

Monthly Investment Strategy

Summertime ... and the (debt) ceiling is nearing

Key points

- The banking system is still a cause for concern, although evidence to date suggests it has not led to a material worsening in credit conditions over recent months.
- The US debt ceiling is coming into focus. We expect an eventual resolution, which should limit the impact to US assets. But global markets watch for a political misstep.
- Emerging market concerns rose in the wake of a poll surprise in Turkey's Presidential Elections and as Argentina attempts to avert currency weakness.
- These developments come against a fragile economic background. The US appears close to a mild recession and while Eurozone growth has surprised in recent quarters, we expect stagnation in the second half of this year.
- Central banks face difficult judgements. We believe that the Federal Reserve, Bank of England and Bank of Canada have all peaked. We see the European Central Bank tightening policy until 3.75% in July.

Global Macro Monthly

Summary by David Page	2
US by David Page	3
Canada by David Page	4
Emerging Latin America by Luis Lopez-Vivas.....	4
Key market calls	5
Macro forecast summary	6

Summertime ... and the (debt) ceiling is nearing

Global Macro Monthly Summary May 2023



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One-off events threaten disruption

The end of May typically sees peoples' focus shift towards the upcoming summer months. However, this year, several issues threaten to make this an eventful period, as there is the risk that market volatility could persist into the often oxymoronically-considered "quieter" month of August.

Financial markets remain anxious over banks – more so in the US, where the bank equity sector is still over 25% lower than in March. This month's *Theme of the Month* investigates this in more detail, highlighting that high-frequency US data suggests the sector, while not deteriorating further, is showing few signs of improvement. Banks in other developed economies are considered less at risk but are still monitored nervously. Recent lending surveys from major central banks suggest little additional tightening in credit conditions because of the recent turmoil. But at the same time, they point to a material tightening overall and steep drops in borrowing – a feature of monetary policy tightening.

The US focus is also on debt ceiling developments, with markets keeping a nervous eye out for any domestic missteps that could make this a global event. We expect market volatility immediately before the final X-date, but ultimately still expect a compromise resolution which should limit the materiality of the impact to the US and the dollar. But all markets are likely to reflect caution from June 1 – the earliest possible date officially indicated for the US to run out of cash.

Emerging markets will also add to the pre-summer tension. Turkey's first-round presidential election results, not to mention its Parliamentary votes, suggest President Recep Erdoğan could win another term after scooping an unexpected 49.5% vote share and forcing a second-round run-off. Market hopes for a return to economic orthodoxy were challenged, although Erdoğan has his own track record of U-turns in policy approach. Turkish market volatility increased sharply after the first round and worse could ensue after the second if economic imbalances are not addressed adroitly. Argentina added to uncertainty with its 600bps policy rate increase and FX interventions, in efforts to stabilize the peso ahead of its own October elections.

Central banks juggle growth and inflation

These developments come against an already-difficult background. We expect the US to post increasing signs of economic deceleration, which could result in output falling outright in Q2 and mark the start of what we expect to be a mild recession, although our baseline is Q3. Moreover, despite the enthusiasm over Eurozone PMI surveys, the reality of Eurozone growth appears bleaker. We expect Q1's weak (but positive) 0.1% expansion to be repeated in Q2 but think that ECB policy tightening will prevent any better outcome in H2 2023.

Inflation remains an issue. Headline rates eased in recent quarters, even the UK's CPI fell to 8.7% in April as the delayed pass through of steep wholesale energy prices finally impacted, as in other regions. But core inflation remains more elevated across developed and emerging economies alike. Contrary to popular belief, headline and core inflation rates are not divorced, and the headline slowdown will increasingly feed through to core. However, rates are expected to remain elevated for some time. We forecast inflation will remain around 5.25% in the Eurozone until July – and will likely require a softening in services inflation, and in turn pay growth – before a return to target consistent levels becomes more likely.

This presents difficult choices for international central banks. Each must judge domestic conditions and local susceptibility to inflation persistence. Each is also considering the lagged effects of tightening already undertaken, particularly relevant for those with housing markets with shorter maturity mortgage rate fixes, leaving households facing material tightening ahead. Gauging these factors across regions, we believe the US Federal Reserve and Bank of Canada have both peaked in this policy cycle but expect markets to de-price the expected cuts for the former for later this year; the ECB will fulfill current expectations for hikes more quickly and keep rates higher for longer but the Bank of England looks delicately poised between persistent inflation and a marked easing in the labor market.

