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Pandemic effects to recede, policy starts to tighten

Outlook 2022 - 2023

AXA IM Research

24 November 2021

Summary: 2022 and 2023 Outlook

Themes to Shape 2022 and 2023

- **Coping with COVID** – expectations of broader vaccination across DM and EM should ease inflation and supply-restrictions.
- **Inflation – "mostly" transitory** – bottlenecks, supply-shocks and price level effects should drop from headline in inflation from around Spring to year-end.
- **Labour markets after the pandemic** – the threat of more persistent inflation – labour market shortages could drive persistent inflation where they occur
- **Policy-making in this uncertain global phase** – the next phase of global growth raises risks of policy errors: too tight in China, too loose in the US
- **The shifting electoral landscape** – European elections set to deliver progressive leadership; gridlock in the US; social risks in Brazil, Colombia and Northern Ireland
- **Entering transition to minimise Climate Change** – global economy increasingly impacted by climate policy, rising investments to support growth in 2022-23

Macro update: Pandemic effects to recede, policy starts to tighten

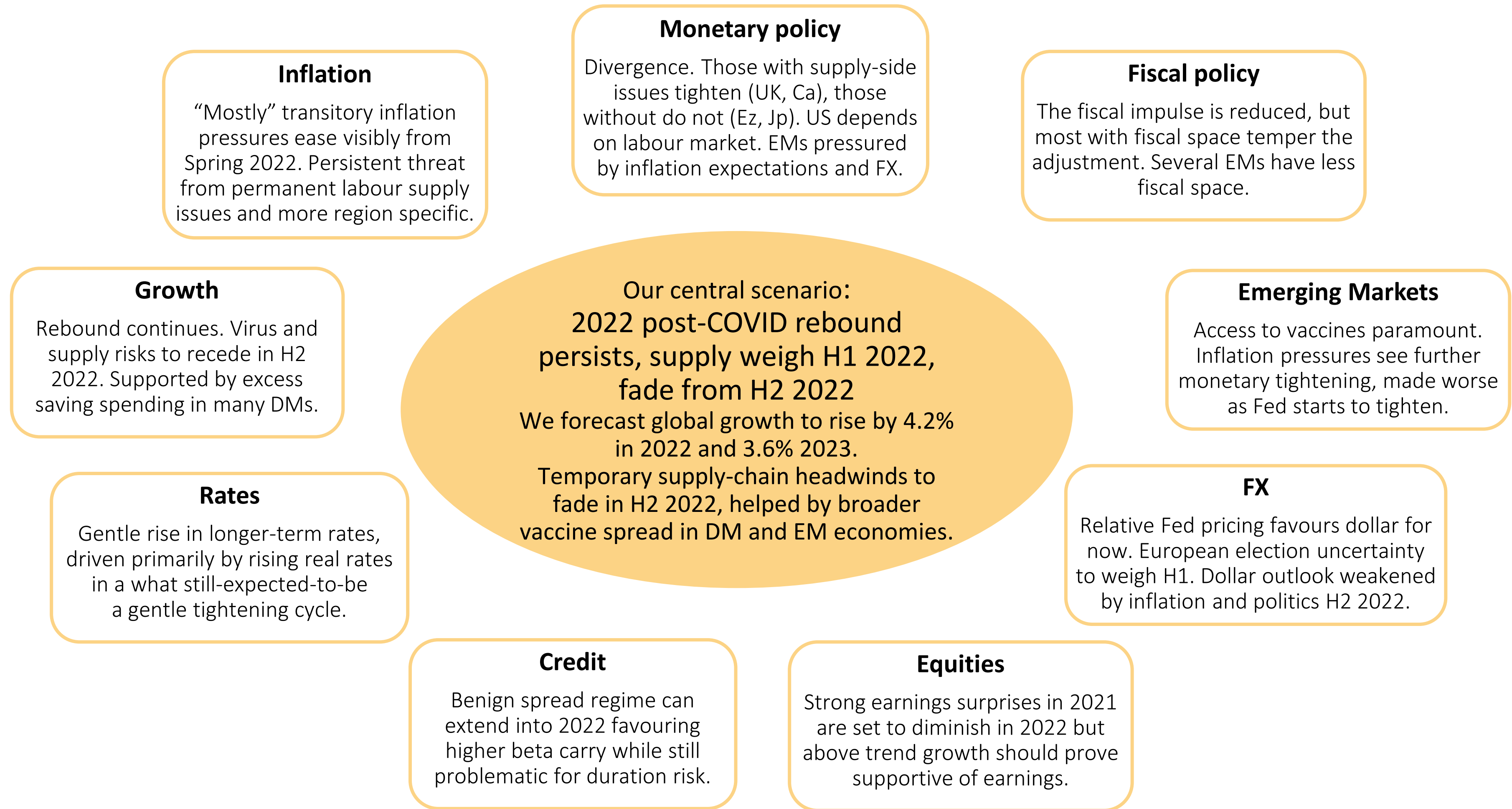
- Growth revived in 2021 driven by a re-opening from COVID shutdowns. Renewed outbreaks across the Eurozone have raised restrictions, which will crimp Q4 GDP. But we expect solid expansion for 2022, before growth evolves more in line with underlying potential in 2023. We expect lingering pandemic effects to fade over the coming years: supply constraints to wane and excess savings to support growth, with much left unspent by wealthier households.
- Inflation recorded a synchronised surge in many economies in 2021 as re-opening created supply bottlenecks and energy price increases. These should also fade in a similar scale disinflation in 2022. How far inflation retraces will likely diverge across jurisdictions, largely reflecting labour markets developments - the key idiosyncratic, persistent inflation pressure for developed markets (DMs) - and FX for emerging markets (EMs).
- Fiscal policies are set to remain supportive but will scale back. DM governments are keen to avoid the mistakes of austerity, but not all EMs can afford this luxury. Monetary policy should become less accommodative. In DMs tightening will be driven by labour capacity, driving early hikes for BoE/BoC, a Fed hike in late-2022 and the ECB later in 2023. EMs policy tightening is underway in the face of deteriorating inflation expectations, and further hikes looks likely.

Investment strategy: risky assets count on a 'steady as she goes' policy withdrawal

- FX: Short-term rate differentials are leading FX moves which should persist. Fed's market pricing could move further, triggering additional USD strength.
- Rates: Policy and inflation expectations have affected 10y UST yields modestly in 2021. Inflation dynamics could accelerate policy normalisation, with consequences for government bond markets, risky assets classes and currencies. A few factors can contribute to higher UST yields in the course of 2022.
- Credit: The calm spread regime can run, favouring higher beta carry. Low rates have subdued debt costs. Rating migration and default cycles are benign.
- Equity: Strong earnings surprises of 2021 are set to diminish next year as economic activity reverts to normal. Real rates may pose a threat to stocks, and so 2022 equity performance may depend on the behaviour in the rates complex. Despite a negative balance of risks, growth outlook should provide support.

Central scenario

Summary – Key messages



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Alternative scenarios

Summary – Key messages

Entrenched supply shock *(probability 20%)*

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 mount 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 15%)*

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

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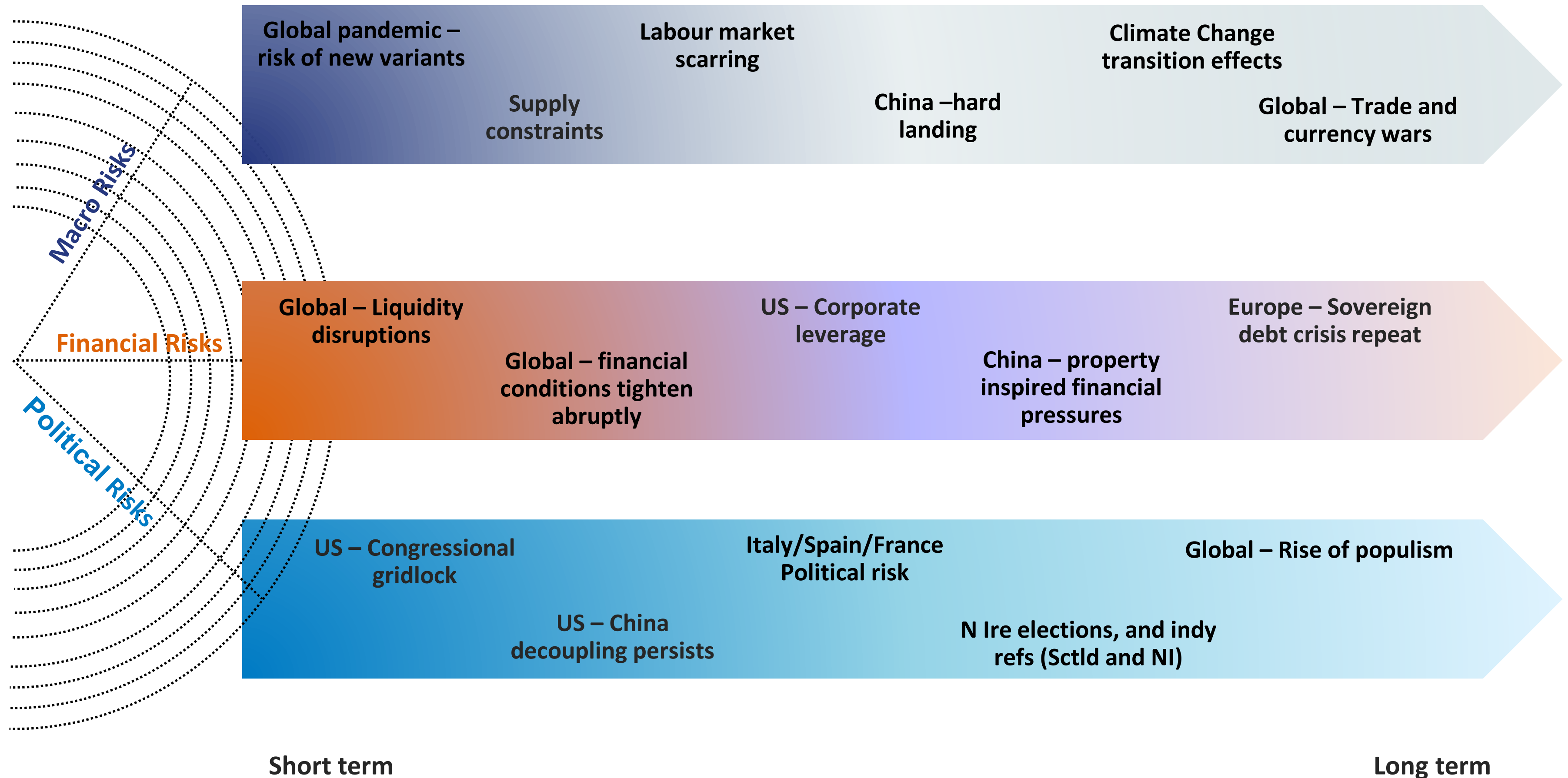
RISk Radar

Summary – Key messages



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Coping with COVID

Themes to shape 2022 & 2023

Learning to live with COVID

Highly vaccinated countries removed pandemic-era restrictions and economies surged on re-opening. Individual precautionary behaviour has risen and the risk of renewed restrictions persists over the coming winter, materialising recently in Europe. 3rd boosters and COVID pills may speed normalisation.

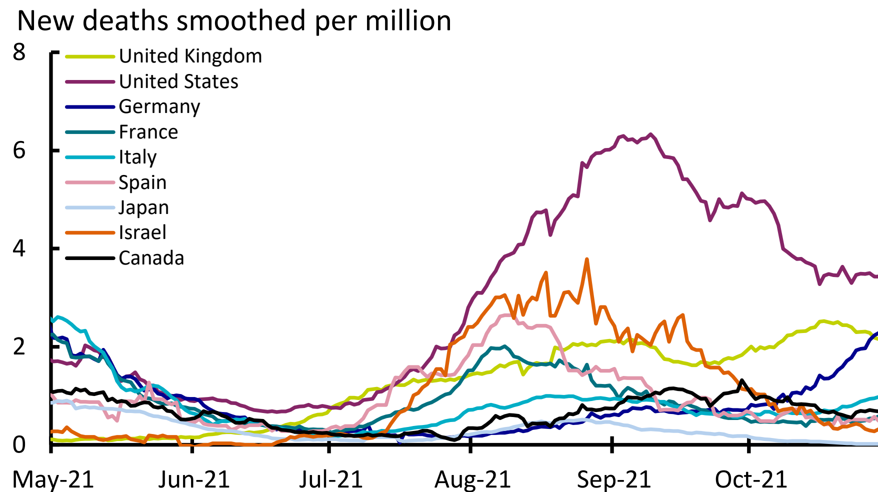
Emerging Market catch-up

Emerging Markets (EM) have not had the same access to vaccines. This should change across 2022. Increased EM vaccination rates should result in a consumption and tourism rebound later in H2 2022 – echoing the DM rebound. It should also ease global supply disruption, softening global inflation.

