AXA Investment Managers

The Great Rate Debate

Monthly Investment Strategy

AXA IM Research

March 2021

The Great Rate Debate

Theme of the month: The Great Rate Debate

- Consensus is growing around a robust pick-up in US activity, but markets face greater uncertainty in anticipating the inflationary impact of this growth and how the Federal Reserve will respond to it. The balance of these expectations is impacting movements in real and breakeven inflation yields.
- Increases in US Treasury yields are spilling over into other international bond markets. Other central banks are adjusting policy to take account of local conditions. The ECB announced a "significant" increase in PEPP purchases over the coming weeks, to contain yield increases across the Euro area.
- The rise in real yields has been the most material change for other asset classes. So long as this is smooth, risk assets should remain well supported. Indeed, large rises in real rates are thought of as detrimental to risk premia because of 2008 which was a major outlier for financial markets, however.
- On the other hand, real rates are a key driver for currencies, particularly the US dollar vs low yielders including the Japanese Yen, Swiss Franc and Euro.

Macro update: Economic outlook remains aligned to virus developments

- In the US, the recent stimulus debate has super-charged the growth outlook, but the rebound remains possible only as the virus fades and vaccines increasingly remove the prospect of its re-emergence. The Fed continues to be mindful of downside risk even as it revises its growth outlook higher.
- Recent disruption to the Chinese New Year appears to be passing but leaving an uneven impact on the Chinese economy. Nevertheless, positive domestic developments, including a slower fiscal tightening and spillovers from the US leave risks to our outlook skewed to the upside.
- A fading virus and swift vaccine rollout should allow the UK to remove Covid restrictions over Q2, which would underpin a material rebound in activity.
- In the Euro Area, a rising virus and slower vaccine rollout leaves a softer growth profile. The ECB has undertaken to "significantly" increase PEPP purchases to insulate the region from an inappropriate spillover of tighter financial conditions, yet in so doing it has added constraints to its own policy-making.
- Emerging markets are varied. Asia is outperforming in virus management, except India. Vaccine rollout is generally slower, but Chile is another exception. Areas where inflation expectations are not so well anchored are seeing earlier adjustments in monetary policy, including Turkey, Brazil and Russia.

Investment strategy: risk assets resilient to rates repricing so far, as investors ponder rising inflation and central banks

- FX: Markets are dominated by the prospect of economies reopening while massive monetary and fiscal stimulus persists. In this dynamic, currencies with higher beta to global growth and where the domestic rebound looks stronger, should continue to outperform – GBP, CAD, NOK stand out.
- Rates: The US inflation path is the most frequently debated macro question worldwide. For now, it seems that a strong commodity-related base effect might lift consumer prices at the end of spring. Investors and policy makers expect the effect to prove transitory; thus monetary policy can look through it.
- Credit: Sensitivity to interest rate volatility has dropped dramatically since the US Federal Reserve intervened in credit markets in March 2020. Realised and expected default rates continue to ease. We expect Moody's default rate to drop to 3.8% & 2.6% respectively over 1 year, close to historical average.
- Equity: The rotation trade has slowed down in line with real rate stabilization recently. As we move forward through the year, however, real rates should resume their uptrend along with growth and inflation, encouraging for further rotation toward Value assets.

Central scenario

Summary – Key messages

Monetary policy

Monetary policy to remain key policy support. Developed economies to see asset purchases through 2021. ECB to increase "significantly", Fed to taper in 2022.

Inflation

Energy and food to lift annual rates in 2021. Sustainable inflation in 2022 depends on spare capacity and unlikely outside US and some EMs.

Fiscal policy

Fiscal support extended in most areas. Europe rolls out support slowly, Biden passes $1.9trn boost, UK extends support.

Growth

Consensus for faster growth: virus fades, vaccines grow and fiscal stimulus. Regional differences depend on each.

Our central scenario:
2021 rebound as virus controlled, recovery needs policy support

We forecast global growth to rise by 5.5% in 2021 and 4.1% 2022.

Economic rebound on vaccine and stimulus, must overcome labour market and indebtedness headwinds. Monetary and fiscal policy to support.

Emerging Markets

EM's see virus fade, but less vaccine access for now. Export economies to benefit. Less policy space for most.

Rates

Rates move higher on growth and inflation outlook. Real/breakeven balance weighs CB response. CBs to oppose excessive real rates move.

FX

Fiscal boost and rising real rates support USD. Strong vaccine rollout supports high beta currencies, incl GBP, CAD and NOK.

Credit

Tight spread levels belie yet higher corporate debt levels, implicitly locking-in central banks as an ultimate backstop.

Equities

Rotation of value and growth underway. Corporate earnings expected to rebound 2021. Equity risk premium suggests value.

Alternative scenarios

Summary – Key messages

Persistent recession *(probability 15%)*

What could be different?

- Coronavirus mutations reduce vaccine effectiveness
- Labour market dislocation and business disruption create ongoing headwinds to demand recovery
- Fiscal policy fades amidst elevated debt and political opposition
- Geo-political tensions mount in post-Covid world

What it means

- Growth/inflation expectations weaken further, further GDP disruption, corporates' earnings under more pressure
- Further monetary policy where space permits (including China). Government's continue with fiscal stimulus and divide between monetary financing blurs further.

Market implications

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

Fast recovery *(probability 25%)*

What could be different?

- Vaccine rolls out more quickly than expected, spurring pent-up demand burst
- Labour market recovers, economies benefit from post-virus euphoria
- Virus-shock reshapes business practice, boosting productivity

What it means

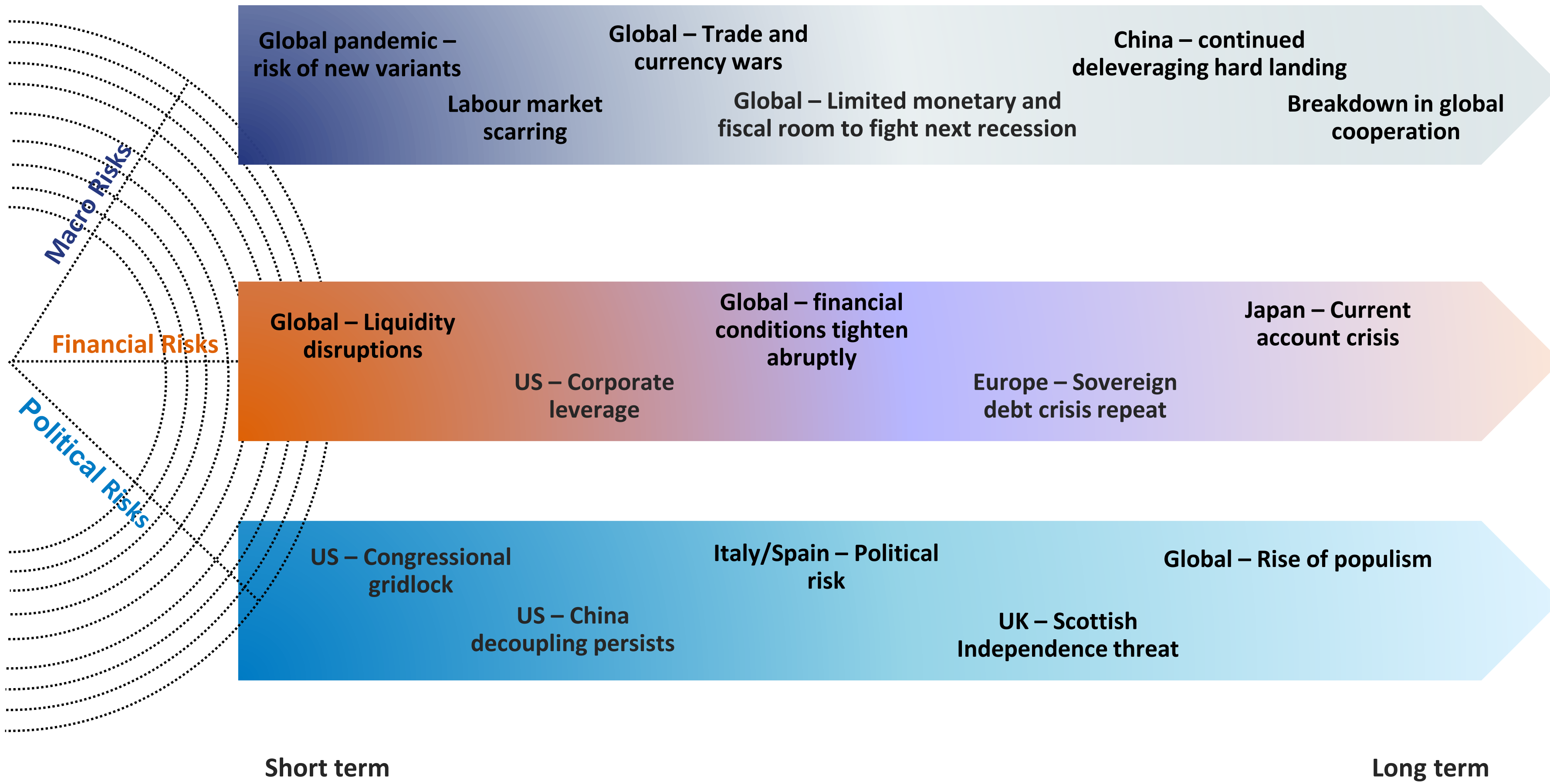
- Global/US/EMU growth surprise on the upside in a stronger and more persistent rebound from 2020
- Monetary policy fights expectations for swift tightening through forward-guidance

Market implications

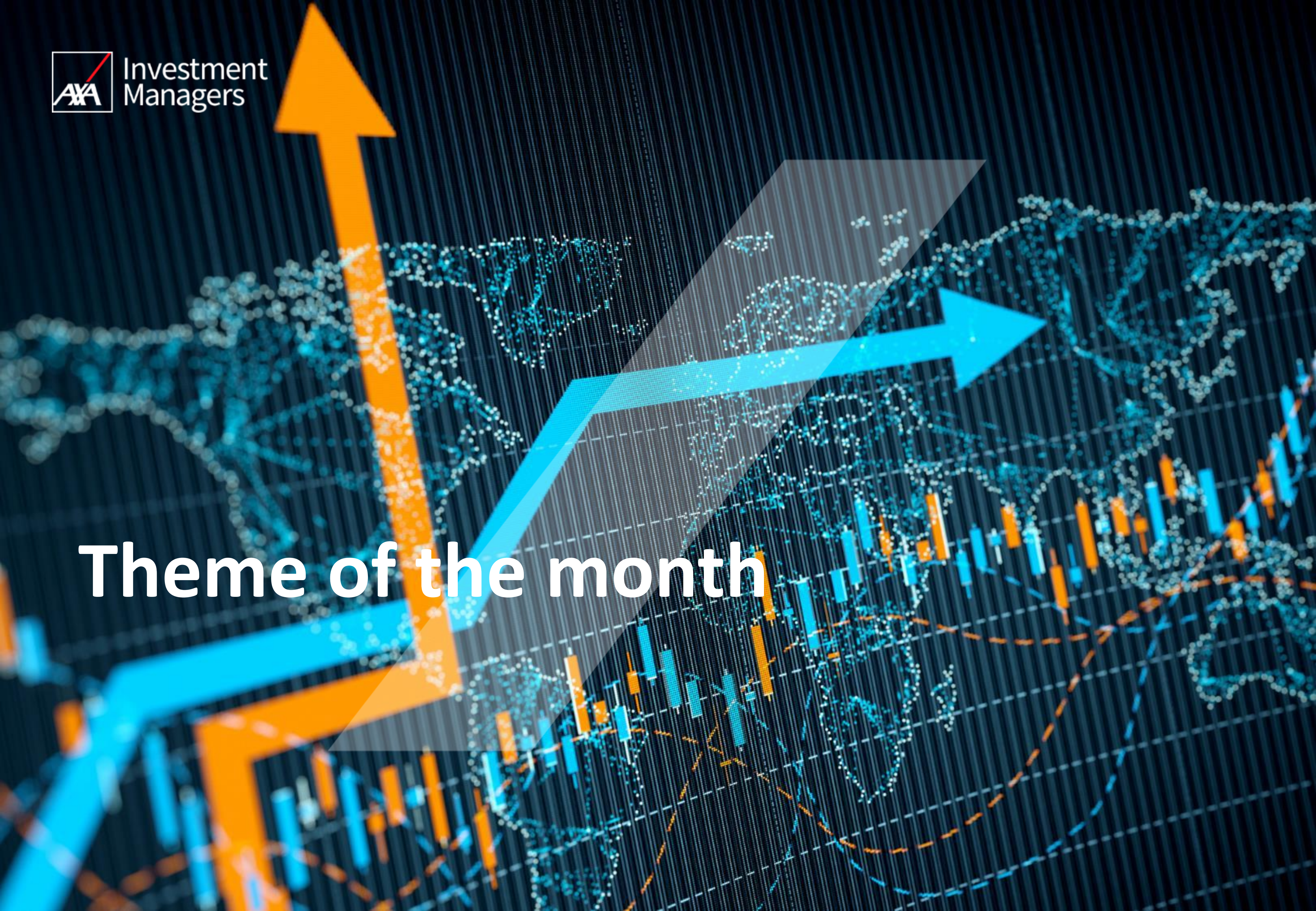
- Risk-on environment with equities making further gains amidst broader rotation
- UST and EUR break-evens rise
- Spreads grind tighter

