

# Monthly Op-ed

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## Dollar reigns supreme

### Key points

- The Fed needs to see a softening of the labour market and will hike until it sees one.
- The Fed's hawkishness has some contagion effects on Europe, but the ECB is finding more and more reasons to underpin its own "big" and "fast" hikes.
- US\$ strength reflects the better position of US economy, cyclically and structurally.
- Vicious circle of inflation, rate hikes and weaker currencies threaten Europe
- Cheap UK and European equity markets may eventually contribute to new inflows

### Central banks on the warpath

In early August, the market was still expecting a "dovish pivot" by the Federal Reserve (Fed). The central bank is actually pursuing the opposite course. Given the noise around a 100-basis point (bp) hike, delivering 75bps last week with a unanimous Federal Open Market Committee (FOMC) might be counted as relief, but that's only testament to how far the goalposts have moved on monetary policy. The Fed is signalling very clearly that it still has far more to do to get the Fed Funds to where it thinks they need to be. The Fed now indicates via its "dot plot" that it expects to raise its policy rate to 4.6% in 2023 against a previous peak – in the June batch – at 3.8%. Much of that is supposed to come fast. There will be quite some effort to make in the remaining two meetings of 2022, with more than 100 bps between the new Fed Funds rate and the 4.4% by year-end suggested by the "dot plot". With the succession of "jumbo" hikes we knew that gradualism was gone, and even getting squarely into restrictive territory – which in principle should make them more prudent – does not seem to change the Fed's narrative much. The Fed wants to see a softening of the labour market, and we see as a logical corollary the idea that it will likely continue hiking until it sees one.

The crucial issue is thus the timing of such a deterioration. While the very recent dataflow has often surprised on the upside – especially when it comes to labour market developments – we expect a significant deterioration in Q4 – in no small part because of the impact of the tightening in financial conditions, which have hit their most restrictive levels since the Great Financial Crisis of 2008-2009 on some measures. Accordingly, we expect the Fed to revert to 50 bps hikes in both November and December, but contrary to what the market is pricing now – and below the Fed's dot plot – we see this 4.25% reached at the end of the year as the peak rate. However, we are reserved on the chances to see the Fed cut rates in 2023 already from this level (again in contrast with the market, but in the opposite direction). While it's difficult for any central bank to keep on hiking in the midst of a confirmed

recession, it will be equally difficult for the Fed to lower its guard if inflation is still above 3%, which is unfortunately likely to be the case through 2023 despite the deterioration in economic conditions, given the “stickiness” of a lot of the current price pressure.

The anticipated trajectory for the European Central Bank (ECB) spiked again after the Fed’s hawkish signals. It may well be that market participants have increased the weight of exchange rate considerations in their understanding of the ECB’s reaction function and consider that any upgrade in the Fed’s trajectory needs to be matched by its European counterpart to protect the currency and curb imported inflation. But to be fair, the ECB-speak has given plenty of ammunition since the last Governing Council meeting for the market to expect even more aggressive monetary policy in Europe. Christine Lagarde in a speech on 20 September has re-stated the point she had made in Sintra that the central bank would be inclined to treat a persistent energy shock as a permanent negative shock to supply which would logically demand more robust action on demand to control inflationary pressure. We add that since the first part of her speech was dedicated to showing the energy shock would have more lasting consequences than previous ones, there is little doubt the ECB has already reached that conclusion. The ECB President also expressed her doubts as to the capacity of the looming recession – still not their baseline – to significantly dampen inflation, since the root of such a recession would lie in the supply side. Finally, her discussion of the fiscal response to the energy crisis came with an element of warning on the capacity of such action to add further to inflationary pressure.

The accumulation of oversized hikes creates the impression of a “race to the peak” across central banks, with the potential to end up with an excessive quantum of tightening, as each central bank fails to take into consideration the impact on global slack of what the others are doing. This would not be borne out of “benign neglect”, but out of a perceived necessity to minimize rate differentials to defend the currency and hence avoid imported inflation.

## Currency markets vote for the dollar

It is tempting to think that what happens in currency markets is reflective of the collective view of investors on the macro-economic position in a particular country or region. Now, markets are voting that the United States is in the best position of the major economies. The dollar is at multi-year highs against the euro, the Japanese yen and sterling. A review of factors driving the dollar suggests that this situation is unlikely to reverse in the foreseeable future.

