AXA Investment Managers

Omicron – the ghost of Christmas past?

Monthly Investment Strategy

AXA IM Research

December 2021

Summary: December 2021

Theme of the month: The outlook for US real yields

- US real yields have continued to set fresh lows. Over the past 25 years, real yields and monetary policy have moved lower together. Monetary policy looks set to present ongoing headwinds for real yields over the coming six months – even if there are questions surrounding the direction of causality.
- Over this period, each fresh crisis has seen yields ratchet lower. Such a ratchet lower is consistent with the decline in the natural rate of interest, r*, which in turn reflects a number of real economy developments. The outlook for r* should be for a modest rise over the medium-term.
- Credit enjoys an inverse relationship with real yields – spreads tighten as real yields rise. For equities, earnings revisions tend to be lower as real yields rise. Real yields have also been associated with a rise in growth over value stocks. A modest reversal should materialise as real yields rise.

Macro update: Omicron – the ghost of Christmas past ?

- The Omicron variant presents a new and as yet undefined risk to the growth outlook for 2022. A risk of a highly transmissible, vaccine evading virus that causes severe illness has been a key downside risk. Omicron appear to have two of those traits, we await evidence on the severity of infections.
- Otherwise, growth more broadly had softened from a robust re-opening pace around mid-year, but most regions saw the promise of above trend growth for next year, even as supply constraints and real income growth promised to be a challenge in coming quarters.
- Inflation continues to rise, but may be close to a peak in several jurisdictions. Developed economies are seeing medium-term inflation expectations in the main well anchored. Headline inflation should stabilise in the early months of 2022 and fall sharply from the spring.
- Labour market idiosyncrasies will shape medium-term inflation risks and central bank reactions. Tight labour markets in the UK and Canada make the BoE and BoC look likely early tighteners. The Fed is tapering more quickly and can tighten earlier in 2022. The ECB has announced its own taper for 2022.

Investment strategy: risky assets shaken but not stirred, amid govie curve bear flattening and Omicron

- FX: The Omicron variant has been a reminder of the importance of monetary policy expectations in driving currency moves, as the dollar's reaction was to depreciate against the euro. Beyond short term noise, expectations for the terminal rate to rise may bring additional support to USD early in 2022.
- Rates: US CPI pricing two years forward does not look too aggressive if we account for inflation risk premium that inflation-linked investors demand. This should be rather comforting for the US Fed, albeit with some caution attached, as survey-based inflation expectations have picked up more notably.
- Credit: Nov spread widening is consistent with the more aggressive Fed pricing, as spreads tend to widen when govie curves bear flatten. Yet the recent correction hardly registers historically. Unless Omicron derails the recovery, we remain constructive for credit in 2022 amid strong credit fundamentals.
- Equity: The Omicron variant does not alter our constructive longer-term outlook for stocks either. Policy divergence between US and Europe raises the risk of Fed policy spillover on Europe's risk premia, but by our estimates this risk appears rather modest as US-Europe implied volatility beta has declined.

Central scenario

Summary – Key messages

Monetary policy

Divergence. Those with supply-side issues tighten (UK, Ca), those without do not (Ez, Jp). US depends on labour market. EMs pressured by inflation expectations and FX.

Inflation

"Mostly" transitory inflation pressures ease visibly from Spring 2022. Threat from persistent labour supply issues and more region specific.

Fiscal policy

Expect final US package in 2022. Support in Europe more gradual. UK aims at some tightening. Omicron risks sharp rise.

Growth

Rebound continues. Virus and supply risks to recede in H2 2022. Supported by excess saving spending in many DMs.

Our central scenario:

Fading virus allows inflation retracement as recoveries persist

We forecast global growth to rise by 4.2% in 2022 and 3.6% 2023.

Economic growth persists despite supply pressures. Fading virus sees inflation and supply constraints recede.

Emerging Markets

Access to vaccines paramount. Inflation pressures see further monetary tightening, made worse as Fed starts to tighten.

Rates

Gentle rise in longer-term rates, driven primarily by rising real rates in a what still-expected-to-be a gentle tightening cycle.

FX

Fed pricing favours dollar for now. European election uncertainty to weigh H1. Dollar outlook weakened by inflation and politics H2 2022.

Credit

Benign spread regime can extend into 2022 favouring higher beta carry while still problematic for duration risk.

Equities

Strong earnings surprises in 2021 are set to diminish in 2022 but above trend growth should prove supportive of earnings.

Alternative scenarios

Summary – Key messages

Persistent recession *(probability 40%)*

What could be different?

- Coronavirus mutation sees renewed outbreaks
- Post-pandemic structural changes – labour market withdrawal and goods demand – persist. Supply shocks last longer
- Geo-political tensions mount in post-Covid world
- Nervous households maintain high saving buffers

What it means

- Growth weaker, employment rebound softer, but inflation remains more elevated
- Monetary policy ill-equipped to deal with supply shocks, deteriorating inflation credibility forces tighter monetary policy in DMs

Market implications

- Risk appetite deteriorates / equities sell off / credit widens
- Safe-haven rates rally resumes
- EM debt to come under pressure

Fast recovery *(probability 5%)*

What could be different?

- Vaccine rolls out more quickly spurring pent-up demand burst
- Labour market participation recovers, strong income growth and easing inflation pressures
- Productivity boost following investment rebound and structural post-pandemic adjustments

What it means

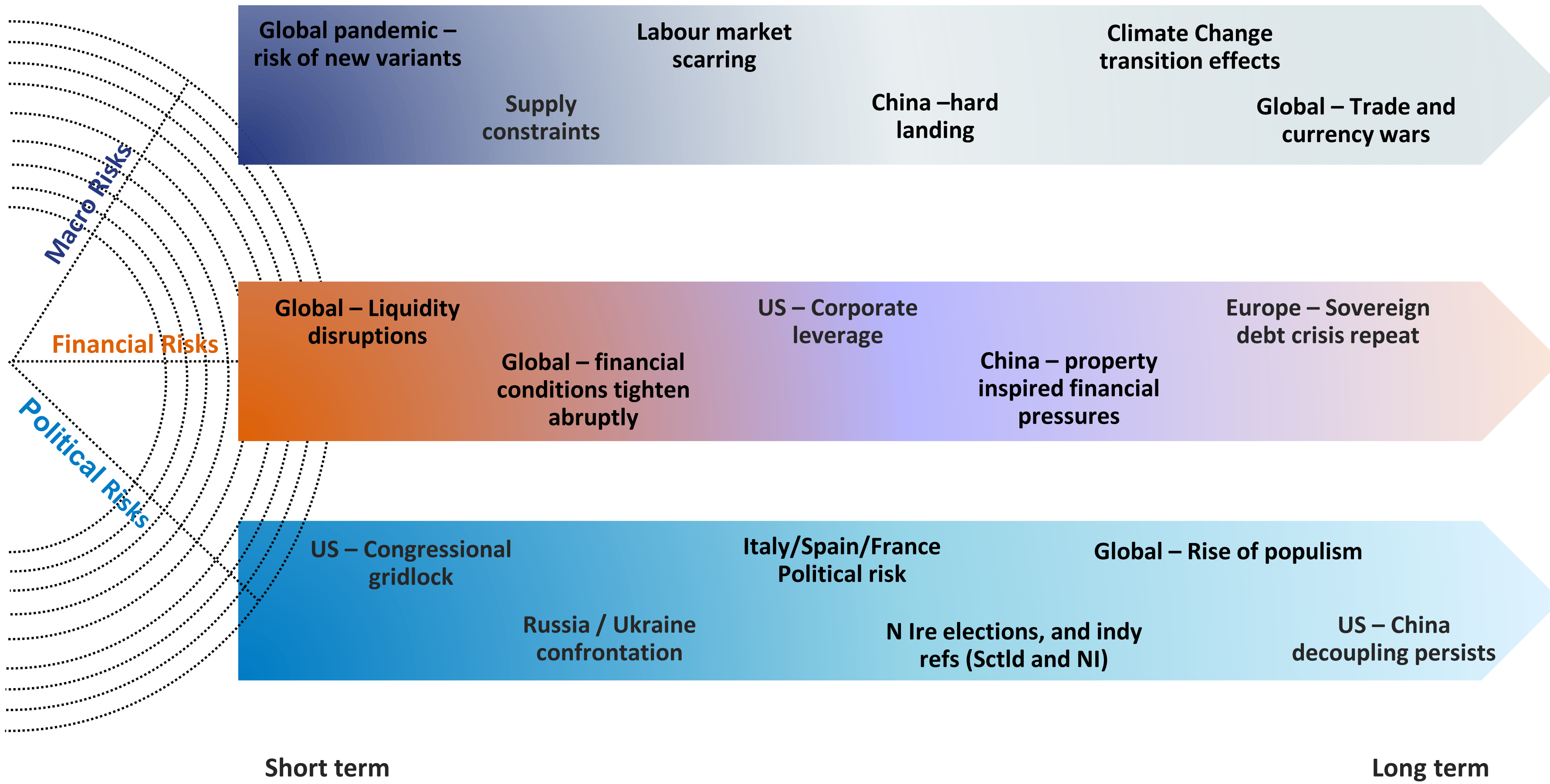
- Growth surprises on the upside in most regions
- Inflation fades towards and below central bank targets
- Monetary policy proves more patient than expectations

Market implications

- Risk-on environment, equities make further gains, growth retains lead over value
- UST softens, EUR strengthens
- Spreads grind tighter

RISk Radar

Summary – Key messages



Contents

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Theme of the month

The outlook for US real yields

The monetary policy effect on real yields

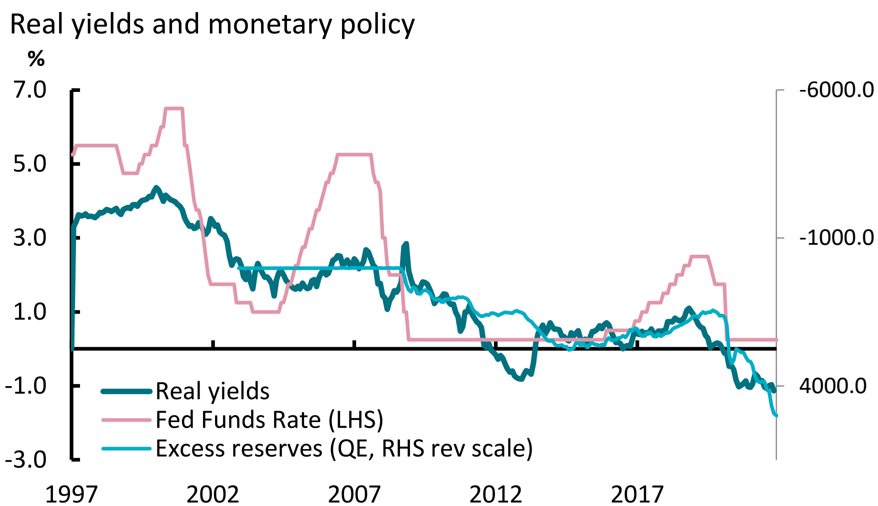
Monetary policy – rates and QE

- Monetary policy has been comprised of two components in the last decade and more: rates and QE. Theoretically, policy rate expectations guide the rate outlook and balance sheet size affects term premium although in practice this distinction is not clear. A combination of the two (and allowing for MEP in 2011) has provided a good model of real yields historically. This outlook suggests ongoing headwinds for real yields as excess reserves (tapered QE and reverse repo unwind) impacts 2022.

Direction of causality not apparent

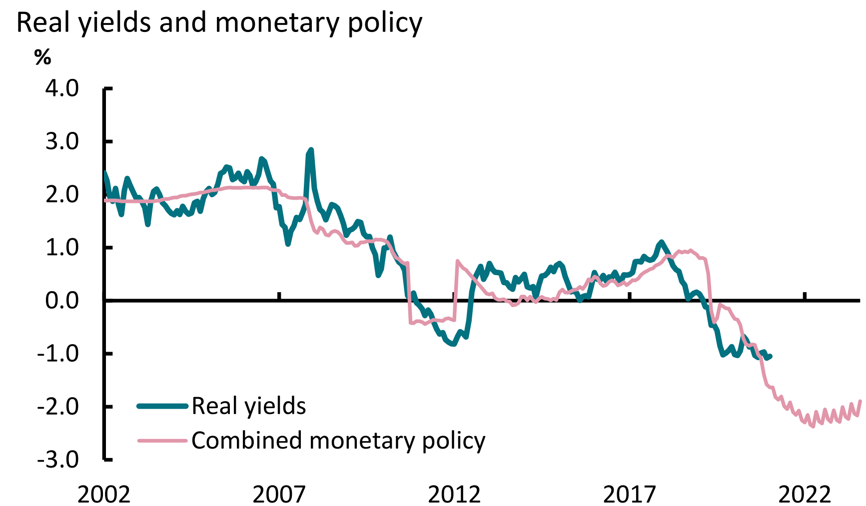
- Technically the trends in real yields may not flower from the stance of monetary policy. Growth and broader demographic factors may reduce r* (influencing real yields), monetary policy will gravitate towards this level (allowing for cyclical variation).

