The Vs to shape recovery – Vaccine vs Virus

Monthly Investment Strategy

AXA IM Research

January 2021

In 2021, it was a very good year ..

Theme of the month: Vaccine vs Virus

- The careful balance of country restrictions and virus spread has been disrupted with new, more contagious variants. This has contributed to a rise in new cases in early 2021 and the need for even tighter restrictions. Increased restrictions across Europe have led us to lower our Q1 GDP forecasts.
- Developed countries are undertaking mass vaccination programmes. These are huge logistical exercises, subject to significant delay risks. When 'herd immunity' can be reached remains uncertain. We estimate the US reaching this by around mid-year, while Europe is likely to take into Q3.
- A vaccine rebound could occur more quickly. But the scope for major deviation from our central projections appears skewed to a more protracted recovery and slower economic rebound.

Macro update: Short-term downgrades, ongoing policy support, vaccine recovery ahead

- The resurgence of the virus in different regions has added to downside growth risks in the near-term, including in China where a new outbreak appears to be dampening Lunar New Year plans. We forecast contraction in Q1 GDP in the Eurozone, UK and US.
- Policy support remains in place. Central banks continue to tilt towards maximum accommodation with ECB, BoJ and BoE all reviewing policies to various degrees. Government stimulus also remains in place, explicitly with extended support programs, or as in the US and Japan with additional stimulus proposals spelt out.
- A sharp pick-up in growth is still expected as the vaccine program ramps up, with strong rebounds expected in Q2 across the globe. But full recovery is likely still some way in the future.
- China remains best placed to achieve a full recovery before others. Other EMs have benefited from a risk associated return of portfolio flows.

Investment strategy: reflation trade still in train even if buffeted by the Vaccine vs Virus struggle

- FX: Most of the USD depreciation fundamentals remain in place. Yet if Democrats action a larger fiscal stimulus, US growth could outperform other developed economies and relative growth prospects could drive currencies as a proxy for monetary policy reduction ahead.
- Rates: Chair Powell's attempt to calm down tapering whispers hasn't gone unappreciated by investors. Today's market backdrop differs to the 2013 taper tantrum: term premia continue to hover near all-time lows and Fed's average inflation strategy provides headwinds against quick policy normalisation.
- Credit: The reflation trade has propelled HY performance ahead of IG YtD. Our base case scenario for a stronger economic rebound into the second half of 2021 should see HY outperformance persist. A further tailwind for HY is that the default cycle appears to be rolling over.
- Equity: started the year on a positive note with global benchmark up 3.8%. Small and mid-caps have outperformed and emerging markets too across regions. Volatility remains elevated compared to historic norms. Q4 earnings are encouraging with positive sales/earning surprises in US and Eurozone.

Central scenario

Summary – Key messages

Monetary policy

Monetary policy will remain key policy support. Developed economies to see asset purchases throughout 2021 with no tapering until 2022

Inflation

Energy base effects to lift annual rates in 2021. Spare capacity to keep inflation below central bank targets in 2022, barring currency depreciation

Fiscal policy

Fiscal support extended in most jurisdictions. Europe rolls out support slowly, in US Biden proposes large $1.9trn boost.

Growth

Virus slowing growth again near-term, rebound later in 2021 from vaccine boost. 2022 more likely time of recovery.

Our central scenario:

A rebound from pandemic fuels 2021, but recovery will take time

We forecast global growth to rise by 5.2% in 2021 and 4.0% 2022.

Economic rebound to reflect vaccine, but will have to overcome labour market and indebtedness headwinds. Monetary policy to support.

Emerging Markets

EM's may receive direct vaccine boost more slowly than DM's. Export economies to benefit. Less policy space for most

Rates

Asset purchases by central banks should offset pressures from massive fiscal policy expansion, keeping yields in a range

FX

A number of factors suggest broader USD sell-off, but large fiscal boost to support. Strong vaccine delivery could support currencies, inc GBP.

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 20%)*

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, a new depression threatens, 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 20%)*

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

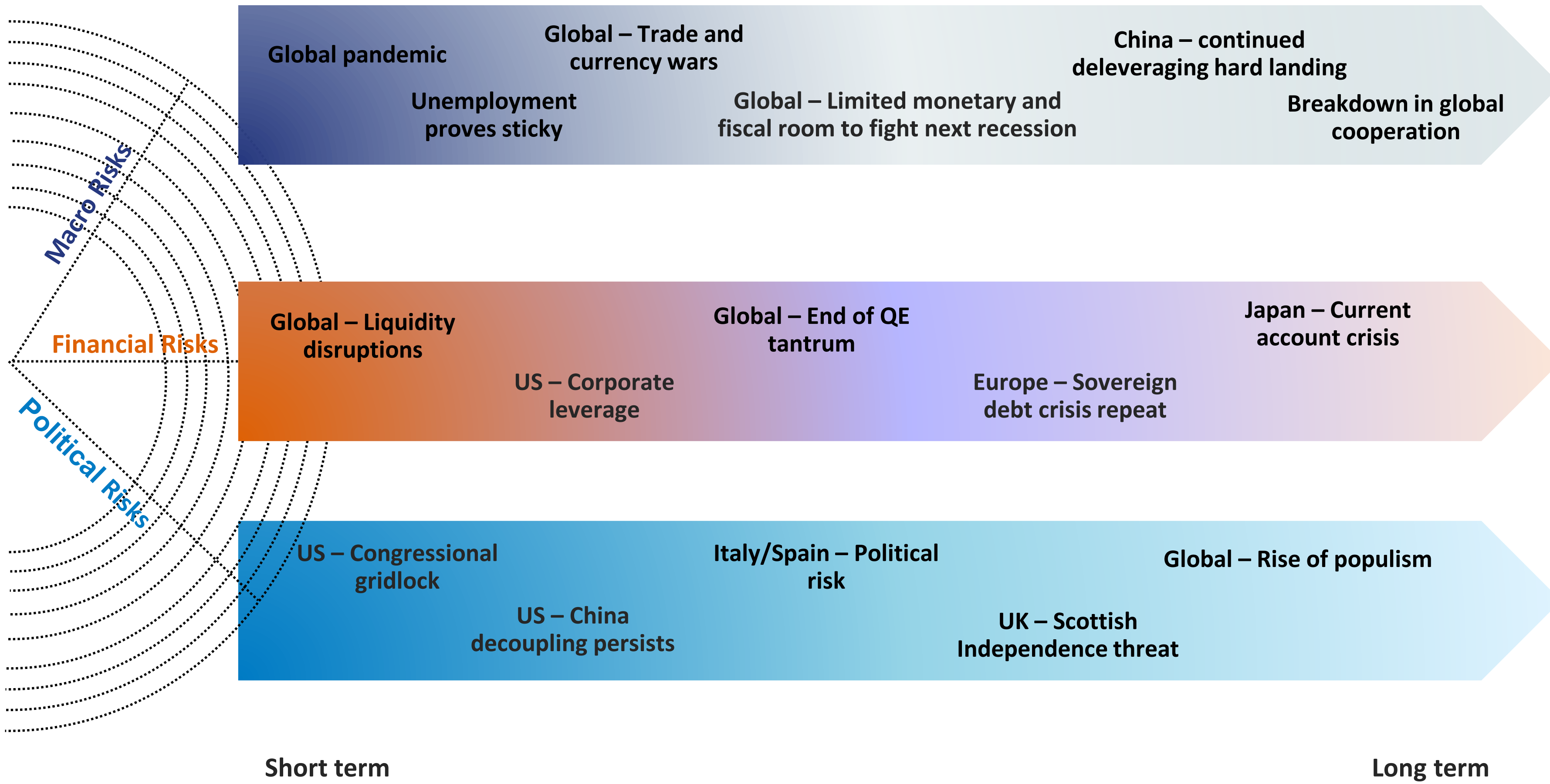
- Global/US/EMU growth surprise on the upside in a stronger and more persistent rebound after 2020
- Monetary policy fights expectations for swift tightening through forward-guidance

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



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Theme of the Month

New Year, new variant

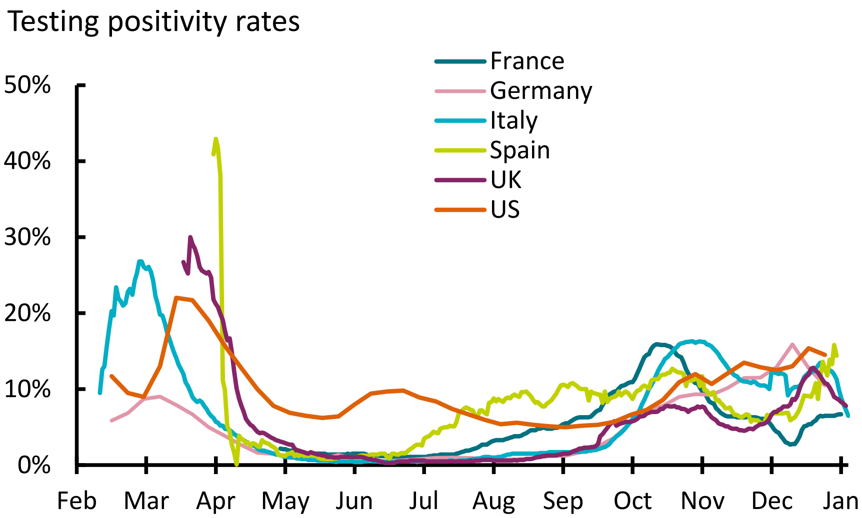
Cases rise sharply at start of 2021

- Despite the fact that much of Europe had enacted a further lockdown throughout Q4 and US restrictions increased materially after the election, the number of new cases failed to fall and in several cases rose sharply in the early days of January. In part this may have reflected planned or unplanned easing of restrictions over the Christmas period. But it likely also reflects the spread of more contagious variants.

New variants, more contagious

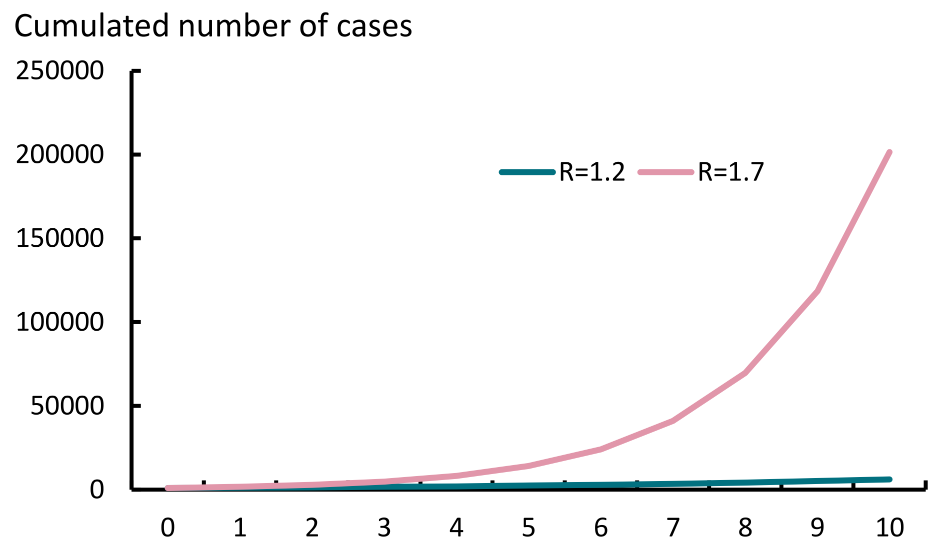
- Early evidence of the South African and UK variants do not suggest the virus is any more deadly. However, both appear more contagious. Imperial College has estimated the virus' reproduction rate is increased by 0.4-0.9 in the new UK variant. This quickly accumulates to substantially more cases. It has also meant that lockdowns gauged to contain the original strain have proven insufficient to contain the new strain. Hence the proliferation in South England to become the dominant strain, despite lockdown.

