Investment Managers

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# Monthly Op-ed

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## Life after the Bang

### Key points

- The Fed chose a bold first move to ensure the "soft landing" can remain soft. The ensuing trajectory remains very dependent on the US elections outcome though
- The ECB still sounds more cautious, even if they started easing earlier. We think they should be more decisive
- Bond returns to be lower
- Equities benefit from soft landing
- Policy uncertainty main risk

### Fed starts with a bang, ECB sounds cautious

The Federal Reserve (Fed)'s choice of starting its easing process with a 50bp cut is bold, but the new forecasts associated with the policy decision make it plain that, according to the Federal Open Market Committee (FOMC), a total of 200bps worth of cuts is what could be needed to "keep the soft landing soft", which is clearly what the central bank is focused on, now that it deems the inflation battle won. As an important aside, the FOMC believes that, probably partly because it chose to "start with a bang", it won't have to take policy rates into properly accommodative territory in this cycle. Indeed, we do not think it is a pure accident that the level at which the Fed Funds rate lands at the end of 2026 in their forecasts coincides with their new estimate of its "long-run level". We think it is an important clue the bond market should not miss.

Now, a central bank's forecasts should be received more as a "statement of intent" than as a proper "plan of action". In retrospect, the June dot plot was too hawkish, over-reacting to the rebound in services inflation in early 2024. Symmetrically, the September one may be overly reactive to the disappointing payroll prints of the summer.

To gauge the probability of September's dot plot materialising, there is in any case a crucial piece of missing information in the Fed's decision function: a lot will depend on the outcome of the elections in November, and we think the Fed may have to reserve judgement on the quantum of cuts it should still provide if Donald Trump is elected and implements his inherently inflationary platform. On the other side of the Atlantic, the European Central Bank (ECB) messaging is not as bold.

True, the Governing Council chose not to wait for the Fed before starting to ease in June, and provided another cut in September, but the hawks continue to argue for a very cautious trajectory ahead. As much as we think the Fed may be over-reacting to signs of economic slowdown which are still tenuous, symmetrically we believe the ECB should act more decisively. Contrary to the US, it is difficult to argue that inflation cooled down in the Euro area within a "soft landing" configuration. It rather seems that Europe is stuck in a sort of never-ending incapacity to take off. The Euro area has been repeatedly brushing with recession since it exited from the pandemic.

Even when taking the gap in potential growth into account, Europe is much closer to a nasty downturn than the US. In its last forecasts, the ECB shaved its GDP projections by only 0.1% and kept the list and characterisation of risks unchanged relative to June, which we found surprising given the recent dataflow. The ECB has been counting on gains in households' purchasing power, as wages continue to rise faster than inflation, to lift private consumption and offset the lack of traction from external demand if China continues to be soft. Yet, most of those gains are being saved by families (the savings rate in all four biggest economies of the Euro area continues to be higher than before the pandemic). There is also much more evidence in the Euro area than in the US that the monetary stance is indeed restrictive: credit origination has taken a hit, and business bankruptcies are now rising fast, more than offsetting the Covid lull. In addition, the perspective of fiscal retrenchment next year is also more certain, in terms of direction of travel, than in the US.

The only factor which could support the hawkish case in Europe are the lingering adverse developments on labour supply, reflected in the still high level of hiring difficulties reported in the business surveys. Yet, when we quantify their impact on wage developments, we find that they played a visible, although not crucial role in the pay developments of the last two years which were dominated by a catch-up process with the now fading external inflation shock. This opens the door to a continuation of the wage deceleration despite a still constrained labour supply.

In a nutshell, we think the Fed may be proposing "a bit too much" and the ECB not enough.

## What could be in store for bond investors

The US soft landing scenario coupled with the pricing of interest rate cuts in most major economies is providing a benign backdrop for financial markets in the final quarter of 2024. Bond markets, in particular, have delivered strong returns over the summer months, reflecting the aggressive shift in central bank rate expectations. Given pricing is now coincident with what most observers suggest could be the level of terminal rates in this cycle, it is likely that fixed income total returns will moderate into year-end. However, 2024 has shown that after a decade-plus of very low yields, investors should have a significant weighting of fixed income in portfolios. The traditional 60:40 approach to investing has certainly reaped dividends this year.

Long-term bond yields are most likely close to fair value levels, both reflecting the likely path of short-term interest rates towards a neutral monetary policy stance, and the likely path of nominal GDP growth. A simple model that regresses the level of 10-year US Treasury yields on a medium-term moving average of nominal GDP growth points to yields in the 4% area. Deviations from that are explained by the cycle and by risk premium considerations.

The Fed's implied interest rate path suggests a terminal rate of around 3% in the next one-to-two years. After November's US presidential election, the US medium-term fiscal outlook could start to have more of an impact on bond prices. Even today, Treasury yields are higher than swap rates at the long end of the curve, suggesting some risk premium is already evident. Neither presidential candidate has addressed the long-term fiscal outlook and both programmes, as they stand, are likely to mean continued high levels for the federal deficit and for borrowing. As such, the risk premium in Treasury yields could widen further.

