Monthly Op-ed

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Political risks get in the way of decent macro

Key points

- A soft landing, allowing the Fed to cut while keeping the economy in a decent shape, is increasingly supported by the US dataflow.
- In the Euro area, while headwinds still abound, purchasing power is positive enough to protect against recession risks.
- Politics get in the way though: focus on Donald Trump's potentially inflationary agenda could put a floor a the decline in long-term interest rates. Uncertainty triggered by the French snap elections could weigh on demand and has already widened spreads.
- Increasing income return in bonds and solid earnings cycle support equities

Decent macro, complicated politics

Were it not for a complex political environment, the overall macro situation would look more than decent. Indeed, in the US a soft landing finally seems to be unfolding, which should allow the Federal Reserve (Fed) to start cutting rates in September while still preserving enough momentum in the real economy to avoid lifting default rates and damage earnings too much.

True, the dataflow remains often difficult to read – see for instance the gyrations in the normally reliable ISM survey, or the divorce within the employment report between a still robust Establishment survey and a quite depressed Household survey. But the softness in retail sales suggests that the weakness in private consumption, already material in a mediocre GDP print for Q1, may have continued into Q2. A correction in building permits also suggests that residential investment, in a context of elevated mortgage rates, is no longer defying gravity. Job openings and the quits rate have returned to their pre-pandemic level, which should help tame wages and prolong the current deceleration in services prices.

Indeed, in May for the second month in a row, the momentum in services prices eased when looking at the three-month annualised change, in contrast with the re-acceleration observed at the beginning of 2024. The Fed had reacted to this by toughening up its message. While we think the central bank will need to see confirmation of the recent trend this summer, a September cut is likely.

In the Euro area, in Q1 GDP grew in line with its potential pace for the first time since the beginning of 2022. While the overall performance was boosted by a remarkable Spanish print, it was reassuring that all four biggest economies of the euro area posted GDP gains in Q1. While the fiscal stance turning restrictive was always going to be a hindrance, the temporary positive gap between wage growth and headline inflation provides enough protection to consumer spending to keep GDP in positive territory in the quarters ahead.

Still, as investors start to contemplate the second half of the year, the US elections of course loom large. A key concern is that some key features of Donald Trump's – who is for now in the lead, both in the national polls and in the swing states – suggested second-term agenda could make it harder for the Fed to continue easing in 2025. Indeed, the combination of restrictive immigration policy, easier fiscal policy and higher trade tariffs would clearly be inflationary. This may put a floor on how low long-term interest rates could fall, even if the Fed cuts.

The Euro area as well – and quite unexpectedly – is coming up with its own home-made political risk with the decision by the French President to call snap parliamentary elections. This has lifted bond spreads not just for France but also across the Euro area periphery, while the uncertainty seems to have some visible effect on business confidence, as per the disappointing Purchasing Managers' Index (PMI) survey for June. There is little existential threats to the monetary union, since the far-right – the closest to secure a majority according to the polls – no longer calls for "Frexit" but concerns could linger as no quick clarification of France's policy stance might emerge, either because no majority emerges – a very plausible outcome – or because it is unclear how much of its 2022 spendthrift agenda a RN-led government would try to implement.

Conversely, the UK appears as a source of stability: the general elections are opposing, in the economic realm, two versions of mainstream policies. It may be that the country's brush with populism after Brexit is now producing a strong vaccine against adventurous choices.

Benign macro supporting strong market performance

Despite some clear risks to investor sentiment and the possibility of political developments spoiling the backdrop, today's environment remains supportive for continued positive returns across asset classes. Following the first quarter's adjustment to rate expectations, returns from fixed income have gradually become dominated by income, so much so that total returns across most credit sectors are positive in the first half of 2024. Even longer-duration, more rate-sensitive assets delivered positive returns in June as long-term government bond yields moved towards the lower end of their trading range. Positive surprises on US inflation and a sense the US labour market is coming off the boil have also given investors more confidence in the lower interest rate outlook. The move by the European Central Bank (ECB) and the second cut in rates by the Swiss National Bank have bolstered this.

It has been a consistent message from AXA Investment Managers – the higher yield environment provides a different fixed income return regime compared to the period when yields were dominated by central bank government bond purchases. Between the end of May 2023 and May 2024, the income return from a typical US dollar corporate bond index has been around 4.5%. For an equivalent euro index the income return component has been 2.3%. As average coupons on bonds increase with the refinancing of low coupon securities, this income component of total return will increase further. The average coupon on the US dollar corporate bond market increased from 3.9% in June 2023 to 4.3% today, with the euro market seeing the average coupon increase from 1.95% to 2.3%. This income outlook coupled with the fact that many bonds are still trading at prices below par, are two key drivers of the positive view on credit.

The same goes for high yield. The US market has seen the average coupon rise from 5.9% to 6.4% and income return over the last year was almost 7% (almost 5% for euro denominated high yield bonds).

There are concerns about valuations. Credit spreads are close to their narrowest in the current cycle and their vulnerability was highlighted by European spreads' reaction to France's snap election announcement. Spreads on French issuers responded to the widening of the French-German government bond spread and financial names were particularly hit. However, broader contagion has been limited, and with the ECB now in easing mode, any widening in European credit spreads is likely to be seen as an opportunity to add to portfolios.

Fundamentals generating income and earnings flows

The backdrop also remains positive for equity investors. Consensus earnings growth forecasts and revisions have been increasing and several sell-side strategists have increased their year-end targets for a number of equity indices. As is the case with credit income, there appears to be more visibility on the earnings cycle for equities given the benign growth outlook. However, there are big differences across sectors both in terms of the outlook and in terms of performance. In the US market, the technology sector has contributed significantly to earnings growth, and to total returns. Current forecasts show the divergence of expected earnings growth in the US running from 20% expected 12-month earnings growth for the IT sector to just 2.2% for energy stocks.

