24 March 2021
Research & Strategy Insights

The great rate debate

Global Macro Monthly

Key points

- Growth rebounds remain virus and vaccine dependent. The outlook is solid in US and good in the UK. Euro area prospects are hampered by vaccine management. Japan is also overseeing a slow inoculation programme. The pace is mixed across Emerging Markets.
- Fiscal stimulus is super-charging the US outlook but creating uncertainty over inflation. Headline inflation will rise globally across 2021, but a sustainable return to central bank inflation targets is unlikely next year outside the US or EM's with loosely anchored expectations.
- Central banks reflect local conditions. The Fed has pushed back on premature tightening; the ECB promised additional PEPP purchases. But EMs with inflation pressure and volatile FX have started to raise rates.
- Bond yields have risen in the US and are having spillover effects elsewhere. Other asset classes are following reactions in real rates space.

Global Macro Monthly

Investment Strategy

Global Macro Monthly – US

David Page,
Head of Macroeconomic Research,
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Strong consensus on growth, not so on inflation

President Joe Biden signed the $1.9tn American Recovery Plan into law this month, adding to the $0.9tn stimulus in late 2020. Debate is turning to the next bill on longer-term infrastructure, clean infrastructure and inequality measures on which Biden campaigned. This looks likely to be a more difficult bill to pass. The President will part-fund this package with tax hikes, including on households earning over $400k. Senate minority leader Mitch McConnell has suggested no Republican support for a bill that includes tax increases. This will likely leave the reconciliation process as the only means to pass much of the proposed legislation. This will delay passage of that bill, probably until early next year, although its contents will likely be debated throughout 2021.

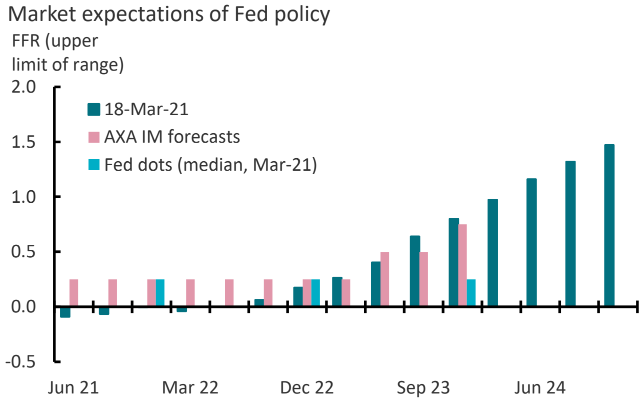
Meanwhile the pandemic backdrop is improving. The US is delivering 2.4 million vaccines per day and appears on track for herd immunity in Q2. The virus has been broadly supressed since the winter surge and many states are easing restrictions. The prospect of further removal of restrictions should deliver a meaningful boost to activity.

This combination of factors will provide a powerful boost to US activity. Following the 7.6% surge in January's retail sales, we have nudged our GDP forecasts yet higher, to 6.5% for 2021, 4.5% for 2022. This continues to be above the (also rising) consensus of 5.6% and 3.9% – although several major institutions expect faster growth. There is significant uncertainty surrounding this outlook. Estimated excess saving in the US ranges from $1.7-2.5tn (8-12% of GDP). There is no good, historical precedent to gauge how quickly households may unwind this excess and to judge the scale of pent-up demand. The extent and pace of this spending will be a key determinant of the shape of US growth. The outlook is uncertain, but we still consider risks skewed to the upside.

If a consensus exists for a strong growth rebound, there is no such agreement on its impact on prices. For sure the US should see spare capacity absorbed much faster than previously expected – we now believe by the end of this year. However, the relationship between resource utilisation and price increases has varied over time and was particularly weak in the latest period of excess demand immediately prior to the pandemic. This raises questions about the scale of any inflation pick-up over the medium-term, particularly as this tends to be related to levels of inflation expectations, which have been subdued and tend to evolve only slowly.

The inflation debate will only be confused over the coming months as headline measures look set to rise sharply towards 3% reflecting a combination of energy base effects, a quick revival in demand and short-term supply bottlenecks. We expect a mid-year peak to fade and headline inflation to soften back to around 2% by year-end – a little above or below, dependent on the short-term evolution of oil prices. The more sustainable inflation trajectory is only likely to emerge towards the end of next year. We currently expect targeted PCE inflation to be at 2% by the end of next year and expect it to moderately overshoot 2% into 2023.

Exhibit 1: Outlook for Fed Funds Rate target



Source: FRB, Bloomberg and AXA IM Research, Feb 2021

The Federal Reserve has left policy on hold and continued to signal that it will not lift rates before 2024, nor taper its large $120bn-per-month asset purchases before "substantial further progress" towards its goals, something it believes will take "some time". Fed forecasts suggest inflation should remain broadly on target through 2023 with firms absorbing rising labour cost pressures in their margins. However, it suggested not to focus on the precise timing of rate policy two to three years out amidst elevated uncertainty.

Of course, this is precisely what is driving current financial market movements. US Treasury yields have risen sharply since the lows in August, currently up nearly 125 basis points (bps) since that time. 75bps of that has reflected a rise in breakeven rates over the period, but the near-50bps increase in real yields has mainly occurred over the last month and appears governed by expectations of Fed monetary policy. This decomposition, and particularly movements in real yields, is key to implications for other asset classes. While the Fed suggests no rate hike before 2024, this is based on a modestly softer outlook for growth this year (just over 6%), and inflation over the medium-term, than our own outlook. Accordingly, we forecast the Fed to begin to tighten policy in 2023, expecting two hikes (June and December) – see Exhibit 1. Markets currently pencil in more. We believe that the expected short-term rise in inflation will add to market concerns about medium-term inflation and a quicker Fed response. As such, we expect market rates to continue to rise over the coming quarter, driven by both real and breakeven components.

Global Macro Monthly – Eurozone

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Not much luck on the COVID-19 front

The coronavirus situation has deteriorated as the UK variant has become dominant in most countries, while the number of cases – and positivity rates – have risen in Italy and France. Mounting hospital pressures have pushed governments to tighten restrictions. France announced the closing of non-essential retail and mobility limitations in 16 departments for a month, while Italy placed 11 regions in the 'red tier' i.e. the closure of non-essential retail and schools. Easing of restrictions before at best mid-April remains unlikely.