RISk Radar

Summary – Key messages



Contents



Theme of the month

Theme of the month: The Great Rate Debate

Stimulus to deliver speedy US recovery

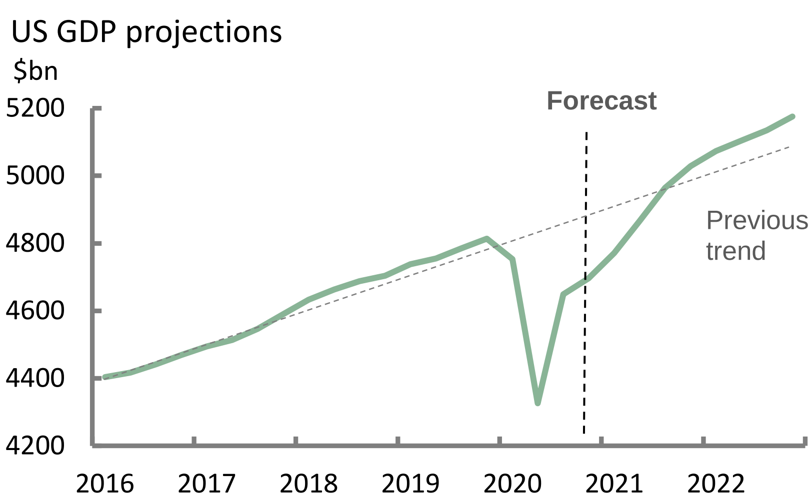
Stimulus continues to lift growth forecasts

- President Biden enacted the American Recovery Plan, a $1.9trn package of largely short-term support measures to boost output and activity. While a large-scale stimulus has now been expected for some time, we continue to be surprised by the prospective impact on activity. Following January's now 7.6% rise in retail sales, we have raised our forecast for GDP growth this year to 6.5% and still if anything see risks skewed to the upside (consensus ranges 2.2 to 7.5%, median 5.6%).

Excess demand

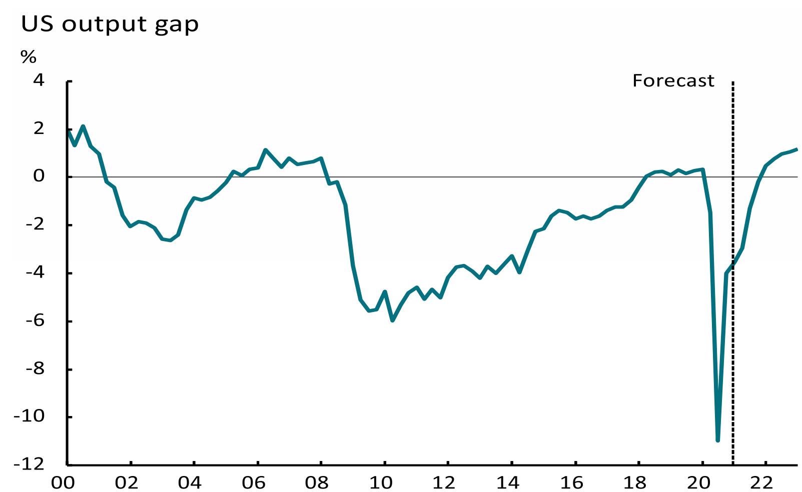
- This scale of growth should return the level of activity to its pre-Covid trend – signifying a full recovery from the downturn – later this year. With growth expected to outstrip potential supply over the coming years, we envisage the US eliminating spare capacity by the end of this year. In 2022, we expect the US to be operating in conditions of excess demand.

Stimulus to deliver speedy recovery to US economy



Source: BEA, AXA IM Research, March 2021

US estimated to operate in excess demand in 2022



Source: CBO, BEA, AXA IM Research, March 2021

Theme of the month: The Great Rate Debate

Markets face two key questions

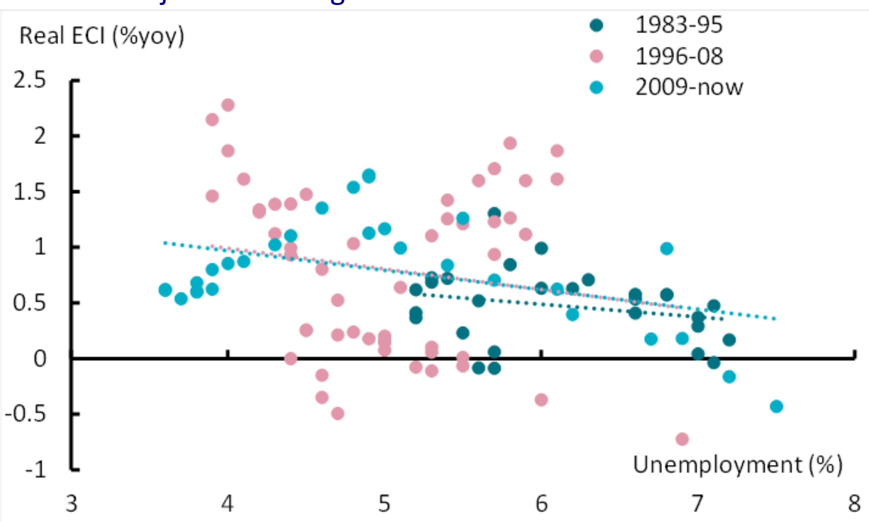
How much inflation will this pace of growth generate?

- After a decade of subdued inflation this is not an easy question. We do not believe that the Phillips Curve has flattened to neutralize the impact of increased resource utilization, nor that issues of demographics, technology utilization nor globalization will reduce inflation to the same extent as in the last ten years. Yet nor do we expect 'rampant' inflation over the coming couple of years. The assessment of the medium-term direction of inflation will be complicated by price level changes and base effects this year adding volatility to headline inflation.

How will the Fed react to it?

- The Fed has changed its reaction function. It has adopted an *average* inflation target, to include a moderate inflation overshoot. It is also prioritizing labour market targets, aspects of which it only controls by degrees of overheating. At face value, the Fed should react much later to signs of emergent inflation, which should add to the chances of an inflation overshoot. Yet markets question whether the Fed will be able to remain on hold for this long if price pressure increases sharply.

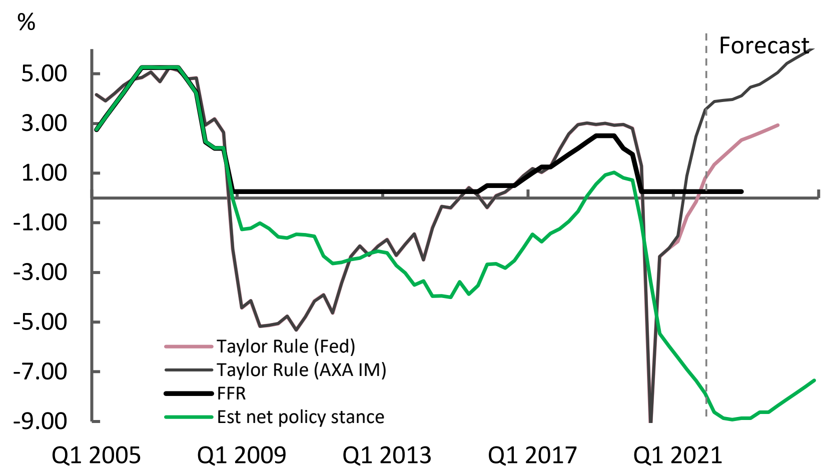
Inflation-adjusted earnings and labour market slack – a stable Phillips Curve



Source: BLS, AXA IM Research, March 2021

Divergence in the Fed's reaction functions

Taylor Rule, Fed Funds Rate and balance sheet



Source: FRBNY, AXA IM Research, March 2021

Theme of the month: The Great Rate Debate

Twin uncertainties drive yields higher

Inflation expectations have underpinned much of the move

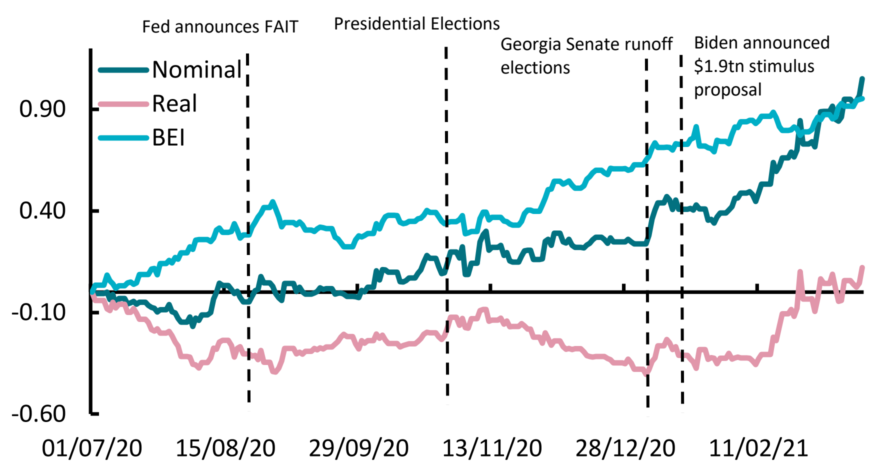
– 10-yr UST yields have been rising since last summer's lows. From August this reflected a steady rise in breakeven inflation expectations, driven by recovery hopes, but also by the Fed's shift to an *average* inflation target. This continued into the new year, with inflation expectations rising after the Georgia run-off elections which saw the Democrats seize control of the Senate. However, from mid-February breakeven inflation rates have been more stable and real rates have risen sharply.

Real rates movement reflects doubts over policy stability

– Since mid-February real rates have risen sharply. This has reflected a rise in term premia, in turn underpinned by an increasing expectation of tighter monetary policy over the coming few years, including an expectation of a number of rate hikes taking place in two years' time.

10yr UST yields driven by breakeven, but more recently by real rates

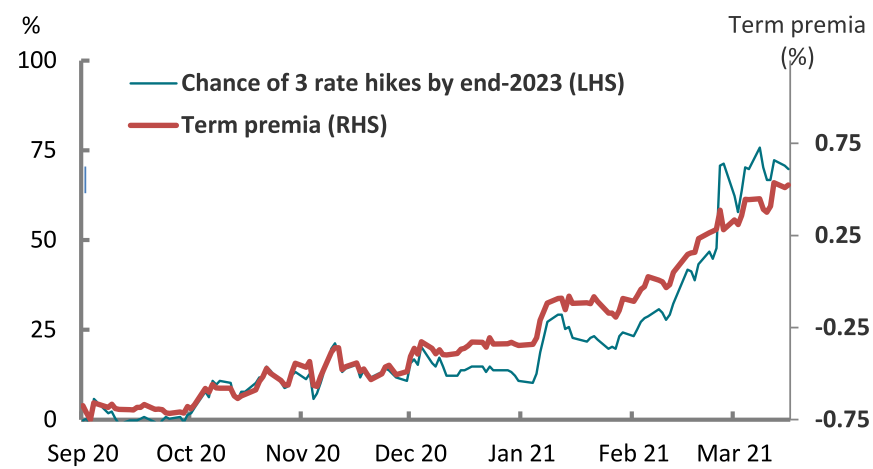
A decomposition of US Treasury yield movements



Source: Bloomberg, AXA IM Research, March 2021

Real rates linked to rising expectations of US rate hikes

Term rates reflect rising perception of rate hikes



Source: Bloomberg, FRBNY, AXA IM Research, March 2021

Investment Managers

Theme of the month: The Great Rate Debate

ECB insulates Euro area from financial conditions spillover

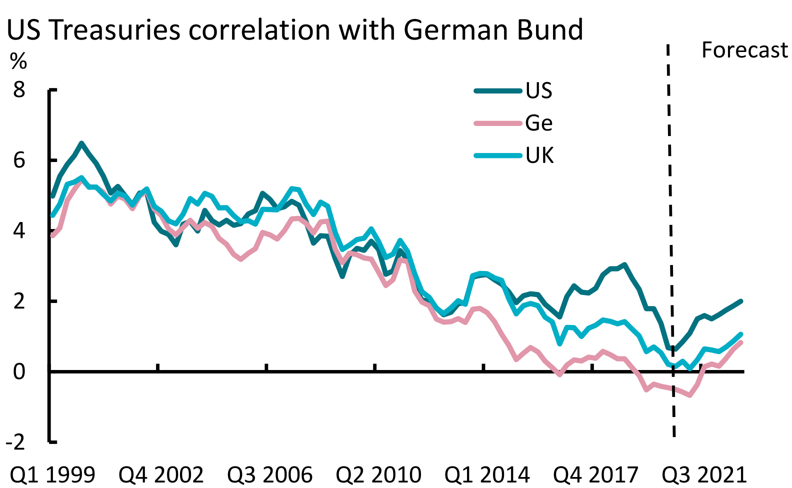
Sovereign bond performances intimately linked

- Historically there has been a large degree of co-movement between sovereign bond yields. The rise in US Treasury yields has put upward pressure on yields around the world, but particularly in other large developed economies, including the Eurozone and UK. However, significantly tighter financial conditions are not necessarily appropriate in economies that are expecting much less fiscal stimulus and a far slower growth rebound.

