



# A Summer of discontent

## Monthly Investment Strategy

AXA IM Research

29 June 2022

# Summary: June 2022

## Theme of the month: Will humble and nimble policy save the US from recession

- US inflation is currently too high. While a large part of it is driven by external shocks, domestically generated inflation is also too high and is more likely to lead to persistent inflation. The Federal Reserve needs to slow domestic activity, to ease labour market pressures to quell this pressure.
- Doing so without causing recession is never easy and there are few instances of a “soft landing”. As well as the structural economic uncertainties in the post-COVID economy, the Fed’s quantitative tightening programme is an additional source of uncertainty, both in terms of scale and timing of impact.
- There is a clear risk of the Fed inducing recession. For now we do not think that the US is committed to that outcome. However, in a large part that relies on our forecast that the Fed will not deliver on the scale of tightening currently envisaged by markets. We forecast rates to peak at 3.25%.

## Macro update: Broadly constant themes dominate international economies

- Rising food and energy prices, exacerbated by the Ukraine war, have pushed headline rates of inflation higher. Rising inflation has also threatened to unanchor expectations in developed economies. Emerging economies already operate on the basis that expectations cannot be taken for granted.
- Central banks have responded to higher inflation (and more pertinently risks of higher expectations) by accelerating the pace of tightening, including the Fed (+0.75%), SNB (+0.50%), BoE (threatening 0.50%). The BoC (0.75%) and ECB (0.25% rising to 0.50%) are expected to join over the coming weeks.
- As financial conditions tighten in reaction to tightening monetary policy, the growth outlook softens. We continue to see recession as a risk, not an inevitability in all economic regions. We have lowered our growth forecasts a little more and continue to be below consensus expectations.
- China remains the main exception where we lower our growth forecast to 3.6%, but the authorities continue to provide stimulus in China to help growth recover from the H1 COVID outbreak.

## Investment strategy: bar a deep recession value is back in risky assets; govie yields too.

- FX: the repricing in ECB expectations and associated sharp rise in euro rates has failed to benefit the EUR. At the same time, the US cyclical position remains more advanced leaving limited room for Fed pricing to adjust lower. USD is thus set to maintain strength, also benefiting from bouts of risk-off.
- Rates: The more hawkish pricing of central bank policy and the higher for longer inflation dynamic has repriced the shape of the curve, with the belly underperforming, driving the yield curve curvature to fresh highs. This has been in tandem with the material rise in interest rate volatility.
- Credit: Refinancing gaps have skyrocketed as underlying yields have risen steeply and spreads have widened materially. This raises an alarm in respect to default risk but refinancing needs over the next two years appear broadly manageable, mitigating the risk from the refi gap.
- Equity: The decline in stocks ytd was mainly driven by derating in forward multiples. Recession risks threaten the health of earnings for the rest of 2022. In a regime of elevated consumer prices and weak economic activity, a fall in the equity risk premium would imply equities underperformance vs bonds.

# Central scenario

## Summary – Key messages

### Inflation

Ukraine supply-shock extends inflation overshoot. China supply disruption a risk. Domestic inflation pressures near peaks, but slow to fall.

### Monetary policy

Most central banks to tighten policy as inflation high, labour markets tight and signs of slowdown tentative. BoE likely to pause first. PBoC and BoJ major exceptions

### Fiscal policy

Euro area leads with fiscal measures to absorb energy shock, also in CEE and other EMs. UK's response caught up. US deadlocked in Congress.

### Growth

Growth will slow, but in most areas remain positive given post-COVID momentum. Contraction a risk for some.

**Our central scenario:**  
Ukraine war poses material supply-shock, raising inflation further and slowing COVID-rebound growth

We forecast global growth to rise by 3.1% and 2.9% in 2022 and 2023.

Economic slowdown amidst supply pressures and tighter monetary policy. Inflation elevated for much of 2022.

### Emerging Markets

CEE still solid for now despite war. Higher inflation, energy and oil particularly, to further strain complex. Asia sheltered.

### Rates

Rates may be finding level having retreated from highs. Flat curves show growth concerns, but may also reflect technical features.

### FX

Dollar pricing remains extreme, risk outlook key to support. Commodity currencies bolstered in light of war.

### Credit

Volatile spreads in 2022 on central bank and geopolitics, but spreads now wide by standards of last decade.

### Equities

Earnings expectations are getting shakier due to inflation & downside risks to growth. Some caution into H2 2022 warranted.

# Alternative scenarios

## Summary – Key messages

### Entrenched supply shock (*probability 25%*)

#### What could be different?

- Escalation in Ukraine conflict
- COVID outbreaks spreads again: China and/or new mutations
- Post-pandemic structural changes – labour market withdrawal and goods demand – persist. Supply shocks last longer
- Inflation expectations rise, affecting wages and persistence

#### 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 still 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 tensions 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

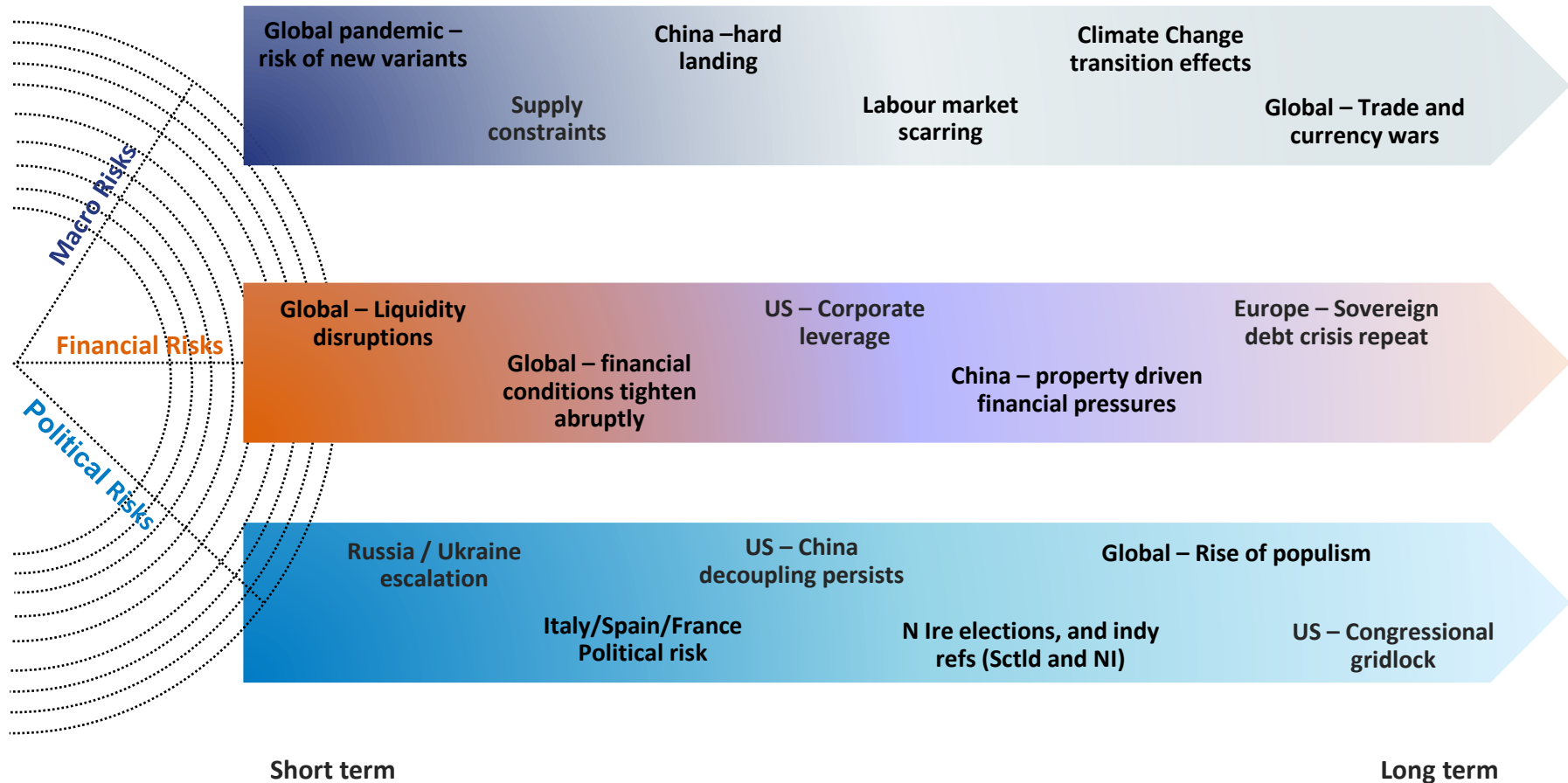
- Growth surprises on the upside in most regions
- Inflation fades more quickly towards and below central bank targets
- Monetary policy proves more patient than expectations

#### 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



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# Theme of the month

# Will humble and nimble Fed policy avoid recession?

## Inflation is far too high

### Fed must slow domestic economy

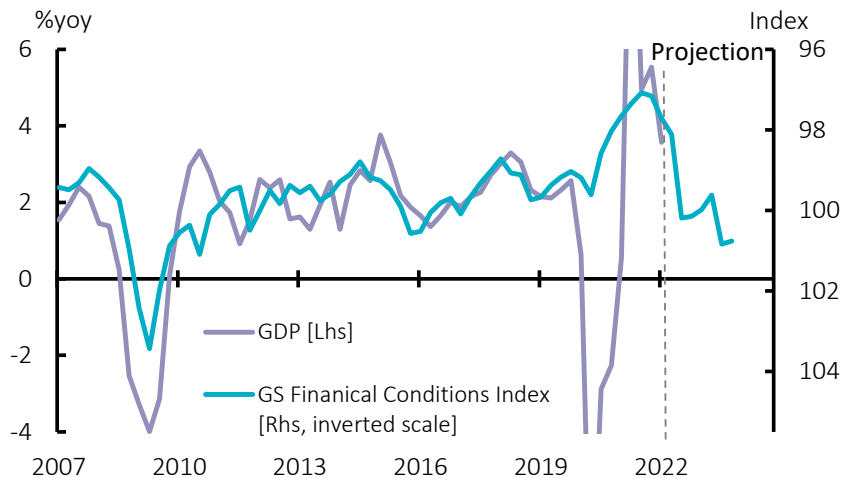
- Despite most of the overshoot of the Fed's inflation target coming from external factors, the persistent portion of inflation will be generated by domestic pressures – a tight labour market and any unanchoring of inflation expectations. To address this the Fed must lower unit labour cost growth by reducing wage growth, slow wage growth by raising unemployment, and raise unemployment by slowing economic activity. To do this the Fed needs to slow economic growth below trend, which it will do by tightening financial conditions.

### The Fed has exceeded historic “pain” thresholds

- In 2015, the Fed wanted to start a tightening cycle, but financial conditions had pre-emptively tightened so much that the Fed had to wait a whole year before a second hike. This scale of adjustment in conditions (highlighted in red in chart below) was the same as had halted or reversed previous Fed cycles. It appears to be the degree of market pain that historically caused the Fed to take stock. Examples of greater adjustment can only be found ending in recession (2001, 2008, 2020). Yet the degree of tightening in current conditions has exceeded this threshold.

### Tighter conditions required to ease domestic inflation pressures

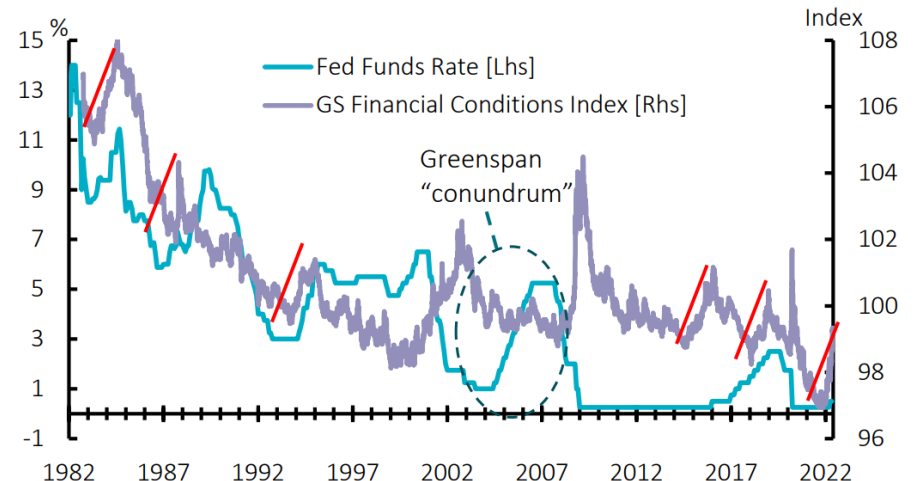
US financial conditions and GDP



Source: Bureau of Economic Analysis, Goldman Sachs and AXA IM Research, June 2022

### Financial conditions have exceeded usual ‘pain’ threshold

US Bank Rate and Financial Conditions



Source: Federal Reserve Board (FRB), Goldman Sachs and AXA IM Research, June 2022



# Will humble and nimble Fed policy avoid recession?

## Fed supplements policy tightening with quantitative tightening

### Balance sheet unwind – quantitative tightening

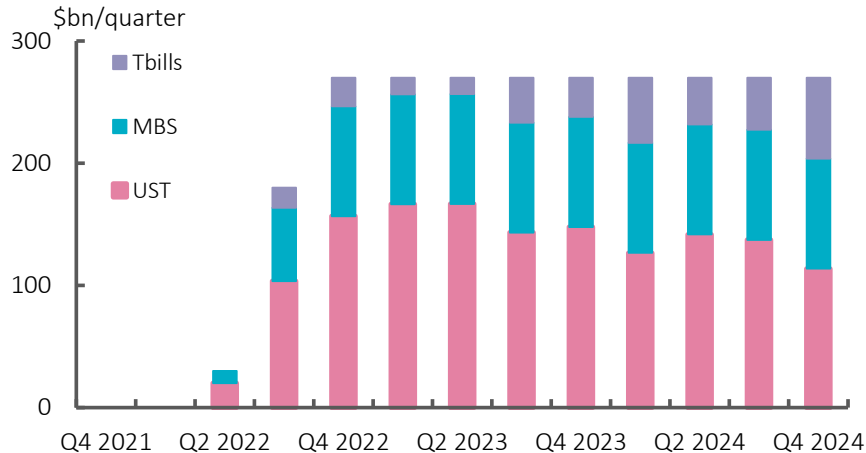
- The Fed began the process of reducing the assets it holds on its balance sheet – quantitative tightening. This will happen by allowing assets to mature, initially allowing US Treasuries to mature capped at \$30bn and mortgage-backed securities capped at \$17.5bn. This will rise to \$60bn and \$35bn respectively in September, with any shortfall being made up by T-bill maturities. This is a faster pace of QT (and earlier in the rate cycle) than seen last time.

