AXA Investment Managers

Investment Institute Macroeconomics

Tighter Global Financial Conditions

Monthly Investment Strategy

AXA IM Research

October 2022

Summary: October 2022

Theme of the month: Markets in a state of flux

- The dollar is a barometer of the defacto tightening in global financial conditions and its swift appreciation can expose cracks across the global financial system as sudden dollar liquidity needs can cause market function disruptions.
- Expectations about central banks' peak policy rates have been ratcheting higher for over a year, and the cyclical shock in US real yield has been unprecedented. Tighter monetary policy may be closer to bearing fruit in taming demand inflation, as supply side pressures are starting to ease.
- Credit spreads have been resilient in the face of macro headings and unprecedented upheaval in interest rate markets, a reflection of broadly healthy corporate balance sheets. Historically, current credit yield levels are consistent with above average returns over medium-longer term, eg a 5-year period.
- The growth/value rotation has run out of steam and the outperformance of defensive stocks suggests a slowdown in economic activity. Rising rates have pulled multiples lower at both ends of the sales growth spectrum; 'junk' value in the spotlight. Earnings headwinds may be gathering as macro weakens.

Macro update: Tighter Global Financial Conditions

- Inflation remains elevated in all jurisdictions and is increasingly seeping into core inflation pressures. External supply factors are starting to fade, including energy price base effects to come during Q4. However, domestic supply constraints, including labour markets remain important in several areas.
- Activity is slowing, but at differing rates. The UK appears to have entered recession in Q3. This is likely the case for some Eurozone economies, but it is more balanced as to whether the Eurozone as a whole will dip before Q4. The US may fall into recession slightly later in Q4.
- Central bank policy tightening remains across DMs and still in most EMs. The Fed now looks unlikely to slow the pace of tightening until December, the ECB looks likely to follow. We expect the BoE to hike by 0.75% in November as well. The BoJ continues to keep an accommodative fiscal stance.
- Few areas have been as politically chaotic as the UK, where the Prime Minister has changed again. Italy's new government is learning lessons from the UK experience, to the benefit of Italian markets. China's Party Congress reiterated its commitment to development. We await US midterm elections.

Investment strategy: assets are feeling the heat from tighter financial conditions

- FX: US data continue to imply more pressure from Fed policy and thus USD strength. Japanese intervention can't change the JPY trend lower; only Fed or BoJ policy could do that. A confluence of factors also keeps EUR, GBP & SEK under pressure. AUD might be the better candidate for a high beta rebound.
- Rates: The level of volatility at the front end of the interest rate curve has jumped by a factor of seven in 2022. This has had spillover effects and implied volatility has increased for longer tenors across the curve. Historically, higher levels of volatility have augmented the term premium for risk-free bonds.
- Credit: Default predictors have deteriorated further since the summer, especially those comprising the impact of persistently rising interest rates. This has pushed default valuations into the red across most HY cohorts. Still, the rise in spreads and rates has brought credit markets to an attractive entry point.
- Equity: Q3 earnings releases have started, and results have been quite decent so far, in line with the ISM levels. But all eyes are on 2023 now and although 2023 EPS forecasts have been revised lower since Jan, they are out line with consensus growth and even more so with our expectations.

Central scenario

Summary – Key messages

Monetary policy

Most central banks continue to tighten as high inflation and inflation expectation concerns persist. Slowing activity to alter this outlook around turn of year. PBoC and BoJ major exceptions.

Inflation

Supply-chain pressures ease, but energy and domestic pressures persist. Headline inflation past peak, but core slow to fall next year.

Fiscal policy

Europe adding to fiscal supports to ameliorate cost-of-living crisis and more measures likely over difficult winter. US deadlocked in Congress.

Growth

Growth beginning to slow more obviously. Recessions expected in Europe and US. Gas interruption to result in severe slowdown over winter.

Our central scenario:

Tighter financial conditions and energy inspired inflation shock to see recession in Europe and the US.

We forecast global growth to rise by 3.1% and 2.4% in 2022 and 2023.

Economic slowdown amidst supply pressures and tighter monetary policy. Inflation slow to fall in 2023.

Emerging Markets

Inflation rising across EM. Central banks hike more, some add FX intervention. Some fiscal response add to fragile finances

Rates

Rates push higher as Fed struggles to rein in economy. Technicals may account for some of inversion, but broadly reflects growth concerns.

FX

Dollar continues to remain elevated and prone to appreciate. Risk outlook key to support. Sterling rebound following government U-turns.

Credit

Volatile spreads in 2022 on central bank and geopolitics, but spreads now quite wider by standards of last decade.

Equities

Earnings expectations are getting shakier due to inflation & growth risks. Despite adjustments to date, risks still to downside.

Alternative scenarios

Summary – Key messages

Entrenched supply shock *(probability 35%)*

What could be different?

- Escalation in Ukraine conflict
- Russian oil supply interruption into European winter
- COVID outbreaks spreads again: China and/or new mutations
- Post-pandemic structural persist. Supply shocks last longer
- Inflation expectations rise, affecting wages and persistence

What it means

- Growth weaker, employment could start to fall, but inflation remains elevated
- Monetary policy ill-equipped to deal with supply shocks, deteriorating inflation credibility forces still tighter monetary policy in DMs

Market implications

- Risk appetite deteriorates / equities sell off / credit widens
- Sovereign yields reprice higher
- Dollar remains elevated
- EM debt to come under pressure

A global boost *(probability 10%)*

What could be different?

- Geo-political tensions ease – peace in our time.
- Labour market participation recovers, strong income growth and easing inflation pressures
- Productivity boost following investment rebound and structural post-pandemic adjustments

What it means

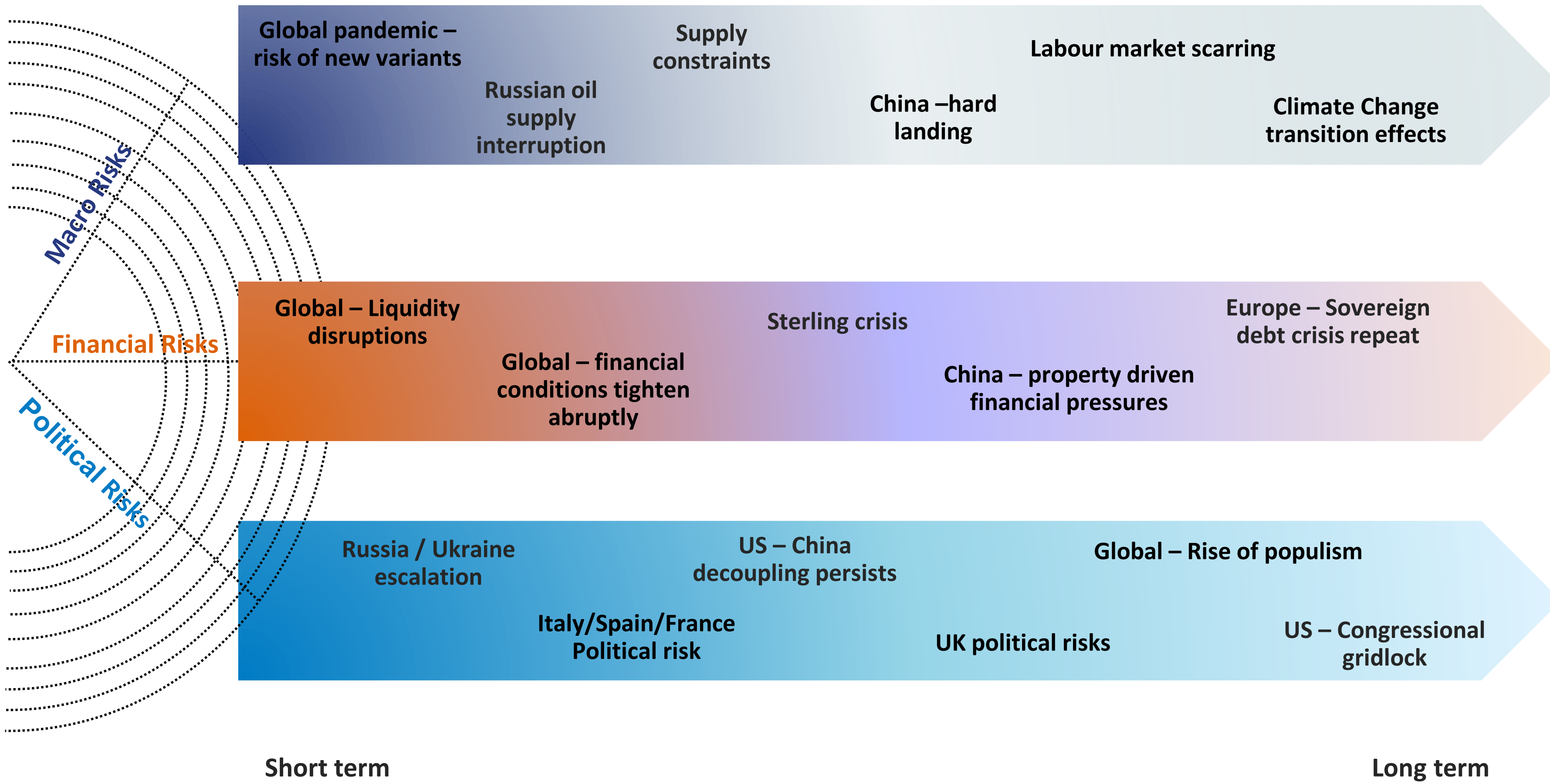
- Growth surprises on the upside in most regions
- Inflation fades more quickly towards and below central bank targets
- Monetary policy proves more patient than expectations

Market implications

- Risk-on environment, equities make further gains, growth retains lead over value
- UST softens, EUR strengthens
- Spreads grind tighter

RISk Radar

Summary – Key messages



Contents

Theme of the month

Markets in a state of flux

Theme of the month: markets in a state of flux

Ongoing dollar strength a headwind for global markets and risk premia

Everything's better in America

- The dollar is a barometer of the defacto tightening in global financial conditions. A confluence of cyclical and structural factors has driven a persistent and speedy appreciation in the dollar since early 2021 which has accelerated in 2022. A stronger cyclical position for the US, an ever more hawkish Federal Reserve as inflation has kept overshooting expectations, fragile investor risk appetite and a perilous geopolitical backdrop.

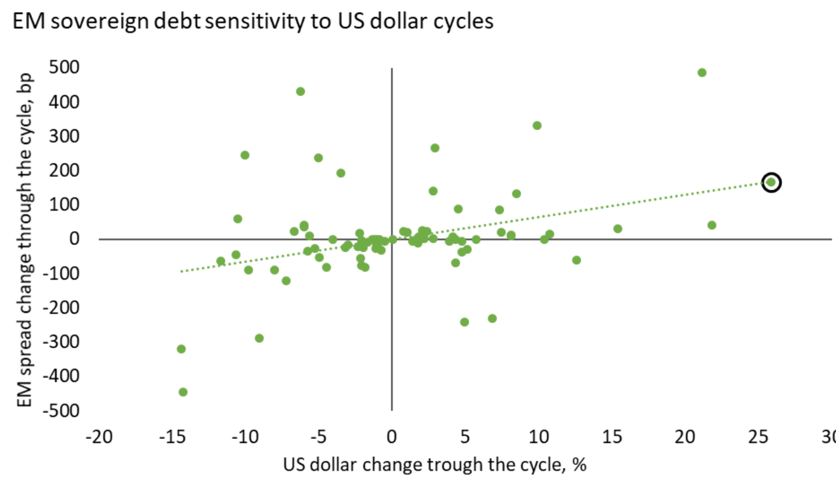
Dollar strength can expose cracks across the global financial system

- A strong dollar can become a trigger for stresses in different corners of the global financial system. Dollar debt in emerging markets becomes harder to service (wider EM spreads); sudden dollar liquidity needs can cause market function disruptions (cross currency basis swap premia); undue currency weakness raises import-inflation risks (central banks need to react). Japanese yen weakness for example (has breached the 150 level) risks a response by the BoJ that could result in further upward pressure in global yields.

Dollar index nearing its millennium highs

Source: Bloomberg & AXA IM Research, Oct 2022

EM external debt spreads are sensitive to dollar cycles



Source: ICE, Bloomberg & AXA IM Research

Theme of the month: markets in a state of flux

Peak policy rates and peak long end yields: are we there yet ?