Bond investors are still likely to find some reward in being positioned for more yield curve steepening. The spread between 10-year and two-year Treasury yields is again positive after being negative since mid-2022. Some further decline in short-dated yields is possible as is some increase in 10-year yields into the post-election period. However, strong duration-driven positive returns from the US market look more difficult to achieve in the coming months.

Curve steepening in Europe is also likely to be ongoing. But as is the case in the US, a lot is already priced in for the ECB and long-term yields have also fallen a lot. The German 10-year bond yields 2.15% at the time of writing, leaving little value in the curve even if the ECB does eventually reduce rates to 2%. Improved fundamentals in some of the other Eurozone countries suggest there is better value in the longer end of Spain and Italy.

## Credit remains in favour

Much is priced into rates curves. Fixed income value sits more with credit where there continues to be opportunities for income investors. Corporate bond fundamentals are healthy given the decent earnings backdrop, manageable leverage levels and the improved financing backdrop. A year ago, the difference between the prevailing yield (the cost of new borrowing) and the legacy coupon (the cost of existing borrowing) in the European investment grade corporate bond market was 247 basis points (bps). Today, that spread has fallen to 92bps. This 'refinancing premium' has also fallen sharply in the US bond market. Companies needing to refinance debt can do so at more manageable levels today than was the case in the height of the interest rate hiking cycle. It is only in the lower-rated parts of the high yield bond market that the refinancing premium remains concerning (around 5% in the US CCC-rated sector). Access to private credit flows and the rise in distressed exchanges has allowed the default rate in high yield to remain lower than historical averages. Meanwhile, better-rated high yield companies are expected to continue to deliver attractive returns to investors given the positive credit backdrop.

## Equity markets have upside given the soft landing

Given the strong returns from bonds in Q3, equity returns are potentially likely to be superior for the foreseeable future. The avoidance of recession is key as this will underpin earnings growth. There are questions over whether current consensus earnings expectations are too high – around 14% for the 12-month growth rate for S&P 500 companies – but earnings grew at a pace of 11% in Q2 and analysts seem to be suggesting the impact of artificial intelligence on earnings will be more evident going forward. In Europe, earnings expectations are lower, reflecting the weaker growth backdrop. However, valuations reflect that.

The Fed's 18 September rate cut was well received by equity markets with both the Dow Jones and the S&P500 reaching record highs. Seasonally, equity markets tend to perform well in the final quarter of the year and the upcoming earnings season will be critical to this. The dominance of technology stocks in the US market faded in Q3, with a negative total return over the last three months compared to a 4.6% return for the S&P500 index as a whole. Strong guidance and numbers from leading technology companies would be a catalyst for a performance bounce and push the overall market to a full-year total return of near to 30%. Not that the Fed publicly cares about such things, but Chair Jerome Powell and company would be privately happy with such an outcome given the market has essentially legitimised the soft landing scenario.

## Risks focused on the US election

The risks to continued strong investment returns stem from some market backtracking on rate expectations, should data in the US and Eurozone be stronger than expected and if inflation fails to fall further. This seems unlikely in the short term given the recent easing of global oil prices, the modest softening in the US labour market and deflationary impulses coming from China. More realistic might be concerns over the policy agenda in the wake of the US election. Donald Trump's policy agenda, a mix of protectionism and tax cuts, could prove to be disruptive to both growth and inflation. With risk premiums modest across both bond and equity markets, election-induced volatility cannot be ruled out, even if underlying fundamentals remain strong.

