

The heat is on

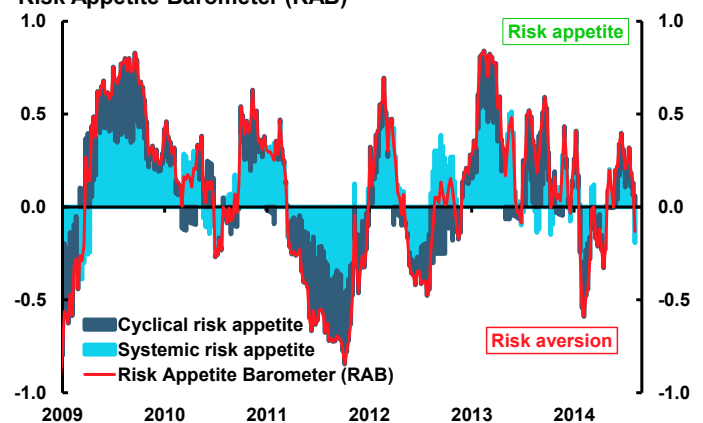
Risky assets: the tug of war between growing geopolitical risk and economic recovery

Key points

- Changes in our short-term recommendation: We are **reducing global equities back to neutral and parking the proceeds in cash**. In equities, we suggest **cutting the euro area to underweight**.
- While the US and China are delivering growth-wise, Europe is suffering from the events in Eastern Europe and a worrisome lack of momentum in France and Italy. The upcoming ECB asset-quality review only adds to the uncertainty.
- Monetary policy remains ultra-accommodative for the time being globally. Very low euro inflation may lead to the perception of large-scale QE by the ECB and thus weigh on Bund yields. **We have revised Bund yields to 1.25% by the end of this year**. Consequently we have a preference for Bunds vs US Treasuries and peripheral spreads vs Bunds. **Credit-wise** we advocate a further reduction in **duration**, particularly in the **HY segment**.
- Geopolitical tensions have heightened in the Middle East** but energy prices have remained in check so far. However, the risks of a disruptive event in the Middle East are rising.

Exhibit 1

RAB suggests to reduce risk
Risk Appetite Barometer (RAB)



Source: Markit, ISM, MSCI, Merrill Lynch, Datastream, AXA IM Research

Asset allocation recommendation

Global allocation	Short term (3-6M)	Medium term (12-24M)
Cash	▲ +	● -
Equities	▼ =	● +
Government bonds	● -	● -
Credit	=	=

▲/▼ Changes of the month

Source: AXA IM Research

Whilst the global recovery is unfolding as expected, risks are on the rise, globally (*Exhibit 1*), but even more so here in Europe. We thus see the need to adjust our asset allocation accordingly.

Global growth: it's happening

July brought a batch of Q2 growth estimates that were on balance positive. In the US, the economy posted gains above expectations, growing by 4% on an annualised basis, while the first quarter was revised upwards to -2.1% from a mere -2.9%. The momentum was driven by the domestic private sector –particularly household consumption and business investment– while strong imports deepened the trade balance.

China, the first large economy to publish GDP figures, posted a 2% gain on the quarter, above expectations. Growth was underpinned by an acceleration in the industrial sectors. The trend confirms that fine-tuning lending to the ailing real estate market and frontloading public spending is paying off. A reacceleration in China should start benefiting emerging economies exposed via trade.

A similar picture emerged in the **UK**, where GDP grew 0.8%qoq, sustaining the rapid expansion started in early 2013. Six years on, the economy has finally surpassed its pre-crisis peak from early 2008.

But **we are not expecting all the other economies to report equally encouraging news.** In particular, we are looking at negative growth in Germany, partly related to pay-back effects after a strong start to the year. Growth is also likely to have been very lacklustre –and possibly negative– in France .

Looking forward, we continue to see the US leading the global recovery, although the growth trend is likely to be a tad lower than in the past few months. The divergence with the euro area looks set to increase, as we foresee a regime of low but steady growth in the region rather than an acceleration. **Japan** should resume its moderate expansion in the second half of the year after the second-quarter contraction. Economic momentum resumed in **EMs**, supporting the overall positive sentiment. PMI prints were stronger in July on a monthly basis, signalling that manufacturing production is set to expand further.

