Monthly Op-ed

Gilles Moëc
AXA Group Chief Economist
and Head of AXA IM Research

Chris Iggo,
Chair of the AXA IM Investment
Institute and CIO of AXA IM Core

In for the long haul

Key points

- All key western central banks now say they are at or close to the tightening peak. Their focus is now on maintaining the restrictive monetary conditions for long enough to fully tame inflation.
- The “high for long” approach minimizes macroeconomic volatility relative to a “ever higher” trajectory, but it is not risk-free: it is difficult to know in real time if the monetary stance has not already gone too far.
- “High for long” creates a challenge for investors as cash rates will remain elevated for some time, making it hard for riskier assets to outperform.
- However, bond yields are at multi-year highs meaning fixed income markets should deliver positive real returns on a multi-year horizon.

Convergent narratives

The Federal Reserve (Fed), the European Central Bank (ECB), and the Bank of England (BoE) are now sharing a common narrative, irrespective of whether they delivered a hike in September. They all consider themselves at or close to their policy rate peak, although they all maintain a hiking bias, and are all reasonably confident the cumulative tightening will eventually “do the trick” and bring inflation back to target in a timely manner. Steering markets away from pricing too early cuts is going to be their main communication problem in the months ahead, as keeping overall financial conditions tight – including long-term interest rates – is probably part of the package they consider necessary to deliver a proper landing of inflation.

The BoE’s Chief Economist Huw Pill has proposed a geophysical image for the “high for long” approach to monetary policy which is likely to take hold: “less Matterhorn and more Table Mountain.” Choosing a “Table Mountain” approach – thus refraining from adding too many rate hikes once the policy stance is already clearly in restrictive territory – should reduce the risks of triggering an abrupt recession down the line which would then need to be accommodated by an equally exaggerated quantum of rate cuts – if for instance inflation ended up undershooting the central bank target as a result of the contraction of the real economy.

There are several long-term benefits to reducing macro volatility. First, a deep recession, even if swiftly addressed with a good dollop of monetary loosening, can depress trend growth by damaging human capital – e.g., through a loss of skills – as unemployment rises and depress the capital stock as businesses cut their capex too far. Second, a “soft landing” would strongly enhance the credibility of central banks by demonstrating their capacity to fine tune. The “Table Mountain” approach is based on the recognition of the sometimes-long transmission lags, as monetary policy should stop hiking before all indicators of inflation have started blinking green.

Still, it is not obvious central banks can easily spot whether they have already unwillingly engaged on a painful trail on the Matterhorn. Indeed, because of the transmission lags, evidence that policy went too far can only be collected after the fact. That the US economy has proved resilient so far does not mean that the ingredients for a hard landing are not already there. We can only notice that it is more likely the Fed has stopped in time last July, given how strong the real economy still is, than the ECB which may have to face a recession very soon. It is however understandable why the ECB is taking this risk: the signs of a softening inflation are harder to spot in the Euro area than in the US. This is indeed where, beyond the common narrative, Europe and the US differ. Core inflation has been receding more clearly these last few months in the US while progress is very limited in the euro area, although cyclical conditions are deteriorating much faster there. Differences in labor market dynamics may help explain the paradox. With collective bargaining dominating in Europe, wage growth tends to play “catch-up” with past inflation for longer than in the US.

Yet, even in the US, the central bank cannot afford to lower the guard. The price of services excluding rents – the Fed’s focus, since this is the component which is normally the most attuned to the domestic cycle – may have hit a line of resistance slightly above 3% in year-on-year terms. Looking ahead, there should be enough decelerating contributions from rents and manufactured goods prices – the latter being now barely in positive territory – to offset such “resistance” and allow for a continued convergence of overall core inflation towards 2%, but the re-acceleration in services prices in the summer when measured on a three-month basis still deserves to be monitored.

In a nutshell, central banks may be “done,” but we would not count on a swift reversal of their stance before the middle of next year.

