AXA Investment Managers

Investment Institute Macroeconomics

A skip and a hop(e)

Monthly Investment Strategy

AXA IM Research

June 2023

Summary: June 2023

Theme of the month: Sovereign debt concerns

- Public debt has been rising in recent decades for most advanced economies. Low interest rates had helped governments finance this. However, as increases in short-term, policy rates have also dragged term rates higher, debt interest costs are starting to mount. We consider debt dynamics in the framework of the balance between annual deficits, interest rates and the pace of growth.
- The US has avoided a damaging confrontation over its debt ceiling. However, the longer-term path of the finances remains unsustainable.
- The Eurozone has seen success in countries that have suffered debt crisis, including Ireland, Greece and Portugal. Other countries, likely including Italy, could struggle over the coming years. This presents a challenging backdrop to revise Eurozone fiscal rules.
- The UK suffered a fiscal crisis last September. The finances have been stabilised for now, but the Chancellor faces a challenging outlook.

Macro update: Central banks hang on inflation dynamics

- In our opinion, the Federal Reserve's decision to "skip" a hike in June does not yet signal the end of the policy tightening cycle and we forecast 5.50% in July. The ECB and BoE also look set to deliver further tightening, the latter having surprised markets with a firmer 50bps rate increase recently. Outlooks for the BoC and BoJ also hang in the balance, our view for the former to see no more change and the latter a tweak to policy next month. Meanwhile central banks across EM are increasingly reaching peaks, although in the main we do not expect much easing before year-end.
- Inflation dynamics underpin this reset of rate expectations. While headline CPI has fallen back sharply in most jurisdictions (even in the lagging UK), 'core' inflation remains stickier, with many seeing labour markets now domestically generating inflation.
- Growth remains more subdued, the Eurozone now recording recession over the winter, the US expected to enter mild recession in H2 and the UK economy at risk as lagged policy transmission increasingly weighs on activity. In EM, some of the earliest hikers are now delivering much more subdued GDP growth.

Investment Strategy: risk premia so far coping with latest hawkish tilt

- FX: Risks look more symmetric for EUR from here while long positioning and relatively rich valuation also limit upside. Shorting CHF might be an interesting proxy to position for EUR downside. JPY potential for a rebound as foreign rates peak-out remains high. GBP's fate is harder to read.
- Rates: US monetary policy anticipation has re-priced materially in the aftermath of the banking shock as markets have moved from a widespread banking crisis to a non-systemic event. The yield curve is skewed towards a recession scenario, while risky assets are skewed towards a soft-or no-landing scenario.
- Credit: Risk appetite across global credit markets including EM has staged a strong recovery in the past month. This broader tone may be a bit complacent and thus merits caution. Mean reversion indicates spread widening over 3M or 12M and decompression in HY vs IG, consistent with recession risk.
- Equities: Market performance in 2023 is mainly attributable to a rebound in multiples as real interest rates appear capped at February's highs In a backdrop of activity slowdown, we favour European quality stocks which benefit from a valuation advantage and tend to outperform amid lower growth.

Central scenario

Summary – Key messages

Our central scenario: Global economy to slow, bank concerns non-systemic.

We forecast global growth to slow to 2.7% in 2023 and 2.8% in 2024.

Headline inflation to slow, more resilient growth to keep core firmer. Central banks tighter for longer.

Inflation

Headline inflation to fall to mid-year. Core disinflation slower as labour markets remain tight. Inflation persistence is now key risk.

Monetary policy

Most central banks close to peak, but Fed, ECB and BoE with further to go. Rate cuts unlikely in 2023 outside some EM.

Growth

Growth better than feared, but subdued in DM. Mild recession expected in US with weaker Q2. Europe likely persists at subdued pace. Credit conditions add to headwinds.

Fiscal policy

Europe has provided fiscal support, but consolidation increasingly the outlook. US debt ceiling leaves longer-run outlook unsustainable.

Emerging Markets

Inflation should ease across EM. Central banks increasingly at peaks, some add FX intervention. Global rate adjustments add to fragile finances

Rates

Longer-term rates rise as short-term policy rate views grow more hawkish. But peak policy points to peak term rates soon.

FX

Euro risks more two-way. BoJ action should underpin yen recovery from weak levels. Sterling overpriced on rate outlook, but risks on reversal timing.

Credit

Unappealing risk/reward in spreads still warrants a prudent stance. HY screens low on default valuation & mean reversion while Europe IG spreads screen better.

Equities

Earnings expectations are key for 2023 returns. A strong start to the year may create complacency amid central banks hawkishness and macro headwinds. Margin pressures at play due to wages.

Alternative scenarios

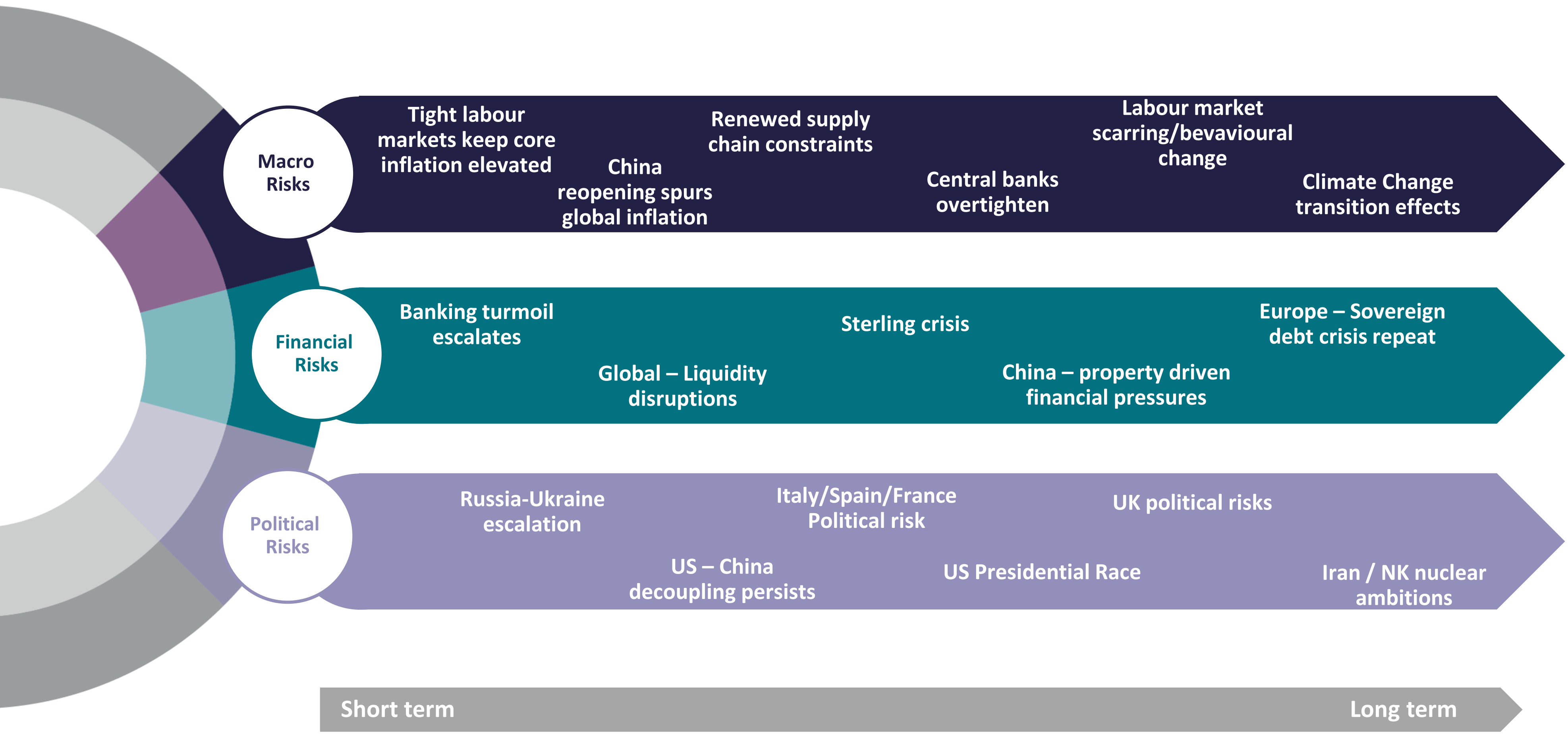
Summary – Key messages

	Entrenched supply shock Probability 25%		A global boost Probability 10%

Entrenched supply shock (Probability 25%)		A global boost (Probability 10%)
- Banking turmoil escalates, credit conditions tighten. - Escalation in Ukraine conflict - COVID outbreaks spreads again: China and/or new mutations - Post-pandemic structural persist. Supply shocks last longer - Inflation expectations rise, affecting wages and persistence	What could be different?	- Geo-political tensions ease – peace in our time. - Labour market participation recovers, strong income growth and easing inflation pressures - Productivity boost following investment rebound and structural post-pandemic adjustments
- Growth weaker, employment could start to fall, but inflation remains elevated - Monetary policy ill-equipped to deal with supply shocks and financial instability, deteriorating inflation credibility forces still tighter policy in DMs	What it means	- Growth surprises on the upside in most regions - Inflation fades more quickly towards and below central bank targets - Monetary policy softens quicker than signalled
- Risk appetite deteriorates / equities sell off / credit widens - Sovereign yields reprice higher - Dollar remains elevated - EM debt to come under pressure	Market implications	- Risk-on environment, equities make further gains, growth retains lead over value - UST softens, EUR strengthens - Spreads grind tighter

RISk Radar

Summary – Key messages



Contents

Theme of the Month

Investment Managers

Sovereign debt concerns

Debt (as % GDP) has been on a rising trend in many advanced economies

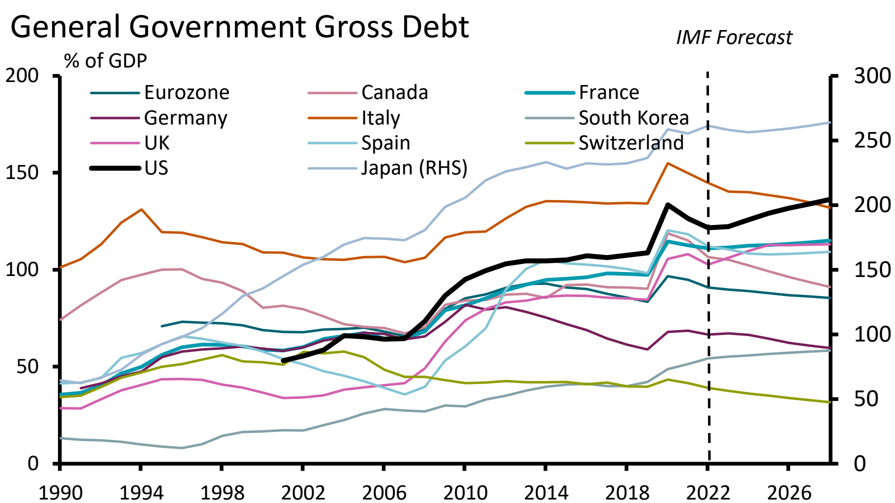
Debt on a rising trend

- Sovereign debt has been on a rising trend for much of the past 40 years in most advanced economies. This has been the result of specific events: recessions, wars, the financial crisis and the pandemic. It has also been reflective of secular trends including ageing populations and rising healthcare expenditure. It has reflected policy decisions – including both tax cutting agendas and both increased public spending and ill-timed spending cuts. Moreover, this trend has evolved – until recently – against a backdrop of falling interest rates. The test for sovereign debt now comes against a sharp rise in government borrowing rates.

