Investment Institute Macroeconomics

Ahead after the first half …

Monthly Investment Strategy

AXA IM Research

July 2023

Summary: July 2023

Theme of the month: Against the odds – markets in first half 2023

- The ominous prospects for risky assets at year start did not materialise, as a rebound in growth expectations and resilient earnings buoyed sentiment. Concerns about banks after SVB in March were trumped by exuberance about AI developments.
- Duration volatility kept government bond returns under pressure. By contrast, global equity returns and global HY fared better, recovering most of the 2022 drawdown. This pecking order across assets could persist as long as recession risk keeps getting postponed and earnings hold up.
- Despite ups & downs, USD kept its depreciation trend since Q3 2022 as stickier inflation provided intermittent support and G10 central banks caught up with the Fed's tightening. GBP has benefited from the sharp rise in UK rates while JPY & CNH have underperformed.
- Central bankers shifted their attention to measures of underlying inflation, deeply concerned that elevated levels of sticky inflation might lead to a de-anchoring of expectations. Labour market imbalances that might lead to wage-price spirals should be avoided.
- Credit spreads resilience has brought them near early 2022 lows, at levels historically associated with spread widening, although recession risk would have to become a catalyst. Valuation remains a key factor in stocks, but easing inflation and less pressure from interest rates is fuelling optimism, for now.

Macro update: Central banks hang on inflation dynamics

- Growth dynamics have been mixed. North American growth has proven more resilient than expected, the US and Canada continuing to expand even if deceleration is expected in Q2. European growth is softening, disappointing in the Eurozone and remaining weak in the UK. Meanwhile Japanese growth has proven solid, while Chinese growth slowed in Q2. EM's remain diverse, but in the main Latam and CEE build on a solid start to the year.
- Inflation trends are clearer. Disinflation is a feature in most economies, synchronised as global energy prices have retreated and food prices started to soften. Core inflation is less clear, softening in some regions (the US), but less obviously so in the Eurozone, UK and Canada. Further core disinflation looks likely over the coming quarters. This trend is echoed in EM and particularly in those benefitting from rising currencies amidst recent dollar weakness.
- As such central banks appear to be reaching peaks, with more hikes expected from the Fed, ECB and BoE, but peaks arriving soon after that. Core inflation risks and resilient economies provide risks of tighter policy. But central banks may achieve that from holding policy elevated for longer, rather than higher peaks. EM economies are also seeing preparations for policy easing in several economies, beyond the handful already to have eased.

Investment Strategy: risky assets still in a constructive mood

- FX: EUR strengthening against USD has been excessive and deserves a tactical correction. USDJPY has been closely tracking the 10Y rate differential and should have limited upside if US rates are toppish. CHF should track the EUR consolidation against the USD, while shorting CHF offers a higher carry.
- Rates: Bond investors seem content with entry levels around 4% on 10y USTs. Bond demand remains an unknown into H2, as the Fed's withdrawal from the bond market leaves a large gap to be filled by private investors. One source of structural demand could be pension funds and insurance companies.
- Credit: Spreads have continued to grind tighter and are clearly not pricing a recession over the next 3-6 months. Low spread volatility also underpins spreads, as low vola allows for lower spreads at a given risk-reward target. Spread/Yield ratio rises off its post GFC lows when if adjusted by volatility.
- Equities: June gains enabled global equities to close one of the best first halves of all time. Global stock valuation has continued to rise and is slightly above its long-term average. The VIX term structure is historically steep between 1st & 3rd month, reflecting a sense ease about a negative shock near term.

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 2.7% in 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, but to emerge over H2. Inflation persistence is now key risk.

Monetary policy

Most central banks close to peak, Fed, ECB and BoE with further to go. Rate cuts unlikely in 2023 outside some EM.

Fiscal policy

Europe has provided fiscal support, but consolidation increasingly the outlook. US debt ceiling resolution leaves longer-run outlook unsustainable.

Emerging Markets

Inflation easing across EM. Central banks starting to consider cuts where conditions are right. Global rate adjustments add to fragile finances

FX

Euro gains seem premature. BoJ action should underpin further yen gains. Sterling overpriced on rate outlook, but risks on reversal timing.

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.

Credit

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

Rates

Longer-term rates rise as short-term policy rate views grow more hawkish. But peak policy points to peak term rates soon.

Growth

Growth resilient in DMs, starting to disappoint in Europe. Mild recession still expected in US, but doubts grow. Credit conditions add to headwinds.

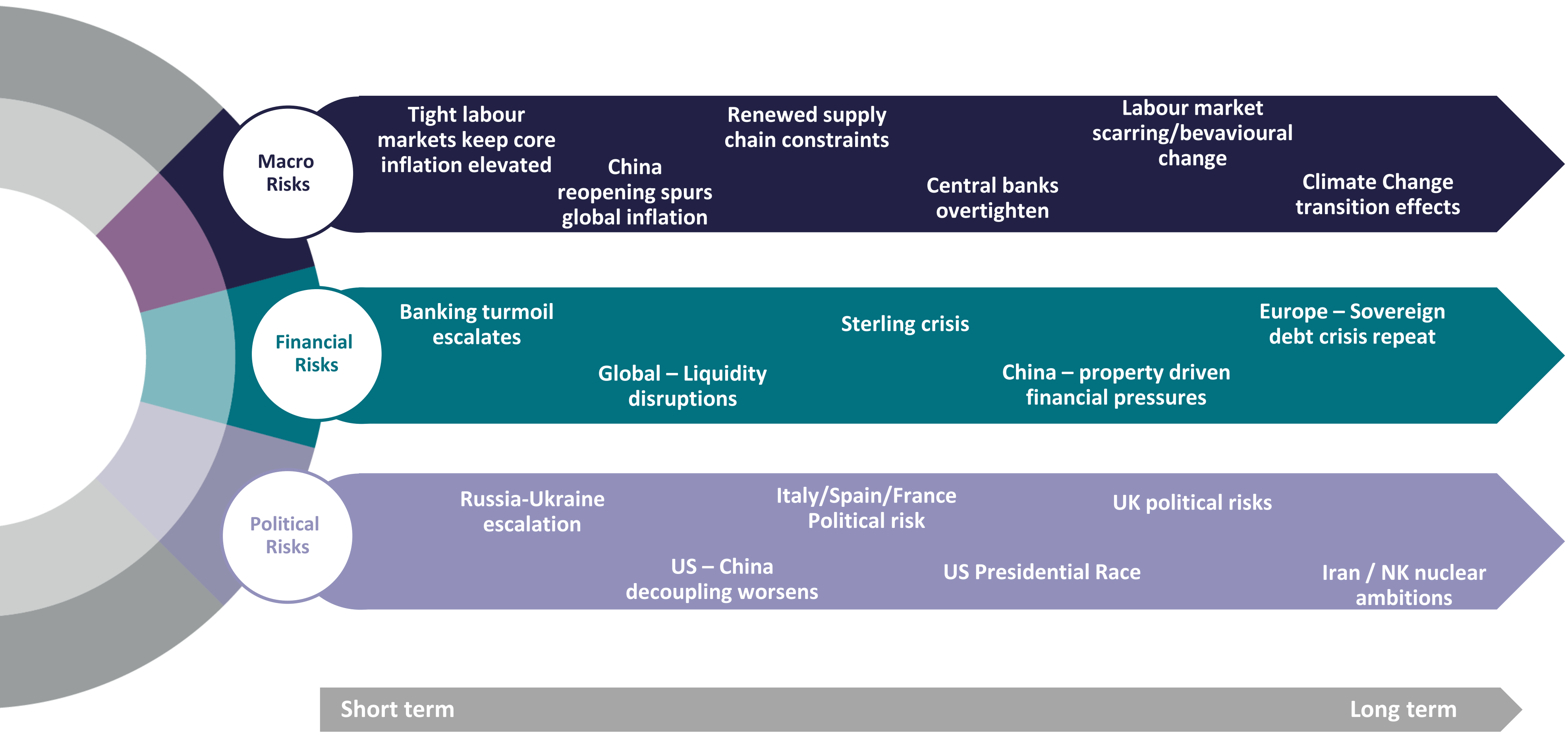
Alternative scenarios

Summary – Key messages

	Entrenched supply shock Probability 20%		A global boost Probability 15%
	- Banking turmoil escalates, credit conditions tighten. - Escalation in Ukraine conflict - COVID outbreaks spreads again: China and/or new mutations - Post-pandemic structural persist. Supply shocks last longer - Inflation expectations rise, affecting wages and persistence	What could be different?	- Geo-political tensions ease – peace in our time. - Labour market participation recovers, strong income growth and easing inflation pressures - Productivity boost following investment rebound and structural post-pandemic adjustments
	- Growth weaker, employment could start to fall, but inflation remains elevated - Monetary policy ill-equipped to deal with supply shocks and financial instability, deteriorating inflation credibility forces still tighter policy in DMs	What it means	- Growth surprises on the upside in most regions - Inflation fades more quickly towards and below central bank targets - Monetary policy softens quicker than signalled
	- Risk appetite deteriorates / equities sell off / credit widens - Sovereign yields reprice higher - Dollar remains elevated - EM debt to come under pressure	Market implications	- Risk-on environment, equities make further gains, growth retains lead over value - UST softens, EUR strengthens - Spreads grind tighter

RISk Radar

Summary – Key messages



Contents

Theme of the Month

Against the odds – markets in first half 2023

Cross asset ‘risk on’ in H1 2023 defies gloom at the start of the year

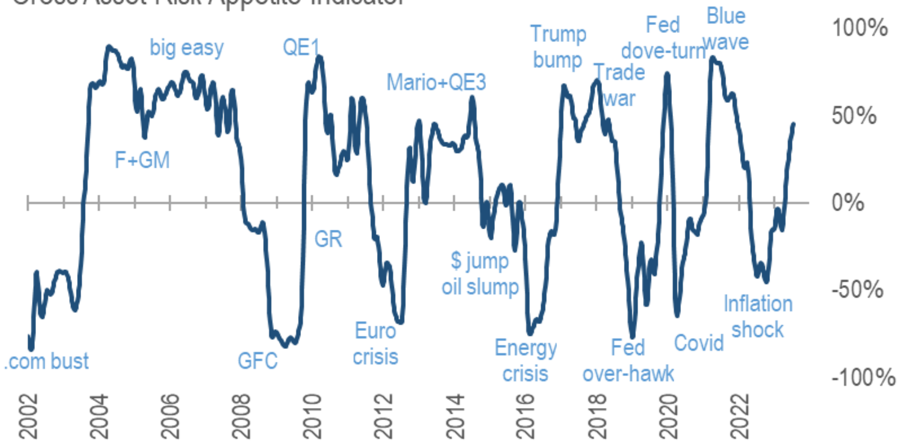
Strong rebound in risk appetite since the Q3 2022 lows

- The ominous prospects for risky assets at year start did not come to pass. A rebound in growth expectations and resilient earnings buoyed sentiment. And this despite ongoing concerns about the stickiness in inflation and the vacillations in central bank policy expectations which kept duration exposure volatile. The risk-off episode triggered by US regional banks (& Credit Suisse in Europe) in March also proved short-lived. It was promptly superseded by the buzz surrounding the AI space, as generative AI tools started to be released. Yet, we remain cautious into year-end, as growth headwinds gather and valuations are stretched.

