For professional clients only
21 October 2020
Research & Strategy Insights

Addicted to policies

Monthly Investment Strategy Oped


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Key points

- The real economy is softening faster than we expected. More stimulus is warranted but politics is getting in the way, while in EM countries dealing with poor fundamentals pre-Covid are getting constrained
- The stimulus splurge of last spring was the easy bit. The true struggle starts now.
- Cyclical investment theme remains nascent
- Chinese and growth stocks dominate performance

Policy addiction challenged

The softening of the global economy we have been expecting for Q4 is already manifest in the dataflow for the end of the third quarter (Q3). In the US, the labour market is slowing after the initial rebound at the end of spring. For the time being this does not seem to be affecting consumption – the September print for retail sales was good – but it is unlikely to be sustained. In Europe, the forward-looking components of the business surveys have already turned south, and consumer confidence surveys continue to suggest a strong preference for saving. What we find particularly concerning is the fact that this inflexion came before the most damaging restrictions to activity – in the context of the resurgence of the pandemic – were implemented.

So far this year, markets have been mostly able to ignore the gyrations in the real economy, given the speed at which public authorities were ready to respond with further layers of stimulus. This time, however, the US fiscal authorities have been slow to react. With the push from government transfers fading, personal income will continue to slow down in the months ahead without an additional push. Political calculations are not necessarily geared towards delivering another package. With Joe Biden's lead looking robust and comfortable, raising the probability that the Senate could change hands as well, Democrats could choose to wait until they have full control of Congress and the White House, allowing them to shape the stimulus to their liking without the need to find a compromise with their opponents. The Republican Senators may start to think that, with or without a fiscal push, the most plausible scenario is that Donald Trump will lose the elections. They might as well choose "ideological purity" and prepare to oppose Joe Biden's future fiscal stimulus. At the time of writing this note, it was still unclear whether a new package could be delivered at all. Even if one clears the legislative hurdles in time before the elections, much time has already been wasted and the confidence effect stimulus programs ordinarily trigger may be dented. The market is not losing hope entirely however, pivoting from focusing on Joe Biden's planned tax hikes to instead welcome the possibility that, especially with an aligned Congress, he will be able to start his presidency with a significant fiscal push.

However, such a fiscal stimulus would probably make the Federal Reserve (Fed) less open to persisting with the current pace of quantitative easing for so long. The Fed's focus on average inflation targeting may also make it less prone to additional emergency support. Indeed, inflation overshooting is a promise to allow the economy to "overheat" for some time in the future without hiking rates, but it does not necessarily offer much succour in the short run. Equity and credit markets would have to balance the good news on the growth front (the fiscal push) with in all likelihood some rise in risk-free long-term interest rates.

In the Euro area, fiscal support is less dependent on the political situation. Faced with the pandemic returning strongly earlier than expected, before the economy had much time to mend, governments will likely prolong the emergency schemes put together last spring, coming on top of the medium-term programmes unveiled for 2021-2022 in many member states. Coupled with the emerging issuance from the European Recovery and Resilience Fund, this will force the European Central Bank (ECB) into an extension in time and duration of their Pandemic Emergency Purchase Programme (PEPP), to be announced in December in our view. This will keep spreads in check, but so far in 2020 the ECB's stimulus has not resulted in a decline in the interest rate paid by households and businesses. The direct impact of monetary policy on the real economy through the traditional channels is thus limited, although another round of even more generous targeted longer-term refinancing operations (TLTROs) would be a nice addition to the PEPP extension at the end of the year.

The policy equation is even more constrained outside developed markets. Central banks in emerging markets have initially emulated their counterparts in more mature economies by responding to the crisis with immediate and far-reaching stimulus – in some cases, for instance in Brazil, even getting ready to embark on quantitative easing for the first time. However, as the pandemic crisis drags on, countries with shaky fundamentals pre-Covid and disputed central bank credibility are finding it more difficult to maintain this stance. Turkey is a key concern for us. The 200-basis points policy hike that the Central Bank of the Republic of Turkey (CBRT) finally delivered in September failed to stem the depreciation in the currency. The central bank continues to tighten monetary policy through indirect means – e.g. by raising the remuneration of cash reserves – but it seems the market continues to demand more.

Policymakers have been – rightly in our view – lauded for their decisiveness in dealing with the first wave of the pandemic. It seems however that the stimulus splurge of last spring was the easy bit. The true struggle starts now.