Positivity rates rising into end-2020



Source: National Public Health Agency, Robert Koch Institut, Presidency of the Council of Ministers, Department of health and Social Care and Public Health England, Department of Health & Human Services and AXA IM Research, January 2021

Higher contagion can greatly increase the number of cases



Source: AXA IM Research, January 2021

AXA Investment Managers

Theme of the Month

The risk of being overrun

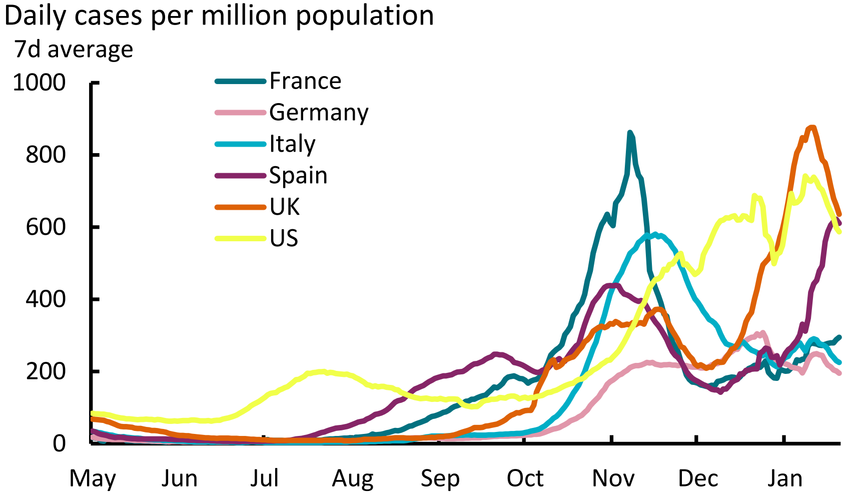
New cases rise sharply

- The impact of the more contagious new variant is clear in the UK. Yet the new variant is also present in the US, Japan and Europe. The sharp increase in new cases in the UK has now turned in response to a renewed national lockdown. The sharp rise in Spain continues, while France has also seen a pick-up in new cases leading to further restrictions. It remains to be seen how the balance of vaccine, new variant and restrictions plays out in the US, where cases have fallen back for now, but restrictions are easing.

Where cases rise

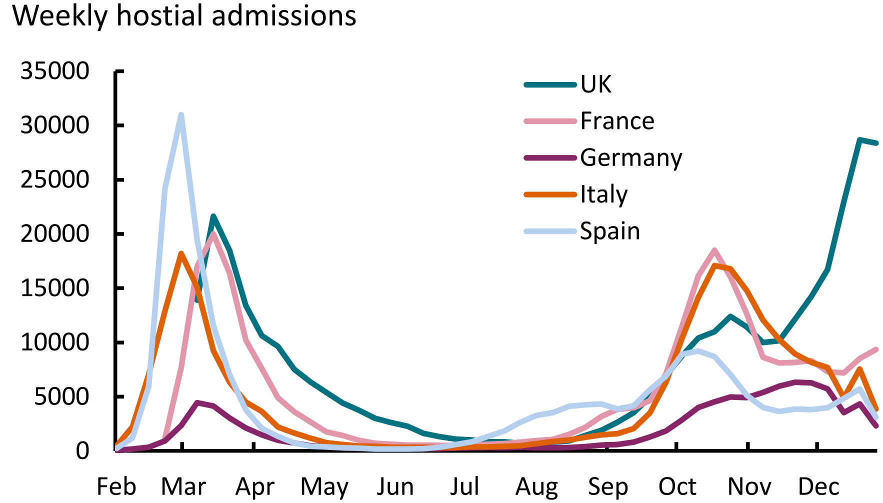
- Inevitably, the increase in new cases has pushed hospitalizations materially higher, with most ICU wards in the UK running close to if not at capacity. An increased death rate will follow from higher hospitalizations.

New cases are rising in part reflecting increased contagiousness



Source: WHO, USA Facts, Worldometer and AXA IM Research, January 2021

Hospital admissions have followed new case increases in the UK



Source: ECDC, UK Government, and AXA IM Research, January 2021

Investment Managers

Theme of the month

Increased restrictions

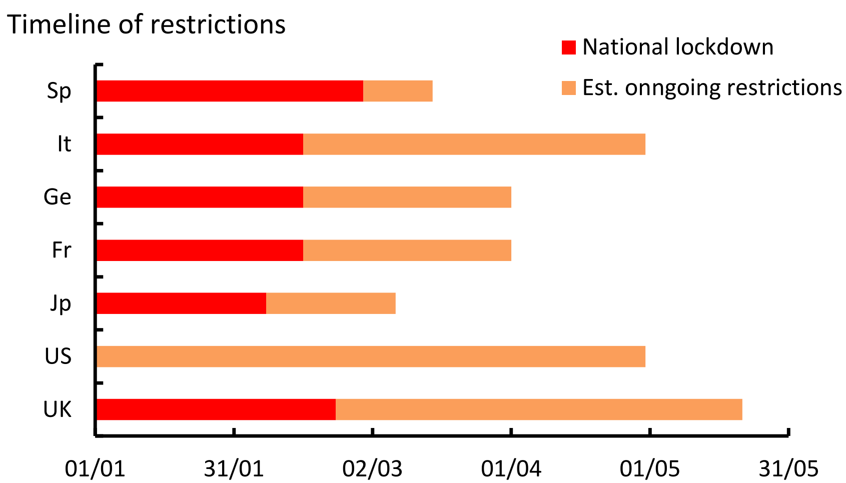
Governments react by tightening restrictions

- In the light of a sharply deteriorating public health backdrop, governments have been forced to respond by extending or deepening restrictions to control the virus. Extensions have been explicit in most European states. Many are now in their most severe lockdowns since the initial outbreaks in 2020. Moreover, even where governments have suggested dates that restrictions are extended to, it is not obvious that restrictions will be quickly removed.

With economic consequences

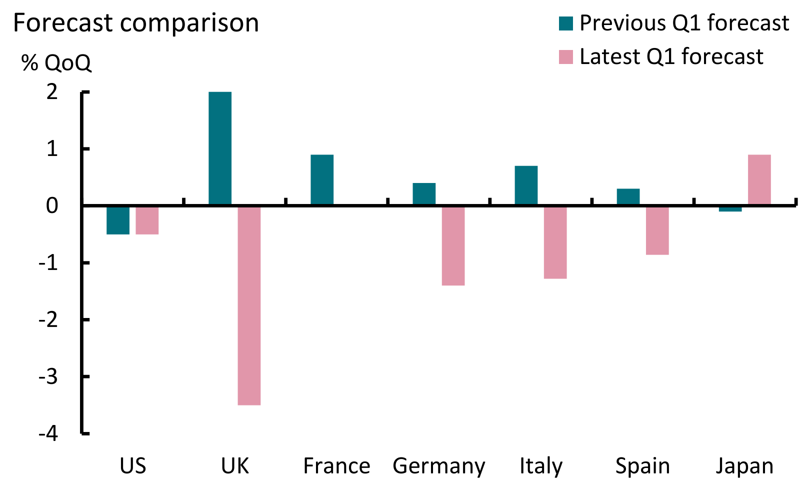
- The extension of restrictions has led us to revise our outlook for economic activity at the start of this year. With restrictions likely to be required to remain in place for the better part of Q1 to contain a more contagious form of the virus, we now expect to see a Q1 contraction in economic activity in the US, across the Eurozone on average and in the UK.

Estimated (minimum) for significant restrictions



Source: AXA IM Research, January 2021

Extended restrictions weaken short-term economic outlook



Source: AXA IM Research, January 2021

Theme of the Month

Vaccinations

Fast rollout

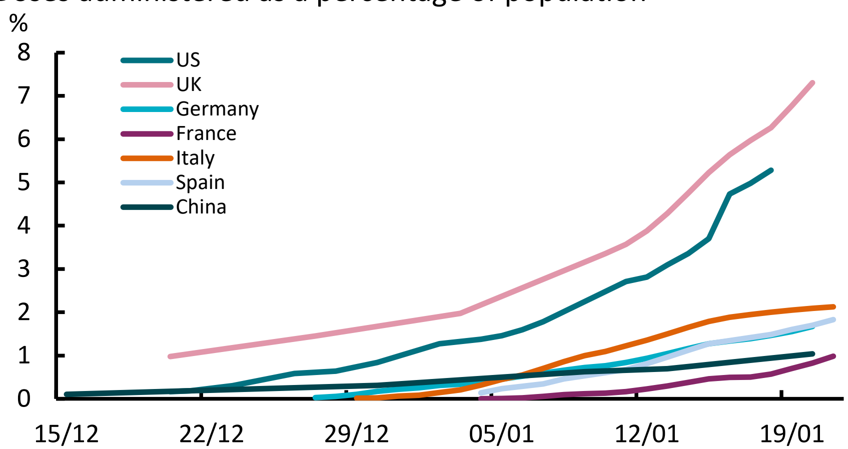
- Quite apart from the record-breaking speed with which new vaccines have been developed, their distribution is a major logistical exercise. Most developed economies (with the exclusion of Japan for now) are in the process of rolling out mass vaccinations. For sure, there will be logistical issues with this undertaking, but after an initial period setting up infrastructure, developed economies should be able to roll out vaccines to large numbers of people. An ability of vaccine supply to keep up with distribution will be critical. Those countries with a centralized healthcare system and a population that is willing to take the vaccine should be at an advantage.

Herd immunity

- The arrival at 'herd immunity' will be a product of how quickly vaccines are distributed, how many of the population have already been infected and the contagiousness of the virus. Some simple scenarios suggest that the US could achieve herd immunity by around mid-year. In the UK, the summer looks ambitious enough. And we expect this to be similar across Europe. But once more vulnerable members of society are vaccinated restrictions should be able to ease, allowing a meaningful rebound in economic growth in the Spring.

Large economies are rolling out vaccines quickly

Doses administered as a percentage of population



Source: National Health Commision, Ministry of Health, Robert Koch Institut, Extraordinary Commissioner for the Covid-19 Emergency, Ministry of Health, Government of the United Kingdom, Centers for Disease Control and Prevention and AXA IM Research, January 2021

Projections of herd immunity

Getting to 72% immunity

Second shots per day, K	Starting Immunity % 5%	10%	15%	20%	25%
500	Apr. 22	Mar. 22	Feb. 22	Dec. 21	Nov. 21
1,000	Aug. 21	Aug. 21	Jul. 21	Jul. 21	Jun. 21
1,500	Jun. 21	May 21	May. 21	May. 21	Apr. 21
2,000	May 21	Apr. 21	Apr. 21	Apr. 21	Mar. 21
2,500	Apr. 21	Apr. 21	Mar. 21	Mar. 21	Mar. 21

Source: Pantheon Macroeonomics, January 2021

Theme of the month

Risks to the outlook

What could go better

- We have **adopted a cautious pace of rollout**, assuming herd immunity is reached in the US around mid-year and in Europe and the UK around the end of the summer. A faster pace of rollout could result in restrictions being lifted earlier.
- Most economies appear to be **adapting to restrictions**, so that each new period of restriction ha relatively less economic impact. This process of adaption could continue and even quicken.

