Central bankers never get to rest

Monthly Investment Strategy Oped

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Key points

- Challenges around the virus and vaccine path continue to argue for supportive central banks.
- Proposed US fiscal stimulus is less supportive than headlines would consider.
- Though Fed tapering is someway off, in the interim the Fed might have to consider adjusting the maturity of its purchases.
- The ECB has complicated its wait and support position.
- Rising earnings per share forecasts and continued low real yields support risk
- Medium-term investment performance at risk from re-pricing of reference rates
- Post-COVID-19 recovery should support markets for now.

New answers got old quickly

By the second half of 2020, central banks could arguably consider their job done in terms of adapting their actual and expected stance to the pandemic emergency. The Federal Reserve (Fed) had set up a steady path of massive purchases of securities and opted for an ultra-dovish forward guidance thanks to their conversion to Average Inflation Targeting, in clear announcing they would tolerate inflation overshooting in the future. The European Central Bank (ECB) announced in December the flexible Pandemic Emergency Purchase Programme (PEPP) would last until March 2022 "at least" with a top up of "at least" EUR500bn, while explicitly acknowledging that their strategy would consist of making the necessary fiscal push possible by keeping governments' funding costs low.

Since the end of last year, the cyclical outlook has on balance deteriorated. Vaccination programmes – with some exceptions – have been disappointingly slow, and news of production bottlenecks have accumulated. Progress towards collective immunity is frustrating, relative to expectations, strengthening our call that full normalisation would have to wait until the summer, since the emerging variants are fuelling an already stubborn "winter wave". True, our economies have learned to live with the virus and GDP probably held up better than expected in most developed economies, but the first half of 2021 looks very challenging, with the horizon of lockdown relaxation being pushed further out.

In such an environment, in principle the market would normally demand even more stimulus from central banks. But paradoxically, investors have chosen to question the capacity of the Fed to merely maintain the current quantum of support, worrying earlier than expected about a possible "tapering", albeit at soonest towards the end of this year. This is of course is in part the result of the massive fiscal stimulus proposed by new President Joe Biden after securing a slim majority in the Senate. The "reflation risk" should be taken with a pinch of salt though. Biden's USD1.9tn package tops up the USD0.9tn agreed in December, but the combined USD2.8tn is not much bigger than the

USD2.5tn of 2020 which has expired for the most part. Considering that Biden's proposal is an opening gambit and will very likely shrink as the congressional process forces some compromise, it is possible that the fiscal stance will actually tighten in 2021: what matters for GDP growth is the *change* in the stimulus, not its absolute level. In all likelihood, the pandemic shock in 2021 will be less pronounced than last year, allowing the US economy to perform much better despite a smaller fiscal push, but that the new US administration is erring on the side of caution in providing significant support this year makes sense. Yes, headline inflation will be higher this year than last, with the disappearance of some base effects on oil for instance, but capacity underutilisation should remain significant enough to prevent a "proper", endogenous acceleration in core inflation.

Even without a strong rebound in inflation, the market should take notice of the higher than expected issuance of US public debt securities brought about by Biden's plan. This is where the Fed's stance is challenged. The Fed is very unlikely to taper in the near term, but there is no discussion at all within the central bank on the possibility of scaling up quantitative easing to mop up some of the additional supply of US government paper. This change alone in demand and supply conditions on the bond market could justify the recent rise in long term interest rates. However, the Fed maintains flexibility over the duration of its asset purchases and could raise this later in the year if Janet Yellen's Treasury increases the duration of its issuance.

The ECB should be in a much better position than the Fed, precisely because it has made plain that they would modulate the quantum and allocation of its emergency quantitative easing to nip in the bud any market-led tightening in market conditions. It may have unfortunately squandered this advantage with a communication issue on 21 January. The ECB pledges to stabilise "financing conditions" but at the latest press conference Christine Lagarde was – understandably – elusive on how it would be measured. It makes sense. The power of the central bank lies partly in the uncertainty it creates for investors who would wish to test its resolve. Mario Draghi would probably have dismissed the question with something like "you will know what the right level is when we act, and you can be sure it will be enough". This time, it seems the ECB is going to work on a set of criteria at a special seminar in March. The ECB's strategy, which seemed so clear in December, is being fine-tuned again.

