21 May 2021
Research & Strategy Insights

The limitation of vaccinations

Global Macro Monthly

Key points

- Economies continue to be governed by the virus. The US grew in the first quarter after a swift easing in restrictions, China slowed and Europe and Japan both saw contractions.
- Inflation has picked up in many areas, reflecting base effects, commodity prices and bottlenecks. The pick-up should prove temporary. We expect inflation to return below target in most developed economies. US inflation is likely more persistent. Some emerging markets may also see pressure.
- Developed market central banks will look through the temporary inflation spike but will monitor inflation expectation developments closely.
- Despite widespread expectations for an inflation easing, against potent fiscal and monetary stimulus, bonds are susceptible to a sudden adjustment in Fed expectations.
- Rising real rates should also support USD vs low-yielder crosses.

Global Macro Monthly

Investment Strategy

Global Macro Monthly – US

David Page,
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Market focus shifts to inflation

The US is a beacon of hope for overcoming coronavirus. Having quashed a rise in cases at the start of the year, most states have eased restrictions to their lightest level since the crisis began. Cases rose initially in April but have resumed falling in recent weeks. High levels of vaccination (60% of adults with first dose, 47% second and a recent instruction to begin 12 to 15-year-olds) should help reduce the spread further – even if the US is running into difficulties maintaining the pace.

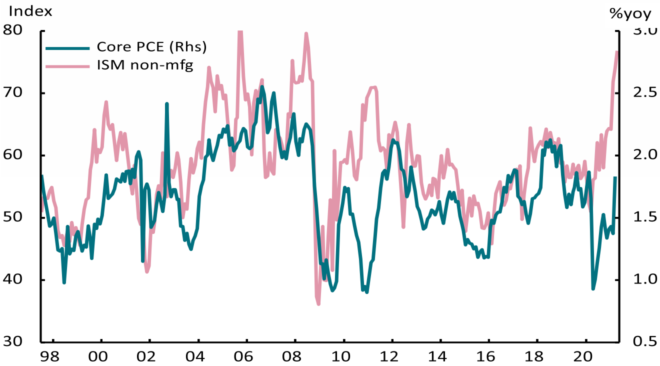
Following the $1.9bn stimulus package in March, President Joe Biden outlined $4tn worth of spending in the American Jobs Plan ($2.25tn) and American Families Plan ($1.8tn). This additional spending is intended to be largely tax-financed, partly through increasing corporate and high-earning household taxes to raise $3.5tn over 15 years. However, reconciliation – the only means likely open to pass legislation – requires budget neutrality over 10 years and White House proposals are around $1tn short on this timespan. Further, $700bn is ear-marked from increased tax collection, which independent forecasters estimate as optimistic. Fellow Democrats are either resisting some tax increases or want to reintroduce state and local tax deductions removed by President Donald Trump – both would increase the shortfall. The US would benefit greatly from Biden's planned spending, but it is too early to assess how much, or how quickly, it will happen.

For now, the economic outlook continues to benefit from recent stimulus packages and an easing in restrictions. Retail sales were flat in April but after March's 10.7% the lift to the second quarter (Q2) consumption remains intact. We have left our GDP outlook stable at 6.9% for 2021 and 4.5% for 2022, still ahead of consensus for 6.3% and 4.0%, but the latter has caught up quickly in recent months.

Payrolls surprised in April. After the ADP Research Institute survey had recorded 742k jobs gains on the month, the official survey posted gains of just 266k, with unemployment rising to 6.1% and average earnings rising by 0.7% on the month. Against a backdrop of demonstrable labour demand, this shortfall in expectation raised concerns over labour supply frictions - despite solid supply gains in the official report. Firms are raising wages to attract labour, whose reservation wages appears to have risen, likely reflecting a combination of childcare problems (schools still being closed), health concerns and more generous unemployment benefits. Each looks like a short-term issue but could last through Q3.

Exhibit 1: Short term inflation pressures surge

Non-mfg ISM (prices paid) and core PCE



Source: ISM, Bureau of Economic Analysis and AXA IM Research, 19 May 2021

Inflation surged in April (Exhibit 1). We expected a sharp rise in the headline rate, but at 4.2% – the highest since 2008 – and core at 3.0% – the highest since 1990 – it was firmer than we expected. A number of short-term factors exacerbated price gains, including base effects, energy prices, commodity and food, labour supply concerns, short-term re-opening bottlenecks (e.g. car prices) and supply disruptions, including from the Suez Canal, with an impact from the Colonial pipeline shutdown and Mississippi freight disruption to come. Inflation looks set to peak closer to 5% in the next couple of months. That said, it is difficult to see these factors persisting. In recent research[1], we argued that this transitory surge will fade, but give way to a more persistent, but modest rise. We forecast personal consumption expenditure (PCE) inflation at 2.0% by end-2022 and 2.3% by end-2023. This assumes expectations remain anchored – but the latest household survey of 5-10year expectations surged to a level only exceeded once in 13 years.

The persistence of the inflation surge is key for monetary policy. The Federal Reserve (Fed) has warned of a "transitory" spike in inflation and recent commentary from several Fed speakers have reiterated this point. However, if inflation expectations rise further, a more permanent inflation increase might occur sooner. If expectations continue to rise the Fed may have to change tack – June's meeting would be key. However, even if expectations soften over coming months, a rise in short-term inflation is still likely to see investors place a greater probability on higher medium-term inflation and the prospect of an earlier Fed tightening. Our view that the Fed will announce an asset purchase taper in December seems widespread, but some forecast a Fed Funds hike later next year. Our own view remains for two hikes in 2023 – itself ahead of current Fed guidance. However, a shift in market expectations would contribute further upward pressure to US Treasury yields, something we expect over the coming months.

[1] Page, D., "The Inflation Outlook: What's changed?", AXA IM Research, 28 April 2021

Global Macro Monthly – Eurozone

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Re-(h)opening

The COVID-19 situation has improved and vaccination is proceeding at faster pace than at the beginning of April, reflecting a supply boost. Maintaining the current daily pace of inoculation would allow 70% of the total population to be vaccinated by September, in line with European Union (EU) goals. But there are two potential downside risks. Current age limits on the AstraZeneca and J&J shots might imply slower progress in vaccinating younger cohorts. And as the US experience illustrates, it might not be easy to cover 'the last mile' as resistance to vaccination slows the process, particularly in France.

