Omicron to a Russian Rubicon

Monthly Investment Strategy

AXA IM Research

January 2022

Summary: January 2022

Theme of the month: The impact of Omicron

- The emergence of the Omicron variant in late November quickly resulted in surging cases across the world. Yet hospitalisations and deaths have been more subdued as Omicron has caused less severe infections. This could see disruption followed by increased global immunity against future waves.
- Governments have enacted a range of restrictions in the face of Omicron, but on balance less than in previous waves. Individual behaviour has also changed with observed drops in consumer spending. A weaker turn of year is likely to give way to a firmer rebound into spring with a small net effect.
- Short-term Omicron disruption may lift inflation in the coming months but exacerbate a drop in inflation thereafter as supply chains improve, labour supply increases and consumers reduce their bias towards goods purchases. Yet downside risks in EM and China could perpetuate supply-chain inflation.

Macro update: Bracing for tightening

- Geopolitical tensions have risen, with concerns of a Russian invasion of Ukraine. This would spark a material risk-off, further energy prices pressures and – in the event of Russia's being cut off from the international payment system – could even increase broader tensions between China and the US.
- The expected swift passage of the Omicron wave has left markets expecting tighter monetary policy from the Fed – where the labour market has tightened more quickly – and in the UK and Canada, amongst other developed economies.
- Inflation has risen further. This may be close to a peak in several regions (US, Canada and the Eurozone), although the short-term Omicron disruption could see pressures persist. The transitional aspects of the inflation surge should fade visibly from the spring – revealing the work left for central banks.

Investment strategy: risky assets caught between hawkish central banks, earnings angst and geopolitical risk

- FX: The forward level of interest rate differential has been more relevant for currency markets, hence further USD upside against low yielders and EUR in particular is possible. That said, USD is starting to look expensive, and it is wise to start looking for cheaper carry alternatives.
- Rates: Last year was full of surprises on inflation and the Fed policy path has repriced notably as a result. The swift repricing of policy expectations is not confined to the Fed, though. However, the USD 2y3y/5y5y spread suggests that rate expectations are very close to their historical maximum.
- Credit: 2022 has seen the worst start in global credit in 25 years, but predominantly due to interest rates rather than spreads. We think that a relative overweight of HY over IG should continue to reap benefits in 2022, as we enter the Fed normalisation cycle and default rate expectations remain benign.
- Equity: In a year shaped by the normalisation of US monetary policy, stocks are going through a tortuous path post-Covid. Based on our wage growth forecasts, profit margin growth is expected to decelerate and even decrease from the third quarter of 2022 onwards. We maintain moderate overweight.

Central scenario

Summary – Key messages

Monetary policy

Divergence. Those with supply-side issues and tight labour markets tighten (US, UK, Ca), those without do not (Ez, Jp). EMs pressured by inflation expectations and FX.

Inflation

"Mostly" transitory inflation pressures ease visibly from Spring 2022. Threat from persistent labour supply issues and more region specific.

Fiscal policy

Expect reduced US package later in Q1. Support in Europe more gradual, but persists. UK NI tax rate in doubt around energy hikes.

Growth

Rebound continues. Virus and supply risks to recede in H2 2022. Supported by excess saving spending in many DMs.

Our central scenario:

Fading virus allows inflation retracement as recoveries persist

We forecast global growth to rise by 4.1% in 2022 and 3.6% 2023.

Economic growth persists despite supply pressures and tighter monetary policy. Inflation and supply constraints recede.

Emerging Markets

Omicron sweeps, but delivering a boon or bust? Inflation requires further monetary tightening, exacerbated by Fed.

Rates

Gentle rise in longer-term rates, driven primarily by rising real rates in a what still-expected-to-be a measured tightening cycle.

FX

Fed pricing favours dollar for now. European election uncertainty to weigh H1. Dollar outlook weakened by inflation and politics H2 2022.

Credit

Benign spread regime can extend into 2022 favouring higher beta carry while still problematic for duration risk.

Equities

Strong earnings surprises in 2021 are set to diminish in 2022 but above trend growth should prove supportive of earnings.

Alternative scenarios

Summary – Key messages

Entrenched supply shock *(probability 25%)*

What could be different?

- Coronavirus mutation sees renewed outbreaks
- Post-pandemic structural changes – labour market withdrawal and goods demand – persist. Supply shocks last longer
- Geo-political tensions spillover in post-Covid world
- Nervous households maintain high saving buffers

What it means

- Growth weaker, employment rebound softer, but inflation remains more elevated
- Monetary policy ill-equipped to deal with supply shocks, deteriorating inflation credibility forces tighter monetary policy in DMs

Market implications

- Risk appetite deteriorates / equities sell off / credit widens
- Safe-haven rates rally resumes
- EM debt to come under pressure

A global boost *(probability 10%)*

What could be different?

- Vaccine rolls out more quickly spurring pent-up demand burst
- Labour market participation recovers, strong income growth and easing inflation pressures
- Productivity boost following investment rebound and structural post-pandemic adjustments

What it means

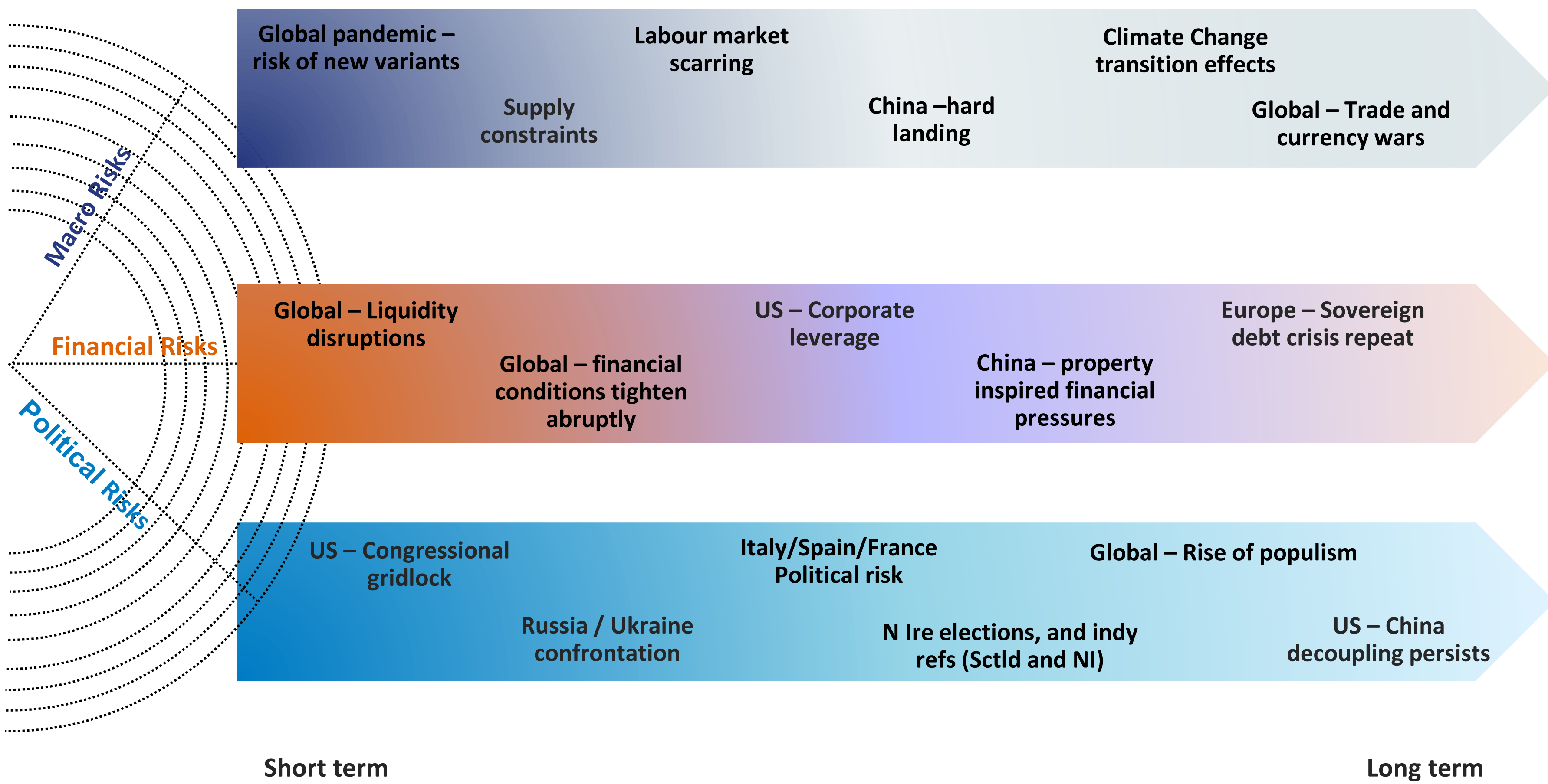
- Growth surprises on the upside in most regions
- Inflation fades towards and below central bank targets
- Monetary policy proves more patient than expectations

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

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Theme of the month

The impact of Omicron

Omicron variant's rapid spread

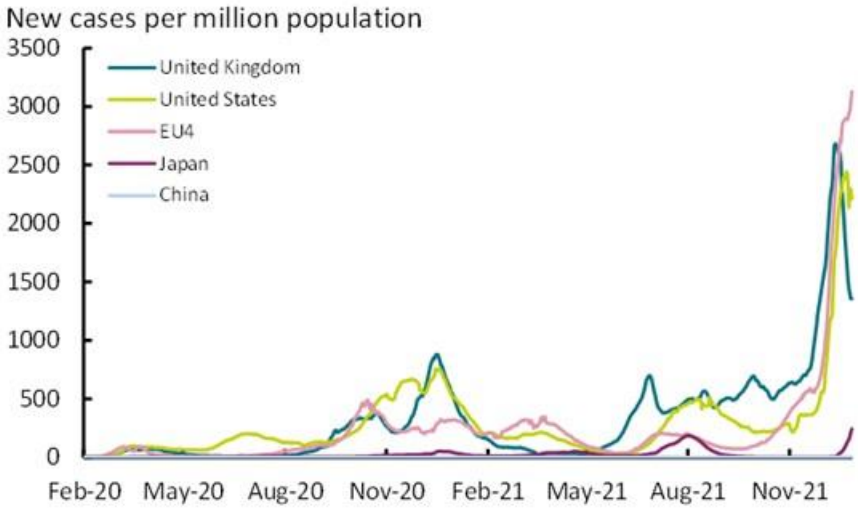
Increased transmissibility

- The Omicron variant was first discovered in South Africa on 24 November 2021. The level of global cases recorded went from 3.8m in that week to 20.8m in the latest week (John Hopkins). The rise in cases has been far faster than with previous variants. Transmissibility is estimated to be around four times that of the Delta variant. It has also evaded previous immunity, from vaccines to natural immunity.

Faster burn-out

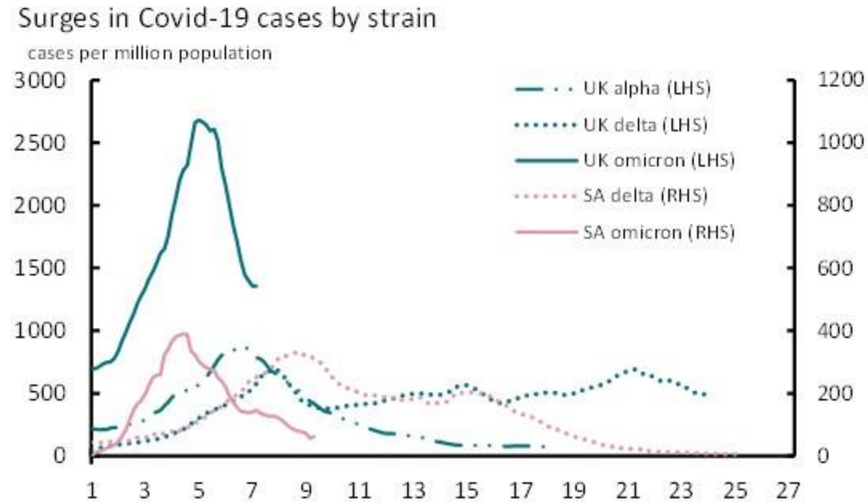
- Yet the faster transmissibility and spread of the virus also appears to have resulted in a faster burn-out. With light increases in restrictions, infections peaked in South Africa and have fallen in subsequent weeks, almost as quickly as they rose. A similar pattern followed first in London, and then more broadly across the UK – populations that are likely more comparable with other developed economies. Omicron now appears to be around a peak in the US, across the Eurozone and in Canada.

