AXA Investment Managers

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Research & Strategy Insights

Prevent horizon: US sidesteps recession for now

Monthly Investment Strategy

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Key points

- The US economic slowdown remains modest – the world's largest economy looks set to avoid a recession in the next 12 months, thanks to the Fed's monetary easing
- Eurozone macro data and easing in the US, should lead the ECB to cut its deposit rate
- (No deal) Brexit worries are back
- China's June rebound is likely temporary with further softness and policy support ahead – other emerging markets are also posting lacklustre numbers
- Given the vulnerability of the macro environment, we are keeping a cautious allocation stance, with a preference for high-carrying fixed income

US economic vulnerability in need of modest support

The US economy has unsurprisingly kept slowing down following 2018's fiscal-fuelled 12-year record-high growth. With US/China trade tensions easing a notch at the Osaka G20 Summit in late June, monthly "hard" data remains relatively healthy while business surveys are holding up, especially in the services sector. Even the internationally exposed manufacturing industry endured a milder slowdown than witnessed in the late-2012 and late-2015 downturns. Altogether, we forecast US GDP growth of 2.4% this year and 1.6% in 2020, thereby avoiding recession in the next 12 months.

Building up on our previous research and mindful that macroeconomic indicators often lag market signals, we cross-checked with our spread-augmented yield curve recession model. This analysis confirmed our macroeconomic assessment of a vulnerable US economy, like where it was 1989 – when Iraq invaded Kuwait, oil prices spiked, and a recession started in 1990 – and then in 1998, there was another three years of expansion.

Fortunately, the Federal Reserve (Fed) hasn't much to do, to provide meaningful support. Indeed, the current policy stance is neutral. Cutting by 50 basis points (bps) in the second half of 2019 – our baseline expectation – would be sufficient to bring it into unambiguously easy territory, enough in our view to avoid a recession. The risk though is that such an approach from the Fed emboldens Donald Trump on his aggressive trade policy, fuelling more global tension – with adverse ramifications for Europe in particular. Another issue is that we end up in a "Greenspanian loop" with markets counting too much on automatic support from the Fed, leading to excessive exuberance in some financial markets' segments.

Eurozone: Less support, more vulnerability

Meanwhile, Eurozone macroeconomic data has been mixed in terms of indicators and countries. Whilst the Composite Purchasing Managers Index (PMI) for the whole region hit an eight-month high, German manufacturing indicators keep falling and the labour market is registering its first cracks with lower hiring intentions and rising unemployment. Whether Germany will fall into recession is a close call, but we believe the Eurozone will avoid one thanks to domestic demand, especially in France and Spain. Conversely, net trade and the industrial sector will keep weighing on Eurozone growth, as China's recovery is not yet on a solid footing. Indeed, we doubt June's rebound, with both retail sales and industrial production accelerating beyond expectations, will be sustained despite renewed policy support.

This economic slowdown coupled with the Fed's summer easing is putting mounting pressure on the European Central Bank (ECB) to also deliver some sort of monetary support. We expect a – already fully priced in – 10bp deposit cut to be delivered in September and announced in July. We are however more cautious on the prospect of the ECB relaunching quantitative easing soon. We believe this would require further economic deterioration going forward, not just a lack of improvement.

Back to the Brexit countdown

On 23 July, Brexit campaigner and former Foreign Secretary Boris Johnson became the leader of the Tory party, and therefore, the UK's new Prime Minister. In his successful attempt to convince the ≈160,000 members of the Conservative Party, Johnson promised to uncompromisingly leave the European Union (EU) on 31 October, whether a new deal is reached or not. Such a political pledge and adamant tone had observers and markets worried, as no alternative deal seems reasonably in sight in such a short period of time. The UK Parliament has repeatedly expressed having a majority against an exit without a deal and the House of Commons passed an amendment last week, requiring it to regularly meet between 9 October and 18 December to avoid an explicitly threatened suspension. This Parliamentary determination is however of little reassurance, as no deal is not an active, Parliamentary-approved choice but simply the default outcome if nothing is proactively done by 31 October. Of similarly little weight, is the insistence of Ursula Von der Leyen, the new President of the EU Commission, to offer another postponement of the Brexit deadline and make sure to avoid no deal. But while you can lead a horse to water, you can't make it drink.

Time for panic? Well, we have been here before; the inexorable dead-end, the lack of compromise, another countdown to Brexit and a country sleepwalking into a no deal exit. Once again, we believe the UK will avoid such an outcome. General elections may well be ahead, albeit with unforeseeable results – remember June 2017 – and yet-to-define campaigns. The Brexit show will go on.

Cautious asset allocation favouring carry

With forecasts for global earnings stabilising at 4%, overall equity valuations are not particularly stretched (with multiples close to long-term averages). We nevertheless maintain our cautious stance on equities, for several reasons. First, fragile investor sentiment seems sensitive to the erratic (geo)political environment. Second, although the "Fed put" is well in place, we believe market pricing offers room for disappointment in communication. Third, and on a relative basis, we maintain our preference to allocate our modest risk appetite to credit, especially high-yielding and emerging debt, with a goldilocks backdrop of modest but resilient growth, low inflation and monetary easing.

In the fixed income space, we maintain a constructive view on duration risk in the medium to longer term, as the Fed embarks on its 'insurance' easing cycle (with the ECB to follow) and material inflationary pressures are few and far between. That said, given the ultra-low level of yields globally, we are conscious of the near-term risk for a mini correction in rates, accompanied by a limited correction in in risky assets – a mini 'rate tantrum'. A catalyst to that could be an effort by the Fed to deliver a hawkish cut to wean the market off the expected five rate cuts over the next 18 months. In any case, we would view such a correction as an opportunity to add spread risk at cheaper levels, as the macro backdrop for spread carry remains very conducive.

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

Global Macro Monthly – US

David Page,
Senior Economist,
Macro Research – Core Investments

Trade talks resume after G20 (again)

The recent G20 meeting was in focus for the fringe meeting between US President Donald Trump and Chinese President Xi Jinping. The meeting saw both agree to avoid further trade tension escalation – the US deferring additional tariff increases for now and easing restrictions on Chinese tech giant Huawei. The two committed to resume talks. So far these have been limited to telephone calls, but US Trade Secretary Lighthizer is scheduled to visit Beijing this week.

Avoiding further escalation of trade tensions saw the US side step a significant policy error that might have tipped its economy into recession. But we are not out of the woods yet. President Trump resumed sniping at China, tweeting that the US could go much further with trade tariffs if it wanted. Moreover, this latest détente is only reminiscent of the peace brokered at the Buenos Aires G20 last year. The following six-months were not tranquil and this pattern could be repeated. Moreover, the US could raise auto tariffs which would affect the EU, Japan and South Korea. Or it could raise other third-party tariffs, echoing the one-week threat against Mexico. Trade uncertainty looks set to remain high. The Federal Reserve's latest Beige Book recorded "widespread concern" about the negative impact this would have.

