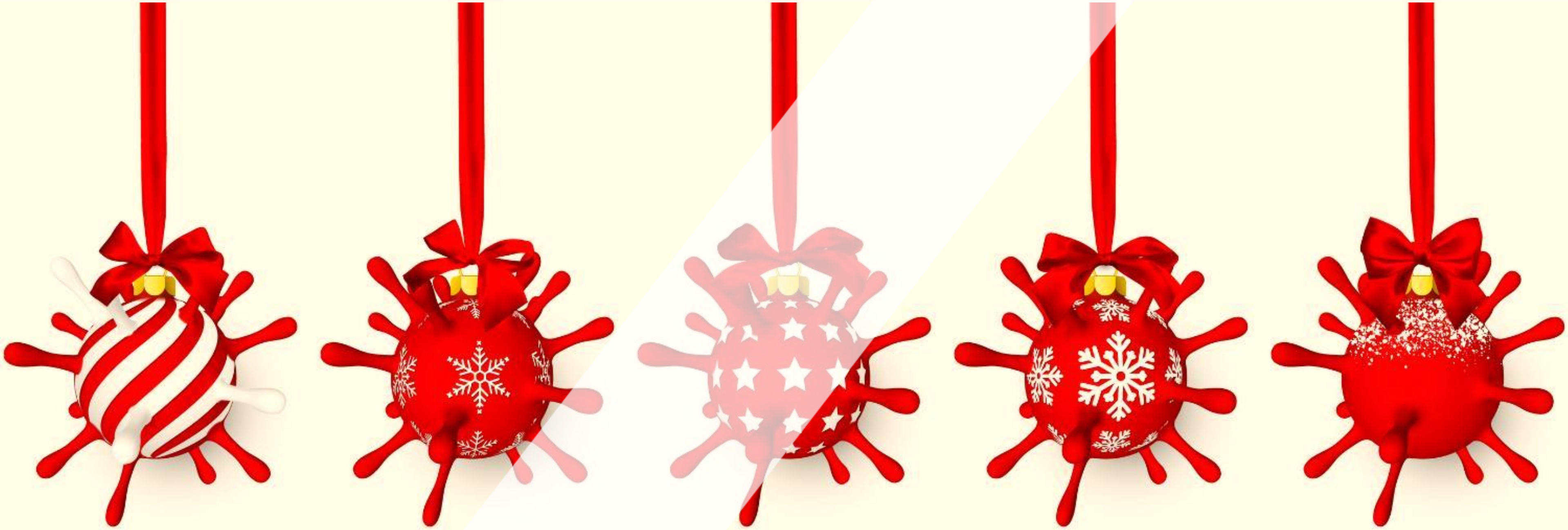
Covid 19: It's behind you … oh no it isn't



Monthly Investment Strategy

AXA IM Research

December 2020

In 2021, it was a very good year ..

Theme of the month: Is the trend your friend ?

- Beyond medium-term cyclical forecasts, an economy's potential growth rate offers the best guide to long-term growth rates. A full analysis includes the estimation of Total Factor Productivity, however, short-hand proxies focused on the more predictable labour side of the economy provide useful guides.
- US trend growth should edge higher after pandemic-related shocks to labour supply growth and productivity, this could edge towards 2% by mid-decade.
- European trend growth should converge towards 1.3% over the longer-term as the Next Generation EU package helps offset demographic headwinds.
- China will need to raise TFP to offset falling contributions from its capital stock and labour supply.
- Japan should struggle to lift potential growth above 0.5% against unfavourable demographics. In the UK, an ageing 'boomer' generation and weak productivity – not helped by the effects of leaving the EU - suggest trend growth slipping towards 1%.

Macro update: Short term (virus) pain, long term (vaccine) gain

- The pandemic still dominates the short run growth outlook. In the Eurozone and UK, despite emerging from national lockdowns, cases remain elevated and restrictions could rise anew. In the US, this process is underway as cases set new records. Both threaten further GDP weakness over the winter.
- A vaccine offers hope for 2021. Restrictions could be eased as the vulnerable are inoculated. Mass vaccination should spur growth more materially.
- Rising global trade has provided a boost to some economies, including China and Germany. While renewed virus cases threaten a renewed dip in demand, perhaps the vaccine poses a bigger threat if consumers rotate back to long-denied services, after bingeing on internationally traded goods.
- Policy remains supportive. The Euro area agreed on its fiscal programme. The US looks set to pass further short-term emergency stimulus. Central banks remain committed to ongoing accommodative policy, with the ECB the latest to extend its policy easing, now through to 2022.

Investment strategy: reflation trades can be great as long as the bond market does not find out

- FX: The US dollar's overvaluation continues to normalise lower and this trend is not yet nearing its end. Aside from a lower yield differential, a split Congress; lesser trade war risk; global risk-on; bad US Covid dynamics and adverse inflation differentials are also weighing on the greenback. The euro has benefited materially from dollar weakness in a move like the pattern seen in 2017.
- Rates: Investors have expressed risks associated with a reflation trade mainly via steepeners e.g. in interest rate swaps. The 10-year yield seems to somewhat lag the surge in standard reflation metrics, e.g. the copper-to-gold ratio. The long end of the US yield curve has already steepened substantially, which is a source of positioning risk for investors in the context of a reflation trade.
- Credit: The duration vs spread pendulum should swing in favour of HY in 2021, as economic growth and cyclical risk premia continue to normalise. The big retracement in spreads has eroded IG excess return expectations over on a 12M horizon. Only HY and EM present positive albeit modest return prospects.
- Equity: The asset class still appears attractively valued on a relative basis with equity risk premium proxies still having room to compress. Absolute multiples appear elevated, but a lot more reasonable if normalised for the expected earnings recovery.

Central scenario

Summary – Key messages

Monetary policy

Monetary policy will remain key policy support. Developed economies to see asset purchases throughout 2021 with no tapering until 2022

Inflation

Energy base effects to lift annual rates in 2021. Spare capacity to keep inflation below central bank targets in 2022, barring currency depreciation

Fiscal policy

Fiscal support extended in most jurisdictions. Europe rolls out support slowly, US more erratic, short term package expected.

Growth

Growth to quicken in 2021 from 2nd wave to vaccine boost. 2022 continuation, when broader signs of recovery should emerge.

Our central scenario:

A rebound from pandemic fuels 2021, but recovery will take time

We forecast global growth to rise by 5.2% in 2021 and 4.1% 2022.

Economic rebound will reflect vaccine, but will have to overcome labour market and indebtedness headwinds. Monetary policy to support.

Emerging Markets

EM's may receive direct vaccine boost more slowly than DM's. Export economies to benefit. Less policy space for most

Rates

Asset purchases by central banks should offset pressures from massive fiscal policy expansion, keeping yields in a range

FX

A number of factors suggest broader USD sell-off. Most currencies to gain, with AUD highlighted. EUR and GBP retain short-term Brexit focus

Credit

Tight spread levels belie yet higher corporate debt levels, implicitly locking-in central banks as an ultimate backstop

Equities

Rotation of value and growth underway. Corporate earnings expected to rebound 2021. Equity risk premium suggests value.

Alternative scenarios

Summary – Key messages

Persistent recession *(probability 15%)*

What could be different?

- Labour market dislocation and business disruption create ongoing headwinds to demand recovery
- Fiscal policy fades amidst elevated debt and political opposition
- Coronavirus mutation reduces vaccine effectiveness
- Geo-political tensions mount in post-Covid world

What it means

- Growth/inflation expectations weaken further, a new depression threatens, corporates' earnings under more pressure
- Further monetary policy where space permits (including China). Government's continue with fiscal stimulus and divide between monetary financing blurs further.

Market implications

- Risk appetite deteriorates / equities sell off / credit widens
- Safe-haven rates rally resumes
- EM debt to come under pressure

Fast recovery *(probability 25%)*

What could be different?

- Vaccine rolls out more quickly than expected, spurring pent-up demand burst
- Labour market recovers, economies benefit from post-virus euphoria
- Virus-shock reshapes business practice, boosting productivity

What it means

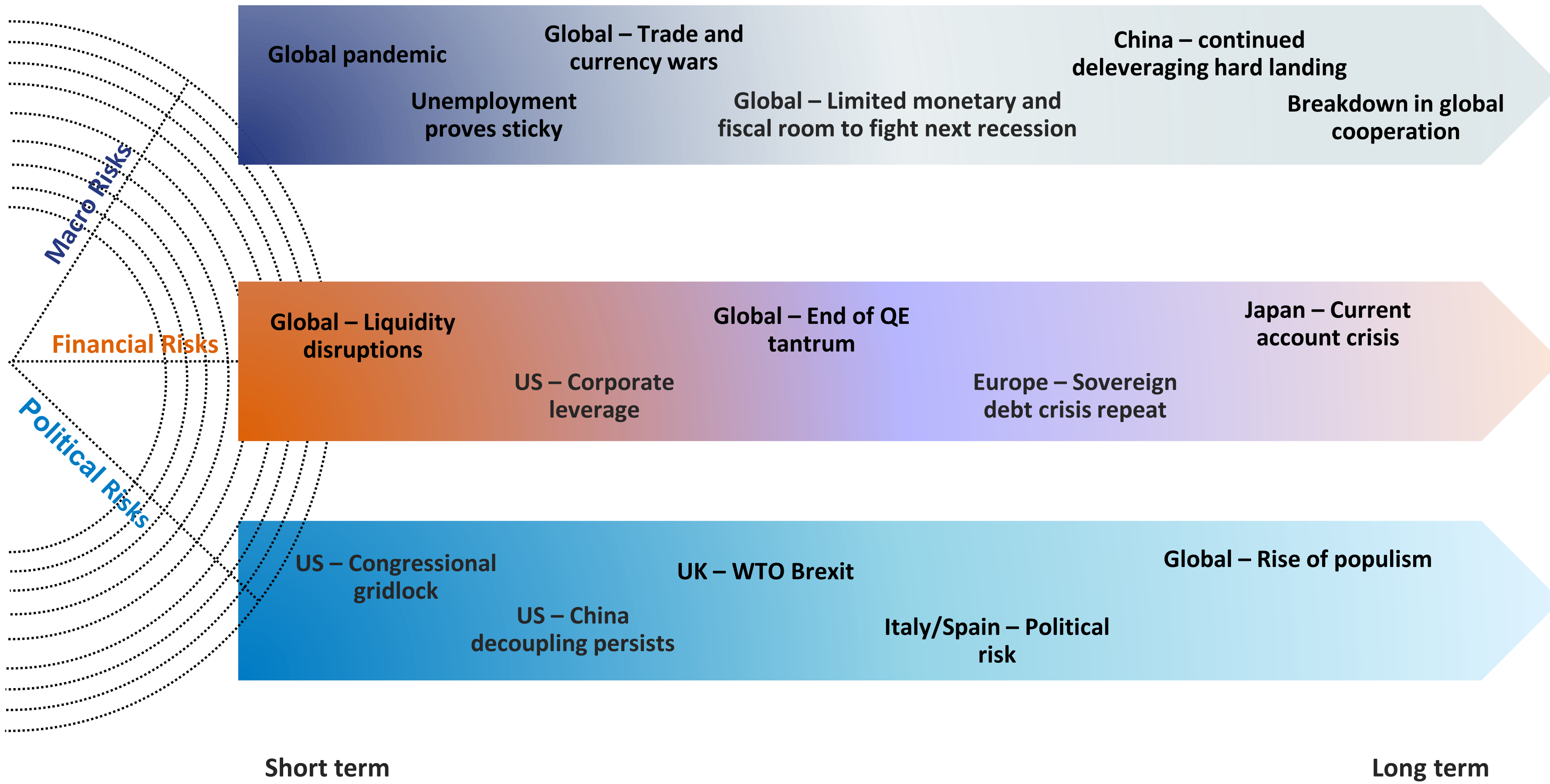
- Global/US/EMU growth surprise on the upside in a stronger and more persistent rebound after 2020
- Monetary policy fights expectations for swift tightening through forward-guidance

Market implications

- Risk-on environment with equities making further gains amidst broader rotation
- UST and EUR break-evens rise
- Spreads grind tighter

