Investment Managers

Investment Institute Macroeconomics

Economic cross-currents and central bank re-pricing

Monthly Investment Strategy

AXA IM Research

February 2023

Summary: February 2023

Theme of the month: ECB QT: Navigating a treacherous path

- Following a sharp overshoot in the ECB's inflation target – one that has reversed the accumulated price gap of the previous 20-years – the ECB has tightened policy sharply and is about to join other developed central banks in gradually unwinding its asset purchases.
- ECB quantitative tightening – though expected to be gradual – will add to near-record levels of Eurozone government bond issuance this year. Adding in ECB maturities, overall levels should reach record highs since 2008 – sharply higher in contrast to previous years where the ECB purchased bonds.
- Our analysis suggests particularly sharp supply in June and September, which could make market conditions quite fragile. We estimate a simple macro fundamentals model for 10-year government bond spreads that suggests further yield increases are likely.

Macro update: Economic cross-currents prevail, but central banks to do more

- Economic data presents uncertainties in several regions: China's re-opening looks strong in high-frequency numbers, but divergence with official data has been a feature; the Eurozone avoided sharp contraction this winter, but individual sectors remain stressed; the US appears to have more momentum, but housing and industry are under pressure. In total, the growth outlook for 2023 appears better than we feared, but headwinds remain.
- Inflation has fallen sharply, but in several jurisdictions this is thanks to wholesale energy costs or other exogenous factors. Endogenous inflation pressures – tight labour markets pushing service sector inflation – remain elevated and are likely to be the increasing focus of central banks.
- Despite economic cross currents, we continue to suggest a more hawkish outlook for most central banks. We continue to expect the ECB to raise rates to at least 3.25% in May; we increase our Fed outlook to 5.25% in May and see greater risks of 5.50% than 5.00%; the BoE also looks set to raise rates further; on balance we think the BoC will probably remain at 4.25%, but there are risks here. We await Ueda's testimony for clues as to the BoJ outlook.

Investment Strategy: risky assets so far resilient to latest hawkish heave

- FX: Significant revisions to US inflation and employment have pushed US rates and the USD higher recently. But the structural shifts since the end of 2022 are still at play and should ultimately pull the USD lower in the medium term. CHF 2022 outperformance to unwind. JPY structural rebound not over yet.
- Rates: The market is in the process of revising recession risk as well as the 'high-for-longer' inflation scenario. Recent Fed-speak is skewed towards a slightly more hawkish stance, as inflation is perceived to be more 'sticky' than previously projected by economic forecasts.
- Credit: Credit spreads have rallied notably since Oct 2022 yet the drawdown in total returns from the late 2021 peak remains at record levels in IG. The upshot to this is that the credit yield continues to be very attractive for investors, including the short end of the curve that is less exposed to duration risk.
- Equities: As the earnings season comes to an end in the US, we note that since its start EPS for 2023 has been revised lower by -0.6%. Beyond the already visible decline in margins, we also expect a slowdown in sales in the months ahead. EPS growth for 2023 is in now line with GDP growth, on historic trends.

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Central scenario

Summary – Key messages

Our central scenario: Global economy to slow, sharp recessions avoided.

We forecast global growth to slow to 2.5% and 2.7% in 2023 and 2024.

Headline inflation to slow, more resilient growth to keep core firmer. Central banks tighter for longer.

Inflation

Supply-chain pressures ease, energy and food base effects strong. Headline inflation to fall sharply in H1 2023. Core slower to fall as labour markets remain tight.

Monetary policy

Most central banks close to peak as headline inflation and inflation expectations soften. Rate cuts unlikely for most in 2023. PBoC and BoJ major exceptions.

Fiscal policy

Europe has provided fiscal supports, but lower energy costs could see consolidation. US debt ceiling debate threatens spending cuts.

Growth

Growth beginning to slow more obviously. Mild recession expected in US, Europe could avoid for now.

Emerging Markets

Inflation should ease across EM. Central banks close to peak, some add FX intervention. Global rate adjustments add to fragile finances

Rates

Term rates remain low relative to policy. Technicals may account for some of inversion, but growth concerns key.

FX

Dollar bounces as Fed rate cut bets fade. Weaker risk outlook would support dollar. Divergent bank policy supports others, particularly euro and yen.

Credit

Spreads have started 2023 on a strong footing, perhaps underpricing recession risk even if balance sheets in good health. Some caution warranted.

Equities

Earnings expectations are key for 2023 returns. A strong start to the year may create complacency given ongoing central banks hawkishness and macro headwinds. Margin pressures on the horizon.

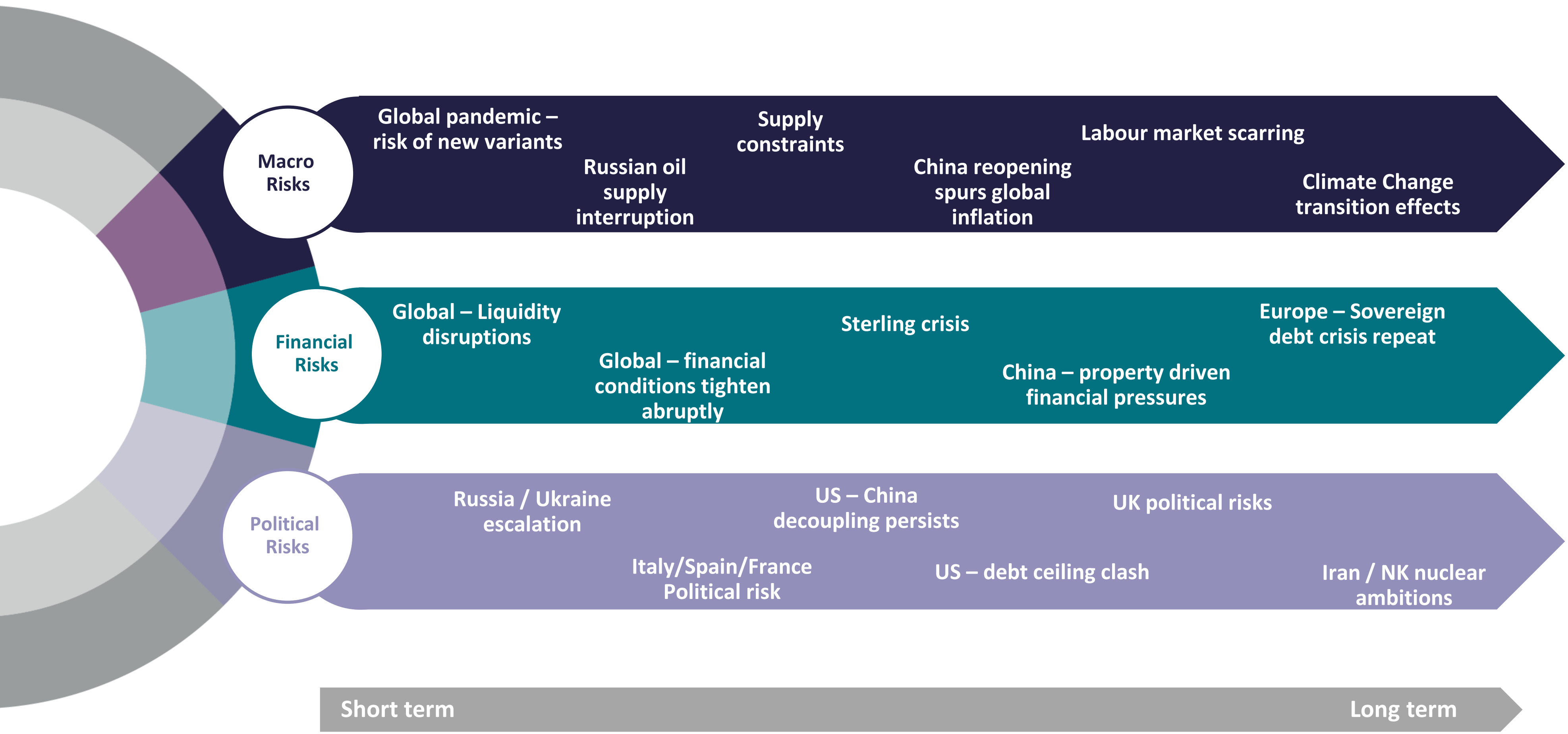
Alternative scenarios

Summary – Key messages

	Entrenched supply shock Probability 15%	**A global boost** Probability 10%
What could be different?	- Escalation in Ukraine conflict - Russian oil 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	- 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 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	- Growth surprises on the upside in most regions - Inflation fades more quickly towards and below central bank targets - Monetary policy softens quicker than signalled
Market implications	- Risk appetite deteriorates / equities sell off / credit widens - Sovereign yields reprice higher - Dollar remains elevated - EM debt to come under pressure	- Risk-on environment, equities make further gains, growth retains lead over value - UST softens, EUR strengthens - Spreads grind tighter

RISk Radar

Summary – Key messages



Contents

Theme of the Month

ECB QT: Navigating a treacherous path

The ECB begins to unwind its balance sheet

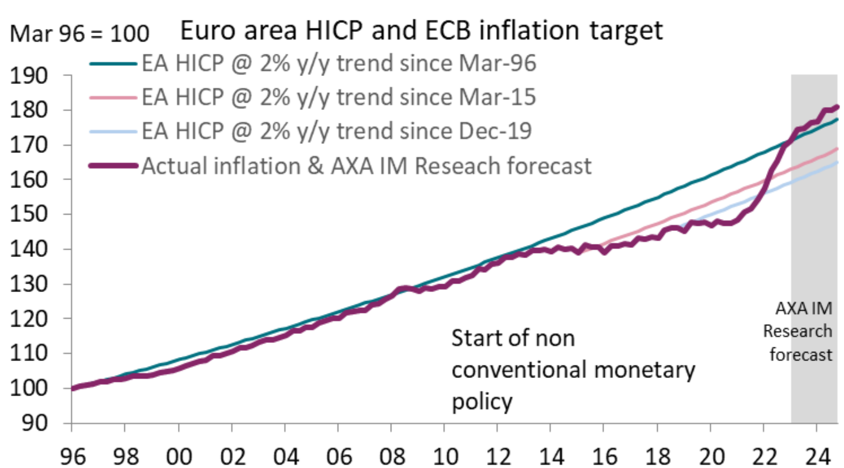
A record inflation surge…

- 18-months of above target inflation has closed the 16.5% price level gap that had accumulated since early 1996.

…leading to historic monetary policy tightening

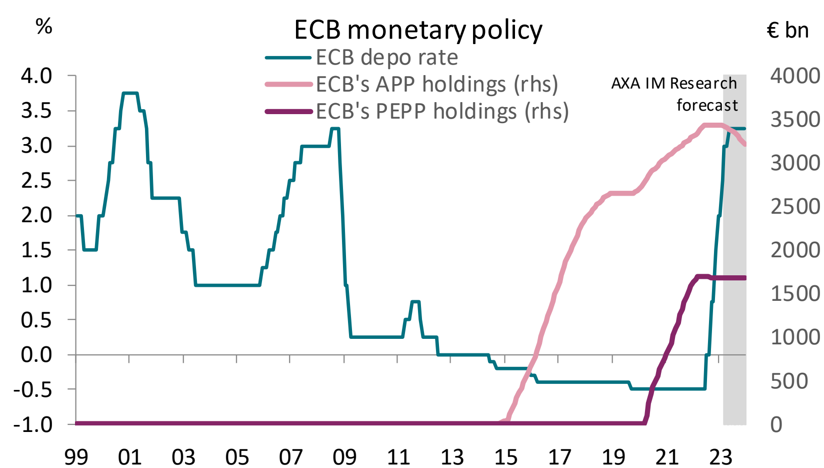
- The ECB ended Pandemic Emergency Purchase Programme (PEPP) and APP net purchases in December 2021 and June 2022 respectively.
- Since July 22, the ECB increased its policy rates by 300bps to 2.5%, intending to "stay the course" with further rate hikes planned.
- At the December 2022 meeting, the Governing Council decided to starting quantitative tightening, by not reinvesting c.€15bn of maturing assets on a monthly basis (roughly 50%) from March until the end of June on its Asset Purchase Programme portfolio.