The Bank of Japan (BoJ) may also add to market volatility over the coming months as we expect it to adjust its yield curve control policy. We expect an adjustment in July, a little later than markets, but concede that the Bank's extended policy review could be a signal of a more languorous approach to policy change, which could see this emerge even later. Either way – with significant uncertainty about exactly what changes the BoJ will deliver – whatever path it follows is likely to see a material market reaction.

Global Macro Monthly – US



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The slow march to recession

The US looks set to face a difficult summer. We expect to see clear signs emerge that it is entering a mild recession, with risks of something more severe if the layers of government miscalculate with regards to the debt ceiling.

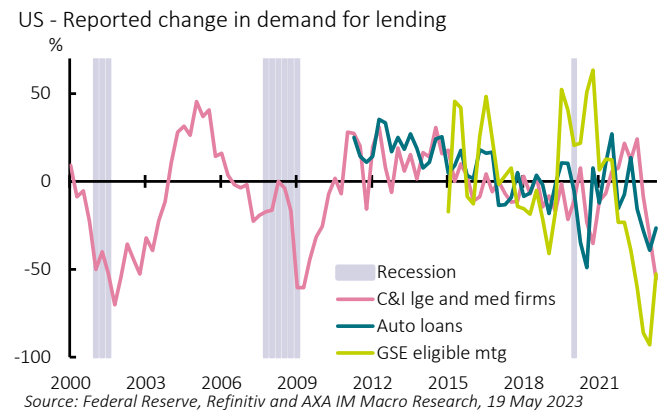
Banking turmoil persists, but the situation hasn't deteriorated. The S&P banking sector index now stands more than 25% below its pre-turmoil levels. The Federal Reserve (Fed) has not added emergency lending to the sector, but total lending is only \$43bn (12%) lower than the March peak. Meanwhile deposits in large and small banks have stabilised, while lending from is falling, and below mid-March levels. The Fed's Senior Loan Officer Opinion Survey (SLOOS) showed only a modest tightening in credit conditions to commercial and industrial firms, more so for commercial real estate, while conditions for household credit cards, auto loans and subprime mortgages also became more difficult. The SLOOS indicates a modest tightening in conditions since the banking turmoil, but more importantly marks a significant hardening in recent quarters that we consider a feature of monetary policy tightening.

The US also faces uncertainty over the debt ceiling. As discussed in detail,¹ the point at which the government exhausts extraordinary measures to avoid default is uncertain. Treasury Secretary Janet Yellen warned this could be from June 1 or possibly several weeks later. We expect it to be towards the end of July but envisage market concern to rise from June. We do not expect the US to default – certainly not on its securities, which would have major implications for the global financial system; nor on domestic payments, that would create a marked fiscal drag and accelerate recession. But we do expect market volatility around the deadline as markets consider alternate outcomes.

The US is also exhibiting signs consistent with recession. Beyond the continued yield curve inversion and rising excess bond premia that keeps our model signaling recession within 12 months, the latest Empire State manufacturing survey deteriorated by its most on record (excluding the pandemic); the Challenger Job Cuts report shows layoffs remain elevated – up an average 300% over the last six months – and the SLOOS indicated steep falls in borrowing demand (Exhibit 1).

¹ Page, D., "US debt ceiling impasse: Unnecessary and unavoidable", AXA IM Investment Institute Macro Research, 3 May 2023

Exhibit 1: A worrisome fall in borrowing demand



Yet the economy has shown signs of resilience. Despite Q1 GDP rising by a subdued 1.1% (annualized), consumer spending was strong. Moreover, April recorded robust growth in car sales, which could reflect higher income households spending excess savings. Employment growth was also strong in Q1. Looking ahead, we expect Q2 GDP to be subdued and consumer spending to be fairly flat. Employment growth is already slowing in trend terms (to 222k 3m/3m in April from 354k recorded in March), with signs of further deceleration for May. We forecast modest Q2 growth of 0.4%, given expected declines in investment. However, a steeper inventory correction could deliver outright contraction. In any case, we forecast a drop in output in Q3 and expect the start of the recession to be around mid-year.

Meanwhile headline inflation continues to fall, to 4.9% in April. We expect it to ease further to around 3.5% in June – significantly below the 9.1% peak seen a year earlier. But it is likely to stabilize around this level over the remainder of the year. Moreover, core inflation has not retreated by as much – at 5.5% in April from a 6.6% peak. We forecast CPI inflation to average 4.4% this year and 3.0% next and to remain above 2% even by end-2024.