### A background process

- The Fed expects the impact of QT to be small (Fed Chair Powell estimated equivalent to around one hike per year) and it does not see this as active monetary policy. As such, the Fed hopes to smoothly continue with asset maturities until reserves in the system are only just “ample”. We estimate that this process will take until end-2025.

### Estimated maturities of Fed held securities

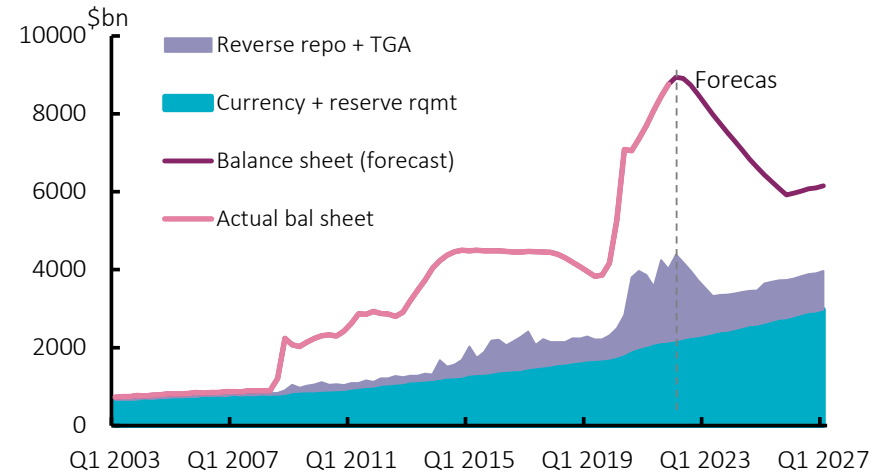
Estimated run off of Fed balance sheet



Source: FRB, AXA IM Research, June 2022

### The Fed’s balance sheet – an overview

Fed balance sheet and excess reserves



Source: FRB, AXA IM Research, June 2022

# Will humble and nimble Fed policy avoid recession?

## Impact of QT highly uncertain

### Little empirical evidence of the impact of QT

- There is only one prior episode of QT, which ended abruptly in 2019 and was immediately followed by the pandemic recession of 2020. There is little empirical evidence to judge the impact of QT. Estimates of QE have varied. Initial estimates suggested a relatively large 12bp FFR equivalent impact for each \$100bn of balance sheet expansion (in constant GDP terms). More recent studies suggest a much lower impact of just 4bp. Moreover, central bankers are not convinced that the impact of QE and QT are symmetric.

### Timing of QT impact also uncertain

- The timing of the impact of QT is also quite uncertain. QE from 2008 operated through the creation of Fed liabilities – the expansion of excess reserves in the commercial banking system – via Fed asset purchases. This is initially how QE started in 2020. However, first the government’s cash account at the Fed (the TGA) expanded and absorbed Fed liquidity, and then overnight reverse repo (ON RRP) expanded – a mechanism draining liquidity back out of the system to avoid downward pressure on short-end rates.

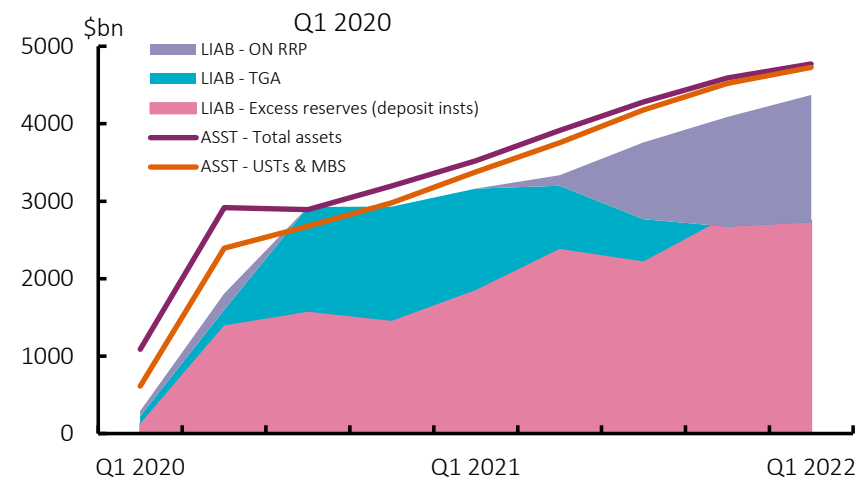
## Summary of Fed assessments of impact of previous episodes of QE

Pre and post QT estimates of balance sheet and FFR equivalences				
Study	Study size of LSAP	GDP equivalent	FFR equivalent	Average \$100bn
<b>Pre QT</b>				
Bernanke (2011)	\$600bn	\$884bn	75bps	
Williams (2014)	\$600bn	\$786bn	75-100bps	
Eugen, Laubach et al (2015)	\$2700bn	\$758bn	133bps	12.2
<b>Post QT</b>				
Kansas City Fed, 2017	\$650bn	\$767bn	25bps	
Fed notes, July 2019	2% of GDP	\$460bn	20bps	
		\$575bn	20bps	3.7

Source: Federal Reserve Board, AXA IM Research, June 2022

## Overnight reverse repo absorbed much of Fed’s QE this time

Increase in Fed balance sheet assets and liabilities since



Source: FRB, AXA IM Research, June 2022

# Will humble and nimble Fed policy avoid recession?

## Uncertain impact of ON RRP on QT

### How will ON RRP unwind ?

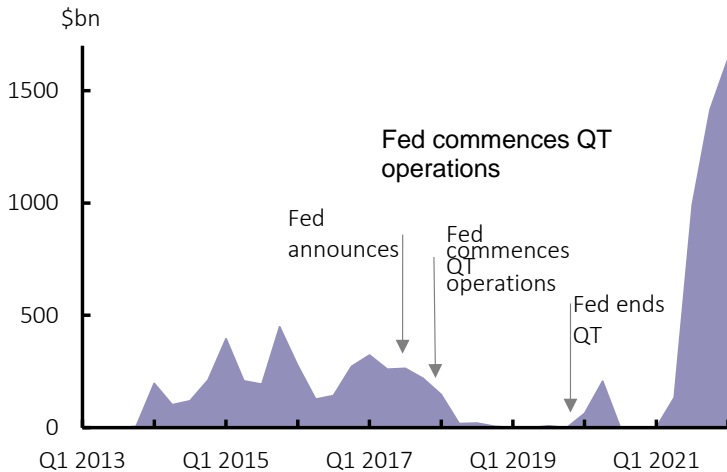
- There is little precedent for the unwind of ON RRP. In 2017 a much smaller build up of ON RRP unwound as the Fed announced and then commenced QT. This suggests that this excess system liquidity will be absorbed first by the Fed's QT operations. Given the current pace of QT, this would take until later in 2023 and would leave commercial bank excess reserves unchanged until then. Or ON RRP might remain elevated, suggesting a quicker pass through to excess reserves.

### Impact on yields

- US real yields have risen sharply, suggesting markets already price the impact of QT – however it translates through the plumbing of the US monetary system. This is similar to 2018, when real yields correctly anticipated a marked easing in monetary policy. However, market expectations proved wrong in 2008, where real yields pulled back sharply. We see some scope for real yields easing from current levels in part reflecting a more delayed impact of QT.

## Previous experience might prove a guide to ON RRP behaviour

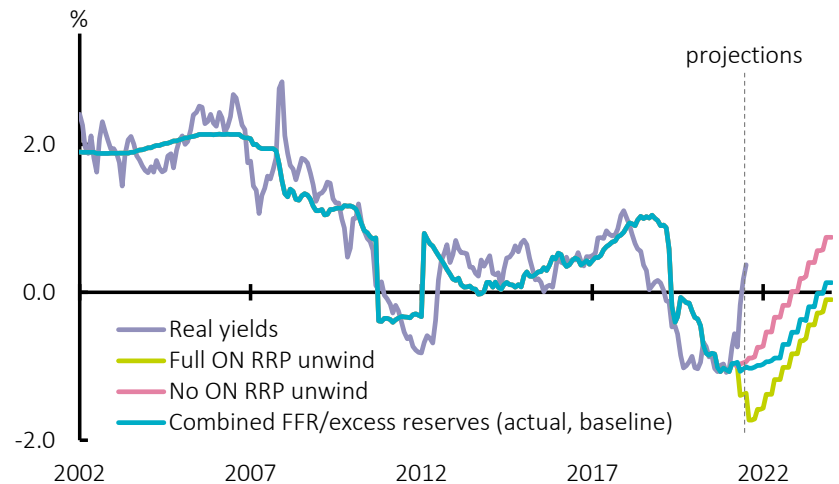
US - Domestic ON RRP holdings



Source: FRB, AXA IM Research, June 2022

## Real yield moveemtn appears to fully anticipate Fed tightening

US Real yields and monetary policy



Source: FRB, AXA IM Research, June 2022

# Will humble and nimble Fed policy avoid recession?

## Recession risk

### Small adjustments in unemployment are hard to pull off

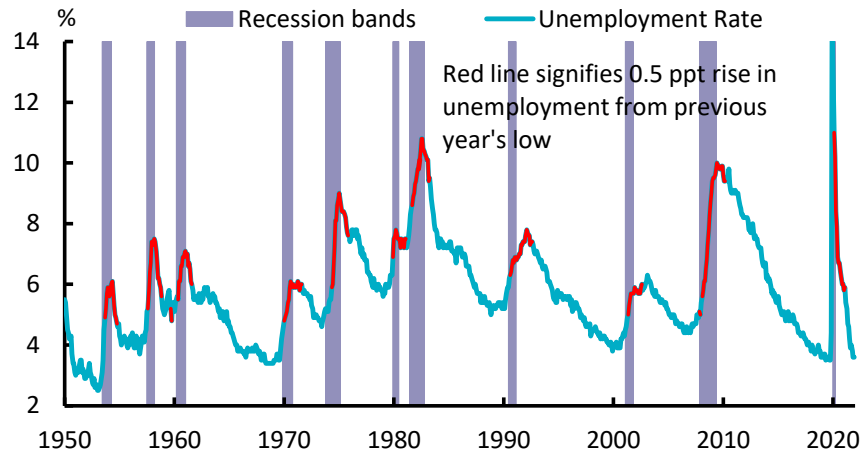
- The Fed's track record in delivering soft-landings is not extensive. The mid-1990s and mid-1960s provide success stories. Fed economist Claudia Sahm identified a 0.5ppt rise in unemployment over 12-months as a timely real-time indicator of recession. To our minds, the Fed needs to purposefully raise unemployment by a similar degree to adequately dampen domestic inflation pressures. This makes the Fed's job of tightening the economy extremely difficult.

### Models suggest no immediate recession for now

- We do not think the economy is currently locked into a recession outcome. We suggest that the Fed will raise the Fed Funds Rate to 3.25% by year-end, below the 3.4% this year and 3.8% next currently signaled. This is likely both in recognition of and to avoid tightening too much and inducing a recession. For now, the economy is slowing from a pace that was too fast. We do not believe for now that growth will contract, although our forecast of 2.4% and 1.2% for this year and next is below the consensus 2.6% and 1.9%.

