Preparing the recovery

Monthly Investment Strategy

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Key points

- Lockdowns seem to work against the covid-19 pandemic, but as they generalise, they will trigger a steep global recession in the first half of 2020. We have taken our forecasts down, again.
- The magnitude of the rebound will depend on the quality of the policy support put together now. We have the building blocks of a very decent package, but some questions linger on implementation.
- Market valuations will stabilise once investors have fully digested the policy stimulus and more tangible good news will emerge on the epidemic front.

Global recession is unavoidable – it does not need to be protracted

The extension of the covid-19 pandemic is forcing a growing number of countries into "lockdowns", which will have a very significant impact on economic activity since the worst-hit sectors (restaurants, hotels, recreational activities) will see their output fall to nearly zero, while the rest of the economy will be impaired by the generic disruption in day to day life and deterioration in confidence triggered by heightened uncertainty.

What is key is how long the lockdowns will take to get the epidemic under control. They seem to be efficient. In Italy – which we use as a benchmark to gauge the impact on complex, democratic Western economies, the daily growth rate in the number of cases in some of the worst-hit locations

in the North which went into lockdown early has fallen below 5%. But for the country as a while, while it has abated, propagation is still on a two-digit pace. Consequently, we retain as our baseline that normalisation in the world economy cannot start before Q3. Indeed, we will need to wait until *all* economic regions are past their epidemic peak, otherwise global trade will continue to be impaired by demand or supply-side disruptions are a point or another of the value chain.

On this assumption, we would expect both the US and the Euro area to go through a steep recession in the first half of 2020. We see GDP falling by 0.4% this year in the US and by 2.1% in the Euro in annual average. The US outperformance would merely reflect a difference in trend growth and a stronger carry-over effect from 2019. The covid-19 shock is symmetric across the Atlantic, to the tune of about 2% of GDP in annual average in 2020.

Our rebound in the second half of the year is dependent on a strong policy stimulus to nip in the bud the second-round effects stemming from business defaults and rising unemployment. The response is becoming commensurate with the task. Fiscal packages worth up to 5% or even 10% of GDP are being set up in the US, the UK and Germany. The ensuing rise in deficits will be absorbed thanks to the extraordinary steps taken by the central banks.

The Federal Reserve (Fed) has committed to unlimited quantitative easing (QE) and plugged some holes in its emergency toolkit by starting to buy corporate bonds (for the first time) and even lending directly to businesses. The European Central Bank (ECB) has disposed in practice of its self-imposed "limits" for the duration of the covid-19 crisis while pledging more than one trillion euros in additional purchases this year. These are truly historic decisions.

Implementation will have to be closely monitored. It will take some weeks to translate the policy decisions into action, especially since central banks and governments are themselves operating under the same organisational constraints as everyone else under the "lockdowns". Some of the aspects of the monetary stimulus still needs to be more detailed (e.g. what would be the pricing of the Fed's new intervention tools. Still, we have the building blocks of a very decent protection capacity for the world economy. Now, while implementation is being beefed up, we need to hear some good news on the epidemic front.

Markets looking for this good news

Looking to markets, attempts to formulate a short-term view are hostage to the ongoing high levels of market volatility and uncertain news flow. Daily information on the evolution of the epidemic is crucial for investors. As is the flow of policy initiatives. Both these sets of factors will determine the shape and veracity of the subsequent recovery. As we note, there are already decent building blocks in place.

However, investors are understandably struggling to evaluate the impact of the crisis. The economic sudden stop makes it impossible to value corporate assets as the trajectory of cash-flows for many businesses and sectors will be unknown for a while. To us, the Fed's most recent package of policies is good news for the US corporate bond market. It essentially provides a massive financing facility for the corporate sector. This is positive for US companies and the US economy, particularly when combined with other initiatives. Ultimately this will be beneficial for stocks too, but for now it is a credit backstop and equity investors must still factor in a big drop in earnings.

Attempting to look ahead

Some signs of market stability are beginning to emerge. However, we can't rule out further losses across asset classes. Corporate bond spreads are not yet as wide as they were in 2008. The fact that the central banks have moved quickly may prevent those levels being tested but it can't be ruled out as the scale of the economic disruption becomes clearer. On the equity side, earnings forecasts will continue to be reduced and multiples have yet to reach the high single digit/low double-digit levels they got to during 2008.

Valuations will stabilise once the full impact of the policy moves is combined with better news on the epidemic. Yet the legacy will be a very different economic landscape. Central banks will own huge shares of the government bond market and will be the lender of last resort to the entire economy. Governments will have socialised numerous economic activities and businesses. Estimating true economic value across asset classes will be a hard job for years to come. Repaying official loans will become a claim on cash-flows over the long-term. Some business models will be changed forever, some for the good and some for the bad. Growth focussed investors will look for those companies that adapt to changing patterns of demand and much altered supply chains.

Unprecedented policy interventions and radical changes to our economies will not come without costs. Equity investors are unlikely to be able to rely on share buy-backs or dividends to be drivers of returns. Government bond holders will find returns in that market dominated by the biggest buyer and seller both being different agencies of government. Investment strategies that have relied on leverage might have been terminally impacted. More than ever, the changes in our economy and in how we assess companies will require active investment management.

Download the full slide deck of our "March" Investment Strategy

Global Macro Monthly – US

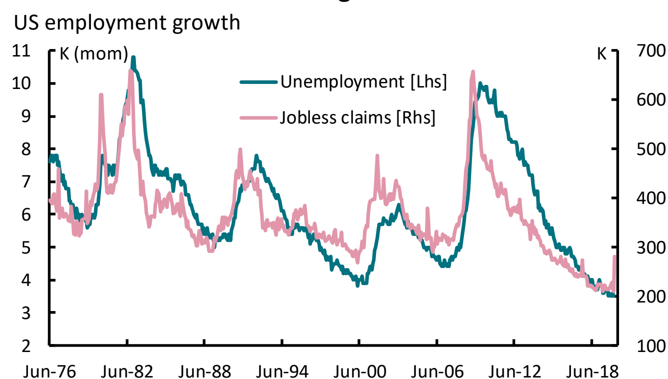
David Page,
Head of Macroeconomic Research,
Macro Research – Core Investments

Coronavirus alters US economic landscape

On 23 February the US had 35 recorded cases of Covid-19. One month later and it has 35,000 recorded cases. California and New York have stay-at-home guidelines in place and President Trump has moved from dismissing the virus to declaring a state of emergency and dispatching the National Guard. The swift evolution of COVID-19 in the US promises an equally swift deterioration in economic conditions.

Official economic data lag the most recent developments. However, some of the more leading indicators are already beginning to herald an unprecedented scale of economic disruption. The Philadelphia and Empire State surveys both recorded their sharpest monthly declines on record, going back to 2001 and 1968 respectively. Jobless claims recorded a rise of 70k in the latest week (Exhibit 1). This saw the level rise to an (ex-hurricane) four-year high. We await future weeks data to gauge the full scale of labour market reaction.