Expectations are lower in Europe, reflecting the lower run rate of nominal GDP. But Europe has the advantage of more attractive valuations, a broader base to the equity rally, and a central bank which is less hamstrung in terms of near-term rate cuts.

This positive backdrop to markets has delivered good risk-adjusted returns over the last year. A typical 60:40 equity and bond portfolio would have generated returns in the 10%-20% range depending on the market and precise allocation (growth over value in equities and credit over rates in fixed income). The soft-landing core scenario with some easing in global monetary settings and the avoidance of a recession should help sustain the bullish outlook for some time, conditional on what happens with elections in Europe and the US.

Secular growth in technology will remain a key theme

The secular story is strong too. The more than doubling – since the Fed started raising interest rates – of the market capitalisation of the three mega cap stocks in the US that are all individually valued at more than $3tn is all about the artificial intelligence (AI) revolution. On balance, economists, and others, think AI will be productivity enhancing and therefore capital spending will be allocated to utilising AI technologies across a range of sectors. That, along with broader digitalisation and investment in green technologies are the driving force of business investment spending in the US and in Europe, once NextGenerationEU funds are used. The semiconductor sector has led the way in terms of US equity market performance but the broadening out of AI infrastructure will create many opportunities related to data centres, cloud computing and cyber security. In time, companies using AI rather than developing the technology's picks and shovels should also see their equity values rewarded. This is a theme which is set to run and run, irrespective of the pace of rate cuts or the political make-up of governments in western democracies.

On that point, however, it is worth mentioning the UK, where the Labour Party looks set to potentially win a large majority at the general election on 4 July. While its manifesto is not necessarily market friendly, it has been careful not to appear to be fiscally reckless, arguing that any policy proposals will be fully funded and not lead to a widening of the deficit. Sterling markets are sanguine about the outlook, with gilt yields stable around 4% at the 10-year level. If expectations are met, UK equities are likely to benefit. They have underperformed since the 2016 Brexit vote and are cheap on a relative value basis. At the mid-cap level, earnings expectations are solid and there is already an increase in merger and acquisition activity. An election bounce in UK equities be a highlight of the summer months.

Download the full slide deck of our June Investment Strategy

Macro forecast summary

Real GDP growth (%)	2023	2024*		2025*	
	AXA IM	AXA IM	*Consensus*	AXA IM	*Consensus*
World	3.2	3.2		3.1	
Advanced economies	1.7	1.5		1.4	
US	2.5	2.4	2.4	1.6	1.8
Euro area	0.5	0.6	0.6	1.1	1.5
Germany	0.0	0.1	0.2	0.9	1.5
France	0.9	0.8	0.8	1.0	1.3
Italy	1.0	0.7	0.8	0.7	1.2
Spain	2.5	2.4	2.0	2.1	1.9
Japan	1.9	0.6	0.5	1.1	1.0
UK	0.3	0.7	0.5	1.1	1.2
Switzerland	0.8	1.2	1.2	1.3	1.5
Canada	1.1	1.3	1.1	1.8	1.9
Emerging economies	4.1	4.2		4.2	
China	5.2	5.0	4.9	4.2	4.4
Asia (excluding China)	5.3	5.4		5.3	
India	7.7	6.8	6.8	6.5	6.6
South Korea	1.4	2.5	2.5	2.6	2.2
Indonesia	5.0	5.1	4.9	5.1	5.1
LatAm	2.3	2.0		2.4	
Brazil	2.9	2.2	1.9	1.9	2.0
Mexico	3.2	2.2	2.2	1.4	2.2
EM Europe	3.0	3.0		2.9	
Russia	3.6	3.2	2.6	1.8	1.1
Poland	0.2	2.8	2.9	3.5	3.4
Turkey	4.3	3.0	2.6	3.6	3.2
Other EMs	2.2	2.9		4.2	

Source: Datastream, IMF, Bloomberg and AXA IM Macro Research – As of 25 June 2024
**Forecast*

CPI Inflation (%)	2023	2024*		2025*	
	AXA IM	AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	4.7	2.8		2.3	
US	4.1	3.3	3.2	2.5	2.3
Euro area	5.5	2.5	2.3	2.2	2.1
China	0.2	0.6	0.7	1.6	1.9
Japan	3.3	2.5	2.5	1.9	1.5
UK	7.3	2.4	2.5	1.8	2.0
Switzerland	2.1	1.4	1.3	1.4	1.3
Canada	3.9	2.5	2.5	2.6	2.0

Source: Datastream, IMF, Bloomberg and AXA IM Macro Research – As of 25 June 2024
**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	Q3-24	Q4-24
United States - Fed	Dates	5.50	30-31 Jul 17-18 Sep	6-7 Nov 17-18 Dec
	Rates		-0.25 (5.25)	-0.25 (5.00)
Euro area - ECB	Dates	3.75	18 Jul 12 Sep	17 Oct 12 Dec
	Rates		-0.25 (3.50)	-0.25 (3.25)
Japan - BoJ	Dates	0 - 0.1	30-31 Jul 19-20 Sep	30-31 Oct 18-19 Dec
	Rates		+0.10 (0.1-0.2)	+0.10 (0.2-0.3)
UK - BoE	Dates	5.25	1 Aug 19 Sep	7 Nov 19 Dec
	Rates		-0.25 (5.00)	-0.25 (4.75)
Canada - BoC	Dates	4.75	24 Jul 4 Sep	23 Oct 11 Dec
	Rates		-0.25 (4.50)	-0.25 (4.25)

Source: AXA IM Macro Research - As of 25 June 2024

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Our Research is available on line: www.axa-im.com/investment-institute

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