



Into the bleak, debt winter

Monthly Investment Strategy

AXA IM Research

October 2020



Summary of views

Theme of the month: How governments can manage the Covid-19 debt surge

- Government debt has been on a rising trend as a proportion of GDP, with few managing to reverse the impact of the GFC. The pandemic has pushed government debt materially higher. However, a simultaneous decline in real interest rates leaves higher debt affordable ... for now.
- Limits to government debt are a function of points of societal fiscal fatigue, as well as future growth and interest rates. Yet many countries now see debt at levels that would have been considered causes for concern at historic growth and interest rates.
- We consider low rates as likely to continue to provide space for fiscal stimulus in the short-term. By boosting growth, this is likely to prove the most effective debt consolidation. However, as recoveries begin to emerge, governments will have to undertake long-term debt consolidation measures.

Macro update: Into the bleak, debt winter

- The pandemic is resurgent across many countries. Europe is an epicentre for renewed outbreak with Spain, France, UK and Netherlands all recording sharp case number increases (and Italy and Germany following). Restrictions have tightened again, including curfews in some European cities. The US sees renewed cases, with positive test cases also rising.
- Most economies look on track to complete a large jump in growth for Q3 as they re-opened into the summer. But many have recorded a softening in momentum before the end of Q3, including in the US where weekly 'fast' data has slipped and the Eurozone where indicators have also started to fall
- The resurgence of the virus is compounding some softening in the data. Fiscal authorities across Europe are providing additional stimulus. In the UK stimulus has slimmed down and in the US it has stalled ahead of the election on 3 November.
- Risks point to a deceleration in Q4. The outlook for 2021 is falling across the world, with downside risks to that outlook still dominating.

Investment strategy: risky assets in a holding pattern amid epidemiological and political uncertainty

- FX: Beyond the election outcome, the medium-term trajectory bodes for a weaker USD as the Fed ensures that US real rates remain very low through reflation and ample USD liquidity . Holding JPY might also be safer through US election uncertainty.
- Rates: We often look at US vs EU spreads in order to express differential views on the business cycle, as well as on the policy stance and related political issues. However, in a world dominated by low/negative interest rates, we should respect absolute yield levels more than ever.
- Credit: Approximately one-third of global investment grade credit is covered by central bank purchase schemes and a 10-15% of global high yield enjoys support via the acceptance of Covid-related fallen-angels in these schemes. The downside to that is a rising amount of negative yielding corporate bonds.
- Equity: Equity markets are facing a clouded near-term outlook on multiple fronts: uncertain earnings, COVID related restrictions, vaccine news, US elections and policy drifts. Positive momentum in earnings revisions has stalled after a V-shaped recovery, reflecting the slowdown in activity indicators.

Central scenario

Summary – Key messages

Inflation

Impact disinflationary for most. Policy should bolster demand ahead. FX tempers localised disinflation in US and some EM.

Monetary policy

Central banks globally pushed beyond 2008 envelope. Only marginal additional easing from here. Fed backstopping most markets, ECB steps beyond limits

Fiscal policy

Most extend fiscal support as virus re-emerges, but US stimulus falters on political timing. Elevated debt affordable with low rates.

Growth

We forecast -4.2% global growth in 2020. Q3 will include strong rebounds, but growth will slow thereafter

Our central scenario:
Coronavirus sparks severe recession in most economies

We forecast global growth to fall in 2020 to -4.2%.

Economic rebound depends on policy, labour market reaction and indebtedness. As well as the virus itself.

Emerging Markets

Virus is playing out more across EM's now, with re-emergence in some areas, Latam cases have receded

Rates

Asset purchases by central banks should offset pressures from massive fiscal policy expansion, keeping yields in a range

FX

USD has found support around low levels. Euro's rise has paused under ECB scrutiny. Brexit weighs on GBP.

Credit

The sharp reduction in spreads after massive central bank intervention is now at odds with fundamentals – a risk

Equities

Earnings expectations may be optimistic. Containment of pandemic a necessary condition for rebound to be sustained

Alternative scenarios

Summary – Key messages

Persistent recession (*probability 35%*)

What could be different?

- Virus-shock fractures key labour markets leading to significant global job losses dampening demand even as virus fades.
- Coronavirus outbreak proves more persistent.
- Scale of shock results in isolationist policies: trade wars and other geo-political tensions, echoing 1930s

What it means

- Growth/inflation expectations weaken further, a new depression threatens, corporates' earnings under more pressure
- Further monetary policy where space permits (including China). Government's continue with fiscal stimulus and divide between monetary financing blurs further.

Market implications

- Risk appetite deteriorates / equities sell off / credit widens
- Safe-haven rates rally resumes
- EM debt to come under pressure

Fast recovery (*probability 10%*)

What could be different?

- Virus contained quickly and policy stimulus results in a “V-shaped” rebound
- Labour market recovers, economies benefit from post-virus euphoria
- Virus-shock reshapes business practice, boosting productivity

What it means

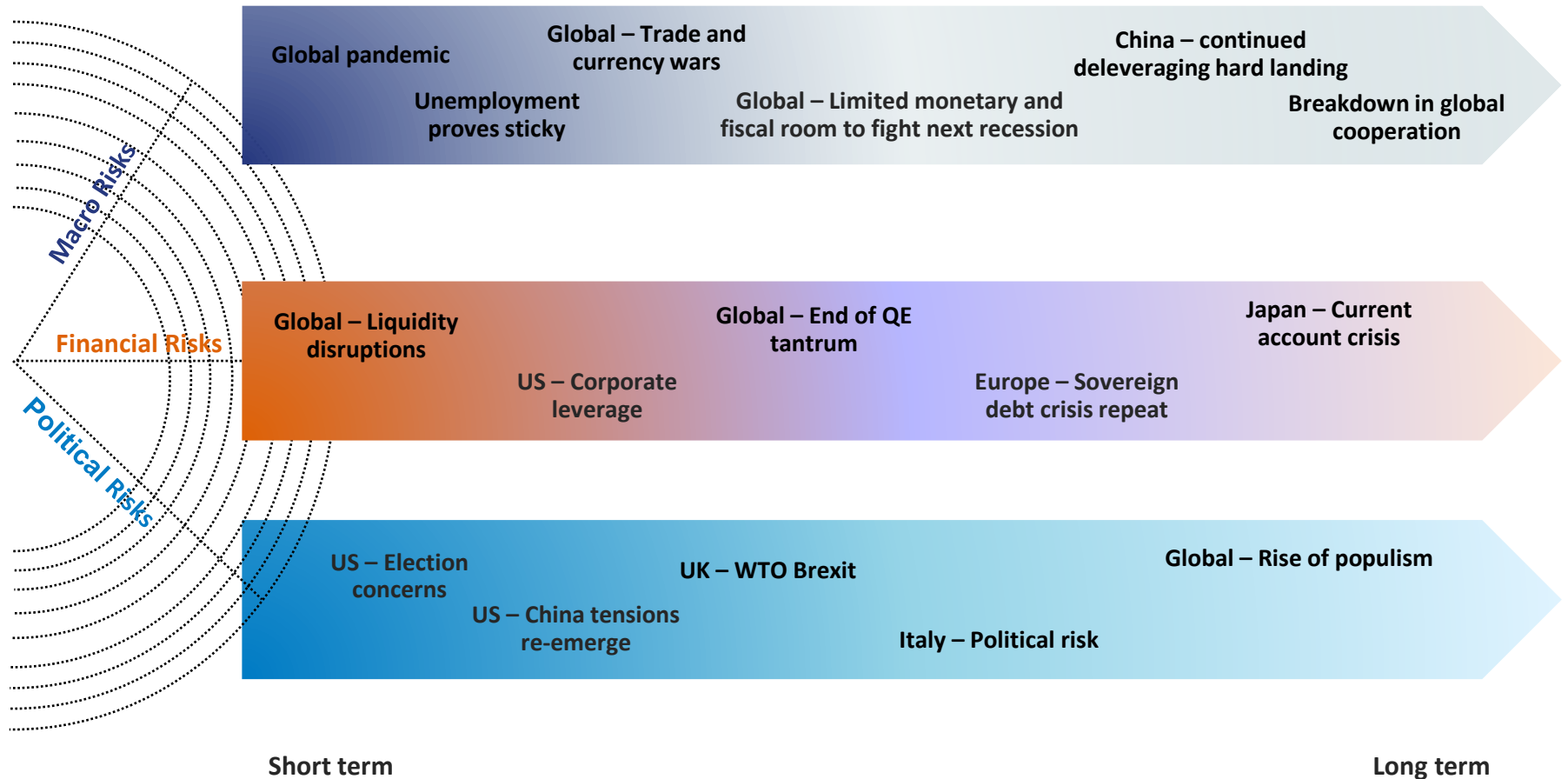
- Global/US/EMU growth surprise on the upside in a stronger and more persistent rebound after the drop in Q2 GDP
- Monetary policy fights expectations for swift tightening through forward-guidance

Market implications

- Risk-on environment with equities recovering losses swiftly
- UST and EUR break-evens rise
- Spreads rally from wides

RISk Radar

Summary – Key messages



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Theme of the month

Theme of the month: How governments can manage the Covid-19 debt surge

Lower interest rates provide fiscal space

Government debt rising before the pandemic

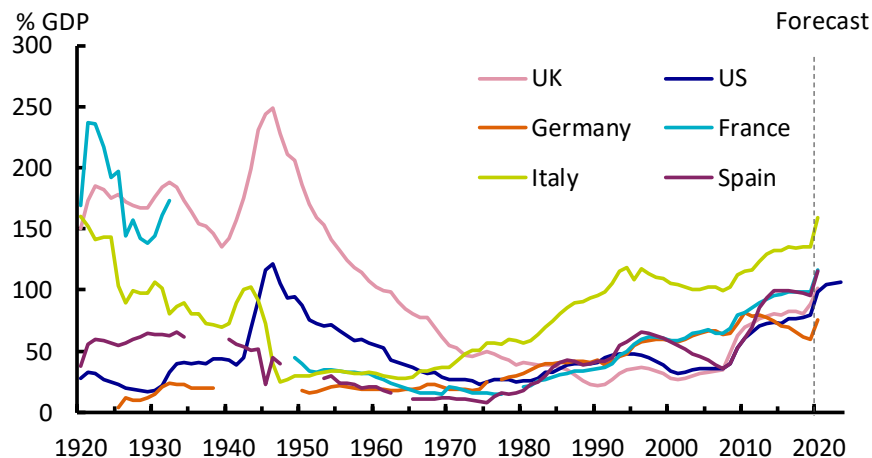
- Government debt has been on a rising trend as a proportion of GDP in most countries. The Great Financial Crisis in 2008 saw a material rise in indebtedness, which few countries have been able to reverse. However, the onset of the pandemic and the material fiscal support that governments have provided is taking debt levels back to highs not seen for many decades.

Fall in interest rates creates fiscal space

- Yet despite the increase in indebtedness, debt interest payments as a proportion of GDP have not increased by the same margin thanks to the continued fall in government funding rates over this period. This is illustrated below in rolling Congressional Budget Office projections for debt interest costs. Lower interest rates have made high levels of debt affordable for now.