Omicron variant spread faster than any previous waves



Source: OWID, AXA IM Research, January 2022

Accelerated rise and fall of current wave compared to previous



Source: OWID, AXA IM Research, January 2022

The impact of Omicron

Reduced severity of cases

Reduced hospitalisations

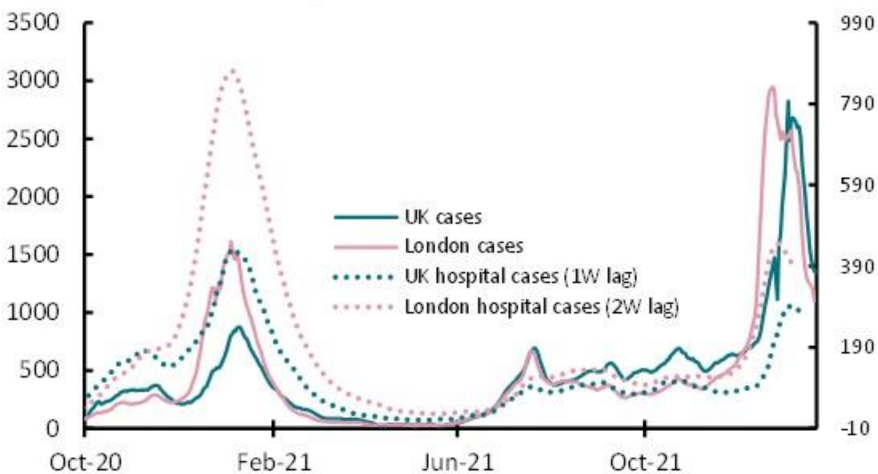
- Concentrating on the more comparable populations of the UK, we can observe three phases of COVID and hospitalisations: pre-vaccination (before March 2021), post-vaccination (Mar-Nov 2021) and omicron (Dec 2021 -). Normalising the post-vaccination phase, we can see that pre-vaccination hospitalisations were much higher relative to cases; during omicron hospitalisations have been much lower. Across London and the UK hospitalisations have been running at approx. half the rate of the previous phase.

Reduced severity common across international economies

- Although the lags in cases with other countries and then with hospitalisations makes broader international comparisons tentative, a reduction in the ratio of hospitalisations to cases is apparent in a number of economies. In fact, initial evidence suggests that the UK's reduction in hospital admissions of around a half may be on the low side, with many European countries recording sharper drops. A similar trend is also observed in the relationship between cases and deaths.

UK hospital admissions far below cases during omicron wave

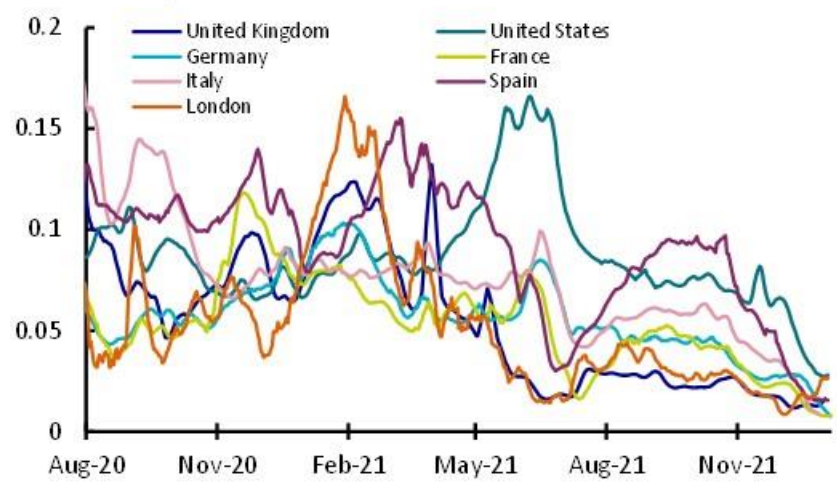
Covid-19 cases and hospital cases



Source: OWID, UK Health Security Agency, AXA IM Research, January 2022

International evidence corroborates falling hospitalisation rates

Ratio of hospitalisations to cases



Source: OWID, UK Health Security Agency, AXA IM Research, January 2022

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The impact of Omicron

Exogenous to endogenous reactions

Omicron led to a range of restrictive actions

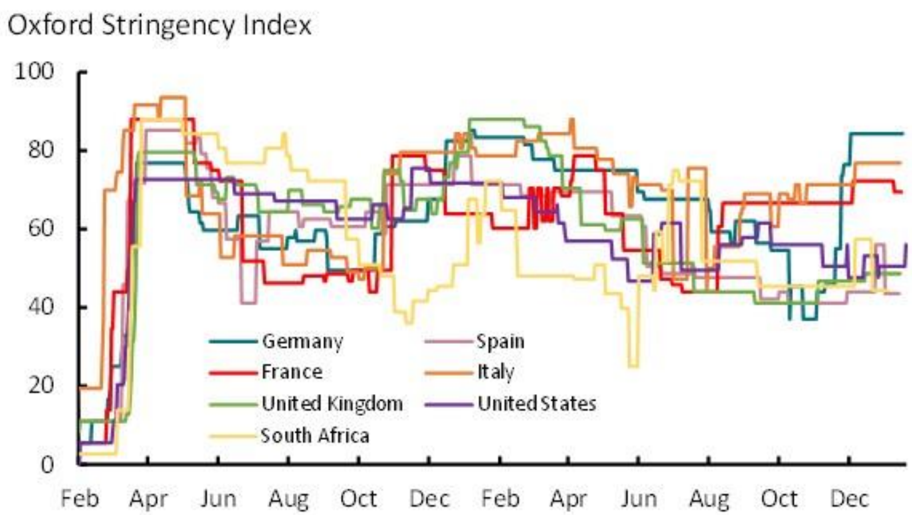
- A range of government restrictions followed the emergence of Omicron. Germany tightened restrictions through the later Delta wave and into Omicron. France's response was limited, but restrictions are elevated overall. In the UK, workers resumed work-from-home, but joined the US with relatively looser restrictions. The Omicron spread has occurred regardless of restrictions.

Behavioural reactions

In the absence of government restrictions, individuals curtailed their own behaviour

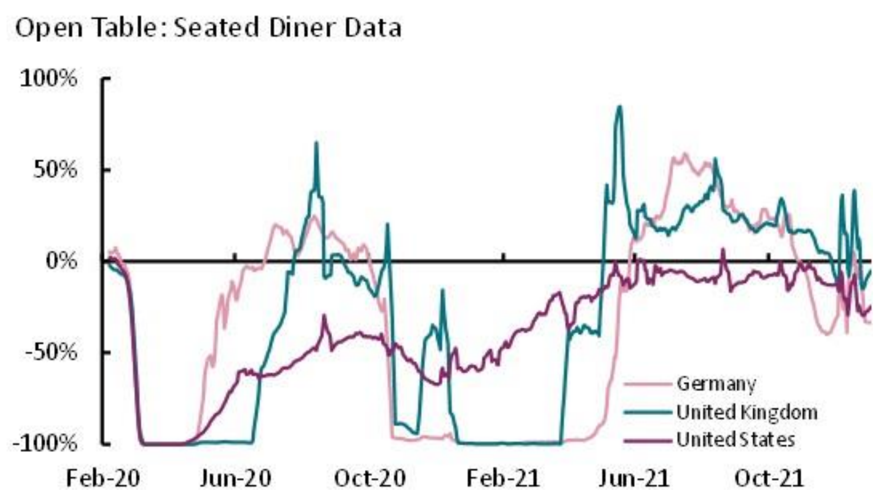
- The outbreak impacted December's sales. US sales dropped by 1.9% (mom) by value in December, UK volumes fell by 3.7%. This occurred even as consumer spending has gravitated more towards retail consumption during COVID episodes.
- Consumer services are expected to have fared worse. Open Table records a material drop in diner numbers in the US, Germany and the UK. This is suggestive of a broader trend in consumer services

Increased restrictions follows heterogenous course



Source: Blavatnik School of Government, University of Oxford, AXA IM Research, January 2022

Falling restaurant bookings barometer for wider consumer services



Source: Open Table, AXA IM Research, January 2022

The impact of Omicron

The combined impact

Gauging with Google

- We look at mobility metrics as a means of merging the impacts of exogenous and endogenous reactions to the Omicron outbreak. There has been a marked drop in activity from around the second half of December. Declines were about as large in Germany, where restrictions were high, as in the UK, where restrictions were low. In the UK there has been a strong relationship between mobility and GDP. We expect GDP to contract in the UK in December and January.

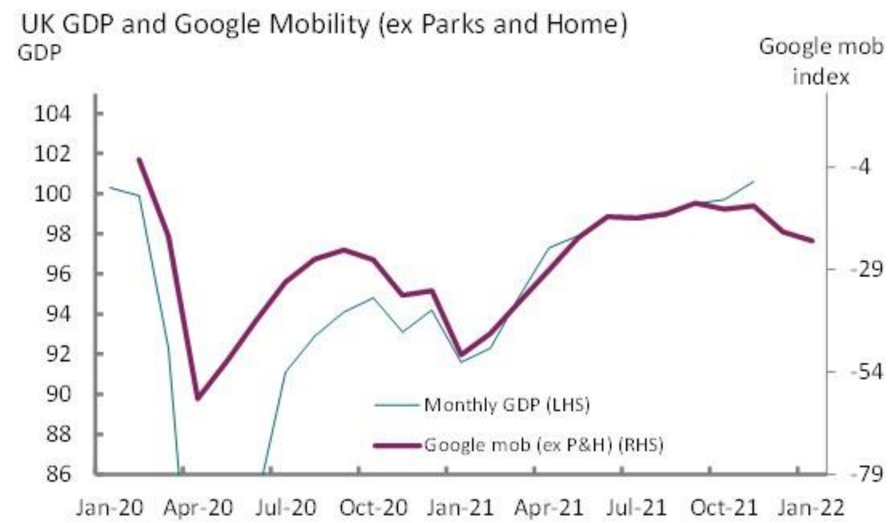
Mostly made up

- This pattern of growth is likely to be echoed across regions resulting in softer Q4 GDP growth and a weaker still Q1 2022. However, we anticipate a marked rebound in activity in February as Omicron fades. This is likely to lift Q2 economic activity. On balance, while we expect the direct impacts of Omicron to weaken the short-term outlook and shift the pattern of growth, we expect the overall rate of growth to be broadly unaffected (forecasting 4.9% vs 5.0% in the UK).

Google mobility falls sharply and across different economies

Source: Google, AXA IM Research, January 2022

Link between mobility and GDP suggests output declines ahead



Source: Google, ONS, AXA IM Research, January 2022

The impact of Omicron

The growth uncertainties

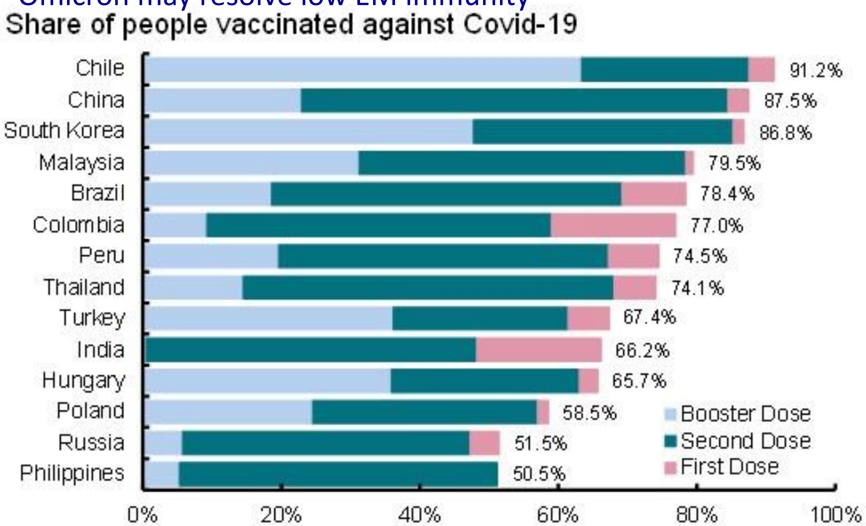
Emerging Market boon or bust ?

- Most EMs– particularly outside of Latin America – have low levels of vaccination. Omicron can be expected to spread quickly. Reduced severity should spare most EMs the worst that a spread of Delta could have delivered. It should also leave populations immune to future waves of COVID – quicker than waiting for vaccines. This could boost EM growth from H2. However, reduced severity may be a function of vaccination. With Omicron cases expected to be high, this could still be highly disruptive for some EM economies.

Can China tame Omicron as well ?

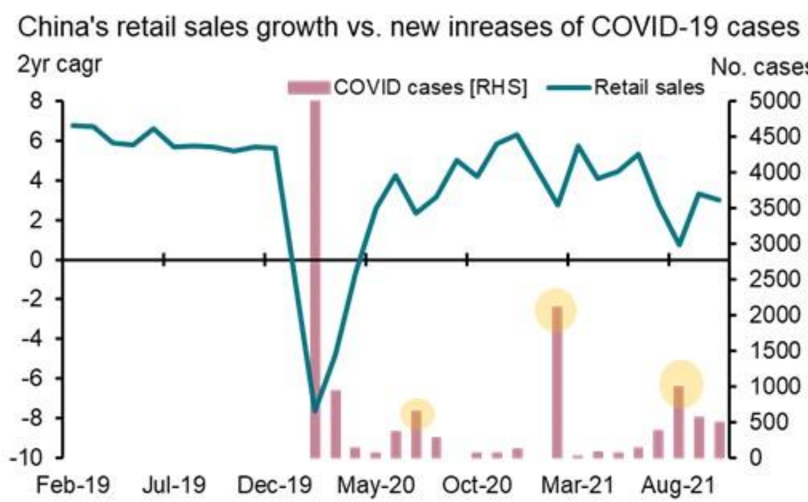
- China has minimized infections from COVID so far with an effective zero-COVID strategy. We do not expect China to choose to relinquish this strategy, but it will be more difficult to maintain with the more transmissible Omicron. If Omicron breaks out in China its population of 1.4bn, without MRNA vaccine protection and little natural immunity would likely suffer a severe outbreak. Beyond impacting Chinese growth, this could have a marked impact on satellite economies and global supply chains.

