It's starting to show

Monthly Investment Strategy Oped

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Key points

- Wholesale gas prices have receded, but the impact from the Ukraine war on the Euro area is now tangible in the business and consumer survey.
- National fiscal policies are mitigating the shock on growth, but no progress is made on a joint European response.
- The additional oil price pressure is strengthening the Federal Reserve's resolve to hit "fast and hard".
- Valuations have adjusted.
- Macro uncertainties will continue to weigh on investor sentiment.
- Credit starting to look more attractive.

Confidence shock

Energy prices are the main transmission channel from the war in Ukraine to the world economy. For Europe, gas prices are key, and they have corrected significantly down from their peak above EUR200/MwH at the beginning of March to roughly EUR100/MwH at the end of the month. The market probably anticipates a continuation of the flows of Russian gas to the EU. Moscow needs all the hard currency it can earn now that its central bank has lost access to the bulk of its reserves, while there is no short-term fix to wean the EU off Russian gas quickly – the US pledge to export to Europe an additional 15bn of cubic meters of Liquified Natural Gas (LNG) would offset only 10% of imports from Russia.

Still, despite the improvement in gas prices, the economic fallout from the war in Ukraine is becoming tangible in the Euro area, especially in Germany where the IFO survey's forward-looking components in manufacturing are now below the levels seen during the "mini recession" of 2012-2013. Consumer confidence has also taken a very significant hit in March. This is key to gauge the depth of the impact. So far, it's the energy-intensive, export-driven industries which are bearing the brunt of the shock. The impact of the inflation shock on consumer spending, and hence on services, can be mitigated to some extent by fiscal policy, and both France and Germany have scaled up their short-term stimulus packages to roughly 1% of GDP. Yet, if consumers revise down their personal outlook abruptly, much of this accommodation effect will be lost to precautionary savings.

European policymakers seem to be after some "division of labour": fiscal policy would focus on protecting economic activity, while the European Central Bank (ECB) would focus on keeping inflation expectations anchored. Yet, if the fiscal weapon is blunted, the ECB could be forced to reconsider its "gradual normalization path". Yet we suspect the bar is high for monetary policy to provide more stimulus given the level of inflationary pressure. The ongoing tightening can be delayed but is unlikely to be reversed.

This leaves the periphery in a fragile state. For now, market pressure has been measured, with Italian long-term yields remaining below the current average interest rate on the stock of debt (2.5%), which continues to keep the debt burden manageable. Yet, one could have hoped that swift progress would be made on further European debt mutualization by the time the ECB terminates quantitative easing. The March European Council meeting has been disappointing from this point of view. We will probably have to wait until the end of May and a report by the European Commission to see anything substantial on the matter, and for now there does not seem to be any clear support on the German side for a breakthrough.

While gas prices have eased back, oil prices remain high. Some of this divergence can be explained by the fact that the EU could more easily decide to boycott Russian oil than gas as the next escalation step. Yet, this would hardly hit the overall quantum of oil available on the global market. Tensions with the Organization of the Petroleum Exporting Countries (OPEC), a reluctance in the US to boost unconventional oil production given regulatory uncertainty and supply chain constraints are probably better candidates. In any case, this continues to fuel consumer price inflation in the US, in turn strengthening the Federal Reserve (Fed)'s resolve to act "hard and fast" to get inflation back in control. The Fed's communication has gone "full hawkish" lately, and the bond market has reacted, with 10-year yields – finally – reaching the long-term level for the Fed Funds pencilled in the Federal Open Market Committee (FOMC) forecasts. We have our doubts however on the capacity of the Fed to deliver on the entirety of its planned tightening. Although nominal wages have accelerated in the US, real wages are falling, which will increasingly impair consumer spending. Combined with the impact of the tightening in financial conditions on firms' behaviour and a likely fiscal paralysis by the end of 2022 if the Republicans win the mid-term elections, the current "overheating" in the US economy may give way to a more sedate growth rate.

Valuations improving but markets are not cheap

Risk premiums are rising across asset classes in response to the heightened uncertainty stemming from inflation, monetary tightening, and the conflict in Ukraine. To put it another way, valuations are improving. But does this necessarily mean things are getting "cheaper"? In recent years, asset prices have been driven to a large extent by the dominant monetary policy being quantitative easing which directly impacted on bond prices and led to portfolio allocation decisions that drove risk premiums lower. To be provocative, many asset prices became dislodged from fundamentals. Today, markets are re-adjusting to a world of higher inflation and growth uncertainty without what has commonly been described as the "central bank put".

Asset prices have already adjusted quite a lot from their elevated levels reached following the burst of policy support provided after the initial onset of the COVID pandemic. German 10-year government bond yields are 120 basis points higher than in mid-2020 while US Treasury yields recently reached 2.5% relative to a mid-2020 trough of 0.5%. Credit spreads have also widened with index level investment grade asset swap spreads in Europe recently reaching 90 basis points, twice their COVID low. Similar proportionate moves have been seen in high yield and in US credit markets.

