For professional clients only
April 2019
Research & Strategy Insights

China in a bull shop

Monthly Investment Strategy

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Key points

- With the "policy put" in place (dovish US Federal Reserve and European Central Bank, fiscal stimulus in China and Eurozone), we have been waiting for signs of a cyclical upswing…
- … getting us to focus on China and Asian trade; both point to the slowdown bottoming out.
- This is good news for the Eurozone where the sequential improvement has been very modest so far.
- US GDP should slow for the third consecutive quarter, partly on temporary factors. Still, our US recession probability model has been worryingly nearing its relevant threshold
- This macro backdrop leaves us with a modest but rising risk appetite, especially in spread product (US High Yield and emerging market debt) amid the renewed trend of lower global rates

World trade and Chinese slowdowns bottoming out

Earlier this month, we outlined that the "policy put" was in place, from the US Federal Reserve (Fed) downgrading its "dots" and announcing the early end of its balance sheet unwind, to the European Central Bank (ECB)'s renewed dovishness in the extension of its forward guidance. Adding the significant Chinese fiscal stimulus (worth more than 2% of GDP) and the more modest fiscal boost in various Eurozone member states, the stage was set for a sequential economic acceleration.

As the main source of this slowdown came from Asian trade and China, we focus in this Monthly Investment Strategy on tracking these, developing new indicators to complement our toolkit. First, our China Economic Cycle Indicator (ECI) adjusts and combines several activity metrics which exhibit similar cyclical trend at odds with the extreme stability of official

GDP growth data. The ECI captures the underlying trend in China's domestic demand and tracks well the fluctuations in Chinese imports and corporate earnings. This indicator confirms that Chinese activity has undergone significant deceleration since 2017, similar to that seen in 2015. Looking forward, early indicators are consistent with Chinese demand bottoming out in the next few months. These include a rise in lending since January – reflecting Chinese stimulus – which historically has preceded an upturn in activity by about six months. This is reassuring as, even though China's real GDP growth surprised on the upside in the first quarter of 2019 (at 6.4% year-on-year), Chinese imports are still contracting sharply.

Second, we introduce our Asian Export Monitor (AEM) which adds to our toolkit of world trade trackers by focusing on emerging Asia. The AEM combines early signals from trade monthly flows of key countries which have recently posted signs of improvement. Here again, the AEM hints at a probable bottoming of Asian export growth.

Eurozone to follow whilst US modestly slows

Current global trade weakness explains subdued readings in global industrial output and manufacturing surveys, including some of the most recent US business surveys. As the consensus view on Eurozone macroeconomics was very hopeful (in terms of timing and magnitude), the latest European business surveys came in below consensus expectations. To date the sequential improvement has been very modest. An improvement in Asian activity and global trade should support industrial indicators over the coming quarters. More importantly, business confidence has remained elevated in services, dissipating fears of a contagion of the past manufacturing slowdown.

Meanwhile, the US economy looks set to slow for the third consecutive quarter, at around 1.5% annualised in the first quarter of 2019. We however see this to prove partly temporary with retail and government spending rebounding to support the second quarter (Q2) – around 2.5% – and with some residual seasonality also persisting. Altogether, our US recession probability model falls short of its relevant threshold over the next twelve months, but the margin has been shrinking and we still see US GDP growth below potential next year, at 1.6% (vs. consensus at 1.9%).

Asset Allocation: risk appetite modest but on the rise as spread product carry attractive

True to form, risky markets have been prompted in pricing a bottoming-out in of global growth following the synchronised slowdown of the last twelve months. US stock indices have been reaching new all-time highs, as price/earnings (PE) ratios have risen to reflect a dovish Fed/lower yields and Q1 earnings have held up reasonably well (as reported so far). Credit markets too continue to trade constructively after record breaking Q1 performance – eg US High Yield (HY). Oil, Chinese stocks and Euro bank stocks lead the pack in terms of year to date returns across assets.