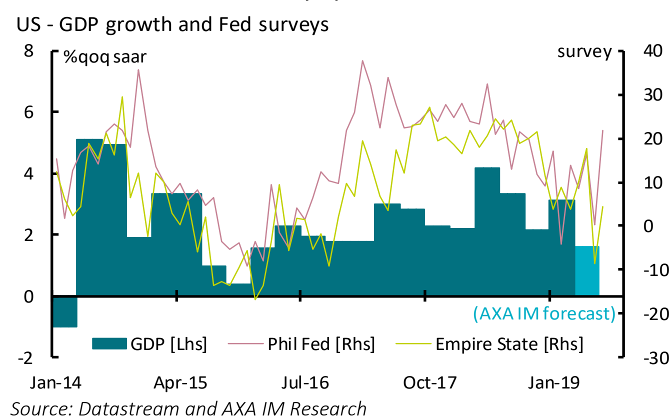
Economic data solid for now

Avoiding a 'worst-case' scenario for trade in June, the economy has posted more buoyant data recently, suggesting that trade fears weighed on June's readings. Both the Empire State and Philadelphia Fed surveys showed a rebound in July – the latter posting its strongest reading in a year at 21.8 – the average level for 2018 (Exhibit 1). While we are cautious in suggesting this will be sustained – particularly in the face of any fresh trade concerns – it illustrates the sensitivity of manufacturing sentiment to protectionist policy and suggests that June's concerns have been averted.

Other US data also surprised to the upside. Core Consumer Price Index (CPI) inflation edged higher to 2.1%, which, combined with solid PPI inflation, suggest that 'core' Personal Consumption Expenditure (PCE) inflation should rise to 1.7% in June – tentative confirmation of the Fed's interpretation of "transitory" inflation softness. Moreover, retail sales figures proved stronger than expected and confirmed our expectation for strong consumption growth in the second quarter (Q2) of 3.6%.

Admittedly, an unwind of Q1's erratic inventory and low import figures is likely to dampen Q2 GDP growth overall, despite stronger consumption. We forecast annualised growth of 1.6% in Q2. While we expect consumer spending to remain underpinned over the coming quarters, we forecast deceleration in business investment, weakened by slowing profit growth and rising trade uncertainties. Nevertheless, we maintain our outlook for 2.4% growth in 2019 (consensus 2.5%) and a sub-trend 1.6% in 2020 (consensus 1.8%).

Exhibit 1: Business surveys post rebound after G20



Source: Datastream and AXA IM Research

Fed confirms prevention outlook

Turns in global events and volatile data have made the Federal Reserve's job more difficult. The Fed left policy on hold in June, in part reflecting concerns about the recent nature of weaker data. At that meeting, minutes reflected that several participants had seen a growing case for easier policy. Fed Chair Jerome Powell provided testimony to Congress stating that since then uncertainties had persisted, apparently acquiescing to overwhelming market expectation for a Fed rate cut in July. Yet as described, data have firmed since then. We forecast the Fed to cut rates by 0.25% in July, dismissing expectations for a more aggressive 0.50% cut. Indeed, we note that St Louis Fed President James Bullard – one of the more dovish of the Committee – stated that the current situation "did not warrant a larger cut".

More generally, markets continue to price effectively five 25bp rate cuts between now and the end of 2020. Unless significant downside risks arise from here, we do not expect the Fed to ease monetary policy by as much as this. Indeed, while the Fed wants to "sustain the economic expansion", it is likely to be mindful of 1998, where rate cuts in response to the Asia crisis contributed to a marked easing in financial conditions, which ultimately unwound dramatically two years later. We expect the Fed to cut rates twice this year to 1.75-2.00%, in July and September. We thus expect the Fed to gradually erode market expectations for more cuts, a task that will become easier if economic data remain firmer. This should see US 2-year rates rise from current levels (<0.8%). That said, risks to this rate outlook are to the downside if negative political developments continue to unfurl. These could include further trade war escalation, US budget problems or geo-political issues.

Global Macro Monthly – EMU

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Germany: Lower for longer

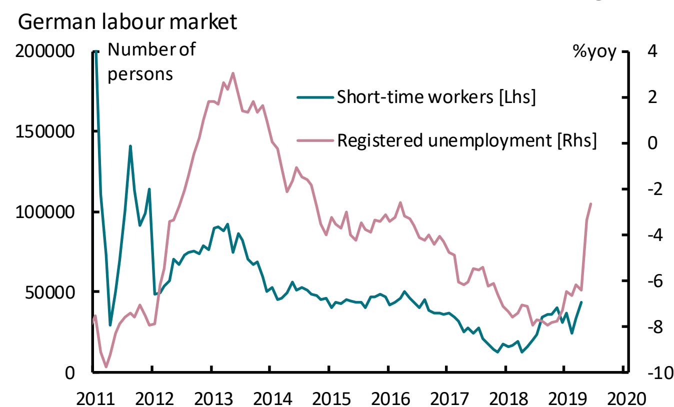
Euro area data have remained mixed, both in terms of indicators and countries. While June composite PMIs stood at the highest since November on the back of stronger French confidence, a large drop in German manufacturing sentiment pushed the European Commission economic sentiment indicator to a 34-month low. The gap between the domestic services and export-oriented manufacturing sectors continues to grow and so does the discrepancy between countries. The more domestic-focused economies of France and Spain appear quite robust, while Germany and Italy are driving the euro area soft patch.

Latest German data were particularly disappointing. Factory orders fell by 8.6% year-on-year (yoy) in May, the steepest decline since September 2009, while the carry-over for industrial production and retail sales stands at -1.5% and -1.0% quarter-on-quarter (qoq), respectively. Car registrations shrank by 0.4%qoq in the second quarter (Q2) and exports are heading to a 2.2%qoq drop. True, some payback from Q1 was to be expected, as that quarter's 0.4% GDP growth was artificially boosted by some rebound in household spending after a depressed second half of 2018 (car purchases) and buoyant construction (unusually mild weather). But the magnitude of the payback is larger than we initially anticipated: we revise down our Q2 GDP growth forecast to 0%qoq from 0.2% and see growth hovering around 0.1%/ 0.2% in the second half of 2019. This brings our forecast for German GDP growth for 2019 down to 0.6%yoy, from 0.8% previously.

Risks remain skewed to the downside, not only because of the potential auto tariffs, but also because labour market data have started to post warning signals. Firms' hiring intentions are getting lower in both the manufacturing and services sectors and the amount of short-time working is increasing. The latter is usually a good leading indicator of a turnaround in the labour market, a buffer between falling and rising unemployment. For now, registered unemployment is still decreasing, but at a much more modest pace than in 2018 (Exhibit 2). Likewise, consumer unemployment expectations have risen, although remain below their long-term average. So, for now, we consider these developments as simply cracks in labour market resilience but monitoring them will be key to gauge whether Germany can avoid recession.

At the euro area level, the picture is less downbeat, with solid signals from France and Spain partially offsetting German and Italian weakness. We expect growth to flatline around potential in the coming quarters at 0.2%/0.3%qoq, averaging 1.1%yoy in 2019.

Exhibit 2: German labour market need monitoring



Source: DataStream and AXA IM R&IS calculations

ECB: Telegraphing monetary policy changes

As the US Fed appears to be heading to a July cut, pressure is mounting on the ECB to deliver a monetary policy easing of its own. Interventions from Governing Council (GC) members did not try to change market expectations – a 10bp cut in the deposit rate is fully priced for the September meeting. We see it as a sign that the GC has reached consensus on such a move and thus include it in our baseline. We believe this will be confirmed by a change in the introductory statement ("the key ECB interest rates to remain at their present levels or lower at least through the first half of 2020") at the July meeting.

