Research &
Investment
Strategy

2016 Lessons for 2017

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January 2017

AXA INVESTMENT MANAGERS

2016 Lessons for 2017

Political risk, the dog that didn't bark

- 2016 was the year of political risk but its impact on markets was limited and mostly ahead of the events
- Central banks managed yet again to surprise, even though they now look more geared toward the exit
- Policy changes and expectations thereof led to sector and style being the main drivers of equity market returns last year
- Chinese authorities are still far from having 'lost control': they successfully engineered the pickup in the economy in H2

What we take away moving forward

- We are less concerned about political risk in 2017 overall and see the main risks in the US, as opposed to France or even Italy
- We expect equity markets to continue being driven by micro rather than macro: embedded duration, regulation changes, buy-backs
- Central banks should not be discounted as market movers. The Fed remains central to global markets while important announcements are expected from the ECB and the BoE in the late part of the year
- In EM, differentiation remains key and those countries geared to China rather than the US should benefit from stability there

We adjust the equity allocation

- We go neutral in the US against the euro area as fundamentals improve in the latter while political risk has diminished
- Time looks ripe to take profit in our long EM Europe vs Latam as enough bad news is now priced into Mexican assets
- Separately, we rotate our positive view on inflation from the US, where markets have moved significantly, to Europe where there appears to be room for further normalisation

Central scenario

Our central scenario

A benign environment of steady growth and rising inflation reduces concerns about secular stagnation. Political risk does not lead to significant stress in DM or EM. Expected returns are modest given valuation levels

Inflation

Increasing globally with energy base effect (peak in Q1 2017) and core normalisation

Monetary policy

2 Fed hikes (maybe 3), ECB to announce QE tapering in late 2017

Fiscal policy

Significant fiscal stimulus in the US, limited elsewhere

Growth

Global GDP acceleration led by the US and large EMs; stable EMU recovery

EM

Improving but fragile macro outlook; Brazil and Russia exiting recession

Rates

Core interest rates should rise gradually as policy rates, inflation expectations and the term premium normalise

FX

We are neutral in EURUSD but see a weaker GBP going forward

Credit

In a steady growth and rising rate environment, credit should be resilient and high yield outperform

Equities

Performance should be modest as high earnings expectations are priced in and multiples are vulnerable to higher rates

Alternative scenarios

False start

What goes different?

Trumponomics disappoints, the US economy remains soft and inflation falls back down

OR

A sharp deterioration, e.g. in China, slows down the global economy

What it means

- Central banks have to make a U-turn, ease further and lose credibility
- Fiscal policy proves unable to take up the baton
- Growth/inflation expectations tank

Market implications

- Risk appetite declines
- Rates rally and the search for yield resumes, the USD depreciates
- Equity and commodity markets fall, credit spreads remain resilient

Rates disorderly correction

What goes different?

US inflation rebounds sharply on the back of tight labour markets and anti-trade policies

OR

Deteriorating geopolitical relations lead to a re-pricing of US Treasuries risk premium

What it means

- US Treasury yields rise sharply, with the Fed unable to contain markets
- Global rates move higher in sympathy, as observed since November

Market implications

- A disorderly sell-off hurts government bonds; credit spreads widen
- The correlation to stocks turns positive as equity valuation declines on higher discount rates
- EM assets suffer with limited differentiation

Themes of the Month

Political risk, the dog that didn’t bark

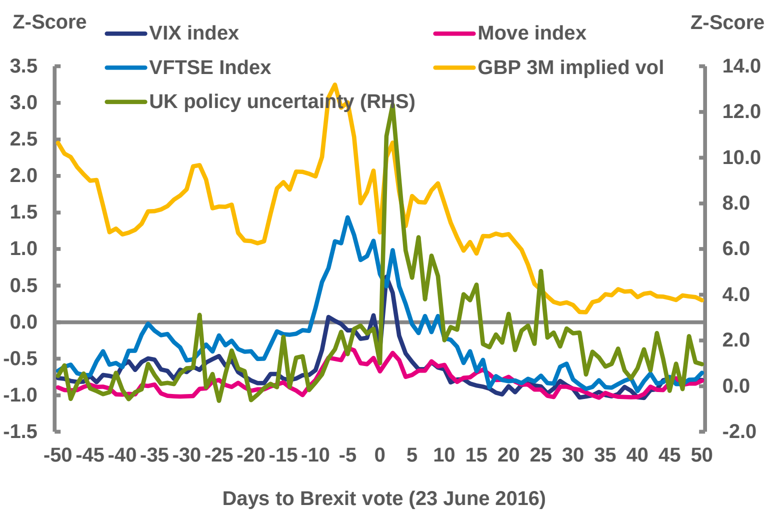
2016 may be remembered as a year of political risk, but little of that has translated into market action

Volatility remained low across asset classes and barely rose around Brexit and the US election. Most of the pickup in volatility occurred ahead of the events and normalised thereafter, in a ‘sell the rumour, buy the fact’ behaviour

For 2017, we think the political risk in Europe is overestimated. We rather see the US as the main source of policy volatility, especially as the Trump administration is looking to move fast in the first 100 days

Market concerns faded after Brexit…

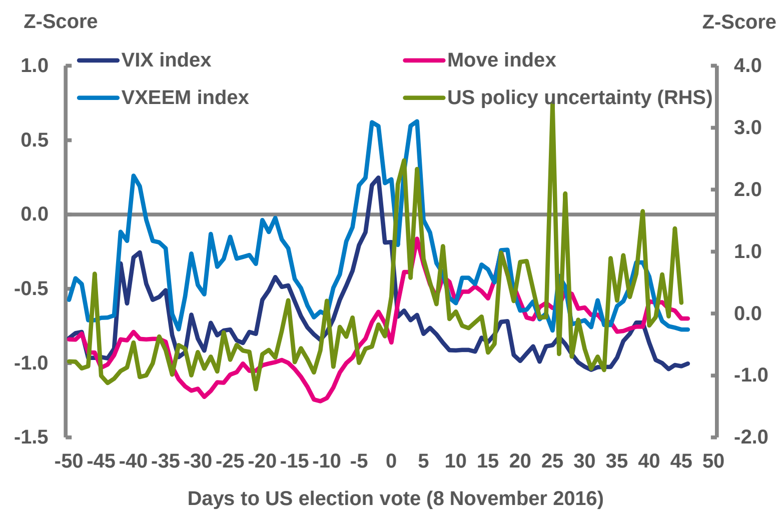
Volatility around the Brexit vote



Source: Bloomberg, Policy Uncertainty Index and AXA IM Research

… and again after the US Presidential election

Volatility around the US election vote



Source: Bloomberg, Policy Uncertainty Index and AXA IM Research

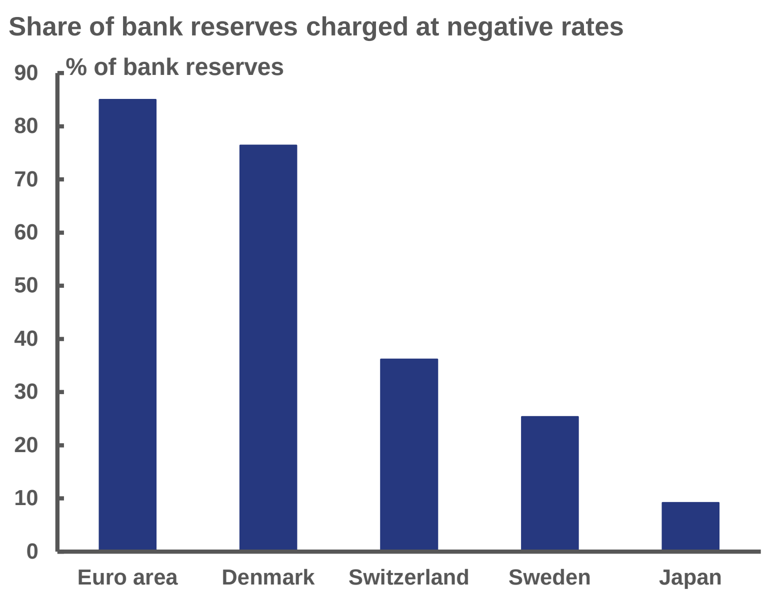
Do not underestimate central banks' creativity

BoJ surprised by introducing negative interest rates (Jan.) then came up with an innovative way to protect banks' margins (Feb.) and made history by introducing hard yield targeting (Sep.)

ECB extended QE to corporate debt (March) and prolonged QE all the way to end-2017 (Dec.)… but 2017 should see the scarcity of politically acceptable parametric adjustments

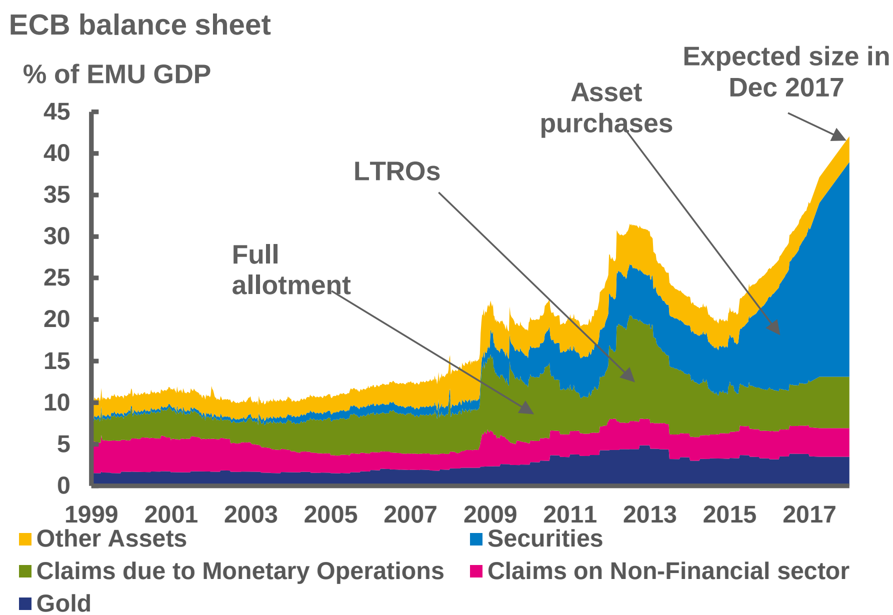
BoE surprised with £10bn corporate QE already in August; in 2017 again, supporting the economy will trump defending the currency

BoJ joined the NIRP club with an innovative system



Source: Bank of Japan and AXA IM Research

December ECB meeting provided clear view for QE in 2017



Source: ECB and AXA IM Research

China is able to maintain macro stability

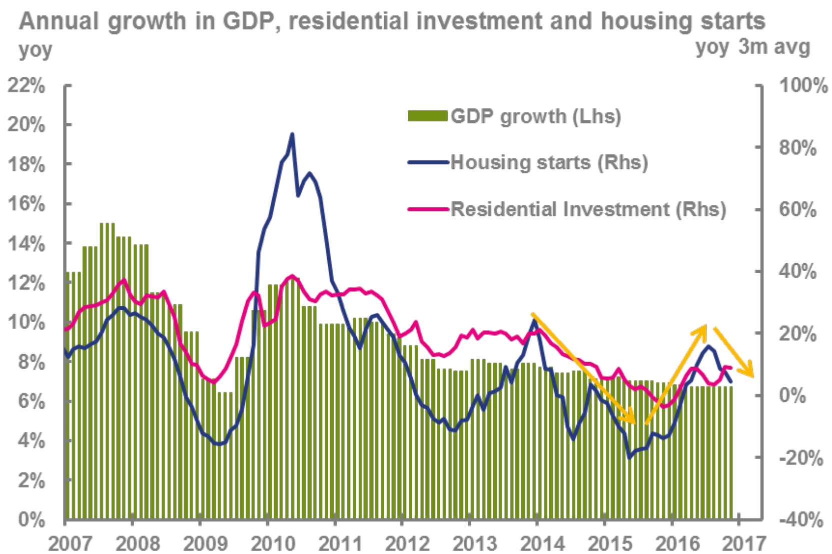
Stable macro backdrop in China came as a surprise against fears of the economy and currency at the start of 2016

