AXA Investment Managers

Frozen conflict

Monthly Investment Strategy

AXA IM Research

23 February 2022

Summary: February 2022

Theme of the month: China: Property is too big to fail

- Housing directly accounts for 16% of China's GDP, including indirect effects, like furniture and appliance purchases, this rises to 25%. With land sales fuelling local government infrastructure revenue and property sales accounting for 30% of Chinese banks loan books, total exposure could exceed 50%.
- Yet as demand for shelter is now, continued housing production appears incompatible with China's longer-term goals of common prosperity, net zero carbon emissions and strong potential growth.
- Chinese authorities appear to be targeting a fundamental realignment of the property sector, more than just a cyclical adjustment. Yet, mindful of the broader consequences, Beijing is fine-tuning policies to ensure a soft-landing. We characterise this as a two-step forwards and one-step back approach.

Macro update: Frozen Conflict

- Geopolitical tensions remain elevated with persistent pressure on energy markets. At the time of writing, developments suggested a material worsening in tensions, which if sustained would imply a materialisation of downside risks to GDP growth, particularly in Europe, but also more broadly, and less expected monetary tightening in some regions.
- Geopolitical tensions have added to 'transitory' inflation pressures, but inflation has been broadening, particularly in regions with tight labour markets, where more persistent pressures have arisen.
- Most central banks now guide for tighter policy. In EM this has been the case for a while and in some cases further hikes will only be fine-tuning and data dependent. The Fed looks likely to start to tighten in March, as does the BoC. We forecast the BoE to hike in May and the ECB to raise rates in December. In most cases, we forecast less tightening – certainly this year – than priced by markets, something that would be exacerbated by tensions in Ukraine.
- Higher inflation, tighter financial conditions and in some cases tax increases present a real challenge to real incomes and GDP. In many regions we have already lowered our growth forecasts to reflect these greater headwinds. This as supply conditions are expected to ease and the Omicron wave fades.

Investment strategy: markets feeling nervous in the "No Put & Putin" pub

- FX: A hawkish turnaround by the ECB at the Feb meeting triggered a sharp rebound in EURUSD to below 1.15. The close relationship with terminal rates points to EURUSD downside in the near term, with EUR also vulnerable to Ukraine related risk-off.
- Rates: Last year was full of inflation expectations. According to its price futures, oil is set to pull US inflation lower starting in July of this year – Ukraine developments threaten this outlook. Beyond rate and inflation expectations, term premium is set to have a positive contribution to US Treasury yields.
- Credit: HY spreads have outperformed IG in beta-adjusted terms in a bearish compression, not atypical ahead of central banks' hiking cycles. Above-trend growth and healthy earnings should continue to underpin HY credit fundamentals. Furthermore, default cycle indicators are currently benign.
- Equity: Negative news flow continues to weigh on global stock markets. Cash return to be a significant element in equity market performance in 2022. The ability to maintain margins will be key in the coming quarters as the balance of risks is negative (RUSUKR conflict, monetary tightening, pandemic).

Central scenario

Summary – Key messages

Monetary policy

Divergence. Those with supply-side issues and tight labour markets tighten (US, UK, Ca), those without do not (Ez, Jp). EMs pressured by inflation expectations and FX.

Inflation

Transitory inflation pressures could extend from Ukraine tensions. Threat from persistent labour supply issues are more region specific.

Fiscal policy

Small US package still possible in Q1. Euro area fiscal support to continue, boosted by energy support . UK NI tax rate in doubt.

Growth

Rebound continues. Virus and supply risks to recede, supported by excess saving. Geopolitics a drag.

Our central scenario:

Fading virus allows inflation retracement as recoveries persist. Ukraine developments threat

We forecast global growth to rise by 4.1% in 2022 and 3.5% 2023.

Economic growth persists despite supply pressures and tighter monetary policy. Inflation and supply constraints recede

Emerging Markets

Omicron sweeps, but delivering a boon or bust? Inflation requires further monetary tightening particularly in Asia.

Rates

Gentle rise in longer-term rates, driven primarily by rising real rates. Short-term safe-haven boost from Ukraine tensions.

FX

Fed pricing and geopolitics favours dollar for now. European election uncertainty could add short-term. Dollar outlook to soften H2 2022.

Credit

Softer spreads in 2022 on central bank and geopolitics concerns but still favour higher beta rather than duration risk.

Equities

Strong earnings surprises in 2021 are set to diminish in 2022 but above trend growth should prove supportive of earnings.

Alternative scenarios

Summary – Key messages

Entrenched supply shock *(probability 30%)*

What could be different?

- Geo-political tensions spillover in post-Covid world
- Coronavirus mutation sees renewed outbreaks
- Post-pandemic structural changes – labour market withdrawal and goods demand – persist. Supply shocks last longer
- Nervous households maintain high saving buffers

What it means

- Growth weaker, employment rebound softer, but inflation remains more elevated
- Monetary policy ill-equipped to deal with supply shocks, deteriorating inflation credibility forces tighter monetary policy in DMs

Market implications

- Risk appetite deteriorates / equities sell off / credit widens
- Safe-haven rates rally resumes
- EM debt to come under pressure

A global boost *(probability 10%)*

What could be different?

- Geo-political tension ease – peace in our time.
- Labour market participation recovers, strong income growth and easing inflation pressures
- Productivity boost following investment rebound and structural post-pandemic adjustments

What it means

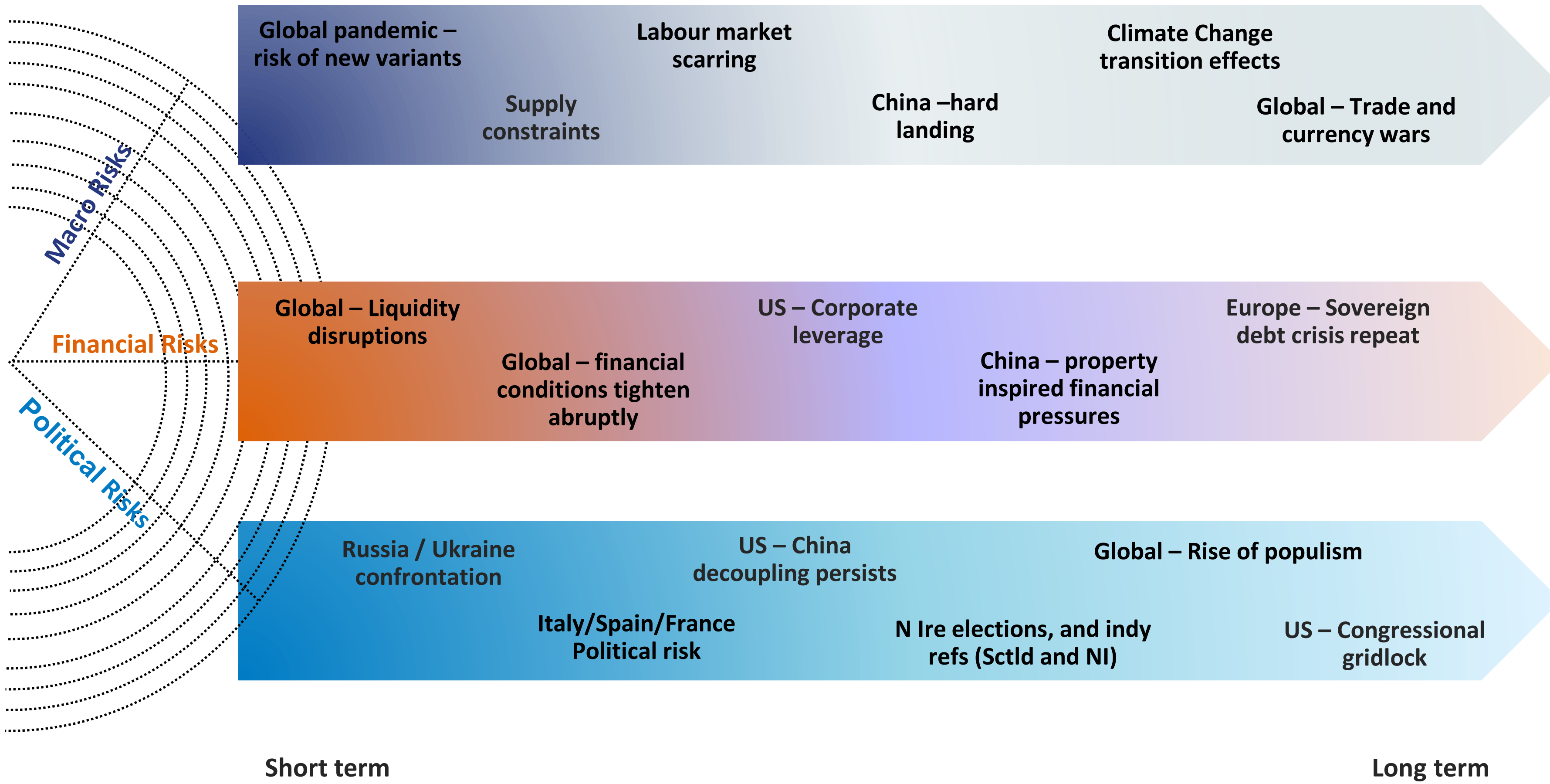
- Growth surprises on the upside in most regions
- Inflation fades towards and below central bank targets
- Monetary policy proves more patient than expectations

Market implications

- Risk-on environment, equities make further gains, growth retains lead over value
- UST softens, EUR strengthens
- Spreads grind tighter

RISk Radar

Summary – Key messages



Contents

Theme of the month

China: Property is too big to fail

The real estate sector could represent a quarter of China's economy

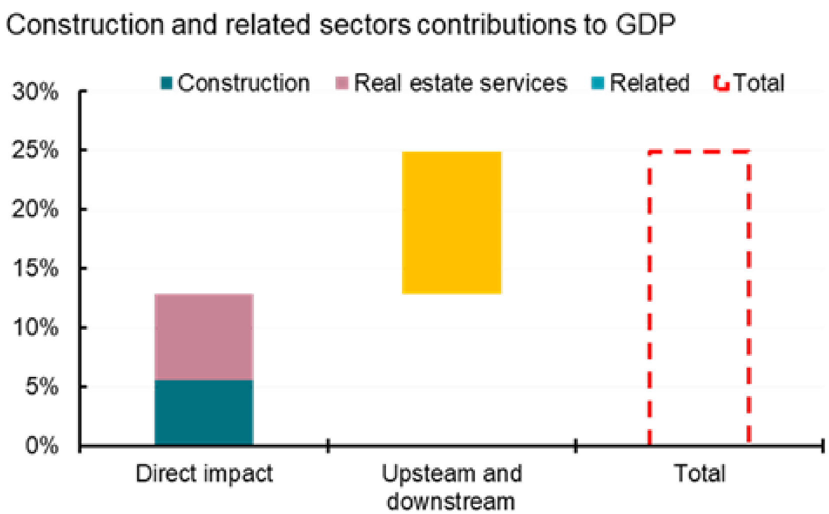
Real estate supply chain stretches far and wide

- In value-added terms, we estimate property construction and real estate services account for 16% of China's GDP. In addition, the provision of building materials – steel, cement and glass – makes up a large portion of industrial production, while sales of furniture, appliances and even cars can be linked to people buying new homes. Adding up the direct and indirect exposures, the real estate sector could represent as much as a quarter of the economy

A large ecosystem highlights contagion risks

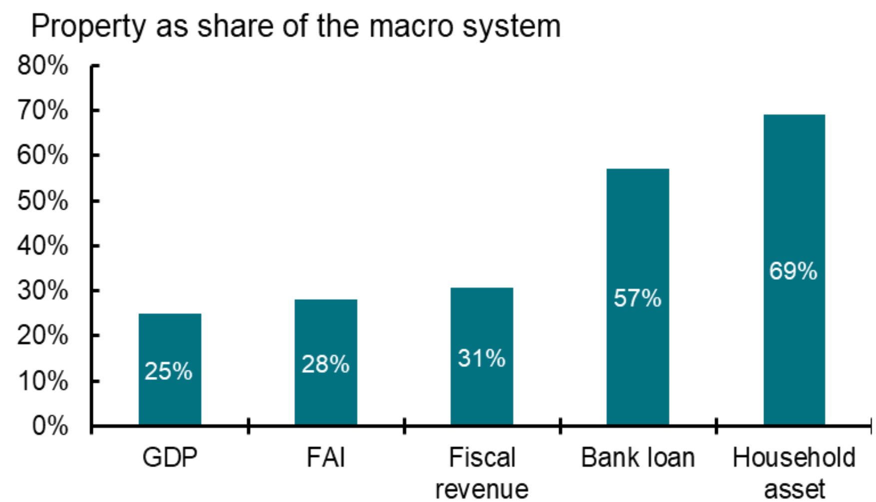
- But the ecosystem does not end there. Land sales are a critical source of local government revenue for spending on infrastructure projects. Banks' lending to property developers and home buyers amounts to around 30% of their loan book. If various further indirect connections are considered, the total exposure could rise to over 50%. 70% of households' wealth is tied to real estate, putting consumption at risk in case of a sharp decline of house prices

Real estate is a pillar industry of the economy



Source: CEIC and AXA IM Research, Feb 22

Contagion risks cannot be underestimated



Source: CEIC, UBS, China Southwest University, AXA IM Research, Feb 22

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China: Property is too big to fail

Changing development priorities force Beijing to redefine the role of real estate

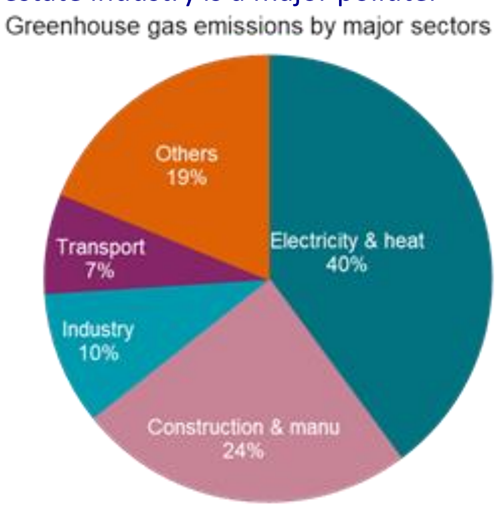
A fundamental shift in Beijing's attitude...