## Varying degrees of policy uncertainty

All major economies are beset with policy uncertainty as investors try to assess how long it will take to declare that the fight against inflation is being won and that broader policies are able to provide some offset to the ongoing energy crisis and the risks of recession. In recent weeks, markets have moved into a new phase with the acceptance of the need to squeeze demand to rebalance with the supply shocks that have hit the global economy in the last three years. That means more monetary tightening than expected and weaker growth. Overall bond, credit and equity returns are at risk of remaining negative until this phase is over. We have for some time warned that macro trends are negative for both bonds and equities. While valuations in some markets are looking better from a long-term point of view, the current cyclical forces driving rates higher and earnings expectations lower are dominating price action.

The US is not immune to all of this with the Fed recently raising the stakes in its attempt to break the back of core inflation. Yet bearish developments in US markets have evolved alongside a stronger dollar. The dollar tends to do better in a risk-off environment and, in relative terms, a stronger economy and less sensitivity to negative energy market developments are also boosting demand for the dollar. While difficult to measure objectively, markets do seem to attach greater credibility to the Federal Reserve than to other central banks. A strong US labour market and robust corporate and household balance sheets in the US are reflected in the dominance of the dollar now.

This contrasts with the situation in the Euro Area, in the United Kingdom and, to some extent, in Japan. Europe’s outlook remains sensitive to the energy situation and the ongoing need to diversify away from Russian energy sources. The potential for output and consumption disruptions this winter remains real even with some suggestion that Ukrainian forces are gaining the upper hand in the conflict. Economic data has revealed the deterioration in European growth in recent weeks. At the same time, the European Central Bank’s policy direction is being driven by the hawks on the Governing Council. After keeping policy too accommodative for too long, the risk is now overkill on the upside for rates. Markets are pricing a policy rate of 3%. Downside risks to growth are hitting the external value of the euro, with the currency recently falling below parity against the dollar for the first time since its

infancy as a currency over twenty years ago. The outlook for inflation in the euro area is not helped by further currency weakness, and a vicious circle loom if the ECB factors this more centrally into its fight against elevated inflationary expectations.

## **Sterling crisis reflects fiscal gambles**

The outlook for the United Kingdom's pound is arguably worse, although it has already fallen to a record low against the dollar. The government's recent fiscal announcements have been interpreted as contributing to worsening trends on public finances, the external balance of the UK and domestic income inequalities. The huge net fiscal boost coming from tax cuts might push the Bank of England to raise rates more than would otherwise be the case. There is also political uncertainty which is impacting on the pound as the radical nature of the fiscal package could undermine the new prime minister's position within the ruling Conservative Party and that party's electoral chances. A typical inflation/sterling crisis tends to impact on domestic demand through higher rates undercutting the property market and then broader consumer spending. The household goods and homebuilders index within the UK equity market is down over 40% year-to-date. Bad news is in the price, but it could get worse.

Currencies tend to overshoot. It is likely that we will see current moves extended before there is any reversal in overall dollar strength and negative sentiment towards sterling and the euro. The Bank of Japan recently intervened in the foreign exchange markets to defend the value of the yen in the wake of the recent round of rate increases in the US and Europe. If there is no willingness to allow domestic interest rates or bond yields to rise, yen weakness is likely to prevail.

