Inflation to rise, but how fast and for how long?

Monthly Investment Strategy

AXA IM Research

April 2021

Inflation to rise, but how fast and for how long ?

Theme of the month: Inflation to rise, but how long and how fast?

- The pandemic was a disinflationary shock to international economies. Countries struggling with disinflation forces before Covid (Japan, Eurozone) will continue to see a subdued inflation outlook. EM see some individual examples of inflation, typically related to f/x depreciation, but spare capacity will keep inflation subdued in most. The biggest change to the outlook comes in the US, where stimulus has been larger, and recovery is expected quicker.
- Fiscal stimulus in the US will close the US output gap sooner than we forecast. The cyclical inflation response has not been large in recent decades but is persistent. The Fed has also changed its inflation target and is encouraging an inflation overshoot.
- After some volatility this year, we forecast US PCE inflation at 2% by end-2022 and rising gradually in 2023. Yet we anticipate some upside risk to this forecast, depending on the evolution of inflation expectations in an unusually loose fiscal and monetary policy environment.

Macro update: Beyond the US, economies remain focused on virus and vaccines

- The virus continues to spread across the Eurozone, France faring amongst the worse. Vaccine roll-out has accelerated, and supplies appear adequate to deliver the 70% of population by Q3 pledge. States face complications agreeing on fiscal spend – a delay to these programmes is a downside growth risk.
- The US economy is responding to fiscal stimulus and an easing of Covid restrictions. Retail sales surged by 9.8% on the month in March. We raise our Q1 GDP outlook and our full year forecast to 6.9% as President Biden negotiates the next spending programme.
- China saw a sequential deceleration in growth in Q1, as the virus disrupted new year celebrations. However, the economy has shown a rebound and we upgrade our outlook for full year growth to 8.5% for 2021. The scale of policy tightening remains a risk for the H2 2021 outlook.
- Emerging markets are also struggling to contain the virus amidst a much slower vaccination programme – and questions over virus efficacy in countries that have progressed well. Mexico, South Africa, Russia and Indonesia continue to see falling new case rates.

Investment strategy: risk assets resilient to rates repricing so far, as investors ponder rising inflation and central banks

- FX: The rebound in US real rates YtD reversed in April and EURUSD has rebounded to above 1.20 during this respite. That said, a sharp economic rebound in the US is likely to drive US real rates higher again, translating to further weakness for the CHF and JPY and also weighing on the EUR afresh.
- Rates: Market positioning has somewhat normalised in the recent sell-off, even though large shorts are still reported by CFTC. Uncertainty about the rates scenario is still high as highlighted by the gap amid different term premium methodologies, suggesting there may be more interest rate volatility to come.
- Credit: Credit spreads have been pre-empting since late November a regime of low volatility and conducive to risk appetite, where HY should continue to outperform IG, in a typical reflation trade fashion. EUR IG has lagged USD in spread terms, a likely reflection of US growth ‘exceptionalism’.
- Equity: The earnings season has begun, and the results could give the asset class a boost given the positive outlook. Corporate earnings tend to correlate positively to rising producer prices. We keep our positive view on equities, maintain our UK exposure, and have added to our position on US & Euro banks.

Central scenario

Summary – Key messages

Monetary policy

Monetary policy to remain key policy support. Fed to unwind support only slowly. ECB to increase purchases “significantly”.

Inflation

Energy and food to lift annual rates in 2021. Sustainable inflation in 2022 depends on spare capacity and unlikely outside US and some EMs.

Fiscal policy

Fiscal support extended in most areas. US passes exceptional stimulus. In Europe and UK fiscal support rolled out more slowly.

Growth

Consensus for faster growth: virus fades, vaccines grow and fiscal stimulus. Regional differences depend on each.

Our central scenario:

2021 rebound as virus controlled, recovery needs policy support

We forecast global growth to rise by 5.5% in 2021 and 4.3% 2022.

Economic rebound on vaccine and stimulus, must overcome labour market and indebtedness headwinds. Monetary and fiscal policy to support.

Emerging Markets

EM’s see virus pressures mount with less vaccine access for now. Export economies to benefit. Less policy space for most.

Rates

Rates move higher on growth and inflation outlook. Real/breakeven balance weighs on CB response that opposes excessive real rates move.

FX

Fiscal boost and rising real rates should support USD. Strong vaccine rollout supports high beta currencies, incl GBP, CAD and NOK.

Credit

Tight spread levels belie yet higher corporate debt levels, implicitly locking-in central banks as an ultimate backstop.

Equities

Value/Growth rotation still at play. Corporate earnings 2021 rebound on track. Equity risk premium has compressed.

Alternative scenarios

Summary – Key messages

Persistent recession *(probability 15%)*

What could be different?

- Coronavirus mutations reduce vaccine effectiveness
- Labour market dislocation and business disruption create ongoing headwinds to demand recovery
- Fiscal policy fades amidst elevated debt and political opposition
- Geo-political tensions mount in post-Covid world

What it means

- Growth/inflation expectations weaken further, additional GDP disruption, corporates' earnings under more pressure
- Further monetary policy where space permits (including China). Government's continue with fiscal stimulus and divide between monetary financing blurs further.

Market implications

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

Fast recovery *(probability 25%)*

What could be different?

- Vaccine rolls out more quickly than expected, spurring pent-up demand burst
- Labour market recovers, economies benefit from post-virus euphoria and faster consumption of 'excess saving'
- Virus-shock reshapes business practice, boosting productivity

What it means

- Global/US/EMU growth surprise on the upside in a stronger and more persistent rebound from 2020
- Monetary policy fights expectations for swift tightening through forward-guidance

Market implications

- Risk-on environment with equities making further gains amidst broader rotation
- UST and EUR break-evens rise
- Spreads grind tighter

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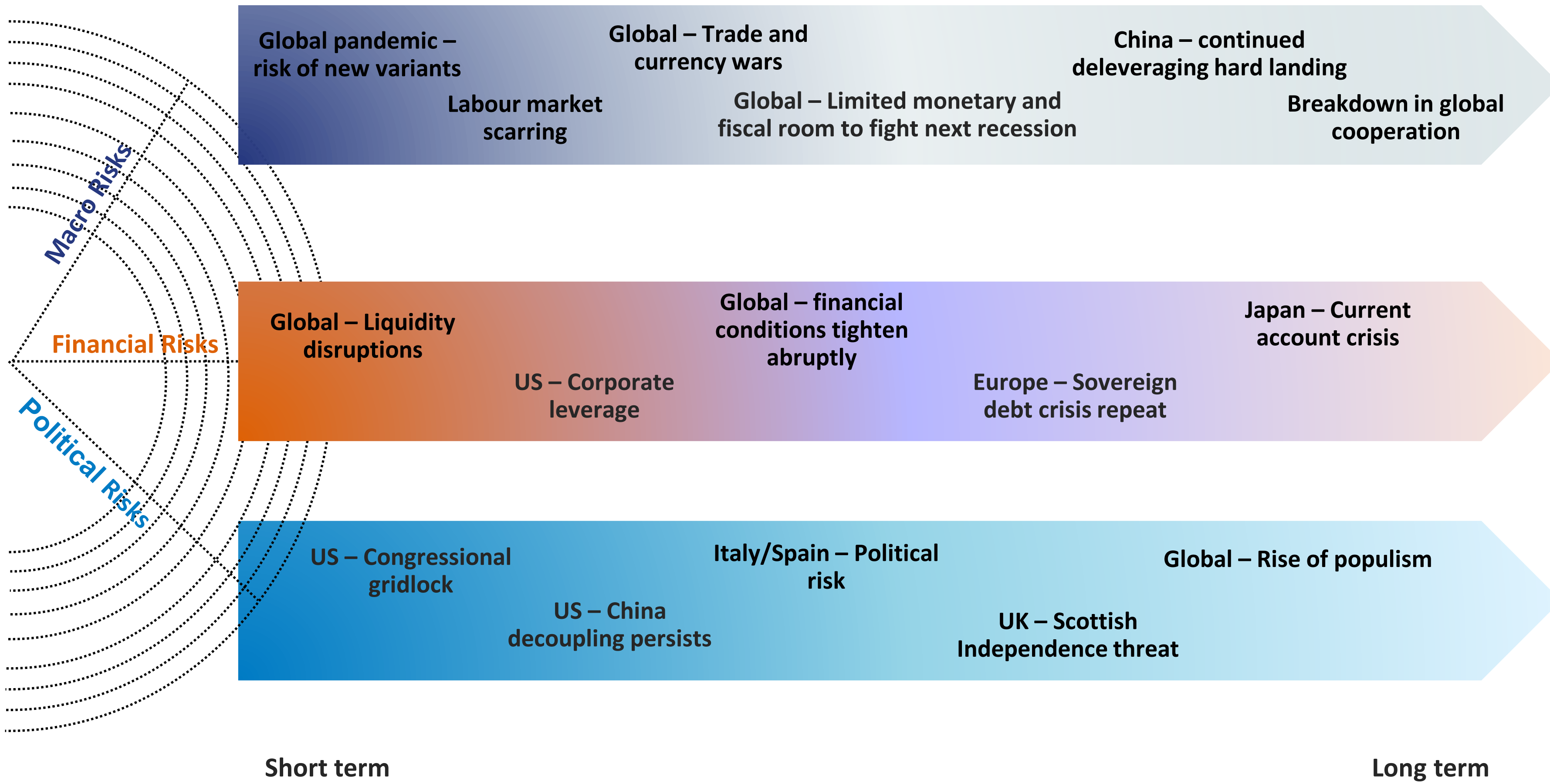
RISk Radar

Summary – Key messages



Contents

Theme of the month

Theme of the month: Inflation to rise, but how fast and for how long ?

The Pandemic was a disinflationary shock

Pandemics and monetary responses are not inflationary

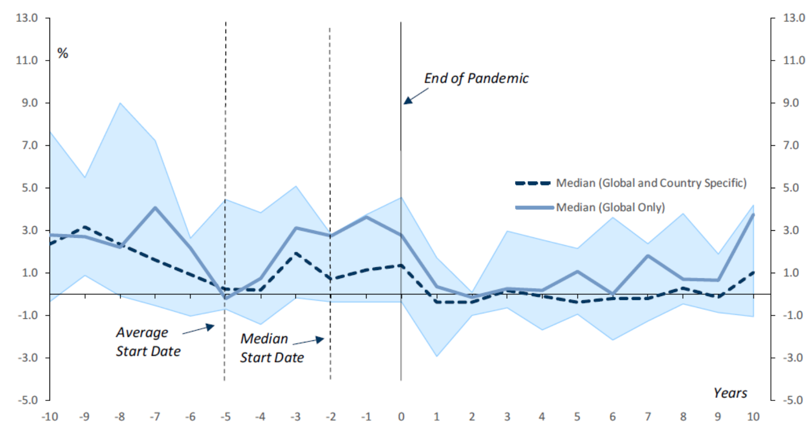
- We published a series of papers last July looking in detail at the inflationary impact of the pandemic. We argued that pandemics – different to wars – were not historically inflationary events. We also looked in detail at the surge in broad money supply that accompanied monetary policy activity, arguing that this would also not be inflationary as it was not a precursor for a material acceleration in spending. Below we present two independent illustrations making the same points.

A global disinflation shock

- We considered inflation rates by region. At the time, we forecast Eurozone inflation to average 0.4% across 2020, the actual outcome was 0.3%. We forecast UK inflation at 0.8% (actual 0.9%), US 0.8% (actual 1.2%) and Japan 0.1% actual (0.0%). We considered inflation to rebound in 2021 (we now forecast a sharper rebound), but guided that 2022 would likely still see inflation below central bank targets. The structure on which we based those projections is broadly unchanged in most economic regions. The key area of change is in the US.

