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Investment Spotlight

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AXA Investment Managers - Research & Investment Strategy

WEEKLY COMMENT

2011: the year cut in half

by

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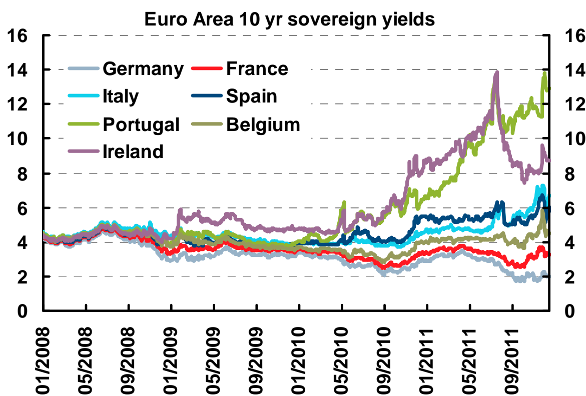
Key points

- Real global growth was hit by the earthquake in Japan and then by a turn for the worse in the euro area debt crisis.
- Central banks have offered strong support, through both standard and non-standard measures. One should never underestimate the power of a central banker's weaponry.
- Credit risk became the main driver for sovereign bonds.
- Traditional safe haven assets (US Treasuries, Bunds and gold) have proven to be the best performers in volatile and risk averse-markets.

Exhibit 1



Source: Datastream, AXA IM Reasearch 16 December 2011

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Two events stand out in the economic and financial landscape of 2011. The first is the earthquake and tsunami that hit Japan in early March. The second is the sudden worsening of the euro area debt crisis in late July.

H1 2011: Japan's natural catastrophe

After the **earthquake in Japan**, the worldwide supply chain was considerably disrupted and it took Japan longer than expected to recover. Only in Q3 2011 did Japan's real GDP (QoQ%) turn positive, after three quarters of negative growth.

Globally, the recovery in H1 2011 was atypical, characterised by (1) sluggish growth for Western economies in the midst of a de-leveraging process, and (2) strong growth in the leading emerging economies such as China, India and Brazil, generated by productivity and income. Inflation faced upward pressure, mainly fuelled by supply side tensions (oil, copper and grains) and by geopolitical tensions in the Arab world.

Turning to the global financial markets, the (negative) effect of the tsunami was short lived. Investors shifted their positions towards riskier assets, playing the theme of a broader global recovery. All in all, the results were in line with our expectations, with equities outperforming government bonds.

H2 2011: financial contagion

The 21 July meeting of euro area heads of state or government was a watershed. During this meeting, private investors were called on to make a "voluntary contribution" by accepting haircuts on their Greek debt holdings.[1] Afterwards, contagion spread outward, hitting Spain and Italy in particular. By mid-summer, the eye of the storm was over Italy, the most vulnerable country because of its high debt burden (€1.9 trn) and sluggish potential growth, two factors which undermine its solvency. To some extent, the acceleration of the crisis was provoked by the banks, which sold huge amounts of their peripheral sovereign debt holdings (Spain and Italy) to comply with marked-to-market accounting rules for the purpose of stress tests.

In light of these developments, the global economy progressively lost growth momentum and uncertainties surrounding the global cycle increased. However, both the American and Chinese economies proved to be quite resilient, in line with our expectations, with the US in particular getting support from private consumption. For the euro area, although the directional call proved to be right, the worsening of the crisis naturally undermined our central forecasts. As time passed, signals that a recession was imminent became more pronounced in Europe.

From the standpoint of global asset allocation, the real and immediate challenge was to deal with the increased stress in the financial markets as the euro debt crisis intensified. In late summer, we removed our initial preference for risky assets and suggested that US Treasuries and Bunds be overweighted (vs equity) and peripheral bonds markets avoided. We maintained our positive stance on US corporate bonds, which finally delivered a satisfactory performance. US corporate bonds remain one of our preferred asset classes for 2012, especially as far as high quality credit (IG) is concerned.

2011's best performing assets are the usual ones in times of market turmoil, i.e., **US Treasuries, German Bunds and gold.**

Monetary policy

For the third year in a row, monetary policy remained extremely accommodating across developed markets. Toward the end of the year, major emerging market central banks began cutting official rates. In early December, Chinese authorities surprised the markets by cutting the reserve requirement rate.