These developments in the US and Europe come at the wrong time: the market needs clarity and anchoring from the central banks at a time of heightened uncertainty on the pandemic front.

Yields and earnings drive markets

Lower real interest rates have been, along with rising earnings forecasts, a key driver of global equity market performance. The current situation remains supportive even if there are concerns about further increases in yields. Real yields have rarely been lower than the current -1% on the 10-year US Treasury inflation linked bond. Compared to the last twenty years the consensus 12-month forecast for the growth in S&P500 currently stands at its 97th percentile ranking. Since global markets bottomed last March, real yields have fallen by 75 basis points (bps) and the consensus 12-month earnings growth forecast has risen from 0% to over 20%. Optimism on earnings is grounded in the view that the global economy will experience a boom once social mobility restrictions are gradually lifted. Optimism on rates is grounded in the view that central banks do have the tools, should they choose, to continue to repress long-term nominal bond yields.

The obvious risk is that things can't get much better and influence of these drivers on market performance will diminish or even reverse if there are material shifts in the macro environment. Markets could be more vulnerable to a shock – economic or political – and risk a correction from what many argue are rich valuations if earnings growth starts to fade or real yields move a lot higher. Investors in fixed income and equities alike need to pay close attention to the dynamics of the Treasury market, how increased supply impacts on bond prices and whether the Fed will lean against rising yields. Having said that, conditions can remain supportive for risky assets for some time. The fourth quarter (Q4) earnings reporting season in the US has delivered strong upside surprises on both sales and earnings. This bodes well for meeting earnings forecasts for 2021 and beyond Moreover, the level of real rates remains extremely low. Ahead of the two major equity bear markets of the 21st century so far, real yields were 300-500bps higher than today's levels.

The combination of liquidity and optimism on recovery from the pandemic in a regime of low real returns from risk-free assets should support capital being allocated to higher beta assets. There has been a persistence in the risk-adjusted performance of assets like high yield, leveraged loans, convertible bonds, small-cap equities and emerging markets. These are asset classes associated with generally higher volatility but also with the ability to generate strong returns in those parts of the economic cycle characterised by expansion and easy monetary conditions. Performance deteriorated during the last Fed tightening cycle in 2017-2018 and was hit by the COVID shock last year. However, since then returns have been strong and the search for yield and more diversified returns should be a support going forward.

We would note, however, that valuations are rich. If Treasury yields adjust to a world of stronger growth, higher inflation and a less supportive Fed, then all asset prices are likely to adjust. Ironically, stronger growth could undercut investment returns as the gap between bond and equity yields could converge. However, such a scenario is not for now as investors look towards some genuinely better news as the countries aim for herd immunity from COVID-19.

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Recommended asset allocation

Asset Allocation	Negative	Neutral	Positive
Key asset classes			
Equities			Positive
Bonds		Neutral ▼	
Commodities			Positive
Cash	Negative		
Equities			
Developed			
Euro area		Neutral	
UK		Neutral	
Switzerland		Neutral	
US		Neutral	
Japan		Neutral	
Emerging & Sectors			
Emerging Markets			Positive
Green Basket			Positive ▲
Europe Cyclical/Value			Positive ▲
US small caps		Neutral	
US Cyclical/value			Positive ▲
Global semiconductors			Positive ▲
Fixed Income			
Govies			
Euro core		Neutral	
Euro periph		Neutral	
UK		Neutral	
US		Neutral ▼	
Inflation			
US		Neutral	
Euro		Neutral	
Credit			
Euro IG		Neutral ▼	
US IG		Neutral ▼	
Euro HY		Neutral	
US HY		Neutral	
EM Debt			
EM bonds		Neutral	