Inflation subdued post-pandemics

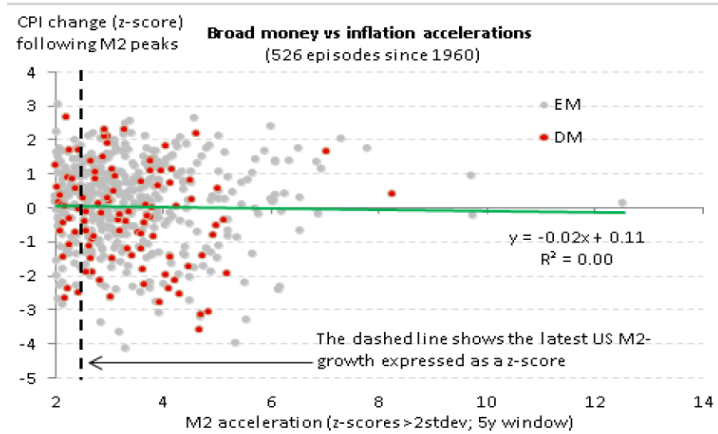
Exhibit 3: Inflation Has Typically Remained Weak in the Aftermath of Major Pandemics
CPI Inflation (% yoy) Around Pandemics, Median and Interquartile Range



Source: Goldman Sachs, Bank of England, April 2021

No relationship between M2 money supply surges and inflation

Figure 28: Broad money and inflation are poorly correlated



Source: UBS, March 2021

Theme of the month: Inflation to rise, but how fast and for how long ?

Inflation outlook: What's changed? – the US outlook

US recovery much faster than forecast

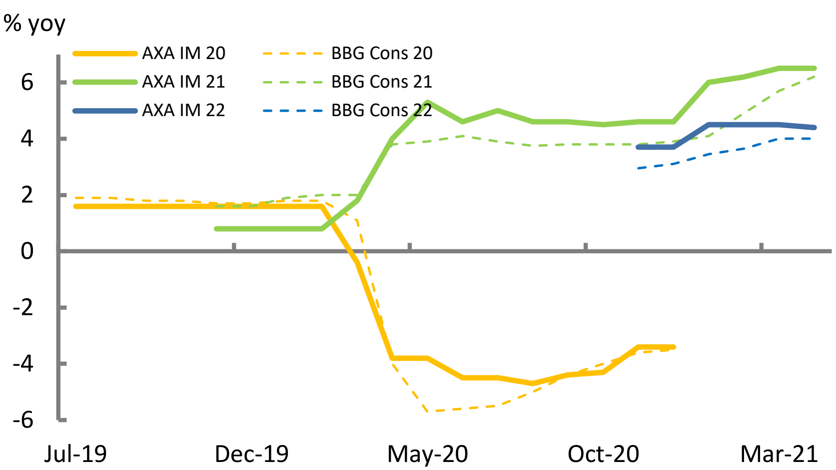
- The key issue for the US has been President Biden's election (expected) and control over Congress (not expected) and the pace at which he has delivered fiscal stimulus. Our growth outlook for 2021 has accelerated from 4.5% end-2020 to 6.9% at present. This could go higher still. Consensus has also moved up towards our outlook. We now expect the US output gap to close by the end of this year. From 2022, the US will be operating in 'excess demand' an environment that is more likely to deliver sustainable inflation sooner than we had previously considered.

Fed has changed its reaction function

- Additionally, the Fed has changed its inflation target to ***average inflation*** over the cycle, it is specifically targeting an overshoot of that long-run target over the coming years and it has introduced an asymmetry into its reaction function such that the Fed now states it will react to actual, rather than anticipated inflation pressures.

A material increase in our growth forecast

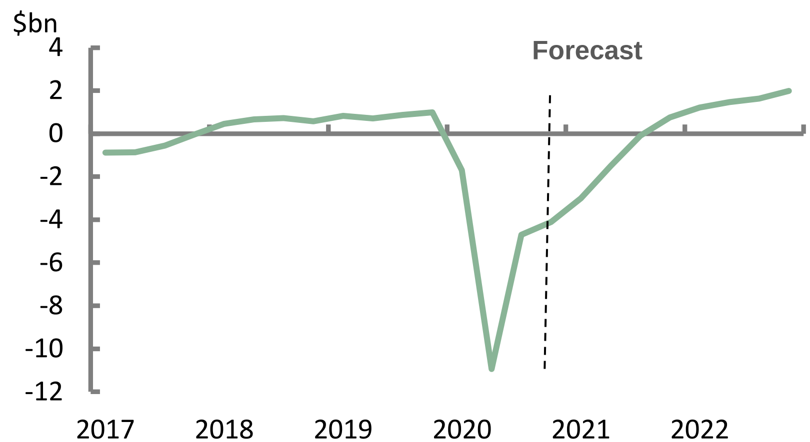
Evolution of GDP forecasts



Source: Bloomberg, AXA IM Research, April 2021

US Output Gap on track to close more quickly than we thought

US Output Gap Projections



Source: CBO, AXA IM Research, April 2021

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Inflation response to the US's cyclical surge

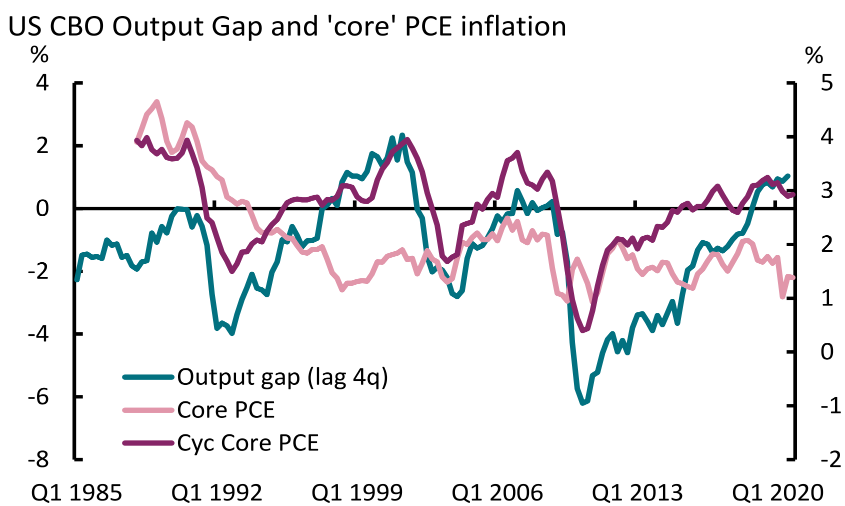
Less than 40% of 'core' PCE inflation is 'cyclical'

- The relationship between core PCE inflation (ex food and energy) and the output gap is not strong. Periods during the late-1990s and since the 2008 financial crisis have seen little change in inflation relative to the spare capacity in the economy. This is because other elements such as healthcare costs (acyclical) and housing costs (quasi-cyclical) combined are almost as large as the cyclical component of PCE inflation. However, the relationship between cyclical inflation components and the output gap is strong and points to sustained upward pressure.

The ratchet effect

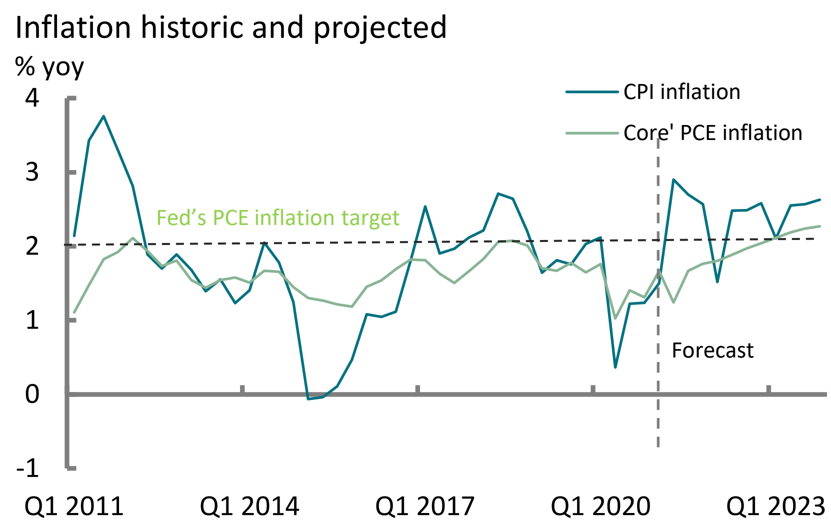
- The relatively small weight of cyclical components in PCE inflation (<40%) means that the immediate effect of faster growth is relatively muted. However, there is a ratchet effect that will continue to deliver elevated cyclical inflation while the economy is in a condition of 'excess demand'. Our estimates of CPI and 'core' PCE inflation suggest a slow but sustained rise in inflation through 2023.

Only sub-components of core inflation highly cyclical



Source: BEA, CBO, FRBSF, AXA IM Research, April 2021

Inflation to build slowly



Source: Commerce Dept, BEA, AXA IM Research, April 2021

Theme of the month: Inflation to rise, but how fast and for how long ?

The impact of the Fed’s reaction function change

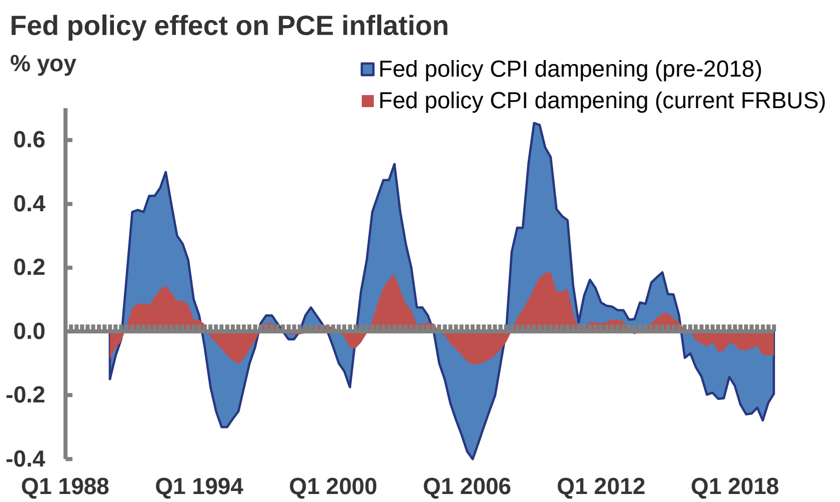
No longer anticipating

- The Fed’s move to average inflation targeting with a targeted overshoot is an effort to anchor inflation expectations at its target of 2%. Additionally, the Fed has stated “policy should be based primarily on observed outcomes rather than forecasts” (FOMC minutes, April 2021). Monetary policy works with a lag and the Fed’s efforts to anticipate inflation in the past contributed to dampening the inflation cycle. Based on current estimates of the Fed’s FRBUS macromodel, we estimate this dampening effect averaging 0.05ppt during previous cyclical peaks. However, based on previous model estimates this effect could have been as much as 0.2ppt on average.

Monitoring the Fed’s reaction change in real time

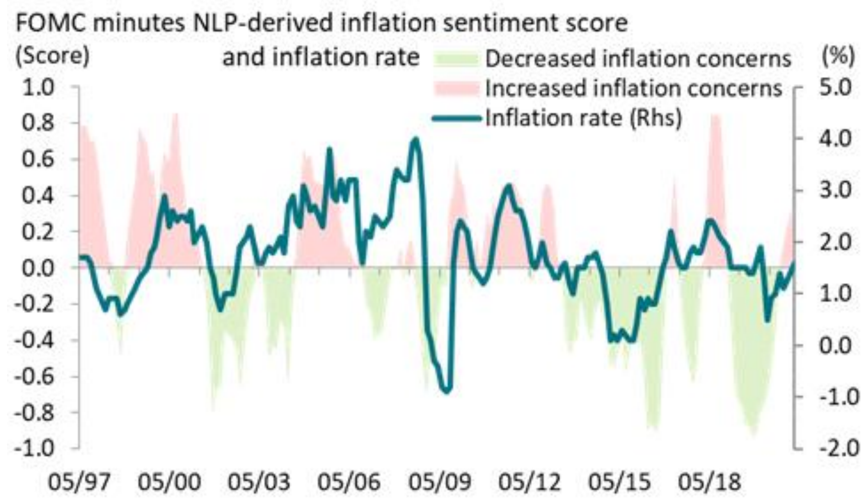
- We use natural language processing (NLP) to monitor FOMC minutes and Beige Book reports to gauge the Fed’s level of inflation concern. This has historically been a reliable signal to changes in monetary policy. Given the Fed’s reaction function, we should expect a policy change only sometime after historic signals for change have emerged.