- Beijing's insistence on property curbs – despite tremendous pains already inflicted – reflects a fundamental shift in its attitude towards the housing market. This has occurred because the reckless and debt-fueled expansion of the property market has become increasingly incompatible with China's long-term development strategies

... as the current development of the housing market conflicts with Beijing's long-term goals

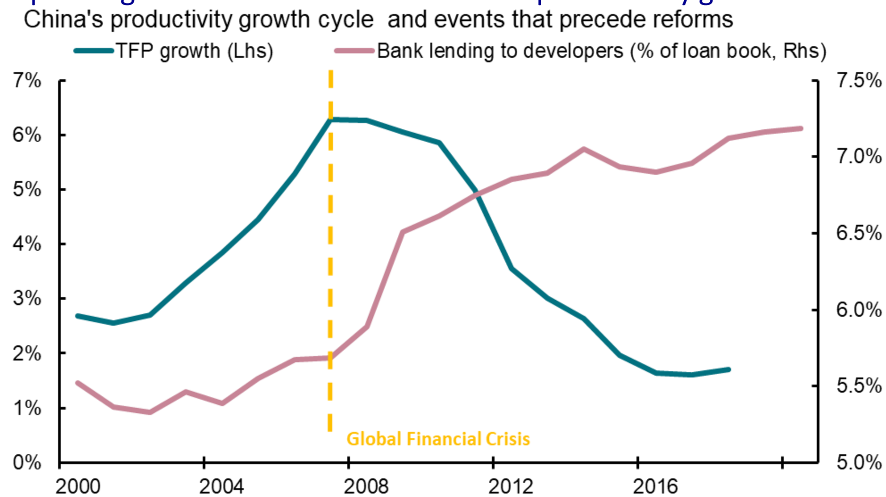
- Rapid house price appreciation – fueled by speculative fervor – has amplified wealth inequality, making it an impediment to common prosperity. Housing construction, along with the production of building materials, are among the largest emitters of greenhouse gas. Hence, excessive building – beyond meeting shelter demand – is inconsistent with China's pursuit of carbon neutrality. Finally, as an investment, property is non-productive. If the same resources were used to financing productive assets, via equity and bond markets, the economy as a whole could benefit

Real estate industry is a major polluter



Source: CEIC and AXA IM Research, Feb 22

Expanding real estate sector undermines productivity growth



Source: CEIC, Penn World, AXA IM Research, Feb 22

China: Property is too big to fail

Diminishing shelter demand sees housing pass peak demand

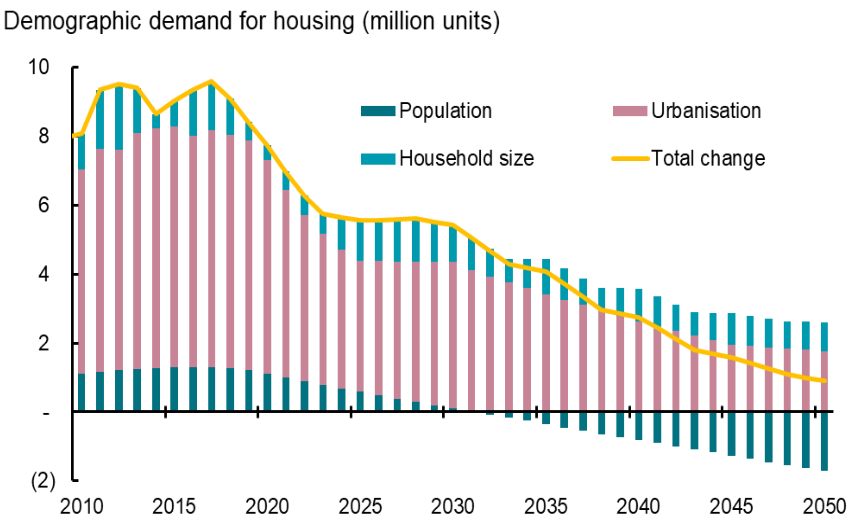
Demographic change implies less shelter demand

- With slowing population and urbanization growth, we estimate fundamental demand growth for housing peaked in 2018 and is expected to slow persistently in the coming decades. China still has room to build higher-quality houses to meet upgrade needs, but this growth too is expected to slow. Diminishing fundamental demand is a key reason why the golden era for China's housing market is probably over

Beijing reins in speculative demand

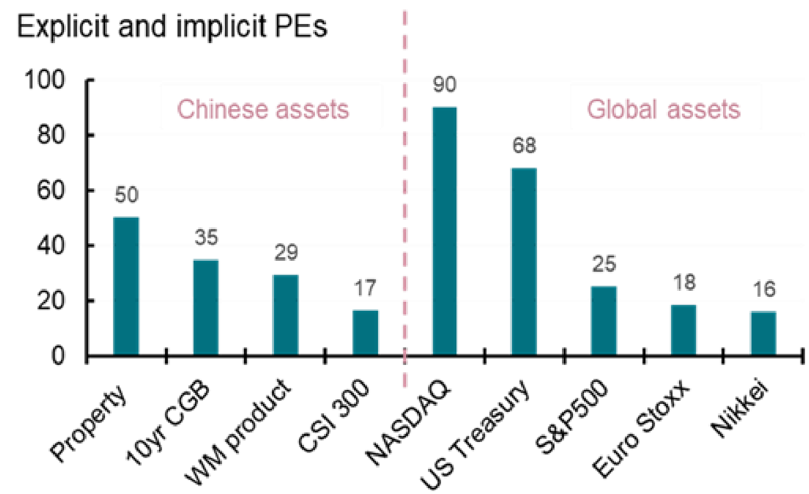
- The investment case of property is resting increasingly on continuous house price appreciation despite signs of overbuild. Beijing's 'house for living, not speculation' is designed to rein in speculative demand and bring housing back to its roots of providing shelter services to the public. By doing so, the authorities aim to prevent a housing market bubble from growing larger and more perilous

Demographic demand for housing peaked



Source: CEIC, UN, and AXA IM Research, Feb 22

Property is expensive, but not the most expensive



Source: Bloomberg, AXA IM Research, Feb 22

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China: Property is too big to fail

Policy fine-tuning to limit systemic risks as Beijing's priority shifts to stabilizing growth

A delicate policy balance to strike

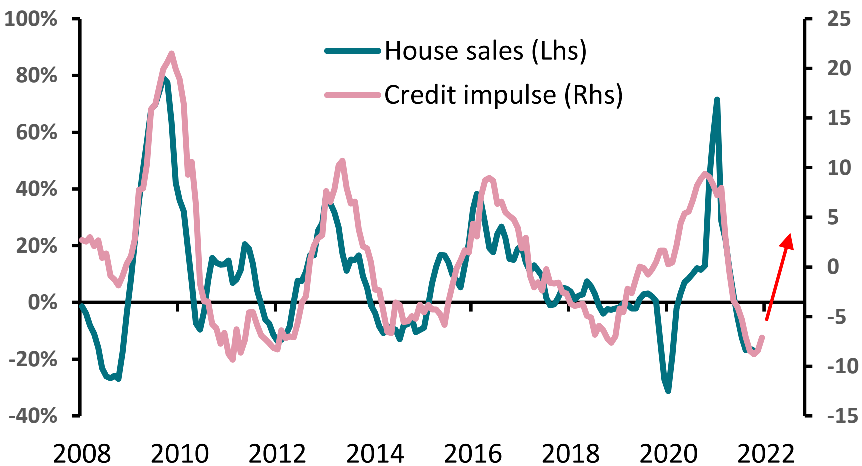
- Beijing's property curbs have started to redirect resources away from the real estate sector, manifested in slowing bank lending to developers and diverging performance between property and non-property credit bonds. However, as the economy slows and financial risks rise, Beijing's priority has shifted. A 'two steps forward and one step back' approach is being adopted to balance near-term macro stability against longer-term economic sustainability

More pain ahead for the weakest developers

- With the worst of the cyclical tightening behind, housing market activity should gradually stabilize. But the strength of the recovery is likely to be more subdued than in previous cycles as Beijing moves away from its property-centric stimulus by keeping some restrictions – like the "three red lines" – in place. This means that the weakest property developers may not get enough help to survive, while stronger players could use their balance sheets to consolidate the sector in the future

Policy cycle has turned

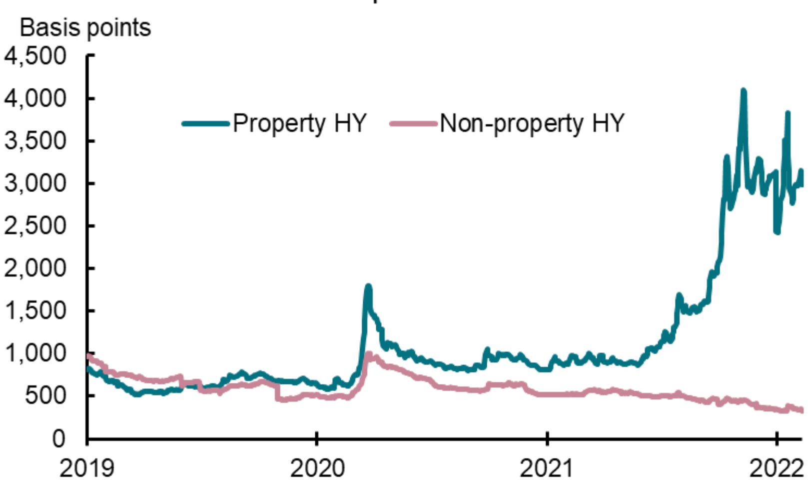
Credit impulse and house sales



Source: CEIC, UN, and AXA IM Research, Feb 22

Ongoing divergence in the credit market

China offshore USD credit spreads



Source: Bloomberg, AXA IM Research, Feb 22

China: Property is too big to fail

Beijing is undertaking a painful but necessary course correction

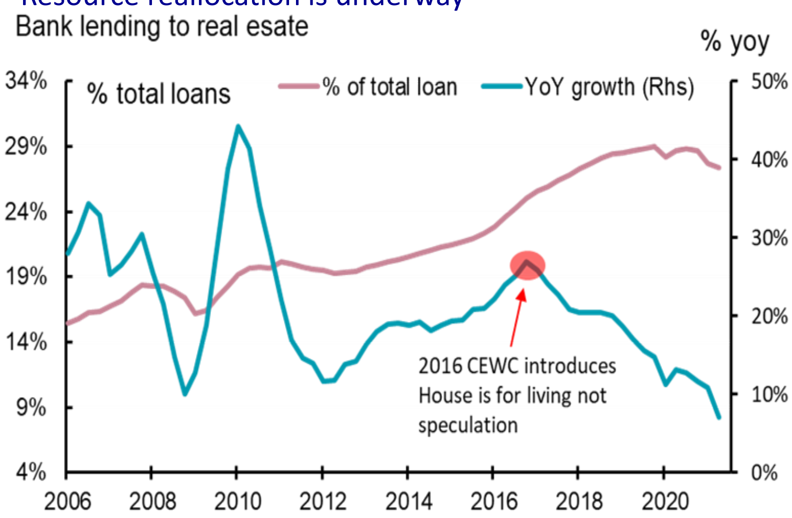
Policy runs its course as macro dynamic changes

- Beijing's supportive housing policies have helped to modernize China's housing stock, which bolstered economic growth, expedited urbanization and raised the living standards of billions. But the same policies have also brewed speculation in recent years, which has kept housing supply high despite slowing fundamental demand, resulting in growing overcapacity. Continuing the status quo could exacerbate social inequality, environmental degradation and the declining quality of economic growth

Bring property back to its foundations under 'housing is for living, not speculation'