Recent inflation burst has reduced debt in the short run

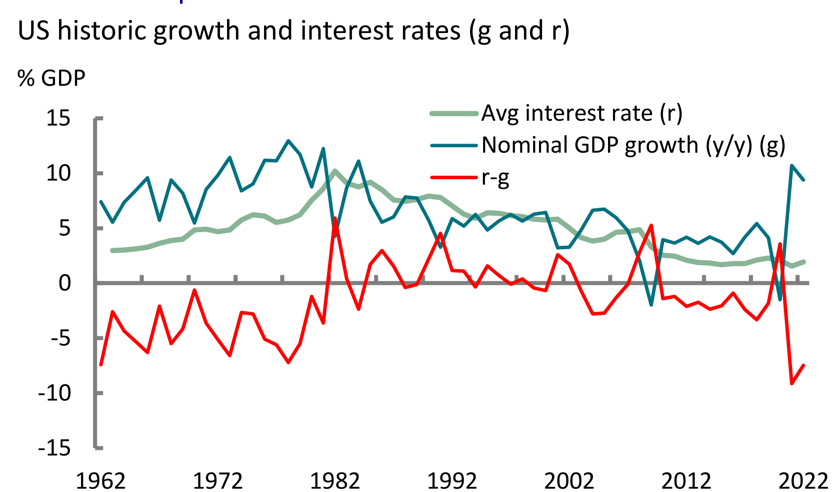
- Despite the recent surge in public spending and borrowing as a result of the pandemic, debt as a proportion of GDP has fallen. That reflects the sharp rise in nominal GDP growth, which has risen by more than borrowing, in turn reflecting the impact of unanticipated inflation. With inflation now having an inevitable impact on interest rates, future debt levels are expected to rise.

Sovereign debt has been on a rising trend



Source: IMF, June 2023

The balance of growth (g) and interest rates (r) determines the evolution of past debt



Source: CBO, AXA IM Research, June 2023

Sovereign debt concerns

Basic principles

If r < g primary borrowing can be positive without raising debt

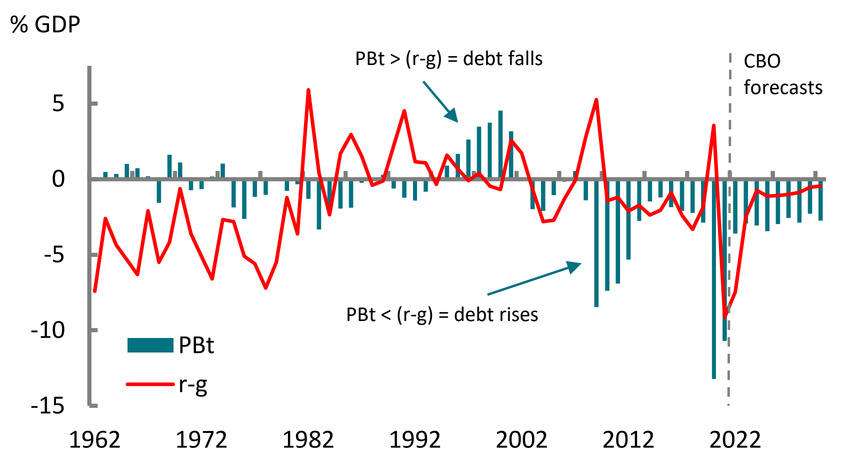
- In terms of debt as a proportion of GDP, the dynamics are driven by the balance of the pace of growth of the debt stock, the interest rate, r, and the pace of economic growth (in nominal terms), g. If r > g, the debt stock rises, but if r < g it will fall. The balance of r-g has changed over time and varies between economies. For the US (below) over the last 60 years, the first 20 years saw g exceed r, the next 20 saw the reverse, and over the most recent 20 years, growth has again exceeded interest rates.

The balance of primary deficits and r-g determines the debt outlook

- This balance between r and g determines the amount of additional borrowing a government can undertake. If the primary balance (public deficits excluding debt interest payments), PBt, exceeds (r-g) then debt will fall, if not it will rise. This means that during periods when growth exceeds interest rates, governments can run primary deficits and the proportion of debt to GDP can still fall. It also suggests that if there are limits to primary surpluses – points of "fiscal fatigue" – there are associated limits to the level of debt.

(r-g) dynamic can create space for current borrowing

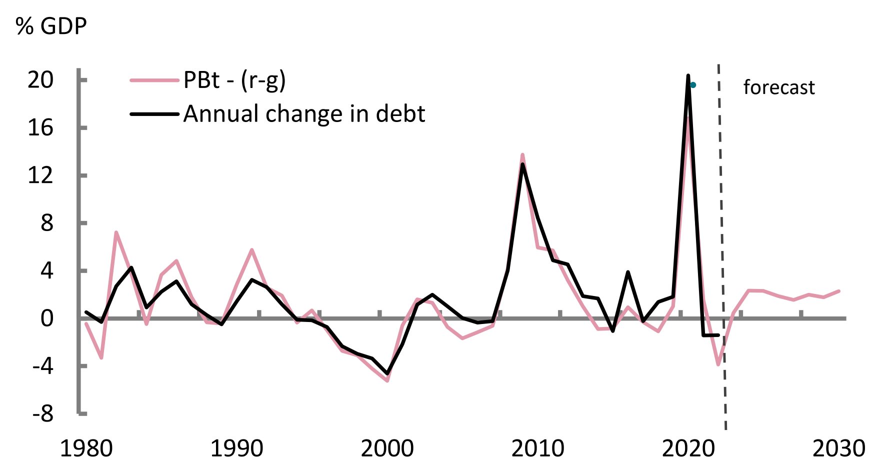
Historic r-g and the primary balance (PBt)



Source: CBO, AXA IM Research, June 2023

Current borrowing and past debt evolution determine total debt

Change in US debt and PBt - (r-g) formulation



Source: CBO, AXA IM Research, June 2023

Sovereign debt concerns

US longer term unsustainable path

US deficits exceed space we anticipate from r-g

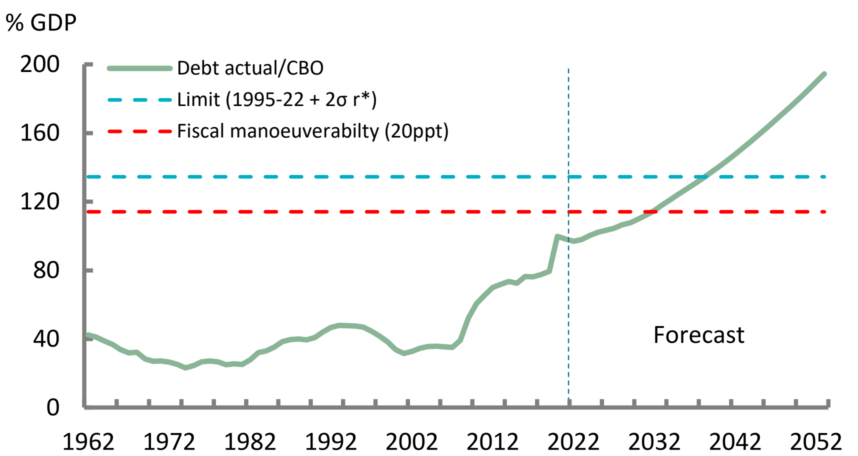
- Despite an expectation that in the US growth should exceed interest rates over the coming years, the current projected fiscal shortfalls are so large that debt is still projected to rise. The Congressional Budget Office's long term projections see the US economy on an unsustainable debt path over the long-term. Indeed, the CBO projections exceed the "limits" to borrowing suggested by our framework, based on historic rates of growth and rates – albeit several years from hence.

2023 debt ceiling episode has not resolved longer-term issues

- The latest debt ceiling episode was the latest attempt to address the US debt outlook. We argued that the threat of voluntary default was not an appropriate vehicle to address the US's debt problem. Indeed the passage of the Fiscal Responsibility Act, which pushed the debt ceiling restriction out to 2025, imposed only marginal fiscal tightening. This has barely altered the deficit outlook over coming years. It has left the US still to address its unsustainable fiscal path.

Sovereign debt has been on a rising trend

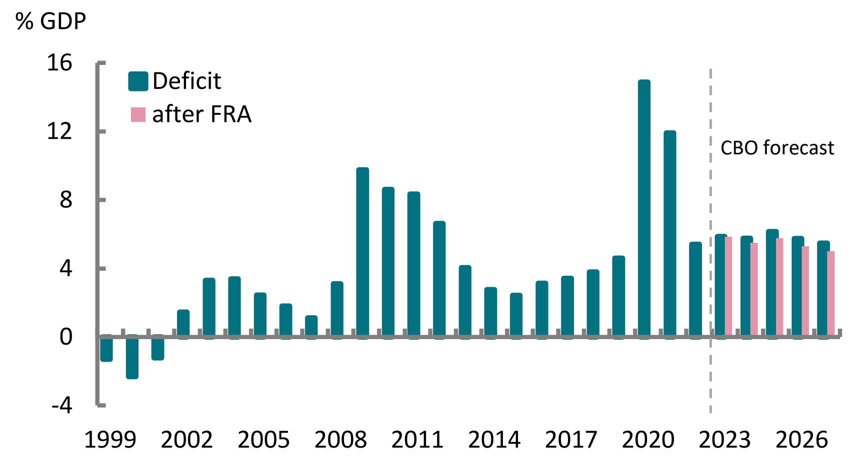
US debt and illustrative debt limits



Source: CBO, AXA IM Research, May 2023

Debt ceiling resolution did little to resolve long-run problems

US Federal Government deficit



Source: CBO, AXA IM Research, June 2023

Sovereign debt concerns

Euro area: fiscal rules that work for all

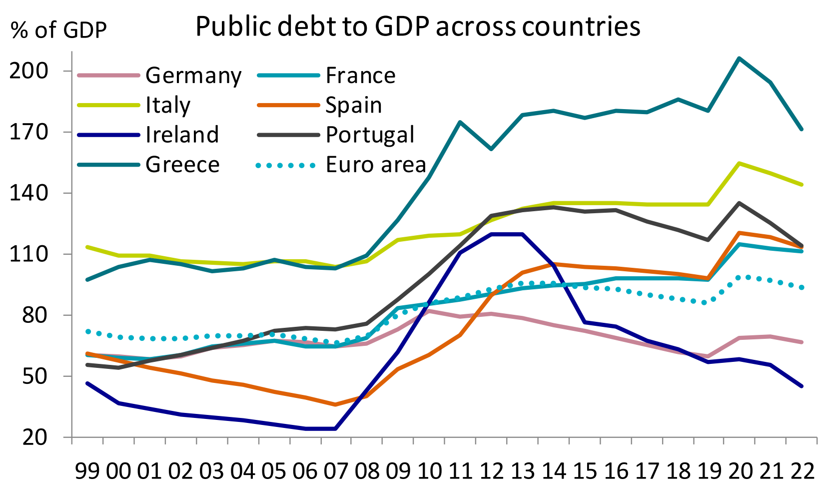
A diverging picture…

- Eurozone public debt-to-GDP ratio has dropped 6ppt to 93.2% in 2022 since its peak in 2020. While a feature shared across countries, very differentiated debt profiles are mainly a result of different nominal growth performance.
- Significant adjustment has taken place in old "peripheral" countries, especially Ireland, Portugal and Greece. Italy still requires a significant effort ahead. Other countries, including France and Belgium, may also come under enhanced scrutiny.

…to be reflected in differentiated fiscal efforts across countries

- Euro area fiscal rules have long been deemed too complicated, opaque and pro-cyclical. While there is broad agreement on EC proposals, significant differences remain essentially on the required debt-to-GDP adjustment paths for high debt countries.
- While a final agreement would ideally be struck ahead of 2024 draft budget presentations (mid-Sept. to mid-Oct.), it will not be an easy path to ratification before EU parliament goes into recess next February (ahead of the EU elections next year).

Wide divergence in public debt trajectories…



Source: Eurostat, AXA IM Research, June 2023

Future euro area fiscal rules in short

Key pillars	In details
National medium-term fiscal & structural plans	Member states to submit four-year plans setting 1) fiscal adjustment path, 2) reforms, 3) public investment commitments which can be extended to seven years.
Fiscal adjustment based on simpler and more transparent rules	Multi-year simple net primary expenditure* target, consistent with public debt reduction and a fiscal deficit below 3% at the end of period. For member states above SGP criteria, EC is to issue DSA. Debt to be on a downward trajectory and deficit reduction has to be more than 0.5% of GDP per year as long it remains above 3%.
New minimum standards for independence and technical capacity for national independent fiscal institutions	Enhanced role for national fiscal councils.
Better enforcement	EDP is: - unchanged for public deficit above 3%. - amended for when debt is above 60%, when there is deviation to multi-year expenditure target (rather than the 1/20th reduction). Escalation to be quicker, and financial sanctions less punitive.

