For professional clients only
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Research & Strategy Insights

Slowly out of limbo

Monthly Investment Strategy

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Key points

- As some capacity is being re-created in healthcare systems, exiting lockdown by mid-May looks doable.
- We think it will be a subdued rebound though, and economic policy will need to help "for the long haul".
- The bounce in world markets implies an optimistic path forward, the reality in not totally known.
- One certainty is that central bank support will remain for a long time, securing government bonds as 'safe-haven's', but leaving returns uninteresting.
- Credit markets present more interesting opportunities.

Some (slow) life after the lockdown

The first goal of the lockdown was to re-create some capacity in the healthcare system so that a potential relapse in the pandemic would be more manageable. This is being achieved in most European countries. In Italy, which we use as a benchmark since the epidemic took off earlier than in the rest of the region, as of April 20 the number of people treated in intensive care unit (ICU) has fallen by 30% from peak. Some countries such as Austria, Denmark and Germany, where the infection rate had remained comparatively low, have already unveiled some precise timelines for a gradual relaxation of the lockdown, and Italy has tentatively set up 4 May as the date for the beginning of the process (11 May for France). We expect that by mid-May most of the Euro area will have started to normalise.

At peak lockdown the level of economic activity is at about two third of its normal level. With two weeks affected in March, mechanically GDP would be down by about 6% in the first quarter (Q1) relative to Q4 2019, and "re-opening" in the second half of Q2 would be consistent with another contraction of at least 12% in Q2, and probably more than that since the normalisation will only be gradual and it will impossible to return to the usual level of activity in the second half of the quarter. Some sectors such as hospitality will remain significantly hampered. Beyond the administrative measures, we can draw on the experience of China, which exited lockdown earlier, to expect a subdued pace of recovery, as precautionary behaviour will stop the accumulated "forced saving" to be immediately spent. We are also convinced that investment will take a lasting hit. Capacity utilisation has collapsed, and the level of uncertainty is still too high. Corporations across the world will probably hesitate to fully resume their capex programs as the possibility of a pandemic relapse cannot be ruled out. Singapore, lauded for its efficiency in controlling the epidemic in its early state, has last week passed the infection rate bar of 1 per 1,000, with an average growth rate in cases of 12% over seven days. This calls for prudence.

This means that economic policy will need to move from emergency support to medium-term accompaniment of the recovery. This will call for some re-thinking. For instance, state-guaranteed emergency loans to corporates are providing a vital lifeline, but their maturity is often short. In some cases – for instance in the Federal Reserve (Fed)'s Main Street Lending Facility – they are not particularly cheap (250/400 basis points (bps) above the Secured Overnight Financing Rate, on top of a 100-bp origination fee). This may create undue pressure on corporate cash flows and impair the speed of the rebound. Longer amortisation will be needed.

In general, fiscal policy will have to keep its tap open long after the acute phase of the pandemic is behind us, and central banks will face some thorny decisions. The most important one in our view is how quickly they will "offload" the public debt they have taken on their balance sheet. Reinvestment over several decades may be needed. This could be a difficult decision for the European Central Bank (ECB) in particular, since it would mean that it would not "re-converge" towards the capital key for a very long time

The market has in general saluted the quantum and policy support and decided to look beyond the catastrophic decline in GDP in the first half of – which indeed makes discussing GDP in annual average for this year quite irrelevant. What matters is the speed of the recovery in Q3 and Q4. We hope market pricing has adjusted to the numerous constraints which will make it look like a "swoosh" (the Nike logo) in our baseline, as well as to the possibility of quite a bit of "political noise" around the future of the stimulus.

Investors and certainty

However, given the uniqueness of the current shock, attempting to discern what markets have "priced-in" is a particularly unrewarding exercise. The bounce in world markets since 23 March implies an optimistic path forward, reflecting the scale of support from governments and central banks. The reality is the pattern of the recovery is not totally known. The growth forecasts are unnerving and navigating a path back to "normal" will not be quick nor easy. It is not clear markets can reflect those uncertainties.

Before the crisis, investors were faced with an "everything is expensive" problem. Risk premiums had been reduced by a generally benign global economy and comfort-blanket monetary policies. The shock has thrown risk-premiums in the air. There has not been this much dispersion amongst asset class performance for years. It has left some assets even more expensive and some a lot cheaper. Attaching risks to valuations is the challenge for investors in the uncertain recovery ahead.

One certainty is that rates are going no-where and central banks will remain engaged in markets for some time. This engagement creates a level of comfort on risk-adjusted returns for certain asset classes. Core government bonds are safe from a cash-flow point of view but not particularly interesting from a return point of view. However, support also extends to the credit markets, where there are more interesting return opportunities. The dislocation to markets in March made the short-end cheap, with yields higher relative to longer-dated maturities. For the US corporate bond market, the risk-premium of "yield per unit of duration" is the most attractive since the Fed stopped raising rates at the end of 2018. For European credit, today's levels are the most attractive since the Euro crisis in 2012.

The returns from short-duration fixed income are unlikely to be enough by themselves to meet most investors' longer-term return ambitions. Using the same risk-premium metric, the high yield bond market looks attractive as well. However, the uncertainty needs be adapted to a universe of highly leveraged companies. And yields were much higher in 2008. Moreover, the US market has the oil problem – energy still accounts for about 9% of the market. Having said that, there are not many occasions when investors are confronted by bonds offering these levels of yield and with the market, even at the speculative end, benefitting from a kind of out-of-the money put option.

The support for credit markets helps companies survive that may have been at risk of not surviving. That is a major support for equities. However, there will be companies that fail and sectors that shrink and the relationship between current stock market valuations and what is likely to happen to earnings seems stretched. That makes it hard to call equity market levels and short-term returns. The longer-term leaders of equity market performance will be companies that benefit from the changes that our economies will go through. Society will value more security in health, food and employment. Business models, supply chains and employee engagement will all change. Opportunities will flow from these trends. The shape of the recovery will become more certain over time, and that is when equities will come into their own in driving the recovery in wealth.

Download the full slide deck of our April Investment Strategy

Global Macro Monthly – US

David Page,
Head of Macroeconomic Research,
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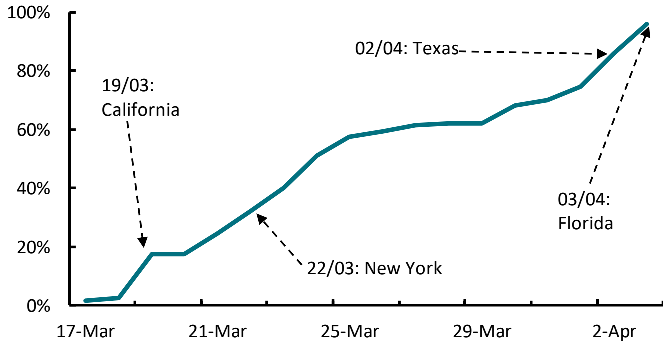
The economy enters shutdown

The number of coronavirus cases has continued to rise in the US. At the time of writing, the US has around 850k reported cases and has suffered 47k deaths. New York remains the worst impacted state, accounting for nearly one-third of the total cases. But several states, including New Jersey, Florida, Pennsylvania and California all have tens of thousands of cases. On the positive side, the number of new cases has slowed in the US, in part reflecting a deceleration in New York, but also slowing case growth more broadly following the piecemeal adoption of lockdowns (Exhibit 1).

