AXA Investment Managers

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Investment Institute *Macroeconomics*

Monthly Op-ed

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Looking outside the West

Key points

- China's recent improvement in dataflow owes a lot to a rebound in exports. As the fiscal stimulus is touching its limits, an externally-led growth model is going to be very tempting to Beijing as it grapples with a protracted real estate correction
- Such an approach is however likely to trigger more tension with the West, especially in the context of the US elections
- Beyond the rivalry with China, geopolitical tensions are high on investors' minds given the situations in Europe and the Middle East
- However, the earnings outlook remains robust. The bottom-up consensus for growth in earnings-per-share over the coming 12 months is 10% for the MSCI World and 11% for the S&P500

China's tough choices

Despite a series of better-than-expected data recently, which have made it more plausible to reach the official target for GDP growth at 5% in 2024, the Chinese economy continues to face significant challenges as it needs to find an alternative to the real estate sector as a lasting source of economic expansion. Indeed, the experience accumulated from many episodes of housing market corrections in other countries, e.g., the US post the "subprime crisis", or some peripheral countries during the Euro area sovereign crisis, suggests that residential investment, as a share of GDP, remains depressed for 5 to 10 years.

Pumping more government money into infrastructure programs has probably reached its limits. China's public debt, as recalculated by the International Monetary Fund (IMF), stood last year at more than 100% of GDP when integrating the liabilities of local authorities which over the last few years have shouldered most of the weight of the various stimulus programs. In addition, since China has escaped the global inflation shock, it has not benefitted from the reverse "snowball effect" when nominal GDP growth rate exceeds the interest rate. This has contributed to the drift in the Chinese public debt to GDP ratio – now exceeding the US level – contrasting with the slight decline seen in most G7 countries. The decision by the central government to take additional infrastructure spending onto its own balance sheet, rather than local government's at the end of last year is an unsurprising reaction to the deterioration in the overall fiscal position.

If the avenue of fiscal stimulus is increasingly restricted, then it is quite logical that the temptation to rely on exports to provide lasting impetus to the economy re-emerges, and most of the recent improvement in Chinese industrial production reflects more

traction from the rest of the world – as the global manufacturing cycle may be turning up at last – while domestic retail sales continue to disappoint. The country is going through a phase of deflation when virtually everyone else is still struggling with the aftermath of the global inflationary shock. This puts Chinese products in a very strong competitive position. Meanwhile, Beijing's "New Quality Productive Forces" strategy, focusing investment on some high value-added sectors in the manufacturing sector – the most exposed to international trade – can be seen as an essentially externally driven approach.

We can however also see clear limits to such a strategy. The sheer size of the Chinese export machine means that a rise in the Chinese export to GDP ratio to offset the lasting drag from residential investment would necessitate a further increase in its share in world trade which would not occur without significant losses for others. Even regions which so far have not been vehement in their criticism of China's surge in world trade, the EU in particular, are uncomfortable with yet another rise in China's share of world export, especially in high value-added sectors, such as the car industry, which they consider as strategic.

Yet, the "New Quality Productive Forces" strategy could be mutually beneficial if its proceeds were channelled into domestic expansion. Indeed, more focus on innovative industries should trigger a rise in aggregate productivity in China. There is no automaticity in seeing these productivity gains primarily employed to raise the competitiveness of Chinese products on international markets. Higher productivity could create space to raise real wages, thus supporting faster growth in personal consumption, instead of merely keeping export prices low. This would be a healthier way to sustain domestic demand than using, directly or indirectly, massive fiscal stimulus.

We think lower interest rates in China could "grease the wheels" of such a strategic turnaround. Indeed, this would make the continuation of the required investment effort towards the productive upgrade easier while protecting the firms' financial position in a way which would allow them to direct more resources to lift wages. At the same time, lower interest rates alleviating the rise in debt servicing costs would help avoid a restrictive shift in fiscal policy, allowing space to develop a more comprehensive system of collective protection against key "life risks", which would help consumers direct less of their income towards savings. In such a configuration, the rest of the world would be better disposed towards tolerating some softness in the Chinese currency since it would merely be a by-product of an internally directed expansionary monetary policy rather than a direct intervention on the exchange rate.

It remains to be seen however, if even this version of China's new growth strategy would be palatable to the US. Donald Trump is explicitly campaigning on a 60% tariff on Chinese products imported in the US (against an already whopping 25% today). It is only one of the ways politics will need to be at the heart of investors' concerns this year.

Geopolitics – a justified concern

The ongoing Ukraine conflict, together with the escalation of Middle East tensions has put geopolitics at the forefront of investor concerns. Disruptive events create uncertainty on a number of fronts and there are often significant market price moves. There can also be unexpected political responses to events, and adverse long-term consequences. Investors often react to uncertainty by de-risking, which can itself lead to distortions in market prices and weigh on investment returns.