This overall backdrop leaves us with a risk appetite that is modest but rising, in spread product in particular – US HY and emerging market (EM) debt – amid the renewed trend of lower global rates. Within equities we direct our overweight in EM and euro banks, where the rebound in valuation multiples year to date has lagged in comparison to US stocks. We maintain a neutral stance in terms of duration exposure amid global fixed income. This is a prudent stance while we navigate a potential turning point in global growth where more prove signals are required before turning cautious on duration.

Download the full slide deck of our April Investment Strategy

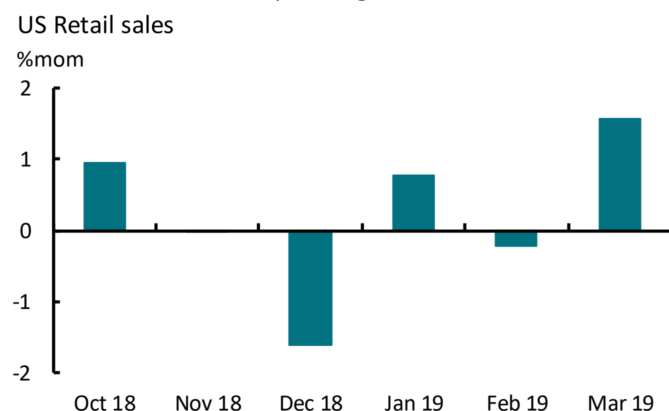
Global Macro Monthly – US

David Page,
Senior Economist,
Macro Research – Core Investments

Growth to accelerate in Q2

Talk of a US recession recently gained momentum as the 3-month/10-year yield curve inverted at the end of March. Curve inversions have been a reliable indicator of impending economic deceleration in the past. We expect inversions to continue to be an important guide, reflecting incentives for bank lending and hence acting as a lead indicator of lending standards across the economy. However, historically, economic downturns have only tended to follow a persistent inversion that has seen supplementary signals from credit markets. The most recent episode lasted only of a matter of weeks, while credit market activity remained benign. We do not however expect the US to fall into recession over the coming 12 months, but we do recognise the elevated chances of such a downturn, if downside risks materialise.

Exhibit 1: Retail sales spending rebounds late in Q1



Source: Bureau of Economic Analysis and AXA IM Research, Apr 19

US Q1 GDP growth looks set to slow for the third successive quarter –we forecast around 1.5%, annualised – from a high of 4.2% in Q2 last year. Currently market expectations are modestly higher, but they have swung sharply, reflecting GDP 'now trackers', including the Atlanta Fed tracker, which started the quarter suggesting 0.3% growth before rising to 2.8%. Household spending should weigh on Q1 GDP but should reflect the sharp drop in spending at the end of last year, in turn caused by the severe sell-off in equities and the US government shutdown. Spending recovered during Q1, despite weather shocks and delayed tax rebates mid-quarter but consumers should support firmer growth in Q2 (Exhibit 1). Government spending should also adversely affect Q1, impacted by the shutdown at the start of the quarter. This should also rebound in Q2. Moreover, several studies continue to point to residual 'seasonality' in the US growth data, despite the Bureau of Economic Analysis suggesting this was resolved. Insofar as some seasonality remains, this should also boost Q2, which we forecast at 2.5%.

We continue to forecast GDP growth of 2.3% in 2019 and note that consensus expectations have softened to 2.4%, from 2.6% at the end of last year – notably the IMF recently lowered its own outlook to 2.3% from 2.5% in January. We consider deceleration this year to be driven by a smaller fiscal boost and tighter financial conditions. However, at 2.3%, growth looks likely to exceed potential and should put further downward pressure on unemployment, which we forecast will dip to 3.6% by year-end from 3.8%. However, we also anticipate further deceleration in GDP growth in 2020 to 1.6% – versus a 1.9% consensus – which should reflect further tightening in financial conditions and less fiscal support.

