Transition costs to net zero: significant but necessary

Global Macro Monthly

Key points

- Rising natural gas prices are the latest supply shock that will leave inflation higher and more persistent. We raise our inflation forecasts, but still see inflation as transitory, absent labour shortage persistence
- Inflation adds to COVID and supply interruptions to soften the growth outlook for the second half of the year, despite a solid first half. The 2021 growth outlook remains strong in most regions, but the 2022 outlook is softening.
- Policymaking is difficult in the face of supply shocks. Most try not to reduce fiscal stimulus too quickly.
- Financial conditions are tightening as markets price earlier central bank rate increases in most major regions. Yet recent moves appear extreme and current market pricing may fail to account for a sharper deceleration in growth over the winter.

Global Macro Monthly

Investment Strategy

Global Macro Monthly – US

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

Supply headwinds complicate buoyant rebound

The US is not as exposed to the global natural gas shortage as other regions. US natural gas prices did rise 350% from their lows last year, and are still 35% higher than two months ago, but this is far milder than increases elsewhere, as the US is less reliant on gas-fired electricity generation. Rather, the US is more exposed to the secondary increase in oil prices, driving gasoline prices higher. Annual fuel price inflation stood at 42% in September, alone accounting for 1.5ppt of the 5.4% current inflation rate.

The fuel price rise is another price level change and will lead to a significant reduction in the headline rate from the end of this year. But it is the latest in a succession of supply shocks that are keeping inflation elevated for longer, increasing risks of second-round effects that could see inflation persistently higher. The latest inflation report also included the sharpest monthly increase in owner-occupied rents since 2006. Further increases in this large sector, accounting for around one quarter of the consumer price basket, look likely. We further delay our expectation of inflation receding, leaving our forecasts for annual inflation at 4.3% and 3.3% for this year and next (consensus 4.3% and 3.0%). Our 2023 outlook is consistent with the Federal Reserve's (Fed) goal for a 'modest' overshoot.

Exhibit 1: Labour rebound key to transitory inflation

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

The labour market remains the primary risk that this prolonged, but transitory inflation overshoot becomes permanent. The labour market softened somewhat in September, payrolls posting a second successive softer increase – below 200k this time – while the Job Openings and Labor Turnover Survey (JOLTS) showed labour turnover fall in August by its most outside of a recession event, albeit remaining extremely elevated. Signs of labour tightness were exacerbated by a 0.1% monthly fall in labour supply and a dip in labour force participation (Exhibit 1). This resulted in another firm wage gain (up 0.6% on the month). We continue to expect a pick-up in labour supply, particularly as concerns fade over COVID-19 impacts on childcare and workplace healthcare. However, a permanent *de facto* reduction of the workforce would result in labour supply shortages, higher wages and more persistent inflation.

This combination of supply shortages, COVID-19 concerns and price increases have weighed on growth prospects, in line with our expectations. Retail sales fell 0.7% in Q3, despite a rise in September. Weak vehicle sales weighed – recording their lowest in September since April 2020. Sales ex-autos and gas were firmer, up 1.7% on the quarter. Nevertheless, we forecast a soft rise in third quarter (Q3) consumption (less than 1% annualised), with Q3 GDP growth likely at just 3% – less than half the previous two quarters. More encouragingly, an expected pick-up in hiring, excess savings and further improvements in the post-pandemic economy look set to spur growth faster in coming quarters. We leave our outlook for 2021 at 5.7%. However, a softer second half (H2) lowers our 2022 forecast to 3.9% (consensus 5.9% and 4.1%). That said, we continue to expect the US to close its output gap by year end – a still impressive rebound in activity.

One headwind to growth was removed when, as expected, the US both averted a government shutdown and secured a debt ceiling extension – the latter with less market fallout than feared. However, neither situation is resolved, with both deferred until December (3rd for a government spending bill). Again, we do not expect either event to materialise, but market nerves could be tested further next time. More broadly, President Joe Biden is struggling to pass his spending bills, with discussions over the larger reconciliation package now anchored on a much lower $2tn, from $3.5tn. We had not expected the full $3.5tn package, but $2tn is lower than our previous expectations. Even delivery of this package is still fraught. House Speaker Nancy Pelosi has scheduled the next key vote for 31 October.

The Fed's last meeting signalled that it would likely announce a taper of its asset purchases in November. Recent minutes suggested it would taper by $10bn US Treasury (UST) and $5bn mortgage-backed security (MBS) per month, to conclude purchases around the middle of next year – a faster pace that we had flagged over the summer. Focus has turned to the Fed's rate outlook with the market now pricing the first Fed Funds rate hike by December 2022. The latest 'dot plot' vindicated such a view, with half of participants considering at least one hike next year, although resignations have since complicated this outlook. To our minds, the Fed will have comfortably met its inflationary pre-conditions for rate lift as of next year, but we are less convinced that it will consider the labour market to be at "full employment" until early 2023. That said, we now consider an earlier hike in 2023 (pencilling in March from June) and think that three hikes across 2023 look more likely than two.

