AXA Investment Managers

Investment Institute Macroeconomics

Temperature keeps on rising for central banks

Monthly Investment Strategy

AXA IM Research

27 July 2022

Summary: July 2022

Theme of the month: The characteristics of EM inflation, causes and effects

- EM inflation has been on the rise since May 2020, as inflation started to rebound from the initial pandemic impact. Inflation has been hit by a series of independently transitory shocks, that have become prolonged by their successive nature, the latest being the Ukraine war.
- Food and energy prices account for a larger portion of EM spending than in developed markets, particularly food. The Ukraine war has had a material impact on both of these sectors and these components have added to over half of the increase in inflation since February.
- Domestic conditions have also turned inflationary, with labour markets as tight or tighter than pre-pandemic. FX depreciation has also exacerbated external shocks, with FX pass-through increasingly threatened by challenges to inflation expectations, something central banks are increasingly defending.

Macro update: Temperatures keep on rising for central banks

- Inflation has risen to 40-year highs in several developed economies (US, UK and Canada) and a new record in the Eurozone. Energy and food increases are impacting all economies in the wake of the Ukraine war. EM economies are also seeing inflation rise higher, with FX depreciation an additional issue.
- Recession risks are rising in multiple jurisdictions. The US has revised consumer spending estimates lower, leaving its outlook closer to contraction over coming quarters. The Eurozone (and UK) also face testing quarters that will at least deliver contraction, if not technical recessions.
- The risk of gas supply interruptions to Europe this winter is high and would turn any eventual mild recession into something sharper.
- Against a difficult economic background, political uncertainty has risen. The front-runner for UK PM proposes a populist tax cutting agenda; in Italy the collapse of the centrist coalition leaves open the likelihood of a right-wing coalition from elections to be held on 25 September.
- Central banks have surprised in their attempts to contain inflation expectations. The BoC raised rates by 100bps, the ECB by 50bps. We expect the Fed to deliver 75bps and the BoE 50bps. EM central banks also continue to tighten, but some have added FX intervention to their toolkit.

Investment strategy: valuations plentiful but ditto for risks

- FX: Rising recession risk is now taking over in pushing the USD higher via risk-off sentiment despite stalled US rates. This can run further while Fed hawkishness is not reduced. JPY and EUR are not a reliable safe havens to rival USD. CHF and AUD may outperform on SNB and RBA hawkishness.
- Rates: Very elevated, broad based and persistent inflation; waning growth and the risk of an energy sudden stop; and the risks for policy transmission are creating a policy dilemma for the ECB. Fragmentation in the periphery not that evident yet, EGB spreads have widened in line with beta-adjusted terms.
- Credit: Adjusted for FX hedging costs and normalised for duration mismatch, the pickup in EUR credit yield over its USD equivalent is at levels not seen since the euro sovereign debt crisis. But this comes with some key macro risks attached while a material increase in refinancing costs is a major issue.
- Equity: Implied volatility of US equities and the bull-bear investor indicator suggest a slowdown in risk off momentum since mid-June. The shift in focus is now towards economic growth prospects, for which the release of earnings will be critical, with the bulk of releases in the week of 25 July.

Central scenario

Summary – Key messages

Monetary policy

Most central banks continue to tighten as inflation high and concerns of inflation expectations rise. Slowing activity to alter this outlook in Q4. PBoC and BoJ major exceptions.

Inflation

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

Fiscal policy

Europe adding to fiscal supports to ameliorate cost-of-living. More material step-up if gas supply interruption occurs. US deadlocked in Congress.

Growth

Growth beginning to slow more obviously. Contraction a growing risk for some. Gas interruption could turn mild slowdown into severe.

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 2.8% in 2022 and 2023.

Economic slowdown amidst supply pressures and tighter monetary policy. Inflation elevated across 2022.

Emerging Markets

Inflation rising across EM. Central banks hike more, some add FX intervention. Some fiscal response add to fragile finances

Rates

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

FX

Dollar pricing remains extreme, if off peak. 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 35%)*

What could be different?

- Escalation in Ukraine conflict
- Russian gas supply interruption into European winter
- COVID outbreaks spreads again: China and/or new mutations
- Post-pandemic structural persist. Supply shocks last longer
- Inflation expectations rise, affecting wages and persistence

What it means

- Growth weaker, employment could start to fall, but inflation remains 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

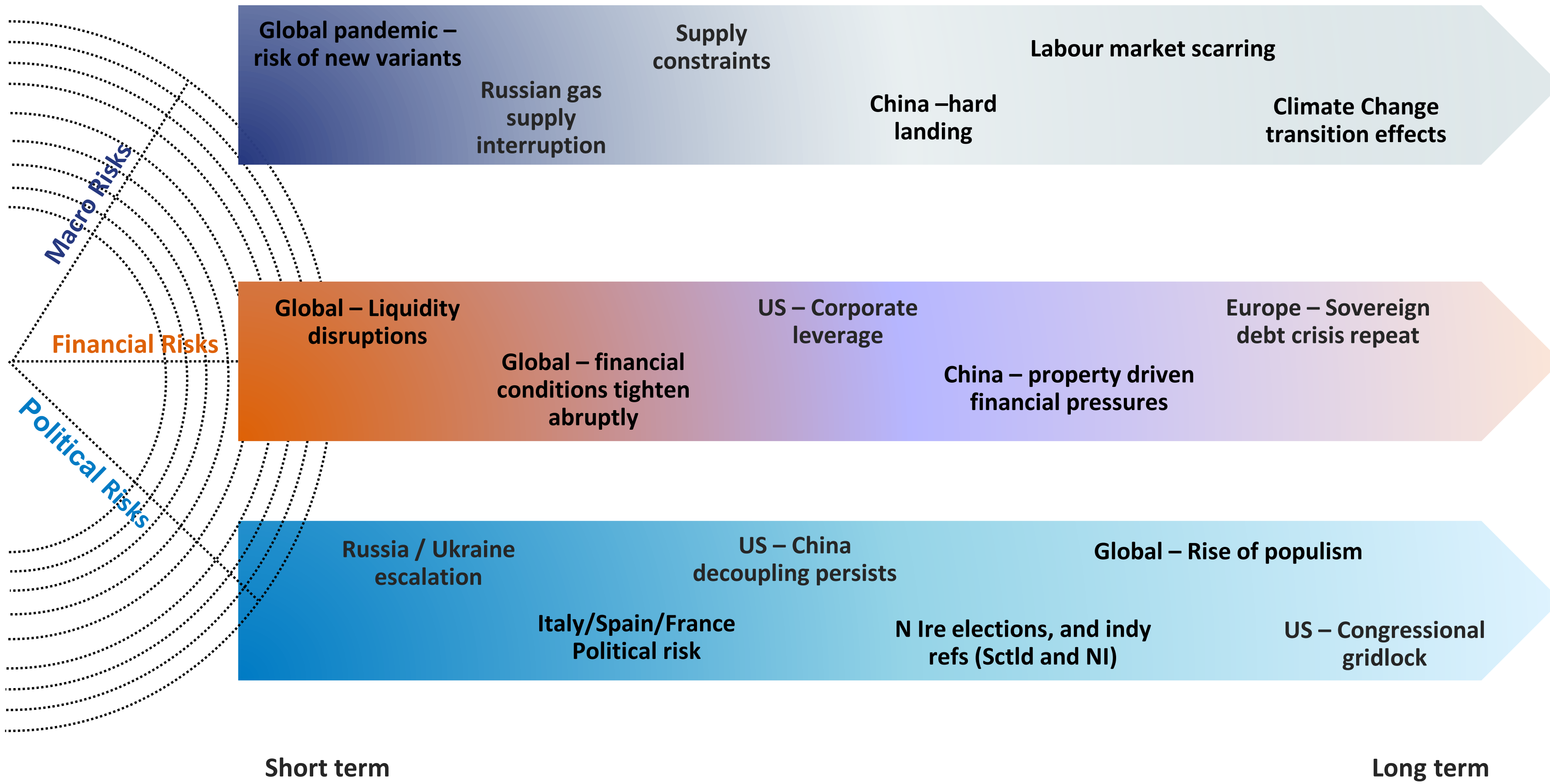
- Growth surprises on the upside in most regions
- Inflation fades more quickly towards and below central bank targets
- Monetary policy proves more patient than expectations

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



Investment Managers

Contents

Theme of the month

AXA Investment Managers

The characteristics of EM inflation, causes and effects

Inflation has accelerated driven primarily by food and energy

Inflation rates picked up well before the war in Ukraine

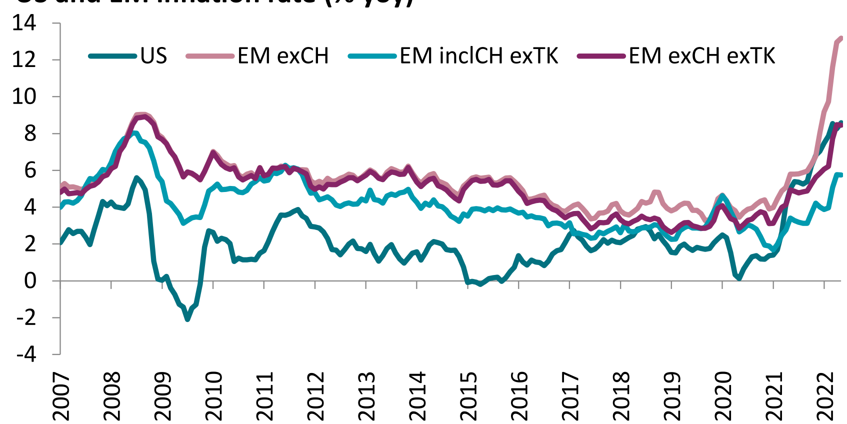
- Inflation started to pick up from May 2020 with a rebound in oil prices and demand. It has accelerated under a variety of shocks both in advanced and developing countries following the Covid-19 pandemic. While individually transitory in nature, these global shocks have nonetheless been prolonged by successive further supply shocks, including most recently the war in Ukraine.

Food and energy inflation are still the primary drivers of inflation

- The rise in EM inflation has been rather broad-based across EM countries, albeit to varying degrees, speed and extent. In EMs, large currency depreciation during the period of financial market stress in March/April 2020 compounded the impact of domestic and global supply chain shocks from lockdowns and re-openings.

EM ex-China inflation on multi decades high

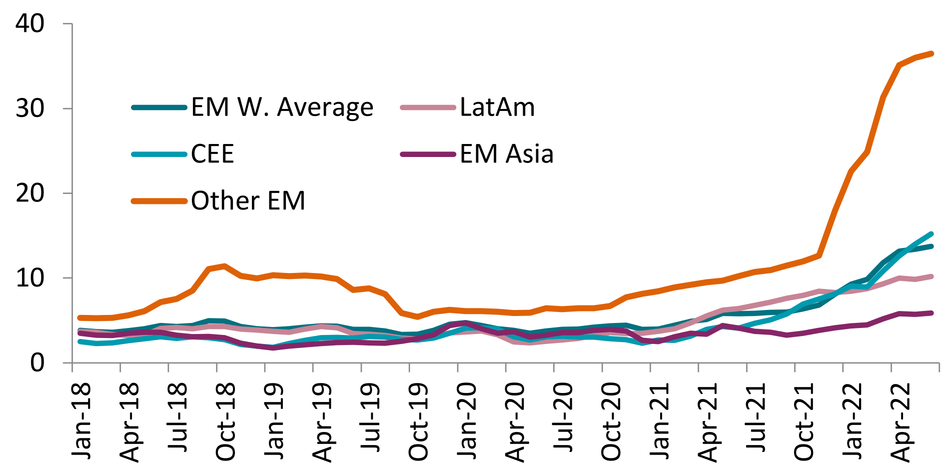
US and EM inflation rate (% yoy)



*Source: Refinitiv Datastream, AXA IM Research, as of July 2022. *EM proxy is GDP PPP weighted measure for 20 countries (China, Korea, Taiwan, India, Indonesia, Malaysia, Thailand, Philippines, Brazil, Mexico, Chile, Peru,*

Global and domestic factors push regional inflation higher, at various degrees

Inflation by region (%yoy)