China's 'zero-tolerance' COVID strategy leaves it isolated and vulnerable

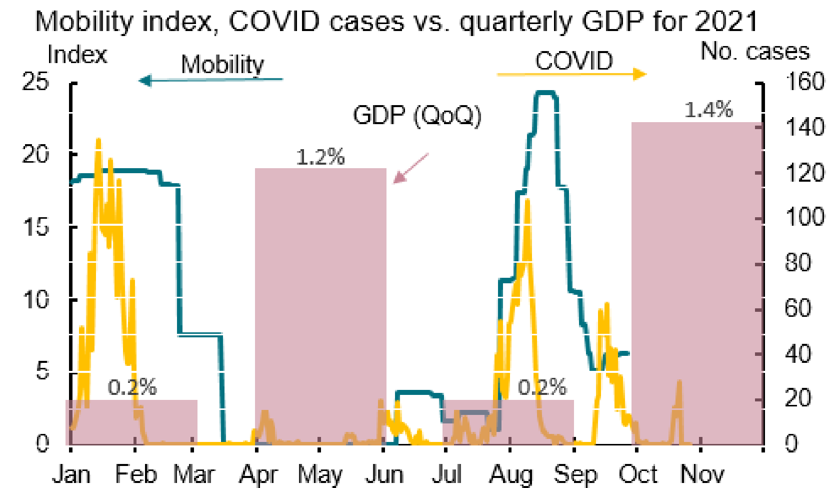
China's 'zero-tolerance' approach has minimised domestic cases and deaths and looks set to remain in 2022 and 2023. However, it leaves the economy vulnerable to renewed outbreaks requiring further interventions. It also increasingly isolates China in a world that otherwise sees the virus as endemic.

Deaths elevated in regions with least precautions



Source: Our World in Data and AXA IM Research, November 2021

China 2021 GDP volatility driven by response to COVID outbreaks



Source: CEIC and AXA IM Research, November 2021

Inflation – “mostly” transitory

Themes to shape 2022 & 2023

COVID’s structural shifts to fade

2022 should see increasing evidence of a supply-side response to price pressures. While some shortages – including semiconductors – may persist, most should ease – helped if COVID disruptions in EM’s abate. A reversion of consumer spending patterns back towards services would also ease supply-chain pressures.

Energy shock to fade

The most recent boost in inflation has reflected energy price pressures. This represents a rise in price levels; oil would need to reach $165/barrel next year to maintain its contribution to inflation. As such, energy should contribute to a material reduction in inflation across H2 2022.

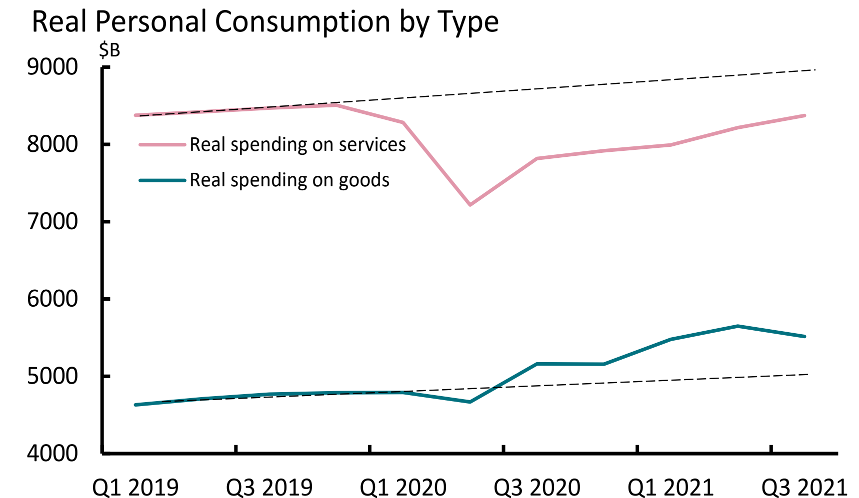
Erosion of purchasing power

Most jurisdictions see real income under pressure from rising prices. This is weakening spending and softening the growth outlook. The softer growth outlook regulates the outlook for inflation in the coming years.

Signs of supply responding to semiconductor shortage

Source: CEIC and AXA IM Research, November 2021

A softening in consumer goods demand would ease supply chain pressure



Source: BEA and AXA IM research, November 2021

Labour markets after the pandemic – the threat of persistent inflation

Themes to shape 2022 & 2023

Labour market structures have shifted: working practices; migration flows and offered labour. But is this permanent?

Some countries face long-term labour supply issues, including the UK (post-Brexit), and Canada, following a weak productivity rebound and risks to its inwards migration model. It is little surprise that the Bank of England and Bank of Canada are amongst the first expected to raise rates in developed economies.

US participation remains subdued despite “substantial” progress in employment. Care-giving and health care issues should fade as a deterrent to work in 2022, while benefits are less generous. The persistence of retired workers would act as a permanent shock. We expect a substantial participation pick-up in 2022.

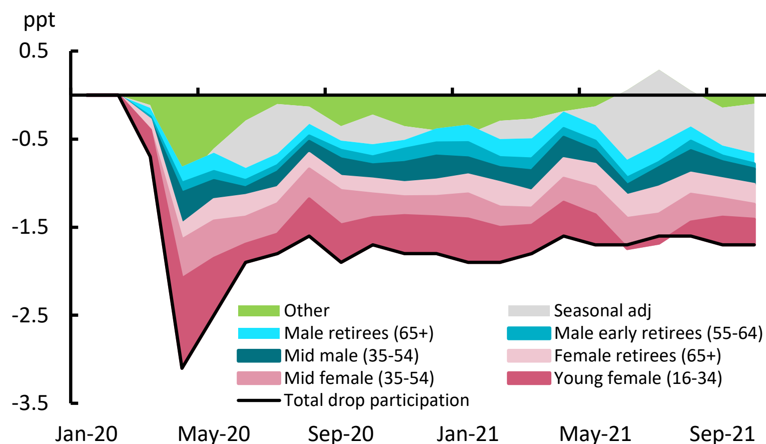
Euro area labour markets continue to exhibit signs of slack and wage demands so far remain contained. This should cap medium-term inflation pressures and explains why we expect the ECB to be one of the slowest to tighten policy. This appears a similar dynamic in Japan.

Emerging Market labour market trends are even more challenging, with informal engagement typically much higher at the best of times

Permanent labour supply shocks risk more persistent inflation pressures and would require faster monetary policy adjustment

Persistent weakness in US participation should ease

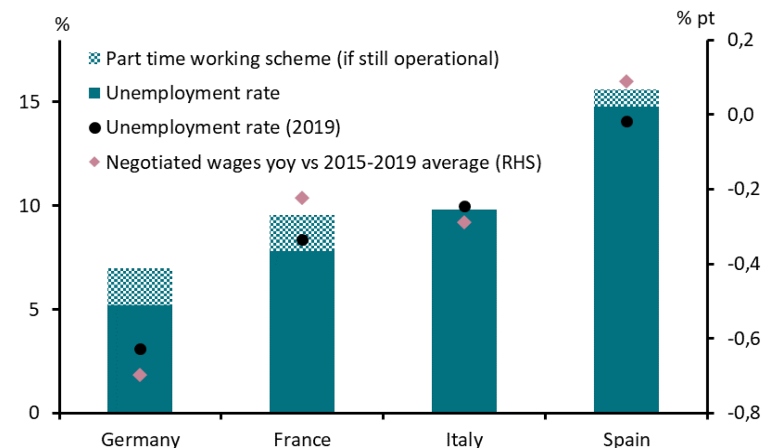
Decomposition of the fall in US labour participation



Source: BLS and AXA IM Research, November 2021

Euro area still exhibits labour market slack

Indicators of labour market slack



Source: Eurostat and AXA IM Research, November 2021

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Policy-making in this uncertain global phase

Themes to shape 2022 & 2023

In an unprecedented global phase, policymakers face significant challenges in getting it right

In China, concerns have emerged that policy remains too restrictive, or that easing has been derailed by broader changes, including housing reform, the common prosperity drive and emissions reductions targets.

In the US, the government has been accused of too much spending, March's $1.9bn American Rescue Plan appears to have limited passage of growth-enhancing social infrastructure, the Build Back Better package passed at $1.6trn down from $3.5trn. Some consider the Fed to be "behind the curve" with elevated inflation.

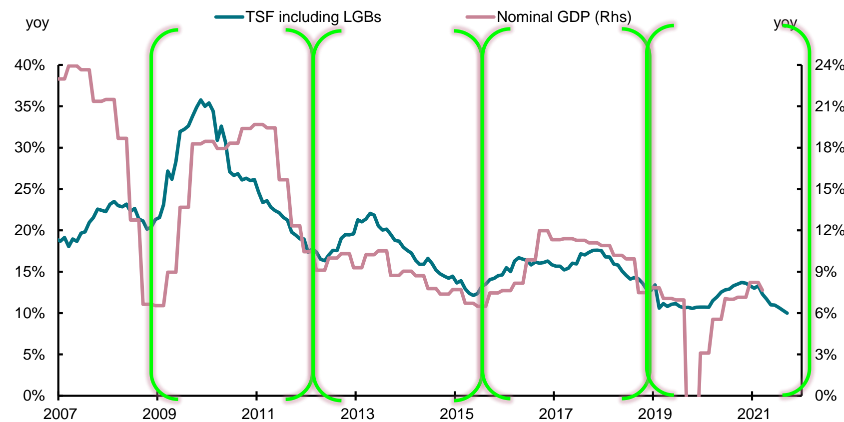
Emerging markets provide some wilder reactions including from the Turkish central bank, and with Brazilian fiscal policy

Volatility has also emerged from the UK with a mix of confusing central bank communication, the prospect of tax hikes, and trade tensions mounting again.

With financial markets "priced for perfection" in many asset classes, policy mis-steps could result in significant volatility

China lending cycle points to deceleration

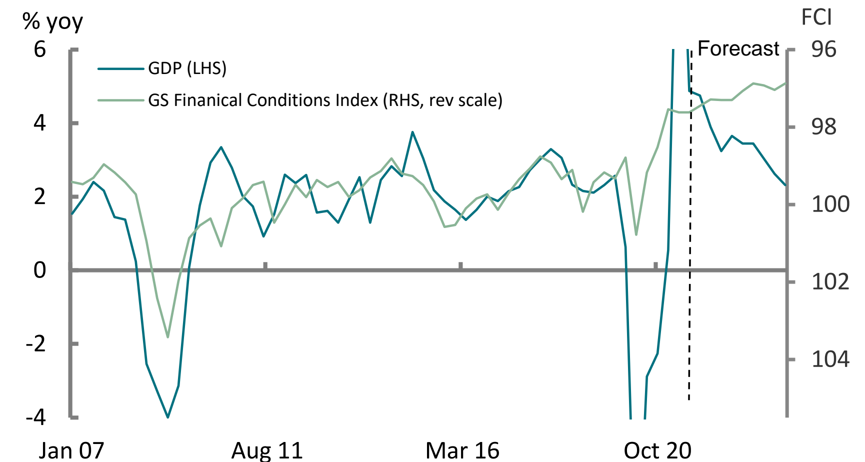
Total social financing (lead 6m) and nominal GDP growth



Source: CEIC and AXA IM Research, November 2021

US financial conditions expected to remain easy through 2023

Financial conditions and GDP



Source: BEA, Goldman Sachs, Bloomberg and AXA IM Research, November 2021

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The shifting electoral landscape

Themes to shape 2022 & 2023

Key elections over 2022 (and 2023) could shift political direction

The euro area should soon see the appointment of the 'traffic light' government in Germany. After an expected benign election in Portugal, the French election in April could cause angst, although polls suggest a Macron second term. Italy's Draghi should remain prime minister. This promises a progressive triumvirate to lead the Euro area through fiscal negotiations, climate transition implementation and broader structural reform.

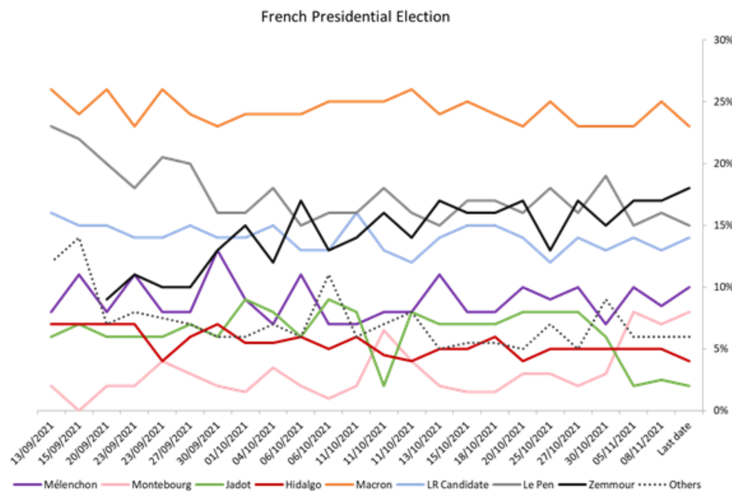
US Mid-Terms (November) look set to overturn Democrat control of Congress. This would leave political gridlock. And set up a pivotal 2024 Presidential Election.

Northern Ireland elections (May) threaten constitutional crisis and explain some of the UK's actions surrounding the NI protocol. An early General Election is plausible from October 2023, although we expect Spring 2024. But a pre-election fiscal giveaway in October 2022 may leave the option open.

Japan Upper House Elections (June) has prompted a pre-emptive, large supplementary fiscal budget.

Elections in Brazil (October 2022) and Colombia (June 2022) will be important for the region. Both risk social unrest that could have wider market implications.

