24 June 2021
Research & Strategy Insights

The European green deal

Global Macro Monthly

Key points

- US developments dominate international markets. The Fed adopted a more hawkish tone at its latest policy meeting. Meanwhile White House spending proposals appear increasingly challenging to deliver.
- Receding virus concerns underpin a more upbeat Eurozone. The European Central Bank remains supportive for now with Pandemic Emergency Purchase Programme purchases continuing to remain elevated.
- China's growth rates soften, although some domestic consumer recovery points to more structure. Yet credit growth deceleration may make the People Bank of China feel uneasy over the pace of deceleration.
- US Treasury yields have been volatile, they remain broadly <1.50%, but real yields have gained at breakeven inflation expense.
- The dollar has also gained significantly since the Federal Reserve meeting, up around 2% against a basket of currencies.

Global Macro Monthly

Investment Strategy

Global Macro Monthly – US

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

Market focus shifts to inflation

Inflation remains a focus for markets. The headline Consumer Price Index (CPI) reached 5.0% in May, and the core measure rose to 3.8% – its highest since 1992. Although higher than expected, this surge continues to appear transitory and we consider May to be the peak, reflecting base effects, supply bottlenecks and energy prices. Elevated inflation is likely to persist across the third quarter (Q3), before showing signs of easing in Q4. Market sentiment is increasingly embracing this scenario – key commodity prices are retreating as supply pressures diminish (lumber) or rains arrive (crops). We expect recent wage pressures to abate across Q3 and into Q4 to confirm the transitory narrative. However, semiconductor shortages look set to persist into 2022 and we maintain a watchful eye on inflation expectations even as they have softened in the latest month.

Inflation is the 'heat' generated from frictions caused by supply and demand mismatches as the economy re-opens. These appear to have weighed on manufacturing output, which has slowed in recent months despite surveys remaining strong. Certain sectors have suffered: May's auto sales fell sharply despite evidence of strong demand. And those mismatches may also be impacting the labour market, with Federal Reserve (Fed) Chair Powell describing a "natural speed limit" to re-employment, providing an alternative to the higher reservation wage argument explained by more generous unemployment benefits. We still expect strong growth, pencilling in 8% annualised gains for Q2 and Q3, but this is likely to be eclipsed by expansion elsewhere. We forecast GDP growth of 6.6% in 2021 and 4.5% in 2022. Consensus is now almost fully in line with our view (6.6% and 4.1%).

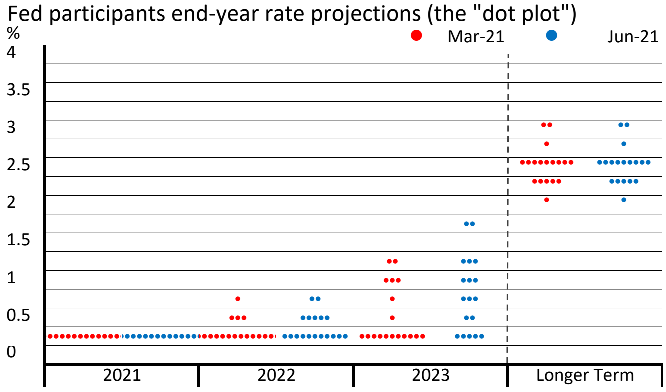
The White House is having difficulty passing a bipartisan infrastructure package. Republicans object to much of the spending and most of the financing, as we expected. Talks with the Republican party have come to nothing: The White House is now negotiating with a smaller moderate group, but with a narrower focus on traditional infrastructure. Democrats still have the option to go it alone, however dissent within their own ranks has cast doubt on delivering all of President Biden's ambitious package via reconciliation. Negotiations look set to remain tortuous. We doubt anything will pass before the summer, or that anything meaningful will be delivered through bipartisanship. We continue to see reconciliation as the only route to many of the White House's goals. But envisage difficult internal trade-offs that will likely reduce the overall package and push back delivery to end-year or early 2022.

Dots Away!

June's Federal Open Market Committee (FOMC) meeting proved something of a turning point. Powell acknowledged that the Fed had started "talking about talking about tapering". The Fed still believes the economy is "a ways" away from the "substantial further progress" it requires to announce asset purchase tapering (currently $80bn US Treasury and $40bn mortgage-backed securities (MBS) per month), but it will now actively review progress over coming meetings. Our interpretation, as Powell described "advanced", rather than a "well in advance" warning, is that a signal about a tapering announcement is now likely in September. We still expect the announcement itself in December.

Exhibit 1: More of FOMC anticipate policy tightening

Fed participants end-year rate projections (the "dot plot")



Source: Federal Reserve Bank and AXA IM Research, 21 June 2021

Markets focused on FOMC participants' future projections of rates (Exhibit 1). The median outlook shifted to include two hikes in 2023, from none in March. Seven members changed their view from no change in 2023 over that time, with most of the rest increasing their expectation of hikes. Moreover, seven members now see at least one hike in 2022 – another two votes would have seen the median first hike shift to 2022.

We draw out three tentative inferences. First, markets have focused on the shift in expected policy changes against a modest increase in the inflation outlook – the Fed's 2023 Personal Consumption Expenditure (PCE) inflation forecast rose to 2.2% from 2.1% – and inferred a lower tolerance for an inflation overshoot than assumed following the shift to average inflation targeting. However, we suggest the Fed is likely responding to a more medium-term build-up of inflation pressures beyond the visible forecast horizon. Second, we contend the Fed will not want to raise the policy rate while it is still purchasing assets. As such, we suggest that at least the seven members that expect a 2022 hike are considering a taper that finishes before the end of next year. This is consistent with our revised outlook for a six-month taper, not the 12-month consensus. Third, the Fed also increased its interest on excess reserves rate by 5 basis points to 0.15%. This implicitly acknowledged the unwind of government-held funds at the Fed and its impact on the short end. Though not a monetary policy change, it will likely add modestly to upward dollar and yield gains.

Global Macro Monthly – Eurozone

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Summer boost…

New COVID-19 cases and hospitalisations have continued to fall in the euro area. This, with the acceleration of the vaccination pace, has allowed a faster than expected reopening. Positive momentum can be seen through Google mobility data: retail and recreation visitors' mobility was just 5% below normal mid-June in Germany, Italy and France, compared to more than 15% below at the end of May. OECD[1] weekly activity trackers point to a narrowing gap compared to 2019 weekly growth levels, from 1.2% on average in the euro area Big Four in May, to 0.8% in the first week of June. In addition, soft indicators such as Purchasing Managers Indices (PMIs) and European Commission surveys have reached new highs. Solid consumer confidence, with major purchases intentions indices already one standard deviation above their long-term average, suggests strong household spending momentum going into the summer. Actually, Banque de France retail sales estimates showed a substantial 8.3% month on month gain in May, as restrictions eased.