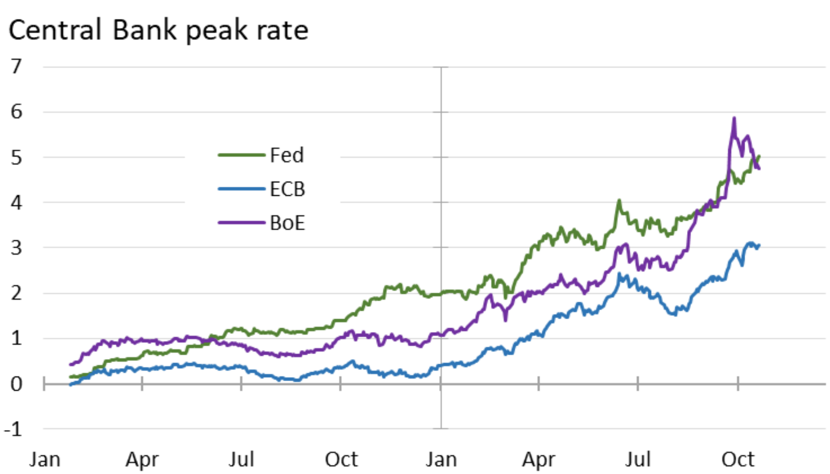
A 'hawkish ratchet' dynamic has plagued markets for over a year

- Expectations about central banks' peak policy rates have been ratcheting higher for over a year, with the current repricing higher comprising the fifth wave in the case of the US Federal Reserve, now priced above 5%, with the Bank of England just below that level and the European Central Bank above 3%. This has kept risk appetite under pressure, a backdrop not likely to change before apt signs that the Fed is set to pivot ('pivot' meaning first a slowdown and then a pause in their interest rate hikes).

Real rates have risen fast and furiously

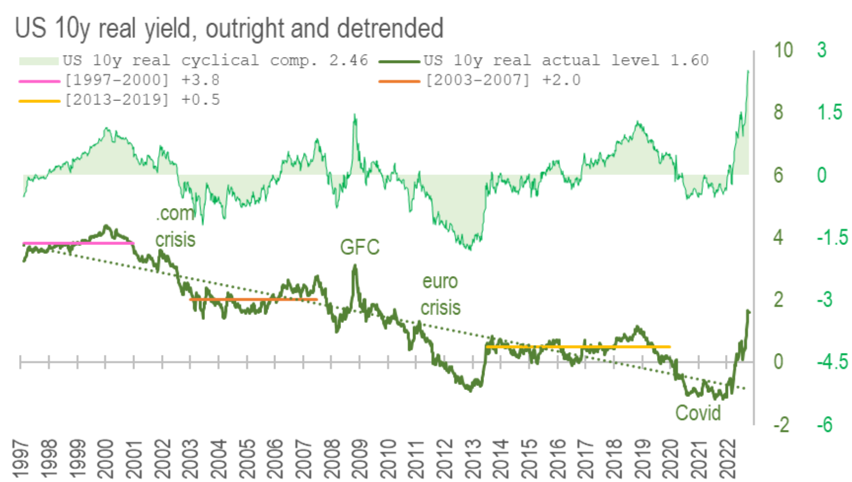
- The speedy hawkish repricing of US Fed policy has pushed US real yields into a rapid path higher, exacerbated by stubbornly elevated levels in the Fed's reverse repo facility, that could alleviate the effects of liquidity withdrawal if unwound. On a cyclical basis (i.e., the level of the real yield once detrended), the upward shock has been unprecedented, twice larger than the GFC or the 2013 taper tantrum. Momentum-wise, one could argue that the move has been excessive and should be near its peak.

Peak policy rate expectations have been climbing for a year



Source: Bloomberg & AXA IM Research, Oct 2022

Cyclical shock in US real yield has been unprecedented



Source: Bloomberg & AXA IM Research, Oct 2022

Theme of the month: markets in a state of flux

Softening inflation figures a necessary condition for a central bank pivot

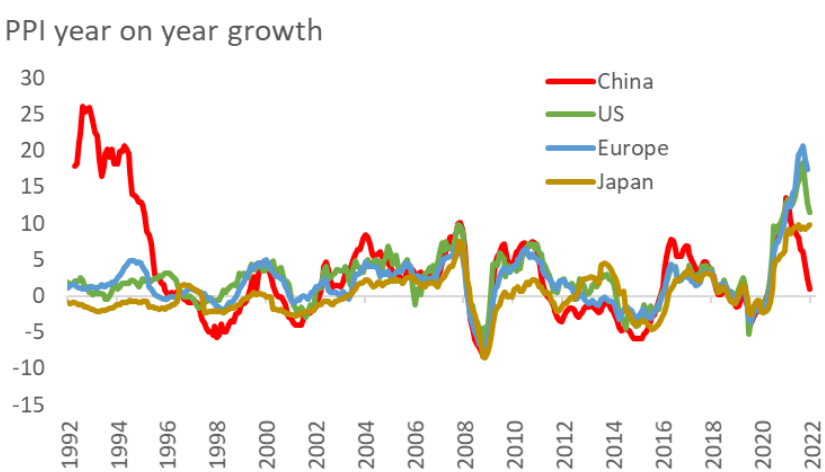
Closely watching and hoping for a U-turn in inflation figures

- While Consumer Price Indices releases continue to come out above expectations and inflation surprise indices are pointing up, Producer Price Indices are exhibiting a material reduction, led by China's PPI. A testament to the easing in supply side pressures, this suggests that tighter monetary policy may be closer to bearing fruit in taming demand inflation.

Anchored inflation expectations are key

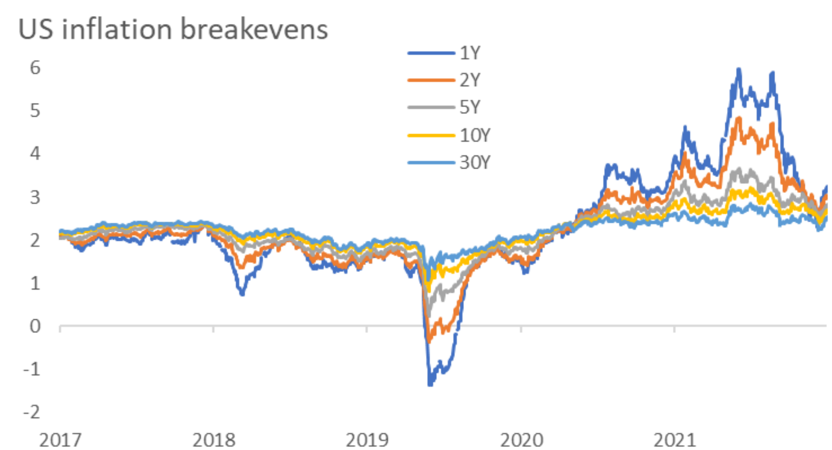
- Market based inflation expectations have been reasonably well behaved. In the US, inflation breakevens have been reverting meaningfully back towards the 2% target, especially at the short end of the term structure (1Y and 2Y tenors). The most recent CPI print has disrupted this reversion but the renewed hawkish stance by the Fed should help keep this anomaly short-lived.

Producer price indices stating to roll over more meaningfully



Source: Bloomberg & AXA IM Research, Oct 2022

US inflation pricing reversal to 2% target disrupted by latest CPI figures



Source: Bloomberg & AXA IM Research, Oct 2022

Theme of the month: markets in a state of flux

Credit has been the innocent bystander so far; entry points attractive

Credit spreads have been relatively resilient

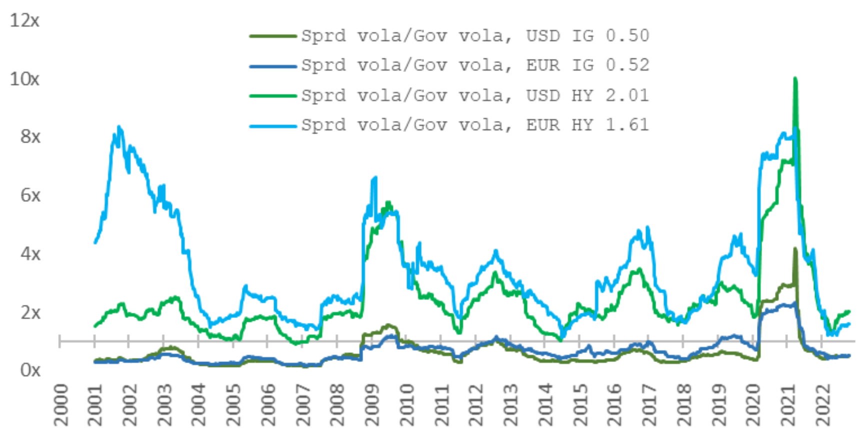
- Credit spreads have inevitably widened in 2022 but not to the extent that one might expect, given the macro headings (spreads not pricing recession), or the upheaval in interest rate markets, both yield levels and yield volatility. Ultimately, this may well be a simple reflection of the fact that corporate balance sheets remain in decent shape. On the other hand, this raises the risk of further spread widening if recessionary pricing takes hold in earnest.

Yield and spread repricing makes for attractive entry point

- Regardless, the entry point in terms of credit yield is already very attractive. Historically speaking, current yield levels are consistent with above average returns over a, say, 5-year period. Investors who seek to deploy cash, should consider to start scaling into credit. *Annualsied return expectations over next 5 years: USD IG 6.5%, EUR IG 4.9% (shown in chart), USD HY 7.3%, EUR HY 5.4%.*

Spread volatility vs interest rate volatility near historic lows

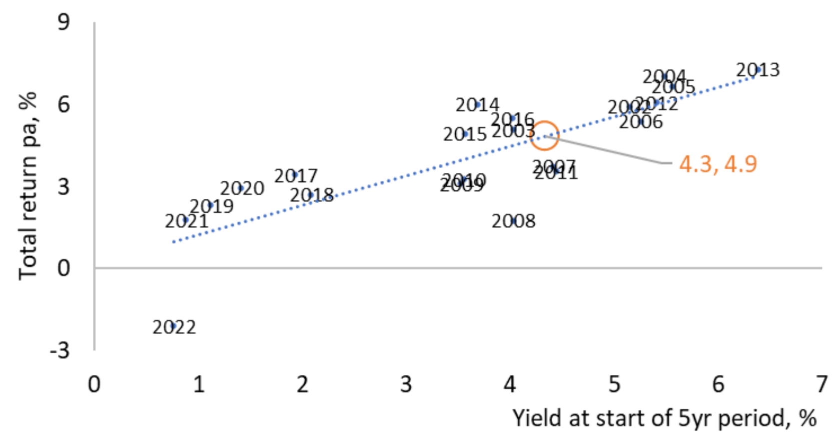
Ratio of spread volatility vs govie yield volatility



Source: ICE, Bloomberg & AXA IM Research, Oct 2022

Current credit yields offer attractive return prospects

EUR IG total return pa over 5yrs vs yield at start



Source: ICE, Bloomberg & AXA IM Research, Oct 2022

Theme of the month: markets in a state of flux

Global equity - market focus shifts to economic growth

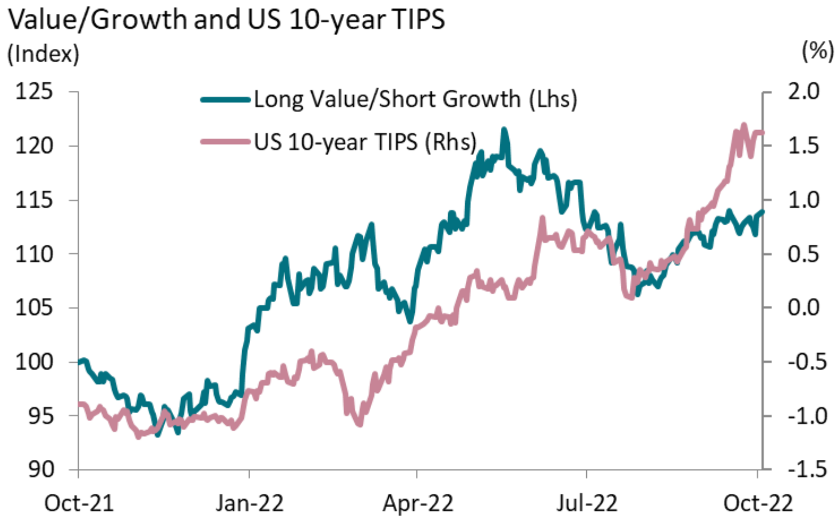
The growth/value rotation has run out of steam

- Since the start of the year, the strong debate around the reaction of central banks to the inflation momentum has been one of the main drivers of the market. The rise in interest rates has fueled the rotation towards value from growth, but in recent weeks we have seen a pause in this relationship. Equity markets may be suggesting that we are nearing the peak in rates.

