Good medicine tastes bitter

Monthly Investment Strategy

AXA IM Research

24 May 2022

Summary: May 2022

Theme of the month: Zero Covid's toughest test

- China has suffered its worst outbreak of COVID since 2020. The Zero COVID policy has successfully contained and reversed the outbreaks in various regions and cities, including Shanghai and Beijing. But the economic cost of this policy has been enormous.
- April's sharp fall in activity data is in line with our expectation of Q2 GDP recording -3% qoq. This is around 30% of the shock suffered in Q1 2020. Unemployment has risen to 6.1% - and 18% amongst youth. This is a threat to economic and social stability.
- China cannot afford to remove all virus safeguards to "live with the virus" – for now its vaccinated population and hospital spaces are too low. Yet it's virus prevention measures have had a large impact on the economy. Beijing is now shifting its policies. But we forecast growth of just 4.5% this year, with risks skewed to the downside.

Macro update: Tighter financial conditions answer to overheating economies

- Inflation is prevalent across economies. It looks to have peaked in the US and UK, and be close to that in the Eurozone, Canada and some Latam countries. But much depends on energy developments over the coming quarters and supply-disruption, especially if downside risks materialise in China.
- Q1 GDP has done better than expected in several regions (barring the US). In many cases this reflects a rebound in services consumption from omicron at the start of the year. We do not expect this to last, but there is a tension between weak consumer outlooks and still solid businesses.
- But signs of slowdown are emerging. China is a special case, but requires a material change in policies to meet even our sub-consensus view. Europe looks likely to be skirting around recession over the coming quarters. And while the US fell in Q1, we expect it to avoid recession, but much depends on the Fed.
- The PBoC has eased policy to support the economy, with more to follow. The BoJ is persisting with accommodation. But elevated inflation, mainly solid growth and tight labour markets point to further central bank tightening elsewhere. We expect peak policy to fall short of market pricing in most developed economies. But financial conditions are likely to tighten further over the coming quarters.

Investment strategy: between a rock (recession) and a hard place (high inflation)

- FX: The appreciation of the US dollar against the Euro appears to be stabilizing as the risk off sentiment diminishes while the trend of the 5y yield spread reverses. Conversely, China's accommodative policy is creating room for a rally in the US currency against the CNY.
- Rates: Term premia are likely to continue exerting upward pressure on government bond nominal yields, as central banks are set to commence balance sheet reduction. Inflation is starting to become an ever-increasing issue for the ECB given the excessive amounts of pipeline pressures.
- Credit: Bar the March 2020 Covid shock spread spike, European credit spreads have widened to decade highs, and now appear to be pricing a significant degree of economic slowdown. There is substantial yield pick-up in favour of EUR over USD credit, of 1.2% in investment grade and of 1.4% in high yield.
- Equity: Global equities have had one of the worst starts to a year (-11.6%) on record (50^{th} of 53). Yet this performance was flattered by positive earnings reports in the most recent period, with US, Europe and Japan reporting positive surprises. However, guidance for future quarters has been coming down.

Central scenario

Summary – Key messages

Our central scenario:

Ukraine war poses material supply-shock, raising inflation further and slowing COVID-rebound growth

We forecast global growth to rise by 2.9% in 2022 and 2023.

Economic slowdown amidst supply pressures and tighter monetary policy. Inflation elevated for much of 2022.

Inflation

Ukraine supply-shock extends inflation overshoot. China supply disruption a risk. Domestic inflation pressures have risen. But near peaks.

Monetary policy

Most central banks to tighten policy as inflation high, labour markets tight and signs of slowdown tentative. BoE likely to pause first, then ECB, then Fed. PBoC and BoJ major exceptions

Fiscal policy

Euro area leads with fiscal measures to absorb energy shock, also in CEE and other EMs. UK's response small for now. US still deadlocked in Congress.

Growth

Growth will slow, but in most areas remain positive given post-COVID momentum. Contraction a risk for some.

Emerging Markets

CEE still solid for now despite war. Higher inflation, energy and oil particularly, to further strain complex. Asia sheltered.

Rates

Rates maybe finding level having retreated from highs. Flat curves show growth concerns, but may also reflect technical features.

FX

Dollar pricing remains extreme, risk outlook key to support. Commodity currencies bolstered in light of war.

Credit

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

Equities

Earnings expectations are getting shakier due to inflation & downside risks to growth. Some caution into H2 2022 warranted.

Alternative scenarios

Summary – Key messages

Entrenched supply shock *(probability 25%)*

What could be different?

- Escalation in Ukraine conflict
- COVID outbreaks spreads again: China and/or new mutations
- Post-pandemic structural changes – labour market withdrawal and goods demand – persist. Supply shocks last longer
- Inflation expectations rise, affecting wages and persistence

What it means

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

Market implications

- Risk appetite deteriorates / equities sell off / credit widens
- Safe-haven rates rally resumes
- EM debt to come under pressure

A global boost *(probability 10%)*

What could be different?

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

What it means

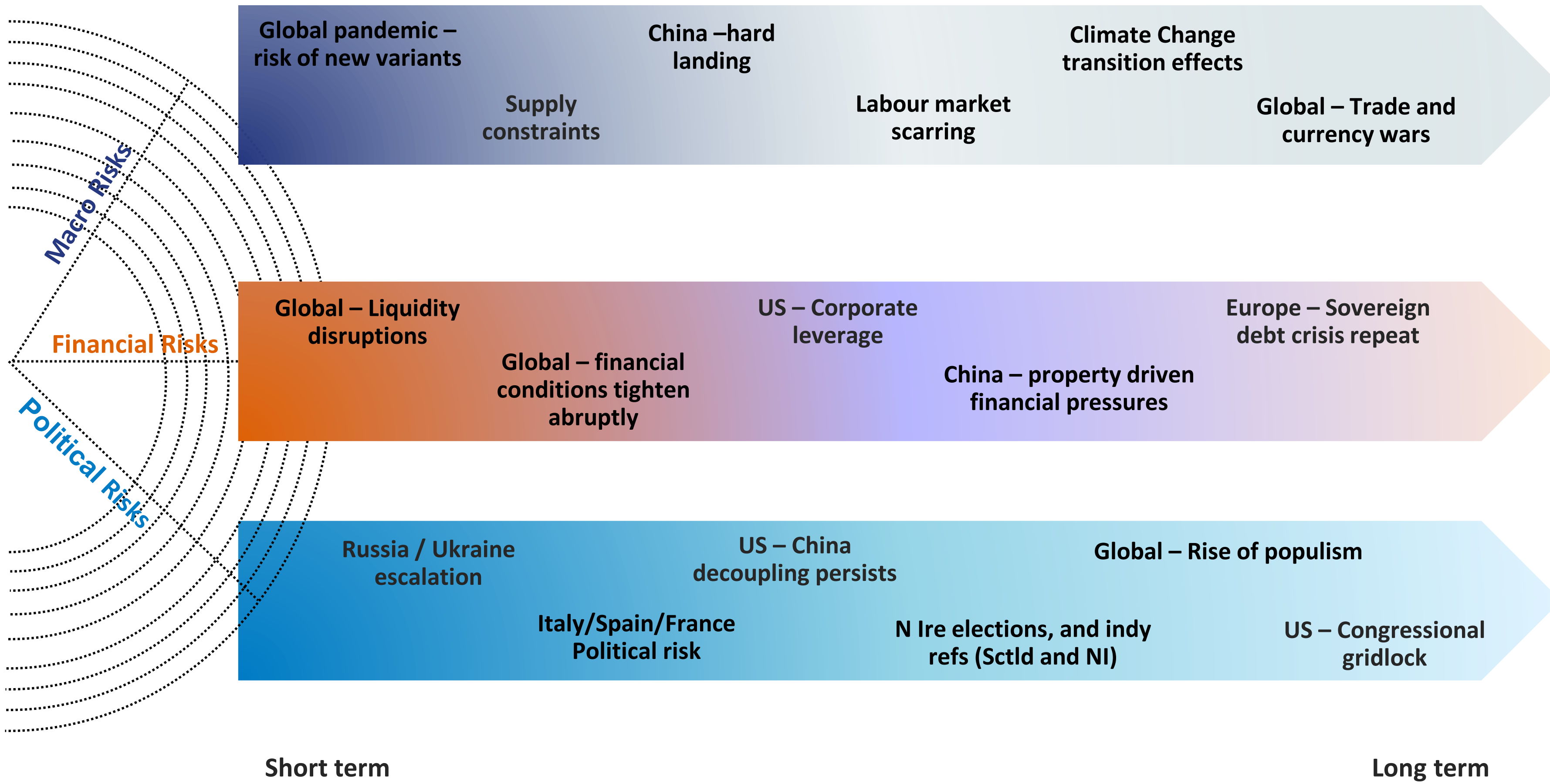
- Growth surprises on the upside in most regions
- Inflation fades more quickly towards and below central bank targets
- Monetary policy proves more patient than expectations

Market implications

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

RISk Radar

Summary – Key messages



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Theme of the month

Omicron wave gives China's 'Zero Covid' policy its toughest test

Strategy has been effective in limiting virus contagion, but at huge expense to the economy

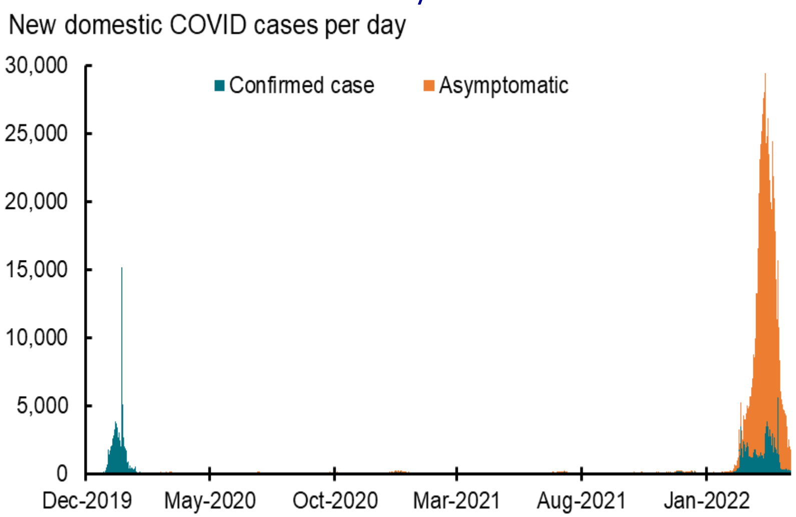
The worst COVID-19 outbreak since the start of the pandemic

- China has been battling its worst COVID-19 outbreak since the pandemic. Total case counts – including those confirmed and asymptomatic – have risen to 770k since March, more than nine times the accumulated caseloads in the initial wave. Currently, there are 17 districts nationwide labelled as high risk, and 81 as medium risk, off from the peak of 63 and c600 respectively in mid-April. Together they account for about a fifth of China's population and GDP

Tightened controls help to limit contagion

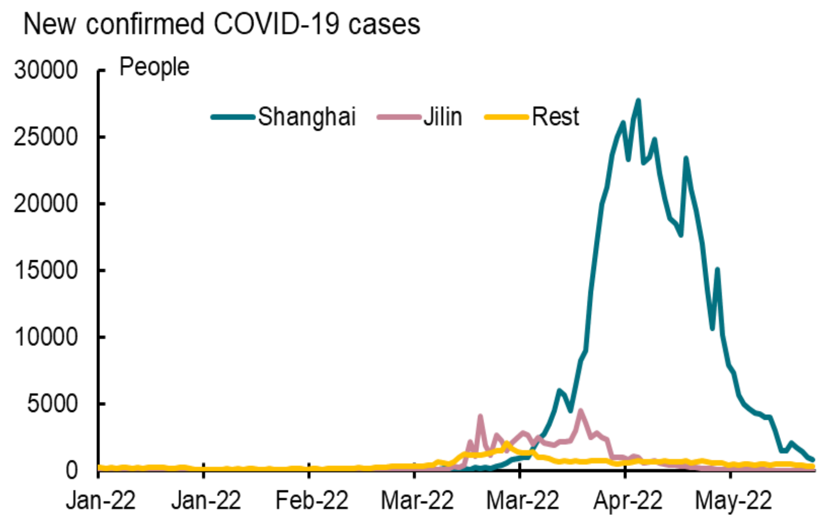
- Despite growing criticism, the 'Zero Covid' policy has been effective in limiting the spread of the virus. Quick resolutions to the outbreaks in Shenzhen and Guangzhou – both are tier-1 cities like Shanghai – were evidence that a proper execution of the strategy can achieve low infection rates while keeping economic costs manageable. Even in Shanghai, the current approach has done a good job at insolating the rest of the country from its debacle