*Source: EC, AXA IM Research. * net primary expenditure would excude (1) discretionary revenue measures, (2) interest expenditures, (3) cyclical unemployment expenditures*

Sovereign debt concerns

Public debt dynamics: contrasting old "periphery" and new challenges

A closer look at "periphery" – old and new

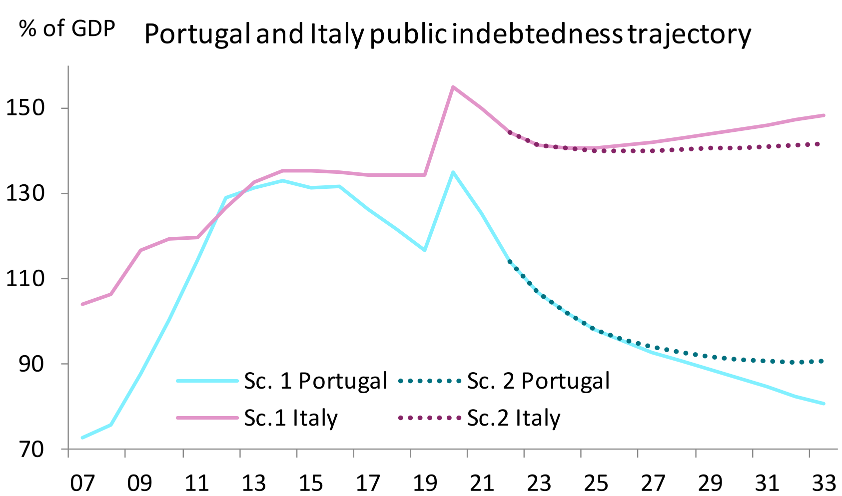
- After the European Debt Crisis, Portugal converged towards a very similar public debt-to-GDP ratio as Italy, slightly above 130%.
- Significant macro and fiscal adjustment, hand-in-hand with a stable political backdrop, has put Portugal on a significantly improved trajectory to 2022, thanks to strong nominal growth, but it is also one of the few countries to already yield a primary surplus in 2022.

Comparing public debt sustainability scenarios

Italy
- Scenario 1: Cautious real growth assumption (0.6%) and a primary surplus stabilised at c.1.5% would not be enough to stabilise public debt dynamics by 2033.
- Scenario 2: A significantly better growth (1.0%) and similar primary balance would just about stabilise public debt dynamics.

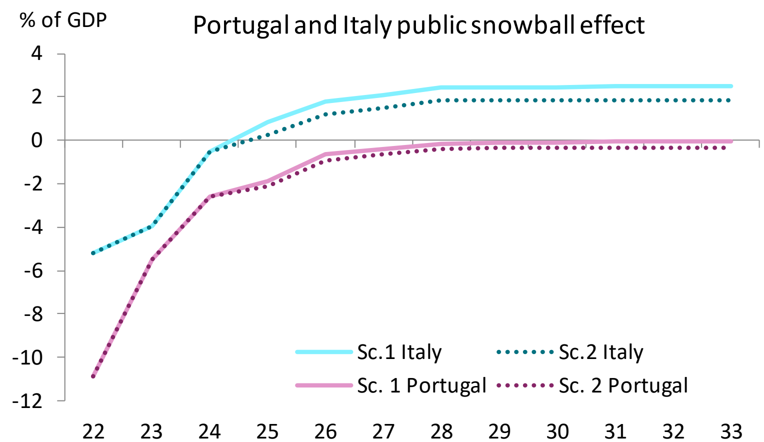
Portugal
- Scenario 1: Cautious real growth (1.2%) and little additional fiscal consolidation effort: primary balance stable at 2.0% throughout 2033.
- Scenario 2: More optimistic growth (1.5%), in part fuelled by looser fiscal policy (primary balance edging down to a deficit in 2033).

Italy and Portugal: likely diverging public debt dynamics ....



Source: Eurostat, AXA IM Research, June 2023

…'snowball' effect confirming Italy more at risk than Portugal



Source: Eurostat, AXA IM Research, June 2023

Sovereign debt concerns

UK – little room for fiscal manoeuvre

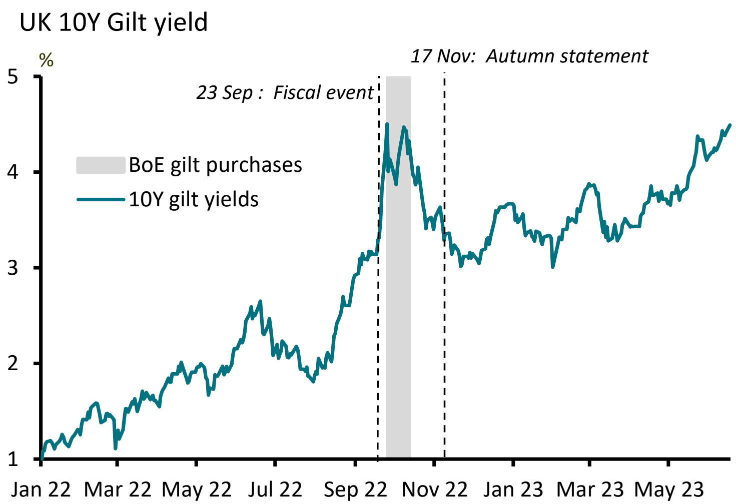
Liz Truss and Lost Trust

- The UK has already had one brush with financial instability as the Truss government's adventure into ideological economics saw investors lose confidence. More recently gilt yields have increased again as fears of inflation persistence have risen. While the increases this time around are less dysfunctional – importantly accompanied by a strengthening in sterling – we believe UK public finances will continue to come under the microscope as government borrowing costs remain elevated.

UK experience fits with our methodological framework

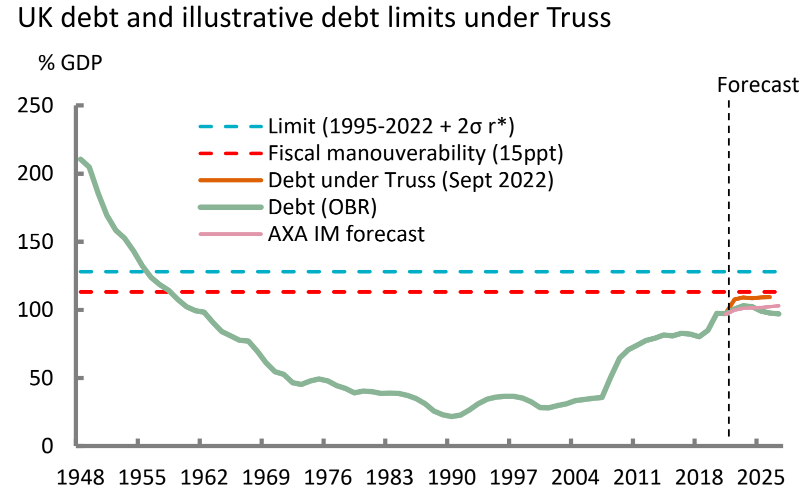
- The UK's experience (late 1990s) leads us to consider a 2.3% primary surplus as a point of fiscal fatigue. Based on these historic readings, the debt profile implied by Truss's policies brought UK borrowing close to estimated borrowing limits.
- Looking ahead, the UK faces the risks of a higher global r* and the reality of lower g following the Brexit impact and other post-COVID developments. Taken together this suggests the government faces challenging choices to deliver fiscal sustainability and the space for tax giveaways is limited.

UK 1-year gilt yields and the summer of Truss now



Source: Refinitiv, AXA IM Research, Jun 2023

UK r-g debt limits



Source: OBR, AXA IM Research, Jun 2023

Macro outlook

Slowing economy

US

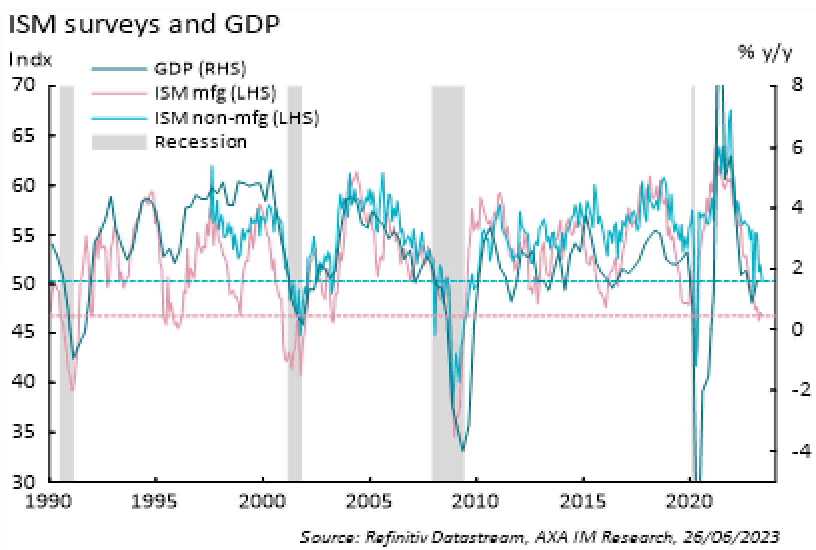
Mixed messages

- The economy continues to post mixed messages on activity adding to uncertainty about any underlying deceleration. Survey evidence has been highly volatile, labour market indicators point in a bewildering range of directions and consumer spending figures are prone to reversal and revision. We broadly characterise the more backward-looking data as resilient – including labour market activity – and more forward-looking data – including surveys as having been amongst the weaker.

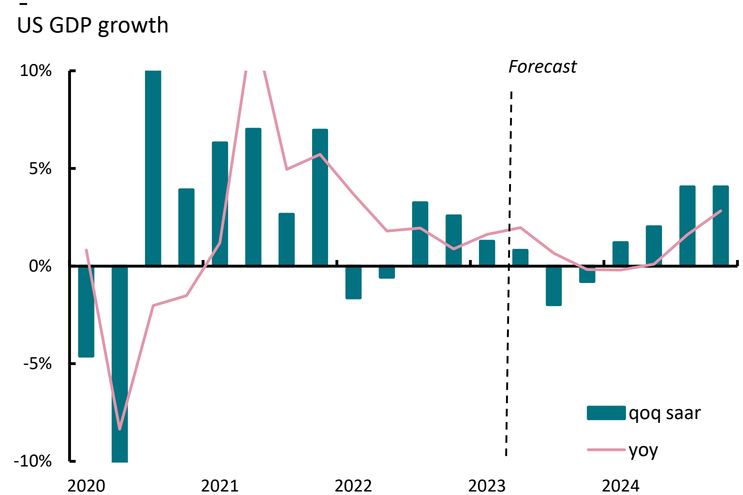
Recession still likely

- Top level dynamics, including the evolution of credit dynamics, remain consistent with recession. We retain our outlook of a mild recession – on a par with the early 1970s or 2000s. We forecast the first contraction in Q3 – although a drop in Q2 remains possible – and see H2 2023 as a period of recession, with recovery in 2024. Indeed, exacerbated by the inventory cycle, we now lift our expectations for end 2024 and forecast GDP growth to average 1.0% in 2023 and 2024 (vs consensus expectations for 1.3% and 0.8%).

