For professional clients only
24 September 2020
Research & Strategy Insights

Biden his time

Global Macro Monthly

Key points

- The US has seen fewer new virus cases since its summer peak, but the virus is rising sharply in some European countries and across emerging markets more broadly. Governments are refraining from imposing the same scale of lockdowns.
- Q3 looks likely to post record quarterly growth in many economies, following the record contraction in Q2. The outlook is more challenging with risks of rising precautionary behaviour and weak employment.
- Some governments have extended support schemes, risks are compounded where others have not. Central banks will remain supportive for the foreseeable future.
- US elections are in focus. Polls suggest a Biden win, but the Congressional outcome is key.
- Equities have been supported by firming earnings outlook and policy support. As has record credit spread tightening. Both face risks from renewed corporate stress.

Global Macro Monthly

Investment Strategy

Global Macro Monthly – US

David Page,
Head of Macroeconomic Research,
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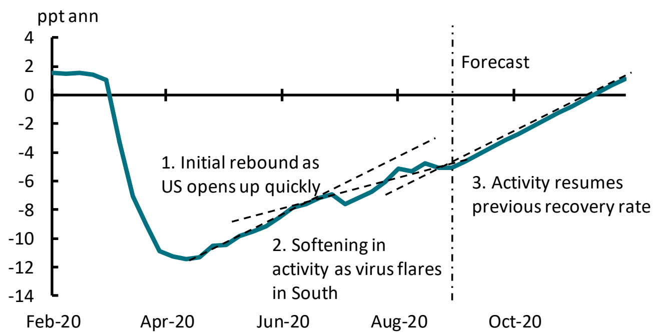
The fastest recovery on record!

US President Donald Trump has already laid claim to the fastest economic recovery in US history. In terms of quarterly growth rates, this will surely be the case. Following the steepest contraction on record, data in Q2 – with GDP down an annualised 31.7% – we forecast the sharpest quarterly rise in Q3 at around 20%. But we see upside risks to our forecast and consensus expectations are around 5ppt annualised higher (just over 1%qoq) for the quarter. There is an uncertain scale of inventory rebound and unwind of negative net trade contribution – exports fell much more sharply than imports in Q2 – providing much of the uncertainty.

Yet beyond the knee-jerk rebound in Q3, there are broader questions. Recent data has shown a pause, and mini-reversal in high-frequency data. For example, mortgage approvals have retreated over the last month, consumer confidence has stalled, and the Federal Reserve (Fed)'s weekly economic index retraced modestly in the past two weeks (Exhibit 1) – the first since the rising virus months of June and July. Moreover, beyond the mirage of quarterly growth rates, even if Q3 rose in line with stronger consensus expectations, it would still lie 5% below its pre-Covid-19 high – still a nasty-sized recession.

Exhibit 1: High-frequency growth indicator

Fed Weekly Economic Index forecasts

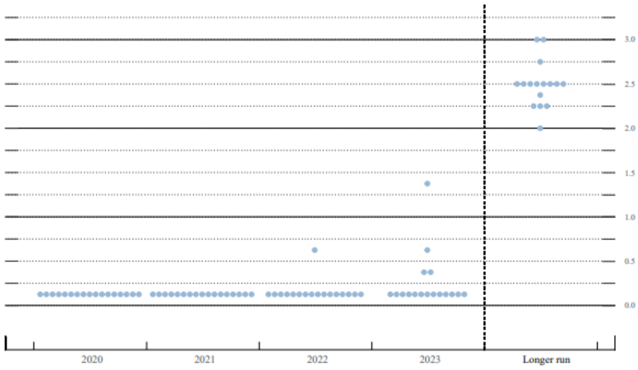


Source: Federal Reserve Bank of New York (FRBNY) and AXA IM Research, Sept 2020

There are brighter spots. The US has succeeded in bringing new coronavirus cases lower again, particularly reining in growth in the Southern states, and without the material reduction in activity required in March and April. However, there are signs that a further reduction in new cases may prove difficult. Moreover, the official unemployment rate has fallen back to 8.4% in August from its 14.7% peak in April. We had hoped to see this level only by Q4. However, we are sceptical about the divergence between institutional and household surveys that have delivered this figure and still see unemployment around this level by year-end. Indeed, with the level of activity down at least 5% in Q3, unemployment looks set to remain elevated for some time to come.

The level of income support for out of work Americans and businesses is a key concern for us. The lapsing of the jobless benefits boost at the end of July, has been mitigated by the short-term repurposing of Federal Emergency Management Agency (FEMA) funds. But these will be exhausted over the coming weeks. Without fresh stimulus, households will face a material decline in income growth in Q4. This would first reduce the high level of household saving, but then result in spending cuts. For now, Congress remains deadlocked over fresh fiscal stimulus and consensus views have shifted away from expecting a boost. However, President Trump approved of a House moderates' suggestion of a $1.5tn package, which may yet gain traction over the coming weeks. Our view remains that we will see a $1.5tn package. But time is running out and risks to our growth forecast lie to the downside in its absence.

Exhibit 2: Fed rates to remain low



Source: Federal Reserve Bank (FRB), Sept 2020

The Fed fulfilled our expectations over the past months. In August it announced the conclusion of if Monetary Policy Review stating that it was changing its Longer-Term Policy Goals to shift its inflation target to an average 2% over the longer-term. This shift means that the Fed would now target a "moderate" inflation overshoot of 2% after extended periods of subdued inflation. In September, having adjusted its longer-term goals, the Fed changed its forward guidance to explicit, state-based guidance. The guidance now says the it will only tighten policy once labour market conditions are consistent with the its view of maximum employment and inflation is at 2% and expected to rise moderately above 2% for some time. While this guidance retains plenty of discretion, it is consistent with Fed forecasts that it will not raise the Fed Funds Rate from the current levels before 2024. However, this was not news to the market and the move prompted little reaction. In addition, the Fed has provided no such guidance over its balance sheet policy. This continues to be the Fed's tool for marginal stimulus and is set to continue to expand by $120bn (0.6% of GDP) per month.

