Economies begin to emerge

Monthly Investment Strategy

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Key points

- The speed of the post lockdown recovery will be partly dependent on how the "saving overhang" is spent.
- Policies can help spur household confidence, but whether our economies generate structural unemployment as some sectors face lasting damage, will be key.
- This will also be reflected in markets. Dispersion in equity markets has already been driven by "winners" and "losers" from the COVID-19 crisis.
- We are confident that policy will continue to support high quality bond markets. Risk assets performance depends on policy, the dynamics of recovery and the prospects of a longer-term solution to virus management.

The fate of the saving overhang

A very specific characteristic of the current recession is that, at least in advanced economies, income – massively protected by fiscal policy – is falling much less than consumption. This is generating a very significant saving overhang. This is reflected in the Euro area by the record rise in households' bank deposits in March (EUR75bn). The quality of the post-lockdown recovery will depend to a large extent on the speed at which this "forced saving" is spent.

It is tempting to look at China, which exited from lockdown much earlier than the Western countries, for guidance. There, it seems consumer spending has been quite subdued so far. But China is an exception among the key economies, since income fell quite significantly during the lockdown phase as Beijing refrained from the kind of all out fiscal packages seen in the West.

We would lay out three conditions for forced saving not to turn into precautionary saving.

First, families must be reasonably confident that the level of fiscal support they will receive will remain massive well after the end of the pandemic. From this point of view, the recent leaks in the UK according to which the Treasury is already discussing what tax hikes and spending cuts will be needed to ensure public debt sustainability is a perfect example of what should not happen. This would be a "Ricardian equivalence"[1] festival, since households would be incentivised to hoard the current handouts in preparation for future austerity. This issue could also come to the fore in the US as elections loom, reducing the scope for bi-partisan deals on further stimulus.

Second, financial markets must remain supportive. This is obviously related to the first condition – markets would respond positively to strong signals of a rebound in consumer demand – but a lot will also depend on the capacity of monetary policy to support the fiscal effort. We are not worried about this in the US and the UK. This is less assured in the Euro area given the specific institutional constraints on European Central Bank (ECB) action. However, we want to be cautiously optimistic after the Franco-German initiative which – if endorsed by the other members – could relieve the pressure on the central bank by building a proper fiscal mutualisation capacity.

Third, the nature of the labour market shock will be key. We can probably expect a wave of "re-hiring" after the lockdown in the US, while in Europe "subsidised employment" will naturally give way to "self-sustained jobs". But some businesses will continue to suffer well after the peak in the pandemic. It is possible some sectors will be affected by lasting changes, e.g. transport, tourism or hospitality in general, conducive to a skills' mismatch in the labour market. There is thus a clear risk that what is for now merely "cyclical unemployment" turns into "structural unemployment", with a lasting adverse effect on consumer confidence.

It is quite possible that upon exiting the worst of the lockdown, some economic data and among them those pertaining to consumer spending rebound spectacularly, which would fuel market positivity. But we would advise to take some time to "gauge the damage" and check if such a rebound does not give way to a very cautious attitude towards spending. Reading real time economic data is challenging now. We need to take our time.

Inputs to investor confidence

In thinking about investment strategy, the near-term expected bounce in some of the high-frequency data is likely to improve investor sentiment. Data will suggest the worst of the economic downturn is behind us. Again, we need to be cautious as the medium-term outlook for economic recovery remains uncertain. US Federal Reserve (Fed) Chairman Jerome Powell recently said that the US economy would not fully recover until 2021. If recovery means attaining the same level of GDP that the US reached at the peak of the expansion before Q1 2020, this is optimistic. In the last recession, it took eight quarters from the trough in growth in Q1 2009 for GDP to return to its previous Q4 2007 peak.

Better short-term data prints are a necessary but not sufficient condition for a continued constructive view on risk assets. Ongoing evidence of a global peak in COVID-19 infections is another. Following the 2009 recession, recovery was held back by weak balance sheets and the credit crunch. Today the pace of recovery will be determined to a large extent by how quickly lockdowns are lifted and economic behaviours normalise. Successful management of this is also key to building investor confidence in credit and equities. Any suggestion that too rapid a loosening of social distancing guidance is leading to renewed spikes in infections will be bad news for markets.

We are positive that policy settings can remain in place for some time. This is important for the continued orderly functioning of money and credit markets. Core government bonds and investment grade credit are the asset classes most directly benefitting from the policy framework, with credit likely to continue to generate positive excess returns over coming months.

The policy framework is fundamental to the outlook for all asset classes to the extent that it will help determine the strength and timing of the recovery. However, there are two other vectors that are important – the longer-term management of the virus threat and the potential for sustained changes in the economic paradigm. Positive news on a vaccine and anti-viral testing is met with better stock market performance and the deployment of a successfully tested vaccine over the next year would certainly reduce the risk of rolling bear markets driven by recurring health and economic fears.

Equity markets appear to be reflecting the balance of positive news and look set to achieve previous highs long before they did after the 2009 downturn. This may be unnerving to many investors given the near-term earnings outlook and market level valuations. However, markets are also presenting a huge dispersion of performance. This is vividly illustrated by the growth-value gap and differences in performance between sectors that reflect the most COVID-19 damaged parts of economies and those that are reflecting changing business trends. Any set-back in risk appetite or more confidence on a traditional cyclical recovery could drive the growth-value gap lower again, but the legacy of the changes enforced by COVID-19 and opportunities created by that may continue to support the dominance of growth over the medium-term.

Download the full slide deck of our May Investment Strategy

[1] Ricardian equivalence is a theory suggesting households anticipate future government financing needs and adjust their savings accordingly, reducing current spending and negating the boost from increased government spending.

Global Macro Monthly – US

David Page,
Head of Macroeconomic Research,
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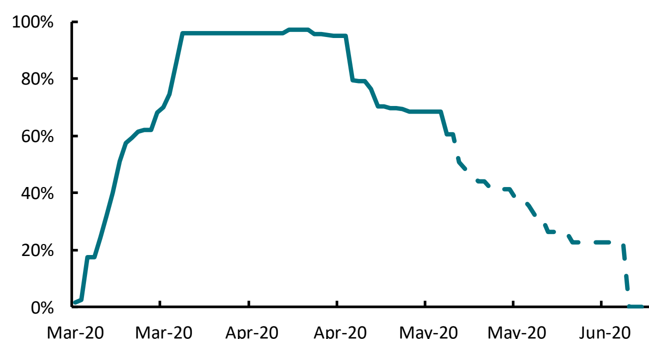
The economy enters shutdown

The US has the largest recorded number of coronavirus cases of any country, 1.5mn at the time of writing. Nationally, new cases are on a gently declining trend, but some states are still recording increases in daily new cases. Nevertheless, most states have now at least partially re-opened (Exhibit 1). This is early by comparison to Europe and China. Environmental factors, such as population density differences, may be driving this timetable, but public opinion and politics are also in the mix. The early re-opening is a gamble, balancing economic cost with virus control. This suggests a relatively higher risk of a second wave of the virus in the US.

