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Investment Institute *Macroeconomics*

Monthly Op-ed

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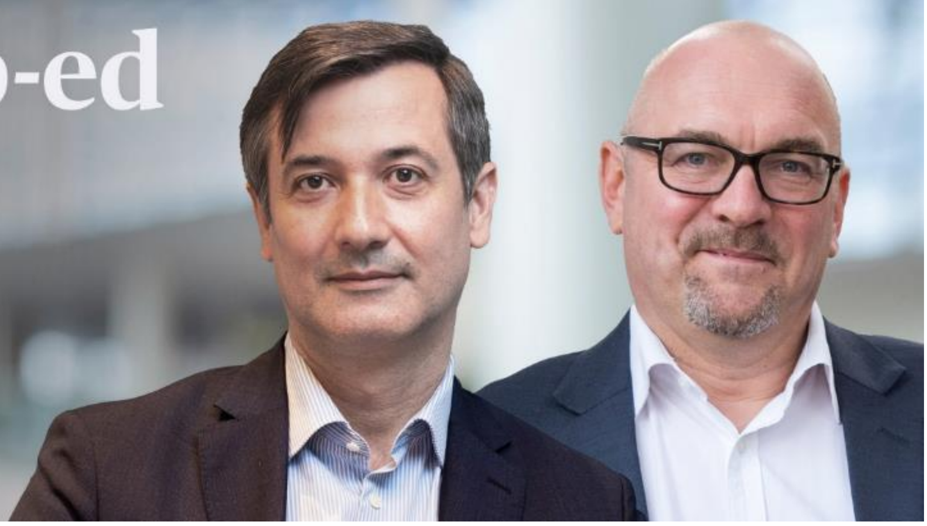

It feels better, but central banks on the lookout

Key points

- “Averted catastrophes” raise growth prospects as 2023 starts
- Yet, macro resilience can be a cause of frustration for central banks in their endeavour to bring inflation back to target
- Markets buoyed by better mood
- Positive view on bonds
- More clarity needed on earnings

Resilience can bring central bank frustration

The “absence of catastrophes” – in particular in Europe which has managed to avoid a sudden stop in energy supply – coupled with the reopening in China, is feeding quite a bit of optimism on the global growth prospects as 2023 starts. Beyond the change in sentiment, hard data continues to be resilient. Usually, effective trackers such as the Atlanta Fed point to very decent US GDP growth in the fourth quarter (Q4) 2022, at 3.5% annualized (we are more conservative, but still comfortably in expansion territory, at 2.6%). An issue though is that this very resilience could ultimately bring about its own undoing, since central banks may be tempted to go even further into restrictive territory in order to finally elicit the correction in domestic demand which would be necessary to get inflation landing close to their target.

True, inflation has started to slow, and in the US this is not only the product of the correction in energy prices. Core inflation has decelerated for two months in a row. When excluding rents – which take time to respond to a change in cyclical conditions – underlying consumer price growth has even been negative over the last 3 months. Still, much of these welcome dynamics is still driven by the normalization of some supply-side factors – such as a correction in used car prices. Job creation, albeit slowing down, remains much stronger than before the pandemic, and wage growth is robust. Actually, real wages have rebounded recently, which may further postpone a necessary adjustment in consumption. It seems we are only in “phase 1” of the US labour market correction. Employers are reducing working time, but headcounts are still expanding. The awareness of structural hiring difficulties may have convinced businesses to engage in “labour hoarding”. In these circumstances, it is tempting for the Federal Reserve (Fed) to consider that the economy may need even more restriction. True, most Fed speakers who took to the wires recently were in majority either implicitly or explicitly in line with a hike of only 25 basis points (bps) at the next meeting – our central scenario anyway – but the issue is not there. Rather, it’s whether the Fed will stop soon (before reaching the 5-5.25% region for the Fed Funds’ terminal rate it telegraphed in the latest dot plot) before reversing course in the second half of 2023 with rate cuts, a course constantly priced in by the market.

Beyond the resilience of the US economy, the Fed needs to take market behaviour into consideration. Our simple "index of financial conditions" has loosened by 90bps relative to a peak in early November**.** While this is still in restrictive territory – especially because of still elevated, albeit declining, mortgage rates – the Fed may feel the market is failing to transmit enough of its tightening to the real economy. The spread between US treasury yields and BBB-rated corporate bond yields has edged back below 2% on a 10-year maturity since 12 January, in line with the average level of 2019. We still expect the Fed to keep rates constant throughout 2023 after reaching a terminal rate of 5%.

The market is impatient in Europe as well. There was a significant pricing reaction after Bloomberg released a paper claiming the European Central Bank (ECB) was having second thoughts about hiking by 50 bps in March 2023. We fail to see why the ECB would want to telegraph a slowdown in the pace of hiking in March already now, since it has the option to do so anyway within its existing guidance. We note that Governing Council members who are not precisely hawkish such as Villeroy de Galhau chose to pour cold water from Davos on this release, while Klas Knot chose to explicitly argue in favour of continuing with 50bps in March.

