Perspectives
Financial Markets

February 2020

Interest rates & bonds
The coronavirus causes safe-haven flows

USA
- Economic data from the US remain resilient. The economy is adding jobs and the unemployment rate is down to 3.5%. The ISM manufacturing survey remains the only weak spot.
- The Fed is reconsidering how it interprets its price-stability mandate as it completes a review of the policy framework by mid-year. Under the drafted approach, the central bank would try to compensate for past inflation shortfalls by letting inflation run above target for some time.

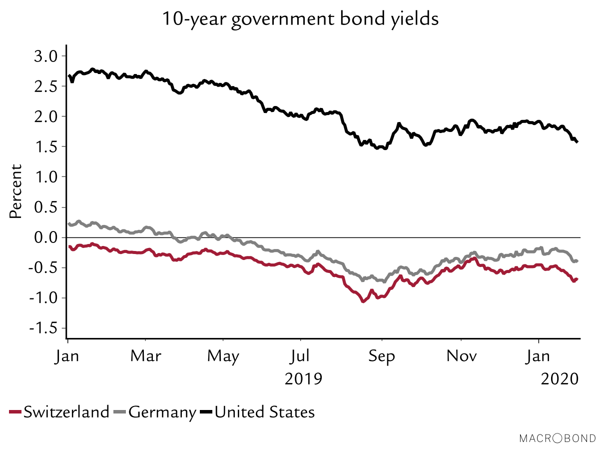
Eurozone
- In Europe, survey data for the manufacturing remain unconvincing, but at least suggest that the worst should be over.
- The ECB has started a review of its monetary policy strategy, which should be completed by end of the year. Furthermore, the ECB signalled its willingness to take measures against climate change.

UK
- The UK has left the European Union. The negotiations for a trade deal need to be completed by the end of the year when the transition period ends.
- The BoE kept the policy rate unchanged but signalled willingness to ease should economic data not confirm the expected turnaround of the economy.

Switzerland
- The US Treasury has put Switzerland on the monitoring list for currency manipulation.
- This could limit the room for interventions by the SNB on the foreign exchange market going forward.

Japan
- Inflationary pressure remains weak as wage growth has stalled and the yen has appreciated.
- Nevertheless, we expect the Bank of Japan to remain on hold as the government has launched a fiscal stimulus package to bolster growth following the October consumption tax hike.

Bond yields: low for longer



Following a risk-friendly start to the year, the spread of the coronavirus has caused significant safe-haven flows on financial markets, leading to lower government bond yields around the globe. Credit markets have also been affected and have traded somewhat weaker recently. At the current stage, it is unclear how the disease will impact the global economy. In a worst-case scenario, infection rates continue to rise globally, quarantine measures are escalated, and more international travel is suspended. This could lead to lower industrial production, a slowdown of international trade and lower consumption. The outbreak comes at a time when economic data has shown signs of stabilization and trade tension between the US and China have alleviated. We therefore think that government bond yields should rebound again if the diffusion of the coronavirus can be contained. For credit, we expect a sideways movement. While credit spreads are arguably compressed, investors' demand for yield and – in Europe – the ongoing asset purchases by the ECB should provide a supportive backdrop for credit markets. Company fundamentals remain broadly unchanged for corporate credit, as companies are not improving their balance sheets further. We tend to favor Financials over Industrials due to a comparably weak manufacturing environment.

Equities

Jump in? Stay? Sell? Protect!

USA

- With the signing of the phase one deal, China committed to increase its purchase of US goods and services by 200 bn USD. The de-escalation of trade tensions was well received by the US stock market which temporarily showed a year-to-date performance of 3.4%.
- However, the outbreak of the coronavirus sent stock prices down, reminding investors how suddenly things can change. We closely follow the evolution of the epidemic, especially its potential spread outside China, but do not change our views yet as the situation remains very fluid.

Eurozone

- While the US-China trade deal was positive for general market sentiment, it might have a slightly negative impact on Eurozone exports as China could potentially re-allocate some of its imports to the US to fulfil the obligations of the agreement.
- In combination with ongoing weak economic data, Eurozone stocks underperformed in January. We reiterate our underweight position for this market.

UK

- UK stocks continued to underperform in January.
- We keep our underweight position in the market as business investment will remain weak given the unclear trade relation with the EU.

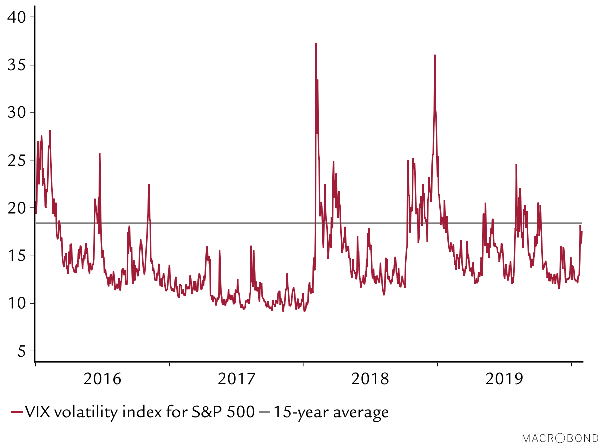
Switzerland

- In January, Swiss stocks showed a continuation of last year's strong performance.
- We expect the high demand for defensive equities to remain in place, but the risk to our positive view on Swiss equities has increased due to the strong Swiss franc, which is a burden for export-oriented companies.