Exhibit 1: The US practices lockdown in instalments

States in lockdown as % national GDP



Source: Bureau of Economic Analysis (BEA), Auravision, AXA IM Research, April 2020

The corollary of the virus and lockdown has been the inevitable impact on the economy. With lockdown only beginning in some states around the middle of March it is alarming to see the first of March's data arrive. Retail sales fell by 8.7% in March alone – the biggest ever one-month drop in spending. Industrial production fell by 5.4% the sharpest decline since the 1940s. Q1 GDP estimates are due at the end of this month. We forecast the first US GDP contraction since Q1 2014 and the steepest since 2009.

Yet Q2 promises to be significantly worse. Early indicators point to a material drop in economic activity, with key Federal Reserve (Fed) surveys recording declines previously off the scale (Exhibit 2). Real time trackers – aggregates comprised of more timely data –corroborate this outlook. The key question remains how long the US will remain in lockdown – an issue that has become more political.

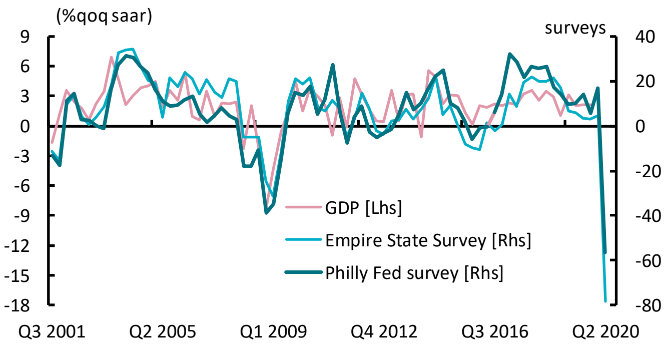
We forecast US GDP growth to contract by 3.8% on average across 2020, before rebounding by 4.0% in 2021. With unusually wide confidence intervals around our own estimate, we were surprised to see this close to Bloomberg consensus forecasts (-3.2% and +3.4% respectively). However, more telling is the greater than 5-percentage point (ppt) tails around this median consensus. For our part, we still see risks skewed to the downside. The International Monetary Fund (IMF) revised its US forecast lower for this year to -5.9%.

That said, the authorities have provided stimulus aimed at filling much of the expected shortfall in activity. The Federal government's $2tn stimulus CARES Act has been put to immediate use. $260bn was earmarked to bolster unemployment benefits by $600/week or four months. The 26mn increase in jobless claims in the past five weeks accounts for most of that. $250bn is in the process of being distributed directly to households by cheque or electronic payment. Moreover, the Small Business Administration (SBA) stated that the $377bn allocated to loans/grants to small business had been exhausted – the Senate has agreed a top-up which could reach $500bn. With much of the remainder going to state and local government ($340bn) or public health ($153bn), stimulus of around 9% of GDP is likely to reach the economy over the next few months.

The Fed is also playing a more direct role. In a recent package of measures worth $2.3tn, it announced a number of lending programmes aimed at facilitating lending to the real economy, backed by a further $200bn of the CARES Act stimulus. This is on top of the swift monetary easing that saw the Fed Funds rate drop to 0-0.25% and balance sheet expansion that has included the purchase of $1.4tn of US Treasuries and over $0.5tn of mortgage-backed securities (MBS), which have combined to see the balance sheet reach $6.5tn. The Fed has also, in the main, addressed liquidity questions in key dollar markets in recent weeks. We estimate a combined stimulus of around 15% of GDP. Yet still we fear further downgrades to growth estimates.

Exhibit 2: The US practices lockdown in instalments

GDP growth and Fed surveys



Source: BEA, Auravision, AXA IM Research, April 2020

It is almost as a footnote that we note that Bernie Sanders has withdrawn from the Democrat Primary Race to leave Joe Biden as the Democrat candidate to face President Donald Trump in November's elections.

Global Macro Monthly – Eurozone

Apolline Menut,
Economist (Eurozone),
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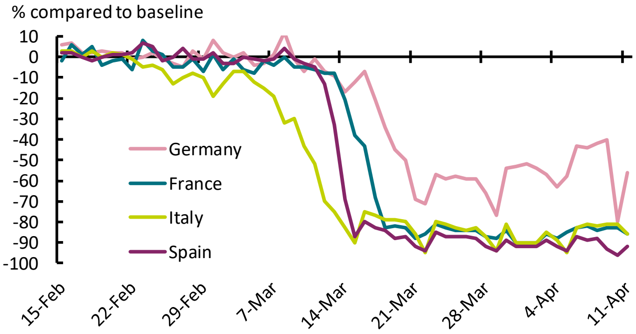
Easing lockdown ≠ return to normality

Soft indicators have, unsurprisingly, shown a massive effect from COVID-19. March Eurozone Composite PMIs plunged to an all-time low of 29.7, dragged lower by services sentiment, while consumer confidence posted its lowest point in six months. Further deterioration seems unavoidable as consumers reassess their financial situation and employment prospects. But traditional data are less relevant and reliable than usual as smaller samples, delayed and incomplete responses, selection bias across respondents and data collection constraints complicate the work of statistical offices. Incidentally, the Italian office ISTAT has suspended confidence surveys in April due to COVID-19-related operational issues.

Exhibit 3: Gauging the lockdown and exit strategies

EMU Retail and recreation mobility



Source: Google and AXA IM Macro Research, as of 17 April 20.

Tracking alternative measures such as electricity consumption (declines compared to the same period in 2019 range between c.10% in Germany to c.30% in Italy), traffic performance toll roads (down c. 27% year-to-date in Italy) or Google community mobility reports which show mobility trends for retail and recreation places down 56% in Germany vs. 92% in Spain becomes crucial (Exhibit 3). Such measures have been helpful to gauge the economic impact of the lockdown and will be critical to see how easing measures transmit to the economy. Indeed, some countries are loosening restrictions: small shops reopened on 20 April in Germany, industry and construction employees were back to work in Spain on 14 April, and phase 2 of the exit strategy from 4 May is being discussed in Italy. Governments pledge to adopt stop and go approaches, implying that the return to normal might be more gradual and bumpier than we expected. This, and the lack of coordination so far across the Eurozone on the exit plans, add significant downside risks to our -4.6%yoy 2020 Eurozone GDP growth forecast.

