21 April 2021
Research & Strategy Insights

# Inflation to rise, but how fast and for how long?

## Global Macro Monthly

### Key points

- Virus and vaccines continue to drive growth outlooks. China saw a slower first quarter, but we raise our annual outlook. The Eurozone faces several downside risks, but the outlook is brighter in the UK. Emerging market developments are mixed.
- US activity has also been supplemented by additional fiscal stimulus. We raise our annual growth forecast again. Yet inflation is only expected to rise gradually to target after volatility in 2021.
- The Fed has convinced markets of long-term accommodation for now. The European Central Bank continues to deliver faster Pandemic Emergency Purchase Programme purchases.
- Bond yields have fallen despite ongoing fundamental concerns, in part reflecting the cost of short positions. This has also allowed a bounce in EURUSD. Credit markets have proven a good steer to equity markets and continue to suggest supportive risk outlook.

### Global Macro Monthly



### Investment Strategy

# Global Macro Monthly – US

**David Page,**
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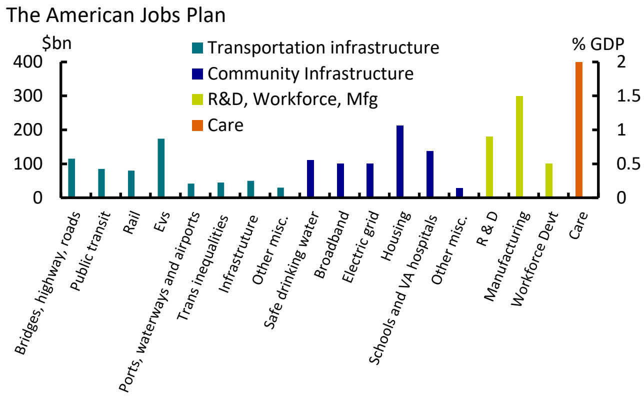
## Re-openings boost growth outlook again

We have previously expressed concern at the pace of re-opening in the US, worried that it might lead to another surge of the virus. There is tentative evidence this is underway, with new virus cases around 80k per day, from below 60k in early March and the number of positive tests rising. Michigan accounts for around 10k of this, with cases showing up in younger (unvaccinated) cohorts. Cases are also trending higher in Florida, Pennsylvania and Illinois – and indeed 80% of US states by GDP. States are not imposing fresh restrictions for now and on balance, we think this is likely to remain the case. This is because vaccines are being deployed at pace, around 3mn day, and the US has so far inoculated around half its population with a first dose. This will likely avert further economic restrictions.

Meanwhile the economic outlook is benefitting from the relatively early easing in restrictions. Combined with stimulus cheques from President Joe Biden's American Recovery Plan (ARP), activity has soared. This was evident in March's retail sales which surged by 9.8% on the month – the sharpest rise since the May 2020 re-opening. It is also evident in consumer confidence and industrial survey data, including April's Philadelphia Fed survey which recorded its highest reading in 48 years. Given the rise in retail sales, we have raised our Q1 GDP forecast to 8.7% annualised (from 6.6%, a revision of 0.5ppt on the quarter). We also lift our 2020 GDP outlook to 6.9% (from 6.5%).

### Exhibit 1: Breakdown of the American Jobs Plan




*Source: Federal Reserve Bank (FRB), Bloomberg and AXA IM Research, Feb 2021*

Hot on the heels of the ARP fiscal stimulus, the White House announced the American Jobs Plan – a $2.25tn spending programme, including elements of traditional infrastructure, clean energy investment and investment to address inequalities, including around education and healthcare (Exhibit 1). Unlike previous stimulus, the administration also provided plans to finance this spending in the Made in American tax plan. This sets out plans to raise corporate tax to 28% (from 21%), impose a minimum foreign earnings tax of 21% and remove fossil fuel subsidies. In total, the administration estimates this will raise around $2tn over 15 years – broadly consistent with the Tax Foundation's assessment of similar components in Biden's manifesto of $1.4bn over 10 years. For now, there is little detail on how quickly these measures could be implemented. However, the administration plans to use next year's reconciliation to pass the bill, which could now be before the summer. On balance, we now see this adding to GDP growth in H2 2022 (our forecast for 2022 stays at 4.5%) and more materially by 2023.

While the outlook for robust growth is increasingly commonplace (consensus growth forecasts for this year have risen to 6.2%), the inflation outlook is less clear. Headline consumer price index (CPI) inflation rose to 2.6% in March, its fastest rate in nearly three years. Headline inflation looks likely to exceed 3% for the first time since 2011 over the coming months, but this will be driven by base effects and price level adjustments. The headline rate should soften across H2 2021, and we forecast it back below 2% in the early months of 2022. Medium-term, we think the quicker healing of the economy will result in inflation rising sustainably, but gradually. We forecast personal consumption expenditures (PCE) inflation to be at the Federal Reserve (Fed)'s 2% target by the end of next year, but to continue to rise in subsequent years. A key unknown is how quickly inflation expectations will follow (or lead) – with some evidence that this is already underway.

The Fed has been successful in taming a pre-emptive tightening in financial conditions. Since the March Federal Open Market Committee (FOMC) meeting, US 10-year Treasury yields have fallen by around 10bps to below 1.60%. This has been driven by a fall in real yields with breakeven inflation expectations continuing to edge higher. The Fed has consistently stated that it will take "some time" before it begins to taper its balance sheet purchases – we expect across 2022. Its forecasts did not envisage an increase in the Fed Funds Rate through 2023 – although Fed Chair Jerome Powell urged not fixating on policy adjustments that far out.

Given the growth we now envisage, we believe that labour market spare capacity will be all but eroded in 2023. We foresee inflation at its target in 2023 and expect it to rise further over the coming years. On balance we assess inflation risks tilted to the upside. We think the Fed will have met its conditions to tighten policy – and harbour some desire to do so amidst an expected continued drift higher in inflation expectations. We expect it will tighten policy gently in 2023, in June and December – the start of a tightening cycle that we would expect to continue over several years.

# Global Macro Monthly – Eurozone

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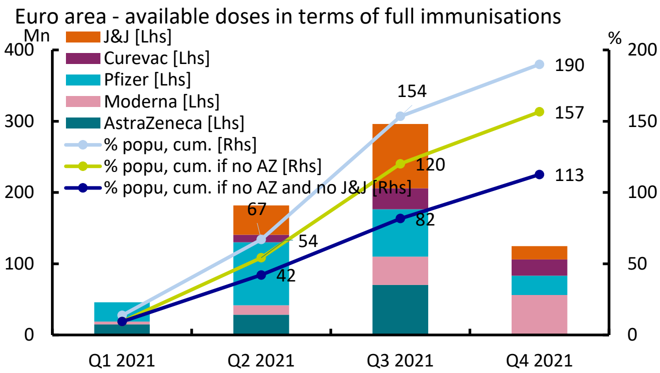
## Summer hopes

The Eurozone coronavirus situation remains worrying. The impact of tighter restrictions is yet to be observed in France, with new cases still stubbornly high, while they are increasing significantly in Germany and Spain. More positively, the vaccination campaign is shifting gear. Maintaining the current daily pace of inoculation would allow 70% of the total population to be vaccinated by September, in line with our baseline.

