AXA Investment Managers

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Investment Institute Macroeconomics

Monthly Op-ed

Gilles Moëc
AXA Group Chief Economist
and Head of AXA IM Research

Chris Iggo,
Chair of the AXA IM Investment
Institute and CIO of AXA IM Core

Looking beyond the immediate challenges

Key points

- Central banks are still acting and talking tough, but we still think the peak in policy rates is not far.
- The price to pay for this is a softening economy on both sides of the Atlantic.
- Central bank activity will be the key determinant of investment duration, with cash-like short duration still attractive for now.
- Rising recession risks, in line with our forecasts, may offer potential for longer-duration fixed income.
- Over the longer run, transformative investment trends will include the energy transition and artificial intelligence (AI) developments.
- Investors face a challenge over multiple time horizons to balance these outlooks.

Central banks forced to inflict more pain in the short run

Hawkish talk from the Federal Reserve (Fed), a resumption of "jumbo hiking" in the UK, and the end of the pauses in Australia and Canada are creating the impression that a large wave of additional tightening is coming in the global economy, defeating hopes that the "peak" is in sight. These central bank moves – triggered by persistent observed inflation or lingering pressure in the pipeline (such as the stubborn robustness of the US labor market) – need however to be put in perspective of global demand. More signs of slowdown are emerging in the real economy at the global level, which are themselves at least partly the result of the monetary tightening. Even if the lags between these real economy signals and disinflation can understandably fuel central banks' frustration, we still think the peak in policy rate is not that far away, although the last mile of tightening may be painful.

The Fed gave us a "hawkish hold" at its June meeting with the upward revision in its "dot plot" rate projections implying two more hikes – more than the market was bracing itself against – and maintaining a "tightening bias" in the soft forward guidance. In a nutshell, this reflects a belief at the Federal Open Market Committee (FOMC) that monetary conditions may not be restrictive enough against a background of a resilient labor market. In practice, this probably means the Fed won't "stop for good" until payrolls unambiguously deteriorate. And it may take more than one batch to be convinced. A soft reading ahead of its July meeting may not be enough to stay their hand.

Still, delivering two more hikes as per the dot plot seems like a lot to us as inflation – both headline and core – has started to recede, and real economy indicators are heading down. While there is quite a thick "data fog" at the moment, the direction of

travel for growth – or the absence thereof – and inflation seem to be tilted towards the downside. We feel we may be in a situation where the Fed says "two to get one in the end." The hawkishness of the dot plot would be largely a ploy to move the market away from triggering a spontaneous softening of financial conditions, which would delay the landing of the economy. From this point of view, the Fed has already been successful in getting the market to push its expectation of rate cuts further out. For the FOMC, making sure monetary conditions remain restrictive for long enough to bring inflation firmly back into its box may matter more than triggering even more restriction. So, in response to the messages of the Fed, we have moved our call for the peak in rate in July, at 5.25-5.50%, but we still don't want to go further than that given our expectation of more bad news on growth and good news on inflation in the coming two months.

On the euro area side, the flash Purchasing Managers Index (PMI) survey in for June is the latest indicator going south. The composite PMI was only marginally in expansion territory at 50.3, sharply down from 52.8 in May and markedly below expectations (52.5). The recent behavior of the index suggests that the usual pattern of manufacturing acting as a forward-looking indicator of the direction of the whole economy is being observed again; the services PMI's resilience, contrasting with the deep deterioration in business confidence in industry, has come to a halt. In a sense, what is surprising is that the PMI was not lower earlier, since after all, the euro area has been in "technical recession" since Q4 2022. Still, the message from the PMI is that any rebound is likely to be modest – if one emerges at all.

There were some good signs on the inflation side as well. Indeed, to quote directly from Markit, the producer of the PMI survey, "*average prices charged for goods and services rose at the slowest rate for 27 months in June, having been on a broad easing trend over the past year but showing an especially large drop in momentum in June*." The combination of prolonged challenges to the real economy and easing inflationary pressure will come as a boon to the doves at the European Central Bank (ECB) Governing Council who are reluctant to see the central bank "sleep-walk" into yet another hike in September.