True, economies continue to cope better with containment and the industrial sector remains solid. Manufacturing confidence indicators show that production expectations keep rising, supported by external demand, while industrial production carry-over for the first quarter (Q1) is strong at 1.5% quarter-on-quarter (qoq). But the services and consumer sectors remain depressed and will push Q1 growth in negative territory (-0.5%qoq). We continue to expect a strong recovery in the second half of the year with 2021 growth at 3.8% year-on-year (yoy), still vaccine distribution challenges remain a risk to our Q3 peak growth momentum forecast.

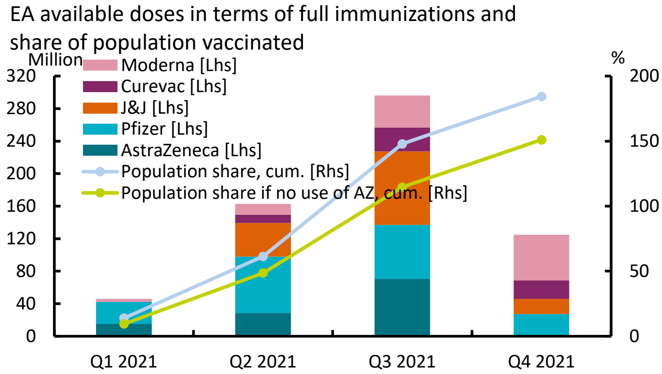
Vaccination hiccups, but should hit targets

There has been mixed news regarding vaccinations. On the positive side, the pace picked up in the first two weeks of March, while the European Medicines Agency approval of the Johnson & Johnson vaccine will reduce supply-side issues in Q2. But the noises around AstraZeneca (further delivery shortfalls for Q2 and its temporary suspension) are negative in the near term. AstraZeneca played a large role in the acceleration of immunisations in March, accounting for 35% of the hastening in Germany. But reduced confidence in this vaccine after several governments halted, and then re-started its rollout, may curb progress in the coming weeks.

This should not endanger the European Commission (EC) target of vaccinating 70% of the population by the end of Q3. On the supply front, even assuming no further use of the AstraZeneca vaccine, other supply should be large enough to vaccinate 49% of the whole population in Q2, and 115% cumulatively by the end of Q3 (Exhibit 2). A significant constraint (for example only 60% of the doses received used) would be required to miss the Q3 target. On the distribution front, the latest data suggest that countries still need to double their current rate to reach the Q3 target, but this seems far from unreachable in our view.

In terms of timing, the more vaccinated in Q2, the more the summer season recovery can take place and boost growth.

Exhibit 2: Supply picture remains positive



Source: European Commission, Ministero della Salute and AXA IM Macro Research, 19 March 2021.

Fiscal support remains underwhelming

Although the EC suggested that fiscal rules will remain suspended in 2022, support remains underwhelming. True, the Italian government has finally approved a €32bn support package, but it has been in discussion since January, while the Spanish €11bn solvency support programme, at just circa 1% of GDP is unlikely to make a big difference for firms.

European Central Bank forced to act

The contagion from US bond markets pushed the European Central Bank (ECB) into action at its March meeting. The unambiguous pledge to step up Pandemic Emergency Purchase Programme (PEPP) buying in the quarter ahead – included in the monetary policy statement – was clearly a positive, especially after a few weeks of disappointing PEPP purchases. It was also fully consistent with its updated inflation outlook (revised up in 2021 but unchanged in 2023, at 1.4%, well below target). But the press conference left us perplexed with the feeling that the ECB had unnecessarily constrained itself. Indeed, it stated that changing the pace of PEPP buying within the agreed envelope is now considered part of the policy stance, which would entail a Governing Council meeting and preferably fresh forecasts – only available once a quarter. In our view, this makes the ECB more reactive than pre-emptive and lowers the flexibility and the agility initially embedded in the PEPP.

The ECB has room to increase its purchases to €20bn in Q2 while keeping its envelope consistent with its soft target deadline of March 2022. It can also continue to push the average maturity of its purchases to protect the longer end of the curve from US bond market contagion. Still, with a relatively unclear reaction function and its "three-month assessment window", the ECB has focused market attention on June's meeting. This may coincide with the peak of "overheating stress" in the US. The ECB may be forced to be more explicit and precise at that point.

Global Macro Monthly – UK

David Page,
Head of Macroeconomic Research,
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A question of financial conditions

The UK has taken its first steps to ease the national lockdown in place since early January, with schools fully resuming in England and some non-essential retail also opening in Wales. The tight restrictions have seen virus cases fall and avoid the resurgence obvious in other jurisdictions. A rapid vaccine rollout is helping and although the pace of delivery has slowed in recent weeks, nearly 50% of adults have now received a first dose. This leaves the government's re-opening schedule on track with an easing of restrictions that should materially boost growth this year. Moreover, with GDP again recording a less-than-expected drop of -2.9% in January, we nudged our 2021 forecast higher to 5.0%, modestly above the 4.7% consensus. Yet uncertainty around this estimate is high, with forecasters estimating a wide -0.8 to -8.0% range around January's figure.

March's Budget added to the positive short-term outlook. Chancellor Rishi Sunak enacted an additional fiscal stimulus of around 3% of GDP for the coming financial year and a net easing for next year, with only modest tightening currently envisioned for 2023-24.

For now, inflation is subdued, at 0.7% in January. As elsewhere, base effects will lift headline rates over the coming months and we see a peak closer to 2.5%, although now somewhat later following Budget decisions to extend VAT cuts. The medium-term outlook is more uncertain, with the Bank of England (BoE) noting "unusual uncertainty" around supply and demand rebounds. Estimates of supply capacity are particularly uncertain, not only gauging pandemic scarring and trade barrier increases, but also the impact on labour migration looking ahead.