Source: Refinitiv Datastream, AXA IM, July 2022

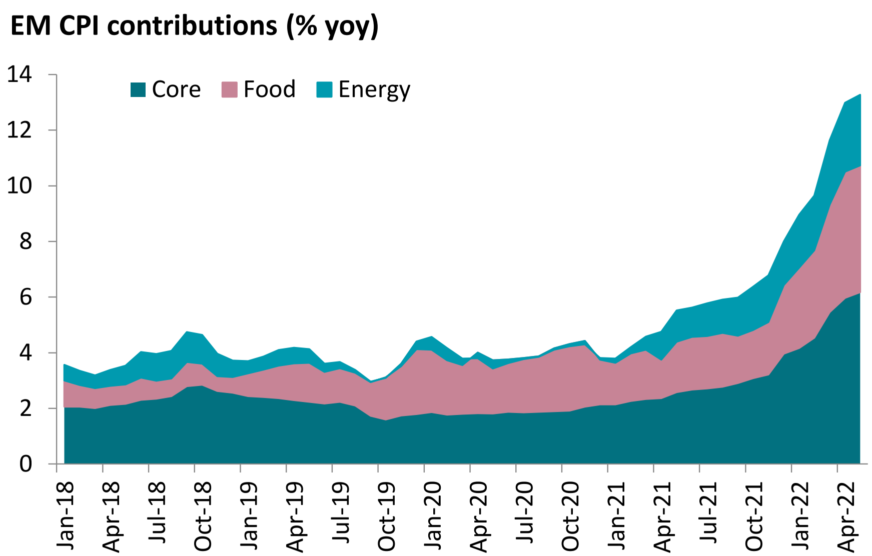
The characteristics of EM inflation, causes and effects

Volatile items and CPI basket specificities in EM

Energy and food prices account for 56% of the inflation acceleration in EM since the start of the war in February

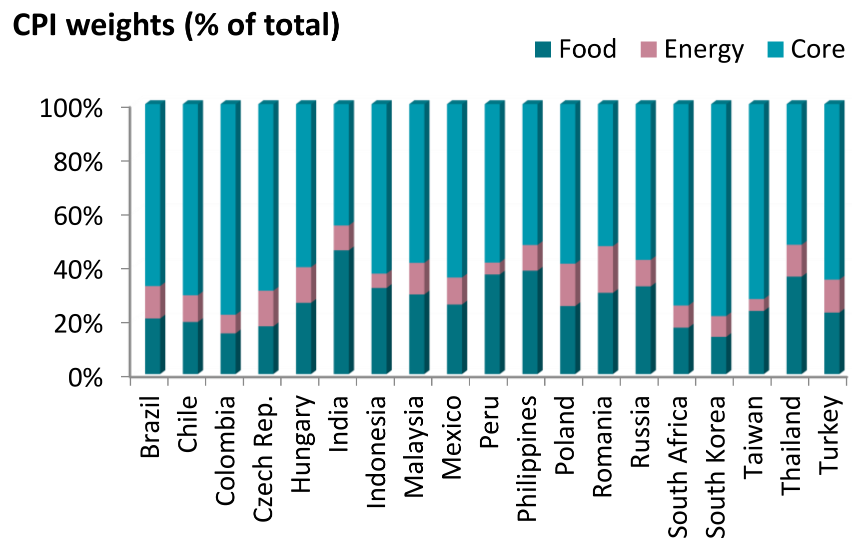
- Volatile items including energy and food prices are very often an important component in EM consumer price indices (CPI). Energy accounts anywhere between 4% and 17% of the individual countries' CPI baskets, on average 10%, somewhat higher than in the US CPI measure.
- The big difference comes from food prices, which account between 14-46% of the EM country inflation measures, an average of 27% of an EM CPI index which is almost twice the size of food component in the US inflation.
- As always, economies in EM are very different in size and structure, and the CPI composition is another example of that with energy and food prices accounting for as much as 55% in India and only 22% in South Korea (compared with 20.5% for the US consumer price basket).

Food and energy are the primary drivers of inflation



Source: Bloomberg, Refinitiv Datastream, AXA IM Research, as of July 2022.

By structure, food is an important component of CPI baskets in EM



Source: Refinitiv Datastream, AXA IM Research, 2022

The characteristics of EM inflation, causes and effects

Among global volatile items in EM CPI, food prices are of utmost importance

Momentum in food price increases appears to have started soften in some countries

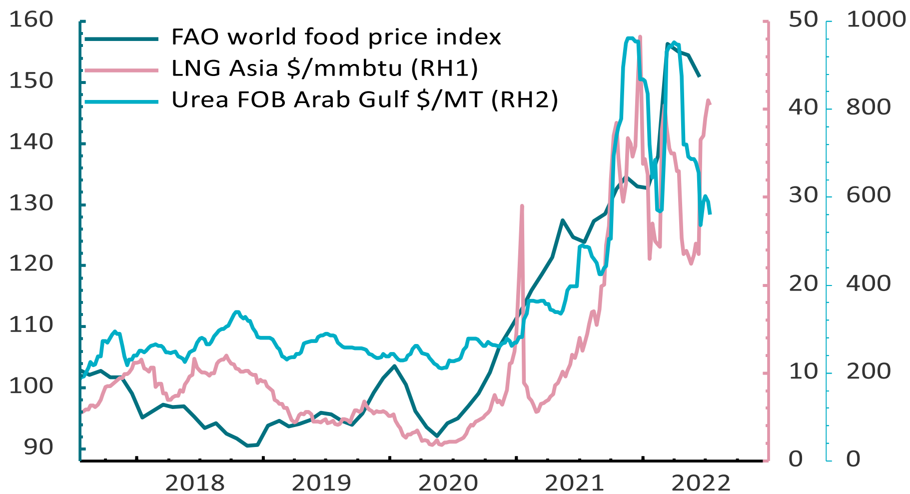
- At close to 30% in the EM CPI basket, food prices are significant for inflation trends. Assuming agricultural prices stabilize at current levels, global food inflation could halve from Q1 to Q4, which could bring EM inflation down by almost 2ppt. Further supply disruptions caused by the Ukraine conflict and weather shocks such as La Niña returning this winter nonetheless remain likely.

The relationship between oil prices and headline inflation is weaker than popular conception

- Under IMF models, assuming Brent oil prices at 94.8$/bl by year end as the futures markets suggest at present (-8.8% from current levels), EM inflation rate would fall by 0.35bp.
- Still, as an important source of energy and transportation, a rise in oil prices translates into an increase in many goods prices in CPI at a relatively faster pace in EM than in developed countries. Additionally, EM governments have implemented various policy responses to shield consumers from the extent of wholesale price increases. These will soften CPI increases, but will show up in the public finances.

Gas prices feed into food prices

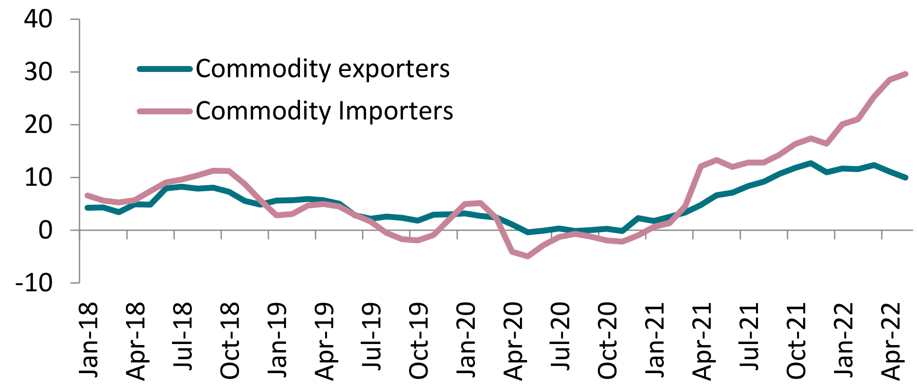
Food and gas/urea price



Source: Refinitiv Datastream and AXA IM Research Jun 22

Energy prices affect EM exporters/importers differently

Energy inflation rate (% yoy)



Source: Refinitiv Datastream, AXA IM Research, as of July 2022.
Commodity exporters: Brazil, Chile, Colombia, Indonesia, Malaysia, Peru, Russia and South Africa. Commodity importers: Czech Republic, Hungary, India, Mexico, Philippines, Poland, Romania, South Korea, Taiwan, Thailand and Turkey

The characteristics of EM inflation, causes and effects

Domestic factors adding to inflation pressures

Domestic price pressures add to global inflation factors

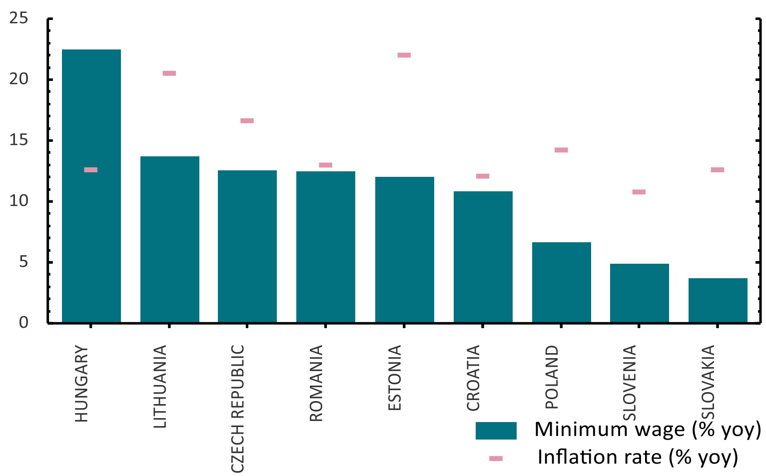
- Economic activity post Covid-19 has been stronger then expected, helped by policy actions in the US and Europe but also domestic measures taken to support households and corporate balance sheets. Several EM countries already had positive output gaps in 2021, according to OECD estimates. There is increasing evidence of rising wage inflation, particularly in Central Europe and in Latin America. Unemployment rates have fallen across the board, generally now back to pre-pandemic levels and sometimes below suggesting tightness in labour markets.

FX pass through was weakening but may be tested again

- FX-pass-through has been a fading feature of EM inflation since the global financial crisis, largely as a result of consistently subdued inflation across EM and the implementation of credible inflation-targeting frameworks put in place in the late 90s and early 2000s, but also given global factors that helped keeping consumer prices largely under control.

Wage pressures mounting in Central Europe

Minimum wage growth (real and nominal, yoy)

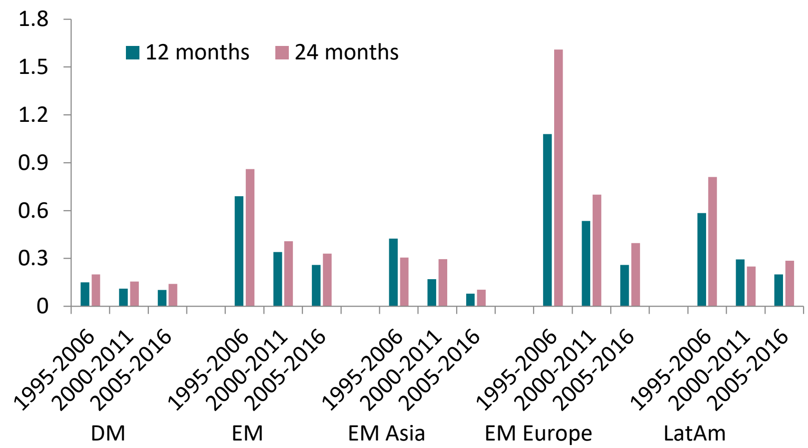


Note: Waga data refers to Q1 and inflation rates to June

Source: Refinitiv Datastream and AXA IM Research

FX pass-through fell in time thanks to credible central banks' policies

FX pass-through evolution by period and region



Source: IMF, AXA IM Research, 2016

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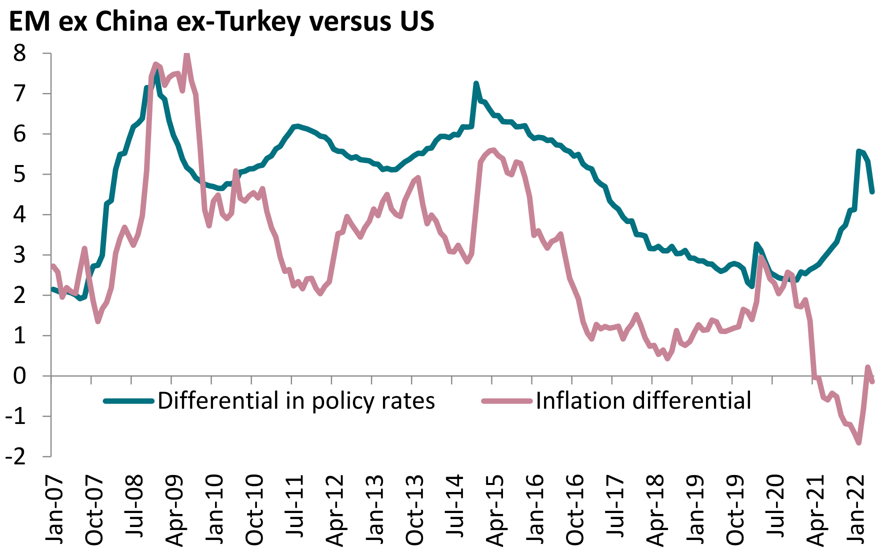
The characteristics of EM inflation, causes and effects

