21 July 2021
Research & Strategy Insights

Negative Delta

Monthly Investment Strategy Oped

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Key points

- The "delta wave" is impairing the speed of the recovery. Still, the impact of each wave on economic activity has been lower than the previous one. The same pattern is likely to be found this time.
- The central banks' prudent approach, even if the face of spectacular inflation prints in the US, is being vindicated. Finding the right dosage for fiscal policy is trickier.
- Yields have defied expectations to rise further into the third quarter, driven by a confluence of technical & macro factors as well as sentiment. Downward pressures are set to last over the summer before events in September allow yields to rise into year-end.

It's not over 'til it's over

The success of the ongoing global reopening was always conditional on the outcome of the race between the vaccines and the emergence of aggressive variants. Even in countries where the vaccination programme had been swift, collective immunity at the beginning of the summer had not yet been reached. Pressure to lift restrictions was understandably high, and hasty decisions to normalize have sent the pandemic soaring again in some countries, notably the UK which once again acts as a sort of live "lab experiment" for other advanced countries. Despite more than 50% of the population twice vaccinated, and strong evidence the inoculations provide high protection against the severe forms of the disease, pressure on the healthcare system is mounting, and there is no better signal of the level of concern than the fact the US Centre for Disease Control warned against travelling to the UK upon "Freedom day", on July 19, when most remaining restrictions were in principle lifted there. More generally, the tourism season, so crucial for Southern European countries, is now in jeopardy. Understandably, the equity market is taking notice, with investors revising down their expectations for a full normalization in the second half of 2021.

It is not all "doom and gloom" though. In most advanced economies, every new wave has had a lower impact on economic activity than the previous one. There are good reasons to think the same pattern will apply to this one. A key development there is the beginning of a shift towards tailoring restrictions to vaccination status. This raises all sorts of thorny legal and political issues there but allowing the continuation of contact-dependent activities for fully vaccinated people will eliminate the need for blanket prohibitions in key services industries which have been badly hit by the pandemic. France and Italy are clearly taking this route. A very positive side-effect of this approach is that many people so far hesitating to vaccinate are now strongly incentivised to do so, which of course will foster progress towards collective immunity.

It will be impossible to avoid all the adverse effects on the growth trajectory though. Beyond government decisions, the impact of a new wave on activity depends on people behaviour, and a measure of "precautionary avoidance", including by people already fully vaccinated, will likely affect contact-dependent activities. On the supply-side, disruptions are likely to continue, if

only as “contact tracing” forces some workers to isolate (in the UK the impact is already visible in key sectors such as retailing and transport). Looking beyond domestic industries, the resurgence of Covid-related concerns in the West should act as a reminder that in many countries, vaccination rates remain too low to seriously dent another wave. This is of course the case in many developing countries, but some advanced nations such as Japan and Australia are in the same situation. This will impair the overall normalisation of the world economy and hence global trade.

The “Delta wave” vindicates the central banks’ prudence. The Federal reserve (Fed)’s dovish signalling, increasingly under pressure given the spectacular inflation prints of the last few months, is fully warranted. Supply-side disruptions may continue to push prices in some sectors, but the market seems to have internalized the idiosyncratic nature of these shocks and that inflation is going to follow a “hump shape” in 2021/2022 – our baseline since the start – is becoming very consensual. In Europe, the European Central Bank (ECB) is likely to make its forward guidance consistent with the conclusions of its strategy review, with a shift towards outcomes – observing an actual, persistent acceleration in observed core inflation before making any decision towards policy normalization – away from an outlook-based approach focusing on changes in the forecast trajectory.

While we can still count of strong monetary support – with the removal of stimulus potentially postponed accommodating the Delta variant hit – finding the right dosage for fiscal policy may be a bit thornier. With the reopening in full swing since the spring, governments were preparing to remove some of the “emergency programmes” which have protected household income and corporate finances in the worst-hit sectors. In a “mixed environment”, with some measure of restrictions still in place but no blanket prohibitions, government may hesitate to prolong those programmes once more. From this point of view, again, the UK will provide an interesting “lab experiment” (the “furlough scheme”, which resembles the German and French “in work” unemployment benefits, is for now projected to be phased out).

What’s the story in transitory?

Investors continue to be puzzled by the price action in government debt and ponder on the most likely path for yields into yearend. Yields have defied expectations to rise further during the second quarter (Q2), driven by declines in real rates since the end of March and ditto in inflation breakevens since the end of April. It looks likely that downward pressures will remain in place over the summer, before a succession of decisions in September – including a Fed signal on tapering, passage of spending bills and an increase in the debt ceiling – should allow yields to rise into year-end. Our valuation signals suggest that the US Treasury (UST) yield is trading below its fair value by 30-40 basis points for the 10-year maturity. A confluence of factors has conspired for the persistent retreat in yields since Q1: macro, technical and sentiment. Some of them are set to persist near term and some are not.