The BoE left policy unchanged in March, adopting a prudent wait-and-see approach against an improved, but highly uncertain, growth outlook. Previous hawkish commentary was dampened with observations of "material spare capacity". But it observed that financial conditions were overall "broadly unchanged" from February, despite material increases in gilt yields and sterling. A more positive growth outlook has reduced the prospect of a further extension of the quantitative easing envelope next month. However, this will leave the BoE tapering its asset purchases ahead of other major central banks, something that is likely to put additional upward pressure on sterling. Too sharp a tightening in financial conditions may yet necessitate the BoE to maintain the current pace for longer and modestly extend the envelope, although this is no longer our central case.

Global Macro Monthly – Japan

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Lower COVID-19 infections are promising but the recovery is fragile given slow vaccination pace

The state of emergency in Greater Tokyo is due to end on 21 March as the number of new cases has stabilised at a low level and hospital capacity is recovering. Vaccinations are underway albeit at a pace of only 0.05% of the population per day. The speed will increase but the government's target of 30 million vaccinated adults by the end of June means it needs to materially pick up the pace. For now, only the Pfizer vaccine has been approved and Japan still faces syringe shortages.

Economic data have been mixed. Private consumption declined in January, as households refrained from returning home over the year-end, while the restrictions weighed on both goods and services spending – retail sales fell 2.4%. Large improvements are unlikely by the end of the quarter as February's surveys pointed to another drop. Yet manufacturing performed well with industrial production coming in at +4.2% on a monthly basis. Exports were volatile around the Chinese New Year, accelerating by 3.3% (mom) and then returning to December's level. The unemployment rate remains at a very low 2.9% but many are still furloughed under the government scheme and overtime work is significantly reduced, suggesting the headline rate is understating spare labour capacity at present. We have lowered our Q1 2021 GDP estimate to -1.3%qoq to reflect the 2nd estimate of Q4 GDP and January data, as well as the renewed extension of the state of emergency in March.

The Bank of Japan (BoJ) kept the policy status quo at its March meeting. Yield curve control (YCC) has proven a powerful tool during the US Treasury sell-off as the 10-year JGB yield reached only 0.15%, within the official target range [+/-0.2%]. As such the yen has depreciated versus the dollar, providing additional leeway for growth and inflation.

The BoJ also unveiled the conclusions of its policy review. It has reinforced its communication toward the possibility of further rate cuts but introduced an "interest scheme to promote lending" with positive rates in a tiered manner to offset the burden of negative rates. On YCC, the range has been widened to +/- 25bps. Surprisingly, the BoJ adopted a more hawkish tone regarding the upper limit by introducing a" fixed-rate purchase operations for consecutive days" while it stated it won't strictly respond to declines that temporarily deviate below the range. On ETFs and Japanese real estate investment trusts, it removed the annual target amount of ¥6tn and ¥90bn respectively, and will adopt a more flexible approach under the upper limit of ¥12tn and ¥180bn respectively.

Global Macro Monthly – China

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A small recovery hiccup

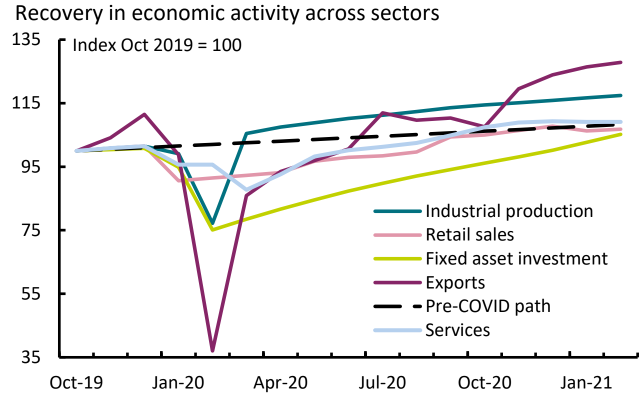
China's economy started 2021 on an uneven footing. The supply-side recovery continued, with industrial and manufacturing production gaining further steam thanks to strong external demand and, paradoxically, less holiday disruption due to this year's 'staying put' policy. In contrast, retail sales and investment, outside real estate, were hit by an unusually cold winter and tighter mobility restrictions, following the discovery of new coronavirus cases before the lunar new year. The recovery in domestic demand therefore paused, although forward-looking indicators suggest that the impact will be short-lived. The combination of a subsiding virus, accelerating vaccination, faster recovery in global demand and a slower exit of fiscal stimulus all suggest upside risks to our 2021 growth forecast of 8%.

Growth surges from a low base

Apart from the usual seasonal patterns, interpretation of this year's economic data is made more difficult by the large base effects. Year-on-year (yoy) growth of major activity indicators skyrocketed in January and February, but mostly reflecting the devastating shock from last year's pandemic. A simple comparison with the consensus shows that industrial production – up 35%yoy and retail sales, which are ahead 34%, beat market expectations, while investment fell short of forecasts but still grew by 35% (Exhibit 3).

Exhibit 3: Exports and production lead the recovery

Recovery in economic activity across sectors



Source: CEIC and AXA IM Research, 24 March 2021

One way to remove these base-effect distortions is to calculate the two-year compound annual growth rate by comparing data in January and February 2021 with that of 2019. This measure shows that industrial production growth accelerated to 8.1% in early 2021, from 7.3% in December, indicating little impact from the renewed virus outbreak. In fact, strong export orders and less holiday taken by migrant workers have boosted production activity in recent months.

In contrast, both retail sales and investment growth weakened relative to end-2020. The former reflected tighter social restrictions limiting holiday travel and spending during the lunar new year. Seasonally-adjusted data showed that retail sales were the weakest in January, contracting by 1.4% month-on-month, although half of that loss was recouped the next month. The weakness in investment was concentrated in infrastructure and manufacturing, while property investment was supported by solid house sales. Overall, despite the limitations in our data manipulation, the directional picture seems to be clear – the domestic economy was hit by the renewed virus outbreak, but the impacts appear uneven and rather short-lived.

Outlook brightens

Looking ahead, there are plenty of reasons to be optimistic about China's economic outlook. Domestically, the clearance of virus cases has allowed the economy and society to normalise, with mobility conditions returning to similar levels seen in 2019. China has also started vaccinating the general public, covering over 50 million people by late February, with Beijing aiming to inoculate 40% of its 1.4 billion people by the end of summer. This should help industries that have so far lagged in the recovery process – such as tourism and accommodation – to get on a faster track to normalisation.