What could go worse

- **Vaccine distribution disruption** – mass vaccination on a worldwide scale is a vast logistical exercise. Any number of factors could disrupt the roll out from vaccine production interruptions to distribution difficulties caused by weather or other factors.
- **Unforeseen negative reactions to vaccine** – Norway reported 23 deaths after the Pfizer vaccine. It is investigating whether this is coincidence or a combination of fever, nausea and diarrhoea common with vaccines tipping the extremely frail over the edge
- **The increased contagion of the virus may require restrictions to remain in place until all are vaccinated**. Although vaccinating the most vulnerable (and largest per capita consumers of healthcare) should allow for a gradual easing of restrictions, a faster transmission rate would result in larger numbers of the remaining population catching the disease. Even with lower per capita healthcare consumption, the higher absolute numbers may still risk overwhelming health services.
- **Vaccination may not reduce transmission**. Data on vaccinations reduction in transmission, particularly in asymptomatic cases is inconclusive. If vaccination does not stop (or significantly limit) the spread of the virus, there will be a risk of reduced social distancing discipline amongst the newly vaccinated and an increase in virus spread before the whole population is inoculated.
- **New variants**. Despite the number of new variants that have emerged, the expectation is that current vaccines will still work because of the size of spike protein and because current mutations have not occurred amidst a largely immune host. However, the roll-out of the vaccine, particularly with developed-world-first focus, will leave large areas of the world for further new mutations to emerge, which could prove resistant to current vaccines.

Macro outlook

Virus brings darkest hour before dawn

US

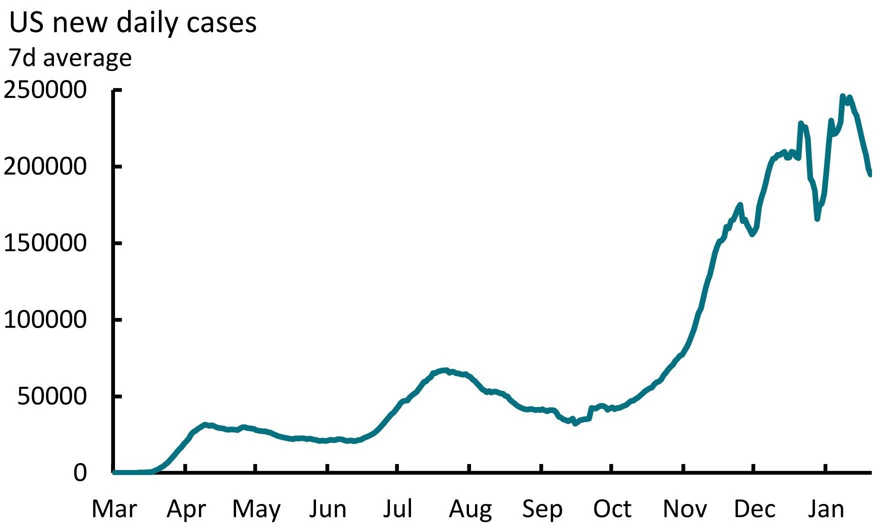
Passing beyond the “winter of peril”

- New daily virus cases have started to ease and positivity rates to fall as the US exceeded 400k deaths. This likely reflects increased restrictions. Restrictions may not be sufficient to contain the more contagious new variants, but with new cases falling back in early 2021 there is already some easing in restrictions, risking renewed resurgence. But vaccine roll-out is underway, the US delivering 1.2m doses per day. The US should be on track to achieve herd immunity around mid-year. Restrictions should ease before then.

End-year slowdown

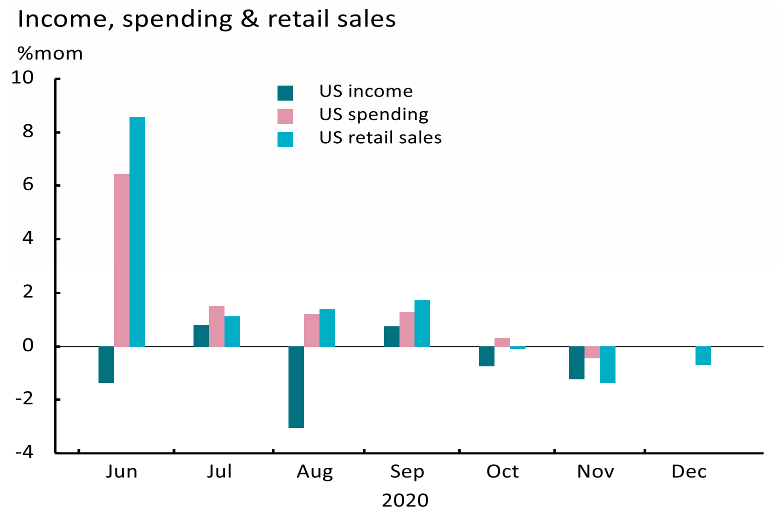
- The increase in restrictions contributed to a 500k drop in hospitality and leisure employment. Meanwhile the erosion of income and saving from a delayed fiscal package saw retail sales contract sharply in November and December. We forecast Q4 GDP at 5.5% - although note the Atlanta Fed ‘nowcast’ is at 7.4%. Late quarter declines and restrictions across Q1 look set to deliver a modest 2.0% contraction of growth in Q1, before we forecast a strong rebound in activity thereafter.

Cases wane from recent peak – watch for new variant



Source: USA Facts, and AXA IM Research, January 2021

Deteriorating income and saving weighs on end-year consumer



Source: BEA, and AXA IM Research, January 2021

Stimulus-fuelled growth brings monetary adjustment closer

US

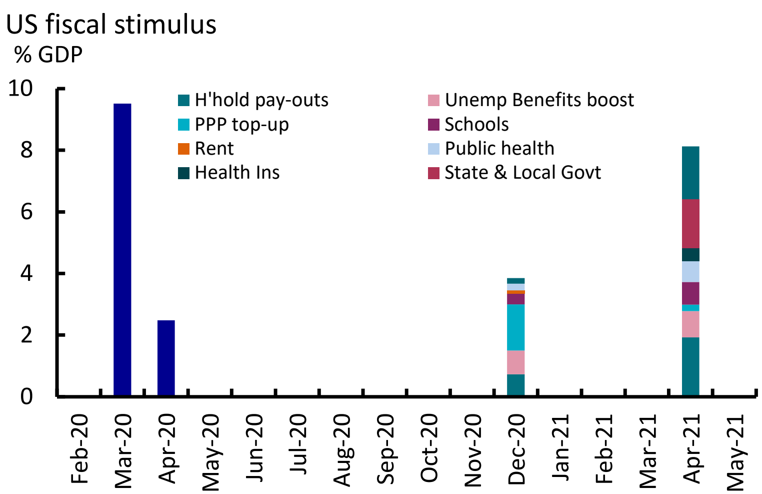
Democrat majorities boost stimulus odds

- Democrats won both seats in the Georgia Senate run-off elections, delivering (slim) majorities in both chambers of Congress. This increases the chances of short and medium-term stimulus. President Biden has proposed an immediate $1.9trn (8.6% GDP) stimulus, although we think only around half will pass. On this assumption, we raise our 2021 GDP forecast to 6.0%. Medium-term stimulus also looks likely, but with a difficult passage through Congress, we do not expect it to boost our 2022 outlook for 3.7%.

Fed says too soon to consider a turn in policy

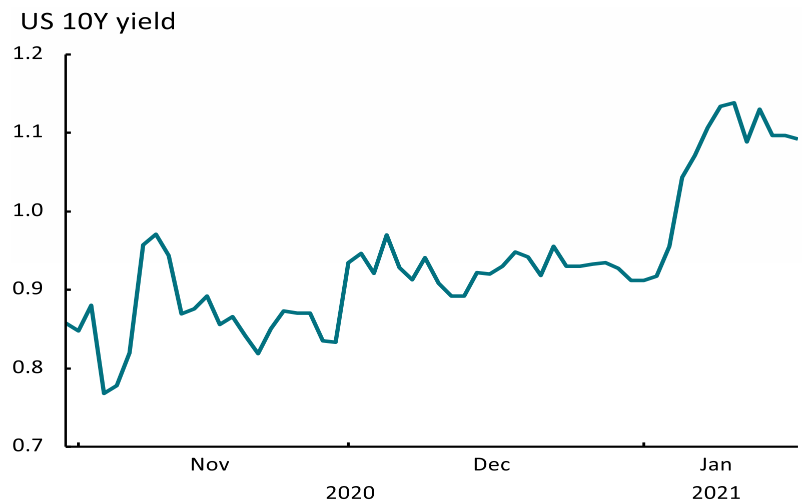
- A fiscal-stimulus-inspired boost to growth will return the economy to full employment and inflation to target sooner than previously expected. We bring forward our expectation of the first Fed rate increase to 2023 from mid-2024. Balance sheet policy will likely change first. We still forecast tapering at the start of 2022. Senior Fed officials ended a taper timing debate saying it was "too soon". But a strong rebound as we expect in the spring will see markets focus on when such a turn in policy could arrive.

Biden proposes $1.9trn stimulus top-up



Source: Bloomberg, AXA IM Research, January 2021

Yields react to stimulus and taper discussions



Source: Datastream, AXA IM Research January 2021

More for longer

Euro area

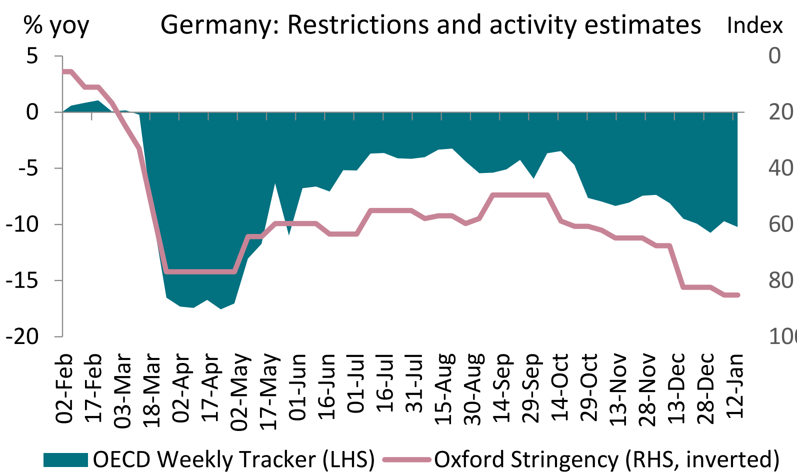
Starting the year with a downgrade…

- Virus developments mean that more and/or longer restrictions are becoming the norm again. On the positive, restrictions seem less economically costly than in the spring, but on the negative very slow progress on the vaccination front (delays in deliveries and slow pace of inoculation) means that restrictions will be lifted more gradually than initially envisaged. We cut our growth forecasts. A weaker H1, with a 0.7%qoq decline in Q1, brings the euro area 2021 growth to 3.1%yoy, down from 3.7%yoy.