Inflation expectations re-anchoring and policy implications

Higher inflation for longer calls for tighter policies for longer

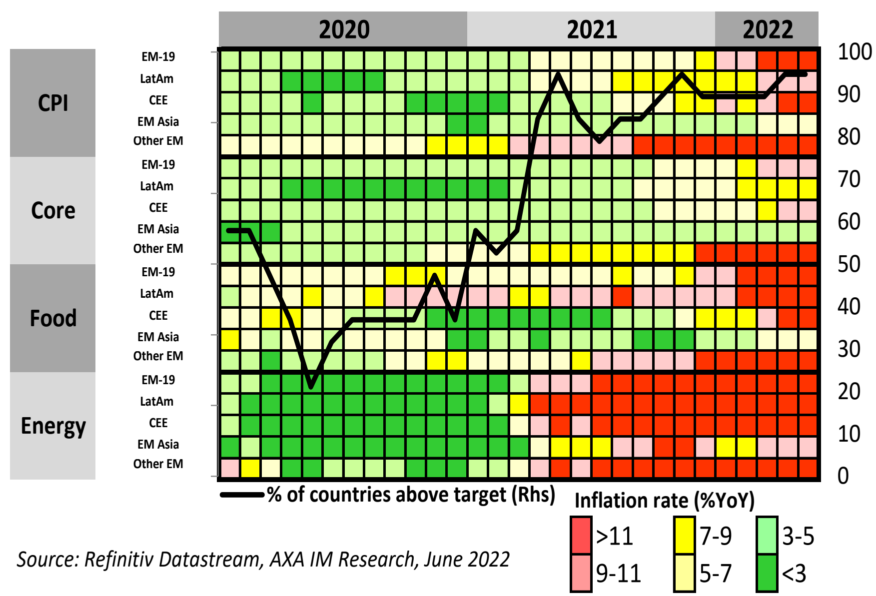
- Inflation is running well above central banks' inflation targets in most inflation-targeting EMs and most will continue to hover above the targets through 2022 and likely in 2023. The persistence of above-target inflation creates a policy challenge for central banks which need to re-anchor expectations. Price stability is a key aspect of the credibility of monetary policy and of macroeconomic stability. As such, central banks need to fine tune their policies in search of a balance between policy credibility and growth.
- We believe central banks will be inclined to err on the hawkish side and retain restrictive monetary policy for longer in order to consistently anchor expectations and preserve or further attract foreign capital by maintaining a sufficient interest rate differential versus the US Federal Reserve and/or ECB. It would probably take a global recession to see a sharp monetary easing into 2023. This is a risk, but not our baseline scenario at present.

Tighter monetary policies in EM…



Source: Refinitiv Datastream, AXA IM Research, as of June 2022

… as inflation likely above targets for most



Source: Refinitiv Datastream, AXA IM Research, June 2022

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Macro outlook

Fed boxed in by inflation

US

Another upside inflation surprise

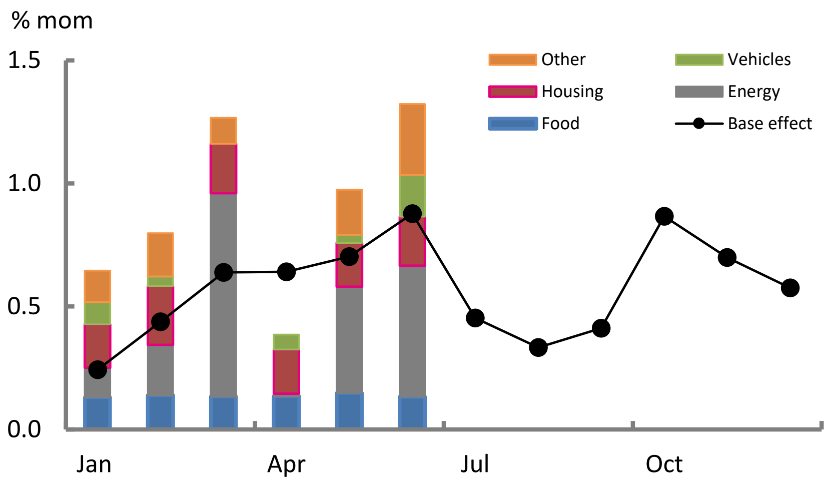
- Inflation surprised to the upside again in June reaching a fresh 40-year high of 9.1%. Once again, energy provided much of the upside surprise in June. This should reverse over the coming months given the 10% drop in oil prices. However, vehicle costs rose again and housing costs are also adding to inflation. We now forecast inflation to remain elevated at over 9% over the summer. We raise our forecasts for annual inflation averages to 8.4% for 2022 and 4.5% for 2023 (consensus 8.0% and 3.5%).

Fed committed to aggressive hikes, but signs of impact emerge

- Fed Chair Powell said he needed "compelling evidence" of falling inflation before declaring victory over inflation. The deteriorating outlook makes a 0.75% hike in July look likely, although signs of weakening economic activity and a fall in long-term inflation expectations (to 2.8% from 3.3% before the Fed's last meeting) should dissuade from a bolder 100bps rise. We forecast the Fed Funds Rate at 3.25% by year-end, but acknowledge risks of a higher 3.50% in line with consensus expectations.

Energy boosts inflation, but pressures broaden

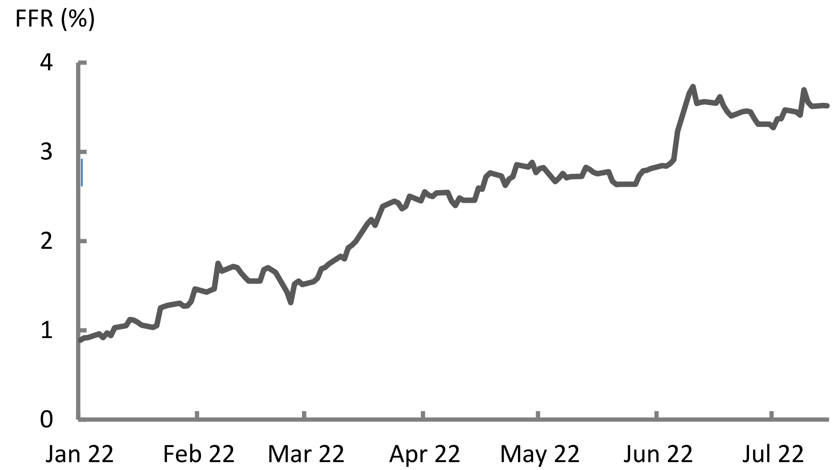
Breakdown of CPI inflation



Source: BLS, AXA IM Research, July 2022

Markets accept Fed's hawkish turn

Market end-2022 FFR expectation



Source: Bloomberg, July 2022

Economy weakens, but not yet in recession

US

Revisions to consumption raise risks of contraction

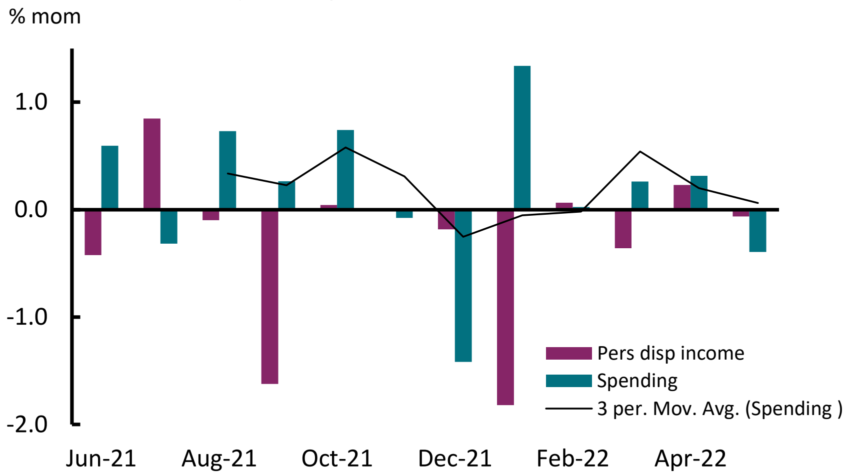
- Revisions to headline Q1 GDP were minimal to -1.6% (annualised) from -1.5%. However, the composition of growth was revised more materially, consumption revised to 1.8% from 3.1% and the initial negative contribution from inventory revised smaller. Both reduce the outlook for Q2 GDP, which we forecast at 1%, but the Atlanta Fed's GDPNow tracker estimates at -1.6% again. We lower our growth forecast to 1.9% for this year and 0.8% for next (from 2.3% and 1.2%), consensus has also fallen to 2.1% and 1.3%.

Labour market casts doubt on recession now, but appears to be turning

- Some suggest the economy is already in recession. The labour market refutes this: unemployment remains close to record lows at 3.6% and payrolls have risen strongly by 375k/month average over Q2. However, the household measure of employment has fallen, averaging -116k over the same period. Differences reflect seasonality, measures of self-employed, multiple job holders and the impact of new businesses. The household measure is more volatile, but contains valuable information, particularly at turning points.

Downward revisions to consumption weaken 2022 outlook

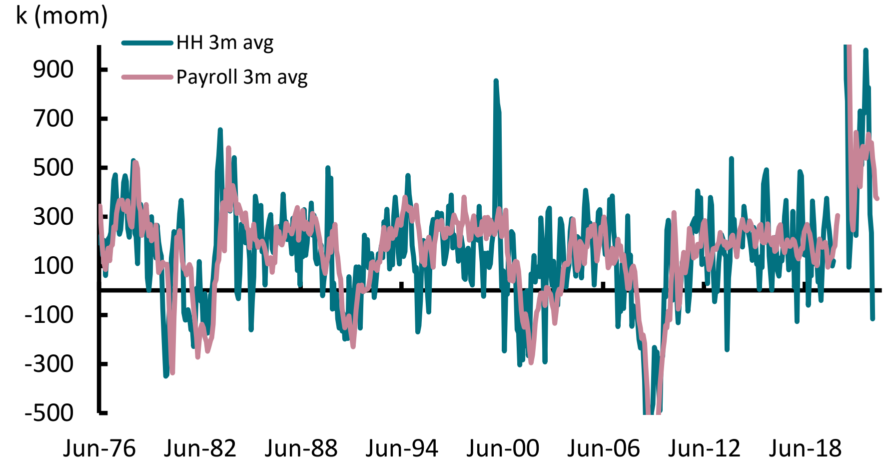
Real income and spending



Source: BEA, AXA IM Research, July 2022

Signs of the labour market beginning to turn

US employment growth



Source: BLS, AXA IM Research, July 2022

Risk of GDP contraction earlier and larger than in our baseline

Eurozone

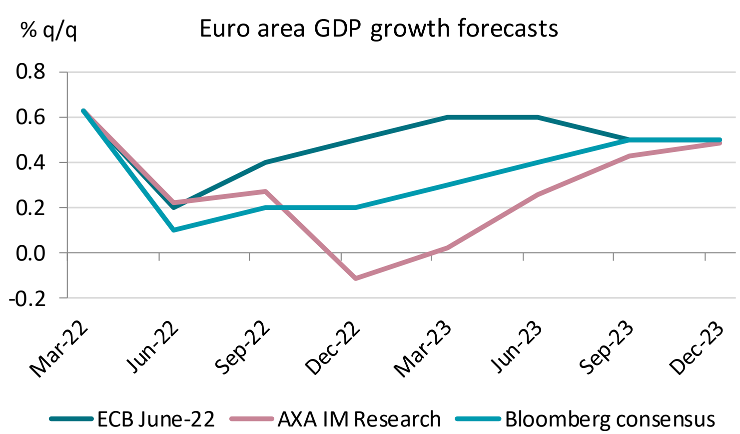
Eurozone GDP growth is heading south

- Flash consumer confidence has dropped to an historic low in July, while the July preliminary composite PMI fell by another 2.6pts to 49.4, consistent with an output contraction. The momentum in services is fading quickly, unable to offset manufacturing weakness. Forward-looking indicators point to further weakness ahead. While we see upside risks to our Q2 0.2% q/q GDP growth, downside risks are predominant for the rest of our horizon. GDP contraction could come earlier than in our baseline (Q4 22).

