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Macro Outlook

Life after SVB and Credit Suisse: testing the separation principle

20 March 2023

Gilles Moec, AXA Group Chief Economist & AXA IM Head of Research

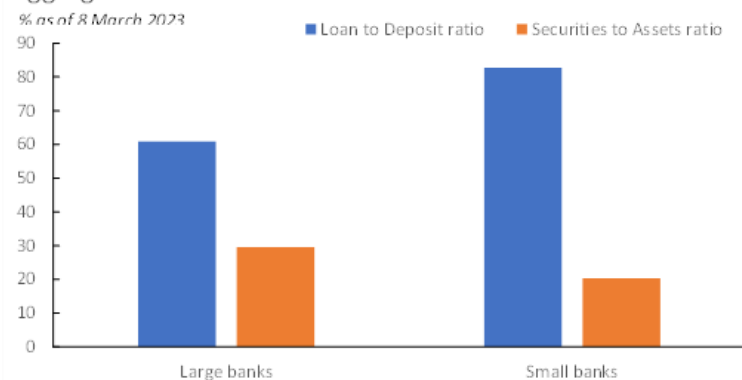
The US banking issue: the macro risks triggered by « deposit migration »

Deposits could continue to shift from smaller to larger banks, with risks for aggregate credit origination

In the US, smaller banks present a much higher Loan to Deposit Ratio than the larger ones – even if on aggregate they are less exposed to IR sensitive securities on their asset side

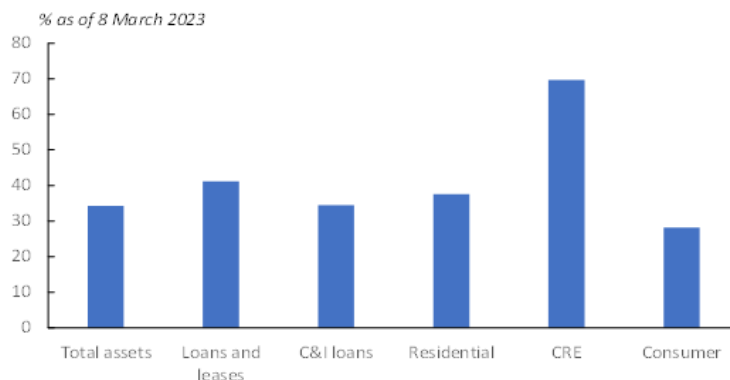
Smaller banks crucial for the real estate sector

Aggregate ratios of US domestic banks



Source: Federal Reserve Bank, AXA IM Research, March 2023

Share of small banks in US domestic banks' assets



Source: Federal Reserve Bank, AXA IM Research, March 2023

SVB's demise driven by sectorially concentrated deposits (tech) combined with poor ALM (no hedging of massive exposure to interest rate sensitive securities). This may be idiosyncratic but deposits are being moved from smaller, regional banks to large institutions, whose appetite to lend – in particular to commercial real estate operators – is lower.

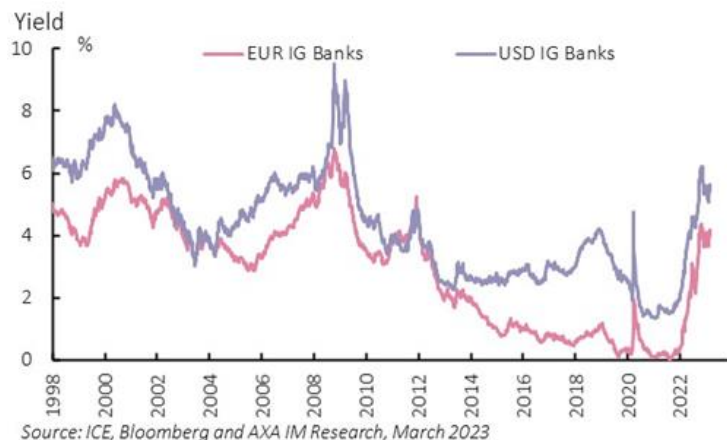
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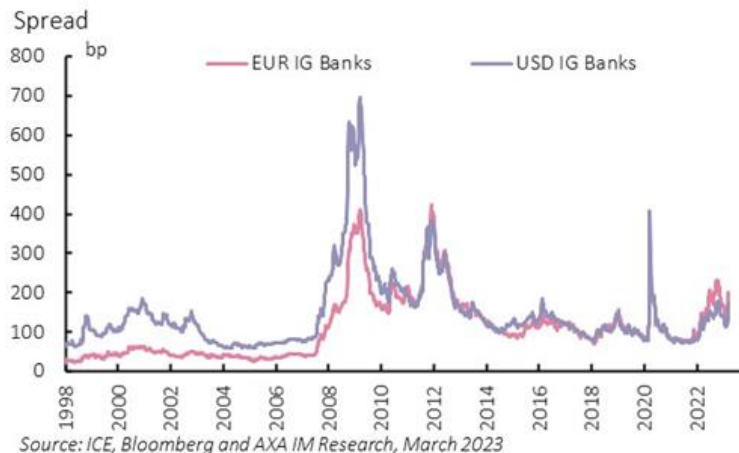
What to monitor after Credit Suisse: banks' funding costs globally

So far, banks' funding costs have risen roughly in line with risk-free rates – it may change if confidence is durably shaken

As central banks were tightening policy, banks' funding costs have significantly risen so far...



...but so far banks' haven't had to pay a large risk premium relative to previous episodes of stress



Tension over the last few weeks triggered a rise in the banks' funding spread (i.e. relative to sovereign yields) but this has remained modest relative to previous episodes of stress. A key issue is how investors will react to the solution found with UBS – and large contribution from the Swiss government and central bank. AT1 bonds have been burned, but bonds further above the seniority ladder have been protected.

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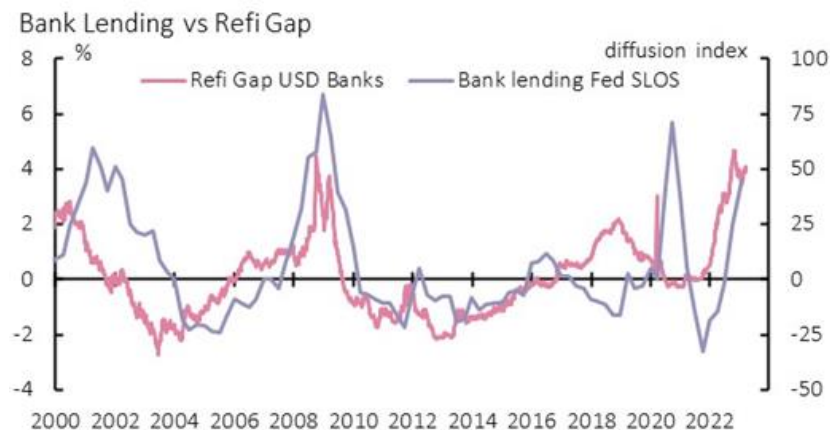
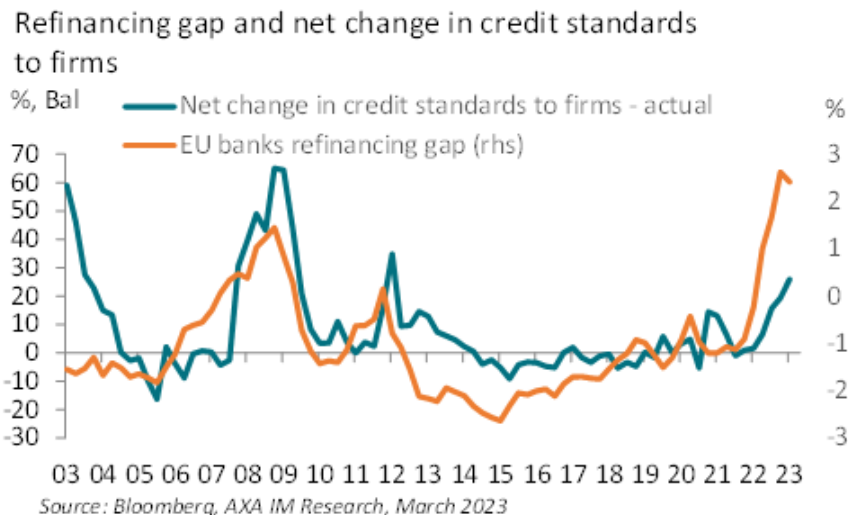
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A key conduit from market stress to the real economy

A tight historical correlation between banks' funding costs and their lending standards

Credit standards – a key determinant of credit supply – often react to changes in banks' funding costs in Europe....

