AXA Investment Managers

For professional clients only
June 2019
Research & Strategy Insights

This war talk's spoiling all the fun

Monthly Investment Strategy

Gilles Moëc,
AXA Group Chief Economist

Laurent Clavel,
Head of AXA IM Research,
Core Investments

Key points

- The US economy is still strong, whereas the Eurozone shows weakening signs
- Yet, the Federal Reserve is increasingly dovish, a by-product of the US administration's trade hawkishness, whilst the European Central Bank is failing to convince markets that it can deliver accommodation
- All eyes are now on the US/China conflict with hopes (we share) of a truce
- Yet, the damage – through tighter financial conditions and unrealistic easing demands – may have already been done
- We maintain a limited risk appetite with an underweight in European equities, and an overweight in emerging market debt and US high yield credit

It's still all about politics

Market gyrations and the fate of the global cycle remain utterly dependent on political noise. There is still little clarity on the trade war(s), and as such the focus is now firmly on the G20 meeting on 28-29 June, but it may not be a big binary event. We could end up with no escalation on tariffs… but still no comprehensive deal between China and the US. We suspect we will have to cope with a continuous stream of skirmishes and flare-ups, especially as the 2020 US presidential race starts in earnest, thus eroding global confidence. The same applies to Brexit. The long extension granted to the UK was expected to bring a measure of peace and quiet. Instead it has offered a window for a Tory leadership challenge which is reviving concerns over a no-deal exit.

The European elections were a collective victory for mainstream parties, undermining the populists' claim they were on the brink of sending the Union on a completely different path. But uncertainty has not disappeared. The discussion between Rome and Brussels on fiscal policy is getting fraught again. The initiative on a Euro area budget is very limited in scope. The mainstream has won but it is unclear what it wants to achieve on solidifying the monetary union.

Dovish Fed: It's not the economy, stupid

The US economy is posting a few signs of slowdown at present. Job creations slowed to 75,000 in May but printed at 150,000 on average over three months – weaker than in the past few years, but enough to absorb labour supply growth and stabilise unemployment at its record 50-year low. Other labour market metrics remain solid. The manufacturing ISM survey has stabilised, but the Empire State survey fell precipitously in June, likely reflecting heightened trade tensions with Mexico. Consumer confidence and non-manufacturing indicators remain relatively upbeat and consumer spending appears to have firmed after a weak start to the year. Altogether, we still forecast above-potential US growth in the second quarter of 2% and expansion of 2.4% in 2019.

The Federal Reserve (Fed)'s dovishness[1] stems more from global crosscurrents and the risk of further trade-related tightening in financial conditions. In previous research[2], we have illustrated that economic data may not reflect a pernicious downturn for several months after signals from financial markets. Hence, the signal sent by the inversion of the US treasury yield curve – a causal trigger for US recessions rather than a mere market indicator – should not be dismissed quickly. The US/China trade negotiations will be key. In our baseline, we expect neither an escalation (all Chinese exports to the US tariffed at 25%) nor a final deal (the conflict has spilled over into a tech war) but rather a truce similar to that offered to the European auto sector. Still, even in this relatively benign kicking-the-can-down-the-road outcome, we expect the Fed to ease policy, most likely cutting interest rates in September and December to offset the past tightening of financial conditions. Indeed, the impact of the trade war is not solely on exports and imports of goods, their prices, nor inflation eroding households' purchasing power and corporates' margins. The first-round effect takes its toll through confidence and deferred capital expenditure.

The next step in European Japanification

Meanwhile, European macroeconomic data flow has been disappointing. Manufacturing business surveys have merely stabilised around six-year lows, often dragged down by forward-looking components. German manufacturing orders posted their worst performance in 10 years, suggesting that the first quarter (Q1)'s economic rebound has been short-lived. True, the domestic-oriented services sector, consumer sentiment, job creations and hiring intentions have remained at still solid levels, at odds with the manufacturing gloom. But clouds are gathering also over European domestic demand.

With core inflation stubbornly stable around 1% for more than two years now, the Eurozone macroeconomic outlook and global trends that worry the Fed also concern the European Central Bank (ECB). At its June meeting, the ECB attempted to defend the case for a still ample monetary toolbox. With 15 more years of experience, the Bank of Japan (BoJ) offers an obvious benchmark and has similarly been repeatedly arguing – and again this week – that further accommodation was possible if needed. Markets were first sceptical (with lower interest rates but with little actual easing seeing real rates almost unchanged) but bought into President Draghi's extreme commitment at Sintra, sending 10Y Bund yields below -0.3%, a new record low.

Asset Allocation: Preference for credit vs. equities

June has been kinder to risk assets, thanks to rising dovish expectations which were compounded by Mario Draghi's speech at Sintra on 18 June. Equities appreciated and credit spreads tightened as a result, while interests rates remained floored at levels last seen in 2017 (US Treasuries at 2.10%) or below (Bunds at -0.25%). Low growth and inflation mean (more) accommodative central banks and that feeds the hunt for yield. This is a favourable environment for credit markets, but less so for equities, which have lost some of their lustre since late April. While equity investors will be waiting for signs of an earnings' reflation, credit investors will be encouraged by benign conditions to refinance and repay bonds.

Looking ahead, we remain prudent on developed market equities, given that risks have increased around the trade negotiations. We remain constructive on higher beta spread products that tend to benefit from central bank accommodation. We maintain euro core government bonds at neutral as lower growth and falling inflation should cap yields. In a nutshell, our key positioning is underweight European equites and overweight emerging market debt and US high yield (HY) credit.

From a tactical standpoint we are alert to the risk of a mini rates tantrum, in which rates could jump higher whilst risk assets could likely sell off simultaneously. This could be triggered by a detente between the US and Chinese Presidents at the G20 Summit, which could force markets to reprice their strong expectations of Fed rate cuts.

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

[1] Page, D., "Rising trade tensions weigh on Fed outlook", AXA IM Research, 13 June 2019

[2] Page, D., Venizelos, G. and Savage, J., "Is the yield curve pointing to recession?", AXA IM Research, 25 October 2018

Global Macro Monthly – US

David Page,
Senior Economist,
Macro Research – Core Investments

White House risks policy error over trade

Tariff tensions continue to cast a shadow over the global and US economic outlook. Policy with China has changed little over the past month, but the practical implications of US companies adapting to new restrictions is starting to sink in. Acting Director Office of Management and Budget Russell Vought, specifically requested more time for US firms to adapt to laws regarding the use of Huawei products, to supply the Federal government. Meanwhile President Donald Trump has continued to antagonise, goading China to attend a meeting at the G20 or face a broadening of US tariffs. To our minds, this risks a political miscalculation that could see any hopes of resuming negotiations fail. The President may have been emboldened by his recent dealings with Mexico, as the threat of tariffs on Mexican products resulted in Mexico swiftly changing its migration policy. President Trump applauded the use of sanctions, but China is not Mexico.

We are mindful of what a further escalation in trade tensions might mean for the US economy. We have previously estimated that tariffs on all Chinese imports could reduce US GDP growth by around 0.5 percentage points (ppt). However, with the US already decelerating, the global economy appearing fragile and financial market sentiment faltering, we fear that the US economy is currently vulnerable and that a further shock could produce a tipping point towards a material downturn, and potential recession over the coming year.

