AXA Investment Managers

24 July 2024

Investment Institute Macroeconomics

Reconvergence

Key points

- It is increasingly likely the Fed will be able to cut this year, while the ECB would continue with its prudent path of "restriction removal", re-creating a good measure of policy re-convergence across the Atlantic in the second half of 2024.
- The continuation of such a pattern – supportive of currency stability – in 2025 will depend on the results of the US elections.
- Markets not at end of cycle.
- Q2 US earnings look robust.
- Bond yields fair value.

A lag, not a divergence

Last spring, the macro debate was focused on the risks of a proper divergence in monetary policy across the Atlantic, exerting downward pressure on the euro. Indeed, while the European Central Bank (ECB) was still seen as cutting rates fairly quickly, it was getting less obvious that the Federal Reserve (Fed) would be in a position to cut even once this year. Fortunately, as the summer starts, what was seen as a divergence is now appearing as a mere lag: the Fed should be able to cut twice in 2024 – in line with our baseline – while it is increasingly clear that the ECB is not tempted by "emergency cuts" and will stick to a prudent path, with only three cuts in total this year.

As we write those lines, the market is pricing a near 100% probability of a Fed cut in September. In early May, it had fallen to a low of 51%. Good news on the inflation front have helped of course. US headline Consumer Price Index (CPI) fell by 0.1%mom in June, 0.2 percentage point below market expectations, hitting 3.0% its lowest year-on-year change since March 2021. Core CPI rose 0.1% on the month but that was also less than expected (0.2%) and at 3.3%, the year-on-year change also hit a more than 3-year low. The short-term momentum, which helps control for base effects, shows that core services excluding rents – a key source of concern for the Fed – have been decelerating quite sharply over the last few months.

What is striking is how the balance is now shifting across the two targets of the Fed: with signs accumulating that inflation is getting back under control, Fed speak is turning to the labour market, and the risk that it would deteriorate too far if the current level of monetary restriction is maintained for too long is increasingly mentioned.

In parallel, in the Euro area the ECB is sending prudent signals. The July ECB press conference was to some extent a disjointed affair: while we found the macro narrative quite dovish, expressing a fairly robust confidence, disinflation will continue despite some gyrations in the monthly data, Christine Lagarde remained tight-lipped on the next steps. We suspect the Council is divided, and the political context in key member states – even if France was not mentioned by name – may trigger tactical positioning by some hawks who don't want to send to potentially spendthrift governments the signal that full-on monetary policy accommodation is just around the corner. Genuine concerns about the resilience in services prices adds to this reluctance. We still maintain our baseline of two more reductions in the policy rate (September and December), but it is clear the ECB is not ready to take risks.

All this would result in a good measure of "re-convergence" of the Fed and the ECB in the second half of 2024 around a common path: removing some of the current monetary restriction, but without moving into "accommodation proper". Indeed, while signals have been mixed recently – the rise in the unemployment rate in the US must now be closely monitored – the two main economic regions of the West are not facing immediate recession risks.

It is for 2025 that risks of divergence are probably increasing rather than fading. Indeed, in case of a victory by Donald Trump in November, the implementation of his platform would probably result in an exacerbation of the inflationary pressure, between the cutdown in immigration, prolongation of the TCJA[1] tax cuts and – most importantly – steep increase in customs duties. It could become difficult for the Fed in these circumstances to continue cutting. Conversely, in the Euro area, even when taking on board the current political uncertainty in France, the overall fiscal stance is likely to err on the restrictive side, which would offer the ECB more space to continue cutting rates, especially if the European producers are hit by the US tariff hike and tougher competition from China. If at the same time financial conditions in the US tighten again – with some contagion to European long-term rates – the ECB would be forced into a much more rapid descent into proper accommodative territory. We note however that more economic difficulty would probably convince even mainstream political forces in Europe – which are still in charge, as the comfortable re-election of Ursula Von der Leyen illustrated – to lean even more towards a "muscular attitude" to international trade themselves, with probably a fair amount of "China targeting".

In such a configuration, China's policy choices would be heavily constrained. Continuing to bet on export-driven sectors when foreign markets are closing would be a dead end. Stimulating domestic demand would be the natural path – and this time targeting consumer spending rather than investment would be appropriate. This would however take a significant re-orientation of the whole macro strategy in Beijing. We will watch the aftermath of the Communist Party plenum proceedings with much interest.