Real yields and monetary policy



Source: FRB, Bloomberg, AXA IM Research, Dec 2021

Monetary policy factors create further head winds for real yields



Source: FRB, Bloomberg, AXA IM Research, Dec 2021

The outlook for US real yields

Real yields and the interest rate cycle

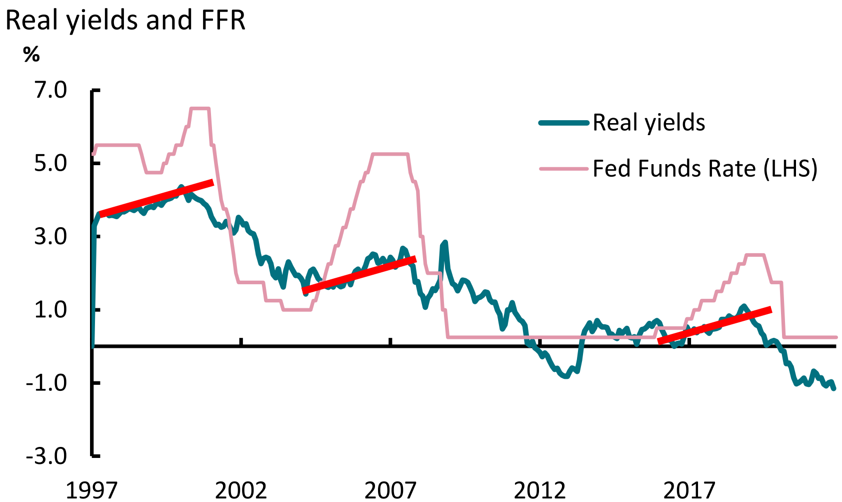
Tightening cycles have been consistent with modest rise in real yields

- We consider the last three policy tightening cycles. These were of markedly different magnitudes, with the 2004-06 cycle far greater and sharper than the rise to 2001 or the 2015-18. Yet each different policy cycle yielded a broadly similar 100bp rise over similar time frames of around three years. Moreover, the rise in real yields materialised as the Fed started hiking – not in advance.

A pleasing consistency

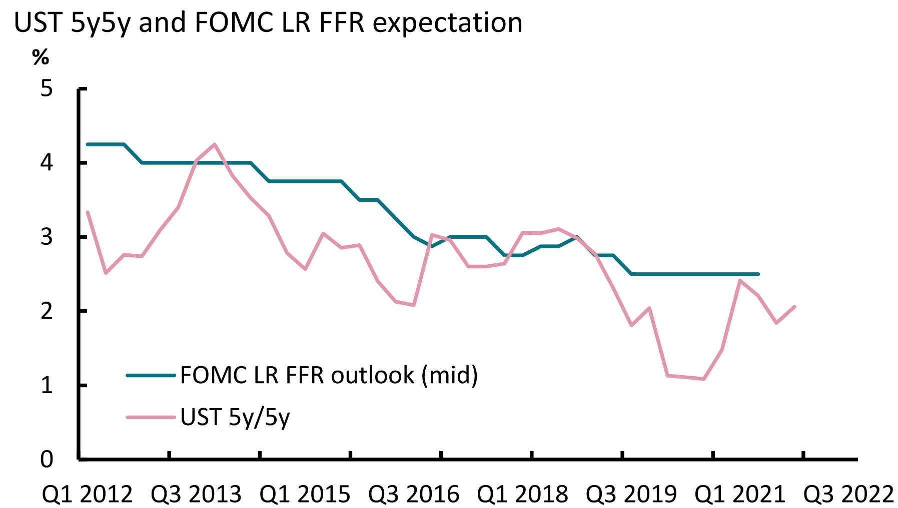
- If real yields begin to rise in 2022 as the Fed begins the next tightening cycle, adding 100bps, as per the last three cycles, onto current levels (-1.00%), while BEI remains broadly unchanged, then nominal yields would rise from around 1.50% now to around 2.50%. This in turn would be consistent with a rise in FFR to 2.50% the Fed's current assessment of the longer-run interest rate.

Real yields and the policy cycle



Source: FRB, Bloomberg, AXA IM Research, Dec 2021.

Fed's longer-term rate outlook



Source: FRB, Bloomberg, AXA IM Research, Dec 2021

The outlook for US real yields

Yields ratchet lower, movements in r*

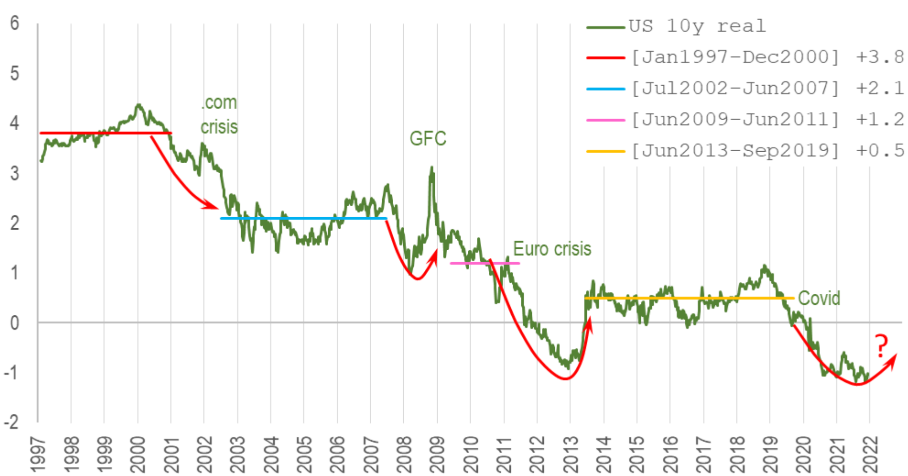
Yields ratchet lower after crisis, falling r*

- Consistent with the above observation that real yields have fallen sharply after each crisis, to rise only modestly, we can see that yields have ratcheted lower after each crisis. This process may be associated with the scarring felt after each crisis in terms of investment, productivity, skills losses and debt accumulation. More broadly, this echoes the overall trends estimated in the natural rate of interest, r*. Estimates of r* have fallen over the same period.

A poor guide for policy, a good guide for term rates

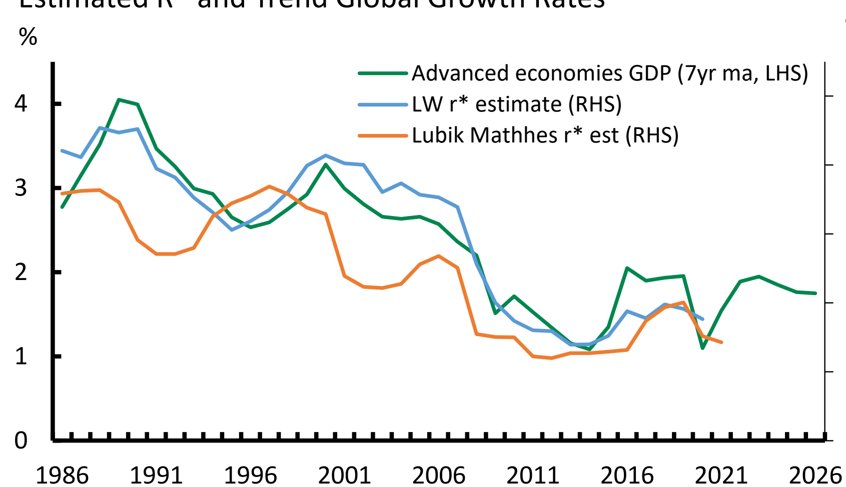
- A host of economic and demographic factors appear likely to have driven r* lower these past decades. The short-term correlation with advanced economy growth may point to some rise in r*, particularly if private sector debt expands further and broader uncertainty fades. That said, trying to ascertain short-term movements to r* has proven a poor guide to policy setting. However, historically r* has been a good benchmark identifying levels of 10-year yields.

The crisis ratchet – real yields settle lower after each crisis



Source: Bloomberg, AXA IM Research, Dec 2021

Trends in r* have been difficult to predict, but some signs of a rise



Source: FRBSF, FRBR, IMF, AXA IM Research, Dec 2021

The outlook for US real yields

Credit does not react adversely to rising real yields

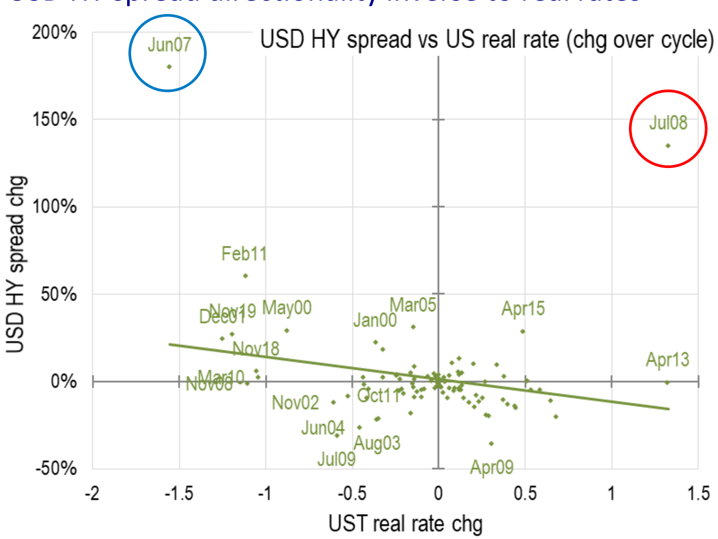
The cycles chico, they don't lie

- Parsing the cycles in US 10y real rates and the accompanying change in US HY spreads reveals an inverse relationship.
- The global financial crisis saw two major widening episodes; one at the start when real rates declined ("Jun07" label on chart) and one around Lehman, when real rates increased ("Jul08" label on chart).

2008 was an outlier year

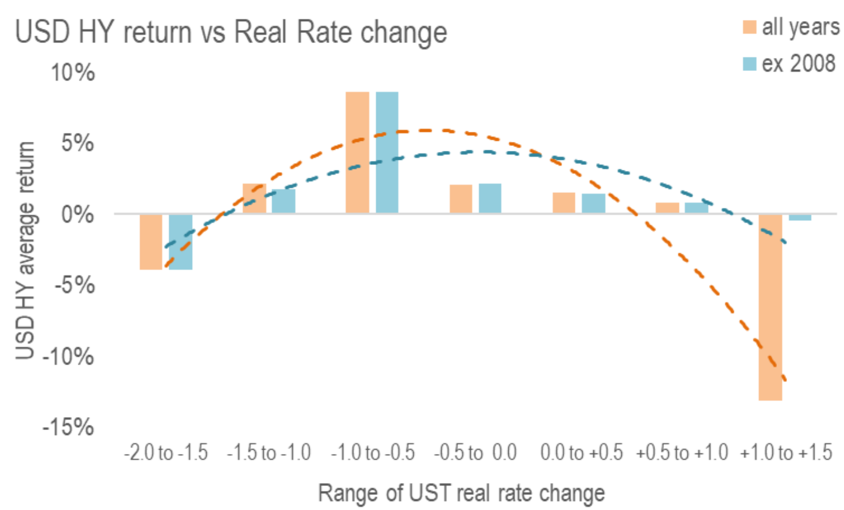
- The massive risk off around the Lehman bankruptcy included a material drawdown in US HY returns. At the same time US real yields spiked, albeit mechanically due to the collapse in inflation expectations.
- Excluding this highly irregular episode from the histogram of USD HY returns vs real rate changes, shows that USD HY returns are mostly positive, even if modest, during rising real rates.