Euro area inflation diverging from ECB's target…



Source: Eurostat, AXA IM Research, February 2023

…yielded historic monetary policy response



Source: Refinitiv, AXA IM Research, February 2023

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ECB QT: Navigating a treacherous path

Good reasons for prudent QT

Reasons why the ECB has decided to reduce its holdings of APP

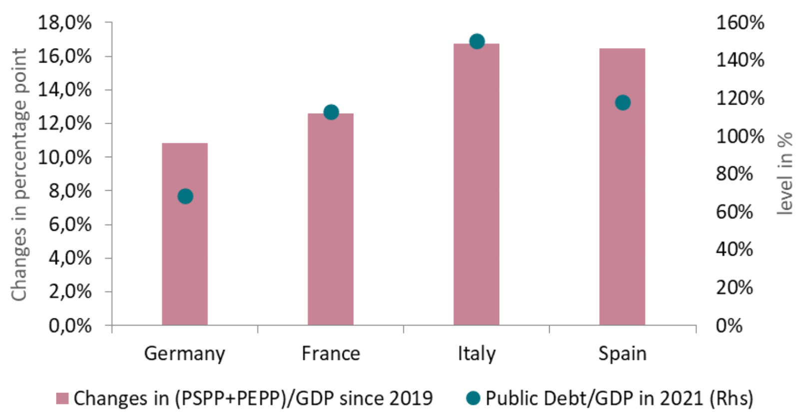
- According to a meta-analysis by the ECB, it is the tool that growth and inflation have benefitted the most from.
- It is the single largest line of assets in ECB's balance sheet.
- Flexible reinvestment of PEPP has been established as the first line of defence against financial fragmentation.

Why the ECB is likely to tread carefully

- There is no historical precedent to gauge market impact, all the more difficult as the ECB withdraws TLTROs at the same time.
- It will occur amidst record planned net issuance since 2008, while public debt-to-GDP ratios have gained ~20pts since COVID-19.
- There can be significant cross-country differences.
- Interest rate to remain primary tool of ECB's monetary policy stance.

Public finance vulnerabilities to lead to a prudent ECB

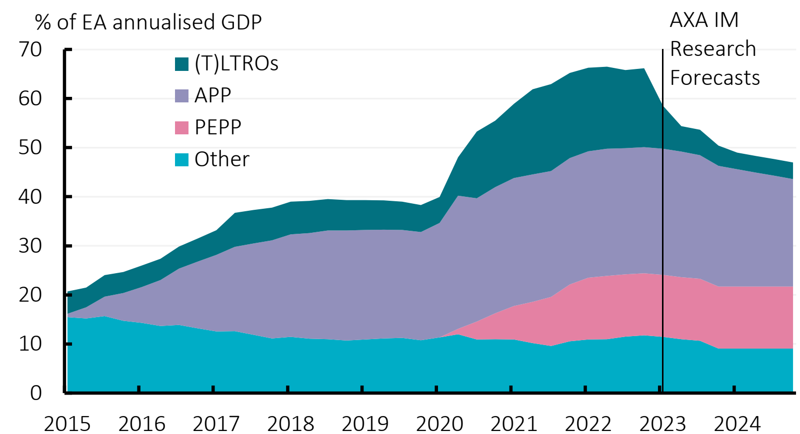
ECB is likely to be prudent



Source: Eurostat, ECB, AXA IM Research, February 2023

A gradual path to APP portfolio unwind

ECB Balance sheet



Source: ECB and AXA IM Research, 20 February 2023

ECB QT: Navigating a treacherous path

Identifying months of possible market stress

QT in the context of record net, net issuance

- EMU-4 net issuance is to reach around €415bn, very close to record highs of 2020-21. Additionally, the partial unwind of the ECBs' APP is likely to add around €95bn (19% of total issuance), bringing this year's total net issuance to an absolute record since GFC. We compute a monthly path for net-net issuance to identify months of possible enhanced market stress.

Main conclusions

- PSPP partial reinvestment matters but is minor relative to the huge net supply the market must digest this year. This contrast is even larger if we allow for ECB QE monthly purchases that will not take place as in the in the last two years. While investors may question the market's absorption capacity, yield grabbing may continue.
- Partial reinvestment from March made sense as net-net supply was huge in the first quarter (36% of FY net issuance is expected to be made in January-February). If the ECB proceeds with no reinvestment at all in 2024, Q1 2024 could prove challenging.
- Our analysis shows months such as June and September have large net-net issuance. This suggest market conditions could be fragile at these times – rather than suggesting a funding accident - especially if in conjunction with other market stresses

All went well so far, yet June and September should be closely monitored

EMU-4	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Total
Gross Issuance	109,5	108,0	103,1	103,3	104,4	98,9	98,8	63,7	92,3	90,1	86,7	34,1	1092,9
Redemptions	37,0	30,5	73,9	65,8	111,4	29,8	51,0	61,5	33,7	118,2	37,9	27,1	677,7
Reinvested by the ECB (PSPP+PEF	14,7	14,4	22,1	21,2	33,4	9,3	11,7	14,5	8,2	28,2	8,0	6,9	192,5
Reinvested by the Markets	22,3	16,1	51,8	44,6	78,0	20,5	39,3	47,1	25,5	90,0	29,9	20,1	485,1
Net issuance	72,5	77,4	29,2	37,5	-7,0	69,1	47,8	2,2	58,7	-28,1	48,8	7,0	415,2
Net QT	0,0	0,0	8,7	8,8	13,2	3,8	9,0	11,3	6,4	21,1	6,3	5,4	94,0
PSPP	0,0	0,0	8,7	8,8	13,2	3,8	9,0	11,3	6,4	21,1	6,3	5,4	94,0
Redemptions	9,0	8,2	17,3	17,5	26,5	7,7	12,0	15,0	8,5	28,1	8,4	7,3	
Reinvested	9,0	8,2	8,7	8,8	13,2	3,8	3,0	3,8	2,1	7,0	2,1	1,8	
PEPP	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Net-net EGB supply	72,5	77,4	37,9	46,3	6,2	73,0	56,8	13,5	65,1	-7,0	55,1	12,5	509,2

Source: Barclays, GS, DB, ECB and AXA IM Research, February 2023

ECB QT: Navigating a treacherous path

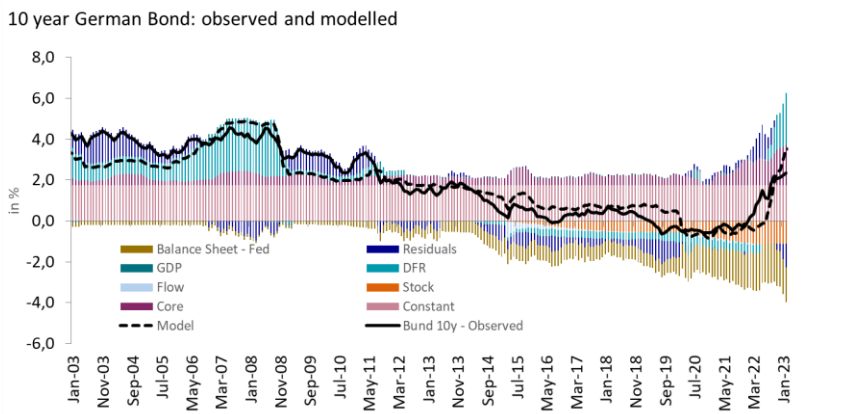
Estimating fair-vale for 10y yields

We provide a simple macro fundamentals model to explain the evolution of 10y sovereign nominal yields (in Germany, France and Italy)

Main conclusions

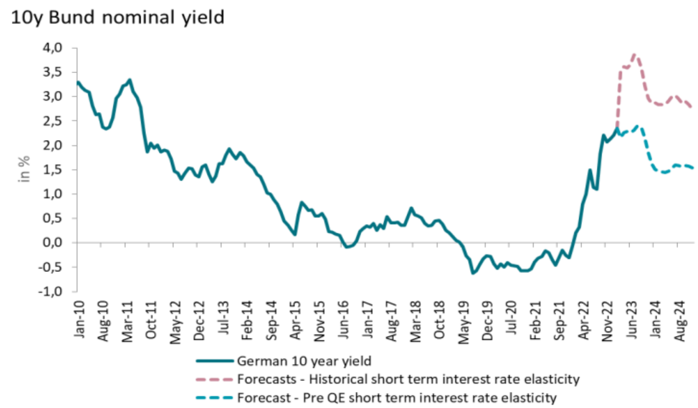
- Core inflation and the policy rate (DFR) are significant drivers for long dated bonds, explaining 53% of dependent variable variance.
- The stock of asset purchases has a much stronger impact than flows, consistent with economic literature.
- The elasticity of domestic asset purchase programmes is three times higher than the impact of worldwide liquidity (proxied by the Fed's Treasury purchases). But the size of Fed purchases (Fed bought 5X UST, than ECB bought Bunds) means the overall impact of the former is stronger. Based on our regression results, we estimate the ECB's stock of APP+PEPP removed the equivalent of 110bps of premia on German bunds. By comparison, proxied worldwide liquidity, compressed Bund yields by 180bps.
- A robustness test on DFR elasticity found results can vary substantially. Estimated over the whole period the elasticity is around twice the pre-QE period (2005-2015) at 0.85 vs 0.42. We use both elasticities to generate an interval for our projections.

Macroeconomic variables are a good proxy for 10-year German yield



Source: Refinitiv, AXA IM Research, February 2023

Model points to short term upside risk for 10-year German yield



Source: Refinitiv, AXA IM Research, February 2023

Macro outlook

Recession doubts

US

Labour market strength

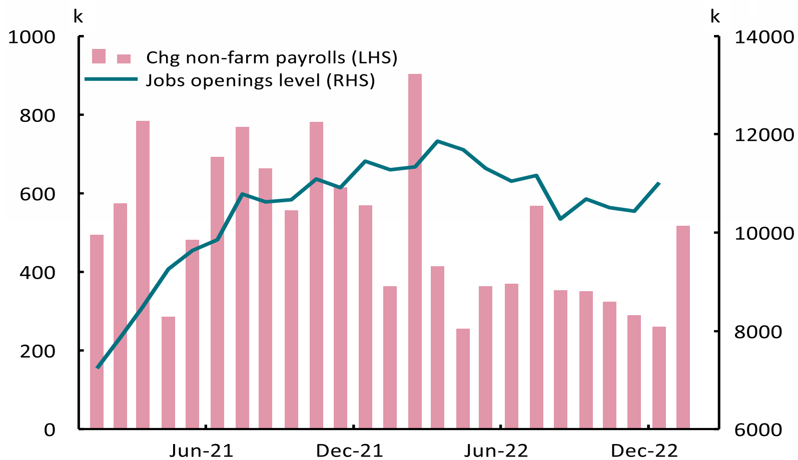
- Payrolls employment rose by 517k in January, the unemployment rate fell to 3.4% - its lowest since May 1969 – and average earnings growth was revised to 5.0% 3m annualised in December, from 4.1%, and stands at 4.6% in January. Nor was strength in this report isolated: initial jobless claims have fallen sharply since end-November and job vacancies rose unexpectedly in December. There is little evidence of a loosening in the labour market and some concerns that it may be tightening further.

Spending given further boost for now

- January's retail sales rose by 3.0%, following the back-to-back falls in November and December that had suggested consumer retracement. This followed a sharp jump in vehicle sales to 15.74m (+18.3% m/m) and its highest since May 2021. The stronger than expected labour market will drive firmer real income growth over the coming quarters, supporting consumer spending further. However, we continue to expect a softening in spending as household excess saving appears likely to be exhausted later in 2023.