Exhibit 1: Labour market begins to deteriorate



Source: BLS and AXA IM Research, March 2020

US authorities have reacted quickly to try and stop a large demand shock associated with severe restrictions on usual activities, and to prevent the expected drop in consumer and business confidence sparking a deep and lasting recession. For now, we lower our forecast for US annual GDP growth to -0.4% (from +1.4%) for 2020. We fully expect a recession. However, even this forecast assumes a relatively benign labour market reaction. Risks are skewed to the downside.

Authorities try to get ahead of virus impact

The Federal Reserve (Fed) was characteristically fast to react to unfolding events. On 3 March, following a G7 teleconference that failed to produce more than reassurances, the central bank cut the Fed Funds Rate by 50bps to 1.00-1.25%. The Fed's statement suggested further easing and on Sunday 15 March, it cut rates by a further 100bps and restarted quantitative easing (QE), announcing $700bn of asset sales ($500bn in UST and $200bn in MBS). On 23 March, the Fed expanded this operation, removing the QE limit altogether and committing to buying "amounts needed" to restore market functioning.

The federal government has also attempted to mitigate the virus impact. On 4 March the government announced an emergency stimulus package of $8.3bn, including funding for public health and for the Centre for Disease Control (CDC). On 13 March, the President declared a state of emergency, releasing $42bn (0.2% GDP) to the Federal Emergency Management Agency (FEMA) On 18 March, the government issued a second relief bill, worth "multi-billions", which allowed for up to 12-weeks sick pay for coronavirus-related illness. However, at the time of writing the government has failed to pass a Senate Republican package estimated to be worth around $2tn (9% of GDP). Democrats are concerned that the package does not support workers or state and local governments, with too much stress on corporate bail-outs, including the $500bn expected support for airlines and other affected business. This delay is allowing economic uncertainty to grow, and jobs to fail. The Fed has also delayed a Main Street Business Lending Program, presumably intended to provide lending to small businesses and households, presumably because it requires support from the stimulus package.

Liquidity concerns

The immediate problem for the economy is dollar liquidity. The expected drop in demand and resultant financial stress has resulted in a sharp increase in demand for dollar liquidity. This has been exacerbated by trading strategies exposed to VAR-shocks, trading reporting regulations and reduced risk appetite as financial institutions use emergency measures to keep staff working. The liquidity shortage is clear in financial markets: 'safe-haven' assets have fallen, including 10-year US Treasury yields that rose by 55bps to 1.20% (currently at 0.81%); an elevated LIBOR-OIS spread at 110bps – the highest since March 2009 – and strong demand for the US dollar, which is up nearly 8% over 10 days.

Fed policy has also been geared towards alleviating this liquidity crisis. The Fed increased repo market intervention – offering over $1trn. It front-loaded and scaled up QE purchases to repair dysfunctional markets. It introduced commercial paper and money market funding facilities to underpin short-term credit markets; eased access to and encouraged use of its Discount Window; and enhanced dollar swap lines with key international central banks. It has now committed to support primary and secondary corporate debt markets. At the time of writing, liquidity continued to look scarce. But we expect the Fed's latest measures to turn the liquidity tide. If not, the Fed will do more in short order.

Global Macro Monthly – Eurozone

Apolline Menut,
Economist (Eurozone),
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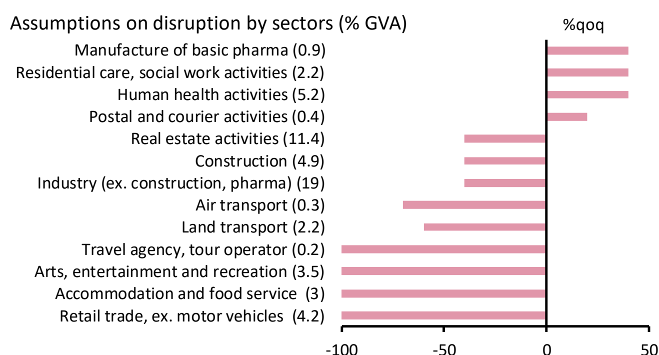
Lockdown mode…

The coronavirus has spread rapidly across Europe forcing countries to adopt strict containment measures. As France and Spain followed Italy into lockdown mode, key sectors of economic activity will be severely hit. We have used a bottom-up approach to gauge the economic cost of the COVID-19 crisis, making assumptions on sectors where activity will fall to zero (restaurants, hotels, events), sectors likely to be partially disrupted (transport, manufacturing), sectors that may operate as usual (information, public sector) and sectors that could see a boost (food retail, pharmacies, pharma firms, health-related services). We assume disruptions will last six weeks, split over the first and second quarters. As to the recovery path, we see only a return to normal in most services sectors impacted (itself an optimistic assumption), with some catch-up only in the manufacturing sector. This pushes our Eurozone growth forecast down to -2.1% in 2020 (from -0.2%), with sharper revisions in Italy (-3.3%) and Spain (-1.8%) than in France (-1.3%) and Germany (-2.3%). Risks remain skewed to the downside, with potentially longer disruption affecting the labour market more severely and creating second-round effects with further deterioration in demand (Exhibit 2).

Exhibit 2: GDP's blow from lockdown



Source: Eurostat and AXA IM Macro Research, as of 21 March 20.

… Forces bold ECB actions…

The European Central Bank (ECB) approach was initially to address specific issues (e.g. providing liquidity and supporting credit flows) with targeted measures. At its March meeting, it launched generous refinancing operations, including new Long-term Refinancing Operations (LTROs) – a funding liquidity backstop for banks – and improved Targeted Long-Term Refinancing Operation (TLTRO)-III terms – which lower banks' funding costs substantially, providing up to a 25bp subsidy on every euro of bank borrowing. Easing capital requirements, as announced by the Single Supervisory Mechanism, also provided significant capital and operational relief for the banking system, that the ECB estimates at €120bn. The ECB also announced an additional €120bn of asset purchases until year-end in order to help stabilise credit spreads. But miscommunication from ECB President ("the ECB is not here to close the spread") during the press conference dented the positive message of the package and revived fears of Eurozone fragmentation.

This pushed the ECB to take bolder action: unveiling a new temporary asset purchase programme of €750bn and promising to do everything necessary within its mandate. Beyond the number, which is massive (c.7% of Eurozone GDP), what is key in our view with this Pandemic Emergency Purchase Programme is that the ECB will deviate from the "self-imposed" limits that existed on previous programmes. The 33% issuer/issuer limits are still there but no longer bite, and although the capital keys remain the "benchmark" for purchases, there will be full flexibility in allocation over time and in composition, both across asset classes and jurisdictions. The ECB has set the stage for fiscal policies to be deployed unambiguously to support the economy.

