AXA Investment Managers

Investment Institute Macroeconomics

# Summertime… and the (debt) ceiling is nearing

## Monthly Investment Strategy

AXA IM Research

May 2023

# Summary: May 2023

## Theme of the month: Assessing the turmoil in banking

- Markets still reflect concerns over banking sectors internationally, but most concern is focused on the US. High frequency data show a stabilisation in Federal Reserve emergency lending to the banks – although no material reduction – and a stabilisation in deposit outflow for small and large domestic banks. However, consumer loans appear to have slowed, ending a rising trend. Credit conditions do not appear to have tightened much since the turmoil, but the broader effects of monetary policy tightening have impacted conditions materially in recent quarters and reduced borrowing demand.
- Eurozone banks have not been as materially impacted. The ECB's Bank Lending Survey showed marginal impact on broader conditions from recent turmoil, but again reflected a tightening in conditions and fall in demand in response to monetary policy tightening.
- More broadly, bank sectors in the UK and Canada also seem to be less affected than in the US with official reports stressing the resilience of each sector.

## Macro update: First signs of softening emerge, but events pose biggest risks before the summer

- Developed markets showed a subdued start to the year in terms of GDP growth, although in Europe the avoidance of contraction was better than had been feared and in the US this was underpinned by solid private final demand. EM economies were in the main stronger, particularly with CEE economies emerging from contraction in H2 2022 and Latam economies also posting solid growth. However, we expect a mild recession in the UUS around mid-year and subdued European growth as central bank policy tightening continues to weigh.
- Inflation continues to trend lower in most regions, although 'core' inflation has been slower to decelerate. Central banks at or near peak levels now with the exception of the ECB, which is likely to tighten twice more and some exceptions in EM. That said critical meetings in the US, UK and Canada, particularly in June could still surprise.
- A number of events will dominate market focus before the summer. The US debt ceiling is first and foremost and looks to come to a head over the coming weeks. Turkey's second-round election will determine the new President, but whoever wins, economic reform will be difficult to deliver. The BoJ looks set to begin an adjustment of policy over the coming months. And Argentina once again is trying to stabilise its currency ahead of elections in October.

## Investment Strategy: Risk premia have regained their composure

- FX: USD is gaining support from, once again, resilient US data, although this may only be temporary. EUR should rebound as ECB hawkishness outlasts the Fed. The divergence in inflation trajectories forces PBoC to maintain a lower rate policy. JPY should benefit from USD and US rates peaking out.
- Rates: Market-based inflation expectations have diverged from surveys and trends in underlying inflation. Short positioning by leveraged accounts may explain the Treasury market's resilience in the wake of a stronger than expected macro landscape. Jury still out in regards to Fed hiking cycle peak.
- Credit: Spreads have been soft over the past month, widening by c.10% in IG and by c.5% in HY. Yet spreads remain resilient overall and do not appear to imply a material risk of recession. Our default forecasts have been hardly affected by the latest loan officer surveys. EU HY still screens cheap vs defaults.
- Equities: Global equity has held up well in May thanks to growth factor, which was boosted by the tech sector. Resilience in earnings at the start of 2023 and improved growth outlook support a rebound in earnings expectations. Muted market price reaction to positive earnings shows caution by investors.

# Central scenario

## Summary – Key messages

**Our central scenario: Global economy to slow, bank concerns non-systemic.**

We forecast global growth to slow to 2.8% in 2023 and 2024.

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

**Inflation**

Headline inflation to fall to mid-year. Core disinflation slower as labour markets remain tight. Inflation persistence is now key risk.

**Monetary policy**

Most central banks close to peak, likely only ECB with further to go. Rate cuts unlikely in 2023. Banking concerns fade, but risks persist.

**Growth**

Growth better than feared, but subdued in DM. Mild recession expected in US with weaker Q2. Europe likely persists at subdued pace. Credit conditions add to headwinds.

**Fiscal policy**

Europe has provided fiscal support, but consolidation increasingly the outlook. US debt ceiling outcome likely includes spending cuts.

**Emerging Markets**

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

**Rates**

Rates volatility remains high as the jury still on Fed's hiking peak. Market-based inflation expectations too sanguine compared to inflation surveys/trends.

**FX**

Dollar gains pre-debt ceiling are unlikely to persist. Euro should make further gains as ECB hawkishness outlasts Fed. Yen upside in H2 2023.

**Credit**

Unappealing risk/reward in spreads still warrants a prudent stance. US HY screens low on default valuation & mean reversion while Europe spreads screen better in these terms.

**Equities**

Earnings expectations are key for 2023 returns. A strong start to the year may create complacency amid central banks hawkishness and macro headwinds. Margin pressures at play due to wages.

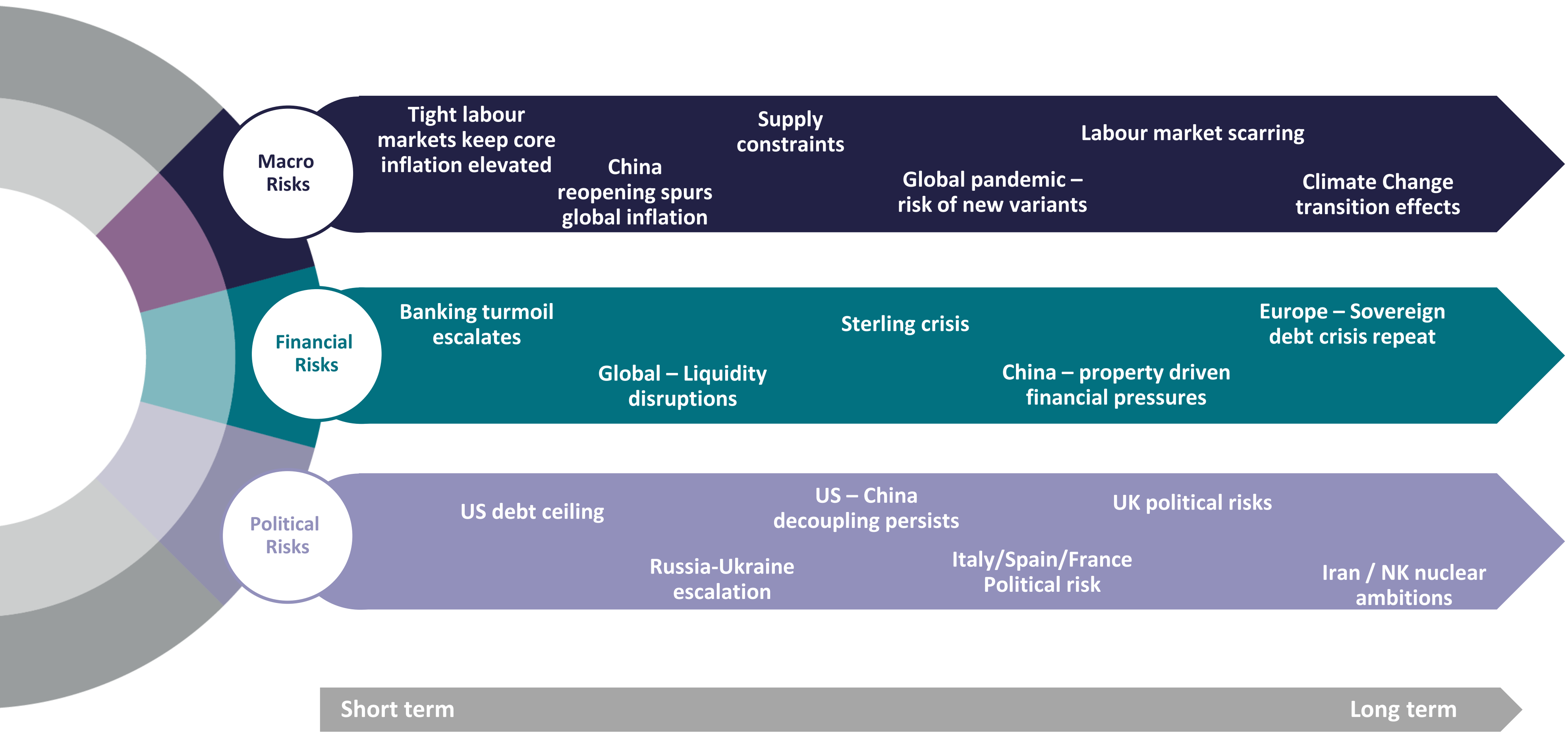
# Alternative scenarios

## Summary – Key messages

| | Entrenched supply shock<br>Probability 25% | A global boost<br>Probability 10% |
|---|---|---|
| What could be different? | - Banking turmoil escalates, credit conditions tighten.<br>- Escalation in Ukraine conflict<br>- COVID outbreaks spreads again: China and/or new mutations<br>- Post-pandemic structural persist. Supply shocks last longer<br>- Inflation expectations rise, affecting wages and persistence | - Geo-political tensions ease – peace in our time.<br>- Labour market participation recovers, strong income growth and easing inflation pressures<br>- Productivity boost following investment rebound and structural post-pandemic adjustments |
| What it means | - Growth weaker, employment could start to fall, but inflation remains elevated<br>- Monetary policy ill-equipped to deal with supply shocks and financial instability, deteriorating inflation credibility forces still tighter policy in DMs | - Growth surprises on the upside in most regions<br>- Inflation fades more quickly towards and below central bank targets<br>- Monetary policy softens quicker than signalled |
| Market implications | - Risk appetite deteriorates / equities sell off / credit widens<br>- Sovereign yields reprice higher<br>- Dollar remains elevated<br>- EM debt to come under pressure | - Risk-on environment, equities make further gains, growth retains lead over value<br>- UST softens, EUR strengthens<br>- Spreads grind tighter |

# RISk Radar

## Summary – Key messages



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# Theme of the Month

# Assessing the turmoil in banking

## US remains principal area of concern

### Adjustments in bank equity illustrate market concerns

- Over two months after the outbreak of troubles in the banking sector, financial markets still clearly exhibit profound concerns about the sector. Internationally equity markets present evidence of persistent concerns about banks, with bank equity indices down 5½%, 7% and 10% in the UK, Canada and across the Eurozone respectively. However, the US continues to attract the most concern with the S&P Banks Select index still more than 25% below its pre-Silicon Valley Bank (SVB) level.

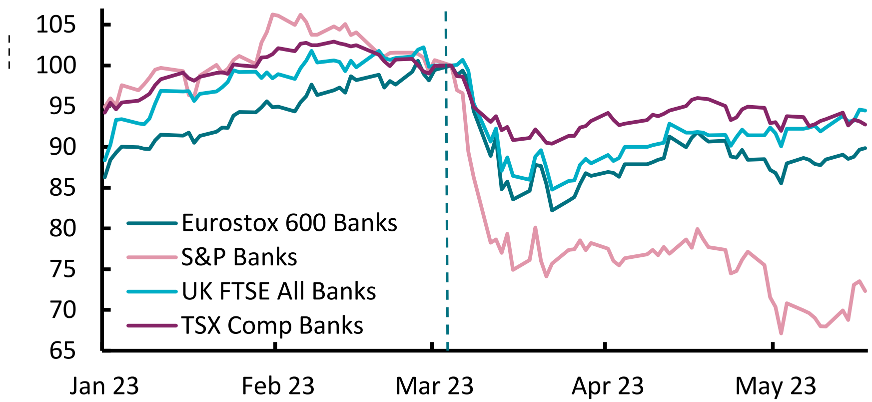
### Fed emergency lending has broadly stabilised

- In one indication that the turmoil in the US banking system has stabilised, the Federal Reserve has not had to extend its emergency lending. The Fed's support to the banking system has come in three broad areas: the traditional Discount Window lending, the new Bank Term Funding Program (BTFP) and other credit extensions which include loans made to the FDIC. This was particularly evident as First Republic Bank of California wound up, the Fed's discount window lending shrank, but was replaced by additional lending to the FDIC. Total Fed lending, is lower but broadly level with peak lending in March.

