21 July 2021
Research & Strategy Insights

Clouds darken Summer re-opening

Global Macro Monthly

Key points

- COVID-19 again haunts markets – the delta strain gains.
- A large re-opening recovery is underway. Yet virus re-emergence and supply-chain constraints are taking the shine off the pace of rebound.
- Inflation is rising synchronously, driven by base effects, commodities and bottlenecks. Mostly expectations remain well anchored suggesting a transitory rise.
- Some developed markets' central banks are reducing asset purchases; the Federal Reserve remains "a ways" from such an announcement.
- Technicals and positioning account for lower yields, although recent dips suggest risk-off delta fears.
- Credit and equity remain well supported, although value-growth rotation in equity has reversed on lower yields. We prefer euro credit spreads to US.

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Global Macro Monthly – US

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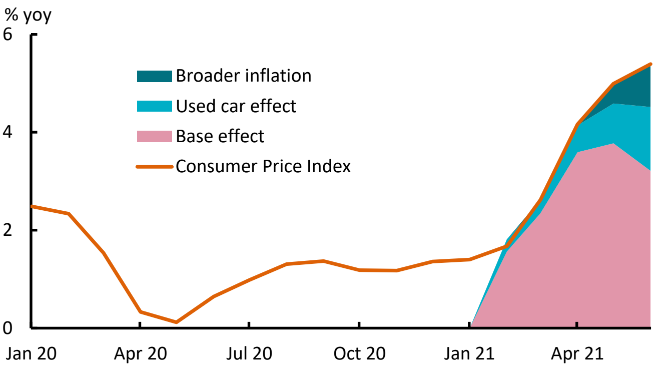
Market focus shifts to inflation

Inflation continues to rise. June's annual rate rose to 5.4% – its highest since July 2008, defying predictions that May's 5.0% would prove the peak, with prices up 0.9% on the month. Core Consumer Price Index (CPI) inflation was its highest since November 1991. Inflation was driven higher by four factors: Oil prices pushed fuel and household energy costs up by over 2% in June (7% of the CPI basket), new and used car prices rose by 2.0% and 10.5% respectively (together nearly 7% again), shelter costs (nearly one-third of the total basket) rose by 0.5% and food prices were up 0.7%. The remaining part of the basket – less than half – saw price growth slow again in June to 0.3% (Exhibit 1). With oil prices levelling off in July and expectations that shelter costs will dip over the coming months, headline inflation should have now peaked. Yet the annual rate looks likely to remain above 4% for much of the rest of the year.

Exhibit 1: Inflation surge still a narrow base

US - A decomposition of the rise in CPI inflation



Source: Bureau of Labor Statistics and AXA IM Macro Research, 19 July 2021

But beyond the short term, persistent inflation pressures are still not obvious. In a year's time, semiconductor shortages should have eased, unwinding car price pressures. Oil prices are unlikely to have risen to the $130/barrel level required to maintain the current annual growth rate, and the shelter component will follow broader economic trends. The persistence of the current inflation spike is a threat if current inflation expectations rise. 5-10-year consumer inflation expectations edged higher to 2.9% in July, around the 2009-2013 level, but below the pre-2008 level (and far lower than the 4.5% recorded the last time core inflation was this high). If expectations rise over coming quarters, medium-term inflation prospects will too. So far this is not the case.

The economic outlook remains robust, but markets are beginning to consider downside risks. New coronavirus cases are rising again and have more than tripled to reach near 80k/day since mid-June. The delta variant explains most new cases and although the US has vaccinated 48% of the population fully and 56% partially, large pockets remain unvaccinated and at risk. We doubt that states will reimpose restrictions; however, continued economic disruption and precautionary behaviour are likely to rise with cases.

Business surveys remain firm and July's Empire State manufacturing survey reached a series high. However, most are easing back from highs – although still elevated – and some, including the services ISM index contain more discomforting details, including a steep drop in the employment index. Manufacturing dipped in two months during Q2 as supply chain issues appear to continue to weigh. Moreover, weekly consumer confidence has posted its steepest drop since December over the past three weeks, while retail sales fell again in June. Retail sales still rose by 6% in Q2, thanks to March's surge, but Q3 will grow more slowly, spilling into broader consumption and weighing on growth. We still expect Q2 GDP to total around 8% (annualised), but we are edging our forecasts lower for H2 2021 and now forecast growth at 6.4% for this year and 4.5% for next (now below the 6.6% consensus for the first time this year).

President Joe Biden's administration has made some progress towards its next spending bill. A $1.2tn bipartisan infrastructure deal has been reached – although this only includes $0.6tn in new commitments. The Senate Democrat Budget Committee has also agreed a $3.5tn "fully paid for" package to be passed by reconciliation. Together this amounts to the $4tn proposals that President Biden set out in April. However, this is far from a done deal and even though reconciliation would require agreement only amongst Democrats, this could still be difficult, particularly over how much should be raised in taxation, which we see as ultimately limiting the deal to $2-3tn. We suspect that these bills will not pass Congress until September – and may well coincide with an extension of the debt ceiling. But the details of the reconciliation package are likely to take until next year, with the approach of next year's midterm elections offering the key impetus to pass a bill in early 2022.

The Federal Reserve (Fed) has acknowledged that the inflation overshoot has been greater than expected, but Fed Chair Powell still insisted inflation was likely to moderate and inflation expectations were "well anchored". He also stated that "substantial further progress" remained "a ways off" and that the Federal Open Market Committee (FOMC) would discuss progress "in coming meetings". We continue to expect the Fed to serve notice in September of a taper that is likely in December and we suggest that this will be conducted over six months. This would provide scope for the FOMC to tighten sooner. We continue to expect the Fed to raise rates only in mid-2023 and forecast two hikes that year.