The end of the cycle? Not yet

Portfolios with low interest rate sensitivity, tilted towards economic growth, and with substantial exposure to technology companies have been the best performers in 2024 to date. The International Monetary Fund's (IMF) latest World Economic Outlook painted a picture of moderate global growth and further easing of inflation over the balance of 2024 and into 2025. This suggests investors would be advised to potentially stick with what has worked well. One of the key risks continues to be the potential for the decline in inflation to stall, as a result of ongoing price increases in services, but the risk of further monetary tightening to combat that is small. A "higher-for-even-longer" rate outlook is possible – as the IMF points out – but the modest cuts to official interest rates over the next year which are currently priced in by markets still look to be the most likely outcome. As such, a modest extension of interest rate sensitivity – or duration – in portfolios might be warranted. That is not likely to change the dial on returns, however, unless there is a more marked slowdown in economic growth. Interest rate curves remain inverted on the whole, which means that benefitting from high rates without taking risk continues to be an attractive strategy. As the recent edition of the US Fed's Flow of Funds report showed, holdings of money market shares in the US continue to be very high.

Bond yields well anchored

Aside from politics, investors' biggest challenge is assessing whether we are coming towards the end of the expansion phase of the economic cycle. The signals are not clear at the moment, and we would suggest an imminent rapid slowdown and recession is not likely. Indeed, the pricing of central bank policies in the major economies is consistent with continued expansion with policy set to ensure inflation does not rise significantly above target levels. Long-term bond yields appear fairly valued – certainly they are consistent with medium-term nominal GDP growth expectations. Deviations from current trading ranges would require a response to policy shocks – more rapid rate cuts or the materialisation of fiscal policies that could lead to increases in government borrowing. Without policy shocks, long-term yields look well anchored. Any normalisation of yield curves is likely to proceed slowly as a result. Again, this is not an environment for taking aggressive bets on long duration in fixed income allocations.

[1] Tax Cuts and Jobs Act

Elsewhere in bond markets there are no red flags either. Spreads on corporate bonds are stable and towards the tightest levels of the cycle. Yet, demand for investment grade and high yield bonds continues to be solid. Of course, there have been credit events, but aggregate bankruptcy and default levels have been stable in the US and Europe. Refinancing risk has been contained, despite higher interest rates, as companies had mostly extended duration of their debt in recent years. There have been ready buyers as well, with yields in Europe in the 3%-4% range for investment grade debt and investors able to secure 5%-5.5% in the US. The abundance of private credit has proved to be extremely supportive for more leveraged corporate borrowers.

Shifting sands in equity markets, but returns still healthy

Equity markets have the potential to signal some cyclical stresses but so far, any unusual price action has been limited to profit taking in technology stocks and shifts in market leadership that seem to reflect changing interest rate expectations rather than recession risks. On the earnings side, the Q2 season is underway as we go to press. So far, for the S&P500 universe, growth looks to be stable at a high single digit pace, with a slight tilt towards positive surprises on earnings in a number of sectors, including financials. In July, the valuation of growth stocks relative to small-cap equities has retreated markedly, with the Russell 2000 index of small-cap stocks significantly outperforming the S&P Growth index since the release of the June consumer price inflation report. This may herald a more balanced performance from US equities – the equal-weighted S&P has also outperformed the market cap-weighted index in recent weeks. If rates are to move lower soon, this should benefit smaller and more cyclically sensitive companies especially if investors have viewed the lack of rate sensitivity a key factor behind the strong performance of tech stocks over the last two years.

There are some concerns over the US consumer, as suggested by the modest weakening in the labour market. Yet consumer discretionary stocks have performed well on the whole. If a soft landing remains the core scenario for the US economy, reflected in a more balanced performance of equity sectors, then perhaps the outsize gains in valuation in the technology area that characterised the first half of the year will not be repeated. However, now does not seem to be the time to turn bearish on technology. Recent results from the Taiwanese semiconductor firm TSMC point to rapid demand for computer chips as investment in artificial intelligence continues to ramp up.

Is equilibrium comfortable?

Behaviourally, investors may find it uncomfortable to take the view that markets are at equilibrium levels. Bonds appear to be fairly valued, the path of rates suggested by forward rates is consistent with the macro consensus, and equity valuations, on the whole, reflect a resilience in corporate earnings growth across major economies. There are concerns about policy and geopolitical risks that could materialise to disrupt supply chains. But these are risks rather than present day realities. Bond markets present very attractive income opportunities and the potential to provide a hedge against more adverse cyclical developments (central banks have plenty of room to cut if a recession does look more likely). The additional income provided by corporate credit has compensated for credit risk more than adequately (the ratio of current US investment grade spreads to the one-year volatility of that spread is currently very close to its long-term average). In equity markets, real concerns about valuation are limited to US technology stocks but it is here where there is the greatest upside potential for earnings. Outside of the US, valuations are comfortable while stable global growth should support decent returns through earnings and dividends.

The upshot is there is no obvious reasons for major portfolio shifts. Higher income from bonds is a theme that is still bedding in. The secular technology story is still running. There are value opportunities in equity markets outside of the US. In the details of the IMF forecasts, the growth gap between the US and Europe is set to close, adding to the relative attractiveness of European equities. The case for a more positive view on emerging markets is also stronger than for some time, given better macro conditions and the progress that a number of sovereign borrowers have made in restricting their debt and implementing structural reform.

