Monthly Op-ed

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Patchy disinflation will trigger policy divergence

Key points

- US headline inflation is softening, although core improvement is slower, held firmer by a still tight labour market.
- In the Eurozone there is scant sign of improvement in core inflation, that will likely require a longer period of further tightening from the European Central Bank.
- The resultant policy divergence is likely to last several months and underpin euro gains.
- Banking sectors turmoil has faded but left its mark on market risk premia.
- A combination of factors has kept risk factors resilient. But given ongoing headwinds, we consider a defensive posture to be most prudent for now.

More tangible signs of disinflation in the US than in Europe

In the US, it seems that some progress is being made on taming inflation, even if it is too early for the Federal Reserve (Fed) to lower its guard. Unfortunately, the Euro area seems to be less advanced on disinflation. This will probably trigger some divergence in monetary policy in the months ahead, consistent with a stronger euro exchange rate.

As a whole, US core inflation is still too high and only slightly decelerating, but some components which the Fed sees as crucial are encouraging. On a three-month annualized basis, the growth rate of services prices excluding rents is now close to 2%. Meanwhile, producer prices excluding energy are slowing down significantly, which confirms that the pressure in the "inflation pipeline" is abating. We need to be cautious: the labour market remains very tight, and the recent slowdown in wage growth could easily be reversed. Even in small businesses – where the economic slowdown is already being felt – hiring intentions remain strong in a context of labour supply scarcity.

Yet, combined with the likely tightening in credit conditions triggered by the banking turmoil – while the immediate financial stability risks are probably under control, the erosion of the deposit base has been large in just six weeks – there is probably enough evidence for the Fed to pause after delivering a 25-basis point (bp) hike in May. In any case, the policy rate is already at twice the level seen by the Fed as the right "long-term value". The degree of monetary restriction now working its way through the economy is already high. The Fed can probably count on the lagged effects of the cumulative tightening to be enough to bring inflation back to target by the end of next year. Yet, we remain quite suspicious of the market's pricing of rate cuts in the second half of 2023. After having spent 2022 playing catch-up with inflation, we think the Federal Open Market Committee (FOMC) will want to err on the side of caution before reversing its stance.

The European situation is quite different. In the Euro area, it takes microscopes to detect a deceleration in core prices. Core inflation as a whole continued to accelerate in March, and while "trimmed mean" alternative measures suggest the peak may have been passed, "supercore inflation", which tracks the components sensitive to demand traction, continues to rise. Key indicators such as the services Purchasing Managers Indices (PMIs) suggest the real economy is holding up well, potentially further fuelling demand-led inflation. This is surprising in a context of declining purchasing power, and national surveys in some cases – particularly so in France – send a more cautious signal. Yet, it's clear the Euro area is avoiding recession – for now.

Looking ahead, credit data tell us that the monetary tightening is working its way through the system, but "guesswork" is needed to substantiate an impact from the banking turmoil. In any case, this has to be balanced against tangible risks on the wage front. Indeed, while observed aggregate wages remain tame, recent industry-based pay deals (e.g., the very generous proposal in the German public sector) can be interpreted as signs that wages will soon replace profit margins as key inflation drivers. The idea that there is "more ground to cover" – and more than one rate hike left in this cycle – is easier to sustain in the Euro area than in the US. The market has already internalized this divergence and sent the euro higher. This will help dampen imported inflation, but this works with long lags, and we do not expect any marked deceleration in core inflation before the end of the summer. This will play in the hands of the hawks at the Governing Council.

Waiting for that sputtering sound

Markets are in the grip of the proverbial fighter pilot angst. They have seen the bullets (bank troubles) hit the engine bay and are awaiting with trepidation for the sputtering sound (recession) to commence. Some lingering negative headlines notwithstanding, concerns about banks have broadly subsided since the mid-March turmoil and the crisis appears to have been averted for now. Like the UK Gilt/liability-driven investment (LDI) crisis in September 2022, measures taken by authorities to remedy the situation seem to have contained systemic contagion risks. At the same time, like the Gilt/LDI crisis, bank troubles have left their mark on market risk premia.

In credit default swaps, senior financial spreads in Europe have recovered all their underperformance vs non financials but subordinated financial spreads only partially so vs senior. Similarly, the global benchmark of contingent capital bonds has recovered only half of the price drop it experienced in mid-March. In the US, financial credit default swap (CDS) spreads continue to trade wider to non-financials compared to early March. In terms of central bank policy expectations too, the peak for the Fed Funds rate has remained much lower compared to early March, currently at just over 5% compared to 5.7% on 8 March.