It will be an uphill struggle for the doves, though. Between surveys hinting at some disinflation to come and hard numbers on higher realized core inflation, so far in this cycle, the central bank has been more focused on the latter. A lot of the slowdown in consumer prices in May could be traced back as a one-off – the timing of the rebate on train tickets in Germany – which will be offset in June. Still, the underlying narrative on the state of the European economy is slowly becoming a bit tougher to maneuver for the hawks. It may not be clear enough by September – especially if the labor market holds tight – which makes September our baseline for peak tightening, but we still think it's a closer call than it looks.

Central banks still dictate duration of investment for now

It's clear that central banks and the path of developed economy interest rates will continue to determine what areas investors consider. Historically, cash and cash-like short duration assets provide a prospective return closely linked to overnight policy rates. Central banks continue to suggest that they may need to keep raising rates or will need to keep them high for an extended period.

This is tending to extend the defensive cash allocation as investors may see little risk of having to roll over their deposits or short-term bond holdings at meaningfully lower interest rates than they are currently enjoying. A 5%-plus yield on money market funds and a 6%-plus yield on short-duration credit securities in US dollars typically offers potential when the prospective return on longer duration, more credit-intensive fixed income, or a broad allocation to equity markets remains so uncertain. Risk assets are not particularly cheap, and while expectations of a recession in the US may have been pushed out, the consensus is still that one is coming.

Short-term interest rates dominate the near term. However, the long-term outlook is fashioned by two potentially transformative trends – the energy transition and artificial intelligence (AI). Investors in the energy transition are exploring the idea that technical progress may make carbon abatement more economically viable across increasing types of economic activity. Companies leading the way to net zero stand to reap the benefits of technological leadership, particularly if policy continues to shape the relative costs of carbon and alternatives through subsidies and taxation.

The world remains extremely dependent on fossil fuels and continues to generate increased volumes of greenhouse gas emissions. If policymakers' ambitions remain aligned to the Paris Agreement on temperature, then more active policy making and investment in green technology will be needed.

In Europe, the price of carbon credits traded through the European Emissions Trading System (ETS) has continued to rise. The increasing number of companies which have become regulated under the ETS has been a factor in reducing per capita CO_2

emissions over the last decade. Higher prices for carbon emissions make alternative technology relatively cheaper, something already seen in comparison to the cost of solar and wind power relative to coal and gas in electricity generation. The transformation of energy systems, agriculture, transport, and construction in the context of the road to net zero is a major investment theme, going beyond discussions over greenwashing and the positioning of environmental, social, and governance (ESG)-related investment products. Capital will be attracted to transition activities through bond markets (green bonds), listed and private equity, and through long-term infrastructure investment vehicles.

As with AI, the returns to the energy transition are not likely to be linear. Shifting production and consumption to more sustainable models cannot only be directly profitable in an economic sense – conditional on the appropriate price signals and policy environment – but it can also have benefits through reducing the external costs borne by natural capital. There are also risks that we don't move quickly enough, and climate change and biodiversity loss raise physical risks beyond our capacity to adapt to a hotter and environmentally-damaged world. In the same way, there are risks from AI being used in ways that are disruptive to society. Hence, there have been widespread calls for regulating AI research and developing cross-border frameworks for demonstrating the utility of AI as it gets embedded in more economic activities. But if we get it right on both counts and the net impact is positive, then pricing today is aligned to some of the individual stock price returns seen in 2023.

There are challenges to investors over multiple time horizons. The short-run balance between potentially attractive cash returns – with even more potential if we are right on inflation continuing to fall – and stocks or high-yield bonds that could yet see another valuation adjustment to reflect recessionary risks, is not an easy one. For the long term, investors may consider whether they are willing to bet that the net benefits of transformative technologies are worth today's growth premium. The temptation to hold a barbell in an investment portfolio may not present much change in the broader markets until central banks are willing to say enough has been done.

Key market calls

Our directional views across assets in key market (3-month horizon)

CURRENCIES	weaker	neutral	stronger
Euro		● ◄	
Yen			●
GBPEUR		► ●	

CURRENCIES

Risks look more symmetric for EUR while long positioning and rich valuation may also limit upside.

Short CHF may be a good proxy for EUR downside. JPY potential for a rebound, as foreign rates peak-out. GBP's fate is harder to read.

EQUITY	lower	neutral	higher
US equity	●		
EU equity		●	
EM equity		●	

EQUITY

We retain our negative view on the US, as we expect a recession to inevitably manifest. We favor Europe, and particularly Quality, in this macro context. Policy support and persistent growth headwinds in China leave us neutral on EMs.