Regarding restarting quantitative easing (QE), we are much more cautious than markets and believe we would need a deterioration of the economic environment, rather than a lack of improvement, to see the ECB embark on this path. Technical constraints (the 33% issue/issuer limits) coupled with political challenges – Italian fiscal brinkmanship – keep the bar relatively high in our view. Further, the speech of ECB Executive Board Member Benoit Coeuré on inflation expectations[1] contains a line highlighting that the situation today is different from 2014/2015 when QE was announced, as inflation expectations are not falling across all the population – households' ones are holding firm.

We believe Draghi wants policy options to be openly debated, preparing the ground for his successor. The election of Ursula von der Leyen as the next President of the EU Commission (with a thin majority of nine votes) has cleared the way for Christine Lagarde at the head of ECB.

[1] Coeuré. B., "Inflation expectations and the conduct of monetary policy", ECB press conference, 11 July 2019.

Global Macro Monthly – UK

David Page,
Senior Economist,
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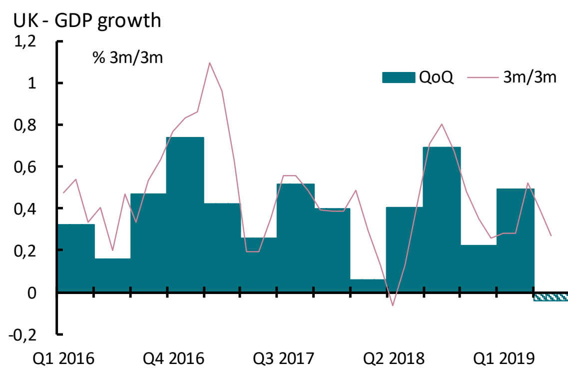
Q2 GDP due to weaken

Short-term GDP has been affected by Brexit behaviour. Q1 GDP rose by 0.5% but was boosted by inventory-build, both in the UK and overseas, supporting exports. This looks likely to have reflected preparations for the 31 March Brexit deadline. The passing of that deadline should have led this boost to unwind in Q2. So, the monthly GDP numbers suggest: GDP was estimated to have dropped by 0.4% in April, although to have risen by 0.3% in May. Based on these data, Q2 GDP looks likely to have been flat on the quarter (Exhibit 3).

Exhibit 3: GDP growth weakened abruptly in April



Source: National Statistic and AXA IM Research

PMI survey data weakened further, with a notable drop in manufacturing and construction indices – both now in contractionary territory – and a further softening in services. This combination has led to some speculation of recession in the UK. However, we think this unlikely, expecting GDP growth to resume a subdued underlying pace of around 0.25% per quarter across H2 2019 as the UK grapples with softer global activity and idiosyncratic Brexit headwinds. We forecast this to deliver growth of 1.2% for 2019 as a whole.

The path of Brexit will remain a key determinant of UK economic activity and financial markets. The announcement that Boris Johnson will be the new Prime Minister came as no real surprise. Markets have been unsettled by his ongoing forthright commitment to leaving the EU on 31 October, fearing a “no-deal” exit. However, PM Johnson has also described a “one in a million” chance of a “no-deal” exit. We do not place great weight on inconsistent campaign pledges. We continue to see a further extension of Article 50, beyond 31 October as the most likely outcome, possibly for further negotiations, but increasingly likely for fresh elections.

Global Macro Monthly – Japan

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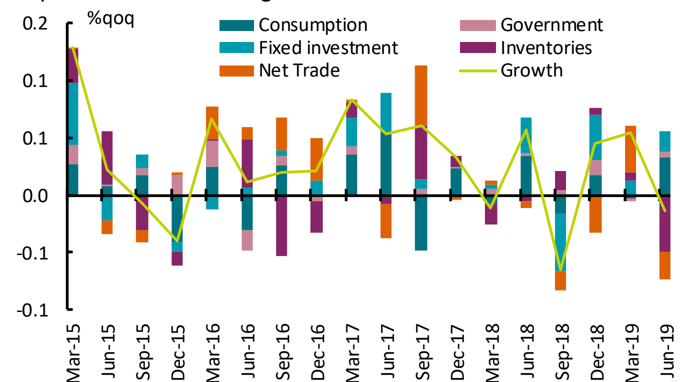
Erratic Q1 contributions should weigh on Q2 GDP

The June Tankan and PMI surveys saw manufacturing sentiment drop more than expected, while confidence among non-manufacturers stabilised. Exports continue to suffer from weak external demand and imports are gradually recovering. Consumption should rebound and investment should stay robust. Finally, Q2 GDP should decline as net trade and inventories unwind from a strong Q1, creating negative contributions (Exhibit 4).

Core inflation (ex-oil products) climbed 0.5% in June compared with a 0.8% gain in May. This was the weakest since July 2017. The so-called core-core Consumer Price Index (CPI), which also removes the effects of volatile food, was up 0.5%yoy in June. Inflation should continue to be volatile as a result of certain special factors: the consumption tax hike in October, the introduction of free preschool education and cuts to mobile phone charges.

Exhibit 4: Decline in net trade will weigh on GDP figure



Source: Cabinet Office and AXA IM Research

The BoJ will have to manage Fed rate cut

Since the Fed is expected to lower its rate from July, the Bank of Japan (BoJ) will have to act to keep an accommodative monetary policy. Markets expect a rate cut before the end of 2019, but we see more costs than benefits from such a move unless the yen appreciates very sharply. A rate cut would weigh on regional banks, which are already in a very fragile position. At the July meeting, we believe the BoJ will adjust its forward guidance by extending the horizon for the current low level of interest rates “at least until the end of the next year”. Regarding the tapering of the BoJ's asset purchases, they should be reoriented towards shorter term maturities in order to steepen the yield curve.

Global Macro Monthly – China

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Another end-of-quarter rebound in activity helped to keep second quarter (Q2) GDP growth in line with the market consensus at 6.2%. However, there are many questions regarding the sustainability of this rebound, particularly in light of the ongoing US-China trade disputes, pessimism among businesses and "prudent" policy operations from Beijing. We find it difficult to believe that the economy can rise above these near-term challenges without additional policy support from Beijing. Learning from past mistakes – withdrawing support prematurely – we think the government will opt to keep existing stimulus in place and stand ready to ease further, should growth falter again. With extra vigilance against downside risks ahead of the People's Republic of China (PRC)'s 70th anniversary, we believe Beijing will work hard to keep growth above 6% in the second half (H2) of 2019.

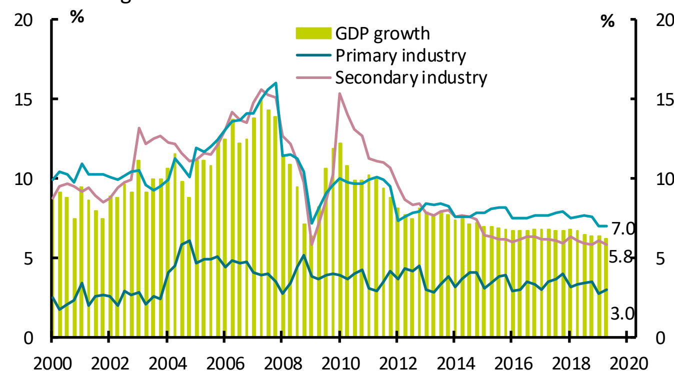
June activity numbers surprise to the upside

After holding steady in Q1, economic growth slid to 6.2% in Q2 from 6.4%. The main culprit was a slowdown in the secondary industry, where yoy growth eased to 5.8% from 6.1%. Primary-sector growth bucked the trend, picking up by 0.3 percentage points (ppt) from Q1 to 3%, while the tertiary industry, which accounts for over 52% of the economy, grew at a steady pace of 7% in Q2 (Exhibit 5).

