# Supply constraints add to inflation angst

## Monthly Investment Strategy

**AXA IM Research**

**September 2021**

# Summary: September 2021

## Theme of the month: EU Fit for 55

- In July, the EU announced "Fit for 55" – a suite of measures to deliver a 55% reduction in GHG emissions by 2030 from 1990 levels. It included an enhancement of the ETS scheme, as well as an extension to other sectors including aviation and shipping and road and buildings fuels.
- It also included a Carbon Border Adjustment Mechanism, a tariff on imports to equalise carbon production costs from other regions that might not apply the same level of carbon pricing. This is designed to stop 'carbon leakage' from the EU. But is also designed as a negotiating tool with competitors.
- Both policies generate large revenues for the EU. The EU will look to redeploy these funds into investment, with an Innovation Fund, designed to boost climate-related investment in lower-income EU economies, and to a Social Climate Fund to help EU citizens finance energy efficiency or greener travel.

## Macro update: Persistent supply effects raise inflation concerns

- Supply constraints are a common theme across economies. We have downgraded our US and Japanese Q3 GDP estimate on the back of these. Chinese growth has softened on renewed COVID outbreaks. While in the UK there are downside risks to the Q3 view. The Eurozone outlook remains solid.
- Inflation pressures remain elevated. There are tentative signs that US inflation has passed its peak. Surges in the Euro area and UK reflect differences in the timing of base effects and utility price developments are a risk. Persistent labour market constraints are a risk for the US and UK.
- Policy outlooks are divergent. The US looks to pass significantly more government spending. The Fed moves towards a year-end taper, while the ECB adjusted its PEPP purchases recently. The BoE sounds hawkish as inflation pressures mount. Some EMs are already reacting to inflation concerns.
- German elections will determine domestic and influence Eurozone spending across 2022. Japanese elections will be held before the end of November, after the Japanese LDP select a new leader.

## Investment strategy: risk backdrop should remain supportive despite pockets of angst

- FX: The rebound in growth, prices and labour markets justifies the normalisation of monetary policy, where inflation is already at target and overheating is a risk. The US Federal Reserve is within this group, even after accounting for its revised average inflation targeting policy, acting as a tailwind for USD.
- Rates: Other factors in addition to productivity may influence the medium-term trend in real interest rates. Such as demographics and the associated 'savings glut' as well as the central banks' crisis response in combination with substantial fiscal support (nominal yields capped amid inflation pressures).
- Credit: Credit markets are in a goldilocks regime once again, with spreads low and spread volatility contained. Credit risk premia are also supported by the improvement in corporate fundamentals. While a headwind for China growth, the crisis in its property sector should not be a source of global contagion.
- Equity: The current level of the valuation gap between Value and Growth stocks has been historically low since mid-2019. According to fundamentals, such a gap is not justified and the current Value discount to Growth can be considered as an opportunity in our view.

# Central scenario

## Summary – Key messages

**Monetary policy**

Fed prepares for taper. But monetary policy remains key policy support and all central banks will be wary of withdrawing support too quickly.

**Inflation**

Inflation persistence concerns amidst energy, base effects and bottlenecks. 2022 depends on spare capacity and unlikely outside US and some EMs.

**Fiscal policy**

US spending in flux, expect large package in Q4. In Europe and UK fiscal support rolled out more slowly.

**Growth**

Strong growth and recovery to remain. But virus revival and supply-chain issues take shine off euphoria. Virus risk remains.

Our central scenario:

2021 rebound as virus controlled, recovery needs policy support

We forecast global growth to rise by 5.7% in 2021 and 4.4% 2022.

Economic rebound on vaccine and stimulus, must overcome labour market and supply constraint headwinds. Monetary and fiscal policy support.

**Emerging Markets**

EM's see virus pressures rise with less vaccine access for now. Export economies still benefit. Less policy space for most.

**Rates**

Rates stable as technicals offset growth and inflation outlook. Macro still argues for higher rates – technicals to unwind over autumn.

**FX**

USD appreciation factors may be at play again, while low yielding currencies may come under pressure.

**Credit**

Tight spreads levels now more justified by improving corporate fundamentals, while central banks still present as backstop.

**Equities**

Value/Growth rotation remains attractive. Corporate earnings 2021 rebound on track. Equity risk premium is compressed.

# Alternative scenarios

## Summary – Key messages

**Persistent recession *(probability 20%)***

**What could be different?**

- Coronavirus mutations reduce vaccine effectiveness
- Labour market dislocation and business disruption create ongoing headwinds to demand recovery
- Fiscal policy fades amidst elevated debt and political opposition
- Geo-political tensions mount in post-Covid world

**What it means**

- Growth/inflation expectations weaken further, additional GDP disruption, corporates' earnings under more pressure
- Further monetary policy where space permits (including China). Government's continue with fiscal stimulus and divide between monetary financing blurs further.

**Market implications**

- Risk appetite deteriorates / equities sell off / credit widens
- Safe-haven rates rally resumes
- EM debt to come under pressure

**Fast recovery *(probability 20%)***

**What could be different?**

- Vaccines suppress hospitalisations and governments can increasingly remove all constraints, easing supply constraints
- Labour market recovers, economies benefit from post-virus euphoria and faster consumption of 'excess saving'
- Virus-shock reshapes business practice, boosting productivity

**What it means**

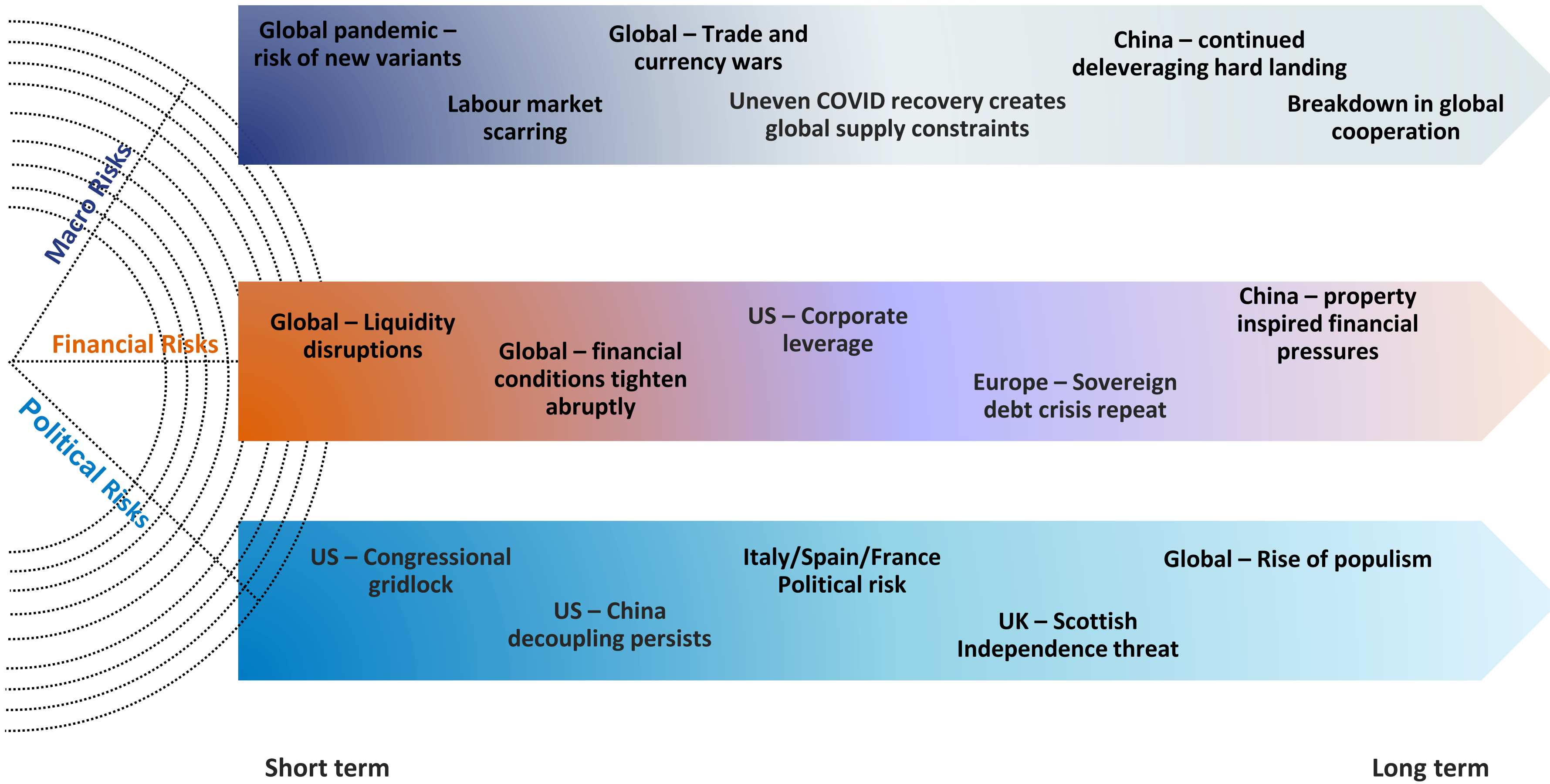
- Global/US/EMU growth surprise on the upside in a stronger and more persistent rebound from 2020
- Monetary policy fights expectations for swift tightening through forward-guidance

**Market implications**

- Risk-on environment with equities making further gains amidst broader rotation
- UST and EUR break-evens rise
- Spreads grind tighter

# RISk Radar

## Summary – Key messages



# Contents

# Theme of the month

# « Fit for 55 », a carbon pricing upheaval

## The EU’ climate ambitions

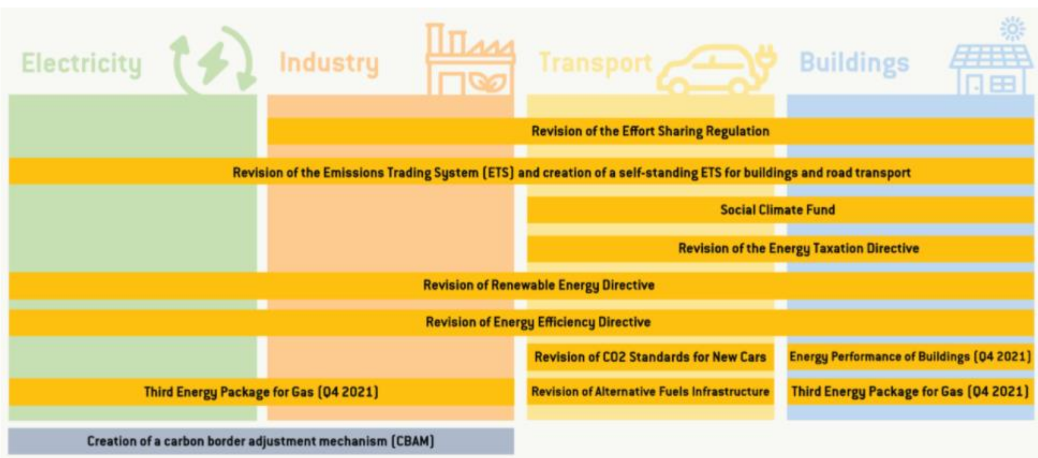
### The European Union wants to remain a leader in climate action and policies

- The EU Green Deal, adopted in January 2020, commits to reducing the bloc’s greenhouse gas emissions (GHG) by at least 55% by 2030, compared to 1990 levels, and reaching carbon neutrality in 2050.
- On 14 July, the European Commission unveiled a suite of measures known as ‘Fit for 55’, including a comprehensive carbon pricing strategy, to achieve the EU Green Deal target. It encompasses a revision of the current Emissions Trading System (ETS) and stricter regulations, a more ambitious emissions reduction target and the proposal of a Carbon Border Adjustment Mechanism (CBAM).