Overall faster reopening, stronger momentum at the beginning of the second quarter (Q2) and upward revisions to Q1 growth, at -0.3% quarter on quarter, instead of -0.5%, have led us to upgrade our euro area 2021 growth forecast to 4.4% year on year, up from 3.8%. We see risks as broadly balanced. On the upside, savings rates or excess savings could normalise faster than expected, boosting consumer growth. But the delta variant requires monitoring, and more persistent supply bottlenecks could weigh further on industrial output.

We remain below consensus for 2022 growth at 3.7%, as we believe it will take time to absorb the large labour market slack, while the fiscal impulse will decline slightly despite Next Generation EU support. The European Central Bank (ECB) sees discretionary stimulus falling from 4.5% of GDP in 2021 to 1.5% of GDP in 2022. Euro area GDP should be back to pre-crisis level in Q1 2022, but the gap with pre-COVID-19 trend should remain significant, at circa 2.4% by the end of 2022.

This has important ramifications for our inflation forecast; we see core inflation at just 1.2% in 2022. Admittedly, euro area headline inflation reached 2% in May and we expect it to move above the ECB target in Q4 2021 on the back of the German VAT cut base effect and seasonality distortions. Catch-up effects and supply bottlenecks are also adding near-term upward pressure. But key ingredients to sustained underlying inflationary pressures are lacking. Long-term inflation expectations remain well below the ECB target (1.6% for core in the ECB Survey of Professional Forecasters for instance), and wage growth remains lacklustre. In Germany, new wage agreements for the metal and electronics industry (1%), the steel industry (1.9%) and the textile and clothing industry (1.1%) are much smaller than in the two years prior to the pandemic. And wage demands for ongoing negotiations (retail and construction) are also lower than previous years.

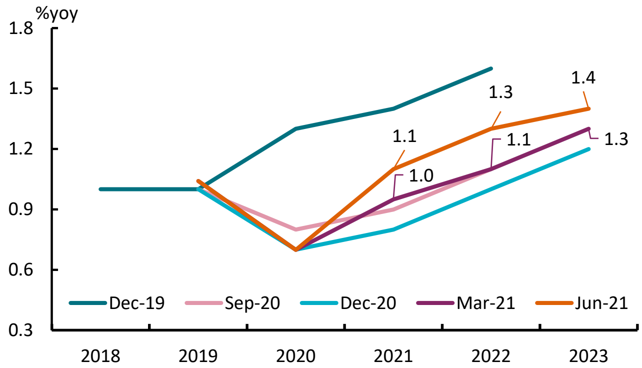
Two things will be worth watching in the months ahead. First minimum wage policies (both German SPD and Greens advocate a minimum wage increase to €12 per hour, that would translate to a 18% increase in the German minimum wage in 2023), and second the European 'Fit for 55 package'. Due to be presented mid-July, the revision of the EU's Emissions Trading System and proposal of Carbon Border Mechanism Adjustment could imply much higher carbon prices, with potential consequences for euro area inflation. For instance, the introduction of Germany's CO2 price in January 2021 is estimated[2] to have increased Germany's Consumer Price Index (CPI) by 0.5% this year.

…and Autumn challenges

At its June meeting, the ECB refrained from signalling a deceleration in the pace of its Pandemic Emergency Purchase Programme (PEPP). And while growth was upgraded, core inflation in 2023 was still significantly lower than the already sub-par pace the ECB was forecasting prior to the pandemic (Exhibit 2). Unless by the end of the PEPP – probably in March 2022 – the ECB brings back its inflation forecasts to where it was in December 2019, purchases under the Asset *Purchase* Programme should rise further, even when ignoring the additional 'price level gap' accumulated since the start of the pandemic.

Exhibit 2: ECB inflation forecasts calling for more

ECB core inflation forecasts



Source: ECB and AXA IM Macro Research, 20 June 2021.

[1] Organisation for Economic Cooperation and Development

[2] Germany Council of Economic experts and Kiel Institute for the World Economy.

Global Macro Monthly – UK

David Page,
Head of Macroeconomic Research,
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A high vax, high virus economy

The number of virus cases has risen again, the latest daily count at 10.8k, up from around 2k for most of Q2. The delta (Indian) variant accounts for 96% of new cases and is more transmissible than the alpha (UK) variant. Yet widespread vaccination has limited the rise in hospitalisations – a genuine success. So far, this combination has only delayed re-opening to 19 July. But it is uncertain how a highly vaccinated, high-virus case economy will perform, with some shine likely coming off growth over the coming quarters.

GDP growth so far this year looks on track to far exceed our hopes. Q1's 1.5% contraction was less than feared, while monthly GDP gains of over 2% in March and April, leaves Q2 on track to surge by 5%qoq. Admittedly, this looks like 'peak rebound'. The gradual unwind of the furlough scheme over Q3, with lingering virus concerns, should see a softer, if still robust 2% gain in Q3 and 1.5% in Q4. We have raised our full-year outlook to 6.8% for 2021 and 5.8% for 2022 (consensus 6.4% and 5.5%). Such strong growth reflects 2020's deep 9.8% contraction. GDP should regain its Q4 2019 high in Q1 2022, but we do not envisage GDP regaining its pre-COVID-19 trend over the foreseeable future.

Inflation rose to 2.1% in May, above the Bank of England (BoE)'s 2% target, for the first time since July 2019. As elsewhere, inflation is being buffeted by base effects, global energy and price pressures appear to reflect timing differences between supply and demand recoveries causing bottlenecks. With these pressures likely to persist in the coming months and support packages unwinding after the summer, we expect inflation to peak in Q4 at circa 3%. However, these developments appear mostly transitory and expect it to fade below target, to around 1.5% by end-2022, averaging 2.0% and 2.1% this year and next (consensus 1.6% and 2.0%). With demand not expected to recover its pre-COVID trend, future pressures depend on the scale of supply-side damage caused by Brexit and the pandemic. We estimate the UK to close its output gap by the end of 2022.

Monetary policy will be governed by this longer-term outlook. The BoE cut its pace of asset purchases in line with ending quantitative easing (QE) this year. We don't expect inflation to exceed target again until 2023. As such we expect tighter financial conditions (rising international yields and firmer sterling) to stay the BoE's hand on interest rates until Q3 2023, a little later than current market pricing (Q1 2023). But if GDP continues to surprise on the upside, hikes could emerge sooner.