…while the fiscal response is mainly national

So far, the fiscal responses have been mainly national, and primarily in the form of "insurance" packages. Policy measures have been broadly similar across countries and could be summarized in three main categories. First, liquidity measures for firms, including state loans or credit guarantees for companies (Germany c. €500bn, France €300bn, Spain €110bn, Italy €5bn) to ensure that viable companies do not go bankrupt because of COVID-19 disruption. Second, job and income support measures have been implemented in the four largest Eurozone countries, with a resizing of short-term work schemes, income subsidies and cash bonuses for affected workers. Such measures underpin our assumption that labour market deterioration should remain contained. Third, discretionary measures have been adopted, mainly to support the health system. Overall, fiscal packages average between 1.4% and 2% of GDP, with a remarkable and unusual exception: Germany adopted a supplementary budget of €156bn (5% of GDP), to be mainly debt financed (helping the ECB with the 33% issue/issuer limits) and waving goodbye to the "black zero". These are positive developments and we would expect further upscaling of government support in the coming months, from damage control to demand stimulus.

The 'European' dimension is still a missing element. The Commission announced that there will be full flexibility related to deficits, and the Eurogroup presented initiatives to supplement national measures – but these funds are reallocated from the existing budget. We are hoping for Eurozone-wide risk-sharing of the fiscal cost via joint issuance. This would be powerful (more so than changes to the European Stability Mechanism) not only economically but also politically, by showing solidarity.

Global Macro Monthly – UK

David Page,
Head of Macroeconomic Research,
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Authorities attempt to protect against COVID-19

The UK outlook has been transformed, along similar lines to other international economies. Cases of coronavirus in the UK have risen to 6,700 at the time of writing – from just 9 one month ago. The number remains a fraction of those in Italy, Germany and France, but the difference is deceiving, with our estimates of the UK being only two weeks behind Italy if the virus follows a similar path. The response from the UK government has ramped up significantly over the last week. The UK has now closed all schools and non-essential shops (food stores and chemists). It has compelled the public to stay at home barring food shopping, medical needs, care duties, essential work and one exercise trip per day. The government has threatened stricter enforcement.

The scale of economic disruption looks likely to be similar to international peers. We have reduced our GDP forecast to -1.2% from +0.7% for 2020, expecting the first recession since 2008-09. However, the expected scale of disruption is unprecedented. Surveys over the coming weeks will provide a better gauge of the initial economic impact. Our current forecasts assume a relatively benign labour market reaction to the shock, in part cushioned by the authorities' policy responses. This assumption needs to be tested.

UK authorities have worked in combination to try and mitigate the disruption. The Bank of England (BoE) initially cut rates by 50bps to 0.25%, introduced a term funding scheme for small businesses (TFSME) and reduced the counter-cyclical buffer, freeing up additional commercial bank capital to lend against. It then further reduced Bank Rate to 0.10% – the effective lower bound in the UK – and restarted QE, announcing a £200bn asset purchase scheme, to be conducted largely in gilts, with some corporate buying.

The government has complemented that with a £330bn loan guarantee scheme to facilitate private borrowing. Additionally, it has provided a total of around £100bn (4½% of GDP) in direct spending. This support includes the suspension of business rates, the deferral of sales tax payments, and direct grants to small business and the leisure industry. The Chancellor also announced a Jobs Retention Scheme financing 80% of workers' salaries up to £2,500 a month for any worker furloughed, rather than made redundant for the next 3-months. This scheme is financially open-ended in its aim to reduce job losses. The government faces pressure to provide similar support for self-employed. Time will tell how successful these policies prove.

Global Macro Monthly – Japan

Hugo Le Damany,
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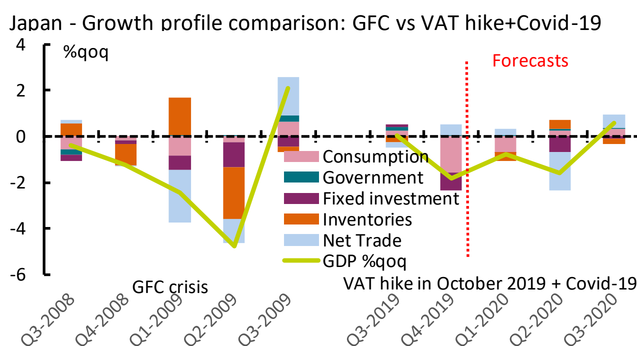
Japan is likely to face a severe recession

Alongside other countries, Japan is in unknown territory. The government has closed schools and stopped issuing visas for visitors from infected areas, while a lot of households are isolating, even without an official confinement policy. This will have a major impact on economic growth. Domestic demand should decline again in Q1 and rebound only in mid-Q2. External demand has suffered from confinement in China and is set to continue with shutdowns in Europe and the US. GDP in Q4 fell -7.1%qoq annualized and should post falls of -3% for Q1 and -6.2% in Q2. Overall, we believe GDP is likely to shrink by -2.4% in 2020 (Exhibit 3).

The government has announced measures to alleviate the effect on households and companies, but the package (0.5% of GDP) remains inadequate against the scale of the shock. Government is likely to deliver a third plan, but the end of the fiscal year in March is a constraint.

Exhibit 3: Japan should experience a W growth profile



Source: Cabinet Office and AXA IM Macro Research, as of 19 March 2020

Bank of Japan (BoJ) members will face issues with inflation momentum after oil's sharp price drop and a negative output gap will not stimulate wages and demand for some time. In response to the financial market turmoil and COVID-19 spreading, the BoJ has announced some accommodation:

- Raising the annual Exchange-Traded Fund (ETF) purchase target to ¥12tn (from ¥6tn)
- Increasing the upper limit of Commercial Papers and Corporate bonds purchases by ¥2tn (to ¥3.2tn and ¥4.2tn) and creating a fund to facilitate Corporate financing
- US dollar funds-supplying operations

The package is again limited by comparison with the Fed or the ECB, but as the Finance Minister acknowledged to Parliament, "*what we can do with monetary measures is getting very limited, so we should take fiscal action*".

Global Macro Monthly – China

Aidan Yao,
Economist (China),
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China grinds to a halt

Official data for January and February blew all forecasts out of the water and made even the most pessimistic projections from the street look optimistic. All gauges of economic activity plunged to their lowest levels on record, confirming the economic paralysis caused by the coronavirus outbreak. Even with accelerated work resumption in March, we now think it's inevitable that the economy will see a sharp contraction in the first quarter, particularly as the Statistical Bureau does not appear to be holding back from acknowledging the full shock.