Exhibit 1: US begins to emerge from lockdown

US - states in lockdown as % national GDP



Source: Auravision, NY Times, Bureau of Economic Analysis (BEA) and AXA IM Research, May 2020

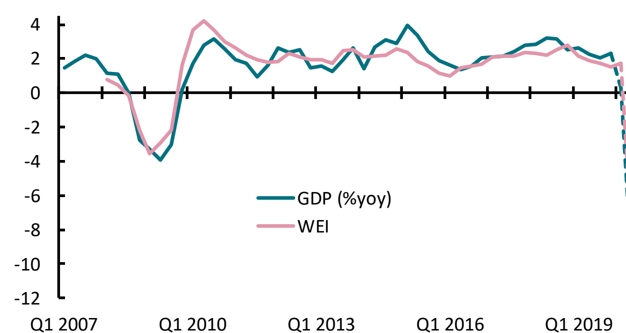
Q1 GDP contracted by 4.7% annualised (1.2%qoq) and in line with our expectation. We expect the economy to contract more sharply in Q2 (Exhibit 2), pencilling in a 34% annualised drop (10%qoq). This is consistent with high frequency data. More conventional evidence also points to a sharp contraction.

The scale of the rebound will depend on a number of factors, not least the unknowable path of the virus itself. We concentrate on the labour market. Loss of income during the lockdown or persistent unemployment thereafter, threatens to dampen any rebound. Much of the $2tn CARES Act fiscal stimulus will offset household income losses incurred through lockdown, through both extended unemployment benefits and direct payments. However, US unemployment rose to 14.7% in April and cumulative initial jobless claims have topped 36m. Continuing claims are at 22.8mn – suggesting over one in three initial claimants are being reemployed – but unemployment threatens to peak around 20% in May. Much of this should prove transitory, including furloughed workers, and we expect unemployment to fall towards 7.5% by end-Q3. But current levels suggest a risk of persistent joblessness, which could dampen the rebound.

Assuming a relatively benign outlook for the virus and jobless numbers, we see a sharp rebound in H2. We forecast -3.8% GDP growth in 2020 and cautiously suggest +5.3% in 2021 (consensus -4.6% and +3.8%). However, this would still leave GDP 3.6% below its pre-COVID trend by end-2020 and 1.7% below it at end-2021. We also emphasise the larger-than-usual uncertainty that surrounds our forecasts.

Exhibit 2: High frequency data suggest sharp Q2 drop

US GDP and the Weekly Economic Index



Source: BEA, Federal Reserve Bank (FRB) and AXA IM Research, April 2020

The Federal Reserve (Fed) has provided substantial stimulus to mitigate the virus impact. It cut policy rates to between 0-0.25% but has dismissed taking rates lower. It has expanded its balance sheet more swiftly than during the financial crisis, buying $1.5tn of US Treasuries and $0.6tn of mortgage-backed securities. It has also announced $2.3tn in programs to encourage broader lending in the economy. These measures – particularly corporate debt schemes – have boosted activity even before the start of official purchases.

The federal government has also committed just under $3tn of spending measures, recently topping up its Payroll Protection Program (PPP) to avoid additional job losses. Our analysis suggests that most of the announced spending measures are designed as income support for the coming months. Beyond the $454bn capital provided to the Fed for loan programs, little of the stimulus to date will be uncommitted beyond Q2. Discussions are also beginning for a fourth stimulus program, with Democrats starting the bidding with a $3tn package.

The Presidential election is now six months away, and a swift economic re-opening is consistent with an incumbent President keen for a supportive economy as voting takes place. Moreover, recent barbed comments towards China look likely to be a key theme of these elections. For now, the presumptive Democrat nominee Joe Biden leads in national polls, marginal state polls and even in some states that he would not be expected to win. That said, previous Democrat contender Hillary Clinton led by more at this stage and lost.

Global Macro Monthly – Eurozone

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Economist (Eurozone),
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German Constitutional court: a wake-up call?

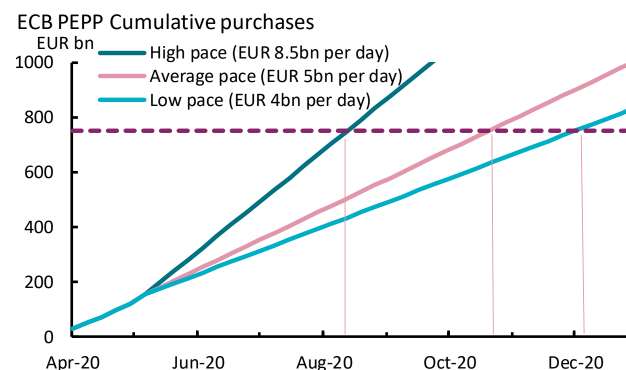
A legal deadlock has emerged in Europe which threatens the Bundesbank's participation in the Public Sector Purchase Programme (PSPP). The German Constitutional Court (GCC) has ruled that the European Central Bank (ECB) did not balance the PSPP's full economic impact against the benefit in terms of monetary policy objectives and stated that the European Court of Justice had failed to correctly check this in a preliminary ruling. This adds uncertainty to an already depressed Eurozone environment.

The ECB now has three months to satisfy the German authorities that the PSPP complies with the principle of "proportionality". Failing to do so would prevent the German central bank from taking part in the PSPP and force it to divest the government bonds it has acquired so far. We do not think the ECB will directly reply to the GCC: this would open the door to an infringement of the its independence and could destroy the EU legal order (If 27 national constitutional courts could individually judge the scope of EU competences in their countries, then EU law would mean different things in each country and would effectively have no meaning at all.

It is not clear to us that alternatives, such as the Bundesbank responding on behalf of the ECB, would satisfy the GCC. So we have to contemplate a scenario in which the Bundesbank ends up being permanently barred from the PSPP, with other national central banks potentially replacing the Bundesbank and buying Bunds, or other national central banks stopping buying Bunds and the ECB thus deviating substantially from the capital keys. The GCC ruling makes the latter less likely, as it underlined the crucial role of both the capital key rule for country allocation of sovereign bond purchases and the issue/issuer limits on sovereign bond holdings.

Such a ruling also has implications for the Pandemic Emergency Purchases Programme (PEPP), as it undermines the ECB's flexibility and raises hurdles for more Quantitative Easing (QE). We still expect an increase in the PEPP quantum at the June meeting – purchases have increased significantly in the week to May 6 and at this pace the EUR750bn of PEPP would be exhausted by mid-August (Exhibit 3) – but with less conviction. The ECB will have to balance between doing nothing, and being perceived as acquiescing to the GCC, or upsizing the PEPP and being accused of an act of defiance. ECB President Christine Lagarde's tenure so far is not the walk in the park lots of commentators were expecting a few months ago. We would not exclude more pressing questions on Outright Monetary Transactions (OMT) in the future.

Exhibit 3: Current PEPP lifetime



Source: ECB and AXA IM Macro Research, as of 15 May 20.

One way to alleviate the pressure on the ECB would be to step up efforts on fiscal mutualisation. The surprise French and German proposal is a proper breakthrough and suggests that the GCC ruling might have acted as a wake-up call to EU leaders on the need of more balanced policy mix. Paris and Berlin have proposed a joint EU issuance of EUR 500bn (c. 4% of EU GDP) that would be distributed through grants (not loans) to the regions and sectors that have been most affected by the Covid-19. This is a significant principle shift as it recognized the need for fiscal transfers and joint issuance, but it will require the unanimous support of EU member states. Attention will now focus on the European Commission proposal on May 27, in particular on details on grants' allocations and repayment key and schedule.