**Markets remain focused on banks, particularly in US**

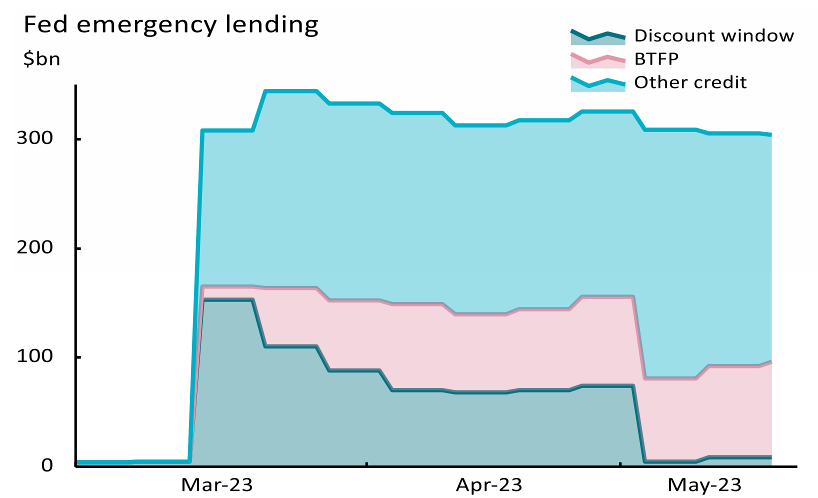
Bank equity

Index March 6 = 100




Source: Bloomberg, AXA IM Research, May 2023

**Fed emergency lending broadly stabilised**




*Source: Refinitiv Datastream, AXA IM Research, 22/05/2023*

# Assessing the turmoil in banking

## US deposits fall and lending stalls

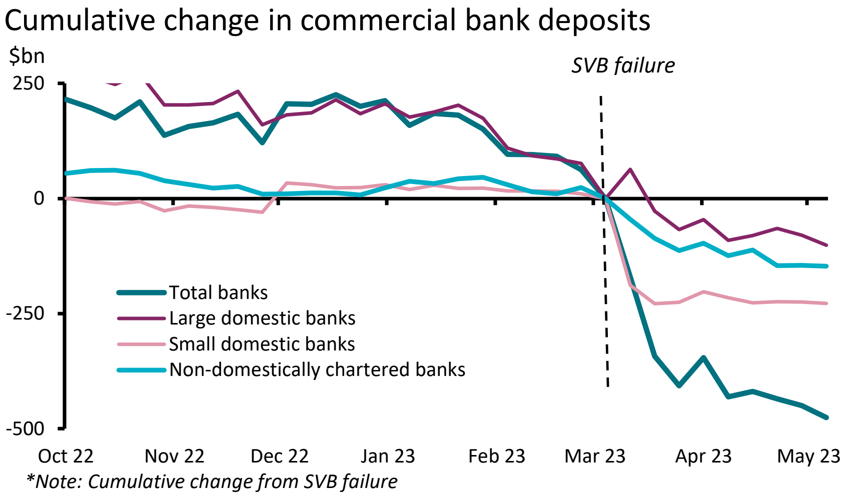
### Deposit flight attenuated

- US bank deposits had been shrinking before March – likely a cyclical phenomena reflecting rate differentials between bank accounts and money market funds. Deposit flight accelerated following SVB asset sales in March, primarily from small banks, but also from non-domestics. The FDIC's reimbursement of even non-insured deposits helped stabilise deposits. Deposits in small banks have been stable since end-March, and large banks in recent weeks. Non-domestic banks are still seeing small withdrawals.

### Lending has been curtailed

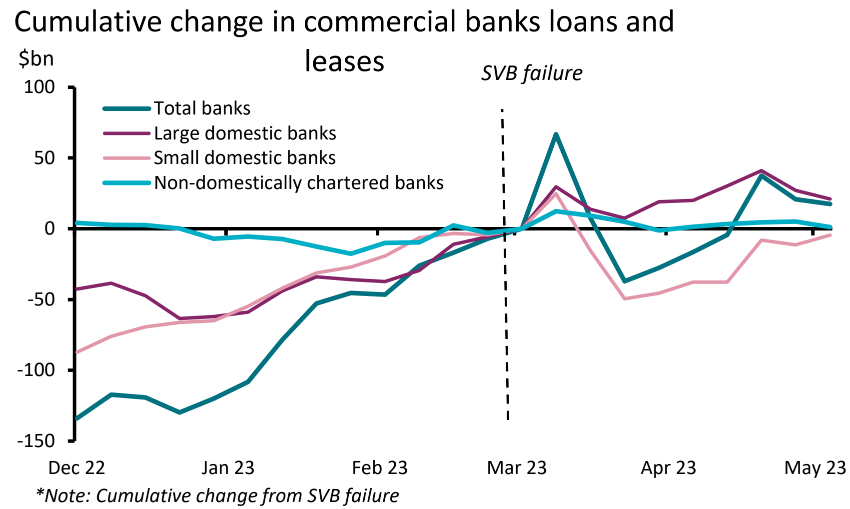
- For domestic banks, there had been a persistent upward trend in new lending before SVB. Since then lending from small banks has fallen back, although there has been some recovery in the latest weeks. Large banks have so far broadly continued with the pre-SVB upward trend, although the latest weeks have seen dips. Non-domestic banks commercial lending has been broadly stable both before and after SVB. In total, bank lending appears to have flattened off since SVB, ending a period of increase.

Commercial bank deposits




Source: FRB, AXA IM Research, May 2023

Commercial bank lending




Source: FRB, AXA IM Research, May 2023

# Assessing the turmoil in banking

## Bank turmoil adds only marginally to tighter conditions

### Credit conditions tight, but banks add little

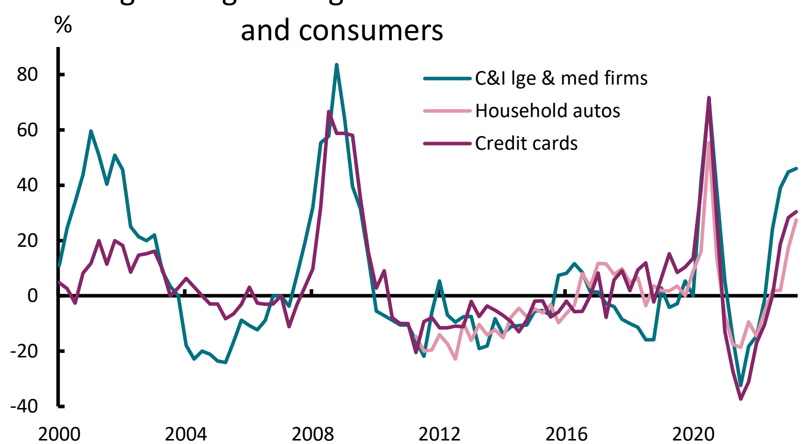
- The Fed's Senior Loan Officer's Opinion Survey (SLOOS) tracks credit conditions. The latest quarter, capturing the post-SVB period, registered only a marginal further tightening in credit conditions for commercial and industrial firms and household credit cards – auto loan conditions tightened further. But credit conditions have tightened more broadly overall. This is the impact of monetary policy tightening. Credit conditions across a range of sectors are at comparable levels to recessions in 2001, 2008 and 2020.

### Demand for lending falls across sectors

- The impact of tighter monetary policy can also be seen in the demand for lending. Borrowing is reported lower across the corporate and household sectors – with some rise from very low levels in mortgage lending in the latest quarter. This falling demand for lending is likely to have a marked impact on activity over the coming quarters.

Credit conditions tightened sharply, but not from bank trouble

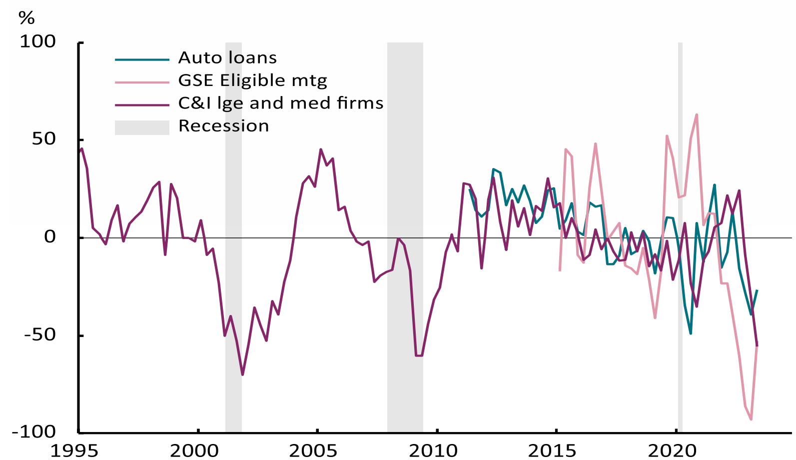
Banks tightening lending conditions for C&I firms and consumers




Source: Federal Reserve, Refinitiv, AXA IM Research, May 2023

Demand for lending falls across sectors

Reported change in demand for lending




Source: Federal Reserve, Refinitiv, AXA IM Research, May 2023

# Assessing the turmoil in banking

## Euro area

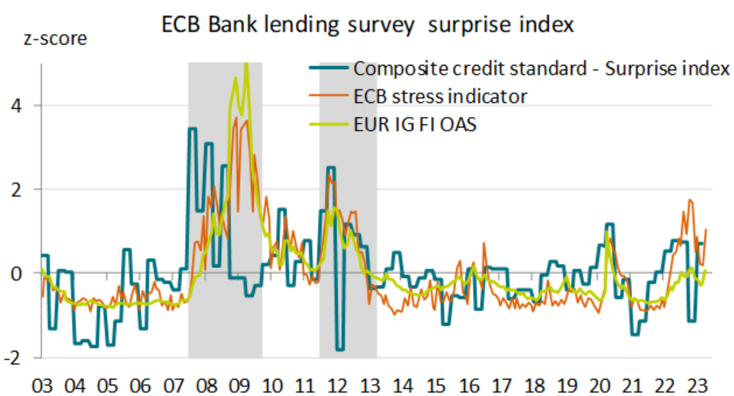
### Tracking banking turmoil with a microscope

- Two months after the outbreak in the Eurozone has provided some detail about developments. The ECB Bank Lending Survey, which gathered answers from banks across the euro area, has shown that this stress has not added significant pressure, in a large part reflecting the much smaller deterioration in European banks. However, similar to the US, credit conditions have tightened materially in recent quarters.

### Credit conditions remain tight but banking turmoil did not worsen them

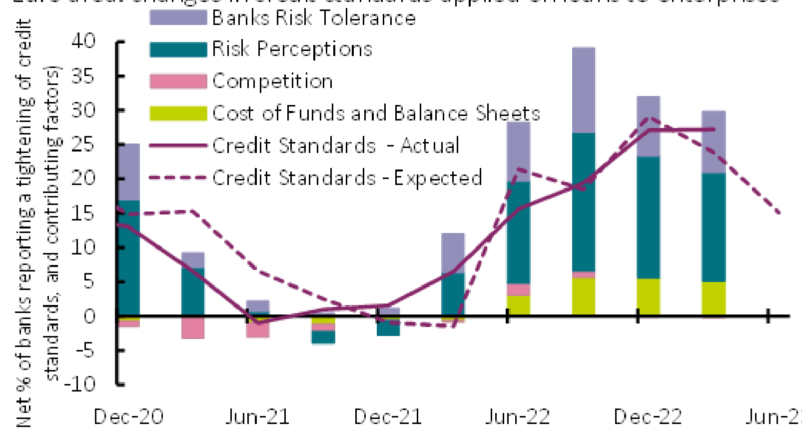
- Credit conditions overall are stable (dark line). The cost of funding – which has been identified as the main channel of recent stress – is also unchanged (dark green bar) while risk perception (light green bar) remains the most important driver.
- Looking forward, credit conditions are expected to improve (dark dotted line), possibly reflecting the recent rally in rates.