It is still all about gas

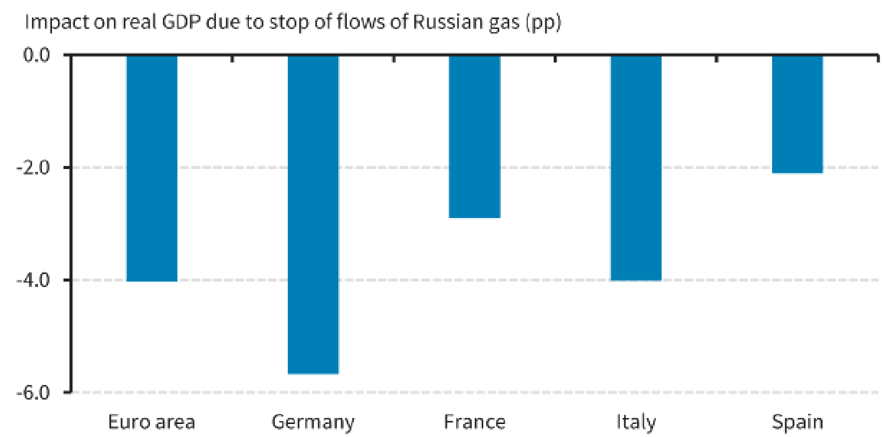
- Significant questions persist on the Eurozone's ability to replenish gas storage ahead – and during - the winter after the end of maintenance period. Even then uninterrupted activity would likely rely on continued Russian gas supply over the winter. In the event of supply interruption there would be large discrepancies in terms of GDP impacts across Eurozone economies. However, our outlook for the scale of any recession would swing from from "mild" to "GFC" like.

Latest data reinforce our below consensus view



Source: ECB, Bloomberg, AXA IM Research

Cutting Russian gas supply cut would be a game changer



Source: Barclays Research, July 2022

ECB: Bold moves but unclear path ahead

Eurozone

Projecting the Deposit Rate at 1.25% by end 2022

- The ECB GC surprised markets by hiking all three rates by 50bps, bringing the depo and refinancing rate to 0% and 0.5% respectively, evidently worried about the inflation outlook. Doves likely agreed to an additional +25bps to generate a unanimous decision on the Transmission Protection Instrument (TPI), reinforcing the announcement effect, and a sine qua none condition for this (and possible future) large rate increases.
- Rate forward guidance was also completely removed, moving to a meeting-by-meeting approach driven by data-dependence. We keep our outlook for subsequent moves, including +50bps in September and October, and raise our depo rate forecast to 1.25% by year-end, in line with market expectations. However, we flag the risk that hikes in September or October may be +25bps (instead of +50bps) owing to growth concerns.

TPI is here, though not for Italy as long as it does not have a new PM

- Agreement on TPI was a big achievement but was undersold during the press conference.
- Details on activation remain vague. Some are measurable (Debt Sustainability Analysis, macro imbalances, NGEU reforms) but others are not (excessive deficit procedure remains at the end a political decision). These criteria will be an “input” into the Governing Council’s decision making. Follow-up GC speeches, especially from hawks will be key to ascertain the ECB’s readiness to act.
- In any case, we do not think it will apply to Italy before a new government is place, leaving further stress on BTPs possible.
- Following a two-step resignation process by Prime Minister Draghi, Italian President Matarella dissolved the Parliament, de facto triggering snap elections. These will be held on 25 September. Besides evolutions of polls, which currently put a coalition between Fratelli d'Italia (FdI), Lega and Forza Italia in prime place to rule the country headed by FdI leader Georgia Meloni, careful monitoring of their respective electoral platforms will be key to judge possible future policy orientation as a coalition.

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Taxation central to race to PM

UK

Truss v Sunak: the battle to be the next PM

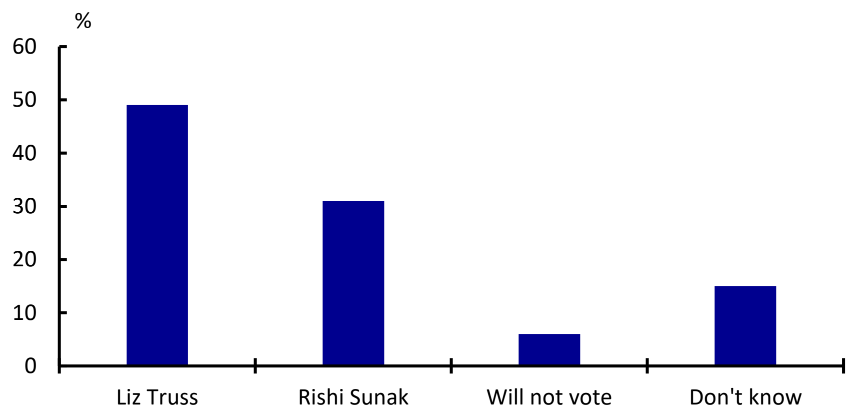
- The race for the next leader of the Conservative party now depends on party members votes with ex-Chancellor Rishi Sunak and Foreign Secretary Liz Truss facing the final ballot. Taxation has been a dividing line between the two candidates with Sunak favouring fiscal conservatism to manage inflation before tax cuts and Truss arguing for immediate tax cuts to boost the economy – with implications for Bank Rate. Results are due on 5 September. The most recent polls suggest Truss has a large lead, which Sunak will be lucky to close over the next 4 weeks of televised debates and hustings.

Services inflation rises as core prices fall

- Price pressures continue to rise, weighing on consumption and challenging the UK growth outlook. In June, inflation rose to 9.4% – setting a new 40-year high. Rising gas prices are likely to see the Ofgem utility price cap increase by around 50% in October pushing inflation above 10% in the autumn. We now expect inflation to average 8.7% this year and 4.8% next (consensus 8.5% and 5.0%).

Truss leads in the race to succeed Johnson as PM

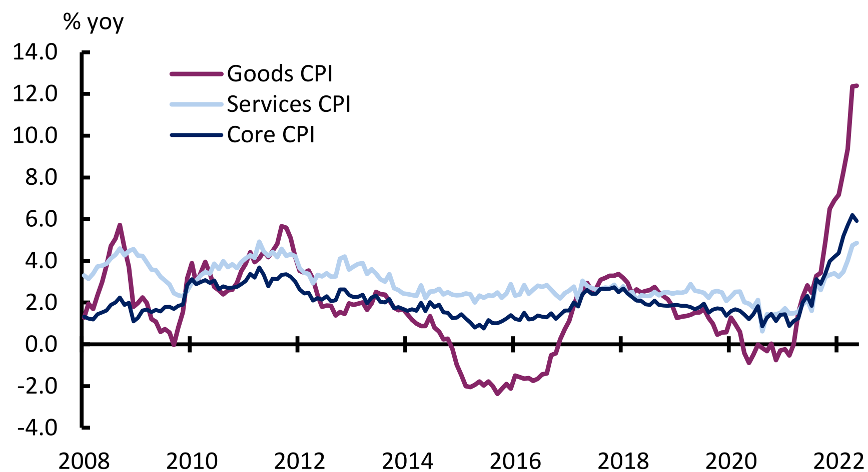
Thinking about the upcoming Conservative leadership election, who will you vote for?



Source: YouGov, AXA IM Research, July 2022 [as of 20-21 July 2022]

Core has begun to fall, but service inflation is on the rise

Goods and Services CPI



Source: ONS, AXA IM Research, July 2022

‘Forceful’ action from the BoE on the horizon

UK

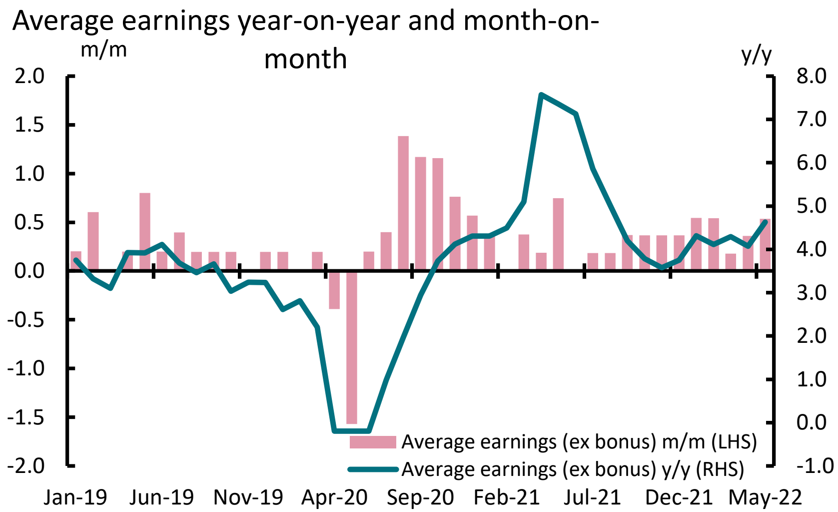
Rising prices put a further spotlight on wages

- Labour market data remains robust. Employment grew by 296,000 in the 3 months to May – the largest growth since the COVID rebound of August 2021. More timely indicators suggest some cooling of employment growth. More importantly, wage growth remains buoyant. Regular wages (excluding bonuses) rose to 4.6% on the year, well above the c.3% we see as in line with the Bank of England’s (BoE) 2% inflation target in the medium term.

MPC set to hike by 50bp in August

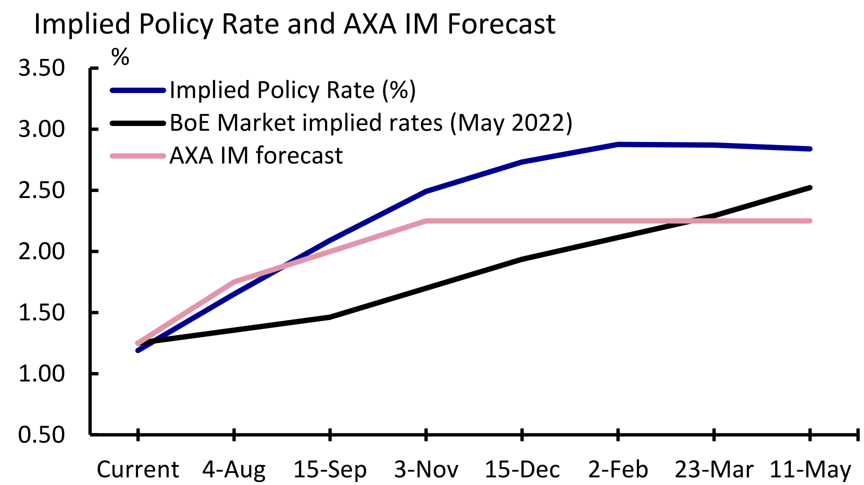
- We expect recent labour market data to lead the BoE to hike rates by 50bps in August. This call is finely balanced, but we see this data alongside more hawkish comments from Governor Andrew Bailey and broader international central bank increases as making a larger hike more likely. We expect the MPC to hike by 25bps in September and November, pausing with Bank Rate at 2.25% as slack begins to emerges in the economy.