While headline GDP growth was bang in line with expectations, the details were packed with surprises. First, the Q2 slowdown appears to have been entirely driven by weakness in the first two months of the quarter, whereas growth is actually reported to have rebounded strongly in June. All three key activities surprised to the upside on a monthly basis, with industrial production and retail sales growth accelerating by 1.3 percentage point (ppt) and 1.2ppt to 6.3% and 9.8% respectively. The latter rose for the second consecutive month and reached a 15-month high, in spite of the overall soft economic backdrop and elevated uncertainty.

The second surprise was a notable pick-up in domestic demand. Last week's trade data suggests that the growth revival in June had little to do with China's external performance. In fact, export growth dipped below zero again (to -1.3%), thanks to a trade-war-inflicted contraction in US-bound shipments, which were down 7.8%). At the same time, sales to other G3 markets – the European Union and Japan – also declined, reflecting weak global demand. Overall, China's external performance was a net drag on the economy. This implies that domestic demand did the most heavy lifting for the growth rebound in June, although there were no prior indications of such an improvement – neither from the PMI, imports, nor Producer Price Index.

Exhibit 5: Secondary industry the main drag



Source: CEIC and AXA IM R&IS calculations

Recovery not on a solid footing

Finally, there has been no recent major policy stimulus to account for such a strong growth spurt. Admittedly, the State Council announced support to infrastructure investment that led to a jump in local government special bond issuance last month. But in terms of money put to use, infrastructure investment growth only quickened modestly to 2.9%yoy (4.1% year-to-date) in June. We expect more activity to come in H2, but last month's growth rebound seems to have little to do with this newly-implemented policy.

Overall, June's positive surprise has raised more questions than answers. It is possible that previous fiscal stimulus – with many rounds of tax/fee reductions – has increased the resilience of the economy. It is also possible that pent-up demand, particularly for auto and property in top- and second-tired cities, was unleashed by lower funding costs for households. Indeed, auto sales and production both rebounded strongly last month. However, these "green shoots", for the time being, do not appear broad-based and have not proven their sustainability. We therefore interpret them with caution.

Policy supports to remain

Investors were misled by a similar end-of-quarter rebound in Q1, but only to find it transitory. What contributed to that short-lived growth bounce was a swift policy withdrawal – after the strong March data – that killed the nascent recovery prematurely. Beijing, in our view, has learned from that mistake and will keep policy supports in place for longer. We expect Beijing to stay vigilant against downside risks to ensure economic stability ahead of the PRC's 70th anniversary and keep growth above 6% in H2.

Global Macro Monthly – EM

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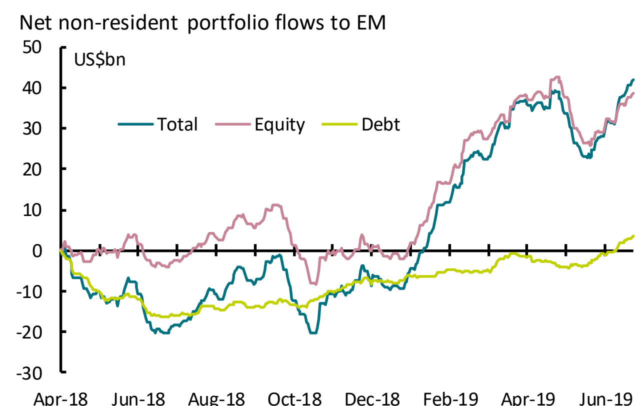
EM assets gain traction…

US President Donald Trump and Chinese President Xi Jinping's meeting at the Osaka G20 resulted in the much expected "trade truce": negotiations are "back on track". While the de-escalation of the trade war is a welcome outcome, we are wary of a nonlinear trajectory of negotiations ahead of us, expecting wobbles along the way. Still, investors appear relieved and portfolio flows are back into emerging market (EM) assets (Exhibit 6). The focus will now turn to US Federal Reserve policy decisions, which are expected to support further monetary easing through emerging markets.

Exhibit 6: Flows are back in EM assets



Source: IIF, AXA IM research, data from 15/04/2018 to 2/07/2019

… while economic slowdown intensifies

While emerging market asset prices benefited from this better trade outlook and the expected support from the Fed ahead, macro-economic data have so far failed to improve. Industrial production continued to slide in export-oriented countries such as South Korea and Taiwan – admittedly in May and before the recent resolution. Some weakness appeared in Eastern European countries as well, albeit a slowdown from very strong levels for Poland and Hungary. Activity remains lacklustre in Latin America, particularly in the biggest countries such as Mexico and Brazil. June Purchasing Managers' Index surveys pointed to a continued deceleration in EM manufacturing activity, now below the 50-threshold and dipping into contractionary territory.

So far, retail sales have remained broadly more resilient. But a pickup in exporting activities and industrial production in the coming quarters is likely to be necessary to avoid a negative spillover to households.

Turkey… post-Istanbul elections

The result of the re-run of Istanbul's mayoral elections that took place on 23 June came as a general surprise: Turkish opposition candidate Ekrem İmamoğlu won by a landslide, beat the ruling AK Party's Binali Yildirim. This is a serious blow to President Recep Tayyip Erdogan who has long argued that Istanbul is of major importance.

June's headline inflation declined more than expected to 15.7%yoy, from 18.7% in May – the fastest deceleration in the Consumer Price Index in eight months. Similarly, the core index fell to 14.6% in June, from 15.8%, reflecting base effects, which could provide impetus for inflation to continue declining in the coming months. Much of the improvement was driven by food inflation, which has been persistently high – averaging 30%yoy in January-May – despite the government's efforts to contain it. Looking ahead, inflation pressures will rise following hikes to natural gas prices for electricity companies and the 15% electricity hike for households and businesses – both effective from July. Higher oil prices would present additional inflation risks.

Markets have continued to be turbulent reflecting political noise relating to the March local elections, the Istanbul mayoral re-run and the S-400 anti-missile system deliveries and associated threatened US sanctions. Moreover, President Erdogan disappointed markets by replacing the central bank Governor Murat Çetinkaya with the Deputy Governor Murat Uysal, adding to fears of political interference. The new Governor immediately indicated more "room to manoeuvre" with future rate policy. This has added to our expectations that the Turkish central bank will begin reversing previous tightening undertaken following last summer's currency crisis. From an economic standpoint, we think both domestic conditions and the global backdrop – with expected US interest rate cuts of 50 basis points this year – are conducive to a more accommodative monetary policy stance, but timing is key to avoid market turbulence.