The minutes of the Federal Reserve's March meeting confirmed a "patient" central bank, but alluded to a persistent upside bias to policy, with "some" participants stating that if growth evolved above trend, as expected, they would advocate a modest tightening in policy before year-end. We forecast that the Fed will leave policy on hold in 2019. Beyond "patience", the Fed seems increasingly focused on a subdued inflation outlook and the risk of inflation expectations resting below the Fed's target rate. Such fears will likely be compounded by a survey suggesting 5-10-year inflation expectations fell to a joint, multi-decade low in of 2.3%. As such, the Fed looks unlikely to tighten policy ahead of evidence of inflation exceeding target, with some suspicion that the central bank may now actively tolerate (or encourage) a modest target overshoot. With this only likely in 2020, we believe there is a window of opportunity to raise rates in H1 2020, before evidence of softer economic growth mounts. However, financial markets consider cuts more likely both in 2019 and into 2020. For this outcome, we believe the economic outlook would have to worsen, consistent with the materialisation of downside risks.

One such risk that has resurfaced is US trade policy. Even as we expect a meeting between US President Donald Trump and Chinese Premier Xi Jinping over the coming months to confirm an extended truce in the Sino-US trade war, President Trump has threatened a second front in his trade war, with the EU. The US Trade Representative (USTR) has proposed tariffs on $11bn of goods associated with a World Trade Organisation ruling on EU Airbus subsidies. While this represents just over 2% of the US's imports from the EU, it echoes the start of the China trade war escalation of last year. More concerning, the White House received the Section 232 report considering the national security implications of the automobile industry in February. A response is due in May, which could raise tariffs on US auto imports. If applied to the EU, this would account for a further 13% of EU imports. This could see a renewed escalation in global trade tensions, and lead to a renewed tightening in financial conditions.

Global Macro Monthly – EMU

Apolline Menut,
Economist (Euro zone),
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Mixed signals from activity indicators…

Eurozone activity indicators remain mixed, with disappointing business surveys contrasting with somewhat better hard data. April's flash PMIs surprised on the downside, with the Euro area composite inching lower to 51.3 – a three-month low. The divergence between the export-oriented manufacturing sector and the domestic-focused service industry remains significant, although it narrowed slightly on weaker services sentiment. We think the latter reflected some retracement in non-core economies, especially after the sharp increase in March's services confidence in Italy and Spain. In addition, hiring intentions remain well oriented in the services sector – at a five-month high – suggesting ongoing domestic resilience. Solid retail sales, with the first quarter (Q1) carry-over standing at 0.6% quarter-on-quarter (qoq), sent a similar message and make us confident that Eurozone area private consumption grew by 0.3% in Q1.

On the manufacturing front, sentiment edged firmer in both Germany and France, but overall, they remained in deep recession territory. New export orders fell sharply, to their lowest level since 2014, in line with our view that green-shoots from China will be only felt after some lag in the euro area in Q3. Moreover, future optimism fell to its weakest level since 2012, suggesting manufacturing weakness is expected to last, amidst protectionist threats, from US car tariffs in particular. The decline in manufacturing sentiment contrasts with better industrial production numbers. The Q1 carry-over stands at 0.7%qoq, the highest since Q4 2017, signalling that the industrial sector has likely stopped being a drag on GDP in Q1. But depressed forward-looking business surveys indicate this improvement might not be sustainable. This poses downside risks to our Q2 2019 GDP forecast of 0.3%. While we see risks as broadly balanced for our Q1 growth projection of 0.2%, flash Q1 GDP data will be released on 30 April.

