AXA Investment Managers

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Research & Strategy Insights

Liquidity: The tide is high as central banks hold on

Monthly Investment Strategy

From the European Central Bank's tiny steps to the US Federal Reserve's balance sheet policy, the liquidity tide is high

Last month[1], we detailed the consequences should our European Central Bank (ECB) Stalemate risk scenario come to pass. Under this scenario, the low levels of inflation and growth in the Eurozone would postpone the normalisation of key interest rates for so long that the global cyclical downturn would eventually prevent any such normalisation. In our view, the March ECB meeting made that risk scenario a reality, with the Governing Council pledging to leave the deposit rate at its current level (-0.4%) until at least the end of 2019. A partial normalisation is still possible in 2020 though. However, a full normalisation would require a sustained economic acceleration to above-potential growth that would elicit a substantial market re-pricing; something we now only see as an upside risk scenario of a Super Long Cycle (20% probability).

In this Monthly Investment Strategy, we investigate the reasons and consequences of the US Federal Reserve (Fed)'s decision at its March meeting to slow the pace of its unwinding from May and stabilising its balance sheet by September (sooner than we expected). Since 2014, the Fed has allowed excess reserves to shrink gradually, and in 2017 the Fed accelerated this process by allowing longer-term assets to mature without re-investment. Turning into a net seller of bonds, the Fed began a process of quantitative tightening (QT), reversing the quantitative easing (QE) that took place between 2008 and 2013. From the onset, economists and central bankers have wondered how much of this unprecedented QT would be needed. Especially as, partly because of increased regulatory requirements, banks now require some "excess reserves". Reducing those back to pre-Global Financial Crisis levels close to zero would therefore create a scarcity of reserves and increase costs of borrowing. Even though the Fed has been adamant about not seeing reserve scarcity, we believe the rising pressure evident in short-term interest rate markets has contributed to the decision to stop reducing the Fed's asset holdings.

Put together, this dovish shift of developed central banks has contributed to the easing of financial conditions, lowering interest rates and boosting risky assets. In our baseline scenario (50% probability), we expect the "global policy put" (monetary accommodation, but also the Chinese and European fiscal stimuli) to prove enough of a support. Market prices and the consensus forecast have however largely subscribed to this view and may have already discounted a lot of good news in their year-to-date adjustments.

Key points

- In March, both the European Central Bank and the US Federal Reserve leant on the dovish side: the "central bank put" is well in place
- The macroeconomic news flow has been rather soft in China and Japan, mixed in the Eurozone and the US with external weakness but domestic resilience
- The strong performance of risky assets so far this year may be pricing a lot of good news, from US-China trade truce, a delayed/soft Brexit, as well as a sequential rebound in global growth
- We therefore remain cautious and maintain our modest risk appetite with neutral tactical asset allocation

[1] "EMU slowdown risks ECB stalemate", AXA IM Research, 21 February 2019

Tentative signs of macroeconomic stabilisation – more needed

All eyes have turned to China, the main source behind the Eurozone economic slowdown and, symmetrically, the potential cyclical saviour through monetary and, more importantly, fiscal stimulus. Earlier this month at the National People's Congress, the Chinese Prime Minister Li Keqiang vowed to step up fiscal supports by enlarging the scope of tax and fee cuts and increasing local government bond issuance to spur infrastructure spending. The total stimulus could amount to 2.1% of GDP in 2019. The People's Bank of China (PBoC) has also stepped up its monetary easing (reserve requirement ratio cuts and liquidity injections) but the transmission to the real economy seems to have been stifled until recently, with many small and medium enterprises (SMEs) still struggling to source the necessary financing to support business expansion. Activity data have remained weak (so far) with exports declining, while retail sales and most of the investment components continue to decelerate. More worrying are the first signs of cracks in the labour and housing markets.

In this context, Eurozone business surveys offer a striking divergence between external weakness and domestic resilience: retail sales rebounded in January, consumer and services confidence edged up in February. The macro news flow has been more disappointing in Japan (from surveys to industrial production, exports and consumption) while short-term signals have been mixed in the US. Manufacturing indices have retraced, whereas the housing sector and consumer confidence have recovered from year-end lows on most metrics.