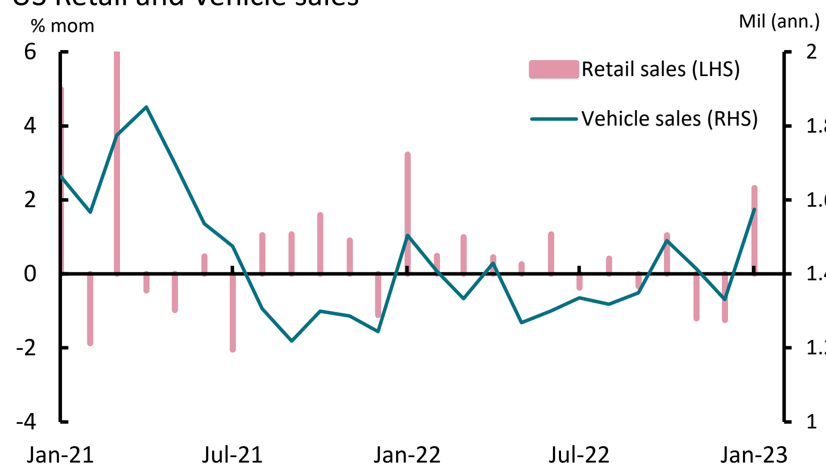
Recent labour indicators strengthen

US Payrolls and JOLTS



January's retail sales point to firmer consumer

US Retail and Vehicle sales



Source: Refinitiv, AXA IM Research, February 2023

Data cross currents make Fed policy making difficult

US

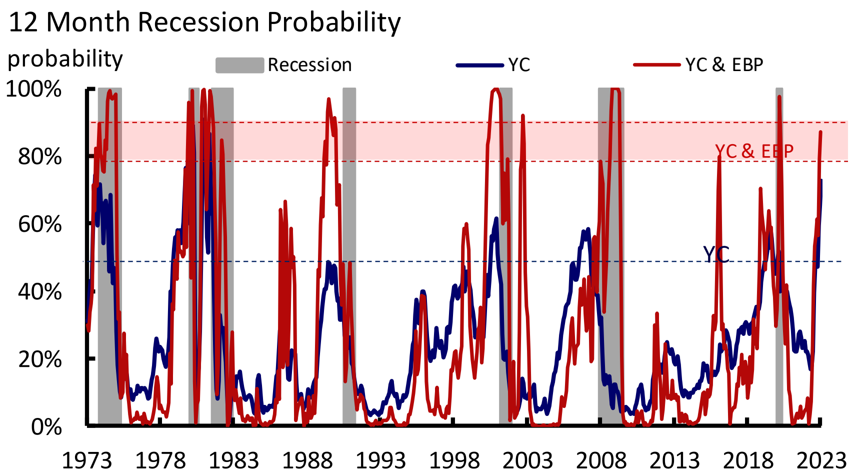
Later recession impacts annual growth rates

- Recent resilience threatens an asynchronous slowdown across sectors where typically synchronised slowdowns result in recession. The risk of the economy muddling through has risen. However, on balance we still consider a mild recession as the most likely outcome, but now see this starting in Q2 2023 at the earliest. This delayed downturn lifts our outlook for GDP growth this year to 0.8% (from 0.1%), but lowers 2024 to just 0.3% (from 0.8%). Consensus estimates are 0.5% and 1.2% respectively.

More Fed, not less

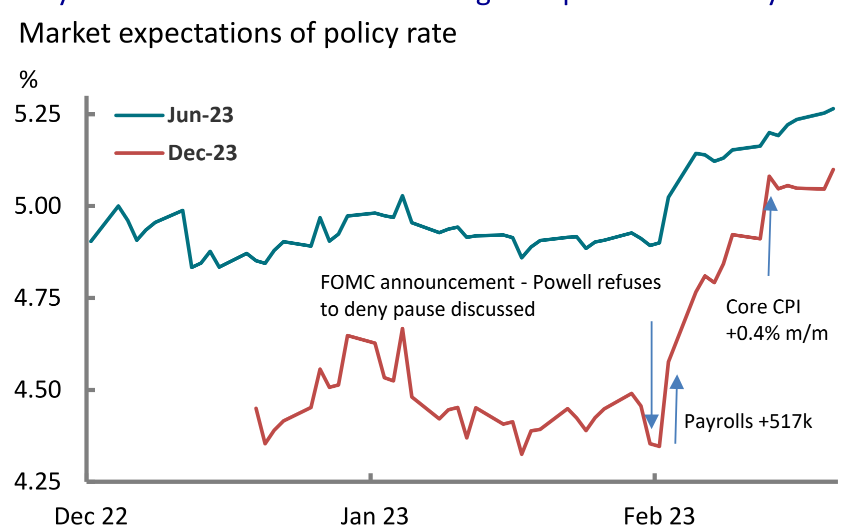
- February's Fed meeting stated that "ongoing increases" were seen as likely. Fed Chair Powell reiterated concerns that a tight labour market would prevent service sector disinflation. However, the rest of the press conference added to views of a Fed pivot as Powell discussed disinflation and refused to deny discussions of a pause. We change our view to a Fed peak at 5.25% in May, but the risks of a higher 5.50% in June have risen. We continue to see the first rate cuts only in 2024.

Recession model signals with more conviction



Source: FRB, NBER, AXA IM Research, February 2023

Wayward communication and strong data provide volatility



Source: Bloomberg, AXA IM Research, February 2023

Near-term activity improved; outlook still subdued

Euro area

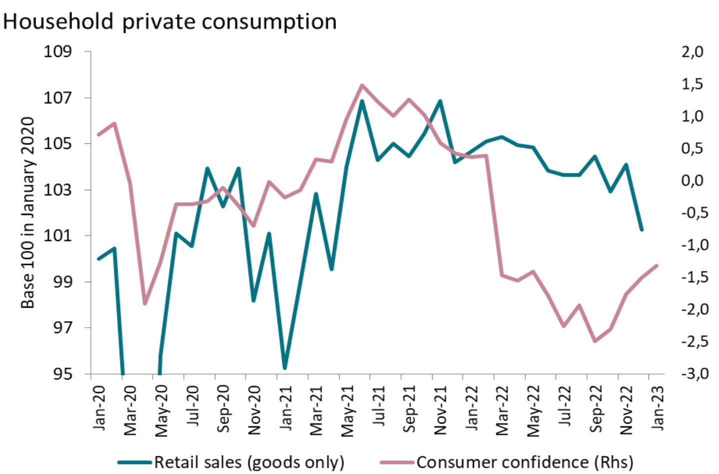
Better-than-expected Q4 GDP growth (+0.1% q/q), but scant details far from being rosy

- Net exports contributed positively to growth, but these were led by imports falling more than exports. Private consumption has been weak as shown by France and Spanish details (-0.9% and -1.8% q/q respectively). GDP was lifted by Ireland's 3.5% q/q rise.

Near term growth is likely to remain weak

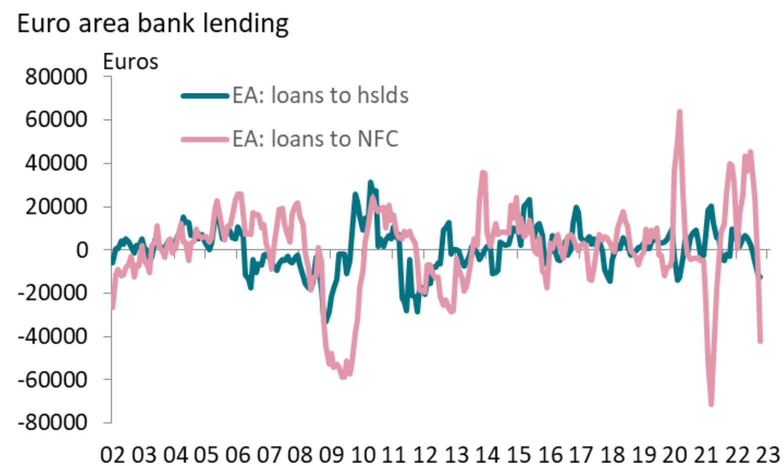
- Demand momentum is weak, as shown by a drop in retail sales in December (-1.1% m/m). This is likely to diminish the carry over for the first quarter. Industrial production also pointed to weaker momentum (-1.1% m/m), pushed down by a sharp decline in Germany (-3.2% m/m). EMU PMIs returned to expansionary territory, but overall economic activity is likely to be slightly positive at best and we can't exclude another negative reading in some countries such as Germany.
- We remain convinced that headwinds are important. Financing conditions continue to tighten and will weigh on already-weak demand (as shown by ECB Bank Lending Survey – right chart). A slowing of US activity in the second half of 2023 is another risk while China reopening may compensate but only partially

Weaker consumption momentum



Source: Refinitiv, AXA IM Research, January 2023

Sharp decline in loan supply



Source: ECB, AXA IM Research, January 2023

The ECB to stay the course

Euro area

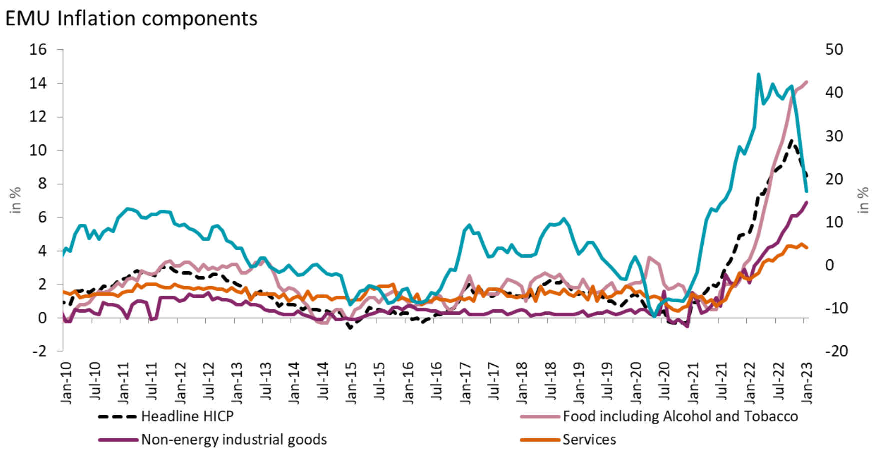
Mixed signal from prices

- Flash January headline inflation eased to 8.5% y/y from 9.2% in Dec (but is likely to be revised up to 8.6/8.7% with the inclusion of German release).
- The drop is only due to lower wholesale energy prices. Final core inflation should finally reach 5.3% from the flash reading of 5.2% (without Germany), unchanged from December. We believe core has reached, or is very close to, a peak - but not expect a fast decline as labour cost concerns rise, gradually replacing supply chain and rising energy cost issues.

Hawkish flip flopping continues

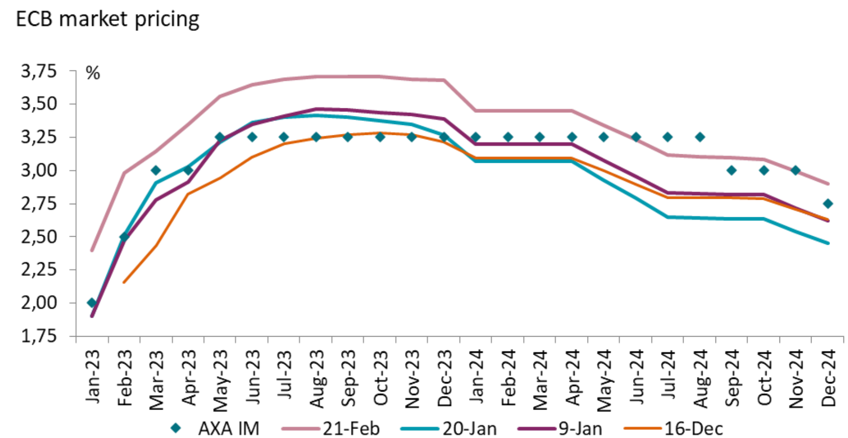
- The Governing Council maintained a hawkish message by committing to a 50bps hike in March and describing the future path as "data dependent". Inflation risks described as more balanced, but "primarily on the upside". Risks that the ECB tightens further remain.
- Our baseline expectation is for the ECB to hike by another 25bps in May, with the risk of adding a further 25bps in June, consistent with a terminal rate at 3.5%, as we have highlighted since December. That would be in line with most recent sharp market repricing.