Outperformance of defensive stocks suggests a slowdown in economic activity

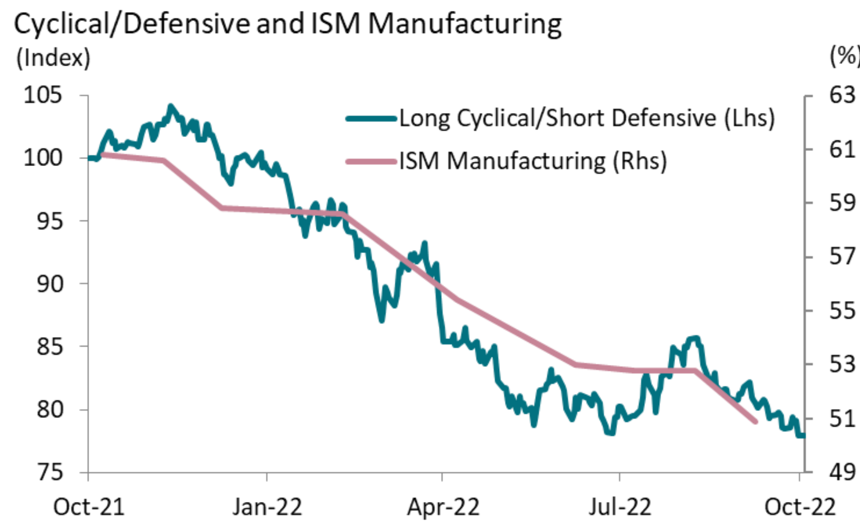
- This points to a reappraisal of the equity market's macro drivers. Defensive stocks, offering protection in times of recession, have consistently outperformed cyclical stocks as of Q4 2021. The market appears to concur that economic activity remains at risk of further deceleration in the coming months and quarters.

The influence of interest rates seems to be fading …



Source: MSCI, Refinitiv and AXA IM Research, October 2022

… an equity markets are focusing towards economic activity



Source: MSCI, ISM and AXA IM Research, October 2022

Theme of the month: markets in a state of flux

US equity - darkening outlook but bright statistics

Currently navigating choppy waters

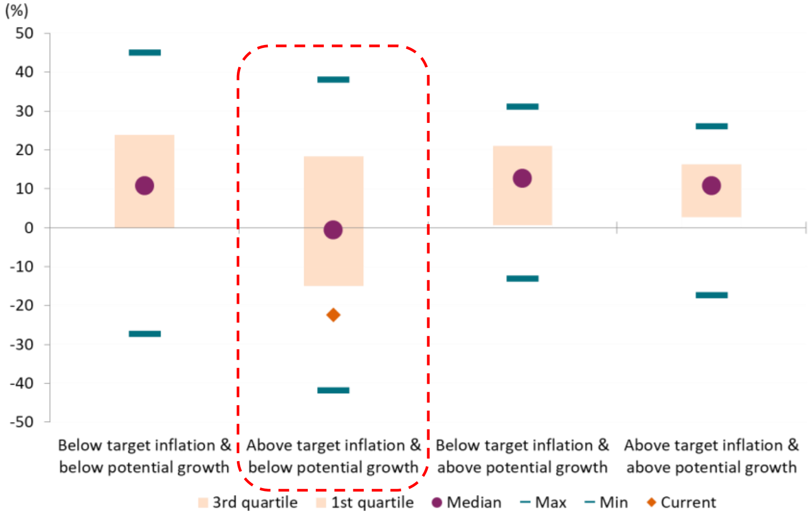
- Galloping inflation and subdued economic growth prospects are certainly not the right mix for stocks. In this regime, the US stock market delivers its poorest performance (-0.7% median p.a.). The current performance of -22.5% year to date doesn't make it the worst year on record, but the headwinds are making downside support brittle. Our outlook does not suggest any improvement in the short term, with inflation to remain high (5.2% vs 3.8% consensus) and below consensus GDP growth in 2023 (-0.2% vs 0.4%).

Time is your best friend

- While it's hard to say if we've reached the bottom of the near market, it's easier to argue that stocks remain a rewarding asset depending on the time horizon. For any investment beyond a year, positive gains by investing in stocks are quite likely (more than 4 out of 5 odds of positive outcome). As your investment horizon increases so does the probability of a positive outcome.

The most challenging environment for equities …

S&P 500 Absolute returns and macro regimes

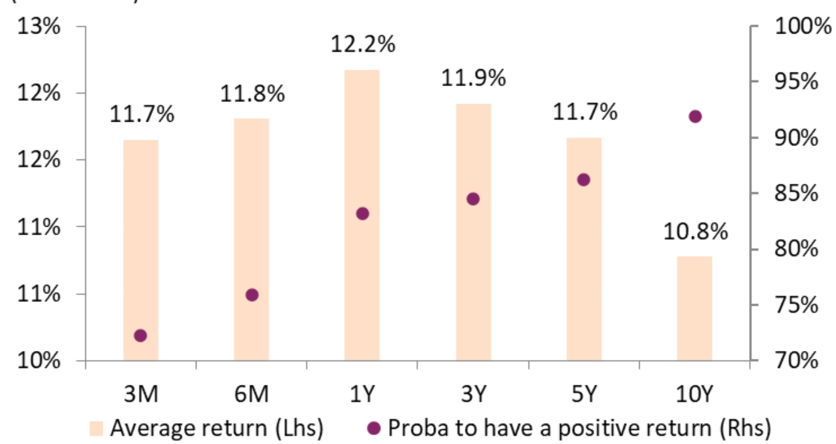


Source: S&P, ICE BAML and AXA IM Research, since 1951, Target inflation = 2%, October 2022

but being calm and patient pays off

S&P 500 Absolute returns by investment horizons

(Annualized)



Source: S&P and AXA IM Research, since 1963, October 2022

Theme of the month: markets in a state of flux

Europe equity – chasing the junk value

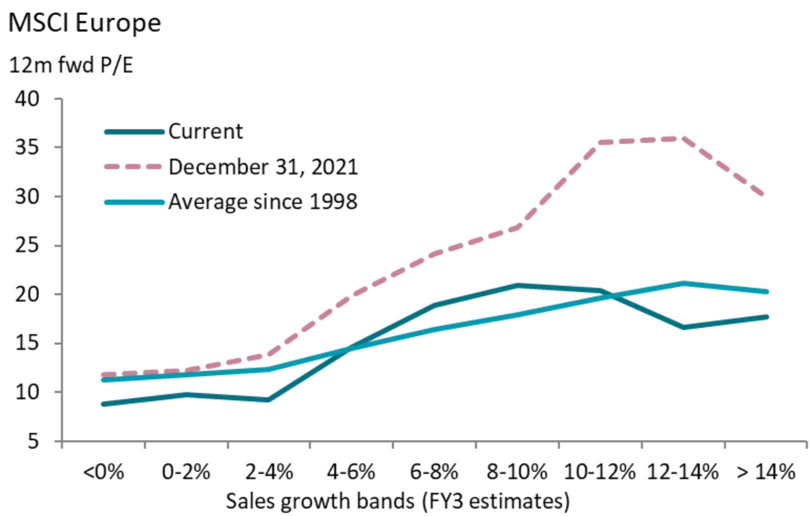
Rising rates have pulled multiples lower at both ends of the growth spectrum

- Europe is facing a few problems beyond the inflationary supply shock. While the rise in interest rates due to the rise in consumer prices has also led to a rotation into cheaper assets in this region - it is worth noting that the low-growth segment of the market (aka deep value) has also been penalised and now trades at multiples below its long-term average.

Junk value in the spotlight

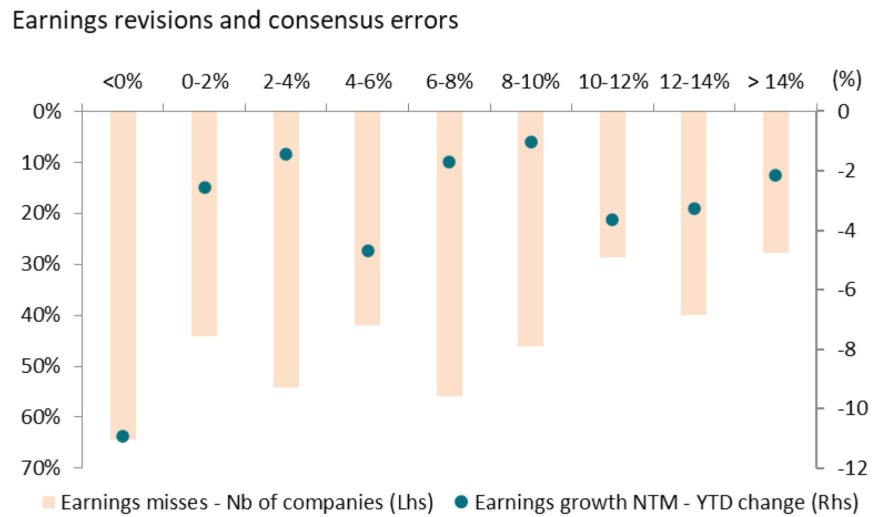
- The downgrade of low growth makes more sense when viewed through the lens of fundamentals. With worse-than-expected earnings releases coupled with downward revisions below the rest of the market – these companies have been punished by investors looking for companies with sound and sustainable balance sheets.

The de-rating did not affect only high-growth stocks …



Source: MSCI, IBES and AXA IM Research, since 1998, October 2022

… it has also affected the junk value spectrum



Source: IBES, Datastream and AXA IM Research, October 2022

Macro outlook

Slower to slow down

US

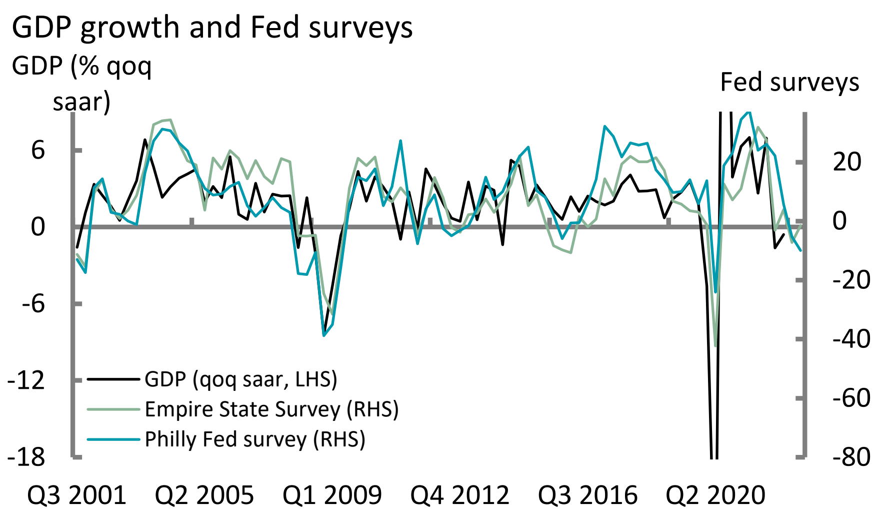
Firmer Q3, recession delayed ?

- Q3 GDP looks likely to come in firmer than our initial expectation, we now expect it around 2% (saar). Momentum may also see the economy avoid contraction in Q4 – deferring the start of recession until early 2023. However, survey evidence continues to worsen, CEO confidence is its worst since 2008-09 and our recession model looks set to signal recession as Fed tightening persists. Short-term quarterly changes lead us to revise growth expectations to 1.8% (from 1.5%) and -0.2% (-0.3%). Consensus is 1.7% and 0.4%.

Inflation to fall, but target unlikely before 2024

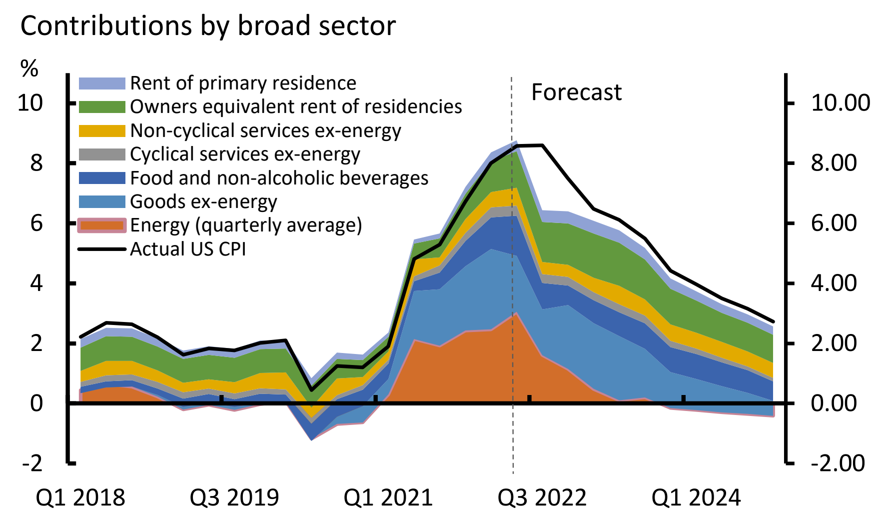
- Inflation dipped again in September to 8.2%, further from its 9.1% June peak as oil prices drove gasoline costs lower. However, 'core' CPI rose to a new 40-year high of 6.6% as inflation spread through shelter, food, apparel and education. We forecast inflation to fall sharply over coming quarters, but with price pressures continuing to spread, particularly in housing, we expect it to take the Fed until 2024 to return inflation to target. We see average rates of 8.2% and 5.2% this year and next (consensus 8.0% and 4.0%)

Surveys continue to weaken



Source: FRBP, FRBNY, BEA, AXA IM Research, October 2022

Inflation forecast to fall more slowly than consensus



Source: BLS, AXA IM Research, October 2022

November a month of decisions

US

Fed forced to keep tightening sharply

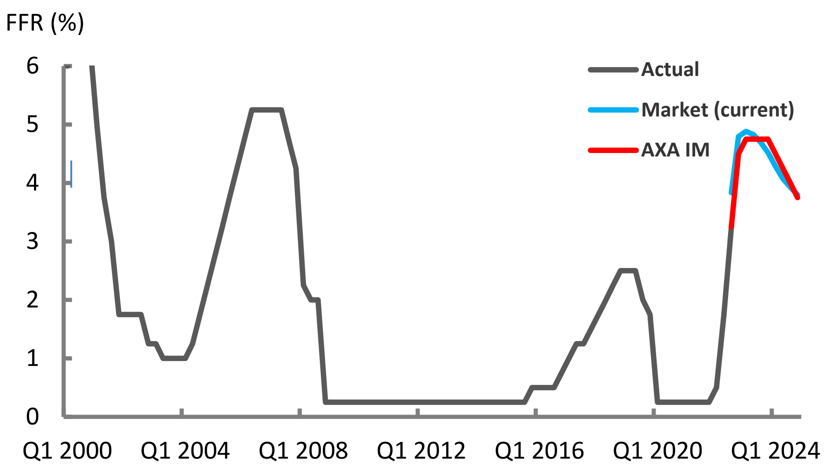
- Minutes described participants as disappointed at inflation's persistence and the rise in September's core has dissuaded us from the view that Fed will taper the pace of hikes in November. We now see 0.75% in November, 0.50% in December and add a final 0.25% in February to see a peak rate at 4.75%. Expectations of a slower pace of inflation easing see us defer expectations for a cut to 2024. The Fed may also have to keep a closer eye on QT as Treasuries liquidity becomes an issue again.