… and with fiscal support still in emergency mode

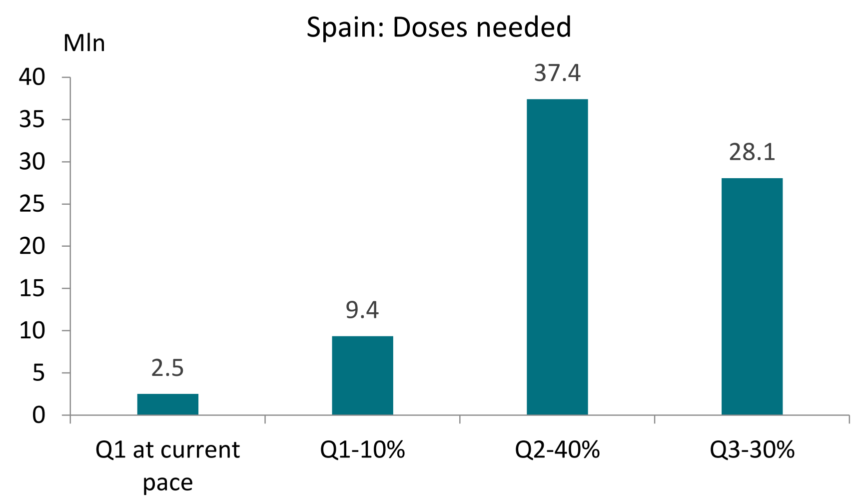
- More economic pain calls for more fiscal support. Developments have been tentatively encouraging, but nowhere close to the US scale. France is making its solidarity fund more generous, Germany is improving access to its business support scheme (which under-delivers in 2020) and Italy has passed a €32Bn (1.9% of GDP) emergency decree, extending most Covid-cushioning measures until the end of Q2.

A smaller – but longer – economic hit



Source: OECD, AXA IM Research, January 2021

A significant ramp-up needed to reach herd immunity in Q3



Source: OWID, Datastream, AXA IM Research January 2021

Politics back in the spotlight

Euro area

Italian and German politics: we are not done yet

- In Germany, Armin Laschet was elected CDU party leader, one of the first steps towards September General elections. The CDU/CSU candidacy for chancellor will be finalized after state elections, but clarity on the policies agenda may have to wait coalition negotiations. In Italy, PM Conte survived a confidence vote and is now working to strengthen his majority. A stable majority is key to ensure an efficient implementation of the Recovery Funds. Snap elections remain a tail risk in our view.

The ECB: only a short-lived relief?

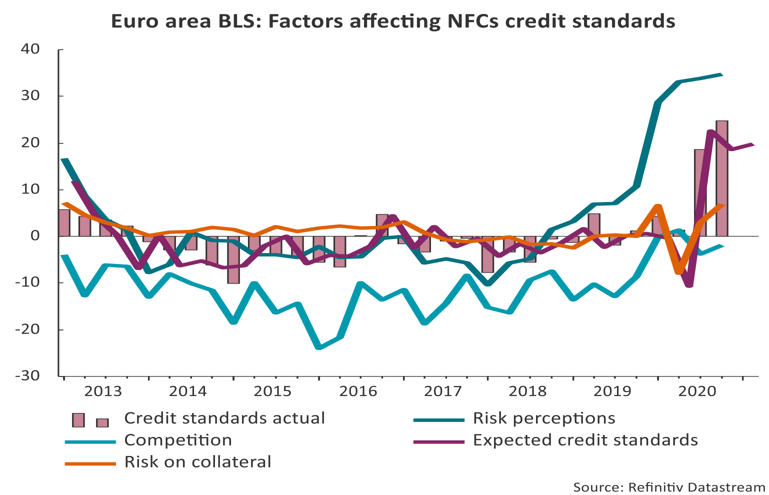
- After the comprehensive December package, the ECB was probably hoping to have bought some time, with its January meeting expected to be a non-event. Yet, if it confirmed implicit yield curve control, it also raised confusion on what "preserving favourable financing conditions" meant. The ECB may now have to clarify its 'holistic' approach and give insights to its reaction function.

Italian Senate: complex arithmetic

Majority threshold	161
M5S	92
PD	35
IV	18
Mixed	19
Autonomies	9
Lega	63
FI	54
FdI	19
Mixed	6

Source: Italian Senate, AXA IM Research, January 2021

Favourable financing conditions, but credit standards tighten



Source: Datastream, AXA IM Research January 2021

Wrapping up 2020

UK

New variant adds to vaccine urgency

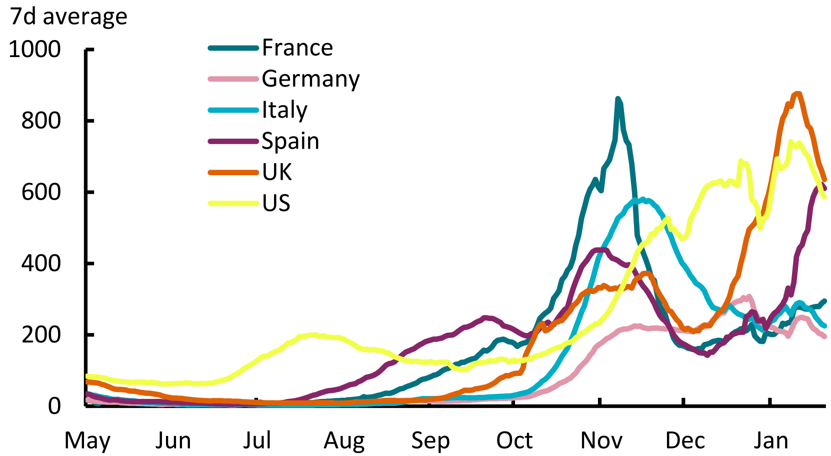
- The sharp rise in UK cases illustrates the impact of a new, more contagious virus variant. The UK returned to lockdown in early January and cases have receded more recently. Vaccinations are underway, currently totaling 5.7mn people, 8% of the population (440k twice), at 2.2mn in the latest week. Increased transmissibility raises the critical threshold of herd immunity. We show illustrative timelines for achieving herd immunity after the government's interim mid-February level. Based on different rates of vaccination and assumptions of numbers previously infected, 4m vaccines per week could achieve herd immunity in the summer.

Coping with lockdown

- GDP contracted by 2.6% in November, less than we expected, with services holding up better than feared (-3.4%mom). After this, it is doubtful that Q4 GDP will contract, we now forecast a 0.3% rise, sparing the UK a double-dip recession and supporting the growth outlook for 2021 as a whole.

UK new variant leads to surge in new cases

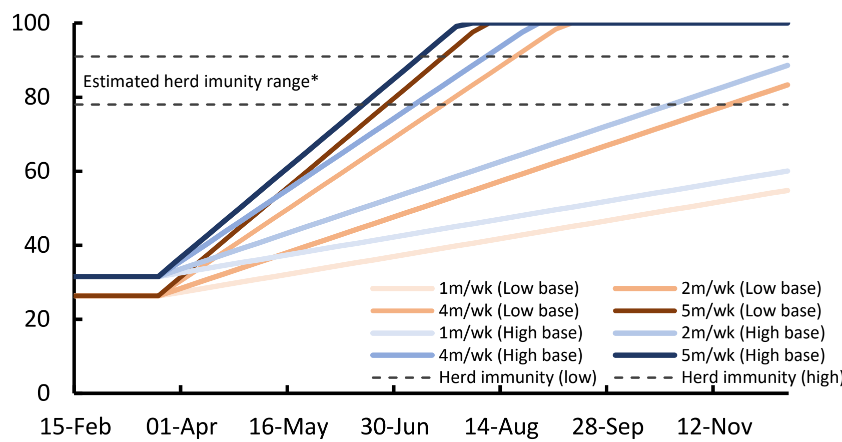
Daily cases per million population



Source: WHO, USA Facts and AXA IM Research, Jan 2021

Different paths to herd immunity

Simple projections of herd immunity timelines



Source: Clinical Infectious Diseases, Imperial, John Hopkins, DHSC, AXA IM, Jan 21
* Estimated with 90% efficacy rates

2021 promises rebound

UK

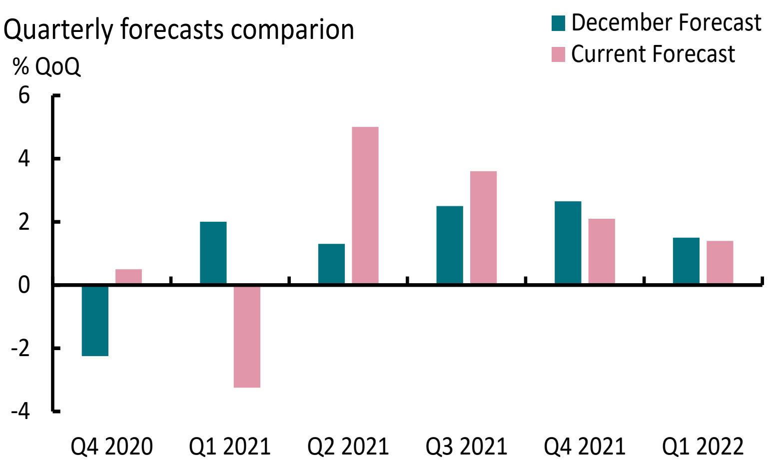
Net GDP effect almost neutral, uncertainty high

- Despite the now better expected Q4 performance, the extension of lockdowns across most of Q1 is likely to lead to a contraction in activity. This is likely to be supplemented by a post-Brexit inventory unwind and export disruption. We forecast a 3.5% drop in Q1. However, following the upgrade to Q4, our 2021 growth forecast softens only slightly to 4.3% (from 4.6%, consensus 4.7%). Yet uncertainty is high. November's GDP estimate alone saw a range of forecasts from +0.6% to -8.0%.

BoE to bring forward easing decision

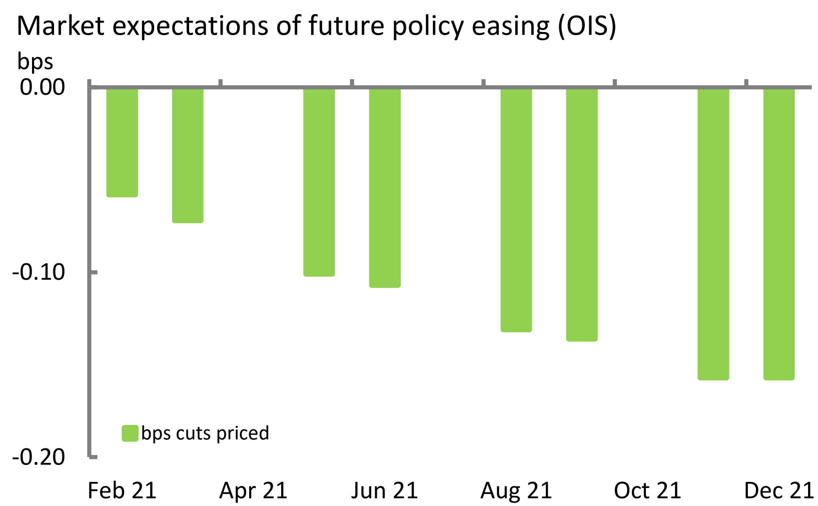
- We expect the BoE to lower its 2021 GDP growth forecast from 7.25%. Risks also appear more skewed to the downside. As such we bring forward our expectation of additional QE of £75bn to February (from May), allowing the BoE to maintain its current pace of asset purchases through 2021, in line with the Fed and the ECB. The BoE will also decide on rate policy. A decision to increase QE, but not use negative rates now would be a strong signal that the BoE does not intend to use negative rates, as still priced.