Legends: Negative | Neutral | Positive — Last change: ▲ Upgrade | ▼ Downgrade

Source: AXA IM Macro Research – As of 27 January 2021

Macro forecast summary

Real GDP growth (%)	2020	2021*		2022*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
World	**-3.8**	**5.2**		**4.0**	
Advanced economies	**-5.6**	**4.9**		**3.4**	
US	**-3.4**	**6.0**	3.7	**3.7**	
Euro area	**-7.1**	**3.1**	5.3	**3.5**	
Germany	**-5.3**	**2.4**	4.4	**3.1**	
France	**-9.0**	**4.4**	6.7	**3.7**	
Italy	**-8.8**	**3.5**	5.3	**3.8**	
Spain	**-11.0**	**4.4**	6.7	**4.2**	
Japan	**-5.5**	**2.3**	2.5	**2.4**	
UK	**-10.0**	**4.3**	5.7	**7.5**	
Switzerland	**-4.8**	**2.5**	3.7	**3.0**	
Emerging economies	**-2.7**	**5.4**		**4.5**	
Asia	**-1.4**	**7.1**		**5.1**	
China	**2.3**	**8.0**	7.9	**5.5**	
South Korea	**-0.8**	**3.5**	3.2	**3.0**	
Rest of EM Asia	**-6.0**	**6.4**		**4.7**	
LatAm	**-7.5**	**3.3**		**2.8**	
Brazil	**-4.0**	**2.7**	3.2	**2.3**	
Mexico	**-8.6**	**2.7**	3.7	**2.5**	
EM Europe	**-2.6**	**2.7**		**3.6**	
Russia	**-2.8**	**1.5**	3.1	**2.5**	
Poland	**-2.7**	**3.1**	4.2	**4.6**	
Turkey	**0.6**	**3.5**	4.6	**4.6**	
Other EMs	**-3.7**	**3.3**		**4.1**	

Source: Datastream, IMF and AXA IM Macro Research – As of 27 January 2021

* Forecast

CPI Inflation (%)	2020	2021*		2022*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	**0.8**	**1.2**		**1.3**	
US	**1.4**	**1.7**	2.0	**2.0**	
Euro area	**0.2**	**0.7**	0.9	**1.0**	
Japan	**0.0**	**-0.3**	0.0	**0.6**	
UK	**0.8**	**1.8**	1.5	**1.5**	
Switzerland	**-0.7**	**0.0**	0.2	**0.2**	

Source: Datastream, IMF and AXA IM Macro Research – As of 27 January 2021

* Forecast

These projections are not necessarily reliable indicators of future results

Forecast summary

Central bank policy Meeting dates and expected changes (Rates in bp / QE in bn)		Current	Q1 -21	Q2-21	Q3-21	Q4-21
United States - Fed	Dates	0-0.25	26-27 Jan 16-17 Mar	27-28 Apr 15-16 Jun	27-28 Jul 21-22 Sep	2-3 Nov 14-15 Dec
	Rates		unch (0-0.25)	unch (0-0.25)	unch (0-0.25)	unch (0-0.25)
Euro area - ECB	Dates	-0.50	21 Jan 11 Mar	22 Apr 10 Jun	22 Jul 9 Sep	28 Oct 16 Dec
	Rates		unch (-0.50)	unch (-0.50)	unch (-0.50)	unch (-0.50)
Japan - BoJ	Dates	-0.10	20-21 Jan 18-19 Mar	26-27 Apr 17-18 Jun	15-16 Jul 21-22 Sep	27-28 Nov 16-17 Dec
	Rates		unch (-0.10)	unch (-0.10)	unch (-0.10)	unch (-0.10)
UK - BoE	Dates	0.10	4 Feb 18 Mar	6 May 24 June	5 Aug 23 Sep	4 Nov 16 Dec
	Rates		unch (0.10)	unch (0.10)	unch (0.10)	unch (0.10)

Source: AXA IM Macro Research - As of 27 January 2021

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Our Research is available online:

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