30 November 2023

Investment Institute *Macroeconomics*

Outlook 2024-2025

Slowing mid-cycle, not crashing end-cycle

Key points

- Following resilient growth across many economies in 2023, we expect a slowdown in 2024. We characterise this more as a mid-cycle adjustment, rather than end-cycle event
- Inflation has come down sharply in most jurisdictions, primarily as energy, food and consumer goods prices have adjusted. Core prices have been slower to fall. Most should see continued disinflation across 2024, but only reach target in 2025. Some will struggle based on our forecasts
- Central banks broadly appear to have reached the peak of policy tightening. Uncertainty surrounds the timing and scale of future easing, but we envisage rate cuts across 2024, if only to manage rising real rates
- 2024 is a key political year with around two billion voters going to the polls. The US Presidential Elections in November are likely to be most consequential globally

From the Core Investment Macro Research team

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Macro outlook– Twin Policy Test

Gilles Moec
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Key points

- We confront our forecasts from last year for 2023: we were too pessimistic on the impact of the monetary tightening on growth, at least in the US
- We expect a still wide transatlantic gap in 2024. The Euro area will need to deal with the beginning of fiscal consolidation coming on top of the lagged effect of monetary tightening
- Higher long-term interest rates are a challenge. Even the US will have to adjust its public finances to a sounder footing, although it's very unlikely to start in 2024

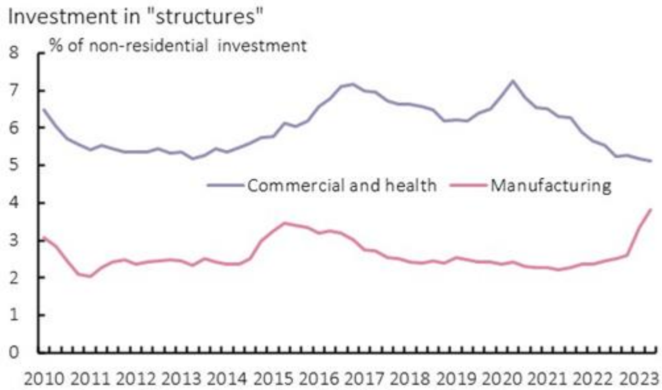
2023 Post-mortem exercise

At the same time last year, we wrote that 2023 would be the year the twin inflationary shock of the post-Covid reopening and the Ukraine war would start to fade at the cost of a significant tightening in financial conditions and an economic slowdown. We were only half right.

True, inflation has started to decline convincingly, and this goes beyond the mechanical effect of the fall in energy prices from the dizzy heights of 2022. The deceleration in core prices in both the US and the Euro area has been facilitated by the normalisation of global supply lines. The difficulties China is encountering with protecting demand from the side effects of the real estate correction are fuelling a return to deflation which supports the moderation of manufactured goods prices at the global level. There is still "way to go" to return inflation to the central banks' objective, but there is enough disinflation in the pipeline to consider that both the Fed and the ECB have reached a peak in their tightening in Q3 at roughly twice what used to be seen as the neutral rate in their respective constituencies.

We were however too pessimistic on the impact the monetary tightening would have on the real economy, at least in the US. We thought that the exhaustion of the fiscal push combined with the adverse effect of still high inflation on purchasing power and the erosion of the savings accumulated during Covid would make the economy particularly vulnerable to the rise in interest rates. What we missed was the fact that the current monetary tightening is very unusual in the sense that it does not follow a phase of rapid leveraging in the private sector. There is no sudden "refinancing cliff" which would force corporations into an emergency deleveraging, compressing spending. With a still financially comfortable corporate sector, employment managed to remain resilient. Job creation has fallen below its pre-Covid trend since the end of spring, but is still positive enough, combined with decelerating but robust wages, to support income growth in excess of headline inflation.

Exhibit 1: The IRA's impact is already tangible



Source: Bureau of Economic Analysis and AXA IM Research, October 2023

Unfortunately, the Euro area did not fare as well and has been flirting with recession since the beginning of the year. The specific vulnerability to energy prices continued to fuel weakness in industrial output, especially in Germany, but softness has extended to countries such as France and Italy which had been quite resilient at the peak of the energy shock. There may be more than just the differing sensitivities to gas prices at work. The US economy is visibly responding fast to the Inflation Reduction Act (IRA), with in particular a steep rebound in manufacturing capex (Exhibit 1), while the EU's own decarbonation support programmes don't seem to move the dial for now. In a nutshell, while in the US a new form of fiscal push continues to offset much of the monetary tightening, the Euro area benefits from less protection from the usual effect of higher policy rates, now fully transmitted by the banking sector.

Transatlantic gap still wide in 2024

2024 would not see any amendment to these diverging transatlantic patterns. Even if we expect both the Fed and the ECB to start cutting rates around the same time in mid-2024, the impact of the accumulated monetary tightening will probably still reach its peak in the second half of the year. In the Euro area, this adverse effect on aggregate demand will be compounded by the austerity turn of fiscal policy, already visible in the budget bills for 2024 voted or in the legislative process in the member states. Governments are proceeding cautiously – they learned from their mistakes when they endeavoured to cut deficits too harshly after the Great Financial Crisis – but still, the "fiscal stance" – the change in the cyclically-adjusted balance – will turn restrictive next year. The Euro area's paradox remains that its biggest member state, with the highest capacity for spill-over across the entire monetary union and one of the widest fiscal spaces given its low public debt, remains reluctant to use its firepower to mitigate its current and structural weakness. Meanwhile, as an election year, 2024 is very unlikely to bring about any fiscal austerity in the US.

The balance of risk is also more clearly tilted to the downside in Europe than in the US. Indeed, the tragic situation in the Middle East is a major source of uncertainty for next year. So far, the crisis has not had any tangible impact on oil markets. In case of escalation though, for instance through a direct involvement of Iran, oil prices moving significantly above USD100/barrel would become very plausible. The direct impact on GDP would be similar across the Atlantic (although the US has become a net exporter of oil, consumers there would still be hit) but the exchange rate ramifications would put the ECB in a very delicate position. Indeed, elevated oil prices are now consistent with a strong dollar, which would magnify the impact on European inflation, making it more difficult to accommodate the shock.

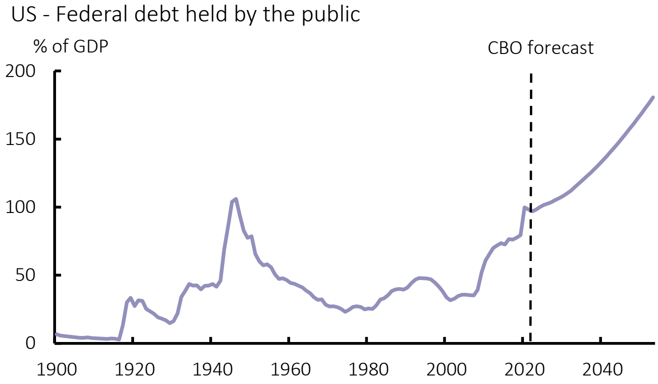
Navigating higher long-term rates

A rise in long-term interest rates now disconnected from expectations on the monetary policy trajectory has been a striking development of the second half of 2023. While ascertaining the causes of this move is difficult in real time beyond the obvious effect of Quantitative Tightening, we would highlight the new-found difficulties for the US Treasury to attract sufficient demand at its auctions as a sign that the continuous rise in supply of new paper, fuelled by the US unwillingness and/or readiness to curb the fiscal deficit, is exceeding traditional investors' appetite for long-term financial assets.

While we expect some additional correction from the 5% peak in US 10-year yields seen in October 2023, some of the forces behind the rise are likely to remain. Irrespective of the causes of the rise in long-term yields, this should in any case call for prudence from policymakers. In his Op-ed to our outlook, Olivier Blanchard, while maintaining his view that advanced economies can sustain a higher debt ratio, calls for credible fiscal consolidation plans to be put forward. In the US, it is fair to say that they are completely missing.

The Inflation Reduction Act came out without any caps to the tax credits. On the Republican side, a victory of Donald Trump next year would probably mean that the nominally time-limited tax cuts he granted in his first mandate would be prolonged. The US fundamental fiscal issue is that its welfare state is gradually providing a "European" level of social protection to a growing proportion of its population without the matching tax receipts. The Congressional Budget Office's long-term trajectory for public debt is quite scary (Exhibit 2). Given the extremely polarized state of US politics, finding the necessary bi-partisan resolve to address these issues is daunting.

Exhibit 2: Scary trajectory



Source: Congressional Budget Office and AXA IM Research, June 2023

No such institutional paralysis can be found in Europe, and despite the region's acute demographic challenges, there is a politically realistic pathway towards a stabilisation of public debt there. The issue in Europe is more the absence of room for manoeuvre. The episode of spread widening in Italy in September 2023 is a reminder that, even though there are arguably fewer fundamental reasons why long-term interest rates should rise than in the US, European governments are walking a tightrope. If an adverse risk to growth materialises, there won't be much dry powder left.

In a nutshell, the US and the Euro area will have to pass two different policy tests in 2024. The US needs to demonstrate it can "push the envelope" a bit further and maintain an accommodative fiscal stance without triggering too much pressure on yields. The Euro area needs to demonstrate it can go through a joint monetary and fiscal tightening without too much damage to growth, political stability and without adding to financial fragmentation.

Investment Strategy Outlook – Modest growth, modest returns

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

Key points

- Given bond yields hit multi-year highs in late 2023 we see strong potential for capital gains from here
- Corporate bond returns should benefit from a more benign interest rate outlook – with investment grade offering especially attractive yields
- If interest rates and bond yields move lower, and growth continues, investors could see the positive equity momentum sustained

  Bias is skewed towards bonds as here the risk premium has emerged; in equities it has eroded

Slower growth threatens equities

There was no recession in 2023 and interest rates rose further than most had expected. This backdrop turned out to be much better for equity investors than for bond holders, as it reflected a strong economy, especially in the US. The cumulative outperformance of global equities relative to government bonds since the end of 2020 has been the third strongest of the last 40 years.

But we don't expect a recession in 2024. We forecast modest GDP growth, further easing of inflation and some limited cuts in interest rates. Nominal GDP growth will be lower. One key risk is that eventually a recession will arrive as "higher for longer" interest rates eventually impact activity. Such a backdrop suggests a reduction – possibly even a reversal – in relative equity outperformance. By contrast, bonds should decisively shake off their losing streak.

Rates to remain high

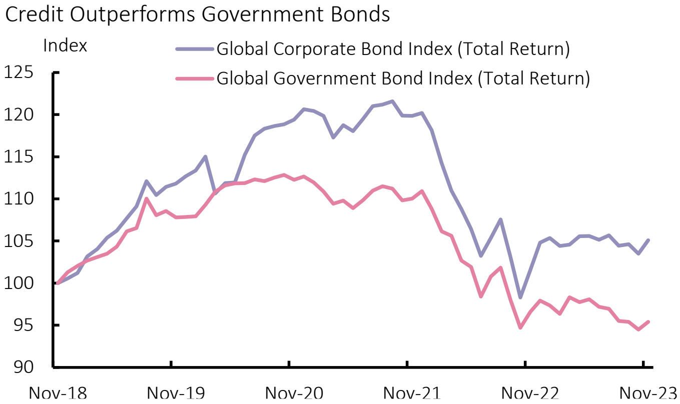
There are nuances in our outlook. Interest rates may have peaked but inflation will remain above target in 2024. The "higher for longer" narrative from central banks will prevail and there will only be limited scope for rate cuts until there is evidence of easing labour market pressures. That should not put investors off investing in fixed income. Higher rates from here are unlikely unless there is another inflation shock. That reduces downside risk from any re-setting (higher) of rate expectations. A higher yield starting point is also a positive. Over a one-year horizon, the total return skew from buying bonds today is much more positive than it was at the start of 2022. In the risk scenario of even weaker growth and a more dovish pivot in central bank rhetoric – and even policy – there is more optionality for capital gains in fixed income than there is scope for drawdowns.

As rates increased, so did measures of interest rate volatility and of the estimated term premium in yield curves. The absence of central banks scooping up government bonds has contributed to increasingly uncertain bond returns – reinforced by higher short rates, inflation and concerns over higher fiscal deficits. On the plus side, investors get paid more for taking bond risk. A higher risk premium in the yield curve and higher interest rates, relative to equity volatility, are further supports for a more positive view.

Credit attractive

Corporate bond returns should benefit from a more benign rate outlook. Credit risk premiums have been generally stable during 2023, helping corporate bonds outperform government bonds (Exhibit 3). The current macro forecast supports a continued solid performance from corporate bond markets, with investment grade bonds offering yields close to 6% in the US and 4.25% in Europe.

Exhibit 3: Credit Outperforms Government Bonds



Sources: Bloomberg, LSEG Datastream and AXA IM Research, 20 November 2023

Credit risk is manageable in modest growth

It is a fact that corporates are likely to face higher financing costs should they need to raise debt in the next couple of years compared to the average coupon on their existing bonds. However, lower rates in 2024 and 2025 and the fact the volume of bonds maturing in the short term is relatively limited means refinancing risks should be limited. High-grade companies extended their debt during the low yield period and have manageable levels of leverage, having benefitted from strong nominal revenue growth in the last three years.

Credit investors need to watch equities though. Any earnings deterioration or increase in equity price volatility would likely push credit spreads wider. This relationship is stronger in the high yield parts of the credit market. Credit spreads, in both US high grade and high yield markets, have been around the 50th percentile of their distribution over the last 10 years. European risk premiums are in the 80th, suggesting there is more value in euro credit through the lens of risk mitigation.

Spread widening is a risk on any general deterioration in the risk environment. However, there has been no excess credit cycle and balance sheets are stronger than in previous tightening episodes. As such, spread widening would create opportunities for investors, especially with lower rates providing cheaper financing for borrowers. The bottom line is that overall yields are attractive relative to where we expect short rates and inflation to end up in 2024.

Bond versus equity risk

In the US, the bond and equity relationship dynamic has moved to the extreme. Real yields on US Treasury Inflation Protected Securities (TIPS) are higher than the dividend yield on the US equity market. More sophisticated measures of the equity risk premium put it at a multi-year low. Moreover, equity volatility has fallen relative to interest rate volatility. Lower nominal growth should benefit bonds to the detriment of stocks.

Uncertain earnings outlook

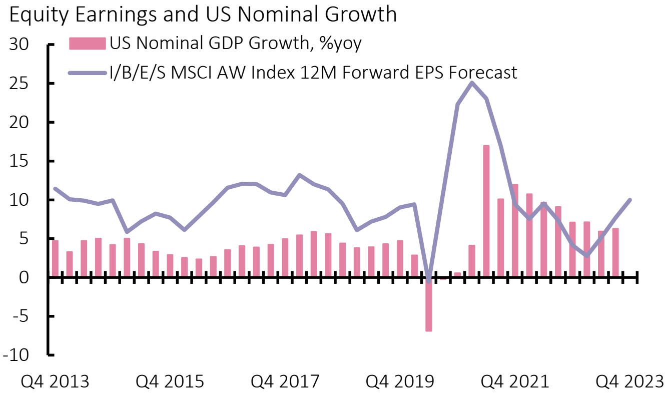
Earnings expectations for 2024 are solid for the US and other equity markets, and US equity valuations are higher than their long-term average. That situation could persist in a 'Goldilocks' type soft landing. AXA IM's implied nominal GDP growth forecast for the US could be enough to allow the 10% to 12% bottom-up expectation of earnings growth to be met. However, the risks are to the downside. As US companies reported Q3 2023 earnings, which were generally a little better than expected, many suggested some downside risks to revenues and margins going forward. Should there be any evidence that earnings growth is weakening in the early part of 2024, then current valuations in the US might not be sustained.

