firstly, China's 'zero-COVID' policy – and the risk of disruption if Omicron proves more difficult to contain – threatens supply chains, with Germany the most exposed. Secondly, inflation, and more specifically, energy prices weighing on consumers' purchasing power may affect private consumption more than we expect despite governments' offsetting measures. This could be further exacerbated if geopolitical tensions rise around Ukraine (Exhibit 2).

Exhibit 2: Spanish electricity prices rose by 72%yoy

Gas and electricity prices paid by consumers (HICP Dec 21)



Source: Refinitiv Datastream and AXA IM Research Dec 21

Inflation likely peaked in December at 5% year-on-year (yoy) and remained mixed across countries. It reached 6.5% in Spain, 5.7% in Germany, 4.2% in Italy and 'only' 3.4% in France. The end of the effect of Germany's temporary sales tax cut will reduce the Eurozone core rate by around 0.5 percentage points from January but price pressures are likely to persist reflecting energy and food past prices (around 2% in Q1), with additional supply disruptions presenting further risks.

Beyond Q1, electricity and gas contributions to inflation should ease, as should supply constraints. However, recent wages data do not point to homogeneous upside pressure across the Eurozone, but with further labour market improvement expected, this could materialise through 2022-2023 (Exhibit 3).

Exhibit 3: Still muted wage growth

Negociated wage growth

Source: Refinitiv Datastream and AXA IM Macro Research (Oct 21)

Don't push it too far!

The European Central Bank's (ECB) inflation outlook is currently challenged by the market, which now prices a first rate hike in October 2022. We believe this is premature and would jeopardise economic activity as inflation should ease materially over the second half of 2022 (from 4% to 1.9%). Recent ECB speeches – including from hawks – do not point to such early actions in our opinion. We believe a move at the start of 2023 would be the earliest appropriate and believe current forward guidance implying a first hike 'shortly after' net purchases end is not appropriate and is likely to be amended in the future.

Long live the President…if no early election

In Italy, we are still awaiting the Presidential election's result. We had previously thought Draghi would stay as PM but as there is little consensus for another candidate, we now believe his election is the most likely outcome. This should only be mildly negative, once we do not have early elections that could compromise the smooth implementation of Next Generation EU funds and reforms. Most Italian parties are quite reluctant for this option as current polls do not suggest a stable majority to either side of the political spectrum. Early elections would also trigger the cut of parliamentary seats voted in September 2020 and Members of Parliament would curtail pension entitlements, eligible only if a legislature lasts at least four and a half years (until September 2022).

Global Macro Monthly – UK

Modupe Adegbembo,
Junior Economist,
Macro Research – Core Investments

Omicron casts doubt on February rate hike

Omicron appears to have peaked in the UK, with cases falling back from 180,000 a day in early January and the government announcing a phased easing of restrictions. Revisions to previous growth and a firmer-than-expected November suggest Q4 GDP will rise by 0.9% and that 2021 growth will be firmer at 7.2% (compared to a pre-revision forecast of 6.9%). Nevertheless, we expect GDP to contract in December and January, following sharp declines in activity, before rebounding – despite challenges for real income growth over the coming quarters. We expect growth in 2022 of 4.9% (from 5.0%) and 2.3% in 2023. This compares to consensus forecasts of 7.0%, 4.5% and 2.2%.

Headline CPI reached a 30-year high of 5.4% in December and is set to rise further. Inflation averaged 2.6% for 2021 as a whole. Food and clothing drove the recent increase, and we expect the deceleration of fuel price inflation to take some pressure off in the next few months. However, inflation is set to peak at around 6%, when utility retail price cap adjustments are made in April, although this could be sensitive to intervention from the government to reduce the impact on households. Following this, we expect prices to fall back across the second half (H2) 2022 to below target in 2023. We now expect inflation to reach 4.5% in 2022 (up from 3.8%) and 2% in 2023. Consensus forecasts are for inflation to average 4.7% for 2022 and 2.1% in 2023.

The labour market remains tight, but there are tentative signs of some easing in the pace of tightening. In November unemployment fell marginally to 4.1% (from 4.2%). Wage growth has continued to fall – in the 3-months to November it slowed to 3.8% from 4.3% and set to soften further as base effects fall out.

After December's rate hike, new data have increased added to the pressures on the Bank of England (BoE) to raise increase interest rates further to quell second-round inflation effects. However, Omicron's likely to dampening of growth and have seen reports of some unwinding of labour market strength should leave the Monetary Policy Committee (MPC) cautious – but when it meets on 3 February, it will not have comprehensive output data for the latest months. We expect the MPC to follow a slower more cautious path and leave the Bank Rate unchanged at 0.25% in February, pencilling in the next hike only for May – which will then begin the passive unwind of the BoE's balance sheet. We forecast a further hike in November, to 0.75%. This is lower than current market expectations, which currently price in a rate increase next month.