...and in the US



Source: Fed, ECB, ICE, Bloomberg and AXA IM Research, March 2023

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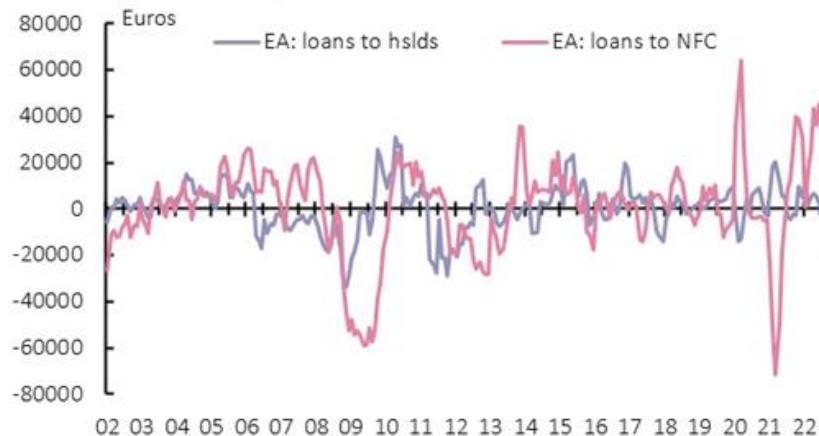
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Credit origination has already taken a hit – but some protection from corporate liquidity buffers

European credit impulse was negative before the turmoil emerged – but firms are still cash rich in aggregate terms

Euro area credit impulse collapsing

Euro area bank lending



Source: ECB and AXA IM Research, February 2023

Impact so far blunted by large liquidity buffers in the corporate sector

France's Liquidity to debt liabilities ratio



Source: Banque de France Flow of Funds and AXA IM Research, February 2023

The flow of new loans to the corporate sector was already falling in yoy terms in December and January. However, one needs to consider the fact that the pandemic has left many corporates unusually cash-rich, with lots of liquid assets allowing them to deal better with a contraction in credit supply.

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Markets have drastically revised their monetary policy expectations – we think this has gone too far

Lower terminal rates – and even rate cuts in the US – are now priced, despite still elevated inflation

Rate cuts are priced for the Fed again

Market pricing of Fed trajectory



Source: Bloomberg and AXA IM Research, March 2023

A pause seen at the ECB

Market pricing of ECB trajectory



Source: Bloomberg and AXA IM Research, March 2023

In a nutshell the market does not believe in the “separation principle”, according to which central banks can deal with financial stability issues by extending liquidity without altering their policy stance. While we agree central banks now need to be more prudent – and proceeding by 25 bps increments makes much more sense than 50s – expecting a reversal of monetary policy is hard to justify in a context of stubborn inflation. Central banks would recalibrate only if it’s absolutely clear that the real economy is hit hard by the banking turmoil, which would imply the CB and government support measures currently activated fail.

The « easy part » of disinflation

Global bottlenecks are being absorbed – good news on the energy side

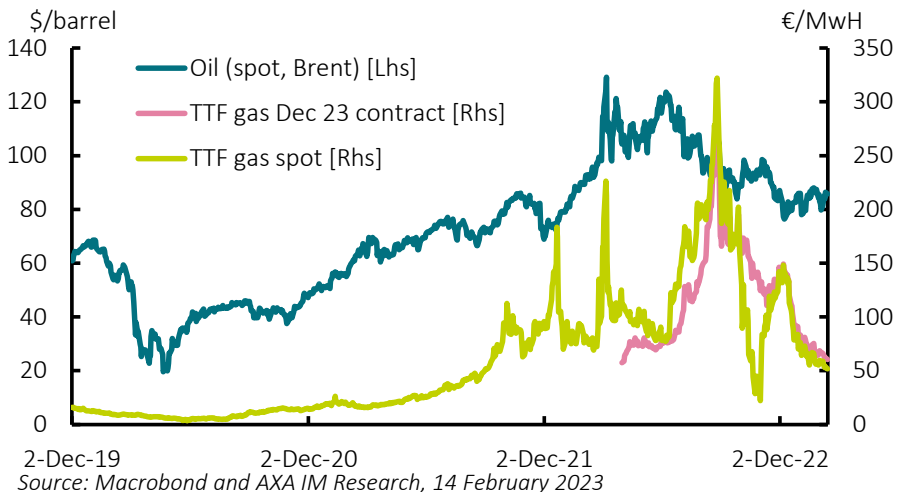
Delivery times and backlog of works now markedly below their long-term average in the US

Indicators of tension in US Mfg



Wholesale energy prices markedly off their peak

Wholesale fossil fuel prices



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More signs that US inflation is falling – but the “last mile” may be harder to cover

Prudence is of the essence though

Excluding rents, core inflation was negative on a 3-month basis

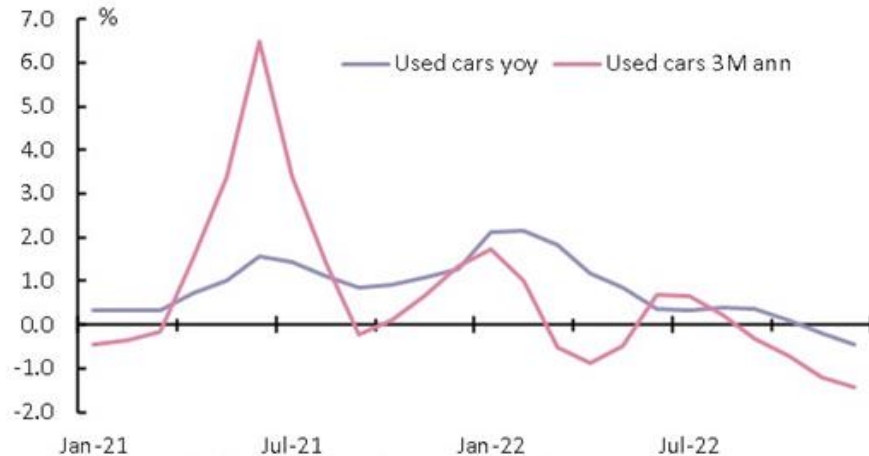
But still a lot of help from used cars

Breaking down core inflation



Source: Bureau of Labor Statistics and AXA IM Research, January 2023

Contribution from used cars' prices to core



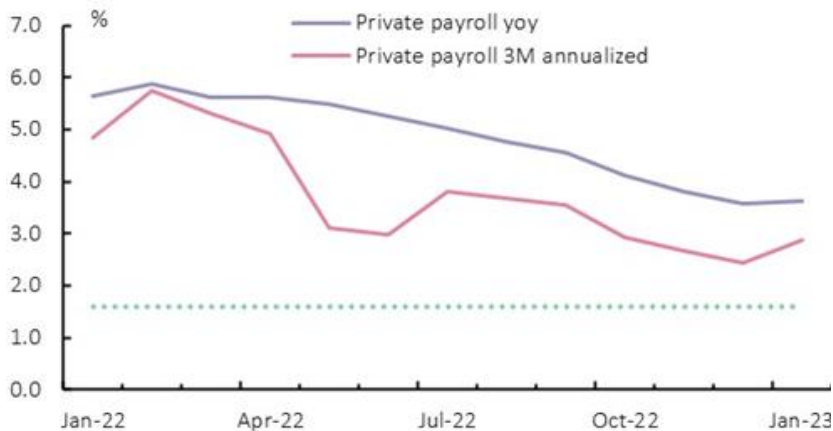
Source: Bureau of Labor Statistics and AXA IM Research, January 2023

No clear sign the labour market is landing

No wage deceleration to see after the January revisions

Can you really see job creation slowing ?

Job creation in the US



Source: Bureau of Labor Statistics and AXA IM Research, February 2023

Wages still very strong

Hourly earnings in the US



Source: Bureau of Labor Statistics and AXA IM Research, February 2023

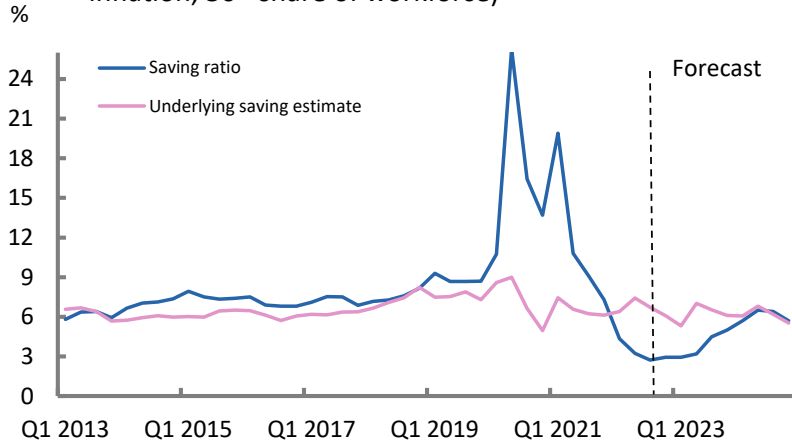
US growth prospects: a race between households' excess savings and real wages

The savings' buffers accumulated during the pandemic are being exhausted – but real wages are up again: Fed won't like that!