A soft landing can support stocks

However, we cannot discount the equity bull market continuing. Easier financial conditions coming from slightly lower interest rates and bond yields – and continued positive real growth – could sustain positive sentiment towards stocks. Add in the ongoing excitement around artificial intelligence and its potential to boost growth, and certain parts of the stock market could continue to deliver strong earnings growth and returns to investors (Exhibit 4). While bond performance was disappointing in 2023, a portfolio weighted to short-duration credit and long-duration technology stocks would have been a very good performer. Until the Federal Reserve pivots, such a barbell strategy could continue to be so.

European investors will face lower equity valuations and lower bond yields relative to the US market. The backdrop looks set for weaker growth and lower inflation, with a European Central Bank which might also be hesitant to pivot. Real yields are lower and the valuation gap between equities and bonds is still stacked more in stocks' favour. To the extent the US has more scope for disappointment on growth and for interest rate expectations to change, European markets might be less volatile but still able to deliver positive returns for investors across asset classes.

Exhibit 4: EPS forecasts look optimistic



Sources: Bloomberg, LSEG Datastream and AXA IM Research, 20 November 2023

Evenly balanced

Modest investment returns based on a modest nominal growth outlook is the core view. The bias is more towards fixed income given that is where the risk premium has emerged over the last year, while in equities it has eroded.

In addition, the relative implied volatility of rates versus equities is also an indicator supporting a positive view on bonds. With rates peaking and inflation falling, uncertainty around rates should decline and, directionally, we expect the yields to be lower.

For risk assets there is less risk premium to compensate for growth and earnings uncertainty. The lack of an 'irrational' credit cycle and reasonable credit spread levels offer some comfort to credit investors with huge demands from corporate refinancing needs not a major negative for investors in 2024.

Equities benefitted from upside growth surprises in 2023. After another year of tightening giving the famous lags more time to work, the risk lies the other way round for equities now. A deterioration in the expected risk adjusted return profile is likely to be the result.

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Summary – Slowing mid-cycle, not crashing end-cycle

David Page
Head of Macro Research
Macro Research – Core Investments

Key points

- Following 2023's resilience, we expect global growth to slow in 2024 – this should be a mid-cycle adjustment, not an end-of-cycle collapse. 2025 should enjoy acceleration
- Central banks are likely to ease policy in the face of further disinflation but most will manage restrictive policy rather than add fresh accommodation
- 2024 will be a big year for elections. Globally the US Presidential race will likely be the most consequential

Uncertain ground

The outlook for 2024 and 2025 is built on end-of-2023 uncertainties – albeit less than there were at the start of 2020, as the world was plunged into the pandemic. Geopolitical uncertainties mirror those at the end of 2021, ahead of Russia's invasion of Ukraine as the Middle East crisis poses a major risk to the global economy. An escalation of the conflict risks a marked impact on oil prices, regional activity and global sentiment. However, it is not obvious that escalation is the most likely path, with the US and others supporting Israel, but cautioning its actions, alongside more divergent interests across the Arabian Peninsula restraining reactionary forces.

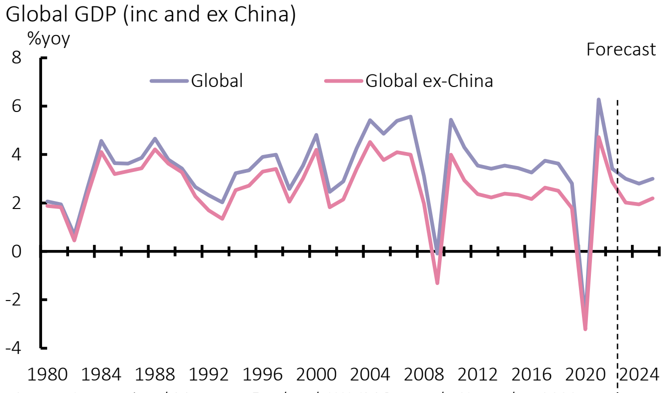
Beyond geopolitics, there is uncertainty around the global economy's cyclical position. This is exemplified in the US, where expectations of recession have faded. Recent economic convulsions have not been cyclical: the pandemic was an exogenous shock that forced a deep recession, resulting in supply constraint and demand-stoking policy responses. The resultant inflation was not the product of an overheating, end-of-cycle economy. Uncertainty still surrounds the degree of quasi-permanent structural change that economies have seen – as well as the balance of central bank tightening versus pent-up demand. The assessment we make is whether the economy faces an end, or mid-cycle, adjustment.

Recessions no longer central forecast

For Western economies we envisage mid-cycle adjustments. For the US, we had expected the degree of tightening from the Federal Reserve (Fed) to result in a dip in output and mild recession. But consumer resilience has delivered a slowdown by instalments. We now expect the US to enter the broadest phase of its slowdown with consumer spending forecast to ease from robust growth over the summer. This should see it slow to a below-potential pace of 1.1% in 2024, before the economy rebounds above trend by end-2025 – we forecast expansion of 1.6%. We no longer forecast outright recession. With an associated modest loosening in the labour market, inflation should reach the Fed's mandate in 2025 but end the year modestly higher. This suggests limited room for renewed Fed accommodation. We envisage modest rate cuts (three this year, two next) but characterise these as moderating restrictiveness as opposed to outright easing.

Exhibit 5: Global growth expected to soften in 2024

Global GDP (inc and ex China)



Source: International Monetary Fund and AXA IM Research, November 2023

European economies are facing a tougher test. Ongoing supply constraints continue to impact Eurozone economies. Solid wage growth and limited easing in labour markets should see firmer real disposable income growth as inflation falls over the next 18 months. This should mitigate risks of outright contraction, despite the weak investment backdrop. We forecast Eurozone GDP growth of 0.5% this year and just 0.3% next – weaker than consensus – before rising to 0.8% in 2025. However, even this subdued outlook is unlikely to drive inflation sharply lower as weak supply growth should limit the emergence of spare capacity. We see inflation back to target around mid-2025 and the ECB easing monetary policy, but more cautiously than markets envisage, forecasting the first cut only from June 2024, ending 2024 at 3.25% and 2025 at 2.75%.

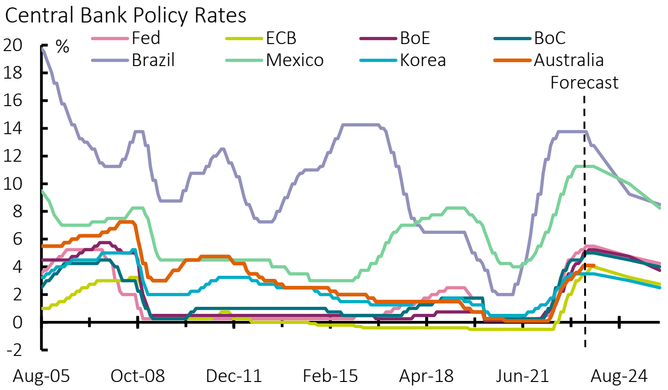
The UK will likely face a weaker outlook. We forecast growth of 0.5% this year, 0.0% in 2024 and 0.5% in 2025 and are very wary of the lagged impact of Bank of England (BoE) monetary tightening – even though policy now appears to have peaked – with delayed mortgage resets likely to tighten monetary conditions across 2024. Our central forecast is for the UK to be on the cusp of recession; risks are skewed to contraction.

Concerns of wage stickiness will likely see the BoE on hold until H2 2024, but then we think the lagged pass through of policy stimulus will require exaggerated stimulus. We forecast rates closing next year at 4.5% and 2025 at 3.75%.

Beyond cyclical dynamics

Firm action from Chinese authorities looks set to deliver China's 2023 growth target of "around 5%" – we forecast 5.2%. Stimulus should quicken the quarterly growth pace next year, even if this equates to lower annual growth of 4.5%, before slowing in 2025 to 4.2%. We expect further stimulus if growth falters. The economy's reliance on fiscal/infrastructure boosts is delivering an unbalanced economy and increasing resource misallocation with implications for China's longer-term growth outlook. The longer-term remedy would be structural, market-led reforms. Yet this appears to run contrary to President Xi Jinping's appetite for control. This creates a long-term risk for China. We do not expect this to come to fruition over the next two years, but it will hang over the longer-term outlook.

Exhibit 6: Central banks should (further) loosen policy



Source: National Central Banks, Refinitiv and AXA IM Research, November 2023

Japan faces longer-term change with inflation above the Bank of Japan's (BoJ) 2% inflation target after decades of battling deflation. The BoJ has all but dismantled its yield curve control but has been cautious of further accommodation withdrawal. It is monitoring wage developments to determine its next move. Early signs suggest solid (positive real) wage growth next year. We expect the BoJ to remove its negative interest rate policy around spring and forecast a modest tightening thereafter. Yet after decades of around zero rates, the economy is vulnerable to rate adjustments. Fiscal and financial stability risks should see the BoJ raise rates only gently to 0.25% by end-2025.

Structurally stronger emerging markets

Emerging markets (EM) proved more resilient in growth terms across 2023, even as inflation fell broadly in line with expectations (though core rates remained stickier) allowing many EM central banks to ease policy. This should continue, although softer global growth and tight financial conditions are likely to prove headwinds next year. Inflation is likely to fall further, although disinflation should be driven more by core adjustments. Central banks have adopted a more cautious tone and this is likely to prevail: we expect rate cuts in 2024, but broadly consistent with stabilising real rates.

Our outlook suggests global growth slows to 2.8% in 2024, softer than the 3.0% in 2023, before accelerating to 3.0% in 2025 with most economies avoiding recession (Exhibit 5). This mid-cycle adjustment should see central bank policy rates falling – but forecast to stay at or above neutral in most regions (Exhibit 6). This has been likened to the mid-1990s US soft landing. But this is an uncomfortable comparison for EM economies, a period remembered for systemic EM crises, including Mexico (1994), Asia (1997) and Russia (1998). While conditions are set to remain tight, we note significant structural improvement since, including institutional credibility; anchored inflation expectations; floating exchange rates; better capitalised banks; and no excess capital inflows lately. Exceptions remain and tight conditions will see stresses for some but we are less concerned about the risk of a systemic shock in EM.

A protracted period of elevated rates raises average financing costs: for households, corporates and sovereigns, suggesting elevated vulnerability. Fiscally, we will monitor Italian sovereign risks – a country with elevated debt, high sovereign yields and one that has recently pushed back its plan to meet a sub-3% of GDP deficit by 2026. France has also pushed its expectation back to 2027. We also focus on the US. The latest official deficit forecasts *average* nearly 6% over the rest of this decade. With debt forecast at 98% for 2023, this is sustainable for now. But with debt projected to exceed 110% by 2030, markets will question future sustainability at some point.

The Trump card

Next year will be a key year for politics. More than two billion people will go to the polls, admittedly, most by virtue of India's elections in April/May. EMs will collectively hold 19 elections in 2024 – we will pay close attention to those in Taiwan (January), South Africa (May-August) and Mexico (June). However, the most significant election for EM – and the world – is likely to be the US Presidential Election. While we are not certain it will be a re-run of the 2020's Joe Biden-Donald Trump race, that still looks likeliest at this stage. A return of President Trump would have domestic implications in terms of adjustment to fiscal policy. However, globally its potential impact on geopolitical events poses the most uncertainty – a return to trade wars as well as questions over support for Ukraine and Israel. European elections (May) and UK elections (likely October) should also have important local impacts.

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US – Avoiding recession leaves little space for easing

David Page
Head of Macro Research
Macro Research – Core Investments

Key points

- The US looks set to slow but avoid recession. We see growth of 2.3% in 2023, 1.1% in 2024 and 1.6% in 2025. There are risks of a sharper slowing in H1 2024, before a pick-up in 2025
- Inflation should fall back to target in 2025 aided by labour market easing and structural improvement
- The Fed is likely to manage restrictiveness, rather than ease outright with QT likely through 2025

Phantom recession?

This time last year we forecast a mild recession in 2023. In fact, this year now looks on track for above-trend growth of 2.3%, thanks to a more resilient consumer, buffered by excess savings and solid hiring by a corporate sector which has avoided the worst excesses of Federal Reserve (Fed) tightening. A quicker pick-up in investment in response to government programmes also helped. The key question is whether recession has been averted or merely delayed. However, despite stronger growth, inflation fell quicker than we expected and is likely to average 4.2% in 2023 (5.1% expected) and Fed policy appears likely to peak at 5.25-50% this year – 50bps higher than forecast.

Growth below potential but should avoid recession

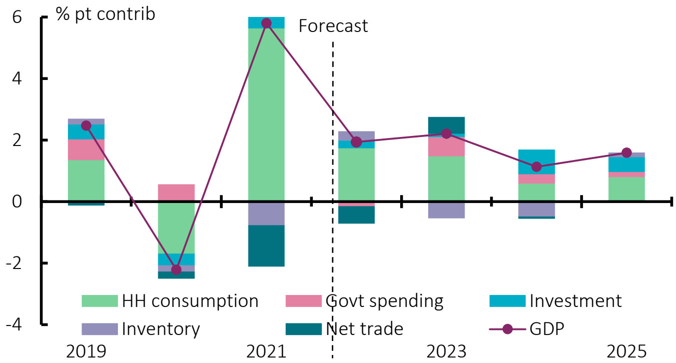
Despite a strong Q3 GDP expansion of 4.9% (saar) with consumer growth of 4.0%, we continue to expect a marked moderation in consumer spending to deliver a significant slowdown next year. We expect real disposable income to fall, with employment income growth softening quicker than inflation is easing, with an increase in tax contributions impacting disposable income growth. We are also wary that support from unwinding excess savings has run its course. The saving rate was estimated at 3.4% in September and we expect this to rise over the coming quarters.

We forecast a deceleration in consumer spending from Q4 that is likely to last through the first half of 2024 before improving. Risks surround this outlook; the treatment of excess saving is uncertain. We argue that late-summer spending suggested an income divide, with iPhone and auto sales offset by subdued clothing and food sales. Higher income households' spending may remain supported by savings, even as buffers for lower income households appear exhausted. Households may also offset real income pressure by increasing borrowing – the sector is in a better position than 15 years ago.

Investment spending is also likely to slow but remain solid – we were surprised at how quickly it responded to policy stimuli. While this looks set to support spending in the immediate quarters, deceleration is likely for the coming year. However, without forecasting a major cyclical event, and with large businesses managing their financing to avoid a refinancing wall over the coming years, we expect investment to remain solid in the face of continued domestic demand, additionally underpinned by energy and artificial intelligence investment.

Exhibit 7: GDP on track for below-trend growth

US contributions to growth



Source: BEA and AXA IM Research, 15 November 2023

We expect quarterly GDP growth to slow sharply in Q4 2023 (to around 1% annualised) and H1 2024, before picking up through 2025. Overall, we forecast GDP growth of 2.3% in 2023, slowing to 1.1% in 2024 and 1.6% in 2025, with quarterly growth rising above trend rates by mid-2025 (Exhibit 7). This is consistent with the Fed's goal of a period of sub-potential growth.