Government debt levels have been on a rising trend

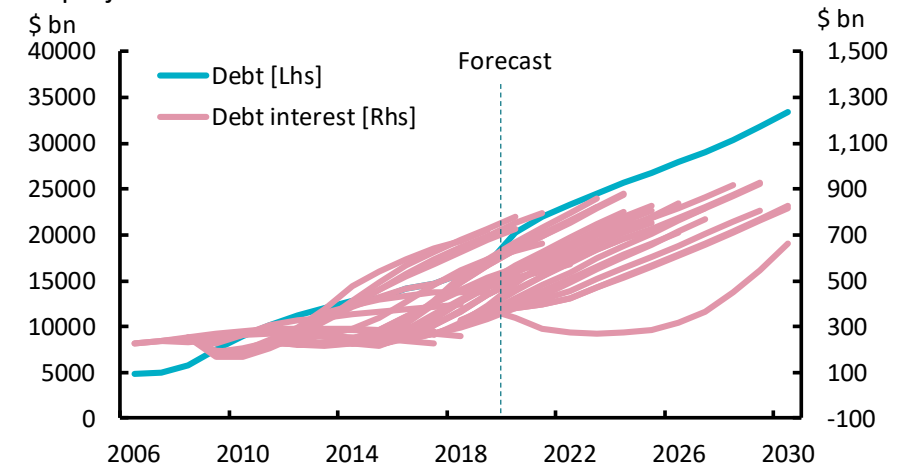
A long-term history of government debt



Source: CBO, Office for Budget Responsibility (OBR), International Monetary Fund (IMF), Trading Economics and AXA IM Research, Sept 2020

US government debt and rolling projections of debt interest payments

US projected debt and debt interest



Source: CBO and AXA IM Research, July 2020

Theme of the month: How governments can manage the Covid-19 debt surge

Steady states and government policy

Steady state assumptions

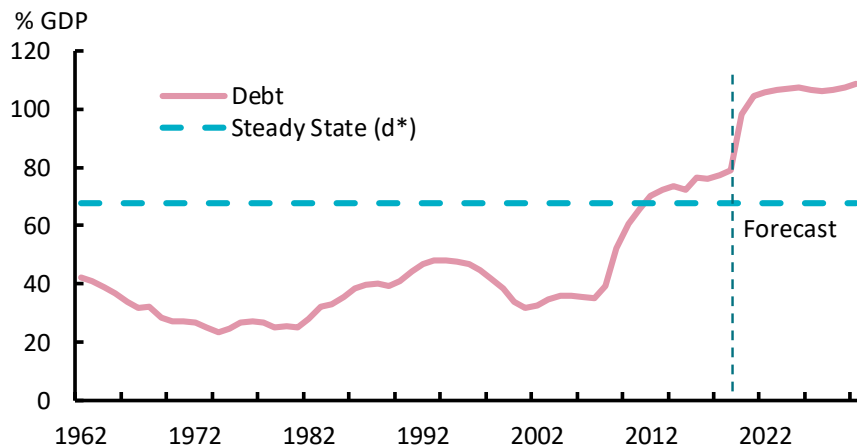
- Simple government financing arithmetic allows the estimation of a steady-state level of government debt. However, such an estimate requires the assumption that future governments will respond in a consistent manner to debt fluctuations – and this is not obviously the case.

Fiscal fatigue – establishing a limit to government response

- More intuitively, the limits to government debt are determined by future governments' abilities to repay and so are a function of future primary surpluses. A government debt 'limit' is therefore defined by determining a maximum level of primary surplus, or a point after which societal 'fiscal fatigue' emerges. This is highly uncertain, but history likely provides some guide.

US steady-state debt estimates suggest change in fiscal reactions

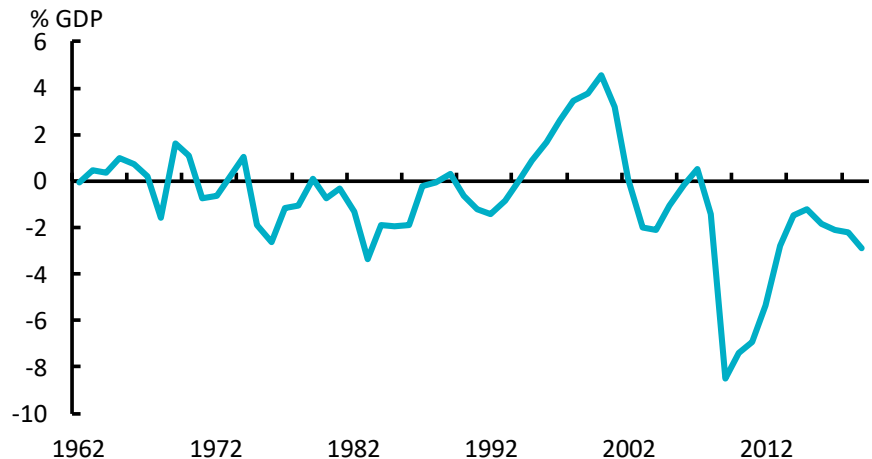
US historic debt and Steady State estimate (d*)



Source: CBO and AXA IM Research, Oct 2020

Using history to gauge where 'fiscal fatigue' might set in

US Government debt - Primary balance



Source: CBO and AXA IM Research, Oct 2020

Theme of the month: How governments can manage the Covid-19 debt surge

Different growth and rate assumptions define a range of debt limits

The growth and interest rate trade-off (r-g)

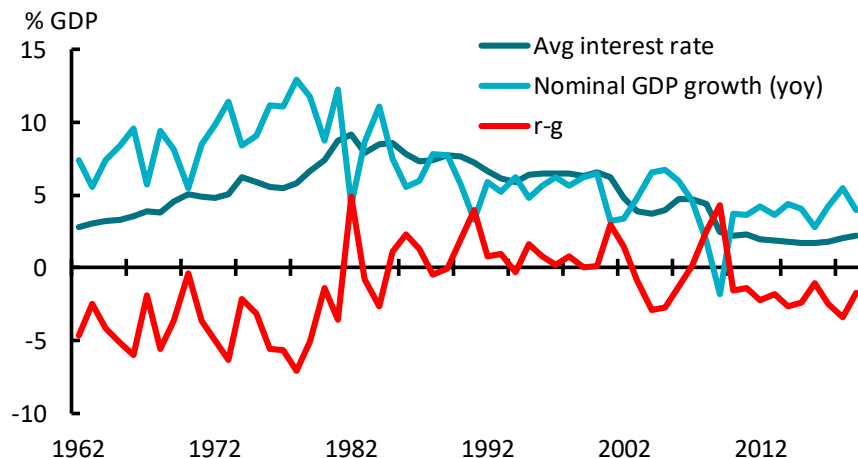
- Having defined the primary surplus limit, government debt limits are then assessed on an effective present value of those future balances. This is determined by the difference between interest rates, r , which determine the rate of growth of the existing debt stock and growth rates, g , which governs the size of the economy and hence the erosion of debt as a proportion of GDP.

Wide range of debt limits

- Future estimates of both r and g are highly uncertain. We illustrate how different assumptions can produce widely different growth rates. The upper limit (below) is determined by the long-term average growth and rates set before the financial crisis. We then consider the average until 2019, but allow for a two-standard deviation increase in interest rates. Additionally, we consider a buffer to ensure maneuverability in the event of another fiscal shock.

Fluctuations in r and g result in different debt outlooks

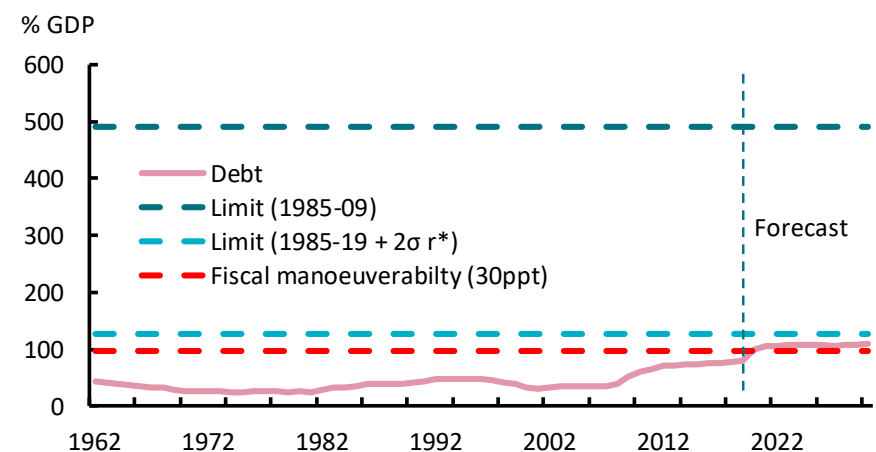
US historic growth and interest rates (g and r)



Source: BEA, CBO and AXA IM Research, Oct 2020

Different estimates of debt limits for US government debt

US historic debt and estimated debt limits (d^{**})



Source: CBO and AXA IM Research, Oct 2020

Theme of the month: How governments can manage the Covid-19 debt surge

Debt portfolio characteristics define susceptibility to different developments

Longer maturity portfolios provide greater insulation

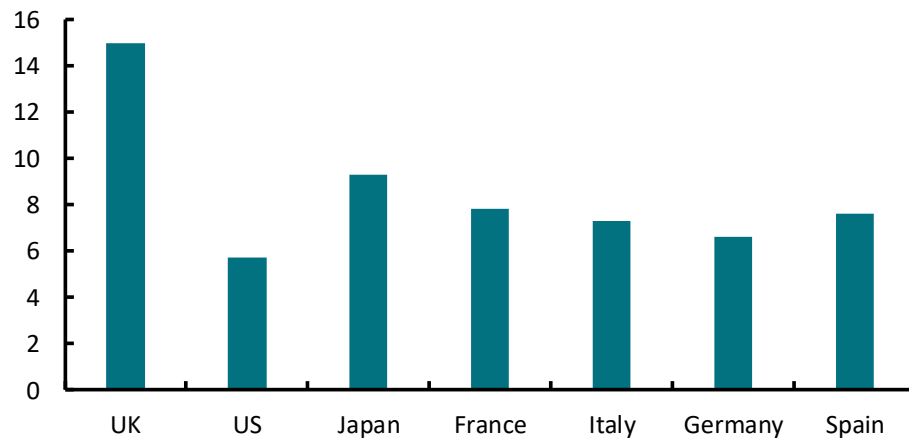
- Different government debt portfolios with differing characteristics respond differently to changing conditions. A longer maturity portfolio refinances less of its debt stock at current rates in any one year. This provides increased insulation from rising rates, either through increased financial market caution, or rising inflation expectations.

Inflation compensated bonds

- Longer-maturity bonds provide more (less) certainty to borrowers (lenders) to changing conditions. Because lenders take on more risk as the maturity lengthens they should demand additional premia. To reduce this borrowing premia, governments have reduced risks to lenders in other ways, including offering bonds that compensate them for any erosion of value over time through inflation. This deliberately reduces the governments ability to reduce its indebtedness through inflation.