Successful reflation of the housing market and limited FX volatility helped to soothe market concerns

Maintaining such stability will be the key focus of macro policies in the year of leadership transition in 2017

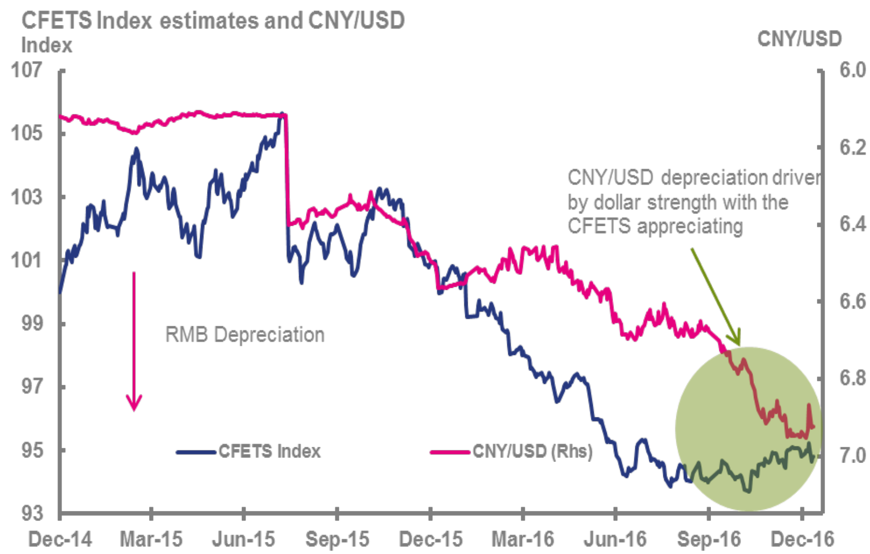
Key risks will be a deepening of China's structural ills (e.g. more debt to pump up growth and more interference to slow the transition towards a free market) and a rise of trade protectionism

Housing market may not support growth, like it did in 2016



Source: CEIC and AXA IM Research (as of Jan 2017)

PBoC will continue to manage FX policies to ensure stability



Source: Bloomberg, CEIC and AXA IM Research (as of Jan 2017)

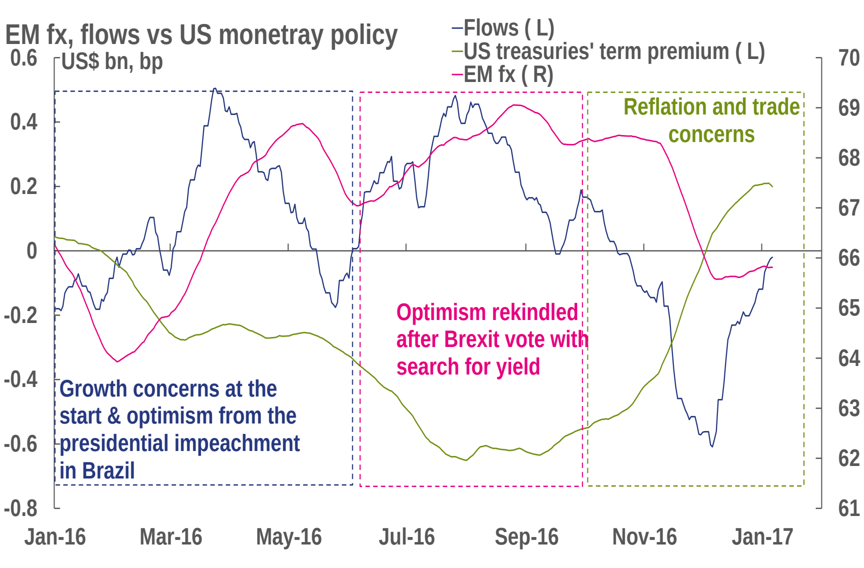
Selectivity of EM investors: to be continued

Last year was split into three parts:

- Part I: concerns over global growth followed by optimism during the presidential impeachment process in Brazil
- Part II: market optimism after the Brexit vote with the ensued search for yield
- Part III: global reflation, reinforced after US Elections and trade concerns

Selectivity of EM investors witnessed at end-2016 to be continued in 2017 (TRY and MXN at risks, rest of Latam over-performing) as investors look for stronger fundamentals and the US monetary policy normalisation proceeds

2016 was a story of three parts



Source: IIF, Bloomberg, AXA IM Research

Selectivity to be continued

Source : Bloomberg, AXA IM Research

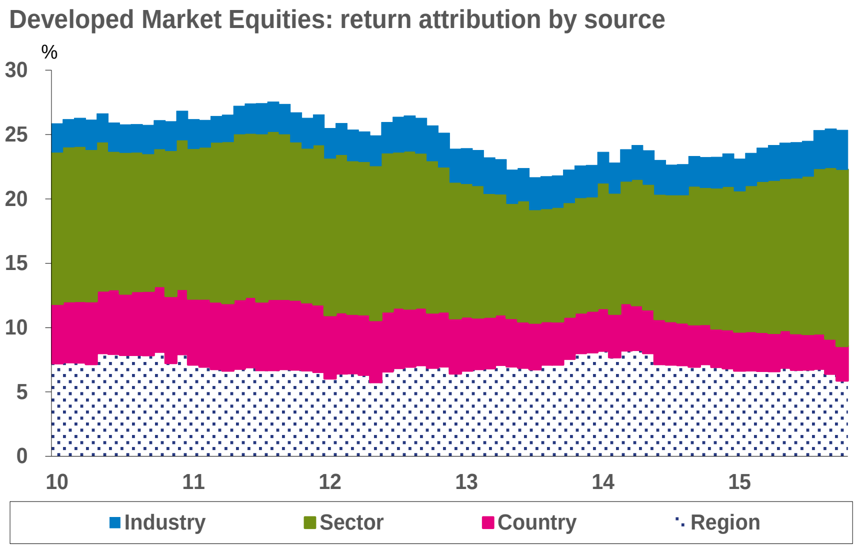
Equity market drivers: sectors and style

Equity markets returns attributable to sector and industry factors have been on the rise in developed markets

We expect this to continue going forward considering distinctive sector implications from changing policy and rates

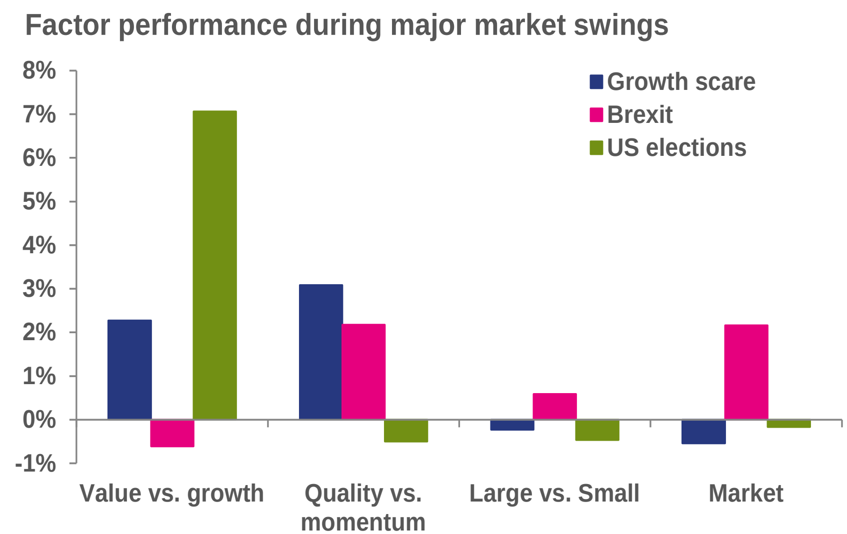
The reflation theme and equity duration dynamics should favour value over growth performance

Increase in sector and industry return contribution



Source: Empirical Research Partners

Value and quality were the winners



Source: AXA IM Research, Bloomberg and DataStream.

Macro Outlook

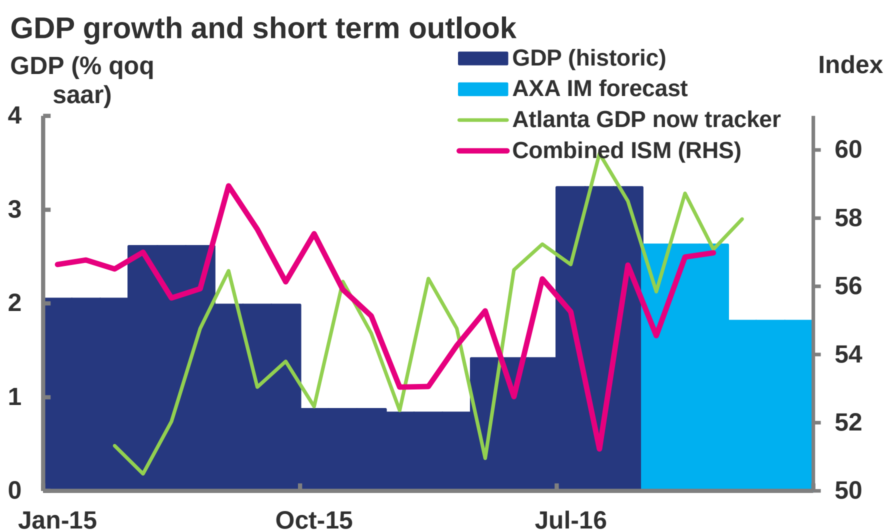
A solid close to 2016

Firmer momentum in the final months of 2016 suggest that US Q4 GDP growth is likely to exceed our 2.2% (annualised) forecast for the quarter – we now consider 2.6% more likely

This would lift the 2017 GDP outlook to 2.2% from 2.1% - in line with consensus. While we do not expect fiscal changes to materially impact 2017, sentiment appears to be lifting and solid momentum suggests upside risks.

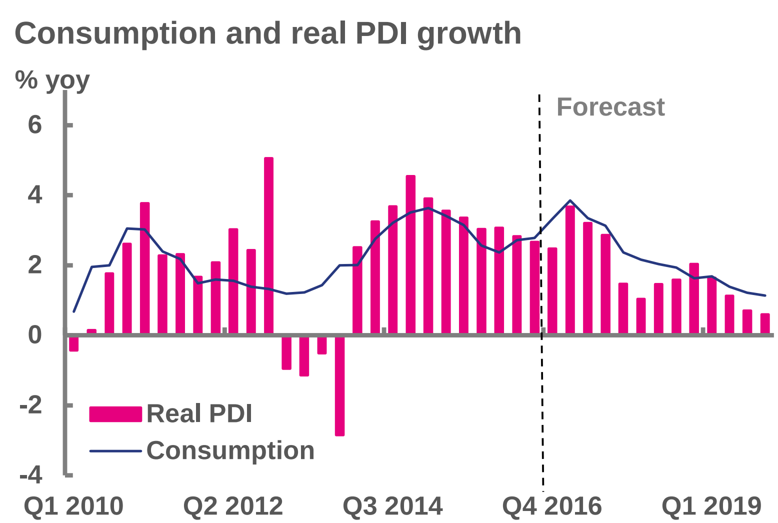
Uncertainty over the scale of the boost to impact 2018 is high. However, we are wary of inflation eroding household real income growth and headwinds from tighter financial conditions keeping growth relatively subdued.

GDP momentum suggests upside risk to our Q4 GDP call



Source: BEA, FRBA, ISM, AXA IM Research - Dec 16

Declining real income growth still to weigh on consumer spend



Source: BEA, AXA IM

Are we nearly there yet?