A combination of factors seems to be keeping risk appetite resilient for the time being. On the macro front, indicators are getting softer but not collapsing. Valuations of risky assets are not flagging a 'screaming buy' but neither are they in a rich territory, broadly speaking. Positioning does not appear overextended, and sentiment remains cautious overall. Liquidity conditions year to date have been supportive too. Nonetheless, we think that maintaining a defensive risk posture feels like the most prudent approach for now, given the headwinds.

On the positive side of the ledger, the earnings season so far has been better than feared; yet again. While we are still at the foothills for nonfinancial corporates' reporting, US banks results overall have given a degree of comfort to markets. Companies have appeared constructive enough for travel and leisure activity into the summer, while others have alluded to a recovery in activity in the second half of the year. At the same time, input cost and supply chain pressures continue to recede, reportedly. Global growth expectations are being underpinned by upside surprises in China macro data. The economic surprise indicators for China and emerging market (EM) are positive and trending higher, with China's at an all-time high. At the same time, investor surveys indicate high caution on recession fears, which is supportive for risky assets from a contrarian point of view.

On the negative side of the ledger, financial conditions have recovered only partially compared to pre bank troubles. and some Leading Economic Indicators are flashing red. At almost -8% year-on-year, the drop in the US Leading Economic Index (LEI) tends to be associated with recessions. At the same time, US Federal Reserve officials have maintained their hawkish stance against market expectations for rate cuts in the second half of the year. We can add to that the escalating brinkmanship around the US debt ceiling. This has been promptly reflected in US CDS spreads, with the 1yr point surging past 100bps and pushing the 1year vs 5year curve to a record inversion of 76bps. At a corporate level, we have the beginnings of an electric vehicle (EV) price war to contend with, as well as cautious commentary by tech companies, vis a vis deal delays and IT investment plans. The historically high divergence between elevated rates volatility and subdued equity volatility is also creating unease amid investors.

China stands out amid equity markets as the only area where upside economic surprises are coupled with downside inflation surprises. Add the benefit of the credit impulse and this puts China in a position for equity market outperformance. Developed markets and indeed the US are witnessing a downshift in earnings momentum despite still positive sales, driven by the downward impact of wages on margins, a trend that is likely to persist. 2023 earnings are at risk of further downgrade as the bulk of this year's growth is due to cyclicals which would suffer in a downturn, bringing the aggregate earnings growth below the current expectation of -5% and questioning current valuations. While positioning and sentiment remains cautious, a steady inflow from high portfolio cash balances into stocks seems consistent with the notably steep implied volatility curve. Despite the steepness, outright volatility levels into year-end remain reasonable for portfolio protection strategies. A further silver lining vis-a-vis downside protection is that stocks-bonds correlation is back into negative territory, restoring the diversification benefit of bonds.

Credit markets have weathered the banking troubles well enough to post positive returns. Spreads are currently wider than in early March, but the widening has been more than offset by the decline in underlying government bond yields. This has brought credit yields lower and has thus protected total returns. All-in credit yields do remain very attractive historically, however. There has predictably been a strong divergence between banks and non-financial corporates, with the 10-15bp widening in investment grade (IG) benchmarks driven by the 20-35bp widening in bank spreads, while corporate spreads have widened by only 5-6bps. The downside to the resilience in spreads is that spread premia currently are not ample enough given the recession risk ahead. USD IG at 135bps is less than half the spread level that is historically associated with zero GDP growth year on year. EUR IG at 155bps likewise, is still some distance from a zero GDP growth spread level that is in the low to mid 200s. Spread don't screen cheap from a mean reversion perspective either. Current levels are historically consistent with flat spreads over three months and mildly wider spreads over 12 months.

Download the full slide deck of our April Investment Strategy

26 April 2023

Key market calls

Our Directional views across assets in key market (3-month horizon)

CURRENCIES	weaker	neutral	stronger
Euro			●
Yen		●	
GBPEUR	● ◀◀		

CURRENCIES

Peak dollar narrative has room to run as higher hard landing odds raise bar for further Fed hikes. EUR has more upside potential and ditto for JPY but in the second half of the year. If BoE does not fulfil what priced by markets; GBP can weaken.