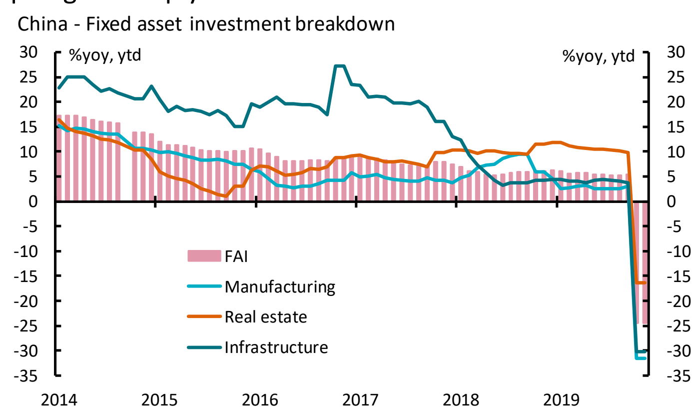
The retail sector was hit hard by the viral outbreak as consumers minimised their social and economic activities. Restaurant and catering services, which account for roughly 10% of retail sales, saw revenues plunge by 43% year-on-year (yoy) in January/February. Sales of large-ticket items, such as auto, home appliances and furniture, were also down by more than 30%. Some of these reflect meagre activities in the housing market, where real-estate transactions ground to a halt during the peak of the viral outbreak.

Some of the suppressed offline consumption re-emerged online, with e-commerce sales bucking the trend with 3%yoy growth. However, with the disruption to logistic services and its small share (21.5%) of overall retailing, growth in online sales was not enough to cushion the scale of the fall. Looking ahead, consumer spending is expected to rebound in the coming months, reflecting pent-up demand and policy support. Labour market weakness presents the largest threat to this outlook, with the official unemployment rate already rising to 6.2% from 5.2% in December. Beijing will likely take this seriously and ensure that sufficient policy support is provided to keep the unemployment risk at bay.

Conditions were no better in the corporate sector. The extended public holiday, followed by a slow business resumption, has led to sharp declines in production and investment among Chinese corporates. Industrial production contracted by 13.5%, from growth of +6.9% in December. Manufacturing production was the worst hit, falling by 15.7%, consistent with early readings from the Purchasing Managers' Indices (PMI) and trade. Mining and energy production fared slightly better, thanks to their less labour-intensive nature, which made work resumption easier. A crude analysis of industrial production and real GDP shows growth will likely contract sharply in the first quarter.

The highly uncertain business environment, coupled with labour shortages, has held back corporate investment. Manufacturing capex slumped by 31.5% in January/February compared to a year ago (Exhibit 4), while investment by real estate companies fell by 16.3%. The surprise came from infrastructure investment, which failed to provide any offset, recording a 30% decline. Despite frontloading bond issuance, local authorities appear to have had their hands full managing the epidemic in the past two months. We think this is an area where a swift rebound in growth is possible as the government has already shifted its focus to supporting the economy.

Exhibit 4: Infrastructure and manufacturing investment plunged sharply after the COVID-19 outbreak



Source: CEIC and AXA IM Research, as of 18 March 2020

Another growth downgrade is warranted

All in all, the official activity data have been simply horrendous, but largely confirmed the devastating shock many had feared. The good news is that the economy has moved past the trough and started to normalise since mid-February. The latter should ensure a sequential growth recovery in March, although year-on-year, growth will likely remain negative.

The bad news is that the global backdrop has deteriorated markedly in recent weeks as the coronavirus wreaks havoc outside China. We have downgraded our global growth forecast to incorporate a recession caused by the worsening pandemic. This will likely feed back to China via weak external demand, supply-chain disruptions and tighter financial conditions at least over the coming quarter. Offsetting these shocks will require Beijing to ramp up policy easing. However, we doubt China now has the intention, or ability, to instigate a stimulus large enough to fully offset a crippling shock internally and a global catastrophe akin – in scale – to the global financial crisis. We have therefore significantly cut our 2020 growth forecast to 2.3% from 5.3%, to account for a deeper plunge at the start of the year, followed by a more lacklustre recovery due to weaker global growth.

Global Macro Monthly – EM

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Economist (Emerging Asia),
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Recession ahead looks certain…

The coronavirus pandemic is taking its toll on emerging markets (EM), which we expect to be in recession during the first semester. The official number of infections has reached 35,000 in EM ex. China, with Iran at over 17,000 and South Korea at more than 8,000 as of 19 March. It is just a matter of time before we see those numbers rise sharply, affecting numerous other EM countries. This is particularly worrying for Latin America – and Africa – whose healthcare systems will be quickly overwhelmed and where governments are just starting to take social distancing actions.

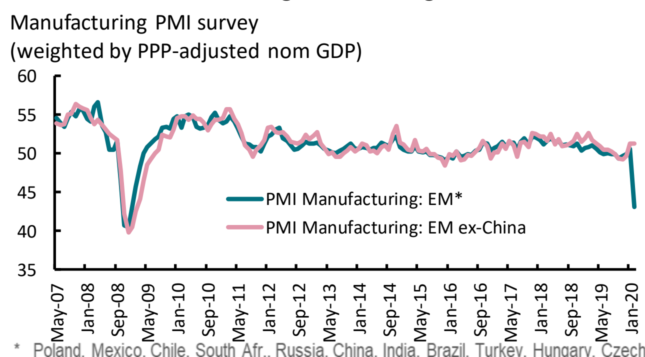
From an economic perspective, the COVID-2019 crisis is spreading through various channels. Health policies undertaken in response to the crisis will be an additional burden on public spending. Yet most of the economic shock comes from the containment measures in developed countries which disrupt tourism – such as the Philippines, Thailand and Brazil, and retail activity, for example Hong Kong, Mexico and Brazil – as well global supply chains in Asian countries supplying China, Central European countries supplying the Eurozone, and Latin American countries supplying the US. This will dampen consumer and investment confidence. The sharp fall in the oil price is likely to benefit oil importing countries, with India, Turkey and South Africa at the forefront, but it will reduce investment and economic activity in countries that are heavily dependent on oil exports such as Gulf countries, Russia and Colombia. Last but not least, the tightening in global financial conditions is hurting economic activity – increased borrowing costs will magnify the impact on financially-vulnerable countries, which have been able to 'kick the can down the road' during the past years of low interest rates. Massive capital outflows were recorded in recent weeks, significantly more intense than during the 2008 financial crisis. The past month has seen outflows close to the total recorded through the entire second half of 2008.

We expect a significant contraction in activity in the first semester and some normalisation in the second half – in the assumption that the world should hopefully have overcome the pandemic by the summer. Asian countries, particularly the small and/or open economies such as Singapore, Malaysia, South Korea and Taiwan, will see sharp adjustments given their dependence on China. Central Europe will be hit both in the first and second quarter given massive lockdowns as measures of confinement throughout Europe. Latin American countries are just about to take measures, being earlier in the epidemic stage.

… but its depth remains unclear for now

The extent of the drop-in activity remains unclear for now. Chinese January/February data show an unprecedented shock, but arguably the measures of confinement taken by Chinese authorities were the most draconian – and successful – so far. Emerging markets' manufacturing activity is likely to follow suit by contracting.

