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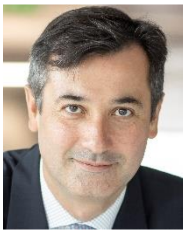
Research & Strategy Insights

Who can resist market contagion?

Monthly Investment Strategy Oped



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Key points

- US long-term yields should continue to rise in the near-term as inflation is likely to rise, a least transitorily. Europe is fighting contagion. Fragile EMs are in the worst position are being forced into pro-cyclical monetary tightening.
- Strong growth, low rates challenge markets
- But reflation keeps driving markets
- US bond yields beginning to be interesting

Central banks tolerance tested

The silence of the Fed is deafening when it comes to addressing the ongoing rise in US long-term yields. True, the central bank is maintaining an ultra-accommodative forward guidance, with the "dot plot" showing the median member of the Federal Open Market Committee (FOMC) still ready to wait until 2024 to hike rates and Jay Powell making it plain that the market will be warned well in advance before the Federal Reserve (Fed) starts tapering its purchases of bonds. But paradoxically this fuels a relentless pressure on market interest rates given the Fed's benign approach to inflation – their forecasts explicitly contain a phase of target overshooting. The Fed's dovishness is designed to make long-term inflation expectations rise. To stop pushing yields up, the market would want to hear the Fed talk about "operation Twist" and alter its bond purchasing framework to control the long end of the curve, but for now the Fed is not making any signals towards such a shift.

Beyond the impact of the Fed's expected stance, inflation concerns are underpinned by the dataflow from the business sector. The price component of the non-manufacturing ISM index hit its highest level in February since 2009, in a range which in the past has been consistent with actual acceleration in core inflation within a 3 to 6 months horizon. The fact that the US administration managed to push through Congress a nearly intact USD1.9tn fiscal stimulus is adding to the probability that the US is soon to go through an "overheating phase", as the fiscal support will coincide with the reopening of the economy thanks to the swift implementation of the vaccination programme.

Fundamentally, the Fed's approach is sound. The Biden push will be short-lived. We don't know if he will have political capital left to get his medium-term investment package implemented later-on, while the rise in long-term interest rates is reducing the attractiveness of such a strategy – it is getting more difficult to argue it will "pay for itself". By year-end the US economy is likely to be more sedate, and Biden's failure to tag his steep rise in minimum wage on the stimulus bill will help keep the risks of a cost-push inflation shock in check. Still, in the meantime, the market is likely to be trading on "confirmation bias" as, at least transitorily, consumer prices will accelerate. We think 10-year yields will continue rising to 2% before slightly receding.

The US economy can probably withstand the ongoing tightening in financial conditions, but any significant contagion to Europe would come at the wrong time. For now, the Euro area is faced with stricter, not looser mobility restrictions as the propagation of the virus is accelerating and the vaccination programme remains slow. Moreover, while fiscal policy is accommodative in Europe, focus is more on a medium-term accompaniment to the recovery with mutualised EU transfers than on big, spectacular short-term packages. The European Central Bank (ECB) has pledged to stand in the way of contagion by accelerating the disbursements under the Pandemic Emergency Purchase Programme (PEPP), but some disagreements appear to be emerging within the central bank. It seems that now it takes a Governing Council meeting, plus preferably a new set of forecasts – which comes only once a quarter - for any decision on this front to be made. This will make the ECB more reactive than pre-emptive, which is consistent with volatility episodes, even if we think that the current Bund/Treasury spread should be maintained on the whole and we expect the German 10-year yield to remain negative by year-end.

Emerging markets are at risk in such a configuration, and capital outflows are starting. Overall, their financial position is stronger than in many episodes of interest rate reappraisal in developed markets, but as usual the most fragile ones are under pressure. We can see central banks forced into hiking rates, most recently in Turkey, Russia and Brazil, to the detriment of the post-pandemic recovery. Turkey in particular is the one to watch since the country seems to have reached the point beyond which political authorities are no longer ready to accept the price of monetary tightening. This is the recipe for significant financial stability turmoil.