Central banks stay put

Despite the encouraging news, there have been few monetary policy developments in recent weeks. **The Fed's statement after the July meeting marginally adjusted its assessment of the economy,** noting the decline in downside risks to inflation and a more convincing improvement in the labour market. Still, beyond the further reduction in asset purchases to US\$25bn per month (QE is due to end in October), the language on interest rates remained the same.

Likewise, **the ECB looks very much in wait-and-see mode** despite a new cyclical low for inflation in the euro area in July (+0.4%yoy). We expect the nadir to be reached in September, so pressure is likely to build on the ECB in the coming months. October looks like crunch time, with a combination of very low inflation prints, the first TLTROs and the results of the comprehensive assessment. Still, the bar is high in our view for the central bank to move before the end of the year, as it will want to see how the first TLTROs work out before making up its mind on further action.

Monetary policy in emerging economies is maintaining its dovish stance with interest rate cuts, particularly in emerging Europe. We expect monetary policy to continue easing while inflationary pressures remain under control and then to reverse as the first interest rate hikes in DMs approach. Of late, stronger US data has raised concerns about the fragile five (IDR, INR, ZAR, BRL and TRY). In our view, this episode is not related to the pick-up in geopolitical risk or Argentina. Instead, it marks the **beginning of a period in which investors will be looking for alpha rather than beta and to differentiate EMs.** This will be a remake of the post-May 2013 market tantrum that EMs experienced.

Ghosts of the past

But we do consider that **a number of risks have increased in recent weeks.** In the euro area, the Banco Espírito Santo case comes as a timely reminder of the potential for bad surprises in the banking sector, especially ahead of the results of the asset-quality review in October. **Geopolitical tensions have also grown in the Middle East,** although energy prices have remained in check so far. The **escalation in the Ukraine-Russia stand-off** and the introduction of level-three sanctions on Russia have led us **to revise downwards our GDP forecast for the euro area in 2014 to just 0.9%.** The tug of war will most likely linger for a long time and could further dent the growth perspectives of the euro area amid a slowdown in trade.

Argentina's endless debt dilemma and ensuing default after a marathon of negotiations with hold-out investors failed to curb sentiment towards EMs. Total non-resident portfolio flows to emerging economies continued heading north in July, supporting further credit expansion as evident in the easing of lending standards.

Bund yields, lower for longer

Contrary to our expectations, bond yields have remained extremely low. Several factors have weighed recently on US Treasury and German Bund yields alike. Strengthened forward guidance has reduced uncertainty over future monetary policy rates and, hence, the duration risk premium. Growing current account surpluses in Asia continue to fuel strong demand for safe and liquid assets. And, above all, the Fed's tone remains dovish despite much better macro data. Despite acknowledging that "inflation has moved somewhat

closer to the Committee's longer-run objective", the FOMC reiterated its firm intention to keep the federal funds rate at historic lows for a considerable time after the asset purchase program ends. **We still expect US Treasury yields to be just under 3% by year-end owing to sustained economic expansion and robust employment growth.**

We may be sticking to our year-end target for Treasuries, **but we have decided to revise our target for Bund yields downwards to 1.25%.** There are several euro-specific factors weighing on the German yield curve. A weaker than expected recovery is being impacted by the Russian/Ukrainian crisis. There is a worrying lack of economic momentum in France and Italy. Inflation has declined more sharply than expected since late 2013, and we now expect it to remain at around 0.5% barring any commodity price shock. Consequently, markets are increasingly expecting large-scale QE by the ECB (implying purchases of sovereign bonds of all euro area members, starting with Bunds) at some point in the future.

In this regard, recent ECB action sends a clear message: lower for longer, and ready to do more. This is likely to lead to a further decoupling of Bunds and Treasuries, **leading to a widening of the Treasury-Bunds spread beyond its 1999 levels. The situation reinforces our expectation that Bunds will outperform Treasuries in the next six months even though we prefer the spreads offered by peripheral bonds.**

We would qualify the **sell-off of US high yield as technical amid substantial outflows**, tight spreads and a more general risk-off-mode. Yet US corporate fundamentals are good and, if anything, improving.