Maturity of government debt portfolio can range

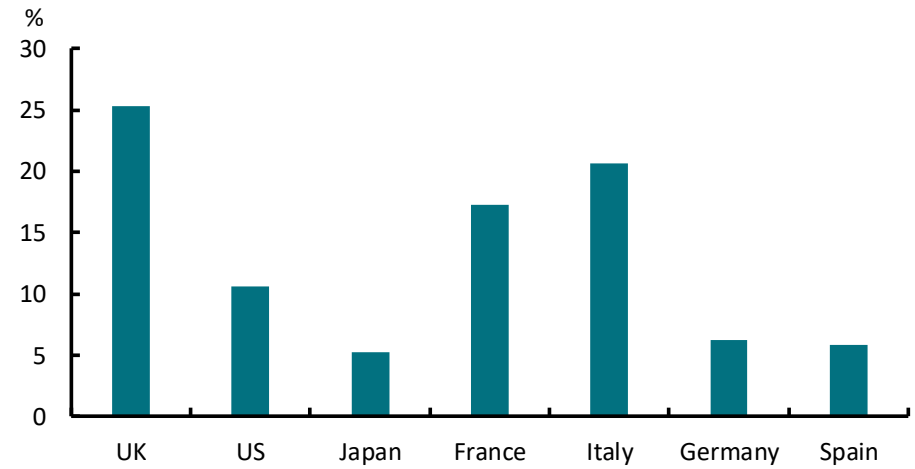
Debt Portfolio Maturity (yrs)



Source: CBO, OBR, AMECO, Minister of Finance and AXA IM Research, Oct 2020

Proportion of debt held in index-linked securities

Inflation linked issuance



Source: OBR, BIS, JP Morgan, Ministry of Finance and AXA IM Research, Oct 2020

Theme of the month: How governments can manage the Covid-19 debt surge

Each country faces its own limits

A spectrum of risks

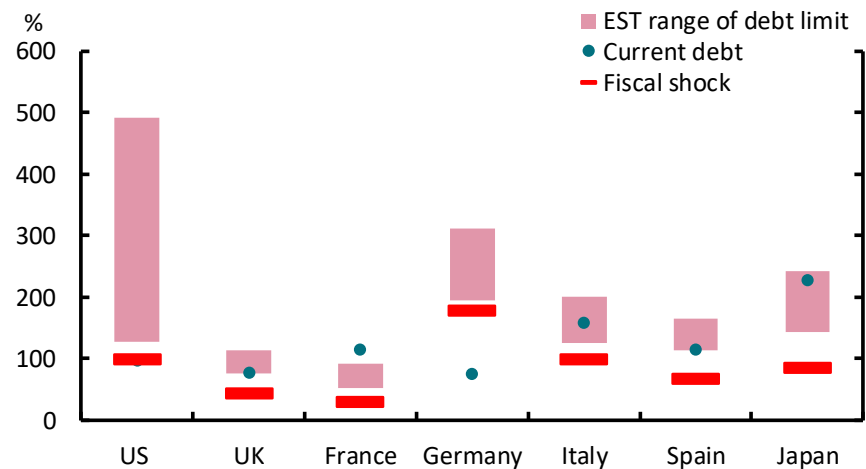
- Summarising across a range of countries illustrates a range of idiosyncrasies. Estimated limits for countries vary according to historic primary surpluses as well as growth and interest rates. Germany stands out for having the lowest debt and limits that far exceed others. Japan records the highest level of debt, but this is a debt that is largely domestically held. France's debt is above the estimate higher limit, emphasizing the importance of rates being lower today than historically.

Growth outlook is paramount

- The growth outlook is key, providing the most painless path to debt consolidation. The US economy operates on the global technological frontier, limiting its scope for future excess growth. Spain and Italy have the most scope for catch-up. The UK threatens the weakest outlook with Brexit and demographics likely to weigh on growth from here, reducing debt erosion.

Country debt and limits differ across countries

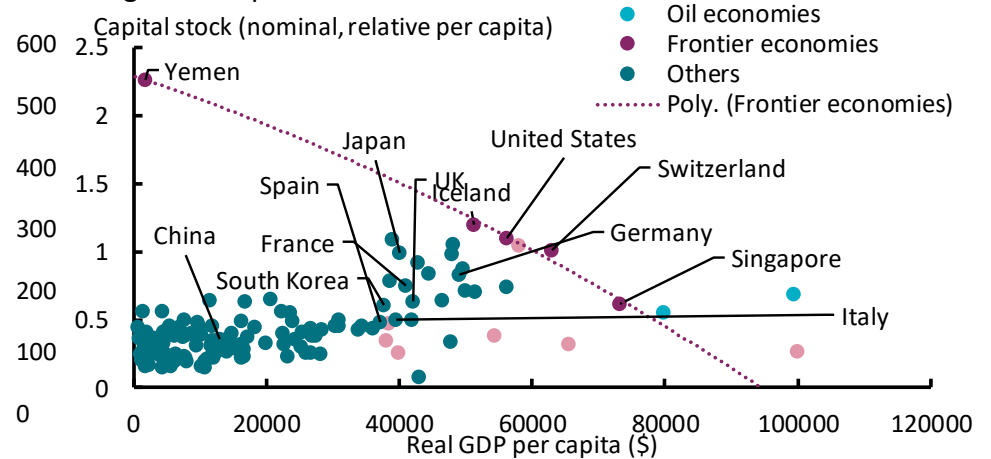
Debt as a % GDP



Source: CBO, OBR, Jp Fin Min, Eurostat, IMF, BIS, AXA IM Research, Oct 2020

The global technology frontier

The growth capital stock frontier



Source: Penn World and AXA IM Research, Oct 2020



Macro outlook

Record Q3, but outlook softening thereafter

US

Record Q3 expansion, but how much ?

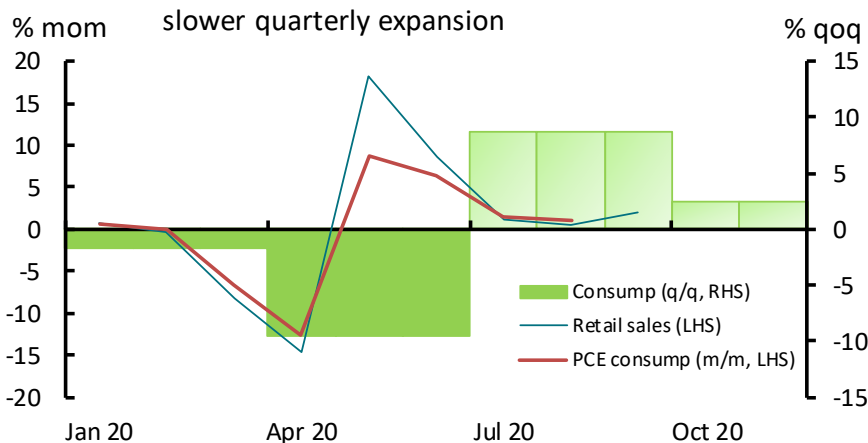
- Following Q2's -31.4% record contraction, we fully expect a record expansion in Q3. New York and Atlanta Fed GDP trackers post a range of 14-35% estimates for Q3, with consensus anchoring around 30%. We forecast a softer 23%, with consumption likely rising alone by nearly 40%, but a net trade drag and a more subdued rebound in inventory is likely to drag the final figure lower.

Downside risks grow for 2021

- Inevitably Q4 growth will slow from this record pace. However, with virus cases rising again, particularly in the Mid-West and the failure of government to provide further fiscal support to out of work workers, spending growth in the coming quarters could fall back more sharply. Income declines have been sharp since April and will be exacerbated by the expiry of unemployment benefit top-ups. Saving should cushion the blow in Q4, but without a further injection this will slow thereafter. We forecast US GDP growth at -4.3% in 2020 and +4.5% in 2021 (consensus -4.0% and +3.7%), but we acknowledge growing risks for next year.

Slowing spending will see slower Q4 consumption growth

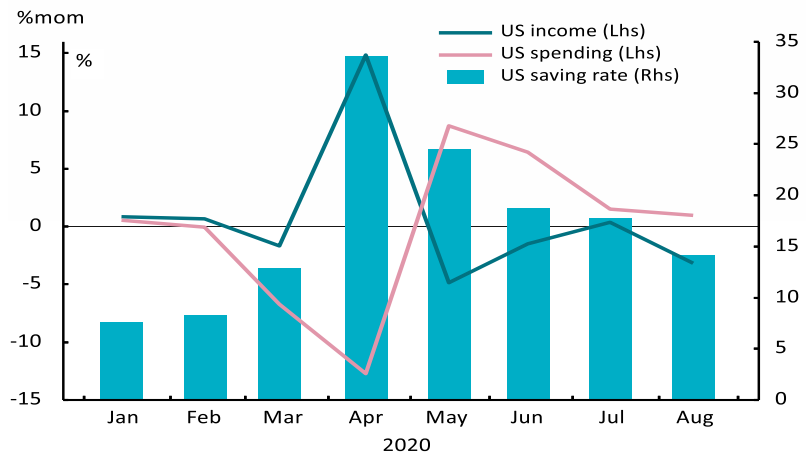
Normalisation of monthly spending growth heralds



Source: Commerce Dept, BEA, AXA IM Research, Oct 2020
Lighter areas denotes AXA IM forecast

Saving unwinds from record levels as income slows and spending rises

Income, spending & saving



Source: BEA, AXA IM Research, Oct 2020

Focus remains on impending election

US

Inflation to remain subdued, Fed rate on hold

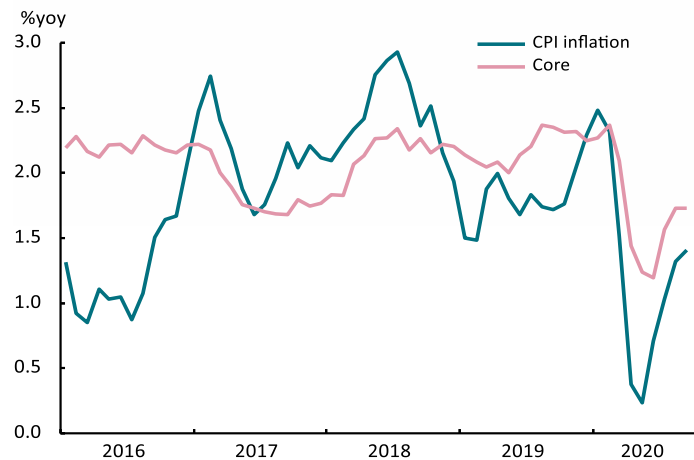
- Inflation has trended higher, reaching 1.4% (y/y) in September, up from 0.1% in May (core 1.7%). A quicker demand rebound, supply-side bottlenecks and a falling dollar have all lifted inflation more than we thought and we now forecast a 2020 average of 1.4%. However, demand growth should slow from here and supply blockages ease. Without a material drop in the dollar, we expect inflation to remain subdued at 1.5% next year. This should keep Fed rates in check, but balance sheet policy has little guidance.

Under two weeks to go and Biden is in pole position

- Democrat contender Joe Biden has seen his polling lead rise in recent weeks, adding to the consistent lead he has held all year. Unless there is a major shift, Biden looks set to be the next POTUS. Congress is much more uncertain. While the Democrats are on track to retain a majority in the House, the Senate vote is very close. Polls suggest a wafer thin Democrat majority, but could be wrong. The recent poll boost has raised hopes of a quick and clean election result. But a contested election remains a threat.

US inflation rebounds more quickly than expected

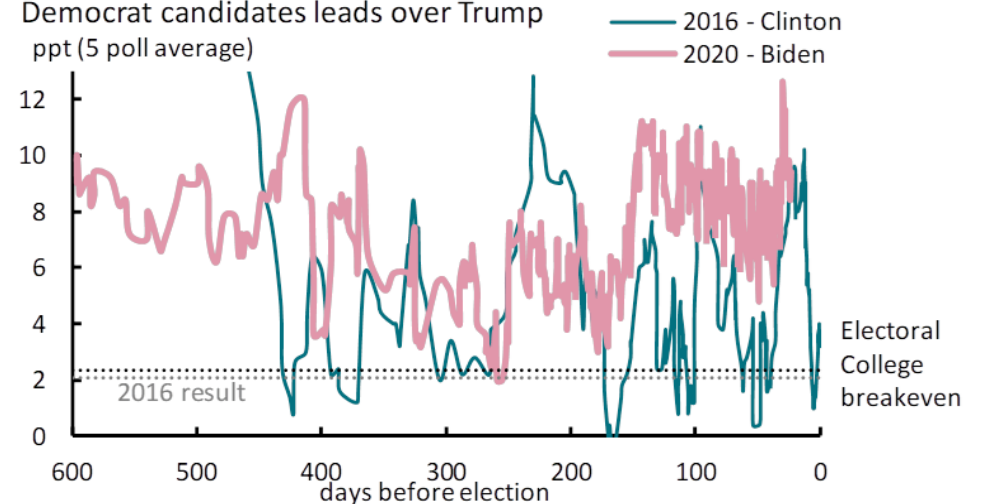
CPI inflation and core



Source: Commerce Dept, AXA IM Research, Oct 2020

Biden in pole position

Democrat candidates leads over Trump
ppt (5 poll average)