The current outbreak is the worst by far



Source: CEIC and AXA IM Research, May 22

Infections have been confined to Shanghai



Source: CEIC, AXA IM Research, May 22

‘Zero Covid’ – featuring full lockdowns – is not sustainable

The strategy has failed to strike a palatable balance between saving lives and keeping economic costs low

Economy paralyzed by draconian lockdowns

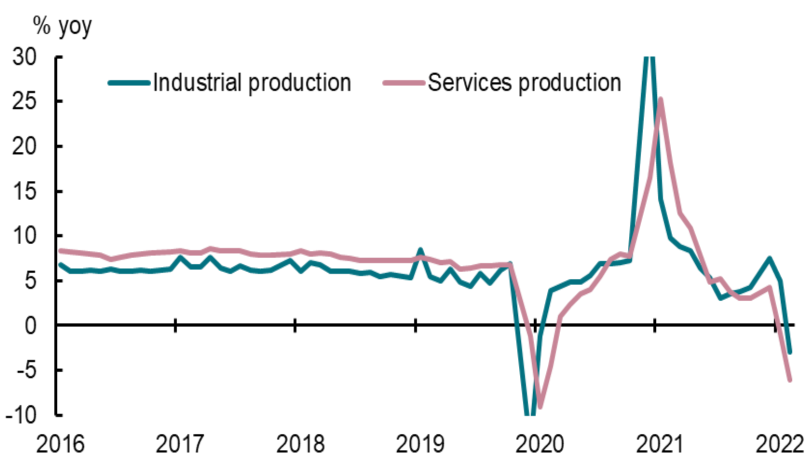
- The obvious flaw of the ‘Zero Covid’ strategy – which currently relies on lockdowns – lies with its vast costs to society and the economy. April data shows the economy was paralyzed by draconian controls, when Shanghai went into full lockdown, sending ripple effects across the country. We estimate the current growth shock is tracking at around 30% of the initial COVID-19 wave, consistent with our -3% qoq GDP forecast for the second quarter

Weakening labor market a warning sign

- Apart from weakening demand and compounding supply disruptions, the labor market is deteriorating at an alarming pace. The urban unemployment rate has jumped to 6.1%, a touch below the peak in early 2020, while youth unemployment is already at a record high. To the extent that job market weakness can be a source of both economic malaise and social disorder, Beijing has to pay attention to the situation and revaluate the viability of its COVID-19 approach

Omicron outbreak causes a double dip

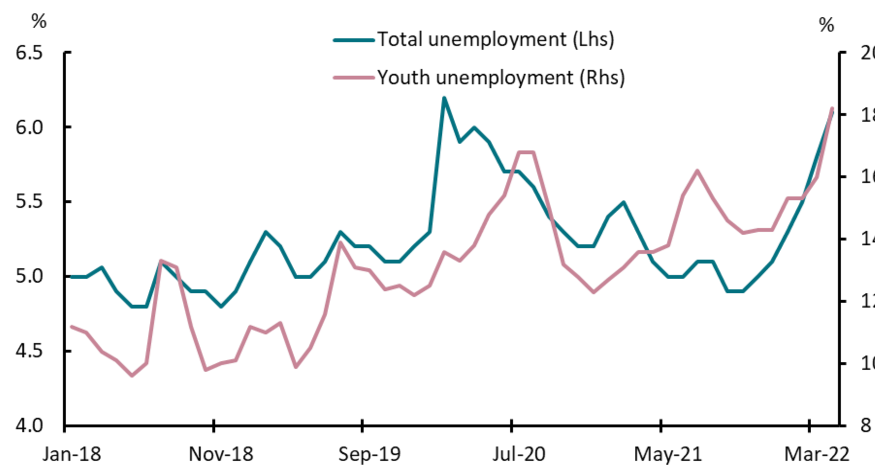
China: Industrial production vs. services production



Source: CEIC and AXA IM Research, May 22

Worsening job market conditions warrant policy rethinking

Total and youth unemployment rate



Source: CEIC, AXA IM Research, May 22

China not ready to 'live with COVID'

Political and medical considerations prevent Beijing from pursuing a full liberalization strategy

'Zero Covid' seen as a political success

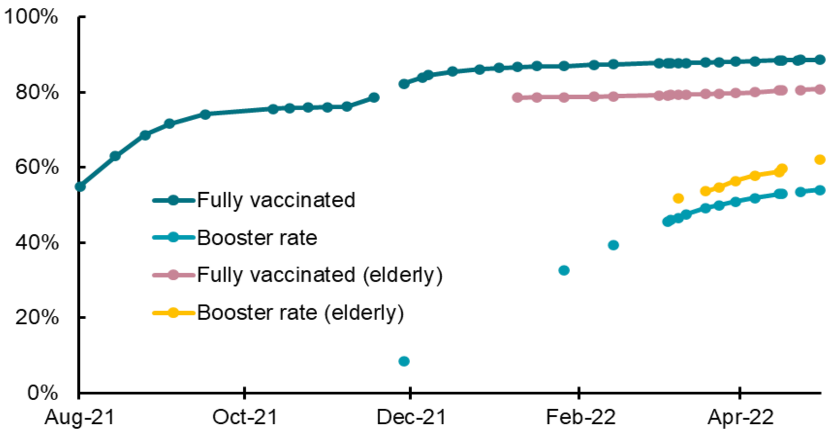
- The 'Zero Covid' strategy has been lauded as a success of China's governing system, and therefore, abandoning it could incur too big a political cost. A drastic change when Shanghai is still in lockdown and the virus is still spreading could be seen as Beijing admitting the failure of its policy. We think the authorities will strongly resist the call for transitioning to a 'living with the virus' approach for now

Full liberalization carries significant health risks too

- China is also not medically prepared to fully relax controls. Only c60% of the population has completed three vaccine shots, which is a big concern for China's 264 million elderly population. In addition, Beijing has only just rolled out antigen test kits and antiviral drugs, while the number of hospital beds could fall far short of what's needed to handle a potential surge in severe cases. The experiences of many western countries enduring a sharp increase in severe cases and death during their transitions is making Beijing reluctant to give up its 'Zero Covid' approach

Booster shot rates remain low

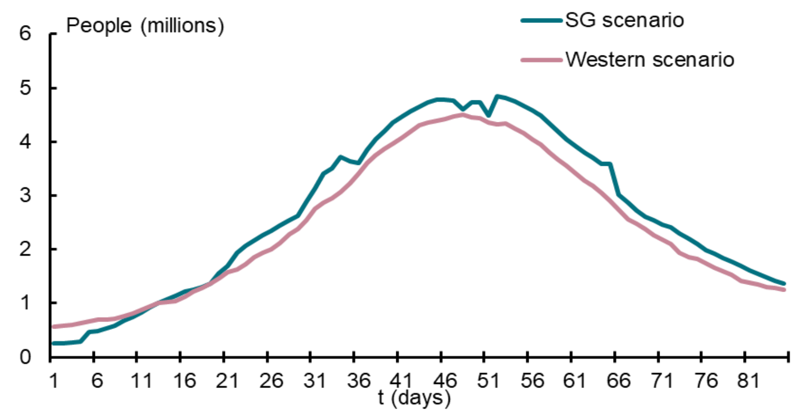
Vaccination for total and elderly population



Source: CEIC, State Council, and AXA IM Research, May 22

China could see a surge in severe cases and death

Scenarios of daily new cases if China replicates Singapore and Western countries*



* Western is the average of US, UK, France, Italy and Spain

Source: Our World In Data, AXA IM Research, May 22

Investment Managers

A gradual shift away from lockdowns

Changing implementation tactics without altering the 'Dynamic Zero Covid' name

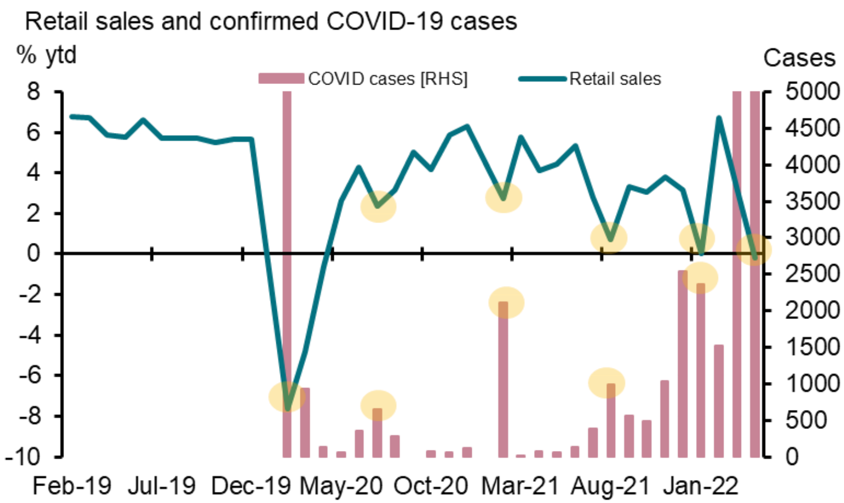
Moving away from the 'unsustainable'

- We see Beijing gradually transitioning away from the current approach – which relies excessively on lockdowns – but far from reaching full liberalization. Such a strategy could involve scaling back draconian administrative controls, replaced by more targeted containment and closed loop operations. Medically, faster and more regular testing can help to detect the virus early, while building herd immunity via vaccines removes the need to maintain punitive controls

New wine in an old bottle

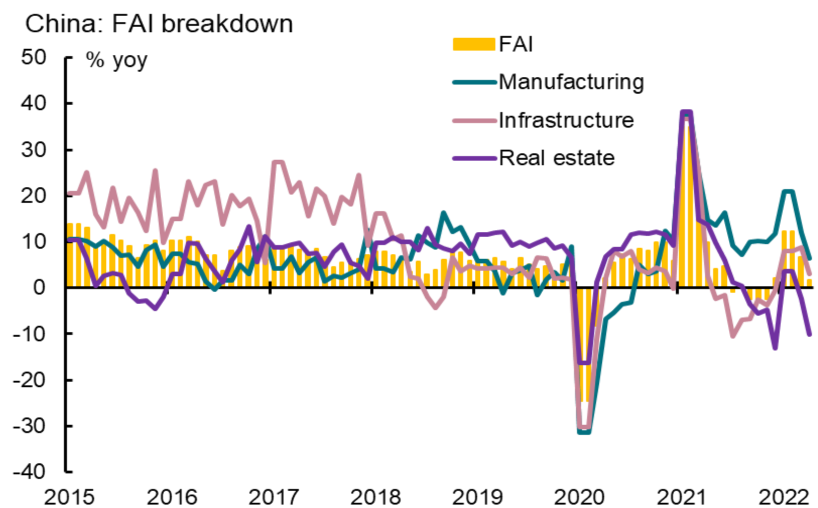
- Importantly, we do not expect Beijing to abandon the policy name 'Dynamic Zero Covid' but to recalibrate the implementation of it to better balance virus containment and economic stability. Timewise, we think policy changes have already started in Shanghai and Beijing as the situation stabilizes, contrary to market expectations that no changes will occur until the Party Congress

Covid flare up impedes consumption



Source: CEIC, and AXA IM Research, May 22

Investment hit by Covid lockdowns



Source: CEIC, AXA IM Research, May 22

No smooth-sailing

Our base case assumes Beijing gets the balancing right, but risks are to the downside

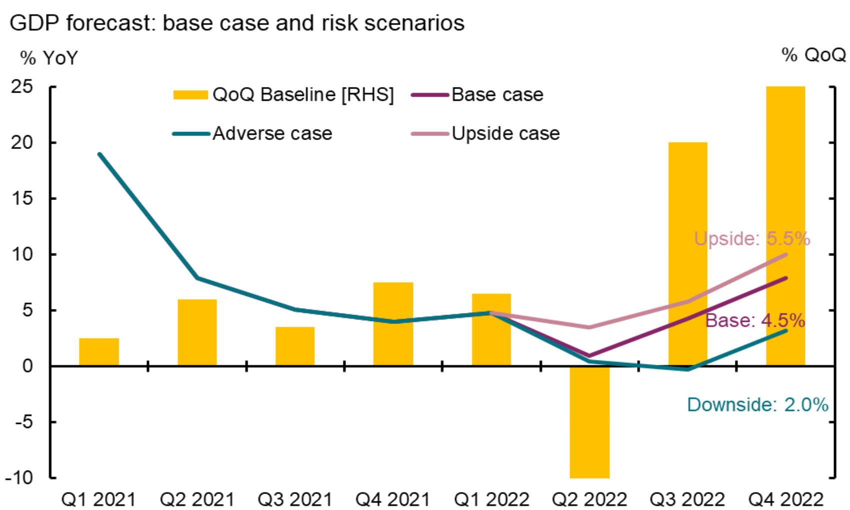
Worst may be behind

- We think April may have marked the trough of the short-term cycle. Softening COVID restrictions – as expected in our base case – is growth positive, although the degree will be checked by a lack of full liberalization. Combining this with pent-up demand and more forceful policy easing, the economy could stage a decent recovery in the second half of the year, taking full year growth to above 4%