#### No major ramifications for euro area




*Source: ECB, Refinitiv, AXA IM Research, May 2023. EUR IG FI OAS: Bloomberg Invest. Grade: Financial Institutions EUR - Optional adj sprd*

#### No harm to credit conditions




*Source: ECB and AXA IM Macro Research, 17 May 2023*

# Assessing the turmoil in banking

## Euro area

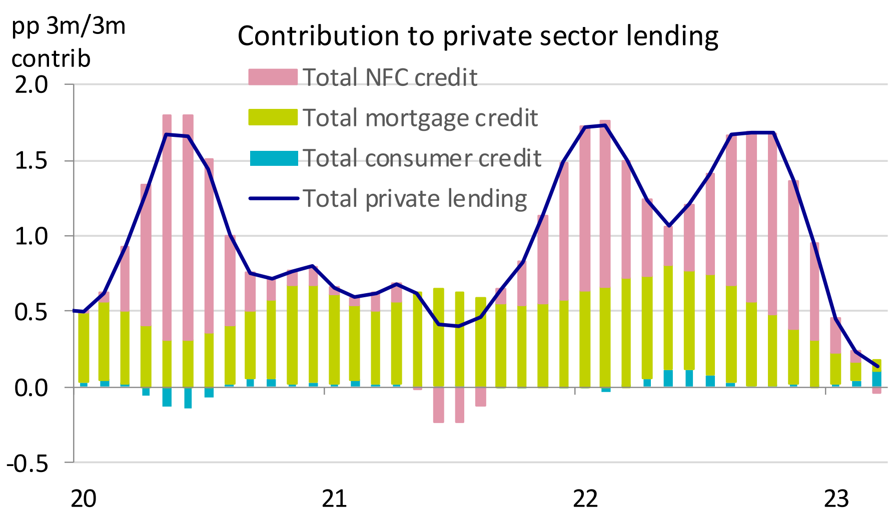
### Credit flows coming to a standstill

- Lending to the private sector has continued to decelerate, reflecting both a deterioration in nonfinancial companies and household sectors. Again, we believe that tighter monetary policy is really starting to dampen credit demand as acknowledged by ECB President Lagarde during the latest ECB press conference. This suggests that it is a matter of time before we see difficulties emerge in the real economy.

### Lending demand expected to remain weak

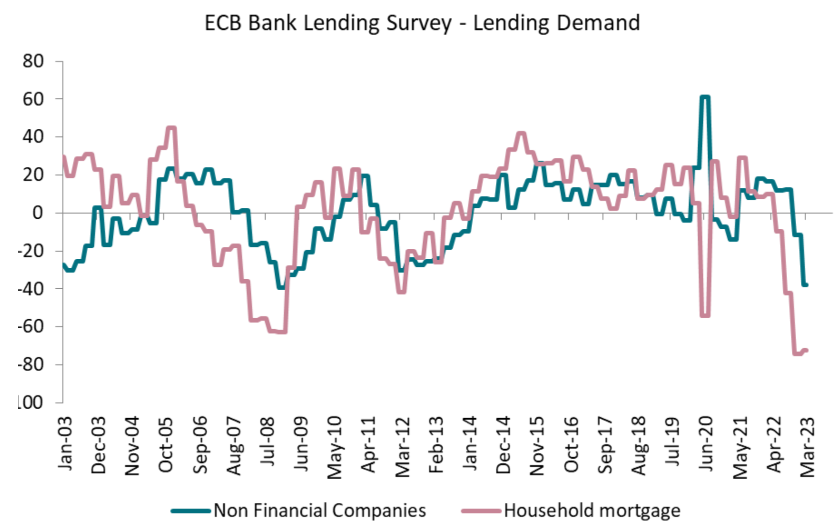
- Finally, banks surveyed in the BLS remain depressed in regard to lending demand as both levels for companies and households are close to 2008-2009 level.

Lending demand remains weak from companies…




*Source: ECB, AXA IM Research, May 2023*

Lending demand remains weak for both companies and households




*Source: ECB, AXA IM Research, May 2023*



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# Assessing the turmoil in banking

## More modest, but similar trends elsewhere

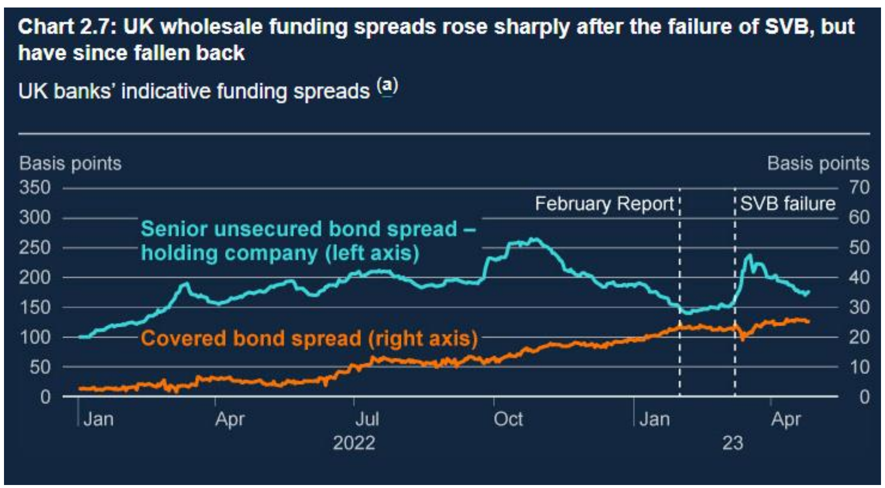
### British banks see a passing impact on wholesale funding costs

- The UK Financial Policy Committee met at the end of March, reflecting on very recent developments. It concluded that UK banks were resilient with sufficient financial resources to absorb shocks. More recently, the BoE's Monetary Policy Report illustrated that bank wholesale funding costs rose post-SVB, but fell back quickly afterwards. We await the Credit Conditions Survey on 13 July for further details on overall conditions, but to date the impact on UK economic conditions from banking turmoil seems modest.

### Canada's banks sound, but housing and wholesale funding vulnerabilities

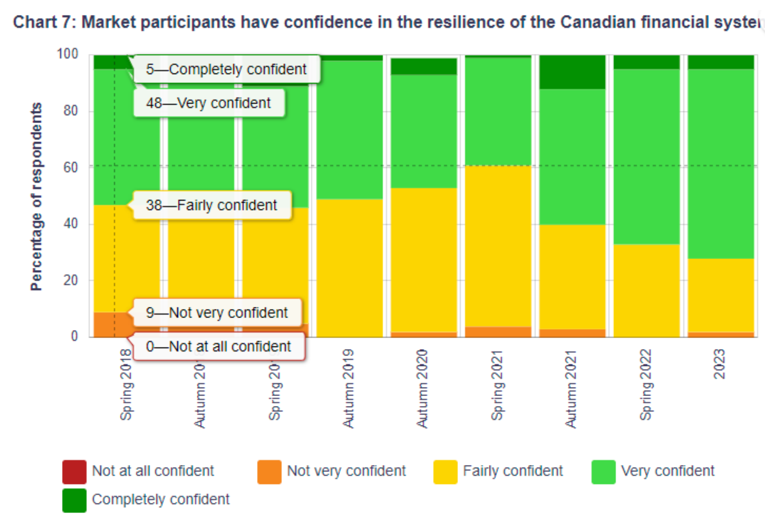
- The BoC's Financial System Review concluded that the Canadian banking system was resilient, well capitalised and had good liquidity. Certainly market confidence to date remains high – stronger in 2023 over the last five years. Canadian banks appear sound for now, but future risks could emerge if the economy weakens materially, particularly if it impacts the highly indebted household mortgage sector. Canadian banks also have higher wholesale funding than international peers. While avoiding deposit flight issues now, this could be a vulnerability in the event of a global banking crisis.

No lasting impact on UK wholesale funding costs




Source: Monetary Policy Report, BoE, May 2023

Confidence remains high in Canadian banking system




Source: Financial System Review, BoC May 2023

# Macro outlook

# Mounting signs of recession

## US

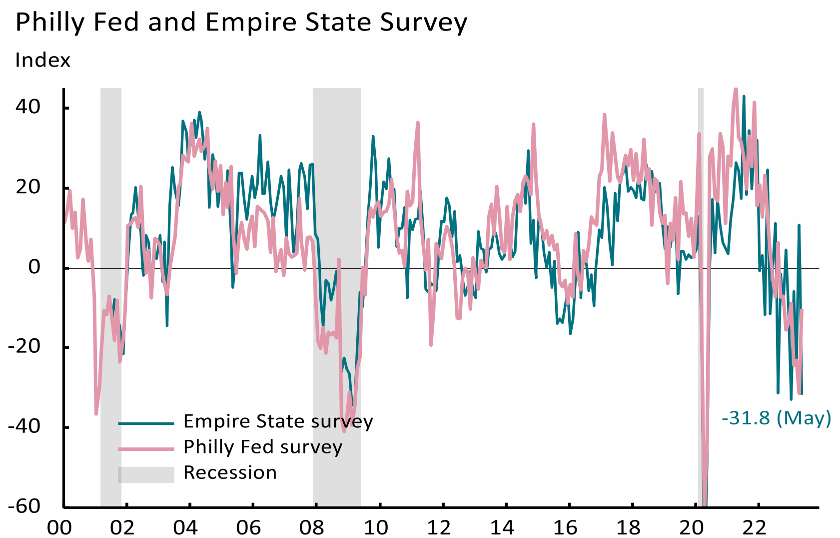
### A slowing economy

- Our own recession models, broader surveys and lending activity all point to recession. Q1 GDP rose by 1.1% annualised, although consumption growth was robust. We expect Q2 to be weaker (and do not rule out contraction) and see Q3 and Q4 as negative, confirming the mild recession expectation we expect to start around mid-year. In annual terms we forecast US growth of 1.0% this year and 0.6% next (consensus 1.1% and 0.8%).

### A resilient but slowing labour market

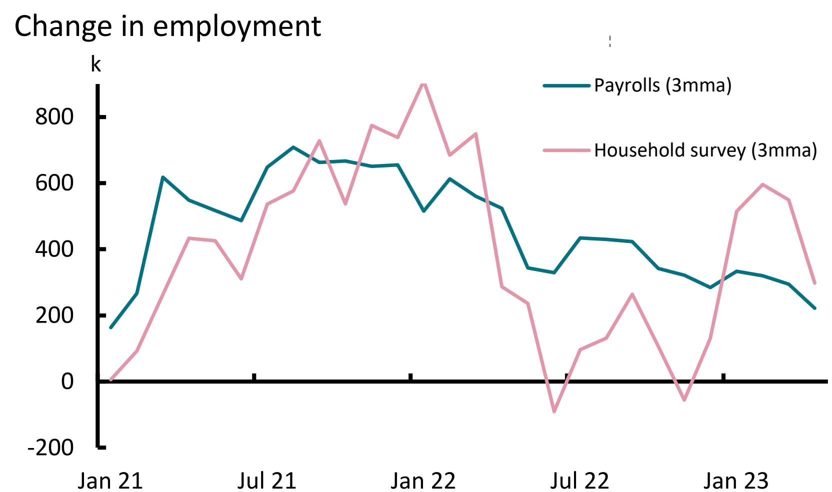
- Economic resilience to date has underpinned the labour market. However, there are clear signs of deceleration in employment growth, with the 3m trend in payrolls slowing to 222k in April, from 354k recorded the previous month. Key surveys suggest further deceleration in Q2, consistent with our assessment that a period of employment “catch-up” is over. More broadly, vacancies are falling, claims rising and job cuts high. We expect payrolls to slow to around 150k over coming months, but slow towards zero in Q3.