Estimated impact of policy dampening effect on inflation amplitude



Source: Refinitiv, AXA IM Research, March 2021

Natural Language Processing highlights FOMC inflation concerns



Source: ECB, AXA IM Research, March 2021

Theme of the month: Inflation to rise, but how fast and for how long ?

Gentle rise, but risks to the upside

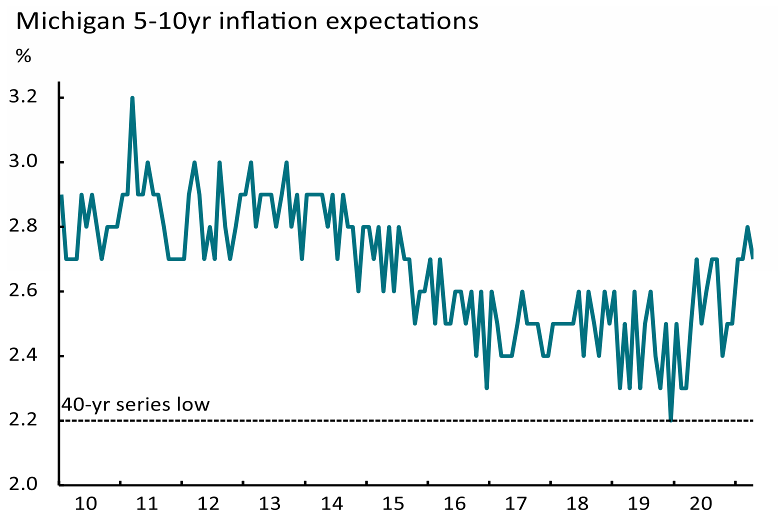
Risks skewed to the upside for US inflation

- The outlook for US inflation beyond base effect/price level volatility expected this year, is for a sustainable, but gradual rise towards the Fed's inflation target. We forecast PCE inflation to close 2022 at target, but to rise further in 2023. One risk to the upside is a rise in inflation expectations, that could boost actual inflation. There is some evidence that this is underway. Another risk would be a sharp fall in the US dollar, although our forecast is for broad dollar stability this year before a softening next.

Other regions broadly see inflation pressures remain subdued

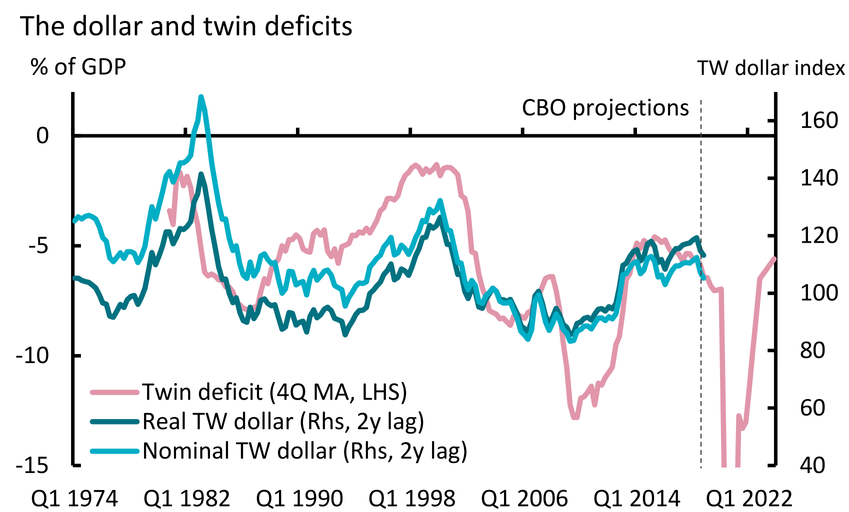
- Beyond the US, inflation will be determined by local factors. In the Eurozone and Japan we forecast inflation accelerating this year, but remaining below respective bank targets. In the UK, we expect headline inflation to exceed the 2% target this year, but fall below it in 2022. More broadly, several individual EM economies may continue to struggle with high inflation – Turkey a case in point – but more generally spare capacity and a stable dollar should keep most inflation rates broadly subdued in 2021 and 2022.

Nascent signs of rising inflation expectations



Source: University of Michigan Surveys of Consumers, April 2021.

Twin deficits threat to USD ?



Source: CBO, BEA, AXA IM Research, April 2021.

Macro outlook

Stimulus and re-opening spur activity

US

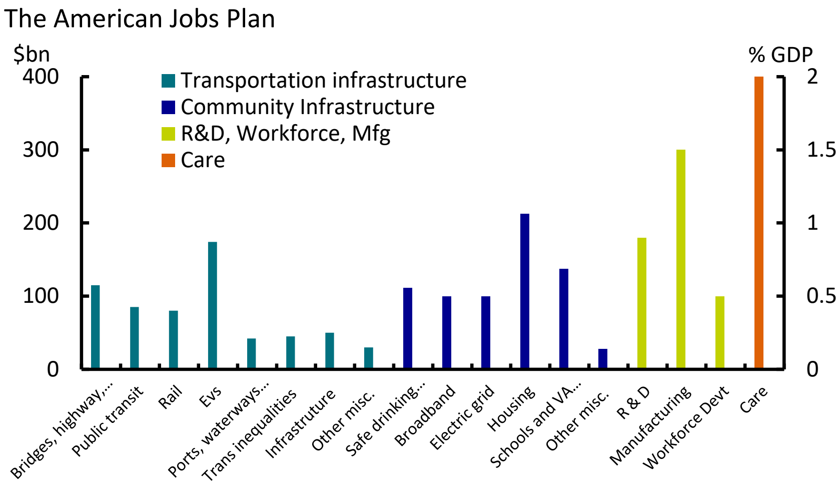
Further government support more complicated

- President Biden announced a $2.29trn spending package – The American Jobs Plan – including traditional infrastructure, clean energy investment and measures to address inequality through education and healthcare. It will be in part financed by the Made in America tax plan, including corporate tax increases, estimated to total $2trn over 15-years. Republicans are resistant to any spending requiring tax hikes. Special Congressional procedures are likely to be required to pass legislation. This could be achieved by summer. We expect a modest boost to growth from later in 2022 and more significantly in 2023 and beyond.

Stimulus and re-opening see sharp gains

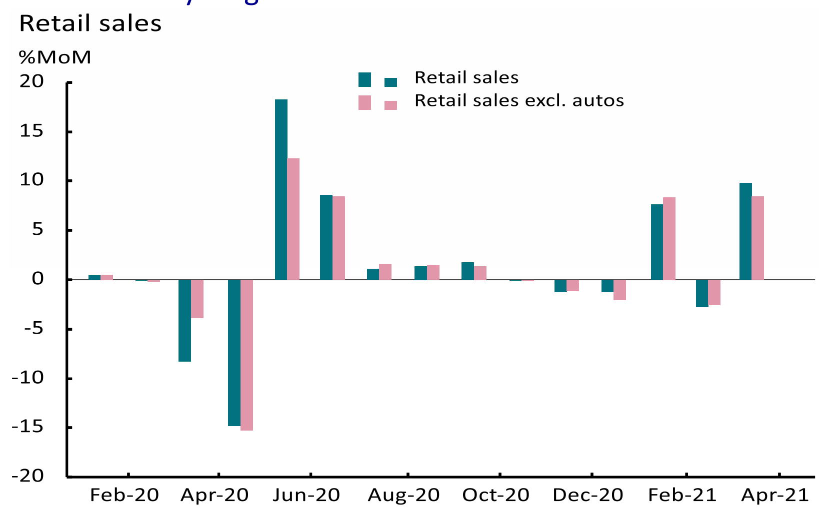
- Retail sales rose by 9.8% on the month in March; industrial production by 1.4% and consumer and industrial survey have risen further – the Philadelphia Fed index reached a 48 year high. Stimulus and an easing of start-of-the-year virus restrictions has spurred activity. We raise our GDP outlook for Q1 and now see US GDP growth at 6.9% in 2021 and 4.5% in 2022 (consensus 6.2% and 4.0%)

A breakdown of Biden's next spending plan



Source: The White House, AXA IM Research, April 2021

Retail activity surges on stimulus and restrictions ease



Source: BEA, AXA IM Research, April 2021

Fed maintains a dovish tone

US

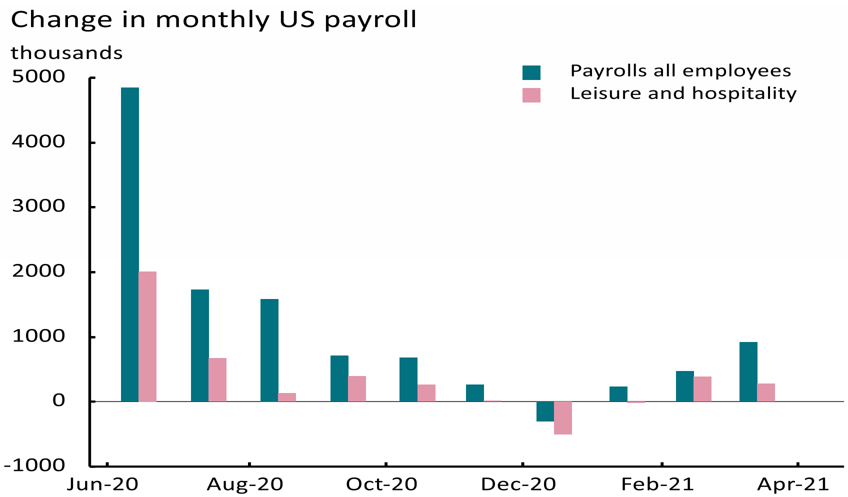
Fed maintains dovish outlook

- Since March's FOMC meeting the Fed has maintained that it does not see an inflation issue and expects it to take "some time" before substantial further progress towards its goals requires a tapering of its QE programme – something we anticipate across 2022. Inflation will be volatile this year, March's rise in CPI inflation to 2.6% part-way towards an expected >3% peak around mid-year, that should soften back below 2% by Q1 2022. Payrolls improved sharply in March and this looks set to continue over the next six months, something that will remove US spare capacity slowly. We forecast the Fed to start to tighten policy in June 2023.

Markets back off

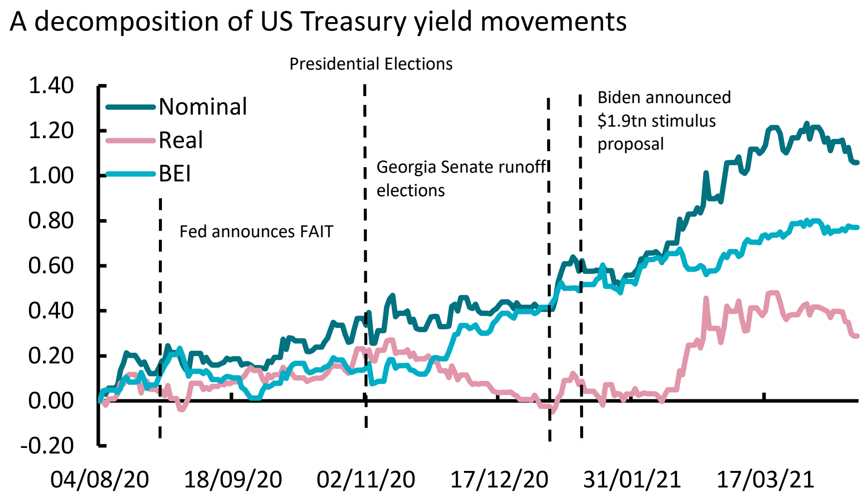
- Despite robust economic data, consistent Fed messaging has seen US Treasury yields retreat, with 10-year rates below 1.60%, driven lower by real yields. Markets now expect two hikes by end-2023, in line with our own view. However, we expect rising headline inflation to raise inflationary concerns again across Q2, resuming upward pressure on real and nominal yields.