Another cut in our forecasts

We have revised our GDP growth forecasts lower. Q1 showed strong divergence between countries (from -2.2%qoq in Germany to -5.8% in France). We expect these to persist in Q2, reflecting different economic structures and a range of lockdown and exit strategies. We would emphasize caution over the Italian GDP number. It fell by only -4.7 %qoq in Q1, suggesting that activity was running just 20% below normal during the lockdown, contrasting with real time activity indicators (PMIs, Google mobility reports) and similar estimates from France and Spain (c. 30% loss of activity). Downward revisions seem likely. Overall, we expect Eurozone growth to drop by 7% in 2020, dragged by sharp contractions in private consumption and investment. Risks remained skewed to the downside, as more damage to the labour market (short-time working scheme are not fully preventing unemployment rise) could weigh further on household spending, while poor demand and liquidity concerns keep firms from investing. The latest ECB Bank Lending Survey showed a surge in demand for working capital, with business seeking cash to cover ongoing payments, but a plunge in the demand for long term investment.

Global Macro Monthly – UK

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Head of Macroeconomic Research,
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Challenges mount for UK outlook

The UK is struggling to control the virus when compared to international peers. New reported cases remain persistently high. The UK data on reported COVID-19 deaths suggests that actual cases could have been far higher. As well as the human cost, this exacerbates the economic cost by delaying the economy's re-opening. This began tentatively last week.

The economy contracted by 2.0%qoq in Q1 – the sharpest drop since Q4 2008 – reflecting a 5.8% drop in March alone. We estimate a far deeper 19.5%qoq drop in Q2, after which growth should pick-up. However, concerns over lost income and persistent unemployment may dent the rebound. We forecast annual growth to contract by 8.7% – the worst since 1921 – but any forecasts have unusually high confidence intervals, in part reflecting the unknowable future virus developments. Both the Office for Budget Responsibility and the Bank of England (BoE), have refrained from forecasts. Instead they have provided scenarios assuming steeper falls – at 12.8% and 14% – which would represent a 300-year low.

Significant stimulus has attempted to mitigate the shock. The Chancellor extended the jobs furloughing scheme to October. Direct government spending should rise to 6% of GDP, with loan guarantees worth a further 15%. The BoE left policy unchanged in May, with stimulus that we estimate should lift GDP by 3-4ppt over the next two years. But it is difficult to estimate the impact of the Term Funding Scheme before seeing its impact on corporate spending. We expect the BoE to extend QE by £100bn in June (and a further £75bn in November). A nuanced debate surrounds whether this is "monetary finance" to government. We believe the provision of interest-bearing reserves is different from monetary finance. However, we expect the BoE to continue to absorb much of the fresh gilt issuance over coming quarters.

Beyond COVID-19, the UK continues to threaten idiosyncratic damage to itself through its approach to Brexit. A third round of discussions failed to deliver progress on a new trade deal. June will see one more round of negotiations before formal assessments and the deadline to extend transition. The UK government continues to suggest it will not extend transition, despite COVID disrupting negotiations. Even a full free-trade agreement would include border disruption, but this would be worse in the case of no deal. We assume some brinkmanship and that a pragmatic extension before year-end will avoid a border shock interrupting an expected rebound. But the prospect of a material policy error looms.

Global Macro Monthly – Japan

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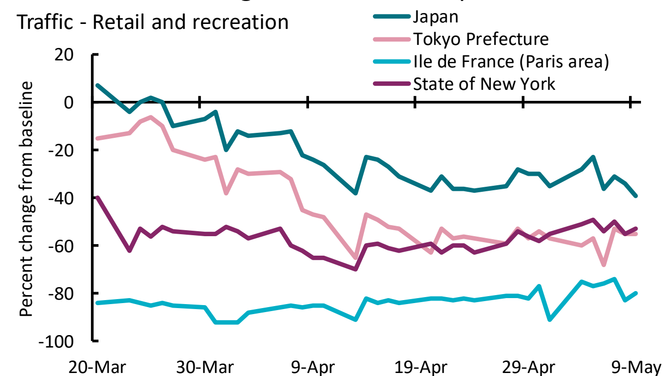
Japan enters recession before the big plunge

The impact of COVID-19 remains milder than elsewhere and the state of emergency seems to be effective in containing the number of new cases. On a seven-day rolling moving average, the number of new cases has fallen eightfold (from 613 per day at peak to 72 as of May 18). The government eased the state of emergency for 50% of the population and gradual relaxation is on its way for the remaining prefectures.

Q1 GDP fell by 0.9%qoq, a little better than expected (consensus -1.2%). Consumption and capital expenditure held up better than projected (at -2.8% and -0.5%) while the trade contribution was negative with exports falling by 6%qoq. We expect the Q2 figure will be worse, shrinking by 7.2%qoq. Activity contracted drastically in April and is likely to resume only gradually. Services PMI fell to 21.5 from 33.8, while the manufacturing PMI declined to 41.9 from 43.7. Traffic in retail stores appears to be 40% below normal (Exhibit 4). Lastly, global trade resumes only slowly and a large share of private investment projects are being abandoned or postponed.

Exhibit 4: Estimating the lockdown impact



Source: Google Mobility and AXA IM Macro Research, as of 9 May 2020

Following its latest monetary policy meeting, the Bank of Japan (BoJ) announced further easing. Commercial paper and corporate bond purchase targets were both increased by ¥7.5tn and the COVID-19 Special Funds-Supplying Operations (loans provision) were strengthened by expanding the eligible collateral and the number of counterparties. The yield curve control policy was unchanged with short-term rates at -0.10% and 10-year around 0%. Forward guidance was adjusted with two important changes: the net JGB purchase target was abandoned and the BoJ decoupled negative interest rate policy from inflation momentum. Both are supposed to give some leeway to normalise monetary policy when and if the economy revives.

Global Macro Monthly – China

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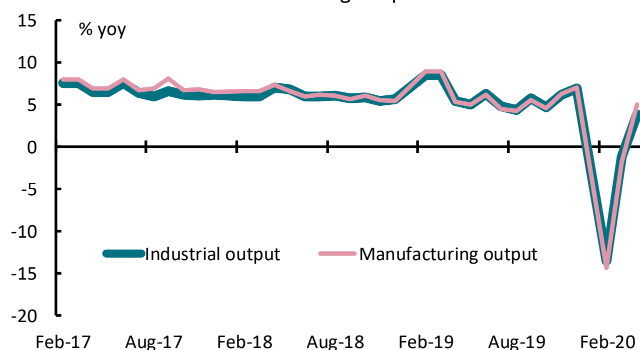
A step closer to normality

Broad-based improvement in April's monthly data suggests the economy inched closer to normality. Most notably, industrial production (IP) growth crossed the line, up 3.9% year on year (yoy) from -1.1% in March, thanks to a strong rebound in manufacturing activity, up 5%. It has taken only two months for IP to resume growth since the virus-induced sudden stop, giving its profile the closest resemblance to a V-shaped recovery (Exhibit 5). However, the outlook for industrial activity is not without concern. With backlogged orders almost cleared, but fresh external and domestic demand not picking up fast enough, the recovery in IP may run out of steam in the coming months until more forceful policy easing kicks in.

