AXA Investment Managers

For professional clients only
February 2020
Research & Strategy Insights

Central bank put, again…

Monthly Investment Strategy

Gilles Moëc,
AXA Chief Group Economist,
Head of AXA IM Research

Chris Iggo,
AXA IM Chief Investment Officer,
Core Investments

Key points

- The trickle of soft and hard data now available to gauge the global economic impact of the Covid-19 epidemic suggests supply-side disruption effects for now exceed the impact on demand. Supply-side effects are harder to treat with policy stimulus.
- Market is now expecting quite a lot from central banks. In the case of the European Central Bank, we think raising the quantum of corporate bonds purchases would be a likely avenue.
- Both bonds and equities like the fact that a central bank put exists, but both are now re-evaluating more sanguine outlooks for the virus spread, while equity markets will have to deal with corporate earnings challenged by supply-side disruptions.

Covid-19 – a supply shock for now

Twice in 10 days the Chinese authorities have changed the way new Covid-19 cases are counted in Hubei, which means that most of the "epidemic projection" exercises, which have been so popular in the market, are now obsolete. However, the World Health Organisation (WHO) has suggested good progress in containing the virus in China.

Focus is now shifting to the propagation of the epidemic outside China, and the emergence of "autonomous contagion points" in South Korea, in a city where 5% of the national population lives is concerning. In Italy, some sort of restrictions is now implemented in regions contributing more than half to the country's GDP. We are now starting to get a trickle of soft and hard data which can help us gauge the global economic impact of the crisis. So far and very tentatively, it seems that supply-side disruption is emerging before demand-side effects kick in.

South Korea has released foreign trade data for the first 20 days of February and reassuringly total exports did very well with growth of 12.4% year-on-year (yoy) – although this was boosted by more working days in the month. But at the same time, imports from China fell by a whopping 18.9%. This is a clear signal that supply-chains are under stress.

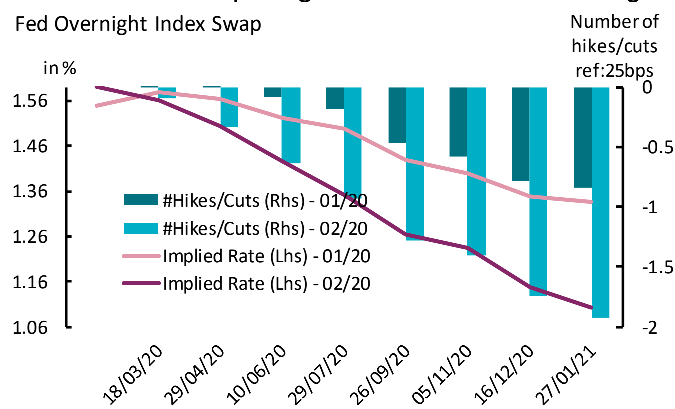
The same applies to the Euro area. At face value, the unexpected rebound in the German manufacturing PMI in February was also reassuring, but half of it came from a statistical artefact: A steep rise in "suppliers delivery time" mechanically raises the overall index because it is normally a signal of "overheating" (suppliers finding it difficult to cope with demand). This time it reflects the disruption in supply lines triggered by difficulties with Chinese components.

We suspect that – short of a swift resolution of the epidemic – demand-side effects will emerge in the next batches of data, but the supply-side issues are problematic in their own right – and are much less "treatable" with policy stimulus. To a large extent, the resilience of financial markets had hinged on a sanguine outlook for containing the virus and expectations of policy support. We think the early consensus of a swift "v shape" recovery is looking increasingly shaky. We were more cautious than most on the global outlook before the epidemic. We are happy to remain below consensus now.

Thinking about plan B

A shift in market expectations for the Federal Reserve (Fed) and the European Central Bank (ECB) since the emergence of the Covid-19 epidemic has been swift. One month ago, market pricing had the Fed cutting by less than 25 basis points (bps) by the end of January 2021. It is now pricing nearly 50bps, with the first cut materialising by the summer of 2020 (Exhibit 1). Our own (pre-epidemic) baseline was 50bps worth of cuts at the end of the year and we now consider the risk of a Q2 easing, despite the constant stream of central bank commentary stating that it is "too early" to tell.

Exhibit 1: Markets price greater chance of Fed easing



Source: Bloomberg and AXA IM Research, as of 25 Feb. 2020

Even for the ECB, the market is starting to price some further reduction in the deposit rate. We continue to think the bar for this is high. The main benefit of such a move would be to depreciate the euro, but the market is already spontaneously producing that, while the central bank has been increasingly ready to acknowledge the side effects of such policy.

We think that if the European economy were to sour further, raising the purchases of corporate bonds would be the ECB's favoured approach. Indeed, on that aspect of quantitative easing, the political and technical limits are much less stringent. This would not necessarily boost activity, but at least it would help support financial stability if a deterioration in economic activity were to raise default rates.

Policy supports markets; watch the dollar

Expectations of further policy stimulus helped rationalise the response of markets to the uncertainty around the eventual impact of the virus. However, with the increased number of cases reported outside China and with evidence of the impact on activity starting to emerge, equities have corrected lower and bonds have rallied, taking US Treasury yields to new lows. These moves will cement expectations of further monetary easing and more active fiscal policy in several economies. China has taken steps to contain the virus and support the economy in the face of the outbreak. In the US, the narrative is starting to be that whoever wins the November election, fiscal policy will add to growth. The UK has seen its budget numbers deteriorate even before the new government delivers its first budget. Yet the longer the crisis lasts, the more challenging will be the task for policy makers.

Supply-side disruption is an issue for equity markets. Apple Inc. already provided negative guidance on Q1 numbers because of the extended shut-down of its business in China. The macro evidence of supply side disruption will show up in corporate results. The impact of this could is likely to be a further delay in any broad rebound in earnings. Our cautious optimism on equities at the beginning of the year was based on better macro data, reduced recession risks and a bounce in earnings growth. Confidence in all of these has been impacted by the uncertainty related to the virus. The recent sharp decline in equity markets may prove to be a buying opportunity given the still positive medium-term outlook, but the short-term uncertainty could see downside moves extended.

Credit markets continue to provide a modest source of comfort. Spreads have widened but remain relatively low and in Europe have barely budged all year, reflecting the role that the ECB's purchases play. Investment grade credit in Europe has outperformed US high yield in local currency terms in 2020, despite the 550bps difference in yield. For now, fixed income returns should be supported by expectations of additional easing in 2020, particularly if we face an extended period of concern about the spread of the virus outside of

China. While expectations of policy moves should eventually provide support for both bonds and equities, the “bad news flow” has already seen the negative correlation between stocks and bonds kick in. In the kind of uncertain environment that we face today, the fact that core government bonds can provide some hedge against equity markets under pressure is an important tenet of investing.

Aside from concerns about the Covid-19 impact on the global economy, it is possible we are also seeing some early US election themes playing out. The recent strength of the dollar has coincided with focus on the Democratic candidate race. The dollar rallied when Donald Trump triumphed in 2016 and there is little yet to suggest a meaningful challenge to him serving a second term. Trump’s policy preferences are perceived to be more market and business friendly than those of most of his potential adversaries. In a world where China’s global economic and political strength is being tested and where Europe continues to struggle to show any evidence of economic or political leadership, a strong dollar is no surprise. The greenback is up because the US looks more resilient both in the short term because of its relative economic strength, but also in the medium term because of (like it or not) strong leadership. This creates an interesting dynamic for investors. If the dollar continues to surge it surely increases the bets on the Fed cutting rates sooner than later. US Treasuries are outperforming European government bonds. If we start to see US equities underperforming the rest of the world as a result of the impact of a stronger dollar and weaker Euro and Yen, then those Fed bets could quite quickly pay off.