Still, our baseline assumes that the vaccination pace and virus situation allow for the gradual reopening governments have already started to implement in the second quarter (Q2). After a 0.6% quarter-on-quarter (qoq) contraction in Q1 – once again reflecting how well countries have adapted to restrictions – we see euro area growth rebounding by 1%qoq in Q2, before accelerating significantly in the second half of 2021. Business confidence data have surprised on the upside in April, with Purchasing Managers' Indices (PMIs) and European Commission (EC) surveys sending a similar message of record high manufacturing and recovering services. As most economies were still performing under severe restrictions in April, this mainly reflects hopes rather than actual activity improvement. Still, it signals the mechanical rebound that we are expecting is on its way.

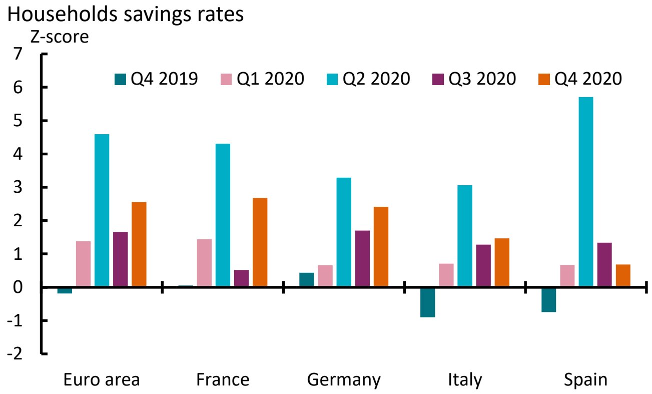
Several factors will help to fine tune its magnitude, including the ability to freely travel (key for tourism-dependent countries such as Spain or Greece) and the speed of savings normalization (Exhibit 2). Meanwhile, fiscal decisions may help to gauge its length. Remember gradual exit from state guarantee schemes and moratoria is fundamental (circa 24% of Italian outstanding loans to non-financial corporations and households are under moratoria), while calls for a second phase of stimulus are getting louder in France. So far, we see slight upside risk to our 3.8%yoy 2021 growth forecast.

Spending the EU money

On the fiscal front, countries have submitted their Recovery and Resilience plans. These show how they intend to spend the Recovery and Resilience Facility money (RRF, €312.5bn in grants, €360bn in loans), and in exchange on which reforms. There are several points worth noting. Italy is making full use of EU resources, while France and Germany do not plan to use the loans component and Spain will reassess its needs in 2022. Consequently, the Italian plan is much bigger (€205 billion, a combination of €69bn RRF grants, €14bn ReactEU grants and €123bn RRF loans) than the Spanish one (just €69.5bn of grants, nothing yet from the €70bn loans).

Spending is allocated in line with the EC guidelines (at least 20% for digitalisation and 37% for the green transition), but strategic action plans differ across countries, reflecting different economic structures and challenges. For instance, in Germany and Spain green mobility mainly targets the development of electric vehicles and infrastructure, while in France and Italy more than 50% of this component is allocated to railway development/ modernisation. Planned reforms also show interesting differences. Italy is aiming to unlock government efficiency via public administration and judicial reforms, while in Spain the focus is on structural challenges: labour market, pension and tax system. Attention will now turn to implementation and reform delivery to gauge the economic impact of this unprecedented EU fiscal tool (and its potential to become a permanent instrument). We concur with the estimated impact on Italian GDP (3.6pp of additional GDP by 2026), but the Spanish estimate (2pp per year) seems overly optimistic.

Exhibit 2: Different speed of normalisation



Source: Eurostat and AXA IM Macro Research, 11 May 2021.

Tapering noises to grow louder

The press conference following the European Central Bank (ECB) policy meeting in April produced little fresh news. The ECB reiterated that asset purchases under its Pandemic Emergency Purchase Programme (PEPP) would continue at a "significantly" higher pace this quarter, while taper discussions were labelled "premature". But the Governing Council remains divided. The battle between hawks and doves has just started: as monetary policy becomes more data dependent, better data could galvanise the hawks into action. Calls to taper PEPP purchases from as soon as Q3 will continue to grow louder. At this stage, we think a majority of the Council will opt to keep the pace of purchases at its new level in June (around €80bn per month in Q2 and Q3, keeping in mind the summer lull). Given the weak forward guidance, all eyes will turn to the September meeting, but it might still be too early to get the outcome of the Strategy Review.

Global Macro Monthly – UK

David Page,
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The rip-roaring recovery

The UK passed another milestone on 17 May – pubs and restaurants opened inside, two households can now mix indoors and up to 30 people outside. This reflected stability in COVID-19 cases – despite easing to date – and that more than two-thirds of adults have had their first vaccination while one-third have had their second. Yet concerns are rising over the Indian variant, particularly in the North-West of England.

March GDP rose by 2.1% – after the first tentative emergence from Lockdown 3.0. This was faster than expected. Q1 GDP contracted by 1.5%, far less than the 3.5% we had forecast at year-end. Some of this reflected an adapting to restrictions, but some reflected special factors. Private spending retreated sharply with household spending down 3.9% and business investment down 11.9% – although this was somewhat offset by strong government (21.9%) and household investment in housing (1.8%). Net trade supported GDP by 2.2% but reflected a 14% collapse in imports (compared to a 7.5% fall in exports), reflecting both Brexit trade frictions and an unwind of Brexit stock building. Government spending was also firmer.

Despite risks of these factors unwinding, we expect a strong rebound in Q2 and Q3, and are looking for 3.5% per quarter in both. This lifted our annual growth outlook to 6.4% (from 5.3%) but lowered our 2022 outlook to 5.9% (from 6.7%). The forecast is currently ahead of the 5.7% and 5.5% consensus outlook, although the Bank of England (BoE) forecasts a firmer 7.25%. It is like the US outlook (6.9%), but US GDP contracted by just 3.5% in 2020, whereas the UK economy fell by 9.9%.