Exhibit 5: Industrial sector shows a V-shaped recovery



Source: CEIC and AXA IM Research, as of 15 May 2020

Production resumes faster than consumption

In contrast to the swift rebound in production, the consumption recovery was more muted. Retail sales contracted by 7.5%yoy, with the decline narrowing from -15.8% in March. Sales of daily necessities and medical goods continued to grow at a robust pace, but the biggest turnaround – since the start of the year – was in auto and mobile phone sales, with yoy growth improving by 37 percentage points (ppt) and 21ppt respectively.

In contrast, consumers remained cautious about eating out and playing out, leaving sales at restaurant/catering, shopping malls and box offices, still depressed. While recent consumer surveys show a notable increase in people's desire to resume old consumption habits, the recovery in these sectors will likely take time, particularly if the recent reoccurrence of mini-outbreaks keeps social distancing in place for longer.

While we do expect consumer spending to recover further in the near-term, there is a risk that the growth momentum may peter out once pent-up demand is exhausted. Households may then find themselves in a difficult position with rising unemployment (6%) and falling wages (-3.9%) weighing on incomes and forcing reduced spending. Beijing has now placed "ensuring job security" ahead of a GDP growth target, and we shall see how they plan to accomplish such a feat at the upcoming National People's Congress (NPC) meetings.

Spurring investment growth could be effective to expedite the recovery. Currently, the investment recovery (0.8%yoy) has lagged behind the production recovery, reflecting weak business sentiment and elevated caution. Among the sub-sectors, real-estate fixed asset investment (FAI) – up 6.7%yoy – has improved the fastest, thanks to a swift rebound in housing market activity. Infrastructure FAI also resumed growth, at 2.3%yoy, as local governments put money raised from recent bond sales to use. Sales of heavy trucks and excavators have rebounded strongly since May, benefiting from the infrastructure-construction push.

Manufacturing investment remained a laggard, with yoy growth contracting by 6.7% after suffering the steepest decline (-31.5%) at the start of the year. Although the production increase mentioned above is encouraging, without enough new orders to shore up confidence, many manufacturing companies may continue to exercise caution with capital expenditure. Once again, policy easing is needed here to make up for the demand shortfall and bring businesses back onto a sustainable growth path.

Policy easing needed to fill the void

Overall, we think the improved April data still reflect mostly supply normalization as the economy emerged from the lockdown. The clearance of backlogged orders boosted production and exports, while consumption and manufacturing investment continued to struggle amidst weak demand. The latter needs an urgent revival to continue the recovery from here, but that task is made difficult by subsequent lockdowns in large parts of the rest of the world and a worsening labour market domestically.

Policy easing is, therefore, needed to fill the void, and there are strong expectations for a comprehensive stimulus package at next week's NPC. We expect Beijing to raise its on-budget deficit to 3.5% of GDP from 2.8% last year, beef up central and local government bond issuance (to RMB2-3tn and 3-4tn respectively) and make good use of monetary policy to supplement/finance fiscal spending. Anything short of this will risk prolonging the economic pain that presents downside risks to our 2020 growth forecast of +2.3%.

Global Macro Monthly – EM

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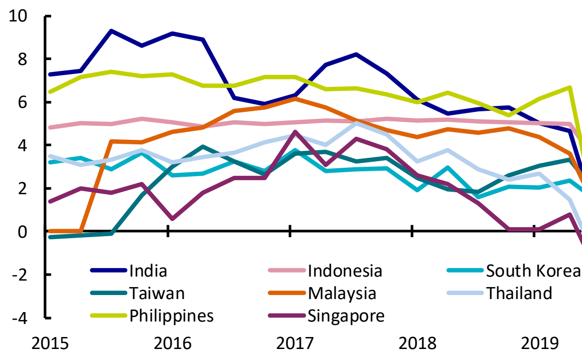
First indications of the COVID-19 damage…

While partial re-openings are starting to take place, the damage done by COVID-19 has already been reflected in the Q1 GDP numbers. Growth has deteriorated significantly across the region in Asia, with Indonesia, Korea, Malaysia, Philippines and Singapore all seeing growth declining to a pace not seen since the global financial crisis. This has been the result of both weak domestic consumption as well as a sharp drop in final demand from China. However, on the back of an extension of lockdown measures, as well as factory and business shutdowns in advanced economies, we expect a deeper contraction in Q2, raising concerns for whole year growth forecasts for the region (Exhibit 6).

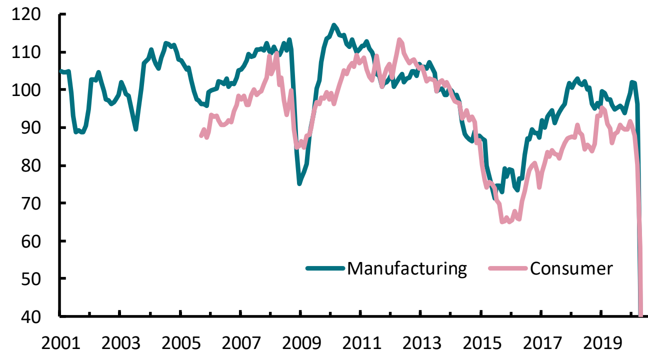
Exhibit 6: Activity contracted in Q1



Source: Refinitv Datastream and AXA IM Research, 18 May 2020

Flash Q1 GDP estimates pointed to a sharp sequential contraction in Central Europe: -2.6%qoq in the Czech Republic; -0.5%qoq in Poland; and -0.4% in Hungary. In Latin America, Mexico released its preliminary estimate of GDP growth recording a -1.6%qoq contraction in Q1. Lockdown measures were only implemented in the second half of March, hurting both industry and services activities. These measures are set to continue until the end of May, presaging a very sharp contraction in Q2. Activity was likely depressed in Brazil as well, where the crisis management was more erratic given a lack of coordination between central and local government. Most regional governments have implemented mitigation measures, including school closures, restrictions to public gatherings and to non-essential services. Industrial production has contracted by 7.8%yoy and broad retail sales plunged by 10% oy in March while confidence surveys have slumped to their lowest levels ever (Exhibit 7).

Exhibit 7: Surveys point to sluggish activity in Brazil



Source: Datastream and AXA IM Research, 18 May 2020

… calling for more policy action

Central banks continued to ease monetary policy in May, with Brazil (-75bps), Malaysia (-50bps) and the Czech Republic (-75bps) cutting policy rates. Additionally, some emerging market central banks are embarking on quantitative easing (QE) measures, including South Africa, Poland, Hungary and Turkey. More recently, Brazilian authorities granted permission to the central bank to start a QE programme (corporate bond purchases) in order to fight the pandemic-led economic slowdown.

On the fiscal policy front, the Indian government has recently announced a special economic package, which combined with earlier stimulus measures aggregates to INR20tn, or about 10% of India's GDP. The first instalment mainly focuses on credit guarantees and ensures that liquidity flows to the financial periphery. This was quickly followed by the second part of the economic package, which focused on the needs of migrant workers, street vendors and farmers, who have been suffering from the COVID-19 related slowdowns. The third, fourth and fifth parts of the package include structural reforms, revitalizing measures for agriculture and allied activities, and an increase in employment guarantee outlays.

Brazil's Lower House has approved a "War Budget" of BRL700bn in pandemic recovery measures, not bound by the provisions of Brazil's Fiscal Responsibility Law nor the constitutional golden rule. Fiscal measures add up to nearly 8% of GDP – the direct impact in the 2020 primary deficit is estimated at around 5% of GDP.

