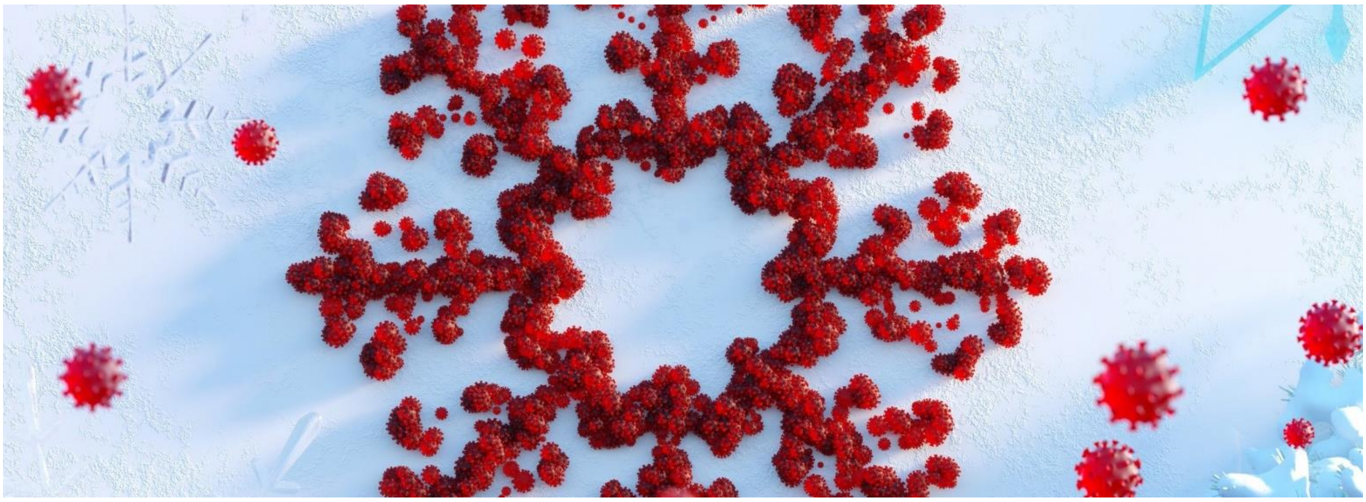
Omicron – the ghost of Christmas past?

Global Macro Monthly



Key points

- The Omicron variant presents a new and as yet undefined risk to the growth outlook for 2022. Evidence on the severity of infections will define the likely growth impact.
- Despite growth softening with supply constraints, the outlook for next year should be for further solid recovery. Inflation continues to rise but should be close to a peak in several jurisdictions.
- Labour market differences will shape medium-term inflation risks. Tight labour markets in the UK and Canada make the Bank of England and Bank of Canada look likely early tighteners. The Federal Reserve is tapering more quickly and can tighten earlier in 2022. The European Central Bank has announced its own taper for 2022.
- Rates and credit markets are positioned for faster Fed rate tightening, while the dollar could benefit further. ECB-Fed rate divergence poses some risk to European equity risk premia, but we remain constructive in outlook.

Global Macro Monthly

Investment Strategy

Global Macro Monthly – US

David Page,
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Risks mount even as growth remains solid

The holiday season has brought its usual focus on consumer spending and the latest round of official data showed a buoyant start to Q4. October retail sales surged by 1.8% on the month, with broader consumer spending up 1.3% – an impressive 0.7% monthly gain even allowing for elevated price pressure. Yet there are concerns that this buoyancy won't last. November sales slowed to just 0.3% with the notoriously difficult-to-interpret Black Friday/Cyber Monday spending estimates coming in lower than in 2020. October's spending may have been front-loaded holiday spending – 'buy now to avoid disappointment' – rather than stronger outright. That said, we expect consumer spending to accelerate to 1.5%qoq in Q4 from a meagre 0.4% in Q3. This would be consistent with Q4 GDP growth at around 4.5% (saar) on our estimates, but far slower than the 7.0% estimate from the latest Atlanta GDP tracker.

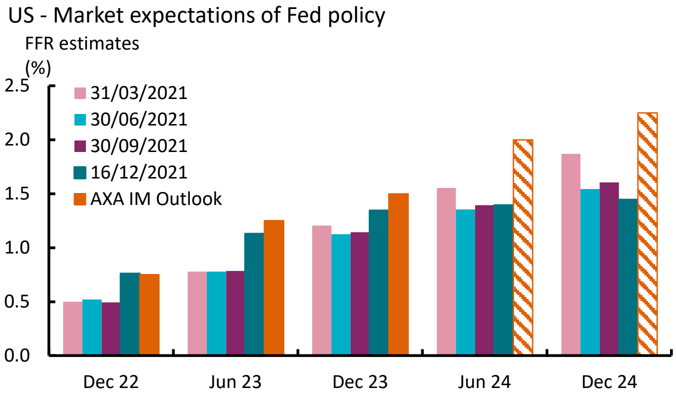
The start of Q1 presents its own challenges. The student loan moratorium ends this month, while the extension to the child tax credit (which has boosted some household incomes by as much as $300/month) is due to end on 15 January. Both risk reducing income growth materially at a time when living expenses are rising sharply. The administration has included a further extension to the child tax credit in the still to be passed Build Back Better Act, which (most) Democrats are keen to pass by Christmas. This may not be possible, but eventual passage in January still looks likely. Additionally, the as-yet-unquantified risks of the Omicron variant could weigh on the US, where vaccination rates still struggle to keep in line with other large economies.