EQUITY	lower	neutral	higher
US equity	●		
EU equity		●	
EM equity			▶▶ ●

EQUITY

Earnings expectations are key for 2023 returns. A strong start to the year may create complacency as central banks still hawkish & macro risks. Margin pressures already at play mainly due to wage growth. China rebound momentum underpins EM.

RATES	higher	neutral	lower
US rates short	●		
US rates long		●	
EU rates short	●		
EU rates long	●		

RATES

Rates volatility remains elevated while market expectations for central banks may be too dovish, raising the risk of a market correction. Further banks headlines more of a risk for the US, implying more rebound potential higher for EU yields.

CREDIT	wider	neutral	tighter
US IG		●	
EU IG		● ◀◀	
US HY		●	
EU HY		● ◀◀	

Source: AXA IM Core Investment Research, as of 24 April 2023

CREDIT

Spreads have sailed through the March bank troubles and are again underpricing recession risks even if balance sheets are in good health. Some caution warranted given the unappealing risk reward although yield levels still attractive.

Macro forecast summary

Real GDP growth (%)	2022		2023*		2024*	
	AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
World	3.4		2.7		2.7	
Advanced economies	2.7		1.0		0.7	
US	2.1	2.1	1.0	1.0	0.3	0.9
Euro area	3.6	3.2	0.7	0.6	0.6	1.1
Germany	1.8	1.8	0.2	0.0	0.6	1.3
France	2.6	2.6	0.6	0.5	0.6	1.1
Italy	3.7	3.8	0.6	0.6	0.5	1.1
Spain	5.5	5.5	1.3	1.3	0.9	1.8
Japan	1.1	1.0	1.7	1.0	1.3	1.1
UK	4.0	4.0	0.0	-0.5	0.5	0.7
Switzerland	2.1	2.1	0.6	0.7	1.3	1.6
Canada	3.4	3.4	1.2	0.6	0.9	1.4
Emerging economies	3.9		3.8		3.8	
Asia	4.3		5.0		4.6	
China	3.0	3.0	5.3	5.3	5.0	5.2
South Korea	2.6	2.6	1.5	1.1	2.0	2.2
Rest of EM Asia	6.0		5.0		4.4	
LatAm	4.0		1.5		2.3	
Brazil	2.9	3.0	1.0	1.0	1.5	1.7
Mexico	3.1	3.0	1.2	1.3	1.8	1.9
EM Europe	0.9		0.9		1.8	
Russia	-2.1		1.7		1.3	1.3
Poland	4.9	4.9	0.1	0.8	2.4	3.0
Turkey	5.6	5.1	0.5	2.1	1.4	2.8
Other EMs	4.9		3.1		3.7	

Source: Datastream, IMF and AXA IM Macro Research – As of 26 April 2023
**Forecast*

CPI Inflation (%)	2022		2023*		2024*	
	AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	7.4		4.8		2.7	
US	8.0	8.0	4.5	4.2	3.1	2.6
Euro area	8.4	8.5	5.7	5.6	2.8	2.4
China	2.1	2.0	2.3	2.3	2.5	2.4
Japan	2.5	2.5	2.7	2.3	1.3	1.3
UK	9.1	9.1	6.6	6.4	2.4	2.9
Switzerland	2.8	2.8	2.0	2.5	1.3	1.4
Canada	6.8	6.8	3.8	3.7	2.7	2.3

Source: Datastream, IMF and AXA IM Macro Research – As of 26 April 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	Q2-23	Q3-23	Q4-23
United States - Fed	Dates	5.00	2-3 May 13-14 Jun	25-26 Jul 19-20 Sep	31-1 Oct/Nov 12-13 Dec
	Rates		+0.25 (5.25)	unch (5.25)	unch (5.25)
Euro area - ECB	Dates	3.00	4 May 15 Jun	27 Jul 14 Sep	26 Oct 14 Dec
	Rates		+0.5 (3.5)	+0.25 (3.75)	unch (3.75)
Japan - BoJ	Dates	-0.10	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)
UK - BoE	Dates	4.25	11 May 22 Jun	3 Aug 21 Sep	2 Nov 14 Dec
	Rates		+0.25 (4.50)	unch (4.50)	-0.25 (4.25)

Source: AXA IM Macro Research - As of 24 April 2023

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

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