Risks to our forecast are two-sided. Consumer spending could rise on increased borrowing. But we continue to suggest the balance of risks is to the downside of our outlook; a risk that our forecast of mild recession was wrong in terms of timing, not direction. Headline indicators still suggest the possibility of recession including ongoing yield curve inversion, tight credit conditions and what appears to be an impending fulfilment of the recession-indicating Sahm rule. However, we believe the aforementioned buffers have desynchronised slowdown across the economy, with a final impending softening in consumer activity anticipated. Other sectors appear now to be stabilising and could pick up, particularly in manufacturing if China's sequential growth pace accelerates as expected.

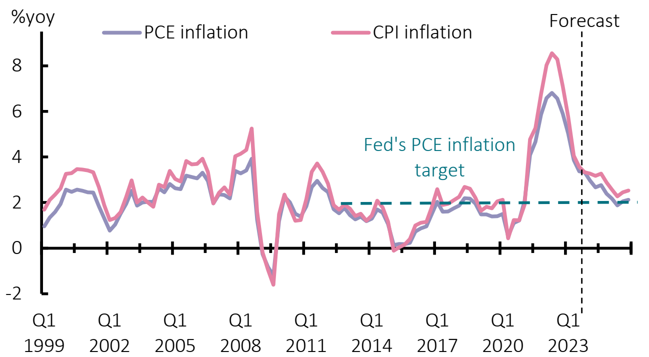
Domestic inflation pressures

Inflation has fallen reflecting an easing in global supply chain pressures and weaker energy price rises. However, the faster-than-expected fall in headline inflation and outlook for core inflation for the coming years will depend on domestic developments – and specifically the labour market.

Despite stronger growth, labour market tightness has eased. Trend employment growth has slowed this year (to 204k in October from 334k in January), unemployment has risen (to 3.9% from 3.4%) and vacancies have fallen to 9.5mn from a peak of 12mn. This has helped wage growth slow to an annual 4.1% in October, a little over the 3.5-4% we would see as consistent with achieving the Fed's long-term inflation mandate. Our outlook includes a further loosening of the labour market and unemployment rising to 4.4% by end-2024. However, some of this would reflect a continuation of more structural features: firmer immigration contributing to strong labour supply growth and improvement in labour matching efficiency, which should help soften wage growth, even with relatively low unemployment rates.

Exhibit 8: Inflation to hit target, but little room for easing

Headline PCE and CPI inflation measures



Source: BEA, BLS and AXA IM Research, November 2023

Other structural developments are likely to help reduce core inflation, including an expected fall in profit margins and a cessation of the goods and services rebalancing seen since the pandemic. On balance we forecast inflation averaging 4.2% in 2023, falling to 3.2% in 2024 and 2.7% in 2025. We forecast inflation ending 2023 at below 4%, 2024 at 2.6% and 2025 at 2.8%, with the Personal Consumption Expenditure (PCE) inflation likely falling to target in Q2 2025 (Exhibit 8).

Fed to manage restrictiveness rather than ease

We believe the Fed Funds Rate (FFR) has peaked at the current level of 5.25-50%, despite suggestions of a possible final hike. Based on our forecasts we do not see space for a significant loosening in policy over the coming two years.

Current policy is restrictive and as inflation falls, conditions will tighten further as the real FFR appreciates. Officials have discussed managing this real rate. We expect the Fed to resist reacting to economic softening but to lower the FFR to moderate real rate appreciation. We forecast 75bps of cuts from June next year, providing only a modest easing in the restrictive stance. We forecast two further cuts in 2025, taking the FFR to 4.25% by end-2025, as the Fed gently pares back restrictiveness further amid an improving growth backdrop.

We also anticipate the Fed will continue its quantitative tightening (QT) over the next two years. We think it will be comfortable reducing still "ample" reserves, with only a modest anticipated monetary tightening impact, whilst dynamically adjusting the real FFR, rather than sharply easing policy. We also expect reverse repo holdings to continue to fall over 2024. We assume that 2019 excess reserve lows act as a limit guide for future reserves (allowing for a precautionary buffer). This should see the Fed reduce excess reserves to just over $2tn, a point we estimate reaching only in early 2026. We expect it to announce ending QT only at the end of 2025. However, a sharper economic slowdown, requiring aggressive stimulus, or higher commercial bank liquidity demands risk an earlier end.

An important political year

Congress averted a government shutdown across 2023 and must now agree appropriations bills by early 2024. We forecast a modest tightening in the fiscal stance across 2024, with current plans for this to be broadly neutral in 2025. However, the US fiscal deficit is forecast at 5.9% of GDP this year and to average 5.8% for the rest of this decade, with a primary deficit of around 3%. With US debt forecast at 98% of GDP this year, US finances are sound for now but are unsustainable over the longer term and are expected to rise to 111% by 2030, 134% by 2040 and 168% by 2050. Treasury yields do not obviously price a credit premium for now (distinct from reflecting supply) and we do not forecast this. But this is a risk over the medium-term without a material fiscal tightening.

November's Presidential Election will be key to this. It is not certain who the candidates will be, although a re-match of the 2020 Joe Biden/Donald Trump contest looks likeliest despite concerns about the former's age and the (barely younger) latter's legal challenges. The outcome is highly uncertain. Congressional elections will also be important. The Senate rotation looks unfavourable for Democrats, meaning a second Biden term could face a mixed or hostile Congress. A Trump win would be more likely to have a slim majority in both houses. For now, we would expect a second Trump term to focus on extending his previous tax breaks (due to expire at the end of 2025), at a further cost to the fiscal outlook. However, we would be more fearful of disruptive geopolitical developments with this outcome.

30 November 2023

Eurozone – Mind the return of market discipline


François Cabau,
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Key points

- Meagre Eurozone growth looks set to continue. Supply issues will fade but are unlikely to disappear
- We project euro area headline inflation to land at the ECB's target mid-2025
- ECB to remain cautious on PEPP roll-off before cutting interest rates during the summer
- Another year of record Italian issuance to add to the ECB's challenges

Growth: Private consumption push, investment pull

Eurozone GDP growth contracted slightly in Q3 following continued business surveys weakness since the spring. They remain stuck in low gear, implying a technical recession in the second half of 2023 cannot be ruled out. However, we believe a further inflation decline will generate marked real purchasing power gains in Q4 – exceeding 2% above pre-Ukraine conflict levels (Q4 2021) – supporting private consumption. Overall, we project Eurozone GDP to grow by 0.5% in 2023.

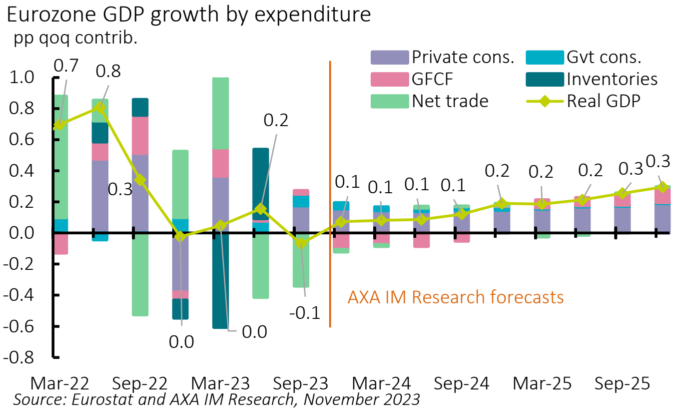
Private consumption is likely to be the Eurozone's main growth engine for the next couple of years (Exhibit 9) based on expected gains in real purchasing power. Although gradually decelerating from this year's high plateau (4.5% year-on-year on average), nominal negotiated wage growth should still be decent, averaging 4.0% and 2.8% in 2024 and 2025. Combined with gentle labour market cooling, it should fuel further real income gains as inflation decelerates further. Consumers have maintained higher savings post-pandemic. We maintain a cautious stance projecting 1.1% and 1.2% private consumption growth over the coming two years.

We think investment is likely to become a drag on GDP growth. The historical relationship between construction activity and mortgage lending suggests further downside to residential investment. Assuming a normalisation in non-financial corporations' profit margin behaviour, further meaningful increases in real interest rates (mainly linked to the inflation fall) are likely to take their toll on business investment. That said, we think the correction is likely to be more limited than historical relationships suggest owing to ongoing fiscal support – mainly the Next Generation EU (NGEU) recovery programme – a weak but not abysmal demand signal; and that non-financial corporations' and banks' financials are in better shape than in previous downturns. We expect overall investment to dip in 2024 (-1.1% on average) – though not crashing – before recovering in 2025 (+0.5% on average) (Exhibit 9).

Events since COVID-19 have highlighted the need to identify the relative importance of supply and demand factors affecting the economy. This daunting task is to continue. For the next couple of years, we think supply issues should fade somewhat – though are far from disappearing - but demand is likely to be the most important factor affecting the euro area economy, barring any new shocks.

All in all, we keep our subdued, though improving sequential growth forecasts, projecting the euro area economy to grow by an uninspiring 0.3% in 2024, before edging up to 0.8% in 2025 – still below potential growth. A weaker demand backdrop is consistent with a mild rise in the unemployment rate, projected to increase from an average of 6.5% this year to 6.9% in 2024 and 7.3% in 2025.

Exhibit 9: Private consumption – the main engine of subdued growth



Source: Eurostat and AXA IM Research, November 2023

Inflation: 2% likely but only in mid-2025

Eurozone headline inflation surprised to the downside falling below 3% in October for the first time since July 2021. However, we think the road to 2% will take more time than the last five months that saw inflation halved to 3%. Energy base effects are the main reason for the end of this recent disinflationary trend. Food and core price disinflation look likely to continue, though at a slow pace. In turn, we expect headline inflation to be volatile between 2.5% and 3% throughout 2024, crucially not starting a further downward trend before the beginning of 2025, when it will react to softer wage growth and labour market easing. We see the European Central Bank's (ECB) 2% target being hit mid-2025.

Overall, we expect euro area headline inflation to come down to 2.7% and 2.2% in 2024 and 2025 after 5.5% this year. The slowdown in core inflation is likely to be more limited, edging to 3% in 2024 from 5.0% this year. We project it to remain above 2% throughout 2025, averaging 2.3%. This will likely keep the ECB in a vigilant mode.

ECB: A challenging policy sequence

Given the backdrop of recession-avoiding low growth, with fading but still present supply constraints, and inflation resistant to a fall to 2%, the ECB's hawkish tone is likely to continue. Though we maintain that ECB's deposit rate has likely peaked at 4% but will remain unchanged until next summer.

Policy decision-wise, the ECB's balance sheet will be next to come into focus, and especially Pandemic Emergency Purchase Programme (PEPP) reinvestments. This is likely to be a difficult topic given they are the first line of defence against financial fragmentation and next year's sovereign gross issuance is set to be very high (again).

We expect the ECB to proceed carefully, mimicking its approach with the Asset Purchase Programme (APP): Not withdrawing support during Q1 2024 when gross issuance is seasonally high and then setting on a gradual and predictable non-reinvestment pace. We expect a decision this winter, March seeming more likely than December, and will in any case be dependent on market conditions. We expect a partial roll-off of PEPP to start in the second half of 2024. A decision in March may also come alongside the operational framework review which would put the ECB in a good place to tackle the (excess) liquidity topic in a comprehensive fashion.

Both the ECB's Chief Economist and President have highlighted the importance of ongoing wage negotiations, with data to be published next spring. Confirmed decelerating wage pressures – amid our predicted volatile 2.5%-3% inflation path during 2024 – would reassure the ECB on its path towards its inflation target. Unit labour cost dynamics and inflation expectations will also be key inputs. Persistent supply issues will make forward-looking approaches difficult.

Owing to our below consensus/ECB growth forecasts, we expect the first ECB rate cut to come next June - 25 basis points (bp) a quarter until June 2025 to 2.75% – but as with rate increases, the ECB is likely to be sensitive to the Federal Reserve (Fed). History would suggest a slight delay (a minimum of four months), which given our June baseline for the Fed makes a cut in September a very reasonable option, which may also be justified in the case of slower-than-projected labour market cooling, especially with regards to unit labour costs. Both argue the market has got ahead of itself again in pricing a first cut in April (Exhibit 10).

Italy: Beware of market discipline (again)

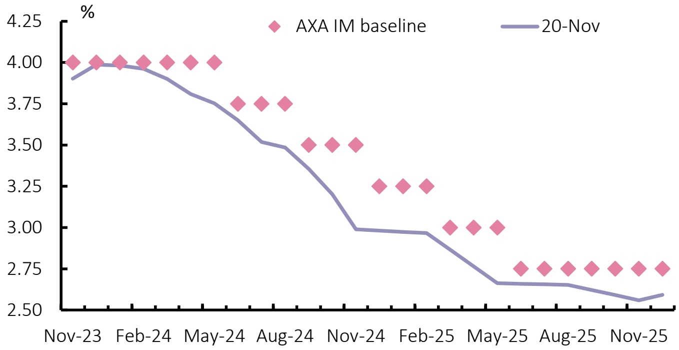
With policy rates set much higher than thought, spring banking stress and record net issuance, sovereign bond markets behaved surprisingly well until the sell-off over the summer. Complacency into 2024-2025 may come at a high price.

More than a year into office, the Italian government's stability is remarkable, unlike other countries e.g., Spain, Portugal and the Netherlands – all forced to endure snap elections. However, we do not think the coming years are likely to be plain sailing.

We forecast Italy to underperform the big four Eurozone countries, projecting 0%/0.5% growth in 2024/2025, affected by contracting investment, resulting from monetary policy tightening (but also a past boost in the construction sector). Meanwhile, it is hard to disentangle it from Germany's manufacturing woes, and more generally tepid global growth. Our growth projections for Italy are far below those of the government (1.2%/1.4%) implying some budget slippage on an already challenging public debt trajectory. Also crucial for medium-term fiscal sustainability, NGEU funding implementation has yet to pick up to cruising speed.

Furthermore, we estimate that Italy's 2024 government net-net issuance (net of the ECB's reinvestment) will be around €50bn higher than this year. Retail absorption played a crucial part in this year's government funding, but it is not only uncertain that it can be tapped again to a similar extent, let alone increase participation. This leaves 10-year government bonds – BTPs – (levels and spread) vulnerable to domestic factors but also global rate dynamics. Again, a fine line for the ECB to walk, pending clarity on future fiscal rules.

Exhibit 10: Market rate cut pricing on the aggressive side



Source: Bloomberg and AXA IM Research, November 2023

UK – Lags could push Bank of England to faster cuts

David Page
Head of Macro Research
Macro Research – Core Investments

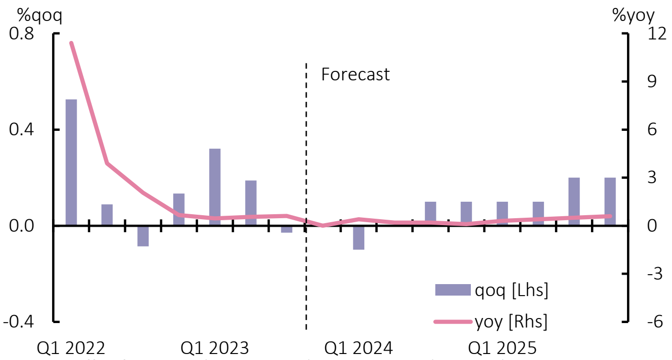
Key points

- Although BoE policy appears to have peaked, rising mortgage rates will continue to tighten monetary conditions throughout 2024
- We see the economy on the cusp of recession in 2024, with risks skewed lower. Growth should accelerate somewhat in 2025
- Given the policy lags, we see the BoE easing from August next year – and more quickly than expected

Lags threaten recession

The UK has had a difficult year but the past 12 months have seen inflation fall to 4.7% from 11.1%, the economy avoid recession and gilts outperform their peers. But 2024 looks set to be tougher. Further disinflation should support household spending power but tighter monetary policy is likely to bear down on households. Despite a smaller proportion of outstanding mortgages, the impact of the sharp rise in mortgage rates will be marked. It is also lagged, with more fixed deals than in previous cycles (Exhibit 11). This delayed the impact this year, but looks set to grow next, including via pass-throughs to rents (already rising at a double-digit pace) as buy-to-let landlords pass on higher borrowing costs.