Source: 538, AXA IM Research, Oct 2020

It's getting worse

Euro area

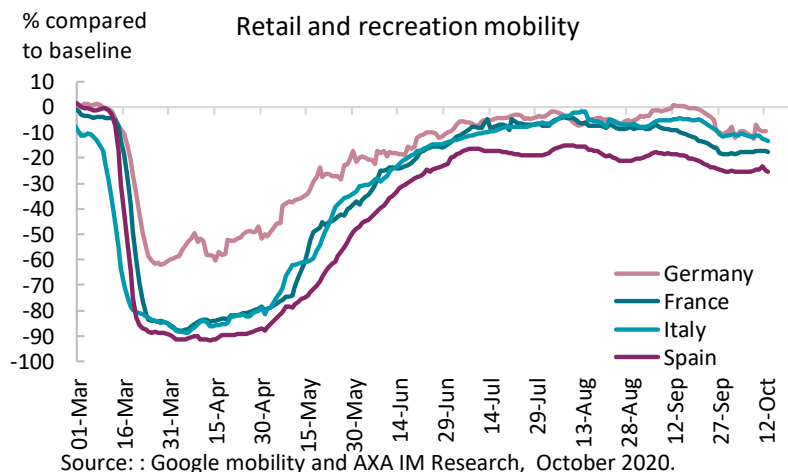
Second wave becoming broader based

- France and Spain are no longer the only hotspots: the number of daily cases has grown exponentially in The Netherlands, and weekly growth rates are picking up in Germany and Italy as well. Hospital ICU occupancy continues to rise everywhere (at 30% of April's average in France, 20% in Italy).
- Covid-related restrictions have increased substantially but most measures remain localised in geography (except in The NL) and economic sectors (hospitality and recreation) and aim at limiting social contacts. They include 9pm-6am curfew in most French large cities, the shutdown of restaurants and bars in Catalonia and The NL, restrictions in social gatherings in Germany and Italy.

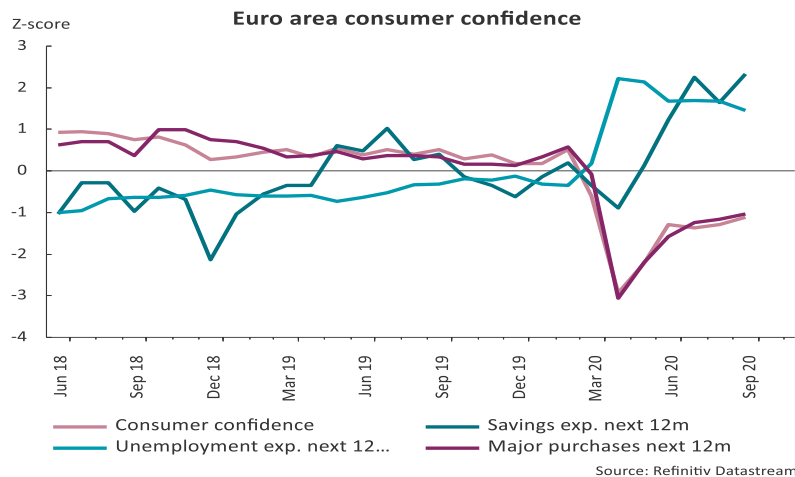
Downward revision to our 2021 growth forecasts

- But mobility data and soft indicators such as PMIs were affected by Covid resurgence even before government actions. EA IP has plateaued at 6% below its February level and consumers savings intentions are on the rise again, on poor employment prospects.
- This does not bode well for Q4 20. We revise down our 2021 euro area growth forecast to 4% yoy (vs. 5.2% before). The sharpest downward revision is for Spain (to 4.2%) due to pandemic developments but also to structural features of the economy.

Covid resurgence impacted mobility, even before restrictions increased



Savings intentions on the rise again



Source: Datastream and AXA IM Research, October 2020.

Budget time

Euro area

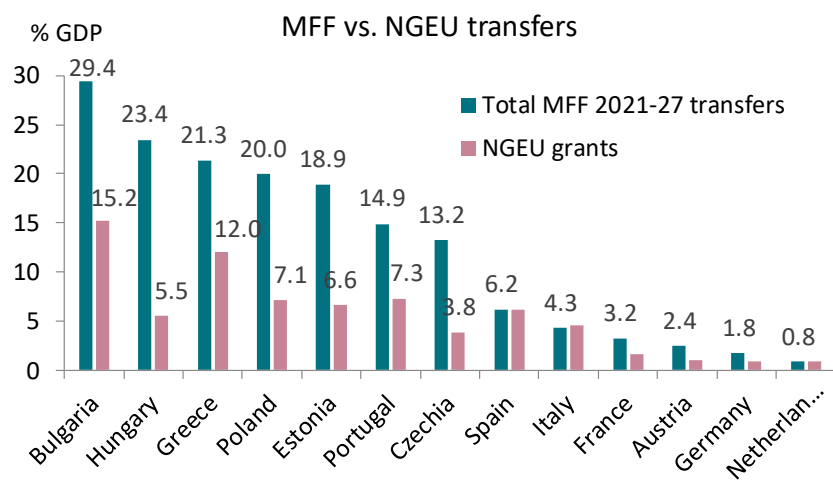
Draft 2021 Budgets and the use of the NGEU resources

- Italy and Spain are the main beneficiaries of the Recovery and Resilience Fund (RRF). Italy is planning a fiscal expansion of €33bn (c.2% of GDP) in 2021, with €14bn financed through the EU programs (€10bn from the RRF). Spain to maximise support for passing the budget, has maximised the ceiling by including €27bn from the EU (€25 from the RRF). In practice, Spain expects actual disbursement of just €7bn, so either the government will issue the remaining €20bn in 2021, or the fiscal stance will need to be adjusted lower. This would have negative consequences for deficit and growth.

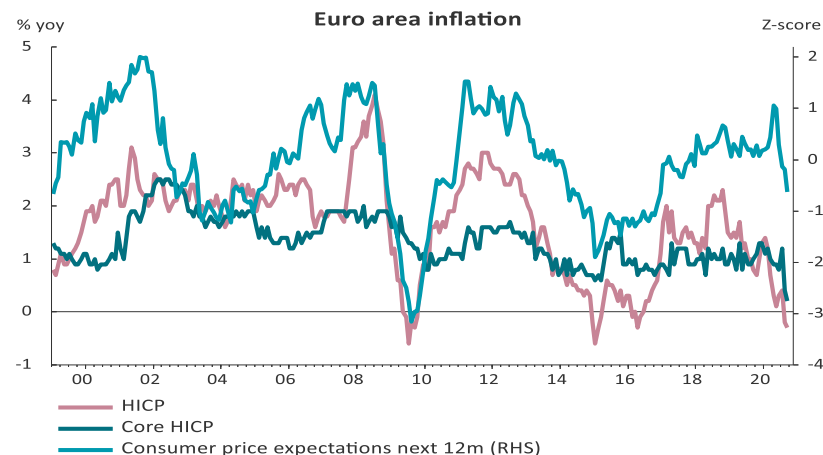
NGEU delayed but not derailed, pressure mounting on the ECB

- The NGEU might be delayed due to the Rule of Law dispute: the European parliament is threatening to vote down the Multiannual Financial Framework (EU budget) without which the RRF cannot exist in its negotiated form. At the same time, Hungary is threatening to veto the MFF if the rule of law provisions are toughened up. We think a compromise is the most likely option: eastern countries cannot afford to miss the funds from the MFF (23.4% of GDP in Hungary).
- Another poor inflation print is increasing pressure on the ECB. We expect a PEPP size and time extension in December.

Eastern countries cannot afford to miss MFF money



Deflationary mood spreading



Source: Refinitiv Datastream

Source: EC, AXA IM Research, October 2020. Note: MFF shows transfers including the Cohesion Policy, European Agricultural Guarantee Fund, and European Agricultural Fund for Rural Development.

Source: ECB, AXA IM Research, July 2020.

Bad news dominates UK outlook

UK

Ending in tiers?

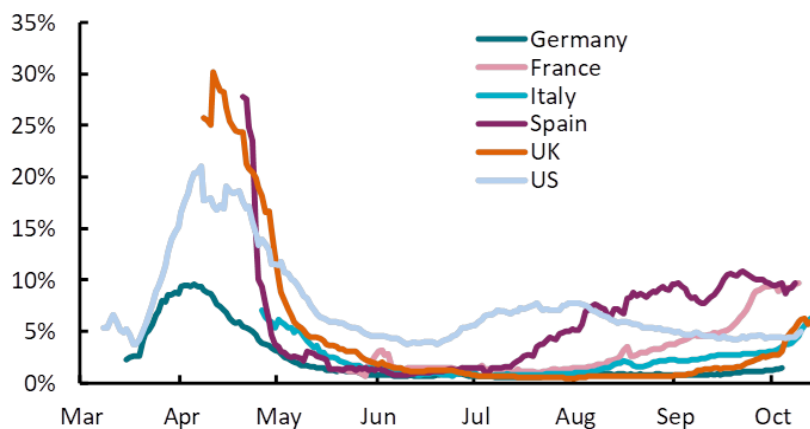
- The UK reported new virus cases rising to 20k/day in mid-October, far exceeding the >5k cases in April. Much of this reflects greater testing now, but the number of positive test cases has also risen sharply back to rates seen in early May, confirming a resurgence of the virus. The UK government has responded with a regional, tiered approach. However, regions are resisting a weakened central government. While the government's scientific advisers suggest restrictions are not going far enough.

Q3 disappoints fast-data

- Large numbers of 'stay-cationers' and the Chancellor's Eat-out-to-help-out scheme had led us to expect strong growth in August. In the event, GDP growth recorded 2.1% on the month, far short of our expectations. This fell short of most measures of 'fast data' that had tracked broader activity well in recent months. It also appears to have missed data gleaned from the CHAPS – commercial bank settlement system – payments, as seen by the Bank of England as Q3 growth looks set to fall short of its 18.3% forecast.

Rising test positivity best gauge of virus re-emergence in UK

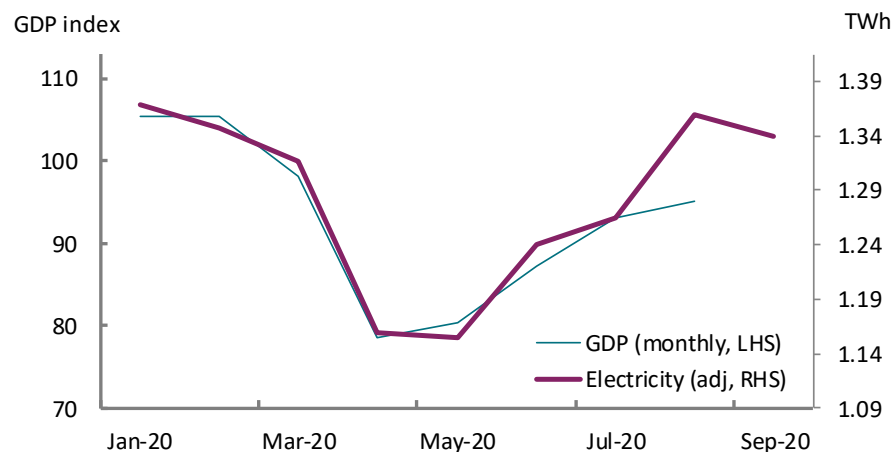
Testing positivity rates



Source: ECDC, AXA IM Research, Oct 2020

August GDP disappoints a number of 'fast data'

UK GDP and adjusted electricity



Source: National Statistics, UK Dept BEIS, AXA IM Research, Oct 20

A winter of risks

UK

Deceleration expected over the Winter

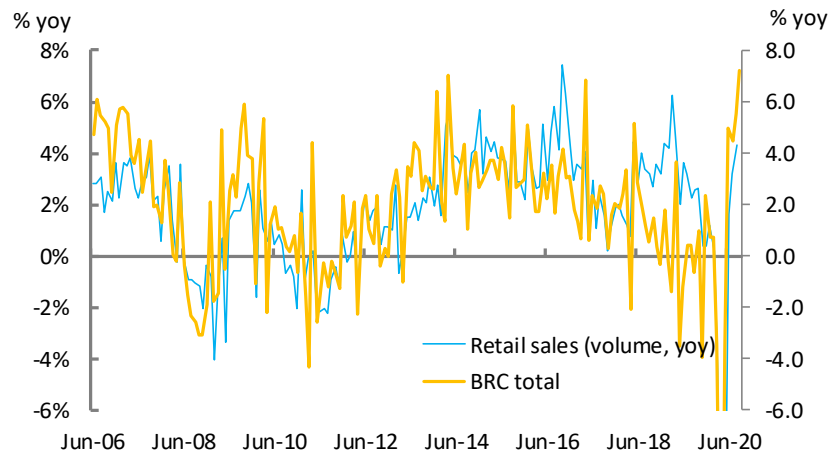
- September may post an upside surprise in retail sales. However, with virus cases rising, restrictions in place across much of the country and consumer and business behavior likely turning more precautionary, we are less hopeful for the Q4 outlook. We have lowered our 2020 GDP forecast to -10.3% (from -10.0%). However, the outlook for 2021 looks set to be affected more. We now forecast growth of 5.5% (from 7.5%) and risks appear skewed to the downside. Consensus (-9.9% and 6.0% respectively).