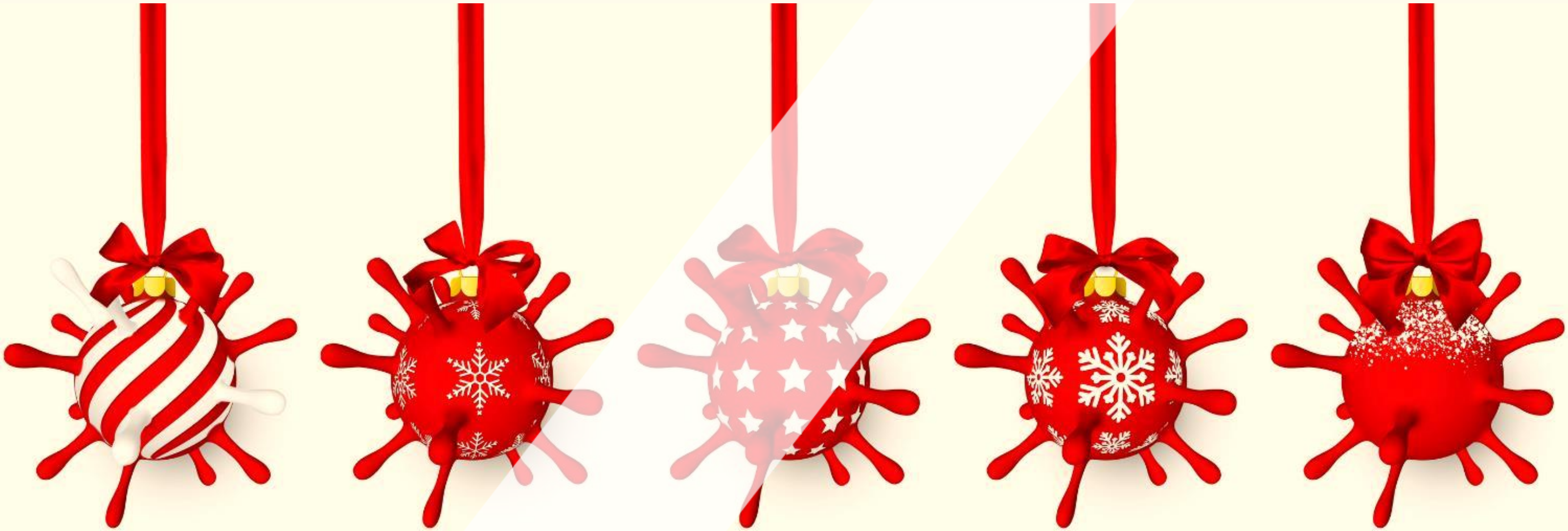
RISk Radar

Summary – Key messages



Investment Managers

Contents



Theme of the month

Theme of the Month

Assessing long-run potential growth

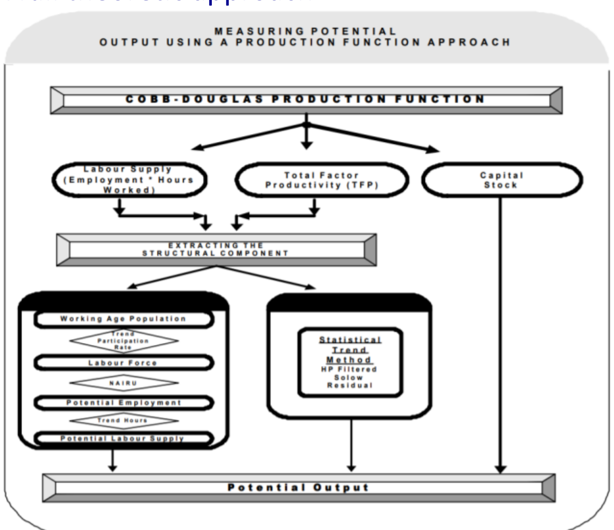
Estimating the unobservable

- An assessment of an economy's potential growth outlook is all the more difficult as it is unobservable and typically only estimable with hindsight. Nevertheless, beyond the medium-term cyclical forecasts, it provides the best guide to longer-term growth rates. A full analysis includes an analysis of the factors of production and an assessment of total factor productivity.

Useful proxies

- A useful proxy for this can be assessed by looking at the labour side of the economy. Long-term labour supply growth tends to be predictable around slow-moving population trends. An assessment of labour productivity growth is more difficult, particularly on an annual basis. But long-term trends in labour productivity are closely associated with business investment and the underlying capital stock. Combining both explains most of the movement in potential growth.

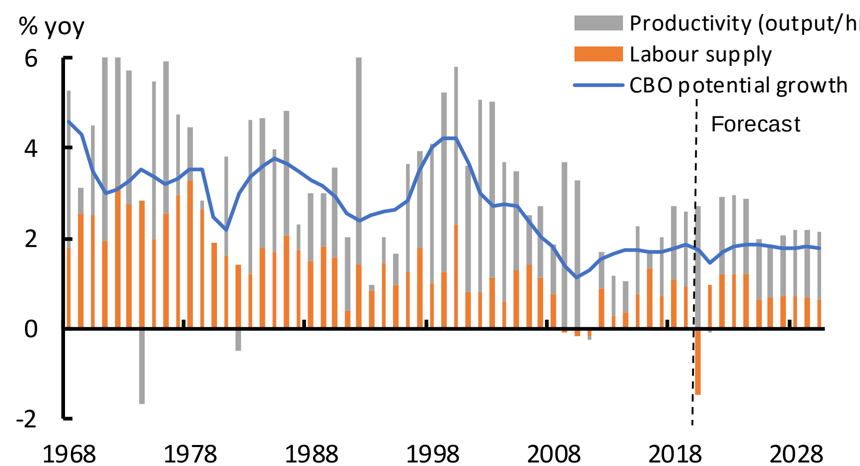
A full theoretic approach



Source: BLS, Census, AXA IM Research, November 2020

Labour supply growth and productivity are useful proxies

US trend growth and key components



Source: BEA, BLS, AXA IM Research, Nov 2020

Investment Managers

Theme of the Month

US – room for optimism

Pandemic confuses outlook

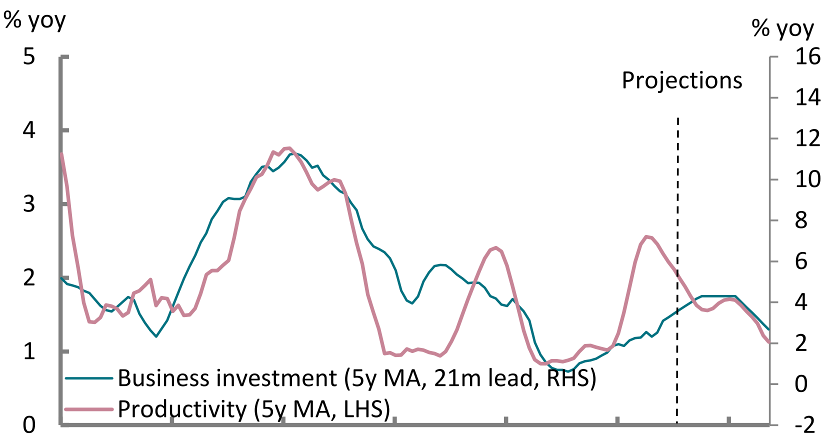
- The pandemic has created volatility in US labour supply and productivity. Beyond a sharp drop in participation, we expect labour supply to catch-up lost ground over the coming years and not to repeat the protracted post-GFC slump. Productivity growth has been subdued relative to business investment and we some scope for acceleration over the coming years and relatedly some rise in the capital stock.

Prospects for faster potential growth

- The CBO estimates US potential growth settling at 1.8% from 2023 onwards. We broadly concur, although with scope for both faster labour supply and productivity growth we shade our own estimates of potential growth higher at 1.9% and could see it reach 2% around mid-decade.

Expected outlook for US economy

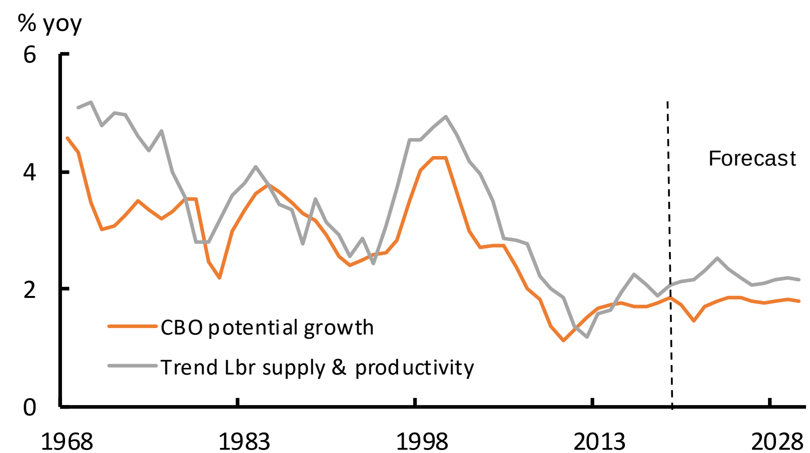
Productivity and business investment



Source: BEA, Census Bureaus, BLS, CBO, AXA IM Research, November 2020

US government debt and rolling projections of debt interest payments

Estimating potential growth



Source: CBO, AXA IM Research, July 2020

Theme of the month

Euro area – "Green shoots" of hope

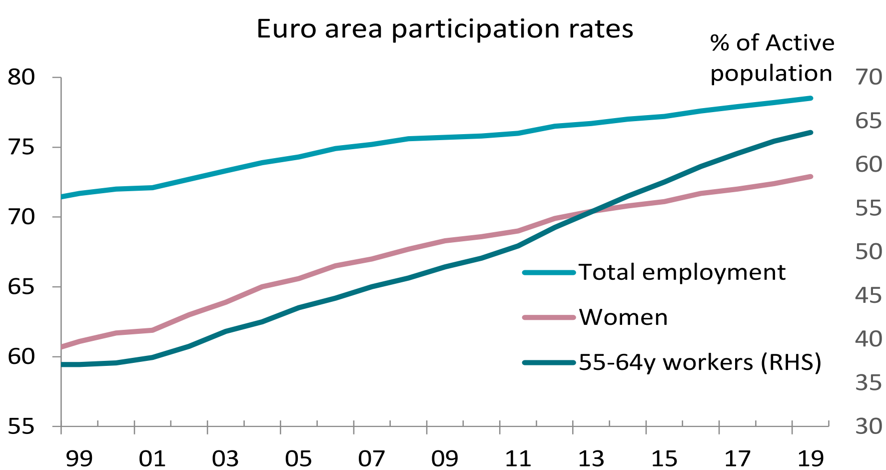
The pandemic, the policies and euro area potential output

- The Covid-19 crisis has severely affected near term euro area potential growth: the ECB sees it averaging between -0.3% and 1.1% yoy between 2020 and 2022, more than 1ppt below its pre-covid estimates. Declines in hours worked and in capital stock due to the sharp investment contraction are the main culprits. Looking ahead, economic policies will play a key role in mitigating permanent scarring effects: short-time working schemes have been efficient so far in limiting employment losses, but state-loans guarantees which have helped firms to access liquidity will need to be accompanied by exit strategies to avoid cliff effects.

The longer term and "Green shoots" of hope

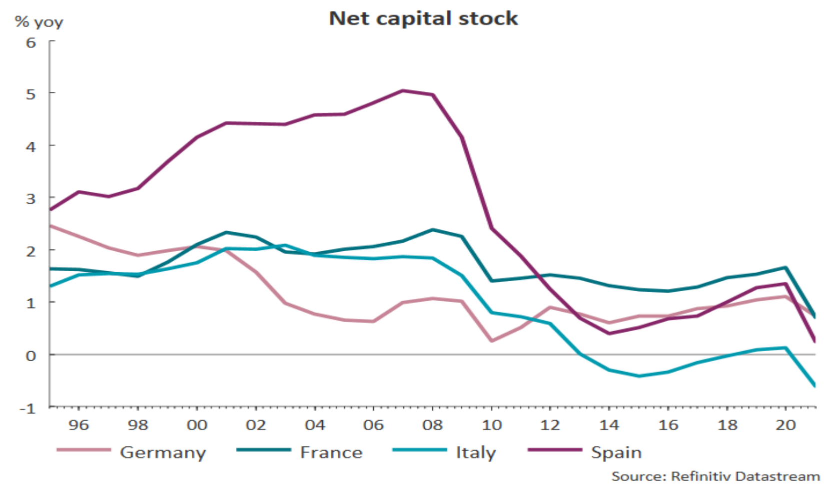
- Demographics are unfavourable across the euro area, and we believe the labour supply upside is limited after the significant increase in women and older workers participation over the past few years. But there are more grounds for optimism on capital stock dynamics and TFP, as the Next Generation EU package will encourage digitalisation and greening of the economy. Yet at c.5% of EU GDP over 6 years, and with implementation risks, we should not be too optimistic. Euro potential growth converging to 1.3% yoy over the longer-term seems a reasonable assumption.

Labour supply upside is somewhat limited…



Source: Eurostat, AXA IM Research, December 2020

… But capital stocks and productivity could be boosted by NGEU



Source: Eurostat, Datastream, AXA IM Research, December 2020

Theme of the Month

China - TFP growth required to cushion aging demographic

Aging population and growth rebalancing to slow trend growth

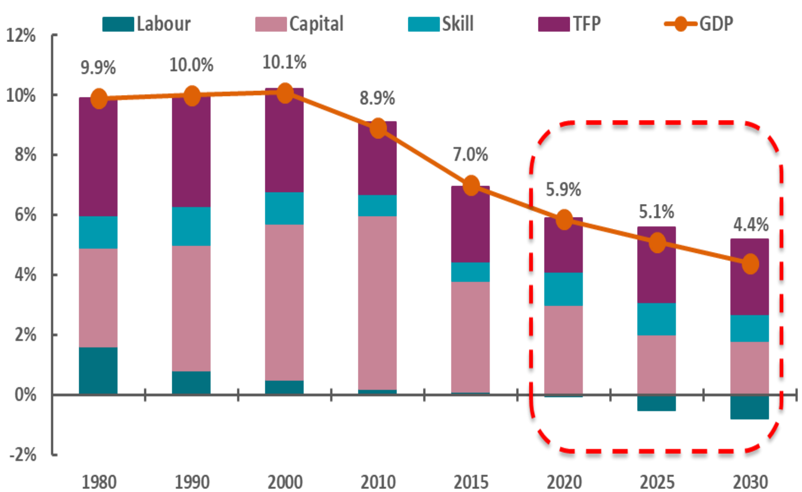
- China's potential growth has slowed in the past decade and that trend is expected to continue in the coming years. The slowdown reflects an aging demographic, with its working-age population having peaked in 2013. Labor contribution to potential growth has turned modestly negative in recent years and is expected to subtract from growth by nearly 1pp by end-2030. Capital formation is also slowing due to the rebalancing towards consumption and services-driven growth. The combination of reduced labor and capital contributions will make the lion's share of potential growth changes for the coming decade

Beijing aims to revive productivity growth through reforms

- To cushion the structural economic slowdown, China needs to revive its ailing productivity growth. Our estimate of TFP growth has fallen persistently over the past decade to its lowest since the economic open-up in the early 1980s. Beijing has recently announced an ambitious reform agenda as part of its 14th Five-Year Plan to reignite productivity growth. If successfully executed, we expect TFP growth to trough at around 1.7% before a recovery to 2.5% by the middle of the current decade, helping China to achieve a "soft-landing" in potential growth