Stocks & HY credit have mostly recovered 2022 drawdown

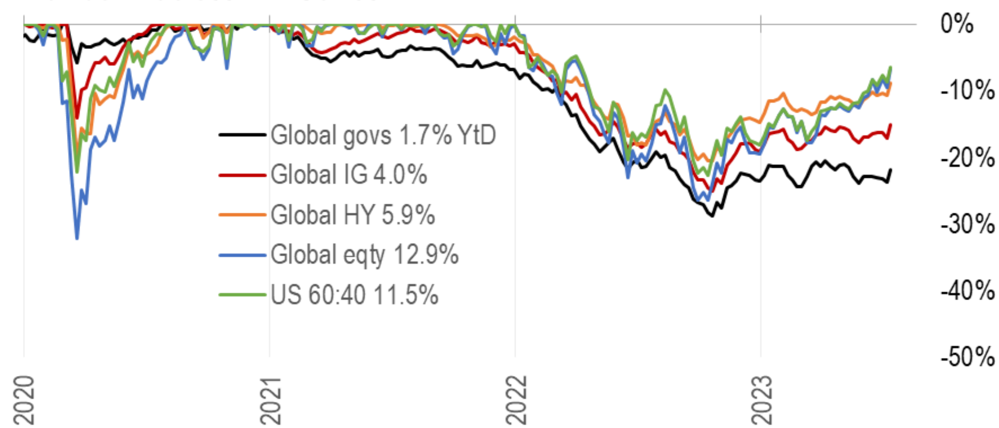
- Duration volatility has kept government bond returns under pressure, with the global govie BM up only 1.7% year to date. By contrast, global equity returns are 13%, global HY credit 6% and global IG credit 4%. This pecking order across assets could persist as long as recession risk keeps getting postponed and earnings are holding up. If, however, recession risk does appear on the horizon, we expect duration risk to rebound, benefiting govies and then IG credit, while HY credit and equities underperform.

Strong rebound in risk appetite across assets in H1 2023



Sourcce: Bloomberg, ICE, MSCI & AXA IM Research; as of Jul 2023

Drawdown due to inflation shock mostly recovered by stocks & HY; not rates



Source: Bloomberg, ICE, MSCI & AXA IM Research; as of Jul 2023

Against the odds – markets in first half 2023

Currencies dealing with the twists and turns in USD

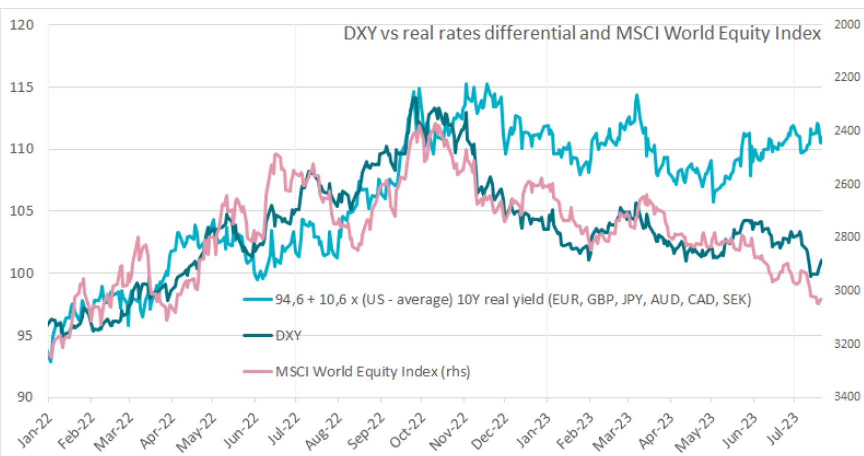
A softer dollar trend has not been altered by bouts of Fed hawkishness

- Despite ups & downs, USD has kept its depreciation trend since Q3 2022. Stickier inflation has provided episodic support as and when US rates repriced higher/for longer, but it has not altered the trend lower in the dollar. Further, the regional banks crisis has highlighted frailties in the US system, capping the potential for aggressive further tightening by the Fed. The US economy has proven resilient to the tighter financial conditions (US labour market has softened gently) supporting risky assets; not a tailwind for USD.

G10 central banks catching up/overtaking the Fed

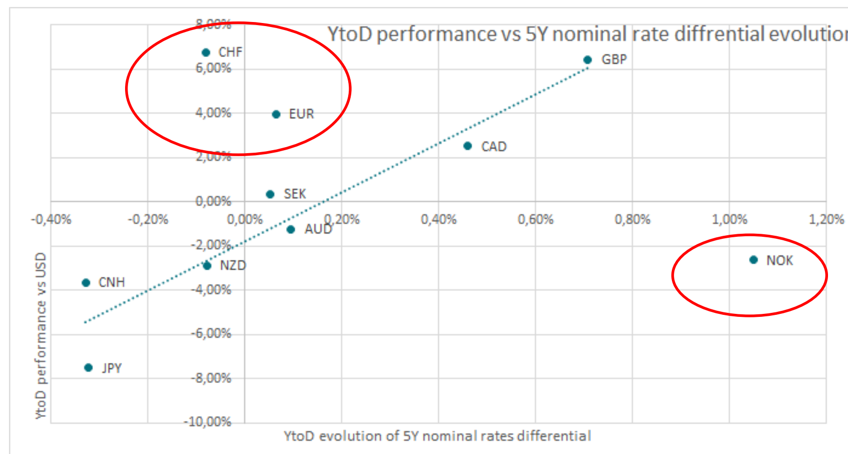
- G10 central banks have been catching up with the Fed's tightening, by pursuing or even reaccelerating hawkish stances like BoE, BoC, RBA and Norges Bank. GBP has benefited from a sharp rise in UK rates. An easing energy crisis and China reopening boosted the EUR. Oddly, CHF continued to strengthen despite sentiment risk, while the NOK failed to follow an impressive rise in NOK rates. JPY & CNH underperformed as the BoJ held its easy policy, while China's rebound disappointed, eliciting more support from PBOC.

DXY following risk sentiment more than rates



Source: Bloomberg and AXA IM Research, July 2023

USD weakens as G10 rates catch up on US rates, with some outliers



Source: Bloomberg and AXA IM Research, July 2023

Against the odds – markets in first half 2023

Rates tormented by central banks' fight against sticky inflation

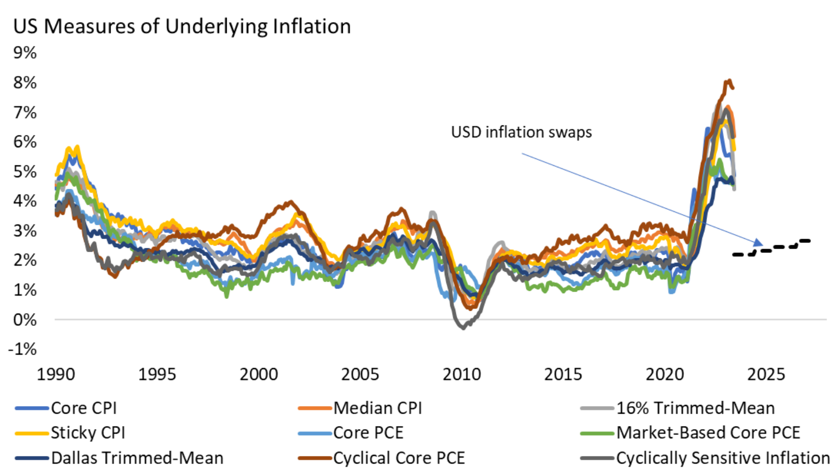
Inflation concerns have fed central banks' hawks

- Central bankers shifted their attention to measures of underlying inflation, deeply concerned that elevated levels of sticky inflation might still lead to a de-anchoring of expectations as today's underlying inflation is the best forecast of future inflation after transitory factors have all played out.

Taming the inflation-wage-inflation nexus

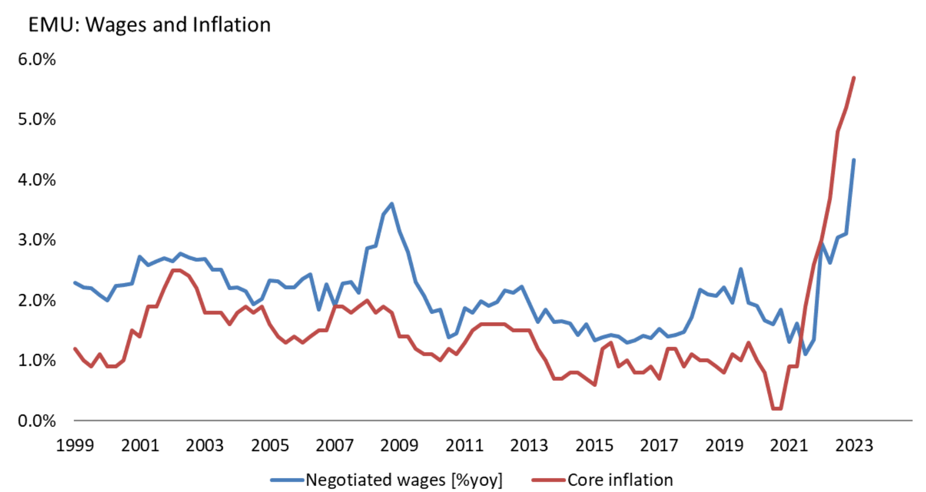
- Labour market imbalances that might eventually lead to wage-price spirals should be avoided. Moreover, attention has shifted to wage trends in the Euro Area, where negotiated wages are growing faster on aggregate than nominal labor productivity.
- As a result, monetary policy expectations were revised higher across the first half of 2023 in each month since its start, except for March due to the SVB collapse and its contagion across US regional banks. Being hawkish appeared to be central bankers' mantra-du-jour, reflecting the view that the social costs of de-anchored inflation overwhelm that of a period of muted economic activity.

Measures of inflation remain elevated vs central bank target



Source: Bloomberg & AXA IM Research; Jul 2023

The inflation-wage-inflation nexus is a major challenge to central banks



Source: Bloomberg & AXA IM Research; Jul 2023

Against the odds – markets in first half 2023

Credit markets unperturbed by recession risk in H1 2023

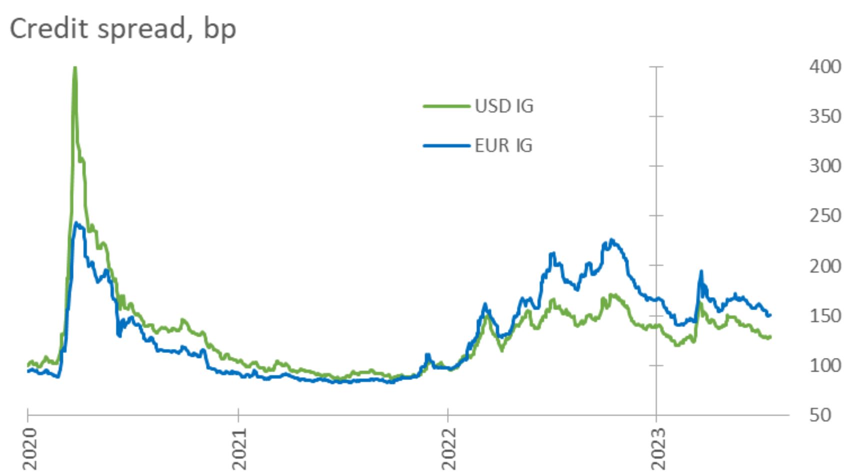
Spread tightening has propped up returns in 2023 so far

- Credit spreads are tighter year-to-date, led by high yield (HY), as investment grade (IG) has been held back by banks risk. The spread shock in March that followed the SVB debacle has been mostly recovered. YtD returns are c.6% in HY and c.3.5% in IG.
- Banks have lagged non financial corporates since early March, which translates to a performance deficit between 0.5% and 1%. Catching up over the rest of 2023 may be a tall order, as earnings headwinds mount on higher deposit rates and less deals/trading.

Spread prospects for the rest of the year appear more challenging

- The resilience in spreads has brought them near lows since early 2022. From a mean reversion perspective, current levels are historically associated with spread widening over, 3, 6 and 12 months. More so in HY than in IG, implying spread decompression.
- HY/IG decompression tends to reflect a recession-like dynamic. Yet, the expected spread widening is below spread breakevens, suggesting a rather shallow recession risk. Excess returns can stay positive too, as carry overcomes negative mark to market.