The Fed faces some tough decisions, typical of turning points in the cycle. At its last meeting, it raised rates by 0.25% to 5.25%. It also removed forward guidance for "some additional tightening," but it held off announcing a pause – likely to avoid encouraging near-term rate cut expectations which would loosen financial conditions before slower activity, a looser labor market and a clear path to restore price stability are confirmed. The scale of activity slowdown – and the depth of any recession – will be key to a debate over whether the Fed can cut rates before year-end. Our current forecast is that it will not, and that it is very unlikely the Fed will be able to cut rates by September, at least, not without a messier debt ceiling event than we expect.

Global Macro Monthly – Canada



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Longer-term risks of additional tightening

The Bank of Canada (BoC) has been the boldest of the central banks so far, announcing a “conditional pause” in January and leaving policy on hold at its last two meetings. However, April’s Summary of Deliberations saw Governing Council members harboring doubts about whether policy was restrictive enough. Governor Tiff Macklem has warned that if inflation does not fall sufficiently the BoC would raise rates further.

Economic developments have fanned such doubts, specifically the labor market. Employment growth has remained solid (although full-time jobs fell), rising by 41k in April, while unemployment remains close to record lows at 5.0% and wage growth is still rising by an annual 5.6%, up 0.8% in the latest month. Inflation has also concerned rate markets. Headline inflation surprised in April, rising to 4.4% from 4.3% – even allowing for a rebound in gasoline costs. Markets swiftly priced the probability of a further rate hike by the BoC (currently over 50% priced by July), but also unwound both rate cuts that had been expected by year-end – December rate expectations rose by 65bps in the last week.

Yet developments have been more mixed than this. While headline CPI surprised, measures of core inflation eased, including the median rate falling to 4.2% from 4.6%. Moreover, broader activity slowed from a firm start to the year. GDP rose by just 0.1% in February and the preliminary March estimate is for a 0.1% decline. We lowered our Q1 forecast, to 2.4%, and also for Q2, expecting April’s GDP to remain subdued following ice storms and a 12-day public worker strike. We forecast GDP up 1.0% (from 1.2%) this year and 0.9% next.

The BoC is also mindful of the lagged impact of policy tightening to date. April’s Monetary Policy Report projected the lagged impact of rising mortgage costs. The BoC’s latest annual Financial System Review described just one-third of mortgage holders as having faced any rise in mortgage rates yet, with nearly all expected by 2026. Meanwhile, it noted that credit card balances were rising in households where mortgage costs had increased. The BoC remains focused on restoring price stability but is wary of an overtightening that could deliver a steep recession. We expect the BoC to leave rates on hold at 4.50%. By September, we expect clear signs of labor market loosening. We forecast the BoC to cut rates only in 2024, to 3.25% by year-end.

Global Macro Monthly – EM LatAm



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A surprisingly strong start

Despite mounting headwinds, most Latin American economies registered surprisingly robust performance at the start of this year. Mexico’s economy accelerated by 1.1% in the first quarter (Q1) on a quarterly basis (from 0.5% in Q4), beating market expectations of 0.8%. Q1 marked the sixth consecutive increase with key sectors like services and agriculture showing favourable momentum. Nonetheless, the economy should still decelerate in the second half of the year, following weaker growth in the US.

In Colombia, activity was also more resilient than expected in Q1, despite the ongoing monetary policy tightening cycle. Growth came in at 1.4% (from 0.4%), above consensus expectations of a 1.1% rise. The expansion was spearheaded by private and public consumption and net exports. Conversely, investment contracted in Q1. Despite these positive developments, leading indicators such as car sales and electricity demand point towards a continued slowdown in consumption. Meanwhile, the Chilean economy grew by less than the consensus forecast (0.8% versus 1.0%), although it still represented the strongest performance since Q1 2022. Public spending led growth this quarter, signalling the government’s implementation of fiscal policy to bolster Chile’s ailing economy.

While Q1 GDP data is not yet available for Brazil, the monthly economic activity indicator suggests a still-resilient economy. In February, the economy grew 4.6% on an annual basis, the second acceleration in a row and the highest reading since August 2022. Likewise, retail sales continued to expand in the first two months of the year. Industrial production was less positive as it contracted in January and February, before picking up again in March.