…Mixed signals from the ECB

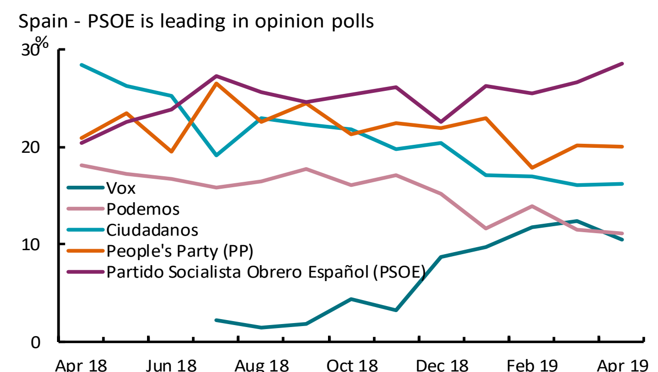
April's European Central Bank (ECB) press conference was notably dovish but followed with mixed comments from Governing Council (GC) members. President Mario Draghi acknowledged that incoming data was still weak, especially in the manufacturing sector, and that the slowdown was lasting longer than expected. He emphasized the importance of the June projections. By then, the ECB hopes for clarity on auto tariffs and information on any external recovery – the main assumption behind the ECB's expectation of accelerating growth into the second half of 2019. Such data dependence was also emphasized as key to the Targeted Longer-Term Refinancing Operation (TLTROs) III pricing decision, together with a thorough assessment of the bank-based transmission channel of monetary policy. The introductory statement also stated that the ECB will consider whether the preservation of negative rates requires the mitigation of side effects, if any. Finally, President Draghi repeatedly said markets understood the ECB reaction function, following the ECB's Watchers conference. In our view, by endorsing the rates rally, Draghi endorsed the market interpretation that the implementation of tiering reflected an expectation that rate hikes were no longer on the horizon. Post-conference, the feeling was that tiering and further rate cuts were possible, while TLTROs III pricing could be as generous as existing operations – so TLTROs III providing monetary policy stimulus rather than just preventing a credit restriction from a funding cliff.

More recent GC member commentary, particularly from Benoit Coeure, tended to downplay both the need for tiering and the conditions of TLTROs III. We do not expect the use of tiering. We believe a significant deterioration in the outlook and aggressive extension of forward guidance would be required before the ECB followed such a course.

… And even more mixed signals from Politics

Spain will hold general elections on 28 April, and polls have evolved materially since February. Back then, a coalition of conservative PP, centrist Ciudadanos, and extreme right Vox was the most likely to win a majority, but this is no longer the case. The Socialist party PSOE has gained votes from both Podemos and Ciudadanos and could lead the next government with regional parties and Podemos (Exhibit 2). Another option could be a PSOE-Ciudadanos coalition, but it has been ruled out by the former on Catalonia divergence. We do not exclude lengthy negotiations and even new elections, as happened in 2015.

Exhibit 2: Fragmented political landscape



Source: Celeste-Tel, El Diario, Simple Logica, Invymark, La Sexta, KeyData, Publico, El Pais and AXA IM Research

Despite political uncertainty – including a potential revival of tensions between Catalonia and Madrid – these elections should have little economic impact in the near term. In fact, unwinding past structural reforms or passing new ones is unlikely in any case, given the fragmentation of the political landscape.

Global Macro Monthly – UK

David Page,
Senior Economist,
Macro Research – Core Investments

Extended Brexit, extended uncertainty

The UK sought a further extension of Article 50 to avoid a "no deal" Brexit on 12 April. The EU agreed to an extension until 31 October, albeit with a break clause if the Withdrawal Agreement is passed beforehand. Prime Minister Theresa May looks likely to attempt to pass her deal again to resolve Brexit and avoid holding European elections on 23 May, but we are not optimistic about her chances of success. Another failed attempt could add to the bad news for the Prime Minister in the run up to regional (2 May) and then European elections. This raises political uncertainty, with many speculating the PM could stand down over the coming months. While a change of Tory leadership could be achieved without elections, the fragility of the current government and the risk of a prolonged Brexit impasse suggests the risks of a General Election – and hence a possible second referendum – looks increasingly likely before the new exit date.

Prolonging the domestic uncertainty is likely to ensure the current headwinds continue to impact UK economic activity. Business investment growth has stagnated since the 2016 referendum, while more recently household sentiment has weakened and appears to be dragging housing market activity lower. That said, Q1 GDP data looks set to post a rebound from Q4's 0.2%qoq, with upside risks to our current 0.3% forecast. This likely reflects a short-term boost from overseas manufacturing demand and domestic inventory gains – both reflecting precautions ahead of the original 29 March Brexit day. Both should unwind over subsequent quarters. We have edged our 2019 GDP forecast lower to 1.2% (from 1.3%) but reduced our 2020 outlook more materially to 1.1% (from 1.5%) on the expectation that the current uncertainty will persist.