Inflation is only driven down by energy



Source: Eurostat, AXA IM Research, February 2023

ECB terminal rate pricing is drifting higher



Source: Eurostat, AXA IM Research, February 2023

Signs of moderating price pressures, but more is needed

UK

Growth flatlined in Q4 2022

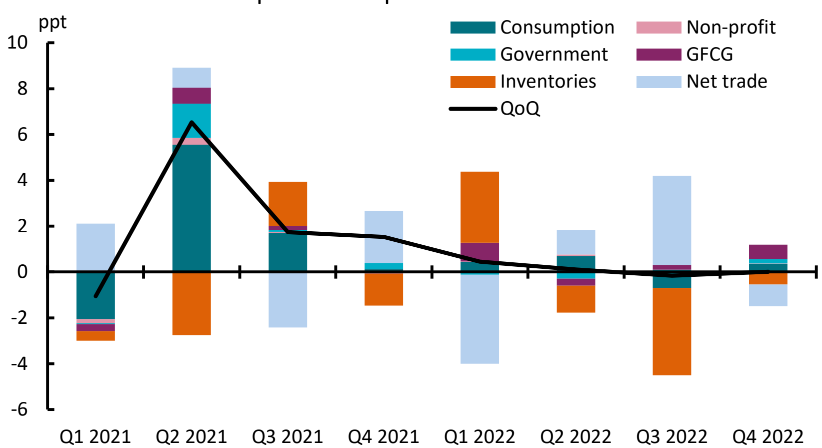
- The economy narrowly avoided recession in 2022, with growth remaining flat in Q4 2022 above our expectations of a -0.1% contraction. The economy remains weak as evidenced by the recent deterioration in consumer and subdued business surveys with PMIs remaining in contraction territory, we expect to see the economy decline further into 2023, shifting the expected timing of recession to Q2 2023. Overall, in 2022 GDP growth averaged 4.0%, but we forecast -0.7% in 2023 and 0.8% in 2024.

Surprise fall in core and services CPI not enough to deter MPC

- Price pressures showed some signs of easing with headline and most importantly – core and services inflation falling in January. The decline in core was enhanced by annual weight updates, which saw the weight of goods in the basket decline to 53.7% from 56.3% and the weight of services increase to 46.3% from 43.7%. Notably, services inflation dropped sharply in January to 6.0% from 6.8% in December– a development that the MPC will welcome - but it's too early to declare victory against inflation.

GDP ends 2022 flat on a quarterly basis

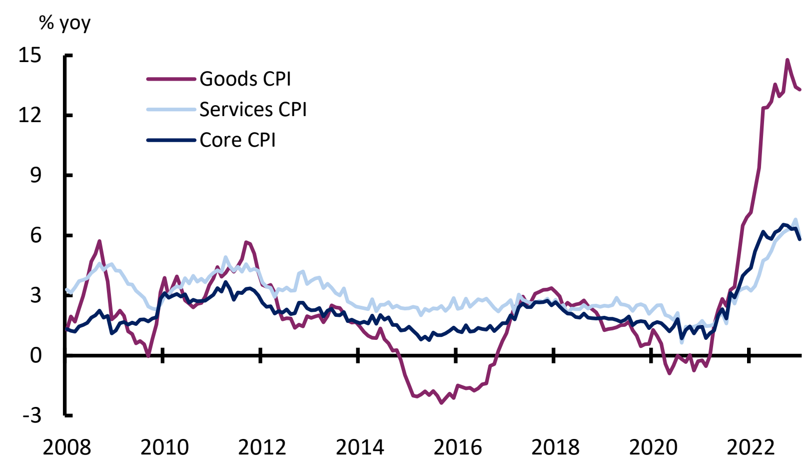
GDP contributions - quarter on quarter



Source: ONS, AXA IM Research, February 2023

Easing seen in headline, core and services CPI

Goods and Services CPI



Source: ONS, AXA IM Research, February 2023

BoE closes in on peak

UK

Tentative signs of labour market tightness moderating

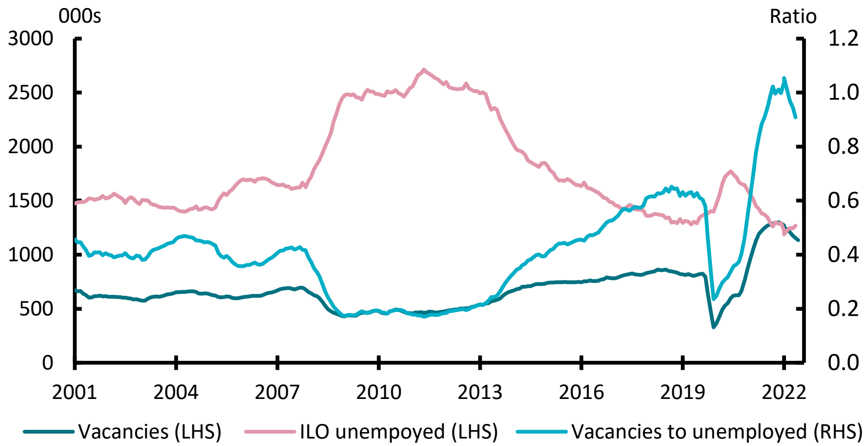
- The labour market remains tight, and demand has shown signs of moderating – employment has fallen by 50k since May and vacancies falling for the seventh consecutive month. Yet we have begun to see a small rebound in labour supply, which would add additional slack to the labour market. Recent developments increase the risks of an early pause from the BoE, but we still expect a final 25bps increase in March given the risks to the upside in their inflation forecasts.

BoE set to hike by 25bp in March where we see them pausing at 4.25%

- The Monetary Policy Committee (MPC) next meets on 21 March. Prior to this meeting additional labour market and inflation reports will be released. We continue to call for one more 25 bp hike brining Bank Rate to 4.25%. We suspect that the MPC will remain cautious in the face of only nascent signs of price pressures easing, given the still tight labour market. We expect the BoE to remain on hold thereafter and begin to unwind these hikes by the end of 2023, pencilling in a 25bp cut in Q4 2023 and Bank Rate at 3.00% by end-2024.

Labour market remains tight – but signs of easing building

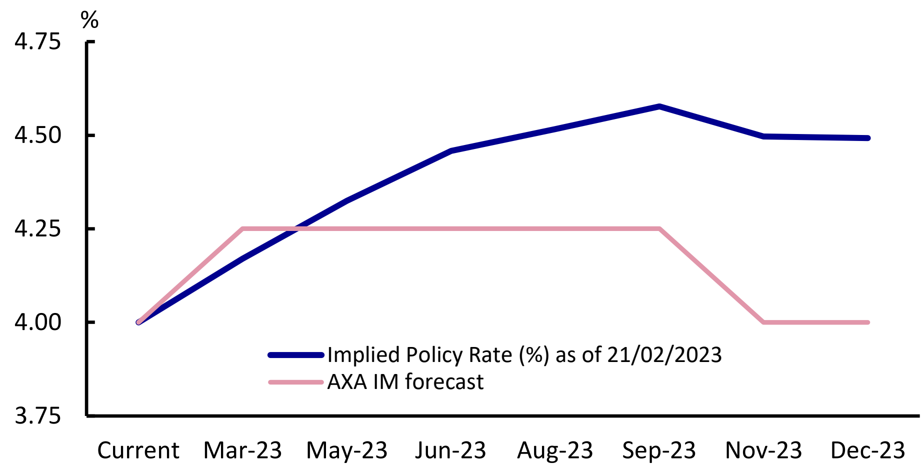
Unemployment and Vacancies



Source: ONS, AXA IM Research, February 2023

Markets see risk of further hikes past March

Market implied Policy Rate



Source: Bank of England, Refinitv, AXA IM Research, February 2023

Consumption and services activity leads the post-reopening recovery

China

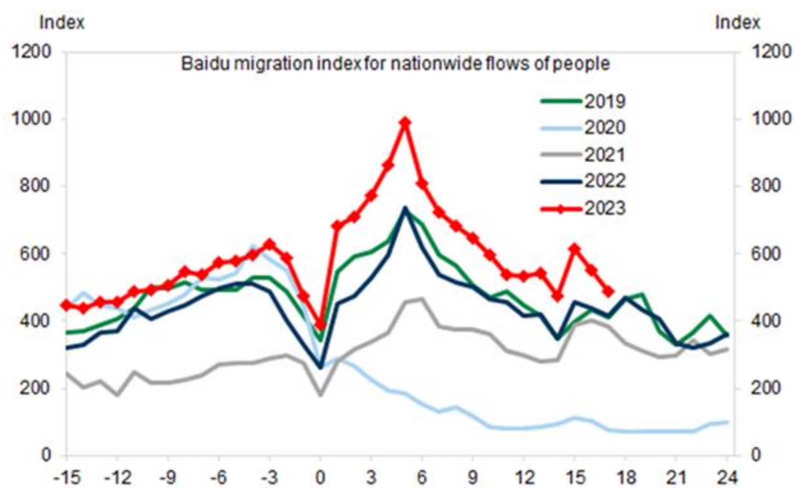
Mobility largely normalized

- Social and economic activity continued their solid recoveries in the Year of the Rabbit. Mobility metrics – such as traffic congestion and subway ridership in major cities – rebounded in the lead up to, and after, the lunar Chinese Lunar New Year (LNY), to above 2019 levels. The Baidu Migration Index, which captures the full spectrum of public and private transports, shows post-LNY travel in 2023 was the strongest in five years.

Consumption stages a comeback

- The strong recovery in mobility partly reflects increased tourism during the LNY. The number of trips and tourism revenue increased by 23% and 30% compared to the same period last year. While on holiday, people rushed to duty-free shops, pushing same-store sales up 21% yoy in Hainan - 3 times the amount recorded in 2019. Box offices recorded their second best LNY sales on record, while restaurant revenue recovered back to pre-pandemic levels. Overall, household consumption – particularly on services – has staged an impressive comeback.