Download the full slide deck of our “February” Investment Strategy

Global Macro Monthly – US

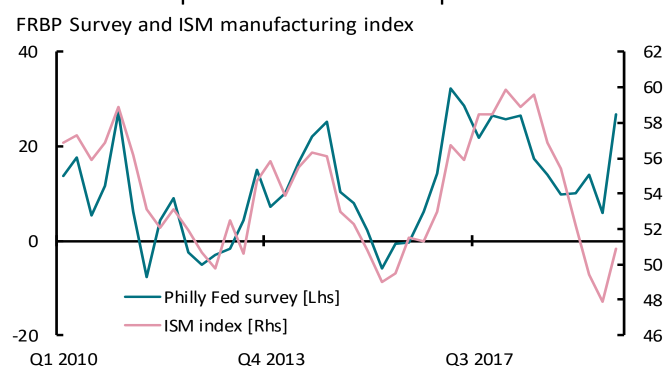
David Page,
Head of Macroeconomic Research,
Macro Research – Core Investments

Forecasting amidst "material" crosswinds

The US economy ended 2019 in line with our forecasts. GDP growth rose by 2.1% (saar) in Q4 with annual growth at 2.3%. Q4 contained elements of weakness that are likely to spill into 2020. Domestic demand experienced its weakest growth in four years, driven by slower consumer spending, stagnation in investment and softer inventory. GDP was supported in Q4 by a sharp drop in imports (-9.0% annualised). Some of this may reflect the tariff war with China, but we expect imports to rebound over the coming quarters, reducing net trade and weighing on economic activity.

Beyond this technical drag, the US economy started 2020 brightly. Consumer fundamentals remained solid with confidence elevated and unemployment around 50-year lows at 3.6%. Last year's Federal Reserve (Fed) rate cuts continue to lift housing activity, likely to further support spending. Moreover, short-term dollar strength and oil weakness – by-products of coronavirus concerns – should provide an additional boost to spending. Finally, February has seen fresh highs in the S&P 500, boosting sentiment and wealth effects. All of this left us considering upside risks to our outlook for 2020.

Exhibit 2: Prospects for 2020 had improved



Source: ISM, Federal Reserve Bank of Philadelphia and AXA IM Research, 24 Feb 20

Yet coronavirus creates a big uncertainty for the global and US economies. In 2003, the SARS outbreak was thought to have reduced China's GDP by 1%, but US GDP by less than 0.1%. Greater direct links between the US and China now (US exports to China are three times more than in 2003) and China's deeper global integration as the country has doubled its share of the global economy means that even a repeat of Severe Acute Respiratory Syndrome (SARS) would likely have a larger impact on the US if it happened now. Preliminary estimates of coronavirus suggest a bigger impact on China this time. We tentatively suggest a 0.2ppt impact on the US economy for now. In total, we leave our forecast for 2020 unchanged at 1.6%, although it is difficult to forecast the path the virus may take. It presents an additional, plausible material downside risk if it spreads more widely beyond China.

Fed skewed to supportive policy

Fed Chair Jerome Powell gave his semi-annual testimony to Congress this month. He reassured that the economy continued to expand at a moderate pace. The Fed has stated that it would take a "material change" to the outlook to see it change policy from here. However, he also repeated that the Fed was "carefully monitoring" coronavirus developments. Given the speed of developments, we will know more about the outbreak by the Fed's next meeting on 18 March. A Fed easing in a "bad outbreak" scenario is not inconceivable.

The Fed's inflation refocus defers any possibility of policy tightening for some time, especially with dollar gains and oil price drops likely delaying Personal Consumption Expenditure inflation's return to the 2% target from its current 1.6%. The Fed's Monetary Policy Review is due around mid-year and some formalisation of an inflation target overshoot, to more actively manage expectations, seems likely. The Fed also continues to expand its balance sheet, shifting from short-term operations to T-bill purchases. The current $60bn/month pace will continue through April but will likely be tapered thereafter. The balance sheet will continue to expand even after the reserves buffer has been rebuilt, removing any prospect of excess reserves reduction. The Fed seems skewed towards easier policy for now, and financial markets appear to be taking this into account.

How could politics not be centre stage?

Coronavirus worries have distracted from historic political developments. President Donald Trump's impeachment proceedings ended with acquittal by the Senate along party lines - only one Republican, Mitt Romney, broke ranks to vote to remove Trump for abuse of power. The President is now clear to run for re-election in November. Meanwhile the Democrat primary process got off to a chaotic start in Iowa. Pete Buttigieg was the surprise winner, and narrowly second in New Hampshire. Bernie Sanders has performed strongly, winning in New Hampshire and Nevada and second in Iowa, although he has not done as well as in 2016. Amy Klobuchar has done unexpectedly well, while the surprise loser so far has been former frontrunner Joe Biden, although he came second in Nevada. Biden needs to do well in South Carolina to keep his campaign alive into Super Tuesday on 3 March.

Whether the coronavirus ultimately proves to be a footnote in history, or a material chapter, remains to be seen. However, the 2020 political developments will be lasting and this year's Presidential Election will have an impact on the economic outlook over and above current cyclical considerations.

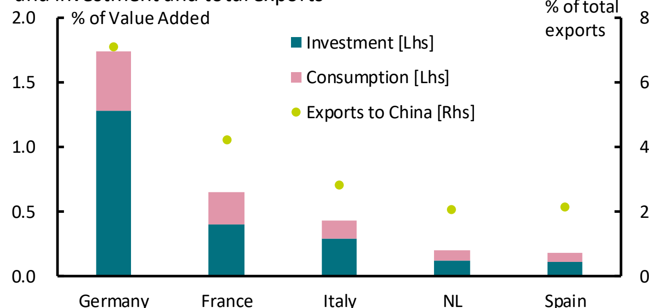
Global Macro Monthly – Eurozone

Apolline Menut,
Economist (Eurozone),
Macro Research – Core Investments

A weak end to 2019

The end of 2019 marked a dichotomy between encouraging soft indicators and disappointing hard data. Industrial output plunged in December, bringing the fourth quarter (Q4) average to -1.4% quarter-on-quarter (qoq), the weakest since the end of 2012. The drop was widespread, although Germany and Italy suffered the most. This was reflected in Q4 GDP numbers, which saw Italy shrinking by 0.3%qoq, and Germany flat, while France suffered from pension reform-related strike disruption, contracting by 0.1%. Overall, the euro area economy grew by a mere 0.1% in Q4, the weakest since 2013. Beyond the poor headline, the growth composition was worrying, with details from national countries – the euro area expenditure breakdown will only be available on 10 March – signalling softer domestic demand, and investment. We had highlighted[1] that low profitability, a declining capacity utilisation rate, bleak demand expectations and persistent uncertainty should drag on capex this year, but disruption from coronavirus is another factor to add to this gloomy list.

Exhibit 3: Euro area countries' sensitivity to China



Source: OECD TiVA and AXA IM Macro Research, as of 21 February 20.

Coronavirus dashes hopes for a better 2020

February's flash composite Purchasing Managers' Index (PMI) for the Eurozone surprised to the upside, rising to a six-month high of 51.6 – driven by better manufacturing and services sentiment, in particular in Germany. Given the sharp decline in the ZEW survey, the German manufacturing PMI at a 13-month high is puzzling. Details reveal that half of the monthly gain was due to a lengthening in supplier delivery times – usually a positive related to stronger demand, but this time reflecting supply-chain disruption in China. New export orders at a three-month low are further evidence of an early coronavirus impact. While we have limited visibility on the magnitude and duration of disruption, weaker Chinese growth, delayed manufacturing stabilisation and increasing contagion across euro area lead us to revise down our Q1 and Q2 growth forecasts to -0.1%qoq (Exhibit 3). We expect a mild rebound in H2 at 0.2%, although risks are for a more protracted impact with spillovers to consumers. Overall, we see euro area growth slowing to 0.2% year-on-year in 2020.