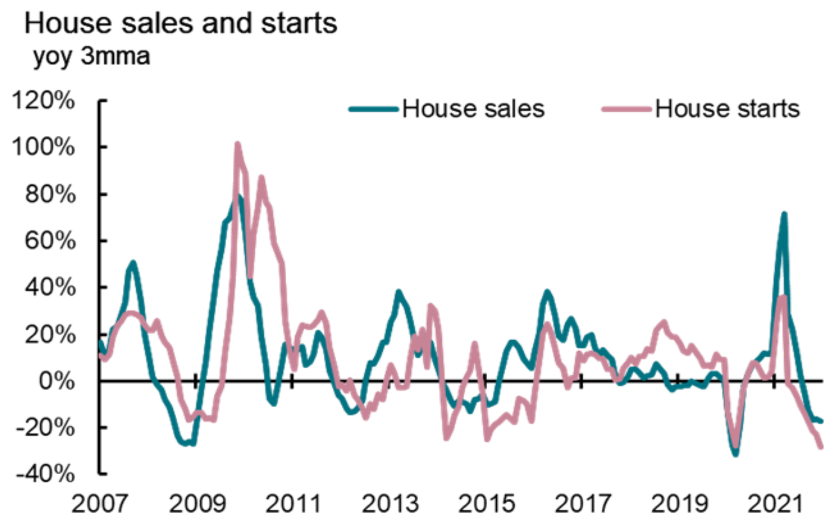
- Hence, policies need to be adjusted to steer a course correction by bringing housing back to its foundations of providing shelter to the public. This reallocation of resources won't be painless as developments of the past 12 months would attest. But a delayed correction could be even more dangerous if a bigger bubble eventually bursts. Beijing may have already passed the optimal moment to address housing imbalances; it is now trying to minimize the risk of deeper regret in the future

Resource reallocation is underway



Source: CEIC, and AXA IM Research, Feb 22

The need to preserve stability rises as the market corrects



Source: CEIC, AXA IM Research, Feb 22

Macro outlook

Inflation rises on transitory *and* more persistent pressures

US

Inflation affected by transitory and more persistent pressure

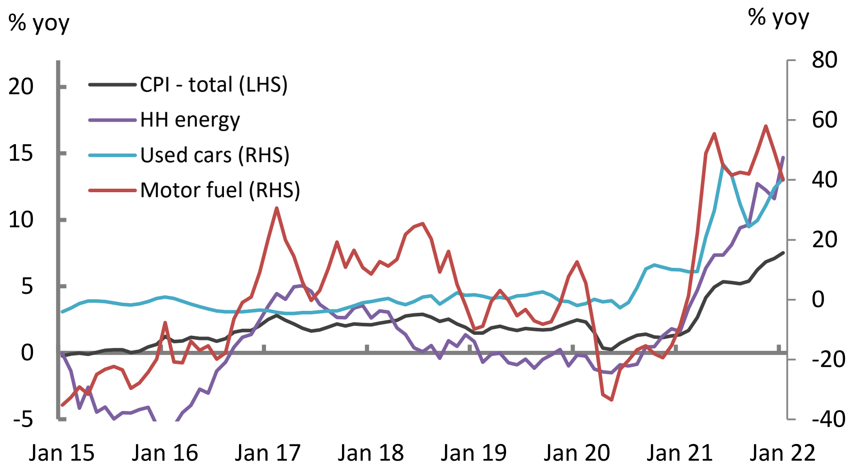
- Inflation rose to 7.5% in January, core to 6.0%, both at 40-year highs. Ongoing supply-disruptions and geopolitical tensions meant that transitory factors, including energy and used car prices continued to lift inflation. Both should turn and conceivably soon. Yet inflation pressures are broadening with rent and broader services inflation both rising by more than 1.5ppt over the past six months. These broader pressures are more consistent with labour market tensions and wage growth at 0.7% m/m in January.

"Remarkable" labour market must slow

- Employment growth averaged 550k/month in 2021 and has not slowed in recent months. Fed Chair Powell described this as "remarkable". While we expect labour supply to improve, unemployment looks set to fall towards 3% over the course of this year with current momentum. Fed tightening must primarily be aimed at slowing economic activity and in all likelihood raising unemployment gently over the coming years. The Fed does not have a good track record at delivering this.

Transitory factors continue to push inflation

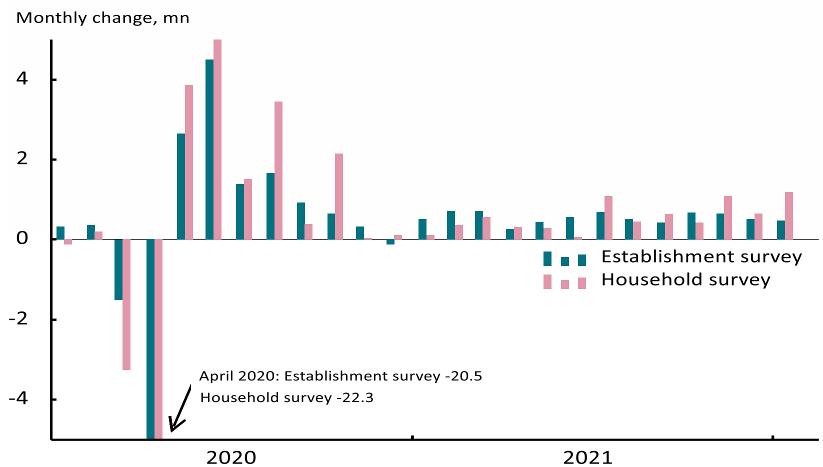
Peaking inflation pressures



Source: BLS, February 2022

"Remarkable" improvement in labour market

Measures of Employment



Source: BLS, AXA IM Research, February 2022

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Fed forced to aim at narrow landing strip

US

Tightening set to start ..

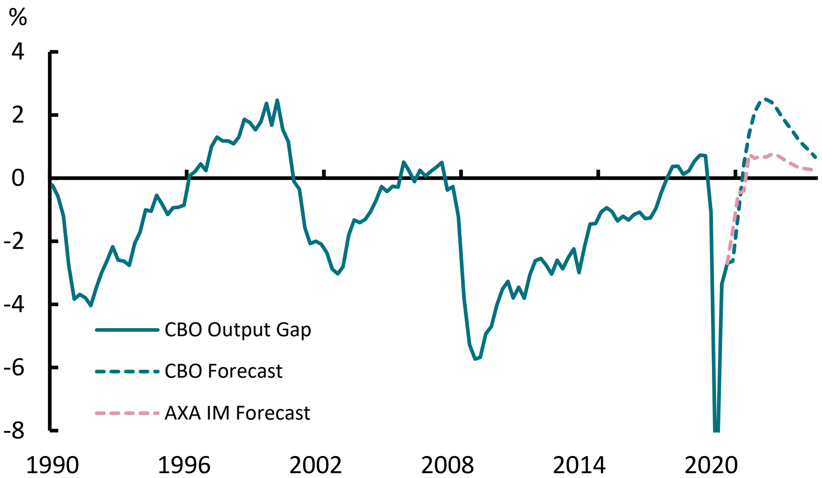
- At the January FOMC meeting Fed Chair Powell said the Committee was of a mind to tighten in March. With inflation elevated, markets consider the prospect of back-to-back hikes, a 50bps start or even a pre-March rise. Yet Fed guidance has remained “steady” and “gradual” and wary of too abrupt a tightening on the broader economy. We expect the Fed to hike four times this year to 1.25% by year-end. We also expect an announcement of balance sheet unwind in June at a quicker pace than in the last cycle.

.. but evolution of financial conditions to govern how far and how fast

- The Fed will require financial conditions to tighten by more than they have to date and will expect QT to deliver some of that. If this does not occur, the Fed will have to quicken the pace of tightening. On balance, we think this is likely, and pencil in a quicker pace in H1 2023. We forecast the Fed Funds Rate target rising to 2.5-2.75% by end-2023, some 0.75ppt above current market forecasts. But the actual path will be governed by geopolitical, post-pandemic and market uncertainties. Risks are skewed to a faster tightening.

Squeezing out excess demand

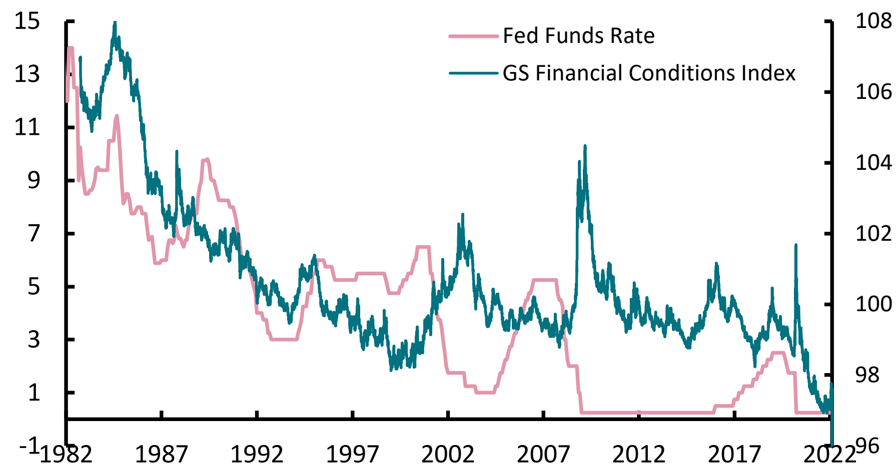
CBO Output Gap



Source: CBO, AXA IM Research, February 2022

Policy interaction in

Federal Funds rate and US Financial Conditions



Source: Refinitiv, Goldman Sachs, AXA IM Research, February 2022

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Towards normal

Euro area

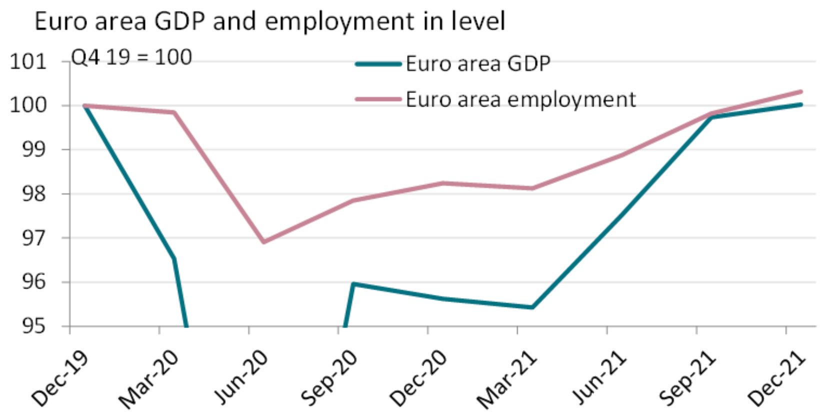
Strong labour market maintains confidence in constructive outlook

- Marked economic activity slowdown in Q4 21(+0.3% q/q). We remain confident in our constructive (yet below consensus) growth outlook projecting EA GDP to grow 3.9% and 2.1% this year and next, respectively.
- EA labour market is buoyant. We expect further tightening which should eventually translate into further wage growth in H2 22-2023. This should prevent household purchasing power from being too severely hit by inflation.

Inflation: edging towards 2% in the medium run

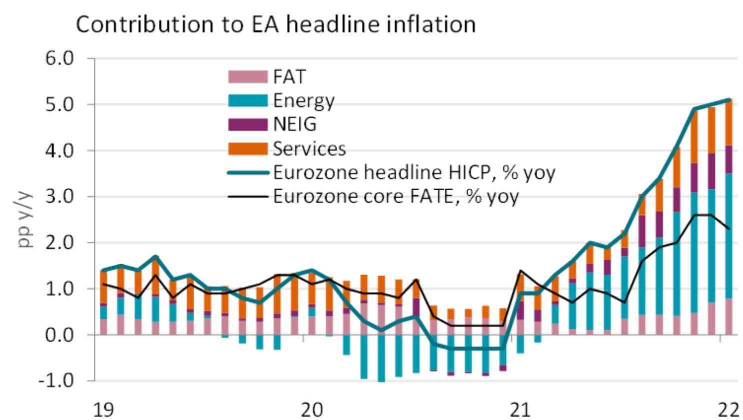
- While volatile components remain in the driving seat, core inflation is showing increasing signs of dynamism.
- We upgraded our inflation forecasts for this year, projecting euro area HICP to average 4.0% y/y (consensus: 3.7%) and recede to 1.7% y/y (consensus: 1.7%%) next year.

Buoyant labour market



Source: Eurostat, AXA IM Research, Dec 2021

Energy and food account for most, core rising



Source: Eurostat, AXA IM Research, Jan 2022

ECB: Catching the hawkish train, yet on its own normalisation trail

Euro area

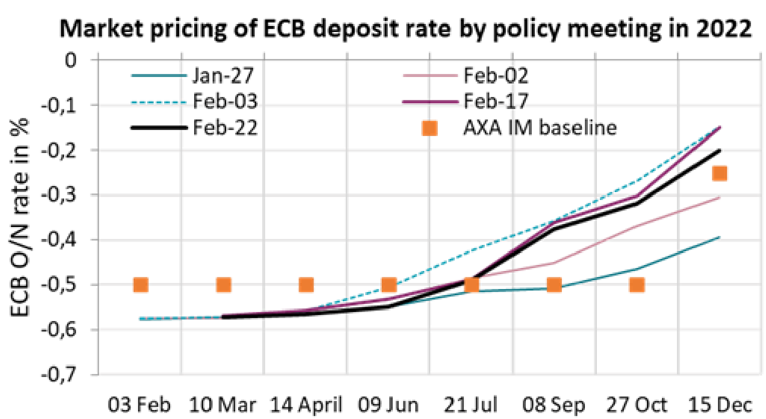
Our (new) ECB baseline:

- Amend the forward guidance indicating that rates are not skewed to the downside anymore (present levels)
- APP: No more open-ended QE from October.
- Rates: Hiking cycle to start in Dec (+25bps), but as early as September if APP is ended before summer break.