Exhibit 11: UK projected to narrowly avoid recession (again)



Source: Office for National Statistics and AXA IM Research, November 2023

Weak consumer spending is likely to dominate the GDP outlook for 2024 and 2025. However, a weak cyclical outlook, elevated borrowing rates and political uncertainty, including infrastructure project cancellations and government commitment to climate change are also likely to contribute to weaker investment. We forecast GDP growth of 0.0% in 2024 and 0.5% in 2025 (from a forecast 0.5% in 2023). Our central view is perilously close to recession, with risks skewed in this direction. However, we forecast a modest acceleration in activity across 2025 as the pass-through of previous tightening ebbs and we anticipate fresh easing.

Weaker growth should loosen the labour market further. We forecast a rise in unemployment to 5% from 4.2% at present, a rise we see occurring sooner than the Bank of England (BoE) does. As such, we forecast wage growth slowing from an elevated 7.9% at present to below 4% by end-2025. Such an easing in labour conditions would help disinflation. The decline in inflation to date is because of a combination of falling energy inflation, slower food price inflation and a sharper fall in non-energy core goods. Services inflation remains elevated for now but has started to ease. The expected loosening in the labour market should see further services disinflation. We forecast inflation averaging 7.5% in 2023, 3.1% in 2024 and 1.8% in 2025. Our forecast sees inflation falling below target by mid-2025. We also recognise a risk that wage inflation remains stickier, which could delay broader services disinflation.

The BoE has left its benchmark interest rate at 5.25% since September and we think it has peaked. The lagged transmission of previous tightening is likely to tighten conditions further across 2024 and into 2025, even as spare capacity rises, and inflation falls. We expect the BoE to start easing policy in 2024 as its focus shifts to inflation falling below target the following year and being on track to remain there over its forecast horizon. We expect the BoE to confirm wage growth deceleration next spring before lowering interest rates by 25bp in August (with risks skewed to an earlier cut). We then forecast rate cuts to 4.50% by end-2024 and to 3.75% by mid-2025 – a sharper reduction than markets currently expect. We also expect the BoE to maintain quantitative tightening through 2025, with a broadly stable pace of active sales.

The UK is also due a General Election within the coming two years – most likely in October 2024. Polls and recent by-elections point to a Labour government for now, although the current Conservative government has a sizeable majority. Both parties are once again competing over the centre ground (having diverged to extremes over the last decade). A centrist government and significant fiscal constraints should limit the differences either new government has on the economy for 2025. We expect a modest fiscal easing (around 0.5% of GDP) in March. A new government is likely to need to tighten significantly in the first few years of the next term, which may add to a loosening monetary policy dynamic.

30 November 2023

Canada – Sticky core inflation challenges Bank of Canada

David Page
Head of Macro Research
Macro Research – Core Investments

Key points

- 2023 growth was firmer than forecast, but GDP has stagnated since Q2 and is on the brink of recession. The lagged impact of policy tightening is a key risk
- Inflation fell broadly in line with expectations, but core measures remain elevated. Elevated unit labour costs will make reaching the 2% target a challenge
- Rates have likely peaked at 5.00%; we see a delayed easing cycle from July 2024 to 3.50% by July 2025

On the cusp of recession

Canada's economy fared better than we feared a year ago, helped by a strong start and resilient neighbour. But growth has stagnated since Q2 and recession is a threat as households weather the lagged impact of Bank of Canada (BoC) tightening. Moreover, with strong population growth (2.9% to mid-year), Canada's per capita GDP growth was the worst in the G7.

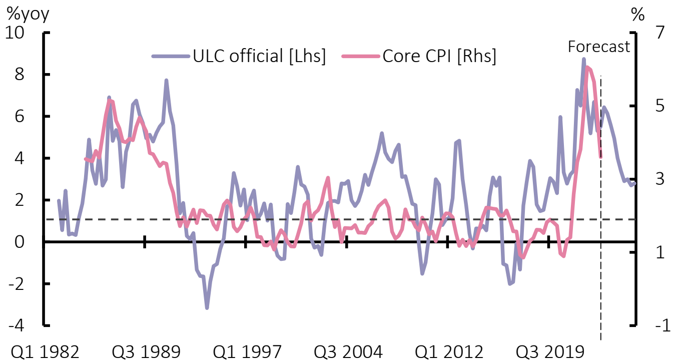
The household sector is a key concern. Like UK households, Canadians are set to bear the brunt of monetary policy tightening. By end-2023 only around 40% of households will have seen mortgage resets reflecting higher rates. That will rise above 60% by end-2024 and 80% by end-2025. We forecast a softening in jobs growth and slower wage gains to soften real income growth even as inflation falls. And Canadian households are highly indebted compared to G7 peers, providing less scope for rising borrowing. That said, unlike in the US, households still have elevated savings which should cushion spending, but we expect continued weakness in consumption and modest contraction in coming quarters.

Beyond household weakness, recent corporate profit declines, higher rates and a weak outlook should see business investment retracement over coming quarters, albeit that Canada has been a beneficiary of US investment incentives supporting foreign direct investment. Moreover, an expected slowing in external growth is likely to weaken exports – even as a terms of trade boost supported exports this year. Net trade looks set to be neutral in 2024 and 2025, from a strong boost in 2023. We forecast GDP growth of 1.1% this year, followed by 0.5% next year and 1.7% in 2025. Weaker US or China growth would push the economy into recession, as could a bigger lagged impact from the BoC's tightening.

Inflation has fallen from 8.1% in June 2022 to 3.1% in October. Inflation should average 4.0% in 2023, close to the 4.2% envisaged a year ago. Most disinflation has reflected energy base effects and core measures remain elevated leading the BoC to warn of core inflation stickiness. We forecast inflation to fall further to average 3.2% in 2024 and 2.6% in 2025.

Exhibit 12: Weak productivity adds to BoC inflation challenge

Core CPI inflation and unit labour costs



Source: CANISM and AXA IM Research, 15 November 2023

Canada faces idiosyncratic and interrelated challenges in achieving core disinflation. It is a high-migration economy; it has high housing costs and relatedly elevated household debt; and it has suffered from weak productivity growth since the pandemic – unusual given its high-skilled migration policy. A sharp increase in public sector employment and protracted business investment weakness are proximate causes of this, but the International Monetary Fund has raised concerns about resource misallocation, highlighting similarities with other economies experiencing housing booms. Weak productivity looks set to keep unit labour costs elevated and challenge core inflation returning to 2% even in 2025 (Exhibit 12).

The BoC is focused on getting inflation to target and is very concerned about core inflation. Yet, the economy appears on the brink of recession, threatening a more meaningful adjustment in housing with financial stability repercussions. We expect the BoC to leave policy at 5.00%, allowing real rates to increase over the next few quarters. Yet concerns about inflation stickiness suggest a slower easing in policy next year, even in the face of weak growth. We forecast the BoC to cut rates by 125bps over 12 months from July 2024, taking the key rate to 4.25% by end-2024 and 3.5% by July 2025. This is slightly later than markets forecast – and what pure policy rules imply. These challenges highlight why the BoC is keen for fiscal and monetary policy to be aligned, something Finance Minister Chrystia Freeland's recent Budget broadly delivered.

30 November 2023

Japan – The Bank of Japan's year

Hugo Le Damany,
Economist
Macro Research – Core Investments

Key points

- Japan is moving endogenously towards a period of slightly higher inflation, stimulated by rising wages
- Economic growth is likely to slow but it should do well compared to other developed economies and potential growth
- The Bank of Japan has been cautious but yield curve control is all but ending. We expect gradual rate rises starting from the spring, to reach 0.25% by end-2025

Moving beyond fears of deflation?

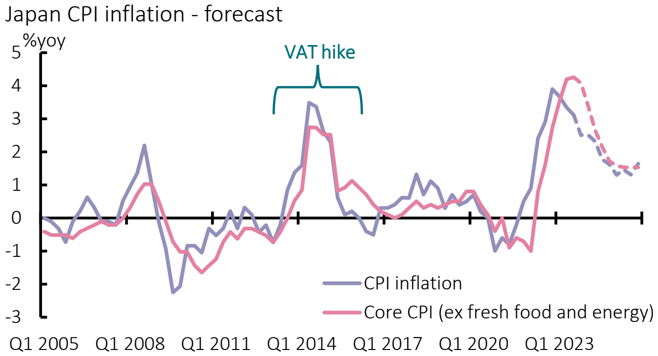
Japan's economy appears to be edging towards a turning point. Helped by the global inflation shock brought on by rising energy costs and a weak yen, pricing dynamics are improving. However, while we think it's unlikely trend inflation will rise to 2% yet, increasing inflation expectations should shift an economy that has battled with deflation for decades. Wages have long been central to the weak domestic inflationary pressures and are showing sustained signs of rising. In 2023, the Shunto trade union confederation spring wage negotiations delivered the largest pay hike in over 20 years (base pay rose by 2.1%). First indications for the upcoming round indicate this could be even higher, as unions have indicated they are likely to ask for total hikes of at least 5% (of which we estimate 3.5% to be base pay).

We expect inflation to ease somewhat next year due to base effects though improved wage pressures are likely to see inflation settle above previous levels. We forecast inflation to average 3.2% in 2023, 2.2% in 2024 and 1.6% in 2025 (Exhibit 13).

We expect growth to remain strong, supported by another generous government stimulus package and improving real incomes. We believe the ¥37.4tn package (of which ¥14.3tn is a supplementary budget) should boost GDP by 0.8 percentage points (ppt) and forecast GDP growth of 1.9%, 1.2% and 1.0% in 2023, 2024 and 2025 respectively.

The Bank of Japan (BoJ) has successively loosened its control on 10-year government bond yields (YCC), now seeing the policy's 1% cap as a soft reference, effectively gutting its policy. We expect the YCC's formal end to be accompanied by an initial step towards rate policy normalisation with the overnight call rate likely to be hiked by 10 basis points (bp) to 0.0% – ending eight years of negative interest rate policy (NIRP). This is likely around April 2024 in our base case – once the BoJ has better sight of 2024's spring wages outcome. It should remain prudent, hiking by small steps – 10bps in Q4 and most likely 15bps in the first half of 2025, bringing the policy rate to 0.25% by the end of 2025.

Exhibit 13: Inflation to ease



Source: MIAC and AXA IM Macro Research, as of November 2023

Road to normalisation fraught with risks

As markets begin to consider what higher rates could look like in Japan, we expect the normalisation path will pose risks for Japan and even the global economy. After years of low interest rates, 60% of Japanese home loans are floating rate. The end of NIRP would not affect the housing market too much if the benchmark short-term prime rate does not change. But if it rises further, payments on existing loans would be affected. While the impact on incomes looks manageable, sentiment and the broader housing market is a risk.

Corporates face a similar issue – firms' funding costs are affected more by short and medium-term interest rates. The impact from an end to NIRP would be felt quickly as higher rates feed through existing floating-rate loans. Again, this should be manageable overall. However, vulnerable corporates and smaller and medium size firms (which includes most of the 'zombie' companies) could face another blow. This underscores the high bar for a sustained rate hike cycle by the BoJ.

The government also faces risks from rising rates. Japan's government debt stands at 263% of GDP – the highest in the G7. The rising cost of servicing its debt is likely to become more burdensome for its already-stretched public finances.

Finally, this expected policy normalisation will also be influenced by the policy cycles in other developed markets. A gradual increase in BoJ rate expectations along with expected easing elsewhere is likely to see yen appreciation, providing headwinds to growth and inflation hitting target.

China – Short-term reprieve, long-term challenges

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Key points

- 2023 – the first-year post-pandemic – endured a sluggish first half due to wavering confidence and delayed policy boosts. Stimulus has quickened the pace since
- 2024 is expected to grow at a faster quarterly pace, backed by supportive measures and eventually firmer external demand
- But the economic upswing from announced stimuli looks set to fade into 2025 and could lead to future imbalances, requiring a potentially prolonged adjustment period

Free from COVID-19 disruptions but marked by scars

China's harsh zero-COVID policy was lifted at the end of December 2022. 2023 was the first year without COVID-19 disruptions. However, the economic recovery faced hurdles. Despite an initial rebound in the first quarter (Q1), several headwinds emerged, exerting pressure on the economy. Somewhat delayed but solid stimulus measures have supported the economy, positioning it well to meet this year's growth target of "around 5%".

The three-year rollercoaster of pandemic restrictions and real estate turmoil have eroded public confidence, evident in weak prices, subdued consumption and sluggish investment in the first half of the year. Beijing began acting in August, unveiling substantial policy support – particularly in mortgage easing – aimed at stimulating housing demand and alleviating household financial pressures.

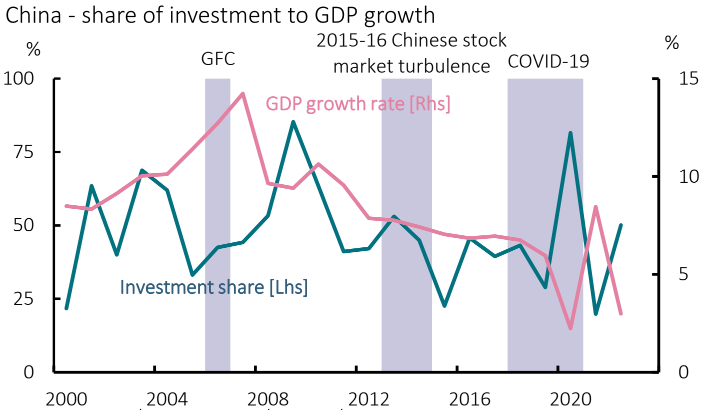
The outlook for China's economy appears to hinge critically on the central government going forwards. Should it provide adequate and timely supports to meaningfully restore consumer and investor confidence, we would anticipate a brighter 2024 and a more stable 2025.

Investment is transmission of stimulus

According to Beijing's conventional economic doctrine, investment, consumption, and exports are the 'three carriages' driving economic growth. When the economy experiences sluggishness, stimulus-backed investment has typically become the marginal policy tool to support growth (Exhibit 14). This time has been no exception. In July, Beijing mandated the acceleration of Local Government Special Bonds issuance. In October, the unusual mid-year budget review surprised markets by adding one trillion renminbi to the budget deficit. Alongside the early issuance of next year's quota for Local Government Bonds (LGB), these directives aim to bolster investment, providing more support as we move into 2024.

Historically, stimulating investment through LGB issuance funnels spending into infrastructure projects, which typically have extended timelines. Consequently, the impact of such stimulus is not immediate but rather gradual. We anticipate continuous investment support throughout 2024, thereby sustaining the economy.