Investment Strategy – Cross-asset

Greg Venizelos
Investment Strategist
Research – Core Investment

Under the central banks' spell

Global markets have traded with an upbeat mood in the past month, boosted by a trade war truce, an ever-dovish Fed and a ECB that seems to have squarely joined the dove street club. So while US recession concerns continue to linger, risky assets like equity and credit appear unconcerned. Government bond yields on the other hand remain notably supressed, perhaps even 'recessionary', notwithstanding a small recent pop higher on the back of payrolls, CPI and retail sales data in the US. With interest rates so low there is a danger of a sudden move higher that unsettles risky assets, pushing credit spreads wider and stock prices lower, May 2013 taper tantrum style. Therein lies the challenge for the Fed inasmuch it may need to deliver a 'hawkish cut' – namely reduce its target Fed Funds rate by 25bps while also convincing the markets that expectations for five 25bp rate cuts over the next 12 months are overambitious.

Given its data dependency, the Fed's language at the 31 July meeting will be shaped by all the economic releases by then and the outcome of the Q2 earnings season – two-thirds of S&P 500 companies report by 31 July. In our base case that economic momentum stabilises, one could argue that markets should be reassured and accepting of any Fed attempt to moderate expectations. In any case, the disappointment of a Fed 'under-easing' into a stabilising/ rebounding backdrop should be less unsettling to markets than the disappointment of a Fed 'over-tightening' into a slowdown, as was the case in Q4 2018.

Investment Strategy – FX

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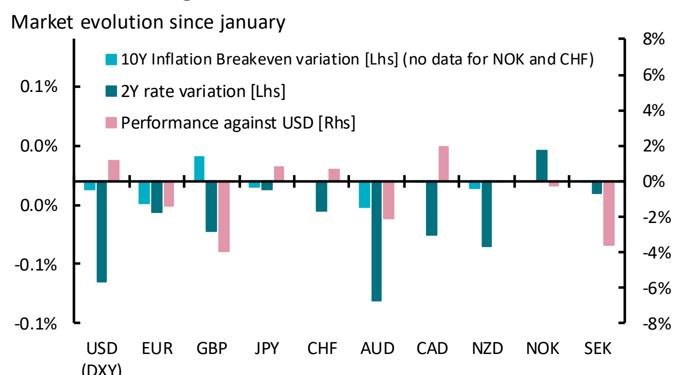
A dovish race between Fed and ECB

Expectations of more quantitative easing from the ECB have quickly risen in June. In the short term, the ECB looks set to deliver a deposit rate cut and maintain a dovish stance, in order to revive falling inflation expectations (Exhibit 7). This, plus the absence of significant rebound in global growth, should keep the EUR/USD exchange rate under pressure. Beyond that, markets may be disappointed by what the ECB can really deploy; a risk to keep in mind. The Fed has more ammunition and, thus, US inflation expectations are better anchored.

Exhibit 7: falling 2Y rates and inflation breakevens

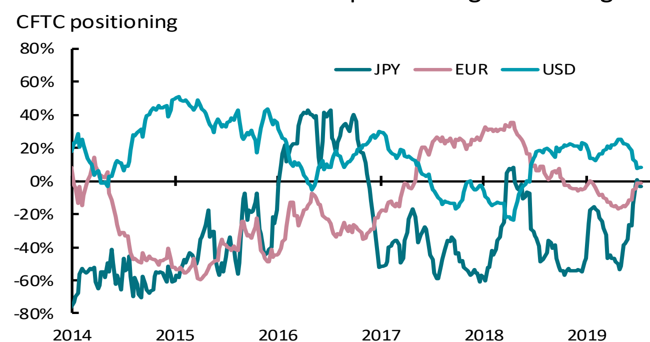


Source: Bloomberg and AXA IM Research

Low expectations on BoJ to keep JPY supported

Small adjustments in expectations aside, central banks are poised to counter downside risks. The Japanese yen (JPY) looks set to benefit from any downward pressure on global rates as expectations on the Bank of Japan remain light and inflation expectations low. The yen may also get additional temporary support from bouts of volatility as central bank potency may be questioned. Yen short positioning has already been unwound and may even turn positive (Exhibit 8). The same is true for euro (EUR) short positioning but is perhaps less likely to turn positive given weak growth momentum. Euro/yen rallies look attractive to sell and offer better carry than selling US dollar/yen.

Exhibit 8: EUR and JPY short positioning unwinding



Source: Bloomberg and AXA IM Research

Norges went the other way, BoC in between

The Reserve Bank of Australia has failed to lift inflation expectations despite cutting twice already, because of a soft domestic outlook. Inflation expectations have risen in the UK in contrast to the rest of G10 as ongoing Brexit uncertainty forces Bank of England inaction despite inflation pressures. Canada is also bucking the global trend, allowing the Canadian dollar to outperform but within limits given oil sector weaknesses and spillovers from Fed policy. The Norwegian krone is also undervalued and has more room to rally given a more hawkish Norges Bank which has hiked rates twice this year). Both currencies would benefit from rising tensions with Iran.

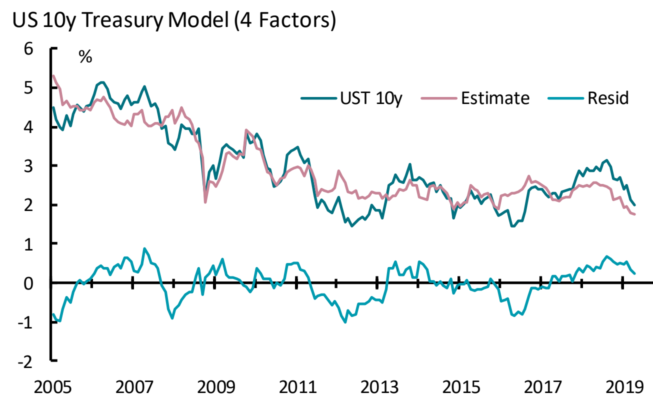
Investment Strategy – Rates

Gregory Venizelos
Credit Strategist
Research – Core Investments

Central banks overcome rates micro tantrums

This past month has witnessed a decidedly dovish message from central banks, both the Fed and the ECB. In the case of the Fed, at times, this appeared at odds with some stronger US economic releases, namely payrolls, inflation and retail sales in June. Indeed, 10-year US Treasury (UST) yields jumped by approximately 10bps after the payrolls and inflation reports and by approx 5bps after the retail sales report, only to be pulled back by dovish Fed rhetoric. Net-net, the 10-year UST has edged higher by a few bps in July to 2.04% and the UST benchmark index has posted small negative returns (-0.08%). In contrast, sovereign yields in Europe have been held back by weak macro and dovish ECB expectations, with the benchmarks indices posting 0.06% in the case of German government bonds, 0.40% in French, 0.23% in Spanish and a stellar 3.5% in Italian government bonds.

Exhibit 9: US Treasury fair value yield pulled down by extended policy accommodation expectations



Source: Bloomberg and AXA IM Research

Blame Fed expectations for low UST fair value

The markets are pricing five rate cuts by the Fed over the next 18 months. We consider fewer rate cuts appropriate for the current state of the US economy and its direction of travel – for example consumer spending is still strong. This is also historically consistent with the two prior episodes of 'insurance' easing cycles in 1995 and in 1998 (three cuts in each). It remains to be seen whether the Fed will attempt to wean markets off their five rate cut expectations, by delivering a hawkish cut at their next meeting on 31 July. The risk is that market disappointment leads to worsening financial conditions that ultimately peg them back to the 'five cuts' expectation when a backdrop of 'not runaway inflation' affords them the space to lean on the dovish side. Certainly, the severe nosedive in policy expectations has contributed mostly to the steep decline in the 10-year UST fair value, from 2.5% in mid-2018 to 1.75% currently (Exhibit 3). Add to the mix receding inflation expectations since mid-2018 and the ongoing decline in the term premium to complete the current dovish backdrop for US rates.

