And after the summer?

Monthly Investment Strategy

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Key points

- Europe has been enjoying a rare moment of outperformance recently.
- Still, given the abundance of "cliffs" ahead, Europe would do well with a nice policy "parachute". For now though, the US is still doing more on the stimulus front.
- Equity gains have been strong despite the know concerns about the virus, the economic impact and other uncertainties like US elections.
- A pre-election fiscal boost, a peak in the current infection rate of success in the hunt for a vaccine could provide a meaningful positive boost.
- Earnings will be important, particularly when analyst expectations of a rebound begin to be confirmed by companies themselves.

Can Europe stay "in the good place" for long?

To borrow recent words from Christine Lagarde, the Euro area has been "in a good place" recently. This is a relative notion of course. Compared with the US, the pandemic is now much better controlled, and the real-time indicators continue, for the most part, to normalise at a strong clip, in sharp contrast with the US where they are now reporting a relapse in activity. This was reflected in equity indices lately, with Europe enjoying a (rare) moment of outperformance. The situation remains precarious though and we would focus on three risks for the near future.

First, although the re-acceleration in virus circulation is nowhere near the pace seen in the US even in Spain, which at the moment is Europe's hotspot, risk tolerance on this side of the Atlantic is low and containment measures – bringing in some disruption on the supply-side – tend to be re-imposed faster than in the US for any given pace of Covid propagation (the recent news from Barcelona are a case in point). Real-time indicators have started to reflect some marginal relapse in activity in Spain, which may also suggest that the European public may react more cautiously than US citizens, as important as government reaction.

Second, so far monetary policy transmission has been swift – reflected in the record flows of loans originated to the business sector since March. But the European Central Bank (ECB) Bank Lending Survey (BLS) is now suggesting that banks are preparing to tighten their credit standards, anticipating the closure of the window of access to state guarantees. Christine Lagarde called on the governments to re-profile their schemes to avoid such "cliff".

Third, the labour market is currently artificially propped-up by extraordinary measures such as very generous part-time unemployment benefits. Business surveys suggest there is ample "pent-up layoffs" ready to materialise when those government schemes are scaled back. This could impair consumer spending after the current, stronger-than-expected rebound observed since the late spring across the Euro area.

Against those cliffs, the European economy needs a "parachute". This is where the contrast with the US works the opposite way. Treasury Secretary Mnuchin is openly discussing the possibility of "blanket forgiveness" for the smaller loans granted through the Paycheck Protection Programme (PPP), while the House passed an additional stimulus package worth 8% of GDP in 2020 and 7% in 2021. Faced with an uphill struggle in his re-election bid – as polls now steadily favour Joe Biden – President Donald Trump is sounding more and more open to some of the aspects of the House package. Finally, the Federal Reserve (Fed) is explicitly having a conversation on shifting to "yield control" should stronger forward guidance fail to contain market expectations.

In Europe, national fiscal stimulus packages still look small. Fortunately, although negotiating the EU's Recovery and Resilience Fund proved more painful than expected, a deal was found which sends a powerful political message, in particular with the taboo of debt mutualisation breaking. Still, the scheme will result in an additional push of only 3 to 4% of GDP cumulatively over seven years. It is not a game-changer from this point of view, and national budgets will need to do more.

Since the start of the crisis, markets have been oscillating between focusing on the pandemic risk itself or on policy support. On the first leg, Europe continues to do better than the US. But on the second, the US is still in the lead. This may hamper the capacity for European markets to outperform much more.

Triumph of the recovery

Overall though, equity investors continue to experience strong returns. While short-term trends may respond to the subtleties of the policy making process and news-flow, the overwhelming force behind rising markets is the belief that the world will recover, both economically and from the pandemic. That is an important psychology and helps explain the apparent disconnect between market momentum and valuations on the one hand, and the insecurities created by the pandemic on the other.

An expectation of superior returns to equity investors as the world adapts to a post-pandemic reality should not be tinged with complacency however. The world economy has taken and continues to take a big hit. There is already and will continue to be less employment. The US election will create medium-term policy uncertainty. The virus could surge again as we approach winter. We are yet to fully understand the extent to which the long-road of globalisation will reverse and the implications of that. But a lot of this we have already known for some time.

The coming months, however, could sustain markets. The European deal, a pre-election fiscal boost in the US, breakthroughs in the search for a vaccine and the potential peaking of the infection rate would be positive drivers. It should be remembered that returns from most equity indices are still negative year-to-date. The shock of the first quarter (Q1) propelled bond returns above those from most equity strategies. Even today, the total return from a US Treasury index from the end of 2019 stands well above returns from most equity strategies. Unless we experience severe reversals in growth or the health crisis it is unlikely that this fixed income outperformance will persist. Investors will struggle to get returns above low single digits from most bond sectors while owning equities provides exposure to the upside of a recovery.

Earnings are important. We are just into the Q2 reporting season in the US and the early results are on the positive side. Consensus forecasts see a return to positive year-on-year earnings per share (EPS) growth at the start of 2021, based on what we have already seen from the bounce in economic activity. However, guidance is still fragile as companies have little visibility about just how the recovery proceeds. Analysts expectations need confirmation from companies themselves. When we start to get that, the doubts about the stock market's ability to stay elevated will begin to diminish.

The fact that markets are up with what we already know suggests that something much worse needs to come along to put us into a bear trend again. That of course could be something as straightforward as a meaningful second wave and renewed lockdown for a large part of the global economy. Returning to the economic activity levels of early April is highly unlikely but the fear of such a scenario could be enough to push markets significantly lower at some point. For now, thankfully, the signals are not pointing in that direction.

Download the full slide deck of our July Investment Strategy

Global Macro Monthly – US

David Page,
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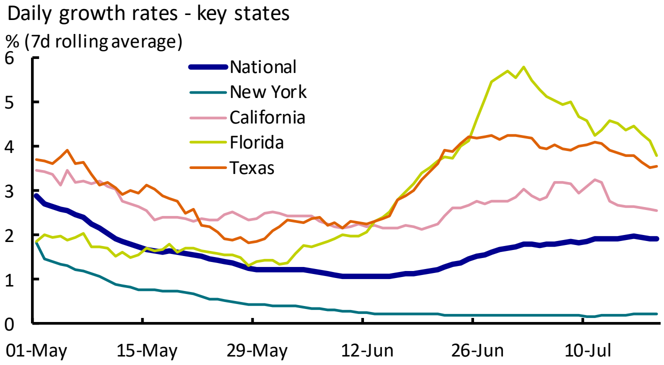
Virus re-emerges to darken outlook

The number of daily new cases of coronavirus has set fresh records, taking the total cases to 4mn. Daily cases in California, Arizona, Florida and Texas account for about two-thirds of the total. In these key states, the growth of new cases has slowed (Exhibit 1) – as has the national average, following the re-imposition of restrictions in many states by closing bars, restaurants and other leisure facilities. But growth rates remain elevated and further deceleration will be necessary to break the chain of new cases, hospitalisations and deaths. We will watch for more evidence that new cases will peak over the coming weeks. So far, the mortality rate has been lower than in the spring