Investment Strategy – Cross-assets

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Hope in adversity

The economic data is dire and the macro outlook bleak but, arguably, the worst of the shock should be behind us. Policy has helped stabilise markets and the slow emergence from lockdown is underway, with activity starting to pick-up. Uncertainties remain though and investors need to be patient in building a medium-term strategy. The policy outlook and its impact in terms of market support is a key factor. Another is near-term information about the bottoming-out of activity and the creation of positive momentum. Also, very important, is having confidence that economic re-opening will not be detrimental to the pandemic's evolution. Finally, one needs to distinguish between winners and losers at the individual company and sector level. Equity markets, for example, may be at the right level or not on an aggregate basis, but the market surely provides opportunities for long-term gains either on recovery plays or structural growth winners.

Investment Strategy – FX

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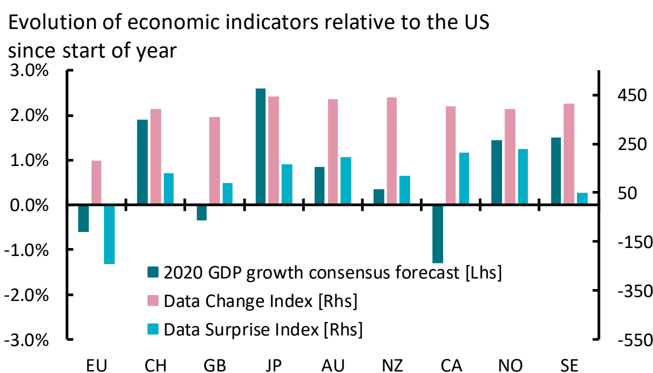
Did Covid put an end to USD exceptionalism?

Exhibit 8: G9 growth data and expectations beating the US



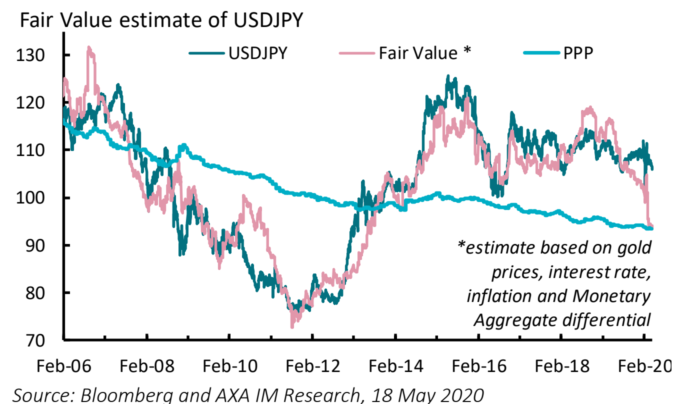
Source: Bloomberg and AXA IM Research, 18 May 2020

After the Fed's dovish U-turn in December 2018, the USD has remained strong, despite the lower interest rate differentials. One key support was attributed to US growth continuing to perform significantly better than other developed economies. Since then, the USD has lost its carry advantage over other currencies, and the US economy is equally threatened by the impact of lockdowns. The deterioration of economic data has been greater than expected in the US, with suggestions that expectations have come down more in the US than in other economies (Exhibit 8). This threatens the US growth 'exceptionalism' support to the USD right now. The US administration is opening parts of the US more quickly than in other parts of the world, which could make a positive difference on growth, but also heightens the risk of a second wave. March's liquidity tensions had also supported the USD, but Fed intervention has brought liquidity back to normal, adding to reasons for the USD to weaken from here.

A game changer for USDJPY

Growth expectations for the EU are equally dire if not worse, and the difficulties of an incomplete fiscal union continues to hang over the euro project. The German Constitutional Court decision on ECB QE (PSPP) in May brought this issue back to the forefront. This development should not, though, derail ECB QE and indeed the EUR has managed to withstand the impact from this adverse news and data flow. All in all, a chance for a timid comeback for the euro from low expectations remains, but our conviction is not high. JPY offers a more compelling case to beat the USD. First, after the Fed's massive intervention compared to a very constrained BoJ, the JPY now looks rather sharply undervalued (Exhibit 9). Second, the uncertain outlook and the lower foreign rates differential against JPY should now depress Japanese investment outflows, at least on an unhedged basis. Furthermore, the large stock of unhedged foreign investment looks cheaper to re-hedge and the positive JPY positioning that has emerged is far from extreme. Finally, JPY safe-haven status is still effective, as we saw in March when USD liquidity tensions struck, offering protection if the global outlook deteriorates further. Among G4, GBP looks for the time being the weakest. The UK government looks intent on not extending the Brexit transition. Markets are likely to reprice the probability that the UK starts 2021 with a limited deal or no deal as we approach June's extension deadline.

Exhibit 9: USDJPY destined to depreciate after Fed massive easing



Source: Bloomberg and AXA IM Research, 18 May 2020

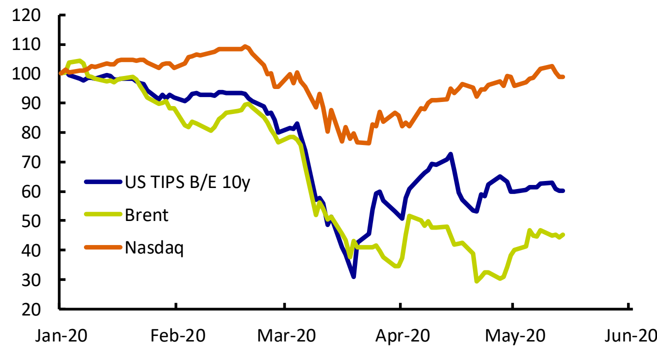
Investment Strategy – Rates

Alessandro Tentori
AXA IM Italy CIO and Rates Strategist
Research – Core Investments

Duration: a rather pleasant asymmetry

Long-dated government bonds have performed very well during the COVID-19 crisis: US Treasuries with >10-year maturity have returned about 22.5% year to date, while Bunds are up some 8.3% in the same maturity range. This shouldn't be a surprise in light of a deep global recession and dismal equity returns. However, different asset classes still seem to price a different path to economic recovery (Exhibit 10): the Nasdaq suggests a V-shaped recovery, while US Treasury Inflation-Protected Securities (TIPS) are in the W-camp and oil prices imply perhaps a more L-like trajectory.

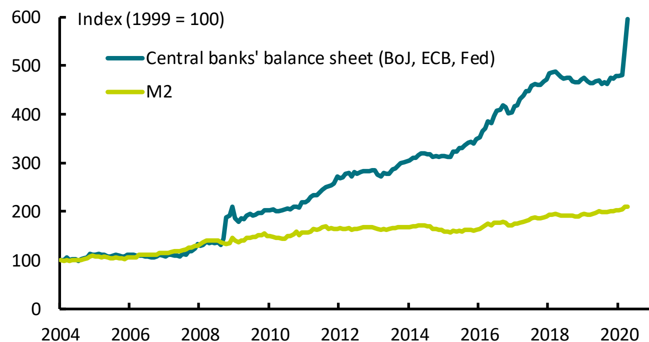
Exhibit 10: How will it look like ex-post?