We reckon, however, that "long credit" has become a very crowded trade for a while due to the "search for yield". As a consequence we are becoming more concerned about liquidity in this asset class once long-dated yields eventually move higher in anticipation of higher fed funds. **We thus suggest to reduce duration further and prefer Europe vs the US.**

Taking some risk off of equities

The combination of the above-mentioned risks suggests that **some risk should be taken off the table.** The opaque euro-area banking sector – which may have still more skeletons in the closet – and the Russia/Ukraine tensions will most likely weigh on European growth and thus on markets. As such, we have trimmed our 2014 earnings growth expectations for the euro area to around 10%. Argentina and the Middle East only add to the overall negative sentiment.

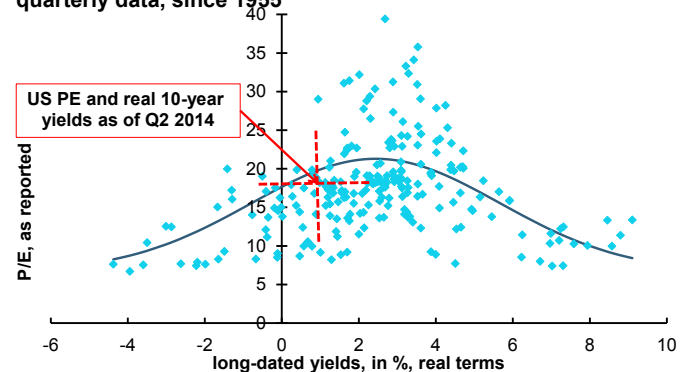
Should we fear the impact on equities of the growing risks of an earlier than expected hike in Fed funds? At this stage we don't think so. First, even if the market continues to price an initial hike in third-quarter 2015, we

don't expect the Fed to hike interest rates before mid-2015. Looking at similar episodes of monetary policy in the past, i.e. long phases of rates on hold prior to the beginning of a tightening cycle, equity markets have always recorded good returns during the pre-tightening phase.¹ So it is too early to ring the rate bell. Second, given the low starting point, monetary policy will remain accommodative even if real long-dated yields increase, which should limit the downward pressure on equity valuations (*Exhibit 2*).

Exhibit 2

Rising bond yields are not bad news for equities

US real yields & P/E
quarterly data, since 1955



Source: Bloomberg and AXA IM Research

Third, **the Fed's decision to hike interest rates is conditional on further evidence of improving labour market and economic activity**, which, ultimately is good news for corporate revenues. We therefore maintain our view that earnings will grow in the 5-10% range in 2014.

Note, however, that a tightening labour market should translate into more wage growth next year and thus weigh on US margins and, hence, on equities, while Chinese growth argues in favour of **Emerging Asia markets in the medium term.** Even though production costs will remain contained in the euro area,² this market is the centre of our biggest worry. Growing growth concerns heighten the risks that foreign investors depart, putting further downward pressure on the market. Which is why we suggest reducing the exposure to underweight.

Weighing up the pros and the cons, we suggest trimming the equity exposure down to neutral **and investing the proceeds in cash**, or, alternatively, **introducing downside protections in the portfolios, either through options or through direct volatility exposure.**

¹ Cf. Wenzel, F. and Signori, O., "[How US markets behave before and after the first rate hike – an historical comparison](#)", AXA IM Research, 31 July 2014

² Cf. Alimi, M., and L'Hoir, M., "[Euro area equities: some margin for margins](#)", AXA IM Research, 19 June 2014

RECOMMENDED ASSET ALLOCATION

Global allocation		Short term (3-6M)	Medium term (12-24M)
Cash	▲	+	-
Equities	▼	=	+
Government bonds		-	-
Credit		=	=

▲/▼ Changes of the month

Equities		Short term (3-6M)	Medium term (12-24M)
United States	▲	=	-
€ area	▼	-	+
UK		=	=
Switzerland		-	-
Japan		=	=
Latin America		=	=
Emerging Europe		=	=
Emerging Asia		+	+