Global Macro Monthly – Japan

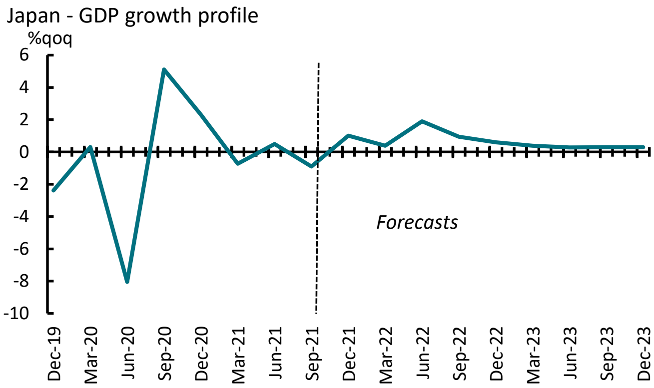
Hugo Le Damany,
Economist,
Macro Research – Core Investments

Another jolt on the road

The latest economic data pointed to a fourth quarter (Q4) rebound but this will likely be less than anticipated, as supply disruption erupted at the end of 2021 and worries grew about the Omicron wave, which is now spreading in Japan.

The government introduced only mild restrictions as the country has a high vaccination rate (80%) and more data on the severity of Omicron. However, we remain cautious on the economic impact as the booster campaign has not picked up significantly and households are likely to adapt their consumption behaviour. We also anticipate further supply chain constraints due to the COVID-19 outbreak in China and/or in some southeast Asian countries on which Japan strongly relies for its industry. Consequently, we have adjusted our Q1 GDP growth forecast to around +0.4% quarter-on-quarter from 1% (Exhibit 4). Once Omicron concerns disappear, we anticipate a strong rebound in private consumption that should coincide with some supply pressures easing.

Exhibit 4: Omicron wave and supply constraints are likely to weigh on Q1 GDP growth



Source: Cabinet Office and AXA IM Macro Research' projections, January 2022

The BoJ stays the course

December inflation data increased by 0.2 percentage points (pp) to 0.8% on the year, but core inflation (excluding fresh food and energy) is still negative (-0.7%) as mobile phone charges remove approximately O.7pp from the index. Assuming high energy prices until Q2, the Consumer Price Index (CPI) would not be too far from 2% but the Bank of Japan (BoJ) emphasised it was not in a position to expect a sustainable 2% target under the virtuous cycle of wages and prices, rejecting de facto any premature normalisation of the monetary policy.

Global Macro Monthly – China

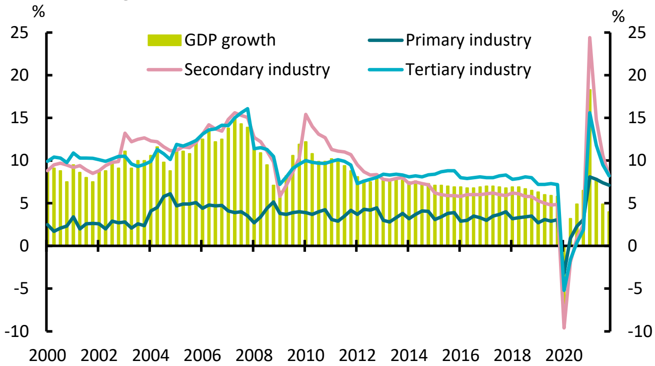
Aidan Yao,
Economist (China),
Macro Research – Core Investments

Better GDP cannot mask underlying weakness

Fading power shortages and supply bottlenecks saw the Chinese economy end 2021 on a decent note. Quarterly GDP growth accelerated to 1.6% in the fourth quarter (Q4) from 0.2% in Q3 on a seasonally adjusted basis. However, the negative base effect continued to drive year-on-year growth lower to just 4% – a record low outside the height of the pandemic (Exhibit 5). Despite beating expectations, the buoyant GDP print – 8.1% growth for 2021 – does little justice to a challenging year for the Chinese economy.

Exhibit 5: GDP data shows a decent finish to 2021

China - GDP growth breakdown across different sectors



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

On the supply side, industrial output staged a decent rebound thanks to a quick resolution to the power shortages and rebuilding after Q3's weather disruptions. Supply bottlenecks also showed signs of easing in some areas, with auto output posting its first growth in seven months. The shortening of delivery times and lower input costs in the Purchasing Managers' Index suggest the improvement has been broad-based.

Beyond the industrial sectors, the growth impulse remained weak. Tertiary activity grew by only 5% on a two-year compound annual growth rate basis, reflecting the sector's continued struggle against COVID-19 resurgences. All housing market metrics deteriorated further as the painful adjustment – partly inflicted by policy tightening – continued. Export activity remained resilient, but growth likely peaked in Q4 – even before the latest Omicron outbreak risked further dampening demand.

The most alarming development was in retail sales. Nominal sales growth dropped sharply to just 1.7% in December, which translates to a near stalling of real sales growth with CPI inflation at 1.5%. The latest virus wave certainly played a role in this weakness, but the soft labour market is also to blame for the lacklustre consumption recovery over the past year. Anecdotal evidence suggests that job market conditions are much worse than the official unemployment rate (which rose to 5.1%) suggests. Without addressing this fundamental weakness, the consumer sector will likely continue to struggle even if China succeeds in containing another round of virus flare-up.

For all these reasons, the better-than-expected GDP outturn will likely do little to dispel pessimism about the Chinese economy. Many brokers have recently cut their growth forecasts to reflect the challenge of preserving growth amid the spread of Omicron and a collapsing property market. Even though Beijing has started to adjust policies, the moves have so far fallen short of what's needed to restore confidence and re-anchor expectations. Indeed, with a "zero-COVID" policy remaining a priority ahead of the lunar new year and the Winter Olympics, the effectiveness of policies to stabilise growth is questionable. We therefore concur that the risks to short-term growth are squarely to the downside.