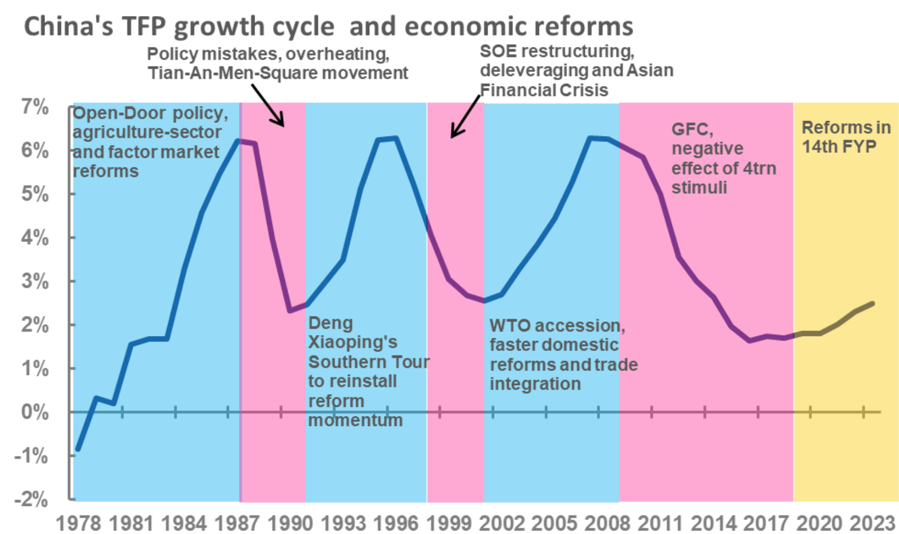
Potential growth slowdown continues

China - composition of potential growth: historic and projection



Source: Penn World Table, AXA IM Research, Dec 20

Reforms are critical for spurring TFP growth



Source: Penn World Table, AXA IM Research, Dec 20

Theme of the month

Japan, UK

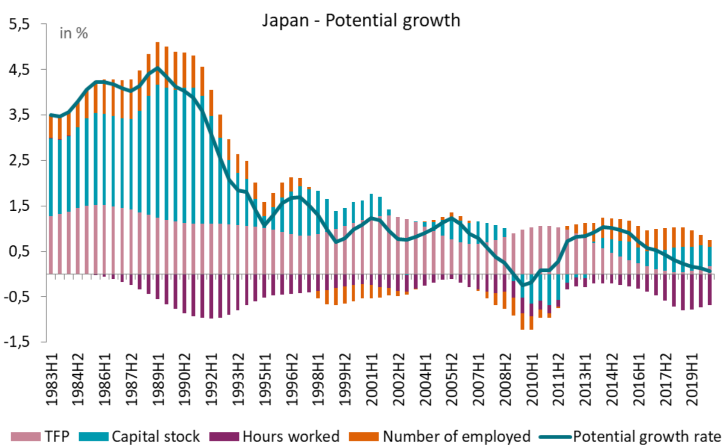
Raising Japanese potential growth with negative contribution from labor supply is challenging

- Japanese potential growth has been severely affected by the COVID crisis, especially on the number of hours worked. Economic activity will recover, but structural weaknesses will remain. An aging working force already associated with a high participation rate amongst women and workers above 55 years old does not provide much tailwind. Some “hope” remains on capital stock dynamics and TFP as recent government announcements on SMEs reforms and digitalisation provide some boost, although it is unlikely to lead to concrete improvement for years. Overall, we believe potential growth in Japan is close to 0.5%.

Lacklustre productivity and demographics weaken trend growth towards 1%

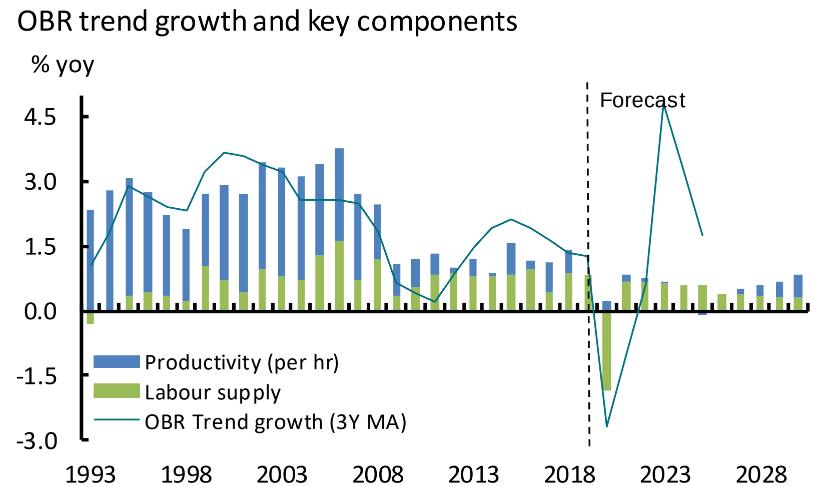
- The Office for Budget Responsibility forecasts material swings in annual potential growth over the coming years. It sees potential growth average 1.9% 2020-2023 and then 1.6% 2024-2025. This is based on an assumption that productivity will rise to exceed 1% by 2023 onwards. With the pandemic associated decline in business investment and the impact of raised trade barriers post-Brexit we are not so confident of this rebound. As such, we expect trend growth to soften towards 1% from 1.3% average 2017-2019.

Near-term reforms promoting capital investments is necessary to offset the upcoming negative contribution from labour supply

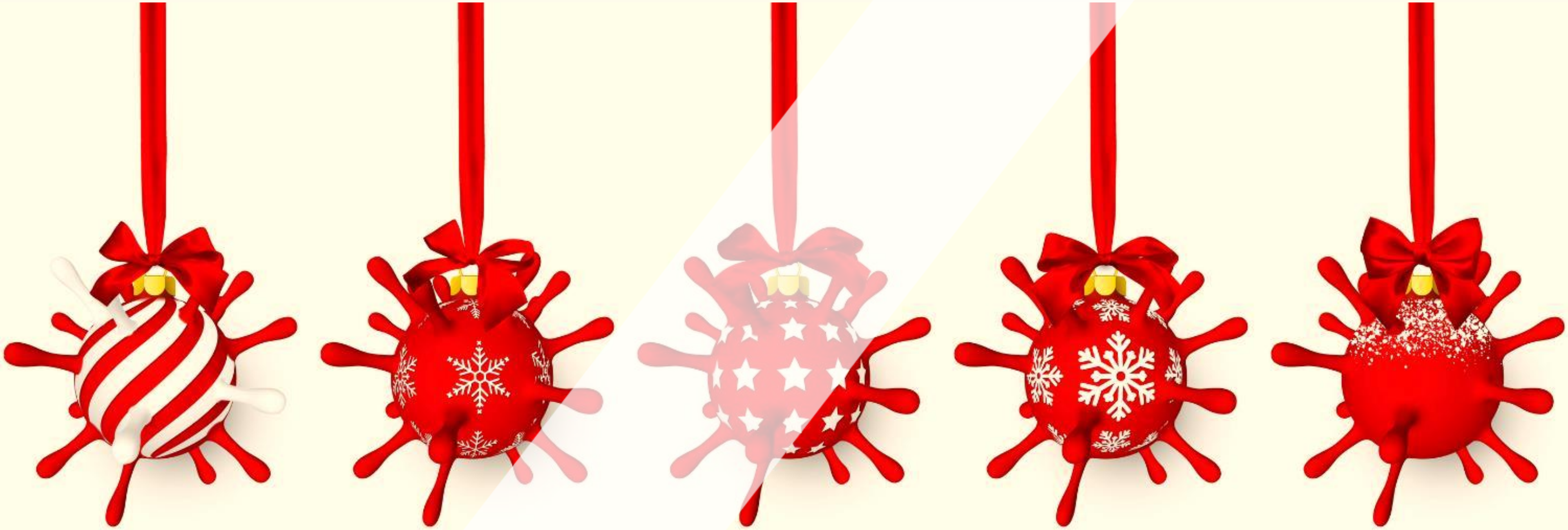


Source: Datastream, Bank of Japan, AXA IM Research, December 2020

UK – productivity challenge warns of subdued potential



Source: Datastream, IMF, AXA IM Research, November 2020



Macro outlook

Virus catching up with the US again

US

Winter outbreak proves worse than summer

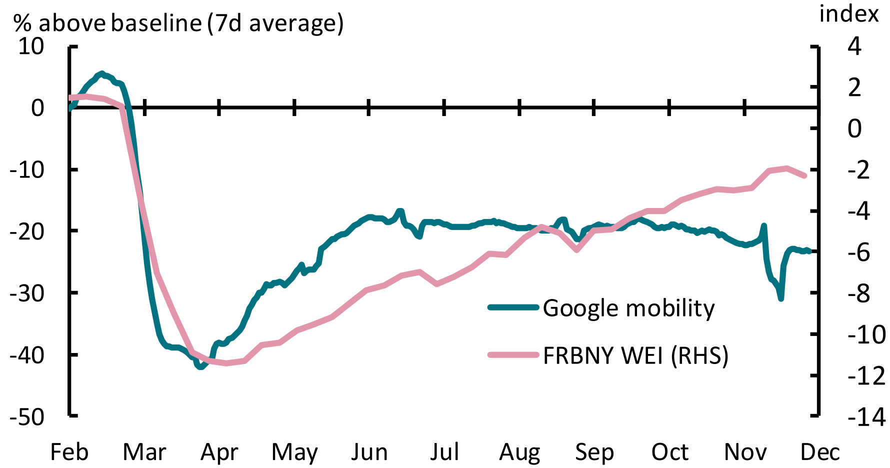
- The US is setting fresh daily records of new Covid-19 cases in excess of 200k. Positivity rates have been extremely high. Accordingly, US States are adjusting for the threat and have increased restrictions, California recently introducing a stay-at-home order. However, this has led to a sharp reduction in mobility of around 10ppt, worse than the 4ppt correction over the summer. With travel associated with Thanksgiving and Christmas risking a further spread, the winter outbreak looks set to be disruptive.

Contraction in Q1

- We maintain that Q4 should deliver solid expansion (if slower than the Q3 record), penciling in 6% (annualized), with most virus disruption occurring late in the quarter. However, this sets the scene for a modest contraction in Q1 – we forecast -2.5%. Beyond that, we are more optimistic in expecting early vaccinations across Q1 to reduce the need for restrictions, and mass vaccination to spur a more material boost to growth in Q2 and Q3.

Winter virus outbreak begins to affect growth outlook

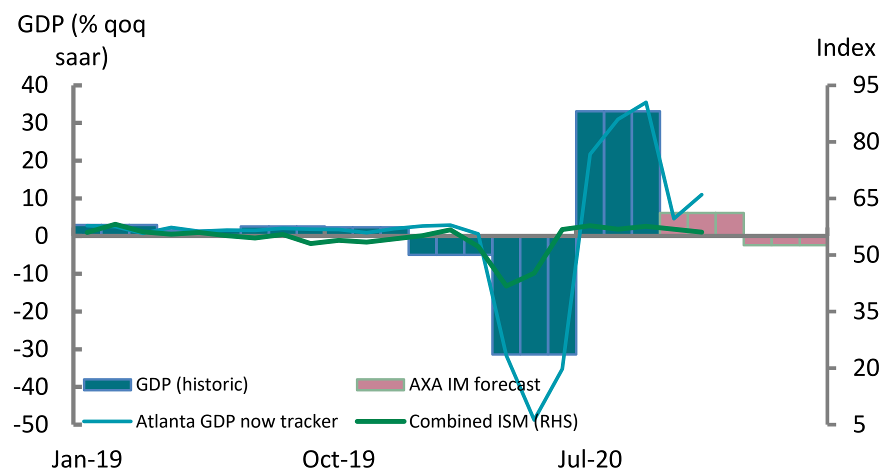
Mobility trends v Weekly Economic Index



Source: Google, FRBNY, AXA IM Research, December 2020

Natural Q4 deceleration to give way to Q1 contraction

GDP growth and short term outlook



Source: BEA, ISM, FRBA, AXA IM Research, December 2020

Rebound expected if obvious traps avoided

US

Stimulus required to clear path for rebound in growth

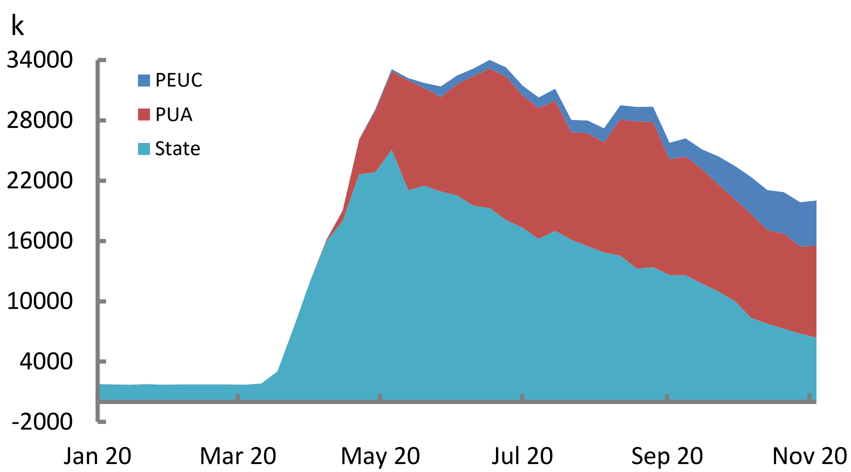
- Negotiations have resumed around a stimulus package to extend support to the millions of unemployed. A package of around $0.9trn now looks likely to be delivered before Christmas. Failure to deliver risks a significant reduction in household incomes and spending in Q1 that would suggest a much deeper contraction. However, we expect growth to rebound sharply alongside mass vaccination next year and forecast 4.6% growth in 2021 and 3.7% in 2022 (above 3.7% and 3.0% consensus forecasts).