Exhibit 14: Investment has saved GDP growth several times



Source: CEIC and AXA IM Research, November 2023

Exports are to follow

This year presented formidable challenges for China's exports, due to global inflation and reduced consumer spending in developed countries. Despite this, certain sectors like mechanical and electrical products and automobiles held up well, with China even surpassing Japan to become the world's top auto exporter, driven by its growing electric vehicle exports since 2018.

As part of its 'industrial upgrading' initiative, China aims to boost high-value manufacturing in its exports. Looking ahead, as inflation eases in developed economies, global demand is expected to recover, potentially improving China's export situation by late 2023 into 2024 and beyond. However, uncertainty looms due to geopolitical dynamics. Any stringent restrictions from the US or European Union could significantly impact China's exports and its manufacturing sector. The recent Asia-Pacific Economic Cooperation (APEC) meeting between Presidents Joe Biden and Xi Jinping suggested a thawing in relations, with the US lifting some restrictions, including on a key China agency. However, next year's US elections could lead to a swift reversal of this warming.

Consumption relies on the property market

China is a nation of homeowners. A 2020 study[1] showed that over 80% of Chinese households own their home. Due to limited investment options in the economy and an inadequate social security system, housing is also the primary investment avenue for Chinese households. Over 20% of urban households own multiple homes, often without generating rental income. Residential property holds a significant 60% of household assets, a stark contrast to the US where it's around 30%.

Since the property market turmoil began in 2021, Chinese households have fretted over asset values, leading to muted consumption and a persistent increase in precautionary saving. This behaviour is not purely reflective of mortgage payments impacting incomes, but rather to compensate the financial insecurity resulting from property devaluation – a wealth effect. Therefore, stabilising the property market is crucial to bolster consumer confidence and underpin consumption.

Efforts have been made since August on monetary and fiscal fronts to alleviate pressure on household finances and enhance housing demand. However, addressing the structural issues in the property sector will be a long journey, which is now only at the start. Continuous government support is vital not only for housing market stability, but to prevent prolonged repercussions on related sectors like construction and private consumption.

Our base view is Beijing will implement adequate measures to support the demand side of the housing market over the coming two years, allaying concerns among households. As the services sector and labour market recover, consumer confidence should rise across 2024. Consequently, improved sentiment and reduced fluctuations in pork prices should enhance consumer prices moving forward. We expect Consumer Price Index inflation to average 1.1% in 2024, before reaching 2% in 2025.

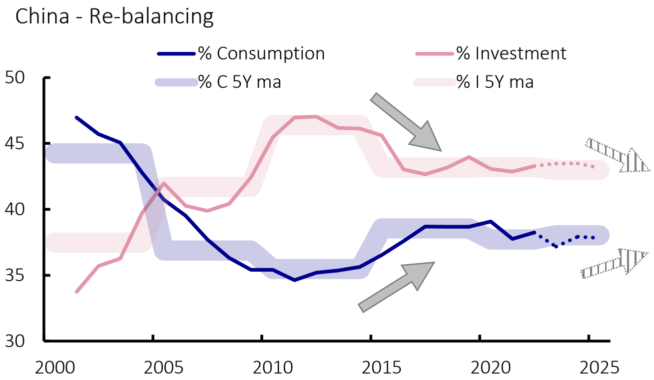
Policy supports now risk future problems

The economy requires policy backing to avert a severe downturn. However, Beijing's strategy mirrors past investment-driven growth models. While historical data are testimony to the short-term effectiveness, it bears future costs. The bulk of local government investments inevitably funnel into infrastructure projects, which mainly provide public goods, typically yielding low returns. This situation strains local government balance sheets. Although the central government has recently indicated willingness to assume more debt on behalf of local governments, it perpetuates a cycle of 'more debt, more investment, low return', exacerbating resource misallocation.

Yet this investment-centric model (Exhibit 15) is Beijing's most familiar and seemingly most-favoured option. Direct fiscal stimulus to households has never been used, with no established channels for such delivery and questions over its effectiveness without a reversal in public confidence.

In 2024, China is expected to prioritise addressing the challenges posed by property market woes and local government indebtedness. Coordinating fiscal and monetary tools for economic support is likely the approach. We expect this to prompt faster quarterly growth in 2024, followed by a slowdown in 2025 as the stimulus effects wane. We estimate annual growth to peak at 4.5% in 2024 before easing to 4.2% in 2025.

Exhibit 15: When re-balancing will be back to agenda



Source: CEIC, AXA IM Research, Nov 2023

Structural reform is the solution in the long run

The impressive 'Chinese speed' of economic growth over the past 40 years owes its success to several key factors: the demographic dividend; World Trade Organization accession; East Asian reshuffling; and, underpinning these, structural reform. The economic reforms of former leader Deng Xiaoping in 1978 spurred China's current economic and global influence. Policy stimulus effectively tackles cyclical issues, providing short-term boosts, but long-standing structural issues resurface when this support wanes – a challenge acknowledged by Beijing. The critical question remains – can it relinquish its grip and embark on much-needed structural reforms? Based on President Xi's recent behaviour, we have our doubts.

[1] Huang, Y., Yi, D., & Clark, W. A., "Multiple home ownership in Chinese cities: An institutional and cultural perspective", *Cities Vol. 97*, February 2020

Emerging Markets – living on the (dollar) edge

Irina Topa-Serry,
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Key points

- Emerging markets (EM) are on a structurally sounder footing amid tighter global financial conditions. Access to international capital markets may remain difficult for some frontier markets
- We expect growth recovery in Central Europe and Asia, but diverging trends within Latin America
- The monetary easing cycle will likely be shallow, guided by the Fed's stance and domestic disinflation. Fiscal consolidation could be limited by a heavy electoral year across EM regions in 2024

This is not the 1990s

The expected "high for long" scenario of US monetary policy is reminiscent of the 1990s which saw a series of major crises in emerging markets (EM): the 1994 Mexican 'Tequila' crisis, the 1997 Asian financial crisis and the 1998 Russian crisis. For sure, high real US yields and a strong dollar will continue to exert pressures on many countries, particularly those in already precarious financial positions which rely extensively on hard currency borrowing. Easy global financial conditions post the global final crisis allowed many frontier market (FM) economies to raise unprecedented amounts of capital on international bond markets. Sovereign issuance remained particularly depressed for most FMs for a second year in a row in 2023, while some countries lost market access altogether. Several countries are in advanced debt restructuring negotiations, and multilateral funding has increasingly stepped in to help cover governments' financing needs. Fragile situations needing close monitoring remain in Egypt or Kenya, to name some.

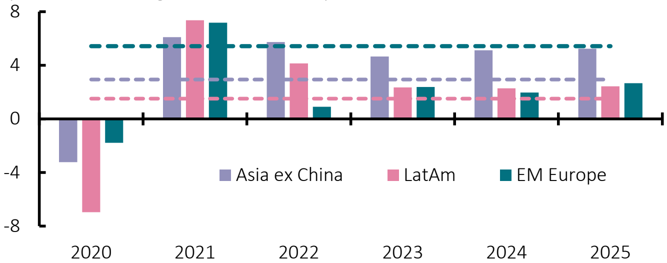
Beyond this specific market segment, EMs are undeniably structurally and institutionally better equipped to face external headwinds than they were during the 1990s. Local debt markets have developed significantly, decreasing their reliance on external financing; exchange rates have been allowed to float, reducing pressure builds; institutional credibility is higher with central banks better able to anchor inflation expectations and to ensure financial stability thanks to foreign exchange reserves management while banking systems are also better capitalised. There are of course exceptions; for example Argentina or Turkey, but a general structurally-sounder footing should limit the risk of a systemic crisis. Moreover, portfolio outflows from EM debt markets for the past two years signal light foreign investors' positioning.

Growth divergence between and within regions

From a bird's eye view, our 2024 and 2025 EM GDP growth forecasts may appear to suggest quite an impressive resiliency, forecasting overall EM growth of 4.0% in 2024 and 4.1% in 2025, from an expected 3.9% this year – more so as China's average GDP growth is slowing. Excluding China, growth should pick up from 3.3% to respectively 3.7% and 4.0%. Yet much of this acceleration comes from smaller countries, on which we rely on International Monetary Fund (IMF) estimates, which make up more than 35% of EM ex-China GDP. Our assessment on bigger EM economies is somewhat less rosy as we see growth decelerating in 2024 and stabilising in 2025 along easier monetary policy stances. GDP growth in 2025 is nonetheless expected to remain below its post-financial crisis to pre-pandemic average in both Asia and EM Europe. We see strong divergence between and within regions (Exhibit 16).

Exhibit 16: Nearing post-crisis/pre-COVID-19 growth averages

Annual real GDP growth in %
(2011-19 average in dotted lines)



Source: IMF and AXA IM Research, November 2023
Regional IMF GDP-PPP weights for Asia (India, Indonesia, Malaysia, Philippines, Thailand, South Korea, Taiwan, Singapore), Latin America (Brazil, Mexico, Chile, Colombia), EM Europe (Russia, Turkey, Poland, Hungary, Czech Republic)

Asia stands out as the only region forecast to see growth accelerate in 2024. Across Asia, India and Indonesia growth which has held up remarkably well in 2023 is expected to continue, while activity in other smaller economies should also pick up. In Latin America, activity in Brazil and Mexico will decelerate, having been supported by exceptional harvests in the former this year, and with positive spillovers from strong US growth to the latter. Meanwhile, we should see a better backdrop for Chile and Colombia, which have had to deal with issues in the mining sector and political uncertainty this year. EM Europe remains a highly-divided region; Russia and Turkey are expected to slow, while activity in Central Europe should be supported by consumption recovery and European Union funds being partially unlocked in 2024/2025.

Overall, economies will have to cope with weaker, albeit not collapsing, growth in the US. At the same time, positive real rates in the US are likely to continue to exert pressure on the level of nominal rates in EM. Investment may still struggle into early 2024 but external demand could start to benefit from stronger sequential growth in China. Moreover, a recent turnaround in Korean exports suggests the global manufacturing cycle may be slowly turning. We will continue to assess the positive fallouts from adjusting manufacturing supply chains, closer to the developed market consumer (near-shoring in Latin America) and/or away from China (friend-shoring in Asia) via incoming foreign direct investments.

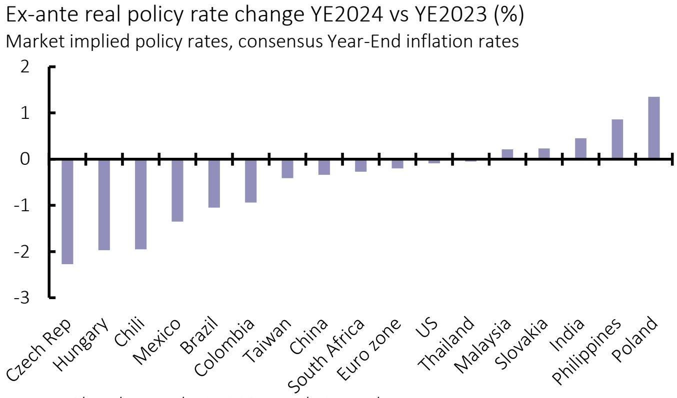
On the consumer side, we could start seeing some benefits of past disinflation improving purchasing power for households. In Central European countries, real wage growth is expected to become positive in 2024. Labour markets have proved resilient so far and we do not envisage a significant deterioration in the years to come. Additionally, according to the IMF, the cumulative excess savings from the COVID-19 period remain across EM, providing a potential cushion to household private consumption, although we may question the uneven distribution of such savings.

Inflation and the Fed to guide monetary easing

Inflation moderated generally more than expected across EMs on the back of supply shocks reabsorption post-pandemic reopening. Energy prices played an important role in the disinflation trend; food price inflation also came off the boil, but risks remain on certain segments on the back of weather-related production disruptions, which could be further distorted by producers imposing export bans, as currently for rice. The possible lifting of remaining price subsidies on fuel or food products in various countries is another upside risk to inflation estimates moving forward. Still, with the notable exception of Turkey, core inflation in EM has come down since its peak roughly a year ago. Headline inflation is expected to reach central banks' targets at various speeds during the next two years of the forecasting horizon in most countries that we cover. Absent any additional external shock, market focus will move from disinflation to monetary policy easing.

Disinflation allowed several developing countries' central banks to start cutting policy rates as of 2023, including in Uruguay, Chile, Brazil or Peru across Latin America, Hungary and Poland in EM Europe. More will do so in 2024 and thereafter. Yet we suspect that relatively high US real yields and a strong dollar will prevent aggressive easing, much depending on the pace of disinflation ahead. We note increasing signs of cautiousness among EM central banks that are keen to ensure that inflation is decisively converging on their targets while maintaining the right level of rates to ensure financial stability and maintain foreign investors' interest. The starkest example being the Bank of Indonesia (BI), which hiked its policy rate by 25bps to 6% in October, having kept rates unchanged since the beginning of the year. Indonesian inflation is close to the lower-end of the BI band (2%-4%) and even though expected to accelerate from here, it should remain well in the BI's comfort zone. BI rather reacted to the weaker rupiah since April 2023 and reacted preventively to cushion against any souring of foreign investor sentiment. Market-implied ex-ante real policy rates are nonetheless suggesting an easing of the monetary stance in many EM countries in 2024 (Exhibit 17).

Exhibit 17: Monetary policy easing expected ahead



Source: Bloomberg and AXA IM Research, November 2023

Absent faster-than-expected disinflation and thus against a backdrop of a rather tight monetary stance – outside Asia – governments across EM will feel increasingly constrained as debt loads have risen since 2020 and the increased interest burden is limiting fiscal policy room for manoeuvre. Anti-inflation shields, which supported the consumer this year, should be phased out, and the fiscal impulse is expected to be contractionary but any fiscal consolidation may provide some surprises in the busiest EM electoral year in decades. Tensions between the fiscal and the monetary authorities may become more palpable, and we tend to believe that central banks will respond by more hawkishness (and less dovishness) to fiscal drifts putting downside pressure on our 2025 growth forecasts.

Risks and uncertainties abound, as always

As always, policy gyrations in China and the US, the direction of travel for the US Treasuries, the dollar, geopolitics and commodity prices remain major risks to our EM macro and market outlook. Local politics will come into the spotlight with many elections, be it local, parliamentary or presidential, scheduled in 2024 – starting with Taiwan in January, Indonesia, India and Korea in spring, Mexico and South Africa during summer, Romania and Uruguay towards the year-end, to name a few. Many frontier markets will also come to polls (e.g., Senegal, Ghana, Sri Lanka). The US Presidential Election may nonetheless be the utmost important electoral deadline for EMs this year given its broader and deeper implications as per the possible trade and investment shifts that it could deliver.

Emerging Europe – looking better, after all

Irina Topa-Serry,
Senior Economist (Emerging Markets),
Macro Research – Core Investments

Key points

- After a weak 2023, growth should revive in 2024 and 2025 across Central Europe. Disinflation should restore consumer balance sheets and allow monetary policy to ease. Fiscal tightening is expected later in Poland, but EU funds are expected to be unlocked
- Turkey opted for a gradual shift to orthodox policies to curb accumulated imbalances ahead of March 2024 local elections. This choice bears risks and will likely leave Turkey still exposed to portfolio flows for financing its external financing needs

Central Europe: Diverging from Germany's woes?