Not all of the saving overhang will be spent

Recent rebound in real wages

Household saving rate and model (net worth, inflation, 50+ share of workforce)



Source: BEA, AXA IM Research, Feb 2023

Hourly wages versus inflation



Source: Bureau of Labor Statistics and AXA IM Research, January 2023

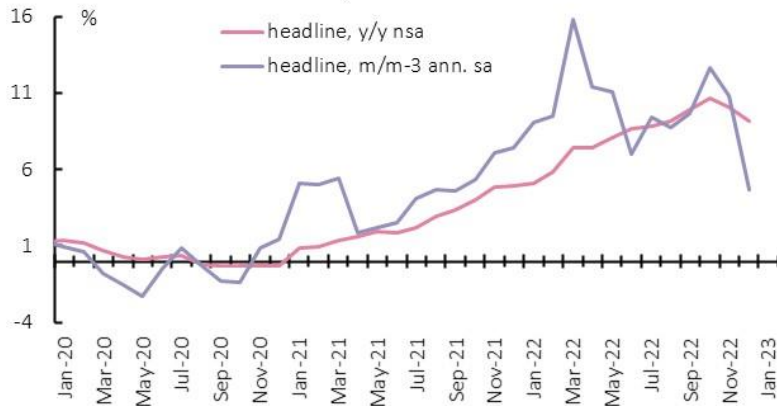
Core inflation continues to rise in the Euro area

Headline inflation has started to decline – but message from core is more ambiguous

Headline inflation markedly down

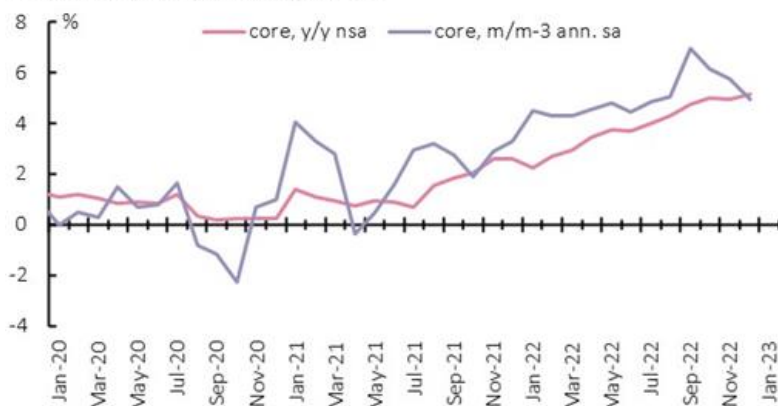
For core it depends on the metric

Euro area headline inflation dynamics



Source: Eurostat, ECB and AXA IM Research, January 2023

Euro area core inflation dynamics



Source: Eurostat, ECB and AXA IM Research, January 2023

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European disinflation ahead – but getting back to 2% will be difficult

Headline down thanks to energy – but “sticky” core inflation

Deceleration of headline inflation should continue

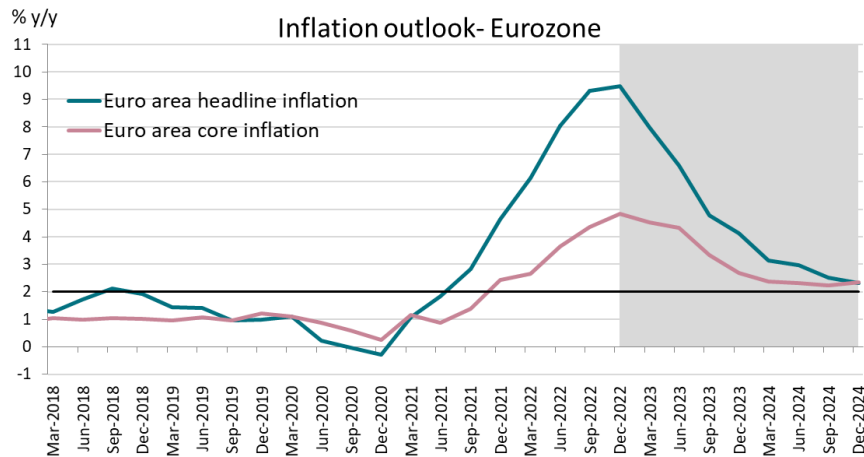
- If wholesale energy prices remain low, base effect should grow through 2023, lowering headline inflation by c. 5p between now and the end of 2023

Deceleration of core inflation will take time

- We believe core reached a peak at around 5.2% but our forecasts remain sticky and elevated in Q1 (5.1%) and Q2 (4.5%).
- Resilient demand and generous fiscal support are creating higher risk for endogenous inflation (inflation generated by higher wages/constant level of margins), which could complicate ECB policy

Our 2024 inflation forecast would remain above 2% in 2024 (2.8%)

Our profile for inflation



Source: Eurostat, AXA IM Research, December 2022

In annual average

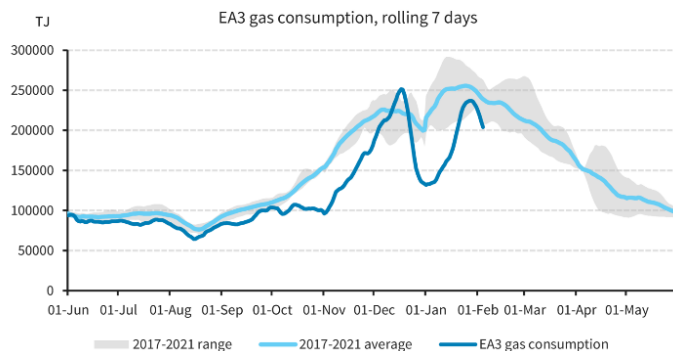
EA	2022	2023	2024
Headline	8.2%	5.9%	2.8%
Core	3.9%	3.7%	2.4%

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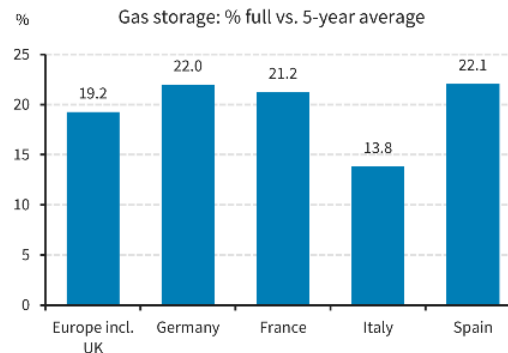
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Averted catastrophe in Europe...

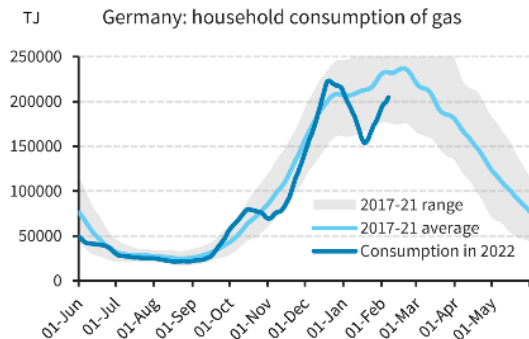
Decline in consumption helped get through the winter



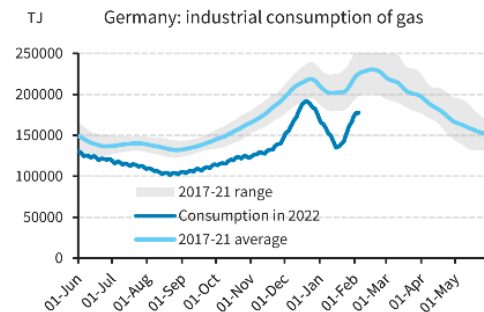
Source: ENTSO-G, THE, Eurostat, Barclays Research



Source: Bloomberg, Barclays Research



Source: THE, Zeit, Barclays Research. NB: Consumption split between household and industrial use is approximate based on meter type.



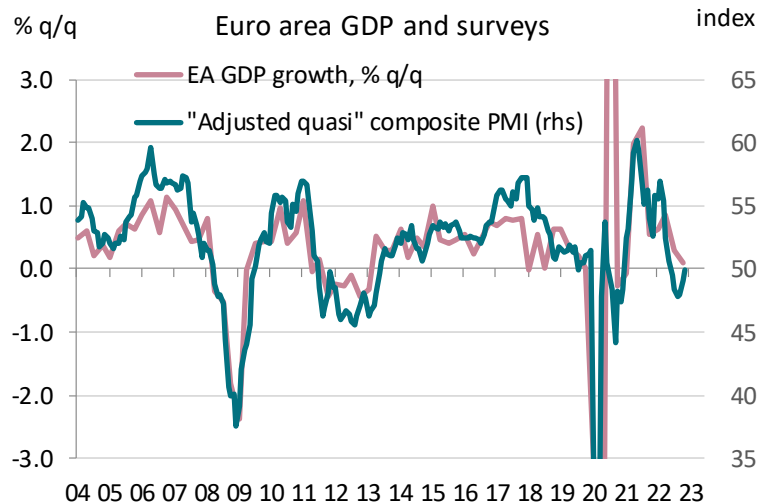
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... triggering a relief reaction in confidence, but levels remain mediocre

