22 September 2021

Research & Strategy Insights

Supply constraints add to inflation angst

Global Macro Monthly

Key points

- The EU's "Fit for 55" programme is a suite of measures to deliver a 55% reduction in GHG emissions by 2030. It includes the Emissions Trading Scheme (ETS) and Carbon Border Adjustment Mechanism (CBAM).
- Supply shortages crimp output in the US and Japan. Chinese growth has been impacted by COVID outbreaks. Eurozone momentum remains intact for now.
- The US attempts to finalise a government spending package. We expect a more forceful policy shift in China. Meanwhile, the Fed heads towards a taper; the ECB has reduced PEPP purchases, but this is not a taper.
- German elections will set the fiscal tone at home and for the Euro area. Japan's vote will follow the leadership race.
- A mix of negative developments have driven a risk negative tone. Credit spreads remain tight while broader government yields look set to rise gently.

Global Macro Monthly

Investment Strategy

Global Macro Monthly – US

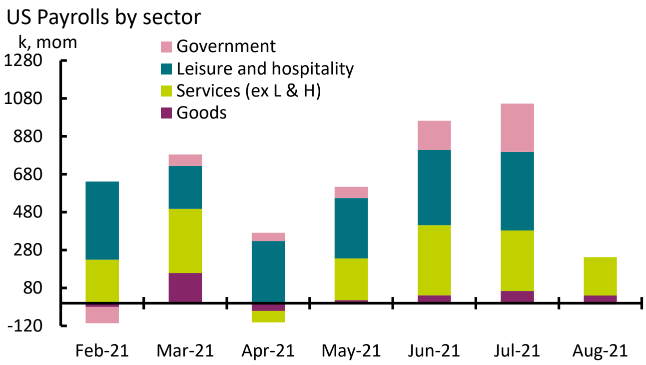
David Page,
Head of Macroeconomic Research,
Macro Research – Core Investments

Supply shock persistence?

US virus case numbers have only recently peaked, with daily cases exceeding 250k – the worst since January. The outbreak was again concentrated in southern states where many precautionary measures were eschewed and vaccination rates are lowest. This may explain the ongoing high correlation between cases and hospitalisations, unlike in other highly vaccinated countries. Or actual cases may have been higher, with US testing relatively low compared to others. The outbreak appeared to weigh on summer activity.

Consumer sentiment also softened, with weakness in the third quarter (Q3) likely reflecting rising inflation – particularly in gas prices – and supply tensions weighing on output. Retail sales rebounded in August after a sharp drop in July, but – constrained by a lack of vehicle production – quarterly sales look likely to contract in Q3. Broader consumption should hold up better – we forecast around 3% growth annualised – supported by firmer services spend, but virus concerns may detract. We forecast US GDP at 2.8% (saar) for Q3. We have lowered our GDP forecast to 5.7% for 2021 as a whole.

Exhibit 1: Employment weakness related to COVID-19



Source: Bureau of Labor Statistics and AXA IM Macro Research, 20 Sept. 2021

Semiconductor shortages are the most prominent supply-chain issue and look set to outlast other shortages, for example in lumber and iron ore, that appear to have resolved. The most pressing issue surrounds the labour market. Exhibit 1 shows that payroll growth slowed sharply in August, likely as virus concerns reduced leisure and hospitality hiring. The lack of recovery in labour force participation, which has topped out at 61.7% since August 2020, adds concerns about labour supply. There is little evidence that unemployment benefits have dissuaded significant numbers from returning to the labour market from states that ended benefits early. Childcare does appear to be a key issue, potentially explaining the relative lack of participation by female workers. But survey evidence also suggests virus concerns – which may overlap with vaccine hesitancy – could persist.

Inflation has shown some signs of easing. August's headline Consumer Price Index (CPI) rate dipped to 5.3% from 5.4%, but the core measure fell to 4.0% with just a 0.1% monthly rise – its smallest since February. Import prices fell by 0.3% in August. Annual inflation looks likely to have peaked, but how quickly it retreats depends on the persistence of supply shortages in labour and product markets. A protracted recovery in labour supply could continue to fuel wage growth and add to second round inflation effects. We do not expect this, but evidence before year-end will be a critical test of this assumption.

The Federal Reserve (Fed) is moving towards tapering its quantitative easing (QE) asset purchases. We expect a December announcement, but recent commentary has increased the chances of November – with labour market developments critical to this call. Either way, by early next year the Fed should be reducing its purchases – likely by $10bn of US Treasuries and $5bn of mortgage-backed securities per meeting – with asset purchases ceasing before end-2022. Focus will turn to the rate outlook. While we consider the current inflation overshoot transitory, we also expect inflation to reach around 2% by end-2022 with an outlook for a (modest) overshoot into 2023. The inflation criteria for rate hikes will have been met. The Fed will have to judge whether labour market conditions are consistent with "full employment" – a more discretionary metric. We continue to expect the Fed to increase the Fed Funds Rate by 0.25% to 0.25-0.50% in June 2023 and again in December.

Washington faces a busy few weeks. Congressional committees are drafting details of the reconciliation package. The House Committee on Ways and Means detailed $2.1tn of tax hikes – an achievement, but one that might be eroded by the political realities of Senate approval. Any shortfall in tax proposals would cap President Joe Biden's $4tn spending plan. We envisage a total spending programme of around $3.5tn. Yet the GDP impact – particularly in the near term – will depend on the implementation timeline.

The government must also pass a budget by the end of September, to avoid government shutdown, and a debt ceiling adjustment no later than some weeks after to avoid a debt default. We expect a continuing resolution to avoid shutdown by end-September. Ideally this would include a debt ceiling resolution. But a political face-off could push this deeper into October, with market tensions rising the nearer to the suggested mid-October deadline. Ultimately, we do not expect a material debt ceiling issue. And resolution of the debt ceiling would likely see the government rebuild its cash buffer at the Fed over Q4, which could lift bond yields.

Global Macro Monthly – Eurozone

Hugo Le Damany,
Economist,
Macro Research – Core Investments

Good signals on the virus and the economic data

Recent pandemic developments have been encouraging across the Eurozone. In most countries, the reproductive rate is below one and pressure on intensive care units is largely below previous waves. The target to fully vaccinate 70% of people has been achieved ahead of schedule in most countries, but risks persist as children return to school and employees head back to the offices at a time when immunity thresholds are probably insufficient for the current dominant Delta variant. We estimate that between 15-20% of people are still unwilling to get vaccinated – enough to overcrowd hospitals this winter. Countries are thus considering further incentivisation or, like Italy, making a vaccine compulsory.

