Monthly Op-ed

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The end of the dovish pivot

Key points

- Recent developments have resulted in a big hawkish shift in the market's expectations for the central banks' trajectory, in response to continued resilience in the data.
- This should keep us on the prudent side: recession probabilities have fallen significantly, but the lagged impact of the accumulated monetary tightening could still show up in the data in the months ahead.
- US earnings-per-share remain above the long-term trend.
- The technology and energy sectors have enjoyed super-normal profits.
- Long-term investors should not be put off by today's valuation levels.

We wrote last month that the resilience in the economy could trigger some frustration at central banks which would ultimately collide with the market's until recently unwavering belief in a "dovish pivot". The last few weeks have finally brought a significant shift in market pricing. Expectations of the Federal Reserve (Fed)'s and the European Central Bank (ECB)'s terminal rates have been revised up and – more crucially – there is now less than a 25-basis point (bp) cut priced in for the Fed in the second half of the year. This results from the combination of many indicators pointing to continued resilience of the real economy – or even re-acceleration – and hawkish noises from policymakers.

Indeed, in the US, it seems that jumbo job creation combined with strong wage growth reflected in the January labour report is confirmed by a wealth of other data sources to paint a strong picture of the US economy as 2023 starts. The ISM in the services sector for January, with a bumper reading at 55.2, spectacularly extricated itself from contraction territory (49.6 in December). Retail sales have been stronger than expected and the latest business surveys convey a reassuring message: the Empire manufacturing survey was much more resilient than the downbeat ISM in the same sector.

Good news on the real economy might have fed further the "goldilocks narrative" were it not for indications that disinflation is hitting some roadblocks. Consumer Price Index (CPI) inflation duly slowed again in January, but less than expected, landing at 6.4% year-on-year, down from 6.5% in December while the market was counting on 6.2%. Core inflation also refused to slow in line with expectations, retreating by only 0.1 pp to 5.6%. Worse, on a 3-month annualized basis, core re-accelerated from 4.3% in December to 4.6%, despite another strong negative contribution from used cars. The Fed has been focusing recently on core services excluding housing: its' been flat at 2.7% year-on-year for three months in a row, while we suspect the central bank would want to see a proper deceleration in this key area which is probably the most sensitive to the domestic cycle. Besides, what is in the pipeline does not look too good, with a much stronger than expected reading for producer prices.

Unsurprisingly in these circumstances, Fed hawks have become more vocal, to the point that a recalibration of the next hikes to 50bps is now on the cards, as was explicitly discussed by James Bullard and Loretta Mester. The Euro area's dataflow has also been supportive – with in particular a continuation of the rebound in the Purchasing Managers Index (PMI) survey further into expansion territory in February, with stronger confidence in the services sector more than offsetting continuing pessimism in manufacturing. As the likelihood of an imminent recession continues to fade in Europe, while core inflation still hasn't turned, ECB hawks are also arguing for more decisive action, Bundesbank President Nagel even stating that even after the 300bps worth of hikes of the past year, monetary conditions are still not restrictive. The only thing the doves can do is warn against "automatic" hikes, but the direction of travel – more tightening – is clear for them as well.

This casts a shadow on the durability of the current macroeconomic rebound. There is no easy way to gauge the time it is going to take for the impact of the cumulative monetary tightening to materialise. We can only look into precedents. The reaction of the labour market to previous episodes of Fed tightening has often been slow to appear. In three cases (1988-1989, 1994-1995 and 1999-2001) a deceleration in job creation started to emerge only after roughly a year into the hikes. This would suggest that the current resilience is not necessarily such an outlier: it seems to be a fairly regular feature of the US economy that the labour market reacts to monetary tightening after only around 12-18 months. In the Euro area, the credit impulse (the year-on-year change in the flow of new loans to businesses and households) fell into deeply negative territory in January, responding to the tougher lending conditions. With the market now revising up its expected trajectory for the central banks, broad financial conditions are tightening, reversing the loosening seen in December and January, which will add to the pressure on the real economy.

The year started on a firmer footing than could have been feared, but equally we continue to guard ourselves against excessive optimism for 2023 as a whole.

Delving into the earnings picture

With the lags between monetary tightening and a significant slowdown in economic growth – one that would create some slack in labour markets and reduce inflationary pressures – having historically shown they can be long, there continues to be a risk to the growth outlook in the US and European economies even if recent data has shown some resilience. In turn this means that the outlook for equity markets remains uncertain. Last year saw a major correction in valuations in response to higher interest rates but since October, markets have rallied even as forecasts for earnings growth have been coming down. Now that bond markets are aligned with the view that interest rates can still go higher and are not likely to be reduced before 2024, one of the key pillars of improved sentiment in equity markets has been weakened. The central bank put is not likely to be used anytime soon. Thus, there is a vulnerability to markets created by the higher for longer monetary mantra and the risk of further disappointments on the corporate earnings front.

The US equity market remains the most vulnerable to a further valuation adjustment. However, the story is a little more complex than just arguing that the market is expensive. On face value this is true, especially when compared to valuation metrics in other markets. The consensus equity analyst forecast for earnings growth over the next 12 months is around 3% for the S&P500 and the EuroStoxx index. This is in line with expectations of the global economy slowing but not experiencing a deep recession. However, the US market is still trading on a 12-month price-to-earnings ratio of 18.3 times relative to a Euro Stoxx valuation of 12.7 times.