Policy responses stepping up but only small steps on solidarity

The European Central Bank (ECB) has put words into actions: flexibility regarding capital keys can be seen through March Public Sector Purchase Programme (PSPP) numbers which showed a strong bias towards Italy (c.32% of March PSPP vs. a capital key of 15.6% excluding Greece). The start of the Pandemic Emergency Purchase Programme has been strong as well, with EUR50.7bn cumulative purchases in its first three weeks of implementation. In addition, the ECB launched a package of temporary collateral easing measures, including a temporary increase in the Eurosystem's risk tolerance, the extension of eligibility to credit claims with a guarantee and to those of small size, a 20% reduction in the collateral valuation haircuts on all eligible assets and a Greek debt waiver. These measures reinforce the efficacy of the LTRO/TLTRO[1] III to provide a liquidity backstop for banks and incentives to lend to the real economy.

On the fiscal front, the responses have strengthened as well. Germany is now offering liquidity and state guarantees worth more than 38% of GDP, France has increased its support package to EUR110bn from 45bn, and Italy April decree include measures estimated at EUR 55bn.

Progress at the European level is more timid. The agreement at the latest Eurogroup meeting focuses on three pillars: i) a 2% of GDP European Stability Mechanism (ESM) credit line with, in principle, little conditionality; ii) a EUR100bn (loan-based) instrument to support employment efforts in each country (SURE program); and iii) a pan-European guarantee fund of EUR25bn from the European Investment Bank (EIB), which could support EUR200bn of financing for companies, with a focus on SMEs. We would highlight two things. First details remain vague. Conditionality for the ESM credit line has not been precisely defined, leaving room for interpretation of what precisely is covered by the line "direct and indirect healthcare, cure and prevention related costs due to the COVID-19 crisis". Nor is there clarity on what the "upfront assessments" and ex-post surveillance would look like. The second point we would emphasize is that it is not enough: the potential gains associated with the use of the EU support mechanisms are small. We calculate that Italy would save just 0.09% of GDP in interest spending, even by making full use of these three schemes.

A fourth point in the Eurogroup statement has more potential: a promise to work on a Recovery Fund to prepare and support the recovery. But the latest EU Council was short and inconclusive on this topic, as the question on how to structure the fund remains controversial. It tasked the European Commission to work on a proposal and to clarify its link to the EU budget, too little too late is a clear risk.

[1] Long Term Refinancing Operation and Targeted Longer-Term Refinancing Op.

Global Macro Monthly – UK

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

UK follows Europe down path of virus impact

The UK has followed other European economies with a steep rise in the number of recorded COVID-19 cases. At the time of writing, the UK has just over 140k cases and has seen 19k deaths. Unlike European peers, so far there is no obvious decline in the number of new cases, which have plateaued around 5k this month. The UK government extended its lock-down until 7 May at the earliest.

Indications of economic disruption are mounting. Consumer confidence and housing activity posted their sharpest monthly drops on record. The services PMI saw its worst monthly decline to 34.5 in March and then dropped further to 12.3 in April – with the manufacturing index falling sharply to 32.9 in the latest reading. Q1 GDP estimates are due on 13 May. We forecast the steepest contraction since Q1 2009 and envisage a much sharper drop in Q2. We expect activity to begin to recover in H2, but even then, forecast UK GDP growth at -4.7% for 2020 and 3.4% for 2021 (the consensus is -4.7% and 3.7%). And yet, as with other economies, our fear is that we underestimate the virus impact. The UK's Office for Budget Responsibility recently suggested a 35% drop in Q2 activity and -12.8% for the year, albeit assuming a far more persistent virus lockdown.

The UK authorities continue to try to mitigate the shock. A self-employment scheme was added to the policy measures, which we estimate to total £140bn – 6.3% of GDP. Implementation is now the material concern. As of 14 April, only £1bn in lending and 6,000 applications had been approved out of four million eligible firms, while the self-employed scheme is not due to be active until June. The number of estimated furloughed workers is currently 8mn, but even so, Universal Credit benefit claimants had risen by 850k to the end of March, with the self-employed encouraged to claim until their scheme was active. This could push unemployment temporarily above 10% in Q2.

The reduction in Bank Rate to 0.1%, the £200bn quantitative easing programme and macroprudential policies remain additional supports to the economy. Although the Bank of England (BoE) remains intent on meeting its inflation target and not providing monetary financing to the government, many misinterpreted the re-opening of the Ways and Means Account at the BoE – a government overdraft facility designed to help cash management during a time of heavy funding – as a step towards direct financing.

Global Macro Monthly – Japan

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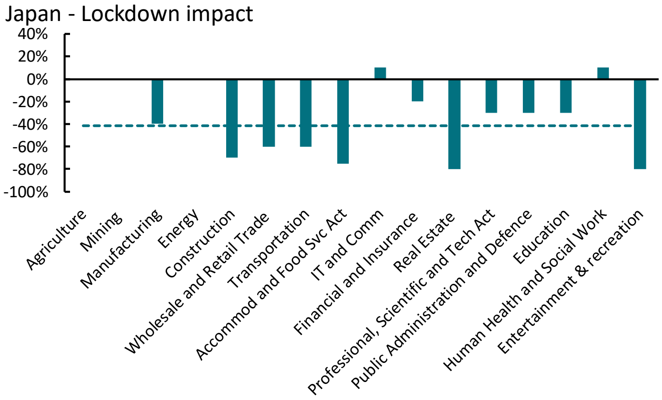
State of emergency

Prime Minister S. Abe expanded a state of emergency to cover the whole country on 16 April in an attempt to prevent the further spread of the coronavirus. Timing is key, with the move occurring before the Golden Week holiday. Some surveys have been published and testify to a huge drop in activity. The Economy Watchers poll broke records to reach 14.2 from 41.9 in January while the Tankan Diffusion Index reached levels last seen in 2008 and 2001.

Based on real time data series provided by Google Mobility Report, we have estimated the cost of the state of emergency by sector (Exhibit 4). Assuming containment lasts at least eight weeks, it would cost 6-8 percentage points of GDP in 2020.

Exhibit 4: Estimating the lockdown impact



Source: OECD and AXA IM Macro Research, as of 10 April 2020

In parallel, Abe announced a massive economic stimulus. The total program size should reach ¥118tn ($109bn), or about 22% of GDP, taking into account a planned ¥100,000 grant per person. Effective fiscal spending is likely to be a much smaller ¥25tn (4.6% of GDP), to include ¥12.3tn of household-support provisions; ¥6.2tn to support businesses through cash and financing assistance; ¥1.4tn to prevent the spread of the virus and bolster the healthcare system; and ¥4.9tn for the economy after the crisis (subsidy vouchers, reserve funds).

Other parts of the package are unlikely to have a fresh direct impact on GDP. It includes the deferment of tax and social security payments by SMEs (¥26tn), the expansion of lending and credit guarantee budgets provided by government-affiliated financial institutions (FILP), and the last economic stimulus package approved at the end of last year (¥20tn).

