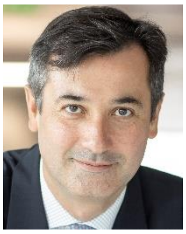
Dealing with overheating concerns (already)

Monthly Investment Strategy Oped



Gilles Moëc,
AXA Chief Group Economist,
Head of AXA IM Research

Chris Iggo,
AXA IM Chief Investment Officer,
Core Investments

Key points

- The Biden plan could close the US output gap by the end of 2021.
- It may not lift inflation permanently, but the market is not taking chances and long-term rates are rising.
- The ECB has started to be vocal against contagion from the US, but action will need to follow.
- Further rise in yields will be attractive for some fixed income investors
- Equity markets on hold given the bond adjustment and confirmation of earnings rebound.

From collapse to overheating in 18 months

The US macroeconomic debate is now focusing on whether Biden's stimulus package, designed amid signs of concerning softness in the US labour market, could end up going too far and precipitate the US economy into "overheating" by the end of this year, only 18 months after the chasm of the spring of 2020. It is not implausible.

In Q4 2020, US GDP stood $950bn below where potential GDP should be at the end of 2021 according to the Congressional Budget Office. So, even without taking on board any "spontaneous" growth as the economy reopens, the $1,900bn package would be enough to fully close the output gap with a multiplier of only 0.5, at the low end of conventional estimates. True, we continue to think that the US administration will have to offer some compromise to get it through Congress, but for now even the moderate Democrats in Congress seem to be on board, which suggests that the "landing zone" could be close to the upper range of expectations for the headline number.

It is not obvious at all that such "overheating" would trigger a shift in the inflation regime. The output gap had been in positive territory in the two years before the pandemic without bringing inflation in line with the Federal Reserve (Fed)'s target, and the impact of the Biden stimulus could be quite short-lived: most of the measures are temporary, and some of the spending will naturally fall back as the economy improves (e.g. the top up to unemployment benefits). It takes time to shift adaptative expectations. We won't know this quickly though. Because of base effects, US inflation will rebound in the coming months, and disentangling mechanical from fundamental factors will be thorny.

The market is not taking chances anyway, and inflation expectations have continued to rise, taking long-term interest rates higher. For the time being the Fed is probably quite comfortable with the move, which to some extent reflects its credibility, following its clear signal that it would tolerate inflation overshooting. However, real yields have started to rise as well, which is more problematic. Their absolute level remains very low in the US (around -80 basis points), and the Fed has some room for manoeuvre. Still, if they get too close to zero too fast, Fed Chair Jay Powell will be under pressure to do something – with a maturity extension of asset purchases most likely – to avoid a general re-appraisal of asset prices which would not help the normalisation of the US economy, where wealth effects matter a lot. In the meantime, we believe there is some space for a further rise in nominal yields.

Pressure on the European Central Bank (ECB) is more immediate. Indeed, real yields have started to rise in the Euro area as well, and the fundamental rationale for this is far less obvious than in the US given the mediocre European performance on cyclical indicators and vaccination, which point to a continuation of macro decoupling relative to the US. The ECB explicitly stated its willingness to keep financing conditions favourable and in the minutes of the last Governing Council real rates were highlighted as a key variable to monitor. Christine Lagarde engaged in verbal intervention on 23 February, but action – probably in the form of a re-acceleration in PEPP Pandemic Emergency Purchase Programme (PEPP) buying – needs to ensue.

Investment outlook depends on where yields settle

Investors will attach different degrees of importance to the drivers of the increase in long-term interest rates in the United States. Some will emphasise the expected acceleration of economic growth and the associated increase in inflation, others will point to monetary policy risks or the rise in government borrowing. This is what makes the narrative so colourful. In turn, investors will also respond in different ways. Investment behaviour will reflect differing views on the outlook for yields themselves as well as the potential for contagion to other asset classes. Note that in the short-term, returns from most asset classes have seemingly been impacted by the bond re-pricing.

Some investors will be tempted to take advantage of the increase in yields. In US dollar terms, 10-year Treasury yields are at their highest level for a year. Hedged into euros, swiss francs or Japanese yen, they are at their highest levels since 2014. The yield curve between 2-year and 10-year maturities has risen to 125 basis points (bps) – right in the middle of its long-term range, offering an attractive carry and roll-down opportunity. If investors believe, as we do, that the next monetary policy tightening cycle remains in the distance, these newly reached market levels might generate enough demand from long-term fixed income investors to bring some stability to the market.

We note the divergence in the near-term macro outlook between the US and Europe. That is reflected in bond spreads, for example between US Treasuries and German bunds. There is nothing new in that. It reflects the superior growth performance of the US economy over the last decade, a reality that led to a tightening cycle in the US between 2016 and 2018. Even though we don't expect the Fed to move on rates anytime soon, such a move would come sooner in the US than in Europe. Moreover, US inflation is likely to be quite a bit higher. The spread differential is warranted, may increase, and does provide investors in euros and other currencies an opportunity to profit from higher US yields in both rates and credit.

For its part, the Federal Reserve is encouraging the belief that its behaviour through the coming cycle will be different to how it was in 2016-2018 and before. It raised rates then by a total of 225bps, much of that coming before inflation got anywhere near 2%. Bond yields topped 3% and the economy slowed sharply in 2018-2019. Such a pattern is unlikely this time. It is noteworthy that expectations of actual interest rate increases have barely budged even as the 10-year yield has climbed 40bps this year and 90bps since last summer's low.