### Small increases in unemployment have often signalled recession

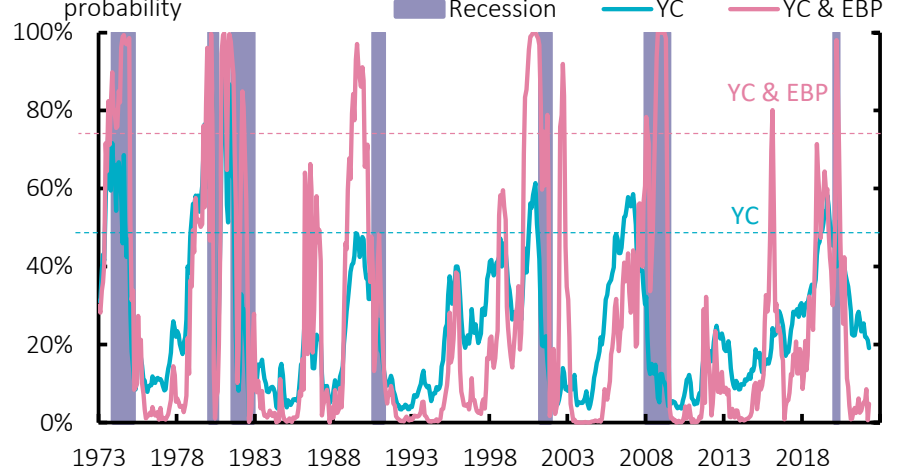
Modest increases in unemployment lead to recession - Sahm effect



Source: FRB and AXA IM Research, June 2022

### Models do not point to a recession in the next 12m for now

US 12-month recession probability



Source: FRB and AXA IM Research, June 2022

# Macro outlook

# Fed worries about unanchoring inflation expectations

## US

### Worries increase about inflation expectations

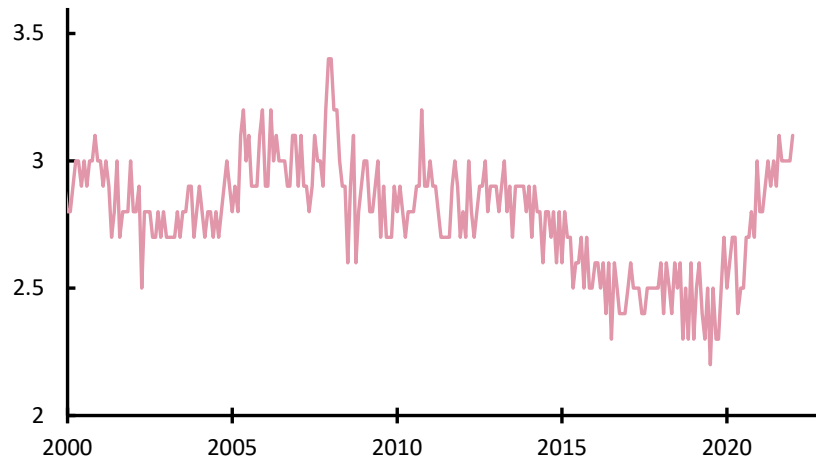
- Headline inflation defied our expectation of having peaked and edged up to a new high of 8.6% in May from 8.5% in March (although core eased to 6.0%). Inflation was driven by food and energy costs, including a 7.8% rise in motor fuel prices. These very visible price increases have contributed to a rise in long-term household inflation expectations. Although long-term market expectations (5y/5y) remain anchored, signs of an unanchoring of expectations are concerning.

### Fed reacts with more hawkish shift

- The Fed reacted to higher inflation and rising expectations by accelerating the pace of tightening. In June the Fed delivered a 0.75% Fed Funds hike – its biggest since 1994. It also shifted its dot plot profile higher, anticipating a median 3.4% FFR at the end of 2022 and 3.8% in 2023. The Fed’s priority appears to be anchoring inflation expectations for now. Yet this can lead to time inconsistent policy, we do not believe that the Fed will need to deliver such a sharp tightening as projected we expect economic slowdown.

### Inflation expectations show risks of rising

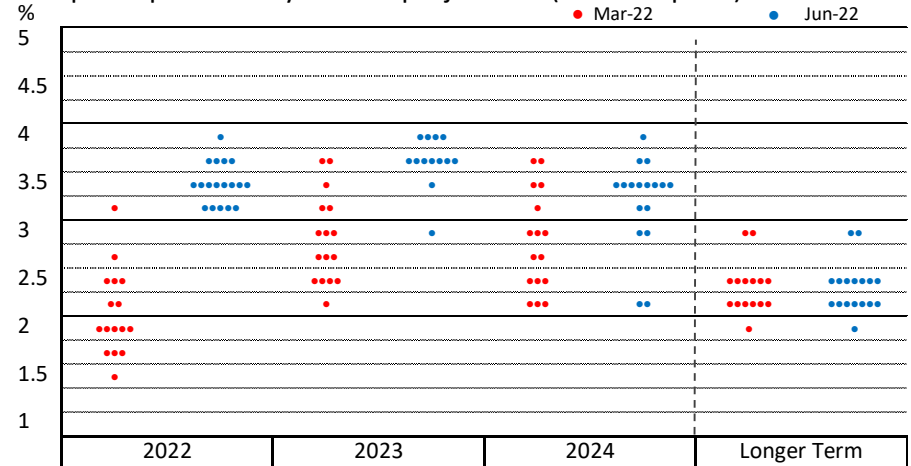
#### Michigan 5-10y inflation expectations



Source: University of Michigan, AXA IM Research, June 2022

### Fed rate outlook turns more hawkish to contain expectations

#### Fed participants end-year rate projections (the "dot plot")



Source: FRB, June 2022

# Recession worries

## US

### Q2 GDP growth to avoid technical recession

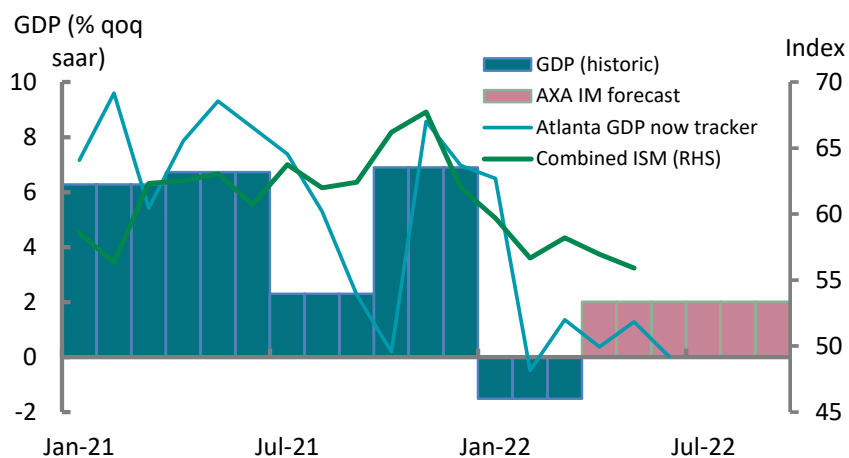
- The contraction in Q1 GDP reflected a sharp widening of the trade deficit and slower inventory accumulation. Neither should occur on the same scale in Q2, while consumption growth appears to remain solid for now. We forecast GDP growth accelerating to around 2% (annualised) in Q2, before slowing below trend over H2. We forecast growth at 2.4% and 1.2% for this year and next (marginally lower than 2.5% and 1.4% last month). Consensus forecasts are for 2.6% and 1.9% respectively.

### Economy not locked into recession, but risks rise

- Market commentary is increasingly focused on the prospect of recession. We join most in seeing this as a rising risk, but not a baseline scenario – despite our growth forecasts being below the consensus. Spending in interest rate sensitive sectors continues to soften, although for now broader services consumption is still recovering. We expect the Fed to stop tightening sooner than market expectations as more visible signs of economic deceleration emerge.

### Q2 should rebound from previous quarter's contraction

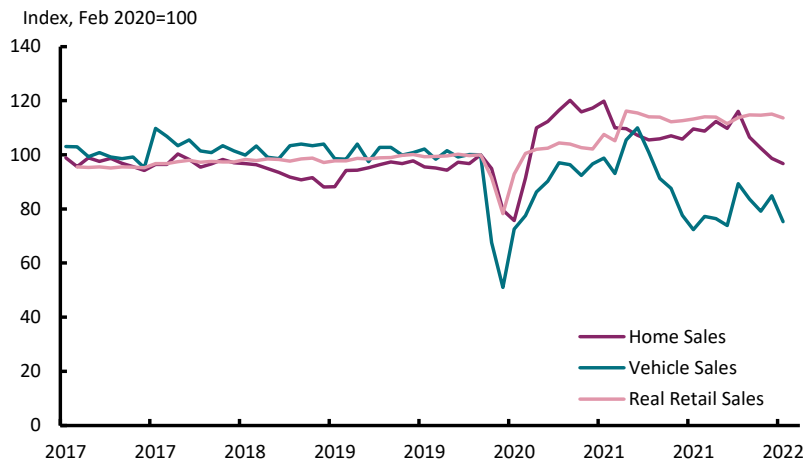
#### GDP growth and short term outlook



Source: BEA, FRBA, AXA IM Research, June 2022

### Signs of slowdown gather pace

#### Real retail sales, home sales, and vehicle sales



Source: NAR, Bloomberg, US Census Bureau, AXA IM Research, June 2022

# Domestic demand to dwindle throughout the year

## Eurozone

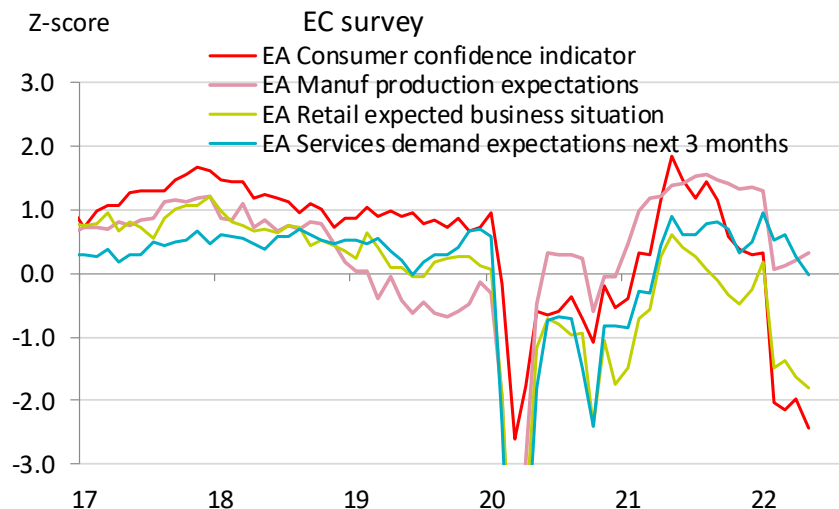
### (Very) short-term activity resilience

- Latest batch of business and consumer surveys have given further grounds for our subdued, below consensus, growth outlook. Most crucially, euro area PMIs have dropped to a 16-month low, led by a notable drop in the services sector from 56.1 to 52.8 in June. At 51.9, the margin above the 50-breakeven for the overall composite index is now limited. Furthermore, forward-looking indicators suggest more downside in the pipeline. Meanwhile, consumer confidence has dropped further in June.

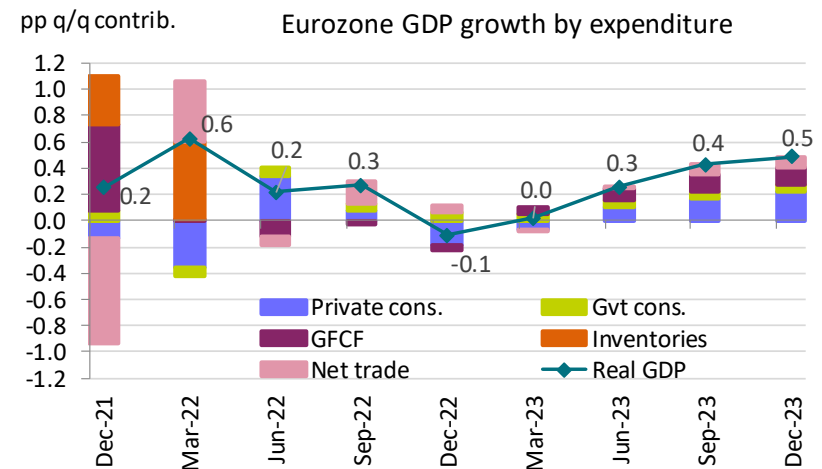
### ... unlikely to persist

- Strong headwinds to eurozone growth remain: 1/ record real income squeeze with upwardly revised inflation projections (7.4% and 3.1% for 2022 and 2023 from 6.6% and 2.4%) with risks still skewed to the upside, 2/high economic uncertainty, 3/ tightening financing conditions (including ramification from an expected slowdown in the US).
- We continue to see high chance of a GDP contraction this year, now most likely in Q4. We now project euro area GDP to grow by 2.8% and 0.7% for this year and next, from 2.1% and 1.2% previously.

