AXA Investment Managers

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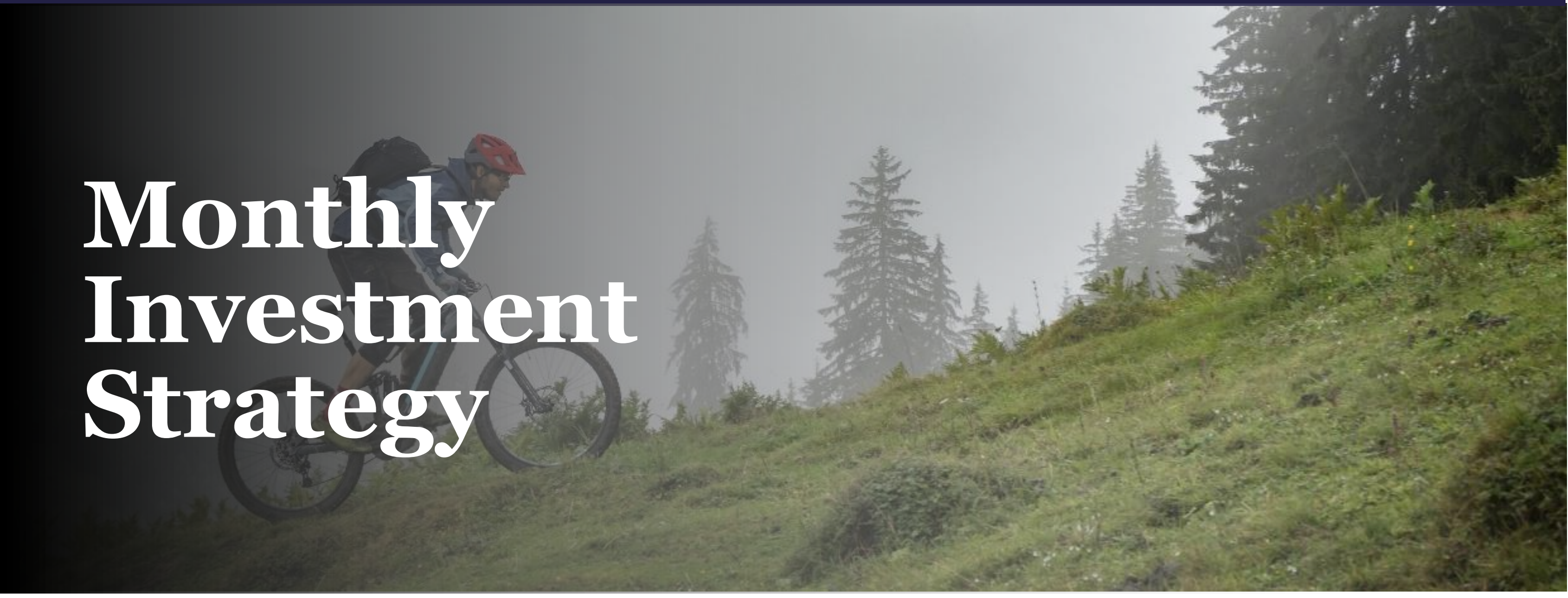
Investment Institute *Macroeconomics*



Monthly Investment Strategy

Geopolitics and yield add to macro uncertainty

Key points

- Terrorist attacks in Israel and retaliation in Gaza has created the threat of a humanitarian crisis, with risks of regional conflict escalation. Market reaction has been cautious to date, but risks are obvious.
- Meanwhile global bond yields continue to rise, driven by a rise in US Treasuries. Technical features appear to be compounding this rise, including the re-emergence of term premium as quantitative tightening continues.
- Yet macro drivers of yields are also compelling, particularly in the US where consumer resilience and solid investment has lifted future interest rate expectations.
- China posted stronger Q3 GDP growth, with consumer activity recovering. This likely secures this year's growth target, yet property remains a risk and ongoing momentum next year requires more stimulus.
- Eurozone growth prospects remain more stagnant, but fiscal concerns dominate as the budget process and higher yields challenge certain governments.

Global Macro Monthly

Geopolitics and yields add to macro uncertainty

Global Macro Monthly Summary October 2023

David Page
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Geopolitics and surging yields threaten outlook

The terrorist attacks on Israel and retaliatory strikes in Gaza have created the latest humanitarian crisis and risk a broader regional conflagration. Political leaders have engaged to dampen the escalation potential, including US, German, and UK Premier visits and the deployment of two US aircraft carrier groups. Whether this helps avoid a broader conflict remains to be seen. Already the normalization of relations between Saudi Arabia and Israel has paused. The outlook is far from predictable. Market reaction and the spillover to the global economy has so far been limited with modest oil price gains, little disturbance in stocks and scant obvious safe-haven support for bonds. For now, we monitor events, but the risks are obvious.

