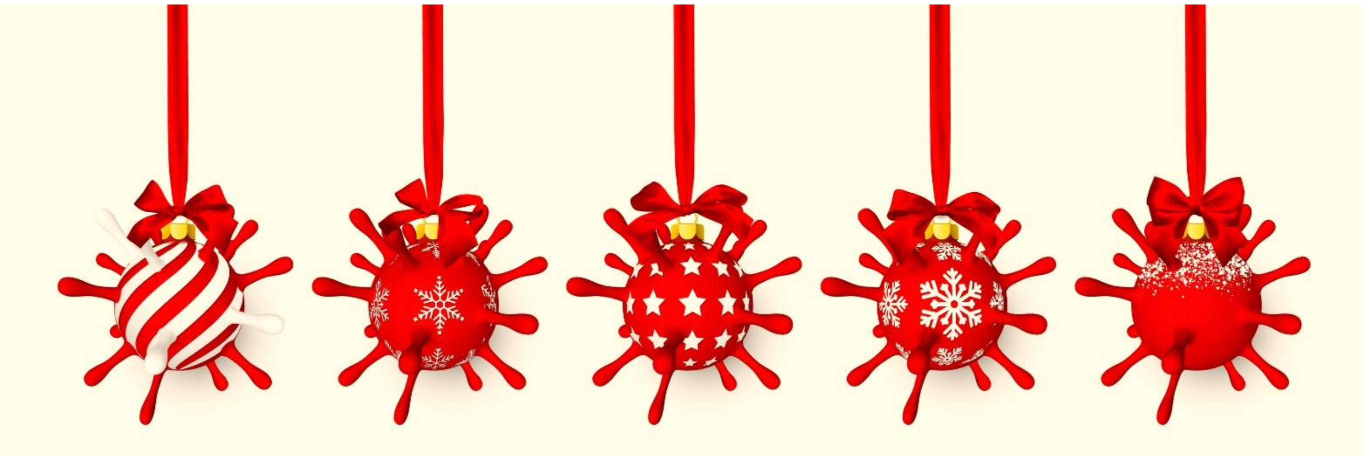
For professional clients only
17 December 2020
Research & Strategy Insights

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

Global Macro Monthly



Key points

- The pandemic dominates the short run outlook. In the Eurozone and UK, cases remain elevated and restrictions could rise anew. In the US, this process is underway as cases set new records. Both threaten winter weakness
- 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 boosted some economies, including China and Germany. While renewed virus cases threaten another demand dip, the vaccine poses some threat if consumers rotate to long-denied services.
- 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.

Global Macro Monthly

Investment Strategy

Global Macro Monthly – US

David Page,
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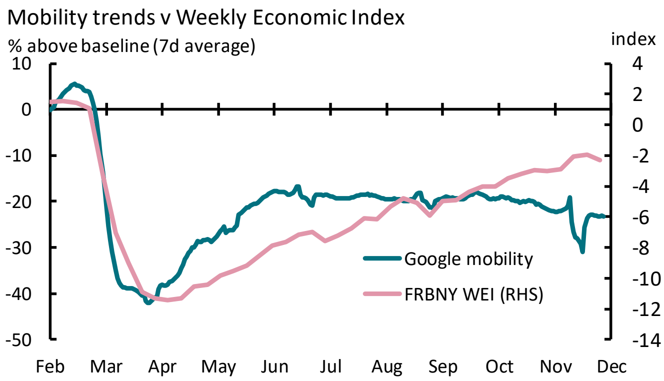
Virus forces GDP reaction but vaccine set to help

There is a significant divergence in virus spread across different parts of the US. The 7-day average of new cases continues to set new highs in December, although its growth rate has slowed. New cases are falling across the mid-west but in contrast are now rising in many other regions. Positivity rates flattened in late November but have climbed again since Thanksgiving. While we hope for stabilisation across December, renewed transit and interactions over Christmas pose a risk of further gains in January. Meanwhile US states are increasingly reacting with renewed restrictions, such as California, which enacted a stay-at-home order.

The impact on economic activity is still uncertain. Mobility as tracked by Google fell sharply, by 10 percentage points (ppts) over the month, far worse than the modest 4ppts seen in the summer with the southern state outbreak (Exhibit 1). Moreover, traditional economic series are beginning to weaken; this includes falls in the ISM indices – successive in the services index, a retracement in consumer confidence and auto sales as well as a rising trend in initial jobless claims. However, other indicators urge caution before writing off US growth. The Federal Reserve (Fed)'s weekly economic indicator continues to trend higher. Moreover, the Atlanta Fed GDP tracker currently suggests 11.2% (annualised) expansion in Q4.

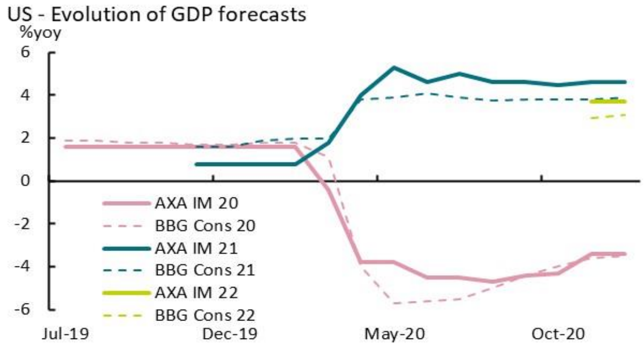
Exhibit 1: Virus to impact short-term path of GDP



Source: John Hopkins, FRBNY and AXA IM Macro Research, December 2020

We continue to forecast slower US GDP growth in Q4, anticipating 6% annualised, followed by a modest contraction of -2.5% in Q1 as restrictions continue to weigh. Our view is also dependent on the passage of a short-term stimulus bill.1tn Renewed discussions around a $0.9tn package are consistent with our expectations of a $1tn bill, but this now looks likely to be passed before Christmas. The expiry of several jobless income support packages, totalling around 13mn people, hangs in the balance and failure to cushion or avert their expiry on 31 December would lead to a sharper contraction in Q1.

