After the first month

Global Macro Monthly

Key points

- The Ukraine war has added to broader global tensions. The Euro area recovery now faces challenges with European gas prices a key drag. Fiscal stimulus will offset some of the shock. This is less so in the UK.
- The war is another supply shock to the US. This will add to the Federal Reserve (Fed)'s difficulty in managing its dual mandate – its recent focus has pivoted to inflation expectations control.
- China faces domestic challenges. The Ukraine war does not help, but the bigger risk is its ongoing relationship with Russia. An aggressive 5.5% growth target suggests supportive stimulus to come.
- Markets have reacted to the war although initial risk-off sentiment has receded somewhat – albeit leaving some legacy in foreign exchange markets.
- Rates adjustments have been sharp as markets reassess the Fed's policy outlook.

Global Macro Monthly

Investment Strategy

Global Macro Monthly – US

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

Ukraine war is another supply shock

Since our last update, Russia has invaded Ukraine. In some ways, this changes everything for the US outlook: Another supply shock further postpones a retreat in inflation and to the risks of unanchoring expectations; tighter financial conditions will further slow growth; and both complicate the Federal Reserve (Fed)'s task of delivering its dual mandate. In other ways the invasion changes nothing – US growth started the year solidly, but consumers face weakening real income growth; the Fed's inflation focus is the domestically-driven element, spurred on by a tight labour market – and both complicate delivery of the Fed's dual mandate.

Yet uncertainty has risen with the Russian invasion. We assume a protracted disruption (militarily and sanctions-based) that will keep energy prices elevated over the next two years and disrupt the delivery of commodities that Russia and Ukraine supply to the world, including wheat, corn and metals including platinum, palladium, nickel and aluminium (10% of US aluminium imports are Russian). However, the outlook could vary wildly, from hopes of a quicker settlement following peace talks, to fears of further escalation.

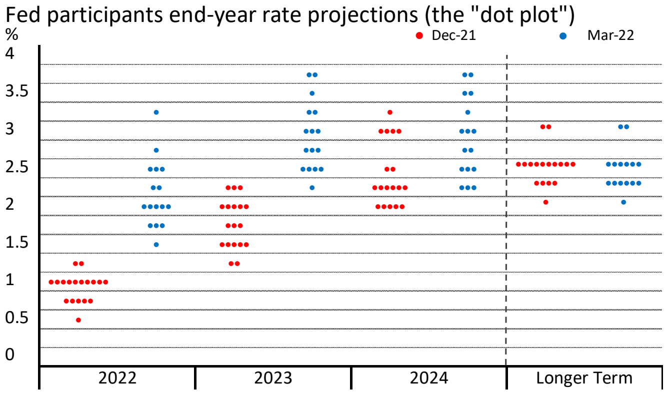
These developments will undo the encouraging indications of receding supply-side disruptions that had been emerging from the turn of the year. They will raise the peak in headline inflation to somewhere above 8% and delay a meaningful decline beyond the spring, as we had previously forecast. As such, we have raised our inflation forecast to average 6.8% in 2022 and 3.8% in 2023 (from 5.0% and 2.9%).

Higher inflation is likely to be the key headwind to economic activity. With real incomes already set to be stretched, higher inflation will reduce this growth further. We expect the $2.25tn-plus excess savings accumulated over the past two years of the pandemic to be unwound over the coming two years to support spending as real incomes weaken. This – alongside an energy and labour cost squeeze on firms weighing on investment, a drop in overseas demand impacting exports and tighter financial conditions — means we have lowered our GDP outlook: 2.8% for 2022 and 1.6% for 2023 – below the consensus 3.5% and 2.3%.

Fed shifts focus to inflation control

Monetary policy is not well-suited to deal with supply shocks. At its latest meeting, the Fed raised the Fed Funds target by 0.25% - the first hike since 2018. It also shifted its outlook for policy rates. The Fed's dot plot (Exhibit 1) shows its rates projections from March 2022 and December 2021. It now envisages an additional 100bps of tightening this year taking the Fed Funds Rate to 1.75-2.00% and further increases to 2.75-3.00% by the end of 2023. Fed Chair Jerome Powell also hinted the Fed's quantitative tightening (QT) package was all but complete, with details expected in the upcoming Fed minutes on 6 April. As such, we expect the Fed to announce QT at its next meeting on 4 May.

Exhibit 1: Fed signals more hawkish outlook



Source: Federal Reserve Board (FRB), Bloomberg and AXA IM Research, March 2022

Tighter policy reflects two concerns. First, an economy in excess demand with a tight labour market and elevated unit labour cost growth. This suggests the Fed needs to slow the economy to soften employment growth and *gently* raise unemployment. Second, there is the risk that inflation expectations become unanchored, creating "persistent" inflation and feeding into wage-setting. In March, Powell said the "plan" was to restore price stability with a strong labour market, but added the priority was to restore price stability.

The Fed's focus thus appears to have shifted to inflation (expectations) control. Given the war-driven, shifting inflation outlook we now see it moving at back-to-back meetings for most of 2022, with risks that any further upside inflation surprise could precipitate a 0.50% hike at one or more meetings. Yet on balance we believe softer growth in 2022 will increasingly caution against too much tightening. We now front-load our policy hike expectations to include six back-to-back hikes to 1.50-1.75% this year and three hikes to 2.25-2.50% next. This falls short of the Fed's median projections and market expectations.

We are also mindful of downside growth risks. An escalation of the war could materially worsen the outlook. Even without this, there is a risk that further supply disruptions – pushing inflation higher; a tightening in financial conditions reflecting weaker market sentiment and an unwind of now strong inventory accumulation could combine to deliver a sharp drop in GDP – including the possibility of a quarter's contraction. We do not expect a recession, but weaker growth – particularly in H2 2022 – is a real risk and underpins our expectation of less monetary tightening.

Global Macro Monthly – Eurozone

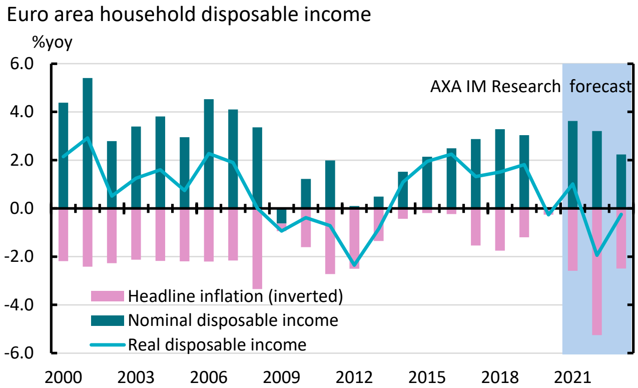
François Cabau and Hugo Le Damany,
Economists,
Macro Research – Core Investments

Eurozone into stagflation this year

We have significantly downgraded our Eurozone GDP growth forecasts for this year and next. This follows the invasion of Ukraine and reflects an upwardly revised inflation profile, squeezing more real incomes, and weighing on sentiment.

We now project Eurozone inflation to average 5.3% this year, peaking at 6.3%yoy in Q2 and decelerating to average 2.5% next year. Assuming a limited impact to the labour market – thanks to fiscal policy support (see below) – this would see household's real disposable income contracting by c. -2% in 2022, a drop not seen since 2012 (Exhibit 2). Consumer surveys weakened sharply in March. We project a contraction in household consumption in Q2/Q3, which could be more significant should this drop in sentiment translate into an increase in precautionary savings – a crucial element to the outlook.