Externally, exports have gone from strength to strength. China's shipments to the rest of the world surged by a whopping 61%yoy in the first two months of the year. While our 2021 forecast already assumed a strong and synchronised global recovery, more fiscal expansion in the US could turn a good year into a great one for exporters serving that market. No wonder manufacturing production has held up well in China, with business expectations at a multi-year high.

Finally, a slower-than-expected reduction of fiscal stimulus could add an additional growth impulse. China's 2021 Budget, announced at the National People's Congress (NPC), implies a more accommodative fiscal stance than previously envisaged, given the larger official deficit and special bond quota earmarked for local governments. Monetary policy, on the other hand, can afford to be less lenient as the fiscal authorities stay guarded against downside risks. Recent People's Bank of China liquidity operations support this view, but these have yet to be reflected in credit growth, which remained strong at the start of 2021. The NPC reiterated the 'no sharp turn' policy stance, although we think that targeted tightening for specific sectors, such as the property market, could increase as financial risks build. We maintain our call for no interest rate or reserve requirement ratio (RRR) hikes this year, despite the modest upside risks to our growth forecast.

Global Macro Monthly – EM

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Pandemic rises amid slow vaccination

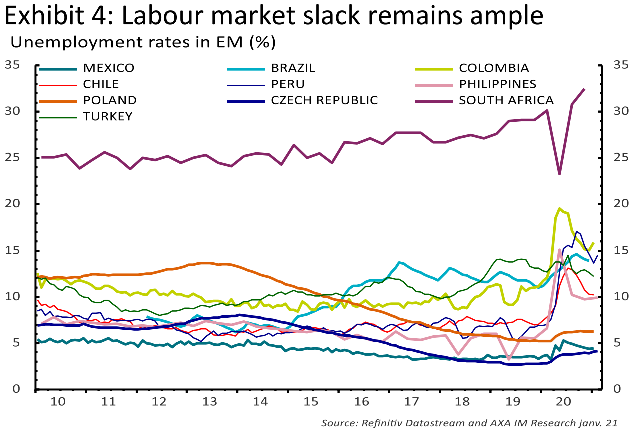
A year after the start of the pandemic, it is fair to say the situation is still not under control in many places in the developing world. The number of new cases has been on the rise in several countries and has become particularly worrying in Brazil where the end of Carnival and summer holidays caused a new wave of infections. In addition, trends are worsening through Central Europe and India.

Furthermore, vaccinations are generally slower in emerging markets (EM) compared to advanced economies, given the rather later start in Asia, but also because of supply constraints. Using population-adjusted metrics, advanced economies have ordered five times more vaccines than developing economies. Extrapolating current vaccination rates, 16% of the EM population would be inoculated by year-end. Hopefully, vaccination rates will accelerate. That said, the Chilean example is particularly impressive, and we doubt many countries around the globe could match it. Within six weeks, Chile managed to vaccinate its entire at-risk population. Still, mobility restrictions are rising in Chile in response to an increase in new, post-summer infections. The vaccination pace should nevertheless allow Chile to reach herd immunity by mid-year and re-open its economy.

Tighter financial conditions

The implementation of ‘America Rescue Plan gives another strong impetus to the US economy. Coupled with a strong recovery in China, EMs more broadly are set to benefit from an accelerating global cycle while mobility restrictions should recede towards the second half of the year as economies open.

Exhibit 4: Labour market slack remains ample



Source: Refinitiv Datastream and AXA IM Research, Feb 2021

But EMs are not anywhere close to economic overheating. Labour market trends remain poor. The unemployment rate reached 32.5% in South Africa from 29% a year ago. It hovers in double-digit territory in Peru, Colombia and Chile. Mexican labour market data is not very relevant as slightly more than half of the workforce is thought to be informal. In Central Europe, at the other end of the spectrum, unemployment rates have risen to 4% to 6%, up from 2.5% to 3.5% pre-crisis (Exhibit 4).

Yet, as US Treasury yields are rising and the dollar is firming, emerging markets have come under some pressure and foreign portfolio outflows have been recorded recently, particularly in fixed income, which may in turn bring forward monetary policy normalisation, particularly where inflation pressures are rising. Inflation rates will be broadly rising in the next few months, driven by genuine economic recovery, base effects, and strong commodity prices. Past currency depreciation may also filter through calling for monetary policy adjustments in some countries.

Brazil’s central bank delivered its first hike since July 2015, up 75 basis points (bps) to 2.75%. The bank’s statement suggests an additional hike in May on the back of stronger stimulus and increased inflationary risk in advanced economies as well as an upbeat recovery in Brazil so far, while the risk of an expansionary fiscal stance remains. The Bank’s projections point to inflation above target this year, suggesting a more likely gradual policy normalisation into the second half.

The Turkish central bank (CBRT) opted for a 200bp hike in policy rate, now at 19%, with a hawkish statement indicating more to come. President Erdogan responded by sacking his third Governor in two years. This casts doubt on the CBRT’s current hawkish stance but has had an immediate impact in depreciating the currency. Inflation is expected to spike above 17% in the next months. The loss of credibility in a context of relatively low FX reserves, leave few options for the central bank. Policy adjustments will eventually come at a much higher cost for growth.

The Russian central bank also decided to respond to the recent deterioration of its inflation outlook by hiking its key rate by 25bps to 4.5%. Inflation was at 5.6% year on year in February, above the 4% target, with upside risks stemming from persistent ruble weakness due to geopolitical risks, as well as higher domestic fuel and food prices. There is also a potential fiscal spending increase ahead of September’s elections to watch for, which should keep the bank alert.

Investment Strategy – Cross-assets

Greg Venizelos,
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US recovery on afterburners

Equities are outperforming bonds, yields are rising, and the belly of the US curve is steepening. The Fed is doing a good job at anchoring short-term interest rate expectations, but the longer-end of the curve and the break-evens curve reflect the reflationary boom, making US fixed income attractive again. Yet the move up in yields is probably not over and few will be surprised if the US 10-year approaches a 2% yield. That is no disaster if the US economy is in 'party mode' again.