Fed surveys indicate recession risks




*Source: Refinitiv Datastream, AXA IM Research, 19/05/2023*

Employment growth trend is certainly slowing




Source: BLS, Refinitiv, AXA IM Research, May 2023

# Managing a slowing economy with elevated inflation

## US

### Rate uncertainty persists, but we see Fed peaked and no cuts before 2024

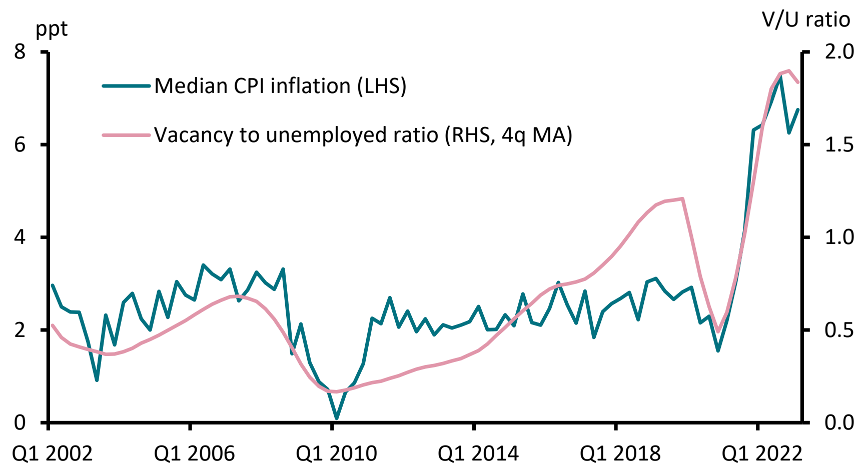
- The Fed removed its bias to "some additional tightening" at its last meeting, but a tight labour market is impeding underlying disinflation. We expect signs of deceleration and a deteriorating credit outlook to add to caution over the lagged impact of policy tightening to date. We believe that the Fed has peaked with rates at 5.25%. However, barring a sharper recession than we expect, we see the Fed on hold until early 2024 to ensure that inflation falls sufficiently next year. We forecast FFR ending 2024 at 3.75%.

### Debt ceiling – "You didn't think it was going to be that easy, did you?"

- The debt ceiling presents an exogenous threat to the US economy. Treasury Secretary Yellen has stated that "extraordinary measures" could be exhausted from 1 June. President Biden and Congressional leaders have been working on a bipartisan compromise to remove the threat. Yet with close timelines and political strains, we still expect market volatility as we approach X-date, although our baseline outlook assumes no default. Political miscalculation could add to recession risks, perhaps materially.

#### Tight labour market hampers core disinflation

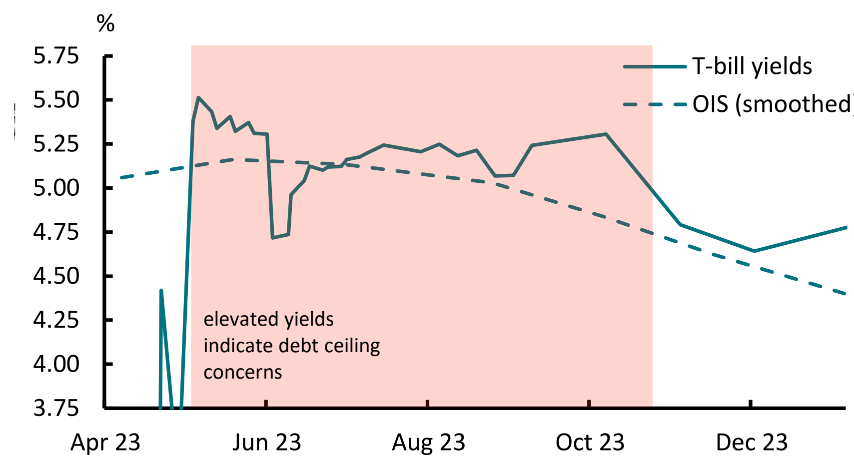
Median inflation and labour market tightness




Source: Cleveland Fed, Refinitiv, AXA IM Research, May 2023

#### T-bill yields indicate X date uncertainty

Tbill and OIS yield curve




Source: Bloomberg, AXA IM Research, 19 May 2023

# A (very) fragile economic activity

## Euro area

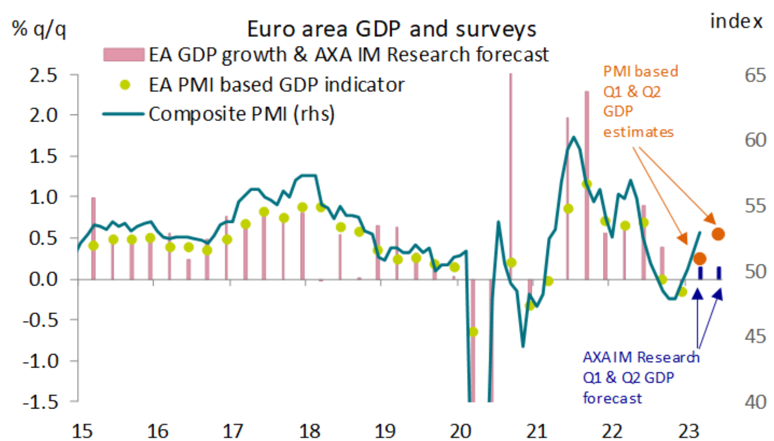
### Tracking banking turmoil with a microscope

- Banking sector developments have led to minimal marginal tightening in credit conditions, although the broader impact of tighter monetary policy is impacting overall conditions and dampening borrowing demand.

### Minimalist growth

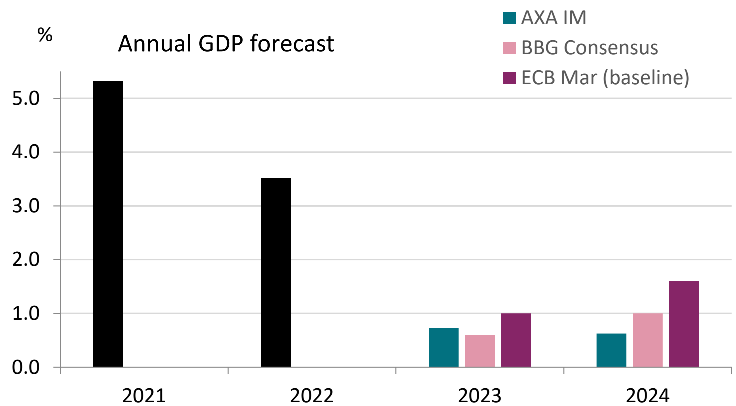
- Eurozone GDP struggled to rise by just +0.1% quarter-on-quarter in Q1. A detailed breakdown has not yet been published, but it seems that private consumption was a drag on growth, but was more than offset by net exports.
- Despite strong services PMIs in April, we remain cautious for the outlook, pencilling in meagre GDP growth in Q2 (+0.1%) as well as in H2 23 as monetary policy tightening continues to weigh, while the expected deceleration in inflation is likely to be too limited to provide material relief to consumers.

PMIs are seemingly overestimating current momentum




*Source: Refinitiv, AXA IM Research, April 2023. NB: Q2 PMI GDP estimate based on April data only while Q1 is based on January to March data*

Muted growth outlook (beware of 2024 projected acceleration)




*Source: ECB, Datastream, AXA IM Research, May 23*

# Unchanged ECB outlook

## Euro area

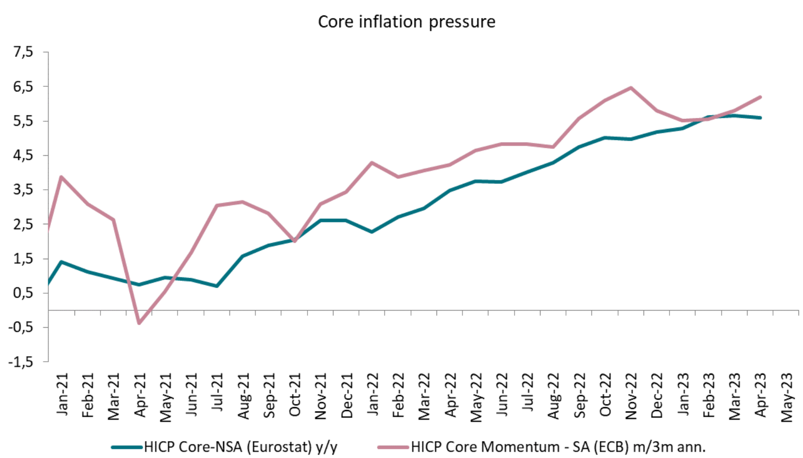
### Temporary pause on falling headline inflation

- Headline inflation was flat in April at 7% y/y - we believe the deceleration trend remains in place as energy and (soon) food base effects impact.
- Momentum on core inflation remains dangerously high. The ECB's seasonally adjusted core measure is much stronger than Eurostat releases (5.6% y/y) and this is mostly driven by a stronger acceleration in services prices. This is a reminder that services prices remain elevated, particularly in the near term, as activity continues to grow, more jobs are created, and recent wage deals start to feed through. May's core inflation will be impacted on the downside by the one-off effect from German cheap train tickets, but we then expect it to fluctuate between 5% and 5.3% y/y until July.

### Compromise, what compromise ?

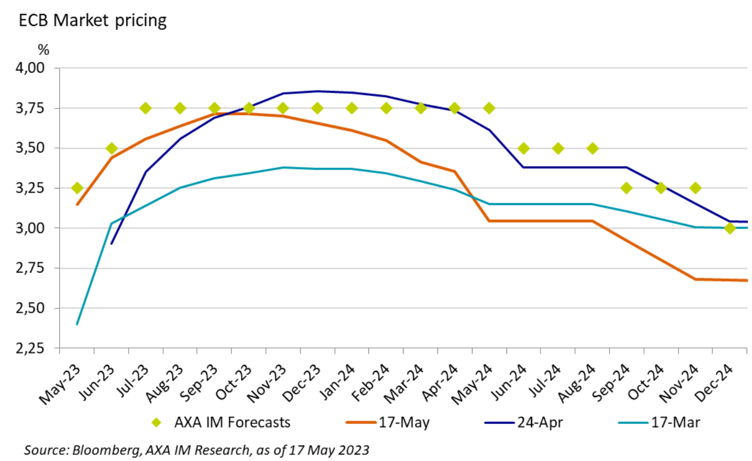
- Such modest core disinflation will not dissuade the ECB from raising interest rates by 25 bps in both June and July. This was well telegraphed by the ECB Governing Council's latest statement and subsequent comments by ECB President Lagarde who reminded that "there is still ground to cover". We continue to see risks to a 3.75% peak rate as skewed to the upside. The ECB also "expects" to discontinue the reinvestment of assets under the APP as of July 2023.

ECB seasonally adjusted core inflation measure accelerated in April




*Source: ECB, AXA IM Research, May 2023*

Short end rate market likely to adjust




*Source: Bloomberg, AXA IM Research, May 2023*

# Labour market cracks

## UK

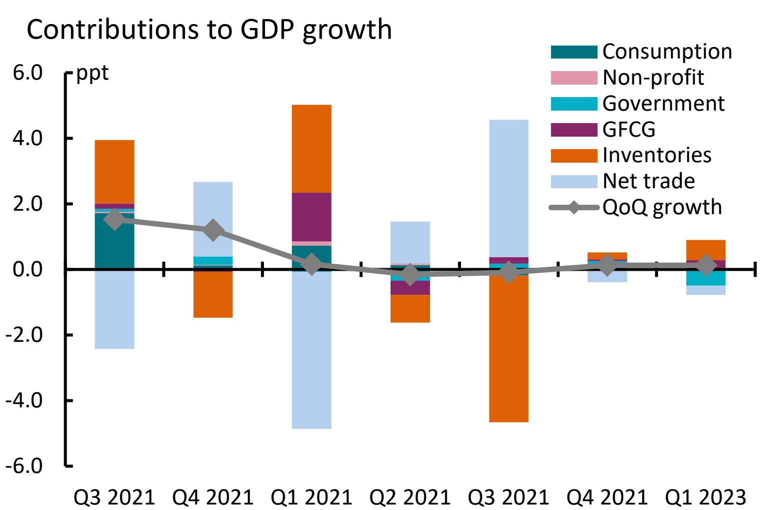
### Growing, but only just

- GDP rose 0.1% in Q1. Despite the economy not experiencing a technical recession as previously feared, domestic demand remains subdued. Consumption remained flat on the quarter and business investment was up just 0.7% in the last month for firms to take advantage of investment super-deductibility. We now expect GDP to decline by 0.1% in Q2 2023 and overall forecast GDP growth of 0.2% this year and 0.6% in 2024 (up from 0% and 0.5%).