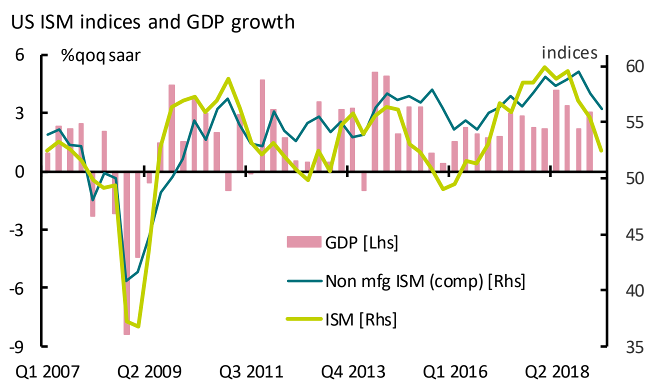
There are few signs of material slowdown at present. ISM survey data remains subdued, but no worse, although the latest Empire survey fell sharply, possibly reflecting Mexico tariff concerns (Exhibit 1). The non-manufacturing survey remains relatively upbeat. Payrolls growth slackened at the latest reading, 3-month growth softened to 150k from 220k in 2018 – its slowest pace in 18-months and closer to the labour supply growth rate. However, other metrics of the labour market remain solid. Consumer confidence resumed elevated levels on several measures and retail sales revisions and solid gains in May underpin our expectation of a revival in final domestic sales for the second quarter (Q2). We expect a more subdued 2% annualised growth rate in Q2 overall, reflecting an unwind of net trade and inventory boosts to Q1's solid 3.1%.

However, if the economy is about to retreat into a more pernicious downturn, economic data may not even start to reflect this for several months. For now, we continue to forecast a moderation in US growth and nothing worse. However, elevated trade tensions see our growth forecasts revert to 2.4% for 2019 and 1.6% for 2020 – as they were before the resumption of trade tariffs at the start of May.

Fed policy to follow trade developments

Financial markets continue to press the Fed for easier policy. In May, the Fed pushed back on expectations of "insurance cuts" to address softer inflation, stating that this was considered "transitory". Core Consumer Price Index (CPI) inflation eased further in May to 2.0% (its joint weakest since early 2018) superficially adding to the case for easier policy. Longer-term inflation expectations (at least as measured by the University of Michigan) have been more volatile dropping from a joint 3-year high of 2.6% in May to a series low of 2.2% in June, reinforcing concerns that inflation expectations may be de-anchoring lower.

Exhibit 1: Surveys suggest moderation, not recession



Source: ISM, Bureau of Economic Analysis and AXA IM Research

However, the Fed appears more cognisant to the risks surrounding trade policy developments. In a speech before going into purdah, Fed Chair Powell stated that the Fed was monitoring trade developments closely. Powell reiterated this in the June Federal Open Market Committee press conference, the statement recording a shift from a "patient" approach to one that stood ready to "support the economic expansion". While the Fed left policy on hold in June, it clearly opened the door to providing additional accommodation in July if "uncertainties" proved persistent.

We consider the Fed's future policy decision to be trade policy dependent. Assuming we avoid an escalation of trade policy in July, we expect the Fed to ease less than markets currently price – forecasting two cuts, in September and December. This could be less if markets react very positively, but even a reversion to the pre-May position would now still likely warrant some easing as trade policy uncertainty is likely to continue to weigh on business sentiment. An escalation of trade tensions, on the other hand would likely warrant the three cuts markets currently price for this year. Moreover, if this further deterioration does push the economy through a tipping point to recession – the Fed is likely to have to continue easing across 2020. This is not our forecast for now.

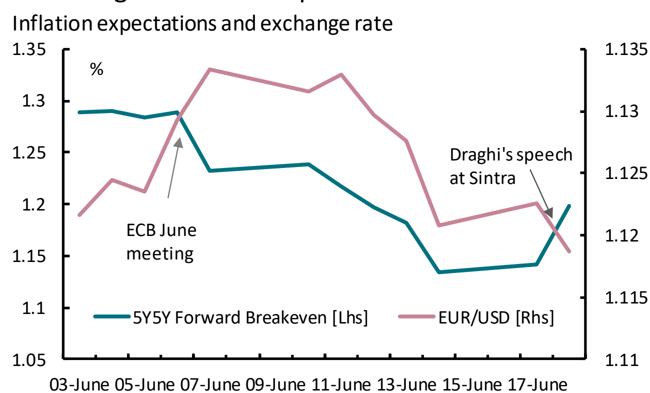
Global Macro Monthly – EMU

Apolline Menut,
Economist (Euro zone),
Macro Research – Core Investments

ECB: Credibility issue

At its June meeting, the European Central Bank (ECB) failed to convince markets that it still had monetary ammunition. Despite President Mario Draghi mentioning that a live debate was starting on available easing tools, medium-term inflation break-evens fell to historically low levels (Exhibit 2). The ECB forum at Sintra was an opportunity to restore a bit of credibility and Draghi sounded more convincingly dovish. But in our view, the ECB is running low on ammunition. In a risk scenario where economic conditions and inflation expectations deteriorate further, we are afraid that the potentially most efficient tool – restarting quantitative easing – would end up being used only as a last resort, after an interest rate cut. This would not primarily be due to technical constraints, as the 33% issue/issuer limits would have to be lifted, but political. Our baseline is still that the ECB remains on hold, but its September meeting is now "live".

Exhibit 2: ECB credibility issues: Trying to avoid a de-anchoring of inflation expectations



Source: Bloomberg and AXA IM Research

Italy: Replay?

Italy is back in the spotlight, in the wake of fresh political noise and renewed tensions with Brussels. At the beginning of the month, the Italian Parliament voted in favour of a motion, supporting the introduction of mini-BOTs i.e. non-interest bearing small denomination government debt securities, which could be used to pay arrears to businesses. Markets are obviously very sensitive and adverse to this type of topic, as those mini-BOTs have been presented by some of their proponents as an alternative currency, and a first step towards an "Italexit". The rating agency Fitch was quick to react, signalling in a note that "broad use of mini-BOTs for payment purposes would have immediate negative rating implications"[3]. So far, we are not overly concerned about mini-BOTs, mainly because a) the Parliament motion is non-binding; b) there is no political consensus on this measure; c) Italians support for the single currency is on the rise. But we expect the political noise to continue and remain a source of volatility.

Volatility will also come from the renewed tensions with Brussels, as the European Commission recommended the opening of a debt-based Excessive Deficit Procedure (EDP) against Italy. The European Union's debt rule stipulates that the debt-to-GDP ratio should decline by a 20th of the gap to 60% every year, which in the case of Italy means more than 3.5ppts per annum. Instead, the European Commission expects the public debt-to-GDP ratio to rise to 133.7% of GDP in 2019 and 135.2% in 2020 – up from 132.2% in 2018. And none of the usual mitigating factors can be invoked to justify the deviation. Certainly, growth is stalling but it is partly due to government policy mistakes; there is no progress on structural reforms, rather some unwelcome unwinding, for example on the pension front, and no structural budget adjustment. Negotiations are ongoing and should be completed by the end of June, before a formal decision is taken at the Eurogroup meeting on 9 July. There seems to be a lively debate behind the scenes, with some euro area governments in favour of delaying the procedure until the Autumn, when the 2020 Budget will be discussed. Others would prefer to proceed and test the Italian government's willingness to comply with EU rules. For now, Lega and Five Star show no signs of backing down on the introduction of a flat tax and new minimum wage. Will 2019 simply replay last year, with the Italian government finally giving in under markets pressure? The difference now, is that the Italian economy is much weaker – consensus has 2019 GDP at 0.2% year-on-year (yoy), vs. 1.2% a year ago – and rating agencies have a negative outlook, so the situation is much more fragile.

Politics also remains very unstable, and a confrontation with the EU could lead to a collapse of the coalition government during the 2020 Budget discussions. In that case, we believe the appointment of a technocratic government would be the most likely scenario (the first option, for President Sergio Mattarella to ask Five Star to form an alternative government, has a low probability of success in our view). But we would expect its lifespan to be limited, with Lega having incentives – if polls stay where they are – to trigger snap elections, once the tricky 2020 Budget is passed which according to the Constitution, should be done by 31 December. We therefore expect Italian politics to remain highly unstable, with snap elections likely in the first quarter, or early in the second, in 2020.