Investment Strategy – FX

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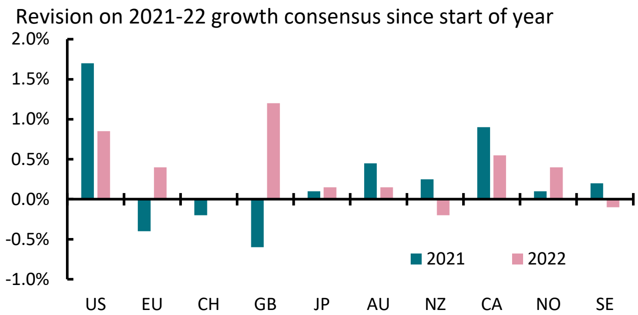
Reflation side A: High beta currencies higher

Markets are dominated by the prospect of economies reopening while massive monetary and fiscal stimulus persists. In this dynamic, currencies with higher beta to global growth and where the domestic rebound looks stronger, should continue to outperform – sterling, the Canadian dollar and Norwegian krone stand out (Exhibit 5).

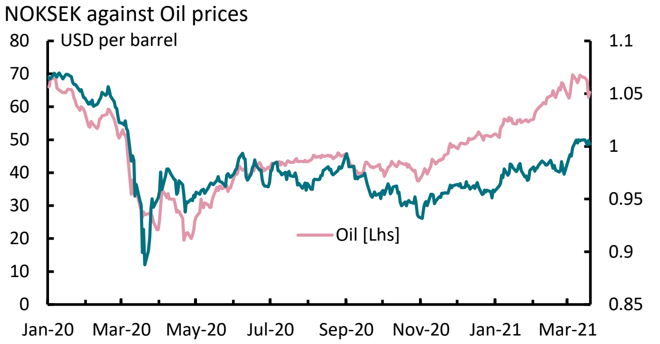
Exhibit 5: GBP, CAD, NOK supported by growth revisions



Source: Bloomberg and AXA IM Research, March 2021

The UK's head start in rolling out vaccinations, points to an earlier reopening than in the rest of Europe. While investors have re-assessed their positions post-Brexit agreement, GBP sterling remains undervalued compared to the period pre-2016 referendum. That said, positioning has almost reached a 10-year high, something to keep an eye on. The Canadian labour market continues to rebound strongly as recent restrictions are withdrawn and vaccine rollouts there have accelerated. Canada is also well positioned to benefit from a US fiscal stimulus spillover and the its dollar has more room to catch up to oil prices. Further, the Bank of Canada sounds marginally more hawkish than other central banks, facing inflation already at target before COVID-19, with house prices overheating. Finally, the Norwegian krone too has more room to catch up versus oil prices as well as other high-beta currencies (Exhibit 6). Indeed, the Norges Bank is contemplating hiking rates as early as 2022, as the domestic economy rebounds and inflation stays above target. Norges Bank is credibly more hawkish than most – it was hiking rates in 2019 while the US Fed was cutting rates.

Exhibit 6: NOK lagging SEK and Oil in the reflation repricing



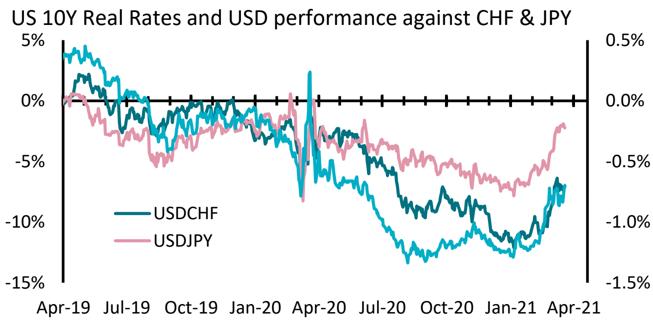
Source: Bloomberg and AXA IM Research, March 2021

Australia's growth and labour market are recovering quickly, yet the economy was in a worse shape before Covid and inflation has been below target, since 2015. The Reserve Bank of Australia is unlikely to turn hawkish as a result – and the country's vaccine rollout has not yet started in earnest.

Reflation side B: Real rates strike back

Comparatively, despite the strong rebound in the US economy and additional stimulus, USD appreciation has slowed due to the Fed's commitment to let inflation overshoot, its negative beta to global growth and an already high valuation. US growth upward revisions have translated to higher US real rates, with further upside. This should push USD/CHF and USD/JPY higher (Exhibit 7). With this in mind, we would favour shorting CHF rather than JPY. We have already had a preference to fund in EUR which is pertinent to CHF's prospects. Moreover, shorting CHF offers a higher carry, while JPY is significantly undervalued and could benefit from Asian economies being in better shape.

Exhibit 7: USDJPY and USDCHF follow US real rates rise



Source: Bloomberg and AXA IM Research, March 2021

Investment Strategy – Rates

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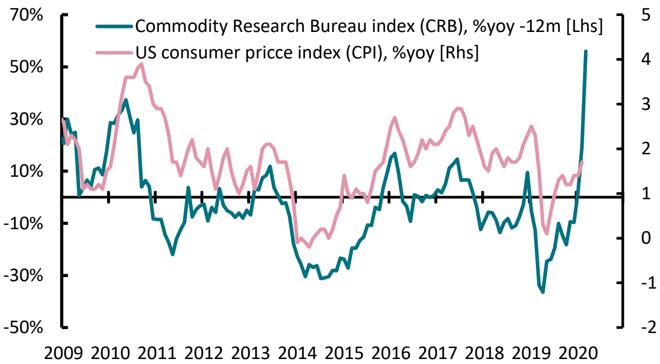
Treasury: It's (still) all about inflation

The Treasury market has been rather challenging since the start of this year. The broad US Treasury index is down about 4.4% year-to-date (ytd), largely driven by the duration component: The long-dated Treasury index is -14.5%ytd. While total returns are negative ytd, 10-year yields are still shy of December 2019 levels and the 2.9% average over 2018. In this environment, the US Federal Reserve maintains a rather relaxed attitude towards the bond markets – rightly so in our view. As long as higher yields are supported by a growing economy and stable financial conditions, then there is no need to worry or to intervene.