Virus uncertainty is also relevant for the price outlook. We remain hopeful that even a more transmissible Omicron variant should not warrant significant government intervention in the US economy in 2022. However, it would likely still impact spending behaviour and labour market participation. Both threaten to keep inflation elevated for longer, despite the likely associated weakening of general demand. November's Consumer Price Index (CPI) inflation rate rose to a 40-year high of 6.8%, consistent with our outlook that inflation would peak close to 7% around the turn of the year. For now, we continue to expect a material drop in inflation from the spring, but still envisage Personal Consumption Expenses (PCE) inflation to average 2.5% in 2023 – around the cusp of the Federal Reserve's (Fed) stated ambition for a "modest overshoot" of its 2% inflation target. We forecast CPI inflation to average 4.7% in 2021, 4.1% in 2022 and 2.9% in 2023, modestly ahead of the consensus of 4.6%, 3.7% and 2.4%.

For now, we make no change to our growth forecasts from our Outlook published last month. We still envisage US GDP growth of 5.5% in 2021, 3.5% in 2022 and 2.7% in 2023. This is modestly lower than the consensus of 5.5%, 3.9% and 2.5%, due to concerns over COVID-19, supply-related disruptions and real income pressure continuing until visible improvement around mid-year.

Fed's turns hawkish as labour focus fades

Exhibit 1: Expectations shift timing not extent of hikes



Source: Bloomberg and AXA IM Research, 16 December 2021

The Fed stepped up a gear in its pace of removing monetary accommodation. In testimony to Congress, Chair Jerome Powell warned that the Fed would 'retire' the transitory description of inflation and would consider quickening the pace of its taper. The Fed's focus (and forward guidance), once seemingly squarely on labour market recovery, appears to have faded in the light of persistently elevated inflation.

The Fed announced that, from January, it would taper at a pace of $30bn/month ($20bn of US Treasuries and $10bn Mortgage-backed securities) from the $15bn seen in the first two months of its taper. This would end asset purchases in March, rather than June. While the impact of this adjustment to policy is relatively minor, it paves the way for an earlier rate hike. Indeed, December's Fed marked a hawkish turn with Fed Chair Powell warning that this risks of "entrenched" inflation had risen and that Fed participants overall now expected three hikes in 2022.

We still expect growth and the labour market recovery to lag Fed expectations, but nevertheless recognise a more hawkish Fed. We now expect the first hike in June, while acknowledging that if the omicron risk is less than we consider, or inflation expectations worsen, the Fed could move sooner. We forecast three hikes in 2022 and three (with a risk of four) in 2023. This would leave the Fed Funds Rate at 1.5-1.75% by end-2023 (Exhibit 1). We continue to forecast the Fed to have to tighten by more than markets currently expect and would expect rates to rise further towards 2.5% in 2024.

Global Macro Monthly – Eurozone

Hugo Le Damany,
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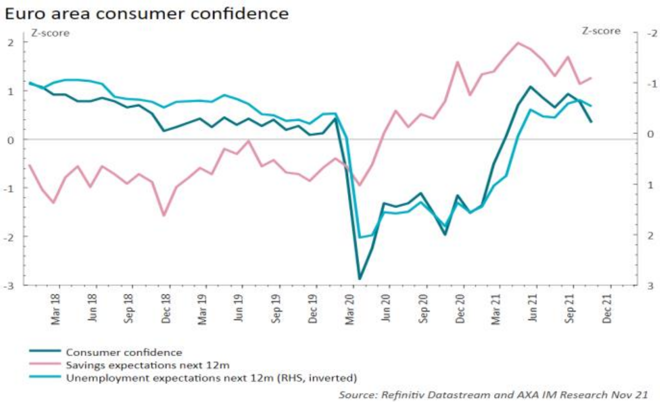
Seasonally adjusted

Recent surveys confirmed our expectations of softening demand in the fourth quarter (Q4). November's consumer confidence eased again (Exhibit 2), while October retail sales declined in Germany (-0.3% month-on-month), France (-0.2%) and Spain (-0.1%) due to rising energy prices and a shift of spending towards services. The latter is now exposed to tougher restrictions from the Delta COVID-19 wave and uncertainty around the Omicron strain.

Exhibit 2: Softening consumer confidence



Source: European Commission and AXA IM Macro Research, November 2021

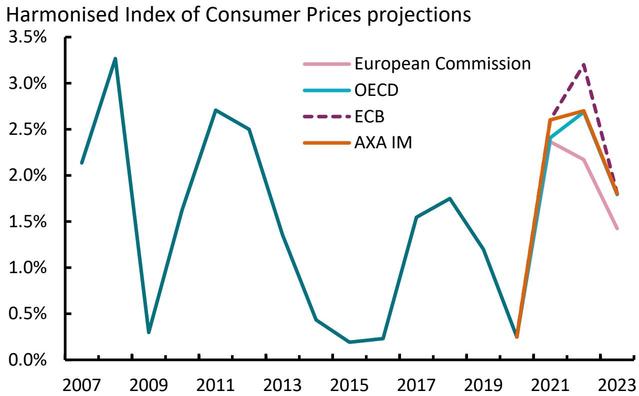
Manufacturing data has been mixed. German industrial production surprised on the upside, rising 2.8%mom but was strongly biased towards auto production, which jumped 26% while data from industry trade body the *Verband der Automobilindustrie* (VDA) pointed to another strong print in November (up 15%) as the sector recovers from extreme weakness relating to chip supply. In the Eurozone, France also saw a 0.9% rise, but Italy and Spain – less exposed to autos – both contracted. However, German orders fell by 6.9% mom pulled down by external demand (-13%), despite robust domestic demand (+3.4%).

Overall, the short-term outlook is mixed. We continue to expect timorous Q4 GDP growth (+0.4% quarter on quarter), while Q1 should be only slightly better. However, as presented in our 2022 Outlook, we are more optimistic for Q2 and the second half of next year as both bottlenecks and inflationary pressures should fade while production capacity should improve.

ECB: Time for recalibration!