[3] Fitch Ratings: Italy Fiscal Uncertainty Persists; Mini-BOTs Would Be Negative, 12 June 2019.

Global Macro Monthly – UK

David Page,
Senior Economist,
Macro Research – Core Investments

Weaker growth to dampen BoE hawkishness

Brexit uncertainty is currently being channelled through the Tory Party leadership contest, following the resignation of Prime Minister (PM) Theresa May, as party leader on 7 June. 10 candidates will be whittled down to two by 22 June and finally selected by Tory party members, by 22 July. So far, the process has done little to dissuade us that favourite Boris Johnson, will become the next PM.

The contest has elicited several pledges to leaving the EU with or without a deal on 31 October. We consider this outcome unlikely given Parliamentary opposition. However, a Brexit impasse appears to remain and we consider the likelihood of a democratic event – election or second referendum – to accompany a further delay to the Brexit process beyond 31 October (we assume into the second half of 2020).

Brexit also appears to have had a visible effect on output. April recorded a sharp manufacturing contraction of 3.9% on the month, reflecting a rescheduling of manufacturing maintenance shutdowns to coincide with the 31 March original deadline (vehicle production fell by 17%). Other industries likely followed – either in sympathy (for ancillary manufacturers) or for similar reasons. Moreover, Q1 posted strong growth, in part because of a build-up of inventory, which also appears to have begun to unwind.

This contributed to a 0.4% drop in monthly GDP (following a 0.1% dip in March). This could suggest economic contraction in Q2 – weaker than our previously expected 0.2% slowdown. However, manufacturing growth will rebound strongly in May, lifting GDP accordingly. We have softened our Q2 GDP outlook to 0.0%-0.1%. However, raise our outlook for Q3, to 0.4%, with manufacturing shutdowns not occurring at this time this year. For now, we edge our 2019 growth forecast lower to 1.4% (from 1.5%) and leave 2020 at 1.3%.

The Monitory Policy Committee (MPC) warned in May that it considered tighter policy than markets considered as necessary. More recently Bank Chief Economist Andrew Haldane and MPC member Michael Saunders have both reiterated hawkish comments. However, with downside risks to short-term GDP growth, risks from an uncertain global economy and the ongoing uncertainty reflecting the Brexit process, we think it unlikely that the Bank of England (BoE) will consider tighter policy this year. If the above risks pass by 2020 as we expect, the BoE may begin to tighten policy next year and we forecast two hikes in 2020. But as with much in the current global outlook – risks are to the downside.

Global Macro Monthly – Japan

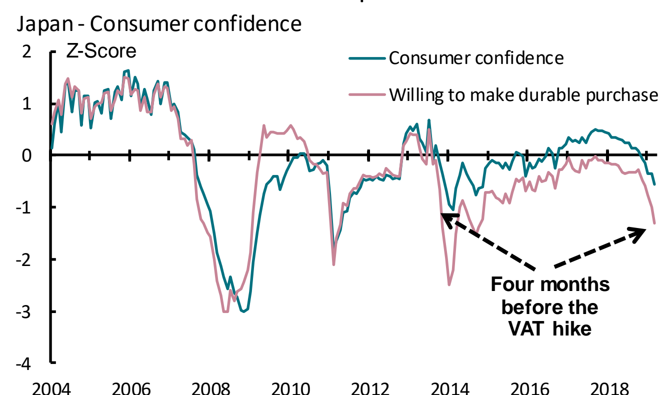
Hugo Le Damany,
Economist (Japan),
Macro Research – Core Investments

The BoJ stays on hold for now…

The second estimate of Q1 GDP confirmed the initial estimate's upside surprise (+2.2% quarter-on-quarter annualised). Net exports added 1.6ppt of this rise, with fixed investment up 0.5ppt and inventories ahead 0.3ppt. On the other hand, consumer and government spending fell 0.1ppt. Q2 GDP is likely to be challenged by an unwind of Q1's erratic strength, and the ongoing uncertainty brought on by the trade war. In May, the Purchasing Managers Index (PMI) stabilized around 49.8 while the services PMI decreased slightly to 51.7. Exports declines on a yoy basis, at -7.8%, while imports slipped back following April's sharp gain at -1.5% vs. +6.5%.

The timing for the sales tax (VAT) hike is not good, but we believe it will be maintained. To alleviate the negative impact from a global slowdown, potential trade war escalation and the fall in consumer confidence since December (Exhibit 3), the government could announce a new economic stimulus package of around ¥3-4tn (0.5-0.7% of GDP). Combining this with the previously announced measures of free education, reduced tax rates for foods and public investment, the total package could reach ¥9-10tn.

Exhibit 3: Current consumer confidence level is lower than four months before the previous hike



Source: Cabinet Office and AXA IM Research

The BoJ left both its rates and asset purchases targets unchanged. In the months to come, the BoJ could have to manage US rate cuts and the VAT hike. Further yen appreciation could also be an issue. Consequently, the BoJ will have to ease to keep an accommodative strategy. Clear and persuasive forward guidance remains essential but is unlikely to be sufficient. As the governor Kuroda mentioned," the central bank could combine interest rate cuts with bigger asset buying if needed to keep the economy on track to achieve its elusive 2% inflation target".

Global Macro Monthly – China

Aidan Yao,
Senior Economist (China),
Macro Research – Core Investments

Despite the upside surprise in retail sales, May's activity data mostly confirmed a further slowing in the Chinese economy. Soft domestic demand, combined with sluggish external growth, makes a challenging environment for Beijing to fight the trade war with the US. Luckily, policy support is on the way, but the scale and speed of the stimulus will likely depend on the result of the upcoming G20 meeting. Even under the current status quo, we expect Beijing to turn more pro-growth, and if a full trade war breaks out, the level of stimulus could be ramped up significantly. In both cases, we expect the Chinese yuan / US dollar to cross the seven mark, as the exchange rate can adjust to any negative macro shocks. We see downside risks to our 6.3% growth forecast and will revisit it once the trade-war scenario becomes hopefully clearer after the G20.

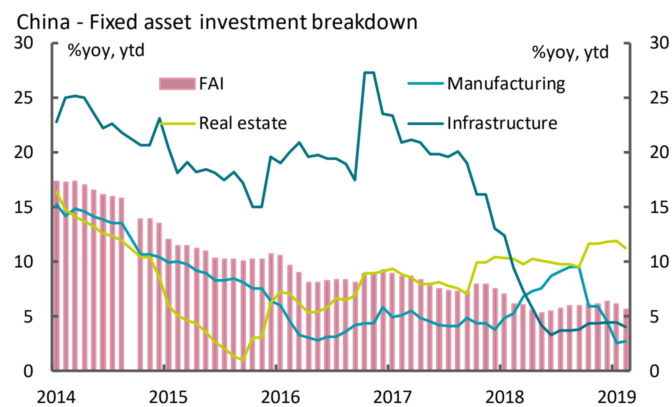
Downside risks deepen

May activity data brought a mixture of surprises. Industrial production (IP) undershot market expectations, with growth slipping to 5% – its lowest in almost 20 years. Energy production weakened, with electricity generation barely growing on a year-on-year basis, while auto production was still mired in deep contraction. Sharp declines in auto production has been a key driver of IP weakness this year, and worryingly, there is little sign that the trend is about to reverse. This has raised the urgency for the long-awaited National Development and Reform Commission's plan on auto subsidies to hit the ground, which we expect to happen in the coming weeks.

There are also some worrying signs in the manufacturing sector, particularly with respect to high-end manufacturing. While the latter still grew at a solid clip of 9.4%, the rate of growth has moderated in recent months. Given its sensitivity to exports, softening external demand, combined with reduced exports to the US due to the trade war, has darkened the outlook for the sector. With the PMI now falling below 50, we think Beijing will soon release more targeted measures such as further tax and fee reductions, to support activity.

