

# On the dot

## Monthly Investment Strategy Oped



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### Key points

- The Fed's latest meeting signalled a difference in views, as well as seeing rates rising sooner.
- Uncertainty over fiscal proposals also asks questions over economic performance.
- Bond yields appear low compared to medium-term indicators, reflecting technical factors
- The positive correlation between stocks and bonds is likely to prove short-lived.
- Our positive outlook for US growth and prices should see rates higher at some point.
- Diversification remains important as cross-asset shifts, yield curve shape and leadership in equities are difficult to predict in this unusual economic rebound.

### Second-guessing the Fed

More than the change in the policy forecasts from the “median member”, it's the division within the Federal Open Market Committee (FOMC) which we think is the most interesting signal we got from the Federal Reserve (Fed)'s communication last week. Indeed, in any case the market did not believe the message from the old “dot plot” – and its unchanged policy rate before 2024 – long before last week. From this point of view, with two 25-basis-point (bp) hikes pencilled in in 2023 (which has been our baseline since the end of last year), the Fed policy forecast is more realistic, while remaining extremely accommodative: the central bank would refrain from hiking the policy rate for around two years after the output gap is plugged, which is likely to have happened in Q2 2021 already.

The FOMC however is looking more polarized, with still five members who forecast no hike at all before 2024, while now seven of them (against only four in March) would see this happening next year already. Moreover, beyond the discussion on the timing of the lift-off, the most hawkish members now expect the Fed to be forced into a rapid succession of hikes, with five of them forecasting a Fed Funds rate above 1.0% in 2023, against only two in March. This polarization echoes the underlying debate on the fate of inflation in the economic profession at large, on which we have been commenting for several months now. The fact that the median forecast for the first hike is still a long way away suggests the “inflation hump” scenario continues to be broadly supported at the FOMC, but some members are clearly concerned by the latest prints and want to get ready to stop

any lasting building up in price expectations above the Fed's target. This is in a nutshell what Jim Bullard expressed quite candidly in an interview on CNBC on 17 June: *“these are big numbers, and we have to be nimble”*.

There is an ongoing debate on the appropriateness of Biden's stimulus even among staunch supporters of active fiscal policy while the central bank has to balance the risk of allowing the resulting overheating to lift inflation too high for too long, against the risk of forcing a “sudden stop” in fiscal support while the economy remains intrinsically fragile by tightening too early.

The Fed's Average Inflation Targeting – and its corollary, waiting for longer than usual after the economy has turned “red hot” before normalizing interest rates – is clearly tilted towards avoiding the second risk. Indeed, during the overshooting phase, the US government finances would continue to benefit from extremely low interest rates. In this configuration, by the time the Fed hikes, the cyclical component of the government finances would have significantly improved, and public debt would have started to spontaneously erode, reducing the need to engage in a brutal fiscal discretionary tightening down the road. A rising number of FOMC members may however start to consider that a too long “grace period” could drive long-term inflation expectations significantly above the Fed's target in an entrenched manner. The result of the debate between hawks and doves may ultimately be settled by the state of fiscal policy at the end of the year, which at this stage remains very uncertain given the Democrats' wafer-thin majority in the Senate.

We need to take financial stability concerns on board. An interesting side-effect of last week's communication by the Fed is that equity prices suffered significantly. If even the whiff of a rate hike sometime in 2023 is enough to spook risky assets, the hawks may think twice about trying too hard to deliver on their urge to hike next year already. As things stand, we remain comfortable with our call for two-rate hikes in 2023.

Turning to the bond market, focusing on the 10 year yield the reaction has been very limited. However, the curve has flattened significantly, the rise in the 5-year yield reflecting expectations of a faster monetary tightening while the decline at the very long-end of the curve (almost 20bps on a 30 year) conveys the message that a less “benign” Fed in the face of price pressure on exiting from the pandemic crisis would provide more protection against an inflation drift in the long term. While these changes are understandable, we remain puzzled by the level of yields. Our compass for this is the FOMC's longer-term forecast for the Fed Funds, which we think is a good proxy for the “equilibrium rate” in the US. Its median level is at 2.5% (unchanged from March). That 30-year interest rates now stand nearly 50 basis points below this equilibrium rate – especially if one takes on board a term premium – would signal intense, and in our view unreasonable, market bearishness on the long-term trend for nominal GDP growth in the US.