The ECB may look through volatility…

The European Central Bank (ECB) is likely to look through short-term disruption in our view. The minutes of the January ECB meeting confirmed the cautiously optimistic tone of the press conference, with increasing confidence in the growth and inflation outlook. At that time, it was too early to worry about coronavirus, but the latest comments from ECB members still sounded relatively positive. Vice President Luis De Guindos simply mentioned that coronavirus "adds a new layer of uncertainty", while Chief Economist Philip Lane expects a "v-shape" impact, which should leave their base case unscathed. As such, we don't expect significant changes in the March ECB projections, mainly an emphasis on downside risks. Should the outlook deteriorate– and the situation in Italy poses substantial risks – meaning substantial growth revisions and a more "L-shape" profile in H2 20, the ECB will likely consider further stimulus. We think the bar remains high for additional cuts to the deposit rate, amid discussions over potential side effects. Instead, we see raising the purchases of corporate bonds as the ECB's favoured approach, ensuring easy financial conditions while not facing the political and technical limits of sovereign bond purchases. The ECB should continue to stress the need for a more balanced policy mix.

… While national politics are unlikely to help

The latest European Union (EU) summit confirmed that calls for fiscal support continued to fall on deaf ears. EU leaders failed to reach an agreement on the 2021-2027 budget, as filling the €60-75bn funding gap created by Brexit caused rifts between the frugal states – Sweden, Denmark, Austria and the Netherlands – and net recipients of EU funds. We find it striking that negotiations stumbled over a mere 0.1% of GDP, a clear signal that a swift fiscal response is not in the cards. A broadly similar picture emerges at the national level. In Germany, the Christian Democratic Union party's internal leadership challenges risk further delaying any fiscal response. In Italy, the political situation remains fluid, with Italia Viva's threat to call for a motion of no-confidence. Given the polls, we continue to see little incentive for ruling parties to proceed with snap elections. But the coronavirus adds further pressure on an already fragile government.

[1] Menut, A., "Eurozone – If only countries could give themselves a leg up", page 9 of AXA IM Research Macroeconomic Outlook 2020, 3 December 2019

Global Macro Monthly – UK

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

Fiscal stimulus to underpin growth outlook

The UK economy slowed to stagnation in the final quarter of 2019, delivering annual growth of 1.4% – marginally firmer than 2018's 1.3%, but around decade lows. The slowdown was exacerbated by a 1.1% quarterly drop in manufacturing output, which had as much to do with global trade weakness amidst US/China trade tensions, as with Brexit developments – despite volatility in car production. However, the reduction in service sector growth to 0.1% – its weakest in a decade was more likely caused by Brexit and election uncertainty.

The outlook for 2020 had improved. The US/China Phase One trade deal led to a rebound in global manufacturing sentiment. The UK's services PMI remained around a 16-month high in February reflecting an unwind of Q4 uncertainties. Nevertheless, the government's ongoing commitment to end the transition phase of its Withdrawal Agreement from the EU at the end of 2020 threatens an abrupt shock to the economy. We have no confidence that the UK will be able to achieve a full trade agreement with the EU in this time. Moreover, shorter-term risks of renewed global trade weakness persist in the wake of the uncertainty over the development of coronavirus.

An expected fiscal loosening in the 11 March Budget is a clear positive for the UK outlook. We had considered Chancellor Sajid Javid likely to ease policy having changed the fiscal rules to allow for a material increase in investment spending. However, a surprise development amid a Cabinet reshuffle saw Javid resign, replaced by Rishi Sunak. Javid's insistence on balancing the current budget looked likely to need some revenue increases. We await the Office for Budget Responsibility's assessment of Sunak's Budget, but wonder if this will mark a shift from conservatism to populism.

The Bank of England (BoE) left monetary policy on hold and the Bank Rate at 0.75%, despite appearing to signal a cut at last month's meeting. Governor Carney pointed to improving survey data but said the rest of the economy would have to "fill in". The scale of fiscal stimulus will determine whether the BoE's Monetary Policy Committee needs to ease policy. We lower our 2020 annual GDP forecast to 1.0% from 1.1%, in anticipation of the impact of coronavirus. But we still forecast GDP growth in excess of 0.3% per quarter on average across 2020. Annualised, this would exceed the BoE's revised estimate of potential growth of 1.1%. This should keep the BoE on hold across 2020, unless a broader spread of the virus results in a greater materialisation of downside risk.

Global Macro Monthly – Japan

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

Sharp contraction in Q4 GDP, virus risks recession

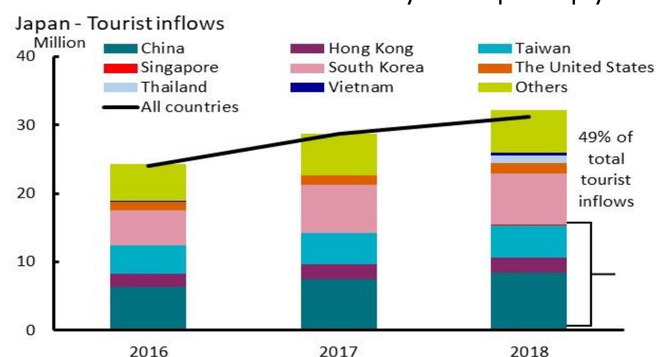
We were more pessimistic than the consensus, but that was not enough. The first estimate showed Q4 GDP shrank by -6.3% quarter-on-quarter annualized. Since 2009, the only quarter to deliver a worse print, came after 2014's VAT hike. This time, private consumption and investment fell to -11.0% and -9.9% respectively, while net trade held up only thanks to imports declining (-10.1%).

Developments have been mixed since January. Private consumption is recovering, but gradually. The services PMI rebounded to 51 from 49.4, but manufacturing has been stuck below 50, indicating contraction, for ten months now. Trade figures for the first 20 days of January have remained weak even without the impact of the COVID-19 outbreak. Coronavirus will likely exacerbate the distortion effect of Chinese New Year on activity.

Coronavirus is impacting activity through two main channels:

- Most of Japan's tourists come from the most virus-affected countries: China, Hong Kong, Taiwan or South Korea (Exhibit 4),
- Exports to China account for about 20% of Japanese exports, while the broader supply chain accounts for 35%. China's slowdown will affect Japanese exports.

Exhibit 4: Tourist inflows are likely to drop sharply



Source: Japan National Tourism Organizationa and AXA IM Macro Research, as of 13 February 2020

Moreover, Japan has 53 confirmed cases of COVID-19 itself (excluding a cruise ship docked in Yokohama). Slow growth in these cases suggests the virus remains contained for now, but a broader outbreak would pose greater downside risks.

Given the latest development in hard data, surveys and a likely decline in China, we believe Japan will face a technical recession in Q1 (-0.5%qoq annualized).