Final figures for second quarter (Q2) GDP growth showed the Eurozone benefiting significantly from the reopening from the middle of the quarter. GDP grew by 2.2% quarter-on-quarter, boosted by the services sector, and with 1.9 percentage points drawn from private consumption alone. Italy and Spain demonstrated strong recoveries in both manufacturing and services, while France and Germany were more heavily impacted by supply shortages in the manufacturing sector.

Solid momentum has persisted into Q3 with Eurozone activity currently running 1% below "normal", according to the OECD weekly activity tracker. There is still heterogeneity across countries and sectors, with industrial production in France and Germany stalling at about 5% below crisis levels, while Italy has already closed this gap. Shortages are expected to fade but should still last for several months. Some sectors, such as auto production, should continue to be heavily impacted. On the demand side, manufacturing orders stand at a very high level, but we remain cautious as activity in the US and China should ease in the coming months. Consumer confidence softened in August but remains high. More importantly, the labour market and savings expectations should provide some tailwinds for domestic demand.

Considering better Q2 GDP growth and well-oriented surveys in Q3, we upgrade our outlook for 2021 in Germany (2.9%), Italy (5.2%) and Spain (5.3%). In 2022, we also increase our outlook for France (3.5%) and Germany (3.8%) but cut it for Italy as higher growth in 2021 should mechanically reduce the path of activity in 2022 (3.7%).

Transitory factors continue to weigh on prices

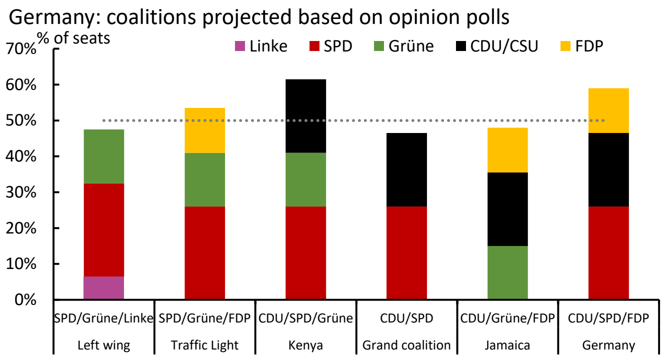
During the summer, prices have accelerated, with the Eurozone consumer price index up 3% year-on-year in August. We reiterate our view that those pressures should remain transitory. Factors such as the resumption of Germany's sales tax, strong energy base effects and supply shortages should fade over the coming months. Moreover, labour markets are not exhibiting the same degree of tightness as in the US and UK, with Eurozone wage pressures remaining muted for now.

The European Central Bank (ECB)'s September meeting did not deliver major surprises. As expected, the Governing Council agreed to reduce net purchases through the pandemic emergency purchase programme (PEPP) at a "moderately lower pace" after assessing "*financing conditions and the inflation outlook*". ECB President C. Lagarde gave no details on the future calibration of quantitative easing (QE) – PEPP and the asset purchase programme (APP) – postponing those decisions to December's meeting. PEPP should cease in March, but we believe the ECB will raise net APP purchases to €40bn per month from €20bn, in response to expectations of a persistent core inflation undershoot of the 2% target (2023 projection now at 1.5%). Uncertainties on the duration and flexibility of APP should be answered in December.

German elections – domestic and EU level impact

Germany holds Bundestag elections on 26 September. Once the votes are in, the parties will try to form a governing coalition. The centre-left SPD party leads current polls with about 26% of the vote, ahead of the centre-right CDU/CSU (20%), the Greens (15%) and the liberal FDP (12.5%). A three-party coalition looks unavoidable and is likely to lengthen negotiations, especially as the most likely option (SPD/Greens/FDP) brings together opposing positions on fiscal and economic policies (Exhibit 2). The SPD and Greens stand for further redistribution, increased taxes on higher incomes, higher minimum wages, large public investment to finance the net zero energy transition and fiscal reforms at domestic and European level. The FDP is more fiscally conservative and stands on a more libertarian platform.

Exhibit 2: Game of Grünes in Germany



Source: Wahlrecht.de and AXA IM Macro Research, 13 September 2021

Global Macro Monthly – UK

David Page,
Head of Macroeconomic Research,
Macro Research – Core Investments

Jobs market questions inflation overshoot

The UK virus situation has not been as bad as feared before the summer. Cases have remained high, exceeding 35k/day in early September, but the peak so far was in mid-July, exacerbated by the Euro football tournament, and cases have fallen short of the 100k/day warned by Health Secretary Sajid Javid. Hospitalisations have risen more slowly than cases, suggesting a beneficial vaccine effect. With the UK authorising one-shot vaccinations for 12+ year-olds and boosters for over-50s and the vulnerable, the UK should weather a winter rise in cases without requiring strict restrictions.

The July virus peak impacted activity. Retail sales contracted on the month, having been boosted by the Euros in June. The drop in goods purchases should have been cushioned by rising demand for services, but the "pingdemic" – forcing people to self-isolate – dampened this impact. GDP rose by just 0.1% in July – its weakest since January. This was consistent with our outlook for deceleration in Q3 GDP to around 2%, although a further drop in sales in August threatens a weaker outlook. We see slower, but still solid growth in H2 delivering total annual growth of 6.7% for 2021.

Inflation hit a 9-year high of 3.2% in August from 2.0% in July. Last year's 'Eat Out to Help Out' restaurant scheme and Value-Added Tax cuts boosted this year's annual figure. A good part of that will reverse next month. But broader supply pressures are evident. Chip shortages have dampened car purchases and second-hand car prices rose by 18% in August. Energy is also a concern. Tight gas markets and low wind production have forced prices higher and tariff increases in October should drive inflation to around 4%. This should prove temporary. However, growing evidence of labour shortages, across transport and ports, agriculture and consumer services threatens a more persistent effect.

Elevated inflation has increased market expectations for the Bank of England (BoE) to increase Bank Rate. Markets now expect two hikes next year and at least one more in 2023. With two hikes to 0.50% now sufficient to trigger a modest, passive balance sheet unwind, we argue that UK rate markets are too enthusiastic. We see the BoE wanting to determine the scale and persistence of any labour market shortages before embarking on a tightening spree. But a first hike by end-2022 is a risk, while the shifting composition of the Monetary Policy Committee is becoming more hawkish with new Chief Economist Huw Pill.