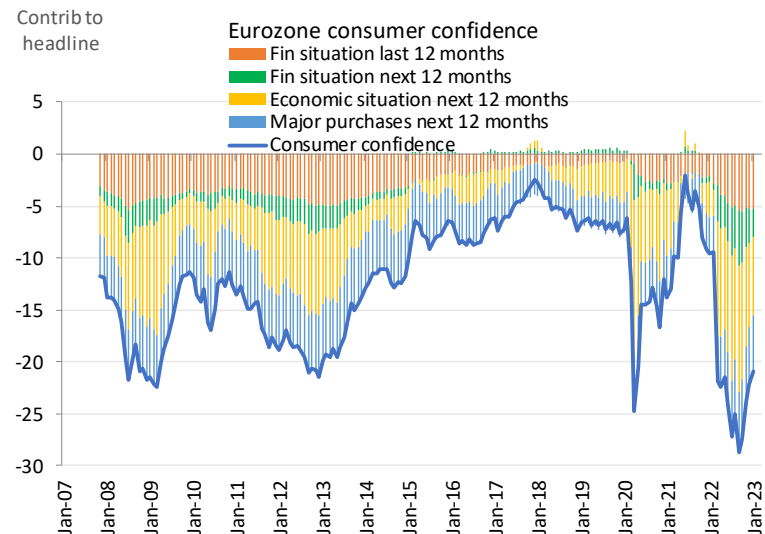
The “absence of catastrophe” consistent with stagnant economy

Nothing to write home about even if confidence has rebounded somewhat



Source: Refinitiv, AXA IM Research, February 2023

European consumers are less depressed, but still very depressed



Source: European Commission, AXA IM Research, February 2023

An old drama makes a return: the debt-ceiling showdown

Last minute solutions have always been found – but to avoid a default, a fiscal contraction may have to be on the cards

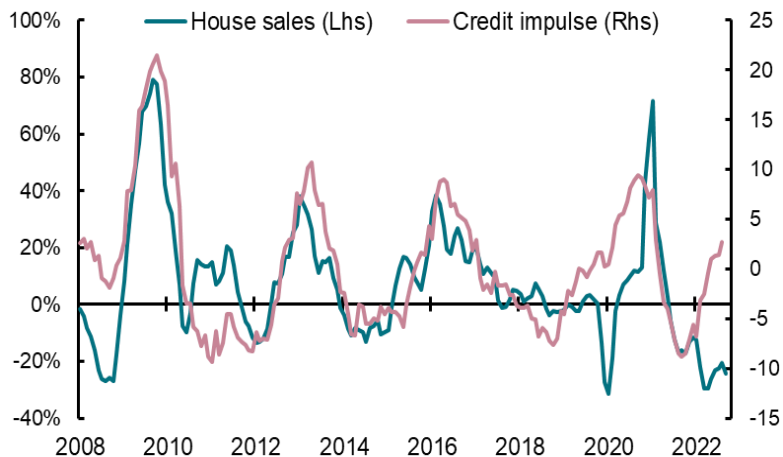
- “Extraordinary measures” now implemented to deal with the USD 31.4 trn debt ceiling (e.g. postponing payments into federal employees pension funds). This buys up to 6 months of wiggle room, but this remains uncertain (spending is predictable, unless unemployment shoots up, income depends on fairly volatile tax receipts).
- The 2011 crisis was ultimately resolved through a spending cut agreement with the Republicans. This is the Republicans’ goal this time, but Biden explicitly refuses to negotiate (for now). If no solution is found, the only alternative to a default is to divert tax receipts away from “ordinary spending” to prioritize the debt service, triggering a massive contraction in aggregate demand (as a proxy, the US federal government would be forced into a brutal adjustment towards a primary surplus).
- Some institutional “solutions” are being mooted (e.g. using the 14th amendment of the Constitution) but they are legally controversial.
- It’s in both parties’ interest to let the drama unfold until “the last minute”.

China and inflation (1)

There is a lot of slack in the Chinese economy – should keep manufactured goods prices tame globally

No response of the real estate sector to monetary stimulus so far

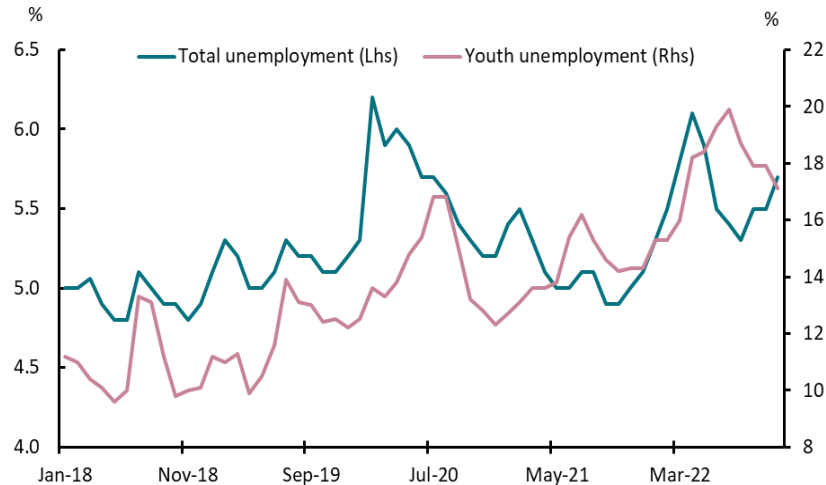
Credit impulse and house sales



Source: CEIC, AXA IM Research, January 2023

Unemployment is historically high

Total and youth unemployment rate



Source: CEIC, AXA IM Research, January 2023

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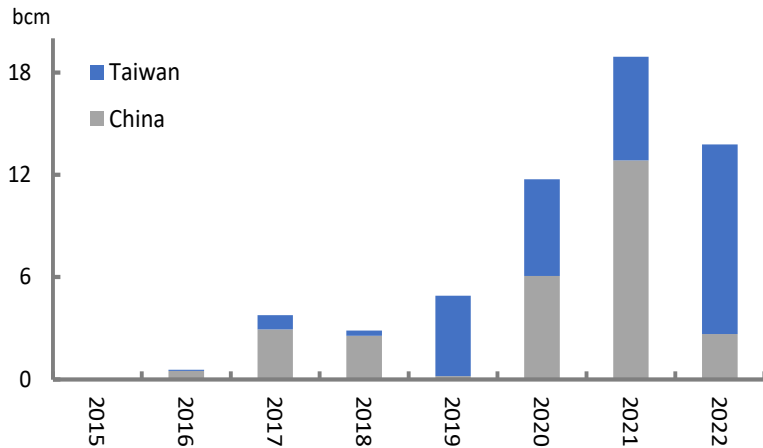
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China and inflation (2)

A race between Chinese demand for gas and US production capacity

6 bcm of LNG were freed by China + Taiwan in 2022

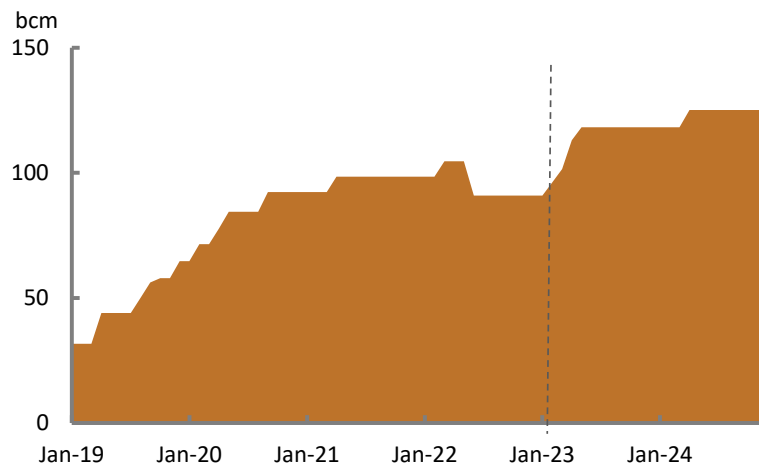
US LNG exports to China and Taiwan



Source: US EIA, AXA Research, February 2023

US production capacity projected to rise by c. 10 bcm

US LNG export annual capacity



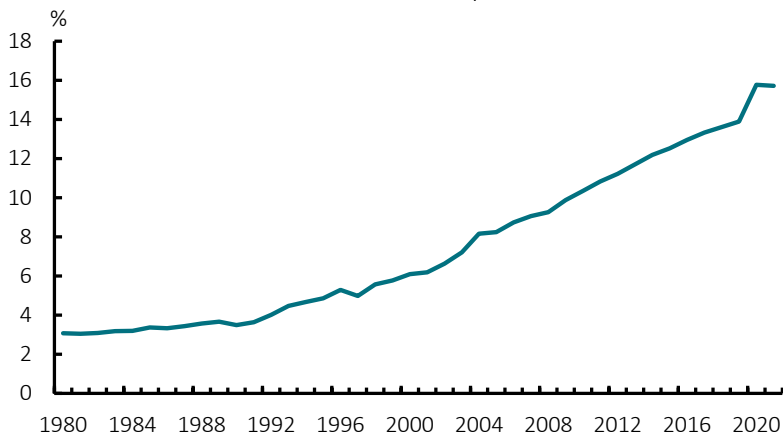
Source: EIA, AXA IM Research, January 2023