As expected, the European Central Bank's (ECB) Governing Council announced the end of the Pandemic Emergency Purchase Programme (PEPP) but maintained some flexibilities in the policy reinvestment that has also been extended until the end of 2024. The 'doves' probably abandoned this battle to focus on recalibrating the Asset Purchase Programme (APP). It will be scaled up to €40bn per month in Q2 (versus €20bn), before declining to €30bn in Q3 and €20bn from October 2022 onwards and this "*for as long as necessary*". The Governing Council still "*expects net purchases to end shortly before it starts raising the key ECB interest rates*". Technically, the statement does not exclude the feasibility of a rate hike in December 2022 but we prefer to believe today's statement is a confirmation of recent speeches given by some hawkish members mentioning rate hike was very unlikely before 2023. The ECB believes inflationary pressure will persist in the near term but should ease in the course of 2022 and end below 2% by the end of 2022. Macroeconomic projections showed inflation could reach 3.2% in 2022, and 1.8% in 2023 and 2024 (Exhibit 3).

Exhibit 3: inflation projections



Sources: EU Commission, OECD, ECB and AXA IM Macro Research, Dec 2021

The three-pillars political focus

Coalition negotiations ended as expected in Germany: Olaf Scholz was nominated Chancellor, FDP leader Christian Lindner became Finance Minister, while the Greens head the Economic, Ecological and Foreign Affairs ministries. The energy transition, increasing minimum wages and strengthening Europe are the new government's top priorities. Fiscal policy is still cautious, but the door remains open to some changes at both domestic and European level.

In Italy, Matteo Salvini reiterated his support for Mario Draghi as Prime Minister, lowering the probability of Draghi being proposed as President. But Parliament may yet fail to agree on a candidate, especially as one is yet to be declared.

In France, contenders for April's Presidential Election have been identified. Valerie Pecresse leads the centre-right Les Republicains and recent polls showed a strong rebound in voting intentions. This is probably due to greater press coverage and we will see if this persists. We continue to see the re-election of President Emmanuel Macron as the most likely outcome.

Global Macro Monthly – UK

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Bank of England moves to hike rates

The emergence of the omicron variant poses some risk to the pace of recovery. With the number of omicron cases doubling every two to three days, the government introduced new social restrictions – Plan B – on 8 December. The evolution of this new variant is a key downside risk to growth.

Given the risks from new restrictions and precautionary behaviour, we now expect Q4 GDP to come in below our prior 1% previously forecast. This would leave 2021 growth a touch weaker at 6.8% (compared to 6.9%). We expect an overall rebound to persist into 2022 but envisage challenges for real income growth over the coming quarters. We expect growth in 2022 of 5.0% (from 5.2%) and 2.3% in 2023. This compares to consensus forecasts of 7.0%, 5.0% and 2.0%.

Headline CPI reached a 10-year high of 5.1% in November. Energy has driven much of the increase, but supply chain bottlenecks and rising retail goods prices have also contributed. Inflation looks set to rise to a fresh 30-year high in Q2 2022, driven by the pass through of utility price increases in the Office of Gas and Electricity Markets (Ofgem)' energy price cap adjustment in April. After that we expect prices to fall back towards target in 2022. On average, we expect inflation to record 2.4% this year, 3.8% in 2022 and 2% in 2023, but rising wage pressures are increasing the outlook for medium-term inflation pressures. Consensus forecasts inflation to average 2.4%, 3.6% and 2.1% for the three years.

Despite 1.1mn people being on the government's furlough scheme when it closed at the end of September, unemployment fell marginally to 4.2% in October (from 4.3%). Combined with vacancies at all-time highs and warnings from employment survey providers, there are growing signs of an overheating labour market. Bank of England (BoE) speeches continue to focus on perceived upside risks to inflation from a tight labour market.

The BoE announced the start of a cautious hiking cycle, increasing Bank Rate by 0.15% to 0.25% in December, despite expectations shifting in the wake of the omicron variant. The BoE pointed to elevated inflation and concerns about second round inflation effects emerging in a tight labour market. The BoE stressed that future moves would in part depend on the virus's evolution, but that it currently expects modest further tightening "is likely to be necessary". For now, we expect Bank Rate to rise to 0.75% by end 2022 (0.25% in May and 0.25% in November) and forecast a rise to 1% only in November 2023.

Global Macro Monthly – Japan

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Demand resilient, cautious on extra budget

Data now confirms a substantial domestic demand increase following the end of the state of emergency. In October, the Bank of Japan's (BoJ) consumption activity index jumped 4.3% on the month, with spending rebounding in durable goods and recovering fast in services. Looking at consumer confidence, employment prospects rose again and are now above the pre-pandemic level while income expectations are flat. Willingness to buy durable goods has declined, although this probably reflects a shift of spending towards services. In the manufacturing sector, output progresses and the auto sector is gradually recovering. December BoJ' Tankan surveys for manufacturing firms were surprisingly unchanged. That said, FY21 profit expectations strengthened considerably and capex plans were only revised down modestly.

Our outlook remains optimistic, but it is worth highlighting that the environment could deteriorate rapidly with the Omicron virus variant. Domestically, demand could be hit again while supply shortages could be increased if the situation worsens in China, which has a 'zero-COVID' policy, or in Southeast Asia, where vaccination coverage is still low.

On the fiscal front, we reiterate our cautious assessment of the latest supplementary budget. Of the ¥56tn announced, only ¥31tn (5.9% of GDP) comes from government spending. Cash handouts, subsidies and vouchers will be distributed, but excess savings that have already reached around 3.7% of GDP may dampen their take-up. On the investment side, the package recycles some previous measures, such as digitalisation and strategic sovereignty, while spending should be smoothed over the coming years. However, the government intends to issue ¥22tn (4.2% of GDP) of debt to finance the supplementary budget.

October Consumer Price Index reached 0.1% year-on-year but the figure remains significantly distorted by lower mobile phone charges that have decreased by 54%yoy, removing approximately 1.6 percentage points from the index. Looking ahead, the likely resumption of the "Go to Travel" campaign and recent yen depreciation will also complicate the reading.