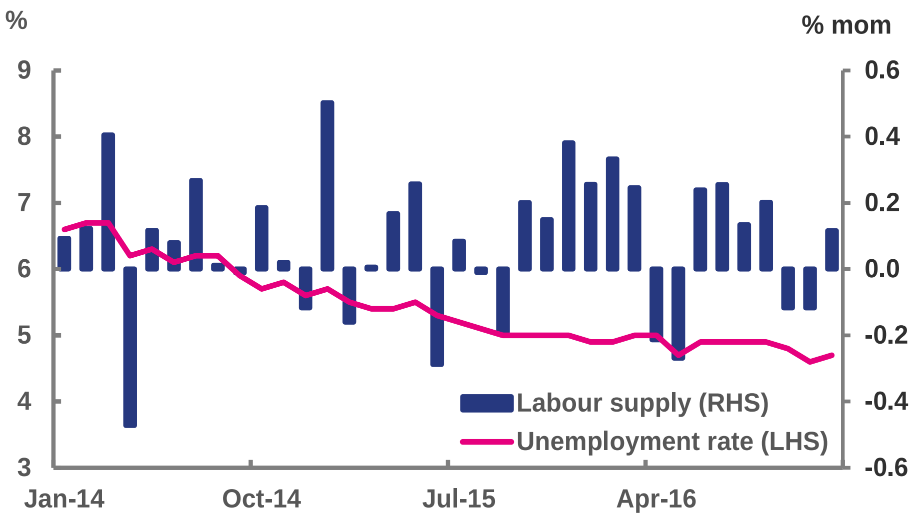
Payrolls growth slowed to 180k across 2016 from 230k in 2015. This has been sufficient to see the unemployment rate broadly level off – albeit at 4.7% below level Fed considers longer-term rate

Fed still looks at a number of measures of slack and has seen signs of accelerating labour supply consistent with drawing workers back to the labour market by running the economy "hot"

Emerging wage pressure is beginning to suggest that the labour market is finally exhausting its slack (that outstanding slack is more structural than cyclical). This is likely to drive the Fed to a more consistent policy tightening.

GDP outlook falls short of Trump's 'aspirational' 3-4% target

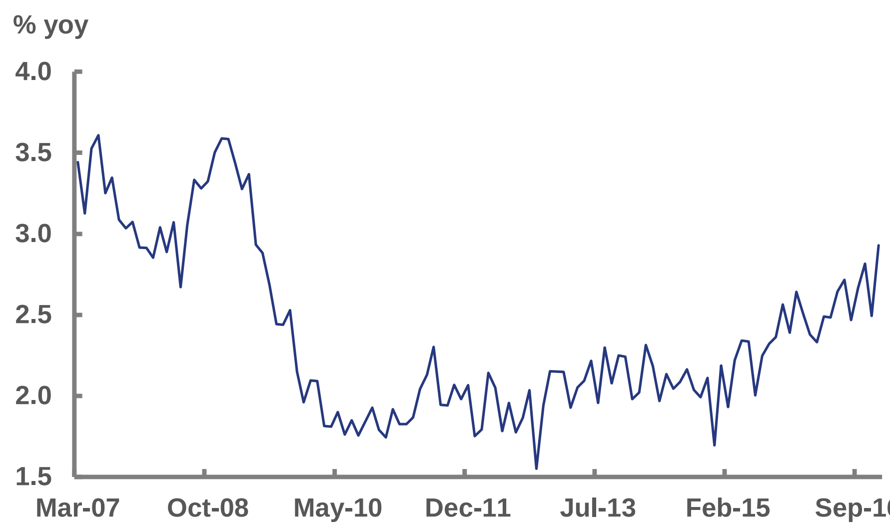
Labour supply growth and unemployment rate



Source: BLS Jan 2017

Inflation pressures set to rise

Average hourly earnings (yoy)



Source: BLS – Jan 2017

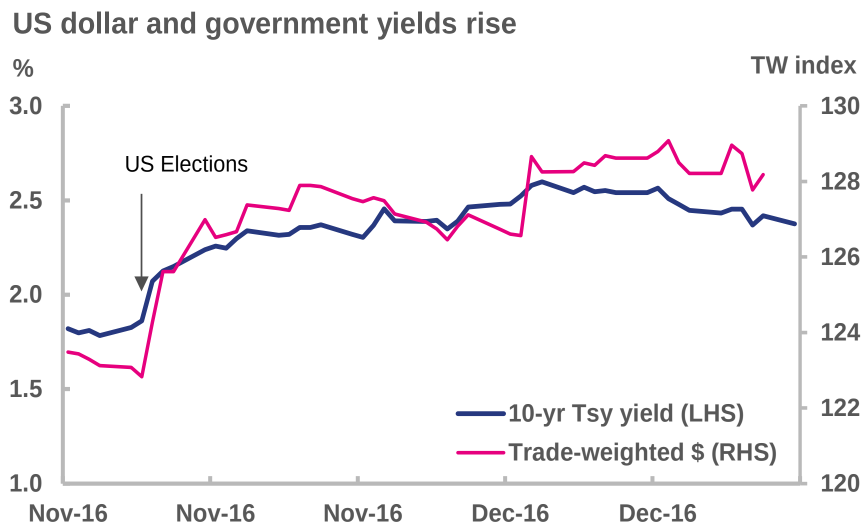
A delicate balancing act – 2 or 3 hikes

An assumption of some fiscal stimulus helped edge the Fed's median outlook for rate hikes to three from two in December, but most acknowledged it was "too early" to gauge what impact the new administration would have.

We consider headwinds from tighter financial conditions, including a material rise in longer-term interest rates and the dollar, as a material headwind to activity before any changes lift the economy.

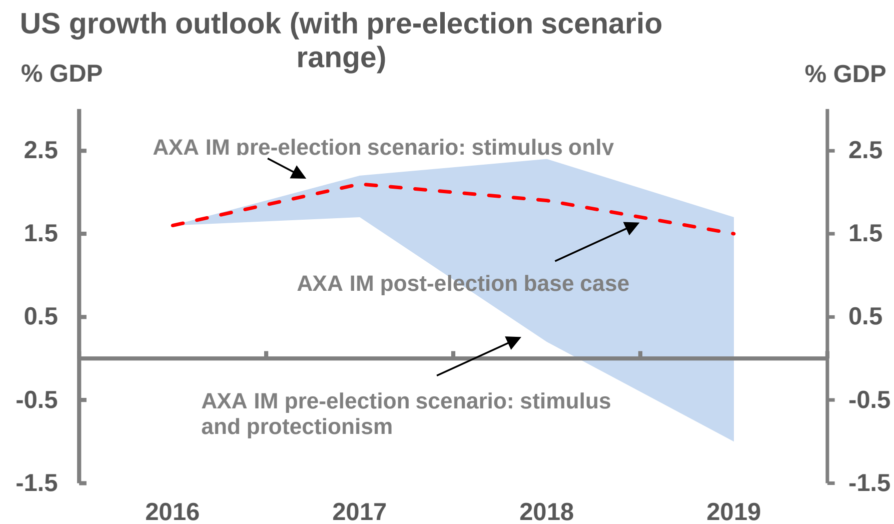
As such, we expect just two hikes in 2017 (Jun and Dec), before a quicker tightening in 2018. However, with the economy closing 2016 with modestly firmer momentum, risks to this projection lie to the upside.

Tighter financial conditions: dollar and yields



Source: DataStream – Jan 2017

Trump agenda still poses major uncertainty ahead



Source: AXA IM Research

On track for a modest recovery

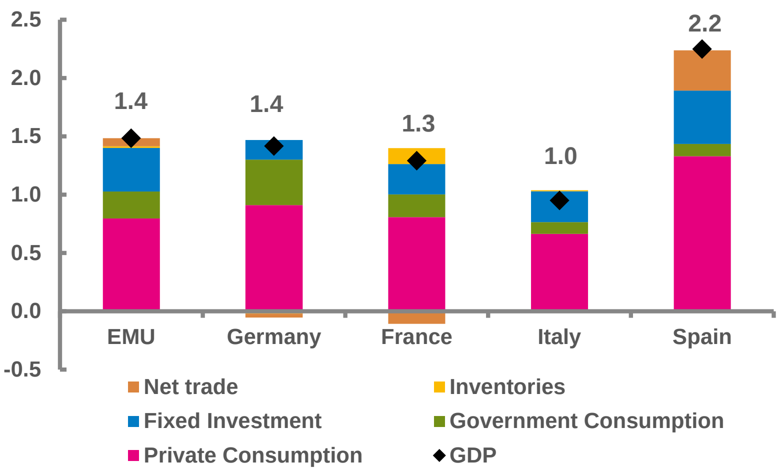
The EMU ended 2016 on a high : labour market further improved in November, IPs surprised on the upside in France and Germany, composite EMU PMI printed at a 5-year high in December, and GDP growth should be in line with our estimate of 1.6%

We expect GDP growth to remain moderate but softer in 2017 (1.5% vs 1.4% consensus) and balanced across countries

- Growth will be domestically driven with consumption as the main contributor
- The limited slowdown will stem from less improvement in labour market, fading oil support and slowing investment growth

GDP forecasts are balanced across EMU countries

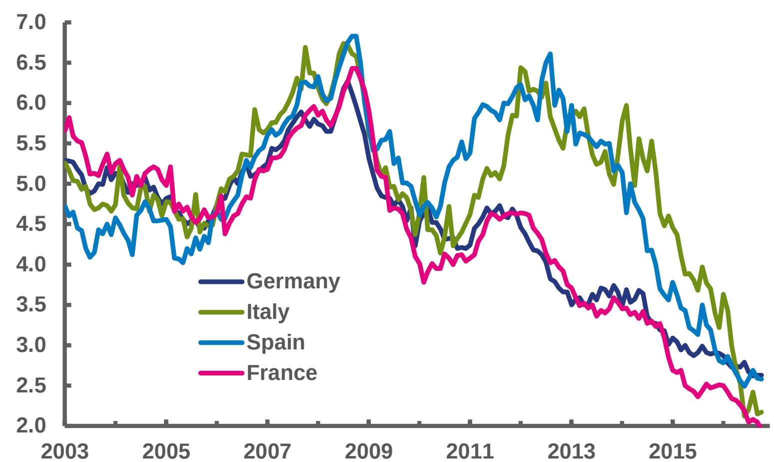
2017 GDP forecasts (%)



Source: Eurostat, AXA IM Research

Corporate interest rates to rebound?

