For professional clients only
21 October 2020
Research & Strategy Insights

Into the bleak, debt winter

Global Macro Monthly

Key points

- The pandemic is resurgent across many countries, with Europe re-emerging as a hotspot and cases rising again in the US. Social restrictions are rising across Europe again.
- Q3 looks likely to post a strong rebound across most economies. However, even before the close of Q3, momentum appeared to be fading.
- Fiscal authorities have in the main expanded policy to accommodate the return of the virus. However, UK policy is reduced and stalled stimulus discussions in the US have caused a hiatus here.
- Risks point to a softer Q4. The outlook for 2021 is falling globally and risks are skewed to further weakness.
- Equity markets face a clouded near-term outlook and positive earnings momentum has stalled. Credit sees some protection from central banks covering around one-third of IG credit.

Global Macro Monthly

Investment Strategy

Global Macro Monthly – US

David Page,
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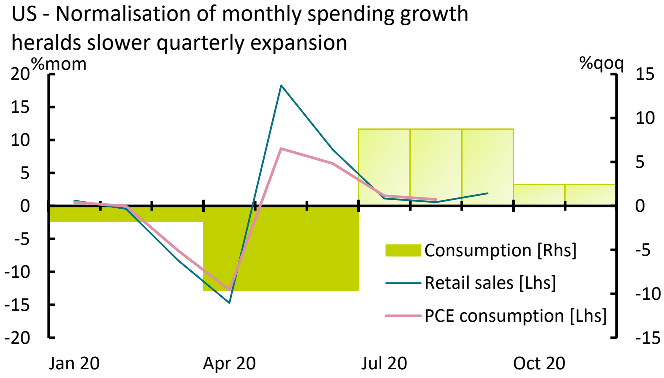
Growth slows as election looms

We expect Q3 GDP growth, released on 29 October, to record the fastest quarterly growth on record. But the scale of that expansion is in doubt. Just before the release, 'now-trackers' can be useful guides. The Atlanta Federal Reserve (Fed) now-tracker suggests annualised growth of 35.2%, while the NY Fed suggests 14.1% – quite a range. Consensus forecasts are currently around the low 30% mark, consistent with Atlanta. Strong retail sales growth in September (Exhibit 1), points to a robust 8.7% rise in consumption. But import growth has been strong and we doubt the scale of any inventory rebound. We forecast Q3 growth at 23% annualised.

Growth will however slow. This is obvious whatever the detail of Q3's record expansion, but our outlook for Q4 GDP is falling. The virus is re-emerging, after having retreated since the summer, with the Mid-West the new hotspot. Failure of the government to provide further support, with stimulus talks stalled for months, has seen unemployment benefits fall. Household saving in aggregate remains elevated and spending should not reverse in Q4. But income has been declining since April and while the saving rate reached 34% in April, it fell back to 14% in August – a pace of decline which must soon slow.

Exhibit 1: Consumption growth spells slower Q4

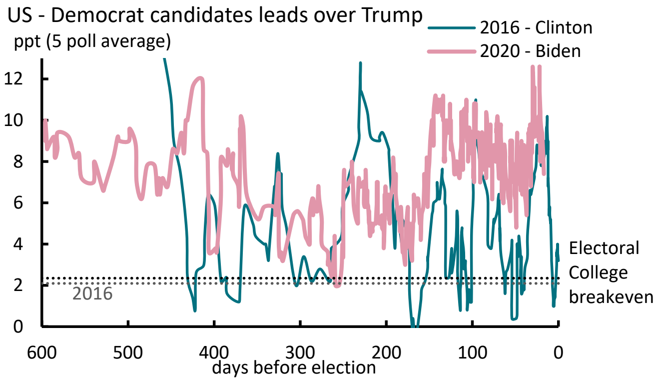


Source: Bureau of Economic Analysis (BEA), Commerce Dept AXA IM Research, Oct 2020 (Lighter area denotes AXA IM forecast)

Our GDP forecast for this year, at -4.2%, is firmer than our previous prediction of -4.7%, although we note that with a firmer outlook for Q3, consensus is now more optimistic than us for the first time since March.

The Presidential Election is now less than two weeks away. The latest polls (Exhibit 2) show Democrat contender Joe Biden extending his consistent lead over President Donald Trump. It is true that four years ago, a last-minute surge for Trump resulted in his election victory. Yet this followed volatile polling that has not been repeated this year. Biden has held a consistent lead, and barring a sharp change, looks set to win.

Exhibit 2: Biden extends lead in the final run in



Source: 538 and AXA IM Macro Research, Sept 2020

The Congressional vote is more uncertain. Biden's recent, modest gains make a Democrat House majority even more secure. The Senate vote is much closer. Our analysis suggests Democrats should squeak a 51-49 majority – slim but sufficient to deliver legislative change. However, this puts much faith on the accuracy of each poll. A small variation would leave a Republican majority and the prospect of a gridlocked Congress. To us, this is the real uncertainty of this election.

Biden's extended lead has also quelled market fears of a contested election result. The prospects for a convincing Biden win do look firmer for now, raising hopes of a swift election result, although mail-in votes may still delay the result into the weekend. However, this outlook is still uncertain and a protracted legal battle which delays the result could still derail financial markets before year-end.

US inflation continued to trend higher in September. CPI inflation reached 1.4% on the year and core 1.7%. COVID-19 supply disruption drove some of this, with used car price increases adding 0.2ppt in the latest month. Inflation has been firmer than we anticipated. We had forecast CPI inflation at 0.5% for 2020 altogether in Q2, and indeed the annual rate did fall to 0.1% in May. However, a quicker rebound in demand, some supply restraint and a sharper drop in the dollar have left inflation firmer. We now forecast inflation at 1.4% for this year. But with supply-constraints likely softening and demand growth slowing, we expect it to remain around this level into 2021.

The Fed has provided explicit forward guidance stating that policy rates would not be raised before labour market conditions were consistent with full employment and inflation was at target – with a moderate overshoot expected. This is not likely for several years. However, the Fed has provided little guidance over balance sheet policy, which looks more likely to change over the course of 2021.