Navigating higher yields (in an optimistic way)

Investors mostly share a positive view of the macro-economic outlook. The recovery differs in magnitude and veracity from economy to economy but with both the US and China expected to grow at rates well above trend for the foreseeable future, it is not unreasonable to have a bullish global view. Ordinarily this would support a significant allocation to risky assets. Indeed, even though there are nuances to be considered at this part of this particular cycle, that does still seem to be the right strategy. Strong nominal growth will support earnings growth and equities into 2022. Credit markets will benefit from deleveraging as earnings grow and a continued supportive financing environment. At the lower quality end of the US bond market, defaults are not likely to reverse higher again with the economy growing so strongly. The emerging market story is more complicated, but some regions can benefit from high growth in developed markets.

As noted above, the uncertainties continue to centre around the US inflation and interest rate outlook. Some investors struggle with the idea that the US Federal Reserve will let inflation move to levels not seen since the credit boom that pre-dated the global financial crisis. The message from Washington is no rate hikes this side of the end of 2023. Strong growth, higher inflation and no rate hikes! This untested policy approach has generated an aggressive steepening of the US yield curve the likes of which have only been seen when the Fed has been cutting interest rates. Higher longer-term yields reflect the "normalisation" of the growth and inflation cycle, stable short-term rates reflect the Fed's resolve to make sure this happens. For the moment, bond investors have not reached a settlement with this new orthodoxy.

The slope of the yield curve, inflation break-evens and real yields could increase further, absent some form of "operation twist". Reading across to the equity markets, this should underpin the recent outperformance of cyclicals that will benefit from increased demand and better pricing power. Further nuances are provided by the interaction of cyclical and secular forces that will play out in equity markets. The current shortage of semi-conductors is a case in point. Supply is likely to have been disrupted over the last year and capacity seems challenged in the face of increased secular demand from ramped-up electronic vehicle production plans and the broader role digitalisation is playing in the energy transition. Spot prices for semis have been increasing in accordance. Investors should also take note of the significant investment in adding more renewable energy and battery storage capacity. The benefits to the entire supply chain will be clear but this could also highlight some bottlenecks and price pressures. This coming at a time when oil and other commodity prices have risen sharply. Our view is that the secular inflation outlook is not materially changed but there will be noise as the global economy recovers.

The US will be the key focus as it surges out of the COVID slump. The rise in yields is already making US fixed income more attractive, but there could be some way to go before reflation is fully priced. Even now though, US bonds hedged into euros or yen are at their most attractive levels of yield for some time. Duration hungry global investors are likely to take advantage. On the equity side, the dominance of US growth over the next 19-24 months makes us wonder if the modestly better local currency performance of Europe over the US market can be sustained when the clear economic outperformance of the US is written large in the coming data. The US consumer is coming back with gusto and the rising tide of spending should lift all boats. So far, the rise in bond yields is less important than the potential spending boom.

Download the full slide deck of our March Investment Strategy

Recommended asset allocation

	Negative	Neutral	Positive
Asset Allocation			
Key asset classes			
Equities			■
Bonds	■		
Commodities			■
Cash	■		
Equities			
Developed			
Euro area		■	
UK			■
Switzerland		■	
US			▲
Japan		■	
Emerging & Sectors			
Emerging Markets		▼	
Green Basket		▼	
Europe Cyclical/Value			■
Euro Opening basket			▲
US Cyclical/value		▼	
US Financials			▲
Global semiconductors			■
Fixed Income			
Govies			
Euro core		▲	
Euro periph		■	
UK		■	
US	▼		
Inflation			
US		■	
Euro		■	
Credit			
Euro IG		■	
US IG		■	
Euro HY		■	
US HY		■	
EM Debt			
EM bonds		■	

