A Year of No Returns

Monthly Investment Strategy

Key points

- When the quantitative easing goes out: 2018 has been unique in terms of the breadth of negative returns across assets.
- The overarching theme of 2019, if not beyond, is likely to be underwhelming asset returns.
- The change in tone at the December Federal Reserve meeting should help contain downside growth scenarios.
- Our asset allocation remains unchanged, with modest risk appetite, partly shifting from US to emerging market equities and underweight investment grade credit

2018, a frustrating year for investors…

As the year comes to an end, we look back in this Monthly Investment Strategy at macroeconomic and market performance and surprises. Such a *post mortem* analysis is a healthy, usually humbling exercise, and is often rich in lessons.

While 2017 was an enjoyable synchronisation of positive growth momentum and strong performance of risky assets, 2018 will hardly be missed. Equity returns are closing the year poorly across the board, with the US outperforming and defensives posting marginally positive returns. Breaking down global equities' total returns (-6.7% year-to-date at the time of writing), robust earnings growth delivered close to 19.4% and dividends contributed around 2.4%. But despite this strong fundamental backdrop, valuation multiples contracted sharply by 23.7%. This de-rating of equities can be attributed to a mix of higher risk-free rates and poor investor sentiment. In particular, on top of lacklustre growth, euro area equities disappointed in the wake of political risk. Emerging market equities, meanwhile, suffered from both tighter financing conditions and concerns around trade protectionism.

Credit inevitably succumbed to equity contagion, especially in the last quarter of 2018. Over the past month, the risk-off mood pushed credit returns deeper into negative territory. The pain has been particularly acute for high yield, upending the reflation trade that saw high yield outperforming investment grade for much of 2018. The repricing is nothing short of dramatic with euro credit spreads almost doubling from their February lows.

…and a challenging 2019 ahead, especially as our risk scenarios are already unfolding

As we explained in our 2019 Outlook published last month, some of this unimpressive market performance stems from the forward-looking feature of asset prices. In this sense, 2017's market gains could be explained by realistically positive expectations for 2018 top-line and earnings growth, whereas risky assets would have suffered this year as a result of the anticipation of the upcoming global economic slowdown. We however believe that the rise in cross-asset correlation (which limited the benefits of diversification in 2018) and in market volatility (first with a spike in February then more gradually and persistently since early October) point to an alternative explanation: the end of the global expansion of central banks' balance sheet and the reversal of the liquidity tide of which Warren Buffet famously warned. If this is the case, 2019 and possibly beyond could prove just as challenging with low returns and high cross-asset correlations.

2019 may prove all the more challenging if the two risk scenarios we outlined in our 2019 Outlook, and which have already begun to unfold in December, gain further traction: the US Federal Reserve (Fed) losing confidence and the Eurozone economy exiting the cyclical expansion first even though it entered the cyclical upswing last.

First, US financial conditions have tightened across a broad range of indices. Most metrics remain looser than in 2015, when the Fed started tightening policy, but this recent, material tightening has been changing the Fed's tone. While its December meeting saw a long-expected hike, with the Fed Fund rate (FFR) reaching 2.25-2.50%, the Fed removed softened its guidance for "some" further gradual tightening and lowered its expected rate outlook (the Federal Open Market Committee's dots). At

the press conference following the announcement, Fed Chairman Jerome Powell also provided a more cautious tone. Looking forward, with the US economy in excess demand and still growing above its potential pace, we believe the Fed will need to gently tighten rates further. However, the Fed's reaction will be governed by overall financial conditions. If the current tightening proves overdone, the Fed will continue to gradually tighten policy. We forecast a pause in the quarterly pace, now forecasting the next hike in June next year. Indeed, much further tightening would threaten a more material slowdown in US economic activity, which could see us bring forward our expectation for recession into 2020. Given the tightening in conditions we have lowered our central expectation for Fed hikes to two next year, but for now drop our outlook for an easing in the second half of 2020. We still forecast the Fed Funds Rate at 2.75-3.00% by end-2020.