Global Macro Monthly – China

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First quarter growth marks the lowest on record

China's first quarter (Q1) GDP growth plummeted to -6.8% year-on-year (yoy), or -9.8% quarter-on-quarter, moderately better than our forecast of -7.5%, but worse than the consensus of -6%. Relative to Q4's +6%, this translates to a 12.8 percentage point growth slump, which is almost three times the size of the peak-to-trough decline during the global financial crisis. Given the breath and strictness of the economic lockdowns, activities in most sectors ground to a halt for the best part of February and were slow to recover in March. For the quarter as a whole, industrial activity contracted by 9.6%, making it the hardest hit sector by the virus-related shutdowns. The services sector did not fare much better, with growth declining by 5.2%, after a 6.9% expansion in Q4 last year. The primary sector saw the smallest growth contraction of 3.2%.

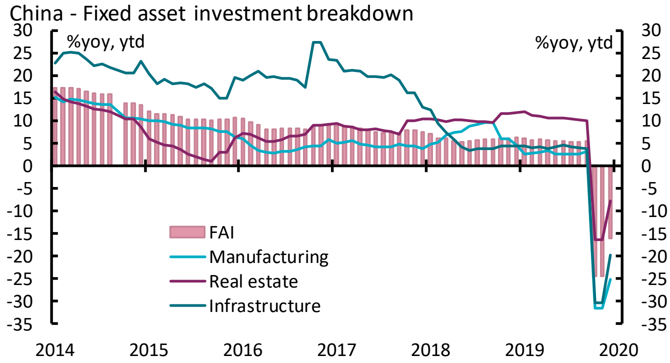
All in all, the GDP reading paints a grim picture of the economy in Q1 as it suffered its worst economic shock in decades. While the trough may be behind it, the path to recovery remains uncertain, given still-cautious consumer behaviour and rapidly deteriorating global demand. We maintain our below-consensus forecast of 2.3% growth for the year but see the balance of risks biased to the downside.

Recovery proceeds, but at uneven pace

More important than the GDP outturn is perhaps the slew of March data that offer a timely look into the current state of the economy. As expected, a noticeable bounce in yoy growth was recorded across all major indicators, following their steep declines in January and February. However, none of the data is "back in the black" in terms of yoy growth, dashing hopes for a V-shaped recovery. Industrial activity got close to "breakeven", with its growth decline narrowing to 1.1% from -13.5% in Jan/Feb. Mining and high-tech manufacturing production rebounded strongly, supported by faster work resumption in less labour-intensive industries.

Fixed asset investment growth improved by eight percentage points to -16.1% in March (Exhibit 5). Property investment made the largest contribution, with the yoy growth decline narrowing to 7.7% from -16.3% at the start of the year. Indeed, our high-frequency data on house sales showed an accelerated recovery in March, with activities now roughly back to the average levels of preceding years. Infrastructure construction growth also picked up apace, but yoy growth still fell by double digits (-19.7%). With local governments stepping up fundraising and Beijing quickening public-private-partnership project approvals, infrastructure investment growth is set to accelerate in the coming months.

Exhibit 5: FAI growth bounce following the Jan-Feb dip



Source: CEIC and AXA IM Research, as of 17 April 2020

The consumer sector remained cautious, with retail sales growth falling by 15.8%yoy, up slightly from -20.5% at the start of the year. While households' spending on staples, such as food, medicines and daily necessities, picked up as people were forced to stay at home, sales at restaurants and shopping malls continued to struggle. Although recent consumer surveys suggest that more people are going out and eating out, the level of activity remains only a fraction of the norm of previous years. What's also concerning is that labour market weakness could prolong the pain even if these sectors survive the initial shock of COVID-19.

Speaking of the labour market, we believe the March decline in the unemployment rate to 5.9%, from 6.1%, should be taken with a pinch of salt, as recent anecdotal evidence has pointed to deteriorating, not improving, job market conditions. Our analysis suggests that China's average unemployment rate could rise to 7.2% in 2020, with potentially a much higher reading in the first half of the year followed by some improvement later. Such a path for the labour market does not bode well for a strong recovery in household spending.

Policy is key to lifting growth

Overall, despite a slightly better GDP reading and improved March data, the economy is far from out of the woods. The fact that none of the monthly indicators have their head above water is a clear indication that the economy is still operating at sub-normal capacities. The driver of this slack has, in our view, shifted from supply deficiencies to a lack of demand. The latter can be addressed more effectively by counter-cyclical policies, which have been stepped up on the monetary side, but fiscal policy needs to play its part too. Relative to some developed countries, Beijing has fallen behind the curve with respect to fiscal stimulus, which risks prolonging a temporary shock and resulting in permanent economic scarring. We expect Beijing to roll out more supportive measures very soon, possibly before the upcoming National People's Congress gathering.

Global Macro Monthly – EM

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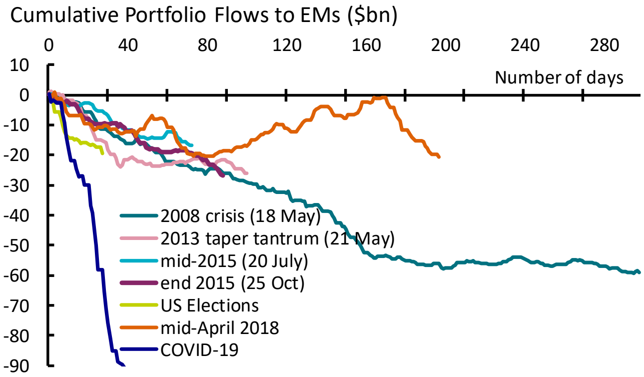
Unprecedented response to the crisis…

Emerging markets (EM) are currently undergoing four simultaneous shocks. There is both an external shock impacting more open economies through global supply chain weakness, and tourism-oriented countries, and an internal shock as the pandemic spreads and requires lockdowns affecting mobility and domestic spending. In addition, a trade shock has been caused by a large drop in commodity prices, and most notably the oil price, affecting exporting countries. Last but not least, there is a financial shock resulting from massive foreign capital outflows. According to the International Institute of Finance (IIF), some US$90bn of EM assets were sold in a matter of a few weeks - already exceeding full-year 2019 inflows (Exhibit 6).

Exhibit 6: Unprecedented EM outflows

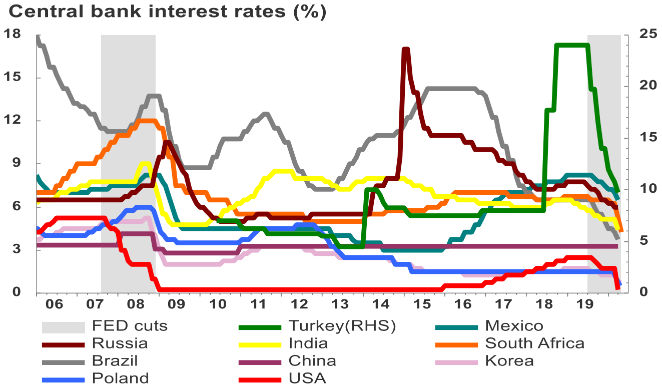


Source: IIF and AXA IM Macro Research, 13 April 2020

The extent of the recession ahead for EMs is highly uncertain. It will depend on the extent of the recession in advanced economies, on the duration and depth of the pandemic crisis within each country, and on the ability of the administrations to manage these health and economic crises. So far, policy responses in emerging countries have been less strong than those seen in advanced economies. There is generally less fiscal space, and a lot of the current fiscal packages are merely a reallocation of spending within budgets. Furthermore, central banks are less likely to accommodate additional spending by providing additional fiscal space as their developed countries counterparts are doing. Still, emerging markets central banks have responded in an unprecedented way by providing material monetary accommodation.