Global Macro Monthly – Eurozone

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Turning sour…

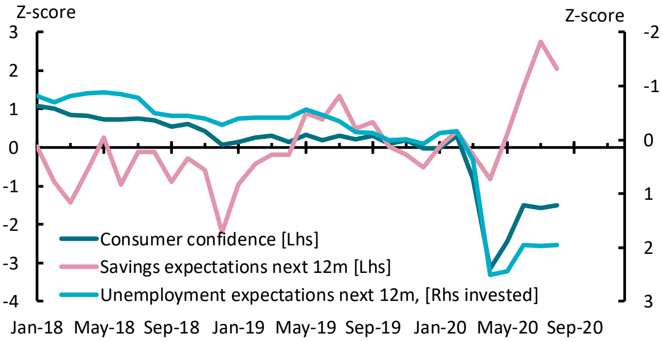
The Eurozone outlook continues to depend on two interrelated factors: how the pandemic plays out and the strength of the demand recovery. Both have soured over the summer. On the first point, the speed of the virus's propagation is exceeding the levels observed just before lockdown measures were relaxed last Spring. Spain and France are the main hotspots, surpassing the US in terms of new cases per capita. While new infections were initially concentrated among the 15 to 44-year-old cohort, the latest data points to a distribution shift towards older people. And given the rising intensive care unit (ICU) occupancy and fatality rates, albeit still well below March/April levels, there is a call for caution. This has forced governments to take action. Madrid has introduced restrictions on mobility, set capacity at stores and other commercial establishments at 50%, and imposed earlier closing times of 10pm. France is re-imposing restrictions at a local level, still focusing on social distancing and mandatory mask use, while others (Germany, Italy) have implemented stricter travel provisions. Our baseline does not envisage widespread lockdown, but risks will rise if these relatively limited measures do not manage to curb the infection rate and pressures on healthcare systems continue to mount.

On our second point, after a record collapse in second quarter (Q2) GDP, at -11.8% quarter-on-quarter (qoq) for the euro area, the reopening of the economy has resulted in a mechanical rebound in activity. We estimate euro area GDP is on track to bounce back by 8.9%qoq in Q3. But signs of the recovery losing steam are accumulating. INSEE sees the monthly pace of improvement fading, with French economic activity expected to remain 4% below pre-shock levels in Q4, only slightly up from 5% below in September. In the euro area, retail sales paused in July, annual growth in car registrations turned negative while industrial production still stands at circa 7% below its pre-Covif-19 level. Demand weakness seems to be the main supply-side constraint: the European Commission Q3 survey shows it has become the main limit to production in both industry and services sectors.

And indeed, consumer confidence is stalling too, dragged down by weak employment prospects (Exhibit 3Exhibit 3). The extensive use of short-term working schemes and labour force developments – a sharp rise in inactivity rates due to lockdown and discouraged workers – have distorted labour market data. Euro area employment dropped by only 2.9%qoq in Q2 and unemployment rate edged up to 7.9% in July (from 7.3% in February) versus a 15.1% cumulative GDP decline in the first half of the year. The normalisation of labour force dynamics – started in Q3 with people resuming job searches as restrictions eased, a trend set to continue in Q4 – which will mechanically push the unemployment rate higher. Declining job vacancy rates and subdued business hiring intentions suggest labour market underutilisation will not be fully and quickly reabsorbed. Despite the extension of short-term working schemes in most euro area countries, we see Eurozone unemployment rate rising to 10% in Q4 2020.

Exhibit 3: Consumers worried about unemployment

Euro area consumer confidence



Source: Datastream and AXA IM Macro Research, 22 September 2020

Countries have also started to work on their 2021 budget plans, which need to be submitted to the European Commission by mid-October. The signalling effect of France's €100bn plan is positive. It is a recovery package, focussing on the supply-side of the economy, with roughly one-third of it supporting the green transition. But the overall number is split over several years and the plan is not totally additive to the European Recovery and Resilience Fund (RRF): 40% of the €100bn will be financed by the RRF. The GDP boost (between 0.6% and 1.0% per year) is decent, but not a game changer given the magnitude of this year's recession which we forecast to be -9.6% year-on-year. The Italian government has also presented its Recovery and Resilience plan to parliament. It includes tax cuts, minimum wage, labour market reform and aims to raise public investment above 3% of GDP. Italy's poor track record on the efficient use of EU funds might be a challenge, but the RRF conditionality (funds disbursed when agreed targets are met) constitutes a strong incentive to boost long term growth.

…means there is no room for complacency

At September's European Central Bank meeting, President Christine Lagarde clearly welcomed help from fiscal policy – a factor behind the upgrade of its 2022 core inflation forecast. If the press conference included some hawkish overtones (dismissing August's deflation print and suggesting deflation are receding), the concerted effort by other board members since has provided a "dovish barrage", suggesting they were not intentional. It also reinforces our view that the ECB will do more, with a time and quantum extension of the Pandemic Emergency Purchase Programme (PEPP) likely in December. But it will be needed to absorb the large increase in public debt issuance next year.

Global Macro Monthly – UK

David Page,
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Q3 a bright spot, but visibility dims

The economy posted monthly growth of 6.6% in July after an 8.7% expansion in June. August looks likely to be another bumper month. The Bank of England (BoE) estimated consumer activity had recovered back to start-of-the-year levels on aggregate, based in part on analysis of banks' payments data. Consumer spending has been buoyed by a fiscal package to encourage a return to restaurants, buoyant housing demand and the rise of British 'staycations'. The outlook for a sharp rebound in Q3 is promising

Beyond that, signals are less rosy. Coronavirus infections have risen in the UK with daily cases rising by around 4k. The government has reimposed modest social restrictions nationally and more stringent local lockdowns. Yet the struggle to ensure testing meets increased demand – as schools, universities and office workers return after an enforced break – risks the virus worsening further from here.

The UK also continues to negotiate with the EU for a trade deal before the transition phase of Brexit expires on 31 December 2020. Prime Minister Johnson drew domestic and international criticism when introducing legislation that plans to break international law by re-writing sections of the Withdrawal Agreement. We view this as a clumsy negotiating tactic. We continue to consider a last-minute trade agreement likely before the 15 October EU Summit deadline. But after a string of apparent government policy missteps in recent quarters, our conviction for this outcome has dimmed.

We forecast 2020 GDP growth at -10.0%, which has now become the consensus outlook. A bumper Q3 could see this rise, but the virus threatens reducing our outlook for Q4, while bungled trade talks could further weigh on activity in Q1. Risks are therefore skewed to the downside for our 2021 GDP growth outlook, currently at 7.5% (consensus 6.4%).

The BoE left policy on hold at its September meeting in the face of "unusual uncertainty". It recognised firmer near-term activity but was uncertain what it suggested for the future. We expect the BoE to extend its QE programme again, beyond its current expiry around the turn of the year. However, the BoE fanned expectations that it could deliver a further rate cut if the outlook dimmed. For now, we do not expect that to be the case, but risks of a reduction in Bank Rate (to 0.0%) and adjustments to the Term Funding Scheme to facilitate negative short-term market rates would rise if downside risks materialise.

