The monetary tide is turning

Monthly Investment Strategy Oped

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Key points

- Although evidence for second round inflation effects is scarce, the communication of central banks in advanced economies is turning more hawkish. The market is taking notice.
- If inflation spurs more central bank hawkishness, risk premiums will rise.
- But fundamentals for equities remain positive.

Best laid plans…

At the beginning of 2021, the likely trajectory for monetary policy across advanced economies looked crystal clear. The pandemic had created a large output gap which would take long to absorb, exerting a downward pressure on price dynamics, justifying an extraordinarily accommodative monetary stance for long. True, in the US, the size of the fiscal stimulus, after the victory of the Democrats, surprised to the upside, pushing the economy fast into "overheating territory", but in any case the Federal Reserve (Fed) had explicitly stated its willingness to tolerate above-target inflation for a while. The European Central Bank (ECB) soon converted to its own, less elaborate version of "average inflation targeting", (AIT) but in the Euro area, in any case, the economy was so far from full recovery that it almost felt like overkill. Yes, inflation would flare up for a little while as the economy was reopening, but that would be a flash in the pan and, quickly, central banks would be faced again with their decade-long incapacity to deliver on their 2% inflation target.

What derailed this benign approach is the rapid succession of exogenous shocks which are prolonging the spike in consumer prices. The global shortage in microchips may not be addressed before the middle of next year. Sea transport is hampered by limited harbour capacity. The price of energy continues to rise.

In principle, this should not put the central banks' plans in jeopardy. Even if they are lasting unusually long, supply-side inflation shocks normally fade on their own, since they are recessionary by nature. They depress consumers' purchasing power, which ultimately triggers enough consumption restriction to stop the price drift. Still, two problems can appear. First, consumers have accumulated a massive saving overhang during the pandemic. They can thus maintain their spending longer than usual despite the erosion in their purchasing power and postpone the reaction of demand. Second, second-round effects can emerge, with wages reacting to the price shock, turning what should have been a "flash in the pan" into a self-sustained upward drift in inflation.

There is little evidence supporting that any of these two phenomena are at play. True, savings have ballooned but in a very unequal manner. The liquidity position of those at the lower end of the income ladder has improved comparatively less, and their spending behaviour is key given their higher-than-average propensity to consumer their income. While there are some signs of wage acceleration in the US, this might still be the reflection of some "friction" as the labour market reopens, and those signs are totally absent in Europe. Hiring difficulties have increases there, but merely back to where they had stood for years without triggering any significant acceleration in wages. Besides, some significant headwinds are appearing for global growth. Even if we expect a policy loosening to help in the coming months, China is slowing down hard. In the US, the difficulties of the Biden administration to deliver on the next steps of its very ambitious fiscal platform may cool down demand next year.

Yet, the "zeitgeist" is changing and communication from central banks has shifted. While the Fed continues to hold the current inflation spike as transitory, the Federal Open Market Committee (FOMC) is now evenly split on the possibility to hike the Fed Funds rate in 2022 already, and, judging by Jay Powell's own words, it seems that the Fed's tapering will happen at a much quicker pace (six months) than expected just a few months ago. The Bank of England (BoE), which had already "pre-sold" a rapid termination of QE this year seems to be on the brink to hike its policy rate as early as December. The Euro area is not as advanced as the US in the recovery, nor dealing with the daunting specific issues the UK has imposed onto itself with Brexit. The ECB has more time. Yet, although we are probably still very far from a rate hike, in the Euro area as well the size of the monetary stimulus is about to shrink, as we expect the ECB to announce in December the end of the Pandemic Emergency Purchase Programme (PEPP) in March 2022, and the likely recalibration of the Asset Purchase Programme (APP) is likely to leave large net drop in the quantum of support.

This movement by central banks goes beyond a reaction to a higher inflation trajectory. We found it striking that in September, FOMC members lifted their rate forecasts although the Fed's inflation projections had barely moved. There is some generic "accommodation fatigue" in the world of central bankers, after years of unconventional policies have raised deep concerns over financial stability.