Technical factors matter. Over the last 10 years there has been a steady increase in the share of US banks in the ownership of US public debt, exceeding that of pension funds for the first time in the second half (H2) 2020. Using weekly data from the Fed, so far in 2021 there has been no trend reversal recently. This may help explain why the US bond market remained composed, with yields retreating from their 1.74% recent peak in late March. The rising share of US banks in public debt ownership since the great financial crisis for a part reflects the regulatory pressure which has forced credit institutions to keep more risk-free, liquid assets on their balance sheet, but the recent spike probably reflects first a flight to safety but later as well as an adaptation to the “deposit glut” triggered by the pandemic.

More hawkish perceptions of the Fed help the European Central Bank (ECB) by reducing the upward pressure on the euro, as long as the ECB “holds the line” on the Pandemic Emergency Purchase Programme (PEPP). The Governing Council is, for now, which should provide for a relatively quiet summer on the European side. The debate will flare up again at the ECB towards the end of the year, when it will have to discuss what to do with “ordinary quantitative easing” once PEPP stops, probably in March 2022. We are confident that a majority will be found to raise the quantum of Asset Purchase Programme (APP), but we would be very surprised if the net effect of the end of PEPP/beefed up APP on the demand and supply conditions on the European bond market is not negative, pushing yields moderately higher.

## **Not all about the macro story**

The interaction of the macro story and the strong influence of technical factors in the US bond market will continue to pose a challenge to investors. What the last three months have demonstrated is how difficult it is to base an investment strategy on a simple directional view of asset prices. Being positioned on the macro view alone – even if a convincing one – would have led to fixed income investors missing out on the impressive rally in bonds and the significant change in the shape of the yield curve. We note above the importance of technical factors and the strength of buying of Treasuries by US commercial banks that faced a surge in deposits over the last year. There is no way to know when these technical factors will subside and allow the macro story to significantly push yields higher in the US. It is important to try and incorporate all potential drivers of prices into a market view. The last decade, especially in fixed income, has convinced us of the importance of these technical factors.

For US yields to move meaningfully higher, it is necessary for real yields to rise. In turn, this is most likely to come in response to actual monetary tightening by the Federal Reserve. In each of the last three tightening cycles, real yields have risen, pushing nominal rates to peak just before policy interest rates peaked. Several factors could come together over the next two to three

years. The Fed is very likely to stop buying Treasuries. The growth in bank balance sheets should diminish once the fiscal stimulus has worked through the economy and the Fed will initiate lift-off. Combined, these factors should push yields higher. In the last cycle total returns from a benchmark US Treasury index were essentially flat over the entire period of Fed tightening. We could see that again, but such a profile does not rule out periods in which bond returns are negative.

One signal as to the timing of a potential move higher in yields comes from the recent positive correlation between equity and bond returns. Stock prices have been going up while bond yields have been going down. History suggests that this positive correlation tends not to last too long, and the longer-term structural relationship remains that of negative correlation between equity and risk-free bond returns. The relationship could be “normalised” by bond yields moving higher as some of the above factors start to get factored into investor expectations, while equities continue to benefit from strong growth.

Our portfolio management teams continue to see the macro environment as positive for equities and credit. Yet, just as a simple directional view on rates is challenging, the crosscurrents in the equity markets have not been easy to read either. The rotations between style factors and size have been significant in recent months. Ahead of us lies the further maturing of this unusual economic cycle which still has a global pandemic as a backdrop. It is not going to get any easier to anticipate what can be significant changes in leadership in equity markets, in yield curve shapes and in cross-market performance. Thus, diversification remains super important in building investment strategies in either single or multi-asset class strategies. We are positive on the growth outlook and on the medium-term behaviour of inflation, but at some point, rates will start to move higher and the Fed has put markets on alert.

**[Download the full slide deck of our June Investment Strategy](#)**

# Recommended asset allocation

Asset Allocation	
<b>Key asset classes</b>	
Equities	Positive
Bonds	Negative
Commodities	Neutral
Cash	Neutral
<b>Equities</b>	
<b>Developed</b>	
Euro area	Positive
UK	Positive
Switzerland	Neutral
US	Positive
Japan	Neutral
<b>Emerging &amp; Sectors</b>	
Emerging Markets	Neutral
Europe Cyclical/Value	Positive
Euro Opening basket	Positive
Euro Financials	Positive
US Cyclical/value	Neutral
US Financials	Positive
Global semiconductors	Neutral
<b>Fixed Income</b>	
<b>Govies</b>	
Euro core	Neutral
Euro peripheral	Neutral
UK	Neutral
US	Negative
<b>Inflation</b>	
US	Neutral
Euro	Neutral
<b>Credit</b>	
Euro IG	Neutral
US IG	Neutral
Euro HY	Neutral
US HY	Neutral
<b>EM Debt</b>	
EM bonds HC	Neutral
Legends	<span style="background-color: #f47920; padding: 2px;">Negative</span> <span style="background-color: #002060; padding: 2px;">Neutral</span> <span style="background-color: #70ad47; padding: 2px;">Positive</span>
Last change	<span style="background-color: #008080; padding: 2px;">▲ Upgrade</span> <span style="background-color: #008080; padding: 2px;">▼ Downgrade</span>