We thought the ECB December forecasts were exceedingly skewed towards the upside risks to inflation, and some fine-tuning might occur in March already, but we don't expect a gearshift down to 25 bps before the second quarter. When the ECB says it is data dependent, we think they are in fact mostly dependent on one piece of data: core inflation. While it has started to decline in the US, it has continued to rise in the Euro area. Governing Council members will need to see some convincing deceleration in core before lifting their foot from the brake, and we still expect solid, albeit decelerating, core inflation at around 4.5% in Q2.

Investors feeling better

There could not be more of a contrast with the mood in markets so far in 2023 with that which prevailed for much of last year. The narrative has turned more positive with the key themes of disinflation, China's emergence from COVID restrictions and the potential for a boom in infrastructure spending in the United States all boosting investor confidence. From the market lows in October of last year there have been very strong returns across a range of markets. The rally in Chinese equities, Asian high yield and the broader emerging market debt universe is certainly reflective of the China re-opening theme. Long-duration fixed income assets have also started to recover some of the heft losses they suffered as bond market re-priced to higher inflation and central bank tightening last year.

What goes down can come back up - eventually

Some of the worst impacted asset classes in 2022 can be broadly defined as long-duration. For bonds the key drivers were the increase in short-term interest rates and the adjustment to a new monetary policy regime in the face of higher inflation. One the equity side, growth stocks suffered the most as higher bond yields meant distant earnings were being discounted at a higher rate. This pushed valuations down from the very high levels they had reached in the post-COVID recovery. The tech-heavy Nasdaq composite, growth indices and small caps were some of the worst performing equity assets last year. In contrast, those assets that were less sensitive to higher rates, performed better. Floating rate fixed income and more value-oriented equities had much lower drawdowns and, in terms of total return, have already almost wiped out the losses incurred in 2022.

There is huge potential for solid investment returns this year across a range of asset classes whose prices today still reflect a lot of the drawdown that occurred over the last year. However, investing in assets because they are cheaper than they were a year ago does not guarantee strong returns. From the macro side, the "goldilocks" scenario that markets appear to be trading on relies on a very narrow landing strip. Disinflation needs to continue this year which in turn would allow central banks to complete their hiking cycles. Given the resiliency of growth in the major economies so far, the bullish argument would be that a deep recession can be avoided if most of the central banks' work is done. Throw in the boost to global growth that should come with a more open China, and you get a rose-coloured outlook, certainly relative to the gloom of just a few months ago.

Optimism can disappear

But it is clear this scenario can easily be de-railed. The news on inflation has been encouraging in recent weeks but the early part of the year tends to be when we get upside surprises. The cold weather snap in Europe and increased Chinese demand for energy products could generate such outcomes. Moreover, industrial action in many European countries is putting upward pressure on wages while the US labour market remains very tight. As we note, the mantra from central banks continues to be hawkish because of the inflation risks. Higher rates than currently priced in or rates staying higher for longer would take the shine of the improved growth outlook.

This would be more of a concern for equities than for bonds. If the trajectory of global growth is weaker than we are likely to see worse news on corporate earnings than has been the case so far. Further downward revisions would again make valuations in some parts of the equity market appear expensive. Indeed, regaining all the 2022 losses for many parts of the stock market looks unrealistic for now, with large-cap US technology stocks being the most obvious drags on such a scenario. There are few sectors where valuations are cheap relative to long-term averages and earnings expectations have been revised down well below expected long-term performance. The exception is the broad healthcare sector which is cheap and where there is scope for upside surprises on earnings, particularly in the biotechnology sector.

Holders of long-duration fixed-income assets will have to wait some time before they recoup the losses of 2022. The ultimate recon value will come from coupon accrual rather than rapid capital gains given that the level of bond yields is unlikely to return to the lows of 2020. Market yields have fallen this year but given our views on central banks, further significant declines in yields look difficult to achieve. For the global benchmark 10-year US Treasury, a « fair-value » range of 3.5%-4.0% would be consistent with the outlook for the Fed and US nominal growth.

For now, we continue to favour short-maturity fixed income assets in credit, both investment-grade and high yield. Such strategies will deliver most of their total return through income and, for the moment, we see the corporate sector in major markets being in reasonable shape. Since the beginning of the year there has been a significant amount of new issues in the corporate bond market, suggesting both that companies can manage a higher cost of borrowing without significant deteriorating their interest coverage or leverage ratios. For European investors, spreads are wider than is the case for US corporate bonds and the cost of hedging US dollar exposure led to a preference for European credit. However, all the major corporate bond markets offer an attractive pick-up over respective government bond curves with less of an « inversion » in the credit curve than is the case with risk-free assets.

The positive view of fixed income extends to emerging market debt, which has seen a strong performance in recent weeks. In a theme that cuts across bond markets, investors can get higher yields for taking less credit risk than has been the case in recent years. A peak in US interest rates, a softer dollar and declining inflation across a number of emerging market economies are all good for bond investors. The re-opening of China has also boosted confidence, particularly in Asia. Asian dollar-denominated corporate bonds have already posted a double digit return from their 2022 lows.