### Labour market shows signs of cooling

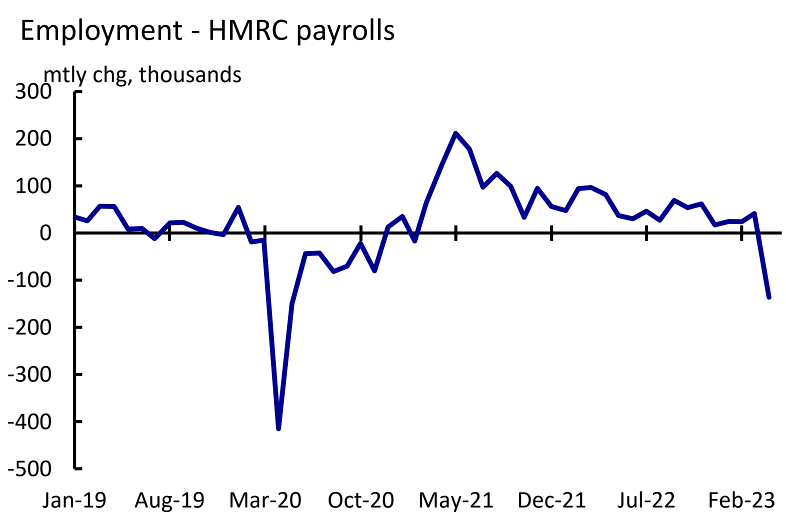
- May's labour market data signalled a turning point approaching in the recent labour market strength. Employment growth over Q1 remained strong (up 182k), but the more timely HMRC payrolls figure was down 135k on the month – the first fall in two years. Despite the pick-up in employment, the unemployment rate increased to 3.9% in March – its highest level in 14 months as more workers returned to the labour market.

Q1 GDP up 0.1% supported by inventories



Source: ONS, AXA IM Research, May 2023

HMRC payrolls point to large drop in April employment



Source: HMRC, AXA IM Research, May 2023

# We expect a June hold, but markets question whether more hikes needed

## UK

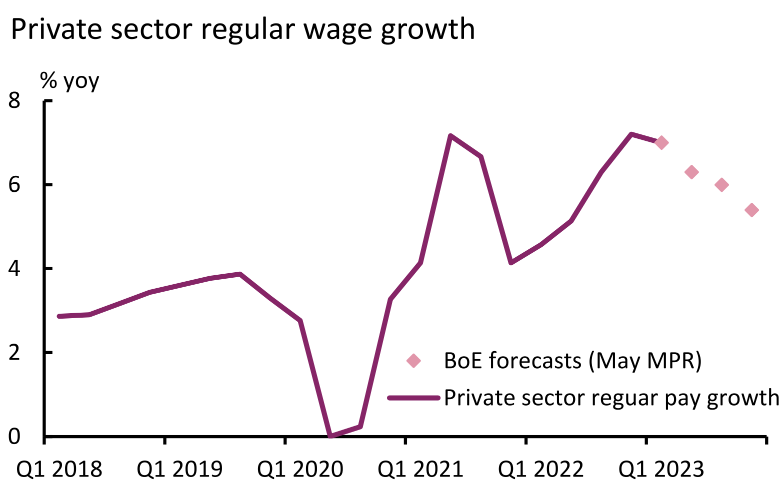
### The last shoe to drop?

- Despite the signs of moderation in labour supply and demand – wages remain elevated. We think that given signs of employment cooling wages hold the key to further hikes. Upside surprises relative to the BoE's expectations of wages to ease could increase the risk of an additional hike.

### A June hold most likely

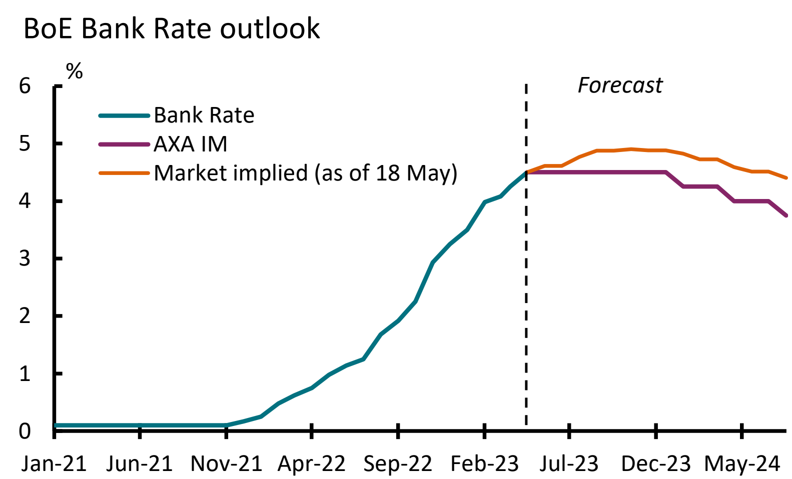
- We expect the BoE to remain on hold in June, particularly as the labour market has shown signs of moderating. The risks of a hike remain, particularly if wages accelerate further in the next labour market print. We will also see two CPI prints between now and the MPC meeting which will also be important. Further out, we expect the BoE to keep rates at 4.5% now until February 2024, only beginning to cut when they are confident that upside risks to inflation are abating. We pencil in 100bp of cuts over 2024, leaving Bank Rate at 3.5% by end-2024.

BoE expect wages to moderate gradually over 2023




Source: ONS, BoE, AXA IM Research, May 2023

Markets expect rates higher for longer




Source: Refinitv, BoE, AXA IM Research, May 2023

# A return to positive growth in Q1

## Japan

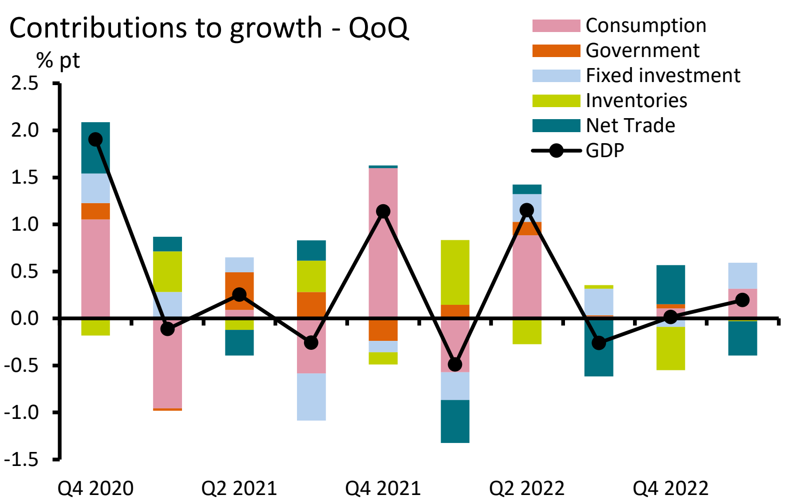
### Q1 growth confirms strong domestic momentum

- GDP rose by a quarterly 0.4% in Q1, above consensus estimates for a more subdued 0.2% rise following GDP remaining flat in Q4. The main driver was domestic demand, with consumption rising by 0.6% and capital expenditure up 0.9%. Sluggishness in global manufacturing activity weighed on exports, with goods exports down 6.5%.

### Business and consumer survey point to continued recovery

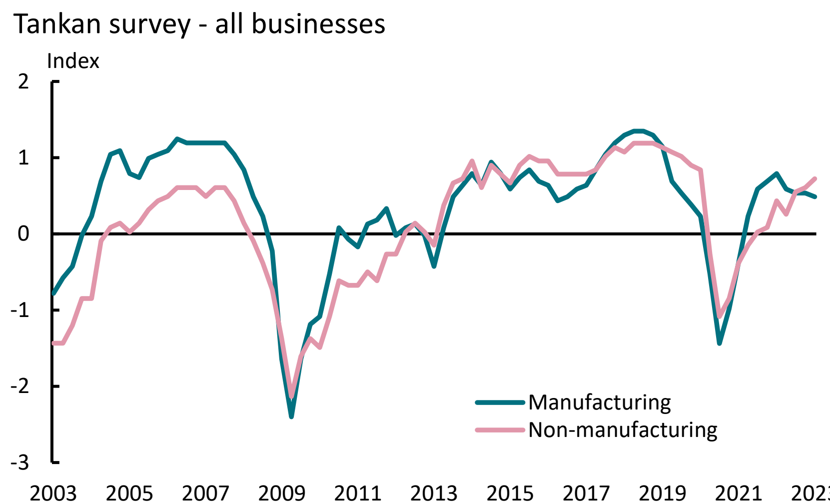
- We think the strength in GDP growth is likely to continue into Q2 as exports stabilise and private consumption continues to recover. Business surveys such as the Tankan and PMIs also point to a continued strength in investment spending. We see high prices and weakening external demand as the key downside risks to growth going forwards. Overall, we forecast annual GDP growth to average 1.5% this year and 1.3% in 2024.

#### PMIs signal strength in growth momentum




Source: Refinitiv, AXA IM Research, May 2023

#### Non-manufacturing firms picked up sharply




Source: BoJ, Refinitiv , AXA IM Research, May 2023

# Rising inflation to keep pressure on BoJ

## Japan

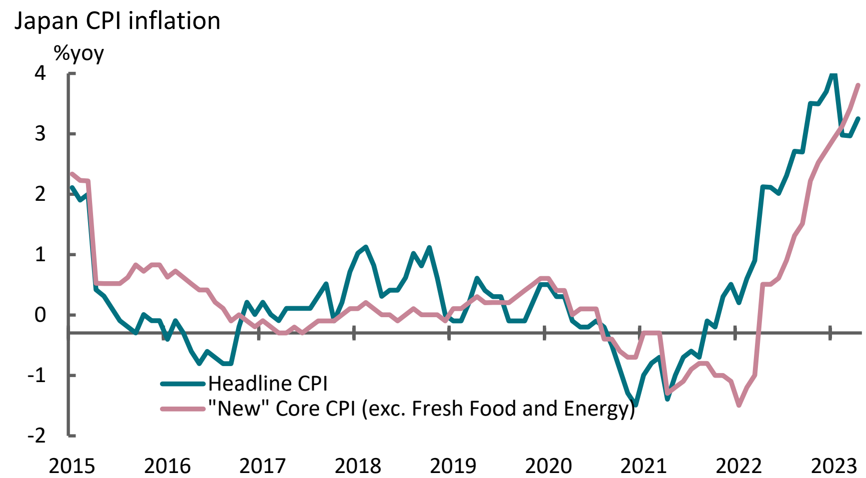
### Prices continue to rise despite government measures to hold down energy

- April CPI inflation rose again to 3.5% yoy from 3.2% in March. Core CPI (ex-fresh food and energy) rose to 4.1% - the highest since 1981. The rise in prices points to a greater pass through of rising costs by firms than we have seen historically in Japan. When considered alongside the strength in wages, expectations for a change in BoJ policy are likely to remain high.

### Ueda's first meeting as BoJ Governor confirms gradual approach most likely

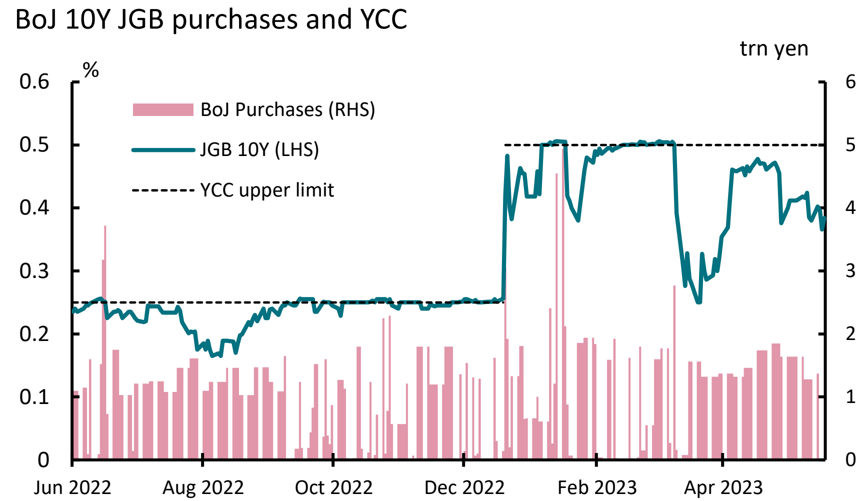
- Ueda's first meeting at the helm of the BoJ came in line with expectations. All policy tools including YCC were left unchanged. The BoJ also announced it would undertake a monetary policy review, to look at the impacts of policy easing since the late 1990s, indicating that this would likely take 1 year to 18 months to complete, but adding it would not preclude policy change during this period. We expect the BoJ to reduce the tenor of its YCC target to 5 years from 10 as an interim step before fully removing YCC. This will most likely come alongside the publication of the BoJ's next Report in July at the earliest, but the risk of delay remains.