Global Macro Monthly – Eurozone

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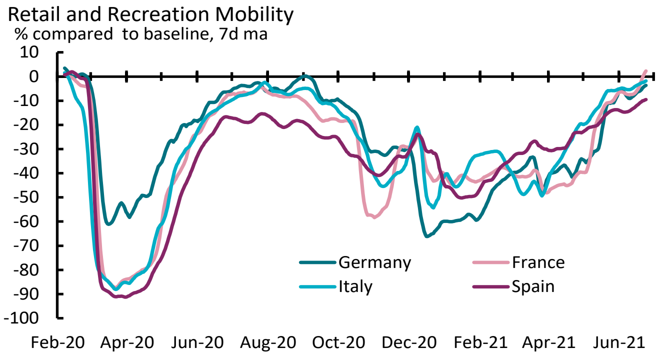
Keep an eye on hospital admissions

The rapid propagation of the COVID-19 delta variant is threatening the recovery in the Eurozone. The number of new cases is increasing rapidly and some restrictions have already been implemented in Portugal, parts of Spain and the Netherlands, to avoid a spike in hospital admissions.

For now, restrictions remain relatively soft (mainly social distancing), so mobility has not been materially impaired (Exhibit 2). Yet we worry about consumer self-censorship and rising precautionary behaviour. So far, retail sales have improved as expected – by 4.6% month-on-month (mom) in May – and should continue to recover in June as confidence rose again. But it has probably peaked already with the delta variant likely weighing on confidence from here.

Exhibit 2: Mobility in retail areas continue to improve



Source: Google Mobility index and AXA IM Macro Research, 10 July 2021

On the manufacturing front, Eurozone May industrial production fell by -1% mom, dragged down by major disruption in auto production (-7.8%mom). The shortage should persist in June, but orders are strong so auto production should rebound once supply chain issues are resolved, although probably not before year-end.

Despite these mixed developments, our outlook remains broadly unchanged. Indeed, following our analysis on the virus and variants[1], we had assumed persistent social distancing measures and some limitations to cross-border tourism flows. That explains our already rather cautious Eurozone Q3 GDP growth forecast of +2.2% quarter-on-quarter (qoq). Vaccination progress will be key to gauge downside risks to our baseline. The UK experience is telling us that the vaccination has not broken but only weakened the link to hospitalisation. As long as pressure on intensive care units remains manageable, we do not expect more stringent restrictions, but for that, vaccination need to keep up pace.

A not so ambitious strategic review

The European Central Bank (ECB) released its strategic review sooner than expected – a positive message on the level of consensus on the governing council. However, ambiguity about the implications for future policy decisions was probably the price to pay for this consensus. The governing council confirmed the adoption of a symmetric definition of price stability at 2% with deviation above and below "equally undesirable". The shift is different from the Federal Reserve's Flexible Average Inflation Targeting, which aims to overshoot. Instead, the ECB may accept "a transitory period in which inflation is moderately above target". The difference between "possibility" and "intention" is key, as forward guidance appears less strong and thus makes the ECB appear less credible. The ECB will have an opportunity to clarify its signal at the 22 July meeting, with changes to the forward guidance in focus. We fear internal disagreement may prevent precise wording on overshooting and details on how to actually get there.

Other aspects of the strategy review include a roadmap to account for owner-occupied housing costs in the harmonised index of consumer prices (HICP) – unlikely to happen at a monthly frequency before 2026. There is also a working agenda to fight climate change via the development of analytical and macroeconomic modelling tools and changes to collateral and asset purchases frameworks.

Separately, the European Commission (EC) unveiled details of its "Fit for 55" strategy, intending to reduce emissions by 55% by 2030. Revisions to the Emissions Trading System (ETS) include steeper annual emission permits reduction (-4.2% each year from 2.2% previously), the gradual removal of free allowances and the extension to aviation and shipping. In parallel, a new ETS will be set up for fuel distribution for road transport and buildings. To avoid carbon leakage, the EC aims to adopt a Carbon Border Adjustment Mechanism. Its introduction will be gradual and will initially apply to iron and steel, cement, fertiliser, aluminium and electricity generation. After a transition phase (until end of 2025), importers will have to purchase certificates based on goods' carbon content. These measures will prove costly for households. To address this issue, the EC is proposing a Social Climate Fund (around €72bn for the 2025-2032 period) to help citizens finance investments in energy efficiency or cleaner mobility. The EC has set the bar high, but discussions with some sectors as well as major trade partners (and the World Trade Organisation) are unlikely to be easy and may last several years.

[1] Page, D. and Qin, Y., "Escaping COVID-19: Will vaccines be sufficient?", AXA IM Research, 19 May 2021

Global Macro Monthly – UK

David Page,
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“Learning to live with the virus”

The die is now cast. The government removed its remaining social distancing restrictions on 19 July and plans to end self-isolation for the fully vaccinated by mid-August. This comes despite a rise in new cases to 54/day – the highest since mid-January – with the delta variant accounting for around 99%. The UK has so far vaccinated 68% of the population with one dose and 51% with two – among the highest in the world. Hospitalisations have thus risen far more slowly than cases (up five times since the start of May, compared to over 20 times). However, Health Secretary Sajid Javid has suggested case numbers could hit 100k/day over the summer, far exceeding January’s 68k peak. Our estimates suggest hospitalisations could surpass 2k/day – around two-thirds the pace seen in Q2 2020. This will put broader strains on the National Health Service (NHS) and increase the UK’s already relatively high death toll[2].

