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Investment Institute Macroeconomics

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Monthly Op-ed

Gilles Moëc
AXA Group Chief Economist
and Head of AXA IM Research

Chris Iggo,
Chair of the AXA IM Investment
Institute and CIO of AXA IM Core

Signs of recession accumulating, but is it fully in the price?

Key points

- Economic slowdown confirmed on both sides of the Atlantic
- Yet, central banks won't change tack quickly
- Valutions in stocks and bonds have improved
- Stable rates and bond yields are bullish signal for better returns
- Growth and quality are the focus in equity markets

Steep slowdown confirmed

On both sides of the Atlantic Ocean, the economy has stopped defying gravity. With PMIs in contractionary territory in July, the magnitude of the impact of the inflation shock on activity is finally emerging. The big question is whether we have reached the point when inflation becomes "self-stabilizing" in the sense that the economic slowdown that it triggers can stop second round effects. What we find particularly interesting in the qualitative details provided with the latest PMI is the emergence of "involuntary inventories ". Coupled with the fact that average suppliers' delivery times lengthened in July to the least extent since October 2020 in the Euro area, reflecting easing supply-line disruptions, this could be the signal that price pressure "up the pipeline" is finally abating. Indeed, so far producers haven't had any difficulty in passing the rise in their input prices to the final consumers amid strong demand. From now on, those left with unexpected inventories may finally be forced to curb their asking price to normalize them.

In the US, the labour market is getting visibly less buoyant. *Initial* jobless claims continue to rise and are now significantly above their 2019 level and the very latest development is that *continuing* jobless claims have stopped falling, which suggests that those losing their job have a harder time finding a new one. This should remove the froth on the labour market and curb wage growth, key to a proper deceleration in core inflation. However, these indicators remain at a comfortably low levels by historical standards and the Fed is likely to want to see more "pain" before being satisfied that it can reduce its pace of normalization. The latest inflation prints have been spectacular on the upside, and the dampening effect of the deterioration in cyclical conditions will only be gradual and the central bank won't want to lower its guard too quickly.

This is the issue in the Euro area as well. The ECB, after choosing to stray from its forward guidance and hiking by 50 basis points in July is clear it wants to continue with normalization. The quick pace of deterioration in the real economy may gradually offer some

ground to the ECB doves, yet we think the next move in September will be at 50 bps as well. This is consistent with a further tightening in broad financial conditions. The latest ECB Bank Lending Survey suggests credit institutions are busy hardening their lending standards for both corporates and households. This will further fuel the slowdown in economic activity in the quarters ahead.

While the deterioration in economic momentum can be observed everywhere, the list of downside risks is specifically long in the case of the Euro area, which helps explain the recent weakness in the Euro exchange rate. True, Europe has for now escaped the "worst case scenario" in which Russia chooses to turn the tap off its supply of gas. Deliveries have re-started at the end of a 10 days "maintenance period". Pressure is not disappearing entirely though, as Moscow continues to warn against possible disruptions ahead and refuses to make full use of the Nord Stream 1 capacity. This will continue to cloud the horizon and is unlikely to instil much confidence in the Euro area business community.

We also need to take into consideration the return of the "fragmentation risk". While we see the Transmission Protection Instrument (TPI) – the ECB's new anti-fragmentation weapon as potentially powerful enough to offer protection to the rest of the periphery in case of contagion from Italy, we don't think the new weapon helps to deal with the Italian drama itself. Even TPI's "light conditionality" entails complying with some existing "contracts" with the EU which were at the heart of the tension within Draghi's coalition. The message to Italy's political circles is that for now, "they are on their own". How the parties likely to win the snap elections on 25 September amend their current manifestos will be key to curb any further spread widening. Giorgia Meloni – leader of Fratelli d'Italia, currently ahead in the polls in a right-wing coalition – has already toned down her Eurosceptic stance, but on tax and structural issues, radicalism still prevails.

Valuations not sufficient but necessary for better market returns

Given the relative performance of major bond and equity markets this year, one might conclude that a period of sub-trend growth or recession is already priced in. That would certainly be a valid conclusion if it were not for the fact that risk premiums had become so thin during the period of quantitative easing. Valuations were pushed to extremes during the COVID pandemic as central banks added liquidity and took interest rates even lower, and fiscal authorities added to aggregate demand. Much of the adjustment in valuations is the unwinding of that. Excessive price-earnings ratios in parts of the equity markets and negative yields in parts of the bond market were the most visible manifestation of the divergence of market pricing to underlying economic valuations. However, since last year and the emergence of the need for a different monetary regime we have seen the higher yields across asset classes as risk premiums rose to reflect greater levels of uncertainty.

