Investment Managers

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# Macroeconomic Outlook 2020: Fragile 20-20 vision

## From the Core Investment Macro Research team


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# Stalling as the traffic light turns green(ish)

By Gilles Moec

## Key points

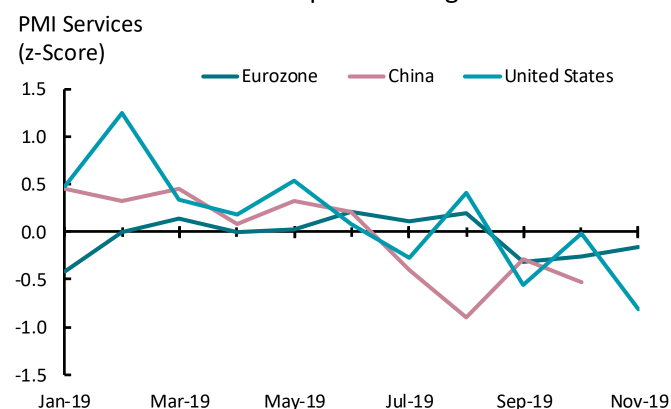
- Fears of a 2019 global recession have abated as major macro risks have started fading.
- However, for 2020 we think actual GDP growth is unlikely to be able to exceed potential in the key economic regions. Too much damage has been done, old headwinds are still with us and new sources of uncertainty have emerged.
- Our baseline for 2021 is that global growth slows down to quasi-stagnation. A lack of policy fire-power will be a dominant theme in the coming two years.

## What lurks behind the obvious risks

2019 has been defined by binary risks in the global economy, with prominently the trade war between the US and China – potentially extending to the EU – and to a lesser extent, but very relevant for Europe, Brexit. Unsurprisingly, the high level of uncertainty has significantly dampened investment everywhere. By the end of the summer, the "natural slope" of the global economy was a gradual contagion from the already contracting manufacturing sector to services, and a major downturn in aggregate demand by winter had become plausible. Fortunately, some "non-negative" signals finally emerged in autumn.

Even if the details are proving difficult to finalise, a partial trade deal between the US and China is in the making which would at least prevent another escalation. The White House has stopped mentioning raising tariffs on European cars. In the UK, risks of "no deal" and hence a brutal drop in British demand to the rest of the world at the end of 2019 has become much less likely.

Exhibit 1: Still time to stop the contagion




*Source: Datastream and AXA IM Research, as of 25/11/19*

Of course, there is a measure of "acquired speed" in the global deterioration in sentiment (Exhibit 1) and confidence in services is likely to continue sliding for a while. but we do not expect this to translate to a late 2019/early 2020 global recession. Crucially, the labour market has remained globally solid, and consumer spending has continued to sustain activity in the key economic regions.

We don't want to give the global economy the "all-clear" though. Risks are receding but lasting damage has been done. We think the "phase one deal" between the US and China will be enough to stop the escalation but we would be surprised if any of the tariff hikes implemented since 2018 would be quickly rolled back. In addition, in Europe, overcapacities have re-emerged, and it will take time to absorb them. Indeed, at the beginning of 2019 surveys were reporting a steep increase in production bottlenecks, output being increasingly constrained by a lack of capital and hiring difficulties. Finally, the ingredients for a convincing wave of investment were there. Unfortunately, these bottlenecks have now completely disappeared. We thus think that corporate investment is unlikely to re-start soon, even amid the news flow improvement.

Moreover. while the balance of immediate risks is improving, we need to take another look at "old headwinds".

First, we should remember that the slowdown in Chinese demand started before the "trade war" and is likely to continue after (and if) it stops. Potential GDP is increasingly impaired by the demographic challenges, while the transition to a less capital-intensive growth model is also weighing on trend growth. The Chinese authorities have showed some restraint so far in their stimulus which probably reflects their willingness not to foster more domestic financial imbalances. If the impact of the trade war fades in 2020, we think they will be ready to show even more restraint and tolerate a further, gentle decline in GDP growth next year.

Second, on average in the euro area corporate profits have diminished on trend as a share of output. It is particularly striking in the case of Germany. This is another reason to be cautious about any rebound in business investment next year.

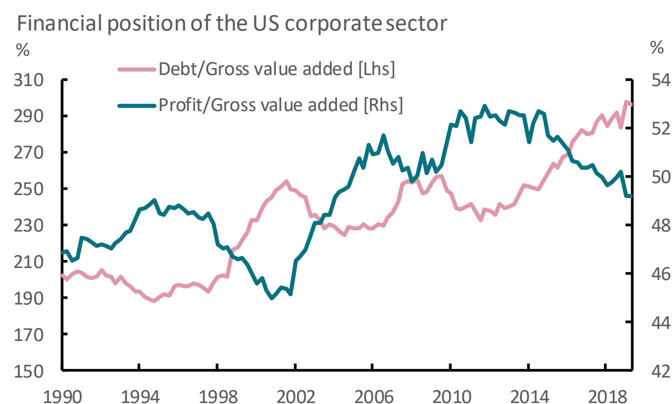
Third, in the US households have become less spendthrift while businesses have been leveraging up.

The US personal saving ratio has not started to converge back to the abysmal level it had reached before the Great Recession (3.7% in 2007), despite the extraordinarily low level of interest rates and unemployment. If anything, it has continued to edge higher lately (8.1% in Q3 2019, from 7.5%

in Q3 2018). This might reflect a willingness to build precautionary savings while the memory of 2008 lingers, but we think more likely reflects demographic factors. This creates a "speed limit" to consumer spending.

Corporate debt has soared, and business profitability has deteriorated (Exhibit 2). This is not a major issue at the current juncture given the low level of interest rates – debt servicing is not impairing current expenditure – but gradually decision-makers in corporate America may be less keen on continuing to take more debt while scaling down a bit on their labour expenditure to preserve their margins.

### Exhibit 2: Watch corporate America's numbers




*Source: Datastream and AXA IM Research, as of 25/11/19*

Finally, new sources of uncertainty have emerged. In the US, the most immediate impact of the impeachment saga is to boost the most radical Democratic candidates in the Primaries. With their regulation and tax-heavy platform, they may further add to the wait-and-see attitude on corporate investment decisions. In Europe, even if "no deal Brexit" is probably off the table, if the Conservatives win the General Election, a very painful negotiation process around a Free Trade Agreement with the EU will start, generating quite some noise. In the euro area, while political developments in Italy have allowed to defuse the tension with the European institutions, instability could come back there on the back of daunting regional elections and potential referendums. In Spain, the centre-left/radical left new alliance won't be able to count on a stable majority while testing the limits of the country's fiscal room for manoeuvre.

All in all, we think most major economic regions will see GDP at or slightly below its potential growth, with the exception of the key emerging countries outside China. Indeed, 2019 has been a very tough year for Turkey, Brazil and Mexico. A mechanical rebound is likely, especially since a more accommodative monetary policy in the developed world will ease external financial pressure on these economies.

## What's to stop the global economy to fall below "stalling speed"?

It is very rare that GDP growth stays in line with potential for very long. From that base, any tiny shock and the labour market starts deteriorating and the usual accelerants play their part. What often nudges the economy towards the sunny uplands of strong growth is a nice policy push. We do not think this will be forthcoming and, consequently, we expect global growth to slow further towards the end of 2020 and in 2021, to a state of quasi-stagnation.

True, the Fed has been pre-emptive this year, but we should balance its willingness to act fast with the quantum of accommodation. Using the Fed's own model, the 75bps in cuts amounts to a stimulus of 0.3-0.4% of GDP, not enough to fully offset the previous tightening. We think the FOMC will be forced to ease further at the end of 2020 when it realises that overcapacities are rising again, but this would be more reactive than pre-emptive, and even if the Fed goes "all the way" the quantum of support should not be overstated (bringing the Fed Funds to zero would lift GDP by 0.8%... after two years). We also need to take the fiscal side of the equation into account. In 2019, we were still benefiting from the last ripples of the 2018 fiscal push in the US. The fiscal room for manoeuvre is now non-existent in America, with a deficit close to 5% of GDP, especially in an electoral year with a divided Congress.

In Europe, monetary policy has reached its limits and even the centrists within the Governing Council have been highlighting the side-effects of its non-conventional instruments. On the fiscal side, the only relevant space is in Germany. There we think that in 2020 automatic stabilisers will be allowed to play but we don't think a proper discretionary push will come before 2021, when the signs of a slack on the labour market accumulate. The political and institutional hurdles for a fiscal stimulus are high there and we think budgetary policy can only be reactive, not proactive.

## How to trade such macro scenario?

Monetary policy has amplified an already strong "grab-for-yield" environment. As a result, performance has been solid across fixed income. The focus is shifting away from conventional policy tools, as central banks are in the process of re-thinking their strategy and their instrument mix. Looking ahead, elements of risk in fixed income such as low volatility, negative-term premia, liquidity risk, are likely to affect performance in the rates markets.

With risks facing the global economy moderating at the moment and interest rates remaining very low, we keep a constructive stance on equities moving into 2020, with a bias towards undervalued cyclical plays in the US, and towards select high dividend yield exposure with adequate free cash flow cover in the euro area. 2021 would be more challenging.

# Investment outlook – 2020: Approach with cautious optimism

By Chris Iggo

## Key points

- Monetary policy and other policy initiatives have likely decreased the chances of developed economies stalling in 2020
- As a result, we see 'bear-market' moves as a tail-risk rather than a base case
- However, the macro outlook, coupled with current valuations, means we are unlikely to see 2020 returns matching those of 2019

For the past two years, investors have feared that the global economic slowdown could eventually turn into a typical end-of-cycle recession. However, recent months have witnessed these anxieties fade.

Monetary policy, together with an easing in global economic uncertainty, could even potentially extend this already prolonged cycle beyond the scope of this current outlook.

As such, we do not believe that there will be a bear market in risk assets in the next 12 months. However, our optimism is tempered, and it will be hard to match 2019's returns in either bond or equity markets.

Valuations are rich in many areas – bond yields are already lower than they were at the start of 2019, while equity ratings are higher. Additionally, if there are risks to the macro outlook, they are biased to the downside – even if sentiment is potentially boosted by positive developments on issues such as trade and Brexit.

## Monetary policy: Likely to stay on hold

What we can have some confidence in is that the interest rate environment is not likely to change much. The pivot from tightening to easing by the Fed at the end of 2018 paved the way for more rate cuts in 2019 while for its part, the ECB delivered further easing in September.

For now, there appear to be few reasons for additional loosening and the modest pick-up in bond yields in the fourth quarter seems to suggest that markets are not looking for it.

Indeed, to achieve the same level of return in the coming year as those achieved in 2019, yields would have to fall a lot further – in many cases to new lows. And only if the economic situation deteriorates significantly would we likely see such an occurrence. Perhaps what is more probable at this stage is somewhat better news on the macro side and modestly higher yields.

## Bonds: Watch out for volatility

Looking ahead, we don't see significant directional moves in fixed income – not when monetary policy is anchoring interest rates at such extremely low levels. Global capital flows are also important. Should US Treasury yields rise to the 2.0% to 2.5% range, investors from Europe and Japan are likely to become buyers, given the low yields on offer in their domestic markets. On the credit side, despite the economic cycle being somewhat long in the tooth, there are few signs of a significant deterioration in the credit cycle.

Low interest rates help – and so does the broader monetary policy environment. Our high-yield teams expect default rates to remain low. A bias towards corporate assets in the bond market might continue to be rewarding. In Europe, the fact that the ECB has re-started buying corporate bonds is also a strong support for credit spreads remaining relatively tight.

A significant bond bear market would require a more dramatic inflexion point in the economic outlook. I am sure that most readers don't attach too much probability to the Fed hiking rates again any time soon, or for inflation to surprise on the upside.

Nor is there much chance of European governments going on a spending splurge – except perhaps in the UK given the promises made during the general election campaign. Europe needs more expansionary fiscal policy and more supply of highly rated government bonds but that is not going to happen quickly.

Nevertheless, we should not rule out possible bouts of bond market volatility. Given the low-yield environment, we favour strategies that limit volatility, focus on income returns and/or are diversified and flexible enough to generate steady returns through active allocation to the parts of the market offering the most value.

For the former, short-duration strategies have a strong track record of limited downside participation in bear markets, while matching a good part of the upside when markets perform well. This is especially the case in the higher beta parts of the market like high yield and emerging market debt. In our view, these strategies seem well suited to the current market outlook.

## Equities: Dominating the yield hunt?

Right now, our multi-asset team's stance is to be more optimistic on equities from a cyclical point of view. Supportive policy and some hope of resolution on the trade war and Brexit should underpin positive sentiment in equity markets. Where there is scope for some upward revision to growth, e.g. Germany and China in an improved global manufacturing scenario, or the UK post a soft-Brexit deal, we could see an improvement in relative equity market performance.

Growth should re-assert its dominance over value in a modest economic growth scenario with low interest rates. Cyclicals are still very cheap relative to bond-like defensives and some further valuation adjustment could take place. While it is less obvious in the US, many equity markets and sectors have a dividend yield that is superior to those offered by bonds.

Income investors are likely to continue to find more rewarding opportunities in the stock market than in fixed income, especially in Europe where much of the bond market is in negative-yield territory. However, exposure to a global inflation risk-premium through inflation-linked bonds and to higher bond income through European high-yield is a useful complement to our tilt towards equity markets. Our multi-asset team believes that this environment is suitable to their outcome-oriented solutions i.e. growth, income, impact and purchasing power maintenance.

## Active ESG: The only way ahead?

Looking ahead to 2020 and beyond, I expect two themes in particular will continue to dominate investor debate - passive and active investing, and the greater need to account for environmental, social and governance (ESG) considerations in investment decisions. At AXA Investment Managers, we characterise ourselves as active, long-term, and responsible investors. While getting access to market beta via a passive approach has its merits, we see the argument as being much more nuanced than simply one style being better than the other.

Our view of what constitutes active management is not simply about outperforming an index. It is about providing solutions to investors by addressing their return objectives, whatever they might be. Active management is about providing investors with choice and flexibility. A short duration strategy in fixed income might not be 'active' in the sense that there is a lot of rotation between sectors and parts of the curve, but it represents an 'active' choice as it targets a specific return profile.

Similarly, the provision of thematic investment choices is an 'active' choice, built on our view of how we see the global economy evolving over the long term on the back of major demographic and technological advancement and change.