### Why do we need carbon pricing ?

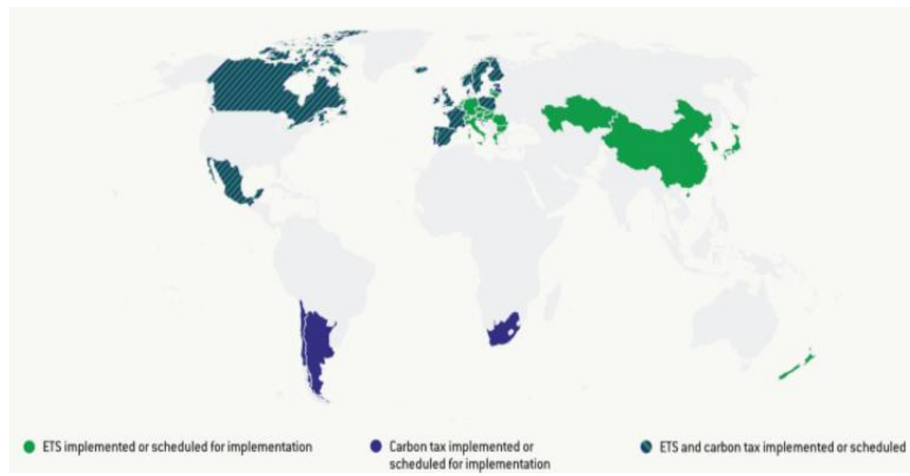
- Carbon pricing is a means of internalising the negative externalities caused by greenhouse gases. If the system is well designed, it should adjust the relative price of goods to allow for their carbon content and hence modify economic behaviours and incentivise investments for a greener economy.

EC’s “Fit for 55” measures to reduce emissions by 2030




Source: Bruegel, as of July 2021

Worldwide carbon pricing initiatives




Source: Bruegel, as of July

# The EU Emission Trading System and the latest propositions

## Focus on the ETS scheme

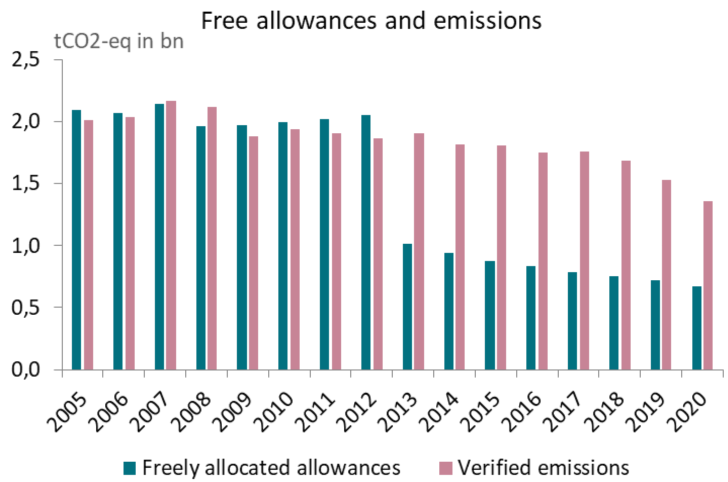
### The importance of a well-designed tool

- Introduced in 2005, the EU ETS currently applies to about 40% of the EU's GHG emissions in the power and heat generation, aviation and energy-intensive industrial sectors. The EU caps the total amount of emissions permitted and those companies must purchase emission permits via auction and can use, trade or keep them for the following year. If a company is unable to cover its emissions, it bears a heavy penalty. The total cap is then reduced over time, in line with the EU's emission reduction strategy.
- 'Free allowances' are designed to shield domestic companies from international competition and avoid relocation of polluting activities outside the EU (carbon leakage). At the beginning of Phase 3 (2013-2020), free allowances represented 80% of new permits but this decreased to 30% in 2020.

### The ETS revision

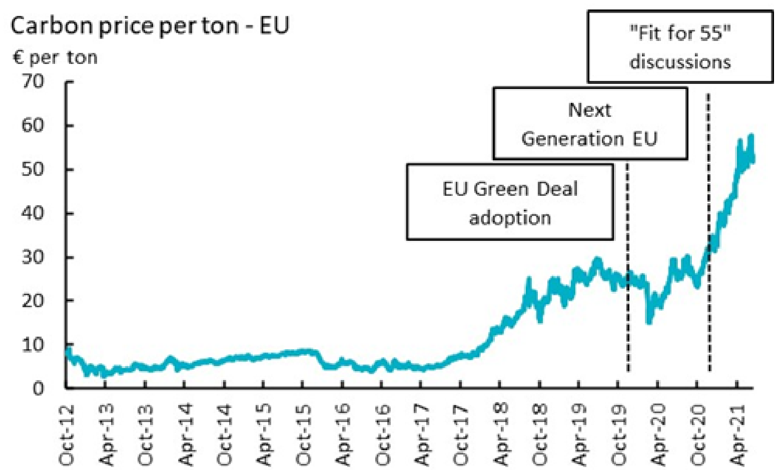
- Phase 4 of the EU ETS revision (2021-2030) introduces a more ambitious emissions reduction target – the total cap will adjust by -4.2% each year from 2.2% previously (plus a one-off reduction on the overall emissions cap) and will address misallocations with the free allowances.
- The EC is also proposing to add new sectors to the ETS where sharper reductions are needed – aviation and shipping - and a new ETS scheme to include fuels used in road transport and buildings by 2026.

In 2020, free allowances accounted for half of verified emissions




Source: European Environment Agency and AXA IM Research, as of 2020

Carbon price surged in light of the 'Fit for 55' discussions




Source: Datastream and AXA IM Research, as of 16 July



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# Is the Carbon Border Adjustment Mechanism (CBAM) a panacea ?

## Focus on the CBAM

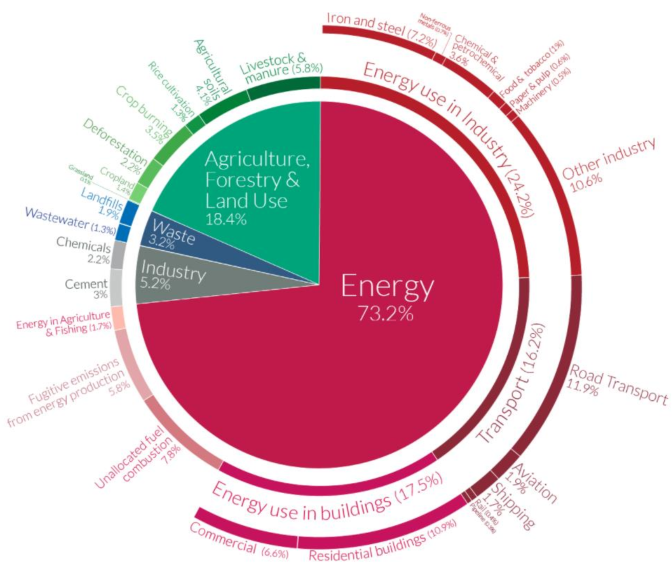
### A CBAM to tackle carbon leakage

- The CBAM addresses the risk of carbon leakage by adding back in the cost of the carbon content of products imported into the EU. EU importers will purchase permits corresponding to the carbon price that would have been paid if the goods had been produced in the EU under the domestic carbon pricing rule. Conversely, if a non-EU producer proves that it has already paid a carbon tax in another country, the corresponding cost can be fully deducted for the EU importer.

### A CBAM threat is a necessity

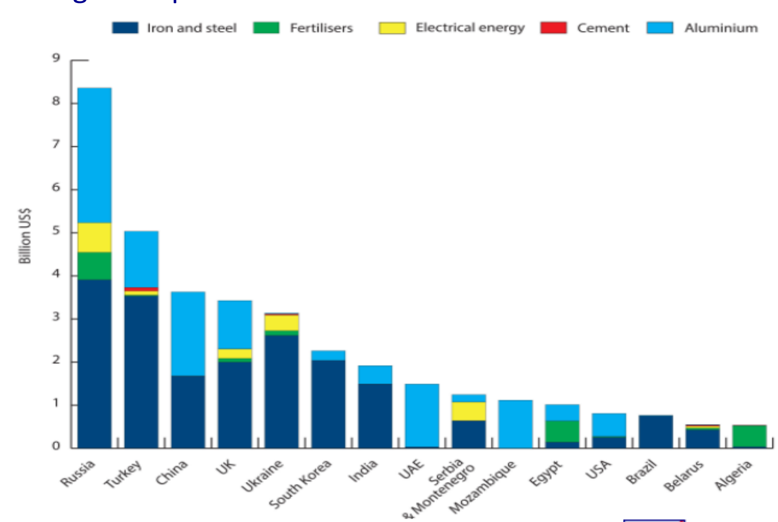
- The EU CBAM will only apply to those goods with a high risk of carbon leakage – iron and steel, cement, fertiliser, aluminium and electricity generation, which together account for approximately 5-10% of EU imports and around 30% of worldwide $CO_2$ emissions. This initial list likely reflects a European ambition to bring others along with it – particularly major trade partners including China and the US.
- As it stands, the EU CBAM should probably be perceived as essentially a negotiation tool. A transition phase will run from 2023 until 2026 with the objective of improving data collection, smoothing the roll out and facilitating dialogue with third-party countries and the WTO.

Global greenhouse gas emissions by sector in 2016




Sources: Our World in Data, Climate Watch, the World Resources institutes

EU imports of products - The impact of CBAM is heterogenous among trade partners




Source: Centre for European Reform as of July 2021

# How will the revenues be used ?

## Let's not forget transition has a huge cost…

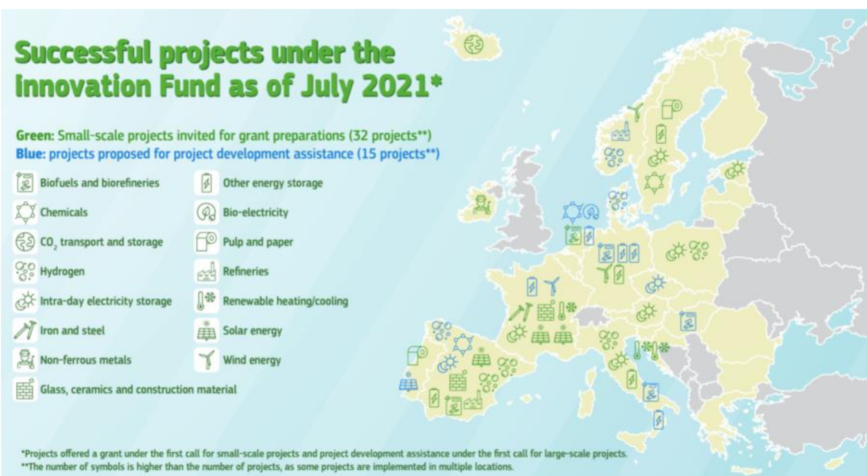
## Carbon pricing instruments raise revenues that can help finance the energy transition…

- Auction revenues from ETS go mainly to member states' budget and are essentially reinvested into climate- and energy-related purposes. Additionally, the current ETS finances an Innovation Fund which supports breakthrough innovations towards climate neutrality and a Modernisation Fund for power sector upgrades in lower-income member states.
- The EC proposes to increase the revenues for those funds. Those proposals are welcome, but it does not entirely solve the issue of the east/west climate divide across member states. Central and Eastern European countries should proportionally receive more but you can also observe on the map below that project remain concentrated in the west.

## But redistribution to low-income households should not be forgotten

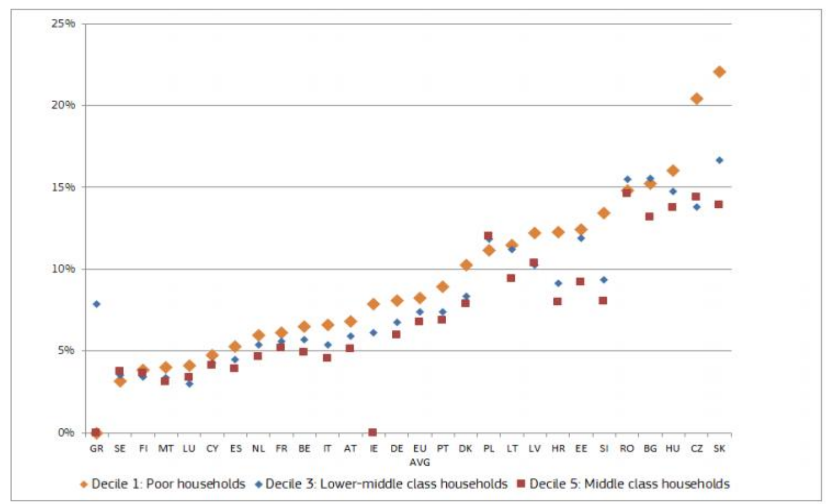
- ETS, CBAM and more generally all the measures to tackle climate change will inevitably place extra pressure on vulnerable households. The EC proposes a Social Climate Fund to help citizens finance investments in energy efficiency and cleaner mobility. But it is not enough and domestic actions on top of the EU efforts are needed.