Global Macro Monthly – Eurozone

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It's getting worse

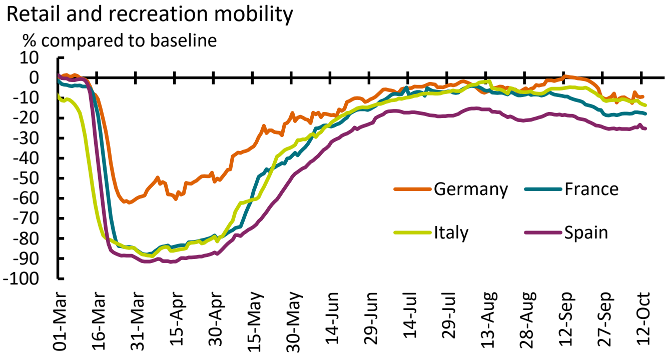
COVID-19's second wave is spreading across Europe, with France and Spain no longer the only hotspots. The number of daily cases has grown exponentially in The Netherlands, reaching 431 per million people (seven-day average), versus 325 for France and 231 in Spain. Weekly growth rates of new cases are also picking up significantly in Italy and Germany, and hospital ICU occupancy continues to rise everywhere – at 30% of April's average in France.

This has led governments to substantially increase COVID-19 related restrictions. Most measures, the aim of which is to limit social contact, remain localised in geographical and economic terms. They include a 9pm to 6am curfew in most of France's major cities, as well as the shutdown of restaurants and bars in Catalonia and the Netherlands. In Germany and Italy, there are restrictions on social gatherings and limited opening hours for bars and restaurants.

But consumers did not wait for these measures to arrive to change their habits. Mobility in the retail and recreation sectors has dropped by circa 10% since the end of August in most euro area countries (Exhibit 3). Like mobility data, soft indicators were affected by the virus's resurgence even before government actions came into force. Service PMIs started to wobble in August, dropping more in France and Spain (by more than 9 points since July), than in Germany and Italy (-5 and -2.8 points respectively). Manufacturing PMIs performed better, confirming the divergence in sentiment between the two sectors and countries. But hard data shows that even in the industrial sector, the recovery has stalled. During August, euro area industrial production stood 6% below its February level, dampened by weak demand. And consumer confidence is not encouraging – most of the catch-up effect seems behind, with major purchase intentions put on hold. Savings intentions are on the rise again, as consumers worry about unemployment. They are right: firms hiring intentions are slowing and the employment gap is wide. In Germany, employment dropped by 65k between February and May, while the cumulative employment gain since June is just 8k.

Overall a deteriorating virus situation, increasing restrictions and negative forward-looking components in most of survey data point to a weaker Q4 than we initially thought We are revising down Q4 and see euro area growth at 4%yoy in 2021 (vs. 5.2% before). The sharpest downward revision is for Spain, from 6.9% to 4.2%, not only due to pandemic developments but also because of its economy's structural features, namely a high reliance on tourism, dual labour markets and political fragmentation, making any policies difficult to be adopted.

Exhibit 3: Virus developments impacting mobility data



Source: Google Mobility reports and AXA IM Macro Research, 19 October 2020

Budget time

In line with the European semester, countries must submit their budget plans for 2021 by mid-October. This time, the exercise is intertwined with the submission of their Recovery and Resilience plans. Although they have until April 2021 to provide them, the European Commission has asked governments to outline a preliminary schedule of the size and timing of the resources they plan to draw over the 2021 to 2026 period.

Italy and Spain, the main beneficiaries of the Recovery and Resilience Fund (RRF) have been on our radar. The Italian government is planning a fiscal expansion of €33bn (approximately 2% of GDP) in 2021, with €14bn financed through the European Union (EU) programmes. Meanwhile Spain, to increase support for passing the budget, has maximised the budget ceiling by including €27bn from the EU (€25bn from the RRF). In practice though, the government expects actual disbursement of just €7bn, so either it will have to issue the remaining €20bn in 2021, or the fiscal stance will need to be adjusted lower. The truth will probably be somewhere in the middle, but this will have negative consequences on deficit and growth. Another caveat is that Italy and Spain have been the worst performers in absorbing EU structural funds. Only about 40% of their European Structural Investment Funds have been used over the 2014 to 2020 period, casting doubts on their ability to quickly absorb large amounts of EU funds.

On a side note, we believe that the ratification of the Next Generation EU package will only be delayed and not derailed. All players including the European Parliament and opponents of the Rule of Law, have a keen interest in passing the associated Budget – a compromise is the most likely option.

Finally, we expect the European Central Bank to convey the message that more action is coming at its December meeting (Pandemic Emergency Purchase Programme time and size extension), in the face of persistently low inflation and deflationary mood spreading across firms and households.

Global Macro Monthly – UK

David Page,
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Risk of it ending in tiers

The growth outlook that had looked so promising for Q3, is suddenly looking less good. We still forecast a record-breaking quarterly increase of more than 15%. But hopes for a strong August had seen us considering upside risks, even to the Bank of England's (BoE) 18.3% forecast – this does not now appear the case. August's GDP rose by just 2.1%, far below our expectations based on staycations and incentives to eat out, and lower than our inference from real-time data. It also appears far short of BoE estimates based on commercial inter-bank payments. While there is a chance of a September surprise, we have lowered our Q3 outlook.

Risks are also rising for Q4 and beyond. Recorded cases of COVID-19 are trending higher – currently around 20k, far more than in spring. Greater testing explains much of this, but the ratio of positive tests has reached its highest since mid-May. The government has introduced a tiered regional approach to restrictions. The lowest tier bans social gatherings of more than six and closes pubs and restaurants at 10pm. The highest sees no mixing of households and the closure of non-food pubs. Yet even the harshest restrictions fall far short of the lockdown seen in Q2. At that time, the UK reduced operating capacity to around two-thirds. For now, even if the measures were nationwide, it would be around 98%. However, it is not obvious that current measures go far enough to slow the virus, meaning worse could follow.

This is a risk for UK activity. Moreover, there is a real risk that consumers act more cautiously, increasing savings, and that business follows, potentially exacerbating job losses. The Q3 GDP disappointment and a more cautious outlook for Q4 removes upside bias to our outlook and we lower our UK growth forecast to -10.3% for 2020 from -10.0%. But there is a more material impact on the 2021 view, which we reduce to 5.5% from 7.5%. Consensus forecasts are -9.9% and 6.0%.

Prime Minister Boris Johnson stated that the UK would focus on a no-deal outcome as his 15 October negotiations deadline expired. But Brexit trade negotiations continue. This is positive and we continue to expect a last minute, bare-bones trade deal as we approach the actual deadline for doing a deal, getting it ratified and in place for 2021. The effect of a 'no deal' outcome now should be much less than last year when the alternative was a loss of the transition period. But it could still reduce 2021 growth by around 1ppt – still harmful as the economy recovers from the pandemic.