▲/▼ Changes of the month

Government bonds		Short term (3-6M)	Medium term (12-24M)
United States		-	-
€ area core		-	-
€ area periphery		=	=
UK		-	-
Japan		=	-
Emerging		=	=
Swap spreads		-	-
Break-even		=	=
- United States		+	+
- Europe		=	+

▲/▼ Changes of the month

Credit		Short term (3-6M)	Medium term (12-24M)
Corporate credit - US		=	=
Corporate credit		=	=
High Yield - US		=	=
High Yield - €		=	=

▲/▼ Changes of the month

Our convictions

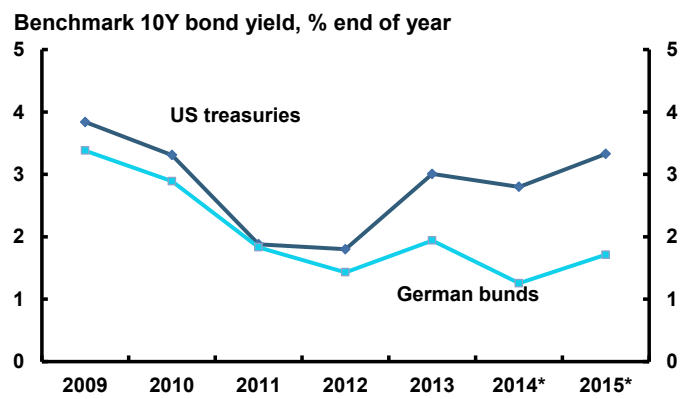
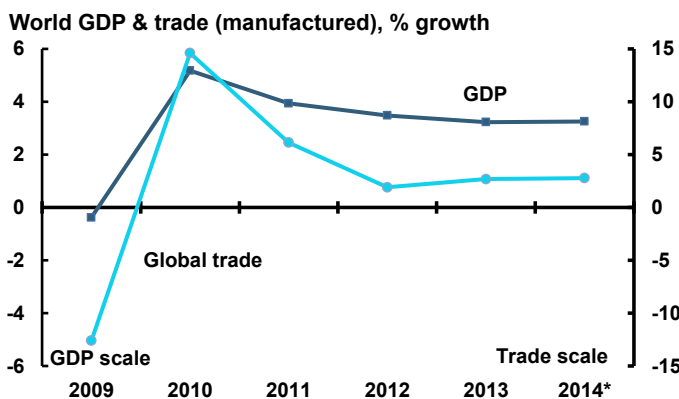
- The economic recovery is on track but mounting risks (geopolitical, EMU banks) are weighing on equities.
- The ongoing monetary policy normalisation is negative for fixed income assets.
- Credit tightening is mostly behind us but spreads still offer a mild advantage over sovereigns.
- US: expensive, margins are expected to suffer, but next year.
- Euro area: Russia/Ukraine, peripheral banks and lacklustre economic momentum are weighing on equities.
- UK: still reasonable valuation relative to peers, but currency appreciation is a strong headwind on earnings.
- Switzerland is too expensive.
- GEM: systemic risk fears have eased, valuations are attractive. Prefer EM Asia where economic activity has bottomed out.
- US: long term, yields are expected to rise as the Fed will end bond purchases in the autumn.
- Expect Bund yields to rise to 1.25%; euro sovereigns offer relatively better value compared to US Treasuries.
- Keep faith in € area periphery thanks to the ECB put.
- Japan: XXL BoJ QE will avoid excessive rise in JGB yields.
- Positive view on US inflation break-evens.
- Rising yields call for caution and selectivity.
- Tilt further toward short-duration HY due to rich valuation and rising geopolitical risks.