Global Macro Monthly – Japan

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PM Suga nominated to pursue Abe's politics

Shinzo Abe resigned as Prime Minister three weeks ago due to deteriorating health. Yoshihide Suga, former Chief Cabinet Secretary and Abe's trusted lieutenant, has been nominated by the Liberal Democratic Party and approved by the Diet to replace him. He has made no statement to change the economic agenda as yet. However, speculation surrounds whether he will announce a general election in the coming weeks to secure his own majority – benefitting from current high standings in the polls – before the scheduled elections in October 2021.

We do not expect a significant shift from 'Abenomics' policies as Suga has pledged continuity. On the economic side, he has indicated that structural reform will be a priority, focusing on digitalisation and administrative and regulatory reforms. He also favours regional bank consolidation and region revitalisation. On fiscal policy, he has been opposed to any consumption tax cut.

Coronavirus indicators point in the right direction, but Japan only performs 20,000 tests per day, insufficient for a clear overview of the health situation. Second quarter (Q2) GDP was revised down to -7.9% quarter-on-quarter, a third consecutive decline. A mechanical rebound should occur in Q3, but the recovery is likely to soften thereafter. The recovery remains the weakest among developed economies, both in supply and demand terms. July's industrial production improved but remains at -15% year on year (yoy). Retail sales fell to -2.9%yoy in July, while August's household spending pointed to a decline of -7.6%yoy. Consumer confidence has stabilised since June, but at very low levels, led by employment uncertainty.

The Bank of Japan (BoJ) kept its monetary policy unchanged during its September meeting, reiterating its confidence in current measures. The refinancing rate remains at -0.1%, yield curve control targets 10-year yields around 0%, with "unlimited" quantitative easing, and credit facilities are large. We see no immediate impact on monetary policy, from the change in Prime Minister as PM Suga also supports the BoJ's accommodative measures. These measures are achieving their intermediate targets: 10-year Japanese government bond yields remain within the prescribed range of +/- 0.2% and bank lending remains dynamic (+6.8%yoy). However, we are sceptical about the ultimate goal, as the BoJ does not seem sufficiently concerned about the rising risks of Japan falling back into deflation – which could further weigh on expectations.

Global Macro Monthly – China

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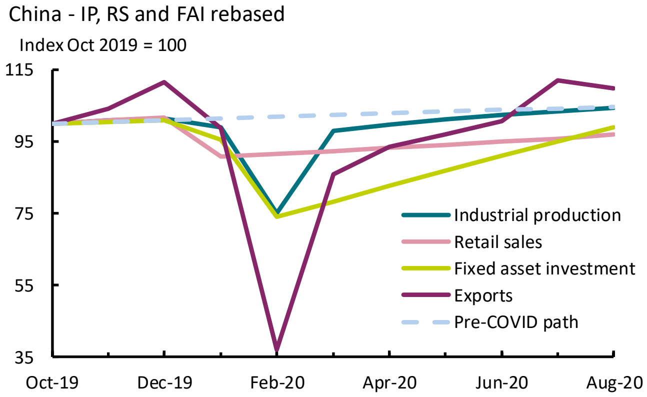
Recovery gains more balance – and steam

August output data showed that China's economic recovery gained further strength, depth and breath, after a strong rebound in Q2. All major activity indicators beat market expectations, with industrial output growth accelerating 0.8 percentage points (ppt) to 5.6%, back to its pre-crisis level much faster than we anticipated. Retail sales also saw annual growth accelerate by 1.6ppt, to record its first yoy gain of 0.5% in 2020.

With other engines – investment and exports – continuing to power ahead, China's economic recovery has become more balanced and broad-based (Exhibit 4). Beijing will likely be reassured by this and further fine-tune monetary policy, reducing stimulus to avoid over-stimulation in key areas, while relying on fiscal measures to continue to propel growth back to previous trajectories and safeguard recovery.

Exhibit 4: Balanced and broad-based recovery



Source: CEIC and AXA IM Research, 15 September 2020

Growth becomes more broad-based

Taking a closer look at the latest data. On the supply side, industrial production growth sped up to 5.6%, as the impact of south-China floods receding removing a constraint to industrial recovery. Mining output resumed growth, rising 1.6%, while Beijing's infrastructure push has continued to benefit machinery production (up 15%). Output of electronics and telecommunication equipment also grew nicely, likely reflecting continued working-from-home demand and an acceleration of 5G rollout within China. To summarize, a strong rebound in energy and utility production sent a clear signal that the overall economic recovery has gained further steam.

On the demand side, while exports have been a source of upside surprises this year, domestic consumer spending was the highlight. of the August data. Retail sales grew for the first time in 2020, up 0.5%yoy – the last sector to make up lost ground. Details of the data showed broad-based recoveries across various industries. For instance, clothing and garment sales posted their first annual gain as shopping malls reopened and people felt more comfortable resuming public activities. Nation-wide movie theatres reached a work resumption rate of over 80% at the end of August, while increased eating out has narrowed the growth decline in restaurant and catering sales. Discretionary spending on autos (11.8%), mobile phones (25.1%), cosmetics (19%) and home appliances (11.4%) also grew strongly, thanks in part to a further decline in the surveyed unemployment rate to 5.6%.

Elsewhere, the investment engine has continued to fire, fuelled by strong credit and fiscal easing. The better-than-expected social financing data was driven largely by a RMB1.4tn increase in government bond issuance, which should provide solid financial backing for infrastructure investment going forward. Manufacturing investment also improved markedly, suggesting that some corporates have finally regained the confidence to carry out capital expenditure. However, the recovery remains fickle and nascent, and requires the continued nurturing of additional credit/tax supports and more clarity on the latest policy initiatives (e.g. dual circulation) to ensure the momentum is not lost prematurely.

Finally, property investment growth picked up further last month, with house sales up 13.7%, reaching a three-year high. The latter has prompted some local authorities to tighten purchasing rules and leverage ratios of property developers to curb "overheating" risks in some regional markets. We think Beijing will continue to manage the housing market with differentiated policies, while a wholesale tightening remains unlikely in the near term before the economy fully regains strength.

Upside risk for growth despite policy fine-tuning

Overall, August data delivered two encouraging messages - economic growth has accelerated and the recovery has become more broad-based. The catch-up of consumer spending is particularly reassuring, as getting the largest engine of the economy back on track is critical for ensuring a balanced and self-sustained recovery.