Exhibit 5: Manufacturing on the verge of the cliff



Source: Markit Purchasing Managers' Index survey and AXA IM Macro Research, as of Feb 2020

The unprecedented crisis calls for unprecedented responses from the world's administrations. Announcements are being made every day, but the impact of these policy actions on economic activity is yet to be seen. So far, we see crisis budgets being brought forward, averaging around 1% of GDP but ranging from 0.2%-2.7% of GDP. As the crisis deepens, fiscal support in EM will likely be larger even in countries that have limited fiscal space. Meanwhile, monetary policy has proved very responsive. Emergency interest rates cuts were enacted in many countries during the first three weeks of March. Turkey has cut rates three times; South Africa, Indonesia, Malaysia, Philippines, Brazil, the United Arab Emirates and Qatar twice; Russia, Thailand, Mexico, South Korea, Chile, Czech Republic, Egypt, Pakistan, Poland and Taiwan once. We expect more easing ahead despite the currency weakness triggered by capital outflows.

For now, EM central banks favour tactical currency interventions to avoid excessive depreciation. They have provided liquidity injections to support local banking systems. All in all, we again lower our GDP growth forecasts for this year, with projected hits of 2% for Latin America and 1.6% for EM Europe, but still see risks tilted to the downside. In such a context, investor sentiment remains weak and risk-off has continued to dominate financial asset returns in EM.

Investment Strategy – Cross-assets

Greg Venizelos,
Credit Strategist,
Research – Core Investment

Like nothing we have experienced before

The last few sessions have been the most extraordinary two weeks. The public health threat from the COVID-19 virus got more real, much closer and more personal for many more people in many more countries. The numbers from Italy and Spain are particularly shocking, and the way in which life has changed is quite astonishing. Actual and virtual lockdowns, school closures, mass cancellations of events and closures of businesses are things we never thought we would see. Life has changed beyond belief – and our priorities have shifted to safety and security in the most fundamental way. Even for market participants who can recall the 1987 market crash, nothing they have experienced before comes close to the way that our entire society has been engulfed by an existential threat like this. Yes, there have been recessions and bear markets. Yes, there has been tumultuous political change and yes there was a threat to the very working of our economy. We can recall the tanks on Red Square, the attack on the World Trade Centre in New York, the shocking news coverage of bombing raids on the Middle East, and the emptying of the offices of Lehman Brothers. But fear and panic like this - with the global economy coming to a sudden stop – has just not been seen on such a global scale. Monetary and fiscal authorities are throwing everything they have at this problem – well beyond what has been done before. Yet like the Australian bushfires, little seems to work in putting out the flames. Ultimately, salvation may rest in the hands of science - those experts who have been pilloried and ignored amid populism and aversion for hard facts.

Investment Strategy – FX

Romain Cabasson,
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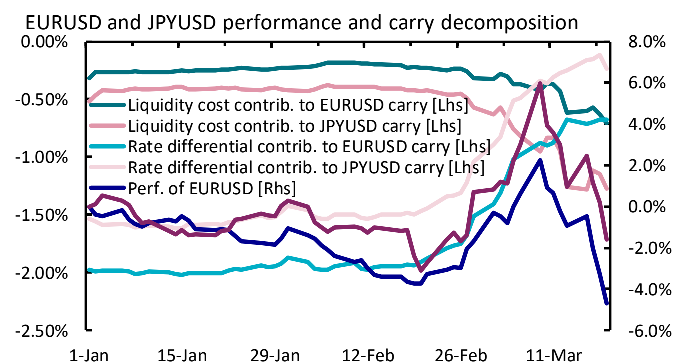
Dollar is king - for now

The US Federal Reserve surprised markets by proactively cutting rates back to zero and restarting quantitative easing, as the spread of the virus accelerated around the world and in the US particularly. The ECB and BoJ are more constrained, already running at very low rates. The lower rate differential and higher volatility should discourage Japanese investors from persisting with unhedged foreign investments in an already overvalued US dollar. This, and the re-hedging of an already large exposed stock of foreign positions in front of heightened market risks, should trigger appreciation of the Japanese yen. The euro does not usually behave as a safe haven asset in such conditions, but it is equally undervalued, as a result of rising carry trade flows lately using the euro as a funding leg. Actually, both the yen and euro started to appreciate ahead of lower rate expectations in the US, but both then fell back when dollar liquidity stress rose. This is shown in Exhibit 6, where liquidity stress is proxied by Libor, as well as cross-currency basis contribution to US dollar carry. We think proactive central banks will find a way to calm this liquidity crisis and that we should then see the euro and yen rise again against a weakening dollar. Additionally, the spread of the virus in the US is only starting to take off now, while fiscal stimulus has been more forthcoming in Europe. In the longer term, European unity risk remains a risk to the outlook for the euro – more acute as debts are rising again.

Exhibit 6: US dollar strengthens as liquidity stress rises

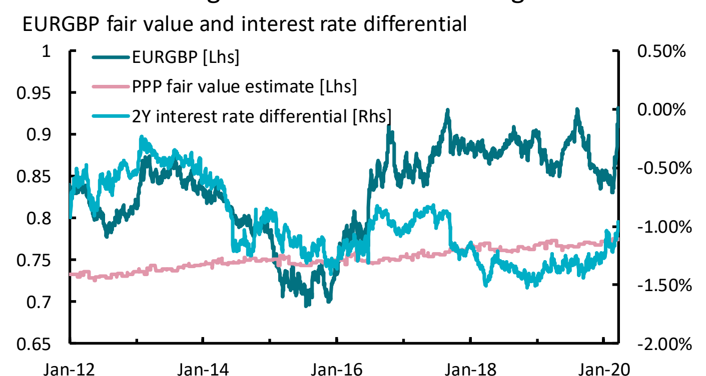


Source: Bloomberg and AXA IM Research, as of 20 March 2020

God save the Queen's sterling

Restless markets have brought sterling back to the worst levels experienced during the Brexit crisis against the dollar and euro (Exhibit 7). Sterling usually behaves as a risk-on currency with large structural weaknesses from the current account or fiscal deficit, so this is partly expected. But this time sterling was already undervalued and could benefit from massive fiscal action, good coordination with the BoE and a large government majority to take action. Future trade relations with Europe are still uncertain for business investments, but undervaluation seems excessive.

Exhibit 7: Sterling back at historical lows against the euro



Source: Bloomberg and AXA IM Research, as of 22 February 2020

Investment Strategy – Rates

Alessandro Tentori
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Research – Core Investments

Bond market swings and liquidity

What a start of the year for bond markets! The global aggregate bond index rallied almost 5.5% year-to-date until the first week of March, only to nosedive almost 8% in the past two weeks on a combination of mounting credit risk and AAA-liquidation to meet margin calls.