We are not convinced the most hawkish scenarios will materialise. In 2022, the base effects which had pushed year-on-year inflation up in 2021 will reverse and central banks are likely to remember that trying to deal with a supply-side inflation shock with monetary policy entails an unacceptable level of demand contraction. We continue to expect the first Fed hike for 2023, not 2022. But, for now, the market is "siding with the hawks", bringing their expectations for the tightening forward.

Rising risk premiums

It has been a good year for markets. Portfolios tilted towards equities, inflation and short-duration bonds have performed well reflecting surging nominal GDP growth in many economies and the tentative pricing of a shift in the monetary policy environment. For benchmark equity indices such as the S&P500 and the EuroStoxx, total returns to date have been around double the long-term average and in the top quartile of annual returns relative to the last thirty years. The reverse is true for risk-free assets – a representative US Treasury index, for example, has lost 2.8% so far this year, a return well below the thirty-year average of 5.4%. The key factors behind these moves have been earnings, inflation and shifts in interest rate term premium. All three will remain important in determining market moves in the coming months. Slower earnings growth, higher inflation and rising rates are the challenges to asset allocators as we head towards 2022.

The most likely, worst-case scenario for markets flows from the desire for normalisation amongst central bankers. If the accumulated evidence on inflation is sufficient a reason to accelerate this, the result will be a rise in risk-premiums across asset classes. Indeed, there are already some cracks. Let's take the earnings picture for equity markets. The analyst community has certainly become less euphoric in terms of earnings forecasts. In both the US and Europe, the number of downward revisions to earnings per share forecasts for the next twelve months have increased rapidly in recent weeks. To be clear, the earnings outlook remains positive but less so than was the case earlier in 2021. Supply side disruptions will impact on sales and some negative guidance could come out of the third quarter earnings season. Yet there remain areas of strength – energy and financials for example – while margins might be sustained by improving corporate pricing power. The message from the US financial sector in presenting the third quarter earnings has been a positive one which should temper any significant bearishness on the fundamentals for equities and credit assets.

Term premiums could also rise further as hawkish central bank rhetoric becomes embedded in rate expectations. So far markets are not pricing in much monetary tightening for 2022 beyond the peculiar example of the UK. However, the risk of a

more rapid tightening cycle being priced is more likely than rates moving lower again. At some point there is a self-regulating process at work – higher rates will reduce growth and inflation expectations sufficiently to allow long-term bond yields to stabilise and move lower again. However, there is some travelling to experience first, especially if inflation numbers remain elevated and growth is in line with current forecasts.

Staying away from long-duration bonds is prudent as inflation and interest rate expectations rise. The historical gap between the level of long-term yields and nominal GDP growth would suggest higher yields even as nominal growth slows in 2022. What we don't know, ex ante, is at what level yields would impact on real growth. In 2018, US Treasury yields peaked at 3.25% but that required a rolling over of growth data and a pivot from the Fed. Again, we have some travelling to do before we get there. Short-duration, floating rate and inflation linked fixed income assets are more desirable currently than longer-duration assets, including corporate bonds.

Equities have proved resilient to the inflation shock so far. It remains to be seen whether markets can be resilient in the face of rising interest rates. Global equity market returns were negative in 2018 but were positive in the two years prior to that when the US Federal Reserve was raising rates. A similar pattern might be seen this time. However, the risks of a correction in markets appears greater than they have been for some time. It seems the re-balancing of the global economy has further to go and the uncertainty that is generating should mean higher risk premiums on financial assets. It has already happened with the inflation compensation factor in bond yields, it looks to be happening to term premiums and credit risk and, at some point, equity risk premia may also need to rise.

Forecasts of a stock market correction are commonplace but prolonged periods of negative returns from equities usually only coincide with recession or an external shock. Absent these any correction in prices should be a buying opportunity. We expect global growth to remain strong in 2022 and that should allow businesses and households – whose balance sheets remain extremely robust – to weather the monetary policy normalisation process. Job creation and inventory re-builds will support demand and that is a positive backdrop for stock markets. So, it may well be the case that what has performed well, in terms of asset allocation, will continue to do so. Markets are going through the re-calibration of interest rate expectations now, driven by higher inflation and central bank hawkishness. There is the risk of a negative response to policy moves but it is too early to call time on the secular bull market.