Our global call on monetary policies in industrialised countries (i.e., official rates on hold for 2011) proved right, if we exclude the two ECB

[1] *Ex-post,* that decision proved to be a mis-management of the crisis. The official statement from the December EU summit reaffirmed that the solutions adopted for Greece were one-off.

rate hikes. The adoption of further QE in both the UK and the US (Operation Twist) were also anticipated as the economic situation worsened.

But there were also some positive elements of surprise from several additional non-standard monetary policy measures taken by major central banks to address pressures in global financial markets.

The Fed, known for its flexibility and pragmatism, announced an unprecedented commitment in early August, pledging to maintain low levels for the federal funds rate at least through mid-2013.

The Swiss National Bank (SNB) committed to a minimum EUR/CHF exchange rate of 1.2.

The ECB reopened the Security Market Program (SMP) in August for Spanish and Italian government bonds. Then it opened a second covered bond purchase programme (CBPP2) in November. And finally, on December 8, three more measures were adopted: two new 3-year refinancing operations, a cut from 2% to 1% in the reserve ratio, and a further expansion of the list of accepted collateral.

At the end of November, a coordinated action involving G6 central banks extended swap lines in USD.

In a word, central banks offered **strong support. One should never underestimate the power of a central banker's weaponry.** Looking ahead, we expect to see even more efforts from the ECB to sustain the government bond market.

Fixed income: widely disparate performances

Long-term government bond yields remained quite stable between the end of 2010 and the end of June 2011. Two factors kept 10-year interest rates in core countries low: the extremely accommodating stance of the US Fed and, in Europe, the Damocles sword of the crisis. Even though everything seemed to be rosy in Germany (and for some of its neighbours), various southern countries were already mired in a recessionary environment. In July, as the sovereign crisis escalated, credit risk became the main driver of the sovereign bond market. Intra-euro area sovereign spreads widened further, with the exception of just a small group of virtuous countries. But in November, the crisis affected even AAA-rated countries (France in particular), and doubts about the survival of the euro area were further reinforced by the "failure" of a 10-year German Bund auction.

Retrospectively, German Bunds and US Treasuries played their safe haven role, offering double digit returns (the return on JP Morgan US and Germany all maturities indices is roughly +10% YTD2). In Europe, the only government securities markets that have kept pace with the Bunds are the British, Finnish hand and Dutch markets. Other sovereign bonds posted disappointing to very negative returns.

Turning to corporate bonds, investment grade and high yield credit spreads tightened in the first part of the year. Then, like any other risky asset, credit felt the impact of the crisis during the summer. Low quality European corporate bonds have been hit particularly hard, posting negative returns for 2011 (the YTD return of the BoFA ML Euro High Yield Index is -3.5%). In the US, solid corporate fundamentals and attractive valuations spared the credit market from excessive contagion (the YTD performances of IG and HY US BofA ML Corporate Index are +7.3% and +3.3%, respectively).

Equities: a bad year

Viewed globally, 2011 equity returns are misleading. The global performance figure (-7.7% YTD for MSCI World) hides substantial variation among countries and over time. Until mid-year, global equity markets were up overall. Then, the deterioration in market sentiment and an increasing perception of risk affected stock price trends. During the autumn, the fear factor shifted to Asia as investors began to question Chinese growth settings.

Looking at the geographical allocation, the US equity market outperformed the Euro Zone, reflecting stronger fundamentals and a lower country risk. Among emerging markets,

[2] All YTD performances are computed on 16 December 2011.

economies in Central and Eastern Europe posted the worst return (-17.3% YTD for the MSCI Eastern Europe Index), since they are the most exposed to the sovereign debt crisis, not only through their trade links but also through the large proportion of total banking assets held by European banks.

Concerning risk, the level of volatility remained significantly higher in the Euro Area than in the United States. We think that cautious investors will have to continue to pay close attention to volatility in early 2012.

Where do we stand?

During the course of 2011, certain political decisions were the real triggers of the markets. The list of adopted solutions and meetings [3] is beginning to get very long. **Political negotiations and further European government progress on the "fiscal compact", outlined at the EU summit of 9 December, will be decisive in early 2012.** As we indicated in our outlook, **we believe 2012 will be the year of bifurcation.** For a complete view, please see our *Special 2012 Outlook.*

[3] An exhaustive chronology of European measures can be found in the "Third chapter - The Euro Area in crisis" http://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/Sonstiges/chapter_three_2011.pdf or in http://mobile.bloomberg.com/news/2011-11-07/europe-timeline-maastricht-to-papandreou

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