Today active also means implementing ESG factors into investment decisions – which a passive approach cannot do. Investors want their capital to be invested in companies that can contribute to the alleviation of climate problems, social injustices and questionable business practices. We firmly believe that this approach will not only help make the world better but potentially reward investors with superior performance over the long run.

As an active investor we devote substantial resources to researching and assessing ESG factors in the same way we assess business models, margins and credit risk. Active management means striving to find the best risk-adjusted returns. But an increasingly vital part of this process is identifying risks and the long-term sustainability of our investment strategies.

# US – Dropping below stall speed

By David Page

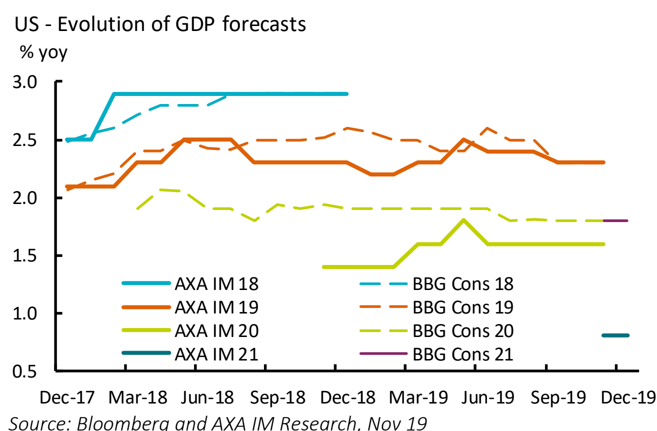
## Key points

- Uncertainty over trade policy and the 2020 Presidential Elections are key unknowns in determining the US outlook for the coming years.
- On balance, economic headwinds look set to dominate tailwinds. We forecast growth slowing to 1.6% in 2020 and slowing further to 0.8% in 2021.
- Further slowing in 2021 risks the economy falling into ‘stall speed’. The Fed should begin to ease policy in Q4 2020 as it anticipates this outcome.

## Near-term risks cloud medium-term outlook

With GDP reported for most of 2019, our conviction for 2.3% expansion grows. Exhibit 1 shows we have held this view for a while, with more recently consensus moving in line. But 2019 saw a more material shift in dynamic, with the Fed cutting rates three times in 2019 – where we expect it to finish – rather than hiking, as we had expected a year ago. The single biggest cause of this shift has been the rise in business uncertainty associated with a more aggressive than anticipated US trade policy – impacting global trade, activity and business investment. As we look to 2020 and 2021, the evolution of near-term uncertainties will continue to have a material impact on the outlook for the next two years, threatening to dominate medium-term economic factors.

Exhibit 3: Evolution of forecasts




*Source: Bloomberg and AXA IM Research, Nov 19*

The US administration appears to have adopted a more conciliatory approach to trade policy recently. We currently expect a “Phase 1” interim trade deal to be agreed between the US and China in December. This limited deal should defer further tariff increases for increased purchases of US agricultural products and improved access for US financial services firms into Chinese markets – a deal that could have been struck in 2018. The thornier issues, of intellectual property protection, forced technology transfer and state subsidy, look set to be deferred to subsequent rounds of negotiations. The US has also delayed the threat of automobile tariffs and we expect both issues to be deferred until after the 2020 Presidential Election.

Next year’s Election is also likely to play a direct role in raising uncertainty. Democrat candidate Elizabeth Warren has closed the lead on front-runner Joseph Biden. Warren is a more extreme Democrat and could struggle to win over the Republican moderates needed to secure victory. But if she did, business’ concerns about her agenda could result in a fall in business sentiment – a reverse of the ‘Trump bump’. The Democrat selection process is in the early stage and Warren’s success is not guaranteed – but remains a risk.

The current impeachment process also means there is no guarantee that President Donald Trump will stand next year. We expect the House to pass Articles of Impeachment formally indicting the President by year-end. It is difficult to envisage enough Republican support for a two-thirds impeachment majority at present. Yet this will likely depend on the public view. Since the Ukraine scandal, polls show public approval for impeachment has risen to 50% from 40%. If public hearings see this climb above 60% – the level approving former President Richard Nixon’s impeachment – senators may be influenced. For now, this looks unlikely, but it is no longer a tail-risk.

## Economic headwinds to slow growth further

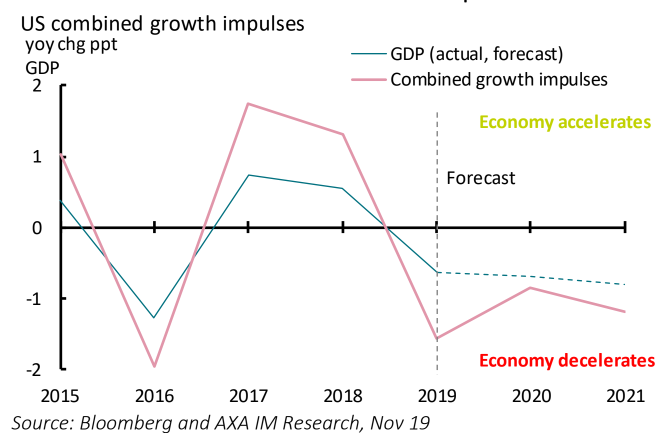
Looking beyond these uncertainties, medium-term economic factors look set to add headwinds to growth – albeit modestly next year, but more aggressively in 2021.

President Trump’s Tax Cuts and Jobs Act 2018 provided a marked fiscal boost in 2018, which faded, but still supported growth in 2019. Residual fiscal support falls away in 2020. Congressional Budget Office projections based on current legislation suggest a tightening in the fiscal stance in 2021.

Deteriorating credit conditions also look likely to weigh on growth. Mortgage credit conditions have tracked the slope of the yield curve with a two-year lag. This suggests this year’s curve inversion should result in tighter mortgage credit conditions over 2020 and 2021, which we expect to weigh on residential investment against a backdrop of weakening real disposable income growth. We also expect an ongoing modest tightening in credit spreads – something also seen in the latter 1990s and an additional headwind to US activity.

These factors should be somewhat offset by monetary policy no longer restraining growth. A combined policy of balance sheet unwind and rate hikes slowed growth by an estimated 0.7ppt in 2019. Although lags in monetary policy suggest this year's easing will not support growth until 2021, the lagged impact of tightening should fade in 2020. We also expect a modest boost from global trade, as stabilisation associated with an interim trade deal emerges. Yet despite stimulus across a range of economies, the degree of stimulus and the scale of expected rebound should be modest compared with previous mid-cycle dips, particularly from China.

Exhibit 4: Economic headwinds set to persist




*Source: Bloomberg and AXA IM Research, Nov 19*

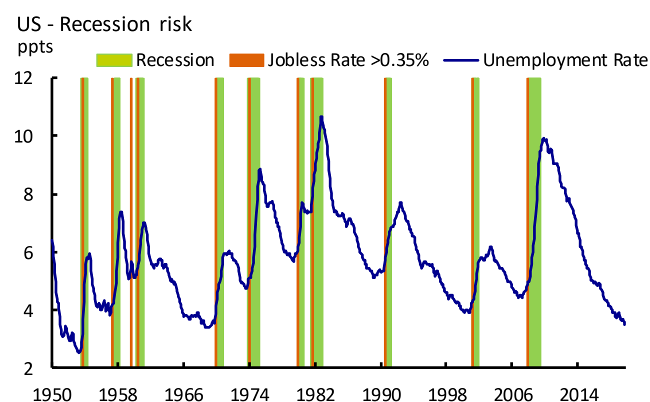
## Accelerators and stall speed

We estimate 2020 growth of 1.6%, although we consider risks to the upside, reflecting Fed stimulus and the outlook for global trade. We consider this to be around potential. Any further slowing into 2021 risks the economy dipping below 'stall-speed', which could derail the expansion.

A number of elements could accelerate a downturn. Unemployment in the US rarely rises gently. Exhibit 5 shows that, with one exception, each time the unemployment rate has risen by 0.35ppt from its latest nadir, it has resulted in recession and a more material jump in joblessness[1]. This likely reflects reduced consumer and business spending as job losses rise, creating a second-round growth effect. We forecast growth to slow below trend in 2021, consistent with a rise in unemployment that could trigger this reaction.

Moreover, financial conditions often exacerbate slowdowns. Equity markets tend to pre-empt deceleration, but a drop in equities can affect consumer spending through sentiment and wealth effects. Moreover, while we do not consider corporate debt levels to be problematic, a downturn would inevitably widen corporate spreads, reducing firms' ability to borrow and spend. As such, market concerns for a downturn can tighten financial conditions, reinforcing a slowdown.

Exhibit 5: Evolution of forecasts




*Source: Bloomberg and AXA IM Research, Nov 19*

Acting together, these accelerators can combine to result in recession. But it is difficult to anticipate the timing of this combination with any precision. Our forecast for growth slowing to 0.8% in 2021 assumes these accelerators are at work and could include quarterly contraction.

## Uncertainties and the role of the Fed

Downturns are often a surprise and it is a valid to ask whether anticipation of a slowdown is sufficient for prevention. The Fed anticipated some softening this year, easing monetary policy[2] as insurance against a sharper slowdown. However, lags in monetary policy mean the Fed would have to perfectly anticipate future deceleration and act early in 2020 to offset risks for 2021.

Historically, the Fed has rarely managed this. Moreover, it currently sees the economy "in a good place" stating that conditions would have to change "materially" to warrant further easing. Our outlook sees the Fed on hold now until Q4 2020. By then, we expect signs of renewed deceleration to lead the Fed to cut rates twice in 2020 (to 1.00-1.25%) and to its effective lower bound in 2021. Yet such renewed easing would not meaningfully boost growth until after 2021.

Forecasting the timing of below trend slowdowns is difficult. Extrapolation risk leads us to project current conditions into the future. Telescoping risks immediate materialisation of a future forecast. And material downturns have historically been associated with exogenous geo-political events. This returns us to whether the 2020 Election will reduce the risk of further slowdown. We have argued it is too early to be sure. However, a second term for President Trump could renew trade tensions, whereas a Warren Presidency could prompt a fall in business sentiment. Alternative outcomes are possible, but these scenarios appear the most likely at this time, suggesting next year's election is likely to add to the prospect of slowdown, rather than reduce it.

[1] The Fed's Claudia Sahm has observed a similar effect based around a 0.5% adjustment – the "Sahm rule".

[2] The Fed reduced its Fed Funds Rate by 0.25% in July, September and October to the current 1.50.-1.75%.

# Eurozone – If only countries could give themselves a leg up

By Apolline Menut

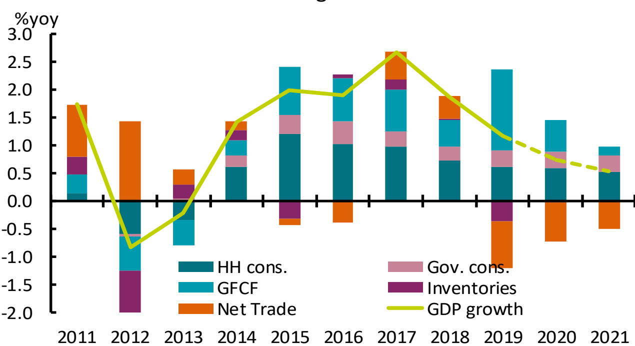
### Key points

- Euro area growth should continue to slow in 2020, falling to 0.7% from 1.2% year-on-year, as spillovers to the broader economy outweigh any globally-driven improvement in manufacturing and trade.
- The ECB has reached its limits and its main challenge will be to keep face while doing nothing. We expect an unchanged deposit interest rate throughout 2020. Some much-awaited fiscal easing should help in 2021, but progress on euro area integration – fiscal mutualisation, banking union – are likely to be scarce.

## 2019 growth dragged down by weak trade…

After an already sharp slowdown in 2018, economic activity in the Eurozone lost further steam in 2019. We expect it to round up the year with an average growth of 1.2%yoy, down from 1.9% in 2018. The highly uncertain external environment and global manufacturing downturn are the main culprits behind this deceleration, weighing on net trade (Exhibit 6[3]). Meanwhile, domestic demand has been broadly resilient. Private consumption growth slowed only marginally – to 1.2% in 2019 so far from 1.4% in 2018 – and services sector growth remained solid, despite four quarters of contraction in its industrial counterpart.

Exhibit 6: Domestic demand to weigh on 2020 growth



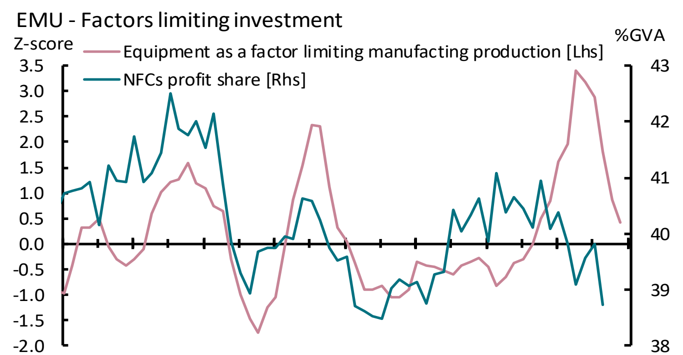

*Source: Datastream and AXA IM Research, as of 18/11/19*

At a country level, Germany – the most export and manufacturing-oriented economy – is suffering the most. We see 2019 growth at 0.6%yoy, half the 1.3% pace seen in France, where targeted fiscal stimulus and the more inward, services-based structure of the economy have helped. Italian growth has been dampened by political uncertainty (0.2%yoy), while in Spain growth is resetting after several years of above-potential growth (2.0%yoy).

## …with negative spillovers on investment into 2020

The main question looking ahead is whether the resilience of the domestic sector will be maintained. We expect that spillovers to the broader economy will increase over time and likely outweigh any globally driven improvement in manufacturing and trade. Despite some respite recently, uncertainties persist: Brexit discussions still focus on the transition period, with no-deal risks at the end of 2020. In addition, a US/China trade agreement remains elusive, and the threat of US tariffs on European Union autos remains a risk for 2020. We would need to see a credible removal of these uncertainties to forecast sequential acceleration in euro area growth. Instead we expect growth to hover around 0.2% in the coming quarters, averaging 0.7%yoy in 2020.