To date, employment growth has remained strong. The Brexit uncertainty effect on business investment has subdued productivity growth further – annual growth slowing to just 0.2% in 2018 from 1.1% in 2017. This has maintained labour demand and unemployment remains at a 44-year low of 3.9% in February, while wage growth reached its fastest pace for a decade, at 3.5%. The strong implied pace of unit labour cost growth continues to make the Bank of England 's Monetary Policy Committee wary of domestic inflation pressures. However, with the growth outlook more subdued, we forecast unemployment to edge higher over the coming two years. As such, we do not expect the BoE to tighten policy before Governor Mark Carney stands down in January next year.

Global Macro Monthly – Japan

Hugo Le Damany,
Economist (Japan),
Macro Research – Core Investments

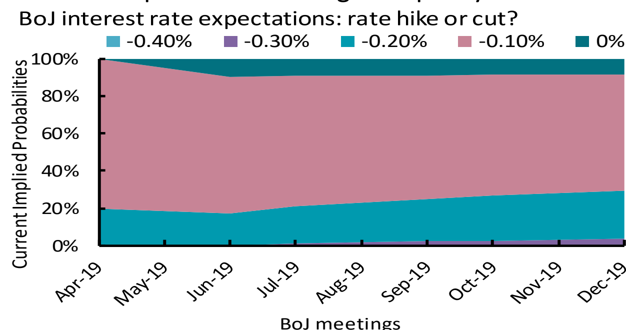
Japan: Modest rebound ahead

For the first three months of 2019, our Japan GDP tracker points to -0.5% quarter-on-quarter annualized growth. January and February exports data have suffered from the Chinese New Year and uncertainties around the US/China trade negotiations. Even with a rebound in March data, exports have only recovered from their December level. Consumption continues to disappoint with only a slight improvement in retail sales, at +0.6% year-on-year. March's 'flash' manufacturing PMI increased slightly from 49.2 to 49.5 but remained soft. The Bank of Japan (BoJ) published its Tankan surveys which illustrated relative resilience in the early months of 2019. The analysis also showed the willingness of Japanese firms to expand capital-expenditure.

We expect a sustained rebound in the Q2 activity. A tight labour market should continue to boost wages and traditional Shunto (annual Spring wage negotiations) has been relatively flat (+2.15% versus 2.26% last year). Furthermore, we expect purchases to be brought forward ahead of October's VAT hike, which could boost consumption. Exports should be stimulated by higher demand from the US and Chinese fiscal and monetary stimulus. However, negative effects could also come from the beginning of US/Japan trade talks. Moreover, an additional public holiday to celebrate the new emperor's enthronement at the end of April, may affect unadjusted growth.

The BoJ meets on 24-25 April. Policy status quo has been maintained, although we anticipate that there will be increasing expectations for expansion of the negative policy rate (NIRP) (Exhibit 3). This has reflected the perception of a rising probability of recession and the BoJ's inability to achieve its inflation target. However, we continue to believe the BoJ will maintain the status quo during 2019 at least, especially in light of how the NIRP can also negatively impact the financial system.

Exhibit 3: Expectations of negative policy rate



Source: Bloomberg and AXA IM Macro Research, April 2019.