Household finances and pent-up demand, more broadly, look poised to sustain above trend economic momentum into year-end. But the emergence of the Delta Covid variant is a headwind to the reopening, which varies across economies. Countries with high vaccine rates are allowing the variant to spread; headwinds should be light on minor economic disruption and increased precautionary behaviour. Countries with lower vaccine rates may have to impose stricter restrictions to dampen the spread, resulting in stronger headwinds. Supply constraints are also weighing on the pace of economic rebound, reflecting short-term issues in labour markets, raw materials and semiconductor chips, for example. Political gridlock in the US has further dampened hopes for further fiscal support by the Biden administration. We expect more clarity of progress of a still large fiscal package after the summer.

The drawdown of the Treasury General Account has added liquidity in addition to that by the Fed quantitative easing (QE) program. While much of this liquidity found its way back to the Fed balance sheet via reverse repos, this is unlikely to be a permanent home, suggesting that ample liquidity will continue to slosh around the system. This adds downward pressure on UST yields, and it may persist through most of Q3. Furthermore, UST yields remain attractive to foreign investors in FX-hedged terms, offering approximately 1% of yield pickup over Bunds in 10y, another technical that is likely to remain in place through the summer. At the same time, UST supply is to remain constrained until debt ceiling issues are resolved, leaving net supply at zero after Fed purchases. While this factor should start easing into September, it will leave UST markets undersupplied through the summer.

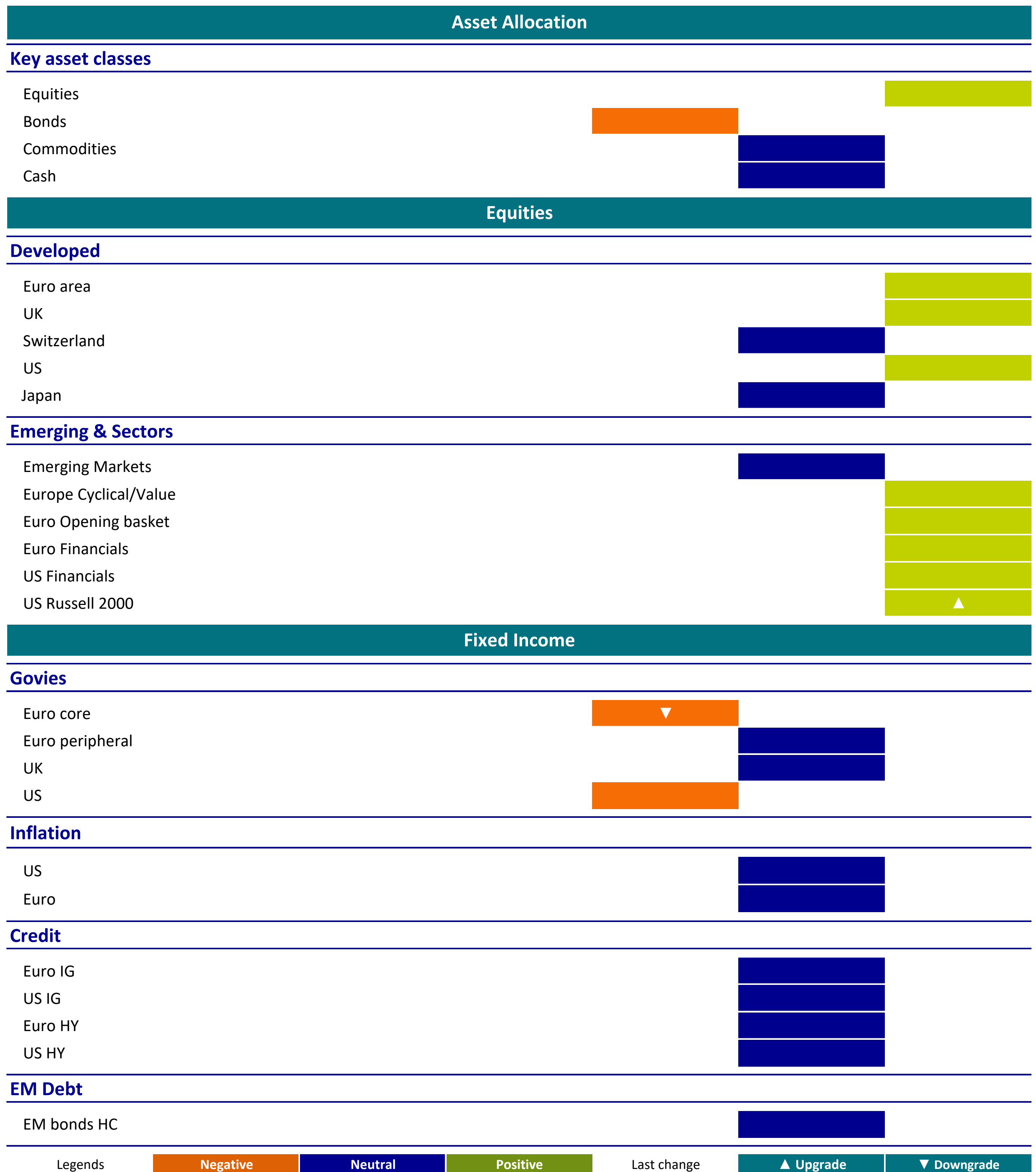
On the other hand, the punitive roll down and negative carry which discouraged short positioning into Q2 due to the steepness of the UST curve has been reduced after some notable flattening in Q2. Furthermore, institutional investor positioning appears to have reverted to neutral and a large part of speculative shorts has been reportedly closed out as UST yields dropped further