In the absence of a major geopolitical reversal of trends, the prevailing dynamic remains the surge in global bond yields, led by US Treasuries. This month's Theme of the Month looks to decompose this rise, focusing on the macro drivers. But technical features are also in play. One such feature appears to be the return of term premia – the additional return investors require to compensate for locking into long-term returns. These were quashed during the expansion of quantitative easing but as central banks – and the Federal Reserve (Fed) specifically – unwind this with quantitative tightening, these premia should add to rate outlooks in the coming years.

Yet macro drivers for higher yields are also compelling, particularly in the US, where consumers continue to defy softening expectations. We forecast a reduction in household income in Q4 reflecting slower real disposable income growth, an exhaustion of excess savings for most income groups and the resumption of student loan repayments. We expect this to weaken spending, but after September's retail strength, we no longer expect consumption to fall in Q4, while there is a risk that further savings declines or rising borrowing shelters spending from falling incomes for longer.

Alongside consumer resilience we see improving investment, which together have reduced the chances of a hard landing. We still expect Fed tightening to slow activity consistent with returning inflation to target but now see this after a period of softer, not falling growth – a fabled "soft landing." As this view becomes more widespread, forecasts for interest rate cuts have faded – lifting term rates even as expectations for the Fed's peak rate have barely changed. Moreover, increased investment spending has raised perceptions that the neutral rate has risen, further boosting longer-term rates.

Globally, the macro picture is more mixed. China reported Q3 GDP growth of 1.3% on the quarter in Q3 – above expectations. Yet revisions to previous quarters included a downgrade to Q2's growth to 0.5% from 0.8%, reducing the overshoot in levels' terms. Yet there are signs of a turn in activity from a mid-year nadir with the latest data suggesting improvement in consumer activity. This increases our confidence that China will achieve its 2023 target, but maintaining momentum for 2024 will likely require additional stimulus.

The Eurozone outlook is more downbeat. We expect a fall in Q3 GDP across the bloc as a whole but see it avoiding recession as a sharper drop in headline inflation boosts real incomes, supporting spending. Yet divergence is taking place. The more industrially focused Germany and Italy are experiencing greater headwinds than France and Spain. We believe the European Central Bank (ECB) has reached a policy rate peak at 4.00%, but will increasingly focus on balance sheet policy, with risks of exacerbating debt sustainability concerns.

The Eurozone is in the process of finalizing next year's budget outlooks, something made more difficult by the stalled agreement on new EU rules. Italy and France stand out with proposals that delay reducing deficits below 3% of GDP until 2026 and 2027 respectively. Rising yields add to concerns about fiscal sustainability. Italy's 10-year bond spread over Germany now exceeds 200 basis-points, presenting the Italian government with a challenging 5% 10-year yield with which to finance its large debt. Italy is not alone in facing such pressures. This is an additional explanation for higher US yields.

Several outstanding political developments may also impact the global outlook. Continued dysfunction of the US Congress, as the majority Republican party fails to elect a new House speaker, threatens government shutdown in November. Argentina's recent election also risks economic turbulence. More positively, Poland's elections pave the way for a government more aligned with broader EU values, which could unblock important EU investment funds. Meanwhile Ecuador's election looks to have prevented the return of the previous populist leader.

Global Macro Monthly – US

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Consumer keeps on rolling for now

September's retail sales rose by a surprisingly strong 0.7% on the month in value terms, the control group up 0.6% with upward revisions to August. Real retail sales continued to rise (Exhibit 1), although we await personal spending data to confirm if this was true for broader consumption. This defied a reversal in consumer sentiment, which surged to a 1½ year high in July from May but unwound by September.

Exhibit 1: Persistently strong consumer spending

Source: LSEG Datastream , AXA IM Research, 20/10/2023

This persistent strength follows strong summer spending, despite a headwind from gasoline costs. We continue to expect household income to come under pressure from the resumption of student loan repayments this month. Q4 should mark a softening in consumer spending but we now see this as around flat – compared to a fall – something that also assumes neither ongoing recourse to excess saving, nor increased borrowing supplementing spending.