Risks squarely to the downside

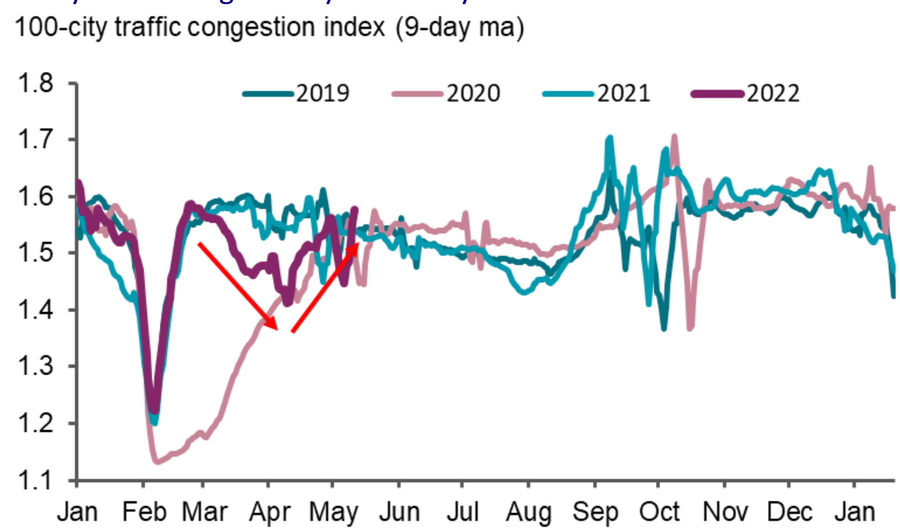
- The greatest risk to our base case lies with the failure to strike a realistic balance between reviving growth and keeping infections low. Easing restrictions too much risks losing control of the pandemic, while tinkering at the edges of the COVID response may not make a sufficient difference to the economy. Not getting that balance right means downside risks for the economy, which, in such a scenario, could struggle more than it did in 2020

Lessening COVID control leads to a growth rebound



Source: CEIC, AXA IM Research, May 22

Policy fine-tuning already underway



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

Macro outlook

External and domestic inflation pressures

US

Inflation likely peaked, but to stay elevated for longer

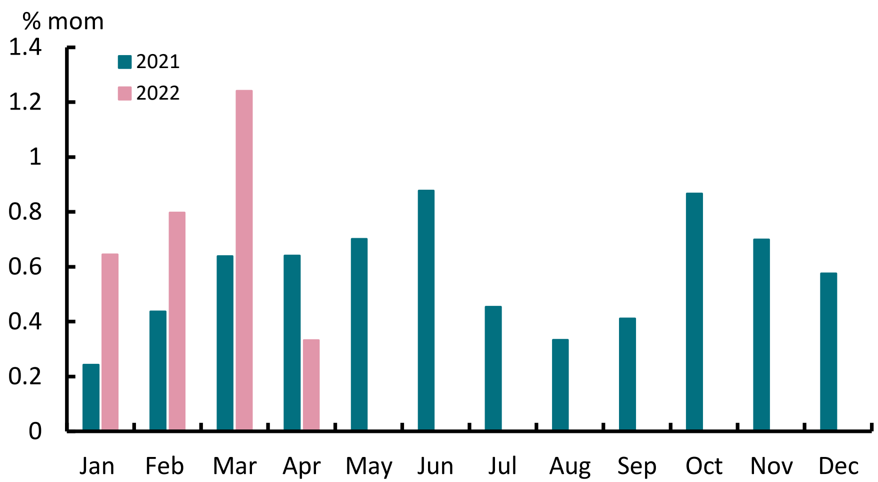
- Inflation dipped to 8.3% in April, from 8.5% adding to our expectation that it has peaked – subject to further exogenous risks from energy markets and COVID related supply chain disruption. However, we do not expect inflation to fall back quickly until after the summer. We expect the end-year rate at around 6%. We raise our average inflation forecast to 7.6% for this year and 4.0% next (from 7.0% and 3.8%). Consensus forecasts 7.0% and 3.0%. This is too elevated for the Fed.

Longer-term price stability requires a loosening of the labour market

- Several of the drivers of inflation are beyond the Fed's control. However, underlying inflation is driven by elevated unit labour costs in turn underpinned by labour market shortage and fast wage growth. Fundamentally, the labour market is too tight – albeit somewhat exacerbated by labour supply issues that we expect to ease over the coming 18-months. For the Fed to restore price stability it must loosen the labour market. Even after supply side improvements, we expect this to require slowing jobs growth.

Inflation has likely peaked, but will be slow to fall

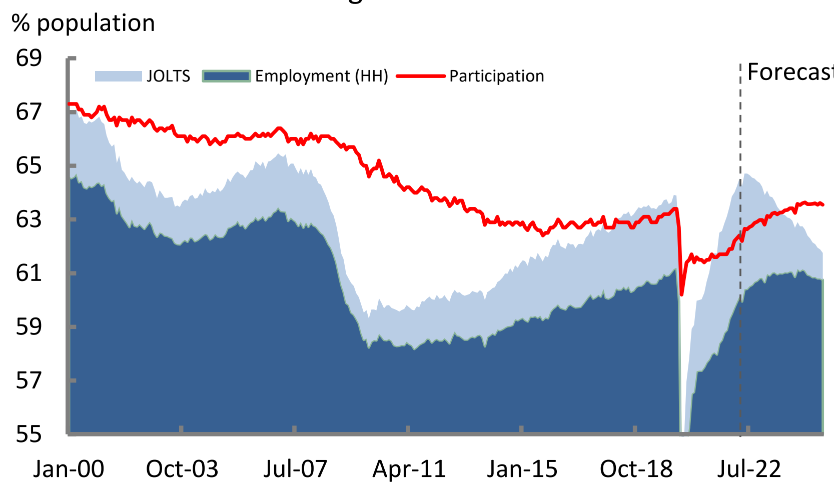
CPI Base Effects



Source: BLS, AXA IM Research, May 2022

Restoring price stability will require labour market easing

Recorded labour market tightness



Source: BLS, AXA IM Research, May 2022

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The Fed's narrow landing strip

US

Growth to slow below trend to achieve looser labour market

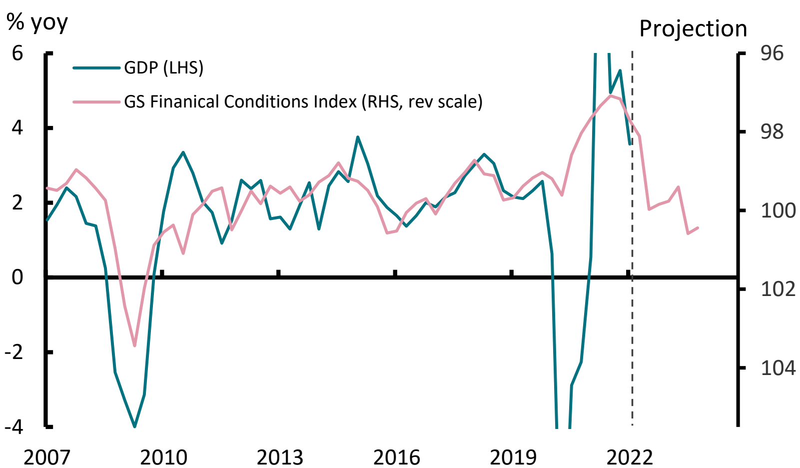
- A looser labour market requires slower GDP growth. The Fed is tightening financial conditions through rate hikes and QT to deliver such a slowdown. After an earlier than expected contraction in growth, we lower our GDP forecast to 2.5% for 2022 and 1.4% for 2023 (from 2.8% and 1.6%). Consensus remains for a more solid 2.8% and 2.1%. We fail to see how the consensus growth outlook for 2023 will deliver a looser labour market.

The Fed's challenge

- Fed Chair Powell sees a "good chance" of a "soft-ish landing". Financial conditions have tightened sharply since March. They have now tightened to the point where historically the Fed has reversed policy. Yet to deliver sufficient slowdown to restore price stability, financial conditions appear to need to tighten further. For now the Fed appears prepared to continue to tighten. This risks passing an event horizon that could lead the US into recession. This underpins our view that rate hikes will end at 2.75% this year.

Growth to slow

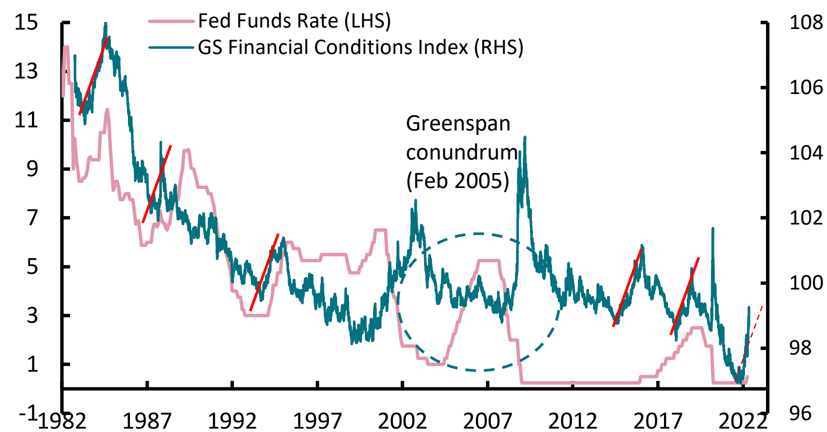
Financial conditions and GDP



Source: Goldman Sachs, BEA, May 2022

Financial conditions have already reached Fed's historic pain threshold

Federal Funds Rate and US Financial Conditions



Source: FRB, Goldman Sachs, AXA IM Research, May 2022

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Downbeat activity narrative to dominate

Eurozone

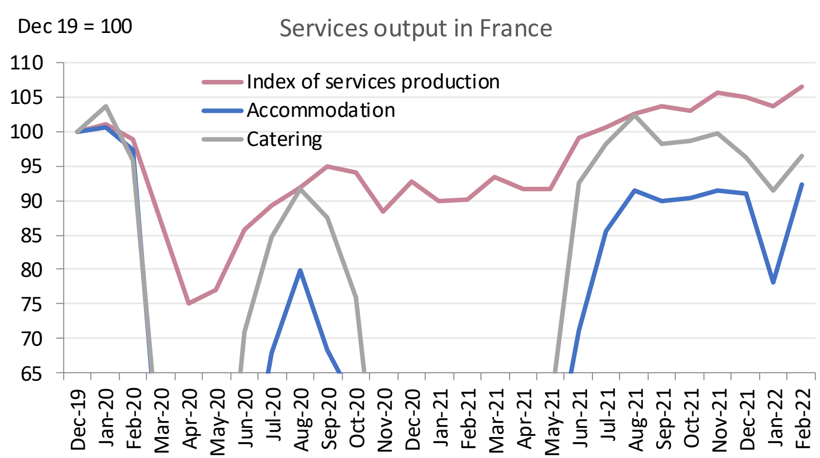
Upside short-term risks…

- Euro area Q1 GDP growth was unchanged at 0.3% q/q, affected by measures to suppress the Omicron wave and only marginally so by ramifications from the Ukraine conflict. Private consumption is likely to rebound strongly in Q2 as suggested by services output carry over and resilient business confidence, suggesting upside risks to our slight GDP contraction forecast in Q2. Meanwhile, we are concerned by the sharp China slowdown and high supply disruptions.

… unlikely to persist

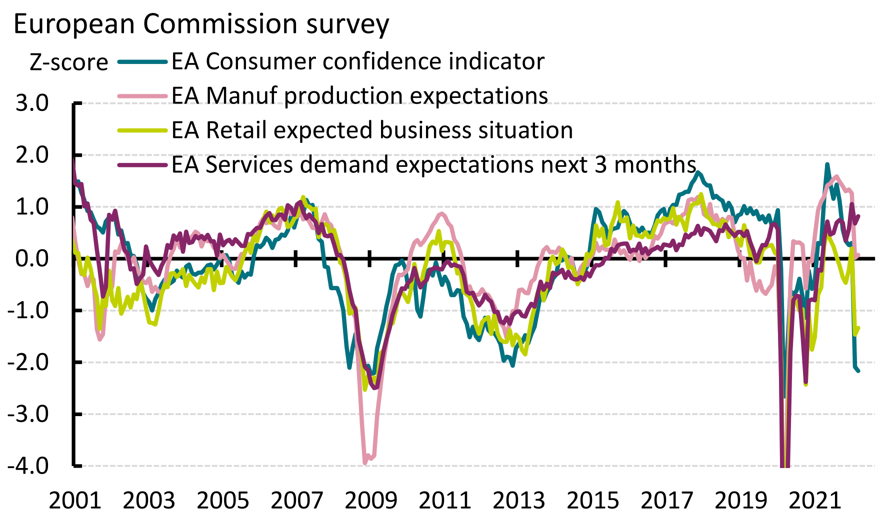
- Strong headwinds to eurozone growth remain: 1/ record real income squeeze with upwardly revised inflation projections (6.6%/2.4% from 6.1%/2.1%) skewed to the upside, 2/high economic uncertainty, 3/ tightening financing conditions (including the ramifications from US expected slowdown).
- Risks of activity contraction in H2 22 remain material supporting our unchanged below consensus forecast, projecting euro area growth at 2.1% and 1.2% this year and next (consensus 2.7% and 2.3%).

