

Monthly Op-ed

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Peak in sight... but it's a twin peak

Key points

- Central banks are deliberating whether policy tightening delivered to date is sufficient to restore price stability.
- For the Fed and the ECB, this appears to set the central banks on a divergent path – the Fed has probably reached a peak; the ECB has further to go.
- The evolution of inflation dynamics explains much of this divergence. The US sees mounting signs of deceleration in core inflation and wage growth. Eurozone core inflation remains close to peak and wage growth elevated.
- Tech performance takes over after a year driven by energy and oil.
- The AI value chain is boosting investment opportunities.

ECB to go on alone

Central banks have been displaying some frustration at the apparent lack of response from the economy to their policy tightening. Evidence is however now accumulating that transmission is materializing. In both the US and the Euro area, the recent surveys on banks' behavior have been reporting a significant tightening in lending standards – and this pre-dated the recent banking turmoil around US regional banks and Credit Suisse. But maybe more interestingly, the latest batch of surveys reflect a steep decline in the demand for credit from the business sector. This suggests that the rise in interest rates is now affecting behavior outside the financial sphere and hitting the real economy.

The key issue is how confident central banks can be that this change in behavior is going to be swift enough to dampen inflation before it becomes fully entrenched. Presently, there seems to be a difference of appreciation between the Fed and the ECB.

The Fed, upon hiking its policy rate by 25 basis points (bps) in May, hinted at a pause. The ECB produced the same additional tightening, but also signaled that it was inclined to continue, stating that monetary conditions are not yet "restrictive enough."

This difference, to some extent, reflects the dataflow. In the US, signs of disinflation are becoming more tangible beyond the mechanical impact of

lower energy costs, in particular the crucial "services excluding rents" component of the consumer price index slowing down significantly. Further up the price pipeline, core producer prices are also going in the right direction. In the Euro area, although core inflation has lost 10 bps in April year-on-year, the improvement still looks shaky and overly driven by the behavior of

small, idiosyncratic components (e.g., package holidays in Germany). Maybe more fundamentally, while in the US, despite a still strong labor market, wages have stopped accelerating. The ECB is bracing for further underlying cost pressure as in some countries – e.g., Germany – wage negotiations are pointing to a very significant acceleration later this year and again at the beginning of 2024. Besides, from the point of view of the balance of power within the ECB Governing Council, we think it matters that all the already hawkish Governors from the old “D-Mark zone” – Austria, Belgium, the Netherlands – are facing particularly strong inflation in their countries.

Beyond the differences in dataflow, we also suspect that the Fed is willing to take a “forward looking” approach, counting on the lagged effect of its accumulated tightening to make inflation fall without the need for further action, while the ECB seems to be driven by an “empirical” approach and wants to see a proper, sustained decline in core inflation before downshifting and ultimately stopping.

Of course, we should not overstate the “divergence” between the Fed and ECB. The Fed commentary maintains a “tightening bias,” with a balance of risks firmly tilted towards more tightening if need be. Yet, while our baseline has the ECB pausing after a last 25 bps hike in July, we see a significant risk that it moves again in September, since we expect only a small deceleration in core inflation this summer, which may add to the frustrations of the Governing Council. We could thus have nearly 6 months of continuing hikes from the ECB while the Fed would stay put.

However, what we find striking in this environment – and market pricing is consistent with an even deeper divergence, with rate cuts expected in the second half of the year in the US – is that the euro exchange rate has stopped appreciating. This may reflect a belief that, irrespective of what the ECB does on rates, a recession in the US – the product of the lagged monetary tightening – would have profound adverse consequences on the euro area economy, triggering the usual “flight to safety” favorable to the US dollar – despite the current political conflict around the debt ceiling.

Technology booms, but not a bubble

Technology stocks have led the way in terms of US equity market performance so far in 2023. This stands in stark contrast to what happened last year when the technology sector saw a marked drop in earnings and a significant reduction in valuation multiples. Companies responded with layoffs amid concerns that a general slowdown in economic growth would reduce enterprise demand for technology, coming after the post-pandemic softening of demand at the consumer end of the market. So why the turnaround? One factor could be that these are nimble companies, able to reduce costs quickly by firing programmers and developers. Another could be that a large part of the adjustment in the technology sector could have come in start-ups and smaller companies, something that may have been exacerbated by reduced funding from venture capitalists. The problems in California’s banking sector points to this as well. However, for big-cap stocks the story is all about the future. The Biden administration’s industrial policies, including the CHIPS (Creating Helpful Incentives to Produce Semiconductors) and Inflation Reduction Acts, have the potential to generate a secular boost to investment in technology. The launch of ChatGPT (Chat Generative Pre-trained Transformer) has also been a factor, raising the possibility of endless applications of generative artificial intelligence (AI) not just in the technology sector itself but across the economy.