Fed suggests current balance sheet expansion to persist

- The Fed has provided clear guidance on the conditions necessary before a rate hike is likely. These include an expected moderate inflation overshoot and labour market conditions consistent with full employment. We do not expect both conditions to be met until 2024 and forecast the first hike in June 2024. Balance sheet policy was more opaque. With real yields at record lows, we did not expect the Fed to increase the pace or maturity of its purchases. The Fed's additional balance sheet guidance to continue at the current pace until "further substantial progress" towards its goals is made suggests the current pace to continue throughout 2021.

Serious dislocation in labour market

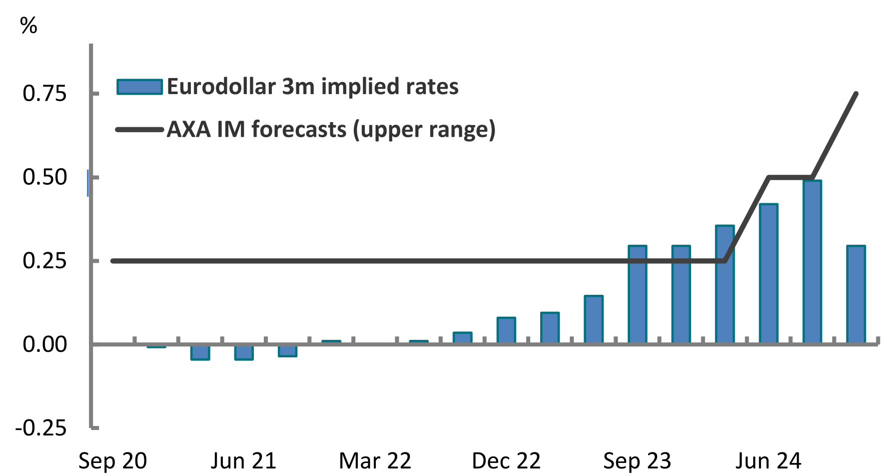
US claiming unemployment benefits



Source: CBO, PIIE, AXA IM Research, Nov 2020

Fed moves to remove balance sheet policy opacity

Market expectations of Fed policy



Source: Federal Reserve, AXA IM Research, Nov 2020

The short-term pain

Euro area

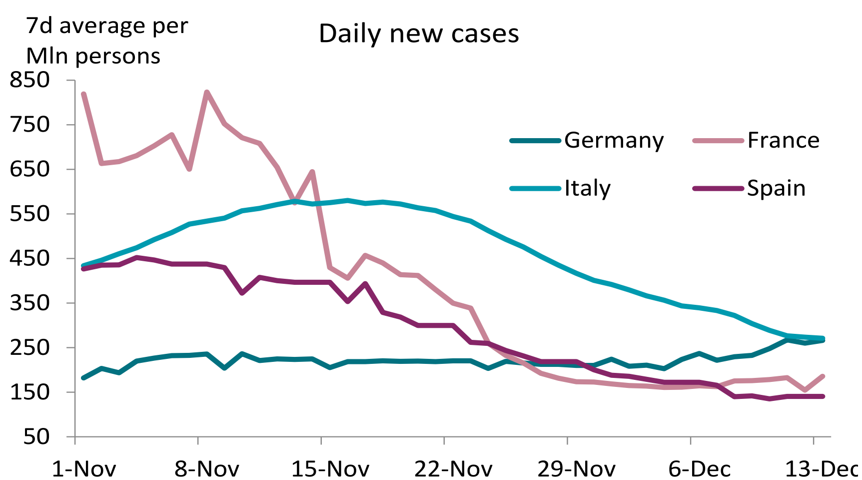
Second wave taking its time…

- Pandemic developments continue to determine the near-term growth prospects. Having improved in November, Covid numbers have stabilised at elevated levels in most euro area countries. Daily cases in France are more than twice the government target and Germany has failed to lower its infection rate, with positivity rates and fatalities even increasing. This has prompted renewed discussions about the planned lockdown easing. France has postponed some easing measures while Germany has opted for a hard lockdown with non-essential shops and schools closed from December 16 to January 10 at least.

… weakness to persist in Q1 21

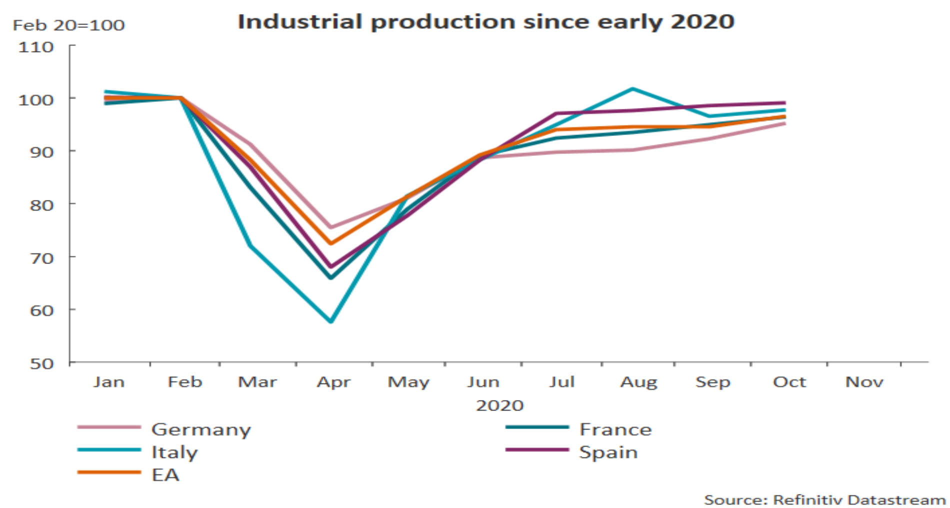
- This points to a weak start to 2021. For Q4 though, we may have been too pessimistic, despite the latest announced restrictions. France’s mobility has recovered faster than we expected, while the German industrial sector is surprising to the upside: industrial production carry-over is solid at 4.9% qoq and could add more than 1ppt to German GDP growth. In Spain, we also see upside risks given the resilience of the labour market. Overall, euro area GDP could shrink by around 2.5% qoq, less than the 4% we initially envisaged.

Stubborn second wave



Source: : Our World in Data and AXA IM Research, December 2020.

German industrial production: enjoying a late catch-up



Source: Datastream and AXA IM Research, December 2020.

Fiscal and monetary support finding their way

Euro area

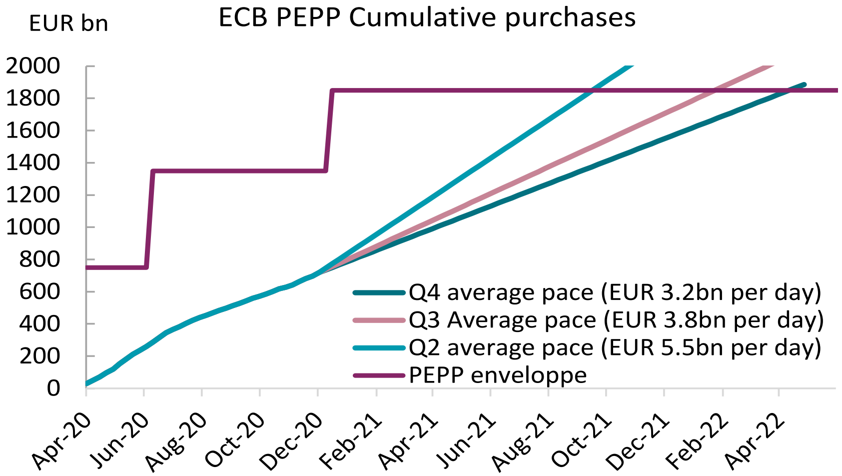
An EU conflict solved…

- The EU has managed to deal with its institutional hurdles on the fiscal front and finally deliver the Recovery and Resilience Fund thanks to a compromise with Hungary and Poland on the rule of law. The impact on effective fiscal action in the first half of 2021 is likely to be very small, but from a political and financial stability point of view, this is a success, making European mutualised support material, contributing to the sustainability of public debt in the most fragile member states.

… and another package from the ECB

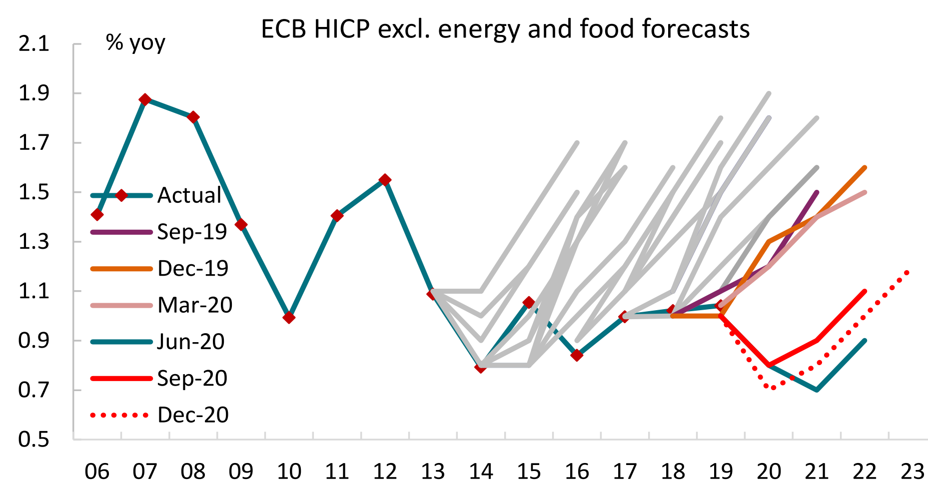
- But the main source of "peace and quiet" on the sovereign bond market comes from the ECB. The EUR 500bn extension of the PEPP until March 22 did not disappoint us: it is offering visibility to governments and markets. And implicit yield curve control has been confirmed: the quantum of purchases will be adjusted upwards or downwards depending on the financing conditions. Support to the banking sector came in the form of more generous TLTRO-IIIs with a longer discount period (June 22) and larger allowances (55% of eligible loans). Lending and the Bank Lending Survey will help to gauge if this is enough. But the big test ahead, given the depressed inflation forecasts, is the post-pandemic recalibration policy.

Steady it goes… only for longer



Source: ECB, AXA IM Research, December 2020.

The next question: the inflation gap



Source: ECB, AXA IM Research, December 2020.

Wrapping up 2020

UK

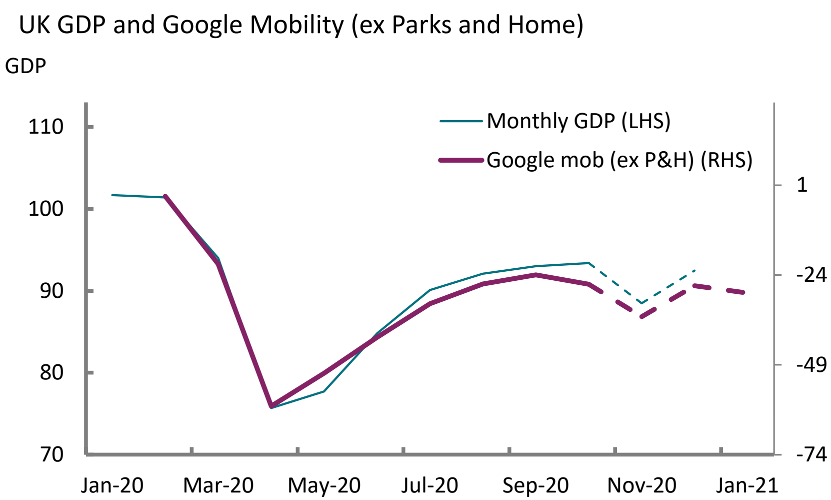
Mobility suggests a lockdown contraction

- GDP in October recorded a modest rise of 0.4% m/m. This was in excess of our forecasts guided by Google mobility, which dipped in October. November's drop was more clear-cut, associated with renewed lockdown in the month. We forecast that this will reduce November's GDP, by around 5%. This is likely to lead to a contraction in Q4, but by less than the over 2% we previously thought. That said, a post-Christmas slump, compounded by further restrictions could undermine our hopes for a rebound in Q1.

Last minute deal would avoid worst outcome, but far from a smooth transition

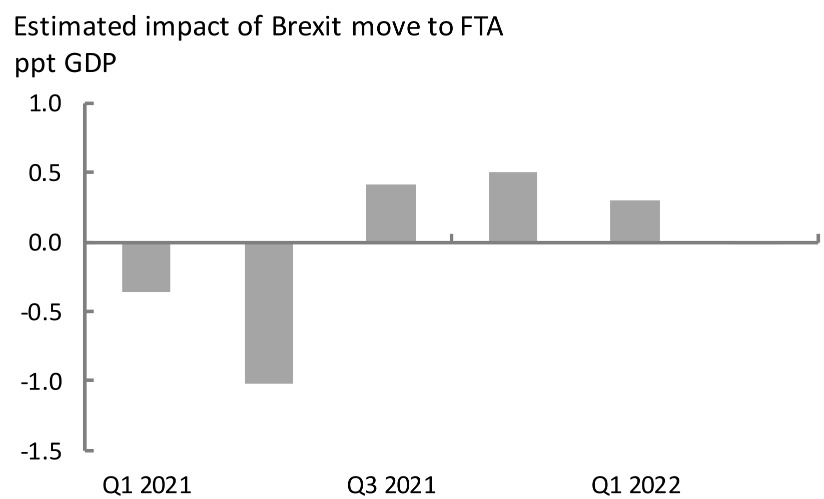
- The EU and UK are still negotiating a trade deal. We expect a deal to be announced in days, but the UK still describes the prospect of 'no deal' as "likely". A deal would avoid the disruption of trading on WTO terms – estimated at 2ppt of GDP in 2021 by the OBR – and should facilitate future agreements, including on equivalence in specific areas of financial services. However, there would still be significant disruption at channel ports in H1 2021 even with a deal, which will ultimately weigh on activity. We estimate this reducing activity by around 1.3ppt in H1.