Beijing will likely take this as a signal for further monetary policy fine-tuning, easing back stimulus towards neutral, while monitoring for any emergence of financial imbalances. The chance of additional aggregate easing, such as the reserve requirement ratio and interest rate cuts, has therefore subsided, particularly as fiscal policy is expected to do more of the heavy lifting. We now see some upside risks to our GDP forecasts of 5% and 6% for Q3 and Q4, and full-year growth at 2.3%.

Global Macro Monthly – EM

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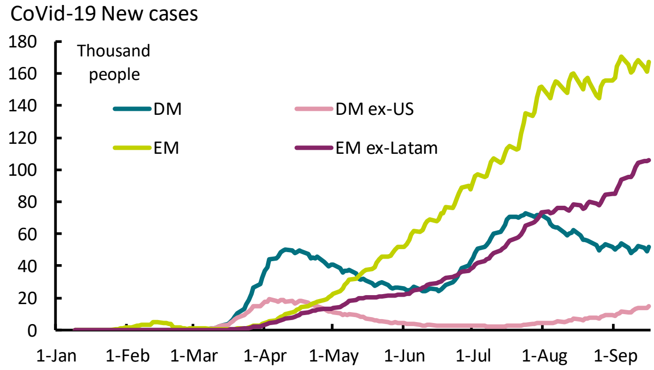
Emerging markets (EM) have become the epicentre of the Covid-19 pandemic. Since the beginning of June, statistics have shown a steady deterioration compared to developed markets (DM). The DM/EM ratio of total infection cases has halved to 0.6x from 1.3x – and adjusted for the number of inhabitants, the ratio decreased even more abruptly to 3.5x from 8.1x. Geographically, Latin America was the hotspot of the pandemic at the start of summer; while the number of infections remains elevated, it has been rising less aggressively in the past weeks. Meanwhile, the epidemic appears to have re-accelerated in other EM regions, especially Asia (Exhibit 5) – with India a particular concern. Yet mobility restrictions continue to be relaxed at a similar pace to developed markets and similarly, financial markets and currencies have broadly stabilised for now.

Exhibit 5: New Covid-19 cases worldwide

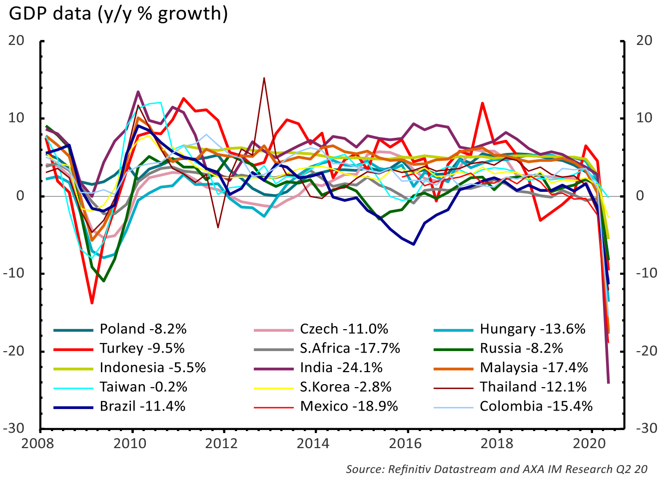


Source: Refinitv Datastream and AXA IM Research, 16 September 2020

A reckless second quarter

The global lockdown caused a significant contraction of activity worldwide in the second quarter (Q2) (Exhibit 5). Emerging markets bore their share of this, to varying extents. Among major EM economies, Taiwan and South Korea fared best with more controlled exposure and hence less stringent lockdown measures imposed since the start of the year, though growth nevertheless contracted versus a year ago. Tourist-dependent countries such as Thailand were additionally hit by a very poor summer season. Export-oriented economies suffered from falling demand from Western countries. The size and timing of the government spending packages also made a difference. The sudden stop in economic activity resulting from nationwide lockdowns led to both supply-side and demand-side shocks. These were particularly strong in India and have resulted in a broad-based contraction in Indian GDP. All in all, the pandemic shock has dwarfed preceding recessions across the EM world.

Exhibit 6: An unprecedent activity contraction in Q2



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

Turkey in focus, again

Even before the Covid-19 crisis, the Turkish administration was providing stimulus to the economy. This mitigated the Q2 GDP contraction relative to expectations and has led us to revise our 2020 average growth forecast to -3.4% from -5.6% previously. Moreover, the health crisis has been well managed, even if cases are continuing to rise now. However, the government has spent 10.8% of GDP in fiscal measures post-Covid-19. Turkey is certainly less constrained on the indebtedness front than its Latin American peers, with government debt of around 30% of GDP last quarter, but it continues to face an inflation problem. Inflation is in double digits (11.8% in August) and sticky, pressuring the central bank to adjust monetary policy. It stayed put at its last monetary policy meeting, with the reference rate unchanged at 8.25% given political pressures stemming from President Tayyip Erdoğan vocally opposing rate hikes.

Foreign exchange interventions in order to limit the Turkish lira's depreciation have accelerated the depletion of the central bank's currency reserves. In truth, a monetary tightening has already started; interbank rates are creeping higher and the cost of funding is rising. This looks like déjà vu with a similar sequence of events as in 2018, when the central bank eventually had to aggressively hike policy interest rates as market pressures intensified, anticipating the country would otherwise tip into a balance of payments crisis. While the timing of such an adjustment is difficult to call, it will undoubtedly cause a renewed weakening of the economy next year.

Investment Strategy – Cross-assets

Greg Venizelos,
Credit Strategist,
Research – Core Investment

Central banks ready if recovery falters

Risk-free yields and curves are range-bound and are set to remain so as central banks strengthen their resolve to encourage a rise in inflation. As such, the traditional cyclical upturn signal from the yield curve might be weaker this time. Stocks, more than ever, need to take their lead from earnings expectations, which in turn need confidence in the growth outlook that may require more fiscal stimulus and ongoing central bank QE. The Fed and the Bank of England were nuanced in their communications this week but you can't rule out more concrete policy steps down the road.