USD HY spread directionality inverse to real rates



Source: Bloomberg, ICE and AXA IM Research, Dec 2021

USD HY returns skewed by the outlier year 2008



Source: Bloomberg, ICE and AXA IM Research, Dec 2021

The outlook for US real yields

Equity and real rates

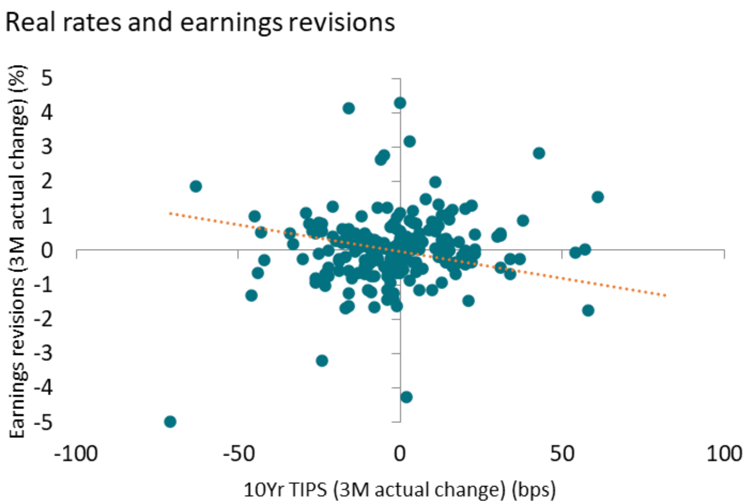
Real rates, a potential headwind

- Companies have maintained high profit margins despite rising input costs, but margins may come under threat if pressures persist. Real rates may also prove a headwind for stocks, as earnings revisions tend to trend lower with rising TIPS yields.
- 2022 consensus forecast for revenue growth at 6.8% is near the long-term trend. Downward revisions could undermine equity returns in year when policy withdrawal is unlikely to support an expansion in multiples.

Value/Growth rotation and real rates

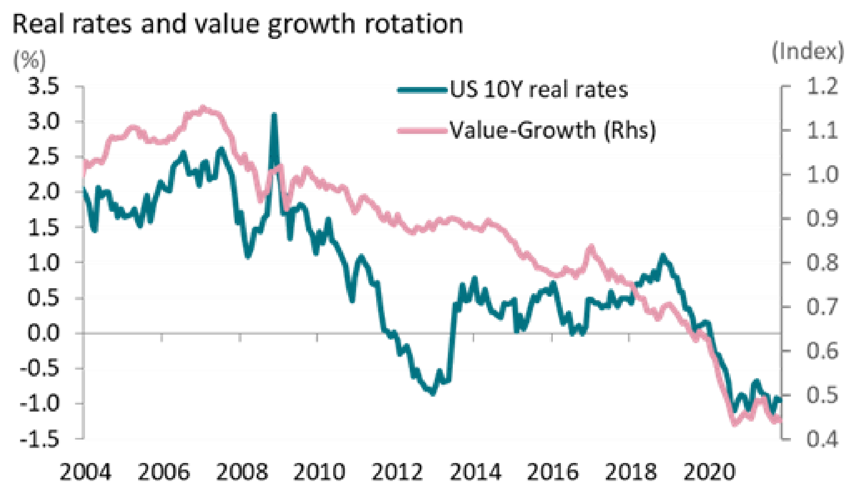
- The under-performance by Value vs Growth has shadowed the downtrend in real yields over the past couple of decades, although the relationship has been less clear-cut over certain periods (2010-12, 2013-17). But there has been strong recoupling post Covid.

Rising real rates may penalise earnings expectations

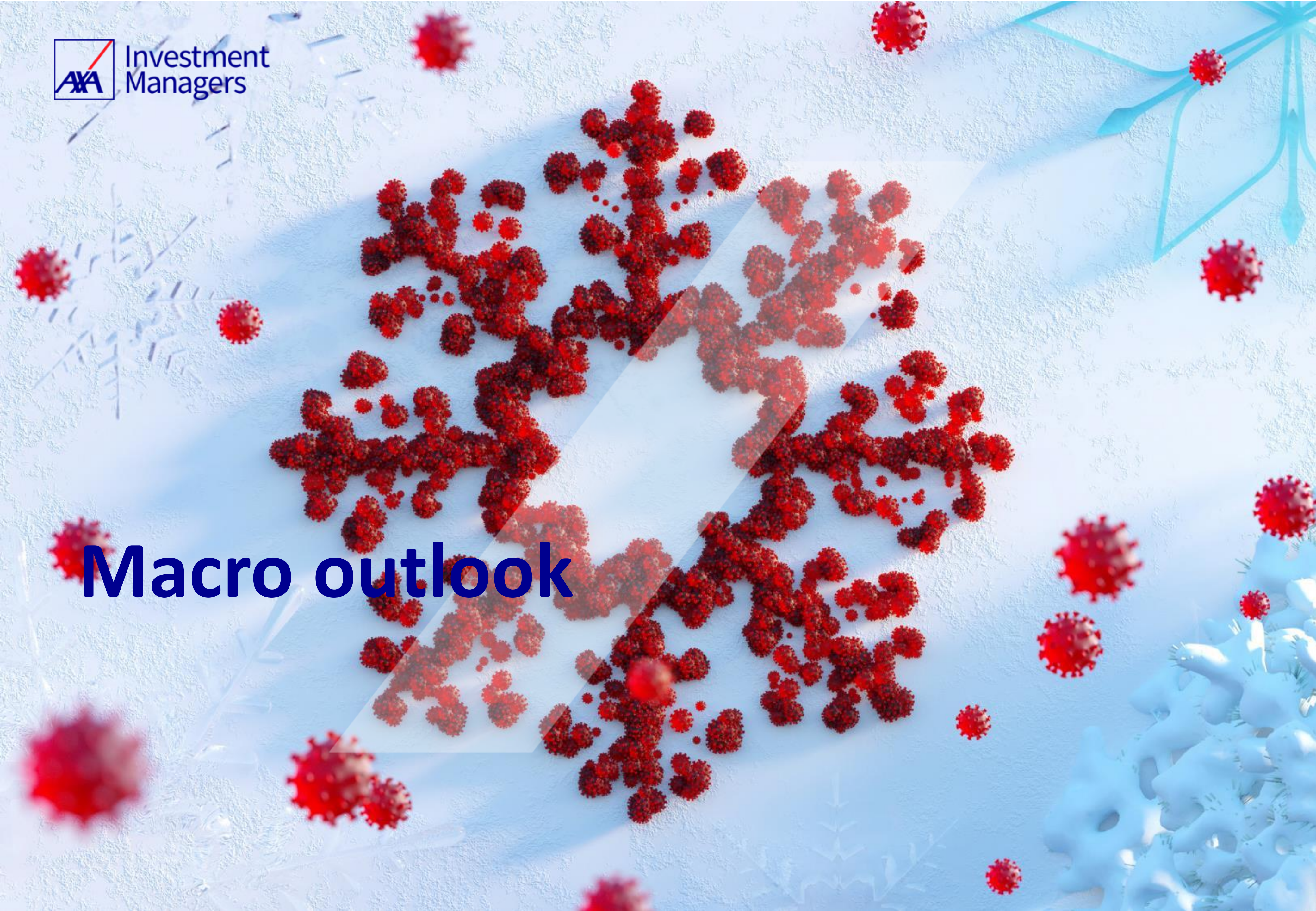


Source: MSCI and AXA IM Research, Nov 2021

USD HY returns skewed by the outlier year 2008



Source: : CBO, MSCI and AXA IM Research, Nov 2021



Macro outlook

Growth outlook solid despite headwinds

US

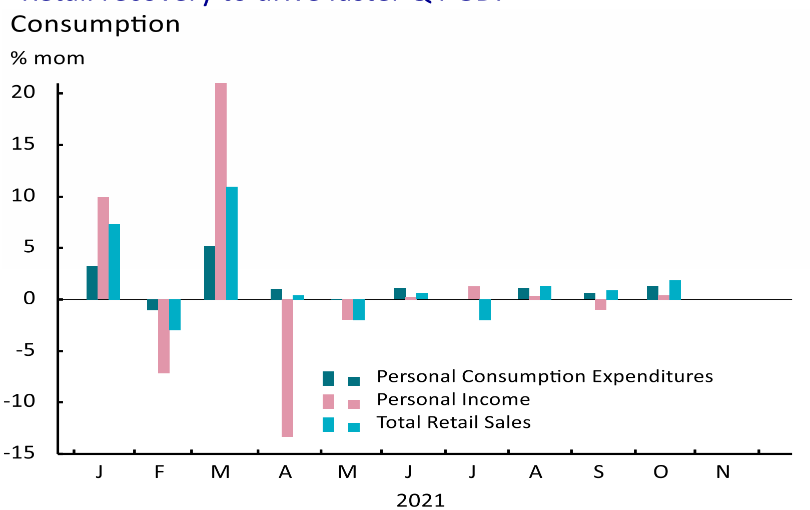
Beginning to feel a bit like Christmas ?

- As the holiday season rolls on the focus turns to consumer spending. October posted strong retail sales (1.7% m/m) and consumption (1.3%, or 0.7% in real terms). However, this may have represented a faster start rather than stronger overall season. November's outturn was a much softer at 0.3% for retail sales and December could also be soft. We expect consumption to rise by 1.5% q/q in Q4. But are wary of the impact of real income compression and COVID on Q1 spending.

Still strong growth outlook

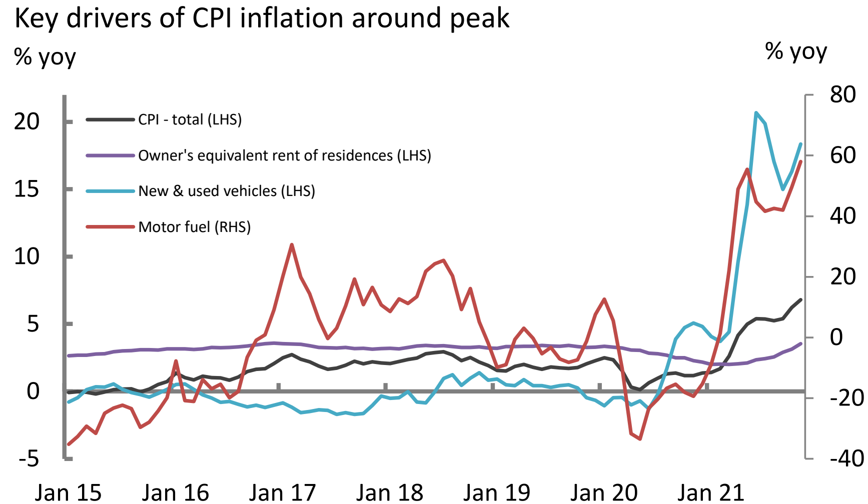
- We forecast 4.5% (saar) growth for Q4 delivering a 2021 total of 5.5%. Headwinds and supply constraints at the start of the year may delay an inventory rebound into H2 2022, dampening growth the 2022 average and lifting 2023. We forecast growth of 3.5% in 2022 and 2.7% in 2023 (consensus 3.9% and 2.5%). However, we expect the US to be operating in excess of potential growth – in excess demand – from 2022, something that should build inflation pressure for the future.

Retail recovery to drive faster Q4 GDP



Source: BEA, US Census Burueu, AXA IM Research, Dec 2021

CPI inflation reaches 40-year high



Source: BLS, AXA IM Research, Dec 2021

The impact of 40-year high inflation

US

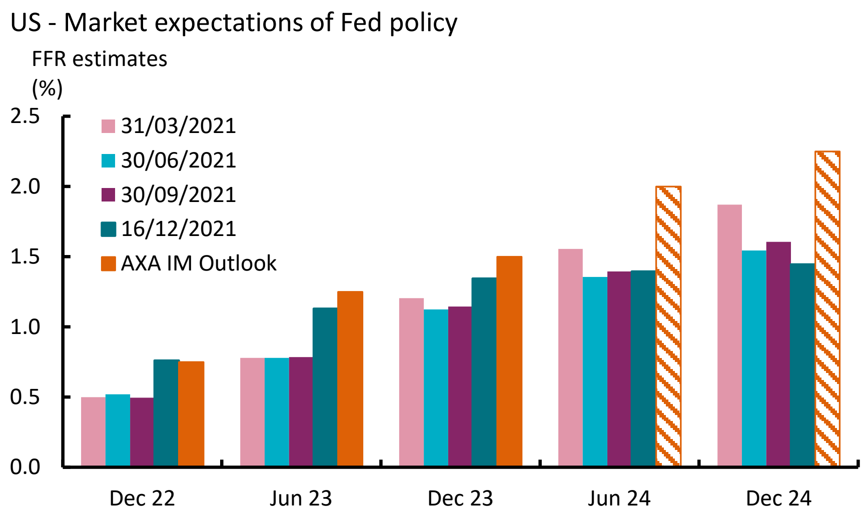
Inflation close to peak

- Inflation rose to 6.8% in November, a 40-year high. On the month, price increases were driven by new & used car prices, rents and motor fuels. Gasoline should be lower next month, and used car prices in a couple of months, but rents look like rising further. Headline inflation should be around a peak, albeit that it will likely take until spring before the rate begins to fall sharply. We forecast inflation to average 4.7%, 4.1% and 2.9% in 2021, 2022 and 2023 – a little ahead of consensus (4.6%, 3.7% and 2.4%).