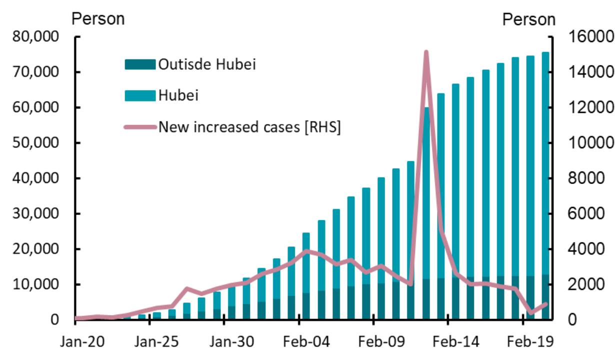
Global Macro Monthly – China

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

Growth downgrade to reflect the virus impact

The rapid escalation of the novel coronavirus (COVID-19) outbreak has completely changed the consensus narrative on the Chinese economy in 2020. The previously optimistic expectation of "smoother sailing" – following the signing of the Phase One trade deal – has now given way to acute concerns around an economy that has been hobbled by a severe epidemic for almost a month. Even under our optimistic case for a quick resolution to the epidemic followed by a decent recovery, we think the economy will struggle to deliver growth much higher than 5%. Our updated projection – 5.3% for 2020 (down from 5.8%) – incorporates considerable policy support from Beijing to mitigate the negative growth shock. However, we caution that the effectiveness of these stimuli is still contingent on the evolution of the viral outbreak.

Exhibit 5: Growth in confirmed cases slows



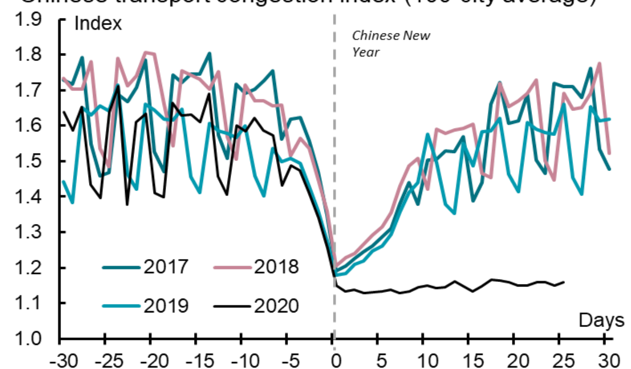
Source: CEIC and AXA IM Research, as of 21 February 2020

A glimmer of light at the end of the tunnel

The macro outlook right now is largely driven by the epidemic, and so it is encouraging to see some positive signs of virus containment. Since early February, the daily increase of new infections has fallen steadily, from almost 4,000 cases to below 1,000 (as of 20 Feb). A recent change in the diagnostic method led to a one-off jump in new cases in Hubei but has not derailed the overall declining trend. Growth in new infections outside Hubei has also fallen, suggesting the aggressive quarantine measures have been effective in limiting the spread of the disease. The latter is important to ensure that the vast majority of the Chinese economy (i.e. 96% of GDP) can gradually resume normality, although it remains to be seen how contained the virus will be once normal operations are restored.

Fast containment of the outbreak is a necessary, but not sufficient, condition to realise the optimistic case in our recent report[2]. The others are: 1) a quick normalisation of the economy, aided by 2) sufficient policy support. On 1), there are fewer reasons for optimism, as the aggressive restrictions imposed by Beijing have continued to limit people's mobility and suppress economic activity. The Ministry of Transport estimates that only 80 million out of 300 million migrant workers have returned to work thus far, consistent with still-anaemic industrial and retail activity (Exhibit 6). A further delay would prolong the initial growth shock and make it harder for the economy to make up lost ground.

Exhibit 6: Delay in work resumption poses a key risk



Source: WIND and AXA IM Research, as of 19 January 2020

On 2), the authorities are doing their part to alleviate the economic pain. Numerous fiscal measures have been announced to resuscitate the economy, including a further frontloading of local government bond quotas to expediate infrastructure investment. Many regional authorities have also announced targeted tax/fee cuts, fiscal subsidies and rental holidays to businesses and individuals who have been hit hard by the viral outbreak. So far, over RMB90bn worth of fiscal resources have gone into epidemic controls and medical supplies in Hubei alone.

Monetary policy is also playing its part. The People's Bank of China (PBoC) cut the reserve requirement ratio (RRR) at the start of the year and has continued to inject liquidity into the system after the lunar new year. It also recently cut the repo and medium-term lending facility rates by 10bps to lower funding costs and boost market confidence. Now, as the turning point of the epidemic may be in sight, the balance of policy may shift further from "fighting the virus at all costs" to ensuring an orderly resumption of economic activity. We therefore expect more policy easing measures to come over the coming months.

[2] Yao, A., "First thoughts on the potential economic impact on China", AXA IM Research Insights, 4 February 2020

Global Macro Monthly – EM

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

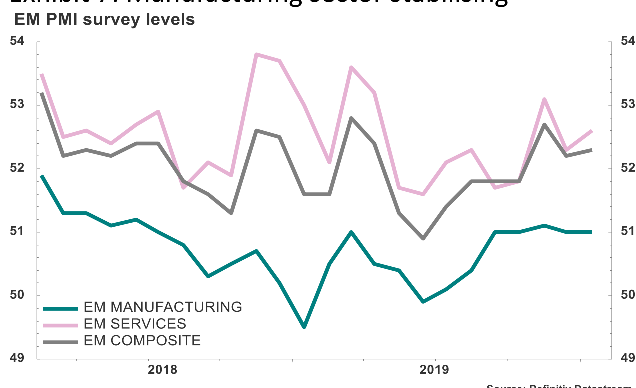
Shirley Shen,
Economist (Emerging Asia),
Macro Research – Core Investments

Just as economic momentum was improving…

Global manufacturing Purchasing Managers' Index (PMI) surveys showed a broad-based improvement, driven by both developed market (DM) and emerging market (EM) countries. Importantly, new orders picked up strongly at a global level, back into expansion and at their highest level since March 2019 – suggesting that the global economy was on a firmer path in January.

Within emerging markets, surveys depicted an improvement in manufacturing activity across all regions, with a particularly strong reading in Asia. India stood out with its manufacturing PMI surging to 55.3, its highest level since 2012. Conversely, China reported a slight deterioration to 50.0 in January, driven mostly by a decline in export orders. In Latin America, industrial momentum appears to be improving in Brazil while Mexico is still struggling in contraction territory, albeit seeing an improvement at 46.7 from 45 in December. The picture remains more mixed in EM Europe, with Poland's PMI drop interrupting a three-month streak of better readings, while an improvement has been reported in the Czech Republic – though the index is still very weak at 45.2. Russia posted a better reading in January, but it still points to contracting industrial activity, while Turkey reported its first "positive" reading above the 50 threshold since March 2018.

Exhibit 7: Manufacturing sector stabilising



Source: Markit PMI survey and AXA IM Macro Research, as of Jan 2020

On the services sector front, we continue to see improvement across the board. Headline services PMIs advanced in all major EM countries, with India outperforming its peers – improving the fastest and now at higher levels than China, Russia or Brazil. Z-scores indicate Brazil and India services activity expanding above trend, while being close to trend in China and Russia in January.

… the COVID-2019 Coronavirus outbreak occurs

Following the first case of the novel coronavirus infection at the end of December 2019, the outbreak has spread to 50 countries, including 22 in Asia. There have been over 1000 confirmed cases and ten deaths outside China at the time of writing. The World Health Organization (WHO) has officially declared the outbreak a public health emergency of international concern (PHEIC), prompting many countries to raise travel alerts on China, restrict flights and impose visa restrictions on Chinese visitors. For the time being, the virus appears broadly contained within China. Its overall economic impact will depend on the geographical spread, the ramifications of contagion and the persistency of the virus.

Asia's small and open economies with a large China exposure will be more vulnerable to the virus, given their proximity to China as well as their interconnected economies in the global and regional value chains. In gauging the economic effect on Asian countries, we assessed four main channels of transmission that could spread the economic impact of the virus – were it to remain broadly contained within China.