Investment Strategy – FX

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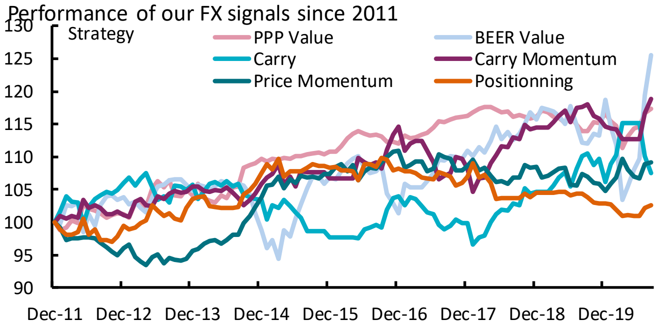
Back to fundamentals: Yen well positioned

The risk on/risk off focus that dominated the first half of the year is finally coming off and post-Covid value strategies arise (Exhibit 7). By bringing global interest rates to zero over the long term, central banks have undermined the carry strategies that dominated in 2018-19. Markets are left to ponder fair value and structural strengths and weaknesses.

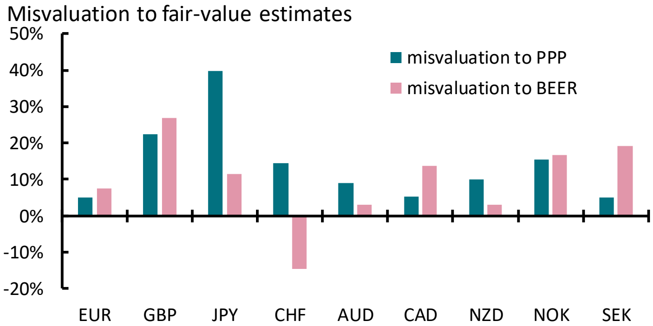
Exhibit 7: Value strategies are making a come back



Source: Bloomberg and AXA IM Research

On this front, USD has more room to fall from a broad overvalued starting point (Exhibit 8). The Fed is adding to its negative dollar influence from already massive liquidity injections with average inflation targeting, dousing rate hike anticipations and reduced risks of USD liquidity stress. The US election and Covid make the US growth differential more uncertain, while twin deficits remain a reality. EUR has already made a notable catch-up but has more room to go in our opinion. Sentiment is supportive, since the agreement on the Recovery Fund reduced perceptions of EU unity risk, and the appreciation move does not appear overextended.

Exhibit 8: USD overvalued across the board, JPY cheapest



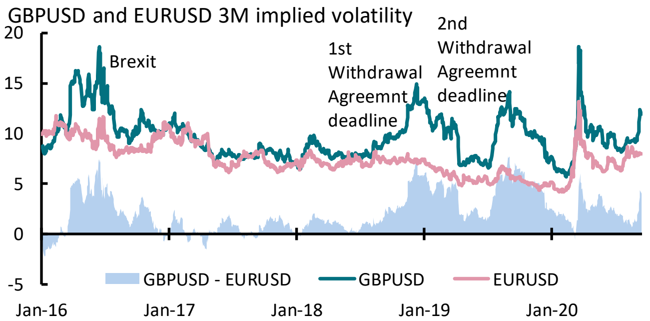
Source: Bloomberg and AXA IM Research

Slowly but surely, JPY is looking more attractive. Although it underperformed vs risk-on currencies recently, it has already initiated an appreciation trend against USD. The appointment of new Prime Minister Yoshihide Suga is unlikely to usher significant policy change. The game changer rather is the massive Japanese investment outflows that should be slowed by the global interest rate environment, plus, a large stock of unhedged foreign exposures that can now be hedged more cheaply. Our BEER value estimate is probably over-reacting but does show the impact of monetary shifts on JPY. BoJ policy no longer looks unorthodox vs others.

The last ride for Sterling

We have been expecting UK-EU negotiations to weigh on GBP in Q3. Implied volatility has already repriced (Exhibit 9), but we think there is room for it to rise a little further. While we think that UK government will ultimately achieve a deal, this will probably come at the last minute once again, near October's EU summit, triggering a sharp relief rally. While probably too early to turn bullish yet, we would look at any sharp dip in the GBP as a buying opportunity and more so as we near the deadline. If a 'no deal' is avoided as we still think the most likely, GBP has upside, due to its undervaluation and a potential Q3 UK GDP upside surprise, which may dampen market conviction that the BoE will lower interest rates to negative territory next year.

Exhibit 9: Volatilities reprice for UK-EU negotiation failure



Source: Bloomberg and AXA IM Research

Investment Strategy – Rates

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AXA IM Italy CIO and Rates Strategist
Research – Core Investments

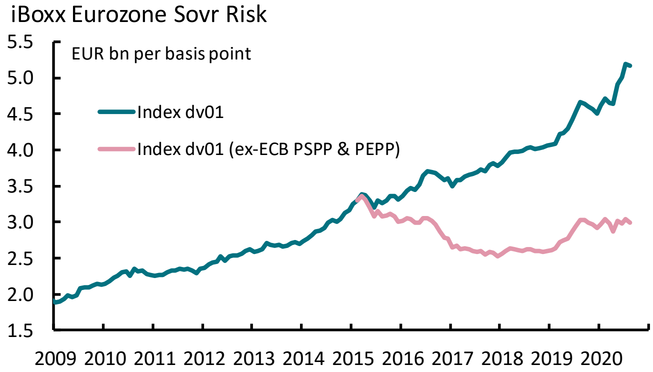
EGB: Risk Factors

Many of us will have seen a chart showing the expansion of central banks' balance sheets and its effect on the outstanding amount of negative yielding global bonds. By and large this is regarded as the most prominent factor in bond performance and bond portfolio risk management. Year-to-date, Euro Sovereigns have returned 3.3% with a rather uniform performance between member states (e.g. Italy 4.3%, France 3.5% and Germany 2.3%). However, we should also be aware of risk factors that might raise the level of alert at any time. Here, we focus on European government bonds (EGBs).

Liquidity

Secondary market liquidity is measured across turnover, depth, bid-ask spreads, latency etc. Looking at volumes, we note how Bund contracts have reached new lows for 20 September expiry. On average, the market has traded 14% lower than 12 months ago and 5% below 20 June expiry. In addition to Mifid regulation, non-conventional monetary policy is having a significant impact on EGB liquidity, as the ECB absorbs both supply and risk from the market (Exhibit 10). At the limit, the EGB market could be subject to discontinuous pricing and larger-than-expected gaps, as signalled by a slight increase in Amihud ratios, a common measure of illiquidity.