Spreads tighter year to date despite banking shock in March …



Source: Bloomberg, ICE, AXA IM Research; Jul 2023

… but this may change in H2 2023 from a mean reversion perspective

Spread chg fcast based on mean reversion

	65D	130D	260D
USD IG	4.7%	7.0%	11.0%
EUR IG	0.1%	0.5%	1.2%
USD HY	6.6%	11.3%	17.8%
EUR HY	1.8%	3.5%	6.5%
IG	3.4%	5.2%	8.2%
HY	5.4%	9.4%	14.9%
USD	5.0%	7.6%	11.9%
EUR	0.3%	0.9%	1.8%
ALL	3.7%	5.7%	9.1%

Against the odds – markets in first half 2023

Equity markets' improbable strong year so far (i)

Tech sector has been cheerleading stocks higher

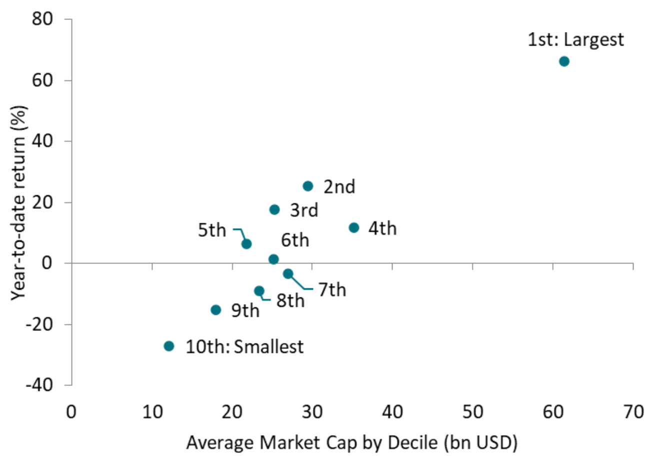
- Against the odds, the stock market achieved a solid half-year performance (+12.9%; 85th percentile). Nonetheless, investors have been eager to comment on the dispersion, as evidenced by the gap between the best sector (IT +36.3%) and the worst sector (Energy -4.3%) over 6 months; a dispersion at the 88th percentile in its history since 1995.
- Size was one factor in explaining the performance dispersion, but other characteristics have also shaped the top 10% in market performance. 1) Quality - exhibits lower leverage and higher margins; 2) Low Dividend – high govie yields can explain why investors may have shunned higher dividend payers; 3) Expensive - even if the rally has boosted their valuation further.

There is substance behind the Tech/AI hype

- The stocks that have led market performance (e.g. mega caps) are amid the few that have benefited from positive 12M EPS revisions (+1.9%) during the past 6 months. By contrast, the broader market was down by -9.9% over the same period. This adds tangible proof to investors' attraction to AI-related stocks, thus a trend not quite comparable to the speculative .com craze of the 2000s.

A linear relationship between return and size …

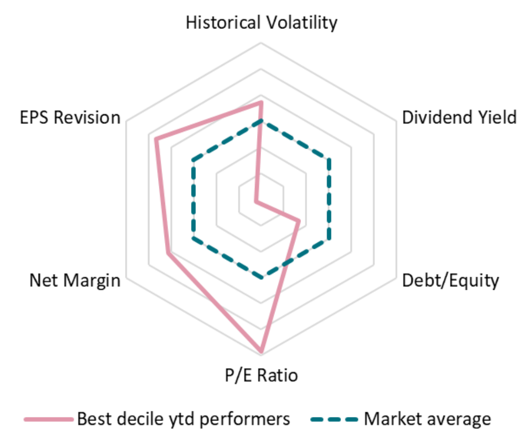
Global Equity - Year-to-date returns by market cap



Source: Datastream, MSCI and AXA IM Research, July 2023

… But the best are defined by other features too

Global Equity - Return decile bucket characteristics



Source: Datastream, MSCI and AXA IM Research, July 2023

Against the odds – markets in first half 2023

Equity markets' improbablly strong year so far (ii)

Investors seem to be looking through the cyclical shock in real rates

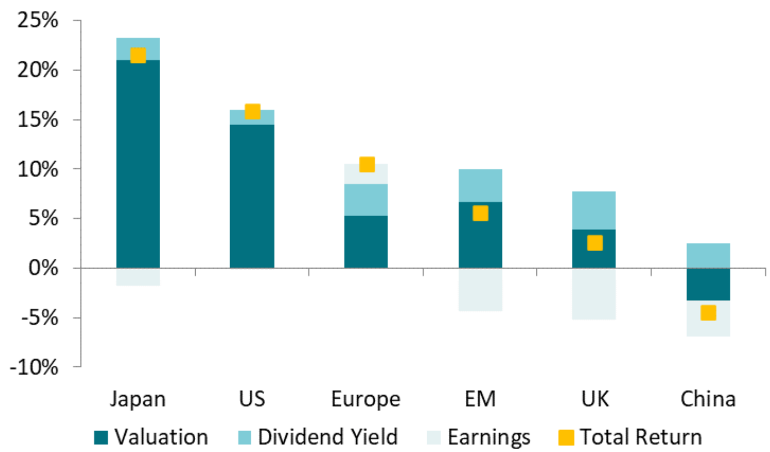
- Markets have been fueled by positive sentiment, against the mantra that real rates erode the present value of future cashflows. Investors appear focused on the gains that 'winners' could reap, post-recession and seem prepared to weather downside risks in the meantime. In addition, there seems to be ample dry powder in retail & mutual funds (cash levels above last 10 years' level) to add exposure in case of a market drawdown.

Multiple expansion has driven market performance

- Except for China where macro uncertainties have undermined its stock market, all regions have posted a positive performance year to date, driven by multiple expansion. The earnings component of the performance has been negative overall, despite positive contributions by IT, Communication Services and Financials.
- Valuation remains a key factor. Improving news on inflation, implies less pressure from interest rates, fueling investor optimism. The transition towards better inflation news has been sufficient to boost stock performance, in contrast to economic news.

Investor optimism has been at the helm …

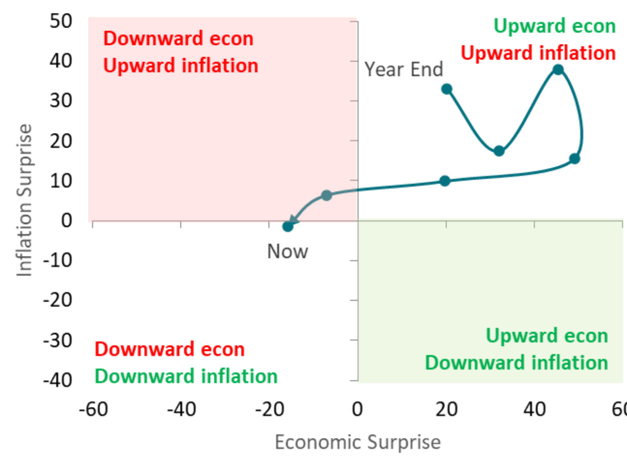
Global Equity - Total return composition by regions



Source: MSCI and AXA IM Research, July 2023, in Local terms

… As inflation newsflow has improved even if tortuously so

Economic suprise - Global path since year-end



Source: Citigroup and AXA IM Research, July 2023

Macro outlook

Resilience

US

Hints of a firmer economy

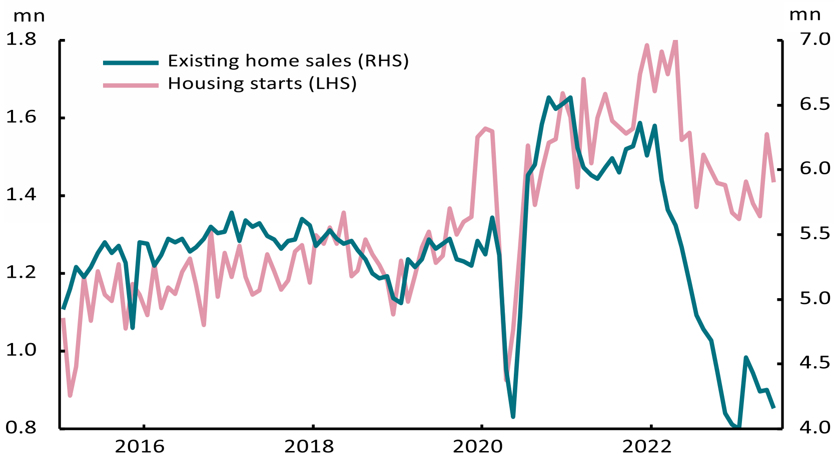
- Indications from housing, to payrolls, to investment all hint at a strengthening, not weakening economy. So far housing strength is limited to new home sales – existing sales, the far bigger market, are still falling. Moreover, rising investment intentions in June have somewhat reversed in July. However, while payroll growth has clearly decelerated, it maintains a solid clip – something that will continue to provide ongoing support to the US consumer into H2 and risks further delaying the emergence of economic weakness.

Recession still likely

- Top-down indicators still point to a recession. Whether this begins in Q3 as we forecast will depend on the breakdown of Q2 GDP. The Federal Reserve expects recession in Q4 2023 and Q1 2024. The timing of a recession will impact annual growth averages, with a firmer start raising our outlook for this year at the expense of next. We forecast GDP growth of 1.4% in 2023 and 0.6% in 2024 (consensus 1.5% and 0.6%).

Housing starts still solid despite broader weakness persisting

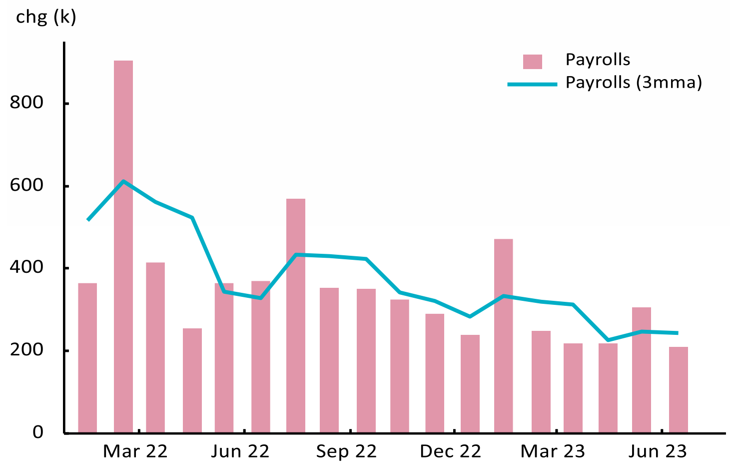
Housing sales and starts



Source: Refinitiv, AXA IM Research, July 2023

Payrolls decelerate in gentle fashion so far

Change in employment



Source: Refinitiv, AXA IM Research, July 2023

Risks rise in favour of a soft landing

US

More broad-based price softening

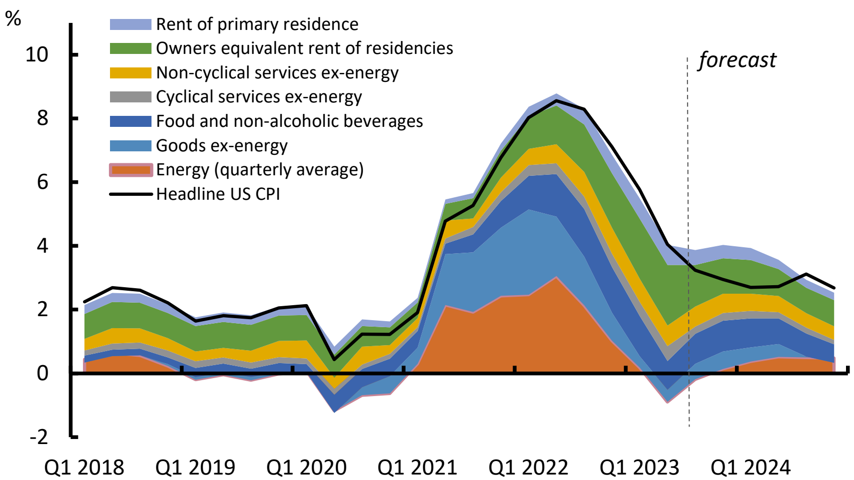
- Headline CPI inflation fell to 3.0% in June from 9.1% a year earlier. Core inflation has fallen more slowly and stands at 4.8% in June. However, price declines were reasonably broad-based in June. We expect headline inflation to remain around this level for the rest of the year, with base effects suggesting little scope for further disinflation. However, core inflation should edge lower over the coming quarters. Despite significant improvement, longer-term inflation expectations have crept higher this month.

Peak in July

- The Fed left rates unchanged in June, but described the meeting as a "skip" forecasting two further hikes this year. We fully expect a further 0.25% hike to 5.50% in July, but believe the Fed will see sufficient progress in economic and inflationary deceleration to see it pause in September and not move again. Given our outlook for a mild recession over H2 2023, we expect the Fed to begin to ease the FFR in March to 4.00% by end-2024. Further resilience to the economy could see a higher peak, or more likely, a longer hold.