During past crisis episodes, which all manifested in the significant depreciation of EM currencies, central banks rather hiked interest rates in an attempt to stall the currency weakness by limiting portfolio outflows. This time, EM central banks are stabilising domestic balance sheets – i.e. households and domestic corporates - and not protecting their capital accounts (Exhibit 7).

Exhibit 7: Monetary policy easing following the Fed



Source: Datastream and AXA IM Macro Research

… but additionally, multilateral help is needed

The recent dollar liquidity squeeze was particularly worrisome. The US Federal Reserve extended currency swap lines with several EM countries' central banks, including Mexico, Brazil and South Korea. But a number of other emerging and developing countries may nevertheless be hurt by dollar shortages, which in turn could trigger outright balance of payments crises for countries with insufficient currency reserves.

The International Monetary Fund (IMF) has promptly provided $50bn in financing lines in order to help combat the coronavirus crisis in the poorest member countries, which is disbursed at present. Additionally, it has offered a payment holiday of debt reimbursement instalments for a period of six months. Among bigger emerging markets, there may be some additional candidates such as Argentina – which will need yet another IMF rescue plan – and potentially also South Africa, whose structural fiscal issues could morph into pressures on the balance of payments as portfolio outflows gain traction. Turkey, which is currently facing peak external debt repayments while the traditionally supportive tourism inflows are cancelled by the pandemic, is another candidate. Turkey's public debt is relatively low but its public finances have been stretched in the past years, and the recent acceleration in currency reserve depletion is worrisome.

Investment Strategy – Cross-assets

Greg Venizelos,
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Research – Core Investment

'Til debt do us part?

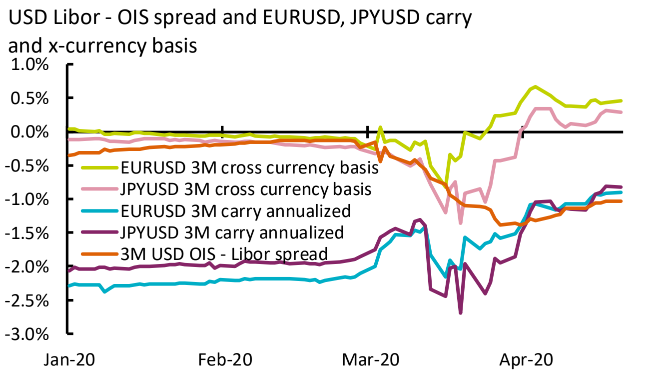
The big rise in government debt is one of the few certainties in our investment outlook. A key concern is how this problem will be dealt with going forward. Does it mean higher taxes down the road? How will some countries with more extreme fiscal positions be able to recover? Will inflation or debt relief – or both – be the more realistic option? In the next few years, most economies will have lower levels of growth and higher levels of debt. At the same time, interest rates levels need to be kept supressed. Government bonds might be safe, but they are not likely to deliver much in the way of real returns. The problem gets worse the longer the crisis goes on. Hopefully, rapid progress on the medical front will ultimately improve the prospect of an economic recovery, but even then, we are looking at debt levels at over 100% of GDP in many developed economies.

Investment Strategy – FX

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

Easy US dollar to cool down

Exhibit 8: Cheap x-currency basis but LIBOR stress lingers



Source: Bloomberg and AXA IM Research

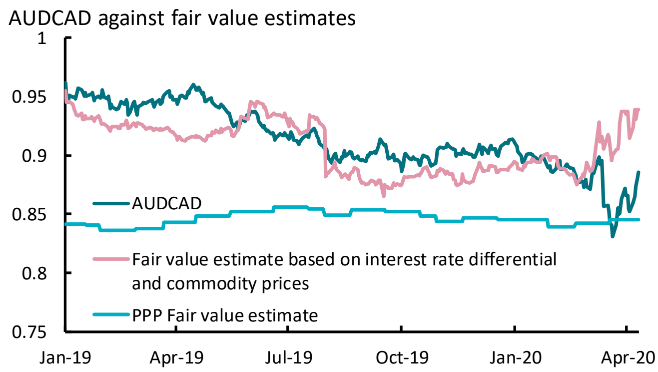
Fed intervention continues to point to a weakening of the overvalued US dollar going forward. Swap lines with major central banks have been effective in stopping liquidity costs from artificially pushing dollar carry higher. But tensions remain, and LIBOR markets still have some room to recover. Off-shore US dollar funding may have become more efficient through swap lines than the on-shore LIBOR market – the three-month LIBOR cross currency basis against the euro or Japanese yen is historically cheap (Exhibit 8). But the dollar carry has not become cheap yet – it is only just starting to reflect the Fed's easing. The ECB and Bank of Japan are more constrained, and the incentive for European or Japanese investors to continue unhedged dollar investments is shrinking. If anything, the incentive is to re-hedge existing exposures. This is particularly true for Japan where the interest rate differential is smaller and unhedged foreign investment is proportionally higher. The current environment also limits the potential for large Foreign Direct Investment flows to counter Japan's positive current account flows.

Net-net, we would expect the yen to appreciate against a weaker dollar. The euro should benefit too, but the case is more balanced. On one hand, US lockdown measures are lagging Europe, adding some downside to US growth. On the other, the chances of a large fiscal package in Europe are getting smaller, with debate revolving around European Union unity risks and concerns about the borrowing levels of some governments across the eurozone individually.

Another dollar race warms up

Commodity-related currencies have particularly suffered since the start of the COVID-19 pandemic, as their affinity with risk appetite would suggest. The Canadian dollar has so far resisted the double whammy of lockdown recession and very low oil prices, which pose a threat for highly leveraged households. The oil sector there looks particularly fragile with high extraction costs, global oversupply and depressed demand – Western Canada Select crude oil prices already trade at a large discount because of a capacity shortage. The Australian dollar looks better positioned to benefit from a restart of activity in China. In reaction to the pandemic, Australia has decided on a large fiscal stimulus, while monetary easing has been limited in comparison to the Bank of Canada (BoC)'s 150 basis point rate cut and quantitative easing. At the same time the virus transmission has already significantly moderated. Furthermore, the Australian dollar to Canadian dollar exchange rate (AUD/CAD) is mostly unchanged since the start of the year, despite fair value estimates and fundamentals pointing to a higher level (Exhibit 9).