Services output rebound underway



Source: INSEE, AXA IM Research, May 2022

Services defy gravity (for now)



Source: European Commission and AXA IM Research, 23 May

ECB: Hike to zero in 2022 and pause

Eurozone

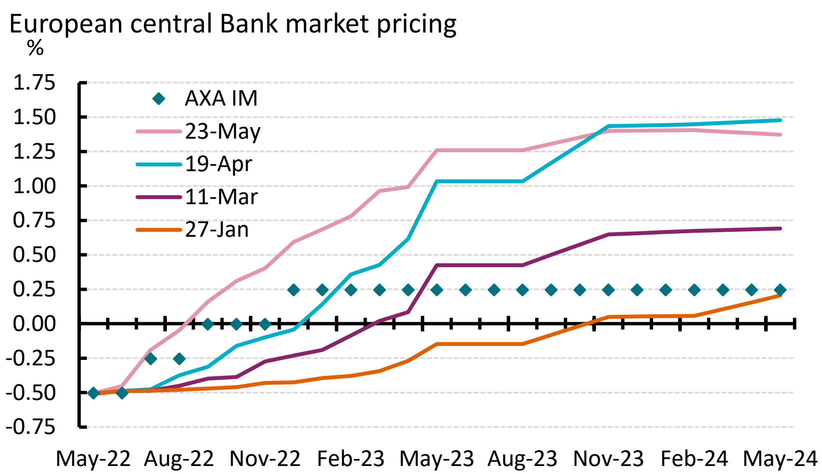
Couple of rate hikes in 2022, sooner than later

- The ECB's Governing Council seemingly struck an early compromise of a July rate lift-off, earlier than the most aggressive market expectations from a few weeks ago, despite its optionality/data dependence mantra. This has likely been motivated by upside surprises on inflation (expectations), a resilient economy and a more hawkish Fed, generating a window of opportunity to start reducing the ECB's extra accommodative stance in a quick fashion.
- We have moved our expected two 25bp rate hikes to July and September from December and March previously. Consistent with our subdued macro scenario, we do not think the ECB will be in a similar rush to move rates into positive territory as currently expected.

Challenging financial fragmentation

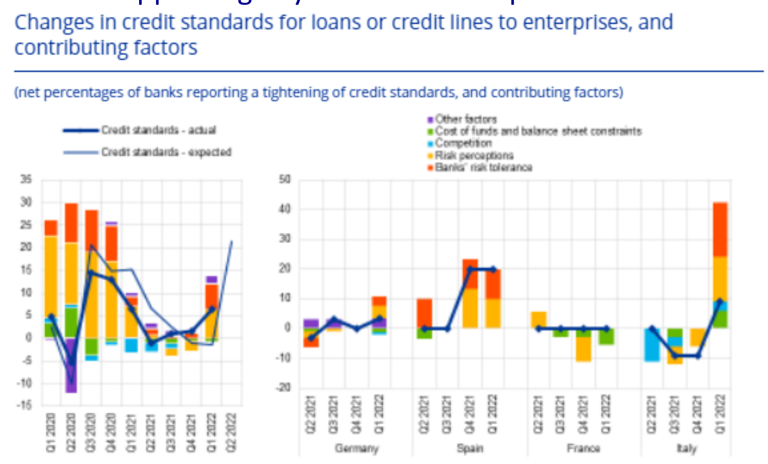
- We continue to think the ECB will act reactively rather than proactively to fight financial fragmentation. Decisions are likely to be guided by three elements 1) level of sovereign spreads/ tightened financing conditions, 2) pace of deterioration/volatility, 3) origin of the market pressure. While more details are unlikely to come before the summer, we think that 2023 budget discussions in September/October, amidst preparation of general elections in Italy next Spring may generate additional market pressures, bringing ECB closer to specify its thinking.

ECB rate hike pricing on the aggressive side



Source: Bloomberg and AXA IM Research, 23 May 2022

Tensions appearing beyond BTP-Bund spread



Source: ECB, May 22

Businesses appear resilient whilst the consumer is under pressure

UK

Consumers hit by inflation at 40-year highs

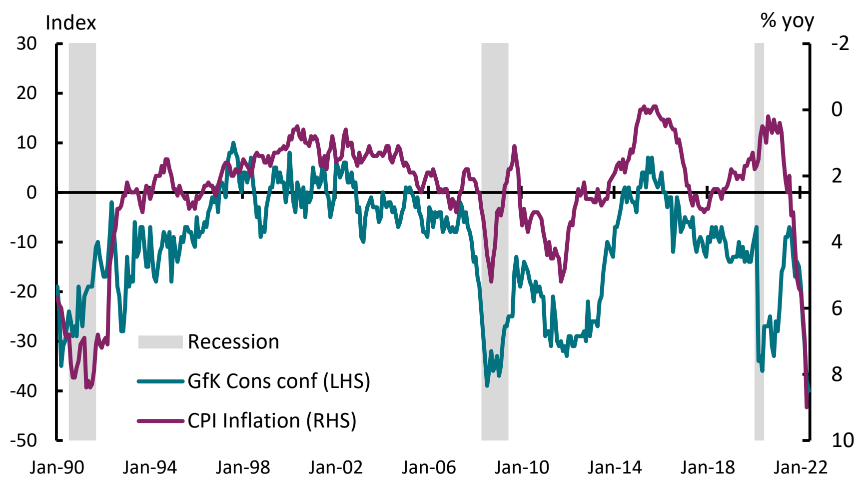
- In April inflation reached 9%, just below market expectations of a 9.1% rise. Rising prices are weighing on consumers, and Consumer confidence has fallen to all time lows in May (records to 1974). We expect consumption growth to remain weak, while retail sales remains subdued despite unexpectedly rising by 1.4% mom in April after 2 months of declines. We expect GDP growth of 3.8% and 0.9% in 2022 and 2023 respectively (Consensus 3.8% and 1.4%).

Business hiring intentions and order books remain solid despite rising prices

- Amidst this weakening consumer outlook and rising prices, business sentiment appears resilient. Whilst headline business optimism has fallen, at the same time business hiring intentions remain solid and order books appear resilient. In the May CBI Trends Survey total orders rose to 26 from 14, despite expectations of total orders falling further.

Consumer confidence drops to all-time lows as prices rise

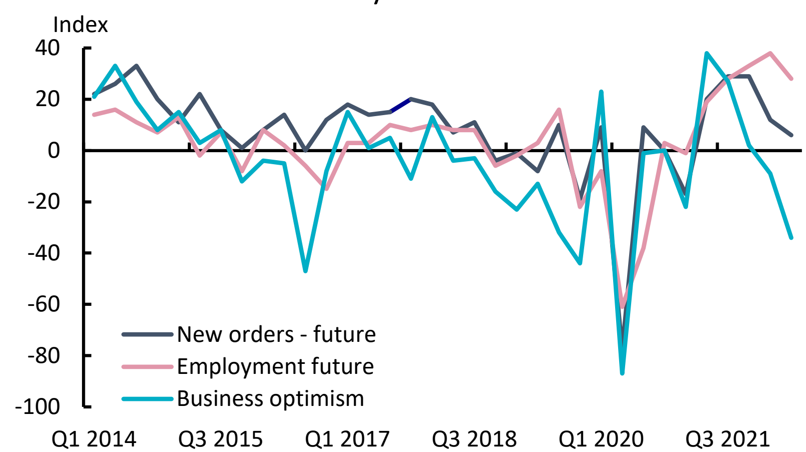
GfK Consumer Confidence, Recessions and Inflation



Source: GfK, ONS, AXA IM Research, May 2022

Employment outlook remains robust while optimism falls

CBI Industrial Trends Survey



Source: CBI, AXA IM Research, May 2022

MPC under fire set to remain on hiking path

UK

The Monetary Policy Committee has faced criticism as inflation climbs

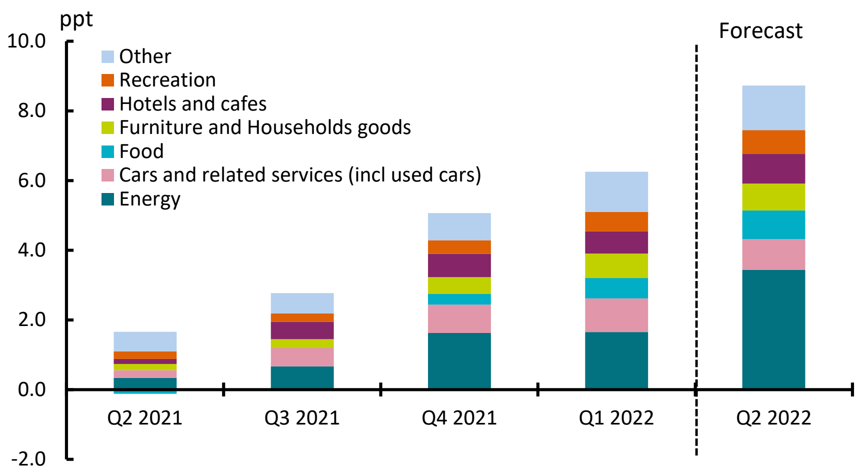
- The MPC has come under criticism from government ministers for failing to prevent inflation rising. The current spike is driven largely by supply chain bottlenecks and rising energy prices; factors largely outside the BoE's control. Our forecasts suggest that energy is set to contribute around 40% of the headline rate of inflation in Q2 2022. We have raised our inflation outlook to 7.6% for 2022 and 3.6% for 2023, up from 7.3% and 3.5%, respectively (consensus 7.6% and 3.9%).

Further hikes are on the way

- We expect the BoE to hike rates by 25bps in June and again in August, bringing rates to 1.5% where we expect them to stay into 2023. Market pricing of rates has changed little since the May MPR despite an initial easing of expectations. Based on market rates, BoE projections saw inflation well below target at the end of their forecast horizon at 1.3% and in their alternative scenario where energy prices followed futures curves inflation fell further to 0.7%.

Energy and other goods price rises are driving the surge

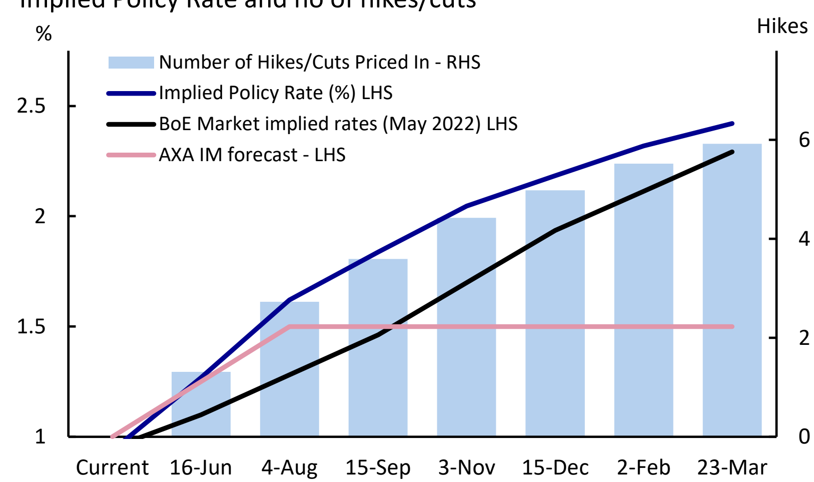
Contributions to CPI



Source: National Statistics, AXA IM Research, May 2022

BoE's warnings of recession have not had a lasting impact on pricing

Implied Policy Rate and no of hikes/cuts



Source: BoE, AXA IM Research, May 2022

Economy paralyzed by a brutal COVID-19 shock

China

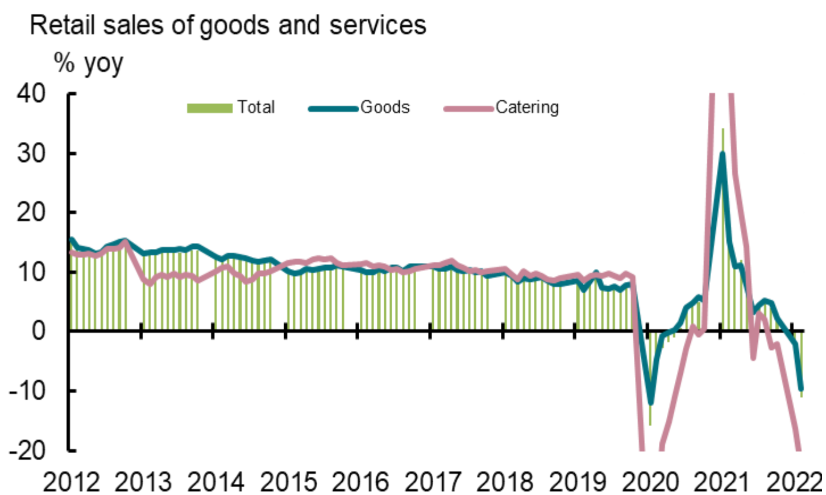
Lockdown hurts all around

- April data showed a collapse of economic activity on both supply and demand sides. Industrial production contracted 7% mom partly on supply-chain and logistics disruptions. Consumer demand was hit hard by tightened COVID-19 controls, with retail sales falling for the second consecutive month. Investment growth remained positive, but only just, with real estate, infrastructure and manufacturing sectors all registering lowering capex growth

