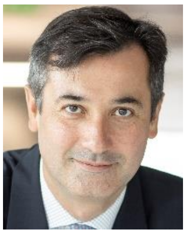
Low visibility flying

Monthly Investment Strategy Oped



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Key points

- Policymakers need to navigate through two major sources of uncertainty: how much of the ongoing inflation shock can disappear spontaneously, and for Europe the risk of military confrontation in Ukraine.
- Central bank guidance has become much less clear. This points to heightened volatility.
- Markets see limited tightening beyond the initial moves with geo-political influences also impacting expectations.
- Further de-rating in equities is possible but long-term returns will be driven by themes that have a longer duration than the current rates cycle.

Useless textbooks?

The market needs to deal with two major sources of macro uncertainty: one is the fate of inflation, and whether it can be taken back to target without too much damage to the real economy, and the other is the exacerbation of geopolitical tension with the Ukraine crisis. Policymakers are walking on a tightrope and forced to improvise, with a heightened risk of mistakes.

Month in, month out inflation surprises on the upside in the US and the Euro area. There remains a key difference between the two regions though: price pressure has clearly turned endogenous in the US while in Europe exogenous factors continue to dominate. Faced with "home grown" inflation when the economy is running hot, the central banking textbook is clear: financial conditions need to tighten until excess demand is tamed. This is what the Federal Reserve (Fed) has set out to do, with a likely rate lift-off in March and the beginning of a reduction in the balance sheet at some point in the third quarter (Q3), but the debate within the Federal Open Market Committee (FOMC) seems to be fierce on the right quantum and pace of tightening. Should the Fed "start with the bang", choose an increment of 50 basis points for their first hike and send a course of one hike per meeting? Or should it opt for prudence (our baseline, with four 25-basis-point hikes this year)? Logically, the current inflation spike should to some extent "burn itself out" as purchasing power erodes, curbing consumption, while supply constraints ease and fiscal policy gets increasingly paralysed. What consumers will do with the excess saving they accumulated during the pandemic could however derail these self-stabilizing mechanisms and hawks may focus on this aspect. The US economy has never been faced with such situation before. While we think ultimately the Fed will choose a "learning by doing" attitude, investors may have to deal with sustained volatility as doves and hawks very publicly debate.

The choice should be easier for the European Central Bank (ECB), since contrary to the US no blatant signs of overheating have appeared. Patience – which we thought was the motto at the December 2021 Governing Council meeting – however gave way in February to "unanimous concern over inflation" and a refusal by Lagarde to reiterate her December statement on a rate hike being unlikely this year. It seems the central bank is moving away from Draghi's textbook and is ready to focus on the mere possibility that inflation expectations start dis-anchoring. The "direction of travel" is now clear: the ECB wants to start normalizing its policy, but it also means that the current forward guidance is obsolete, which leaves the market without much visibility, resulting in overly aggressive pricing of the imminent tightening.

To make the outlook even more complicated, tension between Russia and the West about Ukraine is not abating. Military action in Europe would affect generic confidence in Europe, but the direct effects through energy prices would be significant. Natural gas has become crucial for purchasing power dynamics. The direct effect of higher gas prices has already shaved 0.5% off real disposable income over one year in December 2021. More importantly, the indirect impact through electricity prices has also become significant since gas-fired power stations are now the "marginal supplier" without which electricity demand cannot be fulfilled. The correlation between gas and electricity prices has thus become very tight, and this channel has shaved another 0.7% off purchasing power over one year in December 2021.

There is no easy alternative to Russian supply in the short run. Europe has increased its capacity to receive liquefied natural gas from the US and Qatar, but these two key exporters do not have much spare room to lift their output further. Raising the contribution from coal, as has already been the case last year in Germany, is not palatable given its huge carbon footprint. Raising the share of nuclear power supplied to distributors at below-market prices is in general not an option outside of France. The solution probably lies in a fiscal accommodation of the income shock – possibly offset by some windfall tax on low-cost electricity producers – but the countries where the rise in electricity prices has been the steepest are also the "fiscally fragile" ones, such as Italy and Spain.

Board member Isabel Schnabel has recently focused a lot on the impact that rising energy prices would have on trend inflation, in particular through the expectations channel. It was thus somewhat reassuring that in her interview with the Financial Times last week she stated that *"Given the likely negative effects of an escalation of the crisis on growth and confidence, including through potential sanctions, it is in my view unlikely that we would accelerate policy normalization in such circumstances"*. Yet, investors of a nervous disposition will note that she would accept "not to normalize". She did not contemplate the mere possibility of providing more support amid a geopolitical crisis. The "Draghi spirit" has left the ECB for good.