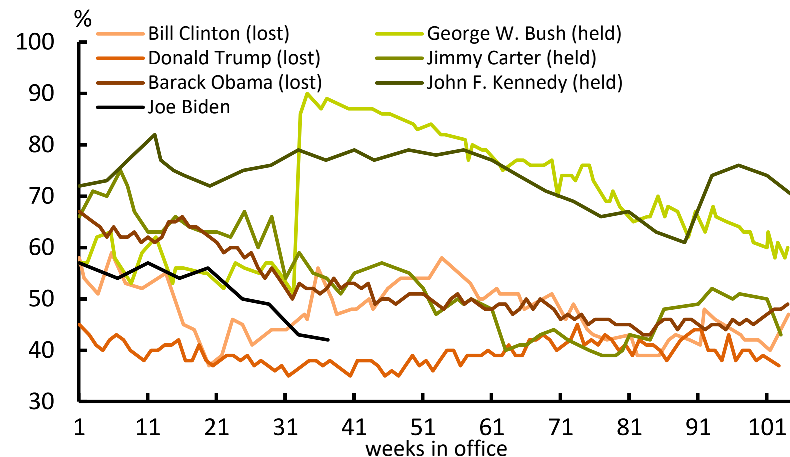
Polling ahead of France's Presidential Election



Source: Opinion way, Harris-Interactive, Elabe, Odoxa, Ifop-Fiducial and AXA IM Research, November 2021

Presidential approval ratings and subsequent Mid Term reactions

Presidential Approval Ratings



Source: The American Presidency Project and AXA IM Research, November 2021

Entering transition to minimize Climate Change

Themes to shape 2022 & 2023

Energy price volatility a feature of transition

Energy prices have surged. In part this reflects supply restrictions, particularly from Russia and OPEC+. Yet as power generation shifts towards greener, renewables volatility may be a feature, reflecting an inability to store renewable generation (at acceptable cost) and declining investment in fossil fuel provision.

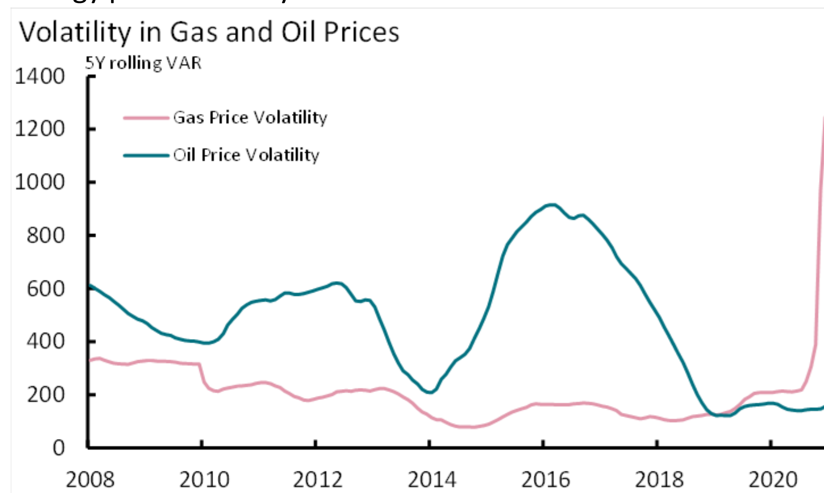
Transition investment key growth driver

The first phase of transition is large government investment in clean infrastructure in a number of regions, including as part of the EU's Next Generation package and the US's spending bills. The increase in infrastructure spending will cushion the drop in broader, pandemic-related government spending over the next years.

Persistent commitment ?

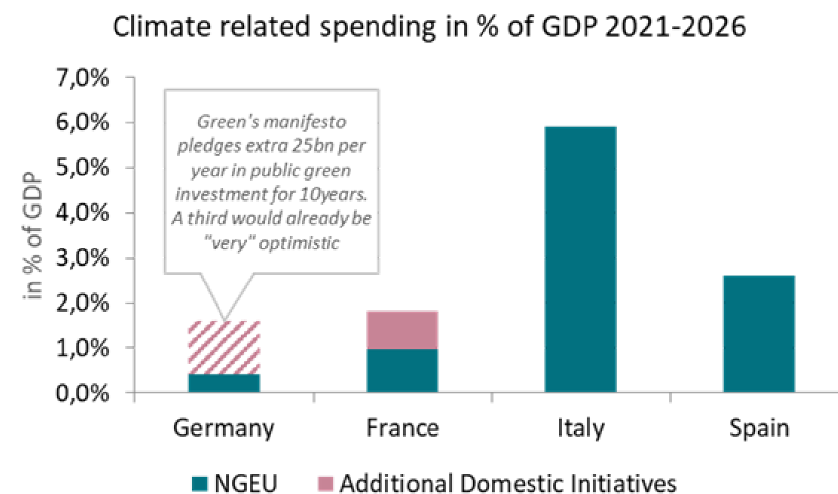
The next two years will start to test individual countries commitments to their COP 26 pledges. A progressive EU looks set to continue to push ahead. In the US, a political volte face risks another U-turn in climate policy. China commitments will be watched having boosted coal usage to cope with short-term power shortage

Energy price volatility – a feature of transition ?



Source: Refinitiv, Bloomberg and AXA IM Research, November 2021

Clean investment provides growth foundation



Source: European Commission and AXA IM Research, November 2021

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Macro outlook

Inflation and supply shocks to fade

US

Transitory inflation becomes ‘mostly’ transitory

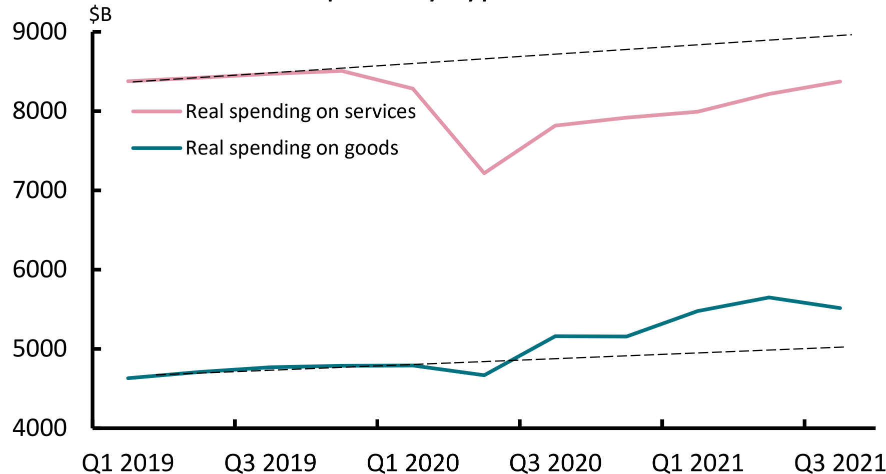
Inflation is likely to exceed the 30-year record of 6.2% before end-2021, before retracing in 2022, gradually in Q1, quickening from Q2. Supply-chain disruptions and an energy price surge added to ‘transitory’ factors. Improving supply-side conditions should be supplemented by an unwind of the surge in consumer goods demand. However, the labour market should determine whether inflation pressures prove more persistent. In Q3 2021, labour costs marked a 20-year high. These should subside as labour force participation recovers as COVID concerns continue to fade. We expect this to materialise over the coming year. As such, we forecast CPI inflation to average 4.7% in 2021, 4.1% in 2022 and 2.9% in 2023 (consensus 4.5%, 3.5% and 2.3%).

Supply impediments take their toll

The US economic outlook remains robust, with growth this year expected to return the economy to a condition of excess demand. However, unexpectedly persistent supply constraints have dampened this outlook, as price increases erode incomes. We forecast growth of 5.5% on average in 2021, 3.5% in 2022 and 2.7% in 2023 (consensus 5.5%, 3.9% and 2.5%). This assumes the impact of COVID continues to fade across the US and broader markets next year.

Composition of demand to begin to revert

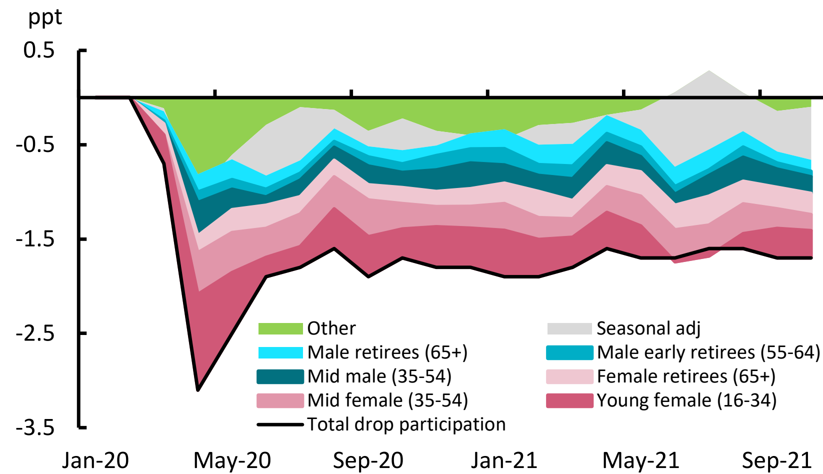
Real Personal Consumption by Type



Source: BEA and AXA IM Research, November 2021

Labour force rebound expected across 2022

Decomposition of the fall in US labour participation



Source: BLS and AXA IM Research, November 2021

Pace of US expansion demands full tightening cycle

US

Fed – early lift-off debate clouds view of full tightening cycle

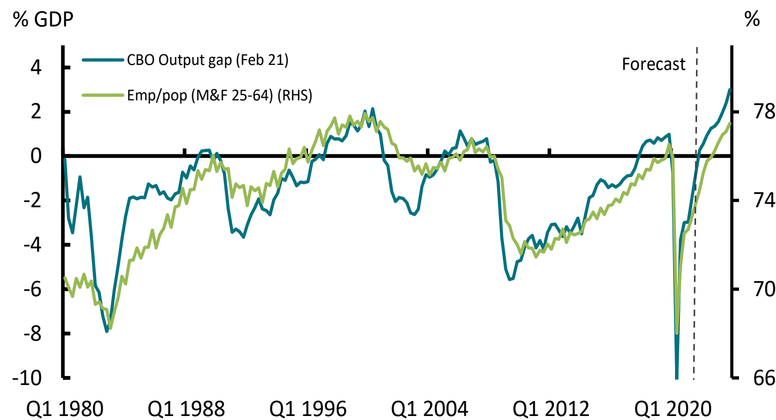
Fed forward guidance states that a rates lift-off will only take place once the labour market achieves full employment. We consider this unlikely next year, but believe inflation pressures will push the Fed to start tightening in December 2022, and acknowledge a risk of that being sooner if expectations rise much further. Yet once it starts, we expect a full tightening cycle to ensue as the economy is likely to be in excess demand. We pencil in three rate hikes in 2023, but consider this likely to extend into 2024 with the FFR moving closer towards the Fed's current assessment of the terminal rate of 2.5% than markets currently consider.

Midterms threaten political gridlock

November 2022 midterm elections threaten President Biden's slim majorities in the House and Senate. Recent elections suggest a swing in favour of Republicans even if Biden's current low approval ratings improve as economic conditions (the labour market and inflation) normalise. Current polling suggests Republicans could gain a majority in both houses, which would likely see fresh policy progress grind to a halt. Economically, delivery of this year's spending packages will dominate and domestic gridlock may force a realignment towards more international policies. But a pivotal 2024 Presidential Election would loom.

US economy moves into excess demand

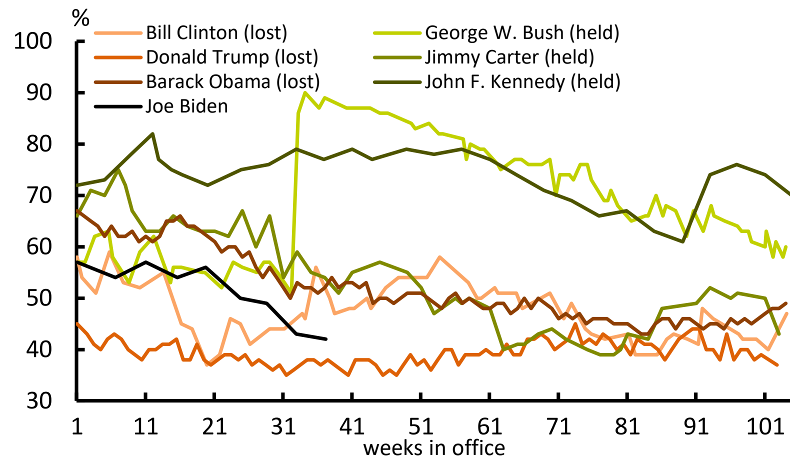
CBO Output Gap and employment ratios



Source: BLS, CBO and AXA IM Research, November 2021

Biden's approvals track those that lost Congress in midterms

Presidential Approval Ratings



Source: The American Presidency Project and AXA IM Research, November 2021

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Short-term headwinds insufficient to derail momentum

Euro area

Short-term outlook threatened by another COVID-19 outbreak, rising prices, supply shortages and China's slowdown

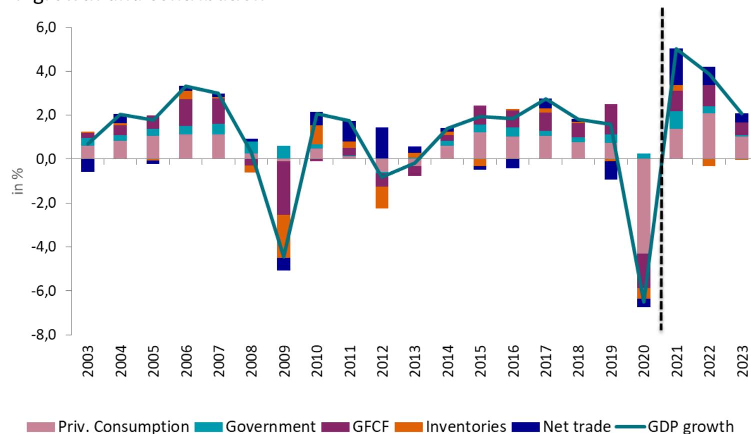
These headwinds should sharply lower the Q4 GDP growth outlook, but the effect should ease thereafter. We expect improvements in vaccination campaigns; progress on supply shortages, as excess demand gradually normalizes and supply improvements emerge; and we expect China's weakness will be managed by more supportive policy over 2022. Looking at individual countries, we believe Germany will be the most impacted economy as it lies on the front line of all of those headwinds