Midterms: big politics, more limited economic impact

- 8 November midterms will be critical in determining the next political development as to who will run for President in 2024. Economically the impact will be less. The most likely outcome is a divided government, possibly even a divided Congress. This should ensure political gridlock, which could become important if recession requires discretionary fiscal intervention. If Republicans take both chambers, the risk of confrontation with the White House would raise shutdown and debt-ceiling episodes.

Expect lower peak, but in place for longer

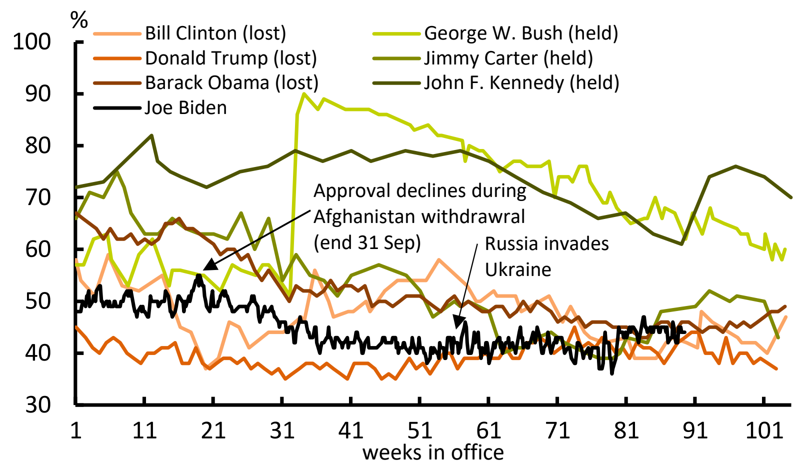
Fed Funds Rate and forecasts



Source: FRB, Bloomberg, AXA IM Research, October 2022

Weak approvals suggest midterm losses

Presidential Approval Ratings



Source: FiveThirtyEight, The American Presidency Project, AXA IM Research, October 2022

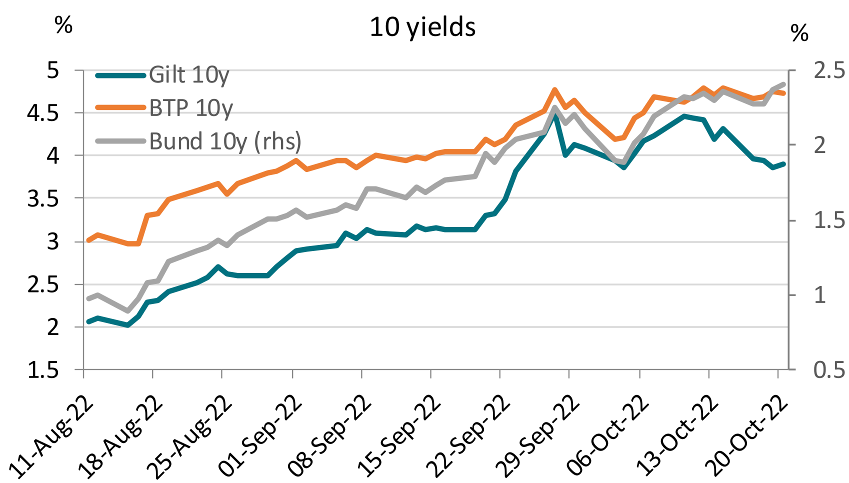
Rome likely learned from London's havoc

Euro area

Rushed, radical decisions unlikely from upcoming Italian government

- Georgia Meloni and Brothers of Italy have won the general election. Going hand-in-hand with the League having disappointed in the actual vote (vs polls) and the evidence of the UK's recent fiscal problems, there is now a stronger likelihood that PM Meloni will implement a "responsible, gradual" policy - at least on the economic front – which is also suggested by the moderate nominated Finance Minister.
- These developments provide further reassurance of well-behaved market in the short-run, though does not fully allay debt sustainability concerns for the medium-run. Combined with concerns about political stability, this supports our cautiousness on BTP Bund spread.

Havoc on UK rates market with little contagion to euro curves



Source: Refinitiv, AXA IM Research, October 2022

Next key dates for Italy

Date	Comment
Mid-late Nov.	Submission of the 2023 budget law. Interesting to see how much (permanent) fiscal easing will be planned (also on a multi-year basis) as well as whether the macro environmment will be revised
After a few weeks of 2023 draft submission	Opinion of EC on submitted draft budget bill
31-Dec	Complete 55 objectives to receive €21bn NGEU funds
31-Dec	Final day by which 2023 budget law is aimed to be voted

Source: AXA IM Research

Risk of fiscal slippage in 2023 may add to ECB's hawkish narrative

Euro area

Governments rather focused on domestic political economy concerns

- Planned significant untargeted, permanent demand supporting measures (including caps on gas/electricity prices and fuel tax rebates).
- Together with optimistic growth forecast implies risk of fiscal slippage.

ECB rate frontloading to continue

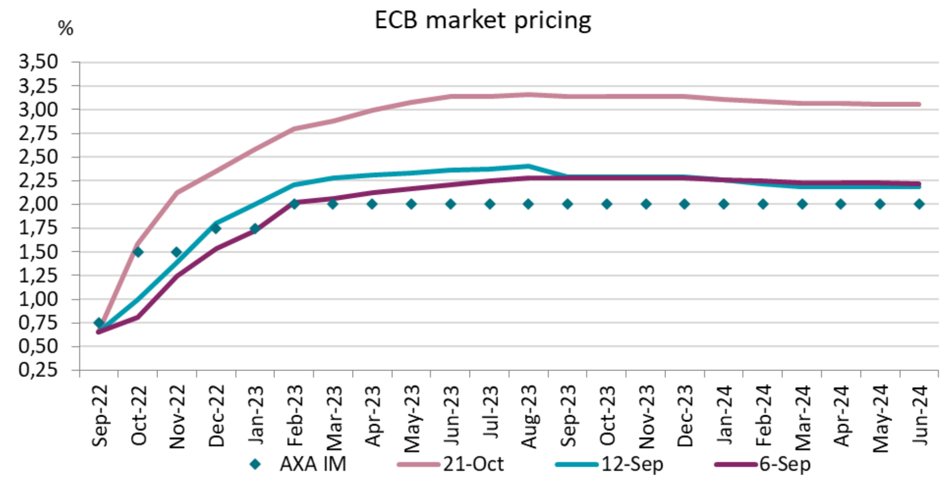
- Fiscal responses to add fuel to the ECB's fight. Could go quicker and further than our peak rate expectation of 2% by February. We forecast +75bp in October, +25bps in December and February. We continue to think that markets are overpricing the ECB with rates staying c.3% throughout 2023.
- APP QT discussions have started but are unlikely to make decisions before Q2 2023. ECB is more likely to make decisions on TLTRO/excess reserves remuneration first.

Risk of fiscal slippage in 2023

	Germany	France	Spain
Government's 2023 public deficit forecast (2022), % of GDP	2 (3.25)	5 (5)	3.9 (5.0)
Government's 2023 GDP forecast, %	-0.4 (AXA IM: -1.5)	1.0 (AXA IM: 0.0)	2.1 (AXA IM: 0.6)

Source: Ministries of Finance

We continue to find ECB market pricing terminal rate too aggressive



Source: Bloomberg, AXA IM Research, as of October 21

End of 'Trussonomics'

UK

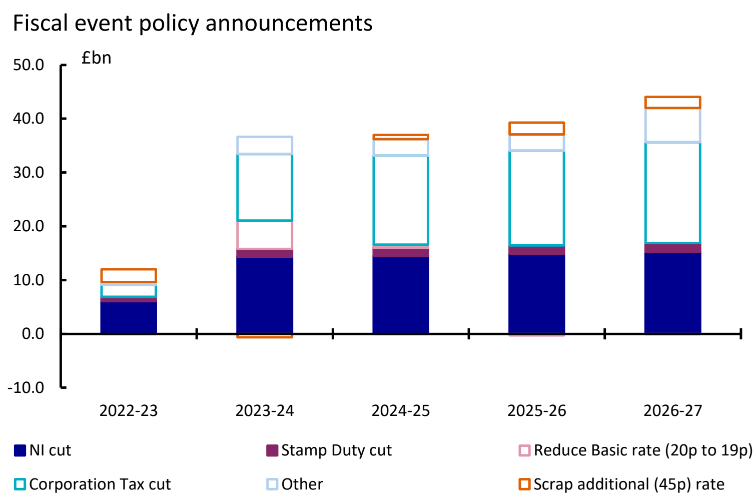
Liz Truss resigns as PM after just 45 days in office

- Liz Truss has resigned as Prime Minister after just 45 days in office – cementing her place in history as the shortest serving UK PM. The now infamous fiscal event triggered weeks of turmoil in politics and markets, and ultimately Truss' demise. Chancellor Hunt has since reversed most of the policies. The party are seeking to appoint a successor rapidly, with the leadership contest set to be concluded by 28 October. Rishi Sunak, Penny Mordaunt and ex-PM Boris Johnson are currently seen as frontrunners.

Economic outlook remains fragile, with growth slowing and price pressures broadening

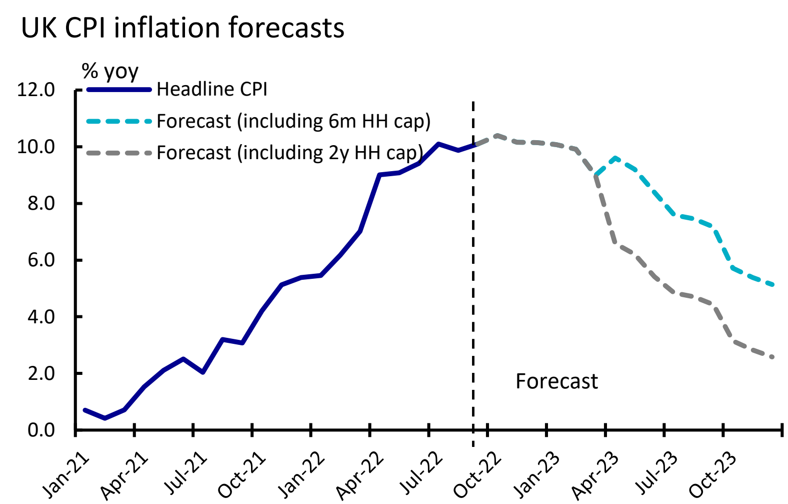
- Despite the significant political implications of the PMs resignation, we are not convinced that it will have a material short-term economic impact. We continue to see growth at 4.2% and -0.7% in 2023. The shortening of the household energy price cap to six months could see inflation much higher in 2023. In our baseline we see inflation averaging 9.0% and 5.6% over this year and next. Currently gas futures suggest that if the Ofgem price cap is reinstated energy prices could rise to around £4,000 in April pushing inflation to 7.9% in 2023.