However, not everything was weak in the manufacturing sector. Manufacturing FAI grew at a moderately faster pace of 2.7% vs. 2.5% in April (Exhibit 4). But this is still very depressing reading. And if the production weakness is here to stay, it is questionable how the improvement in investment growth can be sustained.

Exhibit 4: Fixed asset investment continues to slide



Source: CEIC and AXA IM Research

Both property and infrastructure investment growth moderated in May. For the former, this is the first deceleration (11.2% from 11.9%) in six months. Amazingly, this solid growth was achieved despite sharply slowing house sales over the period. We think the construction cycle has peaked and growth should weaken further in the second half of 2019.

Retails sales data was the only bright spot

Retail sales was the only bright spot in the May data, where growth rebounded sharply to 8.6%. Part of this was due to an unwind of unfavourable seasonality, with April's weakness exacerbated by fewer public holidays. Still, the strength of the bounce – to its second highest reading in seven months – was unexpected. The data offers some solace that the most important engine of the economy is still functioning properly, for now.

Double dip confirmed, more easing on the way

Overall, despite the mixed surprises, we still see May's data as confirming a further slowing of economic momentum. Worryingly, this weakness has occurred before the latest escalation of tariffs has truly hit the ground. Fortunately, Beijing has started to take actions to support infrastructure investment and safeguard consumption. We think the central bank will do more heavy-lifting too in the coming weeks by leaning its "prudent" policy operation to the easing side. The chance of a reserve requirement ratio (RRR) cut is high in June, as domestic headwinds strengthen, and liquidity is tight in certain parts of the financial system, i.e. for small banks and non-bank financial institutions. The chance of a major easing will be even higher if the G20 meeting at the end of the month fails to prevent further tariff escalation. If this is the case, the renminbi could break the psychologic level of seven per US dollar, as it is allowed to play its buffeting role for the economy. The overall policy stance will be eased considerably should a full-blown trade war break out.

Global Macro Monthly – Emerging Markets

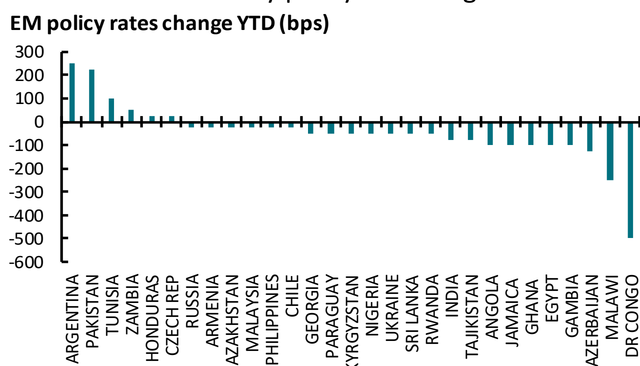
Irina Topa-Serry,
Senior Economist (Emerging Markets),
Macro Research – Core Investments

Shirley Shen,
Economist (Emerging Asia),
Macro Research – Core Investments

Repricing the "Fed put"

The so-called "Fed put" cast its spell again as, in the wake of heightened trade tensions, US Fed Chairman Jerome Powell assured the Fed would "sustain the expansion" while hinting that it has more ammunition in terms of monetary tools – i.e. quantitative easing. Markets incorporated the start of Fed cuts while emerging markets (EM) central banks already started policy easing. Among the top 83 EM central banks, 23 have cut interest rates so far this year (a cumulated 2025 basis points (bps), including Russia, Chile, India, Malaysia, and the Philippines), only six tightened their policy (+675bps, including Argentina, Tunisia and Pakistan) while 54 banks remained on hold (Exhibit 5).

Exhibit 5: EM monetary policy loosening started



Source: central banks data and AXA IM Research

At the mercy of a "great" deal

Alongside the hardening stance taken against China, the US administration has been taking various actions against other countries. A whole set of tariff increases with a precise implementation timeline was threatened against Mexican imports to pressure the Mexican administration on tackling illegal immigration. Mexico hastily acquiesced, introducing several initiatives so that both countries could announce an agreement indefinitely deferring the proposed tariff hikes.

In parallel, the US administration removed India and Turkey from its special trade programme, known as Generalized System of Preferences, which exempts import duties for some goods purchased from developing nations. The trade program exempted "only" 14% and 17% of the total imported goods from India and Turkey respectively. However, if these tensions were to escalate, they will weigh on investment prospects at a delicate point in the economic cycle where capex already appears particularly weak, as illustrated in the first quarter GDP releases.

Trimming growth expectations

Recent macro data paint a deteriorating picture. In Asia, Korea and Taiwan, May export growth continued to decelerate, and Purchasing Managers' Index export orders dipped below nominal break-even levels across the region. Industrial production and retail sales growth have been weak, weighing on first quarter (Q1) GDP. In Latin America, import weakness underlines very weak domestic demand, reflected in weak retail sales. Central Europe stands out as an exception, showing impressive resilience. Turkey technically exited recession after a positive quarterly reading – supported by massive government spending – but is likely to weaken again mid-year. Russia's GDP 'flash' estimate was weak, while South African GDP slumped in Q1, recording its sharpest contraction since 2008/09, with weakness coming from manufacturing and mining sectors. All in all, these negative Q1 GDP surprises lead to a growth downgrade for 2019: EM GDP growth is expected to slow to 4.3% for 2019 from 4.4% last year. We expect acceleration into 2020 to 4.7%.

Rating agencies in action

Several important emerging markets also saw moves in their credit ratings. So far, not all of them point to deterioration – some sent mixed signals, while some were upgraded. In a double blow for Mexico, Fitch downgraded the sovereign debt rating to BBB with 'stable' outlook while Moody's affirmed its rating (A3) but lowered its outlook to 'negative'. Additionally, Standard & Poor's (S&P) cut its stand-alone assessment of Pemex by three notches in March, following Fitch's move to downgrade to BB+ in January. Recently, Turkey's sovereign credit rating was pushed deeper into 'junk' territory by Moody's on rising balance of payments crisis risks (to B1 from Ba3, still 'negative' outlook). More mixed decisions were taken by agencies on Colombia: Fitch's rating was affirmed at BBB but revised down to 'negative' outlook on rising risks to fiscal consolidation, while Moody's announced that it maintained Colombia's rating at Baa2 with an upgraded outlook to 'stable'. We note though some upgrades by S&P: Indonesia's sovereign credit was upgraded to BBB on supportive policy dynamics, Slovenia was upgraded from A+ to AA- ('stable' outlook) thanks to strong economic growth, the Philippines credit rating was raised one notch to BBB+ (from BBB) with 'stable' outlook on the back of above-average economic growth, healthy external position and sustainable public finances. South Africa still awaits Moody's pending rating decision, currently the only major ratings firm to have it above 'junk'. The agency recently lowered South Africa's GDP growth prospects for 2019.

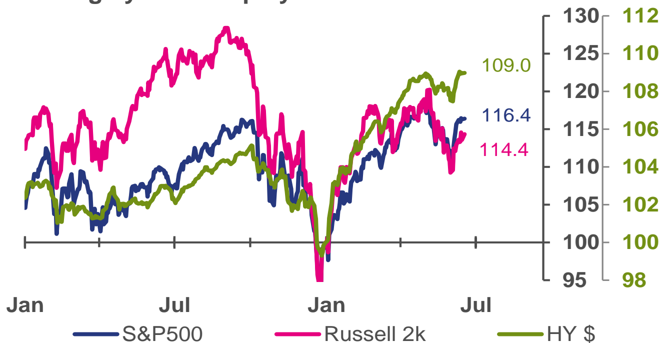
Investment Strategy – Cross-assets

Greg Venizelos,
Credit Strategist,
Research – Core Investment

The Fed that rocks the cradle

June has been kinder to risky assets, thanks to a further dovish shift by the Fed and a concomitant move by the ECB. Equities appreciated and credit spreads tightened as a result, while interests rates remained floored at levels last seen in 2017 (US Treasuries at 2.10%) if not lower than in 2016 (Bunds at -0.25%). This market backdrop looks like Goldilocks: with growth, but inflation low, and therefore central banks (more) accommodative. So the hunt for yield resumes. This is a good backdrop for credit, but less so for equity markets, which indeed have been losing their bull market lustre of late April. While equity investors will be waiting for signs of an earnings reflation, credit investors will be encouraged by benign conditions to refinance and repay bonds (Exhibit 6).