Global Macro Monthly – Japan

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Economist (Japan),
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The recovery is on its way

Japan's state of emergency has been effective in reducing the number of new coronavirus cases and has provided some time to ramp up vaccinations. These have accelerated substantially in recent weeks and currently stand at 800k inoculations per day. As expected, a large number of vaccines have been delivered, but logistical bottlenecks have emerged. We expect all over-64s to have been vaccinated by the end of August and 70% of the population to receive two doses by the end of this year.

On the economic front, the manufacturing sector remains robust. April industrial production rose by +2.5% month-on-month (mom) and returned to its pre-crisis level. Output for capital goods rebounded strongly (+14%mom) while auto production was still down due to semiconductor shortages. May real exports edged 0.2% lower after two strong months of gains. The details confirm a large 5.3% decline for auto exports. The April and May average now stands 3.4% above Q1 level. Conversely, domestic demand has been less resilient. April retail sales fell (-4.5%mom) and the May Services PMI remained in contraction territory at 46.5, down from 49.5. We continue to expect a strong recovery in the coming weeks with GDP growth bouncing by approximately 2%qoq for both Q2 and Q3. The rebound in private consumption should be the main driver, boosted by strong savings accumulated by households since the beginning of the crisis – bank deposits rose by ¥32tn, 6% of GDP.

Japan inflation overheating in Japan, as the debate rages in the US and elsewhere, as price pressures remain muted. In addition, several special factors have complicated the reading of the underlying trend, including a move to free education, the Go To Travel campaign and sharp reductions in mobile phone charges. In May, headline CPI reached -0.1%yoy (up 0.3pt). In detail, this was mostly due to a strong rise in energy prices (+4.1%yoy) as food prices fell (-0.9%yoy). Goods prices have been robust (+0.5%yoy) but services prices declined (-0.6%yoy) reflecting mobile phone charges.

The Bank of Japan (BoJ) left its main monetary policy tools unchanged in June but extended the COVID-19 financing support programme until March 2022. It also announced a new financial support programme to address climate change issues, with further detail to be unveiled in July. Net purchases of exchange-traded funds (ETFs) declined further (¥0.1tn in May) and we believe it reflects the BoJ's concern about the potential impact of its increased holdings of risk assets on its balance sheet.

Global Macro Monthly – China

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Growth slows but improves in quality

May's activity data largely missed market expectations, with base effects contributing significantly to the sizable decline in headline growth. Once the distortions are removed, consumer spending and manufacturing capital expenditure (capex) saw higher sequential growth in May, while industrial output and property investment weakened slightly from their buoyant readings in April. Hence, an improvement in the economic structure was evident, even though headline growth was disappointing. The latter could be due to a number of temporary factors, but we think that more sustained growth headwinds – from softening external demand and credit impulse – will start to weigh on the economy in the second half of the year. This, in conjunction with contained inflation pressure, may prompt Beijing to rethink its policy normalisation strategy. One cannot rule out a change in the policy tone that shifts some emphasis back to preserving growth from risk management.

Delving into the key data, industrial production growth eased slightly to 6.6% from 6.8%, according to our two-year compound average growth rate (CAGR) calculation designed to remove the base effects. The softer headline print was consistent with moderating export demand and some supply disruptions in Guangdong – China's manufacturing powerhouse – which suffered a double whammy of power shortages and COVID-19-related restrictions. In addition, supply bottlenecks in semiconductors, and production restrictions relating to decarbonisation have led to lower auto (6.2% two-year CAGR) and steel (5.4%) output growth, although high-end manufacturing production continued to power ahead, growing 13.1%.

Making up for the slower headline growth was an improved economic structure. May data showed a growth rotation from exports and the housing market to consumption and services activity (Exhibit 3). Retail sales growth accelerated, in two-year CAGR terms, to 4.5% from 4.3%. Nearly all categories saw improved sequential growth, except for auto and mobile phones which were hit by chip shortages. Strong holiday spending during the Labour Day holiday boosted restaurant and catering sales, taking their two-year CAGR growth to above 1% for the first time since coronavirus struck. Notwithstanding this, we have to recognise that consumption remains a clear laggard in China's economic recovery so far. Even though an improved labour market – with the unemployment rate falling to a two-year low of 5% – and accelerated vaccination programme are cause for optimism, a lack of accelerated recovery in consumption will represent a major downside risk for the economy.

On the investment side, headline growth ticked down in May, driven primarily by weak real estate activity. On a two-year CAGR basis, property investment growth fell by one percentage point to 9.1%, as policy tightening for the housing market started to bite. Slowing mortgage lending by banks and falling land sales (in volume terms) were ominous signs of more weakness to come. In contrast, infrastructure and manufacturing capex growth accelerated, albeit not enough to offset the real estate weakness. We see further upside in manufacturing investment as stretched production capacity encourages firms to put their improved profits to use.

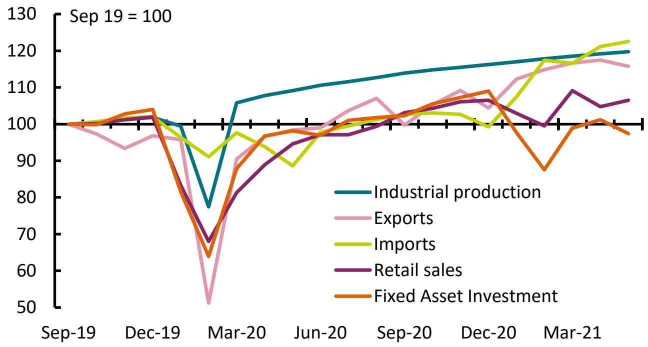
Rising headwinds require some policy rethinking

Looking ahead, we think sequential economic growth is likely approaching a peak in the current quarter and will start to slow in the second half of the year. This partly reflects our view of weakening external demand for Chinese exports, as the global recovery shifts from trade of goods to services activity. Beijing's policy normalisation also contributes to our cautious view, which has manifested so far in falling credit growth and tighter credit controls for the property market and local governments. May credit data showed that China's aggregate financing growth dropped to a 15-month low of 11.1%. The deteriorating credit impulse will weigh on the economy from the third quarter.

The collective policy actions so far have helped to drive a convergence between credit growth and nominal GDP growth, needed to stabilise China's debt ratio. However, any additional tightening from here could be constituted as a policy 'sharp turn' for an economy that still operates on uneven ground. Unless inflation gets out of hand, which we see as unlikely, Beijing could start to feel a little uneasy by the speed of credit growth deceleration and may want to take some pressure off the brake. We continue to see no reserve requirement ratio or interest rate changes this year and expect Beijing to work towards stabilising credit growth at around current levels over the remainder of the year.