The BoJ decided to extend the termination date of the COVID loan program mainly for small and medium enterprises (SMEs) by six months to the end of Sep 2022. Other measures are broadly unchanged. Contrast with other central banks is still important and Gov Kuroda insisted that inflation excluding energy prices was subdued, so the very accommodative polices were still justified.

Global Macro Monthly – China

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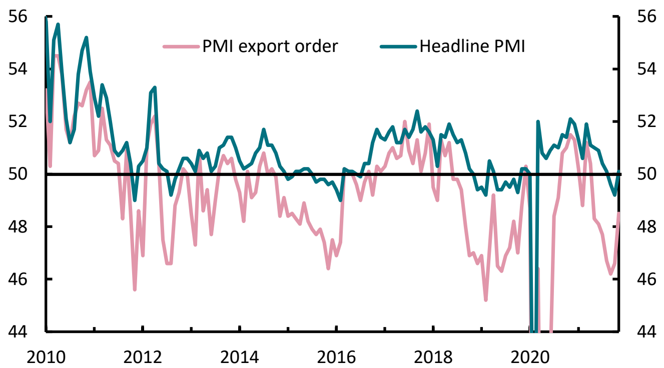
Growth recovers on fading power shortages

After barely escaping contraction, the economy appears to be gradually finding its feet as it enters the final quarter of the year. Fading adverse weather conditions and the containment of the Delta coronavirus wave have helped to remove some temporary pressures in the economy, paving the way for a rebound in quarterly growth in the fourth quarter (Q4).

The power shortages, which plagued industrial and manufacturing firms at the end of Q3, also waned following a concerted government effort to ensure a stable energy supply. The situation served as a stark warning on the danger of an aggressive, uncoordinated and "campaign-style" decarbonisation push. Given the priority of preserving near-term growth and social stability, the authorities acted swiftly to remove curbs on coal production and imports and clamped down on coal futures speculation. A sharp decline in the cost of coal, which fuels the majority of China's power plants, gave electricity companies the necessary incentives to plug the supply gap. With power supply back online, the resumption of production saw the manufacturing Purchasing Managers' Index (PMI) recover to expansionary territory after spending the prior two months below 50 (Exhibit 4).

Exhibit 4: Headline PMI edges above the waterline

China manufacturing Purchasing Managers Index



Source: CEIC and AXA IM Research, 9 December 2021

Omicron reinforces the zero-COVID strategy

China has seen two small waves of COVID-19 infections following the July-August Delta wave, without triggering massive social and mobility restrictions. However, the soft services PMI in November suggests that the economy may not have escaped totally unscathed. Upcoming retail sales data will provide evidence of the impact. So far, there are no Omicron cases reported on the mainland, but a few imported cases in Hong Kong – successfully quarantined at the border. While there are still many unknowns about the new variant, the speed at which it has spread in Southern Africa is a cause for concern on its transmissibility. If coupled with the ability to evade vaccines, Omicron could present a major threat to the global economy.

For China, the emergence of Omicron has a number of implications. First, it reinforces our view that Beijing is unlikely to change its 'Zero-COVID' strategy in light of the constant mutation of the virus. A recent study by Peking University shows that China could see more than 630,000 cases per day if policies were relaxed consistent with the 'living with the virus' approach. Given the current rate of severe illness from the virus, this could overwhelm China's public health system and trigger panic in society. Hence, our 2022 outlook expects Beijing to stick to its current strategy until further major medical breakthroughs are achieved.

Second, the implication for the economy is that growth will likely remain uneven. Constant virus resurgences, combined with periodic lockdowns, will likely continue to inhibit household spending, holding back the already lacklustre consumption recovery. In contrast, China's exports of medical equipment and personal protective gear could be revived by a global spread of Omicron. While this could be offset by weaker demand for other products due to a global lockdown, supply disruption elsewhere could mean that China still gains from a shrinking pie. Export growth, therefore, may not decelerate as fast as we assume in the 2022 outlook.

Finally, a more serious outbreak of Omicron would likely trigger a faster and more aggressive policy response by Beijing. Our 'Outlook 2022' – written before the emergence of the new variant – already expected the authorities to recalibrate their regulatory and countercyclical policies to ensure that the economy does not stumble into a hard landing. While growth is showing signs of recovery from Q3's soft patch, the vigour is still short of what would be expected from a typical rebound after a steep growth decline.

Indeed, Beijing has already started to ramp up policy support, with a fine-tuning of property policies, more generous liquidity injections and faster local government bond issuance. Recently, the People's Bank of China announced a 50-basis point reserve requirement ratio cut on 15 December, which is expected to release about RMB1.2tn of liquidity into the banking system. However, these piecemeal actions alone would be insufficient to reignite economic engines to hit our 2022 growth forecast of 5%. As expected, the recent Central Economic Working Conference sent a clear dovish signal, preparing the local authorities for a more forceful act next year. One thing that could expedite the planning and decision-making process is a wide spread of a virulent virus, which makes the development of Omicron important to watch by Beijing and the market.

Global Macro Monthly – Emerging Markets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Patchy Q3 activity, stabilisation ahead?

The recovery across emerging markets over recent quarters has been neither smooth nor synchronous. Volatility has followed COVID-19 flare-ups and the more or less drastic policy responses imposed to address those waves. The third quarter (Q3) looked more like a soft patch and, Omicron aside, we should see a better trend in activity in Q4 as pressures on the Chinese economy ease.

Growth contracted in Q3 in **Malaysia** (-3.6% quarter-on-quarter) and Thailand (-1.1%) where exports partly fell due to virus-related capacity restrictions and shutdowns in domestic manufacturing units were a drag.

The **South African** economy also retreated (-1.5%) in Q3 following four quarters of uninterrupted recovery, after disruptions from social unrest in July and tighter lockdown restrictions as the government sought to contain a third wave. The possibility of tighter mobility restrictions in response to the new Omicron variant, particularly active in South Africa, is of concern.