There is a bearish interpretation of the re-pricing of US fixed income. Unchecked, higher yields will be negative for indebted companies and may curtail new investment plans. Some bond investors might demand wider credit premiums as a result. Rising yields could also be used to argue that equities are too highly valued. Yet the current context is a positive macro outlook, a market adjustment that has hardly been disorderly and central banks that are determined to nurture the economic rebounds. It is hard to see equity investors making the decision to "sell" just on the rise in yields to date. The motivation would have to come from a changed (more negative) macro view, a re-evaluation of discounted earnings relative to current prices or some concerns about financial stability given current levels of leverage

A stronger growth outlook, healthier inflation and a Fed on hold should support credit and equity markets once they have adjusted to the new range for long-term rates. Support for equities continues to come from the earnings outlook as well as the multiplier effects on spending from President Biden's fiscal stimulus and "green" spending. Corporate bond yields and mortgage rates have hardly risen yet. Still, in the short term after a period of very strong equity returns, higher yields might add to concerns about valuations and speculative activity in the equity market. The economy is close to arriving at the re-opening stage, which has been anticipated by equity investors for some time. Some pause is arguably justified. However, the relative attractiveness of equities has hardly been diminished by the rise in yields so far.

We are not at the start of a monetary tightening cycle. The extent to which inflation trends higher remains to be seen. Higher yields now are more in line with the economic outlook – after all they are just back to where they were before COVID-19. History tells us that equity returns are driven by the growth and earnings cycles, not by the level of bond yields. On that basis some stabilisation in bond yields should herald another period of stronger investment returns after a mixed beginning to 2021.

Download the full slide deck of our February Investment Strategy

Recommended asset allocation

Asset Allocation			
Key asset classes			
Equities			Positive
Bonds	▼ Negative		
Commodities			Positive
Cash	Negative		
Equities			
Developed			
Euro area		Neutral	
UK			▲ Positive
Switzerland		Neutral	
US		Neutral	
Japan		Neutral	
Emerging & Sectors			
Emerging Markets			Positive
Green Basket			Positive
Europe Cyclical/Value			Positive
US small caps		Neutral	
US Cyclical/value			Positive
Global semiconductors			Positive
Fixed Income			
Govies			
Euro core	▼ Negative		
Euro periph		Neutral	
UK		Neutral	
US	▼ Negative		
Inflation			
US		Neutral	
Euro		Neutral	
Credit			
Euro IG		Neutral	
US IG		Neutral	
Euro HY		Neutral	
US HY		Neutral	
EM Debt			
EM bonds		Neutral	

Legends	Negative	Neutral	Positive	Last change	▲ Upgrade	▼ Downgrade

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

Macro forecast summary

Real GDP growth (%)	2020	2021*		2022*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
World	**-3.7**	**5.4**		**4.1**	
Advanced economies	**-5.5**	**5.2**		**3.6**	
US	**-3.4**	**6.2**	3.7	**4.5**	
Euro area	**-6.8**	**3.6**	5.3	**3.2**	
Germany	**-5.3**	**2.4**	4.4	**3.1**	
France	**-8.3**	**5.5**	6.7	**3.0**	
Italy	**-8.9**	**4.4**	5.3	**3.2**	
Spain	**-11.0**	**4.5**	6.7	**4.3**	
Japan	**-4.9**	**3.5**	2.5	**2.3**	
UK	**-10.0**	**4.6**	5.7	**7.5**	
Switzerland	**-4.8**	**2.5**	3.7	**3.0**	
Emerging economies	**-2.7**	**5.5**		**4.5**	
Asia	**-1.4**	**7.1**		**5.1**	
China	**2.3**	**8.0**	7.9	**5.5**	
South Korea	**-1.0**	**3.5**	3.2	**3.0**	
Rest of EM Asia	**-6.0**	**6.4**		**4.7**	
LatAm	**-7.3**	**3.6**		**2.8**	
Brazil	**-4.0**	**3.0**	3.2	**2.3**	
Mexico	**-8.3**	**3.2**	3.7	**2.5**	
EM Europe	**-2.5**	**3.1**		**3.6**	
Russia	**-2.8**	**1.8**	3.1	**2.5**	
Poland	**-2.7**	**3.3**	4.2	**4.6**	
Turkey	**1.2**	**4.5**	4.6	**4.6**	
Other EMs	**-3.7**	**3.3**		**4.1**	

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

* Forecast

CPI Inflation (%)	2020	2021*		2022*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	**0.8**	**1.3**		**1.4**	
US	**1.2**	**2.0**	2.0	**2.2**	
Euro area	**0.3**	**0.8**	0.9	**1.1**	
Japan	**0.0**	**-0.4**	0.0	**0.6**	
UK	**0.9**	**1.8**	1.5	**1.5**	
Switzerland	**-0.7**	**0.0**	0.2	**0.2**	

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

These projections are not necessarily reliable indicators of future results

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

AXA Investment Managers SA
Tour Majunga – La Défense 9 – 6 place de la Pyramide 92800 Puteaux – France
Registered with the Nanterre Trade and Companies Register under number 393 051 826