Most of the time, it is not possible to predict geopolitical events or make appropriate and timely portfolio adjustments. For well-diversified portfolios often, the best strategy is to sit out the volatility. Knee-jerk risk-off market moves often do not persist. This is typically because there is a collective initial over-exaggeration of an event's materiality. Impact is often limited by a lack of clear links to economic activity, or markets are able to quickly rebalance, or events happen in geographies that have limited global economic integration.

Real effects and uncertainty

This is not to say investors should ignore geopolitical risk. There are good reasons to worry when events can impact global prices, demand and, ultimately, the value of financial assets. There can be actual tangible economic effects which impact cash-flows and valuations or work through the effect of increased uncertainty which motivates investors to de-risk. Where possible, investors will seek to mitigate the impact of geopolitical events.

Indeed, when we consider the global equity markets' prospects, geopolitical risk is certainly a factor that could undermine returns. As with other factors, there are two main channels through which the identification and the materialisation of geopolitical risk can

negatively impact equity returns – the earnings channel and the risk premium (or sentiment expressed by price-earnings multiples) channel. In 2023, for most equity indices, earnings growth was flat, but price-earnings ratios increased, allowing total returns to be very positive. In other words, equity risk premiums fell as it became clear the US and other major economies were avoiding recession and that interest rates had peaked.

This year's earnings outlook is potentially looking better than last year. The bottom-up consensus for growth in earnings-per-share over the coming 12 months is 10% for the MSCI World, 11% for the S&P500 and 6% for the Euro Stoxx universe. Confidence in the earnings outlook comes from upward revisions to GDP growth and evidence from cyclical data – like purchasing managers' surveys and Asian exports – of broader-based global growth. We expect comfortable levels of nominal GDP growth in the major economies, which is normally associated with an expansion of corporate profits. The current macro backdrop is characterised by healthy labour markets, consumer spending, strong corporate balance sheets and capital spending on infrastructure and technology.

On the basis of our macro outlook and earnings expectations, equity returns should be healthy again this year. Early indications from the US earnings season are aligned with this outlook. Market valuations are in line with this positive outlook with price-earnings ratios having increased steadily since last October. The risk to valuations, and thus overall returns, comes from investors focussing on events that raise the level of uncertainty over the fundamental outlook and alter the balance between positive and negative returns. Many are obvious – growth is weaker therefore earnings growth disappoints; there is another interest rate shock which makes a hard landing more likely; or geopolitical events transpire to potentially impact supply chains and global demand.

The equity risk premium has come down since interest rates started to increase. The gap between the earnings yield on the S&P500 index and the 10-year US Treasury yield is basically zero today. Outside of the US, the valuations picture is less extreme, with price/earnings (PE) ratios close to their long-term averages. Yet, markets would be vulnerable to the materialisation of any risk that threatened to damage global growth and corporate profitability. If expectations change because of risk events, then investors will reduce their exposure to uncertainty over future profits – thus sending equity markets lower. With the macro backdrop appearing to be somewhat robust, the near-term focus of investors is on geopolitics.

Not all geopolitical risks are the same, nor play out over the same time frames. The Russian invasion of Ukraine and the subsequent imposition of sanctions against Russia happened quickly, was very disruptive to markets. and prolonged the inflation shock that was triggered by broader supply chain disruptions caused by the pandemic. In turn this has contributed to higher rates and near-recessionary economic conditions in parts of Europe that had to rapidly adjust to the energy supply being curtailed. By contrast, the attack on Israel on 7 October 2023 and the subsequent military response in Gaza had only a moderate impact on oil or global equity prices. That is not to downplay its human or political significance but to acknowledge the limited impact – so far – on the regional, let alone, global economy.

The Russia-Ukraine conflict has also set off chain reactions that are in their own way a significant geopolitical risk. Not only has the European energy market had to adapt, but there are potential implications for food security and food prices if Ukrainian grain exports are disrupted. There is the threat of increased security risks to other sovereign nations in the region if Russian dominance of Ukraine prevailed. The consequences of that are global as it would pose a challenge to the North Atlantic Treaty Organisation (NATO) and would lead to further defence-related spending in European countries. Politically, Western leadership and the US election would be impacted – note the acrimony in Congress over the eventual decision to provide more financial and military aid to Ukraine. Broader geopolitical tensions would escalate given the developing axis of countries antagonistic to the Western-aligned powers.

It is events that trigger financial market reactions. In this case, evidence of territorial gains by Russian forces in Ukraine would signal a greater risk of Ukraine's collapse. While it is difficult to recommend what investment strategy mitigates such an outcome, it is likely that markets would go through a typical risk-off episode. Expected outcomes would be a stronger dollar, lower US bond yields and a drop in equity markets. European sovereign bond spreads might widen because of the implications for increased security-related public spending. The threat of any escalation of the conflict would change consumer and business spending decisions, hit economic growth and lead to higher risk premiums on financial assets.

Any escalation of the conflict in the Middle East could clearly impact oil prices, trade flows through the Gulf and Red Sea, and contribute to further political polarisation globally and within countries, with consequences for social unrest. All of which would be negative for investor confidence and create risk-off market moves.