Change in GDP outlook as lockdown extended



Source: National Statistics, AXA IM Research, January 2021

Markets still positioned for negative interest rates



Source: Bloomberg, AXA IM Research, January 2021

Ending a challenging year on a high note

China

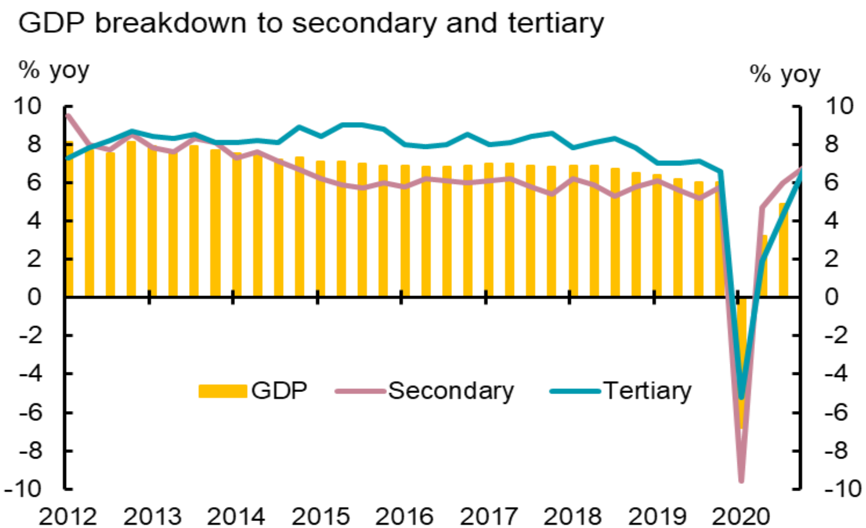
Q4 growth rebounds to above trend

- A further acceleration of growth to 6.5% in Q4 brought the Chinese economy to slightly above our potential growth estimate. With full-year growth recording 2.3%, China is likely the only major economy to have expanded in 2020. Despite being the first to contract the virus and enacting the strictest of lockdowns, the Chinese economy has exhibited resilience and succeeded in an impressive recovery from the devastating shock. After ending a very challenging year on a high note, the economy appears to be entering 2021 with a full head of steam

Growth drivers become more broad-based

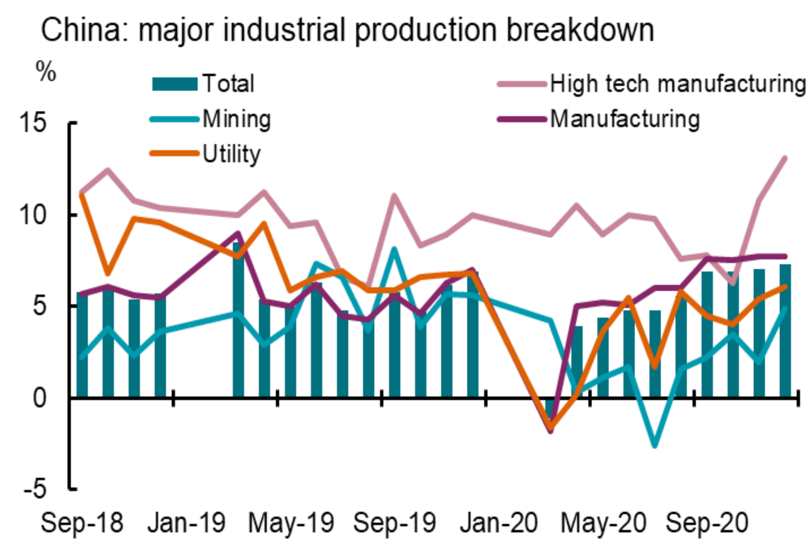
- Apart from the impressive pace of recovery, economic growth has also become more broad-based. Services-sector activity picked up notably in Q4, complementing the strong industrial-sector growth that was responsible for the initial V-shaped rebound. On the expenditure side, growth contributions from consumption recovered handsomely from -2.4% in Q3 to 1.2%, and investment and net exports together made up the remaining 1.1% growth for the full year

Economic recovery becomes broad-based



Source: CEIC, AXA IM Research, Jan 21

Industrial output growth rises to a 2-year high



Source: CEIC, AXA IM Research, Jan 21

Investment Managers

Virus resurgence a near-term headwind, but will not derail the recovery

China

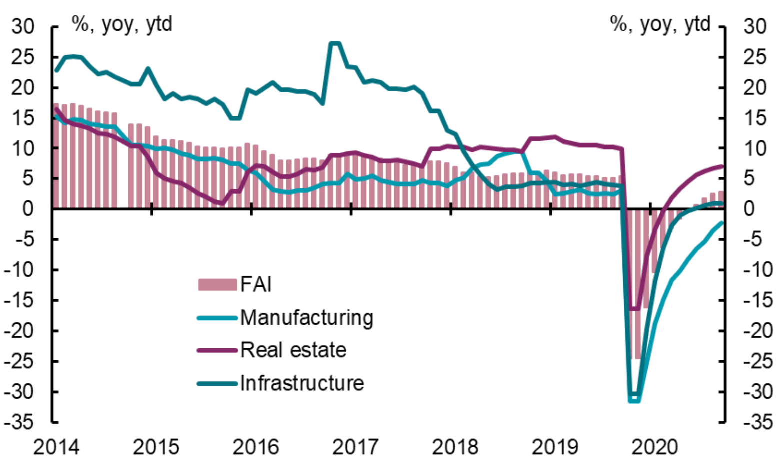
Consumption recovery could be delayed by recent outbreaks

- Monthly data for December was mixed. While industrial output, exports and investment continued to grow briskly, retail sales slowed unexpectedly to 4.6%. Some weakness could be due to front-loaded purchases in the Singles-Week sales in November being unwound thereafter. However, the latest virus resurgence has led to renewed social restrictions in North China and could delay recovery. Recent traffic data has shown lower traffic flows ahead of the lunar new year than previous years.

Policy normalization may take a breather

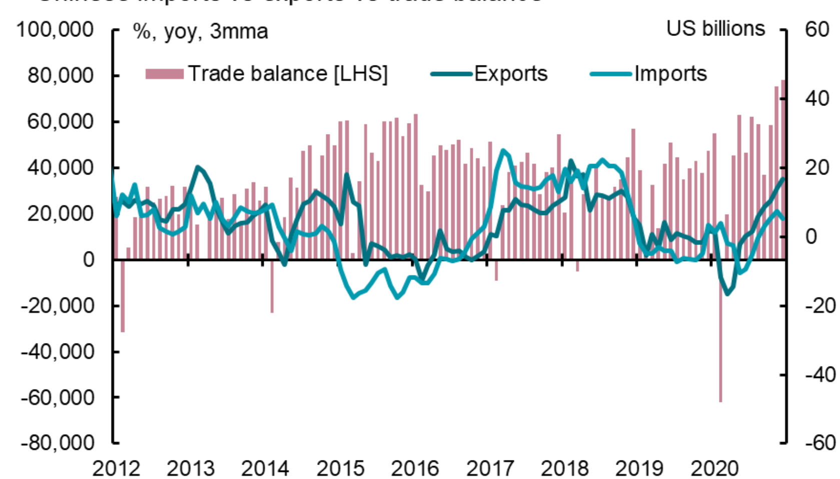
- With the virus situation complicating the near-term outlook, the PBoC can afford to be slow in taking its foot off the gas. This is particularly true given the on-going appreciation of the yuan, tightening the economy where inflation pressure is still rather muted. The PBoC will in fact need to inject liquidity in the coming weeks to manage holiday cash demand. In that regard, an RRR cut cannot be ruled out, but such a move could complicate policy signals at the current juncture, making it less likely this year. Overall, we expect no major changes to policy rates nor RRR in 2021

Investment recovery stays the course



Source: CEIC, AXA IM Research, Jan 21

Strong export receipts push trade surplus to an all-time high



Source: CEIC, AXA IM Research, Jan 21

Renewal of the state of emergency

Japan

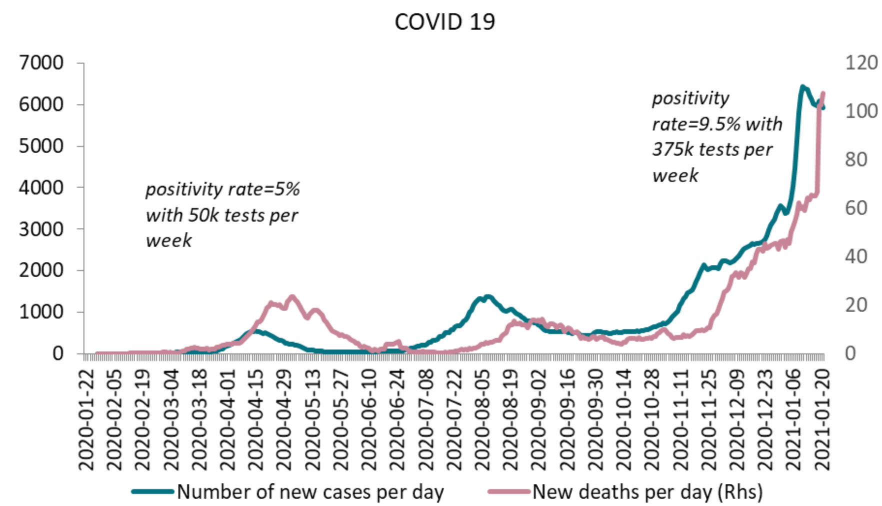
The government has imposed a state of emergency until February 7

- Initially restricted to Greater Tokyo, this was quickly extended to seven more regions, accounting for 53% of GDP. Further restrictions on a nationwide level can't be excluded, while it is highly likely the state of emergency will be extended by several weeks.
- A vaccination campaign is only due to start in late February as the authorities allow time to check for any inoculation side effects elsewhere and run their own late-stage trials.

