AXA Investment Managers

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Investment Institute *Macroeconomics*

Monthly Op-ed

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Macro Roller Coaster

Key points

- Despite the "data fog" and uncertainty on the extent to which President Trump will deliver on his platform, we remain in the "US inflation resumption" camp.
- Europe is – sadly – easier to read, with a very mediocre outlook for the real economy, but this should make it relatively easy for the ECB to continue cutting past the "neutral point" and provide proper accommodation.
- Animal spirits meet policy uncertainty.
- Diversification opportunities
- Income returns improving

What's the starting point?

Much of the macro debate is currently focusing on Donald Trump's "transformation rate", i.e. the proportion of his electoral platform which will make it to actual implementation and given the still high level of uncertainty – on trade tariffs in particular – the market could be excused for displaying a high level of volatility. Still, the pronouncements of the 47th President of the US are only one element of the maze in which investors are currently lost. Indeed, characterising the state of the US economy before any intervention by the new Republican administration is far from straightforward.

The real economy remains very strong. If the Atlanta Federal Reserve (Fed)'s nowcast is correct, GDP was still growing well above potential at the end of last year. The last employment report of 2024 was still pointing to robust job creation, together with a small reduction in a still low unemployment rate. This has, quite understandably, fuelled the rise in long-term yields at the beginning of January. Yet, a better-than-expected print for core inflation in December poured some cold water on the bond market, stopping what looked like an inexorable march towards 5% for the 10-year yield.

Further dampening the "inflation resumption" scenario, the absence of immediate tariff hikes in the first list of executive orders taken by new US President Donald Trump, followed by some potentially conciliatory words about China, have come as a relief to the market. The Fed, which was increasingly seen as stopped out, is again seen as cutting almost twice in 2025 according to the forward contracts. Could the Trump administration end up as much more benign than feared, with a cocktail of deregulation and cheap energy allowing for strong growth with limited inflation?

In truth, riding the current "roller coaster" of news is daunting when it comes to the US. Let us still offer our baseline. Yes, the December print for inflation was good news, but there is always noise around a trend. We see it more as a respite. Even if one is

generous with the estimate of US potential growth, the pressure on supply capacity remains high, and alternative measures of underlying inflation – for instance the Cleveland Fed's trimmed mean Consumer Price Index (CPI), which takes away the impact of the most extreme contributors to price dynamics – suggest disinflation has been stalling since the end of last summer. When it comes to policy, we think that even a modest delivery of Donald Trump's platform will make it even harder for inflation to further converge to the Fed's target. Immigration policy is a good example. One can doubt the US administration's capacity – or even readiness – to effectively deport a sizeable share if the undocumented immigrants currently in the US, but the ongoing round of arrests, and confrontation with Colombia, will probably act as a deterrent anyway to those who were planning to cross the US border. A sizeable reduction in the flow of newcomers on the US labour market would be enough to rekindle wage pressure – especially since wage growth has remained quite robust lately.

On tariffs, we would not take comfort in the fact that none have been announced as of yet. Tariffs are the "Swiss knife" of Donald Trump's platform: they can be used as leverage for anything from punishing Canada for failing to stop Fentanyl crossing the US border to forcing Europe to continue buying American Liquified Natural Gae (LNG). The list for which tariffs could be used is so long that we are quite confident that some will be implemented. In addition, tariffs are seen as a source of revenue for the federal government. Since the fiscal hawks in the Republican party have demonstrated their determination in December by refusing to grant the incoming administration with a two-year extension of the debt ceiling, the cash from customs duties – to be collected in the newly announced External Revenue Service - could be handy to snatch from Congress the presidential agenda of sweeping tax cuts.

All this makes us believe that indeed the Fed is going to be "stopped out" soon – we expect one last 25-bps cut for this year in March – with uncomfortable consequences for the US bond and equity markets.