Fiscal event policies almost entirely scrapped



Source: HMT, AXA IM Research, October 2022

Removal of cap could have material impact on inflation outlook



Source: ONS, AXA IM Research, October 2022

Market pricing moderates as BoE on course to hike by 75bps

UK

Market pricing moderating ahead of Nov MPC

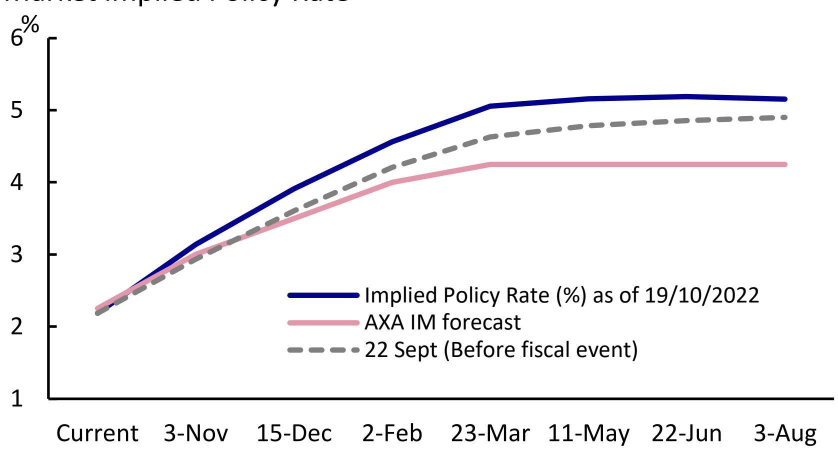
- Markets have repriced significantly following the fiscal u-turns from the government and Ben Broadbent's comments that he saw it unlikely that 'official rates would have to rise as much as currently priced in financial markets'. The Bank of England's November Monetary Policy Committee meeting will be watched closely following weeks of market turmoil. We expect the MPC to hike Bank Rate by 75 basis points with the tightening of the fiscal stance lessening the need for the BoE deliver a larger hike.

QT to accelerate with gilt sales pencilled to begin on 1 Nov

- Following the announcement of their long-dated gilt purchase program, the BoE delayed active gilt sales scheduled to start and paused planned corporate bond sales. The BoE has confirmed they will commence gilt sales on 1 November, to avoid overlapping with the Budget, and excluding longer-dated gilts from the auction to reduce the risk that the tightening cuts across their previous intervention to prevent disorderly moves in long-dated gilt yields. Market conditions remain uncertain, so further delays remain possible.

Market pricing for BoE hikes has moderated since U-turns

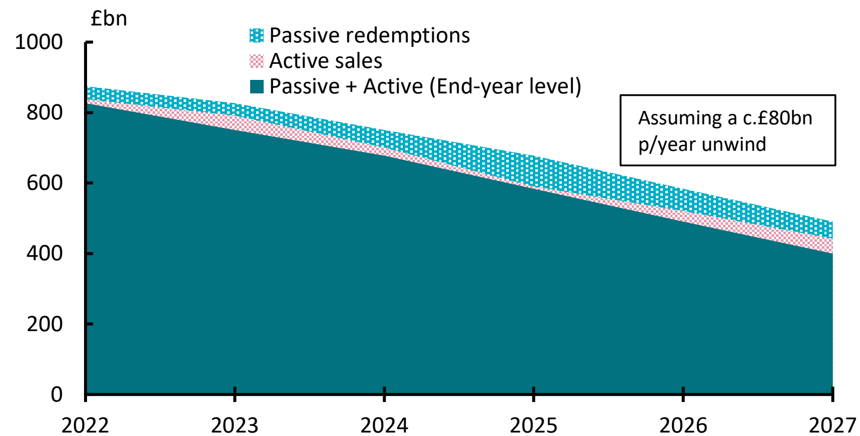
Market implied Policy Rate



Source: Bloomberg, AXA IM Research, October 2022

Active sales set to form a small part of total unwind

Unwind of APF gilts - Passive and Active



Source: Bank of England, AXA IM Research, October 2022

Headline growth masks sector divergence

China

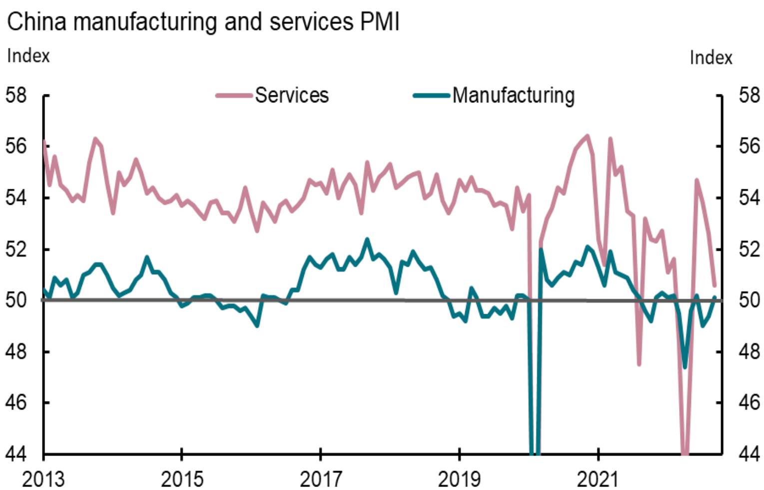
Mixed performance across industries

- Partial data points to a modest recovery in headline growth, but wide divergence across sectoral performance continued in September. The manufacturing PMI rose above the waterline, but services activity weakened sharply due to tightened COVID controls ahead of the National Day holidays. Our high-frequency economic indicator, which leans towards industrial activity, also recovered strongly after a weak start to September. However, given the renewed COVID flare-up post the holiday and tightened controls ahead of the Party Congress, growth momentum might have softened again this month

Piecemeal policy easing continues

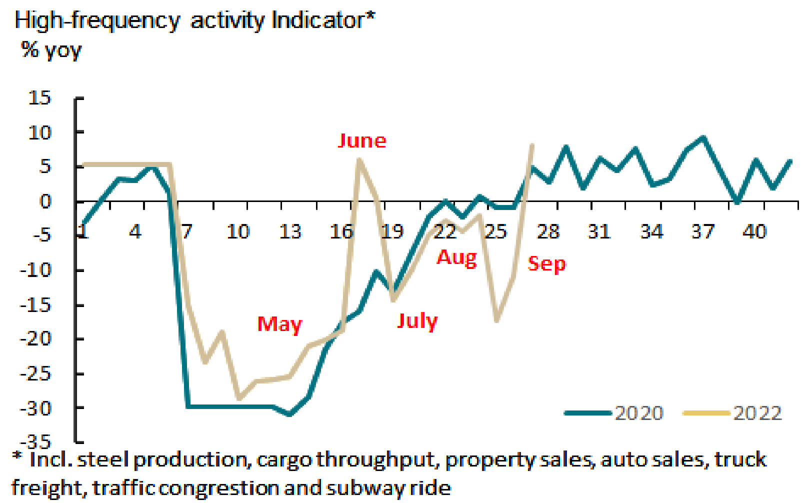
- Policy easing has ramped up, but its scale remains small compared to the pressure the economy is under. Increased support on infrastructure construction and completion of unfinished housing projects to reduce mortgage boycotts helped to keep industrial activity firm. On the monetary side, more aggressive guidance from the PBoC on lending to corporates boosted bank loan growth to a 3-month high. However, supports to households which continue to bear the brunt of the COVID shock remain missing

PMIs show diverging performance



Source: CEIC, AXA IM Research, October 22

Activity recovers after a weak start to September



Source: UBS, WIND, AXA IM Research, October 22

Party leaders vow to prioritize economic development

China

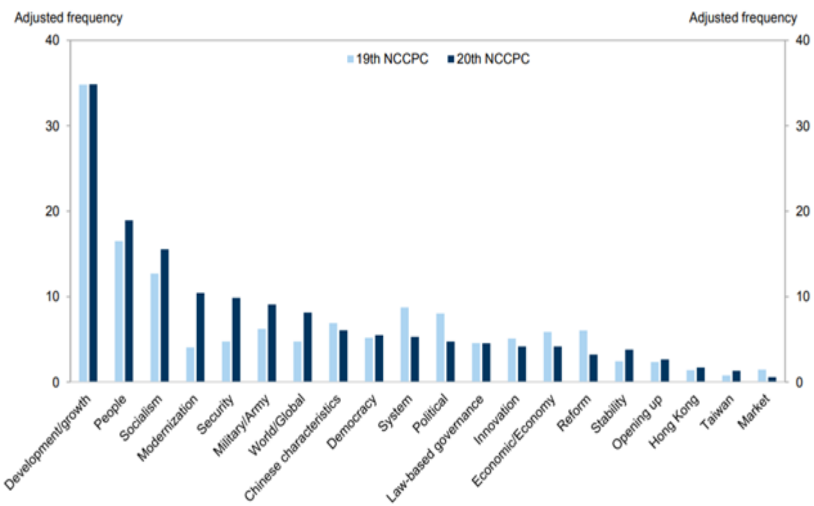
"Development First" doctrine remains

- President Xi's Report at the beginning of the 20th Party Congress hit all the right notes. It stated that the party still sees "economic development" as top priority in building a modern and prosperous China. In doing so, it vows unwavering support to the private economy, continuing to pursue high-quality opening up, and letting the market play a decisive role in resource allocation. The Report also highlighted the importance of education and technology as critical inputs into China's future advancement, suggesting the campaign-style crackdowns on tech and tutoring sectors have broadly come to an end

Concerns about "security" elevated

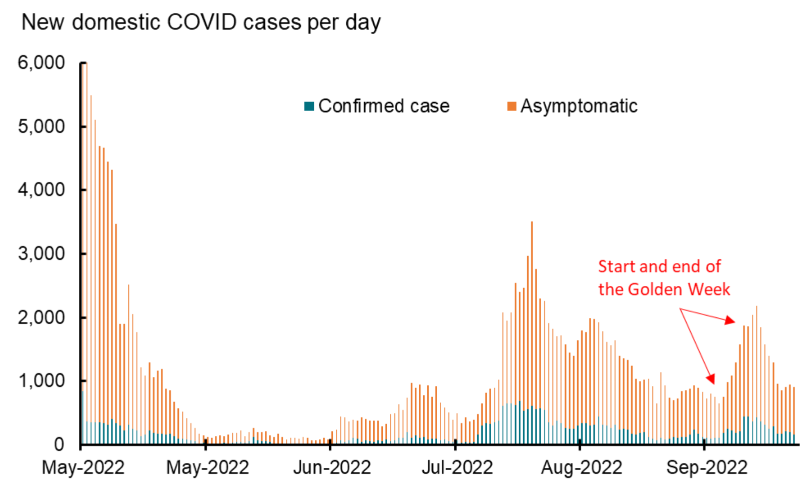
- The importance of "security" was elevated in this year's Report. A rapidly changing global environment has heightened China's concerns about food, energy, technology, supply chains and national securities. On Taiwan, the President reiterated the long-held Party line that Beijing would "devote utmost" effort and present "maximum sincerity" for a peaceful reunification but would never renounce the option of using force. On the pandemic, Xi called the Zero-COVID policy a success, suggesting no imminent policy pivot

"Development" remains center; importance of "security"



Source: Goldman Sachs, AXA IM Research, October 22

Zero-COVID policy sets to stay but implementation can change



Source: CEIC, AXA IM Research, October 22

Weak yen adding to inflationary pressures

Japan

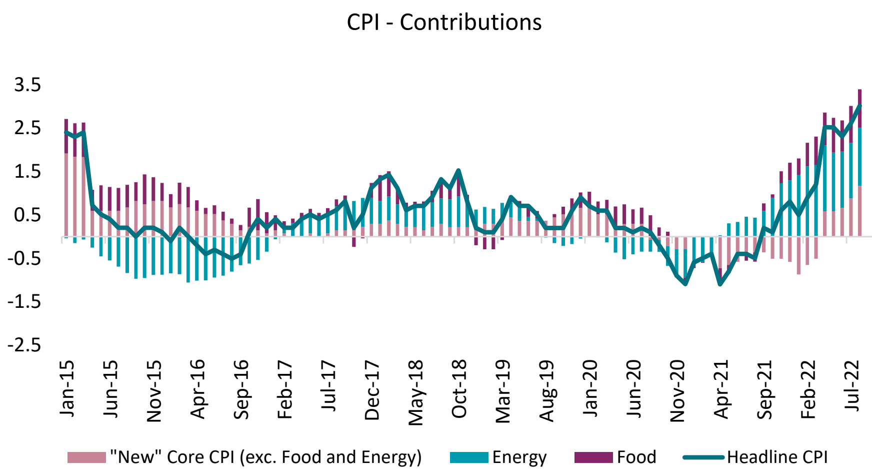
Inflation ex Fresh Food rose to 3% in September

- Prices continue to rise in Japan, with core CPI (excl fresh food) rising to 3%, above the BoJ's 2% target. Current price rises arenot expected to persist and are thus unlikely to shift BoJ policy, but they will continue to weigh on real incomes and household spending. Higher prices for non-fresh food, accommodation and imported goods drove the pickup. Looking ahead we expect yen weakness to peak in Q4 at 3.2% before gradually slowing to 2.7% in Q1 2023.