Global Macro Monthly – China

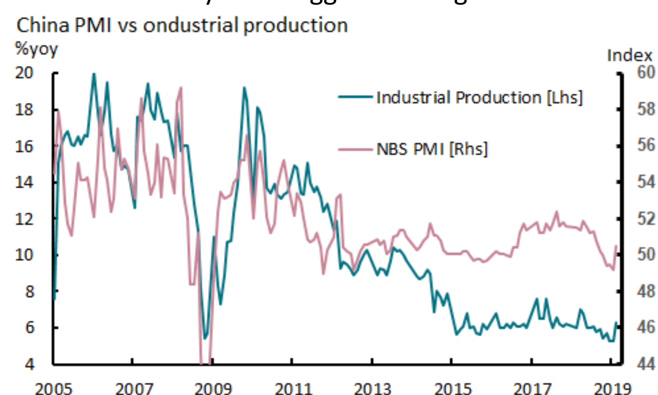
Aidan Yao,
Economist (China),
Macro Research – Core Investments

Blockbuster data suggests growth has bottomed

After a soft start to the year, the Chinese economy rebounded vigorously in March. This lifted Q1 growth to 6.4%yoy, on par with Q4 last year, defying market and our expectations of continued deceleration.

The real surprise came from the broad-based strength in March activity data. Growth in industrial production surged to 8.5%yoy (from 5.7%), reaching its highest since 2014 (Exhibit 4). While March is usually a seasonally-strong month for industrial production – as factories resume production after the Lunar New Year – the 2.8ppt rebound this year was markedly in excess of expectations.

Exhibit 4: Activity data suggests strong momentum



Source: CEIC and AXA IM R&IS calculations

Tracing the source of growth, both domestic and foreign demand seems to have improved in March. Last week's trade data showed a sharp rebound in China's export growth to 14.2% from -20.7% in February. While internally, retail sales also beat the market expectations. Manufacturing investment was the only disappointment, with growth slipping despite strong PMI indices. It is possible that some firms might have postponed their investment decisions, waiting for the cash windfall from the VAT/fee cuts.

All in all, robust data delivered an across-the-board surprise about the Chinese economy. Even though some of this strength may unwind in April (as the seasonal boost wears off), the accumulated evidence to date suggests to us that the worst of China's cyclical slowdown may be behind. Therefore, we have upgraded our 2019 growth forecast to 6.3% from 6.1%, partly due to the Q1 GDP surprise and partly due to the expected upcoming resolution to the trade war.

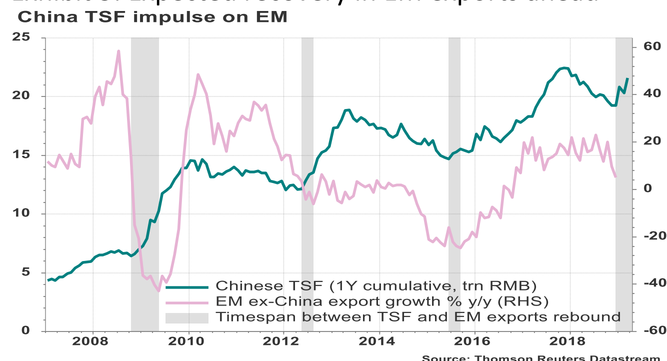
Global Macro Monthly – EM

Irina Topa-Serry,
Economist (Emerging Markets),
Macro Research – Core Investments

Economic recovery in sight, but beware of politics

The recent strength in Chinese data has helped boost the general conviction that a global recovery is slowly but surely gaining traction. Past episodes of Chinese policy easing proved emerging market (EM) supportive with a general three to six months' time lag, suggesting there could be a genuine improvement in exports around the second quarter this year (Exhibit 5). Improvement is already sequentially visible in Korean and Taiwanese export data. On a slowing trend since early 2018, industrial production shows signs of stabilization, while the recent PMI surveys point to greater momentum, both for the manufacturing and service sectors.