Don't underestimate Beijing's policy

Further out, however, we caution against underestimating Beijing's resolve to preserve growth in a politically sensitive year. At the end of the day, the "zero-COVID" policy is designed to maintain social and political stability from a public health angle, whereas stabilising growth and the labour market is just as important for a smooth transition of political leadership at the 20th Party Congress. We think Beijing's pledge to put a floor under the economy should be taken seriously.

The latest medium-term lending facility and repo rates cuts are consistent with the People's Bank of China embarking on a new, and potentially forceful, policy easing cycle. This should be paired with more active fiscal policy, utilising the carry-over funds from last year's RMB1.2tn bond issuance and the frontloading of 2022's new bond quota (worth RMB1.45tn).

With the restrictions on property and local government borrowing still in place, the challenge is to find more sustainable growth engines to channel these stimuli. We see targeted measures to support new infrastructure, decarbonisation, high-tech industries, manufacturing upgrades, small and medium-sized enterprises, and consumption over the course of 2022. A combination of differentiating micro policies and macro policy easing should help to rebalance the economy while fostering aggregate growth stability. For now, we stick to our 5% growth forecast for the year but expect the economy to be weaker in Q1 – reflecting the current virus situation – followed by a recovery in later quarters.

Global Macro Monthly – Canada

David Page,
Head of Macro Research,
Core Investments

Expected growth slowdown to weigh on BoC

The third quarter's (Q3) positive momentum carried into Q4 with October's GDP posting a stronger than expected 0.8% rise. However, the good news probably ended then as flooding in November likely had an immediate impact on GDP. The latest coronavirus variant, Omicron, emerged in December. By year-end, it appeared to be affecting economic behaviour and provincial governments increased restrictions in early January. Although Canada's wave appears to be softening and hospitalisations peaking, the economic impact is likely to take longer to emerge. We expect a softer Q4 and further deceleration in Q1, before a catch-up into mid-year. As such, we have reverted our 2022 forecast to 3.5% and left 2023 at 3.0% (consensus 4.0% and 3.0%).

If Omicron poses a downside risk to activity, it is an upside risk to inflation. CPI inflation hit 4.8% in December – a 30-year high, with most derivative measures including core, trimmed and median measures all marking similar records. By comparison to other countries, the Canadian CPI outlook does not appear so bad. With oil prices lower in December, January's rate should drop, although further supply-chain disruption from COVID-19 is an upside risk. Medium-term risks include the labour market and expectations. The labour market continues to tighten. December's jobs rose 55k and unemployment dipped to 5.9%, close to the pre-COVID-19 rate. Annual pay slowed to 3.0% from 3.2%, around the top of the pre-pandemic range. The Bank of Canada's (BoC) latest surveys showed that inflation expectations are elevated, suggesting businesses and households expect inflation to remain high; 97% of businesses see inflation over 2% for the next two years.

These are the risks the BoC will consider at its January meeting. Elevated inflation points to tighter policy in 2022. Markets expect the first of six hikes to emerge this month. However, the Omicron outbreak's impact on growth and employment is uncertain, while inflation pressure may be close to a peak. The BoC had guided that conditions for tighter policy would be met around the middle quarters of this year. The Federal Reserve's apparent shift in monetary policy tightening may push the BoC to move earlier to avoid additional inflationary pressure via a depreciating Canadian dollar. Overall, we expect the BoC to leave policy unchanged in January. However, we raised our forecasts for four hikes this year (from three) to 1.25%, now likely starting in March, and now envisage two in 2023, taking rates to 1.75%.

Global Macro Monthly – EM

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

Headwinds on the horizon

Emerging markets (EM) are heading into more complicated territory as liquidity conditions tighten amid rising US real yields. A rising cost of debt poses additional risks for higher financing needs as debt – public and private – has increased lately, while external financing needs are likely to expand again for many EMs as domestic demand normalises from the low levels during the pandemic. Additionally, inflation pressures and the central banks' responses in terms of monetary policy adjustments, as well as a less buoyant global trade environment, may trigger a cyclical slowdown in the first part of the year. EM regional growth dominance looks likely to shift from Central Europe and Latin America towards Southern Asia and the Middle East. China's policy easing and hopefully a less damaging Omicron wave should support the EM growth profile further out.

Inflation and… protests

The current inflation spikes in developing countries share similar underlying dynamics with those in advanced economies. Rising energy and food prices as well as supply bottlenecks caused by the pandemic have triggered a sharp rise in producer and consumer prices. Given the stickier pattern of inflation in EM, central banks are responding earlier and more forcefully than in developed markets, as seen by the recent monetary tightening in Central Europe and Latin America. Tighter monetary policy does not address the roots of the inflation surge but is a reasonable response to anchor inflation expectations and avoid inflation slippage in the medium term, also securing foreign capital interest.

Food and energy are big components of Consumer Price Index baskets and household consumption in EM. Excessive prices have in the past triggered humanitarian crises, riots and even regime changes. Recent street protests in Kazakhstan, firstly in reaction to motor fuel price hikes before turning into what seemed a broader political protest, remind us of the challenges oil and food inflation can cause in EM. In late 2006, droughts in grain-producing nations and rising oil prices triggered inflation spikes culminating in unrest in several countries during 2008 and were also likely a contributor to the Arab Spring revolts thereafter. In mid-2011, a ravaging food crisis hit East Africa, Ethiopia, Somalia and Kenya. Governments are wary of repeats and some are implementing consumer price caps on natural gas, cutting Value-Added Tax on basic food items, heating and electricity prices. But this places additional strain on public finances.