China and inflation (3)

China has become the world's "marginal consumer" of oil – this may be the key channel for a rebound of price pressure

China consumes 1/6th of the world's oil production

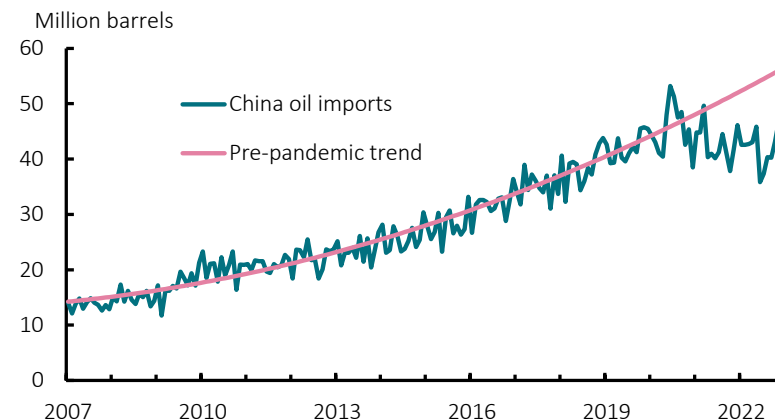
Share of China in total world oil consumption



Source: Energy Information Administration (EIA) and AXA IM Research, February 2023

A catch-up in Chinese oil demand would have a significant impact on the global market

Oil consumption in China



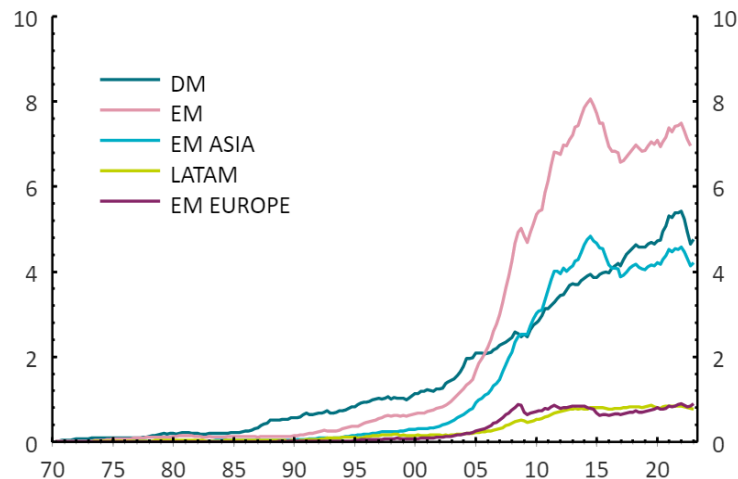
Source: Chinese customs and AXA IM Research, 14 February 2023

EM outside China: no “systemic risk” territory, but the monetary tightening will bite

Still a lot of reserves in aggregate – but watch Eastern Europe and Latam – but central banks in heavy lifting mode

Only small drawdown in historically huge FX reserves

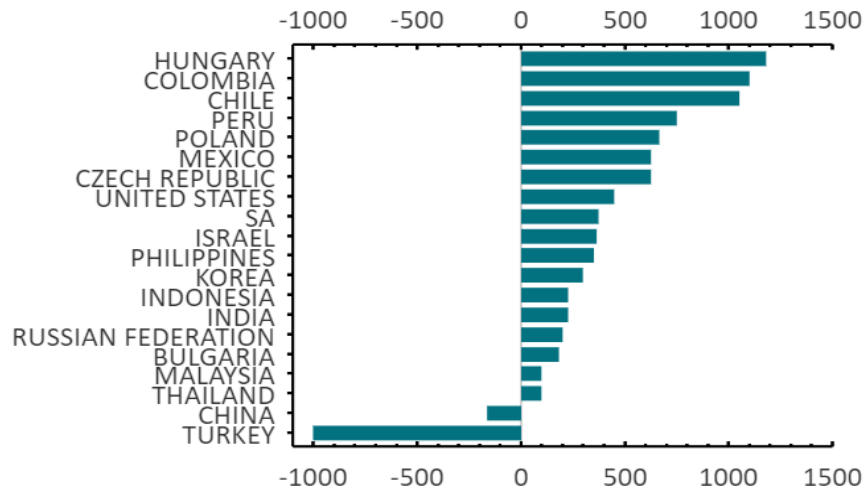
FX reserves ex gold (trn USD)



Source: Refinitiv Datastream and AXA IM Research Q4 22

Massive monetary tightening in general

Policy rates (change past 18 months, bps)



Source: Refinitiv Datastream and AXA IM Research Dec 22

Is a replication of the “1994 miracle” plausible ?

There was only one episode of Fed tightening which did not end up in a GDP contraction – and it was only 300 bps

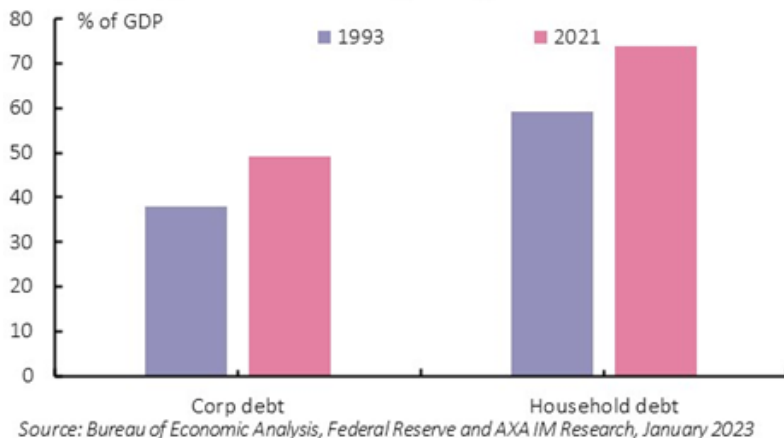
In 1994 the Fed set out to kill imaginary inflation

Debt was lower at the time

US macro indicators in the 1990s



US Leveraging position ahead of tightening

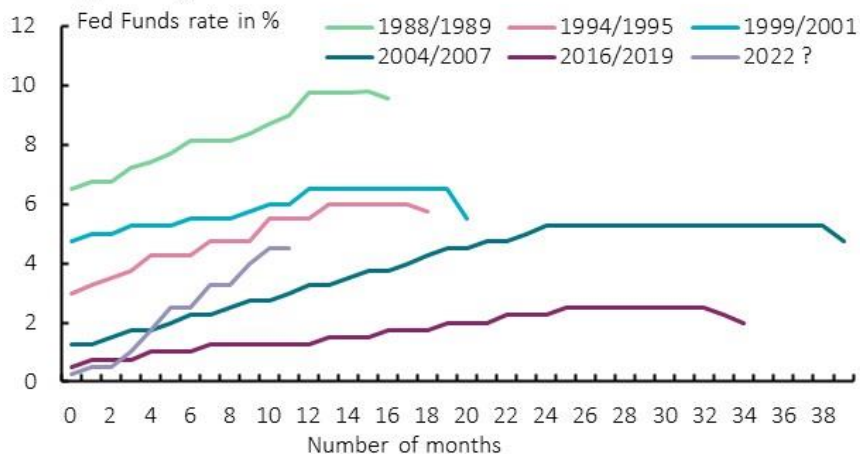


The risk of ignoring the lagged effect of monetary tightening

History tells us long delays can appear between CB hikes and a reaction of the real economy

It usually takes more than a year for the effect to show up...

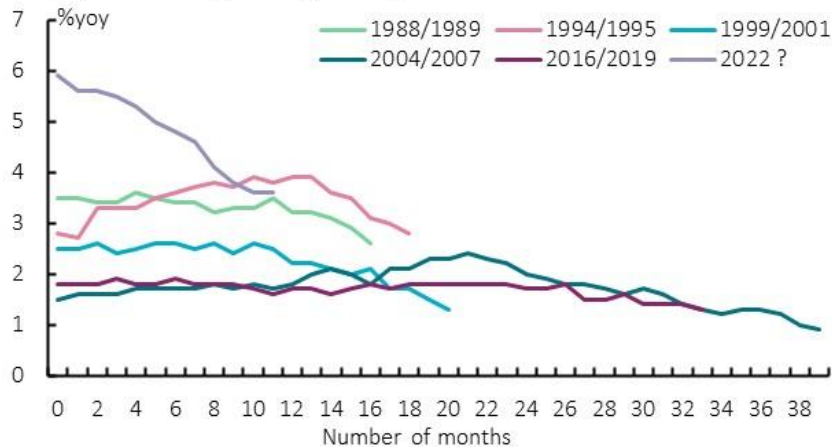
Fed tightening since the mid-1980s



Source: Federal Reserve and AXA IM Research, February 2023

... on the labour market

US payrolls during Fed tightenings



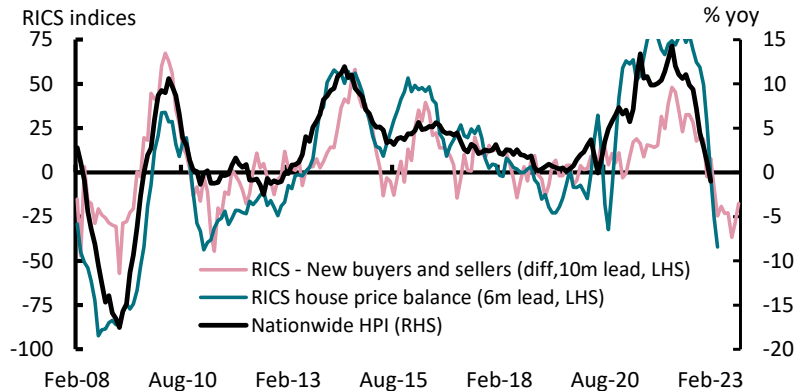
Source: Bureau of Labor Statistics and AXA IM Research, February 2023

Looking for canaries in the coalmine...