We also raised our short-term inflation outlook, in part reflecting more supply-side bottlenecks. We expect inflation to rise to around 3% by year-end, a greater overshoot than the BoE predicts. In its latest meeting it left policy unchanged but confirmed a slower pace of asset purchases to £3.4bn/week (gross)/£2.2bn (net), from £4.4bn. This shift did not change its balance sheet targets though was not considered a policy shift. We see policy unchanged until the second half (H2) 2023.

May saw local and regional elections. The Scottish National Party (SNP) made a further gain in Scottish elections and will form an overall majority with the Greens. It has called for a second independence vote. Prime Minister Johnson has ruled this out, and the SNP's failure to secure an outright majority soothed concerns. But it will continue to pressure Westminster. We do not expect progress on a second referendum, until at least after the 2024 General Elections.

Global Macro Monthly – Japan

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New restrictions but for how long?

The government extended the state of emergency in Tokyo and eight other prefectures until the end of May. The decision seeming unavoidable as initial measures had barely been in place long enough to expect a discernible decline in new cases. The vaccination campaign should really start in May with Japan expected to receive more than 40mn Pfizer doses. But to date it has only vaccinated around 3% of its population.

Preliminary Q1 GDP growth contracted by -1.3% on the quarter, mostly impacted by the decline in private consumption, but surprisingly weakened by falling business investment, while net exports also contracted. Following a better-than-expected March retail sales report, we had raised our forecast, but then lowered it as government spending proved less supportive.

In Q2, recent restrictions are likely to weigh on private consumption again, highlighted by the decline in consumer confidence which fell to 34.7 from 36.1. Nevertheless, GDP should rebound slightly in Q2 (+0.9% on a quarterly basis) thanks to strong exports and an increase in capital expenditures. April's 53.6 in the manufacturing PMI marked the third consecutive month it has been in expansion territory. For the while, industrial production expectations have also pointed to an acceleration. We believe that restrictions could be eased by the end of the quarter, meaning the activity could accelerate in Q3 (+1.7%). We remain very cautious for our Q4 outlook as vaccination will not be complete by then, raising risk of another wave.

March's headline CPI inflation rose to -0.2% year on year, up by 0.2 percentage points. A declining negative energy contribution had some impact and CPI excluding volatile components increased by 0.3% from 0.2%. Looking ahead, we adjust our inflation outlook to account for the delayed resumption of the government's 'Go to Travel' programme, which offers discounts on domestic travel. We anticipate the plan should only resume in September and may last until May 2022. Accordingly, we revise our CPI inflation forecast up for 2021 to 0% (from -0.3%) and down for 2022 to 0.4% from 0.5%.

The Bank of Japan left its monetary policy unchanged at its last meeting. Governor Haruhiko Kuroda reiterated the commitment to maintain long-term interest rates (10 year) in the range of +/-0.25% and expected the Japanese Government Bond (JGB) market to become more functional after March's policy adjustment. He also mentioned the COVID-19 special funding operation, which expires at the end of September, may need an extension given the downside economic risks and slow vaccination progress.

Global Macro Monthly – China

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Improved speed and quality of growth

The economic recovery from the soft patch at the start of the year has continued to gain strength. Leading indicators, such as the Purchasing Manager's Indices (PMIs) for manufacturing and services industries, have either stayed at solid levels or rising to multi-month highs. The strong manufacturing activity was supported by buoyant export performance in April, with China's shipment growth accelerating to 32%, beating market expectations. The latter reflected, in part, strong demand for normal products from developed countries following their exit of economic lockdowns. At the same time, the virus resurgence in India and the Association of Southeast Asian Nations (ASEAN) countries has spurred renewed demand for medical-related goods, which saw China's exports to India jumped 144% last month. The worsening COVID situation in parts of the emerging market will likely keep China's pandemic-related exports strong over the coming months.

The domestic engines of the economy are gathering steam too. The latest golden-week holiday in May provided an opportunity for a closeup examination of the state of the consumer sector. The result was encouraging: a record 230 million tourists took the road during the five-day break, more than double the number in 2020 and 18% higher than in 2019. Nationwide tourism revenue improved dramatically from the Qingming festive in April, while box-office sales broke another record. Even though per-tourist spending has not yet returned to pre-COVID levels – partly due to the lack of international travelling – the improvement in holiday spending was clear, and consistent with our broad expectation that a faster consumption recovery will drive the next phase of China's economic normalisation.

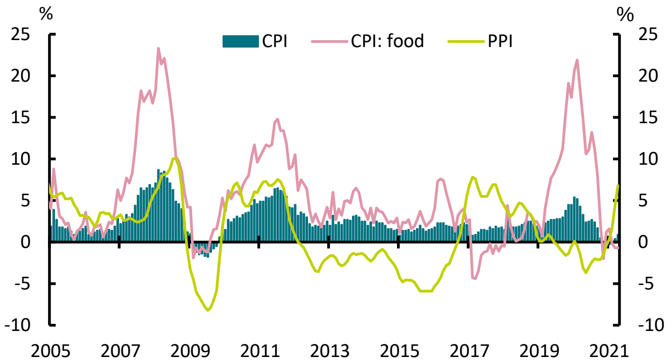
PBoC to look through inflation spike

On the price front, the latest inflation outturns attracted more-than-usual market attention. Rapidly rising global commodity prices have put significant upward pressure on domestic inflation. Indeed, both Consumer Price Index (CPI) and Production Price Index (PPI) inflation jumped in April, to 0.9% and 6.8%, with the latter reaching a 3.5 year high. Even though sequential growth of the PPI eased slightly due to lower oil prices last month, the base effect is dominating the yoy change and will likely keep PPI inflation elevated until well into the second half of the year.

So far, the pass-through of upstream price increases to downstream prices has been limited. This is consistent with the historical relationship between the CPI and PPI in China, and the fact that the nascent recovery of consumer demand is constraining companies' ability to pass on cost increases currently. In addition, headline CPI changes have been driven more by pork price movements over the past year, whose continued decline going forward will help to keep the CPI increases in check (Exhibit 3).

