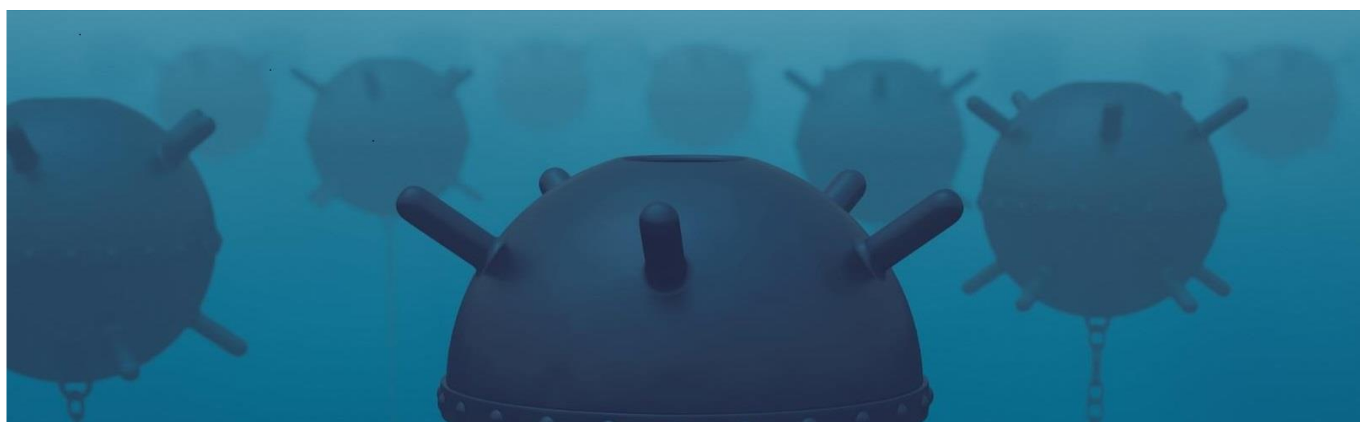
The virus has not gone away

Monthly Investment Strategy



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Key points

- A genuine gap is emerging between the US and Europe on the pandemic front
- So far differences in policy initiatives on either side of the Atlantic have made up for this short-coming
- Interdependency of virus control, policy and rising activity is key to markets remaining positive
- We need to see a turnaround in earnings to relay the flow of money into risky assets

More cases, more stimulus?

A gap has emerged within advanced economies between the US and Europe on the pandemic front. True, large clusters continue to be discovered in the Euro area and the jump in the virus reproduction ratio in Germany calls for attention, but overall, the decelerating trend continues. In the US the re-acceleration is spreading across more states every week and the rise in hospitalisations suggests this is not a by-product of more testing.

While the reluctance of political authorities to delay the re-opening of the US economy is crystal-clear, focus may shift from “top down” directives to decentralized decisions by businesses and behavioural changes by consumers. This

should affect the balance of risks around the shape of the recovery. The consensus view was firmly that every country would be heading – with some lags – towards at least a pause in the pandemic in Q3. Focus was more on the risk of a "second wave" next winter. A risk now is that the re-opening in Q3 could be slower or less effective than expected.

Still, the resilience of risky assets in such a configuration is striking. So far, policymakers have always been able to respond to market wobbles with more stimulus. For instance, last week the Federal Reserve (Fed) announced that it would start intervening on the secondary market for corporate bonds providing the market with another "sugar rush". In truth, this scheme had already been pre-announced in the 23 March package, but some investors might have feared that the Fed would be content with its approach so far (supporting the corporate bond market indirectly by purchasing Exchange Traded Funds). A news release from Bloomberg according to which the Trump administration was working on a USD1tn fiscal stimulus plan focused on infrastructure investment – thus providing more long-term support than the current emergency response – also helped.

European policymakers are showing more restraint though. The success of the European Central Bank's latest Targeted Longer-Term Refinancing Operation (TLTRO) is a reminder of the extraordinary support from monetary policy, but the fiscal push is, on aggregate, more cautious than in the US. While we expect a generic political agreement on the EU's "Recovery and Resilience" fund in July, many thorny technical details will still need to be hammered out and we don't expect much effective disbursement for 2021.

The markets are counting on unlimited firepower from economic policy. So far, they have been right, but we look with some concern at the autumn of 2020. By then a lot of emergency support measures are due to expire. Governments may by then move to longer-term stimulus (e.g. infrastructure spending) which could leave demand exposed for a few months. Our baseline is that by then the pandemic is well under control across all advanced economies, which would reduce the need for direct income support. If it is not the case, we should brace ourselves for another "wobble".

We need to see the turnaround in earnings

A "wobble" in the recovery process would prove troubling, especially for equity markets. Many indices are within 10% of their pre-virus highs with some – the NASDAQ and the S&P Growth index – even above. On some counts equity valuations look stressed. Dividends have been cut across the board and the latest consensus estimate of earnings per share for the coming 12-months is anywhere between 20% and 35% lower than recent "peak" estimates. Yet market level multiples have increased. Simply put, investors are paying more for less earnings in the short-term.

We have consistently stressed the importance of the policy measures put in place. The reduction of risk-free rates and the decline in corporate credit spreads go a long way to explaining the performance of the stock market since it bottomed on 23 March. The strength of the credit backstop – particularly in the US but also in Europe – has allowed credit markets to function well. Importantly, issuance has been up 100% on the equivalent period in 2019. Companies have raised funding to counter the impact of reduced revenues on their balance sheets. In other words, the functioning of the credit markets and the lower cost of funding has reduced the risk of insolvency for many companies.

Companies that remain in business can participate in the recovery in earnings when it materialises. Buying stocks today is like buying a call-option on future earnings. Price-earnings ratios always spike when the market is at trough earnings and will come down as and when earnings start to be revised higher.

Reduced bond yields and credit spreads can only go so far in supporting equity valuations. We need to see the turnaround in the earnings cycle which is very dependent on the broader macro recovery. Analysts are tentatively forecasting some improvement in numbers for next year with the 18-month ahead consensus for the S&P500 now some 12% ahead of the 12-month number. Yet companies themselves are still reluctant to provide much guidance so we attach the usual health warnings to equity analysts' optimism.

At some point credit risk premiums will bottom out. We are probably not far off in the major investment grade markets where spreads have re-traced a good two-thirds or more of their widening. Our credit teams do expect some further modest declines in spread, but the big moves are behind us. Fundamentals should become more important in sustaining the equity price gains already achieved and allowing positive returns to be sustained into 2021. This means the recovery remaining on track and policy remaining in place long-enough to allow companies to benefit from a pick-up in sales. Positive momentum has played a role in the equity rally to date and that itself is driven by a combination of the weight of money coming into risk markets and the news flow.