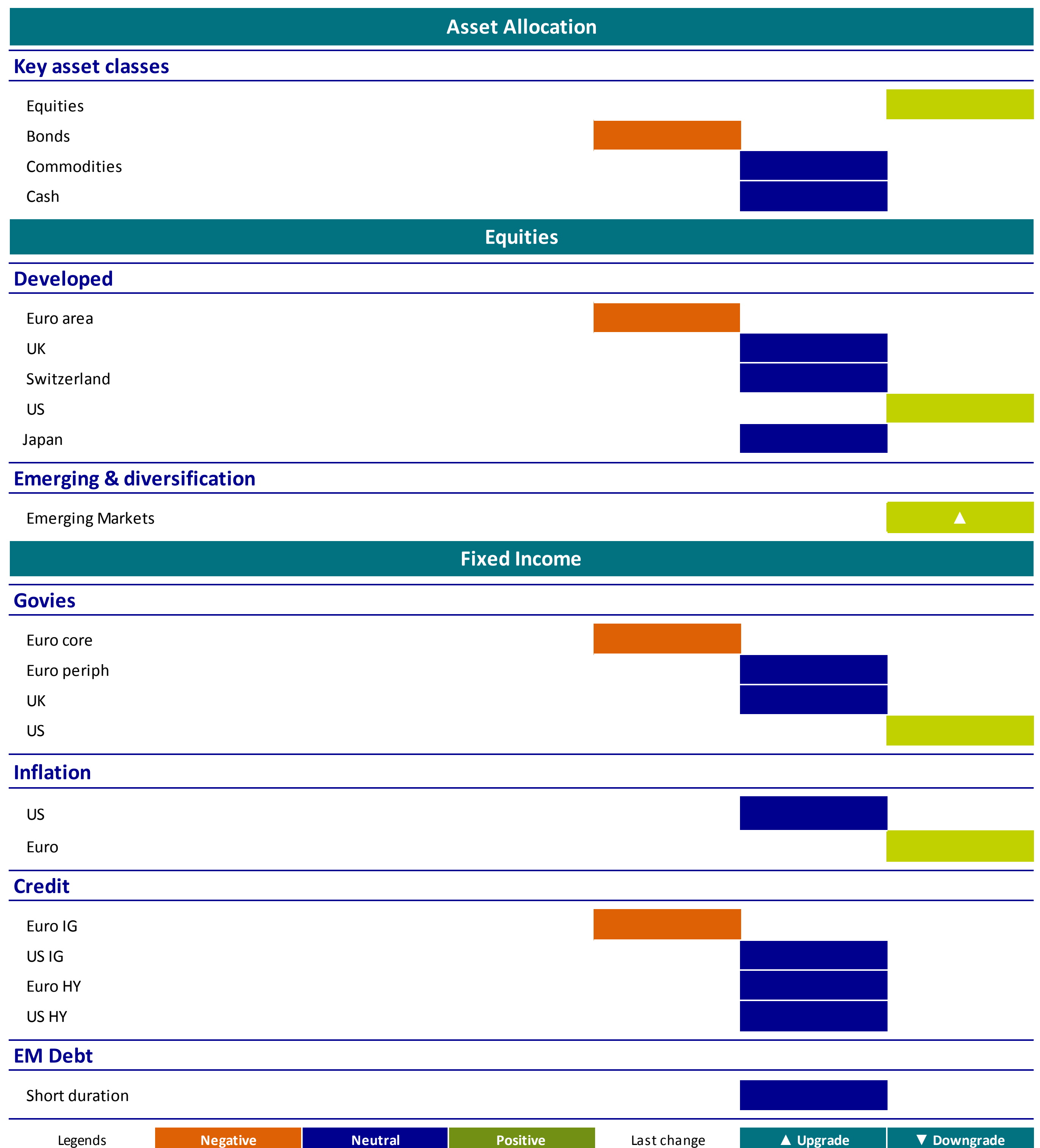
Second, in line with our significantly below-consensus growth forecasts, the news flow has been quite negative for the Eurozone economy. Activity indicators suggest only a mild rebound in the last quarter, after the weak 0.2% quarter-on-quarter (qoq) on the third quarter GDP growth. The European Commission's business surveys barely stabilised, while the December Flash purchasing managers indices (PMIs) fell to a 49-month low. Some of this drop-in sentiment is specific to France with its services PMIs plunging on street protests. But the overall EMU-wide signal is worrying and the German Ifo survey recorded a two-year low in December. At its December meeting, the European Central Bank (ECB) only slightly lowered its growth and inflation forecasts; we believe a further downgrade will come in March and we definitely agree with the ECB's assessment that "the balance of risks is moving to the downside". We therefore expect the Bank to announce another Targeted-Longer Term Refinancing Operation at its March meeting to alleviate funding pressure for banks. Later on, we still see the ECB exiting negative interest rates (with the deposit rate back to 0% by Spring 2020 from -0.4% today) but we acknowledge that this normalisation may be compromised.