Exhibit 1: Virus growth decelerates, but cases still climb



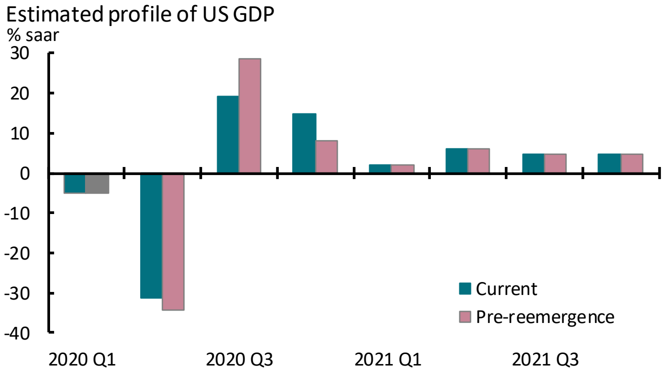
Source: John Hopkins and AXA IM Macro Research, July 2020

While the early easing of lockdown has contributed to the re-emergence of the virus it has also added to a rebound in activity in May and June. Retail sales posted monthly gains of 18.2% and 7.5% in May and June, with broader consumer spending up 8.2% in May. Industrial output grew 1.4% and 5.4% in the same periods. Meanwhile survey evidence has continued to improve with the ISM surveys reaching 52.6 and 57.1 in June, and Federal Reserve (Fed) surveys solid in July, although the Philadelphia Fed survey retraced.

Significant uncertainty still surrounds the scale of GDP contraction likely in Q2. Net trade looks set to make a sharply negative contribution, with exports down 30% in April and May on Q1, compared with imports down 16%. Meanwhile business inventories signal a deep drop, albeit with the usual uncertainty surrounding this contribution. We have revised our outlook for Q2 GDP higher to -31% (seasonally adjusted annual rhythm) from -34%, based on a quicker consumer rebound. Q2 GDP is due on 30 July.

The virus' path remains key for the second half of the year (H2) outlook. The re-emergence of the virus and reimposition of restrictions reduces our expected Q3 rebound. Around 70% of the US by GDP has adjusted its lockdown removal path. We reduce our expected Q3 rebound by two ppt, with most of that now occurring in Q4 (Exhibit 2). Alone, this expected shift would depress 2020 growth, but lift 2021. However, combined with our upgrade to the Q2 outlook, our growth forecast remains broadly unchanged for this year at -4.5%, but we raise our 2021 forecast to +5.0%. This compares with a more pessimistic -5.6% and +4.0% consensus outlook.

Exhibit 2: Virus re-emergence shifts recovery profile



Source: Bureau of Economic Analysis and AXA IM Macro Research, July 2020

Minutes of June's FOMC meeting suggested that having lowered the policy rate and restarted quantitative easing (QE) more quickly than in 2009-2014, changes to forward guidance will be next. Current forward guidance is descriptive, but we expect a more explicit form – likely centred around an unemployment target – to be introduced in September. Markets continue to debate the prospect of Yield Curve Control. We believe the Fed *is* controlling the yield curve, but remains keen to do so through guidance, rather than explicit caps. The Fed's balance sheet dipped below $7tn at the start of July as domestic and foreign emergency liquidity was no longer required. However, Fed QE purchases of $80bn of US Treasuries and $40bn MBS per month will soon reverse this. QE should continue across H2 this year to see the balance sheet reach $8tn in early 2021.

Presidential elections are just over three months away. If the elections were tomorrow, we think Joe Biden would win. President Trump's approval may now be at a trough - a recovering economy and falling unemployment may improve his polling by November. However, with recent polls putting Biden 15 points ahead, we doubt Trump can fully recover. Such appears the swing in national mood that polls currently suggests Democrats could control both Houses of Congress. However, this outlook is more tentative and a Republican polling recovery could still see the Senate remain under Republican majority. This will be critical in determining how much of Biden's manifesto he can deliver – a manifesto described as the most progressive since 1964.

Global Macro Monthly – Eurozone

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Economist (Eurozone),
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Cautiously better…

The Eurozone outlook continues to depend on two interrelated factors: pandemic developments and the strength of the demand recovery. On the first point, daily new cases remain low but reproduction rates close to 1 in most Eurozone countries call for caution. Sudden virus outbreaks and localised containment measures (Galicia, Catalonia, Lisbon) are likely to become the new normal – we should be ready for more in the weeks ahead.

On the second point, the reopening of the economy has resulted in a mechanical rebound in activity and official estimates point to slight upside surprises. The latest INSEE[1] report suggests that French economic activity is recovering faster than expected, with a strong rebound in household consumption (to 3% below normal) and a progressive return of employees to their places of work. The INSEE growth profile and forecasts are similar to our own (-9%yoy in 2020 vs. ours -8.5%). Banque de France is also highlighting upside risks to its -10% 2020 GDP projection. In Germany, the Bundesbank Weekly Activity Index continues to recover sharply, with the implied GDP growth rate for the last 13 weeks up to 19 July compared with the preceding 13 weeks at -1.7%qoq, up from -7%qoq mid-June.

The composition of the data is interesting. Consumers have surprised a little with their resilience, while the manufacturing rebound is somewhat disappointing. Eurozone industrial production increased by 12.4%mom in May, but the gap to the pre-Covid level is large at 19%. Forward-looking indicators such as German factory orders surprised to the downside, dragged down by a lack of improvement from non-Eurozone trade partners. Meanwhile a sharp rebound in Eurozone retail sales (+17.8%mom) left the gap to the pre-Covid-shock level at just 7%. Retail sales are only a part of household consumption, but this challenges our assumption that the services sector would recover slower than industry.

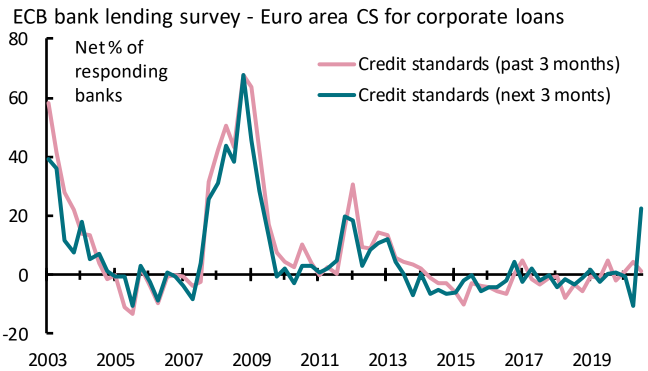
Overall improving data, together with the stabilisation in financial conditions and successful take-up of the latest round of Targeted Longer-term Refinancing Operations (TLTRO) financing allowed the ECB to enjoy a breather at its July meeting. As expected, there was no change to monetary policy.

In our view, the main takeaway of the meeting was ECB President Christine Lagarde's clarification of the use of the Pandemic Emergency Purchase Programme (PEPP) bond buying programme: in the ECB baseline scenario the full €1.35tn envelope will be deployed – and only significant upsides surprises would call that into question. She also referred to the dual nature of the programme to remove ambiguity: yes, market fragmentation has been reduced, but there is need for a persistent accommodative monetary policy stance while inflation projections remain low. We continue to expect a PEPP increase in H2 2020, most likely at the December meeting.

… But beware of the double cliff

Another takeaway from the ECB press conference was the strong emphasis on uncertainty and on the impending challenges for policymakers, particularly with the risk of a 'double cliff' when short-time working and loan guarantee schemes come to end. Governments have started to extend the former, especially for the most-affected sectors. But there is little clarity on the outlook for state loan guarantee schemes, due to end on 31 December in most Eurozone countries. This uncertainty was reflected in the latest ECB Bank Lending Survey, in which banks foresaw a considerable tightening of credit conditions in Q3 (Exhibit 3). Once again, policymakers face a complex choice: too long an extension would fuel free-riding, but severely impaired credit access could increase solvency issues and raise the probability of guarantees being triggered.