Global Macro Monthly – Japan

Hugo Le Damany,
Economist,
Macro Research – Core Investments

Back to the merry-go-round of prime ministers

The resignation of Prime Minister Suga came as a surprise. The Liberal Democratic Party (LDP) must now choose a new leader before dissolving the Diet for general elections (likely in November). Two candidates are close in the polls – Taro Kono, the minister in charge of deregulation and vaccination, and Fumio Kishida, former minister for foreign affairs. Kono leads in the national polls, but Kishida has stronger support within the party. As national voting intentions have already improved for the LDP following Suga's resignation, we believe voters are not too concerned by the differences between the candidates. Consequently, we believe LDP members will take the risk to promote Kishida. That being the case, we do not anticipate major macroeconomic changes, as his programme is consistent with Suga's and Abe's before him. However, Kishida may need the support of another rival candidate, Takaichi, that has recently promoted policies very close to Modern Monetary Theory (MMT), which could suggest a bigger change (MMT: government stimulus should be only calibrated according to inflation expectations, not debt).

New coronavirus cases have recently declined but hospitalisations remain elevated, so the government has once again extended the state of emergency in half of the country. On the vaccination front, Japan is going faster now, inoculating approximately 1% of the population every day.

Economic data have been mixed. Hospitality and leisure continue to struggle as venues operate under shorter hours and/or at reduced capacity. The services PMI has been in contractionary territory since March 2020, and August recorded a fall of 4.5 percentage points to 42.9. Retail sales rose by 1.1% month-on-month (mom) in July, rising a second month in a row. Industrial production declined by 1.5%mom in July mainly reflecting a fall in auto production due to supply chain disruptions. August's exports fell 3.7%mom, with auto plunging by 14.6%. We have reduced our third quarter (Q3) GDP growth forecast to 0.4% quarter on quarter from 1.4% and remain cautious for Q4 as the expected private consumption recovery in services may be challenged by easing activity in the US and China.

On the prices front, recent figures have been difficult to interpret. July's Consumer Price Index (CPI) fell by 0.5ppt to 0.3%yoy, following a reweighting in the consumer basket. Removing the cut-off, we believe the CPI should increase in the coming months on strong energy base effects. Downside pressure may occur if the government resumes the "Go to" subsidy campaign.

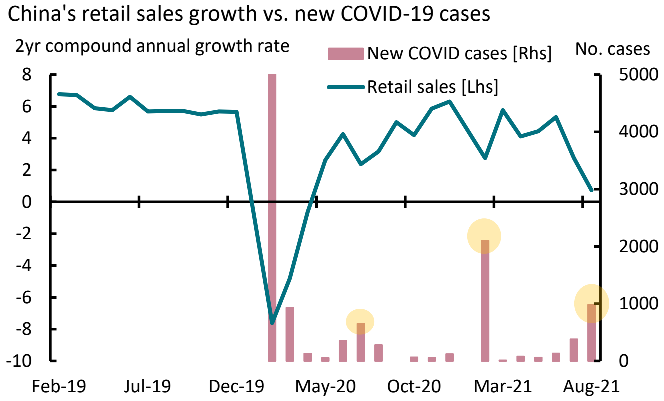
Global Macro Monthly – China

Aidan Yao,
Economist (China),
Macro Research – Core Investments

Growth weakens on Delta resurgence

August activity data painted a gloomy picture of the Chinese economy. Retail sales growth tumbled to 2.5% year-on-year (yoy) from 8.5% in July as the Delta variant wreaked havoc forcing local governments to enact the most stringent social and mobility restrictions since early 2020. Restaurant and catering services took a beating, falling 4.5%yoy – the first contraction since last November. For goods sales, nearly all categories grew more slowly last month relative to July, reflecting increased consumer caution (Exhibit 3).

Exhibit 3: Retail sales drop due to rising COVID-19 cases



Source: CEIC and AXA IM Research, 16 September 2021

Tightened mobility and social controls also weighed on travel, hospitality and off-line entertainment activities, leading to a steep – three percentage points (ppt) – drop in total services output growth, while the services Purchasing Managers' Index fell below 50 for the first time since last February. Although improved mobility matrices since August hint at a pending recovery, a new cluster of COVID-19 cases found in Fujian province in recent days are clouding that outlook.

Growth momentum also eased outside the consumer and services sectors, but not as much as headline figures suggest. The base effects – which have absorbed last year's V-shaped rebound – are starting to bias year-on-year growth downward. Take industrial production as an example. August data showed a steep drop in yoy growth to 5.3% from 6.4%, but its two-year compound average growth rate (2yr CAGR) – which removes the base effect – dipped only 0.1ppt to 5.5%. Of the main components, growth of mining and high-tech manufacturing output actually accelerated on a 2yr CAGR basis. In contrast, notable weakness remained in auto and electronics production, partly due to chip shortages.

For the time being, industrial output growth is being supported by surprisingly strong exports. But as the latter inevitably weaken, domestic demand needs to pick up the baton to be the stabilising force. This is why both COVID-19 containment and additional policy supports are necessary to ensure ongoing trend expansion after the initial strong recovery.

Fixed asset investment (FAI) regained some growth momentum as the impact of severe floods faded. Manufacturing investment did all the heavy lifting, growing 6.1% on a 2yr CAGR basis – the highest for the year. Infrastructure investment remained weak despite a modest pick-up in bond issuance by central and local governments, suggesting improvement in the coming months. However, Beijing's insistence on deleveraging has left local governments and their funding vehicles cautious about taking on more debt, delaying the completion of this year's issuance quota. As a key growth stabiliser, infrastructure investment growth may still fall short of expectations going forward.

The biggest downside risk remains in the property market. Although investment growth has stayed steady so far, the outlook is turning grim as housing starts, turnover, and land sales all continue to fall. Rising defaults by property developers are another risk to manage, particularly as some large and connected real-estate companies are attracting worrying headlines. Even though there is a low chance of Beijing rolling back existing housing market curbs, some administrative interventions may be warranted to keep systematic (financial) risks at bay.

Weaker economy calls for more supports

Overall, August data – despite some base effect distortions – still point to a genuinely weakening economy. While some temporary factors have played a role, the cooling property market, continued emission curbs and falling credit growth are sustained growth headwinds. Softening external demand could be the last shoe to drop to make the slowdown more visible to Beijing.