There are concerns that US equity market performance is heavily concentrated in large-cap technology stocks. Indeed, it is quite easy to show that all the total return performance of the S&P 500 index in 2023 can be explained by price gains among 10 stocks which together account for 25% of the market’s total capitalization. At the same time, technology has done well in other markets. In the EuroStoxx universe, the technology sector is the third best performing sector this year after travel and leisure and the luxury goods sectors – both of which continue to benefit from the post-COVID recovery in travel and China’s re-opening.

Technology takes over from energy

It is surely a positive sign for the global economy that equity market leadership has passed to the growth enhancing technology sector from the energy sector, which led the way in 2022. In the US, both the energy and bank sectors have underperformed. Indeed, it is likely that a lot of investment going into technology in coming years will be directly or indirectly linked to the energy transition (away from fossil fuels) and the more general further digitalization of the global economy. The growth in electronic vehicles, the digitalization of power grids, and the general greening of urban areas cumulatively add to demand for technology. And as technology is more widely deployed, the whole value chain benefits including sub-sectors like hardware, semiconductors, and cyber-security applications.

The decline in long-term interest rates has also helped the technology sector. These stocks are often described as long-duration with an earnings profile that is characterized by high growth rates. Lower bond yields (discount rates) boost the present value of those earnings. In the energy sector, earnings are much more in the here and now. Global energy prices have fallen significantly since their immediate post-Ukraine invasion highs. Consensus forecasts for S&P 500 energy sector earnings per share anticipate consecutive declines in annual earnings this year and in 2024. The IT sector's earnings are forecast to achieve double digit growth over the next two years.

Can secular growth in the technology sector continue to lift broader equity market performance? Our economic assumptions are for a continued slowdown in growth in coming quarters. The boost from the decline in bond yields this year is not likely to be repeated as the "easy" declines in inflation have already been attained. There are also external risks that need to be considered, such as the potential for a regulatory challenge to further AI research or the geopolitical concerns surrounding Taiwan. Valuations are expensive again as well. The S&P 500 technology sector, as a whole, trades on a 30-times price-to-earnings ratio (compared to 20 times for the market as a whole). A lot is priced in, and a slowdown in the performance of the technology sector would translate to much weaker overall index performance given the challenges facing the energy and banking sectors and the generalized risk from slower growth to corporate earnings.

Slower real and nominal GDP growth are likely to be a headwind for revenue growth in the corporate sector going forward. Revenues have risen in line with inflation, and large-cap companies appear to have been better able to manage costs and maintain profit margins during this period of higher inflation. Margins dipped in the US- and European-listed corporate sectors in 2020 but recovered strongly in 2021 and 2022. Big companies have, on the whole, been able to exploit pricing power in a period of generally rising prices. As inflation eases, this will be less of a driver of earnings growth, especially if final demand is going to be weaker. In the US, reported profit margins have already started to move lower.

Over the long term, technology remains an area that is likely to provide above market returns, as it has over the last decade. The entire value chain surrounding AI will boost hardware providers, software developers, and companies that are able to use AI to boost their own businesses. At the same time, technology themes like software-as-a-service (SaaS) and cyber-security should continue to grow, as will applications grouped under the theme of the Metaverse. Changes to operating models and the growth of large-cap companies have made the sector more resilient to the ups and downs of the economic cycle. The US is likely to lead the way, but there are competitors – including China – that underpin the global nature of technology. Moreover, as governments accelerate plans to meet their climate change related targets, investment in technologies that help solutions will grow significantly.

The cycle is proving some interesting challenges to equity investors. Performance has generally been better than expected, with inflation benefiting corporate revenues. The bond market has helped too, with lower longer-term yields. But the longer-term case for a significant exposure to the broad technology sector is stronger than ever given the huge potential for new applications in the energy transition, in the delivery of consumer services, and in healthcare.

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	5.25	13-14 Jun	25-26 Jul	31-1 Oct/Nov
	Rates		unch (5.25)	19-20 Sep	12-13 Dec
Euro area - ECB	Dates	3.25	15-juin	27 Jul	26 Oct
	Rates		+0.25 (3.5)	14 Sep	14 Dec
Japan - BoJ	Dates	-0.10	15-16 Jun	27-28 Jul	30-31 Oct
	Rates		unch (-0.10)	21-22 Sep	18-19 Dec
UK - BoE	Dates	4.50	22-juin	3 Aug	2 Nov
	Rates		unch (4.50)	21 Sep	14 Dec
Canada - BoC	Dates	4.50	07-juin	12 Jul	25 Oct
	Rates		unch (4.50)	6 Sep	6 Dec

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

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