Rising jobless rate a particular concern

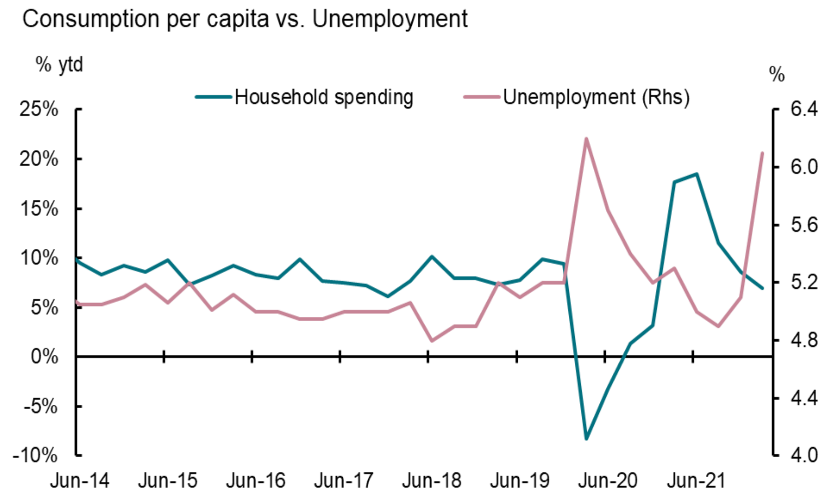
- Labor market conditions deteriorated at an accelerated pace. The urban unemployment rate spiked to 6.1%, a touch below the 6.2% peak in February-2020, while youth unemployment rate was above 18%. These numbers are alarming, and should attract the attention of policy makers given their focus on stability ahead of the leadership reshuffle

Consumption hit hard by COVID lockdowns



Source: CEIC, AXA IM Research, May 22

Labor market weakness could prolong the consumption woes



Source: CEIC, AXA IM Research, May 22

More policy adjustments needed to stabilize the economy

China

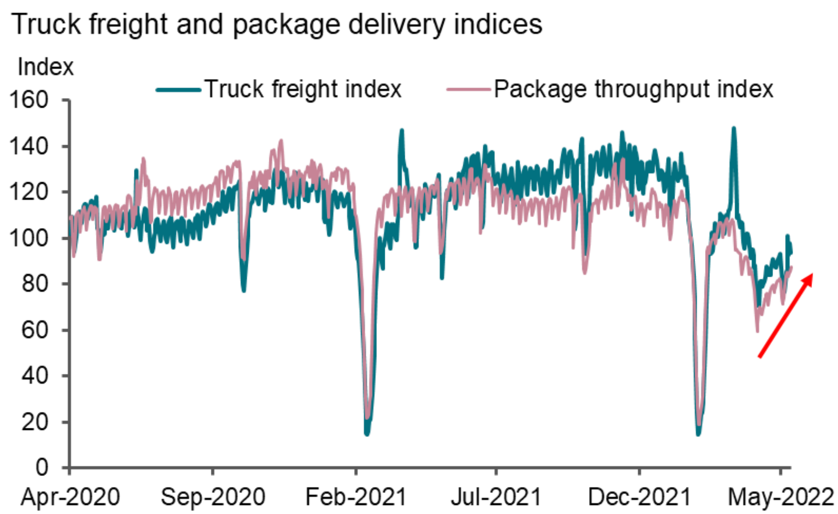
Covid policy starts to be fine-tuned

- Recent developments in Shanghai – under closed loop operation – and Beijing – with targeted containment and faster testing – are signs that the implementation of the 'Dynamic Zero Covid' strategy has been recalibrated even with Beijing sticking to the name. As a result, high-frequency mobility, logistics and production metrics have improved, pointing to a sequential recovery in May

Policy easing stepped up incrementally

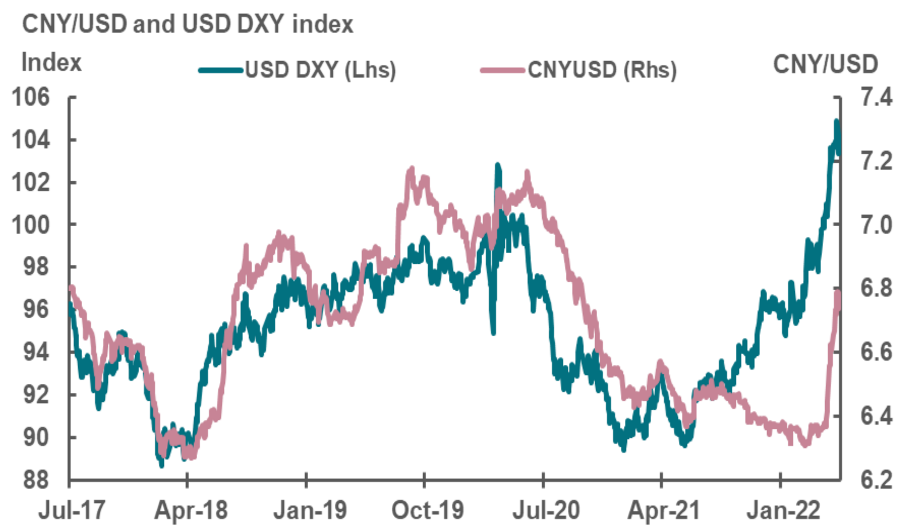
- Counter-cyclical policy easing has been stepped up too. Local governments have continued to relax home purchase controls. Mortgage rates have been cut nationwide, while the currency has weakened markedly in recent weeks. All these have helped to ease financial conditions. Beijing has also ordered faster bond sales to support infrastructure investment, and there is increasing speculation of consumption supports via coupons or transfer payments

Logistics activity improves on easing COVID controls



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

A weaker yuan is growth supportive



Source: Bloomberg, CEIC, AXA IM Research, May 22

COVID-19 scars are slowly healing

Japan

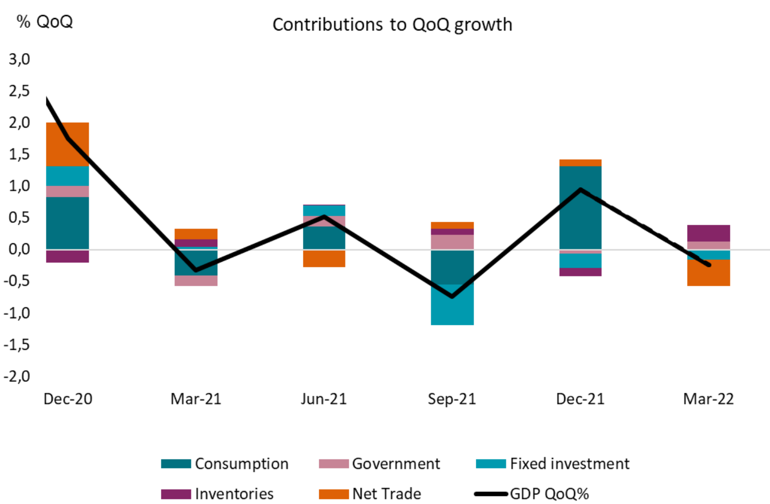
Preliminary estimate of Q1 GDP fell but surprised on the upside

- Q1 GDP contracted after suffering from COVID-19 restrictions at the start of the year but 'only' by -0.2% qoq.
- Private consumption was flat qoq, more robust than anticipated, helped by booming services spending in March. Private fixed investment rose by 0.5%, a bit weaker than expected, while exports rose but remain constrained by bottlenecks.
- Despite some resilient data, Japan is going to be exposed to China's weakness and pressure on purchasing power over the coming quarters.

Outlook should remain positively oriented if private consumption holds

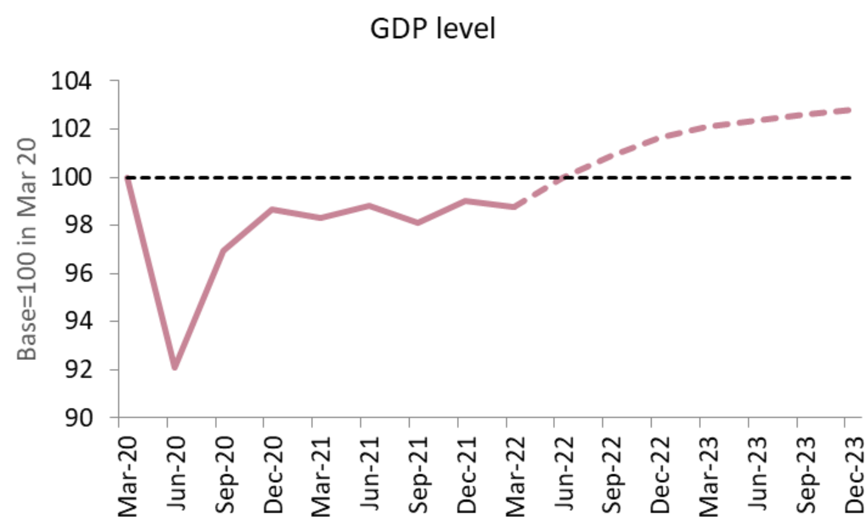
- Despite growing inflationary pressure, Japanese households still hold excess savings of about 4% of GDP and the government has just agreed on a supplementary budget to be submitted to the Diet ($21bn, or 0.5% of GDP). It will include one-off ¥50,000 ($380) cash payouts per child for low-income families and subsidies to fuel wholesalers.

Alternating positive and negative growth…



Source: Cabinet Office, AXA IM Macro Research, May 2022

GDP gap versus pre covid level still not closed



Source: Cabinet Office, AXA IM Macro Research, as of May 2022

Regime shift or temporary environment ?

Japan

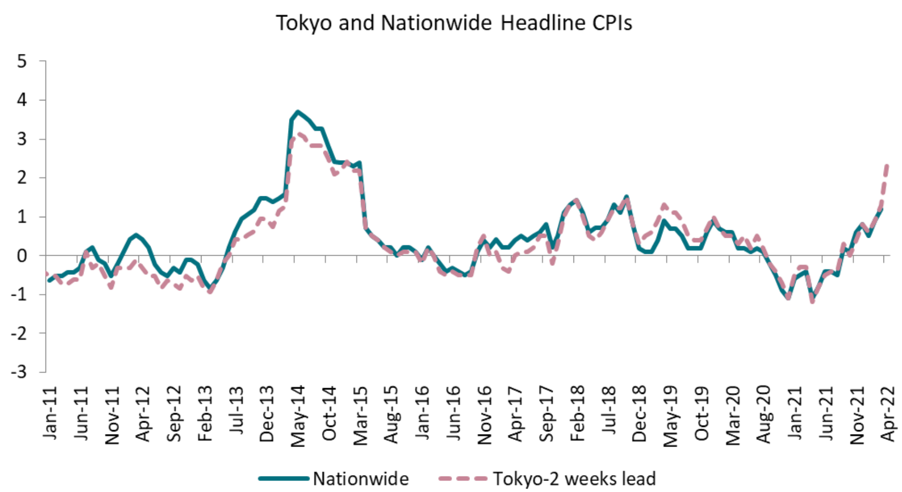
Headline CPI rose by 2.5% yoy in April

- Inflation has been boosted by another rise in energy and food prices. Nationwide and Tokyo price indices rose to 2.5%– the first time they have exceeded the Bank of Japan's (BoJ) inflation target since 2015. We believe that volatile components will build some pressure on core inflation and could reach 1% in the summer (without considering the possibility of the "Go to" campaign restarting).