### Without fund from the Modernisation Fund, some Eastern countries would not have climate project




Source: European Commission, as of July 2021

### Energy share in the total households' expenditure by income decile




Source: European Commission and DG ENER, as of 2018



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# Still an ongoing project...

## German and French elections may alter discussions

### Good direction, await concrete actions

- Both the ETS revision and CBAM launch send strong signals about the EU's intention to transform industry domestically but also take a lead in shaping developments on a global scale. As of now, those initiatives are only proposals and will take several years to convert into actual policies, requiring joint approval by the European Parliament and EU countries.
- Moreover, the CBAM proposal is striking. It is described in heavily diplomatic terms, applies to limited sectors, is very gradual in implementation and details no explicit redistribution other than to the EU budget. As such, it appears for the time being as more a policy designed to buy time and apply pressure on international competitors to establish concrete negotiations rather than a policy fully designed for implementation.
- Discussions over the coming years with sector lobbies, member states, third countries and the World Trade Organization are likely to prove challenging and shift any final mechanism from this initial proposal. But the measures announced in July begin those discussions.

The plan is drafted, now it's time for the discussions with member states and third parties


Source: E3G, July 2021

# Macro outlook

# Activity weakens amidst COVID and supply shortages

## US

### COVID cases still require hospitalizations

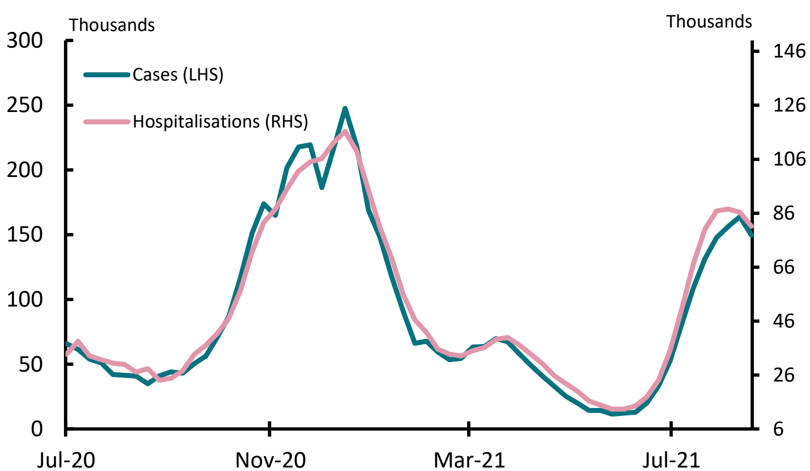
- Cases show tentative signs of peaking, with southern states – many that eschewed basic precautions – suffering the most. These states also have amongst the lowest vaccination rates. This might explain the lack of improvement in cases/hospitalizations ratio – unlike other countries. The outbreak appears to have had some impact on Q3 activity and sentiment. It may also explain the sluggish rebound in US labour supply, with surveys showing some workers fearful of returning to the workplace.

### Q3 GDP outlook lowered

- We have lowered our outlook for Q3 GDP, with slower consumption expected the prime cause. COVID may have impacted an expected goods for services rotation, although retail sales bounced in August. Retail sales are likely to fall in Q3 as a whole, but we forecast broader consumption and Q3 GDP at 3.0% (annualized). We lower our outlook for 2021 GDP to 5.7% from 6.2% before, and expect 2022 to rise by 4.3% (consensus has also softened to 5.9% and 4.2%).

US shows no vaccine dividend

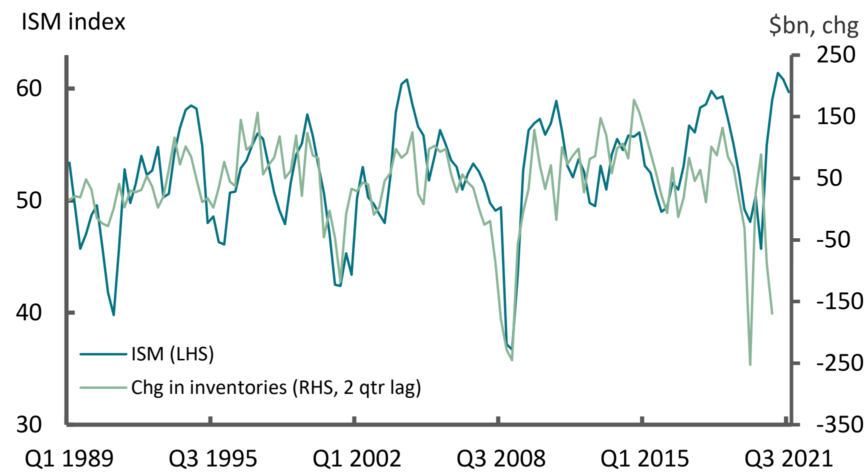
US Covid-19 Cases and Hospitalisations




Source: Our World in Data, AXA IM Research, Sep 2021

Supply shock evident in inventory adjustment

Inventory and ISM survey




Source: BEA, ISM, AXA IM Research, Sept 2021

# Labour outlook key to Fed's transitory inflation outlook

## US

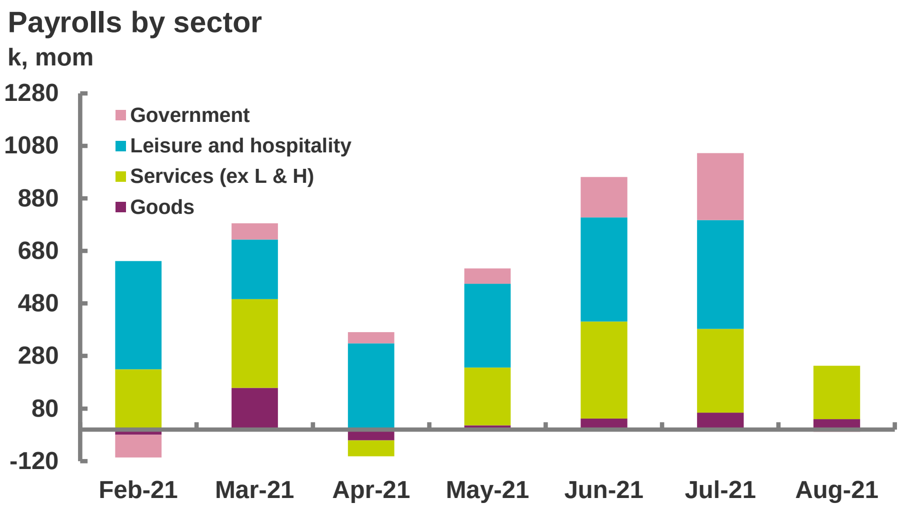
### The uncertain persistence of supply constraints

- August's CPI inflation dipped to 5.3% from 5.4%, but core fell to 4.0% from 4.3%, with a monthly rise of just 0.1% and import prices fell by 0.3%. Inflation should have passed its peak, but its persistence will depend on the persistence of supply shocks. Lumber and iron ore shortage proved temporary and already passed. Semiconductor constraints will persist into next year. Labour is the biggest factor. We expect a rise in labour supply over Q4, but if not strong wage growth could persist keeping inflation elevated.

### An important end-year for policy

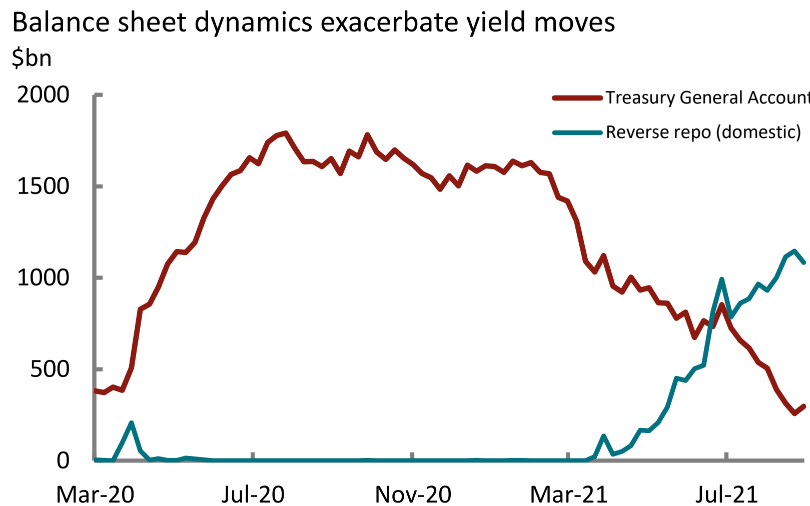
- We expect the Fed to announce a taper before end-year (December), but not to raise rates until 2023. Evidence that the inflation overshoot is more persistent could bring in that forecast. The government is still trying to pass a $4tn spending package. This is difficult, but we expect a final package of around $3tn to pass in Q4. Congress must also avert a government shutdown by passing a budget over the next 10 days, and a debt ceiling resolution to avert a default later in October/early November.

Payroll growth retreats in August




Source: BLS, AXA IM Research, Sept 2021

Debt ceiling exacerbates yield outlook




Source: FRB, Bloomberg, AXA IM Research, Sep 2021

# Cases rise, hospitalizations contained

## Euro area

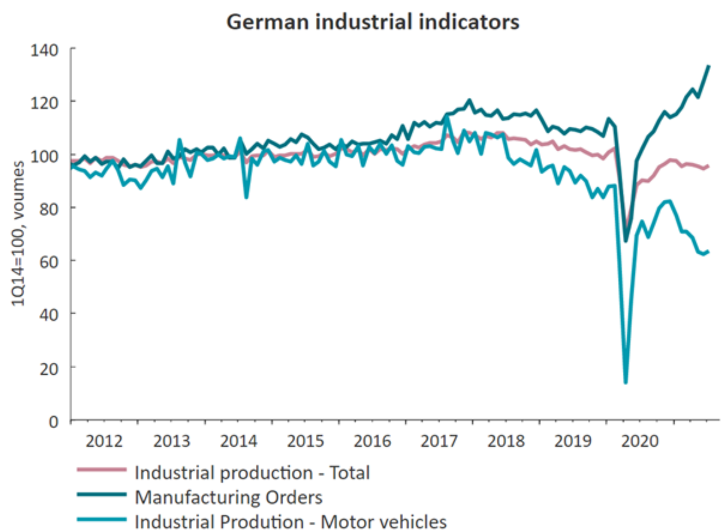
### Recent pandemic developments have been encouraging

- The virus "R" rate is below one, pressure on ICUs is largely below previous waves and the 70% of people fully vaccinated target has already been achieved
- Risks persist as children return to school and employees to the offices while immunity thresholds are will remain insufficient for the current dominant Delta variant. Countries are considering further incentivisation or, like Italy,  making a vaccine compulsory.

### Solid momentum in Q3 after stronger than expected Q2 GDP growth

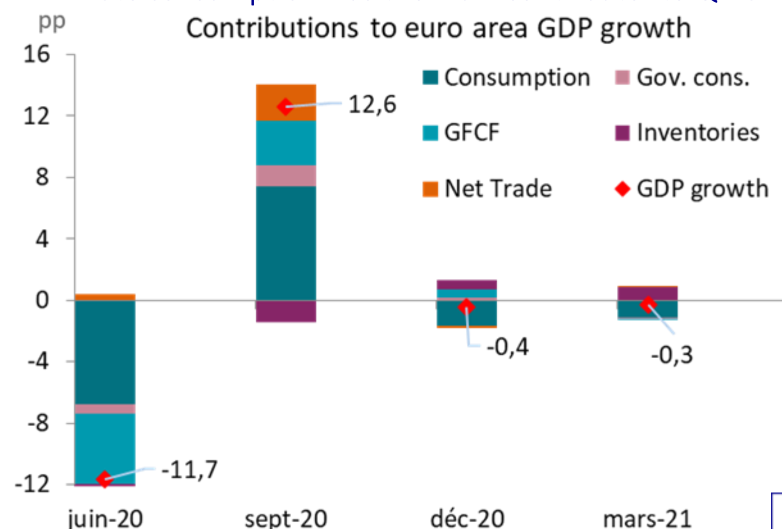
- GDP grew by 2.2%qoq, boosted by the services sector and with a 1.9 pp contribution from private consumption
- Aggregated high-frequency data suggests Eurozone activity currently running approx. 1% below its "normal" (OECD weekly tracker)
- Strong heterogeneity exists between sectors and countries, with industrial production in France and Germany stalling at about 5% below crisis level while Italy has already closed the gap. Some sectors, such as auto production continue to be heavily impacted by shortages. On the demand side, orders stand at a high levels, but we remain cautious as activity in the US and China should ease

Persistent gap between supply and demand in manufacturing sector




Source: Refinitiv Datastream

Private consumption was the main contributor to Q2 GDP growth




Source: Eurostat, AXA IM Research, as of September 2021.