Omicron may resolve low EM immunity



Source: OWID, AXA IM Research, January 2022

A material outbreak in China could have marked growth implications



Source: OWID, National Bureau of Statistics of China, AXA IM Research, January 2022

The impact of Omicron

Three transmission channels to inflation

Supply-chain pressures

- Omicron's disruption is likely to temporarily reverse tentative signs of supply-chain improvement, which could drive inflation higher. Yet a faster fading virus should help inflation fall more quickly thereafter, particularly if EMs rebound with more resilience against future waves. Risks to EMs and China would impact supply chains and suggest more persistent inflation.

The goods – services balance

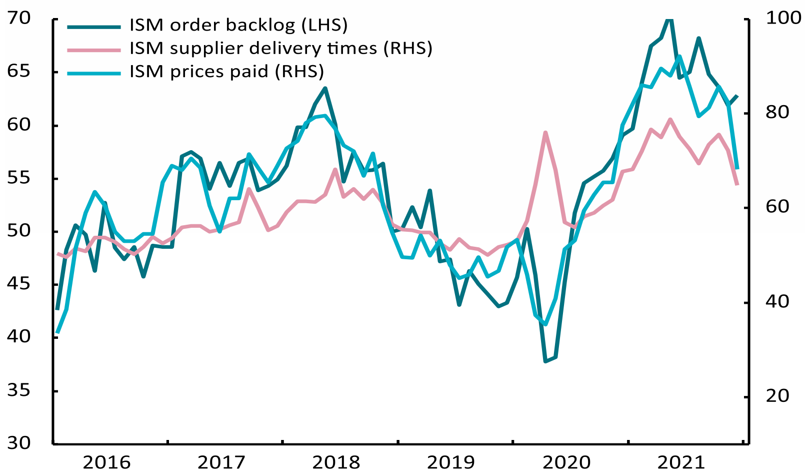
- If the virus fades more quickly after Omicron, the bias of developed economy consumer demand to goods is likely to revert to services, more broadly easing supply-chain stresses and helping bring goods price inflation down more quickly.

And the endogenous labour withdrawal

- The virus has also led to a reduction in labour supply in many countries. As it fades, supply should recover and dampen inflationary wage growth.

Omicron could reverse easing supply chain pressure

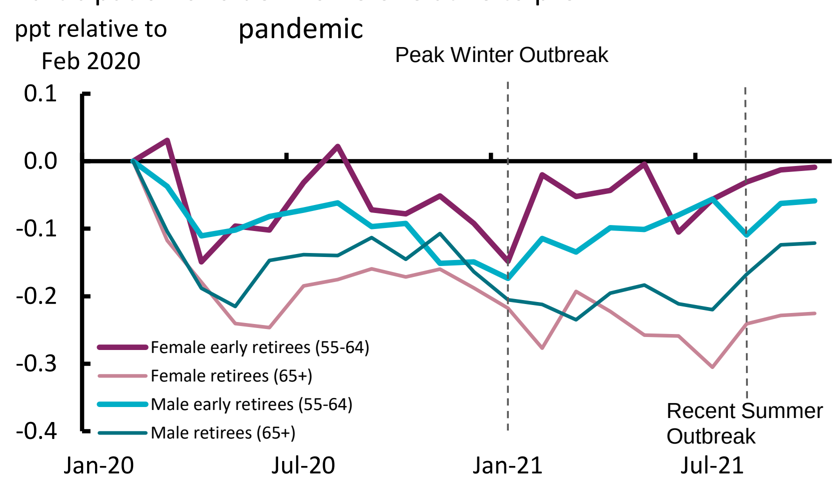
ISM supply-chain pressures index



Source: ISM, AXA IM Research, January 2022

US labour market withdrawal has in part been a result of COVID

Participation of older workers relative to pre-pandemic



Source: xx

Macro outlook

The ups of inflation and the downs of growth

US

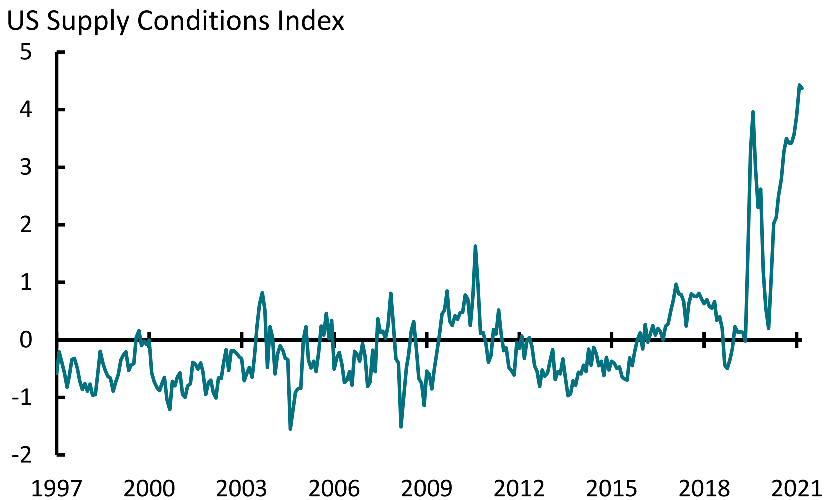
Inflation at a forty-year high

- December's CPI inflation rose to 7.0% as used cars and rents drove prices higher. With PPI inflation, used cars and oil price inflation all appearing to have peaked, inflation could soon ease. However, supply disruption risks (from the Omicron wave) and geo-political pressure (Ukraine) on energy prices threatens a few more elevated months. Inflation should fall visibly from Spring and we lower our 2023 outlook, now anticipating faster policy tightening. We forecast inflation to average 4.6% in 2022 and 2.6% in 2023.

GDP expectations softening

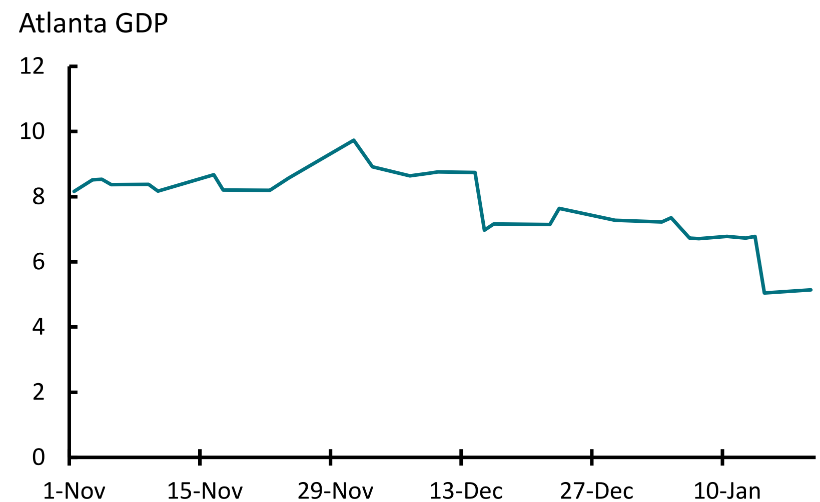
- Retail sales dropped by 1.9% m/m in December and the Atlanta Fed GDP now tracker fell back to 5.0% (saar), closer to our own 4.8% forecast. In December, we forecast growth in 2022 at 3.5%, below the 4.0% consensus and 2.7% in 2023. Although consensus forecasts have softened to 3.8% for this year, we lower our outlook further on a now expected faster pace of Fed tightening. We now forecast GDP growth of 3.3% and 2.5% for this year and next (consensus 3.8% and 2.5%).

Significant supply disruption underpinned inflation surge



Source: Liberty Street Research, Bloomberg, January 2022

Q4 GDP outlook drifts lower



Source: Bloomberg, January 2022

Fed to move sooner

US

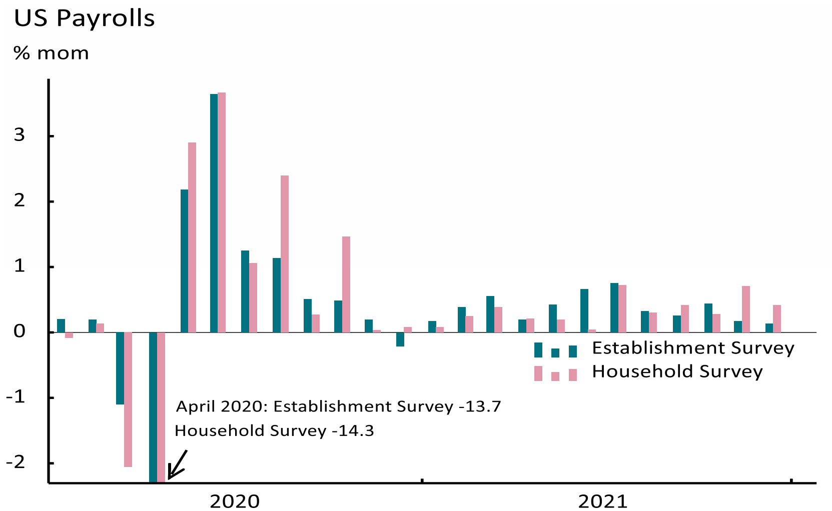
Firmer labour market underpins sooner hike expectations

- Despite subdued payrolls growth in the past two months at 199k and 249k, the household survey recorded much firmer employment, up 650k and 1,090k, unemployment at 3.9% and pay growth of 0.6% m/m in December. This could reverse somewhat over the coming months, but the labour market appears tight and should meet the Fed's forward guidance conditions for rates lift off. As such, we now forecast four 0.25% rate hikes this year to (1.00-1.25%), starting in March and three in 2023 (to 1.75-2.00%).

Lining up QT

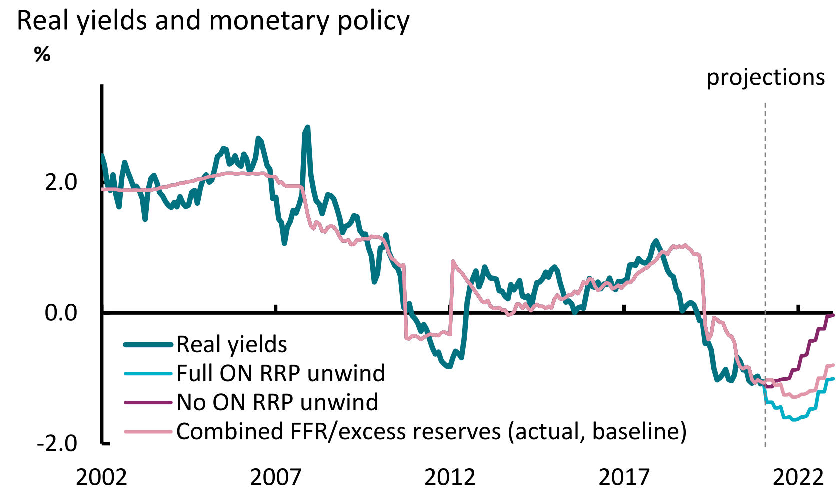
- December's FOMC minutes noted consideration of a balance sheet unwind that was sooner and faster than before. Our estimate is that the Fed will announce QT in Q3 and ultimately allow $60bn in USTs and $30bn in MBS maturities per month. This would see modest tightening this year, but a reduction of around $1trn in 2023. The impact of this tightening will in part depend on the interaction with other liquid holdings on the Fed's balance sheet and we forecast the impact on real yields to be gradual.

Labour market appears tight on household survey



Source: BLS, AXA IM Research, January 2022

Reverse repo holdings likely to dampen QT impact



Source: FRB, Bloomberg, AXA IM Research, January 2022

Brighter days on the horizon

Euro area

The worst of the Omicron wave is probably behind us

- Cases are easing in several countries, while hospitalisations have remained at a manageable level. Restrictions are likely to remain for a few extra weeks but should ease thereafter.

Near term economic developments are mixed

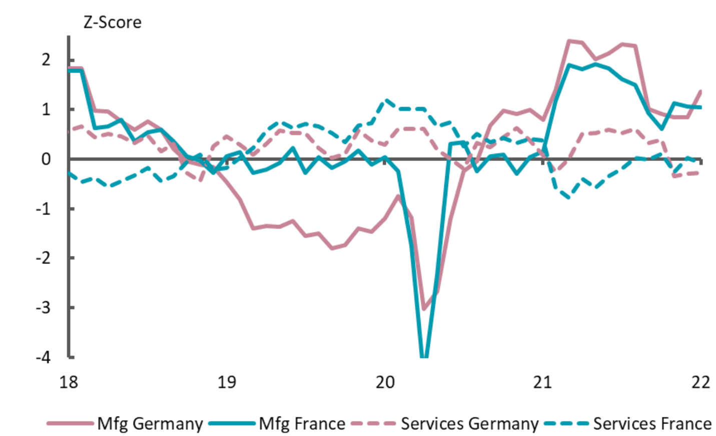
- In Germany, both manufacturing and services PMIs surprised to the upside, but dipped somewhat in France. Business climate also slightly deteriorated while consumer confidence was broadly flat. We believe there is downside risks to our Q1 GDP forecast which currently stands at +0.6%.