A hawkish turn…yet a long normalisation ahead of us

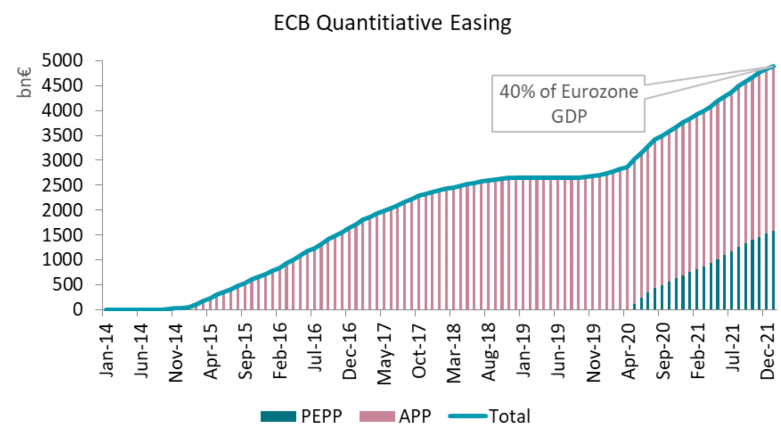
- President Lagarde to rein in GC diverging views and find rightly balanced normalisation tone.
- Any upcoming decision likely gradual and respect established sequencing (i.e slow end of APP before hiking rates)
- ECB has an extra step to do (against Fed, BoE) starting with negative rates (mainly used in the past for FX purposes)
- Reinvestment policy unlikely to be tightened for a very long time (and key for flexibility/avoid market fragmentation)

Short-end rate market likely ahead of itself



Source: Bloomberg, AXA IM Research, as of February 22

Balance sheet normalisation should be very gradual



Source: ECB, AXA IM Research, as of Jan

Challenges ahead for growth

UK

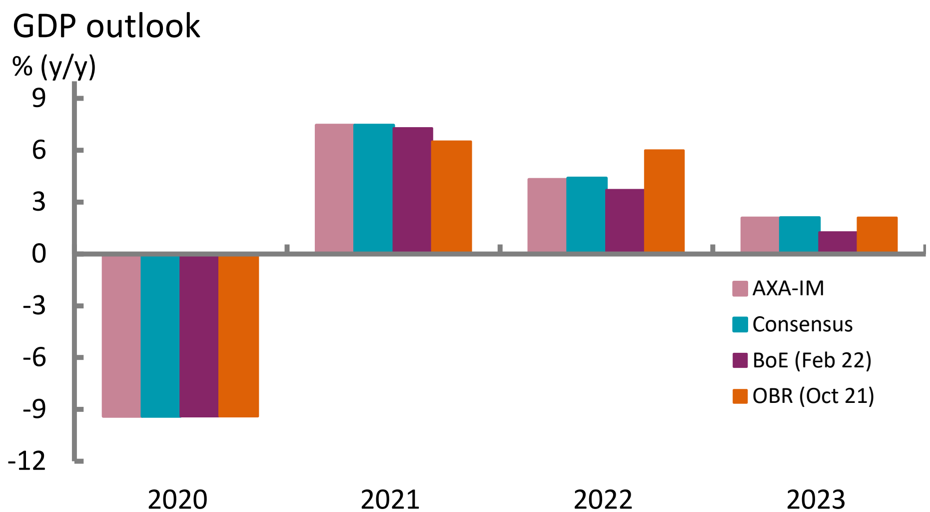
GDP rebounded robustly in 2021, 2022 growth outlook slowing

- UK GDP rose by 7.5% in 2021, the highest since the second World War, but following the 9.4% drop in 2020. Challenges to real incomes are likely to dominate the coming months including tax increases, energy price hikes, and rate increases. Savings will be an important buffer but are unevenly distributed across households. Given the real income squeeze, we downgrade our forecasts for UK growth in 2022 to 4.3% (from 4.9%) and 2.1% (from 2.5%) in 2023. This compares to consensus forecasts of 4.5% and 2.2%.

Labour market continues to tighten, inactivity crucial to easing pressures

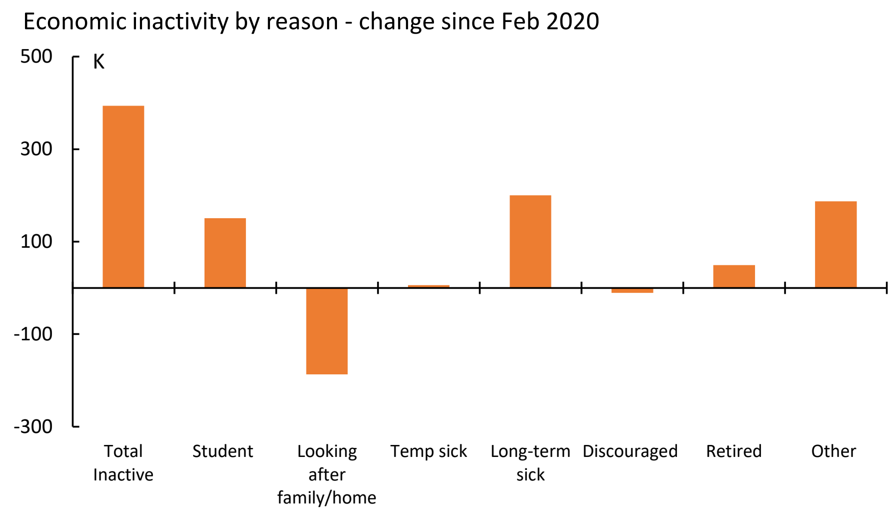
- In December, unemployment remained at 4.1% and in January, the number of vacancies in the economy continued to rise payrolled employees increased by 108k. This tightness is exacerbated by a large numbers of exits from the workforce since the pandemic. Around 400k more people remain economically inactive than just before the pandemic started and though some of them will not return to the workforce, we expect many to.

Falling real incomes to constrain 2022 growth



Source: National Statistics, BoE, OBR, AXA IM Research, February 2022

Economic inactivity remains 400k higher post pandemic



Source: National Statistics, AXA IM Research, February 2022

Markets see consistent rate hikes

UK

Inflation at 30-year high and set to peak at over 7% in April

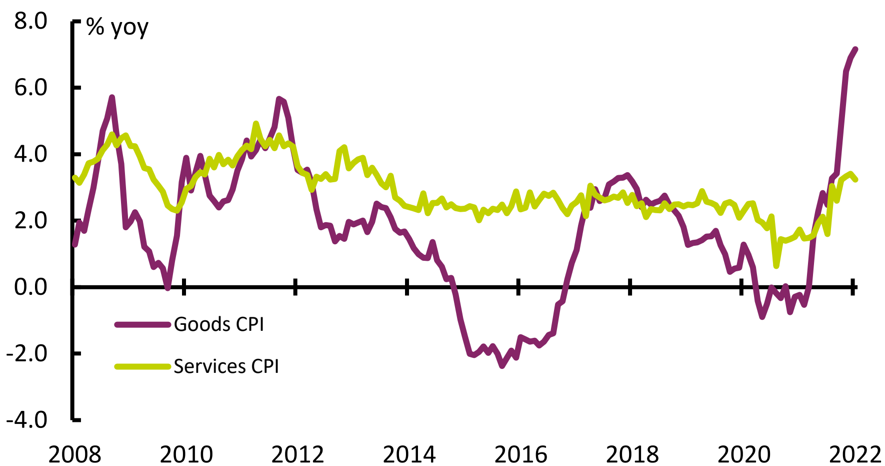
- CPI hit a 30-year high of 5.5% in January and is set to rise further. We now expect inflation to peak at over 7% in April, when the OFGEM energy price cap rises by 54%. We now expect inflation to average 5.5% in 2022 (up from an earlier forecast of 4.5%) and 2.1% in 2023 (up from 2%). Consensus forecasts are for inflation to average 5.3% for 2022 and 2.2% in 2023.

Markets now expect rates to reach 2% by end-2022

- Recent upside surprises in inflation and retail sales mean we cannot rule out a March hike. However, we expect the MPC to follow a more cautious path given the looming income squeeze and leave the Bank Rate unchanged at 0.5% in March, pencilling in the next hikes for May and August, bringing Bank Rate to 1%. This is lower than current market expectations, which price rates at 2% by end-2022. In the Feb MPR, forecasts based on market implied rates at the time – looser than current pricing – saw unemployment rise to 5% and CPI well below target at 1.3% at the end of the forecast horizon.

Goods inflation is driving the current surge

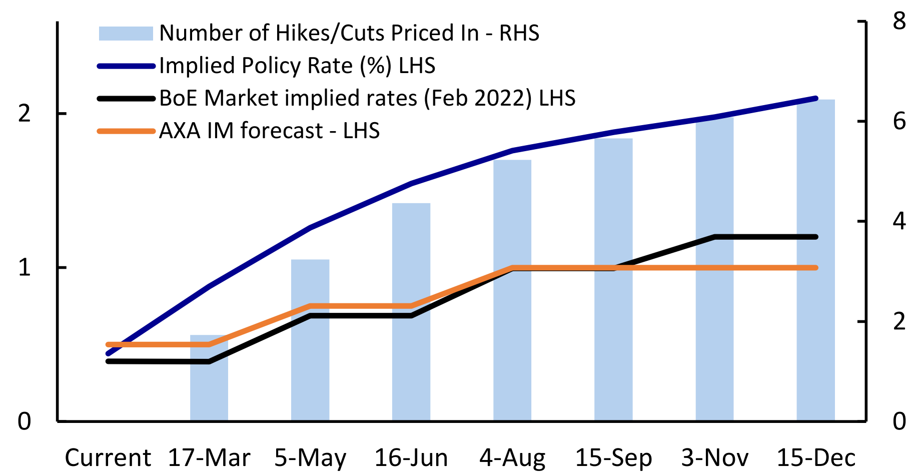
Goods and Services CPI



Source: National Statistics, AXA IM Research, Jan 2022

Current market pricing of interest rates

Implied Policy Rate and no of hikes/cuts



Source: Bloomberg, AXA IM Research, Feb 2022

A soft start to 2022

China

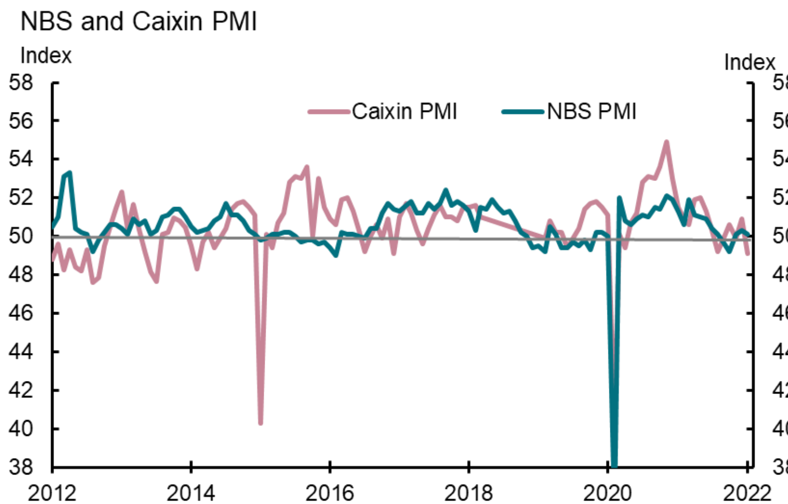
High-frequency data points to weak growth

- High frequency activity data suggests a weak start to the year. The housing market remained in dire straits in January, with sales falling 30% yoy. The PMIs weakened across manufacturing and services sectors, weighed by another virus resurgence. And even with Beijing's more lenient COVID management leading to a strong rebound in passenger flows during the lunar new year, consumers were reluctant to spend, with tourism and box-office revenues slightly down from last year

Some transient pressures should ease

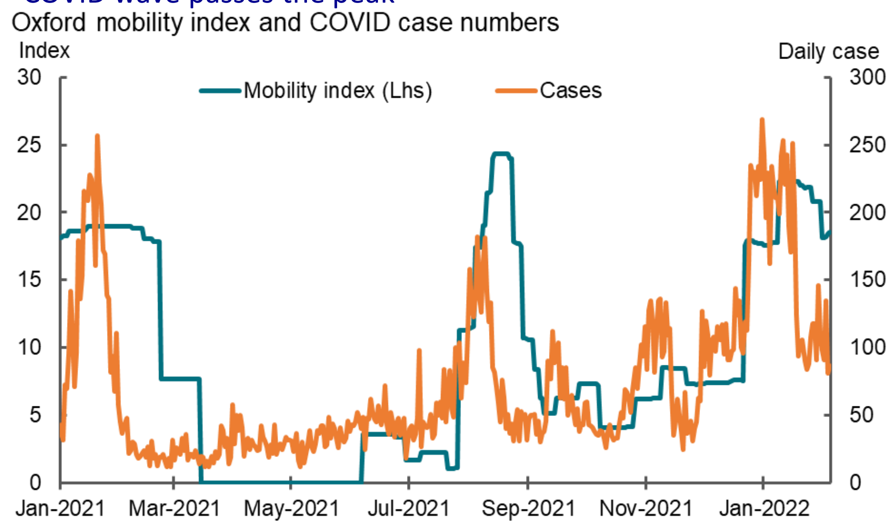
- Some of the pressures on the economy should ease soon. As China is getting on top of containing another COVID-19 outbreak, local authorities have started to relax social restrictions, paving the way for a consumption recovery. Pollution controls ahead of the Winter Olympics, which contributed to the softness in industrial activity, should also ease. The housing market decline could narrow as Beijing fine-tunes the property curbs