Looking through near-term risks

The performance of markets since the first quarter (Q1) crash has been anchored to the stimulus splurge and the expectation and reality, of the economic recovery. If, as seems evident in some of the data, growth is again compromised by the virus and policymakers have less at their disposal near-term, should we expect equity markets to give up some of their gains and bond yields to again plumb new lows? For much of the year some investors have been uncomfortable with the valuation of risky asset classes during a very disruptive period and now risks around the pandemic, the US political situation and Brexit are crystallising. Some short-term volatility in markets would not be a surprise as a result. The haven for low volatility this year has been short-duration fixed income.

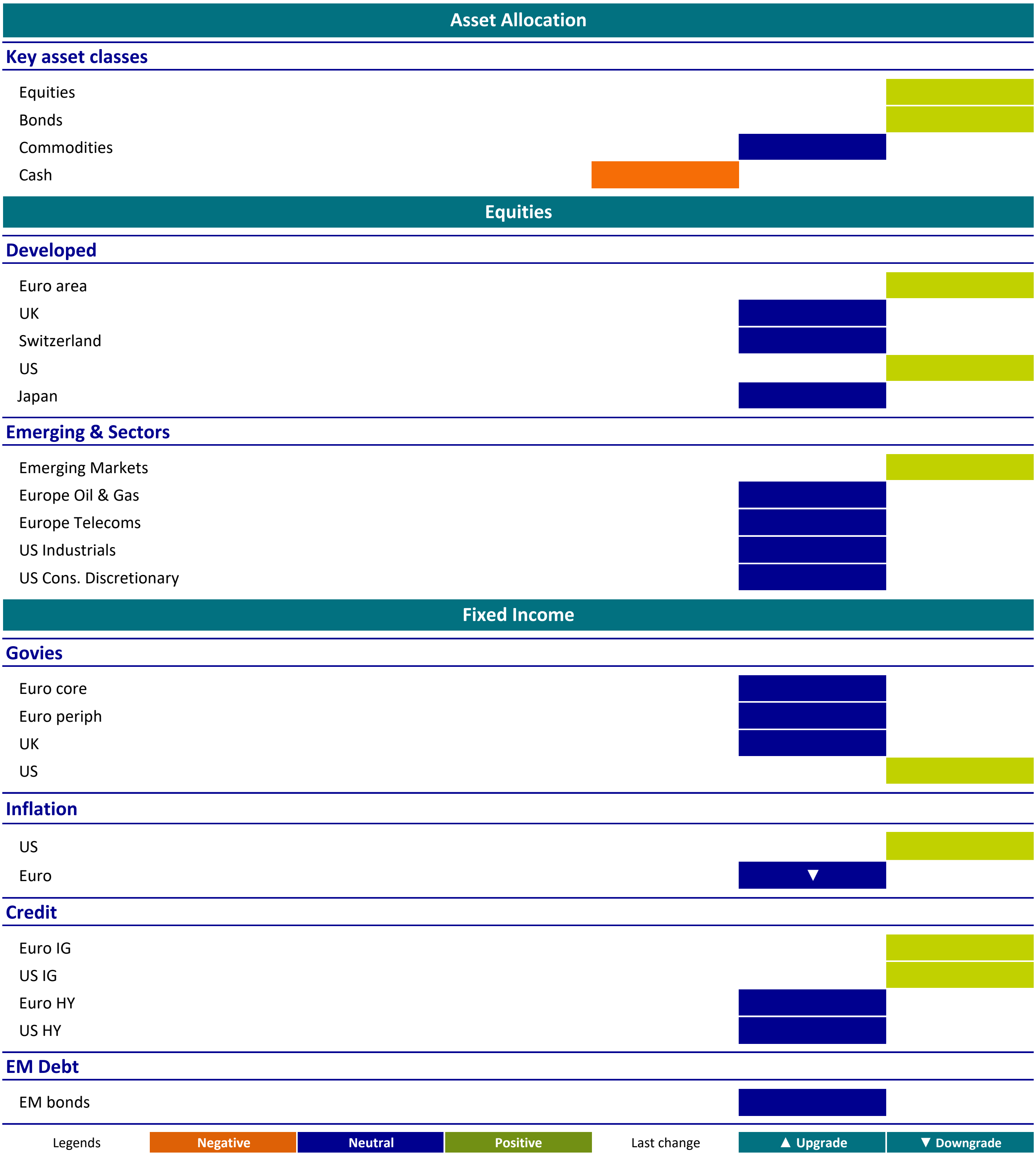
Investors need to look beyond the near-term risks and think about where more positive returns will come from over the medium-term. It won't be from short-duration fixed income. Macro themes may reduce the need for such havens. As we argue above, some fiscal stimulus in the US is likely if there is a "Blue Wave". Europe will also boost fiscal spending next year. Interest rates will remain low. Even in terms of the pandemic, we are closer to being able to more effectively manage the disease, particularly if vaccines and anti-viral drugs begin to be deployed next year. All of this should support investor confidence in riskier assets. Recent growth data from China provide a picture of what could be in store for other parts of the world should transmission rates fall and remain low over the next six months or so.