And therein lies the risk. If our baseline does not materialise and some of the recent trends in infection rates in the US and emerging markets cause a wholesale reassessment of the macro outlook, a significant equity set-back might be seen. The inter-dependency of virus control, policy support and rising activity is core to the market outlook. Disappointment on any of those factors would undermine returns to investors and probably require even more policy commitments to stabilise markets and investor confidence. By contrast, a breakthrough on finding a vaccine would constitute an upside surprise to markets and investors' expectations.

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

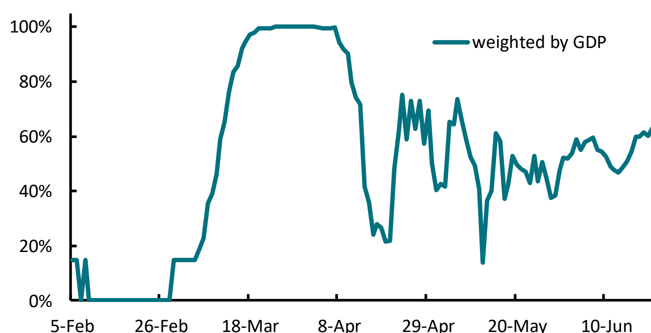
Global Macro Monthly – US

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

Economy bounces, but will the virus too?

We described the US's relatively early re-opening as a gamble. Currently it does not look like one that is paying off. Nationally, new cases began a gently rising trend from end-May. Worryingly, the number of states with accelerating cases has increased (Exhibit 1) – an alarming inflection point from previous declines. Risks of further spread were exacerbated as demonstrations raged across US cities after the police killing of George Floyd.

Exhibit 1: Virus cases begin to accelerate



Source: John Hopkins, Bureau of Economic Analysis (BEA), AXA IM Research, June 2020

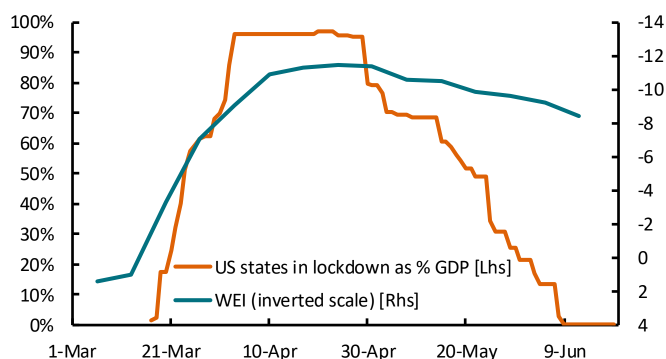
Recent data has pointed to clear, up-front gains from re-opening the economy quickly. Retail sales rose by 17.7% in May, employment by 2.5mn and June's Philadelphia Fed survey reached +27.5 from -56.6 in April. This is encouraging, but strong monthly growth rates can be beguiling after the scale of declines. Moreover, the Federal Reserve (Fed)'s weekly index is more circumspect in its improvement (Exhibit 2). We continue to expect GDP growth to contract by 10%qoq in Q2.

The outlook beyond is less clear. The pace of rebound in H2 2020 and beyond will depend on several factors, not least whether a persistent resurgence of the virus emerges and to what reaction. The labour market is also a key uncertainty. May's unexpected gain in payrolls was welcome but does not sound the all-clear. The Bureau of Labor Statistics stated misclassifications meant the unemployment rate was closer to 16% than the 13.3% recorded in May. Moreover, a vast number of households are being supported by the Paycheck Protection Program. It is unclear how many of these will return to jobs in the coming months. We retain an upbeat outlook for unemployment falling to around 8% by Q4. This would support a rebound in H2 but is far from certain.

Policy support will also be important. The government is considering further stimulus on top of the $2.7tn already provided. House Democrats proposed a $3.4tn package, but Senate Republicans have balked at this in the face of a rebounding economy. Meanwhile, the White House is mulling a $1tn infrastructure package. Further stimulus looks likely before the summer – we suspect around $1tn. A decision not to extend the unemployment benefit boost scheme would weigh on income growth and spending.

We have lowered our outlook for the change in US GDP for 2020 to -4.5% from -3.8%. This is above the consensus outlook for -5.7%. We envisage a more solid pick-up next year, pencilling in +4.6% for the year as a whole (consensus 4.0%). Even then, we forecast GDP to be 2.5% lower than the pre-COVID trend by end-2021, suggesting still elevated unemployment and subdued inflation.

Exhibit 2: Activity improves slowly as lockdown passes



Source: Auravision, NY Times, BEA, Federal Reserve Bank, AXA IM Research, June 2020

The Fed has spent much of the last month implementing measures it has announced. The Main Street Lending program opened this month, although had not secured any assets by 16 June. The Municipal Liquidity Facility had made $1.2bn of purchases and the Corporate Credit Facility increased to $7.0bn as the Fed expanded corporate bond purchases from exchange-traded funds to individual eligible names. However, monetary policy remained unchanged with the policy rate at 0-0.25% and the Fed committing quantitative easing (QE) to at least $80bn per month of US Treasuries and $40bn of mortgage-backed securities. For now, forward guidance remains broad-brushed, but we expect more explicit guidance to emerge in September.

The election countdown continues. President Donald Trump's campaign rally convened the most Americans indoors since the virus outbreak. If the election were tomorrow, Joe Biden would likely win. He leads the President in national polls by around 9 points, in key marginals and even in some unexpected states. A poor handling of the virus, an unprecedented economic shock and the George Floyd demonstrations have weighed on the President's approval rating. Economic recovery might narrow these margins, but the President has much to do to be re-elected.

Global Macro Monthly – Eurozone

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Economist (Eurozone),
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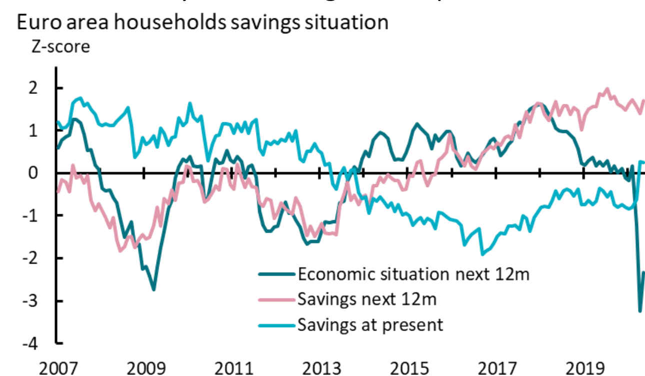
Focus turning to demand

It was no surprise, but it was grim news all the same as hard activity data were published for April, the key month of economic shutdown in most euro area countries. Overall industrial production for the region plunged by 17.1% month on month (mom) compared to a fall of 4.1%mom during the worst of the global financial crisis. Retail sales dropped by 11.7%mom. Data should rebound mechanically in May/June, as economies reopen. The Oxford COVID-19 Stringency Index – which measures the extent of lockdown – has been on a downward trend, reflecting plans for a return-to-normal across Europe. France has reopened bars and restaurants, intra-EU movement is now possible, and extra-EU borders are set to reopen on 1 July. Lockdown easing is reflected in Google community mobility reports, which show mobility volumes catching up to pre-Covid levels. Business surveys have rebounded and INSEE is now expecting French activity to run -12% below the normal in June, improving from -22% in May and -29% in April.