Exhibit 2: Hard real income squeeze this year



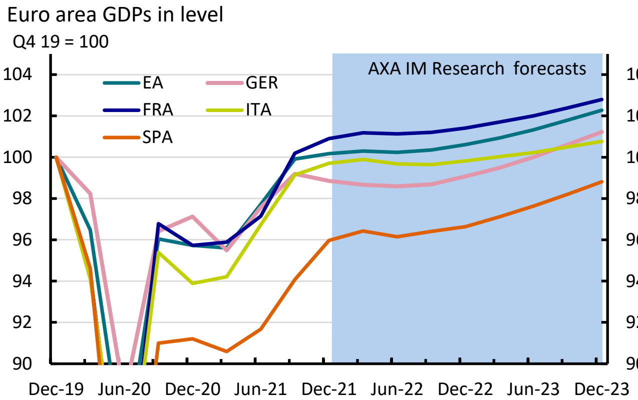
Source: Eurostat and AXA IM Macro Research, 29 March 2022

Meanwhile, details of Purchasing Managers Indices and closely-watched business surveys confirmed dented confidence, implying a likely contraction in business and overall investment.

In sum, we forecast Eurozone GDP to contract mildly in Q2 and recover slowly from there, implying an average 0.1%qoq sequential growth rate through 2022. This would be consistent with a 2.1% GDP growth rate for the year as a whole. We think investment will lead the recovery in 2023. An average 0.4%qoq sequential pace means Eurozone GDP would grow by 1.2% on average in 2023. The balance of risks is skewed to the downside, mainly owing to possible higher inflation (notably from food prices), and supply disruptions.

Combining economic momentum prior to the conflict, exposure to the shock and the fiscal response announced so far, we think that France is likely to outperform peers, while Spain looks more vulnerable (Exhibit 3).

Exhibit 3: France likely to outperform peers



Source: Eurostat and AXA IM Macro Research, 29 March 2022

Fiscal policy coming in support

Member states have been quick to herald measures to ease the increased energy price burden in the short term. France and Germany have announced measures worth 1.2% and 0.8% of GDP respectively (c. €30bn each). With this week's announcement by PM Sanchez, Spain and Italy are scheduled to deploy c.€20bn (i.e. 1.7% and 1.1% of GDP respectively)[1]. Although EU Council meetings have come short of any mutualised financing options on this short-term measures, European member states have coordinated well on the nature of (fiscal) measures, including future joint purchase of gas, as well as on sanctions against Russia.

EU leaders have postponed decisions with regards to medium-term investment initiatives on energy transition and EU defence to May/June at least, another possibility for future mutualised financing.

ECB: Gradual policy normalisation on the way

The ECB's March Governing Council was only a little more hawkish than we expected. We think the ECB's conditions for policy normalisation are met; medium-term inflation expectations anchored at target and the capacity of the economy to absorb shocks due to an adequate policy mix.

We think the ECB will finish its APP at the end of Q2. Amended forward guidance that rate hikes would only follow "sometime after" still means a hike is likely before the end of the year. We foresee two 25 basis point (bp) deposit rate hikes to zero in December and March. We are less aggressive than the market pricing 55-60bp worth of hikes between July and year-end.

[1] Fiscal support measures are in cumulative terms since last fall

Global Macro Monthly – UK

Modupe Adegbembo,
Junior Economist,
Macro Research – Core Investments

Ukraine exacerbates outlook for UK

Despite limited direct trade links with Russia and Ukraine – with just 0.25% of GDP in exports and 1% in imports – the UK may be among those most impacted by the invasion. It is on the European gas hub and subject to the same price rises, despite not directly receiving gas from Russia. Furthermore, it has a large trade exposure (46% of exports) to Europe, which is likely to see growth slow. And unlike many European states, the UK is not offsetting much of this shock with fiscal stimulus.

The energy market outlook is uncertain, but the UK's relative reliance on oil and gas makes it critical. We assume gas prices will be elevated this year and next. As such, UK households face more sharp rises in utility bills. A 54% regulatory cap increase from April could be followed by a 25% rise in October. The war also creates supply constraints for food, metals and other materials, which will delay a drop in inflation. We see inflation remaining elevated in Q4 from a peak of around 8% that we expect in April. We have raised our inflation outlook to 6.8% for 2022 and 3.4% for 2023 (up from 5.5% and 2.1% respectively).

This will add to household challenges; some measures point to the worst real income fall on record. It will also hit firms as they deal with rising costs. Both look set to weigh on activity, further impacted by falling confidence, tighter financial conditions and weaker external demand. We have lowered our GDP forecasts to 3.8% for 2022 and 0.7% for 2023 (from 4.3% and 2.1%).

In his Spring Statement, Chancellor Rishi Sunak did little to alleviate this pressure. He added around £3bn in direct measures, including a fuel duty cut, and a further £6bn/annum in tax threshold changes. This was small relative to the estimated £25bn energy bill faced by households this year. The Chancellor also pre-announced a basic rate income tax cut to 19% from 20% before the end of this Parliament – ahead of the next election. This will be outweighed by frozen tax thresholds.

The Bank of England (BoE) raised rates again by 0.25% in March to 0.75%. Its guidance regarding future tightening shifted to "might be appropriate", from "likely". In February, it forecast GDP would slow to 1.25% in 2023 and 1% in 2024, with unemployment rising to 5% by 2024. Given the Ukraine crisis, the outlook will be worse. We think its focus is shifting to growth risks in the face of the real income squeeze and is likely to hike again in May, and we forecast one more rise to 1.25% after that, most likely in June. However, this peak would be far less than the 2.00% market forecast for end-2022. And we now expect the BoE to cut rates to 1.00% next year.

Global Macro Monthly – Japan

Hugo Le Damany,
Economist,
Macro Research – Core Investments

Russia/Ukraine war and its possible aftermath

Japan is not particularly exposed to the Ukraine conflict as trade relationships are very limited. The most exposed sector is energy imports, but Japan is much more diversified than Europe as just 9% of its natural gas and 4% of oil come from Russia. However, higher global energy prices will weigh on purchasing power.

Inflation is still distorted to the downside by technical factors but in April these will likely disappear, and the consumer Price Index (CPI) is expected to reach at least 2%. Assuming energy prices and the yen stay at current levels, inflation could rise again during the summer. Inflation forecasts also rely on government intervention. Downside revisions are possible if it unfreezes the trigger clause that subsidises pump prices or restarts the "Go to" domestic tourism campaign in June. We forecast 2% inflation in 2022 and 1% in 2023. However, wage pressure remains muted. Preliminary data on *Shunto* (Spring wage negotiations) point to a small increase in nominal base pay of 2.1% from 1.8% last year.

Those developments weigh a little on our outlook for private consumption. Excess savings could help, but historical experiences have pointed the other way. In uncertain times, households tend to save more. As such, assuming a stabilisation in the saving rate is already an ambitious assumption.

Yen weakness should also benefit exporters but the expected decline in global demand and persistent supply disruptions in the auto sector remain a headwind to a more constructive view. As a result, we have lowered our GDP outlook to 2.5% in 2022; it is broadly unchanged for 2023 at 1.8%.