**Download the full slide deck of our September Investment Strategy**

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# Macro forecast summary

| Real GDP growth (%) | 2023 | 2024* | | 2025* | |
|---|---|---|---|---|---|
| | AXA IM | AXA IM | *Consensus* | AXA IM | *Consensus* |
| **World** | 3.1 | 3.2 | | 3.1 | |
| **Advanced economies** | 1.7 | 1.6 | | 1.5 | |
| US | 2.5 | 2.7 | 2.5 | 1.8 | 1.8 |
| Euro area | 0.5 | 0.7 | 0.8 | 0.9 | 1.5 |
| Germany | -0.1 | -0.1 | 0.1 | 0.5 | 1.5 |
| France | 1.1 | 1.1 | 1.1 | 0.6 | 1.3 |
| Italy | 1.0 | 0.8 | 0.8 | 0.8 | 1.2 |
| Spain | 2.5 | 2.8 | 2.4 | 2.1 | 1.9 |
| Japan | 1.9 | 0.0 | 0.0 | 1.1 | 1.0 |
| UK | 0.1 | 1.1 | 1.0 | 1.4 | 1.2 |
| Switzerland | 0.8 | 1.2 | 1.4 | 1.3 | 1.5 |
| Canada | 1.2 | 1.1 | 1.0 | 1.7 | 1.9 |
| **Emerging economies** | 4.0 | 4.1 | | 4.1 | |
| China | 5.2 | 4.8 | 4.9 | 4.4 | 4.4 |
| **Asia (excluding China)** | 4.7 | 5.4 | | 5.2 | |
| India | 6.5 | 6.9 | 7.0 | 6.5 | 6.7 |
| South Korea | 1.4 | 2.5 | 2.5 | 2.4 | 2.2 |
| Indonesia | 5.0 | 5.1 | 5.1 | 5.1 | 5.1 |
| **LatAm** | 2.3 | 2.0 | | 2.5 | |
| Brazil | 2.9 | 3.0 | 2.2 | 2.0 | 2.0 |
| Mexico | 3.2 | 1.1 | 1.8 | 1.2 | 2.2 |
| **EM Europe** | 3.1 | 3.1 | | 2.6 | |
| Russia | 3.6 | 3.2 | 3.4 | 1.5 | 1.1 |
| Poland | 0.2 | 3.0 | 2.9 | 3.5 | 3.4 |
| Turkey | 4.5 | 3.0 | 3.4 | 3.4 | 3.2 |
| **Other EMs** | 2.4 | 3.0 | | 3.9 | |

*Source: Datastream, IMF, Bloomberg and AXA IM Macro Research – As of 20 September 2024*
**Forecast*

| CPI Inflation (%) | 2023 | 2024* | | 2025* | |
|---|---|---|---|---|---|
| | AXA IM | AXA IM | *Consensus* | AXA IM | *Consensus* |
| **Advanced economies** | 4.7 | 2.6 | | 2.3 | |
| US | 4.1 | 2.9 | 3.0 | 2.6 | 2.3 |
| Euro area | 5.5 | 2.4 | 2.4 | 2.1 | 2.1 |
| China | 0.2 | 0.6 | 0.5 | 1.6 | 1.9 |
| Japan | 3.3 | 2.5 | 2.5 | 1.6 | 1.5 |
| UK | 7.3 | 2.5 | 2.6 | 2.0 | 2.0 |
| Switzerland | 2.1 | 1.3 | 1.3 | 1.3 | 1.3 |
| Canada | 3.9 | 2.4 | 2.6 | 1.8 | 2.0 |

*Source: Datastream, IMF, Bloomberg and AXA IM Macro Research – As of 20 September 2024*
**Forecast*

These projections are not necessarily reliable indicators of future results

# Forecast summary

| Central bank policy<br>Meeting dates and expected changes (Rates in bp / QE in bn) | | Current | Q4-24 | Q1-25 | Q2-25 | Q3-25 | Q4-25 |
|---|---|---|---|---|---|---|---|
| United States - Fed | Dates | 5.00 | 6-7 Nov<br>17-18 Dec | 28-29 Jan<br>18-19 Mar | 6-7 May<br>17-18 Jun | 29-30 Jul<br>16-17 Sep | 28-29 Oct<br>9-10 Dec |
| | Rates | | -0.50 (4.50) | -0.25 (4.25) | -0.25 (4.00) | unch (4.00) | unch (4.00) |
| Euro area - ECB | Dates | 3.50 | 17 Oct<br>12 Dec | 30 Jan<br>6 Mar | 17 Apr<br>5 Jun | 24 Jul<br>11 Sep | 30 Oct<br>18 Sep |
| | Rates | | -0.25 (3.25) | -0.25 (3.00) | -0.25 (2.75) | unch (2.75) | unch (2.75) |
| Japan - BoJ | Dates | 0.25 | 30-31 Oct<br>18-19 Dec | 23-24 Jan<br>18-19 Mar | 30 Apr - 1 May<br>16-17 Jun | 30-31 Jul<br>18-19 Sep | 29-30 Oct<br>18-19 Dec |
| | Rates | | unch (0.25) | +0.25 (0.50) | unch (0.50) | unch (0.50) | unch (0.50) |
| UK - BoE | Dates | 5.00 | 7 Nov<br>19 Dec | 6 Feb<br>20 Mar | 8 May<br>19 Jun | 7 Aug<br>18 Sep | 6 Nov<br>18 Dec |
| | Rates | | -0.25 (4.75) | -0.25 (4.50) | -0.25 (4.25) | -0.25 (4.00) | -0.25 (3.75) |
| Canada - BoC | Dates | 4.25 | 23 Oct<br>11 Dec | 29 Jan<br>12 Mar | 16 Apr<br>4 Jun | 30 Jul<br>17 Sep | 29 Oct<br>10 Dec |
| | Rates | | -0.50 (3.75) | -0.50 (3.25) | -0.25 (3.00) | unch (3.00) | unch (3.00) |

*Source: AXA IM Macro Research - As of 20 September 2024*

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




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