These restrictions raise downside risks to our 2021 outlook: +2.3% (prev: +3.3%) | +2.4% (prev: +2.0%)

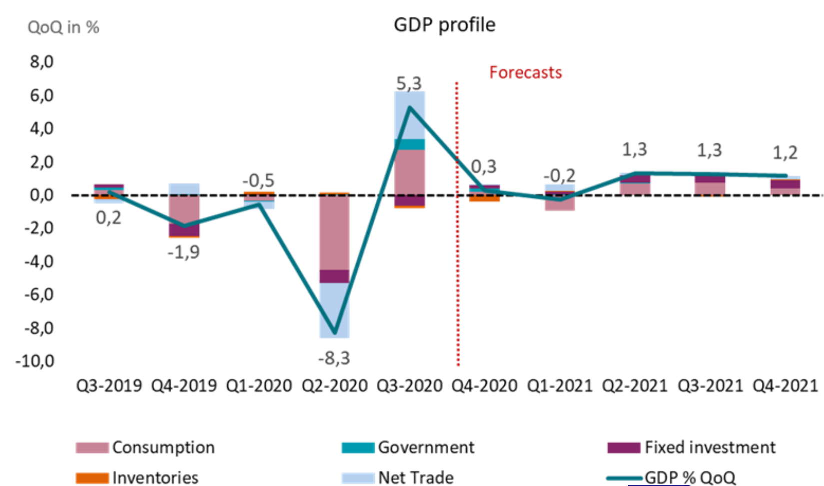
- Private consumption is likely to be most affected even if the impact should be less than before as people adapt to live with the virus: online shopping has increased markedly, and employment has been far stronger than expected.
- Additional fiscal spending in the 3rd supplementary budget, should continue to provide some support.
- Capex should remain robust as companies have more visibility, while net export should continue to recover. We keep an eye on the recent restrictions in China and US demand indicators.

The number of new cases starts to ease – the state of emergency should reinforce the decline



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

Recent restrictions lead to growth reprofiling



Source: Cabinet Office, AXA IM Research, Jan 21

Both fiscal and monetary policies remain supportive

Japan

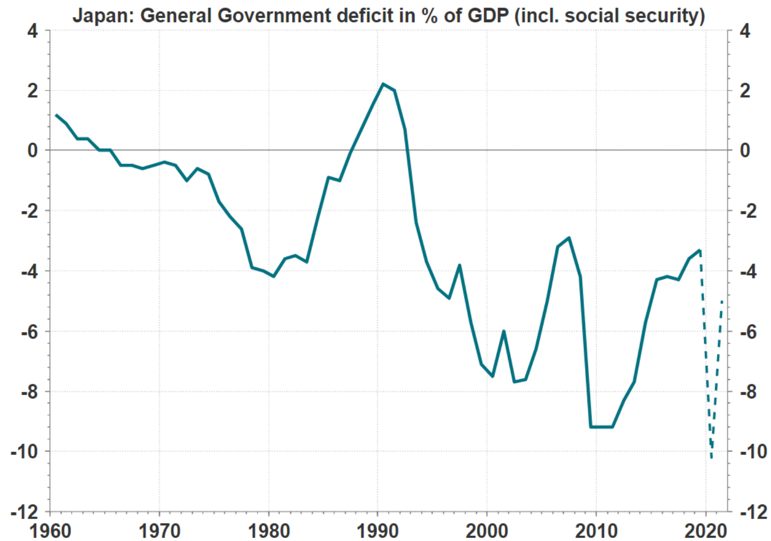
The government released a draft budget for FY 2021

- The draft remains expansionary. The government is projecting to have a fiscal deficit of around 5% of GDP, largely above 2014-2019 average (around 3%). In addition, at least one-third of the 3rd supplementary budget (¥32tn) – which will be adopted in the coming days – is due to be spent in FY 2021.

Bank of Japan held its January meeting

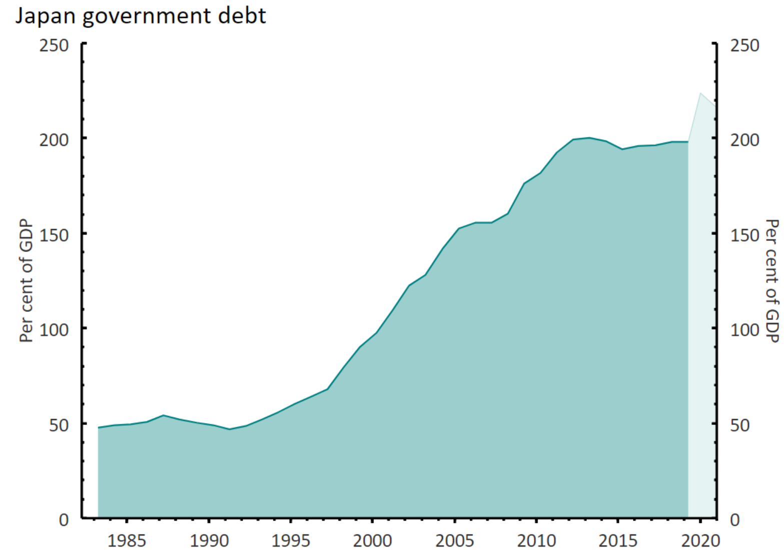
- The Bank of Japan has maintained its current monetary policy framework and kept forward guidance unchanged.
- The BoJ released its Outlook Report and GDP growth has been revised on the upside: +3.9% for FY 2021 (prev: +3.6%) and +1.8% (prev: +1.6%) for FY2022. Core CPI was also revised up slightly at +0.5% for FY 2021, reflecting higher oil prices and suspension of the "Go to" campaign.

Japan had its highest fiscal deficit since the beginning of statistical computation



Source: Refinitiv Datastream, METI, AXA IM Macro Research

Public debt has probably risen to 224% of GDP in 2020



Source: Refinitiv Datastream and AXA IM Research Q4 20

AXA Investment Managers

Investors' appetite for EM assets pursues into the start of the year

Emerging Markets

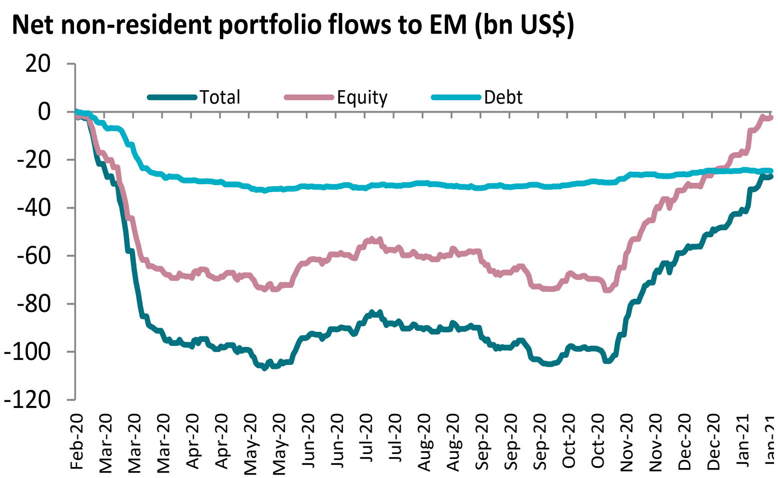
EM assets continue to attract global investors

- EM assets continue to attract flows since Nov 1, when the first vaccine announcement was made. Out of the circa $100bn portfolio outflows recorded last spring, three-quarters made their way back in EM markets since Nov 1, mostly in EM equities so far.
- Recent rising US yields have not curtailed this preference for EM assets. Rising US breakevens suggest markets see a stronger US economic recovery ahead, which is EM positive, while still US negative real interest rates suggest the Fed is expected to remain dovish.

Covid-19 pandemic continues to pressure economic activity in Q1 2021

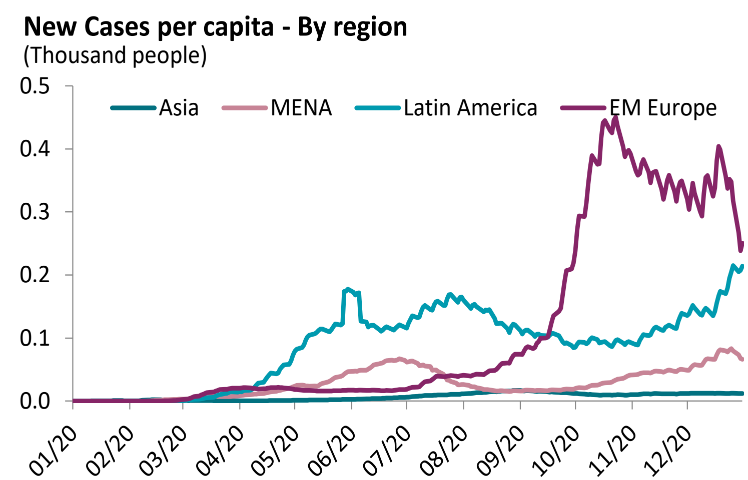
- As the pandemic continued to spread at an alarming pace worldwide, an increasing number of countries reverted to additional or renewed mobility restrictions. The infection curves appear to be receding in the Czech Republic and South Africa where the pandemic was accelerating of late, but they continue to creep higher in Latin America. Activity is likely to take a hit in Q1 2021.
- Vaccination programs are launched across the globe in a dispersed fashion. While some EMs are successfully moving forward (such as the Gulf states), others lag behind as they struggle to have access to vaccines. Several initiatives aim at reducing these disadvantages such as the COVAX multilateral initiative set to guarantee fair access to vaccines.

Portfolio investment inflows into EM stepping up



Source: IIF, AXA IM Research calculations, 19 Jan 2021

EM continues to struggle with the pandemic



Source: Datastream, AXA IM Research calculations, 19 Jan 2021

AXA Investment Managers

Towards a gradual normalisation in economic policy

Emerging Markets

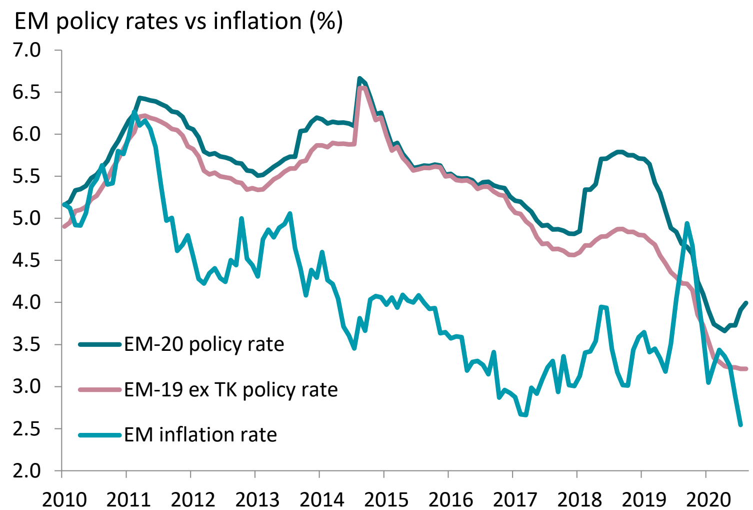
Monetary policy normalisation ahead

- 2020 marked a sharp easing in monetary policy across EM. Our EM-20 proxy inflation rate fell to a historical low of 2.5% by December 2020. Only a handful of countries (among which Turkey and Argentina) raised rates last year, each facing idiosyncratic issues.
- As we move into 2021, and the world hopefully masters the pandemic as vaccinations gain ground, mobility restrictions should be lifted and the pace of economic recovery should pick up. Inflation is likely to accelerate as well. We still see some room for policy easing as the year starts in Mexico, India or Indonesia, but the broad policy stance should be moving towards an upcoming normalisation from historical low levels towards year-end.