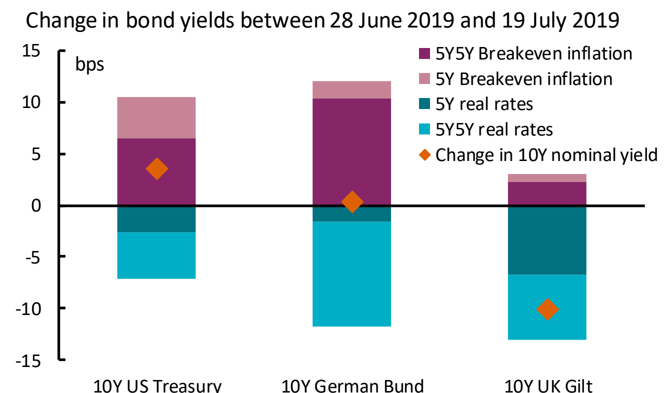
UST curve recession dynamics: saved by the Fed

The flattening/inversion (depending on the tenors observed) of the UST curve has preoccupied investors for some time now, given that such curve dynamics have routinely preceded recessions in the past. But are all curve inversions created equal? During the 2006-7 episode the two-year-10-year UST curve dwelled at mildly inverted levels for a lot longer – well beyond a year. In addition, the three month-10-year UST curve exhibited a much deeper inversion of -80bps. While the hidden leverage of the huge shadow banking sector may have been a factor then, this is in some contrast to what we observe currently. The two-year-10-year UST curve has remained flat – not inverted – at just under 20bps for six months, from December 2018 to May 2019, having bottomed at 12bps in December. The three-month-10-year curve bottomed at -40bps at the end of May and since then has steepened to -20bps. So even if we can assume some causality between the UST curve shape and recessions, perhaps the Fed can arrest recessionary UST curve dynamics through its dovish U-turn earlier in the year.

Some life in inflation expectations after all

Lastly, let us observe that the small uptick (Exhibit 10) in US Treasury yields in July has been driven by a rise in inflation expectations and against falling real rate expectations. This has followed the upside surprise in the US Core Consumer Price Inflation for June, which came in at 2.1% vs a consensus expectation of 2%. Any further moves in inflation in that direction could become the driver for markets to moderate their Fed policy expectations.

Exhibit 10: A rise in inflation expectations has offset the decline in real rate expectations in US and Germany



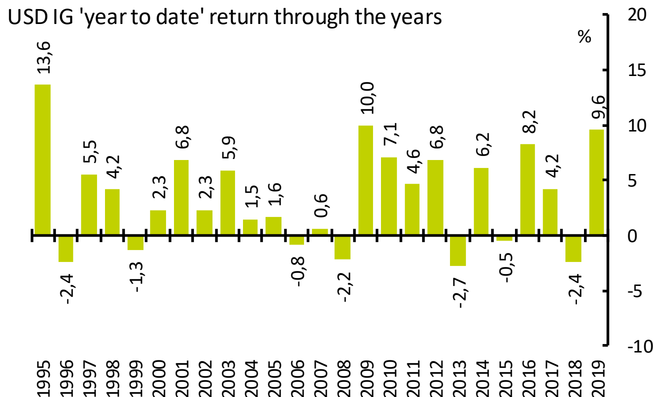
Source: Bloomberg and AXA IM Research

Investment Strategy – Credit

Gregory Venizelos
Credit Strategist
Research – Core Investments

Credit under the spell of central banks

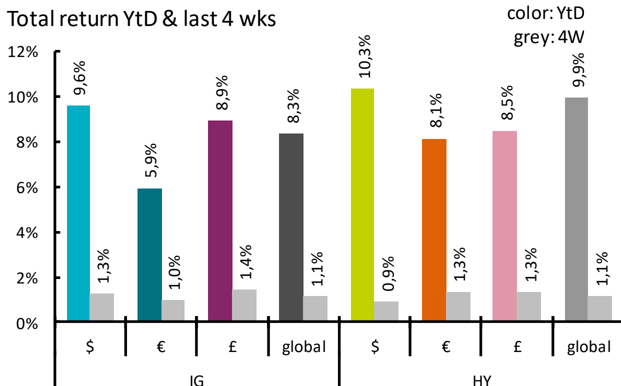
Exhibit 11: USD Investment Grade year-to-date returns are the highest in a decade



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

Credit has seen the benefit from a further boost in risk appetite over the past few weeks as central bank expectations turn ever more dovish. The result has been a material acceleration in year-to-date returns, with US dollar investment grade credit, for example, producing its best year-to-date performance in a decade at 9.6% (Exhibit 11). The rally has been broad-based with credit indices returning near or over 1% in the past four weeks (Exhibit 12). Two things stand out further: First, year-to-date returns are comparable across investment grade and high yield as both rates and spreads have rallied. Second, euro investment grade is lagging because of its carry handicap due to ultra-low euro yields post-eurozone crisis.

Exhibit 12: credit markets have posted a strong performance across the board in past four weeks



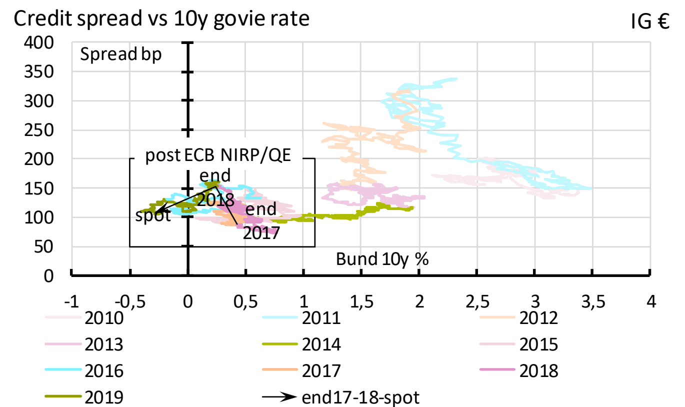
Source: Bloomberg, ICE and AXA IM Research

With interest rates at such low levels on both sides of the Atlantic there is a danger of a sudden move higher that unsettles risky assets and pushes credit spreads wider in what might resemble the May 2013 taper tantrum. Such a scenario would be more punitive for investment grade credit which has higher duration exposure, than high yield credit, which has higher spread exposure, and could thus restore the traditional performance advantage of high yield.

Is Euro credit too presumptuous on ECB QE2?

Euro credit may be more susceptible to a market correction in a scenario where central banks attempt to moderate market expectations for policy accommodation. This is because euro risk premia have rallied materially in the past few weeks on hints that the ECB) may consider resuming asset purchases before year-end. This rally includes a broad-based spread tightening, in Italian sovereign debt, periphery financials and euro investment grade as well as strong spread compression versus US dollar and sterling credit spreads. Supply in euros has picked up too, including reverse Yankees (US companies issuing bonds in euros). To that effect it is quite telling that the face value of the euro investment-grade credit grew by around 1% in June.