Economy gets off to a soft start



Source: CEIC, AXA IM Research, Feb 22

COVID wave passes the peak



Source: CEIC, AXA IM Research, Feb 22

Beijing walks the talk on policy easing

China

Policy easing to put a floor under the economy

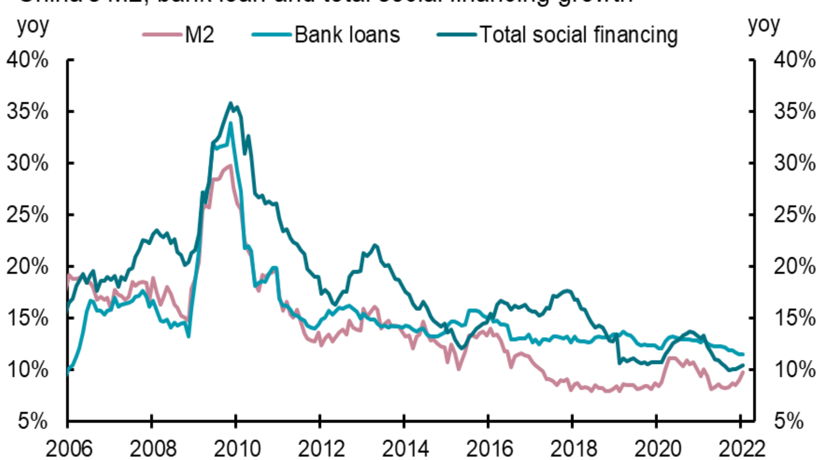
- Beijing has signalled a policy pivot towards growth stabilisation as economic momentum eases. Recent actions show the authorities have heeded the call. Since last November, the PBoC has cut reserve requirements and interest rates, and guided banks to speed up lending. The government has frontloaded RMB1.8trn worth of bond quota to be issued ahead of the National People's Congress in March. Property policies have also been fine-tuned to limit systemic risks

More is needed to defend a 5% growth target

- Recent policy actions suggest Beijing is serious about supporting the economy in a politically sensitive year. But achieving a growth target of around 5% would require more policy heavy-lifting against the lingering pandemic and weak property and labour markets. We expect further easing measures to be announced at next month's annual Congressional gathering

Credit growth recovers on policy easing

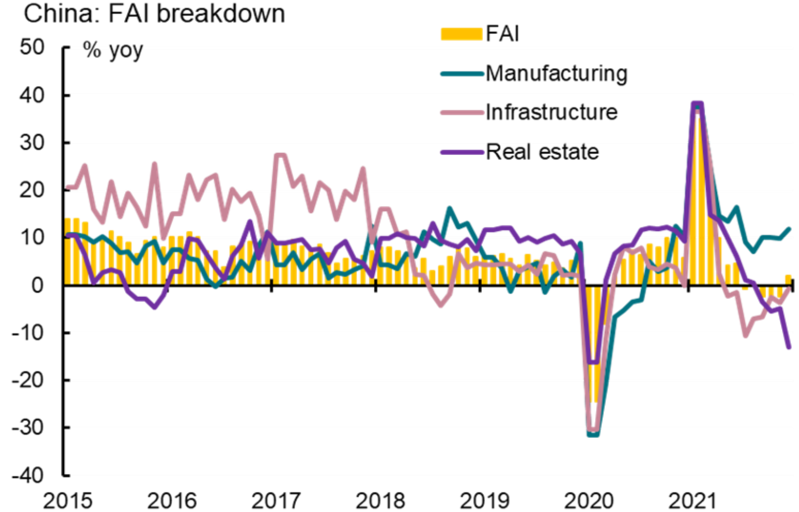
China's M2, bank loan and total social financing growth



Source: CEIC, AXA IM Research, Feb 22

More fiscal supports bode well for infrastructure spending

China: FAI breakdown



Source: CEIC, AXA IM Research, Feb 22

GDP roller coaster

Japan

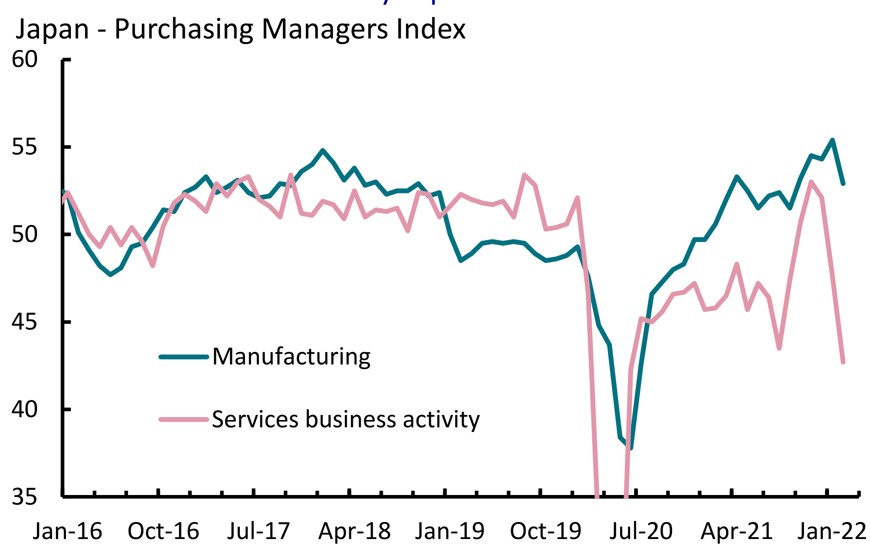
Real GDP swung back to positive growth on a quarterly basis in 2021 Q4

- Strong contributions from private consumption and net exports
- Public investment fell by 4.5%qoq while capital expenditure was weak (0.2%).

Economic activity is likely to slump again in Q1 but then outlook is brighter

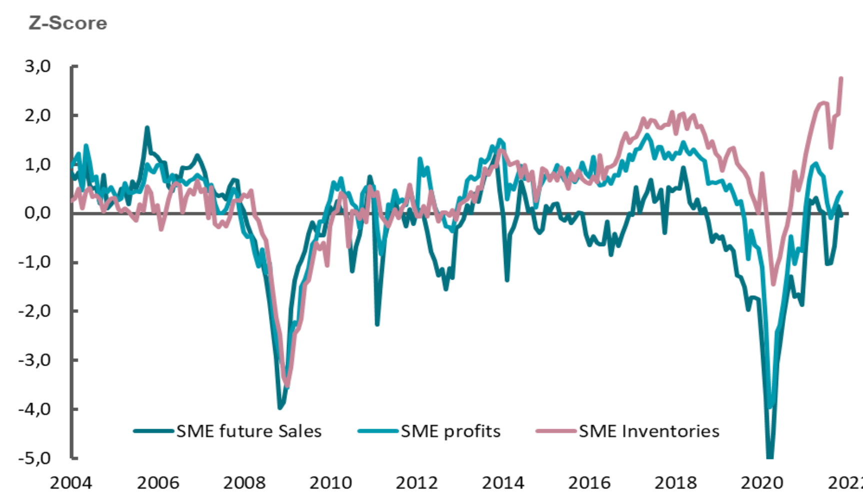
- Omicron is disrupting the services sector as well as the production chain. We have slightly modified our short-term outlook accordingly (Q1: +0.3%qoq from +0.4%; unchanged in Q2 at 1.9%qoq)
- Expectations in services sector surveys remain robust while semiconductor shortages appear to be having less of a negative impact on activity.

Services sector still heavily exposed to COVID wave



Source: IHS Markit and AXA IM Macro Research, 21 February 2022

But outlook is brighter



Source: Japan Finance Corporation for Small and Medium Enterprise, 21 February 2022

Bank of Japan: resisting or resigning ?

Japan

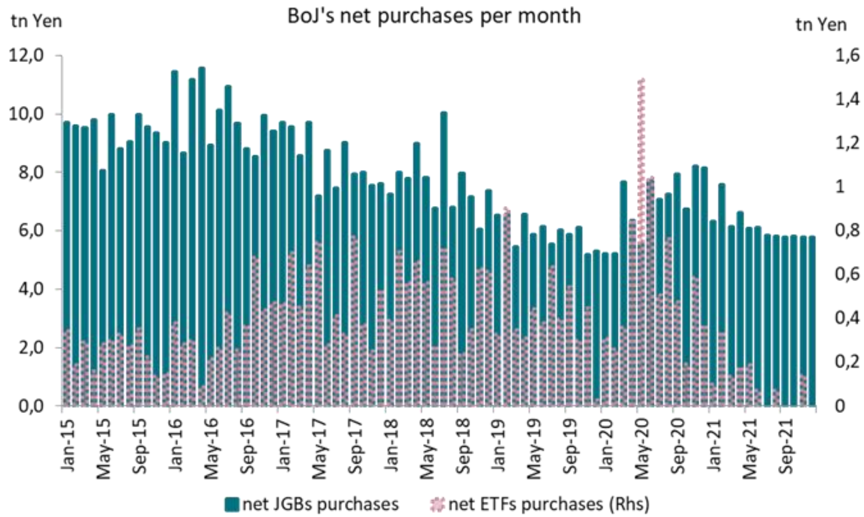
Yield curve control challenged by rising rates

- 10-year yield Japanese Government Bond has briefly reached the upper limit of the Bank of Japan (BoJ)'s yield curve control [+/- 25basis points around 0%). Range extension was adopted in March last year, but the BoJ recently added it would introduce "fixed-rate purchase operations for consecutive days" as a powerful tool to set an upper limit on interest rates if necessary.
- On February 10th, the BoJ acted and warned market it will intervene from 14 February for unlimited amount. Recent speeches by Governor Kuroda strengthen such a position, arguing rate increases were not justified by domestic economic fundamentals, but rather by international spillovers – mostly from the US.

Inflation rising but remains mostly driven by energy and import prices

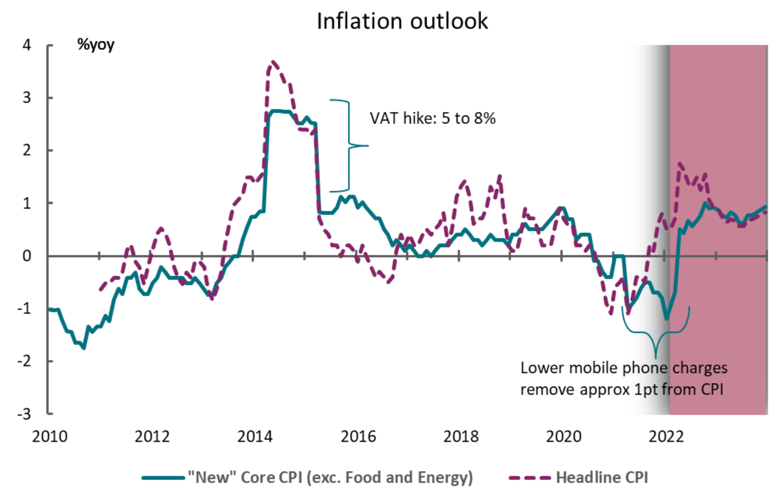
- CPI slightly decline to 0.5%yoy (from 0.8%) in January but still expected to peak around April-May around 2%
- Following persistent higher energy prices, we have upgraded our forecast to 1.2% in 2022 and 0.6% in 2023

How much "fixed-rate purchase operation" ? We will know once February net purchases data are out



Source: Ministry of Internal Affairs and Communications, AXA IM Macro Research, as of December 2022,

Energy component remains the more important contribution



Source: Ministry of Internal Affairs and Communications, AXA IM Macro Research, as of Feb 2022,

Omicron to fade, but growth outlook slowing

Canada

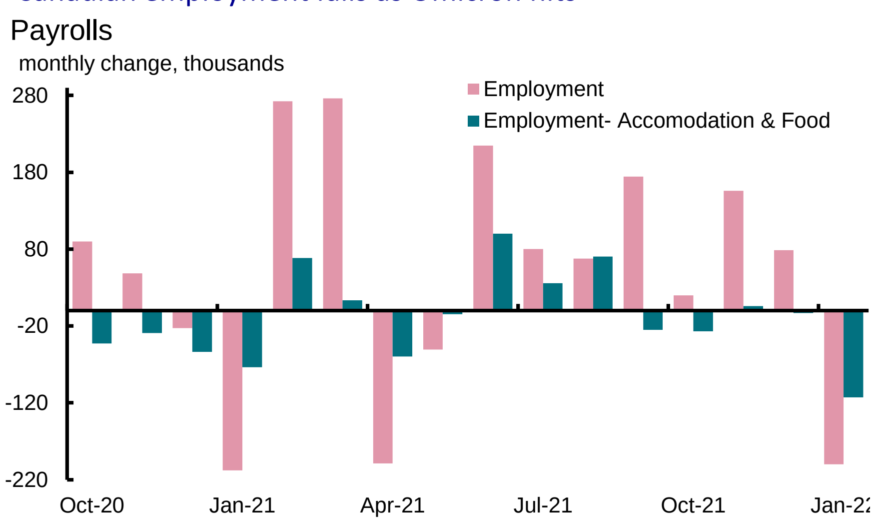
Short-term disruption

- The Omicron wave has created disruption in Ottawa with protests. These threatened a key artery of Canadian trade, which could add to supply pressures, particularly in autos and food, although most protests had been cleared at the time of writing. Payrolls fell by 200k in January and unemployment rose to 6.5%, with declines centred in COVID sensitive sectors and regions with the strictest restrictions. GDP rose by 0.6% in November, but is estimated “around flat” in December. We forecast a drop in January.