GDP to follow the virus ebb and flow



Source: National Statistics, AXA IM Research, Nov 2020

Border disruption to visibly impact GDP even with FTA



Source: National Statistics, AXA IM Research, Nov 20

2021 promises rebound

UK

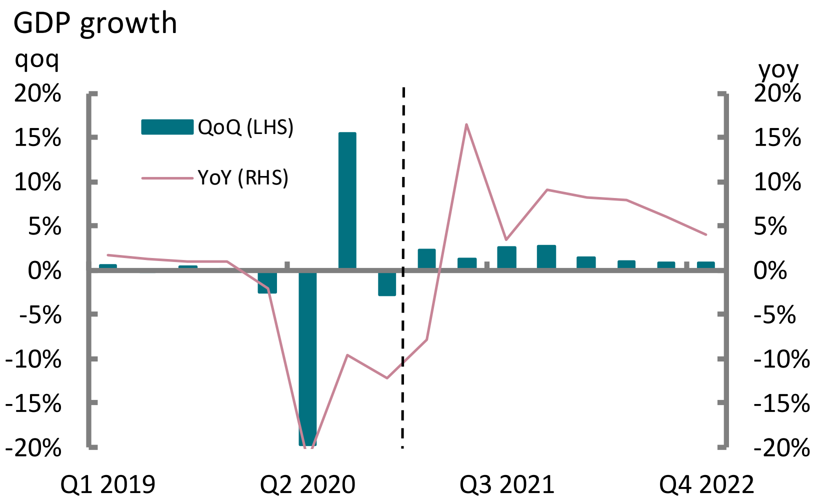
Vaccine to lift activity – risks to when and by how much

- We forecast UK GDP growth to fall by 11.2% in 2020, but to rebound by 4.6% and 6.5% in 2021 and 2022. This is a more delayed recovery than consensus which considers 5.4% and 4.5%. This likely reflects our assumption that mass vaccination will continue past the summer, materially lifting growth only in H2 2021. There is a risk that this emerges more quickly.

Avoid negative rates, prolong QE

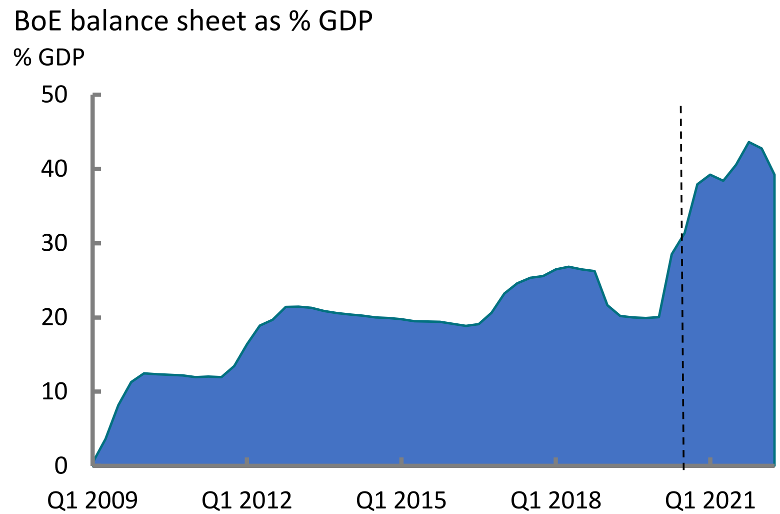
- With uncertainty around a Brexit trade deal remaining, the BoE outlook remains in the balance. We do not expect the BoE to experiment with negative interest rates if the UK leaves the EU with a trade deal as we expect, with signs of a vaccine-led rebound likely to emerge next year. Rather, we expect the BoE to extend QE, which at current pace would expire in August next year – before either the Fed or ECB ends asset purchases. We expect the BoE to extend QE again in May by £75bn, extending purchases – albeit at a softer pace in H2 2021 – into 2022. With no deal, the prospect of technical negative rates becomes greater.

Growth outlook lifted by vaccine from H2 2021



Source: National Statistics, AXA IM Research, December 2020

BoE to sustain balance sheet expansion into 2022



Source: Bank of England, AXA IM Research, December 2020

Growth momentum continues to rebuild

China

Multi-year high PMIs indicate strong expansion

- China continues to rebuild growth momentum as the economy enters Q4 2020. Recent PMI releases showed that conditions in manufacturing and services sectors have reached their highest levels since at least 2017. Key activity indicators, such as production and new orders, have improved further on the back of recovering local and global demand. Strong corporate profit growth and improved business expectations bode well for a further recovery in corporate capex in the coming months

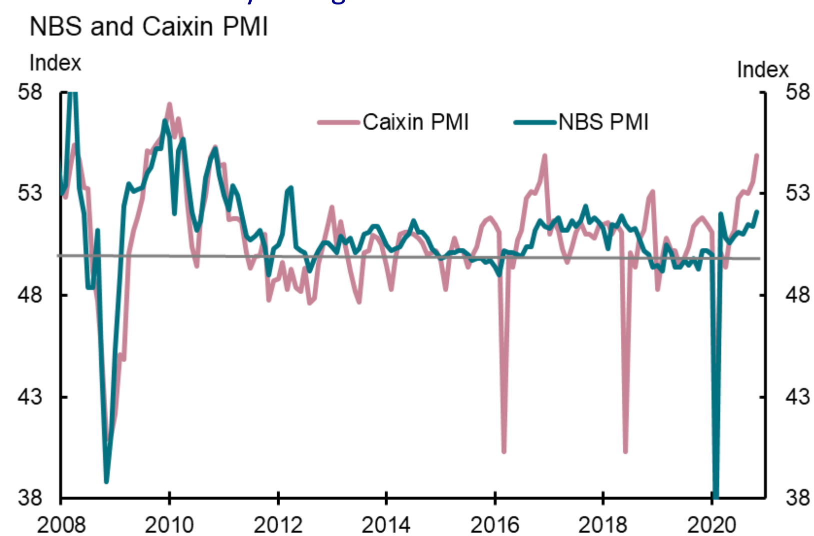
Export growth going from strength to strength

- Export growth accelerated to 21% y/y in November. Shipment of pandemic-related goods was boosted by the worsening pandemic in the US and Europe. At the same time, demand for regular "made in China" products also held up well. While near-term prospect remains solid, China's export growth cannot stay above 20% as production capacity elsewhere restores. We expect export growth to come off their highs over the coming months, but to stay robust in 2021.

Robust trade performance continues

Source: CEIC, AXA IM Research, Dec 20

PMIs rise to multi-year highs



Source: CEIC, AXA IM Research, Dec 20

No change in macro policy direction following recent SOE defaults

China

Recent liquidity injection does not mean policy loosening

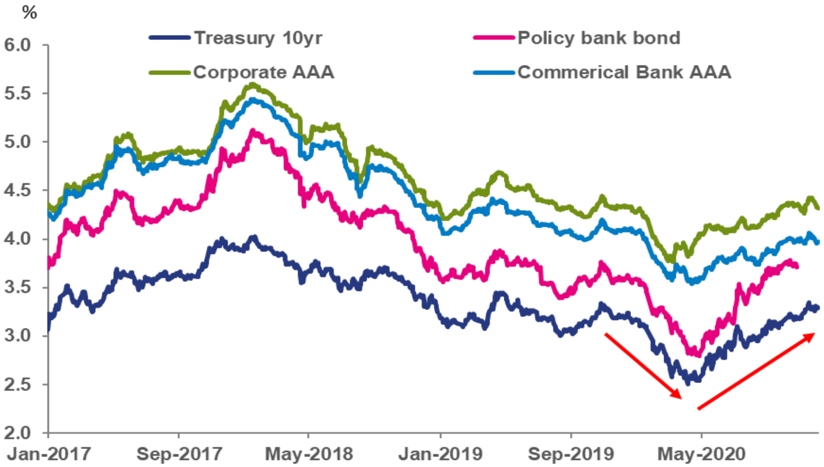
- The onshore bond market has suffered from several unexpected bond defaults by state-owned enterprises (SOEs) lately. The PBoC has carried out two MLF liquidity operations to soothe market fears and ensure no excessive tightening of inter-bank liquidity due to risk aversion. We think these defaults are idiosyncratic events driven by individual corporate problems, not a systematic tightening of policy due to deleveraging. However, the lack of immediate official support suggests greater official tolerance for credit events, needed to break the chronic moral hazard problem involving implicit guarantee for SOEs that has hindered risk pricing in the bond market

RMB exchange rate supported by strong inflows

- Since hitting an inter-year low, RMB has appreciated by 8.8% against the USD and over 4% on a trade-weighted basis. The appreciation has been a result of strong inflows from both trade and capital channels. On the trade front, China's trade surplus has staged an impressive rebound, at a 4-year high last month. At the same time, global investors have poured money into the onshore bond and equity markets, lured by China's attractive yield premium and fast-recovering earnings growth. We expect the currency to stay strong in the near-term as supportive factors remain dominant

Onshore interest rates return to pre-COVID levels

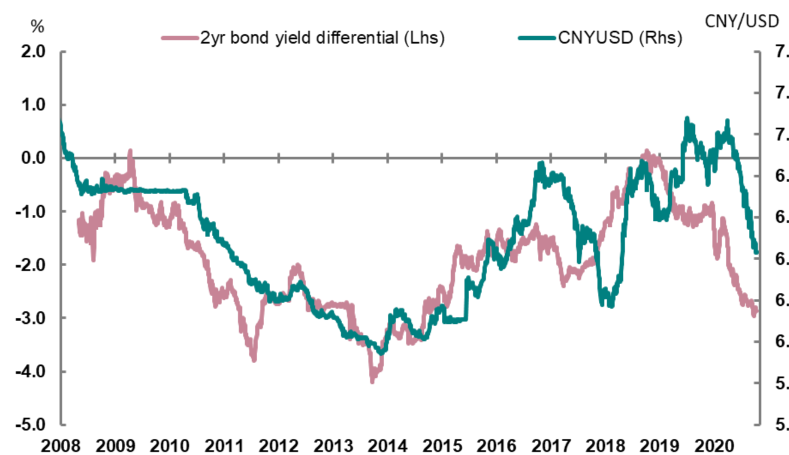
10 year bonds of the government, policy bank, AAA bank and corporate



Source: CEIC, AXA IM Research, Dec 20

RMB rises on widening US-CN interest rate differential

2yr bond yield differential (US-CN) and CNYUSD



Source: CEIC, AXA IM Research, Dec 20

The short-term outlook remains constrained by the evolution of the pandemic

Japan

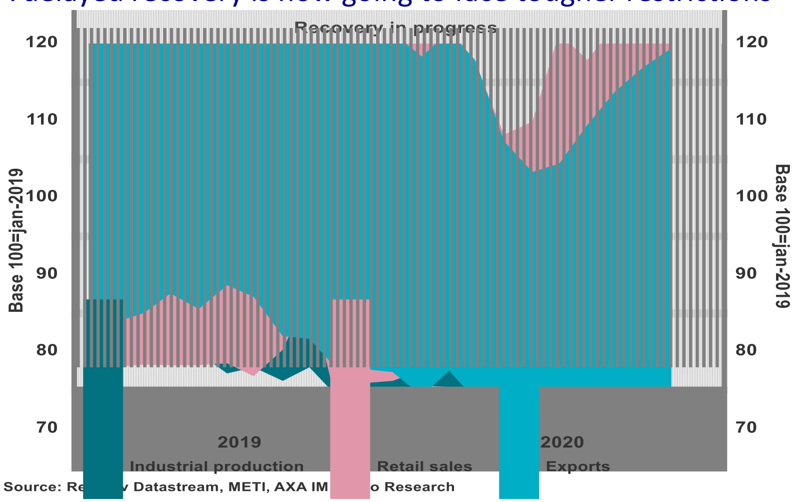
The number of new cases and deaths are rising markedly

The government and regions are imposing further restrictions: Working from home has been prioritized; restaurants and bars have more constrained hours; the "Go to " campaign – which subsidises consumption in heavily impacted sectors – has also been partially suspended.

Sustained recovery postponed to 2021

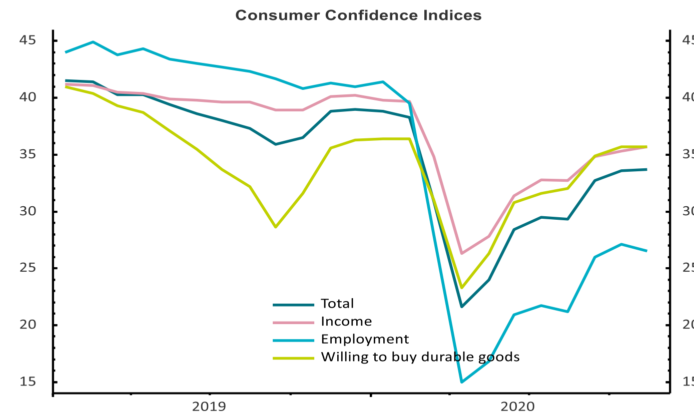
- Data for October pointed to an acceleration in activity: Industrial production came in at +3.8%mom, marking the fifth consecutive increase; real exports rose strongly by 4.5%mom, led by strong demand in Asia; retail sales increased by 0.4%mom, close to their pre-crisis level. But recent restrictions will weigh on December’s activity, as shown by the flattening of the consumer confidence index in November

A delayed recovery is now going to face tougher restrictions



Source: Re… Datastream, METI, AXA IM …o Research

December consumer confidence stabilized at low level



Source: Refinitiv Datastream and AXA IM Research nov. 20

The government unveils a draft for a third recovery plan

Japan

PM Suga unveiled details of a third supplementary budget of ¥73tn

- The headline figure is inflated as it includes expected private sector contributions as well as lending from quasi-government financial institutions. Direct fiscal spending should reach ¥32.3tn over the next 15 months: ¥20.1tn by the end of March 2021 and ¥12.3tn in FY 2021. It would deliver a modest positive boost to 2021 GDP, relative to our expectations of only a ¥15tn stimulus. But any boost is likely to be modest as this package includes recycled measures and reserves, while income support measures tend to be associated with low multipliers and investment-related expenditures are typically overvalued.