Global Macro Monthly – Eurozone

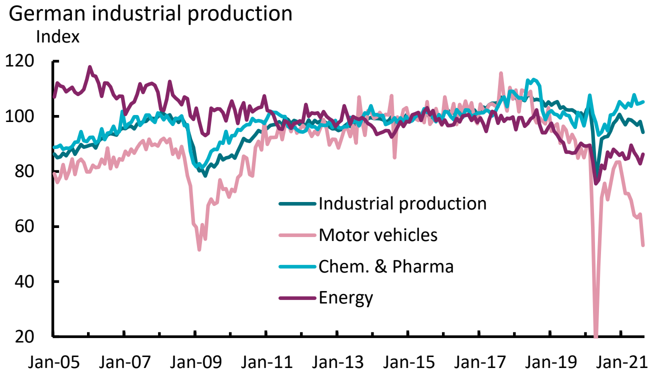
Hugo Le Damany,
Economist,
Macro Research – Core Investments

Recovery struggles in the final stretch

We continue to monitor COVID-19 developments, but recent indicators suggest steady improvements, consistent with very few restrictions. European economies are now much better placed to cope with the pandemic thanks to high vaccination coverage and prudent containment measures. However, an easing of concerns here has been replaced by worries around supply shortages and inflation. After a buoyant recovery in the second quarter (Q2) and in early Q3, the pace of activity is slowing. Some of this is a natural unwinding of the initial faster pace, but headwinds from supply shortages and energy prices are growing and compromising recovery prospects.

German industrial production (IP) fell 4% month-on-month, with manufacturing down 4.6% and construction down 3.1%. Most of the weakness came from a 17.5% plunge in car production given a shortage of semiconductors (Exhibit 2). Eurozone IP fell by "only" 1.6% on better prints in France (+1%) and Spain (+0.1%) – both less reliant on autos – as well as in Italy (-0.2%). But the recent surge in prices in transportation, energy and some components will complicate the outlook. Companies may have to reduce activity or halt production completely in industries including cars, chemicals and basic materials. Separately, China's slowdown adds to Eurozone growth concerns.

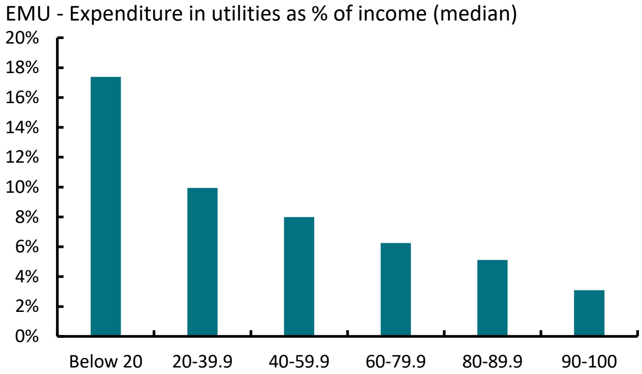
Exhibit 2: Strong heterogeneity in German industrial production



Source: Destatis and AXA IM Macro Research, October 2021

The large rise in energy prices is also impacting household purchasing power despite recent government efforts to mitigate the impact through lower taxes and energy vouchers in France, Italy and Spain. On a macro level, households could absorb this increase, reducing their post-pandemic excess savings. However, these are not equally distributed, while the energy burden will fall hardest on the poorest (Exhibit 3).

Exhibit 3: The impact of rising energy prices is unequal



Source: ECB Household Finance and Consumption Survey (2017) and AXA IM Macro Research, October 2021

On a brighter note, services, which represent the largest share of the Eurozone economy are recovering fast, benefiting from a reallocation of consumer spending while confidence stays at record level. The labour market is also recovering faster than expected, which will further boost aggregate domestic demand. Overall, Eurozone Q3 GDP growth should be robust but biased by a catching up phenomenon. However, we believe industrial weaknesses will persist into Q4 and probably Q1 on continued supply disruption. We lower our outlook accordingly.

"Transitory" may be more persistent

Inflation rose to 3.4% year-on-year (yoy) in September, with core inflation standing at 1.9%. The resumption of German VAT levels will continue to distort readings until December. More importantly, wholesale oil, gas and electricity prices recently broke records and a large share of this will be transmitted to retail prices, raising Consumer Price Index (CPI) inflation over coming months. Prices have softened but the higher contribution will persist in Q4 and probably in Q1. We have raised our Q4 CPI forecast to reach 3.7%yoy across the region and 2.4% on average over 2021 (from 2%).

Post-election: Time for compromise

German election results saw significant disaffection with the centre-right CDU/CSU (or its leader) and the emergence of less conservative parties, namely the Greens and FDP. These are now in coalition talks with election winner the centre-left SPD. Negotiations are moving faster than expected with an initial deal announced last week. A decision to exclude tax hikes and keep domestic fiscal rules has been key, but now each policy will be discussed in detail. The FDP manifesto is by far the least centre-left compatible, but compromises are likely. SPD leader Olaf Scholz's wish to have a government in place before Christmas now seems achievable.

Global Macro Monthly – UK

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

Gas prices put further pressures on inflation

Sharp increases in wholesale gas and electricity prices are driving inflation. Gas prices, recently at all-time highs, reflect lower-than-usual inventory following a cold winter, global demand, constrained Russian supply and a fall in renewables output. Whilst prices retreated somewhat after Russia agreed to increase supply, they remain elevated and will pass through to consumers. We expect Consumer Price Index (CPI) inflation to peak around 5% in Q2 2022, before falling towards the Bank of England (BoE)'s target in Q4 2022. We expect inflation to average 2.4% and 3.7% this year and next.

Recent labour markets trends risk more persistent inflationary pressures. The latest jobs report saw a continued rebound in employment and signs of increased labour market tightness. Payrolls reached pre-pandemic levels in September and job vacancies reached a record high of almost 1.2mn as some sectors reported a significant labour shortage. However, questions remain about the tightness of the labour market. Increases in employment were driven by part-time workers. Moreover, 1.3mn – close to the 1.5mn total unemployed – remained on the furlough scheme at the end of August, a month before the scheme's closure.

UK GDP rose 0.4% in August, softer than expected, with July revised lower to -0.1% from 0%. This followed a material upward revision to Q2 GDP growth to 5.5% from 4.8%. As such, our annual forecast for 2021 is a modestly firmer 6.9%, although we lower our 2022 outlook to 5.2% (consensus of 7.0% and 5.3%).