# Inflationary pressures in the spotlight

## Euro area

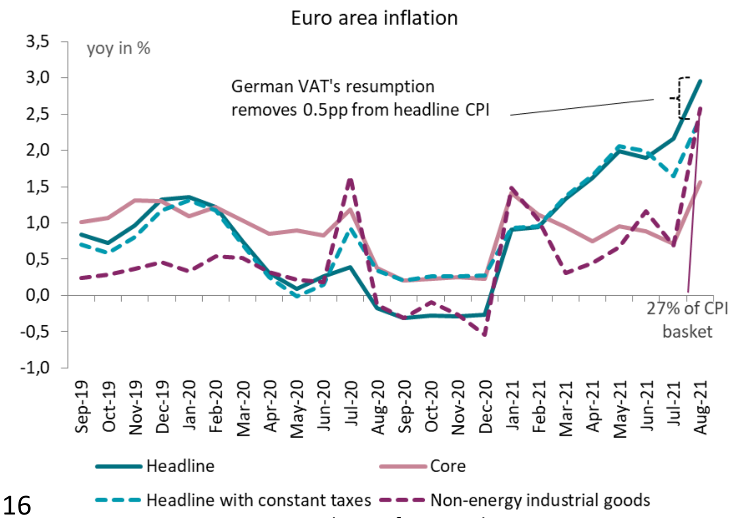
### Transitory inflation, but ECB's balance of risks turns positive on inflation outlook

- Eurozone CPI inflation recorded 3%yoy in August, distorted by the resumption of Germany's sales tax, strong oil prices base effects and supply shortages. We continue to believe those factors will fade over the coming months, although fresh pressure is emerging in electricity prices. As of now, Eurozone wages remain muted
- The ECB's September meeting did not deliver major surprises. As expected, the Governing Council agreed to reduce net PEPP purchases at a "moderately lower pace" but ECB President Lagarde gave no details on the future calibration of QE (PEPP+APP), postponing those decisions to December's meeting.

### German election imminent

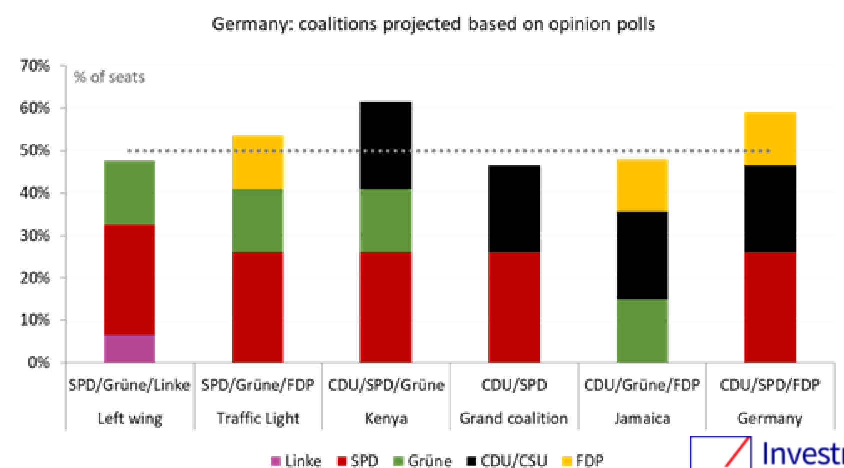
- Germany holds Bundestag elections on 26 September. Once the official results are known, the parties will try to form a governing coalition. The centre-left SPD party leads current polls with about 26% of the vote, ahead of the centre-right CDU/CSU (20%), the Greens (15%) and the liberal FDP (12.5%). A three parties coalition looks unavoidable
- A "traffic light coalition" with the SPD, the Greens and the FDP is the most likely option but opposing positions on fiscal and economic policies may lengthen negotiations.

#### Transitory factors drive inflation




Source: ECB, AXA IM Research, as of September 2021

#### Game of Grünes in Germany




Source: wahlrecht.de, AXA IM Macro Research, 13 Sep 2021

# Re-opening frenzy fading

## UK

### On top of the virus ?

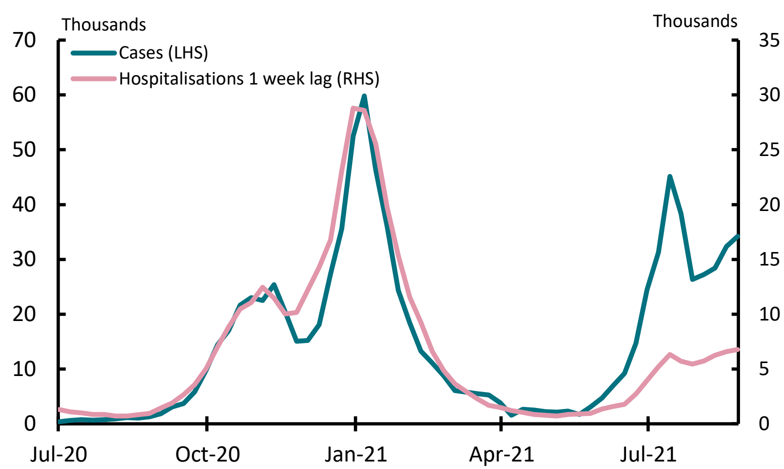
- Virus numbers have been elevated, but fallen from the 35k in early September, and have dropped from the Euros tournament exacerbated July peak and so far remain below Health Secretary Javid's 100k/day outlook. Cases may rise as schools return. Yet a vaccine dividend is clearly evident in the divergence between case increases and hospitalizations. While the latter remain relatively subdued, activity will continue. 3rd doses to 50+ year olds and vulnerables, and 1st doses to 12+ should help.

### Impact on activity

- The high cases in July impacted activity. Retail sales fell in July and August, likely in part reflecting a goods for services substitution. However, July's services uptake was likely dampened by the 'ping-demic'. This dampened July's GDP growth to just 0.1% – its weakest since January. We had forecast a Q3 slowdown, but weaker August sales casts downside risks to our 2% forecast. Our annual outlook remains at 6.7% for 2021.

UK exhibits a clear vaccine dividend

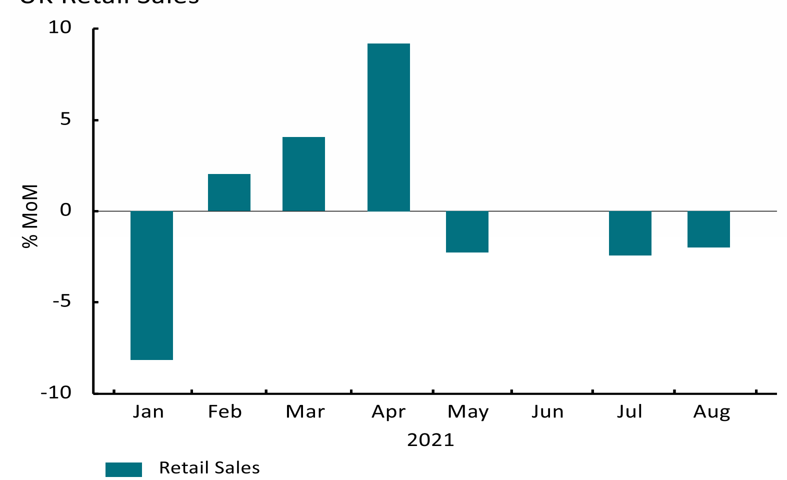
UK Covid-19 Cases and Hospitalisations




Source: Our World in Data, AXA IM Research, Sep 2021

Retail sales declines mark goods for services switch, but some risks

UK Retail Sales




Source: National Statistics, AXA IM Research, Sep 2021

# Questioning the UK supply shock

## UK

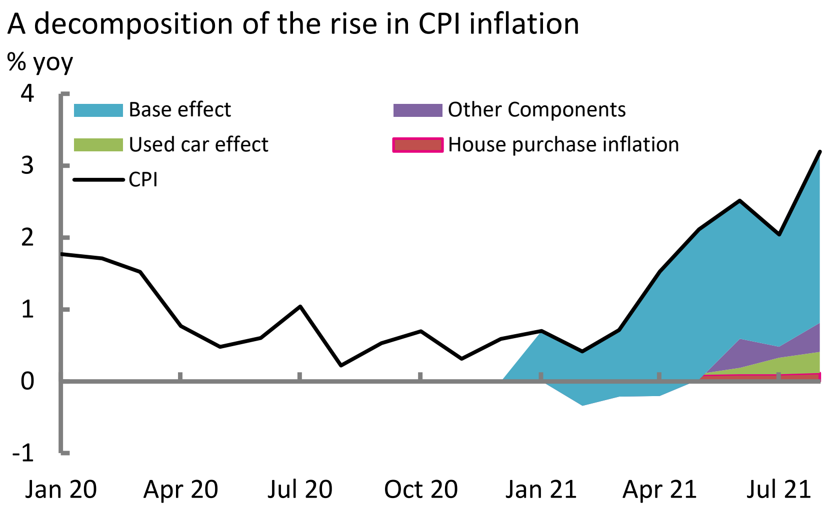
### Inflation reaches 9-year high of 3.2%

- CPI reached a nine-year high of 3.2% in August, rising from 2.0% in July. This big jump – the largest annual rise in 30 years – reflected base effects from last August's restaurant sector support scheme. Much of this will reverse out next month. We argue that much of the current inflation overshoot is explained by base effects. However, utility price increases threaten a further push in inflation to Q4 to around 4%. We expect inflation to return to 2% by H2 2022.

### BoE to assess transitory inflation assessment through labour market developments

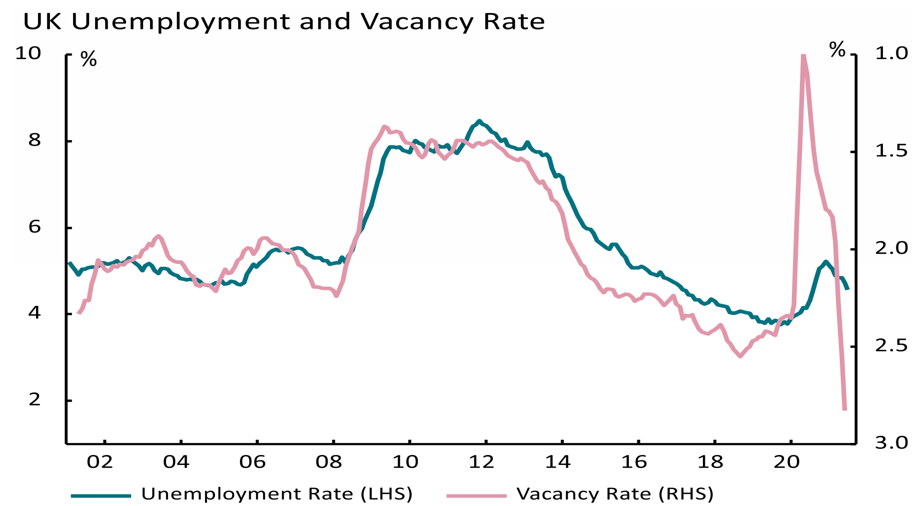
- Questions over how transitory the inflation overshoot proves are related to the labour market. Evidence of labour shortages are growing and if this is a persistent feature, as post-Brexit migration issues might suggest, inflation could also persist. Financial markets now see the BoE raising Bank Rate twice next year. We consider this too enthusiastic, but the risk of a sharper supply shock to the UK would see us expect the BoE to tighten monetary policy before end-2022.