Where variable mortgage rates dominate and housing markets are stretched, pain ahead

UK house prices to fall

House prices and the RICS housing survey

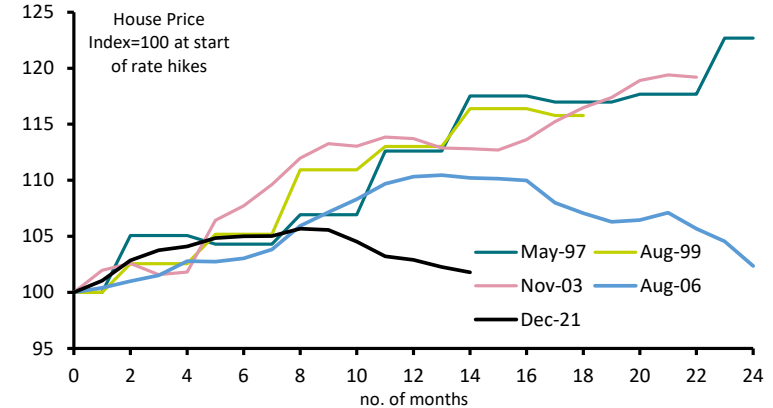


Source: RICS, Nationwide, AXA IM Research, March 2023

It's happening quickly by historical standards

Impacts of bank rate tightening cycles on house prices

Line starts at first rate hike and ends 12m after last rate hike in the cycle

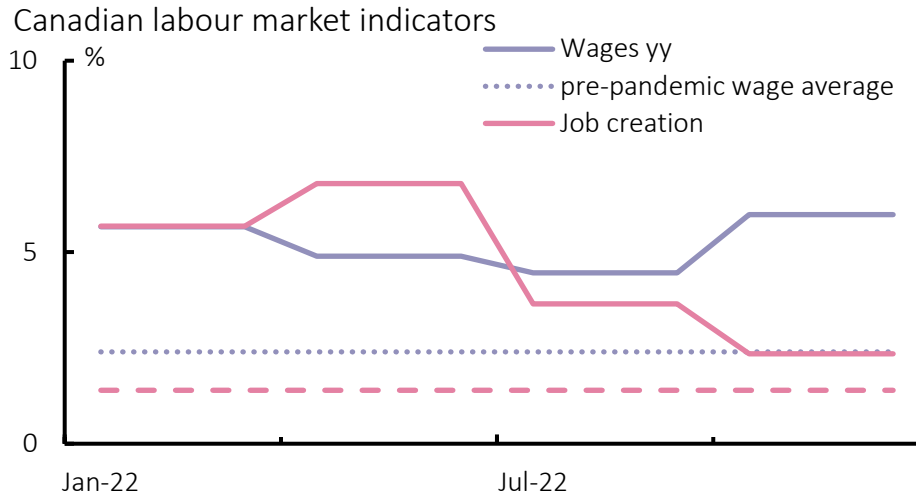


Source: Nationwide, ONS, BoE, AXA IM Research, March 2023

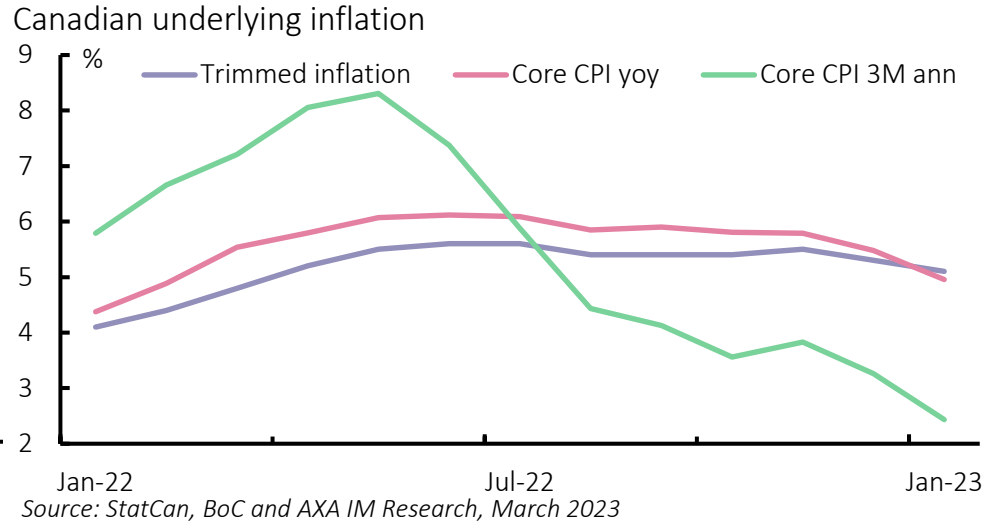
... and looking at dissenters

Canada is pausing => slower core inflation trumps still tight labour market

Still very strong wage growth



Core inflation being tamed

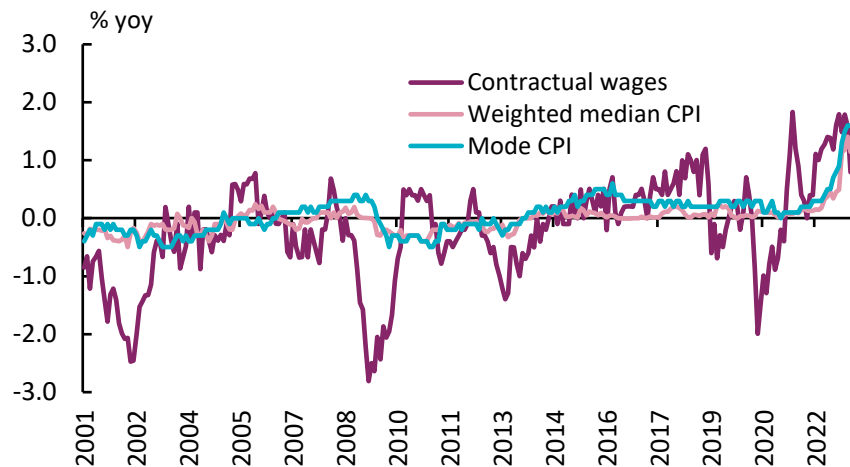


Japan: time for a policy change ...but beware of the transition risks

Inflation is back – but removing YCC too soon could be painful

Inflation ...waiting for confirmation from wages

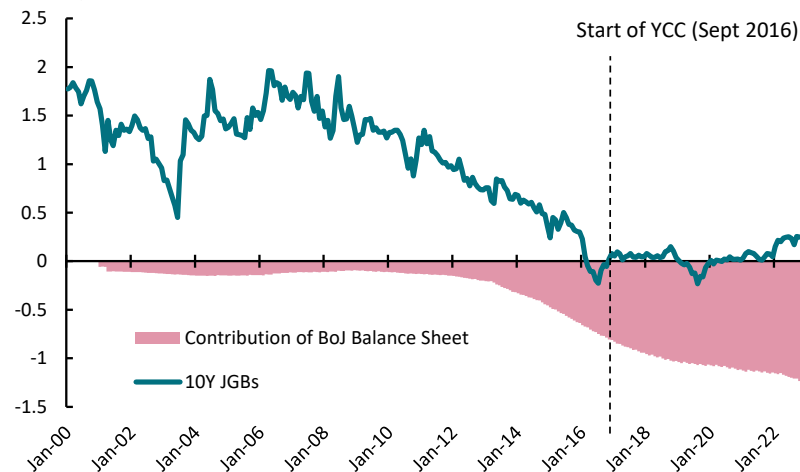
Underlying measures of inflation



Source: BOJ, AXA IM Research, March 2023

Backlash from the end of QE would be significant

JGB yields and BoJ Balance Sheet

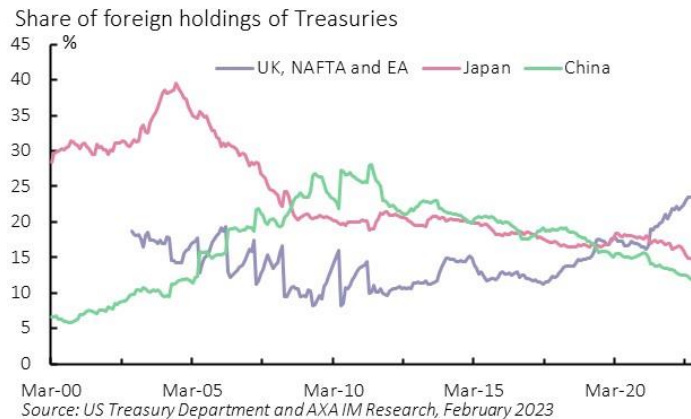


Source: Refinitiv, AXA IM Research, January 2023