Exhibit 6: US dollar high yield return keeps up with equities; superior in risk-adjusted terms



Source: Datastream and AXA IM Research

This macro backdrop leaves us prudent on developed market equities, given that risks have increased as trade negotiations between China and the US have taken a turn for the worse. We remain positive on higher beta spread products that tend to benefit from central bank accommodation that is supportive of carry positions. We maintain euro core government bonds at neutral as lower growth and falling inflation caps bond yields. Our key positioning therefore is to be underweight European Monetary Union equities, overweight emerging market debt and US high-yield credit. From a tactical standpoint we are alert to the risk of a mini rates tantrum where interest rates jump higher and risky assets sell off at the same time. This scenario could be triggered by détente between the US President and the Chinese Premier at the G20 which could force an 'unpricing' of market expectations for the scale of rate cuts by the Fed.

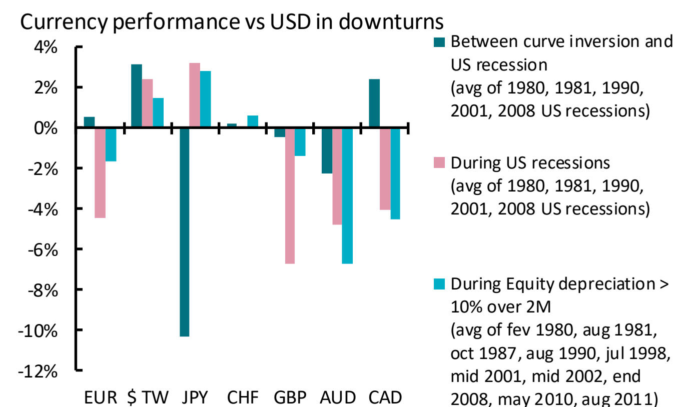
Investment Strategy – FX

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

Rates re-converge: end of US dollar reign or beginning of trouble?

Trade tensions continue to dominate in foreign exchange markets. Markets are repricing the impact of higher tariffs for longer on the global economy and anticipate the associated central bank reaction. The US Fed has much more capacity to cut rates from here than most other developed central banks that did not have time to 'normalise' policy. Expectations have risen sharply to four rate cuts by December 2020 and 2-year euro (EUR) and US dollar (USD) interest rates have started to re-converge. If the carry advantage of USD as the high yielder is shrinking, will the USD carry trade unwind?

Exhibit 7: The euro does not behave as a safe haven during US recessions



Source: Bloomberg and AXA IM Research

This repricing in the EUR/USD exchange rate closes a long period of overvaluation against our Behavioural Equilibrium Exchange Rate (BEER) fair value estimate. But we think that this move is unlikely to accelerate in the short term for two reasons. Firstly, the correlation with interest rate differentials remains weak. Secondly, an environment that would require more Fed cuts than currently priced would likely be a recessionary one and thus also negative for the euro area and the euro. The euro does not behave as a safe-haven currency during US recessions (Exhibit 7). It is the Japanese yen (JPY) rather that tends to benefit from risk-off flows beyond those into the US dollar, thanks to the significant unhedged foreign investment position of Japanese investors. So the yen could continue to outperform if Fed dovishness continues to be tested against market expectations. Ahead of this, selling the EUR/JPY exchange rate into rallies offers an efficient protection from equity downside, with positive carry and limited upside risk.

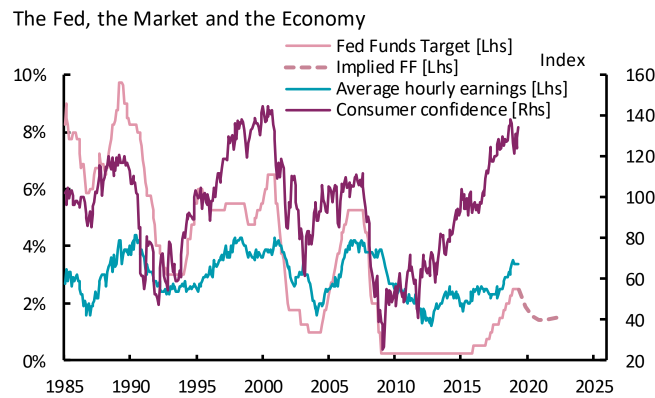
Investment Strategy – Rates

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

Treasury: Market expectations and positioning

Over the past six months, we have witnessed a spectacular turnaround in market-based expectations about the US Fed's policy trajectory. At the end of 2018, the Fed Funds curve was implying unchanged interest rates. Currently, the market is pricing almost 60 basis points (bps) in cuts by the end of this year and slightly less than a cumulated 100bps by the end of 2020 (Exhibit 8).

Exhibit 8: The market is pricing in rate cuts



Source: Bloomberg and AXA IM Research

While the correction in Fed expectations is certainly a key component behind this year's 55/60bp drop in 10-year Treasury yields, we should also mention the 20bp decline in term premium as a significant factor. However, US inflation expectations are back to the same levels seen at the end of December (e.g. Consumer Price Index five-year five-year, i.e. the five-year period starting five years from now, just above 2.05%).

In order to thoroughly evaluate the future trajectory of Treasury yields, it is important to consider the following:

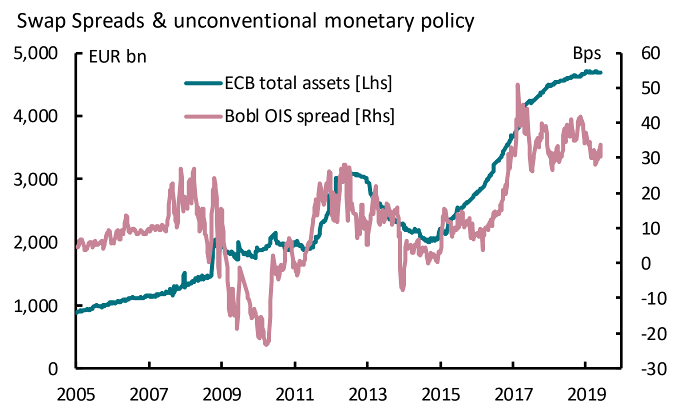
- Market positioning has improved, in particular for shorter tenors. Overall, investors have trimmed historically large shorts and are now essentially flat duration.
- It's hard to reconcile market-based Fed pricing with domestic fundamentals. The Fed has a history of complying with the business cycle and, according to the Fed's own estimates, the probability of a recession over the coming 12 months is still far from the "danger zone".
- An insurance cut might always be motivated with the high level of uncertainty generated by the ongoing trade clash, but that scenario is now (more than) fully priced in.
- Negative carry might become an issue. There are almost 60 cents to be lost by long risk positions, if the Fed stays put.

Bund: ECB's balance sheet and swap spreads

The mechanism of quantitative easing (QE) is fairly straightforward: commercial banks swap their bonds for the ultimate risk-free asset, i.e. central bank deposits. There is not only a credit and duration dimension related to this trade, but also a liquidity dimension.

By draining duration and credit risk from the free-floating stock, central banks make QE-subject bonds relatively scarcer. While this might not yet be an issue in ultra-liquid euro government bond markets, significant liquidity premia are likely to be observed more frequently in shallower market segments (e.g. corporates or asset-backed securities).