The Bank of Japan remains firm

- BoJ Governor Kuroda reiterated the central bank's dovish stance, stating: "Easy policy needs to be maintained to boost the medium- to long-term inflation expectations and support economic activity, and tighten the labour market to cause wage hikes that would boost tolerance of higher prices".
- Kuroda also acknowledged that rapid yen depreciation is "undesirable", but the BoJ was not targeting any yen level. For one month, the dollar/yen pair has stabilised around 130, probably reflecting some uncertainties around whether the US Federal Reserve can deliver what is priced into markets.

Tokyo's CPI usually a good proxy for nationwide index



Source: Cabinet Office, AXA IM Macro Research, May 2022

The BoJ has no intention to follow other central banks

	BoJ recent speeches
May 16 H.Kuroda – BoJ Governor	« easy policy needs to be maintained to boost the medium – to long term inflation expectations and support economic activity, and tighten the labor market to cause wage hikes that would boost tolerance of higher prices"
May 10 S.Uchida - BOJ Executive Director	"no plan to widen target tolerance band, as such action would be tantamount to rate hike"
BoJ's statement on fixed-rate purchase operations	« In order to implement the above guideline for market operations, the Bank will offer to purchase 10-year JGBs at 0.25 percent every business day through fixed-rate purchase operations, unless it is highly likely that no bids will be submitted."

Source: Bank of Japan, AXA IM Macro Research, May 2022

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Strong start to the year drives inflation higher

Canada

Another post-COVID rebound

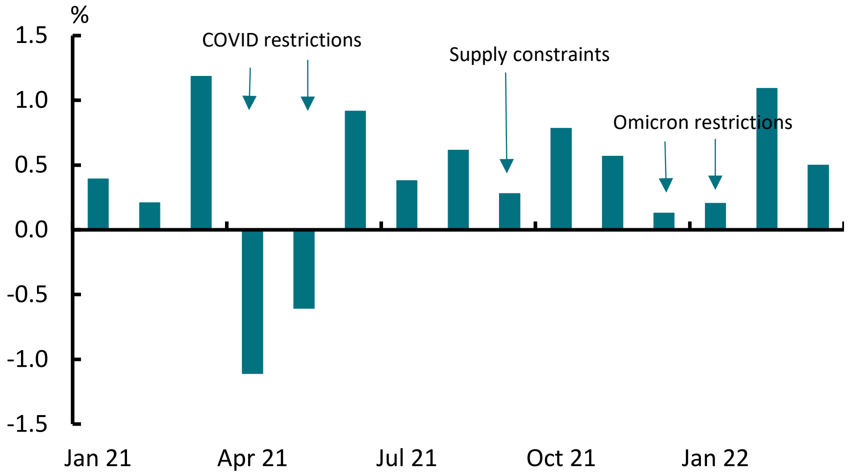
- The Canadian economy was impacted around the turn of the year by the outbreak of omicron. In February, recovering from this softness, the economy rebounded by a robust 1.1%, with a preliminary estimate of 0.5% for March. This would see Q1 GDP rise by a solid 1.4% - in excess of our forecast – and as such we raise our growth forecast to 3.9% for this year (from 3.3%), although we lower our forecast to 2.3% for next year (from 2.5%). Consensus forecasts 4.1% and 2.7% respectively.

Inflation makes fresh 30-year high

- April's inflation rate edged higher to 6.8%, from 6.7% - its highest rate since January 1991. The average core rate also rose to 4.2% - a high since 1990. Prices were driven higher by shelter costs (7.4%), food (8.8%) and services (4.6%) – gasoline softened the rise this month. With energy price risks remaining and China-related supply disruption also a threat, we see a slower retracement in inflation over the rest of this year and raise our inflation forecasts to 6.2% (from 5.9%) and 3.4% (from 3.2%), consensus 5.6% and 2.6%.

Canada surprises with another post-COVID rebound

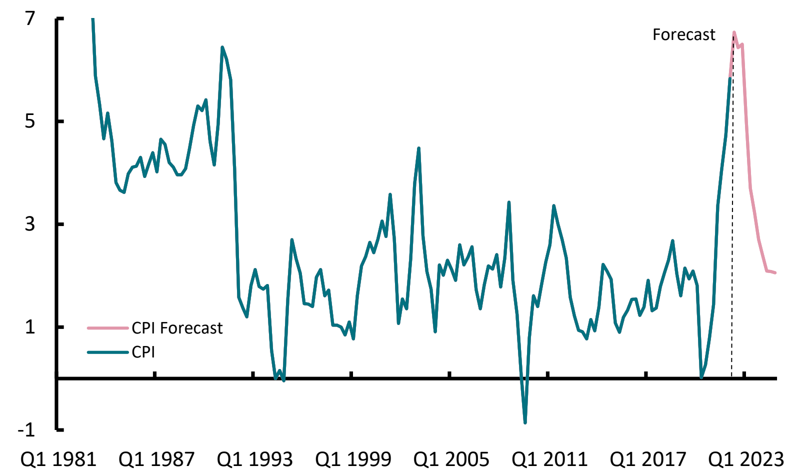
Canadian GDP (mom)



Source: CANISM, AXA IM Research, May 2022

Inflation risks proving more persistent

Inflation Outlook



Source: CANISM, AXA IM Research, May 2022

BoC engaged in mindful tightening

Canada

Pressure for BoC to move

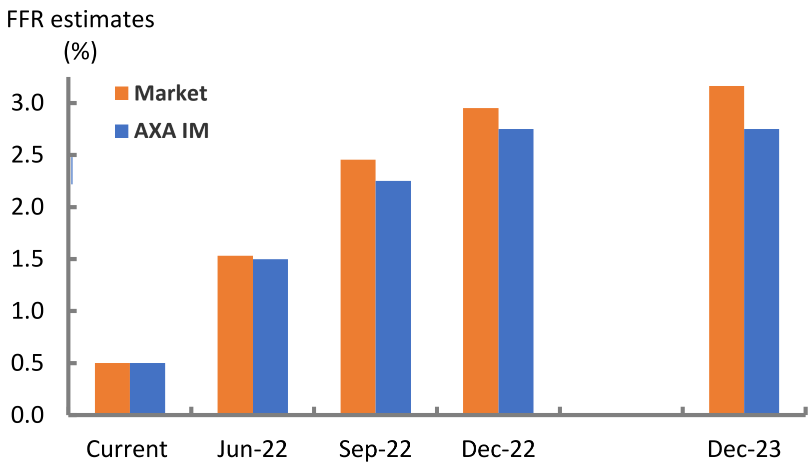
- The BoC faces an obvious pressure to restore price stability, but the new Conservative Party leader has targeted additional criticism at the Bank. With elevated inflation, record low unemployment and strong growth, Governor Macklem's commitment to "act as forcefully as needed" suggests the BoC will repeat last meeting's 0.50% hike both in June and July to get policy rates back to neutral (2-3%) quickly. We raise our forecast for the BoC's policy rate to 2.75% by year-end (from 2.50%).

Interest-rate sensitive sectors start to soften

- Several BoC members have suggested a "pause" at neutral – suggesting some wariness of what might follow. Canada's housing market posted its second monthly fall in sales this year, down 12.6% in April. The housing market has been extremely buoyant since the pandemic and needs to ease. Yet it represented an estimated 20% of GDP in 2021 and residential investment at 10% is larger than business investment. A severe slow down would impact the economy more broadly. This perhaps justifies some BoC caution.

BoC front-loading policy tightening

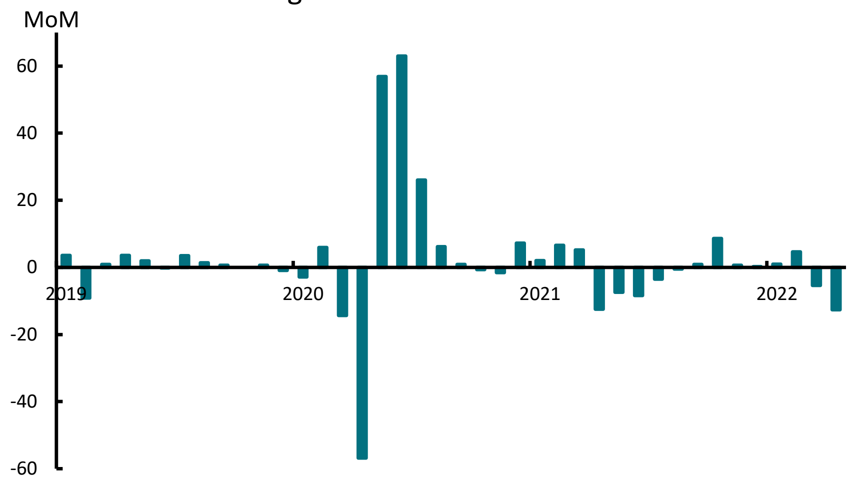
BoC o/n rate target expectations



Source: BoC, Bloomberg, AXA IM Research, May 2022

Housing activity begins to weaken

CREA- Canada existing home sales



Source: Bloomberg, AXA IM Research, May 2022

EM pent-up demand supported Q1 activity, slowdown ahead?

Emerging Markets

Q1 2022 GDP figures surprised on the upside

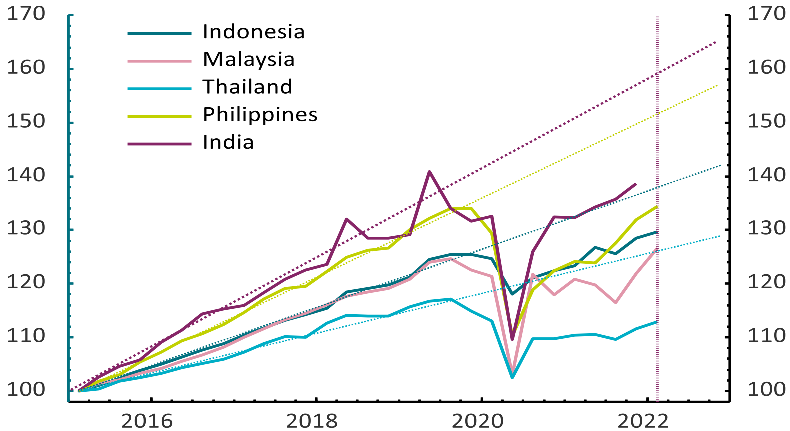
- In Asia, as the Omicron wave gradually subsided and local restrictions eased, domestic demand recovery pushed up growth in Q1 (qoq): +1% in Indonesia, +1.1% in Thailand, +1.8% in the Philippines and +3.9% in Malaysia. India may prove equally very strong.
- A more heterogenous picture is present in Latam: Chile's GDP fell 0.8% qoq in Q1 as high inflation, tighter financial conditions and lower public spending weighed on economic activity. Mexico Q1 2022 GDP rose 0.9% qoq, after a weak H2 21 pressured by the pandemic situation and the outsourcing ban. Colombia's GDP growth remains buoyant, above expectations, supported by positive terms of trade shock. We expect very strong performance as well in Brazil in Q1.

Higher inflation, higher policy rates… slowdown ahead?

- The war in Ukraine continues to pressure oil and food prices on the back of interruptions and bans on grain exports as well as higher fertilizer prices. Central banks have continued hiking policy rates, although soon appear close to reaching their limits. Asian central banks rate increases have started, with Indonesia and Thailand to be the last ones to join in H2. As financial conditions tighten and inflation remains stubbornly high, we expect growth to start cooling over the coming quarters.

Pent-up demand support Asian growth recovery in Q1

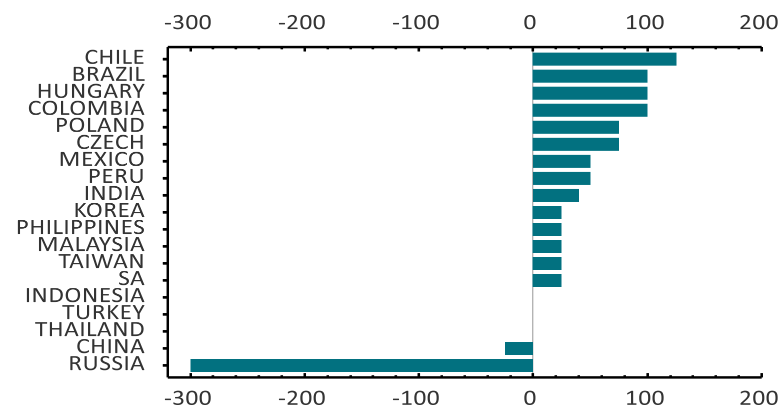
GDP index in EM Asia and pre-Covid trend (Q4 2015=100)



Source: Refinitiv Datastream and AXA IM Research Q1 22

CEE/Latam still hiking, Asian central banks joining the crowd

Policy rates (change last 1M, bps)



Source: Refinitiv Datastream and AXA IM Research May 22

CEE keeps roaring ahead: can it be sustainable?