Beyond these global dynamics, the UK continues its idiosyncratic Brexit drama. The UK government is still unable to garner sufficient support for the negotiated deal with the EU, but Parliament has voted to reject a "no deal" exit and extend Article 50. Prime Minister May is now seeking an extension, deferring the Brexit date beyond 29 March. However, while May doggedly pursues the approval of this deal, the risks of leaving without a deal seemingly just shift until the end of June instead – an observation not lost on the EU, who needs to approve such an extension unanimously. We expect the EU (so far expressing its lack of amusement over the British political drama) to grudgingly accept a short-term extension to the process – prolonging the Brexit uncertainty, which continues to depress UK activity and rates.

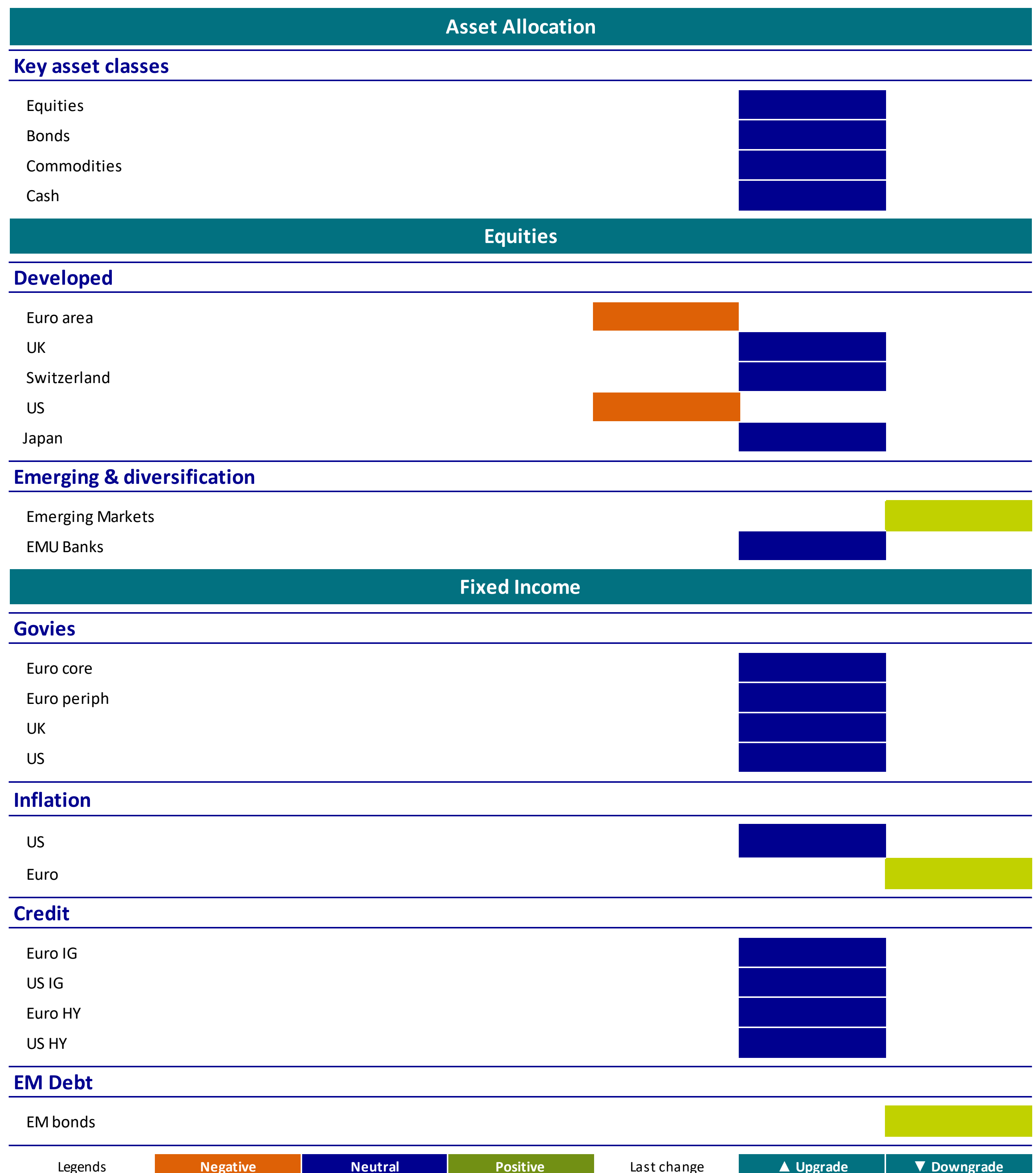
Asset allocation: stable modest risk appetite, neutral on equities

In this context of risk asymmetry, acknowledging that human nature tends to be more attuned to downside than risks, and given the strong start to the year for risk assets (US equities especially, posting 13% year-to-date) we tactically maintain our modest risk appetite and a broadly neutral asset allocation across asset classes. Indeed, the decelerating global economy suggests softer top line growth for firms, while profit margins are at cycle highs. On the other hand, valuation multiples are close to their long-term averages and therefore not a headwind but overall, we see limited scope for short-term upside in the absence of a positive catalyst.