ECB intervenes

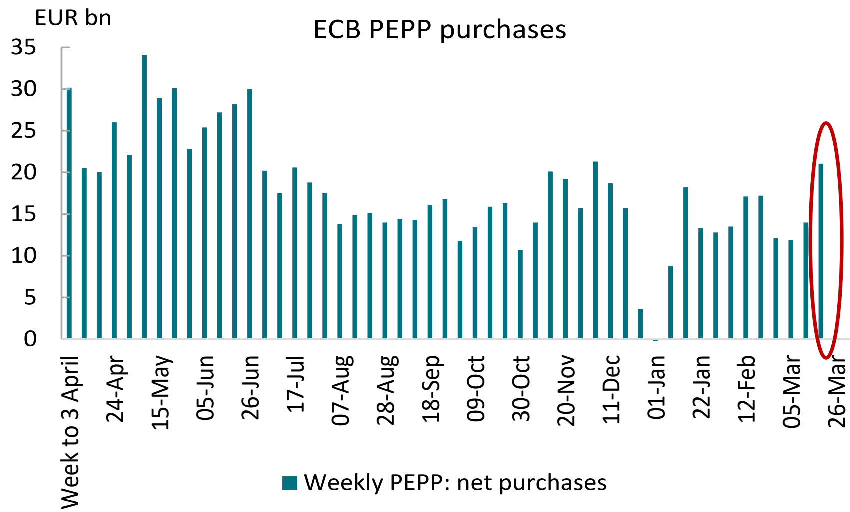
- Fearing the impact that a tightening in financial conditions could have on the outlook for Eurozone inflation – already expected to be far below target (1.4%) in 2023 – the ECB announced that it would undertake “significantly” more asset purchases over the coming quarter. This acceleration in the pace of QE – something that the ECB has characterized as a loosening of monetary policy – has so far kept Eurozone yields more suppressed than in the US, with Treasury-Bund spreads exceeding 200bps.

Sovereign bond yield movements often aligned – simple model



Source: Refinitiv, AXA IM Research, March 2021

ECB ups pace of QE purchases to differentiate reaction from USTs



Source: ECB, AXA IM Research, March 2021

Theme of the month: The Great Rate Debate

The real deal

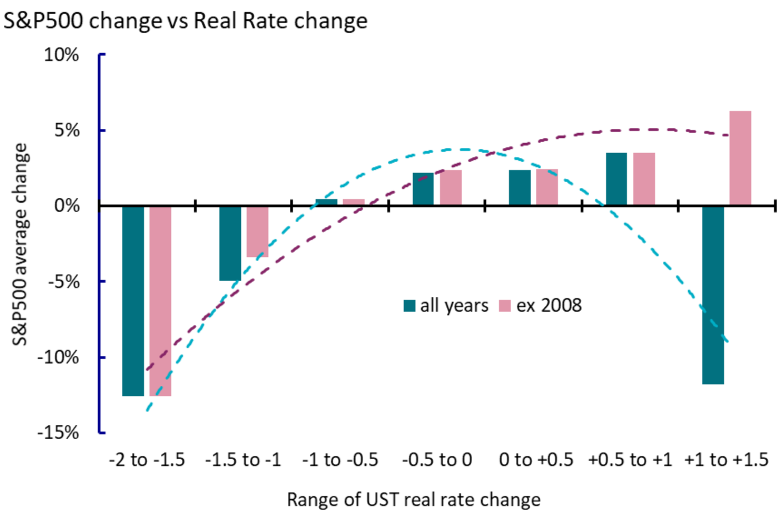
Rising real rates not necessarily detrimental to risky assets …

- A large rise in real rates tends to be viewed as detrimental to risk premia, but this is mainly due to 2008 which was a major outlier for financial markets. The US 10-year inflation breakeven collapsed by 2.6% in the second half of 2008, which led to a 1.8%. jump in real rates when at the same time there was an almighty risk-off in financial markets. Excluding 2008, US stocks show positive returns and US high yield performance is about flat, when real rates increase in by over 1%.

… but a key driver for low yielding currencies

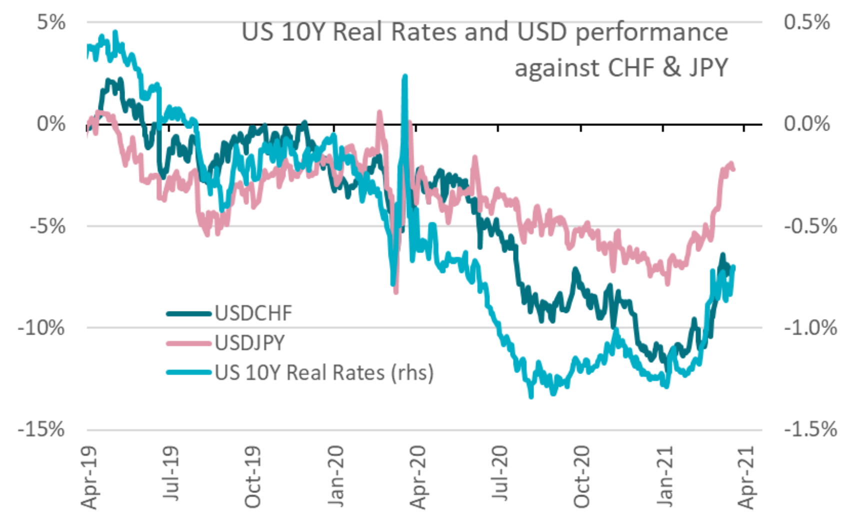
- The impact of real rates on currencies is also apparent, particularly on lower yielding currencies including the Japanese Yen, Swiss Franc and the Euro. The Swiss Franc and the Japanese Yen have already experienced a sell-off vs the dollar. The Euro is also under pressure. We expect any further rise in real rates over the coming months to exacerbate downward pressure on these currencies, although expect this effect to fade as real rates retreat over H2 2021.

Large rises in real rates appears detrimental to risk premia due to 2008



Source: Bloomberg, AXA IM Research, March 2021.

US real rates weigh on low yielding currencies



Source: Bloomberg, AXA IM Research, March 2021.

Macro outlook

Consensus on growth, not on inflation

US

Easing restrictions and stimulus fuel recovery

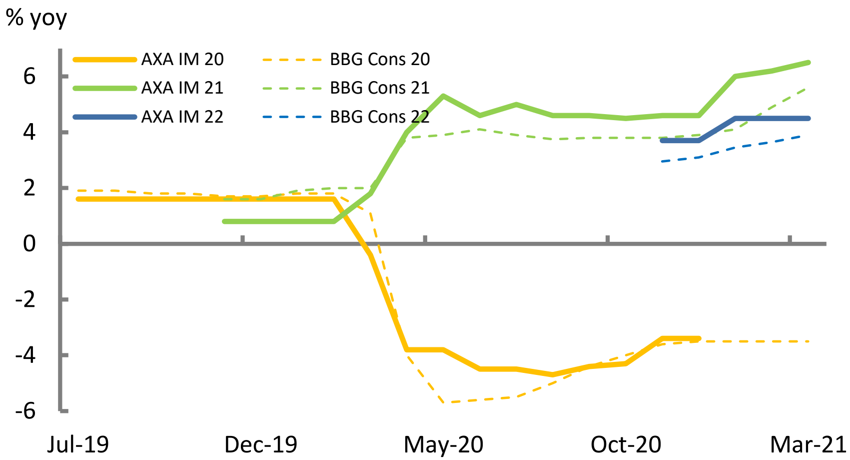
- The decline in new Covid-19 cases since the start of the year, the fast rollout of vaccines and a combined near 13% of GDP in recent fiscal packages looks set to deliver a quicker recovery in US activity than first thought. With retail sales rising 7.6% in January (albeit retreating 3% in February), we edge our GDP outlook for 2021 higher again to 6.5%, expecting 4.5% still in 2022. This remains above consensus forecasts of 5.6% and 4.0% respectively, although these estimates are also rising.

Inflation debate rages

- The inflation debate looks set to rage across the course of this year. In the short-term base effects, a swift rebound in demand and supply bottlenecks are likely to drive the headline rate higher to a peak around mid-year, but this should soften over H2 back to just under 2%. Next year, the expected shift in activity into 'excess demand' should see a more sustainable rise in inflation back to target. Thereafter, we expect a modest overshoot for now.

Continued rising outlook for US GDP

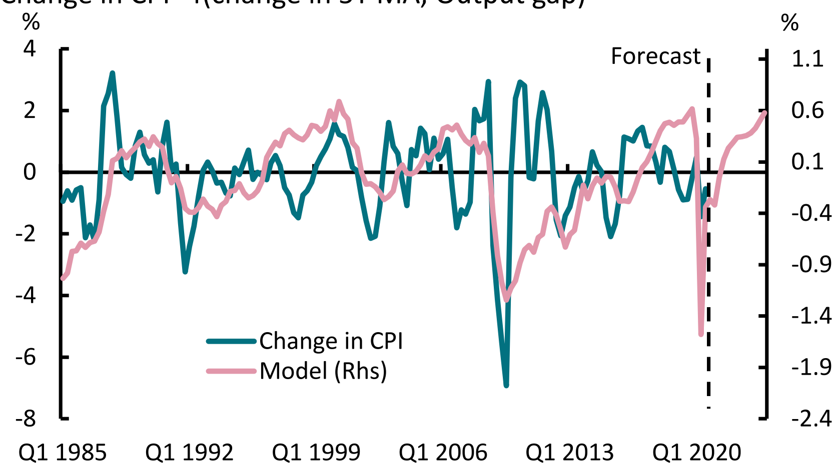
Evolution of GDP forecasts



Source: Bloomberg, and AXA IM Research, March 2021

Recovery should underpin sustainable rebound in inflation

Change in CPI =f(change in 5Y MA, Output gap)



Source: BEA, and AXA IM Research, March 2021

Doubting forward guidance

US

Fed message clear – don't focus on timing of rate hikes

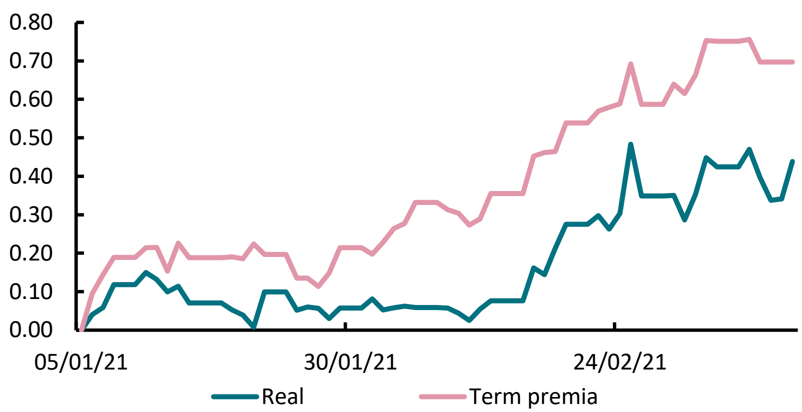
- The latest FOMC meeting saw the median forecast for interest rates remain at 0-0.25% through 2023. This was based on an upward revised, but still lower than our own forecast outlook for GDP growth. And accordingly, only a marginal rise in inflation, with an incomplete forecast for the labour market. Faster-than-Fed-forecast growth, as we expect, could move the Fed along sooner, which is what we expect, penciling in two rate hikes (Jun, Dec) in 2023. Fed Chair Powell urged not to focus on the timing of rate hikes two to three years out in such an uncertain environment.

Volatility ahead

- With short-term inflation expected to rise over the coming months, markets are likely to increasingly equate a rise in headline inflation, with an increased probability of higher medium-term inflation and earlier Fed tightening. While there is a debate to be had over each leg, we think this dynamic will drive real rates and 10-year yields higher over the coming months.