Exhibit 2: More optimistic than consensus



Source: Bloomberg and AXA IM Macro Research, December 2020

We expect US GDP to contract by -3.4% in 2020. But we forecast faster-than-consensus growth to emerge next year, with 4.6% in 2021 and 3.7% in 2022 (Exhibit 2). In part, this is on the expectation of a mass vaccination programme taking place relatively quickly across the US, lifting growth from Q2 2021. Our forecasts suggest the fastest consecutive expansion since 1999/2000 and exceed the consensus forecast of 3.9% and 3.1% respectively. However, given the scale of lost output in 2020, even this would not see pre-Covid growth levels resume until H2 2021, nor the output gap close until 2023.

Policy support remains critical. Beyond the short-term stimulus package, the outlook for fiscal policy will be shaped by the outcome of Georgia's Senate run-off races on 5 January. Polling is close for both seats. Yet we think the chances of the Democrats taking the both seats needed to gain control of the Senate are slim. We expect a Republican-majority Senate that is likely to impede the implementation of President-elect Joe Biden's progressive manifesto. While Biden may be able to negotiate a moderates', compromise infrastructure bill, we think the obstacles are high and do not expect any such bill to lift GDP before end 2022.

The Federal Reserve ended the year by leaving policy unchanged. Explicit forward guidance tying the policy rate path to labour market and inflation conditions meant changes here were unlikely. Yet many considered the possibility of the Fed extending the maturity of its asset purchases. As we expected, it did not. We suspect that the Fed will leave this tool in reserve to use if real term yields rise from near record lows. The Fed added guidance over its balance sheet policy, saying it would continue at its current pace until "further substantial progress" had been made towards its goals. This commits the Fed to sizeable expansion for some time, but in truth leaves ample discretion around when it might taper. We expect purchases to continue at current pace until early 2022.

Global Macro Monthly – Eurozone

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The pandemic's second wave is not over yet

The euro area is in the downward slope of the Covid-19 second wave. The improvement was initially relatively fast given the less stringent, renewed national lockdowns, allowing France, for instance, to reopen its retail sector earlier than we expected at the end of November. But the numbers of daily cases seem now to be stabilising at elevated levels. In France, they are at more than twice the government's target. In Germany, which had dealt so well with the first wave, the rate of new cases per 100,000 people has been flat for a month and is now higher than in France, Italy and Spain, while positivity rates are increasing.

The persistence of the virus has prompted renewed discussions about the scheduled easing of lockdowns. France has postponed its plans to reopen its cinemas, museums and theatres on 15 December, and announced an earlier curfew of 20:00 instead of 21:00. In Germany, a stricter lockdown, with non-essential shops closing, will be implemented from 16 December to 10 January at least. The Italian government is mainly relying on mobility restrictions, with travel across regions severely curbed between 20 December and 6 January.

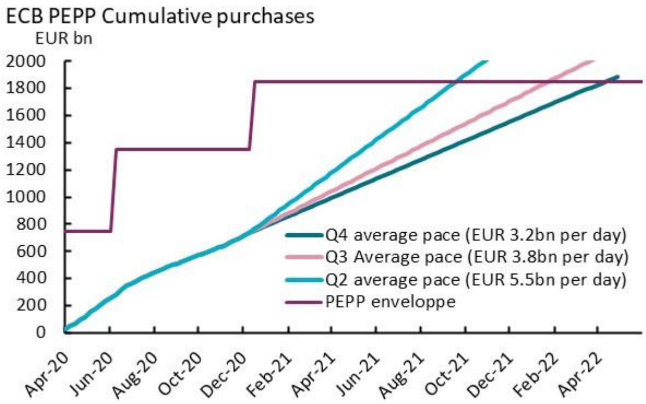
The fact that the virus is proving more persistent in the winter has economic implications – the first quarter (Q1) of 2021 will probably be weaker than expected. Meanwhile we may have been too pessimistic on Q4 growth, despite the latest restrictions. France's mobility has recovered faster than we expected while the German industrial sector is surprising on the upside. Industrial production is catching up with positive sentiment and the Q4 carry-over is strong at 4.9% quarter-on-quarter – this could add more than one percentage point to German GDP growth. Italy seems broadly in line with our forecasts, but we see upside risks to Spain given the surprising strength of the labour market. Overall, we think the euro area's GDP contraction could be around 2.5%qoq, less than the 4% we initially envisaged.

A deal and a package

The European Union has managed to deal with institutional hurdles on the fiscal front to finally deliver the Recovery and Resilience Fund, thanks to a compromise with Hungary and Poland. 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 definitely a success. European mutualised support will be material and will contribute to the sustainability of public debt in the most fragile member states. Still, the main source of calm in the sovereign bond market is the European Central Bank (ECB).

We were not disappointed by its December package. The extension of the Pandemic Emergency Purchase Programme (PEPP) until March 22 offers protection, while keeping some powder dry. The €500bn envelope would allow the ECB to continue to purchase assets at the pace so far observed in Q4 2020 – when financial conditions were benign – until March 2022 (Exhibit 3). This explains ECB President Christine Lagarde's insistence that the quantum was flexible in both directions i.e. it could be further increased or not be used in full, depending on financing conditions (Lagarde referred to broad parameters such as lending rates to households and corporates, credit flows, sovereign and corporates yields). Implicit yield curve control has been confirmed.