Source: Bloomberg and AXA IM Research, 18 May 2020

When we analyse markets, we must account for the likelihood of a policy reaction. This is even more true in the aftermath of the global financial crisis, as central banks have provided an abundant liquidity backstop against the risk of a sharp depreciation across asset classes. This mechanism is necessary because of the increasing reliance on leverage, which tends to amplify profits and losses.

Exhibit 11: Big central bank



Source: Bloomberg and AXA IM Research, 18 May 2020

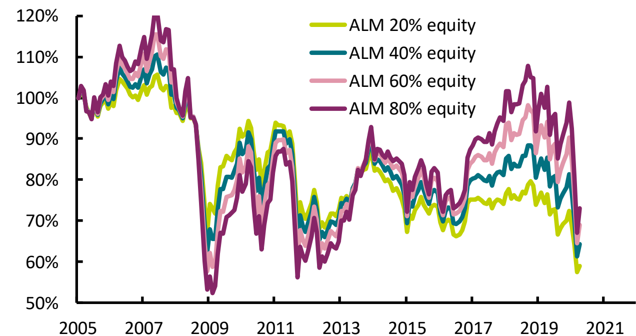
Exhibit 11 shows the extent to which monetary policy has intervened in the marketplace, by comparing the cumulative increase in balance sheet vs the evolution of money supply.

This raises several questions:

- Would a fully-fledged credit crisis à la Hyman Minsky develop without perpetual central bank support?
- Does it imply a constantly increasing role for central banks and governments vs a shrinking relevance of the private sector?
- What can we say about price discovery, asset pricing and eventually about the role of relative prices in allocating scarce resources?

A comprehensive answer to the questions above would require a dedicated forum, but perhaps we can try to briefly address asset pricing and price discovery. Government bond markets are extremely liquid markets, despite the negative liquidity effect of central banks' balance sheets. Not only are Treasuries and Bunds the backbone of general portfolio construction, but they are particularly relevant to managing long-dated pension and insurance liabilities.

Exhibit 12: The effect of lower yields and stocks



Source: Bloomberg and AXA IM Research, 18 May 2020

In theory, buying bonds is similar to selling options: you collect a small premium/coupon against a potentially sizeable loss. But the global financial crisis and central bank involvement have tweaked this relationship. There is a positive feedback loop we should respect, when deciding about the duration profile of our portfolios. If government bond yields rise, then central banks worry about a tightening of financial conditions. Their typical response will move along the path of forward-guidance substantiated by asset purchases.

This reaction provides a cap on long-dated yields, which in turn has consequences for the present value of long-dated liabilities and pension cover ratios (Exhibit 12). Add to this a high level of macro uncertainty, as well as volatile risky assets, and the result is likely to be an asymmetric risk/reward profile of government bonds. Except that this time the asymmetry is in favour of duration. By analogy, it's comparable to buying options and getting paid for it.

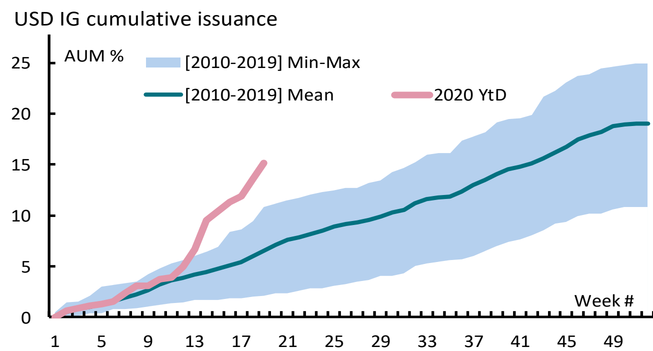
Investment Strategy – Credit

Gregory Venizelos
Credit Strategist
Research – Core Investments

Massive corporate bond supply…

Once the initial COVID-19 shock washed over credit markets, and spreads snapped back, a massive amount of debt issuance followed. With central banks putting a floor under risk premia, investors were encouraged to step back into the market and meet the dash for corporates, to fortify the cash on their balance sheets through fresh borrowing. US dollar investment grade (USD IG) issuance year-to-date has been gigantic and clearly record breaking. Euro investment grade (EUR IG) issuance has been comparably large. During April and May, both USD IG and EUR IG primary markets broke all previous records of weekly issuance. As a result, both EUR IG and USD IG are at a run rate well above the maximum of the 2010 to 2019 envelope, in terms of cumulative year-to-date issuance amounts (USD IG, Exhibit 13). In terms of issuance as a share of the existing market size, EUR IG has not yet broken the 2016 record, the year when the European Central Bank (ECB) launched its corporate securities purchase programme. USD IG, on the other hand, has already reached a share of issuance twice as high as the 2019 record.

Exhibit 13: 2020 issuance run rate well over prior years



Source: Bloomberg and AXA IM Research, 18 May 2020

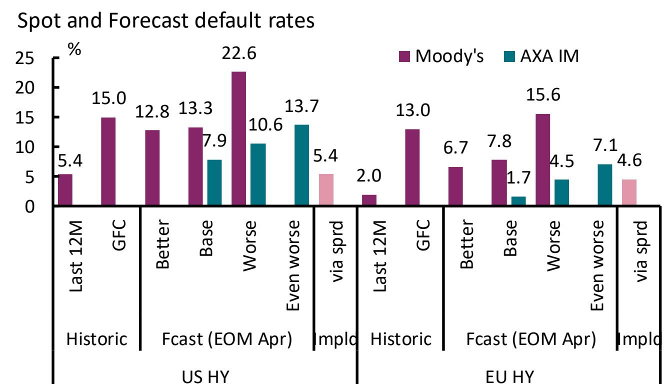
… offset by keen central bank purchases

In the week commencing 4 May, the ECB bought €34.1bn in total securities through its Pandemic Emergency Purchase Programme (PEPP) and €10.7bn via its other purchase strategies – a total of €44.8bn. This amounts to a daily run rate of €6.8bn for PEPP and €9bn for all programmes – both at the highest level since the PEPP began on 26 March, by about one third compared to the prior average. Some €2.6bn out of the €9bn daily amount was in corporate bonds – between a quarter and a third of weekly primary issuance. Even assuming a more modest weekly PEPP run rate of €25bn per week, the PEPP would hit its target of €750bn ahead of schedule, seven weeks before year-end.

Default outlook – adverse and complicated

Default valuations look very rich for the US high-yield (HY) market. In contrast, the picture is somewhat nuanced for European HY: it looks rich against Moody's default forecasts but cheap against our own. Actual default rates have inevitably risen between the end of March and the end of April, from 4.8% to 5.4% in the US and from 1.7% to 2% in Europe. Looking ahead, after an overreaction in March, Moody's has dialled back its default expectations in its April report. Its default rate forecast has been reduced to 13.3% in April from 14.4% in March, for US HY and to 7.8% from 8.1% for Europe HY. Still, Moody's forecasts remain elevated and notably more bearish than our own (Exhibit 14). Additionally, Moody's forecasts also remain below 2008/2009 global financial crisis default rates.