Global Macro Monthly – Japan

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Domestic activity continues to drive recovery, but challenges overseas threaten progress

The stabilisation of new COVID-19 cases and strong government support continue to underpin Japan's economic recovery. More jobseekers have returned to the labour force, technically pushing unemployment rate up to 3% from 2.9% while the job per applicant ratio has marginally declined but remains just above 1. In light of stronger demand both domestically and from overseas, Japan's production and exports are recovering on a monthly basis, even if they remain far below 2019's levels. In terms of business sentiment, the latest Tankan survey indicated modest improvement with economic activity having restarted over the summer. The October Economy Watchers poll rose sharply to 49.3, up from 43.9, a level not seen since the beginning of 2019. Overall, we forecast a strong rebound in the third quarter (Q3) – at 13.2%qoq annualised – and activity should persist into Q4 (+7.9%). Domestic activity should be robust, but the external outlook is mixed. China's continued recovery is proving to be a boost, but weaker recoveries in the US and Europe – where governments are struggling with further COVID-related restrictions – will drag on progress. On the price front, the government's campaign, 'Go to', which offers discounts on travel inside Japan is acting as a headwind as prices have been cut down drastically.

The political outlook remains uncertain, with no clarity whether PM Suga will call a snap election before the scheduled date in Q4 2021. On balance, the government wants to prioritise virus control, which makes an election appear unlikely in the near-term. The government is going to convene an extraordinary month-long session of the Diet on 26 October. This should show which policies the new Suga administration intends to prioritise. In addition, it should reveal whether another round of economic stimulus can be expected in the short-term, or whether it will wait until the ordinary session of the Diet is convened in 2021. Tax revenue has probably been overestimated this year and although the second supplementary budget included reserves (¥10tn), these may not prove enough.

The Bank of Japan (BoJ) holds its monetary policy meeting on 29 October. We do not expect any change, with the policy board members remaining of the view that they have done enough for now – albeit that "it is ready to act with more if necessary". The focus will be on how the BoJ's latest outlook report will be revised to reflect data since its July meeting. The growth outlook could be revised up but considering the inflation headwinds, it may be lowered.

Global Macro Monthly – China

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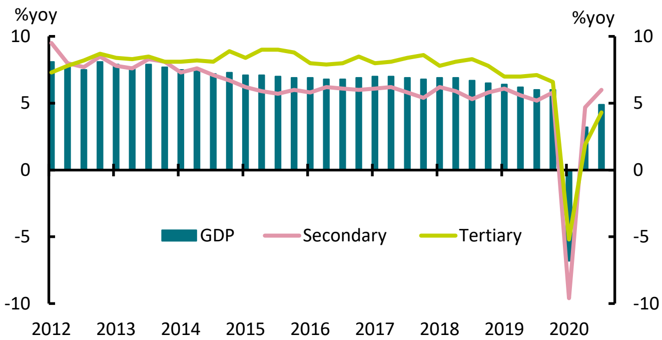
Growth momentum well preserved in Q3

It's currently full steam ahead for China's economy. Third quarter (Q3) GDP data shows that it has retained decent momentum following Q2's V-shaped rebound. While quarter-on-quarter growth slowed to a more normal level of 2.7%, year-on-year (yoy) expansion continued to accelerate to 4.9%, inching a step closer to our estimate of trend growth of between 5.5% and 6% (Exhibit 4). The secondary industry continued to lead the recovery, expanding 6%, thanks to strong industrial production and infrastructure investment bolstered by generous fiscal stimulus. However, it is the services sector rebound, up 4.3%, that explained most of Q3's strength. Notwithstanding this improvement, many parts of the tertiary industry, including tourism, catering and offline entertainment, are still operating at below potential. We expect these sectors to catch-up and help propel the economy toward trend growth in the final quarter.

Exhibit 4: Recovery gains strength and balance

China - GDP breakdown to secondary and tertiary



Source: CEIC and AXA IM Research, 19 October 2020

Zooming in on the high-frequency data reveals a broadening economic recovery. On the supply side, industrial production growth surged to 6.9%yoy, rising above its pre-COVID-19 level. Within it, manufacturing production growth accelerated to 7.6%, consistent with the buoyant PMI, reflecting strong output in auto, machinery, technology products and high-valued equipment. These should be supported further in the near-term by the rollout of new mobile devices from the likes of Apple and Huawei, and strong demand for passenger vehicles with September sales up 12.8%. We expect industrial output growth to stay above 6% in Q4 to meet strong demand from both domestic and global economies.

Evidence of improved external conditions was found in China's solid export performance. September saw export growth accelerate for the fifth consecutive month to 9.9%, beating analyst expectations. While the pandemic-related shipment remained strong, it was the normal "made-in-China" products, such as toys, furniture, machinery and auto, that explained most of the growth acceleration. Even though renewed virus outbreaks have held back purchases from Europe, the gap was filled by the US and emerging market economies. We expect China's export growth to remain solid between now and year-end.

The domestic economy now appears to be firing on more cylinders, adding to the optimism. Retail sales, after exiting a prolonged contraction in August, regained more lost ground on broad-based sales growth across major categories. This momentum seems to have extended to the Golden Week in early October, where consumer spending on travelling, accommodation, entertainment and restaurants all improved notably from previous holidays. With rising consumer confidence and a gradually recovering labour market, consumption growth is set to normalise further in the final quarter of the year.

The growth impetus on the investment side was also well preserved. Manufacturing investment growth rose again, after turning positive in August, supported by rising production, recovering demand and easy credit conditions. Increased government outlays from their recent bond sales – RMB2.3tn since August – helped to keep infrastructure investment growing at a solid pace. While this year's bond issuance quota is almost completed, there are enough unused fiscal resources that can keep the investment momentum going for the coming months. Finally, our estimate of real-estate investment growth moderated, consistent with easing house sales and housing starts growth. We expect rising caution among property developers to the recent tightening of leverage regulations to create some headwinds for the sector going into 2021.