Rate policy uncertainty underpins real rate increase

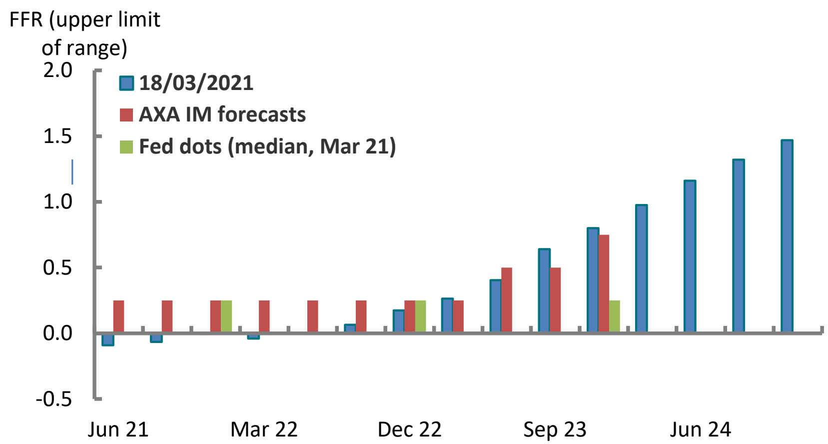
A decomposition of yield movements since Georgia



Source: CBO, BEA, AXA IM Research, March 2021

Divergence of policy rate outlooks

Market expectations of Fed policy



Source: FRBNY, BEA, AXA IM Research, March 2021

Not much luck on the Covid front …

Euro area

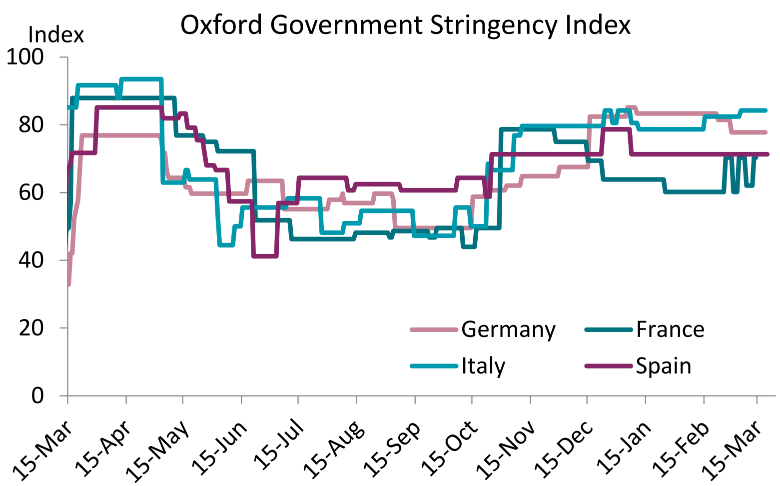
Deterioration means longer and tighter restrictions again

- The UK variant has become dominant in most countries and mounting hospital pressures have pushed governments to tighten restrictions in France and Italy, while Germany is reversing its tentative reopening. Easing of containment measures before at best mid-April remains unlikely. Even though economies continue to cope better with lockdown (IP Q1 carry-over is solid at 1.5% qoq) growth will be negative again in Q1 (-0.5% qoq), with a proper growth acceleration now likely only in Q3.

Vaccination hiccups, but should hit targets

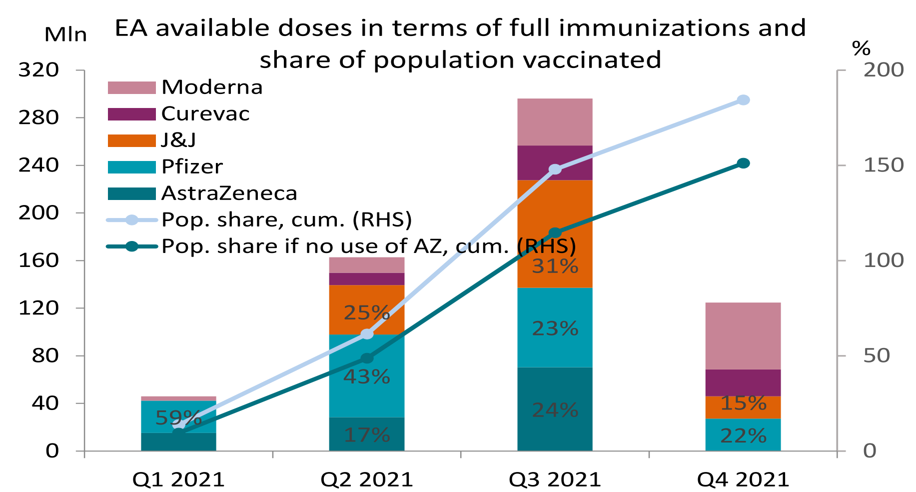
- 35% of the acceleration of immunizations in March was due to AZ in Germany, so reduced confidence in this vaccine may curb progress in the coming weeks. Yet, we believe targets remain within reach (70% of population by end of Q3). On the supply front, even assuming no further use of AZ, other supply should be large enough to vaccinate 49% of the whole population in Q2, and 115% cumulatively by the end of Q3. On the distribution front, countries need to double their current rate: not too ambitious.

Longer restrictions to weigh on Q1 and Q2 activity



Source: OWID, AXA IM Research, as of 22 March 2021.

Targets still within reach, despite AstraZeneca noises in the near term



Source: European Commission, Ministero della Salute, AXA IM Research, as of 16 March 2021. Note: AstraZeneca accounts for 17% of the full immunizations doses available in Q2 21, Pfizer 43%.

… And not much luck for the ECB, forced to act once again

Euro area

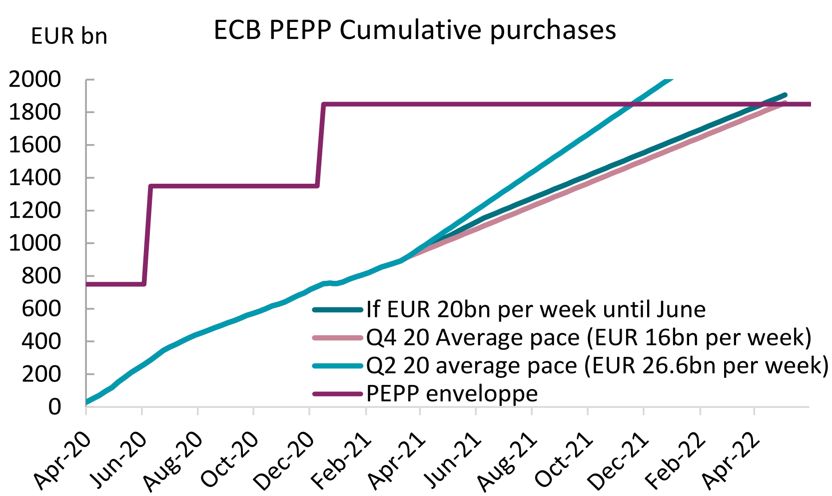
ECB adding constraints onto itself…

- The ECB pledged to accelerate its purchases in the quarter ahead, thus fighting contagion from the US. But, the ECB created additional constraints for itself. The ECB now considers that changing the pace of buying within the agreed envelope is part of the policy stance, which would entail a Governing Council meeting and preferably a new set of forecasts – only available once a quarter, next in June. This makes the ECB more reactive than pre-emptive and may result in future volatility episodes.

… while fiscal support remains underwhelming

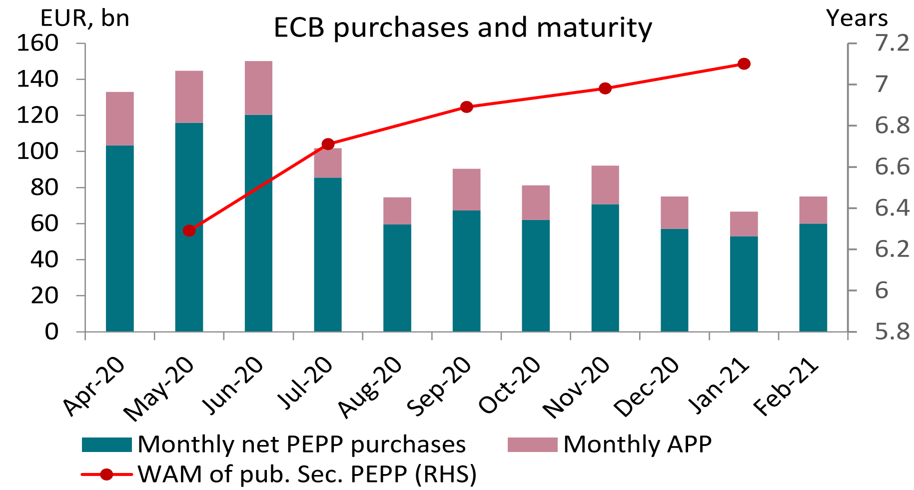
- Although the EC suggested that fiscal rules will remain suspended in 2022, fiscal support remains too shy. True, the Italian government has finally approved a €32bn support package, but it has been in discussion since January, while the Spanish €11bn solvency support programme, at just c. 1% of GDP is unlikely to make a big difference for firms. Also, beware of big numbers from Germany: the supplementary federal budget for 2020 allowed €218bn (6.6% of GDP) of new debt, but the outturn was just €87bn.

The ECB has enough dry power for a while…



Source: ECB, AXA IM Research, March 2021

… And could continue to push the average maturity of its PEPP purchases to protect the longer end of the curve from US contagion



Source: ECB, AXA IM Research, March 2021

GDP boost as restrictions lift

UK

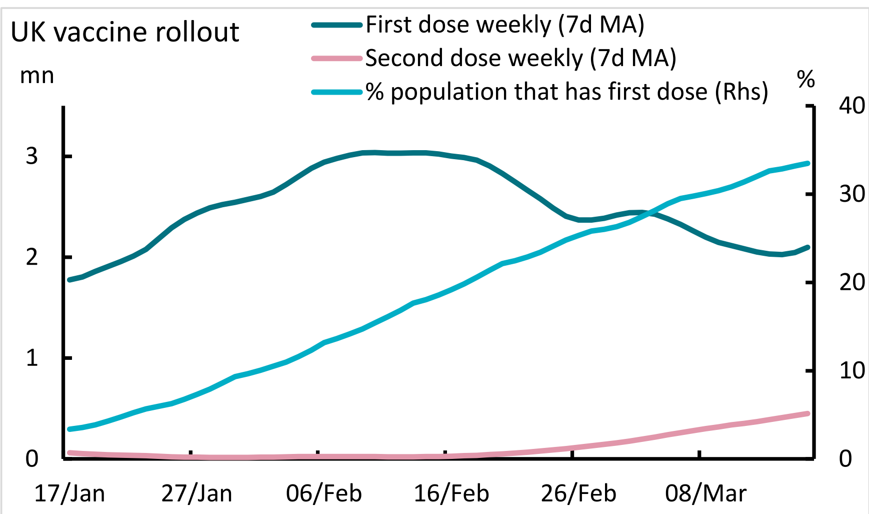
Re-opening underway and on track (for now)

- After two months of lockdown the UK started a gradual pace of easing back restrictions by returning all pupils to schools this month. Virus new cases have fallen sharply since January. The weekly contraction rate has faded recently, however, significant increases in testing may account for this with positivity rates still falling. Vaccine rollout has slowed from the peak rate in mid-February and supply-constraints may increasingly weigh, but for now targets for vaccination and re-opening remain on track.

Service sector to see most of activity swings

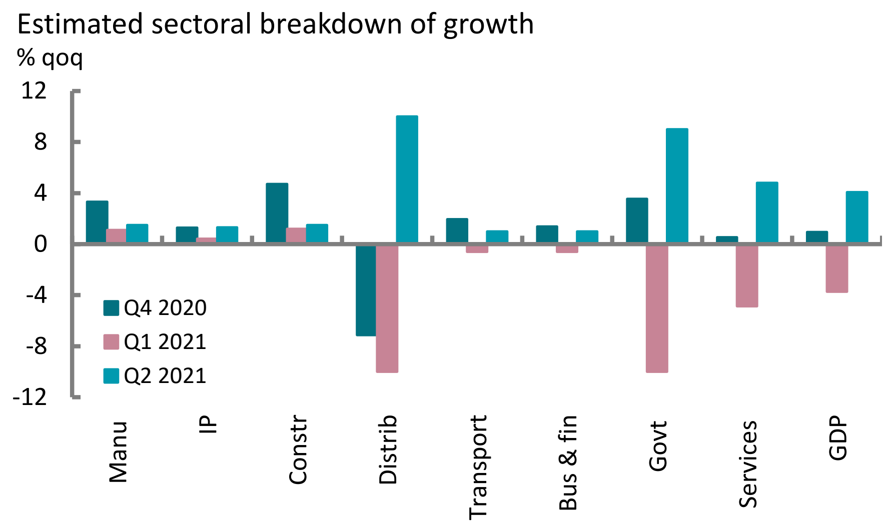
- GDP contracted by 2.9% in January – less of a contraction than we had feared. The expected easing of restrictions over the coming weeks should be most seen through distribution and government components of services output. We have edged our 2021 forecast to 5.0% and continue to see 2022 up 7.5%, ahead of consensus forecasts for 4.7% and 5.7%.