Exhibit 8: Commodity bull market

The effect of commodity prices on US inflation



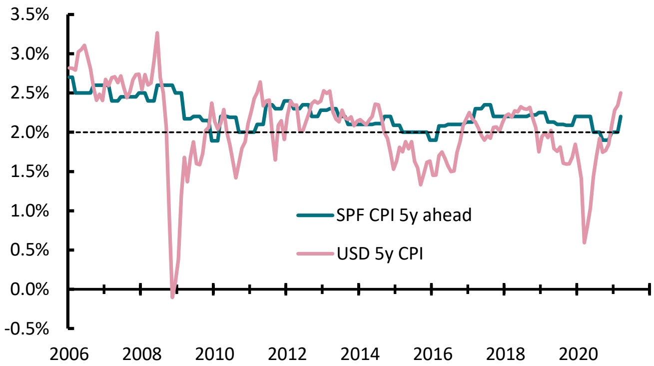
Source: Bloomberg and AXA IM Research, 22 March 2021

Still, the US inflation path is probably the most frequently debated macro question worldwide. For now, it seems that a strong commodity-related base effect might lift consumer prices at the end of spring (Exhibit 8). Both investors and policy makers are in tune on inflation, i.e. believing the effect will be transitory and monetary policy should look through it. Hence, the convergence of US inflation swaps around 2.3-2.5% on forwards up to five years is consistent with the Fed's policy strategy. By the way, the transitory inflation narrative does not apply only to the Fed, but also to the European Central Bank and other central banks in advanced economies.

If higher inflation is transitory, then why are bond investors so sensitive to this topic? We think there is a good reason for the repricing we're witnessing on the Treasury curve – and that reason has to do with expectations. In Exhibit 9, we can see the evolution of market- and survey-based long-term inflation expectations in the US. Both the repricing of inflation swaps and the uptick on the Survey of Professional Forecasters (SPF) suggest that expectations have adapted to the acceleration in global demand and commodity prices and take into account the Fed's higher tolerance for inflation levels above the 2% mark.

Exhibit 9: Expectations are on the move

US Inflation expectations

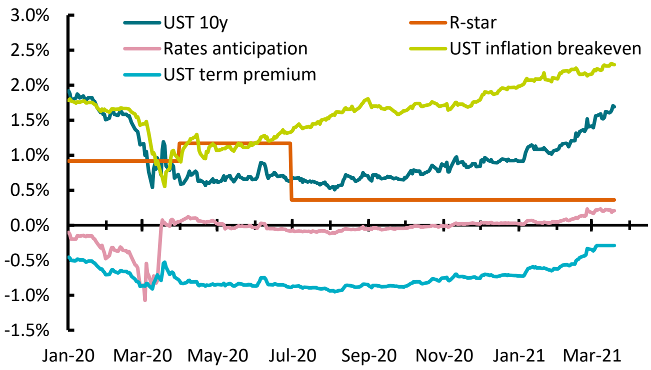


Source: Bloomberg and AXA IM Research, 22 March 2021

However, expectations often tend to feed off themselves (positive feedback) and therefore must be handled with care. Today's inflation is not only a function of demand-pull and cost-push effects, but also of inflation expectations. If inflation expectations rise materially, then tomorrow's realised inflation will also surprise to the upside, thus validating expectations and so on.

Exhibit 10: Treasuries under pressure

US Treasury factor decomposition



Source: Bloomberg and AXA IM Research, 22 March 2021

Central banks' unconventional policy adds a layer of extra complexity to the inflation picture. In fact, bond investors are not reacting exclusively to the repricing of inflation. Rather, investors react to the dichotomy between inflation surprises and the central bank's likely reaction, coming from a policy environment of aggressive quantitative easing.

We can see that in Exhibit 10. The Treasury's weakness not only reflects increased breakeven inflation rates, but also a modest increase in rate hike expectations as well as a rise in the term premium. We interpret this latter factor as a function of increased uncertainty about the future policy stance. Ultimately, it's (still) all about inflation!

Investment Strategy – Credit

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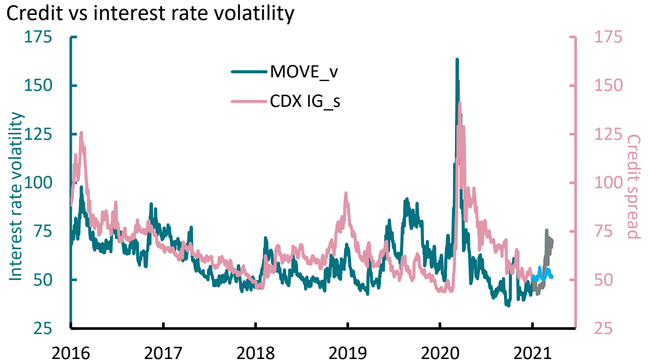
Research – Core Investments

Credit spreads remain oblivious to interest rates

The repricing in interest rate markets continues to keep investors on edge. The evolution in real rates is particularly concerning inasmuch as it determines discount factors for corporate earnings in inflation-adjusted terms. Interest rates and their volatility have risen materially year-to-date (ytd): the US 10-year Treasury yield is up by 81 basis points (bps), UK 10-year gilt yield by 64bps and German and French 10-year yields by 28bps and 29bps. Yet risky assets and especially credit (Exhibit 1) have not reacted badly to this repricing. The S&P 500 is roughly flat since real rates started rising in mid-February and up by 4.2%ytd. Rising rates reflecting better growth and ongoing support for risk premia from central banks' balance sheets are valid reasons for such a reaction.