Even though authorities have already started to ease policy, the limited moves so far have fallen short of what we believe is required to dispel downside risks. We continue to expect the People's Bank of China to step up monetary policy supports – starting with less high-profile tools, such as relending to small and medium-sized firms and Medium-Term Lending Facility (MLF) to keep liquidity ample, before a targeted cut to the reserve requirement ratio in the fourth quarter. More active fiscal policy is also needed to exert pressure on local governments to meet this year's issuance quota and make sure that money is put to work fast. As official attention shifts back to growth preservation, the intensity of regulatory crackdowns may also ease, providing some respite to financial markets.

Global Macro Monthly – EM

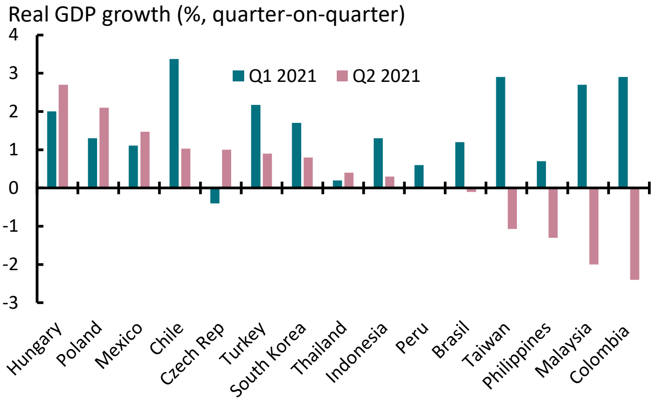
Irina Topa-Serry,
Senior Economist (Emerging Markets),
Macro Research – Core Investments

Shirley Shen,
Economist (Emerging Asia),
Macro Research – Core Investments

Delta: A speed bump on the road to recovery?

There has been a persistent bias in assessments of the pandemic recovery: Each new wave of the virus has left us cautious on the outlook for activity, and yet successive waves have provided less disruption and GDP reports have consistently surprised on the upside. The latest Delta variant exhibited greater infectiousness but has had a surprisingly more modest impact than expected thus far, given the continued rise in mobility in July and August. The increased pace of vaccination may explain a lot of this. Nevertheless, Asian region GDP growth has been affected disproportionately more in the second quarter (Q2) of 2021 (Exhibit 4), while we have revised – mostly to the upside – our annual growth forecasts for many other emerging markets (EMs).

Exhibit 4: A multi-speed recovery into Q2 2021



Source: Datastream and AXA IM Research, 15 September 2021

Fed tapering – different this time?

As the US Federal Reserve (Fed) comes closer to tapering its quantitative easing (QE) purchases, 2013 taper tantrum memories have resurfaced. Back then, when Fed Chair Ben Bernanke just hinted at a gradual toning down of asset purchases in the future, he triggered a market tsunami which led to higher interest rates in the US, followed by capital outflows and balance of payment pressures in many emerging markets. At the time of that speech in June 2013, emerging markets had been enjoying massive capital inflows following years of ultra-loose US monetary policy. The 'fragile five' (i.e. South Africa, Brazil, India, Indonesia and Turkey) were running high current account deficits and became highly dependent on foreign portfolio investments. The taper tantrum became a harsh wake-up call highlighting EM vulnerabilities and the fine line that some countries were walking.

Several factors suggest things may be different this time and EMs should avoid the cold shower of 2013. To begin with, the Fed seems to have learned from that episode and has been particularly good at communicating and preparing the markets far in advance of the event. Importantly, EMs as a whole appear less dependent on foreign portfolio flows than they were back in 2013. Additionally, external financing requirements are very small compared to 2013. Indeed, external imbalances were actually on an improving trend pre-pandemic and continued to improve through the health crisis. Oil exporters and highly tourism-exposed countries were significantly affected last year, but the former at least are likely to have reversed the trend thanks to stronger commodity prices this year. Furthermore, reserve levels are adequate for most EM countries, even more so after the recent new International Monetary Fund (IMF) allocation of Special Drawing Rights (SDRs), and currencies do not appear to be overvalued by standard metrics. Lastly, some important central banks have already been front-loading interest rate hikes recently (including Brazil, Mexico, Peru, Chile, Russia, Hungary, Czech Republic, Ukraine, South Korea), pre-emptively supporting their capital accounts.

Looking ahead

The Fed's upcoming taper may end up not rattling EMs this time, but plenty of other risks loom. Although the Fed has always had a large impact on EMs' balance of payments through capital accounts, China has also become of major importance given its significant impact on EM current accounts. The coincidence of the Fed's tapering and a possible steeper economic slowdown in China – if authorities fail to bring the needed support – could bring a serious blow to EMs.

Additionally, the pandemic is not over. While developing countries appear to have coped relatively better than advanced so far (thought to reflect interconnectedness amongst developed economies), late and insufficient vaccination in EMs could pave the way for a subdued economic recovery in the years to come.

More fundamentally, the weakening growth potential observed in EMs is in many respects worrying. In a post-pandemic, more indebted world, with less impetus to further globalisation, pressures to decarbonise economies and social tensions continuing to reflect rising inequalities, emerging markets will face a difficult balancing act.

Investment Strategy – Cross assets

Greg Venizelos,
Credit Strategist,
Research – Core Investment

Markets fretting about a bit of everything

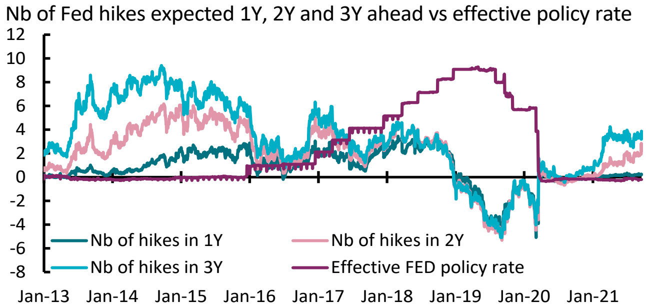
The market mood has turned negative in September amid a confluence of factors. In the US there has been political dysfunction over the prospect of further fiscal support, the debt ceiling and risk of a government shutdown. In China, the ripples from real estate group Evergrande's failure continue. Ultimately, central banks can offset such market jitters through more patience towards policy normalisation, while they balance Delta variant risks against inflation pressures.

Investment Strategy – FX

Romain Cabasson,
Head of Solution Portfolio Management,
Multi-Assets – Core Investments

Who's afraid of the big bad US dollar?