Exhibit 9: QE driving relative bond valuations



Source: Bloomberg and AXA IM Research

Nonetheless, markets usually discount the likelihood of future events into today's price. As we can see in Exhibit 9, the 5-year German swap spread has a tendency to follow the evolution of the ECB's balance sheet. Note in particular the spread compression as a result of the large long-term refinancing operation (LTRO) repayment in early 2013, which substantially altered the size and the composition of the ECB's balance sheet.

Of course, monetary policy isn't the only driver of spreads. Financial regulation also plays an important role, by forcing banks to hold large and stable portfolios invested in high-quality liquid assets (HQLA). Similarly, solvency regulation makes investments in government bonds relatively more attractive for the pension and insurance industry.

Therefore, monetary policy – QE in particular – acts on top of already existing forces by boosting the liquidity premium and the relative valuation of HQLA. Looking ahead, wider swap spreads are not unlikely should the ECB decide to resume its asset purchase programmes.

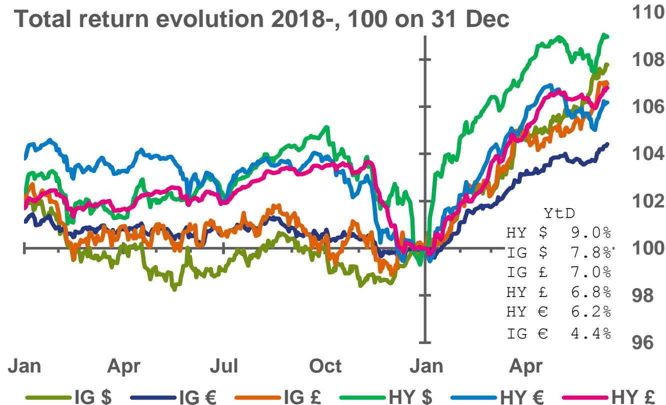
Investment Strategy – Credit

Gregory Venizelos,
Credit Strategist,
Research – Core Investments

Credit not tarrified

June was kind to spreads, largely due to an added dovish shift by the US Fed, which helped reverse the 'sell in May' spread correction. Add a further decline in interest rates, again due to the added dovish shift, and you get certain credit markets regaining or exceeding their high watermark in returns seen in early May (Exhibit 10). High-yield (HY) credit has outperformed investment grade (IG), with one exception - the sterling market, whose very long duration has pushed IG ahead of HY as rates declined. But equally a reversal in rates could easily reverse this dynamic.

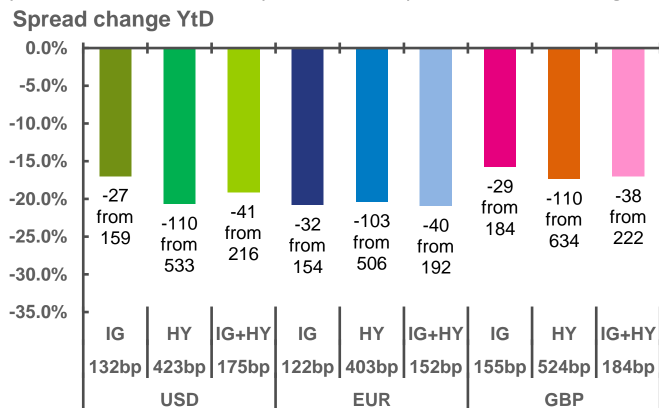
Exhibit 10: Credit returns regain their 2019 watermark amid a Fed-inspired June recovery in spreads



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

Canary in the coalmine for ECB corporate QE?

Exhibit 11: Euro credit spreads are relatively tighter year to date; in anticipation ECB quantitative easing?



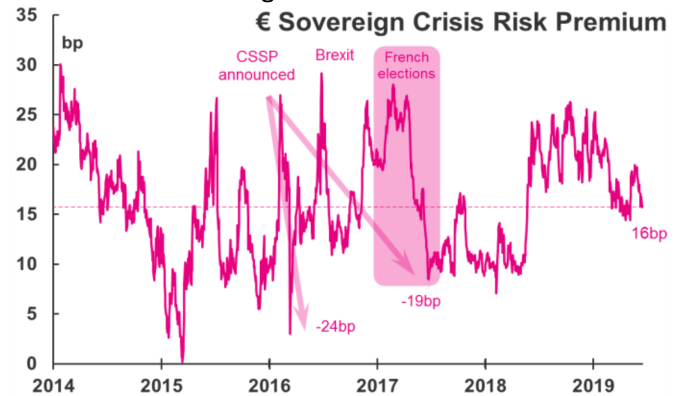
Source: Bloomberg, ICE and AXA IM Research

When it comes to central bank policy impact on credit, the Fed may not be the only game in town, as the ECB follows suit. While the 6 June meeting did not convince inflation markets about the ECB's capacity to provide further stimulus (the 5-year 5-year breakeven has dropped below 1.2% since then) credit markets chose a different interpretation. Euro credit spreads rallied in the three sessions that followed and are now outperforming their developed market peers (Exhibit 11).

Eurozone risk premium unruffled by Italy noise

The rally has been particularly pronounced in credit default swaps (CDS), bringing the Eurozone risk premium to the lows of its recent range (Exhibit 12). If one considers CDS as a volatility instrument in addition to credit risk (in contrast to the spread-rates nature of bonds) such a strong rally in CDS is consistent with expectations of further rounds of QE, the ultimate suppressor of market volatility.

Exhibit 12: eurozone crisis risk premium back to the lows of its recent range

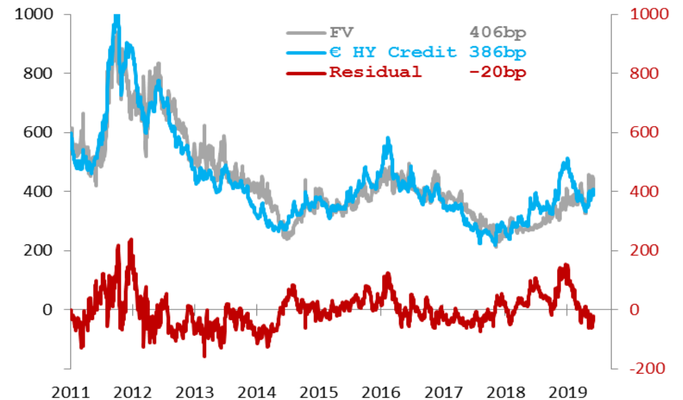


Source: Bloomberg, IHS Markit and AXA IM Research

Goldilocks backdrop for credit carry trade

The overall resilience in credit spreads and outperformance versus other asset classes (Exhibit 13) should not surprise given the backdrop of growth, low inflation and interest rates – a 'goldilocks' backdrop for spread carry into year-end.

Exhibit 13: credit outperforming other assets, consistent with low growth/inflation and accommodative policy



Source: Bloomberg and AXA IM Research

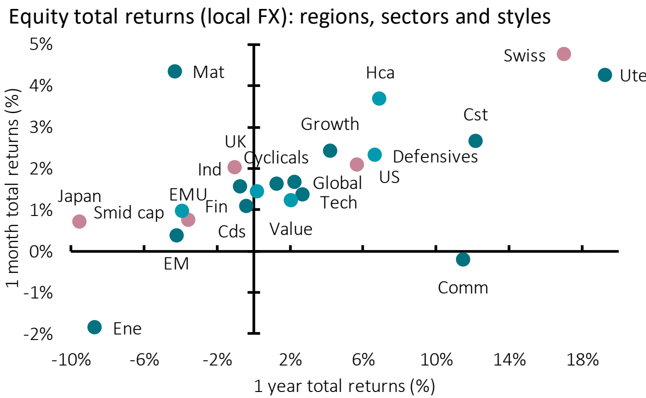
Investment Strategy – Equity

Varun Ghotgalkar,
Equity Strategist,
Research – Core Investments

Fed put or market collar

Global equity market performance has been choppy over the past month with concerns around global trade driving investor sentiment. Defensive plays like Switzerland (+4.7%), utilities (+4.3%) and health care (+3.7%) fared well while communication services (-0.2%) and emerging markets (+0.4%) lagged the global benchmark (Exhibit 14). A heavy event-risk calendar suggests current volatility levels should persist moving into the second half of the year.