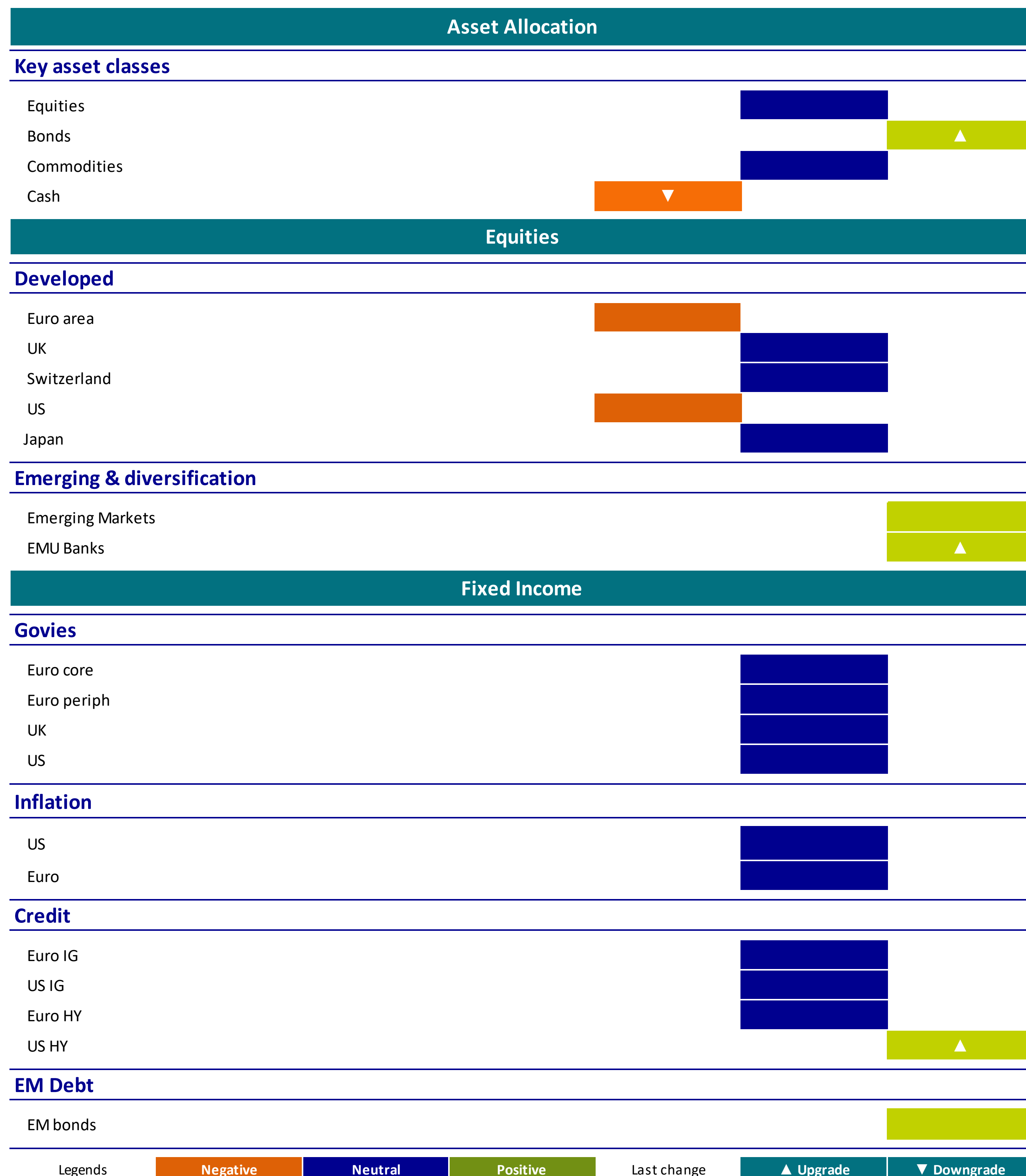
Exhibit 5: Expected recovery in EM exports ahead



Source: Datastream and AXA IM Research

Yet, activity in several major countries remains constrained by political uncertainties. Following the recent local elections in Turkey, the ruling party appealed for a rerun of Istanbul's elections – which could take place in June -– citing claims of fraud. Prolonged political turbulence could undermine the sustainability of the nascent economic recovery. In Argentina, persistent inflation (54.7%yoy in March) and its dampening impact on household purchasing power are severely denting President Macri's popularity ahead of this year's elections. The government announced various monetary and non-monetary measures aimed at controlling inflation and alleviating the social burden of the current economic adjustment, but their potential effectiveness remains in question. The focus in Brazil remains social security reform. Congress needs to approve a constructive version of the Bolsonaro administration proposal to secure debt sustainability and unlock Brazilian economic growth potential. Current policy uncertainty in Mexico under the new Lopez Obrador administration is weighing on investment prospects; the ratification process of the new North America Free Trade Agreement (NAFTA) deal with the US needs to go smoothly in the coming months.