Trade balance deeply in the red on weak yen

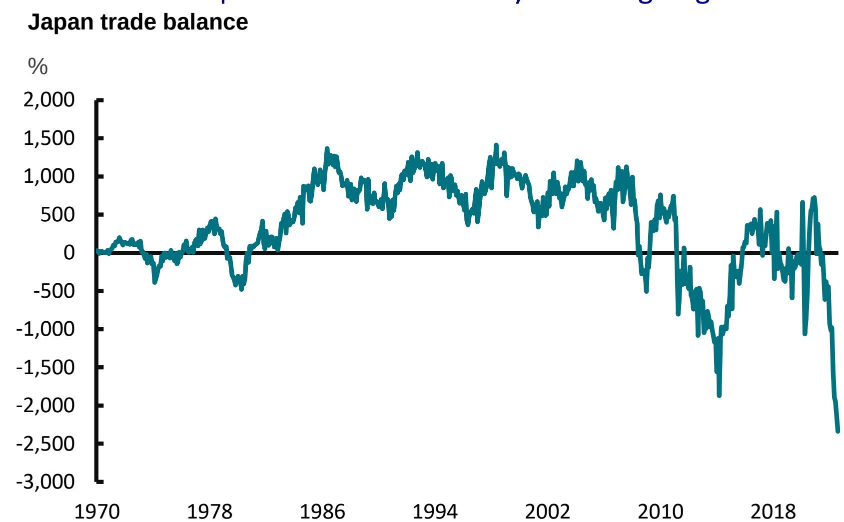
- The weakening currency is also contributing to Japan's trade deficit which has widened over recent months, posting a ¥2tn deficit in September after hitting a record in August as energy import costs continue to take a large toll . Export gains may start to reverse this trend but slowing global demand could see the deficit high for the coming months.

Inflation rose further in September



Source: Refinitiv, AXA IM Research, October 22

Trade balance posted a small recovery following August's record deficit



Source: Refinitiv, AXA IM Research, October 22

AXA Investment Managers

BoJ to stay on course despite Yen weakness

Japan

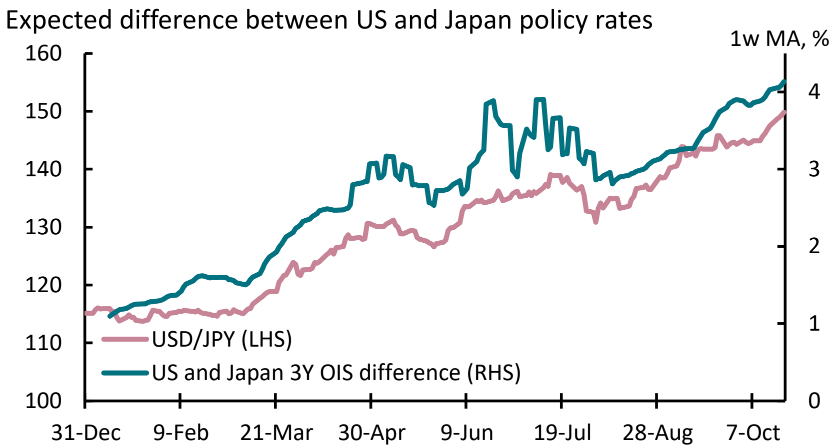
Yen continues to weaken breaking 150 against dollar

- Japan's accommodative monetary policy stance continues to stand out against the global trend and is contributing to further pressure on the yen. The yen fell to ¥150 against the dollar, its weakest level in 32 years. Japan's Finance Minister Shunichi Suzuki reiterated that the recent moves in the yen continued to be monitored and that the Ministry of Finance (MoF) remained ready to act if needed. His comments follow last month's foreign exchange intervention, which the MoF confirmed cost ¥2.9tn ($19.7bn), and only temporarily reversed the slide in the yen. The recent moves in the yen could see the MoF intervene again.

YCC continues to come under pressure, No change expected in BoJ's October meeting

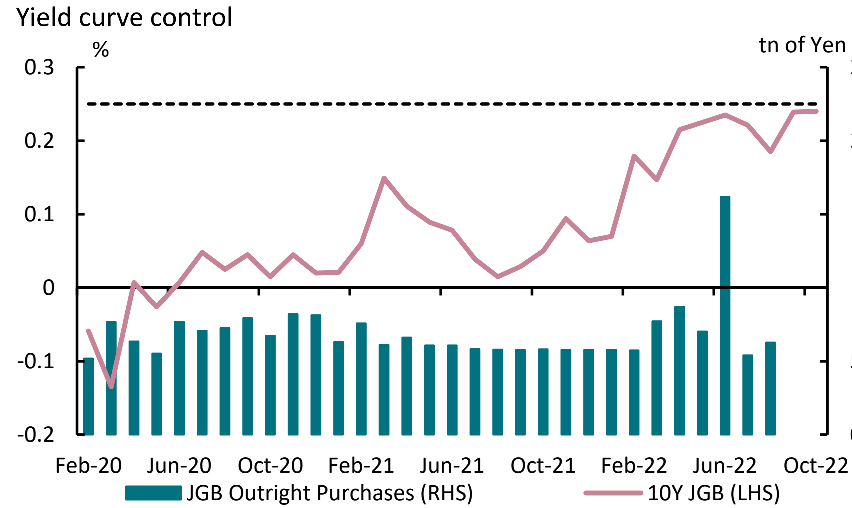
- Ahead of the BoJ's October Meeting, we continue to expect it to leave all monetary instruments unchanged maintaining their accommodative stance. Recently speaking in parliament, Governor Kuroda continued to rule out countering the weak yen with a shift in monetary policy. The continued weakness in the yen is adding to speculation that the BoJ could be forced to abandon its current yield curve control (YCC) policy on 10-year Japan government bonds (JGB). 10-year JGB yields rose 0.5bp over the upper limit to 0.255% on 19 October.

Yen breaks 150 against the dollar



Source: Refinitv, AXA IM Research, October 22

YCC continues to come under pressure



Source: Refinitiv, AXA IM Research, October 22

Inflation pressures persist

Canada

CPI passes peak – but not quickly

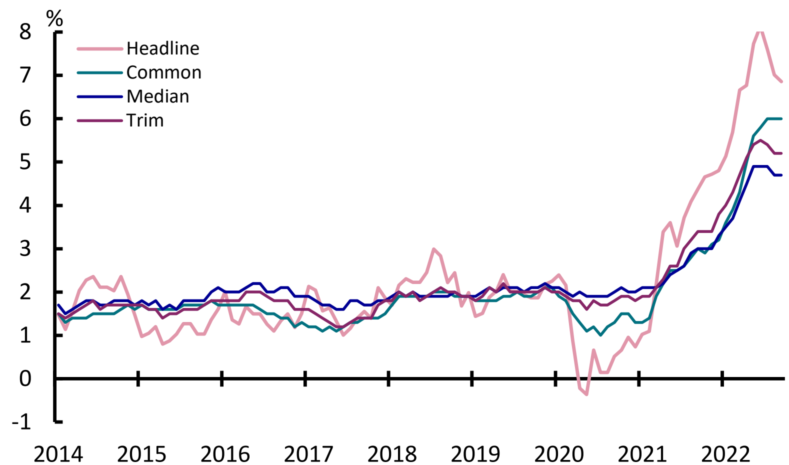
- CPI inflation dipped to 6.9% in September, down from the 8.1% high in June and largely reflecting the drop in oil prices. However, the latest measure disappointed with core measures remaining firmer than expected and barely off their respective peaks. We expect inflation to fall sharply next year, but more slowly than consensus. We forecast an average 6.9% for this year (from 6.8%) and 4.3% for next (consensus forecasts 6.9% and 3.7%).

Labour market loosening

- Following three successive months of decline, employment increased modestly in September (+21k), but with labour supply declining again, unemployment dropped back to 5.2% from 5.4%. However, the BoC's latest quarterly surveys showed a rising number of businesses recording that labour market conditions are easing and a material drop in wage expectations. This is a necessary condition for an easing in the pace of BoC monetary policy tightening.

Core measures remain elevated

CPI measured variations



Source: CANSIM, AXA IM Research, October 22

Firms wage expectations ease materially

BoS: Firms' expectations of average wage increases next year

Source: Bank of Canada, AXA IM Research, October 22

Investment Managers

The rate peak vs recession trade-off

Canada

BoC “more work to do”

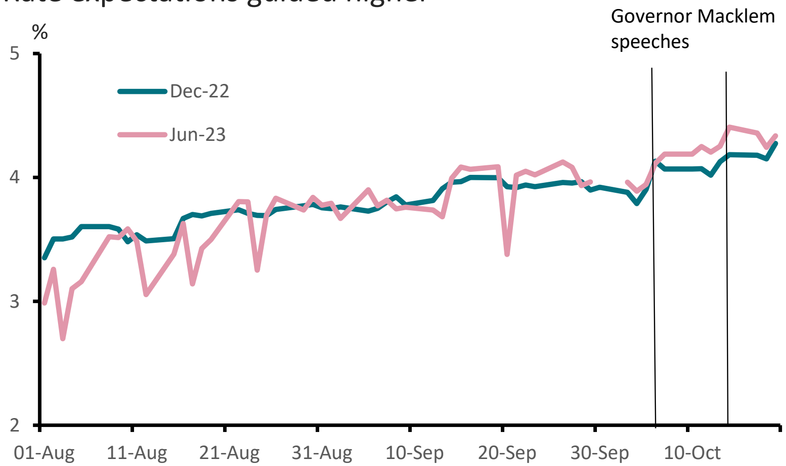
- BoC Governor Macklem delivered successive speeches, the latest from the IMF, point to “more work to do”. We expect the BoC to hike rates somewhat more gradually in October by 0.50%, but now forecast a further 0.25% in December taking the policy rate to 4.00%. We forecast the BoC to pause here, wary of tipping the economy into a sharper decline. However, the BoC’s “immediate” threat for now remains inflation and risks are skewed to a 4.25% peak (or higher) if the economy does not slow as we expect.

But higher rate increases raise the chance of recession

- For now, we leave our growth forecasts unchanged at 3.3% and 0.7% for this year and next. We note though that consensus forecasts have fallen over the last month to 3.2% from 3.5% for this year and to 0.8% from 1.5% for 2023. Our forecasts see Canada narrowly escape a recession. However, if the BoC is forced to tighten policy above our current 4% expectation, the chances of the economy escaping recession are likely to fade, with a sharper retrenchment in housing a primary transmission channel.

Evolving market rate expectations

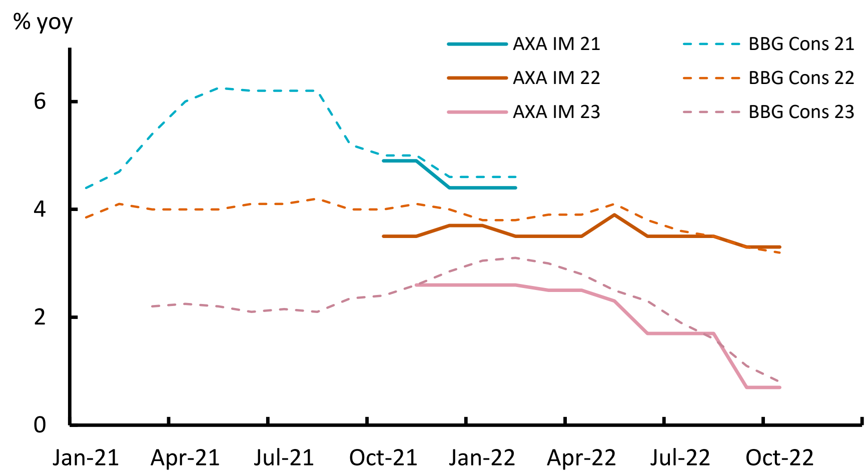
Rate expectations guided higher



Source: Bloomberg, AXA IM Research, October 22

Consensus growth expectations fall into line with our own

Evolution of GDP forecasts



Source: CANISM, Bloomberg, AXA IM Research, October 22

Diverging trends

Emerging Markets

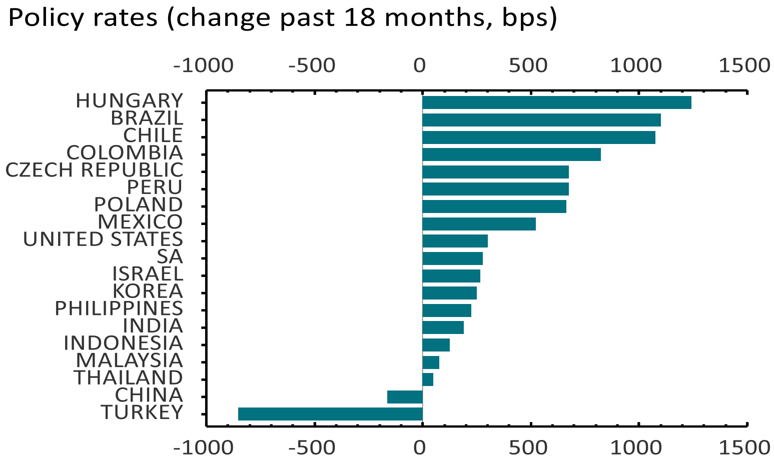
While mostly above targets, inflation momentum experiences divergent trends

- Stronger energy and food prices, as well as weaker currencies through EM, have pushed inflation rates now well beyond the upper end of central bank target bands. Inflation is hovering in double digit territory in Chile and Colombia, and all through Central Europe. Some inflexion appeared here and there, often on the back of basis effects or administered prices being capped. Core inflation remains mostly on the upside, with only Brazil (early in the monetary policy tightening) peaking at present.