Asset allocation: Unchanged modest risk appetite, partly shifting from US to EM equities

In this context, our asset allocation has a reduced risk appetite but nevertheless remains overweight US equities with above-potential growth (even if it is decelerating) and more attractive valuations. We however shift some of this regional preference inside the equity allocation from the US to emerging markets with cheap valuations and a potential for outperformance in case of further dollar weakness. We keep an underweight on investment grade credit with an expectation of further spread widening. Finally, mindful of the expected economic slowdown and of risks (from trade war to European politics and potential concerns over China), we keep our long positioning on 10-year US Treasuries.

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

Recommended asset allocation



Source: AXA IM Research – As of 19 December 2018r

Macro forecast summary

Real GDP growth (%)	2018	2019*		2020*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
World	**3.8**	**3.6**		**3.5**	
Advanced economies	**2.4**	**2.0**		**1.5**	
US	**2.9**	**2.3**	*2.6*	**1.4**	*1.9*
Euro area	**1.9**	**1.4**	*1.7*	**1.2**	*1.5*
Germany	**1.5**	**1.4**	*1.7*	**1.2**	*1.5*
France	**1.6**	**1.4**	*1.7*	**1.3**	*1.6*
Italy	**1.0**	**0.6**	*1.0*	**0.5**	*0.9*
Spain	**2.5**	**2.2**	*2.3*	**1.7**	*1.9*
Japan	**0.7**	**0.9**	*1.1*	**0.5**	*0.6*
UK	**1.3**	**1.6**	*1.5*	**1.7**	*1.6*
Switzerland	**3.0**	**1.7**	*1.7*	**1.5**	*1.7*
Emerging economies	**4.7**	**4.6**		**4.7**	
Asia	**6.3**	**6.1**		**6.1**	
China	**6.6**	**6.1**	*6.2*	**6.1**	*6.0*
South Korea	**2.8**	**2.6**	*2.6*	**2.5**	*2.5*
Rest of EM Asia	**6.1**	**6.1**		**6.1**	
LatAm	**1.2**	**2.1**		**2.2**	
Brazil	**1.5**	**2.5**	*2.3*	**2.5**	*2.6*
Mexico	**2.2**	**2.2**	*2.1*	**2.0**	*2.4*
EM Europe	**3.2**	**2.2**		**2.6**	
Russia	**1.9**	**1.8**	*1.5*	**1.8**	*1.7*
Poland	**5.2**	**3.5**	*3.6*	**3.0**	*3.1*
Turkey	**3.5**	**0.5**	*0.8*	**2.5**	*3.0*
Other EMs	**2.9**	**3.2**		**3.4**	

Source: Consensus Economics, IMF and AXA IM R&IS calculations – As of 20 December 2018

CPI Inflation (%)	2018	2019*		2020*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	**2.0**	**1.7**		**2.0**	
US	2.4	2.1	*2.3*	2.9	*2.2*
Euro area	1.8	1.5	*1.7*	1.4	*1.7*
Japan	1.0	0.7	*1.9*	0.5	*1.7*
UK	2.5	2.0	*1.7*	2.2	*1.5*
Switzerland	1.0	0.7	*1.4*	1.0	*1.3*
Other DMs	1.8	1.9		2.0	