Exhibit 3: ECB yield curve control



Source: ECB and AXA IM Macro Research, 14 December 2020

The ECB also offered further support to banks via a recalibration of the third series of its Targeted Long-Term Refinancing Operations (TLTRO). The Governing Council added three new operations between June 2021 and December 2021, with similar modalities including a three-year maturity. The discount period has been extended by one year, until June 2022, during which the minimum interest rate applies to banks meeting their lending criteria (50 basis points below the deposit rate). Moreover, the amount of maximum TLTRO allowances has been raised to 55% of their stock of eligible loans, from 50%. But according to press reports, debate was tense and the original plan submitted to the Council pushed the allowances to 60%, which would have freed some space for banks which are already close to their ceiling – most of them located in peripheral countries. Lending data and the next Bank Lending Survey released on 19 January will be interesting, to gauge whether the ECB will have to do more on the credit side.

But we think that the real question now is on the quantum of monetary support on offer once PEPP stops in March 2022 (at the earliest). Given the ECB's inflation forecasts, which remain significantly below its target at the end of 2023 (core at 1.2% year-on-year), the logical conclusion is that the "ordinary" quantitative easing programme will be stepped up. This will be the toughest test for Lagarde in our view.

Global Macro Monthly – UK

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Can the UK shake off both COVID-19 and Brexit?

Brexit talks have continued to dominate headlines, and only in the latest days have they suggested any signs of progress, but still with no definitive end date. However, as the end of 2020 approaches – when the UK's transition period finishes – the absolute deadline hoves into view. Optimism for a deal has ebbed and flowed amid prolonged negotiations, but important developments over the Northern Ireland protocol and top-level political engagement augur more optimism. We still consider a deal likely within days, which could be ratified by Parliament over the Christmas recess. But a no deal outcome is still described as "likely" and would likely reduce the outlook for next year's growth by around 1ppt.

The UK emerged from lockdown in December, but into a national tiered system that we estimate leaves the country at an operating capacity of around 96.5%, from 91.5% under lockdown. With positivity rates slowing gradually but new cases remaining elevated, restrictions look set to remain into the New Year, weighing on activity. However, the UK has become the first of the major economies to start administering a COVID-19 vaccine. We expect this to take into the second half of next year to achieve full herd immunity and an associated rebound in activity. However, inoculating the vulnerable may ease the need for the harshest Tier 3 restrictions in the early months of 2021.

GDP growth has held up better than expected so far, with October posting a monthly rise of 0.4%mom, against our fears of a dip. Q4 still looks set to contract overall, but by less than we feared. Though this is likely to dampen a rebound in Q1 – which looks set to be further affected by increased restrictions in January – the outlook for 2021 may improve marginally. We now consider risks to our forecasts of -11.2% for 2020 and 4.6% for 2021 as skewed to the upside.

The Bank of England's (BoE) final meeting of the year was not expected to deliver any further change to policy, having increased the QE total by £150bn in November. While risks persist for 2021 in the form of the virus and Brexit, 2020 does not appear likely to end as weakly as the BoE feared (forecasting -2.5% for Q4 in November). This adds to our view that the BoE is unlikely to deliver negative interest rates next year. However, we continue to expect a further extension of QE (£75bn), which will likely be announced in Q2 2021. But a messy, no deal exit would add to calls for further stimulus.

Global Macro Monthly – Japan

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Sustained recovery postponed to 2021

The short-term outlook remains constrained by the evolution of the pandemic. The number of new cases and deaths are rising markedly, encouraging the government and regions to take further restrictions. Working from home has been prioritised, while restaurants and bars have more constrained hours. The "Go to" campaign – which subsidises consumption in heavily impacted sectors – has also been partially suspended.

Japan's recovery has been disappointing since late spring but data for October pointed to an acceleration in activity. Industrial production came in at +3.8%mom, marking the fifth consecutive increase, while 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. Overall, we expect modest GDP growth in Q4 of +0.3%qoq.

PM Suga unveiled details of a third supplementary budget of ¥73tn (Exhibit 4). As usual, this 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. If the draft is adopted - changes can still occur before January – it would deliver a modest positive boost to 2021 GDP – we had expected only a ¥15tn stimulus. But any boost is likely to be modest - 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.

Exhibit 4: Japan will implement a third budget stimulus

Measures	Govt spending (¥ tn)	Total package (¥ tn)
Preventing COVID-19 spread	4.5	6.0
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	10.0	10.0

Source: Minister of Finance and AXA IM Macro Research, December 2020

At its 17-18 December meeting, the Bank of Japan should maintain the status quo on the main policy parameters but it may expand its special fund-supplying operations, echoing the government's support extension to corporates.

Global Macro Monthly – China

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Growth momentum preserved in third quarter

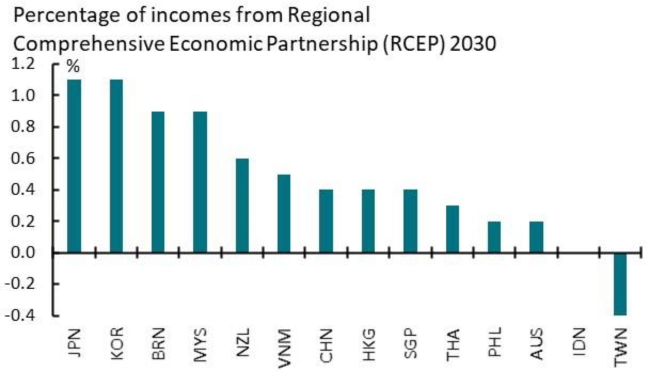
China continues to rebuild growth momentum, with recent economic data surprising consistently on the upside. Conditions in manufacturing and services sectors are at their highest levels since at least 2017 as reflected by the recent Purchasing Managers' Indices (PMIs). Part of this is due to continued export strength, with November shipments growing by 21%, the highest since the trade war in 2018. Exports of medical-related equipment were boosted by the worsening pandemic in the US and Europe. But given that mobility restrictions have only just been re-enacted, and are less strict than before, demand for regular "made in China" products seems to be uninterrupted for the time being. In fact, growth of non-pandemic-related exports has accelerated briskly, due to strong Christmas-season demand. The near-term prospects for exports look solid as reflected by the buoyant export order index in the PMI. But demand conditions may deteriorate somewhat later as the impact of the second wave drives US and European economies into another temporary contraction in the coming months.