Forward looking surveys indicate recession risks



We expect contraction in Q3, but a risk for Q2



Source: BEA, AXA IM Research, June 2023

Fed struggles to tighten financial conditions

US

Core inflation to increasingly soften

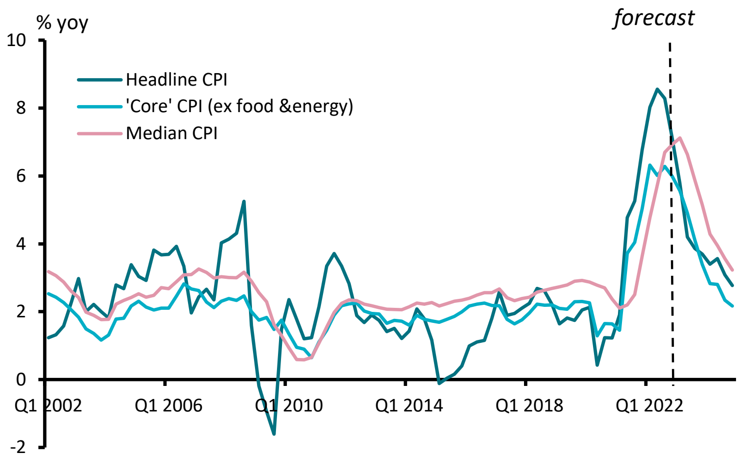
- Headline inflation has fallen to 4% and we expect it to settle into a range of 3-3.5% for the rest of this year. Underlying inflation has been slower to fall. Core inflation has dropped to 5.3% from its 6.6% peak, but measures of median inflation remain elevated. The coming months look set to deliver stronger evidence of disinflation in underlying measures. We forecast inflation to end this year at 3.25% (headline) and 3.75% (core). We forecast average inflation at 4.2% and 3.0% this year and next (consensus 4.1% and 2.6%).

Doubts about two hikes

- The Fed left rates unchanged in June, but indicated a "skip" – connotating a hike to come – rather than a pause. Indeed the Fed's projections suggested two further rate hikes to 5.75% by year-end. We expect greater evidence of economic deceleration to dissuade the Fed from two hikes, but believe the Fed is ready to raise rates to 5.50% at its next meeting. The broader market has taken more persuading of even one more hike. We still consider cuts off the agenda until next year.

Core inflation has been slower to ease

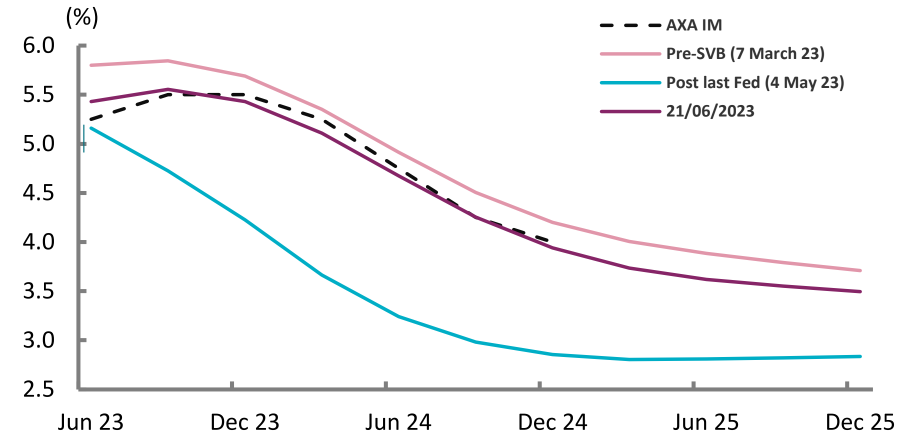
CPI Inflation measures



Source: Cleveland Fed, Refinitiv, AXA IM Research, June 2023

Scepticism over latest Fed outlook

Market expectations of Fed policy (SOFR futures)



Source: Bloomberg, AXA IM Research, June 2023

Stagflation outlook is confirmed

Euro area

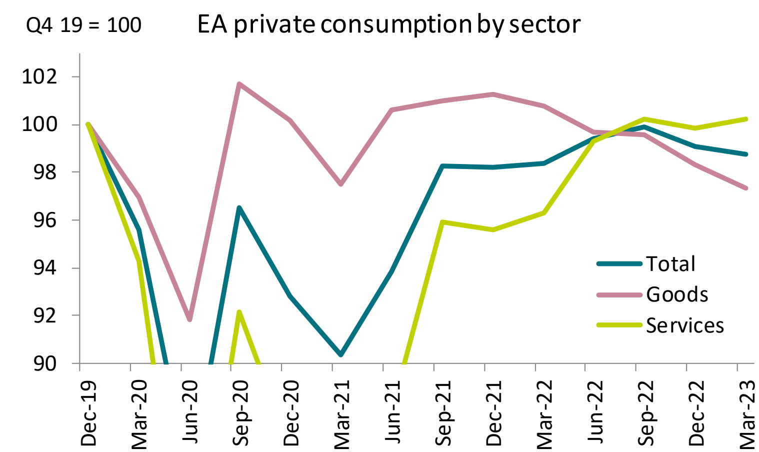
Multi-faceted winter recession

- The eurozone eventually recorded a technical recession during the winter. Private consumption dropped a cumulative 1.3%, mainly a result of a real disposable income squeeze and constraints on energy consumption. More structural behaviour changing trends may also be at play.

Muted growth outlook continues

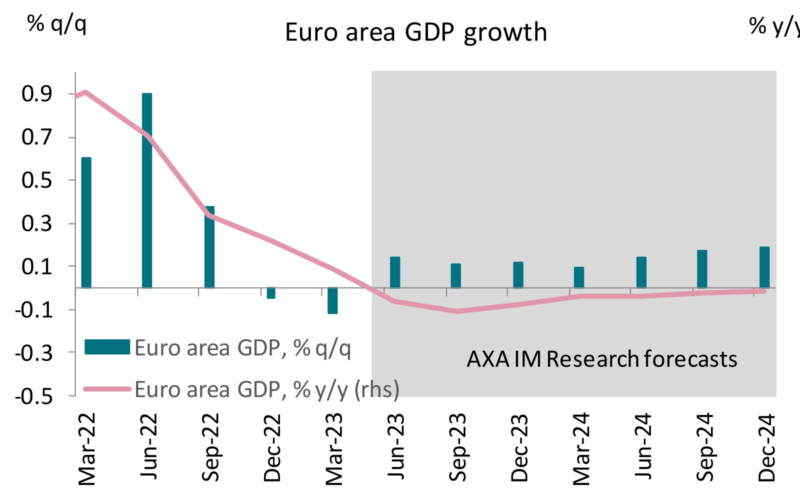
- The sizeable fall in headline inflation, fiscal stimulus and accelerating wages will likely support growth by the end of this year. In turn, we do not think expect the technical recession to continue, projecting 0.1% q/q GDP growth for the remainder of the year, consistent with 0.4% GDP growth on average this year, just below consensus (0.6%). We flag upside risks to this year's forecasts.
- For 2024, we remain concerned by the simultaneous tightening of fiscal policy and lagged effect of monetary policy, consistent with downside risks to our muted +0.1% q/q on average, yielding 0.5% on average (consensus: 1.0%).

Multi-faceted drop in private consumption



Source: Refinitiv, AXA IM Research, June 2023

A muted growth outlook



Source: Refinitiv, AXA IM Research, June 2023

ECB: Hawkish tone continues with increased data dependence

Euro area

An inflationary labour market

- The ECB "only" pre-committed to a July hike amid an uncertain macro outlook, and possibly low confidence in forecasts coming from the Eurosystem.
- Wages are now "the major" driver of inflation. Given expected strong services demand and continued robust labour markets, pay growth is likely to accelerate further in the short-term. Changing expectations of unit labour costs were a key element to core inflation forecast revisions, a reflection of more persistent inflation expectations.

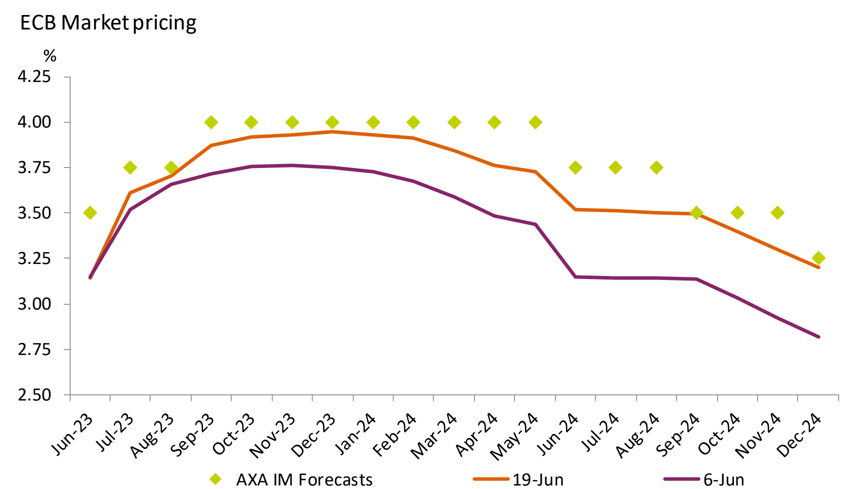
We add 25bps to our baseline, now projecting ECB peak rate at 4.0% in September.

- We have more confidence in our core inflation forecasts suggesting it will hover between 5.5-5.7% until July, higher than the current 5.3% y/y. By September's meeting, the ECB will have data up to August, insufficient evidence of a marked slowdown.
- Negotiated wage growth surged 0.9pp to 4.3% y/y in Q1 23, and we project that the peak is still ahead (though not far).

Wages growth peak is near, deceleration too slow for comfort

Source: ECB, Refinitiv, AXA IM, June 2023

ECB: destination 4%



Source: Bloomberg, AXA IM Research, as of 20 June 2023

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Labour market tight, inflation remains hot

UK

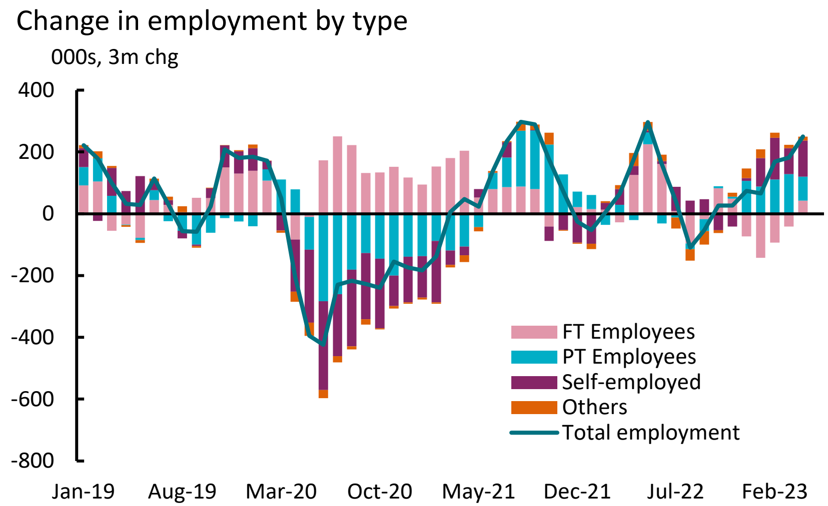
Labour market remains tight, but maybe not strong

- Unemployment declined unexpectedly in April as strong employment growth offset increases in labour market activity. Whilst employment growth remains elevated, rising by 250k over the quarter in April, this strength has increasingly been driven by self-employment and part-time employees – questioning the strength of the jobs market. Other measures such as vacancies and employment surveys e.g. KPMG/REC, continue to signal declines in the demand for labour.