With a “learning to live with the virus” strategy being adopted, it’s hoped the relaxation of restrictions will bolster the economy. Since March’s initial easing there has been a sharp rise in activity. GDP rose by 0.8% in May, slower than in March and April as progress was impacted by a consumer spending rotation, supply-chain issues, and the strength of the rebound to date. We expect Q2 to show quarterly growth of just under 5% but we anticipate slower growth thereafter, at 2% and 1.5% in H2 2021. The rise in infections threatens disruption and as more evidence of severe cases for the fully-vaccinated emerges, we expect more precautionary behaviour to return – just as the government furlough scheme unwinds in Q3 and ends in September.

Our 2021 growth outlook is 6.7%, below the Bank of England (BoE)’s 7.25%, although we acknowledge significant uncertainty. We also believe inflation will be transitory, peaking around 3% at year-end, before dropping below target by end-2022. This softer outlook should add caution to calls for monetary policy adjustment. The Monetary Policy Committee (MPC) composition will be a little more dovish following hawkish Chief Economist Andy Haldane’s exit and Catherine Mann’s arrival. But BoE commentary is increasingly hawkish, with external member Michael Saunders recently suggesting he may vote to end quantitative easing (QE) before year-end. On balance, we do not expect policy tightening before 2023. But continued growth outperformance over the rest of the year could bring forward the first hike to H2 2022.

[2] Page, D. and Qin, Y., “Escaping Covid-19: Will vaccines be sufficient?”, AXA IM Research, 19 May 2021.

Global Macro Monthly – Japan

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A challenging summer

As everywhere, the spread of the delta variant is threatening recovery. After three weeks without any domestic restrictions, the government has reintroduced a state of emergency in Tokyo in response to a rapid increase in the number of new COVID-19 cases – as well as to satisfy the electorate before the next general elections.

Prime Minister Suga has pressed ahead with preparations for the Olympics despite a widespread pandemic, weakening his position if infections accelerate sharply. According to a recent poll by national broadcaster NHK, 36% of Tokyoites said the Olympics should be cancelled or postponed while 38% were against the presence of spectators. In this context, the likelihood of snap elections just after the Olympics remains very high but includes rising uncertainties. In parallel, there is on-going discussion about an extra budget of ¥30tn. The stimulus would be packaged this summer and funded after the elections.

New restrictions will mostly impact services as shops will operate under shorter hours, bars/restaurants close at 8pm and travel will be constrained during the holidays. Vaccination is improving quickly as 34% of the population have now received at least one dose, but it is unlikely to be enough to avoid more cautious consumer behaviour. Consequently, we have slightly adjusted our outlook on the downside for private consumption in Q3 and Q4.

Industrial production fell 6.5% month on month in May, strongly impacted by semiconductor shortages in car production. Manufacturing demand remains solid as June’s purchasing managers index (PMI) improved to 52.4 from 51.5 while Q2 Tankan surveys improved substantially despite persistent heterogeneity between small and large firms and manufacturing and services sectors. The services PMI increased but remains in contractionary territory at 48.

The Bank of Japan (BoJ) did not announce any changes to its monetary policy framework or its forward guidance. The GDP growth outlook was downgraded slightly for FY2021 to 3.8% (-0.2 percentage point) but upgraded for FY2022 to 2.7% (+0.3pp). The BoJ unveiled details for its Green funding program and will start providing financing for eligible assets by the end of this year (green loans/bonds, sustainability-linked bonds and transition finance). The interest rate will be 0% and financial institutions can add twice the outstanding amounts in the Macro Add-on balance (tier remunerating reserves at 0%).

Global Macro Monthly – China

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Growth rebounds from COVID-19 shock

China's economy bounced back from its COVID-19 induced weakness in the second quarter (Q2). Sequential growth rebounded to 1.3% quarter-on-quarter, in line with our expectation, but firmer than the market estimate. Year-on-year growth slowed further to 7.9% as the base effect from 2020 fades. In nominal terms, GDP grew by 13.2% driven partly by a sharp jump in the GDP deflator, consistent with soaring producer price index (PPI) inflation over the past quarter. Our measure of growth – free of base-effect distortions – shows stronger economic activity in both secondary and tertiary sectors following the relaxation of social and mobility restrictions after the lunar new year. Overall, the Q2 data confirms a normalisation of growth conditions from Q1's transient shock but may mark the peak of sequential growth for 2021.

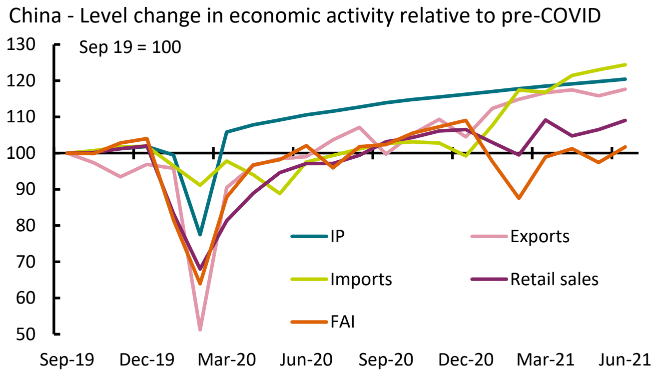
The monthly data beat market expectations across the board. Even though industrial output growth slowed moderately, the 6.5% print sat comfortably above the pre-COVID-19 trend rate of sub 6%. Mining growth slowed notably due to a forceful implementation of decarbonisation measures at the start of the quarter. Auto production also suffered from a worldwide chip shortage, which currently shows no signs of abating. However, production of high-end machinery and electronics remained buoyant, supported by strong external demand, and increased capex investment both locally and overseas.

Fixed asset investment growth accelerated to 4.5%, driven primarily by manufacturing investment. Growth of the latter quickened in the past three months, as firms – struggling to keep up with strong demand against already stretched capacity – put profits to use. We have highlighted that an upturn in the manufacturing investment cycle could present a positive surprise for the economy in 2021, and the recent data suggests such a surprise may be materializing.