Japan

- Japanese equities had a good start to the year due to a weaker JPY, but the outperformance was halted by the spread of the coronavirus.
- We still do not see any catalyst for a notable outperformance of Japanese equities and keep a cautious view on the market.

Spikes in volatility come without warning



Global equity markets had an excellent start to the year, fuelled by the de-escalation of US-China trade tensions. While market participants were weighing potential triggers for setbacks against arguments for a continuation of the rally, a trigger appeared that was on no one's radar: the novel coronavirus 2019-nCoV. While it is too early to evaluate the mid-to-long-term impact on the stock market, it reminds us how quickly trends can stop or even reverse without warning, even when markets look fine otherwise. At the time of writing, the market was stabilising and even reversing some of the losses. This illustrates once more that selling equities once a potential problem arises often turns out to be an inadequate reaction, as it shrinks the participation in the rebound and raises the question of where to put the funds raised. Moreover, we do not believe that reviewing the equity weight on a daily basis makes sense: equities have an important role to play in portfolios given the lack of alternatives in a world of extremely low bond yields.

However, after a multi-year bull market, it is reasonable to be prepared for higher volatility and potential setbacks, especially against a backdrop of slightly below-potential growth that we expect for the next quarters. We therefore think it makes sense to protect at least part of the portfolios using put options, which allow a (reduced) participation to the market upside (our current base case) but will reduce the impact of an unexpected correction in a mature equity market cycle.

Currencies

No relief for EUR/CHF in sight

USA

- On a trade-weighted basis, the USD was the best-performing developed market currency in January, buoyed by solid economic data and, at the end of the month, the "risk-off" sentiment caused by the coronavirus epidemic.
- We keep a positive view on the USD both against EUR and CHF. The main reasons are the favourable interest rate differential and the outperformance of the US economy compared to Europe.

Eurozone

- In line with our expectations, the EUR resumed its slide in January, depreciating around 1.3% against the USD.
- We expect the drivers for the weakness, notably a sluggish economy compared to the US and a continuously dovish ECB, to remain in place over the period ahead, and thus reiterate our negative view on EUR/USD.

UK

- As a cyclical currency, GBP came somewhat under pressure in the second half of January as risk aversion among market participants increased.
- The UK has formally left the EU, but the tricky part, namely trade negotiations, are now lying ahead. This will keep uncertainty elevated and caps the upside on sterling. We keep a neutral view on GBP/USD.

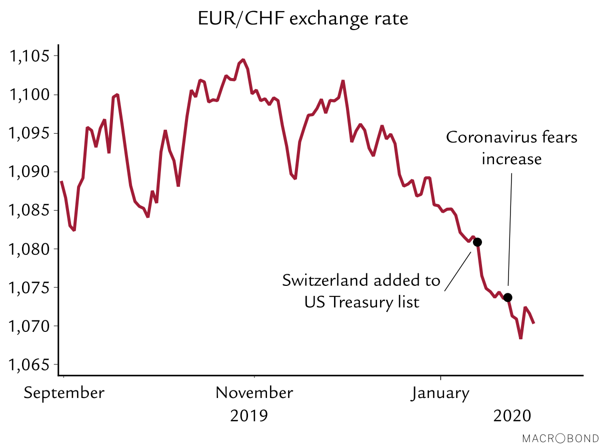
Switzerland

- The CHF was in high demand in January as investors fled into safe havens and speculators appear to be "testing" the monetary policy reaction function of the SNB which is perceived to have lost room for manoeuvre after Switzerland was again put on the US Treasury monitoring list.
- At these levels, we see further downside against EUR as limited and thus keep our neutral view on the pair.

Japan

- USD/JPY had an up and down in January in line with the swings in market risk sentiment.
- From current levels, we see more upside than downside risks for USD/JPY over a one-month period but must admit that forecast risks are unusually high given the unpredictable nature of the coronavirus epidemic.

An event-driven month for the Swiss franc



The new year started with a lot of optimism among financial market participants due to signs of a turnaround in the manufacturing cycle and the signing of the "phase one" trade between the US and China. However, volatility suddenly returned by mid-January with the spread of the coronavirus. Emerging market currencies and the more cyclical developed market currencies, notably the EUR, came under renewed pressure and investors fled into the safe havens USD, JPY and CHF. The latter had already been under appreciation pressure before. In December, a slight narrowing of interest rate differentials supported the CHF while in January, market participants were increasingly questioning the SNB's room for manoeuvre as Switzerland was again put on the monitoring list of the US Treasury regarding alleged currency manipulation. We indeed think that the SNB will be more reluctant to intervene in the FX market going forward. Hence, we do not expect a rebound of EUR/CHF even if markets were to return to a more risk-friendly sentiment once fears regarding the coronavirus subside. In that scenario, we see bigger depreciation potential for the JPY. Regardless of how the situation on the epidemic evolves, we stick to our negative EUR/USD view due to weak economic fundamentals in the Eurozone and a very dovish ECB policy stance, which was reiterated at the ECB's January monetary policy meeting. In addition, the persistently positive interest rate differential between the USD and EUR should continue to support the greenback.

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