Exhibit 3: Recovery continues but remains uneven

China - Level change in economic activity relative to pre-COVID



Source: CEIC and AXA IM Research, 21 June 2021

Global Macro Monthly – EM

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Gradual recovery in EM Asia underway

The revival of the virus has been rather noticeable in Asia recently. Indonesia's daily count has spiked again; Thailand, Malaysia and Taiwan continue to struggle as well; and while India's daily case counts have significantly dropped compared to the peak in May, the level remains elevated. In addition to the struggle to contain the virus, some of the most populous countries in the region (e.g., India, Indonesia, and the Philippines) are also facing difficulty in speeding up vaccination. Within Asia, only Singapore, China and Hong Kong are expected to vaccinate 70% of their populations by end-2021. For the rest of the region, lack of both vaccine supply and forceful government action suggest challenges to that goal.

Despite the slow progress in fighting the virus, economic recovery has continued. First quarter growth improved for the region in general. In particular, for Korea, Taiwan, Singapore and Hong Kong, first quarter (Q1) growth accelerated on the back of strong exports, while recoveries in Indonesia, the Philippines and Thailand were less impressive due to lacklustre consumption growth. Elevated COVID-19 cases and mobility restrictions were the main reasons for the sluggish performance. As for India, Q1 GDP came in stronger than consensus. Growth accelerated to 1.6% year-on-year (yoy) and 7.5% quarter-on-quarter (qoq) compared to 0.5% and 9.9% in the previous quarter. The recovery was broad-based in manufacturing and construction as firms rushed to complete projects following last year's nationwide lockdown, and before the end of the fiscal year.

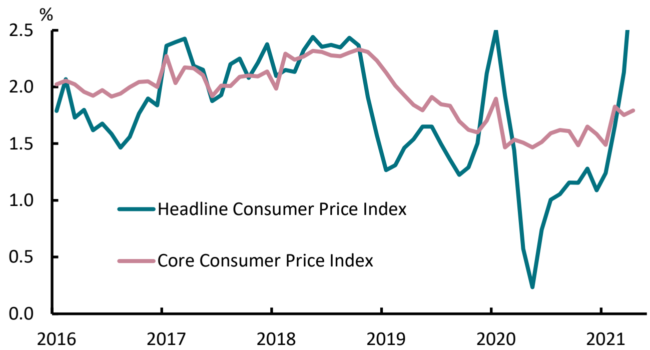
Looking at the more recent high-frequency data, manufacturing activity appears to have softened as the virus has re-emerged. Asia's May headline Purchasing Managers Indices (PMI) eased back from multi-month highs following the re-imposition of social and mobility restrictions. Notably, the Philippines and Thailand saw their PMIs fall into contractionary territory, while the rest of the region remained above the waterline.

On trade, our export model continues to show improvement in export performance for the region. Notably Korea's May export growth for the full month printed another strong reading. Apart from the solid tech exports, non-tech export growth also accelerated. By region, exports to China, the US, the EU, Japan and the Association of Southeast Asian Nations (ASEAN) all gained momentum. We expect the positive trend in Asia export growth to continue, albeit likely at a less buoyant pace.

Inflationary pressure has also been rising in recent months (Exhibit 4). Korea's consumer inflation accelerated to a nine-year high and India's Consumer Price Index (CPI) print also rose sharply to 6.3%yoy. While base effects partially explained the rise, supply-side bottlenecks and higher prices in food and energy were also at play. The near-term trend is expected to remain in the upper range of most emerging market Asia central banks' targets. This likely marks an end to the rate cut cycle.

Exhibit 4: Asia inflation momentum accelerating

Asia ex China CPI and core CPI



Source: CEIC and AXA IM Research, 18 June 2021

However, factors driving recent price upturns are likely to prove transitory and so should not pose too much concern for Asia. At present, policy setting for the region remains unchanged, with most central banks expected to keep rates on hold throughout this year. As long as COVID-19 risks persist, some sort of restrictions will remain in place, putting a cap on the pace of the recovery. However, as central banks consider policy normalisation, assuming vaccination programmes continue to reduce the risks to growth, policymakers may become less likely to pay heed to potentially transitory jumps in prices.

Coupled with the gradual growth recovery, governments in Asia are slowly rolling back stimulus. However, fiscal policy will remain expansionary throughout this year. Recently, the Indian government announced a fiscal package in the form of free vaccines for all as well as extended free food allocation for another five months. The Finance Ministry in Thailand also indicated more stimulus is in the pipeline.

Investment Strategy – Cross-assets

Greg Venizelos,
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Research – Core Investment

Fed inflation shift not a torpedo for markets

It appears that the US Federal Reserve (Fed) is closer to achieving its inflation target than expected when the framework of "average inflation" was first presented. Some officials have brought forward their expected timing of the first hike in the policy rate. Rate rises in 2023 look very likely now with the risk of a 2022 hike increasing. However, markets remain sanguine with yields unchanged from last week, equities a bit lower and credit spreads almost unchanged. The bottom line is that growth is strong in developed economies, liquidity is plentiful, balance sheets in good shape and rates set to remain low for now.

Investment Strategy – FX

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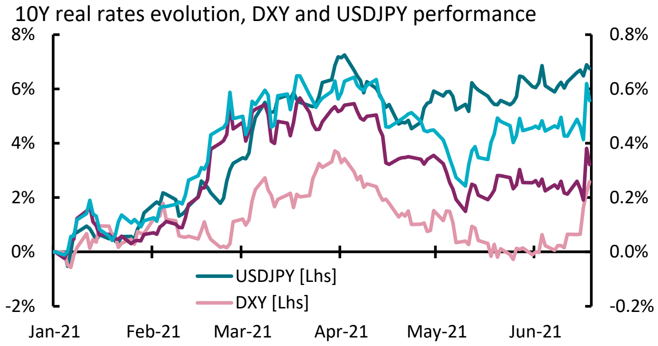
The Fed comes out of hibernation

Exhibit 5: Yen already low prior to US real rate rebound

10Y real rates evolution, DXY and USDJPY performance

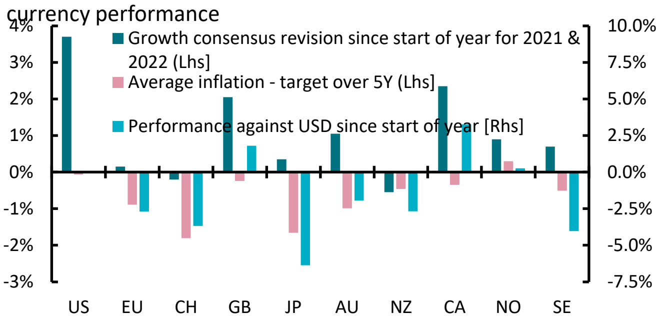


Source: Bloomberg and AXA IM Research, 21 June 2021

The Fed has expressed uncertainty on the transitory nature of inflation and brought forward its rate hike expectations. This has shifted policy expectations, pushing US real rates a bit higher. The appreciation in the US dollar was notable versus most currencies, except the Japanese yen. The yen had not strengthened when US real rates retreated, nor did it weaken as they rose last week. This may reflect yield curve control in Japan, where fixing the nominal rate pushes real rates lower as global reflation rises (Exhibit 5). This may make the yen a candidate to short against the dollar, although yen valuation is already very low. Shorts in euro or Swiss franc might be better as the European Central Bank and Swiss National Bank face large 'inflation gaps' keeping them from turning hawkish. In addition, beyond recent fresh optimism on vaccines and the economy reopening, growth revisions are subdued versus the US (Exhibit 6). The euro and Swiss franc also appear less undervalued than other currencies – Swiss franc shorts potentially offer more carry.