European markets were also very volatile with a 5.5% correction of the iBoxx Sovereign Index in the second week of March alone. Generalised spread widening took its toll on aggregate performance. At one point before the European Central Bank announced a new calibration of its quantitative easing programme, Italian government bonds were trading as wide as 320bps over their German equivalents.

While there are reasonable concerns about secondary market liquidity, it should be remembered that:

- So far, fund managers have coped rather well with this volatile environment and there are no reports of asset under management (AUM)-mitigation measures in place at large managers.
- The world of bond exchange-traded funds is untested in this environment, but apart from the already-known issues with performance slippage, there are no major redemption issues reported yet.
- Sovereign bonds seem to suffer short periods of low liquidity, but this might be related to a more general interplay between safe assets (in the money) used to cover losses on risky assets.
- The only safe way to prevent the rise of risk premia in a deep and liquid sovereign market is to prevent that market from trading. This is usually achieved via extensive use of a central bank's balance sheet together with strict regulation on banks' high-quality liquid assets, and on government assets for financial institutions like pension funds and insurance companies. Japan is an example in this respect.
- Liquidity indicators we were following during the 2008 financial crisis, such as the difference between three-month Libor and the overnight rate, Libor-term bases and cross-currency bases, have moved as well in 2020. However, they have moved at a slower pace and are nowhere near the level of stress seen in the aftermath of the collapse of Lehman Brothers. Liquidity and capital are not a bottleneck for the banking sector this time around. Moreover, counterparty risk has migrated from a largely bilateral model to a multilateral one with the involvement of Central Clearing Counterparties.

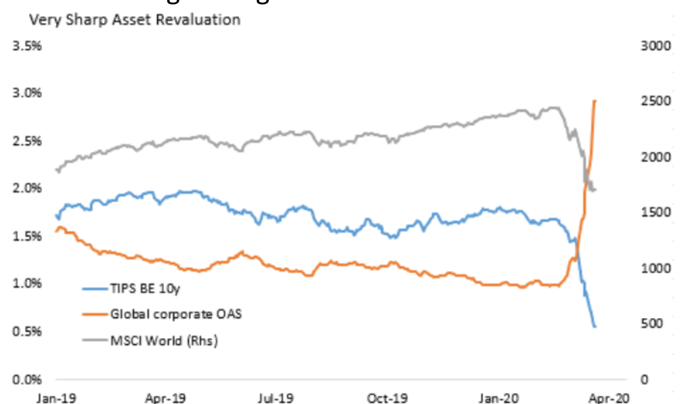
Liability management in a zero rates world

It wasn't particularly easy to excel in the noble art of asset and liability management (ALM) in 2019, despite a very good year for performance of risky assets. One reason for this was the extremely low coupon income generated by government bond allocations, especially in Europe and Japan. Another issue was linked to an existing large duration gap, which together with a strict regulatory framework introduced a source of negative convexity into fixed income markets.

One simple way to conceptualise this effect is as follows: Typically, liabilities have a duration that is a multiple of assets' duration. In a normal world, you allocate a part of your risk budget to equities and the remaining part to bonds. When equities do well, they do so by a large margin and bonds sell off, thus closing the duration gap. Furthermore, the bond's coupon income is a steady source of increase for the asset side.

Unfortunately, we're now in a world where the bond allocation is skewed to extreme levels, despite very low levels of coupon income. Furthermore, the portfolio's sensitivity to equities is rather high, such that in a downturn the cover ratio is very likely to suffer both from the duration gap and the asset devaluation. In order to partially hedge this scenario, the action is to receive duration (mainly via swaps) the lower bond yields fall, the more the ALM investor has to receive to compensate for this effect.

Exhibit 8: Large swings on the asset size



Source: Bloomberg, AXA IM research

Evidently, things took a turn for the worse in 2020: On the asset side, pretty much every allocation is under water at this stage (Exhibit 8), while the present value of euro-based liabilities has increased as a result of a strong bull-flattening at the long end of the swap curve. Year-to-date, the 5/30s curve in EUR is down by about 50bps with 30-year rates lower by a similar amount. The strong receiving at the long-end of the euro curve is also reflected in the 3s6s basis swap inversion: This basis has been trading in a three to six bp range for the past five years, only to move down to -2bps as a likely result of extreme pressure on the 6s curve by pension funds.

Investment Strategy – Credit

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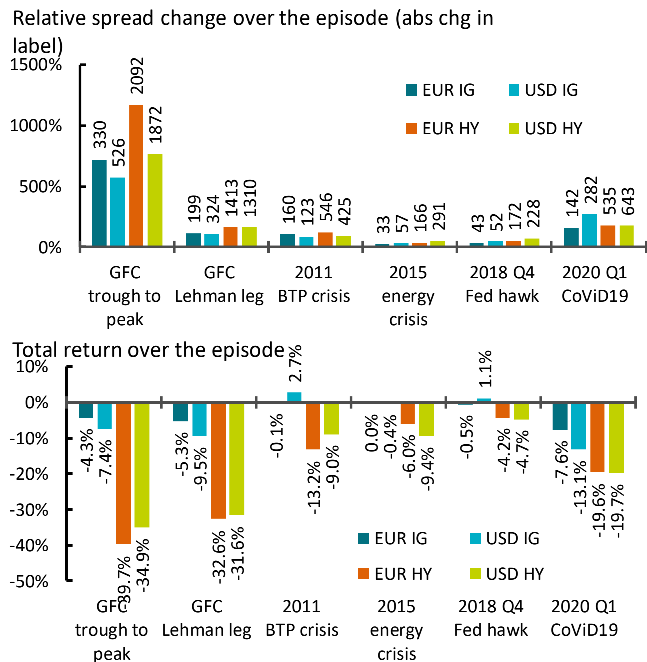
Through the glass darkly

Macro: Deep uncertainty dominates global markets. The Covid shock is arguably larger than the global financial crisis, (GFC). GFC was a titanic mess in the financial sector, but a well understood one. The remedies required where self-evident: liquidity, guarantee liabilities, recapitalise the banks. With Covid we are faced with unknown-unknowns and are in unchartered water. Initial readings on macro data are quite disturbing. The collapse in activity is almost certain to be much worse than 2008-9. Let's hope that the rebound can be equally sharp. The view that social distancing may have to last for a year is gaining traction. The monetary and fiscal response that is required to offset this macroeconomic catastrophe is Herculean. Thankfully, central banks and government have stepped up to the plate, even if in a hesitant and disjointed fashion at first.