Mexico's economy fell 0.4% quarter-on-quarter, marking its first quarterly decline since the post-pandemic recovery began. The result was driven by a decline in services, as activity in the country was disrupted over the summer by a resurgence of the virus. **Brazil** GDP eased 0.1% in Q3 for the second successive quarter, below market expectations for a slight expansion, on the back of a steep, weather-driven contraction in agricultural production.

However, fuelled by strong growth in household consumption and investment, **Colombia** enjoyed a Q3 rebound with growth of 5.7% after dropping 2.5% in Q2. **Chile** posted its best growth (4.9%) since the final quarter of 2020, in the wake of the easing of pandemic-related restrictions, fiscal stimulus and pension drawdowns.

A rather broad-based slowdown in Q3 was reported in **Russia** while growth surprised to the downside in **Central Europe** (still up on a sequential basis). In **Hungary** (0.7%) and **Romania** (0.3%), the pace of growth has slowed considerably but recovery remains broadly robust in the region, with **Poland** and the **Czech Republic** both delivering strong quarter-on-quarter growth (2.1% and 1.4% respectively). Activity growth has proved very strong in India (10.4%).

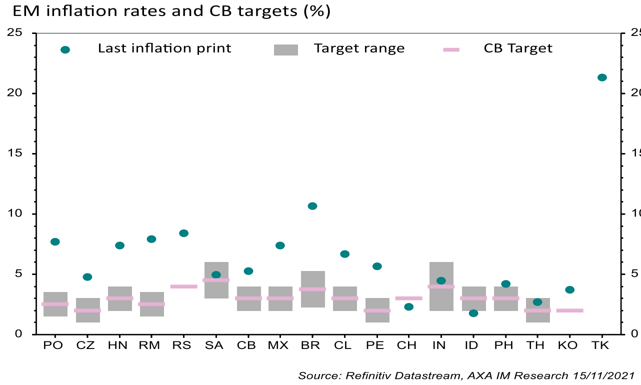
Turkey provided a positive surprise, as consumer and government spending were exceptionally strong – the economy expanded by 2.7% in Q3, further accelerating from Q2 (+1.5%). All in all, growth from January to September 2021 was an impressive 12%, which puts upside pressure to our annual growth forecasts for Turkey.

There are several key risks to emerging market growth going forwards. For one, the Omicron variant is more transmissible, and if it or a future variant proves to evade vaccines or produce more severe symptoms, the restrictions designed to contain it could mean:
- A sharper China slowdown, perhaps driven by bigger-than-expected property woes
- Normalising goods demand from advanced economies with a shift towards services consumption in the upcoming quarters
- An abrupt adjustment in global financial conditions
- A tighter policy mix with lower-than-expected government spending as cost of debt increases and weighs on fiscal leeway while domestic monetary conditions tighten further.

Higher inflation and tighter monetary policy

Exhibit 5: Inflation increasingly rising above targets

EM inflation rates and CB targets (%)



Source: Datastream and AXA IM Research, November 2021

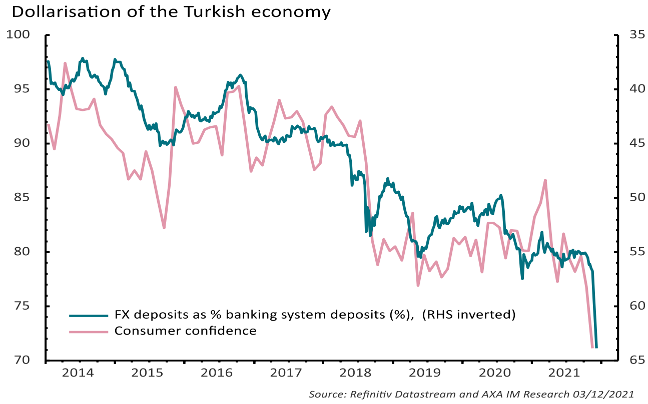
Inflation has sped up globally, more so in developing markets, and these countries are yet to recover all of their COVID-19 induced losses – let alone regain pre-pandemic growth trends.

Supply constraints have eased and energy and commodity prices have fallen recently. Still, global food prices continue to pressure headline inflation – often well beyond central bank targets (Exhibit 5). Some pass-through appears visible in core inflation measures, particularly where currencies have been weakening. Annual core inflation was 7.2% in Brazil, 8.7% in Russia and 17.6% in Turkey in November.

Inflation has been largely driven by external factors rather than domestic demand, but emerging market central banks are tightening policy and keeping hawkish rhetoric, with a few exceptions. Past currency depreciation and wages and pensions indexation mechanisms may further pressure inflation expectations. Monetary policy must respond faster, though could be hindered by lower financial penetration and shallower local markets. Policy also needs to maintain the necessary inflow of foreign capital. Year-to-date, 32 banks across emerging markets have hiked rates, by as much as 725 basis points (bps) in Brazil and 2500bps in Zimbabwe. More hikes are likely, although some central banks, such as Russia or Mexico, have probably already done most of the heavy lifting ahead of the upcoming Federal Reserve lift-off.

Turkey is an outlier, having cut rates by a cumulative 400bps since September despite seeing high – and accelerating – inflation rates. November annual Consumer Price Index (CPI) showed inflation at 21.3%, above expectations. Underlying trends in core CPI show persistent inflation and an evident currency pass-through. Producer Price Index inflation was even more dramatic, showing a 10% jump on the month, and an annual increase of 54.6%. Despite the tough inflation outlook and the secular deterioration in price dynamics, further easing in December is likely. A far tighter stance is badly needed to anchor expectations. Worryingly, the size of foreign currency deposits in the Turkish banking system reached almost 64% by early December (Exhibit 6). The current monetary policy stance is increasingly difficult to sustain and is likely to lead to tightening into 2022. The sooner, the better.