Exhibit 11: Credit spreads unchanged year to date despite the notable rise in interest rate volatility



Source: Bloomberg, InterContinental Exchange (ICE) and AXA IM Research, Mar 2021

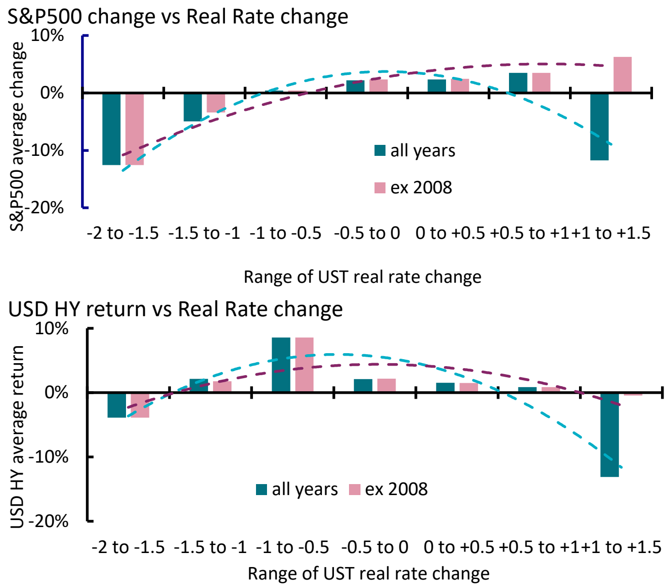
The sensitivity of credit to interest rate volatility has dropped dramatically since the Federal Reserve intervened in credit markets in March last year. The table below shows a 12-fold decline in the spread beta between the CDX Investment Grade (IG) index (US IG credit) and the MOVE index (US Treasuries' volatility).

CDXIG vs MOVE - spread beta

Taper tantrum	[May-Jun] 2013	0.45
Pre Covid	Jan-20	0.23
Covid start	Feb-20	0.40
Covid worst	Mar-20	1.17
Post US elec	[Nov-Dec] 2020	0.55
Current		0.10

Regarding real rates, a large increase tends to be viewed as detrimental to risk premia, but this is mainly due to 2008 which was a major outlier for financial markets. The US 10-year inflation breakeven collapsed by 2.6% in the second half of 2008, which led to a 1.8%. jump in real rates. By contrast, the US breakeven has risen by 1.4% and the real rate has fallen by 0.3% since March 2020. Excluding 2008, US stocks show positive returns and US high yield credit is just about flat, for an increase in real rates by over 1% (Exhibit 2).

Exhibit 12: A large rise in real rates appears detrimental to risk premia because of 2008 – a major outlier

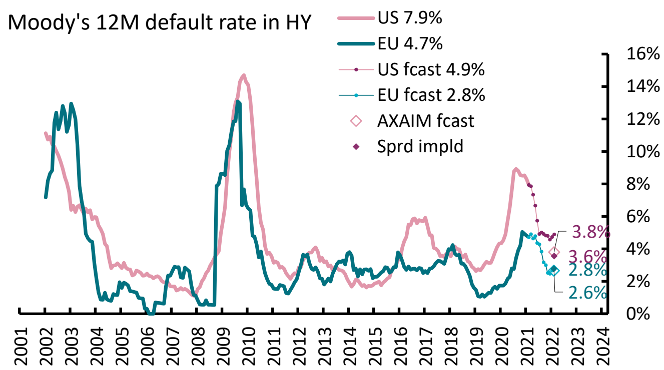


Source: Bloomberg, ICE and AXA IM Research, Mar 2021

Default outlook continues to improve

High yield is our preferred allocation within credit against the reflation trade backdrop. Realised and expected default rates continue to decline. Moody's defaults have peaked at around 9% for the US and around 5% for Europe, the worst reading since the global financial crisis. But we expect them to decline to 3.8% and 2.6% respectively over one year (Exhibit 13).

Exhibit 13: Realised and expected default rates continue to decline



Source: Moody's, ICE and AXA IM Research, Mar 2021 (lines show Moody's data; points and labels show AXA IM calculations)

Investment Strategy – Equity

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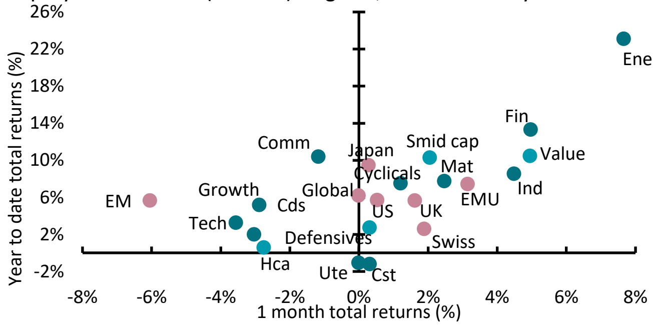
Some respite in equity markets

Concerns over rising interest rates dominated equity markets last month, leading to various movements across the asset class. Although the rise has recently slowed thanks to vocally dovish central banks, global equities delivered a flat -0.01% over February (Exhibit 14), the US returned a modest 0.5% while emerging markets underperformed, down -6.1% in local currency terms. On the sector and style fronts, energy (+7.7%) clearly outperformed followed by financials (+5%), and value (+4.9%).

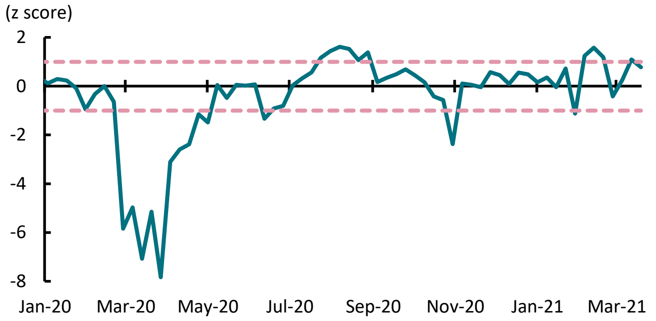
Exhibit 14: EM wobble with US rates rise



Source: Datastream and AXA IM Research, March 2021

The VIX term structure suggested elevated market volatility expectations have risen in the near term, as the VIX futures contracts curve showed a steep contango (z score ranging between 1.19 and 1.58) (Exhibit 15) during the three first weeks of February. Yet despite that, this 'fear' premium has compressed over the last few weeks, supporting stocks' performance. As the VIX remains high in historical terms (above its 10-year weekly average), a return to lower levels could provide additional tailwinds for equity markets.