Payrolls signal healing in the labour market



Source: BLS, AXA IM Research, April 2021

Bond yields post a (temporary?) retreat



Source: Bloomberg, AXA IM Research, Apr 2021

Summer hopes

Euro area

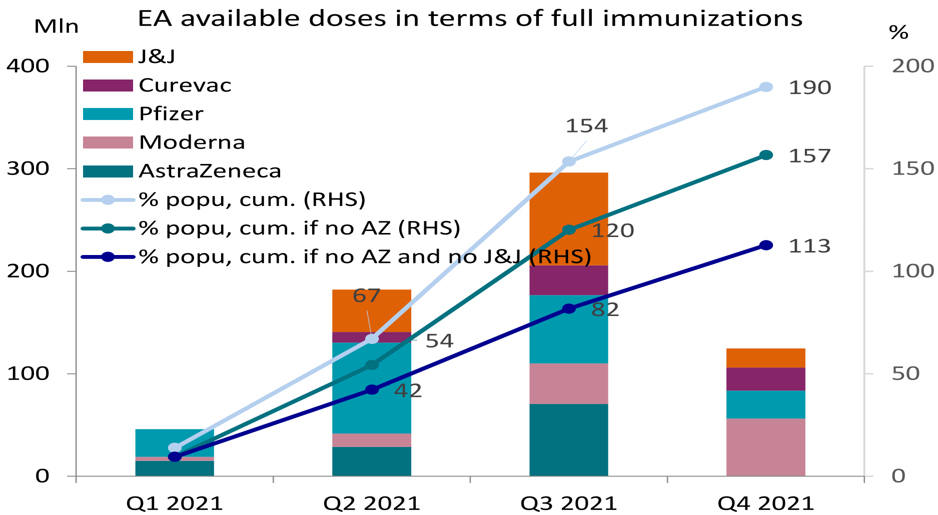
Focus on the vaccine supply…

- The vaccination campaign is shifting gear. At the current daily pace of inoculation more than 70% of the total population would be vaccinated by September, in line with our baseline. But supply delivery is key and latest developments point to some downside risk. The total "maximum supply" contracted would be enough to fully vaccinate 67% of the population in the EU by the end of Q2, but this would fall to 54% without AstraZeneca, and to 42% if AstraZeneca and J&J were both excluded (but still >70% Q3 target in both cases).

… and on the risk to summer season

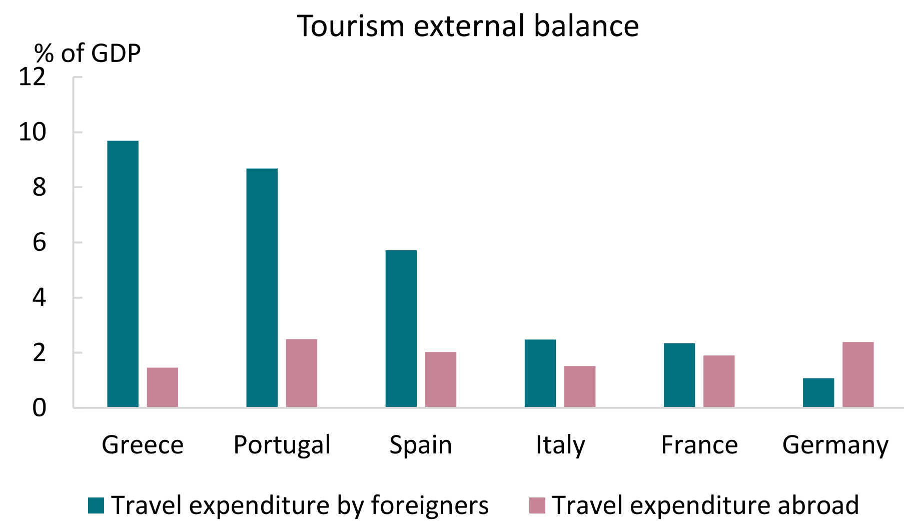
- Timing could be problematic: Being far from collective immunity at the beginning of Q3 implies a slower start of the summer season, a key contributor to our 2% qoq Q3 euro area GDP (and 3.8% yoy in 2021). Divergence between countries would re-emerge: the share of tourism in GDP matters and the composition of spending as well, here Italy or France would be less impacted than Spain or Greece.

Gauging the vaccine supply risk: loosing two vaccines…



Source: European Commission, Ministero della Salute, AXA IM Research, as of 19 April 2021.

… would dash summer hopes, with significant country divergence



Source: Eurostat, AXA IM Research, as of 19 April 2021.

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Budget season

Euro area

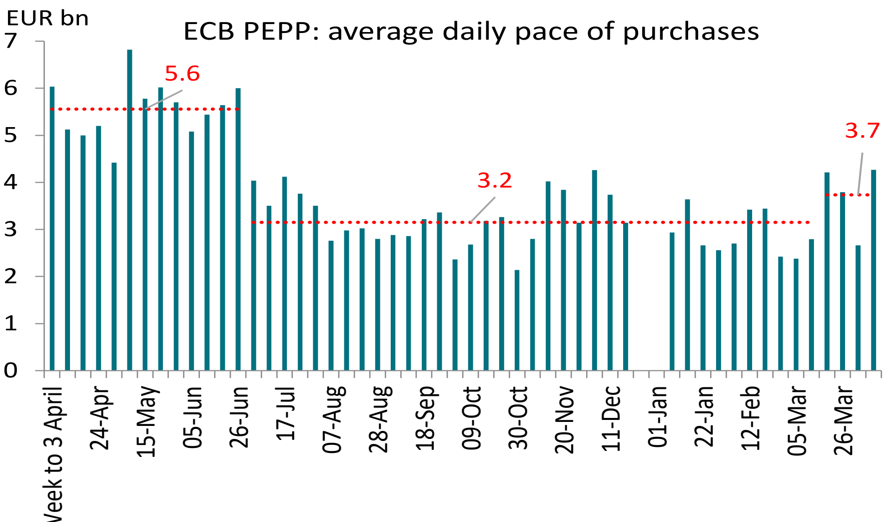
Finger-crossing on no NGEU delay

- Details of countries Recovery and Resilience plans, to be submitted by end-April are still lacking. More importantly, 10 countries have still to ratify the Own Resources Decision (the legal basis for the funding of the EU Recovery Fund), with the German Constitutional Court actually suspending its ratification. Although our baseline is that the NGEU money starts to flow to countries in the summer we cannot fully exclude delays or ramifications that tarnish the symbolism of the NGEU. Lower or delayed fiscal support would trigger downside revision to our growth forecast.

Waiting for June's ECB meeting

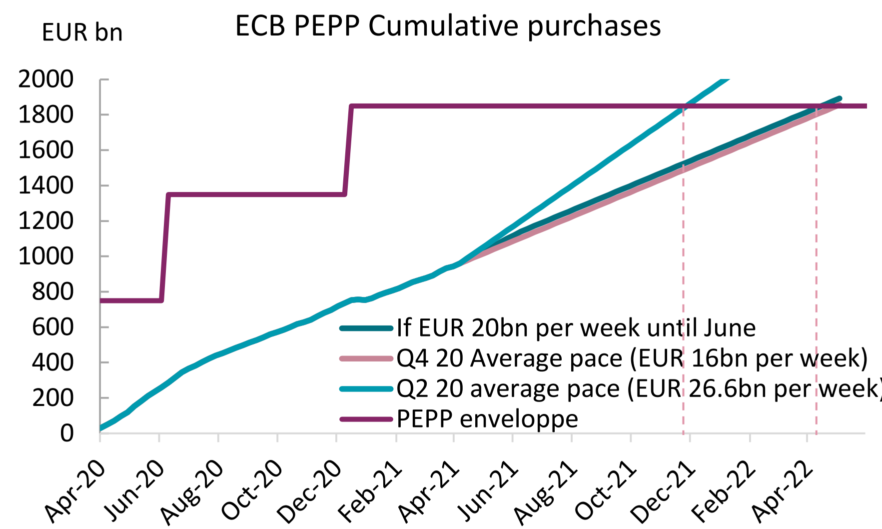
- And could also complicate the task of the ECB. The June meeting is already due to be an interesting one, as a new set of forecasts will allow the ECB to reassess its monetary policy stance. NGEU delay would call for reassurance from the ECB, while if all goes well, PEPP taper noises might increase. In both cases the ECB will be pressed to clarify its reaction function.

The ECB has increased the pace of PEPP purchases…



Source: ECB, AXA IM Research, as of 19 April 2021

…but there is room if more needs to be done



Source: ECB, AXA IM Research, April 2021

The start of a gradual re-opening

UK

On top of the virus for now, tentative re-opening underway

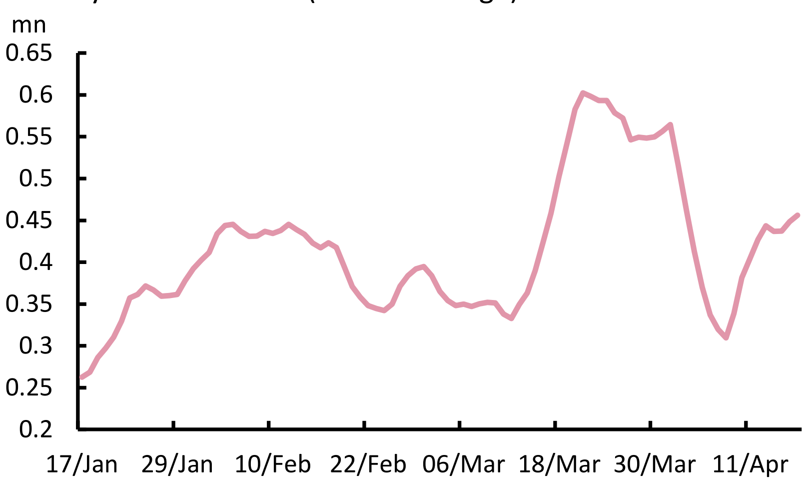
- The UK has tentatively begun to re-open its economy. Schools returned 8 March, 6 people could meet outside from 29 March and 12 April saw non-essential retail and gyms re-open, and pubs and restaurants begin outside service. This reflects managing the virus. New cases are currently <2k – their lowest rates since early September. Positivity rates are around early summer levels. Vaccinations continue at around 3m/week, 62% of adults have received 1st doses, 2nd doses are now increasingly rolled out.

Restrictions ease, but economy adapts

- The easing in restrictions should underpin a marked rebound in activity over the coming quarters. However, the economy has adapted to lockdown. Declines in output were much less than feared in November's and Q1's lockdowns. Subsequent upward revisions have raised our growth outlook. Following the upward revision to January GDP (to -2.2% from -2.9%) we have raised our Q1 forecast to -2.0% (from -2.5%) and out whole year forecast to 5.3%, with 2022 expected at 6.7% (consensus 5.0% and 5.6%)

Total vaccine rate solid as 2nd doses catch-up

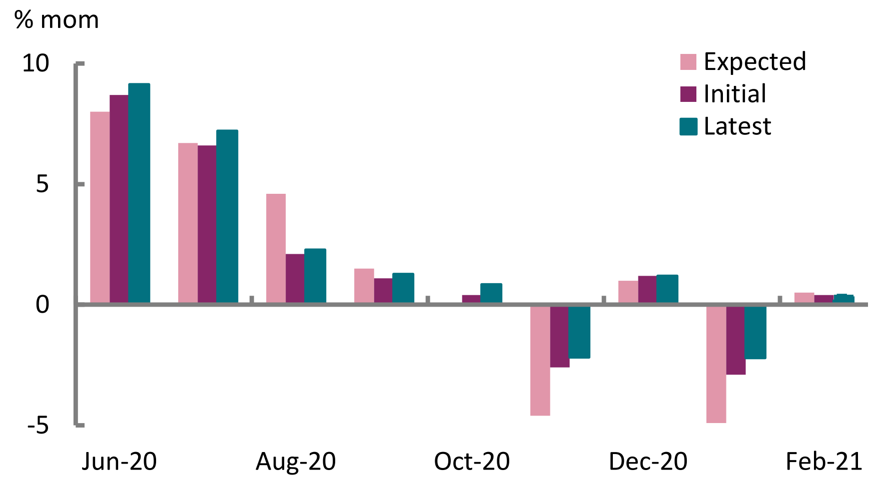
UK daily vaccine rollout (7d MA average)