The BoE Monetary Policy Committee is increasingly concerned about the impact of the current inflation spike on expectations as well as the medium-term balance of supply and demand. Recent comments from Governor Bailey have prompted us to bring forward our rate hike expectations to a 0.15% hike in February and a 0.25% hike in August. A Bank rate of 0.50% would trigger a passive unwind of the BoE's balance sheet, starting with £6bn in September. We then forecast a rise to 0.75% in May 2023. Markets currently expect rates of around 1% by end-2022, but we see this as too sharp a tightening in financial conditions given other shocks to incomes looming over the coming quarters.

Trade tensions with the EU have re-emerged as the UK seeks to renegotiate the Northern Ireland Protocol. The EU has proposed easing restrictions, but it is unclear whether the UK will accept.

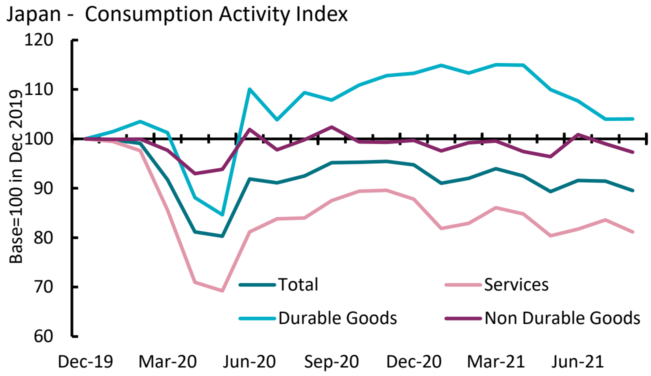
Global Macro Monthly – Japan

Hugo Le Damany,
Economist,
Macro Research – Core Investments

Japan sees the light at the end of the tunnel

The state of emergency and "stop-and-go" policies have weighed heavily on activity, and even though restrictions have mostly been removed, surveys and data are yet to fully reflect the changes, especially in the services sector. The September services Purchasing Managers' Index stayed in contractionary territory at 47.8, but was improved from a month earlier, while August services spending was still 20% below the end-2019 level (Exhibit 4). Industrial production remains heavily impacted by the effect of shortages on car production. Fortunately, public and business investments are better oriented and in the third quarter (Q3) we think it will grow by 1.5% from the previous three months. Considering these developments, we have lowered slightly our Q3 GDP growth forecast to 0.3% quarter-on-quarter.

Exhibit 4: An imminent rebound in service spending?



Source: Bank of Japan, AXA IM Macro Research, October 2021

Fumio Kishida has been appointed Prime Minister and will lead the Liberal Democratic Party into legislative elections on 31 October. Kishida has focused on three policies: response to COVID-19, "new capitalism" and diplomacy and security. Despite supporting the basic policy of Abenomics, which calls for overcoming deflation through bold monetary policy, flexible fiscal policy, and promotion of growth strategies, Kishida noted it has widened the wealth gap. He stressed his ambition for a "new capitalism" that balances economic growth with the reduction of inequality through a favourable cycle of growth and redistribution.

On fiscal policy, he ruled out any immediate fiscal consolidation and proposed a new stimulus to cope with persistent weaknesses derived from the pandemic. Globally, the economic agenda is unchanged and as the proposition on more redistribution comes just before elections, we prefer to wait to assess any potential impact

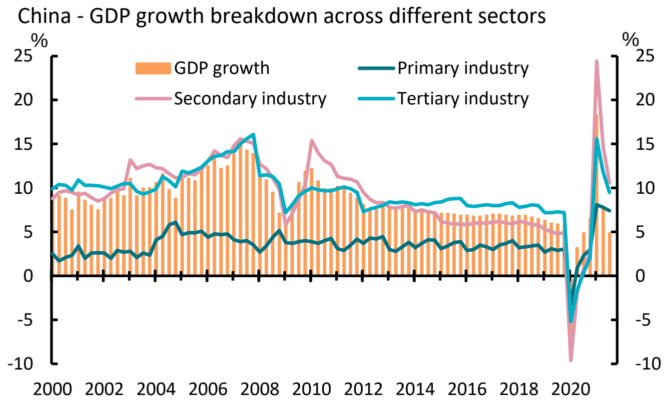
Global Macro Monthly – China

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

GDP growth almost stalls

The Chinese economy barely escaped a contraction in the third quarter (Q3) – rising only 0.2% quarter-on-quarter – after running into multiple speedbumps. Service sector growth weakened notably due to tightened containment measures against the Delta variant (Exhibit 5). Industrial growth also fell sharply to 4.8% from 6.1% as production was hit by severe floods and power shortages at the end of Q3. In addition, the continued normalisation of monetary conditions – which manifested in slowing credit growth – did no favours to business investment and household spending on big ticket items. Q3's economic slowdown was therefore a result of broad-based weakness in domestic demand, which stood in sharp contrast to buoyant exports.

Exhibit 5: Growth depressed by multiple headwinds



Source: CEIC and AXA IM Research, 18 October 2021

Economy hit by supply and demand constraints

September's data revealed fresh woes in the economy. Industrial production growth slowed sharply to 3.1%, making it the second worst reading after March 2020 when the economy was paralysed by COVID-19. An unexpected power crunch – driven by soaring coal prices and the government's push to reduce carbon emission – forced many provinces into power rationing which hit energy-intensive sectors.

The good news is the authorities have started to respond by increasing coal production, raising power prices, and pledging to avoid a "campaign-style" decarbonisation push. This suggests the worst of the power crunch may be over, although how quickly conditions can return to normal – particularly for heavy energy users – remains unclear.