China's equity market has been one of the best performing this year along with the Nasdaq and other US growth equity indices. Indeed, these markets fell less in Q1 and have risen the most since. By contrast Japan, European and small cap equity cohorts had bigger drawdowns in Q1 and much more modest recoveries since. This reflects the resilience of the Chinese economy and its success in controlling the pandemic. At the same time, US equity performance has been dominated by internet and selected consumer staples stocks. The NYFANG index has returned 80% this year compared to the 9.4% S&P500 Composite's total return and flat performance of the equal-weight S&P index.

The cyclical outlook remains uncertain. Even though the US Q3 earnings season looks to be better than expected, 2021 consensus earnings forecasts for the US and Europe remain below the level they were at end-2019. Moreover, long bond yields have yet to make a convincing move higher even though break-even inflation rates have been edging up. Equity performance continues to be not very broad-based. Signals of a stronger cyclical-reflationary trade could build in the year ahead but in the meantime, growth may still dominate. Longer-term structural and disruptive trends support US technology-based companies. China is a growth story too and the recovery to almost pre-pandemic GDP growth and its own strength in technology suggest that it will rival the US for performance. How both US big-tech and China fare under a potential Biden Administration will be key investment themes in the coming years.

Download the full slide deck of our October Investment Strategy

Recommended asset allocation



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

Macro forecast summary

Real GDP growth (%)	2019*	2020*		2021*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
World	**2.9**	**-4.2**		**5.4**	
Advanced economies	**1.7**	**-6.2**		**4.6**	
US	**2.3**	**-4.2**	-5.2	**4.5**	4.0
Euro area	**1.3**	**-7.5**	-7.9	**4.0**	5.7
Germany	**0.6**	**-5.3**	-6.1	**4.0**	4.7
France	**1.3**	**-9.5**	-9.6	**5.0**	7.2
Italy	**0.3**	**-9.6**	-10.2	**3.7**	5.7
Spain	**2.0**	**-11.8**	-11.7	**4.2**	6.9
Japan	**0.7**	**-5.8**	-5.3	**3.1**	2.5
UK	**1.4**	**-10.3**	-9.9	**5.5**	6.4
Switzerland	**0.9**	**-5.5**	-5.6	**4.0**	4.4
Emerging economies	**3.6**	**-3.1**		**5.8**	
Asia	**5.2**	**-1.2**		**7.4**	
China	**6.1**	**2.3**	2.1	**8.0**	7.8
South Korea	**2.0**	**-2.8**	-1.1	**4.5**	3.3
Rest of EM Asia	**4.4**	**-5.2**		**7.0**	
LatAm	**0.1**	**-6.5**		**6.5**	
Brazil	**1.1**	**-7.4**	-6.2	**8.3**	3.2
Mexico	**-0.1**	**-6.8**	-9.6	**7.0**	3.6
EM Europe	**2.1**	**-6.6**		**5.7**	
Russia	**1.3**	**-6.1**	-5.1	**3.7**	3.4
Poland	**4.1**	**-5.0**	-4.1	**5.4**	4.5
Turkey	**0.9**	**-5.6**	-4.4	**6.5**	5.2
Other EMs	**1.5**	**-4.2**		**3.3**	

Source: Datastream, IMF and AXA IM Macro Research – As of 21 October 2020

CPI Inflation (%)	2019*	2020*		2021*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	**1.5**	**0.9**		**1.1**	
US	**1.8**	**1.4**	0.9	**1.5**	1.7
Euro area	**1.2**	**0.3**	0.4	**0.6**	1.1
Japan	**0.5**	**0.1**	-0.1	**0.0**	0.2
UK	**1.8**	**0.8**	0.7	**1.4**	1.4
Switzerland	**0.4**	**-0.6**	-0.7	**0.0**	0.2
Other DMs	**1.8**	**1.4**		**1.9**	

Source: Datastream, IMF and AXA IM Macro Research – As of 21 October 2020

These projections are not necessarily reliable indicators of future results

Forecast summary

Central bank policy

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

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

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

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