As economic activities gradually resume and supply-side disruptions normalise, focus is now turning to demand. High frequency indicators show some signs of awakening. Open table bookings are up – not only in German cities but also in Naples for instance – passenger car registrations are improving and the Banque de France monthly survey on retail trade posted a 50% mom increase in May. But details of consumer surveys are mixed, as consumers remain very concerned about unemployment prospects.

We have argued[1] that labour market developments will be a key factor for the shape and speed of the recovery. For now, short-time working schemes are helping to avoid a massive rise in unemployment rates, but employment growth and job vacancy rates have declined markedly. This may impact the way households spend the massive cash buffers they have accumulated during the lockdown. Monetary statistics showed that euro area households have added another €80bn to their bank deposits in April (compared with a long-term historical average of c. €20bn). The savings rate for French households jumped to 19.6% in Q1 2020 from 15.1% in Q4 2019. It is hard to disentangle forced savings caused by lockdown (consumers just could not spend) from precautionary motives. But avoiding a permanent increase in saving is crucial. Consumer surveys provide some reassurance here. While savings rates are elevated, saving rate expectations for the coming year are unchanged (Exhibit 3). Behind the mechanical rebound we expect in Q3, savings will be key to monitoring the strength of demand.

Exhibit 3: All eyes on savings developments



Source: Datastream and AXA IM Macro Research, as of 15 June 20.

Policymakers should also shift their focus from emergency measures to demand stimulus. Germany is leading the way with its latest fiscal package of €130bn (3.8% of GDP). Not all of it will be spent in 2020, but there is a welcome mix of short-term support – via temporary VAT cuts and one-off payments to families – and more structural, longer term incentives to investment programmes supporting the green and digital transition. The VAT cut alone would bring €20bn to the economy (1.2% of GDP over the second half of 2020), not an unsubstantial boost for an economy which so far has done comparatively well through the pandemic shock. Other euro area countries need to follow this path, or downside risks to our -7.1%yoy 2020 euro area growth forecast will accumulate. We also flag the need to keep a close eye on the virus reproduction rate (R), as countries ease restrictions and second wave risks loom.

EU institutions delivering

On the institutional front, the European Central Bank (ECB) continues to deliver. At its June meeting it surprised positively with a larger-than-expected boost to the Pandemic Emergency Purchase Programme (PEPP), adding €600bn for a total of €1.35tn. It also announced a six-month extension of the programme and a pledge to reinvest PEPP proceeds until end-2022. This provides a lot of visibility to markets for persistent loose financial conditions.

The EU has made its own meaningful intervention. The "Next Generation EU" proposal puts joint debt issuance, fiscal transfers and proposed joint tax revenues on the table. But we argue[2] the package is too small (c.5% of EU GDP) and slow (peaking in 2023-24) to be a proper cyclical stabilisation tool.

[1] Page, D., Yao, A., Menut, A. and Le Damany, H., "COVID-19 Update: Labour market deterioration to dampen rebound", AXA IM Research, 7 May 2020

[2] Menut, A., "COVID-19 update: Euro area policy response" AXA IM Research, 22 June 2020.

Global Macro Monthly – UK

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

Economy past its worst, but virus lingers

The UK continues to struggle with COVID-19. The number of virus-related deaths continues to fall and is far below the April peak, but new cases remain persistently high compared with European neighbours. The decline in cases has levelled off to around 1.3k/day since the start of June as lockdown measures were eased. This has delayed the economy re-opening further. Non-essential retail opened last week after 80 days of closure, compared with 70 days in Italy, mid-50s in France and Spain and 34 days in Germany.

April's monthly GDP fell by 20.4%, following -5.8% in March. The pace of rebound in May and June will determine the overall quarterly change. Mobility increased in May, but electricity output remained subdued. Retail sales posted a 12% rebound on the month, but the boost to broader consumption will be more subdued. We forecast GDP to rise by 4% in May and edge our Q2 forecast lower to -20.0% from -19.5%. The outlook for H2 2020 remains less clear and depends on the labour market. Unemployment remained at 3.9% in April, but 9mn workers are now furloughed. It is not clear how many will ultimately return to jobs. We estimate the unemployment rate to be 8-9% in Q4 this year. We forecast growth to fall by 9.1% in 2020, below the consensus 8.0%.

The Bank of England (BoE) added a further £100bn of QE in June, taking its total to £300bn. Chief Economist Andy Haldane voted not to extend QE and the BoE did not extend its corporate bond purchase programme. The Bank suggested the outlook for H1 was "less severe" than it had considered in May – however, then it had discussed a 14% contraction for 2020 as a whole. The government has announced plans to end its furlough scheme by end-October. However, rumours suggest further spending announcements next month. Government debt rose to 100% of GDP in May for the first time since 1963. Cash borrowing totalled £126bn in April and May, with £225bn of planned issuance for April to July.

Brexit has re-emerged to weigh on sterling. As expected, the government looks set to eschew the opportunity to extend transition in June, but has secured an intensification of trade negotiations from 29 June. We expect the UK to avoid resorting to World Trade Organization conditions from January and a bare-bones trade deal with extended implementation period looks most likely. This will fall short of hopes for a Canadian-style deal and will raise trade barriers from current EU conditions.

Global Macro Monthly – Japan

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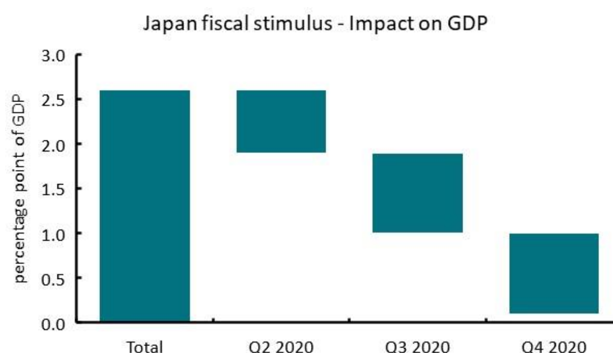
Government to the rescue

The government lifted its state of emergency, following a fall in the number of new cases. Economic activity probably bottomed in April, indicated by improvement in the May Services Purchasing Managers Index (PMI) to 26.5 from 21.5. On the manufacturing side, industrial production fell by 15.2% in April and should bounce in May. The manufacturing PMI declined for the fourth month to 38.4. This reflects an easing of the distortion in these indices caused by falling delivery times, usually perceived as negative, as supply chains recover.

Japan's government has approved a second economic stimulus package, totalling some ¥117.1tn (21.5% of GDP), roughly the same as the one adopted in April, bringing all measures to a staggering 43% of GDP. However, this includes significant contributions from the private sector and via government-affiliated financial institutions. Overall, we estimate net direct stimulus to be ¥30.7tn (5.5% of GDP), after allowing for other financial support and budget reserves. Historic estimates of fiscal multipliers suggest an impact of 2.6ppt of GDP in 2020 (Exhibit 4). We believe GDP growth will fall by 5.8% and the fiscal deficit will rise by 11ppt to 14% in 2020.