Our sense is that markets are acting to suggest that these valuation adjustments have gone far enough. Starting with interest rates and government bonds the need for monetary tightening has pushed spot and forward yields higher. While inflation rates are yet to peak, expectations of how much is needed in terms of rate hikes have. Indeed, the last month has seen those expectations moderate somewhat from the peak reached in mid-June. This is the case for both the US, Euro Area, and the UK. Yields are lower along the curve and total returns from bond markets should return a positive in July. The stabilisation of rates is a bullish condition for other asset classes.

The reason rate expectations have peaked is because investors believe that central bank tightening will bring down inflation. However, the decline in inflation is expected to take place gradually over the next year. As such, inflation linked bonds will continue to benefit from inflation indexation even if break-even inflation rates are not likely to change much. For the rest of the fixed income world the return outlook depends on perceptions of how corporates manage their cash-flows and balance sheets in a more challenging economy. Valuations are clear though – at current levels of yield and spread in corporate bond markets, the probability of receiving positive returns over the next twelve months is high.

The high yield bond markets are interesting in this regard. At current yield and spread levels, history suggests a strong return outlook. However, previous bear markets have seen spreads reach much wider levels than they are today – namely in the first outbreak of COVID, in the energy crisis of 2015, in the global financial crisis and during the aftermath of the dot.com boom and bust. Yet these are the only occasions spreads have been wider than today's levels and it is hard to argue that the current macro context is as bad or that there is a specific sectoral weakness that pushes spreads wider. In 2016, the energy sector accounted for 15% of the US high yield market and spreads reached almost 2000 basis points. Today with dollar prices of bonds low, no significant sector weaknesses and default rates expected to rise to just the low single digit level, the market looks attractive. If rate expectations have peaked this will help returns in the next year given the pull-to-par effect on bond pricing.

For the US and European credit markets, valuations have improved in both an absolute (level of yield) and relative (level of spread) basis during 2022. There continue to be headwinds, namely higher short-term rates, higher financing costs and weaker economic growth. In both the investment grade and high yield sectors, prospective returns from investing in better quality companies are compelling. At the recent peak in yields, single A-rated European corporate bonds were yielding as much as high yield European bonds were as recently as December 2021. Investors are getting more yield for less risk in the credit market today. This bodes well for income focussed investment strategies going forward and will certainly be welcomed by European pension funds and other liability driven investors.

More nuances in equities

There is value in equity markets as well. However, the picture is nuanced. First there are considerable differences between markets. Using consensus forecasts for 12-months out earnings-per-share, the US equity market stands out as being the most expensive relative to Europe, the UK, Japan and Asia. Moreover, the dollar has been strong. Value seeking investors might prefer equity exposure outside of the US given relative cheapness and the risk of some reversal in dollar strength over the coming year.