Exhibit 10: ECB's duration extraction

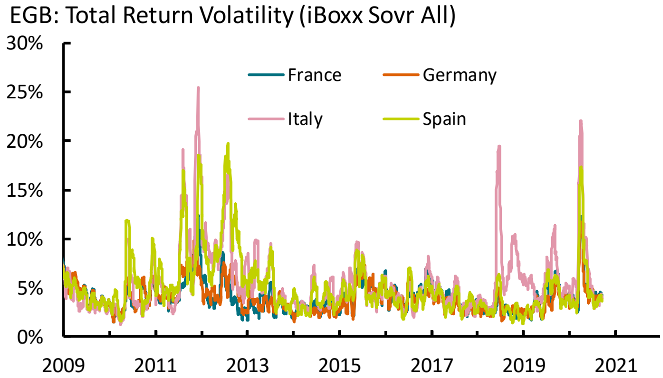


Source: ECB, Markit and AXA IM Research, 18 September 2020

Complacency

Volatility is back to pre-Covid levels (Exhibit 11), likely reflecting improved investor sentiment on the back of the pathbreaking Resilience and Recovery Plan (RRP) agreement. While this landmark improvement in the EU's architecture has brought more stability to the bloc, periods of very low delivered volatility – i.e. periods of increased complacency and risk accumulation – should always be viewed as a potential risk factor. Deteriorating liquidity conditions are the perfect price-shock amplifier, thus leading to more frequent and severe volatility jumps. For strategic asset allocations, the question is: Will this be enough to offset the benefits of a strengthened EU-model and deliver a structurally higher trend volatility to the EGB markets?

Exhibit 11: Volatility back to pre-Covid levels

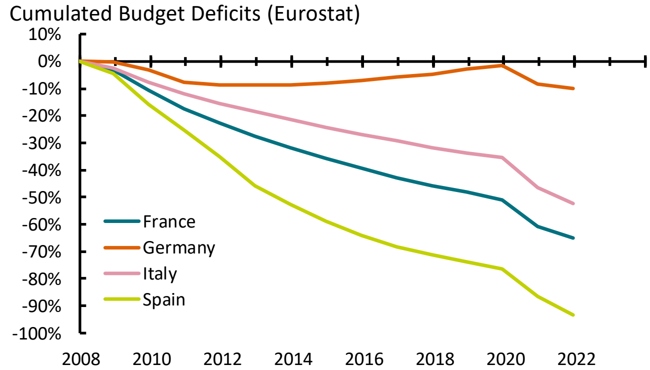


Source: Markit and AXA IM Research, 18 September 2020

Long-term fundamentals

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.

Exhibit 12: Debt-financed growth?



Source: Eurostat and AXA IM Research, 18 September 2020

Investment Strategy – Credit

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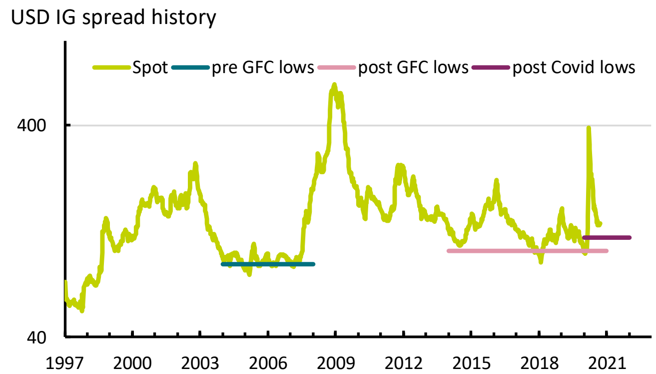
Research – Core Investments

Credit returns have overcome the Covid shock

The Covid shock has been unprecedented in most aspects of macroeconomic and markets impact. So too in credit, where the widening in spreads has been the sharpest on record and the spread recovery has been equally remarkable (Exhibit 13). Arguably, the spread recovery is more than enough given the lingering uncertainty around the economic recovery. Were we to get more confident in the clinical, medical and logistical aspects of handling Covid, further tightening in spreads could then be justified. Furthermore, the post Covid regime is likely to be typified by a higher steady-state lower-bound for spreads, like post the Great Financial Crisis (GFC).

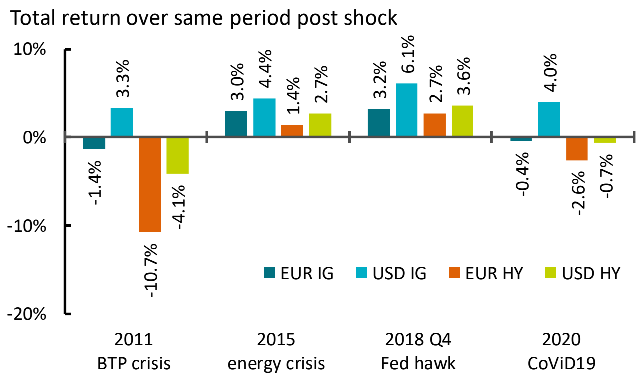
Exhibit 13: A higher steady-state lower-bound for spreads post Covid is likely (log scale)



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

The remarkable rebound in credit is aptly reflected in returns, where the recovery is starting to resemble previous, less severe, bearish episodes (Exhibit 14). Spread carry should bring High Yield (HY) into the black over the next six months.

Exhibit 14: Recovery in credit returns starting to resemble previous, less severe, bearish episodes

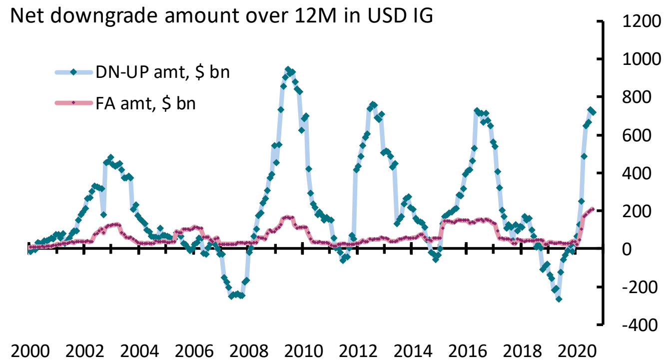


Source: ICE and AXA IM Research, September 2020

Downgrades and defaults slowing

Rating downgrades and defaults remain a core concern for credit investors, given the risk of a second wave of corporate stress as fiscal support measures near expiry while the economic recovery is not secured. The volumes of net downgrades in USD Investment Grade (IG) over 12 months has reached $717bn, a level comparable to the 2012 and 2016 peaks (Exhibit 15). $210bn of that is fallen angels, names downgrade to HY, which represent c.3% of the IG index 12 months ago. This negative rating migration wave is slowing and has been well absorbed by credit markets, largely due to the explicit support by central banks globally through their asset purchase programs.