### Services: defying gravity is hard



### Domestic demand to contract, timid recovery



Source: Eurostat, AXA IM Research, June 2022

Source: European Commission, AXA IM Research, June 2022



# ECB: Removing hurdles to hike swiftly

## Eurozone

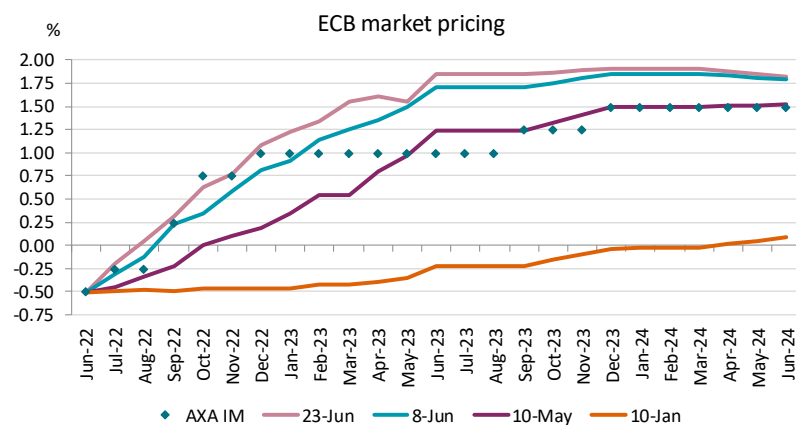
### Projecting Deposit Rate at 1.0% by end 2022

- ECB Governing Council managed surprised markets on the hawkish side in June, notably through a medium-term inflation outlook slightly above its target (2024: 2.1%). Its completely overhauled forward guidance indicated that this would justify a faster than 25bps rate hikes per meeting pace of tightening.
- Consistent with core inflation remaining above target through our forecast horizon, we think the ECB is likely to play catch up with other DM central banks, hiking its deposit rate facility by 25bps in July, 50bps in September and October, and another 25bps in December ending the year at 1.0%.

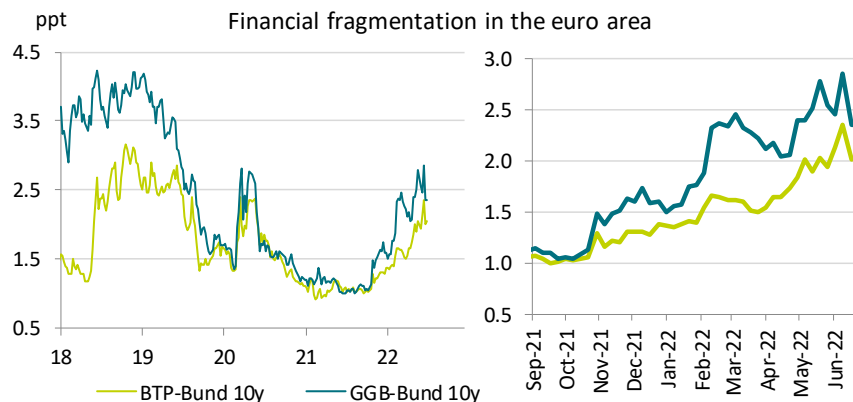
### Sorting financial fragmentation for “good” is not easy

- Following the ad-hoc Governing Council meeting on 15 June, we think it is likely to specify its thinking on a new anti-fragmentation tool at its 21 July meeting. Managing to bridge the significant technical, legal, political difficulties would certainly give all the more reassurance that the ECB would be able to normalise the monetary stance at a swift pace.
- Holistically, we think the new tool should look like OMT 2.0.

### A swift return to the lower end of neutral rate range



### ECB to rein in financial fragmentation



Source: Bloomberg, AXA IM Research, June 2022

Source: Refinitiv, AXA IM Research, June 2022

# Business Surveys remain resilient as prices rise

## UK

### Grow set to dip negative in Q2

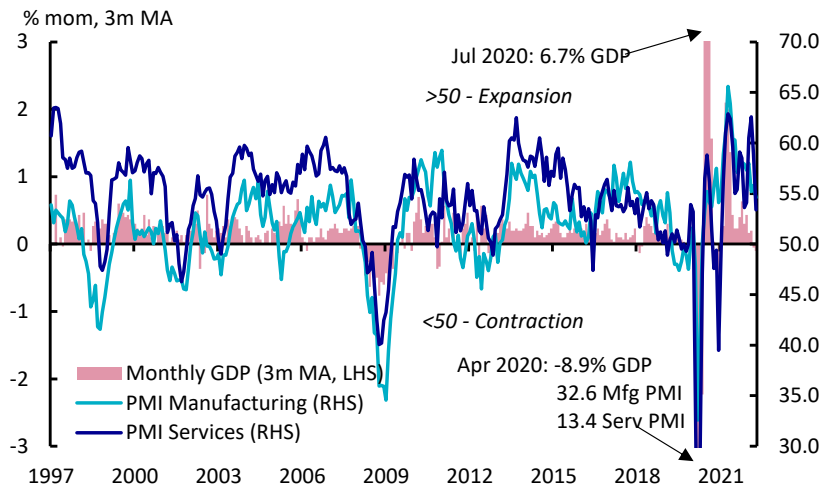
- GDP unexpectedly declined in May by 0.3% as the unwind of Test and Trace weighed heavily on growth. We now expect GDP to fall by 0.3% in Q2 (vs 0% prior). We expect to a rebound in growth in Q3, when we expected around 0.6% boosted by fiscal support for energy. Whilst the PMI remains resilient and output continues to grow, sub-indices for new orders have fallen sharply increasing fears of a sharp slowdown. We forecast growth at 3.7% this year and expect growth at 0.9% next year (consensus 3.7% and 1.2%).

### Inflation continues to push higher

- In May CPI inflation rose to 9.1% (y/y) in line with expectations. The was driven by rising food prices which we expect to continue over the coming months. We also expect a further increase in the Ofgem price cap in October that could push inflation back towards these levels in the Autumn. Core inflation dipped to 5.9% in May, but Services CPI continues to rise – now at 4.9% it's highest level since April 2011. We now expect inflation to average 7.7% this year and 3.6% next year (consensus 8.2% and 4.4%).

### PMIs remain resilient as growth begins to slow

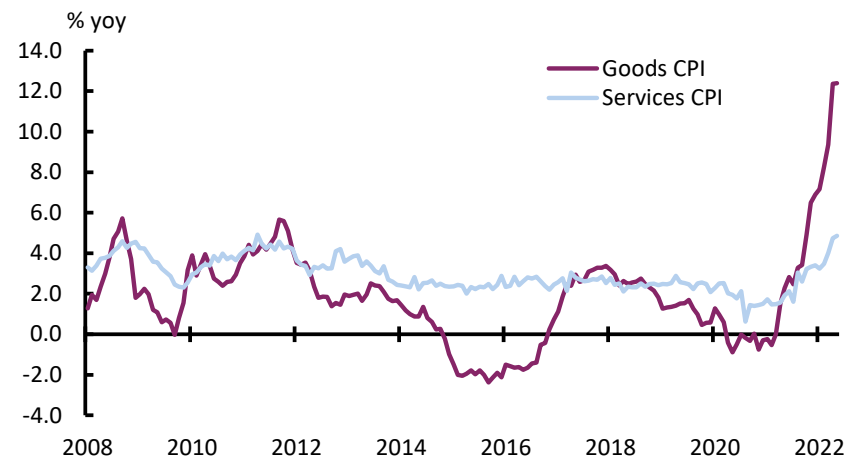
#### PMIs and GDP



Source: ONS, HIS Markit, AXA IM Research, June 2022

### Goods CPI remains flat, but Services continues to climb

#### Goods and Services CPI



Source: ONS, AXA IM Research, June 2022

# MPC stand ready to 'act forcefully' against persistent inflation

## UK

### Rising prices put a further spotlight on wages

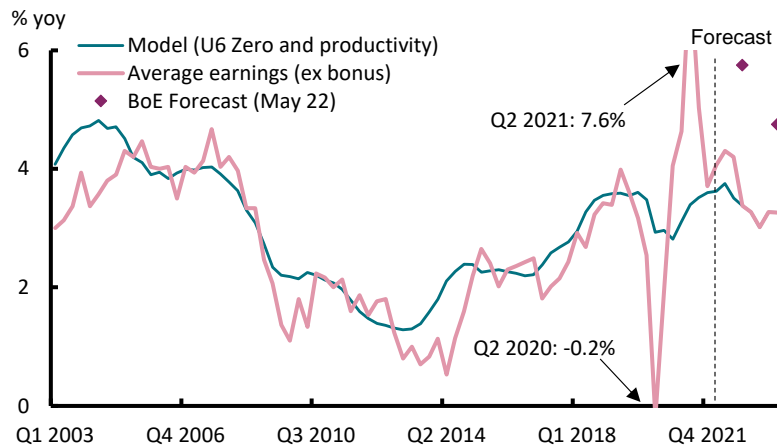
- Amidst a week of industrial action in the UK over wage settlements, increasing inflation is likely set the scene for further industrial disputes as real incomes continue to be squeezed. The BoE currently forecasts average earnings will increase by 5.75% in 2022 and 4.25% in 2023, far above the c.3% wage growth we would consider consistent with the Bank's target. We see a more subdued path for wages, expecting wages just above trend at 4% in 2022 and 3.2% in 2023.

### Door remains open to 50bp hike in August

- At present, we expect to see the MPC hike by 25bps in each of their next three meetings (Aug/Sep/Nov) bringing rates to 2%. Further strength in wage growth in upcoming labour market data could see the BoE move to 50bp hikes to ensure expectations remain anchored, but the MPC will weigh these factors against growing evidence of slowing growth. Our expectation for rates remains far short of market expectations which see rates at 3% by year end.

### Wage growth below inflation under pressure

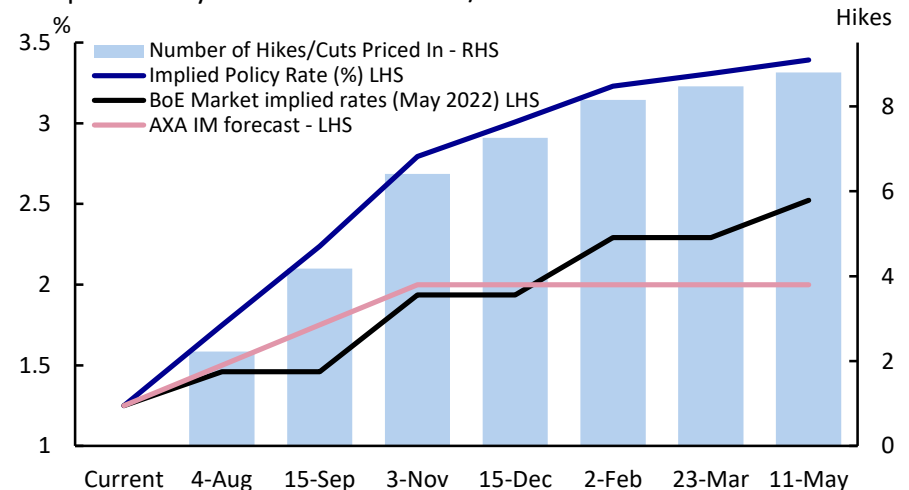
Average earnings and simple model



Source: ONS, BoE, AXA IM Research, June 2022

### We expect fewer hikes than markets

Implied Policy Rate and no of hikes/cuts



Source: Bloomberg, BoE, AXA IM Research, June 2022

# Uneven recovery underway

## China

### Sequential growth recovers after April's slump

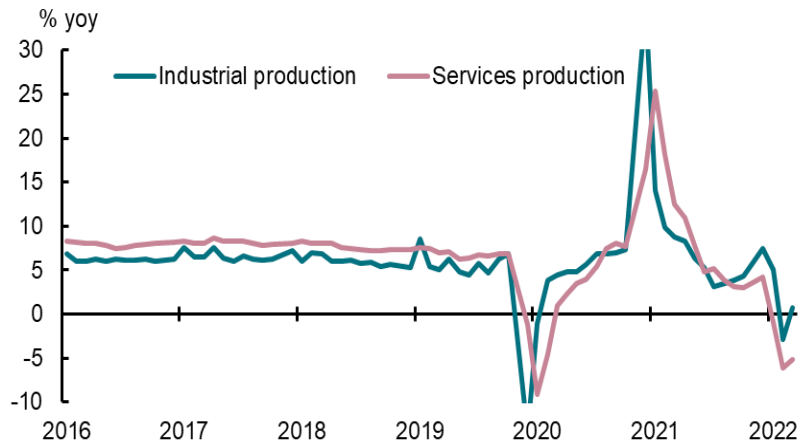
- May activity data confirmed that the worst of the COVID-19 shock has passed. Sequential growth improved notably thanks to improving virus conditions and Beijing recalibrating containment policies to ease supply-chain and logistical bottlenecks. Industrial output growth surged 5.6% mom, almost fully offsetting the 5.8% decline in April, taking year-on-year growth back to positive territory

### But the recovery is uneven, similar to 2020

- Compared to the fast supply normalization, domestic demand was slow to regain strength. The decline in retail sales narrowed somewhat, mostly driven by improved car sales, while services spending remained anemic. Growing labor market stress has added to the lockdown effect, making households reluctant to spend. Headline investment growth improved modestly, but the divergence among subcomponents remained wide. Infrastructure investment continued to benefit from a strong fiscal push, while property construction showed little sign of revival despite policy easing