Exhibit 6: Australia and Sweden could follow Canada and UK's hawkish turn as growth is revised higher

Revision on growth consensus, inflation gap and currency performance



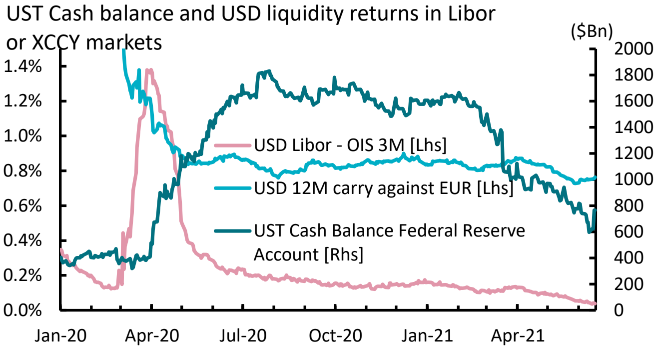
Source: Bloomberg and AXA IM Research, 21 June 2021

Clearing the path for others to follow

The British pound and Canadian dollar have benefited from better growth prospects this year, while inflation has been in line with targets, which makes a hawkish shift by the Bank of Canada and Bank of England plausible. The Canadian dollar is already a bit expensive, in our view, but still worth buying on weakness. The Australian dollar and Swedish krona have lagged this year despite moderate inflation gaps and supportive growth forecasts. Strong commodity prices amid reflation and infrastructure spending should be supportive for the former. Australia and Sweden have seemingly recovered well from the pandemic's impact and the Reserve Bank of Australia and Swedish Riksbank may be the next candidates to turn hawkish.

Exhibit 7: Excess US dollar liquidity has driven dollar carry to historic lows

UST Cash balance and USD liquidity returns in Libor or XCCY markets



Source: Bloomberg and AXA IM Research, June 2021

The Fed increased its interest on excess reserves rate by five basis points last week to address a fall in money market yields. This recent excess of dollar liquidity was exacerbated by the US Treasury reinjecting its large cash balance back into the real economy (Exhibit 7). This has driven the carry of the dollar to historic lows and partly explains prior dollar weakness. We expect this dynamic to diminish going forward.

Investment Strategy – Rates

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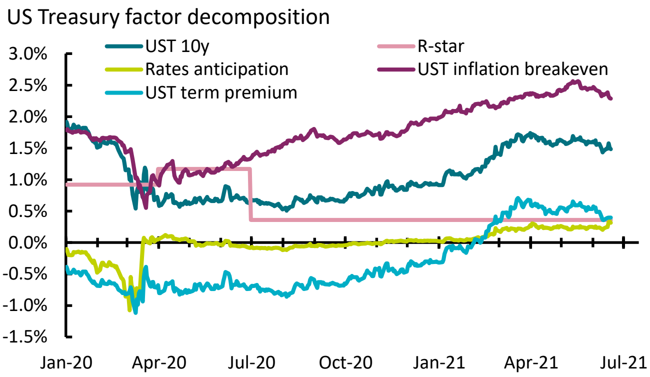
Treasury: Still the main call for 2021

After a challenging first quarter (Q1) for the US Treasury market (-4.2%), it is now on track to stage a somewhat better performance in Q2 (+1.3%). Some market participants and officials have started a discussing the near-term stance of US monetary policy, but the Federal Open Reserve remains reluctant to add to this debate and continues to “monitor the implications of incoming information for the economic outlook”. Together with technical factors, we believe the Fed’s new strategy of acting upon data (rather than forecasts) and tolerating inflation in excess of 2% for some time are the main drivers behind the stabilisation of common factors affecting Treasury yields over the past two months. Interestingly, both the term premium and Treasury Inflation-Protected Securities (TIPS) breakevens have stabilised in Q2 (Exhibit 8), while rate expectations have only recently repriced a little for the shift in Fed rate expectations.

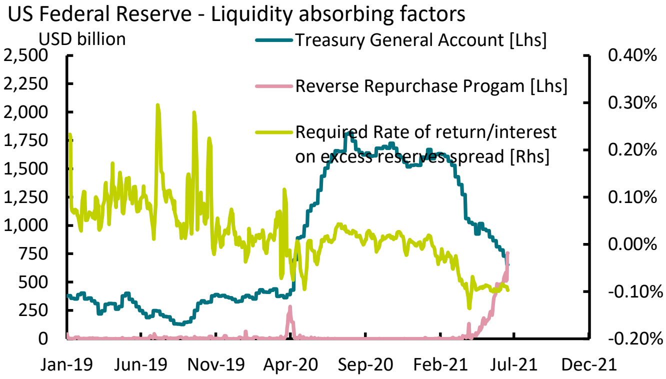
Exhibit 8: US Treasury factors have stabilised in Q2



Source: Bloomberg and AXA IM Research, 21 June 2021

However, fundamentals are not the only variable in our investment framework. With the benefit of hindsight, we argue that two technical variables might have contributed to stabilise the Treasury market after a quite heavy Q1. The first is liquidity, more precisely the location of excess liquidity within the system. Exhibit 9 shows the evolution of two liquidity absorbing facilities available at the Federal Reserve: The Treasury General Account (TGA) and the Reverse Repurchase facility (RRP). Evidently, liquidity has shifted from the public sector TGA (-$400bn) to the private sector RRP (+$600bn), during Q2, with obvious implications for the spread between repo and interest on excess reserves (IOER).