In contrast, both infrastructure and real estate investment weakened last month. The former could be temporary as local governments have already started to ramp up bond issuance to support infrastructure build-up. The real estate market weakness is, however, more structural reflecting Beijing's commitment to rein in asset bubbles. Even with the latest reserve requirement ratio (RRR) cut, there is unlikely to be any relaxation of housing market controls any time soon, and we think the People's' Bank of China will work hard to ensure the liquidity added does not end up in the property market which would undermine its risk management objective.

Consumption proved the bright spot in June's data. Retail sales growth accelerated, for the third month running, to 4.9%, beating market expectations. Most sub-categories recorded faster growth, except auto and catering sales, which can be explained by abnormal factors – such as chip shortages and the virus outbreak in Guangdong. Notwithstanding the move in the right direction, the pace of the consumption recovery remains slow in relative terms (Exhibit 3). Maybe the accelerated vaccine rollout, to dispel COVID-19 fears, and increased policy supports – to quicken job and income growth – will eventually spur a faster consumption recovery to further rebalance the economy.

Exhibit 3: Growth rebalances steadily



Source: CEIC and AXA IM Research, July 2021

Strong Q2 GDP hints at growth peaking

On the policy front, we think that the latest RRR cut indicates Beijing is monitoring the macro situation carefully and is willing to act aggressively against downside risks. Judging by Q2's data, it's hard to see why the economy needs an RRR cut, with growth rebounding nicely over the past quarter. Our interpretation is that Beijing is acting **pre-emptively to the anticipated slowdown** in the second half, but the move does not (yet) represent a U-turn on its *overall* policy stance.

For example, policy tightening on the housing market is unlikely to be reversed any time soon, nor is the control over local government debt (beyond this year's issuance quota). Even the quantum of liquidity injection from the RRR cut will depend on how much the upcoming medium-term lending facility (MLF) maturity is rolled over. It is worth noting of the RMB400bn MLF loans which matured on 15 July, only RMB100bn was rolled over, leaving the remaining to offset the RRR move. A follow-up reserve requirement or interest rate cut is not impossible if growth falters more than expected and/or the virus returns with a vengeance. But for now, such a move appears unlikely as it is inconsistent with the prudent policy stance that Beijing vows to uphold.

Global Macro Monthly – EM

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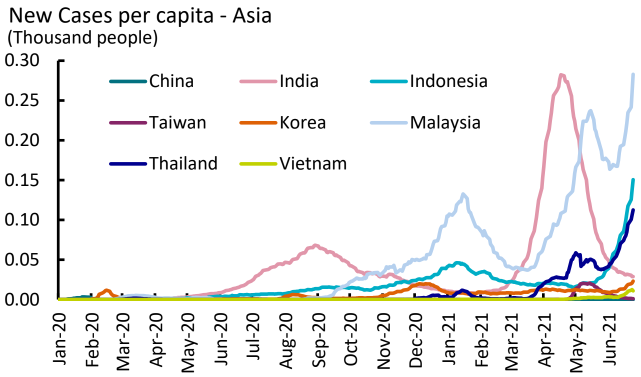
Delta: Speed bump on the road to recovery?

At the G20 meeting in Venice, International Monetary Fund Managing Director, Kristalina Georgieva, described the global economic recovery as broadly in line with the International Monetary Fund (IMF) projection of 6% GDP growth in 2021. However, she noted an increasing divergence across economies, with the world facing “a two-track recovery”, reflecting different pandemic risks and macroeconomic policy responses. The latest purchasing managers’ index (PMI) surveys reported a widening gap between advanced economies and many developing economies – particularly in Asia. This primarily reflects supply chain disruptions adversely affecting economic activity as well as higher prices and input costs as a fresh resurgence of COVID-19 cases has recently emerged (Exhibit 4).

Exhibit 4: Resurgence of Covid-19 infections in Asia



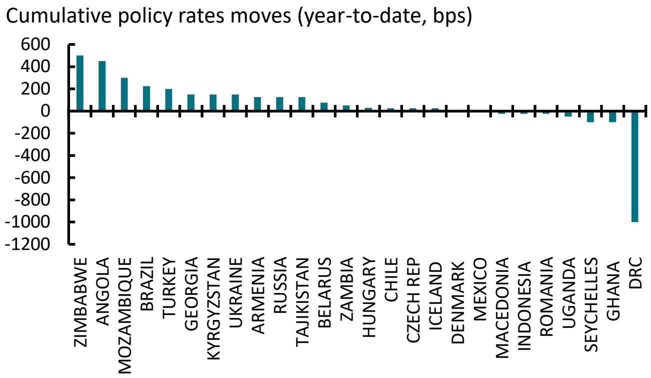
Source: Datastream and AXA IM Research, 14 July 2021

With the delta variant increasingly becoming the prevalent strain throughout the world, countries – emerging markets (EM) and developed markets (DM) alike – are being forced to impose renewed restrictions. Emerging markets continue to lag their DM peers in terms of vaccination, even as they are stepping up distribution efforts. The tourism season is threatened again as we warned in our recently published research paper[3]. The inevitable question is how much of a hurdle the delta variant will be to the economic recovery that was starting to take shape in recent months.

To begin with, EM growth forecasts have continued to be revised upward in recent months. Demand for goods from advanced economies has proved strong and driven a vigorous rise in export activity since the start of the year. Furthermore, raw material prices recovered quickly and remain generally at elevated levels, which is supportive for a lot of EM commodity producers. Finally, global liquidity remains ample, supported by very accommodative monetary policies in advanced economies, particularly the US Federal Reserve, which helps EM financial conditions overall.