UK vaccine roll out softens, but still on track



Source: PHE, AXA IM Research, March 2021

Service sector to experience biggest swings in activity



Source: National Statistics, AXA IM Research, March 21

Fiscal and monetary policy outlooks

UK

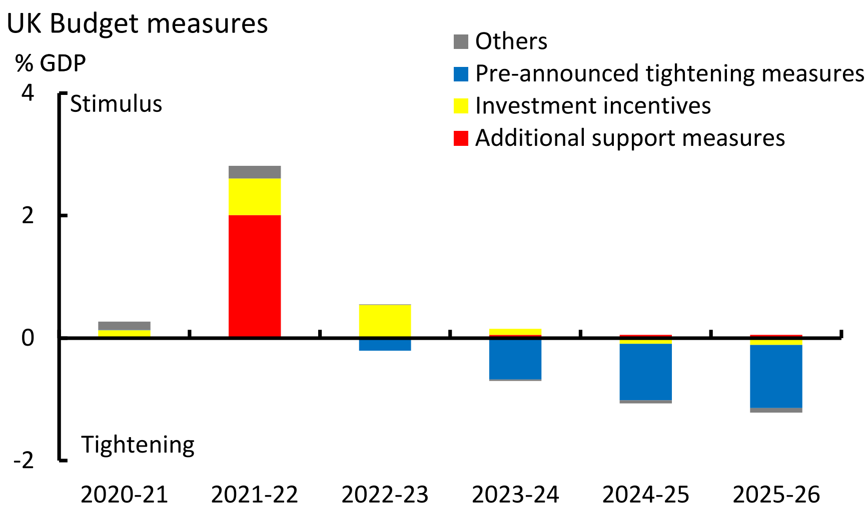
Chancellor underpins economic recovery

- The March Budget saw Chancellor Sunak extend emergency measures including the furlough scheme and VAT holiday as the UK economy remained in lockdown. Additional measures totaled just under 2% of GDP. The Chancellor also announced an investment incentives scheme adding to easing this year and next. Most importantly, he deferred a material tightening in the fiscal stance until 2023-24. Fiscal policy is supporting economic recovery and creating the best chance to reduce debt:GDP over the medium-term.

BoE policy stance unchanged

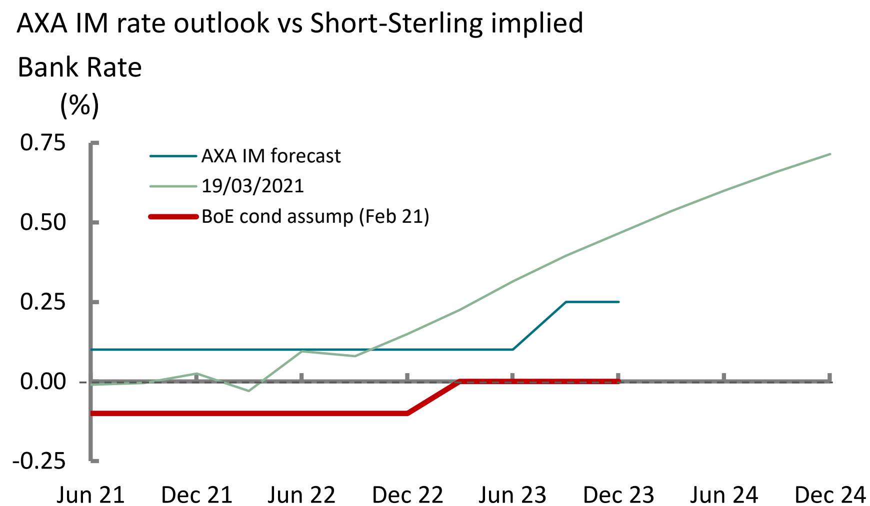
- The BoE left policy unchanged in March, buoyed by better short-term growth news on the international and domestic front, although it was “less clear” of the impact on the medium-term. The BoE is adopting a wait-and-see policy in the face of significant uncertainty. However, its QE envelope is depleting, while markets push key sterling rates higher. BoE status quo looks likely to remain, but a fine-tune final expansion of the QE envelope to avert premature asset tapering remains a risk.

Chancellor extends emergency stimulus measures



Source: OBR, HMT, AXA IM Research, March 2021

Outlooks for Bank Rate



Source: BoE, Bloomberg, AXA IM Research, March 2021

Renewed virus causes uneven impacts

China

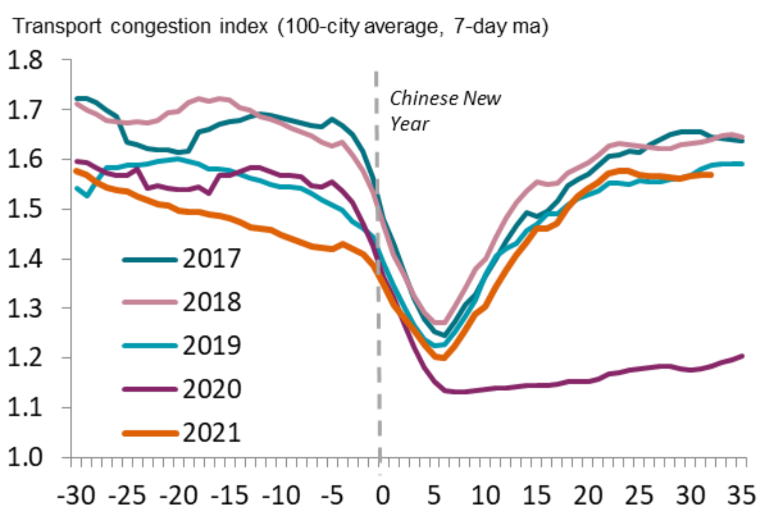
Domestic demand slows but supply-side recovery continues

- Renewed virus outbreak and the associated tightening of social restrictions exerted uneven impacts on the economy. Retail sales and investment growth – after taking into account the base effects – slowed relative to end-2020. However, strong export orders and less holiday disruption – because of this year's "staying put" policy – boosted industrial and manufacturing production. The supply-side recovery therefore continued apace, while the normalisation in domestic demand paused.

Economic outlook brightens after a small hiccup

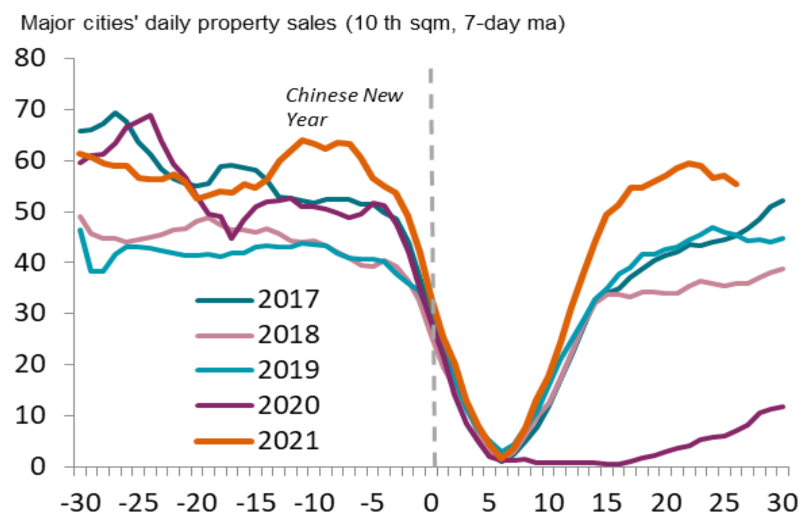
- Despite the temporary setback, the outlook for the Chinese economy has brightened. The clearance of virus cases has allowed mobility levels to normalise, while accelerated vaccinations will help China to build herd immunity against future COVID outbreaks. A stronger recovery in the US economy, following a bigger fiscal stimulus, will bode well for Chinese exporters serving that market. Finally, a slower exit of China's own fiscal stimulus will add growth impulse to an economy that is already on a fast track to normalization. We see the risks to our 2021 growth forecast as squarely on the upside

Traffic returns to normal levels



Source: CEIC, AXA IM Research, March 21

Urban activity boosted by "staying put" policy



Source: CEIC, AXA IM Research, March 21

Policy priority shifts to shore up quality of growth

China

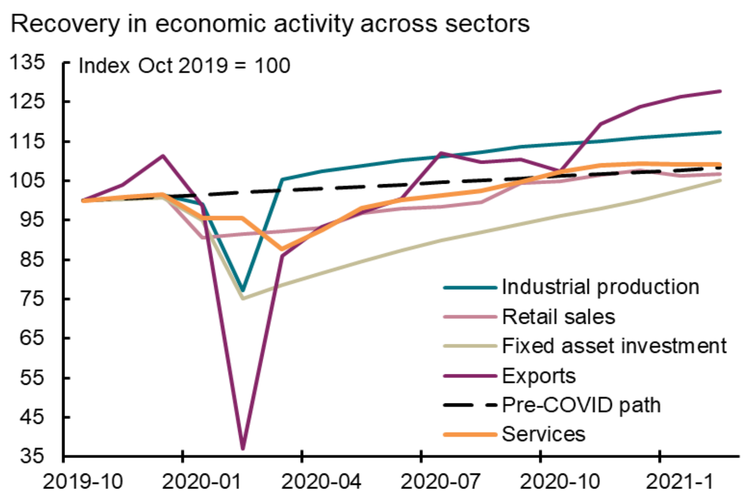
Stable policy to nurture growth rebalancing

- The priority of Beijing economic policy has shifted from pursuing speed of growth to quality of growth as the economy normalizes and the pandemic retreats. The former is reflected in setting a low-bar for 2021 growth (>6%) at this year's National People's Congress and scrapping the growth target for the 14th Five Year Plan. The aim to raise quality of growth is manifested in the emphasis on job creation (creating 11m jobs and keeping the unemployment rate at <5.5%) and continuing the supports for SMEs and low-income earners (by extending tax exemptions and increasing social security payments) to rebalance growth engines

Long-term focus on fostering smarter, greener and more inclusive growth

- The pursuit of higher quality and more sustainable growth is also reflected in Beijing's medium-term economic strategies in the 14th FYP. The focus on technology and innovation has led the government to set high bars for raising R&D spending and development on basic research. Ambitious targets, consistent with the carbon neutrality goal, are introduced to guide green development in future years. The NPC also pledges to further China's economic and financial integration with the rest of the world, via recently signed RCEP and CAI, and negotiations to set up a CN-JP-KR Free-Trade-Zone and potentially joining of the CPTPP

Improving quality of recovery requires a rebalancing of growth



Source: CEIC, AXA IM Research, March 21

Slow fiscal tapering ensures resources for targeted stimulus

Fiscal measures	2019	2020	2021 target
Budget deficit, RMB bn (% of GDP)	2,760 (2.8%)	3,760 (3.7%)	3,570 (3.2%)
Special LG bond, RMB bn (% of GDP)	2,150 (2.2%)	3,750 (3.7%)	3,650 (3.3%)
Special CG bond, RMB bn (% of GDP)	0 (0.0%)	1,000 (1.0%)	0 (0.0%)
Broad fiscal deficit, RMB bn (% of GDP)	4,910 (5.0%)	8,510 (8.4%)	7,220 (6.5%)

Source: Budget reports, AXA IM Research, March 21

Brighter outlook may fade if vaccination campaign doesn’t ramp up

Japan

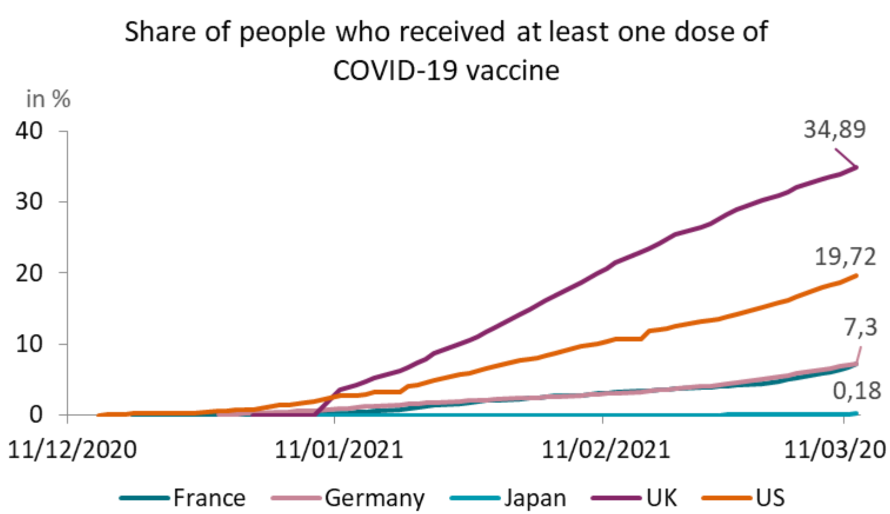
Lower COVID-19 infections are promising but the recovery is fragile given slow vaccination pace

- The state of emergency in Greater Tokyo is due to end on March 21 after the number of new cases stabilized at a low level
- The vaccination campaign is now underway but currently only 0.05% of the population is inoculated each day. The pace will increase but the government’s target of 30 million vaccinated adults by end of June seems ambitious.