Brexit misses another deadline.

- PM Johnson threatened to walk away from negotiations without clear sign of a deal on 15 October. On 16 October, Johnson said the UK would focus on preparing for a 'no deal' exit, but would remain open to further trade discussions. A deal does not appear too distant with state aid and fisheries the final obstacles. We continue to expect a bare-bones deal to be announced over the coming weeks. A 'no deal' outcome now would likely lower next year's growth by around 1ppt. This would not help an economy struggling to recover from the pandemic, but would not be the same order of magnitude shock as if it had arisen in previous years.

BRC survey suggests upside risk for September sales

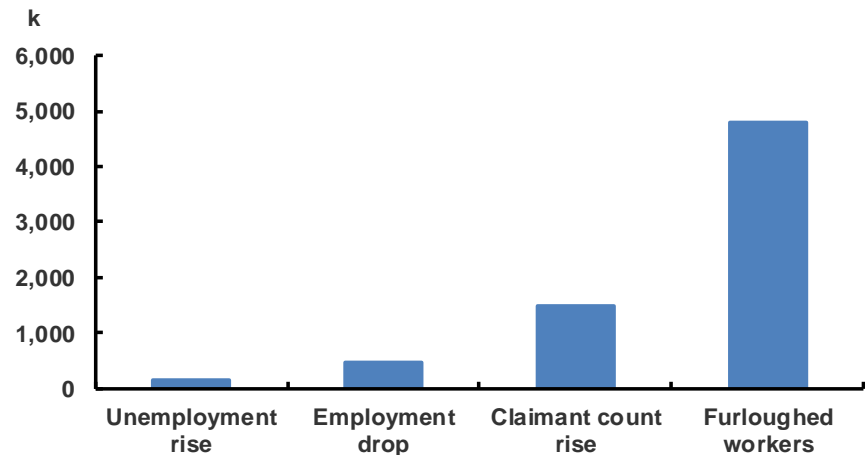
BRC (deflated) and retail sales volumes



Source: National Statistics, BRC, AXA IM Research, Oct 2020

Uncertainty surrounds scale of impact on labour market

Different measures of labour market impact



Source: National Statistics, HMRC, AXA IM Research, Oct 2020

Economic recovery gains more strength and balance

China

Growth accelerates due to faster catch-up of laggards

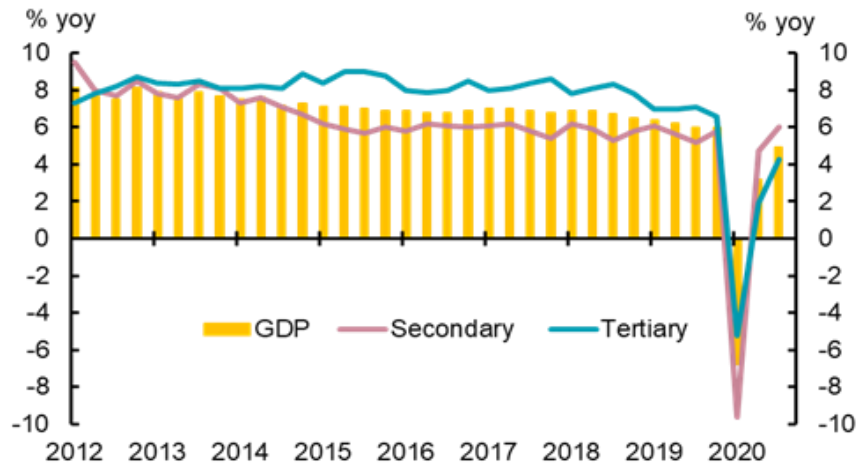
- The economy expanded by 4.9% in the third quarter, in line with our expectations. While quarter-on-quarter growth slowed to a more normal rate of 2.7%, after a 11.5% rebound in Q2, year-on-year growth continued to accelerate to 4.9% from 3.2%, inching a step closer to our estimate of trend growth of 5.5-6%. The secondary industry continued to lead the recovery, growing 6%, thanks to strong industrial production and infrastructure investment bolstered by extraordinary fiscal support. However, it is the services sector recovery, gaining 2.4 percentage points to 4.3%, that explained more of Q3's strength.

Economic recovery becomes more broad-based

- Q3 GDP, along with September's monthly data, shows not only strong headline growth but that the recovery has become more broad-based. The leaders of the recovery, industrial production, exports and fixed asset investment, have largely returned to their pre-COVID growth paths, while the laggards, employment and consumption, are catching up. With nearly all cylinders firing, the economy is set to revert back to its pre-crisis trend growth of 5.5%-6% by the year-end.

Service-sector growth catches up to industrial sector

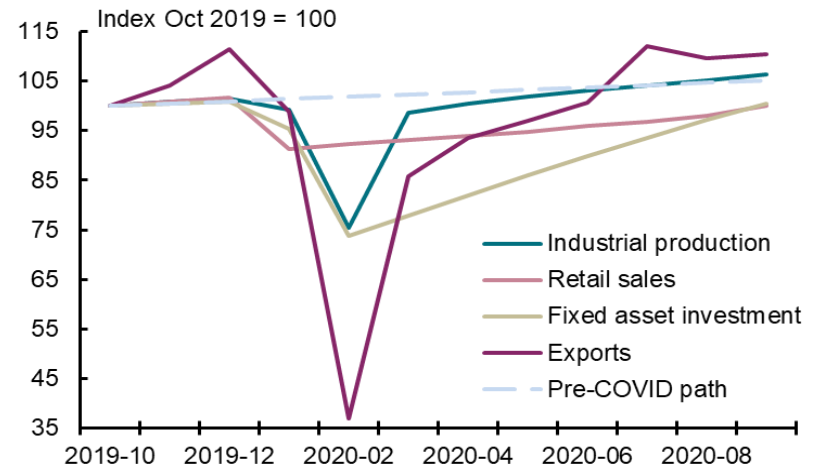
GDP breakdown to secondary and tertiary



Source: CEIC, AXA IM Research, Oct 20

Recovery remains multi-speed, but the gaps are narrowing

China - Industrial production, retail sales and fixed asset investment rebased



Source: CEIC, AXA IM Research, Oct 20

Continued recovery reduces chance of additional monetary easing

China

Strong data reinforces PBoC's move toward neutral

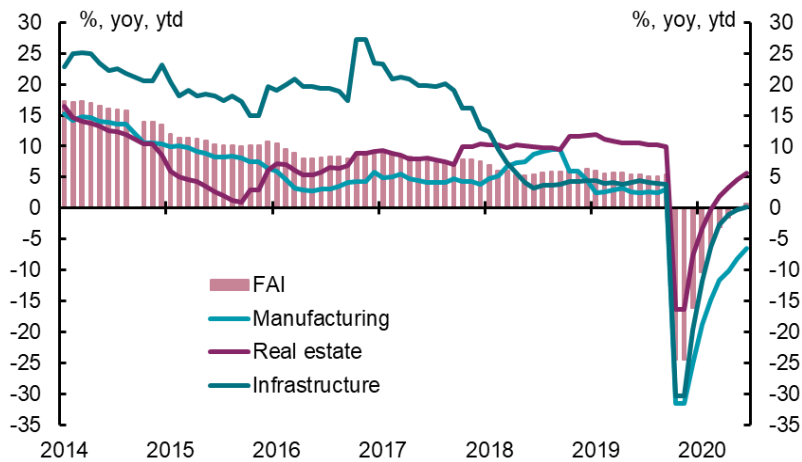
- Solid economic data should encourage the PBoC to take its foot off the gas, even as some tightening effects are already manifested through a stronger RMB. In addition, rising asset prices have started to draw the authorities' attention to risk management and leverage control in some sectors. The recent tightening of balance-sheet regulations for property developers was a case in point and could cool the housing market in 2021. We have removed our call for any RRR or interest rate cuts for the remainder of 2020.

Monetary tightening is premature, while fiscal easing should continue

- While further policy easing is less likely, monetary tightening is also off the table for the time being. With inflation on the decline, the global backdrop remaining uncertain, and parts of the economy (employment and consumption) still growing at below trend, we see no imminent need to withdraw monetary stimulus. The PBoC seems to be comfortable with its neutral policy setting at the moment – relying on lower-profile policy tools, such as repo and medium-term lending facility, to keep liquidity conditions stable, while leaving fiscal policy to drive the economy back to its pre-COVID path.

Investment engine continues to power ahead

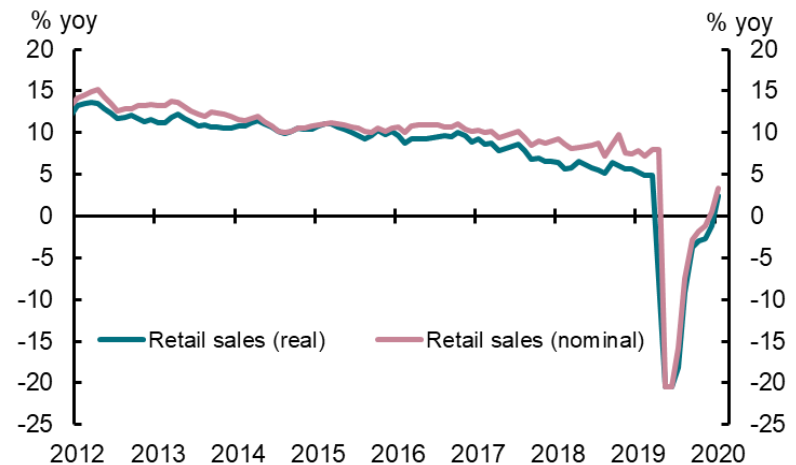
Fixed asset investment breakdown



Source: CEIC, AXA IM Research, Oct 20

Consumer spending plays catch up

Real vs. nominal retail sales



Source: CEIC, AXA IM Research, Oct 20

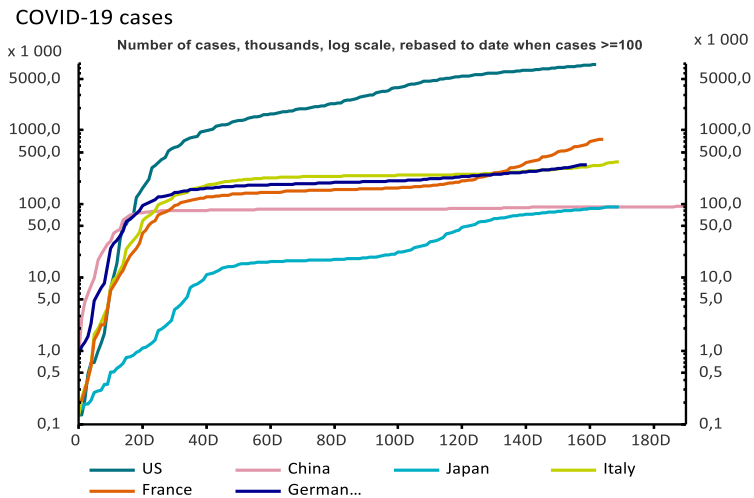
Domestic activity should continue to recover but Japan also depends on overseas activity