Emerging Markets

No sign of cooling growth… or inflation

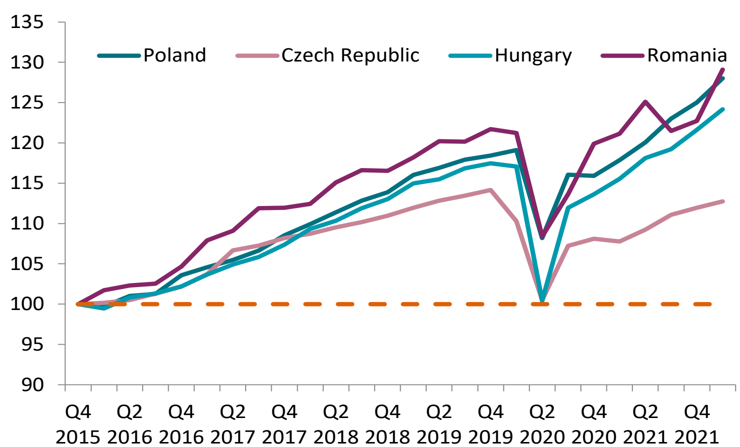
- Q1 GDP qoq growth also beat expectations: +2.4% in Poland, +2.1% in Hungary, +5.2% in Romania (after a weak H2 21), and "only" 0.7% in the Czech Republic. Germany rose by just +0.2%. With all above expectations, there is a mechanical upward pressures on 2022 GDP forecasts. However, we remain wary of the effects of the expected Eurozone slowdown in the coming quarters, as well as waning effects of the Ukraine refugees' additional consumption in the coming months.
- April inflation reached 13.8% in Romania, 13.2% in the Czech Republic, 12.4% in Poland and "only" 9.4% in Hungary where food and energy prices are capped. Core inflation is accelerating everywhere, with inflationary pressures visible in both goods and services.

Adjustments of the policy mix still needed

- Despite higher policy rates (+515bps for Poland, +480bps for Hungary, +550bps for the Czech Republic since lift-off), mounting second-round effects and inflationary expectations de-anchoring are increasingly visible. Buoyant wage growth and expansionary fiscal policy is keeping consumption robust and calls for a more decisive monetary tightening throughout the region to higher peak rates. Tighter fiscal policy is expected in Hungary post-elections, which may allow a less aggressive stance for the NBH in the next quarters.

Back to pre-Covid trend for most in CEE

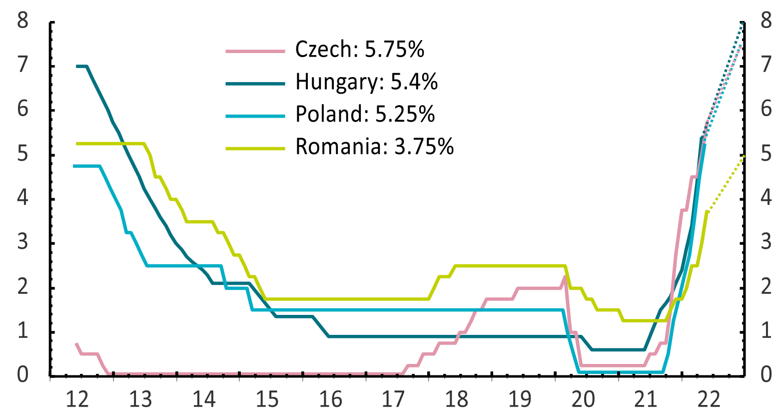
GDP index in Central Europe (Q4 2015 = 100)



Source: Datastream, AXA IM Research, Q1 2022

Higher policy rates going higher

CEE CB policy rates (%), Apr 22



Source: Refinitiv Datastream and AXA IM Research Apr 22

AXA Investment Managers

AXA Investment Managers

Investment Strategy

Multi-Asset Investment views

Our key messages and convictions

Neutral on equites

#1
Economic activity rapidly decelerating while persistent inflation pressuring central banks to slow growth further

#2
Valuations have improved following recent spread widening albeit not attractive enough to warrant being overweight

Neutral on Investment Grade Credit

Positive short-term Sovereign Bonds

#3
Central banks hiking cycle priced in, limiting bond yield upside. Seeking to increase carry and duration

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

Neutral High Yield

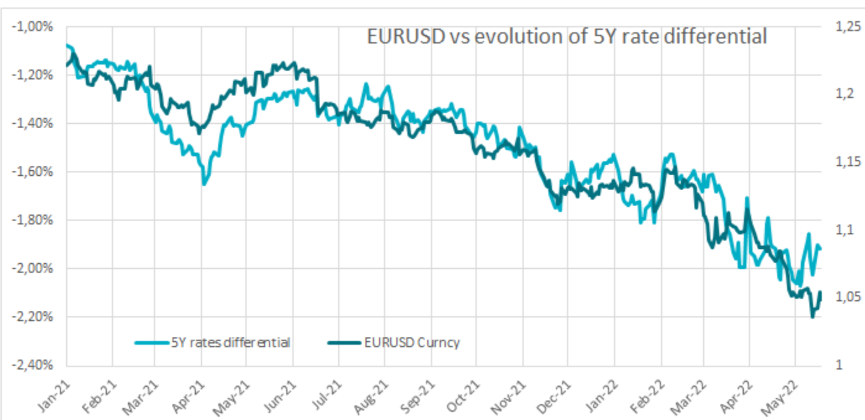
Source: AXA IM as at 23/05/2022

FX Strategy

USD peak ? Don't hold your breath for a turnaround anyway

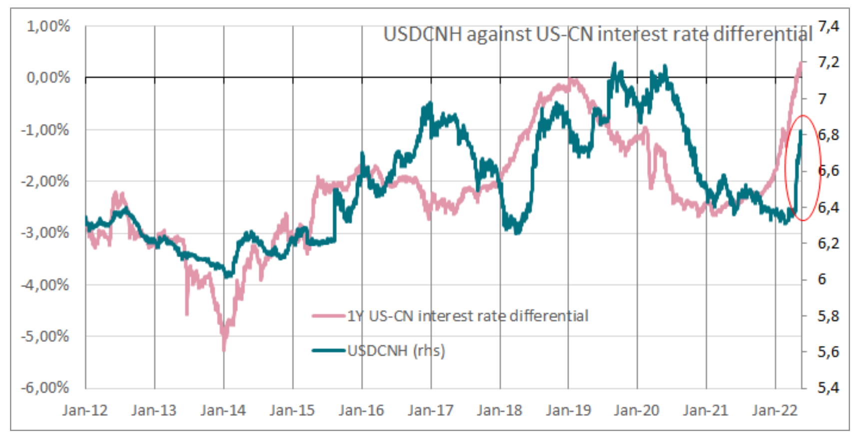
- Since April, risk-off sentiment has accelerated USD strength. But USD appreciation since Ukraine conflict is for a large part structural, reflecting US exceptionalism in its very advanced cyclical position in front of rising global inflation.
- Hence beyond a possible unwind of this last bout of Risk Off pressure, we see no catalyst for a structural rebound of EUR or GBP in the near term. Softening growth in China is another drag on growth on top of durably higher energy prices. EU labor and housing markets are much cooler than in the US and market expectations on ECB pricing look excessive. If anything, ECB pricing might adjust lower and further weigh on EUR. Brexit disruptions are hurting the UK growth outlook as much as they exacerbate inflation pressures domestically.
- Increased number of lockdowns in China accelerated CNH depreciation. PBOC will probably be willing to slow it down, but divergence with Fed will remain necessary in order to digest the impact of real estate deleveraging and lockdowns. Exports have already started to peak out as global reopening demand shifts from goods to services and as China zero Covid policy creates domestic disruptions against peers.

Last bout of EUR depreciation risk driven, but expectations on ECB could be revised lower



Source: Bloomberg and AXA IM Research, May 2022

USDCNH is adjusting to Fed / PBOC divergence, 7 in target



Source: Bloomberg and AXA IM Research, May 2022

Rates Strategy

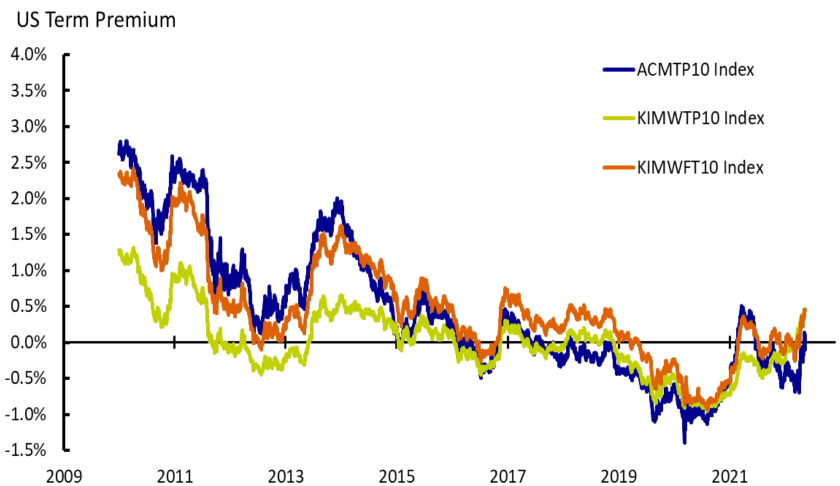
Inflation and the term premium are still on our radar screens

- Term premia have been on the rise again and are approaching highs last seen at the end of the first quarter of 2021 on the back of the Biden admininstrations fiscal push. Term premia are likely to continue exerting upward pressure on government bond nominal yields, as central banks attempt to start reducing their balance sheet and bond market volatility reverts to more normal conditions.

- Inflation is starting to become an ever increasing issue for the ECB given the excessive amount of pipeline pressures, as demonstrated by the severe wedge between the Producer Price Index and the Consumer Price Index.

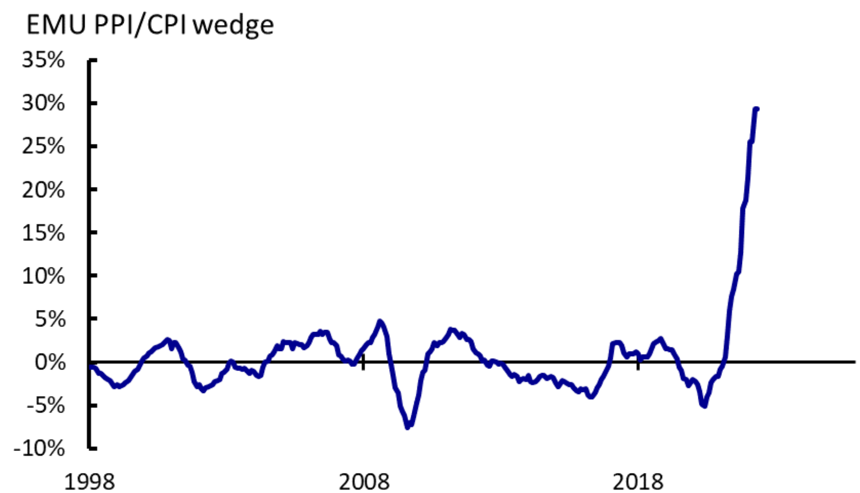
- EGB yields and for the euro periphery in particular are also vulnerable to further fragmentation as geopolitical risks play out and the reaction function amid EU governments may start to diverge.

US government bond term premia are on the rise again



Source: Bloomberg and AXA IM Research, May 2022

Severe inflation pressures in the pipeline in the EU



Source: Bloomberg and AXA IM Research, May 2022

Credit Strategy

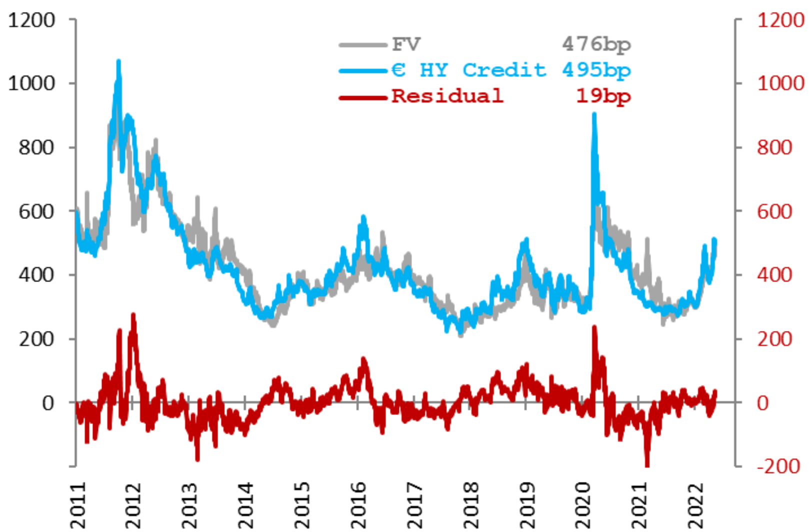
Are we there yet in terms of spread widening ?