Exhibit 3: Beware of the funding cliff



Source: Datastream and AXA IM Macro Research, 15 July 20.

EU Council dealing with compromises

After almost five days of acrimonious negotiations, the EU Council reached a deal on the €750bn Recovery Fund. It is less ambitious than the Commission proposal (the share of grants is reduced from 500bn to 390bn), and is laden with future difficulties, given its complex governance (objection from one country can delay disbursement of funds). Cuts have been made to important programmes (InvestEU, Just Transition Fund, Solvency instrument) while budget rebates for the frugals were boosted. Yes, the taboo of debt mutualisation is finally broken, and member states are showing concrete financial solidarity. But compromises mean that the deal is probably too big and prone to free-riding for the frugals and too small and conditional for the peripherals.

[1] *Institut national de la statistique et des études économiques*

Global Macro Monthly – UK

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Sharp fall, but recovery ahead

The UK has made more material progress in overcoming coronavirus in the last month. Save for one day, daily new virus cases have fallen below 1000 to 600-700 per day since mid-June. The estimated reproduction rate of the virus has stayed below one. And this has been as the UK has tentatively eased restrictions, opening bars, restaurants and parts of the leisure sector. The UK is belatedly introducing mandatory mask-wearing in shops and on transport. It has also undertaken targeted lockdowns, for example in Leicester. But app-based contact tracing is still elusive.

The extended UK lockdown will take a heavy toll on the economy. Monthly GDP disappointed in May with a rise of just 1.8%, below our own and market forecasts, and small by comparison to the 6.3% and 20.3% contractions posted in March and April. Construction and manufacturing saw much more solid gains of 8.2% and 8.4% on the month - but in the dominant service sector that remained under lockdown in May, output rose by just 0.9%. June should post a bigger gain (we see 6%), but our already sub-consensus -20% quarter-on-quarter forecast is subject to downside risk.

The outlook for the second half continues to be uncertain and will depend in part on the path of the virus. We forecast a solid rise in GDP in Q3, but labour market developments as the government winds down its furlough scheme will shape the pace of growth thereafter. We have lowered our annual forecast and now expect GDP to fall by 10.7% in 2020, before rebounding by 7.0% in 2021. This compares to a consensus outlook of -8.8% and 6.0%.

The Office for Budget Responsibility recently revised its outlook to consider a range of scenarios. GDP is now expected to fall by 10.6%-14.3% in 2020 – our own view is in line with its upside scenario. It now forecasts net borrowing of £350bn. The Debt Management Office extended its cash financing requirement to £385bn for the April-November period, a mild deceleration in the average pace of weekly borrowing to <£9bn (Sep-Nov) from £13.8bn (Apr-Jul).

Amid the coronavirus shock, the UK continues to negotiate a post-Brexit trade deal with the EU. Despite some positive sounds, progress has not been apparent. Sterling continues to underperform as the prospect of a no-deal rises. However, we continue to expect last-minute concessions in October to result in a staggered-introduction bare-bones deal. If not, 2021 growth could be weaker still.

Global Macro Monthly – Japan

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A tough recovery

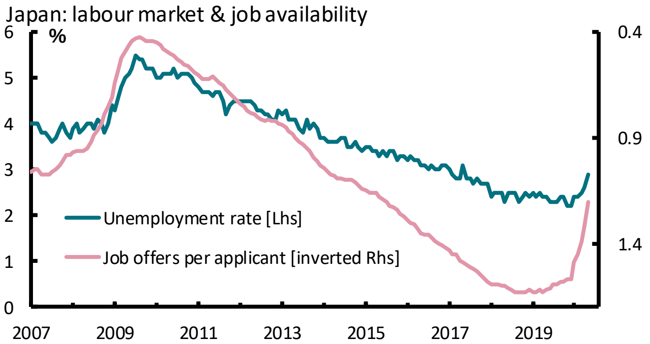
On the pandemic front, the number of new coronavirus cases remains low, but the government is paying attention to any resurgence of the pandemic, particularly in Tokyo.

Japan's recovery has been gradual and quite heterogeneous. We have observed some improvements in the services sector, as illustrated by the PMI index which rose to 45 from 26.5 – although still signalling contraction. The manufacturing sector is struggling with large surplus inventories unrequired for domestic or external demand. The Reuters Tankan survey showed Japanese manufacturers' mood remained close to the most pessimistic level in 11 years.

Lending conditions remain very accommodative, as highlighted by the recent acceleration in bank lending (+6.5%yoy). Yet the investment outlook does not sound very optimistic, as many firms seem to be reassessing the importance of maintaining a high stock of cash equal to or higher than capex when borrowing money from financial institutions. This drop in velocity of circulation is why we do not expect faster money growth to drive inflation higher.

Despite the end of the state of emergency and cash handouts, private consumption has not yet rebounded. We expect some improvements in June, but the Google Mobility Report shows the retail and recreation index is stabilising well below the "baseline". We see three headwinds to household incomes after the summer: an increase in furloughed workers; a drop in overtime pay and decline in bonuses; and a fall in employment. Although the pace of job losses in Japan has been much less than in the US (Exhibit 4), there has been a sharp increase in the number of furloughed workers.

Exhibit 4: job offers per applicant is suggesting a large increase in the unemployment rate



Source: Ministry of Internal Affairs & Communication, The Japan Institute for Labour Policy and Training and AXA IM Macro Research, as of July 2020

Global Macro Monthly – China

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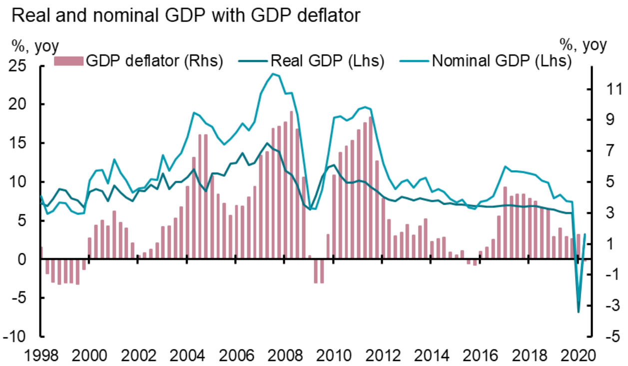
V-shaped recovery confirmed

After its unprecedented decline, the Chinese economy bounced off the bottom with vigour. GDP growth turned positive in the second quarter (Exhibit 5), rising by 11.5% on the quarter following the previous quarter's 10.0% drop – 3.2% year-on-year (yoy) from -6.8% in Q1–, leading most countries in the world. With the economy resuming growth faster than expected and drivers of growth becoming more broad-based, we have become more comfortable with our above-consensus growth forecast of 2.3% for 2020. This will require quarter-on-quarter growth to reach 3.2% in Q3 and 2.3% in Q4, leading yoy growth to 5-6%. We also see risks to our forecasts as more balanced than before and expect the consensus – currently at 1.8% – to be revised higher as a result of the positive GDP surprise.