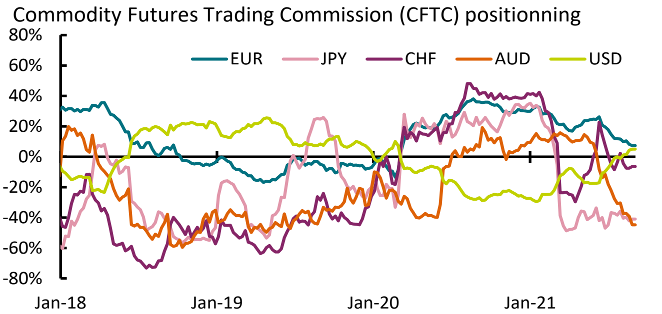
Exhibit 5: Pricing of next Fed hiking cycle still timid



Source: Bloomberg and AXA IM Research, 20 September 2021

Interest rates across the G10 reconverged towards zero on the back of the coronavirus crisis. This saw the US dollar, which was the high yielder of the previous cycle, lose ground. But since the start of the year, the massive fiscal and monetary support deployed in developed economies has created a sharp turnaround and revived inflation pressures. Most of this looks temporary, but the rebound in growth, prices and labour markets will justify normalising monetary policy where inflation was already at target and overheating is a risk. Markets are quickly repricing central banks' interest rate hikes as a result – including the US Federal Reserve (Fed), even after accounting for its revised average inflation targeting policy. Monetary policy divergence is thus making a comeback as a driver for currencies. There is more room to reprice the next Fed cycle, which may bring fresh dollar strength (Exhibit 5). Congress voting through a new fiscal package could add to the momentum, as could a rebound in long-term US real rates similar to that seen in March. Such a move could be triggered in the fourth quarter (Q4) as debt ceiling issues are resolved, the Fed moves closer to tapering, and US net debt supply recovers.

Exhibit 6: US dollar sentiment outside negative territory



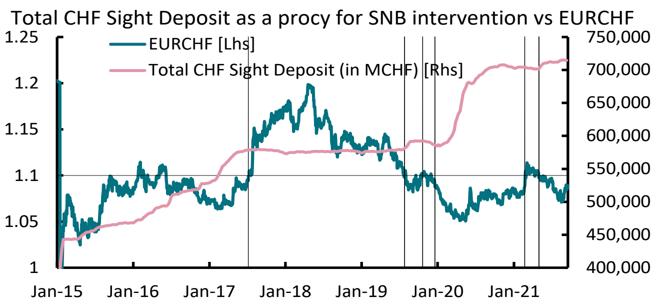
Source: Bloomberg and AXA IM Research, 20 September 2021

Policy normalisation is being priced into other currencies such as the Canadian dollar, Norwegian krone or New Zealand dollar. However, market expectations for these central banks have already risen more than for the Fed, so the currencies may better resist US dollar appreciation. This is particularly so for New Zealand where the central bank seems to be heading for rate hikes as early as Q4. Inflation pressures are up in New Zealand amid rebounding growth, a tight labour market, and with house prices up 27% year-on-year. The Delta variant also seems better handled than in Australia, with vaccination rolled out swiftly. We became more bearish on the Australian dollar this summer on doubts about China-driven demand (Exhibit 6).

Euro, Swiss franc and yen running for shelter

Central banks in the Eurozone, Switzerland and Japan are less likely to normalise policy soon. Inflation has been persistently below-target for a while and inflation pressures are much less acute (a spike in gas prices notwithstanding). The growth rebound and fiscal thrust are also rather underwhelming in Europe. The euro and Swiss franc are hence likely to suffer in any repricing of US dollar monetary policy divergence once again. The Swiss central bank's proactive stance against appreciation is adding to the mix (Exhibit 7). The yen, on the other hand, may prove more resistant to dollar strength, as it is more undervalued to start with and sentiment has already been largely negative for some time. Indeed, the dollar/yen rate has been very stable recently and Japan's outbound investment outflows have declined.

Exhibit 7: Swiss National Bank still intervening



Source: Bloomberg and AXA IM Research, 20 September 2021

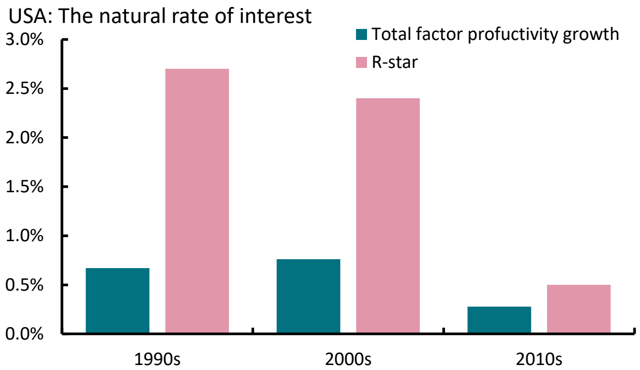
Investment Strategy – Rates

Alessandro Tentori
AXA IM Italy CIO and Rates Strategist
Research – Core Investments

There is no alternative in the real rates world

Theoretical economists have long held the view that real interest rates are linked to productivity growth, as for example in the famous Ramsey model. Conceptually, GDP growth is a proxy for the total return of investing in an economy, which is again proxied by the real interest rate. Hence, in the long run, there should be a link between the determinants of an economy's growth (mainly technology, but also labour force) and the equilibrium real interest rate (r-star). In Exhibit 8, we show the average of total factor productivity growth and r-star over three distinct decades in the US. Note the collapse in both productivity and r-star during the 2010-2019 decade.

Exhibit 8: Does productivity drive r-star?



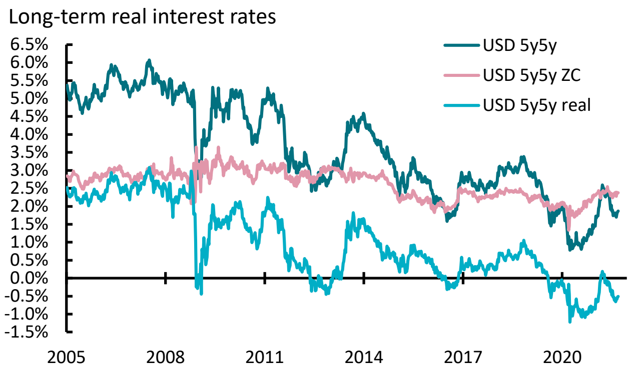
Source: Bloomberg, The Conference Board and AXA IM, 20 September 2021

The true story might be more nuanced, with a simple visual analysis sometimes misleading. Analysts at the Federal Reserve Bank of Cleveland have investigated a similar relationship over a much longer sample of data and the results do not seem to validate the initial hypothesis of a positive relationship between productivity and real interest rates. Furthermore, the consensus seems to accept that other factors – in addition to productivity – might have influenced the medium-term trend in real interest rate.