Exhibit 14: Moody's default expectations, more bearish than our own



Source: Moody's, ICE and AXA IM Research, 18 May 2020

There has been a significant divergence between the US and Europe regarding a key default driver. While bond distress ratios have deteriorated comparably in the US and Europe by circa 15 percentage points, bank lending constraints have worsened from 0 to more than 40 in the US but have improved from 0 to -10 in Europe (3). Because of this divergence in lending standards, our default model* implies a forecast for Europe that is much lower than for the US (1.7% vs. 8%). The default rate forecast of 1.7% for Europe looks very benign outright, but it's a simple reflection of the sharp reversal in risk premia and the material easing in lending standards. However, even a more adverse scenario would still leave Europe default expectations just below the level implied by spreads at 4.5% forecast versus 4.6% implied. From a spread valuation perspective, Moody's default expectations make HY markets look very expensive across the board and massively so in the US. In contrast, our model's lower default forecasts still leave US HY spreads looking overvalued but to a much lesser degree than Moody's. Notably, Moody's base case scenario is more in tune with our most severe scenario out of three severity levels: "base", "worse", "even worse" (Exhibit 14).

** our 2-factor model predicts the 12M default rate, one year out, based on the current reading of distress ratio and lending standards.*

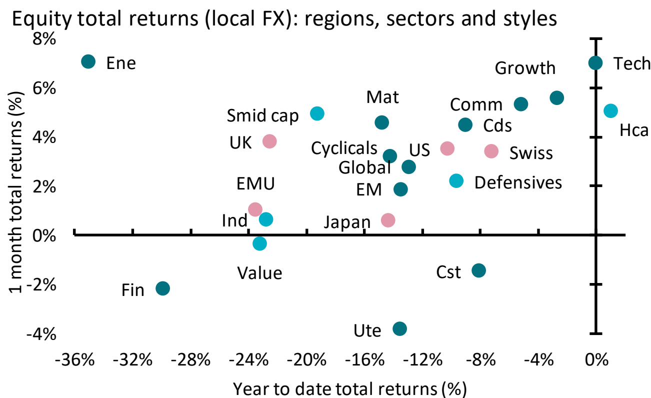
Investment Strategy – Equity

Varun Ghotgalkar,
Equity Strategist,
Research – Core Investments

Growth leads amid persistent volatility

Global equites have recovered around half their decline since March's low. At the time of writing, year-to-date returns for global equities stood at -13%; the peak to trough drawdown before the rebound was around 34%. The timing and quantification of this situation remains challenging and equity markets are still volatile with the VIX gauge hovering around 30 points. Growth investing, driven by the technology space, continues to significantly outperform other styles (Exhibit 15).

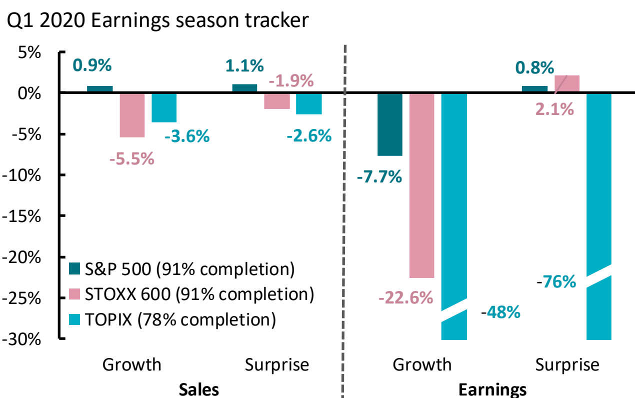
Exhibit 15: Tech and health care stay market leaders



Source: Datastream and AXA IM Research, 18 May 2020

The first quarter earnings season is winding up, with earnings and sales surprises mixed across regions. In the US, earnings surprises are running at 0.8% and in the Eurozone at 2.1%. Reported numbers show meaningful contractions in profit margins with overall earnings growth negative (Exhibit 16). Given the high degree of uncertainty, many companies have suspended guidance, focusing instead on their cash positions.

Exhibit 16: First quarter earnings growth in the red

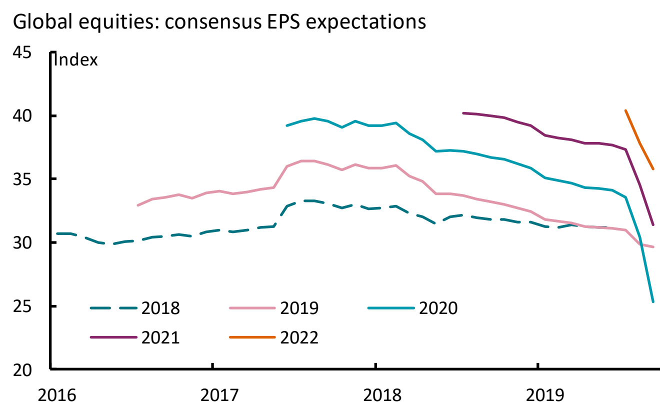


Source: Bloomberg and AXA IM Research, 18 May 2020

2020… The lost year

Global earnings in 2020 are now expected to decline by around 12.4% but then rebound by 22.2% in 2021, implying that earnings-per-share for the global indices are expected to regain their 2019 high water mark next year. Consensus expectations still appear optimistic given the economic impact of the crisis and are likely to be revised further downwards. However, the market is continuing to try to price an uncertain growth trajectory (Exhibit 17), given the stimulus impact and recovery prospects for the second half of 2020.

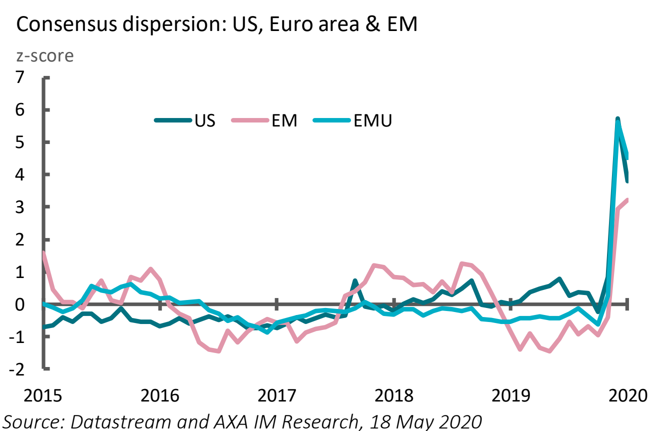
Exhibit 17: Global EPS to recover in 2021



Source: Datastream, IBES and AXA IM Research, 18 May 2020

A sustainable rebound is only likely once there is sufficient confidence, that the virus is contained – and that there will be no significant second wave in regions where lockdowns are being withdrawn. Given the negative earnings revisions, global equities are now trading at around 17x forward earnings following the bounce, with the earnings and bond yield gap, still elevated.