Global Macro Monthly – EM Asia

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

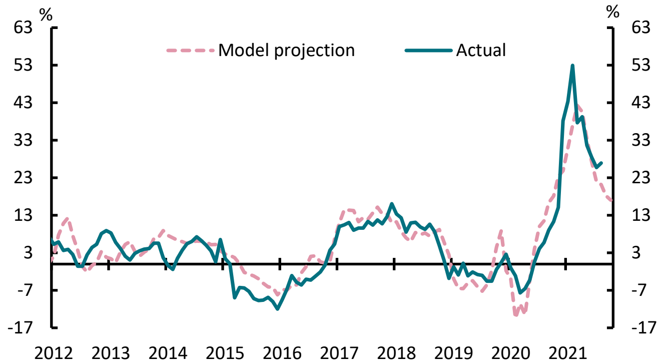
Exports' normalisation

The Omicron variant continues to plague Asian economies, resulting in rising daily cases in most parts. India, the Philippines and Thailand, in particular, have seen significant spikes in daily infections. Restrictions have been implemented, though public policy responses vary across countries. In addition to enhanced tightening measures, authorities across Asia have further highlighted the need to accelerate their respective vaccination programmes as well as increase booster shots. Singapore is the most advanced economy in the region for vaccinations, now with about half of the population having received a third dose. South Korea and Malaysia follow closely behind.

Although the Omicron variant remains a key risk to Asia's growth recovery in the near term, the economic cost of each subsequent wave has lessened as people and businesses have adapted. In fact, headline Purchasing Managers' Indices (PMIs) looked rather reassuring. Apart from Thailand, all saw headline figures pushing higher into the growth territory. New export order PMIs, however, showed a mixed picture, with orders falling in South Korea, the Philippines and Thailand. This is in line with our Asia export monitor (Exhibit 6), which compiles several advance estimators such as PMIs and semiconductor stock indices. Our monitor suggests continued moderation in the region's exports. But despite recent concerns over weakening contract prices, South Korea's December semiconductor exports remained resilient, backed by solid new smartphone sales. What's more, there are finally signs of easing chip shortage concerns as inventory-to-shipment ratios have risen. We continue to expect a gradual softening of overall export growth on slowing global demand and China's growth concerns.

Exhibit 6: Exports growth normalising

Asia trade actual vs. fitted trend



Source: CEIC and AXA IM Macro Research, 19 January 2022

Global Macro Monthly – LatAm

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

A two-speed recovery

It has been clear for some time the recovery in Latin America (LatAm) will not proceed in a synchronised manner. Recent economic data for the fourth quarter (Q4) continues to suggest a strong recovery in Chile and Colombia. But the economies of Brazil and Mexico appear to have stalled in the final quarter of 2021 after both posted GDP contractions in Q3 at -0.1% and -0.4% respectively on a quarter-on-quarter basis.

In Brazil, double-digit inflation and tight monetary conditions are weighing on consumption and investment. In November, both retail sales and industrial production contracted in year-on-year terms for a fourth consecutive month. Similarly, unemployment is the highest in the region at 12.1%. On a more positive note, inflation decreased in December for the first time since May 2020. Meanwhile in Mexico, tight fiscal policy, rising interest rates and surging inflation (currently at a 20-year high) are keeping a lid on growth. Economic activity contracted for a third consecutive month in October, reflecting a decline in services and primary activities. There is a growing possibility that GDP contracts again in Q4, which would push the country into a technical recession.

In contrast, significant fiscal stimulus and still-low interest rates continue to fuel the economies of Chile and Colombia. In Chile, economic activity surpassed expectations and grew a whopping 14.3% in November (year-on-year). In addition, unemployment continues to fall, and is now back at pre-pandemic levels. In the political arena, Chileans recently elected left-wing politician Gabriel Boric. Colombia's economic picture is not as rosy as Chile's, but growth remains strong, albeit still unbalanced. Both retail sales and industrial production grew strongly in November, unemployment fell to 10.8%, the lowest rate since end-2019 – though still one of the highest in the region. However, inflation is accelerating, and expectations are not fully anchored.

On the pandemic front, Latin American countries have been quite effective in their vaccination campaigns despite diplomatic and financial hurdles to gain access to vaccines. We estimate that, in the economies in our focus, around 65% of the population is fully vaccinated and Chile leads the way with an 88% vaccination rate. While the current Omicron wave is a cause for concern, high vaccination rates and a lack of appetite from governments for lockdowns suggest that risks to the economy seem low for now. Among large Latin American countries, only Peru and Argentina have seen a significant spike in infections.

Investment Strategy – Cross assets

Greg Venizelos,
Credit Strategist,
Research – Core Investment

Too much of a good hawk

Markets are struggling and there is the threat of war in Eastern Europe. On the upside, the bond market might be taking a break from worrying about an even more hawkish Federal Reserve (Fed). Elsewhere, equity markets are becoming better valued, although not cheap enough for the bears yet. We remain constructive for risk over the year but cautious near term.