Interest rate on new loans to nonfinancial corporations, 1 to 5Y maturity, below €1mln (%)



Source: ECB, AXA IM Research

Italian politics still uncertain

PM Gentiloni's government has two priorities

- **Solving the banking sector issue.** Precautionary recap plan decided for MPS: €6.6bn will be provided by Italian State, and €2.2bn by institutional investors via a debt-to-equity conversion (in line with State Aid rules). Other banks recap plans are still pending. DBRS downgrade of Italian rating also mounted pressure on banks' financing cost with an estimate extra cost of €6.7 Bn.
- **Complete the electoral law reform**, to harmonize the two chambers electoral systems

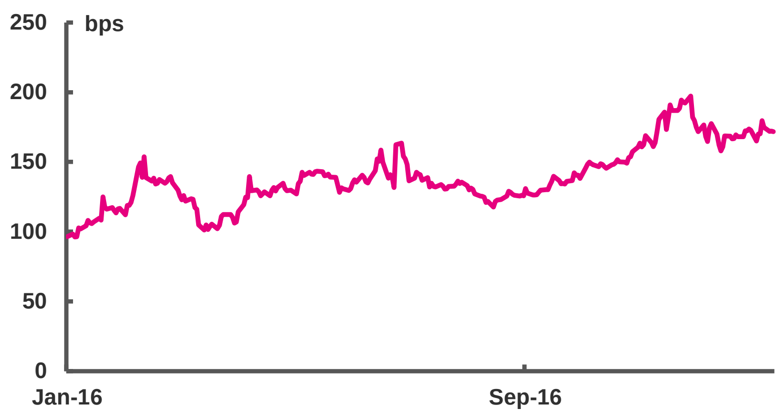
Life expectancy of the new government could be shortened if it fails one of these tasks

On Jan. 11, Constitutional court rejected the grounds for holding a referendum on the most sensitive part of Renzi's "Jobs Act" but accepted a referendum on 2 less sensitive questions

At this stage, probabilities of an early election in 2017H1 are low but credible in H2 with reduced risk of Five Star after electoral reform

Markets relieved by Jan. 11 Constitutional Court decision

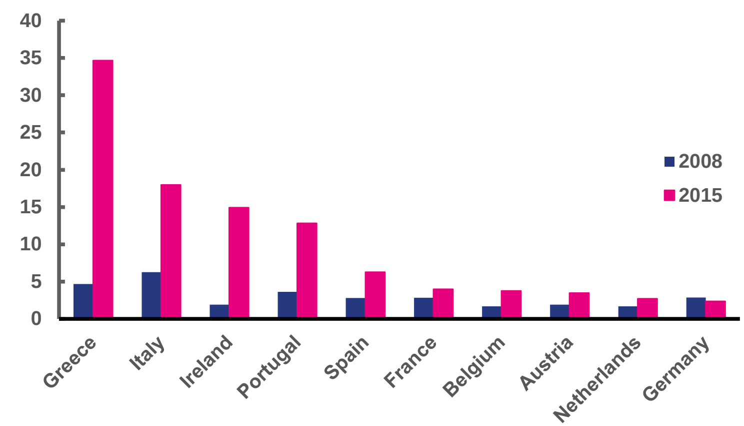
Italian Spread since 2016



Source: Datastream and AXA IM Research

NPL at record high

Euro-area banks' non-performing loans (% total loans)



Source: FRB, AXA IM Research

All eyes on inflation

In Dec-2016, ECB decided to lower pace of purchases from €80bn to €60bn from Apr-17, until Dec-17 and changed technical parameters to address scarcity issue

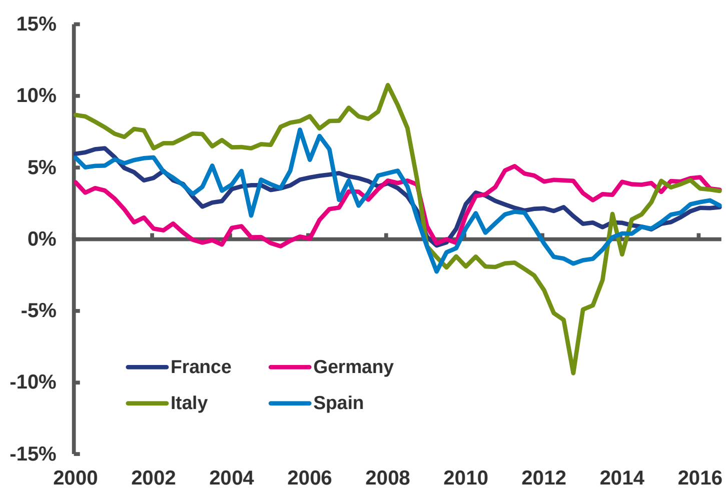
We have **clarity on ECB balance sheet throughout 2017** and notably beyond the German elections. We do not expect EMU financial conditions to deteriorate (peripheral spreads and FX)

German headline inflation printed at +1.7%yoy in December, on the back of rising energy and food prices (+2.5%yoy). Spain inflation printed at +1.4% while Italy and France are lagging respectively at +0.5% and +0.8%. Core reflation remains the key question

January's ECB press conference provided technical details on purchases of bond yielding below the deposit rate

Wages are increasing faster in Germany

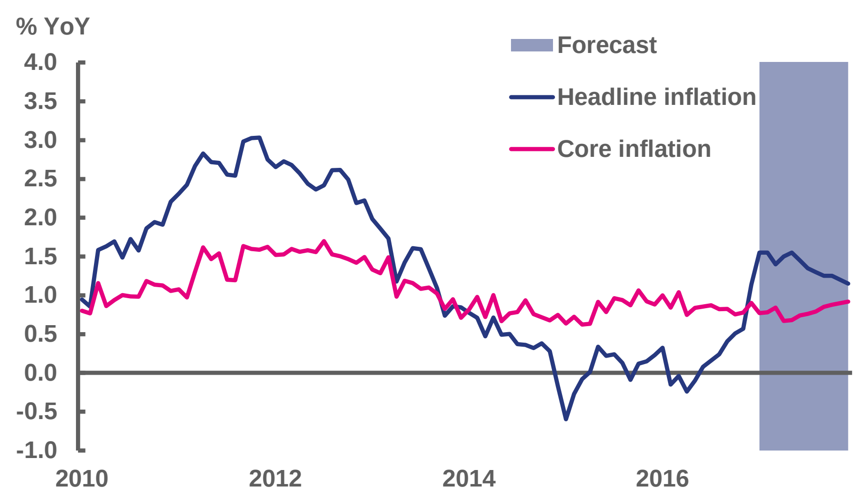
Wage & salaries in EMU (%-yoy)



Source: Eurostat and AXA IM Research

Core inflation to rise through 2017

Euro-area inflation



Source: Eurostat and AXA IM Research

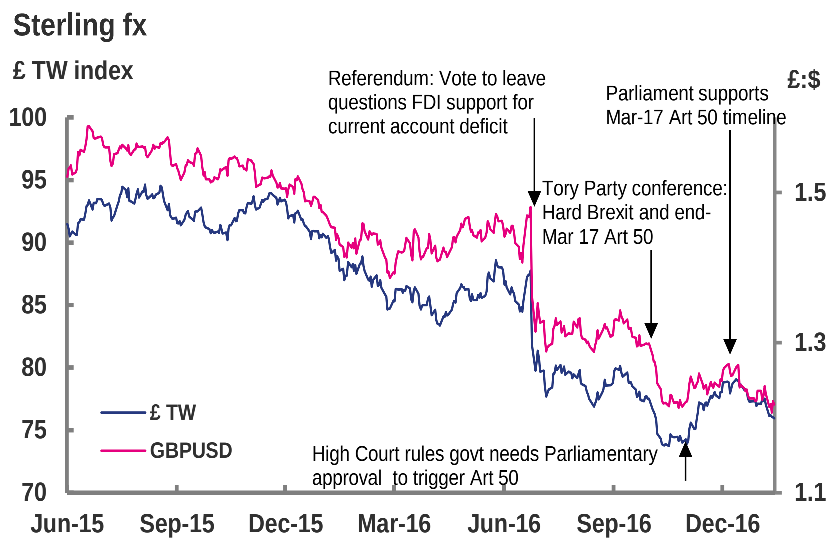
Brexit – the shape of things to come

PM May presented an overview of her government's Brexit negotiation ambitions. Control of migration and justice imply the UK will leave the Single Market. May discussed ambitions for a new trade deal, but a transition deal may be necessary to bridge the gap. May still plans to trigger Art 50 by end-March.

The remainder of the month awaits the Supreme Court rulings. The involvement of devolved governments could delay May's timetable with the collapse of the Northern Ireland government – elections expected early March.

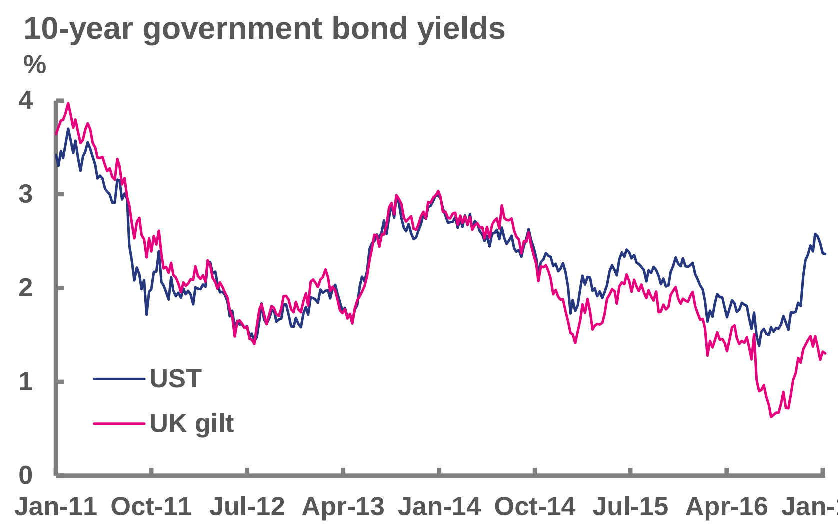
Parliament otherwise appears supportive. Triggering Art 50 will begin a two-year negotiation with the rest of the EU. However, domestic political focus in key EU economies may slow initial progress.

Sterling faces renewed pressure



Source: DataStream, AXA IM Research

Gilt yields hold steady



Source: BoE, AXA IM Research

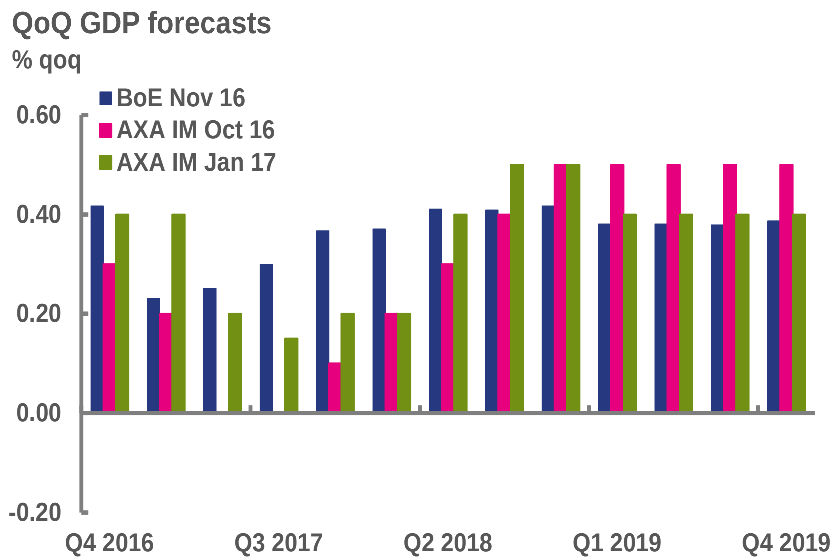
Economy shows resilience

Output data for Q4 surprised to the upside including a 2.1% m/m rise in industrial activity. As such we have increased our Q4 GDP outlook to +0.4% (from 0.3%). PMIs suggest Q1 growth of +0.5% (we had estimated 0.2%)

A stronger turn of the year raises the outlook for 2017. However, a faster translation of sterling weakness to inflation looks underway. We forecast GDP growth at 1.4% (from 0.9%) for 2017 and 1.2% (from 0.9%) for 2018

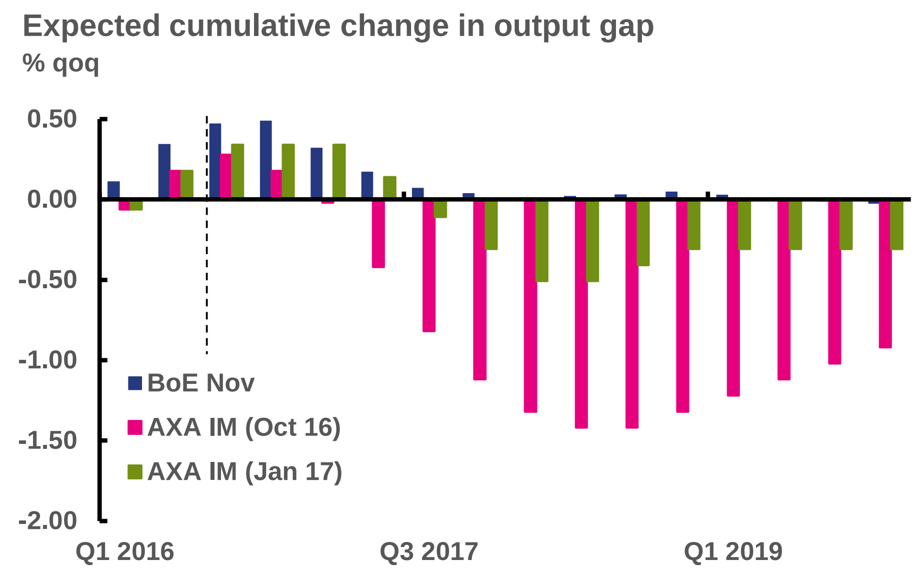
This is closer to the BoE outlook (1.4%, 1.5%), which saw it switch to a neutral policy outlook