Short term Outlook : two majors risks to monitor

- Germany would be the most exposed to the supply-chain disruption likely if Omicron challenges China's 'zero-COVID' policy
- Energy price and broader inflationary pressures on consumer purchasing power This could be further exacerbated if geopolitical tensions rise around Ukraine.

Buoyant industries but struggling services

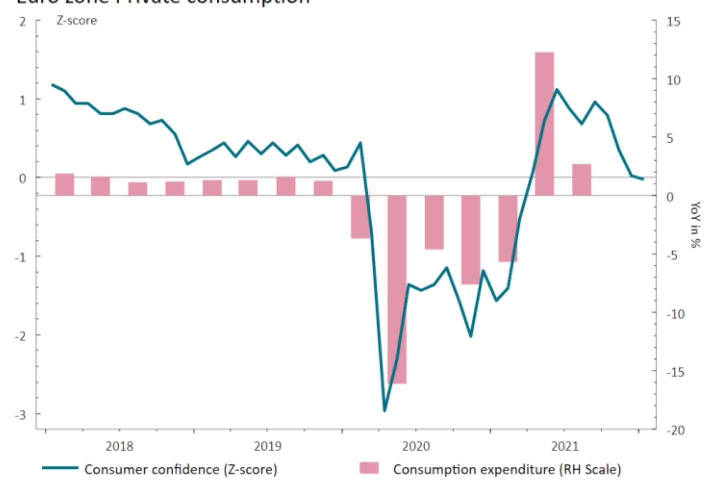
German and French PMIs



Source: IHS Markit, AXA IM Research, January 2022

Stabilisation in consumer confidence point to private consumption normalisation January

Euro zone Private consumption



Source: Refinitiv Datastream and AXA IM Research Jan 22

Don’t push it too far

Euro area

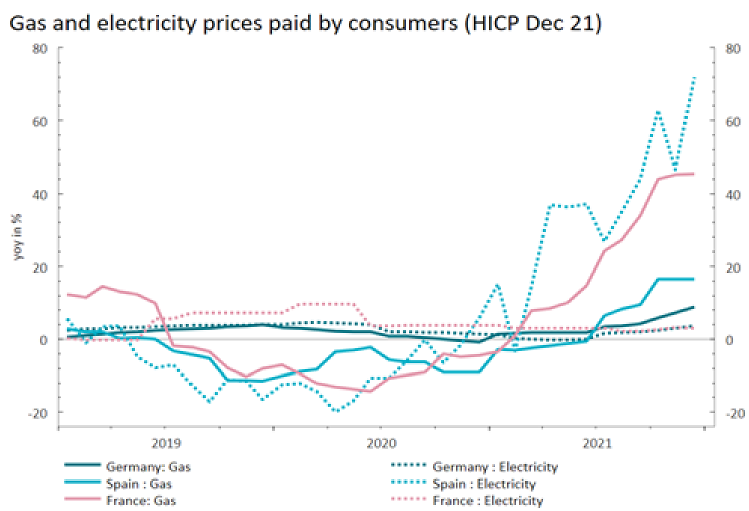
Inflation: we have probably seen the peak in December

- Inflation peaked at 5%yoy but remained mixed across countries (reached 6.5% in Spain, 5.7% in Germany, 4.2% in Italy and ‘only’ 3.4% in France). The end of the Germany VAT cut effect will reduce the Eurozone core rate by around 0.5 pp from January, but price pressures are likely to persist reflecting energy and food past prices (around 2% in Q1)
- Beyond Q1, electricity and gas contributions to inflation should ease, as should supply constraints. However, recent wages data do not point to homogeneous upside pressure across the Eurozone, but with further labour market improvement expected, this could materialise through 2022-2023.

The ECB’s inflation outlook is challenged by the market, which now prices a first-rate hike in October 2022

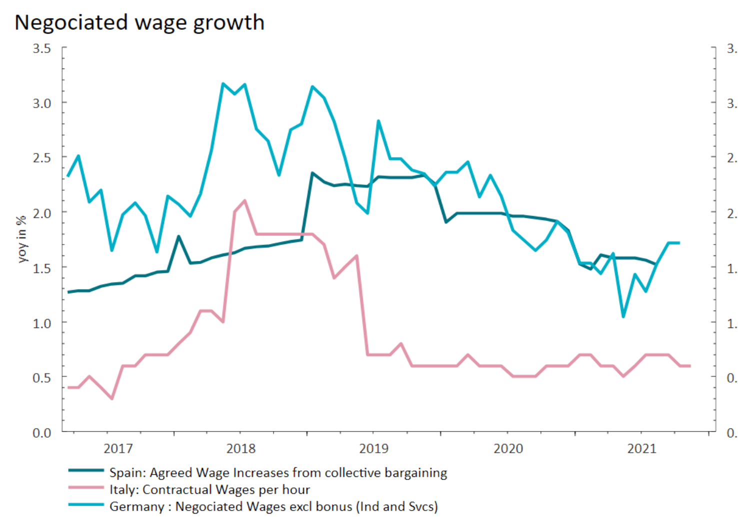
- We believe this is premature and would jeopardise economic activity as inflation should ease materially over the second half of 2022 (from 4% to 1.9%). Recent ECB speeches – including from hawks – do not point to such early actions in our opinion. We believe a move at the start of 2023 would be the earliest appropriate and believe current forward guidance implying a first hike ‘shortly after’ net purchases end is not appropriate and is likely to be amended in the future.

Government measures only offset a share of the rise in energy prices



Source: Refinitiv Datastream and AXA IM Research Dec 21

Still muted wage growth



Source: Refinitiv Datastream and AXA IM Macro Research (Oct 21)

Omicron likely to weigh on GDP outlook

UK

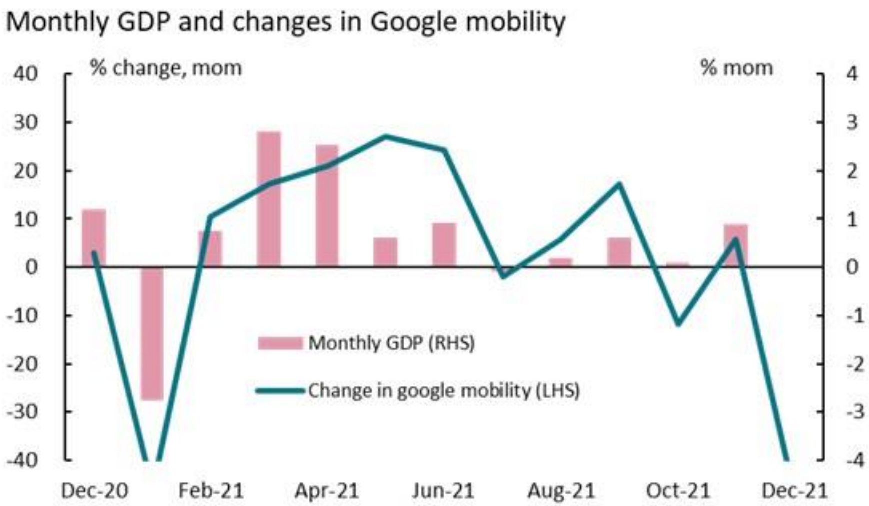
Omicron appears to have peaked, but will weigh on near-term growth

- Omicron appears to have peaked in the UK and the government has announced a phased easing of restrictions. Revisions to previous growth and a firmer-than-expected November suggest Q4 GDP will rise by 0.9% and that 2021 growth will be firmer at 7.2% (from 6.9%). GDP is expected to contract in December and January, following sharp declines in activity, before rebounding thereafter. We expect growth in 2022 of 4.9% (from 5.0%) above consensus of 4.5%.

Inflation edged higher in December and is set to rise further

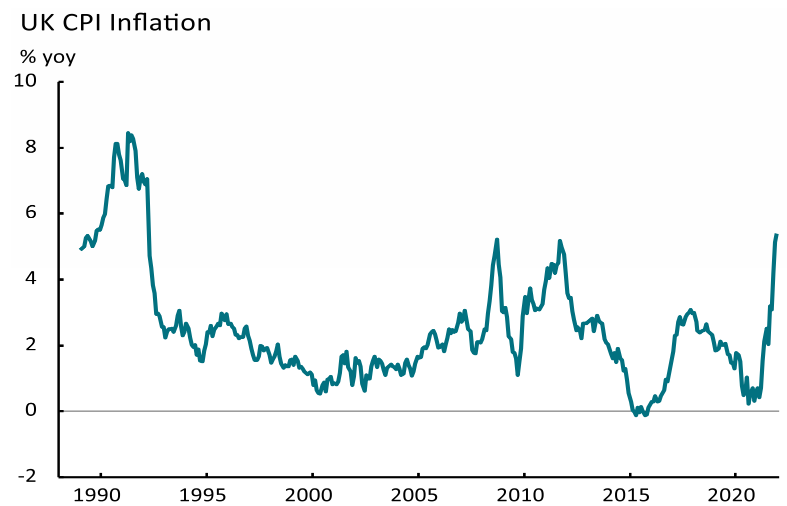
- Headline CPI reached a 30-year high of 5.4% in December and averaged 2.6% for 2021 as a whole. Food and clothing drove the recent increase, and we expect the deceleration of fuel price inflation to take some pressure off in the next few months. However, inflation is set to peak at around 6%, when utility retail price cap adjustments are made in April, although this could be sensitive to intervention from the government to reduce the impact on households.

Recent mobility data suggest sharp falls in activity



Source: National Statistics, Google, AXA IM Research, January 2022

Inflation at 30-year highs and set to rise further



Source: ONS, AXA IM Research, January 2022

Omicron poses dilemma for MPC

UK

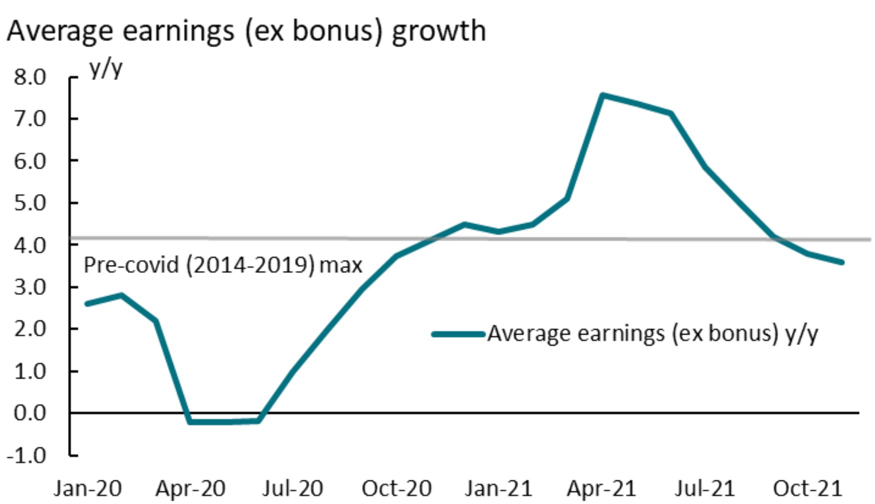
The labour market remains at record levels of tightness, but pressures have shown tentative signs of easing

- In November, unemployment fell marginally to 4.1% (from 4.2%). The pace of tightening appears to be easing, vacancy growth has continued to soften and annual wage growth has continued to fall – in the 3-months to November it slowed to 3.8% from 4.3% and is set to soften further as base effects fall out. However, it remains elevated when considering historic levels of wage growth. In the five years before the pandemic the highest rate of wage growth was 4.1% (in July 2019).

Markets have almost fully priced a Feb hike

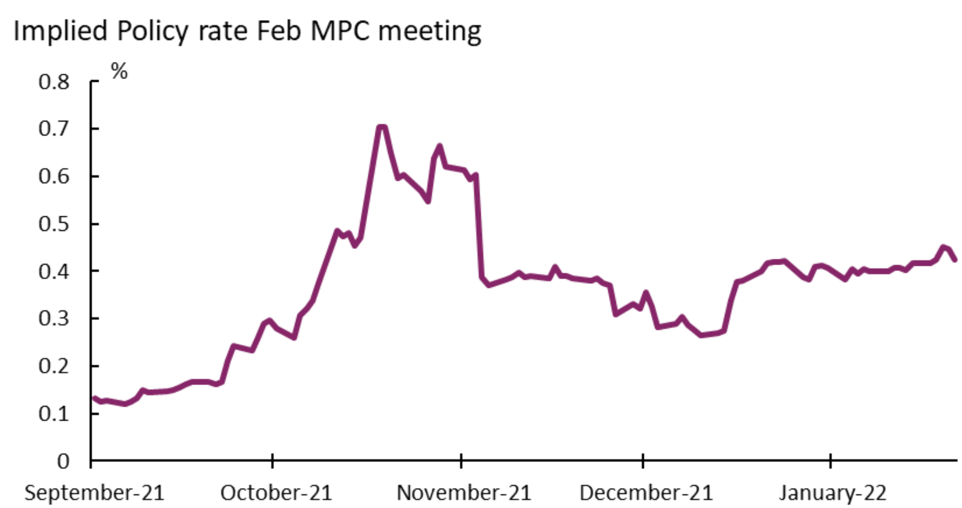
- Given Omicron's likely dampening effect on growth and reports of some unwinding of labour market, we expect the MPC to follow a slower, more cautious path and leave the Bank Rate unchanged at 0.25% in February, penciling in the next hike only for May – which will then begin the passive unwind of the BoE's balance sheet. We forecast a further hike in November, to 0.75%. This is lower than current market expectations, which currently price in a rate increase next month and four hikes in 2022.