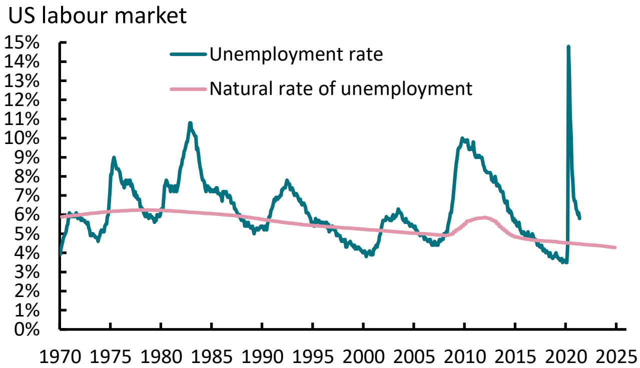
Exhibit 9: Technical factors behind the UST rally



Source: Bloomberg and AXA IM Research, 21 June 2021

The second is negative carry. As the Treasury market showed tentative signs of stabilisation in early Q2, the value of time versus the spot forecast of higher yields developed into an increasingly binding constraint for bond investors. The difference between forecasting and investing is well rooted in the value of time and the negative carry often associated with shorting bonds or not being invested relative to a benchmark.

Exhibit 10: Deepest & shortest modern recession



Source: Bloomberg and AXA IM Research, 21 June 2021

Looking ahead, we believe the market is now fully internalizing technical factors into current valuations, which circles back to fundamentals and the key question of temporary inflation. Commodity markets are up anywhere between 15% and 22% year to date, while the Fed’s narrative hasn’t really drifted away from “temporary”. No central banker dares to define “temporary” in terms of months or quarters, thus allowing for a continuum of interpretations among investors. Furthermore, the labour market is likely to contribute to the discussion about the risk of a longer (than expected) transitory inflation episode. At the current pace of hiring (478,000 non-farm payrolls on average in 2021), it won’t take long for the unemployment rate to approach its natural level (Exhibit 10), thus fuelling speculation over increasing wage pipeline pressure and more persistent inflation.

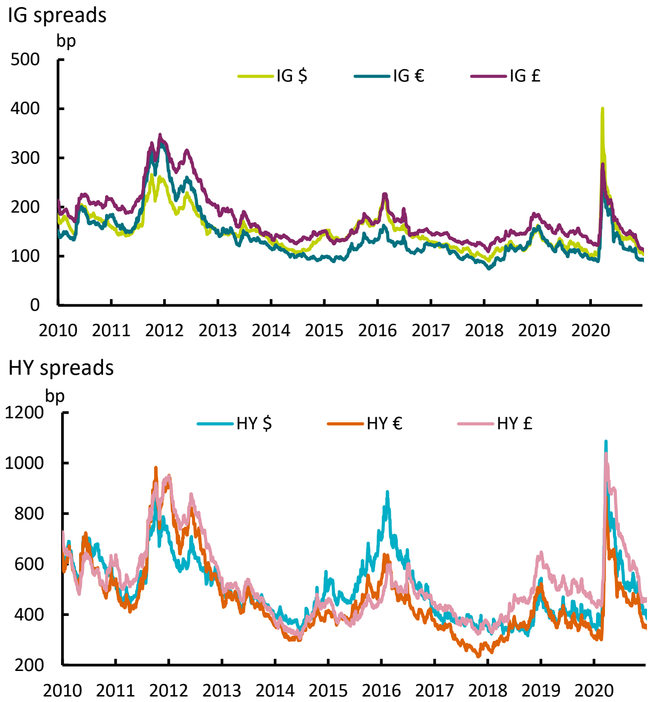
Investment Strategy – Credit

Gregory Venizelos
Credit Strategist
Research – Core Investments

Credit markets: Cool as a cucumber

Credit markets continue to be unperturbed by exogenous factors, the most recent being the Federal Reserve (Fed) policy meeting on 16 June. The immediate aftermath saw US Treasury bond yields rise by 10 basis points (bp) and equity markets correct. By contrast, credit default swap indices (CDX) in the US widened by less than 1bp in investment grade (IG) and by less than 5bps in high yield (HY).

Exhibit 11: Credit spreads back to the lows of the post global financial crisis period (IG top, HY bottom)



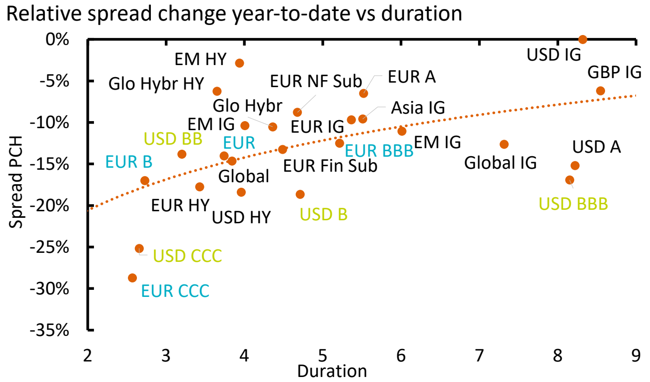
Source: InterContinental Exchange (ICE) and AXA IM Research, 21 June 2021

It appears credit is taking the longer view over uncertainties in macro fundamentals and central bank policy. Rather than sharing in intermittent bouts of angst in interest rate and equity markets, spreads have been tightening since March 2020's COVID-19 shock (Exhibit 11). A reflection of improving pandemic dynamics, rebounding economic activity and strong market technicals thanks to central bank liquidity. In both IG and HY spreads are currently at, or have made, new post-global financial crisis lows.

Strong spread compression

The ample liquidity that has suppressed interest rates has also pushed investors down the credit quality curve, driving spread compression – higher beta spread to outperform lower beta spreads in beta adjusted terms. The compression theme year to date has been quite directional with duration (Exhibit 12). This reflects investor caution regarding duration risk, as interest rates have rebounded from their pandemic lows. The lower end of the credit spectrum, CCC-rated credit, stand out with their very strong spread retracement. BBs on the other hand, at the cusp between IG and HY, have underperformed in relative terms due to the impact of the large wave of fallen angels in 2020 (credits downgraded from IG to HY).

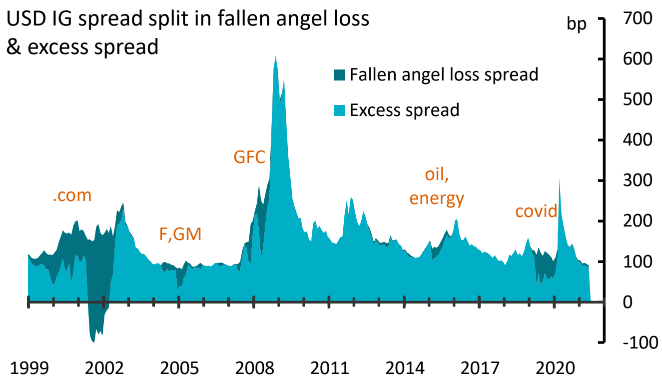
Exhibit 12: Relative spread change year to date has correlated inversely with duration across credit indices



Source: ICE and AXA IM Research, 21 June 2021

The fallen angel cycle has been the worst since the financial crisis and of material impact on IG portfolio performance. Exhibit 13 shows USD IG spread history, split between fallen angel risk (dark) and excess spread (light). Passive investors who may had bought USD IG in the 12 months preceding March 2020 would have lost as much as 60% of the spread due to fallen angels. This emphasises the value of active investing with more defensive positioning on higher risk IG credits, e.g. BBB- rated credits with higher leverage.