Softer consumption should mark the final phase of an asynchronous slowdown that started with sharp falls in residential investment in the second half of 2022. However, as other economic sectors are unlikely to drop sharply from here (housing and inventory) or should start to firm (investment and manufacturing) we have already dropped our outlook for recession. We now see US GDP firmer, up 2.2% in 2023 and 1.4% in 2024. Yet upside risks persist. The Atlanta Fed GDPNow tracker suggests Q3 growth exceeded 5% (annualized); the latest labor report showed a 336k jobs gain, consistent with firmer GDP, and our outlook for softer consumption assumes weaker incomes will reduce spending, not raise borrowing.

Consumer Price Index (CPI) disinflation also stalled in September, the annual rate remaining at 3.7% as CPI rose by 0.4% on the month, buoyed by a further oil-inspired rise in gasoline. This should unwind in October, assuming oil prices remain steady. Core inflation, excluding food and energy, fell further to 4.1% – its lowest in two years. This drop was driven by core goods prices; services inflation eased to 5.2%, but the more recent trend suggests services disinflation also stalled, underpinned by services ex-shelter. We expect a more definitive easing in services ex-shelter inflation across Q4, but a persistently tight labor market poses a continued risk.

Fed at or near peak amid broader uncertainty

September's Fed minutes reiterated that a small majority of members (12 vs. 7) still expect one more rate hike this year. We remain unconvinced, with Fed Chair Jerome Powell stressing data-dependency and more recent Fed commentary before the next meeting's purdah period acknowledging broader tightening in financial conditions reduces the need for further policy tightening. This highlights the circularity of the Fed-market influence on financial conditions, which are currently at one-year highs according to some metrics. It also appeared to signal a reluctance to tighten policy at the next meeting (1 November), a message the market has heeded pricing a 10% chance of a hike. We believe weaker data will dissuade the Fed from raising the Fed Funds Rate in December and see 5.50% as the policy peak. However, ongoing consumer resilience makes this a genuinely closer call. We forecast three rate cuts for the second half of 2024, with rates at 4.75% by year-end.

Politics remains an area of outstanding risk for the US economy. Having avoided a government shutdown at the end of September, House Speaker Kevin McCarthy was ousted from his position by four members of his own party. The House struggles to appoint a successor, the next nominee garnering only 113 votes of support and sufficient holdouts to see him drop his bid. Second-placed contender Jim Jordan is currently failing to secure sufficient votes. The House is in uncharted territory with the current Speaker pro tempore possessing limited powers, thus stopping Congress resolving longer-term government spending, threatening a shutdown when the current extension expires on 17 November. This occurs before the Republican Primary season starts early next year in Ohio and before next year's Presidential race. As well as threatening a government shutdown and exposing the significant shortcomings in US governance, it will also hold up funding for the Ukraine war and potentially any additional support the US may offer Israel as recent terror attacks have raised additional potential headwinds from global geo-political developments.

Global Macro Monthly – Canada

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Inflation persistence spurs BoC on

This year's strong start was undone by a fall in Q2 GDP – exacerbated by strikes and wildfires. Q3 data is due at the end of November but with July's output estimated to be flat and 0.1% in August, Q3 looks on track for modest growth. We expect households to remain under pressure, with mortgage costs accounting for a larger share of income. However, export growth has outperformed and investment spending remained resilient. Canada should narrowly avoid recession, before seeing firmer quarterly growth from Q1 2024. We have lowered our 2023 growth outlook to 1.1%, from 1.3%, leaving 2024 unchanged at 0.9%.

Headline inflation fell in September to 3.8% despite firmer oil prices and we expect it to end 2023 a little firmer before disinflation resumes next year. Core inflation has proved stickier but the latest reading eased and the 3m-annualised median core rate fell below 4%. A softening in employment growth and easing in earnings growth should temper core price pressures but core inflation trends have been persistent over the last year. We forecast inflation to average 4.2% this year and 3.1% next.

Structural uncertainties complicate the outlook. Canada has raised migration targets to address skill shortages, adding over 400k again in 2022, boosting labour supply. But productivity has consistently fallen since the pandemic. These factors have opposite effects on potential growth. The Bank of Canada (BoC) estimates a broad range for potential growth from 1.0-3.2%. We see risks to the lower end, suggesting softer GDP growth may not deliver sufficient disinflation.