Exhibit 4: GDP stimulus from economic packages should reach 2.6 percentage points in 2020



Source: Cabinet Office and AXA IM Macro Research, as of 14 June 2020

The Bank of Japan (BoJ)'s June monetary policy meeting saw it state that it will closely monitor the impact of COVID-19 and *"will not hesitate to take additional easing measures if necessary"*. Forward guidance on yield curve control has been strengthened. The BoJ promises to "*purchase a necessary amount of JGBs without setting an upper limit so that 10-year JGB yields will remain at around zero percent.*" Credit transmission to the "real economy" seems to work well as bank lending in May sharply increased to 4.6%yoy.

Global Macro Monthly – China

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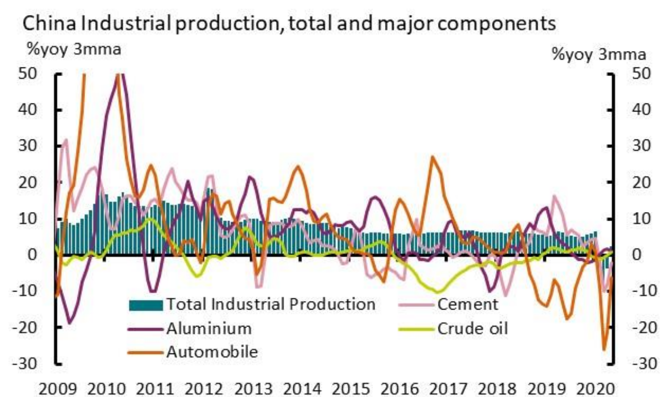
More evidence of growth resumption

After staging a V-shaped rebound, the recovery slowed somewhat. Industrial production growth accelerated to 4.4% year-on-year (yoy) in May from 3.9%, slightly below the consensus. But the detail of the data was not weak, with broad-based gains across major manufacturing sectors consistent with the better than expected PMI (Exhibit 5). The most standout was auto production, which grew by 6.4%yoy, its fastest pace since the first half of 2018. Various government incentives to spur pent-up demand seemed to prove effective in lifting sales and production of passenger vehicles.

Production of electronic, telecom and medical products also enjoyed strong growth, thanks to external demand, as seen in the May export data. However, forward-looking indicators continued to show lacklustre orders, hinting at renewed weakness once backlogged orders are cleared.

Exhibit 5: Industrial sector recovery continues



Source: CEIC and AXA IM Research, as of 16 June 2020

Finally, the booming construction sector gave a strong boost to production of heavy-duty equipment and raw materials. With government stimulus likely to keep infrastructure investment buoyant, we expect activities across the upstream and downstream construction industries to remain strong in the foreseeable future. Overall, with aggregate industrial production resuming growth since April, we now see upside risks to our flat GDP growth forecast for the second quarter.

Headwinds remain for the second half

Despite the rising growth momentum, China's economy is not out of the woods yet. We think the impact of weak global demand is yet to filter through, as headline exports have been flattered by the clearance of previous orders and shipment of medical equipment. Genuine demand, as reflected by the PMI export orders, has remained weak and will likely take a toll on export activity in the coming months.

In addition to external woes, China is also facing the possibility of a second wave of COVID-19 since it exited lockdown. A cluster of locally transmitted infections – more than 240 cases – were discovered in a wholesale market in Beijing since 13 June, which led to partial lockdowns of the city. The source of the infection is still under investigation, but the fact that the virus has penetrated perhaps the most diligently-managed preventive system, at least in China, shows just how stealthy the invisible enemy is. Even without a Wuhan-style shutdown, the local economy will suffer, and fears of contagion will propagate, leading to more cautious management of economic and social resumption. We have highlighted such a risk for some time, and it is concerning that this risk is materialising.

More easing needed to bolster the recovery

Thankfully it is not all doom and gloom. Barring a severe setback on the virus front, we think the natural demand in the economy should continue to recover. In the household sector, spending has normalised broadly in line with market expectations, with retail sales growth getting closer to breakeven (-2.8%). In fact, if it wasn't for restaurant sales and spending on gasoline – likely depressed in nominal terms by falling oil prices – the headline number might have turned positive in May. It is also encouraging that the retail sub-sectors, which reported growth were no longer just staples, but discretionary areas too including auto, cosmetic, electronic, furniture and home appliances – all of which are regaining some lost ground for the first time in four months. While the release of pent-up demand undoubtedly helped, we think the broad-based nature of growth suggests a genuine recovery in household spending is underway.

Finally, policy easing has also added strength to the economy. This was most obvious in the increased infrastructure investment growth, which accelerated to 8.3% in May. But higher credit growth suggests that stimulus effects have reached far across the economy. Notably, growth in house sales/starts turned positive – at 9.7% and 2.5% respectively – thanks to easier monetary conditions, even though policy easing was not intended to stimulate the housing market. The People's Bank of China also introduced two new facilities to assist lending to small enterprises, on top of its existing programmes, which helped to prevent business failures and keep the unemployment rate stable at 5.9%. Encouragingly, even service-sector output resumed growth, up 1%, in May. Being the largest sector of the economy, continued normalisation here will be critical for sustaining the overall recovery.

Global Macro Monthly – EM

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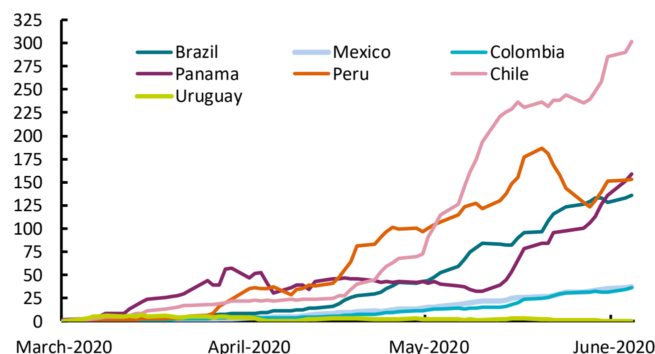
April's real activity indicators starkly illustrate the massive effect of lockdowns across emerging markets. For example, in Brazil, retail sales fell by 17.5% month-on-month, running at -44% on a three-month basis in seasonally adjusted terms. Elsewhere they were down 43% year-on-year in Colombia, -30% in Chile and -23% in Poland. On the same annual basis, industrial production was down 30% in Mexico, 31% in Turkey and 55% in India – the latter marking the lowest on record since the 1970s series' inception, but possibly exacerbated by poor data collection. Unemployment rose to 17% in the Philippines and 20% in Colombia.