Exhibit 3: inflation rises due to imported cost increase

CPI inflation (headline and food) and PPI



Source: CEIC and AXA IM Research, May 2021

With the current inflation spike not a result of economic overheating and could prove temporary if some of the global supply bottleneck gets resolved, the People's Bank of China (PBoC) should be happy to look through these transitory price increases. The latest Politburo meeting stressed the need to keep policy stable and continuous, without "sharp turns". Tightening monetary policy for an economy that is suffering from an imported cost shock is counterproductive. Instead, policy makers are focusing on recalibrating domestic policies – such as those related to decarbonization – that might have exacerbated the current price increases. The pledge for a more lenient pursuit of the green targets in the 14th Five-Year-Plan will help to alleviate inflation pressure going forward. We expect a gradual rise in CPI inflation towards 3% by the end of this year before a modest policy tightening commences in 2022.

Mixed news from the latest census

China released its latest census data, providing a rare peek into the nation's demographic changes over the past decade. The result was a mixed bag. On the one hand, contrary to fears that China's total population has already started to decline, the data showed continued growth, although the 72 million increments since 2010 was the smallest increase the census started in 1950. Population aging has worsened over the past decade, with the share of elderly population (aged 65+) rising to 13.5%, while the percentage of working-age population shrank to 63.4% from 70.1%. To compensate, the labour force is now more educated, with the average years of schooling rising 9.91 from 9.08, and working in higher paying jobs in cities, with the urbanization ratio rising 14 points to 64%. The most troubling statistics are the rapid declines of new-borns in recent years, which calls for an urgent rethinking of China's family-planning policy.

Global Macro Monthly – EM

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Vaccines, recovery, inflation and… more hawkish central banks

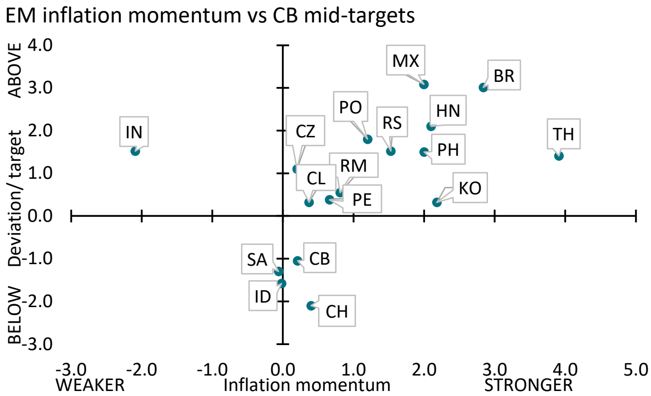
The global backdrop has been somewhat more favourable to emerging markets (EM) recently, primarily thanks to a stabilisation in the level of US Treasuries yields, which in turn has tamed the US dollar. Vaccinations are rising globally, although developing nations are lagging. In this respect, the recent discussions about the willingness of the US to loosen export restrictions on finished products and raw materials, as well as possible waivers for COVID-19 vaccines, may alleviate some concerns around vaccine supply constraints for EMs.

Manufacturing activity still appears on a strong footing. April Purchasing Managers' Index (PMI) surveys suggest strong momentum in the months ahead. In Asia, manufacturing activity is accelerating across the board; the Philippines was the only country reporting a PMI below the 50-threshold, indicating a contraction in output. Meanwhile, exports of tech and non-tech products continue to grow healthily in South Korea and Taiwan. Manufacturing activity remains robust through Central Europe, although the PMI index appears anaemic in Russia, not being able to sustain an acceleration. The pandemic continues to weigh on economic activity in Turkey where industrial activity is less buoyant. Brazil's PMI also remained in expansionary territory but was at its lowest level since June 2020 and significantly below the October high. Manufacturing activity continued to improve in Mexico, although the PMI remained below 50.

So far, Q1 GDP releases have shown that economies are coping increasingly well with the various pandemic-related constraints. Taiwan, South Korea and Singapore all saw a strong rebound in Q1 GDP, thanks to still-solid tech exports. In Mexico, activity expanded on the back of a stronger services activity pick-up – the rise in the Mexican Institute of Financial Executives (IMEF) Non-Manufacturing PMI in April, ahead of further economic activity opening, bodes well for Q2. Indonesia also recorded a slower pace of contraction. The Philippines disappointed slightly with a slow pace of domestic demand recovery.

Inflation also surpassed expectations: our EM inflation rate proxy jumped to 3.1% in March from 2.6% in February, mostly on the back of the acceleration in China (to 0.9%) and to a lesser extent Turkey (to 17.1%). Energy price inflation is part of the explanation, while food inflation showed mutually offsetting regional divergences. In Korea, headline inflation rose sharply on soft base effects and higher food and oil prices. Similarly, in India, March's Consumer Price Index (CPI) edged higher again (5.5% in March from 5.0% in February) on rising commodity prices. The near-term path of Indian inflation will likely be affected by progress of the South-West monsoon this year and the trajectory in global commodity prices. In addition, we are also cautious of any supply-side price pressures from the COVID-induced lockdowns locally. In Latin America, April core CPI showed upward pressure across the board, prolonging March's elevated readings. Cost pressures from past and current FX weakness could weigh further, particularly on high-yielders, while supply bottlenecks may continue to put pressure on core prices in the very near future (Exhibit 4).

Exhibit 4: EM inflation momentum accelerating



Source: Refinitiv Datastream and AXA IM Research, 10 May 2021

Given this backdrop, some central banks are increasingly hawkish and the normalisation in interest rates is no longer on the backburner. Brazil is at the front of the process: early this month, the Copom hiked the policy rate again by 75 basis points to 3.5%, signalling further additional tightening, which will likely take the Selic policy rate to 6.0% by end-year. The Russian central bank hiked interest rates as well last month and its hawkish tone left the door open for further front-loaded hikes in the months to come. Meanwhile, the Turkish central bank kept rates unchanged at 19% for a second month in a row and, according to its own inflation projections, is unlikely to cut rates before Q4 2021.

Normalisation in interest rates will remain the main focus for central banks across EM as economic activity gains traction and the foreign exchange assessment becomes an important part in the CPI trend. Communication will be key in deciphering the "back to normal" framework in which central banks will have to start operating again in the near future.