Headline disinflation material but slows from here

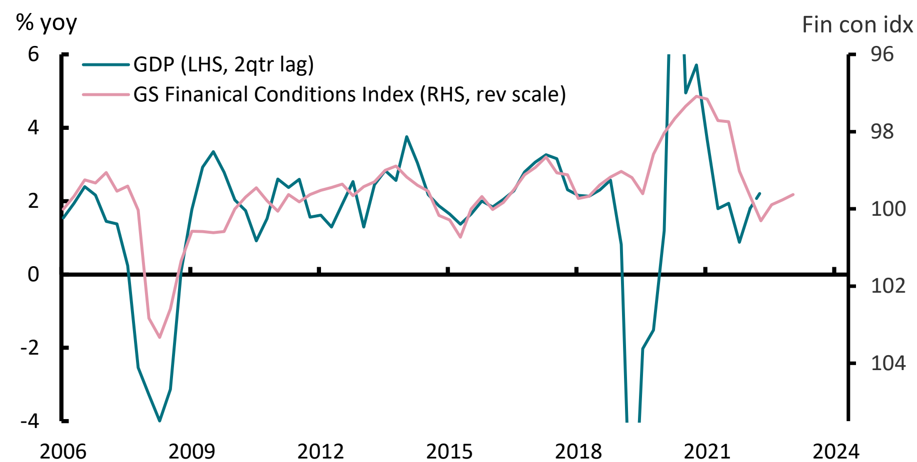
Contributions to CPI inflation by broad sector



Source: BLS, AXA IM Research, July 2023

Financial conditions do not point to further GDP deceleration

Financial conditions and GDP



Source: BEA, Bloomberg, AXA IM Research, July 2023

Does recession end in Q2?

Euro area

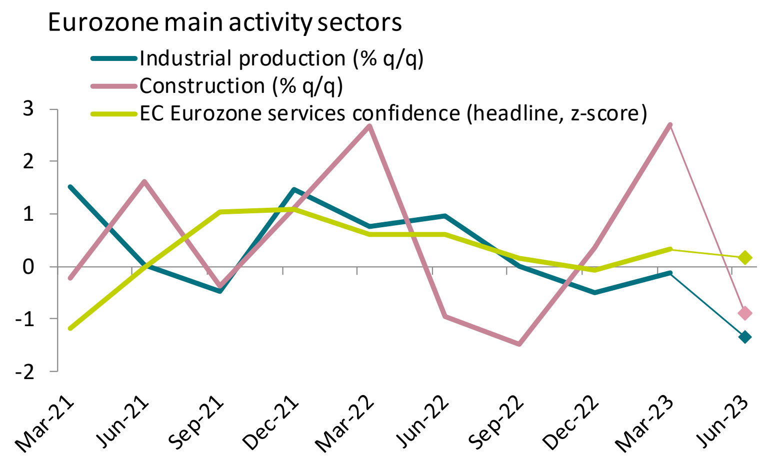
All sectors under strain

- Euro area industrial production has not recovered from previous drops, implying a large -1.3% Q2 carry over. Service business surveys suggest a weakening of the Eurozone's main growth engine. After a strong Q1, construction is set to resume contraction.
- Latest data suggest downside risks to our +0.1% q/q eurozone Q2 GDP forecast such that we cannot rule out another slight negative reading, similar to Q4 2022 and Q1 2023.

Confirms our "stagflationary" scenario

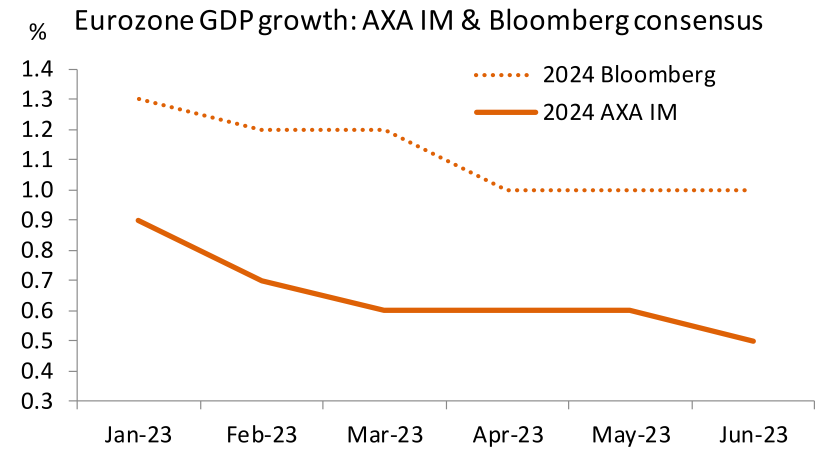
- We think that industrial sector revival, ongoing labour market strength and recovering household purchasing power in the second half of the year should prevent a slide into a continued and more meaningful recession.
- However, we maintain that risks to our 0.5% 2024 GDP forecast – below the consensus of 1.0% - are skewed to the downside, after a +0.4% forecast this year (consensus 0.5%, 1.0%).

Weak performance across sectors in Q2



Source: Refinitiv, AXA IM Research, July 2023. Diamonds represent Q2 carry over for industrial production and construction with data up to May, and actual data up to June for European Commission headline service survey

We remain below consensus for 2024



Source: Bloomberg, AXA IM Research, July 2023

Investment Managers

ECB: to keep a hawkish tilt

Euro area

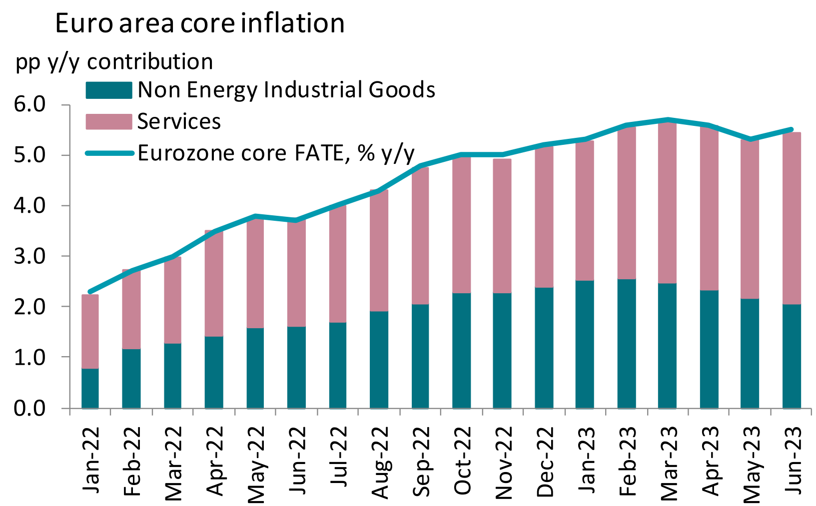
Another +25bps hike in July…

- The bar is high for the ECB not to deliver on its pre-committed +25bps hike to 3.75% in July, especially after the upward revisions to eurozone final core HICP to 5.5% y/y in June, just 0.2pp away from its March peak.

…to enhance data-dependence ahead of September meeting

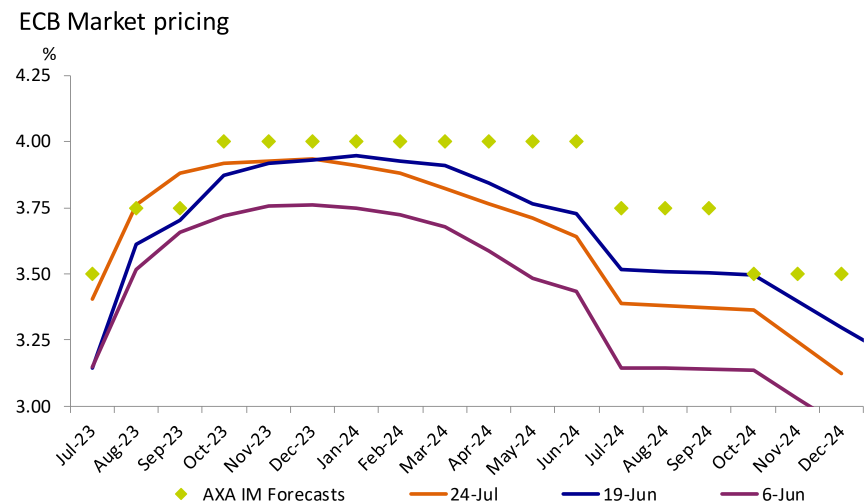
- We think a split Governing Council will emphasise data dependence, rather than pre-committing again ahead of the September meeting.
- We nonetheless expect a hawkish tone to continue following the Sintra Symposium, driven by increased inflation pressures from June's upward revisions to unit labour costs and little convincing evidence of a downward trend in core inflation.
- We continue to expect the ECB to hike to 4% in September.

Core inflation yet to engage on a decisive downward path



Source: Eurostat, AXA IM Research, July 2023

ECB: destination 4%



Source: Bloomberg, AXA IM Research, as of 24 July 2023

Welcome disinflation

UK

Labour market remains tight, but maybe not strong

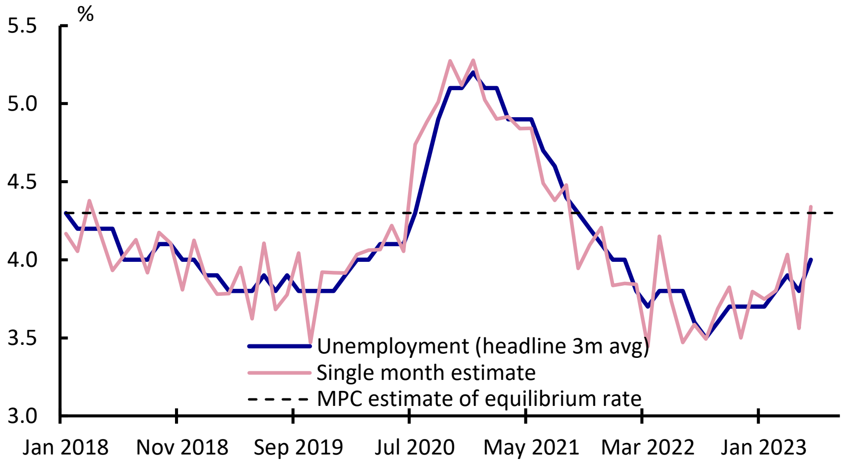
- The ongoing tightness of the UK labour market remains a key upside risk to our forecasts. Unemployment rose to 4.3% in May, driven by a sharp 141k drop in inactivity. Headline employment growth remains strong, but we see rising signs of deceleration. Employment rose by 103k, driven by part-time employment, but with a full-time drop of 16k. Furthermore, employment surveys such as that KPMG/REC survey continue to point to a slowing in hiring and a pickup in redundancies.

A welcome drop in June CPI – energy to add to disinflation in coming months

- June's CPI inflation ended a run of upside inflation surprises: Inflation slowed to 7.9% from 8.7% in May. While too early to declare victory, it will give the BoE space to slow its pace of hiking. The drop was primarily driven by falling petrol prices, but declines were broad-based, with core and services CPI also easing to 6.9% and 7.2%. Over the coming months we expect inflation to continue to fall with energy price drops contributing -80bp in July and -150bp in October adding to downward pressure on prices.