Fixed asset investment (FAI) also fell short of market expectations in September. Property investment growth fell (by 3.5% year-on-year) for the first time in 2021, consistent with earlier declines in house sales and starts. Financially weak property developers have increasingly been shut out of the bond market and banks are reluctant to lend to those violating the three "red lines". The inability to refinance has pushed some large developers to the brink of collapse.

Thankfully, recent moves from government departments suggest that Beijing is taking action to ringfence the problem. The People's Bank of China (PBoC) has started to ease mortgage controls by allowing banks to cut lending rates and speed up loan disbursement. Banks are also told to correct their 'one-size-fits-all' lending curbs to developers with refinancing needs. Further fine-tuning of policies is likely as Beijing manages contagion risks, but we expect no reversal to the overall tightening stance.

Infrastructure fixed-asset investment (FAI) has been an enduring disappointment for those anticipating more fiscal support. During September, there was little evidence of local governments putting the money from recent bond sales to work. While we expect the situation to improve as the issuance pipeline gets busier in the coming two months, it remains to be seen how fast the disbursement of funds can occur to benefit growth this year.

Balancing the negative news was a further strengthening of manufacturing investment growth. It appears that strong external demand has offset supply disruptions to underpin business capex decisions. Retail sales growth also rebounded last month, to 4.4%, as did services output, recovering to 5.2%, supported by pent-up demand after the containment of the Delta outbreak.

More policy support needed

We think the weak Q3 data will prompt Beijing to further dial back growth-restraining policies. In addition to fine-tuning property market curbs and mitigating the energy crisis, standard monetary and fiscal policies will do more of the heavy lifting too. The PBoC has pledged to keep liquidity stable by utilizing targeted tools and creating new facilities to support green financing. The chance of a broad-based reserve requirement ratio (RRR) cut has diminished, given recent hawkish communications. But we still think a targeted move is possible if growth falters further. Fiscal support will come, first and foremost, from local governments deploying the cash from special bond sales. However, the overall stimulus effect will be limited by Beijing's steadfast control over the housing market and shadow banking, which are traditional channels of policy transmission. Beijing's tolerance for short-term pain has been a major surprise to the market this year. Factoring this in, together with the Q3 data, we have downgraded our 2021 growth forecast to 7.9%, and see downside risks to our 2022 forecast at 5.5%.

Global Macro Monthly – EM


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

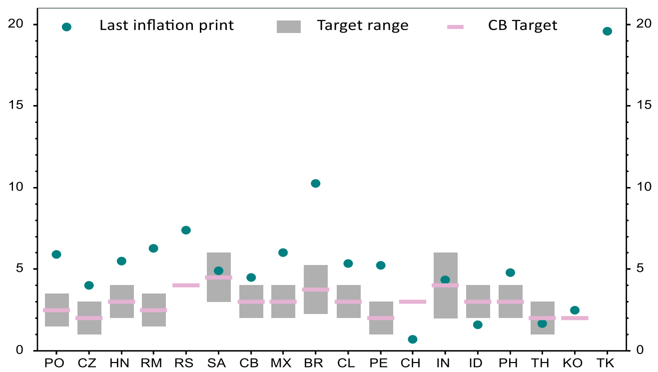
Shirley Shen,
Economist (Emerging Asia),
Macro Research – Core Investments


Slower growth, higher inflation?

The economic rebound in emerging markets (EM) has broadly proven stronger than expected but the pace of recovery still varies widely between different countries. This can be explained by differences in the timing of coronavirus infection waves and in the nature of national containment policies, while varying vaccination rates have meant uneven timetables for economic reopening, and policy support disparities remain. Aggregate output for emerging markets is expected to remain below the pre-pandemic trend path for the next couple of years – and probably longer for low-income developing countries. Downside risks to EM growth expectations would include an economic slowdown in China, a consumer rotation back to services, a gradual normalisation in global financial conditions and the lingering risk of more aggressive COVID-19 variants before emerging markets can achieve widespread vaccination.

Exhibit 6: Inflation increasingly rising above targets

EM inflation rates and CB targets (%)



Source: Datastream and AXA IM Research, 15 September 2021

The recent inflation acceleration as a result of supply and demand mismatches, and rising global food, energy and commodity prices – often beyond central banks' targets (Exhibit 6) – poses additional risks. Core inflation has been more subdued so far, but lagged pass-through from higher oil and food prices, and past currency depreciation to broader inflation should not be dismissed. The risk of an unanchoring of inflation expectations is higher in EM than in advanced economies – a reason why several EM central banks have started normalising their monetary policy stance. Some 30 have already hiked rates this year, with cumulative increases ranging from 25 basis points (bps) to 500bps year-to-date, mostly in Africa, Central and Eastern Europe and Latin America.

Diverging policies: Turkey versus Brazil

The timing of the Turkish central bank's (CBRT) decision to cut its policy rate by 100bps to 18% was unexpected and appears dissonant. Turkish Inflation was expected to soften into year-end on the back of supportive base effects, but the last inflation data still recorded 19.25% (August), almost four times the central bank's official target of 5%. In the absence of clear forward guidance and given obvious political interreference, there is a non-negligible risk that the CBRT errs towards larger cuts than previously envisaged. Monetary policy has been increasingly used by President Recep Tayyip Erdoğan's administration to over-stimulate economic activity, causing overheating and macroeconomic volatility. The 10-year government bond yield rose by 200bps after the rate cut as inflation expectations rose and the Turkish lira crossed the level of nine to the US dollar, an all-time low. Turkey's external financing needs are currently limited, but concerns may grow in the face of further policy accommodation and as energy bills mount. A front-loaded easing cycle at a time of tightening global financial conditions feels uncomfortable and raises the odds that the CBRT will need to once again resort to using scarce reserves to support the currency and abruptly reverse its policy path. This policy easing "experiment" bears risks that we consider unnecessary at this juncture.