- Tourism is likely to be a main channel of impact as governments impose travel restrictions. The importance of the tourism industry makes Hong Kong, Thailand, Vietnam and Singapore vulnerable to reduced tourism.
- A sharp slowdown in the Chinese economy will be painful for Asian trading partners. Small and open economies such as Hong Kong, Taiwan, South Korea and Singapore are thus more vulnerable, while more-domestically oriented economies such as Indonesia and India should be more insulated to a spillover from China.
- Many Asian countries will also be vulnerable to domestic demand shocks. The experience of the SARS virus in 2003 shows that countries and regions with more local infections experienced sharper declines in domestic consumption. This does not bode well for Thailand, Singapore, Hong Kong and South Korea as fears of infections and tighter government controls could hinder domestic activity.
- Asian financial markets have also reacted to the virus - stock markets and currencies have fallen sharply in the past two weeks.

At this stage, the number of cases outside China is still relatively small. However, a broader outbreak would threaten a sharper drop in activity globally – and close, interconnected neighbours are most vulnerable to the spread of the virus.

Investment Strategy – Cross-assets

Greg Venizelos,
Credit Strategist,
Research – Core Investment

Coronavirus fears to the fore

Global markets finally awoke to the coronavirus outbreak halfway through the third week of February, as infection hotspots sprung up in South Korea and then Italy. The inevitable flight to safety has created another 'duration bonanza' in cross-asset returns, with gilts returning 4.4% year-to-date, second to gold at 9.4%. In US Treasuries, 30-year yields fell well below 2% and 10-year yields are flirting with the 1.36% lows of 2016. Both sterling and dollar credit already exceed 3% year-to-date, which on an annualised basis appears as strong as 2019 returns – that would be a notable outcome for two years in a row.

Risk premia have corrected notably at the time of writing, with the S&P 500 down 4.7% from its all-time high and dollar credit spreads wider by 10% in relative terms. This risk-off momentum looks set to accelerate in the near term as the risk of a CoViD19 pandemic hangs over markets, threatening a more significant market correction into March amid the uncertainty – will the partial economic shutdown spread from Italy to France and Germany? And for how long? This complicates efforts to gauge the degree of correction that is consistent with the macro impact of the virus and thus the potential timing for 'buying the dip', which we see as the more likely conclusion of this market correction once more.

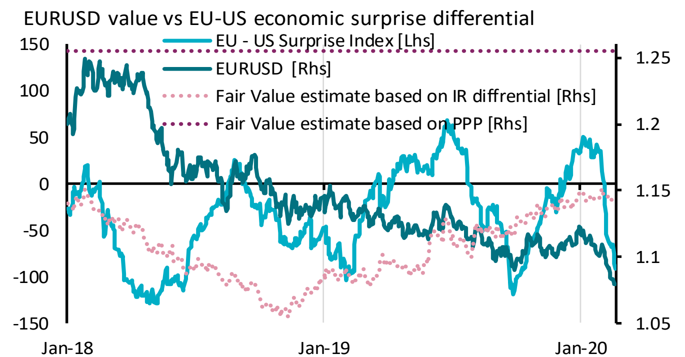
Investment Strategy – FX

Romain Cabasson,
Senior Portfolio Managers,
Multi-Assets – Core Investments

Trade war to coronavirus: no respite for the euro

Despite significant undervaluation and an improving interest rate differential versus the US, the euro (EUR) vs US dollar (USD) rate is unlikely to rebound in the short term. The Phase One US/China trade deal was a cause for optimism for global trade, whose weakness had been so painful for German manufacturing. But support for the euro proved short-lived as the trade narrative was quickly jeopardized by the coronavirus outbreak. European data have also displayed weakness in contrast to a more resilient US economy so far this year (Exhibit 8). This leaves little hope for a turnaround in external demand for the euro area soon. Thus, momentum for a weaker euro has returned, which should weigh on EUR/USD in the coming month. The Australian dollar is also likely to suffer from the renewed headwind to Chinese demand, and a weaker Australian economy.

Exhibit 8: Weak Eurozone drives EUR/USD pessimism

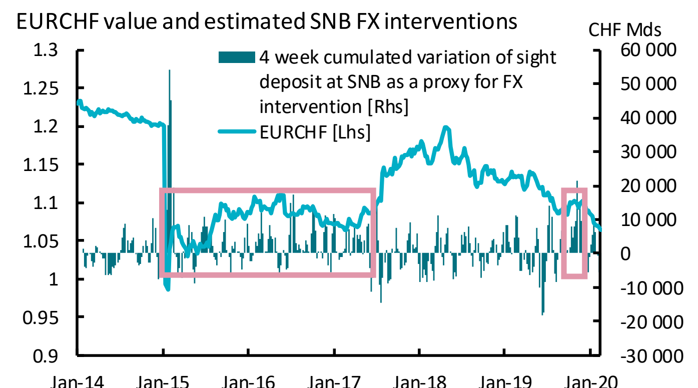


Source: Bloomberg and AXA IM Research, as of 22 February 2020

Cautious Swiss investors, Japanese hunt for yield

The Swiss Franc (CHF) and gold remained elevated despite the initial risk-on environment at the start of the year, even as most traditional safe-haven assets adjusted lower. CHF seemed to be gaining more fundamental support than just flight-to-safety flows: it is now relatively less expensive to hold given the lower broader rate outlook. Foreign investment outflows also appear limited. Moreover, the Swiss National Bank (SNB)'s currency interventions, which resumed in the third quarter – and should have capped CHF appreciation – have now stopped, despite EUR/CHF falling below levels the SNB had previously defended in 2016 and 2017 (Exhibit 9). It seems the bar for currency intervention is now higher, given recent domestic data resilience, the large size of the SNB balance sheet and the scrutiny of the US administration that put Switzerland back on the 'currency manipulator' watchlist. Japanese investors seem more eager to continue unhedged foreign investments to harvest carry, provided volatility remains low. These flows are likely to weigh on the yen against high yielding currencies, exacerbated by the lower global yield outlook. We continue to like the Canadian dollar in this environment - it now offers the highest carry in the G10 and is much cheaper than USD, while Canada displays similar resilience to the US economy.

Exhibit 9: CHF appreciation not met by SNB intervention



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

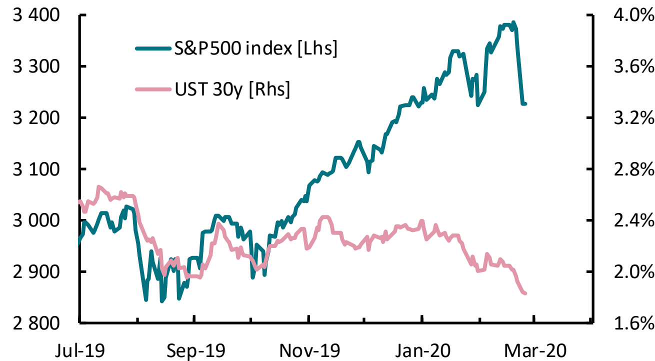
Investment Strategy – Rates

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

The bond market in the driving seat

When looking at financial markets, the first question that comes to a bond trader's mind is: Why are bonds not selling off as stocks keep rallying? Are we missing something? Are bonds pricing an overly grim scenario? Can we think of a high probability scenario that reconciles 30-year Treasuries below 2% while the S&P500 valuations remain elevated even after the recent ~5% correction due to coronavirus fears?