Exhibit 13: Euro yields and spreads at the lows of their post ECB NIRP/QE low rate regime



Source: Bloomberg, ICE and AXA IM Research

The significant move lower in both sovereign bond yields and credit spreads in euroland becomes quite apparent when we examine the credit spread and interest rate regime (Exhibit 13). Even within the low yield and low spread regime that has prevailed post the ECB's negative interest rate policy and quantitative easing, German Bund yields made new lows of -0.4% in June and investment grade spreads dropped towards the 100bp level, not far above their 74bp low in January 2018. If ECB policy expectations were to moderate, we would expect yields to rise towards zero or above and spreads to widen by 20-30bps. Thus the 'spread-rates' co-ordinate on Exhibit 13 would migrate towards the middle of the 'end-2017/end-2018-spot' triangle that we have highlighted on the chart.

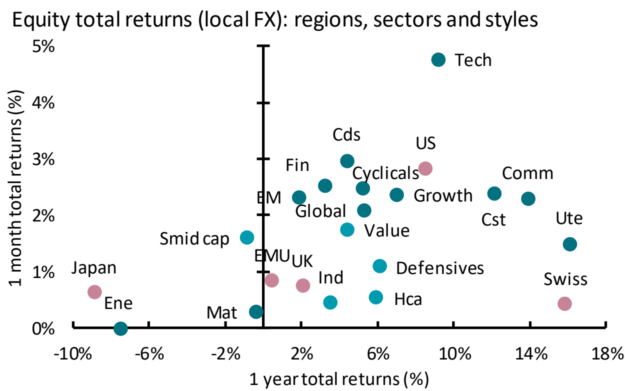
Investment Strategy – Equity

Varun Ghotgalkar,
Equity Strategist,
Research – Core Investments

Who's right - equities or bonds?

Global equity markets posted strong gains over the past month. The S&P 500 index made new all-time highs, crossing the 3000 mark, supported by continued strength in the technology and consumer discretionary sectors (Exhibit 14). Performance can be largely attributed to the trade war truce between US and Chinese authorities, dovish pivots from major central banks and a decent start to the second quarter (Q2) earnings season.

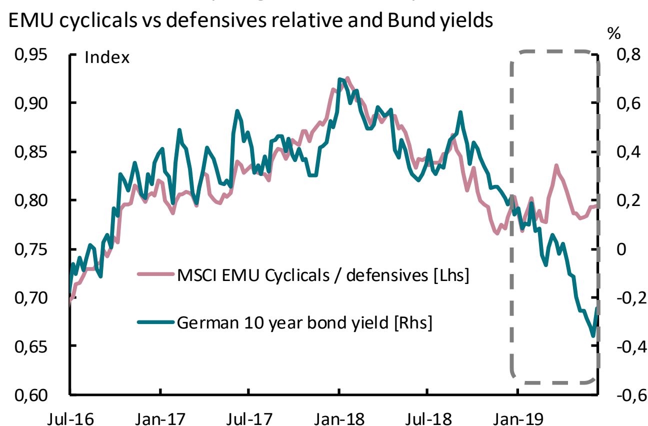
Exhibit 14: Rebound in global equities; tech stands out



Source: Datastream, MSCI and AXA IM Research

A decoupling can be observed between equities and bond yields with the relative performance of cyclical and defensives pricing in higher yields (Exhibit 15). Although aggregate valuations are not particularly stretched, a meaningful divergence can be observed with quality growth names demanding steep premiums visible in the record divergence of multiples between value and growth factors.

Exhibit 15: Decoupling between equities and bonds

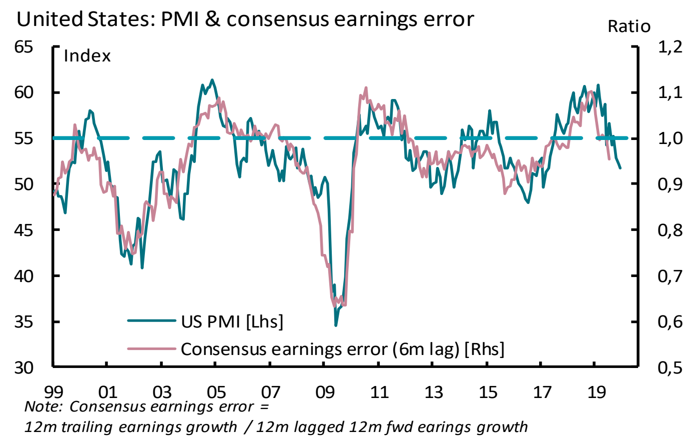


Source: MSCI, Datastream, Bloomberg and AXA IM Research

Encouraging start to the earnings season

The Q2 earnings season in the US is at 24% completion by market cap, with the aggregate earnings beat at 5% and earnings growth running at 2.5%yoy. Positive surprises were widespread with close to 78% of reported companies beating consensus estimates. Our indicators suggest a slight positive surprise with overall growth coming in close to flat for the Q2 season. There is a considerable risk of disappointing management guidance given the range of macro and policy uncertainty. Cyclical momentum suggests in-line earnings results for 2019 at around 3% in the US and 4% for the euro area (Exhibit 16).

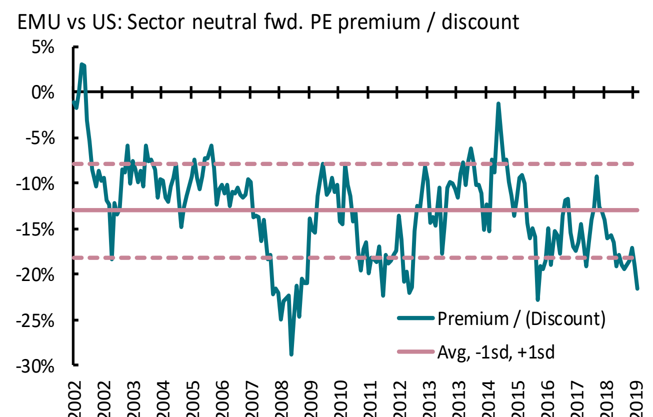
Exhibit 16: Cyclical momentum suggests inline earnings



