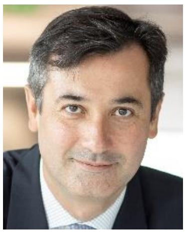
22 September 2021
Research & Strategy Insights

Unfortunate Combination

Monthly Investment Strategy Oped



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Key points

- The world economy is dealing with a nasty delta variant wave in the US, an inflation spike hurting purchasing power, supply-side disruptions impairing factory output and a Chinese slowdown.
- Headwinds are transitory and manageable, so the recovery is dented, not stopped in its tracks.
- An over-optimistic market is being wrong-footed. Investors are 'taking profit' for now, but a broader correction may emerge. Safe havens, including CHF, JPY and USD, should benefit.
- Sept/Oct looks set to experience more volatility than 2021 so far, but may also limit fixed income downside and create opportunities for risk

Transitory, manageable, but painful headwinds

Outside Europe, which has started to emerge later than China and the US from the massive GDP loss of 2020, the dataflow is pointing to a significantly slower pace of recovery. This was always going to happen once the immediate catch-up effects after the reopening were absorbed, but there is also an unfortunate combination of downside forces which are adding to the mechanistic deceleration.

First, in the US, the delta variant has triggered significant pressure again on healthcare capacity, after the vaccination programme decelerated markedly following a strong start. While public authorities still balk at resuming large-scale sanitary measures, it seems that people are "taking matters in their own hands" and consumption on hospitality and recreation is softening. What we found striking when looking at restaurant booking data is that even in cities such as New York where the vaccination take-up has been high, hospitality spending is still markedly down.

Second, the rebound in food and energy prices, combined with the second-round effects of the global shortage in semi-conductors, has pushed consumer prices significantly higher, dampening purchasing power. This is more pronounced in the US than in Europe, but there as well inflation has accelerated significantly in the last few months, with electricity prices more of a focus for the latter.

Third, the disruption in global value chains is impairing the capacity of the manufacturing sector to meet demand, resulting in "missed output". This is particularly visible in the German car industry where the discrepancy between the order book and production has reached historical highs.

Fourth, the Chinese authorities' decision to opt for a much smaller stimulus than in the West to deal with the pandemic has resulted in a lingering weakness in consumption. Moreover, the regulatory crackdown on real estate is dampening activity in a crucial sector for the Chinese economy (it directly and indirectly contributes to about a quarter of GDP) and is leading to financial stability concerns. In August, all key macro indicators in China came out below expectations, except for foreign trade. This softer demand in China is already having an impact on the country's main suppliers: German exports to China have taken a hit this summer.

What is reassuring though is that all these issues should prove transitory and/or manageable. The very latest data suggests the Delta variant wave has reached a plateau in the US. While purchasing power is hit, households in advanced countries sit on piles of cash thanks to the savings accumulated last year. While it may take time to sort out the sources of supply disruptions, there are tentative signs that price pressures in some of the hottest sectors – for instance used cars in the US – have started to abate. Finally, the Chinese slowdown is largely self-inflicted and policy driven, hence reversible. Although Beijing seems to be genuinely intent on addressing the speculative aspects of real estate, the risks to social stability – a key goal for the Chinese leadership – from a too brutal correction are significant, and we expect a shift towards accommodation by year-end.

Still, this is putting the market in an awkward position because it had expected to reach the "sunny uplands" of total covid eradication and plain sailing. Central banks are also to some extent wrong-footed. The ECB's confidence in an improved macroeconomic outlook and discussions of upside risks to their inflation forecasts don't come at the best of time. Our baseline is that the recovery is dented, but not reversed, and that the trajectory of prudent monetary policy normalisation has barely moved. Yet, the next weeks and months may be choppy from a market perspective.

Sentiment turning sour

For the last eighteen months we have respected the performance of risky asset classes – credit and equities – in that returns were driven by the combination of huge policy support, scientific progress towards control of the COVID-19 virus and the eventual normalisation of economic activity. Together, those factors have contributed to well above average returns. There have been wobbles as investors became concerned about new variants of the virus, supply side distortions, the jump in inflation and fears of premature monetary tightening. Yet the underlying supports have continued to win out and this has been reflected in very healthy fundamentals for both stocks and corporate bonds. The first half of 2021 has seen bumper corporate earnings. Defaults have declined and corporate financial health is robust. From a fundamental standpoint, it is tough to switch to a more entrenched bearish market view.

However, we know markets are not just about fundamentals. As much as we have respected the positive drivers of market performance, we have also paid increasing regard to valuations across a range of asset classes and markets. Valuations have become most stretched in fixed income where both the absolute level of yields and the risk-spreads in the credit markets have continued to trade near to post-global financial crisis lows. In the equity markets, price earnings multiples have continued to be elevated even with strong – and perhaps justified – forward earnings expectations. There is some merit in the view that quantitative easing has contributed to all financial assets becoming expensive. It is notable that concerns about house prices are evident across several developed economies as well. Liquidity and accumulated savings through the pandemic have impacted on asset prices and created a challenge to investors of where to invest now.

Right now, it seems that investors are showing signs of taking fright, after benefitting from markets that have seen no significant drawdowns for a long time. We note recent bearish predictions from investment banks which appeal to a view held by some market participants that "things just can't keep on going up". Investor sentiment appears to be starting to crumble amid ongoing threats to the recovery from supply side distortions, raging energy prices, issues in the Chinese credit market and dark clouds on geo-political horizon. From a macro point of view, we would argue that a lot of the issues that are worrying investors are likely to be resolved through supply-side rebalancing or policy actions. However, that does not mean financial markets will sit and wait for the news to get better. A take-profits mentality could easily morph into a more pronounced market correction that would drive Treasury yields towards 1%, deliver a widening of credit risk premiums and lower equity market prices further. A confluence of such events would favour traditional safe-haven currencies like the Swiss Franc and Japanese Yen, but the dollar might also benefit more broadly, especially if emerging markets become caught up in a risk-off move.

It is prudent to consider this bearish scenario in the short-term. It is also wise to think through the opportunities this may bring. An increase in volatility would likely tilt central banks back in a more dovish direction, even leading to a delay in the Fed's tapering if liquidity conditions in markets were to deteriorate. The combination of supportive fiscal policy in Europe and the US and any pushing back to monetary normalisation suggests that the recovery itself is not at a significant risk. A correction in markets in the traditionally volatile September and October period might bring with it a renewed buying opportunity for risk as we head into a year which is likely to see lower inflation and supply side distortions work themselves out. Before then, be prepared for more volatility than we have experienced so far in 2021. The best of the equity market performance is likely behind us and credit markets might begin pricing in some more realistic medium-term risks. The biggest surprise of all might be if the 10-year Treasury yield ends the year where it began – at 1% – marking another year of disappointment for the bond bears!

Download the full slide deck of our September Investment Strategy

Recommended asset allocation

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

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

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

Macro forecast summary

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

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

* Forecast

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

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

* Forecast

These projections are not necessarily reliable indicators of future results

Forecast summary

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

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

These projections are not necessarily reliable indicators of future results

Our Research is available online:

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