Bank of Japan holds it December meeting next week

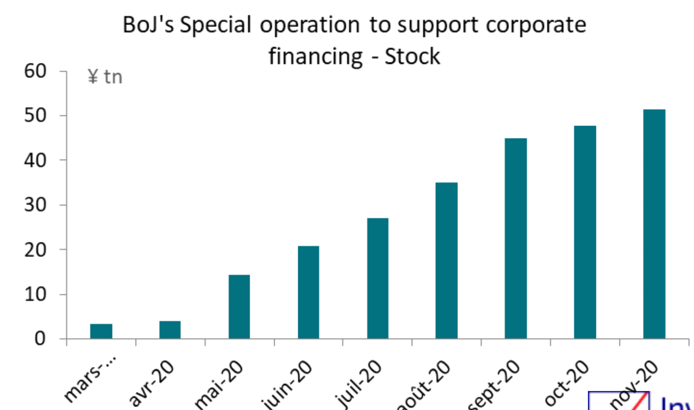
- The BoJ is likely to expand its special fund-supplying operations in response to the expected extension of the financial support for corporates by the government in the 3rd supplementary budget. In detail, the government provides companies with interest payable on loans, but also assurances from credit guarantee associations. In parallel, the BoJ provides liquidity to financial institutions which extend their loans (and revenue as they can earn 10 bps on their current account depending on the use of this operation).

A ¥32tn of "new" government spending for the next 15 months

Measures	Govt spending (Y tn)	Total package (Y tn)
Preventing COVID-19 spread	4.5	6
Transform economic structure in Post Covid Area: Green initiatives Digitalisation Subsidies to facilitate re-organisation of SMEs Support for business continuation (EASP) Living support – cash handouts	13.4	51.7
Resilience against natural disasters (infrastructure)	4.4	5.9
Reserve	10	10

Source: Ministry of Finance, AXA IM Research, Dec 20

BoJ's measure to support corporate financing should be extended at least until the end of 2021



Source: Bank of Japan, AXA IM Research, Nov 20

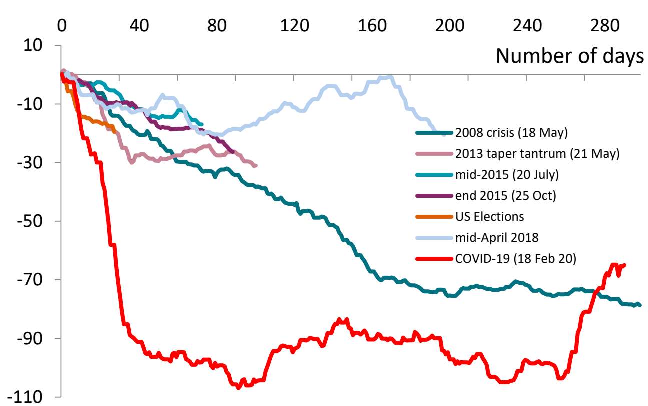
Investors' appetite for EM assets reignited

Emerging Markets

Key drivers fuel EM sentiment

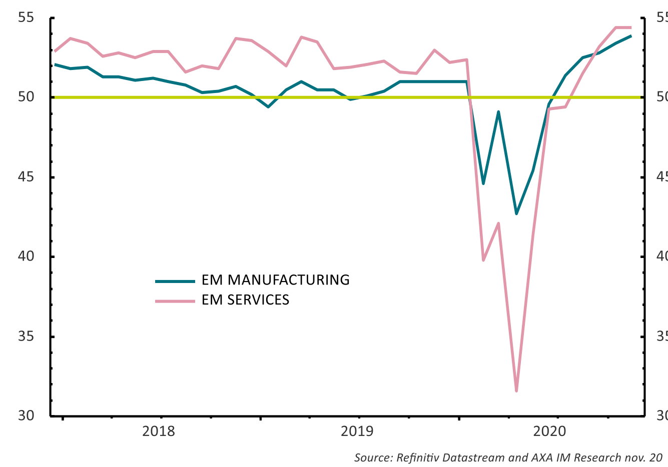
- Optimism with Covid-19 vaccination, a smooth transition to a more predictable US administration, particularly when it comes to diplomatic relations, and a general environment where advanced economies are pursuing vast monetary and fiscal expansions are undeniably supportive for sentiment towards EM. Recent data releases continue to suggest that the Chinese recovery is well on track, another important driver for emerging markets.
- Since the initial financial market reaction to the pandemic on 18 February, approximately US$104bn worth of foreign portfolio outflows from EMs have been reported by the Institute of International Finance (IIF). At its trough on November 1 – this accounted for around US$30bn in EM debt assets and US$74bn in EM equities. Some $38.7bn inflows were reported since, mostly flowing into EM equities so far
- As mobility restrictions are eased, manufacturing activity rebounds from its spring shock. Latest PMI surveys reinforce the view that the manufacturing sector is improving at a good pace supportive of an upcoming recovery into 2021.

Portfolio investment inflows into EM stepping up



Source: IIF, AXA IM Research calculations, 4 Dec 2020

EM recovery firming



AXA Investment Managers

South Africa blowing hot and cold

Emerging Markets

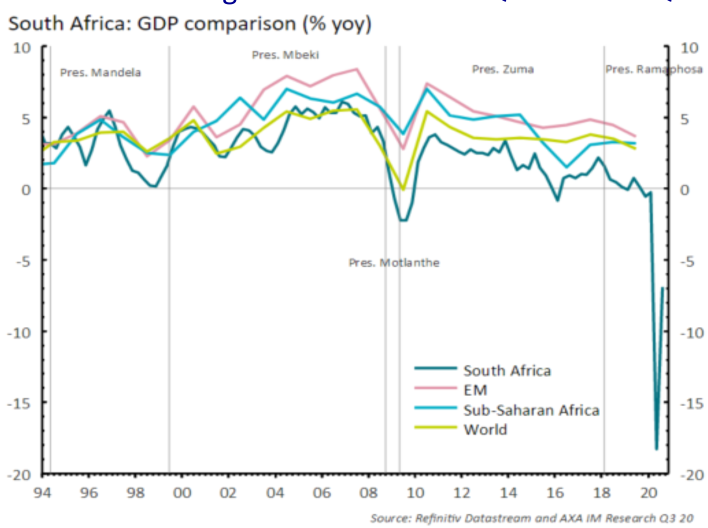
GDP growth rebounded in Q3 2020

- South African GDP growth bounced by a solid 13.8% qoq (-6.9% yoy) after a collapse of 17.5% qoq in Q2 mainly led by household consumption (+14.1% qoq) and exports (+31.8% qoq) mirrored in the strong rebound in mining and manufacturing activities.
- 2020 GDP growth forecasts point at -7% for 2020. Still, we expect a limited 3.5% GDP expansion in 2021. Economic recovery should continue in Q4 2020 and through 2021, on the back of exports (global recovery progressing in a context of lower Covid-infections thanks to vaccination) and some pent-up demand.
- Meanwhile, the central banks is likely to keep interest rates unchanged at 3.5% during 2021.

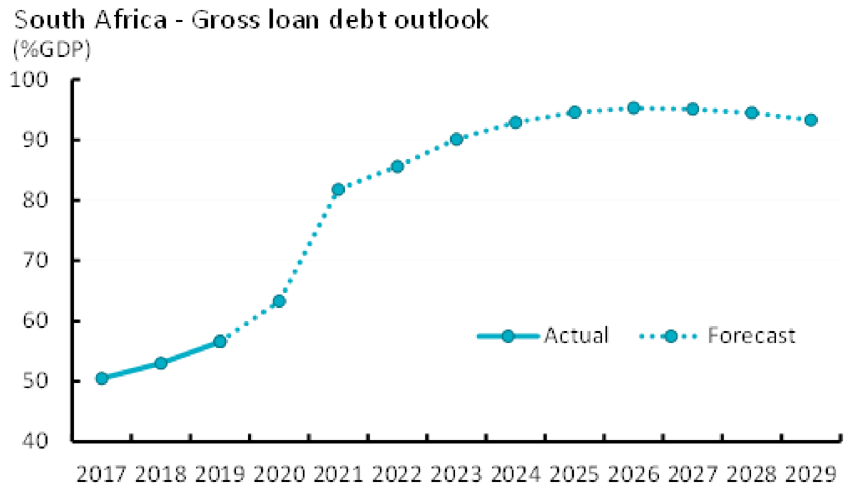
Focus on public debt sustainability

- Yet, public debt sustainability issues are likely to retain attention: the government's ability to deliver the civil servants wages' freeze for the next three years in order to secure the planned public savings (this measure is expected to provide the 90% bulk of savings) which should grant a peak in public debt at 95.3% of GDP by 2025 remains questionable.

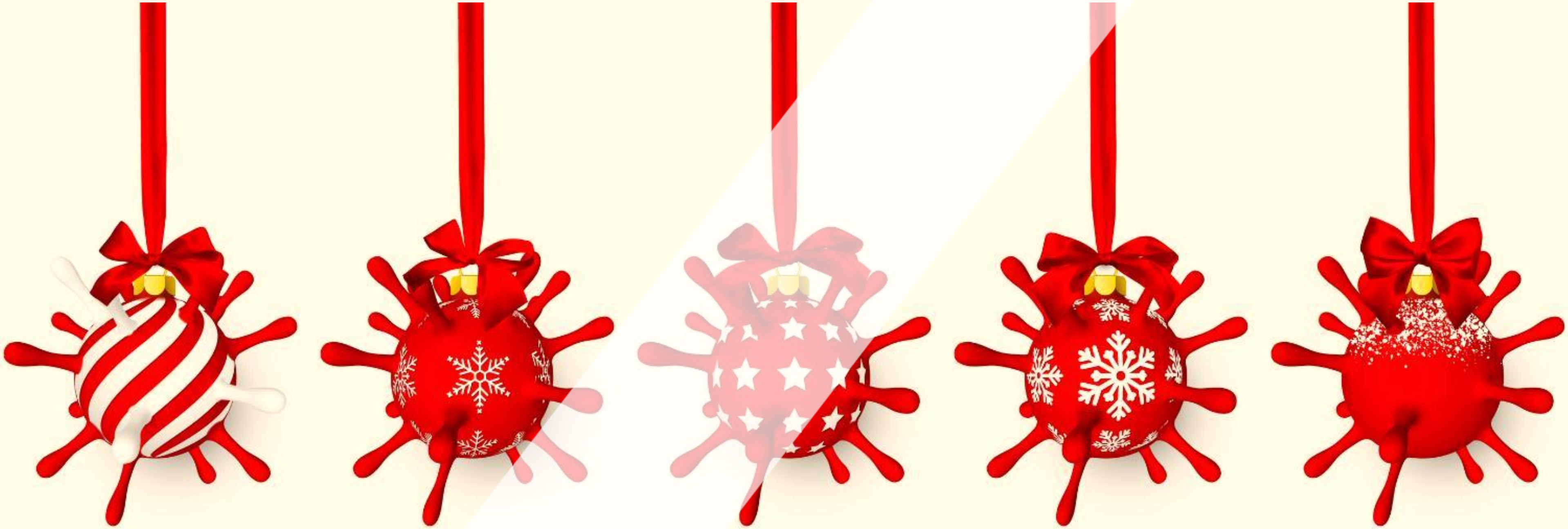
South Africa GDP growth rebounds in Q3 after the Q2 collapse



Will the government be able to curb public sector debt as promised?



Source: South African National Treasury, 2020 MBTBPS, AXA IM Research, Oct 2020



Investment Strategy

Multi-Asset Investment views

Our key messages and convictions

Positive on equites

#1
Despite the virus resurgence, economic and earnings rebound remains on track amidst ultra loose monetary policy

#2
Unprecedented initiatives from both fiscal and monetary authorities supportive of valuations

Positive on Investment Grade Credit

Positive US Sovereign Bonds

#3
Monetary arsenal is a significant support for bonds; Federal Reserve indicates that it will retain full flexibility well into 2023

#4
Concerns over a second wave of COVID-19 virus and political risks generate higher volatility

Long Volatility

Source: AXA IM as at 15/12/2020

FX Strategy

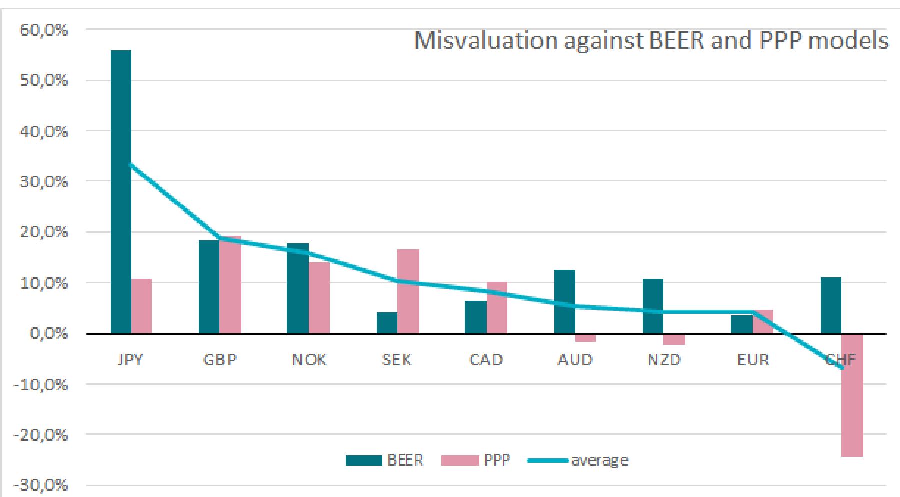
Euro/dollar rate rises like it's 2017 as the US dollar is caught in the perfect storm

- The US dollar's overvaluation continues to normalise lower and this trend is not yet nearing its end. Aside from the fundamental driver of the lower yield differential, additional factors are at play: split Congress likely; lesser trade war risk; global risk-on; bad US Covid dynamics.