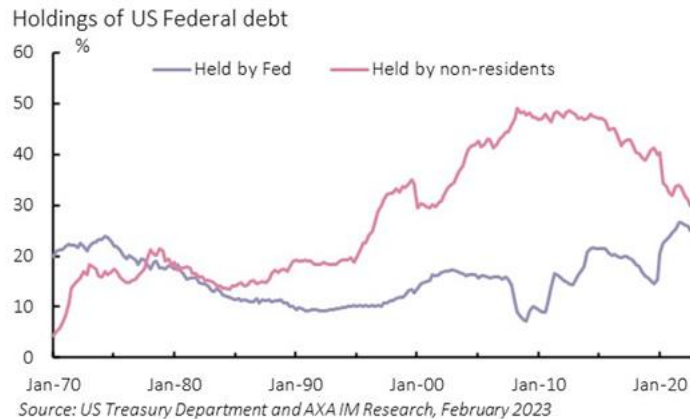
Knock on effect on US yields ?

Japanese investors have been reducing their exposure on treasuries - a question mark on the European market

Japan's holding share of US treasuries below that of Europe nowadays



Less reliance of US federal debt funding on non-residents

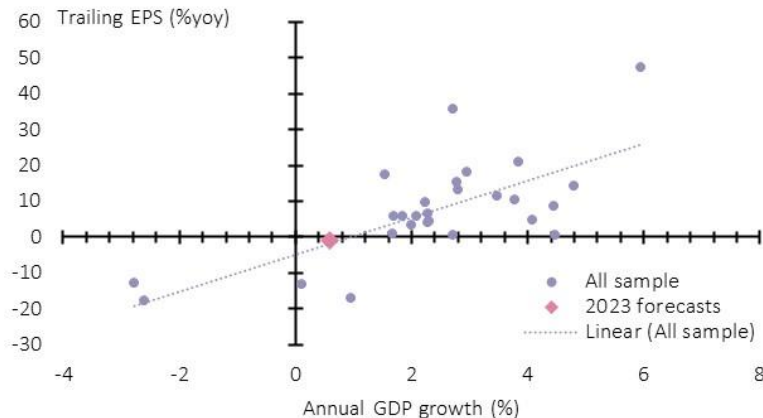


Focus on equity valuations (1)

Expected earnings have come down – in line with expectations of a near stagnant economy

Earnings expectations are not out of line with a “nearly stagnating” economy in 2023 in the US...

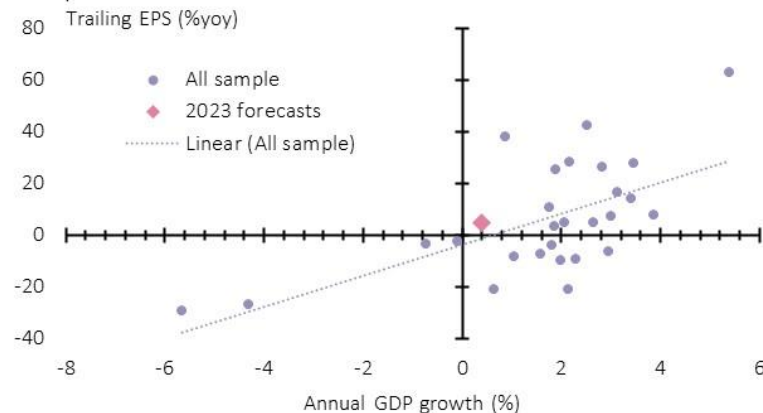
US - GDP Growth and EPS Growth



Source: IBES, BEA, Bloomberg and AXA IM Research, February 2023

... and in Europe

Europe - GDP Growth and EPS Growth

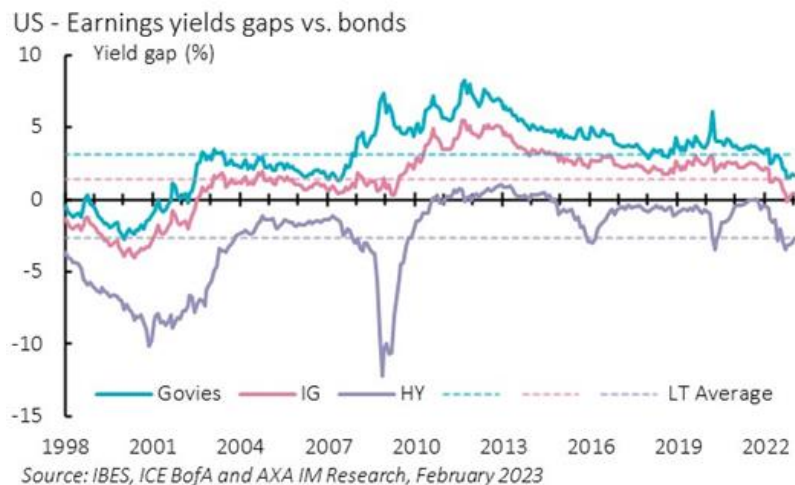


Source: IBES, Eurostat, Bloomberg and AXA IM Research, February 2023

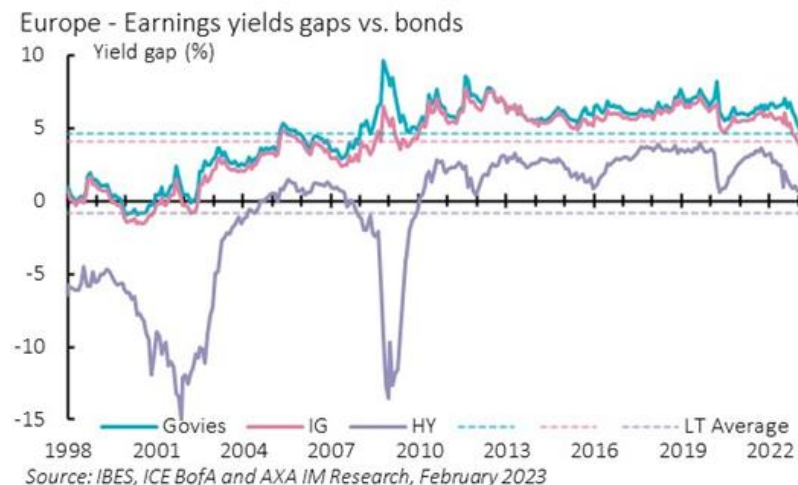
Focus on equity valuations (2)

When compared with low-risk yields in FI, US equity looks very expensive

US equity premium gone



Less problematic in Europe

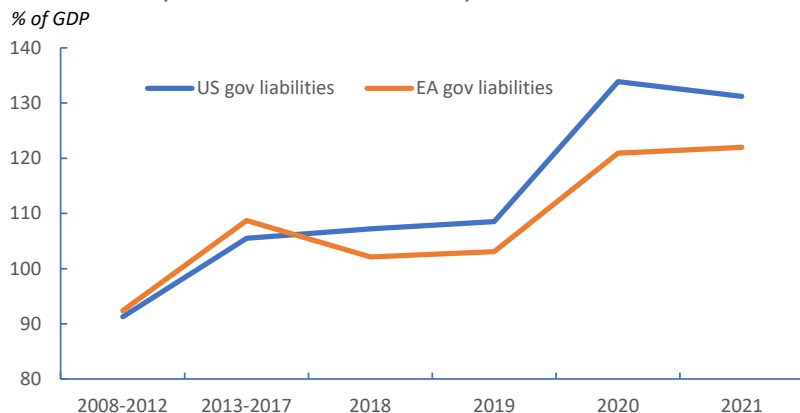


Medium term challenge #1 : narrower fiscal room for manoeuver

Public debt rose over the last 2 decades, but debt service fell. This is over.