Headline picks up in April




Source: Refinitiv, AXA IM Research, May 2023

Pressure on YCC has eased




Source: Refinitiv, BoJ, AXA IM Research, May 2023

# GDP starts to slow, but yet to show in jobs market

## Canada

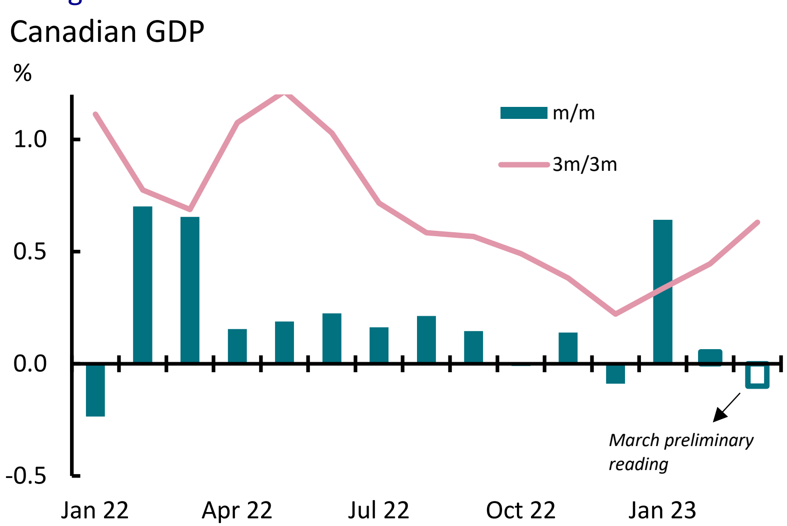
### Growth begins to sputter

- GDP growth rose by just 0.1% in February (from a 0.3% preliminary estimate) and fell by 0.1% in March (preliminary). With ice storms and a 12-day public sector strike to contend with in April, we expect Q1 and Q2 GDP now to be modestly weaker than previously expected and still look for a drop in output in Q3. We lower our annual growth outlook to 1.0% (from 1.2%) for 2023 and forecast 0.9% for 2024. Consensus forecasts 0.9% and 1.3% respectively.

### Labour market raises policy doubts, but should slow into Q3

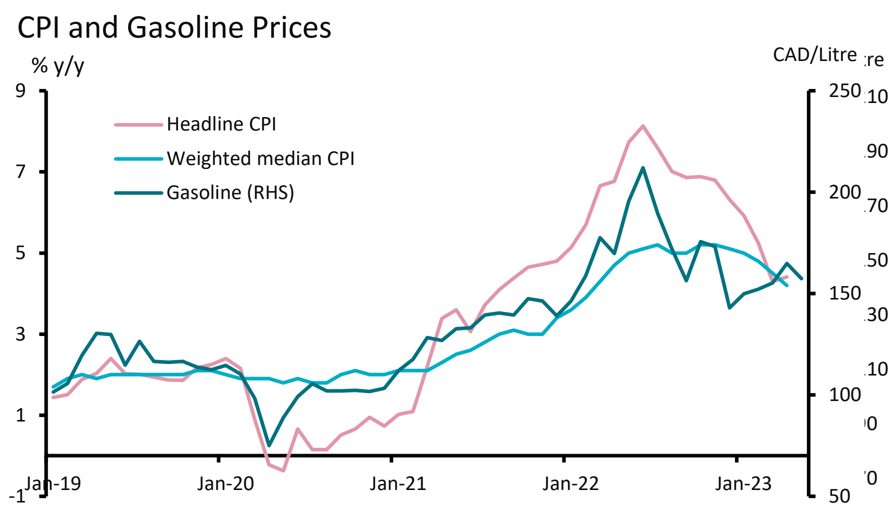
- Employment growth posted another solid 41k rise in April, following an average 69k/month across Q1, although April's full-time jobs fell for the first time in 8-months. Unemployment remains at 5.0% - close to multi-decade lows. Earnings growth persisted at an annual 5.6% (a monthly 0.8% in April). There are few signs of softening in the labour market yet, leading to doubts about whether policy is restrictive enough. We expect weaker growth to slow employment more visibly over the coming months.

GDP growth falters after a solid start




Source: CANSIM, AXA IM Research, May 2023

Headline CPI surprised, but core eased




Source: CANSIM, Bloomberg, AXA IM Research, May 2023

# BoC doubts, but lagged effects to dominate

## Canada

### CPI shifts consensus rate outlook

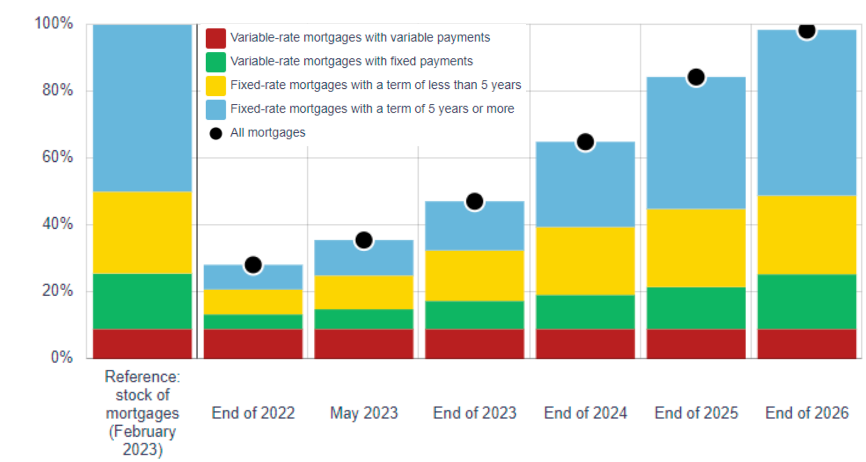
- CPI inflation rose to 4.4% in April as gasoline prices helped deliver an upside surprise which had a material impact on the outlook for policy rates. However, underlying measures, include ex food & energy, trimmed mean and median estimates all softened, median to 4.2% from 4.6%. The BoC still expects headline to fall below 3% in H2 this year. We forecast inflation to average 3.9% in 2023 and 3.0% in 2024, with consensus forecasting 3.6% and 2.1%.

### BoC watching policy tightening lags

- The BoC's April deliberations showed the Governing Council questioning the need for further tightening. However, the BoC's assessment that previous tightening is not yet fully impacting the economy urges caution. The BoC's recent Financial System Review reiterated that most Canadian mortgage holders have not seen mortgage rates adjust. With market volatility expected over the coming months, we believe the BoC has peaked at 4.50%, but expect cuts only from 2024 to 3.00% by year-end.

#### Materiality of BoC tightening for mortgage holders yet to be felt

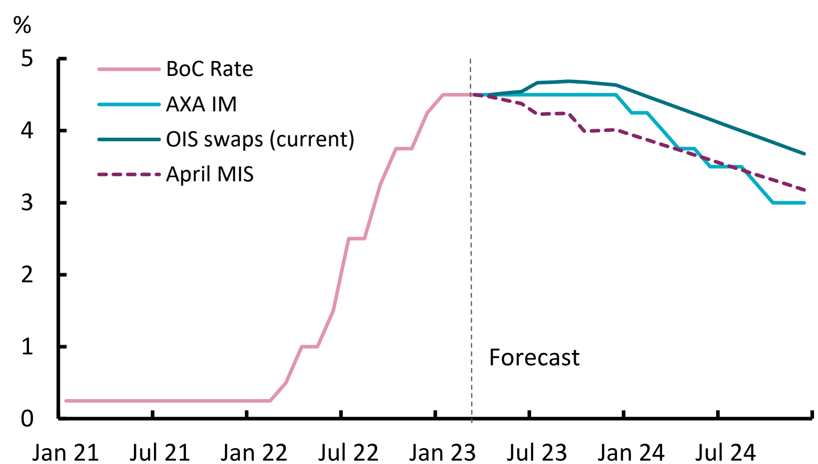
Cumulative share (by count) of mortgages subject to a payment increase (relative to the payment in February 2022)




Source: Financial System Review, BoC, May 2023

#### CPI inflation results in material re-pricing of market rate outlook

Bank of Canada overnight rate and outlook




Source: Bloomberg, AXA IM Research, May 2023

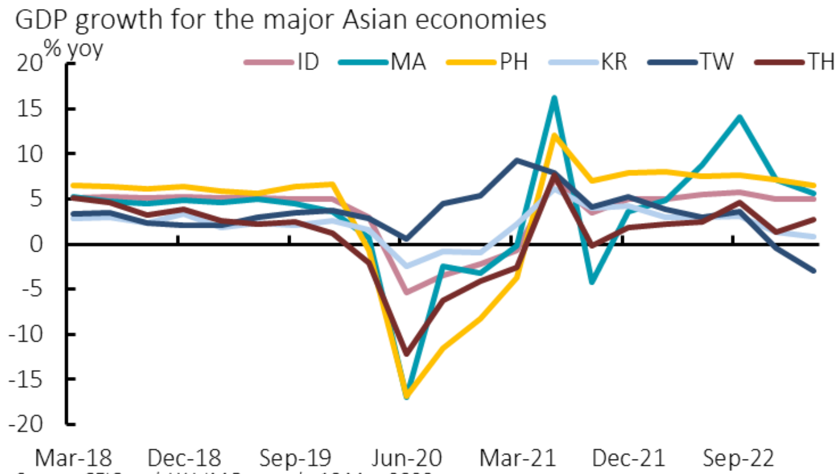
# Still resilient growth at the start of 2023

## Emerging Markets

### Q1 gets off to decent start

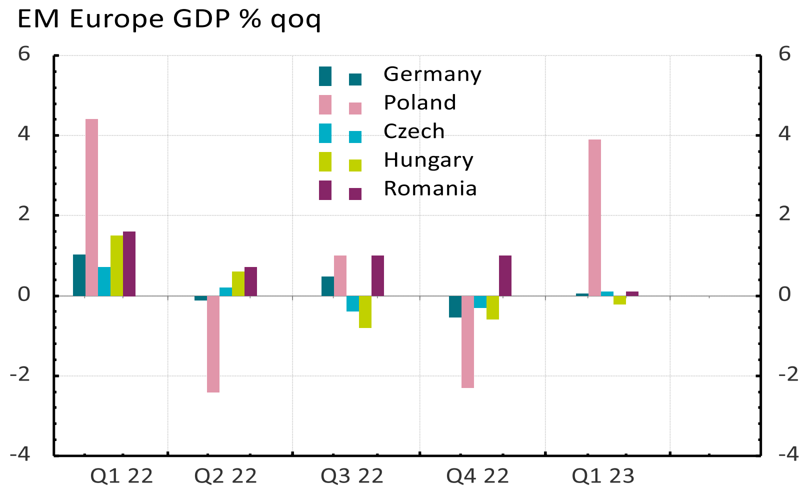
- Q1 GDP growth in EM Asia was mixed. Indonesia's growth remained steady at 5% yoy, while sequential growth for Malaysia, Korea and Thailand improved. Taiwan's first quarter GDP contracted again, which pushed it into a technical recession.
- In Latam, GDP surprised to the upside by accelerating in Colombia and Mexico to 1.4% qoq and 1.1% qoq. Likewise, growth accelerated in Chile to 0.8% qoq. Q1 GDP data is not yet available for Brazil, but the monthly activity indicator for February suggests resilience. In contrast, Peru's economy contracted 0.4% qoq in Q1, which reflected the consequences of social unrest in January.
- Most CEE economies have seen economic recovery in Q1 2023. GDP has contracted in Hungary, albeit by less than in the previous quarters. Polish GDP growth spiked by +3.9% qoq - very volatile since the pandemic. Stronger than expected Q1 GDP's suggest our 2023 forecast will need to be revised up. Romania GDP surprised to the downside.