Focus on public debt sustainability

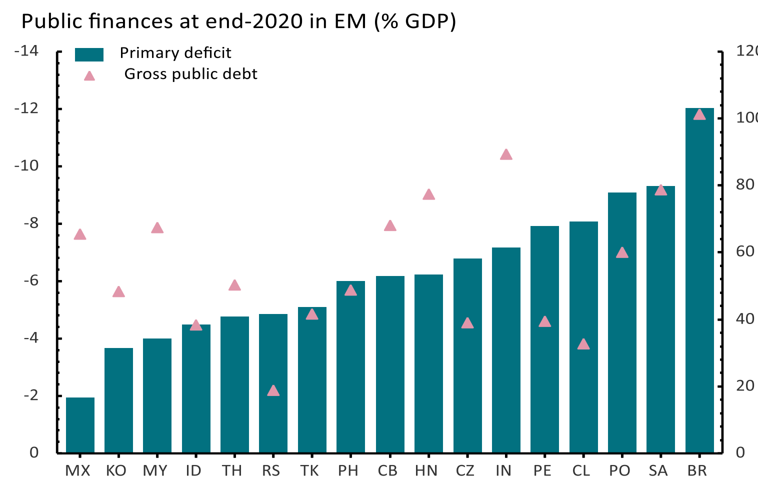
- EM governments pledge for a return to orthodoxy but cutting down on spending while economic activity is still weak may prove difficult. This could be more problematic for countries that have implemented big stimulus packages last year such as Brazil and South Africa. Public debt sustainability issues are likely to retain attention for the upcoming years.

Towards a gradual normalization of monetary policy



Source: Refinitiv Datastream, AXA IM Research, Dec 2020. EM-20 proxies (China, Korea, Taiwan, India, Indonesia, Malaysia, Thailand, Philippines, Mexico, Peru, Chile, Brazil, Turkey, Russia, Poland, Czech, Romania, South Africa

A complicated return to fiscal orthodoxy



Source: Refinitiv Datastream and AXA IM Research 31 Dec 2020


AXA Investment Managers
Investment Strategy

Multi-Asset Investment views

Our key messages and convictions

Positive on equites

#1

Despite the virus resurgence, economic and earnings rebound remains on track amidst ultra loose monetary policy

#2

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

Neutral on Investment Grade Credit

Neutral Sovereign Bonds

#3

Monetary arsenal supportive for bonds; However markets could anticipate Fed policy shift as fiscal stimulus takes hold

#4

Concerns over a second wave of COVID-19 virus and political risks generate higher volatility

Long Volatility

Source: AXA IM as at 26/01/2021

FX Strategy

Fiscal policy to the USD rescue while GBP clear of cliffhanger negotiations

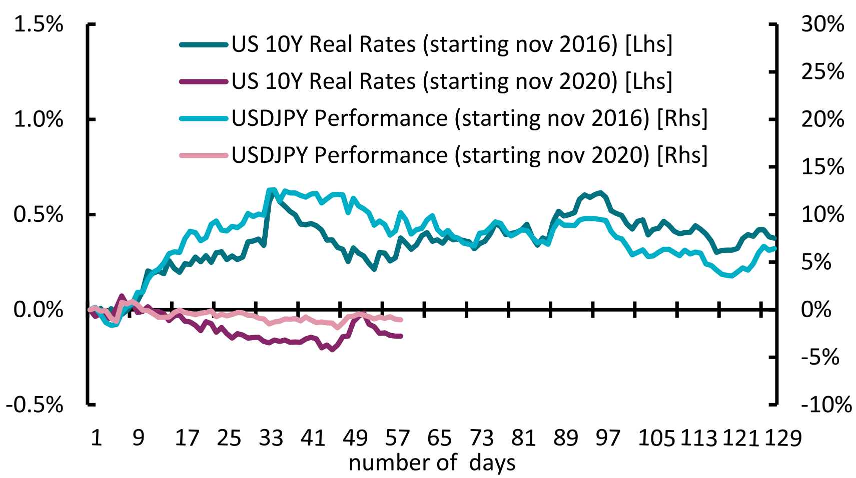
- Most of the USD depreciation fundamentals remain in place: Dollar carry advantage vanished, overvaluation not fully unwound, Federal Reserve committed to inflation overshoot, US trade conflicts to de-escalate under President Biden, global growth to rebound as vaccine rolls out. Yet if Democrats action a larger fiscal stimulus, US growth could outperform other developed economies, and relative growth prospects could drive currencies as a proxy for monetary policy reduction ahead.

- This should give pause to dollar depreciation in the near term, especially versus the euro - which has appreciated close to fair value - but also versus the Japanese yen. However, the yen remains more undervalued than the euro, while the carry of unhedged dollar short-term positions is much less attractive this time. Japanese investors could achieve a better carry/volatility profile in long-term currency-hedged US assets.

- December delivered the long-awaited conclusion of the UK-EU free-trade agreement. A lot of uncertainty still surrounds Brexit impact, but the end of cliff-hanger negotiations allows investors to re-assess their positions. Sterling may see some support against the euro in the short term, due to persistent large undervaluation, more efficient vaccine rollout in UK, and BoE set to avoid negative rates.

USDJPY versus real rates in 2016 and 2020 US election periods

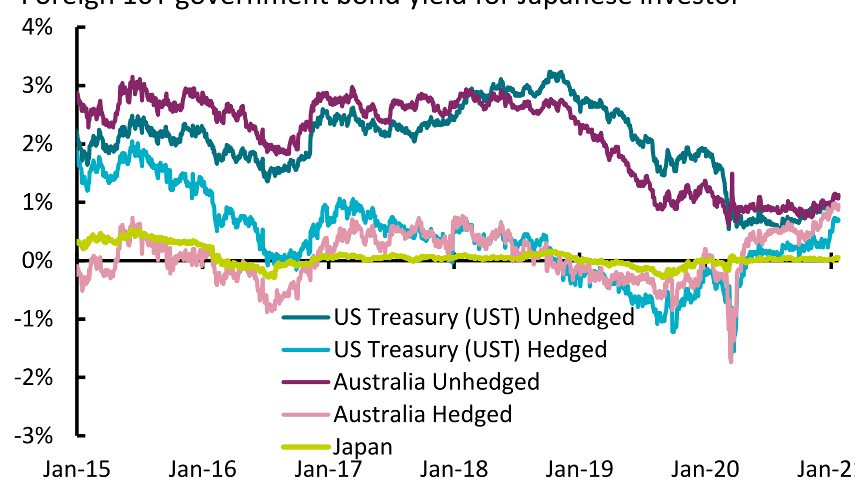
US Real rates vs USDJPY performance



Source: Bloomberg and AXA IM Research, Jan 2021

Currency-hedged US Treasuries are now as attractive for JP buyers

Foreign 10Y government bond yield for Japanese investor



Source: Bloomberg and AXA IM Research, Jan 2021

Rates Strategy

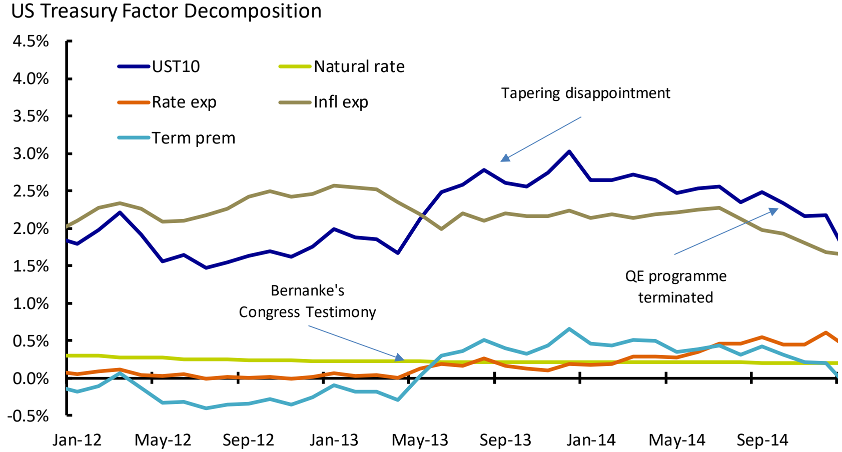
How likely to see a redux of the 2013 taper tantrum in US Treasury yields ?

- Federal Reserve Chair Jerome Powell's emphatic attempt to calm down tapering whispers as 'premature' hasn't gone unnoticed by investors. Bond markets remember the events of summer 2013 all too well, including the polarised (and wrong) consensus around September of that year, as the official tapering start.

- Back then, we had a similar backdrop in terms of the natural rate as well as the absence of interest rate hike expectations. However, in 2013 we saw a rapid and significant movement in Treasury term premia from -0.25% at the end of 2012 to +0.65% at the end of 2013. At the same time, market-based inflation expectations eased from 2.5% to 2.2%, net-net lifting real yields by around 150bps in 2013.

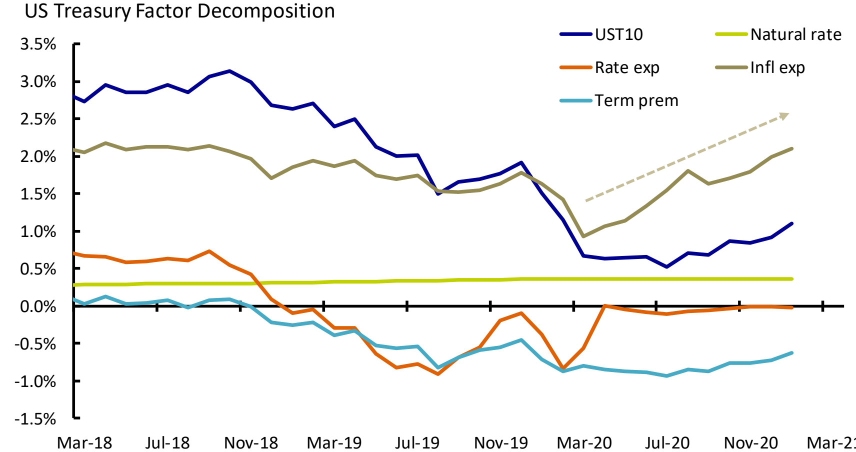
- Today's market backdrop differs in 2 ways: Term premia continue to hover near all-time lows. Moreover, the Fed's average inflation strategy provides headwinds against a quick normalisation of policy stance. Also, breakeven inflation has risen significantly (+160bps in 10y) from March 2020 lows. Net-net, real yields remain contained around -1%, preventing a 2013-like tightening in policy stance.

Fed's taper tantrum in USTs in 2013 …



Source: Bloomberg and AXA IM Research, Jan 2021

… today's picture is quite different



Source: Bloomberg and AXA IM Research, Jan 2021

Credit Strategy

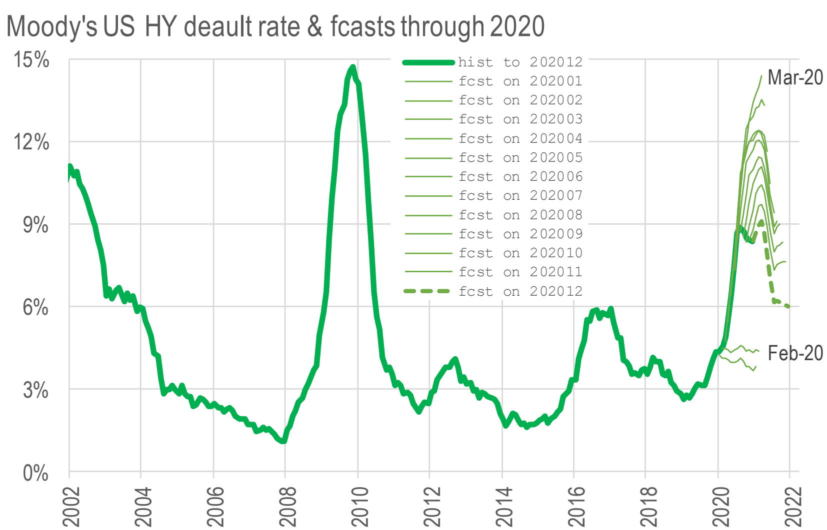
HY buoyed by reflation trade & stabilising default rate cycle while spread-rates regime not yet a major risk

- The reflation trade has propelled HY performance ahead of IG YtD. Our base case scenario for a stronger economic rebound into the second half of 2021 should see HY outperformance persist. HY tends to outperform in beta-adjusted terms when systemic risk threatens to increase. Indeed, our eurozone risk premium indicator is flashing amber in this respect, driven by developments in Italian politics.