Forward-looking indicators such as the Purchasing Managers' Index surveys for May suggested that April likely marked the lowest point in the global recession – yet any rebound in May will likely still leave manufacturing output contracting. June's data should start reflecting the easing of lockdown measures across the world and give more indication about the relative pace of recovery across the countries.

Latin America: The latest COVID-19 hotspot

The COVID-19 outbreak is presently unfolding quickly in South America. With the notable exception of Uruguay, daily new cases are still rising, despite lockdowns in place in many countries – raising concerns that authorities may not be able to control the health crisis (Exhibit 6). Brazil's outbreak has come into the spotlight given the chaotic management of the administration, with recurrent changes in health ministers and incoherent messages between the federal and the local authorities which may have led to a less stringent application of lockdowns. More worryingly, countries where the health response was quite good, such as Peru and Chile, are struggling to flatten the curve of the epidemic.

Exhibit 6: Latin America: COVID-19 hotspot



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

Given the uneven data availability across the region, Chile may prove a good barometer of the potential development on the ground, given its ample testing and likely better data reliability. The infection rate per capita appears more than twice as high in Chile than in Brazil, and eight times higher than Mexico's. The possible error of accounting in low-testing countries across the region may result in policy miscalculations regarding the timing of the end of lockdown measures ahead.

An additional shock for the region

Within the emerging market universe, Latin America is expected to suffer a deeper recession and a shallower recovery as it already had been struggling with low growth, as well as prolonged social and political tensions. Last year, growth decelerated sharply from already sub-trend levels as trade tensions rose: Mexico reported a slight contraction of 0.1%, while Brazil and Chile posted meagre expansion of 1.1%. The global lockdown has delivered an unprecedented shock to activity, beyond the 2008/2009 financial crisis. We forecast that GDP will contract by 7% in Brazil and Mexico this year, and by at least 5% in Chile and Colombia. GDP growth fell by just 2% in Latin America in 2009, with Mexico reporting the steepest drop, at -5.3%.

We expect a strong rebound in activity in the second half of 2020, on the back of improved external backdrop and policy support. Monetary policy has been actively seeking to ease financial conditions, cutting policy rates in the context of significant output gaps and disinflationary pressures, with some countries paving the way for the use of unconventional measures to provide liquidity and even quantitative easing. Chile's central bank has recently committed 10% of GDP's worth of liquidity in the form of credit support and set up an asset purchase programme. Fiscal policy is also being used in countries which have fiscal space, such as Peru and Chile. The other more fiscally-constrained nations, including Brazil and Mexico, are trying to provide spending responses by deferring medium-term consolidation plans. But this constraint is likely to limit the extent of the economic recovery into 2021 and beyond. The consumption recovery is expected to be more protracted given significant deterioration in the labour market, while the lingering health crisis is likely to provide an additional negative drag on growth. The main challenge for medium- to long-term growth remains the poor condition of public accounts. Measures will be required in the near-term to drive the structural reforms necessary to curb the rising public debt trajectories.

Investment Strategy – Cross-assets

Greg Venizelos,
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Research – Core Investment

Waiting for earnings

Credit backstops across most developed economies are helping corporates to improve their chances of survival – for the time being. Corporate revenues have fallen off a cliff and face the prospect of chronic decrease. Those that can still muster earnings growth are rewarded by the higher premium of the "future growth option". Investors are paying up for stocks that have a higher near-term survival rate and a higher longer-term growth rate potential. These are few rather than many, but they are "mega caps" who dominate indices and make equity appear expensive as a result, more so in the US. But much of the price action hinges on expectations for a decent rebound in earnings. Credit markets, the "TINA earner" class amid fixed income, continue to improve and spreads to narrow, a positive influence on equity markets. The ebb and flow of news about the virus and the veracity of the recovery will continue to generate short-term volatility. The trillion-dollar question is how quickly earnings can come back. Current expectations that 2021 earnings per share in the US regains its 2019 watermark may be somewhat overambitious.

Investment Strategy – FX

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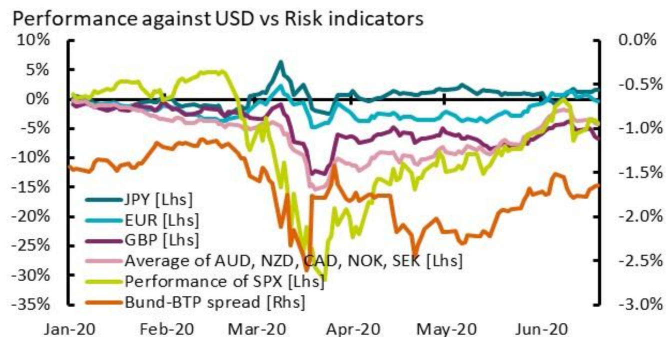
Risk on recovery finally bringing US Dollar down

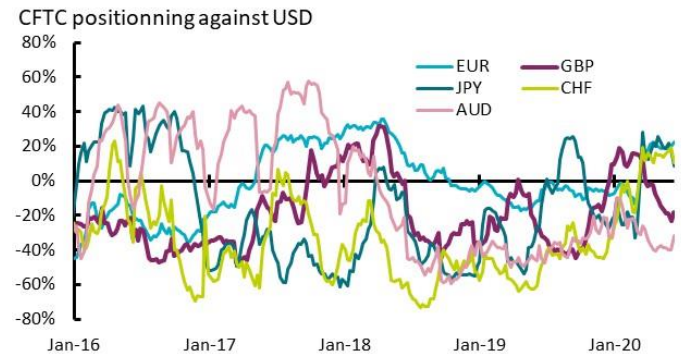
Exhibit 7: Risk-on rebound, JPY holds, GBP underperforms



Source: Bloomberg and AXA IM Research, 22 June 2020

The striking rebound in markets has brought USD weakness and its valuation has more room to fall. Fed liquidity, balance sheet expansion, defused risk aversion and US interest rates back in line with G10 should deprive the USD of support. Meanwhile, a brighter EU outlook due to the Recovery Fund, hinting at fiscal solidarity, suggests that the EUR may finally benefit, beyond a near term pause in its move higher. However, the interplay between economic reopening and infection reacceleration, is likely to drive near term swings in EURUSD. JPY has not been affected much by the recent risk-on tone (Exhibit 7) and looks set for further appreciation: Longer-term, JPY is the most undervalued currency within G10; shorter- term, lower interest rate differentials should depress unhedged foreign investment flows. Short bouts of risk-off could also benefit JPY. Positioning against USD remains light (Exhibit 8).