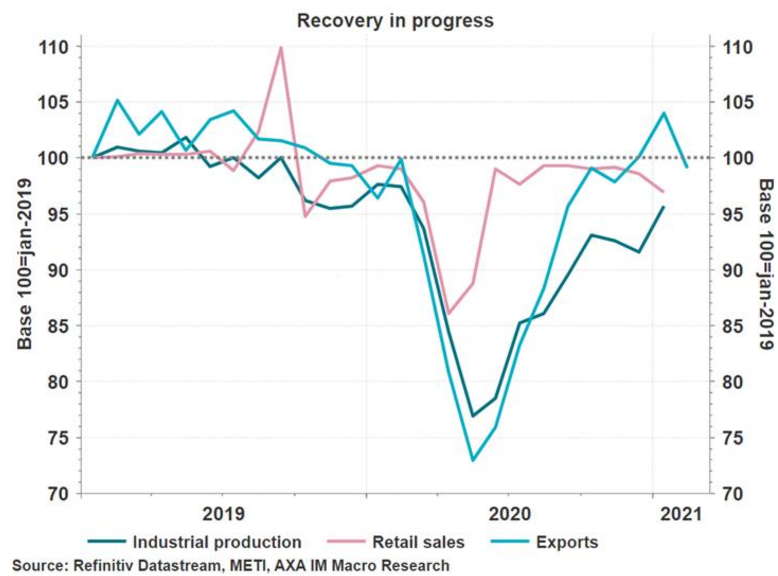
Reflecting January data and the renewed extension of the state of emergency, we lower Q1 GDP estimate to -1.3% qoq

- Private consumption declined in January, as households refrained from returning home over the year-end, while the restrictions weighed on both goods and services spending – retail sales fell 2.4%. February’s surveys pointed to another drop.
- On the other side, the manufacturing sector performed well with industrial production came in at +4.2% on a monthly basis. Exports were volatile around the Chinese New Year.

Vaccination pace is hardly ramping up



A two-speed economic activity that persists



Source: Our world in data, AXA IM Research, March 21

The BoJ unveiled its policy review conclusions

Japan

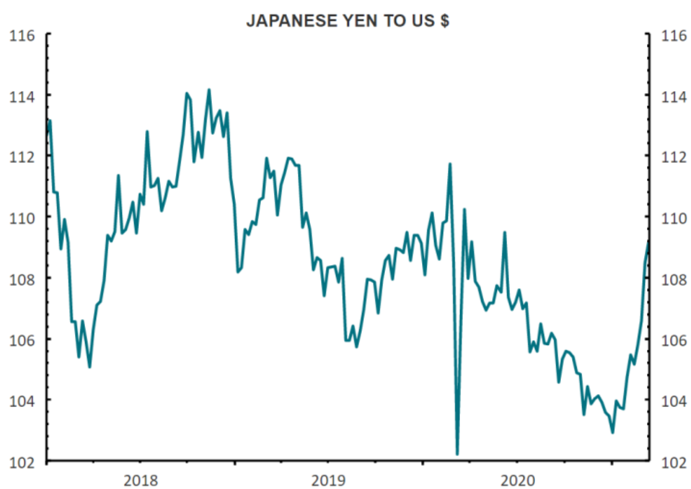
The Bank of Japan keeps the status quo at its March monetary policy meeting

- Yield curve control has proven a powerful tool during the US Treasuries sell-off at 10-year.
- Recent yen depreciation versus the dollar provides additional leeway for growth and inflation.

The BoJ's policy review has released minor surprises

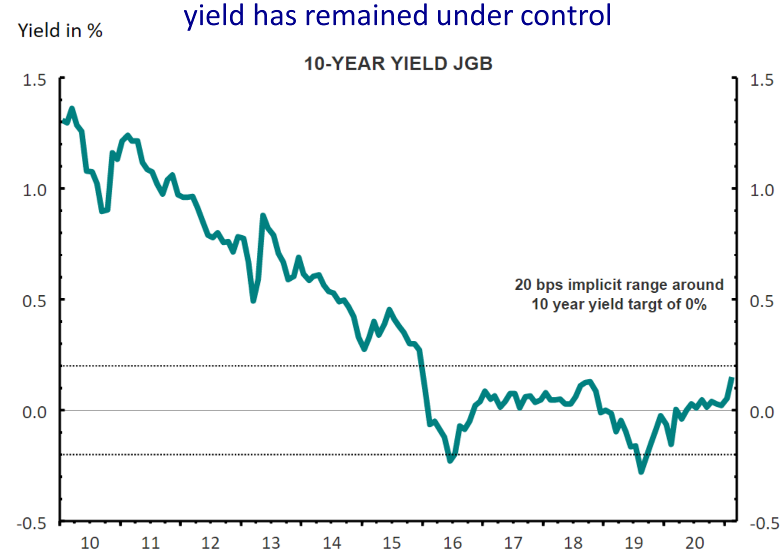
- The possibility of further rate cuts hasn't been excluded but it introduced a more favorable tiering system with positive rates to offset the burden of negative rates.
- On YCC, the range was widened to +/- 25bps (from +/-20bps) but the BoJ adopted a more hawkish tone on the upper limit, introducing "fixed-rate purchase operations for consecutive days" while it stated it won't strictly respond to declines that deviate below the range.
- On ETFs and J-REITS, it removed the annual target amount of ¥6trn and ¥90bn respectively and will adopt a more flexible approach under the upper limit of ¥12trn and ¥180bn respectively.

Yen depreciation versus the dollar is alleviating some pressure for the BoJ



Source: Refinitiv Datastream and AXA IM Research 16/03/2021

For the time being, Treasuries sell-of contagion to JGB yield has remained under control



Source: Refinitiv Datastream and AXA IM Research Feb 21

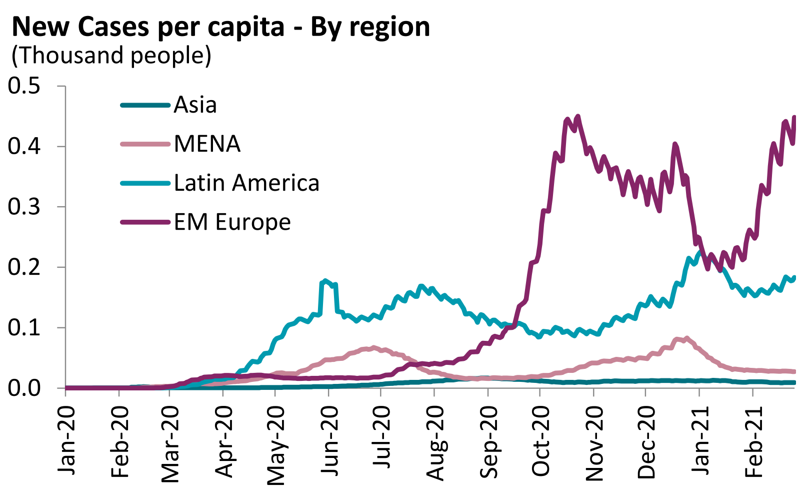
Pandemic still around … but vaccination should accelerate

Emerging Markets

New cases rising calling for additional restrictions. Vaccination is slow outside Chile.

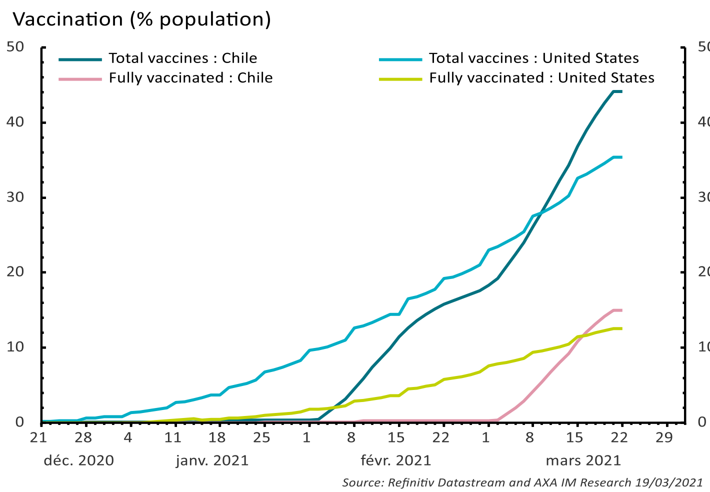
- Aside from India, where the daily infection rate has been rising, Asian countries are still relatively better at containing the virus spread. A better situation allowed for more relaxation of mobility restrictions in Malaysia, for example.
- Central Europe continues to see deterioration in pandemic trends and renewed restrictions have been introduced. The Czech Republic has seen an exceptionally high infection rate which is just starting to decelerate lately.
- Increased infection occurrence is taking place in Latin America and particularly in Brazil post-Carnival and summer holidays.
- Vaccination had a slow start in EM – particularly, but not only in Asia. At current pace, only 16% of the population would be vaccinated by year-end. Some acceleration in the vaccination pace should improve this estimate, although the stellar performance of Chile is unlikely to be mimicked : in 1.5 months, Chile vaccinated all of its at-risk population and should reach herd immunity by mid-2021.

Infection rate still not under control



Source: Datastream, AXA IM Research, 17 March 2021

Chile, among the global leaders in vaccination



Source: AXA IM Research, 18 March 2021

Monetary policy normalisation ahead of schedule

Emerging Markets

Inflation will accelerate but output gaps remain and inflation should not be an issue …

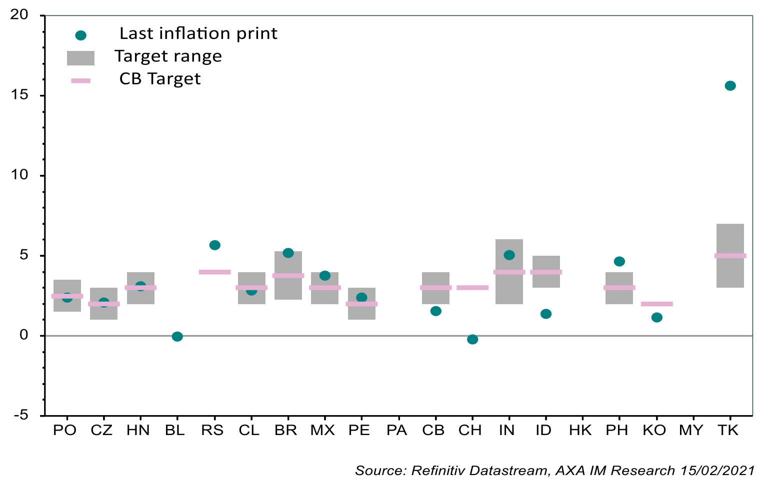
- Genuine economic recovery along with base effects and high commodity prices will push inflation rates generally higher. Underlying inflation trends are likely to remain nevertheless subdued. Labour market trends remain poor. Output gaps are still negative across emerging markets and unlikely to be closed by year-end for most.

… but some policy adjustment may come earlier

- Most EM central banks should adopt a wait-and-see stance. However, less well anchored inflation expectations resulting in FX depreciation can pose headaches to some central banks, which may be forced to start raising rates sooner than previously thought. This month, Brazil, Turkey and Russia surprised markets with bold action front-loading rate hikes to anchor inflation expectations and support currencies. Inflation rates were running above targets and are likely to spike further in the coming months.
- Following a surprising 200bp policy rate hike (to 19%), the Turkish central bank governor was sacked, reversing earlier TRY returns and inducing volatility and foreign outflows in a context of low FX reserves and high short-term financing needs. The bank may eventually be forced into excessive tightening causing additional damage to economic growth in the quarters ahead.