Price pressures show few signs of abating

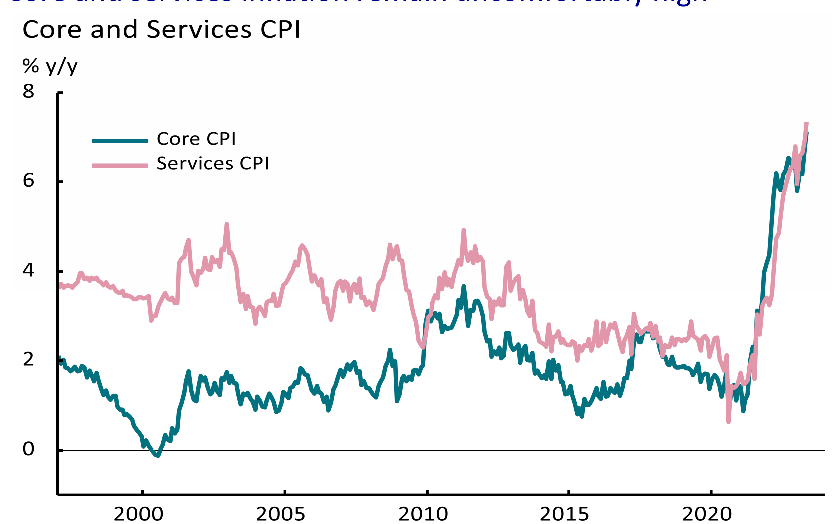
- Inflation also remains elevated. In May, headline inflation remained at 8.7% above expectations for a decline to 8.5%. Core CPI inflation rose to 7.1% and services CPI to 7.4%. We think core is likely to stay around its current levels for the next quarter, declining to around 6% only by year end. We now expect CPI inflation to average 7.1% this year and 2.5% next year (6.6% and 2.3% prior).

Employment strong, but self and PT employment buoying figures



Source: ONS, AXA IM Research, June 2023

Core and services inflation remain uncomfortably high



Source: Refinitiv Datastream, AXA IM Research, 21/06/2023

BoE delivers larger-than-expected June hike to anchor inflation expectations

UK

Fears of inflation persistence push Bank Rate higher

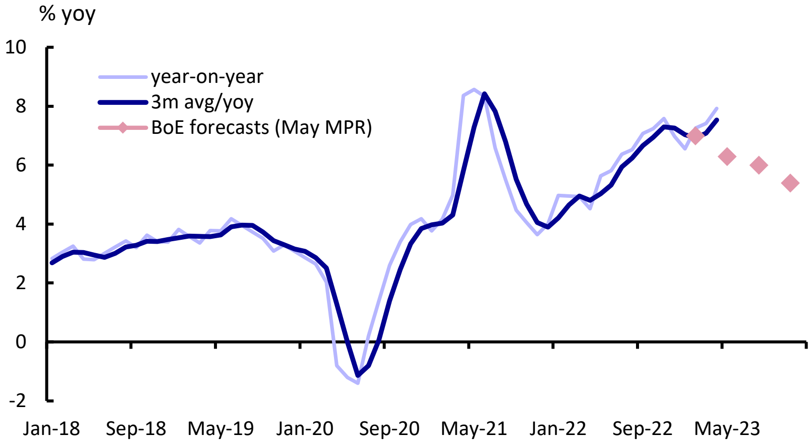
- The BoE's assessment of inflation persistence is focused on three key indicators: Labour market tightness, services CPI and private sector wages. Based on all these metrics, the recent data flow has surprised to the upside, stoking fears of inflation persistence and convincing the BoE of the need to go further to deliver price stability.

Expect further hike in August, but markets see further risks

- We expect one additional hike in August after June's surprise 50bp increase – bringing Bank Rate to 5.25%. Markets price a peak Bank Rate of 6%, but now see that peak earlier than before the June meeting. The labour market is likely to slow more materially this summer allowing the BoE pause, while the BoE will consider the lagged impacts of monetary tightening – the delayed mortgage hit – as it judges how much further to tighten policy. We continue to expect rate increases to end sooner than markets currently suggest. And expect the Bank to be able to ease monetary policy across 2024, bringing policy to 4.25% by end-2024.

Wages on a higher path than BoE expected in May

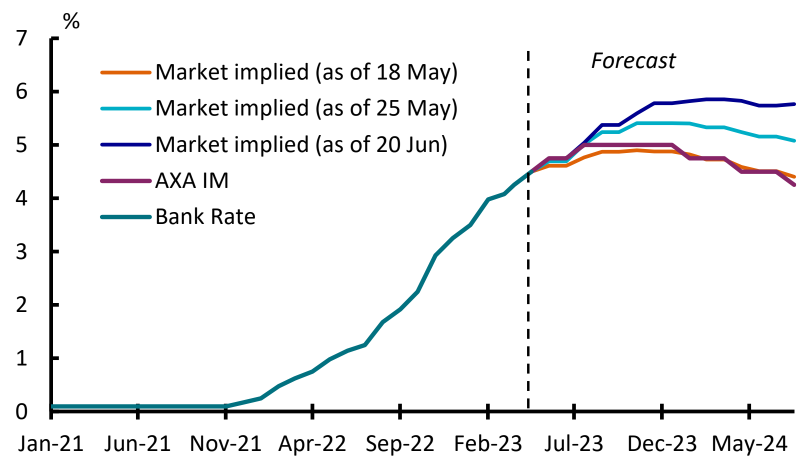
Private sector regular wages and BoE forecasts



Source: ONS, BoE, AXA IM Research, June 2023

Markets expect rates higher for longer

BoE Bank Rate outlook



Source: Refinitv, BoE, AXA IM Research, June 2023

Wage growth disappoints

Japan

Price pressures remain strong

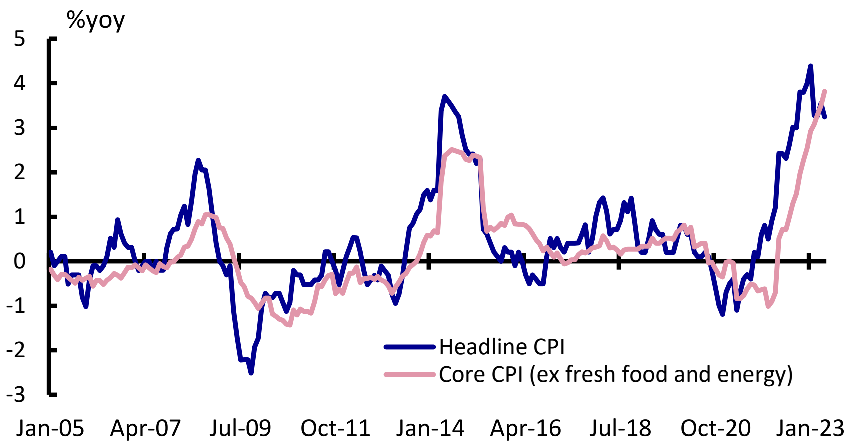
- Headline CPI continues to moderate in Japan as energy base effects unwind. However, the core measure continues to pick up, above market expectations reflecting a broadening in inflation pressures. Core CPI (ex fresh food and energy) rose by 4.3% up from 4.1% in April. The increase was driven by an uptick in non-durable goods and core foods.

Wage growth not yet reflecting Shunto gains

- April's wage figures surprised to the downside, reporting that scheduled cash earnings (base pay) increased by 1.1% compared to expectations of a 1.8% rise. By April, historically 40-50% of firms who participate in Shunto have implemented their hikes, so following a 2.1% hike in base pay, markets had expected wage numbers to follow. May's numbers will be watched closely for any catch-up, but if this does not occur, doubts about the reliability of the Shunto readings may grow.

Core CPI continues to edge higher

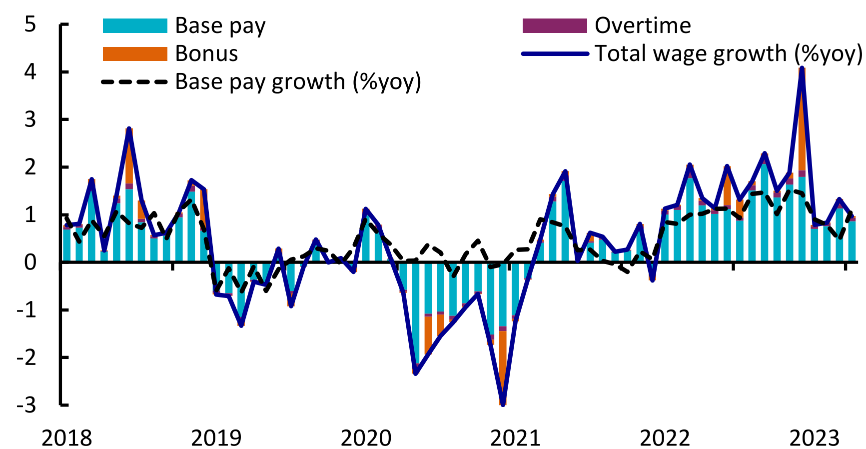
CPI - Contributions



Source: Statistics Bureau of Japan, AXA IM Research, June 2023

April wages not yet reflecting Shunto gains

Contributions to yoy growth in nominal wages



Source: MHLW, Refinitiv , AXA IM Research, June 2023

Rising inflation to keep pressure on BoJ

Japan

Yen weakness could see intervention

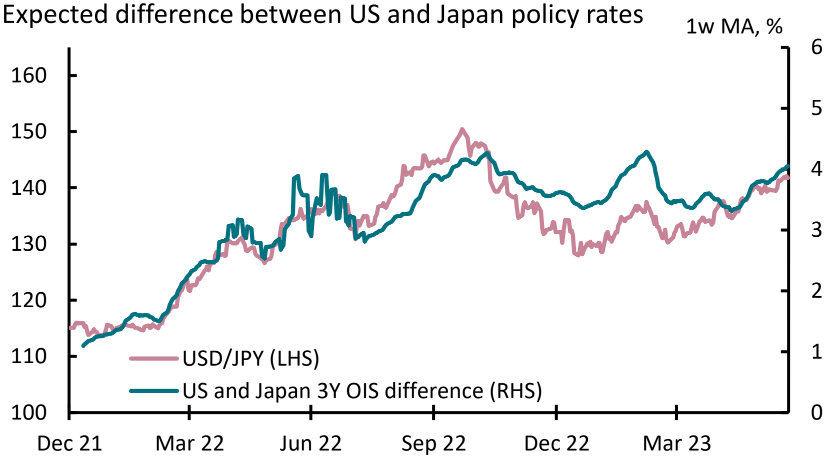
- The yen has continued to weaken as the monetary policy gap between Japan and other markets widens. The yen slid to 143 yen per dollar, close to the 146 per dollar level that saw the government intervene in FX markets last September. The yen could move towards levels which could provoke intervention again the in coming days and weeks.

Data holds key to June move from BoJ

- At the BoJ's June meeting, it kept all policy tools unchanged in line with our expectations. We continue to expect the BoJ to adjust its policy of YCC in July, most likely lowering its tenor of target to five years. We think key data releases between now and June will be central to this namely: June Tokyo CPI, Q2 BoJ Tankan survey and May wages. We suspect that continued strength in these releases will give the BoJ confidence to adjust its policy.

Yen falls close to September 2022 intervention levels

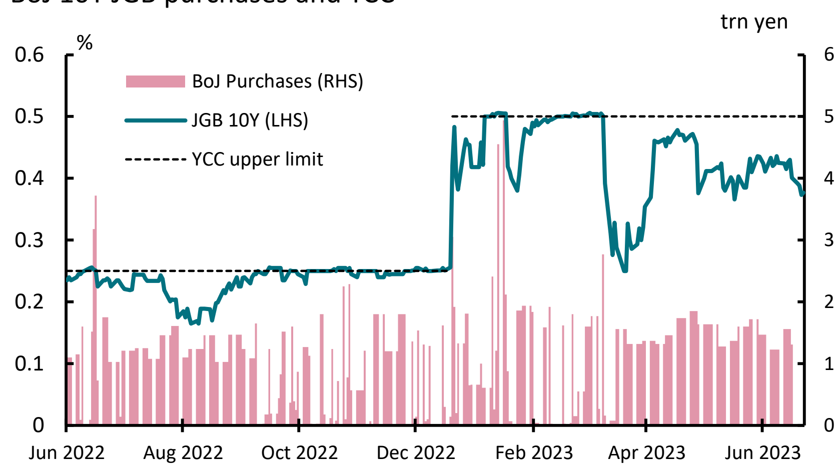
Expected difference between US and Japan policy rates



Source: Refinitiv, AXA IM Research, June 2023

Pressure on YCC has eased

BoJ 10Y JGB purchases and YCC



Source: Refinitiv, BoJ, AXA IM Research, June 2023

Canada started 2023 much stronger than expected

Canada

Coming off a strong Q1

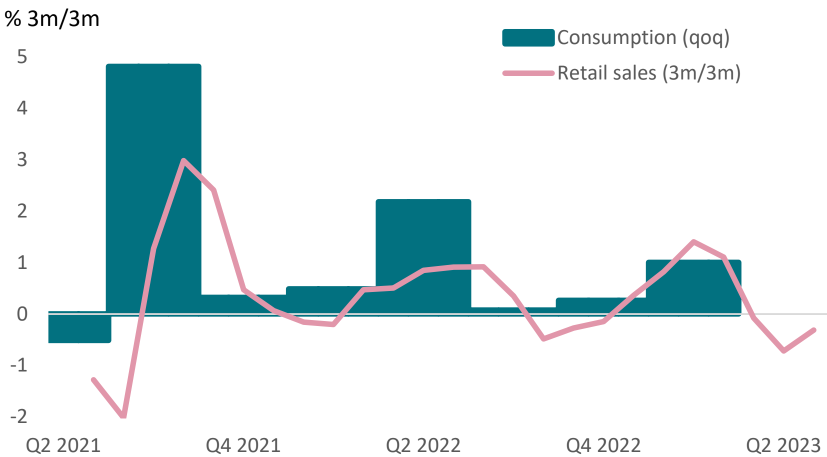
- GDP surprised to the upside in Q1, rising by 3.1% (annualised). This was underpinned by a strong 5.6% rise in household consumption. Q2 looks more subdued. While solid in nominal terms, April's retail sales volumes rose by just 0.3% after steep drops in the preceding months. If repeated in May and June, retail sales will fall on the quarter. Consumption looks likely to slow to around flat. And we expect weaker growth in Q2. We forecast GDP at 1.2% for 2023 and 1.0% for 2024 (consensus 1.0% for both).