Exhibit 7: Investment dragged down by low profitability




*Source: Datastream and AXA IM Research, as of 18/11/19*

We see private consumption easing slightly as job creation slows, real disposable income moderates and the saving rate continues to edge up amidst persistent uncertainty. More importantly, investment should lose impetus in 2020, dragged down by several factors. First, after remaining solid in 2019, the European Commission survey shows that equipment is now a less limiting constraint to production (Exhibit 7) and a declining rate of capacity utilisation (the lowest since Q3 16) signals reduced need for capital expansion or upgrade. Second, the weaker external environment embodied in our forecasts of lower US and China growth should weigh on firms' investment incentives, while net trade would remain a drag. Companies' demand for credit has already softened, as per the Q3 ECB Bank Lending Survey, and the latest credit data suggest that the peak of credit growth is behind us. Finally, profitability should continue to suffer in an environment of still decent wage growth but sluggish productivity. Our outlook for 2021 is highly dependent on our US and China growth forecasts, and given our bleak scenario, we see 2021 Eurozone growth at just 0.5%yoy.

[3] The investment profile is blurred by large swings in investment Irish data.

Below-potential growth means inflation should remain depressed over the coming years. Core inflation has hovered around 1.0%yoy in 2019. We expect it to rise at a broadly similar pace of 1.2% in 2020 and 1.1% in 2021, as a shrinking output gap, inertia and weak inflation expectations should keep counteracting wage growth.

## The ECB challenge: keep face while doing nothing

Will that push the ECB to ease monetary policy further? In our view, the short answer is no. We think the deposit rate has bottomed, even with the mitigation brought about by tiering. We are not so concerned about the "reversal rate" – the point where policy easing becomes counter-productive from a technical point of view – than the social and political costs of reducing rates further into negative territory. Generating negative income for savers and twisting capital allocation can end up triggering a backlash against the central bank.

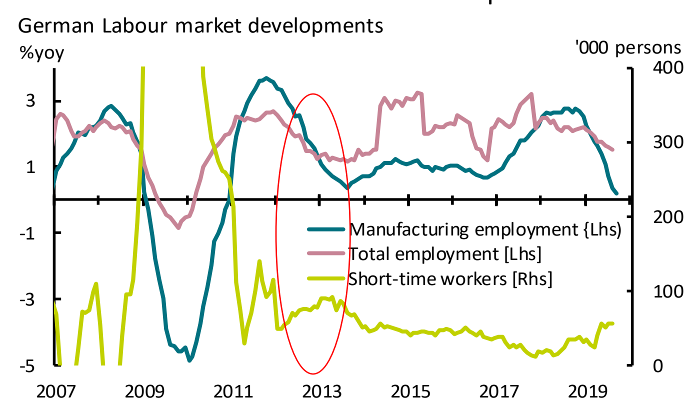
Dissent within the Governing Council against September's renewed quantitative easing cannot be ignored when considering future balance sheet policy. Estimates suggest that QE could run at the current pace until mid-2021, before the question of the 33% issue/issuer limit rises. Until then we expect new ECB President Christine Lagarde to build on former President Mario Draghi's rhetoric i.e. that monetary policy has reached its limits and can no longer bail the euro area out of every cyclical shock without the help from fiscal policy. The ECB strategy review, which will likely drag into mid-2020 – the preceding review lasted six months – may provide another excuse for inaction. Nor do we exclude the risk that the ECB framework review ends up in an exercise of reverse engineering. That could mean, for example, the ECB opting for a change in the definition of the inflation target – for instance to a range – to justify the practical impossibility for monetary policy to do more.

## Better late than never: German fiscal reaction

In this context, all eyes are turning to Germany, the only country to have both the fiscal space and the ability to trigger positive spillovers for the euro area as a whole. We think the labour market is key. If public opinion remains largely oblivious of the cyclical deterioration because the labour market remains resilient, Berlin would probably still refrain from any fiscal push.

However, the latest signals show a significant deceleration in job creation and not only in the manufacturing sector (Exhibit 8). We are not far from the pace of employment growth recorded during the 2012-2013 technical recession, which did not trigger a reaction from the government. Greater damage will likely be needed to trigger policy action, but we think we will get there in 2020. In particular, we believe that the government will ease access to "Kurzarbeitergeld" – the short-term worker funding where the government pays 60% of workers' income shortfall for up to 24 months, if companies reduce their workload temporarily in a downturn. This would strengthen Germany's automatic stabilisers and equate to a temporary fiscal boost. Other measures could include support for families and a corporate rate tax cut, although the latter is more controversial within the grand coalition. Another boost, of €10.9bn per year, or 0.3% of GDP, should come from the abolition of the solidarity income tax surcharge for 90% of taxpayers from 2021, despite a regressive composition. Overall, these measures could see fiscal stimulus of around 0.7% of GDP to German growth in 2020-2021 but it will be tied to a worsening labour market

Exhibit 8: German labour market developments matter




*Source: Datastream and AXA IM Research, as of 18/11/19*

## Domestic challenges mean European inertia

Even if we were to get a broad-based fiscal push across euro area countries, we remain sceptical of the possibility to advance on fiscal mutualisation. For that, we would need political will and a clear consensus within the European Council. The fact that a lot of national governments are busy facing significant existential issues on their domestic turf will likely result in political inaction at the European level. Italy's new coalition is fragile, Germany is dealing with its own challenges as Angela Merkel's leadership is fading, France is getting ready for another winter of protests that could materialise in votes in the Spring municipal elections, and Spain is struggling with political paralysis. The European Council's Budgetary Instrument for Convergence and Competitiveness is a wasted opportunity, reflecting division amongst members over further integration leaving it small, co-financed and with almost no potential role for stabilisation. Separately, the recent proposals by the German Finance minister for a banking union contained a lot of red lines. We fear that European structural features will remain fragile, despite the current predicament calling for action. This will be a risk if a more pernicious slowdown were to materialise.

# UK – Life after Brexit

By David Page

## Key points

- The General Election on 12 December will determine the path of Brexit. We expect a small Conservative majority, which will deliver Brexit on 31 January 2020.
- Growth in 2020 will reflect a trade-off between economic uncertainties and degrees of fiscal easing in a range of scenarios. We expect GDP growth of 1.2%.
- By 2021, UK growth should re-engage with global trends. There is a risk this will come at a time of renewed global softening, dashing hopes for a post-Brexit recovery.

## Election outcome governs the short-term

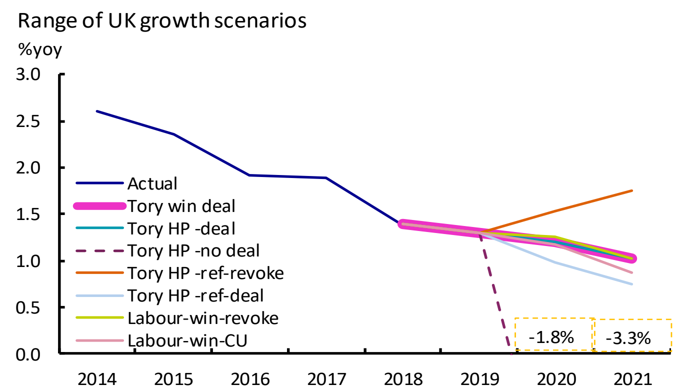
The immediate outlook for the UK remains tied to the path of Brexit and the result of the 12 December General Election will be critical. At the time of writing, the Conservative Party has a solid lead in the polls and Prime Minister Boris Johnson is substantially ahead of Labour leader Jeremy Corbyn. What's more, the Brexit Party has pulled out of contesting the 317 seats that the Tories took in 2017 to avoid splitting the leave vote. We expect the Conservatives to win the election by a small majority. This should allow passage of the Withdrawal Agreement Bill and deliver Brexit on 31 January.

Such an outcome would move the Brexit process along, it would not "get Brexit done" – as Johnson has promised – removing it from business considerations. Brexit's main impact has been to raise uncertainty and hobble business investment. Passing the Bill should reduce that uncertainty, but the Tories now suggest not extending the transition phase beyond 2020. This risks the UK leaving current (EU) trading arrangements in 2021 without a replacement agreement, reverting to World Trade Organization trade terms with the EU – significantly increasing trade barriers. This commitment is likely political and should reverse next year. However, its effect will be to keep uncertainty high and squander the prospect of a business investment recovery.

Material pledges of fiscal easing should offset some of this ongoing uncertainty, with the Tories proposing a new, long-term fiscal rule to balance government spending *excluding investment*, subject to limits on investment and debt interest spending. This should see an easing in the fiscal stance of around 0.7% of GDP in 2020-21, with modest further easing in subsequent years. The net effect should be to underpin quarterly growth in 2020, quickening to 0.4%, from a 0.25% expected average in 2019. Annual GDP growth would remain subdued at 1.2% in 2020, from an estimated 1.3% in 2019.

Different electoral paths are possible. The most contrasting would be a Labour-led Parliament. This would lead to a second referendum – which could deliver a closer post-Brexit trading arrangement, or revoke Brexit altogether. This more business-friendly Brexit outlook would, however, be overshadowed by Labour's broader radical economic agenda, presenting business with fresh uncertainty. Admittedly, Labour's fiscal programme would provide a significant boost to GDP, replacing private with public investment. We forecast this would see similar growth in 2020, marginally faster expansion in 2021[4]. Exhibit 1 considers different scenarios.

Exhibit 9: GDP outlook highly dependent on election result




*Source: ONS and AXA IM Research, Nov 19. NB HP=Hung Parliament*

As Brexit begins to diminish in importance, trends in global growth will reassert their predominance for the UK outlook. Global activity should start 2020 on a firmer footing, with trade tensions receding somewhat. However, our longer-term outlook sees renewed weakening in US activity, further slowing in China, and a continued softening in Eurozone growth in 2021. The UK's tentative pick-up – underpinned by easier fiscal policy - should allow UK outperformance of other developed economies in 2021. But we still see quarterly growth stalling, resulting in slower annual growth of 1%.

Monetary policy will hinge on the shifts in the economic outlook. Quicker growth in 2020 would reduce the downside risks that the BoE has indicated could require "further [policy] support". However, any period when the Bank is likely to consider withdrawing policy stimulus will probably be curtailed by renewed signs of global weakening. We forecast the BoE to leave the Bank Rate unchanged at 0.75% across 2020, but we expect global slowing to see the rate cut back to 0.25% in 2021.

[4] Page, D. and Kerr, A., "UK faces Brexit-fuelled General Election – what happens next?", AXA IM Research, 14 Nov 2019.

# Japan – The land of the rising sun… and falling growth

By Hugo Le Damany

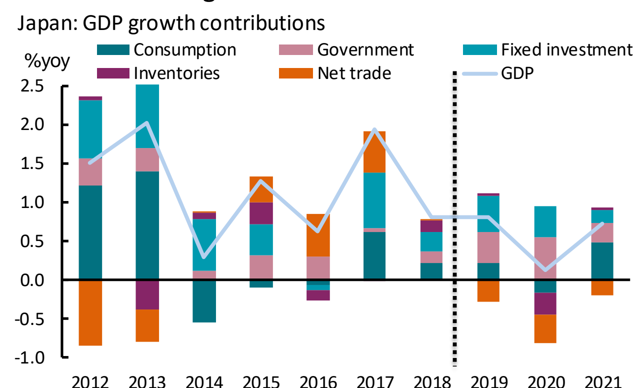
## Key points

- Japan is likely to face an economic downturn in 2020, impacted by both sluggish external demand and negative pressure from this year's sales tax hike. Modest fiscal easing could reduce downside risks.
- In 2021, a slight rebound in domestic demand is expected, but could be affected by likely further deceleration in the US and China.
- Overall, GDP growth is likely to fall to 0.1% in 2020 and recover in 2021 to 0.8%.

## Domestic demand is always the key

Domestic demand is set to slow in 2020 (Exhibit 10). The VAT hike will weigh on purchasing power into next year, but there are also more structural issues. Household precautionary saving has risen, despite continually rising disposable income. Changes to the public pension system and cutbacks in overtime payments remain the main concerns. Fiscal expansion might ease downside risks. The latest fiscal expansion was financed with revenue from the VAT increase as PM S. Abe has been wary of increasing government bond issuance. This included temporary measures to ease the pain on durable goods consumption and permanent one: offering free pre-school education from the age of three, improving the social security system and increasing the pension contribution. At the time of writing, the impact of the VAT hike is likely to be worse than expected and compounded by typhoon damage. This may prompt additional fiscal easing of around ¥5tn, to be voted upon in early 2020.

Exhibit 10: GDP growth and contributions




*Source: Cabinet Office and AXA IM Research, as of 18/11/2019*

Business investment – which equates to 80% of total investment – is likely to decelerate, negatively impacted by softer domestic. Private residential investment is also likely to be affected by the VAT hike and public investment should decline after the Olympic Games in July-August 2020.

Trade tensions have disturbed global demand and Japanese exports have not been immune. In addition to some signs of easing tensions between the US and China, Japan concluded a limited trade agreement with the US, increasing imports of agricultural products. Meanwhile the US lowered tariffs on some Japanese industrial goods exports, with a market-opening agreement on $40bn worth of digital trade. The agreement did not mention auto tariffs, which would remain a risk. Conflict with South Korea will also have to be monitored, as it weighed on both diplomatic and economic channels. Overall, we expect a stabilisation in exports in 2020 and only a modest rebound in 2021. Net trade should continue to contribute negatively.

Core inflation – excluding volatile components – remains muted at 0.3-0.6% since 2018, far below the BoJ's 2% target. The underlying pace of inflation will be difficult to gauge in 2020 with companies not fully passing the VAT hike into final prices and some government fiscal countermeasures, such as free education, being disinflationary. Further ahead, medium term inflation pressures look set to wane as growth falls short of potential, increasing the economy's excess supply. An increasing number of part-time jobs, and recent restrictions on overtime work, may also exaggerate labour demand. Recent labour market tightness has failed to deliver a material pick up in wages, suggesting a relatively flat Phillips curve. Import prices also present downside risks, as we do not expect a material pick-up in oil prices next year and the ¥ could rise later if US economic activity begins to soften again into 2021. Overall, core inflation should remain flat at 0.6% till 2021.