We remain underweight on US and European equities, favouring emerging market assets which should benefit from the "low for longer" interest rate environment, growth divergence and more attractive valuations.

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

Recommended asset allocation



Source: AXA IM Macro Research – As of 21 March 2019

Macro forecast summary

Real GDP growth (%)	**2018**	**2019***		**2020***	
		AXA IM	*Consensus*	**AXA IM**	*Consensus*
World	**3.7**	**3.4**		**3.5**	
Advanced economies	**2.3**	**1.8**		**1.5**	
US	**2.9**	**2.3**	*2.5*	**1.6**	*1.9*
Euro area	**1.8**	**1.0**	*1.4*	**1.1**	*1.5*
Germany	**1.4**	**0.9**	*1.4*	**1.2**	*1.5*
France	**1.5**	**1.1**	*1.4*	**1.2**	*1.5*
Italy	**0.9**	**0.0**	*0.7*	**0.6**	*0.9*
Spain	**2.5**	**2.2**	*2.2*	**1.6**	*1.9*
Japan	**0.7**	**0.5**	*0.9*	**0.3**	*0.5*
UK	**1.3**	**1.3**	*1.5*	**1.5**	*1.6*
Switzerland	**2.5**	**1.0**	*1.6*	**1.3**	*1.6*
Emerging economies	**4.5**	**4.4**		**4.7**	
Asia	**6.0**	**5.6**		**5.5**	
China	**6.6**	**6.1**	*6.2*	**6.1**	*6.0*
South Korea	**2.7**	**2.6**	*2.5*	**2.5**	*2.5*
Rest of EM Asia	**5.7**	**5.5**		**5.4**	
LatAm	**1.2**	**1.9**		**2.1**	
Brazil	**1.5**	**2.5**	*2.5*	**2.5**	*2.5*
Mexico	**2.2**	**1.8**	*1.9*	**1.8**	*2.0*
EM Europe	**2.4**	**1.6**		**2.4**	
Russia	**2.3**	**1.8**	*1.5*	**1.8**	*1.7*
Poland	**5.2**	**3.5**	*3.8*	**3.0**	*3.3*
Turkey	**3.5**	**0.2**	*0.2*	**2.5**	*2.9*
Other EMs	**2.8**	**2.9**		**3.4**	

Source: Consensus Economics, IMF and AXA IM Macro Research calculations – As of 21 March 2019

CPI Inflation (%)	**2018**	**2019***		**2020***	
		AXA IM	*Consensus*	**AXA IM**	*Consensus*
Advanced economies	**1.9**	**1.5**		**2.0**	
US	2.4	2.2	*2.0*	2.7	*2.2*
Euro area	1.7	1.2	*1.5*	1.4	*1.6*
Japan	1.0	0.5	*1.0*	0.9	*1.4*
UK	2.5	1.8	*2.1*	2.3	*2.0*
Switzerland	0.9	0.7	*0.8*	1.0	*1.0*
Other DMs	1.7	0.8		1.8	

Source: Bloomberg, IMF and AXA IM Macro Research calculations – As of 21 March 2019

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 - 19	Q3 - 19	Q4 - 19
United States - Fed	Dates	2.25-2.50	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)
Euro area - ECB	Dates	-0.40	10 Apr 6 Jun	25 July 12 Sep	24 Oct 12 Dec
	Rates		unch (-0.40)	unch (-0.40)	unch (-0.40)
Japan - BoJ	Dates	-0.1/¥25tn	24-25 Apr 19-20 Jun	29-30 Jul 18-19 Sep	30-31 Oct 18-19 Dec
	Rates / QE		unch/taper	unch/taper	net QQE ¥15tn
UK - BoE	Dates	0.75	2 May 20 Jun	1 Aug 19 Sep	7 Nov 19 Dec
	Rates		unch (0.75)	unch (0.75)	+0.25 (1.00)

Source: Datastream, AXA IM Macro Research - As of 21 March 2019

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