Central Europe (CE) economies will continue to operate under weak external demand, particularly from Germany to whom they direct 20%-35% of their exports. The automotive industry accounts for 25% of total Czech exports, 10% of industrial production in Poland, 14% of GDP in Slovakia and will have to continue to remodel itself away from the basic European car manufacturers assembly line for combustion engine vehicles. We see better outcomes for Hungary and Poland with a focus on electric vehicles' (EV) batteries production, already benefitting in terms of export activity. New production lines will be coming online in 2024 which should support output and exports, despite major trading partner activity weakness.

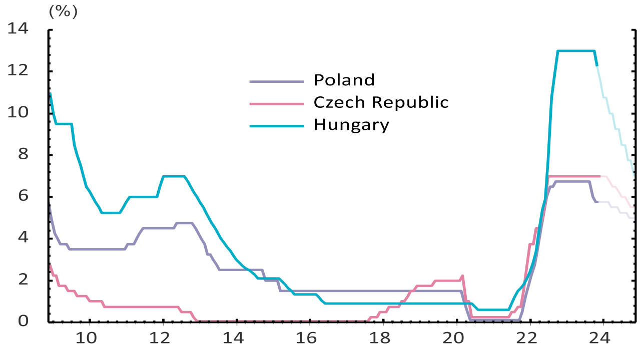
CE's accelerating growth will also be supported by improved consumers' purchasing power. Strong disinflation will support positive real wage growth, while savings remain ample and could be used to support consumption ahead; we are already seeing tentative signs of turnaround in retail sales in Poland. Housing markets have been affected by tighter monetary policy although various measures such as subsidised or capped mortgage rates and subsidised housing loans will be supportive in Poland and Hungary.

Public finances consolidation appears obvious for Hungary and the Czech Republic as of 2024, while there are risks of slippages for Romania and Poland next year as the former heads into a quadruple election and the latter is in the process of forming an opposition-led government which made several spending pledges during the campaign. More positively, the future Polish government will strive to unlock the frozen European Union (EU) Recovery and Resilience funds, starting with the €25bn RePowerEU grants and loans, which could be released towards the end of 2024. Conversely, Hungary is focused on unlocking EU Cohesion Funds (€13bn) for which it needs to achieve several milestones to comply with the EU's "rule of law".

Central banks in Poland and Hungary have already started to cut rates; the Czech central bank should join them soon. Inflation has been better than expected, both on the retreat of volatile price shocks and thanks to weak activity this year. It should be back, or close to targets, in the next couple of years with significant adjustments in policy rates (Exhibit 18).

Exhibit 18: Monetary easing in response to inflation falling

Central Europe: policy rates, history and forecasts (%)



Source: LSEG Datastream and AXA IM Research Nov 23

Turkey: The fine rebalancing act

Since 2023's elections, the new administration, under a re-elected President Recep Tayyip Erdoğan, has engaged in the rebalancing of large economic imbalances accumulated in recent years, starting with a set of orthodox policies, including raising interest rates (to 35% in October), regulatory and quantitative tightening and tax increases. Real interest rates nonetheless remain negative with core inflation close to 70% in October 2023 and inflation expectations a year out hovering at 45%. Fiscal policy should remain stimulative beyond earthquake reconstruction spending efforts, at least until March 2024 local elections. Beyond this, we assume policy action will continue to favour gradual, but not decisive rebalancing, which should translate into continued currency depreciation for the period under review. Inflation is likely to peak by mid-2024 but the pace of disinflation may be altered if the central bank cuts rates hastily. We expect GDP growth to halve in 2024 from above 4% in 2023 but this will likely be insufficient to lead to a massive improvement in the current account *à la* the 2018/2019 episode, leaving Turkey exposed to oil price volatility and foreign investor appetite when it comes to its external financing needs.

Latin America – Growth to bottom out in 2024

Luis Lopez-Vivas,
Economist (Latin America),
Macro Research – Core Investments

Key points

- Led by strong performances from both Brazil and Mexico, regional growth in 2023 surpassed expectations but will likely run out of steam in 2024 due to weaker US and China growth
- Inflation is on a firm downward trend, paving the way for easing. But risks remain including a potential El Niño event and foreign exchange weakness
- Despite 2024's packed electoral calendar including Mexico's presidential election, the region is unlikely to face substantial political risks.

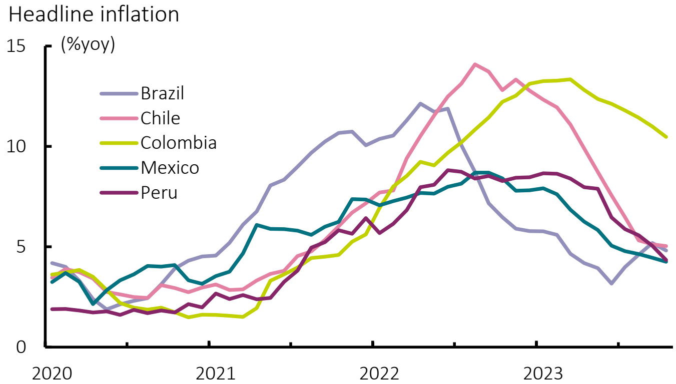
Resilient 2023

Although 2023 was anticipated to be a challenging year for Latin America because of inflation tackling restrictive monetary policy, the region's economic activity has shown remarkable resilience. This strength is mainly the result of robust growth in the US, the post-COVID-19 reopening in China and sturdy consumption supported by tight labour markets. As such, we expect the so-called LA4 region (Brazil, Chile, Colombia and Mexico) to grow 2.7% (2022:3.6%), significantly surpassing our initial estimates of 0.9% at the beginning of 2023. Nonetheless, this regional figure obscures considerable disparities among countries; the two largest economies, Brazil and Mexico, have been the key drivers behind this stronger-than-expected performance.

Brazil is projected to grow 3.0% in 2023, boosted by a robust agricultural sector and strong private consumption. Similarly, Mexico is forecast to register a 3.3% expansion, thanks to factors like the US economy avoiding recession and increased construction activity related to public projects and potentially to nearshoring activities. In contrast, Chile should register a small contraction of -0.5% while Colombia will see modest growth (1.6%) due to the withdrawal of policy stimulus and political uncertainty that has hampered investment.

Disinflation has also been a positive development this year, thanks to the proactive stance of the region's central banks, which began hiking rates earlier than in other regions. Inflation in Latin America is now at 5.5%, a significant drop from the 7.9% at the end of last year (Exhibit 19). With this improved situation, monetary policy is expected to continue its easing trajectory into 2024. Both Brazil and Chile have already embarked on easing cycles and Mexico and Colombia should follow suit next year. However, it's hard to predict the timing given concerns around the higher-for-longer rates and possible foreign exchange vulnerabilities from potentially lower commodity prices.

Exhibit 19: Inflation close to target across the region



Source: LSEG Datastream and AXA IM Research estimates, November 2023

Challenging 2024

However, there are some challenges on the horizon. In 2024, the LA4 region is projected to see a slowdown in growth (1.8%) due to factors like softer annual growth in China, the potential for a US recession, and lower commodity prices. Once more, significant divergences are expected among countries, with Mexico and Brazil poised for deceleration. Mexico's growth will be hindered by sluggish economic conditions in the US, while Brazil would require an unexpected boost like this year's record harvest to regain strong growth, which is unlikely. Meanwhile Chile and Colombia should see a resurgence in activity driven by looser monetary policy and reduced political uncertainty. In Chile, the constitutional process will have concluded, and in Colombia, the likelihood of radical reforms is limited given President Gustavo Petro's lack of support in Congress and declining approval ratings.

Risks ahead

For 2024 the balance of risks to our outlook is tilted to the downside. A severe El Niño event would be a drag on growth in Peru and Colombia and drive food prices higher across the region. Likewise, any escalation in global conflicts could fuel food and energy prices. A weaker economy in either the US or China would be a blow to the region's outlook due to its trade dependence on these two countries. Finally, 2024 will be a busy electoral year with presidential elections in the Dominican Republic, El Salvador, Mexico, Panama and Uruguay, but none of them pose a significant risk to their outlooks.

Currencies – US dollar high(er) for longer

Romain Cabasson,
Head of Solutions Portfolio Management,
Market & Liquidity Solutions – Core Investments

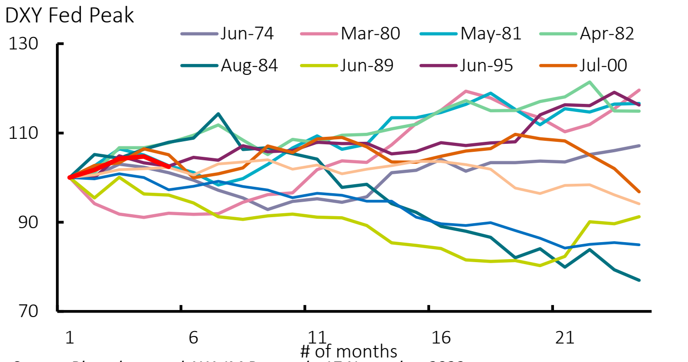
Key points

- The US dollar looks set to remain supported by high US yields and a continuation of US's macro resilience
- Both the euro and sterling are not cheap, with weaker fundamentals and are likely to depreciate
- In a US soft landing scenario, high betas might get a chance to finally shine. The Norwegian krone is particularly cheap
- Japan's yen might breathe again if rates stop rising, but don't expect it to steal the show

Fed, not US dollar, peak

After markets' multiple attempts to call the Federal Reserve's (Fed) last hike in this policy cycle, it seems we have finally reached it. At its last meeting it left policy unchanged at 5.25%-5.50% and while the Fed is reluctant to say it has peaked, we believe it has. Rising US rates have been a key factor behind the US dollar's (USD) strength in 2023 but it doesn't mean it is doomed to fall if rates stop rising. Looking at previous cycles (Exhibit 20), there is no clear evidence to suggest this, particularly looking at the 1970s and early 1980s high inflation periods.

Exhibit 20: Fed peak not necessarily leading to USD weakness

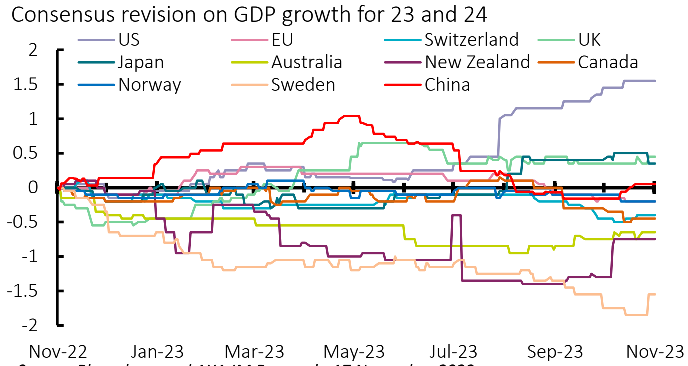


Source: Bloomberg and AXA IM Research, 17 November 2023

US inflation is softening but not yet back to target, and neither the economy nor labour market have materially decelerated. The transmission of tighter policy seems particularly slow and as long as the market keeps pushing back the perspective of rate cuts, the USD will remain supported.

The greenback is undoubtedly not cheap but for good reasons. It has now become the undisputed high yielder within the G10 – even against the renminbi (RMB). Additionally, as mentioned, the US is showing much greater resilience against global monetary policy tightening (Exhibit 21), which supresses the point in the horizon where it might be ousted by foreign yields. Stability in yield differentials might only mean USD stability, not strength. But the market is so far only expecting other central banks to mostly match the Fed's cut pace, not exceed it.

Exhibit 21: Unrivalled US exceptionalism



Source: Bloomberg and AXA IM Research, 17 November 2023

Reality check for euro and sterling

The euro (EUR) is firmly in the expensive camp too. When looking at the real effective exchange rate, it has actually appreciated the most amongst the G10 (Exhibit 22). Not only did it depreciate by less than most against the USD but it also endured a much higher PPI-based inflation trend, looking at a seven-year time horizon (both criteria found as the most statistically relevant, focusing on more tradable items).

There are fewer reasons to support such a valuation. The Eurozone economy has slowed more than the US, inflation is falling faster, and European Central Bank (ECB) policy appears more fragile than current Fed pricing, while higher EUR rates would raise further concerns about Italian sovereign debt. Unlike in November 2022, when the prospect of China reopening was boosting global growth forecasts, the potential rebound on this front looks much slower. Indeed, we expect an upcoming growth differential with the US and a renewed focus on ECB balance sheet policy to lead the EUR/USD back towards parity in 2024.

In the post-Brexit world, sterling (GBP) also does not appear to be particularly cheap, although less expensive than EUR. The UK economy has also broadly stagnated over the past 18 months, with the prospect of further weakness ahead. Transmission of Bank of England (BoE) policy tightening is typically faster – the labour market appears to have turned and potential interest rate cuts seem underestimated, relative to other central banks. GBP/USD should also adjust lower.

NOK’ed out but getting up off the canvas

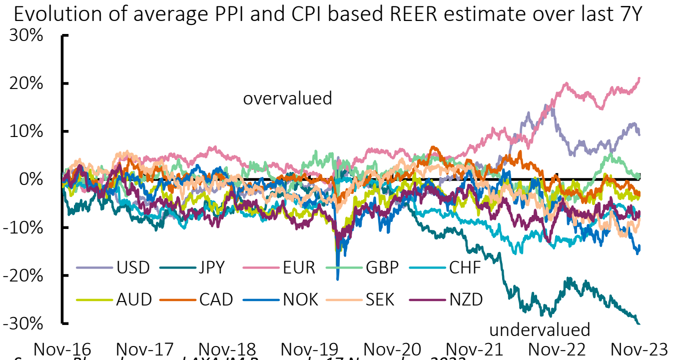
High beta currencies failed to strengthen materially in this cycle and appear – on average – rather cheap. This might in part be explained by their incapacity this time to deliver a higher yield than the dollar. This also might in turn reduce the potential drawdown under risk, from a move towards lower yields.

USD rates have been a dominant driver in 2023 and left little room for high beta currencies with unexceptional yield momentum. Risk sentiment needs to take the driving seat again for those to rise. This might be the turn the USD has recently taken with rising confidence in a soft landing (Exhibit 23).

Australia, New Zealand, Sweden and Norway all have highly indebted households with short-maturity mortgage resets which could lead their economies to decelerate faster. But if a global soft landing emerges Norway’s krone (NOK) has more potential for a comeback from a currently very cheap valuation. Domestic growth looks more resilient than in Sweden. Both the Australian dollar (AUD) and New Zealand dollar (NZD) are also currently impacted by their ties to Chinese growth, although the domestic housing markets appear in better shape.

Exhibit 22: EUR not cheap, but NOK and JPY are

Evolution of average PPI and CPI based REER estimate over last 7Y



Source: Bloomberg and AXA IM Research, 17 November 2023

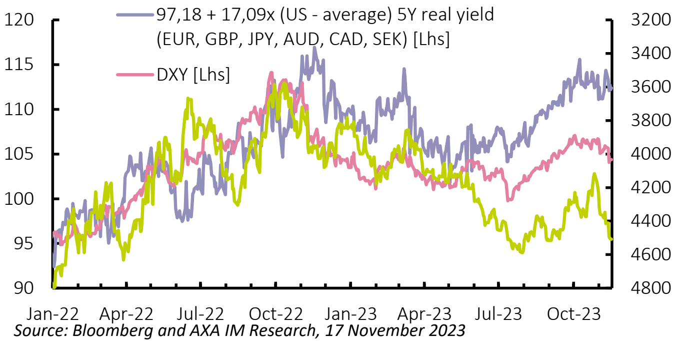
Japan’s yen: Rate differential is yesterday’s enemy

The yen’s (JPY) sharp undervaluation is fully explained by the divergence between Fed and Bank of Japan (BoJ) policy. The USD/JPY has been faithfully tracking the US-Japan 10-year rate differential over the last two years, while the BoJ maintained its yield curve control (and negative rates as the Fed hiked by 525bps, with echoes from other central banks impacting all JPY crosses.