Longer-term deceleration

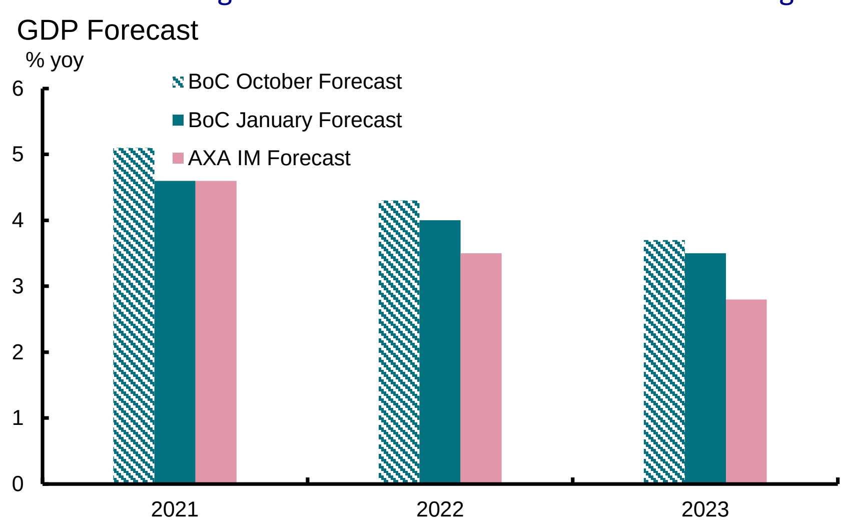
- While we expect a subdued Q1, we expect the economy to rebound swiftly thereafter. However, with an expectation of monetary policy tightening both domestically and increasingly overseas, financial conditions look set to tighten further and act as a headwind to growth. We retain our outlook for GDP growth of 3.5% in 2022 (considering downside risks), but lower our 2023 growth forecast to 2.8% from 3.0%. The Bank of Canada lowered its growth forecasts to 4.0% and 3.5% for this year and next.

Canadian employment falls as Omicron hits



Source: CANISM, AXA IM Research, February 2022

BoC lowers its growth outlook – we think it has further to go



Source: Bank of Canada, AXA IM Research, February 2022

Policy now set to tighten

Canada

Bank of Canada signals tighter policy ahead

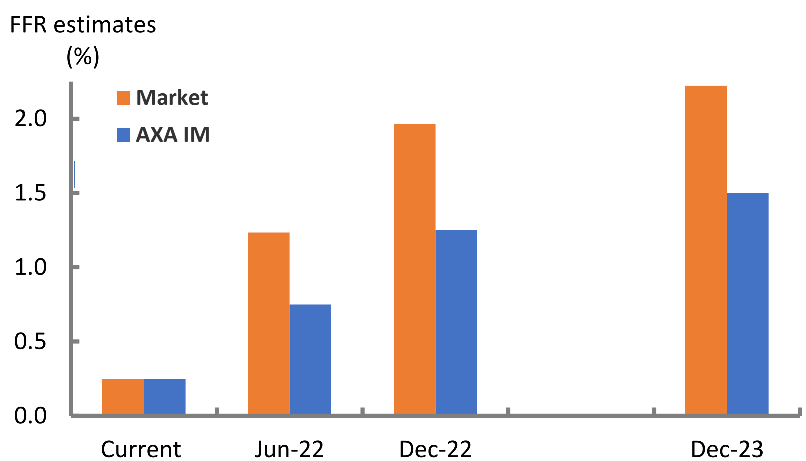
- The BoC left policy unchanged in January as we forecast, but at odds with broader market forecasts. However, it clearly signalled an expectation for rates to rise ahead, explicitly announcing that "slack" had been absorbed and removing its extraordinary forward guidance. We forecast the BoC raising the policy rate by 0.25% at its next meeting and again in April. We forecast four hikes this year (to 1.25%) and two the year after (to 1.75%). However, markets envisage a much steeper path.

Balance sheet unwind also under way

- The BoC said in January that it would "start to consider" ending balance sheet reinvestment after it had started raising rates. Governor Macklem more recently suggested that this would be "in fairly short order". We expect more guidance on quantitative tightening in April and expect an end to reinvestments early in H2 2022. 10% of the BoC's asset holdings mature over H2 2022, but the BoC has not stated how quickly it will allow a balance sheet run-off.

Market still expects more tightening

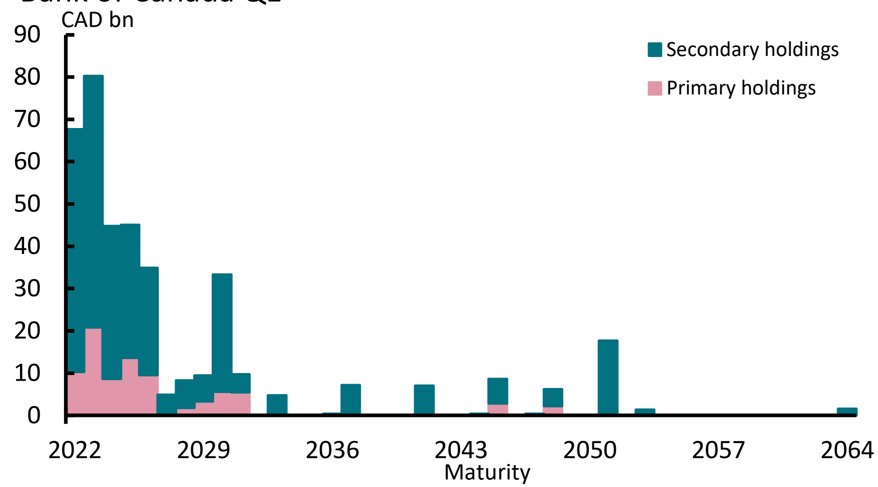
BoC o/n rate target expectations



Source: Bloomberg, AXA IM Research, February 2022

BoC to announce details of QT over coming meetings

Bank of Canada QE



Source: Bank of Canada, AXA IM Research, February 2022

Robust growth and inflation pressures

Emerging Markets

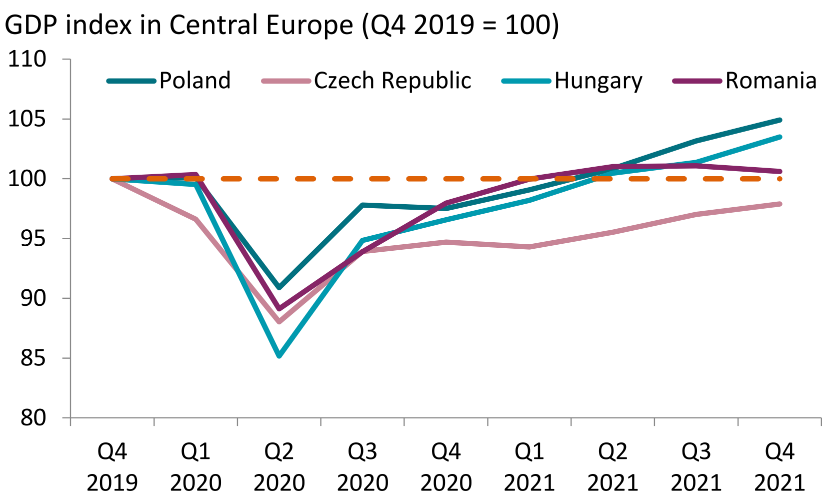
A robust end for 2021 despite Omicron wave looming

- In CEE, sequential GDP remained strong in Poland (1.7% qoq), Hungary (2.1% qoq) and the Czech Republic (0.9% qoq). Romania has nevertheless reported a contraction (-0.5% qoq) during the quarter, after having seen a vivid recovery after the Q2 2020 shock (the first economy in the region to have reached its pre-Covid level in mid-2021). In Asia , Q4 GDP growth readings suggest continued recovery on the back of easing restrictions and recovering domestic demand, with many actually beating market expectations.

Inflation tensions remain

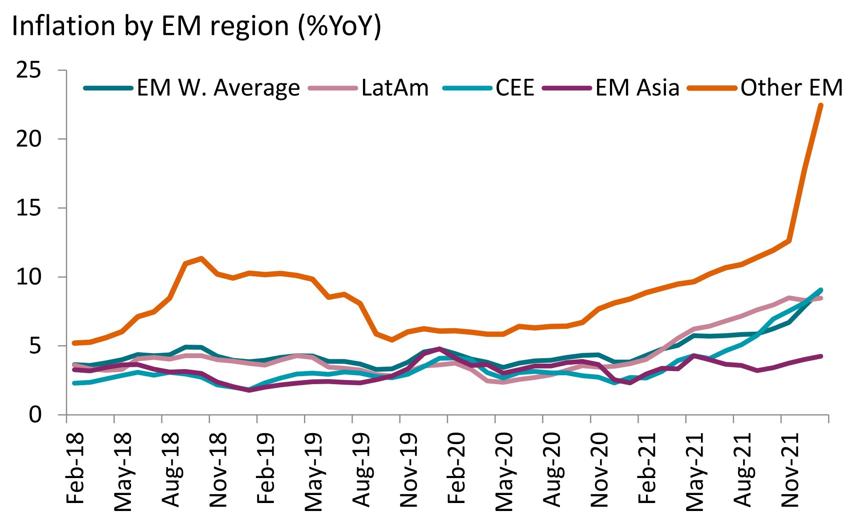
- Commodity prices remained elevated in the current tense geopolitical environment. The longer commodity prices stay high, the more they feed into the other components of inflation. The GDP-weighted EM ex-China proxy inflation rate, which compounds the biggest 20 developing countries accounting for 28% of world's GDP, reached 9% yoy in January, (5.5% excluding Turkey) where last inflation data printed 48.7%. Some stabilisation has been seen in Latin America but needs to be confirmed in the coming months. We continue to expect a gradual cooling of inflation into H2 as supply chain disruptions are being resolved and commodity prices normalise.

Robust growth in Central Europe



Source: Datastream, AXA IM Research, Q4 2021

Inflation rates across EM regions



Source: Datastream, AXA IM Research, Jan 2021

Monetary policy at various speeds

Emerging Markets

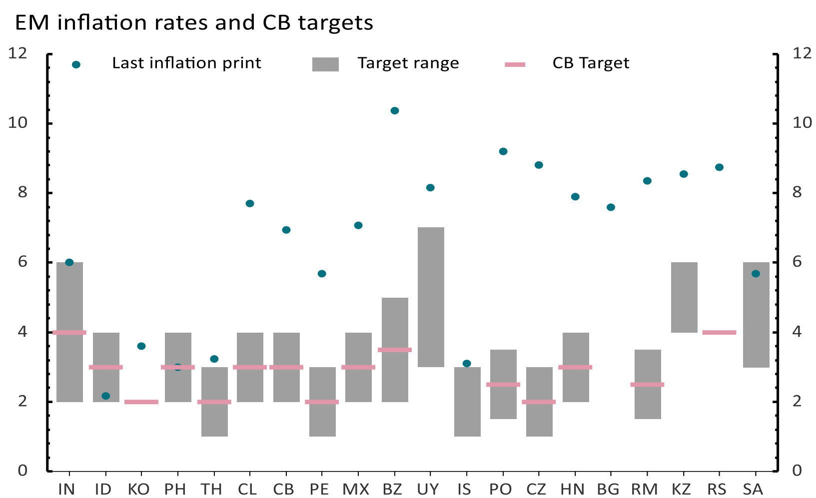
Policy normalization continues for most

- Asian central banks lag the tightening process as inflation pressures are manageable for now. Korea raised its policy rate three times since August 2021, while MAS recently announced an off-cycle increase in the SG$ nominal effective exchange rate slope and Bank of Indonesia hiked the reserve requirement rates to absorb excess liquidity. Policy rates were hiked again last month by +150bps in Chile and Brazil, +100bps in Russia, Ukraine and Colombia, +75bps in the Czech Republic, +50bps in Mexico, Peru, Poland and Hungary, +25bps in South Africa, with some central banks (Brazil, Czech Rep) indicating that most of the heavy lifting has probably been done. Future policy will be fine-tuned and data dependent. Inflation expectations are broadly well-anchored with the exception of Poland.