Rates and uncertainty

If investors knew precisely how far interest rates were going to rise in the upcoming monetary cycle, then portfolio strategies could be aligned with long-term investment goals with greater confidence than is currently the case. The reality is that the outlook for rates is uncertain in terms of the duration of the tightening cycle, the extent to which it will be synchronized across economies, the size of the eventual increase in rates and the impact that all of this has on economic growth and investment returns. There are difficult choices to make in terms of portfolio management and whether to hedge against additional rate increases, growth downgrades and valuation adjustments.

At the core of the uncertainty is inflation and how central banks will respond in the next one to two years. In addition, the situation in Ukraine clouds the outlook even more. What we know there is that energy prices have risen further and will contribute to higher inflation and probably have a negative impact on global growth. Recent events have not changed market pricing too much regarding central banks. The message from markets is that rates will go up quite quickly in the next year or two in most major economic regions. However, interest rate futures and forward markets suggest that after the initial move higher not much will happen thereafter. Bond yield curves are flat in both spot and forward markets and the level of yields anticipated for future periods is consistent with terminal levels for policy rates being extremely low by historical standards. Just to illustrate the point, the 10-year sovereign bond yield priced 5-year forward is currently only between 30 and 60 basis points higher than today's spot rate for most major currency areas.

The market is suggesting that modest interest rate hikes will be enough to either confirm one of two scenarios. The first is that the current rise in inflation will reverse as supply issues ease and energy prices eventually fall back. Under that scenario – which we need to start seeing data to confirm quite soon – central banks won't need to tighten that much. The second scenario, which has more bearish implications for risky assets, is that what is priced in is enough to undermine global growth which itself will stop central banks in their tracks. Of course, we will only know which of these is correct in time and with more data. The Russia and Ukraine situation also needs to be incorporated into the view. If the conflict persists, central banks might be less aggressive than some observers and recent market expectations have suggested.

Aside from that geo-political risk, the short-term outlook suggests that most of the adjustment in inflation and interest rate expectations has been achieved, as has the impact on valuations in credit and equity markets. Long-term inflation expectations have stabilized, forward rate expectations are limited and multiple de-rating in equity market is well advanced relative to what is the norm in tightening cycles. Depending on the political situation, the most bullish outcome for markets near term is some easing of inflation pressures in the Spring which would allow interest rate expectations to stabilise. With growth still supported by decent fundamentals, markets could respond to that positively.

On a slightly longer term we need to judge whether markets are still distorted by financial repression and whether that eventually fades as policy normalises. Flat yields curves, low terminal rates, and equity price-to-earnings ratios that remain higher relative to inflation than has been the case in the past. Real yields remain extremely low as well. There is a risk that central bank balance sheet reduction will raise real yields and steepen yield curves. That might ultimately be a major problem for the valuation of high-growth stocks in the equity market – as we have seen already this year. Certainly, the emergency monetary policies put in place at the beginning of the pandemic pushed ratings on these assets higher. The minimum result of taking back that easing is a return to more sustainable valuations in parts of the equity and credit markets. The greater the speed of normalization – through either the rates or balance sheet routes – the greater the risk there is of a more pronounced adjustment. This is perhaps another reason to expect central banks to take a cautious approach to normalising the size of their balance sheets.

The good news is that even those parts of the market which appear to be more sensitive to increases in long-term yields, recent earnings reports have shown that many companies in this space can continue to deliver a strong long-term performance. As we emerge from the pandemic and re-strengthen the focus on the energy transition and strengthening logistics and supply chain management, these are trends that can help sustain those growth trajectories. The tailwinds behind themes such as renewable energy, digitalization and automation will blow for longer than the current interest rate cycle. Equity market multiples, especially for high growth companies, might come down with higher bond yields but superior earnings growth mean they should still be considered a core part of an investment portfolio. Of course, in the very short-term what happens in Ukraine will determine market price action and potentially deliver even more attractive long-term entry levels.

Download the full slide deck of our February Investment Strategy

Recommended asset allocation

Asset Allocation	Negative	Neutral	Positive
Key asset classes			
Equities			■
Bonds		▲	
Commodities		■	
Cash	▼		
Equities			
Developed			
Euro area			■
UK		■	
Switzerland		■	
US		■	
Japan		■	
Emerging & Sectors			
Emerging Markets		■	
Europe Cyclical/Value		■	
Euro Financials		▼	
European Auto			▲
US Financials		■	
US Russell 2000		■	
Fixed Income			
Govies			
Euro core		▲	
Euro peripheral		■	
UK		▲	
US		▲	
Inflation			
US		■	
Euro		■	
Credit			
Euro IG	■		
US IG		■	
Euro HY			■
US HY		■	
EM Debt			
EM bonds HC		■	

Legends: Negative | Neutral | Positive — Last change: ▲ Upgrade | ▼ Downgrade

Source: AXA IM Macro Research – As of 22 February 2022

Macro forecast summary

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

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

These projections are not necessarily reliable indicators of future results

Forecast summary

Central bank policy Meeting dates and expected changes (Rates in bp / QE in bn)		Current	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

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