Now the Fed has probably peaked, the next move is for (eventually) lower rates, which should take pressure off the yen and allow some rebound. But as discussed, US rates may remain high for longer – any bounce might be slow and limited, in particular against the USD. And with a 6% adverse carry, there is no incentive to position too early. We do expect the BoJ to shift away from accommodative policies, albeit cautiously, waiting for confirmation on wage growth, while inflation is decelerating globally and not rising locally.

Exhibit 23: USD torn between Rates and Risk drivers

DXY vs real rates differential and SPX



Source: Bloomberg and AXA IM Research, 17 November 2023

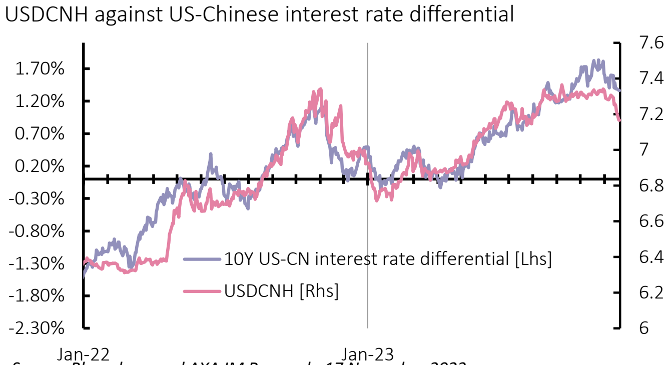
Renminbi’s golden parachute

As with the JPY, policy divergence is the main reason for RMB weakness over the past two years - and there is also a very close link between the 10-year rate differentials and USD/CNH – offshore renminbi (Exhibit 24). The People’s Bank of China (PBoC) is maintaining lower domestic rates to manage the transition and revive its economy. China’s growth failed to rebound as quickly as expected in 2023 after reopening and fiscal support remained limited to avoid reigniting excess leverage until the second half of 2023. Investment flows should remain muted with such low rates and higher geopolitical tensions. The trade balance has also yet to deflate from pandemic-era levels, as global demand decelerates, and China imports rise again.

The PBoC is trying to resist those weakening pressures on RMB by maintaining lower USD/CNY fixing and withdrawing liquidity. This policy might take a heavy toll on foreign exchange reserves if USD rates remain high for longer.

Exhibit 24: PBoC action causing USD/CNH to diverge from rates

USDCNH against US-Chinese interest rate differential



Source: Bloomberg and AXA IM Research, 17 November 2023

Rates – The year of bonds redux

Alessandro Tentori,
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Key points

- While monetary policy is quite restrictive, there are reasonable doubts about overall economic stance
- Demand and supply conditions need careful monitoring
- 2023 has been the year of money markets and credit, not necessarily the year of all fixed income
- Investors might increasingly focus on carry as a driver of returns in 2024, potentially compensating them for still uncertain policy paths

Are interest rates restrictive enough?

The Federal Reserve has hiked by 525bps over just 17 months, lifting the Fed Funds Rate to 5.50%. And yet, the US economy is likely to grow by 2.3% in 2023, up from 1.9% in 2022. The days when a recession was priced in with nearly 100% probability – not too long ago – are now gone, and the Bloomberg consensus has revised its expectations for US GDP growth month after month, starting from a rather modest 0.3% in early January.

Central bankers on both sides of the pond are convinced about their restrictive monetary stance and we might agree on that, but the real question is about the overall economic policy stance. There are no doubts that fiscal policy is going the other way and is actually adding stimulus to the economy, both in the US and the Eurozone, and therefore somewhat diluting monetary policy's restrictive efforts. Former ECB board member Fabio Panetta has addressed this issue in the not-too-distant past by highlighting the asymmetric orientation of monetary and fiscal policy. Of course, we're all reminiscent of the high degree of uncertainty and market volatility created by former UK Prime Minister Liz Truss and her expansionary budget.

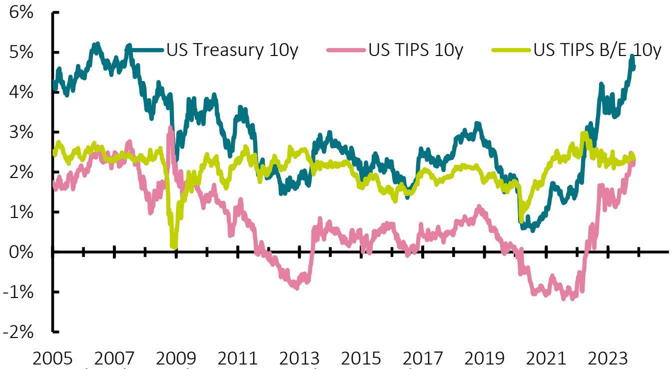
Furthermore, the ultimate effect of higher policy rates must be assessed in the context of inverted yield curves and slower pass-through to interest expenditures. It should be no mystery that both corporate and public sector treasurers have lengthened debt duration during the zero-interest rate period. Similarly, the effective mortgage rate might be much lower than indicated by markets, as households have fixed their debt over a long period of time at very low rates. Perhaps the economy is less sensitive to interest rates than in the past?

Real rates in the driving seat

Real rates started to edge higher in March 2022, after nominal rates had already drifted 180bp higher compared to pandemic-era lows. The reflation trade has been characterised by two distinct legs – inflation expectations moving from 1% to 3%, and real rates moving from -1% to +2.4% (Exhibit 25).

Exhibit 25: Higher real rates in 2022 and 2023

Nominal Yields, Real Yields and Inflation Expectations



Source: Bloomberg and AXA IM Research, 16 November 2023

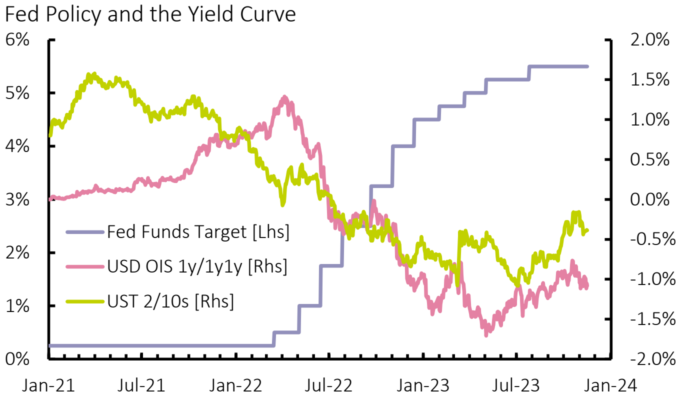
Leaving inflation expectations aside – and assuming convergence to 2% objectives will take a few more years (as projected by central banks) – we might want to ask ourselves the question about the drivers of real rates. In fact, a higher level of real rates should be consistent with an economy growing at a higher potential rate. A deep dive into models of economic growth is outside our scope, but we should not dismiss the idea that the US economy might have experienced a technology shock – via machine learning and artificial intelligence – which ultimately makes it more productive and lifts the long-term potential GDP.

In practical terms, this argument opens the door to yet another source of so-called policy dilution and stimulates the well-known discussion around the Fed's neutral rate. Of course, we will only know in the future how high the Fed Funds Rate is relative to a non-observable neutral rate, but at the same time policy makers should learn from errors in the late 1960s and early 1970s, when US monetary policy was believed to be sufficiently restrictive – it turned out to be not the case when it was already too late.

Duration: Yes or no?

Central bankers can take three actions regarding their policy rate: cut, hike or leave it unchanged. Currently, markets are discounting the ECB's and Fed's initial rate cut to occur by June 2024, an expectation that has accompanied investors ever since mid-2022 (Exhibit 26). However, market-based expectations have been wrong by a substantial margin so far.

Exhibit 26: Pricing in rate cuts since July 2022



Source: Bloomber and AXA IM Reserach, 16 November 2023

A higher duration exposure might be a profitable choice in two out of three scenarios, in particular (and obviously) in a rate cut situation. The unchanged rates scenario merits a few more observations, though. Central banks might want to keep rates at current levels for a longer-than-anticipated period to play the long and variable lags implied by their models. The time horizon is variable as well and really depends on the economy's reaction to their policy tightening. The longer they stay put, however, the higher the odds that their policy decision will be felt also at longer maturities.

The yield curve's response to a "higher-for-longer" scenario is all that matters for fixed income investors' duration choice. The main risk here is a yield curve normalisation – from an inverted to a flat or slightly steep curve – that might be fast enough to negate the relatively large coupon income. This normalisation is worth approximately 2.5%-3% negative price return, probably not enough to generate a negative total return over the year, but definitely large enough to test investors' patience again.

Credit risk has paid well in 2023

Credit and high yield particularly are areas of fixed income where "the year of bonds" is actually a fairly accurate description. By mid-November, Bloomberg's Global High Yield universe has gained over 7% year-to-date in US dollar terms. This result has been achieved not only thanks to a rather contained duration profile but also to a benign spread environment. A much better than originally anticipated macroeconomic environment has prevented spreads from lifting off despite higher rates and the accumulation of geo-political risks.

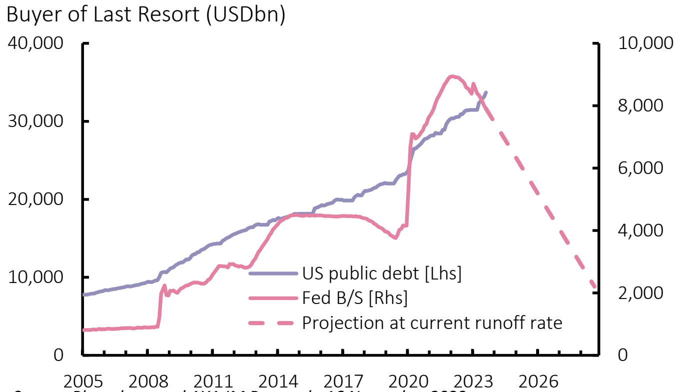
By contrast, duration exposure has not been rewarding at all and delivered a negative year-to-date performance by mid-November: The Bloomberg Global Aggregate 10+ year index is down 3.5% in US dollar terms versus a +1.1% performance for the same index's one-to-three-year duration bucket.

Unfortunately, fixed income is often confused with duration. Every cash flow has a duration, but we should treat this variable actively, i.e. as a risk variable, rather than as a random by-product of our bond portfolio allocation. Duration is essentially a commodity in fixed income space and as such might add to or subtract from total return.

2024: The year of bonds redux?

Expect investors to focus on carry in 2024 (i.e., borrow and pay interest to purchase another asset with a higher interest rate), even more than they might have done – albeit with mixed results – this year. Carry has the beneficial property of reducing the cost of being on the wrong side of a trade, thus increasing investors' confidence in entering and holding to a position. Risks will mainly result from the macro side and the associated monetary policy paths. In this respect, the Bank of Japan and Japanese government bonds might be the proverbial elephants in the room.

Exhibit 27: Who Will Buy Bonds?



Source: Bloomberg and AXA IM Research, 16 November 2023

Furthermore, every market price is the result of demand and supply variables. Demand conditions need to be monitored carefully in an environment where major central banks reduce their large economic footprint (Exhibit 27) and governments keep running public deficits on a path that has recently drawn criticism from the International Monetary Fund. The situation is particularly pressing for those countries starting from substantial debt-to-GDP levels and/or modest potential growth, which is so often the result of mediocre political choice leading to an inferior allocation of resources and ultimately to structural and demographic impoverishment.

Equity – Thriving in the mist

Emmanuel Makonga
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Macro Research – Core Investments

Key points

- 2023 was an unusual period for equity markets, which made gains despite sharp interest rates rises. However, only a handful of stocks drove these gains
- As we expect rates to remain high, we believe quality should be considered over the duration of securities
- The question of 'who's right' between GDP and earnings consensus has to be solved, and one of these two projections is likely to be wrong

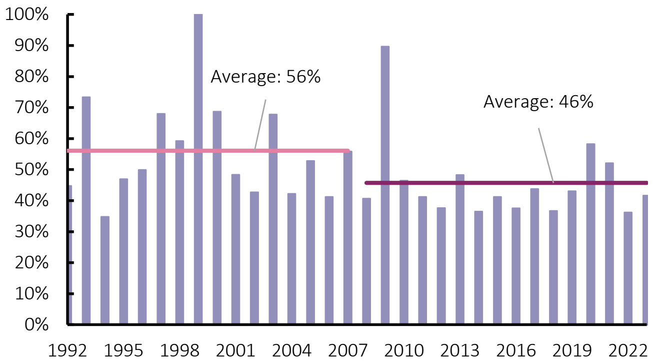
There is no doubt that 2023 was a year for the textbooks. Low economic growth, high inflation and hawkish central banks were not enough to moderate overall equity market gains. Instead, this trio's momentum supported the asset class.

But 2023's performance should be taken with a pinch of salt, as it was largely attributable to a few large-cap stocks. The top 10% of companies ranked by market capitalisation gained 17%, compared with just 3% for the rest. But this divergence in returns between the component stocks of the global index is not abnormal, as evidenced by the below-average level of dispersion (Exhibit 28).

In the future, dispersion could settle higher in the context of higher interest rates. In such a scenario, the equity risk premium would be lower, creating a higher hurdle rate for companies, so active management should overtake passive.

Exhibit 28: Super dispersion

Global - Performance dispersion



Source: MSCI and AXA IM Research, November 2023

Throughout the course of the year, real global GDP growth expectations have steadily been revised higher, offering support to upward earnings revisions. Although global profits have declined, companies surprised on the upside thanks to the resilience of profit margins.

Interest rate volatility was clearly one of the determining factors of equity market performance. As inflation fell, however, central banks began to halt their tightening cycles. This has been reflected in a performance driven by the multiple expansions in global equity markets, which is at odds with the rise in interest rates.

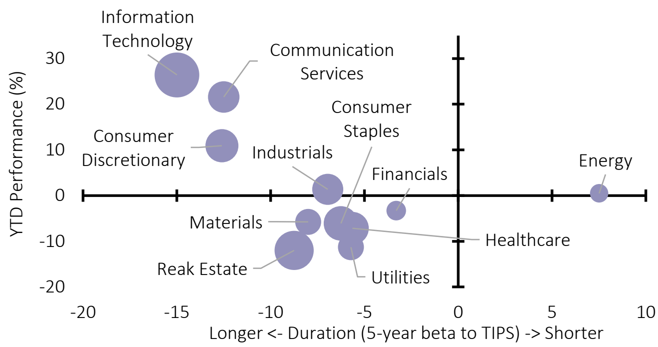
In our central scenario where growth remains sluggish but a recession is avoided, inflation heads back towards its target and central banks broadly start to reverse course in the second half of the year. We believe that global equities should generate a positive return with some volatility likely reflecting the precise timing of when central banks reverse course.

High for longer

Uncertainties over the short and long ends of US interest rate curves were one of the highlights of the year. These uncertainties were explained for the short end by the constant revision of the expected peak rate until mid-year and then the scale of cuts thereafter, while apparent reassessment of the 'neutral rate' mainly occurring in the second half of the year helped explain higher term rates.