Inflation is also rising sharply in Brazil, returning to double digits in September (10.25%) after more than five years. The monthly acceleration was the highest since 1994, driven by food prices, but also more material second-round effects including an acceleration in services and industrial goods prices. Electricity prices are still high (a harsh drought in Brazil has affected hydro generation) and inertia is evident in core prices. The central bank has been hiking interest rates since March 2021, to date by a cumulative 425bps to 6.25% and signalling more to come. We expect policy rates to reach 8.25% by year-end. Fiscal slippage – new extensions of COVID-19 relief measures and additional social spending ahead of elections – is an extra risk for inflation. The central bank could hike rates further into early 2022, as it has stated that a tightening to a significantly restrictive level is the most appropriate strategy. The National Monetary Council is moving towards a lower inflation target, at 3.0% in 2024, +/- 1.5 percentage points (ppts), reducing annually by 0.25ppts from this year's 3.75% target. This is more in line with targets across the region and seems to call for tighter policy. Growth looks set to weaken, while inflation may prove sticky – a common dilemma for monetary policy setters around the world right now.

Investment Strategy – Cross assets

Greg Venizelos,
Credit Strategist,
Research – Core Investment

On the inflation tightrope

Higher inflation could trigger further repricing of monetary policy expectations, raising real yields and term premia, and lowering growth expectations. This depends on how soon supply-side issues can be resolved. On balance, we expect continued growth and retreating inflation in 2022, but some caution by investors about inflation risks is warranted.

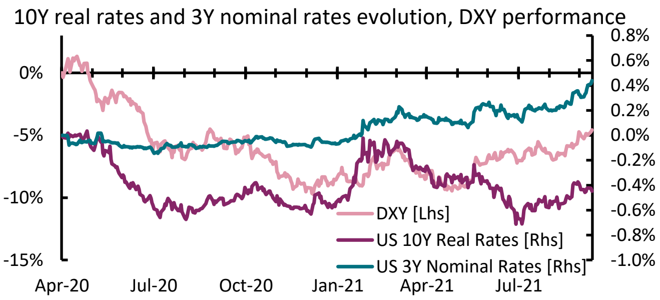
Investment Strategy – FX

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

US dollar buoyed by prospects of Fed lift-off

Monetary policy normalisation has now officially begun among the G10, with both Norway's Norges Bank and the Reserve Bank of New Zealand raising rates. Inflation pressures, from supply chain bottlenecks or tight labour markets, are set to last longer than expected and markets are repricing for earlier and further central bank rate hikes. Without the benefit of significant inflation undershoots in the past, the Federal Reserve's support for the dollar has switched from tapering expectations via the real rate differential to the more direct and powerful driver of rising interest rate differential (Exhibit 7). The dollar has already benefited from this; additional strength may come from US yields rising further as the Fed tapers, waning excess liquidity as debt ceiling issues get resolved and further growth prospects if the Build Back Better package is approved.

Exhibit 7: Switching dollar drivers from tapering to rate hikes expectations

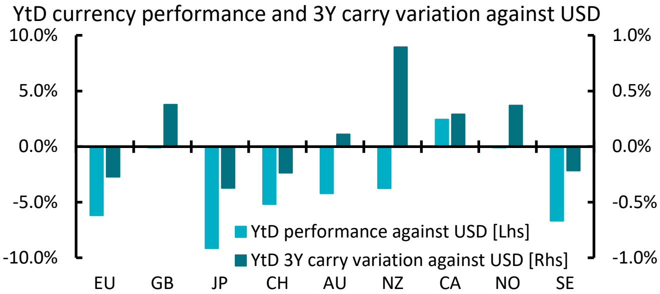


Source: Bloomberg and AXA IM Research, 18 October 2021

Canadian dollar boosted by energy prices

Rising energy prices are now adding to already significant inflation pressures. This helps Canadian dollar appreciation beyond what the repricing of Bank of Canada normalisation implies (Exhibit 8). This dynamic has supported other commodity currencies too, but the Norwegian krone has some catching up to do. Antipodean currencies are lagging, dragged down by renewed lockdowns and concerns about China's growth outlook. Yet both New Zealand and Australia are quickly catching up on vaccinations and moving towards economic reopening. The New Zealand dollar in particular looks cheap compared to the recent repricing of the central bank's policy, triggered by a sharp rebound in second quarter growth. On the other hand, energy importers are likely to suffer. This does not bode well for the euro, Swiss franc and in particular yen; expectations for those central banks were already low by contrast given less acute inflation pressures. These currencies should underperform, including the yen, despite its already large undervaluation.

Exhibit 8: Canadian dollar running ahead of rate hike expectations, New Zealand dollar behind

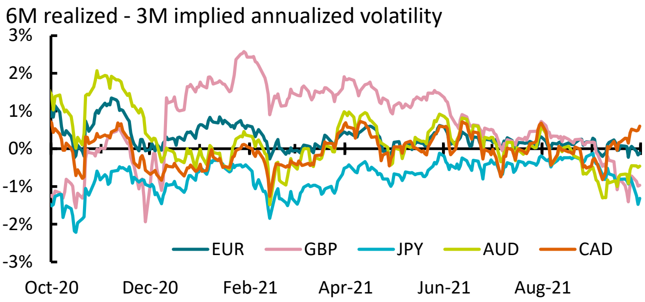


Source: Bloomberg and AXA IM Research, 18 October 2021

Sterling accelerating in the fog

Rising energy prices are also a challenge for the UK, though sterling has performed well recently as Bank of England expectations have been sharply repriced to the hawkish side. Yet the horizon seems more uncertain in the UK than in other G10 countries, as inflation pressures are amplified by Brexit supply shocks and are potentially more damaging to growth. The recent uptick of implied volatility on the sterling/US dollar rate above realised volatility, could be an indication of rising concerns, and a potential headwind to further sterling appreciation. The spread between realised volatility and implied volatility tends to be an advanced indicator of market sentiment and a leading signal on currency performance (Exhibit 9).