Source: Bloomberg, IMF and AXA IM R&IS calculations – As of 20 December 2018

These projections are not necessarily reliable indicators of future results

Forecast summary

		Current	Q1 - 19	Q2 - 19	Q3 - 19	Q4 - 19
Central bank policy **Meeting dates and expected changes (Rates in bp / QE in bn)**						
United States - Fed	Dates	2.25-2.50	29-30 Jan 19-20 Mar	30-1 Apr/May 18-19 Jun	30-31 July 17-18 Sep	29-30 Oct 10-11 Dec
	Rates		unch (2.25-2.50)	+0.25 (2.50-2.75)	unch (2.50-2.75)	+0.25 (2.75-3.00)
Euro area - ECB	Dates	-0.40	24 Jan 7 Mar	10 Apr 6 Jun	25 July 12 Sep	24 Oct 12 Dec
	Rates		unch (-0.40)	unch (-0.40)	+0.15 (-0.25)	unch (-0.25)
Japan - BoJ	Dates	-0.1/¥42tn	22-23 Jan 14-15 Mar	24-25 Apr 19-20 Jun	29-30 Jul 18-19 Sep	30-31 Oct 18-19 Dec
	Rates / QE		net QQE ¥40tn	unch/taper	unch/taper	net QQE ¥30tn
UK - BoE	Dates	0.75	7 Feb 21 Mar	2 May 20 Jun	1 Aug 19 Sep	7 Nov 19 Dec
	Rates		unch (0.75%)	+0.25% (1.00%)	unch (1.00%)	+0.25% (1.25%)

Source: Datastream, AXA IM R&IS calculations - As of 20 December 2018

These projections are not necessarily a reliable indicators of future results

Our Research is available on line:

Insights Hub

The latest market and investment insights, research and expert views at your fingertips

www.axa-im.com/insights

DISCLAIMER

This document is for informational purposes only and does not constitute investment research or financial analysis relating to transactions in financial instruments as per MIF Directive (2014/65/EU), nor does it constitute on the part of AXA Investment Managers or its affiliated companies an offer to buy or sell any investments, products or services, and should not be considered as solicitation or investment, legal or tax advice, a recommendation for an investment strategy or a personalized recommendation to buy or sell securities.

It has been established on the basis of data, projections, forecasts, anticipations and hypothesis which are subjective. Its analysis and conclusions are the expression of an opinion, based on available data at a specific date. All information in this document is established on data made public by official providers of economic and market statistics. AXA Investment Managers disclaims any and all liability relating to a decision based on or for reliance on this document. All exhibits included in this document, unless stated otherwise, are as of the publication date of this document. Furthermore, due to the subjective nature of these opinions and analysis, these data, projections, forecasts, anticipations, hypothesis, etc. are not necessary used or followed by AXA IM's portfolio management teams or its affiliates, who may act based on their own opinions. Any reproduction of this information, in whole or in part is, unless otherwise authorised by AXA IM, prohibited.

This document has been edited by AXA INVESTMENT MANAGERS SA, a company incorporated under the laws of France, having its registered office located at Tour Majunga, 6 place de la Pyramide, 92800 Puteaux, registered with the Nanterre Trade and Companies Register under number 393 051 826. In other jurisdictions, this document is issued by AXA Investment Managers SA's affiliates in those countries.

In the UK, this document is intended exclusively for professional investors, as defined in Annex II to the Markets in Financial Instruments Directive 2014/65/EU ("MiFID"). Circulation must be restricted accordingly.

© AXA Investment Managers 2018. All rights reserved

AXA Investment Managers SA
Tour Majunga – La Défense 9 – 6 place de la Pyramide 92800 Puteaux – France
Registred with the Nanterre Trade and Companies Register under number 393 051 826