Turkey, the outlier

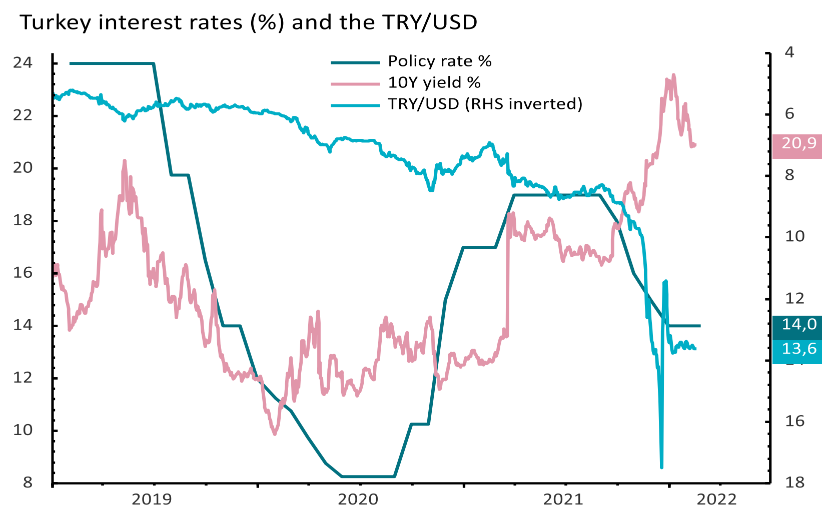
- CMBT kept interest rates unchanged at 14% despite soaring prices, with no appetite for rate hikes. The recently introduced FX-protected deposit scheme aimed to stabilise the TRY has so far been successful in stopping temporarily the increase in dollarisation of the economy. VAT cuts and targeted price controls have been introduced in order to supress price increases.

Inflation rates beyond targets through EM ex-Asia



Source: Datastream, AXA IM Research, January 2022

Export growth losing steam after last year's peak



Source: Datastream, AXA IM Research, February 2022

AXA Investment Managers

Investment Strategy

Multi-Asset Investment views

Our key messages and convictions

Moderately constructive on equites

#1

Valuations improved; economic activity is strong, corporate earnings will grow

Cautious on Investment Grade Credit

#2

While recent spread widening has improved valuations, rates volatility continues to render duration risk problematic.

Neutral on Sovereign Bonds

#3

Central banks hiking cycle fully priced, limiting bond yield upside in the short term

 # 4

Rising geopolitical tensions support commodity markets but supply constraints should gradually ease

Neutral on Commodities

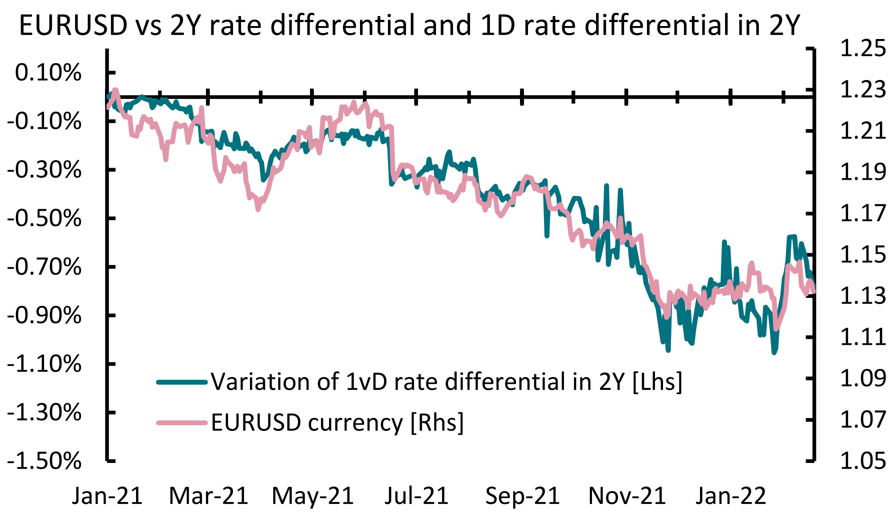
Source: AXA IM as at 22/02/22

FX Strategy

False start for the EURUSD post ECB meeting

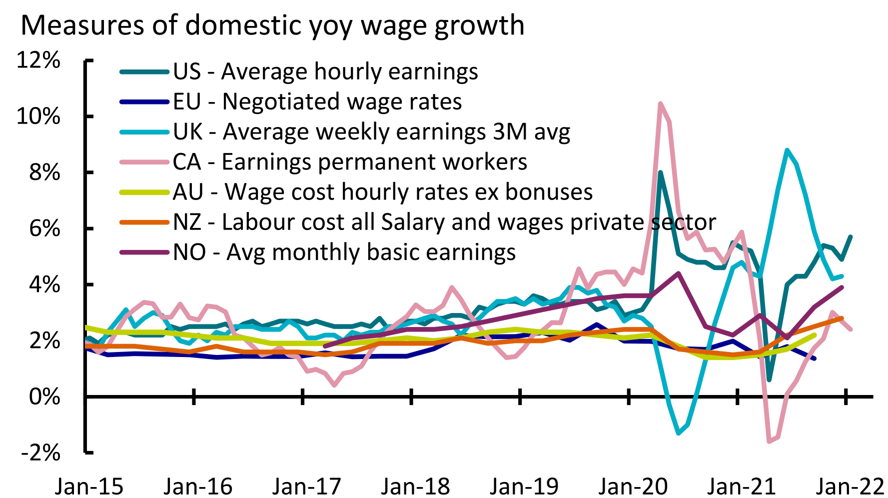
- A hawkish turnaround by the ECB at the February meeting triggered a sharp rebound in EURUSD to slightly below 1.15. Despite the sizable surprise, the move in EURUSD did not reflect signs of a larger repositioning towards a EURUSD fair value of 1.25. It simply reacted to the central bank terminal rate differential (1-day rate in 2 years' time), as has been the case since 2021.
- The close relationship with terminal rates skews the outlook for EURUSD to the downside in the near term. An adjustment between terminal rates for the US and the EU could push EURUSD back towards 1.10, something that could be exacerbated by risk-off tensions surrounding Ukraine. Longer term, a fuller Eurozone recovery, including higher wages could move EURUSD towards 1.20.
- Wages are a key driver of central bank expectations at this juncture. In the EU, they have risen but are not accelerating. Neither are they rising notably in Canada or Sweden, and both the BoC and the Riksbank surprised to the dovish side in their latest meetings. By contrast, wages are rising in Norway and New Zealand, making the hawkish case for Norges Bank and RBNZ more credible.

EURUSD tracking terminal rate differential



Source: Bloomberg and AXA IM Research, February 2022

Wage inflation pressures vary notably across regions



Source: Bloomberg and AXA IM Research, February 2022

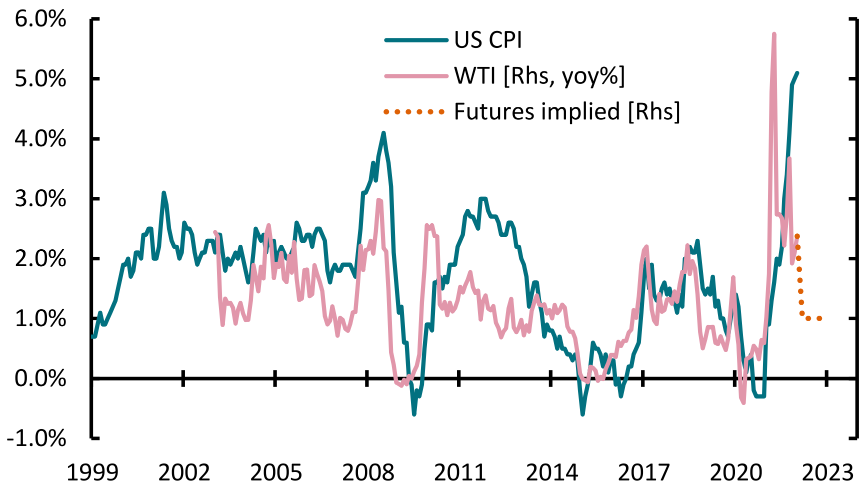
Rates Strategy

Policy, inflation and the term premium

- Inflation expectations are an essential variable in virtually every inflation model. Central banks pay attention to the evolution of these forecasts, which often motivate policy decisions on the back of the risk of so-called positive feedback from inflation expectations to measured inflation.
- Market-based expectations have the obvious advantage of being readily available for several economies around the world. The flipside of the coin has to do with the tight relationship between crude oil prices and inflation expectations, across the entire breakeven curve. According to WTI oil price futures, oil is set to pull US inflation lower starting in July of this year.
- In addition to interest rate and inflation expectations, we should not underestimate the term premium's contribution to both the level and shape of the yield curve. In a hiking cycle scenario characterised by increased policy uncertainty, it is fair to assume the term premium will have a positive contribution to the level of Treasury yields.

Positive base effects into the summer

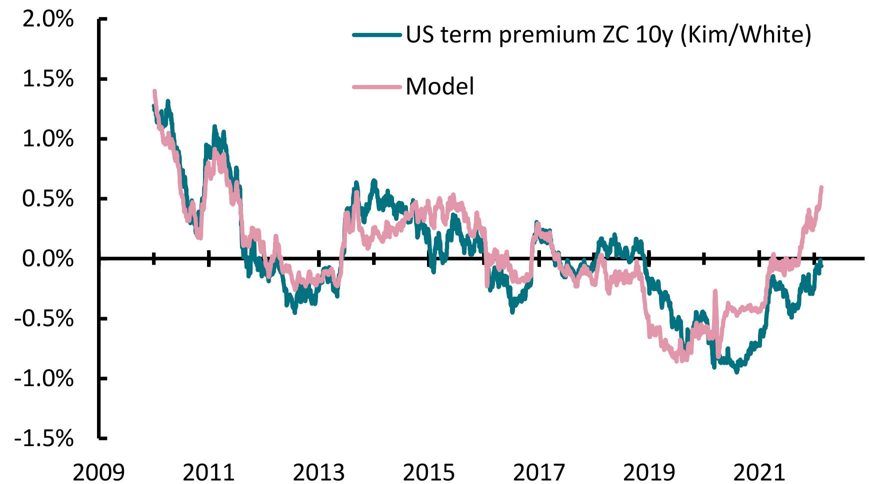
US Inflation - Oil Price Base-Effect



Source: Bloomberg and AXA IM Research, February 2022

Term premium is lagging

US Term Premium



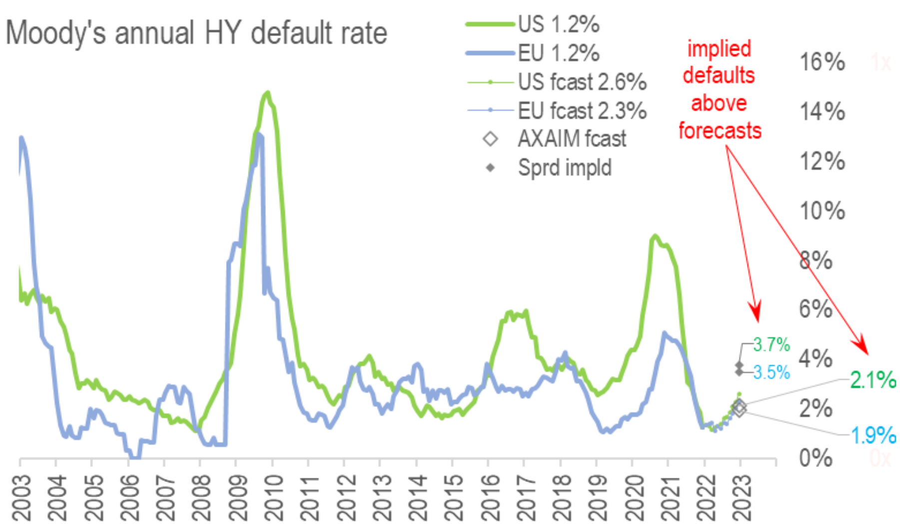
Source: Bloomberg and AXA IM Research, February 2022

Credit Strategy

Constructive by default

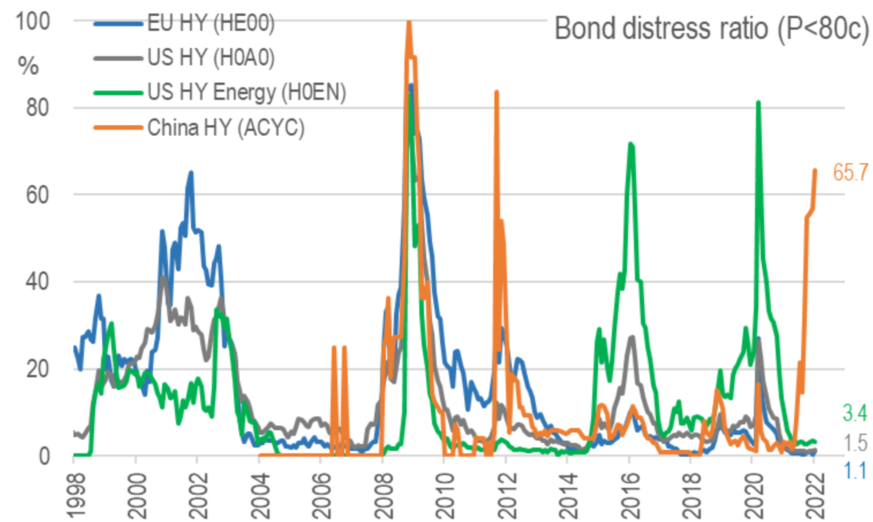
- High yield (HY) credit has outperformed both equities and investment grade (IG) credit in 2022. Moreover, HY spreads have outperformed in beta-adjusted terms, having widened relatively less than IG spreads, in a pattern of bearish compression which is not atypical ahead of central banks' hiking cycles.
- Above-trend growth and healthy earnings should continue to underpin HY credit fundamentals. Furthermore, default cycle indicators are currently very benign, adding to the tailwinds. Indeed, the COVID-19 default cycle has come to an end, after a default peak that has been the highest since the global financial crisis.
- Typical default predictors like HY bond distress ratios - the share of bonds trading below a certain price or above a certain spread - and bank lending standards remain very well-behaved despite the recent uptick in market volatility. As a result, HY markets screen cheap compared to default expectations, given that spread-implied default rate is currently above our model forecasts.