Continuous rise in public debt

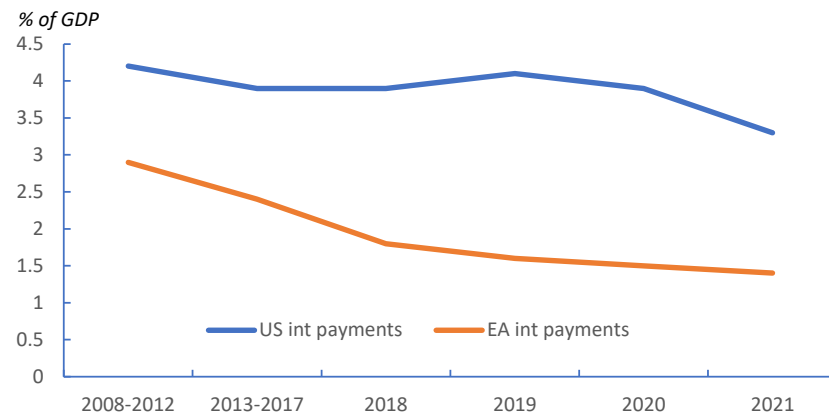
Public debt (broad OECD definition)



Source: OECD, AXA IM Research, May 2022

Continuous drop in debt servicing costs

Government interest payments



Source: European Commission, AXA IM Research, May 2022

Medium-term challenge #2 : « Greenflation »

The green transition may well trigger structural inflationary pressure

The significant rise in carbon price in the EU

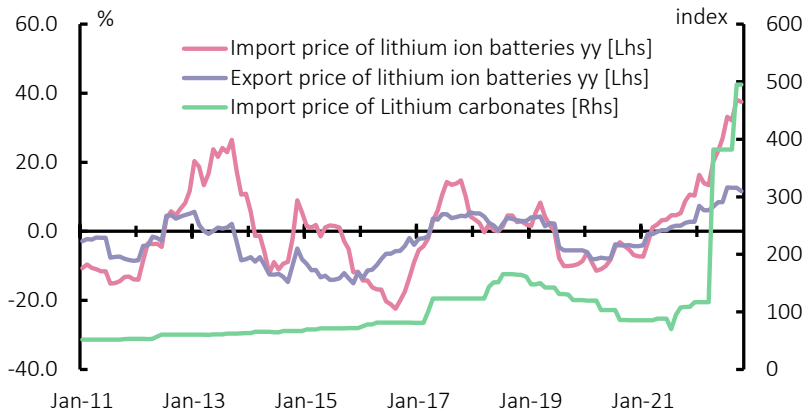
Carbon price



Source: Eikon Refinitiv and AXA IM Research, November 2022

Cleaner technologies are not necessarily cheaper

Lithium and lithium battery price in Japan



Source: Bank of Japan and AXA IM Research, November 2022

Medium-term challenge # 3 : « de-globalization »

It has already started in the financial sphere – trade deglobalization would collide with the disinflation objective though

China has stopped recycling its external surplus in US securities

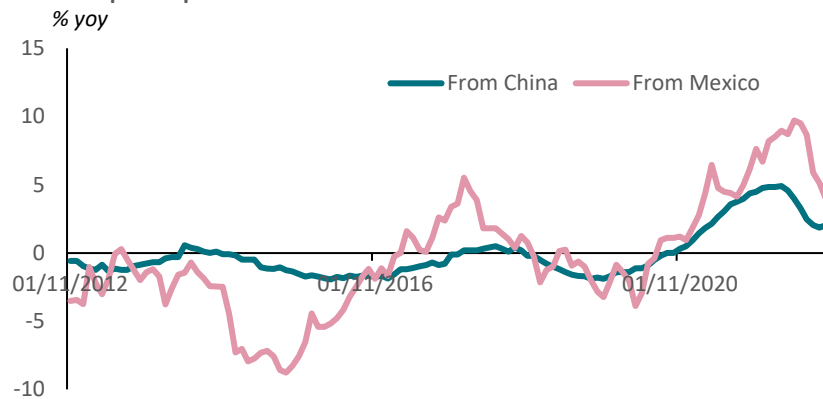
China continues to export disinflation to the rest of the world

The US/China bilateral relationship



Source: US Census, Fed, AXA IM Research, November 2022

US import prices



US department of commerce, AXA IM Research, November 2022

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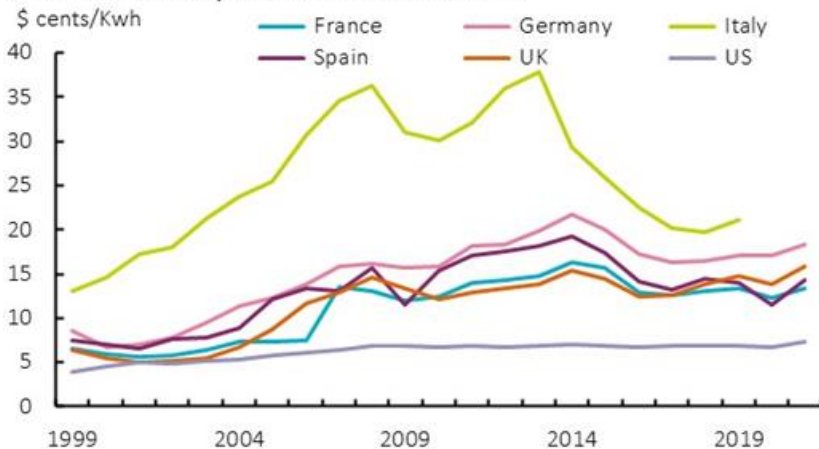
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Medium-term challenge # 4 : the US rising competitiveness vs Europe

Lower cost of energy will play in favour of the US in a context of industrial re-localization

Very low electricity prices in the US

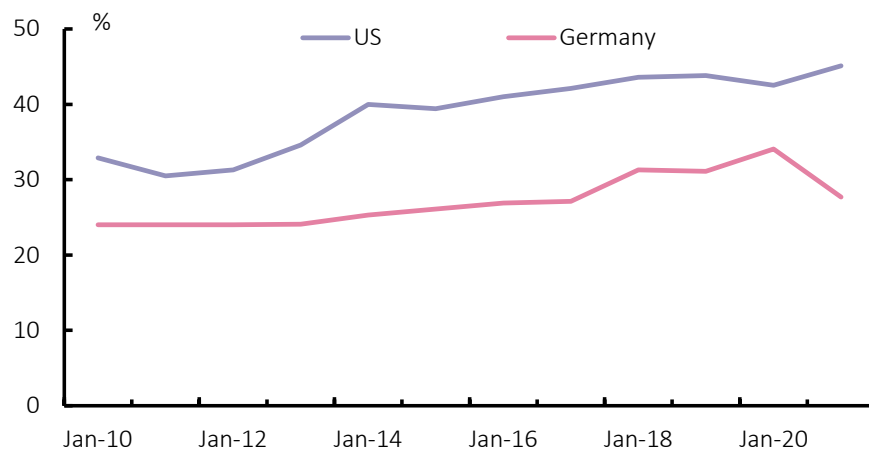
Price of electricity to industrial consumers



Source: UK Dpt for business and energy and AXA IM Research, November 2022

Even in renewables the US have an advantage

Onshore wind capacity factor



Source: IRENA and AXA IM Research, November 2022

Summary of forecasts

Real GDP growth (%)	2022*		2023*		2024*	
	AXA IM	Consensus	AXA IM	Consensus	AXA IM	Consensus
World	3.4		2.6		2.7	
Advanced economies	2.7		0.9		0.7	
US	2.1	1.9	0.7	0.3	0.3	1.1
Euro area	3.5	3.2	0.8	0.0	0.7	1.2
Germany	1.9	1.7	0.3	-0.5	0.8	1.4
France	2.6	2.5	0.6	0.2	0.8	1.2
Italy	3.9	3.7	0.6	0.0	0.4	1.1
Spain	5.5	4.5	1.1	0.9	0.9	2.0
Japan	1.6	1.5	1.7	1.2	1.3	1.1
UK	4.1	4.4	-0.7	-1.0	0.8	0.6
Switzerland	2.3	2.1	0.6	0.5	1.3	1.7
Canada	3.5	3.4	1.0	0.4	1.0	1.6
Emerging economies	3.9		3.6		3.8	
Asia	4.2		4.8		4.5	
China	3.0	3.1	5.0	4.6	4.8	5.3
South Korea	2.6	2.6	1.5	1.2	2.0	2.2
Rest of EM Asia	5.7		5.0		4.4	
LatAm	3.7		1.5		2.3	
Brazil	3.0	2.9	1.0	1.0	2.0	1.8
Mexico	2.2	2.9	1.0	1.1	2.0	1.8
EM Europe	1.2		0.0		2.2	
Russia	-3.0		-3.8		2.0	1.2
Poland	4.4	4.9	0.1	0.8	2.4	3.0
Turkey	5.9	5.1	0.5	2.2	1.4	2.4
Other EMs	4.8		3.0		3.4	

Source: Datastream, IMF and AXA IM Macro Research – As of 21 February 2023

*Forecast

CPI Inflation (%)	2022*		2023*		2024*	
	AXA IM	Consensus	AXA IM	Consensus	AXA IM	Consensus
Advanced economies	7.3		4.7		2.7	
US	8.0	8.1	4.3	3.8	3.0	2.5
Euro area	8.3	8.5	5.7	5.9	2.8	2.4
China	2.1	2.1	2.3	2.3	2.5	2.3
Japan	2.5	2.4	2.7	1.9	1.5	1.2
UK	9.1	9.0	6.4	7.2	2.3	3.1
Switzerland	2.8	2.9	2.0	2.2	1.3	1.2
Canada	6.8	6.8	4.3	3.7	2.4	2.2

Source: Datastream, IMF and AXA IM Macro Research – As of 21 February 2023

*Forecast

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