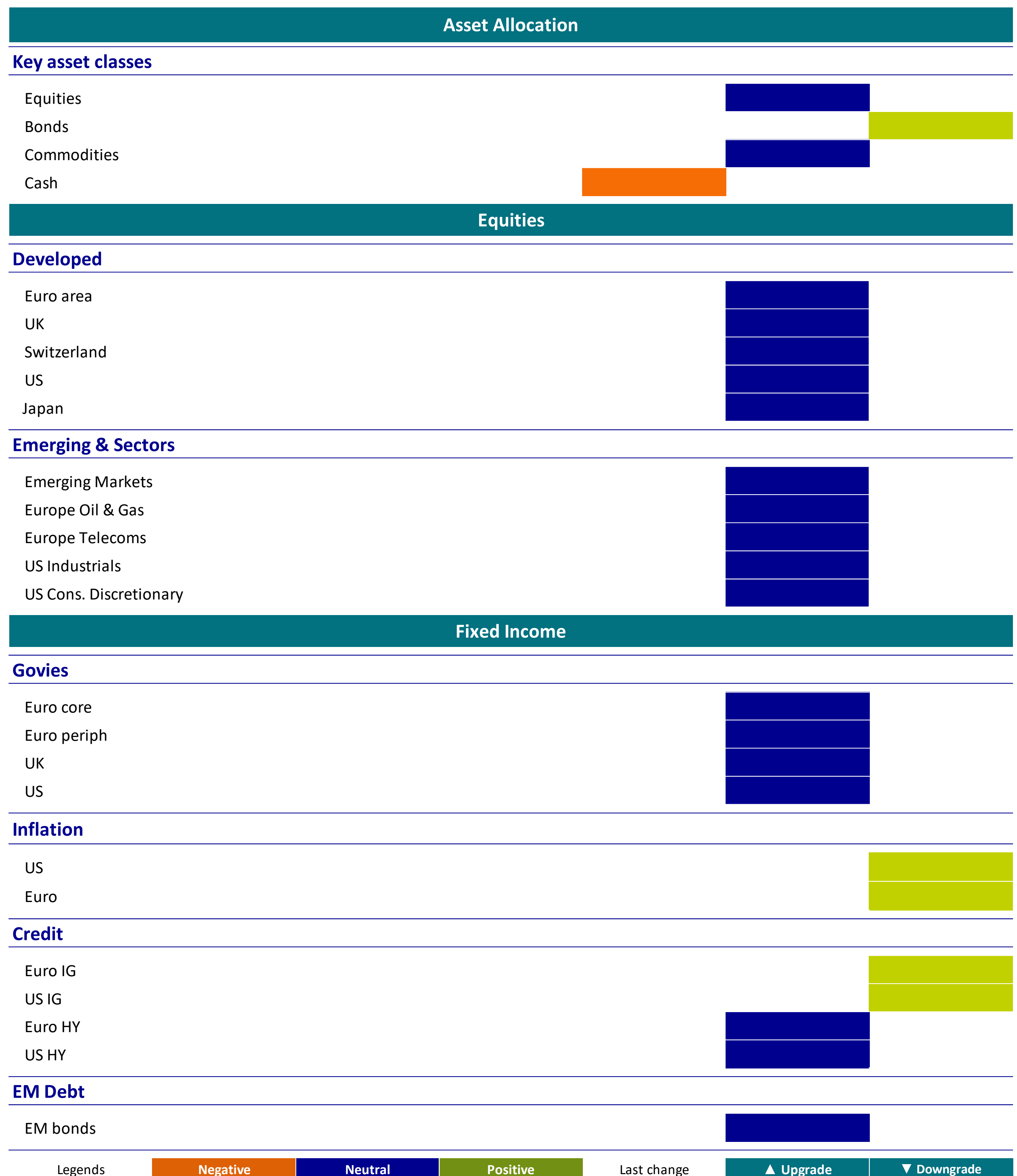
Exhibit 18: Earnings visibility remains poor



Source: Datastream and AXA IM Research, 18 May 2020

The way the growth shock versus stimulus backstop plays out, remains key. Earnings visibility, which is crucial for a rebound in sentiment, remains very poor for now – reflected in the massive dispersion within analyst forecasts (Exhibit 18). We remain medium-term constructive, given the initial signs of virus containment, the easing of lockdowns and the strong monetary and fiscal stimulus packages in place.

Recommended asset allocation



Source: AXA IM Macro Research – As of 20 May 2019

Macro forecast summary

Real GDP growth (%)	2019*	2020*		2021*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
World	**2.9**	**-2.8**		**6.3**	
Advanced economies	**1.7**	**-5.7**		**5.9**	
US	**2.3**	**-3.8**	-4.0	**5.3**	3.9
Euro area	**1.3**	**-7.0**	-5.7	**6.2**	5.4
Germany	**0.6**	**-5.2**	-5.0	**4.4**	4.5
France	**1.3**	**-8.5**	-5.4	**9.5**	5.1
Italy	**0.3**	**-8.0**	-7.5	**5.7**	4.5
Spain	**2.0**	**-9.1**	-5.7	**7.8**	5.2
Japan	**0.7**	**-5.8**	-3.3	**3.3**	2.1
UK	**1.4**	**-8.7**	-5.4	**8.0**	4.7
Switzerland	**0.9**	**-4.9**	-3.3	**3.5**	3.6
Emerging economies	**3.6**	**-1.1**		**6.5**	
Asia	**5.2**	**0.5**		**7.2**	
China	**6.1**	**2.3**	2.0	**8.0**	7.8
South Korea	**2.0**	**-2.8**	-0.5	**4.5**	3.1
Rest of EM Asia	**4.4**	**-1.3**		**6.5**	
LatAm	**0.1**	**-6.5**		**6.5**	
Brazil	**1.1**	**-7.4**	-3.2	**8.3**	3.1
Mexico	**-0.1**	**-6.8**	-6.2	**7.0**	2.5
EM Europe	**2.1**	**-6.6**		**5.7**	
Russia	**1.3**	**-6.1**	-3.8	**3.7**	3.0
Poland	**4.1**	**-5.0**	-3.1	**5.4**	4.3
Turkey	**0.9**	**-5.6**	-2.2	**6.5**	4.5
Other EMs	**1.5**	**-2.5**		**4.0**	

Source: Datastream, IMF and AXA IM Macro Research – As of 20 May 2020

CPI Inflation (%)	2019*	2020*		2021*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	**1.5**	**0.1**		**1.2**	
US	**1.8**	**-0.4**	0.8	**1.8**	1.8
Euro area	**1.2**	**0.3**	0.4	**0.8**	1.3
Japan	**0.5**	**-0.5**	-0.1	**-0.1**	0.2
UK	**1.8**	**0.7**	1.0	**1.2**	1.6
Switzerland	**0.4**	**0.6**	-0.5	**0.5**	0.5
Other DMs	**1.8**	**1.4**		**1.9**	

Source: Datastream, IMF and AXA IM Macro Research – As of 20 May 2020

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	Q2 - 20	Q3 - 20	Q4 - 20	Q1 -21
United States - Fed	Dates	0-0.25	9-10 Jun	28-29 Jul 15-16 Sep	4-5 Nov 15-16 Dec	26-27 Jan TBC
	Rates		unch (0-0.25)	unch (0-0.25)	unch (0-0.25)	unch (0-0.25)
Euro area - ECB	Dates	-0.50	4 Jun	16 Jul 10 Sep	29 Oct 10 Dec	21 Jan 11 Mar
	Rates		unch (-0.50)	unch (-0.50)	unch (-0.50)	unch (-0.50)
Japan - BoJ	Dates	-0.10	15-16 Jun	21-22 July 16-17 Sep	28-29 Oct 17-18 Dec	TBC TBC
	Rates		unch (-0.10)	unch (-0.10)	unch (-0.10)	unch (-0.10)
UK - BoE	Dates	0.10	18 Jun	6 Aug 17 Sep	5 Nov 17 Dec	4 Feb 18 Mar
	Rates		unch (0.10)	unch (0.10)	unch (0.10)	unch (0.10)

Source: AXA IM Macro Research - As of 20 May 2020

These projections are not necessarily reliable indicators of future results

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