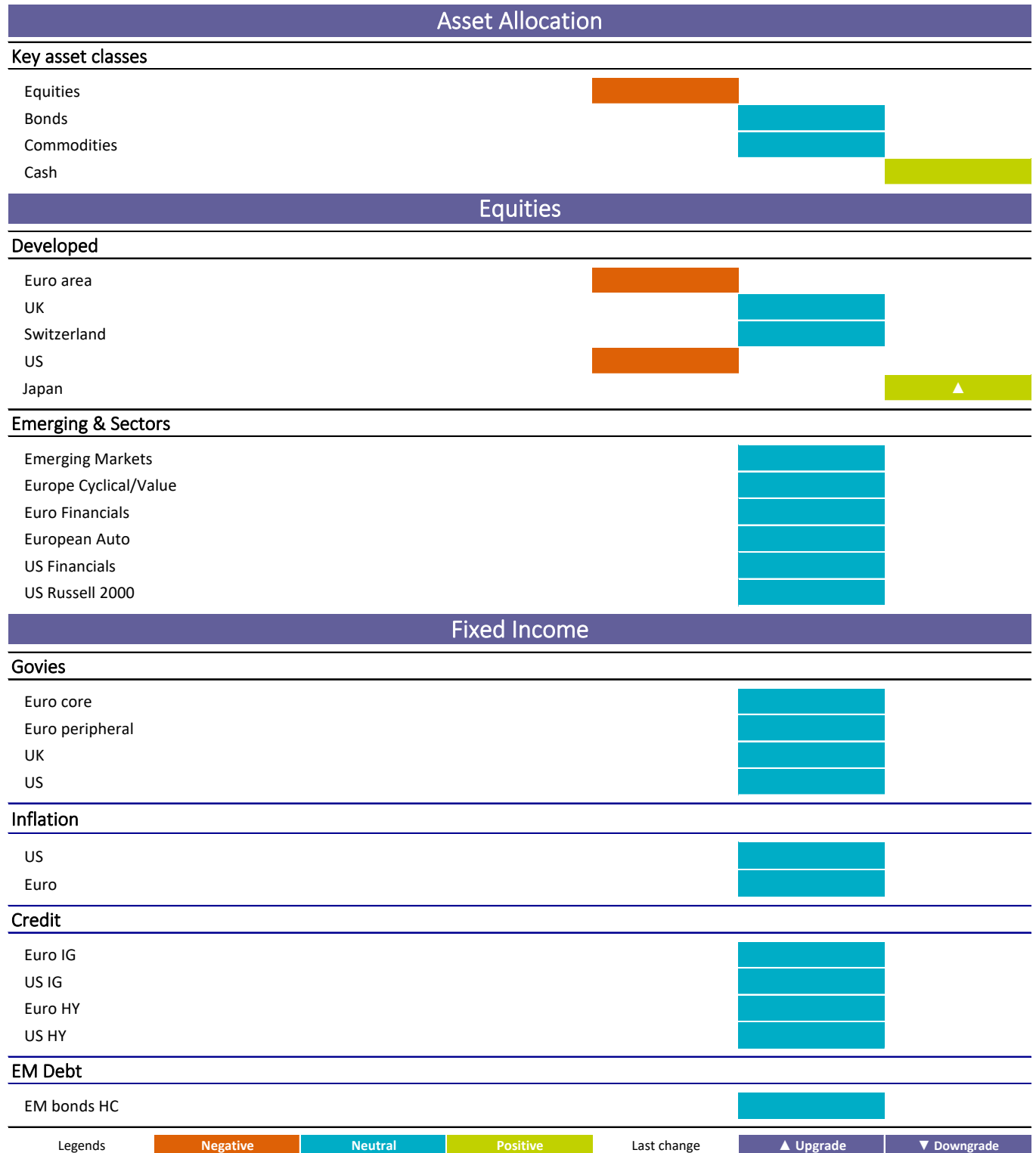
The broader market implications of these currency moves are not straightforward. Currently, risk-off sentiment and defensive flows dominate. However, at some point relative valuations will play a part. Both UK and European equity valuations are at a significant discount to the US market. Factoring in currency moves make them cheaper still. The UK has already seen significant amount of merger and acquisitions activity amongst UK firms that have US dollar earnings. As yields rise on European assets and currencies cheapen, flows should turn positive eventually.

For that to happen we are likely to need some break in the duration of policy. The Fed will need to signal a pause to its hiking cycle once there are signs of inflation starting to weaken. This could reduce the attraction of the dollar at the margin, particularly considering how far it has moved in recent weeks and what that implies about market positioning.

One thing that appears unlikely now is co-ordinated international action to push the dollar down. There is no Plaza Accord redux on the horizon. Global political focus is dominated by Russia, US-China relations, and climate change. Exchange rate misalignments are not very high up the agenda.