One such factor is demographics and the associated 'savings glut', which has increased the universe of viable investments. Central banks' textbook response, i.e. calibrating their reaction function to a structurally lower nominal equilibrium rate, might have fuelled a positive feedback loop between excess savings and monetary policy (at least as long as the reversal rate is not reached). Zombie firms are the eventual result of this doom loop and such reasoning leads us back to low productivity and low equilibrium interest rates.

However, a relatively naïve dynamic may also be at work, relying almost exclusively on the mechanics of the bond market. On the one hand, central banks keep a firm lid on the level of long-term risk-free rates by deploying unconventional tools like asset purchase programmes. On the other hand, the powerful policy implications of a coordinated monetary, fiscal and macroprudential strategy might be pushing inflation expectations higher. The combined effect of this quantitative easing (QE) and coordinated economic policy is historically depressed real interest rates, as we can see in Exhibit 9. Again, this narrative might lead us back to zombie firms and a structurally low level of productivity.

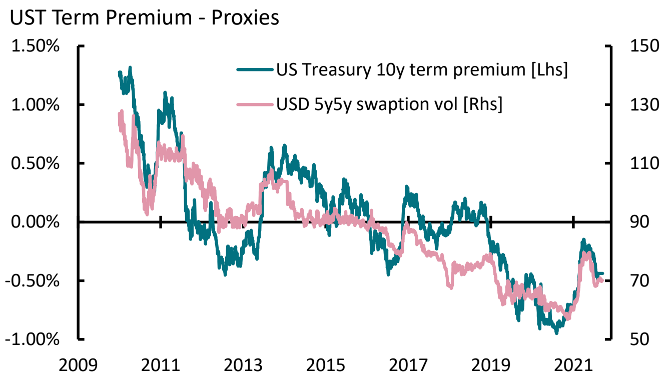
Exhibit 9: Nominal, real and inflation swaps



Source: Bloomberg and AXA IM, 20 September 2021

To somewhat complete the picture, we observe that a QE strategy is akin to controlling the level of risk in the market. In Exhibit 10, we show the relationship between the US Treasury term premium and the implied volatility of a five-year, five-year swaption. However, bond market QE and depressed real interest rates easily spill over, beneficially, to other markets. As we briefly mentioned above, in a persistent QE environment, the pool of viable investments is greatly enlarged and the philosophy of 'TINA' – There Is No Alternative – becomes a successful investment strategy.

Exhibit 10: The largest seller of volatility in the world



Source: Bloomberg and AXA IM, 20 September 2021

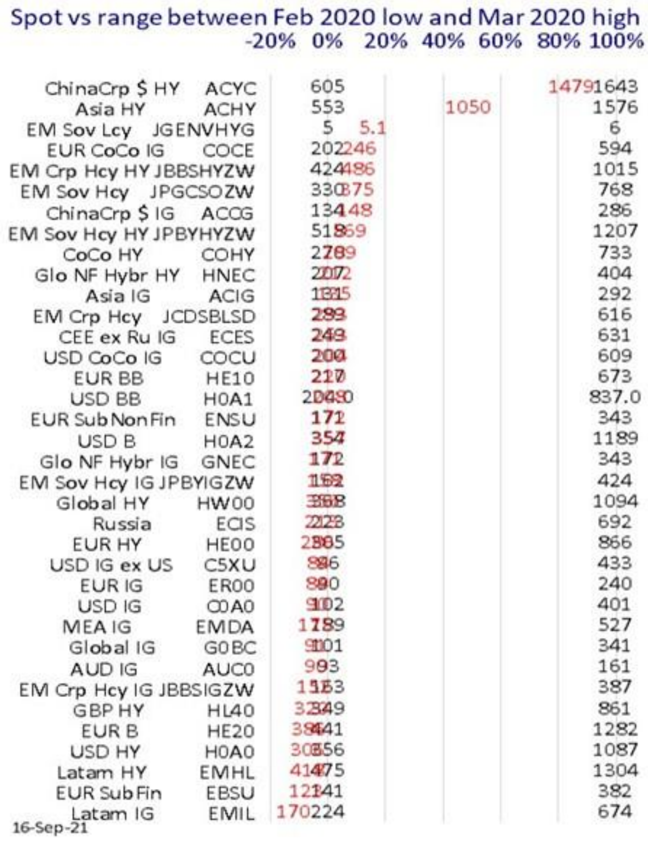
Investment Strategy – Credit

Gregory Venizelos
Credit Strategist
Research – Core Investments

Credit markets: In a Goldilocks world again

Credit markets have entered a 'Goldilocks regime' (neither too hot nor too cold) once again, with spread levels persistently low and spread volatility well contained. Credit indices across currencies and regions are trading at, or through, the lows of their 2020 range, including the pre-pandemic shock lows and the post-shock highs (Exhibit 11). The sole exception is the China high yield (HY) index and by association Asia HY, due to a credit event at Chinese property group Evergrande and its contagion across Chinese markets.

Exhibit 11: Credit indices trading at or through their 2020 range lows except for China/Asia HY

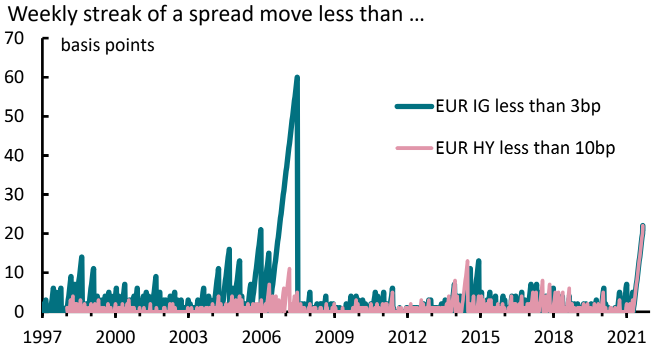


Source: InterContinental Exchange (ICE) and AXA IM Research, Sep 2021

While a potential headwind for Chinese growth, these developments should not become a source of contagion for global risk premia. Non-domestic exposures and any multiplier effects of the kind we saw after the Lehman bankruptcy during the global financial crisis appear limited.