Recommended asset allocation



Source: AXA IM Macro Research – As of 25 April 2019

Macro forecast summary

Real GDP growth (%)	2018	2019*		2020*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
World	**3.6**	**3.4**		**3.5**	
Advanced economies	**2.3**	**1.7**		**1.5**	
US	**2.9**	**2.3**	*2.4*	**1.6**	**1.9**
Euro area	**1.8**	**1.0**	*1.1*	**1.1**	**1.4**
Germany	**1.4**	**0.9**	*0.9*	**1.2**	**1.4**
France	**1.5**	**1.1**	*1.2*	**1.2**	**1.4**
Italy	**0.9**	**0.0**	*0.1*	**0.6**	**0.7**
Spain	**2.5**	**2.2**	*2.2*	**1.6**	**1.9**
Japan	**0.7**	**0.5**	*0.7*	**0.5**	**0.5**
UK	**1.3**	**1.2**	*1.2*	**1.1**	**1.5**
Switzerland	**2.5**	**1.0**	*1.2*	**1.3**	**1.6**
Emerging economies	**4.4**	**4.4**		**4.7**	
Asia	**6.0**	**5.6**		**5.5**	
China	**6.6**	**6.3**	*6.2*	**6.1**	**6.0**
South Korea	**2.7**	**2.6**	*2.5*	**2.5**	**2.4**
Rest of EM Asia	**5.7**	**5.5**		**5.4**	
LatAm	**1.1**	**1.3**		**2.1**	
Brazil	**1.1**	**2.0**	*2.0*	**2.5**	**2.5**
Mexico	**2.2**	**1.4**	*1.6*	**1.8**	**1.9**
EM Europe	**2.3**	**2.2**		**2.7**	
Russia	**2.3**	**1.8**	*1.5*	**1.8**	**1.7**
Poland	**5.2**	**3.5**	*3.8*	**3.0**	**3.4**
Turkey	**2.9**	**0.2**	*-0.8*	**3.0**	**2.5**
Other EMs	**2.4**	**2.4**		**3.5**	

Source: Bloomberg, IMF and AXA IM Macro Research calculations – As of 23 April 2019

CPI Inflation (%)	2018	2019*		2020*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	**1.9**	**1.6**		**1.9**	
US	2.4	2.2	*1.9*	2.6	*2.1*
Euro area	1.7	1.2	*1.3*	1.4	*1.4*
Japan	1.0	0.7	*0.8*	0.8	*1.2*
UK	2.5	1.8	*2.0*	2.3	*2.0*
Switzerland	0.9	0.7	*0.7*	1.0	*1.0*
Other DMs	1.7	1.6		1.8	

Source: Bloomberg, IMF and AXA IM Macro Research calculations – As of 23 April 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	Q1 - 20
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	Jan (TBC) March (TBC)
	Rates		unch (2.25-2.50)	unch (2.25-2.50)	unch (2.50-2.75)	+0.25 (2.75-3.00)
Euro area - ECB	Dates	-0.40	10 Apr 6 Jun	25 July 12 Sep	24 Oct 12 Dec	Jan (TBC) March (TBC)
	Rates		unch (-0.40)	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	Jan (TBC) March (TBC)
	Rates / QE		unch/taper	unch/taper	net QQE ¥15tn	unch (-0.10)
UK - BoE	Dates	0.75	2 May 20 Jun	1 Aug 19 Sep	7 Nov 19 Dec	Jan (TBC) March (TBC)
	Rates		unch (0.75)	unch (0.75)	unch (0.75)	unch (0.75)

Source: Datastream, AXA IM Macro Research - As of 23 April 2019

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