Exhibit 5: Growth sees a v-shaped rebound



Source: CEIC and AXA IM Research, 16 July 2020

Looking at the high frequency data, a differentiating growth pattern has continued across different industries. The industrial sector maintained its lead, with output growth accelerating to 4.8% in June. While the speed of the recovery has slowed since the initial rebound, only steady improvement from here is needed to realise our growth forecasts for the second half of the year.

Within the industrial sector, manufacturing production started to come back to life, consistent with the steady improvement in the Purchasing Managers' Indices and surprising resilience in exports. However, continued normalisation in this sector is by no means guaranteed, with many small-and-medium-sized enterprises (SMEs) still struggling for survival. More targeted policy easing is therefore needed to foster further growth, alleviate stress and protect jobs.

Part of the impetus fuelling further recovery is expected to come from abroad. Export growth has so far proven resilient thanks to shipments of pandemic-related equipment. Given the virus has continued to wreak havoc in many parts of the world, exports of medical goods will likely stay strong for the foreseeable future. In addition, demand for normal "made-in-China" products should recover as developed economies exit lockdowns and their consumer demand resumes. In fact, declines in exports of non-medical goods have already started to narrow, to -2.9% in June from -8.5% in May and double-digit contraction at the start of the year. We think a further normalisation in external demand will form a tailwind for the economy in the second half of the year.

Domestically, policy support has continued to manifest in accelerated growth in fixed asset investment. Infrastructure investment has led the gain (up 7.2%) supported by abundant financing from local governments, who have completed around two-thirds of their bond selling quota by end-June. Part of the Special Treasury Bond was also used for this purpose to ensure that the infrastructure push has legs over the remainder of the year.

Finally, the laggard of the recovery remains the household sector. Retail sales growth was still mired in contraction (-1.8%), with activity in restaurants and catering showing little improvement and auto sales reverting back to declines. Some of this weakness could be temporary, given the new virus outbreak in Beijing – which is now under control – and severe floods in Southern China. In addition, the surveyed unemployment rate ticked down to 5.7% from 5.9%, suggesting an improved labour market that will be important for a faster consumption recovery in the second half.

More targeted easing to continue the recovery

Overall, the momentum appears to be building in the Chinese economy for a further growth recovery. Not only could the global recovery support an export revival, existing policy easing should also nudge the domestic economy back to its trend growth.

While we expect further policy easing to come, Beijing has shown preference lately to deliver support in a targeted and measured manner. This is all the more appropriate given the recent rally in equity and property markets that has led some to worry about financial excesses. With economic risks more concentrated in SME sectors, some services industries, and parts of the country that are hit hard by the ongoing floods, a targeted approach seems more appropriate to channel resources to where they are most needed. We still expect another 50-100 basis points of targeted reserve requirement ratio cuts – to be delivered mostly likely in Q4 – along with modest rate reductions and flexible easing from fiscal authorities.

Global Macro Monthly – EM

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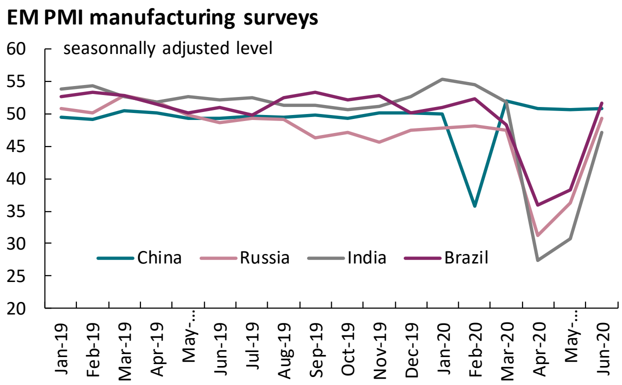
Recovery from the lows of April confirmed

After a slump in April, May's real activity indicators reflect the easing of lockdowns across emerging markets. Retail sales jumped by +13% month-on-month in Colombia (after -16% in April), +23% in Brazil (after -32%), +8.3% in Taiwan (after -4%), but only by +1% in Indonesia (after -13%, where reopening occurred in June). On the industrial production side, output was up by +7.3% month-on-month in Turkey (after -31.4% in April), +12% in Poland (after -20%), +13.8% in the Czech Republic (after -23%), +7% in Brazil (-18.8%), +5.9% in Colombia (after -22.8%), but was still down by -1.8% in Mexico (after -25%, as the country was still locked down).

Forward-looking indicators such as the Purchasing Managers' Index (PMI) surveys for June have continued to improve (Exhibit 7). The sharpest rebounds were recorded in Colombia, India, Brazil and Russia. Again, Mexico was an outlier with the most limited progression (+0.3) on the month and the lowest level, at 38.6, of June's surveys. Most indices remained below the 50 threshold with exceptions being Colombia, Turkey, Brazil, Malaysia, Vietnam and China. This suggests a significant breakdown in these indices' relationship with growth and raises questions about their use over the coming months, having failed to signal the sharp rebounds in May. Emerging markets seem to be following a similar pattern to their developed economy counterparts. Actual activity appears to have hit the bottom in April and reached its inflection point in May – but it will take more than a year to see recovery to pre-pandemic levels of real GDP.

Exhibit 6: Industrial activity resumes as lockdowns ease

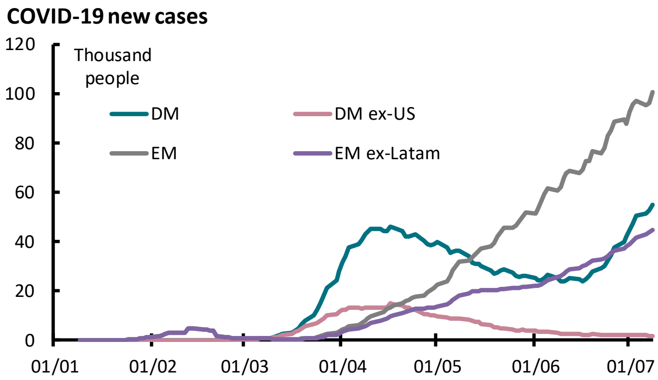


Source: Refinitv Datastream and AXA IM Research, 16 July 2020

COVID-19 hurdle remains…

The COVID-19 outbreak remains virulent in a number of developing countries. In South America, the number of infections is still rising – albeit at a declining, but still high, growth rate. More than 3.5 million cases and 150,000 deaths have been reported in Latin America, more than the US and Canada, and second only to Europe. Mexico and Argentina are seeing new cases accelerate, while Brazil, Peru and Chile have passed the peak but numbers are still elevated. Outside Latin America, the number of new infections is still rising in Asia and the Middle East and North Africa. India is setting new records daily, despite one of the earliest and strictest lockdowns globally. Within emerging markets, Central and Eastern Europe appears to be the only region seeing negative average daily growth rates since the beginning of June (Exhibit 7).

Exhibit 7: New COVID-19 cases worldwide



Source: Refinitv Datastream and AXA IM Research, 16 June 2020

Despite these trends, most emerging countries are lifting their confinement restrictions by varying degrees. Supply data thus improves mechanically worldwide, but the continuation of the recovery will depend on policy support to limit mass unemployment and corporate defaults, while avoiding renewed lockdowns, both in developed and developing countries.

… and policy support remains vital

Central banks continue to strive to ease financial conditions. So far this month, Indonesia, Sri Lanka and Malaysia cut policy rates further; Russia will likely cut rates again later in the month. Unconventional monetary policies are increasingly used across emerging markets. This may raise concerns as COVID-19-related spending packages drive problematic fiscal trajectories that require credible exit strategies, with substantial adjustments and reforms by policymakers in the following years. Yet, in countries with credible institutions, flexible currency regimes and well-anchored inflation expectations, quantitative easing measures may be the best tool to ease financial conditions.