The end of the cycle is not upon us yet. The main risks stem from political uncertainty but that alone is not sufficient to become markedly more defensive yet. Selected exposure to income and growth opportunities, in markets backed by a resilient global economy, should remain the key driver of investment activity for the remainder of this year.

Download the full slide deck of our July Investment Strategy

Macro forecast summary

Real GDP growth (%)	2023	2024*		2025*	
	AXA IM	AXA IM	*Consensus*	AXA IM	*Consensus*
World	3.2	3.2		3.1	
Advanced economies	1.7	1.4		1.4	
US	2.5	2.3	2.3	1.6	1.8
Euro area	0.6	0.6	0.7	1.1	1.5
Germany	0.0	0.1	0.2	0.9	1.5
France	1.1	0.9	0.9	1.0	1.3
Italy	1.0	0.7	0.8	0.7	1.2
Spain	2.5	2.5	2.1	2.1	1.9
Japan	1.9	0.6	0.3	1.1	1.0
UK	0.3	1.1	0.6	1.1	1.2
Switzerland	0.8	1.2	1.3	1.3	1.5
Canada	1.1	1.2	1.0	1.7	1.9
Emerging economies	4.2	4.2		4.1	
China	5.2	5.0	5.0	4.2	4.4
Asia (excluding China)	5.3	5.3		5.3	
India	7.7	6.8	6.8	6.5	6.7
South Korea	1.4	2.5	2.5	2.6	2.2
Indonesia	5.0	5.1	5.0	5.1	5.1
LatAm	2.3	2.0		2.5	
Brazil	2.9	2.2	2.0	1.9	2.0
Mexico	3.2	2.2	2.1	1.4	2.2
EM Europe	3.0	3.1		2.7	
Russia	3.6	3.2	3.1	1.5	1.1
Poland	0.2	2.8	2.9	3.5	3.4
Turkey	4.3	3.0	3.3	3.6	3.2
Other EMs	2.4	3.0		3.9	

Source: Datastream, IMF, Bloomberg and AXA IM Macro Research – As of 23 July 2024
**Forecast*

CPI Inflation (%)	2023	2024*		2025*	
	AXA IM	AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	4.7	2.7		2.3	
US	4.1	3.1	3.2	2.5	2.3
Euro area	5.5	2.5	2.4	2.1	2.1
China	0.2	0.6	0.6	1.6	1.9
Japan	3.3	2.5	2.6	1.9	1.5
UK	7.3	2.4	2.6	1.8	2.0
Switzerland	2.1	1.3	1.3	1.3	1.3
Canada	3.9	2.6	2.5	2.6	2.0

Source: Datastream, IMF, Bloomberg and AXA IM Macro Research – As of 23 July 2024
**Forecast*

These projections are not necessarily reliable indicators of future results

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Forecast summary

Central bank policy Meeting dates and expected changes (Rates in bp / QE in bn)		Current	Q3-24	Q4-24	Q1-25	Q2-25	Q3-25	Q4-25
United States - Fed	Dates	5.50	30-31 Jul 17-18 Sep	6-7 Nov 17-18 Dec	Jan Mar	Apr Jun	Jul Sep	Oct Dec
	Rates		-0.25 (5.25)	-0.25 (5.00)	-0.25 (4.75)	unch (4.75)	-0.25 (4.50)	unch (4.50)
Euro area - ECB	Dates	3.75	12-sept	17 Oct 12 Dec	30 Jan 6 Mar	17 Apr 5 Jun	24 Jul 11 Sep	30 Oct 18 Sep
	Rates		-0.25 (3.50)	-0.25 (3.25)	-0.25 (3.00)	-0.25 (2.75)	unch (2.75)	unch (2.75)
Japan - BoJ	Dates	0 - 0.1	30-31 Jul 19-20 Sep	30-31 Oct 18-19 Dec	Jan Mar	Apr Jun	Jul Sep	Oct Dec
	Rates		+0.10 (0.1-0.2)	+0.10 (0.2-0.3)	+0.10 (0.3-0.4)	+0.10 (0.4-0.5)	unch (0.4-0.5)	unch (0.4-0.5)
UK - BoE	Dates	5.25	1 Aug 19 Sep	7 Nov 19 Dec	6 Feb 20 Mar	8 May 19 Jun	7 Aug 18 Sep	6 Nov 18 Dec
	Rates		-0.25 (5.00)	-0.25 (4.75)	-0.25 (4.50)	-0.25 (4.25)	-0.25 (4.00)	-0.25 (3.75)
Canada - BoC	Dates	4.75	24 Jul 4 Sep	23 Oct 11 Dec	Jan Mar	Apr Jun	Jul Sep	Oct Dec
	Rates		-0.25 (4.50)	-0.25 (4.25)	-0.25 (4.00)	-0.25 (3.75)	-0.25 (3.5)	unch (3.5)

Source: AXA IM Macro Research - As of 23 July 2024

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