With the logistical issue of vaccine distribution now under control, the focus is on supply. Here developments are mixed. Pfizer has announced 50 million additional doses in the second quarter (Q2), but most countries have restricted the use of the AstraZeneca vaccine to sub-sections of the population, while the Johnson & Johnson (J&J) vaccine distribution could be significantly delayed. Based on the Italian vaccine schedule delivery, we build alternative scenarios. The total "maximum supply" currently contracted would be enough to fully vaccinate 67% of the population in the European Union (EU) by the end of Q2 and 154% at the end of Q3 (Exhibit 2). This would fall to 54% and 120% respectively without AstraZeneca, and to 42% and 82% with AstraZeneca and J&J both excluded.

### Exhibit 2: Gauging the supply risks




*Source: European Commission, Ministero della Salute and AXA IM Macro Research, 19 April 2021.*

Although we acknowledge these scenarios are extreme, they nonetheless flag a major risk to our growth outlook – timing. Being far from herd immunity at the beginning of Q3 implies a slower start of the summer season, a key contributor to our 2%qoq Q3 euro area GDP (and 3.8%yoy in 2021).

But budget season precedes summer season in Europe! Countries must submit their Stability Programme (a three- year budget plan) by mid-April. Italy is doing more: the 2021 deficit forecast has been revised up to 11.8% of GDP (from 7% in the October draft budget) on lower expected growth and stronger fiscal support (another €40bn package is being discussed). And France is already thinking beyond the pandemic, but its plan to push the deficit below the 3% of GDP target in 2027 is based on very optimistic forecasts for public spending in our view (just a 0.7% increase per year versus 1% in 2012-2019 the most "austere" period in 40 years).

Countries are also working on their Recovery and Resilience Plans, to be submitted by the end of the month. Press reports suggest that the European Commission is not fully satisfied with the reforms part, and that delays in submissions might be likely. Another type of delay might be more worrying though. The ratification of the Own Resources Decision (the legal basis for the funding of the EU Recovery Fund) has been suspended in Germany by the Constitutional Court (and is still pending in nine other countries). While a swift decision by the Court is a possibility, it could also request the opinion of the European Court of Justice or specify some conditionality. Although our baseline is that the Next Generation EU (NGEU) money starts to flow to countries in the summer, as the EU issuance strategy confirmed, we cannot fully exclude delays or ramifications that tarnish the symbolism of the NGEU. Lower or delayed fiscal support would trigger a downside revision to our growth forecast.

Beyond the German Constitutional Court decision, Germany has been in the spotlight as the CDU/CSU and the Greens, leading political parties for September's elections, choose their leaders. This may affect voting intentions. More importantly, the vaccination campaign will be a key factor for the polls – a close-to-normal summer could help the CDU to recoup some lost votes. Voting intentions in favour of the CDU/CSU troughed at the end of March – before the vaccination pace accelerated – at 27%, down from around 36% at the start of the year. Whether this drop is temporary will impact the coalition formation and balance of power. So far, a Greens/CDU/CSU coalition is the most likely (and our baseline), but a left-wing alliance of SPD/Left/Greens is not far from majority. In both cases, less conservative views on fiscal support and EU integration are likely. This would be welcome as the EU is due to rethink its fiscal framework at the end of 2021/start of 2022. On the domestic issue of the debt brake rule, we are less optimistic as a two-thirds majority is needed in both chambers.

On the monetary front, the European Central Bank's (ECB) April meeting is likely to be uneventful. The ECB will likely be satisfied – the pace of Pandemic Emergency Purchase Programme (PEPP) purchases has increased as promised and financing conditions are favourable. The interesting meeting will come in June, with an updated batch of forecasts, but we fear we will not have much clarity on the forward guidance yet, given a divided Governing Council.

# Global Macro Monthly – UK

**David Page,**
Head of Macroeconomic Research,
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## First orders at the bar

Schools returned on 8 March, then on 12 April, non-essential retail and gyms re-opened while pubs and restaurants could serve outside. These were the first tentative steps out of a national lockdown that began at the start of January. Easing restrictions were consistent with falling reported virus cases, currently at their lowest levels since early September, and a rapid drop in positive test rates, as the number of tests surged with the return of schools. The key will be whether virus numbers can stay low as the UK re-opens. Vaccinations will help – the UK has vaccinated over 62% of adults with a first dose, although this pace will slow as second doses are now due. Despite concerns about supply, after a dip around Easter, vaccinations have continued at around 3m/week, although somewhat slower than the 4m/week pace in late March.

GDP continues to surprise to the upside during lockdown. February's GDP rose by just 0.4% on the month, including a more modest 0.2% rise in services. January's drop was revised to -2.2% from -2.9%. We have raised our Q1 GDP outlook to -2.0% (from -2.5%) and our 2021 GDP forecast to 5.3% (from 5.0%), lowering our 2022 outlook to 6.7% (from 7.0%). The UK is on track to recover to its pre-Covid level by Q2 2022.

While significant uncertainty surrounds the growth outlook, supply-side developments are even harder to judge. In total, we expect around 4ppt of GDP to be permanently lost. Some of this reflects pandemic hysteresis effects, which could be less if growth rebounds more quickly. Some reflects the impact of Brexit. Following sharp declines in exports to the EU in January, February saw some rebound, but the level of exports to the EU remained 15% lower than at the end of December – a material shortfall for a sector worth around 30% of GDP.

The Bank of England (BoE) remains in wait-and-see mode as judged by individual members' comments since the March meeting. May's Monetary Policy Report will be interesting with sterling and market rate movements suggesting a downgrade of the inflation outlook even as base effects look set to see a sharp rise in headline inflation. We forecast the BoE to remain on hold in May, despite an expectation of softer inflation next year. Changes within the Monetary Policy Committee could influence future policy decisions with Chief Economist Andy Haldane (a hawk) due to leave after June and external member Gertjan Vlieghe (a dove) leaving after August.

# Global Macro Monthly – Japan

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## Due to the spreading of COVID-19 variants, the government is imposing new restrictions

The government has imposed new restrictions in big cities to curb a fourth wave of coronavirus outbreaks – just one month after ending the state of emergency in Tokyo. Officials are worried about the rapid spread of the more contagious UK variant. Japan is still short of doses to accelerate its vaccination programme that so far has only reached 1% of the population with a first dose. As such, risks are rising around the expected recovery in the coming weeks.