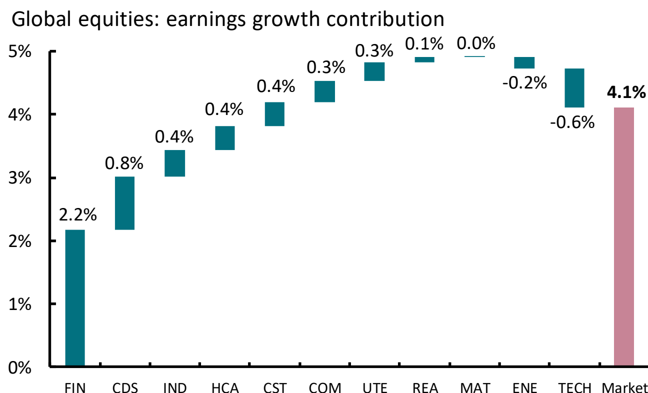
Exhibit 14: Risk off in global equity markets



Source: Datastream, MSCI and AXA IM Research

After the long run of downward revisions, the earnings growth outlook for 2019 appears to be well anchored around the 4% mark with a large convergence of expectations between regions and sectors. The technology sector is now the largest drag on aggregate earnings growth, driven by weakness in the semiconductor space and smartphone sales, while financials are leading the pack (Exhibit 15).

Exhibit 15: Earnings expected to growth at 4% in 2019

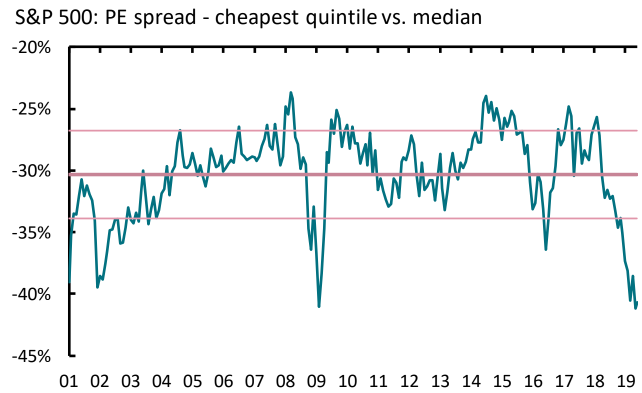


Source: Datastream, IBES and AXA IM Research

A tale of two markets

Overall valuations for the asset class are not particularly stretched, with most metrics close to long-term norms. Within major indices, a meaningful divergence can be observed between a high bid for growth/quality and the beaten-down value names. The median stock in the S&P 500 trades at an earnings' multiple of 19.5x while the lowest quintile is close to 11.5x (Exhibit 16). This is mirrored in the earnings growth and corporate leverage profiles of the respective buckets, reflecting the current state of business disruption and cyclical momentum. Equities do offer reasonable relative value against fixed income, but we would need a pick-up in earnings revisions and some visibility on the global policy outlook for this to crystallise.

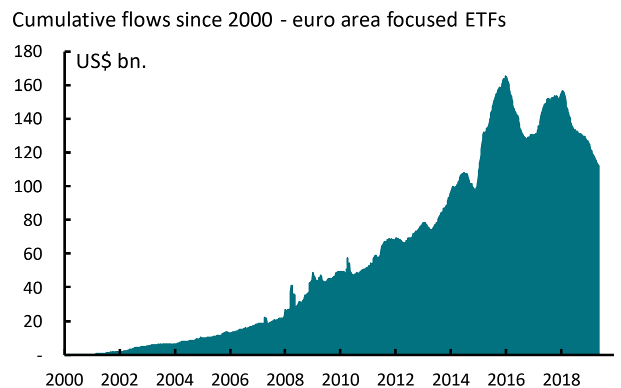
Exhibit 16: Large divergence within valuation multiples



Source: Bloomberg, S&P and AXA IM Research

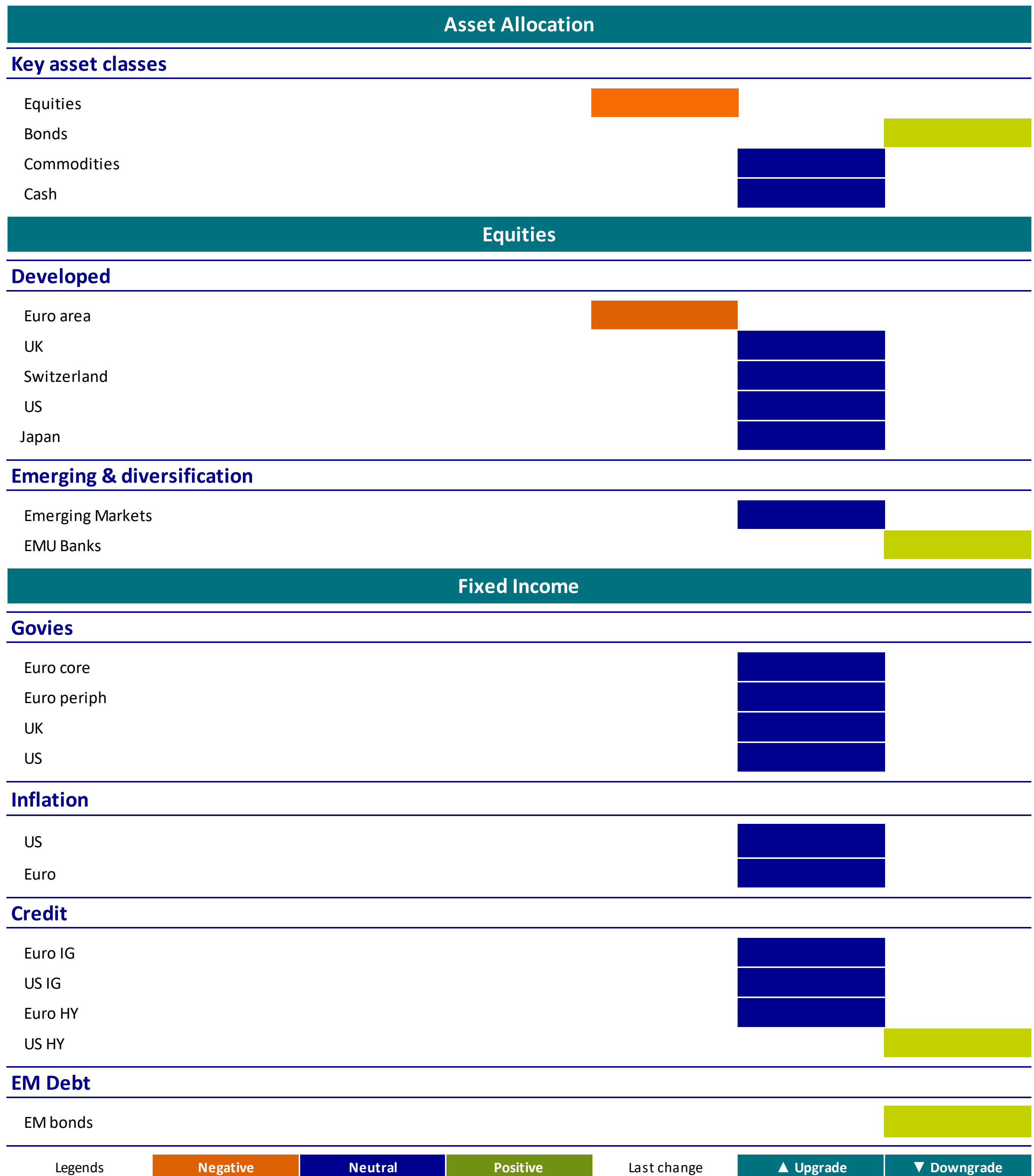
Investor sentiment remains fragile, visible in the large outflows from the asset class. Cumulative inflows since 2000 into European equities Exchange Traded Funds into are back to 2015 levels (Exhibit 17). We maintain our cautious stance on equities given the erratic policy environment and lacklustre earnings backdrop. Although the "Fed put" appears in place, there is sizable room for disappointment given the aggressive market pricing for rate cuts in 2019. The obvious counter case is that the trade war-risk scenario is rapidly reversed, leading to a broad-based risk-on rally as seen when tariffs on Mexico were called off shortly after being introduced.