Exhibit 6: Turkish economy increasingly dollarized



Source: Datastream and AXA IM Research, December 2021

Global Macro Monthly – Canada

David Page,
Head of Macro Research,
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Labour capacity to weigh on growth

Third quarter (Q3) GDP growth of 5.4% (annualised) beat forecasts of 3.0%. This reflected a downgrade to Q2 growth (now seen at -3.2% from -1.1%), but Q3 GDP was still 0.4ppt higher than expected. The economy was again disrupted by COVID-19 and then benefitted from a stronger rebound. Q4 may be more challenging. High vaccination rates kept new cases relatively subdued through most of Q4 – below the October 20 and May 21 lows. Omicron poses an uncertain risk. Around 10% of new cases are omicron - amongst the highest recorded outside of southern Africa. Canada also suffered severe flooding in mid-November. This should have a short-term effect, depressing Q4 growth (boosting early 2022). The net impact sees us lower our growth outlook to 4.4% (from 4.9%) this year and raise 2022 to 3.7% (from 3.5%). We keep our 2023 forecast unchanged at 2.6%.

This is softer than consensus forecasts (5.0%, 4.1% and 2.8%), which in part reflects our supply concerns. Beyond flooding and more persistent global supply constraints (seen easing into the second half of 2022), labour capacity is a worry. Employment posted a sharp rise of 154k in November, regaining pre-virus levels. Participation remained at 65.3% – close to its pre-pandemic level. Yet productivity contracted by 1.2% in Q3 and should fall again in Q4. Canada has resumed managing its labour force growth through migration – 300k net immigrants to October, close to target – but weak productivity growth leaves unit labour costs elevated.

November CPI inflation remained at 4.7%, a 30-year high. We still see a sharp unwind in the first half of 2022, but elevated unit labour costs present medium-term risks. We forecast CPI inflation to average 3.4% in 2021, 3.1% in 2022 and 2.3% in 2023 (consensus 3.3%, 3.2% and 2.2%).

The Bank of Canada (BoC) left its overnight rate target unchanged at 0.25% in December. It continued to guide that conditions for a rate hike would likely be met in the middle quarters of next year. The five yearly review of the BoC mandate made explicit reference to the labour market, but this largely embodied current practice and Governor Macklem added that it would not slow tightening in the current environment. Markets price five hikes in 2022 to 1.5%, starting in January, and twice in 2023. We still forecast the first-rate hike in April. But faster labour market tightening and quicker tightening from the US Federal Reserve leads us to add an expected hike in July (to three hikes) and one hike in 2023, taking rates to 1.25%, but see a risk of two.

Investment Strategy – FX

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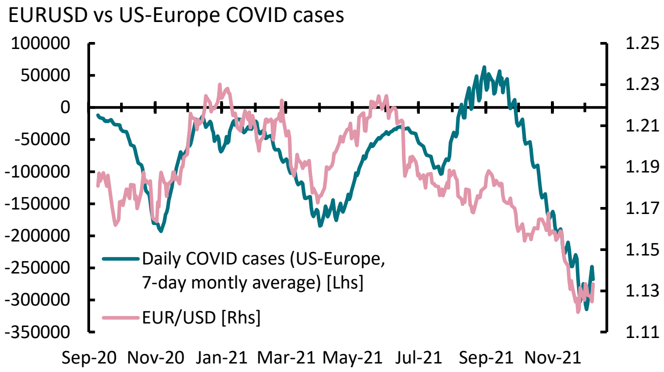
The Omicron stress test

The emergence of the Omicron variant has been a fitting reminder of the importance of monetary policy expectations in driving currency moves. As the Omicron news emerged and risk appetite took a hit, the dollar's reaction was to depreciate against the euro, in contrast to its customary appreciation in a risk-off in environment.

This was mainly caused by the partial unwind of expectations for interest rate hikes by the US Federal Reserve (Fed) earlier in 2022, given the emerging uncertainty about the economic outlook. As it happens, the dollar did appreciate against certain currencies post Omicron – currencies where expectations about their central banks' policy had been rising in tandem with expectations about the Fed's hiking cycle. In this context the safe-haven status of the dollar prevailed as the dominant driver of relative currency strength.

Exhibit 7: The Delta variant spread in Europe has accelerated the depreciation in the EURUSD



Source: Bloomberg and AXA IM Research, 13 December 2021

Further to the market reaction to Omicron risks, concerns subsided a little on early indications that Omicron might prove more benign than the Delta variant, thus reducing the number of hospitalisations and deaths once it becomes the dominant strain across communities. This has allowed for a more aggressive pricing of the Fed's hiking cycle to recur, in line with more hawkish recent comments by the Fed Chair.

Beyond that, the terminal rate appears underpriced and expectations for it to rise could bring additional support to the dollar early in 2022. The euro may find some relief versus the dollar as the latest wave of COVID-19 starts peaking in Europe (Exhibit 7), but ultimately the approaching French elections are likely to keep the risks for the euro skewed to the downside for the first months of 2022.

Investment Strategy – Rates

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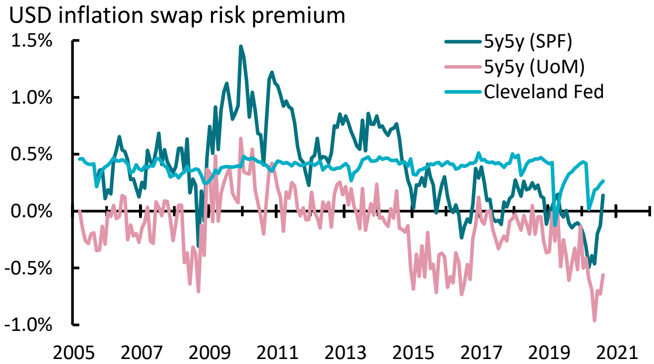
Inflation still matters

Inflation expectations are a key performance factor for the months to come, as in 2021. Annual consumer prices (CPI) in the US two years forward are expected to grow by 2.75%. This does not look too aggressive if we account for the so-called 'inflation-risk premium' that investors require in order to hold inflation-linked bonds given uncertainty about future inflation. Exhibit 8 shows measures of inflation-risk premium based on inflation-swap markets, the Survey of Professional Forecasters by the University of Michigan (UoM), and the Cleveland Fed's model. The latter indicates an inflation premium of about 0.45%, which results in CPI expectations two years forward of 2.3% (2.75% minus 0.45%).