Firmer data result in an upgrade to our 2017 GDP outlook



Source: BoE, AXA IM Research

Expected rise in capacity to warrant some, but less stimulus



Source: BoE, AXA IM Research

Moderate expansion and mildly negative (core) inflation

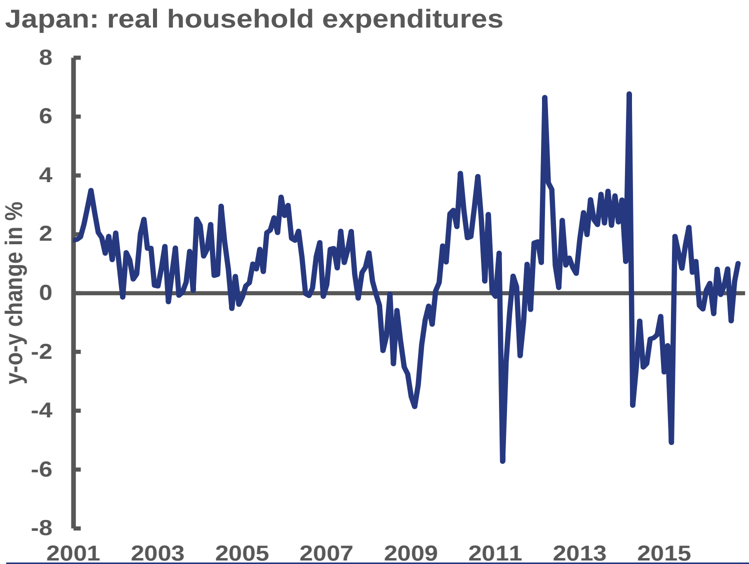
Growth on track with a moderate expansion, core inflation still at zero

- With an encouraging uptick in consumption growth and rising consumer confidence, we expect GDP growth to remain stable around 1.3-1.4% q-o-q annualised rate in 2016Q4-2017Q1. Latest manufacturing business surveys are however disappointing
- Tokyo CPI confirms slightly negative core inflation prevails despite November's national uptick

Will BoJ's "yield curve control" remain resilient to rising global rate?

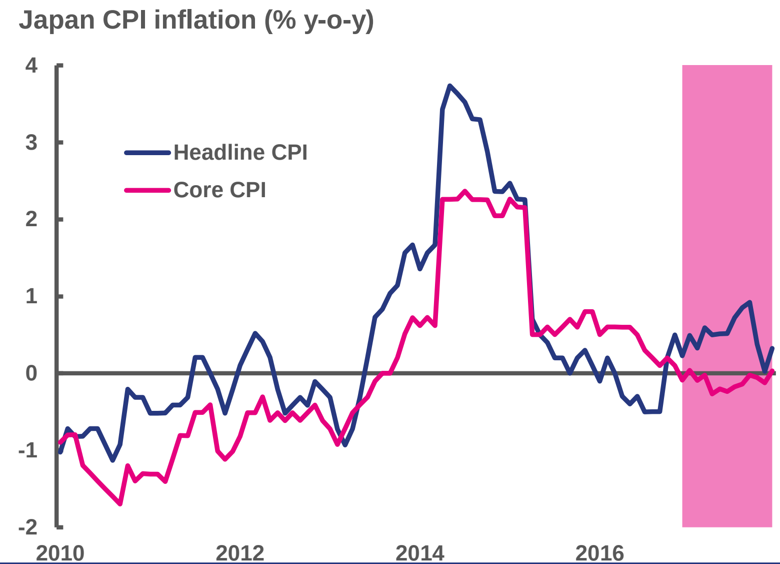
- BoJ should stick with its "yield curve control" framework in 2017, nevertheless the 0% target might be adapted with a 'tolerance range' as rising UST yields could increased difficulty to sustain target

Encouraging signs from private consumption



Source: Cabinet Office, AXA IM Research

No domestic/core reflationary pressure



Source: Datastream, AXA IM Research

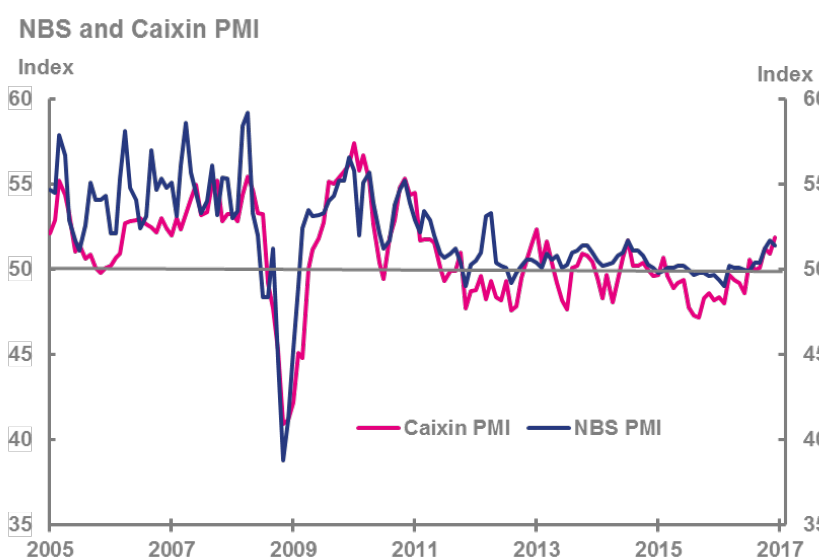
Stable growth continues, amidst rising inflation pressure

Chinese economy ended the year on a stable footing, with robust readings in the PMIs and high-frequency indicators

Q4 growth should print on-par with, if not slightly stronger than, that of Q3, taking 2016 growth to 6.7%

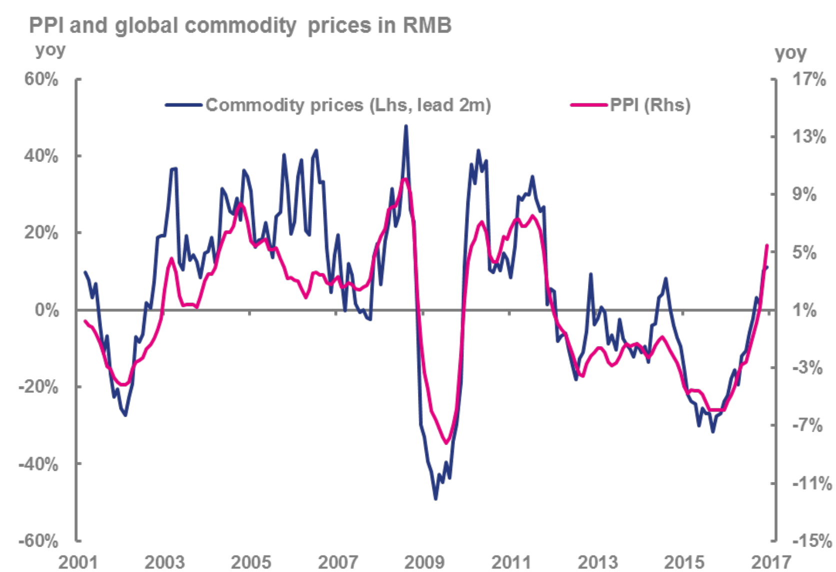
Input (commodity) prices have fuelled PPI inflation, reaching its highest since 2011

PMIs point to a robust growth backdrop



Source: Bloomberg, CEIC and AXA IM Research (as of Jan 2017).

Fast PPI reflation reflects higher commodity prices



Source: Bloomberg, CEIC and AXA IM Research (as of Jan 2017)

PBoC takes actions to alleviate RMB depreciation pressure

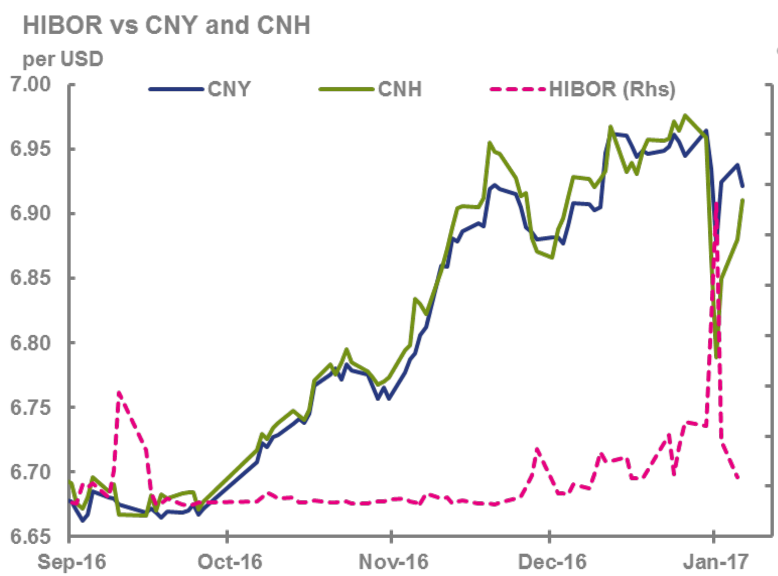
Accelerating FX depreciation and capital outflows have prompted official actions to ease market pressure

Capital controls have been tightened and market interventions have ratcheted up a notch

A big surge in CNH liquidity recently, partially orchestrated by the authorities, significantly pushed up the cost of shorting the RMB, resulting in a sharp unwinding of short-yuan positions and reversals in CNH/USD

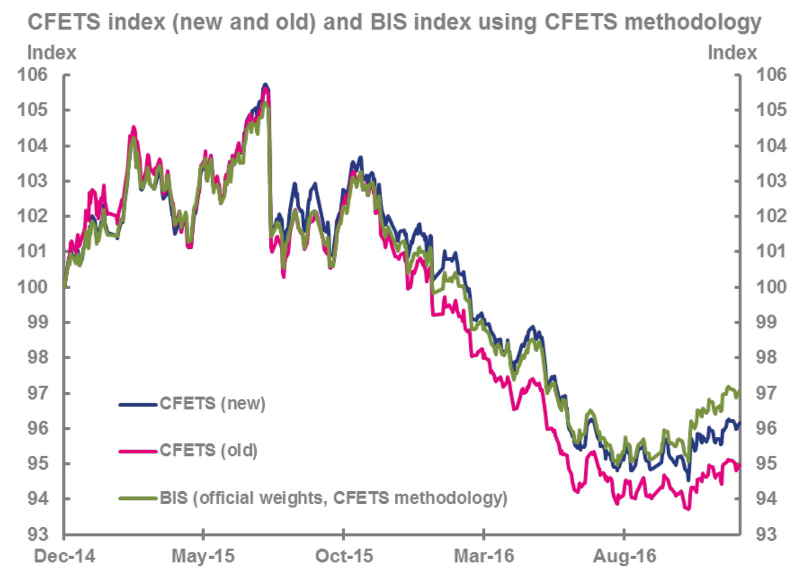
The PBoC also revised the CFETS calculation to align the index with the BIS NEER, and make it more reflective of the RMB's fundamental competitiveness

Surging HIBOR washes out RMB shorts



Source: Bloomberg and AXA IM Research (as of Jan 2017).

CFETS revision to improve index's representativeness



Source: BIS, Bloomberg, CEIC and AXA IM Research (as of Jan 2017)

Improving economic backdrop… about to be Trumped?