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

Source: AXA IM Research – As of 24 March 2021

Macro forecast summary

Real GDP growth (%)	2020	2021*		2022*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
World	**-3.7**	**5.5**		**4.2**	
Advanced economies	**-5.5**	**5.4**		**3.7**	
US	**-3.4**	**6.5**	4.7	**4.4**	3.6
Euro area	**-6.8**	**3.8**	4.4	**3.5**	4.1
Germany	**-5.3**	**2.4**	3.5	**3.3**	3.8
France	**-8.3**	**6.0**	5.5	**3.3**	3.6
Italy	**-8.9**	**4.5**	4.3	**3.5**	3.9
Spain	**-11.0**	**4.5**	5.7	**4.7**	5.7
Japan	**-4.9**	**2.9**	2.3	**2.5**	2.3
UK	**-10.0**	**5.0**	4.2	**7.5**	5.6
Switzerland	**-3.0**	**2.8**	3.0	**2.7**	3.0
Emerging economies	**-2.7**	**5.6**		**4.5**	
Asia	**-1.4**	**7.1**		**5.1**	
China	**2.3**	**8.0**	8.4	**5.5**	5.5
South Korea	**-1.0**	**3.5**	3.4	**3.0**	3.0
Rest of EM Asia	**-6.0**	**6.4**		**4.7**	
LatAm	**-7.4**	**4.0**		**2.8**	
Brazil	**-4.1**	**3.0**	3.3	**2.3**	2.5
Mexico	**-8.5**	**4.7**	4.0	**2.5**	2.9
EM Europe	**-2.5**	**3.1**		**3.6**	
Russia	**-2.8**	**1.8**	2.9	**2.5**	2.5
Poland	**-2.7**	**3.3**	3.9	**4.6**	4.7
Turkey	**1.2**	**4.5**	4.4	**4.6**	4.2
Other EMs	**-3.7**	**3.3**		**4.1**	

Source: Datastream, IMF and AXA IM Macro Research – As of 24 March 2021

* Forecast

CPI Inflation (%)	2020	2021*		2022*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	**0.8**	**1.6**		**1.4**	
US	**1.2**	**2.0**	2.3	**2.2**	2.2
Euro area	**0.3**	**1.5**	1.2	**1.1**	1.2
Japan	**0.0**	**-0.3**	-0.2	**0.5**	0.4
UK	**0.9**	**1.9**	1.5	**1.7**	2.0
Switzerland	**-0.7**	**0.1**	0.3	**0.4**	0.5

Source: Datastream, IMF and AXA IM Macro Research – As of 24 March 2021

* Forecast

These projections are not necessarily reliable indicators of future results

Forecast summary

Central bank policy

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

		Current	Q1 -21	Q2-21	Q3-21	Q4-21
United States - Fed	Dates	0-0.25	26-27 Jan 16-17 Mar	27-28 Apr 15-16 Jun	27-28 Jul 21-22 Sep	2-3 Nov 14-15 Dec
	Rates		unch (0-0.25)	unch (0-0.25)	unch (0-0.25)	unch (0-0.25)
Euro area - ECB	Dates	-0.50	21 Jan 11 Mar	22 Apr 10 Jun	22 Jul 9 Sep	28 Oct 16 Dec
	Rates		unch (-0.50)	unch (-0.50)	unch (-0.50)	unch (-0.50)
Japan - BoJ	Dates	-0.10	20-21 Jan 18-19 Mar	26-27 Apr 17-18 Jun	15-16 Jul 21-22 Sep	27-28 Nov 16-17 Dec
	Rates		unch (-0.10)	unch (-0.10)	unch (-0.10)	unch (-0.10)
UK - BoE	Dates	0.10	4 Feb 18 Mar	6 May 24 June	5 Aug 23 Sep	4 Nov 16 Dec
	Rates		unch (0.10)	unch (0.10)	unch (0.10)	unch (0.10)

Source: AXA IM Macro Research - As of 24 March 2021

These projections are not necessarily reliable indicators of future results

Our Research is available online: http://www.axa-im.com/en/insights

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