#### Q1 GDP mixed in Asia, but generally prove to be decent




*Source: CEIC and AXA IM Research, 19 May 2023*

#### CEE coming out of recession




*Source: Refinitiv Datastream and AXA IM Research Q1 23*

# Turkish elections: towards a tight run-off

## Emerging Markets

### President Erdoğan's strong result in the first round defied polls

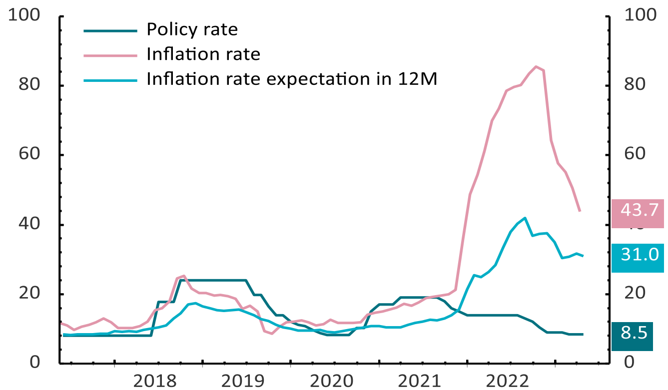
- Turkey's first round presidential elections had contenders on May 14 after the ex-CHP (Republican's People Party) candidate Ince withdrew, fuelling hopes of an outright opposition win. Instead, incumbent President Erdoğan obtained a better-than-expected 49.5% of the votes, while joint opposition candidate Kılıçdaroğlu trailed with 44.9%. The third candidate, ex-MHP (Nationalist Movement Party) independent Oğan secured more than 5%.
- Incumbent People's Alliance obtained a simple majority in the Parliament, at odds with opinion polls ahead of elections

### The run-off on May 28 … what next?

- Undeniably, President Erdoğan appears in a stronger position into the run-off although most polls do point to Kılıçdaroğlu winning. The race will be tight. By June 1, final official results will be known. Whoever wins the race will nonetheless face the task of improving Turkey's economic outlook, which has grown increasingly unbalanced. Painful adjustments, among which on the currency side, are necessary before Turkish assets appear attractive for foreign investors. Improving the institutional framework appears to us key to implementing effective stabilization reforms, which look more difficult were President Erdoğan be re-elected.

#### Unorthodox monetary policy

Turkey: monetary policy and inflation




*Source: Refinitiv Datastream and AXA IM Research Apr 23*

#### Insufficient reserves in the face of high external financing needs

FX reserves as % short term external debt


*Source: Refinitiv Datastream and AXA IM Research Q2 23*

# Investment Strategy

# Investment Strategy

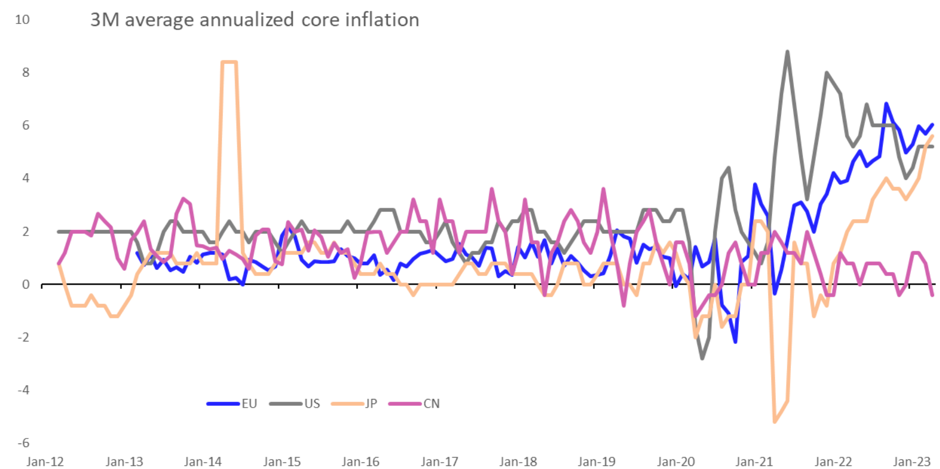
## FX: Tears of the middle kingdom

- USD is gaining support from, once again, resilient US data. Yet this may only be temporary as we have likely reached 'Fed peak', while 'younger' economic cycles abroad are gaining pace. The impact of US debt ceiling negotiations on the USD is hard to read and may be simply neutral, but a resolution could bring further fiscal constraints in the US, which should weigh on the dollar outlook.
- EUR should rebound as the ECB maintains a hawkish stance, facing elevated core inflation and services demand that is surprising to the upside. Further, strong EU equity markets and high yielding rates in EUR assets should attract further capital flows. Already rich valuation, and long positioning limits the upside in EURUSD beyond 1.14 though.
- USD had also benefited from disappointment in China's recovery. The divergence in inflation trajectories forces PBoC to maintain a lower rate policy. As a result, investment inflows should remain muted, given also higher geopolitical tensions and ESG criteria. Rebound in imports and softening foreign demand is likely to compress the trade balance surplus. CNH should underperform in this background.
- BoJ also disappointed markets, but the JPY now looks cheap. YCC adjustment is still on the table and positioning is much lighter, while wage negotiations have beaten expectations. JPY should benefit from USD and US rates peaking out, and/or from late cycle dynamics.

### USD looks rich against interest rate differential


Source: Bloomberg & AXA IM Core Research; May 2023

### Japanese inflation catching up, Chinese inflation diverging




Source: Bloomberg & AXA IM Core Research; May 2023



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# Investment Strategy

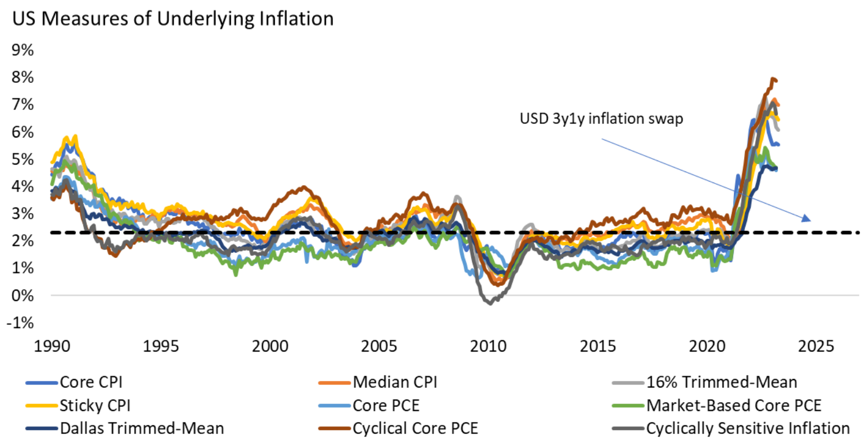
## Rates: Market positioning vs inflation expectations

- Market-based inflation expectations have diverged from surveys and trends in underlying inflation and this is the case in the US and the Eurozone. In particular, long-term consumer inflation expectations ring an alarm bell for central bankers' credibility. Central banks have only recently changed their inflation narrative from "temporary" to "persistent", while the ECB started its hiking cycle later than the Fed.

- While the front-end of the curve still implies that the Fed is to deliver a quite sharp, fast cutting cycle, CFTC positioning hints at substantial shorts across the US bond futures curve by leveraged accounts. Technical factors (e.g. carry, delta-hedging of corporate debt) might partly explain such positioning, which is a likely reason for the Treasury market's resilience in the wake of a stronger than expected macro landscape.

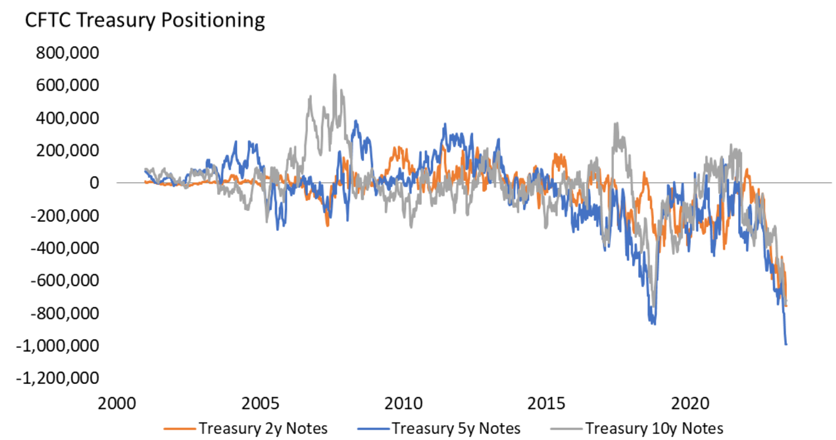
- With regards to the Fed's future policy path, markets may still question the peak of its hiking cycle. A re-pricing of expectations for interest rate cuts would most like push bond yields higher, even on longer maturities.

### Divergence between actual and expected inflation remains




Source: Bloomberg & AXA IM Core Research, May 2023

### Leveraged accounts short positioning in UST has accelerated




Source: Bloomberg & AXA IM Core Research, May 2023

# Investment Strategy

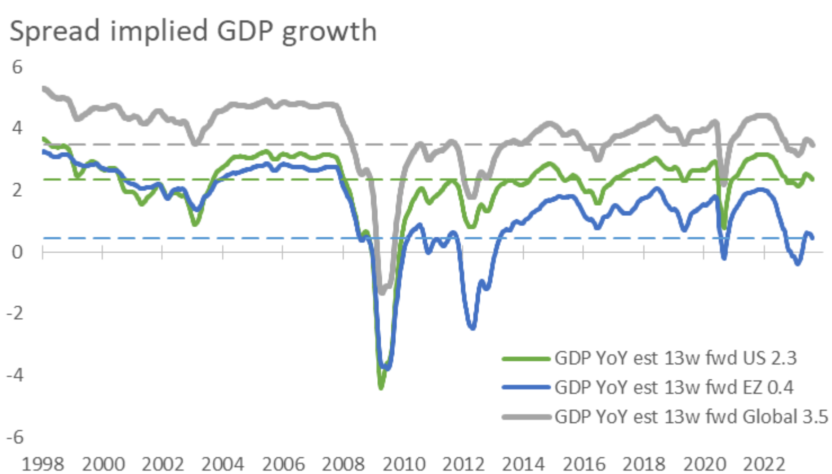
## Credit: Spread levels not recessionary; too confident or too complacent

- Spreads have been soft over the past month, widening by c.10% in IG and by c.5% in HY. With underlying government bond yields almost unchanged over the period, credit yields have risen to the detriment of performance. This has been more evident in USD markets, where credit return was negative, while EUR markets managed to eek out small gains, as yield carry managed to cover the drop in price.

- That said, spreads remain resilient overall and at current levels do not appear to imply a material risk of recession. Indeed, the average spread in USD IG over the past 3 months is consistent with US GDP growth of 2.3% YoY over the next 3 months. Similarly, EUR IG implies 0.4% for Europe and Global IG implies 3.5% for Global growth. Overall, we remain rather cautious in terms of the risk-reward in spreads.