Exhibit 10: Goldilocks versus tug-of-war



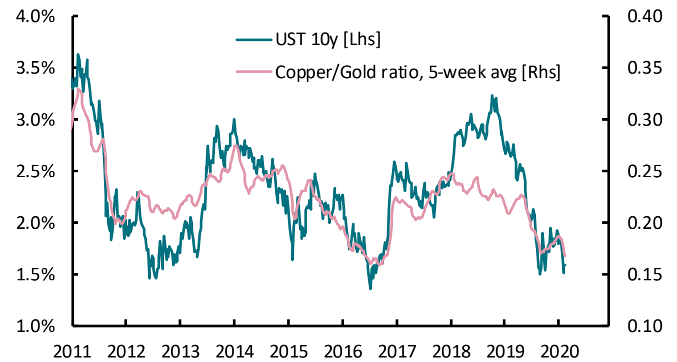
Source: Bloomberg and AXA IM Research, as of 25 February 2020

Under the assumption that the US will slow in 2020 and 2021, as projected in our forecasts, Exhibit 10 suggests two possible market scenarios:

- **Scenario 1:** Both stocks and bonds discount monetary policy easing going forward. Easing can take the form of lower rates and/or a larger balance sheet. Both measures work well with the Fed, but less so with the ECB. Why aren't the Fed and the ECB already acting? There is no need to pre-emptively ease policy – markets are quite happy to wait until the data start showing us the true extent of economic damage. Under this 'goldilocks' scenario, bonds and stocks are both bid.

- **Scenario 2**: Bond markets correctly anticipate a negative demand shock propagating from China (Exhibit 11), which will likely slow advanced economies and put a lid on already depressed inflation expectations – five-year in five-year (5y5y) inflation is 1.2% in euros and 1.95% in US dollars. Central banks should come to the rescue, but monetary policy can only smooth the economic cycle, it cannot prevent it. Under this dichotomous scenario, bonds are still bid, but there is growing uncertainty about corporate profitability and the stock market needs to correct. After all, we haven't yet tested the efficacy of unconventional monetary policy – forward guidance in particular – during an economic downturn.

Exhibit 11: Demand shock means bond yields lower

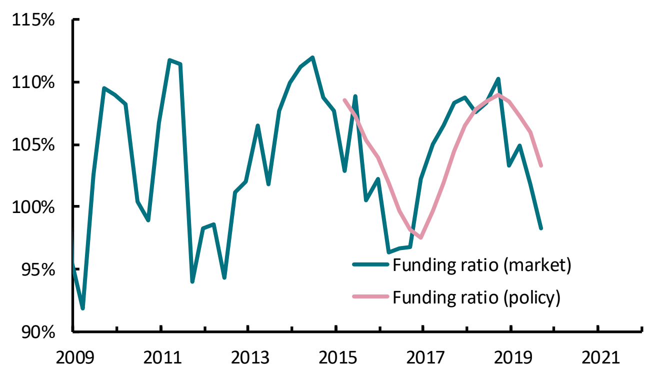


Source: Bloomberg and AXA IM Research, as of 25 February 2020

Duration is likely to remain bid under both scenarios, as the likelihood of seeing a strong rebound in inflation expectations is contained. On the other side, markets will not reprice central banks anytime soon, on the contrary they might even start pricing additional quantitative easing from the Fed with obvious consequences on term premia.

Regulated demand for duration/convexity is yet another important point to keep in mind. We've discussed this topic in the past - pension funding ratios seem not to have improved during 2019, despite the global stock market rally. For example, the funding ratio of Dutch pension funds has dropped by five percentage points during the first three quarters of 2019 (Exhibit 12).

Exhibit 12: Regulated demand for duration



Source: DeNederlandscheBank and AXA IM Research, as of 25 Feb. 2020

During that period, we had the MSCI World index returning almost 15%, but the long-end of the euro swap curve collapsed leading to 55 basis points (bps) of flattening in the spread between 5-year and 30-year yields. The same 5-30s curve is now trading again very close to last year's lows of 56bps, levels we've last seen during the high yield meltdown during the commodity/oil crisis in the first half of 2015.

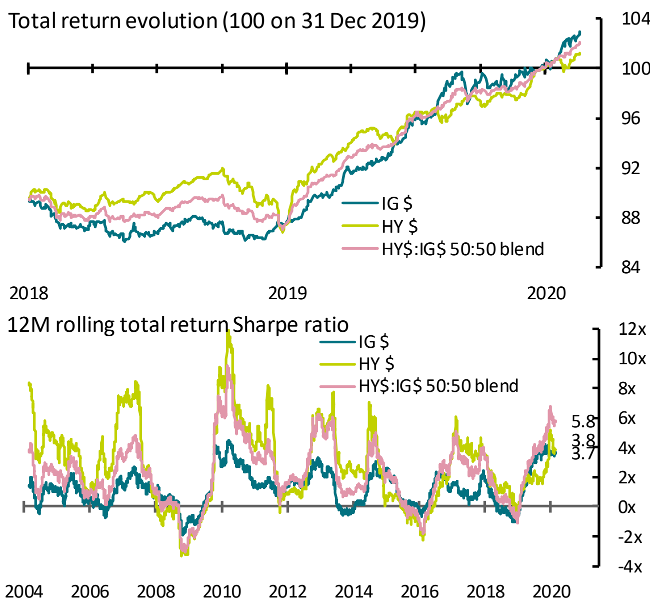
Investment Strategy – Credit

Gregory Venizelos,
Credit Strategist
Research – Core Investments

IG plus HY: a Sharpe(r) blend

As investor sentiment continues to vacillate between risk-on and risk-off, so does the 'duration pendulum' within fixed income markets. This in turn drives the relative performance between the investment grade (IG) and high yield (HY) credit markets. The coronavirus outbreak saw a renewed bid for safe-haven assets, namely government debt and US Treasuries in particular. This 'bid for duration' has boosted IG returns once again, pushing sterling IG to 3.1% and dollar IG (Exhibit 13Exhibit 13, top) to 2.9% year-to-date (ytd) – a strong start. Global IG is leading Global HY at 2.5% versus 1.6%.

Exhibit 13: The US dollar IG:HY 50:50 blend has exhibited a superior Sharpe ratio since early 2019



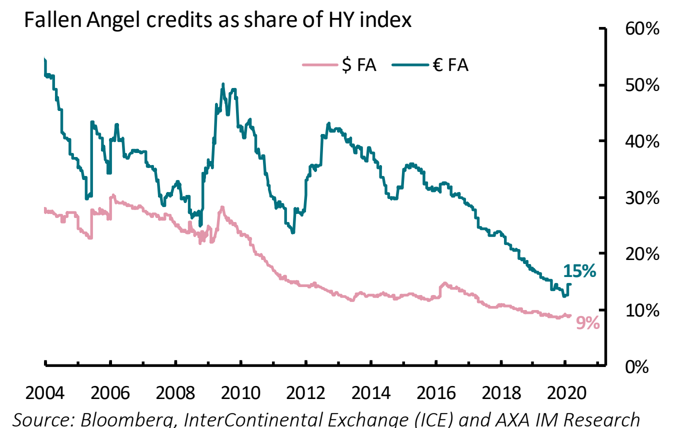
Source: Bloomberg, InterContinental Exchange (ICE) and AXA IM Research

What is quite remarkable is that the ebb and flow of relative performance between dollar IG and HY has been so orderly, that a 50:50 blend of the two markets exhibits an almost straight line upwards in performance since early 2019 (Exhibit 13, top). As a result, the 12-month rolling Sharpe ratio of this 50:50 blend is currently far superior than either the IG or the HY Sharpe ratio – a historical first over the past 15 years.

Fallen angel risk revival

Recent weeks have seen a spate of companies that have lost their IG rating and been downgraded into sub-IG (aka HY or junk). Such companies are known as 'fallen angels' in credit market jargon (Exhibit 14). A few of the recent fallen angels are companies that have taken on substantial debt, often to embark on shareholder-friendly activity, taking their leverage to levels incompatible with an IG rating. While rating agencies may have given such companies the benefit of the doubt at first, an inability to generate higher earnings or embark on asset sales in order to cure excessive leverage has ultimately led to a downgrade into junk. In some cases, management teams have even been unwilling to actively reduce leverage.