Elevated wage growth suggest persistent inflation pressure



Source: ONS, AXA IM Research, July 2022

We see the MPC pausing at 2.25%, lower than markets



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

Post-lockdown recovery gains steam

China

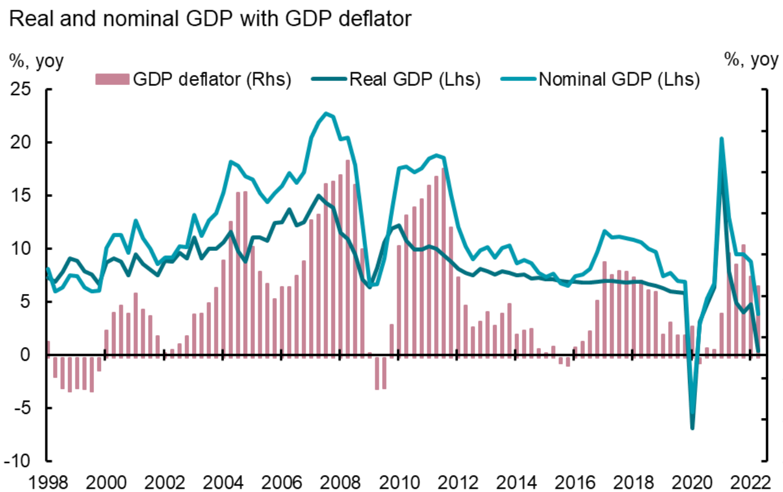
Q2 GDP contracts on COVID-19 lockdowns

- Second quarter GDP grew by 0.4% on the year, in line with our forecast but weaker than the market's. While narrowly avoiding a contraction on a year-on-year basis, sequential growth clearly reflected the brutal hit from the two-month lockdown in Shanghai. The 2.6% quarterly decline was the second GDP contraction since the start of the pandemic. Nominal growth also fell sharply to 3.9% from 8.9% in Q1, exacerbated by a softer GDP deflator

But recovery has taken hold

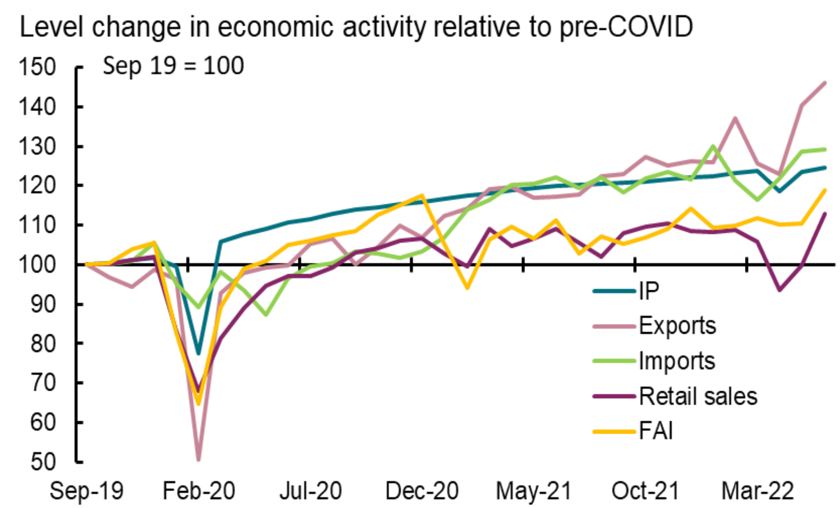
- The good news is that the post-lockdown recovery has started and gained strength in June. Production recovery has continued thanks to easing supply-chain and logistic bottlenecks. On the demand side, export growth remains buoyant for now, but may not last amidst slowing external demand. Domestic green shoots have broadened too, with manufacturing investment and consumption surprising on the upside. The latter was partly supported by another decline in the unemployment rate, although youth unemployment has remained stubbornly high

Growth slows sharply on COVID-19 lockdowns



Source: CEIC, AXA IM Research, Jul 22

Recovery remains uneven, but laggards have started to catch up



Source: CEIC, AXA IM Research, Jul 22

Path ahead remains bumpy and uncertain

China

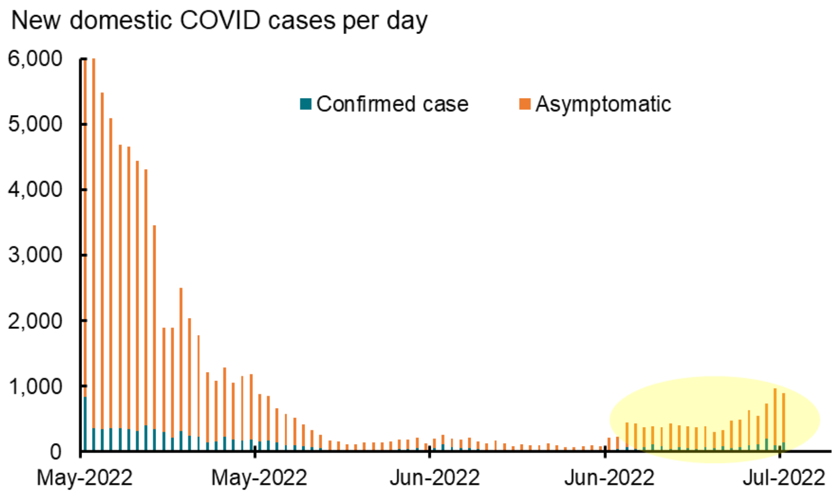
Dark clouds gather again

- The most recent developments are a cause for concern. Another COVID-19 flare-up poses a critical test of Beijing's resolve to manage the pandemic without resorting to draconian lockdowns. The momentum of the housing market is fading further after a brief rebound. Some homebuyers have refused to service their mortgages on pre-sold properties that have passed delivery dates. So far, this appears manageable given strong bank balance sheets against potential debt write-downs, but Beijing needs to act fast to guard against contagion risks

No room for policy complacency

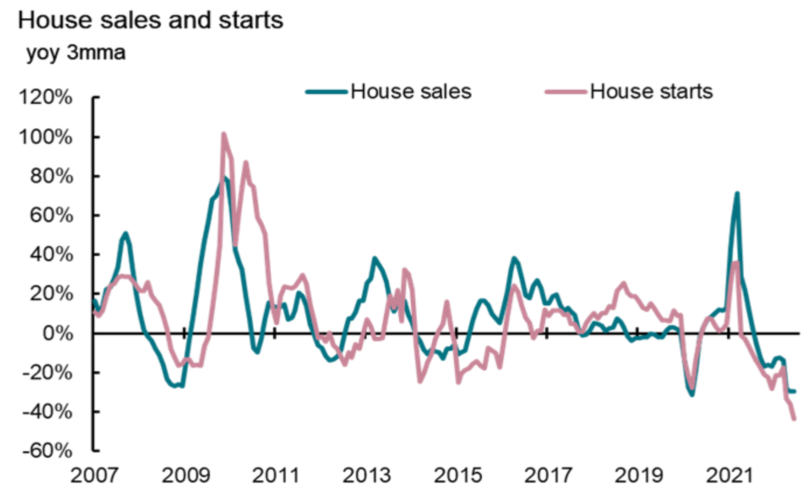
- Given the economy is far from out of the woods, Beijing needs to keep its feet on the pedal to ensure the recovery can continue heading into the Party Congress. We expect additional fiscal easing – most likely in the form of frontloading next year's special bond quota – supplemented by targeted monetary easing to keep the economy humming. The risks are large, but broadly balanced around our 3.6% forecast for the year

COVID-19 remains the biggest wildcard



Source: CEIC, AXA IM Research, Jul 22

The property remains depressed



Source: Bloomberg, AXA IM Research, Jul 22

Rising COVID cases could threaten growth

Japan

Rising covid cases throws adds to growth challenge

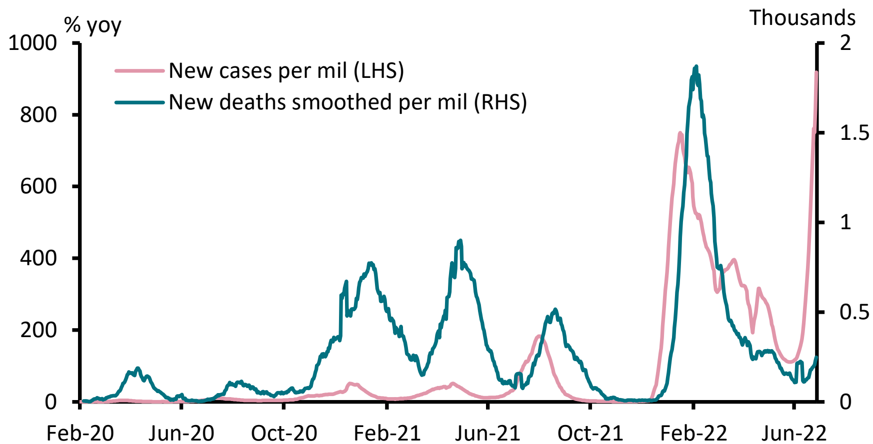
- COVID cases have risen sharply in Japan, with more than 180k cases recorded last week. The government has thus far reiterated it has no plans to reimpose movement restrictions. Rising cases could impact the rebound in services including tourism and restaurants that are preparing for the vital summer season. The flash July services PMI declined by 2.8ppt on the month to 51.2

Recovery is underway, but some distance remains

- The weakness of the yen and China's production constraints boosted exports, which rose to their highest levels on record, but imports also kept pace – leaving the trade deficit wider in Q2. Softer commodity prices should see imports stabilize and recovery in China should support external demand. The impact of rising inflation is weighing on consumers, real wages fell by 1.8% on the year in May. Currency weakness is likely to keep the cost of imported goods elevated and government's intervention to cap gasoline prices are likely to prevent inflation rising above 3%, we expect consumption to remain weak this year.

COVID-19 have picked up as Japan faces a seventh wave

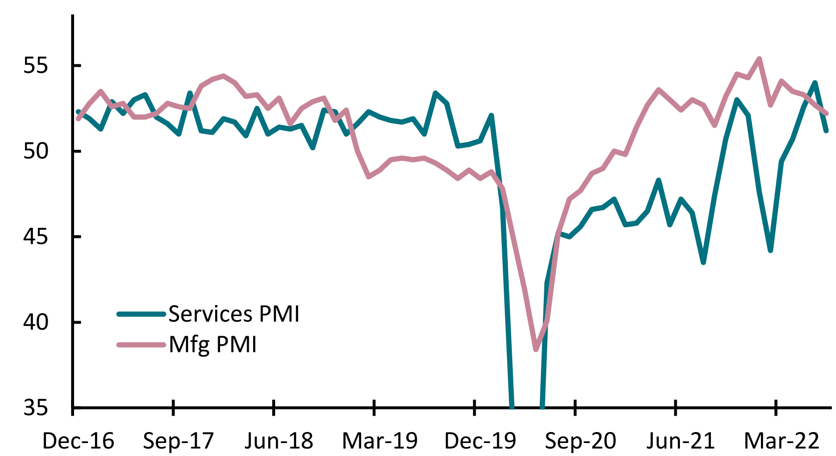
Japan new Covid-19 cases and deaths per mil



Source: OWID, AXA IM Research, July 22

PMIs reflect rising COVID concerns

Japan Purchasing Managers' Index (PMI)



Source: IHS Markit, AXA IM Research, July 22

BoJ holds steadfast

Japan

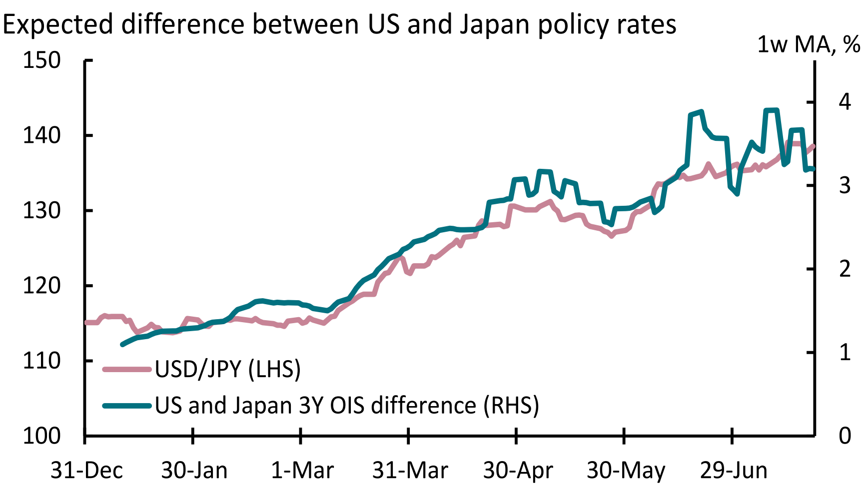
The yen continues to slide

- The yen continues to fall against the dollar, although the pace of the deprecation has slowed. The yen is at a 24-year low.