Wage growth has begun to fall, but remains elevated



Source: National Statistics, AXA IM Research, Jan 2022

Evolution of market pricing of interest rates



Source: Bloomberg, AXA IM Research, Jan 2022

A decent finish to 2021

China

Economy ends the year on a high note

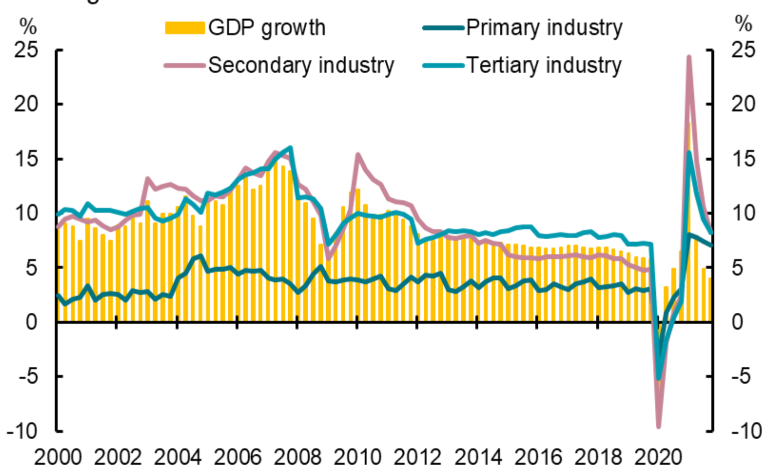
- Thanks to fading power shortages and respite (albeit short-lived) from COVID, the Chinese economy ended 2021 on a strong footing. Quarterly GDP growth accelerated to 1.6% in Q4, even though base effects drove year-on-year growth lower to just 4%. Despite beating expectations, the strong GDP print – 8.1% growth for the whole year – does little justice to the challenging year it was for the Chinese economy

Structural problems remain unresolved

- The rosy GDP print is not enough to alleviate concerns about the growth outlook. High frequency data shows that the economy remains reliant on export-driven growth, consumption is still weak, and the housing market continues its free fall. The near-term outlook is further clouded by the resurgence of COVID cases, which have led authorities to tighten social and mobility controls ahead of the lunar new year and the Winter Olympic. Barring a quick containment of the outbreak and aggressive policy easing, growth is likely to dip again in early 2022

Base effect drives growth lower, despite sequential improvement

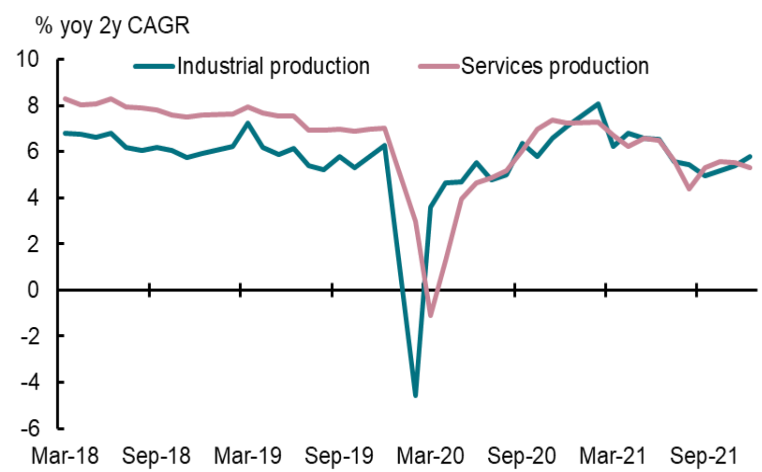
GDP growth breakdown across different sectors



Source: CEIC, AXA IM Research, Jan 22

Industrial activity improves on normalizing power supply

China: Industrial production and services production



Source: CEIC, AXA IM Research, Jan 22

Investment Managers

Policy easing to step up

China

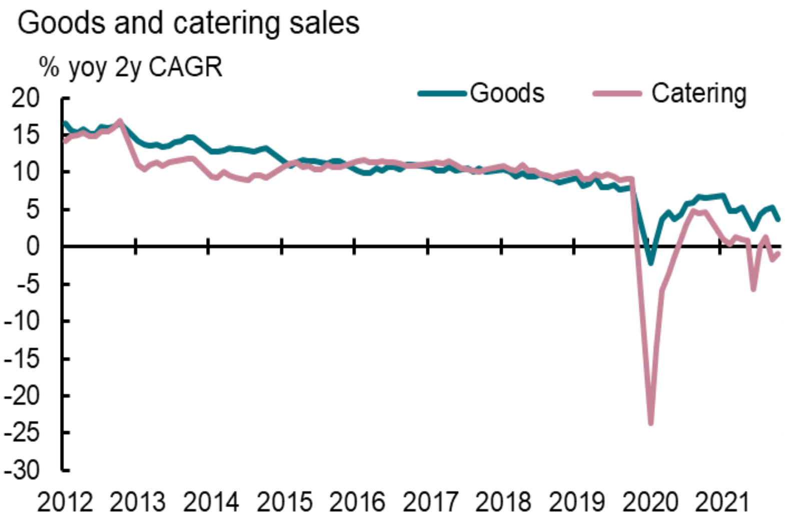
Beijing starts to ease policy, but more needs to be done

- Beijing has started a new round of policy easing to counter growth headwinds. Following the RRR and LPR cuts, the PBoC lowered the 1-year MLF and repo rates by 10bp in early January ahead of market expectations. The fiscal coffers are also filled by carry-over funds from last year and pre-allocated bond quota before the NPC. However, these measures have so far failed to overturn pessimism about the economy, with many brokers downgrading growth forecasts lately

Macro and micro policies work together for a comprehensive support

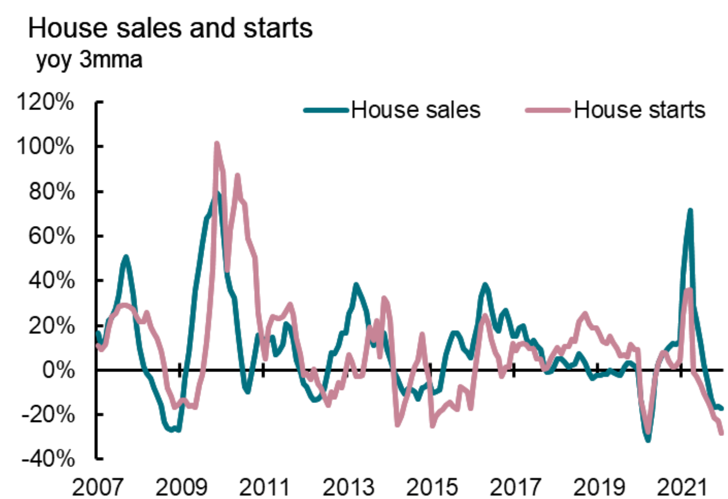
- We think Beijing has a strong intention to stabilise the economy in a politically sensitive year. An economic hard-landing, triggering mass unemployment, will create an unconducive environment for the leadership transition at the 20th Party Congress. At the same time, the authorities are unlikely to reverse the property curbs and alter the COVID strategy drastically. The trick is to stimulate growth without compromising structural resource reallocation. We think achieving this will require a combination of further macro policy easing and differentiating micro policies for different sectors – tight for property, but loose for green, tech, SME and consumption related industries

Consumption continues to struggle against COVID resurgence



Source: CEIC, AXA IM Research, Jan 22

Housing market still in free fall



Source: CEIC, AXA IM Research, Jan 22

Another jolt on the road

Japan

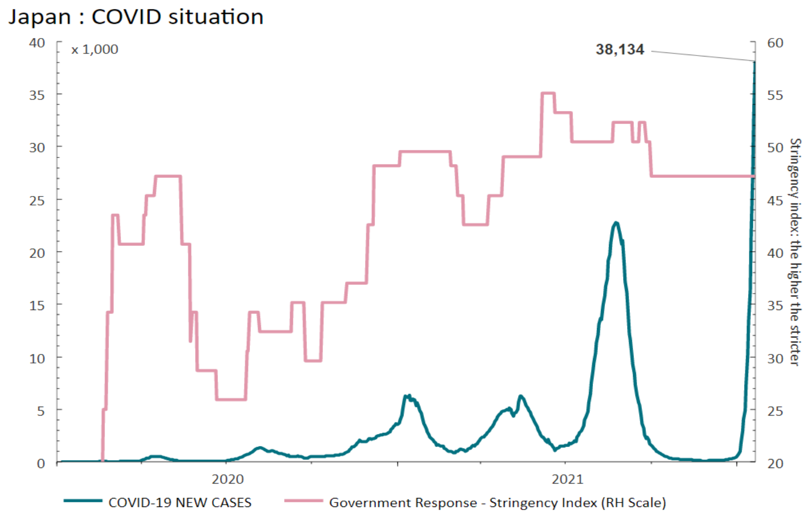
A catch up in Q4 …

- The latest economic data pointed to a fourth quarter (Q4) rebound but this will likely be less than anticipated, as supply disruption erupted at the end of 2021 and worries grew about the Omicron wave, which is now spreading in Japan.

… But worries for Q1 !

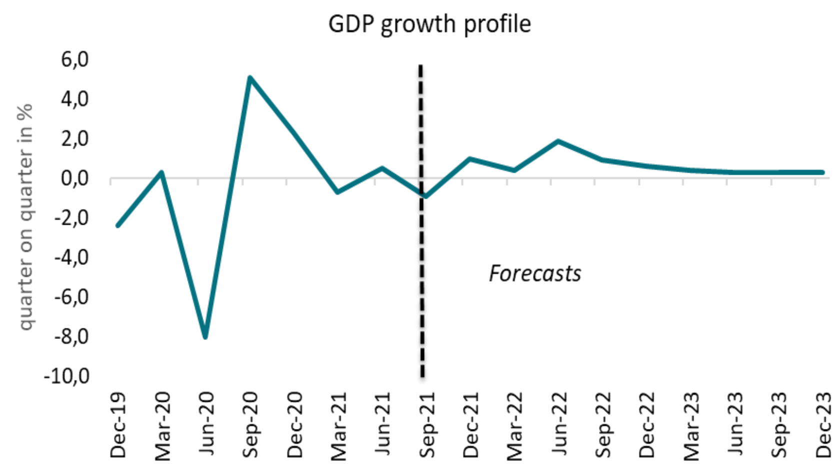
- The government introduced only mild restrictions as Omicron reached Japan as the country has a high vaccination rate (80%) and available data pointed to reduced Omicron severity. However, we remain cautious on the economic impact as the booster campaign has not picked up significantly and households are likely to adapt their consumption behaviour.
- We also anticipate further supply chain constraints due to the COVID-19 outbreak in China and/or in other southeast Asian countries on which Japan strongly relies for its industry. Consequently, we have adjusted our Q1 GDP growth forecast to around +0.4% quarter-on-quarter (from 1%). Once Omicron concerns disappear, we anticipate a strong rebound in private consumption that should coincide with some supply pressures easing.