Source: Bloomberg, Datastream, IBES and AXA IM Research

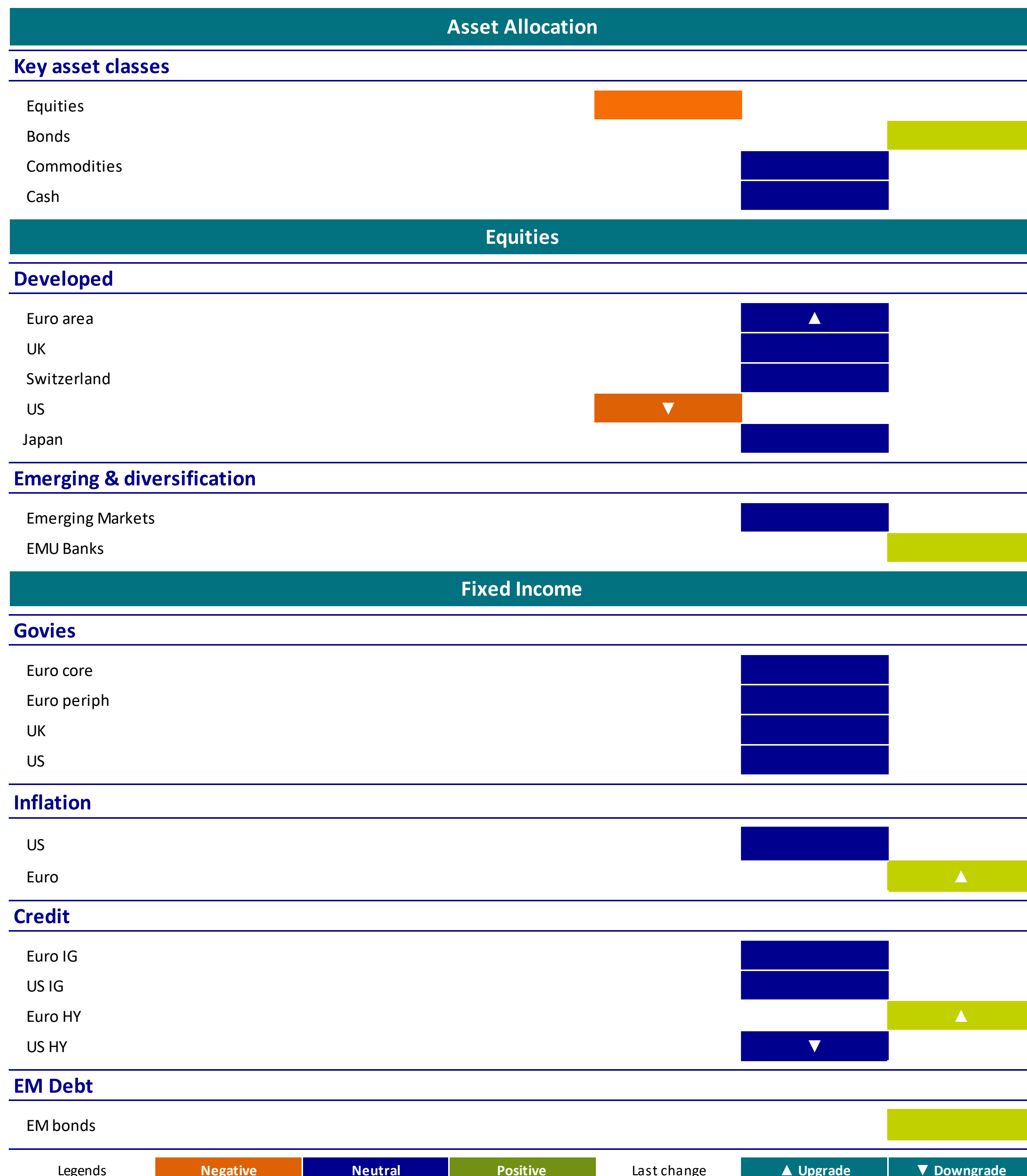
Equities do offer reasonable relative value against fixed income, but we would need a pickup in earnings revisions and more visibility on the global policy outlook for this to crystallise. We maintain our cautious stance given the erratic policy environment and lacklustre growth backdrop. Although the "Fed put" appears in place, there is room for disappointment given the aggressive market pricing for rate cuts in 2019. We close our preference for US over euro area, given the improving comparative growth dynamics and appealing relative valuation proposition (Exhibit 17).

Exhibit 17: Euro area discount starts to look stretched



Source: IBES, Datastream, Bloomberg and AXA IM Research

Recommended asset allocation



Source: AXA IM Macro Research – As of 24 July 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**	*1,1*	**1,2**	**1,3**
Germany	**1,4**	**0,6**	*0,7*	**1,0**	**1,2**
France	**1,7**	**1,3**	*1,3*	**1,2**	**1,3**
Italy	**0,7**	**0,1**	*0,1*	**0,4**	**0,5**
Spain	**2,6**	**2,3**	*2,3*	**1,7**	**1,9**
Japan	**0,7**	**0,6**	*0,7*	**0,4**	**0,4**
UK	**1,3**	**1,2**	*1,3*	**1,1**	**1,3**
Switzerland	**2,5**	**1,0**	*1,3*	**1,3**	**1,5**
Emerging economies	**4,4**	**4,2**		**4,6**	
Asia	**4,9**	**4,7**		**4,8**	
China	**6,6**	**6,1**	*6,2*	**6,1**	**6,0**
South Korea	**2,7**	**2,4**	*2,1*	**2,3**	**2,3**
Rest of EM Asia	**5,5**	**5,4**		**5,4**	
LatAm	**1,1**	**0,9**		**2,2**	
Brazil	**1,1**	**1,0**	*1,0*	**2,0**	**2,1**
Mexico	**2,2**	**1,2**	*1,0*	**1,8**	**1,7**
EM Europe	**2,3**	**1,5**		**2,1**	
Russia	**2.3**	**1,3**	*1,2*	**1,5**	**1,7**
Poland	**5,2**	**3,6**	*4,2*	**3,0**	**3,5**
Turkey	**2,9**	**-2,0**	*- 1,6*	**1,0**	**2,4**
Other EMs	**2,4**	**2,4**		**3,5**	

Source: Bloomberg, IMF and AXA IM Macro Research – As of 24 July 2019

CPI Inflation (%)	2018	2019*		2020*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	**2,0**	**1,5**		**1,8**	
US	2,4	1,8	*1,8*	2,3	*2,1*
Euro area	1,8	1,3	*1,3*	1,4	*1,4*
Japan	1,0	0,7	*0,7*	0,8	*1,0*
UK	2,5	1,9	*1,9*	2,3	*2,0*
Switzerland	0,9	0,7	*0,6*	1,0	*0,8*
Other DMs	1,7	1,6		1,8	

Source: Bloomberg, IMF and AXA IM Macro Research – As of 24 July 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	Q3 - 19	Q4 - 19	Q1 - 20	Q2 - 20
United States - Fed	Dates	2.25-2.50	30-31 July 17-18 Sep	29-30 Oct 10-11 Dec	28-29 Jan 17-18 March	28-29 Apr 9-10 Jun
	Rates		-0.25 (2.00-2.25)	-0.25 (1.75-2.00)	unch (1.75-2.00)	unch (1.75-2.00)
Euro area - ECB	Dates	-0.40	25 July 12 Sep	24 Oct 12 Dec	23 Jan 12 March	30 Apr 4 Jun
	Rates		-0.10 (-0.50)	unch (-0.50)	unch (-0.50)	unch (-0.50)
Japan - BoJ	Dates	-0.1/¥25tn	29-30 Jul 18-19 Sep	30-31 Oct 18-19 Dec	Jan (TBC) March (TBC)	Apr (TBC) Jun (TBC)
	Rates / QE		unch/taper	net QQE ¥15tn	unch (-0.10)	unch (-0.10)
UK - BoE	Dates	0.75	1 Aug 19 Sep	7 Nov 19 Dec	30 Jan 26 March	7 May 18 June
	Rates		unch (0.75)	unch (0.75)	unch (0.75)	+0.25 (1.00)

Source: Datastream, AXA IM Macro Research - As of 24 July 2019

These projections are not necessarily reliable indicators of future results

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