Japan

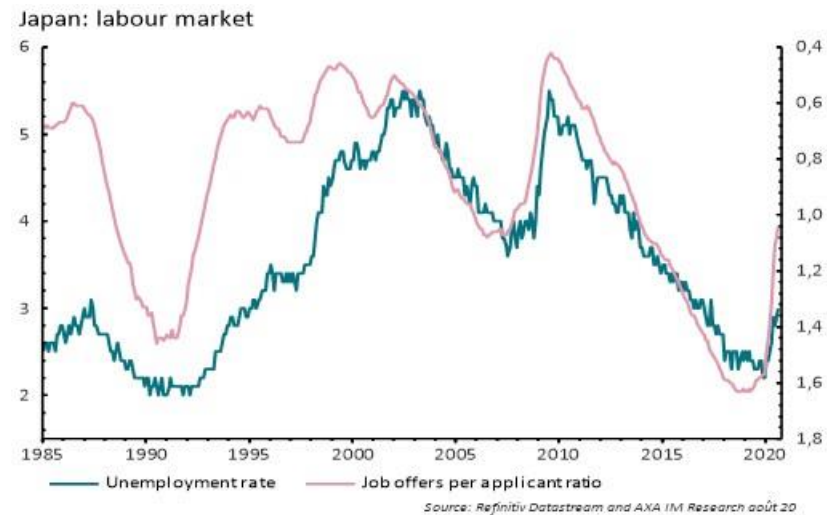
Activity continues to recover while the pandemic remains “under control”

- The stabilization in new COVID-19 cases at low levels (Exhibit 1) and strong government support continue to underpin the economic recovery.
- More job-seekers have returned to the labour force, technically pushing unemployment rate up to 3% from 2.9%. The job per applicant ratio declined a bit but remains just above 1 (Exhibit 2)
- Overall, we forecast a strong rebound in Q3 (13.2% QoQ annualised) and activity should persist into Q4 (+7.9%). Domestic activity should be robust, but the external outlook is mixed with China’s continued recovery a boost, but weaker recoveries in the US and Europe - where governments are struggling with further restrictions – will drag.

Number of new cases is stabilizing



Labour market is resilient



Political and monetary policy outlook

Japan

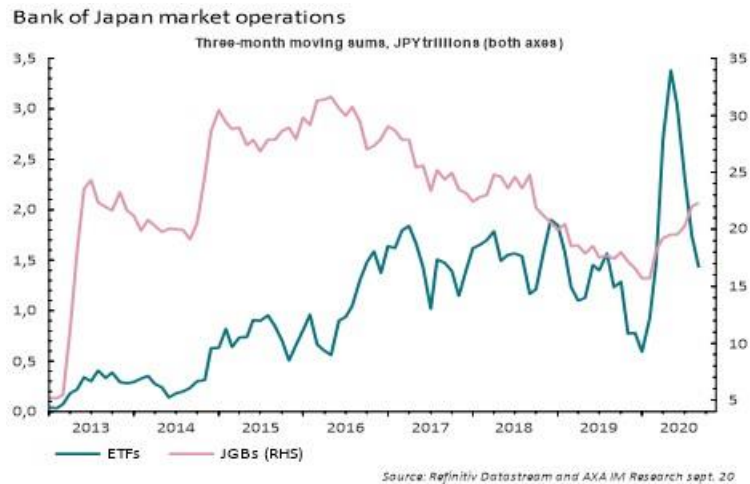
Snap election now seems unlikely in the near-term.

- The political outlook is still uncertain, with no clarity whether PM Suga will call a snap election before the scheduled date in Q4 2021. On balance, the government wants to prioritise virus control, making an election seem unlikely in the near-term.
- The government is going to convene an extraordinary month-long session of the Diet on 26 October. This should show which policies the new Suga administration intends to prioritise and should reveal whether another round of economic stimulus is likely

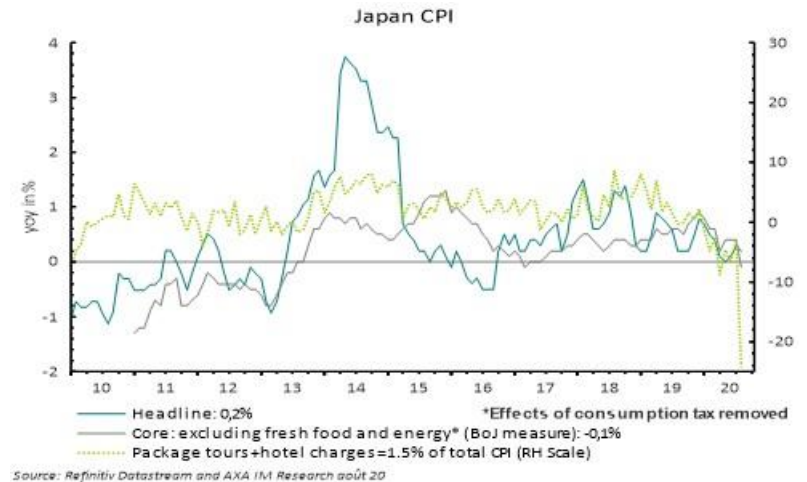
Bank of Japan holds its monetary policy on 29 October

- We do not expect any change, with the policy board members remaining of the view that they have done enough for now – albeit that “it is ready to act with more if necessary”.
- The focus will be on how the BoJ’s latest outlook report will be revised. The growth outlook could be revised up but considering the inflation headwinds, the inflation outlook could be revised down.

The Bank of Japan has calmed down on ETFs



CPI is severely impacted by large discounts in accommodation and package tour prices



COVID-19 remains active in EM

Emerging Markets

Pandemic still needs attention in emerging markets

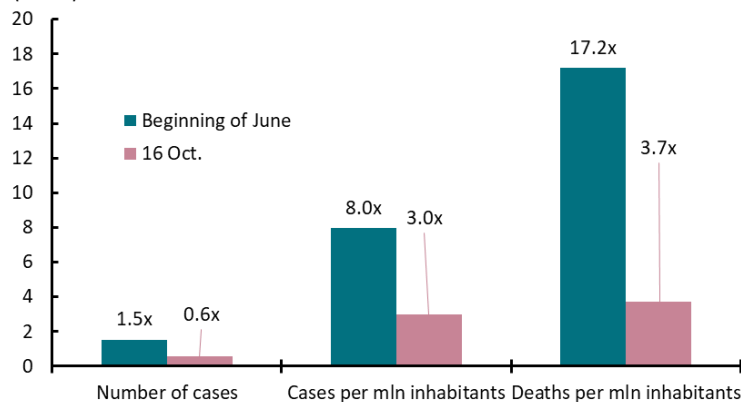
- Since the beginning of October, the growth in the number of new cases in emerging countries (-1.6%MTD) has been lower than in developed countries (+59.9%MTD). However, emerging countries remain the most affected region with 1.7x more cases than in developed countries. The recent figures show a stabilization of the increase in cases in the area, which had been decreasing since mid-September (-10%MoM). But we keep an eye on the future evolution of the pandemic in the region since the risk of a strong resumption of the pandemic in the area is not negligible.

The hotspots are spreading

- By looking at the breakdown by regions, we note a strong growth of new cases (+107%MTD) in Central and Eastern European countries. The main contributor of the rise is the Czech Republic (+314%MTD), the country now totals 149,010 cases (6.6% in the CEE). This increase is partly explained by the increase in the number of tests delivered (+36%MTD). In order to counter the resumption of the pandemic, the government has taken stricter measures notably by closing bars and banning gatherings of more than people.

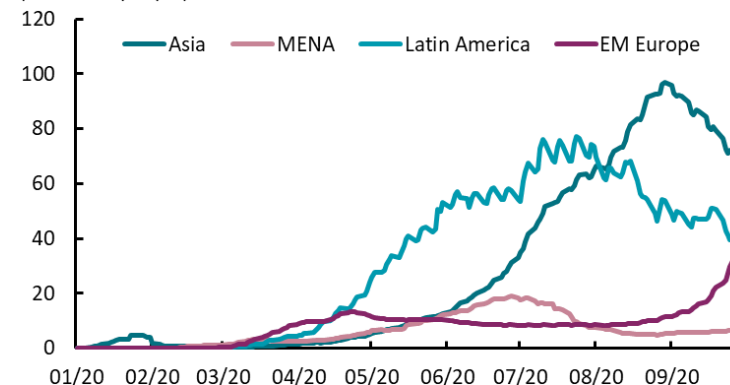
Developed markets are closing the gap...

Ratio of DM cases to EM cases (Ratio)



... but EMs remain more touched and virus spread across regions

New Cases - By region (Thousand people)



A recovery in EM absent of foreign investors so far

Emerging Markets

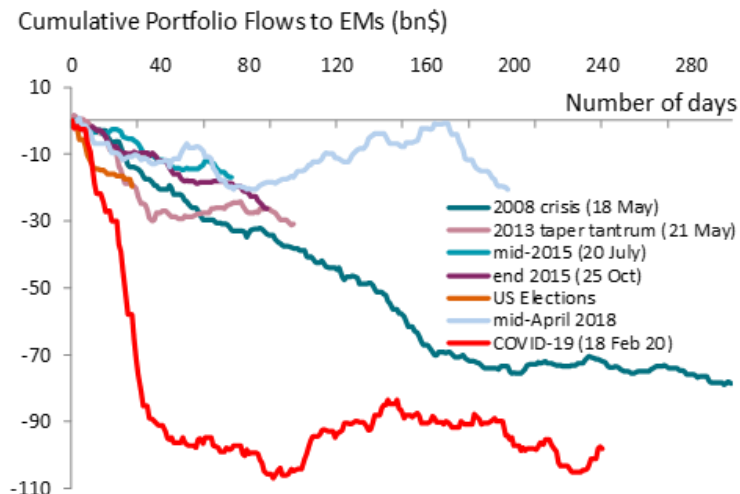
Recovery confirmed, both supply and demand side, but fragilities remain

- Supply side recovery gains ground. Manufacturing production is picking up; latest PMI surveys suggest that the trend should continue into the start of Q4 2020, albeit that some loss of momentum appeared in EM Europe. Thanks to the fiscal and monetary policy support, which has been deployed at various speeds and depths, demand started to recover as well but remains intrinsically linked to the continuing improved sentiment affecting the propensity to consume and the underlying strength in the labour market, both of which may require additional policy support.

Foreign investors still on the side lines. Domestic banks absorbed most of the government issuance so far.