Inflation pressures have resurfaced recently, although remain moderate overall. Some developing countries have recently raised interest rates to counter rising inflation rates, but this is not a general move, as most central banks remain wary of still nascent economic recoveries. Year-to-date, 78 central banks out of 104 tracked, have remained on hold, 26 have changed rates, 6 of which have cut rates, and 20 hiked (of which 19 are in the EM space). Among the major EM economies, Brazil, Turkey and Russia have taken more decisive steps with policy rates hikes of 225 basis points (bps), 200bps and 125bps respectively since March. This has come in an attempt to anchor inflation expectations and support currencies, given a strong historic relationship between inflation and foreign exchange. Otherwise, Hungary (30bps in June), the Czech Republic, Mexico and Chile (+25bps each), have started a monetary policy normalisation process (Exhibit 5). We do not believe that an aggressive policy tightening cycle is about to start, not least given the dampening effect of the delta variant spread.

Exhibit 5: Gradual normalisation in monetary policy



Source: Datastream and AXA IM Research, 15 July 2021

The EM recovery could be jeopardized by an economic slowdown in China. But, while Chinese growth is likely to have peaked in Q2 2021, the recent signs of more supportive policy should support EM sentiment ahead, rather than herald a significant deceleration.

[3] Shen, S. and Topa-Serry, I., “Tourism: how Asia and other emerging markets could bounce back (a long path to recovery) , 10 June 2021

Investment Strategy – Cross assets

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Between perky inflation and a perky variant

The summer lull is serving up many challenges. On the one hand, sharper than hoped for inflation pressure has nudged the Federal Reserve (Fed) to a somewhat more hawkish view and the signs from the second quarter (Q2) earnings season are encouraging. But the delta variant is posing a material threat to the reopening process and political friction around the US infrastructure plan is another obstacle. Add in some technical factors – excess liquidity and a scarcity of government bonds – and the persistent decline in yields since mid-May starts to look less unorthodox. We remain constructive on markets, but August can be the cruellest month, so some near-term caution is warranted.

Investment Strategy – FX

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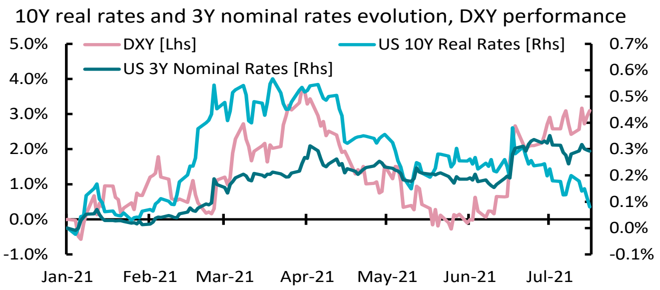
FOMC puzzles rates market but boosts USD

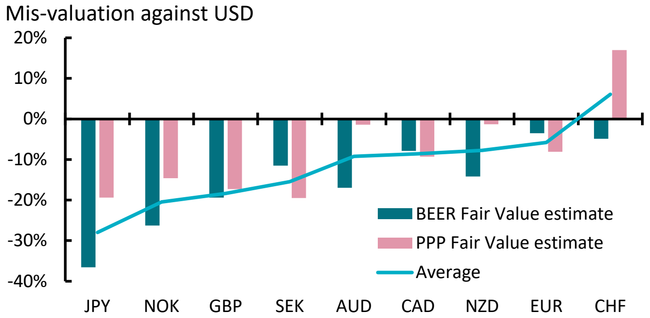
Exhibit 6: USD decoupling from US real rates



Source: Bloomberg and AXA IM Research, 19 July 2021

Since the pandemic, the US dollar (USD) had moved in sympathy with US real rates; when markets repriced US fiscal stimulus in Q1, or after the Fed's June meeting when it acknowledged the possibility of more persistent inflation pressure and drove a rebound for US real rates and the USD. While this kneejerk reaction was expected, the subsequent move in real rates lower while the USD continued to strengthen was unusual. It could be markets priced in an earlier albeit shorter hiking cycle. Technical factors have probably been at play too, through short covering in US Treasuries (UST) and limited net supply. USD felt better anchored and decoupled from US real rates as the Fed also revived the short-term part of the UST curve (Exhibit 6). Delta variant concerns may also have triggered risk-off flows.

Exhibit 7: EUR, CHF have more room to weaken vs USD



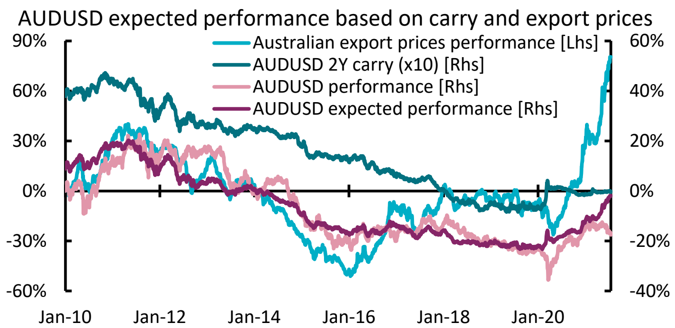
Source: Bloomberg and AXA IM Research, 19 July 2021

While the USD may ultimately be hindered by low real rates it could continue to strengthen against the euro and Swiss franc (CHF). Both are closer to fair value (Exhibit 7). Recent euro optimism may start to fade as the European Union's economic rebound lags the US and the spread of delta variant is threatening to depress tourism during summer and to delay reopening. The European Central Bank (ECB) Bank policy review came sooner than expected but served as a reminder of its dovish stance, as the ECB – as well as the Swiss National Bank (SNB) – are facing a long-lasting inflation gap. CHF should track the euro as euro/CHF approaches the SNB pain threshold, while shorting CHF offers extra carry.