The BoC continues to trade-off risks of over-tightening and inflation persistence. Last month, the labour market's surprising strength, wage acceleration and a rise in core inflation led us to up our forecast to one more rate hike. Over the course of this month, the continued fall in the BoC outlook survey, the drop in core Consumer Price Index (CPI) pressures and the emergence of geopolitical tensions all suggest more caution. We drop our call for a further hike in October. December remains a risk but our expectation that lagged tightening will increasingly impact the economy suggests the more time elapses, the less likely further hikes become. We expect the BoC to leave policy unchanged at 5.00% and cut rates from next July to 4.50% by year-end.

Global Macro Monthly – EM

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Populism: *quo vadis*?

Populism is not a new phenomenon but in recent years has appeared to gain significant traction. A deeper suspicion of the prevailing establishment has taken hold and populists (whether leaning right or left) have been increasingly successful in developing countries, with the likes of Viktor Orbán in Hungary, Recep Tayyip Erdoğan in Turkey, Narendra Modi in India, Jair Bolsonaro – then Luiz Inácio Lula da Silva in Brazil – and Andrés Manuel Lopez Obrador in Mexico. More recently, the populist pro-Russia party led by former Prime Minister Robert Fico has won Slovakia's parliamentary elections.

Yet recent results suggest rising populism is not a default outcome. Polish people went to the polls on 14 October[2] to elect the members of Parliament amid a very tense environment, with the incumbent anti-EU populist Law and Justice (PiS) party attempting to stay in power for a third consecutive term. Official results confirmed that opposition coalition parties were able to secure the majority in the lower house. Donald Tusk may become the next Prime Minister. If so, he will have the difficult task of restoring independence to the media and judicial institutions – both undermined during the past eight years under PiS that put Poland in a "rule of law" conflict with the EU, affecting the disbursement of EU funds.

Ecuador also avoided a populist outcome with Luisa González's defeat in the October presidential elections. Center-right Daniel Noboa becomes the interim President, keeping the left-wing Citizen Revolution Movement (known as Correistas) away for the next two years. This ends the political instability that has been a drag on the economy for years, although Noboa's lack of track record and the challenges that his government will face remain areas of concern.

During the first round of Argentina's presidential election, Economy Minister Sergio Massa achieved a surprising victory, securing 36% of the vote. Javier Milei came in second with 30% of the support. As a result, Massa and Milei will compete in the runoff scheduled for 19 November. Notably, Milei could still emerge as the victor in the runoff by garnering the votes of Patricia Bullrich, who obtained 23% of the initial vote.

Global Macro Monthly – Mexico

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Mexico's surprising strength

In a period when many major economies in Latin America are experiencing a slowdown amid tight financial conditions, Mexico's economic activity stands out as a beacon of resilience, consistently surpassing expectations. Mexico's GDP grew 0.9% quarter-on-quarter in Q2, exceeding consensus forecasts. Additionally, leading indicators for Q3 signal continued economic strength, with retail sales and industrial production both maintaining impressive year-on-year growth rates of around 5%.

Several factors are contributing to Mexico's economic vitality. Notably, the US's robust economic performance has generated positive spill-over effects, including higher demand for Mexican vehicles, increased remittances and a surge in US tourists. On the domestic front, the construction sector is gaining momentum, driven by accelerated government spending on critical infrastructure projects. As a result of these dynamics, we anticipate that Mexico's economy will expand by 3.3% this year and 2.0% in 2024.

There is also encouraging news on inflation. Headline inflation has continued its downward trajectory, reaching a year-on-year rate of 4.5% in September. Mexico's strong economic performance and decelerating inflation align with the notion of a soft landing scenario. Nevertheless, it appears unlikely that the Bank of Mexico (Banxico) will initiate an easing cycle soon, in contrast to other major central banks in the region, such as those in Brazil, Chile, and Peru.

The minutes from Banxico's September policy meeting conveyed a notably hawkish tone. Concerns revolve around the possibility of a slower convergence to the inflation target in the coming months, as well as apprehensions regarding the government's expansionary 2024 budget, which could bolster aggregate demand in the upcoming year.

In politics, the ruling party Morena has selected former Mexico City Mayor Claudia Sheinbaum as its candidate for the 2024 Presidential elections. Sheinbaum is a close ally of President Andrés Manuel López Obrador and represents a continuation of his social agenda. López Obrador's popularity and Morena's hold on most governorships gives Sheinbaum a significant advantage.