Employment strong, but self and PT employment buoying figures

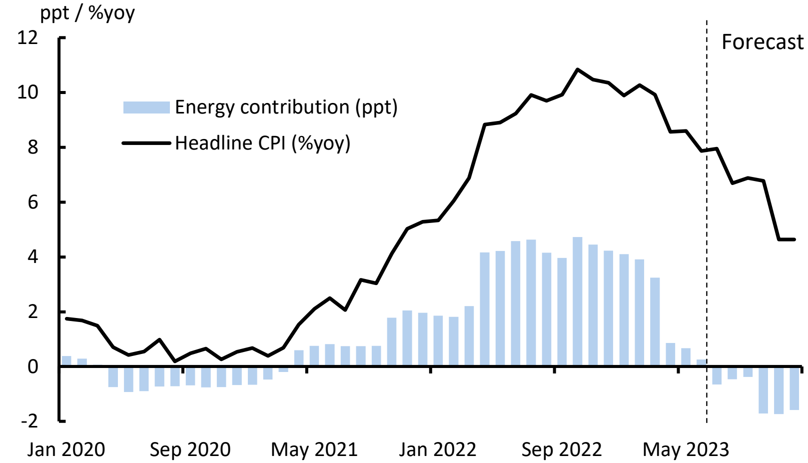
UK unemployment rate - headline and single month



Source: ONS, AXA IM Research, July 2023

Core and services inflation remain uncomfortably high

UK CPI inflation energy contribution



Source: ONS, AXA IM Research, July 2023

Easing in inflation sets scene for 25bp hike in Aug

UK

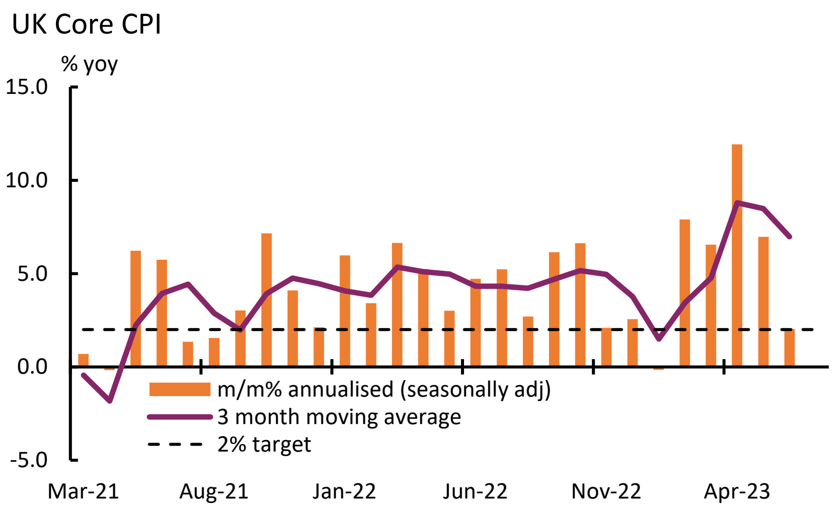
A turning point?

- Looking at seasonal patterns in monthly CPI, we estimate that seasonally adjusted core CPI rose by an annualised 2% in June. This is well below the average 8% annualised seen in the 4 months before. Though we have seen false starts before, we think that this time likely marks the start of a gradual easing in core. Producer output prices have also turned negative suggesting scope for a rapid fall in inflation, while sterling strength will add to disinflation.

Expect further hike in August, but markets see further risks

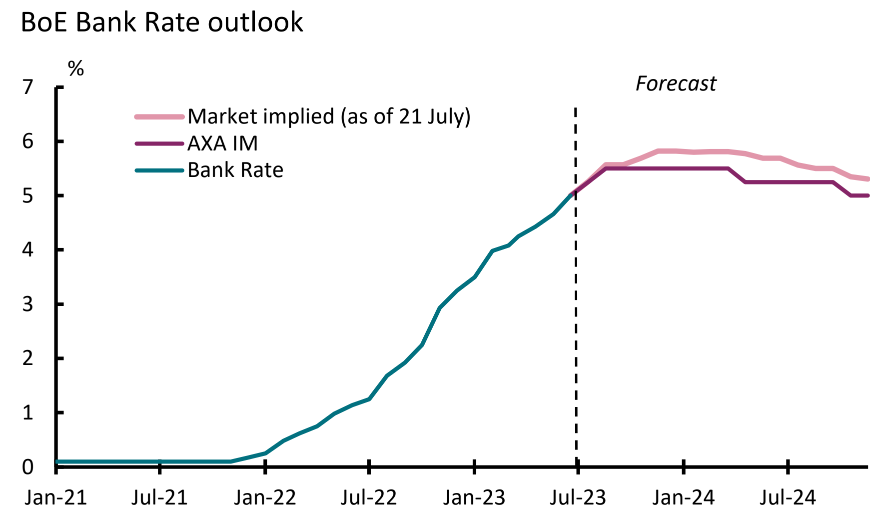
- The BoE next meets on 3 August, when on balance we expect it to deliver a 25bp hike alongside updated economic projections. The risk of a 50bp hike remains, but the improvement in core and services inflation and the fall in inflation expectations reduces some of the immediate pressure for a further 50bps hikes. We expect a further 25bp hike at the September meeting, bringing Bank Rate to 5.50% where we expect it to peak. Following recent inflation data, markets have pared back rate expectations – now expecting a peak around 5.75% compared to near 6.5% prior at the start of the month.

Wages on a higher path than BoE expected in May



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

Markets now expect rates to peak around 5.75%



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

Recovery remains strong

Japan

Recovery remains on track

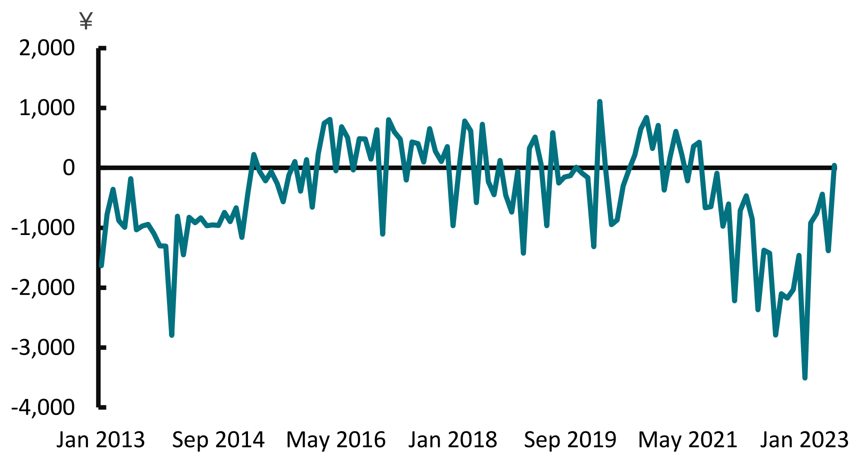
- Japan's June trade balance unexpectedly swung to its first surplus since July 2021 of ¥43bn ($308 bn), which is likely to provide a material boost to GDP. The value of exports rose 1.5% as car and machinery exports picked up, and imports dropped by 12.9% driven by sharp drops in the value of fuel shipments. The BoJ Tankan survey also signalled that sentiment remains strong with business confidence picking up across industries and firm sizes.

Inflation remains elevated, firms expect inflation to remain high

- Headline inflation continues to moderate as energy base effects drop out of the annual comparison, but core inflation is still elevated. In June, core CPI ex fresh foods and energy, eased marginally to 4.2%. Inflation expectations also appear to have shifted higher – Q2 Tankan survey respondents continue to expect inflation to remain above 2% one, three and five years out despite the recent easing in headline inflation. The survey also confirmed the continued strength of Japan's ongoing economic recovery, with business conditions improving for both manufacturing and non-manufacturing firms.

Trade balance back in surplus

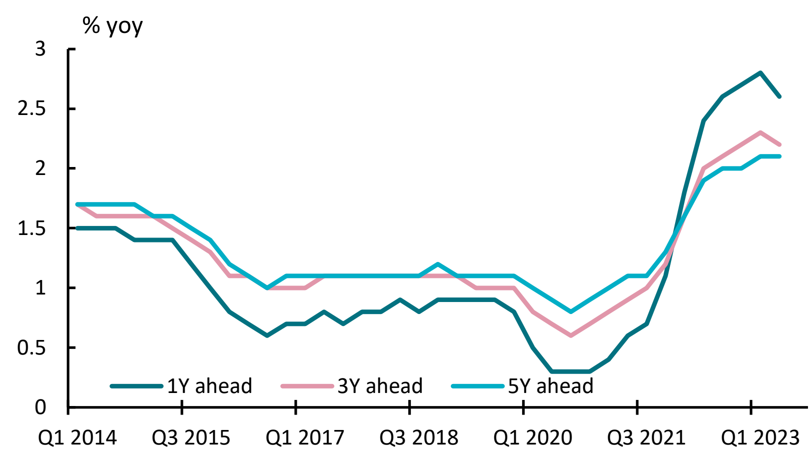
Japan trade balance



Source: Statistics Bureau of Japan, AXA IM Research, July 2023

Firms' inflation expectations have shifted

Companies' average CPI inflation forecast



Source: Bank of Japan, Refinitiv , AXA IM Research, July 2023

Improving price dynamics should see July YCC tweak

Japan

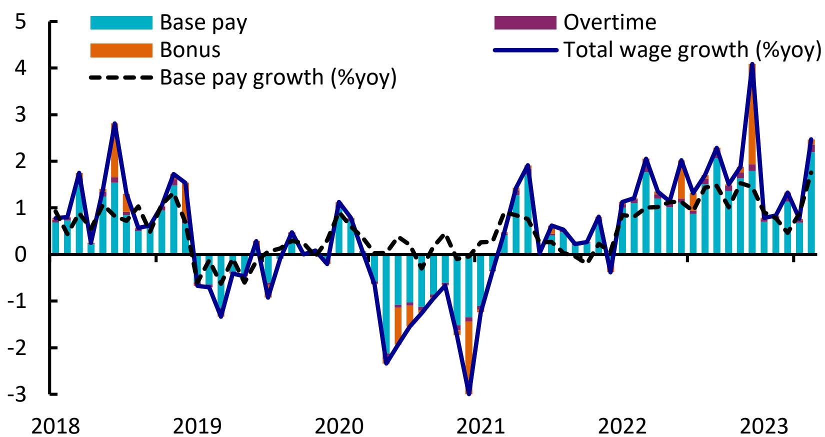
May wages reflect historic Shunto gains

- Wage growth – key to driving medium-term inflation – is also picking up. Final figures for the Shunto spring wage negotiations confirmed a 2.1% base pay hike on average for the 2023-2024 fiscal year. May's wages rose above expectations following some disappointment in April's lacklustre numbers. Annual cash earnings rose by 1.8% – the highest since 1995 – echoing the Shunto negotiations. We expect this momentum to continue as more companies adjust their pay in the coming months.

July YCC adjustment remains base case, but considerable risks of delay

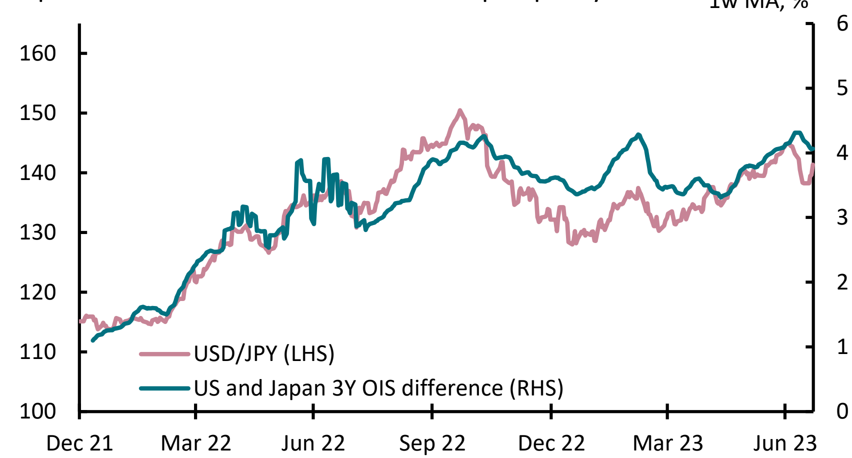
- On balance we continue to expect the BoJ will adjust its YCC policy at its next meeting (28 July), lowering its tenor of target to 5Y from 10Y currently. This meeting comes alongside the publication of the BoJ's Quarterly Monetary Policy Report where we expect it to revise its inflation forecast higher. Yet there is a considerable risk that the BoJ will remain on hold. As markets weigh the chances of a policy tweak, the yen has appreciated to ¥139.8 from ¥144.9 to the USD, though since falling back to ¥141.3 as expectations of a pause have risen. Adjustments to the BoJ's YCC policy in July would likely provide further support.