Investment Strategy – Cross-assets

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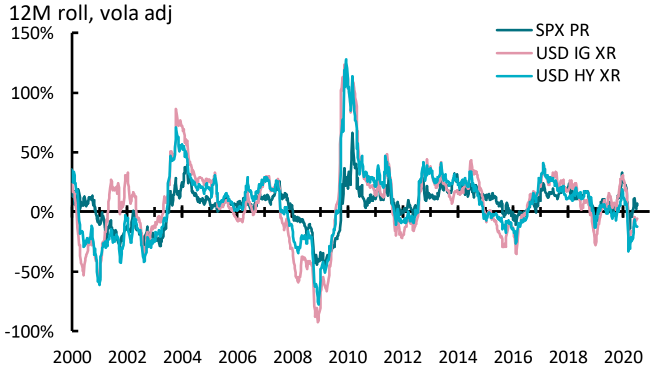
Fragile recovery may yet unsettle markets

The outlook for market returns in Q3 has become less clear than it was at the start of Q2. The factors underpinning risky assets were much stronger three months ago than today, both from a policy support and a valuation perspective. Investors who were taking the initial rebound in activity as a source of support for risk premia (Exhibit 8) have now shifted their focus to how the economic outlook will evolve. Companies will soon have to make decisions about whether to retain jobs or let workers go as job support schemes are wound down. Retail, travel and hospitality look as though they will remain very challenged for a long time. Companies facing uncertain demand are not likely to embark on capital spending either, adding to activity headwinds.

There is a continued need for policy to support the real economy, but the immediate post-crisis deluge of measures will inevitably fade. Central banks can provide a backstop for markets, but preserving employment and income is much tougher if economic activity continues to be constrained by the global pandemic. There has been a bounce and there is pent-up demand, but consumer spending is likely to remain sub-trend if people remain cautious about the health risks involved with getting out and about. The hope is that improved epidemic logistics can control local outbreaks without the need for fresh lockdowns and that medical progress can lessen Covid symptoms so that we can learn to live with the virus. However, there is a risk that the divergence between a gloomy outlook and very strong asset returns is reconciled by a pull-back in assets rather than a surge in economic optimism.

Exhibit 8: Volatility adjusted return has rebounded the strongest in equity, then IG credit, then HY credit



Source: ICE, Bloomberg and AXA IM Research

Investment Strategy – FX

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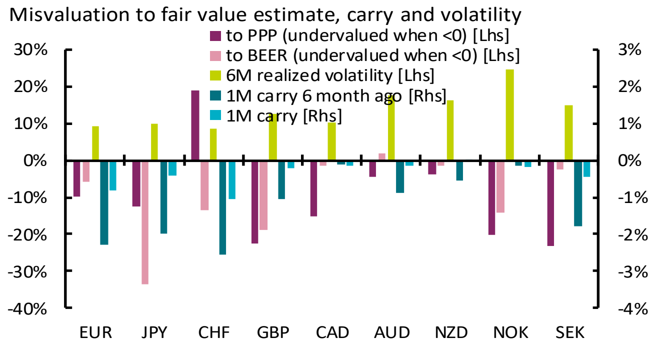
USD: Risk on and down

Risk sentiment continues to be supported by ample central bank liquidity and by the cautious reopening of developed economies. Such constructive risk sentiment on the one hand, and a worrying trend in new Covid cases in the US on the other, are likely to continue to weigh on the US dollar (USD). In the event that the US situation turns into a full-blown crisis, with a re-imposition of total lockdown, then this would weigh on global risk and drive a flight to safety, which could well boost the USD.

Exhibit 9: EUR and JPY: still cheap, with much better carry and lower volatility



Source: Bloomberg and AXA IM Research

Given the massive intervention by the Fed on policy rates and excess reserves, the carry in the euro (EUR) and yen (JPY) is no longer prohibitive (Exhibit 9). This should allow both to appreciate towards their fair value, also lifted by positive structural current account flows and more subdued foreign capital investment outflows given the uncertain low yield environment. Even if market sentiment was to turn negative again, these currencies also tend to be less volatile, which should offer some protection. Progress on the EU Recovery Fund and the near resolution of the German court demand regarding the proportionality of ECB purchases under the PSPP sovereign bond buying scheme also reduces EU unity risk in the short term. The reopening of EU economies offers additional support to the EUR.

The Canadian dollar (CAD) has been less volatile and appears a bit undervalued, while offering further upside to a continuation of the risk-on tone through its correlation with oil prices. Recent rebounds in Canadian employment and the housing market are encouraging, while Covid-case dynamics are less disturbing than in the US. Lastly, sterling (GBP) remains less attractive. Markets seem to still be under-pricing the risk around UK-EU negotiations, which must now be concluded before year end. Moreover, UK growth is set to disappoint further after a longer lockdown period.

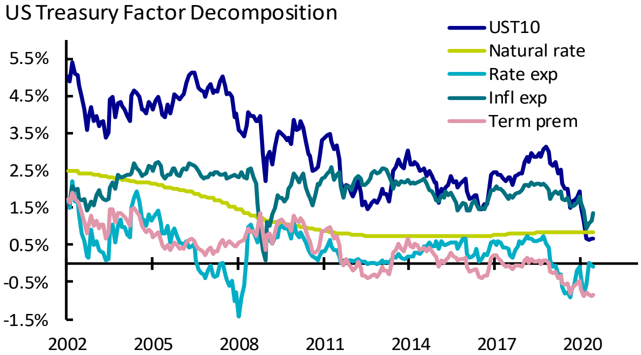
Investment Strategy – Rates

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

UST: Thoughts for the second half of 2020

Treasuries traded in a rather narrow range during the second quarter (Q2). If we exclude the brief spike in yields at the start of June, we can say that they have been confined to a 0.6%-0.7% range most of the time. This lack of realised volatility is interesting not only when compared to the equity market's strong performance, but also given the dynamics of the common factors that are usually associated with nominal yields.

Exhibit 10: Special factors at work?

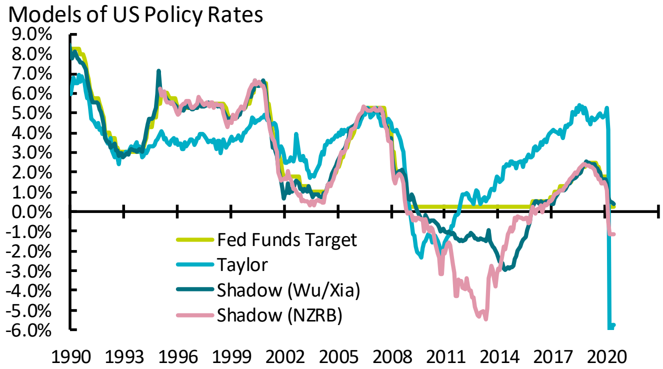


Source: Bloomberg and AXA IM Research, July 2020

Typically, we think of nominal bond yields as a function of r-star, interest rate and inflation expectations (Exhibit 10). Over the past three to four months, inflation expectations have risen – with the 10-year breakeven (BE) up about 40 basis points (bps) compared to March – while a gradual normalisation of rate expectations, have mainly followed the fading negative interest rates narrative. While a liquidity premium could have led to such stability, this would likely have been obvious in all liquidity-driven spreads – which we haven't seen, so far at least. In fact, instead of declining, swap spreads have been stable over the past few months. Furthermore, there is no signal of a US dollar liquidity shortage in cross-currency markets, which might have been associated with a significant pick-up in the US Treasuries' liquidity premium, with many international central banks letting their FX swap drawdowns with the Fed expire recently.