### Goods production recovers faster than services

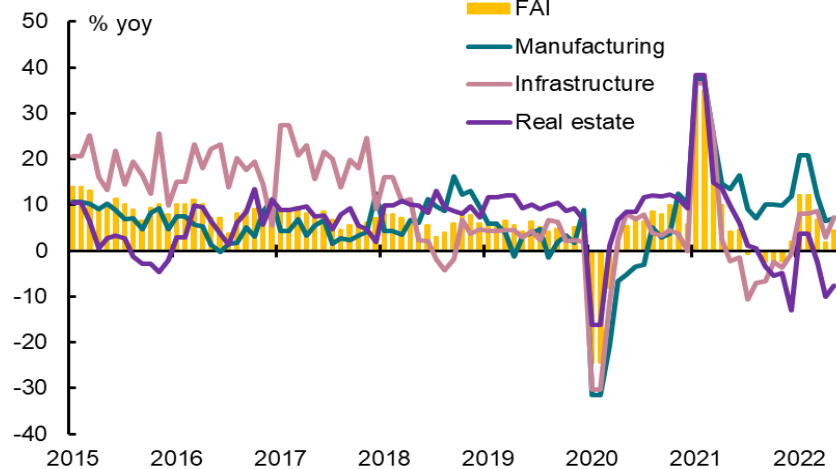
China: Industrial production vs. services production



Source: CEIC, AXA IM Research, Jun 22

### Uneven recovery within the investment complex

China: FAI breakdown



Source: CEIC, AXA IM Research, Jun 22

# Worst behind, but challenges remain

## China

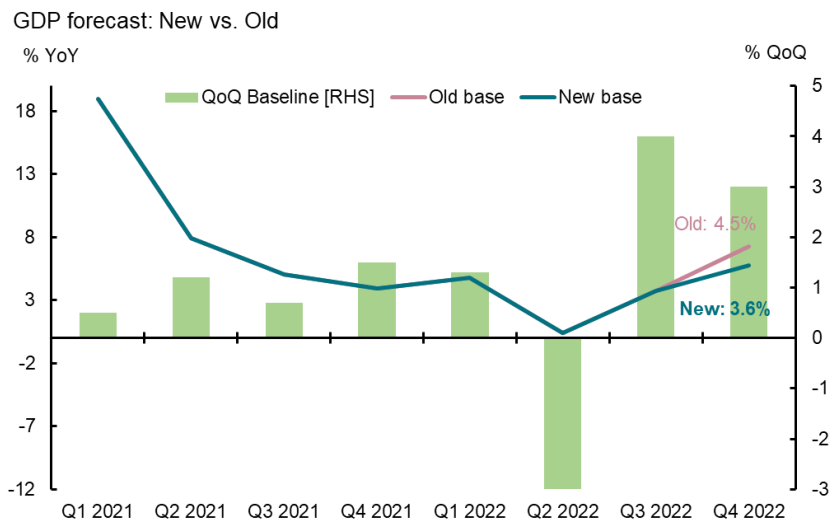
### Less vigorous recovery expected for H2

- Despite having passed the worst, the recovery ahead won't be smooth sailing. Broad macro conditions remain fragile so that even a small flare-up of virus could setback the recovery and create panic for markets. While we are comfortable with our near-term forecast, our assumed growth recovery in H2 looked optimistic in the light of Beijing's reluctance to ease COVID and economic policies aggressively. We thus lowered our Q4 forecast, leaving full-year growth at 3.6%, below the market consensus at 4.5%

### Turning policy cycle positive for markets

- Safeguarding the recovery will require more policy heavy-lifting. Given the impaired transmission channels (e.g. property), monetary policy is not as effective as fiscal stimulus. On the latter, Beijing has ramped up easing measures lately, with more tax/fee cuts, greater supports for infrastructure investment and some subsidies for consumption. Property market policy has also been relaxed, helping to stabilize house sales at low levels, although no signs of revival yet. Finally, growing evidence of regulatory cycle turning the corner has given the equity market a shot in the arm, with tech stocks strongly outperforming other sectors

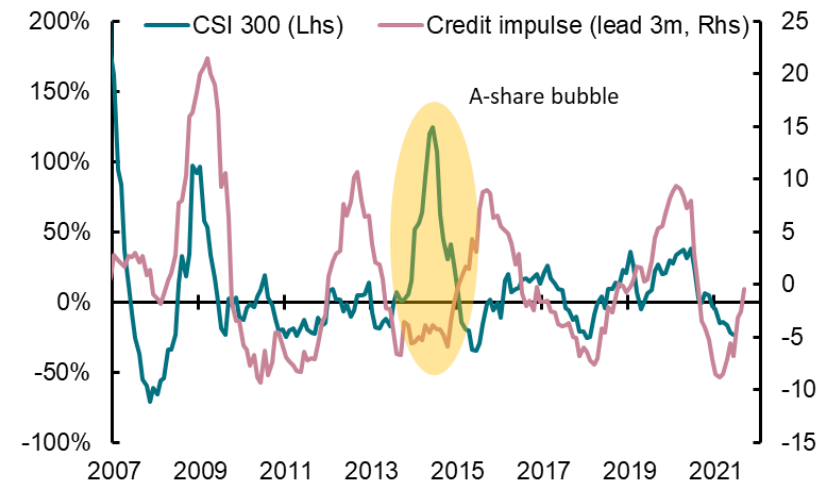
### Cutting forecast to reflect a less vigorous H2 recovery



Source: CEIC, AXA IM Research, Jun 22

### Turning policy cycle bodes well for risky assets

China's equity market and monetary conditions



Source: Bloomberg, AXA IM Research, Jun 22

# Japan is re-synchronising: For better or for worse

## Japan

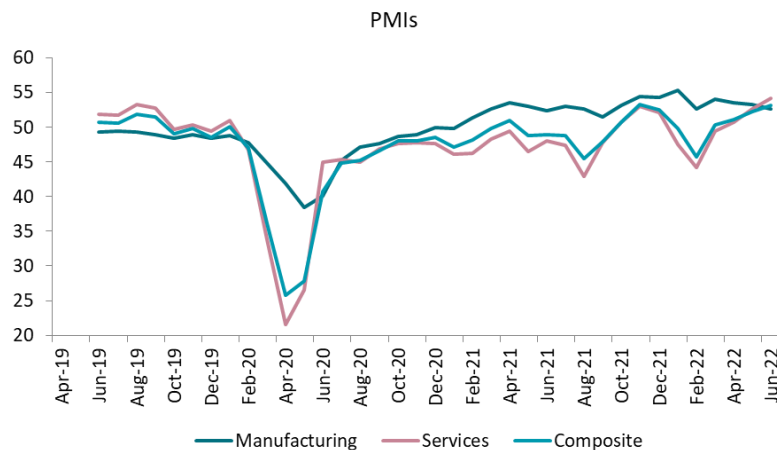
### PMIs show some resiliency, but we doubt it will last

- June's services PMI rose for the fourth consecutive month, by 1.6 points to 54.2.
- Manufacturing PMI declined -0.6 to 52.7. All components were down (output, new orders, stock of purchases) despite improving delivery times and a resilient employment index. Supply constraints appear to be improving, but demand for goods is now clouding manufacturers' perspectives.

### H2 is going to be challenging

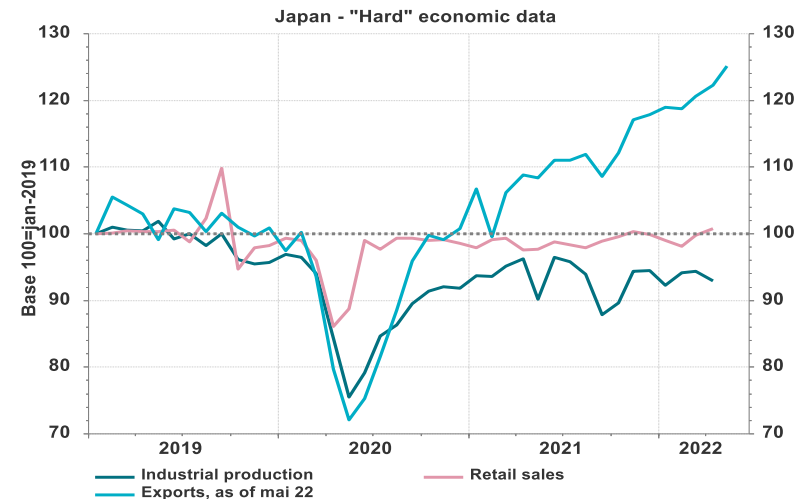
- There is a risk of the service sector running out of steam as tourism and travel contends with the government's reluctance to open borders. Despite having a limited impact on purchasing power so far, inflation is expected to reach 3% this summer and could remain elevated until the end of this year. After decades of low inflation, the changes in prices are impacting consumer confidence. The large amount of savings should cushion this blow to incomes in the short term, but we pencil in a significant deceleration in private consumption from Q4.

### Manufacturing sector is showing some signs of weakness



Source: Jibun Bank, IHS Markit, as of June 2022

### Recovery is still incomplete



Source: Refinitiv Datastream, METI, AXA IM Macro Research, avr. 22

# How long can the BoJ hold this position?

## Japan

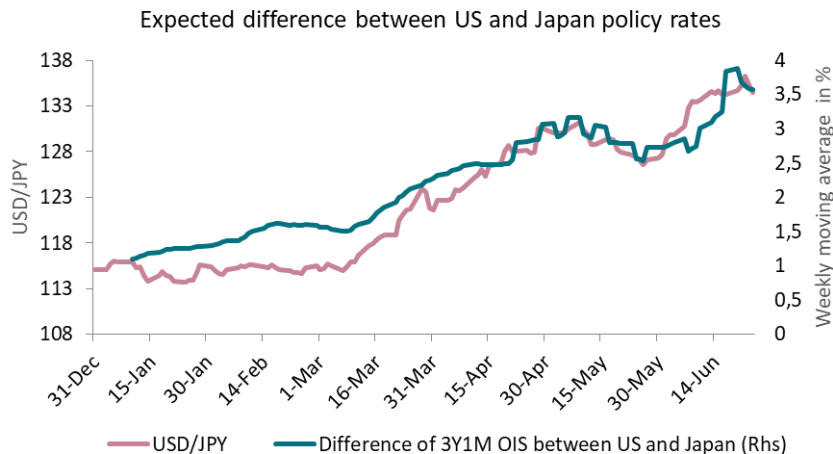
### USDJPY is stucked at 30-year lows

- Despite some easing in recent days due to increasing fear of US recession, the yen has lost 6%-7% against the dollar since last month

### Easing the pressure on the yield curve control is also becoming a hot topic

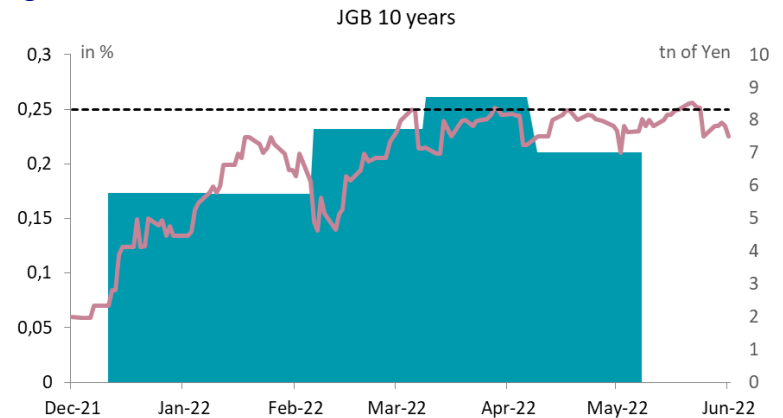
- The BoJ renewed its commitment to maintain a “very” accommodative policy and kept all tools unchanged. The BoJ is concerned that a premature tightening could jeopardise economic recovery and the long-term convergence of inflation towards its target.
- We acknowledge the pressure on 10-year JGBs is becoming unmanageable under YCC and we no longer exclude the possibility that the BoJ may signal its readiness to adjust its stance by shortening the YCC and/or extending the range on the 10-year JGB. But we believe this would be conditional on a resilient economic outlook. However, as recession risks build in the Eurozone and, to a lesser extent, in the US, we continue to believe that the BoJ will wait some months before starting any normalisation of its monetary policy.