Exhibit 8: Inflation risk premium compensating for inflation uncertainty



Source: Bloomberg and AXA IM Research, 13 December 2021

For the Fed, this level of market-based expectations must be comforting. After subtracting the 40 basis points usual spread between CPI and the personal consumption expenses (PCE) deflator, the level of policy-relevant inflation expectations seems to be a little under the Fed's 2% target. We also need to look at survey-based inflation expectations, which have recently picked up significantly: The UoM five to 10 year expectation has been at 3% in recent months, back to 2012-2013 highs, while the NY Fed three-year inflation outlook exceeds 4%.

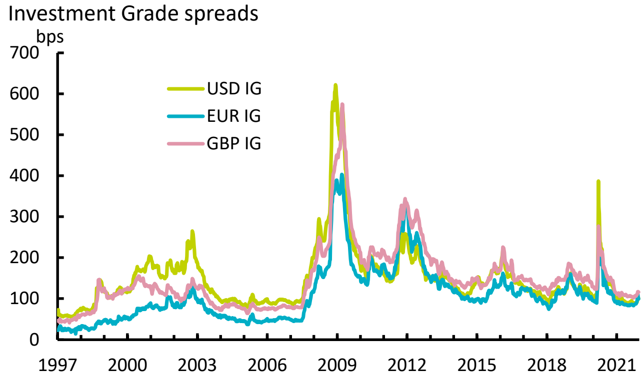
Against this background, the growth outlook for advanced economies is deteriorating somewhat. Even though expansion in 2022 is projected materially above potential, a combination of softening growth and sustained inflation may become a fertile ground for policy mistakes. Hence, nominal Treasuries are likely to be trapped in a tug of war between inflation expectations and real yields, reflecting long-term fundamentals such as potential growth and productivity trends, as well as reacting to the Fed's policy cycles.

Investment Strategy – Credit

Gregory Venizelos,
Credit Strategist,
Research – Core Investments

Credit spreads shaken, not stirred

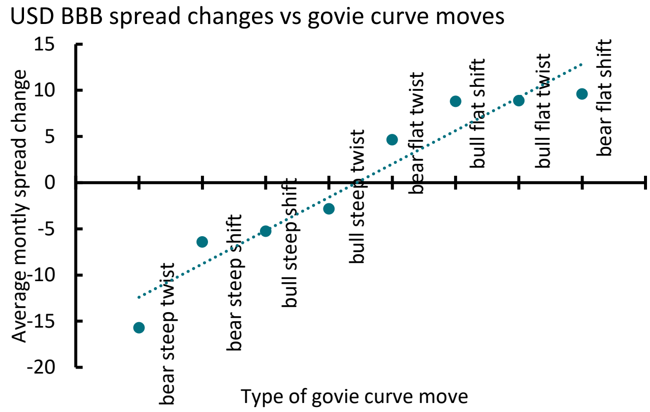
Exhibit 9: November's spread correction barely registers compared to long-term spread history



Source: InterContinental Exchange (ICE) and AXA IM Research, 13 Dec. 2021

November's spread widening was the first notable correction in credit markets since October 2020. Spreads reacted to the broader risk-off that was triggered by more hawkish messaging by central banks and the emergence of the Omicron variant. The widening is also consistent with the more aggressive pricing of the US Fed's rate hiking cycle, as credit spreads tend to widen when government bond curves bear-flatten (Exhibit 10). Spreads tightened in December as Fed expectations and Omicron fears steadied, and the recent correction barely registers in the grand scheme of things (Exhibit 9). Providing that the Omicron variant does not upend the global recovery from the pandemic, we remain constructive for spread risk in 2022, given strong credit fundamentals and decent earnings growth expectations.

Exhibit 10: Spreads tend to widen on average when govie curves bear-flatten



Source: Bloomberg, ICE and AXA IM Research, 13 December 2021

Investment Strategy – Equity

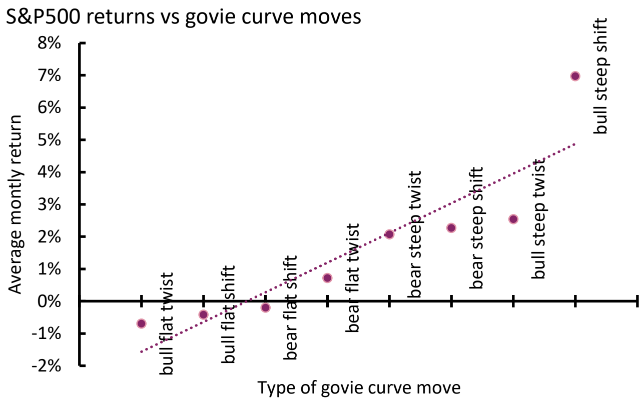
Emmanuel Makonga,
Investment Strategist,
Research – Core Investments

Staying the course

The Omicron variant proved a short-term catalyst for stocks, with global equities down -1.1% over the month. Utilities, materials and technology were the only three sectors to post a positive performance. The outperformance of cyclicals relative to defensives came to a halt as inflation break-evens declined, while the value/growth rotation remained stable. The new virus strain does not alter our constructive longer-term outlook for now, as it may prove relatively more benign and lockdowns may be avoidable.

The change of tone by the US Fed that retired the 'transitory' term for inflation, triggered the more aggressive pricing of US monetary policy outlook. This drove a bear flattening in the US Treasury (UST) curve with the spread between two-year and 10-year USTs declining further. Our analysis shows that stocks don't tend to perform well when the government bond curve bear-flattens (Exhibit 11), which is consistent with the 0.6% drop in the S&P 500 over the previous month.