Threats of persistent inflation

- CPI inflation surprised to the upside in April, rising to 4.4%, with core measures softening to 4.2%. Admittedly, the latest print recorded a steep drop in headline to 3.4% and core below 4.0%. Yet, this remains somewhat higher than the BoC had expected. With signs of housing stabilisation, a tight labour market and resilient growth to date, the Bank of Canada remains concerned that disinflation could be slower. We forecast inflation to average 3.9% this year, but still 3.0% next (consensus 3.7% and 2.4%).

Retail sales suggest softening consumer spending

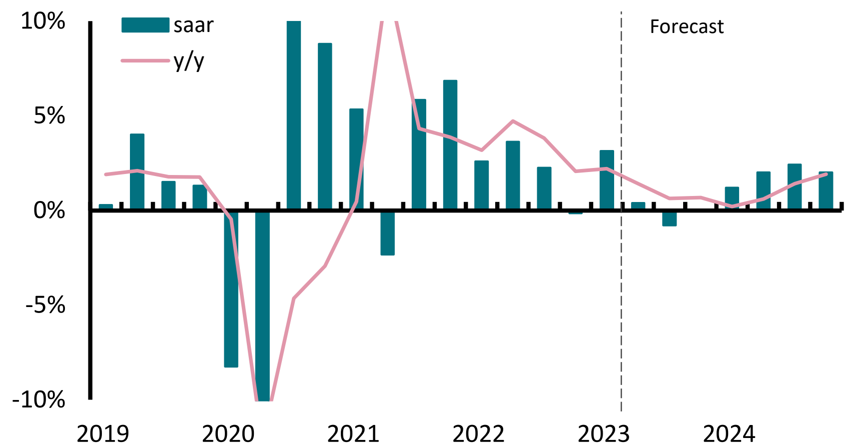
Consumer spending and retail sales



Source: CANSIM, AXA IM Research, June 2023

Expect material weakening over the rest of the year

GDP Growth and outlook



Source: CANSIM, AXA IM Research, June 2023

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Accounting for structural factors

Canada

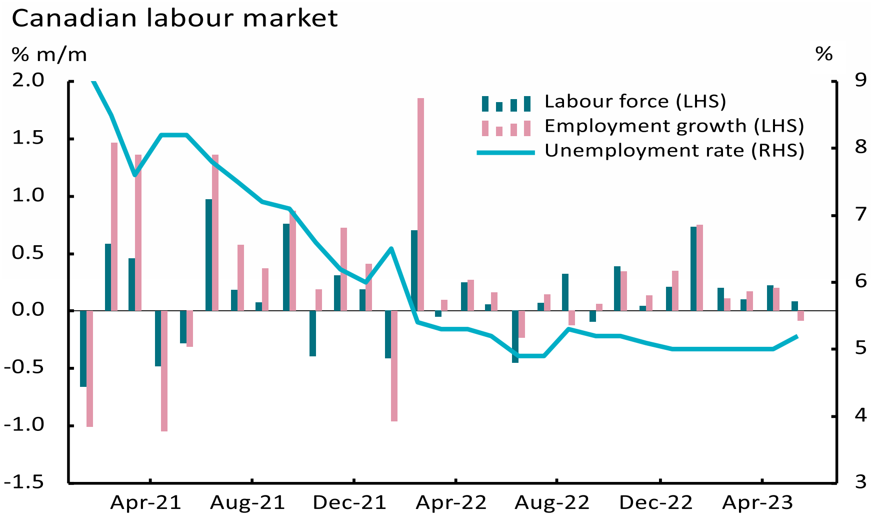
Strong immigration boosts labour supply

- Employment fell by 17k in May, its first drop in 9 months, while full-time employment fell by 33k, it second successive contraction- the first signs of loosening in the labour market. Yet at the same time, the labour force rose by 17k. This is part of a 1m boost to Canada's population in 2022 alone. Strong immigration should help ease labour market pressures – indeed unemployment rose to 5.2%. While this should be broadly disinflationary, a rising population is adding to inflationary pressures in some sectors.

Judging structural adjustments, wary of excess demand

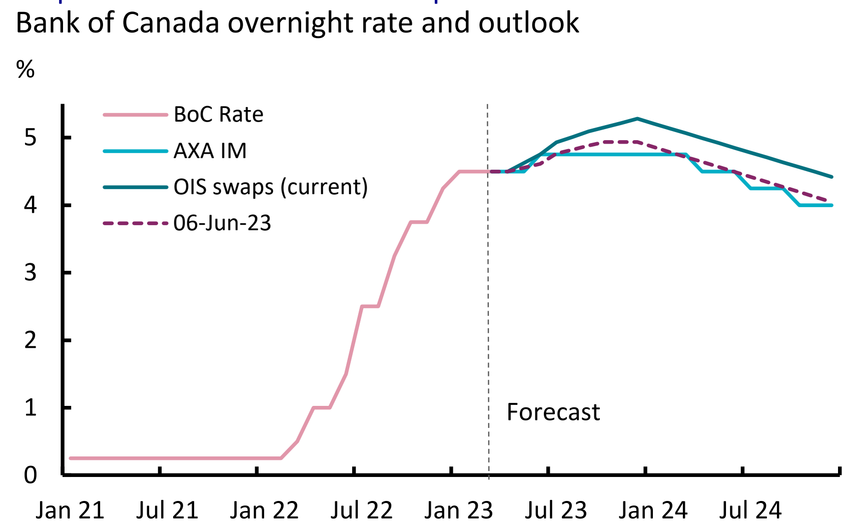
- The BoC resumed tightening in June, raising the overnight rate by 25bps to 4.75%. The BoC warned that the economy was "clearly still in excess demand". However, more recent data have softened, increased labour supply is loosening labour conditions and only around one-third of mortgage holders have seen rates rise yet, suggesting longer lags in the transmission mechanism. We expect the BoC to pause in July, and see softer data leaving 4.75% as a peak for this year. But risks are clearly skewed to higher rates.

Rising labour supply contributes to labour market loosening



Source: Refinitiv Datastream, AXA IM Research, 23/06/2023

Surprise BoC hike shifts curve expectations



Source: Bloomberg, AXA IM Research, June 2023

Disinflation is now mainstream

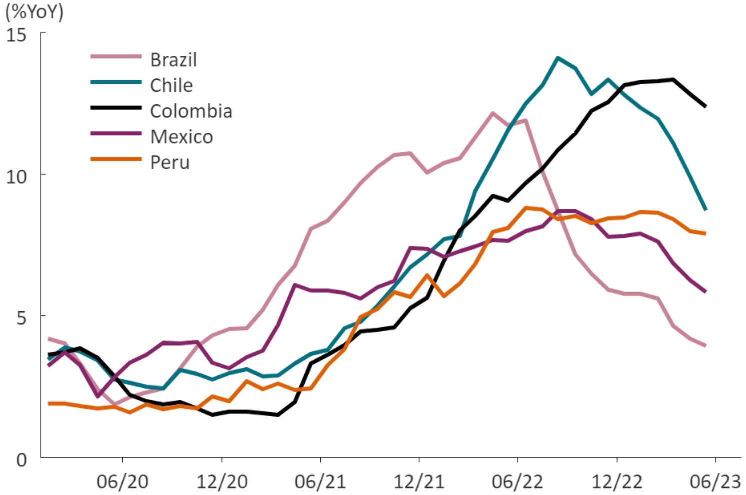
Emerging Markets

Disinflation is firmly underway but core remains a challenge

- Headline inflation is showing a sustained decline in Latin America, surprising to the downside in May. The regional inflation indicator fell to 6.0% in May from 6.4% in April, but was not homogenous across countries, with Brazil's inflation already within target, Colombia's inflation rate at 12.4%. Core inflation remains sticky, posing a challenge to central banks in the region.
- For most parts of Asia, headline CPI has declined obviously since the peak in 2022 thanks to favourable base effects, slowing economic growth, easing core and food prices. Looking ahead, headline CPI numbers are likely to remain within targets, allowing most central banks to remain comfortably on hold until year-end.
- Base effects, weaker energy and food prices, but also strong past FX performance have also helped the disinflation process through CEE. While the disinflation trend is likely to continue in the short run, reaching inflation targets in the medium term could nonetheless prove challenging given strong wage growth and sticky services inflation.

Progress has been made in LatAm but there is a still long way to

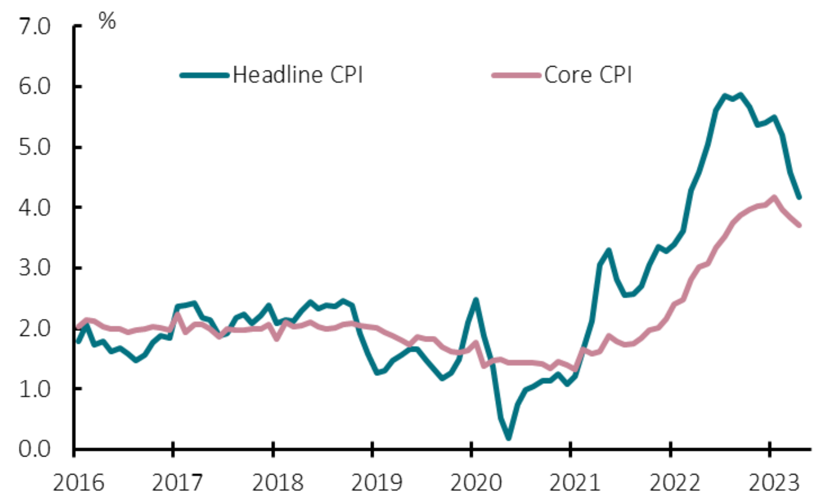
Inflation in LatAm



Source: Refinitiv Datastream and AXA IM Research, Jun 23

Inflationary pressures continue to ease in Asia

Asia excluding China headline and core inflation



Source: CEIC and AXA IM Research, 19 June 2023

Turkey: a disappointing start of policy normalisation

Emerging Markets

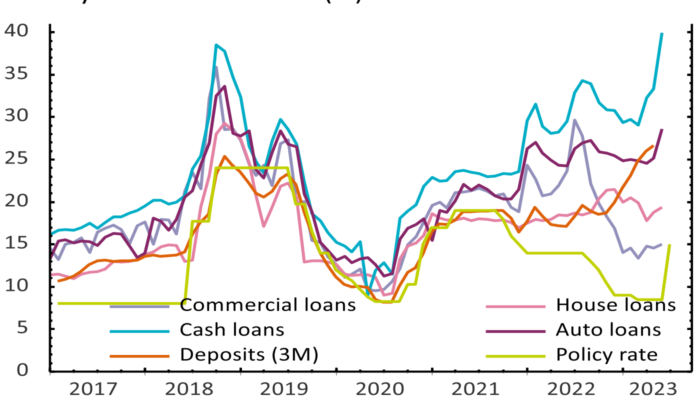
Central bank delivers its first underwhelming rate hike

- For its first meeting, the CBRT hiked policy rates by 650bp to 15%, far less than market expectations for 20%. The bank hinted at gradual adjustments ahead until the outlook for inflation improves significantly.
- CBRT also signalled an upcoming simplification of the existing micro- and macro-prudential framework to support market mechanisms. Easing these regulatory measures such as the *liraisation* targets and security maintenance requirements will help monetary transmission, but gradualism was also hinted.