Beyond these short-term weaknesses, some tailwinds should support Eurozone activity over the medium term

In the industrial sector, order books are full while domestic demand has not fully recovered and savings accumulated during the crisis may provide an additional boost (albeit allowing for a cautious approach on the use of excess saving given uneven distribution across households)

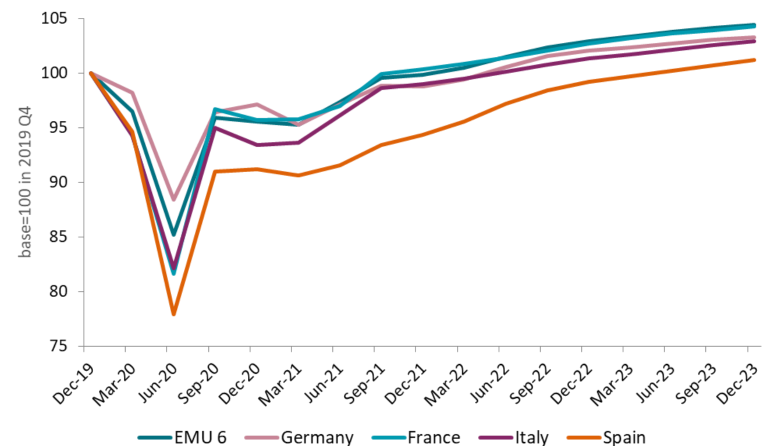
Overall, we are optimistic on the Eurozone growth outlook (3.9% in 2022 and 2.1% in 2023) as current headwinds dissipate

GDP growth outlook still supportive



Source: Eurostat and AXA IM Research, November 2021

Germany transitory weakness, Spain permanent laggard



Source: Eurostat and AXA IM Research, November 2021

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Fiscal and monetary waltz should continue

Euro area

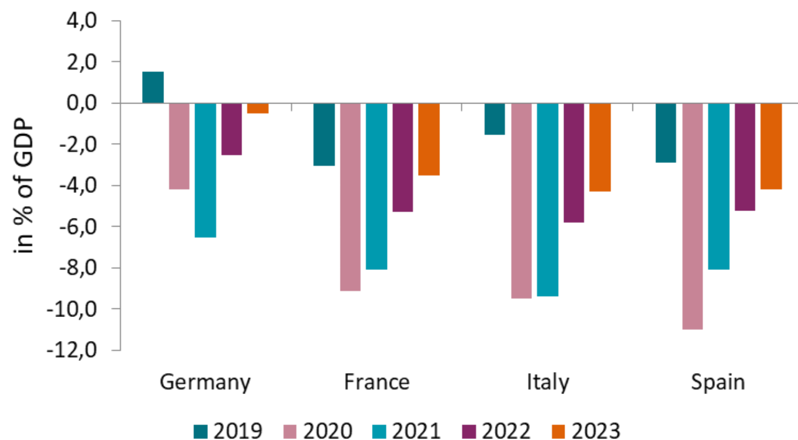
European governments now recognise that fiscal policy should not be tightened quickly to avoid jeopardising the recovery

Fiscal rules were suspended until 2022 but should resume in 2023. Thus, most governments are using this largesse to further support economies. Some countries, such as Italy and Spain, should also benefit from the Next Generation EU (NGEU). The pace of reforms in Italy is compatible with NGEU objectives, but Italy does not have a good track record of channelling money into projects and remains a risk to monitor.

We do not see the ECB tightening rates before 2023

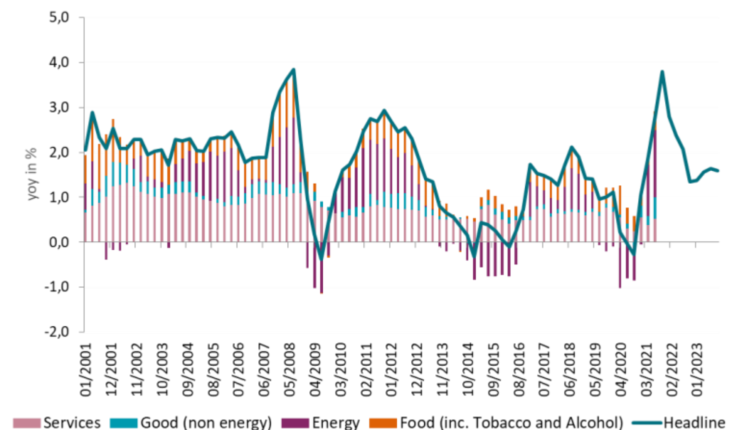
Despite persistent inflationary pressures, we expect inflation to soften in 2022 (2% in 2022 and 1.6% in 2023). At present, we do not see wage increases sufficient to de-anchor inflation as slack is still evident in several individual markets. In consequence, the ECB should maintain its very accommodative monetary policy. We continue to expect the end of the PEPP from March and a scaling up of the APP to €40bn to avoid a sharp step change. We also believe the ECB will introduce more flexibility to cope with potential threats. Amid a firmer macro-outlook and a desire from some Governing Council members to exit super-accommodative monetary policy, we believe the ECB will hike rates in September 2023

Governments maintain support



Source: European Commission and AXA IM Research, November 2021

Inflation peak expected in Q4, still transitory



Source: ECB and AXA IM Research, November 2021

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Inflation and supply shocks mount

UK

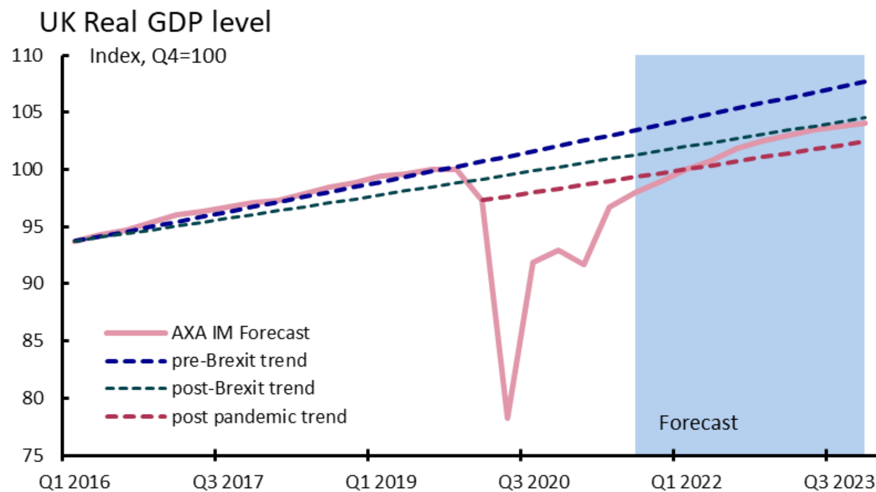
A supply-constrained backdrop

The UK economy has been impacted by the combined and increasingly intertwined shocks of Brexit and the pandemic, weighing on the long-term growth potential of the economy. The Bank of England currently estimates supply potential reduced by around 6% from the pre-Brexit trend. We forecast growth to deliver a 6.9% rise this year, before slowing to 5.2% in 2022 and 2.3% in 2023 (consensus 7.0%, 5.0% and 2.1%). This would leave GDP below the pre-COVID trend, but still in 'excess demand' based on the BoE's supply potential estimates.

Rising energy prices will be a key driver of inflation outlook

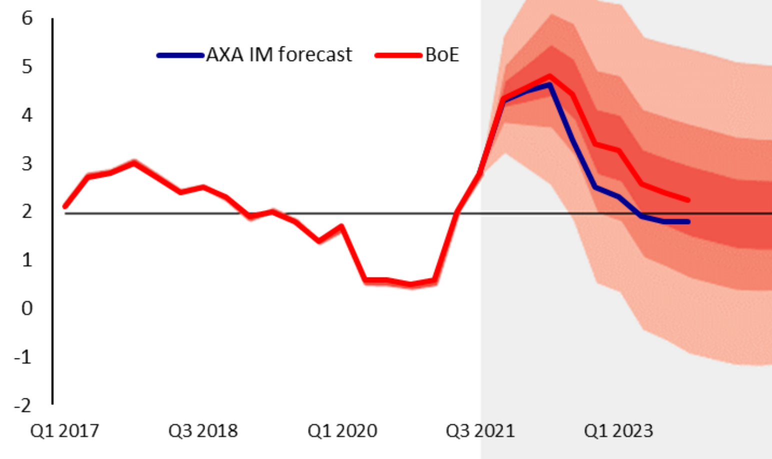
Inflation has been driven by a combination of supply-chain disruptions and a significant energy shock. Wholesale gas prices remain elevated and retail prices will rise into Q2 next year when we expect a CPI inflation peak close to 5%. These transitory effects should then start to fade. The longer-term outlook will be governed by domestic labour conditions. We await developments post-furlough, but there are current signs of a tightening labour market. We expect inflation to fall back from H2 2022 towards the target, forecasting annual rates to average 2.4%, 3.8% and 1.9% for 2021, 2022 and 2023 (consensus 2.4%, 3.4% and 2.1%).

UK economy suffers combined supply shocks



Source: National Statistics and AXA IM Research, November 2021

Inflation set to rise further above target



Source: Bank of England and AXA IM Research, November 2021

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Monetary tightening imminent

UK

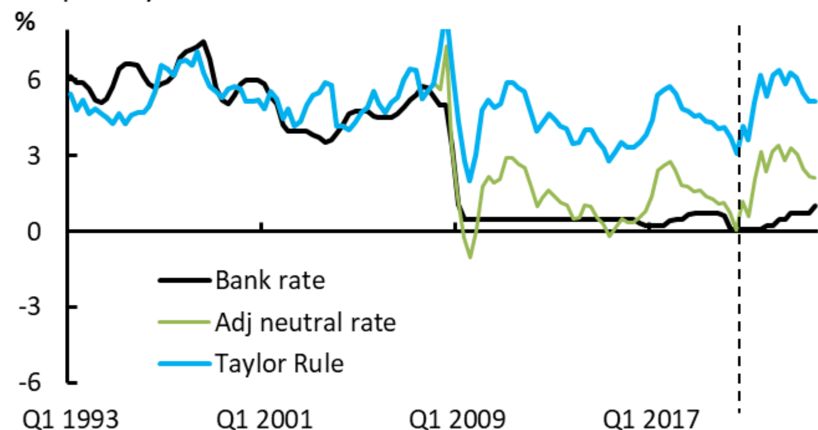
Rate hikes now and on the horizon

Given emerging signs of labour market tightness and an elevated outlook for inflation, the BoE has signalled that some tightening in monetary policy is imminent. Expecting no dramatic post-furlough effect, we forecast the MPC to raise Bank Rate by 0.15% in December. With growth expected to reach its supply-damaged capacity next year, we expect a further tightening of 0.25% in May triggering the passive unwind of the BoE's balance sheet, starting with £9bn in Q3 2022. We then forecast a rise to 0.75% in November and to 1.00% one year later in November 2023, which would open a more active unwind of the balance sheet in 2024.

Brexit weighs adding to political tensions

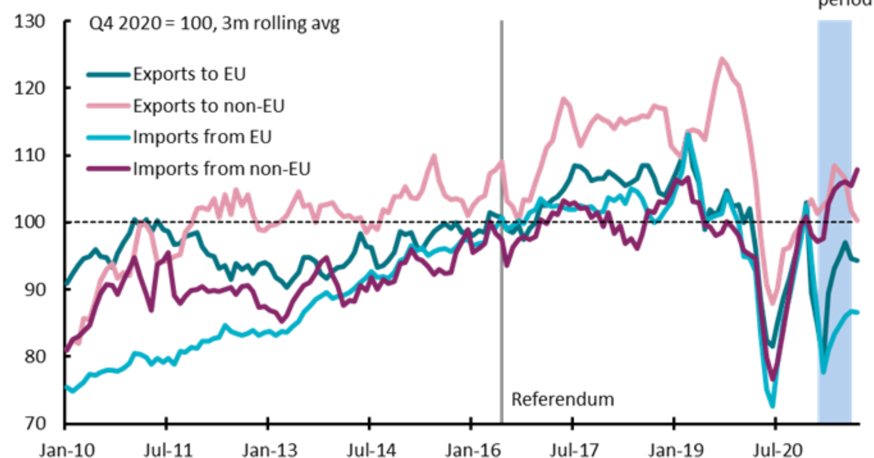
The EU-UK FTA is due to be fully implemented from 2022, we expect that increased trade costs between the EU and UK will continue to weigh on the UK outlook. Furthermore, the renegotiation of the Northern Ireland (NI) Protocol poses risks – while a negotiated outcome is preferred by both sides, pressures from upcoming NI elections (May 2022) could see a more disorderly outcome, which might include EU sanctions, or a suspension of the FTA. Brexit-related border costs and uncertainty look set to remain elevated next year and weigh on activity. These pressures are likely to dispel ambition for an early General Election, which could be slated for October 2023. But fiscal policy is likely to be set to leave this option open.