More broadly on trade, the recent signing of the Regional Comprehensive Economic Partnership (RCEP) represents a milestone, particularly against the worrying trend of rising protectionism. The deal has created the world's largest trading bloc that accounts for roughly a third of the world's population, GDP and trade volumes and should help to accelerate regional economic integration in Asia Pacific.

RCEP is by no means a perfect deal. Compared to the Comprehensive and Progressive Trans-Pacific Partnership Agreement (CPTPP), it has a long transition period for tariff reduction for certain industries, such as agriculture, in less developed countries. Some of its agreements on information sharing, and standards adoption are non-binding, which creates the risk of non-compliance that could be difficult to address by the weak dispute settlement mechanism. Nevertheless, RCEP is still the most significant regional trade agreement, which will impact the Asian economies profoundly through three dimensions.

First, through trade: RCEP members will gain from the creation of the world's largest tariff-free zone, where over 90% of goods traded will be exempted of custom tax. Two caveats should be kept in mind, however. The first is the long transition period, which will make the gains from tariff elimination gradual and drawn-out. The second is that there are already several free trade agreements (FTAs) among most of the RCEP members. This will make the incremental gains from tariff reductions less than meets the eye. But the most significant changes, we think, will likely occur between the larger economies in the region i.e. Japan, China and Korea, where no bilateral FTAs exist currently. A study from the Peterson Institute suggests that RCEP will boost China, Korea and Japan's GDP by 0.5 to 1 percentage point in 2030, with a 0.5% gain for the region overall (Exhibit 5).

Exhibit 5: Gains from RCEP across Asia



Source: Peterson Institute and AXA IM Research, 19 December 2020

The second channel is via supply chain deployment and productivity-enhancing reforms. RCEP has provisions on investment, services trade, tech standards, labour market rules and intellectual property protection. Although not as strict as CPTPP, fulfilling these criteria will likely require less-developed RCEP members to undertake structural reforms, boosting productivity growth in the coming years.

In addition, a unified "rule of origin" will encourage RCEP members to share supply chains within the bloc. This is because components sourced within RCEP will enjoy preferential tax treatments, while those imported from outside may not. This will likely reinforce the supply chain reshuffle already underway, with low-margin production capacities migrating out of China to countries in southeast Asia, such as Vietnam and Cambodia.

Finally, the geostrategic and geopolitical consequences of RCEP should not be downplayed. The Association of Southeast Asian Nations (ASEAN) has demonstrated its ability to stitch together an ambiguous trade deal involving countries at different stages of development. This success will likely raise ASEAN's voice on the global stage going forward. China, while not the initiator of the agreement, is clearly a proponent of trade liberalisation that has won the support of the most populous region of the world. By tying economic interests together, RCEP will make splitting Asia more difficult by other (e.g. political) means. Lastly, with China integrating with the rest of Asia, any attempt by other countries to decouple with China could expose the isolationist to the risk of foregoing the entire Asian market, making decoupling very costly and thereby less likely.

Global Macro Monthly – EM

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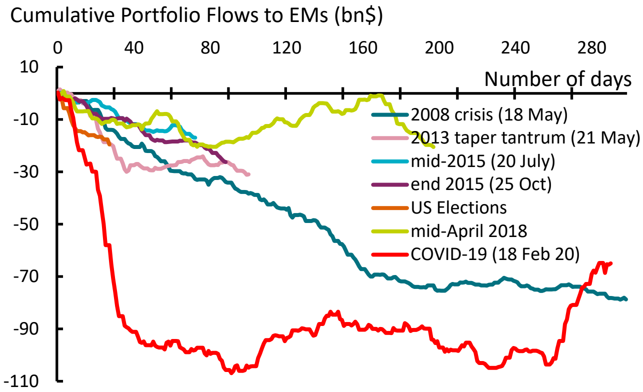
Leveraged to a vaccine solution for COVID-19

Since the first vaccine breakthrough was announced on 2 November, emerging market (EM) assets have enjoyed renewed foreign investor interest. Optimism surrounding vaccination, alongside the arrival of a more predictable US administration, particularly with regards to international relations – given that advanced economies are pursuing vast monetary and fiscal stimulus – are undeniably supportive for sentiment. Recent data releases continue to suggest that the Chinese recovery is well on track, another important driver for emerging markets. Since 18 February, when the crisis was taking hold, EM have endured approximately US$104bn of foreign portfolio outflows[1]. At its trough on 1 November this reflected around $30bn in EM debt assets and $74bn in EM equities. Since then, some $38.7bn of inflows have been reported, mostly flowing into EM equities (Exhibit 6).