Monetary stance staying tight or tighter… with some divergent notes

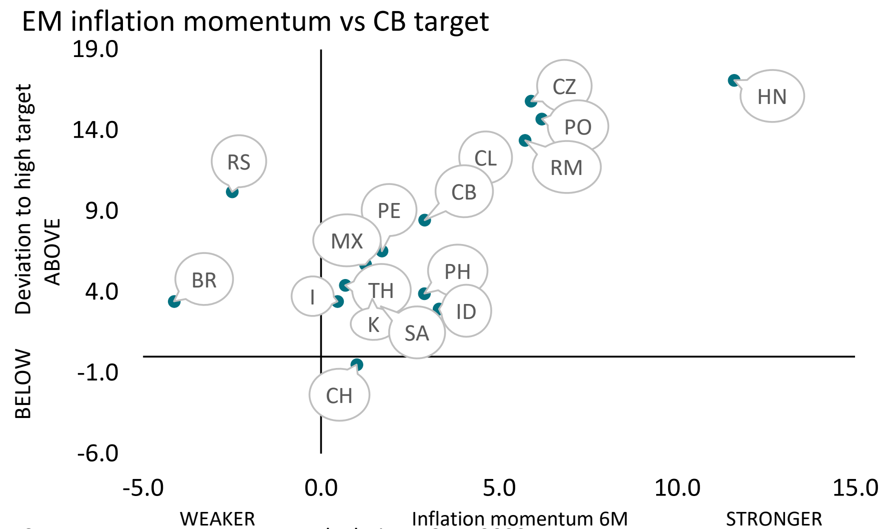
- Generally, EM central banks continued hiking rates. Some central banks (Czech, Hungary, Poland, Chile, Brazil) started indicating that they had reached or approached their peak rates. Hungary had to implement emergency hikes (+500bp) after that as FX weakness couldn't be contained. Asian banks are pursuing hikes as they joined the trend relatively late (except Korea). Bar China and Russia, Turkey, remains an outlier in EM, with it banks cutting rates (cumulative of 350bp in the past 3 months) indicating a last cut for November and policy rate at 9%, while managing FX and credit stance through regulations.

Hiking rates still… except for Turkey



Source: Refinitiv Datastream and AXA IM Research sept. 22

Inflation above targets, strong momentum in CEE



Source: Datastream, AXA IM calculations, Sept 2022

Asian economies remain under pressure amid external volatilities

Emerging Markets

Foreign exchange reserves see continued decline in Asia

- Foreign exchange reserves have seen sharp declines as policy makers in the region have used billions of reserves to ease the currency slump. While actual reserves levels still seem relatively healthy compared to other Emerging market economies, the pace of the decline has been concerning for many. The last time such a rapid drop occurred was during the Global Financial Crisis back in 2008. Looking ahead, continued and cautious monitoring of forex reserve levels is essential

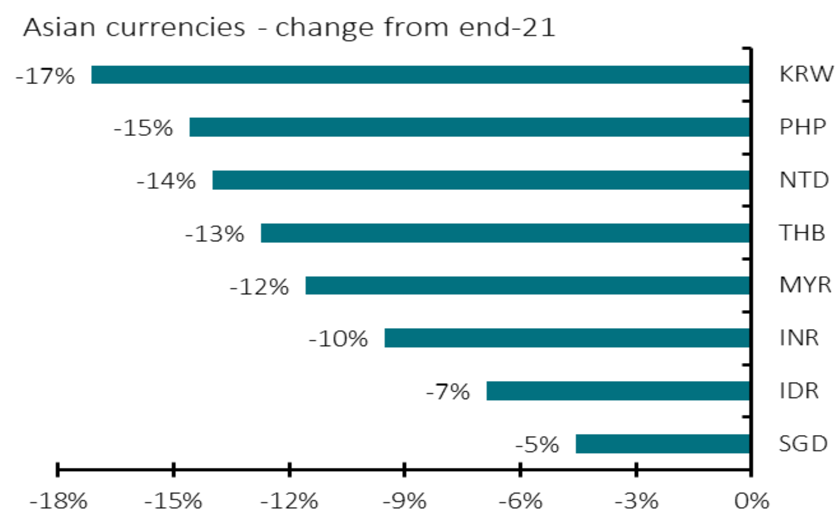
Asian central banks deploy ammunition to defend currency volatility

- While a large portion of the reserve depletion is related to valuation and global issuance effect, the other significant portion is due to ammunition deployed by Asian central banks to fend off currency depreciation pressures. Korean won by far has seen the most depreciation against the dollar, falling by over 17% compared to end-2021. Philippine peso (-15%), the New Taiwan dollar (-14%), and Thai baht (-13%) follow immediately after

Concerning pace of forex decline

Source: CEIC, AXA IM Research, October 22

Of all Asian currencies, KRW sees largest depreciation against the dollar



Source: CEIC, AXA IM Research, October 22

Investment Strategy

Investment
Managers

Multi-Asset Investment views

Our key messages and convictions

Positive long dated Sovereign Bonds

#1
Markets increasingly concerned by the rising risk of recession. Central banks hiking cycle already fully priced in

#2
Earnings deteriorating as economic activity decelerates while persistent inflation pressuring central banks to slow growth further

Negative on Equities

Neutral on Investment Grade Credit

#3
Valuations have improved following recent spread widening albeit not attractive enough to warrant being overweight

#4
Pricing at levels consistent with positive returns over medium term. However, default expectations should further increase as activity decelerates

Neutral High Yield

Source: AXA IM as at 26/10/2022

Investment Strategy

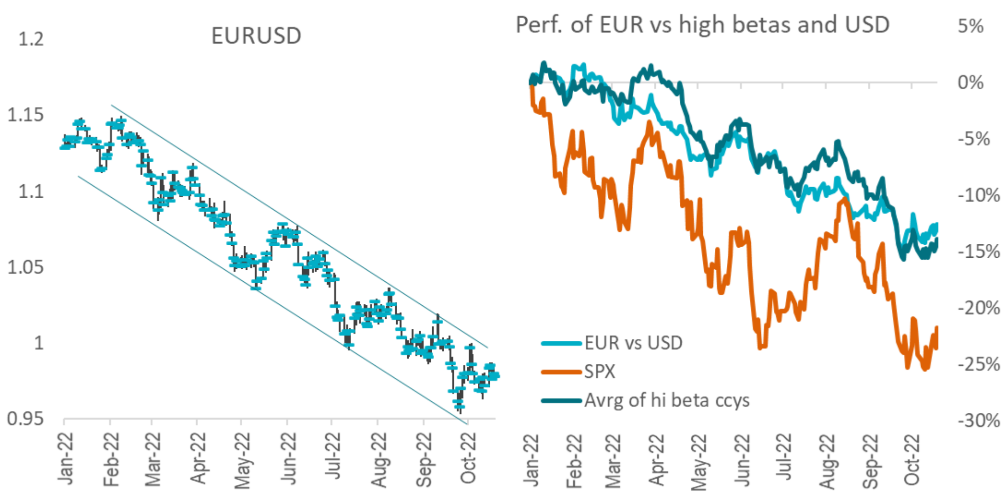
Currencies: USD intoxication, till the last drop

- US data continue to imply more pressure from Fed policy and thus USD strength. Market is on edge about the Fed 'pivot' which may be closer but there yet. If Fed decelerates sooner than expected, and absent a major risk off, we see more risk of a high beta currencies rebound than a fall in rates and then JPY appreciating. BoJ market interventions can't change the JPY trend lower; only Fed or BoJ policy could do that. We also see low potential of a durable EUR rebound.

- With the USD and energy prices rising, many central banks are stuck between high imported inflation and weak domestic demand. In UK and Sweden, already indebted households are also facing rising mortgage rates. EUR and SEK are also seeing structural support from their current account fading, while concerns are rising on growing UK twin deficits, dysfunctional politics and BoE uncertainty. China slowdown is also weighing on EU exports, while Brexit constrained UK labour supply is supressing its growth potential.

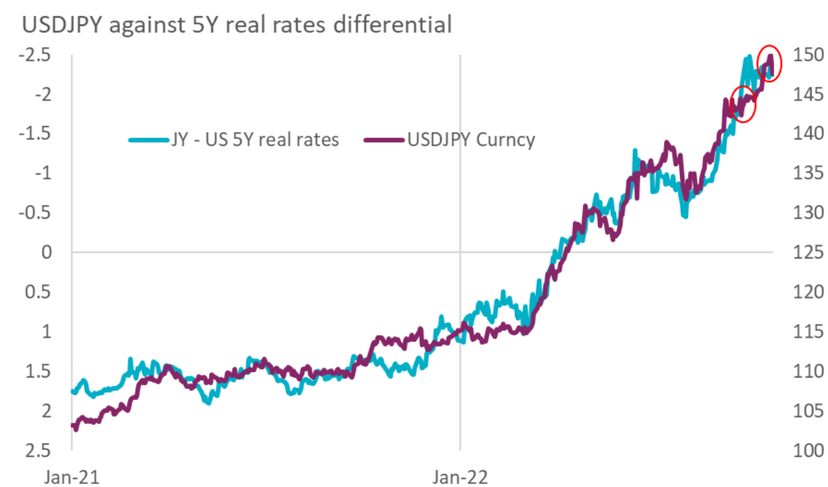
- AUD might be the better candidate for a high beta rebound. Despite RBA is getting more cautious and high household leverage, domestic growth and consumer demand are much more resilient, while trade balance benefits from energy prices through LNG and coal exports.

EURUSD caught in downward channel, less sensitive to risk rebounds



Source: Blomberg & AXA IM Research, Oct 2022

Rates divergence more powerful than FX interventions



Source: Blomberg & AXA IM Research, Oct 2022

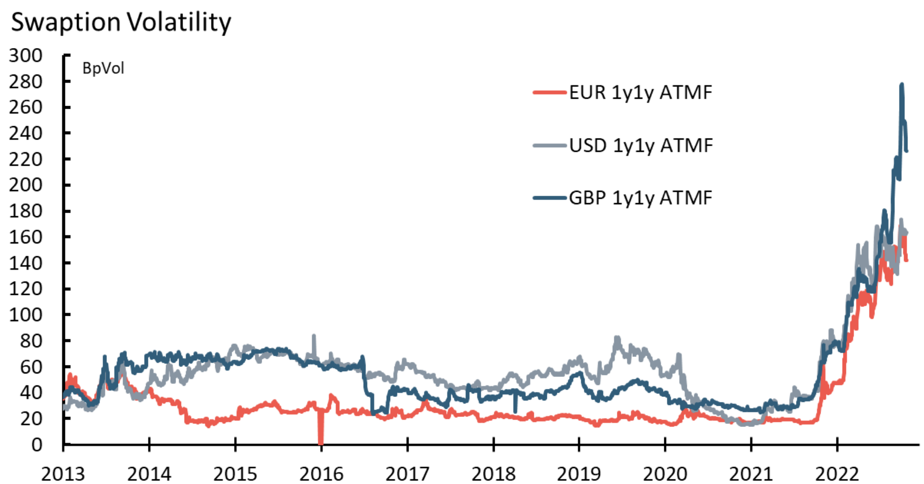
AXA Investment Managers

Investment Strategy

Rates: have turned out quite risky for a risk-free market

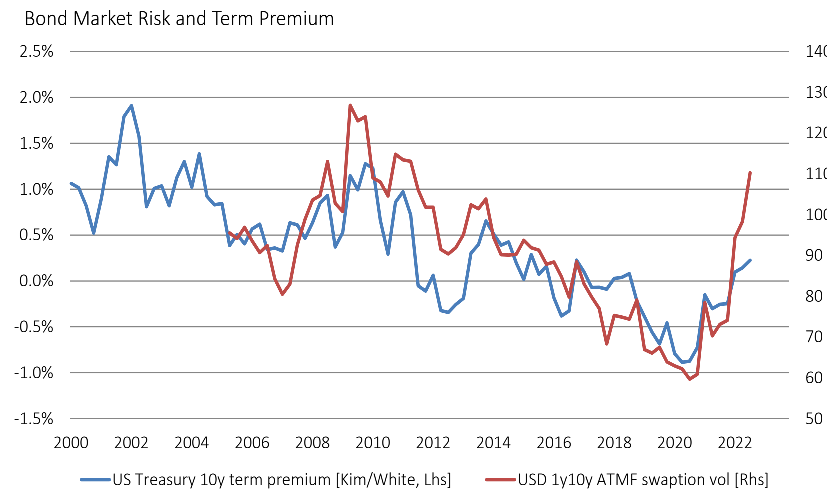
- The level of volatility at the front end of the interest rate curve has jumped by a factor of seven in 2022. This is a reflection of escalating hawkish expectations by central banks which have been the bugbear for government bond markets and risky assets for over a year now.
- Implied volatility has also increased for longer tenors across the curve, which is understandable as a natural transmission of monetary policy actions and more specifically the fact that the so called 'pivot' (namely an easing in the hawkish stance by central banks) has been pushed further out and towards the end of next year.
- Historically, higher levels of volatility have augmented the term premium for risk-free bonds, thus embedding the effect of expected inflation and interest rates anticipation in yield levels at the longer end of the curve.