The most obvious culprit is unconventional monetary policy, i.e. the $2.6bn of Fed asset purchases since March, traditionally thought to reduce term premia. This balance sheet expansion is not surprising given the COVID-19-related impact on the business cycle and the limits on conventional monetary policy. The need for policy accommodation via the Fed's balance sheet is even more evident, if we analyse different Fed Funds models and its implied interest rates (Exhibit 11). Needless to say, different models deliver different results, but it's fair to observe that an economic crisis of such proportions – not even mentioning income and wealth inequality and other social aspects – would have required deeper interest rate cuts than 'just' 150bps.

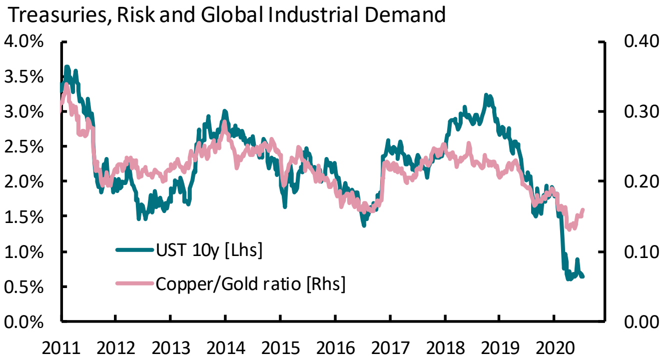
Exhibit 11: Policy accommodation through balance sheet



Source: Bloomberg and AXA IM Research, July 2020

Looking ahead, the current setup asks how long this apparent stability can be sustained. Should the current 'reflation' scenario play out well into the rest of this year, then some upward pressure on Treasury yields may begin to materialise. There is already an evident disconnect between the industrial demand for commodities and Treasury yields (Exhibit 12) – although we note that some of this reflects supply disruption, not demand strength, from commodities – and we expect this gap may be closed from the fixed income side, in the case of a faster than expected economic rebound.

Exhibit 12: Notes anchored despite tentative reflation



Source: Bloomberg and AXA IM Research, July 2020

This is where the Fed yield curve control debate is relevant. The Fed does want to control yields, albeit at this stage through verbal guidance rather than explicit caps. This may change if market expectations deviate too far from the Fed's outlook. However, this is a debate about short-term, not 10-year yields. If the focus on short yields is successful, the expected reflation should start to be reflected in a steeper curve. Yet the market picture is also somewhat blurred by gold prices. At this stage the price of the precious metal reflects not only general market risk parameters and the huge universe of negative yielding fixed income assets but also – and more importantly – a popular narrative about universal currencies in a world of accelerating debt issuance in part financed by central banks.

Investment Strategy – Credit

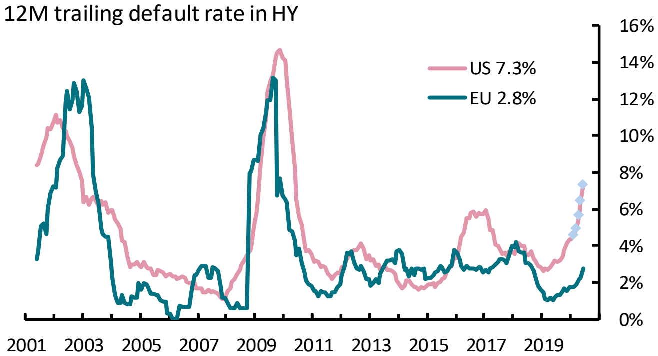
Gregory Venizelos
Credit Strategist
Research – Core Investments

Bankruptcy risk – intricate by default

The severity of the COVID-19 shock to the economy has been so immense that, despite the huge amount of monetary and fiscal policy support, the risk of bankruptcy still looms large across all sizes of businesses and enterprises. This is a major concern for investors in high yield (HY) credit. Given the scale of the shock, investors are even concerned about the risk of investment grade (IG) credits 'jumping to default'.

Exhibit 13: Default rates in HY have risen notably in the four months post-COVID, especially in the US

12M trailing default rate in HY

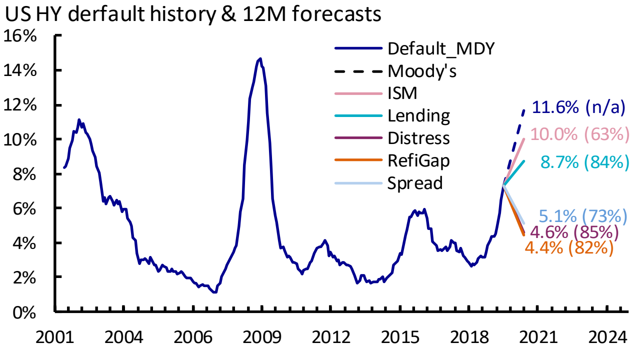


Source: Moody's and AXA IM Research, June 2020

Realised default rates in HY have picked up notably since the coronavirus crisis took hold in late February - particularly in the US where the default rate has risen by one percentage point every month since then (Exhibit 13). The obvious question here is: Where next? What levels of default rates should we expect over the next 12 months? Using various predictors, both in a single-factor and a multi-factor model set up, and three sources of default histories (Moody's, S&P and ICE indices) we make some key observations:

Exhibit 14: Market-based and economic-based predictors diverge on default expectations (R^2)

US HY derfault history & 12M forecasts

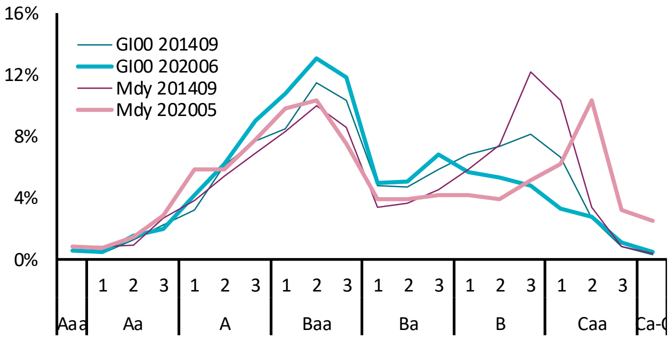


Source: Bloomberg, Moody's, InterContinental Exchange (ICE), ECB, Fed and AXA IM Research, June 2020

– There is currently a substantial divergence between default expectations based on market-based variables (spread, distress ratio, funding gap) and those based on economic variables (Purchasing Managers' Index, unemployment rate, lending surveys, Exhibit 14).
– The Moody's cohort has a rating distribution that is particularly 'heavy' on lower-rated HY credits and is therefore not necessarily representative of broad credit benchmarks like the ICE indices (Exhibit 15). Investors need to be aware of this when considering Moody's default rate forecasts in respect to their portfolios.
– Our default rate model, which combines lending standards and distress ratio as inputs, produces more benign default expectations than either the Moody's or the S&P model (Exhibit 16, first three rows).
– The strong retracement in credit risk premia has left US HY overvalued versus default expectations. European HY is cheap on the back of less bearish default expectations (Exhibit 16, rows three and four).
– Realised default rates over the past 12 months (Exhibit 16, last row) suggest that for credit quality, the ICE cohort is higher than S&P's, and S&P's is higher than Moody's.

