AXA Investment Managers

26 July 2023

Investment Institute Macroeconomics

Monthly Op-ed

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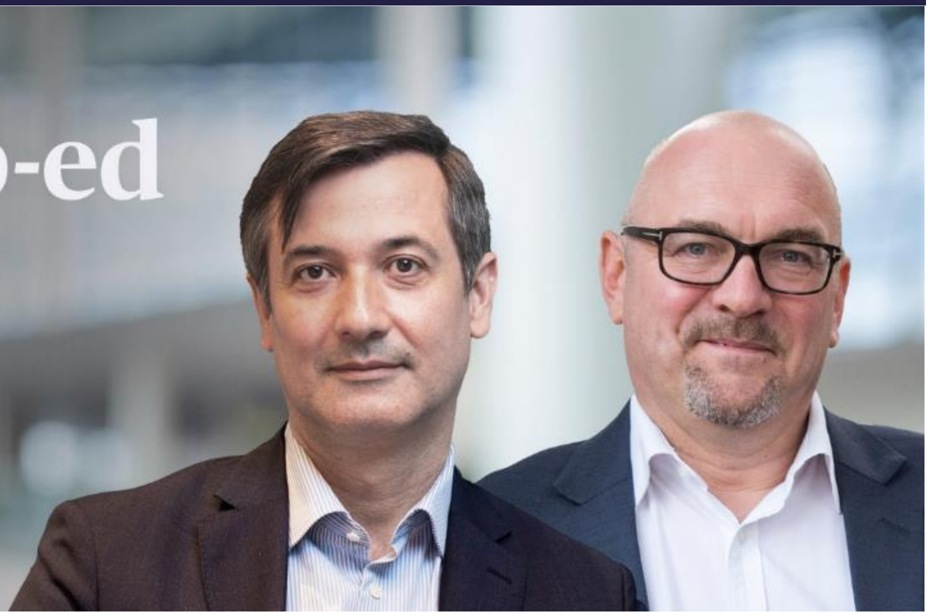

Of landings, soft and hard

Key points

- Macro narrative starting to diverge across the Atlantic, with a soft landing is often seen as likely for the US – more so than in Europe where soft data continue to point to contracting GDP.
- Even in the US case we continue to think avoiding a GDP contraction is going to be difficult.
- Bonds provide income and diversification in a softer outcome.

Are the US and Europe still on the same trajectory?

The macroeconomic narrative has long been similar for the US and Europe. In both cases, persistent inflation called for a symmetric monetary tightening which would remove excess demand and deliver a wage-braking labour market landing, at the cost of a shallow recession. The story is however getting more complicated, as in the US tangible signs of disinflation have emerged without any major loss of momentum in the real economy, while in the Euro area – where several member states including Germany have been in a state of recession since the end of 2022 – soft data point to even more deterioration in activity in the months ahead without much relief on the core inflation side. The market is now pricing more monetary tightening in the Euro area than in the US, which strengthens the risks of a "hard landing" in Europe.

The respective institutional features of the labour market in the Euro area and the US may contribute to such divergence. The wage bargaining process in the US tends to be individualized, potentially reacting quickly to even fairly small changes in employment opportunities. In the Euro area collective bargaining dominates, with more focus on catching up on *past* purchasing power losses in times of high inflation and less sensitivity to the employment outlook. The "second round effects" of the inflation shock could thus last longer in the Euro area, and it may take a steeper deterioration of the labour market to finally get inflation to land at the ECB's target. Even if the hawks at the Governing Council have been less vocal lately, these are the kind of issues they tend to focus on.

The fiscal stance could also play a role. While the era of massive budgetary stimulus is probably over in the US, there is no prospect of an austerity turn in 2024 – especially in an electoral year. Conversely, all the Euro area member states – to different degrees – are planning a fiscal adjustment effort for next year, as the EU's surveillance framework is kicking in again. It is precisely at the time that the impact of the cumulative monetary tightening will hit its peak that the fiscal drag will start affecting aggregate demand.