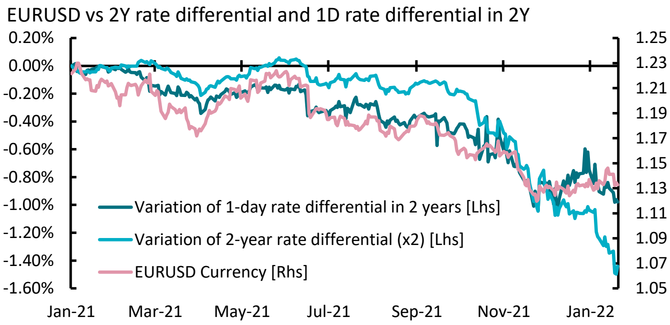
Investment Strategy – FX

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

Peak USD? Not just yet

The repricing of dollar (USD) rates higher has accelerated since December. Expectations had already grown in the fourth quarter (Q4) from almost zero to three hikes for 2022. But the Fed did nothing to talk those down, and on the contrary raised its forecast and added quantitative tightening to the agenda. This triggered a further significant rise of the two-year rate differential in favour of the USD, which is usually very well correlated with currency moves. Yet this time, to our surprise, the USD failed to appreciate. Had we reached the peak? The USD started this cycle at an already high valuation, and we were expecting some correction later in 2022 once the Fed repricing was fully baked-in and inflation had started normalising lower. But it is a bit too early for this to happen, it seems. The forward level of interest rate differential has been more relevant for currency markets (Exhibit 7).

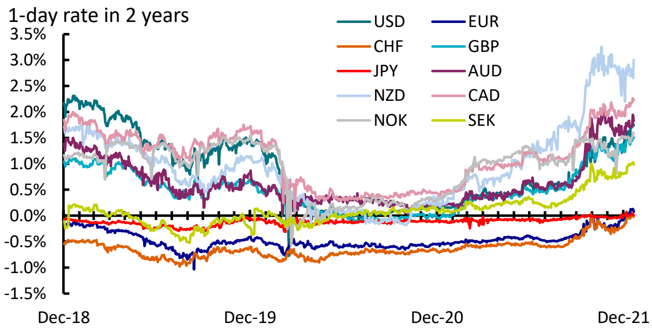
Exhibit 7: Correlation with rates not broken as terminal rate still matters



Source: Bloomberg and AXA IM Research, 24 January 2022

Hence, the USD is still skewed to the upside against low yielders, in particular the euro. European Central Bank (ECB) policy expectations have risen notably since December (Exhibit 8) countering USD strength. Yet the Fed outlook looks more credible, as the US faces higher inflation and a tighter jobs market. This leaves room for the ECB to disappoint and thus for euro/USD downside. Further, the Fed terminal rate is still underpriced in our view and a repricing could trigger further USD strength. Finally, Russia-Ukraine tensions risk more downside and euro short positioning and its undervaluation are still limited. Expectations for the Bank of Japan have not shifted, leaving less room for the yen to soften than the EUR. The yen looks more undervalued and also supported by current equity market volatility.

Exhibit 8: Broadening of policy normalisation expectations since Q4 2021

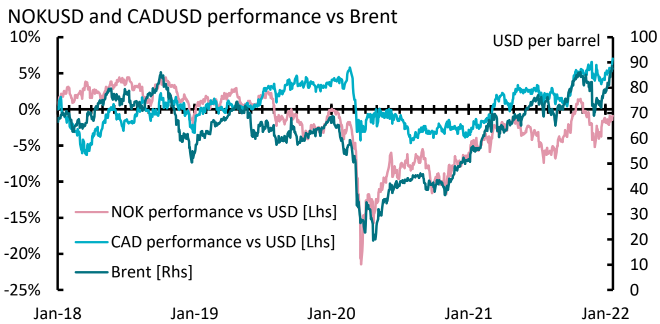


Source: Bloomberg and AXA IM Research, 24 January 2022

Carry rising not for USD only: others may benefit

That said on the USD, it is starting to look expensive and it is wise to look for cheaper carry alternatives. We find that 'higher' carry and 'rising' carry are both significant drivers of currency strength The Norwegian Krone, Canadian dollar (CAD) and New Zealand dollar (NZD) are set to see policy rates go above others in the coming months and seem to be starting from far cheaper valuations than the USD. Their central banks are 'credible hawks' as they face tight labour markets and inflation pressures. They should do well against the euro and may even beat the USD if global growth surprises to the upside as economies reopen and bottlenecks normalise. The Norway and Kiwi central banks have delivered two hikes making the NZD and the Krone high yielders in the G10 space. The Krone looks slightly cheaper than CAD and should benefit further from higher energy prices (Exhibit 9).

Exhibit 9: NOK lagging Oil prices



Source: Bloomberg and AXA IM Research, 24 January 2022

Investment Strategy – Rates

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

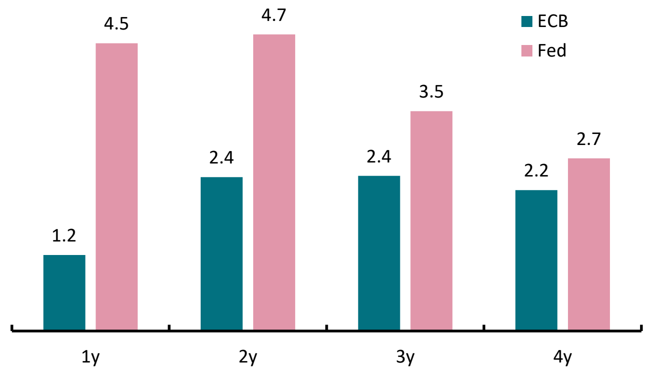
Central bank expectations

Last year was full of surprises on the inflation front: The consensus started the year expecting US Consumer Price Index inflation to average 2%, but it eventually averaged 4.7%. Similarly, at the January 2021 Federal Open Market Committee (FOMC) press conference, Federal Reserve (Fed) chair Jerome Powell said he saw the risk of "some upward pressure on inflation" but dismissed this scenario as "likely to be transient and not to be very large".