Exhibit 17: Fund flow exodus from euro equities goes on



Source: Bloomberg and AXA IM Research

Recommended asset allocation



Source: AXA IM Macro Research – As of 20 June 2019

Macro forecast summary

Real GDP growth (%)	2018	2019*		2020*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
World	**3.6**	**3.3**		**3.5**	
Advanced economies	**2.3**	**1.8**		**1.6**	
US	**2.9**	**2.4**	*2.5*	**1.6**	**1.8**
Euro area	**1.9**	**1.1**	*1.2*	**1.2**	**1.3**
Germany	**1.4**	**0.8**	*0.8*	**1.1**	**1.2**
France	**1.7**	**1.3**	*1.3*	**1.2**	**1.3**
Italy	**0.7**	**0.1**	*0.2*	**0.4**	**0.6**
Spain	**2.6**	**2.4**	*2.3*	**1.8**	**1.9**
Japan	**0.7**	**0.6**	*0.7*	**0.4**	**0.4**
UK	**1.3**	**1.4**	*1.3*	**1.3**	**1.4**
Switzerland	**2.5**	**1.0**	*1.2*	**1.3**	**1.5**
Emerging economies	**4.4**	**4.3**		**4.7**	
Asia	**4.9**	**4.7**		**4.8**	
China	**6.6**	**6.3**	*6.3*	**6.1**	**6.0**
South Korea	**2.7**	**2.4**	*2.2*	**2.3**	**2.4**
Rest of EM Asia	**5.5**	**5.4**		**5.4**	
LatAm	**1.1**	**1.2**		**1.9**	
Brazil	**1.1**	**1.5**	*1.2*	**2.0**	**2.2**
Mexico	**2.2**	**1.4**	*1.4*	**1.8**	**1.7**
EM Europe	**2.3**	**1.8**		**2.4**	
Russia	**2.3**	**1.5**	*1.4*	**1.5**	**1.7**
Poland	**5.2**	**3.6**	*4.1*	**3.0**	**3.5**
Turkey	**2.9**	**-1.0**	*- 1.2*	**2.5**	**2.5**
Other EMs	**2.4**	**2.4**		**3.5**	

Source: Bloomberg, IMF and AXA IM Macro Research calculations – As of 20 June 2019

CPI Inflation (%)	2018	2019*		2020*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	**2.0**	**1.5**		**1.7**	
US	2.4	1.7	*1.8*	2.1	*2.1*
Euro area	1.8	1.3	*1.3*	1.4	*1.4*
Japan	1.0	0.7	*0.7*	0.8	*1.1*
UK	2.5	1.9	*1.9*	2.3	*2.0*
Switzerland	0.9	0.7	*0.6*	1.0	*0.9*
Other DMs	1.7	1.6		1.8	

Source: Bloomberg, IMF and AXA IM Macro Research calculations – As of 20 June 2019

These projections are not necessarily reliable indicators of future results

Forecast summary

Central bank policy Meeting dates and expected changes (Rates in bp / QE in bn)						
		Current	**Q2 - 19**	**Q3 - 19**	**Q4 - 19**	**Q1 - 20**
United States - Fed	Dates	2.25-2.50	- 18-19 Jun	30-31 July 17-18 Sep	29-30 Oct 10-11 Dec	Jan (TBC) March (TBC)
	Rates		unch (2.25-2.50)	-0.25 (2.00-2.25)	-0.25 (1.75-2.00)	unch (1.75-2.00)
Euro area - ECB	Dates	-0.40	- 6 Jun	25 July 12 Sep	24 Oct 12 Dec	Jan (TBC) March (TBC)
	Rates		unch (-0.40)	unch (-0.40)	unch (-0.40)	unch (-0.40)
Japan - BoJ	Dates	-0.1/¥25tn	- 19-20 Jun	29-30 Jul 18-19 Sep	30-31 Oct 18-19 Dec	Jan (TBC) March (TBC)
	Rates / QE		unch/taper	unch/taper	net QQE ¥15tn	unch (-0.10)
UK - BoE	Dates	0.75	- 20 Jun	1 Aug 19 Sep	7 Nov 19 Dec	30th Jan 26th March
	Rates		unch (0.75)	unch (0.75)	unch (0.75)	+0.25 (1.00)

Source: Datastream, AXA IM Macro Research - As of 20 June 2019

These projections are not necessarily reliable indicators of future results

Our Research is available on line:

Insights Hub

The latest market and investment insights, research and expert views at your fingertips

www.axa-im.com/insights

DISCLAIMER

This document is for informational purposes only and does not constitute investment research or financial analysis relating to transactions in financial instruments as per MIF Directive (2014/65/EU), nor does it constitute on the part of AXA Investment Managers or its affiliated companies an offer to buy or sell any investments, products or services, and should not be considered as solicitation or investment, legal or tax advice, a recommendation for an investment strategy or a personalized recommendation to buy or sell securities.

It has been established on the basis of data, projections, forecasts, anticipations and hypothesis which are subjective. Its analysis and conclusions are the expression of an opinion, based on available data at a specific date. All information in this document is established on data made public by official providers of economic and market statistics. AXA Investment Managers disclaims any and all liability relating to a decision based on or for reliance on this document. All exhibits included in this document, unless stated otherwise, are as of the publication date of this document. Furthermore, due to the subjective nature of these opinions and analysis, these data, projections, forecasts, anticipations, hypothesis, etc. are not necessary used or followed by AXA IM's portfolio management teams or its affiliates, who may act based on their own opinions. Any reproduction of this information, in whole or in part is, unless otherwise authorised by AXA IM, prohibited.

Neither MSCI nor any other party involved in or related to compiling, computing or creating the MSCI data makes any express or implied warranties or representations with respect to such data (or the results to be obtained by the use thereof), and all such parties hereby expressly disclaim all warranties of originality, accuracy, completeness, merchantability or fitness for a particular purpose with respect to any of such data. Without limiting any of the foregoing, in no event shall MSCI, any of its affiliates or any third party involved in or related to compiling, computing or creating the data have any liability for any direct, indirect, special, punitive, consequential or any other damages (including lost profits) even if notified of the possibility of such damages. No further distribution or dissemination of the MSCI data is permitted without MSCI's express written consent.

This document has been edited by AXA INVESTMENT MANAGERS SA, a company incorporated under the laws of France, having its registered office located at Tour Majunga, 6 place de la Pyramide, 92800 Puteaux, registered with the Nanterre Trade and Companies Register under number 393 051 826. In other jurisdictions, this document is issued by AXA Investment Managers SA's affiliates in those countries.

In the UK, this document is intended exclusively for professional investors, as defined in Annex II to the Markets in Financial Instruments Directive 2014/65/EU ("MiFID"). Circulation must be restricted accordingly.

© AXA Investment Managers 2019. All rights reserved

AXA Investment Managers SA
Tour Majunga – La Défense 9 – 6 place de la Pyramide 92800 Puteaux – France
Registered with the Nanterre Trade and Companies Register under number 393 051 826