## The BoJ will remain under pressure

The BoJ will have to navigate a difficult landscape of a shrinking output gap, falling household confidence and risks of inflation expectations falling. This suggests the need for further monetary easing. However, the central bank has reached unprecedented levels in terms of balance sheet size and seems reluctant to cut rates further into negative territory. Further rate cuts could be counter-productive, weighing on household confidence and financial sector transmission. Changes tied to a Loan Support Programme and a modification of the current tiering system could alleviate the impact on banks, but would also depend on credit demand, which is already high. There is more leeway over asset purchases. Net purchases of Japanese government bonds have steadily decreased since the introduction of Yield Curve Control in 2016 and could be increased again, although scarcity could become an issue. Finally, the BoJ is likely to reinforce its communication on the entire yield curve and not just the 10-year target. We believe the BoJ will delay rate cuts for as long as possible, only acting if yen appreciation risks more obviously threaten the domestic economy

# China – Entering sub-6% growth amidst trade truce

By Aidan Yao

## Key points

- A structural slowdown will take the Chinese economy into a new chapter of sub-6% growth, starting in 2020
- But the economy may be near a cyclical trough and its subsequent recovery could be helped by a trade truce
- Prudent policy easing will continue to function as an auto-stabiliser should the labour market stay resilient

## New year, same challenges

After a moderate slowdown in 2018, annual growth is likely to have decelerated at its fastest rate in seven years to 6.1% in 2019. External shocks from intensified US/China trade conflicts, and a synchronised slowdown in domestic and global manufacturing growth, were the main culprits, creating a shock that Beijing's tepid stimulus could not fully offset. The economy is therefore expected to end 2019 on a soft note, recording its first sub-6% growth in the fourth quarter since the early 1990s.

Looking ahead, the 2020 macro picture will likely remain precarious. The raging trade war and cautious policy easing will likely compound the trend slowdown, taking annual growth to 5.8% in 2020 and 5.6% in 2021. Key to this forecast are three considerations: the evolution of "natural growth" in the economy, the prospect for the trade war, and the degree of policy easing from Beijing. We examine each factor in turn.

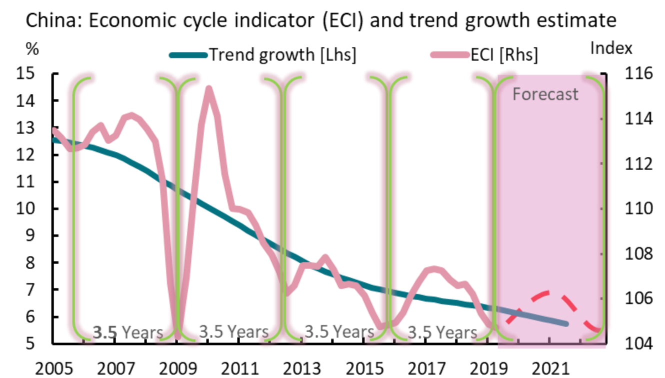
## Natural growth to gravitate lower

China's "natural growth" will likely slow further, even without considering any external and internal shocks. Our estimate of natural growth consists of two parts: a trend component and a cyclical component. The former is constructed by running a Hodrick-Prescott (HP) filter through official GDP and some third-party activity indicators[5]. Exhibit 11 shows this estimate as the blue trend line, which has declined at a steady rate of 0.2-0.3 percentage points (ppt) per annum in recent years. We assume a 0.25ppt trend growth deceleration to continue in 2020 and 2021.

The cyclical variation of the economy is shown by the pink line around the trend. This is captured by our Economic Cycle Indicator (ECI), which extracts the common trend among a number of short-term indicators that consist of both official and non-official data. A major finding of the ECI is a persistent duration of cycles that spans over 3½ years historically. If this pattern repeats itself, the current cycle – which started in mid-2016 – should be approaching an end in late-2019, giving way to a new cycle into 2020. We expect this cyclical component to subtract 0.1ppt from headline growth next year but add 0.1ppt in 2021 as growth rises above trend.

### Exhibit 11: Natural growth gravitates lower

China: Economic cycle indicator (ECI) and trend growth estimate




*Source: Bloomberg, CEIC and AXA IM Research, as of 17/11/2019*

Translating the above in economic language: the trend growth deceleration – driven by forces of ageing population and slower capital formation – should dictate a continued structural slowdown in well-followed indicators, such as industrial production and retail sales. The latter should, however, be more resilient in relative terms as economic rebalancing continues and further tax reliefs are likely for households. On the cyclical side, there are some tentative signs of stabilisation in trade, manufacturing and auto activities lately, which could be consistent with a bottoming of the cycle. Surveyed capacity utilisation is also near recent-year highs, suggesting scope for a capex recovery once the gloomy business sentiment subsides. An extended truce in the US/China trade war should, in our view, help to elicit a gradual pick-up in the ECI over the coming year.

## Tariffs continue to bite, but worst behind for now

Besides the natural growth slowdown, the economy will continue to endure shocks. The trade war has been a major driver of export and manufacturing weakness in the past year and will likely continue to influence the economy in 2020. Fortunately, progress in recent trade talks has brought the two sides closer to a partial deal, which – if signed – should help to halt further tariff increases in the near future. However, the bar for a material rollback of existing tariffs is much higher, in our view, given the significant gaps remaining

[5] See Yao, A "Unveiling China's Economic Cycle" AXA IM Research and Strategy Insights, March 2019

on thornier issues such as technology transfer, intellectual property protection and China's industrial policies.

The road ahead, therefore, remains long and treacherous. We think that US President Donald Trump will keep existing tariffs in place to force concessions from Beijing on structural issues. Without significant breakthroughs in future trade talks – difficult in a US election year – an extended truce that preserves the status quo in tariffs is the most likely outcome for 2020. The outlook beyond that will depend on next year's US election, with a second term for Trump threatening renewed tensions. Alternative outcomes would likely see continued negotiations but with less confrontational actions.

Without considering the long-term consequences of supply-chain readjustments, the immediate impact of tariffs on trade growth should fade after 12 months. This means that most levies imposed on Chinese exports in 2018 should fall out of annual growth calculations after 2019. What matters for 2020's growth is, therefore, tariffs imposed in May and September of this year, which we estimate will have a lingering impact of 0.2-0.3%. Compared to the 0.8% shock in the past 12 months, this is a smaller drag on incremental growth for next year.

## Cautious easing not enough to defend 6% growth

The escalation of the trade war has prompted Beijing to step up policy easing lately. Without this policy cushion, the economy would have fallen below 6% earlier. However, it is also true that Beijing has so far been more reserved with its easing operation than in past cycles, which we think can be explained by two reasons.

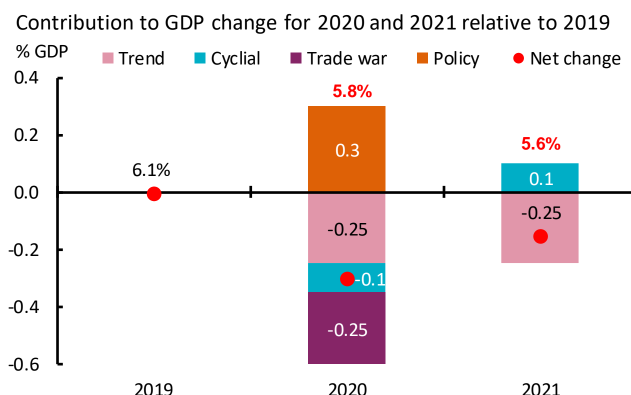
The first is an imperfect match between the desire and scope of using certain policy tools. On the monetary side, the People's Bank of China has plenty of room to cut interest rates and banks' reserve requirement ratio (RRR). Yet actual policy easing has been timid, due to a number of structural and cyclical concerns, including high domestic debt levels, rising food price inflation, housing market bubbles and excessive renminbi depreciation that could destabilise the financial system and antagonise trade negotiations. Also, the problem facing monetary policy now is more related to its ineffective transmission of cheap credit to the private sector than an overall lack of liquidity. Hence, simply cutting interest rates or RRR will not cure this structural ill.

In contrast to monetary policy – where the authorities have more scope than willingness to stimulate – the mismatch on the fiscal side is exactly the opposite. The aggressive tax/fee reductions suggest that Beijing is keen to deploy fiscal policy as its primary tool to rescue the economy. But with the budget deficit approaching 3%, and off-balance-sheet financing constrained by lower land sales and tightened control of local government debts, the scope for further stimulus has become more limited. How to extract more policy room and improve the quality of spending will be key to amplifying the fiscal power in 2020.

We think the other reason for Beijing's restrained policy response is the resilience of the labour market. While official labour market data has moderated somewhat, they are far from ringing alarm bells. This is partly because China's economic rebalancing has resulted in more jobs created by domestic-oriented sectors relating to consumption and services than by trade and manufacturing activities. In other words, the economy has become more insulated from the external and manufacturing slowdowns.

Overall, we think Beijing can afford to continue this prudent policy setting so long as the labour market stays resilient. We estimate the combined monetary and fiscal boosts will add 0.3ppt to 2020 growth. Since current tariffs would not cut 2021 growth and the economy may be growing above trend by then, we expect no more incremental policy easing beyond next year. Adding all of the above together, we forecast 2020 GDP growth to be 0.3ppt lower than 2019's at 5.8% and 2021's to be 0.2ppt lower still at 5.6% (Exhibit 12).

Exhibit 12: Growth enters sub-6% starting 2020




*Source: Bloomberg, CEIC and AXA IM Research, as of 17/11/2019*

## Don't discount upside risks

We see the risks around our baseline forecast as broadly balanced. A key downside risk is the housing market, whose surprising buoyancy this year could give way to a more pernicious downturn in 2020. Our forecast also makes no allowance for supply-chain adjustments in response to the trade war, which could have a lasting negative impact on the economy. More broadly, a sharper external slowdown could create additional headwinds for China's growth progress.

On the flipside, our expectation of a mere trade truce could prove too conservative if existing tariffs are rolled back. Such a move could significantly lift export growth, boost business sentiment and accelerate the capex recovery. Also, Beijing could choose to stick to its target of "doubling GDP" by 2020, which will require greater policy easing to keep growth at above 6%.

# Emerging Markets – tomorrow is another day

By Irina Topa-Serry

## Key points

- Growth has been weak in 2019, hurt by the US/China trade war and a series of idiosyncratic issues for countries such as India, Brazil, Mexico, Argentina or South Africa. We expect some rebound in 2020.
- Policy has generally turned more proactive. Fiscal policy has eased, and street protests could spur additional public spending even in more fiscally constrained economies. Central banks have also eased policy.
- The path of the US economy and dollar, developments in the trade war and shifts in Chinese stimulus will dominate developing countries' growth profiles, currencies and financial markets performance.

## 2019 growth undershot expectations

Ongoing weakness in global growth has been driven by a sharp deterioration in manufacturing activity, while higher tariffs and prolonged trade policy uncertainty have damaged investment and global trade. In addition, the automobile industry has been under pressure from a variety of factors, including new emissions standards in the euro area and China. The global tech cycle has been going through its own downturn too. We now envisage growth to be 0.6ppt weaker in EM in 2019 compared to 2018, slowing from 4.4% to 3.8% (Exhibit 13).

The trade war has made a crucial contribution to this slowdown but is not the only factor in play. Emerging Asia is expected to be affected by the ongoing trade tensions, but a few countries appear to be net beneficiaries from relocations of lost Chinese tariffed goods – likely Vietnam and to a lesser extent India. Most are, on balance, net losers – hurt by losses related to weaker Chinese demand, more than they gain from displaced US demand, with South Korea and Taiwan the most notable examples. Both economies have also suffered from a downturn in the tech cycle. Furthermore, domestic demand resilience faded throughout the region by mid-2019 and prompted us to revise down our growth expectations for Asia ex. China to 5.2% from 5.8%.

Central Europe (CE4) is also feeling the manufacturing slowdown, particularly given its close alignment with German automotive production. Nevertheless, the region remains strong by virtue of resilient domestic demand, supported by expansionary public spending policies, including strong EU structural funds. Growth in CEE remains solid around 3.9%, albeit weakening from exceptional levels of 4.6% in 2017 and 2018.

Exhibit 13: EM growth forecasts

| | Real GDP growth (%) | | | |
|---|---|---|---|---|
| Region/Country | 2018 | 2019 | 2020 | 2021 |
| **Emerging economies** | **4.4** | **3.8** | **4.3** | **4.2** |
| **China** | **6.6** | **6.1** | **5.8** | **5.6** |
| **Asia ex-China** | **5.8** | **5.2** | **5.3** | **5.5** |
| South Korea | 2.7 | 2.0 | 1.7 | 1.5 |
| India | 6.8 | 5.9 | 6.2 | 6.5 |
| **Latin America** | **1.1** | **0.1** | **1.7** | **1.3** |
| Brazil | 1.1 | 0.8 | 1.8 | 1.2 |
| Mexico | 2.2 | 0.0 | 0.9 | 0.5 |
| **Emerging Europe** | **3.8** | **2.9** | **3.7** | **3.4** |
| Russia | 2.3 | 1.1 | 1.5 | 1.7 |
| Poland | 5.2 | 4.3 | 3.5 | 3.0 |
| Turkey | 2.9 | -0.3 | 2.3 | 1.2 |
| **Other Ems** | **1.4** | **1.1** | **2.3** | **2.1** |

*Source: IMF and AXA IM Macro Research, as of 28/11/19*

Most of the disappointment in the growth projections for this year come from countries that we had expected to be more insulated from global trade tensions, but which suffered from idiosyncratic issues. In India, for example, trouble in non-banking financial corporations dampened everything from car to housing sales. Brazil's economic recovery from one of its worst recessions on record has been underwhelming overall, with policy uncertainty proving a drag on investment.

Meanwhile, mixed policy signals from the Mexican administration undermined business sentiment and depressed investment there. Neighbouring Argentina faced renewed economic pressure as the currency sank in the wake of a political comeback by the Peronists, reviving the spectre of debt restructuring. Russia had to absorb a sales tax hike imposed this year, while the administration kept a tight grip on its policy mix through the first half of 2019. Broad-based weakness took hold in South Africa, which has struggled with a constantly growing cost of debt. The contingent liabilities of state-owned enterprises, in a context of weaker global demand, have dampened public revenues and private investment.

## A better 2020: the laggards' comeback

While the global backdrop is not expected to improve significantly next year, nor is it expected to collapse. In this context, we expect some catch-up from those economies pressured by idiosyncratic issues this year. Meanwhile, monetary policy easing and fiscal packages should be supportive and encourage stabilisation. We forecast broader EM growth to recover to 4.3% in 2020.