Fed pivoting to inflation

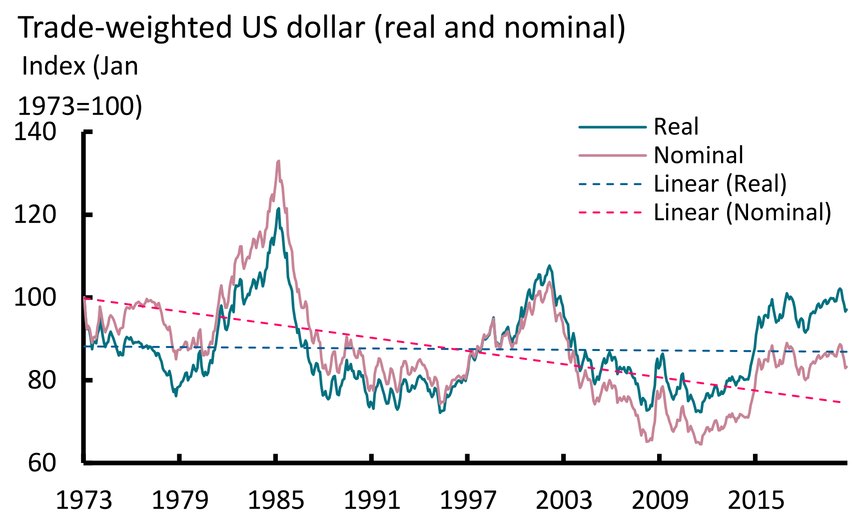
- The Fed announced a quickening in the pace of asset purchases in December. These are now forecast to finish in March. The Fed's December meeting marked a mor hawkish turn. We omicron concerns and a softer growth and employment outlook than the Fed, as well as signs of inflation retracing, as persuading the Fed to wait until June before tightening – but now expect three hikes in 2022 and three in 2023 to close the year at 1.50-1.75%, with risks skewed to a fourth.

Market expectations have adjusted timing not extent of hikes



Source: Bloomberg, AXA IM Research, Dec 21

Inflation has weighed on the dollar



Source: FRB, AXA IM Research, Dec 21

Investment Managers

Seasonally adjusted

Euro area

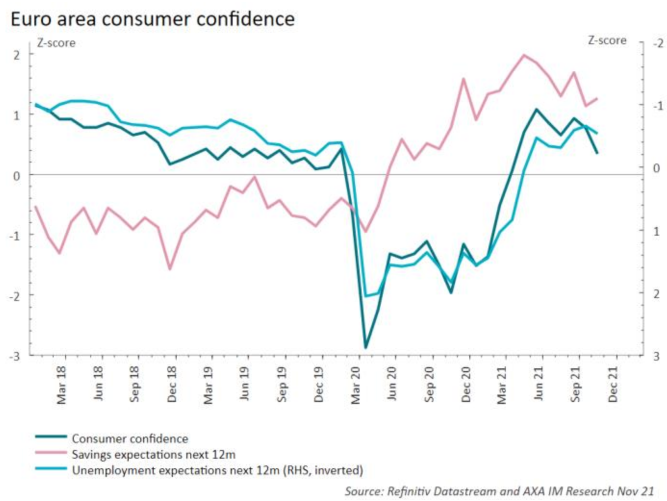
Softening demand

- November’s consumer confidence eased again, while October retail sales declined in Germany (-0.3% mom), France (-0.2%) and Spain (-0.1%) due to rising energy prices and a shift of spending towards services. The latter is now exposed to tougher restrictions from the Delta COVID-19 wave and uncertainty around the Omicron strain.

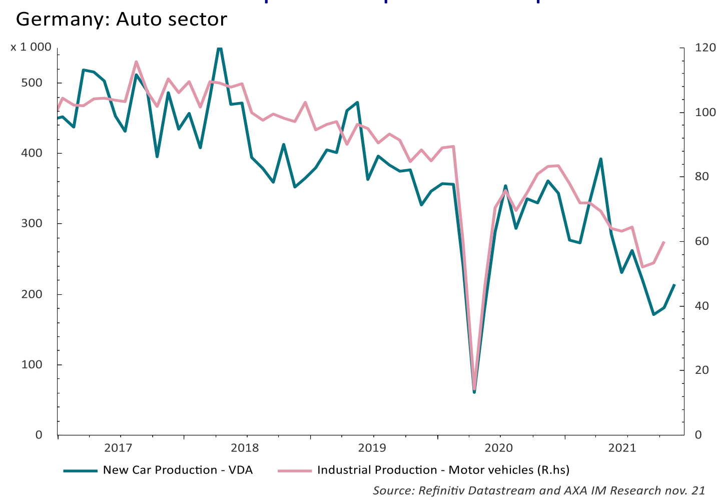
Mixed manufacturing data

- German industrial production surprised on the upside, rising 2.8% mom but was strongly biased towards auto production, which jumped 26% while VDA data pointed to another strong print in November (up 15%) as the sector recovers from extreme weakness relating to chip supply.
- In the Eurozone, France also saw a 0.9% rise, but Italy and Spain – less exposed to autos – both contracted. However, German orders fell by 6.9% mom pulled down by external demand (-13%), despite robust domestic demand (+3.4%).
- We continue to expect timorous Q4 GDP growth (+0.4% quarter on quarter), while Q1 should be only slightly better.

Softening consumer outlook



Auto sector rebound pushed up industrial production



Political developments

Euro area

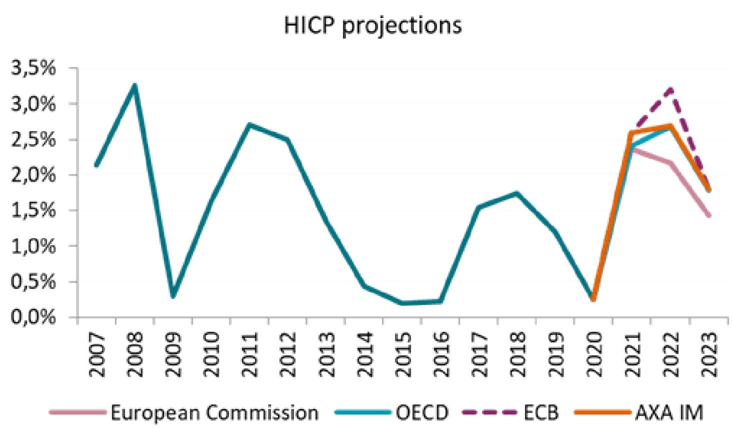
ECB: Time for recalibration!

- The ECB announced the end of the PEPP but maintained some flexibilities in the policy reinvestment and extended it until the end of 2024. The APP will be scaled up to €40bn per month in Q2 (versus €20bn), before declining to €30bn in Q3 and €20bn from October 2022 onwards and this "*for as long as necessary*". We believe rate hike is very unlikely before 2023.
- The ECB anticipates high inflation will persist in the near term but should ease in the course of 2022 and end below 2% by the end of 2022. Macroeconomic projections showed inflation could reach 3.2% in 2022, and 1.8% in 2023 and 2024.

German government is now in office, focus shifts to Italian and French Presidential elections

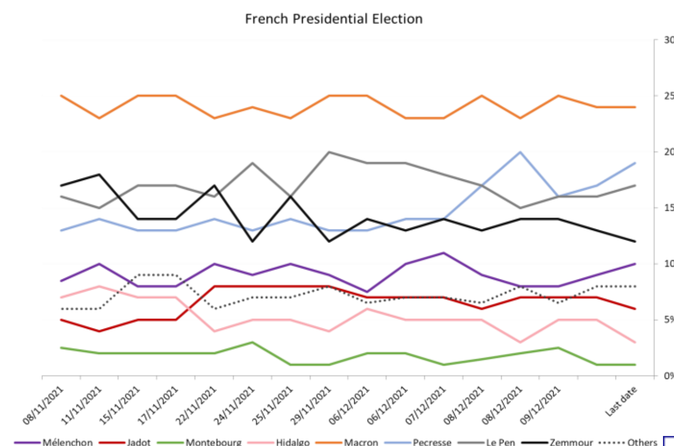
- The energy transition, increasing minimum wages and strengthening Europe are the top priorities for the new German government. Fiscal policy is still cautious, but the door remains open to some changes at both domestic and European level.
- In Italy, Matteo Salvini reiterated his support for Mario Draghi as Prime Minister, lowering the probability of Draghi being proposed as President. But Parliament may yet fail to agree on a candidate, especially as one is yet to be declared.
- In France, we now have contenders for April's Presidential Election. Valerie Pecresse will lead Les Republicains and recent polls showed a strong rebound in voting intentions. We continue to see the re-election of President Emmanuel Macron as the most likely outcome.

Inflation projections



Source: EU Commission, OECD ECB, AXA IM Research, as of December 2021

Pecresse is now favourite for second round against Macron



Sources: Odoxa, BVA, IPSOS, Elabe, Ifop-Fiducial, Harris-interactive, AXA IM Research, as of December 2021

Omicron likely to weigh on GDP outlook

UK

Fresh social restrictions are put in place to counter Omicron

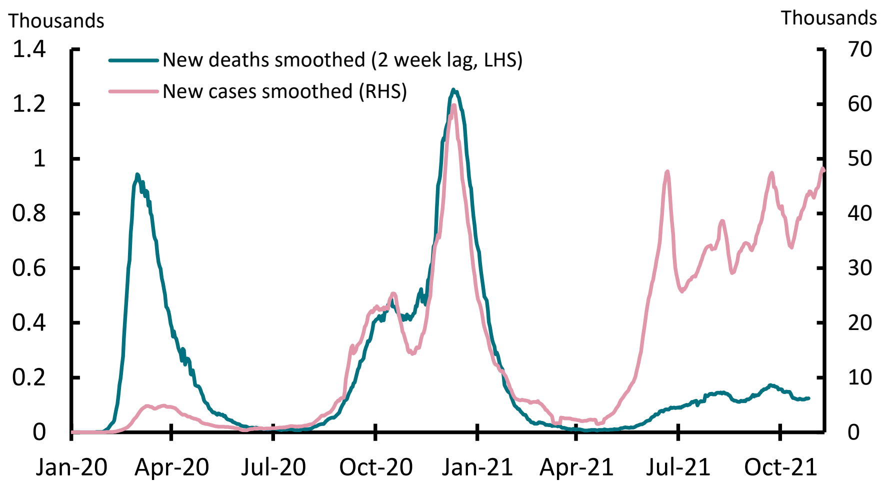
- The omicron variant's emergence has challenged the government's previous approach to mitigate the pandemic. With cases of the new variant doubling every two to three days, the UK government has implemented Winter 'Plan B' mandating mask-wearing in public places and asking workers to work from home where possible, the latter a risk to ancillary leisure services.

Trend of weak growth continues into October, with omicron uncertainty likely to weigh in further months

- UK growth has been weaker than expected in recent months, up by just 0.1% in October. This softer start to Q4, also raises the prospect of a softer Q4 in total – not least with Omicron related concerns and additional restrictions threatening to weigh later in the quarter. We now forecast Q4 GDP coming in below the 1% we had previously forecast. Retail sales rebounded in October by 0.8% after five consecutive months of contraction. We expect retail sales to come under increased pressure over the coming months reflecting pressure on households real incomes.