Simple Taylor Rule suggests policy tightening



Source: Bank of England, OBR and AXA IM Research, November 2021

Trade with the EU lags pre-pandemic levels



Source: National Statistics and AXA IM Research, November 2021

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Three forces shape the 2022 outlook

China faces transitory, persistent and uncertain economic drivers

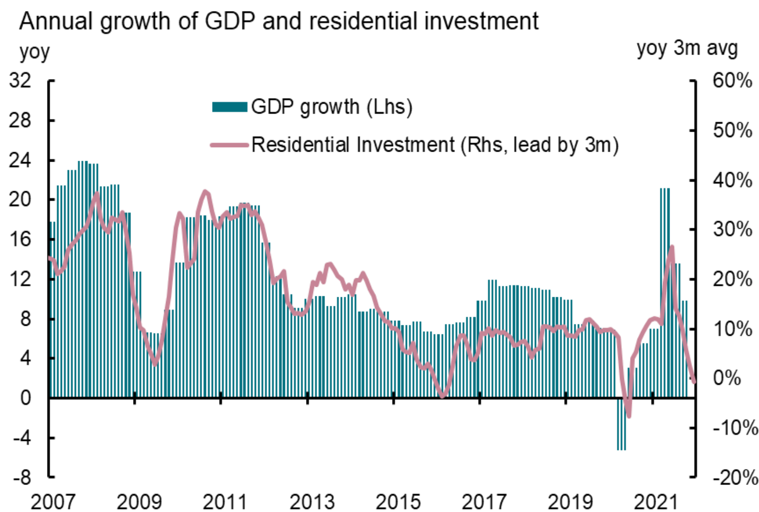
Property woes exert more persistent pressure than the power crunch

The power crunch is set to have a transitory impact following a concerted effort to raise coal production, widen the electricity price band and crack down on coal speculation. While energy-intensive users may still face some power rationing, the bulk of the economy should see its energy use normalise. In contrast, the property market curbs will likely continue in 2022, reflecting a structural shift in the official attitude towards housing market developments. However, against mounting growth headwinds, Beijing has started to fine-tune its policies in a “two steps forward and one step back” approach. Incremental policy adjustment should help to stabilise the market in the second half of 2022

Uncertainty around COVID-19 presents the biggest domestic risk

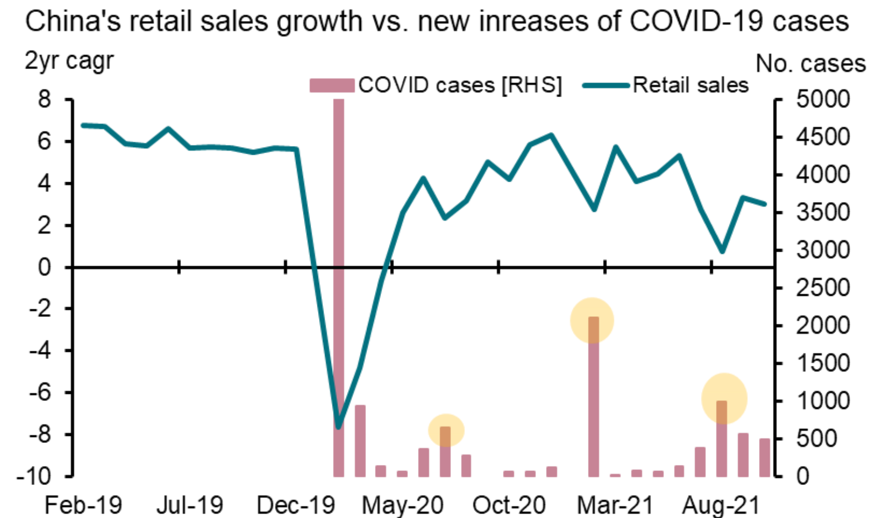
China’s “zero COVID” strategy has led to periodic lockdowns against even relatively small flare-ups of infections. These have come at great cost to the economy, inhibiting consumption and services recoveries. Despite these costs, Beijing is unlikely to change its current COVID-fighting approach, unless further major medical breakthroughs are achieved. This suggests downside risks for our consumption forecast, which assumes a steady recovery to trend growth

Cooling housing market weighs on growth



Source: CEIC and AXA IM Research, November 2021

COVID resurgence disrupts consumption recovery



Source: CEIC and AXA IM Research, November 2021

AXA Investment Managers

Policy to strike a finer balance between growth and sustainability

Beijing recalibrates policies to counter growth shocks

Tighter policies reflect a higher pain threshold

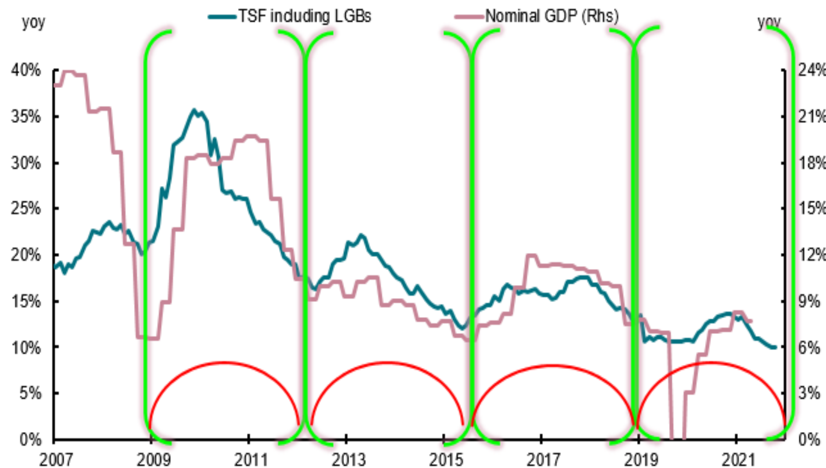
Policies have been much tighter than indicated at the start of the year. Beijing's high pain threshold probably reflects recognition that the structural developments that China is undergoing – including the pursuit of common prosperity and higher quality growth – would inevitably create short-term pain. Those pains are better faced through a strong, cyclical economic rebound from a low base. 2021 therefore offered an opportunity to pursue these reforms despite their known side effects

Conserving policy room for next year

But as the macro environment changes, an urgent rethink of policies is needed for 2022. With growth slowing sharply and base effects turning unfavourable, Beijing cannot afford to continue with the current operation that risk driving the economy into a hard landing. We expect a wholesale recalibration of policies, which could consist of 1) more lenient regulatory policies, 2) more accommodative monetary policies – focusing on targeted liquidity injections and credit growth stabilization – and 3) greater frontloading of fiscal stimulus next year

Policy tighter than expected

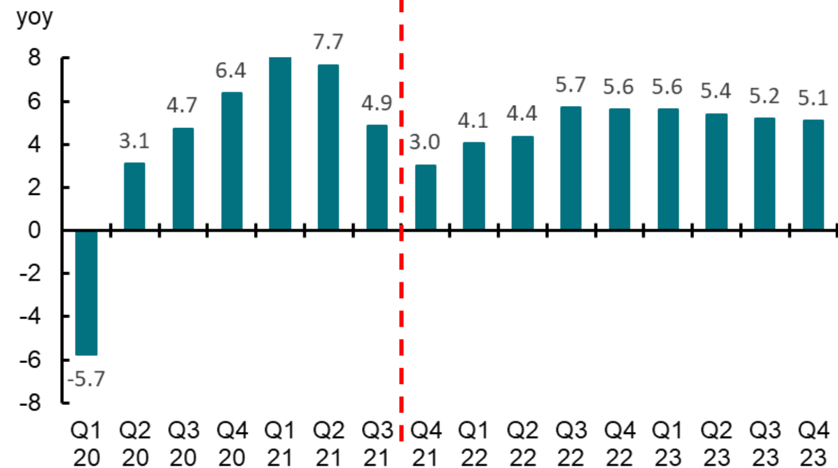
Total social financing (lead 6m) and nominal GDP growth



Source: CEIC and AXA IM Research, November 2021

Policy fine-tuning supports economic recovery

GDP growth and forecast



Source: CEIC and AXA IM Research, November 2021

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Late comer to the recovery club

Japan

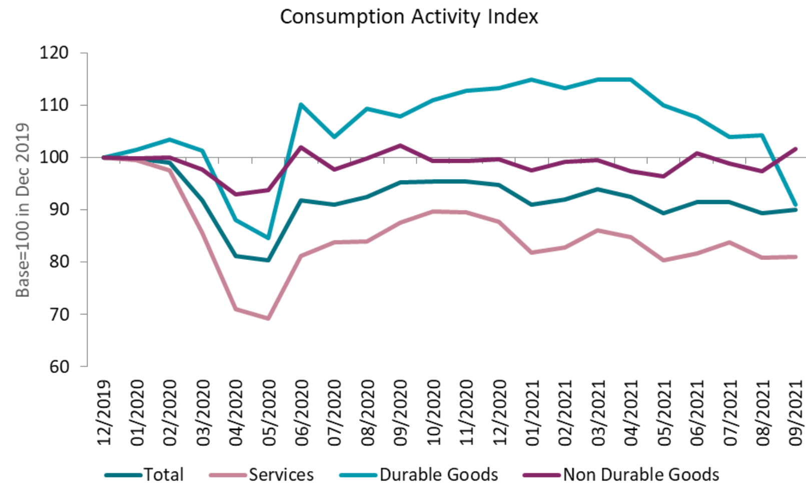
Imminent take-off

Despite milder restrictions, Japan recorded subdued GDP growth in 2021 as a relatively late start to its vaccination campaign delayed fuller reopening. The outlook for 2022 is brighter and we expect a strong mechanical catch up even in Q4 2021 and we see more tailwinds over the coming months: A recovery in domestic demand is largely incomplete and excess savings have reached 3.7% of GDP; the recent fiscal push has a headline worth 10% of GDP), which includes cash handouts for young people , shopping vouchers and the resumption of the "Go to" campaign. Conditions are supportive for a boost to private consumption. However, already high levels of excess savings may dampen some of this stimulus.

Auto sector recovery and public/private investments on digitalisation should boost economic activity

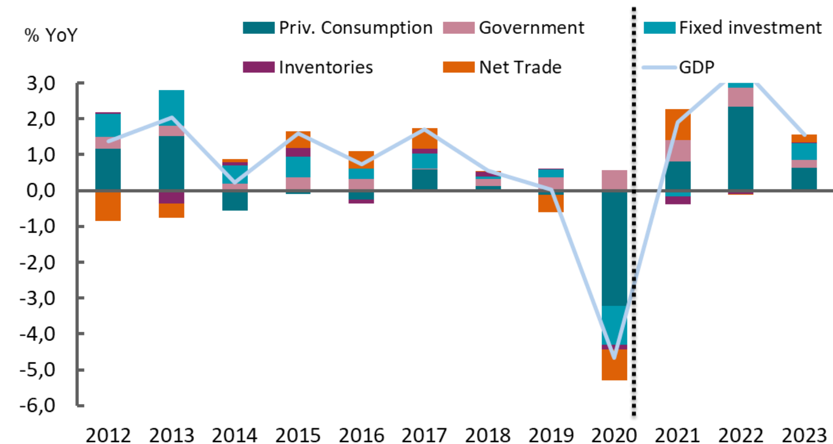
An improvement in auto sector output as global semiconductor supply improves should mechanically boost activity, even if we do not anticipate a complete recovery soon. The government also relies on strong investment in digitalisation and this would help to address low productivity in SMEs and the heavy administration burden

Services spending has remained subdued



Source: Bank of Japan and AXA IM Research, November 2021

GDP rebound driven by private consumption bounce



Source: Cabinet Office and AXA IM Research, November 2021

AXA Investment Managers

Bank of Japan still has plenty of time

Japan

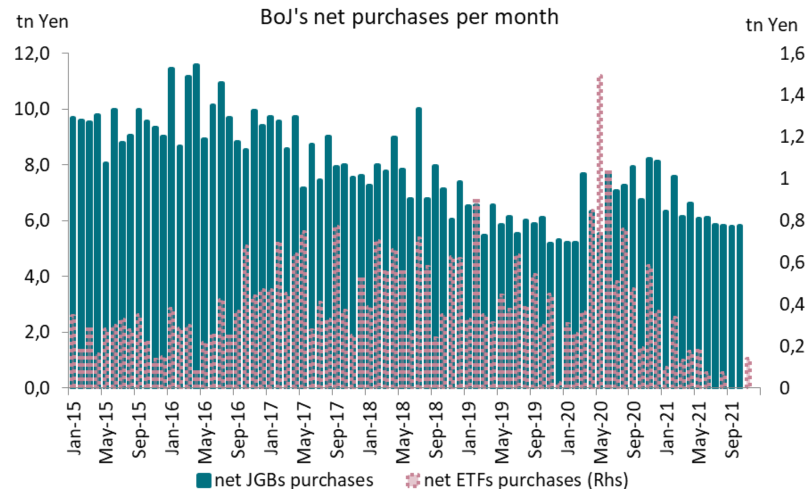
Upside pressure on inflation also present, but not visible in indices

Rising energy and transport costs and a weaker yen have lifted prices, but the net inflation effect is complicated by one-off factors, including a large fall in mobile phone charges. This effect will fall out in April 2022, but a resumption of the "Go to" campaign would further complicate the reading. Our strong conviction remains that inflation is unlikely to breach 2%. The Bank of Japan (BoJ) should maintain accommodative monetary policy at least until 2024, while steadily tapering government bond and risk asset purchases. Bar is likely too high to taper faster. BoJ Governor Kuroda's mandate ends in Spring 2023 - a more hawkish outlook is a succession risk.