Exhibit 9: Rising concerns over sterling and yen, rising confidence in Canadian dollar



Source: Bloomberg and AXA IM Research, 18 October 2021

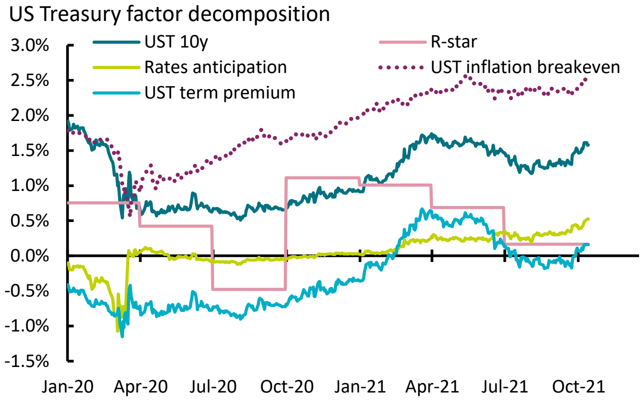
Investment Strategy – Rates

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

US Treasuries: In transition

US Treasuries continue to have a challenging year. Total return stands at -2.6% year-to-date, with a rather heavy decline of 1.5% during the past month. By contrast, Treasury Inflation-Protected Securities (TIPS) are enjoying the ride, up 4% year-to-date, especially the duration-hedged TIPS index (+7.5%, a proxy for breakevens' performance).

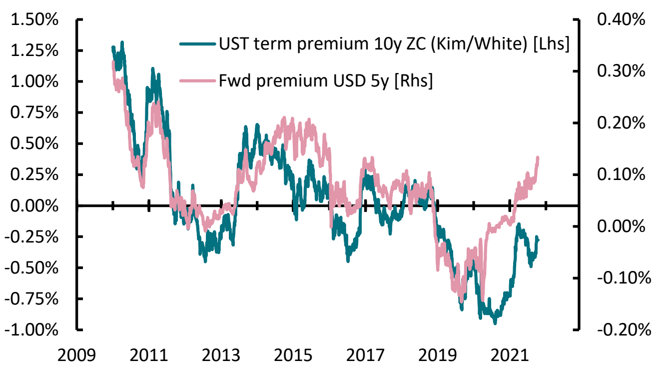
Exhibit 10: Common yield factors are all higher



Source: Bloomberg and AXA IM Research, 18 October 2021

Common yield factors have recently seen an acceleration: Breakeven inflation is up 15 basis points (bp), rates expectations are 22bp higher and the term premium has jumped by almost 30bps (Exhibit 10). Supply-side bottlenecks, commodity prices and various exogenous factors (e.g. drought and frost in Brazil) have charged the inflation theme, spilling over into tapering expectations and ultimately in rising premia. Exhibit 11 shows the relationship between the 10-year Treasury term premium and the five-year US dollar forward premium.

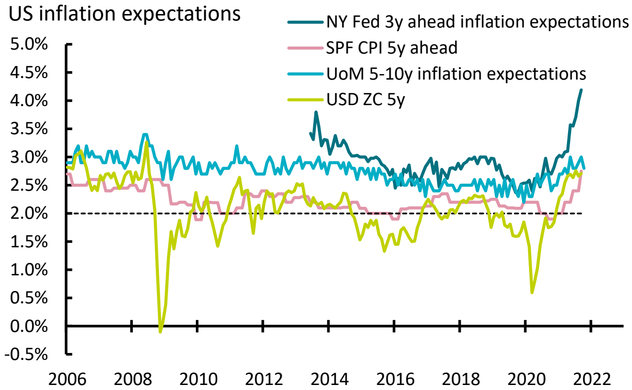
Exhibit 11: Tapering implies a higher term premium



Source: Bloomberg and AXA IM Research, 18 October 2021

Rising inflation expectations merit a deeper look. Exhibit 12 depicts the sharp increase in several medium-to-long-term inflation expectations, both survey and market-based. The sharper moves are associated with the near term (New York Fed three-year ahead survey), while the longer-term Michigan University five-to-10-year outlook is only back to its 2010-2014 range. This reflects recent developments: Throughout the course of this year, US inflation consensus forecasts have increased dramatically from 2% in January to 4.3% now. Both market participants and policymakers focus on transitory components – mainly related to commodity markets. But there is a risk of a more persistent effect.

Exhibit 12: Higher inflation for longer?



Source: Bloomberg and AXA IM Research, 18 October 2021

For example, the severe price and output effects resulting from several production and delivery bottlenecks are symptomatic of the fragility of the value chains that constitute today's globalised economy. Unfortunately, it will take time to transition toward a more resilient production and consumption model. Similarly, the energy transition might be inflationary as we switch from tried and tested technologies to less established lower carbon ones. Not only is this technological change time consuming, but it is very likely to be associated with increased uncertainty.

The same transition argument could be made for monetary policy normalisation and the effect that different liquidity conditions might have on financial markets and the business cycle more generally. There might be a cost associated with a patient approach to inflation, as the future policy reaction would have to be faster and stronger than under a more proactive approach – as implied by standard models, for example the European Central Bank's area-wide model.

In any case, the Treasury market is facing two not unrelated challenges: Internalising the combined scenario of tapering and higher-than-target terminal inflation, and in addition, internalising the inflationary and output risks of an economy in transition across several fronts.