The Bank of Japan is pushed to the limit

At its latest monetary policy meeting the Bank of Japan (BoJ)'s rhetoric was more 'dovish' than expected. Governor Haruhiko Kuroda rejected any premature tightening, arguing inflation was still chiefly driven by energy prices and did not reflect any improvement in economic fundamentals. Having said that, the pressure is growing on the BoJ. Inflation is likely to be above its 2% target in April and 10y JGB reached its upper limit under yield curve control (YCC). We continue to believe rate hike is premature, but we cannot exclude anymore a shortening of the YCC or widening of the 10y range. First option seems more likely to counter further Yen depreciation.

Global Macro Monthly – China

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

Looking past the strong data

A notable growth acceleration – as indicated by the strong activity data for January and February – came as a surprise after early signs of a soft start to the year for the Chinese economy. A few inconsistencies between these data and earlier developments are worth noting:

- Retail sales growth rebounded strongly in the first two months of the year to 6.7% year-on-year (yoy), from 1.7% in December, despite earlier indications of an Omicron wave holding back consumer spending. The strong recovery in restaurant and catering activity was particularly puzzling given that tightened COVID-19 restrictions had led to a notable decline in the services Purchasing Managers' Index (PMI) at the start of the year.

- The 12.2% growth in fixed asset investment was also much stronger than expected. An acceleration of infrastructure investment growth was not inconceivable given the strong policy push, but the pace – an acceleration of almost nine percentage points – was much faster than anything related to construction activity (e.g., steel and cement production). Manufacturing investment growth also quickened sharply to 21% despite slowing export growth. But the most unexpected of all was the turnaround in real estate investment, which posted a 3.7%yoy gain, making a stark contrast to the 40% decline in property sales from major developers.

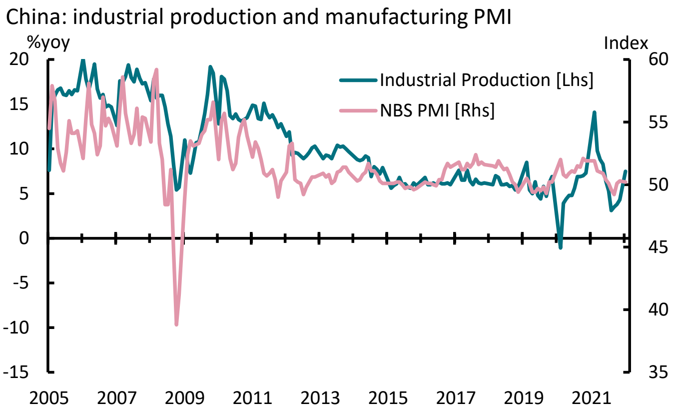
- Finally, the acceleration of aggregate industrial production growth was also at odds with the sluggish manufacturing PMI (Exhibit 4). The same goes for the faster services sector growth despite a notable decline in the non-manufacturing PMI.

Granted, assessing the Chinese economy at the start of the year is always tricky given the potential data distortions from the Lunar New Year. However, these multiple inconsistencies do suggest caution when drawing conclusions from the data.

The financial market will also likely take the data with a pinch of salt. In fact, investors' attention has already shifted to worrying about China's near-term economic outlook in light of a vicious resurgence of COVID-19. With case numbers at their highest since early 2020 and more than 20 provinces reporting local transmissions, China is now battling against the severest COVID-19 outbreak since the onset of the pandemic.

Local authorities have responded by stepping up containment measures and putting economic powerhouses, such as Shenzhen and Shanghai, under semi-lockdowns. The economic consequences – on consumption, services activity, the labour market and supply chains – should not be underestimated. So even if the economy was in much better shape at the start to the year – as portrayed by the official data – that strength has likely been eroded since then by the virus flare-up putting activities on hold.

Exhibit 4: Industrial output growth stronger than PMI



Source: CEIC and AXA IM Macro Research, 18 March 2022

Hence, there is no let up on policy vigilance against downside risks. We see a growing likelihood of a reserve requirement and/or interest rate cut in the near term. This, combined with targeted liquidity injections and 'window guidance', should help to revive credit growth beyond the first quarter. The delivery of fiscal stimulus should also speed up as the government puts this year's ambitious budget plan to work. Finally, further fine-tuning of property and regulatory policies, as communicated recently by Vice Premier Liu He, is necessary to shore up investor confidence, stabilise markets, and guard the system against capital outflows.

The effectiveness of these policies in stabilising the macro environment will depend, in a large part, on the severity and duration of the current COVID-19 outbreak. In light of the changing nature of the virus, Beijing has further recalibrated its policies by relaxing quarantine requirements for asymptomatic patients, approving antiviral drugs and encouraging self-testing for early detection. China is still some way away from a full reopening, but it looks like the government has started to prepare for such an eventuality with the recent policy changes. As for the economy, a more lenient implementation of virus containment measures will help lessen the shock even if the 'zero tolerance' principle stays intact.

Global Macro Monthly – Canada

David Page,
Head of Macro Research,
Core Investments

Ukraine impact different for commodity economy

The Canadian authorities' response to the Ukraine invasion echoed that of their G7 peers: Announcing sanctions on Russia, backing its removal from SWIFT and revoking export permits. Yet the impact of the invasion will be felt differently in Canada thanks to the similarity of its exports to Russia. Climate concerns have dampened the relationship between oil prices and investment in recent years, reducing Canada's traditional outperformance in times of high energy prices. However, energy accounts for 10% of the Canadian economy (and 15% of its equity market). The rise in energy and other commodities prices will boost corporate profits and tax revenues, improve the current account and should support the currency. In short, it is a relative terms of trade boost.

The broad growth impact should still be negative given a weaker investment response. Consumer confidence has softened and 80% of consumers are moderating behaviour ahead of higher prices. Yet activity was solid before the war. Q4 GDP growth exceeded our forecast, rising by 6.7% annualised, from 5.5% in Q3. January's flash estimate was for a 0.2% rise – suggesting no contraction during the Omicron outbreak. GDP rose by 4.6% in 2021. We forecast GDP growth of 3.3% in 2022 (from 3.5%), and 2.6% in 2023 (from 2.8%), both below consensus of 3.8% and 3.0%.

Inflation is likely to be higher for longer. The Canadian dollar has risen by 2% in trade-weighted terms since the invasion, but this will only dampen CPI inflation somewhat. Moreover, inflation was already elevated, up 5.7% in February, its highest since 1991. Inflation now looks set to peak over 6% in the coming months, before receding more slowly.

The Bank of Canada (BoC) hiked by 0.25% to 0.50% in March, its first since 2018. Focus will likely shift to the balance sheet. BoC Governor Macklem stated that quantitative tightening (QT) "is a logical next step" and that it could begin in "fairly short order". We see a good chance of QT announced in April. Macklem also suggested a "full roll-off" of securities, a pace that would be around twice that of the Fed's roll-off in 2017-18, by end-2023 and nearly half of the BoC's government bond holdings by end-2024. This aggressive unwind should temper calls for a 0.50% hike in April, although Macklem refused to rule this out for the future. With inflation now seen higher for longer, we edge our BoC rate outlook higher to 1.75% for end-2022 and 2.25% for end-2023. But expectations for weaker growth will likely see the BoC fall short of market views for 2.25% and 2.75%.