Investment Strategy – Cross-assets

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Minor market wobble

After a strong month for equities in April, the early part of May has seen an increase in volatility and some losses in stock markets, in some cases coming off record highs. Last week, the tech-dominated NASDAQ US equity index registered a decline of 2.4%, while some Asian bourses also fell. The moves have been dominated by declines in technology stocks, auto-makers and some sectors that are re-opening post-lockdown. Bond markets have been relatively stable; yields on benchmark government bonds are lower than the highs reached in early April. Breakeven inflation rates have edged higher in recent weeks but are consistent with inflation remaining close to central bank targets over the medium term. 'Steady as she goes' remains the mantra.

Investment Strategy – FX

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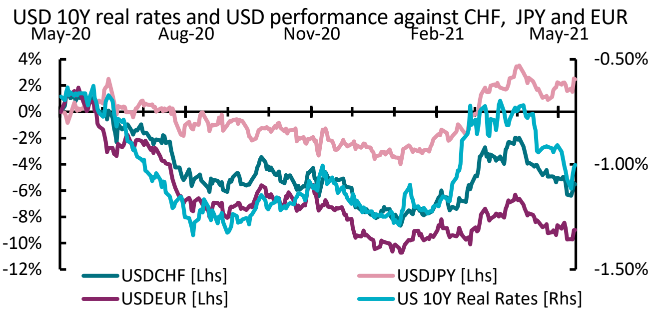
US real yield and US dollar can bite again

Exhibit 5: Low yielders' fate tied to US real rates rebound



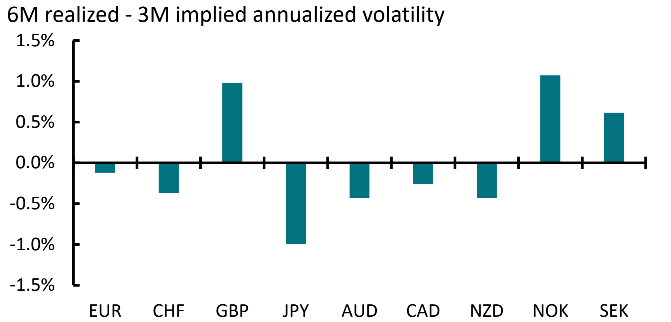
Source: Bloomberg and AXA IM Research, 14 May 2021

US real yields have almost fully unwound their gains due to the massive fiscal stimulus delivered by President Joe Biden. The US Federal Reserve (Fed) dialled down tapering fears and the US labour market is struggling to regain its pandemic-driven losses. This has translated into dollar weakness against low yielders (Exhibit 5). However, inflation pressures remain in place and risks of a rebound in real rates remain, as markets may question again the Fed's stance. This is a threat for the euro/dollar rate in the short term: Though still undervalued from a long-term perspective it has already moved closer to fair value than most, while long positioning remains sizable and has room to unwind. Euro optimism may have come too early, boosted by acceleration of the vaccination pace in the European Union (EU) and the German court's approval of the recovery fund. In the coming months, the EU economic rebound will continue to lag with a smaller fiscal package, slower vaccinations, later reopenings and subpar tourism during the summer. Dollar/Swiss franc longs may be a better choice to express a higher US rates view, as they exhibit higher correlation and deliver higher carry.

No fear: Sterling and krone will not blink

The Norwegian krone (NOK) and sterling suffered particularly during the height of the pandemic. Since then, the UK's reopening and relief from Brexit risks have helped a sentiment rebound in sterling (GBP). The krone outlook has benefited from rising oil prices and a hawkish Norges Bank. Market confidence in both currencies can be seen in their implied volatility versus the dollar – persistently below recent realised volatility (Exhibit 6).

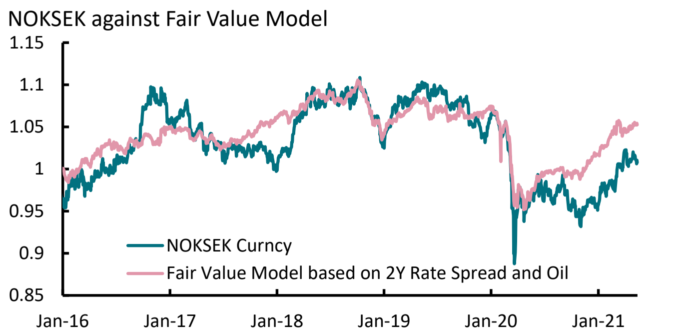
Exhibit 6: Lower volatility shows confidence in GBP, NOK



Source: Bloomberg and AXA IM Research, 14 May 2021

The spread between realised and implied volatility is a good indicator of market sentiment and a leading signal on currency performance. Long positions against USD on currencies having lower implied than realised volatility and short positions on others, is a strategy that delivers a Sharpe ratio of 0.65 since 2001. We expect sterling and the krone's relative outperformance to continue (Exhibit 7), as both remain largely undervalued against the euro and Swedish krona (SEK). A headwind, however, is an already significant long positioning on sterling from a historical perspective, as well as market expectations of the Bank of England that are arguably too hawkish, and risks of a new variant virus strain.

Exhibit 7: NOK lagging SEK, Oil & Norges Bank expectations



Source: Bloomberg and AXA IM Research, 14 May 2021

Investment Strategy – Rates

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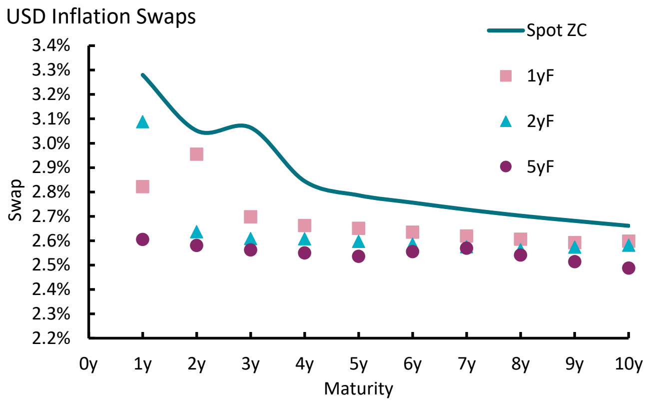
US inflation surprise but look at Europe now!