Overall, today's data should provide comfort to investors that China's "first in, first out" economy has continued to lead the global recovery out of the COVID-induced slump. For the People's Bank of China (PBoC), the need for additional monetary support is waning, while rising asset prices have started to draw the authorities' attention to risk management and leverage control in some sectors. We have therefore removed our call for any reserve requirement ratio (RRR) cuts for the remainder of this year. But with inflation on the decline, the global backdrop uncertain, and parts of the economy (employment and consumption) still growing at below trend, we do not see an imminent need to withdraw monetary stimulus. The PBoC seems to be comfortable with its current neutral policy setting – relying on lower-profile policy tools such as the medium-term lending facility– e.g. Open Market Operation (OMO) and Medium-term Lending Facility (MLF) – to keep liquidity conditions stable – while leaving fiscal policy to drive the economy back to its pre-COVID-19 path. We see some moderate upside risks to our 2.3% growth forecast for 2020.

Global Macro Monthly – EM

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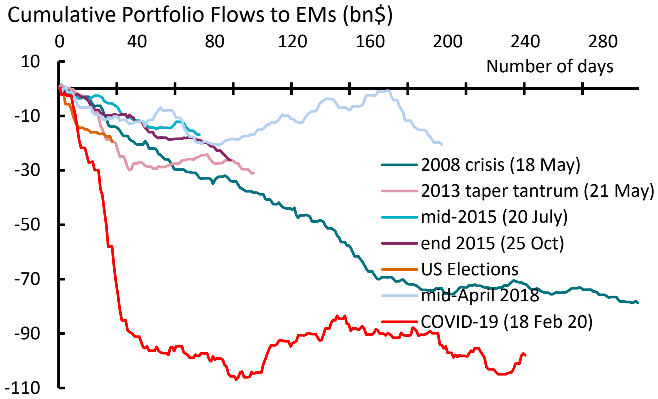
Recovery lacking foreign investors

Since lockdowns and mobility restrictions began to ease at the start of the summer, the supply-side recovery has gained traction. Manufacturing production is picking up and the latest PMI surveys suggest that the trend should continue into the start of the fourth quarter (Q4), albeit with some loss of momentum in European developing markets. Thanks to fiscal and monetary policy support, which has been deployed at various speeds and depths, demand has started to recover. But it remains linked to sentiment, which is affecting consumption patterns, and the underlying strength in the labour market – both of which may require additional policy support.

Exhibit 5: Foreign investors still shy of EM assets



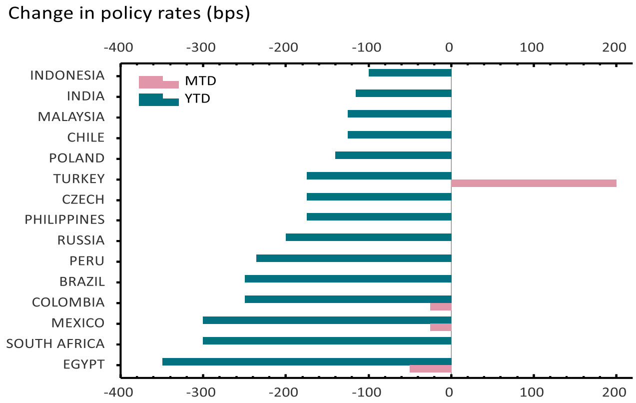
Source: IIF and AXA IM Research, 14 October 2020

Undeniably, it is still early days and fragilities remain. The evolution of the pandemic remains unknown; the path of recovery in advanced economies is losing some steam, which could reduce future external demand for emerging market (EM) exports, and in addition, fiscal space in most developing markets is shrinking. Foreign investors remain on the side lines of EM financial markets. Since the start of the financial market reaction to the COVID-19 pandemic on 18 February, US$98bn worth of foreign portfolio outflows from EMs have been reported by the Institute of International Finance (IIF) – at US$30bn in EM debt assets and US$68bn in EM equities. Since early October, there seems to be a bit more appetite for EMs but it remains to be seen if this will prove more long lasting than the short-lived euphoria of the early days of the summer (Exhibit 5).

Beyond interest rate cuts…

To support domestic balance sheets, EM central banks have aggressively cut interest rates in the wake of the crisis, despite massive portfolio outflows, which triggered significant depreciation of currencies. Real rates are now close to zero and negative real rates have become rather common. Most EM central banks remained on hold at their latest policy meetings (Exhibit 6). Turkey's 200 basis point rate hike was the outlier, and an illustration of the harshness of adjustments necessary in order to attempt to regain lost institutional credibility (see last month's EM comment). Monetary policy is likely to increasingly rely on unconventional policies going forward. Quantitative Easing (QE) is practiced in a series of emerging economies such as Colombia, Indonesia, Poland, Hungary and Thailand.

Exhibit 6: Conventional monetary policy space shrunk



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

On average, EM governments spent 6.7% of GDP in emergency measures and stimulus packages this year. This compares to an average of 8% for advanced economies. The surge in bond issuance required to finance this spending comes at a time when foreign investors' appetite for EM assets appears weak. While several EM central banks have engaged in QE measures most have been reluctant. In fact, local banks have been absorbing most of the governments' bond issuance so far, thanks to various policy decisions taken by central banks such as, among other measures, relaxing reserve requirements rules and applying easier accounting rules, which allowed commercial banks to invest in domestic sovereigns. While so far banks have been a support for government bond issuance, absorbing most of their financing needs, banks' balance sheets become de facto more dependent on the evolution of the governments' balance sheets themselves. QE may help us avoid a lasting depression worldwide, including in EM, but it is not likely to be the final solution to debt sustainability issue.

Investment Strategy – Cross-assets

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Market peering through the US election portal

Increasing coronavirus cases across Europe have led to renewed restrictions, hitting economies that have hardly had time to steady themselves after the first wave. The US picture is more mixed, with the focus on the Presidential Election, prospects for fiscal stimulus and – like the rest of the world – hopes for a vaccine in early 2021. However a decent start in Q3 earnings is helping US assets outperform. Yet long yields have fallen again, implying that the global economy may need more help. Low yields allow governments to keep spending if they so chose. If that means 'quicker and bigger' in the US, the continued outperformance of dollar assets could be the ongoing story of 2021.

Investment Strategy – FX

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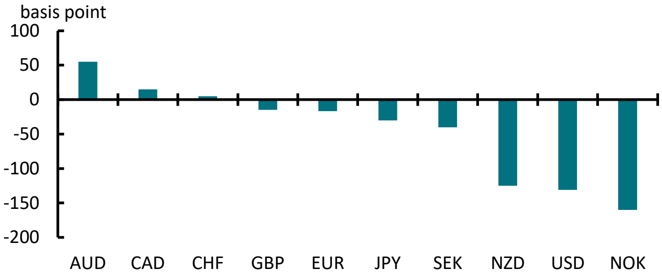
Who will make the US dollar weak again?