Global Macro Monthly – EM

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

Central and Eastern Europe in the line of fire

Since the start of the Russian military invasion of Ukraine, emerging markets (EM) have struggled. Overall, EM equities are selling off, spreads are widening, and capital is flowing out of EM asset classes. This crisis is a supply shock with stagflation-like consequences on the global economy – i.e., higher inflation and lower growth. With Russia producing around 15% of the world's gas, 10%-15% of its oil, and many other important mineral and agricultural commodities, the terms-of-trade shock will support some, but be detrimental to others, with a clear divergence between net commodity exporters and importers.

The war in Ukraine puts EM Europe at the epicentre of this crisis. Beyond Ukraine and Russia, the broader region will likely feel the shock given its proximity, a high degree of economic integration, dependence on Russian supplies, as well as movement of refugees, heightened uncertainty and a broader slowing in the European economy.

We anticipate a sharp 7% contraction of Russian GDP this year and another 3% in 2023, under the assumption of long-lasting sanctions. Yet even these estimates could prove optimistic if European sanctions eventually include hydrocarbon imports from Russia. In all, this war will durably affect capital accumulation and technological transfers leading to a significant cumulative output loss over the medium term, even if this may be somewhat mitigated by increased trade with China.

For Central Europe, we have trimmed GDP growth forecasts to an average of 4% for 2022. The growth shock could create a dilemma for monetary policy but for now, the pace of tightening accelerates with short term inflation risks looming larger. Targeted currency interventions could also be employed to limit excessive currency weakness. An easing of fiscal policy in several states would absorb some of the commodity price impact onto the public balance sheets.

The war in Ukraine could also bring more cohesion to the EU. This would help a swift channelling of EU funds in the short term (around 4% of GDP per year), which had been held up due to EU concerns with domestic policies in Hungary and Poland. In the medium term, the region may also benefit from Eurozone industrial reshoring, while the current refugee inflow may alleviate some of the structural labour market tensions in the region.

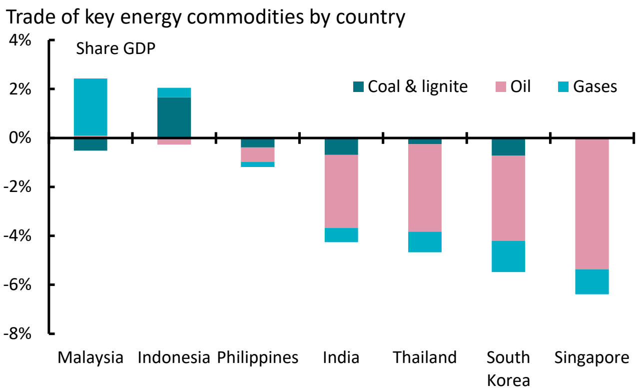
Global Macro Monthly – EM Asia

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

The Ukraine war and elections dominate

Escalating geopolitical tensions will impact Asia, partly by adding to uncertainty, but more significantly through commodity markets as net importers suffer a terms-of-trade shock resulting in deterioration of the region's external current account balances. Differentiation will be particularly marked between energy importers and exporters (Exhibit 5). Indonesia and Malaysia will likely benefit, while energy importers such as Thailand, Philippines and India will likely see a narrowing of external balances.

Exhibit 5: Energy importers and exporters in Asia



Source: CEIC and AXA IM Macro Research, 18 March 2022

Going forward, a more severe and prolonged conflict between Russia and Ukraine – or prolonged sanctions – will serve as a major risk for Asia. With rising risks of stagflation, the challenge facing Asian central banks is to strike a balance between maintaining financial and price stability and fostering continued economic recovery. We expect a leaning towards the latter to result in less aggressive policy tightening in Asia than in the US.

South Korea's 20th presidential election concluded last week, with conservative Yoon Suk-yeol claiming victory. Lee Jae-myung's defeat suggested the people's desire for a change and cast doubts on incumbent Moon Jae-in's legacy. However, looking ahead, policymaking may be more constrained for Yoon as the democratic party has a strong majority in the parliament. Politics in India are also important with state polls showing Bharatiya Janta Party (BJP), the ruling party of Prime Minister Narendra Modi, has won four out of five states. Overall, this suggests policy continuity and a smooth progression of planned reforms.

Global Macro Monthly – LatAm

Luis Lopez Vivas,
Economist (Latin America),
Macro Research – Core Investments

Politics take centre stage in Colombia and Peru

Colombia recently held congressional and presidential primaries, yielding mixed results for the country's political and economic outlook. As expected, the leftist coalition Pacto Histórico elected populist Gustavo Petro by a wide margin of over 80%. Moreover, the left-wing coalition primaries had by far the highest participation rate with around 5.5 million votes, almost as many as the two other coalition primaries combined. However, Colombia's Congress will remain divided, which should significantly constrain the possibility of a radical policy shift in the country's traditionally market-friendly framework. In fact, Pacto Histórico only secured 15% of Senate seats.

The presidential primaries also showed a stronger-than-anticipated support for the right-wing coalition *Equipo por Colombia*, which obtained 3.8 million votes and elected Federico Gutierrez as its candidate. Conversely, the centre-left coalition Centro Esperanza had a very weak showing, garnering only 2.2 million votes. While it seems likely that Gutierrez will face Petro in a run-off vote, the presidential race remains wide open. Even if Centro Esperanza is defeated in the first round on 29 May, it could play kingmaker in a hypothetical Gutierrez-Petro showdown. Centro Esperanza's elected candidate, Sergio Fajardo, has yet to offer any clues as to whom he would support in such a scenario.

Meanwhile in Peru, political noise is ramping up again. Congress approved an impeachment trial against President Pedro Castillo. The opposition-controlled Congress voted 76 to 41 to start the impeachment motion over allegations of corruption. Following the trial, lawmakers will need at least 87 votes to remove the President from office. This is already the second time the legislature has attempted to impeach Castillo since he took office in July 2021. The President's approval rating has recently plummeted to 26%, according to a recent poll.

While Peru has been one of the region's fastest growing economies over the past decade, its unceasing political wrangling continues to undermine its true potential. Peru has had five Presidents since 2016, including Castillo. President Martín Vizcarra was impeached in 2020, while President Pablo Kuczynski resigned in 2018 before an impeachment vote.

Investment Strategy – Cross assets

Greg Venizelos,
Credit Strategist,
Research – Core Investment

Global yield curves: Flat and furious

The Federal Reserve's tightening cycle is underway and bonds have performed very poorly. While there is a decent chance that they do better going forward, yields may climb further in the near term. It all depends on how much the Fed suggests it needs to tighten, which in turn depends on inflation. All in all, we should start considering the possibility that bond markets, and credit particularly, are setting up for an improvement in returns, hopefully sometime soon.