So far, inflation remains well behaved

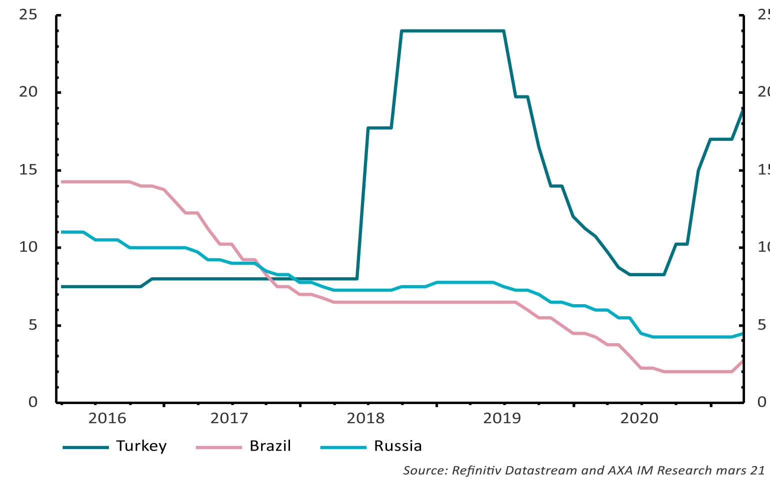
EM inflation rates and CB targets



Source: Refinitiv Datastream, AXA IM Research, February 2021

Front-loading rate hikes

Policy rates adjustments (%)



Source: AXA IM Research, 19 March 2021

Investment Strategy

Multi-Asset Investment views

Our key messages and convictions

Positive on equites

#1

Economic and earnings rebound remains on track amidst very loose monetary policy

#2

Despite support from monetary and fiscal initiatives, valuations are no longer attractive due to tight spreads

Neutral on Investment Grade Credit

#3

Bond markets starting to price a policy shift by the Fed as fiscal stimulus takes hold although monetary arsenal remains supportive

Negative Sovereign Bonds

#4

Concerns over COVID-19 variants and inflation vs Fed monetary policy transition generate higher volatility

Long Volatility

Source: AXA IM as at 24/03/2021

FX Strategy

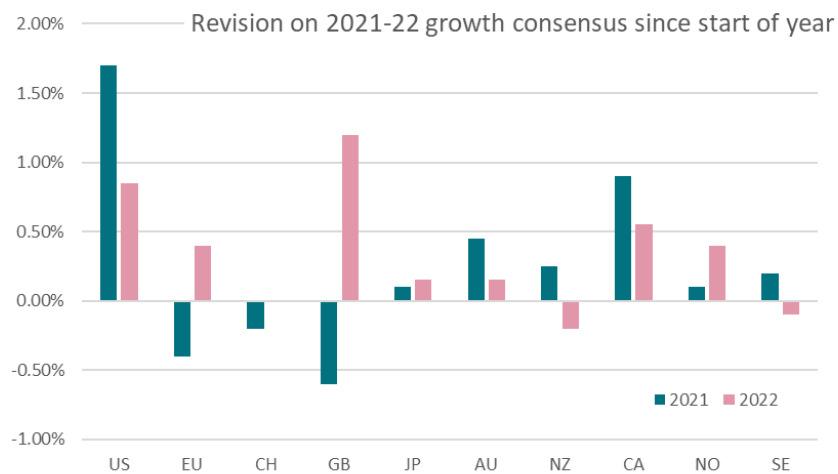
Reflation trade side A: High beta currencies higher … side B: Real rates strike back

- Markets are dominated by the prospect of economies reopening while massive monetary and fiscal stimulus persists. In this dynamic, currencies with higher beta to global growth and where the domestic rebound looks stronger, should continue to outperform – sterling, the Canadian dollar and Norwegian krone stand out.

- The UK's head start in vaccinations, points to an earlier reopening than in the rest of Europe. While investors have re-assessed their positions post-Brexit agreement, sterling remains undervalued compared to the period pre-2016 referendum. That said, positioning has almost reached a 10-year high, something to keep an eye on.

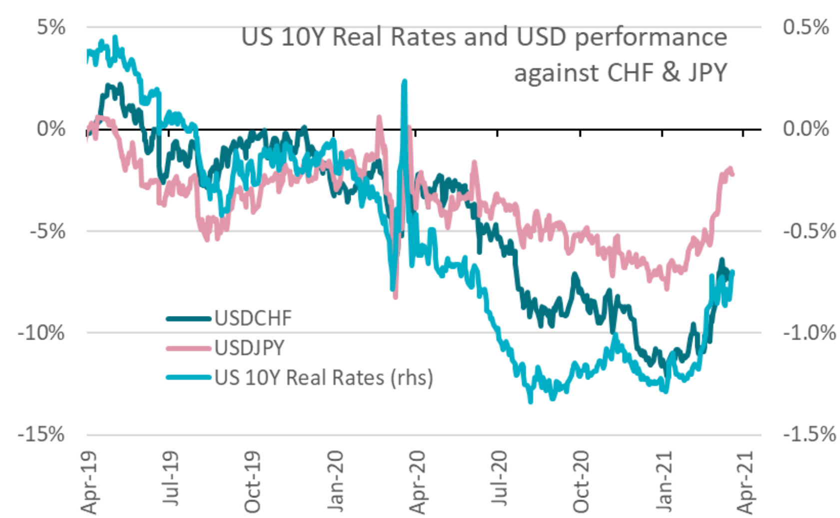
- US growth upward revisions have translated to higher US real rates, with further upside. This should push USD/CHF and USD/JPY higher (Exhibit 3). With this in mind, we would favour shorting CHF rather than JPY.

GBP, CAD, NOK supported by growth revisions



Source: Refinitiv and AXA IM Research, Mar 2021

USDJPY and USDCHF follow US real rates rise



Source: Bloomberg and AXA IM Research, Mar 2021

Inflation, monetary policy and inequality

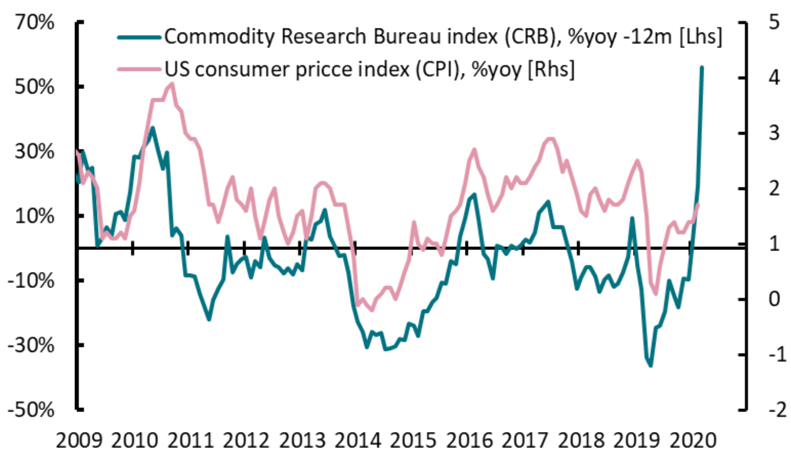
- The US inflation path is probably the most frequently debated macro question worldwide. For now, it seems that a strong commodity-related base effect might lift consumer prices at the end of spring. Both investors and policy makers are in tune on inflation, i.e. the effect will be transitory and monetary policy should look through it.

- If higher inflation is transitory, then why are bond investors so sensitive to this topic? We think there is a good reason for the repricing we're witnessing on the Treasury curve. And that reason has to do with expectations.
  The evolution of market- and survey-based long-term inflation expectations in the US, namely the repricing of inflation swaps and the uptick on the Survey of Professional Forecasters, suggests that expectations have adapted to the acceleration in global demand and commodity prices and take into account the Fed's higher tolerance for inflation levels above the 2% target.

- However, expectations often tend to feed on themselves (positive feedback) and therefore must be handled with care. Today's inflation is not only a function of demand-pull and cost push-effects, but also of inflation expectations.

Inflation implications from commodity bull market

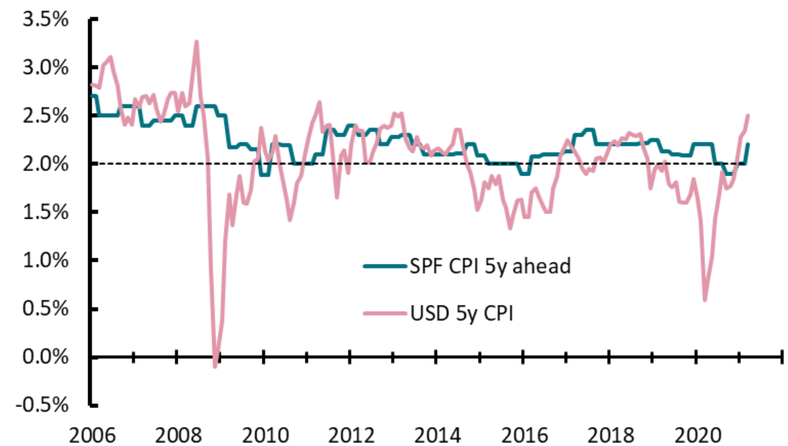
The effect of commodity prices on US inflation



Source: Bloomberg and AXA IM Research, Mar 2021

Inflation expectations are on the move

US Inflation expectations



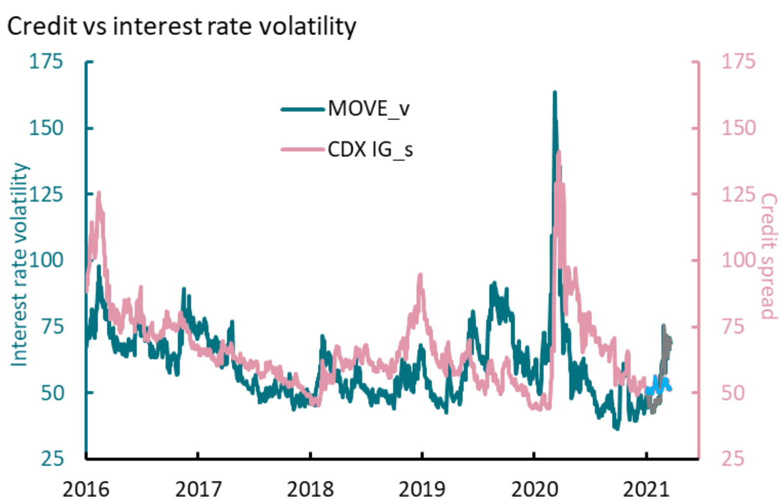
Source: Bloomberg and AXA IM Research, Mar 2021

Credit Strategy

The asymmetry in credit risk premia and the risk from rising real rates

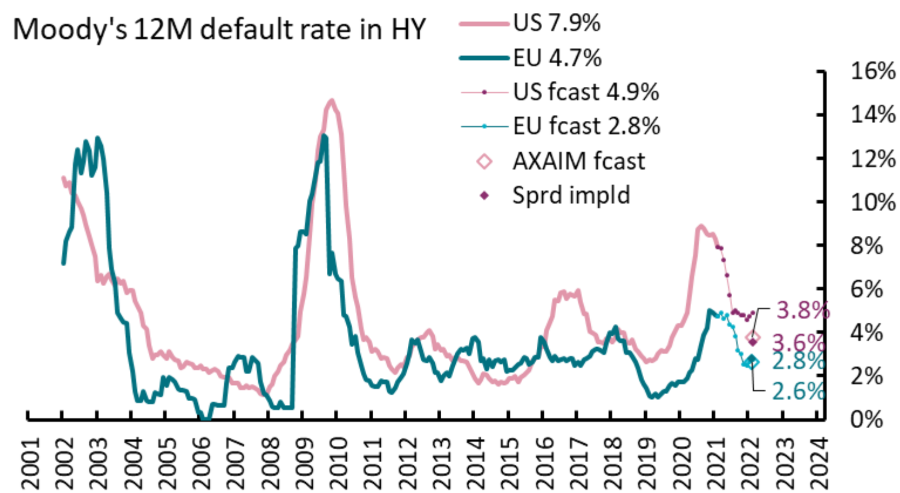
- The sensitivity of credit to interest rate volatility has dropped dramatically since the US Federal Reserve intervened in credit markets in March last year. The spread beta between the CDX IG index (US IG credit) and the MOVE index (US treasuries' volatility) has seen a 12-fold decline.
- The popular narrative that a large increase in real rates will be detrimental to risk premia, is premised (since 2000 at least) on the fact that the data includes 2008, a major outlier for financial markets. Excluding 2008, US HY credit performance is about flat when real rates rise by over 1%.
- Realised and expected default rates continue to decline. Moody's defaults have peaked at c.9% for the US and c.5% for Europe, the worst reading since the global financial crisis. We expect them to decline to 3.8% and 2.6% respectively over 1 year, close to their historical average.