Exhibit 9: AUDCAD cheap after BoC cuts and oil drop



Source: Bloomberg and AXA IM Research

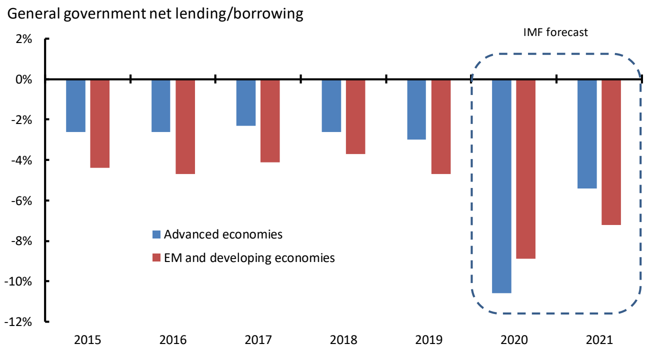
Investment Strategy – Rates

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

Demand for bonds: Not all that glitters…

As governments seek to support their economies, budget deficits will increase beyond levels seen in recent decades. In its World Economic Outlook, the IMF estimated that 2020's general government borrowing will sky-rocket to 10.6% of GDP in advanced economies and almost 9% of GDP in emerging market and developing economies (Exhibit 10). Financing needs are projected to remain elevated in 2021.

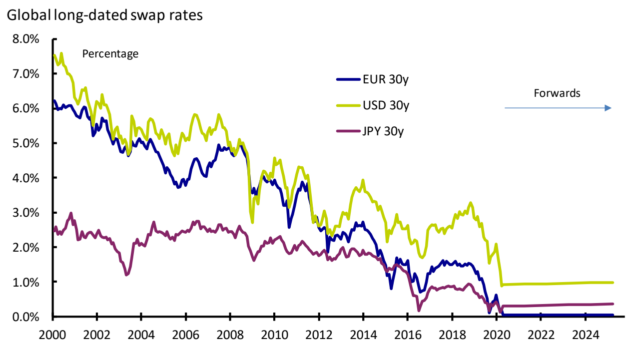
Exhibit 10: A wave of new sovereign debt is coming…



Source: International Monetary Fund (IMF) and AXA IM Research

The likely increase in supply will hit a global bond market that is already saturated with paper, especially in advanced economies, where debt-to-GDP ratios exceeding 100% are not at all uncommon. Furthermore, benchmark nominal bond yields are already historically depressed (Exhibit 11), thus raising a legitimate question about long-term valuations.

Exhibit 11: …at a time when rates are historically low

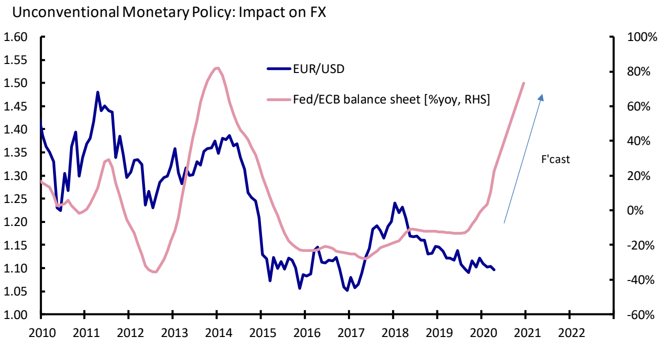


Source: Bloomberg and AXA IM Research

Crucially, who will buy all these bonds? Sovereign issuers have a broadly diversified investor base: 1) Regulated demand (banks, pension funds, insurance companies); 2) Non-regulated demand (asset managers, foreign reserve managers); 3) Domestic monetary authorities. This last investor category has attracted much interest in the aftermath of the global financial crisis, given their fascination with non-conventional policy instruments. As a percentage of domestic GDP, the size of the ECB's and the Fed's balance sheets has more than doubled over the past 10 years.

For the time being, central banks are in the game of occasionally filling demand/supply gaps that appear in the market. Of course, the rules of this game could change with a transition into a world of debt monetisation. It is nowadays rather fancy to associate these developments with the acronym MMT (modern monetary theory), while missing out on important aspects like Abba Lerner's "Functional Finance" dating from World War II[2].

Exhibit 12: Choose your portfolio currency wisely



Source: Bloomberg and AXA IM Research

The global investor community is at a bifurcation:

- If central banks purchase all the bond supply: The pressure is likely to build on the currency side. Which currency is more trustworthy in an environment of increasing central banks' balance sheets? Only one country has the luxury of printing US dollars (Exhibit 12). Another problem that is very likely to result from this strategy is a massive drain of secondary-market liquidity. In other words, price discovery across several asset classes will be severely impaired.
- If central banks do not purchase all the bond supply: We might face tough competition between sovereign issuers. Not every issuer will be lucky enough to meet strong demand, thus putting upward pressure on bond yields. As refinancing costs increase, so do risks to financial stability.

There will be competition among sovereigns, as a financial side-effect of the pandemic. And this competition will be tough, irrespective of the central banks' stance on debt monetisation. Again, not every Treasury is in a position as comfortable as the US Treasury. In this game, the bond and the currency are essentially different sides of the same coin. In a world plagued by asset inflation, the allocation across currencies and the mix between financial and real assets are key portfolio decisions.

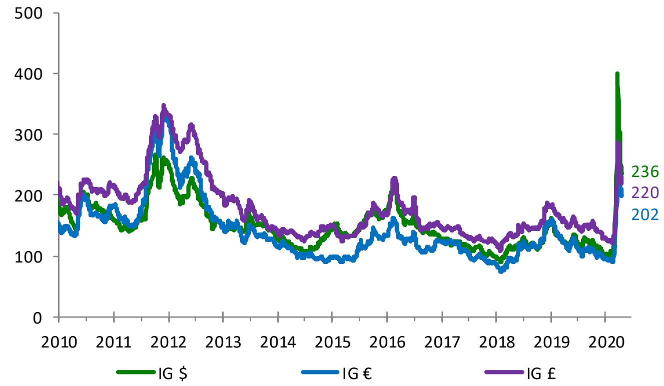
[2] Functional finance is a macroeconomic theory that seeks to eliminate economic insecurity through government intervention. Functional finance emphasizes the result of interventionist policies on the economy and actively promotes government deficit spending as an effective way of reducing unemployment.