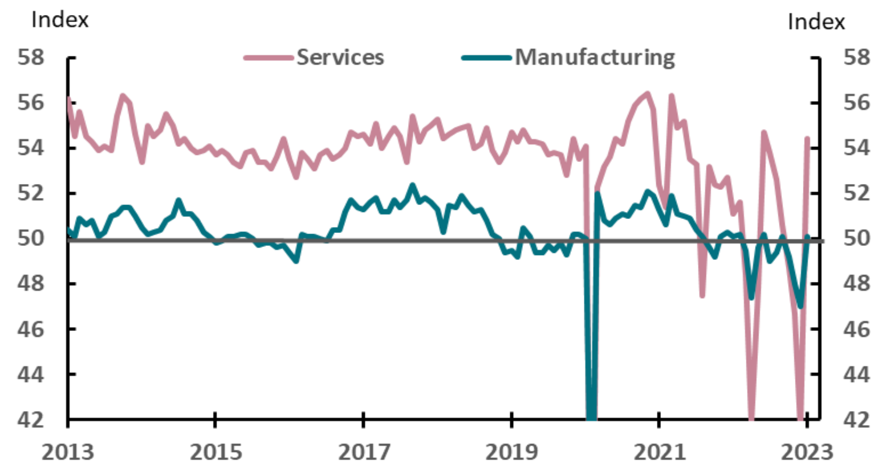
Mobility at a five-year high



Source: GS, WIND, AXA IM Research, February 23

Services activity leads the recovery

China manufacturing and services PMI



Source: CEIC, AXA IM Research, February 23

Recovery is not without weak spots

China

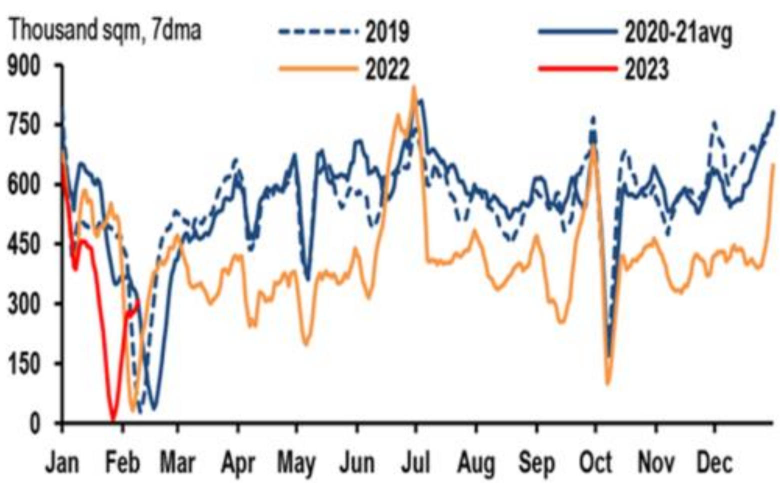
Housing market remains lackluster

- The housing market has been slow to regain strength. While the latest weekly sales improved somewhat, the overall level of activity remains lacklustre, especially considering recent policy supports. Indeed, falling mortgage rates have so far not generated the 'animal spirits' that propel massive new home purchases. Instead, many have chosen to refinance or pay down existing debt. This underscores continued caution amongst households particularly when it comes to making large investments.

Lingering headwinds call for continued policy support

- Exports remain a further headwind, which to struggle against waning global demand. Ocean freight costs for US bound cargo have fallen precipitously, with anecdotal evidence of empty containers piling up at ports. With darker days still expected ahead for developed economies, Beijing has work to do to ensure domestic demand is strong enough to pick up the slack from reduced sales overseas. We expect more policy nurturing to be announced at the upcoming National People's Congress to solidify the economic recovery and reinforce investor confidence.

Property market recovery less impressive



Source: JPM, WIND, AXA IM Research, January 23

Darker days for exports may still be ahead

Source: CEIC, AXA IM Research, February 23

Surveys point to around 3% in FY Shunto

Japan

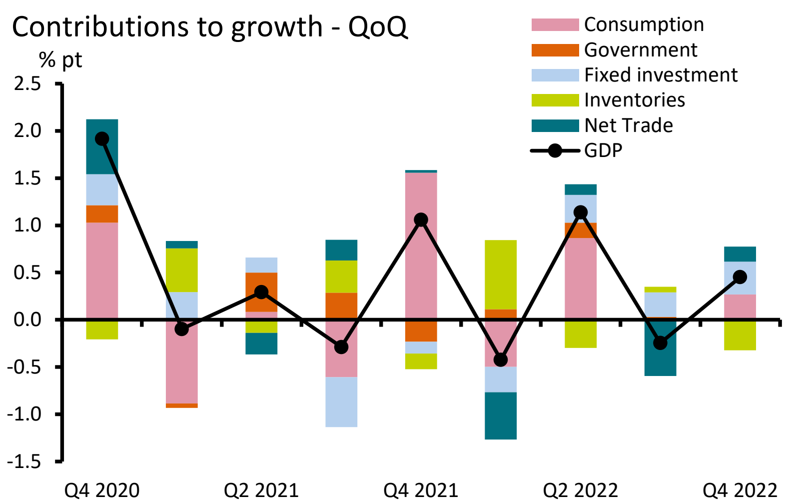
Growth in Q4 disappoints

- Q4 GDP rose by 0.2% on the quarter, well below consensus estimates of a 0.5% rise, which had expected to be supported by considerable tailwinds from Japan's delayed re-opening from the pandemic and a pickup in inbound tourism. Private consumption growth remained strong, rising by 0.5% qoq, but volatile swings in investment drove the miss.

Wage negotiations suggest virtuous circle could be underway

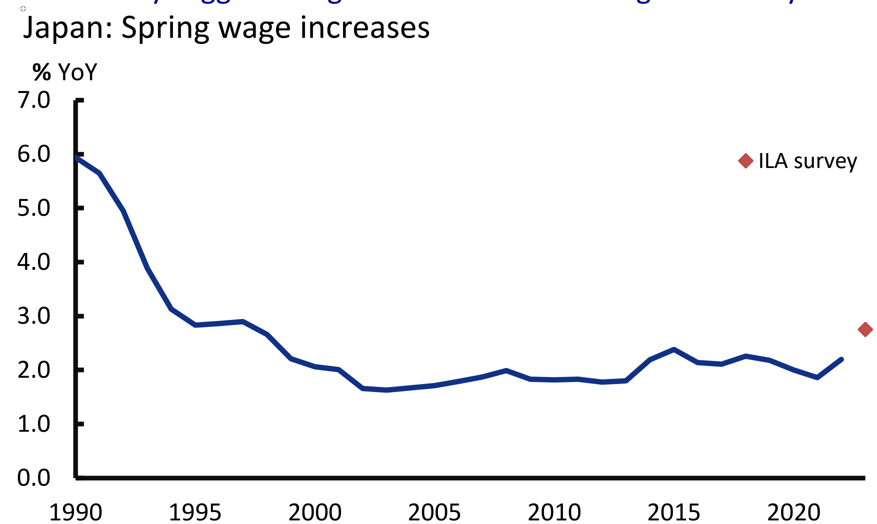
- Price pressures continue to rise and though services inflation remains low, its contribution has begun to rise markedly. Spring wage negotiations remain important. The Institute of Labour Administration (ILA) released the results of its Survey on Wage Hikes – a useful reference in gauging the outlook for the spring wage negotiations. The results of the survey point to an overall 2.75% increase in FY23 Shunto wage revision rate. This would mark the biggest rise in 25 years and comes in line with consensus expectations – a nascent sign of improving price dynamics, in the context of sustainably reaching 2% inflation.

Q4 GDP up 0.2% - falling short of expectations



Source: Cabinet Office, AXA IM Research, February 2023

ILA survey suggests wage increases could be highest in 25 years



Source: Statistics Bureau Japan, AXA IM Research, January 2023

Ueda Named as BoJ governor

Japan

The beginning of the Ueda regime approaches

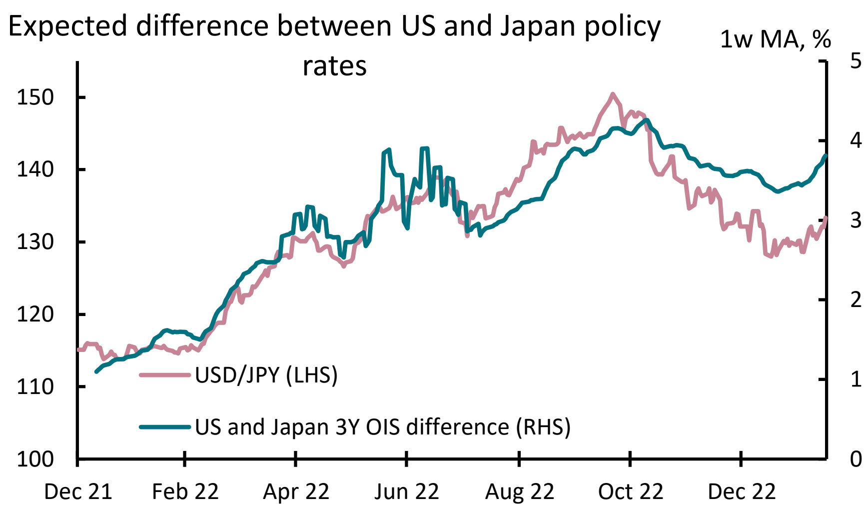
- The Japanese Government surprised market participants in nominating Kazuo Ueda, an academic economist and former BoJ policy board member, to succeed BoJ Governor Kuroda. The government also nominated former Financial Services Agency chief Ryozo Himino and current BoJ Executive Director Shinichi Uchida as deputy governors.
- Ueda is known as one of Japan's leading experts on monetary policy and was generally seen as a dove during his time on the BoJ policy board, but we would caution over extrapolating this to his future stance. In fact, Ueda's views on current monetary policy and the impact of yield curve control (YCC) are not widely known and his upcoming comments to the Diet will be closely watched.
- The change in leadership does not alter our call on the BoJ. We continue to expect the BoJ to exit YCC in 2024 when it can be confirmed that inflationary pressures have increased, and we expect the new Governor to remain cautious about making hasty moves that could jeopardise the clear green shoots in the economy. But the wholesale change of leadership significantly increases the uncertainty.

Key dates upcoming

Key dates for BoJ outlook	
Parliamentary hearings for BoJ Gov/Deputy Gov nominees	Feb 24
Last Monetary Policy Meeting under Governor Kuroda	Mar 9-10
End of term of Dept Governors (Amamiya and Wakatabe)	Mar 19
Results of Spring Wage Negotiations Start to be Released	Mid Mar
End of Governor Kuroda's term	Apr 8
First Monetary Policy Meeting under New BoJ Governor	Apr 27-28
Tally of wage negotiations released	Mid May

Source: AXA IM Research, February 2023

Dollar rose to six week high against the Yen since the announcement



Source: Refinitiv, AXA IM Research, February 2023

Employment growth shows little sign of slowing

Canada

We expect Q4 GDP at 0.4% qoq

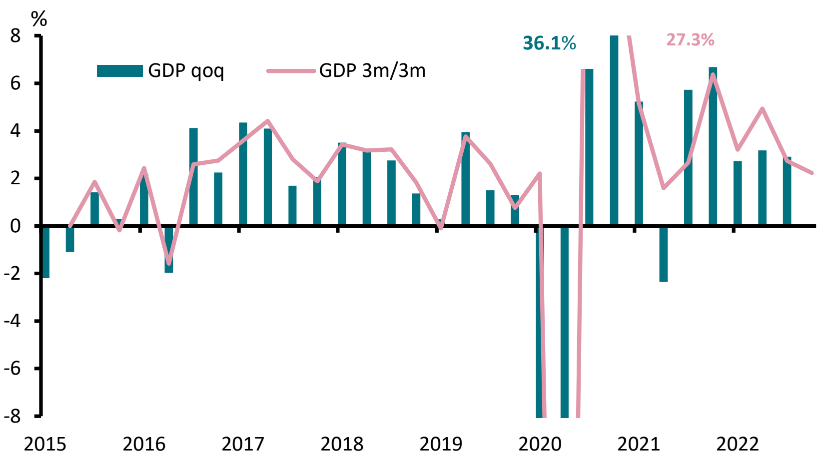
- Growth continues to moderate, in line with our expectations. Monthly GDP in November rose by 0.1% mom and we expect Q4 GDP to increase by 0.4% on the quarter. We expect growth to continue to slow into 2023, but expect the economy to avoid a recession. We forecast GDP growth of 3.6%, 1.0% and 1.0% for 2022, 2023 and 2024 respectively. This compares to consensus forecasts of 3.5%, 0.5% and 1.5%.

Another upside surprise in January employment

- Recent employment data showed the labour market remains tight with employment rising by 150k in January, well above consensus expectations of a 15k rise. Despite the large increase in employment, unemployment moved sideways remaining at 5.0% (consensus 5.1%) due to an increase in labour force participation. Annual wage growth also slowed slightly to 4.5% from 4.7% in December.