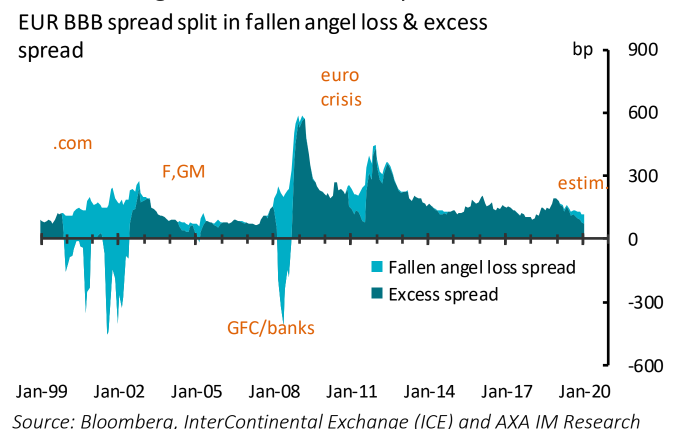
Exhibit 14: Fallen angel volumes tick up amid downgrades



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

Current high levels of BBB-rated corporate debt are a worry to investors. They are a potential trigger for a wave of fallen angels in case of a serious downturn in growth. We are not unduly concerned that BBB debt poses a systemic risk – not in the near-term anyway – inasmuch as low-for-longer interest rates render debt service costs affordable. That said, the recent spate of fallen angels does emphasise the need for active credit selection in order to avoid fallen angel risk, which in extreme instances can be very detrimental to investment grade credit excess spread/returns (Exhibit 15).

Exhibit 15: Fallen angel risk can be very detrimental to investment grade credit excess spread



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

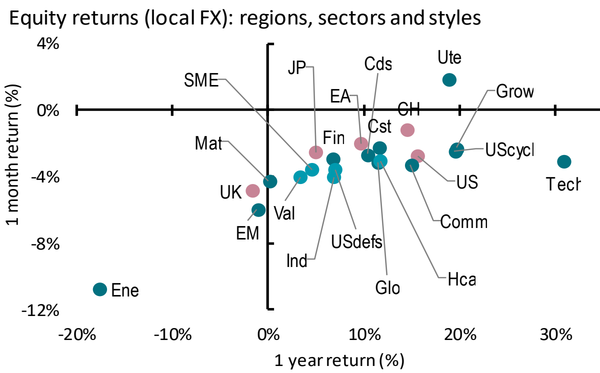
Investment Strategy – Equity

Varun Ghotgalkar,
Equity Strategist,
Research – Core Investments

Fourth quarter earnings beating expectations

With recent news dominated by coronavirus, equities have exhibited some volatility and witnessed a sell-off, amid the uncertainty of whether CoViD19 will become a pandemic. Overall, market internals have continued to favour cyclicals over defensives, but this dynamic may get questioned if the risk-off persists. Indeed, Utilities (1.9%) are the only positive sector over the month (Exhibit 16), while Tech (-2.9%) have suffered, even if not to the extent that Energy has (-10.7%).

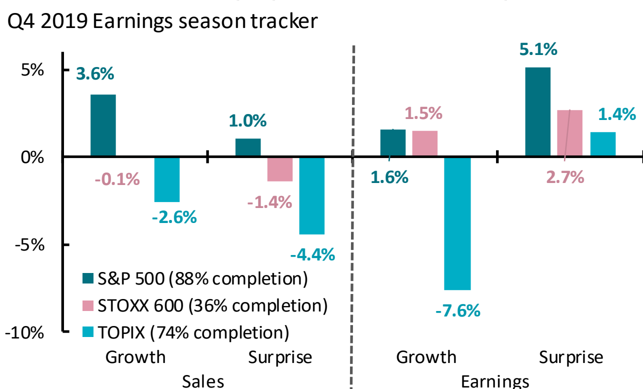
Exhibit 16: CoViD19 catches up with equity returns



Source: MSCI, Bloomberg and AXA IM Research, as of 25 Feb. 2020

Healthy earnings surprises have been broad-based across major regions and sectors so far in the 2019 fourth quarter (Q4) period. US equity earnings continue to lead other developed markets, while growth in commodity sectors was particularly weak this season (Exhibit 17). Profit margins, while still robust, have shown signs of rolling over given top line growth pressures, lack of pricing power in many industries given persistent low inflation, and ongoing wage inflation.

Exhibit 17: Encouraging start to Q4 earnings season

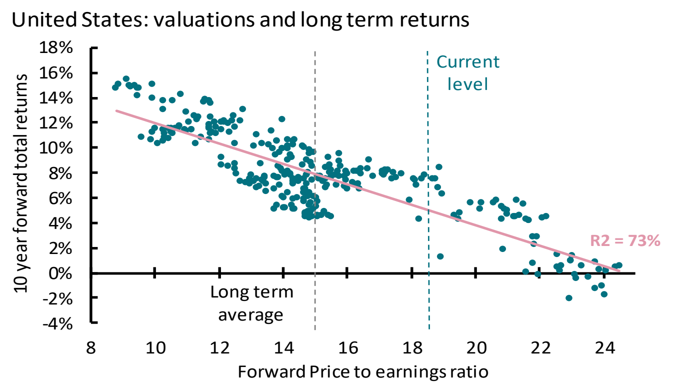


Source: Bloomberg and AXA IM Research, as of 25 Feb. 2020

Returns expected to moderate going forward

Going forwards, our leading indicators suggest that the negative earnings momentum should bottom out moving into the second half of the year, bar a material deterioration due to coronavirus. Aggregate global equity market valuations are not stretched on most metrics and still provide relative value against fixed income markets. Still, after a stellar run for the asset class, current valuation levels and the economic growth backdrop suggest that equity market returns should moderate going forward (Exhibit 18).

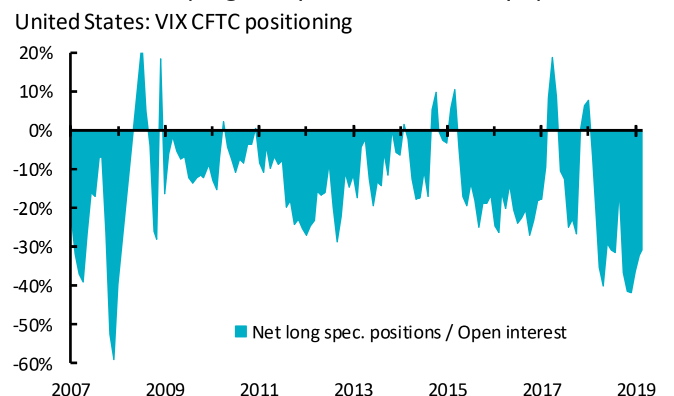
Exhibit 18: Valuations multiples and long-term returns