Interest rate volatility has eased from its highs and should this continue on the back of a more balanced outlook for the major central banks it will be to the continued benefit of fixed income investors. Bond prices remain very low relative to a year ago while new issues are coming with more attractive coupons. This trend both favours a more important role for bonds in a mixed-asset portfolio but should also support confidence in equity markets too. What matters there, however, is earnings. For now, while we wait for more corporate news, our inclination is to see equity markets generally remaining above 2022 lows but not having enough fundamental strength to push to new highs.

Download the full slide deck of our January Investment Strategy

Recommended asset allocation

Asset Allocation

Key asset classes	Negative	Neutral	Positive
Equities	■		
Bonds			■
Commodities		■	
Cash		■	

Equities

Developed	Negative	Neutral	Positive
Euro area	■		
UK		■	
Switzerland		■	
US	▼		
Japan		▼	

Emerging & Sectors	Negative	Neutral	Positive
Emerging Markets		■	
Europe Cyclical/Value		■	
Euro Financials		■	
European Auto		■	
US Financials		■	
US Russell 2000		■	

Fixed Income

Govies	Negative	Neutral	Positive
Euro core		▼	
Euro peripheral		■	
UK		■	
US		■	

Inflation	Negative	Neutral	Positive
US		■	
Euro		■	

Credit	Negative	Neutral	Positive
Euro IG		■	
US IG		■	
Euro HY		■	
US HY (short duration)		▼	

EM Debt	Negative	Neutral	Positive
EM bonds HC			▲

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

Source: AXA IM Macro Research – As of 25 January 2023

Macro forecast summary

Real GDP growth (%)	2022*		2023*		2024*	
	AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
World	3.2		2.3		2.8	
Advanced economies	2.6		0.3		1.0	
US	2.1	1.9	0.1	0.2	0.8	
Euro area	3.2	3.2	-0.2	-0.1	0.9	
Germany	1.7	1.7	-0.6	-0.7	0.8	
France	2.4	2.5	0.0	0.1	0.8	
Italy	3.6	3.7	0.0	-0.1	0.6	
Spain	4.5	4.5	0.3	0.8	1.3	
Japan	1.6	1.5	1.7	1.3	1.3	
UK	4.1	4.4	-0.7	-1.0	0.8	
Switzerland	2.3	2.1	0.6	0.5	1.3	
Canada	3.5	3.4	1.0	0.4	1.0	
Emerging economies	3.6		3.5		3.8	
Asia	4.1		4.8		4.5	
China	3.0	3.1	5.0	4.5	4.8	
South Korea	2.3	2.6	1.5	1.3	2.0	
Rest of EM Asia	5.5		4.9		4.4	
LatAm	3.5		1.7		2.4	
Brazil	2.7	2.9	1.0	1.0	2.0	
Mexico	2.2	2.8	1.0	1.1	2.0	
EM Europe	0.5		-0.9		2.1	
Russia	-3.0		-3.8		2.0	
Poland	4.4	4.8	0.1	0.8	2.4	
Turkey	5.9	5.2	0.5	2.2	1.4	
Other EMs	4.5		3.6		3.6	

Source: Datastream, IMF and AXA IM Macro Research – As of 23 January 2023 *Forecast

CPI Inflation (%)	2022*		2023*		2024*	
	AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	7.4		5.0		2.8	
US	8.0	8.1	4.9	4.1	3.2	
Euro area	8.4	8.5	5.8	6.3	2.8	
China	2.1	2.1	2.3	2.4	2.5	
Japan	2.5	2.4	2.7	1.8	1.5	
UK	9.1	9.0	7.2	7.3	2.3	
Switzerland	2.8	2.9	2.0	2.3	1.3	
Canada	6.8	6.8	4.3	3.8	2.4	

Source: Datastream, IMF and AXA IM Macro Research – As of 23 January 2023 *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	Q1-23	Q2-23	Q3-23	Q4-23
United States - Fed	Dates	4.50	31-1 Jan/Feb 21-22 Mar	2-3 May 13-14 Jun	25-26 Jul 19-20 Sep	31-1 Oct/Nov 12-13 Dec
	Rates		+0.5 (4.75-5.00)	unch (5.00)	unch (5.00)	unch (5.00)
Euro area - ECB	Dates	2.00	2 Feb 16 Mar	4 May 15 Jun	27 Jul 14 Sep	26 Oct 14 Dec
	Rates		+1.0 (3.00)	+0.25 (3.25)	unch (3.25)	unch (3.25)
Japan - BoJ	Dates	-0.10	9-10 Mar	27-28 Apr 15-16 Jun	27-28 Jul 21-22 Sep	30-31 Oct 18-19 Dec
	Rates		unch (-0.10)	unch (-0.10)	unch (-0.10)	unch (-0.10)
UK - BoE	Dates	3.50	2 Feb 23 Mar	11 May 22 Jun	3 Aug 21 Sep	2 Nov 14 Dec
	Rates		+0.75 (4.25)	unch (4.25)	unch (4.25)	-0.25 (4.00)

Source: AXA IM Macro Research - As of 23 January 2023

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Our Research is available on line: www.axa-im.com/investment-institute

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