COVID related deaths rise, but far less than new cases

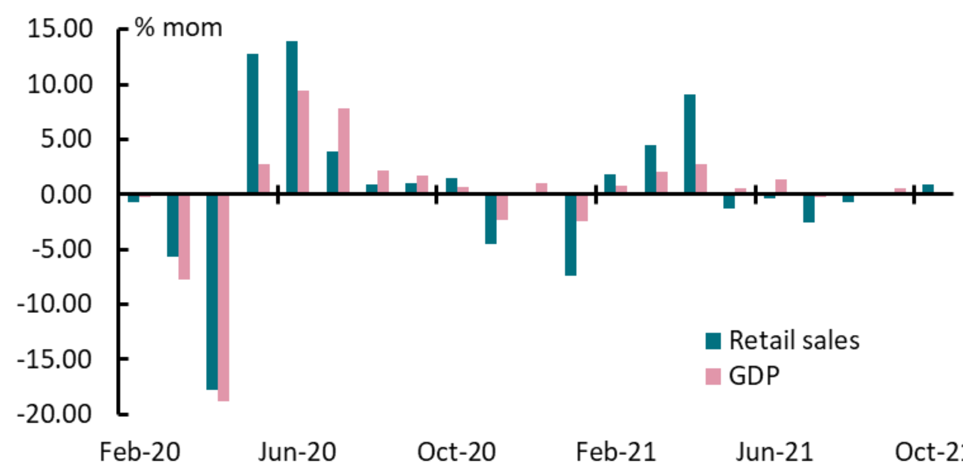
UK Cases and Deaths



Source: Our World in Data, AXA IM Research, Dec 2021

Momentum from the re-opening rebound fades

GDP and Retail sales



Source: National Statistics, AXA IM Research, Dec 2021

Labour market remains key to inflation outlook

UK

Recent labour market trends risk more persistent inflationary pressures

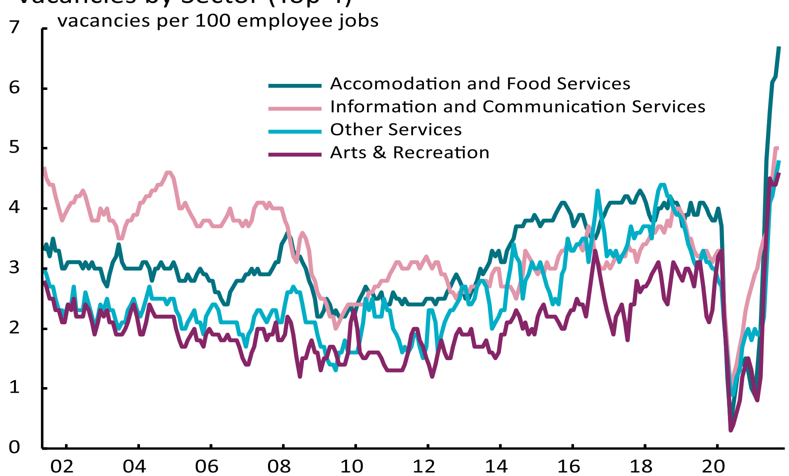
- Despite output still being below pre-pandemic levels, the economy has begun to face signs of capacity issues. The latest labour market report showed that unemployment fell further to 4.2% in the three months to October despite the end of the furlough scheme. In addition, vacancies were at all time highs in 15 out of 18 sectors. These suggest that UK activity is operating around or beyond its capacity limit, even while total output is still below its pre-pandemic level – let alone its pre-crisis trend.

MPC begins a cautious hiking cycle

- The MPC voted to increase Bank Rate to 0.25% from 0.1% in December. Despite the uncertainty posed by the omicron variant, the MPC viewed the threat of elevated inflation and a tight labour market as warranting an increase from the low emergency rates. The MPC highlighted that any future tightening will depend on the uncertain future developments in the virus. However, it suggested that further modest tightening was viewed as "likely". We forecast two hikes in 2022 and one in 2023.

Labour market tightness appears to be widespread

Vacancies by Sector (Top 4)

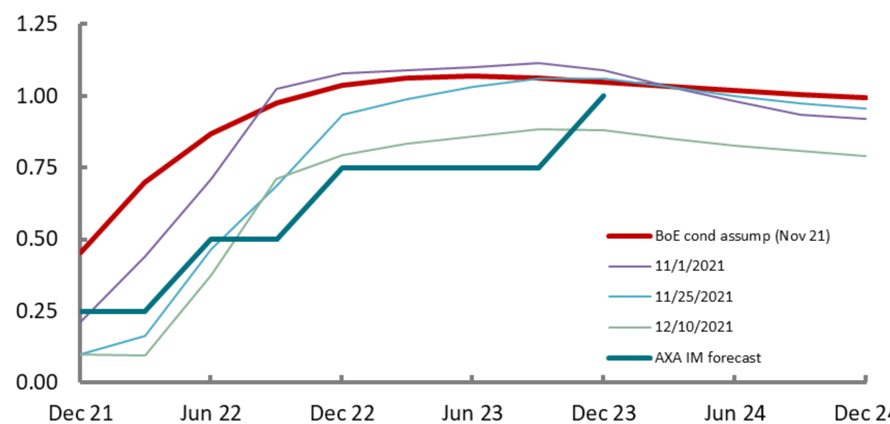


Source: National Statistics, AXA IM Research, Dec 2021

Evolution of market pricing of interest rates

AXA IM rate outlook vs Short-Sterling implied

Bank Rate (%)



Source: National Statistics, AXA IM Research, Dec 2021

Investment Managers

Growth recovers on fading power shortages

China

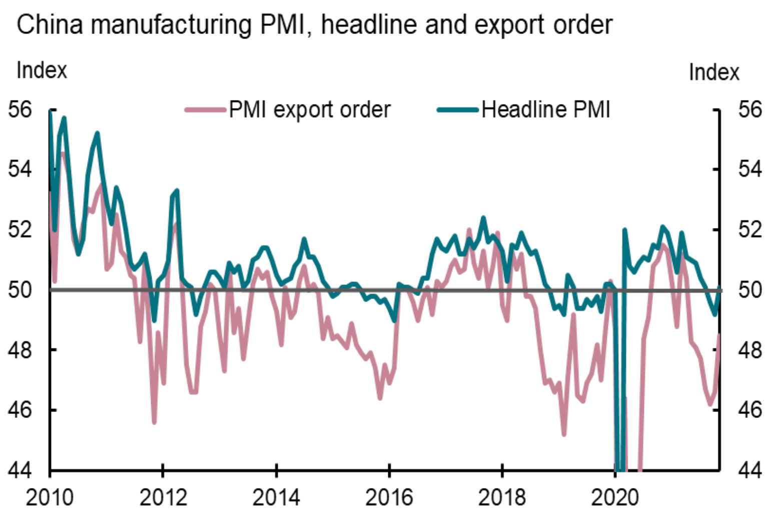
Property woes exert more persistent pressure than the power crunch

- The power shortages waned following a concerted effort across governments to ensure a stable supply of energy. Given the priority of preserving near-term growth and social stability, the authorities acted swiftly to remove curbs on coal production and imports. A sharp decline in the cost of coal gave electricity companies the necessary incentives to plug the supply gap. With power supply back on-line, the resumption of production saw the Purchasing Manufacturing Index (PMI) recover to expansionary territory after spending the prior two months below 50

Trade still serves as a cushion against economic headwinds

- Despite the supply chain disruptions and as well as rising uncertainties from the Omicron variant, November's export growth surprised to the upside, rising by 22% yoy on the back of tech resilience and higher global demand in advance of the holiday seasons. Import growth also continued its acceleration due to still strong demand for coal as a source for electricity inputs

Headline PMI edges back above the waterline



Source: CEIC, AXA IM Research, Dec 21

Trade resilience continues

Source: CEIC, AXA IM Research, Dec 21

Investment Managers

Policy to turn more growth-supportive

China

Inflation picks up on rising food and energy prices

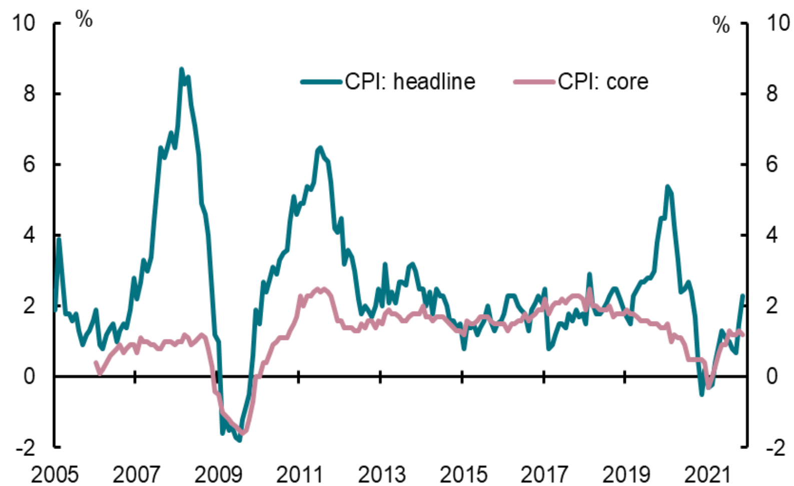
- Headline CPI increased to 2.3% in November from 1.5% in October. While the gain was partly due to base effects, it was also because of rising fuel and food prices. In particular, pork prices are finally showing signs of a rebound. In contrast, core CPI declined, likely impacted by on-and-off COVID outbreaks. Overall, despite the notable rise in CPI, it is still below PBoC's 3% target.

RRR back on the table

- The PBoC recently announced an RRR cut of 50bps to be effective on 15 December, taking the all-bank weighted average ratio down from 8.9% to 8.4%. This is estimated to release around RMB 1.2 trillion of liquidity into the banking system. In fact, Beijing had already started to ramp up policy supports: fine-tuning property policies, more generous liquidity injections and faster local government bond issuance. However, these piecemeal actions are insufficient to spur activity to hit our growth forecast of 5% next year. We expect the upcoming Central Economic Working Conference to send a clear dovish policy signal, preparing the local authorities for more forceful action next year

Inflation continues to rise, but still below PBoC target for now

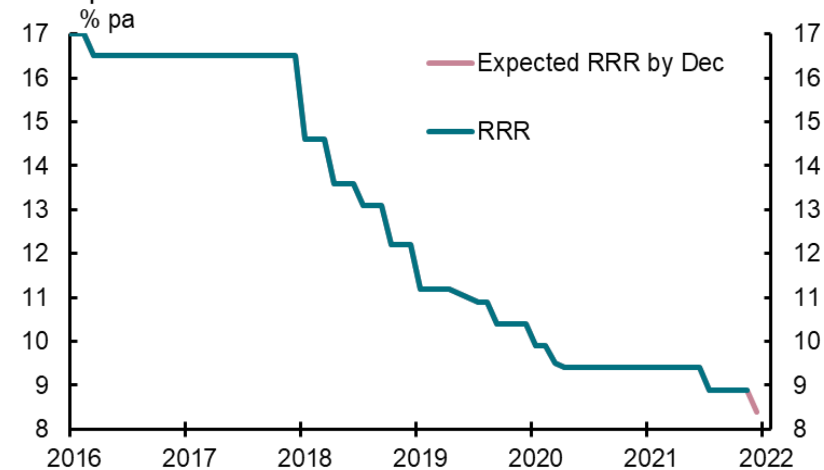
China headline and core CPI



Source: CEIC, AXA IM Research, Dec 21

50bp cut of RRR, effective mid-Dec 2021

Required reserve ratio



Source: CEIC, AXA IM Research, Dec 21

Domestic demand and auto sector rebound

Japan

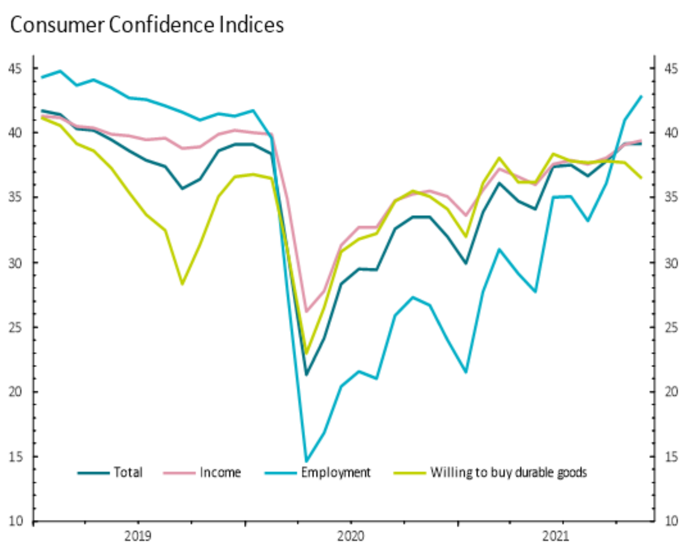
Demand resilient

- Data now confirms a substantial domestic demand increase following the end of the state of emergency. In October, the BoJ's consumption index jumped 4.3% on the month, with spending rebounding in durable goods and recovering fast in services. Looking at consumer confidence, employment prospects rose again and are now above the pre-pandemic level while income expectations are flat. Willingness to buy durable goods has declined, although this probably reflects a shift of spending towards services.