Exhibit 13: Significant spread erosion due to fallen angel risk during Covid



Source: ICE and AXA IM Research, 21 June 2021

Investment Strategy – Equity

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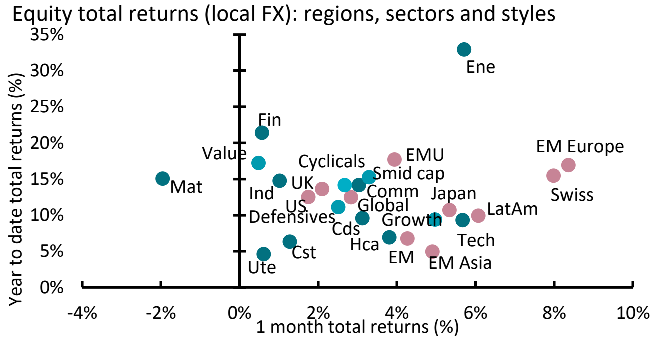
Cruising after take-off

The execution of a flight consists of five main phases: Taxiing, take-off, cruising, landing and finally taxiing. The economic cycle follows a similar sequence, as does the performance of equities. After a swift take-off, the equity market gained +67.5% post-COVID-19 in 2020, while the cruise phase i.e. year-to-date (YTD) has seen gains of +12%. Over the past month, European emerging markets (+8.4%) and Switzerland (+8%) have outperformed on a regional basis (Exhibit 14). Across sectors, energy (+32.9% YTD) continues to deliver a stellar performance while materials have shown some signs of weakness (-2% over one month). Retreating breakevens are turning rotation towards Growth (+5.0%) from Value (+0.5%).

Exhibit 14: Energy outshines everything year-to-date

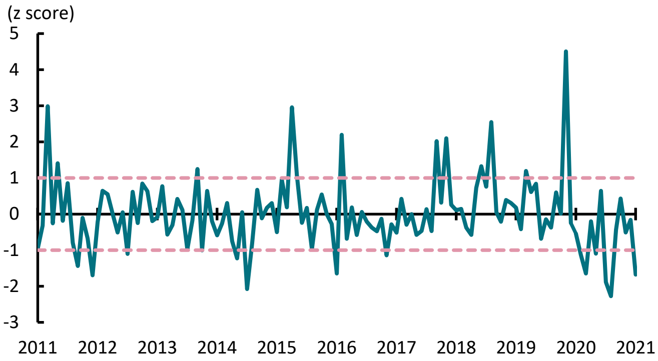


Source: Datastream and AXA IM Research, 21 June 2021

During flight, of course, there can be turbulence; or in the case of markets, volatility. The level of implied volatility has been stabilising – averaging 17.3 in June and showing a clear break below the resistance level of 20. Still, some risks persist, notably the difficulty of achieving collective immunity against infection. This uncertainty has resulted in a historically low realised volatility compared to implied volatility (Exhibit 15) and a high term premium between one-month and three-month volatility contracts.

Another notable development in recent weeks is that we have seen the correlation between global equities and bonds return to positive territory for the first time in three years. In such a regime, the hedging property of bonds no longer applies as a rise in nominal yields would penalise risky assets. This phenomenon is not uncommon, as shifts in the correlation regime can take place under certain market conditions. It is therefore important to understand the prevailing environment behind such a shift.

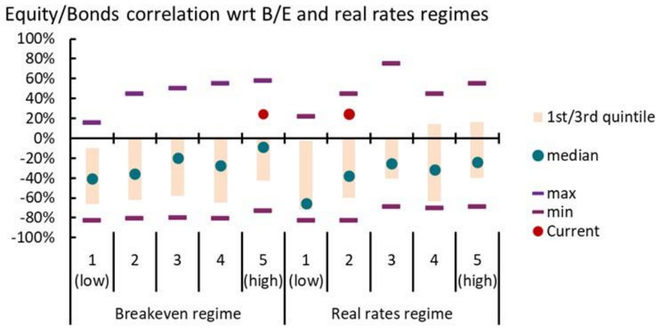
Exhibit 15: Realised volatility is low compared to implied



Source: Bloomberg and AXA IM Research, 21 June 2021

We have investigated the levels of correlation as a function of the breakeven (B/E) regime in the first instance as well as real rates in the second (Exhibit 16). We note that while negative, the correlation tends to increase with both of these nominal yield components. Currently we are in a high regime in B/E (fifth quintile) and a medium/low in real rates (second quintile). This suggests that the current level of correlation between global equities and nominal yields (+24.6%) is historically high. The expectation for further gains in real rates in response to a more hawkish tone from the Federal Reserve could cause the correlation level to rise yet further, which would be negative for equity markets.