Exhibit 7: Fed has taken US real rates to very low levels

Current real rates

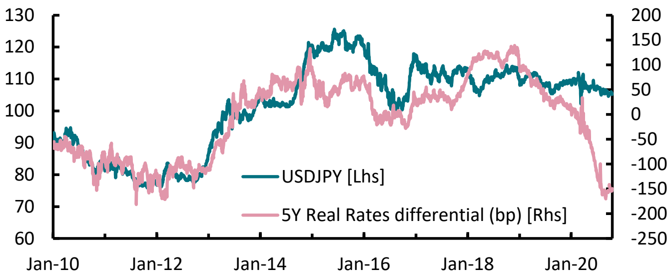


Source: Bloomberg and AXA IM Research, 19 October 2020

Trump's 2016 US election victory took markets by surprise and the potential of tax cuts, profit repatriation and protectionist measures, drove the USD higher by ever 5%. By recent polls, a Joe Biden victory looks likely and a Democrat majority in the Senate a possibility. This points to larger fiscal loosening, but would it mean a stronger dollar? We think that Biden's reforms will be more inflationary, less pro-business, with higher taxes on high incomes and corporates, and less support for energy, discouraging capital inflows overall. We therefore expect the dollar to weaken, whereas in a contested election we would expect risk-off sentiment to temporarily support the greenback. But this could reverse if a constitutional crisis arises, as it did in 2000. A Trump win would bring back fear of confrontational trade policies. Election aside, we think the medium-term trajectory bodes for a weaker dollar as the Federal Reserve ensures that US real interest rates remain very low through reflation (Exhibit 7) and ample US dollar liquidity. Indeed, recent increases in US rates did not alter the dollar's downward trend, as they were mainly driven by higher inflation expectations. Amid currencies whose central banks have little room to adjust policy, the Japanese yen is particularly undervalued against the dollar. The major adjustment in US real rates should translate to a higher JPY (Exhibit 8). Of course, Japanese investment outflows may cap this appreciation but are likely to remain contained by low foreign rates and an uncertain outlook. Holding yen might also be safer through US election uncertainty. While the euro should be supported as well, the second wave of COVID-19, noise around Brexit and the Recovery Fund may create a better buying opportunity near term. Extremely negative real rates (Exhibit 7) can explain why the NOK failed to appreciate despite its cheap valuation and strong fiscal backdrop. At the other end of the scale, policy easing by its central bank is a risk for the Aussie dollar.

Exhibit 8: Fed policy shift justifies a lower USDJPY

USDJPY aganist 5Y real rates differential



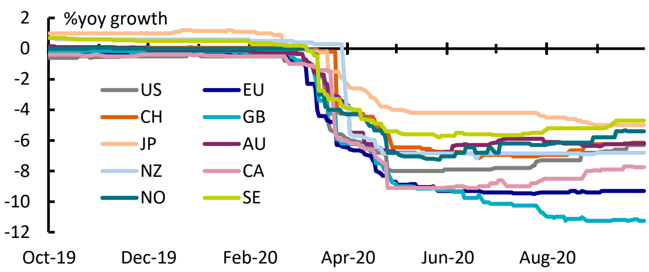
Source: Bloomberg and AXA IM Research, 19 October 2020

Disillusioned relief rally for Sterling

UK-EU negotiations are continuing beyond UK's self-imposed deadline, raising the risk of more dramatic headlines. Buying sterling dips makes tactical sense as we still think that the UK will ultimately achieve some kind of a deal. But beyond a potential relief rally, the pound has lost some of its shine as UK growth data has disappointed and COVID cases rise again. coronavirus against our expectations (Exhibit 9), and the rise of COVID cases are continuing to rise.

Exhibit 9: UK growth expectations revised downwards

Bloomberg consensus revision on GDP 20 vs GDP 19



Source: Bloomberg and AXA IM Research, 19 October 2020

Investment Strategy – Rates

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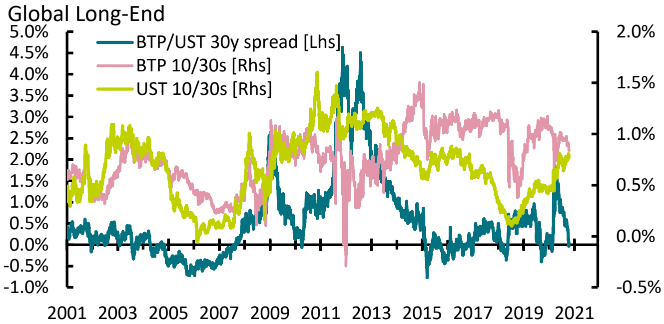
UST/BTP: A Tale of Two Worlds

In rates markets, we often look at US vs EU spreads in order to express differential views on the business cycle, as well as on the policy stance and related political issues. By doing so, we leave aside the credit and liquidity components, which are more typical of European government bonds' relative value or asset-swap-spread trades.

However, in a world dominated by low/negative interest rates, we should respect absolute yield levels more than ever. Recently, 30y Italian BTPs managed to briefly trade below US bonds in yield terms. This marks a 185bp performance for the long-end of the Italian curve since mid-April. Similarly, both 10s/30s curves are trading around 80bp (Exhibit 10).

Exhibit 10: UST vs BTP at the long end of the curve

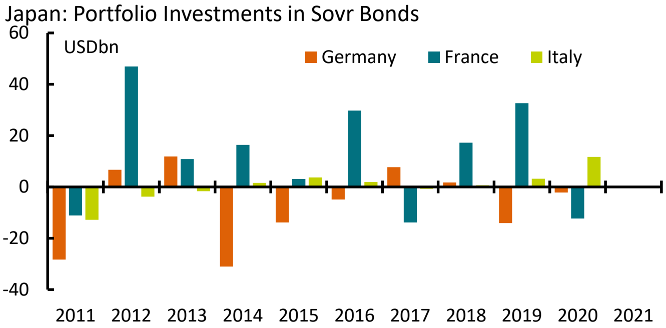


Source: Bloomberg and AXA IM Research, October 2020

Market intelligence and flow reports tend to suggest a skew in investor positioning:

1. The structural appetite for BTP-risk has been strong in 2020, as investors have realised the value of Next Generation EU as a defining moment for Europe.
2. Non-resident investors have been very active on the Italian market, both as result of the improved EU architecture, as well as the attractive relative valuations. This is evident not only from the participation to syndicated deals at long-end maturities, but also from official Japanese statistics showing a strong appetite from Japanese investors (Exhibit 11).
3. As a result, 10s/30s flatteners appear to be a crowded trade in the BTP-space, while the opposite might be true on the Treasury market where arguments like budget deficits and the Fed's new policy strategy have attracted steepeners.
4. In cross asset-terms, the setup bodes well for a reversal of the past month's BTP strength. US equities are again close to their all-time highs and flows into credit markets have been sustained for a long period, while the US dollar could offer a "cheap" hedge against a soft patch in the data (i.e. lockdown economics).