Equity de-rating has also been a feature of the last year. The crude trailing price-to-earnings ratio of the MSCI World index peaked at 32.9x earnings in Q4 2020 and fell to 21.4 by the last year, according to Bloomberg data. The onset of monetary tightening typically leads to multi-point declines in price-to-earnings ratios. Of course, this means that equity prices fall. Total returns for most major equity markets are negative this year, as they are for fixed income markets in response to rising yields.

Investor behaviour will be interesting going forward. The decline in asset prices suggests returns could improve going forward. The losses incurred in recent months, especially in fixed income markets, are well to the left of the distribution of historical returns. The incremental impact on returns of further increases in bond yields from current levels is much less than it was when yields started to rise in early 2021. In the US, 10-year Treasury yields recently touched 2.5% which is close to the peak in the Fed Funds rate implied by the famous FOMC dot plot. Flat yield curves and forward markets suggest that yields will not move much higher than that.

Credit spreads are also looking more attractive at levels that, historically, have been associated with the outperformance of credit relative to government bonds. The outright yield on the US investment grade market is close to 4% and above 6% in high yield. Similarly, across equity markets, today's earnings yields (inverse of the PE ratio) are above long-term averages and, relative to bond yields, make equities look good value. This is especially the case in Europe and Japan where bond yields have moved less than in the US.

A reliance on some "mean-reversion" and the notion that central banks won't let interest rates rise too much could be a dangerous stance. While valuations have certainly improved, macro uncertainty will provide a big psychological barrier for many investors. Clearly there is a roadmap to improved market returns. A peak in US and European headline inflation in the coming months would be a positive signal. An end to the current configuration of conflict in Ukraine is also likely necessary. If these were met also with some easing of energy and other supply concerns, investor confidence would rise, and central banks would be able to send stronger guidance in terms of the rate outlook.

Bond yields, credit spreads and equity multiples still signal asset prices being more expensive than during the last US monetary tightening cycle. Investors need benchmarks and currently the most recent cycle provides the closest in terms of monetary policy expectations (peak of 2.5%). However, the inflation and geo-political backdrops are different. It is not clear that asset price valuation adjustments are necessarily over yet. For equities specifically, the pattern of a recession starting once the Fed has finished raising rates suggests earnings forecast downgrades could still be ahead, especially in the US. Higher bond yields and lower earnings remain the key risk. With a longer time horizon in mind, the prospect of a persistently higher inflation rate than prevailed pre-2021, more spending on defence, health and energy security, and the pressing need to accelerate the transition to net zero could mean a world of negative bond yields and price-earnings multiples in the high 20s is a very distant memory.

Finding value in an uncertain macro-economic environment is challenging. Higher rates and inflation, and lower growth remain the big macro risks. This tends to support short-duration strategies in fixed income, inflation protection and equity exposure where there is more visibility on earnings. Credit markets offer better prospective returns for bond investors, but it will require a change in the big macro drivers to create market conditions that can compensate for the losses incurred during the last six months.

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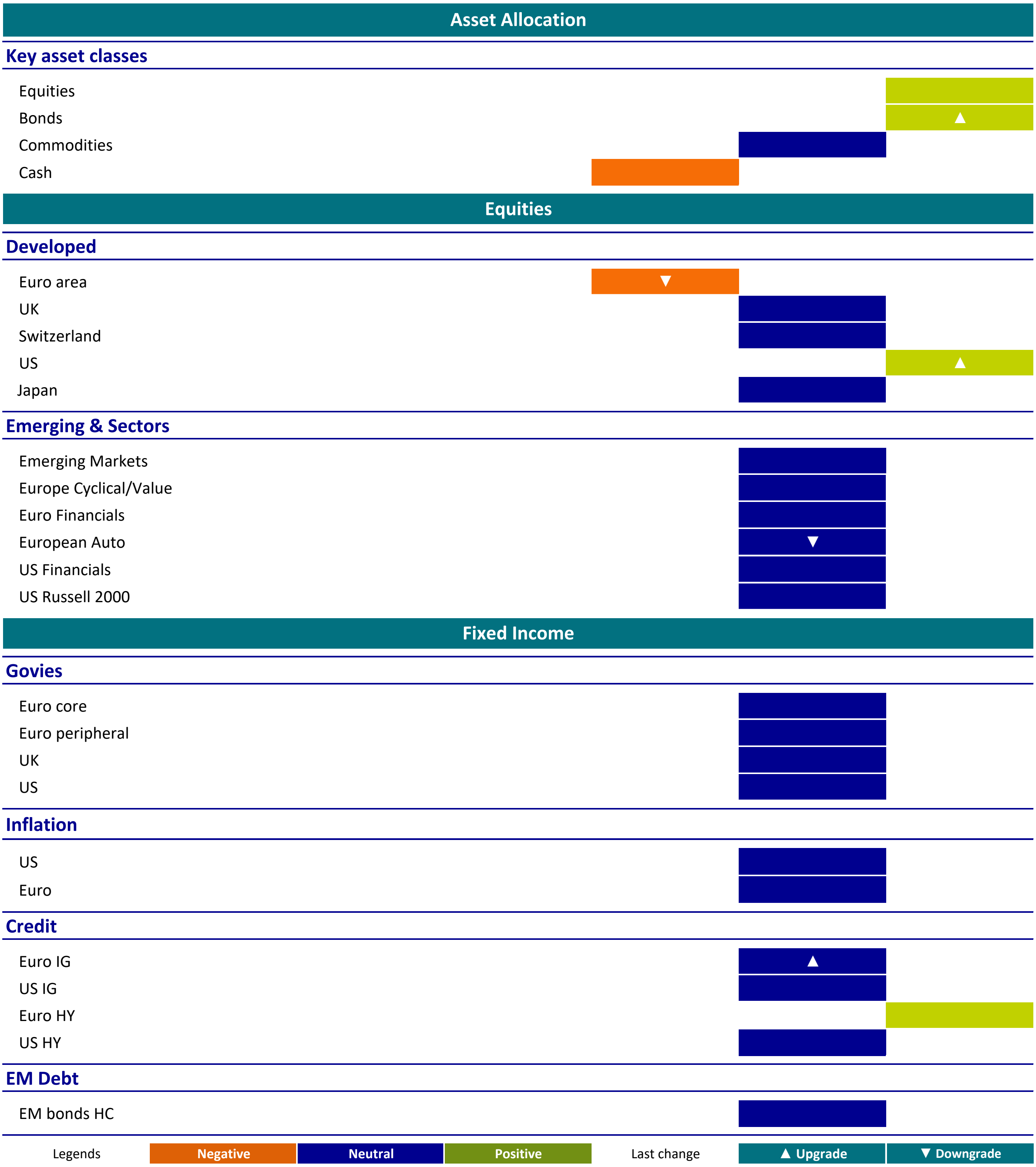
Recommended asset allocation