The government adopted the status quo in regards to the new wave



Source: Refinitiv Datastream and AXA IM Research 21/01/2022

The Omicron wave and supply constraints are likely to weigh on Q1 GDP growth



Source: Cabinet Office, AXA IM Research, Jan 2022

The Bank of Japan stays the course

Japan

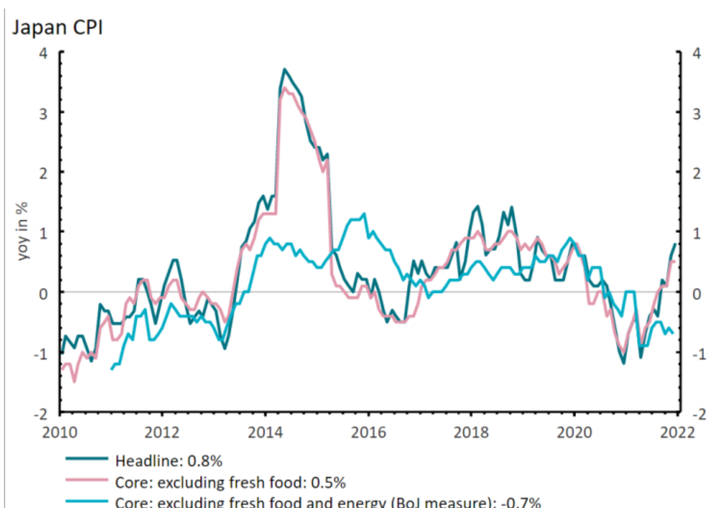
Headline inflation is not very far from the Bank of Japan's target …

- December inflation data increased by 0.2 percentage points (pp) to 0.8% on the year, but core inflation (excluding fresh food and energy) is still negative (-0.7%) as mobile phone charges remove approximately 0.7pp from the index. Assuming high energy prices until Q2, CPI would not be too far from 2%

… But the Board stays the course

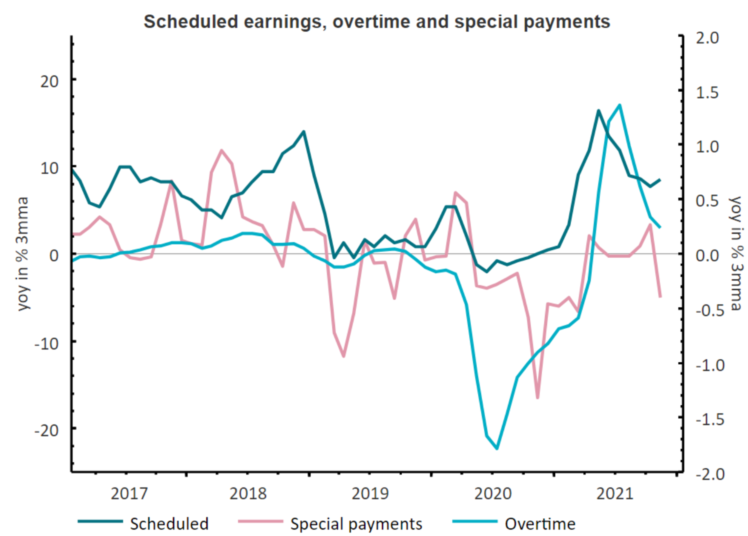
- In its latest press conference, the Bank of Japan emphasised it was not in a position to expect a sustainable 2% target under the virtuous cycle of wages and prices, rejecting de facto any premature normalisation of the monetary policy.

Removing negative contribution from mobile phone charge and CPI has never been that high in a decade



Source: Refinitiv Datastream and AXA IM Research Dec 21

But wages remain stubbornly low



Source: Refinitiv Datastream and AXA IM Research Nov 21

Peak expectations

Canada

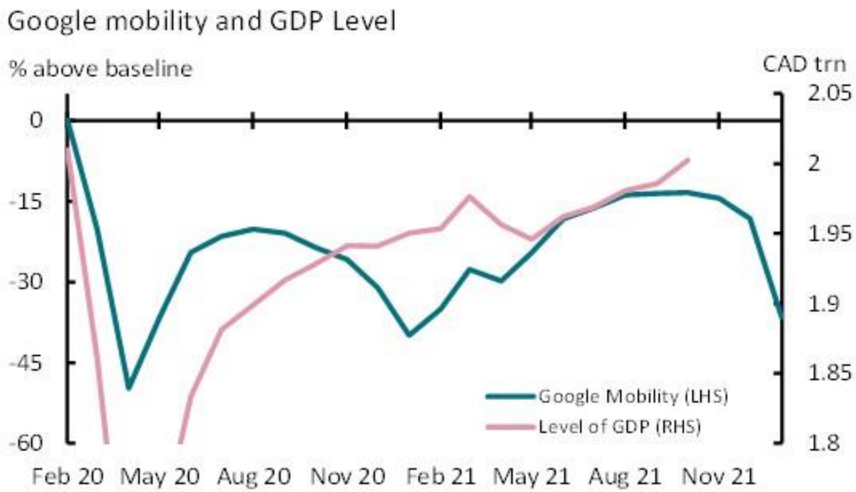
October’s GDP could be the peak for a while

- Monthly GDP recorded a strong 0.8% rise in October, but the outlook is less positive. Flooding likely impacted November, while Omicron weighed on behaviour from late December, and restrictions were introduced in January. With signs of the latest wave peaking and hopes for restrictions to be lifted, we expect a solid rebound from February, but Q4 GDP growth should be slower than Q3 and Q1 weaker still. We lower our growth outlook back to 3.5% for next year and 3.0% for 2023 (consensus 4.0% and 3.0%)

Labour market tightened to year-end

- Jobs increased by 55k in December, solid after Novembers 154k and the unemployment rate dipped to 5.9% - close to the pre-COVID peak. Yet pay growth slowed in December, to 3.0% from 3.2% the previous month and remains close to the top of the pre-COVID decade range. Omicron may lead to a fall in employment over the coming months. While the labour market is tightening, it does not appear as extreme as other jurisdictions.

Mobility data suggest fall in output



Source: CANISM, Google, January 2022

BoC Survey inflation expectations surge

Source: Bank of Canada, AXA IM Research, January 2022

Expect less tightening than market

Canada

December's CPI inflation could also be at a peak

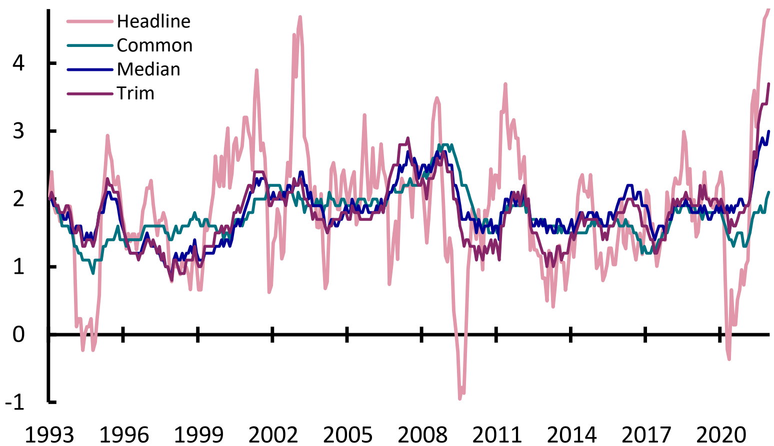
- December's CPI inflation rose to 4.8% - a 30 year high, with most derivative measures around similar records. However, monthly inflation fell by 0.1%. With oil prices lower in December, January's inflation print could record the first dip since June. Broader expectations remain elevated, with the latest Bank of Canada (BoC) survey showing 97% of firms expecting inflation to remain above 2% for the next two years and a majority of households envisaging inflation around 4%.

January a live month for the Bank of Canada

- Markets went into January's monetary policy meeting expecting the first of six hikes. With inflation and expectations elevated, the pressure for a BoC hike had grown. Yet with the scale of the Omicron impact unknown and Canada's inflation outlook not as extreme as others, we expected the BoC to wait. However, with the Fed seemingly accelerating its plans for tightening, pressure has increased on the BoC. We forecast the first hike in March, expecting four hikes this year (to 1.25%) and two next (to 1.75%).

CPI inflation set a new 30-year high

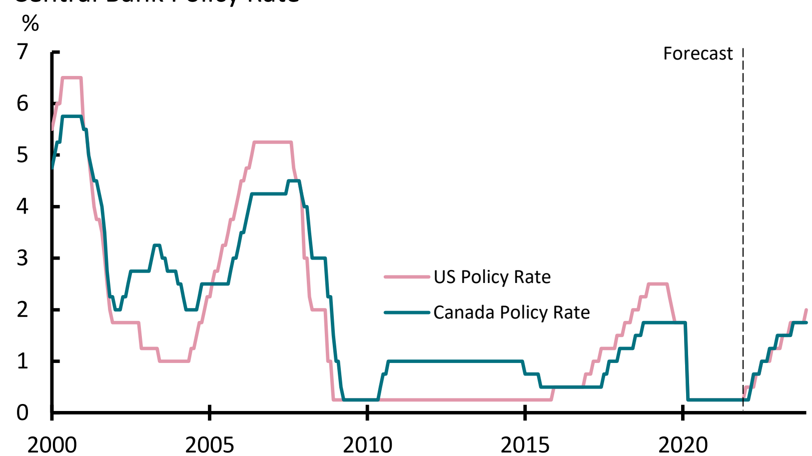
CPI measured variations



Source: CANISM, AXA IM Research, January 2022

BoC policy expectations influenced by faster Fed

Central Bank Policy Rate



Source: FRB, BoC, AXA IM Research, Jan 2022

Slowdown in Latin America and in Asian exports

Emerging Markets

High inflation and tight monetary policy has pushed Brazil into recession and Mexico could soon join

- In Mexico, recent data suggests that the economy slipped into recession, as GDP is expected to contract again on a quarterly basis in Q4. Inflation is at its fastest pace in 20 years (7.4%), supply chain constraints and the government's refusal to provide any significant stimulus are weighing on economic activity. The central bank's hawkish stance will be an additional drag on growth.
- The situation is more dire in Brazil, the region's largest economy. A rough mix of high inflation, unemployment and an aggressive hiking cycle (a cumulative +725 bps to date) is keeping a lid on growth. After recession in Q3, the economy is expected to have barely grown in the last quarter of the year as these headwinds remain in place.

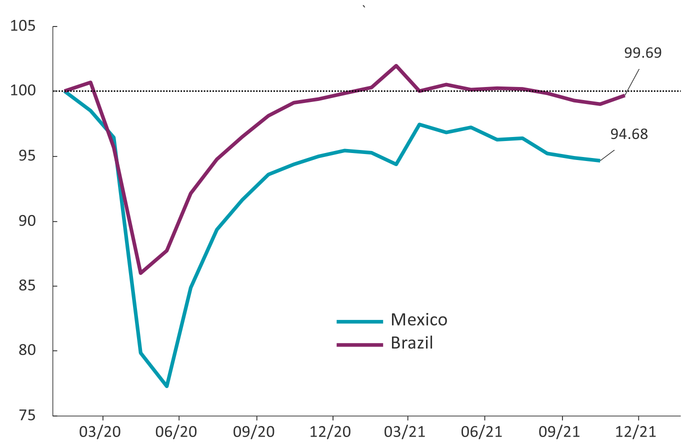
Exports normalization in Asia

- Our Asia export monitor, which compiles several advance estimators such as PMIs, points to a moderation in the region's exports given the ongoing rotation from consumption of goods to services. On a positive note, there are finally signs of easing chip shortage concerns as inventory-to-shipment ratio for Korea has risen recently. We expect the gradual softening of export growth to continue due to slowing global demand and China's growth concerns.

Brazil and Mexico are struggling to stay afloat

Economic activity index

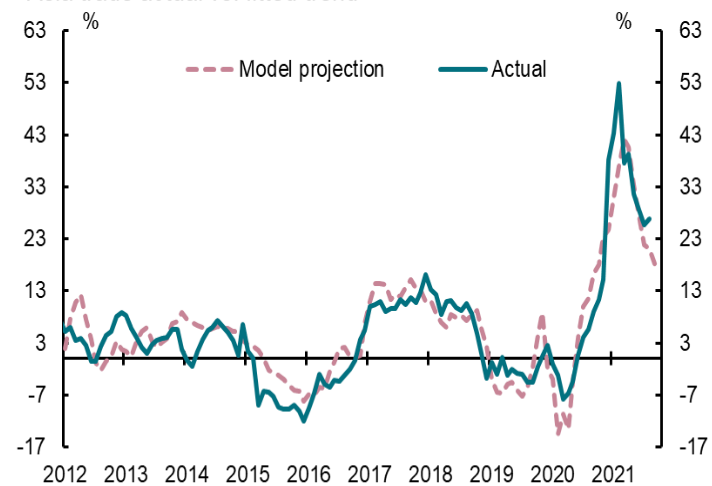
(Jan 2020=100)



Source: Datastream, AXA IM Research, January 2022

Export growth losing steam after last year's peak

Asia trade actual vs. fitted trend



Source: CEIC, AXA IM Research, January 2022

Politics, geopolitics and … inflation

Emerging Markets

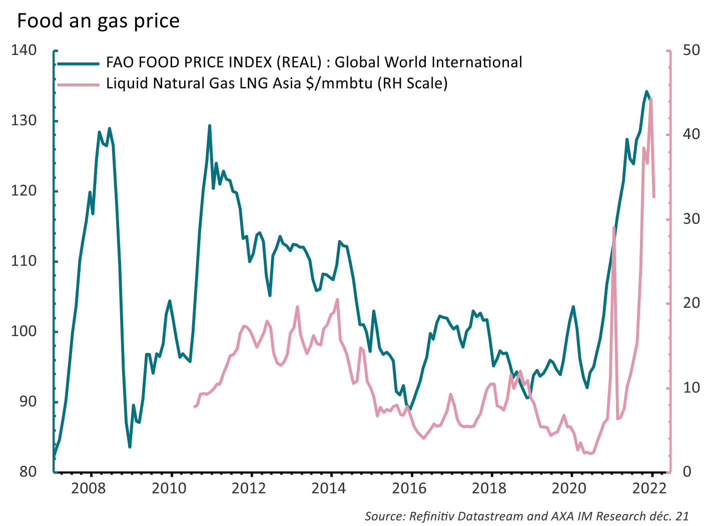
Excessive food and energy inflation have a bad history in developing countries

- Excessive food and energy prices have in the past triggered humanitarian crises, riots and even regime changes live massive unrest in several countries during 2008, or the ravaging food crisis that hit East Africa, Ethiopia, Somalia and Kenya in mid-2011.
- While many EM central banks started hiking interest rates, some governments are implementing consumer price caps on natural gas, cutting VAT on basic food items, heating and electricity prices, an additional strain on public finances at a time when deficits and debts have massively increased during the Covid-19 crisis.