In contrast to the rest of the region, Peru’s economy fell by a quarterly 0.4% in Q1, marking the first contraction since Q2 2020. The drop reflected the consequences of social unrest in January which caused major disruption. Fortunately, protests have subsided which has allowed the economy to return to growth in March, according to the economic activity indicator. However, Peru will continue to face headwinds this year including from tight monetary policy, subdued business sentiment and lingering political uncertainty.

Key market calls

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

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

CURRENCIES

USD has gained support, once again, from resilient US data, yet this may be only temporary. EUR should rebound as ECB maintains a hawkish stance. JPY should benefit from USD and US rates peaking out.

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

EQUITY

Muted market price reaction to positive earnings surprises shows caution by investors. EM equity may be vulnerable to US recession risk over the next few months. US equities vulnerable to setbacks in tech mega cap performance.

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

RATES

Rates volatility remains elevated and the jury is still out in regards to Fed's hiking cycle peak. Market-based inflation expectations perhaps too sanguine compared to inflation surveys and underlying inflation trends.

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

CREDIT

Unappealing reward vs recession risk in spreads still warrants a prudent stance. US HY screens low on default valuation & mean reversion potential. Europe spreads look somewhat better in mean reversion and valuation terms.

Source: AXA IM Core Investment Research, as of 23 May 2023

Macro forecast summary

Real GDP growth (%)	2022		2023*		2024*	
	AXA IM	Consensus	AXA IM	Consensus	AXA IM	Consensus
World	3.4		2.8		2.8	
Advanced economies	2.7		1.0		0.8	
US	2.1	2.1	1.0	1.1	0.6	0.7
Euro area	3.6	3.2	0.7	0.7	0.6	1.0
Germany	1.8	1.8	0.0	0.1	0.6	1.2
France	2.6	2.6	0.6	0.5	0.6	1.0
Italy	3.7	3.8	0.6	0.6	0.5	1.0
Spain	5.5	5.5	1.6	1.4	0.9	1.8
Japan	1.1	1.0	1.5	1.1	1.3	1.1
UK	4.0	4.0	0.2	-0.2	0.6	0.8
Switzerland	2.1	2.1	0.6	0.7	1.3	1.5
Canada	3.4	3.4	1.2	0.8	0.9	1.3
Emerging economies	3.9		3.8		3.9	
Asia	4.3		5.0		4.6	
China	3.0	3.0	5.3	5.5	5.0	5.1
South Korea	2.6	2.6	1.5	1.1	2.0	2.2
Rest of EM Asia	6.0		5.0		4.4	
LatAm	4.0		1.5		2.3	
Brazil	2.9	2.9	1.0	1.0	1.5	1.7
Mexico	3.1	3.1	1.2	1.4	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	0.6	2.9	3.1
Turkey	5.6	5.6	2.1	2.1	3.1	2.8
Other EMs	4.9		3.1		3.7	

Source: Datastream, IMF and AXA IM Macro Research – As of 22 May 2023

*Forecast

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	4.3	3.0	2.6
Euro area	8.4	8.5	5.8	5.5	2.9	2.4
China	2.1	2.0	2.3	2.2	2.5	2.4
Japan	2.5	2.5	2.7	2.5	1.3	1.4
UK	9.1	9.1	6.6	6.4	2.4	2.8
Switzerland	2.8	2.8	2.0	2.6	1.3	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 22 May 2023

*Forecast

These projections are not necessarily reliable indicators of future results

Forecast summary

Central bank policy					
Meeting dates and expected changes (Rates in bp / QE in bn)					
		Current	Q2-23	Q3-23	Q4-23
United States - Fed	Dates		13-14 Jun	25-26 Jul	31-1 Oct/Nov
	Rates	5.25	unch (5.25)	unch (5.25)	unch (5.25)
Euro area - ECB	Dates		15-juin	27 Jul	26 Oct
	Rates	3.25	+0.25 (3.5)	+0.25 (3.75)	unch (3.75)
Japan - BoJ	Dates		15-16 Jun	27-28 Jul	30-31 Oct
	Rates	-0.10	unch (-0.10)	unch (-0.10)	unch (-0.10)
UK - BoE	Dates		22-juin	3 Aug	2 Nov
	Rates	4.50	unch (4.50)	unch (4.50)	unch (4.50)
Canada - BoC	Dates		07-juin	12 Jul	25 Oct
	Rates	4.50	unch (4.50)	unch (4.50)	unch (4.50)

Source: AXA IM Macro Research - As of 22 May 2023

These projections are not necessarily reliable indicators of future results

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