Exhibit 6: Foreign investors comeback in EM assets

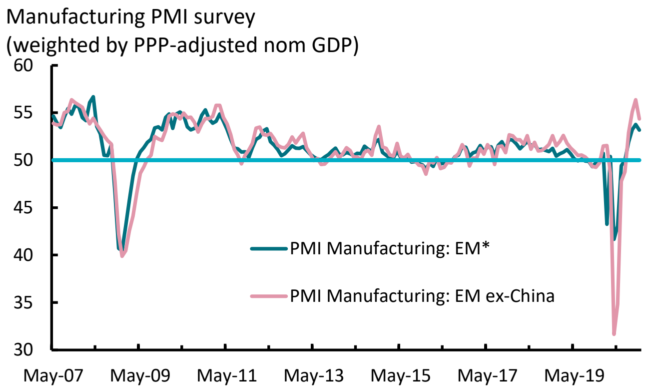


Source: IIF and AXA IM Research, 3 December 2020

Manufacturing-led rebound confirmed

Undeniably, it is still early days and fragilities remain. Service sectors continue to operate under strong constraints. The path of the pandemic remains unknown and the recovery in advanced economies is losing some steam, which could reduce future external demand for EM exports. In addition, fiscal space in most developing markets is shrinking. However, as mobility restrictions are eased, manufacturing activity has rebounded from its spring shock. The latest Purchasing Manager Index (PMI) surveys reinforce the view that the manufacturing sector is improving at a good pace and is supportive of a growth rebound into 2021. As always, there are differences between countries, but the general message from the production and orders components of the data point to robust manufacturing activity into year-end. In November, Indonesia's PMI came in at 50.6, representing a 2.8-point rise versus October. Meanwhile the Czech Republic with 53.9, (+2.0) and Taiwan at 56.9 (+1.8) registered the sharpest improvements on the month before. Despite seeing some normalisation in November, Brazil shows the highest headline manufacturing PMI level globally (64.0, -2.7), while India (56.3, -2.7) also scores very high worldwide (Exhibit 7).

Exhibit 7: Manufacturing activity further expands



Source: Refinitv Datastream and AXA IM Research, November 2020

South Africa blowing hot and cold

For South Africa, the good news came from the third quarter (Q3) GDP release. Growth bounced by 13.8% quarter-on-quarter (-6.9% on an annual basis) after a collapse of 17.5% in Q2, mainly led by household consumption (+14.1%) and exports (+31.8%), which mirrored the strong rebound in mining and manufacturing activities. 2020 GDP looks set to contract by 7%. We expect a limited 3.5% GDP expansion in 2021. Economic recovery should continue in Q4 2020 and build through 2021, on the back of a revival of exports, as global growth rebounds and the virus recedes as vaccinations are rolled out, and some pent-up demand.

Public debt sustainability issues are likely to remain in focus. The government's ability to deliver the civil servants wage freeze for the next three years is questionable, but this lies at the heart of securing planned public savings (this measure is expected to provide 90% of the saving) which is necessary to achieve a peak in public debt at 95.3% of GDP by 2025. Meanwhile, the Reserve Bank is likely to keep interest rates unchanged at 3.5% throughout 2021.

[1] Institute of International Finance (IIF)

Investment Strategy – Cross-assets

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Into 2021 – through a glass brightly

As we prepare for 2021, there are certain known unknowns to contemplate. The beginning of the end of the pandemic might come into view; the Donald Trump administration in the US will be gone and Brexit will be done, on paper at least. The one thing that will remain clearly present is the all-encompassing influence of central banks over financial markets through monetary policy. While policy rates remain very low and real yields in negative territory, risky assets are bound to hopefully deliver in terms of returns and markets should be able to bounce back from any setbacks driven by headlines.

As income cashflows from fixed income assets are set to remain meagre, equity markets will prevail as a viable alternative. Investors have been crowded out of so-called risk-free assets and the demand for gaining access to the one cashflow that can grow – namely corporate earnings – is likely to underpin performance in equity markets. This may appear rather unorthodox as an investment philosophy at first, but it does come as the most likely inevitable rational conclusion, as long as – and until – central banks are inclined to lessen their influence on risk-free premia.

Investment Strategy – FX

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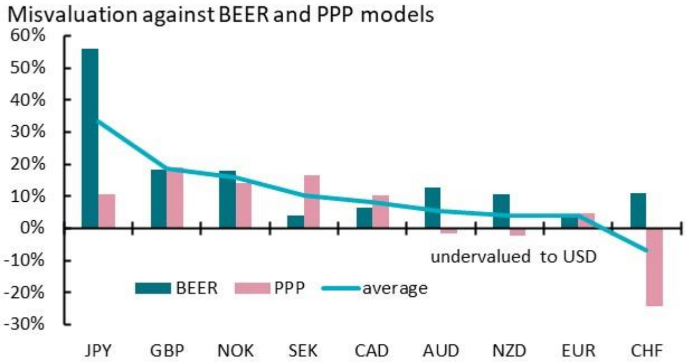
The US dollar is caught in the perfect storm

The US dollar's overvaluation continues to normalise lower and this trend is not yet nearing its end (Exhibit 8). Aside from the fundamental driver of the lower yield differential, additional factors are at play. Elections that look set to deliver a split Congress act as a constraint on further fiscal packages in the US, which in turn implicitly guarantees that the Federal Reserve will have to maintain its very large policy accommodation for longer. Avoiding further escalation of confrontational US trade policy under a Joe Biden administration should prove supportive of risk sentiment. However, the prospective vaccine rollout that should gradually allow global growth to rebound could be hindered initially in the US by very negative virus dynamics, which could dampen US growth outperformance in 2021.

Exhibit 8: USD overvaluation – further room to normalise



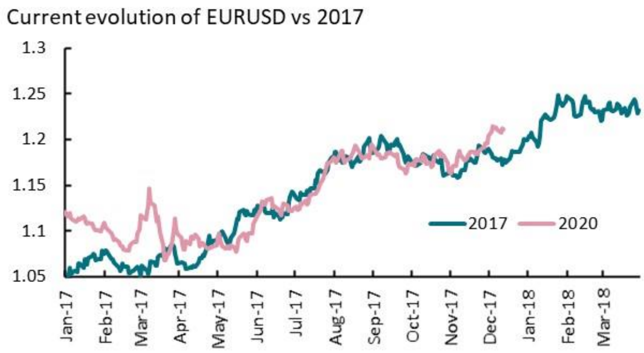
Source: Bloomberg and AXA IM Research, December 2020

Euro/dollar rate rises like it's 2017

The euro has benefited materially from dollar weakness in a move like the pattern seen in 2017 (Exhibit 9). The risk-on environment has been supportive lately, while the recent approval of the Recovery Fund has stifled European Union (EU) unity concerns. Global growth should support EU exports and while EU growth is not outperforming, its carry differential versus the dollar is much less. Finally, Eurozone inflation is expected to undershoot US inflation, creating real exchange rate appreciation. On the downside, the euro remains vulnerable to bouts of risk-off, be it due to noise around the Fed's quantitative easing (QE), US macro data due to renewed virus restrictions, or Brexit. Net-net, we think that the euro/dollar rate has more upside potential in the medium term even if more limited in the short term.