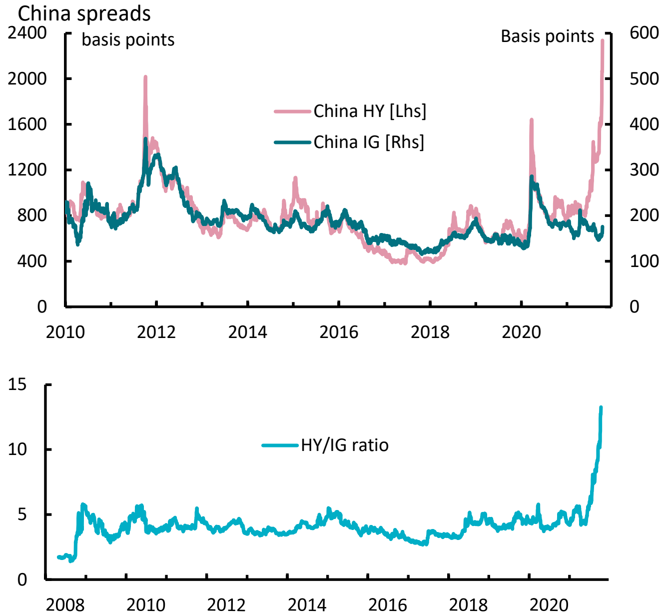
Investment Strategy – Credit

Gregory Venizelos
Credit Strategist
Research – Core Investments

(Un)like a China in a bull shop

Evergrande's troubles have spread to a few other Chinese property companies, driving (offshore) China high yield (HY) spreads to record levels. (Exhibit 1, upper panel). Yet, contagion remains contained, not only at the global level but even within China's credit markets. Indeed, the China investment grade (IG) index is showing little sign of stress. China IG spreads are off their recent lows but remain within their post-COVID-19 range. As a result, the spread decompression between HY and IG has registered a six-sigma move (Exhibit 13, lower panel).

Exhibit 13: A 6-sigma HY-IG decompression event in China credit markets as IG spreads resist contagion



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

This dynamic reflects the predominance of the Real Estate sector within the China HY index (Exhibit 14). It amounts to $91bn of face value or two thirds of the HY index, compared to 11% for the Real Estate sector within the IG index. It's worth noting that, within the HY index, no other sector is priced at a distressed spread level of over 1,000 basis points (bps) compared to the circa 33% that Real Estate is trading at. China's property sector difficulties therefore appear ringfenced on multiple levels; within HY sectors (Exhibit 2), in HY versus IG index spreads (Exhibit 13), and in Chinese versus global risk premia.

Exhibit 14: Sector composition of China IG and HY indices

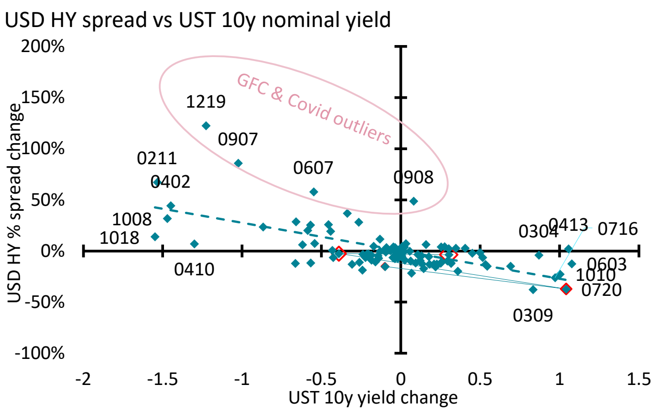
	Face value, $ bn		Weight		Spread, bp	
Sector	IG	HY	IG	HY	IG	HY
Automotive	2,210	0	0.6%	0.0%	179	-
Banking	39,800	9,960	11.4%	12.6%	78	188
Basic Industry	33,342	4,500	9.6%	5.5%	192	705
Capital Goods	2,700	600	0.8%	0.8%	150	291
CASH	324	154	0.1%	0.2%	0	0
Consumer Goods	5,400	300	1.5%	0.4%	147	447
Energy	47,140	750	14.4%	1.0%	107	369
Financial Services	67,673	5,780	19.1%	6.9%	196	815
Insurance	5,910	0	1.7%	0.0%	231	-
Leisure	2,200	2,750	0.7%	3.4%	121	497
Media	29,150	0	8.4%	0.0%	121	-
Real Estate	40,677	90,700	11.2%	66.6%	423	3267
Retail	17,481	400	5.0%	0.5%	137	468
Services	1,100	1,000	0.3%	1.2%	471	787
Tech & Electr.	7,850	0	2.2%	0.0%	160	-
Transportation	13,700	0	3.9%	0.0%	145	-
Utility	30,300	800	9.0%	1.0%	100	248
Total	346,957	117,694	100.0%	100.0%	176	2333

Source: ICE and AXA IM Research, Oct 2021

The 'spreads vs. yields' debate is back in vogue

The notable rise in global interest rates since mid-September has reignited investor concerns about the potentially adverse impact of higher yields on credit spreads. By and large, such concerns are misplaced. Historical data does confirm the mechanical relationship between yields and spreads, whereby spreads tend to absorb the rise in yields, shielding credit yields in the process. This negative correlation applies not only to nominal yields (Exhibit 15) but real yields and inflation breakevens as well. A handful of outliers (circled in Exhibit 3) are the result of outsized market moves during the 2007-2008 global financial crisis and the early 2020 COVID-19 pandemic shock.