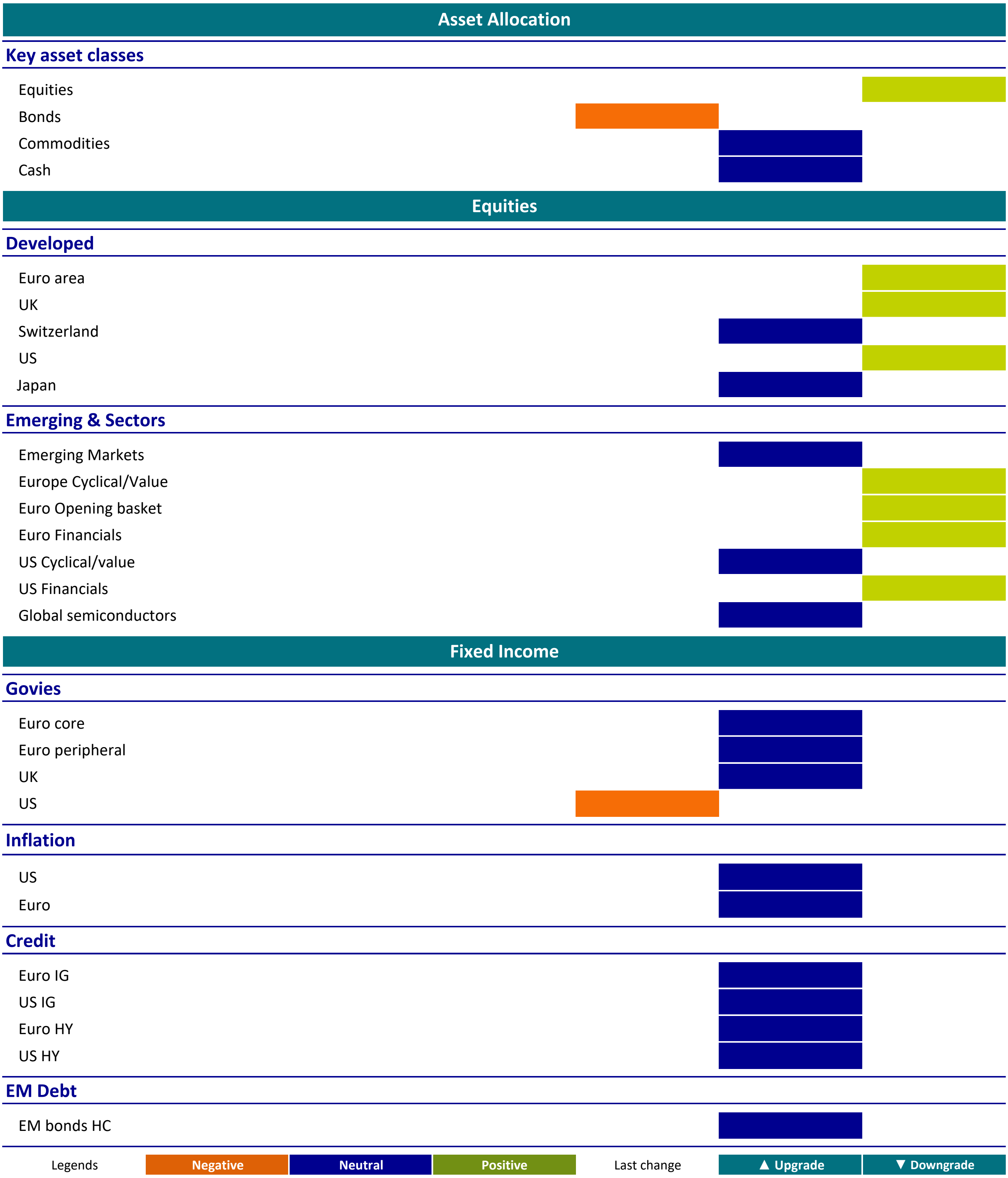
Exhibit 16: Higher real rates could increase equity/bonds correlation



Source: Bloomberg, MSCI and AXA IM Research, 21 June 2021, MSCI World/ US Treasury bond index monthly return 12-month correlation

As the economy reopens and the recovery in activity takes hold, peaking macro momentum in the US is pointing toward a subsequent softening. Indeed, the March surge in the US Manufacturing Purchasing Managers' Index (PMI) to 64 has been followed by lower levels, and currently stands at 61.2. Moreover, risks remain on the pandemic front, with the faster spreading Delta variant and the difficulty in achieving collective immunity. Taking all these moving parts into account, we hold our positive stance on equity markets while maintaining a positive bias towards the Eurozone and the UK.

Recommended asset allocation



Source: AXA IM Macro Research – As of 23 June 2021

Macro forecast summary

Real GDP growth (%)	2020	2021*		2022*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
World	**-3.6**	**5.8**		**4.3**	
Advanced economies	**-5.3**	**5.4**		**4.2**	
US	**-3.4**	**6.6**	5.7	**4.5**	4.0
Euro area	**-6.8**	**4.4**	4.3	**3.7**	4.2
Germany	**-5.3**	**2.7**	3.4	**3.4**	3.8
France	**-8.3**	**5.9**	5.5	**3.1**	3.7
Italy	**-8.9**	**4.8**	4.2	**4.1**	4.0
Spain	**-11.0**	**5.2**	5.7	**5.0**	5.7
Japan	**-4.9**	**3.0**	2.8	**3.3**	2.3
UK	**-10.0**	**6.8**	4.6	**5.8**	5.8
Switzerland	**-3.0**	**3.6**	3.2	**3.3**	2.9
Emerging economies	**-2.5**	**6.0**		**4.4**	
Asia	**-1.1**	**7.4**		**5.1**	
China	**2.3**	**8.5**	8.4	**5.5**	5.4
South Korea	**-0.8**	**4.0**	3.5	**3.0**	3.1
Rest of EM Asia	**-5.3**	**6.5**		**4.7**	
LatAm	**-7.3**	**5.0**		**2.7**	
Brazil	**-4.1**	**4.7**	3.3	**2.5**	2.4
Mexico	**-8.5**	**5.4**	4.4	**2.3**	3.0
EM Europe	**-2.3**	**4.2**		**3.6**	
Russia	**-2.8**	**3.0**	2.9	**2.5**	2.6
Poland	**-2.7**	**4.1**	4.1	**4.6**	4.7
Turkey	**1.6**	**6.1**	5.1	**4.6**	3.9
Other EMs	**-3.7**	**3.3**		**4.1**	

Source: Datastream, IMF and AXA IM Macro Research – As of 23 June 2021

* Forecast

CPI Inflation (%)	2020	2021*		2022*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	**0.8**	**2.3**		**1.7**	
US	**1.2**	**3.5**	2.4	**2.6**	2.2
Euro area	**0.3**	**1.7**	1.5	**1.5**	1.3
Japan	**0.0**	**0.0**	-0.1	**0.5**	0.5
UK	**0.9**	**2.0**	1.6	**2.1**	2.0
Switzerland	**-0.7**	**0.4**	0.3	**0.5**	0.5

Source: Datastream, IMF and AXA IM Macro Research – As of 23 June 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	Q2-21	Q3-21	Q4-21	Q1-22
United States - Fed	Dates	0-0.25	27-28 Apr 15-16 Jun	27-28 Jul 21-22 Sep	2-3 Nov 14-15 Dec	25-26 Jan 15-16 Mar
	Rates		unch (0-0.25)	unch (0-0.25)	unch (0-0.25)	unch (0-0.25)
Euro area - ECB	Dates	-0.50	22 Apr 10 Jun	22 Jul 9 Sep	28 Oct 16 Dec	20 Jan 10 Mar
	Rates		unch (-0.50)	unch (-0.50)	unch (-0.50)	unch (-0.50)
Japan - BoJ	Dates	-0.10	26-27 Apr 17-18 Jun	15-16 Jul 21-22 Sep	27-28 Nov 16-17 Dec	TBC TBC
	Rates		unch (-0.10)	unch (-0.10)	unch (-0.10)	unch (-0.10)
UK - BoE	Dates	0.10	6 May 24 June	5 Aug 23 Sep	4 Nov 16 Dec	3 Feb 7 Mar
	Rates		unch (0.10)	unch (0.10)	unch (0.10)	unch (0.10)

Source: AXA IM Macro Research - As of 23 June 2021

These projections are not necessarily reliable indicators of future results

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