Markets need catalysts to outperform cash

The "higher for longer" stance of the developed market central banks has driven market pricing to be consistent with the message from policymakers. Based on current market expectations, the Fed will have kept the policy rate at 5.5% for around 11 months, based on when a full 25-basis-point (bp) cut in rates is priced in. This is a long time. There have been few occasions in the past that have seen rates stay at the peak for such a long period. The most recent was in 2006 to 2007 when the plateau lasted for 15 months. For the ECB, there is perhaps more re-pricing ahead. Currently, the market has the ECB on hold for nine months.

This represents one of the two policy choices facing central bankers when inflation is still well above target. The other is to raise rates further now. Either way, monetary policy must be tight until inflation is much lower. For investors, this means that cash will continue to be a hurdle to beat. It may also mean that fundamentals for equities and credit steadily deteriorate. The longer policy and market rates remain high, the greater the impact on corporate borrowing costs will be as more and more refinancing of debt is undertaken at higher costs.

Given the shape of yield curves, it is likely to be difficult for government bonds to outperform cash in the near term unless markets reverse the recent re-pricing of the monetary policy outlook. Yields are at multi-year highs but the "higher for longer" mantra and arguments that equilibrium interest rates are likely to be higher than previously thought have kept pushing them higher. Investors who have entered long duration bond strategies this year have mostly failed to enjoy positive returns.

Higher yields have improved the risk-return trade-off for bonds, however. For core benchmark yields, a 100bp decline would generate a total return (yield plus capital gain) well in excess of the total return loss that would be incurred as the result of a 100bp increase in yields (assuming a one-year holding period). For those investors that are less sensitive to marked-to-market gains and losses, the long duration trade in government bonds looks attractive based on the view that cash rates will have started to come down in a year’s time. The additional return from good quality investment grade corporate bonds makes the argument even stronger. Single A-rated investment grade bonds in the US and Europe offer a spread above the rates curve of 120bps to 150bps.

For more performance-sensitive investors, short duration strategies with some spread can potentially compete with cash returns. This has been the case over the summer with short duration credit, high yield, and assets like leveraged loans delivering marginally better returns than cash. A soft landing with limited credit deterioration would support such an expectation.

The outlook for equity markets is more challenging. Outside the US, there are markets with attractive valuations. Markets in the UK, the Eurozone, and Asia are more attractively valued in terms of earnings multiples and with higher dividend yields compared to the major US stock market indices. Japan has been very much in favor this year, with the Nikkei 225 stock average returning more than 25%. There is an interesting story there too. At last Japan is seeing some inflation which helps pricing power for corporates, the authorities are being more proactive in dealing with some of the structural issues, such as cross-shareholding, and geopolitical trends are benefiting Japan. The diversification of semiconductor production away from Taiwan is one such factor. Japanese corporates are also leveraging off well-established manufacturing processes for new technology, including electronic vehicles and battery storage.

Looking for the growth

Equity markets need catalysts. The US benefited from the unveiling of ChatGPT as it sparked significant flows into assets associated with artificial intelligence. For now, however, the initial euphoria has faded given the high valuations and ambitious earnings expectations it has provoked. For 2024, the consensus forecast for US earnings growth is around 12%, after a negative earnings year in 2023. It is relatively aggressive in the context of an economy that could still suffer sub-trend GDP growth. At any rate, a lot is priced into US share prices.

The news around China has not yet improved noticeably, but this is a market that could see a substantial bounce once the macro-outlook improves. China equity markets have gone sideways recently and have only managed a 4%-5% total return all year. For performance to improve, it is probably necessary to see further policy initiatives to boost growth and an easing of tensions between Beijing and the West – although that may be a big ask heading towards a US election year. However, China is one of the few major equity markets that has the potential to enjoy a major rebound on any upgrade in confidence around the economy.

That doesn't appear likely to be the case for Europe. Growth is weak with manufacturing and service sector Purchasing Managers' Indices well below 50,[1] indicating contraction. The ECB has acknowledged that growth has slowed but is unlikely to relent in its anti-inflationary crusade until inflation is a lot lower. After being modestly positive in the first part of this year, earnings momentum for the key European markets has turned negative again. Short of rate cuts, a much weaker euro exchange rate or an increase in demand for autos and consumer goods from China, drivers of European equity markets are not obvious.