- The euro has benefited materially from dollar weakness in a move like the pattern seen in 2017. The risk-on environment has been supportive lately, while the recent approval of the Recovery Fund has stifled European Union unity concerns. On the downside, the euro remains vulnerable to intermittent bouts of risk-off.

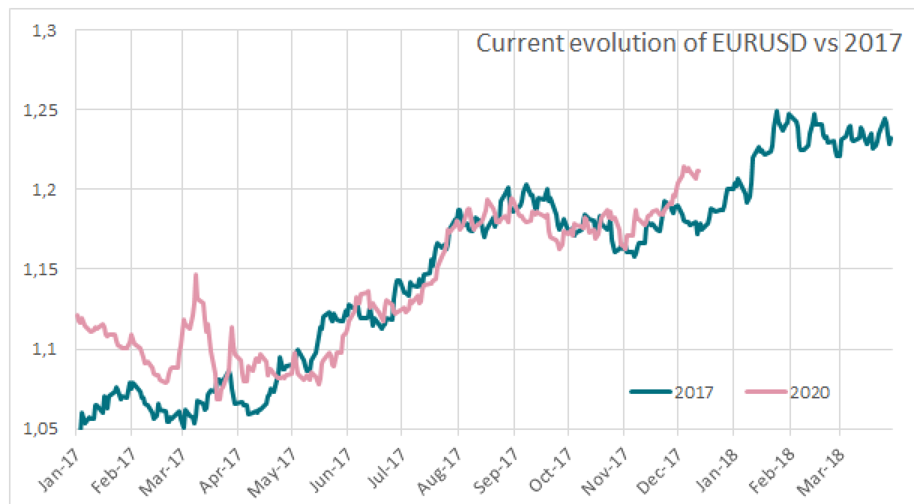
- The JPY should be more immune to negative global factors and it now appears more undervalued against the dollar than the euro. The AUD is now as undervalued versus the USD as the EUR, driven by rebounding Chinese demand, global infrastructure stimulus, higher domestic fiscal support, and the fact that the Australian summer starts with virtually no COVID-19 cases.

USD overvaluation has further room to normalise



Source: Bloomberg and AXA IM Research, Dec 2020

EURUSD has already replayed 75% of its 2017 appreciation



Source: Bloomberg and AXA IM Research, Dec 2020

Rates Strategy

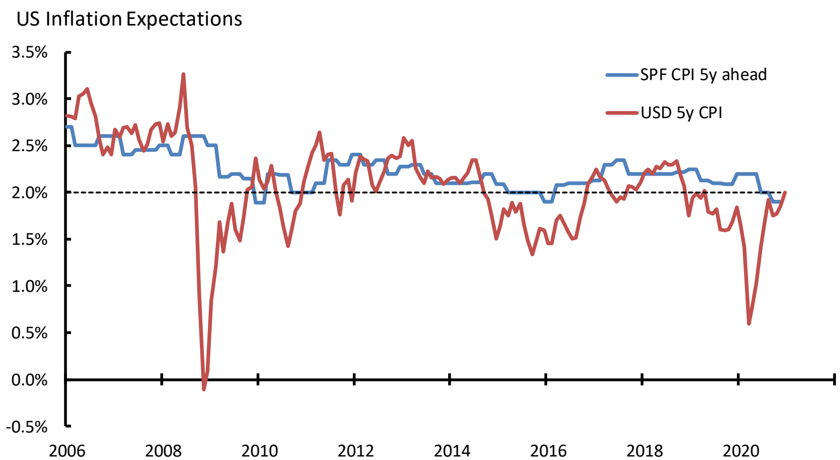
US Treasuries: a look at 2021 inflation considerations

- Following a spectacular 160bp collapse in Q1, US Treasury yields have hovered between 0.6% and 0.7% until the end of Q3. We've had a 20bp increase in 10-year yields since then, but nothing to worry about so far and 2020 will be considered 'classic' in terms of total return.

- Inflation expectations are not yet fully discounting the potential strong base effects stemming from commodity markets over the course of 2021. On the other hand, market-based US inflation gauges have crawled back above levels not seen since the start of this year. Nonetheless, survey-based inflation expectations have eased to slightly below 2%.

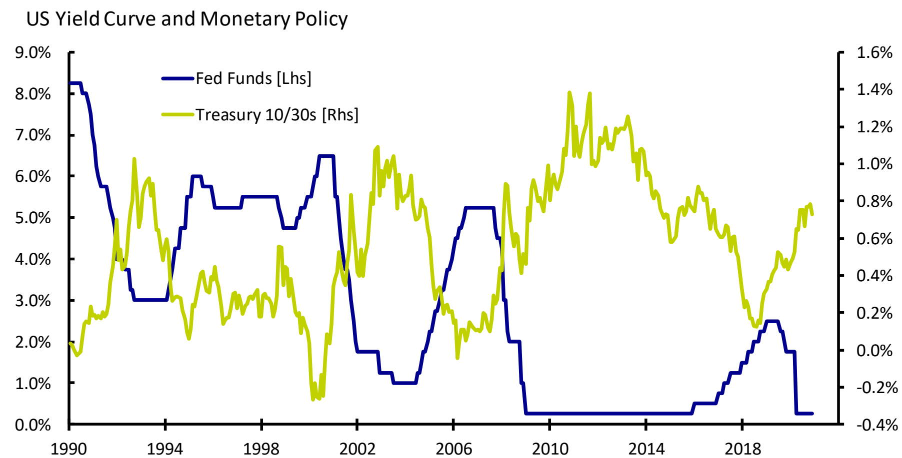
- Investors have expressed the risks associated with the reflation trade mainly via steepeners, e.g., in interest rate swaps. In fact, the 10-year yield seems to somewhat lag the surge in standard reflation metrics, like the copper-to-gold ratio. The long end of the US yield curve has already steepened substantially, which is a source of positioning risk for investors in the context of a reflation trade.

Expected US inflation is back to 2%



Source: Bloomberg and AXA IM Research, Dec 2020

Historically US curve tends to flatten ahead of a hiking cycle



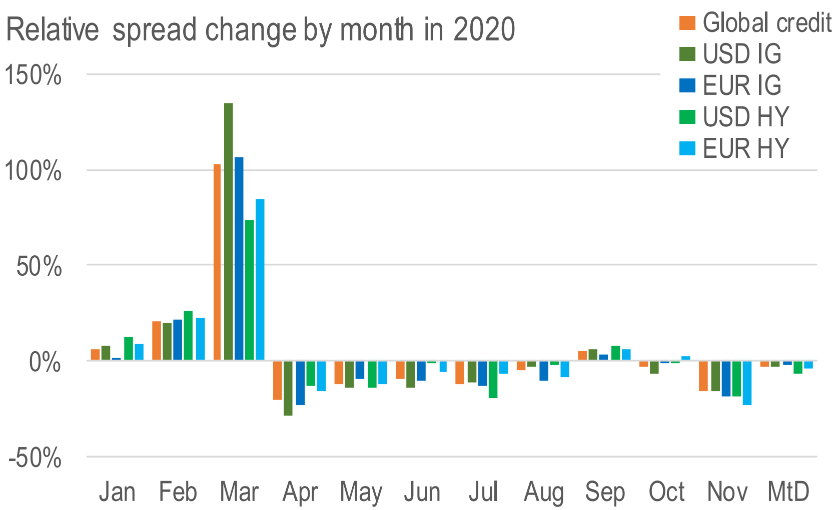
Source: Bloomberg and AXA IM Research, Dec 2020

Credit Strategy

The vaccine 'ate my spreads', making for modest return expectations in 2021, mostly in HY & EM

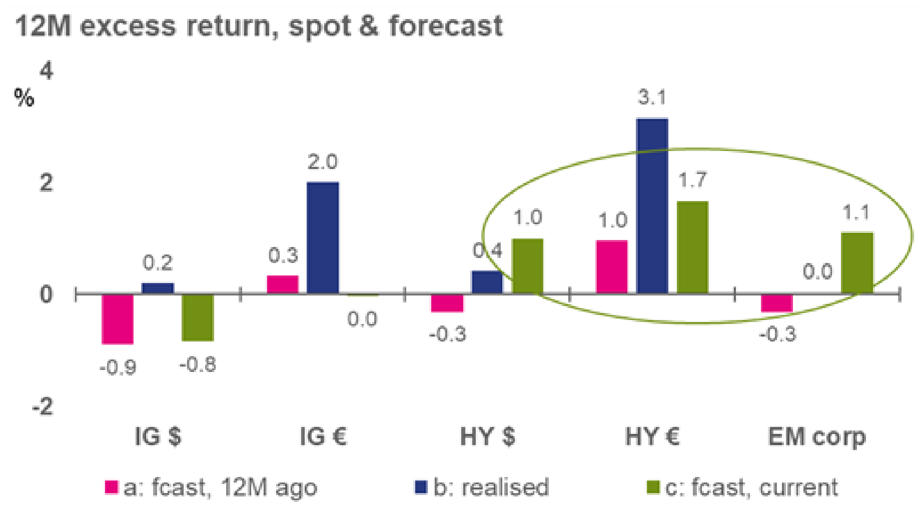
- November's vaccine news turbo-charged sentiment in financial markets. As global credit spreads enjoyed their strongest month since April, HY credit spreads exceeded April's rally. HY market performance jumped as a result, clocking more than 4% in November and closing the gap vs IG. Yet, 'duration' markets like dollar and sterling IG are still set to win the 2020 race in returns.
- A setback to the cyclical rebound notwithstanding, the duration/IG versus spread/HY pendulum should swing in favour of HY in 2021, as economic growth and cyclical risk premia continue to normalise. The remarkable retracement in credit spreads has eroded IG excess return expectations on a 12-month horizon. Only HY and EM present positive albeit modest return expectations.
- The lack of potential for returns in IG credit becomes starkly evident in a portfolio context under a yield-target framework. In euro credit, investors would require one third of their portfolio invested in HY to achieve a blended yield of 1% (a 68:32% IG:HY blend vs a benchmark of 87:13%). On a 5yr duration equivalent basis, one would require a comparable 80:20 IG:HY blend approx, in both USD and EUR markets.

The November rally in HY spreads has been stronger than April's



Source: ICE, US Fed, TRACE and AXA IM Research, Dec 2020

Excess return expectations for the next 12M are positive only in HY & EM



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

Investment Managers

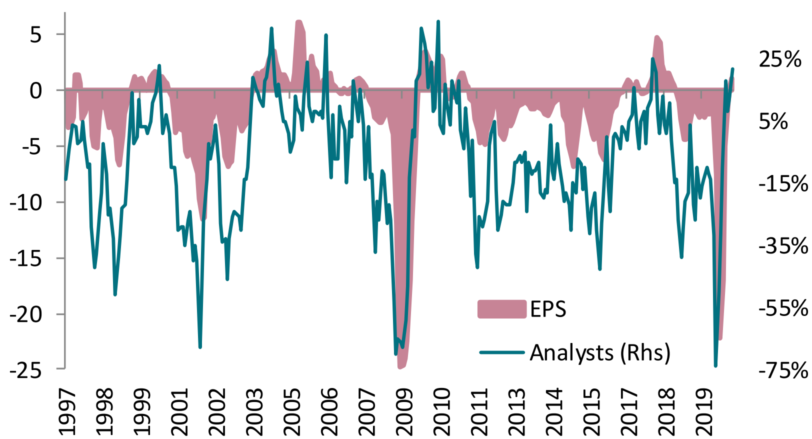
Equity strategy

In the green after a rollercoaster year

- After a rollercoaster year, equities are in the green. More recently, with the US election results and positive news flow on the vaccine front, a rotation is underway. Whether the rotation can spread beyond the current event driven catalysts remains a key debate for the year ahead.
- Overall, market sentiment indicators continue to normalise from a depressed base. Volatility and policy uncertainty are trending down from extremely elevated levels and earnings visibility is gradually improving.
- Earnings momentum had also fully recovered with both the magnitude and breadth of analyst revisions now in positive territory. Consensus expectations for global earnings per share growth in 2021 are running at around 27%, implying we cross the 2019 high-water mark.
- The asset class still appears attractively valued on a relative basis with equity risk premium proxies still having room to compress. Absolute multiples do appear elevated but a lot more reasonable if normalised for the expected earnings recovery.
- We maintain our constructive stance on equities, acknowledging that selectivity remains key given the still elevated uncertainty. Moving into the year ahead, we continue to believe that recovering economic activity, supportive policy measures, subdued positioning and an ultra-low hurdle rate in other assets should support equity markets.