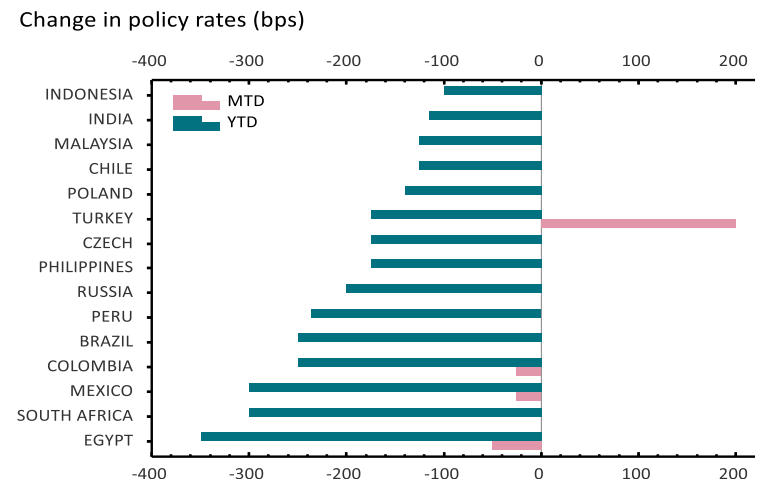
- Since February 18, US\$98bn worth of foreign portfolio outflows from EMs have been reported (US\$30bn in EM debt assets, US\$68bn in EM equities), at a time when government issuance hits new highs on higher Covid-19 financing needs. Some EM central banks have engaged in QE – the Philippines, Poland or Indonesia – but most EM central banks have been reluctant purchasers of outright sovereign bonds. In fact, local banks have been absorbing most of the governments’ bond issuance so far, thanks to various policy decisions taken by central banks. They are likely to move towards more unconventional policy tools as conventional space shrinks.

Foreign investors remain on the side lines



Source: IIF, AXA IM Research, 14 Oct 2020

Traditional monetary policy running out of steam



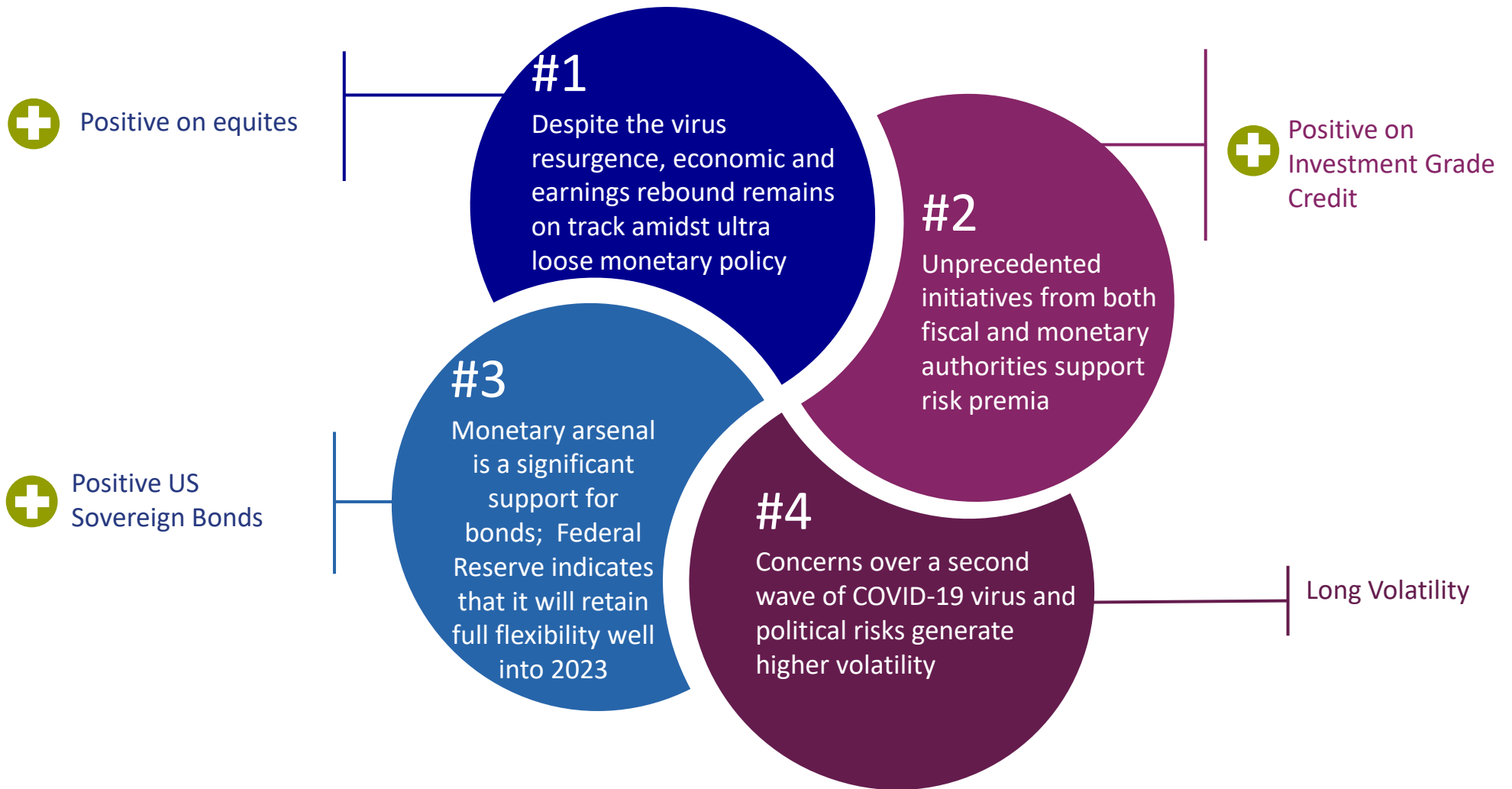
Source: Refinitiv Datastream and AXA IM Research 30/09/2020



Investment Strategy

Multi-Asset Investment views

Our key messages and convictions



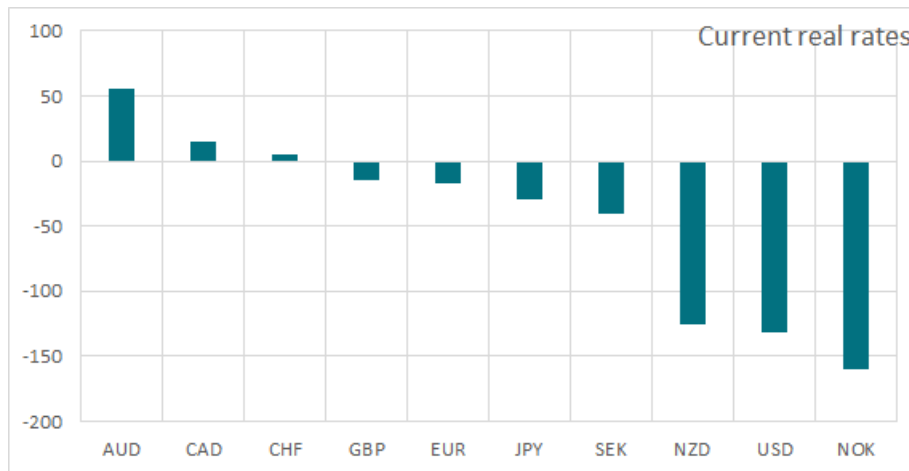
Source: AXA IM as at 21/10/2020

FX Strategy

Dollar path may be materially influenced by US election outcome; ditto for GBP vis a vis Brexit outcome

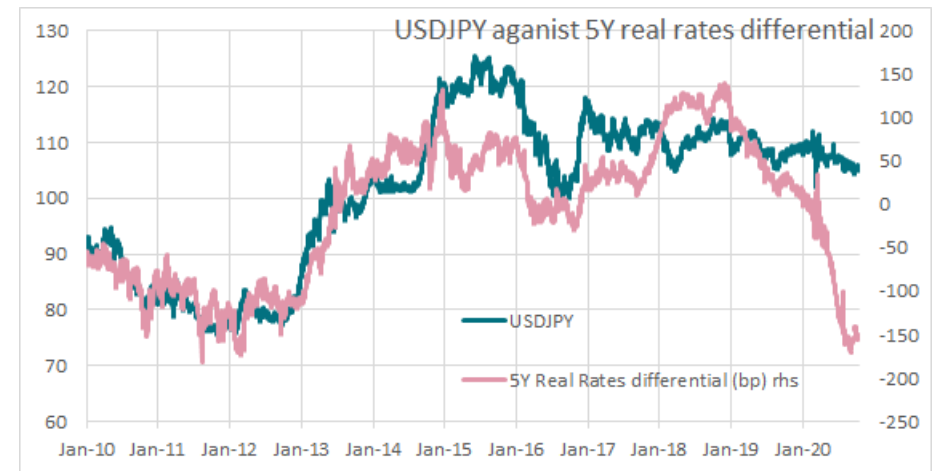
- By recent polls, a Biden victory looks likely, and maybe even a Democrat majority in the Senate. This points to larger fiscal loosening, but would mean a stronger USD again? We think that Biden’s reforms will be more inflationary, less pro-business, with higher taxes on high incomes and corporates, and less support for the old energy sector, discouraging capital inflows.
- Beyond the election outcome, the medium-term trajectory bodes for a weaker USD as the Fed ensures that US real rates remain very low through reflation and ample USD liquidity . Indeed, recent increases in US rates did not alter the USD downward trend, as they were mainly driven by higher inflation expectations. JPY still stands to benefit from USD weakness.
- Holding JPY might also be safer through US election uncertainty. While the EUR should be supported as well, the Covid second wave and noise around Brexit and the Recovery Fund may create a better buying opportunity near term. Very negative real rates explain NOK failure to appreciate despite cheap value and strong fiscal backdrop. At the other end , easier RBA policy is a risk for AUD.

FED has taken US real rates to very low levels



Source: Bloomberg and AXA IM Research, Sep 2020

FED policy shift justifies a lower USDJPY



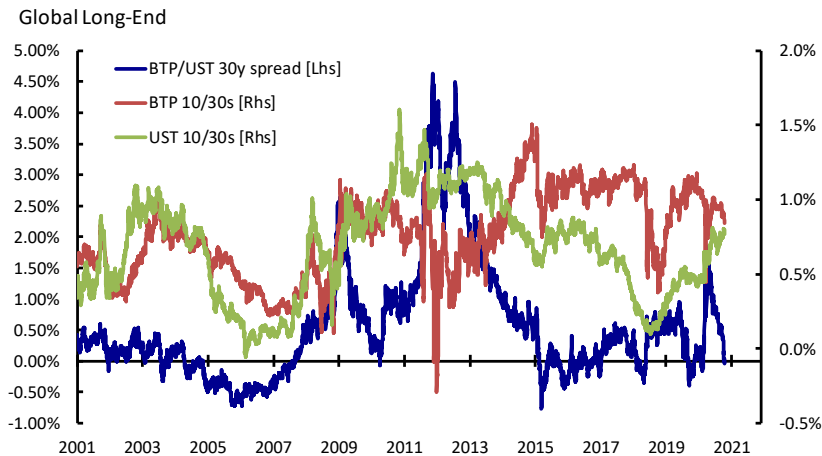
Source: Bloomberg and AXA IM Research, Sep 2020

Rates Strategy

US Treasuries vs Italy's BTPs: a tale of two worlds

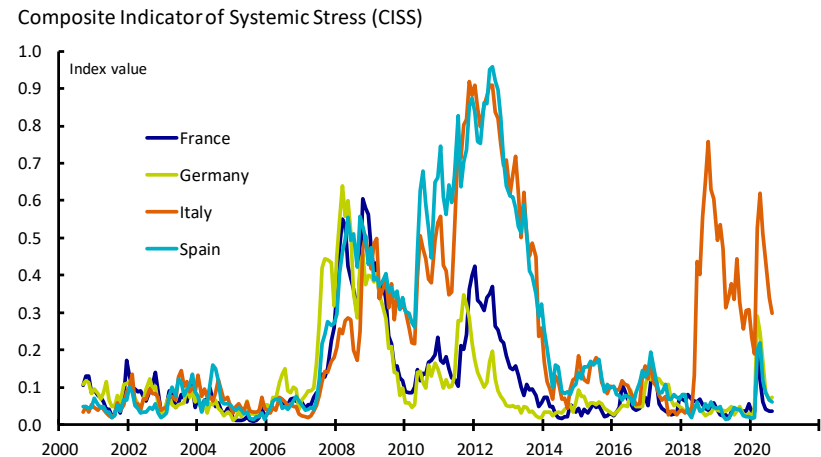
- We often look at US vs EU spreads in order to express differential views on the business cycle, as well as on the policy stance and related political issues. By doing so, we leave aside the credit and liquidity components, which are more typical of EGB relative value or ASW-spread trades.
- However, in a world dominated by low/negative interest rates, we should respect absolute yield levels more than ever. Recently, 30y BTPs have managed to briefly trade below US bonds in yield terms. This marks a 185bp performance for the long-end of the Italian curve since mid-April. Similarly, both 10/30s curves are trading around 80bp.
- The combination of valuation, flows and positioning factors should provide enough rationale for lightening up on (or hedging with US Treasuries) exposure to Italy in fixed income portfolios, at least with a short-term horizon in mind. An additional argument is that long-term debt fundamentals have not improved in 2020 and that 'systemic stress' is still high relative to the rest of the Eurozone.