**[Download the full slide deck of our September Investment Strategy](#)**

## Recommended asset allocation



Source: AXA IM Macro Research – As of 28 September 2022

## Macro forecast summary

Real GDP growth (%)	2021	2022*		2023*	
		AXA IM	Consensus	AXA IM	Consensus
<b>World</b>	<b>6.1</b>	<b>3.1</b>		<b>2.4</b>	
<b>Advanced economies</b>	<b>5.1</b>	<b>2.2</b>		<b>0.1</b>	
US	5.5	1.4	1.7	-0.4	0.7
Euro area	5.2	3.0	2.8	-0.5	0.9
Germany	2.6	1.3	1.5	-1.5	0.7
France	6.8	2.4	2.4	0.0	1.2
Italy	6.6	3.3	3.0	-0.6	1.1
Spain	5.1	4.7	4.3	0.6	2.3
Japan	1.7	1.5	1.4	1.7	1.6
UK	7.2	3.4	3.4	-0.2	0.1
Switzerland	3.5	2.3	2.5	0.6	1.2
Canada	4.4	3.3	3.5	0.7	1.5
<b>Emerging economies</b>	<b>6.7</b>	<b>3.6</b>		<b>3.9</b>	
<b>Asia</b>	<b>7.0</b>	<b>4.4</b>		<b>5.1</b>	
China	8.1	3.6	3.7	5.2	5.4
South Korea	4.1	2.3	2.6	2.0	1.9
Rest of EM Asia	6.1	5.6		5.2	
<b>LatAm</b>	<b>6.8</b>	<b>2.8</b>		<b>2.0</b>	
Brazil	4.6	1.5	1.8	1.0	0.8
Mexico	4.8	1.7	1.9	1.3	1.6
<b>EM Europe</b>	<b>6.7</b>	<b>-0.7</b>		<b>-0.2</b>	
Russia	4.7	-6.0		-3.5	
Poland	6.0	4.8	4.8	0.9	2.3
Turkey	11.5	5.6	3.7	1.5	2.3
<b>Other EMs</b>	<b>5.4</b>	<b>4.2</b>		<b>3.7</b>	

Source: Datastream, IMF and AXA IM Macro Research – As of 27 September 2022

CPI Inflation (%)	2021	2022*		2023*	
		AXA IM	Consensus	AXA IM	Consensus
<b>Advanced economies</b>	<b>3.2</b>	<b>7.2</b>		<b>4.7</b>	
US	4.7	8.2	8.1	5.2	3.8
Euro area	2.6	8.1	7.8	5.5	4.1
China	0.9	2.1	2.4	2.3	2.5
Japan	-0.2	2.3	2.0	1.3	1.4
UK	2.6	9.0	8.6	5.6	5.6
Switzerland	0.5	2.8	2.7	2.0	1.6
Canada	3.4	6.8	7.0	4.3	3.5

Source: Datastream, IMF and AXA IM Macro Research – As of 27 September 2022

These projections are not necessarily reliable indicators of future results

## Forecast summary

Central bank policy		Meeting dates and expected changes (Rates in bp / QE in bn)				
		Current	Q3-22	Q4-22	Q1-23	Q2-23
United States - Fed	Dates	1.50-1.75	26-27 July	1-2 Nov	31-1 Jan/Feb	2-3 May
	Rates		20-21 Sep	13-14 Dec	21-22 Mar	13-14 Jun
			+1.5 (3.00-3.25)	+1.0 (4.00-4.25)	unch (4.00-4.25)	unch (4.00-4.25)
Euro area - ECB	Dates	-0.50	21 July	27 Oct	2 Feb	4 May
	Rates		8 Sep	15 Dec	16 Mar	15 Jun
			+1.5 (0.75)	+1.0 (1.75)	0.25 (2.00)	unch (2.00)
Japan - BoJ	Dates	-0.10	20-21 July	27-28 Oct	Jan	May
	Rates		21-22 Sep	19-20 Dec	Mar	Jun
			unch (-0.10)	unch (-0.10)	unch (-0.10)	unch (-0.10)
UK - BoE	Dates	1.00	4 Aug	3 Nov	Feb	May
	Rates		15 Sep	15 Dec	Mar	Jun
			+1.00 (2.25)	+1.25 (3.50)	+0.5 (4.00)	unch (2.50)

Source: AXA IM Macro Research - As of 27 September 2022

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