After two prime minister resignations since August 2020, we expect a more stable government

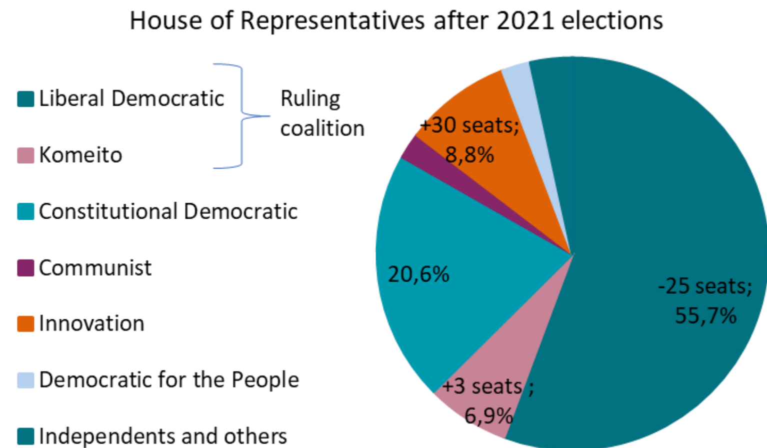
Recent legislative elections granted legitimacy to newly appointed Prime Minister Fumio Kishida, but the summer Upper House elections will be important in stabilising the government. November's big fiscal push is not trivial in this regard.

Tapering should continue, tightening not on horizon



Source: Bank of Japan and AXA IM Research, November 2021

Liberal Democratic Party keeps its majority



Source: The Japan Time and AXA IM Research, November 2021

AXA Investment Managers

Broad rebound dampened by supply-side constraints

Canada

Global supply-chain headwinds dampen COVID rebound

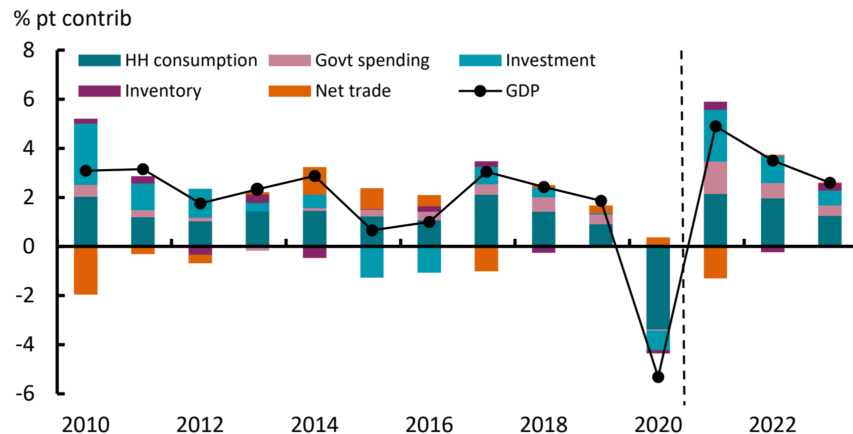
The Canadian vaccination programme should allow for a broad consumption rebound to persist and drive recovery throughout next year. However, supply-chain and energy-based inflation pressures look set to erode demand both domestically and in Canada's largest export market. We forecast the economy to post growth of 4.8% in 2021, following a Q2 contraction and some subdued growth in Q3. Supply pressures are likely to keep growth relatively subdued in H1 2022, before easing in H2. We forecast annual growth of 3.5% in 2022 and 2.5% in 2023 (consensus 5.0%, 4.0% and 2.5%).

Persistent migration shortfall to underpin medium-term wage gains

The labour market has posted a quick recovery, certainly relative to US developments. However, this reflects softer productivity growth – in part reflecting a recovery in low-productivity services roles. Canada once again targets a relatively high rate of migration to underpin broader labour force growth. Yet we see a risk that persistent COVID concerns – particularly in China, traditionally a large source of Canadian immigrants – could delay a rebound in overall migration, creating some stresses in the labour market as growth recovers, building pay pressures.

Domestic consumption cornerstone of domestic recovery

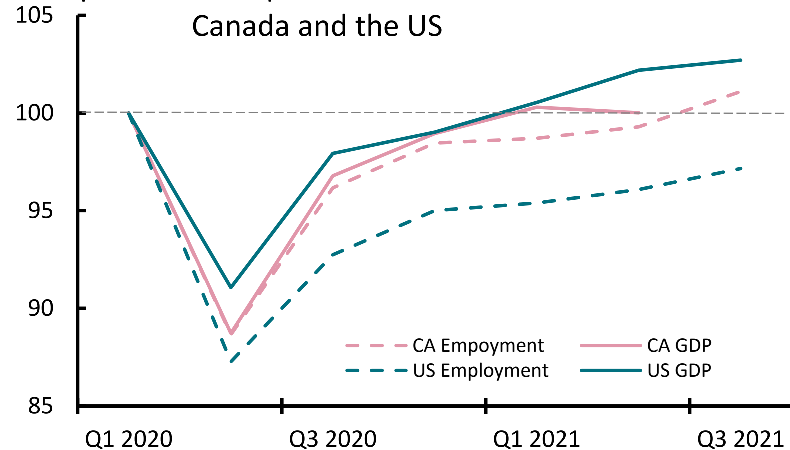
CA contributions to growth



Source: CANISM- Statistics Canada and AXA IM Research, November 2021

Canadian labour rebound questions scope for future expansion

Comparison of output and labour recoveries:



Source: CANISM- Statistics Canada, BLS and AXA IM Research, November 2021

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Bank of Canada to react to persistent inflation rise

Canada

Inflation surge to ebb later in 2022

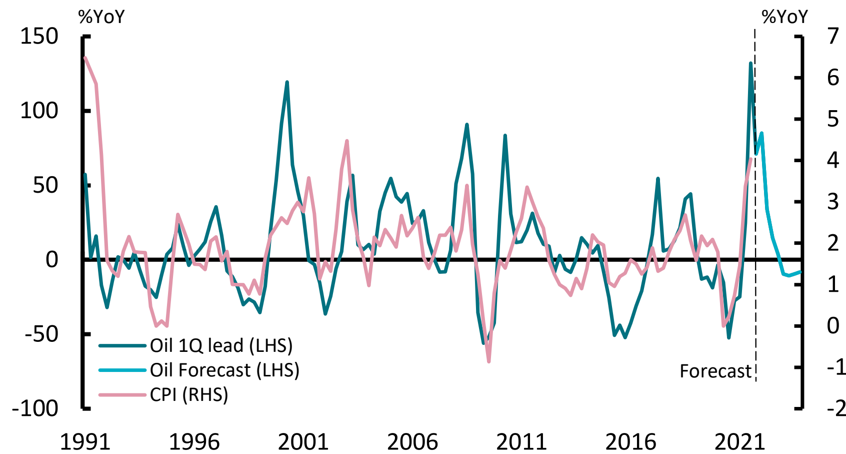
CPI inflation far exceeds the BoC's 1-3% inflation target range and is likely to rise further towards 5% by end-2021. This has been driven by a mix of global supply-chain pressures, a surge in energy costs and some domestic inflation pressures, including housing. Inflation should retrace from early 2022, but it will likely take until the second half to see inflation materially lower than the expected peak. We forecast inflation to average 3.4% in 2021, 3.1% in 2022 and 2.3% in 2023 (consensus 3.2%, 2.6% and 2.1%), although we acknowledge some uncertainty in the longer-term depending on labour market developments.

BoC early mover, slower finisher ?

The Bank of Canada ended its QE program in October, symbolically sooner than the Q1 2022 many in markets had expected. This created space for the BoC to tighten policy sooner. With inflation likely to remain elevated in the early months of 2022 and some questions around labour market capacity, we forecast the BoC to raise rates in April – to 0.50% - and again in October to 0.75%. However, evidence of significant disinflation in from H2 2022 and GDP expected to come in below the BoC's forecast should temper the pace of tightening in 2023. We forecast just one hike in April 2023 to 1.00%.

Oil price stabilisation would add significant disinflation

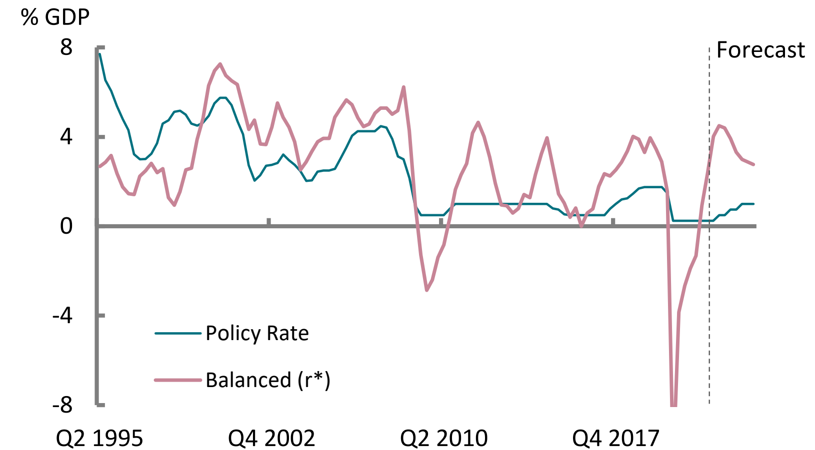
Inflation and oil



Source: CANISM, New York Mercantile Exchange and AXA IM Research, November 2021

Policy guides point to gently tighter monetary policy

Taylor Rule - balanced, r*



Source: Bank of Canada and AXA IM Research, November 2021

AXA Investment Managers

From rebound in 2021 to recovery in 2022 and normalisation in 2023

Emerging markets

Changing gears: from external to domestic drivers

Several factors will be less supportive as activity normalises after the Covid-19 pandemic: advanced economies' supportive policies, from fiscal pandemic packages to ultra-loose monetary conditions, will be gradually phased-out; demand from advanced economies should revert to services from a strong goods bias; global trade momentum will also likely come off the boil; a Chinese self-inflicted slowdown will also weigh on EM trade balances; while the normalisation in EM policy mix, as fiscal room has been reduced and monetary policies respond to rising inflation, will eventually weigh on the strength of the recovery. Overall, economic activity will have to rely increasingly more on domestic demand engines.

Recovery timeline still Covid-19 path dependent

EM Asia is just coming out of the last Covid-19 wave thanks to stronger consumption as well as better touristic seasons ahead. Latin America sees monetary tightening in the wake of inflation spiking, which will put a brake on the extent of the domestic demand recovery; politics will be back under the spotlight with elections in heavyweights Brazil and Colombia. CEE should normalise from overheating levels - the recovery hitting capacity constraint limits from tight labour markets. Turkey is self-inflicting macro-volatility yet again, we believe TRY depreciation will limit political will to excessive policy loosening.

Fading export momentum

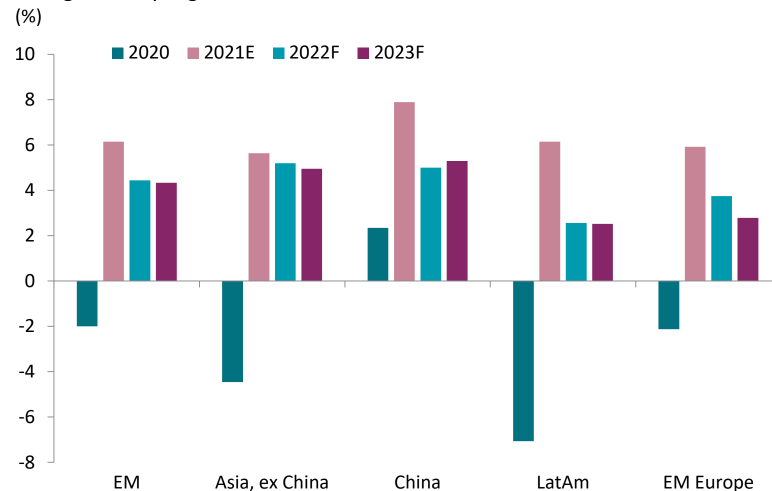
China TSF impulse on EM

Source: Datastream and AXA IM Research, November 2021

EM regional GDP growth expectations

GDP growth by region

(%)



Source: Datastream and AXA IM Research, November 2021

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Policy normalisation moving ahead at various speeds

Emerging markets

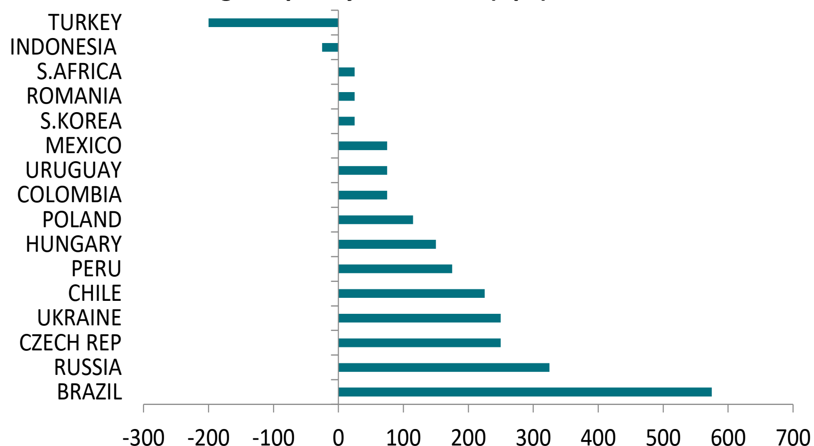
Normalisation in monetary policy steps up the pace

Inflation tensions have been affecting advanced and developing economies alike. While energy and food prices rising, as well as the inflation pressures coming from disruption of global supply chains ignited by Covid-19 pandemic, may prove transitory, and few EMs face tight labour markets, most EM central banks do not have the leisure to wait and look through the hump: monetary tightening cycle has started, mostly in Latin America and EM Europe (ex Turkey) with some pretty advanced in the cycle (eg Russia). Asia has been lagging the process and should only gradually join the normalisation trend.