Source: PHE, AXA IM Research, April 2021

GDP keeps surprising to upside

UK monthly GDP, revisions and expectations



Source: National Statistics, Bloomberg, AXA IM Research, April 21

BoE wait-and-see amidst supply-side woes

UK

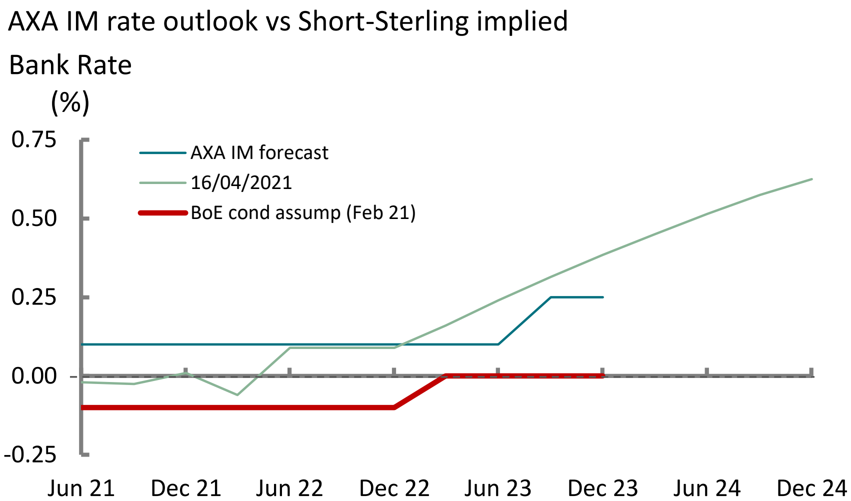
Bank of England continues wait-and-see outlook

- Market rate expectations have softened over the last month from considering Bank Rate close to 0.75% by end-2023, to now not fully pricing in a move to 0.50% - much closer to our own outlook. The BoE has said little and is clearly waiting to see how the economy fares if it fully re-opens as hoped over the coming quarters. Personnel changes will complicate the outlook, the hawkish Chief Economist Haldane to leave the BoE after June and the dovish Vlieghe's term expiring in August.

Structural impediments

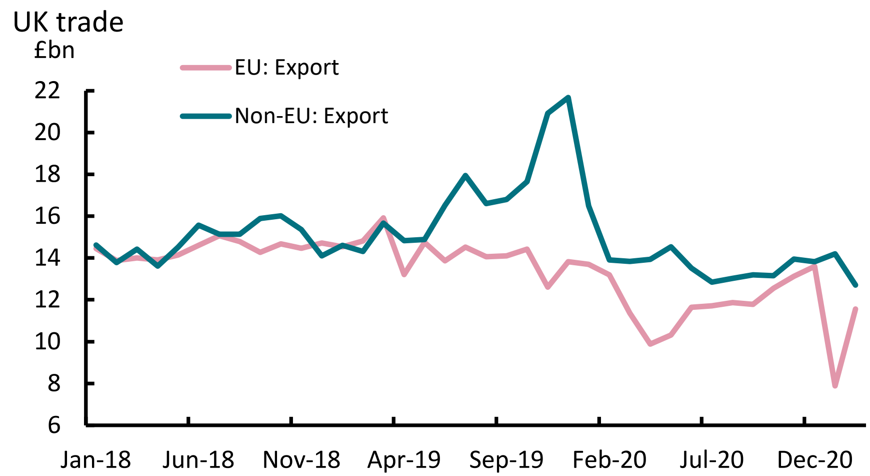
- The UK faces a number of structural impediments. Estimates of hysteresis effects from the pandemic are around 2ppt of GDP over the coming three years. Brexit is expected to deliver similar damage. Exports to the EU recovered somewhat in February, but the level remains 15% below December's. There will be a permanent loss from the change in trading conditions. However, renewed tensions in Northern Ireland following PM Johnson's regulatory border separating NI and the rest of the UK could lead to even more disruption.

Market rates assume gentle tightening ahead



Source: Bloomberg, BoE, AXA IM Research, April 2021

EU exports show partial rebound in February



Source: National Statistics, AXA IM Research, April 2021

Sequential growth slows due to virus resurgence

China

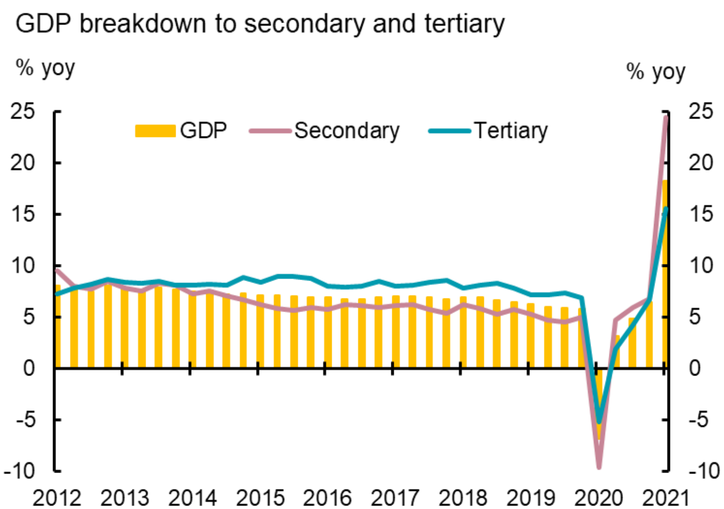
Rebound in annual growth masks a sequential slowdown

- Headline economic growth rebounded to a historic high in Q1 due to extreme base effects. However, looking through the distortions, sequential growth slowed markedly from Q4-2020 due to mobility and social controls following the virus outbreak at the start of this year. The good news is that the shock was small and short-lived. High-frequency data since February has pointed to mostly improved macro conditions

Growth drivers rotate with the laggards catching up

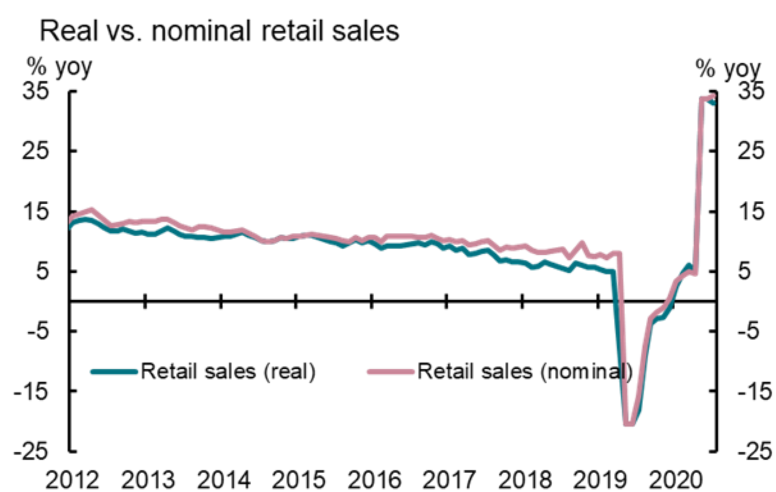
- March saw a rebalancing of growth drivers. Industrial production growth slowed after a strong start to the year, consistent with slower export growth and perhaps some margin compression from rising PPI inflation. Total fixed asset investment growth was steady. But the key upside surprise was retail sales, with sequential growth rebounding strong after the removal of social restrictions. Fundamentally, the consumption recovery was also supported by improved labour market conditions, with the unemployment rate falling to 5.3% and income growth accelerating.

GDP growth rebounds on low base



Source: CEIC, AXA IM Research, April 21

Revived consumption leads to a growth rotation



Source: CEIC, AXA IM Research, April 21

GDP forecast upgraded, with broadly balanced risks

China

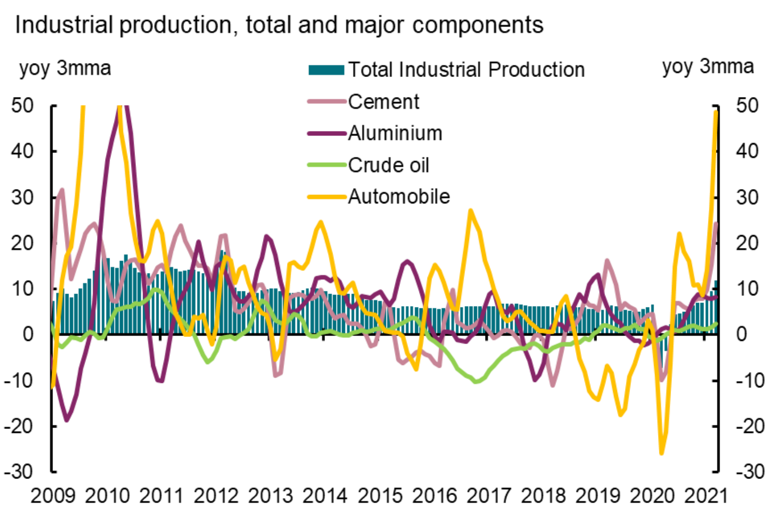
GDP growth forecast revised to 8.5%

- The collective flow of recent data has made us slightly more upbeat about China's economic outlook relative to our previous projection. We have therefore revised our full year growth forecast higher to 8.5% from 8%, to be broadly in line with the market consensus. The sequential growth profile remains the same – the weak Q1 will be followed by a rebound in Q2 before the economy slows in H2 as the impact of policy exit kicks in

Growth risks balanced, but markets focus more on policy exit

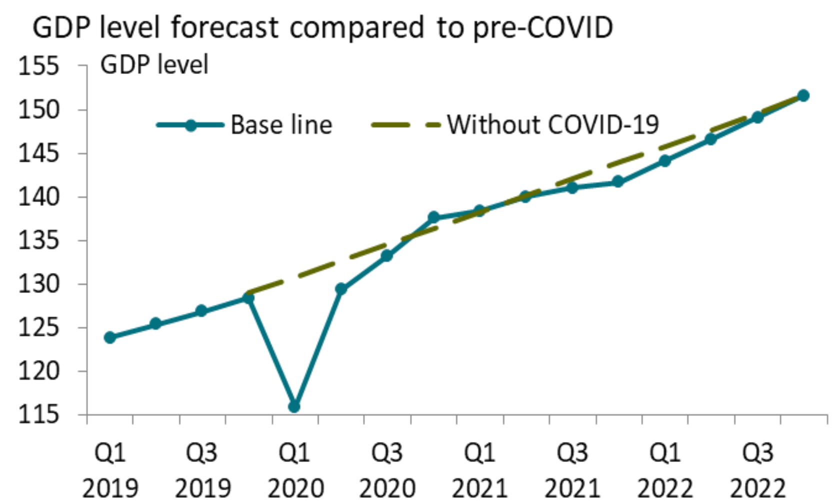
- The risks around this outlook are large, but broadly balanced. Exports and manufacturing capex could surprise on the upside amidst strong profit growth and external demand. Yet managing policy exit amidst rising investor nervousness could be challenging. The attempt to rein in property bubbles and local government debt growth has already resulted in rising bond defaults that have unsettled the credit market lately. This has also slowed corporate and local governments bond sales, adding to a sharp decline in aggregate financing growth in March. If unchecked, this could precipitate a steeper growth decline in H2

Supply-side recovery continues



Source: CEIC, AXA IM Research, April 21

Sequential growth to rebound in Q2 but slow into the yearend



Source: CEIC, AXA IM Research, April 21

COVID variants threatens the outlook while vaccination remains stuck

Japan

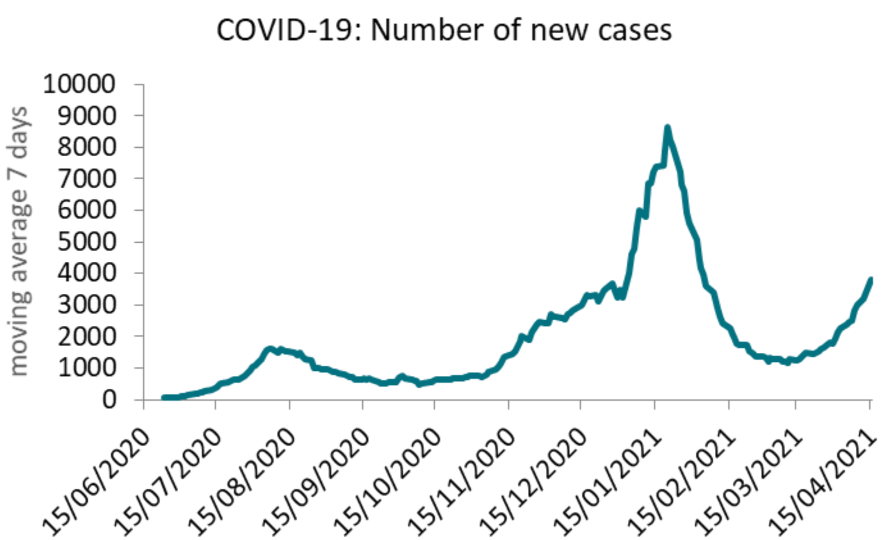
A fourth wave is threatening the outlook