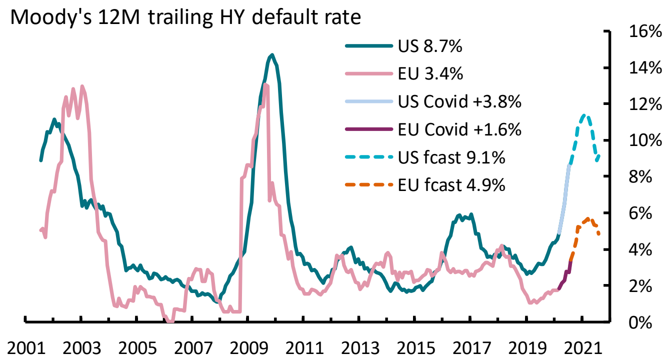
Exhibit 15: Volumes of net downgrades over 12 months stabilised in August



Source: ICE and AXA IM Research, August 2020

Similarly, the pace of 12-month trailing defaults, while still rising, is starting to slow down, especially in the US which has seen a 3.8% rise since the end of February (+1.6% rise in Europe, Exhibit 16). Market expectations are for defaults to peak in Q1 2021 and 12-month forward default forecasts have been coming down, as macro- and market-based default predictors have been improving.

Exhibit 16: Defaults still rising but momentum is slowing



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

A clear and present danger, however, is a second round of lockdowns and the associated relapse in economic activity that brings about a second wave of corporate stress, re accelerating downgrades and defaults to the detriment of credit portfolio returns.

Investment Strategy – Equity

Varun Ghotgalkar,
Equity Strategist,
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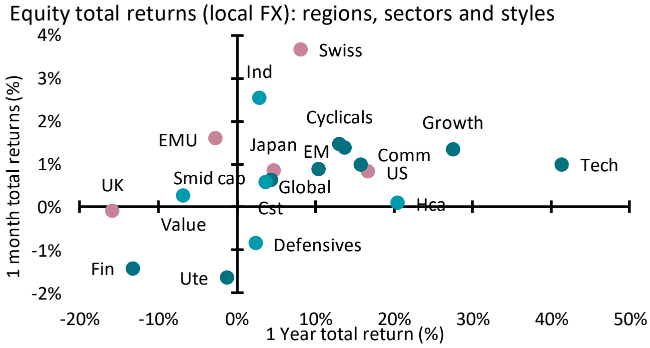
Earnings momentum on the rise

Global equities continued to grind higher over the month (Exhibit 17). Both growth and cyclical stocks outperformed benchmarks, helped by improving data and the robust liquidity backdrop. Earlier in September, there was a crack in equity momentum despite an upbeat macro data flow. This was driven largely by a correction in US technology stocks, with the Nasdaq experiencing around a 10% drawdown in just three days. Various market commentators have attributed this to an aggressive unwind of bullish positioning in equity derivatives counters.

Exhibit 17: Global equities continue to grind higher

Equity total returns (local FX): regions, sectors and styles

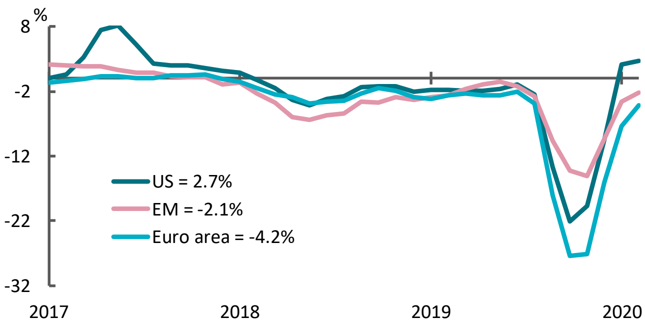


Source: Datastream and AXA IM Research, 21 September 2020

Earnings revisions have been trending upwards after troughing in May and are now in positive territory in the US (Exhibit 18). The second quarter reporting season was encouraging with strong positive surprises. Similarly, dividend pay-outs have not been cut to the extent initially envisaged suggesting that corporate fundamentals have overall been more resilient than expected at the onset of the crisis. In this sense, markets do appear vulnerable to a growth disappointment given that a rather optimistic economic rebound seems to be increasingly getting priced in.

Exhibit 18: A "V shape" recovery in earnings revisions

3M earnings revisions: US, Euro area & EM

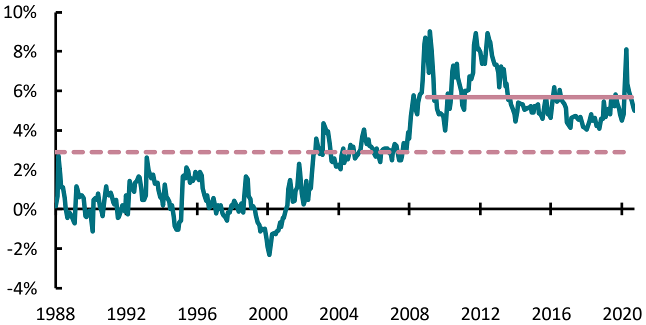


Source: Datastream, IBES and AXA IM Research, 21 September 2020

Consensus estimates signal that global earnings are expected to decline by 19.3% in 2020 and then rebound by 29.7% in 2021, implying that earnings per share is expected to regain its 2019 high water mark by end next year. With the repricing in interest rates, relative to bonds, the earnings yield gap is still arguably wide at 5% 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). Volatility is likely to remain elevated given the uncertainty surrounding the virus, lack of earnings visibility and the political landscape.

Exhibit 19: Looking across the valley

AC World earnings and bond yield gap (FY1/FY2 EPS)

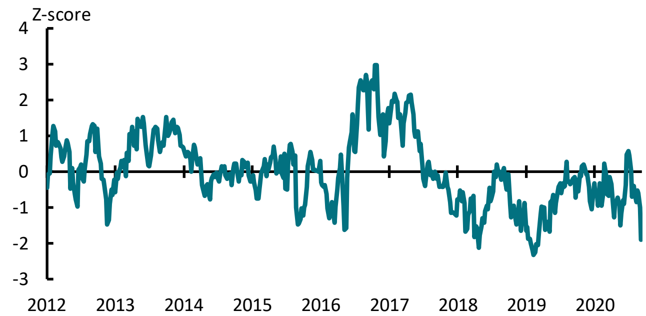


Source: Datastream, IBES, Bloomberg and AXA IM Research, 21 September 2020

Policy support remains a key tailwind with both a monetary and a fiscal 'put' well in place while the recovery looks more sustainable as a vaccine gets more likely. Considering the level of rates, valuations are not alarming with the equity risk premium having room to compress. The huge dispersion between growth and value styles persists with the crisis reinforcing the strength of the tech sector with the lift to digitalisation and lower bond yields. Crowded positioning, rich valuations and regulatory hurdles remain as risks though. After the correction in US tech earlier this month, some positioning indicators are signalling less excess (Exhibit 20).