Threats and opportunities

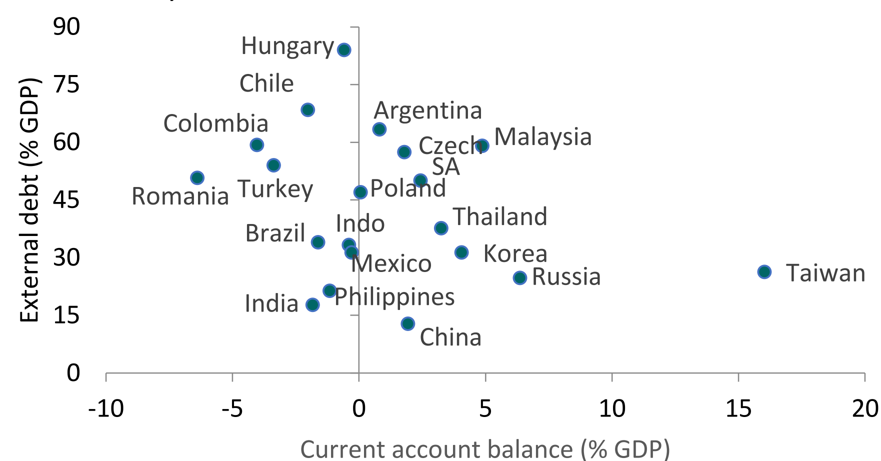
External threats remain: (1) Covid-19, as "Zero covid" policies throughout Asia induce strong macro volatility; (2) a reassessment of US inflation pushing markets' expectations of Fed rate hikes abruptly, risking another bout of EM portfolio outflows; (3) sharper Chinese slowdown. Additionally, a tighter policy mix in EM outside Asia may curtail the nascent economic recovery; reduced EM fiscal firepower will limit governments' ability to finance needed structural reforms. Idiosyncratic risks concern political events in Latin America (Brazil, Colombia, Chile) and the fallouts of the current policy experiment in Turkey. Opportunities in EM may lie around the share some EM may get from the upcoming DM capex cycle supported by infrastructure spending and the ongoing green transition.

Monetary policy tightening underway (mostly)



Source: Datastream and AXA IM Research, 18 November 2021

External vulnerability into 2022



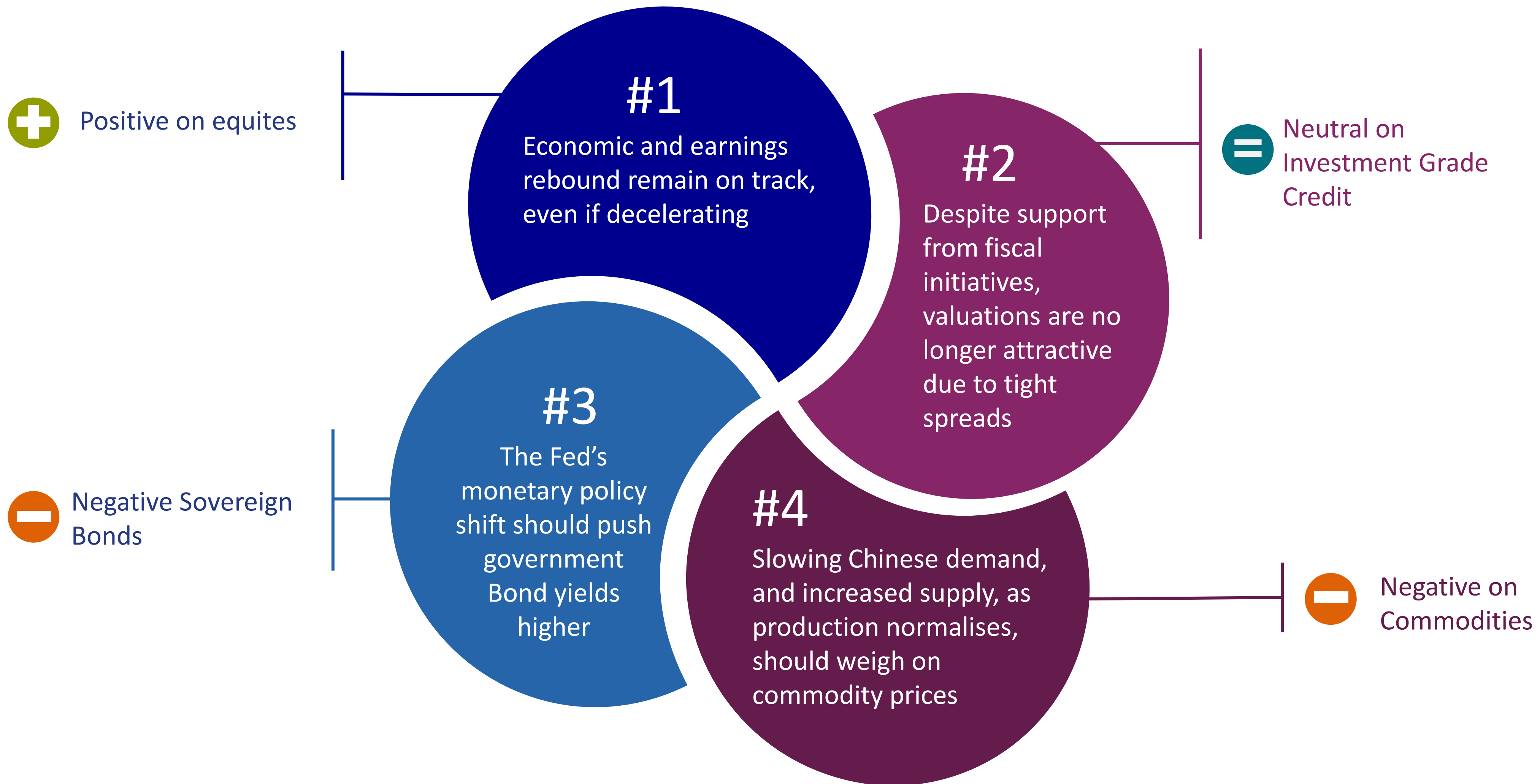
Source: IMF and AXA IM Research, November 2021

Investment Managers

Investment Strategy

Multi-Asset Investment views

Our key messages and convictions



Source: AXA IM as at 23/11/2021

AXA Investment Managers

FX Strategy

Foreign Exchange – Anticipation moves from tapering to hikes

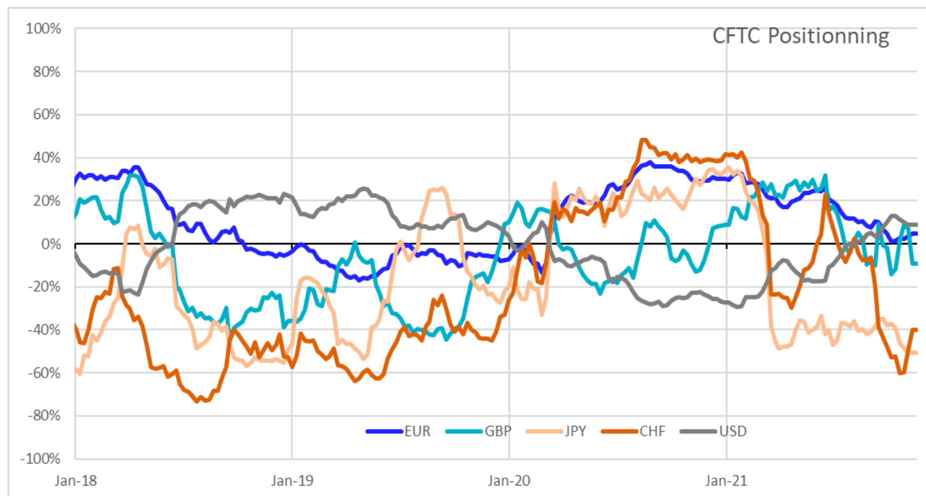
Dollar strength as monetary policy gets exciting again

The Covid crisis compressed all developed market (DM) rates to the zero-lower bound and value became the first driver of currencies. Rising short-term interest rate differentials are now leading FX moves and should continue to do so. Current Fed market pricing could move further, triggering more USD strength, especially as long USD positioning is not that stretched yet. Beyond the near term, our valuation model points to a EURUSD rebound above 1,20, based on our macro forecasts. Timing the turn in favour of the EUR will be difficult. It could come in mid-2022, after French elections and ahead of US mid-term elections.

Inflation: the haves and the have nots

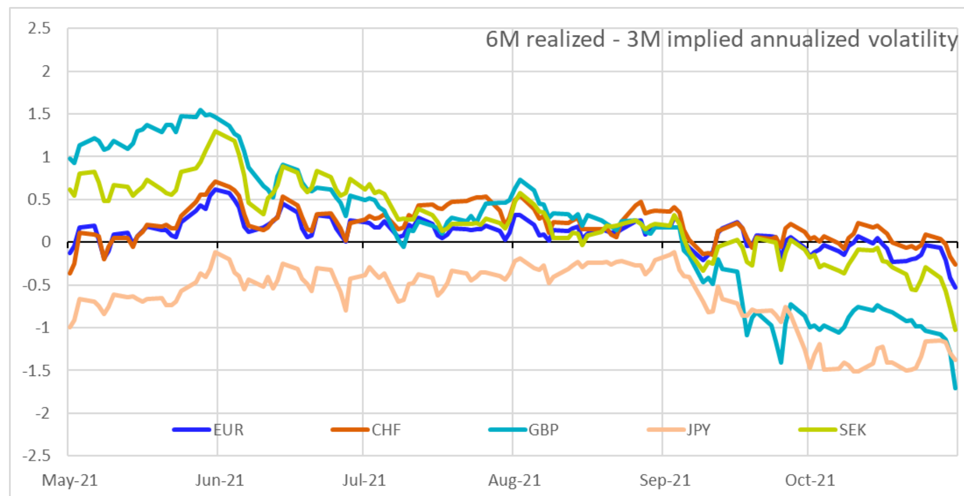
Despite facing a yet larger cumulative inflation miss, JPY and CHF may prove more resistant to further weakness vs the USD than the EUR. Central bank expectations are also rising for commodity currencies as well as sterling, implying positive performance. Expectations on the BoE still look excessive after the repricing following MPC miscommunication. UK growth outlook is uncertain due to labour shortages and fiscal and monetary tightening, while revived Brexit tensions around the NI protocol also pose downside risks.

Short EUR and long USD have room to extend



Source: Bloomberg and AXA IM Research, November 2021

Rising concerns about sterling



Source: Bloomberg and AXA IM Research, November 2021

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Upward pressure on yields

The last line of defence: the term premium

During 2021 we've seen a positive contribution to US Treasury yields both from interest rate and inflation expectations, while the term premium is only marginally higher. We expect the Fed to conduct a 'smooth tapering' to avoid a quick rise in market volatility and hence term premia. Policy response to Covid has targeted firms and households directly – i.e., the core of the economy – with a more direct impact on inflation, including wages. Central banks may have to hike rates as soon as policy normalisation criteria are met, in order to narrow the gap between wages and policy rates.

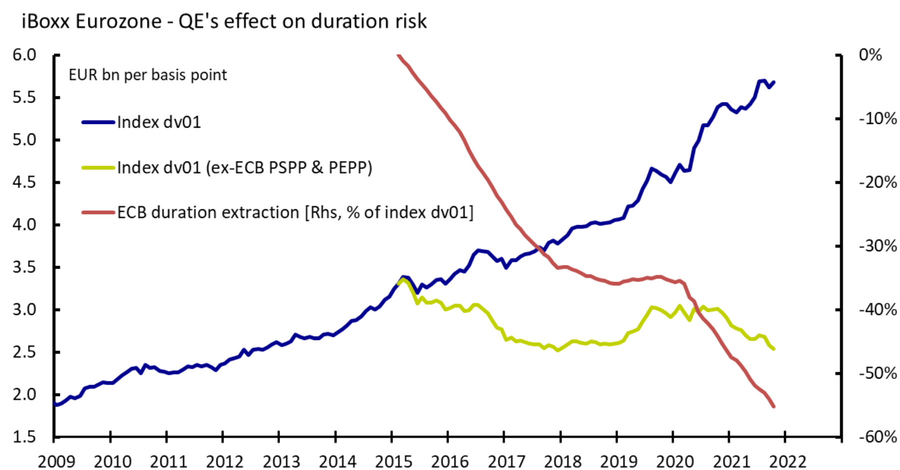
The changing structure of the EGB market

A combination of ECB's PSPP and PEPP has extracted around 55% of the government bond market's duration risk. This can introduce liquidity risks in Euro government bond markets, leading to more frequent 'collateral scarcity' episodes that could require ECB intervention in repo markets, especially into year end. The speed at which yields rise matters for overall risk appetite/aversion. Almost by definition, lags between central banks will affect cross-market spreads as well as currencies' valuation and hedging costs. The sequence and timing of central bank lift-off is key in capturing relative value between bond markets in 2022.