Exhibit 11: Stocks tend to underperform on average when government bond curves bear-flatten



Source: Bloomberg and AXA IM Research, 13 December 2021

The risk of contagion from US monetary policy tightening should not be significant. The current environment is one of policy divergence between the US and Europe as the transitory inflation message on the US side proved unsustainable. While some spillover from Fed policy on European risk premia may occur, our estimates appear rather modest. Looking at the beta of implied volatility of European equities relative to US equities, we find that the level currently is historically low (below the first quartile). This reflects a reasonable degree of decoupling between the equity markets across the Atlantic.

Recommended asset allocation

Asset Allocation	Negative	Neutral	Positive
Key asset classes			
Equities			■
Bonds	■		
Commodities	■		
Cash			■
Equities			
Developed			
Euro area			■
UK		■	
Switzerland		■	
US			▲
Japan		■	
Emerging & Sectors			
Emerging Markets		■	
Europe Cyclical/Value		■	
Euro Opening basket		▼	
Euro Financials			■
US 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 16 December 2021

Macro forecast summary

Real GDP growth (%)	2020	2021*		2022*		2023*	
		AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
World	**-3.2**	**5.7**		**4.2**		**3.6**	
Advanced economies	**-5.0**	**4.9**		**3.8**		**2.4**	
US	**-3.4**	**5.5**	5.5	**3.5**	4.0	**2.7**	-
Euro area	**-6.7**	**5.0**	5.0	**3.9**	4.3	**2.1**	-
Germany	**-4.9**	**2.6**	2.7	**3.5**	4.3	**1.9**	-
France	**-8.0**	**6.7**	6.5	**3.6**	3.8	**2.0**	-
Italy	**-8.9**	**6.2**	6.1	**3.7**	4.2	**1.9**	-
Spain	**-10.8**	**4.3**	5.0	**5.5**	5.9	**3.0**	-
Japan	**-4.9**	**1.9**	2.2	**3.5**	3.0	**1.6**	-
UK	**-10.0**	**6.8**	6.9	**5.0**	4.7	**2.3**	-
Switzerland	**-2.5**	**3.5**	3.4	**3.0**	3.0	**1.6**	-
Canada	**-5.3**	**4.4**	5.0	**3.7**	4.1	**2.6**	-
Emerging economies	**-2.0**	**6.2**		**4.4**		**4.3**	
Asia	**-0.8**	**6.8**		**5.1**		**5.1**	
China	**2.3**	**7.9**	8.0	**5.0**	5.1	**5.3**	-
South Korea	**-0.9**	**4.0**	4.0	**2.6**	3.1	**2.1**	-
Rest of EM Asia	**-4.6**	**5.8**		**5.5**		**5.3**	
LatAm	**-7.1**	**6.2**		**2.6**		**2.5**	
Brazil	**-4.1**	**5.1**	4.9	**1.2**	1.1	**2.0**	-
Mexico	**-8.5**	**6.0**	5.9	**2.6**	2.9	**2.2**	-
EM Europe	**-2.1**	**5.9**		**3.8**		**2.8**	
Russia	**-3.0**	**4.5**	4.2	**3.2**	2.6	**2.0**	-
Poland	**-2.7**	**5.1**	5.1	**5.0**	5.0	**3.6**	-
Turkey	**1.8**	**9.5**	8.9	**3.6**	3.5	**3.0**	-
Other EMs	**-2.4**	**4.2**		**4.1**		**3.9**	

Source: Datastream, IMF and AXA IM Macro Research – As of 16 December 2021 * Forecast

CPI Inflation (%)	2020	2021*		2022*		2023*	
		AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	**0.7**	**3.1**		**3.1**		**2.2**	
US	**1.2**	**4.7**	4.4	**4.1**	3.7	**2.9**	-
Euro area	**0.3**	**2.6**	2.4	**2.7**	2.3	**1.8**	-
Japan	**0.0**	**-0.2**	-0.2	**0.7**	0.7	**0.6**	-
UK	**0.9**	**2.4**	2.4	**3.8**	3.7	**1.9**	-
Switzerland	**-0.7**	**0.5**	0.5	**0.6**	0.7	**0.7**	-
Canada	**0.7**	**3.4**	3.3	**3.1**	2.9	**2.3**	-

Source: Datastream, IMF and AXA IM Macro Research – As of 16 December 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	Q4-21	Q1-22	Q2-22	Q3-22
United States - Fed	Dates	0-0.25	2-3 Nov 14-15 Dec	25-26 Jan 15-16 Mar	3-4 May 14-15 June	26-27 July 20-21 Sep
	Rates		unch (0-0.25)	unch (0-0.25)	unch (0-0.25)	unch (0-0.25)
Euro area - ECB	Dates	-0.50	28 Oct 16 Dec	20 Jan 10 Mar	14 April 9 June	21 July 8 Sep
	Rates		unch (-0.50)	unch (-0.50)	unch (-0.50)	unch (-0.50)
Japan - BoJ	Dates	-0.10	27-28 Oct 16-17 Dec	17-18 Jan 17-18 Mar	27-28 April 16-17 June	20-21 July 21-22 Sep
	Rates		unch (-0.10)	unch (-0.10)	unch (-0.10)	unch (-0.10)
UK - BoE	Dates	0.10	4 Nov 16 Dec	3 Feb 17 Mar	5 May 16 June	4 Aug 15 Sep
	Rates		+0.15 (0.25)	unch (0.25)	+0.25 (0.50)	unch (0.50)

Source: AXA IM Macro Research - As of 16 December 2021

These projections are not necessarily reliable indicators of future results

Download the full slide deck of our December Investment Strategy

Our Research is available on line: http://www.axa-im.com/en/insights

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