Source: AXA IM Macro Research – As of 23 June 2021

## Macro forecast summary

Real GDP growth (%)	2020	2021*		2022*	
		AXA IM	Consensus	AXA IM	Consensus
<b>World</b>	<b>-3.6</b>	<b>5.8</b>		<b>4.3</b>	
<b>Advanced economies</b>	<b>-5.3</b>	<b>5.4</b>		<b>4.2</b>	
US	-3.4	6.6	5.7	4.5	4.0
Euro area	-6.8	4.4	4.3	3.7	4.2
Germany	-5.3	2.7	3.4	3.4	3.8
France	-8.3	5.9	5.5	3.1	3.7
Italy	-8.9	4.8	4.2	4.1	4.0
Spain	-11.0	5.2	5.7	5.0	5.7
Japan	-4.9	3.0	2.8	3.3	2.3
UK	-10.0	6.8	4.6	5.8	5.8
Switzerland	-3.0	3.6	3.2	3.3	2.9
<b>Emerging economies</b>	<b>-2.5</b>	<b>6.0</b>		<b>4.4</b>	
<b>Asia</b>	<b>-1.1</b>	<b>7.4</b>		<b>5.1</b>	
China	2.3	8.5	8.4	5.5	5.4
South Korea	-0.8	4.0	3.5	3.0	3.1
Rest of EM Asia	-5.3	6.5		4.7	
<b>LatAm</b>	<b>-7.3</b>	<b>5.0</b>		<b>2.7</b>	
Brazil	-4.1	4.7	3.3	2.5	2.4
Mexico	-8.5	5.4	4.4	2.3	3.0
<b>EM Europe</b>	<b>-2.3</b>	<b>4.2</b>		<b>3.6</b>	
Russia	-2.8	3.0	2.9	2.5	2.6
Poland	-2.7	4.1	4.1	4.6	4.7
Turkey	1.6	6.1	5.1	4.6	3.9
<b>Other EMs</b>	<b>-3.7</b>	<b>3.3</b>		<b>4.1</b>	

Source: Datastream, IMF and AXA IM Macro Research – As of 23 June 2021

\* Forecast

CPI Inflation (%)	2020	2021*		2022*	
		AXA IM	Consensus	AXA IM	Consensus
<b>Advanced economies</b>	<b>0.8</b>	<b>2.3</b>		<b>1.7</b>	
US	1.2	3.5	2.4	2.6	2.2
Euro area	0.3	1.7	1.5	1.5	1.3
Japan	0.0	0.0	-0.1	0.5	0.5
UK	0.9	2.0	1.6	2.1	2.0
Switzerland	-0.7	0.4	0.3	0.5	0.5

Source: Datastream, IMF and AXA IM Macro Research – As of 23 June 2021

\* Forecast

These projections are not necessarily reliable indicators of future results

## Forecast summary

<b>Central bank policy</b>						
<b>Meeting dates and expected changes (Rates in bp / QE in bn)</b>						
		<b>Current</b>	<b>Q2-21</b>	<b>Q3-21</b>	<b>Q4-21</b>	<b>Q1-22</b>
<b>United States - Fed</b>	Dates		27-28 Apr 15-16 Jun	27-28 Jul 21-22 Sep	2-3 Nov 14-15 Dec	25-26 Jan 15-16 Mar
	Rates	0-0.25	unch (0-0.25)	unch (0-0.25)	unch (0-0.25)	unch (0-0.25)
<b>Euro area - ECB</b>	Dates		22 Apr 10 Jun	22 Jul 9 Sep	28 Oct 16 Dec	20 Jan 10 Mar
	Rates	-0.50	unch (-0.50)	unch (-0.50)	unch (-0.50)	unch (-0.50)
<b>Japan - BoJ</b>	Dates		26-27 Apr 17-18 Jun	15-16 Jul 21-22 Sep	27-28 Nov 16-17 Dec	TBC TBC
	Rates	-0.10	unch (-0.10)	unch (-0.10)	unch (-0.10)	unch (-0.10)
<b>UK - BoE</b>	Dates		6 May 24 June	5 Aug 23 Sep	4 Nov 16 Dec	3 Feb 7 Mar
	Rates	0.10	unch (0.10)	unch (0.10)	unch (0.10)	unch (0.10)

Source: AXA IM Macro Research - As of 23 June 2021

These projections are not necessarily reliable indicators of future results

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