Base effects explain most of CPI overshoot




Source: National Statistics, AXA IM Research, Sep 2021

Vacancies suggest tightening labour market – and skills mismatch




Source: National Statistics, AXA IM Research, Sep 2021

# Economic activity slumps on Delta resurgence

## China

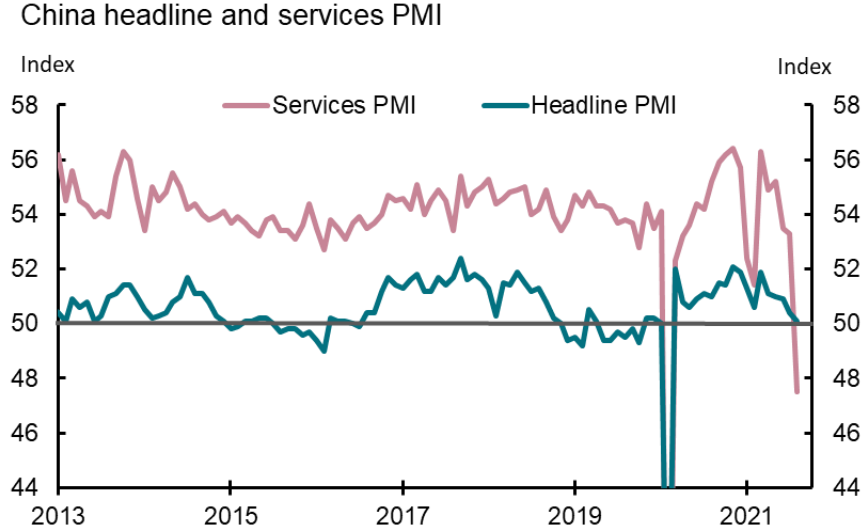
### Growth weakens as a result of mobility restrictions

- Economic activity took a tumble in August due to the Delta-variant resurgence. Tightened mobility and social controls undermined consumer spending on travel, hospitality and off-line entertainment, leading to a steep drop in retail sales and services output growth. The services PMI fell below 50 for the first time since Feb-2020

### Sequential rebound contingent on COVID control

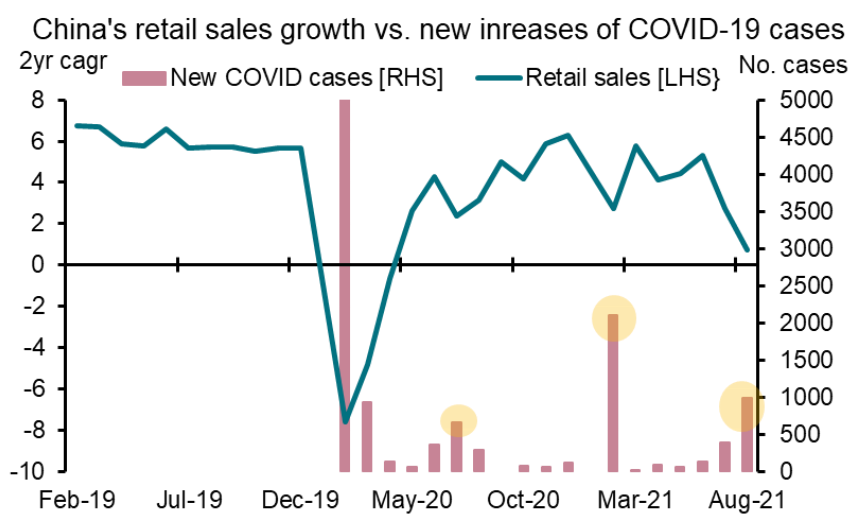
- Successful virus containment has led to a removal of restrictions since late August, paving the way for a rebound in consumption and services activity going forward. Holiday booking ahead of Mid-Autumn and National Day holidays suggests pent up demand is strong. However, the discovery of another COVID cluster in Southern China in mid-September is clouding the outlook. The strength of the consumption recovery will be contingent, in part, on the management of the new outbreak

Services PMI drops below the waterline




Source: CEIC, AXA IM Research, Sept 21

Retail sales growth declines on COVID resurgence




Source: NBS, AXA IM Research, Sept 21

# Faltering growth calls for policy supports

## China

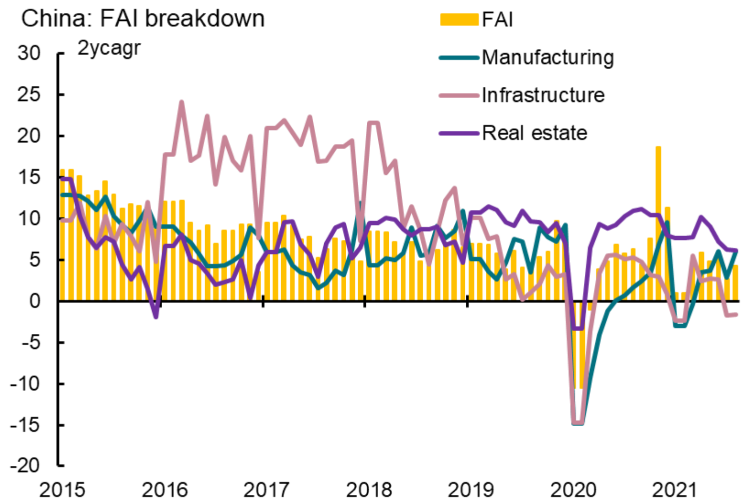
### Rising headwinds increase downside risks

- Industrial output growth held up thanks to surprisingly strong exports. As the latter weakens, domestic demand needs to rise to stabilize growth. Unlike consumption that has been affected by on-and-off virus controls, fixed asset investment growth has been steady, despite large divergences among subcomponents. Manufacturing investment has been a bright spot, growing at its fastest pace in a year. Infrastructure investment is lacklustre despite a modest pick-up in project-bond issuance by central and local governments. Property investment growth is resilient so far, but sharp declines in house sales and starts bode ill for future activity

### Policy support fails to impress so far

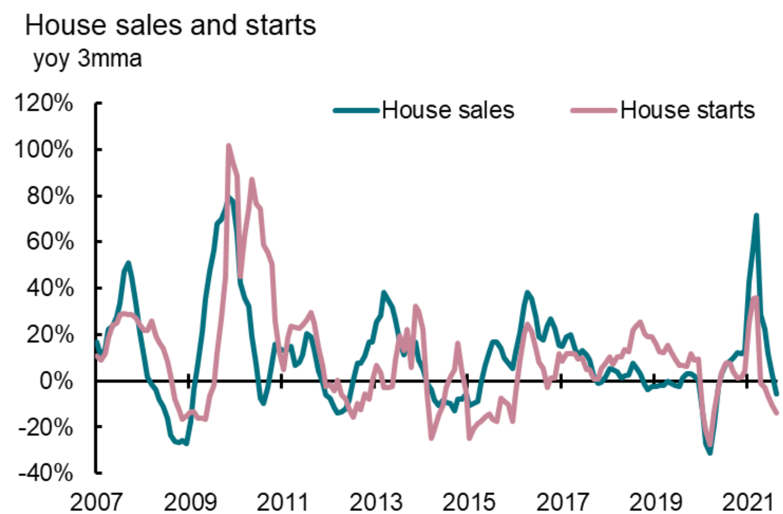
- Policy easing has started, but its vigour pales in comparison to the downward pressure in the economy. The reluctance to remove debt curbs for the housing market and local governments is hampering the scale and transmission of policy easing. We continue to expect the PBoC to step up monetary supports – starting with less high-profile tools to inject liquidity before a targeted RRR cut in Q4. More active fiscal policy is also required by putting pressure on local governments to put the budgeted money to work

Fixed asset investment growth remains steady




Source: CEIC, AXA IM Research, Sept 21

Property market curbs slow activity




Source: CEIC, AXA IM Research, Sept 21

# Back to the merry-go-round of prime ministers

## Japan

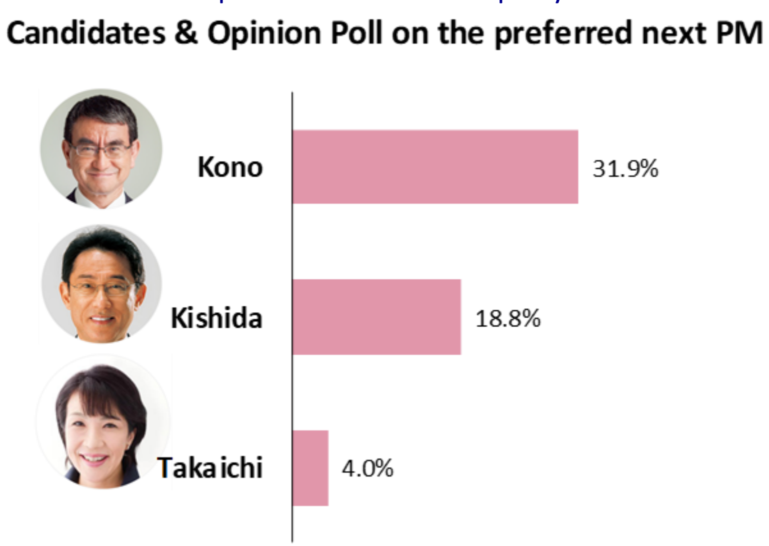
### Surprise resignation of Prime Minister Suga

- Following the surprise resignation of PM Suga in September, the Liberal Democratic Party in Parliament and local representatives must now choose a new leader before the General elections.
- Two candidates are close in the polls, T. Kono and F. Kishida. Kono leads in the national polls, but Kishida has stronger support within the party. We believe LDP members risk promoting Kishida as LDP voting intentions for LDP have risen since Suga's resignation.

### His program is the continuity of his predecessors

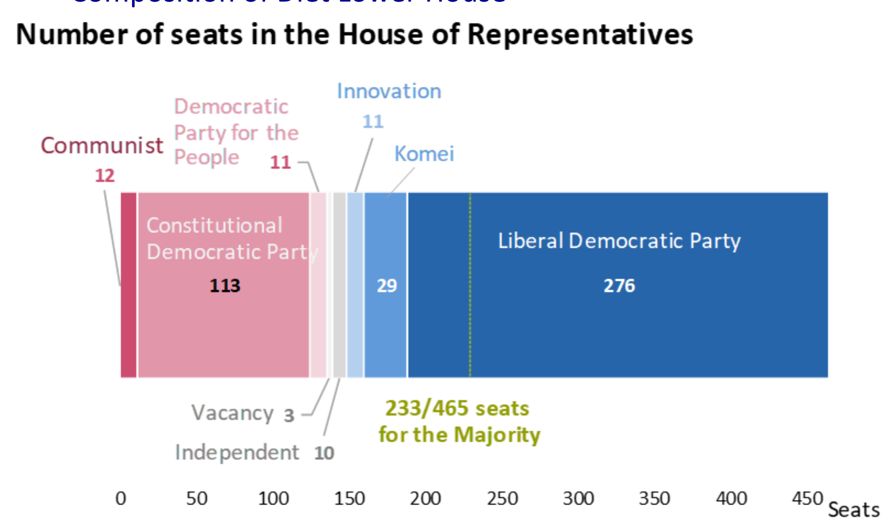
- Kishida's programme is consistent with Suga's and Abe's economic, fiscal and monetary policies.
- A fiscal stimulus has been promised by all candidates. It could be more prominent in the event of a Kishida victory as he may need the support of another rival candidate, Takaichi, who has recently promoted polices very close to Modern Monetary Theory.
- If Kono were to win the election, the relationship with the BoJ may change slightly as he has already criticized the ineffectiveness of Abenomics to reach the inflation target and raise wages while stated "monetary policy must be left to the BOJ".