Markets are not giving investors much incentive to move away from cash and take more risk. It is interesting that equity volatility remains low, credit default swap index levels are at the tightest of the year, and interest rate volatility has come down since the spring. Volatility is cheap, interest rates are high, bond yields are the most attractive they have been for 15 years, and the global economy is not in recession. Things could be worse and although total returns are not likely to benefit from the direct effects of lower interest rates anytime soon, it seems that the current set-up of markets cries out for focus on income and diversification.

1 AXA Investment Managers as of September 26, 2023

Macro forecast summary

Real GDP growth (%)	2022		2023*		2024*	
	AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
World	3.5		2.9		2.7	
Advanced economies	2.7		1.4		0.8	
US	2.1	2.1	1.9	1.9	1.1	0.6
Euro area	3.6	3.2	0.5	0.6	0.3	0.8
Germany	1.8	1.8	-0.3	-0.3	0.3	0.9
France	2.5	2.5	0.7	0.7	0.3	0.9
Italy	3.7	3.7	0.7	1.0	0.1	0.7
Spain	5.5	5.5	2.2	2.1	0.6	1.4
Japan	1.0	1.0	1.9	1.4	0.9	1.0
UK	4.1	4.1	0.5	0.2	0.2	0.4
Switzerland	2.1	2.1	0.7	0.7	1.0	1.4
Canada	3.4	3.4	1.4	1.5	0.9	0.8
Emerging economies	4.0		3.9		3.8	
Asia	4.4		5.0		4.4	4.0
China	3.0	3.0	5.0	5.3	4.5	4.7
South Korea	2.6	2.6	1.4	1.2	2.4	2.1
Rest of EM Asia	6.3		5.4		4.4	
LatAm	3.9		2.2		2.3	
Brazil	2.9	2.9	2.9	2.2	1.1	1.5
Mexico	3.0	3.0	2.5	2.7	1.9	1.7
EM Europe	0.9		1.3		2.4	
Russia	-2.1		1.5		1.3	1.2
Poland	5.1	4.9	0.0	0.9	3.5	2.7
Turkey	5.6	5.6	2.1	2.6	3.1	2.0
Other EMs	4.8		2.8		3.8	

Source: Datastream, IMF and AXA IM Macro Research – As of 26 September 2023
**Forecast*

CPI Inflation (%)	2022		2023*		2024*	
	AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	7.4		4.8		2.8	
US	8.0	8.0	4.3	4.1	3.0	2.6
Euro area	8.4	8.5	5.7	5.5	2.9	2.5
China	1.9	2.0	1.0	0.8	2.0	2.0
Japan	2.5	2.5	3.0	3.0	1.5	1.7
UK	9.1	9.1	7.5	7.3	2.8	3.0
Switzerland	2.8	2.8	2.4	2.3	1.5	1.5
Canada	6.8	6.8	4.2	3.6	3.0	2.3

Source: Datastream, IMF and AXA IM Macro Research – As of 26 September 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	Q4-23	Q1-24
United States - Fed	Dates	5.50	31-1 Oct/Nov 12-13 Dec	30-31 Jan 19-20 Mar
	Rates		unch (5.50)	unch (5.50)
Euro area - ECB	Dates	4.00	26 Oct 14 Dec	25 Jan 7 Mar
	Rates		unch (4.00)	unch (4.00)
Japan - BoJ	Dates	-0.10	30-31 Oct 18-19 Dec	22-23 Jan 18-19 Mar
	Rates		unch (-0.10)	unch (-0.10)
UK - BoE	Dates	5.25	2 Nov 14 Dec	1 Feb 21 Mar
	Rates		unch (5.25)	unch (5.25)
Canada - BoC	Dates	5.00	25 Oct 6 Dec	24 Jan 6 Mar
	Rates		0.25 (5.25)	unch (5.25)

Source: AXA IM Macro Research - As of 26 September 2023

These projections are not necessarily reliable indicators of future results

The information has been established on the basis of data, projections, forecasts, anticipations and hypothesis which are subjective. This analysis and conclusions are the expression of an opinion, based on available data at a specific date. Due to the subjective aspect of these analyses, the effective evolution of the economic variables and values of the financial markets could be significantly different for the projections, forecast, anticipations and hypothesis which are communicated in this material.