Trouble in the Central Asia/CIS region

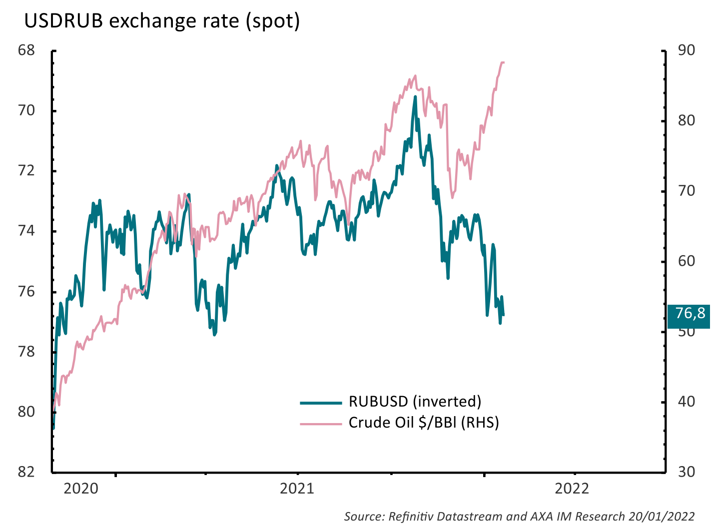
- Central Asia is a politically stagnant region, and 2022 was going to be a very “boring” year on the surface with no national polls to watch. Recent street protests in Kazakhstan, firstly in reaction to motor fuel price hikes before turning into what seemed a broader political protest, are unprecedented for the biggest CIS nation and remind us of the troubles inflation can ignite. Meanwhile, the rise in tensions over the Russia-Ukraine border situation push global commodity prices (especially oil) higher and the Russian Rubble lower.

Food prices at danger levels



Source: Datastream, AXA IM Research, December 2021

Geopolitics pressure oil higher and the RUB lower



Source: Datastream, AXA IM Research, 20 Jan 2022

Investment Strategy

Multi-Asset Investment views

Our key messages and convictions

Positive on equites

#1

Despite downward pressure on valuations from rising real rates, higher corporate earnings should continue to support equities

Negative on Investment Grade Credit

#2

Despite support from fiscal initiatives, valuations are no longer attractive due to tight spreads

Negative on Sovereign Bonds

#3

Government bond yields expected to rise as Central Banks tighten monetary policy

Neural on Commodities

#4

Supply constraints and rising geopolitical tensions support commodity markets whilst demand remains relatively robust in many key markets

Source: AXA IM as at 26/01/2022

AXA Investment Managers

FX Strategy

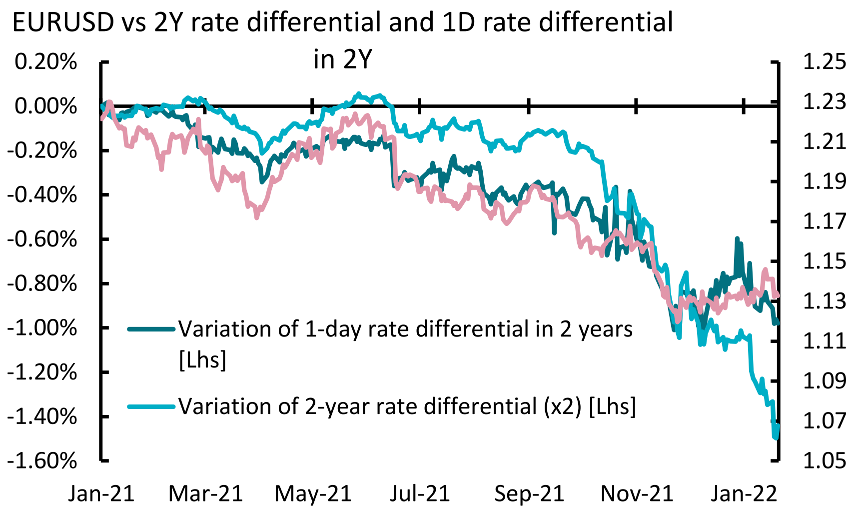
'Peak USD' not just yet although the carry is rising not only for USD

- The repricing of USD rates higher has accelerated since December. This triggered a further significant rise of the 2Y rate differential in favour of the USD, which is usually very well correlated with currency moves. The forward level of the interest rate differential has been more relevant for currency markets. Hence USD is still skewed to the upside against low yielders and in particular against EUR.

- Finally, Russia-Ukraine tensions risk more downside and EUR short positioning and its undervaluation are still limited. Interestingly, expectations on the BoJ have not shifted, leaving less room for the JPY to soften than for the EUR. JPY is also more undervalued and also supported by current equity market volatility.

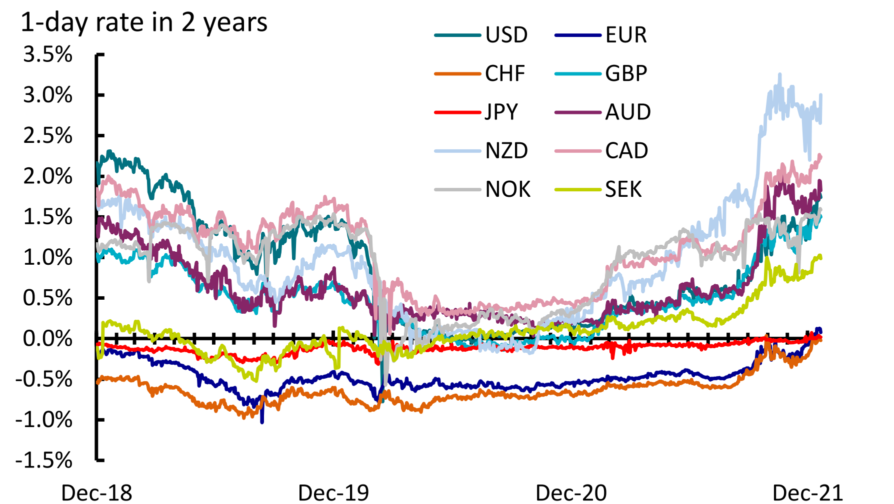
- All that said on the USD, it is starting to look expensive and it is wise to start looking for cheaper carry alternatives. We find that 'higher' carry and 'rising' carry are both significant drivers of currency strength. NOK, CAD and NZD are set to see their policy rate rise above others in the coming months and they seem to be starting from much cheaper valuations than the USD.

Correlation with rates not broken as terminal rate still matters



Source: Bloomberg and AXA IM Research, January 2022

Broadening of policy normalisation expectations since Q4 2021



Source: Bloomberg and AXA IM Research, January 2022

Rates Strategy

A swift rise in global yields as markets price a yet more hawkish in central bank policy

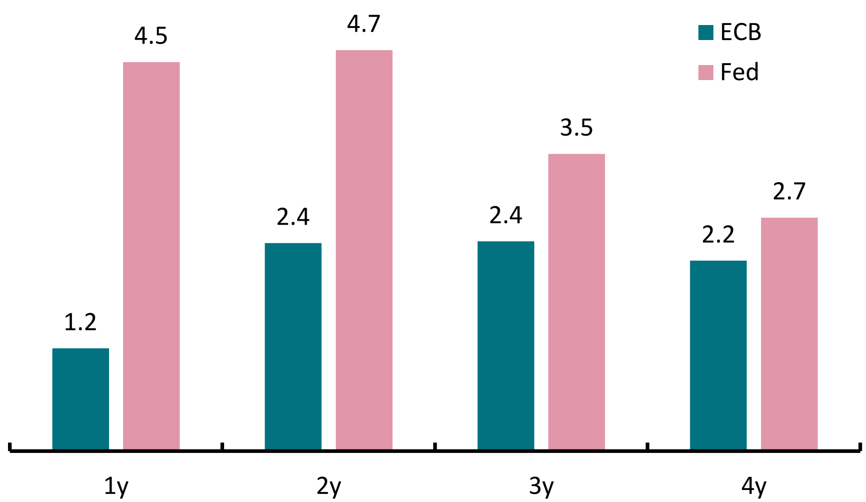
- Last year was full of surprises on the inflation front: The consensus started the year expecting US CPI to average 2%, while inflation eventually averaged 4.7%. The repricing of the Fed's policy path has been rather pronounced at the front-end of the curve as a result, where a bit more than a 25bp rate hike is priced every quarter for two years. The swift repricing of policy expectations is not specific to the Fed, though.

- Whether interest rate expectations are exaggerated is a crucial question for the management of duration in both fixed income and equity portfolios. In previous cycles, in addition to the slope of the money market curve, we used to look at 2/5/10y curvature as a reliable indicator of monetary policy expectations.

- The USD 2y3y/5y5y spread, a risk-equivalent to the 2/5/10y butterfly curvature suggests that rate expectations are very close to their historical maximum. This also suggests that the 5y point of the Treasury curve might be a relative performer over the coming quarters.

Swift repricing in monetary policy for Fed and ECB since Q3 2021

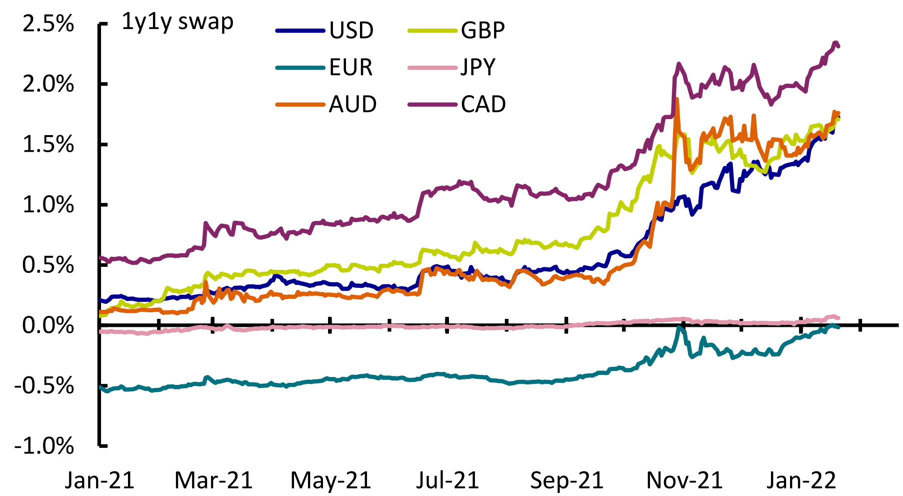
Policy expectations vs 6m ago (# of rate hikes)



Source: ICE and AXA IM Research, January 2022

Global policy tightening more broadly

Global front-end forwards



Source: CBOE and AXA IM Research, January 2022

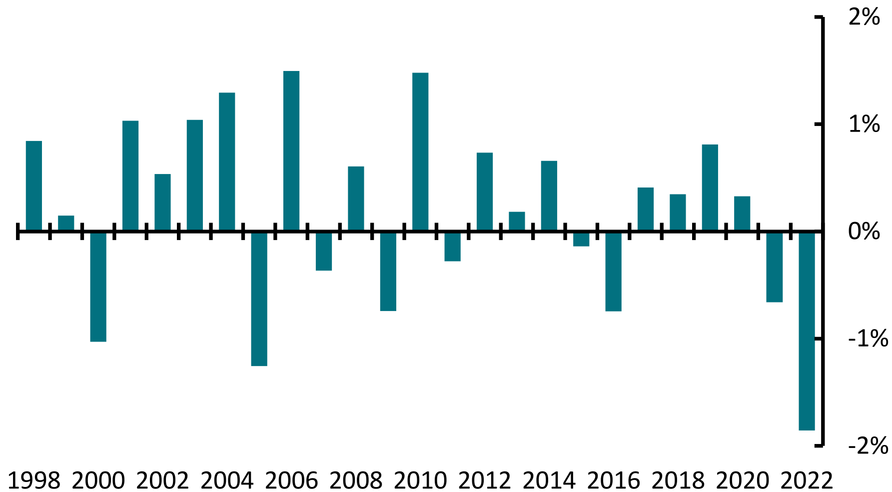
Credit Strategy

Credit kicks off the year badly but not because of credit risk premia

- 2022 has seen the worst start in global credit in 25 years, with a drawdown of near 2% and near twice as steep as that in 2000 and 2005.But the steep drawdown has been predominantly due to the interest rate component, which reflects the swift rise in govie yields. The excess return due to credit risk has been a small negative or even positive in developed market high yield, offsetting some of the interest rate driven drawdown.
- We think that a relative overweight of HY over IG should continue to reap benefits in 2022, as we enter the US Federal Reserve's policy normalisation cycle. High yield markets (ex-China) continue to enjoy the headwind of benign default expectations. The current HY default rate forecasts for US and European HY are at near 2%, below their historical average as well as what implied by current spread levels.
- A further tailwind for credit markets overall is that the decline in govie yields and credit spreads post Covid, has made the servicing of corporate debt even more affordable than pre Covid. Indeed, the cost of debt for the USD IG index (face value x coupon) has dropped back to its post GFC lows, despite the stock of debt being c.7% higher than pre Covid.