Kono ahead in the polls - Kishida carries party favour




Source: Kyodo as September 6, AXA IM Tokyo FI team

Composition of Diet Lower House




Source: NHK, AXA IM Tokyo FI Team, September 2021

# Services sector continue to struggle

## Japan

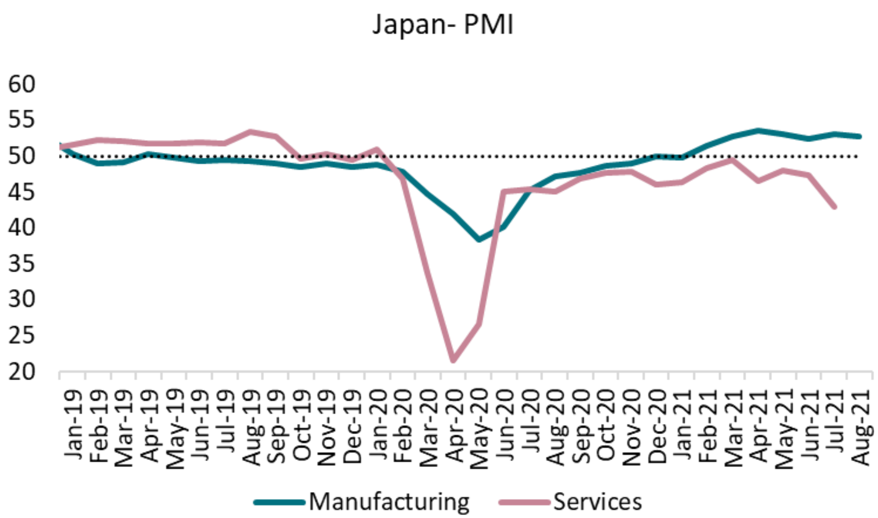
### Still in a State of Emergency

- New coronavirus cases have recently declined but hospitalizations remain elevated, so the state of emergency has been extended once again. Japan' vaccinations are now going faster, inoculating approximately 1% of the population every day

### Economic data have been mixed

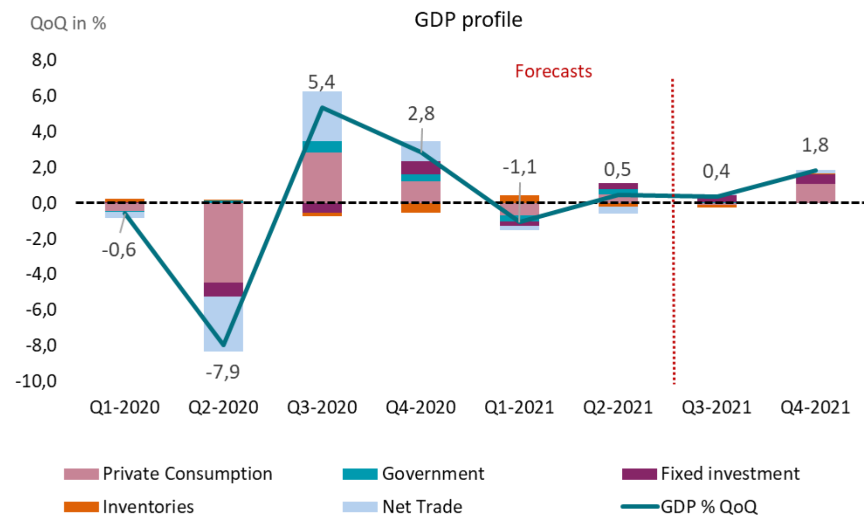
- Service sectors continue to struggle as venues operate under shorter hours and/or at reduced capacity. The services PMI has been in contractionary territory since March 2020 and August's final estimated fell by 4.5pp to 42.9.
- Industrial production declined by 1.5%mom in July, mainly reflecting a fall in auto production
- We reduced our Q3 GDP outlook to 0.4%qoq from 1.4% and remain cautious for Q4 as the expected private consumption recovery in services may be altered by easing activity in the US and China.

Services PMI is in contractionary territory since March 2020




Source: Markit, AXA IM Research, September 2021

Delayed recovery may be challenged by easing activity in the US and China




Source: Cabinet Office, AXA IM Research, September 2021

# Economic recovery and the Delta variant

## Emerging Markets

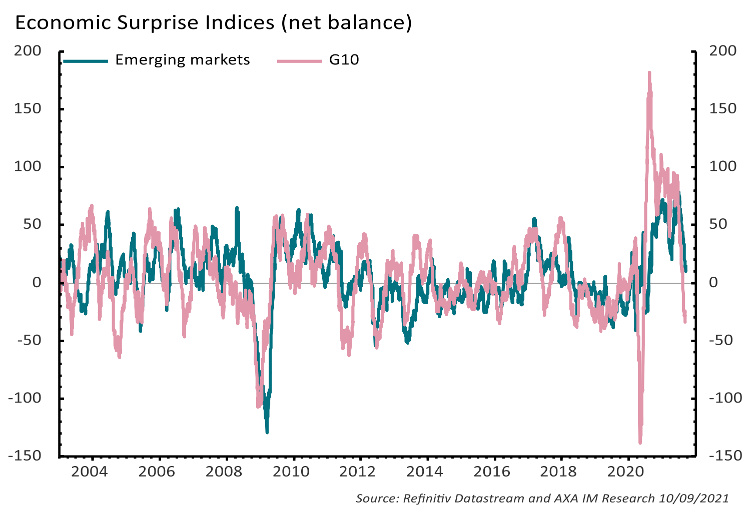
### Positive start improved EM forecast revisions…

- Tracking of the pandemic recovery has displayed a persistent bias: the damage inflicted by the virus has not proved as bad as we feared and GDP has genuinely surprised on the upside.

### … but Delta variant proves to be a hurdle in the Asian region recovery in Q2 2021

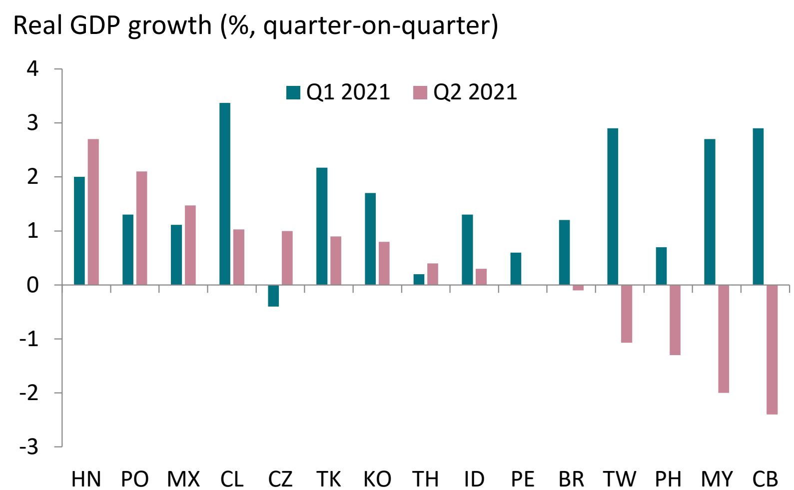
- The latest Delta variant affected the Asian region GDP growth disproportionately more in Q2 2021, as a result many countries in the region have not yet returned to pre-pandemic levels of GDP in real terms.
- While the Delta variant has dampened business sentiment and consumer spending, exports in the region should remain resilient on recovering global demand as well as chip shortage.

#### Economic surprise indicators nosediving




Source: Datastream, AXA IM Research, Sept 2021

#### Asian Q2 2021 GDP growth affected by the delta variant




Source: National sources, AXA IM Research, Sept 2021

# Some risks to consider ahead

## Emerging Markets

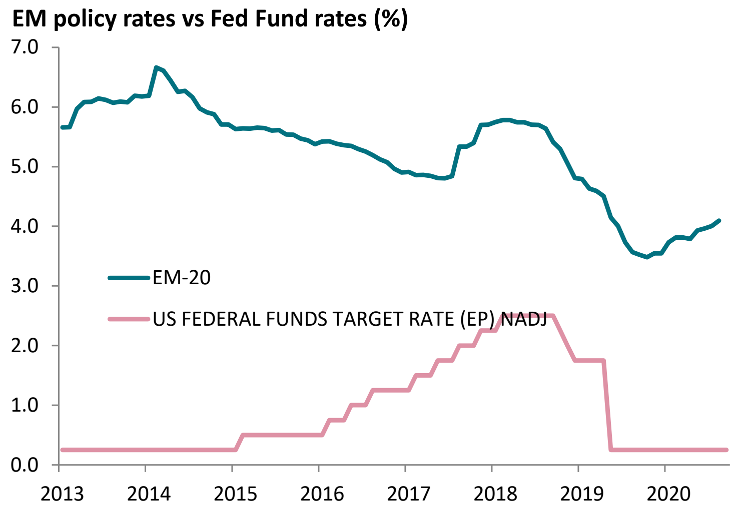
### Domestic demand is likely to be affected by tighter monetary policies in the next 6 months

- Covid-19 remains active. The reimposition of mobility restrictions in areas affected by the virus and/or where vaccination progress is not sufficiently advanced may weigh on the reopening and thus the economic recovery.
- As inflation rates exceed official targets, EM central banks have front-loaded interest rate hikes. Domestic demand will be impaired.

### Towards a normalization in EM exports!

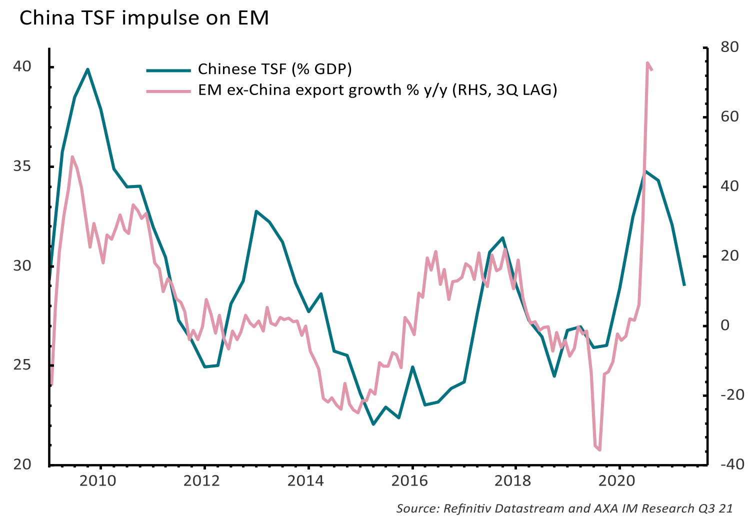
- Liquidity conditions in China are often a good forward indicator for EM exports. These point to an upcoming normalisation in EM ex-China exports from very high levels. Additionally, as tensions on global value chains fade somewhat with supply conditions recovering, we expect a gradual softening in exceptionally strong EM exports in H2.