The relationship between volatility and yields

Source: Bloomberg and AXA IM Research, November 2021

Duration extraction by ECB going too far ?



Source: ECB, IHS Markit and AXA IM Research, November 2021

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Credit Strategy

Spread hibernation can extend into 2022

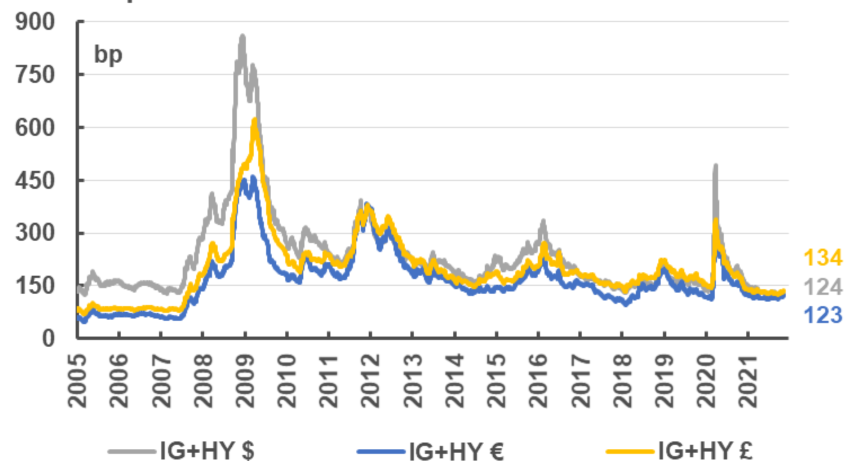
Keep calm and carry on

Credit markets have been immune to exogenous market developments for the past twelve months. This spread regime can extend into 2022 even as monetary policy accommodation begins to be withdrawn. First, spreads tend to react more to announcements than actual flows of quantitative easing. Second, economic activity and thus earnings growth should continue to underpin credit fundamentals. Lower duration outperformance/higher beta carry trade has room to run further as long as risky asset volatility remains contained.

Credit cycle relies on policy support

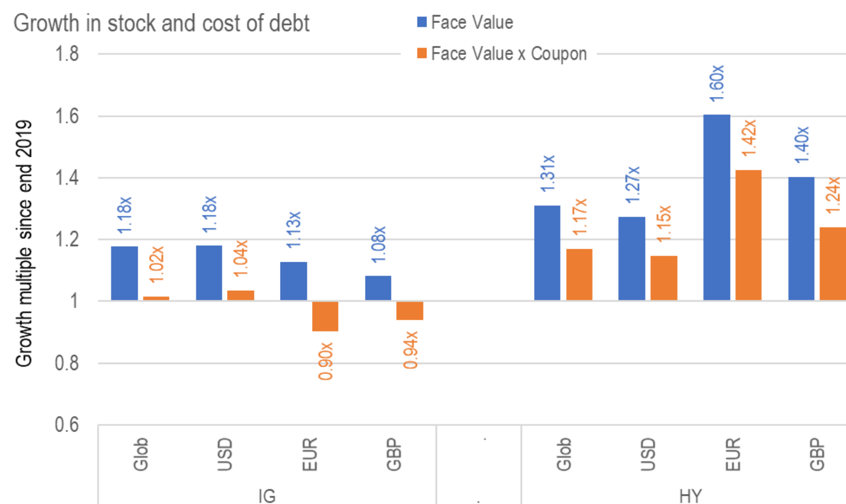
The Covid shock has brought about a material increase in corporate debt. Yet, the global policy response suppressed interest rates and so has contained the rise in the cost of servicing the higher debt stock. The credit quality cycle also offers support for a constructive view on credit in 2022. The downgrade cycle appears all but complete, after peaking at 12% of net downgrades as a share of the global IG index in late 2020. Similarly, the default cycle appears complete after peaking at just under 9% in the US and just under 5% in Europe in 2020. Both 12M realised and forecast default rates are currently running at around 2%.

Credit spreads have enjoyed their longest period of calm since the Global Financial Crisis



Source: ICE and AXA IM Research, November 2021

IG debt stock has grown by a fifth and HY by a third during the Covid crisis; debt cost by much less



Source: ICE and AXA IM Research, November 2021

Lost in transition

Equity strategy

The bottom-line wobbles

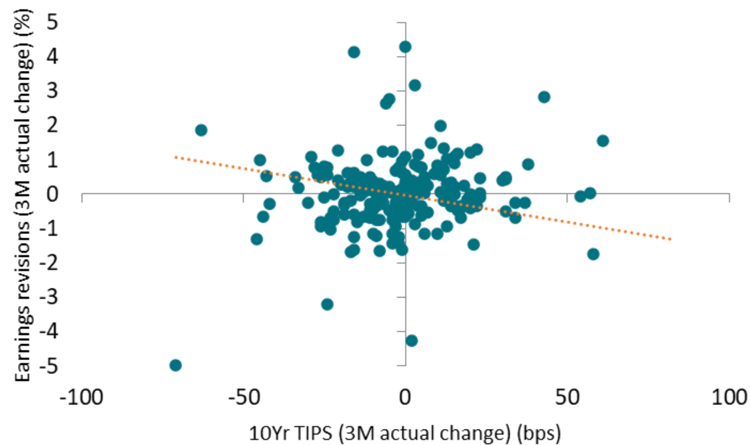
Equity investors have been well rewarded this year, as the asset class returned 21%, driven by earnings. But the strong earnings surprises experienced this year are set to diminish in 2022 as economic activity reverts to trend. Uncertainty on inflation keeps the balance of risks tipped towards rising interest rates. Companies managed to maintain historically high profit margins despite rising input costs, but this may come under threat if input cost pressures persist. Real rates may also prove a threat for stocks, as we observe that since 2004 rising 10-year TIPS yields tend to lead to lower earnings revisions.

A glimmer of sunshine in the mist

In addition to absolute valuations being stretched, the fallback argument of appealing relative valuations start to become less evident. The relative valuations gap of stocks to bonds has tightened and, next year, movements in interest rates might trigger less appetite for equities than for other asset classes. Historically, the regime of economic growth (above/below potential) seems to have made a key difference for equity performance. In 2022, our team anticipates US gross domestic product growth above potential at 3.5% yoy which should help to mitigate interest rate related headwinds for the risky asset class.

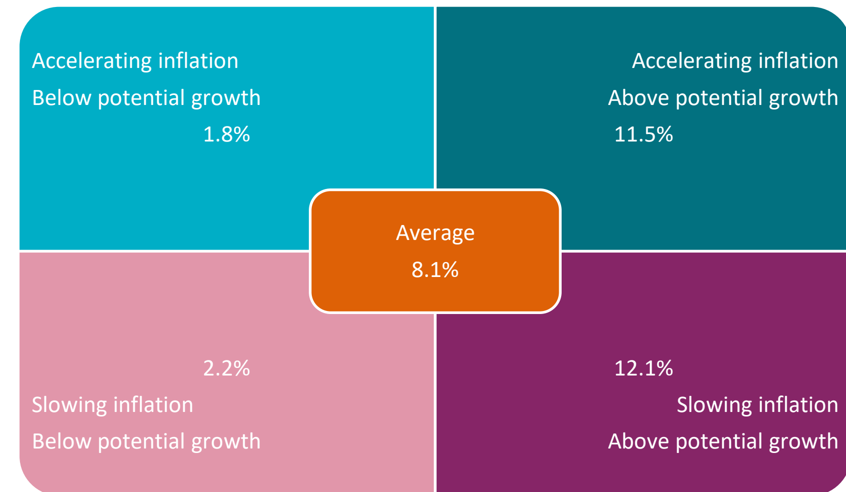
Rising real rates may penalise earnings expectations

Real rates and earnings revisions



Source: MSCI and AXA IM Research, November 2021

Strong growth should alleviate headwinds (equity returns by cycle phase)



Source: : CBO, MSCI and AXA IM Research, November 2021

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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			
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			
US		■	
Euro		■	
Credit			
Euro IG		■	
US IG		■	
Euro HY		■	
US HY		■	
EM Debt			
EM Bonds HC		■	

Legend Negative | Neutral | Positive

Change ▲ Upgrade | ▼ Downgrade

Source: AXA IM as at 23/11/2021

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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**		**4.2**		**3.6**	
Advanced economies	-5.0	**5.0**		**3.8**		**2.4**	
US	-3.4	**5.5**	5.7	**3.5**	4.1	**2.7**	–
Euro area	-6.7	**5.0**	5.1	**3.9**	4.4	**2.1**	–
Germany	-4.9	**2.6**	2.8	**3.5**	4.4	**1.9**	–
France	-8.0	**6.7**	6.1	**3.6**	3.8	**2.0**	–
Italy	-8.9	**6.2**	5.9	**3.7**	4.3	**1.9**	–
Spain	-10.8	**4.3**	5.6	**5.5**	6.1	**3.0**	–
Japan	-4.9	**1.9**	2.3	**3.5**	3.0	**1.6**	–
UK	-10.0	**6.9**	6.9	**5.2**	5.1	**2.3**	–
Switzerland	-2.5	**3.5**	3.4	**3.0**	3.1	**1.6**	–
Canada	-5.3	**4.9**	5.1	**3.5**	4.1	**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**	8.2	**5.0**	5.5	**5.3**	–
South Korea	-0.9	**4.0**	4.1	**2.6**	3.2	**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**	5.0	**1.2**	1.7	**2.0**	–
Mexico	-8.5	**6.0**	6.1	**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**	2.5	**2.0**	–
Poland	-2.7	**5.1**	5.2	**5.0**	5.1	**3.6**	–
Turkey	1.8	**9.5**	8.7	**3.6**	3.6	**3.0**	–
Other EMs	-2.4	**4.2**		**4.1**		**3.9**	

Source: Datastream, IMF and AXA IM Macro Research – As of 23 November 2021 * Forecast

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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**	**3.1**		**2.9**		**2.1**	
US	**1.2**	**4.7**	4.4	**4.1**	3.4	**2.9**	–
Euro area	**0.3**	**2.4**	2.3	**2.1**	2.0	**1.6**	–
Japan	**0.0**	**-0.2**	-0.2	**0.7**	0.5	**0.6**	–
UK	**0.9**	**2.4**	2.3	**3.8**	3.3	**1.9**	–
Switzerland	**-0.7**	**0.5**	0.5	**0.6**	0.6	**0.7**	–
Canada	**0.7**	**3.4**	3.1	**3.1**	2.7	**2.3**	–

Source: Datastream, IMF and AXA IM Macro Research – As of 23 November 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	Q4-21	Q1-22	Q2-22	Q3-22
United States - Fed	Dates	0-0.25	2-3 Nov 14-15 Dec	25-26 Jan 15-16 Mar	3-4 May 14-15 June	26-27 July 20-21 Sep
	Rates		unch (0-0.25)	unch (0-0.25)	unch (0-0.25)	unch (0-0.25)
Euro area - ECB	Dates	-0.50	28 Oct 16 Dec	20 Jan 10 Mar	14 April 9 June	21 July 8 Sep
	Rates		unch (-0.50)	unch (-0.50)	unch (-0.50)	unch (-0.50)
Japan - BoJ	Dates	-0.10	27-28 Oct 16-17 Dec	17-18 Jan 17-18 Mar	27-28 April 16-17 June	20-21 July 21-22 Sep
	Rates		unch (-0.10)	unch (-0.10)	unch (-0.10)	unch (-0.10)
UK - BoE	Dates	0.10	4 Nov 16 Dec	3 Feb 17 Mar	5 May 16 June	4 Aug 15 Sep
	Rates		+0.15 (0.25)	unch (0.25)	+0.25 (0.50)	unch (0.50)

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

Calendar of 2022 events

2021	Date	Event	Comments
November	27-28 Nov	BoJ Meeting	Unchanged (-0.1)
December	Early Dec	US debt ceiling	
	Dec	China Central Economic Work Conference	
	3 Dec	US: Continuing resolution to avoid government shutdown ends	
	14-15 Dec	FOMC Meeting (expected taper announcement)	Unchanged (0-0.25)
	15 Dec	Treasury Secretary Yellen identifies debt ceiling impact from this point	
	16 Dec	ECB Meeting	Unchanged (-0.5)
	16 Dec	BoE Meeting	Unchanged (0.1)
	16-17 Dec	BoJ Meeting	Unchanged (-0.1)
	31 Dec	LIBOR fixings discontinued	
2022	**Date**	**Event**	**Comments**
	Q3-Q4 2022	Chilean Constitutional Referendum	
January	Jan	Italian Presidential Elections	
	Jan	FOMC to commence taper (expected)	
	1 Jan	EU introduces Rules of Origin requirements	
	20 Jan	ECB Meeting	Unchanged (-0.5)
	25-26 Jan	FOMC Meeting	Unchanged (0-0.25)
	Feb	BoE Meeting	Unchanged (0.1)
	6 Feb	Costa Rican General Elections	
March	March	FOMC Meeting	Unchanged (0-0.25)
	March	China Annual National People's Congress	
	9 March	South Korea Presidential Elections	
	13 March	Colombian Legislative Elections	
	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 Jun	French Legislative Elections	
July	1 July	UK border checks on EU imports scheduled to resume	
August	Aug	US Federal Reserve Jackson Hole Symposium	
October	Oct	China's 20th National Congress- President Xi to be re-elected (expected)	
	2 Oct	Brazil General Elections	
November	8 Nov	US Midterm Elections	

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