GDP expected to slow in 2023, but avoid recession

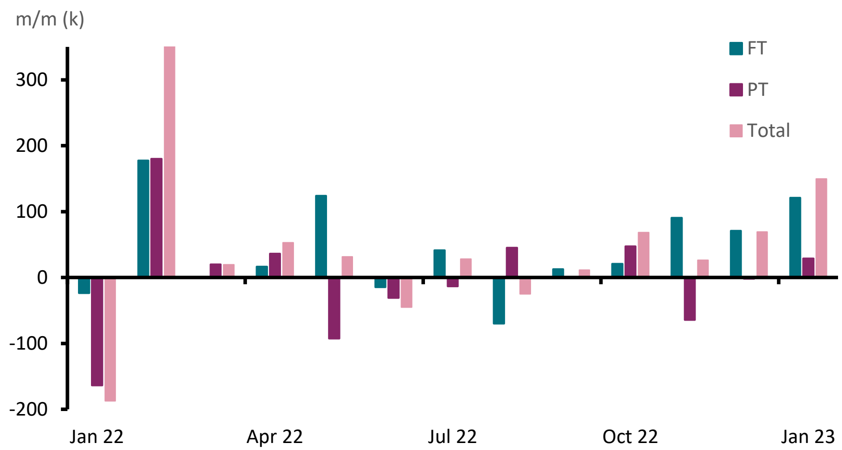
GDP quarterly and 3mma (annualised)



Source: CANSIM, AXA IM Research, February 2023

Employment shows punchy 150k increase in January

Changes in part time and full time employment



Source: CANSIM, AXA IM Research, February 2023

BoC likely to remain on hold

Canada

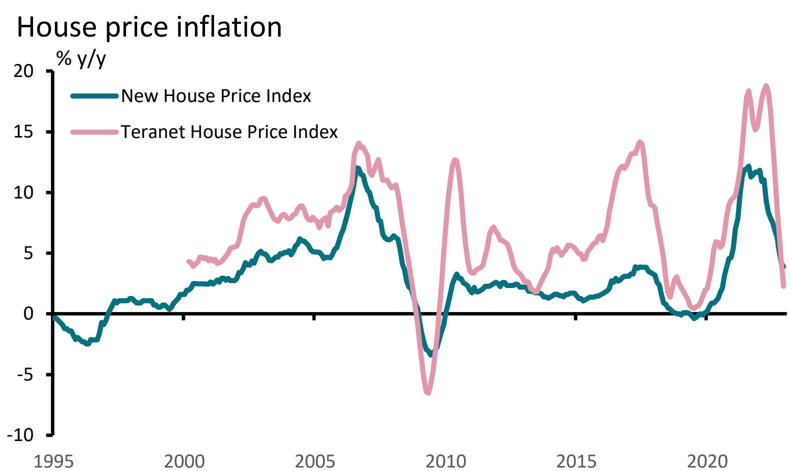
Minutes add some colour to BoC deliberations

- The BoC also published, for the first time, a summary of monetary policy deliberations following their January meeting. The summary described the Governing Council's debate between leaving the policy rate unchanged and a 25-basis point hike – suggesting a more dovish tilt. It also included discussions around a change to forward guidance to formalise this tilt. Policymakers expressed concern over the housing market, with further deceleration expected given lags in the transmission of monetary policy.

Conditional pause with a high bar

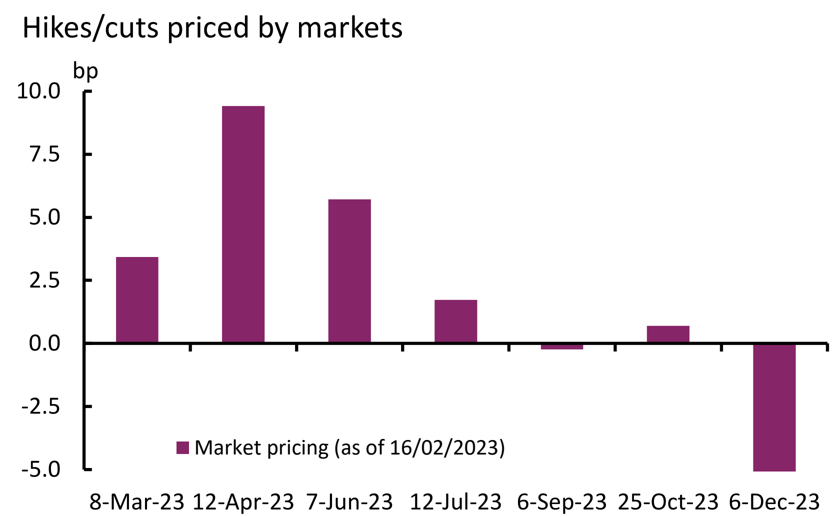
- The minutes show the GC "wanted to convey that the bar for additional rate increases was now higher" and that they would require "an accumulation of evidence" to determine whether further rate hikes were needed. We think recent labour market data increases the risk of a further rise (most likely in their April meeting), but that it is insufficient on it's own. More evidence suggesting persistent inflation would be needed to see the BoC resume hiking rates. At present, we expect the BoC to begin cutting rates in 2024, pencilling in 150bps of cuts over the year, bringing rates to 3.00% by end-2024.

House price inflation has fallen back sharply from post-covid highs



Source: CANSIM, Teranet, AXA IM Research, February 2023

Markets starting to price a greater risk of hikes



Source: Refinitiv, AXA IM Research, February 2023

Disinflation path questioned with the January bump?

Emerging Markets

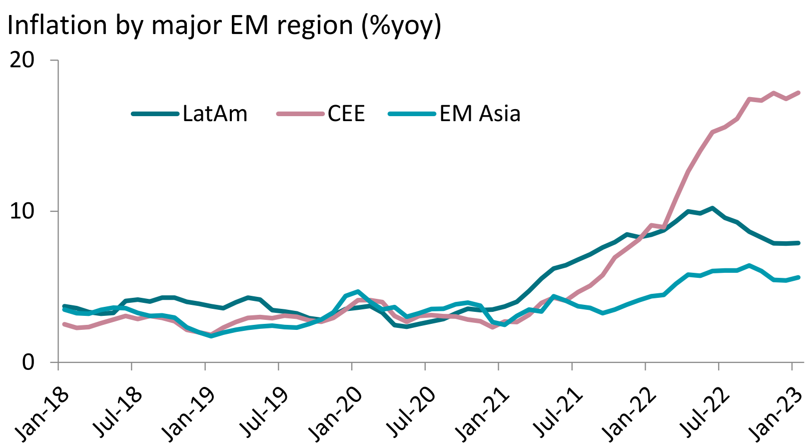
Headline disinflation lies ahead despite January hiccup

- Headline inflation rose again in many countries. In some, it has not even reached their year-on-year peaks like in Colombia (13.3%), Hungary (25.7%) or the Philippines (8.7%). Some caution is necessary for January CPI readings, as many price resets, administrative price adjustments, methodological and basket changes are implemented.
- Food prices appeared to be rising again in many countries, but this may prove temporary. The FAO food price index reached its peak in March 2022, back to its summer 2021 levels, and the continuous fall in gas prices is likely to continue to support this trend.

Core inflation is more stubborn

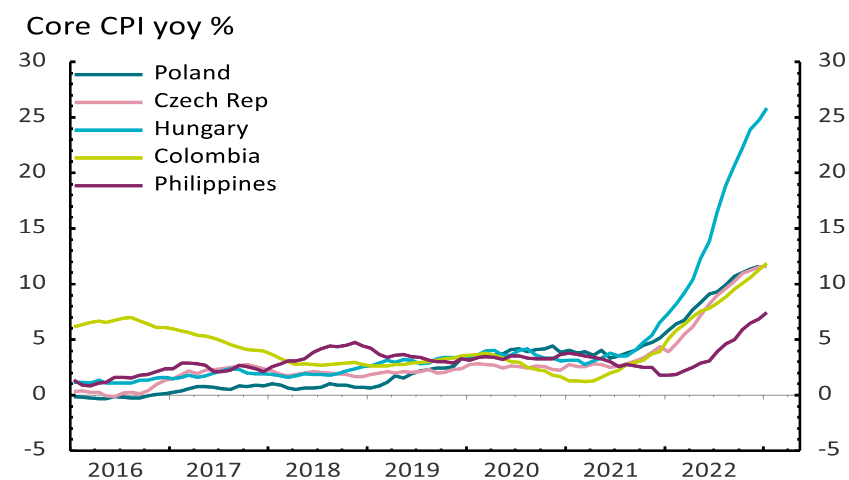
- The focus will turn increasingly on the core inflation trend to assess the stickiness of this inflationary episode and gauge the capacity of central banks to start easing policies at a time when sluggish growth takes its toll on many EM economies.
- Core inflation has yet to reach its peak in Central Europe, Colombia or the Philippines.

EM: *en route* to lower headline inflation rates



Source: Refinitiv Datastream and AXA IM, Jan 2023

Core inflation has not peaked everywhere yet



Source: Refinitiv Datastream and AXA IM Research déc. 22

GDP growth: a slow end to 2022, a slow start for 2023

Emerging Markets

A cyclical trough may have been reached in Q4 22 in CEE, but recovery ahead may prove sluggish

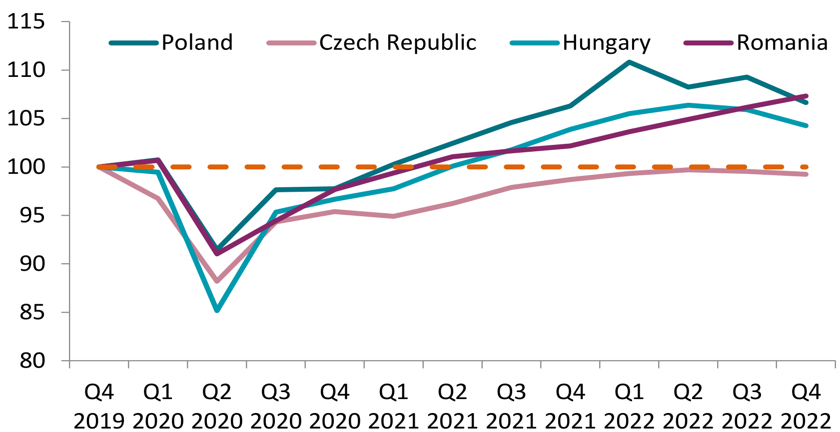
- Q4 GDP contracted in most CEE countries. The level of GDP has not even recovered its Covid-19 pandemic losses in Chechia. Still, a deeper recession has been avoided in the absence of energy supply shortages this winter. We remain concerned about a rather sluggish recovery into 2023 given weak domestic and external demand.

Growth softer in Asia on easing global demand

- 2023 has suggested a weak start on the back of softening global backdrop. Headline manufacturing PMIs continue to point to an ongoing divergence between the export-driven and domestically oriented economies in Asia. Q4 yoy GDP figures are in general weaker compared to previous quarter for many countries, though Indonesia and Singapore's growth numbers have printed sequential improvements on private consumption and services sector recovery.