South East Asian economies are likely to see growth continue to decelerate in 2020, albeit at a slower pace. Indeed, a partial trade resolution and the recent turnaround in the tech cycle may attenuate the slump in investment. Additionally, central banks have delivered an easing in financing conditions with monetary policy moves this year (Exhibit 14). There is still some scope for further interest rate cuts as inflation remains under control. Moreover, governments have implemented counter-cyclical fiscal policies to alleviate the slowdown. As mentioned earlier, India has been the unexpected laggard of the region in terms of economic performance, decelerating for the third year in a row – likely to sub-6% in 2019 from 8.2% in 2016. Fiscal stimulus via corporate tax cuts, more forceful reforms – such as labour market reform – and monetary easing – the central bank reduced interest rates this year by 135bps – should eventually help domestic demand recover. We expect Indian GDP growth to improve to 6.2% in 2020.

Exhibit 14: Past monetary policy supportive into 2020

*Source: AXA IM Research, as of 14 Nov, 2019*

Latin America's activity should begin to normalise from currently depressed levels, but rising social tensions remain a threat. Growth appears to be stabilising, albeit slowly. An investment slump should gradually recover, helped by monetary policy easing – both former and expected – in the region in a context of weak growth, limited inflation pressures, a global easing bias and generally tight fiscal policies. Brazil's reform agenda will continue beyond the diluted Social Security reform that has recently been approved by the Senate, while Mexico's 2020 budget continues to signal discipline. A gradual recovery from very depressed levels of domestic demand should be supportive next year. A better communication of economic policies by the administration of President Andrés Manuel López Obrador should bring recovery to construction and mining sectors in Mexico, while remittances and positive real wage growth support consumption. Exports remained relatively strong, indicating that a degree of US import substitution from China has taken place, and underlining the importance of the US-Mexico-Canada Agreement trade deal, which is still awaiting US Congressional approval. Brazilian investment should also recover gradually, reducing the economic slack. Fiscal policy will remain tight post-Social Security reform, allowing more monetary easing. We forecast Latin America growth to reach 1.7% in 2020 from 0.1% this year, but there is a risk of another disappointing year. The region remains dependant on the commodity cycle. Moreover, social tensions are becoming more visible in Latin America, with more populist leaders emerging in Brazil, Mexico, Colombia and Argentina, and street protests erupting more recently in Chile, Bolivia and Ecuador, raising concerns for the political stability of these countries. Argentina and Venezuela remain in very challenging situations.

Central European countries continue to show robust economic growth**.** While the region cannot remain immune to the Eurozone slowdown, domestic demand cushions the deceleration in manufacturing sector. Consumer confidence remains strong – close to historical highs – on the back of structurally tight labour markets supporting strong wage growth and still-subdued inflation. Public finances are sound, and governments can provide further stimulus in case of an abrupt slowdown. Abundant EU structural funds should continue to translate into robust investment activity in 2020. Turkey is also likely to see growth bottoming out**.** Investment collapsed following the sharp depreciation of the currency in 2018 which allowed the current account to balance and inflation to recede. The central bank cut rates massively, by 1,000 bps this year, while the government enacted significant fiscal stimulus. Most of the policy levers now appear exhausted – though the risk of over-reach is non-negligible under President Recep Tayyip Erdoğan's pressure – but the past stimulus is likely to allow Turkish domestic demand to recover in 2020. In Russia, a difficult external environment and US sanctions weighed on the economy this year. A less tight policy mix is likely to support Russian activity in 2020.

## As always, at the mercy of shocks

A rebound in EM growth in 2020 depends on a reversal of several factors seen in recent years, including global trade tensions, which brings downside risks. However, key EM regions would also be dependent on policy responses globally, particularly in the US and China. Additionally, the multitude of street protests reported around the globe – particularly in Latin America and the Middle East and North Africa – increases the political risks in these regions.

Looking at 2021, the pace of US economic deceleration should remain a major driver for EM economies and financial markets performance through risk on/risk off periods. Furthermore, the continuing deceleration of the Chinese economy should continue to be a drag on the Asian region and more broadly across emerging markets through trade links and/or the impact on commodity prices. A lot of the fiscal and monetary space will have been used, leaving the region more vulnerable to external factors and events. As such, we envisage emerging markets growth to decelerate in 2021 from 4.3% to 4.2%.

# Foreign exchange – US dollar tailwinds abate but carry still matters

By Romain Cabasson

## Key points

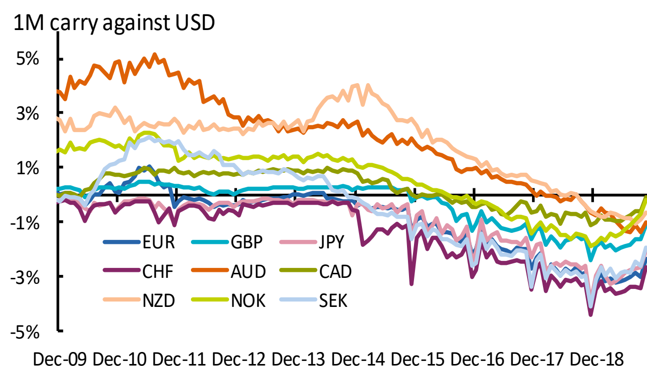
- Cautious optimism on global growth may finally be the catalyst for some US dollar weakness in 2020.
- However, this may not benefit the euro, as carry still matters a lot to investors.
- We believe the Canadian dollar is a better 'upside' choice than the Australian dollar, and the Japanese yen a better safe-haven than the Swiss franc.

## The case for US dollar weakness is growing

Downside economic risks to growth appear to have eased somewhat. The US administration appears more conciliatory over trade, actively suggesting an interim deal with China may be likely. This could take the October and December tariff hikes off the table – and maybe even partially unwind previous ones. Growth data overall has stopped deteriorating, and the market is now looking for signs of a growth rebound. Risk sentiment is turning cautiously – but undoubtedly – positive.

The bleak global growth outlook and fear of an escalating trade war have supported the USD, but this advantage may now disappear. Our signals have been already turning negative on the dollar as the Fed delivered its rate cuts and as the carry of holding long USD positions was slowly losing its shine (Exhibit 15). In fact, we believe that a shrinking carry trend is an effective signal of potential currency weakness, as following such a strategy delivers a Sharpe ratio of 0.5, reliably since 1998. Finally, political uncertainty is also now weighing in, with the US Presidential Election next year and an impeachment investigation in motion. As a result, we expect the monetary policy divergence that has driven USD overvaluation against other G10 currencies since 2014 to start unwinding (see Exhibit 18 for all references to valuations).

Exhibit 15: USD carry loses its shine

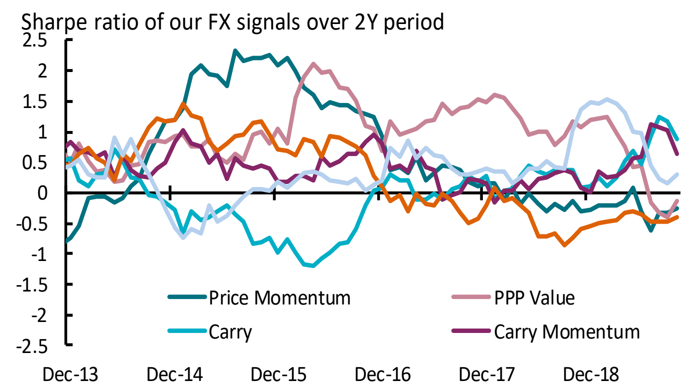



*Source: Bloomberg and AXA IM Research, as of 18/11/2019.*

## Unfortunately for the euro, carry still matters

Most central banks already maintain very low interest rates. As much as they would probably like to follow the Fed – and prevent appreciation pressure on their currencies from jeopardizing fragile domestic growth and inflation – they have little room to adjust lower. The euro should in theory benefit from a possible truce in the US/China trade war, which via the export channel affected the German economy. But it could take time before this translates into better Eurozone data, while the growth gap is for now still in favour of the US economy. So, we do not see the euro/dollar exchange rate rising sharply – or much further than $1.15 to the euro by the end of 2020. A fiscal stimulus – as called for by the ECB – would be very supportive, but also seems very hypothetical at this point, in the absence of extreme circumstances. Additionally, there is no overextended short positioning in the EUR (Exhibit 17) and thus there is limited risk for a sharp turnaround similar to the EUR appreciation in 2017. And most of all, the carry of being long euro against dollar is still quite prohibitive.

Exhibit 16: Carry strategies dominate



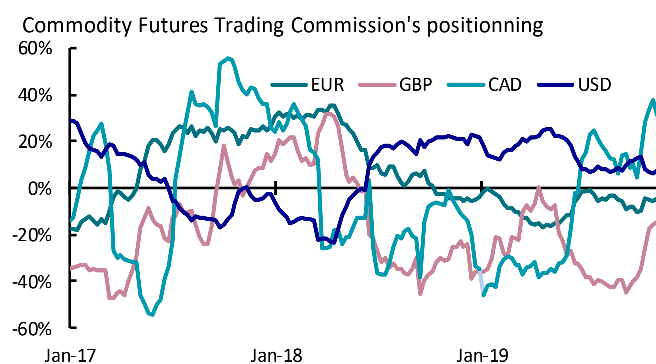

*Source: Bloomberg and AXA IM Research, as of 18/11/2019*

Carry strategies – borrowing at lower yielding currency to invest in a higher yielding one – have dominated in 2019 and we expect this to continue (Exhibit 16). Even if the market focus turns to domestic cyclical factors and regional relative growth rebounds, the potential of value strategies still appears limited. Unlike in 2017-18, central banks are unlikely to depart from their accommodative stance – and so the hunt for yield and low volatility should prevail. Moreover, if the Fed pauses, the dollar might temporarily recover against low yielding currencies. In the short term, in what should probably be a slow 'bottoming out' process, we think taking tactical positions on the euro/dollar exchange rate at the top and bottom of its current range can make sense.

## Carry, value and risk-on sensitivity – what else?

The CAD has become a proxy for the USD and we believe it has upside potential. It now delivers the same yield as the USD, while being significantly cheaper. It should also benefit from better risk sentiment through its dependency on oil. Even if sentiment relapses, CAD has been relatively spared in recent risk-off episodes compared to other commodity-driven currencies, exhibiting the volatility of safe-haven currencies. The Bank of Canada has recently adopted a more cautious tone, but given resilient inflation and wage growth, it is unlikely to cut rates unless the Fed does. Also, although long positioning is building up, it is not extreme (Exhibit 17).

Exhibit 17: GBP shorts unwind, EUR neutral, CAD longs rise



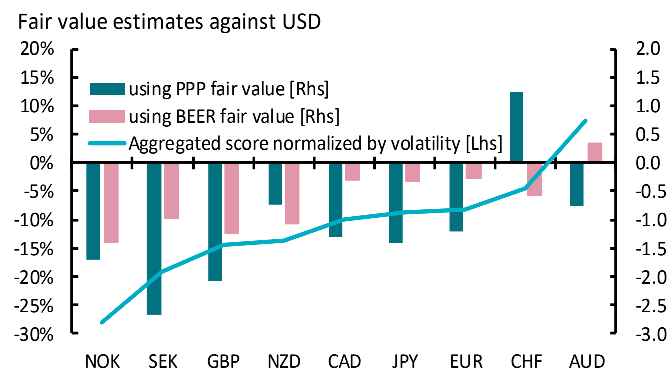
*Source: Bloomberg and AXA IM Research, as of 18/11/2019*

Like CAD, NOK is also offering USD-like carry at a cheap value. It is worth keeping an eye on, but for now broader European weakness, appear to be weighing it down. In regard to the GBP, a Brexit resolution should bring additional upside in the short term, if the Conservative Party wins a majority in the upcoming General Election. GBP is still significantly undervalued, and positioning is yet to turn positive, while carry remains attractive. However, a hung parliament – which would reinstate uncertainty remains a risk. Even if this is avoided, the longer-term outlook remains a challenge as negotiations with Europe on the future trade relationship unfold.

## Short at both ends of the haven-cyclical spectrum

Despite our constructive view on risk in the medium-term, we are alert on safe-haven currencies, given the fragile environment. We remain negative on the CHF, however, as it has proven less efficient in recent risk-off episodes. Repatriation risk is low, as most of the foreign exposure is held by the Swiss National Bank – and gains are limited as the bank has re-started currency intervention near current levels, to support its weakening export-oriented economy. Also, a short position in the CHF offers attractive carry. On the other end of the spectrum, we think the AUD should continue to underperform, despite an improving global outlook. Australia is facing weak underlying domestic demand and a softening labour market from already subdued levels. Unlike those of emerging Asian countries, Australian exports are more sensitive to decelerating Chinese growth than to the trade war impact on supply chains (Exhibit 19). The AUD is thus less likely to rebound, as the outlook for China remains fragile. The Reserve Bank of Australia has still room to cut rates, with a quantitative easing programme perhaps even on the menu. This should keep the AUD carry against the USD from rising.

Exhibit 18: Time for USD over-valuation to revert

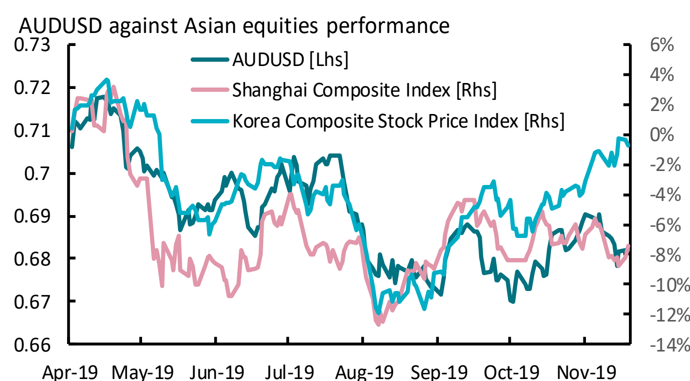


*Source: Bloomberg and AXA IM Research, as of 18/11/2019.*

## Sweden: hike by necessity – hapless currency

The Swedish central bank has scheduled a second interest rate hike in December that should bring back the local interest rate to 0%. This is unfortunately driven by concerns over financial stability and the efficiency of negative rate policies rather than confidence in the strength of the domestic economy. Growth and inflation have remained weak, and unemployment has risen, at odds with other developed economies. Demand from a highly leveraged household sector may not hold up. So, despite cheap valuation, the Swedish krona is unlikely to rebound.

