27 March 2024

AXA Investment Managers

Investment Institute Macroeconomics

Monthly Op-ed

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Direction of travel confirmed

Key points

- The Fed's latest message reveals a quite high tolerance margin for accidents on the disinflation road, as supply conditions improve
- We count on the three major Western central banks starting their – prudent – easing cycle in synch in June
- Lower cash rates will prompt modest yield curve steepening
- Cyclical and secular support for broader equity performance

Tide turning

Since the end of last year, the market had gradually dialled down its expectations for rate cuts by the major Western central banks to the point that, after the concerning details in the two latest inflation prints in the US, the possibility of any easing by the Federal Reserve (Fed) this year was starting to be questioned. Yet, at the March meeting Jay Powell and the Federal Open Market Committee (FOMC) stuck to their guns: the new "dot plot" retains a median at three cuts in 2024, the same as in December. True, the resilient dataflow has probably dampened the enthusiasm of the doves for a significant easing this year – the number of FOMC participants forecasting more than three cuts this year has fallen – but the direction of travel was confirmed.

It seems the Fed's margin of tolerance for accidents on the "bumpy" disinflation road is quite wide. The FOMC still wants to get more data to become "fully confident that inflation is moving towards 2% sustainably" but crucially the Fed Chairman stated that strong job creation by itself would not necessarily be a reason NOT to cut, because some of this current strength in the US economy may come from improved supply. Strong net immigration has been estimated to be 3.5 million for 2023, around 1% of the US population. This can explain why the Fed is comfortable with communicating that they can still telegraph the same quantum of easing this year while at the same time revising up its forecasts for GDP growth and employment. We maintain our call that the first cut will still come in June.

The countdown to rate cuts is underway well outside the US as well. The Bank of England (BoE) surprised – again – in March as votes for further hikes disappeared, in keeping with the peak language from last month, the accompanying minutes also adopted a more dovish tilt. No Monetary Policy Committee member is now advocating further hikes (against two at their previous meeting), and Governor Bailey's statements conveyed a strong easing bias. He explicitly engaged in the "various shades of restriction" narrative which we explored last month, with his point that the *"stance of monetary policy could remain restrictive even if Bank*

Rate were to be reduced, given that it was starting from an already restrictive level". While the Bank remains concerned with the strength of the labour market, the downward revision in the inflation trajectory – now seen as falling temporarily below 2% in Q2 2024 on the back of the freeze in the fuel duty – has tilted us into pencilling in the first cut by the BoE in June instead of August.

This echoes the European Central Bank (ECB)'s message, with the downward revision in its inflation forecasts, now seen as falling slightly below 2% in 2025. The central bank seems less worried by labour cost developments – negotiated wages have slightly decelerated in Q4 2023 after two years of steep acceleration – while weak cyclical conditions should trigger some compression in margins.

The three major Western central banks would then move in synch. The Swiss National Bank (SNB) chose not to wait and delivered a surprise cut last week. Inflation in Switzerland was coming down fast (1.2%yoy for headline and 1.1% for core in February, systematically below 2% for the latter since May of last year) and we suspect the SNB did not want to take the risk to trigger further upward pressure on the Swiss currency if it appeared as a mere follower on the monetary easing trail. In trade-weighted terms, the Swiss franc was still up by more than 7%yoy last month (and a whopping +30% over 10 years). Even the Bank of Japan (BoJ) – which conversely is starting to normalise its monetary policy, exiting negative policy rates in March, sounded very prudent on the future path for hikes. While it has stopped its yield curve control policy and no longer targets a specific level for long-term rates, the BoJ will still be active in the bond market which should help keep financial conditions broadly supportive.

This does not mean that it's "all clear" for an accommodative stance. Even in the Euro area, the resistance of services prices needs to be monitored closely. Also, investors should not bet on a return to the "Status Quo ante". The Fed has revised up its forecast for policy rate beyond 2024 (by 25bps). Powell made the point that his "*instinct would be that rates will not go back down to the very low levels that we saw*". Even in the Euro area where the case for a stronger growth potential – and hence a higher neutral rate – is much less likely than in the US, we don't think the post-Draghi ECB will want to go to fast on accommodation. Yet, relative to the concerns which were mounting in the market, as the first quarter is closing the outlook for rate cuts has cleared.