Credibility at stake

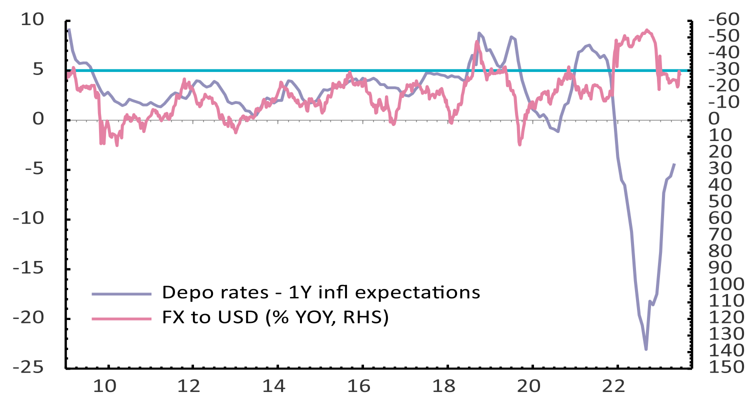
- This suggests a muddle-through scenario until local elections next year, raising the odds of a possible incomplete and insufficient policy normalisation. This leaves a range of imbalances accumulated these past years: overheated credit-fuelled economy; excessively high inflation and de-anchoring of inflation expectations; massive external financing needs; insufficient reserves at the central bank; significant slippage of public finances and accumulating contingent liabilities are the most pressing.

A first underwhelming policy rate hike



Source: Refinitiv Datastream and AXA IM Research 16/06/2023

Gradual policy adjustment vs lack of an FX anchor



Source: Refinitiv Datastream and AXA IM Research Apr 23

Investment Strategy

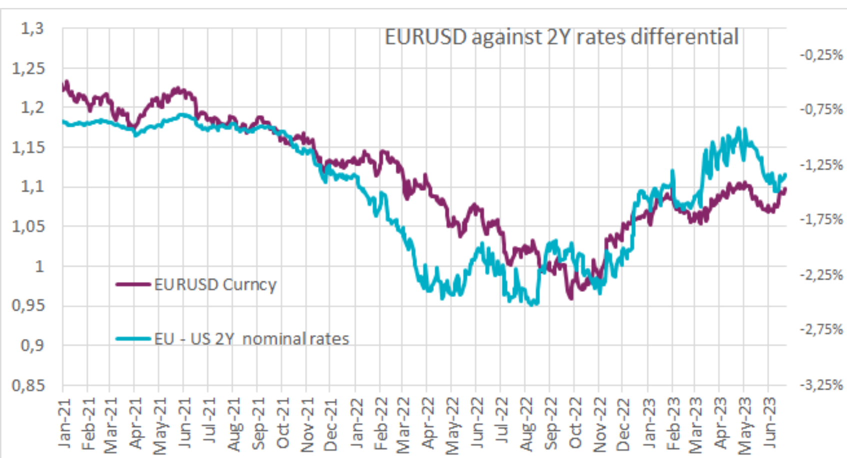
Investment Managers

Investment Strategy

FX: EUR rebound reaching a peak, looking for volatility elsewhere

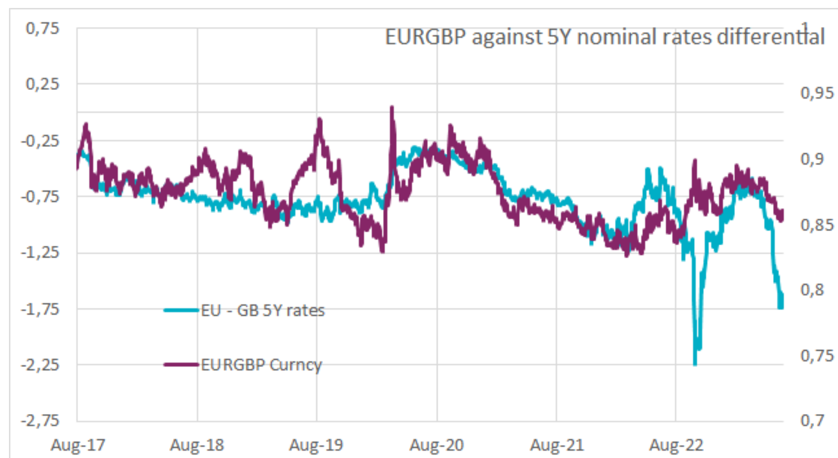
- Data momentum in EU has softened. Domestic wage growth remains high, but the ECB is now well priced while the inflation impulse is slowing. Risks look more symmetric for EUR from here while already long positioning and relatively rich valuation also limit the upside.
- Shorting CHF might be an interesting proxy to position for EUR downside. SNB has less reason to keep a hawkish stance as Swiss core inflation is already falling below 2% faster than expected. As markets get more optimistic on a global softer landing, CHF could lose some of its safe haven premium while its valuation is also becoming rich.
- GBP’s fate is harder to read. On the one hand, expectations on BoE seem excessive, while the higher mortgage rate sensitivity and supply driven labor market tightness gives a bleaker macro-outlook. On the other hand, data has surprised to the upside and GBP did not nearly strengthen as much as the UK rates rise would imply.
- JPY continues to weaken in sync with foreign rates rising. But the potential for a rebound as those rates peak remains high. Additionally, reasons accumulate for the BoJ to adjust its policy: Japan’s inflation pace has reached EU and US levels, while wage negotiations – if not total wage increases - beat expectations. Services demand is also strong, and the trade balance has recovered to pre-energy crisis levels.

Rate differential no longer signalling upside risk to EURUSD



Source: Bloomberg and AXA IM Research, June 2023

GBP not weakening like at mini budget, but not following rates either



Source: Bloomberg and AXA IM Research, June 2023

Investment Strategy

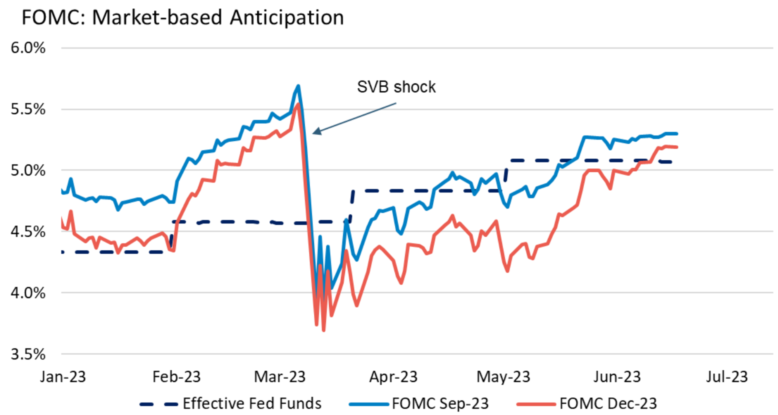
Rates: It is not always about either cutting rates or hiking rates

- US monetary policy anticipation has re-priced materially since the aftermath of the negative SVB shock, broadly reverting to pre-SVB levels. Expectations for September and December FOMC meetings have added back approximately 125bp of tightening, with a distinct acceleration after the May FOMC. Markets have moved from pricing the risk of a widespread US banking crisis to a rather localised, non-systemic event.

- However, thinking that central banks can at any time only be in a rate-cutting or a rate-hiking mode would be an overly simplistic approach to the complexity of monetary policy. As the macro effects of monetary policy are subject to lags, a tightening impulse can also be delivered through the entire yield curve by keeping rates above a «neutral level» for an extended period of time.

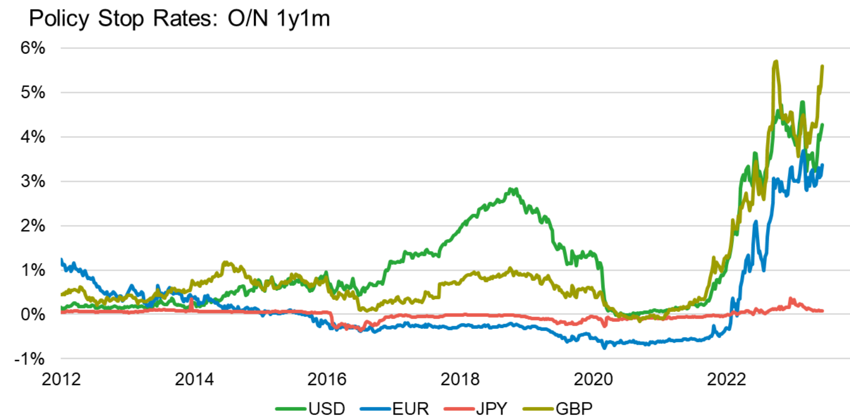
- The yield curve is still skewed towards a recession scenario, while rate cut expectations have shifted forward into 2024. Notably, term premiums have so far failed to move higher, despite increased bond market volatility and the gradual removal of QE's artificial bid. By contrast, the odds of a soft-landing or no-landing scenario seem to be better captured by credit and equity risk premia, than by rates markets.

Fed policy expectations have recovered most of the SVB shock



Source: Bloomberg & AXA IM Research, Jun 2023

Policy peak rates may persist for a longer period of time



Source: Bloomberg & AXA IM Research, Jun 2023

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Investment Strategy

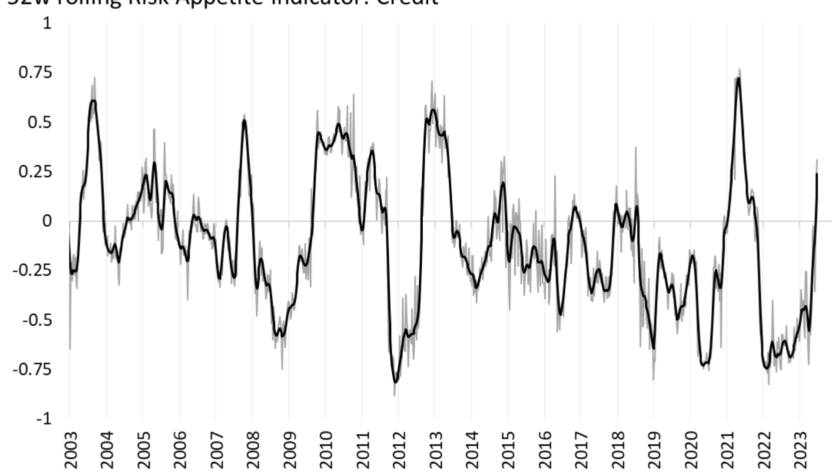
Credit: Unattractive risk reward in spreads merits caution

- Spreads have moved tighter over the month despite ongoing recession concerns, tightening by c.6% in IG and by c.5% in HY. Indeed, risk appetite across global credit markets including EM has staged a strong recovery in the past month. Spreads are tighter year to date, especially in HY which is tighter by approx 10%. This broader constructive tone may be somewhat complacent and merits caution.

- The banking shock in March has left spreads wider since then, but lower govie yields have helped limit the rise in credit yields overall, protecting returns. Global IG & Global HY have returned 2.5% & 4.5% YtD. Just the yield carry for the second half of the year could take Global IG to a 5% full year return and Global HY to 9%. A spread direction wider is more likely to subtract from that return into year end.