May cash earnings rise to 28-year high



Source: MHLW, Refinitiv, AXA IM Research, July 2023

Yen slides as expectations of a pause grow



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

Resilience to ebb in H2

Canada

Activity expected to soften

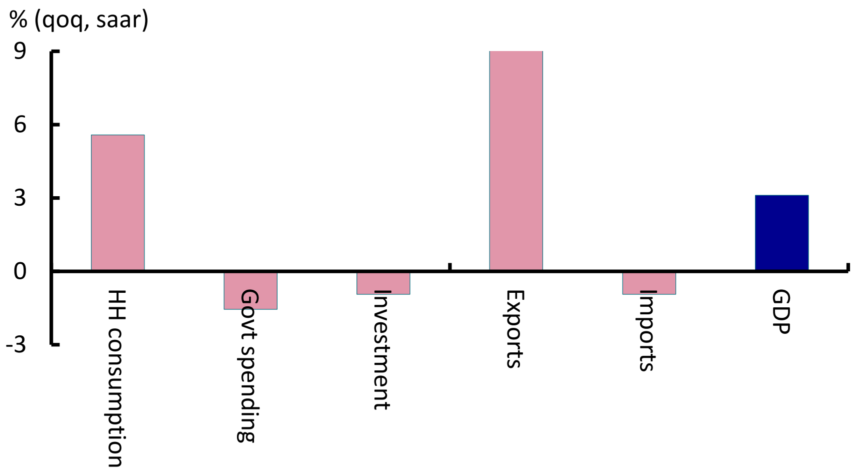
- Following strong Q1 GDP of 3.1% (annualised), we expect a softer Q2 – pencilling in 1.4% for Q2 and 0.4% for Q3. This is softer than the BoC's 1.5% forecast for the coming two quarters. We see a softening in consumer spending following lacklustre retail sales volume growth and a weaker contribution from net trade. In total, our annual growth forecast is now 1.6% for 2023 (up from 1.4%) and 0.9% for 2024 (from 1.0%), which compares with the BoC's outlook for 1.8% and 1.2% respectively.

Headline disinflation faster than core

- Headline CPI inflation fell further than expected in June to 2.8% - its slowest in 27-months. However, most of this reflected energy and food costs, with core measures remaining firmer than expected, median inflation unchanged at 3.9% and trimmed easing back to 3.7% from 3.8%. This echoed concerns voiced by the BoC about lack of progress in reversing core inflation. We expect to see further progress in core over the coming months, forecasting total inflation at 3.9% and 2.8% this year and next.

Expect softening in sectors that boosted Q1

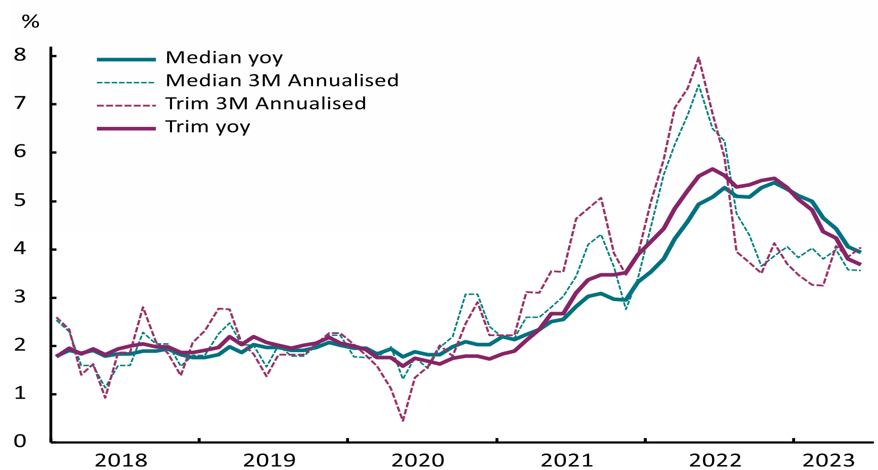
Breakdown of Q1 GDP growth



Source: CANSIM, AXA IM Research, July 2023

Core CPI displays unconvincing disinflation

Median and Trim Inflation



Source: Refinitiv, AXA IM Research, July 2023

BoC reaches 5.00% - now at peak

Canada

Ongoing uncertainties

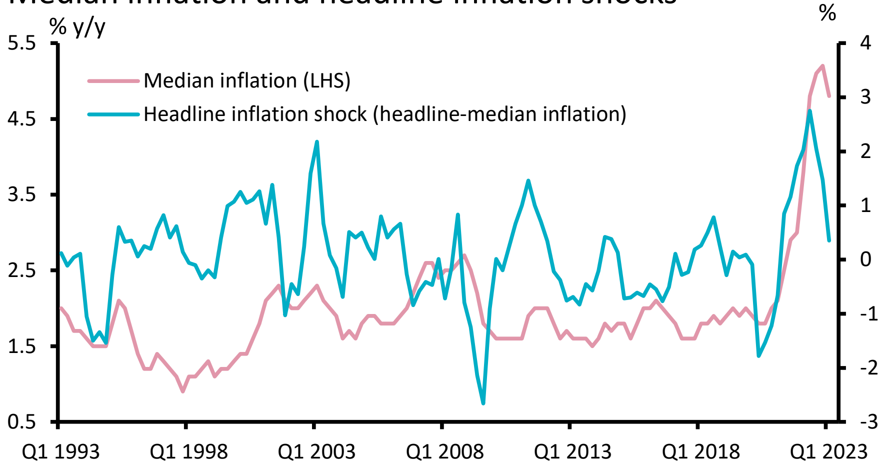
- Yet the outlook includes 3 uncertainties. First we assume an external headwind from a US recession, but as discussed elsewhere the timing of this is uncertain. Second, household excess savings appear to have supplemented Q1 consumer spending. It is uncertain if households will continue this pace of saving use over coming quarters. Third, strong immigration contributed to a rise in unemployment (to a 16 month high), but is also boosting inflation in some sectors. Its net effect is unclear.

BoC at the peak .. probably

- The BoC followed its June hike with another 0.25% increase in July to 5.00%. It stated excess demand had persisted for longer than expected and inflation was not expected to reach 2% until mid-2025, warning it was “prepared to go further”. Yet the BoC is balancing doing too little with too much and is wary of the lagged impact of tightening through mortgage resets still to come. We believe 5% will prove the peak rate and expect the Bank to cut to 4.25% by end-2024, but risks are skewed to a further hike.

Drop in headline should impact core

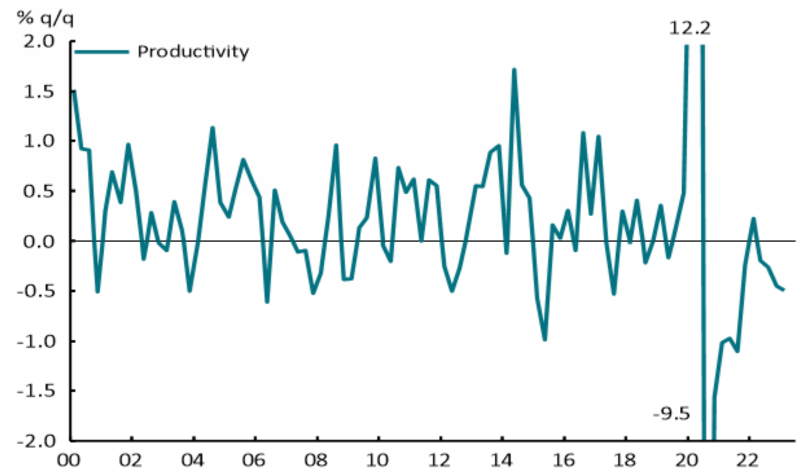
Median inflation and headline inflation shocks



Source: CANSIM, Refinitiv, AXA IM Research, July 2023

Weak labour productivity poses key structural challenge

Labour Productivity Rate



Source: CANSIM, AXA IM Research, July 2023

Disinflation gaining ground

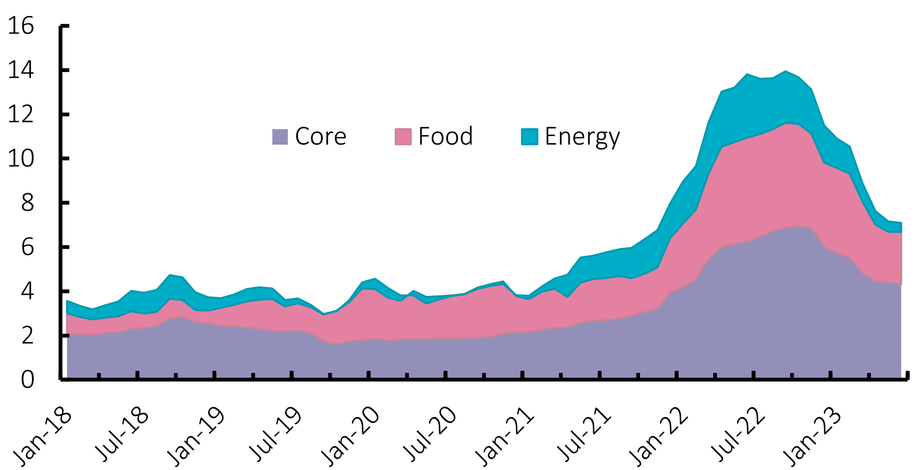
Emerging Markets

Disinflation is firmly underway but at various degrees at regional level

- EM inflation has been on a downward trend since August 2022, driven firstly by lower food and energy prices, but now also by core components. An additional recent supportive factor has been the strength in currencies which has ignited a virtuous disinflation cycle in some EMs. Yet, selected frontier markets remain a hostage of weaker FX, higher inflation and CB dilemma in adjusting policy rates given high government financing needs/costs.
- Headline inflation is showing a sustained decline in Latin America. For most parts of Asia, headline CPI has declined within central banks' inflation targets, allowing them to remain comfortably on hold until year-end. The one EM region where inflation appears to sit at a higher level is CEE; despite visible disinflation recently, bringing inflation within targets in the medium term will prove challenging given strong wage growth and sticky services inflation.

Both non-core and core items drive EM disinflation

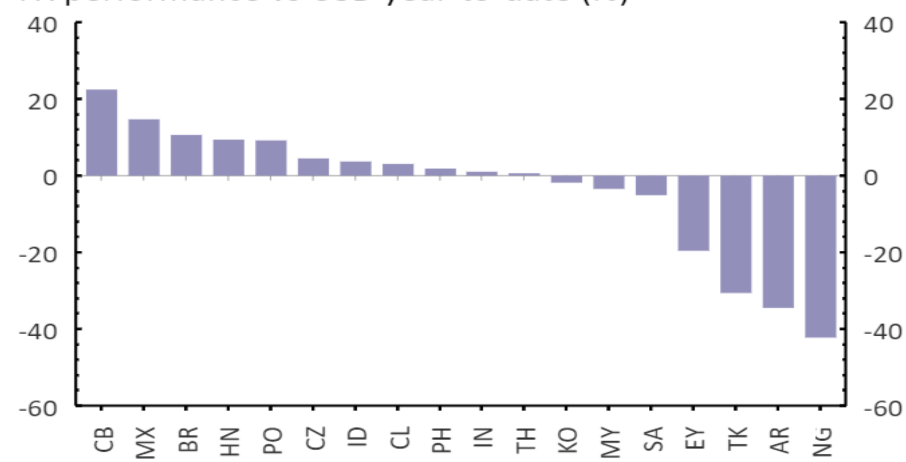
EM CPI contributions (% yoy)



Source: Bloomberg, Refinitiv Datastream and AXA IM Research, as of June 2023

FX strength has further supported goods disinflation

FX performance vs USD year-to-date (%)



Source: Refinitiv Datastream and AXA IM Research 21/07/2023

Monetary policy easing starting in earnest

Emerging Markets

Real rates buffer paves the way for a policy pivot in selected EMs

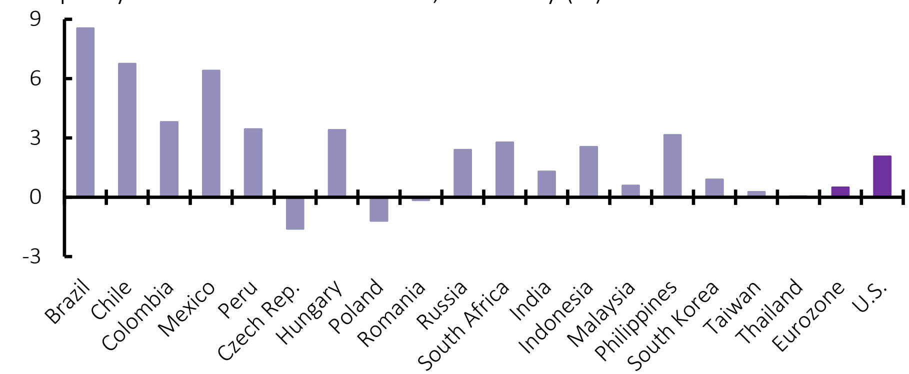
- While some EM central banks may approach a policy pivot and even consider rate cuts before year-end, Russia and Turkey hiked policy rates again in July. These countries face idiosyncratic situations, and while Russia surprised with a higher-than-expected rate hike (100bp vs 50bp expected), Turkey disappointed with yet again a smaller change (250bp vs 350bp expected), failing to decisively anchor the TRY.
- EM central banks can start easing monetary policy if (1) inflation expectations are well anchored (2) real interest rate policy buffers are ample (3) external financing needs are moderate and easily financed.