The Japanese yen should be more immune to negative global factors and it now appears more undervalued against the dollar than the euro. The better macro outlook might drive foreign investment flows by Japanese investors, but not to a very high degree, given the low level of global rates. Lastly, the Australian dollar is now as undervalued versus the US dollar as the euro, 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. In addition, the Reserve Bank of Australia has cut interest rates closer to zero in early November and has added QE purchases, putting further dovish surprises behind us for the time being.

Exhibit 9: EURUSD already replayed 75% of 2017 move



Source: Bloomberg and AXA IM Research, December 2020

Investment Strategy – Rates

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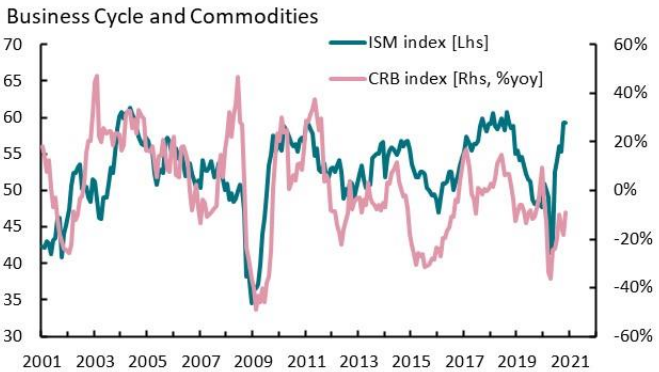
US Treasuries: a look at 2021 Inflation

Following a spectacular 160 basis point (bp) collapse in the first quarter (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, with +7.4% year to date. Looking ahead, in our 2021/2022 Outlook, we identified inflation as the key source of uncertainty for investing in the rates markets.

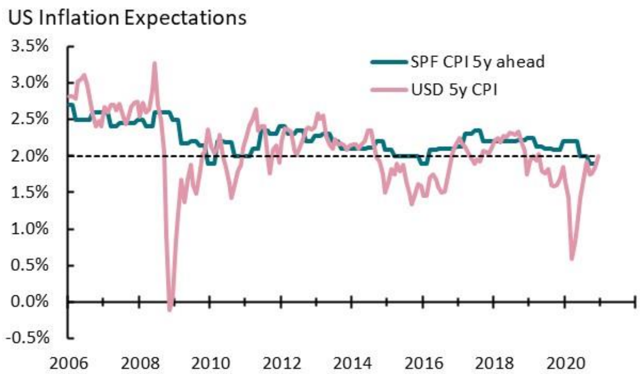
Exhibit 10: Commodities lagging the cyclical rebound



Source: Bloomberg and AXA IM Research, 14 December 2020

The severe demand shock suffered by the global economy in the wake of the pandemic has dealt a direct blow to commodity markets, including energy which is down -60% year to date. Only recently has demand started to rebound, presumably thanks to China's economy firing on all cylinders. As a result, global demand has pulled up industrial metals by almost 17%. Yet commodity indices are still down some 14% on the year and are lagging the quick cyclical rebound in business expectations (Exhibit 10).

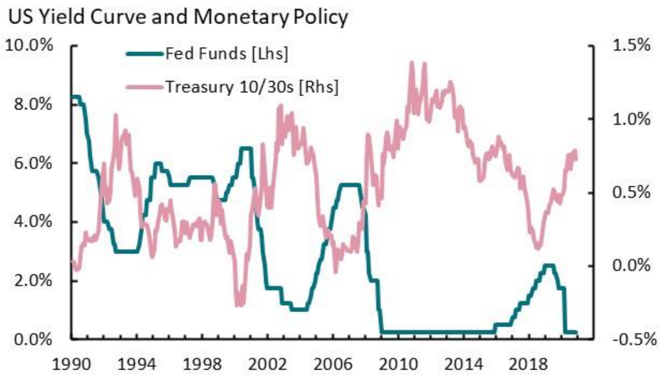
Exhibit 11: Expected US inflation is back to 2%



Source: Bloomberg and AXA IM Research, 14 December 2020

From this perspective, we might expect that 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. The US two-year Consumer Price Index has delivered a monster rally of 220bps since plunging into negative territory as of mid-March. Nonetheless, survey-based inflation expectations have eased to slightly below 2% (Exhibit 11), but this should not be of concern for the Federal Open Market Committee (FOMC), provided it can successfully commit to the new policy strategy.

Exhibit 12: Historically US curve tends to flatten as the Fed prepares for a hiking cycle



Source: Bloomberg and AXA IM Research, 14 December 2020

Investors have expressed the risks associated with the reflation trade mainly via steepeners, i.e. interest rate swaps. In fact, the 10-year yield seems to somewhat lag the surge in standard reflation metrics, like for example the copper-to-gold ratio – which is up six percentage points from April's low. Looking at the speculative Commodity Futures Trading Commission positioning, the steepener theme appears to be still in place, despite a retracement of ultra-long bond shorts established this summer.

Two concluding observations. First US monetary and financial conditions are still very generous and even a moderate rise in real yields is likely to be counterbalanced by this year's dollar weakening. However, it's the pace of adjustment that matters for financial markets, probably even more than the absolute change in financing conditions.