FORECAST SUMMARY

07 August 2014	2009	2010	2011	2012	2013	2014*	2015*	2016*
Growth								
World GDP (PPP)	-0.4	5.2	3.9	3.5	3.2	3.2	3.3	3.3
World GDP (market FX rate)	-2.1	4.1	3.0	2.6	2.8	2.9	3.0	3.0
USA	-2.8	2.5	1.8	2.8	1.8	1.8	2.5	2.7
Euro area	-4.4	1.9	1.6	-0.6	-0.4	0.9	1.4	1.4
UK	-5.2	1.7	1.1	0.3	1.4	3.3	2.7	2.5
Japan	-5.5	4.7	-0.4	1.4	1.8	1.7	1.4	1.4
China	9.2	10.4	9.3	7.7	7.7	7.4	7.0	6.8
Rest of Asia	5.5	8.7	5.8	5.2	5.0	4.5	4.3	4.2
RoW	-2.4	4.7	3.9	3.5	3.2	3.0	3.0	3.0
Global trade								
Manufactures goods	-12.6	14.6	6.1	1.9	2.7	2.8	4.9	5.0
Inflation								
US	-0.3	1.6	3.1	2.1	1.5	1.8	2.0	2.1
Euro area	0.3	1.6	2.7	2.5	1.4	0.5	1.4	1.5
UK	2.2	3.3	4.5	2.8	2.6	1.7	1.8	2.0
Japan	-1.1	-0.7	-0.4	-0.5	0.0	2.5	2.0	1.9
Crude oil (Brent), US\$/bbl								
	61.7	79.9	111.6	112.0	108.9	107.7	108.8	110.4
Interest rates, FX (end of period)								
US								
Fed funds (actual / target)	0.20	0.20	0.15	0.17	0.09	0.10	0.50	1.50
10Y Treasuries yield	3.84	3.31	1.88	1.80	3.01	2.8	3.3	3.8
Euro area								
EONIA	0.39	1.00	0.63	0.13	0.17	0.1	0.1	0.1
10Y Bund yield	3.38	2.89	1.83	1.43	1.94	1.3	1.7	2.2
€1 = ... US\$	1.46	1.34	1.33	1.33	1.38	1.3	1.3	1.3
Japan								
Overnight call rate	0.11	0.00	0.10	0.09	0.10	0.1	0.1	0.1
10Y JGB	1.28	1.12	0.99	0.79	0.74	0.5	0.9	1.2
US\$1 = ... JPY	87	85	78	76	105	105	103	101
€1 = ... JPY	127	114	104	115	145	137	133	130
UK								
BoE base rate	0.5	0.5	0.5	0.5	0.5	0.8	1.3	2.0
10Y gilt	4.11	3.51	1.98	1.96	3.03	3.0	3.5	4.0
€1 = ... GBP	0.89	0.85	0.86	0.81	0.83	0.79	0.75	0.76

Sources: IMF, Datastream, AXA IM Research

*AXA IM forecasts



These projections are not necessarily a reliable indicator of future results.

ABBREVIATION GLOSSARY

1Q11	first quarter of 2011	INR	Indian rupee
1H11	first half of 2011	ISM	Institute of Supply Management
[Lhs]	left hand scale (graph)	JGB	Japanese Government Bonds
[Rhs]	right hand scale (graph)	£	Sterling pound
a.r.	annualised rate	LatAm	Latin America
AQR	Asset Quality Review	LBO	Leveraged buy-out
ARS	Argentine peso	LTRO	Long Term Refinancing Operation
BoE	Bank of England	mom	month on month
BoJ	Bank of Japan	n.s/a	non-seasonally adjusted
bp(s)	basis point(s)	NAIRU	non-accelerating inflation rate of unemployment
BRL	Brazilian real	OECD	Organisation for Economic Cooperation and Development
CNY	Chinese renminbi (yuan)	P/E	price/earnings
CPI	Consumer price index	PEG	price/earnings to growth
EBITDA	earnings before interest, taxes, depreciation, and amortization	PMI	Purchasing Manager Index
ECB	European Central Bank	pp	percentage point
EM	Emerging market	PPI	Producer price index
EMU	European Monetary Union	QE	Quantitative easing
EPFR	Emerging Portfolio Fund Research, Inc.	qoq	quarter on quarter
EPS	Earnings per share	s/a	seasonally adjusted
€	Euro	TLTRO	Targeted Longer Term Refinancing Operation
FOMC	Federal Open Market Committee	TRY	Turkish lira
GDP	Gross Domestic Product	US\$	US dollar
HY	High Yield	¥	Yen
IDR	Indonesian rupiah	yoy	year on year
IG	Investment Grade	ytd	year to date
IMF	International Monetary Fund	ZAR	South African rand

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