Exhibit 19: China, not trade war, affects AUD



*Source: Bloomberg and AXA IM Research, as of 18/11/2019*

## Yen appreciation due, but not just yet

The Japanese yen has potential for appreciation – though not in the current risk-on environment. Undervaluation, its status as a safe-haven and not too large negative carry, make it attractive to hold when risk sentiment becomes fragile. There may be such occurrences in 2020, if global growth fails to stabilise and recession risks grow.

# Rates – Modest performance likely in 2020

By Alessandro Tentori

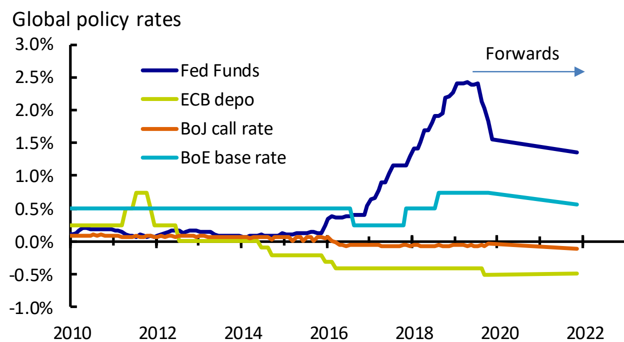
## Key points

- Monetary policy has amplified an already strong "grab-for-yield" environment. As a result, performance has been solid across fixed income.
- The focus is shifting away from conventional policy tools, as central banks are in the process of re-thinking their strategy and their instrument mix.
- Looking ahead, elements of risk in fixed income such as low volatility, negative-term premia, liquidity risk, are likely to affect performance in the rates markets.

## Strong performance in 2019

Global rates have delivered a very good performance during the past 12 months, thanks to an additional round of stimulus provided by the ECB and a U-turn in the Fed's policy rates (Exhibit 20). Year-to-date, Eurozone sovereigns have returned about 10% in euro terms, while US Treasuries are up by 7.7% in US dollar terms. At this stage, we think the moderate incremental value of further conventional policy easing might shift the focus to unconventional instruments, especially in the Eurozone.

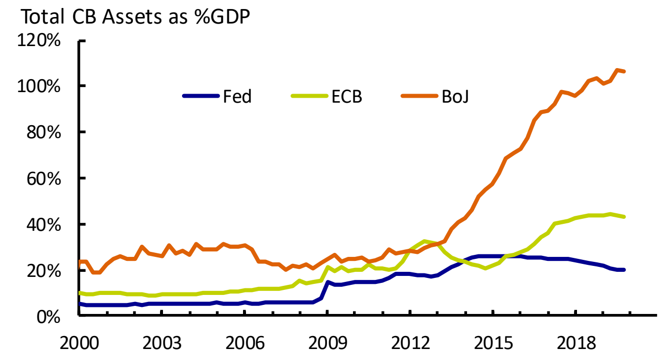
Exhibit 20: Conventional monetary policy fatigue…




*Source: Bloomberg and AXA IM Research, as of 28/11/19*

Looking at central banks' balance sheets (Exhibit 21), there appears to be quite some space for both the Fed and the ECB to expand their assets in order to provide stimulus if needed. Of course, the academic discussion has already shifted from "pure inflation targeting" to a synthesis of monetary, fiscal, and macroprudential policy. The effect on rates markets of a somewhat different monetary instrument mix is likely to be felt – specifically along the duration vector, as we have already witnessed this year. Rates investors have quickly reacted to the unprecedented surge in negative yielding bonds by extending their duration profiles, thus compressing term premia beyond levels implied by market risk parameters (Exhibit 22). This effect has been amplified by positioning at the long-end of the euro curve, where investors held carry-generating forward-steepeners in substantial sizes.

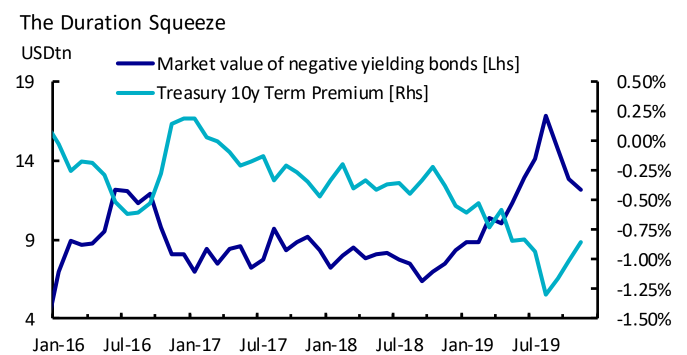
Exhibit 21: …but still room for unconventional policy




*Source: BoJ, ECB, Fed and AXA IM Research, as of XX/XX/19*

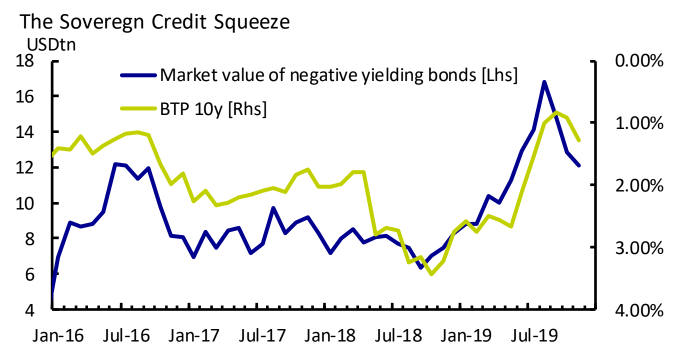
The second line of response to negative yields has been an extension of portfolio credit risk. In rates markets, this has favoured a compression of peripheral euro government bond spread. In particular, the Italian government bond market has benefitted from the surge in negative yielding bonds (Exhibit 23) and the related strong compression in global credit risk, delivering a total return close to 14% year-to-date.

Exhibit 22: Investors have extended their duration risk…




*Source: BofAML, Fed and AXA IM Research, as of 15/11/19*

Exhibit 23: …and their credit risk profile




*Source: Bloomberg, BofAML and AXA IM Research, as of 15/11/19*

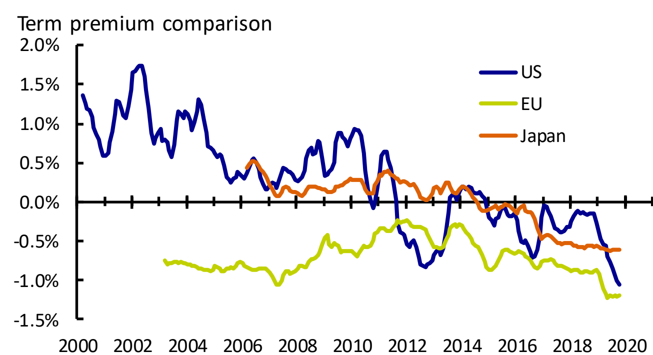
That said, the current interest rate environment is not particularly healthy from a pure economic perspective. Heavily distorted benchmark interest rates might send the wrong allocation signals to the real economy, potentially

favouring a crowding-out of private investments. Over time, this effect might outweigh the benefits of low interest rates on the sustainability of public finances.

## 2020: Expect a modest performance

The nature of investing in rates markets has quickly evolved in the recent past. Expected returns from the income component – i.e. coupons – have almost evaporated in Japan and the Eurozone, leaving only price return as a driver of performance. This in turn calls for a strong focus on market timing and active strategies in general.

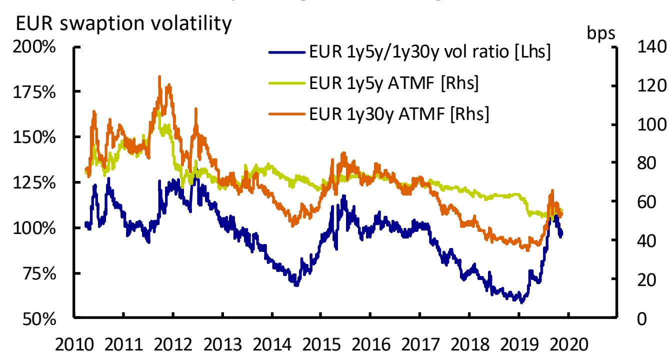
### Exhibit 24: The term premium could be a risk factor




*Source: Bloomberg and AXA IM Research, as of XX/XX/19*

One factor that has contributed to performance in 2019 is the term premium. We think this is likely to be a dominant risk factor for rates investors in 2020, as we will start the year from historically very compressed levels (Exhibit 24). While the term premium stands for the extra return required by investors for assuming extra duration risk, this variable has been the subject of central banks' policy strategy ever since the Fed's famous "Maturity Extension Programme" in 2011.

### Exhibit 25: Risk re-pricing at the long end of the curve




*Source: Bloomberg, At The Money Forward and AXA IM Research, as of 28/11/19*

A second risk factor that is worth highlighting is market volatility, and investor complacency in general. The combination of forward guidance and balance sheet control have supported the idea that rates markets are more likely to show subdued levels of volatility compared to the past. However, while asset purchase programmes reduce a market's aggregate risk in terms of outstanding duration, they still leave bond price volatility subject to market forces. We've had a glimpse of the practical implications of market volatility during 2019, as one-year swaption volatility for 30-year rates outperformed shorter-dated rates volatility by more than 25% (Exhibit 25).

One way of conceptualising the arguments discussed above, in the context of forecasting benchmark rates, would be to decompose a nominal 10-year yield into its key components. These are the real equilibrium rate, rate expectations, inflation expectations and the term and liquidity premia. Exhibit 7 is a summary of our thoughts on the 10-year US Treasury and the German government bond (Bund).

### Exhibit 26: Benchmarks are not far from fair values

| | US | EU |
|---|---|---|
| R-star | 1.00% | 0.00% |
| Rate anticipation | -0.25% | 0.00% |
| Inflation expectations | 2.00% | 1.20% |
| Term premium | -1.00% | -1.20% |
| Liquidity premium | 0.00% | -0.25% |
| Model 10-year yield | 1.75% | -0.25% |
| Spot 10-year yield | 1.84% | -0.34% |
| 1-year forward 10-year yield | 1.95% | -0.25% |

*Source: Bloomberg r-star = natural rate of interest and AXA IM Research, as of 15/11/19*

In addition, it should be noted that:

1. The table in Exhibit 26 above is composed of observable market prices, e.g. five-year/five-year inflation forwards as a proxy of inflation expectations. as well as non-observable model estimates. For instance, the natural rate of interest, known as r-star, is proxied by the Laubach-Williams model. As such, our results are subject to some degree of model uncertainty.

2. The variable "liquidity premium" is, in reality, a discretionary variable that is supposed to signal "bond scarcity risk" as perceived by financial markets. For this reason, we have assumed it is zero in the US and negative for German government bonds. Estimating liquidity premia is a very complex task. Therefore, we have decided to arbitrarily set the premium at zero for the US Treasury market and calibrate the premium for Bunds in line with the swap spread differential between Treasuries and Bunds. Again, this is a source of uncertainty.

3. Our results suggest that both Bunds and Treasuries currently trade within 10bps from fair value. The main difference is the direction of adjustment, which argues – together with a positive expected income return – for a slightly better performance of US Treasuries relative to Bunds.

# Credit – endless summer amid growth lowlands

By Gregory Venizelos

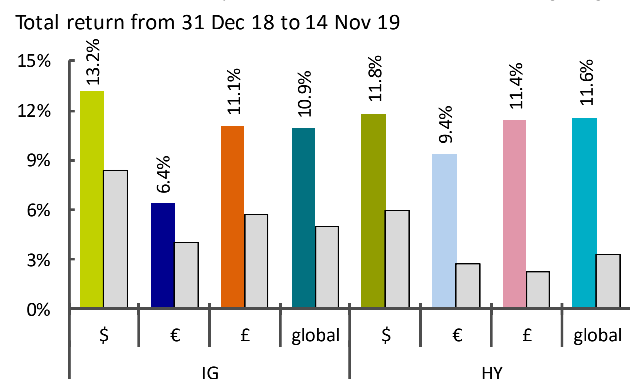
## Key points

- It has been a year of strong returns for credit, stellar even for long duration markets.
- The duration pendulum should swing in favour of high yield in 2020, barring a bad downturn in growth.
- Neither the large BBB rated cohort nor covenant-lite loans are likely to upend credit markets in 2020.

## A year of living generously

2019 has been a year of strong returns for credit markets (Exhibit 1), even stellar historically in certain cases. This has been the product of wide spreads and elevated yields at the start of the year, which historically bode well for returns over the 12 months that follow. The U-turn in central bank policy at the start of the year boosted this dynamic, making long duration the stand-out strategy in 2019. USD HY credit behaved by the book - where an 8% yield at the start of the year tends to be associated with returns in the low single digits in the 12 months that follow.

Exhibit 27: a strong year for credit returns with long duration unusually so (rates contribution in light grey)




*Source: InterContinental Exchange (ICE) and AXA IM Research, as of 14/11/2019*

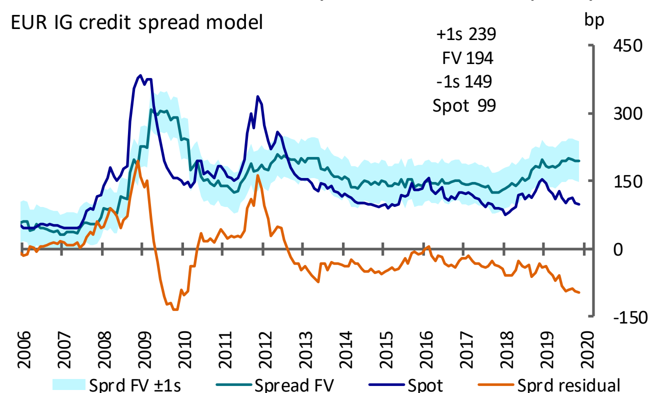
But USD IG returns have been unusually high – 13.2% year to date and the highest since 2009. That compares to an historic average of around 8% annualised, over the slowdown stage of the cycle (Purchasing Managers' Index above 50 but falling). This marked IG outperformance, driven by its long duration characteristic, adds to our view that the pendulum is set to swing in favour of HY over the next 12 months, barring a material slowdown in US growth.

Monetary policy can be a factor here. If the interest rate cut by the US Fed at the end of October proves to be the last of an 'insurance' easing mini cycle, then historically this bodes well for credit spreads into next year. Indeed, spreads tightened by 20% in relative terms on average in the six months that followed the two prior mini cycles in 1995 and 1998. At the same time, US Treasury yields rose by 20% on average over the same period. This scenario on current market pricing would suggest an outperformance by USD HY over USD IG, with the former returning over 4% and the latter returning under 1% over the next six months.