The latest economic data was mixed. Retail sales rebounded by 3.1%mom after a sharp fall in January (-1.7%) while real 'core' spending improved to 2.8%mom, but from a steeper -6.7%. We expect an improvement in March, but April data may be flat as consumer confidence points to a stabilisation. Manufacturing production fell by 2.1% in February after a 4.3% rise in January, impacted by notable declines in the production of autos, electrical machinery, and equipment due to semiconductor shortages and other supply chain disruptions. Real exports also fell back (-5.6%mom after +3.3%) but distortions are usual following the Lunar New Year. First quarter (Q1) Tankan surveys on business investment are mixed. Indices across companies have improved, but only large manufacturers are in positive territory – that is, more companies expect an improvement than a worsening of activity in the coming weeks. Small and medium-sized companies in the manufacturing and services sectors continue to struggle and have difficulty projecting their activity in the coming weeks. We have slightly raised our Q1 GDP forecast to reflect more resilient private consumption, to -4.6% quarter-on-quarter annualised from -5.1%.

Following the recent announcements of renewed restrictions and the prospects of a slower vaccination campaign, the possibility of a supplementary budget for fiscal year 2021 is already being discussed. For the time being, we see little need as the government still has ¥5tn ($50bn) of reserves in the initial budget. Depending on how the situation evolves, further spending may be needed, particularly for health services and businesses requested to close temporarily.

The Japanese general elections must be held in October 2021. Prime Minister Yoshihide Suga remains ahead in the polls but the outcome is more uncertain as he faces a complicated vaccination campaign and growing discontent over holding the Olympic Games, albeit without spectators.

# Global Macro Monthly – China

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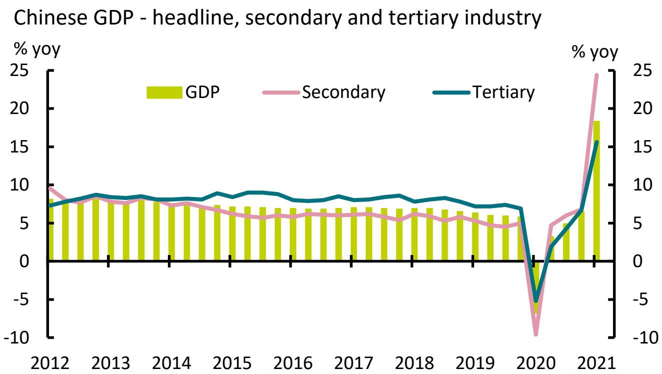
## Stellar growth flattered by low base

The extreme base effects from Q1 2020 have led to record-beating annual growth numbers in the first quarter of this year. Q1 GDP grew a whopping 18.3% from the same period last year when the economy was paralysed by the COVID-19 pandemic. Compared to Q1 2019, our estimate of the two-year compound annual growth rate (2YCAGR) – designed to iron out the base effect – stands at 5%, which is lower than that of Q4 2020 but broadly in line with our original estimate. Extending from the prior quarter, today's outturn has taken the absolute level of GDP slightly above our estimate of pre-COVID-19 growth path, signalling a full recovery from the devastating shock has been completed (Exhibit 3).

Exhibit 3: GDP growth rebounds from low base




*Source: CEIC and AXA IM Research, 16 April 2021*

## Sequential slowdown due to virus resurgence

However, beneath the impressive year-on-year gains lies a sequential slowdown in quarterly growth to 0.6% in Q1 from an upwardly revised 3.2% in Q4. The cause was clear – the resurgence of the virus ahead of the Lunar New Year stopped the migration of hundreds of millions of people, dampened holiday spending, and held back the overall economic recovery. The good news is that the resurgence was relatively small and short-lived. High-frequency data since February has pointed to mostly improved economic conditions.

There remains an unevenness in the recovery, with the supply side faring better than demand in absolute terms, but that gap has narrowed slightly in March. Industrial output grew by 14% in March (2YCAGR at 6.8% in Q1), although seasonally-adjusted month-on-month growth slowed to 0.6% from 0.69%. The slowdown was at odds with the robust Purchasing Managers' Index, but in line with weak export growth and perhaps some margin compression from rising Producer Price Index inflation (up 4.4%). Looking ahead, leading indicators – such as manufacturing new orders and power usage – seem to suggest that the sector is about to regain some steam. We expect growth to recover in the second quarter in line with strong profits and rosy business expectations.

Retail sales provided the main upside surprise in March. This segment of the economy was hit hard by the renewed outbreak, and its recovery is critical to ensure the economy can grow sustainably without ongoing policy nurturing. March data showed a notable acceleration of retail sales growth to 34.2% year-on-year, up from 33.8% in January to February, with 2YCAGR reaching 6.3%. The details of the data are more mixed, however, with household spending on big-ticket items growing at a slower pace, while sales of clothing and cosmetics accelerated. Encouragingly, restaurant and catering sales nearly doubled from the same period last year. Underpinning this was a solid improvement in the labour market, with the unemployment rate falling to 5.3% after a brief spike at the start of the year. Per capita income growth also quickened to 12.7% (or 5.8% in 2YCAGR terms), inching closer to the pre-COVID-19 level of 8%-9%. Both are fundamental aspects of households' balance sheet repair necessary to ensure a sustainable recovery in consumption.

## Growth forecast upgraded to 8.5%

Overall, despite the mixed signals, the collective flow of recent data has made us slightly more upbeat about China's economic outlook relative to our original forecast. Incorporating today's outturn and a stronger projection for Q2, our full-year growth forecast is revised to 8.5%, up from 8%. The sequential growth profile remains the same – the weak Q1 will be followed by a rebound in Q2 before the economy slows in the second half of the year as the impact of policy exit kicks in.

The risks around this projection are large, but broadly balanced in our view. Exports and manufacturing capex have the potential to surprise on the upside amidst strong profit growth and external demand pushing corporates to expand production capacity. On the flipside, managing the policy exit against rising investor nervousness about stimulus withdrawal could be challenging for the authorities. The attempt to rein in a property bubble and local government debt growth has already resulted in rising bond defaults that have unsettled the credit market lately. Besides increased market volatility, these events have also slowed bond sales by corporates and local governments, contributing to a sharp decline in aggregate financing growth in March. With credit growth generally leading GDP growth by around two to three quarters, such a slowdown, if left unchecked, could significantly tighten financial conditions, and precipitate a steeper growth decline in the second half of the year than currently envisaged. Investors need to monitor these risks carefully.