Source: AXA IM Macro Research – As of 29 March 2022

Macro forecast summary

Real GDP growth (%)	2020	2021*		2022*		2023*	
		AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
World	-3.1	5.2		3.1		2.8	
Advanced economies	-5.0	3.4		2.0		1.2	
US	-3.4	5.5	5.6	2.8	3.7	1.6	2.5
EMU-4	-7.4	5.0		2.1		1.2	
Germany	-4.9	2.8	2.7	1.2	3.5	1.7	2.7
France	-8.0	7.0	6.6	2.7	3.8	1.0	2.1
Italy	-9.0	6.5	6.3	2.3	4.1	0.6	2.3
Spain	-10.8	5.0	4.7	3.5	5.7	1.6	3.6
Japan	-4.9	1.7	1.8	2.5	2.8	1.8	1.8
UK	-10.0	7.2	7.0	3.8	4.3	0.7	2.0
Switzerland	-2.5	3.5	3.5	2.0	2.9	1.3	1.9
Canada	-5.2	4.4	4.6	3.3	3.9	2.5	3.1
Emerging economies	-1.9	6.3		3.8		3.8	
Asia	-0.8	6.8		5.1		5.0	
China	2.3	7.9	8.0	5.0	5.0	5.0	5.2
South Korea	-0.9	4.0	4.0	2.0	3.0	2.0	2.6
Rest of EM Asia	-4.6	5.8		5.6		5.3	
LatAm	-7.0	7.0		2.5		2.5	
Brazil	-3.9	4.8	4.7	0.9	0.5	1.9	1.9
Mexico	-8.5	4.8	5.6	2.4	2.3	2.2	2.3
EM Europe	-2.0	6.6		-0.3		0.9	
Russia	-2.7	4.7		-7.0		-3.0	
Poland	-2.5	5.8	5.3	4.2	4.7	3.3	3.8
Turkey	1.8	11.5	9.9	3.9	2.9	3.4	3.2
Other EMs	-2.1	4.2		3.0		3.0	

Source: Datastream, IMF and AXA IM Macro Research – As of 29 March 2022

* Forecast

CPI Inflation (%)	2020	2021*		2022*		2023*	
		AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	0.7	3.2		5.4		2.9	
US	1.2	4.7	4.6	6.8	5.2	3.8	2.6
Eurozone	0.3	2.6	2.5	5.3	3.9	2.5	1.7
Japan	0.0	-0.2	-0.2	2.0	1.0	1.0	0.7
UK	0.9	2.6	2.5	6.8	5.4	3.4	2.7
Switzerland	-0.7	0.5	0.5	2.0	1.0	1.0	0.6
Canada	0.7	3.4	3.4	4.2	3.7	2.8	2.3

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* 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)	+0.50 (0.75-1.00)	+0.50 (1.25-1.50)	+0.25 (1.50-1.75)
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	0.75	3 Feb 17 Mar	5 May 16 June	4 Aug 15 Sep	3 Nov 15 Dec
	Rates		+0.5(0.75)	+0.5 (1.25)	unch (1.25)	unch (1.25)

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Our Research is available online:

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