AUD: Best move against USD on the chessboard

We continue to think that commodity currencies should remain supported and the USD rebound has created interesting buying opportunities. As the Fed has become slightly more hawkish, other central banks may feel more confident to tighten policy. But much is already priced-in, even accounting for the robust labour market rebound and Canada's vaccination acceleration. The Australian dollar (AUD) seems a better candidate for appreciation versus the USD. The Reserve Bank of Australia is also facing inflation pressures and Australia's labour market and growth rate have already rebounded very close to pre-COVID-19 levels. Australian export prices seem durably strong (Exhibit 8) and a worldwide infrastructure stimulus should support AUD. Its current account has even turned positive, now displaying a surplus above 2%. A renewed lockdown in Sydney and low vaccination rates are a risk, but may already be priced in.

Exhibit 8: AUD under-pricing surge in raw material prices



Source: Bloomberg and AXA IM Research, 19 July 2021

Investment Strategy – Rates

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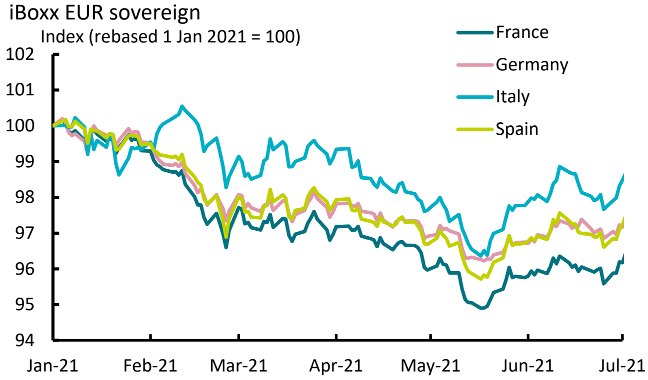
EMU: Frankfurt remains crucial

The first half of 2021 proved to be challenging for passive investments in European government bonds. The European Monetary Union (EMU) government bond index delivered a disappointing -2.1% total return (Exhibit 9), with Italy standing out (-0.8%) mainly thanks to a quick changeover between Prime Ministers Giuseppe Conte and Mario Draghi in early February. As for other global bond markets, direction was initially dictated by the reopening-reflation trade and the associated repricing of monetary policy trajectory and timing. central banks' common narrative ("transitory inflation") amplified by the Federal Reserve (Fed)'s average inflation approach has added to a renaissance of pandemic-related risks, stabilising the market's first principal component over the past two months.

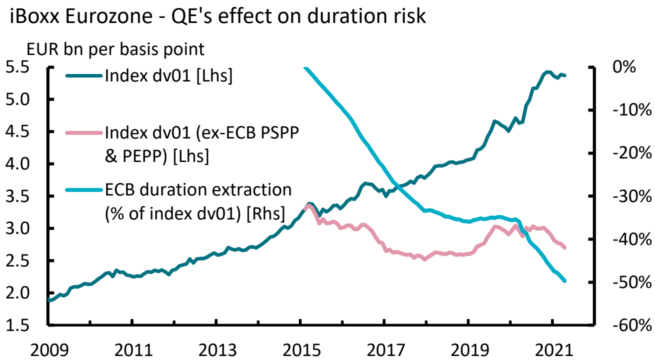
Exhibit 9: Challenging EMU bond market



Source: Bloomberg and AXA IM Research, 20 July 2021

Looking ahead, the European Central Bank's (ECB) powerful monetary stimulus is likely to remain in place in the near term. Financial markets had already well anticipated a transition from a "pre-emptive" to a more "persistent" approach, one of the several defining concepts of the ECB's new strategy. Nevertheless, the asset purchase programme's destiny remains an open question as market participants try to best guess its evolution against the background of self-imposed limits and the new information revealed by ECB President Christine Lagarde during the strategy review presentation. Of course, the ECB's weight on European bond markets doesn't go unnoticed. Since 2015, it has absorbed 50% of EMU government bonds' duration risk (Exhibit 10), stabilizing this key parameter despite the near doubling of market value as well as debt issuers' efforts to lengthen debt duration in order to lock in historically cheap funding conditions.

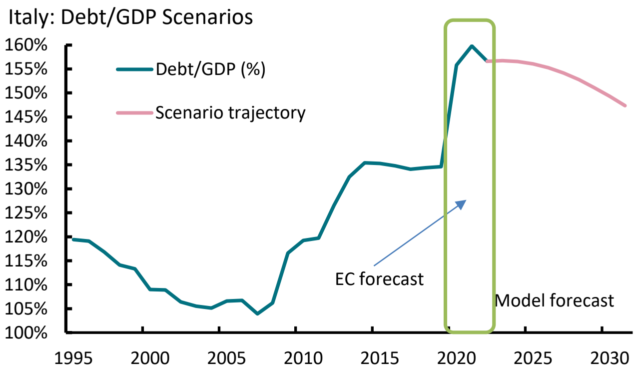
Exhibit 10: A big central bank



Source: ECB, Bloomberg and AXA IM Research, 20 July 2021

The importance of ECB monetary policy is best illustrated in the context of government debt sustainability. The combination of negative interest rates, quantitative easing and forward guidance has managed to reduce government interest expenditures year after year. For example, Italy's interest costs dropped from an average of 4.8% of GDP in 2002/2006 to a forecast 2.9% of GDP by the end of next year. Again, the low yield environment – 10-year Italian government bonds (BTP) currently hover just above 0.7% – delivers a beneficial effect on public finances, as the average cost of debt is reduced with each long-term issuance. Compared to Eurozone average interest costs (1.5% of GDP in 2020), Italy still has ample room to improve its public finances as a function of the low yield environment. This is also true for other sovereign issuers like Greece, Portugal and Spain. Unfortunately, the cost of financing is just one of several conditions that need to be met to achieve the goal of debt-to-GDP reduction. Therefore, the timely and efficient use of funds linked to the Next Generation EU recovery package will prove critical in terms of boosting productivity and potential real GDP growth. This is true for Italy in particular, where potential output has averaged just 0.25% since the introduction of the common currency, compared to 1.25% for both France and Germany. By our calculation, even doubling Italy's potential to 0.5% and achieving 2% inflation over the medium period, would leave a huge burden on the ECB. If we assume a 0.1% reduction in the annual cost of financing, Italy's debt-to-GDP would still be above 2019 levels by the end of the decade (Exhibit 11).