Governor Kuroda signals ‘no intention’ for policy change

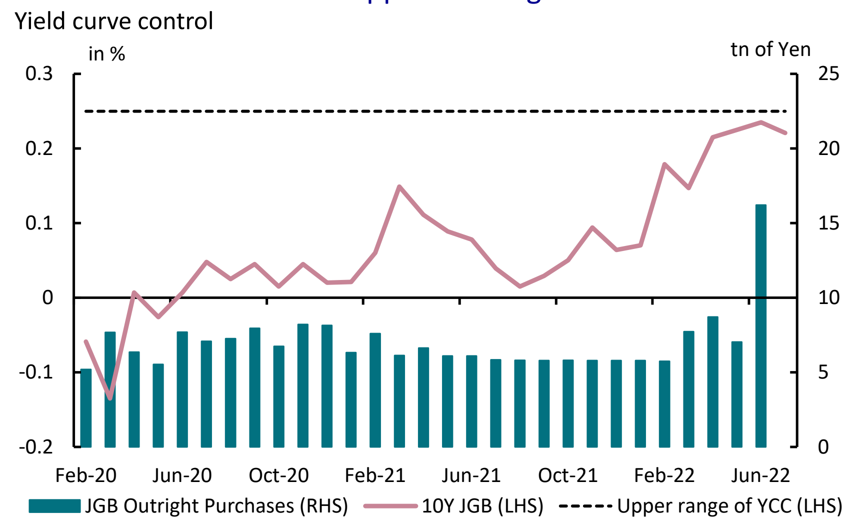
- In July the Bank of Japan (BoJ) reaffirmed its commitment to maintaining accommodative policy and kept all tools unchanged, despite raising their inflation forecasts to 2.3% for the year ending in March. Governor Kuroda remarked that the BoJ has “no intention at all of raising rates under the yield curve control (YCC) framework” and further argued they have “no intention at all of expanding the 0.25% range on either side of the yield target”.
- We acknowledge the pressure on 10-year Japanese Government bonds (JGBs) as these have traded close to the 0.25% upper limit and the yen has continued to depreciate, but we see a low probability of any change in policy in the coming months. Rising inflation expectations could give the BoJ scope to begin to tighten over the longer term, but we are far from this point right now

The yen has extended its declines against the dollar



Source: Refinitiv, AXA IM Research, July 22

10Y JGBs remain close to upper YCC target



Source: Bank of Japan, Refinitv, AXA IM Research, July 22

Inflation and labour market show first signs of easing

Canada

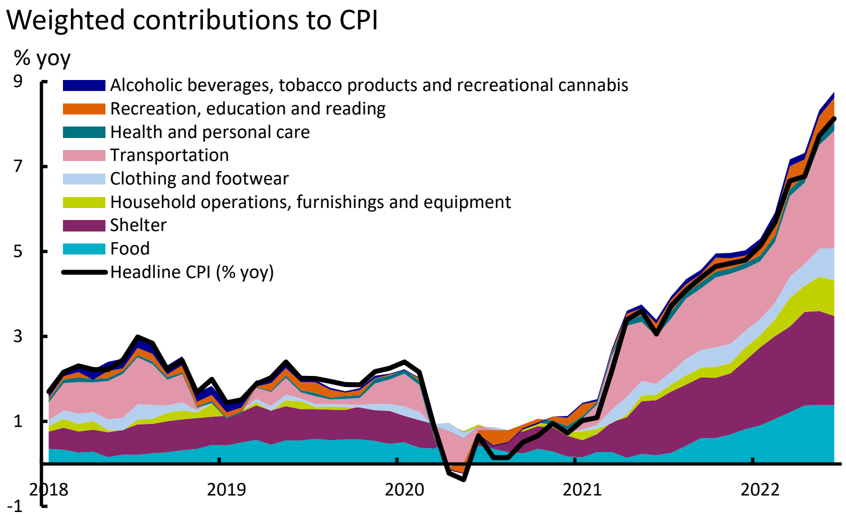
Inflation still rising, but downside surprise

- Inflation continues to rise in Canada and as elsewhere the impact of energy has been a key driver in recent months impacting both through transport (motor fuel) and shelter (household energy use). However, there are some signs of moderation in broader categories. June's CPI increased to a fresh near 40-year high of 8.1% - but it came in below market expectations. We have raised our forecasts for inflation to 7.0% from 6.7% for this year, but leave our 2023 outlook unchanged at 3.4% (consensus 6.9% and 3.4%).

Labour market tight, but showing signs of weakening

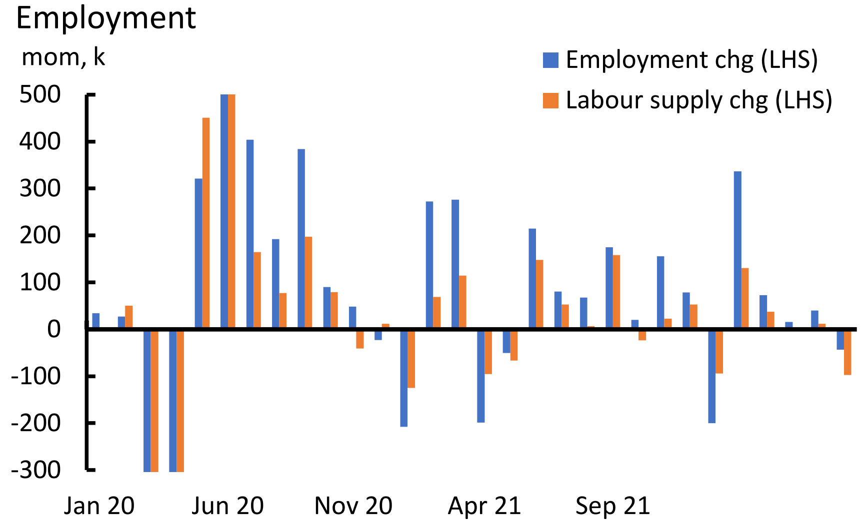
- The labour market remains tight with Canadian unemployment falling to a new record low of 4.9%. Yet the latest drop is not a sign of strength. Payrolls posted their first decline since the sharp COVID-induced drop in January, falling by 43k in June. Unemployment dropped as the labour supply contracted by an even larger 98k. A lack of available labour is a longer-term constraint to the economy and Canada remains reliant on a rebound in immigration. However, we will watch for further declines in employment.

CPI rises further, but surprises to the downside



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

Labour market begins to soften



Source: CANISM, AXA IM Research, July 2022

BoC acts “forcefully”, but is it consistent with a “soft landing”?

Canada

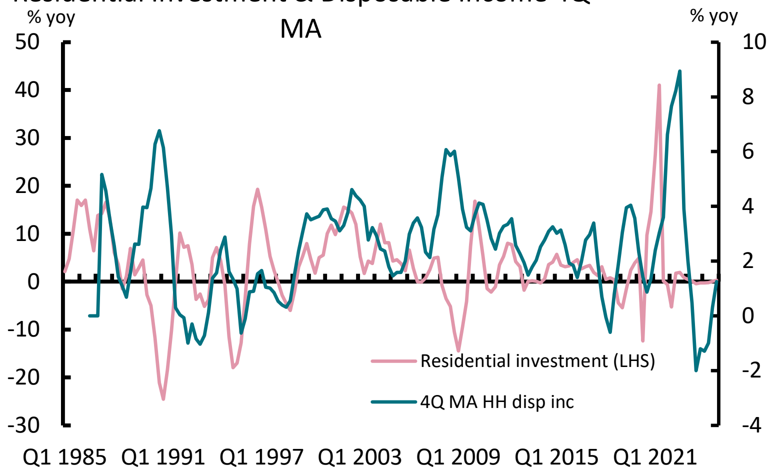
BoC surprises with 100bps hike

- The BoC raised its overnight lending rate by 100bps. Following the Fed’s 75bps we had argued it would move by more than June’s 50bps, but were surprised. The BoC argued that “front-loading” hikes tended to be associated with “soft landings”. A strong policy response should help anchor inflation expectations and reduce the cost of restoring price stability. However, large moves risk their own dislocations. We do not expect another large increase from the BoC. We forecast the policy rate at 3.50% by year-end.

Activity showing signs of weakening

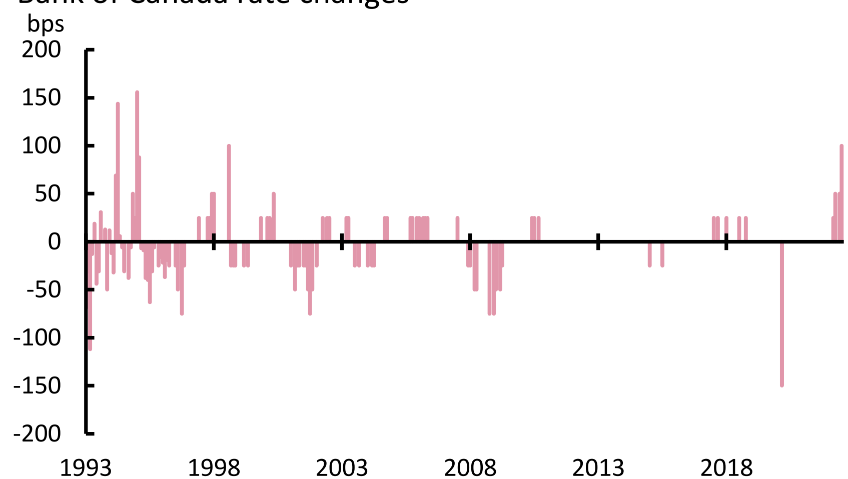
- The housing market has already reacted to the tightening in policy rates, which has quickly fed through to mortgage rates. Other interest rate sensitive sectors of the economy may also soften and GDP was estimated to have contracted in May. The BoC acknowledged a sharply weaker outlook and in its July forecast round reduced its growth forecasts to 3.5% and 1.7% for this year and next (from 4.2% and 3.2%). This brought their view exactly in line with our own (consensus 3.6% and 1.9%).

Housing faces strong headwinds from income squeeze



Source: CANISM, AXA IM Research, July 2022

BoC raises rates by 100bps for first time since 1998



Source: BoC, AXA IM Research, July 2022

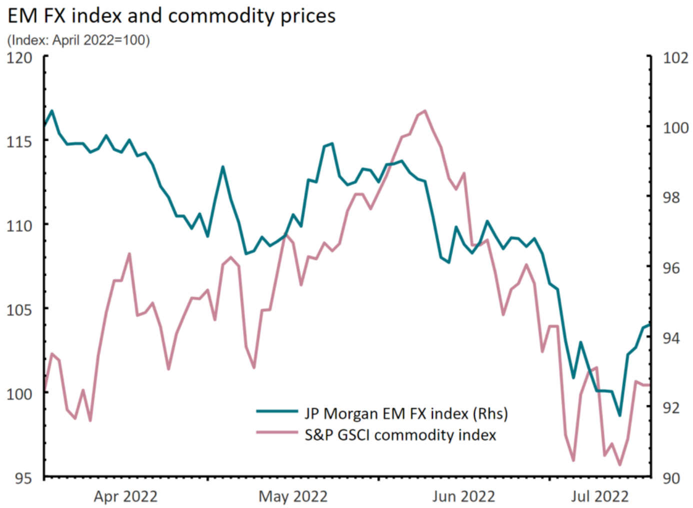
FX weakness in EM

Emerging Markets

EM currencies under pressure amid global recession fears and falling commodity prices

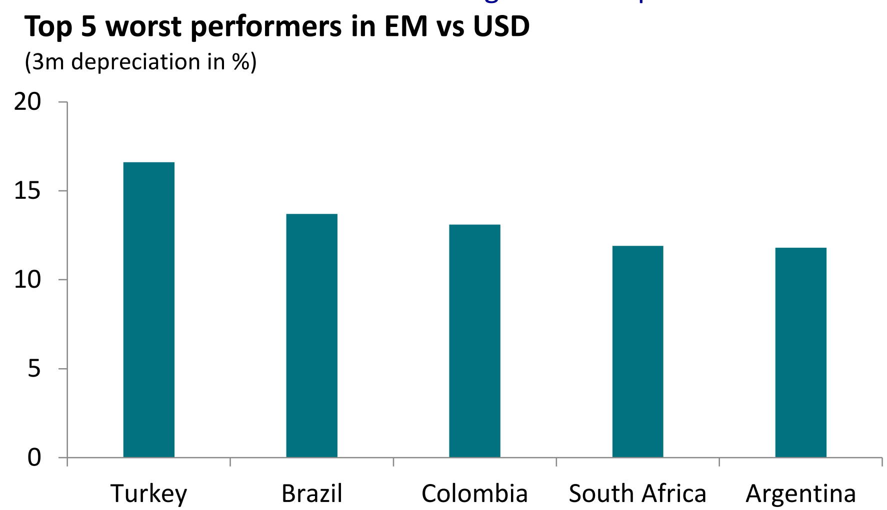
- EM currencies have tumbled in the last few months due to lower commodity prices and higher demand for the safe-haven US dollar amid growing fears of a global recession and an energy crisis in Europe. Countries like Chile have already intervened in the FX market to prop up their currency and others could soon follow if the dollar continues to strengthen.
- Despite a mature hiking cycle, Latin American currencies have borne the brunt of the fall as their currencies are more closely linked to commodity prices. Mexico is an exception to the trend as it’s a favourite among carry traders and is, in fact, one of the best performing EM currencies in the last three months.