By year-end, the Fed had engineered a spectacular U-turn on inflation by admitting that some components might be more structural than expected. Of course, markets did not wait until Powell's last word had been spoken in order to anticipate a change in course. The repricing of the Fed's policy path has been rather pronounced at the front end of the curve (Exhibit 10), where a bit more than a 25-basis-point (bps) rate hike is priced every quarter for two years.

Exhibit 10: Monetary policy U-turn for Fed and ECB

Policy expectations vs 6m ago (# of rate hikes)



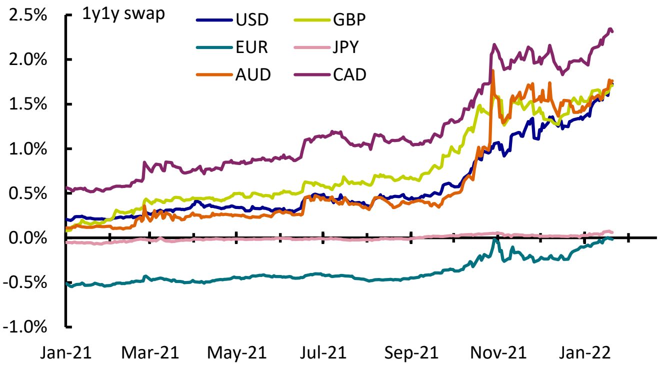
Source: Bloomberg and AXA IM Research, 24 January 2022

The swift repricing of policy expectations is not specific to the Fed, though. As we can see in Exhibit 11, apart from the Bank of Japan, a significant increase in front-end rates across several major currencies can be observed.

For example, 1y1y sterling bond pricing (one-year forward rate on one-year bond) increased by 145bps in 2021, followed by an additional 18bps year-to-date. Canada has experienced similar behaviour of short-term rates. At the other end of the spectrum, the repricing in European Central Bank expectations is less evident, as if the market were still captive to the heated debated between hawks and doves.

Exhibit 11: Global policy tightening more broadly

Global front-end forwards

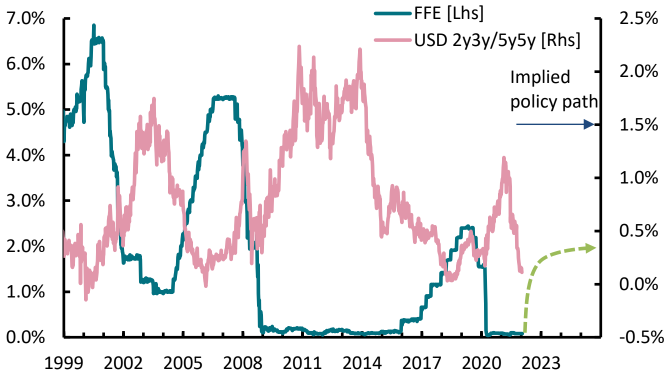


Source: Bloomberg and AXA IM Research, 24 January 2022

Are rate expectations exaggerated? This is a crucial question for managing duration in fixed income and equity portfolios. In previous cycles, in addition to the slope of the money market curve, we looked at 2-5-10-year curvature as a reliable indicator of monetary policy expectations. Unfortunately, quantitative easing has distorted several empirical relationships (as well as liquidity metrics).

Exhibit 12: Fully priced in?

Curvature as a measure of policy expectations



Source: Bloomberg and AXA IM Research, 24 January 2022

We can approximate measures of curve curvature with butterfly curve trades. The 2-5-10-year US Treasuries butterfly appears to be near the extreme of its 20-year range (-60bps/+60bps). This is an indication that rate hike expectations are probably hovering toward the top of their range as well. The forward space provides us with an even clearer picture, as forward rates magnify the shape of the curve.

The spread between the US dollar 2y3y (two-year forward three-year bond) and the 5y5y (five-year forward five-year bond) is risk-equivalent to the 2-5-10-year butterfly and tells us a similar story – rate expectations priced across the curve are very close to their historical maximum (Exhibit 12). In addition to being informative for the likely future of monetary policy, this notion also suggests that the 5-year point of the Treasury curve might be a relative performer over the coming quarters, as the Fed starts to deliver policy normalisation against the market's implied path.

Investment Strategy – Credit

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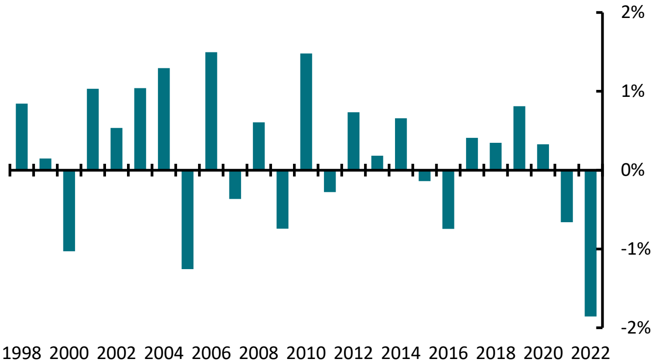
Credit starts 2022 badly but not due to spreads

Credit markets have begun the year in negative territory, in sympathy with equities and risk assets more broadly, amid a swift rise in global government bond yields. In fact, 2022 has seen the worst start for global credit in 25 years, with a drawdown of nearly 2%, almost twice as steep as that seen in 2000 and 2005 (Exhibit 13).