### Yen has retraced to its lowest level in 30 years !



Source: Datastream, as of 27 June

### The BoJ stepped up net JGB purchases to defend its 10 year target



Source: Bank of Japan, Datastream, AXA Macro Research, as of June 22

Legend:  
■ JGB net monthly purchases (Rhs)  
— 10 years JGB yield

# Inflation pressures mount internally and externally

## Canada

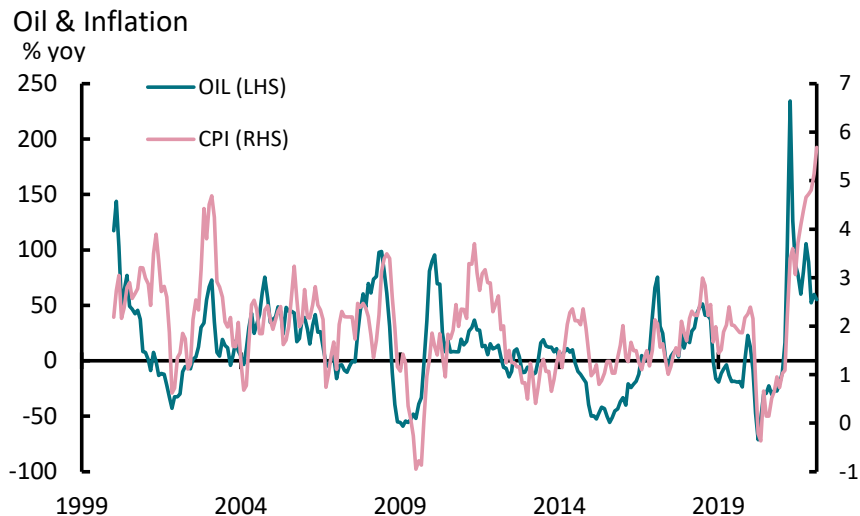
### Inflation just keeps rising

- May's annual CPI inflation rate set a 40-year high of 7.3%. Rising oil prices pushed PPI inflation up 1.7% on the month (raw materials 2.5%). However, an update to the CPI basket this month increased the weight of (rising) gasoline prices by 20% to 4.28% and added used car prices. Inflation looks set to edge higher in June and remain elevated for the rest of the year before dropping in Q1. We raise our annual inflation forecast to 6.6% for 2022 (from 6.2%) and 3.4% for 2023 (unch). Consensus forecasts 6.2% and 2.8%.

### Labour market creates domestic price pressures

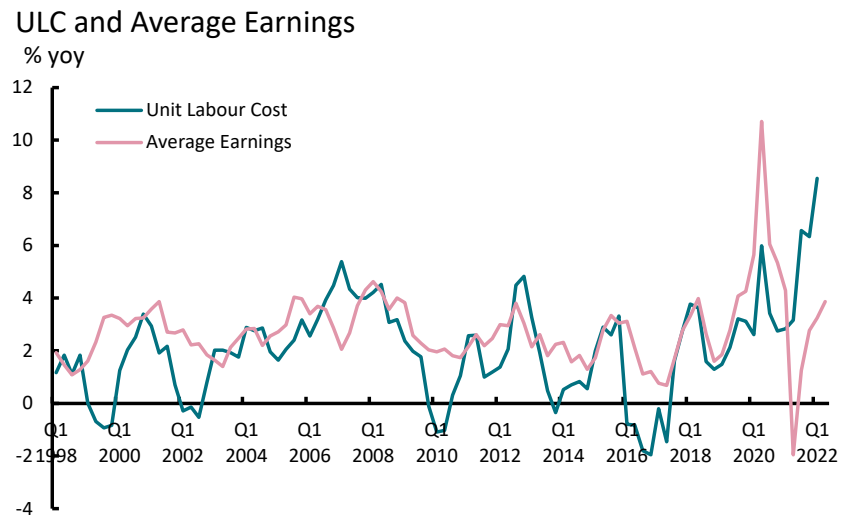
- Employment growth was solid (40k) in May and unemployment set a new low of 5.1% (records back to 1976). Pay growth rose to 3.9% in May from 3.3% in April. Although this does not appear particularly elevated, weak productivity growth has seen unit labour costs soar. The Bank of Canada has warned that the economy faces a labour and skills shortage. Meanwhile unions are pressing for wage increases: 7 settlements since March have averaged 3.1% - the highest since 2008 – while train drivers are on strike and Federal employees are seeking a 4.5% rise.

#### Oil and CPI inflation



Source: CANISM, Refinitiv, AXA IM Research, June 2022

#### Wages and unit labour costs



Source: CANISM, AXA IM Research, June 2022



# Pressure on Bank of Canada

## Canada

### Bank of Canada to act forcefully

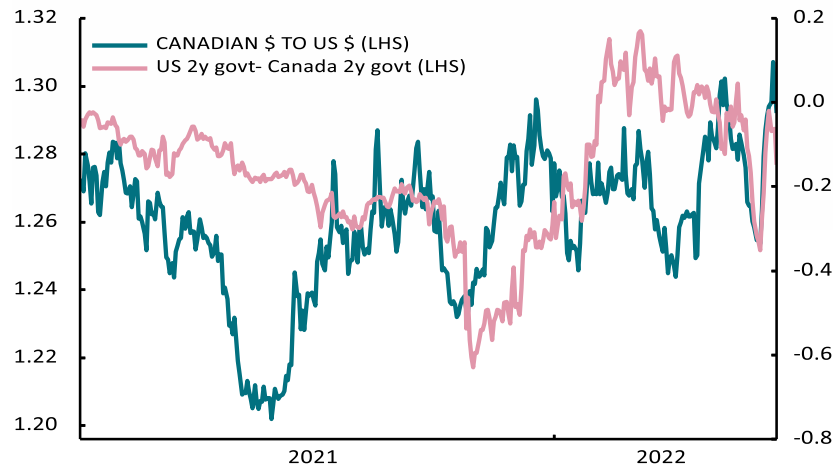
- The BoC hiked rates by 0.50% to 1.50% in June and promised to act “more forcefully” if needed. Governor Macklem clarified, this meant with more or bigger increases. Following the Fed’s 0.75% hike in June the CAD has softened to 2020 lows. This increases pressure on the BoC. However, both central banks will be focused on risks to inflation expectations. A 0.75% rate hike in July looks most likely and we raise our forecast for end-year rates to 3.25%.

### Tightening beginning to take its toll

- Housing sales fell 8.6% in the latest month and are down 22% on the year. The Canadian Real Estate Association warned that the correction it had expected over two years had occurred in two months. The BoC Financial System Review added it was not clear if the fall in housing would “deepen”, while it warned that mortgage debt was a major vulnerability to the economy. Consumer confidence slumped to its lowest since 2008. Fears of too sharp a slowdown should limit the BoC rate hikes beyond our forecast.

### Canadian dollar fluctuates as BoC and Fed views oscillate

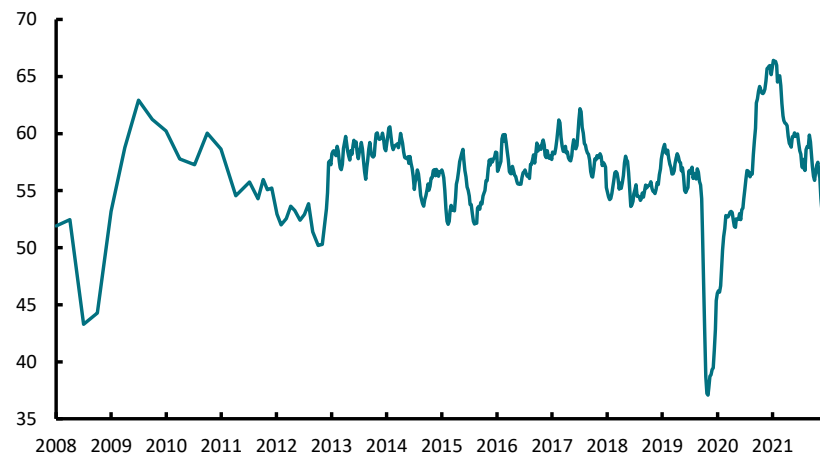
CADUSD Currency & 2y Govt rate differential



Source: Refintiv, DataStream, AXA IM Research, June 2022

### Consumer confidence

Canada Economic Mood Index National



Source: Bloomberg, AXA IM Research, June 2022

# External shocks push inflation and inflation expectations higher

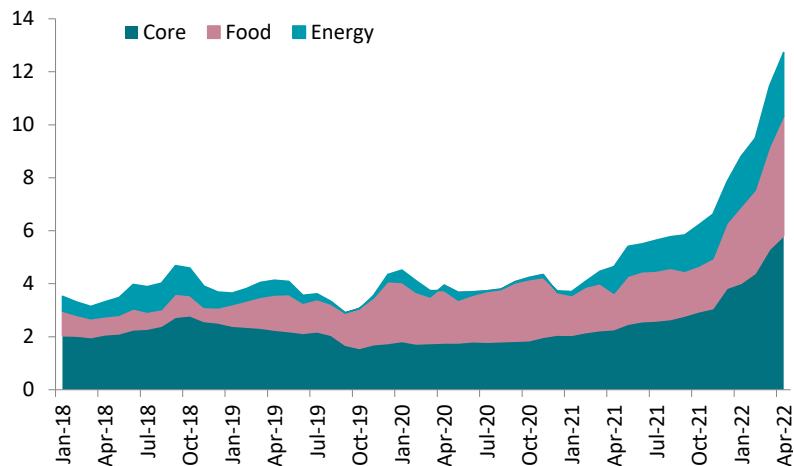
## Emerging Markets

### Energy and food price shocks push inflation rates higher

- Inflation rates were already on the rise after the Covid-19 reopening in the context of global supply chain shocks. The war in Ukraine added another layer of pressure on food prices as well as on energy prices pushing inflation rates above central banks' targets in most EMs.
- The transmission from headline to core inflation is faster in EM. They are facing additional imported inflation pressures from weakening currencies.

### Core inflation is accelerating

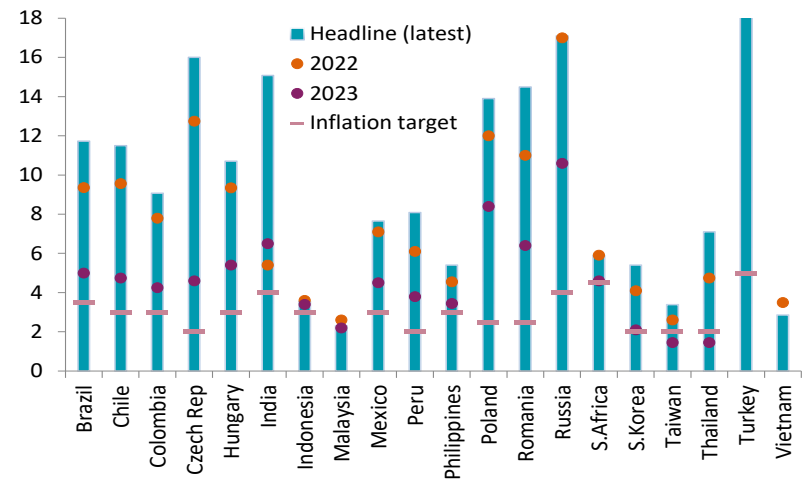
EM CPI contributions (% yoy)



Source: Datastream, AXA IM Research, May 2022

### Central banks are fighting to anchor inflation expectations

Inflation expectations in the EM region (%)



Source: Bloomberg, AXA IM Research, 1<sup>st</sup> June 2022

# Tighter global and domestic financial conditions to weigh on growth into H2 2022

## Emerging Markets

### The task of anchoring inflation expectations calls for proactive monetary policy normalisation

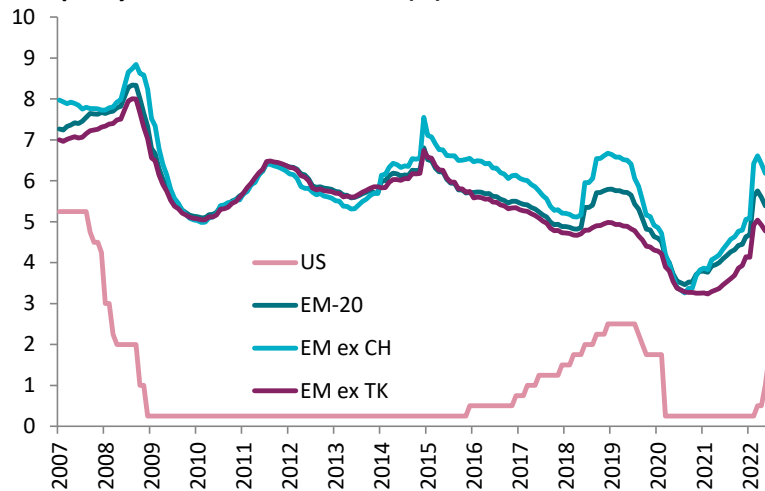
- EM central banks have been hiking policy rates earlier and faster than advanced peers. This not only reflected a fight for credibility, but also the need to offer sufficient yield to foreign investors in order to limit capital outflows.
- Inflation rates in main-EMs (ex-China which exerts downward pressure and ex-Turkey which is running at above 70% annual rates) is now close to US inflation. The policy rates differential needs to sustain capital flows.

### Growth risks

- Q1 2022 GDP was broadly better than expected and 2021 backward revisions lift our growth profiles for this year in many EMs. Still, we are wary that tighter global and domestic financial conditions as well as a less supportive global demand outlook from DMs will curb growth prospects in H2 2022. We cut our growth expectations of 2023 particularly in the Central Europe and Latam regions.