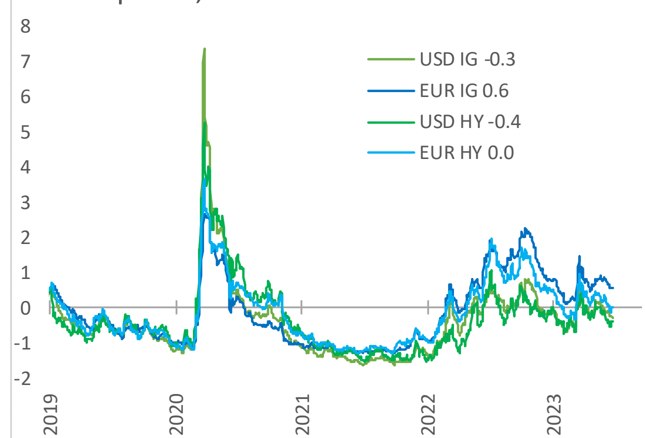
- This is what spread mean reversion indicates for the next 3-12 months. Spreads are trading around a neutral/tight levels since 2010 with the exception of EUR IG which still scores 0.5 in z-score terms. The implication of this is that, historically, spreads end up wider than current levels over a 3-month or 12-month horizon. Further, mean reversion indicates spread HY vs IG decompression, consistent with recession.

Risk appetite in credit has staged a strong rebound



Source: Boomberg, ICE & AXA IM Research; Jun 2023

Spread mean reversion indicates wider spreads over 3-12M



Mean reversion sprd chg fcast

	65D	260D
USD IG	3.4%	8.0%
EUR IG	-0.7%	-1.8%
USD HY	4.2%	11.4%
EUR HY	2.2%	7.7%
IG	2.3%	5.3%
HY	3.7%	10.4%
USD	3.5%	8.4%
EUR	-0.3%	-0.7%
ALL	2.5%	6.0%

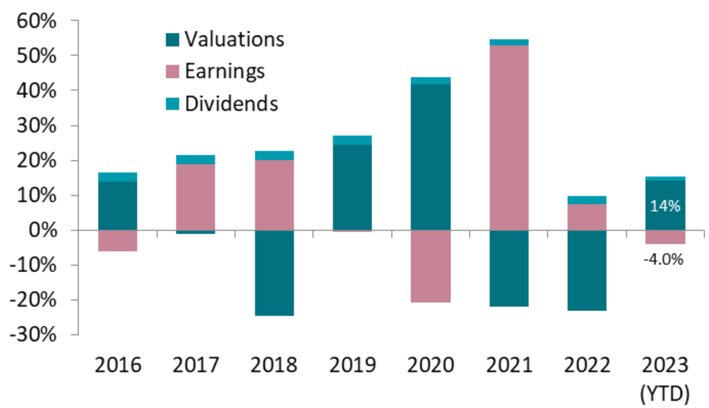
Source: Bloomberg, ICE, AXA IM Research; Jun 2023

Investment Strategy

Equities: How about a summer blanket

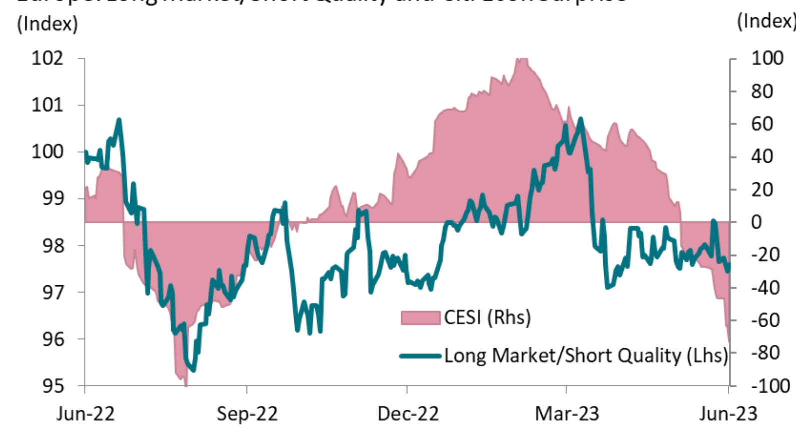
- As we write, global equities are posting their 2nd best monthly performance of 2023, with +4.2% since the beginning of June. Consumer Discretionary stocks are the main contributors to this performance (+8.5%), helped by the resilience of the job market and the fall in consumer prices, which is supporting real purchasing power.
- Market performance is mainly attributable to a rebound in multiples (+14%). Real interest rates appear capped at February's highs (declining inflation, policy peak looming) and equity investors seem to attribute a low probability to recession risk. The global equity rally over the last 3M would more usually have been consistent with low inflation & unemployment and medium economic activity.
- In Europe, recent weakness aside, economic resilience has broadly outdone expectations YtD, while in the US economic newsflow has shown signs of weakness and monetary tightening is near its end but not yet there. In this environment, we favour European quality stocks which benefit from a valuation advantage and tend to outperform in an activity slowdown backdrop.

The expansion in multiples has buoyed returns in 2023



Source: IBES, MSCI and AXA IM Research, June 2023

European Quality has good hedge features amid a slowdown



Source: MSCI, Refinitiv and AXA IM Research, June 2023

Investment Managers

Key market calls

Our directional views across assets in key markets (3-month horizon)

CURRENCIES	weaker	neutral	stronger
Euro		● ◀	
Yen			●
GBPEUR		▶ ●	

EQUITY	lower	neutral	higher
US equity	●		
EU equity		●	
EM equity		●	

RATES	higher	neutral	lower
US rates short	●		
US rates long		●	
EU rates short	●		
EU rates long	●		

CREDIT	wider	neutral	tighter
US IG		●	
EU IG		●	
US HY	●		
EU HY	● ◀		

CURRENCIES

Risks look more symmetric for EUR while long positioning and rich valuation also limit upside. Short CHF may be a good proxy for EUR downside. JPY potential for a rebound, as foreign rates peak-out. GBP's fate is harder to read.

EQUITY

We retain our negative view on the US, as we expect a recession to inevitably manifest. We favour Europe, and particularly Quality, in this macro context. Policy support and persistent growth headwinds in China leave us neutral on EMs.

RATES

US monetary policy expectations repriced materially as the banking shock faded and markets moved from widespread crisis to non-systemic event. Yield curve suggests recession , while risky assets suggest a soft- or no-landing scenario.

CREDIT

Risk appetite across global credit incl EM recovered strongly in past month. This constructive tone may be complacent and merits caution. Mean reversion shows spread widening over 3-12M and decompression in HY/IG, consistent with recession.

Source: AXA IM Core Investment Research, as of 22 Jun 2023

Forecasts & Calendar

AXA Investment Managers

Macro forecast summary

Forecasts

Real GDP growth (%)	2022		2023*		2024*	
	AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
World	3.4		2.7		2.8	
Advanced economies	2.7		0.9		0.9	
US	2.1	2.1	1.0	1.1	1.1	0.6
Euro area	3.6	3.2	0.4	0.7	0.5	0.9
Germany	1.8	1.8	-0.5	0.1	0.3	1.1
France	2.6	2.6	0.6	0.6	0.5	0.9
Italy	3.7	3.8	1.2	0.8	0.4	0.9
Spain	5.5	5.5	2.0	1.6	1.0	1.6
Japan	1.1	1.0	1.5	1.0	1.3	1.1
UK	4.0	4.0	0.2	-0.1	0.3	0.8
Switzerland	2.1	2.1	0.7	0.7	1.0	1.4
Canada	3.4	3.4	1.3	0.9	0.9	1.2
Emerging economies	3.9		3.8		3.9	
Asia	4.3		5.0		4.6	
China	3.0	3.0	5.3	5.8	5.0	4.9
South Korea	2.6	2.6	1.5	1.1	2.0	2.1
Rest of EM Asia	6.0		5.0		4.4	
LatAm	4.0		1.5		2.3	
Brazil	2.9	2.9	1.0	1.2	1.5	1.6
Mexico	3.1	3.1	1.2	1.8	1.8	1.7
EM Europe	0.9		1.5		2.3	
Russia	-2.1		1.7		1.3	1.3
Poland	4.9	4.9	1.0	0.7	2.9	3.1
Turkey	5.6	5.6	2.1	2.2	3.1	2.6
Other EMs	4.9		3.1		3.7	

Source: Datastream, IMF and AXA IM Macro Research – As of 26 June 2023

**Forecast*

Investment Managers

Expectations on inflation and central banks

Forecasts

Inflation Forecasts

CPI Inflation (%)	2022		2023*		2024*	
	AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	7.4		4.7		2.7	
US	8.0	8.0	4.3	4.2	3.0	2.6
Euro area	8.4	8.5	5.6	5.5	2.8	2.4
China	2.1	2.0	2.3	1.8	2.5	2.4
Japan	2.5	2.5	2.7	2.6	1.3	1.4
UK	9.1	9.1	7.1	6.7	2.5	2.8
Switzerland	2.8	2.8	2.4	2.5	1.5	1.5
Canada	6.8	6.8	3.9	3.6	3.0	2.2

Source: Datastream, IMF and AXA IM Macro Research – As of 27 June 2023
**Forecast*

Central banks' policy: meeting dates and expected changes

Central bank policy Meeting dates and expected changes (Rates in bp / QE in bn)		Current	Q3-23	Q4-23	Q1-24
United States - Fed	Dates	5.25	25-26 Jul 19-20 Sep	31-1 Oct/Nov 12-13 Dec	30-31 Jan 19-20 Mar
	Rates		+0.25 (5.50)	unch (5.50)	-0.25 (5.25)
Euro area - ECB	Dates	3.50	27 Jul 14 Sep	26 Oct 14 Dec	25 Jan 7 Mar
	Rates		+0.50 (4.00)	unch (4.00)	unch (4.00)
Japan - BoJ	Dates	-0.10	27-28 Jul 21-22 Sep	30-31 Oct 18-19 Dec	Jan Mar
	Rates		unch (-0.10%)	unch (-0.10)	unch (-0.10)
UK - BoE	Dates	5.00	3 Aug 21 Sep	2 Nov 14 Dec	1 Feb 21 Mar
	Rates		+0.25 (5.25)	unch (5.25)	unch (5.25)
Canada - BoC	Dates	4.75	12 Jul 6 Sep	25 Oct 6 Dec	Jan Mar
	Rates		unch (4.75)	unch (4.75)	unch (4.75)

Source: AXA IM Macro Research - As of 27 June 2023

Calendar of 2023 events

	Dates	Events	Comments
June	29-30 Jun	European Council Summit	
July	12-Jul	BoC meeting	unch (4.75%)
	23-Jul	Spanish general election	
	26-Jul	FOMC meeting	+0.25 (5.50%)
	27-Jul	ECB meeting	+25bps (3.75%)
	28-Jul	BoJ meeting	unch (-0.1%)
	Late Jul	US Estimated resolution of the debt ceiling	
August	03-Aug	BoE meeting	+25bps (5.25%)
	Late Aug	Federal Reserve's Central Bank Symposium Jackson Hole	
September	06-Sep	BoC meeting	unch (4.75%)
	14-Sep	ECB meeting	+25bps (4.00%)
	20-Sep	FOMC meeting	unch (5.50%)
	21-Sep	BoE meeting	unch (5.25%)
	22-Sep	BoJ meeting	unch (-0.10%)
October	29-Oct	Argentina general elections	
December		Spain (National Parliament)	

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12 June 2023

[Nearshoring in Mexico: Mirage or the real deal?]

7 June 2023

[Is there a premium for low-carbon-intensity European equities?]

25 May 2023

[May Global Macro Monthly – Summertime … and the (debt) ceiling is nearing]

24 May 2023

[May Op-Ed – Peak in sight… but it's a twin peak]

24 May 2023

[Turkey General Elections: The final countdown]

9 May 2023

[US debt ceiling impasse: Unnecessary and unavoidable]

3 May 2023

[April Global Macro Monthly – Central banks gauge lagged effects]

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[April Monthly OpEd – Patchy disinflation will trigger policy divergence]

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24 April 2023

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