# Global Macro Monthly – EM

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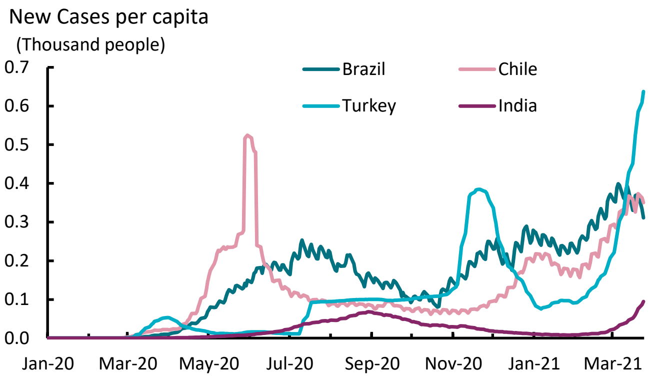
## Uncertainty around the pandemic remains

A year on from the start of the pandemic and it is fair to say the situation is still not under control in many developing countries. The number of new cases has been on the rise and additional mobility restrictions are being imposed as we write (Exhibit 4). The pandemic continues to weigh on recovery prospects and additional public spending may be needed to respond to these infection waves, which could be difficult in countries where fiscal anchors are not strong.

### Exhibit 4: New infection hotspots in emerging markets

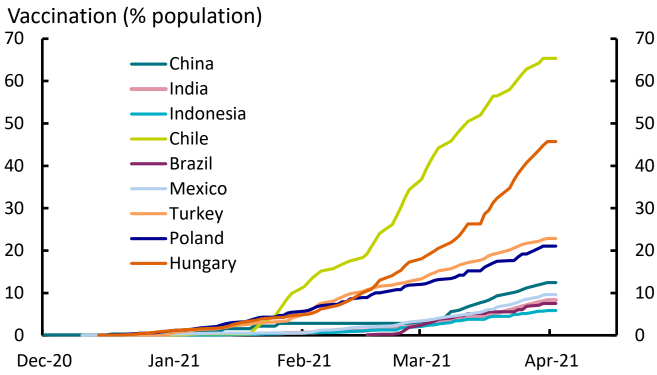



*Source: Refinitiv Datastream and AXA IM Research, 13 April 2021*

The resurgence of COVID-19 cases across India is worrying, with daily cases overtaking the earlier peak in 2020. While a nationwide lockdown has been avoided, partial restrictions have been reimposed until the end of May. The vaccination pace has continued to pick up, and as of 14 April, data suggests that 4% of the population has been vaccinated based on a two-dose regime. But this is far short of levels that could be expected to reduce the virus spread or severity. Vaccine availability, like many other developing economies, continues to be the main concern. As such, it is highly unlikely that vaccination alone can control the current infection spread, and further local restrictions could be imposed.

Latin America continues to endure a strong infection rates following the end of the carnival season and summer holidays in February. Recent data suggests the infection peak is now behind us in Brazil, but the number of daily deaths remains high, particularly in Uruguay and Brazil, where they have significantly surpassed the summer 2020 daily toll. Mexico appears to be faring better, with limited reported new cases recently, but the official death toll has been revised significantly higher (+60%). Vaccinations are progressing well in Chile (Exhibit 5) and Uruguay but remain slow elsewhere and supply constraints limit any real acceleration. In this respect, the fact that new infections are accelerating in Chile and Uruguay – despite having fully vaccinated respectively 40% and 28% of their populations – is a matter of concern. Most Latin America countries have used China's Sinovac vaccine so far, which a recent trial in Brazil has estimated to be 50.7% effective. Additionally, people may be less respectful of social distancing measures as vaccine coverage increases, thus accelerating transmission. Finally, studies have shown the Brazilian P1 variant, which has quickly become dominant in Brazil, to be as much as 2.5 times more contagious than the original coronavirus and more resistant to antibodies. Limitations in genomic sequencing have made it difficult to know the true breadth of the variant's spread but local evidence suggests it is probably gaining speed throughout Latin America. In Lima, scientists have detected the variant in 40% of cases; in Uruguay, it has been found in 30%; in Paraguay, officials say half of cases at the border with Brazil are the P1 variant. Other South American countries — Colombia, Argentina, Venezuela, Chile — have discovered it in their territories. Additionally, mutations of this variant towards an even more contagious version, closer to the South African variant, have also been detected recently.

### Exhibit 5: Vaccination cannot fight the virus spread




*Source: Refinitiv Datastream and AXA IM Research, 15 April 2021*

Central European countries are just about exiting a strong infection wave post-Christmas. Turkey faces a more virulent third wave with the country reporting a new record every day in terms of single-day new infections. Additional restrictions have been imposed with earlier curfews and inter-city travel bans being enforced until the end of the Ramadan.

All in all, the pandemic path continues to weigh on recovery prospects and divergence is likely to increase. Furthermore, political (elections in Peru) and geopolitical (Russia, Ukraine) events may dominate markets' focus.

# Investment Strategy – Cross-assets

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### Spring is in the air

The vaccination rollout appears to be providing some breathing space for markets and societies in countries that have reached a high level of coverage. Spring is in the air and economies are re-opening or considering doing so. The burst of life will boost economic growth and markets are already pricing it in. Investors are expecting stronger data and watching if expectations are confirmed. If so, the recovery will strengthen, equities should continue to perform, and the reflation trade will re-advance. Beyond this recovery, sustainability will be at the centre of the next cycle.

# Investment Strategy – FX

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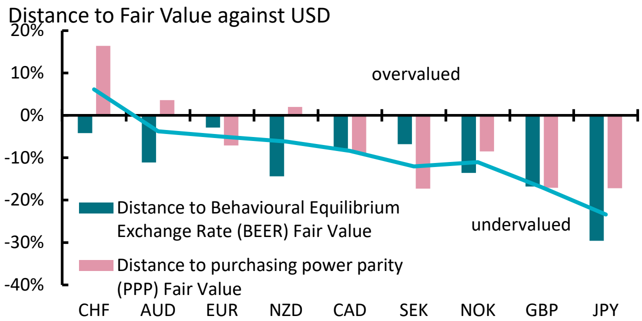
### Euro fights back but is not out of trouble yet

The rebound in US real rates since the start of the year reversed somewhat in April. The euro bottomed out and bounced to above $1.20. That said, a sharp economic rebound in the US, boosted by the large fiscal package, is likely to drive US real rates higher again, as markets question the US Fed reaction function. This should translate to further weakness for the Swiss franc and yen and should also weigh on the euro anew.