The COVID-19 default cycle has ended



Source: Moody's, ICE, and AXA IM Research, Feb 2022

HY distress ratios at rock bottom, ex. China



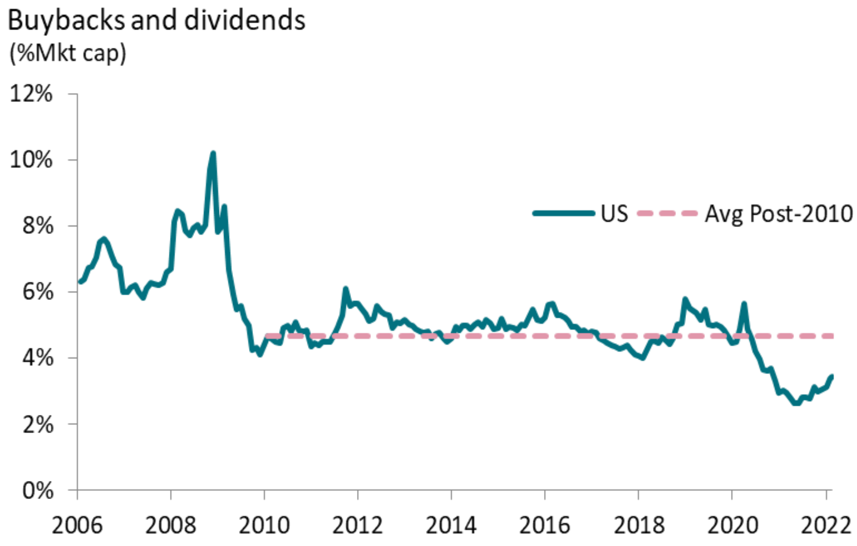
Source: ICE, and AXA IM Research, Feb 2022

Equity Strategy

Some room to breathe

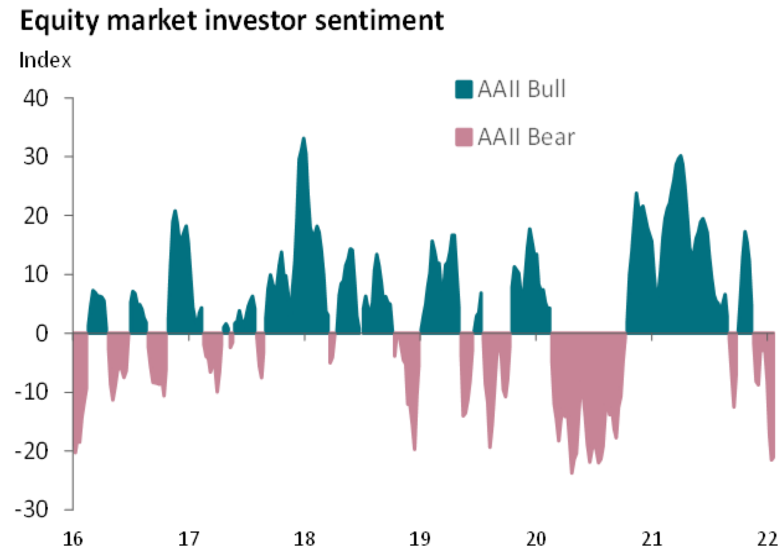
- Negative news flow continues to weigh on global stock markets. In the past month, global equities have contracted by -5.0%, while the UK at +5% has come on top across regions. The energy sector is the standout performer (+20%), driven by rising commodity prices.
- Capital returns remain well below pre-pandemic level relative to market capitalisation in the US. We also observe such a gap in Europe albeit by less. As buybacks and dividend growth tend to lag earnings by 2-3 quarter, we expect cash return to be a significant element in equity market performance in 2022.
- The earnings season continues in constructive tone, providing support for the asset class. Most surprises are positive (77% EPS beat in US, 65% in Europe), but negative ones are punished (-2.7% 1D price reaction relative to market). Thus, the ability to maintain margins will be key in the coming quarters as the balance of risks is negative (RUSUKR conflict, monetary policy tightening, pandemic).

Buybacks and dividends remain below average



Source: Bloomberg, Datastream and AXA IM Research, February 2022

Sentiment on equities is at its lowest since Q1 2020



Source: AAII and AXA IM Research, February 2022

Asset allocation stance

Positioning across and within asset classes

Asset Allocation

Key asset classes	Negative	Neutral	Positive
Equities			Positive
Bonds		Neutral ▲	
Commodities		Neutral	
Cash	Negative ▼		

Equities

Developed	Negative	Neutral	Positive
Euro area			Positive
UK		Neutral	
Switzerland		Neutral	
US		Neutral	
Japan		Neutral	
Emerging & Equity Sectors			
Emerging Markets		Neutral	
Europe Cyclical/Value		Neutral	
Euro Financials		Neutral ▼	
European Auto			Positive ▲
US Financials		Neutral	
US Russell 2000		Neutral	

Fixed Income

Govies	Negative	Neutral	Positive
Euro core		Neutral ▲	
Euro peripheral		Neutral	
UK		Neutral ▲	
US		Neutral ▲	
Inflation Break-even			
US		Neutral	
Euro		Neutral	
Credit			
Euro IG	Negative		
US IG		Neutral	
Euro HY			Positive
US HY		Neutral	
EM Debt			
EM Bonds HC		Neutral	

Legend Negative | Neutral | Positive   **Change** ▲ Upgrade | ▼ Downgrade

Source: AXA IM as at 22/02/22

Forecasts & Calendar

Macro forecast summary

Forecasts

Real GDP growth (%)	2020	2021*		2022*		2023*	
		AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
World	-3.1	5.8		4.0		3.5	
Advanced economies	-5.0	5.0		3.4		2.1	
US	-3.4	5.5	5.6	3.2	3.9	2.0	2.6
Euro area	-6.7	5.2	5.1	3.4	4.0	2.1	2.5
Germany	-4.9	2.8	2.7	2.9	3.7	2.7	2.5
France	-8.0	7.0	6.6	3.9	3.8	2.4	2.0
Italy	-9.0	6.5	6.3	3.8	4.2	1.9	2.2
Spain	-10.8	5.0	4.7	5.9	5.6	3.0	3.6
Japan	-4.9	1.7	1.8	2.9	3.1	2.2	1.5
UK	-10.0	7.2	7.0	4.3	4.3	2.1	2.2
Switzerland	-2.5	3.5	3.5	3.0	3.0	1.6	1.9
Canada	-5.2	4.4	4.7	3.5	3.9	2.6	3.0
Emerging economies	-1.9	6.4		4.4		4.3	
Asia	-0.8	6.8		5.1		5.2	
China	2.3	7.9	8.0	5.0	5.0	5.3	5.3
South Korea	-0.9	4.0	4.0	2.6	3.0	2.1	2.5
Rest of EM Asia	-4.6	5.8		5.4		5.3	
LatAm	-7.0	7.0		2.6		2.6	
Brazil	-3.9	5.1	4.7	1.2	0.6	2.0	2.0
Mexico	-8.5	6.0	5.6	2.6	2.5	2.2	2.3
EM Europe	-2.0	6.6		3.8		2.8	
Russia	-2.7	4.7	4.2	3.2	2.6	2.0	2.2
Poland	-2.5	5.8	5.3	4.9	4.7	3.8	4.0
Turkey	1.8	11.4	9.9	3.6	3.0	3.0	3.4
Other EMs	-2.1	4.2		3.9		3.9	

Source: Datastream, IMF and AXA IM Macro Research – As of 21 February 2022

* Forecast

Expectations on inflation and central banks

Forecasts

Inflation Forecasts

CPI Inflation (%)	2020	2021*		2022*		2023*	
		AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	**0.7**	**3.2**		**4.0**		**2.2**	
US	**1.2**	**4.7**	4.6	**5.0**	4.8	**2.9**	2.6
Euro area	**0.3**	**2.6**	2.5	**4.0**	3.1	**1.7**	1.6
Japan	**0.0**	**-0.2**	-0.2	**1.2**	0.8	**0.7**	0.7
UK	**0.9**	**2.6**	2.5	**5.5**	4.6	**2.1**	2.5
Switzerland	**-0.7**	**0.5**	0.5	**0.6**	0.9	**0.7**	0.6
Canada	**0.7**	**3.4**	3.4	**3.1**	3.4	**2.3**	2.2

Source: Datastream, IMF and AXA IM Macro Research – As of 21 February 2022

* Forecast

Central banks' policy: meeting dates and expected changes

Central bank policy

Meeting dates and expected changes (Rates in bp / QE in bn)

		Current	Q1-22	Q2-22	Q3-22	Q4-22
United States - Fed	Dates	0-0.25	25-26 Jan 15-16 Mar	3-4 May 14-15 June	26-27 July 20-21 Sep	1-2 Nov 13-14 Dec
	Rates		+0.25 (0.25-0.5)	+0.25 (0.5-0.75)	+0.25 (0.75-1)	+0.25 (1-1.25)
Euro area - ECB	Dates	-0.50	03 Feb 10 Mar	14 April 9 June	21 July 8 Sep	27 Oct 15 Dec
	Rates		unch (-0.50)	unch (-0.50)	unch (-0.50)	+0.25 (-0.25)
Japan - BoJ	Dates	-0.10	17-18 Jan 17-18 Mar	27-28 April 16-17 June	20-21 July 21-22 Sep	27-28 Oct 19-20 Dec
	Rates		unch (-0.10)	unch (-0.10)	unch (-0.10)	unch (-0.10)
UK - BoE	Dates	0.25	3 Feb 17 Mar	5 May 16 June	4 Aug 15 Sep	3 Nov 15 Dec
	Rates		+0.25(0.5)	+0.25 (0.75)	+0.25 (1)	unch (1)

Source: AXA IM Macro Research - As of 21 February 2022

Investment Managers

Calendar of 2021-2022 events

2022	Date	Event	Comments
	Q3-Q4 2022	Chilean Constitutional Referendum	
March	March	FOMC Meeting	+0.25 (0.25-0.5)
	March	China Annual National People's Congress	
	3 March	ECB minutes of 3 February GC meeting	
	9 March	South Korea Presidential Elections	
	10 March	ECB GC policy meeting	Likely decisions towards gradual normalisation
	10-11 March	Extra-ordinary EU Council	Likely focus on future Stability and Growth Pact rules
	13 March	Colombian Legislative Elections	
	17 March	MPC Summary and minutes	
	23 March	UK OBR Update	
	31 March	UK Business rates relief ends	
	31 March	UK Reduced VAT for hospitality and tourism ends	
April	6 April	UK National Insurance contributions increase 1.25ppt	
	6 April	UK Dividend Tax increase by 1.25ppt	
	6 April	UK Super-deductibility for UK investment begins	
	10 & 24 April	French Presidential Elections	
May	May	Philippines Elections	
	5 May	Monetary Policy Report & MPC Summary and minutes	
	5 May	UK Elections in Scotland, Wales, and Northern Ireland and UK Local Elections in England	
	29 May	Colombian Presidential Elections	
June	12 & 19 June	French Legislative Elections	
	16 June	MPC Summary and minutes	
July	1 July	UK border checks on EU imports scheduled to resume	
August	August	US Federal Reserve Jackson Hole Symposium	
	4 August	Monetary Policy Report & MPC Summary and minutes	
September	15 September	MPC Summary and minutes	
October	October	China's 20th National Congress- President Xi to be re-elected (expected)	
	2 October	Brazil General Elections	
November	3 November	Monetary Policy Report & MPC Summary and minutes	
	8 November	US Midterm Elections	
December	15 December	MPC Summary and minutes	

Latest publications

Omicron update: Boon or Bust?

1 February 2022

January Global Macro Monthly - Omicron to a Russian Rubicon

26 January 2022

2022 emerging market elections: The who's who and the so what…

19 January 2022

December Global Macro Monthly - Omicron- the ghost of Christmas past?

17 December 2021

2022-2023 Macroeconomic Outlook: Pandemic effects to recede, policy starts to tighten

1 December 2021

Tapering, profit and equity prices

15 November 2021

China: Riding the green wave

3 November 2021

Investment management and blockchain: The great reshuffle

22 October 2021

October Global Macro Monthly – Transition costs to net zero: significant but necessary

20 October 2021

The cost of climate change: Action versus inaction

30 September 2021