Exhibit 20: Some indications of cleaner positioning

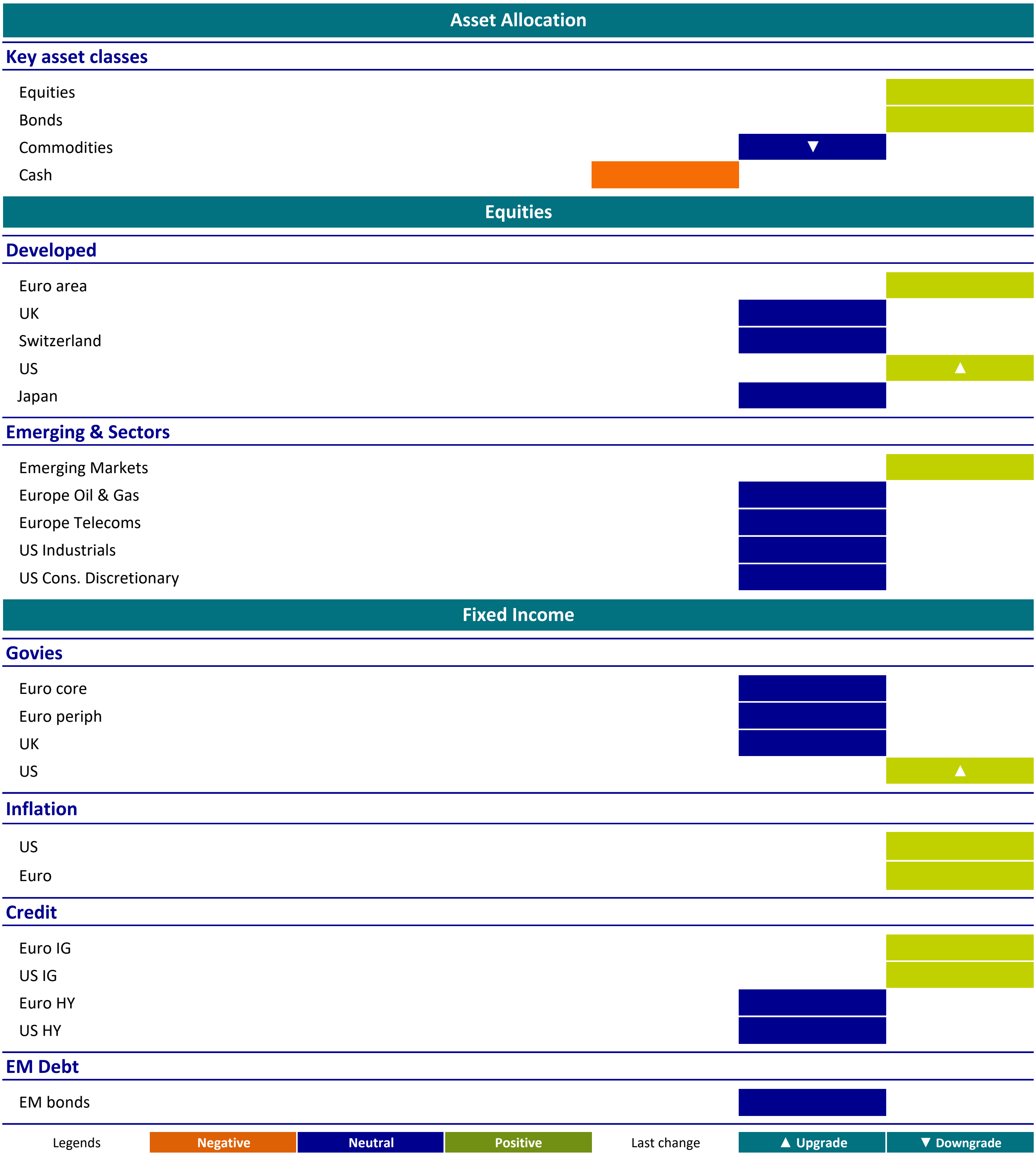
CFTC Nasdaq net speculative futures positioning



Source: Bloomberg, Commodity Futures Trading Commission (CFTC) and AXA IM Research

We remain overweight equities in our multi-asset allocation framework. In the face of our constructive stance on the asset class, we acknowledge that selectivity remains key given the high degree of uncertainty. Overall, we continue to believe that recovering activity, aggressive policy measures, subdued positioning and an ultra-low hurdle rate in other assets should support equity markets in the medium term.

Recommended asset allocation



Source: AXA IM Macro Research – As of 23 September 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**	**-6.4**		**4.8**	
US	**2.3**	**-4.7**	-5.2	**4.6**	4.0
Euro area	**1.3**	**-7.7**	-7.9	**5.2**	5.7
Germany	**0.6**	**-5.3**	-6.1	**4.3**	4.7
France	**1.3**	**-9.6**	-9.6	**7.4**	7.2
Italy	**0.3**	**-9.7**	-10.2	**4.9**	5.7
Spain	**2.0**	**-11.7**	-11.7	**6.9**	6.9
Japan	**0.7**	**-5.8**	-5.3	**3.1**	2.5
UK	**1.4**	**-10.0**	-9.9	**7.5**	6.4
Switzerland	**0.9**	**-6.5**	-5.6	**4.5**	4.4
Emerging economies	**3.6**	**-3.0**		**5.8**	
Asia	**5.2**	**0.5**		**7.2**	
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**	**-1.3**		**6.5**	
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 23 September 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**	0.9	**1.6**	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**	**0.7**	0.7	**1.5**	1.4
Switzerland	**0.4**	**-0.3**	-0.7	**0.3**	0.2
Other DMs	**1.8**	**1.4**		**1.9**	

Source: Datastream, IMF and AXA IM Macro Research – As of 23 September 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 Mar	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 Mar	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 Mar	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 Mar	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 23 September 2020

These projections are not necessarily reliable indicators of future results

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

Our Research is available on line:

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