Exhibit 11: Italy's slowly improving public finances



Source: European Commission, Bloomberg and AXA IM Research, 20 July 2021

Investment Strategy – Credit

Gregory Venizelos
Credit Strategist
Research – Core Investments

Credit markets set to keep their poise

We remain constructive on credit in the near term and over a 12- to 18-month horizon. Ongoing economic momentum, accommodative monetary policy, and lack of carry in sovereign debt all continue to underpin credit markets. Indeed, spreads have traded in a rock-bottom, zero-volatility regime for eight months now, undisturbed by the various mini risk-off episodes in equities and rates. This regime looks set to extend through the summer, if not into year end. We may see some mild widening into year end, if the September Federal Reserve (Fed) meeting serves another hawkish surprise, but the presence of the delta variant may counteract some potential hawkishness by the Fed.

Fundamentals are in decent shape too, despite the excess debt issuance due to COVID-19. Margins have held up and the second quarter (Q2) earnings season is expected to deliver as anticipated. Ongoing improvements in earnings should assist in some deleveraging via the denominator (in terms of debt/earnings). Supply has been elevated in 2021 too but the use of proceeds has been conservative by and large. Positive momentum in rating migration after a sharp but short fallen-angel cycle is also supportive of performance in credit portfolios.

That said, some caution is warranted. Risk dispersion within credit has been suppressed and correlation is elevated due to the macro and policy tailwinds – and "liquidity lifts all boats". Sector selection is therefore key going forward, inasmuch as dispersion is likely to rise as policy accommodation starts to be withdrawn in 2022.

Region-wise we have a preference for euro over US dollar (USD) spreads, mainly due to the European Central Bank's (ECB) policy accommodation that is set to stay in place for longer than the Fed's, given the lagging inflation dynamics in the Eurozone. Emerging market credit continues to offer an incremental pickup over developed markets but probably at the expense of higher volatility. This is in part because inflation pressures have forced some developing market central banks to commence policy tightening. China risk premia have also underperformed recently as monetary policy has been tightening (China credit impulse has been dropping since November) but we may be getting closer to the end of this underperformance as some easing by the People's Bank of China is starting to materialise.

Presently there are two macro tail risk scenarios for credit. A 'good/bad' scenario, where the delta variant fails to disrupt the reopening momentum (currently it looks like it will disrupt) and, come September, the Fed makes a more material hawkish shift than in June. This raises the prospect of a bigger rates tantrum than in February/March, which finally unsettles credit spreads (e.g. spread levels widen by 30%-40%). This risk becomes more valid if US Treasury yields continue to trade around current levels (i.e. 1.25-1.40) into the 22 September Fed meeting. Worth mentioning that the level of protection in credit risk premia versus inflation is currently at historic lows.

However, a 'bad/bad' scenario, would be where a new COVID-19 strain emerges which evades vaccine efficacy. Given that fiscal space would be more limited now, the prospect of another round of full lockdowns could seriously undermine market sentiment and drive a material risk-off. And as has been the case post-global financial crisis, a serious risk off would likely be exacerbated by vanishing secondary market liquidity (spread levels wider by 40%-60%). One mitigant in such a scenario is that inflation expectations and thus the pressure on the Fed to act would likely ease.

Between these two risk scenarios, we are watching the mergers and acquisitions (M&A) and leveraged buyout (LBO) trends. That said, like the case in 2005 – a spate of LBOs including the chemical sector – we think that M&A and LBO risks will remain idiosyncratic, affecting the credit spread curves (wider/steeper) of the names involved but not repricing credit markets more broadly. Still, individually, M&A and LBOs do present a risk of premature re-leveraging, especially if low yields persist.

Overall, valuations are very stretched across the credit continuum which presents a possible problem, albeit likely later down the road, as policy support is withdrawn, and the macro backdrop normalises. Investors who are more concerned about spread risk over a three to six-month horizon can take advantage of the low implied volatility to add some tactical hedges to their portfolios (e.g. payer spreads in the CDS index space).

Also, any change in corporate tax policy beyond what is already anticipated is one other risk for credit spreads to bear in mind. Companies whose spreads benefitted after the 2017 US corporate tax reform have seen their spreads underperform since the US election.

Lastly, the China technology firm crackdown seems to be more of an equity than credit story. The Hang Seng Tech index has underperformed the Nasdaq by 24% year to date. In credit, property developer companies are the more dominant sector in China credit indices – especially high yield (HY) – and a key source of underperformance year to date (at -5.8% versus USD high yield in local currency terms) which has however partially recovered recently as China HY was at -7.5% behind USD HY at its worst.