## Rich valuations not a headwind near term

A key concern for investors is that credit – not unlike the overall fixed income market – is fundamentally overvalued. But this has been a long-term, arguably structural, theme (Exhibit 28), given that extraordinary unconventional central bank policy has suppressed risk premia well below levels that are justified by fundamentals. Our four-factor model in Exhibit 2 shows that IG spreads have been trading rich by over one standard deviation since late 2018 but also for extended periods in the past since 2012-13.

Exhibit 28: spreads have traded rich since central banks embarked on extraordinary unconventional policy




*4 variables: GDP growth, corporate debt, corporate profit &market volatility*
*Source: Bloomberg, Datastream, ICE and AXA IM Research, as of 7/11/2019*

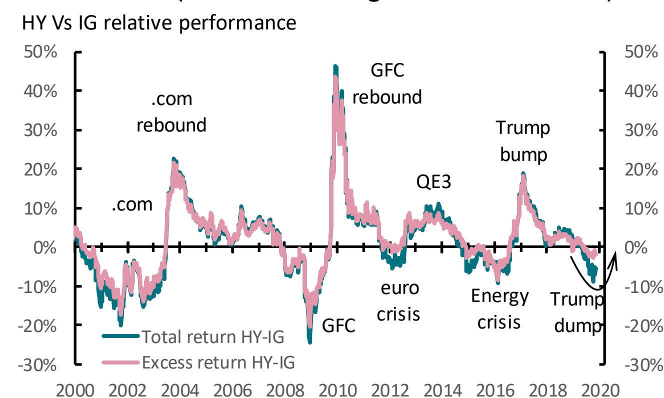
This persistent overvaluation can be quantified by the central banks' balance sheet expansion. Indeed, if we add to our model as a variable the amount of duration that the ECB asset purchase program has 'extracted' from the euro fixed income markets, the overvaluation over 2016-2018 is erased. Similarly, the restart of ECB asset purchases since October 2019 will help narrow the valuation gap that has reopened in 2019.

## The duration pendulum: HY 2020, by default

Divergence in returns between HY and IG is not uncommon. Indeed, the duration pendulum swings back and forth under the influence of macro factors, thus driving the performance differential between HY and IG (Exhibit 29). Strong risk-on periods, like the dotcom rebound, the global financial crisis

recovery, quantitative easing and the 'Trump bump', see HY outperform. Risk-off periods, like the bursting of the dotcom bubble, the financial crisis, the euro crisis or the energy crisis, see IG outperform. The extent of IG outperformance over HY in the past 12 months has been the largest since the global financial crisis, suggesting a likely turning point.

### Exhibit 29: relative performance set to swing in favour of HY in 2020 (12 month rolling differential shown)




*Source: ICE and AXA IM Research, as of 14/11/2019*
*GFC = global financial crisis, QE3 = quantitative easing (round 3)*

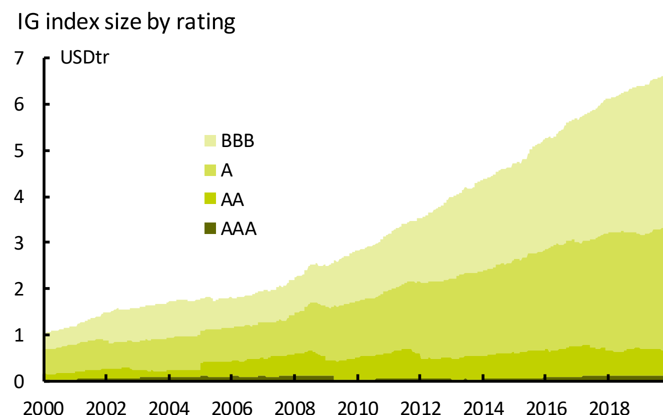
The default rate outlook is key in respect to HY credit. Our default rate model has shown a deterioration for the US market, with the 12-month default rate rising towards 4%, due to a tightening in bank lending standards and a rise in the bond market distress ratio. We remain alert to this forecast but do not expect a US default cycle of the magnitude of the 2015-16 energy crisis, when realised defaults reached 6% or more. As for European HY, our 12-month default rate forecast remains at a very benign 2%.

## Key risks in credit

The very prolonged credit cycle is inevitably making investors nervous about the lurking risks that might bring it to an end. Two of these feature the most in investors' minds. First, the very large size of BBB rated credits within IG, and second, the prevalence within leveraged finance of covenant-lite loans. These are loans that carry fewer or less restrictive covenants and bestow more flexibility to the borrower at the expense of the control or oversight by the lender.

The amount of BBB rated US debt has risen from well under $1tn in the aftermath of the financial crisis in 2009, to well over $3tn currently (Exhibit 30). This poses the risk that a severe economic downturn could trigger a material downgrade cycle that pushes a large swathe of these lower rated credits – aka Fallen Angels – into the HY market. The HY market would not have the capacity to absorb the inflow thus creating a major market disruption. However, there are a couple of mitigating factors against such a severe scenario. Higher leverage/lower ratings are the mirror image of structurally lower rates that make debt more affordable. It would take a significant backup in rates and widening in spreads to undermine debt affordability. Further, the size of the lowest rated BBB- cohort – one rating notch away from HY – has remained stable over the past decade at 10% of the IG market. Meanwhile the highest rated BBB+ cohort – three rating notches away from HY – has seen most of the growth. It would thus require a downgrade cycle worse than that in the IG energy sector in 2015-16 (two to three notches on average) in order to push a large swathe of BBBs into HY.

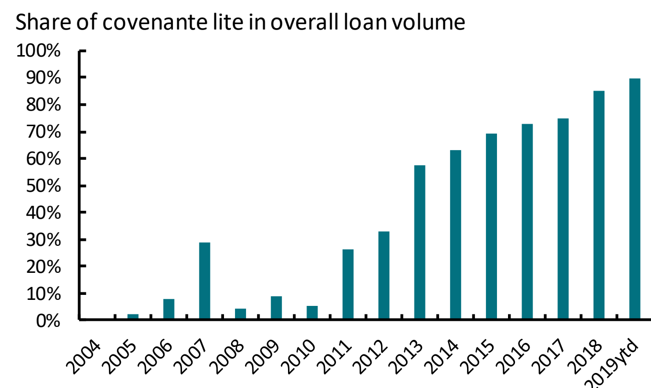
### Exhibit 30: the ever-growing BBB cohort (USD IG shown)




*Source: ICE and AXA IM Research, as of 14/11/2019*

Another concern for credit investors is the rising incidence of covenant-lite instruments in leveraged finance markets. Two key mitigants that we see here is that although the cov-lite share has risen to record levels (Exhibit 31), the share of other forms of leverage like second lien and/or zero-coupon debt remains well below levels we saw before the GFC. In addition, the lower recovery rate expectations associated with cov-lite debt – inasmuch as it may delay a credit event to the further detriment of balance sheet health – can be offset by a lower probability of a credit event. This is because the higher flexibility afforded to the borrower may enable a turnaround and balance sheet repair. Arguably, cov-lite debt is yet to be fully tested through a full default cycle. Indeed, post financial crisis the default cycle was halted by extraordinary central bank policy.

### Exhibit 31: the share of cov-lite loans has risen notably since the global financial crisis




*Source: S&P LCD and AXA IM Research, as of Oct 2019*

# A decade into the cycle – it’s still hard to be bearish

By Varun Ghotgalkar

## Key points

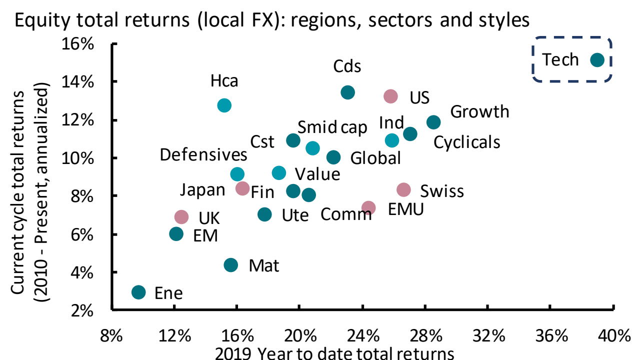
- Our leading earnings indicators suggest that earnings growth momentum is starting to trough and is likely to pick up in the second half of 2020.
- Equity valuations are close to long term averages and still provide relative value against sovereign bond and credit markets compared to historical standards.
- We keep a constructive stance on equities moving into 2020, with a bias towards undervalued cyclical plays in our allocation.

## It ain't over ’til it’s over

Year-to-date equity returns have been stellar after the sharp market slump in the last quarter of 2018. The technology sector (+39%) continues its dream run. Industrials (+26%) and consumer discretionary (+23%) also outperformed, while emerging markets (+12%) and energy stocks (+10%) notably lagged. The global benchmark is up around 22% for the year at the time of writing, making 2019 one of the strongest calendar years in the current cycle – and extending the bull market that has been in place for close to a decade.

The current market cycle has been one of the longest in recent financial history, delivering an annualised total return of around 10% in local currency terms for global equities, and closer to 13% for the US (Exhibit 1). To put this in perspective, the 12 S&P 500 rallies that have taken place since the 1950s have had a median annualised real price return of 15.4% and have typically lasted around four years. Most of the move higher for equities in 2019 can be attributed to valuation-multiple expansion.

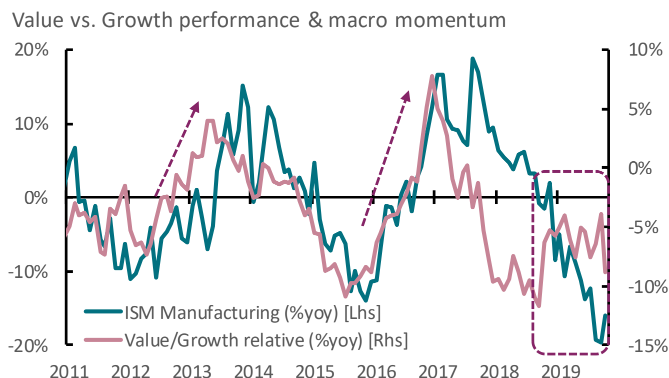
### Exhibit 32: Stellar run for equities year to date




*Source: MSCI, Datastream and AXA IM Research, as of 14/11/2019*

In the year ahead, volatility is likely to stem from political concerns, especially developments in the US presidential elections and the ongoing negotiations around US/China trade relations.

### Exhibit 33: Recent style rotation still has room to run




*Source: MSCI, Bloomberg and AXA IM Research, as of 14/11/19*

In terms of styles, growth stocks continued to beat value stocks with the former gaining 28% in comparison to the latter’s 19%. Cyclicals at +27% outperformed defensives at +16% over the year. More recently, markets have seen early signs of a rotation broadly in line with the rise in yields in major bond markets globally. Going forward, performance dynamics will continue to be closely linked to economic momentum and highly correlated to the rate of change in global leading indicators, which now appear to be bottoming out and suggesting some mean reversion in the divergence between value versus growth stocks (Exhibit 33).

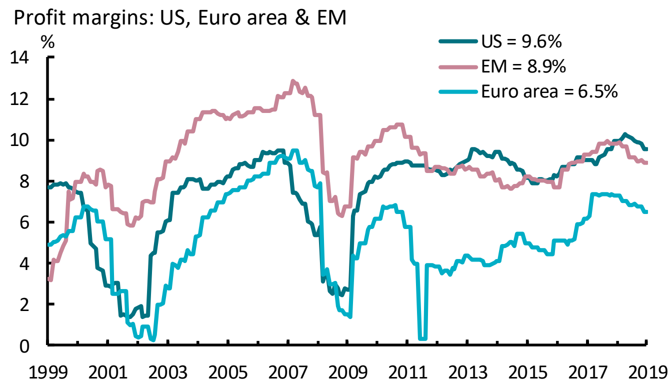
### Exhibit 34: Leading earnings indicators bottoming out

*Source: MSCI, Bloomberg, Datastream and AXA IM Research, as of 14/11/19*

## Earnings momentum beginning to stabilise

The headwinds to earnings revisions have begun to fade as the growth outlook takes precedence. Global earnings growth is now just above flat year-to-date. Our leading earnings indicators (Exhibit 34) suggest that overall momentum appears to have bottomed out and is likely to pick up in the second half of 2020. Consensus expectations for 2020 and 2021 still appear anchored around the typical starting point of 10%, with commodity sectors in the lead and financials expected to lag.

### Exhibit 35: Profit margins starting to roll over




*Source: MSCI, Bloomberg and AXA IM Research, as of 14/11/19*

From a longer-term perspective, emerging market and Eurozone earnings-per-share remain respectively at 16% and 38% – below their previous peaks but showing gradual improvement. Investors remain concerned about profit margin compression given the pressure on top line growth, the lack of pricing power in many industries given persistently low inflation, the effect of tariffs on input prices and ongoing wage inflation (Exhibit 35).

### Exhibit 36: Equity valuations close to long term average

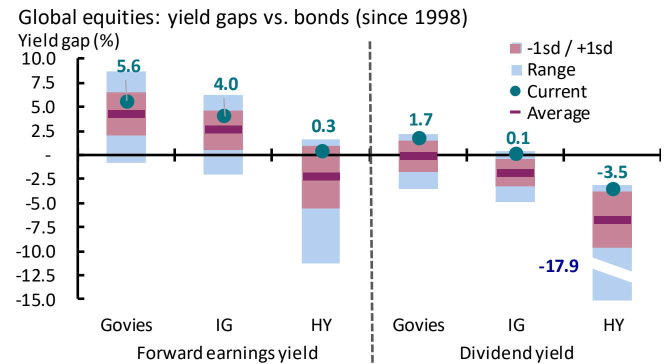
*Source: IBES, Datastream and AXA IM Research, as of 14/11/19*

## Keep calm and carry on

In absolute terms, aggregate global equity market valuations are not stretched on most metrics with global equities ex. US continuing to trade at a steep discount to the US. The asset class still appears attractively valued on an absolute basis, with the global market forward price-to-earnings multiple of 16 times close to long-term averages (Exhibit 36). Overall, we expect equity market returns to be moderate in the near term, although the risk of a decline in valuation multiples has receded given expanding global excess liquidity. Below the surface, a divergence persists between valuation metrics in value and growth styles. Like past episodes, a pickup in cyclical momentum is necessary for a prolonged rotation.