Latest PMI readings imply an acceleration in the real GDP growth momentum in Emerging Europe and Asia to 4.9%qoq saar in 2016Q4 (from -1.9% in 2016Q3) and 8.2% (from 6.7%), respectively

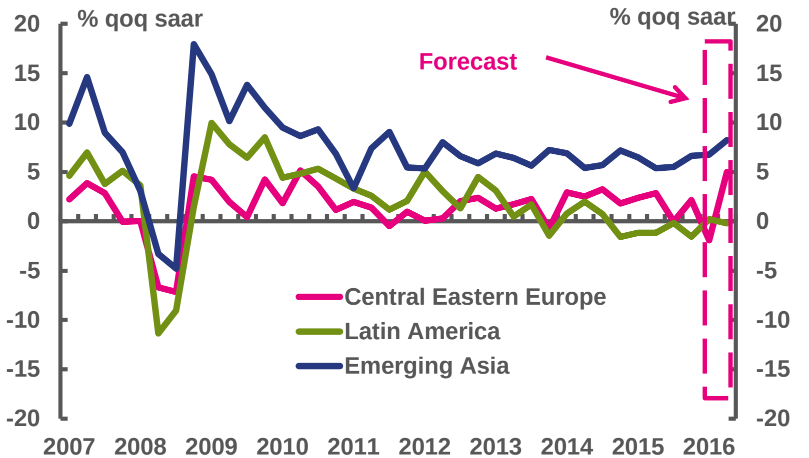
Latin American PMIs imply slower growth momentum of -0.2%qoq saar in 2016Q4 from 0.2%

EMs' economic outlook remains fragile as the currency depreciation post-Trump win may fuel inflationary pressures, erode purchasing power and contain economic growth

As yet, no EM is in deflation, while headline inflation is rising calling for a more hawkish monetary policy stance

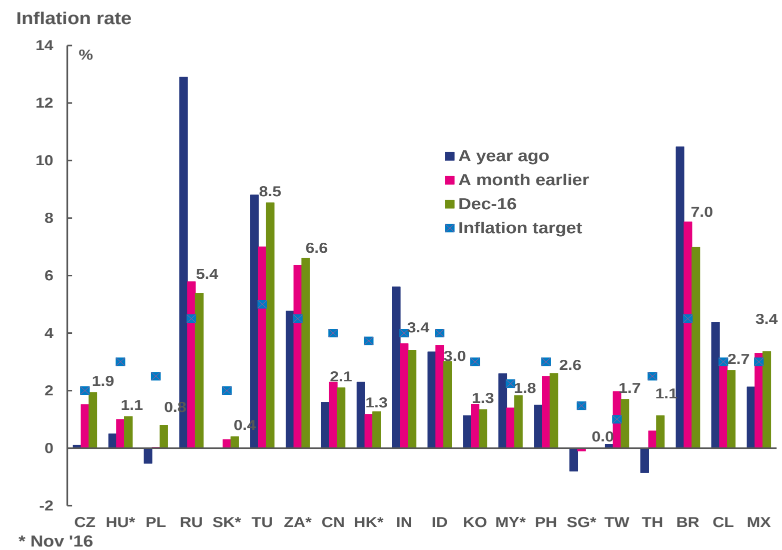
Growth momentum improving

Actual and forecasted regional real GDP growth implied by the PMIs



Source: Bloomberg, Markit, Datastream, AXA IM Research

The end of deflation in EMs



Source: Datastream, AXA IM Research

Mexico not looking forward to the new US President

US presidential nominations for key international trade posts hint a trade protectionist tilt in the US trade policy

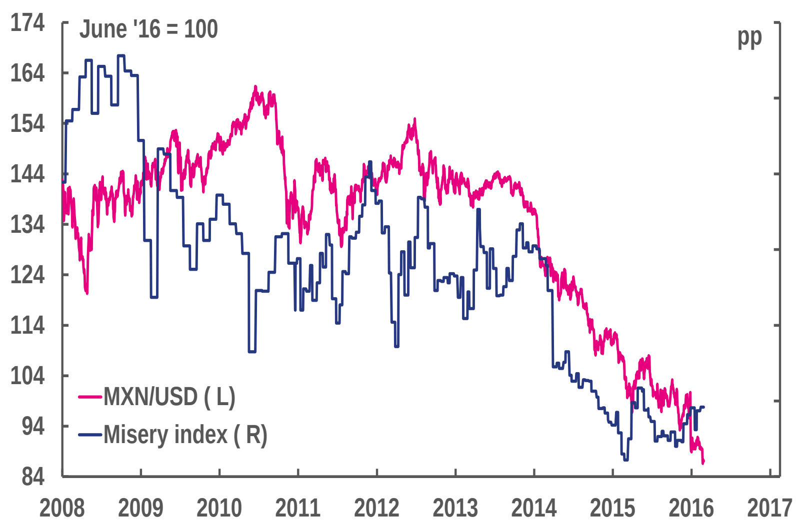
US automakers are putting on hold investments in Mexico... but the real risk is the FDI stock with disruptions in the supply capacity, MXN depreciation deepening fuelling inflation and unemployment…

Thanks to a good starting point, Mexico is far from alarming misery level which could lead to social instability

More discussion over the build of the wall at the US border and/or questioning NAFTA would accelerate the MXN depreciation via a wider current account deficit at the risk of higher social misery and unrest

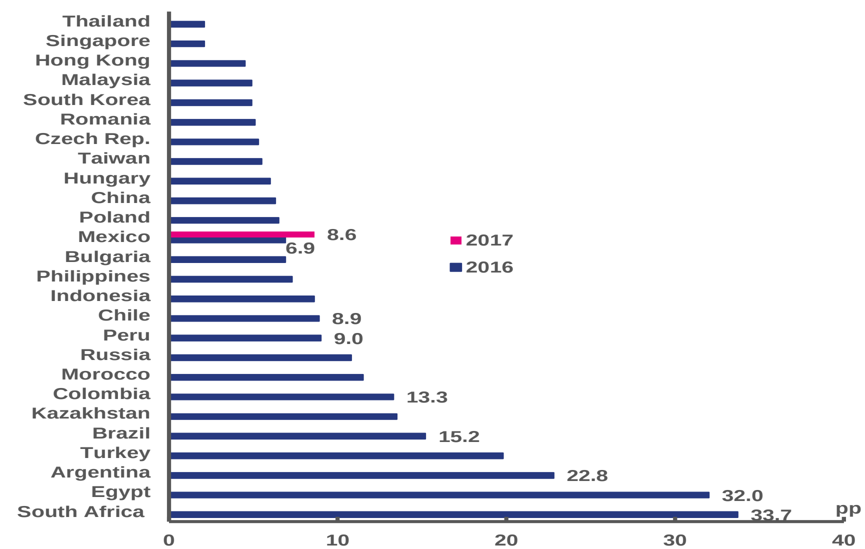
Misery in Mexico goes together with the MXN

Mexico, misery index (ie inflation plus unemployment rate) and the MXN



Inflation and unemployment rising from low levels

Misery index (inflation+unemployment)



Source: Bloomberg, AXA IM Research

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Investment Strategy

Cross-asset allocation: modest returns ahead

Core view 1: We expect returns to be modest across the board

- The secular bull market in fixed income may have come to an end, meaning very limited returns for duration risk
- Most financial assets trade on the expensive side of historical norm, implying limited upside
- A more active management, especially of duration, looks warranted

Core view 2: We express a mildly positive stance on risk through fixed income rather than equities

- Core interest rates should rise gradually as inflation expectations and the term premium normalise globally
- We are short duration and long low-grade and the most yieldy segments of credit

Core view 3: We expect credit spreads to be resilient while risks are more balanced on equities

- Stable economic growth and low defaults should support stable spreads in a rising rates environment
- Equities look more vulnerable to downside scenarios despite improving earnings expectations

Core view 4: We remain cautious about the implications of rising rates

- Rising interest rates may eventually hurt equity valuations, limiting diversification between bonds and stocks
- A strong rise in the USD and US interest rates could unveil vulnerabilities in some EM

Core view 5: We will be looking for entry points in EM

- The Trump election has hurt EM assets at a time of improving fundamentals and attractive valuations
- Once we have more clarity on US policy, we will be looking to overweight EM again

Core view 6: Alternative investments are attractive in this environment

- Liquidity and complexity premiums can enhance returns significantly when yields are low
- Real estate and structured finance offer opportunities

Source: AXA IM Research

Our MVST views in a nutshell

Cross asset	Our assessment
Macro	Growth remains supportive for risky assets although expectations have risen
Valuation	All financial assets are expensive, fixed income the most, EM the least
Sentiment	Risk appetite and positioning suggest optimism dominates, although not excessively
Technicals	Rotation takes places mostly within asset classes. Technicals remain strong but

Equities	Our assessment
Macro	Expect a rebound in earnings growth in 2017, driven by higher top lines and stable margins
Valuation	Developed market equities trade at a premium to our fair value estimates and historical averages
Sentiment	Investor sentiment continues to be optimistic for US equities. Other markets are a mixed bag
Technicals	Markets appear overbought and can expect some consolidation given the recent momentum

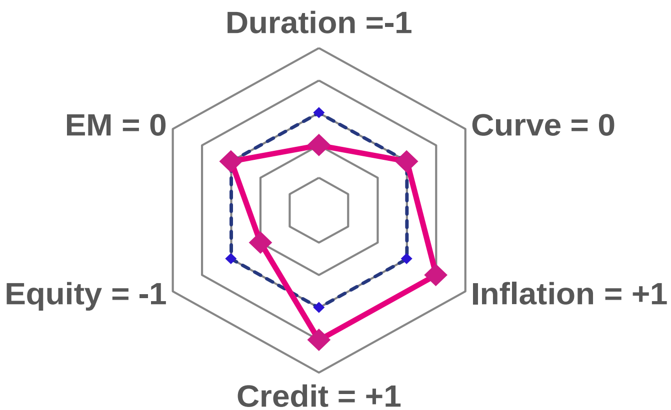
Rates	Our assessment
Macro	Reflationary policies reduce fear of secular stagnation, leading to higher policy rates and inflation expectations
Valuation	Government bonds are expensive, especially in Europe
Sentiment	The market remains short duration, although some profit-taking has taken place
Technicals	The technical background is deteriorating as central banks unwind QE. Foreigners reduce their US Treasury holdings

Credit	Our assessment
Macro	Gradually rising rates and inflation breakevens are not detrimental to credit spreads.
Valuation	Spreads are broadly rich vs macro fundamentals albeit on an improving path. Default outlook benign.
Sentiment	Sentiment for spread products remains constructive as spread pick up over govies remains attractive.
Technicals	Corporate QE flows are restarting after the festive break and supply is ample but so far manageable.