- The government has imposed new restrictions in big cities to curb a fourth wave of Covid outbreaks
- Officials are worried about the rapid spread of the more contagious UK variant.
- As such, risks are rising over the expected recovery in the coming weeks

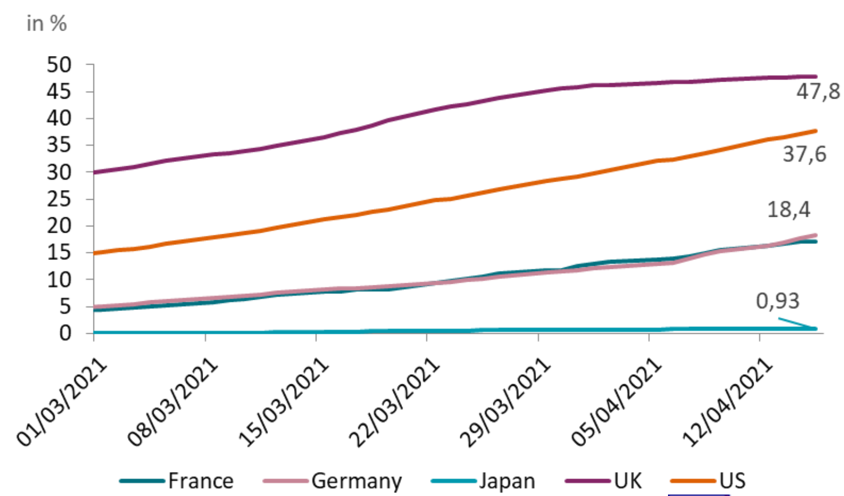
Only 1% of the population has received at least one dose…

- Japan is still short of doses to accelerate its vaccinations. With distributions limited by two factors: only Pfizer has so far been approved and most doses are imported from Europe. The government estimates vaccination will accelerate in May, following a 43m dose delivery, followed by a further 45m planned for June.

COVID-19 variants threaten the outlook



Vaccination is not accelerating



Source: Our world in data, AXA IM Research, as of April 15

“Stop and go” policy continue to distort economic data

Japan

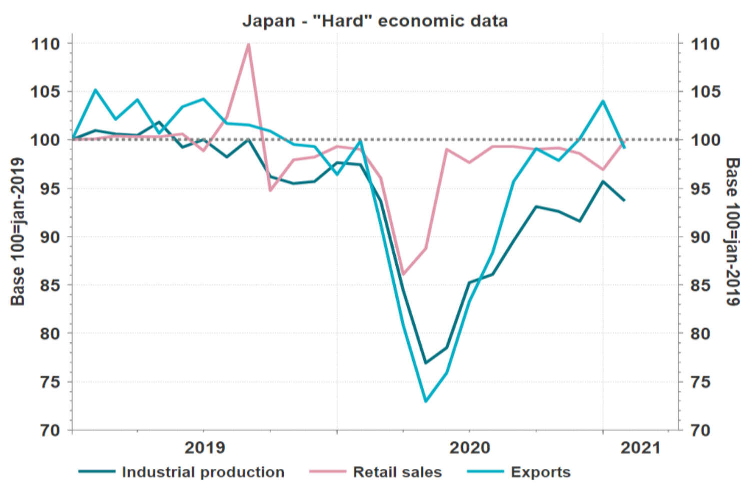
February data were mixed

- Q1 households spending was more resilient than expected, but the stabilization may last longer as the government has imposed new restrictions and consumer confidence (surveyed before the announcement) was already flat for April. Manufacturing production has been impacted by notable declines in production of autos, electrical machinery and equipment due to semiconductor shortages and other supply-chain disruptions. Real exports also fell back, but distortions are usual at this time of the year reflecting the lunar new year.

Tankan surveys have improved but most of the firms continue to struggle

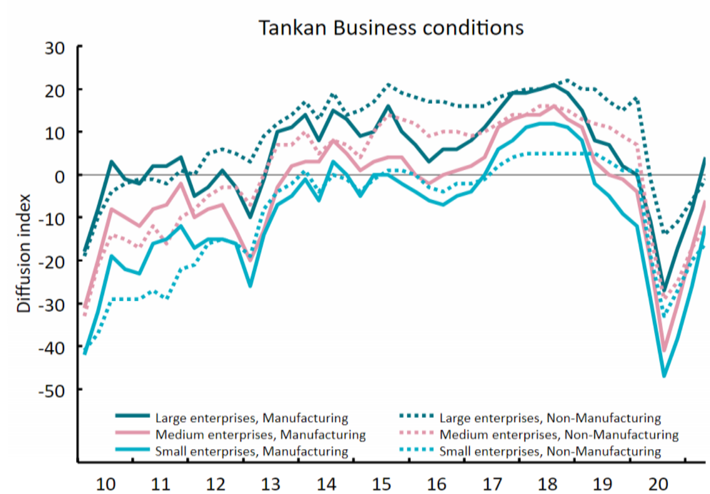
- Q1 Tankan surveys are mixed. Indices across companies have improved, but only large manufacturers are in positive territory (more companies expect an improvement than worsening of activity in the coming weeks). For small and medium enterprises in the manufacturing sector and services sectors, it means they have difficulties to project their activity in the coming weeks

New year, State of emergency and chip shortages impact hard data



Source: Refinitiv Datastream, METI, AXA IM Macro Research

Tankan surveys improve, only large manufacturers positive



Source: Refinitiv Datastream , AXA IM Research

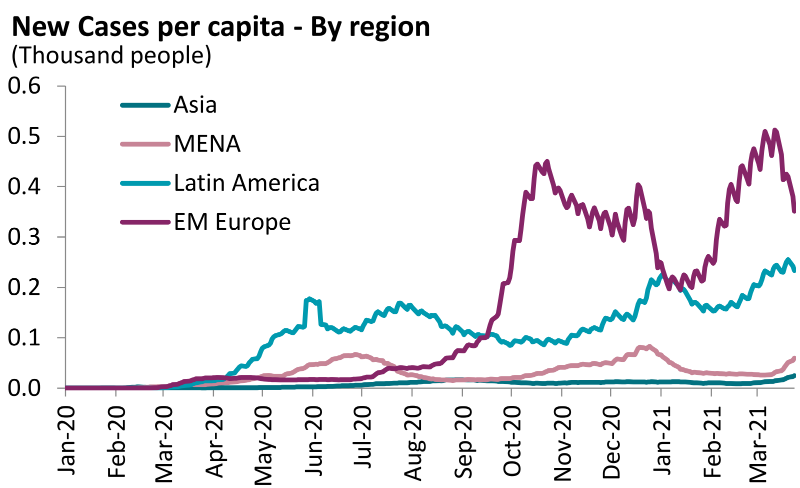
Pandemic still around … vaccination accelerates but more restrictions needed

Emerging Markets

New cases rising calling for additional restrictions. Vaccination is slow.

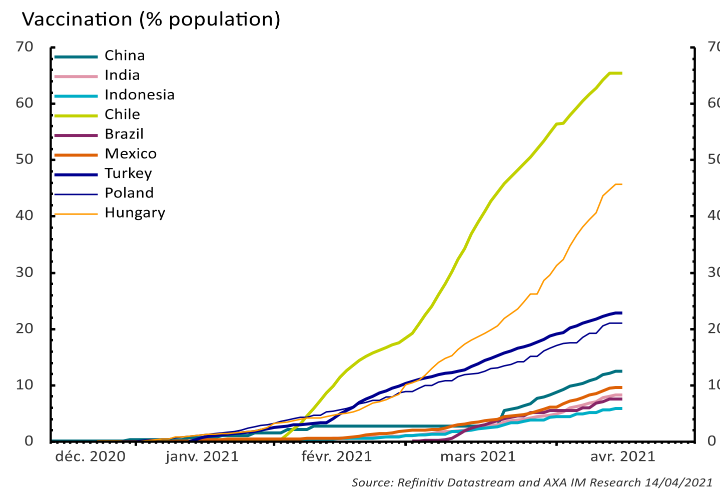
- India is seeing another Covid-19 wave, with daily infection rates far above previous episodes.
- Latin America struggles with the Brazilian P1 variant and potentially some further mutations (Uruguay, Argentina, Colombia).
- Central Europe is now passed the infection peak, but daily rates remain elevated. Turkey sees a strong infection wave and the government has enacted additional mobility restrictions.
- On the brighter side, Russia, South Africa and Indonesia are faring better with mobility rising and new cases falling.
- Vaccination has had a slow start in EM – particularly, but not only in Asia. Some acceleration in the vaccination pace has been reported in the past weeks but likely not sufficient to put a cap on the current wave: additional restrictions (and likely public spending) may be needed. Moreover, questions have been raised about the efficacy of vaccines used in some of the regions.

Infection rate still not under control



Source: Datastream, AXA IM Research, 13 April 2021

Vaccination accelerates but remains insufficient



Source: Datastream, AXA IM Research, 14 April 2021

Brazil: Covid-19, debt, politics and credibility

Emerging Markets

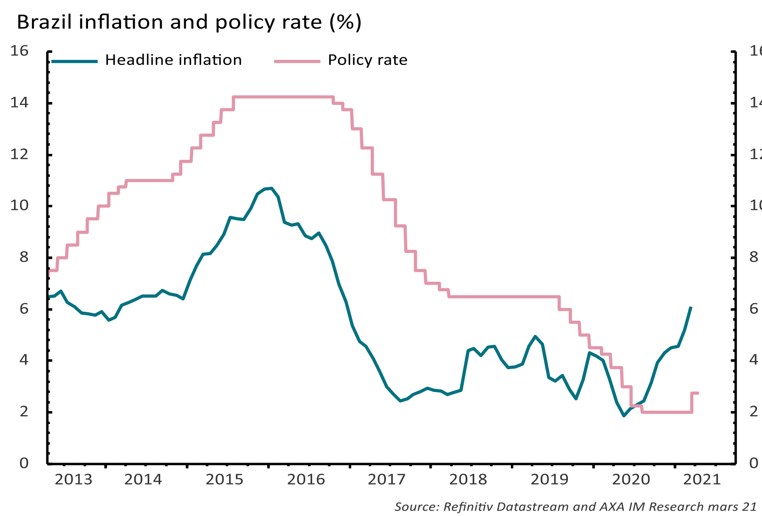
Pandemic still looms…

- The pandemic seems to be abating in Brazil in recent days, but the number of new infections remains elevated. Recent COVID-19 numbers are probably distorted by a holiday effect, with under-reporting for some days and over-reporting for others.
- Difficulties in vaccine production increase uncertainty about the availability of vaccines as well as downside risks to economic growth.