Rate outlook positive for markets

The prospect of broad-based interest rate cuts across developed economies remains one of the key drivers of expected market returns. Central banks have stabilised interest rate expectations which should help contain volatility. Once there are no economic data shocks, this backdrop should be supportive for carry strategies, and a broadening of equity market performance relative to stock market gains that have been, at times, very concentrated and focused on the US technology sector. Going forward we see scope for more balanced equity market performance by region and sector.

Curve steepening to be modest

As central banks cut policy rates, the yield curve shapes across major currencies are likely to evolve gradually. However, over the balance of 2024 policy moves are expected to be limited which suggests long-term bond yields will continue to be anchored close to current levels. If we are right on three rate cuts from the Fed – totalling 75 basis points – then cash rates will still be above the current level of the 10-year Treasury by year-end. Of course, markets will anticipate additional cuts in 2025 and beyond so the spread between 10-year and two-year Treasuries could just move into positive territory.

In Europe, cash rates are likely to remain well above core government bond yields with the European Central Bank expected to take the policy rate from 4.0% to 3.25% this year. Again, the short-end of the bond market could see lower yields as more easing is anticipated for 2025, but with 10-year German bund yields at 2.35% at the moment, it will be a difficult for the curve to become materially positive. The kind of mid-cycle rates adjustment expected this year is not likely to be enough to generate a huge steepening of yield curves with therefore consequent limited opportunities for aggressive long-duration strategies in bond markets.

Cash to become less attractive

Cash rates will remain somewhat elevated then, even with central banks confirming the easing cycle. However, this should be supportive for credit markets as cash rates will fall below prevailing yields on high grade corporate bonds and even further below running yields in the high yield market. The prospects for potentially healthy compound returns in credit should make the asset class more favourable than cash where the remuneration in terms of interest will decline. From a total return point of view,

investors could assume that credit markets deliver medium-term returns that are close to current coupon levels – around 5% to 6% in the US dollar and sterling markets and 3.5% to 4.5% in the Euro denominated bond market. Again, assuming no shocks in terms of economic data, high yield returns will provide an additional 250-350 basis points of return.

Of perhaps more interest is what the beginning of the easing cycle will mean for equity markets. A steepening of the yield curve, albeit a modest one, is typically associated with better returns from more cyclical equity sectors and markets, as well as being more supportive of returns from the financial sector. There is growing evidence, as well, that global economic growth may be becoming more balanced. Purchasing manager survey data suggests industrial activity in the major economies is bottoming. The rapid decline of producer price inflation over the last year points to healthier supply chains, and recent data from Asia show a marked upturn in exports. Taiwan's export orders are rising rapidly, driven by semi-conductors supplies bound for the US.

These trends are already showing up in equity market performance in 2024. Year-to-date total returns are still dominated by US growth and technology stocks but over the last month there has been some rotation with markets such as Taiwan, Italy, Germany and the UK outperforming US equities. The gap between growth and value has also been reduced. The evolution of rates and yield curves combined with stronger cyclical economic data should help cyclical and more value-oriented sectors perform in the quarters ahead. In the US, over the last month, banks and energy stocks have led their way in terms of performance – partially reversing the trend of the last year and a half. There has also been a solid performance from industrials and materials, supporting the thesis of a cyclical recovery broadening stock market returns.

Secular drivers support broader based equity returns

As well as a more positive cyclical outlook, equity returns will remain driven by strong secular themes. Automation, renewable energy, environmental efficiency, digitalisation across sectors, artificial intelligence and drug development roll-out are among the key ones. The ongoing impact of policies such as the CHIPS Act and the Inflation Reduction Act (IRA) in the US, and the NextGenEU policy framework in Europe provide a major tailwind for many of these themes. The investment supported by these policies and the general shift towards decarbonisation have long lead times but it seems clear that positive capital expenditure trends are underway. And capital markets are helping. Green bond issuance continues to rise steadily while the health of both public and private debt markets in general is supportive to these investment themes.