Source: Bloomberg and AXA IM Research

Allocation & tactical tilts

Tactical allocation: overall exposure



Scores range from -2 to +2, 0 stands for a neutral position

Global allocation	Positioning
Cash	🟢
Core rates	🔴
Credit	🟢
Equities	🔴

Asset class	Positioning
Core rates	🔴
United States	🔴
Germany	🔴
UK	🔴
Japan	=
Swap spreads	=
Inflation break-evens	🟢
United States	=
Euro	🟢
Credit	🟢
Corporate Investment Grade	🔴
United States	=
Euro	=
Euro periphery government	=
Emerging Markets government	=
Corporate High Yield	🟢
United States	=
Europe	=
Equities	🔴
United States	=
Euro area	=
UK	=
Switzerland	=
Japan	=
Emerging Markets	=
Latin America	=
Emerging Europe	=
Emerging Asia	🟢

Source: AXA IM Research

The correction in core rates should be sustained

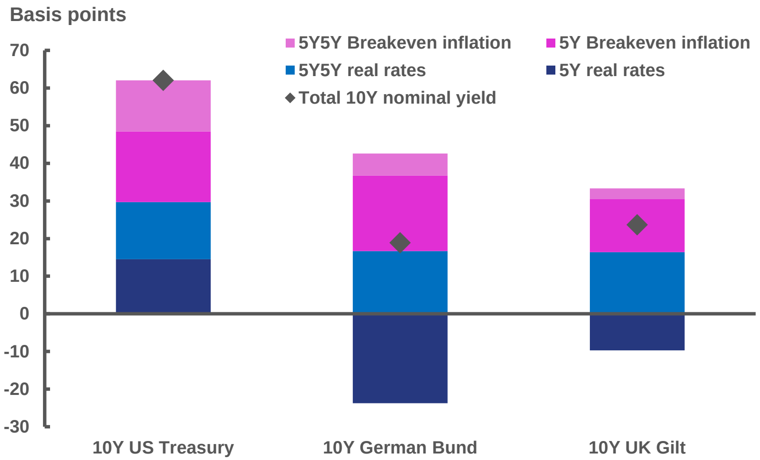
The bond sell-off may take a breather in coming weeks but we see the upward trend as a structural shift

There is still room for upside as central banks (Fed, ECB) tighten policies and inflation expectations normalise

Term premia in core rates remain far from our estimated equilibrium levels

Anatomy of a selloff

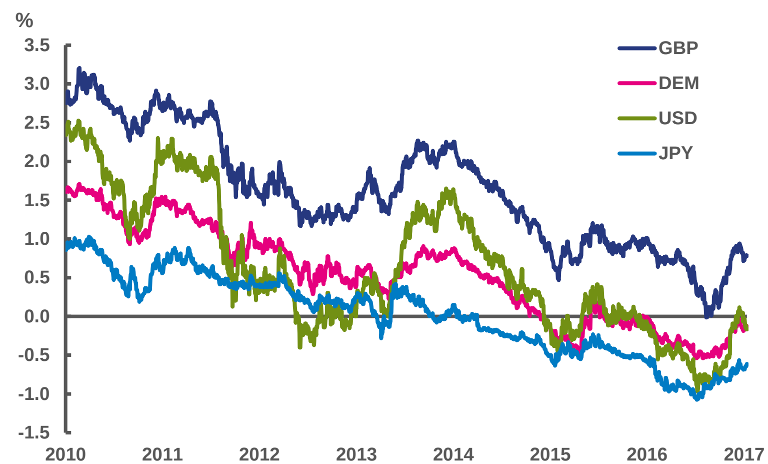
Change in bond yields between 4 November and 13 January



Source: Bloomberg and AXA IM Research

Term premia have rebounded but remain very low

G4 term premia on 10Y government bonds



Source: Bloomberg and AXA IM Research

We rotate the positive view on inflation from the US to Europe

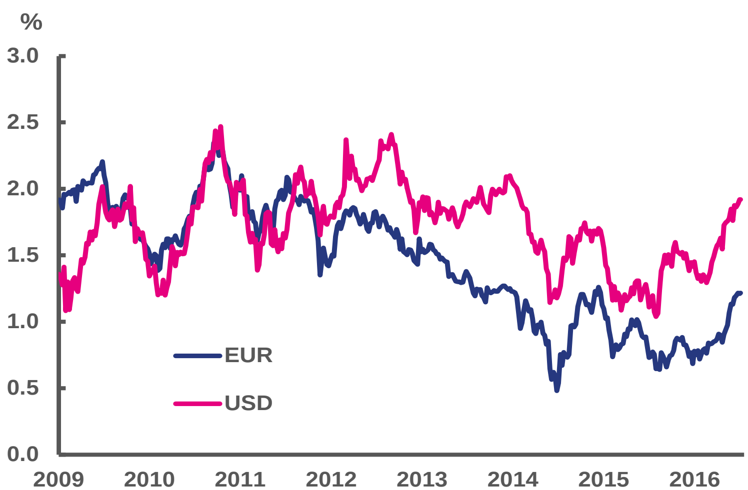
The market has moved significantly on US inflation expectations while remaining more sceptical in the euro area

Academic research has shown the increasing global nature of inflation*, implying more room to go in Europe as the US normalises

With the euro inflation swap market pricing inflation below 1.5% for the next 5 years, we see some upside

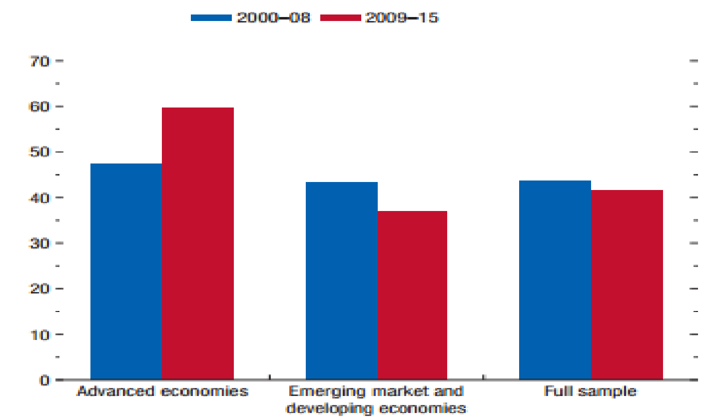
Inflation closer to historical average in the US than Europe

5Y inflation swaps



Source: Bloomberg and AXA IM Research

Global factor increasingly important for DM inflation



Source: IMF staff calculations.
Note: The figure reports the share of variation in headline consumer price inflation explained by the first common factor based on a principal component analysis. The sample comprises 120 economies, including 31 advanced economies.

Source: IMF

* See for a recent example, The globalisation of inflation: the growing importance of global value chains, BIS WP602, January 2017.

Good yield hunting – better value in Financials across IG credit

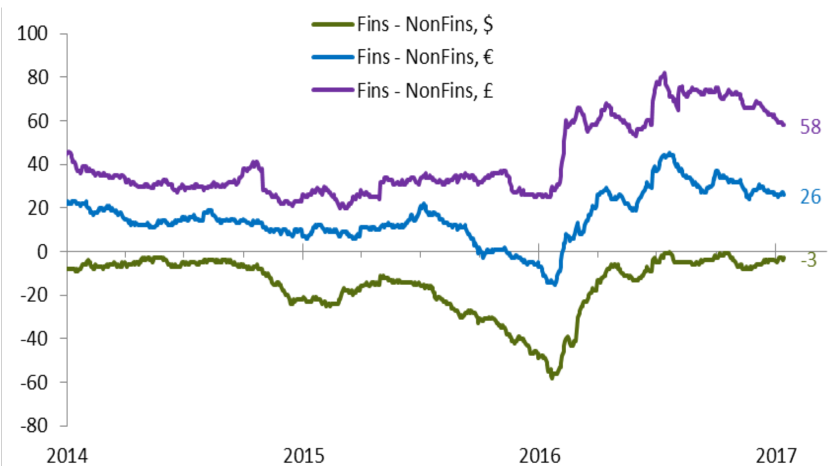
Financial spreads had a difficult time in 2016 due to growth concerns, lacklustre earnings, Brexit volatility and stress test jitters

Financials continue to trade near 3-year wides vs Non-Financials despite a retracement since summer, offering attractive spread pick up over Non-Financials across key currencies within IG credit

There is material scope for Financials vs Non-Financials spread to narrow, driven by improving business sentiment, rising/steepening yield curves, improving earnings (US in particular) and receding tails risks (Italian banks)

We initiate a trade of going long risk in € Senior Fins via iTraxx FinSen and short risk in € IG via iTraxx Main

3 year history of the Fins vs NonFins spread differential (spread to govies, normalised by duration)



Source: Bloomberg, BAML and AXA IM Research

Fins offer an attractive spread pick up over NonFins

13-Jan-17		MV $ bn	MV % of IG	Duration yr	Spread bp	Sprd/Dur bp	Yield %
USD	NonFins	4,259	71%	7.6	129	16.9	3.4
	Fins	1,738	29%	5.4	126	23.5	3.1
	IG	5,997		7.0	128	18.3	3.3
EUR	NonFins	1,303	63%	5.7	113	19.9	0.9
	Fins	774	37%	4.7	139	29.8	1.0
	IG	2,077		5.3	123	23.2	0.9
GBP	NonFins	286	67%	9.7	125	12.8	2.6
	Fins	143	33%	6.6	183	27.6	2.8
	IG	430		8.7	144	16.6	2.7

Source: Bloomberg, BAML and AXA IM Research

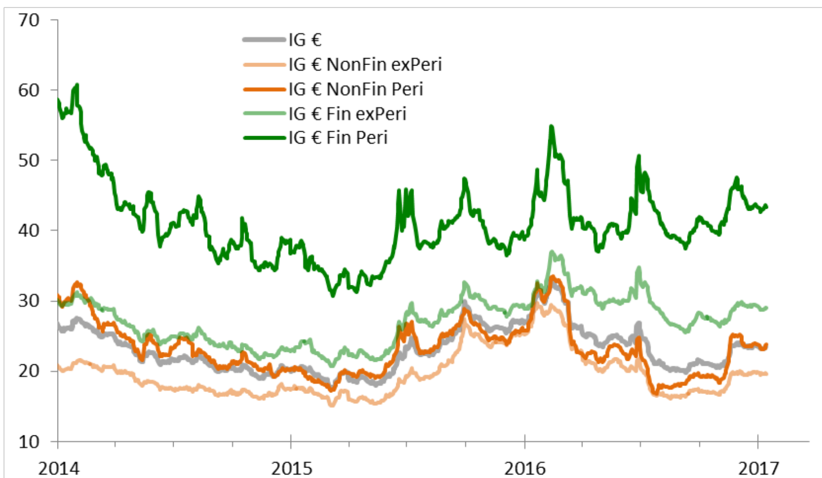
Peripheral credit spreads should narrow

Despite the ECB corporate QE program (CSPP) peripheral spreads have widened in 2016, driven by political noise (Spain/Italy), banking sector concerns (Italy/Portugal).

Periphery vs core spreads should narrow as state support for MPS/Italian banks reduces peripheral risk premia. A risk to this view is earlier tapering of ECB's QE if upwards inflation pressures persist

That said, spreads of CSPP eligible paper (incl periphery credits) are trading off their tights and are thus less vulnerable to any change in the positive technical/sentiment associated with CSPP

3 year history of Periphery vs ex Periphery spreads in EUR (spread to govies, normalised by duration)



Source: Bloomberg, BAML and AXA IM Research

ECB corporate QE eligible spreads have moved off their tights

Source: Bloomberg, BAML and AXA IM Research

Multiple de-rating to limit equity market returns

Global earnings growth headed for a rebound next year following two years of contraction

With a re-pricing in interest rate and higher uncertainty, we expect valuation multiples to slide lower

Equity markets to remain broadly flat in 2017 driven by a struggle between multiples and earnings growth

Earnings to recover after two years of contraction

United States: earnings growth, actual vs. model

Note: Model inputs include the change in US leading economic indicators, spot commodity prices and trade weighted US Dollar (R2 = 72%)

Source: AXA IM Research, Bloomberg and Data stream

Equity market valuation multiples appear stretched

United States: CAPE / Shiller PE

Source: AXA IM Research, Bloomberg and Data stream.