Exhibit 9: spread widening comparable to, and returns as bad if not worse than, the global financial crisis



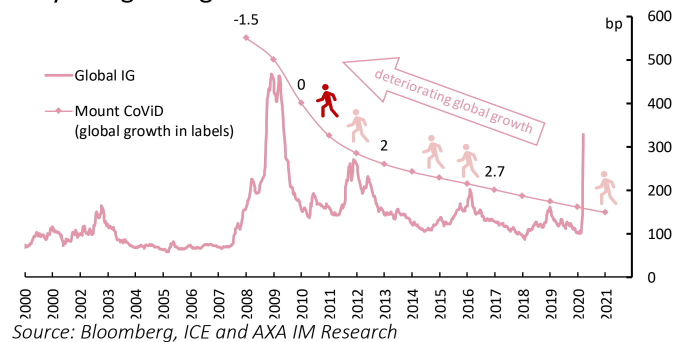
Source: Bloomberg, InterContinental Exchange (ICE) and AXA IM Research

The ferocity of the market correction should therefore not surprise (Exhibit 9). Both the speed and magnitude of the moves in risk premia have been unprecedented. Looking at z-scores across asset classes, the readings are comfortably above four-times the standard deviation – and often at six times. The correction took place in distinct stages. At first, the brunt of the impact was felt by volatility/hedge instruments (eg VIX, CDS indices) as well as the initial declines in equity markets and bond yields. The second stage came when actual portfolio liquidation/forced-selling materialised, forcing equity markets sharply lower while bond yields actually rose. Some stability has taken hold in the past couple of sessions. But it is far too early to call the correction complete. The worst may be to come.

The great credit reckoning

Credit: spreads have smashed through previous spread peaks (2011, 2015-16, 2018) and are heading for the levels only seen in 2008-2009, if not higher (Exhibit 10). Global investment grade (IG) debt is currently trading at ~350bps, which is consistent with 1% growth in global real GDP. Our current forecast is for -0.2% growth, but still with large downside risks. Credit funds are seeing substantial outflows, which unless stemmed may lead to more forced selling. The massive improvement in valuations, although appealing at first glance, may prove a fallacy inasmuch as macro data is yet to reflect the collapse in economic activity.

Exhibit 10: current spread levels are consistent with very low global growth in 2020



Source: Bloomberg, ICE and AXA IM Research

Corporates have arrived at this crisis carrying a lot of debt. While the debt cost has been manageable, this now may be changing fast, as both sides of the ledger are moving in the wrong direction. Ballooning spreads and difficult market conditions are set to drive borrowing costs higher. At the same time, earnings in 2020 may collapse by 15-20%, if not more. Downgrade and default risks are rising notably, and this includes in IG, which is rather uncommon. The high BBB cohort within IG, a concern for investors over the past few years in case of downgrade to bud-investment level, may finally be coming home to roost. In terms of defaults, a situation comparable to the GFC could see a 10-15% default rate in High Yield (HY) and even a 2-3% default rate in IG. The latter is set to face an acute downgrade risk. In the US in particular, a downgrade of 10-20% of BBB-rated credits within the IG index and into HY would see fallen angel volumes between USD300bn and USD600bn, compared to a HY index size of USD1600bn. This large-scale threat to the financial system is a key reason for the Federal Reserve's decision to include corporate debt in its QE operations.

Investment Strategy – Equity

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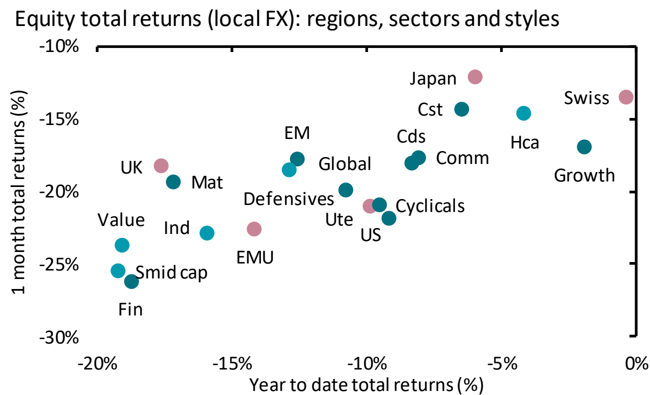
The end of an era

The rapid spread of coronavirus across the world has created unexpected bottlenecks in the global economy, pushing stocks into a bear market after the decade-long stellar run. Higher-beta regions and sectors have lost over a quarter of their value over the last month, with high financial leverage companies heavily underperforming. Volatility spiked to levels not seen since 2009 with the VIX Index shooting up to over 80 points (Exhibit 11).

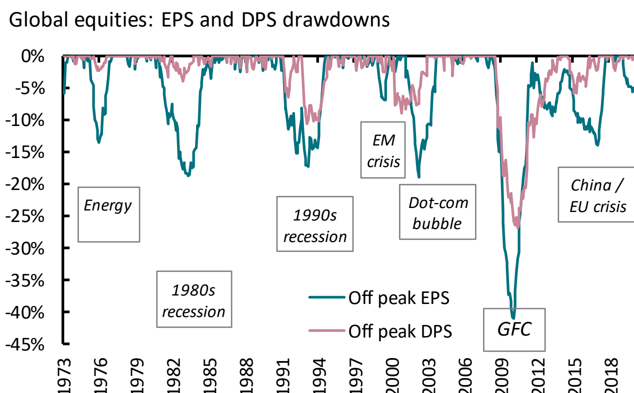
Exhibit 11: Equities lose almost a quarter of their value



Source: MSCI, Datastream and AXA IM Research

So far, consensus earnings growth estimates still appear stale with limited downward revisions. Our macro base case confirms an earnings recession in the making, with aggregate earnings potentially contracting to the tune of 15-20% in 2020. This is in line with previous recessions since the 1970s when peak-to-trough aggregate earnings per share (EPS) contracted by 16.5% on average – except for the 2007-2008 global financial crisis when the drawdown in EPS was close to 40% (Exhibit 12).

Exhibit 12: 2020 earnings to decelerate sharply

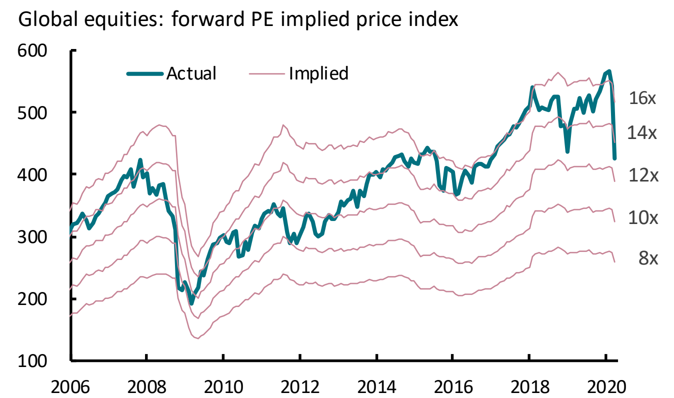


Source: Datastream and AXA IM Research

In search of sunrise

Global equity valuation multiples are now trading slightly above 12 times forward earnings, levels not seen since 2013 – suggesting that investors have priced in a substantial shock. A more severe move down to around 10 times forward earnings, like we observed in 2008-2009, implies a further drawdown of roughly 24% from index prices at the time of writing (Exhibit 13). Typically, in crisis situations, markets and multiples tend to trough roughly two quarters before the trough in earnings per share. The recent price action in the equity and bond markets have also pushed the earnings and bond yield gap close to record highs.