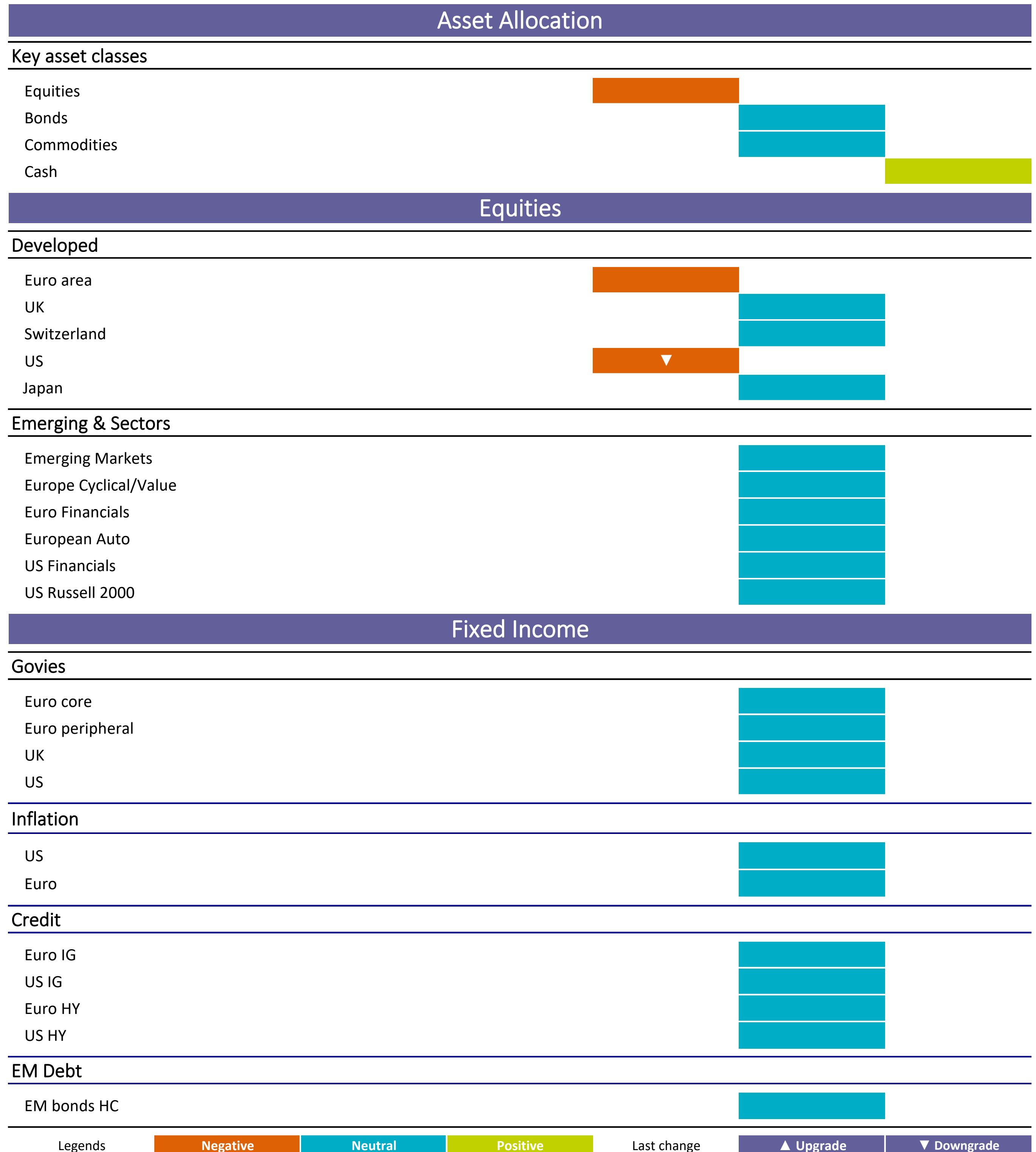
However, even the US market is looking more attractive in valuation terms and the "valuation gap" between the US and the rest-of-the world is now back at pre-COVID levels. The price-earnings ratio is close to its medium-term average and the recent rally in bond markets has improved the bond-equity yield gap in favour of stocks. Within the market there has been a marked performance differential between "growth" and "value" over the last year. Rising bond yields hit the valuation of longer-duration "growth" stocks and sectors while "value" and more cyclical companies experienced a rapid rise in earnings as the global economy came out of the pandemic. Indeed, all equity markets experienced strong earnings growth in 2021 such that the level of earnings per share, in aggregate, reached new peaks.

If earnings are going to slow, and there has been some downward revision to 2022 and 2023 estimates in recent weeks, then the more cyclical parts of the equity market are at risk. The US has delivered stronger growth in recent years and has tended to be less cyclical in the evolution of earnings, thanks to the larger share of technology stocks in the market. Sectors such as energy, materials and the broader industrials in the US market have performed well and seen strong earnings growth but look to be more at risk from a slowdown in growth than sectors like information technology, healthcare and parts of consumer services. Valuations of these sectors have come down and traditionally they have displayed more resilience in periods of overall slower earnings growth. With the economic growth outlook in Europe deteriorating quickly, it is likely that earnings for European equities are perhaps more at risk than is the case in the US.

Valuation is not everything but markets have adjusted a lot in recent months. The more positive outlook for interest rates is still at risk from further inflation surprises but for now stable rate expectations are bullish for credit and parts of the equity market. For stocks, the earnings outlook is key and, so far, the second quarter has come out in line with expectations. It may be too soon to look for significant performance from equites but on the basis that bond yields and the earnings outlook were the two key drivers of prospective returns, one of them has turned neutral for now. For the other, it depends on the industry and the individual companies but those that can report resilient earnings in the coming quarters will be rewarded by better stock price performance.