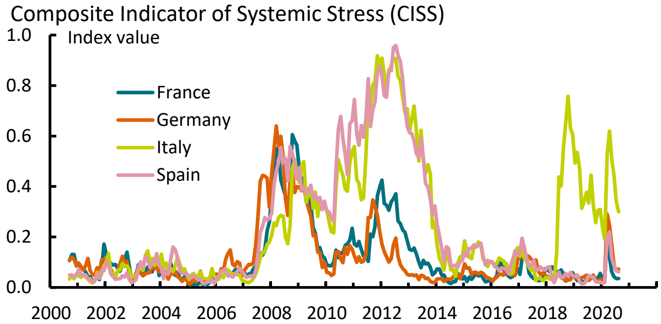
Exhibit 11: Strong interest from Japanese investors



Source: Japan Ministry of Finance and AXA IM Research, October 2020

The combination of factors like valuation, flows and positioning should already provide enough rationale for lightening up on (or hedging with US Treasuries) exposure to Italy in fixed income portfolios, at least with a short-term horizon in mind. Furthermore, pandemic dynamics are likely to put BTPs under pressure after a relatively calm spell throughout the summer period. The additional argument might come from the observation that long-term debt fundamentals have not improved in 2020 and that the level of "systemic stress" is still high relative to other Eurozone member states (Exhibit 12).

Exhibit 12: Systemic risk hasn't normalised yet



Source: ECB and AXA IM Research, October 2020

Of course, this is just the short-term story. The long-term narrative reads slightly different and tries to strike a balance between the prospective improvement in the EU's resilience and the chronic lack of structural reforms in Italy. Or put differently, the story is about lifting Italy's depressed potential growth through long-term investments financed through common-EU funding. Despite calls for radical austerity after the global financial crisis, large Eurozone countries have implemented a long series of budget deficits (Exhibit 12). As a result, debt-to-GDP ratios of around 100% are not unusual. A closer co-ordination between monetary and fiscal policy is a necessary condition to ensure the sustainability of this economic model, pretty much along the lines of the BoJ/MoF paradigm in Japan. In this respect, a stronger EU architecture has greatly reduced the likelihood of a sovereign credit event. However, there are two aspects worth highlighting: 1) Debt-financed growth integrated with non-conventional monetary policy, might foster income inequality and social change. This is a risk especially in those countries plagued by worsening demographics; 2) Economic instability is not always only a result of exogenous shocks. As we know from Hyman Minsky's analysis, an economy might experience a situation of endogenous instability as a consequence of unstable/unsustainable finance.

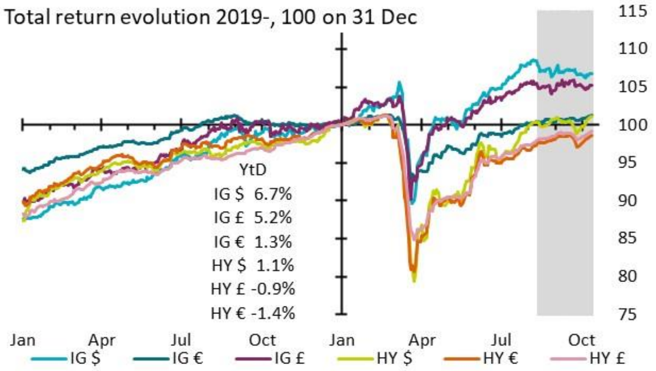
Investment Strategy – Credit

Gregory Venizelos
Credit Strategist
Research – Core Investments

All quiet on the spread front

Approximately one-third of global investment grade (IG) credit is covered by central bank purchase schemes. A further 10-15% of global high yield (HY) credit enjoys similar support through the explicit or implicit acceptance of COVID-related 'fallen angels' (IG to HY) in these purchase schemes. The resultant stability in credit spreads, should therefore not come as a surprise. On the other hand, tight spreads combined with ultra-low if not negative government debt yields create an environment of lacklustre returns (Exhibit 13).

Exhibit 13: Credit returns have broadly stagnated over the past couple of months



Source: InterContinentalExchange (ICE) and AXA IM Research, October 2020

The low-yield theme has been a factor in the outperformance of US over European assets, along with the US Fed's drastic market intervention and bigger direct fiscal support package.

Exhibit 14: US assets have more than recovered the COVID shock drawdown

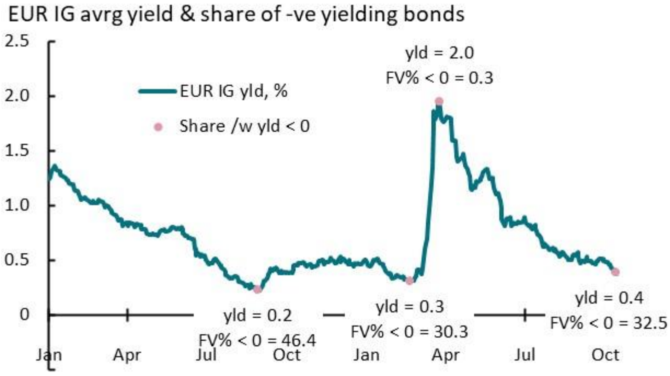
	19 Feb to 23 Mar	23 Mar to 15 Oct	19 Feb to 15 Oct
Market	Return	Return	Return
US equity	-33.9%	55.7%	2.9%
US credit IG	-21.5%	27.0%	-0.3%
US credit HY	-12.4%	19.1%	4.3%
EU equity	-35.7%	28.5%	-17.4%
EU credit IG	-20.4%	22.0%	-2.9%
EU credit HY	-7.9%	8.8%	0.2%

Source: Bloomberg, ICE and AXA IM Research, October 2020

The burden of negative-yielding credit bonds

As yields along the entire German government debt curve now trade below zero and spreads have tightened strongly, negative-yielding corporate bonds in euro are front and centre once more. Just under one-third of the face value of the euro IG index is currently yielding less than zero while the overall index is yielding 0.4% (Exhibit 15, point labels). This compares to an index yield of 0.3% and 30% of the index below zero in mid-February 2020. The record negative was at the end of August 2019, with nearly half of the index below zero and a record low index yield of 0.2%. At the post-COVID-shock spread peak this year, the index yield reached 2% and practically none of the index traded at a yield below zero.