Earnings momentum fully recovered

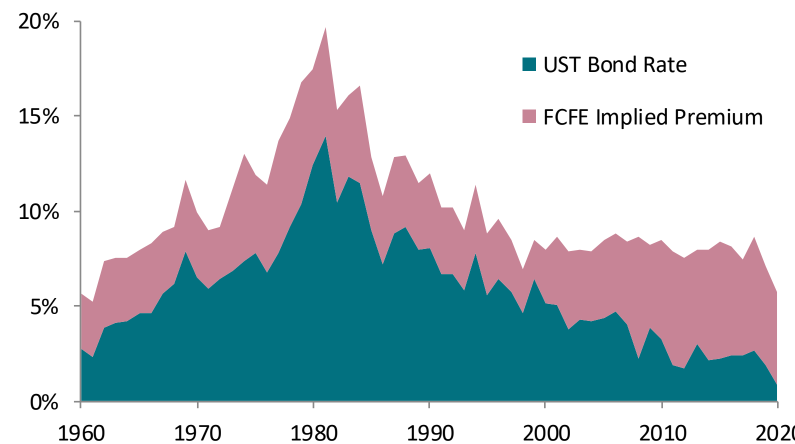
Global equities: earnings revisions



Source: MSCI, IBES, Datastream and AXA IM Research, Dec 2020

Global equity valuations still not demanding

US bond yields and global equity risk premium

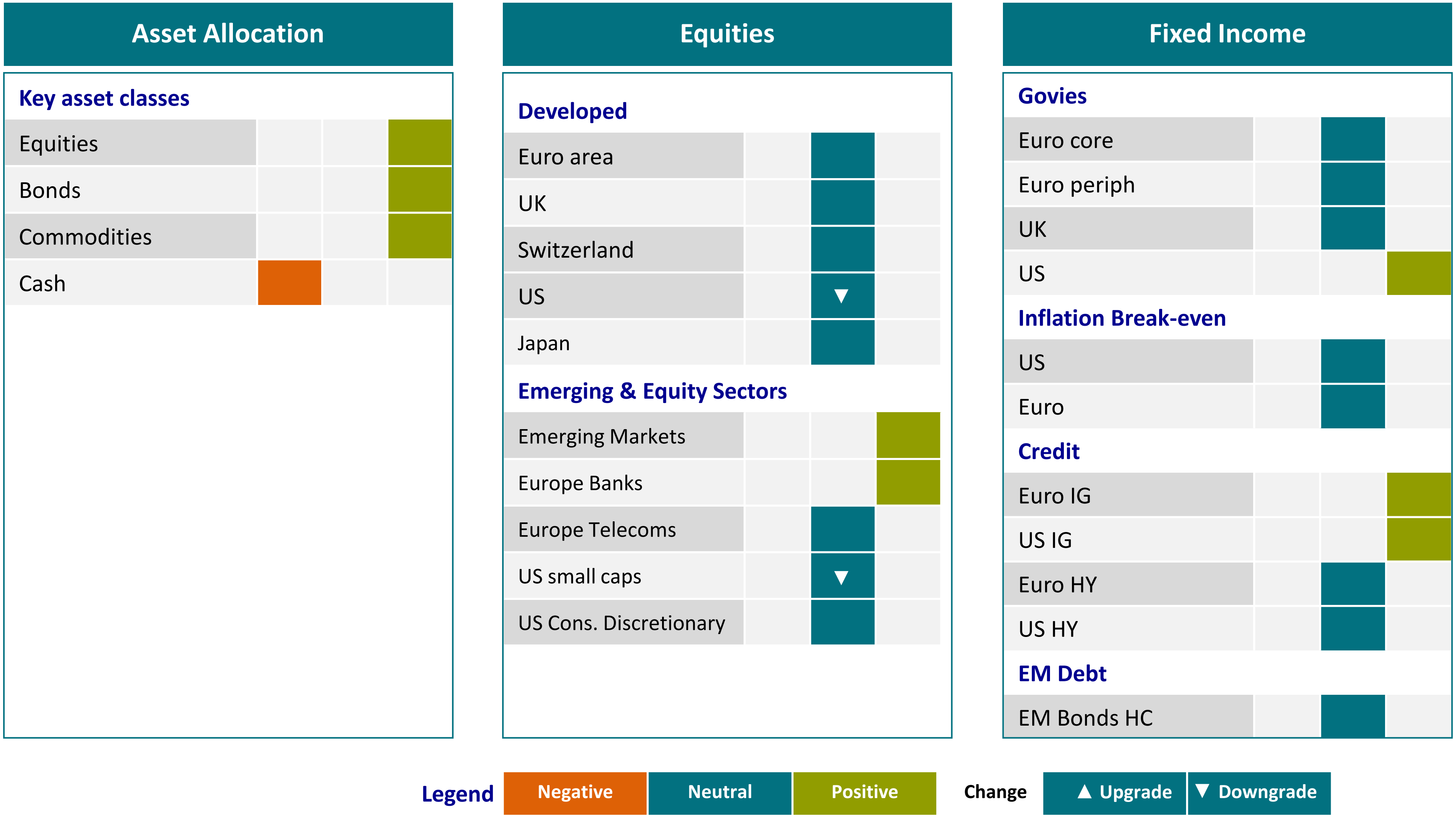


Source: NYU Stern, Aswath Damodaran data and AXA IM Research, Dec 2020

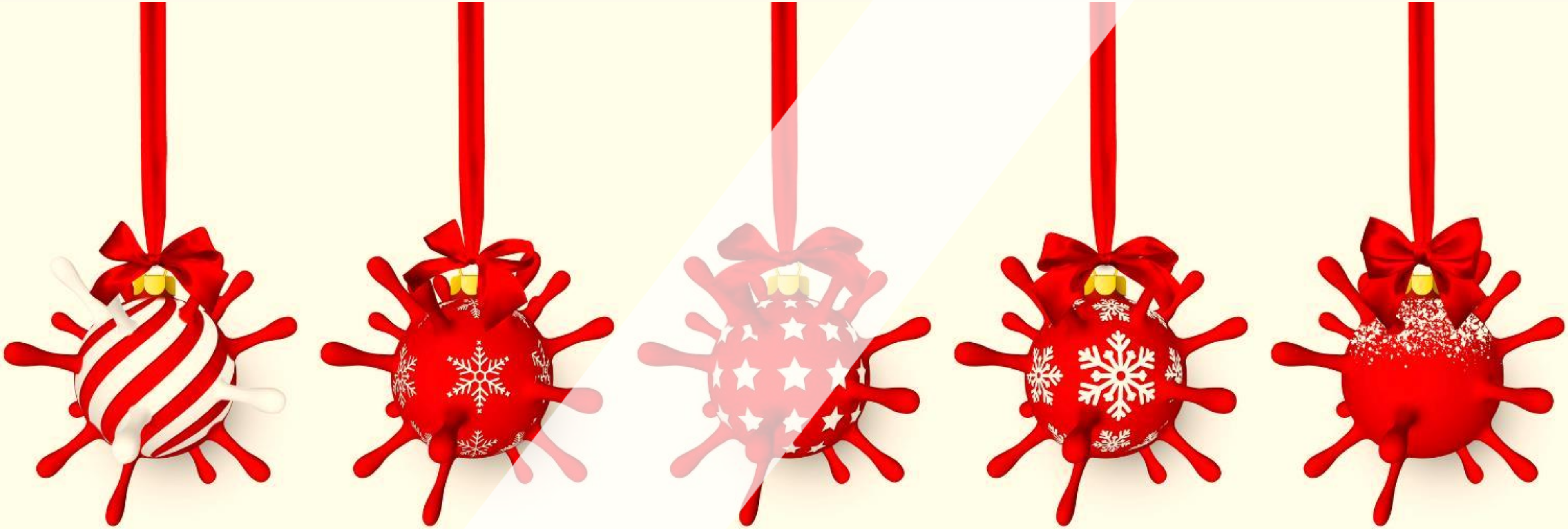
AXA Investment Managers

Asset allocation stance

Positioning across and within asset classes



Source: AXA IM as at 15/12/2020



Forecasts & Calendar

Macro forecast summary

Forecasts

Real GDP growth (%)	2020	2021*		2022*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
World	-4.0	5.2		4.1	
Advanced economies	-5.9	4.6		3.5	
US	-3.4	4.6	3.7	3.7	
Euro area	-7.7	3.7	5.3	4.4	
Germany	-6.0	3.0	4.4	4.6	
France	-9.6	4.5	6.7	4.9	
Italy	-9.2	4.2	5.3	4.2	
Spain	-12.0	3.5	6.7	5.2	
Japan	-5.5	3.0	2.5	2.0	
UK	-11.2	4.6	5.7	6.5	
Switzerland	-4.8	2.5	3.7	3.0	
Emerging economies	-2.9	5.5		4.4	
Asia	-1.4	7.1		5.1	
China	2.3	8.0	7.9	5.5	
South Korea	-0.8	3.5	3.2	3.0	
Rest of EM Asia	-6.0	6.4		4.7	
LatAm	-8.0	4.0		2.7	
Brazil	-5.0	3.4	3.2	2.0	
Mexico	-9.4	4.6	3.7	2.5	
EM Europe	-3.5	2.8		3.6	
Russia	-3.2	1.5	3.1	2.5	
Poland	-2.9	4.0	4.2	4.6	
Turkey	-2.0	3.5	4.6	4.6	
Other EMs	-3.7	3.3		4.1	

Source: Datastream, IMF and AXA IM Macro Research – As of 17 December 2020

* Forecast

Expectations on inflation and central banks

Forecasts

Inflation Forecasts

CPI Inflation (%)	2020	2021*		2022*	
		AXA IM	*Consensus*	**AXA IM**	*Consensus*
Advanced economies	**0.8**	**1.1**		**1.3**	
US	**1.4**	**1.7**	2.0	**2.0**	
Euro area	**0.2**	**0.5**	0.9	**1.0**	
Japan	**0.1**	**-0.2**	0.0	**0.3**	
UK	**0.8**	**1.8**	1.5	**1.5**	
Switzerland	**-0.7**	**0.0**	0.2	**0.2**	

Source: Datastream, IMF and AXA IM Macro Research – As of 17 December 2020

* Forecast

Central banks' policy: meeting dates and expected changes

Central bank policy
Meeting dates and expected changes (Rates in bp / QE in bn)

		Current	Q4 - 20	Q1 -21	Q2-21	Q3-21
United States - Fed	Dates	0-0.25	4-5 Nov 15-16 Dec	26-27 Jan 16-17 Mar	27-28 Apr 15-16 Jun	27-28 Jul 21-22 Sep
	Rates		unch (0-0.25)	unch (0-0.25)	unch (0-0.25)	unch (0-0.25)
Euro area - ECB	Dates	-0.50	29 Oct 10 Dec	21 Jan 11 Mar	22 Apr 10 Jun	22 Jul 9 Sep
	Rates		unch (-0.50)	unch (-0.50)	unch (-0.50)	unch (-0.50)
Japan - BoJ	Dates	-0.10	28-29 Oct 17-18 Dec	20-21 Jan 18-19 Mar	26-27 Apr 17-18 Jun	15-16 Jul 21-22 Sep
	Rates		unch (-0.10)	unch (-0.10)	unch (-0.10)	unch (-0.10)
UK - BoE	Dates	0.10	5 Nov 17 Dec	4 Feb 18 Mar	6 May 24 June	5 Aug 23 Sep
	Rates		unch (0.10)	unch (0.10)	unch (0.10)	unch (0.10)

Source: AXA IM Macro Research - As of 17 December 2020

Calendar of 2021 events

2021	Date	Event	Comments
December	17 Dec	BoE Meeting	Unchanged (0.10)
	17-18 Dec	BoJ Meeting	Unchanged (-0.10)
	31 Dec	UK/EU	End of transition period
January	1 Jan	UK/EU	UK starts trade with EU with new trade rules
	5 Jan	US	Georgia Senate run-off elections
	20 Jan	US	Presidential Inauguration
	21 Jan	Germany	Election of CDU party leader
	20-21 Jan	BoJ Meeting	Unchanged (-0.10)
	21 Jan	ECB Meeting	Unchanged (-0.5)
	26-27 Jan	FOMC Meeting	Unchanged (0-0.25)
February	4 Feb	BoE Meeting	Unchanged (0.10)
March	Mar	UK	Budget
	11 Mar	ECB Meeting	Unchanged (-0.50)
	16-17 Mar	FOMC Meeting	Unchanged (0-0.25)
	18 Mar	BoE Meeting	Unchanged (0.10)
	18-19 Mar	BoJ meeting	Unchanged (-0.10)
	21 Mar	The Netherlands	General Election
	Late March	China	NPC
April	26-27 Apr	BoJ Meeting	Unchanged (-0.1)
	27-28 Apr	FOMC Meeting	Unchanged (0-0.25)
May	6 May	BoE Meeting	Unchanged (0.1)
	6 May	Scotland	Scottish Parliament Elections
June	10 Jun	ECB Meeting	Unchanged (-0.5)
	15-16 Jun	FOMC Meeting	Unchanged (0-0.25)
	17-18 Jun	BoJ Meeting	Unchanged (-0.1)
	24 Jun	BoE Meeting	Unchanged (0.1)
July	23 Jul	ECB Meeting	Unchanged (-0.5)
	27-28 Jul	FOMC Meeting	Unchanged (0-0.25)
September	9 Sep	ECB Meeting	Unchanged (-0.5)
	21 Sep	Germany	Federal Elections
	21-22 Sep	BoJ Meeting	Unchanged (-0.1)
	21-22 Sep	FOMC Meeting	Unchanged 90-0.25)
	23 Sep	BoE Meeting	Unchanged (0.1)
	30 Sep	Japan	End of term as LDP leader for PM Suga
October	21 Oct	Japan	House of Representatives term ends
	28 Oct	ECB Meeting	Unchanged (-0.5)
November	2-3 Nov	FOMC Meeting	Unchanged (0-0.25)
	4 Nov	BoE Meeting	Unchanged (0.1)
	1-12 Nov	UK/UN	Climate Conference
	27-28 Nov	BoJ Meeting	Unchanged (-0.1)
November 2022	8 Nov	US	Mid Term Elections

AXA Investment Managers

Latest publications

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03 December 2020

The emerging market COVID-19 debt surge – no crisis on the horizon, yet

18 November 2020

US Election update: clarity, but not certainty

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04 November 2020

Individual government challenges and the Covid-19 debt surge

22 October 2020

October Global Macro Monthly & Investment Strategy – Into the bleak, debt winter

21 October 2020

How governments can respond to the COVID-19 debt surge

7 October 2020

September Global Macro Monthly & Investment Strategy – Biden his time

24 September 2020