Exhibit 13: Worst start in 25 years for global credit

Global credit total return to 20 January 2022

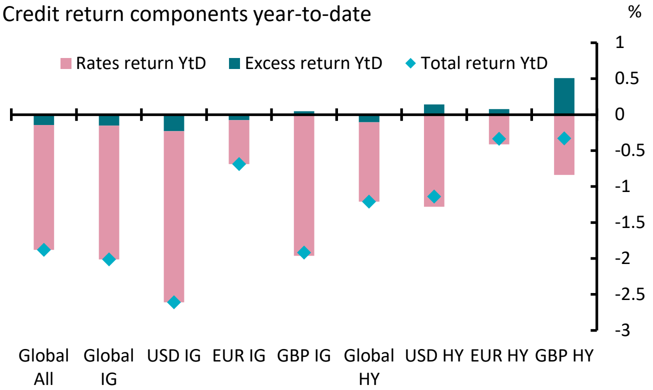


Source: InterContinental Exchange (ICE) and AXA IM Research, Jan 2022

The steep drawdown in credit has been predominantly due to the interest rate component (Exhibit 14), which reflects the swift rise in government bond yields. This is particularly pronounced in long-duration markets like US dollar and sterling investment grade (IG). The excess return due to credit risk has been a small negative – or even positive, in the case of developed market high yield (HY), offsetting some of the interest rate driven drawdown.

Exhibit 14: The interest rate rather than the spread component has done the damage in credit this year

Credit return components year-to-date

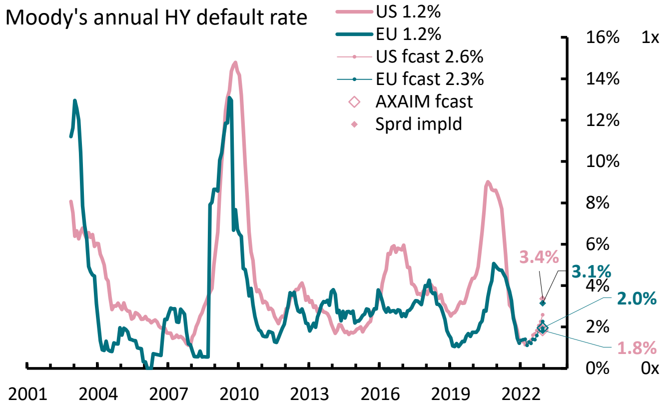


Source: ICE and AXA IM Research, Jan 2022

Default rate expectations still sanguine

Concerns about duration exposure informed our preference for HY over IG credit since early 2021. think this relative overweight should continue to reap benefits in 2022, as we enter the Fed's hiking cycle. HY markets (excluding China) continue to enjoy the headwind of benign default expectations (Exhibit 15). The current default rate forecasts for US and European HY are near 2%, below their historical average and what is implied by current spread levels. This is due to ultra-low distress ratios and easy bank lending conditions. Both of these are likely to rise this year, but at a measured pace that does not de-anchor default expectations. We estimate a 2.5% forecast at the end of the first quarter (Q1) and a 3% forecast at the end of Q2.

Exhibit 15: Default expectations remain benign and below what priced by spreads



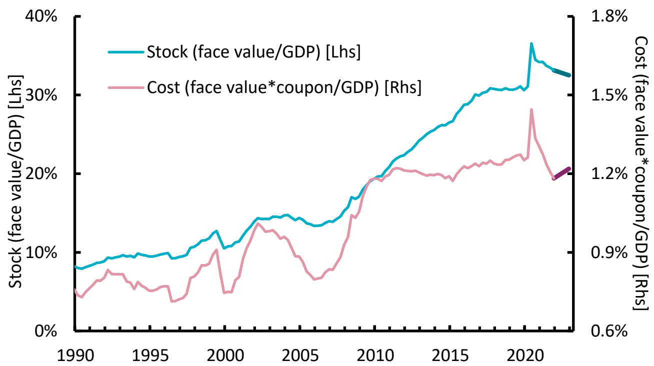
Source: Moody's, ICE and AXA IM Research, Jan 2022

Cost of debt back to post-financial crisis lows

A further tailwind for credit is the decline in government bond yields and credit spreads since the height of the pandemic. This has made corporate debt servicing even more affordable than pre-COVID-19 (Exhibit 16). Indeed, the cost of debt for the US dollar investment grade index has dropped back to its post-global 2008/2009 financial crisis lows, despite a stock of debt that is some 7% higher than pre-COVID-19.