Exhibit 15: USD HY spread change during UST yield cycles



Labels are date in mmyy format. Red diamonds are last for cycles.
Source: Bloomberg, ICE and AXA IM Research, Oct 2021

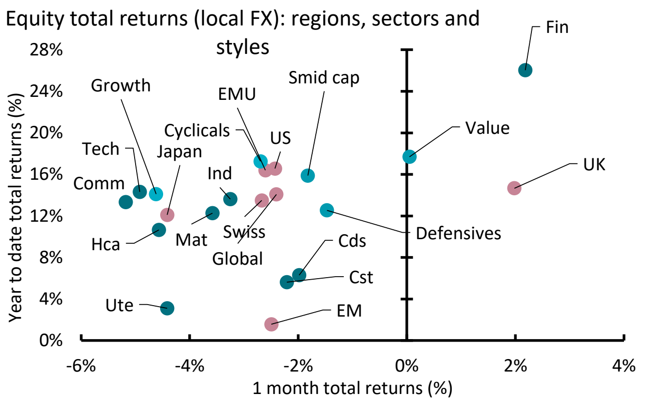
Investment Strategy – Equity

Emmanuel Makonga,
Investment Strategist,
Research – Core Investments

All eyes on earnings season

September was the first month in 2021 where global equities posted a negative return. The asset class fell by 2.4% on a monthly basis (Exhibit 16) with the UK the only positive contributor across all regions with a +2% month-on-month gain. The rotation to value (+0.1%) from growth (-4.6%) was at play during the month amid rising bond yields in major bond markets. On the sector front, Energy (+16.2%, off chart) and Financials (+2.2%) led the pack while Communications (-5.2%) and Technology (-4.9%) lagged.

Exhibit 16: First month of the year in negative territory

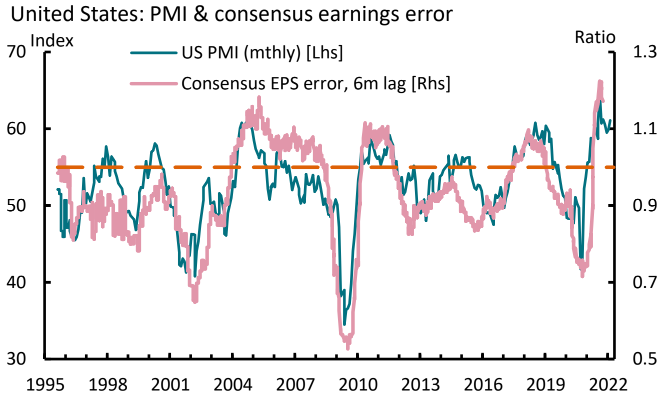


Source: Datastream and AXA IM Research, 13 October 2021

The third quarter earnings season has just begun and will be an important driver of year-end performance. Softer consumer spending and supply chain issues have likely had an impact on corporate earnings. In addition, companies' guidance will give an insight into their ability to manage supply chain disruptions and/or pass costs to consumers.

Earnings growth consensus estimates remain strong on a year-on-year (yoy) basis at 63% for Europe and 46% for the US, while forecasts have been upwardly revised over the last three months – by 5.1 percentage points (ppt) and 3.5ppt respectively. The Financial and Energy sectors have been the two biggest contributors to earnings growth this year. The former rose by 10%, benefitting from the interest rate outlook, while Energy increased by 7.3% in response to commodity price increases this year. That said, the current backdrop of elevated but declining Purchasing Managers' Indices (PMIs) (Exhibit 17) implies downside risk to the consensus error on earnings, or in other words, less surprising earnings beats.

Exhibit 17: Less surprising earnings beats to come?

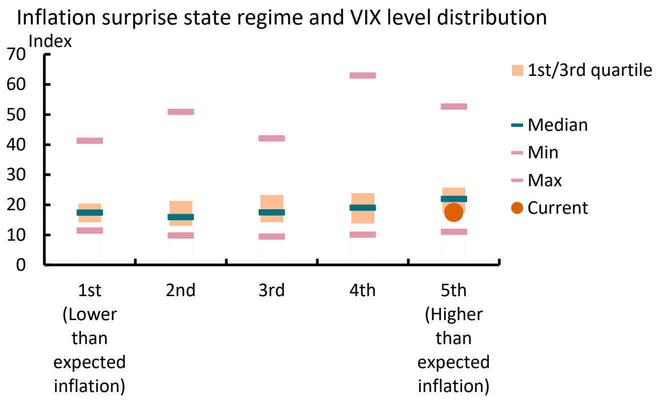


Source: Datastream and AXA IM Research, 13 October 2021

Who's afraid of the inflation regime?

The VIX, as a key proxy for market risk, does not currently question the transitory inflation narrative. We have looked at the VIX's reaction function to inflation dynamics, considering both inflation levels (state) and momentum (change). Exhibit 18 shows that the VIX is currently trading within the first and third quartile of its historical distribution when the inflation state is at its highest quintile, as is now the case.

Exhibit 18: Inflation surprises not unsettling the VIX yet



Source: Datastream, Citigroup and AXA IM Research, 13 October 2021

The macro environment remains supportive albeit amid rising downside risks, as evident in manufacturing surveys that have pulled back from recent highs. The monetary policy stance is also becoming less accommodative, amid persistent inflation pressures. The US Federal Reserve is set to announce a reduction in asset purchases in November and the European Central Bank is expected to announce a reduction in its Pandemic Emergency Purchase Programme. All in all, we think yields could push higher over the remainder of the year and into 2022. With that in mind, we remain overweight in equities in our multi-asset allocation framework with a bias towards value and sectors with stronger pricing power.

Recommended asset allocation

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

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

These projections are not necessarily reliable indicators of future results

Download the full slide deck of our October Investment Strategy

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Tour Majunga – La Défense 9 – 6 place de la Pyramide 92800 Puteaux – France
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