Auto production rebound

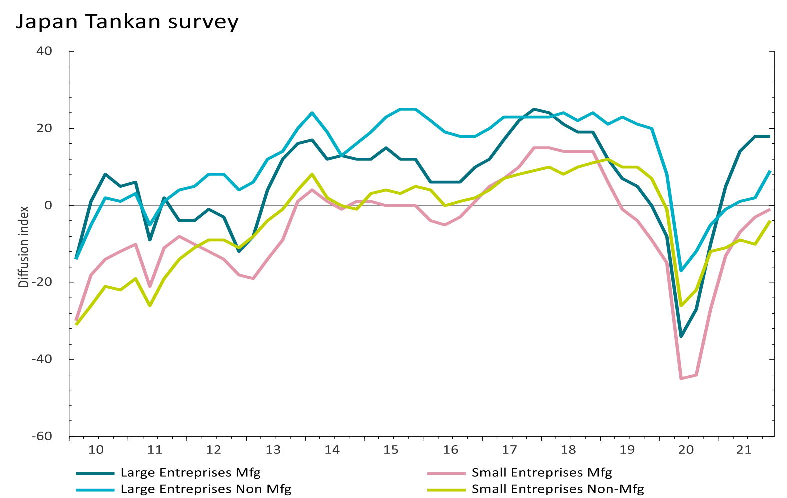
- In the manufacturing sector, output progressed, and the auto sector is gradually recovering. December's BoJ Tankan surveys for manufacturing firms were surprisingly unchanged. That said, FY21 profit expectations strengthened considerably and capex plans were only revised down modestly.

Consumer confidence are close to pre pandemic levels



Source: Refinitiv Datastream and AXA IM Research nov. 21

Only large manufacturers were unchanged in last Tankan surveys



Source: Refinitiv Datastream and AXA IM Research Q4 21

Government and Bank of Japan policies

Japan

Cautious assessment on the latest supplementary budget

- Of the ¥56trn announced, only ¥31tn (5.9% of GDP) comes from government spending. Cash handouts, subsidies and vouchers will be distributed, but excess savings that have already reached around 3.7% of GDP may dampen their take-up. On the investment side, the package recycles some previous measures, such as digitalisation and strategic sovereignty, while spending should be smoothed over the coming years.

Despite strong distortions, underlying inflation remains low so the BoJ kept the status quo

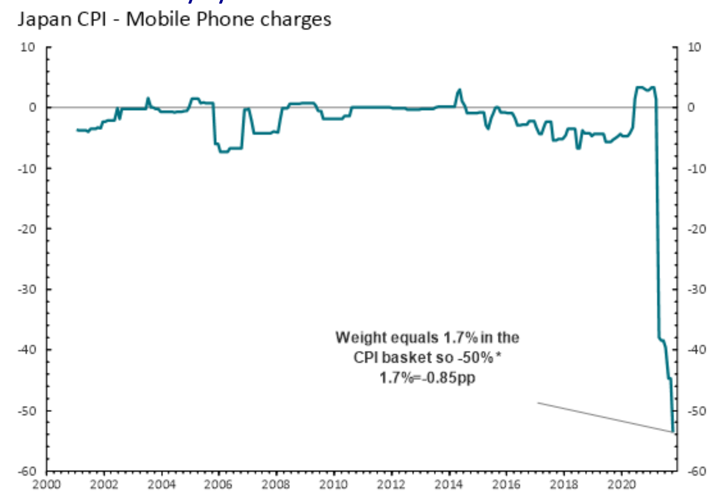
- October CPI reached 0.1% yoy but the figure remains significantly distorted by lower mobile phone charges that have decreased by 54%yoy, removing approximately 1.6 percentage points from the index.
- The BoJ decided to extend the termination date of the COVID loan program mainly for SMEs by six months to the end of Sep 2022. Other measures are broadly unchanged. Contrast with other central banks is still important and Gov Kuroda insisted that inflation excluding energy prices was subdued, so the very accommodative polices were still justified.

The expected impact of supplementary budget is likely to be lower

Measures	Amount (¥XXbn)
Containment measures for the COVID-19 i. Securing the medical treatment system ii. Support for business, daily life and livelihood (cash handouts, subsidies for SMEs, EASP, measures against energy prices)	18.6 of which 4.5 14.1
Live with Corona environment i. « Go to Travel » campaign resumption …etc	1.8
New form of capitalism » i. Growth Strategy: University fund, R&D project for enhancing 5G, space field, securing domestic production base for storage and semi conductors as well as developing digital infrastructure and digitalisation (MyNumber) ii. Distribution Strategy: benefits for housing raising children, raising income in medical, childcare and elderly care services	8.3 of which 6.3 2.0
Securing safety and relief with respect to disaster management	2.9
Transfer to the Special Account for the National Debt Consolidation Fund (¥2.3bn)	2.3
Sub total (of which ¥22bn would be financed with bond issuance) Other expenses Local allocation tax grants reduction in previously approved expenses	31.6 (5.9% of GDP) 0.2 3.5 -1.6

Source: Cabinet Office, AXA IM Research, December 2021

Mobile phone charges only accounts for 1.7% but decline reaches -50%yoy



Source: Refinitiv Datastream and AXA IM Research oct. 21

Growth running into constraints

Canada

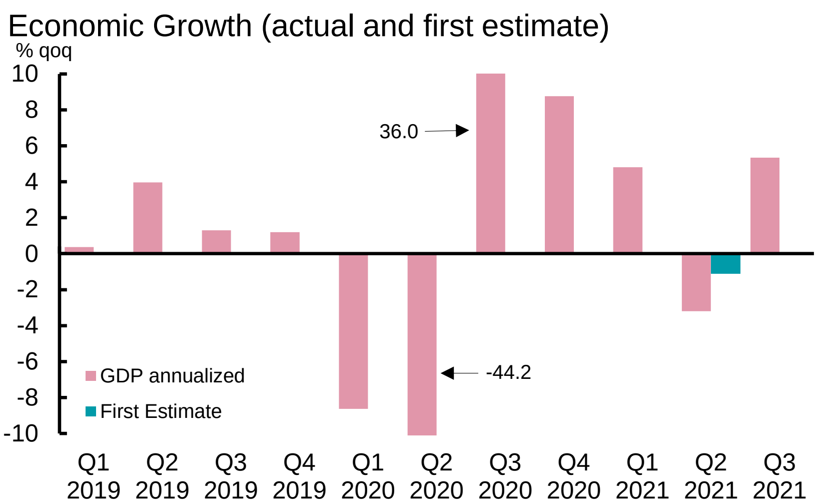
Growth swings with virus

- GDP contracted more heavily in Q2 2021 than first estimated (-3.2% saar) during the most recent material COVID spread in Canada. But it rebounded strongly (+5.4%) in Q3 as the economy re-opened. The new omicron variant poses a risk even to Canada's highly vaccinated population. However, Q4 growth is also likely to be impacted by flooding in November. We adjust our GDP outlook accordingly to 4.4% for 2021 (from 4.9%), 3.7% 2022 (from 3.5%) and 2.6% 2023 (consensus 5.0%, 4.1% and 2.8%).

Labour market tightens sharply

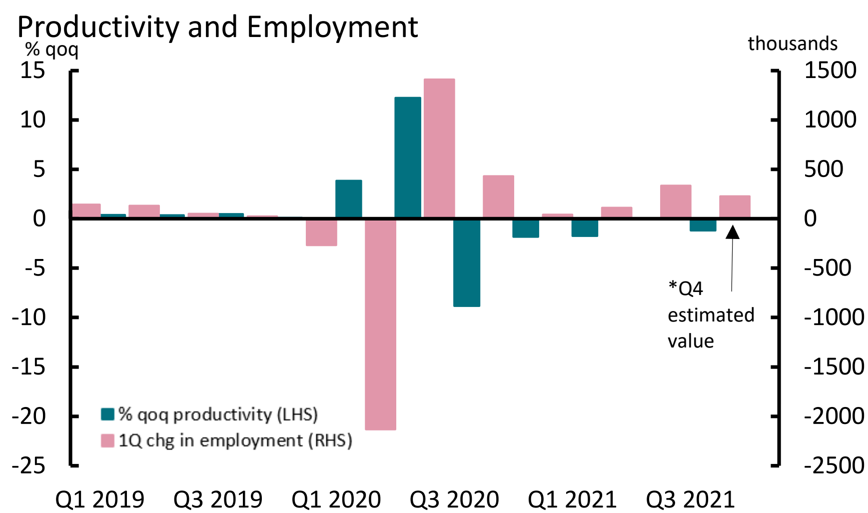
- The labour market shows signs of recovering well. Employment jumped by 154k in November, taking it to pre-pandemic levels. Labour supply barely rose, but at 65.3% participation is also close to its pre-pandemic 65.5%. And the unemployment rate dropped to 6.0% from 6.7% - its lowest since February 2020. However, productivity fell by 1.2%qoq in Q3 and looks set to fall again in Q4 – which would be a sixth consecutive fall (bar +0.1% in Q1 20).

Quarterly GDP impacted by swings in virus and restrictions



Source: CANISM, AXA IM Research, Dec 2021

Strong employment rebound matched by subdued productivity



Source: CANISM, AXA IM Research, Dec 2021

Constraints to spur Bank of Canada from Q2 2022

Canada

CPI inflation to fall from 2022

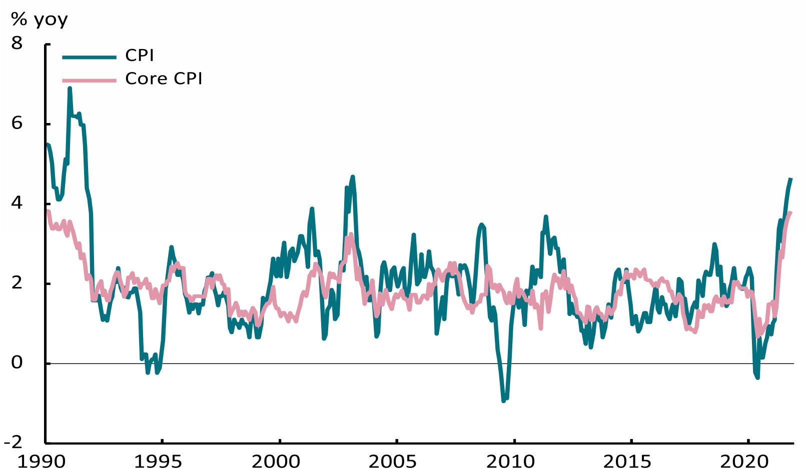
- CPI inflation reached 4.7% in November, its highest in 30-years. While the supply-chain issues that have helped drive prices higher are likely persist into H2 2022, headline inflation should start to fall sharply from the start of 2022 – earlier than in most developed economies. For now we forecast inflation at 3.4% in 2021, 3.1% in 2022 and 2.3% in 2023 (consensus 3.3%, 3.2% and 2.2%). However, we are monitoring unit labour cost development as a key source of medium-term inflation pressure.

Market to keen on policy tightening ?

- The BoC left its overnight rate target unchanged in December at 0.25% as we and markets expected. However, expectations diverge from here. The market prices five hikes next year, starting in January, and two in 2023, taking policy to 1.50% end-2022 and 2.00% end-2023. The BoC has guided to policy tightening from the middle quarters of 2022. We forecast an April lift-off, but now see three hikes in 2022. For now we forecast one more hike in 2023, but further labour market outperformance could see two to 1.50%.