Investment Strategy – FX

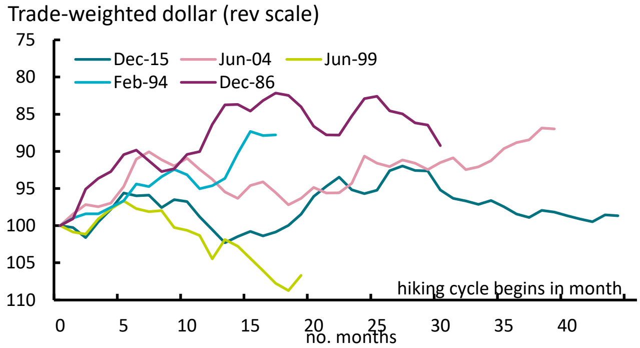
Romain Cabasson,
Head of Solution Portfolio Management,
Multi-Assets – Core Investments

US exceptionalism amid uncertainty

The Fed delivered its rate hike in March as expected. This could be a signal the US dollar may be near its peak (Exhibit 6) unless this time it is indeed different. The Ukraine conflict has brought more than just temporary risk-off support to the dollar. Renewed energy price pressures are pushing the Fed to accelerate policy normalisation. Simultaneously, durably higher energy prices will weigh on growth for oil importing countries in the EU, UK and Japan, while the US may be more insulated.

Exhibit 6: US dollar to peak now Fed starts hiking?

Trade-weighted dollar (rev scale)

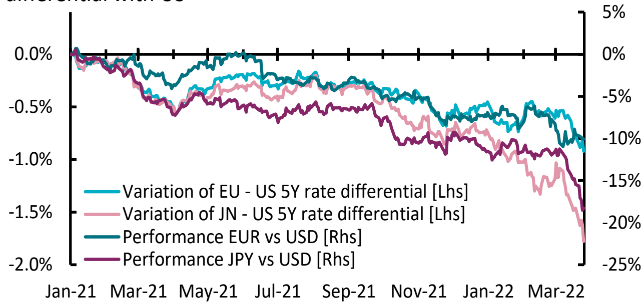


Source: Bloomberg and AXA IM Research, March 2022

The euro/dollar rate drop to 1.10 since the invasion seems to reflect the repricing of implications for the Fed and ECB beyond a geopolitical risk discount (Exhibit 7). The relative pricing of Fed versus ECB is now quite in line with our expectations – the rate should stabilise here, or perhaps drop a bit if risk sentiment deteriorates further, so selling after rallies in the dollar/euro looks attractive as the trade's carry is set to rise.

Exhibit 7: Relative monetary policy expectations still in the driving seat

Performance of EUR and JPY vs evolution of 5Y rate differential with US

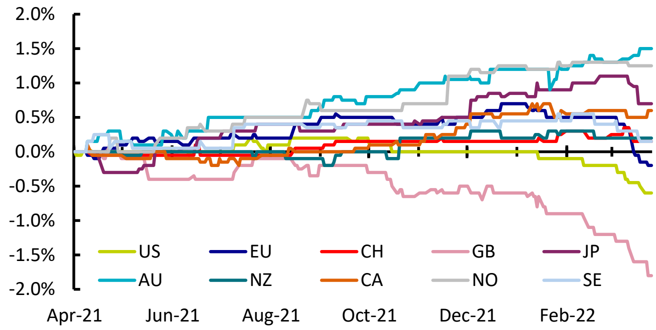


Source: Bloomberg and AXA IM Research, March 2022

The rise in Fed hike expectations has hindered the Japanese yen as the customary safe haven, with the dollar/yen rate surging above 120. Much further yen depreciation looks unlikely, as Fed expectations are high and Bank of Japan expectations low. But the yen may remain under pressure once the BoJ remains the dovish outlier amid central banks. Expectations of normalisation by the Bank of England are still close to the Fed's, despite UK growth downgrades since the start of year having outpaced G10 countries (Exhibit 8). High energy prices are adding to existing inflation pressures as a headwind to domestic demand, while Brexit disruptions continue to hurt labour supply and trade. Sterling looks like it has more room to depreciate.

Exhibit 8: Ukraine conflict hits growth expectations

Bloomber consensus revision for GDP growth in 2022 and 2023



Source: Bloomberg and AXA IM Research, March 2022

Commodity currencies overthrowing US dollar?

Against the backdrop of war in Ukraine, commodity currencies have outperformed the US dollar. The Canadian dollar and Norwegian krone should continue to rise as both currencies still look reasonably cheap. Their domestic tight labour markets and inflation pressures were already supportive of further policy normalisation by the central banks. Both countries' oil and gas exports have been boosted, bringing additional support and could dampen the impact of energy prices on households. Rate hike pricing on the Bank of Canada might be slightly excessive but still more credible than for others central banks.

Investment Strategy – Rates

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

Bonds, Curves and Currencies

Bonds have largely disappointed since the start of this year, leaving investors with uncomfortably negative returns. Global aggregate bond indices are down 7.1% (year-to-date, unhedged in US dollars), while the drawdown from January's peak in 2021 is some -11.6%.

Duration has been in the driving seat all along. Exhibit 9 shows high yield (HY) credit risk has only contributed to a lesser extent to overall performance. Furthermore, we also note the negative performance of duration-heavy inflation-linked bond indices, despite the dramatic increase in global inflation rates.

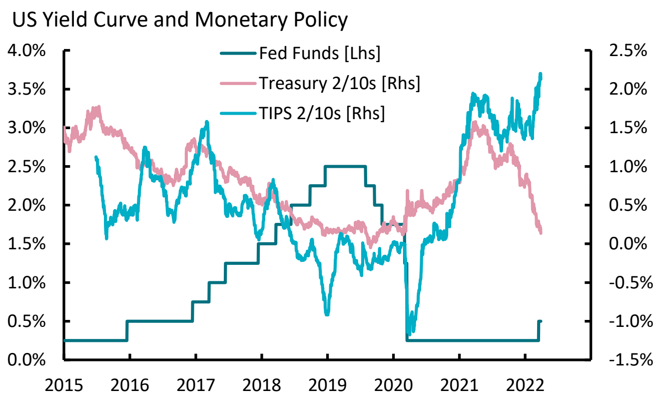
Exhibit 9: A bad start for bond markets

Category	Bloomberg Index	Ccy	Hedge	Ytd %
Global	Global Aggregate	USD	Unhedged	-7.1
	Treasuries	USD	Unhedged	-7.0
	Credit	USD	Unhedged	-8.8
	Global High Yield	USD	Unhedged	-7.0
	Global Inflation-Linked	USD	Unhedged	-5.3
	Global Convertibles	USD	Unhedged	-7.3

Source: Bloomberg and AXA IM Research, 28 March 2022

Meanwhile, the outlook for bond returns has not improved substantially, at least not in the near term. High levels of inflation will not disappear overnight and might even risk becoming entrenched into expectations, thus begging for a firm and decisive central bank reaction. However, market participants are increasingly focusing on the US yield curve's flattening as a signal of increased recession probability over the coming 12 months.