Exhibit 15: Negative-yielding bonds within EUR IG back to one third of face value, after near zero in March



Source: ICE and AXA IM Research, October 2020

Sectors that stand to benefit from the structural effects of the COVID crisis reflect this in their lower risk premia and thus higher share of negative-yielding bonds – *vice versa* for sectors that stand to suffer. Over half of the tech sector yields less than zero, ditto for over 40% of healthcare and retail (Exhibit 16). In contrast, leisure, real estate and services exhibit a much lower share of negative-yielding bonds.

Exhibit 16: Share of (level 3) sector yielding below zero within the euro IG credit benchmark

	Bonds	Face Value		
	#	$ b	$ b yld < 0	% yld < 0
Sector Level 3		*14-Oct-20*	*14-Oct-20*	*14-Oct-20*
Overall	3614	**2648.9**	**860.1**	**32.5%**
Banking	796	659.6	240.2	36.4%
Utility	366	231.6	83.9	36.2%
Telecommunications	208	167.9	54.0	32.2%
Automotive	200	161.8	44.6	27.6%
Consumer Goods	219	161.4	62.4	38.7%
Energy	183	154.2	47.2	30.6%
Healthcare	188	154.0	62.9	40.8%
Financial Services	191	145.7	45.6	31.3%
Basic Industry	223	142.2	41.1	28.9%
Real Estate	253	136.0	10.1	7.5%
Insurance	169	116.7	18.2	15.6%
Transportation	176	114.0	31.6	27.7%
Capital Goods	135	92.5	31.9	34.5%
Technology & Electronics	108	86.5	43.7	50.5%
Retail	70	50.7	20.5	40.4%
Services	67	36.1	7.6	21.2%
Media	59	35.8	13.2	36.7%
Leisure	2	1.0	0.0	0.0%
	3613	2647.6	858.8	32.4%

Source: ICE and AXA IM Research, October 2020

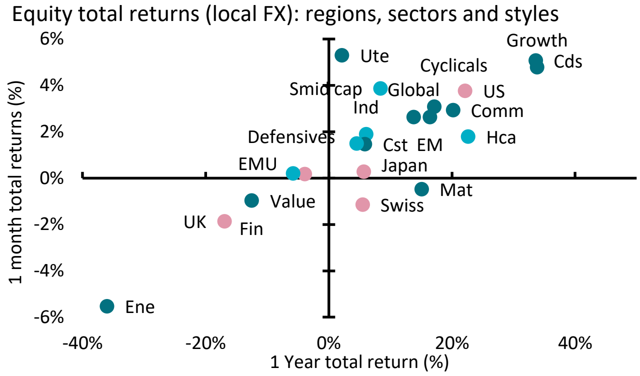
Investment Strategy – Equity

Varun Ghotgalkar,
Equity Strategist,
Research – Core Investments

Standing at the crossroads

Global equites recovered the brief downturn over the last month with market leadership remaining broadly intact (Exhibit 17). Risk assets are facing a clouded near-term outlook on multiples fronts: uncertain earnings, COVID related restrictions, vaccine news, US elections and policy drifts. Equity markets are likely to trade sideways until we have more clarity on the health crisis and next US administration.

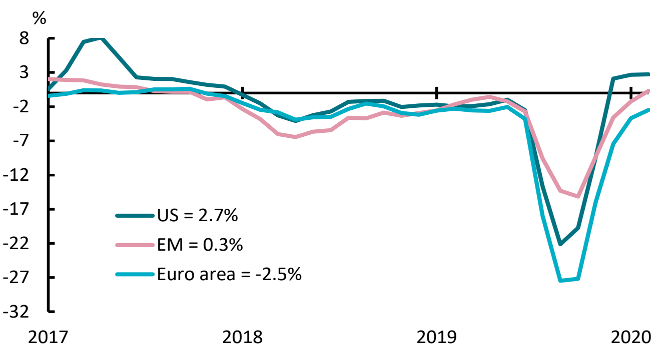
Exhibit 17: Broader market momentum intact



Source: Datastream and AXA IM Research, October 2020

Positive momentum in earnings revisions have stalled after the sharp V-shape recovery reflecting the slowdown in activity indicators (Exhibit 18). The Q3 earnings season has kicked off (just under 10% completion for S&P 500 companies) on a positive note in the US with earnings beats running at 23% on aggregate. Most managements should remain reluctant to provide forward guidance given the lack of earnings visibility. The top down valuation picture remains largely intact with contrasting absolute and relative value metrics – multiples remain undemanding compared to the fixed income space but elevated by historical measures.

Exhibit 18: Stalling momentum after "V shape" recovery

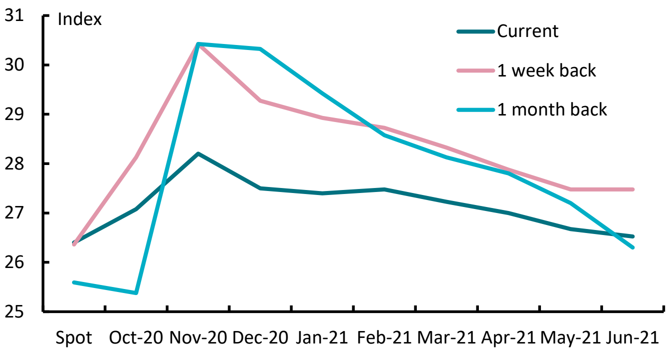


Source: Datastream, IBES and AXA IM Research, October 2020

On the election front, there appears to be no obvious consensus within the investment community on market direction regarding a republican or democrat victory – the contested election scenario is universally perceived as the key risk. Overall sentiment is warming up to a democrat victory (which remains the base case) and it appears that a clear election outcome itself would provide respite for markets. Potential tax hikes are the most direct consequence for earnings – the isolated impact of the proposed plan would shave off roughly 10% of aggregate US earnings per share. Although, these are likely to be diluted and accompanied by increased stimulus, consumer focus and relatively favourable trade policies. The net impact is highly dependent on the trade-off between higher taxes and higher spending along with the sequencing of policy.