There are long-term considerations on this theme too. In recent years, relations between Western democracies and China and Russia have deteriorated. As a result, protectionist policies have increased, impacting market access, import costs and the location of direct investment. Supply chains are changing as a result and that poses a challenge to companies operating across different markets. Countries want more reliance on domestic sources of energy, food, technology and so on as part of a broader focus on security in a potentially more adversarial world. This is playing out clearly in technology at the moment with, for example, large scale investment taking place in the semiconductor industry to reduce the reliance on Taiwan as a key pinch point in the global supply chain. For global equity investors, all of this generates risks to some companies and opportunities for others. Active management is thus key to ensuring portfolios are positioned where earnings growth is less at risk from changing geopolitical patterns of investment, policy and trade.

Despite all this, equity markets tend to go up over the medium term. Businesses adapt to changing risks and investors tend to seek out new opportunities. Again, actively-managed diversified equity portfolios focused on long-term quality growth in earnings provide investors with the best chance of enjoying returns despite the threats posed by a changing world.

Download the full slide deck of our April Investment Strategy

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Macro forecast summary

Real GDP growth (%)	2023	2024*		2025*	
	AXA IM	AXA IM	*Consensus*	AXA IM	*Consensus*
World	3.2	3.1		3.1	
Advanced economies	1.7	1.4		1.3	
US	2.5	2.4	2.1	1.6	1.8
Euro area	0.5	0.3	0.5	0.8	1.5
Germany	-0.1	-0.1	0.3	0.7	1.5
France	0.9	0.4	0.7	0.7	1.3
Italy	1.0	0.3	0.5	0.6	1.2
Spain	2.5	1.6	1.5	1.3	1.9
Japan	1.9	1.2	0.7	1.0	1.0
UK	0.3	0.4	0.3	0.8	1.2
Switzerland	0.9	0.8	1.1	1.3	1.5
Canada	1.1	1.2	0.6	1.7	1.9
Emerging economies	4.1	4.1		4.2	
Asia	5.3	5.2	4.0	4.7	
China	5.2	5.0	4.6	4.2	4.4
South Korea	1.3	2.2	2.1	2.3	2.2
Rest of EM Asia	5.9	5.8		5.4	
LatAm	2.4	1.7		2.6	
Brazil	2.9	1.6	1.6	2.0	2.0
Mexico	3.3	2.2	2.2	2.1	2.2
EM Europe	2.6	2.5		2.6	
Russia	3.0	2.6	1.7	1.1	1.1
Poland	0.2	2.8	2.8	3.5	3.4
Turkey	4.3	2.0	2.2	3.6	3.2
Other EMs	1.9	2.8		4.6	

Source: Datastream, IMF, Bloomberg and AXA IM Macro Research – As of 25 April 2024
**Forecast*

CPI Inflation (%)	2023	2024*		2025*	
	AXA IM	AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	4.7	2.8		2.2	
US	4.1	3.1	2.6	2.4	2.3
Euro area	5.5	2.5	2.3	2.0	2.1
China	0.2	0.6	0.9	1.6	1.9
Japan	3.2	2.2	2.3	1.6	1.5
UK	7.7	2.7	2.6	1.6	2.0
Switzerland	2.2	1.6	1.6	1.3	1.3
Canada	3.6	2.4	2.6	2.2	2.0

Source: Datastream, IMF, Bloomberg and AXA IM Macro Research – As of 25 April 2024
**Forecast*

These projections are not necessarily reliable indicators of future results

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Forecast summary

Central bank policy Meeting dates and expected changes (Rates in bp / QE in bn)		Current	Q2-24	Q3-24	Q4-24
United States - Fed	Dates	5.50	1 May 12 Jun	30-31 Jul 17-18 Sep	6-7 Nov 17-18 Dec
	Rates		unch (5.50)	-0.25 (5.25)	-0.25 (5.00)
Euro area - ECB	Dates	4.00	11 Apr 6 Jun	18 Jul 12 Sep	17 Oct 12 Dec
	Rates		-0.25 (3.75)	-0.25 (3.50)	-0.25 (3.25)
Japan - BoJ	Dates	0 - 0.1	25-26 Apr 13-14 Jun	30-31 Jul 19-20 Sep	30-31 Oct 18-19 Dec
	Rates		unch (0-0.1)	unch (0-0.1)	+0.15 (0.15-0.25)
UK - BoE	Dates	5.25	9 May 20 Jun	1 Aug 19 Sep	7 Nov 19 Dec
	Rates		-0.25 (5.00)	-0.25 (4.75)	-0.25 (4.50)
Canada - BoC	Dates	5.00	10 Apr 5 Jun	24 Jul 4 Sep	23 Oct 11 Dec
	Rates		unch (5.00)	-0.25 (4.75)	-0.50 (4.25)

Source: AXA IM Macro Research - As of 25 April 2024

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Our Research is available on line: www.axa-im.com/investment-institute

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