Credit spreads unchanged YtD despite rise in interest rate volatility



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

Realised and expected default rates continue to decline



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

Investment Managers

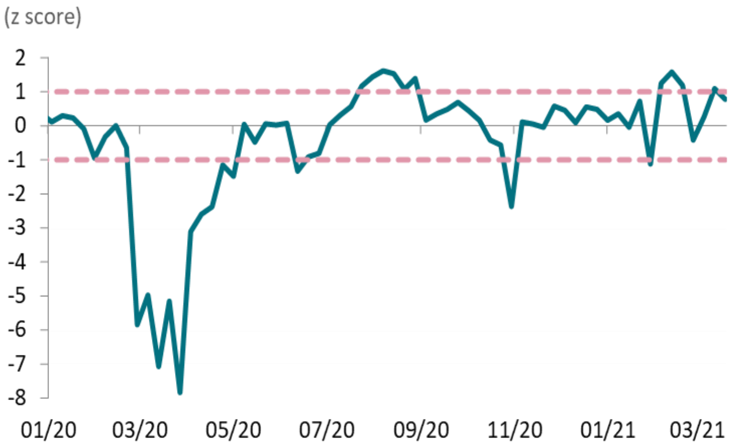
Equity strategy

Some respite in equity markets

- At the start of February, the VIX term structure showed elevated market volatility expectation in the near term with a steep contango (z score ranging between 1.2 and 1.6) but this 'fear' premium has narrowed in recent weeks. A reversion to lower implied volatility levels could provide additional tailwind for equity markets, given that the VIX remains historically (above its 10-year weekly average).
- The rotation trade has slowed down in line with the real rate stabilization recently as central banks have pushed back against rising interest rates. As we move forward through the year, however, real rates should resume their uptrend along with growth and inflation, encouraging for further rotation toward Value assets.
- The vaccination campaigns' progress, which is key for a more complete resumption in activity, and divergences across countries and regions create relative value opportunities. The expected earnings growth for 2021 reflect such divergences. We have upgraded the UK region to positive as a result, while we remain overweight on the asset class overall.

Concerns seen in the VIX futures curve are fading

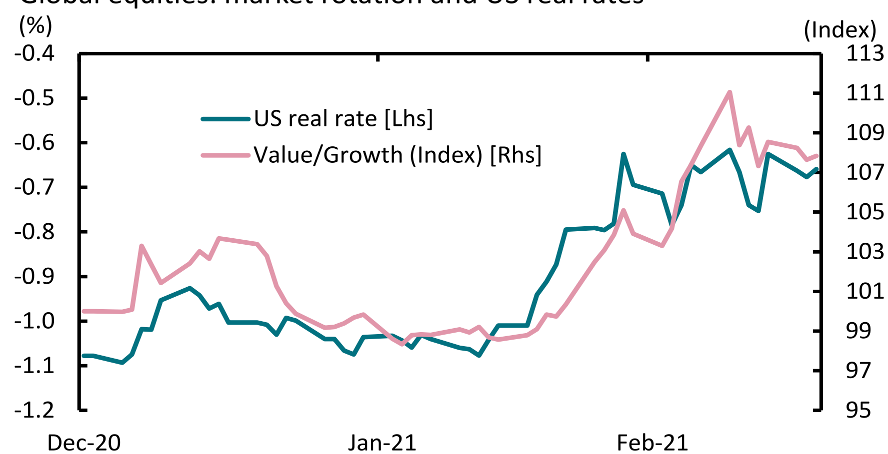
VIX term spread: spot vs second month future



Source: Datastream and AXA IM Research, March 2021, based on 10Y weekly VIX spot versus second future contract spread

Stalled yield, subdued rotation: it almost perfectly matched it

Global equities: market rotation and US real rates



Source: Datastream and AXA IM Research, March 2021

Asset allocation stance

Positioning across and within asset classes

Asset Allocation			
Key asset classes			
Equities			
Bonds			
Commodities			
Cash			

Equities			
Developed			
Euro area			
UK			
Switzerland			
US			▲
Japan			
Emerging & Equity Sectors			
Emerging Markets		▼	
Green Basket		▼	
Europe Cyclical/Value			
Euro Opening basket			▲
US Cyclical/Value		▼	
US Financials			▲
Global semiconductors			

Fixed Income			
Govies			
Euro core		▲	
Euro peripheral			
UK			
US			
Inflation Break-even			
US			
Euro			
Credit			
Euro IG			
US IG			
Euro HY			
US HY			
EM Debt			
EM Bonds HC			

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

Source: AXA IM as at 24/03/2021

Forecasts & Calendar

Macro forecast summary

Forecasts

Real GDP growth (%)	2020	2021*		2022*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
World	**-3.7**	**5.5**		**4.1**	
Advanced economies	**-5.5**	**5.3**		**3.6**	
US	**-3.4**	**6.5**	4.7	**4.4**	3.6
Euro area	**-6.8**	**3.6**	4.4	**3.2**	4.1
Germany	**-5.3**	**2.4**	3.5	**3.1**	3.8
France	**-8.3**	**5.5**	5.5	**3.0**	3.6
Italy	**-8.9**	**4.4**	4.3	**3.2**	3.9
Spain	**-11.0**	**4.5**	5.7	**4.3**	5.7
Japan	**-4.9**	**2.9**	2.3	**2.5**	2.3
UK	**-10.0**	**5.0**	4.2	**7.5**	5.6
Switzerland	**-3.0**	**2.8**	3.0	**2.7**	3.0
Emerging economies	**-2.7**	**5.6**		**4.5**	
Asia	**-1.4**	**7.1**		**5.1**	
China	**2.3**	**8.0**	8.4	**5.5**	5.5
South Korea	**-1.0**	**3.5**	3.4	**3.0**	3.0
Rest of EM Asia	**-6.0**	**6.4**		**4.7**	
LatAm	**-7.4**	**4.0**		**2.8**	
Brazil	**-4.1**	**3.0**	3.3	**2.3**	2.5
Mexico	**-8.5**	**4.7**	4.0	**2.5**	2.9
EM Europe	**-2.5**	**3.1**		**3.6**	
Russia	**-2.8**	**1.8**	2.9	**2.5**	2.5
Poland	**-2.7**	**3.3**	3.9	**4.6**	4.7
Turkey	**1.2**	**4.5**	4.4	**4.6**	4.2
Other EMs	**-3.7**	**3.3**		**4.1**	

Source: Datastream, IMF and AXA IM Macro Research – As of 24 March 2021

* Forecast

Investment Managers

Expectations on inflation and central banks

Forecasts

Inflation Forecasts

CPI Inflation (%)	2020	2021*		2022*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	**0.8**	**1.5**		**1.4**	
US	**1.2**	**2.0**	2.3	**2.2**	2.2
Euro area	**0.3**	**1.2**	1.2	**1.1**	1.2
Japan	**0.0**	**-0.3**	-0.2	**0.5**	0.4
UK	**0.9**	**1.9**	1.5	**1.7**	2.0
Switzerland	**-0.7**	**0.1**	0.3	**0.4**	0.5

Source: Datastream, IMF and AXA IM Macro Research – As of 24 March 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	Q1 -21	Q2-21	Q3-21	Q4-21
United States - Fed	Dates	0-0.25	26-27 Jan 16-17 Mar	27-28 Apr 15-16 Jun	27-28 Jul 21-22 Sep	2-3 Nov 14-15 Dec
	Rates		unch (0-0.25)	unch (0-0.25)	unch (0-0.25)	unch (0-0.25)
Euro area - ECB	Dates	-0.50	21 Jan 11 Mar	22 Apr 10 Jun	22 Jul 9 Sep	28 Oct 16 Dec
	Rates		unch (-0.50)	unch (-0.50)	unch (-0.50)	unch (-0.50)
Japan - BoJ	Dates	-0.10	20-21 Jan 18-19 Mar	26-27 Apr 17-18 Jun	15-16 Jul 21-22 Sep	27-28 Nov 16-17 Dec
	Rates		unch (-0.10)	unch (-0.10)	unch (-0.10)	unch (-0.10)
UK - BoE	Dates	0.10	4 Feb 18 Mar	6 May 24 June	5 Aug 23 Sep	4 Nov 16 Dec
	Rates		unch (0.10)	unch (0.10)	unch (0.10)	unch (0.10)

Source: AXA IM Macro Research - As of 24 March 2021

Calendar of 2021 events

2021	Date	Event	Comments
April	26-27 Apr	BoJ Meeting	Unchanged (-0.1)
	27-28 Apr	FOMC Meeting	Unchanged (0-0.25)
May	6 May	BoE Meeting	Unchanged (0.1)
	6 May	Scotland	Scottish Parliament Elections
June	10 Jun	ECB Meeting	Unchanged (-0.5)
	15-16 Jun	FOMC Meeting	Unchanged (0-0.25)
	17-18 Jun	BoJ Meeting	Unchanged (-0.1)
	24 Jun	BoE Meeting	Unchanged (0.1)
July	23 Jul	ECB Meeting	Unchanged (-0.5)
	27-28 Jul	FOMC Meeting	Unchanged (0-0.25)
August	23-28 Aug	Japan	Tokyo Olympics
September	9 Sep	ECB Meeting	Unchanged (-0.5)
	21 Sep	Germany	Federal Elections
	21-22 Sep	BoJ Meeting	Unchanged (-0.1)
	21-22 Sep	FOMC Meeting	Unchanged 90-0.25)
	23 Sep	BoE Meeting	Unchanged (0.1)
	30 Sep	Japan	End of term as LDP leader for PM Suga
October	21 Oct	Japan	House of Representatives term ends
	28 Oct	ECB Meeting	Unchanged (-0.5)
November	2-3 Nov	FOMC Meeting	Unchanged (0-0.25)
	4 Nov	BoE Meeting	Unchanged (0.1)
	1-12 Nov	UK/UN	Climate Conference
	27-28 Nov	BoJ Meeting	Unchanged (-0.1)
December	14-15 Dec	FOMC Meeting	Unchanged (0-0.25)
	16 Dec	ECB Meeting	Unchanged (-0.5)
	16 Dec	BoE Meeting	Unchanged (0.1)
	16-17 Dec	BoJ Meeting	Unchanged (-0.1)
November 2022	8 Nov	US	Mid Term Elections

Investment Managers

Latest publications

China: Path to ‘Net-Zero’

18 March 2021

Central bank digital currencies: policy and design

17 March 2021

UK Budgets: Next steps, not complete vision

03 March 2021

February Global Macro Monthly & Investment Strategy – Vaccine and Stimulus: too much of a good thing?

24 February 2021

Entering the world’s second largest bond market

09 February 2021

January Global Macro Monthly & Investment Strategy – The Vs to shape recovery – Vaccine Vs Virus

27 January 2021

How can President Biden tackle Climate Change?

21 January 2021

RCEP: Integrating Asia beyond trade

12 January 2021

This document is for informational purposes only and does not constitute investment research or financial analysis relating to transactions in financial instruments as per MIF Directive (2014/65/EU), nor does it constitute on the part of AXA Investment Managers or its affiliated companies an offer to buy or sell any investments, products or services, and should not be considered as solicitation or investment, legal or tax advice, a recommendation for an investment strategy or a personalized recommendation to buy or sell securities.

It has been established on the basis of data, projections, forecasts, anticipations and hypothesis which are subjective. Its analysis and conclusions are the expression of an opinion, based on available data at a specific date. All information in this document is established on data made public by official providers of economic and market statistics. AXA Investment Managers disclaims any and all liability relating to a decision based on or for reliance on this document. All exhibits included in this document, unless stated otherwise, are as of the publication date of this document. Furthermore, due to the subjective nature of these opinions and analysis, these data, projections, forecasts, anticipations, hypothesis, etc. are not necessary used or followed by AXA IM's portfolio management teams or its affiliates, who may act based on their own opinions. Any reproduction of this information, in whole or in part is, unless otherwise authorised by AXA IM, prohibited.

Neither MSCI nor any other party involved in or related to compiling, computing or creating the MSCI data makes any express or implied warranties or representations with respect to such data (or the results to be obtained by the use thereof), and all such parties hereby expressly disclaim all warranties of originality, accuracy, completeness, merchantability or fitness for a particular purpose with respect to any of such data. Without limiting any of the foregoing, in no event shall MSCI, any of its affiliates or any third party involved in or related to compiling, computing or creating the data have any liability for any direct, indirect, special, punitive, consequential or any other damages (including lost profits) even if notified of the possibility of such damages. No further distribution or dissemination of the MSCI data is permitted without MSCI's express written consent.

This document has been edited by AXA INVESTMENT MANAGERS SA, a company incorporated under the laws of France, having its registered office located at Tour Majunga, 6 place de la Pyramide, 92800 Puteaux, registered with the Nanterre Trade and Companies Register under number 393 051 826. In other jurisdictions, this document is issued by AXA Investment Managers SA's affiliates in those countries.

In the UK, this document is intended exclusively for professional investors, as defined in Annex II to the Markets in Financial Instruments Directive 2014/65/EU ("MiFID"). Circulation must be restricted accordingly.