Bond markets, central bankers and private-sector analysts continue to shrug off the risk of structural inflation despite the strong upward surprise in April's US Consumer Price Index (CPI). Admittedly, an inflation data surprise does not tell us much about the base effect. Rather, it just tells us that the consensus forecast was wrong. On the policy side, the US Federal Reserve's new strategy is perfectly rational both from the point of view of a prolonged period of below-target inflation as well as the US federal debt jumping to 129% of GDP at the end of 2020. We should continue to assume that financial markets are very efficient at internalising probability-weighted outcomes. After all, there are few signs of accelerating wages or destabilised inflation expectations. At least for now.

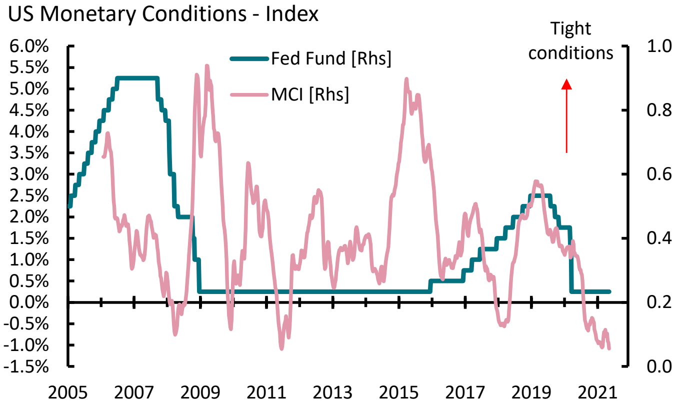
Exhibit 8: Still convinced about a base-effect



Source: Bloomberg and AXA IM Research, 18 May 2021

The inflation market has played it by the book: Dealers have adjusted levels at the front-end of the inflation curve in line with the almost relentless rise in commodity prices. The consensus view is that there will be a commodity base effect and it will be a rather strong one. However, a base effect is transitory by definition. Therefore, the rest of the inflation-forward space converges towards the Fed's target plus some time-premium implied by the new policy strategy of achieving a "moderate" overshoot (Exhibit 8). There is a fierce debate about the exact definition of "above 2% for some time", but in our view the Fed's definition is not static, but rather path-dependent: The higher the realised inflation, the shorter the time period of above 2% inflation will need to be, in order to achieve average inflation of 2% "over time", thus anchoring inflation expectations.

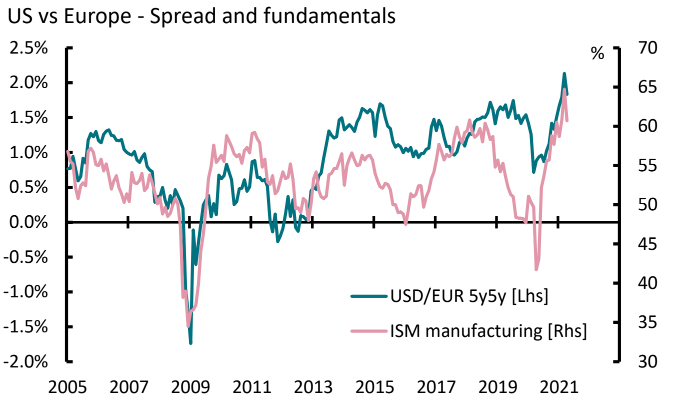
Exhibit 9: Fed's monetary support is still plentiful



Source: Bloomberg and AXA IM Research, 18 May 2021

The other side of the coin tells the story of an economy that is supposed to grow around 7% in 2021 backed by potent and synchronised monetary and fiscal stimulus. We get a feeling for the Fed's accommodative monetary conditions by aggregating information from the bond and the foreign exchange markets into a single indicator (Exhibit 9). The risk is that markets start fiddling with expectations at some stage, i.e. they start questioning the transitory-inflation mantra. For example, one could argue that the current expansionary policy stance could be mis-calibrated against an environment of fast output gap reversion and booming commodity markets. In this respect, the rise in core inflation needs to be monitored, as an early indicator of structural inflation pressures.

Exhibit 10: US/Europe spreads look toppish



Source: Bloomberg and AXA IM Research, 18 May 2021

The inflation surprise and the accompanying rise in Treasury yields should also be seen in the global context. With US confidence indicators already implying a robust economic rebound and Fed policy maintaining a moderate narrative on inflation risks (and the implied rate path), a correction of the US/Europe spread could well be on the cards in the near term (Exhibit 10). In particular, such a scenario would be sensitive to an acceleration of Eurozone fundamentals, perhaps on the back of a faster-than-expected reopening. Of course, US/Europe spreads are also likely to be very sensitive to a change in wording either from Washington or Frankfurt.

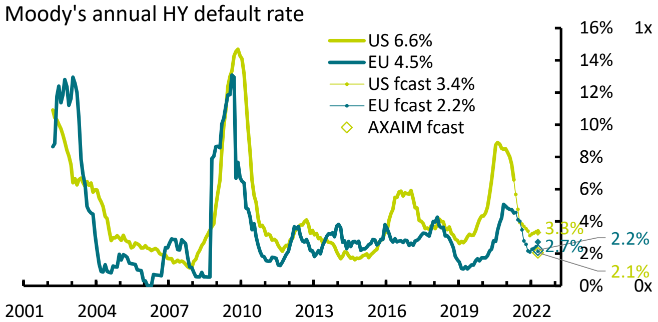
Investment Strategy – Credit

Gregory Venizelos
Credit Strategist
Research – Core Investments

End of a default cycle

Unprecedented monetary and fiscal intervention during the COVID-19 crisis has curtailed the corporate default cycle very effectively. Fears of annual default rates in the mid-teens – comparable to the global financial crisis – have not materialised (Exhibit 11). So, while the default cycle has been more severe than that of the 2015-16 energy-commodity crisis, it has remained below the peaks of both 2008-2009 and the 2000s dot-com bubble.