Exhibit 16: Cost of debt in USD IG index is back to post GFC lows (dark segments are end 2022 estimates)

USD IG index debt stock and cost as % of GDP



Source: Bloomberg, ICE and AXA IM Research, Jan 2022

Investment Strategy – Equity

Emmanuel Makonga,
Investment Strategist,
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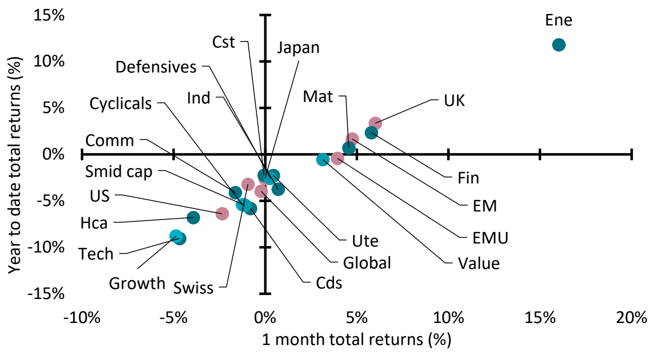
A bittersweet cocktail

In a year shaped by the normalisation of US monetary policy, stocks are going through a tortuous post-COVID-19 moment. At the time of writing, global stocks had fallen by -5.6% on a year-to-date basis (Exhibit 17). If the month ended now, this would be the sixth worst monthly performance in January since 1970 (inception date). Across sectors, long duration stocks have been severely impacted by rising yields notably the IT sector (-4%). In addition, the upturn in interest rates has triggered the rotation from growth (-4.9%) to value stocks (+3.2%).

Exhibit 17: Value vs. Growth revival…

Equity total returns (local FX): regions, sectors and styles

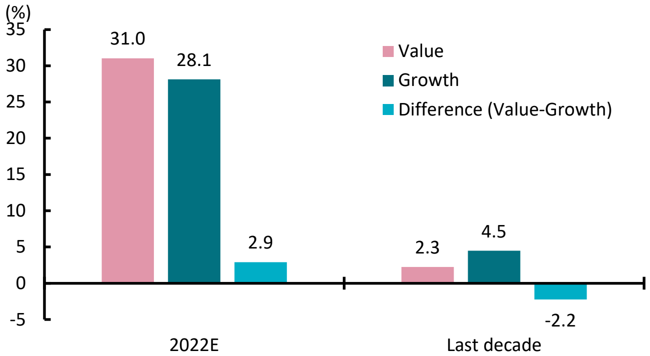


Source: Datastream and AXA IM Research, 24 January 2022

Fundamentals as co-pilot of value rally – Although the rise in real rates appears to be a valid technical support for the value outperformance factor, fundamentals also underpin this narrative. For 2022, analysts expect higher earnings growth for value stocks (Exhibit 18).

Exhibit 18: Justified by the fundamentals

Global equities: 12M Forward Earnings per Share

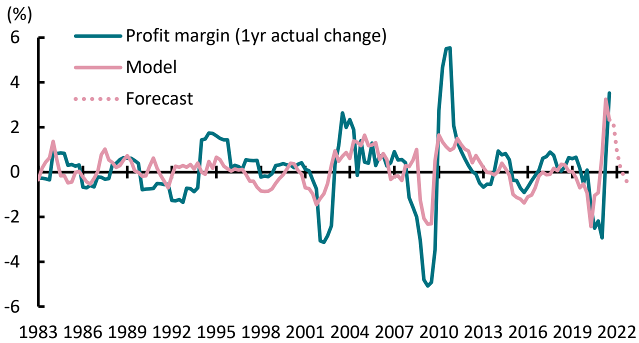


Source: MSCI, IBES and AXA IM Research, 24 January 2022

Profit and Wages – Even though we are in the early stages of the earnings season (about 10% of S&P500 companies and 4% of STOXX companies have reported) one trend seems to be emerging: Wages. The US banks, almost all of which have reported earnings, have been severely punished (-2.7% one-day price reaction) despite reports beating sales and earnings estimates. One of the explanations is the unanticipated increase in non-interest expenses which include compensation. Consequently, we looked at the annual change in US equity net margins as a function of average hourly earnings, producer input prices and corporate taxes to estimate the ability of companies to maintain their margins this year (Exhibit 19). Considering our wage growth forecasts, annual profit growth is expected to decelerate and to decrease from the third quarter (Q3) onwards. Keeping in mind the negative wage coefficient, further surprises would lower these expectations.

Exhibit 19: Peak in margin growth has passed

US Equity - Profit margin model

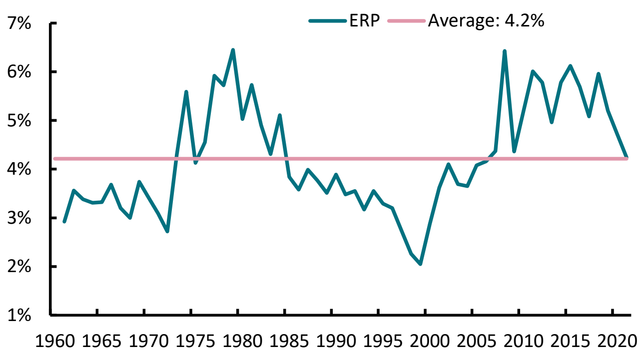


Source: Bureau of Labor Statistics, Bureau of Economic Analysis, OECD, Datastream and AXA IM Research, 24 January 2022

Staying overweight – The change in the Federal Reserve's assessment of rising inflation has led to a recalibration of the Fed's rate hike cycle. In parallel, a softening in economic activity survey evidence and the Omicron effect on consumer demand are driving downward revisions in Q1 2022 growth forecasts. Equities still seem to be attractive with the risk premium close to neutral (Exhibit 20). As such, we remain overweight in equities with a bias towards the Eurozone in our multi-asset framework.

Exhibit 20: Equity risk premia at long term average level

US Equity - Implied Equity Risk Premium



Source: Aswath Damodaran and AXA IM Research, 24 January 2022

Recommended asset allocation

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

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

These projections are not necessarily reliable indicators of future results

Download the full slide deck of our January Investment Strategy

Our Research is available on line:

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