CPI inflation set a new 30-year high

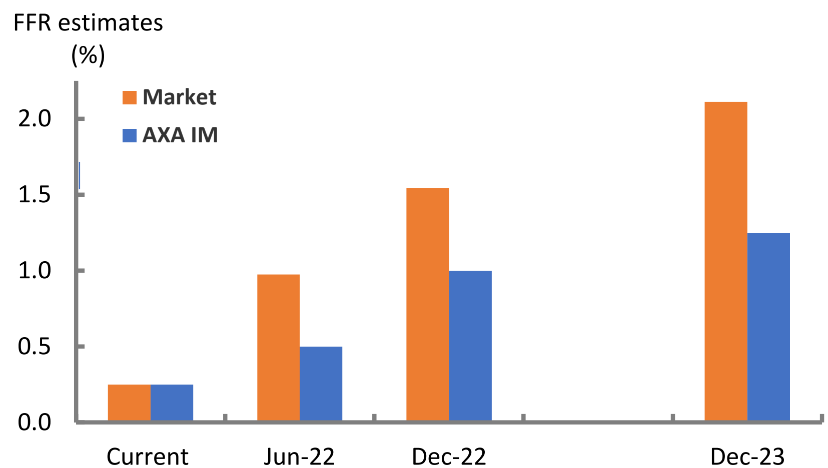
CPI and Core CPI



Source: CANISM, AXA IM Research, Dec 2021

Forecasting fewer hikes than the market

BoC o/n rate target expectations



Source: Bloomberg, AXA IM Research

Diverging recoveries, converging inflation, diverging monetary policies

Emerging Markets

Recovery paths remain Covid-19 dependent, but inflation acceleration is broad-based

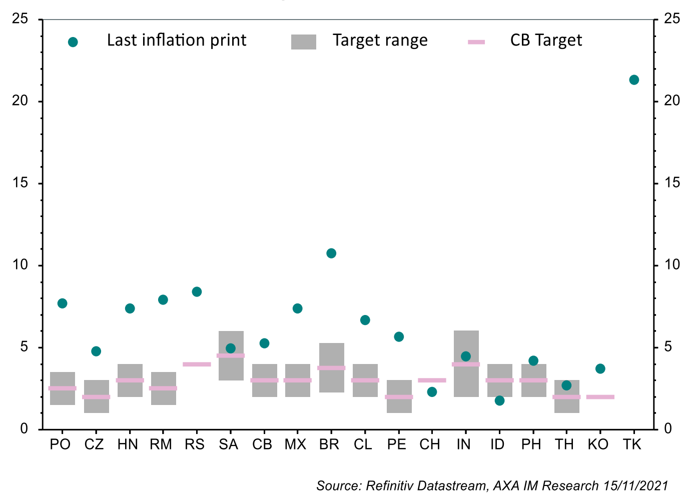
- Differences in the timing of coronavirus infection waves and the type of containment policies implemented locally impact the recovery path. Supply chain limitations have also pressured some countries' production.
- Q3 GDP growth contracted in Malaysia, Thailand, South Africa, Brazil and Mexico, but came out stronger in Chile, Colombia, Turkey and CEE region.

Inflation accelerates further. Normalization in monetary policies on diverging trends.

- Inflation further accelerated in EM mainly driven by external factors, domestic demand plays only a limited role in the recent pick-up in inflation. Still, EM central banks are reacting to higher inflation by delivering hikes and keeping a hawkish rhetoric.
- Year-to-date, 32 EM banks have hiked rates this year and more hikes are likely, although some central banks, such as Russia or Mexico, have probably already done most of the heavy-lifting ahead of the upcoming Fed lift-off.

Inflation rates are more consistently above targets…

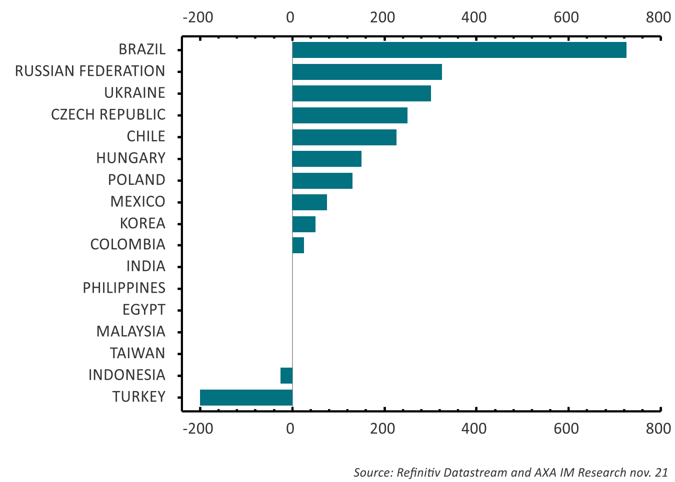
EM inflation rates and CB targets (%)



Source: Datastream, AXA IM Research, November 2021

… results in monetary tightening (almost) everywhere

Policy rates (change year-to-date, bps)



Source: Datastream, AXA IM Research, November 2021

Turkey : playing dangerously

Emerging Markets

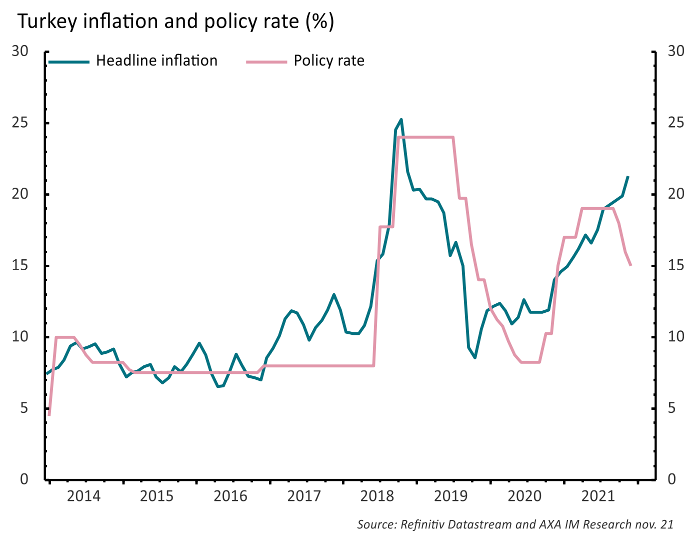
Turkey's inflation expectations de-anchoring

- November's CPI inflation stood at 21.3% yoy, yet again above consensus expectations. Underlying trends in core CPI show persistent inflation and an evident FX pass-through. PPI inflation jumped 10% on the month, +54.6% yoy.

Further easing in December likely, but current monetary policy stance becomes increasingly difficult to sustain

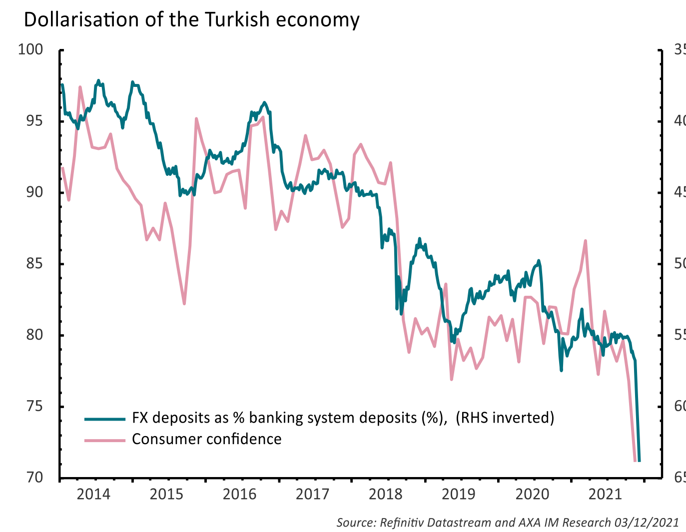
- CBRT has cut rates by a cumulative 400bps since September, despite seeing already very high and accelerating inflation rates. Despite secular deterioration in price dynamics, another cut appears on the cards at the December meeting given political interference.
- A considerably tighter stance is badly needed to anchor expectations and stabilise the currency. Economic dollarisation is accelerating: 64% of Turkish bank deposits are FX-denominated. A U-turn in the monetary policy should occur in 2022: the sooner, the better.

A dissonant easing cycle in Turkey …



Source: Datastream, AXA IM Research, November 2021

… accelerating dollarization of the economy



Source: Datastream, AXA IM Research, December 2021

Investment Strategy

Multi-Asset Investment views

Our key messages and convictions

Positive on equites

#1
Despite a slowdown in economic activity, corporate earnings continue to rebound

Neutral on Investment Grade Credit

#2
Despite support from fiscal initiatives, valuations are no longer attractive due to tight spreads

Negative on Sovereign Bonds

#3
Government bond yields expected to rise as Central Banks tighten monetary policy

Negative on Commodities

#4
Slowing Chinese demand, and increased supply, as production normalises, weighs on commodity prices

Source: AXA IM as at 15/12/2021

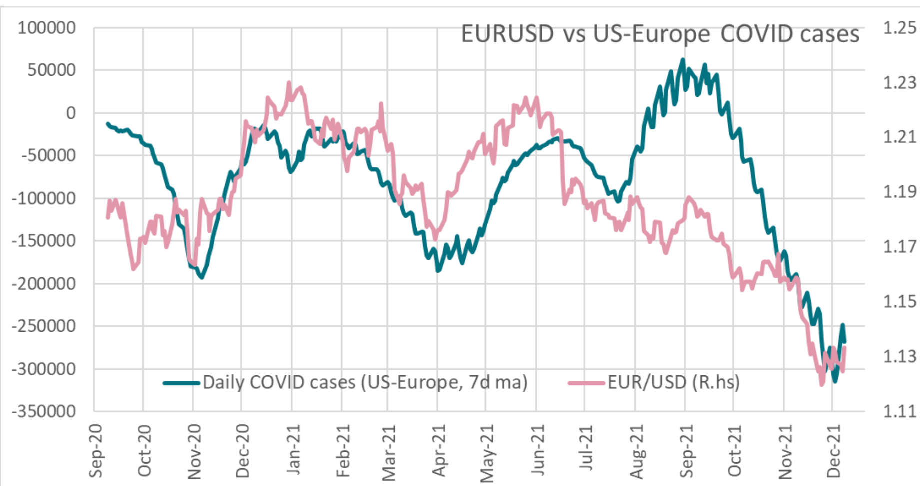
FX & Rates Strategy

The Omicron stress test emerges while inflation still matters

- The emergence of the Omicron variant has been a fitting reminder of the importance of monetary policy expectations in driving currency moves, as the dollar's reaction was to depreciate against the euro upon a partial unwind of Fed policy expectations. As Omicron concerns subsided and the Fed Chair made some hawkish comments on inflation, a more aggressive hiking cycle was priced-in again. Beyond that, the terminal rate seems underpriced; expectations for it to rise may bring additional support to USD early in 2022.

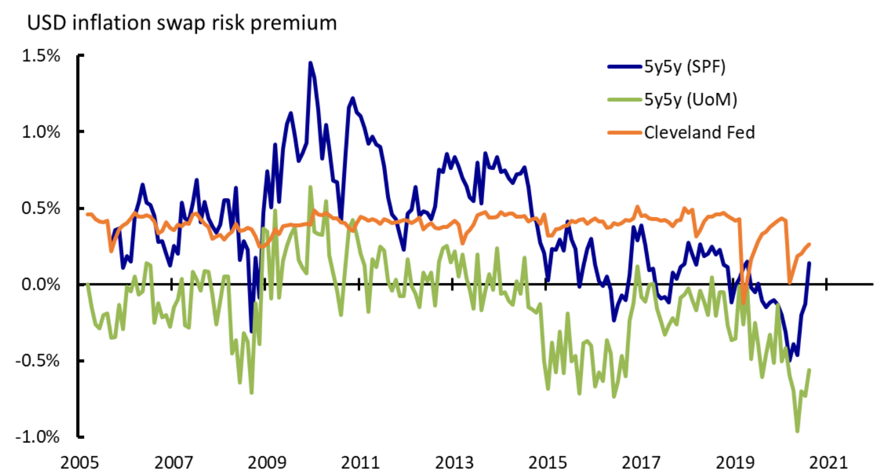
- Inflation expectations are a key performance factor for the months to come, as in 2021. US CPI pricing two years forward does not look too aggressive if we account for inflation risk premium that inflation-linked investors demand given uncertainty about future inflation. This should be rather comforting for the US Fed, albeit with some caution, as survey-based inflation expectations have picked up notably. Uni of Michigan survey hints at 3% in five to ten years, while the NY Fed survey indicates inflation expectations above 4% in three years.