Exhibit 8: Positioning against USD remains light

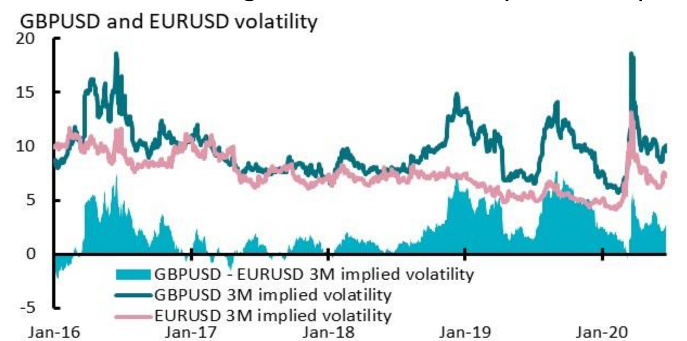


Source: Bloomberg and AXA IM Research, 22 June 2020

Sterling: a laggard in the risk-on pack

Despite enduring a 12% slump in March, GBP has not recovered as much as other risk-on currencies. Markets have progressively repriced the probability of a UK exit with a narrow or no deal, given little progress in negotiations so far and the UK's intent not to ask for an extension in the transition period (Exhibit 1 & Exhibit 9). Moreover, the UK has remained longer under lockdown than peers as new virus cases remain elevated, while the BoE flirting with negative rates and UK twin deficits are also headwinds.

Exhibit 9: UK-EU negotiations risk not fully reflected yet



Source: Bloomberg and AXA IM Research, 22 June 2020

In contrast, AUD is on a strong footing. Australia's current account has recently turned firmly positive and the Reserve Bank of Australia has enacted lighter monetary policy actions than other G10 countries while a similarly massive fiscal package was introduced. Australia has had far fewer cases of COVID1-9 and is much more advanced in its pandemic recovery. Its exports are also well positioned to benefit from infrastructure spending in China, while the pandemic is disrupting supply from other countries like Brazil.

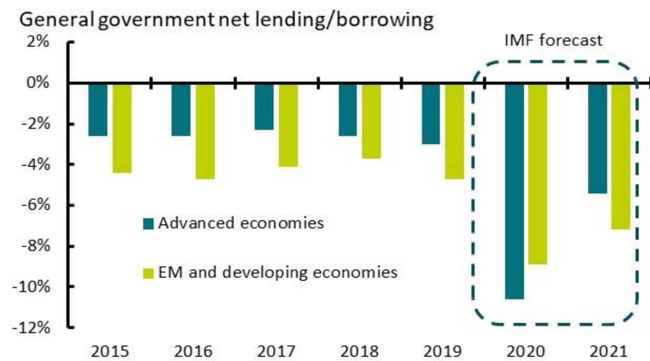
Investment Strategy – Rates

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

Reflections on Swap Spreads

A big wall of debt is being amassed on top of an existing huge wall. This is a direct consequence of economic policies put in place to counter the negative effects of the COVID-19 pandemic. According to International Monetary Fund (IMF) estimates, advanced economies' net borrowing is expected to increase from 3% of GDP in 2019 to over 10% of GDP by the end of this year. The increase in emerging markets' borrowing will be less extreme, albeit still of the order of four percentage points (Exhibit 10).

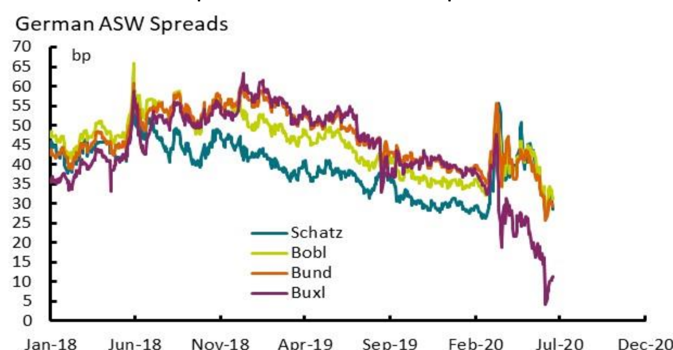
Exhibit 10: Expansionary fiscal policies



Source: IMF and AXA IM Research, June 2020

The corresponding increase in government bond issuance is unavoidable and the street's estimates for 2020 range anywhere from 60% to 110% higher than 2019, depending on the issuer and currency of denomination. While the supply pressure is likely to be concentrated in shorter maturities, at least in the early stages of the process, we cannot exclude a competitive scenario: Given the structural difference between bond demand and bond supply elasticities, it is highly unlikely that all issuers will be able to find enough demand to fulfil their enhanced programmes.

Exhibit 11: Compression in German spreads

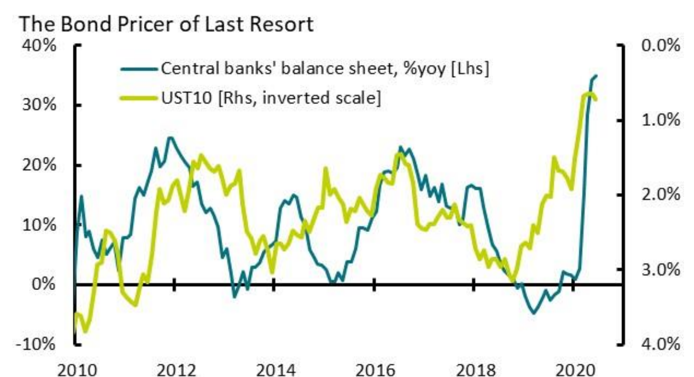


Source: Bloomberg and AXA IM Research, June 2020

We are already experiencing the first iteration of this process, which is likely to be the driving force behind the recent compression in swap spreads. For example, German swap spreads have compressed year-to-date, especially at longer maturities, where supply/demand imbalances are more likely to have a marginal effect on relative valuations (Exhibit 11): German Buxl bonds have been almost 28 basis points cheaper than EURIBOR since the end of 2019.

Of course, this new supply/demand dynamic should be seen in the context of an unprecedented expansion of central banks' balance sheets. Since the start of the year, the combined balance sheet of the Bank of Japan, Federal Reserve and European Central Bank has increased by $4.7tn or 32% (Exhibit 12) – and central bank balance sheet dynamics tend to affect government bond valuations. But, aside from the lengthy discussion about inflation targeting, the nexus between central banks and bond markets also asks key questions: Is this monetary financing when reserves are now remunerated? Are there absolute limits? And what about the social costs of income inequality and wealth concentration?

Exhibit 12: Bonds and central banks



Source: Bloomberg and AXA IM Research, June 2020

We're in a complex environment, where the standard interplay between monetary and fiscal policy is somewhat blurred by the need of a fast and strong response to the COVID-19 emergency. The compression in swap spreads is an important signal both for investors and policy makers. The latter should be wary of pushing the boundaries of economic policy beyond certain limits. The concept of a risk-free asset and the almost infinite demand for it is predicated upon unlimited confidence and trust.

As far as investors are concerned, a change in an otherwise-stable relative valuation might have quite important consequences. For example, a structural cheapening of the long end of the cash curve might attract a new breed of investors into an unnatural habitat, thus altering their risk exposure. On the other hand, regulated investors (e.g. insurers) might face a structural change in asset/liability ratios, simply a consequence of the significant compression between LIBOR and cash curves.