Exhibit 10: Different signals from the Treasury market

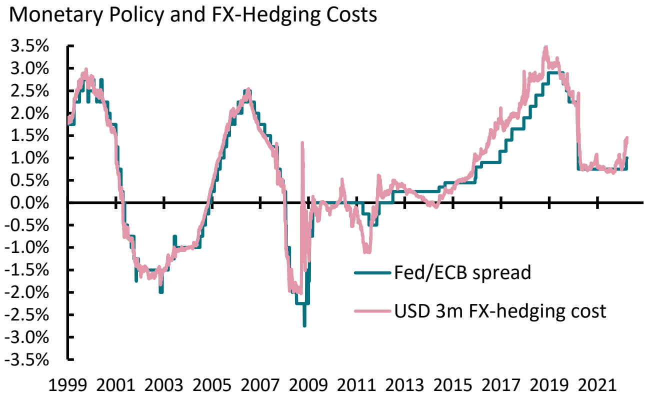


Source: Bloomberg and AXA IM Research, 28 March 2022

One should not overlook factors which tend to bias the signals we extract from the Treasury universe. The Federal Reserve still holds a very large bond portfolio – likely to be one of the ultimate causes of a depressed term premium, and in addition, the Treasury Inflation-Protected Securities (TIPS) curve has recently decoupled from the nominal curve and is trading in excess of 200 basis points (bps) between 2y and 10y tenors, likely reflecting the belief the inflation peak will be reached during the course of this year (Exhibit 10).

Eventually, the whole debate collapses back to the dynamics of market-based inflation expectations. A normalisation of the sharply inverted TIPS breakeven curve (2-year at 4.95% versus 10-year at 3%) would not only allow for a flattening of the TIPS curve, but also for a re-steepening of the nominal coupon curve. The best outcome would be for both curves to meet somewhere in the middle, thus sending a positive signal to both policymakers and investors.

Exhibit 11: Hedging US dollar risk will become more expensive



Source: Bloomberg and AXA IM Research, 28 March 2022

Another source of concern for investors, again linked to the evolution of monetary policy, is the cost of currency hedging. Since the start of 2022, the cost of hedging US dollar exposure into euros on a three-month basis has risen from 76bps to 145bps (Exhibit 11).

The Fed's change in tone is increasingly tilting the balance of risks toward larger and/or faster policy steps, at a time when the ECB is somewhat caught between the economic cost of a war in Ukraine and the prospect of a near-term jump in inflation rates.

Given the close relationship between policy differentials and currency hedging costs, there is a chance the latter might increase further over the coming months. In fact, the futures strips are indicating the risk of another 100bp increase in hedging costs by the end of the year (3-month Eurodollar versus Euribor spread at 2.56%). Interestingly, currency hedging costs are implied to drop substantially again in 2023, probably reflecting the belief that the Fed might be close to a neutral rate, while the ECB will be in the midst of its tightening cycle.

Investment Strategy – Credit

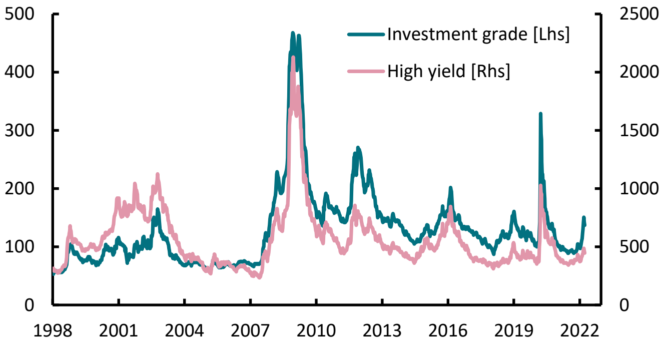
Gregory Venizelos
Credit Strategist
Research – Core Investments

The spreads of wrath

Credit spreads widened further in March, in the wake of the Ukraine crisis. With sentiment fragile, ever-ratcheting hawkish expectations for central bank policy have not helped. COVID-19 spikes in March 2020 aside, spreads are at multi-year 'wides' (below). Investment grade (IG) spreads have widened more than high yield (HY) spreads in relative terms, reflecting the larger presence of banks within IG as well as the relatively higher exposure of large-cap blue chip companies to Russia.

Exhibit 12: IG spreads have widened more than HY spreads in relative terms

Global IG and HY spreads



Source InterContinental Exchange (ICE) and AXA IM Research, 28 March 2022

Short of recession, credit offers value

Exhibit 13: Spreads (upper) and even more notably yields (lower) have moved well above their lows

5yr Sigma score normalised (Spread)

	Level					
	spot	min	1st quartile	median	3rd quartile	max
EUR IG	0.42	0	0.16	0.24	0.41	1
GBP IG	0.41	0	0.20	0.29	0.39	1
EUR HY	0.31	0	0.14	0.18	0.24	1
GBP HY	0.24	0	0.13	0.19	0.26	1
USD IG	0.22	0	0.10	0.14	0.24	1
USD HY	0.19	0	0.11	0.17	0.32	1

5yr Sigma score normalised (Yield)

	Level					
	spot	min	1st quartile	median	3rd quartile	max
EUR IG	0.90	0	0.25	0.32	0.52	1
GBP IG	0.72	0	0.19	0.26	0.33	1
USD IG	0.48	0	0.21	0.29	0.46	1
EUR HY	0.41	0	0.13	0.18	0.24	1
GBP HY	0.37	0	0.16	0.22	0.28	1
USD HY	0.31	0	0.18	0.22	0.32	1

Source: ICE and AXA IM Research, 28 March 2022

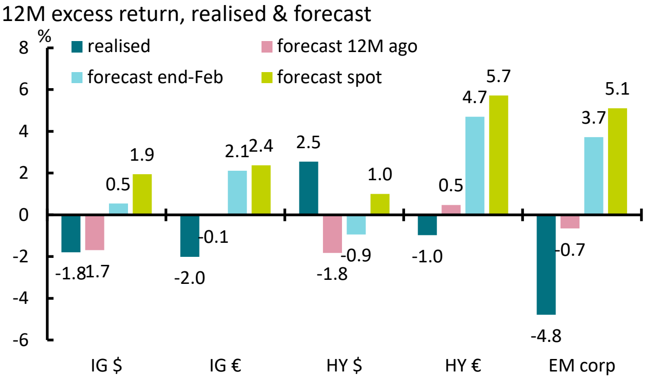
The impact of the conflict across credit markets has been proportional to their proximity to the conflict, in geographic and economic terms. European spreads now trade above the third quartile of their five-year range, as a result (Exhibit 13, upper). By contrast, US dollar spreads have remained insulated, especially in HY where energy is the largest sector.

Mean reversion excess returns attractive

In addition to the spread widening, the epic year-to-date rise in government bond yields has pushed credit yields towards the top of their five-year range (below, lower). This makes for a material valuation improvement. But the flip side of the widening is excess return expectations based on spread mean reversion have improved materially (green bars in Exhibit 14). Over 12 months, euro IG is expected to return more than 2% and HY more than 5%.

Exhibit 14: Mean reversion-implied excess return expectations look quite attractive

12M excess return, realised & forecast



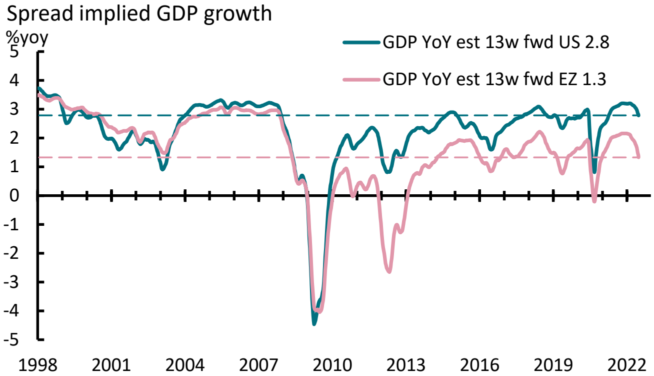
Source: ICE and AXA IM Research, 28 March 2022

Spreads reflect impact on eurozone growth

Using spreads as a GDP 'nowcast', we see the credit repricing reflecting a steeper drop for the Eurozone. Average weekly spreads over Q1 imply 1.3% in Q2 GDP year on year for the Eurozone versus 2.8% for the US. This from a 'nowcast' peak of 2.1% and 3.2% respectively at the end of 2021 (below).