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Recommended asset allocation

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

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

Source: AXA IM Macro Research – As of 20 October 2021

Macro forecast summary

Real GDP growth (%)	2020	2021*		2022*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
World	**-3.6**	**5.6**		**4.3**	
Advanced economies	**-5.2**	**5.0**		**4.0**	
US	**-3.4**	**5.7**	5.9	**3.9**	4.3
Euro area	**-6.7**	**4.7**	5.0	**3.9**	4.4
Germany	**-4.9**	**2.3**	3.1	**4.0**	4.4
France	**-8.0**	**5.9**	6.1	**3.5**	3.8
Italy	**-8.9**	**5.2**	5.7	**3.7**	4.3
Spain	**-10.8**	**4.8**	6.1	**5.4**	6.0
Japan	**-4.9**	**2.5**	2.3	**3.2**	3.0
UK	**-10.0**	**6.9**	6.7	**5.2**	5.4
Switzerland	**-3.0**	**3.6**	3.5	**3.3**	3.0
Emerging economies	**-2.6**	**5.9**		**4.6**	
Asia	**-1.3**	**6.9**		**5.3**	
China	**2.3**	**7.9**	8.4	**5.5**	5.6
South Korea	**-0.9**	**4.0**	4.1	**3.0**	3.2
Rest of EM Asia	**-5.6**	**5.9**		**5.4**	
LatAm	**-7.3**	**5.6**		**2.4**	
Brazil	**-4.1**	**5.2**	5.0	**1.6**	2.2
Mexico	**-8.5**	**6.5**	6.1	**2.3**	3.0
EM Europe	**-2.3**	**5.5**		**3.6**	
Russia	**-2.8**	**4.5**	3.5	**3.3**	2.7
Poland	**-2.7**	**5.3**	4.8	**5.2**	5.1
Turkey	**1.6**	**8.0**	6.2	**3.0**	3.5
Other EMs	**-3.7**	**3.3**		**4.1**	

Source: Datastream, IMF and AXA IM Macro Research – As of 18 October 2021

* Forecast

CPI Inflation (%)	2020	2021*		2022*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	**0.8**	**2.8**		**2.2**	
US	**1.2**	**4.3**	4.3	**3.3**	3.1
Euro area	**0.3**	**2.4**	2.2	**1.7**	1.7
Japan	**0.0**	**-0.1**	-0.2	**0.4**	0.5
UK	**0.9**	**2.4**	2.2	**3.7**	2.8
Switzerland	**-0.7**	**0.5**	0.5	**0.6**	0.6

Source: Datastream, IMF and AXA IM Macro Research – As of 18 October 2021

* Forecast

These projections are not necessarily reliable indicators of future results

Forecast summary

Central bank policy Meeting dates and expected changes (Rates in bp / QE in bn)						
		Current	**Q4-21**	**Q1-22**	**Q2-22**	**Q3-22**
United States - Fed	Dates	0-0.25	2-3 Nov 14-15 Dec	25-26 Jan 15-16 Mar	3-4 May 14-15 June	26-27 July 20-21 Sep
	Rates		unch (0-0.25)	unch (0-0.25)	unch (0-0.25)	unch (0-0.25)
Euro area - ECB	Dates	-0.50	28 Oct 16 Dec	20 Jan 10 Mar	14 April 9 June	21 July 8 Sep
	Rates		unch (-0.50)	unch (-0.50)	unch (-0.50)	unch (-0.50)
Japan - BoJ	Dates	-0.10	27-28 Oct 16-17 Dec	17-18 Jan 17-18 Mar	27-28 April 16-17 June	20-21 July 21-22 Sep
	Rates		unch (-0.10)	unch (-0.10)	unch (-0.10)	unch (-0.10)
UK - BoE	Dates	0.10	4 Nov 16 Dec	3 Feb 17 Mar	5 May 16 June	4 Aug 15 Sep
	Rates		unch (0.10)	+0.15 (0.25)	unch (0.25)	+0.25 (0.50)

Source: AXA IM Macro Research - As of 18 October 2021

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