Exhibit 6: Euro already closer to fair value than most



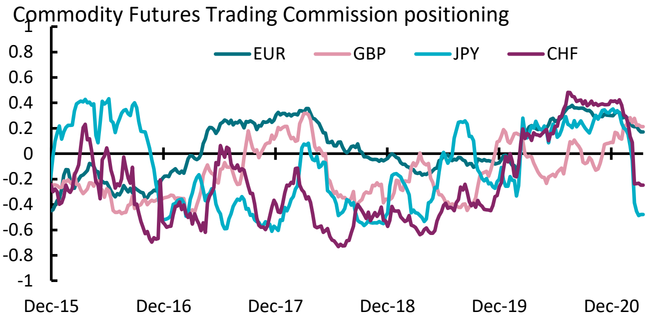

*Source: Bloomberg and AXA IM Research, April 2021*

Lagging vaccination rates and a third lockdown are delaying the European Union's (EU) economic rebound. The euro is already close to fair value (Exhibit 6) and long positioning has only marginally unwound in March compared to the yen or Swiss franc (Exhibit 7). Euro/US dollar risks appear to be skewed to the downside near-term, before a possible rebound in H2 as the US/EU growth differential starts to narrow. The US dollar/Swiss franc delivers higher carry, positioning that has room to turn more negative with the Swiss economy being tied to the EU. The nascent trend of global coordination on corporate tax might also put additional pressure on the Swiss currency.

### UK: Where the grass looks greener in Europe

In Europe, the UK reopening in contrast to fresh restrictions elsewhere is already benefiting sterling and could drive the euro/sterling rate still lower. A sharper rebound in data will continue to drive momentum and the slower vaccination pace over Easter proved temporary. We remain mindful that market positioning is quite long, and the Bank of England's expectations still too hawkish, in our view (Exhibit 8).

Exhibit 7: Euro positioning marginally unwound in March

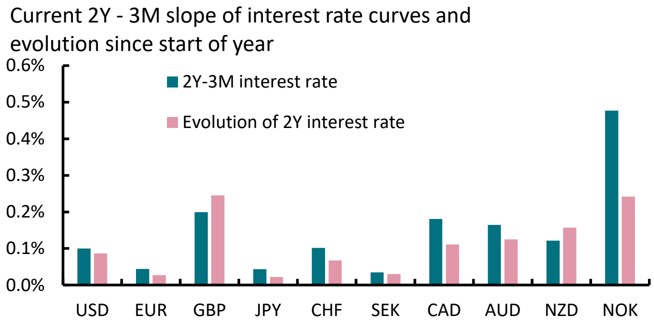



*Source: Bloomberg and AXA IM Research, April 2021*

### Norges Bank leaving the pack behind

Expectations for central bank rates of commodity currencies have exceeded those for the Fed since the start of the year. That said, headwinds to tighter policy still exist: The Reserve Bank of Australia is unlikely to hike as inflation was already below target before the pandemic; New Zealand has other means to fight surging house prices; and although the Bank of Canada is a credible candidate for tighter policy, the third coronavirus wave is threatening to delay the return to normality. Norges Bank has been notably more hawkish, hiking while the Fed was cutting in 2019 and already warning of a possible hike in December. Norwegian inflation is indeed well above target and the krone continues to lag amid the risk-on environment and the rebound in oil.

Exhibit 8: Norges Bank outlook highest, but looks solid




*Source: Bloomberg and AXA IM Research, April 2021*

# Investment Strategy – Rates

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AXA IM Italy CIO and Rates Strategist
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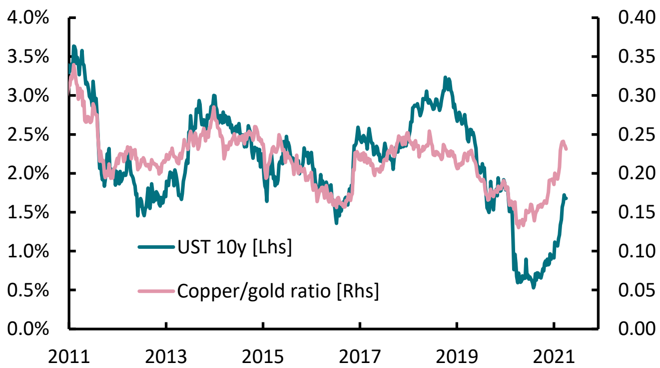
## US Treasuries: Time value re-considered

After rising by 70 basis points (bps) over the first quarter, 10-year US Treasury (UST) yields seem to have temporarily found a plateau. This idea is also supported by popular macro indicators like the copper-to-gold ratio (Exhibit 9), which has recently tested the top of its multi-year range. Market positioning has somewhat normalised in the sell-off, even though large shorts are still reported by the Commodity Futures Trading Commission (CFTC), both in bonds and ultra-long UST futures. On the demand side, Treasuries have significantly improved their attractiveness for global investors on a currency-hedged basis. One question that frequently arises in investment discussions concerns the sustainability of short positions – even though reasonably motivated by fundamental analysis – in an environment of rather punitive carry when taking a short exposure.

### Exhibit 9: Metals are at the top of the range




*Source: Bloomberg and AXA IM Research, 19 April 2021*

While inflation expectations have been the main driver behind Treasury yields in 2020, the nexus between term premia and policy interest rate anticipation has contributed to an almost as strong contribution from real rates. The interest rate curve's steepening has exacerbated the increase in forward-based expectations. For example, US dollar one-year rates in three years have risen by almost 90bps year-to-date. Similarly, in the volatility space, expiries between two years and four years for front-end tenors have seen a major pick-up in volatility since the start of the year (for example, the normal volatility for the three-year forward rate for a one-year bond (3y1y) normal has increased by 38bps year-to-date).

### Exhibit 10: Punitive carry in UST space

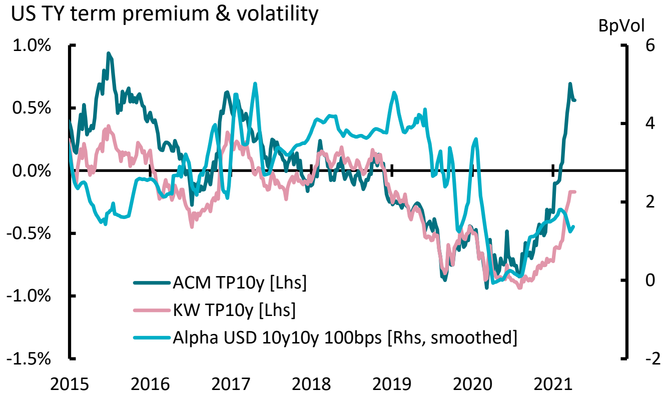
| **Fwd swap** | 3m1y | 1y1y | 2y1y | 3y1y |
|---|---|---|---|---|
| Rate (%) | 0.22 | 0.36 | 0.88 | 1.45 |
| Rolldown (%) | | 0.13 | 0.52 | 0.57 |

| **Swaption** | 3m1y | 1y1y | 2y1y | 3y1y |
|---|---|---|---|---|
| Nvol (bps) | 9 | 31 | 62 | 81 |
| Decay (bps) | | 22 | 31 | 19 |