Investment Strategy – Credit

Gregory Venizelos
Credit Strategist
Research – Core Investments

Spreads saved by the Fed and ECB…

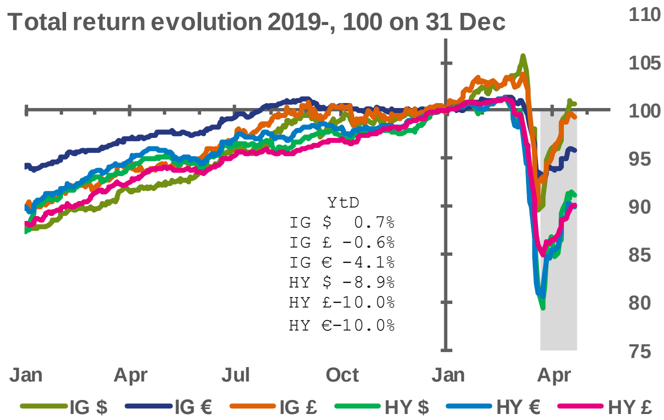
Exhibit 13: Credit spreads fall sharply after massive intervention by central banks



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

The massive policy intervention by central banks has 'nuked' credit markets into submission. A sharp retracement has brought spread levels back to the middle of their year-to-date range (Exhibit 13). In the US, this is even before the Federal Reserve (Fed) executes any credit purchases, for which It has earmarked up to $750bn across primary and secondary markets. This will comprise both investment grade (IG) and high yield (HY) bonds as credits downgraded to high yield (HY) post-COVID-19 are eligible. The European Central Bank (ECB) may purchase up to €200bn of IG credit this year.

Exhibit 14: Year-to-date returns have recovered sharply



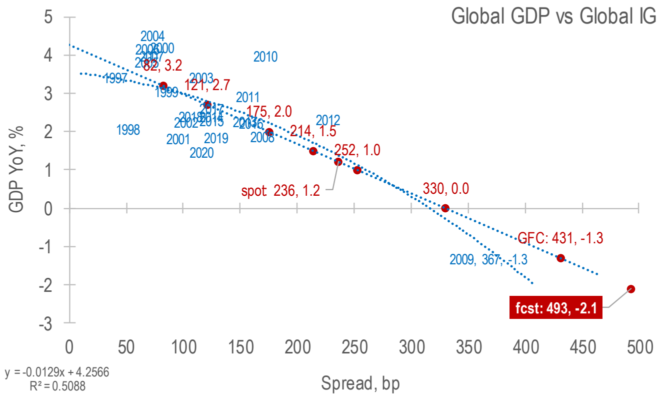
Source: ICE, Bloomberg and AXA IM Research

The impact of policy intervention has been a clear boon for investors, inasmuch as it has helped retrace half of the gut-wrenching drawdown in returns to mid-to-late March (Exhibit 14). US dollar IG is back to black even year-to-date, at 0.7%.

… but spreads no longer reflect fundamentals

At the same time, however, suppression of credit risk premia by central banks has driven a wedge between credit markets and growth fundamentals. Our current forecast for a 2%+ contraction in global GDP excluding China in 2020 (worse than 2008-09) is consistent with an IG spread more than double the current level ("fcast" vs "spot" on Exhibit 15). Spreads appear to become sub-linear at extremely low levels of growth (see curved line on Exhibit 15) but even then, the implied spread is 400bps compared to 236bps currently.

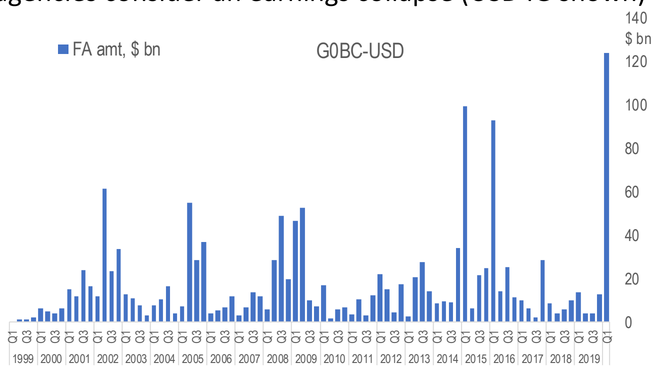
Exhibit 15: very big gap between current spread levels and growth expectations



Source: ICE, Bloomberg and AXA IM Research

As rating agencies started to consider the collapse in earnings in 2020, a shockwave of downgrades has driven volumes of fallen angels – credits downgraded from IG to HY – to explode. The amount of fallen angels in US dollars has seen a record-breaking quarter, reaching $120bn+ at an index level (Exhibit 16) and exceeding $150bn overall. In euros, it has been the second highest quarter with fallen angel volumes including index ineligible debt exceeding €40bn. Historically, a transition of 4-5% of IG into HY (1-2% realised so far) could see IG credit spreads at the start of the year completely eroded by mark-to-market losses due to downgrades. Current IG spread levels do offer some cushion in that respect, but the risk of a more protracted and severe recession could push fallen angels to 8-10% of IG.

Exhibit 16: Fallen angel volumes have exploded as rating agencies consider an earnings collapse (USD IG shown)



Source: ICE and AXA IM Research

Investment Strategy – Equity

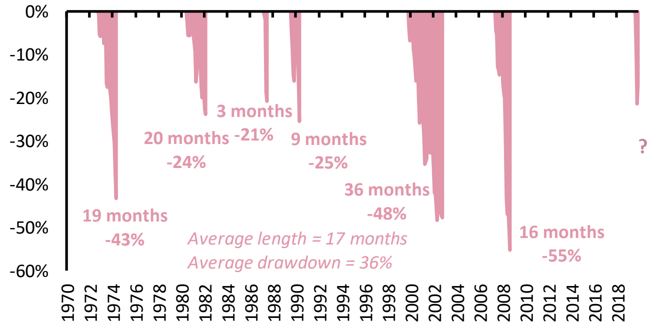
Varun Ghotgalkar,
Equity Strategist,
Research – Core Investments

Bear lockdown

Equity markets remain volatile amid the COVID-19 crisis. At the time of writing, the drawdown for global equities has been 18% (the peak to trough drawdown before the rebound was 34%) driven by a deterioration in the earnings outlook and recessionary fears. The timing and quantification of this situation is challenging, but high-frequency information on the evolution of the epidemic is crucial – given that the spread of the virus remains the biggest wildcard.

Exhibit 17: How deep is your trough?

Global equities historical bear markets

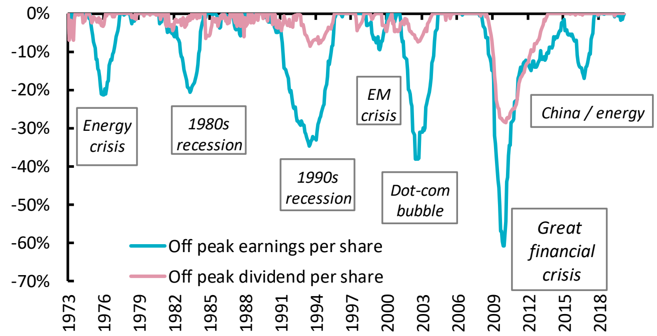


Source: Bloomberg and AXA IM Research

The six bear markets that have taken place since the 1970s had an average drawdown of close to 36% and typically lasted around 17 months. The range in terms of drawdowns lies between -21% and -55% with a meaningful variation in lengths, lasting anywhere between three months and three years (Exhibit 17). The uniqueness of different bear market triggers leaves little convincing evidence of recurring patterns to aid market timing. We expect activity to pick up moving into the second half of 202020, implying that the length of the equity slump is likely to be at the shorter end of previous drawdowns.