Download the full slide deck of our July Investment Strategy

Recommended asset allocation



Source: AXA IM Macro Research – As of 25 July 2022

Macro forecast summary

Real GDP growth (%)	2020	2021*		2022*		2023*	
		AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
World	-3.1	6.1		3.1		2.8	
Advanced economies	-5.0	5.1		2.4		1.1	
US	-3.4	5.5	5.6	1.9	2.6	0.8	1.8
Euro area	-6.4	5.3	5.1	2.8	2.8	0.7	2.0
Germany	-4.6	2.9	2.7	1.5	1.8	0.7	2.1
France	-8.0	6.8	6.6	2.3	2.5	0.8	1.6
Italy	-9.0	6.6	6.3	2.7	2.6	0.2	1.7
Spain	-10.8	5.1	4.7	4.2	4.3	0.6	3.0
Japan	-4.9	1.7	1.8	1.6	1.7	1.9	1.9
UK	-10.0	7.2	7.0	3.7	3.5	0.9	0.8
Switzerland	-2.5	3.5	3.5	2.5	2.5	1.0	1.6
Canada	-5.2	4.4	4.5	3.5	3.7	1.7	2.3
Emerging economies	-1.9	6.7		3.5		3.9	
Asia	-0.7	7.0		4.3		5.0	
China	2.2	8.1	8.0	3.6	4.3	5.2	5.2
South Korea	-0.9	4.1	4.0	1.5	2.7	1.6	2.3
Rest of EM Asia	-4.2	6.1		5.5		5.2	
LatAm	-7.0	6.8		2.6		1.9	
Brazil	-3.9	4.6	4.7	1.4	1.3	0.5	1.1
Mexico	-8.2	4.8	5.6	1.5	1.8	1.5	2.0
EM Europe	-2.0	6.7		-0.8		0.4	
Russia	-2.7	4.7		-6.0		-3.5	
Poland	-2.5	6.0	5.3	6.0	4.9	2.0	2.7
Turkey	1.6	11.5	9.9	4.6	3.0	2.0	2.4
Other EMs	-2.5	5.4		4.2		3.7	

Source: Datastream, IMF and AXA IM Macro Research – As of 25 July 2022 * Forecast

CPI Inflation (%)	2020	2021*		2022*		2023*	
		AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	0.7	3.2		7.1		3.6	
US	1.2	4.7	4.6	8.4	7.7	4.5	3.6
Euro area	0.3	2.6	2.5	7.6	7.2	3.5	3.2
China	2.5	0.9	0.9	2.1	2.2	2.3	2.3
Japan	0.0	-0.2	-0.2	2.2	1.9	1.0	1.2
UK	0.9	2.6	2.5	8.7	8.5	4.8	5.2
Switzerland	-0.7	0.5	0.5	2.0	2.3	1.0	1.2
Canada	0.7	3.4	3.4	7.0	6.3	3.4	3.1

Source: Datastream, IMF and AXA IM Macro Research – As of 25 July 2022 * Forecast

These projections are not necessarily reliable indicators of future results

Forecast summary

Central bank policy						
		Meeting dates and expected changes (Rates in bp / QE in bn)				
		Current	Q3-22	Q4-22	Q1-23	Q2-23
United States - Fed	Dates	1.50-1.75	26-27 July 20-21 Sep	1-2 Nov 13-14 Dec	31-1 Jan/Feb 21-22 Mar	2-3 May 13-14 Jun
	Rates		+1.25 (2.75-3.00)	+0.25 (3.00-3.25)	unch (3.00-3.25)	unch (3.00-3.25)
Euro area - ECB	Dates	-0.50	21 July 8 Sep	27 Oct 15 Dec	2 Feb 16 Mar	4 May 15 Jun
	Rates		+1.00 (0.50)	+0.75 (1.25)	unch (1.25)	unch (1.25)
Japan - BoJ	Dates	-0.10	20-21 July 21-22 Sep	27-28 Oct 19-20 Dec	Jan Mar	May Jun
	Rates		unch (-0.10)	unch (-0.10)	unch (-0.10)	unch (-0.10)
UK - BoE	Dates	1.00	4 Aug 15 Sep	3 Nov 15 Dec	Feb Mar	May Jun
	Rates		+0.75 (2.00)	+0.25 (2.25)	unch (2.25)	unch (2.25)

Source: AXA IM Macro Research - As of 25 July 2022

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

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Tour Majunga – La Défense 9 – 6 place de la Pyramide 92800 Puteaux – France
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