Tighter monetary stance to weigh on domestic demand in next 6M




Source: Datastream, AXA IM Research, Sept 2021

Chinese support for EM exports fading




Source: Datastream, AXA IM Research, Sept 2021


# Investment Strategy

# Multi-Asset Investment views

## Our key messages and convictions

Positive on equites

**#1**
Economic and earnings rebound remains on track, even if decelerating

**#2**
Despite support from fiscal initiatives, valuations are no longer attractive due to tight spreads

Neutral on Investment Grade Credit

Negative Sovereign Bonds

**#3**
Bond markets should start to price a policy shift by the Fed

**#4**
Concerns over Fed monetary policy transition, China slowdown and COVID-19 variants generate higher volatility

Long Volatility

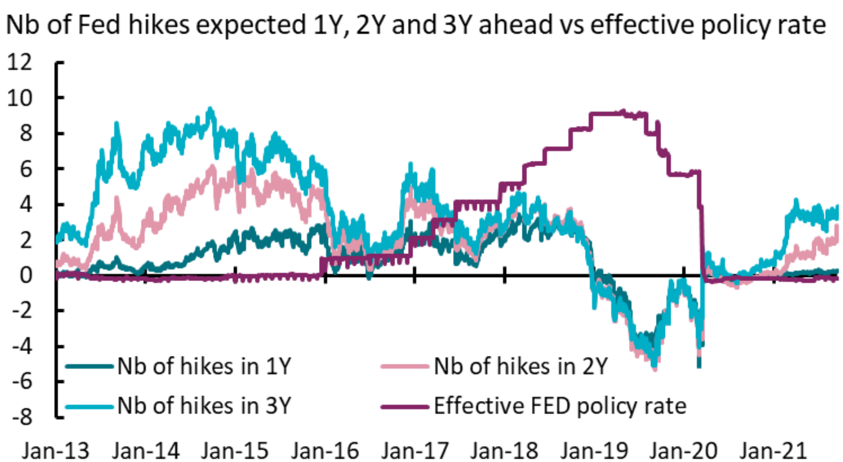
Source: AXA IM as at 22/09/2021

# FX Strategy

## Contemplating dollar appreciation again while low yielding currencies under pressure

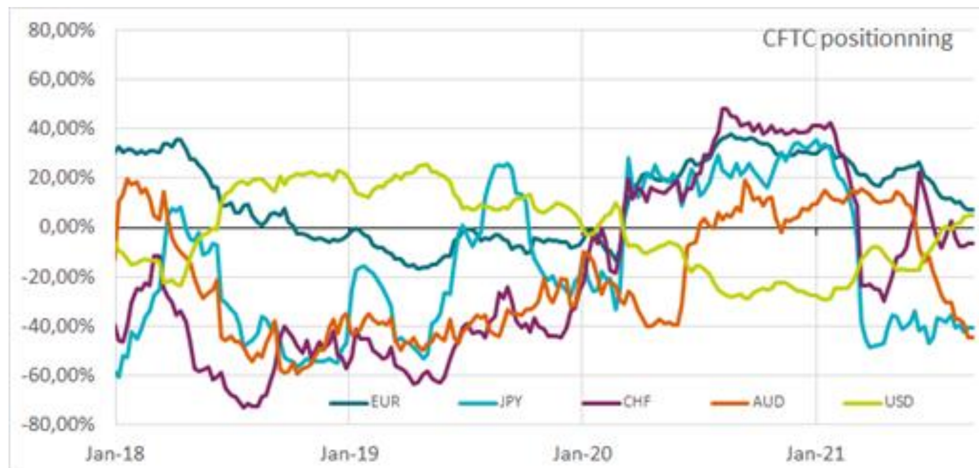
- The rebound in growth, prices and labour markets justifies the normalisation of monetary policy, where inflation is already at target and overheating is a risk. Markets are quickly repricing central banks' interest rate hikes as a result. The US Federal Reserve is within this group, even after accounting for its revised average inflation targeting policy.
- Monetary policy normalisation is also being priced in other currencies such as CAD, GBP, NOK or NZD. However, market expectations for these central banks have already risen more than for the Fed, so these currencies should better resist further USD appreciation.
- ECB, SNB and BoJ are less likely to normalise policy anytime soon. Inflation has been persistently below target for a while and inflation pressures are much less acute (recent spikes in gas prices notwithstanding). The growth rebound and the fiscal thrust are also rather underwhelming in Europe. EUR and CHF are hence likely to suffer in such repricing of USD monetary policy divergence once again.

### Pricing of next Fed hiking cycle still quite timid




Source: Bloomberg and AXA IM Research, September 2021

### USD sentiment back into positive territory



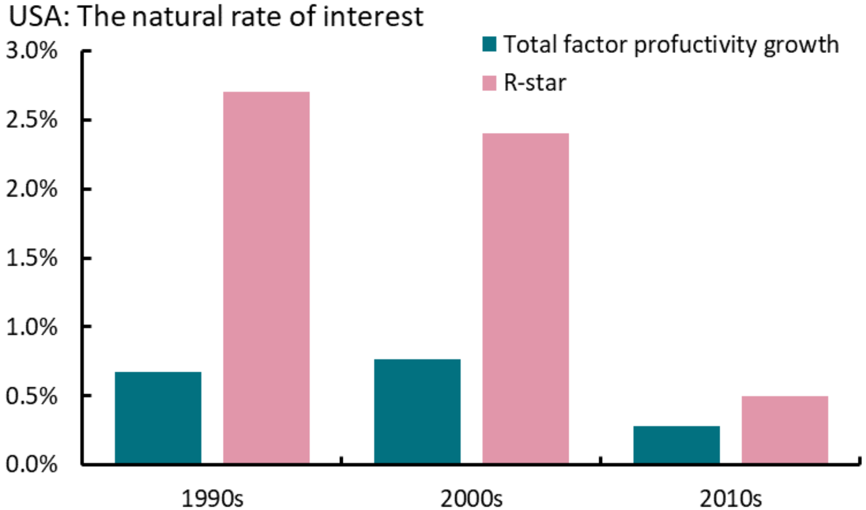

Source: Bloomberg and AXA IM Research, September 2021

# Rates Strategy

## TINA (there is no alternative) in the real rates world

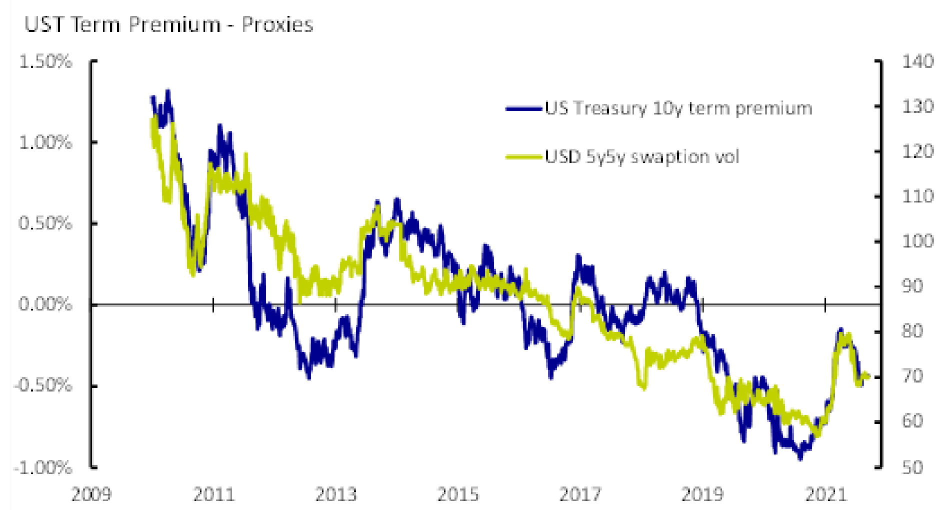
- A long-held view is that real interest rates are linked to productivity growth. Hence, there should be a link between the determinants of an economy's growth (technology, labour force) and the equilibrium real interest rate (r-star). Productivity growth and r-star shows a distinct link between productivity and r-star, particularly downwardly during the last decade.
- However, consensus now seems to accept that other factors – in addition to productivity – may influence the medium-term trend in real interest rates. One such factor is demographics and the associated 'savings glut'. Central banks' response of calibrating their reaction function to structurally lower equilibrium rates may have fuelled a positive feedback loop between excess savings and policy.
- Another factor, more cyclical in nature, may be the combination of QE supressing nominal yields while the fiscal and monetary response to the pandemic is stoking inflation, thus supressing real rates further as well as interest rate risk premia more broadly.

### Large decline in US productivity in the last decade




Source: Bloomberg and AXA IM Research, September 2021

### Central bank QE has driven both yields and yield volatility  lower




Source: Bloomberg and AXA IM Research, September 2021

# Credit Strategy

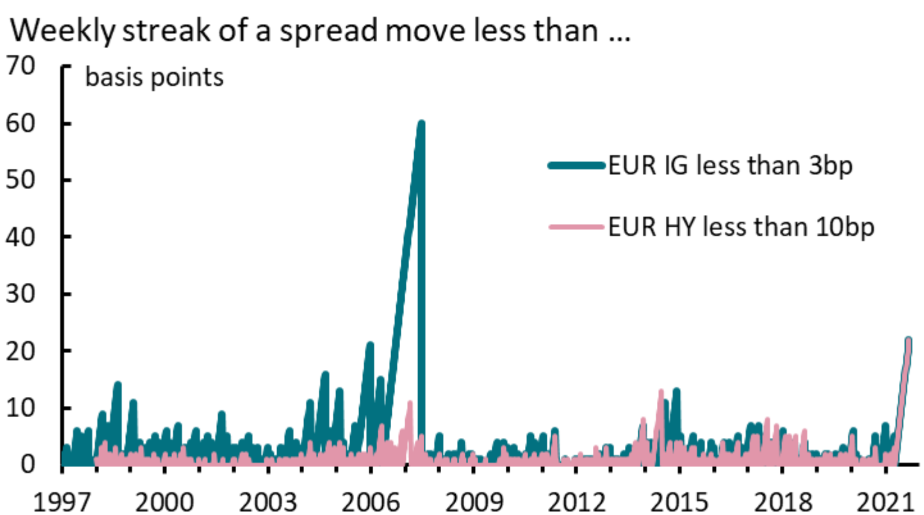
## Credit markets cool as a cucumber as spread compression strong

- Credit markets have entered a goldilocks regime once again, with spread levels persistently low and spread volatility very contained. Credit indices across currencies and regions are trading at, or through, the lows of their 2020 range. The sole exception is the China high yield (HY) index and by association Asia HY, due to the Evergrande credit event and its contagion across Chinese markets.

- While a potential headwind for Chinese growth, the upheaval in the China property sector should not become a source of contagion for global risk premia. Non-domestic exposures appear limited and ditto for multiplier effects of the kind we saw after the Lehman bankruptcy during the global financial crisis.

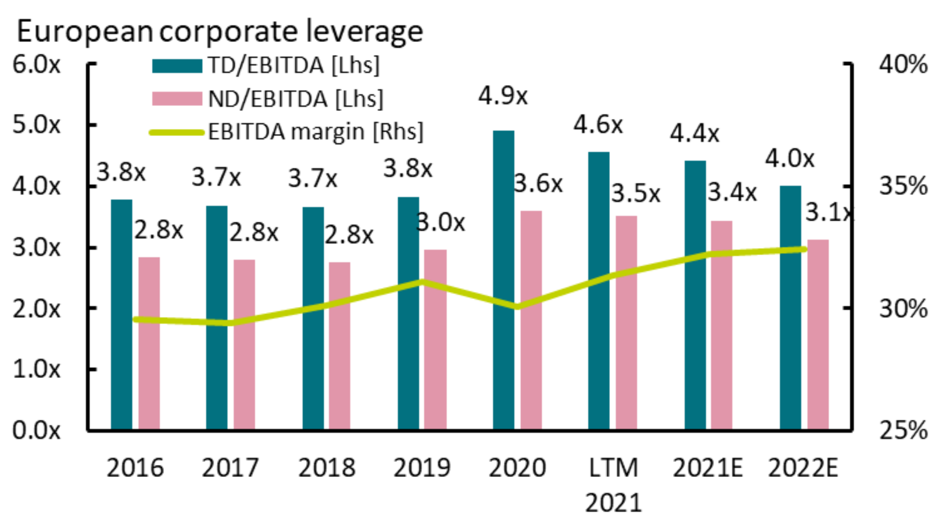
- Credit risk premia are also supported by the improvement in corporate fundamentals. The deterioration in leverage after Q1 2020 was driven by both the numerator and the denominator in debt to earnings, earnings collapsed and debt shot up as corporates borrowed to build cash. Yet, the massive fiscal support limited the earnings drawdown and the cash burn, even for very exposed sectors like airlines.