Exhibit 18: 2020 earnings to decelerate sharply

Global equities: EPS and DPS drawdowns



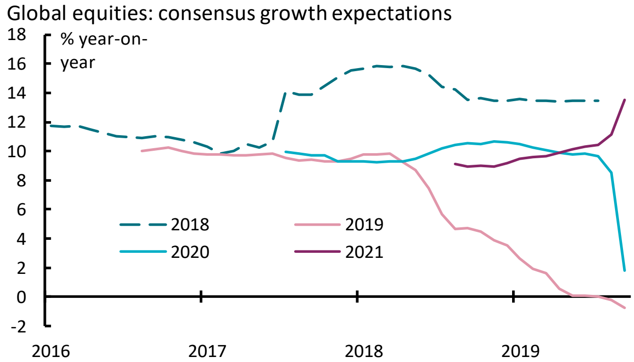
Source: Datastream and AXA IM Research

Lack of earnings visibility

The US earnings season started negatively. Earnings misses so far are attributable to a ramp up in loan loss reserves at banks. Companies have been suspending guidance and cutting shareholder pay-outs. Looking at historical precedence, an earnings contraction of around 25% appears to be priced in (Exhibit 18). This seems optimistic given the GFC precedent but reflects how the market is trying to price in the uncertain growth trajectory, stimulus impact and recovery prospects in the second half of the year. Still positive for global equities, consensus earnings expectations appear stale despite the large negative revisions (Exhibit 19).

Exhibit 19: Negative revisions still due

Global equities: consensus growth expectations

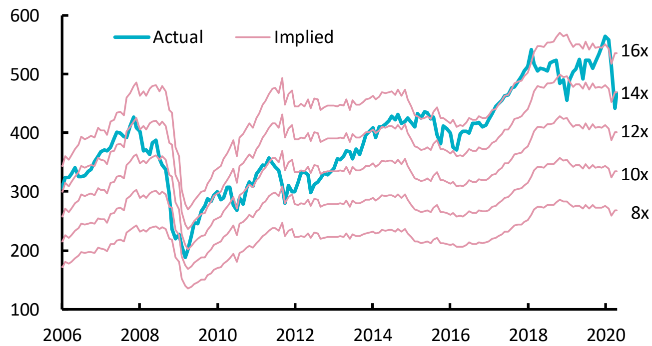


Source: Datastream, IBES and AXA IM Research

A sustainable rebound is likely to only be triggered once there is sufficient confidence that the virus is contained. Effective transmission of stimulus would give the rebound legs. Global valuation multiples are now back to around 14x forward earnings after the quick bounce back (Exhibit 20), with the earnings and bond yield gap close to record highs. Given that the grab for yield is likely to persist, equity risk premia proxies should be better indicators of value.

Exhibit 20: Are we there yet?

Global equities: forward price/earnings implied index



Source: Datastream and AXA IM Research

The way the growth shock versus stimulus backstop plays out remains key, as a rebound in sentiment rests on earnings visibility. We remain medium-term constructive, given the strong monetary stimulus packages and fiscal impulse put in place. In the near term, success of the containment measures is essential for a recovery to materialise.

Recommended asset allocation

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

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

Source: AXA IM Research – As of 24 April 2020

Macro forecast summary

Real GDP growth (%)	2019*	2020*		2021*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
World	**2.9**	**-1.9**		**5.4**	
Advanced economies	**1.7**	**-4.1**		**4.2**	
US	**2.3**	**-3.8**	1.9	**4.0**	2.0
Euro area	**1.2**	**-4.6**	0.9	**5.2**	1.2
Germany	**0.6**	**-4.7**	0.9	**5.4**	1.1
France	**1.3**	**-4.0**	1.1	**5.3**	1.2
Italy	**0.3**	**-6.6**	0.3	**5.3**	0.6
Spain	**2.0**	**-5.1**	1.6	**4.6**	1.6
Japan	**0.8**	**-5.8**	0.3	**3.3**	0.8
UK	**1.3**	**-4.3**	1.1	**3.4**	1.5
Switzerland	**0.9**	**-3.5**	1.3	**3.0**	1.3
Emerging economies	**3.7**	**-0.6**		**6.1**	
Asia	**5.2**	**1.8**		**4.9**	
China	**6.1**	**2.3**	5.6	**8.0**	5.8
South Korea	**2.0**	**-2.8**	2.2	**1.9**	2.4
Rest of EM Asia	**4.2**	**1.2**		**4.2**	
LatAm	**0.0**	**-3.4**		**2.5**	
Brazil	**1.1**	**-3.0**	2.1	**2.2**	2.6
Mexico	**-0.1**	**-4.7**	1.0	**3.0**	1.7
EM Europe	**3.2**	**-5.0**		**5.3**	
Russia	**0.9**	**-4.1**	1.8	**4.5**	1.9
Poland	**5.3**	**-4.6**	3.3	**3.6**	3.1
Turkey	**0.9**	**-3.4**	3.1	**5.3**	3.3
Other EMs	**1.1**	**-4.0**		**4.0**	

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

CPI Inflation (%)	2019*	2020*		2021*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	**1.3**	**0.0**		**0.7**	
US	**1.7**	**-0.8**	2.0	**0.3**	2.1
Euro area	**1.2**	**0.3**	1.2	**0.8**	1.4
Japan	**0.5**	**-0.1**	0.6	**0.3**	0.6
UK	**1.8**	**0.5**	1.6	**0.7**	1.9
Switzerland	**0.7**	**0.6**	0.3	**0.5**	0.7
Other DMs	**0.8**	**1.4**		**1.9**	

Source: Datastream, IMF and AXA IM Macro Research – As of 23 April 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	Q2 - 20	Q3 - 20	Q4 - 20	Q1 - 21
United States - Fed	Dates	0-0.25	28-29 Apr 9-10 Jun	28-29 Jul 15-16 Sep	4-5 Nov 15-16 Dec	26-27 Jan TBC
	Rates		unch (0-0.25)	unch (0-0.25)	unch (0-0.25)	unch (0-0.25)
Euro area - ECB	Dates	-0.50	30 Apr 4 Jun	16 Jul 10 Sep	29 Oct 10 Dec	TBC TBC
	Rates		unch (-0.50)	unch (-0.50)	unch (-0.50)	unch (-0.50)
Japan - BoJ	Dates	-0.1	27-28 Apr 15-16 Jun	21-22 July 16-17 Sep	28-29 Oct 17-18 Dec	TBC TBC
	Rates		unch (-0.10)	unch (-0.10)	unch (-0.10)	unch (-0.10)
UK - BoE	Dates	0.10	7 May 18 June	6 Aug 17 Sep	5 Nov 17 Dec	4 Feb 18 Mar
	Rates		unch (0.10)	unch (0.10)	unch (0.10)	unch (0.10)

Source: AXA IM Macro Research - As of 23 April 2020

These projections are not necessarily reliable indicators of future results

Our Research is available on line:

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