Earlier policy rates lift-off in EMs

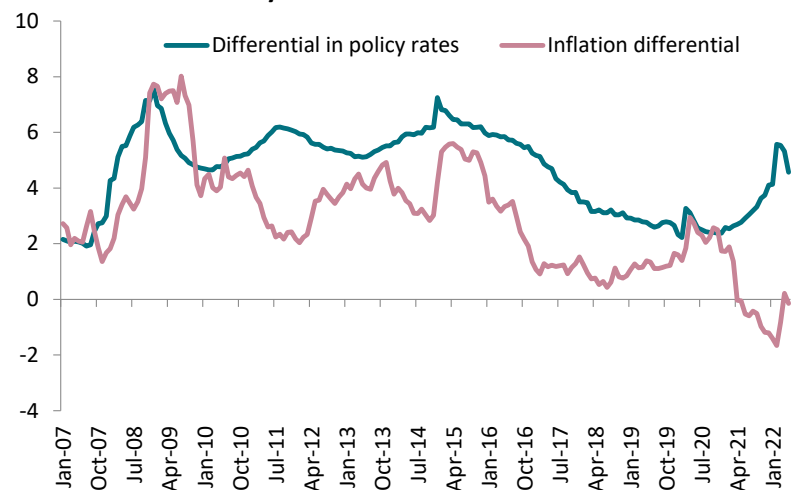
EM policy rates vs Fed Fund rates (%)



Source: Datastream, AXA IM Research, June 2022

The race against the Fed

EM ex China ex-Turkey versus US

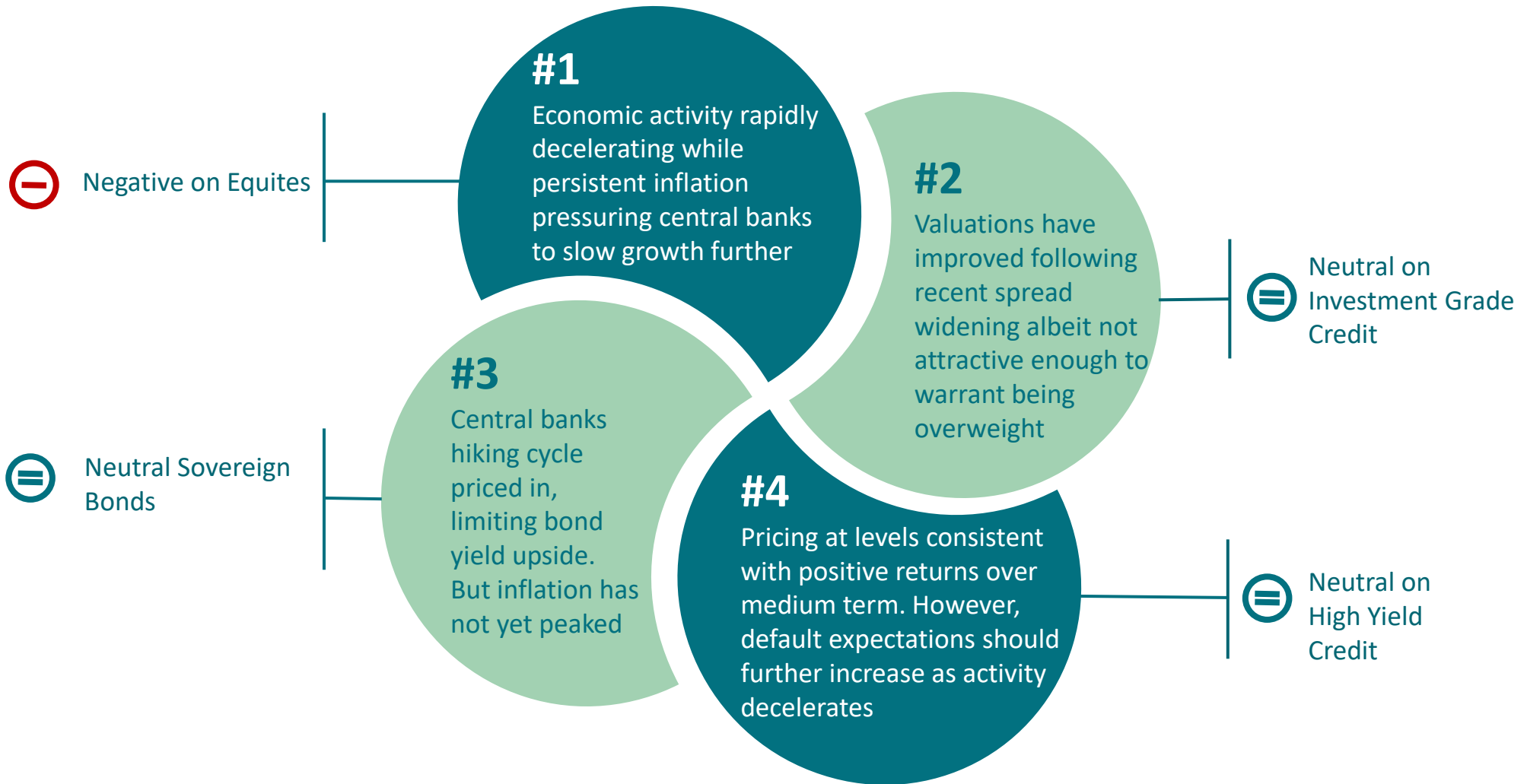


Source: Datastream, AXA IM Research, June 2022

# Investment Strategy

# Multi-Asset Investment views

Our key messages and convictions



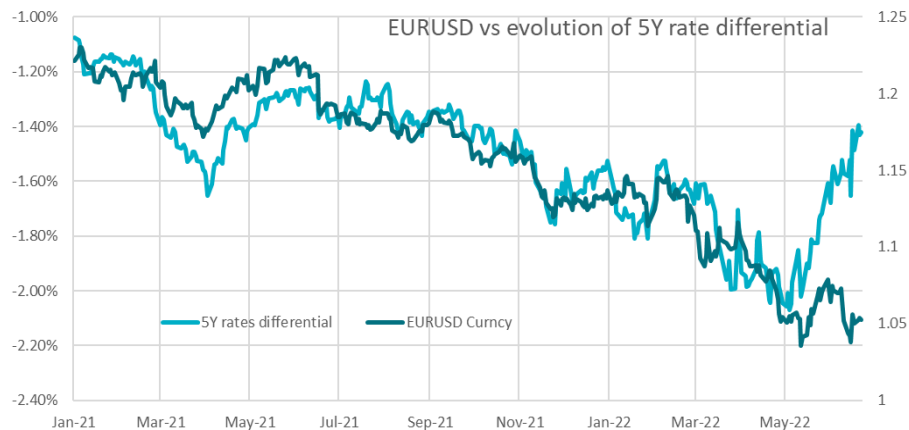
Source: AXA IM as at 24/06/2022

# FX Strategy

## EUR weakness prevalent as the worst of safe havens

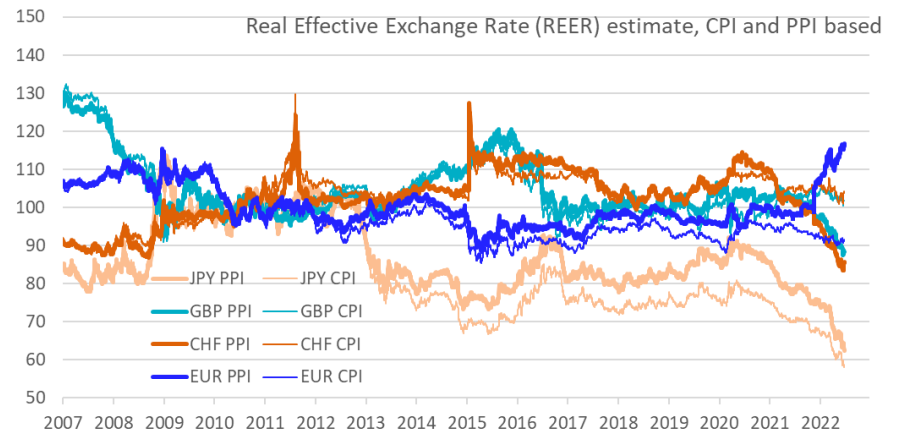
- The ECB has pushed hike expectations to levels which seem incompatible with fundamentals: rising peripheral spreads, consumption threatened by high energy prices, lack of durable wage growth, fading current account surplus and weakened export demand from China. EUR has failed to benefit from the sharp rise in EUR rates and is thus not as cheap as one might think; it has room to fall further.
- The US cyclical position remains more advanced, and the Fed is fully priced. The bar seems set high for this pricing to adjust lower. USD might hold steady, as a result. Additional inflation surprises might increase the US recession risk and bring additional support due to risk off.
- JPY and CHF appear less at risk than EUR. The SNB has also turned hawkish and tolerates CHF appreciation, in order to slow inflation that has risen steadily above target. Inflation is also timidly rising in Japan, extreme JPY weakness creates domestic concerns, and BoJ expectations cannot be lower than they already are. That said, a policy shift seems remote as the BoJ is still actively defending YCC.

### EUR not benefiting from the sharp repricing of ECB policy



Source: Bloomberg & AXA IM Research; Jun 2022

### EUR not undervalued from a PPI-based REER perspective



Source: Bloomberg & AXA IM Research; Jun 2022

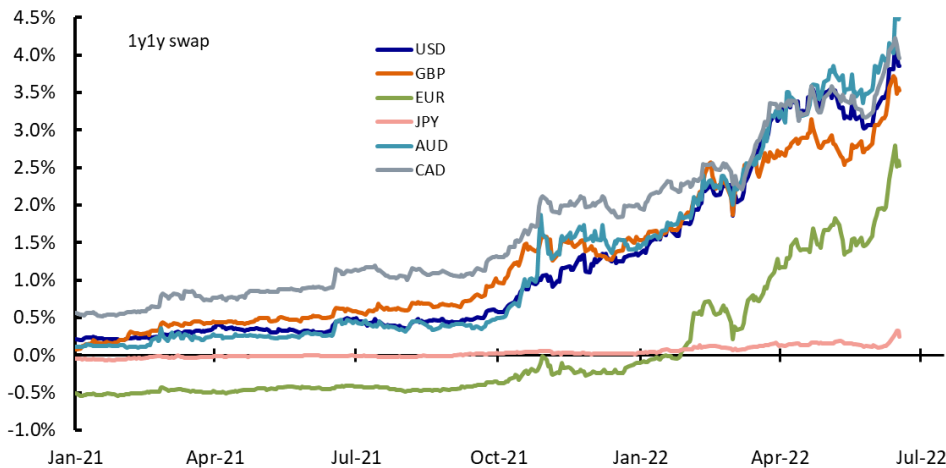
# Rates Strategy

## Re-pricing of the government bond yield curves and the rates volatility grid

- With the exception of the Bank of Japan, most advanced economies' central banks have tilted to a rather hawkish stance, thus sending front-end rates to yet higher levels in a relatively short period of time. This repricing has moderated somewhat as of late, as recession concerns have taken hold amid investors.
- A consequence of the more hawkish pricing of central bank policy and the higher for longer inflation dynamic is the repricing of the shape of the curve, with the belly underperforming, driving the yield curve curvature to fresh highs. This has been in tandem with the material rise in interest rate volatility, especially at the top-left corner of the volatility surface (shorter option expiries and shorter swap tenors).
- A retracement in interest rate volatility is a necessary condition for risk premia and credit spreads in particular to find an equilibrium. We expect such a decline in rates vola to occur once we have seen 'peak hawk' central bank pricing during the summer (if it is not already behind us).

### Yield curve front-end forwards have risen much further in June

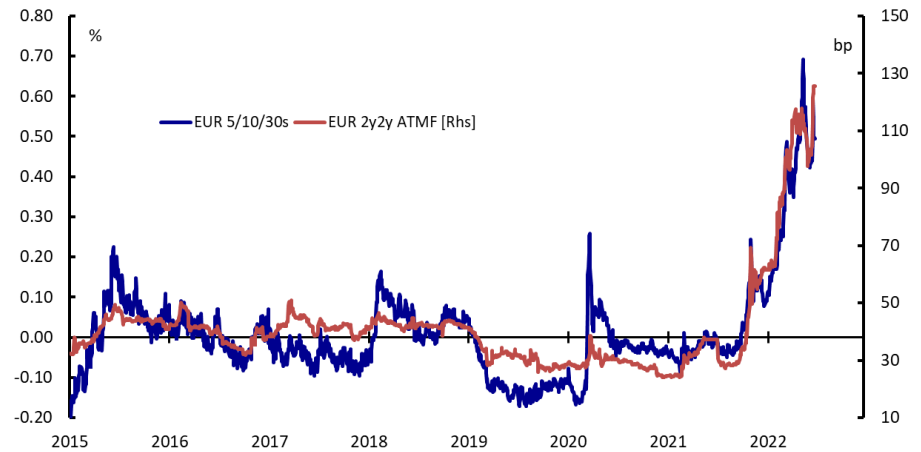
Global front-end forwards



Source: Bloomberg and AXA IM Research, Jun 2022

### The belly of the curve has underperformed in tandem with higher volatility

Yield curve curvature & rates volatility



Source: Bloomberg and AXA IM Research, Jun 2022

# Credit Strategy

## Manageable bond redemption profiles should counter the jump in refinancing gaps, staving off default risk

- Refinancing gaps have skyrocketed as underlying yields have risen steeply and spreads have widened materially. This has been especially stark in investment grade credit where refinancing gaps are near record highs, while in high yield credit they are back to multi year highs.
- This raises an alarm in respect to default risk, as default expectations based on refinancing gaps are currently double the expectations based on bank lending standards combined with bond market distress ratios (3.7% and 2% respectively for the USD HY ICE benchmark). The are two key mitigants, however.
- Firstly, that the refinancing gap has become an inferior default predictor since 2017. Secondly and mainly, the refinancing needs over the next two years appear broadly manageable. For the USD HY ICE benchmark, for example, the refinancing wall is notably more benign currently compared to pre-Covid. The amount of USD HY bonds due in year #1 and #2 is currently 10% of the total (or \$187b out of a \$1898b total) compared to 20% of the total at the end of 2019 (or ~\$340b out of a \$1671b total).