RATES	higher	neutral	lower
US rates short	●		
US rates long		●	
EU rates short	●		
EU rates long	●		

RATES

US monetary policy expectations repriced materially as the banking shock faded and markets moved from widespread crisis to non-systemic event. Yield curve suggests recession, while risky assets suggest a soft- or no-landing scenario.

CREDIT	wider	neutral	tighter
US IG		●	
EU IG		●	
US HY	●		
EU HY	● ◄		

Source: AXA IM Core Investment Research, as of 26 June 2023

CREDIT

Risk appetite across global credit incl EM recovered strongly in past month. This constructive tone may be complacent and merits caution. Mean reversion shows spread widening over 3-12M and decompression in HY/IG, consistent with recession.

Macro forecast summary

Real GDP growth (%)	2022		2023*		2024*	
	AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
World	3.4		2.7		2.8	
Advanced economies	2.7		0.9		0.9	
US	2.1	2.1	1.0	1.1	1.1	0.6
Euro area	3.6	3.2	0.4	0.7	0.5	0.9
Germany	1.8	1.8	-0.5	0.1	0.3	1.1
France	2.6	2.6	0.6	0.6	0.5	0.9
Italy	3.7	3.8	1.2	0.8	0.4	0.9
Spain	5.5	5.5	2.0	1.6	1.0	1.6
Japan	1.1	1.0	1.5	1.0	1.3	1.1
UK	4.0	4.0	0.2	-0.1	0.3	0.8
Switzerland	2.1	2.1	0.7	0.7	1.0	1.4
Canada	3.4	3.4	1.3	0.9	0.9	1.2
Emerging economies	3.9		3.8		3.9	
Asia	4.3		5.0		4.6	
China	3.0	3.0	5.3	5.8	5.0	4.9
South Korea	2.6	2.6	1.5	1.1	2.0	2.1
Rest of EM Asia	6.0		5.0		4.4	
LatAm	4.0		1.5		2.3	
Brazil	2.9	2.9	1.0	1.2	1.5	1.6
Mexico	3.1	3.1	1.2	1.8	1.8	1.7
EM Europe	0.9		1.5		2.3	
Russia	-2.1		1.7		1.3	1.3
Poland	4.9	4.9	1.0	0.7	2.9	3.1
Turkey	5.6	5.6	2.1	2.2	3.1	2.6
Other EMs	4.9		3.1		3.7	

Source: Datastream, IMF and AXA IM Macro Research – As of 27 June 2023
**Forecast*

CPI Inflation (%)	2022		2023*		2024*	
	AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	7.4		4.7		2.7	
US	8.0	8.0	4.3	4.2	3.0	2.6
Euro area	8.4	8.5	5.6	5.5	2.8	2.4
China	2.1	2.0	2.3	1.8	2.5	2.4
Japan	2.5	2.5	2.7	2.6	1.3	1.4
UK	9.1	9.1	7.1	6.7	2.5	2.8
Switzerland	2.8	2.8	2.4	2.5	1.5	1.5
Canada	6.8	6.8	3.9	3.6	3.0	2.2

Source: Datastream, IMF and AXA IM Macro Research – As of 27 June 2023
**Forecast*

These projections are not necessarily reliable indicators of future results

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Forecast summary

Central bank policy Meeting dates and expected changes (Rates in bp / QE in bn)		Current	Q3-23	Q4-23
United States - Fed	Dates	5.25	25-26 Jul 19-20 Sep	31-1 Oct/Nov 12-13 Dec
	Rates		+0.25 (5.50)	unch (5.50)
Euro area - ECB	Dates	3.50	27 Jul 14 Sep	26 Oct 14 Dec
	Rates		+0.50 (4.00)	unch (4.00)
Japan - BoJ	Dates	-0.10	27-28 Jul 21-22 Sep	30-31 Oct 18-19 Dec
	Rates		unch (-0.10%)	unch (-0.10)
UK - BoE	Dates	5.00	3 Aug 21 Sep	2 Nov 14 Dec
	Rates		+0.25 (5.25)	unch (5.25)
Canada - BoC	Dates	4.75	12 Jul 6 Sep	25 Oct 6 Dec
	Rates		unch (4.75)	unch (4.75)

Source: AXA IM Macro Research - As of 27 June 2023

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