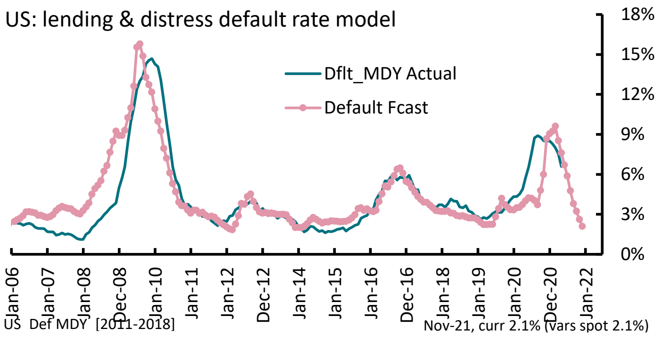
Exhibit 11: Covid default cycle coming to an end and default rate forecasts below spread-implied levels



Source: Moody's, Fed, ECB, InterContinental Exchange (ICE) and AXA IM Research, May 2021

Furthermore, forecasts point to a very benign outlook. Our default rate model, which nailed the default peak (Exhibit 12) albeit with some lag compared to the rapid rise we saw last year, expects the default rate to fall towards its historic lows over the next 12 months. A key tail risk to this forecast is a material relapse in the pandemic, like the emergence of a very transmissive strain that also escapes vaccine efficacy.

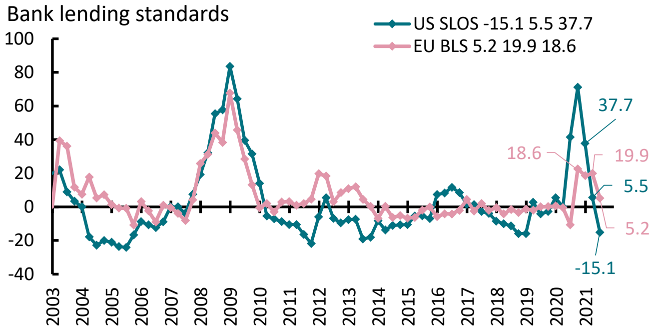
Exhibit 12: Our model expects the US HY default rate to fall towards its historic lows



Source: Moody's, Fed, ECB, ICE and AXA IM Research, May 2021

Another, perhaps more insidious risk is that of companies that fail to benefit sufficiently from the economic rebound and end up folding. This could give rise to an M-shaped default cycle with a second (albeit lower) peak later, say 12-18 months down the road.

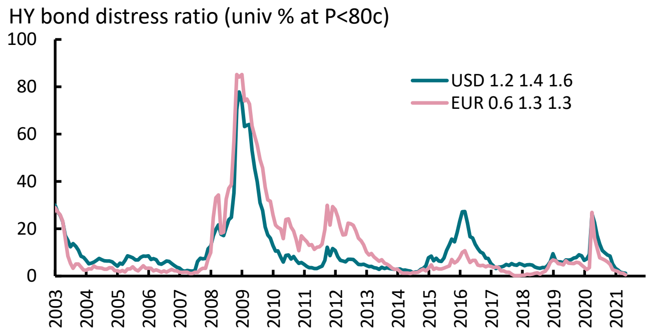
Exhibit 13: Bank lending standards have eased markedly



Source: Moody's, Fed, ECB, ICE and AXA IM Research, May 2021

In the near term, conditions remain very favourable. Bank lending standards have improved markedly on both sides of the Atlantic (Exhibit 13) – a reflection of rebounding banking stocks, a steepening yield curve and ample liquidity provision by central banks. The bank loan officers' survey in the US has dropped close to historic lows (very easy conditions), and high yield (HY) bond market distress ratios are at all-time lows in both Europe and the US (Exhibit 14). These two metrics are the inputs to our two-factor model, justifying the very low default rate expectations.

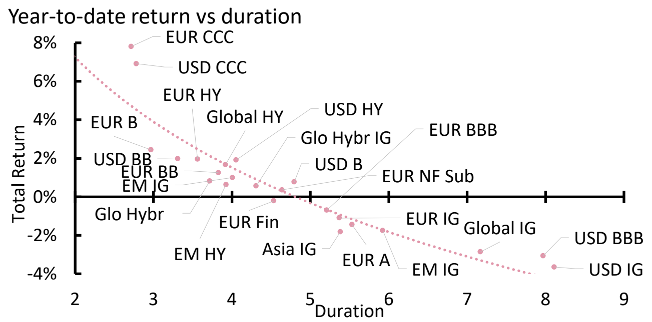
Exhibit 14: HY bond market distress ratio at rock bottom



Source: Moody's, Fed, ECB, ICE and AXA IM Research, May 2021

The benign default outlook underpins our view for higher beta/lower duration credit to continue outperforming lower beta/higher duration credit in 2021 (Exhibit 15).

Exhibit 15: Lower duration credit has outperformed YtD



Source: Moody's, Fed, ECB, ICE and AXA IM Research, May 2021

Investment Strategy – Equity

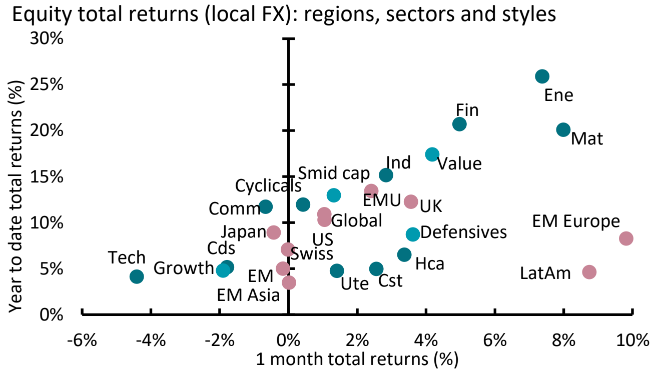
Emmanuel Makonga,
Investment Strategist,
Research – Core Investments

Inflation dictates equity market rhythms

Despite strong earnings results in the first quarter (Q1), market reaction has been muted as inflation risks have weighed on equity performance. At the time of writing, global equities have returned a modest +1.0% over one month (Exhibit 16). In terms of regional equity returns, Emerging Markets Europe (up +9.8%) and Latin America (+8.7%) lead while Japan, where coronavirus cases are rising, is lagging with -0.4% performance. Materials (+8.0%), energy (+7.4%) and financials (+5.0%) are the best performing sectors, while technology has been weak (-4.4%). The current economic environment appears to favour rotation towards value (+4.2%) over growth (-1.9%).