- Credit spreads and particularly in European credit (due to the Ukraine conflict) have widened to decade highs, barring the spike in March 2020 due to the Covid shock. Short of an actual recession in 2022, spreads appear to be pricing a material degree of economic slowdown. EUR spreads are currently pricing a mere 0.9% of year on year growth within the next 3 months.

- The underperformance in EUR spreads in Q2, together with the high FX hedging cost due to central bank policy divergence, and the duration mismatch between USD and EUR investment grade, all combine towards a substantial yield pick-up in favour of EUR over USD credit, of 1.2% in investment grade and of 1.4% in high yield.

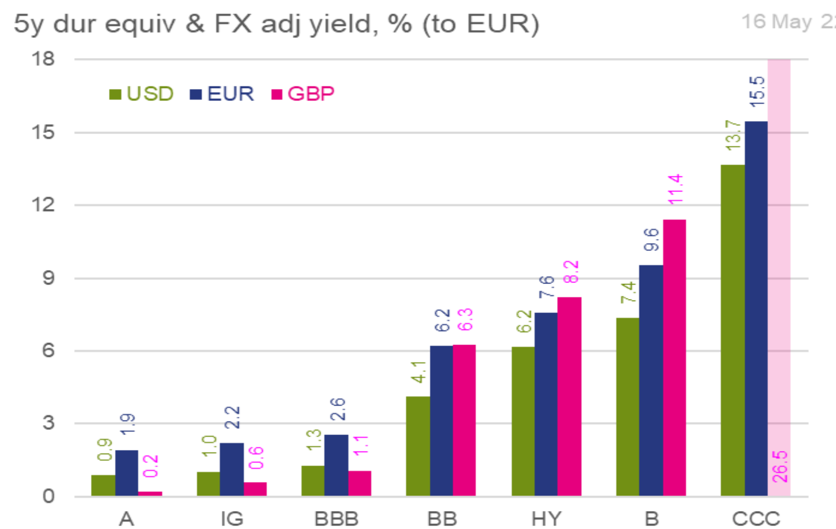
- Default expectations have risen further to 3.4% for US HY and 2.7% for European HY, due to a tightening in bank lending standards and a rise in HY bond distress ratios. Yet at the same time, the widening in spreads has pushed spread-implied default rates to above 4%, keeping valuations cheap in terms of default risk.

Covid spike aside, EUR credit spreads are at decade wides



Source: Bloomberg and AXA IM Research, May 2022

Substantial yield pick up in favour of EUR credit over USD credit



Source: Bloomberg, ICE and AXA IM Research, May 2022

Equity Strategy

Running out of ammo

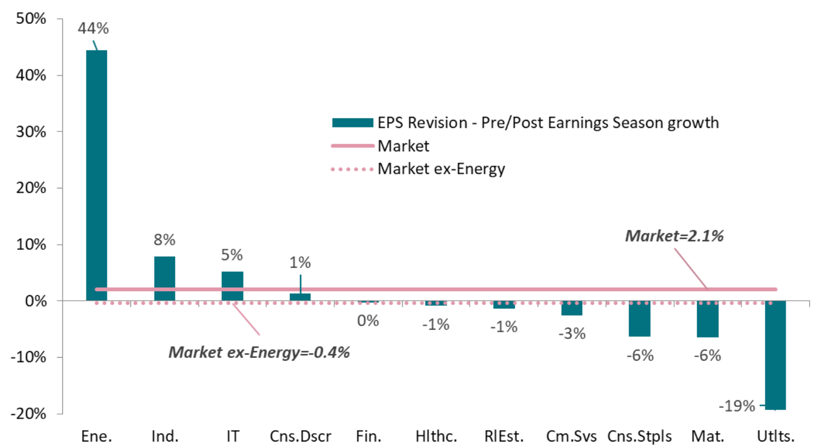
- Positive earnings surprises have been supportive in a year where valuations are being slashed – the earnings season that is coming to an end has cushioned what has been one of the worst starts to a year for global equities (-11.6% is 50th of 53). Companies reported better than expected results across regions, with the US, Europe, and Japan (+4.9%, +8.0% and +14.0% respectively) having positive earnings surprises.

- Bad news never travels alone – forward guidance points towards more complicated quarters ahead; indeed, guidance this season has been rather pessimistic leading to negative revisions for this fiscal year's results. In the period before and after the release of Q1 results, earnings for the year 2022 were revised by -0.4% ex- Energy.

- High dividend strategies present attractive characteristics in the current regime, as companies cash holdings are comfortable and dividend payout ratios are suppressed. Despite that, the MSCI World High Dividend is overperforming MSCI World by +12.8% year to date. High Dividend Yield stocks remains attractive relative to global equities (-26.7% discount).

Without energy, the story is different

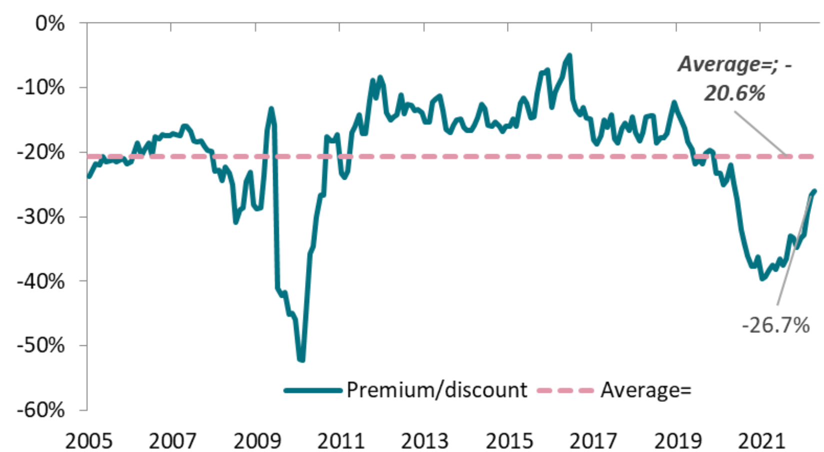
Pre/Post Earnings season - Global sectors 2022 EPS consensus



Source: IBES and AXA IM Research, May 2022

Still some room for High Dividend yield strategy to appreciate

Forward PE 12m - premium/discount



Source: MSCI and AXA IM Research, May 2022

Asset allocation stance

Positioning across and within asset classes

Asset Allocation

Key asset classes

Equities		▼	
Bonds			
Commodities			
Cash			

Equities

Developed

Euro area			
UK			
Switzerland			
US			
Japan			

Emerging & Equity Sectors

Emerging Markets			
Europe Cyclical/Value			
Euro Financials			
European Autos			
US Financials			
US Russell 2000			

Fixed Income

Govies

Euro core			▲
Euro peripheral			
UK			
US			

Inflation Break-even

US			
Euro			

Credit

Euro IG			
US IG			
Euro HY		▼	
US HY			

EM Debt

EM Bonds HC			

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

Source: AXA IM as at 23/05/2022

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Forecasts & Calendar

Macro forecast summary

Forecasts

Real GDP growth (%)	2020	2021*		2022*		2023*	
		AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
World	-3.1	6.1		3.2		3.0	
Advanced economies	-5.0	5.1		2.5		1.5	
US	-3.4	5.5	5.6	2.5	3.2	1.4	2.2
Euro area	-6.7	5.4	5.1	2.1	2.8	1.2	2.3
Germany	-4.9	2.8	2.7	1.2	2.2	1.7	2.5
France	-8.0	7.0	6.6	2.7	3.1	1.0	1.8
Italy	-9.0	6.5	6.3	2.3	2.7	0.6	1.9
Spain	-10.8	5.0	4.7	3.5	4.6	1.6	3.3
Japan	-4.9	1.7	1.8	1.8	2.1	2.1	1.8
UK	-10.0	7.2	7.0	3.8	3.9	0.9	1.4
Switzerland	-2.5	3.5	3.5	2.0	2.6	1.3	1.8
Canada	-5.2	4.4	4.6	3.9	3.9	2.3	2.8
Emerging economies	-1.9	6.7		3.6		4.0	
Asia	-0.7	7.1		4.8		5.1	
China	2.2	8.1	8.0	4.5	4.9	5.2	5.1
South Korea	-0.9	4.0	4.0	2.0	2.8	2.0	2.5
Rest of EM Asia	-4.2	6.2		5.5		5.2	
LatAm	-7.0	6.8		2.6		2.6	
Brazil	-3.9	4.6	4.7	0.9	0.6	1.9	1.5
Mexico	-8.2	4.8	5.6	2.4	1.7	2.2	2.2
EM Europe	-2.0	6.5		-0.2		1.0	
Russia	-2.7	4.7		-7.0		-3.0	
Poland	-2.5	5.7	5.3	4.2	3.9	3.3	3.4
Turkey	1.8	11.0	9.9	3.9	2.1	3.4	2.7
Other EMs	-2.5	5.4		3.0		3.0	

Source: Datastream, IMF and AXA IM Macro Research – As of 23 May 2022

* Forecast

Expectations on inflation and central banks

Forecasts

Inflation Forecasts

CPI Inflation (%)	2020	2021*		2022*		2023*	
		AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	**0.7**	**3.2**		**6.4**		**3.0**	
US	**1.2**	**4.7**	4.6	**7.6**	7.0	**4.0**	3.2
Euro area	**0.3**	**2.6**	2.5	**6.6**	6.5	**2.4**	2.4
Japan	**0.0**	**-0.2**	-0.2	**2.2**	1.6	**1.0**	1.0
UK	**0.9**	**2.6**	2.5	**7.6**	7.2	**3.5**	3.9
Switzerland	**-0.7**	**0.5**	0.5	**2.0**	2.0	**1.0**	0.9
Canada	**0.7**	**3.4**	3.4	**6.2**	5.2	**3.4**	2.5

Source: Datastream, IMF and AXA IM Macro Research – As of 24 March 2021

* Forecast

Central banks' policy: meeting dates and expected changes

Central bank policy

Meeting dates and expected changes (Rates in bp / QE in bn)

		Current	Q2-22	Q3-22	Q4-22	Q1-23
United States - Fed	Dates	0.75-1.00	3-4 May 14-15 June	26-27 July 20-21 Sep	1-2 Nov 13-14 Dec	Jan Mar
	Rates		+1.00 (1.25-1.50)	+0.75 (2.00-2.25)	+0.5 (2.50-2.75)	unch(2.50-2.75)
Euro area - ECB	Dates	-0.50	14 April 9 June	21 July 8 Sep	27 Oct 15 Dec	Feb Mar
	Rates		unch (-0.50)	+0.5(0.00)	unch (0.00)	unch(0.00)
Japan - BoJ	Dates	-0.10	27-28 April 16-17 June	20-21 July 21-22 Sep	27-28 Oct 19-20 Dec	Jan Mar
	Rates		unch (-0.10)	unch (-0.10)	unch (-0.10)	unch(-0.10)
UK - BoE	Dates	1.00	5 May 16 June	4 Aug 15 Sep	3 Nov 15 Dec	Feb Mar
	Rates		+0.5 (1.25)	+0.25 (1.50)	unch (1.50)	unch(1.50)

Source: AXA IM Macro Research - As of 23 May 2022

Calendar of 2022 events

2022	Date	Event	Comments
	Q3-Q4 2022	Chilean Constitutional Referendum	
May	May	Philippines Elections	
	Mid-May	EC and European Defence Agency to make proposals on defence investment gaps	
	29 May	Colombian Presidential Elections (first round)	
	30-31 May	EU Council	
June	12 & 19 June	French Legislative Elections	
	15 June	FOMC meeting	
	16 June	MPC Summary and minutes	
	19 June	Colombian Presidential Elections (second round)	
	25 July	Japan Upper House election	
	27 July	FOMC meeting	
August	August	US Federal Reserve Jackson Hole Symposium	
	4 August	UK Monetary Policy Report & MPC Summary and minutes	
September	15 September	MPC Summary and minutes	
	21 September	FOMC meeting	
October	October	China's 20th National Congress- President Xi to be re-elected (expected)	
	2 October	Brazil General Elections	
	30 October	Brazil Presidential Elections (second round)	
November	2 November	FOMC meeting	
	3 November	UK Monetary Policy Report & MPC Summary and minutes	
	8 November	US Midterm Elections	
December	14 December	FOMC meeting	
	15 December	MPC Summary and minutes	

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Latest publications

[Colombian election: a left turn?](#)

10 May 2022

China: Navigating its way out of 'Zero-Covid'

05 May 2022

April Global Macro Monthly - Macron encore

27 April 2022

China green bonds: Too big and attractive to ignore

13 April 2022

The real story behind the value/growth rotation

7 April 2022

French elections: Wait until summer

5 April 2022

March Global Macro Monthly – After the first month

30 March 2022

China's property sector: This time is different

9 March 2022

Russia Ukraine: Frozen conflict heats up

25 February 2022

February Global Macro Monthly - Frozen Conflict

23 February 2022

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