Chile BCCh to kick off rate cuts among big EM countries

- Chile is poised to reduce its policy rate by 50bps, making it the first large EM country to begin easing. The central bank had previously signaled its intention to cut rates if disinflationary patterns continue - these have materialized. The latest CPI reading for June showed inflation at 7.6%, lower than anticipated. Moreover, the Chilean economy has experienced two consecutive quarterly contractions on a y/y basis, and ex-post real interest rates are currently at multi-year highs, providing room for potential rate cuts.

Real rates buffer paves the way for a policy pivot

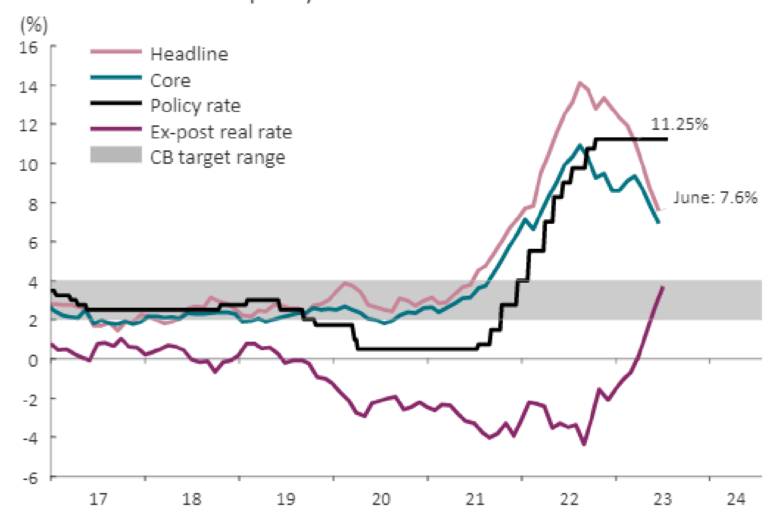
Real policy rates across EM countries, ex-Turkey (%)



Source: Bloomberg, Eikon DS, AXA IM Research, July 2023 (using 2023 consensus inflation expectations)

Inflation is falling quickly in Chile

Chile - Inflation and policy rate



Source: Refinitiv Datastream and AXA IM Research, Jun 23

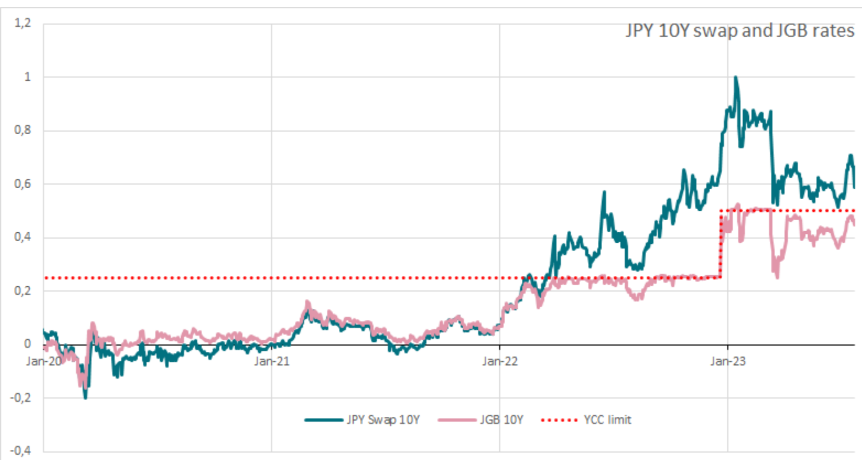
Investment Strategy

Investment Strategy

FX: Misplaced hopes in EUR, underestimated JPY

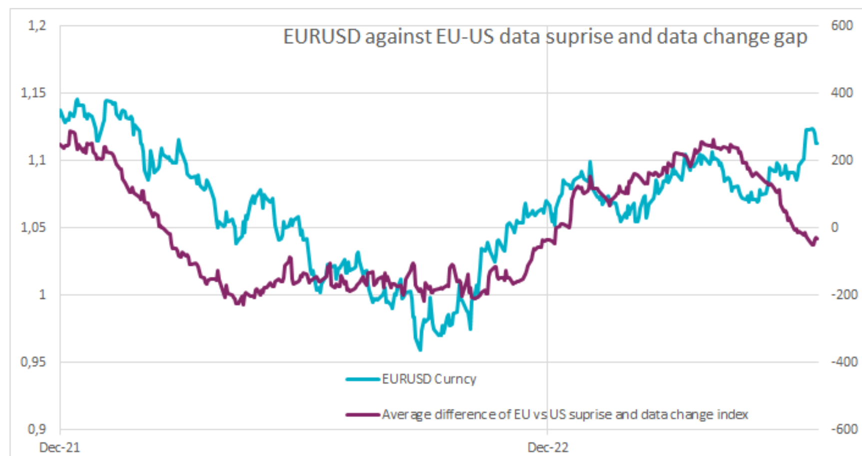
- The better environment (softer inflation, gently softening US labour market, resilient US growth) is supportive of risk assets. It may also be pointing to a topping out in rates and thus a weaker USD overall.
- USDJPY has been closely tracking the 10Y rate differential and should have limited upside if US rates are toppish. There is also short-term downside potential if the BoJ adjusts its YCC policy further. Japanese inflation has remained solid and is starting to show in accelerating wage growth. Domestic services demand is also strong, and the trade balance is finally rebounding back to pre- energy crisis levels.
- EUR strengthening against USD appears excessive and may warrant tactical correction. EU data momentum has deteriorated, diverging from the US, while the ECB's hawkish stance might be softening. At current levels, EUR is no longer cheap and positioning appears long.
- CHF has followed and even outperformed the EUR. This seems at odds with the improving global backdrop and lower stagflation risks. Swiss inflation has continued to soften faster than expected, with core and headline back in the 0-2% target, easing pressures on the SNB. CHF should track the EUR consolidation against the USD, while shorting CHF offers a higher carry (+2%).

Still soft positioning on a potential YCC adjustment



Source: Bloomberg and AXA IM Research, July 2023

EURUSD diverging from EU-US data momentum



Source: Bloomberg and AXA IM Research, July 2023

Investment Strategy

Rates: Two plus two equals four

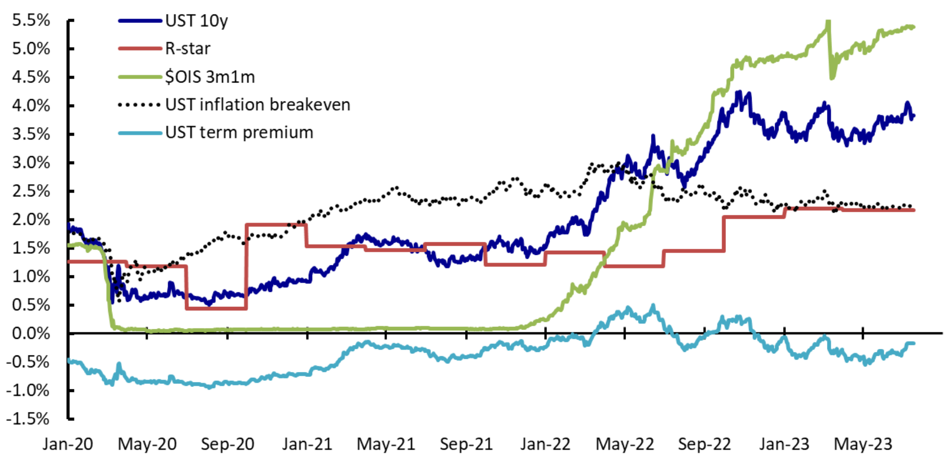
- Bond investors seem content with entry levels around 4% on 10y Treasuries, i.e. the sum of a 2% inflation target and a 2% r-star. Elevated bond volatility and compressed term premia are a source of uncertainty around those estimates. Furthermore, somewhat stronger commodity markets and positive inflation base effects in the second-half of 2023 could reinforce central banks' tightening strategy ('for how long' stage).

- Bond demand remains another big unknown into H2, as the Fed's withdrawal from the bond market leaves a relatively large gap to be filled by private investors. The broader repercussions on market liquidity are not yet a major source of concern, even though this time around the private sector (corporates) is in direct competition for liquidity with the public sector, in contrast to recent cycles.

- One source of structural demand could be ALM, in particular regulated pension funds and insurance companies, which have benefitted from a rapid improvement in cover ratios over the past 24 months. The opportunity to partially reduce duration gaps in ALM portfolios – and at attractive yield levels – might generate a persistent bid for high-rating govie paper for the time being.

2% inflation and 2% r-star make for 4% nominal yield

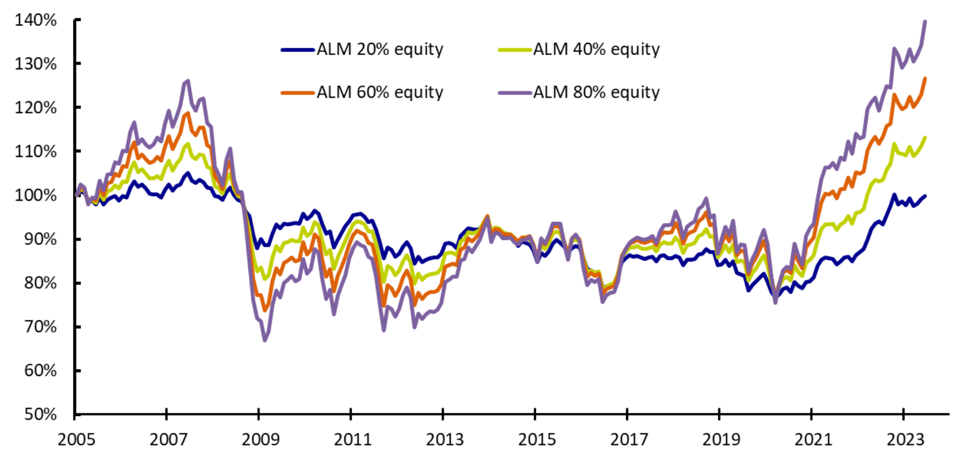
US Treasury Factor Decomposition



Source: Bloomberg & AXA IM Research; Jul 2023

Pension fund cover ratios have recovered materially

ALM: Theoretical Cover Ratio



Source: Bloomberg & AXA IM Research; Jul 2023

Investment Strategy

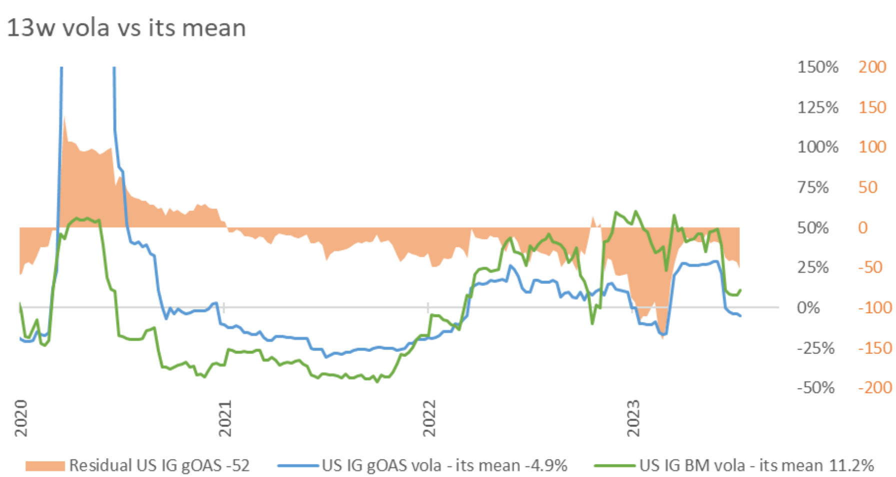
Credit: low spread volatility underpins tight spread levels for now

- Credit spreads have continued to grind tighter in the past few weeks. USD HY is through 400bp and now less than 100bp away from the 2021 lows. EUR HY has lagged somewhat but is below the 450bp level. IG markets in USD and EUR are at ~130bp and ~150bp. Clearly, spreads are not pricing a recession over the next 3-6 months, as recession-like levels are high 200s in EUR IG and low 200s in USD IG.