GDP growth contracted in many CEE countries in Q4

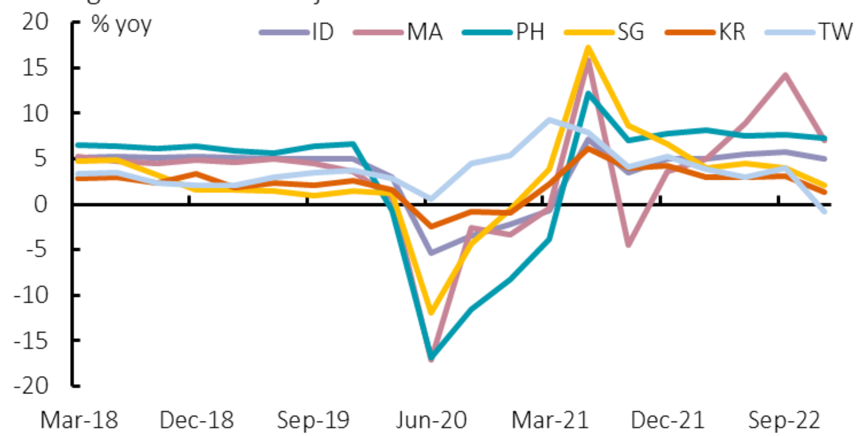
GDP index in Central Europe (Q4 2019 = 100)



Source: Refinitiv Eikon and AXA IM Research, Feb 2023

Q4 2022 GDP growth weakens for most Asian countries

GDP growth for the major Asian economies



Source: CEIC and AXA IM Research, 16 February 2023

Investment Strategy

Multi-Asset Investment views

Our key messages and convictions

Neutral on Equities

#1

Earnings expectations coming down but easing inflation and resilient growth could offer support

#2

China reopening to support Emerging Economies. Higher carry with spreads at attractive levels for EM debt.

Positive Emerging Market equities and debt

#3

Rate curves pricing recession risk but also further rate hikes as central banks re-affirm need to dampen inflation pressures

Neutral on Government Bonds

#4

Valuations have richened despite some very recent spread widening, yet investor flows remain supportive

Neutral Investment Grade

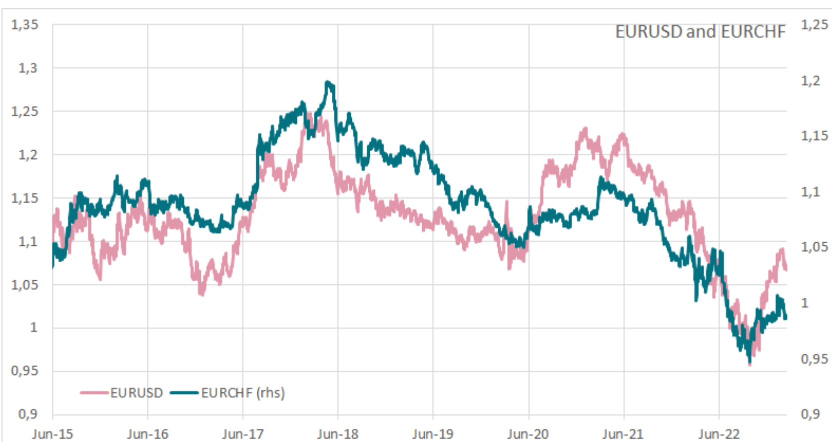
Source: AXA IM as at 23/02/2023

Investment Strategy

FX: USD rebound déjà vu, different background

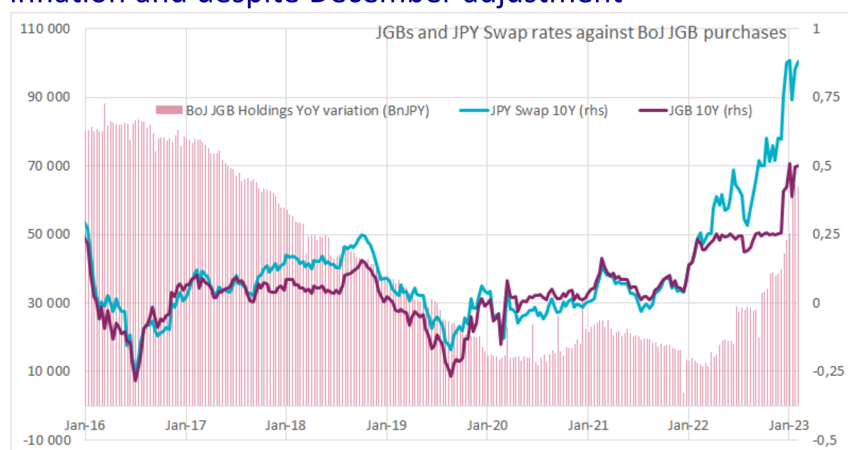
- The significant revisions to US inflation and employment data have recently pushed US rates and the USD higher. But in the background, the structural changes initiated at the end of 2022 are still at play and should ultimately pull the USD lower in the medium term: US inflation is softening overall, even if at slower pace, and the global growth outlook is stronger.
- In this context, equity markets and risk sentiment are more immune to the vagaries of USD. High beta currencies should follow the same pattern. Among those AUD has more upside, lifted by China reopening and the RBA turning more hawkish to address rising inflation.
- Stagflation risks are fading, and the outperformance of CHF in 2022, second only to the USD, should unwind. Rates will remain lower in Switzerland than in EU, as SNB normalised policy through CHF purchases and should stop intervening now that inflation is stabilising. Better global growth outlook and a higher rate environment abroad should also trigger CHF outflows.
- JPY structural rebound is not over yet. Rising inflation and April wage negotiations should provide a good rationale for BoJ to remove YCC.

EURCHF lagging EUR rebound and better risk sentiment



Source: Bloomberg and AXA IM Research, Feb 2023

BoJ forced to purchase more JGBs to defend YCC amid rising inflation and despite December adjustment



Source: Bloomberg and AXA IM Research, Feb 2023

Investment Strategy

Rates: another wave of hawkish repricing

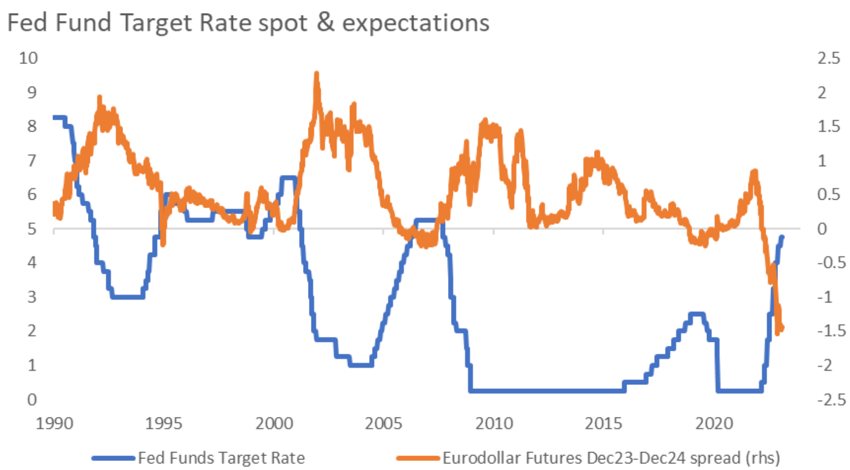
- The market is in the process of forecast revision, both in terms of the recession risk as well as the 'high-for-longer' inflation scenario. Recent Fed-speak is skewed towards a slightly more aggressive stance, as inflation is perceived to be more 'sticky' or 'persistent' than previously anticipated and projected in the SEPs.

- There are three distinct scenarios for the Fed: i) Follow the market, i.e. start a cutting cycle after July 2023; ii) Keep rates at the terminal level for longer; iii) Continue to hike rates. In scenarios ii) and iii) both fixed income and equity markets will be subject to higher discount factors, hence the risk of a temporary repricing to lower valuations.

- We should not underestimate the conditions of scenario number 2, in which the Fed reaches a stop rate (say 5.25% or 5.5%) and then stays at that level for several quarters, rather than cutting rates straight away. In this scenario, a normalization of the FOMC expectations curve – as visualized for example via the Dec23/Dec24 Euro$ spread – is the most likely outcome.

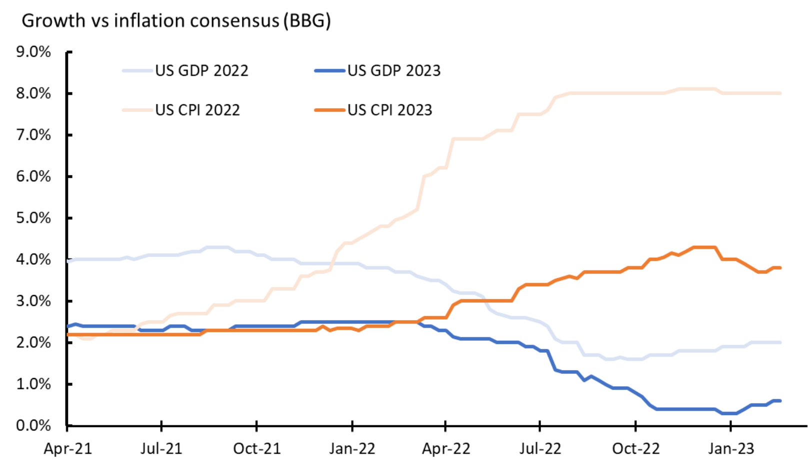
- Scenario number 3 is the toxic scenario, in which inflation expectations are out of control a la late 1970s/early 1980s and the policy mix does not provide investors with the necessary backstop, i.e. fiscal and monetary policy are at odds.

Market expects swift cuts in 2024 after steepest hiking cycle



Source: Bloomberg and AXA IM Research, Feb 2023

US growth expectations creeping higher but ditto inflation



Source: Bloomberg and AXA IM Research, Feb 2023

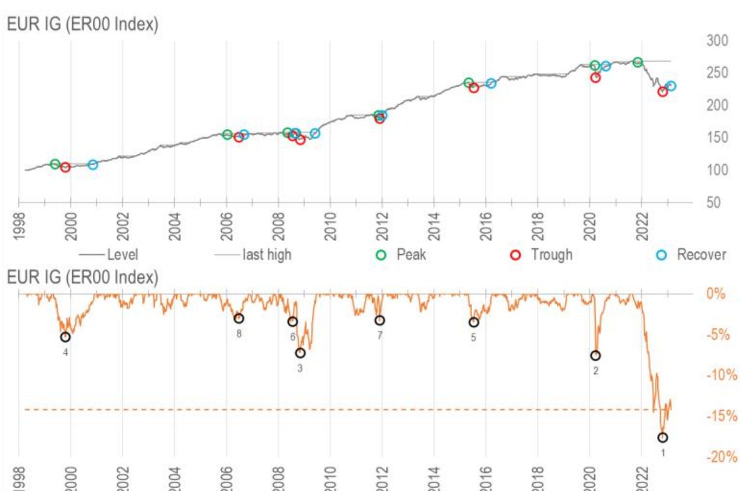
Investment Managers

Investment Strategy

Credit: navigating the headwinds

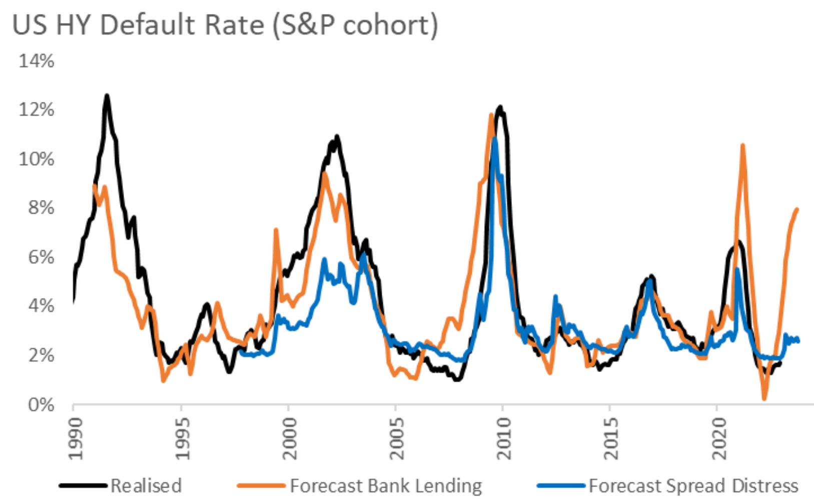
- Credit spreads have rallied notably since October 2022, especially in European credit. Year to date, US credit spreads have tightened by 10-12% while European spreads have tightened by 16-17%. 2022 returns so far are 1.5% in investment grade (IG) and 3% in high yield (HY).
- Despite the notable rebound, the drawdown in total returns from the late 2021 peak remains record breaking in IG. The EUR IG benchmark, for example, has recovered only one-fifth of its 'drop to worst' since the Oct 2022 trough. The corollary to this is that the all-in credit yield continues to offer a very attractive entry point for investors, including the short-end of the credit curve that is less exposed to duration risk.
- The ongoing deterioration (tightening) in bank lending standards has caused some concerns amid investors. Historically, lending standards have led default rates by a lag of 9-10 months and the latest dynamic does appear alarming. Two caveats are worth making. First, the Covid shock saw a similar sharp jump in lending constraints, but the default peak did not follow to the same degree. Second, other default predictors like the spread distress ratio imply a much more benign outlook.