*Source: Bloomberg and AXA IM Research, 19 April 2021*

When going short interest rates, time can be a very costly factor and even more so after the moves higher that we've seen this year. Exhibit 10 summarises the time value at the front-end of US dollar rates, both in terms of the rolldown in forward space and the decay in the volatility space. Typically, a long position in volatility is consistent with a scenario of an unanticipated rise in interest rates. Hence, we can think of payers of 3y1y rates and buyers of 3y1y swaption straddles as approximately equivalent positions. If nothing happens, paying in dollars for the 3y1y at current levels costs almost 5bps per month of rolldown for the next 12 months. Similarly, holding a dollar 3y1y straddle at 81 basis point volatility (bpvol) costs roughly 19bpvol over 12 months. From current levels, we would need a catalyst for higher rates sooner rather than later or else investors might have to re-consider their strategy due to the hefty cost of carry.

### Exhibit 11: Divergence between various estimates of the term premium




*Source: Bloomberg and AXA IM Research, 19 April 2021*

Eventually, uncertainty about the rates scenario is still rather high, as highlighted by the gap between different term premium methodologies (Exhibit 11). Evidence from the options market – we show here the realised 10y10y SABR volatility model parameter alpha constant, essentially a measure of the out-of-the-money premium – suggests that the Kim-Wright model better captures the "true" increase in the Treasury term premium. From that point of view, there might be more interest rate volatility to come. Certainly, a source of comfort for those with US Treasury short positions.

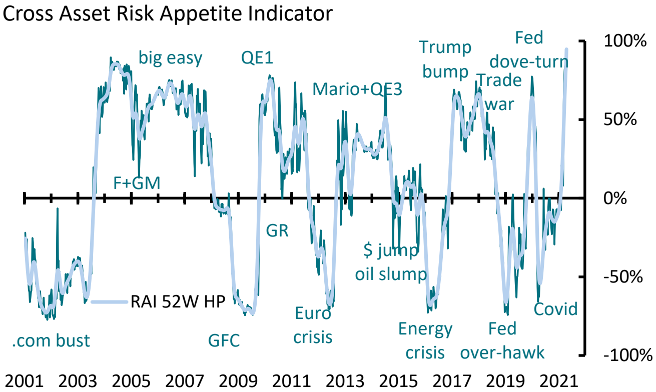
# Investment Strategy – Credit

**Gregory Venizelos**
Credit Strategist
Research – Core Investments

## The risk-on show goes on

### Exhibit 12: Risk appetite indicator (RAI) at a 20-year high

Cross Asset Risk Appetite Indicator

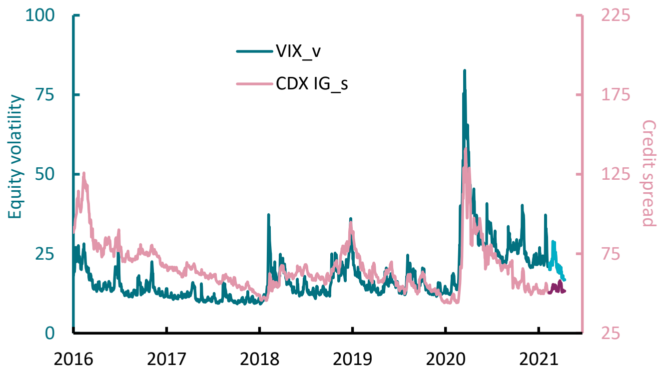



*Source: Bloomberg and AXA IM Research, 19 April 2021*

Financial markets have taken courage from the stability in interest rates and associated decline in interest rate volatility. Equity markets moved higher, credit spreads ground tighter and risk appetite improved more broadly. Indeed, our cross-asset risk appetite indicator[1] has risen to the highest reading over a 20-year period (Exhibit 12).

### Exhibit 13: Equity volatility has converged back to credit spreads which have ignored interest rate volatility

Credit spread vs equity volatility

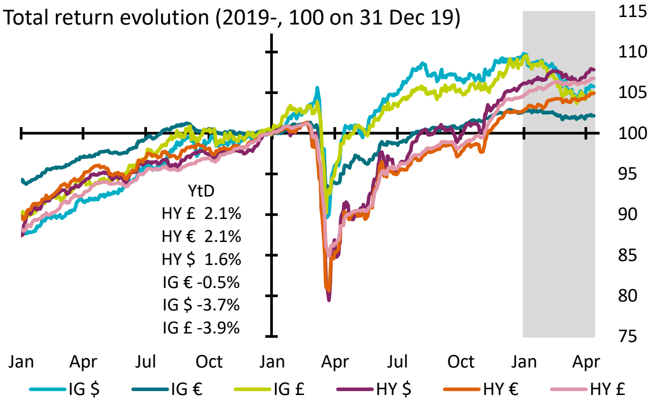



*Source: Bloomberg and AXA IM Research, 19 April 2021*

From a contrarian point of view, a high reading in the RAI may raise concerns of a pending market correction. On the other hand, there have been periods when the RAI remained elevated (Exhibit 12). Credit spreads have been pre-empting such a regime of low volatility, conducive to risk appetite. The Credit Default Swap Investment Grade (CDX IG) index, for example, has traded in a narrow range since late November 2021 (Exhibit 13). Unlike equity markets, it hardly reacted to the volatility in interest rates over the six weeks to the end of March. It is the equity market volatility that has converged towards credit spread levels (Exhibit 13).

### Exhibit 14: The reflation trade continues to split returns

Total return evolution (2019-, 100 on 31 Dec 19)

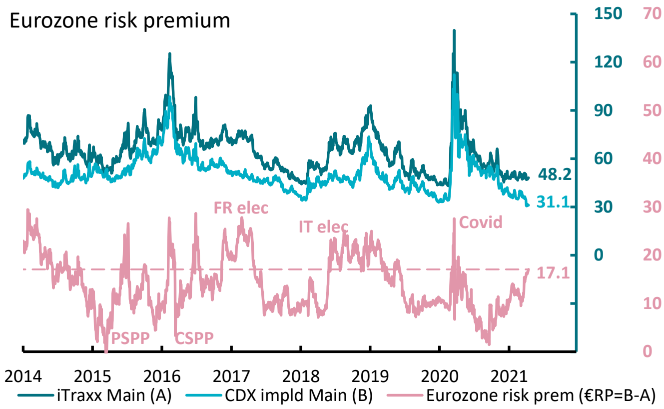



*Source: InterContinental Exchange (ICE) and AXA IM Research, 19 April 2021*

If indeed the US Fed has convinced markets it can maintain policy accommodation in the face of rising inflation, we may be in a period of healthy risk appetite for the rest of this year. This should see high yield (HY) continue to outperform IG amid the reflation trade (Exhibit 14). Yield carry alone would take full-year return to 5% for US dollar HY and 4% for euro HY. By contrast, carry alone in IG is not sufficient to regain the losses due to the rise in interest rates.