Exhibit 15: Spread-implied GDP growth has declined notably more for the Eurozone than for the US

Spread implied GDP growth



Source: ICE and AXA IM Research, 28 March 2022

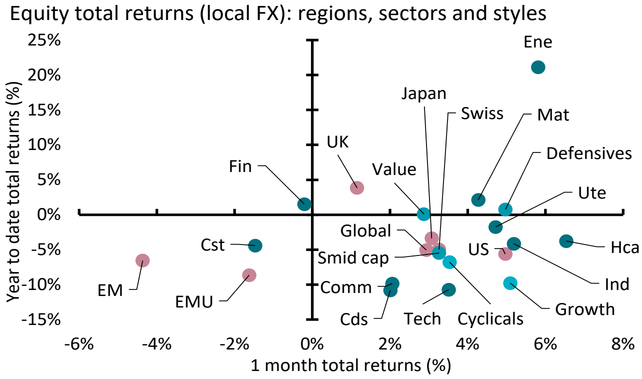
Investment Strategy – Equity

Emmanuel Makonga,
Investment Strategist,
Research – Core Investments

Playing with a bad hand

Equity markets have enjoyed some relief after a tortuous start to the year. Over the past month, global stocks rebounded +2.9% (Exhibit 16). In regional terms, emerging markets (EM) (-4.4%) and Europe (-1.6%) suffered the most as the war in Ukraine and a COVID-19 resurgence in China weighed on sentiment, while the US delivered a healthy +5%. Across sectors, healthcare (+6.5%) and energy (+5.8%) outpaced peers. This reflects a shift in market sentiment towards stagflation risk – hedging low growth with defensives and inflation with commodity assets.

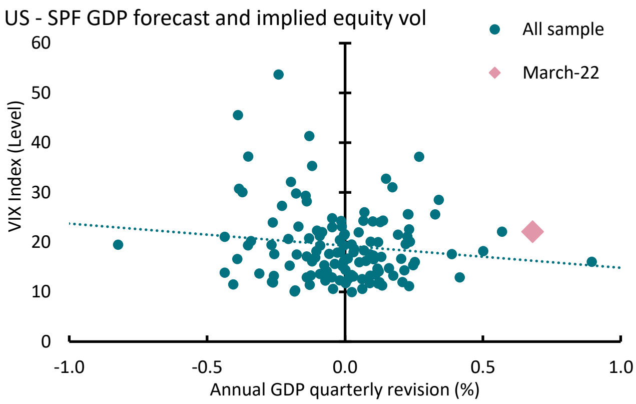
Exhibit 16: EM and European Monetary Union lagging



Source: Datastream and AXA IM Research, March 2022

Growth forecasts appear under pressure. At 22, the VIX volatility index implies a -0.6 percentage point decline in annual GDP growth in 2022 for the US (Exhibit 17). Adjusting the 3.6% consensus, accordingly, would imply 3% year-on-year growth, in line with our own forecast (+2.8%).

Exhibit 17: Market risk and downward GDP revision



Source: CBOE, SPF and AXA IM Research, March 2022

The prospects for growth in the developed world are not good. While 2022 earnings growth expectations for global equities were reasonably healthy as of February (+8.2%), weaker-than-expected global economic growth is likely to have an impact on companies' bottom lines. The sales outlook is uncertain as high inflation is eroding real household incomes and will dampen spending. In addition, wage increases are not supporting any improvement in margins, albeit their levels are historically high across sectors.

To understand the behaviour of equity market segments during periods of downward earnings revisions, we studied the excess returns of the factors relative to the market (Exhibit 18). It suggests the Quality factor seems to be the one offering the best excess return (+0.46%). The current valuation level compared to the market has decreased over the last few weeks. The Quality factor shows a premium of 57% consistent with the post-COVID-19 average of 58%.

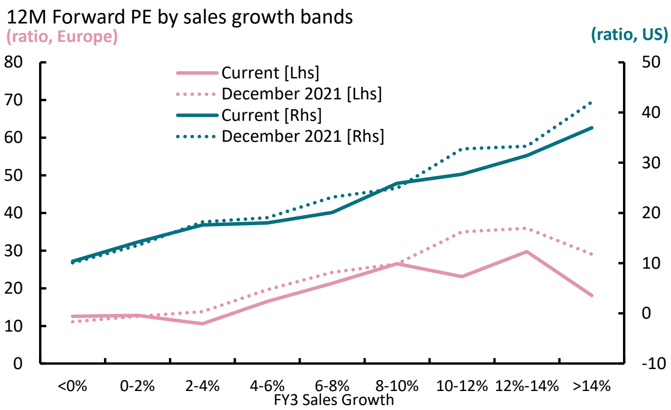
Exhibit 18: Quality overperforms when earnings are being revised lower

	Value	Growth	Low Vol	Quality	Size	Momentum	Yield
1m chg	-0.30%	0.30%	-0.10%	0.52%	0.08%	-0.05%	-0.16%
3m chg	-0.21%	0.25%	-0.16%	0.48%	0.03%	-0.03%	-0.04%
6m chg	-0.29%	0.31%	-0.17%	0.39%	0.01%	-0.02%	-0.21%
Average	**-0.27%**	**0.29%**	**-0.14%**	**0.46%**	**0.04%**	**-0.03%**	**-0.13%**

Source: IBES, MSCI and AXA IM Research, March 2022, Monthly excess return relative to MSCI World, 1 year forward fiscal period.