Euro credit in a record-breaking run of very narrow spread trading range




Source: ICE and AXA IM Research, September 2021

Euro corporate leverage almost back to pre Covid levels



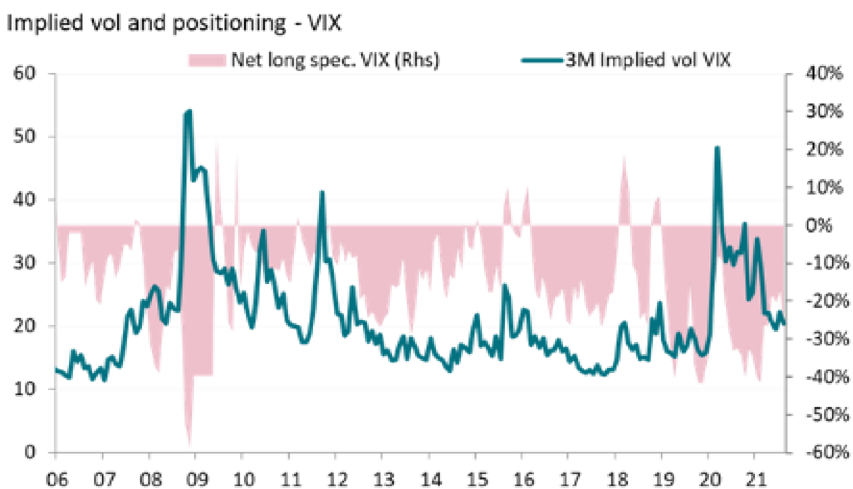

Source: Company reports and AXA IM Research, September 2021

# Equity strategy

## It's fall, y'all

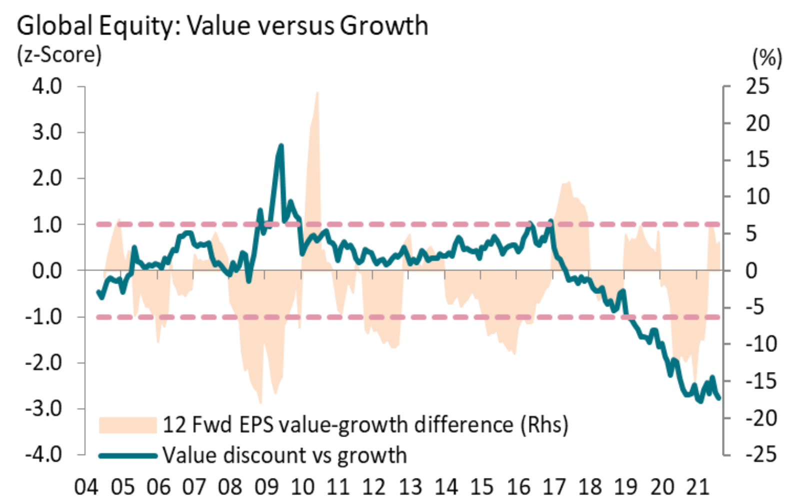
- Over the last month, global equities rose by +2.2% after a softer July that had the weakest monthly performance (+0.6%) since the beginning of the year. Across countries, Japan outperformed its peers (+7%) driven by positive political developments. On the sector front, Communications delivered the highest performance with +7.2%, While Growth stocks (+3.4%) overperformed other styles for a 3rd month.
- Implied volatility has climbed above the 20 level several times since May but has been declining compared to last year's levels. Since then, the VIX volatility index averaged 18.4 – below its 1-year average of 21.5. The term premium remains attractive. As a result, volatility positioning stands at a net short of -27.5% compared to a first quartile level of -23% as the carry remains appealing.
- The current level of the valuation gap between Value and Growth stocks has been historically low since mid-2019. According to fundamentals, such a gap is not justified and the current Value discount to Growth can be considered as an opportunity in our view.

### Short volatility bets remain at play




Source: Bloomberg and AXA IM Research, September 2021

### Value discount to Growth is at historically low levels




Source: MSCI, IBES and AXA IM Research, September 2021

# Asset allocation stance

## Positioning across and within asset classes

### Asset Allocation

**Key asset classes**

| | | | |
|---|---|---|---|
| Equities | | | |
| Bonds | | | |
| Commodities | ▼ | | |
| Cash | | | ▲ |

### Equities

**Developed**

| | | | |
|---|---|---|---|
| Euro area | | | |
| UK | | | |
| Switzerland | | | |
| US | | ▼ | |
| Japan | | | |

**Emerging & Equity Sectors**

| | | | |
|---|---|---|---|
| Emerging Markets | | | |
| Europe Cyclical/Value | | ▼ | |
| Euro Opening basket | | | |
| Euro Financials | | | |
| US Financials | | ▼ | |
| US Russell 2000 | | ▼ | |

### Fixed Income

**Govies**

| | | | |
|---|---|---|---|
| Euro core | | | |
| Euro peripheral | | | |
| UK | | | |
| US | | | |

**Inflation Break-even**

| | | | |
|---|---|---|---|
| US | | | |
| Euro | | | |

**Credit**

| | | | |
|---|---|---|---|
| Euro IG | | | |
| US IG | | | |
| Euro HY | | | |
| US HY | | | |

**EM Debt**

| | | | |
|---|---|---|---|
| EM Bonds HC | | | |

**Legend** Negative | Neutral | Positive

**Change** ▲ Upgrade | ▼ Downgrade

Source: AXA IM as at 22/09/2021

# Forecasts & Calendar

# Macro forecast summary

## Forecasts

| Real GDP growth (%) | 2020 | 2021* | | 2022* | |
|---|---|---|---|---|---|
| | | AXA IM | *Consensus* | AXA IM | *Consensus* |
| **World** | **-3.6** | **5.7** | | **4.4** | |
| **Advanced economies** | **-5.2** | **5.1** | | **4.2** | |
| US | **-3.4** | **5.7** | 6.2 | **4.3** | 4.4 |
| Euro area | **-6.7** | **4.7** | 4.8 | **3.9** | 4.4 |
| Germany | **-4.9** | **2.9** | 3.3 | **3.8** | 4.4 |
| France | **-8.0** | **5.9** | 5.9 | **3.5** | 3.9 |
| Italy | **-8.9** | **5.2** | 5.3 | **3.7** | 4.2 |
| Spain | **-10.8** | **5.3** | 6.0 | **5.1** | 5.9 |
| Japan | **-4.9** | **2.6** | 2.4 | **3.3** | 3.0 |
| UK | **-10.0** | **6.7** | 6.8 | **5.7** | 5.4 |
| Switzerland | **-3.0** | **3.6** | 3.7 | **3.3** | 2.9 |
| **Emerging economies** | **-2.6** | **6.1** | | **4.6** | |
| **Asia** | **-1.2** | **7.2** | | **5.3** | |
| China | **2.3** | **8.5** | 8.6 | **5.5** | 5.6 |
| South Korea | **-0.9** | **4.0** | 4.1 | **3.0** | 3.2 |
| Rest of EM Asia | **-5.6** | **5.9** | | **5.4** | |
| **LatAm** | **-7.3** | **5.6** | | **2.4** | |
| Brazil | **-4.1** | **5.2** | 5.0 | **1.6** | 2.2 |
| Mexico | **-8.5** | **6.5** | 6.1 | **2.3** | 3.0 |
| **EM Europe** | **-2.3** | **5.5** | | **3.6** | |
| Russia | **-2.8** | **4.5** | 3.5 | **3.3** | 2.7 |
| Poland | **-2.7** | **5.3** | 4.8 | **5.2** | 5.1 |
| Turkey | **1.6** | **8.0** | 6.2 | **3.0** | 3.5 |
| **Other EMs** | **-3.7** | **3.3** | | **4.1** | |

*Source: Datastream, IMF and AXA IM Macro Research – As of 21 September 2021*

* Forecast

# Expectations on inflation and central banks

## Forecasts

### Inflation Forecasts

| CPI Inflation (%) | 2020 | 2021* | | 2022* | |
|---|---|---|---|---|---|
| | | AXA IM | *Consensus* | AXA IM | *Consensus* |
| **Advanced economies** | **0.8** | **2.6** | | **1.8** | |
| US | **1.2** | **4.0** | 4.1 | **2.7** | 2.9 |
| Euro area | **0.3** | **2.0** | 2.1 | **1.5** | 1.5 |
| Japan | **0.0** | **-0.1** | 0.1 | **0.4** | 0.5 |
| UK | **0.9** | **2.3** | 2.2 | **2.7** | 2.7 |
| Switzerland | **-0.7** | **0.4** | 0.4 | **0.5** | 0.6 |

*Source: Datastream, IMF and AXA IM Macro Research – As of 21 September 2021*

* Forecast

### Central banks' policy: meeting dates and expected changes

**Central bank policy**

**Meeting dates and expected changes (Rates in bp / QE in bn)**

| | | Current | Q4-21 | Q1-22 | Q2-22 | Q3-22 |
|---|---|---|---|---|---|---|
| **United States - Fed** | Dates | 0-0.25 | 2-3 Nov<br>14-15 Dec | 25-26 Jan<br>15-16 Mar | 3-4 May<br>14-15 June | 26-27 July<br>20-21 Sep |
| | Rates | | unch (0-0.25) | unch (0-0.25) | unch (0-0.25) | unch (0-0.25) |
| **Euro area - ECB** | Dates | -0.50 | 28 Oct<br>16 Dec | 20 Jan<br>10 Mar | 14 April<br>9 June | 21 July<br>8 Sep |
| | Rates | | unch (-0.50) | unch (-0.50) | unch (-0.50) | unch (-0.50) |
| **Japan - BoJ** | Dates | -0.10 | 27-28 Oct<br>16-17 Dec | 17-18 Jan<br>17-18 Mar | 27-28 April<br>16-17 June | 20-21 July<br>21-22 Sep |
| | Rates | | unch (-0.10) | unch (-0.10) | unch (-0.10) | unch (-0.10) |
| **UK - BoE** | Dates | 0.10 | 4 Nov<br>16 Dec | 3 Feb<br>17 Mar | 5 May<br>16 June | 4 Aug<br>15 Sep |
| | Rates | | unch (0.10) | unch (0.10) | unch (0.10) | unch (0.10) |

*Source: AXA IM Macro Research - As of 21 September 2021*

# Calendar of 2021-2022 events

| 2021 | Date | Event | Comments |
|---|---|---|---|
| September | Sep/ Oct | US Debt Ceiling Lifted (expected) | |
| | 30 Sep | US to pass spending bill to avoid government shutdown | |
| | 15 Sep- 15 Oct | Italian Local Elections | |
| | 26 Sep | German Federal Elections | |
| | 21-22 Sep | BoJ Meeting | Unchanged (-0.1) |
| | 21-22 Sep | FOMC Meeting | Unchanged (0-0.25) |
| | 23 Sep | BoE Meeting | Unchanged (0.1) |
| | 29 Sep | LDP election to replace Y. Suga after his resignation | |
| October | Q4 | US expected to pass bipartisan infrastructure bill and reconciliation package | |
| | Oct | Jay Powell reappointment as Fed chair (expected) | |
| | 21 Oct | Japan's House of Representatives term ends (likely postponed to Nov) | |
| | 27 Oct | UK Budget | |
| | 28 Oct | ECB Meeting | Unchanged (-0.5) |
| November | 2-3 Nov | FOMC Meeting | Unchanged (0-0.25) |
| | 4 Nov | BoE Meeting | Unchanged (0.1) |
| | 1-12 Nov | UN Climate Conference COP (held in UK) | |
| | 27-28 Nov | BoJ Meeting | Unchanged (-0.1) |
| December | 14-15 Dec | FOMC Meeting (expected taper announcement) | Unchanged (0-0.25) |
| | 16 Dec | ECB Meeting | Unchanged (-0.5) |
| | 16 Dec | BoE Meeting | Unchanged (0.1) |
| | 16-17 Dec | BoJ Meeting | Unchanged (-0.1) |
| **2022** | **Date** | **Event** | **Comments** |
| January | Jan | Italian Presidential Elections (TBD) | |
| | Jan | FOMC to commence taper (expected) | |
| | 20 Jan | ECB Meeting | Unchanged (-0.5) |
| | 25-26 Jan | FOMC Meeting | Unchanged (0-0.25) |
| February | Feb | Fed Chair Jay Powell's term expires | |
| | Feb | BoE Meeting | Unchanged (0.1) |
| March | March | FOMC Meeting | Unchanged (0-0.25) |
| April | 10 & 24 April | French Presidential Elections | |
| June | 12 & 19 Jun | French Legislative Elections | |
| November | 8 Nov | US Mid Term Elections | |

# Latest publications

[Asia: "Made in Vietnam"- Understanding the rise of Vietnam as an export powerhouse]

*14 September 2021*

[Fit for 55: A carbon pricing upheaval]

*27 July 2021*

[July global Macro Monthly - Clouds darken Summer re-opening]

*29 April 2021*

[Unpacking Made in China]

*15 July 2021*

[June Global Macro Monthly- The European green deal]

*24 June 2021*

[Tourism: How Asia and other emerging markets could bounce back]

*10 June 2021*

[Central bank digital currencies, reserve currencies and geopolitics]

*09 June 2021*

[May Global Macro Monthly – The limitation of vaccinations]

*21 May 2021*

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