Investment Strategy – Equity

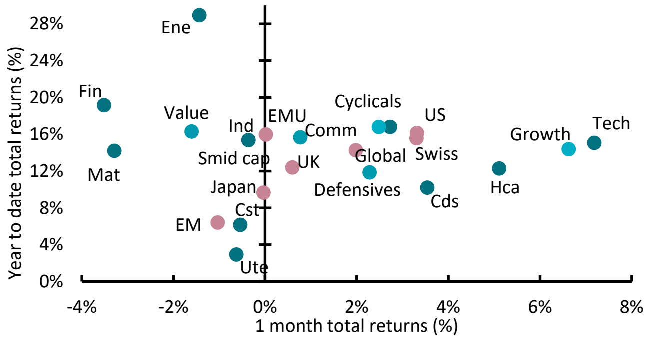
Emmanuel Makonga,
Investment Strategist,
Research – Core Investments

Reshuffling the cards

Global equity markets keep delivering positive returns (Exhibit 12), rising by +1.9% over the past month. Globally, the US and Swiss equity markets did best, with each delivering +3.3%. In terms of sector performance, the technology sector led the way, up +7.2%, followed by healthcare (+5.1%) and consumer discretionary (+3.5%). The value/growth rotation reversed with growth up +6.6% and value down -1.6%. According to fundamentals, the VIX looks fair value at the current level, of circa 17.

Exhibit 12: Growth stocks leave behind remainders

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

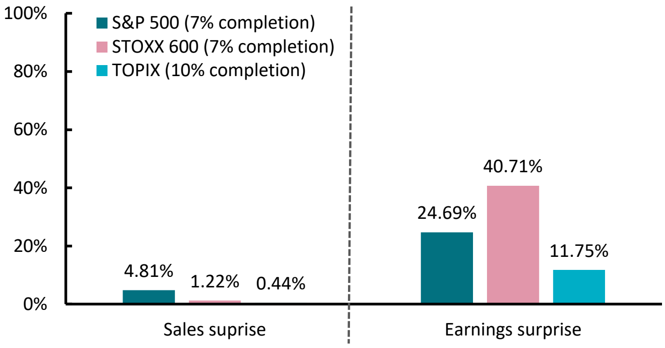


Source: Datastream and AXA IM Research, 20 July 2021

The second quarter earnings season has just started and so far, the reporting rate across countries remains low: 10% of TOPIX companies have published their results and 7% of both the S&P500 and STOXX 600 (Exhibit 13). At the time of writing, all three regions have posted positive double-digit surprises for bottom line growth with European equity leading (+40.7%). Sales surprises by contrast are not as high in Europe (0.4%) as in the US (4.8%) and Japan (1.2%).

Exhibit 13: Encouraging start of the earnings season

Q2 2021 Earnings season tracker

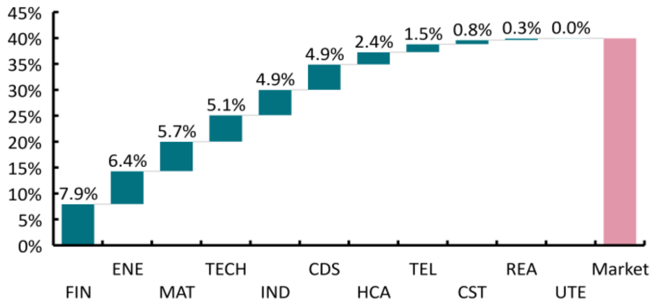


Source: Bloomberg and AXA IM Research, 20 July 2021

Since the start of the year, the highest share of global equity performance has been provided by earnings (+18.8%). In the meantime, the earnings-per-share growth consensus estimates stand at 40% for 2021 (Exhibit 14) and earnings should remain a tailwind for equities. That said, after being revised up 9% year-to-date, the earnings momentum is now slowing down in line with the peak in US economic activity indicators. Even though the economy is likely to remain above trend for the rest of the year, other regions may mitigate peaking US activity in relation to global equities. Notably in Europe, where a healing labour market, pent up demand and the future implementation of the European Union's recovery fund will help. Cyclical and value sectors should be the greatest growth contributors for 2021, including financials (+7.9%), energy (+6.4%) and materials (+5.7%), while defensive sectors are set to lag: Utilities (+0.0%), real estate (+0.3%) and consumer staples (+0.8%).

Exhibit 14: Robust earnings growth for Cyclicals in 2021

Global equities: 2021 earnings growth contribution

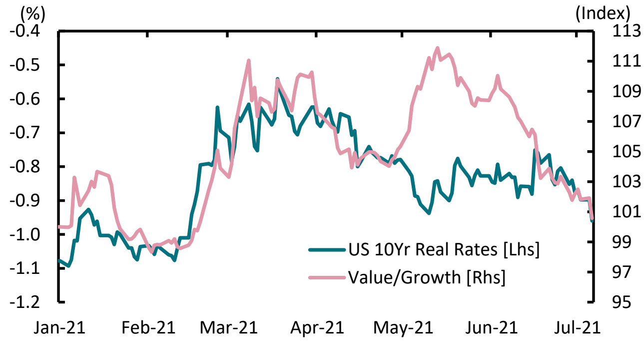


Source: IBES and AXA IM Research, 20 July 2021

Despite a hawkish tone in June, the Federal Reserve's transitory inflation message seems to have been adopted by the market. The last, above consensus, US consumer price index print (5.4%) triggered a muted bond yield reaction – yields trended lower after an initial jump. Under the current rangebound bond yield regime, the value/growth rotation has reversed and underperformed by -7.6% since the start of June as US 10-yr real rates have remains broadly unchanged, between -80 and -90 basis points (Exhibit 15). We believe that this reversal is temporary, and we keep our positive stance on value stocks as well as cyclicals. Across regions, we continue to favour the Eurozone, the UK and the US.

Exhibit 15: Reversal on Value/Growth rotation

Global equities: rotation and US real rates



Source: Datastream, MSCI and AXA IM Research, 20 July 2021

Recommended asset allocation

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

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

Source: AXA IM Macro Research – As of 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

These projections are not necessarily reliable indicators of future results

Download the full slide deck of our July Investment Strategy

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