Worst start in 25 years for global credit …

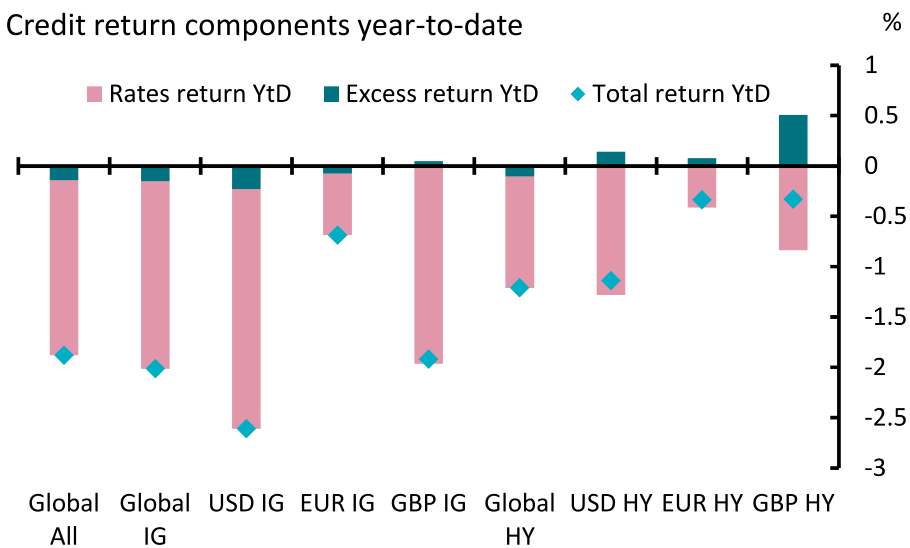
Global credit total return to 20 January 2022



Source: MSCI, IBES and AXA IM Research, January 2022

… but it's interest rates, not spreads, that have done the damage

Credit return components year-to-date



Source: Datastream, BLS, BEA, OECD and AXA IM Research, January 2022

Equity Strategy

A bittersweet cocktail

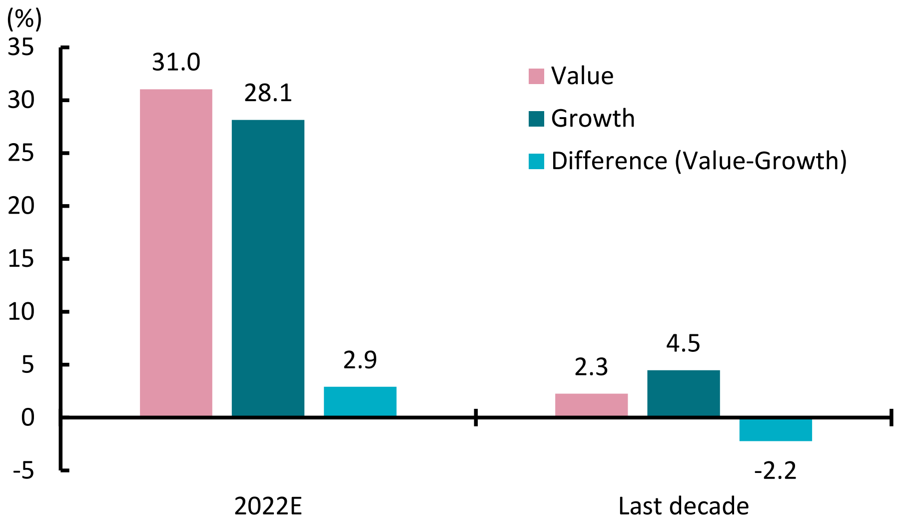
- In a year shaped by the normalisation of US monetary policy, stocks are going through a tortuous path post-Covid. At the time of writing, global stocks had fallen by -5.6% on a year-to-date basis. The upturn in interest rates has triggered the rotation from growth stocks (-4.9%) to value stocks (+3.2%) but fundamentals are also supporting the trade.

- Even though we are in the early stages of the earnings season (about 10% of S&P500 companies and 4% of STOXX companies have reported) one trend seems to be emerging - wages. Based on our wage growth forecasts, profit margin growth (function of average hourly earnings, producer input prices and corporate taxes) is expected to decelerate and even decrease from the third quarter onwards.

- The equities still seem to be attractive with the risk premium close to neutral but not expensive. In this setting, we remain modestly overweight in equities with a bias towards the Eurozone in our multi-asset framework.

Fundamentals are an extra tailwinds for the rotation to Value from Growth

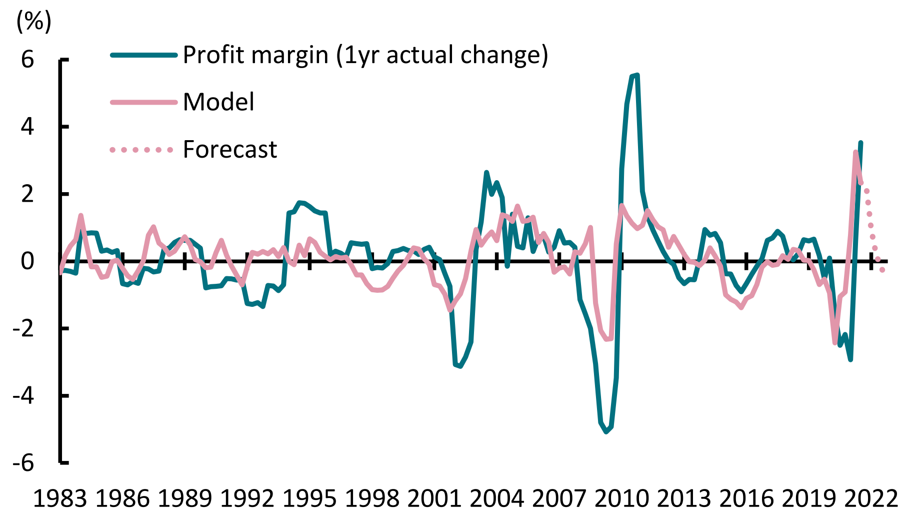
Global equities: 12M Forward Earnings per Share



Source: MSCI, IBES and AXA IM Research, January 2022

Peak in margin growth has passed and should normalize this year

US Equity - Profit margin model



Source: Datastream, BLS, BEA, OECD and AXA IM Research, January 2022

Asset allocation stance

Positioning across and within asset classes

Asset Allocation

Key asset classes

	Negative	Neutral	Positive
Equities			■
Bonds	■		
Commodities		▲	
Cash			■

Equities

Developed

	Negative	Neutral	Positive
Euro area			■
UK		■	
Switzerland		■	
US		▼	
Japan		■	

Emerging & Equity Sectors

	Negative	Neutral	Positive
Emerging Markets		■	
Europe Cyclical/Value		■	
Euro Opening basket		■	
Euro Financials			■
US Financials		■	
US Russell 2000		▼	

Fixed Income

Govies

	Negative	Neutral	Positive
Euro core	■		
Euro peripheral		■	
UK	■		
US	■		

Inflation Break-even

	Negative	Neutral	Positive
US		■	
Euro		■	

Credit

	Negative	Neutral	Positive
Euro IG	▼		
US IG		■	
Euro HY			▲
US HY		■	

EM Debt

	Negative	Neutral	Positive
EM Bonds HC		■	

Legend Negative | Neutral | Positive **Change** ▲ Upgrade | ▼ Downgrade

Source: AXA IM as at 26/01/2022

Investment Managers

Forecasts & Calendar

Macro forecast summary

Forecasts

Real GDP growth (%)	2020	2021*		2022*		2023*	
		AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
World	**-3.2**	**5.7**		**4.1**		**3.6**	
Advanced economies	**-5.0**	**4.9**		**3.6**		**2.4**	
US	**-3.4**	**5.5**	5.6	**3.3**	4.0	**2.5**	–
Euro area	**-6.7**	**5.0**	5.1	**3.9**	4.2	**2.1**	–
Germany	**-4.9**	**2.6**	2.7	**3.5**	4.0	**1.9**	–
France	**-8.0**	**6.7**	6.6	**3.6**	3.8	**2.0**	–
Italy	**-8.9**	**6.2**	6.3	**3.7**	4.3	**1.9**	–
Spain	**-10.8**	**4.3**	4.7	**5.5**	5.8	**3.0**	–
Japan	**-4.9**	**1.5**	1.8	**2.9**	3.2	**2.2**	–
UK	**-10.0**	**7.2**	7.0	**4.9**	4.7	**2.5**	–
Switzerland	**-2.5**	**3.5**	3.5	**3.0**	3.0	**1.6**	–
Canada	**-5.3**	**4.4**	4.7	**3.7**	4.0	**2.6**	–
Emerging economies	**-2.0**	**6.2**		**4.4**		**4.3**	
Asia	**-0.8**	**6.8**		**5.1**		**5.1**	
China	**2.3**	**7.9**	8.0	**5.0**	5.1	**5.3**	–
South Korea	**-0.9**	**4.0**	4.0	**2.6**	3.1	**2.1**	–
Rest of EM Asia	**-4.6**	**5.8**		**5.5**		**5.3**	
LatAm	**-7.1**	**6.2**		**2.6**		**2.5**	
Brazil	**-4.1**	**5.1**	4.7	**1.2**	0.9	**2.0**	–
Mexico	**-8.5**	**6.0**	5.6	**2.6**	2.8	**2.2**	–
EM Europe	**-2.1**	**5.9**		**3.8**		**2.8**	
Russia	**-3.0**	**4.5**	4.2	**3.2**	2.6	**2.0**	–
Poland	**-2.7**	**5.1**	5.3	**5.0**	4.8	**3.6**	–
Turkey	**1.8**	**9.5**	9.9	**3.6**	3.1	**3.0**	–
Other EMs	**-2.4**	**4.2**		**4.1**		**3.9**	

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

* Forecast

Expectations on inflation and central banks

Forecasts

Inflation Forecasts

CPI Inflation (%)	2020	2021*		2022*		2023*	
		AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	**0.7**	**3.2**		**3.1**		**2.1**	
US	**1.2**	**4.7**	4.6	**4.0**	4.2	**2.7**	–
Euro area	**0.3**	**2.6**	2.5	**2.7**	2.6	**1.8**	–
Japan	**0.0**	**-0.2**	-0.2	**0.9**	0.7	**0.7**	–
UK	**0.9**	**2.6**	2.5	**4.5**	4.1	**2.0**	–
Switzerland	**-0.7**	**0.5**	0.5	**0.6**	0.8	**0.7**	–
Canada	**0.7**	**3.4**	3.4	**3.1**	3.3	**2.3**	–

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

* Forecast

Central banks' policy: meeting dates and expected changes

Central bank policy

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

		Current	Q1-22	Q2-22	Q3-22	Q4-22
United States - Fed	Dates	0-0.25	25-26 Jan 15-16 Mar	3-4 May 14-15 June	26-27 July 20-21 Sep	1-2 Nov 13-14 Dec
	Rates		+0.25 (0.25-0.5)	+0.25 (0.5-0.75)	+0.25 (0.75-1)	+0.25 (1-1.25)
Euro area - ECB	Dates	-0.50	20 Jan 10 Mar	14 April 9 June	21 July 8 Sep	27 Oct 15 Dec
	Rates		unch (-0.50)	unch (-0.50)	unch (-0.50)	unch (-0.50)
Japan - BoJ	Dates	-0.10	17-18 Jan 17-18 Mar	27-28 April 16-17 June	20-21 July 21-22 Sep	27-28 Oct 19-20 Dec
	Rates		unch (-0.10)	unch (-0.10)	unch (-0.10)	unch (-0.10)
UK - BoE	Dates	0.25	3 Feb 17 Mar	5 May 16 June	4 Aug 15 Sep	3 Nov 15 Dec
	Rates		unch (0.25)	+0.25 (0.50)	unch (0.50)	+0.25 (0.75)

Source: AXA IM Macro Research - As of 24 January 2022

Calendar of 2021-2022 events

2022	Date	Event	Comments
	Q3-Q4 2022	Chilean Constitutional Referendum	
February	3 February	BoE Meeting	Unchanged (0.1)
	6 February	Costa Rican General Elections	
March	March	FOMC Meeting	+0.25 (0.25-0.5)
	March	China Annual National People's Congress	
	9 March	South Korea Presidential Elections	
	13 March	Colombian Legislative Elections	
	23 March	UK OBR Update	
	31 March	UK Business rates relief ends	
	31 March	UK Reduced VAT for hospitality and tourism ends	
April	6 April	UK National Insurance contributions increase 1.25ppt	
	6 April	UK Dividend Tax increase by 1.25ppt	
	6 April	UK Super-deductibility for UK investment begins	
	10 & 24 April	French Presidential Elections	
May	May	Philippines Elections	
	5 May	UK Elections in Scotland, Wales, and Northern Ireland and UK Local Elections in England	
	29 May	Colombian Presidential Elections	
June	12 & 19 June	French Legislative Elections	
July	1 July	UK border checks on EU imports scheduled to resume	
August	August	US Federal Reserve Jackson Hole Symposium	
October	October	China's 20th National Congress- President Xi to be re-elected (expected)	
	2 October	Brazil General Elections	
November	8 November	US Midterm Elections	

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