Europe is (sadly) easier to read

No such uncertainty is at play in Europe. Consumer surveys continue to suggest households will continue to save the essential part of the purchasing power gains triggered by the gap between still robust wage growth – essentially a lagged effect of the price shock of two years ago – and rapidly falling inflation. Business surveys tell us that corporate investment is unlikely to flourish, while hiring intentions are weakening dangerously. The perspective of fiscal tightening, on average across the Euro area, is not going to help. In Davos, Ursula Von der Leyen tried to respond to the Trump offensive by re-stating European values while promising more effective delivery on a growth strategy focused on completing the capital market union, to better recycle the European savings into domestic investment, simplifying European regulation and making progress on the EU's energy framework. Yet, while there seems to be more urgency in Brussels, the political situation in several key member states remains unsupportive of big breakthroughs at the European level. The coalition talks after the German election may dilute ambition, while no full political clarification looks imminent in France.

As often, the European Central Bank (ECB), which remains the only European institution with ample policy space and a capacity for relatively quick decisions, will have to provide a "bridge" to the European economy. Fortunately, it should not be very difficult for the ECB to provide Europe with some rays of light, removing restriction at every meeting in the months ahead. In Davos, Christine Lagarde recognized Europe is facing an "existential crisis". This should be a strong enough reason for the ECB to focus on the downside risks to growth, rather than on any residual upside risks to inflation, in its decision-making. Even if it is not for immediate consumption, we continue to think – unlike the market, which has revised up lately its expected trajectory for European monetary policy – that the central bank will move its rates squarely into accommodative territory, hitting 1.5% by the end of this year (the market's baseline is at 2%).

US policy creates uncertainty for investors

Nor is the investment outlook straightforward. The most obvious reason for that is the uncertain implementation and impact of President Donald Trump's policies. Another concern is valuations. This is most evident in US equity valuations, especially those of technology companies. Even in the fixed income markets there are some concerns about valuations. Credit spreads, representing the additional risk premium bond investors receive compared to risk-free government bonds, are towards the tight end of their historical ranges. The risk scenario is that markets – at some stage – react badly to policy announcements, pushing risk premiums higher (meaning lower equity prices and wider credit spreads), which in turn have negative consequences for both consumers (through a negative wealth effect) and companies (through higher borrowing costs). These risks need to be assessed against a clear pro-growth and pro-wealth creation ambition. So far this has been associated with displays of so-called *animal spirits* amongst the American business community and the desire for the rest of the world not to be left behind in what is touted by the President as America's new "Golden Age." More than ever, diversification is key for investors.

Diversification needed more than ever

Two levels of diversification are between asset classes – the right balance of bonds and equities in a portfolio – and within asset classes – US equities versus the rest of the world and how to be positioned within fixed income markets against a backdrop of interest rates and bond yields being higher than in the pre-COVID-19 world.

Indeed, the increase in yields and interest rates is important on several levels. We do expect interest rates to fall in major economies in the year ahead but revisiting the extremely low levels that prevailed in the decade after the global financial crisis is unlikely. Inflation and fiscal concerns will underpin long-term interest rates and restrict central bank room for manoeuvre, especially in the US. We only expect more aggressive rate cuts from the Fed to emerge when and if growth slows substantially, a risk we see only next year. For now, markets are priced to expect policy rates to anchor around 4% over the medium term, which sets something of a floor for US dollar bond yields. In Europe, lower inflation and weaker growth give the ECB more scope to reduce policy rates to below 2%, but markets have priced the medium-term anchor rate between 2.0% and 2.5%.

In the US, the relative valuation of equities and bonds has shifted in favour of bonds over the last year. A quite simple comparison – the equity earnings and risk-free government bond yield – puts stocks at their most expensive on a relative value basis since the dot.com boom of the late 1990s. Using a Shiller-type methodology to adjust earnings for the business cycle and inflation, the US equity market has recently traded with an adjusted price-earnings ratio of close to 30 times (the same level as in early 2000 and early 2022, just before the Fed started to hike rates). Against bonds, US equities are expensive with the 10-year Treasury yield around 4.5%.

This is no guarantee of future returns from a portfolio of US equities. Valuation measures are distorted by the high prices of a small number of US technology companies. However, when we have previously witnessed similar relative valuations, an equity market correction has tended to follow. Given the technology sector is subject to competition risk, bonds are now able to provide a more meaningful hedge against an equity setback driven by adjustments in technology valuations. Bond and equity price moves are not always negatively correlated but in times of equity stress they are likely to be, and a meaningful fixed income allocation can help deliver better risk-adjusted returns, especially if we do see more volatility in equity markets.