EM FX and commodities are moving in tandem



Source: Datastream, AXA IM Research, July 2022

Latin American countries are among the worst performers



Source: Bloomberg, AXA IM Research, July 2022

Vulnerabilities to higher global/domestic interest rates

Emerging/Frontier Markets

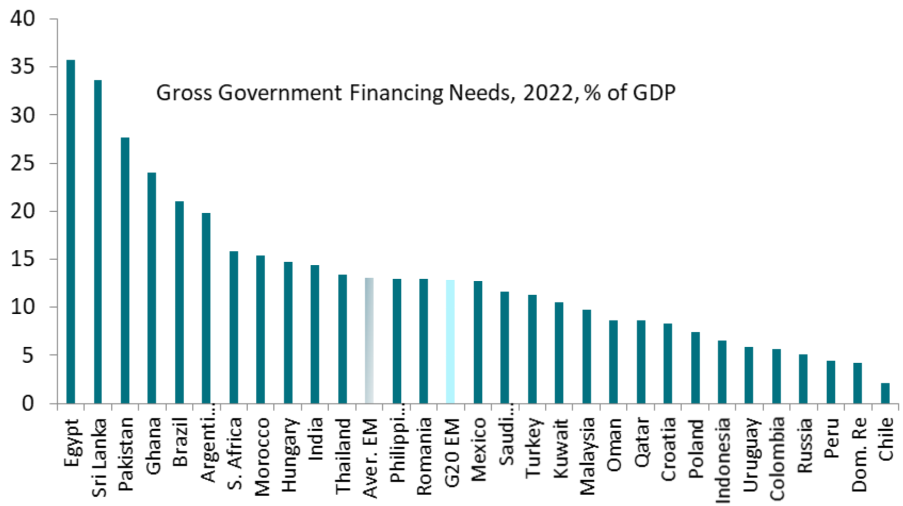
External shocks (Covid-19/war in Ukraine) caused BoP issues to several fragile EMs …

- With large rollover needs and wide budget deficits, a few EM countries have proved particularly vulnerable to the rise in global and domestic interest rates.
- External shocks have acted as catalysts in some fragile EMs, causing BoP weakness and a decline in FX reserves: lower tourism revenues and/or remittances during the pandemic have exacerbated the current account imbalances; higher food and energy import bills in the aftermath of the Russian invasion of Ukraine hit net importers (e.g. Egypt, Sri Lanka…).

… further exacerbated by tighter financial conditions

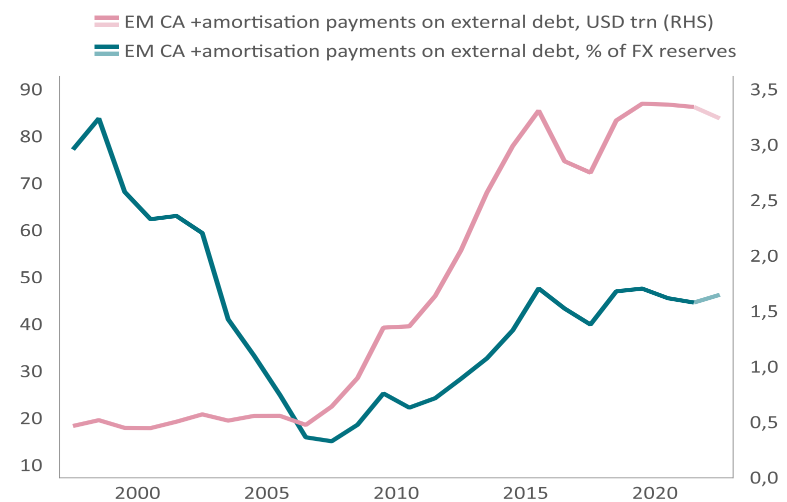
- Although EM FX reserves have overall increased in recent years, external financing needs (=current account deficit + amortisation on external debt) are heavier than during GFC as a share of exports, which makes EM sensitive to a tightening in global financing conditions.

Very large government funding needs in Egypt, Sri Lanka, Ghana



Source: IMF, AXA IM Research, July 2022

Significant external financing needs, despite higher FX reserves



Source: Macrobond, IMF, AXA IM Research, July 2022

Investment Strategy

Multi-Asset Investment views

Our key messages and convictions

Negative on Equites

#1
Economic activity rapidly decelerating while persistent inflation pressuring central banks to slow growth further

#2
Valuations have improved following recent spread widening albeit not attractive enough to warrant being overweight

Neutral on Investment Grade Credit

Neutral Sovereign Bonds

#3
Central banks hiking cycle priced in, limiting bond yield upside. But inflation has not yet peaked

#4
Pricing at levels consistent with positive returns over medium term. However, default expectations should further increase as activity decelerates

Neutral on High Yield credit

Source: AXA IM as at 25/07/2022

FX Strategy

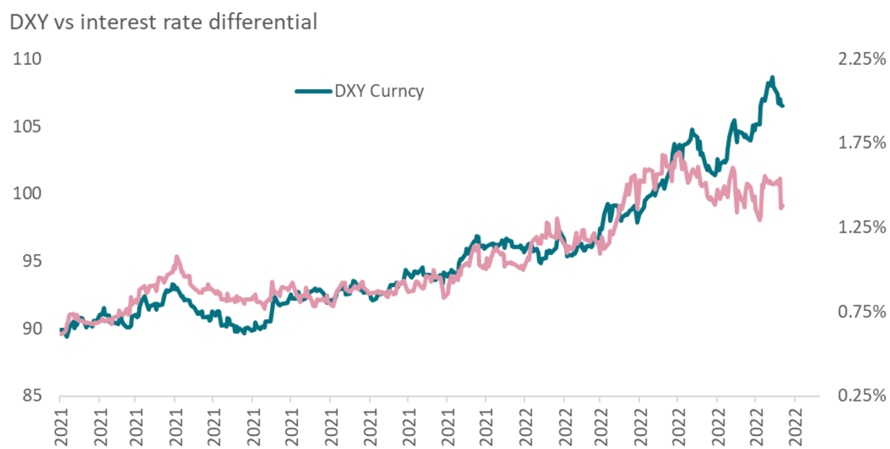
Risk sentiment taking over with fewer places to hide

- USD has been buoyed by the more advanced US cyclical position and US rates rising faster. Rising recession risks are now taking over in pushing the USD higher via risk-off sentiment despite stalled US rates. This can run further while Fed hawkishness is not reduced.

- JPY and in particular EUR are not reliable safe havens to rival USD this time. High energy prices are eating away at the structural support from current account surpluses, and in the case of the EUR pushing down PPP fair value. Despite high expectations, the ECB is not facing endogenous durable wage growth pressures as the Fed. External threats to EU growth are rising, from gas supply to Zero Covid policy that is disrupting China's demand of EU exports. And Italian politics are now adding noise when ECB's TPI was supposed to calm markets.

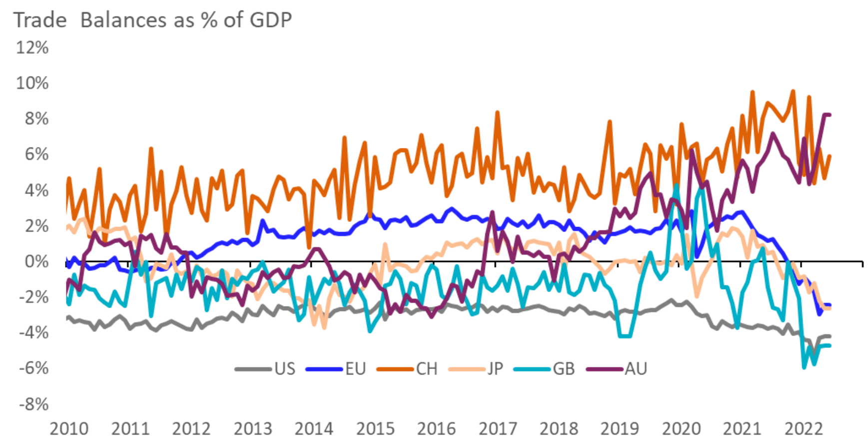
- CHF may outperform. SNB has taken a hawkish U-turn to focus on fighting rising domestic inflation. Swiss growth may also be shielded by a lower energy dependency and less energy-intensive industry. AUD too may outperform other risky assets. Australia labor market is getting extremely tight and the RBA tightening cycle is still young. Gas exports are taking over from iron ore prices in generating further budget and trade balance surpluses.

USD support switching from US rates to recession risk



Source: Bloomberg and AXA IM Research calculations

Structural trade flow support for EUR and JPY vanishing



Source: Bloomberg and AXA IM Research calculations

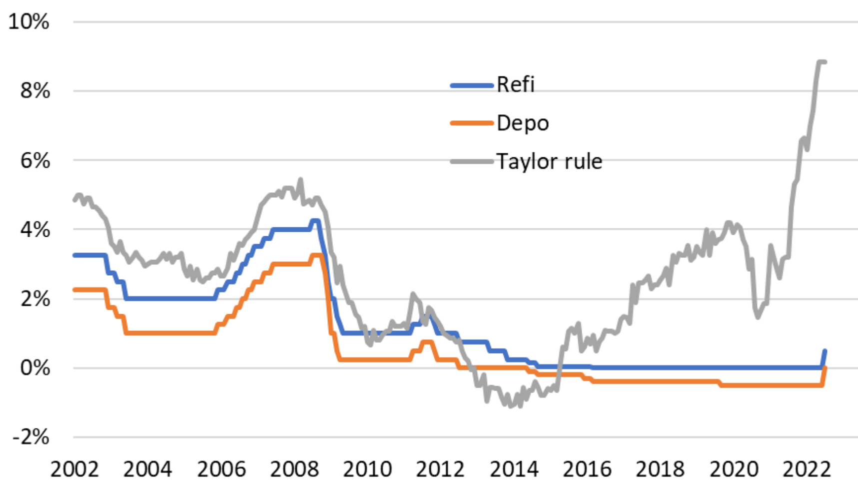
Rates Strategy

Policy dilemma for the European Central Bank

- Very elevated, broad based and persistent inflation; waning growth and the risk of an energy sudden stop; and the risk of fragmentation in policy transmission are creating a complex policy dilemma for the ECB.
- While, currently, monetary policy may appear behind the curve, according to the traditional Taylor rule approach rate, such a gap could narrow fairly swiftly if the euro area was to enter a significant recession.
- Fragmentation within peripheral markets is not that evident yet, as yields have risen in tandem with their historic volatility profiles and EGB spreads vs Bunds have widened broadly in line in beta-adjusted terms. Thus comparing Italy government spreads to Spain government spreads suggest little abnormal dynamics; while there are some tentative signs of decompression between Italian and French spreads.

Despite the 50bp hike a large policy gap remains for the ECB

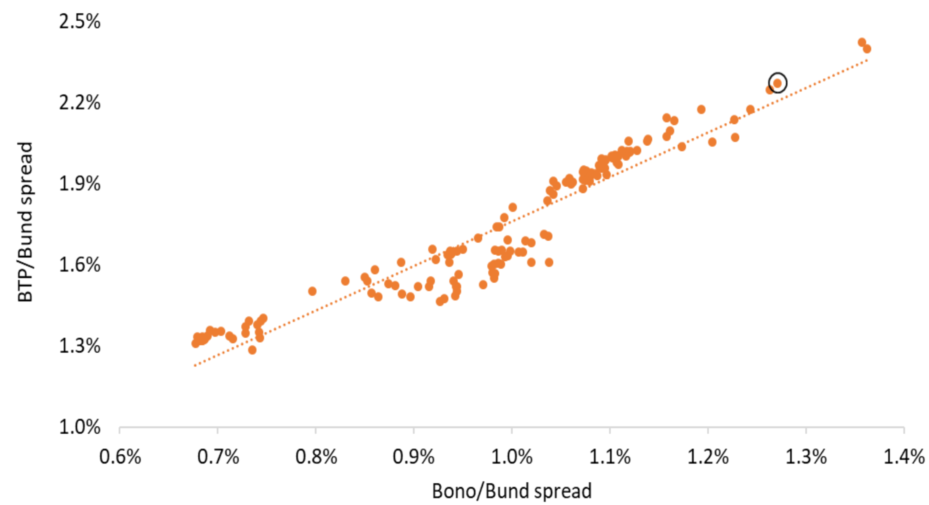
ECB Policy Rates vs Taylor Rule



Source: Bloomberg and AXA IM calculations, July 2022

No divergence yet evident within peripheral government bond spreads

Italy vs Spain, spread to Bunds



Source: Bloomberg and AXA IM calculations, July 2022

AXA Investment Managers

Credit Strategy

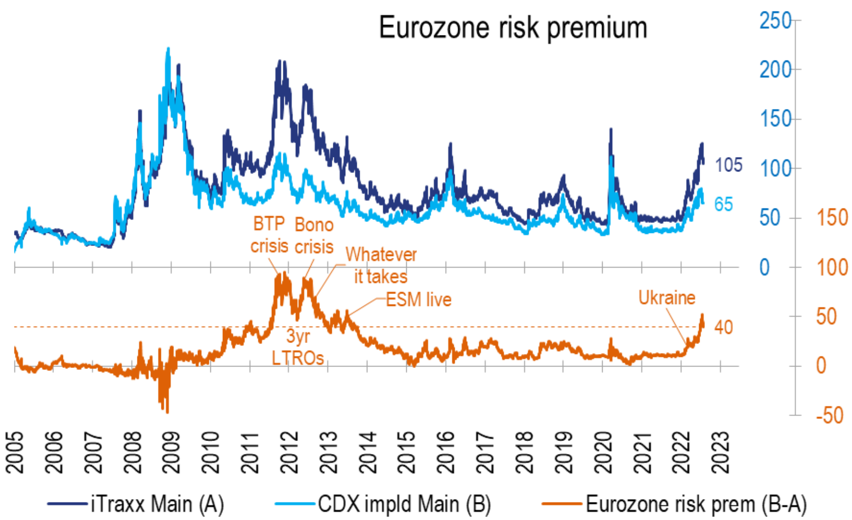
Euro credit yields – the value that dares not speak its name

- European risk premia have underperformed markedly since the invasion of Ukraine by Russia, given the closer proximity to risks from the conflict and the energy shock. The CDS implied euro risk premium jumped to over 50bp in mid July (has retraced since), levels not seen since the depth of the euro sovereign debt crisis.