This leaves us with the prospect for very low spreads and low volatility to persist into 2022 (Exhibit 12). The headwinds from the Delta coronavirus variant, while vaccination penetration may be plateauing, should allow central banks to be very patient with their policy withdrawal. Such a backdrop would continue to underpin credit risk premia amid the need for yield by fixed income investors. A risk to this outlook is that inflation proves too sticky and it forces the hand of central banks vis-à-vis policy normalisation.

Exhibit 12: Euro credit in a record-breaking run (in HY) of very narrow spread trading range

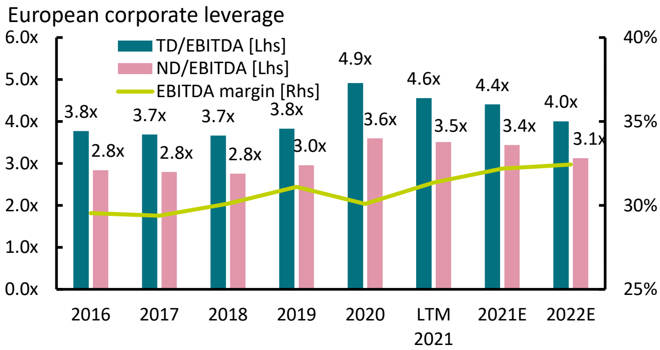


Source: ICE and AXA IM Research, Sep 2021

Credit fundamentals in repair mode

Credit risk premia are also supported by the improvement in corporate fundamentals (Exhibit 13). The deterioration in leverage after the first quarter of 2020 was driven by earnings collapsing as the economy shut down and debt shooting up as corporates borrowed heavily to build up balance sheet cash. Thankfully, largely due to massive fiscal support, the earnings drawdown proved not as deep or protracted as feared – similarly for the cash burn, even for very exposed sectors like airlines. On top of that, the subsequent rebound in earnings also proved stronger than expected and helped to improve the leverage metrics. Th pace of improvement is likely to slow, but leverage has almost returned to pre-pandemic levels already and interest cover has risen to new highs (not shown).

Exhibit 13: Euro corporates leverage* almost back to pre-pandemic levels



Source: Company reporting and AXA IM Research, Sep 2021.
**Gross leverage in blue (total debt), net leverage in orange (net debt)*

Investment Strategy – Equity

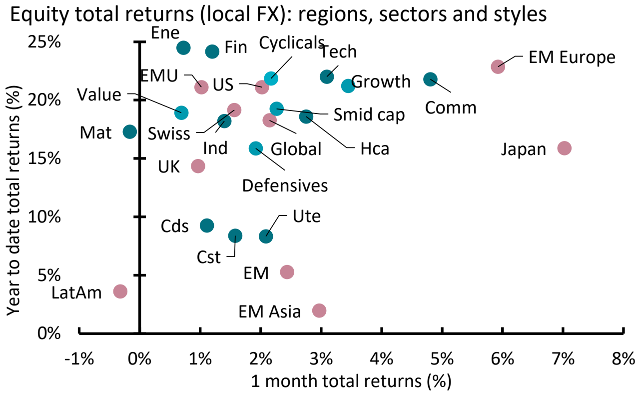
Emmanuel Makonga,
Investment Strategist,
Research – Core Investments

It's Fall, Y'all

After taking a breather in July – the weakest monthly performance (+0.6%) since the start of the year – global equities regained momentum with a +2.2% increase in monthly performance (Exhibit 14), their biggest monthly increase since late April. Across countries, Japan outperformed its peers with a strong +7% growth as political events reassured investors on future economic developments. On the sector front, communications (+4.8%) delivered the greatest performance in August. Meanwhile growth stocks (+3.4%) outperformed other factors for the third month in a row.

Exhibit 14: Positive equity performance continues

Equity total returns (local FX): regions, sectors and styles



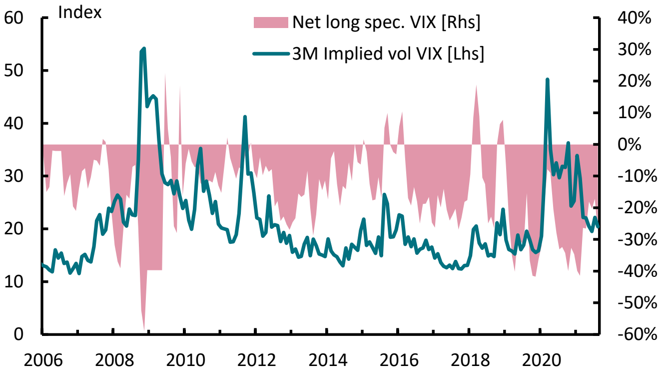
Source: Datastream and AXA IM Research, 20 September 2021

Implied volatility has climbed above the 20 level several times since May but has been declining compared to last year's levels. Since the start of May, the VIX volatility index averaged 18.4, below its one-year average of 21.5. The term premium remains attractive. As a result, volatility positioning stands at a net short of -27.5% compared to a first quartile level of -23% (Exhibit 15), as the carry remains appealing.

The current valuation gap between value and growth stocks has been historically low since mid-2019 (Exhibit 16). Since March 2020 this gap has continued to widen, due to the performance of global stocks – mainly driven by valuation (+41.6%) in 2020 – and the exceptional rally in growth stocks (+74.7%) compared to value stocks (+57.5%) from the pandemic trough to the end of 2020. This phenomenon suggests an appealing entry point in favour of value. But the decline in the value factor premium[1] recently makes some investors sceptical that such an outcome will unfold.

Exhibit 15: Short bets remain at play

Implied vol and positioning - VIX

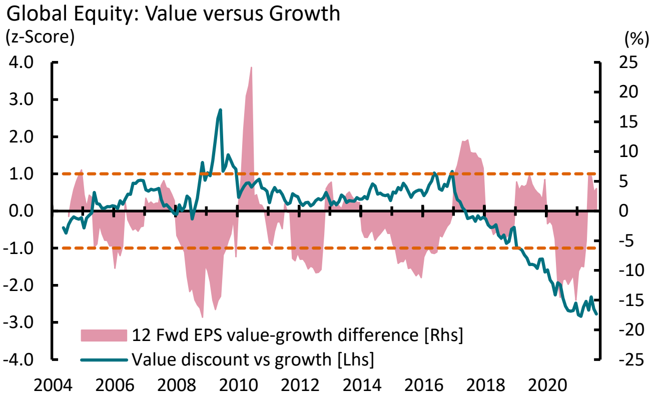


Source: Bloomberg and AXA IM Research, 20 September 2021

What do the fundamentals tell us? If valuation multiples reflect investors' expectations of earnings growth, the current gap in valuations would be justified by a large spread in anticipated earnings. But looking at the difference in 12-months forward earnings growth between value and growth stocks, we do not observe such a gap. Perhaps the earnings difference explained the valuation gap between 2016 and 2020, but the current 3.8% gap no longer supports it, which strengthens our view of the attractiveness of value stocks.