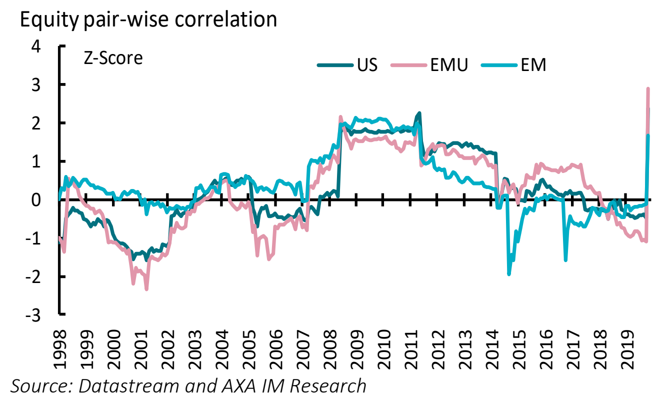
Exhibit 13: Forward earnings multiples down to 12 times



Source: Datastream, MSCI, Bloomberg, IBES and AXA IM Research

Overall investor positioning and fund flows data appear to be suggesting early signs of capitulation. Individual stock correlations within major equity indices, a strong indicator of systemic risk, have shot up to unprecedented levels indicating there has been limited differentiation between names in the sell-off (Exhibit 14). History suggests that from current valuation and volatility levels, equity markets tend to generally offer strong returns looking 12 months ahead. We remain medium-term constructive on equities, given the strong monetary stimulus packages from central banks and the fiscal impulse being prepared by various governments. In the near term, success of the current containment measures and an inflection point in virus infections are essential for a recovery to materialise.

Exhibit 14: Sharp spike in stock pairwise correlations



Source: Datastream and AXA IM Research

Recommended asset allocation

Asset Allocation	Negative	Neutral	Positive
Key asset classes			
Equities		■ ▼	
Bonds		■	
Commodities		■ ▼	
Cash		■ ▲	
Equities			
Developed			
Euro area		■ ▼	
UK		■	
Switzerland		■	
US	■ ▼		
Japan		■	
Emerging & Sectors			
Emerging Markets			■ ▲
Europe Oil & Gas		■	
Europe Telecoms		■	
US Industrials		■ ▼	
US Cons. Discretionary		■ ▼	
Fixed Income			
Govies			
Euro core		■	
Euro periph		■	
UK		■	
US		■	
Inflation			
US			■
Euro			■
Credit			
Euro IG		■	
US IG		■	
Euro HY		■	
US HY		■	
EM Debt			
EM bonds		■	

Legends: Negative | Neutral | Positive — Last change: ▲ Upgrade | ▼ Downgrade

Source: AXA IM Macro Research – As of 24 March 2020

Macro forecast summary

Real GDP growth (%)	2019*	2020*		2021*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
World	**2.9**	**-0.2**		**3.6**	
Advanced economies	**1.7**	**-1.0**		**1.8**	
US	**2.3**	**-0.4**	1.9	**1.8**	2.0
Euro area	**1.2**	**-2.1**	0.9	**1.1**	1.2
Germany	**0.6**	**-2.3**	0.9	**1.0**	1.1
France	**1.3**	**-1.3**	1.1	**1.0**	1.2
Italy	**0.3**	**-3.3**	0.3	**0.4**	0.6
Spain	**2.0**	**-1.8**	1.6	**1.4**	1.6
Japan	**0.8**	**-2.4**	0.3	**2.0**	0.8
UK	**1.3**	**-1.2**	1.1	**1.4**	1.5
Switzerland	**0.9**	**-1.5**	1.3	**1.5**	1.3
Emerging economies	**3.7**	**0.4**		**4.6**	
Asia	**5.2**	**1.3**		**4.9**	
China	**6.1**	**2.3**	5.6	**8.0**	5.8
South Korea	**2.0**	**-0.4**	2.2	**1.9**	2.4
Rest of EM Asia	**4.2**	**0.2**		**4.2**	
LatAm	**0.0**	**-2.0**		**1.2**	
Brazil	**1.1**	**-1.5**	2.1	**0.6**	2.6
Mexico	**-0.1**	**-1.1**	1.0	**1.2**	1.7
EM Europe	**3.2**	**-1.6**		**3.5**	
Russia	**0.9**	**-1.0**	1.8	**0.8**	1.9
Poland	**5.3**	**1.5**	3.3	**3.6**	3.1
Turkey	**0.9**	**2.0**	3.1	**4.3**	3.3
Other EMs	**1.1**	**0.0**		**2.0**	

Source: Bloomberg, IMF and AXA IM Macro Research – As of 24 March 2020

CPI Inflation (%)	2019*	2020*		2021*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	**1.3**	**0.6**		**1.5**	
US	**1.7**	**0.0**	2.0	**1.8**	2.1
Euro area	**1.2**	**1.2**	1.2	**1.3**	1.4
Japan	**0.5**	**-0.1**	0.6	**0.3**	0.6
UK	**1.8**	**0.7**	1.6	**1.4**	1.9
Switzerland	**0.7**	**0.6**	0.3	**0.5**	0.7
Other DMs	**0.8**	**1.4**		**1.9**	

Source: Bloomberg, IMF and AXA IM Macro Research – As of 24 March 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	Q1 - 20	Q2 - 20	Q3 - 20	Q4 - 20
United States - Fed	Dates	0-0.25		28-29 Apr 9-10 Jun	28-29 Jul 15-16 Sep	4-5 Nov 15-16 Dec
	Rates		unch (0-0.25)	unch (0-0.25)	unch (0-0.25)	unch (0-0.25)
Euro area - ECB	Dates	-0.50		30 Apr 4 Jun	16 Jul 10 Sep	29 Oct 10 Dec
	Rates		unch (-0.50)	unch (-0.50)	unch (-0.50)	unch (-0.50)
Japan - BoJ	Dates	-0.1		27-28 Apr 15-16 Jun	21-22 July 16-17 Sep	28-29 Oct 17-18 Dec
	Rates		unch (-0.10)	unch (-0.10)	unch (-0.10)	unch (-0.10)
UK - BoE	Dates	0.10	26 March	7 May 18 June	6 Aug 17 Sep	5 Nov 17 Dec
	Rates		unch (0.10)	unch (0.10)	unch (0.10)	unch (0.10)

Source: AXA IM Macro Research - As of 24 March 2020

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