

March 2019

Interest rates & bonds

Keeping a cautious view on credit

USA

- Although industrial data out of the US has weakened, the overall macroeconomic picture and particularly the job market continues to be robust
- Corporate credit and risky assets continue to rally, driving credit spreads tighter. Meanwhile, rates remain range-bound
- Markets continue to price an end of the Fed hiking cycle. We view that as too conservative and maintain our expectation for two US rate hikes this year

Eurozone

- The rally in risky assets continues to be in stark contrast to the weakening macroeconomic picture, which has deteriorated further over the past month
- German 10-year bond yields still hover at 0.1-0.2% despite a material spread compression in corporate credit
- We do not expect an ECB rate hike this year, but rather see a higher chance for easing measures such as a new TLTRO

UK

- Uncertainty around Brexit remains elevated, but we view a no-deal scenario as unlikely
- We expect the BoE to remain put until a clearer picture on Brexit emerges

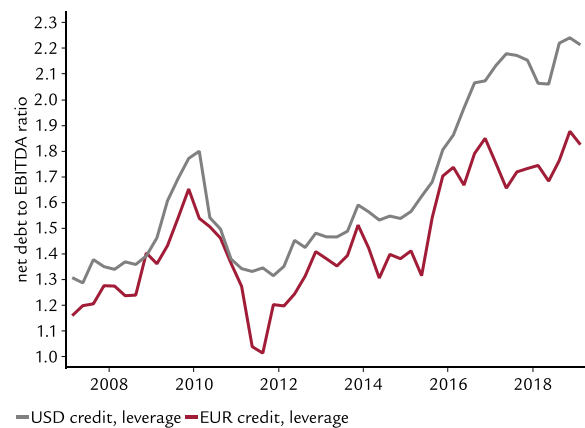
Switzerland

- Macroeconomic data continues to deteriorate with both PMIs and inflation numbers down
- Although the economy is slowing down, we think that current yield levels are too low. We expect moderately higher yields going forward, in line with Eurozone rates

Japan

- The Japanese economy has slowed due to weak export dynamics, which was partly offset by healthy domestic demand

Corporate leverage moderated slightly from high levels



MACROBOND

This year is off to a remarkable start with US and EUR corporate bonds returning 2.9% and 1.9%, respectively. Bonds have almost offset the sell-off from December, despite a range of disappointments on the macroeconomic front. The more dovish stance of the central banks around the globe has also kept a tight lid on rates despite the strong rally in risky assets. In the US, the recent performance was also supported by a solid earnings season, while Europe lagged behind. Although less companies were able to beat consensus than in previous quarters, overall sales and earnings growth was still healthy. Even corporate fundamentals saw a slight improvement over the quarter, although in a historical context, leverage is still elevated and asset turnover continues to decline. We therefore remain cautious on corporate credit and maintain our neutral to short risk position.

On the rates side, we currently have slightly less conviction. While geopolitical risks and weak macroeconomic data should prevent a meaningful increase, we feel that absolute levels are relatively low. Especially in the US, we still see room for higher rates should the Fed hint at further rate hikes down the road. The ECB has less room to manoeuvre given the fragile state of the economy. We therefore maintain a neutral to slightly short duration position.

Equities

A maturing rally

USA

- The decision by President Trump to delay an increase in tariffs on Chinese goods has lent support to market sentiment
- US earnings data came in relatively strong and surprised in many cases to the upside
- We monitor, however, the data flow quite closely as the latest economic data were disappointing. We think that this was due to a series of one-off effects

Eurozone

- The recent drop of the PMIs for both the Eurozone and Germany below 50 suggests a weakening growth outlook for the Eurozone
- Nevertheless, earnings remain at a relatively high level. We thus maintain a neutral stance on Eurozone equities

UK

- We continue to overweight UK equities. Despite a slowdown in activity, economic momentum has held up better than on the Continent. Also, UK large caps tend to move closely with the Eurozone market as they make most of their business outside UK
- Still, we continue to monitor Brexit developments closely. The lack of clarity about a resolution and the risk of further “kicking the can down the road” keeps uncertainty in the UK market elevated

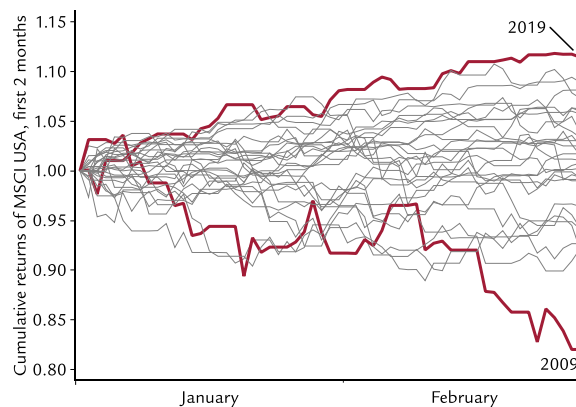
Switzerland

- We expect Swiss equities to perform in line with the rest of the world, as their economic and market characteristics are broadly in line with the global average