Exhibit 16: The value factor is appealing

Global Equity: Value versus Growth



Source: MSCI, IBES and AXA IM Research, 20 September 2021

The macroeconomic environment continues to indicate the recovery is slowing, albeit that it remains strong – despite manufacturing surveys pulling back from recent highs. The monetary policy stance is heading for less support in the months ahead. Our economists expect the US Federal Reserve to announce a reduction in asset purchases in December. In parallel, the European Central Bank announced a reduction in net purchases of its Pandemic Emergency Purchase Programme during its last meeting. This could push yields higher given the market's complacency about high inflation prints, although we also consider inflation pressures to be transitory. Overall, we remain overweight in equities in our multi-asset allocation framework with a bias towards value-oriented risk assets.

[1] Fama, E. and French, K., "The Value Premium", Fama-Miller Working Paper No. 20-01, 1 January 2020

Recommended asset allocation

Asset Allocation	Negative	Neutral	Positive
Key asset classes			
Equities			■
Bonds	■		
Commodities	▼		
Cash			▲
Equities			
Developed			
Euro area			■
UK			■
Switzerland		■	
US		▼	
Japan		■	
Emerging & Sectors			
Emerging Markets		■	
Europe Cyclical/Value		▼	
Euro Opening basket			■
Euro Financials			■
US Financials		▼	
US Russell 2000		▼	
Fixed Income			
Govies			
Euro core	■		
Euro peripheral		■	
UK		■	
US	■		
Inflation			
US		■	
Euro		■	
Credit			
Euro IG		■	
US IG		■	
Euro HY		■	
US HY		■	
EM Debt			
EM bonds HC		■	

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

Source: AXA IM Macro Research – As of 22 September 2021

Macro forecast summary

Real GDP growth (%)	2020	2021*		2022*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
World	**-3.6**	**5.7**		**4.4**	
Advanced economies	**-5.2**	**5.1**		**4.2**	
US	**-3.4**	**5.7**	6.2	**4.3**	4.4
Euro area	**-6.7**	**4.7**	4.8	**3.9**	4.4
Germany	**-4.9**	**2.9**	3.3	**3.8**	4.4
France	**-8.0**	**5.9**	5.9	**3.5**	3.9
Italy	**-8.9**	**5.2**	5.3	**3.7**	4.2
Spain	**-10.8**	**5.3**	6.0	**5.1**	5.9
Japan	**-4.9**	**2.6**	2.4	**3.3**	3.0
UK	**-10.0**	**6.7**	6.8	**5.7**	5.4
Switzerland	**-3.0**	**3.6**	3.7	**3.3**	2.9
Emerging economies	**-2.6**	**6.1**		**4.6**	
Asia	**-1.2**	**7.2**		**5.3**	
China	**2.3**	**8.5**	8.6	**5.5**	5.6
South Korea	**-0.9**	**4.0**	4.1	**3.0**	3.2
Rest of EM Asia	**-5.6**	**5.9**		**5.4**	
LatAm	**-7.3**	**5.6**		**2.4**	
Brazil	**-4.1**	**5.2**	5.0	**1.6**	2.2
Mexico	**-8.5**	**6.5**	6.1	**2.3**	3.0
EM Europe	**-2.3**	**5.5**		**3.6**	
Russia	**-2.8**	**4.5**	3.5	**3.3**	2.7
Poland	**-2.7**	**5.3**	4.8	**5.2**	5.1
Turkey	**1.6**	**8.0**	6.2	**3.0**	3.5
Other EMs	**-3.7**	**3.3**		**4.1**	

Source: Datastream, IMF and AXA IM Macro Research – As of 21 September 2021 * Forecast

CPI Inflation (%)	2020	2021*		2022*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	**0.8**	**2.6**		**1.8**	
US	**1.2**	**4.0**	4.1	**2.7**	2.9
Euro area	**0.3**	**2.0**	2.1	**1.5**	1.5
Japan	**0.0**	**-0.1**	0.1	**0.4**	0.5
UK	**0.9**	**2.3**	2.2	**2.7**	2.7
Switzerland	**-0.7**	**0.4**	0.4	**0.5**	0.6

Source: Datastream, IMF and AXA IM Macro Research – As of 21 September 2021 * 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	Q4-21	Q1-22	Q2-22	Q3-22
United States - Fed	Dates	0-0.25	2-3 Nov 14-15 Dec	25-26 Jan 15-16 Mar	3-4 May 14-15 June	26-27 July 20-21 Sep
	Rates		unch (0-0.25)	unch (0-0.25)	unch (0-0.25)	unch (0-0.25)
Euro area - ECB	Dates	-0.50	28 Oct 16 Dec	20 Jan 10 Mar	14 April 9 June	21 July 8 Sep
	Rates		unch (-0.50)	unch (-0.50)	unch (-0.50)	unch (-0.50)
Japan - BoJ	Dates	-0.10	27-28 Oct 16-17 Dec	17-18 Jan 17-18 Mar	27-28 April 16-17 June	20-21 July 21-22 Sep
	Rates		unch (-0.10)	unch (-0.10)	unch (-0.10)	unch (-0.10)
UK - BoE	Dates	0.10	4 Nov 16 Dec	3 Feb 17 Mar	5 May 16 June	4 Aug 15 Sep
	Rates		unch (0.10)	unch (0.10)	unch (0.10)	unch (0.10)

Source: AXA IM Macro Research - As of 21 September 2021

These projections are not necessarily reliable indicators of future results

Download the full slide deck of our September Investment Strategy

Our Research is available on line: http://www.axa-im.com/en/insights

AXA Investment Managers SA
Tour Majunga – La Défense 9 – 6 place de la Pyramide 92800 Puteaux – France
Registered with the Nanterre Trade and Companies Register under number 393 051 826