Global equities still provide relative value against sovereign bond and credit markets with yield gaps between equities relative to government bonds, investment grade and high yield credit close to record highs compared to historical standards (Exhibit 37). Currently, while late cycle warnings are visible, we believe it is it still early for a bear market. Sluggish economic momentum and ultra-low unemployment are the main alarms, although the momentum has shown signs of improvement and monetary conditions remain supportive.

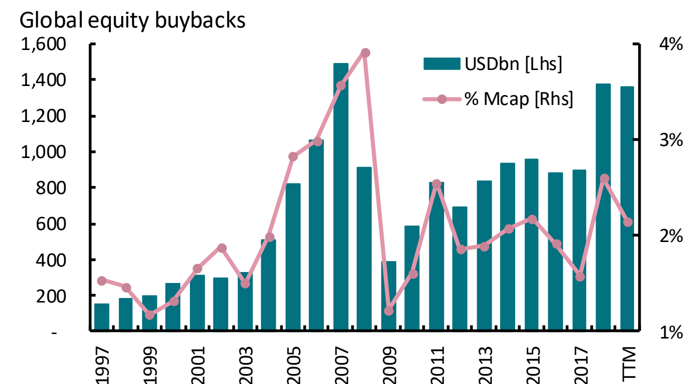
### Exhibit 37: Global equities still offer relative value




*Source: Datastream, MSCI, BofAML and AXA IM Research, as of 14/11/19*

Along with the earnings outlook, investor sentiment has started to pick up recently with volatility levels normalising. Corporate share buybacks remain a significant source of equity demand with the global trailing buyback yield currently at 2.2%, implying a total shareholder pay-out yield of 4.6%. Our sample of equity-linked exchange traded funds indicates that the asset class attracted around US$83bn of passive net inflows, mostly in developed markets.

### Exhibit 38: Stock buyback run rate remains robust




*Source: Datastream, MSCI, BofAML and AXA IM Research, as of 14/11/19*

Although the political calendar leaves financial markets prone to high event risk, we believe risks facing the global economy have moderated overall. In line with our macro base case, we keep a constructive stance on equities moving into 2020, with a bias towards undervalued cyclical plays in the US, and towards select high dividend yield exposure with adequate free cash flow cover in the euro area. We also have a broader regional preference for euro area equities in our allocation.

# Forecast summary

| Real GDP growth (%) | 2018 | 2019* | | 2020* | | 2021* | |
|---|---|---|---|---|---|---|---|
| | | AXA IM | Consensus | AXA IM | Consensus | AXA IM | Consensus |
| **World** | **3.6** | **3.0** | | **3.2** | | **3.0** | |
| **Advanced economies** | **2.3** | **1.7** | | **1.3** | | **1.0** | |
| US | **2.9** | **2.3** | *2.3* | **1.6** | *1.8* | **0.8** | *1.9* |
| Euro area | **1.9** | **1.2** | *1.1* | **0.7** | *1.0* | **0.5** | *1.3* |
| Germany | **1.4** | **0.6** | *0.5* | **0.4** | *0.7* | **0.5** | *1.2* |
| France | **1.7** | **1.3** | *1.3* | **1.1** | *1.2* | **1.0** | *1.4* |
| Italy | **0.7** | **0.2** | *0.1* | **0.4** | *0.5* | **0.4** | *0.6* |
| Spain | **2.6** | **2.0** | *2.0* | **1.5** | *1.7* | **1.2** | *1.7* |
| Japan | **0.7** | **0.8** | *0.9* | **0.1** | *0.3* | **0.7** | *0.8* |
| UK | **1.4** | **1.3** | *1.2* | **1.2** | *1.1* | **1.0** | *1.5* |
| Switzerland | **2.5** | **1.0** | *0.8* | **1.1** | *1.2* | **0.9** | *1.4* |
| **Emerging economies** | **4.4** | **3.8** | | **4.3** | | **4.2** | |
| **Asia** | **6.0** | **5.4** | | **5.2** | | **5.1** | |
| China | **6.6** | **6.1** | *6.1* | **5.8** | *5.9* | **5.6** | *5.7* |
| South Korea | **2.7** | **2.0** | *1.9* | **1.7** | *2.2* | **1.5** | *2.4* |
| Rest of EM Asia | **5.5** | **4.7** | | **4.7** | | **4.8** | |
| **LatAm** | **1.1** | **0.1** | | **1.7** | | **1.3** | |
| Brazil | **1.1** | **0.8** | *1.0* | **1.8** | *2.0* | **1.2** | *2.5* |
| Mexico | **2.2** | **0.0** | *0.2* | **0.9** | *1.2* | **0.5** | *1.9* |
| **EM Europe** | **3.8** | **2.9** | | **3.7** | | **3.4** | |
| Russia | **2.3** | **1.1** | *1.1* | **1.5** | *1.6* | **1.7** | *1.9* |
| Poland | **5.2** | **4.3** | *4.3* | **3.5** | *3.4* | **3.0** | *2.8* |
| Turkey | **2.9** | **-0.3** | *-0.3* | **2.3** | *2.3* | **1.2** | *3.1* |
| **Other EMs** | **1.4** | **1.1** | | **2.3** | | **2.0** | |

*Source: Bloomberg, IMF and AXA IM Macro Research – As of 2 December 2019*

| CPI Inflation (%) | 2018 | 2019* | | 2020* | | 2021* | |
|---|---|---|---|---|---|---|---|
| | | AXA IM | Consensus | AXA IM | Consensus | AXA IM | Consensus |
| **Advanced economies** | **1.9** | **1.4** | | **1.5** | | **1.7** | |
| US | 2.4 | 1.7 | *1.8* | 2.0 | *2.0* | 2.3 | *2.0* |
| Euro area | 1.8 | 1.2 | *1.2* | 1.2 | *1.2* | 1.3 | *1.5* |
| Japan | 1.0 | 0.4 | *0.6* | 0.5 | *0.9* | 0.5 | *0.8* |
| UK | 1.8 | 1.9 | *1.9* | 2.3 | *1.9* | 1.9 | *2.0* |
| Switzerland | 0.9 | 0.7 | *0.5* | 0.6 | *0.6* | 0.5 | *0.7* |
| Other DMs | 1.7 | 1.4 | | 1.5 | | 1.8 | |

*Source: Bloomberg, IMF and AXA IM Macro Research – As of 2 December 2019*

## Central bank policy

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

| | | Current | Q4 - 19 | Q1 - 20 | Q2 - 20 | Q3 - 20 |
|---|---|---|---|---|---|---|
| **United States - Fed** | Dates | 1.50-1.75 | 10-11 Dec | 28-29 Jan<br>17-18 March | 28-29 Apr<br>9-10 Jun | 28-29 Jul<br>15-16 Sep |
| | Rates | | unch (1.50-1.75) | unch (1.50-1.75) | unch (1.50-1.75) | unch (1.50-1.75) |
| **Euro area - ECB** | Dates | -0.50 | 12 Dec | 23 Jan<br>12 March | 30 Apr<br>4 Jun | 16 Jul<br>10 Sep |
| | Rates | | unch (-0.50) | unch (-0.50) | unch (-0.50) | unch (-0.50) |
| **Japan - BoJ** | Dates | -0.1 | 18-19 Dec | 20-21 Jan<br>18-19 March | 27-28 Apr<br>15-16 Jun | 21-22 July<br>16-17 Sep |
| | Rates | | net QQE ¥10tn | unch (-0.10) | unch (-0.10) | unch (-0.10) |
| **UK - BoE** | Dates | 0.75 | 19 Dec | 30 Jan<br>26 March | 7 May<br>18 June | 6 Aug<br>17 Sep |
| | Rates | | unch (0.75) | unch (0.75) | unch (0.75) | unch (0.75) |

*Source: Datastream, AXA IM Macro Research - As of 2 December 2019*

# Calendar of 2020 events

| 2020 | Date | Event | Comments |
|---|---|---|---|
| December 2019 | 6-8 Dec | Germany | SPD party convention, election of the leader |
| | 11 Dec | FOMC Meeting | Unchanged (1.50-1.75) |
| | 12 Dec | ECB Meeting | First meeting of Lagarde, unch. (-0.50) |
| | 12 Dec | UK | UK General Election, expect Conservative win |
| | 15 Dec | US-China | Second tranche of the $300bn tariffs to come into effect, expect no implementation |
| | 16 Dec | US | House expected to vote on Articles of Impeachment this week, will move to Senate if passed |
| | 19 Dec | BoJ Meeting | Unchanged - Net QQE ¥10tn |
| | 19 Dec | BoE Meeting | Unchanged (0.75) |
| January 2020 | 21-janv | BoJ Meeting | Unchanged (-0.10) |
| | 23-janv | ECB Meeting | Unchanged (-0.50) |
| | 29-janv | FOMC Meeting | Unchanged (1.50-1.75) |
| | 30-janv | BoE Meeting | Including Monetary Policy Report, unchanged (0.75) |
| | 31-janv | UK | Extended Article 50 term expires, BoE Governor Carney term expires |
| February | | US | Possible Senate verdict on Impeachment this month; 67 votes are required |
| | 3 Feb | US | Election caucuses commence |
| March | 03-mars | US | Super Tuesday: c. 16 jurisdictions are expected to hold an election primary or caucus |
| | 12-mars | ECB Meeting | Unchanged (-0.50) |
| | 18-mars | FOMC Meeting | Including Summary of Economic Projections, unchanged (1.50-1.75) |
| | 26-mars | BoE Meeting | Unchanged (0.75) |
| April | 4 Apr | US | Potential tariffs on imports of Mexican cars and second stage negotiations with Japan and EU |
| | 29 Apr | FOMC Meeting | Unchanged (1.50-1.75) |
| | 30 Apr | ECB Meeting | Unchanged (-0.50) |
| May | 7 May | BoE Meeting | Including Monetary Policy Report, unchanged (0.75) |
| June | 4 Jun | ECB Meeting | Unchanged (-0.50) |
| | 10 Jun | FOMC Meeting | Includes Summary of Economic Projections (1.50-1.75) |
| | 12 Jun | G7 | G7 Summit |
| | 18 Jun | BoE Meeting | Unchanged (0.75) |
| July | 1 Jul | UK | Deadline to extend transition period if EU Withdrawal Agreement passes into law before the 31 Jan |
| | 13-16 Jul | US | Democratic National Convention: Party delegates select their president nominee |
| | 16 Jul | ECB Meeting | Unchanged (-0.50) |
| | 29 Jul | FOMC Meeting | Unchanged (1.50-1.75) |
| August | 6 Aug | BoE Meeting | Includes Monetary Policy Report, unchanged (0.75) |
| | 24-27 Aug | US | Republican National Convention: Party delegates select their president nominee |
| | 27-30 Aug | US | Jackson Hole Symposium |
| September | 10-sept | ECB Meeting | Unchanged (-0.50) |
| | 16-sept | FOMC Meeting | Unchanged (1.50-1.75) |
| | 17-sept | BoE Meeting | Unchanged (0.75) |
| | 29-sept | US | First Presidential debate |
| October | 29-oct | ECB Meeting | Unchanged (-0.50) |
| November | 03-nov | US | Presidential and Congressional Elections |
| | 04-nov | FOMC Meeting | rate in Q4 – (1.25-1.50) |
| | 05-nov | BoE Meeting | Including Monetary Policy Report |
| | 21-22 Nov | G20 | 2020 Summit, Riyadh |

# Abbreviation glossary

1Q18 first quarter of 2018
1H18 first half of 2018
[Lhs] left hand scale (graph)
[Rhs] right hand scale (graph)
a.r. annualised rate
AUD Australian dollar
BAML Bank of America Merrill Lynch
BEA US Bureau of Economic Analysis
BEER Behavioural Equilibrium Exchange Rate
BIS Bank for International Settlements
bn billion
BoC Bank of Canada
BoE Bank of England
BoJ Bank of Japan
bp(s) basis point(s)
CAD Canadian dollar
CEE Central and Eastern Europe
CEEMEA Central and Eastern Europe/Middle East/Africa
CHF Swiss franc
CPI Consumer price index
DM Developed market
EBA European Banking Authority
EC European Commission
ECB European Central Bank
EM(s) Emerging market(s)
EMU European Monetary Union
EPFR Emerging Portfolio Fund Research, Inc.
EPS Earnings per share
ERP Equity risk premium
ESM European Stability Mechanism
ETF Exchange-Traded fund
EU European Union
EUR/€ Euro
Fed US Federal Reserve
FFR Fed fund rate
FOMC Federal Open Market Committee
FTA Free Trade Agreement
FY Fiscal Year
GBP/£ Pound Sterling
GDP Gross Domestic Product
GFC Global Financial Crisis
GVA Gross value added
HKD Hong Kong dollar
HP filter Hodrick-Prescott filter
HY High Yield
ICT information and communications technology
IG Investment Grade
IIF Institute of International Finance
INSEE French National Institute of Statistics and Economic Studies
IMF International Monetary Fund
ISM Institute of Supply Management
JGB Japanese Government Bonds
JPY/¥ Yen
LatAm Latin America
LBO Leveraged buy-out
LTRO Long Term Refinancing Operation
MBS Mortgage-backed security
METI Japan’s Ministry of Economic Trade and Industry
mom month on month
MRO Main Refinancing Operation
n.s/a non-seasonally adjusted
NAFTA North American Free Trade Agreement
NBER National Bureau of Economic Research
NPL non-performing loans
NFIB National Federation of Independent Business
NOK Norwegian krone
NZD New Zealand dollar
OECD Organisation for Economic Cooperation and Development
OMT Outright Monetary Transactions
P/B price-to-book ratio
P/E price/earnings
PBoC People Bank of China
PCE personal consumption expenses
PEG price/earnings to growth
PMI Purchasing Manager Index
pp percentage point
PPI Producer price index
PPP purchasing power parity
QE Quantitative easing
QE3 Third quantitative easing
QQE Quantitative and qualitative easing
qoq quarter on quarter
REER Real Effective Exchange Rate
RMB renminbi chinois (yuan)
RRR Required rate of return
s/a seasonally adjusted
SEK Swedish krona
SMEs Small and medium size enterprises
SMP Securities Markets Programme
SWF Sovereign Wealth fund
TFP total factor productivity
TLTRO Targeted Longer Term Refinancing Operation
tn trillion
UN United Nations
USD/$ US dollar
yoy year on year
ytd year to date

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