Policy balancing act increasingly delicate

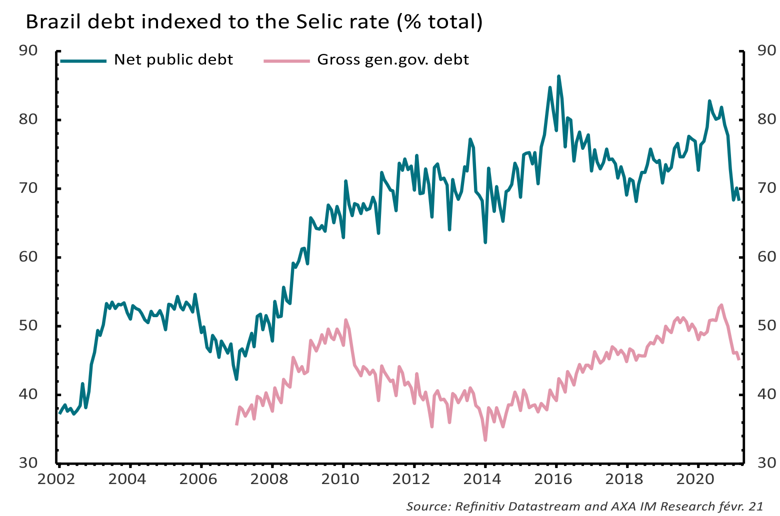
- An impasse between Brazil's economic team and Congress over the 2021 budget will likely end up with President Bolsonaro accepting only part of the austerity pleas as lawmakers push to ramp up spending ahead of next year's elections. A solution must be found in the coming days, but if the spending cap anchor is not preserved, Brazil will be left with no credible plan to balance its budget, which could further weaken the currency, fuel inflation and derail the recovery.
- On the monetary policy front, normalisation started as of last month, as the Copom hiked the Selic rate by 0.75% to 2.75%, the first hike since July 2015, with another preannounced for the following meeting. The interaction of monetary and fiscal policy may get complicated as central bank leeway may be limited by the large share of public debt linked to short term policy rates.

Monetary normalization needed as inflation rises



Source: Refinitiv Datastream, AXA IM Research, March 2021

Brazil's debt is highly indexed to the Selic



Source: AXA IM Research, Feb 2021

AXA Investment Managers

Investment Strategy

Multi-Asset Investment views

Our key messages and convictions

Positive on equites

#1
Economic and earnings rebound remains on track amidst still very loose monetary policy

Neutral on Investment Grade Credit

#2
Despite support from monetary and fiscal initiatives, valuations are no longer attractive due to tight spreads

Negative Sovereign Bonds

#3
Bond markets starting to price a policy shift by the Fed as fiscal stimulus takes hold although monetary arsenal remains supportive

Long Volatility

#4
Concerns over COVID-19 variants and Fed monetary policy transition generate higher volatility

Source: AXA IM as at 21/04/2021

FX Strategy

EUR fights back but is not out of trouble yet

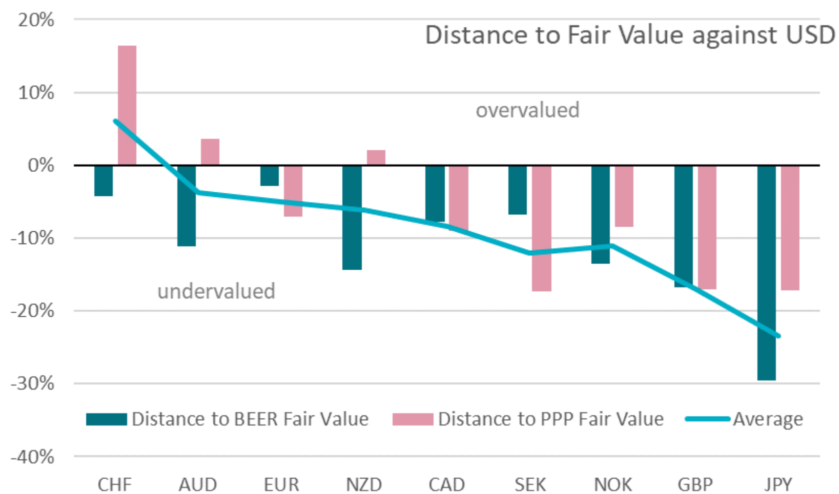
- The rebound in US real rates since the start of the year has reversed somewhat in April. The EUR bottomed-out and bounced during this respite, to above 1.20 in EURUSD terms. That said, a sharp economic rebound in the US is likely to drive US real rates higher again. This should translate to further weakness for the CHF and JPY and should also weigh on the EUR anew.

- The USDCHF seems the better choice to express higher US rates in FX: delivering higher carry; positioning that has room to turn more negative; and the Swiss economy tied to the EU.

- In Europe, the reopening of the UK in contrast to renewed restrictions elsewhere, is already benefiting the GBP and could drive the EURGBP still lower. We remain mindful though that market positioning in GBP remains quite long.

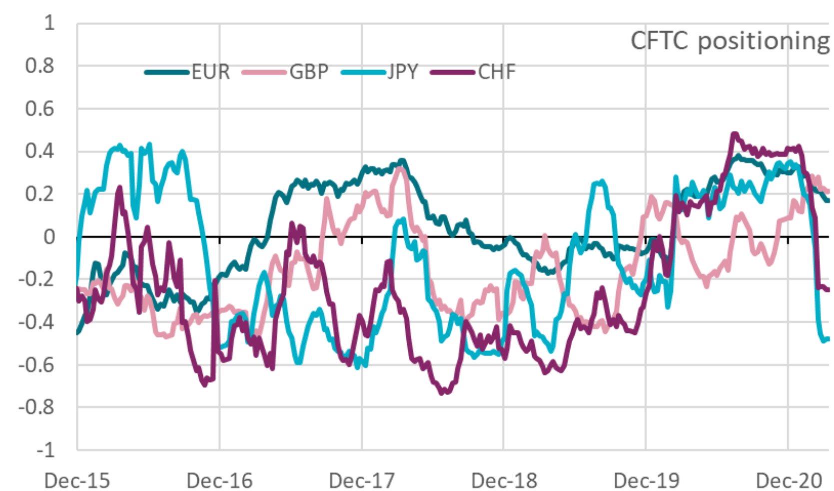
- Expectations for central bank rates of commodity currencies have exceeded those for the Fed since the start of the year. Norwegian Inflation is indeed well above target and the NOK continues to lag amid the risk-on environment and the rebound in Oil.

EUR already closer to fair value than most



Source: Refinitiv and AXA IM Research, April 2021

EUR long positioning unwound only marginally in March



Source: Bloomberg and AXA IM Research, April 2021

Rates Strategy

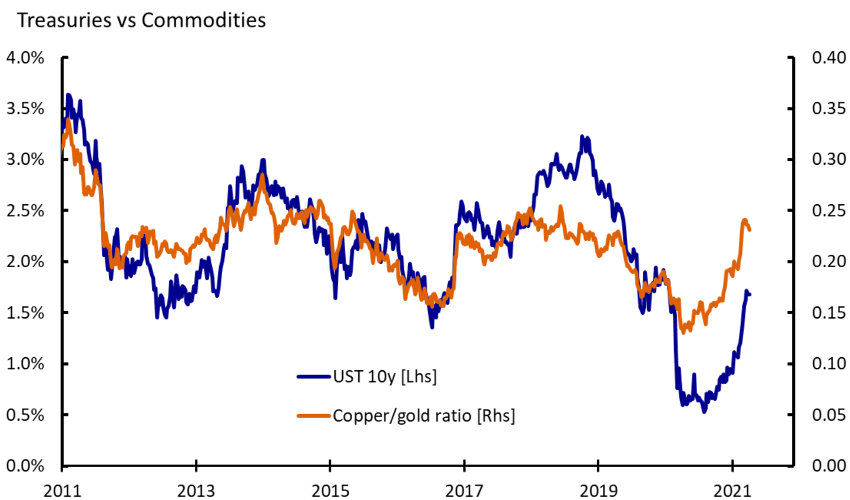
US Treasuries: time value re-considered

- Market positioning has somewhat normalised as UST yields have fallen, even though large shorts are still reported by CFTC, both in UST bonds and ultra-long UST futures. On the demand side, Treasuries have significantly improved their attractiveness for global investors on an fx-hedged basis.

- One question remains the sustainability of short positions – even if reasonably motivated by fundamental analysis – in an environment of rather punitive carry when taking a short exposure. When going short interest rates, time can be a very costly good and even more so after the moves higher that we've seen this year.

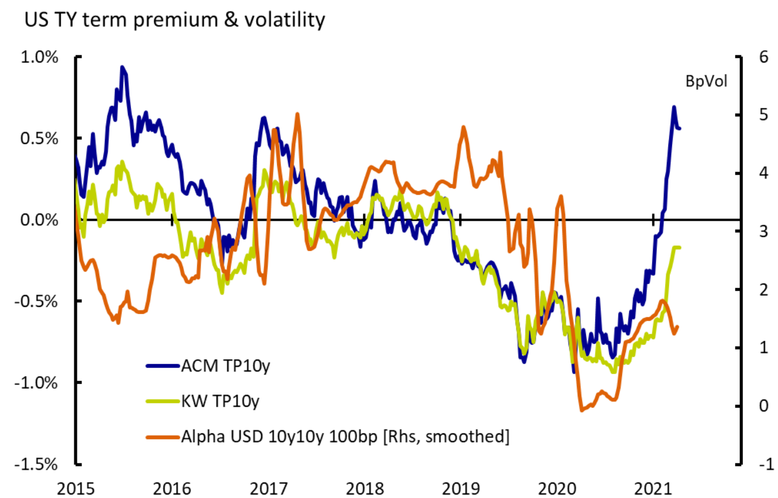
- Eventually, uncertainty about the rates scenario is still rather high as highlighted by the gap between different term premium methodologies. From that point of view, there might be more interest rate volatility to come; certainly, a source of comfort for those with US Treasury short positions.

Metals are at the high end of their range



Source: Bloomberg and AXA IM Research, April 2021

Divergence between various estimates of the term premium



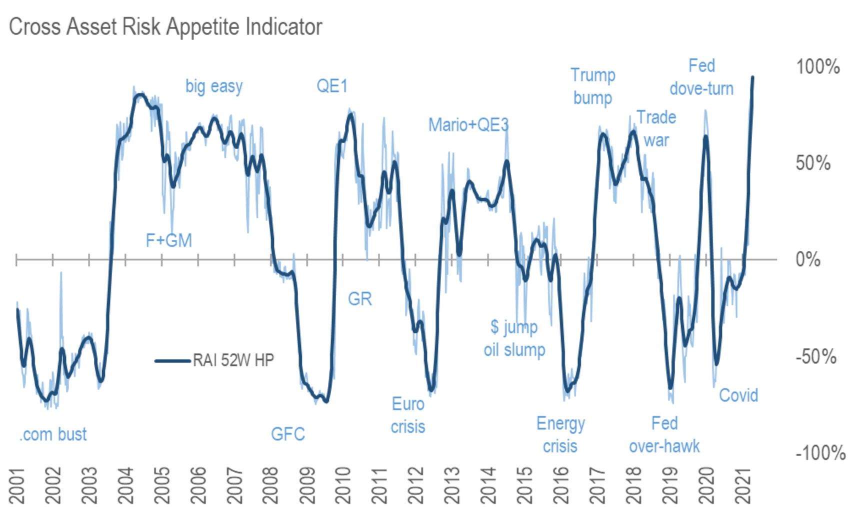
Source: Bloomberg and AXA IM Research, April 2021

Credit Strategy

The risk-on show goes on

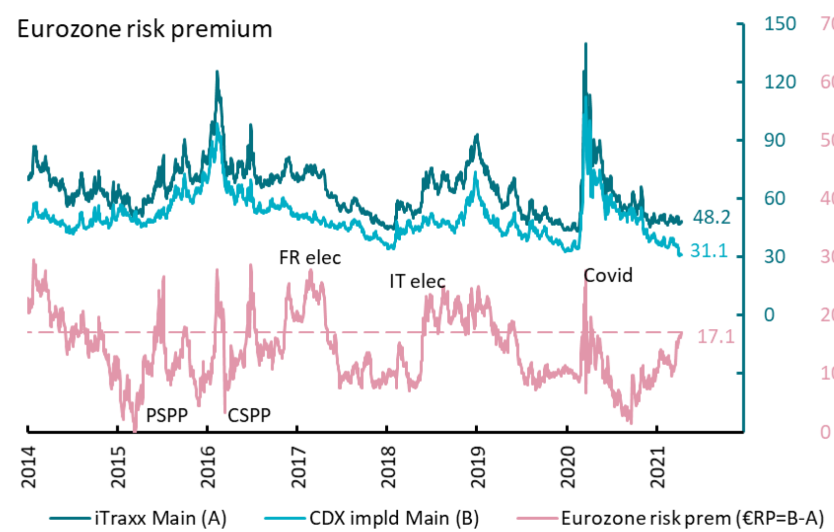
- From a contrarian point of view, a high reading in our risk appetite indicator may raise concerns of a pending market correction. On the other hand, there have been periods when the RAI remained elevated. Credit spreads have been pre-empting such a regime of low volatility, conducive to risk appetite.
- Inasmuch as the Fed has convinced markets that it can maintain policy accommodation in the face of rising inflation, we may be in a period of healthy risk appetite for the remainder of 2021. This should see HY continuing to outperform IG amid the reflation trade. Yield carry alone would take full year return to 5% for USD HY and 4% for EUR HY, whereas in IG it is not sufficient to regain the losses due to the rise in rates.
- Within IG total returns, EUR credit has suffered less than USD credit from the rise in interest rates, thanks to its lower duration. But EUR credit has lagged in spread terms, a likely reflection of US growth 'exceptionalism' and a trend that may persist as the vaccination campaign in Europe faces ongoing side-effect and supply headwinds.