Source: Datastream, IBES and AXA IM Research, as of 25 Feb. 2020

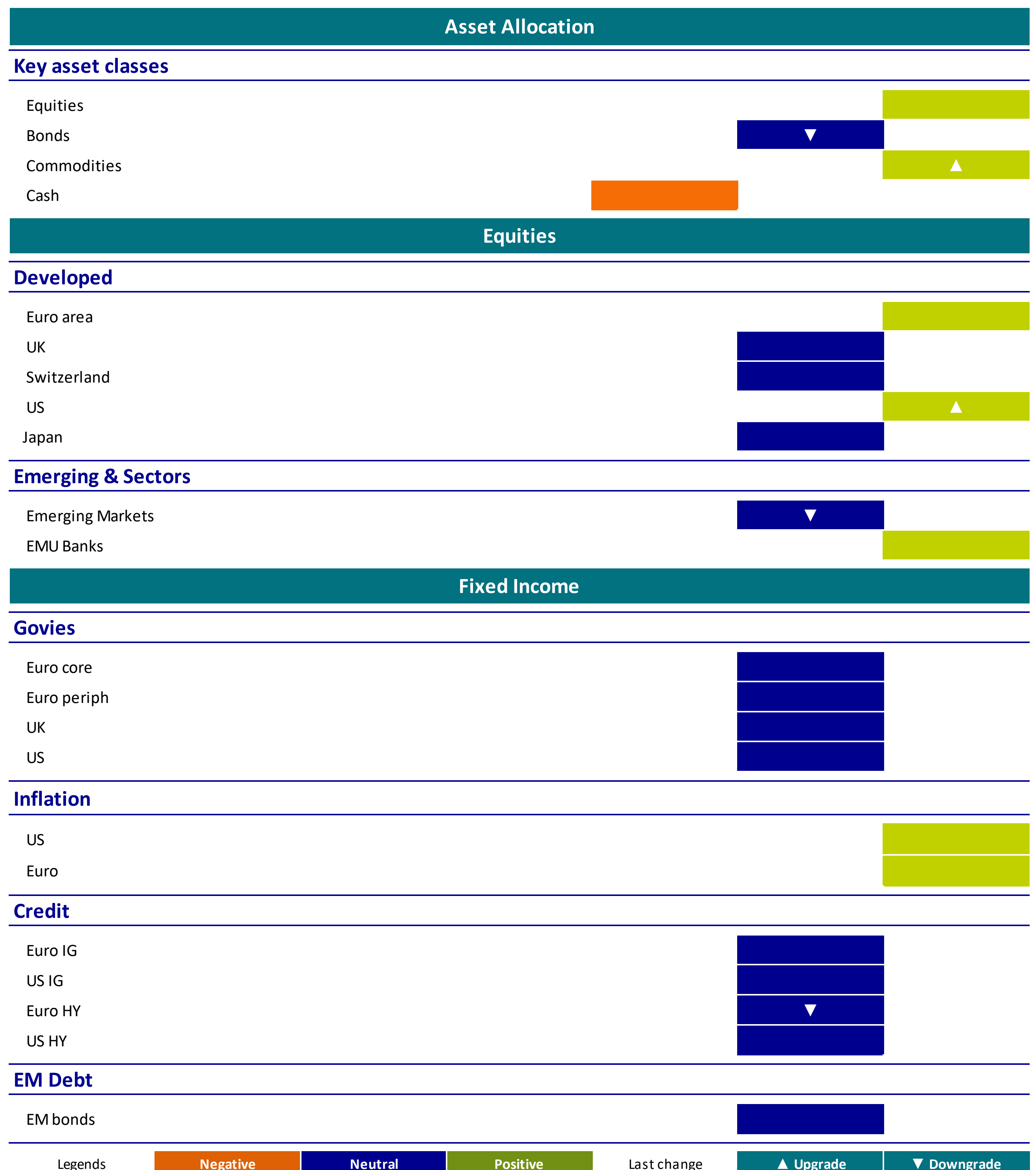
Although macro risks have moderated, the political calendar leaves financial markets prone to event risk, with coronavirus an additional source of volatility. While overall investor sentiment continues to improve, volatility levels suggest a build-up in complacency (Exhibit 19). Stock repurchases are still a strong tailwind for the market, with the global trailing buyback yield close to 2%, implying a total shareholder pay-out yield north of 4%. Overall, we keep a constructive stance on equities, with a bias in our allocation towards undervalued cyclical plays and, in the euro area, select high dividend yield exposure with adequate free cash flow cover. We also have a regional preference for US and euro area equities in our allocation and remain neutral on emerging markets. To protect from near term downside from a coronavirus flare up, long volatility positions are a prudent overlay strategy.

Exhibit 19: Keeping an eye on the volatility space



Source: Commodity Futures Trading Commission (CFTC), Bloomberg and AXA IM Research, as of 25 Feb. 2020

Recommended asset allocation



Source: AXA IM Macro Research – As of 26 February 2020

Macro forecast summary

Real GDP growth (%)	2019*		2020*		2021*	
	AXA IM	Consensus	AXA IM	Consensus	AXA IM	Consensus
World	3.1		3.2		3.0	
Advanced economies	1.7		1.3		1.0	
US	2.3	2.3	1.6	1.8	0.8	1.9
Euro area	1.2	1.1	0.6	1.0	0.5	1.3
Germany	0.6	0.5	0.4	0.7	0.5	1.2
France	1.2	1.3	1.0	1.2	1.0	1.4
Italy	0.2	0.1	0.2	0.5	0.4	0.6
Spain	2.0	2.0	1.5	1.7	1.2	1.7
Japan	0.9	0.9	0.1	0.3	0.7	0.8
UK	1.3	1.2	1.0	1.1	1.0	1.5
Switzerland	1.0	0.8	1.1	1.2	0.9	1.4
Emerging economies	3.9		4.4		4.2	
Asia	5.7		5.2		5.1	
China	6.1	6.1	5.8	5.9	5.6	5.7
South Korea	2.0	1.9	1.7	2.2	1.5	2.4
Rest of EM Asia	5.2		5.3		5.5	
LatAm	0.1		1.6		1.3	
Brazil	0.8	1.0	1.8	2.0	1.2	2.5
Mexico	-0.1	0.2	0.6	1.2	0.6	1.9
EM Europe	2.9		3.7		3.4	
Russia	1.3	1.1	1.5	1.6	1.7	1.9
Poland	4.0	4.3	3.5	3.4	3.0	2.8
Turkey	-0.3	-0.3	2.3	2.3	1.2	3.1
Other EMs	1.2		2.5		2.0	

Source: Bloomberg, IMF and AXA IM Macro Research - as of 26 February 2020

CPI Inflation (%)	2019*		2020*		2021*	
	AXA IM	Consensus	AXA IM	Consensus	AXA IM	Consensus
Advanced economies	1.3		1.5		1.7	
US	1.7	1.8	2.0	2.1	2.3	2.1
Euro area	1.2	1.2	1.2	1.3	1.3	1.4
Japan	0.5	0.6	0.5	0.6	0.4	0.6
UK	1.8	1.8	2.0	1.7	1.9	1.9
Switzerland	0.7	0.4	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 26 February 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	1.50-1.75	17-18 March	28-29 Apr 9-10 Jun	28-29 Jul 15-16 Sep	4-5 Nov 15-16 Dec
	Rates		unch (1.50-1.75)	unch (1.50-1.75)	unch (1.50-1.75)	-0.50 (1.00-1.25)
Euro area - ECB	Dates	-0.50	12 March	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	18-19 March	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	0.75	26 March	7 May 18 June	6 Aug 17 Sep	5 Nov 17 Dec
	Rates		unch (0.75)	unch (0.75)	unch (0.75)	unch (0.75)

Source: Datastream, AXA IM Macro Research - As of 26 February 2020

These projections are not necessarily 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.

Neither MSCI nor any other party involved in or related to compiling, computing or creating the MSCI data makes any express or implied warranties or representations with respect to such data (or the results to be obtained by the use thereof), and all such parties hereby expressly disclaim all warranties of originality, accuracy, completeness, merchantability or fitness for a particular purpose with respect to any of such data. Without limiting any of the foregoing, in no event shall MSCI, any of its affiliates or any third party involved in or related to compiling, computing or creating the data have any liability for any direct, indirect, special, punitive, consequential or any other damages (including lost profits) even if notified of the possibility of such damages. No further distribution or dissemination of the MSCI data is permitted without MSCI's express written consent.

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 2020. All rights reserved

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