- The repricing in spreads together with the rise in underlying government yields has driven credit yields to very elevated levels historically. Adjusted for FX hedging costs from USD to EUR and normalised for duration mismatch, the pick up in EUR credit yield over its USD equivalent is at levels not seen since the euro sovereign debt crisis. Very attractive relative value.

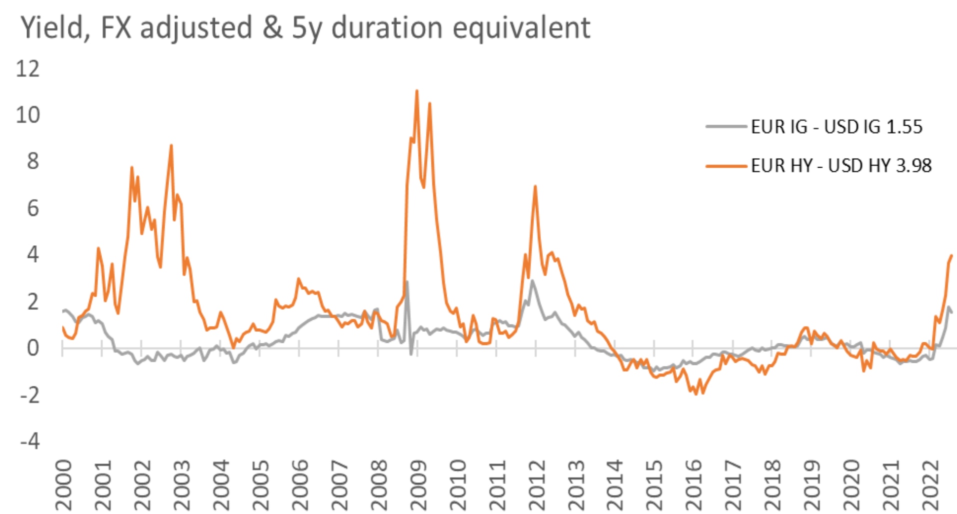
- But this comes with some key macro risks attached. Higher risk of recession in Europe due to the sudden-stop risk in gas supplies. A material increase in refinancing costs, as current yields imply a doubling in the cost of debt over the weighted average life of EUR credit indices. This would require mid-to-high teen figures in earnings growth to overcome, almost double the median corporate earnings growth in Europe.

CDS implied euro risk premium shot up to euro crisis levels in July



Source: Bloomberg and AXA IM Research, 22 Jul 2022

Pickup in yield in EUR credit vs USD credit historically very high



Source: Bloomberg, ICE and AXA IM calculations

Equity Strategy

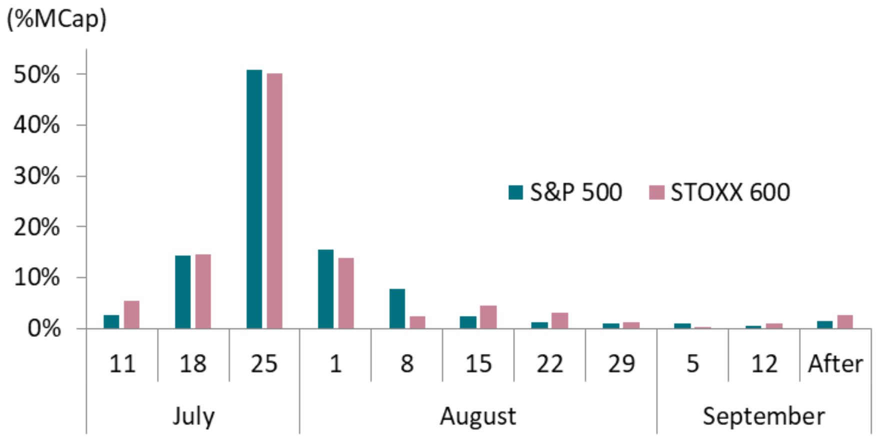
Floor seats

- Earnings season: at the time of writing, less than 20% of S&P 500 (18%) and STOXX 600 (19%) companies have reported their financial results. In the US, earnings surprised on the upside (+4.8%) despite a decline in annual growth (-4.7%). In Europe, the picture is less positive - the bottom line came below analysts' expectations (-6.2%) while growth is in steep decline (-42%). The bulk of reporting will take place during the week of July 25, where we will have more visibility on companies' expectations for year-end in an environment where sentiment, rising input prices and short-term indicators point to a deterioration of growth prospects.

- Deterioration in sentiment and technicals pausing for breath: Using implied volatility of US equities and the difference between bear and bull individual investors as proxies respectively - we observe a slowdown in risk-off momentum since mid-June. The lack of reactivity of the equity market to the latest surprisingly high inflation number suggests that the market has fully digested the fact that consumer prices are likely to remain high for some time. And secondly, the shift in focus to economic growth prospects, for which the release of earnings will be critical.

The bulk of reporting in the week of the 25th will guide us

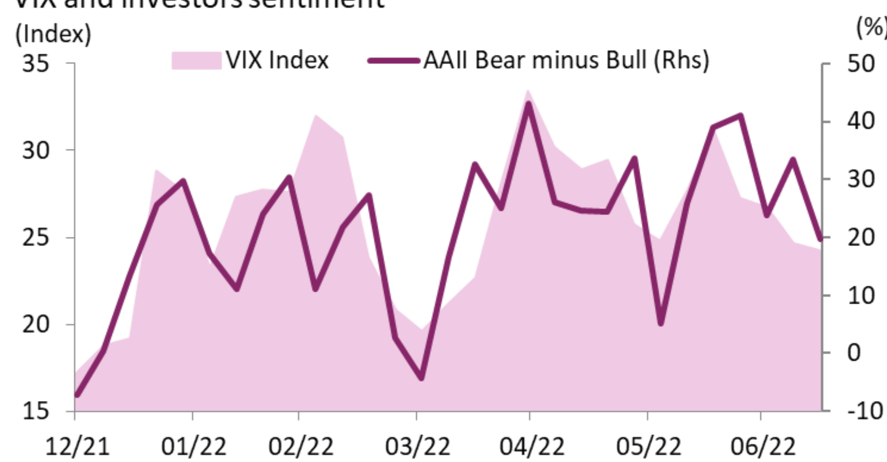
Q2 earnings season distribution



Source: Bloomberg and AXA IM Research, July 2022

Sentiment and technicals appear to be in sync

VIX and investors sentiment



Source: CBOE, AAII and AXA IM Research, July 2022

Asset allocation stance

Positioning across and within asset classes

Asset Allocation

Key asset classes

Equities	■		
Bonds		■	
Commodities		■	
Cash			■

Equities

Developed

Euro area	■		
UK		■	
Switzerland		■	
US	■ ▼		
Japan		■	

Emerging & Equity Sectors

Emerging Markets		■	
Europe Cyclical/Value		■	
Euro Financials		■	
European Autos		■	
US Financials		■	
US Russell 2000		■	

Fixed Income

Govies

Euro core		■	
Euro peripheral		■	
UK		■	
US		■	

Inflation Break-even

US		■	
Euro		■	

Credit

Euro IG		■	
US IG		■	
Euro HY		■	
US HY		■	

EM Debt

EM Bonds HC		■	

Legend Negative | Neutral | Positive

Change ▲ Upgrade | ▼ Downgrade

Source: AXA IM as at 25/07/2022

AXA Investment Managers

Forecasts & Calendar

Macro forecast summary

Forecasts

Real GDP growth (%)	2020	2021*		2022*		2023*	
		AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
World	-3.1	6.1		3.1		2.8	
Advanced economies	-5.0	5.1		2.4		1.1	
US	-3.4	5.5	5.6	1.9	2.6	0.8	1.8
Euro area	-6.4	5.3	5.1	2.8	2.8	0.7	2.0
Germany	-4.6	2.9	2.7	1.5	1.8	0.7	2.1
France	-8.0	6.8	6.6	2.3	2.5	0.8	1.6
Italy	-9.0	6.6	6.3	2.7	2.6	0.2	1.7
Spain	-10.8	5.1	4.7	4.2	4.3	0.6	3.0
Japan	-4.9	1.7	1.8	1.6	1.7	1.9	1.9
UK	-10.0	7.2	7.0	3.7	3.5	0.9	0.8
Switzerland	-2.5	3.5	3.5	2.5	2.5	1.0	1.6
Canada	-5.2	4.4	4.5	3.5	3.7	1.7	2.3
Emerging economies	-1.9	6.7		3.5		3.9	
Asia	-0.7	7.0		4.3		5.0	
China	2.2	8.1	8.0	3.6	4.3	5.2	5.2
South Korea	-0.9	4.1	4.0	1.5	2.7	1.6	2.3
Rest of EM Asia	-4.2	6.1		5.5		5.2	
LatAm	-7.0	6.8		2.6		1.9	
Brazil	-3.9	4.6	4.7	1.4	1.3	0.5	1.1
Mexico	-8.2	4.8	5.6	1.5	1.8	1.5	2.0
EM Europe	-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	4.9	2.0	2.7
Turkey	1.6	11.5	9.9	4.6	3.0	2.0	2.4
Other EMs	-2.5	5.4		4.2		3.7	

Source: Datastream, IMF and AXA IM Macro Research – As of 25 July 2022

* Forecast

Expectations on inflation and central banks

Forecasts

Inflation Forecasts

CPI Inflation (%)	2020	2021*		2022*		2023*	
		AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	0.7	3.2		7.1		3.6	
US	1.2	4.7	4.6	8.4	7.7	4.5	3.6
Euro area	0.3	2.6	2.5	7.6	7.2	3.5	3.2
China	2.5	0.9	0.9	2.1	2.2	2.3	2.3
Japan	0.0	-0.2	-0.2	2.2	1.9	1.0	1.2
UK	0.9	2.6	2.5	8.7	8.5	4.8	5.2
Switzerland	-0.7	0.5	0.5	2.0	2.3	1.0	1.2
Canada	0.7	3.4	3.4	7.0	6.3	3.4	3.1

Source: Datastream, IMF and AXA IM Macro Research – As of 25 July 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
United States - Fed	Dates	1.50-1.75	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		+1.25 (2.75-3.00)	+0.25 (3.00-3.25)	unch (3.00-3.25)	unch (3.00-3.25)
Euro area - ECB	Dates	-0.50	21 July 8 Sep	27 Oct 15 Dec	2 Feb 16 Mar	4 May 15 Jun
	Rates		+1.00 (0.50)	+0.75 (1.25)	unch (1.25)	unch (1.25)
Japan - BoJ	Dates	-0.10	20-21 July 21-22 Sep	27-28 Oct 19-20 Dec	Jan Mar	May Jun
	Rates		unch (-0.10)	unch (-0.10)	unch (-0.10)	unch (-0.10)
UK - BoE	Dates	1.00	4 Aug 15 Sep	3 Nov 15 Dec	Feb Mar	May Jun
	Rates		+0.75 (2.00)	+0.25 (2.25)	unch (2.25)	unch (2.25)

Source: AXA IM Macro Research - As of 25 July 2022

Calendar of 2022 events

2022	Date	Event	Comments
	Q3-Q4 2022	Chilean Constitutional Referendum	
August	August	US Federal Reserve Jackson Hole Symposium	
	4 August	UK Monetary Policy Report & MPC Summary and minutes	
September	5 September	UK Conservative Party Leader Result	
	15 September	MPC Summary and minutes	
	21 September	FOMC meeting	
	25 September	Italian Elections	
October	October	China's 20th 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

Equity market compass in the Fed’s hiking trail

11 July 2022

June Global Macro Monthly – A summer of discontent

29 June 2022

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

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