- Low spread volatility also underpins spreads, as low volatility allows for lower spreads at a given risk-reward target. Currently, USD IG spread 3M realised vola is 5pt below its historic average while BM govie yield 3M vola is 11pt *above* its historic average. This 16pt divergence would be even larger, had it not been for the banks driven risk-off in March (in late Feb, spread vola was 16pt below its average while rates vola was 38pt above; a 54pt gap).

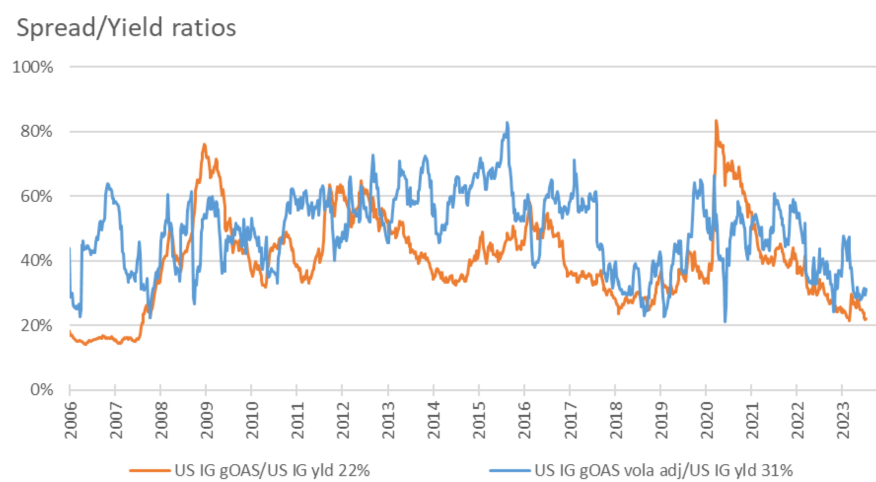
- If we adjust credit spread & govie yield in USD IG according to their historical volatility relative to each other, while keeping credit yield at the current 5.5%, credit spread would be 50bp wider (or +38%) & govie yield 0.5% lower (or -12%). This would raise the ratio between credit spread & yield, from 22% currently (post GFC lows) to 31%. Still towards the lows of the range, but not at an extreme richness.

Spread vola below its average while govie BM vola above it



Source: Bloomberg & AXA IM Research; as of Jul 2023

Spread/yield ratio off its post GFC lows if adjusted for vola



Source: Bloomberg & AXA IM Research; as of Jul 2023

AXA Investment Managers

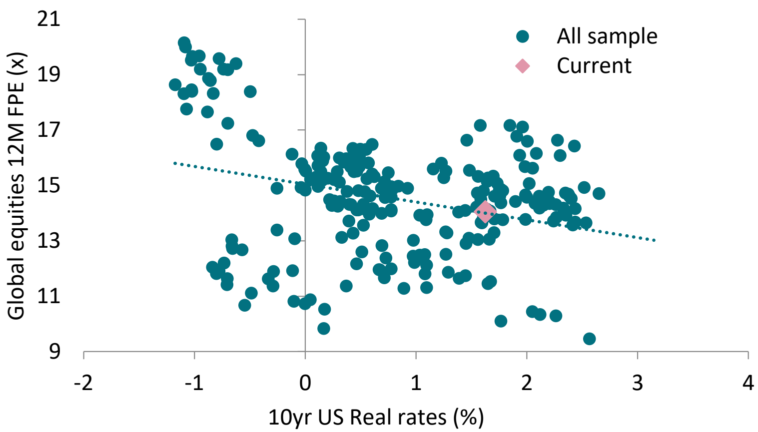
Investment Strategy

Equities: The glass is half full

- June's stellar performance (+5.2%; 90th percentile) enabled global equities to close one of the best first halves of all time (+12.9%; 85th percentile). The earnings season has kicked off with decent results from big US banks, and the 'better than expected' trend seems to be holding up on both sides of the Atlantic - which should give the bulls some reassurance.
- Global stocks valuation has continued to rise (+4% over the last month) and is slightly above its long-term average (17x vs 16x). Such multiples remain consistent with US real rates hovering between 1.5% and 2%. This suggests little leeway to absorb a further rise in real interest rates in terms of levels (much will depend on the speed of a further shock if there is one).
- The VIX term structure is currently exhibiting a historically high steepness between the 1st and 3rd month, reflecting a sense ease regarding a possible negative shock over the next few months. Three reasons make us cautious: 1) favourable seasonality as July is the 2nd lowest month in VIX trading; 2) neutral valuation as our fair value model does not indicate a strong sell signal on volatility; 3) the relationship with real rates suggests that an upward shock to the VIX could occur in Q4 2023.

PE valuation vs real rates not particularly exuberance

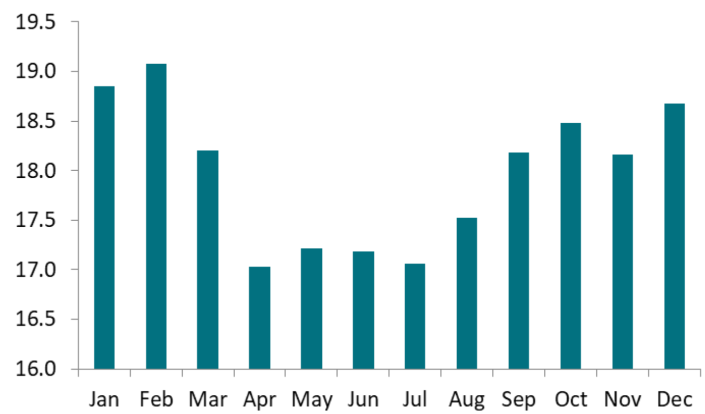
Global equities Forward PE and real rates



Last 20 years

Summertime tends to see low activity in VIX

VIX - Monthly seasonality



Source: Bloomberg and AXA IM Research, July 2023

Forecasts & Calendar

Macro forecast summary

Forecasts

Real GDP growth (%)	2022		2023*		2024*	
	AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
World	3.4		2.8		2.7	
Advanced economies	2.7		1.1		0.7	
US	2.1	2.1	1.4	1.3	0.6	0.5
Euro area	3.6	3.2	0.4	0.6	0.5	0.9
Germany	1.8	1.8	-0.5	-0.2	0.3	1.1
France	2.6	2.6	0.6	0.6	0.5	0.9
Italy	3.7	3.8	1.2	1.0	0.4	0.8
Spain	5.5	5.5	2.2	1.8	1.0	1.5
Japan	1.1	1.0	1.3	1.1	1.3	1.0
UK	4.0	4.0	0.2	0.1	0.3	0.8
Switzerland	2.1	2.1	0.7	0.7	1.0	1.4
Canada	3.4	3.4	1.4	1.2	0.9	1.0
Emerging economies	3.9		3.9		3.9	
Asia	4.3		5.0		4.6	4.0
China	3.0	3.0	5.3	5.7	5.0	4.9
South Korea	2.6	2.6	1.5	1.1	2.0	2.1
Rest of EM Asia	6.0		5.0		4.4	
LatAm	4.0		2.1		2.3	
Brazil	2.9	2.9	1.9	1.2	1.3	1.6
Mexico	3.1	3.1	2.3	1.8	1.9	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	0.7	2.9	3.1
Turkey	5.6	5.6	2.1	2.2	3.1	2.6
Other EMs	4.9		3.1		3.7	

Source: Datastream, IMF and AXA IM Macro Research – As of 24 July 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	**7.4**		**4.6**		**2.6**	
US	**8.0**	8.0	**4.0**	4.1	**2.8**	2.6
Euro area	**8.4**	8.5	**5.5**	5.4	**2.7**	2.4
China	**1.9**	2.0	**1.0**	1.3	**2.0**	2.3
Japan	**2.5**	2.5	**2.7**	2.8	**1.5**	1.5
UK	**9.1**	9.1	**7.3**	7.3	**2.5**	3.2
Switzerland	**2.8**	2.8	**2.4**	2.4	**1.5**	1.4
Canada	**6.8**	6.8	**3.9**	3.7	**2.8**	2.3

Source: Datastream, IMF and AXA IM Macro Research – As of 24 July 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	Q3-23	Q4-23	Q1-24
United States - Fed	Dates	5.25	25-26 Jul 19-20 Sep	31-1 Oct/Nov 12-13 Dec	30-31 Jan 19-20 Mar
	Rates		+0.25 (5.50)	unch (5.50)	-0.25 (5.25)
Euro area - ECB	Dates	3.50	27 Jul 14 Sep	26 Oct 14 Dec	25 Jan 7 Mar
	Rates		+0.50 (4.00)	unch (4.00)	unch (4.00)
Japan - BoJ	Dates	-0.10	27-28 Jul 21-22 Sep	30-31 Oct 18-19 Dec	Jan Mar
	Rates		unch (-0.10%)	unch (-0.10)	unch (-0.10)
UK - BoE	Dates	5.00	3 Aug 21 Sep	2 Nov 14 Dec	1 Feb 21 Mar
	Rates		+0.50 (5.50)	unch (5.50)	unch (5.50)
Canada - BoC	Dates	5.00	06-Sep	25 Oct 6 Dec	Jan Mar
	Rates		unch (5.00)	unch (5.00)	unch (5.00)

Source: AXA IM Macro Research - As of 24 July 2023

Calendar of 2023 events

2023	Dates	Events	Comments
July	23-Jul	Spanish general election	
	26-Jul	FOMC meeting	+25 bps (5.50%)
	27-Jul	ECB meeting	+25bps (3.75%)
	28-Jul	BoJ meeting	unch (-0.1%)
August	03-Aug	BoE meeting	+25bps (5.25%)
	Late Aug	Federal Reserve's Central Bank Symposium Jackson Hole	
September	06-Sep	BoC meeting	unch (5.00%)
	14-Sep	ECB meeting	+25bps (4.00%)
	20-Sep	FOMC meeting	unch (5.50%)
	21-Sep	BoE meeting	+25bps (5.50%)
	22-Sep	BoJ meeting	unch (-0.10%)
October	25-Oct	BoC meeting	unch (5.00%)
	26-Oct	ECB meeting	unch (4.00%)
	29-Oct	Argentina general elections	
	31-Oct	BoJ meeting	unch (-0.10%)
November	01-Nov	FOMC meeting	unch (5.50%)
	02-Nov	BoE meeting	unch (5.50%)
		UK Autumn Statement (expected)	
December	06-Dec	BoC meeting	unch (5.00%)
	13-Dec	FOMC meeting	unch (5.50%)
	14-Dec	ECB meeting	unch (4.00%)
	14-Dec	BoE meeting	unch (5.50%)
	19-Dec	BoJ meeting	unch (-0.10%)

Investment Managers

Latest publications

June Global Macro Monthly – A skip and a hop(e)

28 June 2023

June Op-Ed-Looking beyond the immediate challenges

28 June 2023

UK public debt sustainability: Post-Truss truths

12 June 2023

Nearshoring in Mexico: Mirage or the real deal?

7 June 2023

Is there a premium for low-carbon-intensity European equities?

25 May 2023

May Global Macro Monthly – Summertime … and the (debt) ceiling is nearing

24 May 2023

May Op-Ed – Peak in sight… but it's a twin peak

24 May 2023

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

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