Income returns more important

Bonds are also able to potentially deliver more income returns now. Average coupons have been rising and will continue to do so as low coupon bonds issued during the quantitative easing period mature. Income returns from bond indices have been increasing over the last year. In 2024, cash returns did still exceed income from government and investment grade bonds, but the dominance of cash is receding as short-term rates come down. For the US market, an investment grade bond portfolio should deliver around 4.5% of income in the coming year; for a euro denominated similar portfolio the return is expected to be 2.5% or above. High yield corporate bonds have and should continue to deliver superior levels of income return.

The key return factor for US equities has been earnings growth and high growth companies have been rewarded with higher stock prices. Currently, investor expectations for earnings remain solid. It looks like the Q4 2024 earnings season will deliver another quarter of double-digit growth. The core of the Trump agenda – corporate tax cuts and deregulation – is also growth positive. However, there are scenarios that could challenge the growth outlook for equities. A trade war on the back of US tariffs and more disruptive competition in technology are two threats. Even if earnings growth remains resilient – which the macro backdrop suggests should be the case – policy uncertainty and geopolitical tensions might require lower valuation multiples. A solid income stream from fixed income can help protect portfolios from such developments.

Arguments for European equities

For equity markets in the rest of the world, US policy and how US markets react will be important. However, there are some specific arguments for increased geographical diversification. In Europe, the combination of a solid dividend yield and growth in earnings could again allow returns to reach double digits. As Europe responds to more aggressive US policies, there is the potential for stronger growth to become priced in – developments on issues like capital markets union and deregulation need to be watched, as does whether Europe will continue to be enthusiastic about green investments in the face of a climate-change sceptical Washington. An end to the Ukraine war could also raise Europe-wide business confidence. Elsewhere there seems to be a bottoming of confidence around China. Incremental policy steps and China's need to adapt to a hostile US could be rewarded in

better equity market performance after a torrid few years. The relative cheapness of European and Asian markets versus the US has been a feature of global markets for some time. However, today's uncertainties mostly stem from the US policy outlook which, combined with valuation, create arguments for a lower level of concentration in US markets.

For fixed income, outright yields are in ranges which we think are fairly valuation neutral. However, again in the US there are upside risks to Treasury yields given the macroeconomic, inflation and fiscal outlook. The additional yield provided by corporate bonds, both high grade and high yield, makes them more attractive than government bonds. And for Europe-based investors, the cost of hedging a US dollar exposure and risks around interest rates mean home markets are more attractive. Credit fundamentals remain strong, and we would not expect a significant widening of euro-denominated spreads. For some investors, the cheapening of government bonds relative to credit and interest rate swaps – reflecting, in our view, some fiscal risk premium – could also be interesting, especially for those with institutional portfolios and constrained credit limits.

Download the full slide deck of our January Investment Strategy

Investment Managers

29 January 2025

Macro forecast summary

Real GDP growth (%)	2024*		2025*		2026*	
	AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
World	3.2		3.2		2.9	
Advanced economies	1.6		1.7		1.4	
US	2.8	2.7	2.3	2.0	1.5	2.0
Euro area	0.7	0.8	0.9	1.0	1.3	1.4
Germany	-0.2	-0.1	0.3	0.4	1.0	1.3
France	1.1	1.1	0.7	0.8	1.0	1.3
Italy	0.5	0.5	0.4	0.8	0.8	1.0
Spain	3.1	3.0	2.8	2.2	2.5	1.7
Japan	-0.3	-0.2	1.1	1.2	0.9	0.9
UK	0.8	0.9	1.2	1.3	1.4	1.5
Switzerland	1.6	1.4	1.5	1.3	1.4	1.6
Canada	1.3	1.2	2.0	1.7	1.7	2.1
Emerging economies	4.2		4.2		3.9	
China	5.0	5.0	4.5	4.5	4.1	4.2
Asia (excluding China)	5.4		5.0		4.8	
India	6.9	6.5	6.6	6.5	6.5	6.6
South Korea	2.1	2.2	1.5	1.9	1.5	2.2
Indonesia	5.1	5.0	5.0	5.0	4.9	5.1
LatAm	2.0		2.2		2.1	
Brazil	3.0	3.3	1.9	2.1	1.8	2.2
Mexico	1.4	1.5	1.2	1.1	1.0	2.0
EM Europe	3.0		2.1		2.2	
Russia	3.8	3.6	1.4	1.7	1.2	1.3
Poland	2.5	2.8	3.1	3.5	2.7	3.5
Turkey	2.8	2.9	2.6	2.6	3.4	3.6
Other EMs	2.8		4.0		3.8	