Still record drawdown in IG despite strong rebound



Source: Bloomberg, ICE & AXA IM Research, 17 Feb 2023

Bank lending implies 8% default rate but spread distress just 2.5%



Investment Strategy

Equities: markets trying to earn their keep

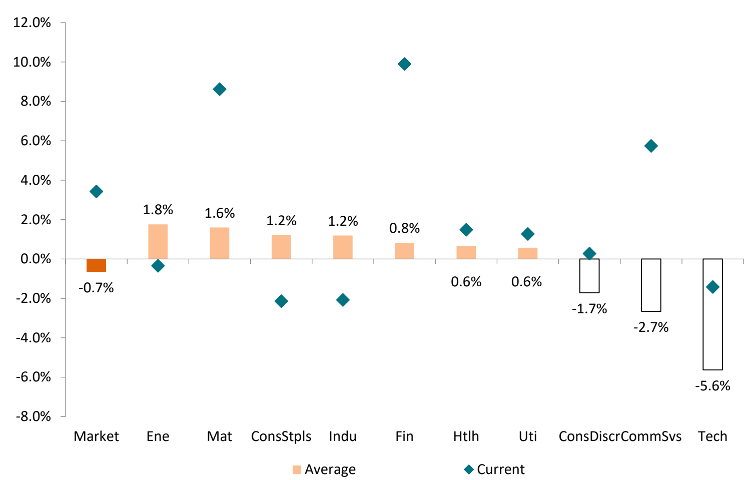
- Heading towards February-end, the global equity market is quite flat month to date (+0.5%). Across regions, the Nordics (+2.9%), the UK (+2.6%) and the EMU (+1.8%) have outperformed, but overall, the picture is a bit gloomy with most regions and countries showing negative performance: emerging markets (-0.7%), and Latin America (-3.9%), posting the biggest decline month to date.

- Last month we talked about the risk of market complacency, and we still hold this view as the market is still not performing in line with the current macro regime. Current 1-month returns across US sectors are historically inconsistent with a regime of high inflation, low ISM and low unemployment. Rather, current sector performance is more consistent with low inflation, medium ISM and low unemployment.

- As the earnings season comes to an end in the US (75% of companies have reported), we highlight some guidance insights. Since the beginning of the earnings season, EPS for 2023 has been revised lower by -0.6%. Beyond the already visible decline in margins, we also expect a slowdown in sales in the coming months. EPS growth for 2023 is in now line with GDP growth, based on historic trends.

Out of the current regime fashion

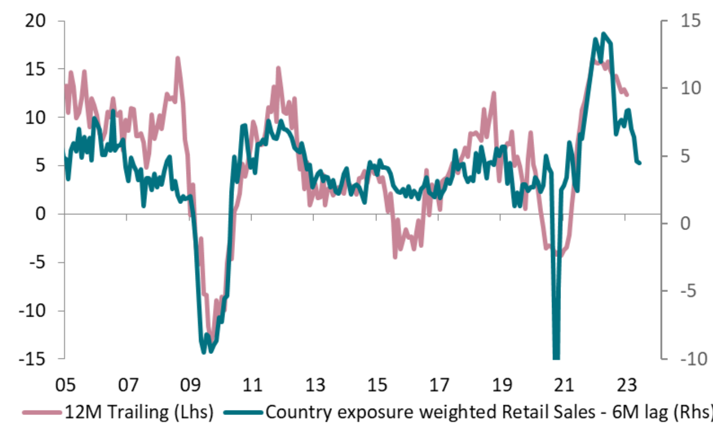
Average monthly return with: Inflation=High, ISM=Low, Unemployment=Low



Source: BLS, ISM and AXA IM Research, February 2023, Low= 1th quintile return, High= 5th quintile return

Sales support should soften in the coming months

US Equity - Sales growth and retail sales



Source: Bloomberg and AXA IM Research, February 2023

Asset allocation stance

Positioning across and within asset classes

Asset Allocation

Key asset classes	Negative	Neutral	Positive
Equities		▲	
Bonds		▼	
Commodities		●	
Cash		●	

Equities

Developed	Negative	Neutral	Positive
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	Negative	Neutral	Positive
Euro core	▼		
Euro peripheral		●	
UK		●	
US		●	
Inflation Break-even			
US		●	
Euro		●	
Credit			
Euro IG		●	
US IG		●	
Euro HY		●	
US short duration HY		●	
EM Debt			
EM Bonds HC			●

Legend: ● **Negative** ● **Neutral** ● **Positive** **Change** ▲ **Upgrade** ▼ **Downgrade**

Source: AXA IM as at 23/02/2023

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Forecasts & Calendar

Macro forecast summary

Forecasts

Real GDP growth (%)	2022*		2023*		2024*	
	AXA IM	Consensus	AXA IM	Consensus	AXA IM	Consensus
World	3.4		2.5		2.7	
Advanced economies	2.7		0.9		0.7	
US	2.1	1.9	0.7	0.3	0.3	1.1
Euro area	3.5	3.2	0.8	0.0	0.7	1.2
Germany	1.9	1.7	0.3	-0.5	0.8	1.4
France	2.6	2.5	0.6	0.2	0.8	1.2
Italy	3.9	3.7	0.6	0.0	0.4	1.1
Spain	5.5	4.5	1.1	0.9	0.9	2.0
Japan	1.6	1.5	1.7	1.2	1.3	1.1
UK	4.1	4.4	-0.7	-1.0	0.8	0.6
Switzerland	2.3	2.1	0.6	0.5	1.3	1.7
Canada	3.5	3.4	1.0	0.4	1.0	1.6
Emerging economies	3.9		3.5		3.8	
Asia	4.2		4.7		4.5	
China	3.0	3.1	5.0	4.6	4.8	5.3
South Korea	2.6	2.6	1.5	1.2	2.0	2.2
Rest of EM Asia	5.7		4.7		4.4	
LatAm	3.7		1.5		2.3	
Brazil	3.0	2.9	1.0	1.0	2.0	1.8
Mexico	2.2	2.9	1.0	1.1	2.0	1.8
EM Europe	1.2		0.0		2.2	
Russia	-3.0		-3.8		2.0	1.2
Poland	4.4	4.9	0.1	0.8	2.4	3.0
Turkey	5.9	5.1	0.5	2.2	1.4	2.4
Other EMs	4.8		3.0		3.4	

Source: Datastream, IMF and AXA IM Macro Research – As of 21 February 2023
**Forecast*

Investment Managers

Expectations on inflation and central banks

Forecasts

Inflation Forecasts

CPI Inflation (%)	2022*		2023*		2024*	
	AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	7.3		4.7		2.7	
US	8.0	8.1	4.3	3.8	3.0	2.5
Euro area	8.3	8.5	5.7	5.9	2.8	2.4
China	2.1	2.1	2.3	2.3	2.5	2.3
Japan	2.5	2.4	2.7	1.9	1.5	1.2
UK	9.1	9.0	6.4	7.2	2.3	3.1
Switzerland	2.8	2.9	2.0	2.2	1.3	1.2
Canada	6.8	6.8	4.3	3.7	2.4	2.2

Source: Datastream, IMF and AXA IM Macro Research – As of 21 February 2023

**Forecast*

Central banks' policy: meeting dates and expected changes

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

		Current	Q1-23	Q2-23	Q3-23	Q4-23
United States - Fed	Dates	4.75	21-22 Mar	2-3 May 13-14 Jun	25-26 Jul 19-20 Sep	31-1 Oct/Nov 12-13 Dec
	Rates		+0.25 (5.00)	+0.25 (5.25)	unch (5.25)	unch (5.25)
Euro area - ECB	Dates	2.50	16-Mar	4 May 15 Jun	27 Jul 14 Sep	26 Oct 14 Dec
	Rates		+0.5 (3.00)	+0.25 (3.25)	unch (3.25)	unch (3.25)
Japan - BoJ	Dates	-0.10	9-10 Mar	27-28 Apr 15-16 Jun	27-28 Jul 21-22 Sep	30-31 Oct 18-19 Dec
	Rates		unch (-0.10)	unch (-0.10)	unch (-0.10)	unch (-0.10)
UK - BoE	Dates	4.00	23-Mar	11 May 22 Jun	3 Aug 21 Sep	2 Nov 14 Dec
	Rates		+0.25 (4.25)	unch (4.25)	unch (4.25)	-0.25 (4.00)

Source: AXA IM Macro Research - As of 21 February 2023

**Forecast*

AXA Investment Managers

Calendar of 2023 events

	Dates	Events	Comments
February	25-Feb	Nigeria general election	
March	March	National People's Congress	
	10-Mar	BoJ Meeting	Unchanged (-0.1%)
	16-Mar	ECB Meeting	+50bps (DFR=3.00%)
	21-22 Mar	FOMC Meeting	+25bps (5.00%)
	23-Mar	BoE Meeting	+25bps (4.25%)
	23-24 Mar	EU Summit	
	27-Mar	Scottish National Party leadership elections	
April	02-Apr	Finland elections (National Parliament)	
	08-Apr	BoJ Governor Kuroda's term ends	
	13-Apr	Northern Ireland Assembly elections	Latest date if executive not formed
	24-Apr	BoE Meeting	Unchanged (4.25%)
	28-Apr	BoJ Meeting	Unchanged (-0.1%)
May	02-03 May	FOMC Meeting	+25bps (5.25%)
	04-May	ECB Meeting	+25bps (DFR=3.25%)
	04-May	UK local elections	
	07-May	Thailand general elections	
	11-May	BoE Meeting	Unchanged (4.25%)
	14-May	Germany (Federal state elections)	
	23-May	BoE Meeting	Unchanged (4.25%)
	28-May	Spain Regional elections	
June	Early June	US Earliest Treasury special measures could see debt ceiling impact	
	13-14 June	FOMC Meeting	Unchanged (5.25%)
	15-Jun	ECB Meeting	Unchanged (3.25%)
	16-Jun	BoJ Meeting	Unchanged (-0.1%)
	18-Jun	Turkey presidential and parliamentary elections	
	29-30 June	EU Summit	
July	July	US Estimated resolution of the debt ceiling	
	July	Greece elections (National Parliament)	
September	Autumn 23	Poland presidential elections	
October	29-Oct	Argentina general elections	
December		Spain (National Parliament)	

AXA Investment Managers

Latest publications

ESG dissection of European equities

2 February 2023

2023 emerging market elections: The who's who and the so what…

27 January 2023

January Global Macro Monthly – 2023 starts on a more positive note

25 January 2023

January Monthly OpEd – It feels better, but central banks on the lookout

25 January 2023

Outook 2023-2024 – Global slowdown to subdue inflation

1 December 2022

The unequal impact of inflation: How governments are responding

27 October 2022

October Global Macro Monthly – Tighter global financial conditions

26 October 2022

October Monthly OpEd – How far is too far?

26 October 2022

The economic impact of a Russian gas cut-off

30 September 2022