Exhibit 15: Moody's cohort is 'heavy' in lower rated HY

Rating distribution by ticker count



Source: Moody's, ICE and AXA IM Research, June 2020

As a last word, IG companies rarely suffer defaults without dropping to HY first. Often, this is due to fraud (e.g. Enron in 2001, Parmalat in 2003) or extraordinary circumstances (Pacific Gas & Electric in 2018). Even in severe downturns, the IG default rate has barely exceeded 0.2%. The global financial crisis saw IG defaults at just over 0.2% due to some IG-rated banks that went bankrupt.

Exhibit 16: Default rate forecast comparison

Default rate forecast, 12M forward

	Cohort source: US			Cohort source: Europe		
Model source	Moody's	S&P	ICE	Moody's	S&P	ICE
Moody's	10.5	_	_	6.2	_	_
S&P	_	12.5	_	_	8.5	_
AXA IM	6.6	6.1	5.9	3.5	2.0	1.2
Sprd Imp	_	_	4.6	_	_	3.7

Default rate realised, 12M trailing

	Moody's Jun	S&P May	ICE Jun	Moody's Jun	S&P May	ICE Jun
	7.3	4.7	3.3	2.8	2.8	1.3

Source: Moody's, S&P, ICE and AXA IM Research, June 2020

Investment Strategy – Equity

Varun Ghotgalkar,
Equity Strategist,
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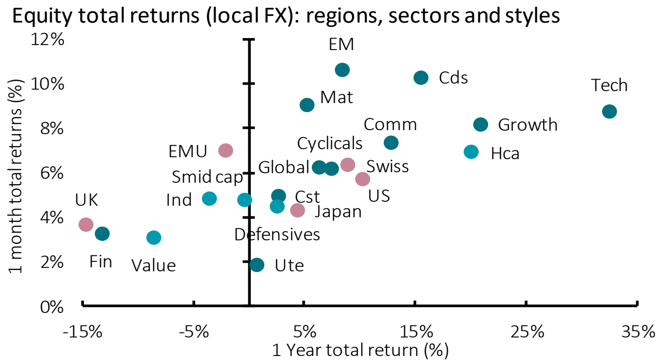
Low hurdle for second quarter earnings

Global equites continued to rebound over the month, rising 6.3%. Emerging markets strongly outperformed – bouncing by 10% – as a result of upbeat data and a remarkable improvement in the global liquidity backdrop. The VIX fear gauge continues to edge lower, currently trading close to 27 points. In terms of sector performance, consumer discretionary, up some 10%, as well as materials and technology, with each ahead approximately 9%, led the pack while financials, at just 3% and utilities, with circa 2%, lagged (Exhibit 17).

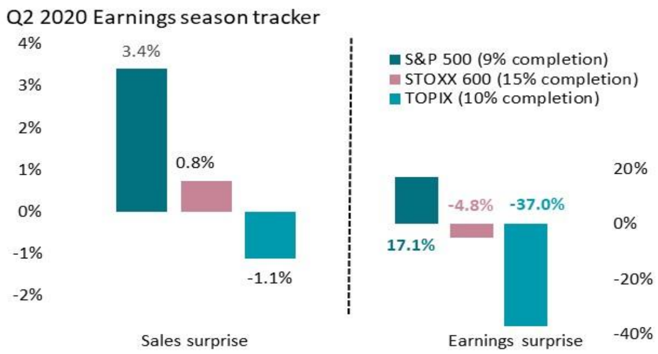
Exhibit 17: EM back in flavour over the past month



Source: Datastream and AXA IM Research, July 2020

Although early to jump to the gun, the second quarter reporting season has kicked off on the right foot in the US but is more mixed elsewhere. Results from the large US banks reflected strong trading and investment banking activity with a pickup in deposits and loans. The sector bumped up provisions for loan losses to the tune of $30bn. The S&P 500 completion rate stands at around 10% with aggregate earnings surprises running at 17% while the euro area and Japan are missing expectations so far (Exhibit 18).

Exhibit 18: US earnings season kicks off on the right foot

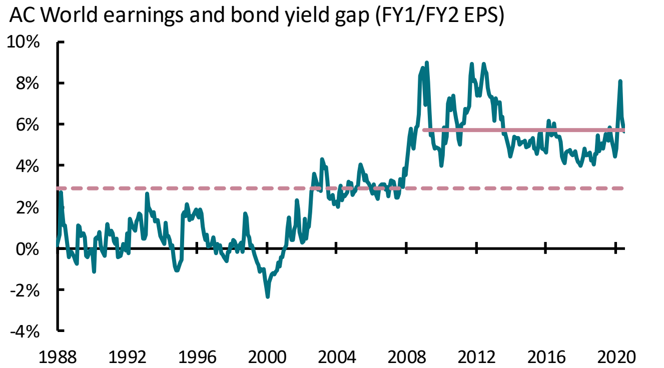


Source: Bloomberg and AXA IM Research, July 2020

The hurdle for "the COVID quarter" is low with consensus expecting a 45% year-on-year decline for S&P 500 earnings per share and a 59% fall for the EuroStoxx 600 index, the lowest projections since the global financial crisis.

Consensus estimates signal that global earnings are expected to decline by around 20% in 2020 and then rebound by 29% in 2021, implying that earnings-per-share for the global benchmark is expected to regain its 2019 high water mark next year. Market optimism from late March can largely be attributed to investors looking through the provisional shock and anticipating a swift recovery in activity with second-order effects of the crisis combated by fiscal and monetary policy measures put in place. Price-to-earnings multiples based on 2021-2022 EPS (given the poor earnings visibility for 2020) are now a little under 16 times, With the repricing in interest rates, relative to bonds the earnings yield gap is still arguably wide at 5.7% compared to the long-term average of 2.9% and in line with the post 2009 average which has been around 5.7% (Exhibit 19).