Regional equity allocation: closing the US overweight

We close the US vs. Euro area overweight

- Positive earnings surprises appear less likely for US equities
- Fair value indicators now favour Euro area equities over US
- Overextended investor sentiment for US equities while Euro area positioning remains low after massive outflows in 2016

Close EM EMEA vs. LatAm overweight

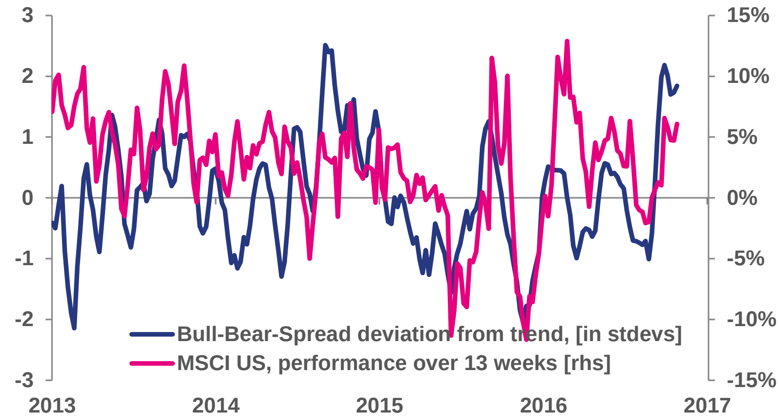
- Strong recent outperformance moderates the relative value gap
- Positive earnings revisions have concluded for EM EMEA
- Accelerated monetary easing and reforms in Brazil

Asia remains our preferred region within EM

- Ability to provide more monetary and fiscal support than other EMs
- Cheap valuations with superior profitability position
- Most major emerging Asian countries remain under-owned
- Key risks include Trump's trade policies and China tails risks

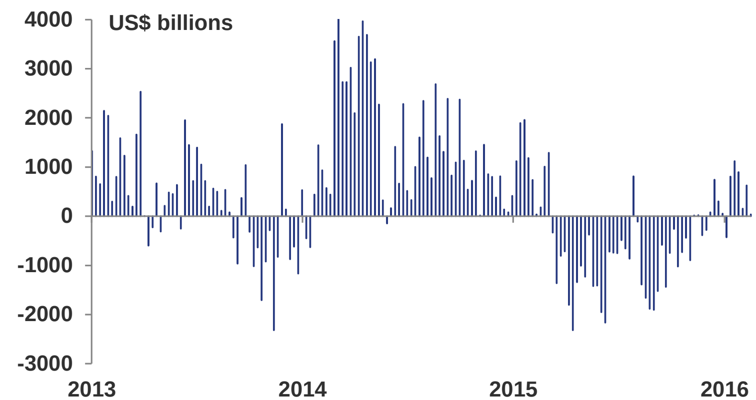
US sentiment indicators suggest a pullback

United States: AAII bull-bear spread



Large outflows from Euro area equities in 2016

ETF Flows: Euro area



Source: AXA IM Research, Bloomberg and DataStream

USD trade-weighted appreciation but neutral EURUSD

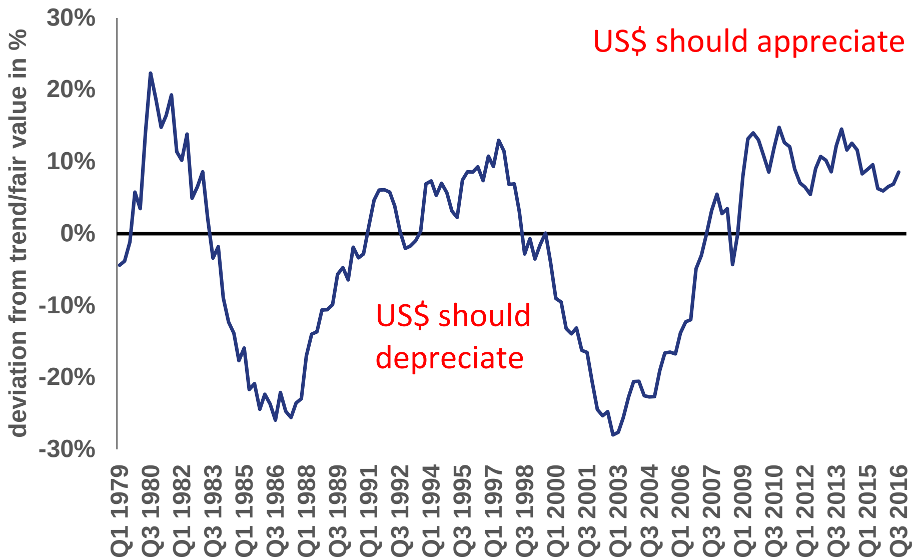
The cyclically-adjusted US external imbalance points to a USD TW-appreciation… but market positioning, the Fed being already largely re-priced and PPP-deviation (now large enough to significantly point for USD depreciation *versus* EUR) advocate **neutral EURUSD**

With upside surprises on inflation and growth, the BoE may be less dovish than previously expected and already broadly priced in the GBP past fall

We remain short EURSEK with Sweden reflating and long NOKCAD, partly as a hedge for more US protectionism

US should appreciate in trade-weighted terms

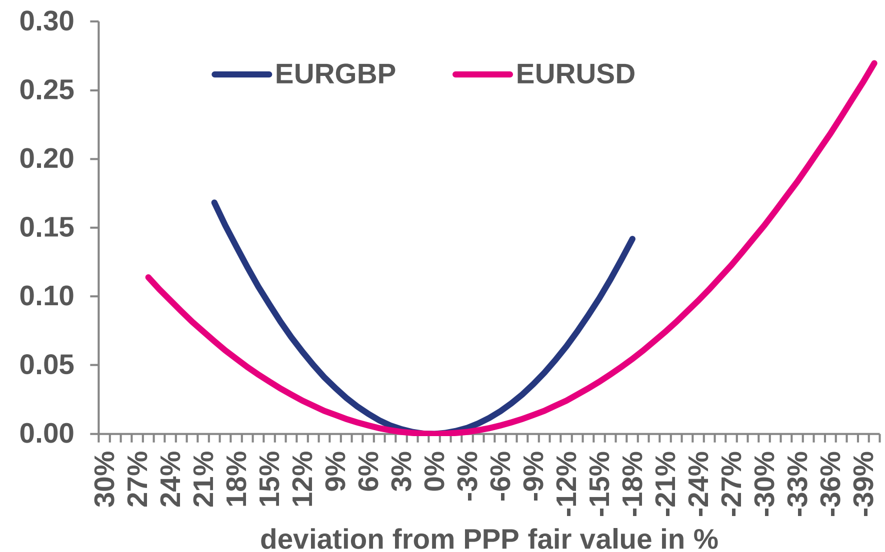
US cyclical external imbalances: forecasting TW$



Source: DataStream and AXA IM Research

Large PPP-deviation *vs* EUR indicates USD depreciation

Mean-reversion strength of PPP anchor



Source: ECB WP and AXA IM Research

INVESTMENT MANAGERS

Forecasts

Macro forecast summary

Real GDP growth (%)	2015	2016*	Consensus	2017*	Consensus	2018*
World	**3.3**	**3.1**		**3.4**		**3.5**
Advanced economies	**2.1**	**1.6**		**1.9**		**1.8**
US	2.6	1.6	*1.6*	2.2	*2.3*	1.9
Euro area	2.0	1.6	*1.6*	1.45	*1.4*	1.5
Germany	1.5	1.7	*1.8*	1.4	*1.3*	1.6
France	1.5	1.3	*1.2*	1.3	*1.2*	1.6
Italy	1.3	0.9	*0.8*	1.0	*0.7*	0.9
Spain	0.7	3.1	*3.2*	2.2	*2.3*	2.1
Japan	1.2	0.7	*0.7*	1.3	*1.0*	1.3
UK	2.2	2.0	*2.0*	1.4	*1.3*	1.2
Switzerland	0.8	1.5	*1.4*	1.3	*1.5*	1.5
Emerging economies	**4.1**	**4.2**		**4.4**		**4.7**
Asia	**6.7**	**6.5**		**6.2**		**6.1**
China	6.9	6.6	*6.7*	6.2	*6.4*	6.1
Rest of EM Asia	6.4	6.3		6.3		6.2
LatAm	**0.1**	**-0.7**		**1.5**		**2.2**
Brazil	-3.8	-3.2		1.2		2.0
Mexico	2.6	1.7		1.6		1.9
EM Europe	**-0.1**	**1.0**		**2.1**		**2.3**
Russia	-3.7	-0.7		1.1		1.4
Poland	3.7	2.4		3.2		3.3
Turkey	4.0	2.9		2.8		3.0
Other EMs	**3.2**	**3.6**		**3.0**		**3.9**

Source: Consensus Economics, IMF and AXA IM Research

Expectations on central banks

Inflation forecasts

CPI Inflation (%)	2015	2016*		2017*		2018*
			Consensus		*Consensus*	
Advanced economies	**0.3**	**0.7**		**1.8**		**1.9**
US	0.1	1.3	*1.3*	2.3	*2.4*	2.7
Euro area	0.0	0.2	*0.2*	1.4	*1.3*	1.3
Japan	0.8	-0.1	*-0.2*	0.3	*0.5*	0.4
UK	0.1	0.7	*0.7*	2.5	*2.5*	3.0
Switzerland	-1.1	-0.2	*-0.4*	0.2	*0.3*	0.6
Other DMs	1.0	0.9		1.8		1.9

Source: Consensus Economics, IMF and AXA IM Research

Central banks' policies: meeting dates and expected changes

		Current	Jan-17	Feb-17	Mar-17	Apr-17	May-17
United States - Fed	Date	0.50-0.75	31st-1st	--	14th-15th	--	2nd-3rd
	Rates (bp) / QE		unch	--	unch	--	unch
Euro area - ECB	Date	0.00 / 80bn	--	--	9th	27th	--
	Rates (bp) / QE	60bn from Apr-17	--	--	unch	unch	--
Japan - BoJ	Date	-0.1 / 80tn (JGBs)	30th-31st	--	15th-16th	26th-27th	--
	Rates (bp) / QE		unch	--	unch	unch	--
UK - BoE	Date	0.25 / 70bn	--	2nd	16th	--	11th
	Rates (bp) / QE		--	unch	unch	--	unch

Source : Datastream, AXA IM Research

Asset classes forecasts

Asset classes	Reference	Current	Target 3 months	Target 12 months
Rates (%)				
US 10Y Treasury		2.44	2.50	2.75
German 10Y Bund		0.40	0.50	0.80
British 10Y Gilt		1.40	1.50	1.70
Japanese 10Y JGB		0.06	0.00	0.00
Credit (bps)				
USD Investment Grade	BofA C0A0	128	130	135
EUR Investment Grade	BofA ER00	121	125	130
USD High Yield	BofA H0A0	402	425	435
EUR High Yield	BofA HE00	348	375	385
Equities				
US	MSCI US	2,163	2,130	2,050
Eurozone	MSCI Euro	206	205	210
Japan	MSCI Japan	923	925	950
Emerging markets	MSCI EM	893	900	935
FX				
EUR/USD		1.07	1.08	1.05
USD/JPY		113	113	115
GBP/USD		1.25	1.23	1.26

Source : Bloomberg, AXA IM Research

Calendar

Main events in 2017

Macro

UK

- 2 Feb – BoE meeting
- 16 Mar – BoE meeting
- 11 May – BoE meeting

Euro area

- 9 Mar – ECB meeting
- 27 Apr – ECB meeting

US

- 1 Feb – FOMC meeting
- 15 Mar – FOMC meeting
- 02 May – FOMC meeting

Japan

- 31 Jan – BoJ meeting
- 15-16 Mar – BoJ meeting
- 26 Apr – BoJ meeting

Politics

UK

- 24 Jan – Supreme Court ruling on Parliamentary vote before triggering Article 50
- March – PM May's deadline for triggering Article 50

Euro area

- 24 Jan – Constitutional Court decision on Italicum
- 15 March – Dutch elections
- March – EU Summit in Rome
- 23 Apr / 7 May – French Presidential elections
- June – French legislative elections
- 24 September– German Federal elections

China

- Fall 2017 – 19th Communist Party of China's (CPC) party congress

EM

- Apr – Constitutional Referendum in Turkey
- May – Iran Presidential Election
- July – Elections in India

Latest Publications

Latest publications

[Thailand: 2017 outlook](#)

20 January 2017

[Brexit: “Great moment of national change”](#)

18 January 2017

[Consider this – “Eight centuries of bond market reversals”](#)

16 January 2017

[EM in 2017: the shield of capital inflows](#)

12 January 2017

[China: fighting an uphill battle to stabilise RMB](#)

9 January 2017

[Stock-bond correlation - looking for a shift](#)

6 January 2017

[Brexit the French way – regulation, tax and politics](#)

22 December 2016

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