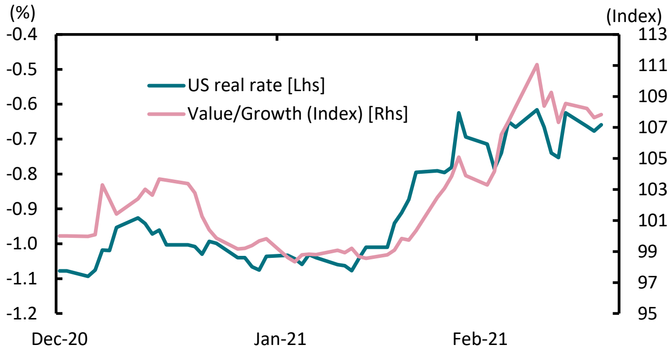
Exhibit 15: Concerns observed through the VIX futures curve fade away



Source: Datastream and AXA IM Research, March 2021, based on 10Y weekly VIX spot versus second future contract spread

The rotation into Value has slowed down in line with the real rate stabilisation observed more recently (Exhibit 16). During their last meeting, both the ECB and the Federal Reserve decided to maintain the accommodative stance keeping their respective policy rates and purchase programmes unchanged, with the ECB indicating that it will increase its programme in the next quarter. Those recent decisions may weigh on the reflation trade in the short term but also help stimulate the economic recovery in the longer term. As we move forward through the year, growth and inflation are expected to accelerate and this, combined with a further rise in yields, should help maintain the rotation into value assets.

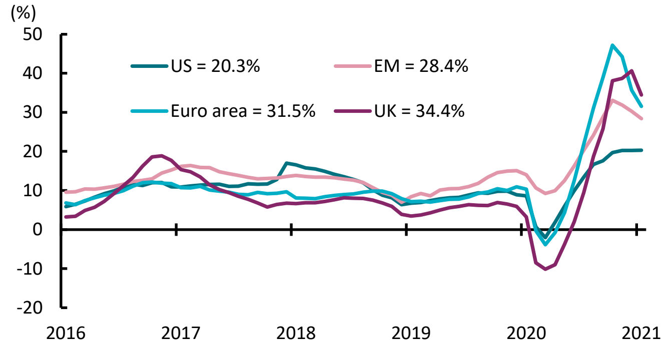
Exhibit 16: Stalled yield, subdued rotation



Source: Datastream and AXA IM Research, March 2021

In addition, the evolution of the catalysts for the rotation trade should be monitored. Vaccination progress, which is crucial for a more complete resumption in activity, is key, and the divergences across countries and regions creates relative value opportunities. The expected earnings growth for 2021 reflects such divergences. Back in January, the Eurozone had the strongest expected earnings growth. Yet, after the past month's developments on the virus and vaccination fronts, the Euro area gave up the lead edge to the UK's earnings growth, where the pandemic trajectory looks better (Exhibit 17). We have upgraded the UK region to positive as a result, while we remain overweight on the asset class overall.

Exhibit 17: UK earnings are leading the block



Source: IBES and AXA IM Research, March 2021

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		▼	
Green Basket		▼	
Europe Cyclical/Value			■
Euro Opening basket			▲
US Cyclical/value		▼	
US Financials			▲
Global semiconductors			■
Fixed Income			
Govies			
Euro core		▲	
Euro periph		■	
UK		■	
US	▼		
Inflation			
US		■	
Euro		■	
Credit			
Euro IG		■	
US IG		■	
Euro HY		■	
US HY		■	
EM Debt			
EM bonds		■	

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

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

Macro forecast summary

Real GDP growth (%)	2020	2021*		2022*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
World	**-3.7**	**5.5**		**4.2**	
Advanced economies	**-5.5**	**5.4**		**3.7**	
US	**-3.4**	**6.5**	4.7	**4.4**	3.6
Euro area	**-6.8**	**3.8**	4.4	**3.5**	4.1
Germany	**-5.3**	**2.4**	3.5	**3.3**	3.8
France	**-8.3**	**6.0**	5.5	**3.3**	3.6
Italy	**-8.9**	**4.5**	4.3	**3.5**	3.9
Spain	**-11.0**	**4.5**	5.7	**4.7**	5.7
Japan	**-4.9**	**2.9**	2.3	**2.5**	2.3
UK	**-10.0**	**5.0**	4.2	**7.5**	5.6
Switzerland	**-3.0**	**2.8**	3.0	**2.7**	3.0
Emerging economies	**-2.7**	**5.6**		**4.5**	
Asia	**-1.4**	**7.1**		**5.1**	
China	**2.3**	**8.0**	8.4	**5.5**	5.5
South Korea	**-1.0**	**3.5**	3.4	**3.0**	3.0
Rest of EM Asia	**-6.0**	**6.4**		**4.7**	
LatAm	**-7.4**	**4.0**		**2.8**	
Brazil	**-4.1**	**3.0**	3.3	**2.3**	2.5
Mexico	**-8.5**	**4.7**	4.0	**2.5**	2.9
EM Europe	**-2.5**	**3.1**		**3.6**	
Russia	**-2.8**	**1.8**	2.9	**2.5**	2.5
Poland	**-2.7**	**3.3**	3.9	**4.6**	4.7
Turkey	**1.2**	**4.5**	4.4	**4.6**	4.2
Other EMs	**-3.7**	**3.3**		**4.1**	

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

* Forecast

CPI Inflation (%)	2020	2021*		2022*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	**0.8**	**1.6**		**1.4**	
US	**1.2**	**2.0**	2.3	**2.2**	2.2
Euro area	**0.3**	**1.5**	1.2	**1.1**	1.2
Japan	**0.0**	**-0.3**	-0.2	**0.5**	0.4
UK	**0.9**	**1.9**	1.5	**1.7**	2.0
Switzerland	**-0.7**	**0.1**	0.3	**0.4**	0.5

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

* Forecast

These projections are not necessarily reliable indicators of future results

Forecast summary

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

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

These projections are not necessarily reliable indicators of future results

[Download the full slide deck of our March Investment Strategy]

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

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