Exhibit 16: EM Europe and Latin America are leading

Equity total returns (local FX): regions, sectors and styles

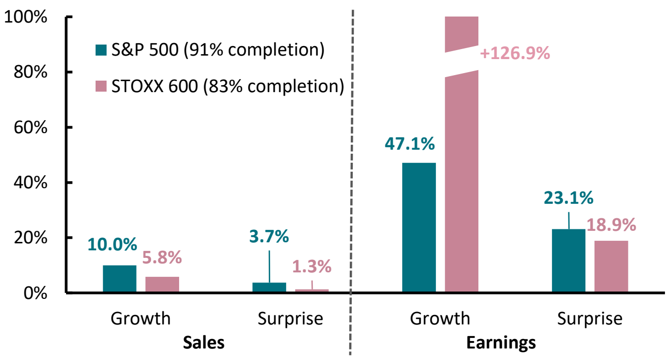


Source: Datastream and AXA IM Research, 19 May 2021

The Q1 earnings season is underway, with positive earnings and sales surprises in the US and Europe (Exhibit 17). In the US, the average earnings surprise is +23.1%, bringing overall earnings growth to +47%, while Europe has higher earnings growth (+126.9%) for a roughly identical overall surprise (+18.9%).

Exhibit 17: Positive surprises across the board

Q1 2021 Earnings season tracker

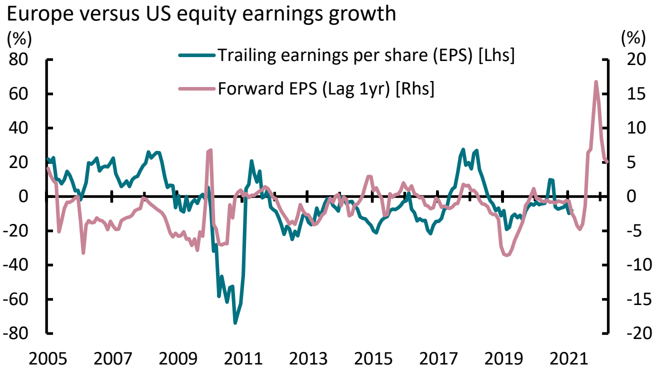


Source: Bloomberg and AXA IM Research, 19 May 2021

Year-to-date, the European stock market (+13.4%) has outpaced the US stock market (+10.9%), a trend that looks likely to persist. Recent economic developments tip the balance in favour of Europe, with the April manufacturing survey improving to a record high while having peaked in the US. Vaccination campaigns are gaining ground in Europe and reopening plans are being deployed across countries. The relative earnings growth consensus for next year is higher for European assets than US and, given the historical relationship, suggests that the trailing earnings differential should be in Europe's advantage for the year ahead (Exhibit 18). The more cyclical profile and more attractive valuations relative to the US should keep benefiting European assets.

Exhibit 18: Europe to outperform US earnings per share growth in 2021

Europe versus US equity earnings growth

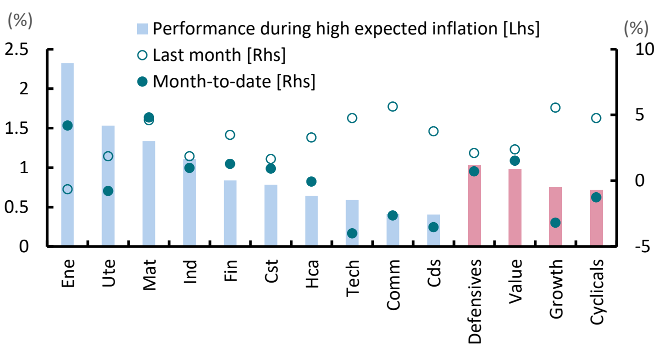


Source: IBES, MSCI and AXA IM Research, 19 May 2021

But the reflation theme is key and inflation risks have elicited some reaction in stock markets, albeit varied across asset classes. Positioning by sector, styles and factors are also key. We investigated equity performance when expected inflation is high (US five-year breakevens in fifth quintile, Exhibit 19). In the current environment of high expected inflation, we note that recent performance seems to follow what has been historically observed across equity categories. We remain positive on equities with a favourable view on the Eurozone and we have downgraded our exposure to global semiconductors to neutral.

Exhibit 19: Inflation has been a key driver for recent stock market performance

Global equities performances and expected inflation



Source: MSCI, Datastream and AXA IM Research, 19 May 2021

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 Cyclical/value		■	
US Financials			■
Global semiconductors		■	
Fixed Income			
Govies			
Euro core		■	
Euro periph		■	
UK		■	
US	■		
Inflation			
US		■	
Euro		■	
Credit			
Euro IG		■	
US IG		■	
Euro HY		■	
US HY		■	
EM Debt			
EM bonds		■	

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

Source: AXA IM Research – As of 21 May 2021

Macro forecast summary

Real GDP growth (%)	2020	2021*		2022*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
World	**-3.7**	**5.6**		**4.3**	
Advanced economies	**-5.3**	**5.3**		**4.1**	
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**	**2.7**	2.8	**2.9**	2.3
UK	**-10.0**	**6.4**	4.6	**5.9**	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 May 2021

* Forecast

CPI Inflation (%)	2020	2021*		2022*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	**0.8**	**2.1**		**1.5**	
US	**1.2**	**3.1**	2.4	**2.4**	2.2
Euro area	**0.3**	**1.5**	1.5	**1.1**	1.3
Japan	**0.0**	**0.0**	-0.1	**0.4**	0.5
UK	**0.9**	**2.0**	1.6	**2.1**	2.0
Switzerland	**-0.7**	**0.1**	0.3	**0.4**	0.5

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

These projections are not necessarily reliable indicators of future results

Download the full slide deck of our May Investment Strategy

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