Second, 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. The US curve typically flattens as the Federal Reserve prepares for a hiking cycle (Exhibit 12). However, we think the situation might be slightly different in 2021/2022, since the Fed is now implementing a new policy strategy, which is supposed to delay the inaugural rate hike until average inflation is back to 2% – i.e. the FOMC will "*likely aim to achieve inflation moderately above 2% for some time*".

Investment Strategy – Credit

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Credit Strategist
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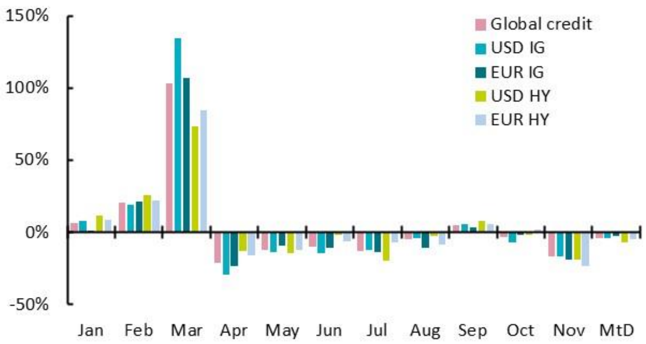
The vaccine ate my spreads

The good news in early November about the COVID-19 vaccine turbo-charged sentiment in financial markets. The medical breakthrough triggered a broad rally and a significant outperformance in risky assets that are more highly geared to the business cycle. As global credit spreads enjoyed their strongest month since April (Exhibit 13), high yield (HY) credit spreads exceeded April's rally.

Exhibit 13: the November rally in HY spreads has been stronger than April's

Relative spread change by month in 2020

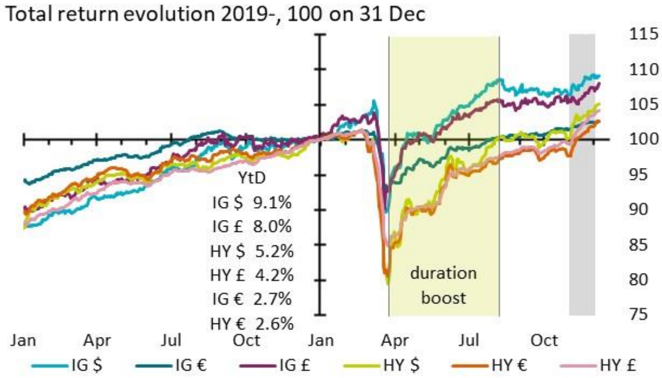


Source: InterContinentalExchange (ICE) and AXA IM Research, December 2020

HY markets saw a jump in performance as a result, clocking returns of more than 4% in November (Exhibit 14, grey shade) and closing the gap on investment grade (IG) markets. However, 'duration' markets like dollar and sterling IG are still set to win the 2020 race, given the boost from falling interest rates during the first half of the post-COVID-19 rebound (Exhibit 14, green shade).

Exhibit 14: another year of good returns, almost unthinkable back in March (and duration wins again)

Total return evolution 2019-, 100 on 31 Dec

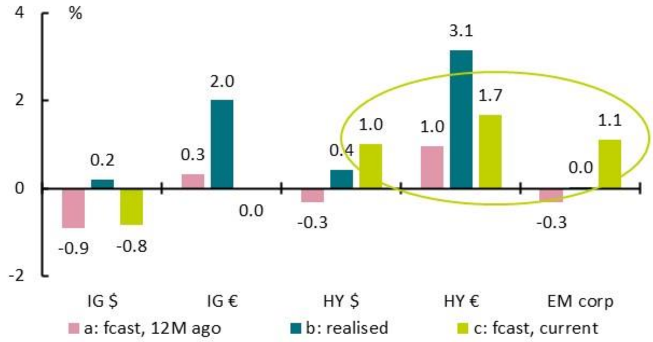


Source: ICE and AXA IM Research, December 2020

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. Indeed, the remarkable retracement in credit spreads overall, despite the deepest recession in living memory, has eroded IG excess return expectations on a 12-month horizon (Exhibit 15). Only HY and emerging markets (EM) present positive albeit very modest return expectations.

Exhibit 15: excess return expectations for the next 12 months are positive only in HY and EM markets

12M excess return, spot & forecast



Source: ICE and AXA IM Research, December 2020

The lack of potential for returns in IG credit becomes starkly evident in a portfolio context under a yield-target framework (Exhibit 16). In euro credit, investors would require one third of their portfolio invested in HY to achieve a blended yield of 1%, namely an IG:HY blend of 68:32% vs a benchmark of 87:13% (in red). A euro credit yield target of 1% translates to 2% in dollar credit, after accounting for currency hedging costs of circa 1%. This can be reached with a modest 4% of HY, thanks to the much longer duration (hence higher yield) of dollar IG. On a five-year duration equivalent basis, however, one would require a comparable 80:20 IG:HY blend approximately, in both USD and EUR markets (in blue).

Exhibit 16: a portfolio blend requires a large share of HY in order to achieve even a modest yield target

	EUR	IG	HY	Blnd Dur	Blnd Yld
Spot read	FaceVal, $b	3,201	498	–	–
	Duration, yr	5.4	3.5	–	–
	Yield, %	0.2	2.8	–	–
	Yield 5y, %	0.2	4.0	–	–
Wght	BM	87%	13%	5.1	0.5
	1% target	68%	32%	4.8	1.0
	1% trgt 5y	78%	22%	5.0	1.0
	USD	**IG**	**HY**	**Blnd Dur**	**Blnd Yld**
Spot read	FaceVal, $b	7,349	1,433	–	–
	Duration, yr	8.4	3.7	–	–
	Yield, %	1.9	4.6	–	–
	Yield 5y, %	1.1	6.2	–	–
Wght	BM	84%	16%	7.7	2.3
	2% target	96%	4%	8.2	2.0
	2% trgt 5y	83%	17%	5.0	2.0