- A further tailwind for HY is that defaults appear to be rolling over. Default rate in Moody's US HY cohort looks set to remain below double digits, peaking at 9% and declining to 6% in a year's time. The current peak is higher than 2015-16 commodity crisis but much lower than the Global Financial Crisis (15%), testament to the extraordinary policy response.

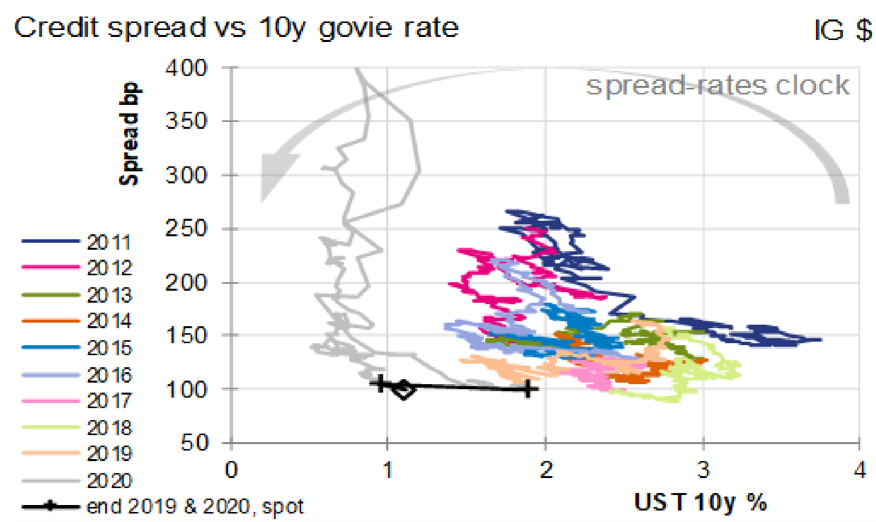
- The relationship of spreads vs rates is a concern for investors, amid fears that the US Federal Reserve may start reducing accommodative policy earlier than expected. The spread-rate regime shows that spreads are at the low end of their historical range, hinting towards spread widening as rates increase. That said, there are few data points for rates in the 1-1.5% range and the spread-rates 'clock' does not preclude spreads to tighten further as rates continue to normalise (e.g. 2018).

Defaults have undershot very bearish estimates at start of pandemic



Source: Moody's and AXA IM Research, Jan 2021

Spreads were practically unchanged in 2020 while yields declined by c.1%



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

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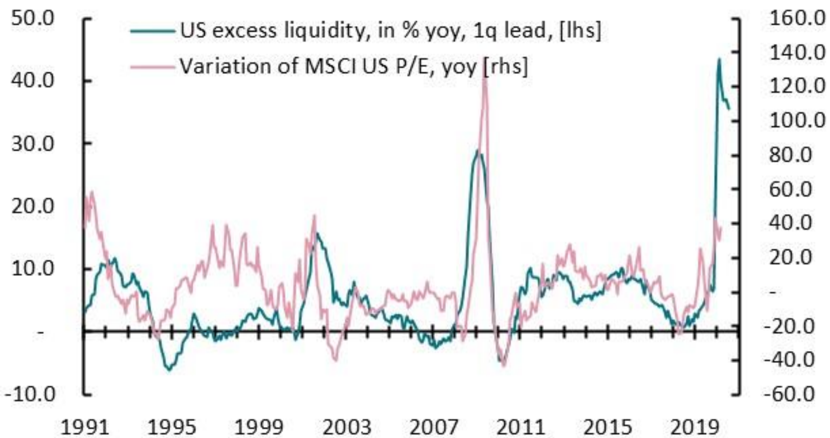
Equity strategy

Opportunity and concern moving into 2021

- Equity markets started the year on a positive note with the global benchmark up 3.8% at the time of writing. Consistent with the cyclical risk-on sentiment, small and mid-caps have outperformed and emerging markets too across regions. Although it has declined, volatility remains elevated at a level of 20+ (VIX) compared to historic norms.
- Early Q4 earnings season results are encouraging with positive sales/earning surprises in the US and Eurozone. US banks, which completed the reporting for the quarter, posted an earnings surprise of 26%. In line with the earnings' visibility improvement, consensus expectations for global EPS growth in 2021 are around 27%, a potentially strong rebound.
- The asset class still appears attractively valued on a relative basis with equity risk premium proxies still having room to compress. Absolute multiples do appear elevated but a lot more reasonable if normalised for the expected earnings recovery.
- We keep our constructive stance on equities by exposure to emerging markets, the green economy and cyclicals in Europe . We continue to see support by recovering economic activity, supportive policy measures, positive sentiment and an ultra-low hurdle rates in other assets.

Excess liquidity spike and trailing multiples

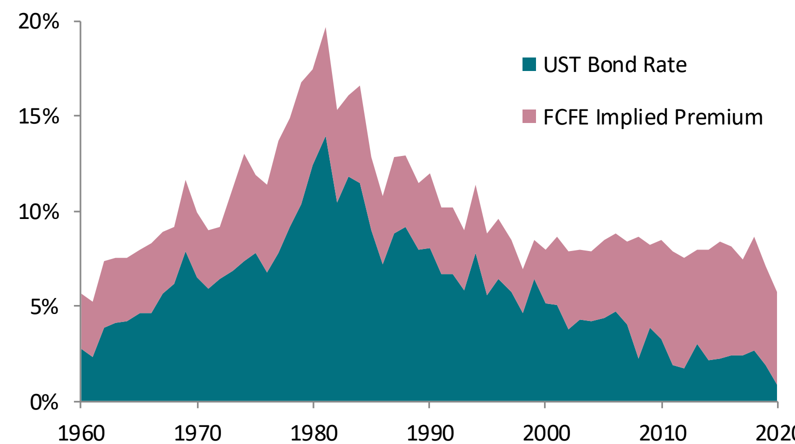
US excess liquidity & stock market valuation



Source: Datastream, Bloomberg and AXA IM Research, Jan 2021

Global equity valuations still not demanding

US bond yields and global equity risk premium



Source: NYU Stern, Aswath Damodaran data and AXA IM Research, Jan 2021

Asset allocation stance

Positioning across and within asset classes

Asset Allocation

Key asset classes

Equities			Positive
Bonds		Neutral ▼	
Commodities			Positive
Cash	Negative		

Equities

Developed

Euro area		Neutral	
UK		Neutral	
Switzerland		Neutral	
US		Neutral	
Japan		Neutral	

Emerging & Equity Sectors

Emerging Markets			Positive
Green Basket			Positive ▲
Europe Cyclical/Value			Positive ▲
US small caps		Neutral	
US Cyclical/Value			Positive ▲
Global semiconductors			Positive ▲

Fixed Income

Govies

Euro core		Neutral	
Euro periph		Neutral	
UK		Neutral	
US		Neutral ▼	

Inflation Break-even

US		Neutral	
Euro		Neutral	

Credit

Euro IG		Neutral ▼	
US IG		Neutral ▼	
Euro HY		Neutral	
US HY		Neutral	

EM Debt

EM Bonds HC		Neutral	

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

Source: AXA IM as at 26/01/2021

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Forecasts & Calendar

Macro forecast summary

Forecasts

Real GDP growth (%)	2020	2021*		2022*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
World	-3.8	5.2		4.0	
Advanced economies	-5.6	4.9		3.4	
US	-3.4	6.0	4.0	3.7	
Euro area	-7.1	3.1	4.7	3.5	
Germany	-5.3	2.4	3.9	3.1	
France	-9.0	4.4	5.9	3.7	
Italy	-8.8	3.5	4.9	3.8	
Spain	-11.0	4.4	6.1	4.2	
Japan	-5.5	2.3	2.6	2.4	
UK	-10.0	4.3	5.3	7.5	
Switzerland	-4.8	2.5	3.3	3.0	
Emerging economies	-2.7	5.4		4.5	
Asia	-1.4	7.1		5.1	
China	2.3	8.0	8.0	5.5	
South Korea	-0.8	3.5	3.4	3.0	
Rest of EM Asia	-6.0	6.4		4.7	
LatAm	-7.5	3.3		2.8	
Brazil	-4.0	2.7	3.4	2.3	
Mexico	-8.6	2.7	3.9	2.5	
EM Europe	-2.6	2.7		3.6	
Russia	-2.8	1.5	3.0	2.5	
Poland	-2.7	3.1	4.2	4.6	
Turkey	0.6	3.5	4.5	4.6	
Other EMs	-3.7	3.3		4.1	

Source: Datastream, IMF and AXA IM Macro Research – As of 27 January 2021

* Forecast

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Expectations on inflation and central banks

Forecasts

Inflation Forecasts

CPI Inflation (%)	2020	2021*		2022*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	**0.8**	**1.2**		**1.3**	
US	**1.4**	**1.7**	2.0	**2.0**	
Euro area	**0.2**	**0.7**	0.9	**1.0**	
Japan	**0.0**	**-0.3**	0.0	**0.6**	
UK	**0.8**	**1.8**	1.6	**1.5**	
Switzerland	**-0.7**	**0.0**	0.2	**0.2**	

Source: Datastream, IMF and AXA IM Macro Research – As of 27 January 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 27 January 2021

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Calendar of 2021 events

2021	Date	Event	Comments
January	26-27 Jan	FOMC Meeting	Unchanged (0-0.25)
February	4 Feb	BoE Meeting	Unchanged (0.10)
March	Mar	UK	Budget
	11 Mar	ECB Meeting	Unchanged (-0.50)
	16-17 Mar	FOMC Meeting	Unchanged (0-0.25)
	18 Mar	BoE Meeting	Unchanged (0.10)
	18-19 Mar	BoJ meeting	Unchanged (-0.10)
	21 Mar	The Netherlands	General Election
	Late March	China	NPC
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)
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)
November 2022	8 Nov	US	Mid Term Elections

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21 January 2021

[RCEP: Integrating Asia beyond trade]

12 January 2021

[December Global Macro Monthly & Investment Strategy – Covid 19: It's behind you… oh no it isn't]

17 December 2020

[India: Growth returns, but challenges remain]

03 December 2020

[The emerging market COVID-19 debt surge – no crisis on the horizon, yet]

18 November 2020

[US Election update: clarity, but not certainty]

09 November 2020

[Trump outperforms polling, in for the long haul]

04 November 2020

[Individual government challenges and the Covid-19 debt surge]

22 October 2020

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