The delta variant spread in Europe accelerated euro depreciation



Source: Bloomberg and AXA IM Research, December 2021

Inflation risk premium compensating for inflation uncertainty



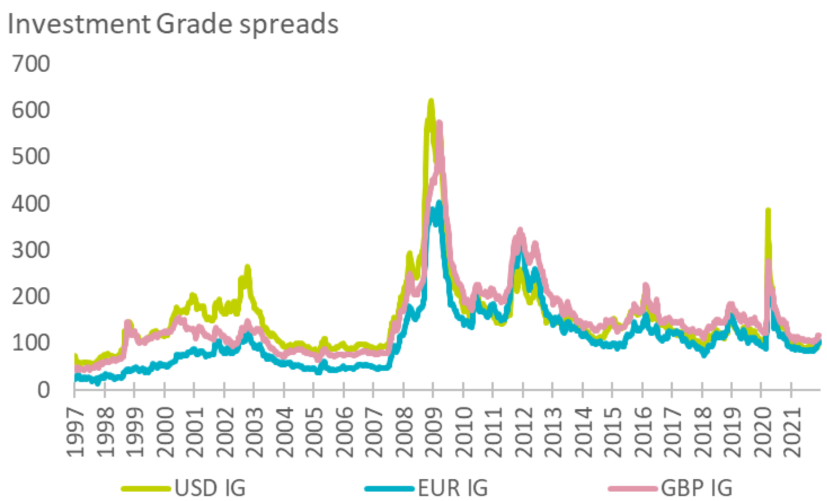
Source: Bloomberg and AXA IM Research, December 2021

Credit & Equity Strategy

Returns weaker in November as govie curves bear flatten; risky assets are shaken but not stirred

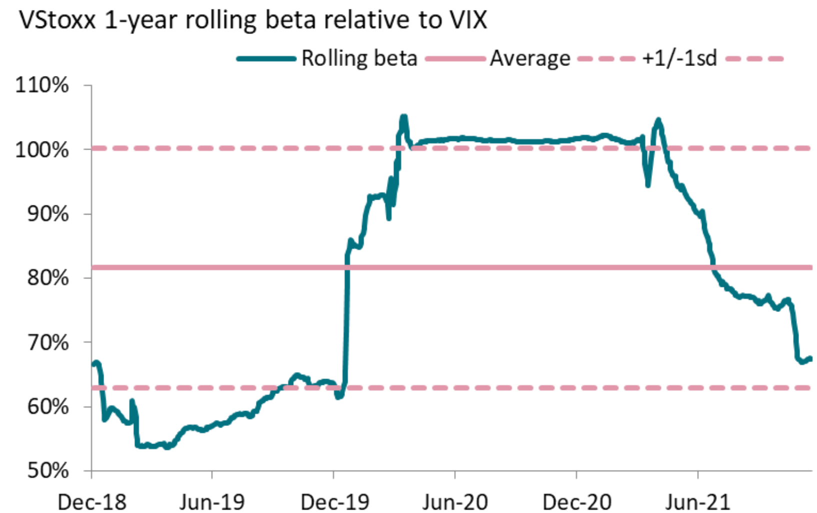
- The credit spread widening in November is consistent with the more aggressive pricing of the US Fed's rate hiking cycle, as credit spreads tend to widen when govie curves bear flatten. Sentiment steadied in December, and spreads retraced. The recent correction hardly registers in the grand scheme of things. Unless Omicron derails the global recovery, we remain constructive for credit in 2022 amid strong credit fundamentals.
- The Omicron variant does not alter our constructive longer-term outlook for stocks either, being a rather short-term catalyst. More aggressive pricing of US monetary policy was also a headwind, as stocks don't tend to perform well when the govie curve bear flattens. Global equities declined by 1.1% over the month; cyclicals outperformance over defensives came to a halt; the value/growth rotation remained stable.
- The current environment of policy divergence between US and Europe as the transitory inflation message appears no longer viable in the US, raises the risk of Fed policy spillover on European risk premia. Yet by our estimates this risk appears rather modest, as the beta of implied volatility between European and US equities is currently near historic lows (1st quartile).

November spread widening hardly registers in the grand scheme of things



Source: ICE and AXA IM Research, December 2021

US monetary policy contagion on European stocks appears limited



Source: CBOE and AXA IM Research, December 2021

Asset allocation stance

Positioning across and within asset classes

Asset Allocation

Key asset classes

	Negative	Neutral	Positive
Equities			Positive
Bonds	Negative		
Commodities	Negative		
Cash			Positive

Equities

Developed

	Negative	Neutral	Positive
Euro area			Positive
UK		Neutral	
Switzerland		Neutral	
US			▲ Positive
Japan		Neutral	

Emerging & Equity Sectors

	Negative	Neutral	Positive
Emerging Markets		Neutral	
Europe Cyclical/Value		Neutral	
Euro Opening basket		▼ Neutral	
Euro Financials			Positive
US Financials		Neutral	
US Russell 2000			▲ Positive

Fixed Income

Govies

	Negative	Neutral	Positive
Euro core	Negative		
Euro peripheral		Neutral	
UK	▼ Negative		
US	Negative		

Inflation Break-even

	Negative	Neutral	Positive
US		Neutral	
Euro		Neutral	

Credit

	Negative	Neutral	Positive
Euro IG		Neutral	
US IG		Neutral	
Euro HY		Neutral	
US HY		Neutral	

EM Debt

	Negative	Neutral	Positive
EM Bonds HC		Neutral	

Legend Negative | Neutral | Positive **Change** ▲ Upgrade | ▼ Downgrade

Source: AXA IM as at 15/12/2021

AXA Investment Managers

Forecasts & Calendar

Macro forecast summary

Forecasts

Real GDP growth (%)	2020	2021*		2022*		2023*	
		AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
World	**-3.2**	**5.7**		**4.2**		**3.6**	
Advanced economies	**-5.0**	**4.9**		**3.8**		**2.4**	
US	**-3.4**	**5.5**	5.5	**3.5**	4.0	**2.7**	-
Euro area	**-6.7**	**5.0**	5.0	**3.9**	4.3	**2.1**	-
Germany	**-4.9**	**2.6**	2.7	**3.5**	4.3	**1.9**	-
France	**-8.0**	**6.7**	6.5	**3.6**	3.8	**2.0**	-
Italy	**-8.9**	**6.2**	6.1	**3.7**	4.2	**1.9**	-
Spain	**-10.8**	**4.3**	5.0	**5.5**	5.9	**3.0**	-
Japan	**-4.9**	**1.9**	2.2	**3.5**	3.0	**1.6**	-
UK	**-10.0**	**6.8**	6.9	**5.0**	4.7	**2.3**	-
Switzerland	**-2.5**	**3.5**	3.4	**3.0**	3.0	**1.6**	-
Canada	**-5.3**	**4.4**	5.0	**3.7**	4.1	**2.6**	-
Emerging economies	**-2.0**	**6.2**		**4.4**		**4.3**	
Asia	**-0.8**	**6.8**		**5.1**		**5.1**	
China	**2.3**	**7.9**	8.0	**5.0**	5.1	**5.3**	-
South Korea	**-0.9**	**4.0**	4.0	**2.6**	3.1	**2.1**	-
Rest of EM Asia	**-4.6**	**5.8**		**5.5**		**5.3**	
LatAm	**-7.1**	**6.2**		**2.6**		**2.5**	
Brazil	**-4.1**	**5.1**	4.9	**1.2**	1.1	**2.0**	-
Mexico	**-8.5**	**6.0**	5.9	**2.6**	2.9	**2.2**	-
EM Europe	**-2.1**	**5.9**		**3.8**		**2.8**	
Russia	**-3.0**	**4.5**	4.2	**3.2**	2.6	**2.0**	-
Poland	**-2.7**	**5.1**	5.1	**5.0**	5.0	**3.6**	-
Turkey	**1.8**	**9.5**	8.9	**3.6**	3.5	**3.0**	-
Other EMs	**-2.4**	**4.2**		**4.1**		**3.9**	

Source: Datastream, IMF and AXA IM Macro Research – As of 16 December 2021

* Forecast

Investment Managers

Expectations on inflation and central banks

Forecasts

Inflation Forecasts

CPI Inflation (%)	2020	2021*		2022*		2023*	
		AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	**0.7**	**3.1**		**3.1**		**2.2**	
US	**1.2**	**4.7**	4.4	**4.1**	3.7	**2.9**	-
Euro area	**0.3**	**2.6**	2.4	**2.7**	2.3	**1.8**	-
Japan	**0.0**	**-0.2**	-0.2	**0.7**	0.7	**0.6**	-
UK	**0.9**	**2.4**	2.4	**3.8**	3.7	**1.9**	-
Switzerland	**-0.7**	**0.5**	0.5	**0.6**	0.7	**0.7**	-
Canada	**0.7**	**3.4**	3.3	**3.1**	2.9	**2.3**	-

Source: Datastream, IMF and AXA IM Macro Research – As of 16 December 2021

* Forecast

Central banks' policy: meeting dates and expected changes

Central bank policy
Meeting dates and expected changes (Rates in bp / QE in bn)

		Current	Q4-21	Q1-22	Q2-22	Q3-22
United States - Fed	Dates	0-0.25	2-3 Nov 14-15 Dec	25-26 Jan 15-16 Mar	3-4 May 14-15 June	26-27 July 20-21 Sep
	Rates		unch (0-0.25)	unch (0-0.25)	unch (0-0.25)	unch (0-0.25)
Euro area - ECB	Dates	-0.50	28 Oct 16 Dec	20 Jan 10 Mar	14 April 9 June	21 July 8 Sep
	Rates		unch (-0.50)	unch (-0.50)	unch (-0.50)	unch (-0.50)
Japan - BoJ	Dates	-0.10	27-28 Oct 16-17 Dec	17-18 Jan 17-18 Mar	27-28 April 16-17 June	20-21 July 21-22 Sep
	Rates		unch (-0.10)	unch (-0.10)	unch (-0.10)	unch (-0.10)
UK - BoE	Dates	0.10	4 Nov 16 Dec	3 Feb 17 Mar	5 May 16 June	4 Aug 15 Sep
	Rates		+0.15 (0.25)	unch (0.25)	+0.25 (0.50)	unch (0.50)

Source: AXA IM Macro Research - As of 16 December 2021

Calendar of 2021-2022 events

2021	Date	Event	Comments
December	31 Dec	LIBOR fixings discontinued	
2022	**Date**	**Event**	**Comments**
	Q3-Q4 2022	Chilean Constitutional Referendum	
January	Jan	Italian Presidential Elections	
	Jan	FOMC to commence taper (expected)	
	Jan	Build Back Better Act passed (expected)	
	1 Jan	EU introduces Rules of Origin requirements	
	20 Jan	ECB Meeting	Unchanged (-0.5)
	25-26 Jan	FOMC Meeting	Unchanged (0-0.25)
	Feb	BoE Meeting	Unchanged (0.1)
	6 Feb	Costa Rican General Elections	
March	March	FOMC Meeting	Unchanged (0-0.25)
	March	China Annual National People's Congress	
	9 March	South Korea Presidential Elections	
	13 March	Colombian Legislative Elections	
	31 March	UK Business rates relief ends	
	31 March	UK Reduced VAT for hospitality and tourism ends	
April	6 April	UK National Insurance contributions increase 1.25ppt	
	6 April	UK Dividend Tax increase by 1.25ppt	
	6 April	UK Super-deductibility for UK investment begins	
	10 & 24 April	French Presidential Elections	
May	May	Philippines Elections	
	5 May	UK Elections in Scotland, Wales, and Northern Ireland and UK Local Elections in England	
	29 May	Colombian Presidential Elections	
June	12 & 19 Jun	French Legislative Elections	
July	1 July	UK border checks on EU imports scheduled to resume	
August	Aug	US Federal Reserve Jackson Hole Symposium	
October	Oct	China's 20^{th} National Congress- President Xi to be re-elected (expected)	
	2 Oct	Brazil General Elections	
November	8 Nov	US Midterm Elections	

Latest publications

2022-2023 Macroeconomic Outlook: Pandemic effects to recede, policy starts to tighten

1 December 2021

Tapering, profit and equity prices

15 November 2021

China: Riding the green wave

3 November 2021

Investment management and blockchain: The great reshuffle

22 October 2021

October Global Macro Monthly – Transition costs to net zero: significant but necessary

20 October 2021

The cost of climate change: Action versus inaction

30 September 2021

German elections: The post-Merkel era

23 September 2021

September Global Macro Monthly –Supply constraints add to inflation angst

22 September 2021

Asia: “Made in Vietnam”- Understanding the rise of Vietnam as an export powerhouse

14 September 2021

Fit for 55: A carbon pricing upheaval

27 July 2021

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