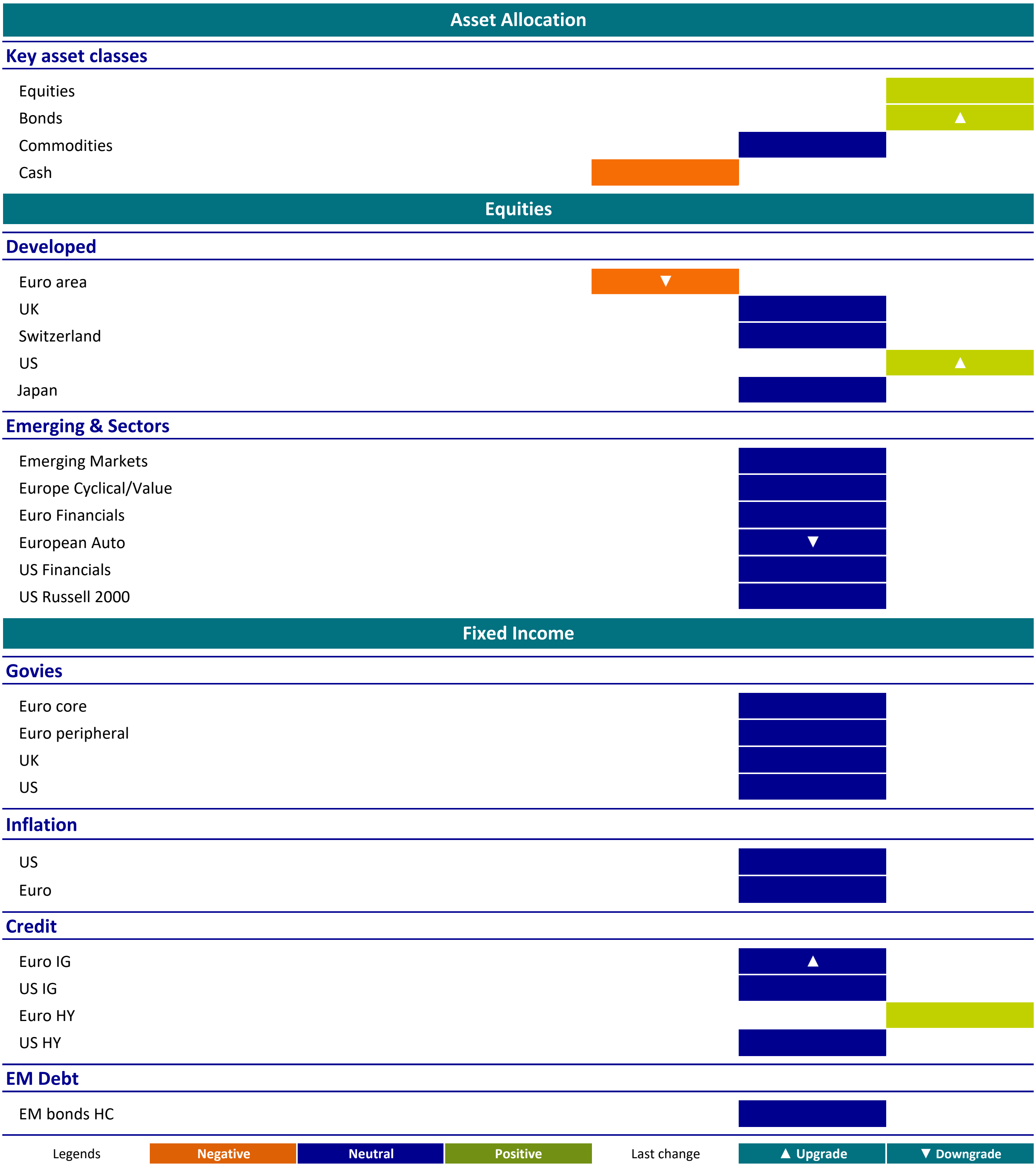
We see several areas of potential opportunity**.** Reduced support from central banks, uncertainty over the conflict and the ever-present risk of the pandemic are affecting investor sentiment. In Europe, fiscal support should alleviate some of those headwinds while in the US, President Joe Biden's administration has less room to manoeuvre. In that context, we favour Quality/Defensive stocks and look for opportunities in longer-term growth themes like renewables and digital payments whose valuations have deflated recently (Exhibit 19, right end).

Exhibit 19: Growth stocks have been the most affected



Source: IBES, S&P, MSCI and AXA IM Research, March 2022

Recommended asset allocation



Source: AXA IM Macro Research – As of 29 March 2022

Macro forecast summary

Real GDP growth (%)	2020	2021*		2022*		2023*	
		AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
World	-3.1	5.2		3.1		2.8	
Advanced economies	-5.0	3.4		2.0		1.2	
US	-3.4	5.5	5.6	2.8	3.7	1.6	2.5
EMU-4	-7.4	5.0		2.1		1.2	
Germany	-4.9	2.8	2.7	1.2	3.5	1.7	2.7
France	-8.0	7.0	6.6	2.7	3.8	1.0	2.1
Italy	-9.0	6.5	6.3	2.3	4.1	0.6	2.3
Spain	-10.8	5.0	4.7	3.5	5.7	1.6	3.6
Japan	-4.9	1.7	1.8	2.5	2.8	1.8	1.8
UK	-10.0	7.2	7.0	3.8	4.3	0.7	2.0
Switzerland	-2.5	3.5	3.5	2.0	2.9	1.3	1.9
Canada	-5.2	4.4	4.6	3.3	3.9	2.5	3.1
Emerging economies	-1.9	6.3		3.8		3.8	
Asia	-0.8	6.8		5.1		5.0	
China	2.3	7.9	8.0	5.0	5.0	5.0	5.2
South Korea	-0.9	4.0	4.0	2.0	3.0	2.0	2.6
Rest of EM Asia	-4.6	5.8		5.6		5.3	
LatAm	-7.0	7.0		2.5		2.5	
Brazil	-3.9	4.8	4.7	0.9	0.5	1.9	1.9
Mexico	-8.5	4.8	5.6	2.4	2.3	2.2	2.3
EM Europe	-2.0	6.6		-0.3		0.9	
Russia	-2.7	4.7		-7.0		-3.0	
Poland	-2.5	5.8	5.3	4.2	4.7	3.3	3.8
Turkey	1.8	11.5	9.9	3.9	2.9	3.4	3.2
Other EMs	-2.1	4.2		3.0		3.0	

Source: Datastream, IMF and AXA IM Macro Research – As of 29 March 2022

* Forecast

CPI Inflation (%)	2020	2021*		2022*		2023*	
		AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	0.7	3.2		5.4		2.9	
US	1.2	4.7	4.6	6.8	5.2	3.8	2.6
Eurozone	0.3	2.6	2.5	5.3	3.9	2.5	1.7
Japan	0.0	-0.2	-0.2	2.0	1.0	1.0	0.7
UK	0.9	2.6	2.5	6.8	5.4	3.4	2.7
Switzerland	-0.7	0.5	0.5	2.0	1.0	1.0	0.6
Canada	0.7	3.4	3.4	4.2	3.7	2.8	2.3

Source: Datastream, IMF and AXA IM Macro Research – As of 29 March 2022

* 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	Q1-22	Q2-22	Q3-22	Q4-22
United States - Fed	Dates	0-0.25	25-26 Jan 15-16 Mar	3-4 May 14-15 June	26-27 July 20-21 Sep	1-2 Nov 13-14 Dec
	Rates		+0.25 (0.25-0.5)	+0.50 (0.75-1.00)	+0.50 (1.25-1.50)	+0.25 (1.50-1.75)
Euro area - ECB	Dates	-0.50	03 Feb 10 Mar	14 April 9 June	21 July 8 Sep	27 Oct 15 Dec
	Rates		unch (-0.50)	unch (-0.50)	unch (-0.50)	+0.25 (-0.25)
Japan - BoJ	Dates	-0.10	17-18 Jan 17-18 Mar	27-28 April 16-17 June	20-21 July 21-22 Sep	27-28 Oct 19-20 Dec
	Rates		unch (-0.10)	unch (-0.10)	unch (-0.10)	unch (-0.10)
UK - BoE	Dates	0.75	3 Feb 17 Mar	5 May 16 June	4 Aug 15 Sep	3 Nov 15 Dec
	Rates		+0.5(0.75)	+0.5 (1.25)	unch (1.25)	unch (1.25)

Source: AXA IM Macro Research - As of 29 March 2022

These projections are not necessarily reliable indicators of future results

Download the full slide deck of our March Investment Strategy

Our Research is available on line:

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