Still, in our opinion, the "soft landing" scenario in the US – where even a shallow recession would be avoided – is still not the most obvious outcome. True, US inflation has already declined significantly, benefitting from the combination of lower energy prices, decelerating food and manufactured goods' prices, and the services sector seems close to be following the same pattern, thanks in part to the beginning of a deceleration of rents. Yet the "last mile" – getting core inflation from a June pace of 4.8% to the Fed's targeted 2% - may still be difficult to cover without a proper decline in aggregate demand. We find it difficult to reconcile a "soft landing" scenario, in which the economy eschews contraction, with the kind of sustained close-to-2% inflation the Fed would want to see before moving the monetary stance away from restrictive territory. The current policy rate is already at roughly twice the equilibrium level. Miracles do of course happen, but we fail to see what structural change in the US economy would have made it resilient to a protracted phase of restrictive monetary conditions. It may be that the legacy of the pandemic – for instance its impact of personal saving - is disturbing the usual transmission *time* of the policy signal to the real economy, but we are sceptical the effect itself would have so significantly declined. We recognize however that the US soft landing is now the market's baseline.

A hard landing changes the investment outlook

There is nothing particularly unusual about the fact that equity returns have outperformed bond returns in 2023, against a backdrop of significant increases in short-term interest rates. In the US, the Federal Reserve has increased rates by 350 basis points over the last twelve months. The S&P500 index has delivered a total return of around 11% since then, while the Bloomberg US aggregate bond index had a negative 3% return. Of course, the macro driver of all these moves has been strong nominal GDP growth.

This profile of market performance is likely to change significantly if the US and other economies go into a recession over the next year. Historically, equity returns become negative once the recession gets underway and the Federal Reserve is cutting interest rates. In the last fifty years, significant equity underperformance has come when monetary policy becomes looser in response to falling rates of GDP growth. This was the case in 1980, 2000 and 2009. Performance is driven by GDP growth and the implications that has for corporate earnings.

Consensus forecasts are not for a deep recession in the US. In fact, taken at face value, GDP forecasts look more like the fabled soft-landing where growth is below trend allowing just enough spare capacity to emerge to bring inflation back down. This consensus on growth is matched by a similarly comfortable outlook for earnings. The current consensus forecast for the S&P500 is for 2024 to register an earnings-per-share growth rate of 11% compared to a flat outcome for 2023.

Soft or hard, bonds or equities?

It appears investors face two scenarios in the year ahead. The first is the consensus described above. The other is that the economy reacts how it always has done to an inflation shock and monetary tightening. In other words, there is a recession. Investment outcomes would differ between the two. In the soft-landing scenario, equities would continue to outperform bonds driven by renewed earnings growth in 2024. However, with the economy at close to full capacity – soft-landings do not usually lead to a significant increase in the unemployment rate – there would be little scope for an aggressive reduction in interest rates that would boost bond returns. Inflation would continue to be a concern for central banks and more active changes in policy settings might become the norm. A bigger term premium may be necessary in yield curves to reflect more uncertainty about future interest rate levels and a re-assessment of equilibrium interest rates.

The main attraction of fixed income in such a scenario would come in terms of income from yield levels that might not deviate too much from current levels. Any requirement to keep monetary policy on the tighter side of neutral would limit the extent to which long-term risk-free rates could move down and the extent to which credit spreads would narrow significantly from current levels that are close to long-term averages. Bonds would be a source of income and a source of diversification to equity exposure.

The recession scenario would be different. Corporate earnings would come under pressure from reduced revenues as GDP growth slides, and firms would find it more difficult to maintain profit margins. For the US equity market particularly, current valuations do not offer any value in a scenario of earnings growth turning negative again. Falling stock prices would generate negative feedback to the real economy through reductions in investment spending and consumer confidence. The Federal Reserve would move quickly to cut interest rates, allowing bond yields to decline and generating total returns well above those suggested by current yield levels. The result, in the US, would need to be a sizeable increase in ex-ante equity risk premiums sufficiently to attract investors back into stocks in anticipation of an eventual economic and corporate recovery.

Resiliency persists

It is hard to envisage this more negative outcome now. There have been no obvious global excesses. Corporate debt levels have been manageable, although become less so the longer interest rates remain high. Labour markets are tight in most developed economies. So far, the Q2 earnings season has been robust with banks, often the bellwether for brewing economic problems, reporting strong numbers with little anticipation of major credit problems. Yet there are signs of weakness. Global purchasing manager surveys indicate manufacturing is in recession and has been for some time. Higher interest rates are starting to hit household purchasing power in those economies with more sensitive mortgage borrowing costs. At the global level, China's growth rate is disappointing and has not provided the post-lockdown boost to demand, a reason that parts of the Euro Area economy have weakened. A global hard landing cannot be ruled out.