The top-down view of a soft-landing in the US, better cyclical indicators globally and an easier monetary environment over the next six to 12 months is a positive one for investors. After valuation adjustments related to the re-setting of interest rates in 2022 and 2023, returns across equities and bonds could revert to being close to medium-term trends. Certainly, the health of corporate sectors suggests risk-assets (credit and equities) can deliver decent returns to investors and there are likely to be more upside in areas that have underperformed in the last year or so – Asian equities, the UK, small and mid-cap and more value and cyclically tilted sectors. There are considerable valuation gaps in equities, with virtually no equity risk premium in big-cap US stocks but better metrics in European and emerging market equities.

Download the full slide deck of our March Investment Strategy

Macro forecast summary

Real GDP growth (%)	2023	2024*		2025*	
	AXA IM	AXA IM	*Consensus*	AXA IM	*Consensus*
World	3.2	3.0		3.1	
Advanced economies	1.7	1.3		1.2	
US	2.5	2.1	2.1	1.5	1.8
Euro area	0.5	0.3	0.5	0.8	1.5
Germany	-0.1	-0.1	0.3	0.7	1.5
France	0.9	0.4	0.7	0.7	1.3
Italy	1.0	0.3	0.5	0.6	1.2
Spain	2.5	1.6	1.5	1.3	1.9
Japan	1.9	1.2	0.7	1.0	1.0
UK	0.3	0.4	0.3	0.8	1.2
Switzerland	0.6	0.8	1.1	1.3	1.5
Canada	1.1	0.8	0.6	1.7	1.9
Emerging economies	4.1	4.0		4.2	
Asia	5.3	5.0	4.0	4.7	
China	5.2	4.6	4.6	4.2	4.4
South Korea	1.3	2.2	2.1	2.3	2.2
Rest of EM Asia	5.9	5.8		5.4	
LatAm	2.4	1.7		2.6	
Brazil	3.0	1.5	1.6	2.0	2.0
Mexico	3.2	2.2	2.2	2.1	2.2
EM Europe	2.6	2.5		2.6	
Russia	3.0	2.6	1.7	1.1	1.1
Poland	0.2	2.8	2.8	3.5	3.4
Turkey	4.3	2.0	2.2	3.6	3.2
Other EMs	1.9	2.8		4.6	

Source: Datastream, IMF, Bloomberg and AXA IM Macro Research – As of 26 March 2024
*Forecast

CPI Inflation (%)	2023	2024*		2025*	
	AXA IM	AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	4.7	2.7		2.2	
US	4.1	3.0	2.6	2.4	2.3
Euro area	5.5	2.5	2.3	2.1	2.1
China	0.2	1.1	0.9	2.0	1.9
Japan	3.2	2.2	2.3	1.6	1.5
UK	7.7	2.7	2.6	1.6	2.0
Switzerland	2.2	1.6	1.6	1.3	1.3
Canada	3.6	2.3	2.6	2.2	2.0

Source: Datastream, IMF, Bloomberg and AXA IM Macro Research – As of 26 March 2024
*Forecast

These projections are not necessarily reliable indicators of future results

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Forecast summary

Central bank policy Meeting dates and expected changes (Rates in bp / QE in bn)					
		Current	Q2-24	Q3-24	Q4-24
United States - Fed	Dates	5,5	1 May 12 Jun	30-31 Jul 17-18 Sep	6-7 Nov 17-18 Dec
	Rates		-0.25 (5.25)	-0.25 (5.00)	-0.50 (4.50)
Euro area - ECB	Dates	4.00	11 Apr 6 Jun	18 Jul 12 Sep	17 Oct 12 Dec
	Rates		-0.25 (3.75)	-0.25 (3.50)	-0.25 (3.25)
Japan - BoJ	Dates	0 - 0,1	25-26 Apr 13-14 Jun	30-31 Jul 19-20 Sep	30-31 Oct 18-19 Dec
	Rates		unch (0-0.1)	unch (0-0.1)	+0.15 (0.15-0.25)
UK - BoE	Dates	5,25	9 May 20 Jun	1 Aug 19 Sep	7 Nov 19 Dec
	Rates		-0.25 (5.00)	-0.25 (4.75)	-0.25 (4.50)
Canada - BoC	Dates	5.00	10 Apr 5 Jun	24 Jul 4 Sep	23 Oct 11 Dec
	Rates		unch (5.00)	-0.25 (4.75)	-0.50 (4.25)

Source: AXA IM Macro Research - As of 26 March 2024

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