Japan

- The Japanese equity market should benefit from a relaxation of the US-Sino trade dispute. However, the Japanese stock market shows a more muted reaction to “good” news than its Chinese counterpart
- This reflects the lack of economic dynamics. As we do not see much improvement on that front, we expect this market to move along the global equity market

Strongest start of the US market of the last 28 years



MACROBOND

The extraordinarily strong equity market performance in January has been extended into February. The MSCI US has rallied by 11% year-to-date at the time of writing, which is the best start to the year of the last 28 years. Other equity markets also rallied after the losses in 2018: MSCI Emerging Markets 9% year-to-date, MSCI Switzerland 12%, MSCI EMU 10%, MSCI Japan 8%, MSCI UK 5%.

The question is now for how long this momentum will continue, especially given that for example equity market valuations look to be more stretched than in Q3 2018. A positive resolution of the current trade disputes would likely be a positive factor, whereas a significant worsening of the political climate in the US or around the world would have a negative impact. If fundamentals remain supportive, the recent stock market rally can sustain its momentum, which we think is the more likely scenario. In case of a short-term drop due to surprising negative news flow, support to the equity market could come from institutional investors, who currently seem to be underinvested in equities and could exploit any potential market weaknesses to re-balance their portfolios.

Currencies

Is the rally in Sterling sustainable?

USA

- US macroeconomic data has arguably disappointed recently, but so has data out of other economies. Hence, the USD has remained strong year-to-date
- Ongoing political risks and the potential re-pricing of overly cautious rate hike expectations by the market should lend support to the USD going forward

Eurozone

- Continuously weak data out of the Eurozone and ongoing political risk, especially related to Brexit and potential US auto tariffs, have kept the EUR weak over the past month
- These issues are unlikely to disappear in the near future. Also, we do not expect any hawkish shift by the ECB anytime soon. Hence, we keep a negative view on EUR

UK

- GBP has rallied further over the past month, as markets are increasingly pricing out a “no-deal” Brexit outcome
- While we believe that a transitional period (“blind Brexit”) remains the most likely scenario, political uncertainty remains elevated. We thus keep a negative view on GBP

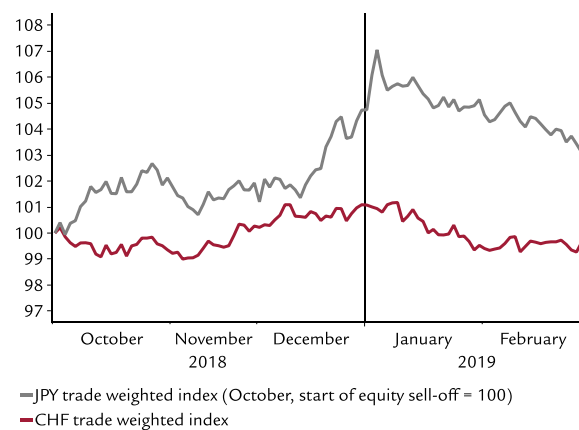
Switzerland

- Amid the more risk-friendly market environment, CHF slightly depreciated against EUR and USD.
- Switzerland’s economy is vulnerable to a slowdown in the Eurozone. Hence, we do not expect any move by the SNB ahead of the ECB and keep a neutral view on EUR/CHF

Japan

- The combination of weak Japanese economic data, risk-on sentiment in financial markets and dovish talk by BoJ officials has led to JPY depreciation over the past month
- Given the very cheap valuation of JPY, we see further downside as limited and keep a neutral view on JPY

Safe haven currencies have weakened year-to-date



The most significant currency move year-to-date pertains to Sterling. GBP has appreciated 5% on a trade-weighted basis as market participants have continued to price out a “no-deal” Brexit scenario. The latest rally occurred following Prime Minister May’s announcement that she will put a “no-deal” Brexit and an extension of the Article 50 deadline to a vote if her deal fails for the second time. The latter remains quite likely. As a “no-deal” Brexit is only favoured by a minority in Parliament, a short 2-3 month extension of the Brexit deadline beyond March with an eventual agreement on a deal is our current base case scenario. Still, uncertainty remains very elevated given the unpredictable political situation in the UK, and we thus keep a cautious view on GBP over the short-term.

Else, the return to a risk-on regime in financial markets has finally left its mark on foreign exchange. The JPY and to a lesser extent CHF, both considered safe have currencies, have depreciated on a trade-weighted basis (see chart). Developments in EUR/USD remain, however, the same as last year. In line with our negative view on the pair, a continuous run of weak Eurozone data and a political risk premium has kept EUR/USD under pressure. We do not expect these issues to be resolved in the very near future and thus stick to our negative view. Also, we judge the re-pricing risk regarding central bank market expectations to be higher for the US Fed than for the ECB, which should lend additional support to USD versus EUR.

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