Source: ICE and AXA IM Research, December 2020

Investment Strategy – Equity

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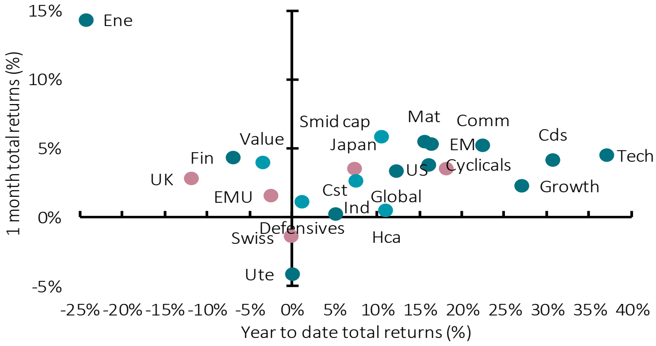
In the green after a rollercoaster year

After battling a global pandemic, facing unprecedented policy stimulus and a momentous US Presidential Election, we have been buoyed by a great healthcare breakthrough, and seem to be wrapping up 2020 with equity markets in the green. Global equities are up around 12% year to date. By sector, technology (+37%) remains on top, followed by consumer discretionary (+31%) and communication services (+23%), with strong contributions from some major internet names (Exhibit 17).

Exhibit 17: In the green after a rollercoaster year

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

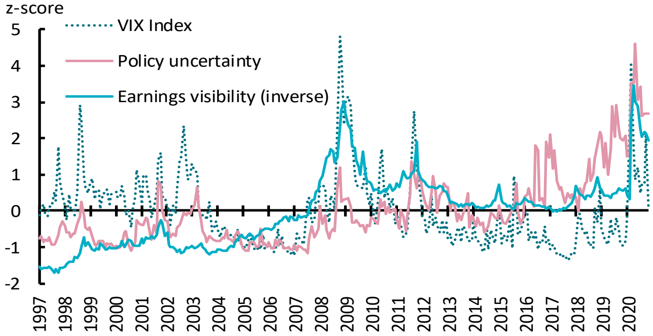


Source: Datastream and AXA IM Research, December 2020

Overall, market sentiment indicators continue to normalise from a depressed base. Volatility and policy uncertainty are trending down from extremely elevated levels and similarly, earnings visibility is gradually improving (Exhibit 18). Earnings momentum has also fully recovered with both the magnitude and breadth of analyst revisions now in positive territory (Exhibit 19). Consensus expectations for global earnings per share growth in 2021 are running at around 27%, implying we will cross the 2019 high-water mark.

Exhibit 18: Visibility still clouded but improving

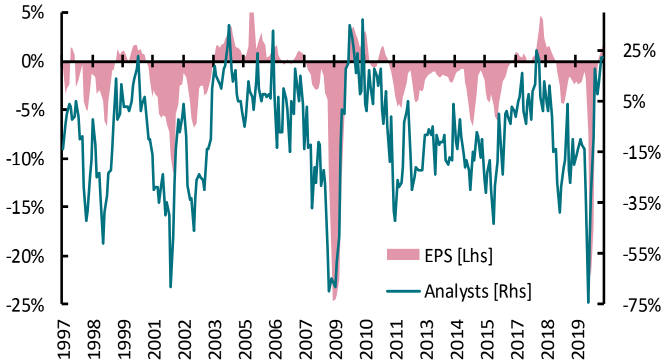
Volatility, policy uncertainty & earnings visibility



Source: Datastream, Bloomberg, IBES and AXA IM Research, December 2020

Exhibit 19: Earnings momentum fully recovered

Global equities: earnings revisions

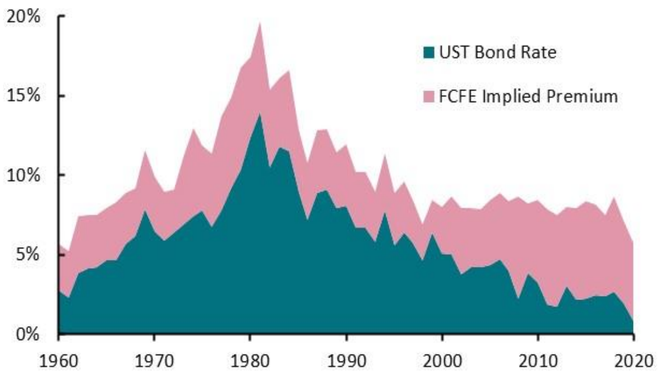


Source: Bloomberg and AXA IM Research, December 2020

The top-down valuation picture remains largely intact with contrasting absolute and relative value metrics – the former elevated by historical measures, the latter undemanding compared to fixed income, where the asset class still appears attractively valued on a relative basis with equity risk premium (ERP) proxies still having room to compress. From a free cashflow implied approach, the current ERP is around 5% – with the historic norm somewhere around 4% – and lows touching close to 2% in frothy markets (Exhibit 20). Absolute multiples do appear elevated but a lot more reasonable if normalised for the expected earnings recovery.

Exhibit 20: Global equity valuations still not demanding

US bond yields and global equity risk premium



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

We maintain our constructive stance on equities in our framework, acknowledging that selectivity remains key given the still-elevated uncertainty. Looking past the near-term outlook, in a world with negative-to-low returns, equities continue to look attractive from a risk-reward perspective for long-term oriented investors. Beyond overall market direction, a new policy mix could potentially put in place catalysts for broader participation in terms of sectors and style. However, as witnessed several times over the past decade, we would need confirmation from earnings growth for this to persist. 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.

Recommended asset allocation

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

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

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

Macro forecast summary

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

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

These projections are not necessarily reliable indicators of future results

Forecast summary

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

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

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

These projections are not necessarily reliable indicators of future results

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

Our Research is available on line:

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