The data and the policy responses will be key in the months ahead. Equities in the US are expensive again. The equity earnings yield does not compare very well against yields on investment grade corporate bonds. Leaving aside what may happen to earnings multiples in parts of the technology sector, it is more likely that multiples come down if a slowdown in growth becomes broad-based. Indeed, the worst outcome for stocks would come from downward revisions to 2024 earnings estimates and a partial reversal in this year's expansion of multiples. Some relief would come from lower bond yields, but a major price correction would need to occur before then.

A soft landing might be the outcome. Positive GDP growth should allow companies to maintain some growth in corporate earnings while easing inflation would lower cost pressures as well as nominal revenue growth, meaning margins can still be healthy. It would be quite remarkable if this turns out to be the scenario for US markets in the next year or so but after the shocks of the last three years, the resilience of the economy is not in doubt. However, bonds are more fairly valued today than they have been in recent years while parts of the equity market reflect super-optimistic valuations. Some investors might want to take advantage of low levels of implied volatility to buy some insurance for equity portfolios. More simply, implied cash returns will remain high for some time and as growth risks increase, the surety of cash returns need to be weighed against the prospects for a US equity market where valuations and earnings risks are not screaming "buy".

Download the full slide deck of our July Investment Strategy

26 July 2023

Macro forecast summary

Real GDP growth (%)	2022		2023*		2024*	
	AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
World	3.4		2.7		2.8	
Advanced economies	2.7		0.9		0.9	
US	2.1	2.1	1.0	1.1	1.1	0.6
Euro area	3.6	3.2	0.4	0.7	0.5	0.9
Germany	1.8	1.8	-0.5	0.1	0.3	1.1
France	2.6	2.6	0.6	0.6	0.5	0.9
Italy	3.7	3.8	1.2	0.8	0.4	0.9
Spain	5.5	5.5	2.0	1.6	1.0	1.6
Japan	1.1	1.0	1.5	1.0	1.3	1.1
UK	4.0	4.0	0.2	-0.1	0.3	0.8
Switzerland	2.1	2.1	0.7	0.7	1.0	1.4
Canada	3.4	3.4	1.3	0.9	0.9	1.2
Emerging economies	3.9		3.8		3.9	
Asia	4.3		5.0		4.6	
China	3.0	3.0	5.3	5.8	5.0	4.9
South Korea	2.6	2.6	1.5	1.1	2.0	2.1
Rest of EM Asia	6.0		5.0		4.4	
LatAm	4.0		1.5		2.3	
Brazil	2.9	2.9	1.0	1.2	1.5	1.6
Mexico	3.1	3.1	1.2	1.8	1.8	1.7
EM Europe	0.9		1.5		2.3	
Russia	-2.1		1.7		1.3	1.3
Poland	4.9	4.9	1.0	0.7	2.9	3.1
Turkey	5.6	5.6	2.1	2.2	3.1	2.6
Other EMs	4.9		3.1		3.7	

Source: Datastream, IMF and AXA IM Macro Research – As of 27 June 2023
**Forecast*

CPI Inflation (%)	2022		2023*		2024*	
	AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	7.4		4.7		2.7	
US	8.0	8.0	4.3	4.2	3.0	2.6
Euro area	8.4	8.5	5.6	5.5	2.8	2.4
China	2.1	2.0	2.3	1.8	2.5	2.4
Japan	2.5	2.5	2.7	2.6	1.3	1.4
UK	9.1	9.1	7.1	6.7	2.5	2.8
Switzerland	2.8	2.8	2.4	2.5	1.5	1.5
Canada	6.8	6.8	3.9	3.6	3.0	2.2

Source: Datastream, IMF and AXA IM Macro Research – As of 27 June 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	Q3-23	Q4-23
United States - Fed	Dates	5.25	25-26 Jul 19-20 Sep	31-1 Oct/Nov 12-13 Dec
	Rates		+0.25 (5.50)	unch (5.50)
Euro area - ECB	Dates	3.50	27 Jul 14 Sep	26 Oct 14 Dec
	Rates		+0.50 (4.00)	unch (4.00)
Japan - BoJ	Dates	-0.10	27-28 Jul 21-22 Sep	30-31 Oct 18-19 Dec
	Rates		unch (-0.10%)	unch (-0.10)
UK - BoE	Dates	5.00	3 Aug 21 Sep	2 Nov 14 Dec
	Rates		+0.25 (5.25)	unch (5.25)
Canada - BoC	Dates	4.75	12 Jul 6 Sep	25 Oct 6 Dec
	Rates		unch (4.75)	unch (4.75)

Source: AXA IM Macro Research - As of 27 June 2023

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

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