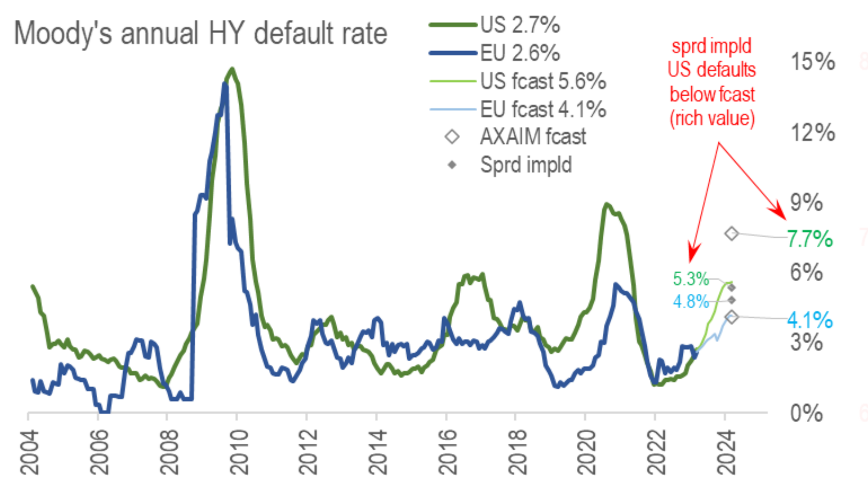
- The much-anticipated bank loan officer survey in the US for Q1 2023 (spanning 2 months before banks' troubles and 1 month after) showed a marginal tightening in bank lending standards (from +44.8 to +46, '+' is tight). Our default forecasts have been hardly affected as a result, given that at the same time, bond market distress ratios have remained subdued. Default valuation wise, EU HY continues to screen cheap.

### Credit spreads implying modest to normal growth




Source: Bloomberg, AXA IM Research; May 2023

### Default expectations no worse after latest loan officer surveys




Source: Moody's, ICE, Fed, ECB & AXA IM caclulations; May 2023

# Investment Strategy

## Equities: Back on track

- Global equity market has held up well in May (+0.9%) thanks to the positive contribution by growth companies (+3.8%). The growth factor was fuelled by the strong performance of the technology sector (+5.3%), which benefited the overall index due to the large size of is the stocks. In addition to being the best sector this month, tech is up +25.4% YtD, due to multiple expansion, despite the sector's rich valuation.

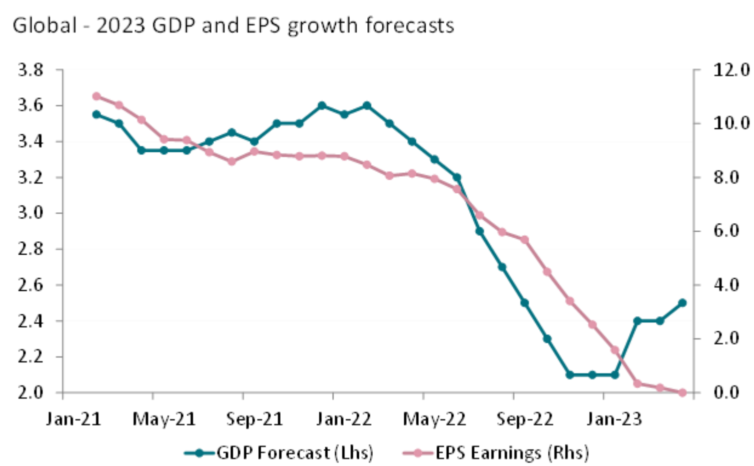
- Interestingly, cyclical stocks (+2.3%) have rallied against defensives (-1.7%) in May after a difficult April, partly due to the rebound in tech and communications services (particularly in semis, +8.7%), as the cloudy outlook was helped by surprisingly positive Q1 2023 earnings results. The resilience in the results at the start of the year and improved growth outlook could support a rebound in earnings expectations.

- Continuing with the earnings season, results have overall been better than expected both in the US (-3%y/y) and Europe (+3%y/y). These positive surprises are mainly due to sales growth (inflation impact has helped). On the other hand, profit margins are (finally?) showing signs of reversal with the weakest quarterly growth seen since Covid. Despite the positive surprises, the muted market price reaction has been well below historical norms, reflecting a certain degree of caution from investors.

### Cyclicals rebound again ?


Source: MSCI, Refinitiv and AXA IM Research, May 2023

### Momentum divergence in 2023 growth forecasts




Source: Bloomberg, IBES and AXA IM Research, May 2023

# Key market calls

## Our directional views across assets in key markets (3-month horizon)

**CURRENCIES**

| | weaker | neutral | stronger |
|---|---|---|---|
| Euro | | | ● |
| Yen | | | ▶▶ ● |
| GBPEUR | ● | | |

**EQUITY**

| | lower | neutral | higher |
|---|---|---|---|
| US equity | ● | | |
| EU equity | | ● | |
| EM equity | | ● ◀◀ | |

**RATES**

| | higher | neutral | lower |
|---|---|---|---|
| US rates short | ● | | |
| US rates long | | ● | |
| EU rates short | ● | | |
| EU rates long | ● | | |

**CREDIT**

| | wider | neutral | tighter |
|---|---|---|---|
| US IG | | ● | |
| EU IG | | ● | |
| US HY | ● ◀◀ | | |
| EU HY | | ● | |

**CURRENCIES**

USD has gained support, once again, from resilient US data, yet this may be only temporary. EUR should rebound as ECB maintains a hawkish stance. JPY should benefit from USD and US rates peaking out.

**EQUITY**

Muted market price reaction to positive earnings surprises shows caution by investors. EM equity may be vulnerable to US recession risk over the next few months. US equities vulnerable to setbacks in tech mega cap performance.

**RATES**

Rates volatility remains elevated and the jury is still out in regards to Fed's hiking cycle peak. Market-based inflation expectations perhaps too sanguine compared to inflation surveys and underlying inflation trends.

**CREDIT**

Unappealing reward vs recession risk in spreads still warrants a prudent stance. US HY screens low on default valuation & mean reversion potential. Europe spreads look somewhat better in mean reversion and valuation terms.

*Source: AXA IM Core Investment Research, as of 23 May 2023*



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# Forecasts & Calendar

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# Macro forecast summary

## Forecasts

| Real GDP growth (%) | 2022 | | 2023* | | 2024* | |
|---|---|---|---|---|---|---|
| | AXA IM | *Consensus* | AXA IM | *Consensus* | AXA IM | *Consensus* |
| World | 3.4 | | 2.8 | | 2.8 | |
| Advanced economies | 2.7 | | 1.0 | | 0.8 | |
| US | 2.1 | 2.1 | 1.0 | 1.1 | 0.6 | 0.7 |
| Euro area | 3.6 | 3.2 | 0.7 | 0.7 | 0.6 | 1.0 |
| Germany | 1.8 | 1.8 | 0.0 | 0.1 | 0.6 | 1.2 |
| France | 2.6 | 2.6 | 0.6 | 0.5 | 0.6 | 1.0 |
| Italy | 3.7 | 3.8 | 0.6 | 0.6 | 0.5 | 1.0 |
| Spain | 5.5 | 5.5 | 1.6 | 1.4 | 0.9 | 1.8 |
| Japan | 1.1 | 1.0 | 1.5 | 1.1 | 1.3 | 1.1 |
| UK | 4.0 | 4.0 | 0.2 | -0.2 | 0.6 | 0.8 |
| Switzerland | 2.1 | 2.1 | 0.6 | 0.7 | 1.3 | 1.5 |
| Canada | 3.4 | 3.4 | 1.2 | 0.8 | 0.9 | 1.3 |
| Emerging economies | 3.9 | | 3.8 | | 3.9 | |
| Asia | 4.3 | | 5.0 | | 4.6 | |
| China | 3.0 | 3.0 | 5.3 | 5.5 | 5.0 | 5.1 |
| South Korea | 2.6 | 2.6 | 1.5 | 1.1 | 2.0 | 2.2 |
| Rest of EM Asia | 6.0 | | 5.0 | | 4.4 | |
| LatAm | 4.0 | | 1.5 | | 2.3 | |
| Brazil | 2.9 | 2.9 | 1.0 | 1.0 | 1.5 | 1.7 |
| Mexico | 3.1 | 3.1 | 1.2 | 1.4 | 1.8 | 1.7 |
| EM Europe | 0.9 | | 1.5 | | 2.3 | |
| Russia | -2.1 | | 1.7 | | 1.3 | 1.3 |
| Poland | 4.9 | 4.9 | 1.0 | 0.6 | 2.9 | 3.1 |
| Turkey | 5.6 | 5.6 | 2.1 | 2.1 | 3.1 | 2.8 |
| Other EMs | 4.9 | | 3.1 | | 3.7 | |

*Source: Datastream, IMF and AXA IM Macro Research – As of 22 May 2023*
**Forecast*

# 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 | 7.4 | | 4.7 | | 2.7 | |
| US | 8.0 | 8.0 | 4.3 | 4.3 | 3.0 | 2.6 |
| Euro area | 8.4 | 8.5 | 5.8 | 5.5 | 2.9 | 2.4 |
| China | 2.1 | 2.0 | 2.3 | 2.2 | 2.5 | 2.4 |
| Japan | 2.5 | 2.5 | 2.7 | 2.5 | 1.3 | 1.4 |
| UK | 9.1 | 9.1 | 6.6 | 6.4 | 2.4 | 2.8 |
| Switzerland | 2.8 | 2.8 | 2.0 | 2.6 | 1.3 | 1.5 |
| Canada | 6.8 | 6.8 | 3.9 | 3.6 | 3.0 | 2.2 |

*Source: Datastream, IMF and AXA IM Macro Research – As of 22 May 2023*

**Forecast*

### Central banks' policy: meeting dates and expected changes

| Central bank policy<br>Meeting dates and expected changes (Rates in bp / QE in bn) | | Current | Q2-23 | Q3-23 | Q4-23 |
|---|---|---|---|---|---|
| United States - Fed | Dates | 5.25 | 13-14 Jun | 25-26 Jul<br>19-20 Sep | 31-1 Oct/Nov<br>12-13 Dec |
| | Rates | | unch (5.25) | unch (5.25) | unch (5.25) |
| Euro area - ECB | Dates | 3.25 | 15-Jun | 27 Jul<br>14 Sep | 26 Oct<br>14 Dec |
| | Rates | | +0.25 (3.5) | +0.25 (3.75) | unch (3.75) |
| Japan - BoJ | Dates | -0.10 | 15-16 Jun | 27-28 Jul<br>21-22 Sep | 30-31 Oct<br>18-19 Dec |
| | Rates | | unch (-0.10) | unch (-0.10) | unch (-0.10) |
| UK - BoE | Dates | 4.50 | 22-Jun | 3 Aug<br>21 Sep | 2 Nov<br>14 Dec |
| | Rates | | unch (4.50) | unch (4.50) | unch (4.50) |
| Canada - BoC | Dates | 4.50 | 07-Jun | 12 Jul<br>6 Sep | 25 Oct<br>6 Dec |
| | Rates | | unch (4.50) | unch (4.50) | unch (4.50) |

*Source: AXA IM Macro Research - As of 22 May 2023*

# Calendar of 2023 events

| | Dates | Events | Comments |
|---|---|---|---|
| May | 28-May | Spain Regional elections | |
| June | Early Jun | US Earliest Treasury special measures could see debt ceiling impact | |
| | 13-14 Jun | FOMC Meeting | Unchanged (5.25%) |
| | 15-Jun | ECB Meeting | +25bps (3.50%) |
| | 16-Jun | BoJ Meeting | Unchanged (-0.1%) |
| | 18-Jun | Turkey presidential and parliamentary elections | |
| | 22-Jun | BoE Meeting | Unchanged (4.50%) |
| | 29-30 Jun | European Council Summit | |
| July | Jul | Greece elections (National Parliament) | |
| | Late Jul | US Estimated resolution of the debt ceiling | |
| August | Late Aug | Federal Reserve's Central Bank Symposium Jackson Hole | |
| September | Autumn 23 | Poland presidential elections | |
| October | 29-Oct | Argentina general elections | |
| December | | Spain (National Parliament) | |

# Latest publications

Turkey General Elections: The final countdown

*9 May 2023*

US debt ceiling impasse: Unnecessary and unavoidable

*3 May 2023*

April Global Macro Monthly – Central banks gauge lagged effects

*26 April 2023*

April Monthly OpEd – Patchy disinflation will trigger policy divergence

*26 April 2023*

Brazil: Lula 3.0 – Good news for climate and biodiversity?

*24 April 2023*

Bank of Japan policy update: A question of when, not if

*11 April 2023*

March Global Macro Monthly – Faith in the system

*29 March 2023*

March Monthly OpEd – Accelerated monetary tightening pass-through

*23 February 2023*

ECB Quantitate Tightening: Navigating a treacherous path

*1 March 2023*



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