Macro forecast summary

Real GDP growth (%)	2022		2023*		2024*	
	AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
World	3.5		3.0		2.7	
Advanced economies	2.6		1.5		1.0	
US	**2.1**	2.1	**2.2**	2.1	**1.4**	0.8
Euro area	**3.5**	3.2	**0.5**	0.5	**0.3**	0.7
Germany	**1.8**	1.8	**-0.3**	-0.4	**0.3**	0.6
France	**2.5**	2.5	**0.7**	0.8	**0.3**	0.8
Italy	**3.7**	3.7	**0.7**	0.8	**0.1**	0.7
Spain	**5.8**	5.5	**2.5**	2.2	**0.7**	1.4
Japan	**1.0**	1.0	**1.9**	1.8	**0.9**	0.9
UK	**4.1**	4.1	**0.5**	0.3	**0.2**	0.4
Switzerland	**2.7**	2.1	**0.7**	0.8	**1.0**	1.3
Canada	**3.4**	3.4	**1.1**	1.3	**0.9**	0.7
Emerging economies	4.1		3.8		3.7	
Asia	4.4		4.9		4.4	4.0
China	**3.0**	3.0	**5.0**	5.0	**4.5**	4.5
South Korea	**2.6**	2.6	**1.4**	1.1	**2.2**	2.0
Rest of EM Asia	**6.2**		**5.2**		**4.4**	
LatAm	4.1		2.3		2.2	
Brazil	**2.9**	2.9	**2.9**	2.9	**1.2**	1.6
Mexico	**3.9**	3.9	**3.3**	2.9	**2.0**	1.8
EM Europe	0.9		1.7		2.2	
Russia	**-2.1**		**2.2**		**1.1**	1.3
Poland	**5.1**	4.9	**-0.1**	0.5	**2.6**	2.6
Turkey	**5.5**	5.6	**2.1**	3.4	**3.1**	2.0
Other EMs	5.1		2.4		3.5	

Source: Datastream, IMF and AXA IM Macro Research – As of 24 October 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**	2.5
Euro area	**8.4**	8.5	**5.7**	5.5	**2.9**	2.5
China	**1.9**	2.0	**1.0**	0.7	**2.0**	1.8
Japan	**2.5**	2.5	**3.0**	3.1	**1.5**	2.0
UK	**9.1**	9.1	**7.5**	7.4	**2.8**	3.1
Switzerland	**2.8**	2.8	**2.4**	2.3	**1.5**	1.6
Canada	**6.8**	6.8	**4.1**	3.8	**3.2**	2.5

Source: Datastream, IMF and AXA IM Macro Research – As of 24 October 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	Q3-22	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24
United States - Fed	Dates	5.50	26-27 July 20-21 Sep	31-1 Oct/Nov 12-13 Dec	30-31 Jan 19-20 Mar	30-1 Apr/May 11-12 Jun	30-31 Jul 17-18 Sep	6-7 Nov 17-18 Dec
	Rates		+1.5 (3.00-3.25)	unch (5.50)	unch (5.50)	-0.25 (5.25)	-0.25 (5.00)	-0.25 (4.75)
Euro area - ECB	Dates	4.00	21 July 8 Sep	26 Oct 14 Dec	25 Jan 7 Mar	11 Apr 6 Jun	18 Jul 12 Sep	17 Oct 12 Dec
	Rates		+1.5 (0.75)	unch (4.00)	unch (4.00)	-0.25 (3.75)	-0.25 (3.50)	-0.25 (3.25)
Japan - BoJ	Dates	-0.10	20-21 July 21-22 Sep	30-31 Oct 18-19 Dec	22-23 Jan 18-19 Mar	25-26 Apr 13-14 Jun	30-31 Jul 19-20 Sep	30-31 Oct 18-19 Dec
	Rates		unch (-0.10)	unch (-0.10)	unch (-0.10)	+0.10 (0.00)	unch (0.00)	unch (0.00)
UK - BoE	Dates	5.25	4 Aug 15 Sep	2 Nov 14 Dec	1 Feb 21 Mar	9 May 20 Jun	1 Aug 19 Sep	7 Nov 19 Dec
	Rates		+1.00 (2.25)	unch (5.25)	unch (5.25)	unch (5.25)	-0.25 (5.00)	-0.50 (4.75)
Canada - BoC	Dates	5.00	4 Aug 15 Sep	25 Oct 6 Dec	24 Jan 6 Mar	10 Apr 5 Jun	24 Jul 4 Sep	23 Oct 11 Dec
	Rates		+1.00 (2.25)	unch (5.00)	unch (5.00)	unch (5.00)	-0.25 (4.75)	-0.25 (4.50)

Source: AXA IM Macro Research - As of 24 October 2023

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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.