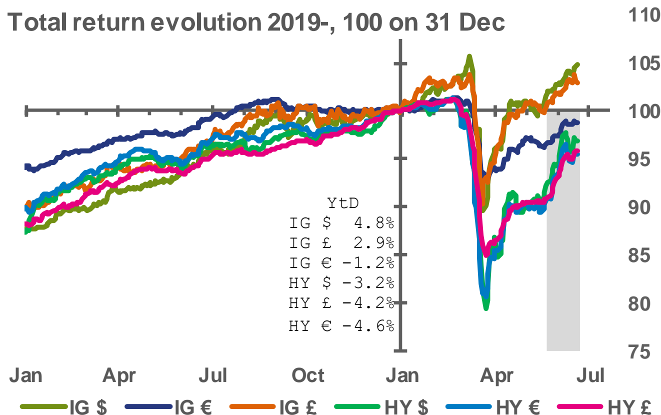
Investment Strategy – Credit

Gregory Venizelos
Credit Strategist
Research – Core Investments

Stellar returns no longer reflect Covid shock

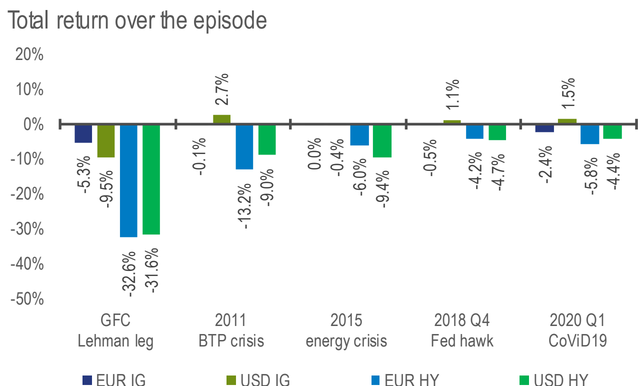
The recovery in credit returns resumed over the past four weeks after a pause between mid-April and mid-May (Exhibit 13). The move has been one way in the long duration markets like US dollar (USD) and UK sterling (GBP) investment grade (IG). These two markets have all but recouped their pre-Covid high watermark. Less so for high yield (HY) where it has been a game of two halves, as the 'cyclical rebound' trade lost steam over the past couple of weeks. Still, credit returns over the Covid episode have seen a material repair across the board and are now reflecting a market correction no worse than that in late 2018 (Exhibit 14).

Exhibit 13: Credit returns have improved further over the past 4 weeks (shaded)



Source: InterContinental Exchange (ICE) and AXA IM Research, June 2020

Exhibit 14: Covid drawdown in returns now no worse than that in late 2018



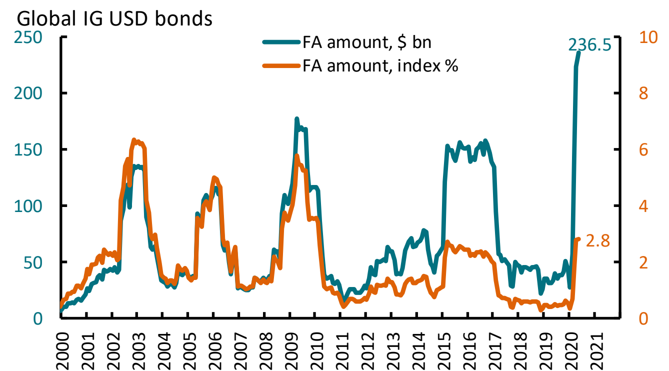
Source: ICE and AXA IM Research, June 2020

Following the sharp rebound in assets, a key concern for investors currently is the disparity between growth and unemployment prospects and stretched risk premia.

Can corporate earnings pick up the baton from income and liquidity support measures that may be coming to an end? What about the risk of a second wave of infections (or unextinguished first wave) that knocks back the nascent recovery and causes lasting damage to consumer sentiment? Can central banks continue to expand their balance sheet and governments their liabilities in support without consequences? Clearly, the risk to investors from credit deterioration including bankruptcies, remains present.

Rating migration lower now entrenched

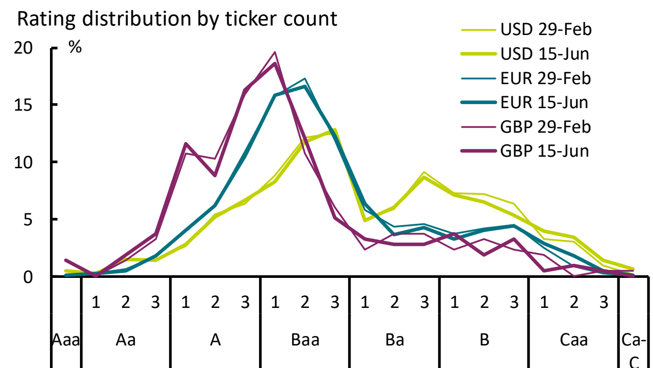
Exhibit 15: Fallen angel volumes over a 12-month period setting new records



Source: ICE and AXA IM Research, June 2020

The pace and volume of fallen angels (credits downgraded from IG to HY) is setting new records (USD IG in Exhibit 15). According to our estimates, a further $250bn of USD IG index debt could potentially be downgraded to HY over the next 12 months. In such a case, the 12M volume of US fallen angels could double from an already record-breaking $236.5bn (Exhibit 15) to close to half a trillion and, as a share of IG, double from 2.8% currently (similar to the 2015-16 peak) towards 5.5-6% (similar to the dot-com and global financial crisis peaks). Should we reach $500bn of fallen angels in 2020, that would amount to over 50% of the BBB- cohort in the index at the end of 2019 ($901bn), or 40% of the USD HY index ($1215bn). Indeed, rating distribution curves already exhibit larger right-side tails (Exhibit 16).

Exhibit 16: right-side tails of rating distribution curves already getting larger



Source: ICE and AXA IM Research, June 2020

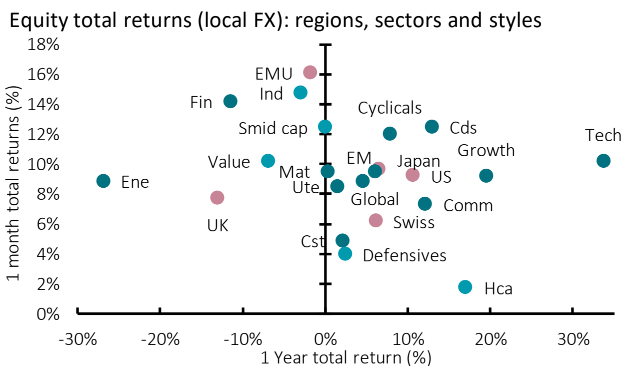
Investment Strategy – Equity

Varun Ghotgalkar,
Equity Strategist,
Research – Core Investments

Looking across the valley

Global equites are now trading a little less than 10% below their February highs. Over the past month, markets moved into risk-on mode with cyclicals outperforming defensives, and mid-caps leading. In terms of regional performance, the euro area led the pack with little differentiation between other major equity markets (Exhibit 17).