### Exhibit 15: The Eurozone risk premium has risen further on US growth 'exceptionalism'

Eurozone risk premium




*Source: Bloomberg and AXA IM Research, Apr 2021*

Within IG total returns, euro credit has suffered less than US dollar credit from the rise in interest rates (Exhibit 14), thanks to its lower duration. But euro credit has lagged in spread terms (Exhibit 15), a likely reflection of US growth 'exceptionalism', a trend that may persist as the vaccination campaign in Europe faces ongoing headwinds related to side-effect precautions and supply bottlenecks.

[1] Correlation between returns' rankings and returns' volatility rankings across assets

# Investment Strategy – Equity

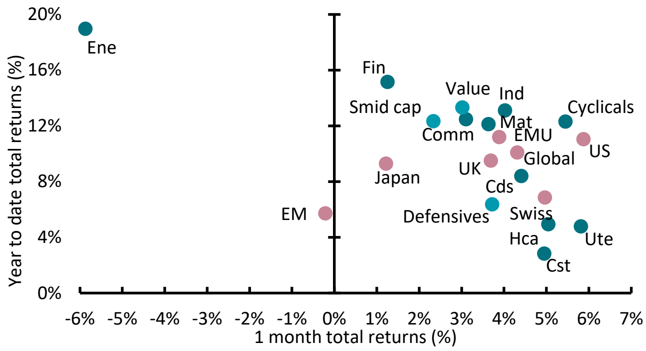
**Emmanuel Makonga,**
Investment Strategist,
Research – Core Investments

## Back on track

After an unexceptional performance in March, equity markets have rebounded this month. At the time of writing, global equities have returned 3.4% month-on-month (mom), bringing year-to-date performance to +9.2%. Across regions, most markets delivered positive performance, led by the US with +4.6%mom, but emerging markets stand out, returning -0.4%mom. The retracement in US nominal yields lower has favoured long duration stocks, with the technology sector (+6.5%) and growth stocks (+5.8%) leading their peers this month. The energy sector struggled, at -5.5% on the month (Exhibit 16).

### Exhibit 16: Energy and emerging markets are missing out in the market rebound

Equity total returns (local FX): regions, sectors and styles

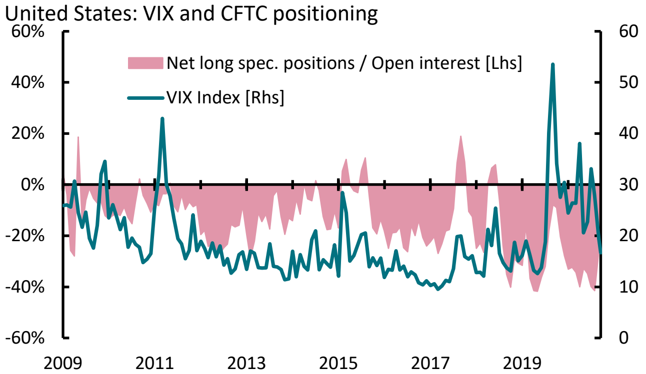



*Source: Datastream and AXA IM Research, 19 April 2021*

Volatility seems to be heading lower as well. The VIX index is now back below its historical average of 16.7. Despite a favourable economic background and a high short volatility positioning by historical standards (Exhibit 17), the VIX term structure continues to steepen, making the three-month risk premium look attractive.

### Exhibit 17: VIX through the 20 level

United States: VIX and CFTC positioning

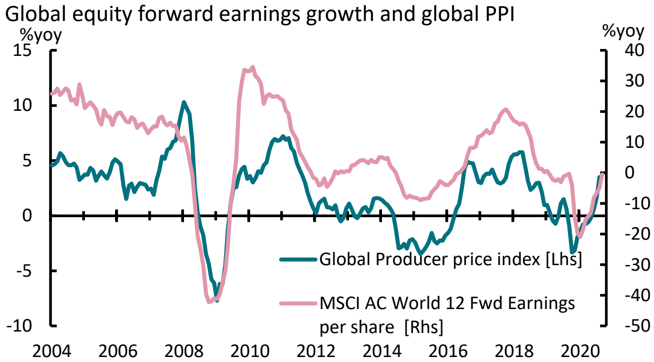



*Source: CBOE, CFTC and AXA IM Research, 19 April 2021*

The first earnings season of the year has begun, and the results could create a tailwind for the asset class given the positive outlook. Recent US Purchasing Managers' Index (PMI) data have been solid, where we observe a significant relationship with the earnings consensus error: 12-month trailing earnings per share (EPS) divided by one year lagged 12-month forward eps. PMIs now indicate that the consensus error should decline in the coming months. In addition, profit margins are set to continue reverting to normal. We believe that concerns about rising prices affecting future corporate earnings are unwarranted. Looking at the historic relationship between Producer Price Indices (PPI) and earnings, the two are positively correlated (Exhibit 18). Overall, analysts are forecasting strong global earnings growth of 30.6% for 2021.

### Exhibit 18: EPS growth tends to move positively with PPI

Global equity forward earnings growth and global PPI

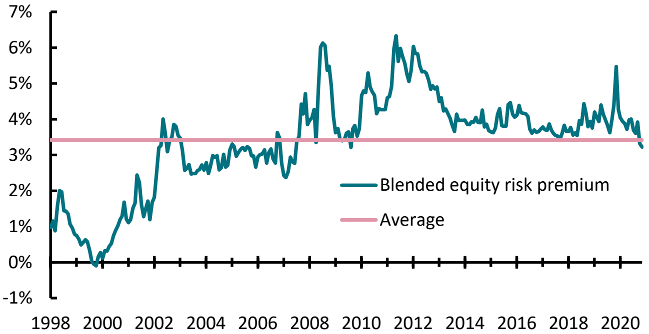



*Source: OECD, MSCI and AXA IM Research, 19 April 2021*

The vaccination campaign is improving across the world, albeit at different speeds locally. The base case for a global recovery in the second half of the year keeps the outlook positive. The market can accept higher bond yields as long as this is due to growth rather than less accommodative central bank expectations. Equities look rich in absolute terms, with multiples at the high end of historical ranges. The equity risk premium has compressed to its historical average (Exhibit 19), implying a more constructive signal in relative terms. Broadly, we keep our positive view on equities, and maintain our UK exposure, as the vaccination progress should drive an economic growth rebound. We have also added exposure to the US and European banking sectors as rising bond yields should offer support and valuations remain reasonable.