Source: Datastream, IMF, Bloomberg and AXA IM Macro Research – As of 28 January 2025
**Forecast*

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CPI Inflation (%)	2024*		2025*		2026*	
	AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	2.6		2.4		2.4	
US	2.9	2.9	2.8	2.4	3.2	2.3
Euro area	2.4	2.4	2.0	2.0	1.6	2.0
China	0.2	0.2	1.0	1.3	1.6	1.6
Japan	2.4	2.5	2.1	2.0	1.8	1.7
UK	2.5	2.5	2.5	2.3	2.2	2.0
Switzerland	1.1	1.1	0.8	1.0	1.0	1.0
Canada	2.4	2.4	1.7	2.1	1.9	2.1

Source: Datastream, IMF, Bloomberg and AXA IM Macro Research – As of 28 January 2025
**Forecast*

These projections are not necessarily reliable indicators of future results

29 January 2025

Forecast summary

Central bank policy Meeting dates and expected changes (Rates in bp / QE in bn)		Current	Q1-25	Q2-25	Q3-25	Q4-25	Q1-26	Q2-26	Q3-26	Q4-26
United States - Fed	Dates	4.50	28-29 Jan 18-19 Mar	6-7 May 17-18 Jun	29-30 Jul 16-17 Sep	28-29 Oct 9-10 Dec	29-30 Jul 16-17 Sep	28-29 Apr 16-17 Jun	28-29 Jul 15-16 Sep	27-28 Oct 8-9 Dec
	Rates		-0.25 (4.25)	unch (4.25)	unch (4.25)	unch (4.25)	unch (4.25)	-0.25 (4.00)	-0.25 (3.75)	-0.25 (3.50)
Euro area - ECB	Dates	3.00	30 Jan 6 Mar	17 Apr 5 Jun	24 Jul 11 Sep	30 Oct 18 Sep	5 Feb 19 Mar	30 Apr 11 Jun	23 Jul 10 Sep	29 Oct 17 Dec
	Rates		-0.50 (2.50)	-0.50 (2.00)	-0.25 (1.75)	-0.25 (1.50)	unch (1.50)	unch (1.50)	unch (1.50)	unch (1.50)
Japan - BoJ	Dates	0.50	18-19 Mar	30 Apr - 1 May 16-17 Jun	30-31 Jul 18-19 Sep	29-30 Oct 18-19 Dec	Jan Mar	May June	Jul Sep	Oct Dec
	Rates		unch (0.50)	unch (0.50)	+0.25 (0.75)	unch (0.75)	unch (0.75)	unch (0.75)	unch (0.75)	unch (0.75)
UK - BoE	Dates	4.75	6 Feb 20 Mar	8 May 19 Jun	7 Aug 18 Sep	6 Nov 18 Dec	Jan Mar	May June	Jul Sep	Oct Dec
	Rates		-0.25 (4.50)	-0.25 (4.25)	-0.25 (4.00)	-0.25 (3.75)	-0.25 (3.50)	unch (3.50)	unch (3.50)	unch (3.50)
Canada - BoC	Dates	3.25	29 Jan 12 Mar	16 Apr 4 Jun	30 Jul 17 Sep	29 Oct 10 Dec	Jan Mar	May June	Jul Sep	Oct Dec
	Rates		-0.50 (2.75)	unch (2.75)	unch (2.75)	unch (2.75)	unch (2.75)	unch (2.75)	-0.25 (2.50)	-0.25 (2.25)

Source: AXA IM Macro Research - As of 28 January 2025

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Our Research is available on line: www.axa-im.com/investment-institute

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AXA IM manages approximately €859 billion in assets*, and has €480 billion of ESG-integrated, sustainable or impact assets**. Our purpose is to act for human progress by investing for what matters. As a responsible asset manager, we are committed to integrating ESG principles across our business, from stock selection to our corporate actions and culture.

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*As at the end of June 2024, including non-consolidated entities.
** As at the end of December 2023.

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