Exhibit 19: Looking across the valley

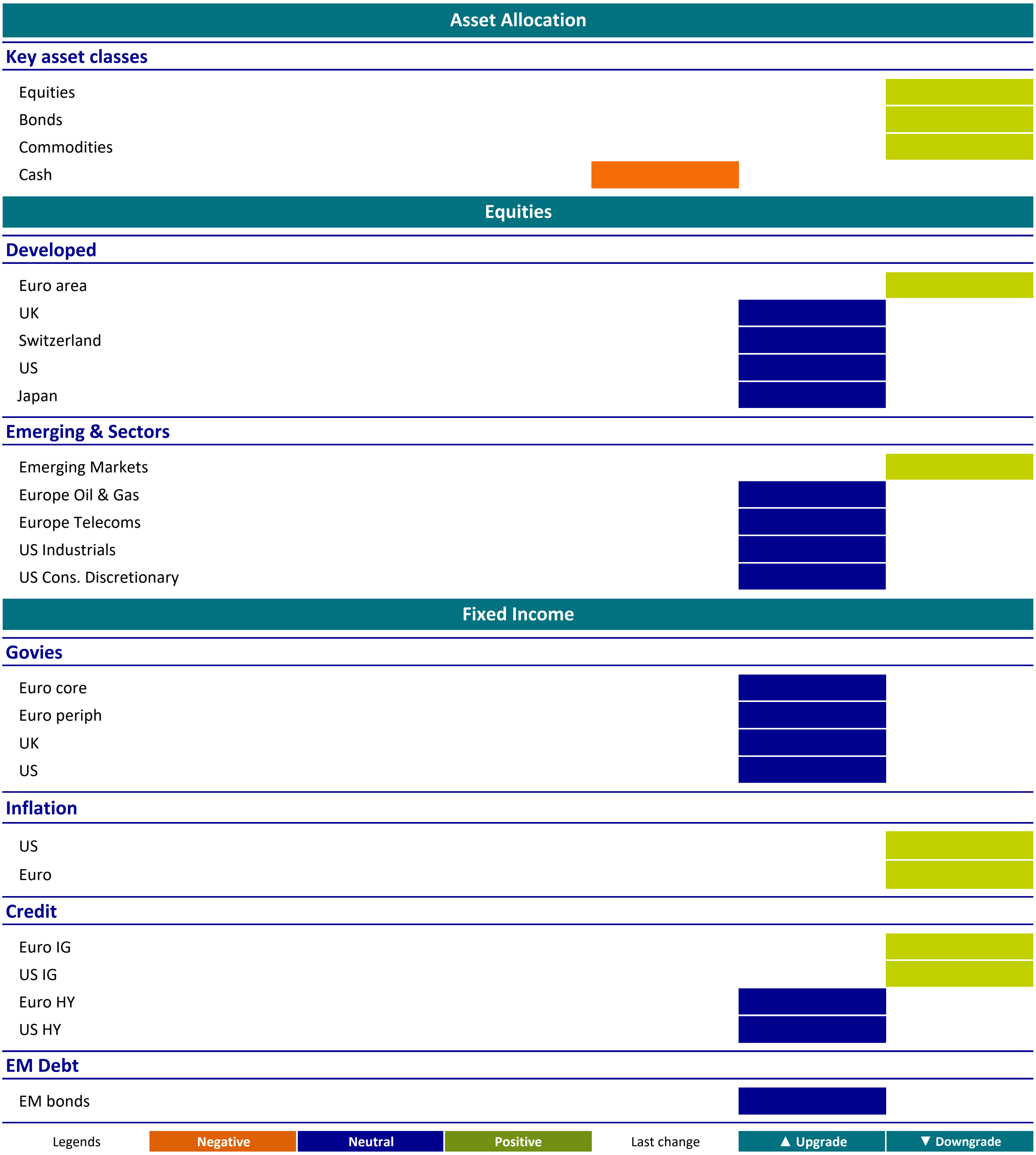


Source: Datastream, IBES and AXA IM Research, July 2020

Overall, the way the economic growth shock plays out against the policy stimulus backdrop going forward remains key. Equity market volatility is likely to remain elevated in the short term given the uncertainty surrounding the virus, lack of earnings visibility and the political landscape. Markets face multiple optionalities on these fronts given the timing of a healthcare breakthrough versus the spread of the virus and the outcome of the upcoming US Presidential Election.

Fundamentally, we continue to believe that subdued positioning, aggressive policy measures and an ultra-low hurdle rate in other assets should support equities. The market is continuing to try to and price the uncertain growth trajectory, stimulus impact and recovery prospects of the second half of the year. Given the high degree of uncertainty, selectivity remains key. We remain medium-term constructive given the easing of lockdowns, the strong monetary stimulus packages and fiscal impulse put in place.

Recommended asset allocation



Source: AXA IM Macro Research – As of 22 July 2020

Macro forecast summary

Real GDP growth (%)	2019*	2020*		2021*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
World	**2.9**	**-4.1**		**5.7**	
Advanced economies	**1.7**	**-6.2**		**5.6**	
US	**2.3**	**-4.5**	-5.6	**5.0**	4.4
Euro area	**1.3**	**-7.1**	-7.9	**5.9**	6.2
Germany	**0.6**	**-5.2**	-6.3	**4.4**	5.2
France	**1.3**	**-8.5**	-8.2	**8.1**	6.7
Italy	**0.3**	**-9.3**	-10.7	**5.4**	6.5
Spain	**2.0**	**-9.1**	-9.1	**7.7**	6.7
Japan	**0.7**	**-5.8**	-5.3	**3.3**	2.6
UK	**1.4**	**-10.7**	-9.0	**7.0**	6.1
Switzerland	**0.9**	**-4.9**	-6.0	**3.5**	4.7
Emerging economies	**3.6**	**-3.0**		**5.8**	
Asia	**5.2**	**0.5**		**7.2**	
China	**6.1**	**2.3**	1.4	**8.0**	8.1
South Korea	**2.0**	**-2.8**	-0.7	**4.5**	3.3
Rest of EM Asia	**4.4**	**-1.3**		**6.5**	
LatAm	**0.1**	**-6.5**		**6.5**	
Brazil	**1.1**	**-7.4**	-6.5	**8.3**	3.3
Mexico	**-0.1**	**-6.8**	-8.3	**7.0**	3.1
EM Europe	**2.1**	**-6.6**		**5.7**	
Russia	**1.3**	**-6.1**	-3.8	**3.7**	3.0
Poland	**4.1**	**-5.0**	-3.1	**5.4**	4.3
Turkey	**0.9**	**-5.6**	-2.2	**6.5**	4.5
Other EMs	**1.5**	**-4.2**		**3.3**	

Source: Datastream, IMF and AXA IM Macro Research – As of 22 July 2020

CPI Inflation (%)	2019*	2020*		2021*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	**1.5**	**0.6**		**1.1**	
US	**1.8**	**0.8**	0.8	**1.6**	1.8
Euro area	**1.2**	**0.4**	0.3	**0.7**	1.1
Japan	**0.5**	**0.1**	-0.3	**-0.1**	0.0
UK	**1.8**	**0.7**	0.9	**1.5**	1.3
Switzerland	**0.4**	**-0.3**	-0.7	**0.3**	0.3
Other DMs	**1.8**	**1.4**		**1.9**	

Source: Datastream, IMF and AXA IM Macro Research – As of 22 July 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	Q3 - 20	Q4 - 20	Q1 -21	Q2-21
United States - Fed	Dates	0-0.25	28-29 Jul 15-16 Sep	4-5 Nov 15-16 Dec	26-27 Jan 16-17 Mar	27-28 Apr 15-16 Jun
	Rates		unch (0-0.25)	unch (0-0.25)	unch (0-0.25)	unch (0-0.25)
Euro area - ECB	Dates	-0.50	10 Sep	29 Oct 10 Dec	21 Jan 11 Mar	22 Apr 10 Jun
	Rates		unch (-0.50)	unch (-0.50)	unch (-0.50)	unch (-0.50)
Japan - BoJ	Dates	-0.10	16-17 Sep	28-29 Oct 17-18 Dec	20-21 Jan 18-19 Mar	26-27 Apr 17-18 Jun
	Rates		unch (-0.10)	unch (-0.10)	unch (-0.10)	unch (-0.10)
UK - BoE	Dates	0.10	6 Aug 17 Sep	5 Nov 17 Dec	4 Feb 18 Mar	6 May 24 June
	Rates		unch (0.10)	unch (0.10)	unch (0.10)	unch (0.10)

Source: AXA IM Macro Research - As of 22 July 2020

These projections are not necessarily reliable indicators of future results

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