### Exhibit 19: Equity risk premia have compressed

Global equities: Blended ERP




*Source: AXA IM Research, 19 April 2021*

# Recommended asset allocation

| Asset Allocation | Negative | Neutral | Positive |
|---|---|---|---|
| **Key asset classes** | | | |
| Equities | | | ■ |
| Bonds | ■ | | |
| Commodities | | ▼ | |
| Cash | ■ | | |
| **Equities** | | | |
| **Developed** | | | |
| Euro area | | | ▲ |
| UK | | | ■ |
| Switzerland | | ■ | |
| US | | | ■ |
| Japan | | ■ | |
| **Emerging & Sectors** | | | |
| Emerging Markets | | ■ | |
| Europe Cyclical/Value | | | ■ |
| Euro Opening basket | | | ■ |
| Euro Financials | | | ■ |
| US Cyclical/value | | ■ | |
| US Financials | | | ■ |
| Global semiconductors | | ▼ | |
| **Fixed Income** | | | |
| **Govies** | | | |
| Euro core | | ■ | |
| Euro periph | | ■ | |
| UK | | ■ | |
| US | ■ | | |
| **Inflation** | | | |
| US | | ■ | |
| Euro | | ■ | |
| **Credit** | | | |
| Euro IG | | ■ | |
| US IG | | ■ | |
| Euro HY | | ■ | |
| US HY | | ■ | |
| **EM Debt** | | | |
| EM bonds | | ■ | |

Legends: Negative | Neutral | Positive — Last change: ▲ Upgrade | ▼ Downgrade

*Source: AXA IM Macro Research – As of 21 April 2021*

# Macro forecast summary

| Real GDP growth (%) | 2020 | 2021* | | 2022* | |
|---|---|---|---|---|---|
| | | AXA IM | *Consensus* | AXA IM | *Consensus* |
| **World** | **-3.7** | **5.5** | | **4.3** | |
| **Advanced economies** | **-5.3** | **5.1** | | **4.0** | |
| US | **-3.4** | **6.9** | 5.7 | **4.5** | 4.0 |
| Euro area | **-6.8** | **3.8** | 4.3 | **3.6** | 4.2 |
| Germany | **-5.3** | **2.4** | 3.4 | **3.3** | 3.8 |
| France | **-8.3** | **6.0** | 5.5 | **3.6** | 3.7 |
| Italy | **-8.9** | **4.5** | 4.2 | **4.1** | 4.0 |
| Spain | **-11.0** | **4.5** | 5.7 | **4.7** | 5.7 |
| Japan | **-4.9** | **2.9** | 2.8 | **2.5** | 2.3 |
| UK | **-10.0** | **5.3** | 4.6 | **6.7** | 5.8 |
| Switzerland | **-3.0** | **3.4** | 3.2 | **2.9** | 2.9 |
| **Emerging economies** | **-2.7** | **5.7** | | **4.5** | |
| **Asia** | **-1.5** | **7.4** | | **5.1** | |
| China | **2.3** | **8.5** | 8.4 | **5.5** | 5.4 |
| South Korea | **-1.0** | **3.5** | 3.5 | **3.0** | 3.1 |
| Rest of EM Asia | **-6.0** | **6.5** | | **4.7** | |
| **LatAm** | **-7.3** | **4.0** | | **2.8** | |
| Brazil | **-4.1** | **3.0** | 3.3 | **2.3** | 2.4 |
| Mexico | **-8.5** | **4.7** | 4.4 | **2.5** | 3.0 |
| **EM Europe** | **-2.3** | **3.1** | | **3.6** | |
| Russia | **-2.8** | **1.8** | 2.9 | **2.5** | 2.6 |
| Poland | **-2.7** | **3.3** | 4.1 | **4.6** | 4.7 |
| Turkey | **1.6** | **4.5** | 5.1 | **4.6** | 3.9 |
| **Other EMs** | **-3.7** | **3.3** | | **4.1** | |

*Source: Datastream, IMF and AXA IM Macro Research – As of 21 April 2021*

* Forecast

| CPI Inflation (%) | 2020 | 2021* | | 2022* | |
|---|---|---|---|---|---|
| | | AXA IM | *Consensus* | AXA IM | *Consensus* |
| **Advanced economies** | **0.8** | **1.7** | | **1.4** | |
| US | **1.2** | **2.3** | 2.4 | **2.2** | 2.2 |
| Euro area | **0.3** | **1.5** | 1.5 | **1.1** | 1.3 |
| Japan | **0.0** | **-0.3** | -0.1 | **0.5** | 0.5 |
| UK | **0.9** | **1.9** | 1.6 | **1.7** | 2.0 |
| Switzerland | **-0.7** | **0.1** | 0.3 | **0.4** | 0.5 |

*Source: Datastream, IMF and AXA IM Macro Research – As of 21 April 2021*

* Forecast

These projections are not necessarily reliable indicators of future results

# Forecast summary

| Central bank policy<br>Meeting dates and expected changes (Rates in bp / QE in bn) | | Current | Q1 -21 | Q2-21 | Q3-21 | Q4-21 |
|---|---|---|---|---|---|---|
| **United States - Fed** | Dates | 0-0.25 | 26-27 Jan<br>16-17 Mar | 27-28 Apr<br>15-16 Jun | 27-28 Jul<br>21-22 Sep | 2-3 Nov<br>14-15 Dec |
| | Rates | | unch (0-0.25) | unch (0-0.25) | unch (0-0.25) | unch (0-0.25) |
| **Euro area - ECB** | Dates | -0.50 | 21 Jan<br>11 Mar | 22 Apr<br>10 Jun | 22 Jul<br>9 Sep | 28 Oct<br>16 Dec |
| | Rates | | unch (-0.50) | unch (-0.50) | unch (-0.50) | unch (-0.50) |
| **Japan - BoJ** | Dates | -0.10 | 20-21 Jan<br>18-19 Mar | 26-27 Apr<br>17-18 Jun | 15-16 Jul<br>21-22 Sep | 27-28 Nov<br>16-17 Dec |
| | Rates | | unch (-0.10) | unch (-0.10) | unch (-0.10) | unch (-0.10) |
| **UK - BoE** | Dates | 0.10 | 4 Feb<br>18 Mar | 6 May<br>24 June | 5 Aug<br>23 Sep | 4 Nov<br>16 Dec |
| | Rates | | unch (0.10) | unch (0.10) | unch (0.10) | unch (0.10) |

*Source: AXA IM Macro Research - As of 21 April 2021*

These projections are not necessarily reliable indicators of future results

## Download the full slide deck of our April Investment Strategy

**Our Research is available on line:** http://www.axa-im.com/en/insights



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