### Refinancing gaps skyrocket as yields jump and spreads widen

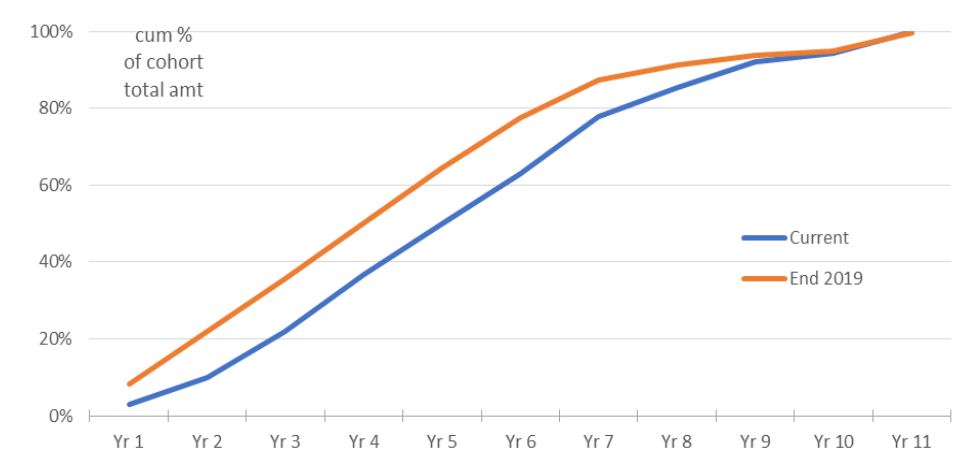
Refinancing Gap ( index yield - index coupon )



Source: Bloomberg, ICE & AXA IM Research; Jun 2022

### Refinancing needs over next two years milder than pre Covid

USD HY Refinancing Wall



Source: ICE & AXA IM Research; Jun 2022



# Equity Strategy

## Braking and gear shifting

- A twisting path so far: over the first half of the year equities recorded one of the worst starts since 1970 (-12% or 20th percentile). This decline is mainly explained by the derating in forward multiples. While we do not think that a recession is necessarily unavoidable, it is interesting to note that usually multiples tends to contract inside the recession rather than into the recession.
- A braking that is not yet done: our concerns over the health of 2022 earnings remain as they are vulnerable to recession risks. Consensus still expects global earnings to grow by +10.7% this year, which seems disconnected from our global growth expectations. Earnings season kicks off in a few weeks and we will be watching for profit warnings. US CEO confidence already suggest a decline in EPS growth; such EPS revisions could be the catalyst that pushes stock prices yet lower.
- A second gear corner: relative valuations now appear stretched. The post-GFC environment has witnessed a higher equity risk premium (ERP, 4.2% avrg). The historical relationship between ERP, inflation and PMI suggests that ERP should fall in a regime of elevated consumer prices and weak economic activity, hurting the performance of equities relative to bonds as shown by the historical relationship vs ERP.

### An earnings fall is looming

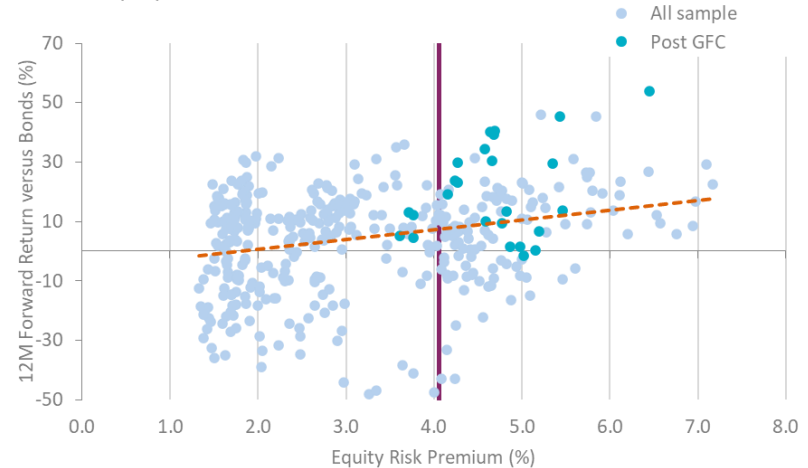
CEO Business confidence and 12M Trailing EPS growth



Source: The Conference Board, MSCI and AXA IM Research, June 2022

### Are we just getting back to more normal equity risk premia ?

Global - Equity Risk Premium and forward rel returns



Source: ASR, ICE BAML, MSCI and AXA IM Research, June 2022

# Asset allocation stance

## Positioning across and within asset classes

Asset Allocation			
<b>Key asset classes</b>			
Equities	▼		
Bonds		▼	
Commodities			
Cash			▲

Equities			
<b>Developed</b>			
Euro area		■	
UK			■
Switzerland			■
US			▼
Japan			■
<b>Emerging &amp; Equity Sectors</b>			
Emerging Markets			■
Europe Cyclical/Value			■
Euro Financials			■
European Autos			■
US Financials			■
US Russell 2000			■

Fixed Income			
<b>Govies</b>			
Euro core		▼	
Euro peripheral			■
UK			■
US		▼	
<b>Inflation Break-even</b>			
US			■
Euro			■
<b>Credit</b>			
Euro IG			■
US IG			■
Euro HY			■
US HY			■
<b>EM Debt</b>			
EM Bonds HC			■

Legend

Negative

Neutral

Positive

Change

▲ Upgrade

▼ Downgrade

Source: AXA IM as at 24/06/2022

# Forecasts & Calendar

# Macro forecast summary

## Forecasts

Real GDP growth (%)	2020	2021*		2022*		2023*	
		AXA IM	Consensus	AXA IM	Consensus	AXA IM	Consensus
<b>World</b>	-3.1	6.1		3.1		2.9	
<b>Advanced economies</b>	-5.0	5.1		2.6		1.2	
US	-3.4	5.5	5.6	2.4	2.8	1.2	2.1
Euro area	-6.4	5.3	5.1	2.8	2.7	0.7	2.2
Germany	-4.6	2.9	2.7	1.5	2.0	0.7	2.4
France	-8.0	6.8	6.6	2.3	2.9	0.8	1.7
Italy	-9.0	6.6	6.3	2.7	2.5	0.2	1.8
Spain	-10.8	5.1	4.7	4.2	4.4	0.6	3.0
Japan	-4.9	1.7	1.8	1.6	2.0	1.9	1.9
UK	-10.0	7.2	7.0	3.7	3.8	0.9	1.0
Switzerland	-2.5	3.5	3.5	2.5	2.6	1.0	1.8
Canada	-5.2	4.4	4.6	3.5	4.1	1.7	2.6
<b>Emerging economies</b>	-1.9	6.7		3.5		3.9	
<b>Asia</b>	-0.7	7.0		4.3		5.0	
China	2.2	8.1	8.0	3.6	4.7	5.2	5.1
South Korea	-0.9	4.1	4.0	1.5	2.7	1.6	2.4
Rest of EM Asia	-4.2	6.1		5.5		5.2	
<b>LatAm</b>	-7.0	6.8		2.4		2.1	
Brazil	-3.9	4.6	4.7	0.9	0.8	1.6	1.4
Mexico	-8.2	4.8	5.6	1.5	1.7	1.0	2.2
<b>EM Europe</b>	-2.0	6.7		-0.8		0.4	
Russia	-2.7	4.7		-6.0		-3.5	
Poland	-2.5	6.0	5.3	6.0	4.2	2.0	3.2
Turkey	1.6	11.5	9.9	4.6	2.2	2.0	2.8
<b>Other EMs</b>	-2.5	5.4		4.2		3.7	

Source: Datastream, IMF and AXA IM Macro Research – As of 24 June 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
<b>Advanced economies</b>	<b>0.7</b>	<b>3.2</b>		<b>6.7</b>		<b>3.4</b>	
US	<b>1.2</b>	<b>4.7</b>	4.6	<b>7.8</b>	7.2	<b>4.5</b>	3.3
Euro area	<b>0.3</b>	<b>2.6</b>	2.5	<b>7.4</b>	6.8	<b>3.1</b>	2.6
China	<b>2.5</b>	<b>0.9</b>	0.9	<b>2.1</b>	2.2	<b>2.3</b>	2.3
Japan	<b>0.0</b>	<b>-0.2</b>	-0.2	<b>2.2</b>	1.7	<b>1.0</b>	1.1
UK	<b>0.9</b>	<b>2.6</b>	2.5	<b>7.7</b>	7.8	<b>3.6</b>	4.3
Switzerland	<b>-0.7</b>	<b>0.5</b>	0.5	<b>2.0</b>	2.1	<b>1.0</b>	1.0
Canada	<b>0.7</b>	<b>3.4</b>	3.4	<b>6.7</b>	5.7	<b>3.4</b>	2.9

Source: Datastream, IMF and AXA IM Macro Research – As of 24 June 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	Q3-22	Q4-22	Q1-23	Q2-23
<b>United States - Fed</b>	Dates		26-27 July 20-21 Sep	1-2 Nov 13-14 Dec	31-1 Jan/Feb 21-22 Mar	2-3 May 13-14 Jun
	Rates	1.50-1.75	+1.00 (2.50-2.75)	+0.5 (3.00-3.25)	unch (3.00-3.25)	unch (3.00-3.25)
<b>Euro area - ECB</b>	Dates		21 July 8 Sep	27 Oct 15 Dec	2 Feb 16 Mar	4 May 15 Jun
	Rates	-0.50	+0.75 (0.25)	+0.75 (1.00)	unch (1.00)	unch (1.00)
<b>Japan - BoJ</b>	Dates		20-21 July 21-22 Sep	27-28 Oct 19-20 Dec	Jan Mar	May Jun
	Rates	-0.10	unch (-0.10)	unch (-0.10)	unch (-0.10)	unch (-0.10)
<b>UK - BoE</b>	Dates		4 Aug 15 Sep	3 Nov 15 Dec	Feb Mar	May Jun
	Rates	1.00	+0.50 (1.75)	+0.25 (2.00)	unch (2.00)	unch (2.00)

Source: AXA IM Macro Research - As of 24 June 2022

## Calendar of 2022 events

2022	Date	Event	Comments
	Q3-Q4 2022	Chilean Constitutional Referendum	
May	May	Philippines Elections	
	Mid-May	EC and European Defence Agency to make proposals on defence investment gaps	
	29 May	Colombian Presidential Elections (first round)	
	30-31 May	EU Council	
	12 & 19 June	French Legislative Elections	
June	15 June	FOMC meeting	
	16 June	MPC Summary and minutes	
	19 June	Colombian Presidential Elections (second round)	
	25 July	Japan Upper House election	
August	27 July	FOMC meeting	
	August	US Federal Reserve Jackson Hole Symposium	
	4 August	UK Monetary Policy Report & MPC Summary and minutes	
September	15 September	MPC Summary and minutes	
	21 September	FOMC meeting	
October	October	China's 20 <sup>th</sup> National Congress- President Xi to be re-elected (expected)	
	2 October	Brazil General Elections	
	30 October	Brazil Presidential Elections (second round)	
November	2 November	FOMC meeting	
	3 November	UK Monetary Policy Report & MPC Summary and minutes	
	8 November	US Midterm Elections	
December	14 December	FOMC meeting	
	15 December	MPC Summary and minutes	

## Latest publications

[Will humble and nimble Fed policy avoid recession](#)

*17 June 2022*

[May Global Macro Monthly - Good medicine tastes bitter](#)

*24 May 2022*

[Colombian election: a left turn?](#)

*10 May 2022*

[China: Navigating its way out of 'Zero-Covid'](#)

*05 May 2022*

[April Global Macro Monthly - Macron encore](#)

*27 April 2022*

[China green bonds: Too big and attractive to ignore](#)

*13 April 2022*

[The real story behind the value/growth rotation](#)

*7 April 2022*

[French elections: Wait until summer](#)

*5 April 2022*

[March Global Macro Monthly – After the first month](#)

*30 March 2022*

[China's property sector: This time is different](#)

*9 March 2022*



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