UST vs BTP at the long end of the curve



Source: ECB, Markit and AXA IM Research, 18 September 2020

Systemic risk hasn't normalised yet



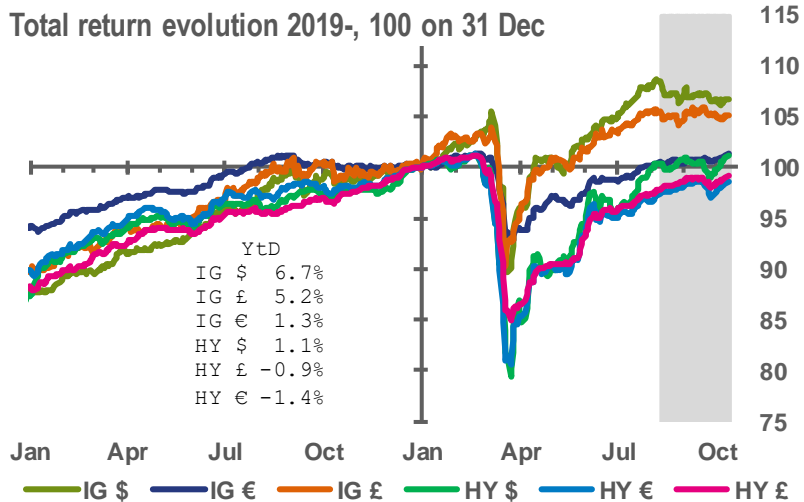
Source: Bloomberg and AXA IM Research, Jun 20

Credit Strategy

All quiet on the spread front but the burden of negative yielding credit bonds befalls investors again

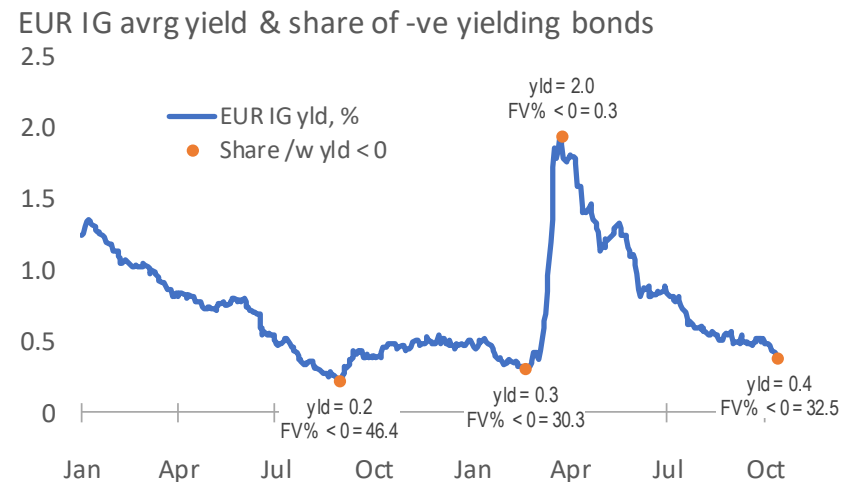
- Approximately one-third of global investment grade credit is covered by central bank purchase schemes. A further 10-15% of global high yield credit enjoys similar support through the explicit or implicit acceptance of Covid-related fallen-angels in these purchase schemes. The resultant stability in credit spreads as a result, should therefore not come as a surprise.
- On the other hand, tight spreads combined with ultra-low if not negative government debt yields contrive for an environment of lackluster returns . This low-yield theme has been a factor in the outperformance of US over European assets, along with the US Fed’s drastic market intervention and bigger direct fiscal support package.
- As yields along the entire German Bund curve trade below zero and spreads have tightened a lot, negative yielding corporate bonds have risen again to just under one-third of the face value of the euro IG index which is yielding 0.4% overall. At the post Covid shock spread peak this year, the index yield reached 2% and practically none of the index traded at a yield below zero.

Credit returns have broadly stagnated over the past two months



Source: ICE and AXA IM Research, Sep 2020

Negative yield bonds in EUR IG back to one third of index face value



Source: Moody’s and AXA IM Research, Aug 2020

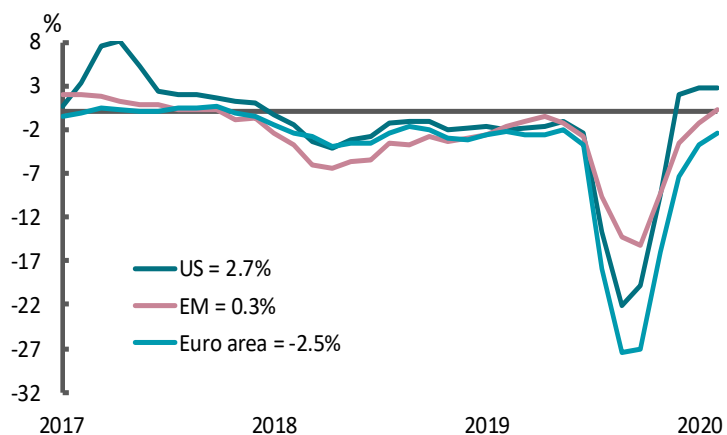
Equity strategy

Standing at the crossroads

- Equity markets are facing a clouded near-term outlook on multiple fronts: uncertain earnings, COVID related restrictions, vaccine news, US elections and policy drifts. Positive momentum in earnings revisions have stalled after the sharp V-shape recovery reflecting the slowdown in activity indicators. The Q3 earnings season has kicked off on a positive note in the US with earnings beats running at 23% on aggregate. Most managements should remain reluctant to provide forward guidance given the lack of earnings visibility.
- On the election front, there appears to be no obvious consensus on market direction regarding a Republican or Democrat victory – the contested election scenario is universally perceived as the key risk. Overall sentiment is warming up to a Democrat victory (which remains the base case) and it appears that a clear election outcome itself would provide respite for markets. The new policy mix could also potentially put in place catalysts for broader equity market participation in terms of sectors and style.
- Volatility is likely to remain elevated given the uncertainty surrounding the coronavirus developments, lack of earnings visibility and the political landscape. We maintain our constructive stance on equities in our cross-asset framework, acknowledging that selectivity remains key given the high degree of uncertainty. Overall, recovering economic activity, aggressive policy measures, subdued positioning and an ultra-low hurdle rate in other assets should support equity markets in the medium term beyond the looming event risk.

Stalling momentum after initial “V shape” recovery

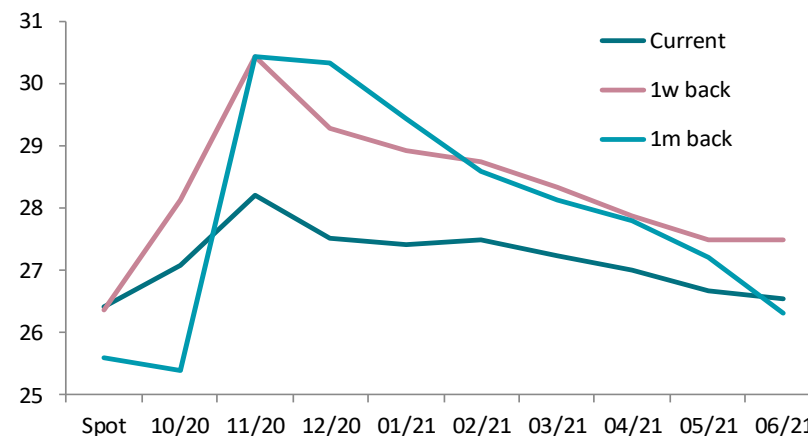
3M earnings revisions: US, Euro area & EM



Source: Datastream, IBES and AXA IM Research, Oct 20

Volatility pricing elevated well into 2021

US equity implied volatility (VIX) term structure



Source: Bloomberg and AXA IM Research, Oct 20

Asset allocation stance

Positioning across and within asset classes

Asset Allocation			
Key asset classes			
Equities			Positive
Bonds			Positive
Commodities		Neutral	
Cash	Negative		

Equities			
Developed			
Euro area			Positive
UK		Neutral	
Switzerland		Neutral	
US			Positive
Japan		Neutral	
Emerging & Equity Sectors			
Emerging Markets			Positive
Europe Oil & Gas		Neutral	
Europe Telecoms		Neutral	
US		Neutral	
US Cons. Discretionary		Neutral	

Fixed Income			
Govies			
Euro core		Neutral	
Euro periph		Neutral	
UK		Neutral	
US			Positive
Inflation Break-even			
US			Positive
Euro		Downgrade	
Credit			
Euro IG			Positive
US IG			Positive
Euro HY		Neutral	
US HY		Neutral	
EM Debt			
EM Bonds HC		Neutral	

Legend

Negative

Neutral

Positive

Change

▲ Upgrade

▼ Downgrade

Source: AXA IM as at 21/10/2020



Forecasts & Calendar

Macro forecast summary

Forecasts

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

Expectations on inflation and central banks

Forecasts

Inflation Forecasts

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

Central banks' policy: meeting dates and expected changes

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

Calendar of 2020 events

2020	Date	Event	Comments
October	22 Oct	US	Third US Presidential debate
	28-29 Oct	BoJ Meeting	Unchanged (-0.10)
	29 Oct	ECB Meeting	Unchanged (-0.50)
	29 Oct	US	Q3 GDP advance estimate
	30 Oct	Euro Area	Q3 GDP flash estimate for EU19, France, Italy and Spain
	Late Oct/Early Nov	UK/EU	Expectations for conclusions of UK/EU trade agreements
November	3 Nov	US	Presidential and Congressional Elections
	4-5 Nov	FOMC Meeting	Unchanged (0-0.25)
	5 Nov	BoE Meeting	Unchanged (0.10), including Monetary Policy Report
	11 Nov	UK	Q3 GDP first estimate
	13 Nov	Germany	Q3 GDP flash estimate
	15 Nov	Japan	Q3 GDP prel. estimate
	21-22 Nov	G20	2020 Summit, Riyadh
December	10 Dec	ECB Meeting	Unchanged (-0.50)
	12 Dec	UK/UN	Climate Summit
	14 Dec	US	Electoral College Vote
	15-16 Dec	FOMC Meeting	Unchanged (0-0.25), including SEP
	17 Dec	BoE Meeting	Unchanged (0.10)
	17-18 Dec	BoJ Meeting	Unchanged (-0.10)
	31 Dec	UK/EU	End of transition period
January	20 Jan	US	Presidential Inauguration
	20-21 Jan	BoJ Meeting	Unchanged (-0.10)
	21 Jan	ECB Meeting	Unchanged (-0.5)
	26-27 Jan	FOMC Meeting	Unchanged (0-0.25)
February	4 Feb	BoE Meeting	Unchanged (0.10)
March	11 Mar	ECB Meeting	Unchanged (-0.50)
	16-17 Mar	FOMC Meeting	Unchanged (0-0.25)
	18 Mar	BoE Meeting	Unchanged (0.10)
	18-19 Mar	BoJ meeting	Unchanged (-0.10)

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