The level of aggregate earnings in the US market remains well above that implied by the longer-term trend. Earnings were boosted during the pandemic largely because of super-normal profits made by technology companies because of the huge demand for products driven by the shift to remote working. Aggregate earnings per share in the Information Technology sector of the S&P500 grew by 46% between the end of 2019 and the end of 2021 (compared to 26% for the index as a whole). More recently, the energy sector has benefitted from elevated oil and gas prices, leading to a surge in profits and, again, boosting the aggregate number.

Away from those sectors, earnings behaviour has been more aligned with trends in the broader economy. Profits with the Consumer Discretionary sector have fallen, reflecting the squeeze on household's real incomes, while the recovery in profits from the pandemic hit in the broader industrials sector has started to fade.

More so than in other markets, the US showed a clear break in the level of reported earnings and in the overall valuation of the market during the COVID pandemic. While forward earnings expectations have been cut and valuation multiples have come down, there would need to be a significant further reduction in earnings to bring the level of earnings back to its trend. Similarly, the price-earnings ratio for the US continues to be well above the average that was in place before the pandemic.

A full correction to the historical trend earnings level and the historical average multiple is unlikely. Theoretically, such a correction would mean the S&P index trading some 30% lower than today's level. Even higher interest rates and a deep recession would be needed to result in such a market move. Instead, what we expect is an equity market trading in a broad range. The technology sector is already seeing some adjustment, with firms reporting a difficult trading environment and making some cuts in jobs. The consensus earnings per share forecast for the IT sector is just 4.6% for the next twelve months. For the energy sector, the outlook depends on what happens in global oil and gas markets. The consensus outlook is that earnings will fall going forward but this is subject to developments in global energy markets and what impact the re-opening of China might have on prices.

The technology and energy sectors enjoy much higher weights in the US market relative to Europe. The sectors have boosted aggregate earnings leaving the US further away from trend than is the case elsewhere. The valuation difference between the US and European markets remains high. Given the higher share of growth stocks in the US market, it is likely to remain the case that the US price-earnings ratio will be above that of other markets. However, there is a risk of a further adjustment in earnings over the next year or so which could mean underperformance of US equities relative to the European markets.

Investors can mitigate these risks. Equity strategies that deviate from a market-cap weighted approach can reduce vulnerability to further valuation and earnings adjustments in the technology sector. The equal-weighted S&P500 index had a total return of -1.17% in the year to 17 February, compared to -5.3% for the market cap-weighted index, and has marginally outperformed this year to date. The contrast between the performance of value relative to growth stocks is even more vivid over the last year.

Long-term growth

Growth investors need to focus on the long-term. History tells us that the companies and sectors with the best track-record in terms of delivering earnings growth are the ones that reward investors the most. The US sectors which have demonstrated the highest long-term growth rates are those that have delivered the strongest returns – Information Technology, Biotechnology and Consumer Discretionary – for example. With strides being made in the development and use of artificial intelligence and other areas of technology, there is good reason to think that the sector will return to a higher earnings growth trajectory. Growth companies in the broader market should also benefit from likely increased investment spending in automation and on areas identified as strategic by the US Administration in its Inflation Reduction Act.

The adjustments to valuation across financial markets over the last year have given investors more attractive levels at which to invest, particularly if the horizon for returns is a multi-year one. Credit markets offer the highest yields relative to credit risk than they have for years. The level of credit spreads today, across most investment grade and high yield markets, suggests positive excess returns investors over 3-5 year holding periods. Similarly with equity markets. Current price to earnings ratios suggests a very strong probability of positive total returns over similar investment horizons. Even in the US, history suggests that starting from a price-earnings ratio similar or lower than today's, over five-year holding periods, returns have been positive most of the time. Past performance is no guarantee of future returns, but if we believe in economic growth, exposure to the companies that generate that growth help meet investors demand for returns.

Download the full slide deck of our February Investment Strategy

Recommended asset allocation

Asset Allocation	Negative	Neutral	Positive
Key asset classes			
Equities		■ ▲	
Bonds		■ ▼	
Commodities		■	
Cash		■	
Equities			
Developed			
Euro area		■ ▲	
UK		■	
Switzerland		■	
US	■		
Japan		■	
Emerging & Sectors			
Emerging Markets			■
Europe Cyclical/Value		■	
Euro Financials		■	
European Auto		■	
US Financials		■	
US Russell 2000		■	
Fixed Income			
Govies			
Euro core	■ ▼		
Euro peripheral		■	
UK		■	
US		■	
Inflation			
US		■	
Euro		■	
Credit			
Euro IG		■	
US IG		■	
Euro HY		■	
US HY (short duration)		■	
EM Debt			
EM bonds HC			■

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

Source: AXA IM Macro Research – As of 22 February 2022

23 February 2023

Macro forecast summary

Real GDP growth (%)	2022*		2023*		2024*	
	AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
World	3.4		2.6		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		3.6		3.8	
Asia	4.2		4.8		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**		**5.0**		**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*

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*

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	Q1-23	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

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23 February 2023

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

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