in early July. Limited short positioning can pave the way for an upward trajectory in yields. On the other hand, the abrupt decline in yields in the first week of July may have had an adverse effect on pension funds' coverage ratio, leading to purchases of long maturity govies as a hedge.

Some recent declines notwithstanding, risky assets have held up well in the face of declining yields. Outside tail risk scenarios we remain constructive on credit into. Low interest rates and stable earnings should support fundamentals, driving a deleveraging via the denominator (debt/earnings). Furthermore, the fallen angel/default cycles are drawing to a close and positive rating migration is a tailwind for credit portfolio returns. Likewise, equity markets are underpinned by monetary and fiscal policy and the rebound in earnings as per analysts' expectations for 2021. 2022 earnings outlook is facing some headwinds due to the Delta variant but remains constructive on the whole. The rotation trade in favour of value vs growth has broken down in Q2, as real rates retreated to early 2021 levels. Yet, we think there is scope for it to resume in Q4, consistent with our expectation for higher yields.

Download the full slide deck of our July Investment Strategy

Recommended asset allocation



Source: AXA IM Macro Research – As of 21 July 2021

Macro forecast summary

Real GDP growth (%)	2020	2021*		2022*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
World	**-3.6**	**5.7**		**4.3**	
Advanced economies	**-5.3**	**5.3**		**4.2**	
US	**-3.4**	**6.4**	6.7	**4.5**	4.1
Euro area	**-6.8**	**4.4**	4.4	**3.7**	4.4
Germany	**-5.3**	**2.7**	3.3	**3.4**	4.2
France	**-8.3**	**5.9**	5.5	**3.1**	3.9
Italy	**-8.9**	**4.8**	4.5	**4.1**	4.2
Spain	**-11.0**	**5.2**	5.7	**5.0**	5.7
Japan	**-4.9**	**2.7**	2.6	**3.4**	2.8
UK	**-10.0**	**6.8**	6.6	**5.8**	5.3
Switzerland	**-3.0**	**3.6**	3.5	**3.3**	2.9
Emerging economies	**-2.5**	**6.0**		**4.4**	
Asia	**-1.1**	**7.4**		**5.1**	
China	**2.3**	**8.5**	8.7	**5.5**	5.6
South Korea	**-0.8**	**4.0**	4.1	**3.0**	3.2
Rest of EM Asia	**-5.3**	**6.5**		**4.7**	
LatAm	**-7.3**	**5.0**		**2.7**	
Brazil	**-4.1**	**4.7**	4.8	**2.5**	2.2
Mexico	**-8.5**	**5.4**	5.6	**2.3**	3.1
EM Europe	**-2.3**	**4.2**		**3.6**	
Russia	**-2.8**	**3.0**	3.3	**2.5**	3.3
Poland	**-2.7**	**4.1**	4.7	**4.6**	4.7
Turkey	**1.6**	**6.1**	5.7	**4.6**	5.7
Other EMs	**-3.7**	**3.3**		**4.1**	

Source: Datastream, IMF and AXA IM Macro Research – As of 20 July 2021 * Forecast

CPI Inflation (%)	2020	2021*		2022*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	**0.8**	**2.3**		**1.7**	
US	**1.2**	**3.6**	3.5	**2.6**	2.6
Euro area	**0.3**	**1.7**	1.8	**1.5**	1.4
Japan	**0.0**	**0.0**	0.0	**0.5**	0.5
UK	**0.9**	**2.2**	1.7	**2.1**	2.3
Switzerland	**-0.7**	**0.4**	0.4	**0.5**	0.5

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

Source: AXA IM Macro Research - As of 20 July 2021

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