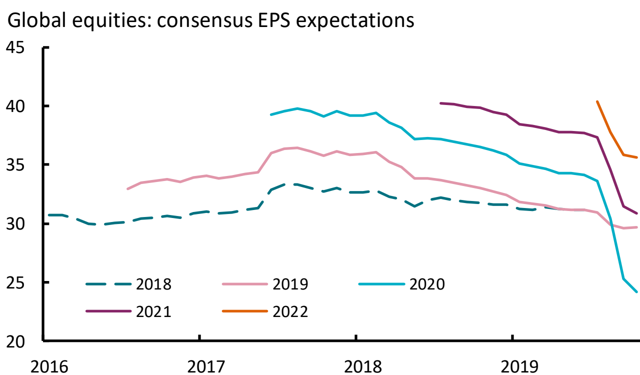
Exhibit 17: Cyclical rebound over the last month



Source: Datastream and AXA IM Research, 21 June 2020

Global earnings are now expected to decline by around 18% in 2020 and then rebound by 27% in 2021, implying that consensus earnings per share (EPS) for the global benchmark is expected to regain its 2019 high-water mark next year (Exhibit 18). Market optimism from end-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 policy measures. The other key factor at play is the lower interest rate environment which justifies a case for higher present values.

Exhibit 18: 2020… a lost year for global earnings

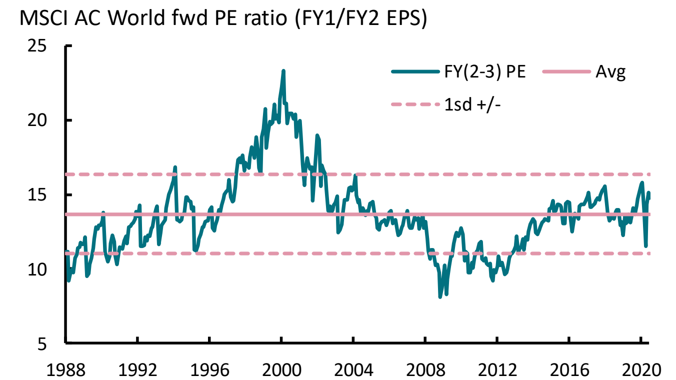


Source: Datastream, IBES and AXA IM Research, 21 June 2020

The risk/reward puzzle

Price-to-earnings multiples based on 2021-2022 EPS (given the poor earnings visibility for 2020) are now a little under 15 times, close to an 8% premium over the long-term average (Exhibit 19). With the repricing in rates, relative to bonds the earnings yield gap is still arguably wide at 6.1% compared to the long-term average of 2.9%, and more in line with the post-2009 average, which has been around 5.7%.

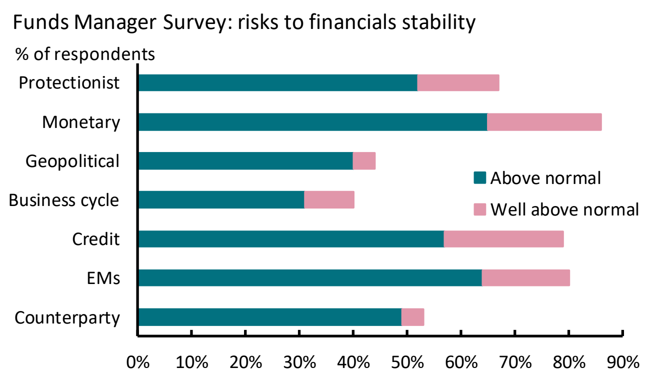
Exhibit 19: Looking at multiples on 2021-2022 earnings



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

Overall, the way the economic growth shock plays out going forward, versus the policy stimulus backstop, remains key. It goes without saying that the upbeat performance of the asset class rests on the assumption of no material deterioration in outlook for the virus. As the world re-opens for business, investor perception of broader risks – including protectionism, monetary, credit and emerging markets – remains relatively elevated (Exhibit 20).

Exhibit 20: Investors' risk perception remains elevated



Source: Bank of America Securities and AXA IM Research, June 2020

With the various risks and upcoming US presidential elections, volatility is likely to persist well into the fourth quarter. The market continues to try to price the uncertain growth trajectory, stimulus impact and recovery prospects in the second half of the year. Given the high degree of uncertainty, selectivity remains key. We remain medium-term constructive given the easing lockdowns, the strong monetary stimulus packages and fiscal impulse put in place.

Recommended asset allocation

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

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

Source: AXA IM Research – As of 23 June 2020

Macro forecast summary

Real GDP growth (%)	2019*	2020*		2021*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
World	**2.9**	**-2.9**		**6.1**	
Advanced economies	**1.7**	**-6.1**		**5.5**	
US	**2.3**	**-4.5**	-4.0	**4.6**	3.9
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**	-9.9	**5.4**	6.3
Spain	**2.0**	**-9.1**	-9.1	**7.7**	6.7
Japan	**0.7**	**-5.8**	-3.3	**3.3**	2.1
UK	**1.4**	**-9.1**	-5.4	**8.5**	4.7
Switzerland	**0.9**	**-4.9**	-3.3	**3.5**	3.6
Emerging economies	**3.6**	**-1.1**		**6.5**	
Asia	**5.2**	**0.5**		**7.2**	
China	**6.1**	**2.3**	1.4	**8.0**	8.1
South Korea	**2.0**	**-2.8**	-1.0	**4.5**	3.4
Rest of EM Asia	**4.4**	**-1.3**		**6.5**	
LatAm	**0.1**	**-6.5**		**6.5**	
Brazil	**1.1**	**-7.4**	-5.5	**8.3**	3.5
Mexico	**-0.1**	**-6.8**	-7.6	**7.0**	2.7
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**	**-2.5**		**4.0**	

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

CPI Inflation (%)	2019*	2020*		2021*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	**1.5**	**0.5**		**1.2**	
US	**1.8**	**0.5**	0.8	**1.7**	1.8
Euro area	**1.2**	**0.4**	0.4	**0.7**	1.3
Japan	**0.5**	**0.1**	-0.1	**-0.1**	0.2
UK	**1.8**	**0.6**	1.0	**1.0**	1.6
Switzerland	**0.4**	**-0.3**	-0.5	**0.3**	0.5
Other DMs	**1.8**	**1.4**		**1.9**	

Source: Datastream, IMF and AXA IM Macro Research – As of 23 June 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 TBC	TBC TBC
	Rates		unch (0-0.25)	unch (0-0.25)	unch (0-0.25)	unch (0-0.25)
Euro area - ECB	Dates	-0.50	16 Jul 10 Sep	29 Oct 10 Dec	21 Jan 11 Mar	22 Apr 10 June
	Rates		unch (-0.50)	unch (-0.50)	unch (-0.50)	unch (-0.50)
Japan - BoJ	Dates	-0.10	21-22 July 16-17 Sep	28-29 Oct 17-18 Dec	TBC TBC	TBC TBC
	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 23 June 2020

These projections are not necessarily reliable indicators of future results

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