Exhibit 29: Long duration did well despite higher interest rates

Global - Performance by real rates betas



Source: IBES and AXA IM Research, size of bubble is based on valuations, November 2023

There is still uncertainty about the exact timing of the rate cut, but markets are counting on a change towards the end of the first half of 2024 – our own view is for the first cut to be delivered in June 2024. But investors are more convinced rates will stabilise at higher levels for longer, and this convergence of views should mitigate long-term interest rate risks for equities.

Yet the impact of rising interest rates on equities has not been observed in the usual way. Long duration stocks did not fall significantly (Exhibit 29). Instead, those names outperformed the rest of the market and, for instance, value (+2.5%) has underperformed growth (+25.6%).

How do we explain this? The rise in real rates has been uneven – the first half of the year saw real rates remain fairly stable; they then rose by around 80 basis points (bp) from late June. This has been a determining factor in the relative performance of growth versus value (first half: +20.5%, second: +1.8%).

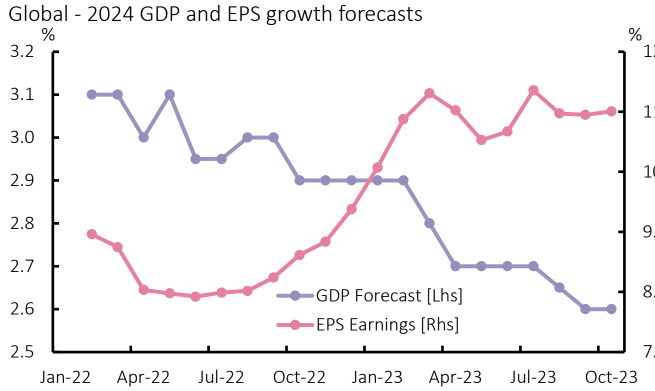
Additionally, it is important to note that, at present, long-duration companies generally have relatively sound balance sheets. Currently, the information technology (IT) sector is the least leveraged, unlike in the past. As a result, equity investors have rewarded these quality stocks regardless of their valuation.

For 2024, we believe the market will continue to favour low-leverage stocks. Also, reaching a new range in long-term rates would suggest less volatility in interest rates, which would improve growth stocks' forward earnings visibility. This is why a barbell allocation to IT (benefiting from lower rate volatility) and financials (benefiting from structurally higher rates) looks reasonable.

Sluggish growth outlook

At the global level, analysts have consistently and significantly upgraded their 2024 forecasts for earnings growth expecting +11% while consensus GDP forecasts have declined to +2.6% from +3.1% (Exhibit 30). This discrepancy has resulted in an inconsistent relationship between earnings and GDP.

Exhibit 30: The market and macro at odds



Source: Bloomberg, IBES and AXA IM Research, November 2023

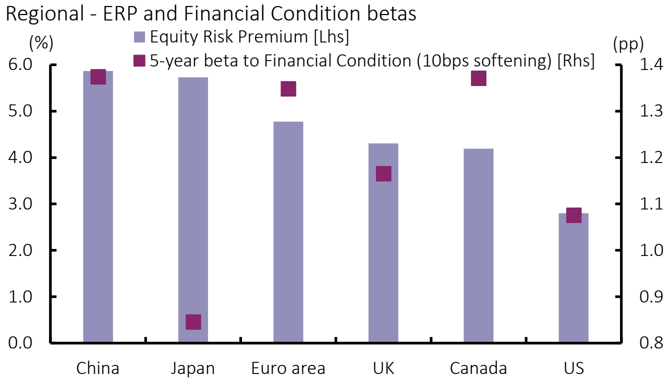
The resilience in earnings-per-share has been largely attributed to resilient margins. However, we expect this resilience to fade in 2024, after positive surprises of the results published by companies this year. With pressure from slowing inflation (lower pricing), tight financial conditions and still increasing wage growth, the profit margin could evolve at a below trend pace next year. This suggests a fall in consensus margin expectations of the order of at least 150/300 percentage points for Europe and US market constituents respectively.

Yet this margin contraction alone would not be sufficient to bring earnings growth in line with our 2024 GDP growth forecasts. To achieve this, sales would also require a sizeable downward revision, as the consensus is for +5% in the US and +2.6% in Europe. Such a scenario would push multiples even higher, prompting a greater potential of correction in share prices, although we should not ignore the chance of an upward adjustment in economic growth, as we have seen this year.

If economic growth was to be revised up in 2024, we would prefer exposure to the US than to the rest of the world as historically, upward revisions of US GDP forecasts have been a catalyst for forward US outperformance versus global equities.

To get in on this theme, we think that a long position on US cyclicals, which are currently cheap, would be a judicious move. On a relative basis, we are cautious on emerging markets cyclicals given the uncertainty surrounding the Chinese economic situation.

Exhibit 31: Japan is at the right spot



Source: Absolute Strategy Research, Bloomberg, MSCI and AXA IM Research, November 2023

From a broader perspective, we believe Japan can continue to outperform its peers on a purely macro relative basis. Firstly, we expect Japan to deliver above-trend GDP growth and below-target inflation, which is the best combination for equities. Second, it has the second largest equity risk premium across countries and, finally, we see the lowest market price elasticity to tighter financial conditions (Exhibit 31). Insofar as the study is conducted in local terms, the risk of the yen appreciating could erode the returns for international investors.

This last point is not the least important, since credit defaults, fiscal consolidation and higher minimum rates of return could undoubtedly feed a tighter financial condition trend which should be a clear risk to monitor for the equity market.

30 November 2023

Forecast summary

Real GDP growth (%)	2023*		2024*		2025*	
	AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
World	3.0		2.8		3.0	
Advanced economies	1.5		0.8		1.3	
US	2.2	2.2	1.1	0.9	1.6	1.8
Euro area	0.5	0.5	0.3	0.6	0.8	1.5
Germany	-0.1	-0.4	0.2	0.5	0.7	1.5
France	0.9	0.8	0.6	0.8	0.7	1.3
Italy	0.7	0.7	0.0	0.6	0.5	1.2
Spain	2.4	2.3	0.9	1.3	1.3	1.9
Japan	1.9	1.9	1.2	0.9	1.0	1.0
UK	0.5	0.4	0.0	0.3	0.5	1.2
Switzerland	0.6	0.8	0.8	1.2	1.3	1.5
Canada	1.1	1.1	0.9	0.6	1.7	1.9
Emerging economies	3.9		4.0		4.1	
Asia	4.9		4.8	4.0	4.7	
China	5.2	5.0	4.5	4.4	4.2	4.4
South Korea	1.4	1.2	2.2	2.0	2.3	2.2
Rest of EM Asia	5.0		5.4		5.5	
LatAm	2.3		2.3		2.4	
Brazil	3.0	3.0	1.4	1.6	2.0	2.0
Mexico	3.3	3.1	2.0	1.9	1.5	2.2
EM Europe	2.4		2.0		2.7	
Russia	2.2	1.7	1.1	1.4	1.0	1.1
Poland	0.6	0.2	2.8	2.7	3.5	3.4
Turkey	4.3	3.5	2.0	2.1	3.6	3.2
Other EMs	2.3		3.5		4.0	

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

CPI Inflation (%)	2023*		2024*		2025*	
	AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	4.7		2.8		2.8	
US	4.2	4.2	3.2	2.6	3.2	2.3
Euro area	5.5	5.6	2.7	2.5	2.7	2.1
China	0.4	0.6	1.1	1.7	1.1	1.9
Japan	3.0	3.2	1.5	2.2	1.5	1.5
UK	7.5	7.4	2.8	3.1	2.8	2.0
Switzerland	2.4	2.2	1.5	1.6	1.5	1.3
Canada	4.1	3.9	3.2	2.6	3.2	2.0

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

Central bank policy Meeting dates and expected changes (Rates in bp / QE in bn)		Current	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24
United States - Fed	Dates	5.50	13-Dec	31 Jan 20 Mar	1 May 12 Jun	30-31 Jul 17-18 Sep	6-7 Nov 17-18 Dec
	Rates		unch (5.50)	unch (5.50)	-0.25 (5.25)	-0.25 (5.00)	-0.25 (4.75)
Euro area - ECB	Dates	4.00	14-Dec	25 Jan 7 Mar	11 Apr 6 Jun	18 Jul 12 Sep	17 Oct 12 Dec
	Rates		unch (4.00)	unch (4.00)	-0.25 (3.75)	-0.25 (3.50)	-0.25 (3.25)
Japan - BoJ	Dates	-0.10	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)	+0.10 (0.00)	unch (0.00)	unch (0.00)
UK - BoE	Dates	5.25	14-Dec	1 Feb 21 Mar	9 May 20 Jun	1 Aug 19 Sep	7 Nov 19 Dec
	Rates		unch (5.25)	unch (5.25)	unch (5.25)	-0.25 (5.00)	-0.50 (4.75)
Canada - BoC	Dates	5.00	6-Dec	24 Jan 6 Mar	10 Apr 5 Jun	24 Jul 4 Sep	23 Oct 11 Dec
	Rates		unch (5.00)	unch (5.00)	unch (5.00)	-0.25 (4.75)	-0.25 (4.50)

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

AXA Investment Managers

30 November 2023

Calendar of events

2023	Dates	Events	Comments
November	17-nov	US budget extension expires, risk of shutdown	
	22-nov	UK Autumn Statement	
December	01-déc	UK Credit rating review (Fitch)	
	06-déc	BoC meeting	unchanged (5.00%)
	06-déc	UK Financial Stability Report	
	10-12 Dec	Egypt Presidential election	
	13-déc	FOMC meeting	unchanged (5.50%)
	14-déc	ECB meeting	unchanged (4.00%)
	14-déc	BoE meeting	unchanged (5.25%)
	19-déc	BoJ meeting	unchanged (-0.10%)
2024	**Dates**	**Events**	**Comments**
January		ECB Operational framework review	
		OPEC+ Oil production target cuts	
	01-janv	UK Post Brexit border regulations on EU goods introduced	
	13-janv	Taiwan Presidential election	
	22-23 Jan	BoJ meeting	unchanged (-0.10%)
	24-janv	BoC meeting	unchanged (5.00%)
	25-janv	ECB meeting	unchanged (4.00%)
	31-janv	FOMC meeting	unchanged (5.50%)
February	01-févr	BoE meeting	unchanged (5.25%)
	06-févr	Reserve Bank of Australia (RBA) meeting	
	26-27 Feb	BoE's Agenda for Research conference	
March		UK Chancellor Jeremy Hunt delievers Spring Budget	
	05-mars	US Super Tuesday	
	06-mars	BoC meeting	unchanged (5.00%)
	07-mars	ECB meeting	unchanged (4.00%)
	17-mars	Russia Presidential elections	
	18-19 Mar	BoJ meeting	unchanged (-0.10%)
	19-mars	Reserve Bank of Australia (RBA) meeting	
	20-mars	FOMC meeting	unchanged (5.50%)
	21-mars	BoE meeting	unchanged (5.25%)
	31-mars	Ukraine Presidential election	
April		BoE Term Funding Scheme repayments begin	
		India General Elections	
	10-avr	BoC meeting	unchanged (5.00%)
	11-avr	ECB meeting	-25bps (3.75%)
	25-26 Apr	BoJ meeting	+10bps (0.00%)
	30-avr	Post Brexit border full SPS checks on EU goods introduced	
May	01-mai	FOMC meeting	-25bps (5.25%)
	07-mai	Reserve Bank of Australia (RBA) meeting	
	09-mai	BoE meeting	unchanged (5.25%)
June	02-juin	Mexico Presidential election	
	05-juin	BoC meeting	unchanged (5.00%)
	06-juin	ECB meeting	-25bps (3.75%)
	6-9 Jun	European Parliament election	
	12-juin	FOMC meeting	-25bps (5.25%)
	13-14 Jun	BoJ meeting	+10bps (0.00%)
	18-juin	Reserve Bank of Australia (RBA) meeting	
	20-juin	BoE meeting	unchanged (5.25%)
	30-juin	BoE MPC member & Deputy Governor Ben Broadbent's term ends	

Abbreviation glossary

1Q23	first quarter of 2023
1H23	first half of 2023
[Lhs]	left hand scale (graph)
[Rhs]	right hand scale (graph)
a.r.	annualised rate
APP	Asset Purchase Programme
AUD	Australian dollar
BAML	Bank of America Merrill Lynch
BEA	US Bureau of Economic Analysis
BIS	Bank for International Settlements
bn	billion
BLS	Bureau of Labor Statistics
BoC	Bank of Canada
BoE	Bank of England
BofA	Bank of America
BoJ	Bank of Japan
bp(s)	basis point(s)
CAD	Canadian dollar
CANSIM	Canadian Socio-Economic Information Management System
CEE	Central and Eastern Europe
CEEMEA	Central and Eastern Europe/Middle East/Africa
CHF	Swiss franc
CPI	Consumer price index
DFR	Deposit facility rate
DM	Developed market
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
EM(s)	Emerging market(s)
EMU	European Monetary Union
EPS	Earnings per share
ERP	Equity risk premium
ESM	European Stability Mechanism
ETF	Exchange-Traded fund
EU	European Union
EUR/€	Euro
Fed	US Federal Reserve
FFR	Fed fund rate
FOMC	Federal Open Market Committee
FTA	Free Trade Agreement
FRB	Federal Reserve Bank
FY	Fiscal Year
GBP/£	Pound Sterling
GDP	Gross Domestic Product
GFC	Global Financial Crisis
HKD	Hong Kong dollar
HY	High Yield
ICE	InterContinental Exchange
IG	Investment Grade
IIF	Institute of International Finance
INSEE	French National Institute of Statistics and Economic Studies

IMF	International Monetary Fund
ISM	Institute of Supply Management
JGB	Japanese Government Bonds
JPY/¥	Yen
LatAm	Latin America
LBO	Leveraged buy-out
LTRO	Long Term Refinancing Operation
MBS	Mortgage-backed security
MIAC	Japanese Ministry of Internal Affairs and Communication
mom	month on month
MPC	Monetary Policy Committee
MRO	Main Refinancing Operation
n.s/a	non-seasonally adjusted
NBER	National Bureau of Economic Research
NPL	non-performing loans
NFIB	National Federation of Independent Business
NOK	Norwegian krone
OECD	Organisation for Economic Cooperation and Development
OMT	Outright Monetary Transactions
ONS	Office for National Statistics
P/B	price-to-book ratio
P/E	price/earnings
PBoC	People Bank of China
PCE	personal consumption expenses
PEG	price/earnings to growth
PEPP	pandemic emergency purchase programme
PMI	Purchasing Manager Index
pp	percentage point
PPI	Producer price index
PPP	purchasing power parity
QE	Quantitative easing
QE3	Third quantitative easing
QQE	Quantitative and qualitative easing
qoq	quarter on quarter
REER	Real Effective Exchange Rate
RMB	renminbi chinois (yuan)
RRR	Required rate of return
s/a	seasonally adjusted
SEK	Swedish krona
SMEs	Small and medium size enterprises
SMP	Securities Markets Programme
SWF	Sovereign Wealth fund
TFP	total factor productivity
TLTRO	Targeted Longer Term Refinancing Operation
tn	trillion
UN	United Nations
USD/$	US dollar
VAT	value-added tax
yoy	year on year
ytd	year to date
WTO	World Trade Organisation

30 November 2023

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