Beyond overall market direction, the new policy mix could potentially put in place catalysts for broader equity market participation in terms of sectors and style. We could potentially move into a reflation trade on the back of fiscal stimulus and better news flow on the virus. On the other hand, regulatory concerns around the big tech market leaders could materialize. In terms of valuations, this backdrop with yields moving higher would also penalize the higher duration growth pockets of the market. Although, as witnessed several times over the past decade, the growth to value style rotation will be short lived without a persistent move higher in growth and interest rates.

Exhibit 19: Volatility pricing elevated well into 2021



Source: Bloomberg and AXA IM Research, October 2020

Volatility is likely to remain elevated given the uncertainty surrounding the coronavirus developments, lack of earnings visibility and the political landscape. VIX futures continue to exhibit a kink peaking in November and remain elevated by historical standards well into 2021 (Exhibit 19). We maintain our constructive stance on equities in our cross-asset framework, acknowledging that selectivity remains key given the high degree of uncertainty. Overall, we continue to believe that recovering economic activity, aggressive policy measures, subdued positioning and an ultra-low hurdle rate in other assets should support equity markets in the medium term beyond the looming event risk.

Recommended asset allocation

Asset Allocation	
Key asset classes	
Equities	Positive
Bonds	Positive
Commodities	Neutral
Cash	Negative
Equities	
Developed	
Euro area	Positive
UK	Neutral
Switzerland	Neutral
US	Positive
Japan	Neutral
Emerging & Sectors	
Emerging Markets	Positive
Europe Oil & Gas	Neutral
Europe Telecoms	Neutral
US Industrials	Neutral
US Cons. Discretionary	Neutral
Fixed Income	
Govies	
Euro core	Neutral
Euro periph	Neutral
UK	Neutral
US	Positive
Inflation	
US	Positive
Euro	Neutral ▼
Credit	
Euro IG	Positive
US IG	Positive
Euro HY	Neutral
US HY	Neutral
EM Debt	
EM bonds	Neutral

Legends: Negative | Neutral | Positive — Last change: ▲ Upgrade | ▼ Downgrade

Source: AXA IM Macro Research – As of 21 October 2020

Macro forecast summary

Real GDP growth (%)	2019*	2020*		2021*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
World	**2.9**	**-4.2**		**5.4**	
Advanced economies	**1.7**	**-6.2**		**4.6**	
US	**2.3**	**-4.2**	-5.2	**4.5**	4.0
Euro area	**1.3**	**-7.5**	-7.9	**4.0**	5.7
Germany	**0.6**	**-5.3**	-6.1	**4.0**	4.7
France	**1.3**	**-9.5**	-9.6	**5.0**	7.2
Italy	**0.3**	**-9.6**	-10.2	**3.7**	5.7
Spain	**2.0**	**-11.8**	-11.7	**4.2**	6.9
Japan	**0.7**	**-5.8**	-5.3	**3.1**	2.5
UK	**1.4**	**-10.3**	-9.9	**5.5**	6.4
Switzerland	**0.9**	**-5.5**	-5.6	**4.0**	4.4
Emerging economies	**3.6**	**-3.1**		**5.8**	
Asia	**5.2**	**-1.2**		**7.4**	
China	**6.1**	**2.3**	2.1	**8.0**	7.8
South Korea	**2.0**	**-2.8**	-1.1	**4.5**	3.3
Rest of EM Asia	**4.4**	**-5.2**		**7.0**	
LatAm	**0.1**	**-6.5**		**6.5**	
Brazil	**1.1**	**-7.4**	-6.2	**8.3**	3.2
Mexico	**-0.1**	**-6.8**	-9.6	**7.0**	3.6
EM Europe	**2.1**	**-6.6**		**5.7**	
Russia	**1.3**	**-6.1**	-5.1	**3.7**	3.4
Poland	**4.1**	**-5.0**	-4.1	**5.4**	4.5
Turkey	**0.9**	**-5.6**	-4.4	**6.5**	5.2
Other EMs	**1.5**	**-4.2**		**3.3**	

Source: Datastream, IMF and AXA IM Macro Research – As of 21 October 2020

CPI Inflation (%)	2019*	2020*		2021*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	**1.5**	**0.9**		**1.1**	
US	**1.8**	**1.4**	0.9	**1.5**	1.7
Euro area	**1.2**	**0.3**	0.4	**0.6**	1.1
Japan	**0.5**	**0.1**	-0.1	**0.0**	0.2
UK	**1.8**	**0.8**	0.7	**1.4**	1.4
Switzerland	**0.4**	**-0.6**	-0.7	**0.0**	0.2
Other DMs	**1.8**	**1.4**		**1.9**	

Source: Datastream, IMF and AXA IM Macro Research – As of 21 October 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	Q4 - 20	Q1 -21	Q2-21	Q3-21
United States - Fed	Dates	0-0.25	4-5 Nov 15-16 Dec	26-27 Jan 16-17 mars	27-28 Apr 15-16 Jun	27-28 Jul 21-22 Sep
	Rates		unch (0-0.25)	unch (0-0.25)	unch (0-0.25)	unch (0-0.25)
Euro area - ECB	Dates	-0.50	29 Oct 10 Dec	21 Jan 11 mars	22 Apr 10 Jun	22 Jul 9 Sep
	Rates		unch (-0.50)	unch (-0.50)	unch (-0.50)	unch (-0.50)
Japan - BoJ	Dates	-0.10	28-29 Oct 17-18 Dec	20-21 Jan 18-19 mars	26-27 Apr 17-18 Jun	15-16 Jul 21-22 Sep
	Rates		unch (-0.10)	unch (-0.10)	unch (-0.10)	unch (-0.10)
UK - BoE	Dates	0.10	5 Nov 17 Dec	4 Feb 18 mars	6 May 24 June	5 Aug 23 Sep
	Rates		unch (0.10)	unch (0.10)	unch (0.10)	unch (0.10)

Source: AXA IM Macro Research - As of 21 October 2020

These projections are not necessarily reliable indicators of future results

Download the full slide deck of our October Investment Strategy

Our Research is available on line:

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