Risk appetite indicator at a 20-year high



Source: ICE, Bloomberg and AXA IM Research, April 2021

Eurozone risk premium has risen on US growth exceptionalism



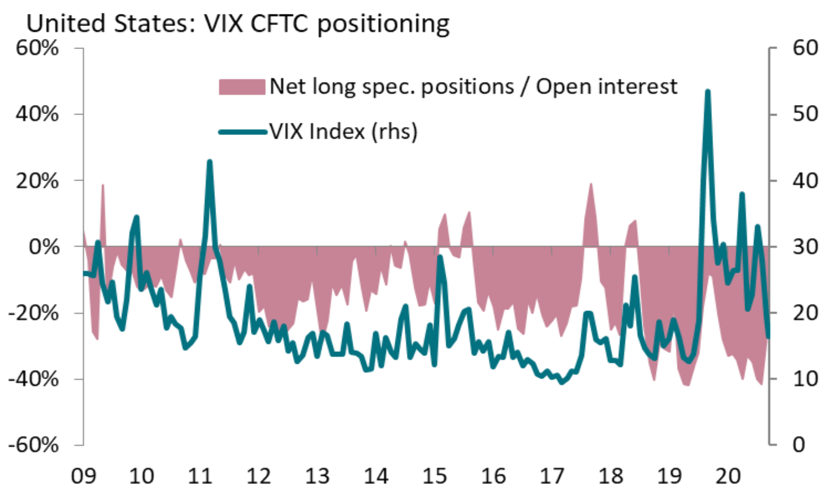
Source: ICE, Bloomberg and AXA IM Research, April 2021

Equity strategy

Back on the track

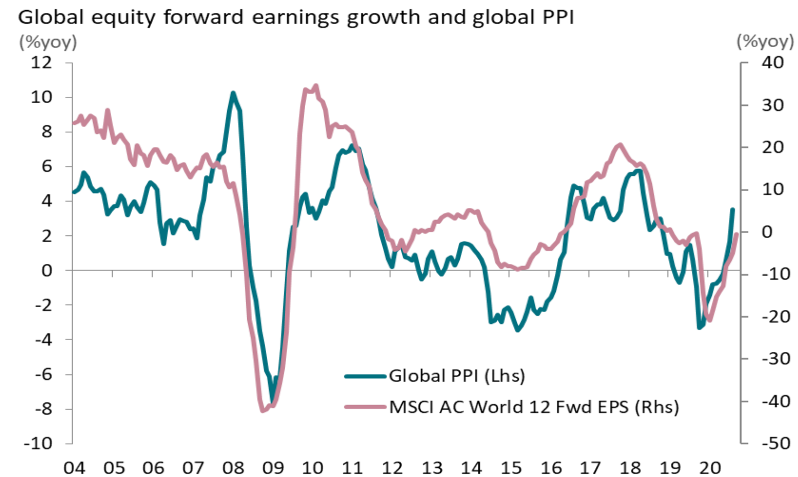
- After a mediocre performance in March, the equity market has rebounded this month. Except for emerging markets, all other regions delivered a positive performance, led by the US. The strong performance of the US market has resulted in a lower level of volatility, with the VIX now below its historical average. Indicators point to a continuation of this decline.
- The earnings season has begun, and the results could give the asset class a boost given the positive outlook. We expect a low consensus error this year given that the recent US PMI figures have been solid while profit margins are set to keep normalising. Concerns that rising prices undermine future corporate earnings are unfounded, as the two tend to be positively correlated.
- The vaccination campaign is improving across the world, albeit at different pace locally , so the base case for a global recovery in the second half of the year keeps the outlook positive. We keep our positive view on equities and maintain our UK exposure. We added to our position on US and Euro banking sector, as rising bond yields should benefit them, and valuations remain reasonable.

VIX has continued decline after breaking through the 20 level



Source: CBOE, CFTC and AXA IM Research, April 2021

EPS growth tends to correlate positively with PPI



Source: OECD, MSCI and AXA IM Research, April 2021

Asset allocation stance

Positioning across and within asset classes

Asset Allocation

Key asset classes

	Negative	Neutral	Positive
Equities			■
Bonds	■		
Commodities		■ ▼	
Cash	■		

Equities

Developed

	Negative	Neutral	Positive
Euro area			■ ▲
UK			■
Switzerland		■	
US			■
Japan		■	

Emerging & Equity Sectors

	Negative	Neutral	Positive
Emerging Markets		■	
Europe Cyclical/Value			■
Euro Opening basket			■
Euro Financials			■
US Cyclical/Value		■	
US Financials			■
Global semiconductors		■ ▼	

Fixed Income

Govies

	Negative	Neutral	Positive
Euro core		■	
Euro peripheral		■	
UK		■	
US	■		

Inflation Break-even

	Negative	Neutral	Positive
US		■	
Euro		■	

Credit

	Negative	Neutral	Positive
Euro IG		■	
US IG		■	
Euro HY		■	
US HY		■	

EM Debt

	Negative	Neutral	Positive
EM Bonds HC		■	

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

Source: AXA IM as at 21/04/2021

Investment Managers

Forecasts & Calendar

Macro forecast summary

Forecasts

Real GDP growth (%)	2020	2021*		2022*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
World	**-3.7**	**5.5**		**4.3**	
Advanced economies	**-5.3**	**5.1**		**4.0**	
US	**-3.4**	**6.9**	5.7	**4.5**	4.0
Euro area	**-6.8**	**3.8**	4.3	**3.6**	4.2
Germany	**-5.3**	**2.4**	3.4	**3.3**	3.8
France	**-8.3**	**6.0**	5.5	**3.6**	3.7
Italy	**-8.9**	**4.5**	4.2	**4.1**	4.0
Spain	**-11.0**	**4.5**	5.7	**4.7**	5.7
Japan	**-4.9**	**2.9**	2.8	**2.5**	2.3
UK	**-10.0**	**5.3**	4.6	**6.7**	5.8
Switzerland	**-3.0**	**3.4**	3.2	**2.9**	2.9
Emerging economies	**-2.7**	**5.7**		**4.5**	
Asia	**-1.5**	**7.4**		**5.1**	
China	**2.3**	**8.5**	8.4	**5.5**	5.4
South Korea	**-1.0**	**3.5**	3.5	**3.0**	3.1
Rest of EM Asia	**-6.0**	**6.5**		**4.7**	
LatAm	**-7.3**	**4.0**		**2.8**	
Brazil	**-4.1**	**3.0**	3.3	**2.3**	2.4
Mexico	**-8.5**	**4.7**	4.4	**2.5**	3.0
EM Europe	**-2.3**	**3.1**		**3.6**	
Russia	**-2.8**	**1.8**	2.9	**2.5**	2.6
Poland	**-2.7**	**3.3**	4.1	**4.6**	4.7
Turkey	**1.6**	**4.5**	5.1	**4.6**	3.9
Other EMs	**-3.7**	**3.3**		**4.1**	

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

* Forecast

Investment Managers

Expectations on inflation and central banks

Forecasts

Inflation Forecasts

CPI Inflation (%)	2020	2021*		2022*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	**0.8**	**1.7**		**1.4**	
US	**1.2**	**2.3**	2.4	**2.2**	2.2
Euro area	**0.3**	**1.5**	1.5	**1.1**	1.3
Japan	**0.0**	**-0.3**	-0.1	**0.5**	0.5
UK	**0.9**	**1.9**	1.6	**1.7**	2.0
Switzerland	**-0.7**	**0.1**	0.3	**0.4**	0.5

Source: Datastream, IMF and AXA IM Macro Research – As of 21 April 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	Q1 -21	Q2-21	Q3-21	Q4-21
United States - Fed	Dates	0-0.25	26-27 Jan 16-17 Mar	27-28 Apr 15-16 Jun	27-28 Jul 21-22 Sep	2-3 Nov 14-15 Dec
	Rates		unch (0-0.25)	unch (0-0.25)	unch (0-0.25)	unch (0-0.25)
Euro area - ECB	Dates	-0.50	21 Jan 11 Mar	22 Apr 10 Jun	22 Jul 9 Sep	28 Oct 16 Dec
	Rates		unch (-0.50)	unch (-0.50)	unch (-0.50)	unch (-0.50)
Japan - BoJ	Dates	-0.10	20-21 Jan 18-19 Mar	26-27 Apr 17-18 Jun	15-16 Jul 21-22 Sep	27-28 Nov 16-17 Dec
	Rates		unch (-0.10)	unch (-0.10)	unch (-0.10)	unch (-0.10)
UK - BoE	Dates	0.10	4 Feb 18 Mar	6 May 24 June	5 Aug 23 Sep	4 Nov 16 Dec
	Rates		unch (0.10)	unch (0.10)	unch (0.10)	unch (0.10)

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

Calendar of 2021 events

2021	Date	Event	Comments
April	26-27 Apr	BoJ Meeting	Unchanged (-0.1)
	27-28 Apr	FOMC Meeting	Unchanged (0-0.25)
May	6 May	BoE Meeting	Unchanged (0.1)
	6 May	Scotland	Scottish Parliament Elections
June	10 Jun	ECB Meeting	Unchanged (-0.5)
	15-16 Jun	FOMC Meeting	Unchanged (0-0.25)
	17-18 Jun	BoJ Meeting	Unchanged (-0.1)
	24 Jun	BoE Meeting	Unchanged (0.1)
July	23 Jul	ECB Meeting	Unchanged (-0.5)
	27-28 Jul	FOMC Meeting	Unchanged (0-0.25)
August	23-28 Aug	Japan	Tokyo Olympics
September	9 Sep	ECB Meeting	Unchanged (-0.5)
	21 Sep	Germany	Federal Elections
	21-22 Sep	BoJ Meeting	Unchanged (-0.1)
	21-22 Sep	FOMC Meeting	Unchanged 90-0.25)
	23 Sep	BoE Meeting	Unchanged (0.1)
	30 Sep	Japan	End of term as LDP leader for PM Suga
October	21 Oct	Japan	House of Representatives term ends
	28 Oct	ECB Meeting	Unchanged (-0.5)
November	2-3 Nov	FOMC Meeting	Unchanged (0-0.25)
	4 Nov	BoE Meeting	Unchanged (0.1)
	1-12 Nov	UK/UN	Climate Conference
	27-28 Nov	BoJ Meeting	Unchanged (-0.1)
December	14-15 Dec	FOMC Meeting	Unchanged (0-0.25)
	16 Dec	ECB Meeting	Unchanged (-0.5)
	16 Dec	BoE Meeting	Unchanged (0.1)
	16-17 Dec	BoJ Meeting	Unchanged (-0.1)
November 2022	8 Nov	US	Mid Term Elections

Latest publications

[Bank of Japan: Assessing the outcome of its strategic review]

15 April 2021

[China: Decarbonizing the economy]

08 April 2021

[March Global Macro Monthly – The great rate debate]

24 March 2021

[China: Path to 'Net-Zero']

18 March 2021

[Central bank digital currencies: policy and design]

17 March 2021

[UK Budgets: Next steps, not complete vision]

03 March 2021

[February Global Macro Monthly & Investment Strategy – Vaccine and Stimulus: too much of a good thing?]

24 February 2021

[Entering the world's second largest bond market]

09 February 2021