Interest rate volatility has seen an epoch defining rise in volatility



Source: Bloomberg & AXA IM Research, Oct 2022

The rise in volatility implies upside risk for term premia



Investment Strategy

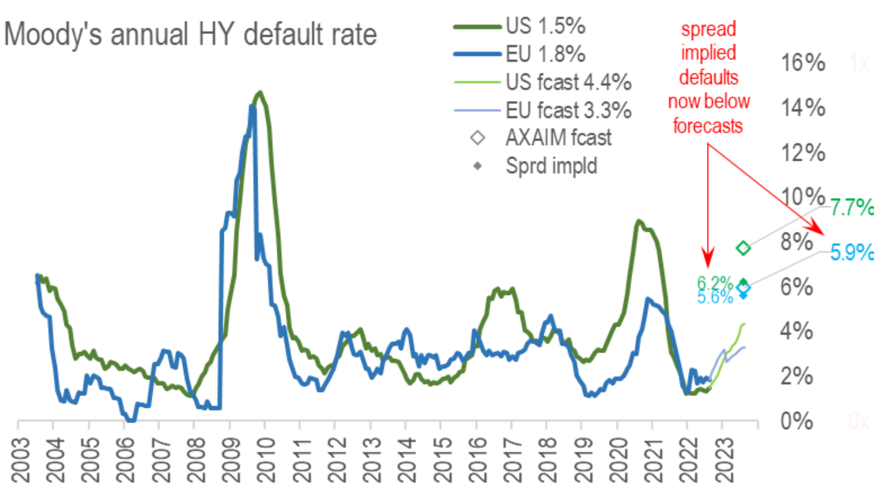
Credit: deterioration in default predictor is pushing default valuations into the red

- Default predictors have deteriorated further since the summer, especially those comprising the impact of persistently rising interest rates (eg, price-based distress ratio, refinancing gap). This has pushed default valuations into the red across most HY cohorts, as model-forecast defaults now exceed spread-implied defaults. Excess spread expectations, as a result, remain positive but have fallen below historic norms.

- On the other hand, spread type predictors like the spread-based distress ratio have remained resilient and still suggest a cheap valuation vs default expectations. The table below exhibits this nuance across default predictors, when applied to a key USD HY benchmark (ICE). The spread-based distress ratio implies a default valuation of +150bp while the refinancing gap implies a default valuation of -30bp.

- Essentially, it's a tug of war between resilient credit fundamentals (what spreads suggest) and macro/policy headwinds (what refinancing gaps and/or bank lending appetite suggest). Either way, the combined rise in spreads and interest rates has already brought HY markets to an attractive entry point, with annualised 5-year returns in the mid to high single digits according to historic norms.

Moody's HY cohort default valuation now screens rich



Source: Moody's, ICE, Fed, ECB & AXA IM caclulations

Defaut valuation varies depending on the predictor used

(our main model is in the row outlined by the border)

USD HY default expectations (H0A0 index)			543bp
Predictor	Default Rate, %		Valuation, bp
	forecast	sprd impld	
Distress ratio (spread)	1.71	3.88	150.0
Bank lending	3.97	3.88	-5.0
Distress(S) + Lending	4.12	3.88	-15.0
Distress ratio (price)	4.13	3.88	-15.0
Distress(P) + Lending	**4.25**	**3.88**	**-25.0**
Refinancing gap	4.31	3.88	-30.0

Investment Managers

Investment Strategy

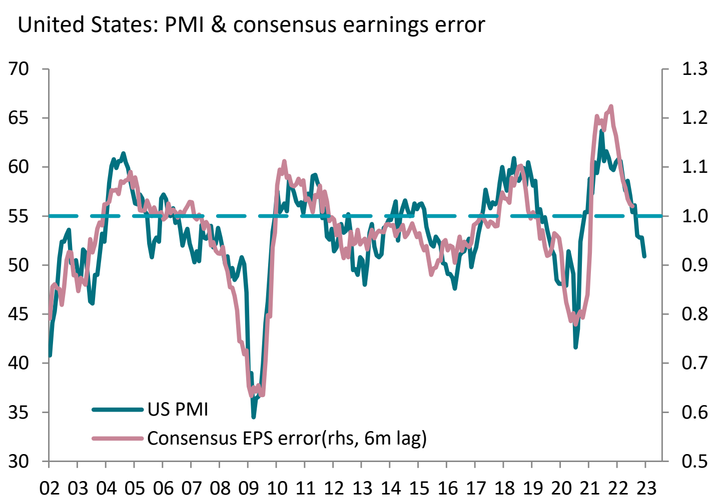
Equities: can earnings keep flying above the macro turbulence?

- In terms of monthly performance, there were no surprises within the asset class over the past month. Energy still stands alone (+0.4%), defensives (-6.2%) and value (-8%) continue to lead in terms of style and factors, while growth stocks keep struggling (-11%).

- Q3 earnings releases have started, and results have been quite decent so far. The ISM index is a good predictor of US corporate earnings surprises, and this relationship has remained robust. Current ISM levels suggested a slightly positive level of surprises and the first reports are in line with this. In the US, about 20% of companies have released financial results and the overall earnings beat stands around 5%. In Europe, first results show a similar trend (+3% earnings surprise) albeit with fewer companies having reported so far (about 10%).

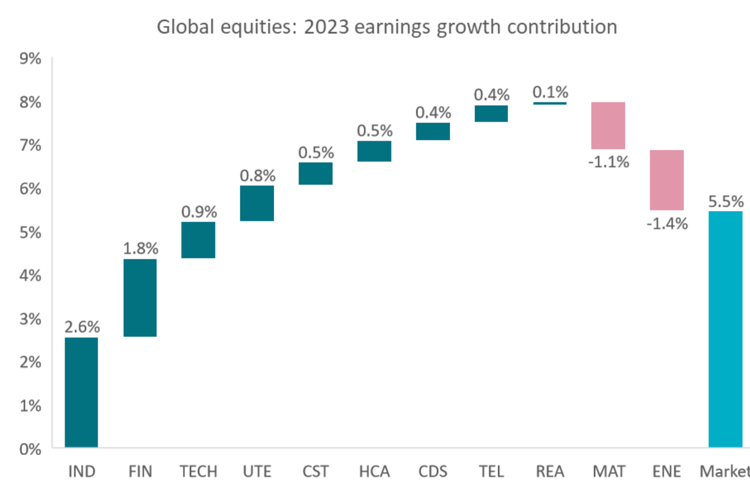
- All eyes are on 2023 now. The consensus is looking for earnings growth of +5.5% with industrials (+2.6%), financials (+1.8%) and technology (0.9%) contributing most to this growth. Even though the EPS growth forecasts for 2023 have been revised downward since January (by -3%), they remain out line with the consensus expectations for US growth (+0.4%) and even more out of line with our expectations (-0.5%).

The real pain in earning likely to come in mid-2023



Source: ISM, IBES and AXA IM Research, October 2022

EPS expectations still too high vs GDP expectations



Source: ISM, IBES and AXA IM Research, October 2022

Investment Managers

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 Financials			
European Autos			
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 short duration HY			▲

EM Debt

EM Bonds HC			

Legend Negative | Neutral | Positive **Change** ▲ Upgrade | ▼ Downgrade

Source: AXA IM as at 26/10/2022

Forecasts & Calendar

Macro forecast summary

Forecasts - update

Real GDP growth (%)	2021	2022*		2023*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
World	6.1	3.1		2.4	
Advanced economies	5.2	2.5		0.1	
US	5.7	1.8	1.7	-0.2	0.5
Euro area	5.4	3.0	2.9	-0.5	0.2
Germany	2.8	1.3	1.4	-1.5	-0.7
France	7.0	2.4	2.5	0.0	0.6
Italy	6.6	3.3	3.3	-0.6	0.3
Spain	5.1	4.7	4.3	0.6	1.6
Japan	1.6	1.5	1.5	1.7	1.5
UK	7.4	4.2	3.4	-0.7	-0.3
Switzerland	3.7	2.3	2.3	0.6	0.8
Canada	4.6	3.3	3.3	0.7	1.2
Emerging economies	6.7	3.6		3.9	
Asia	7.1	4.4		5.1	
China	8.1	3.6	3.3	5.2	5.0
South Korea	4.0	2.3	2.6	2.0	1.7
Rest of EM Asia	6.2	5.6		5.2	
LatAm	6.8	2.8		2.0	
Brazil	4.6	1.5	2.4	1.0	0.9
Mexico	4.8	1.7	2.0	1.3	1.3
EM Europe	6.5	-0.7		-0.2	
Russia	4.7	-6.0		-3.5	
Poland	5.7	4.8	4.1	0.9	1.4
Turkey	11.0	5.6	4.8	1.5	2.2
Other EMs	5.4	4.2		3.7	

Source: Datastream, IMF and AXA IM Macro Research – As of 25 October 2022

Expectations on inflation and central banks

Forecasts - update

Inflation Forecasts

CPI Inflation (%)	2021	2022*		2023*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	3.2	7.2		4.7	
US	4.7	8.2	8.0	5.2	3.8
Euro area	2.6	8.1	8.2	5.5	5.4
China	0.9	2.1	2.3	2.3	2.3
Japan	-0.2	2.3	2.2	1.3	1.4
UK	2.6	9.0	9.2	5.6	7.0
Switzerland	0.6	2.8	2.9	2.0	2.0
Canada	3.4	6.9	6.9	4.3	3.6

Source: Datastream, IMF and AXA IM Macro Research – As of 25 October 2022

Central banks' policy: meeting dates and expected changes

Central bank policy		Meeting dates and expected changes (Rates in bp / QE in bn)				
		Current	Q3-22	Q4-22	Q1-23	Q2-23
United States - Fed	Dates	1.50-1.75	26-27 July 20-21 Sep	1-2 Nov 13-14 Dec	31-1 Jan/Feb 21-22 Mar	2-3 May 13-14 Jun
	Rates		+1.5 (3.00-3.25)	+1.25 (4.25-4.50)	+0.25 (4.50-4.75)	unch (4.50-4.75)
Euro area - ECB	Dates	-0.50	21 July 8 Sep	27 Oct 15 Dec	2 Feb 16 Mar	4 May 15 Jun
	Rates		+1.5 (0.75)	+1.0 (1.75)	0.25 (2.00)	unch (2.00)
Japan - BoJ	Dates	-0.10	20-21 July 21-22 Sep	27-28 Oct 19-20 Dec	Jan Mar	May Jun
	Rates		unch (-0.10)	unch (-0.10)	unch (-0.10)	unch (-0.10)
UK - BoE	Dates	1.00	4 Aug 15 Sep	3 Nov 15 Dec	3 Feb 17 Mar	5 May 16 Jun
	Rates		+1.00 (2.25)	+1.25 (3.50)	+0.75 (4.25)	unch (4.25)

Source: AXA IM Macro Research - As of 25 October 2022

Calendar of 2022 events

2022	Date	Event	Comments
	Q3-Q4 2022	Chilean Constitutional Referendum	
October	October	China's 20th National Congress- President Xi to be re-elected (expected)	
	2 October	Brazil General Elections	
	30 October	Brazil Presidential Elections (second round)	
November	2 November	FOMC meeting	
	3 November	UK Monetary Policy Report & MPC Summary and minutes	
	8 November	US Midterm Elections	
December	14 December	FOMC meeting	
	15 December	MPC Summary and minutes	

Latest publications

The economic impact of a Russian gas cut-off

30 September 2022

September Global Macro Monthly – Temperature keeps on rising for central banks

27 July 2022

September Monthly OpEd – Dollar reigns supreme

27 July 2022

Brazil's Presidential Election: Familiar names for an uncertain future

27 September 2022

Asia's decarbonisation potential

14 September 2022

The outlook for China against US or European recession

07 September 2022

UK Conservative party leadership elections: The battle to be the next PM

31 August 2022

Emerging markets inflation: Characteristics, causes and effects

28 July 2022

July Global Macro Monthly – Temperature keeps on rising for central banks

27 July 2022

July Monthly OpEd – Signs of recession accumulating, but is it fully in the price?

27 July 2022

Investment Managers

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