Perspectives
Financial Markets

April 2019

Interest rates & bonds
Rates imply recession while credit shows a boom

USA
- US macroeconomic data has disappointed with weak industrial production numbers and manufacturing PMIs
- While markets had expected the Federal Reserve to become more dovish at the March meeting, the Fed over-delivered by signalling no further interest rate hikes for this year
- Consequently, we adjusted our stance following the Fed announcement and do not foresee any interest rate hikes this year, while markets even price in a cut

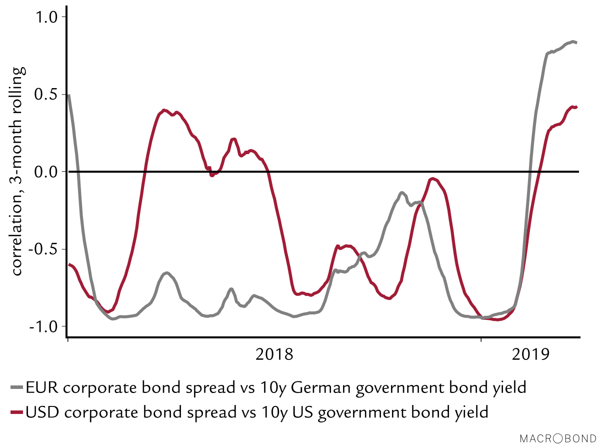
Eurozone
- Macroeconomic data out of Europe continue to disappoint with pronounced weakness in the manufacturing sector, while services are more resilient
- Yields on the 10-year German bund turned negative again following the dovish ECB meeting in March and dismal manufacturing PMIs
- Similar to the Fed, the ECB over-delivered, guiding for unchanged benchmark rates throughout the year while also announcing another TLTRO

UK
- The Brexit chaos continues as the EU set an ultimatum for April 12 to get some clarification on the future relationship between the UK and EU
- We expect the BoE to remain on hold until after a solution on Brexit is found

Switzerland
- Switzerland defied global macro trends recently as inflation and growth data remained fairly stable
- Nevertheless, government bond yields dropped significantly in sympathy with Bunds and Treasuries

Japan
- Japan's export-oriented economy continues to suffer from the slowdown in global trade and the weaker demand from China
- We expect the BoJ to keep its loose monetary policy

Lower rates have coincided with tighter spreads recently



Credit markets continue to defy historical correlations (see chart). Even though macro data weakens and corporate fundamentals deteriorate, credit spreads continue to tighten. Year-to-date, corporate bonds total returns have been 4.9% in USD and 3.95% in EUR. Longer-dated and lower-quality bonds were the clear outperformers as investors were seeking higher-beta instruments, despite the plethora of risks. Counterintuitively, the 3-month to 10-year US Treasury spread turned negative, leading to an inverted yield curve, often cited as a leading recession indicator. Similarly, the yield curve has flattened dramatically over the past three months in Europe. Even yields of longer-dated bonds now fell into negative territory, pushing the pile of negative yielding government bonds to more than USD 10 trn again. Arguably, the ECB and Fed have turned more dovish while becoming more cautious on their economic outlook. So either the interest rate market is too cautious or the credit market is too optimistic. We currently think that both are somewhat mispriced. We therefore remain cautious and prefer a defensive position on credit, while we feel that the drop in government bond yields has been too pronounced.

Equities

Positive but not euphoric

USA

- Our indicators have turned more positive on US markets mainly based on momentum and option sentiment
- The dovish shift of the US Federal Reserve and the high likelihood that other liquid asset classes will not provide significant returns should continue to support the equity rally in the S&P 500
- Investor positioning and buyback programs suggest that there is still room for buying support in case of falling markets, which makes a continuation of the "buy-the-dip" mentality likely

Eurozone

- Our business cycle analysis shows that the acceleration probability remains low
- Nevertheless, we expect some stabilization in Eurozone data going forward. In combination with the weaker EUR and attractive valuations, Eurozone equities should remain supported
- We observe a large dispersion of earnings across sectors in Europe with Financials, Telecoms and Consumer Goods having large drops while Utilities and Energy experience stronger growth, which provides outperformance opportunities within the Eurozone

UK

- The continuation of Brexit uncertainty weighs on sentiment and will likely bring more volatility into the UK equity market
- However, we still do not think that most large caps will overly suffer given their international exposure

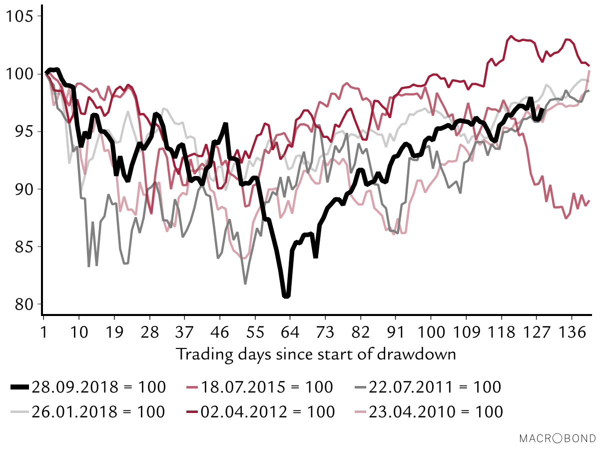
Switzerland

- Swiss equities have been among the strongest this year
- We expect this relative strength to persist due to the defensive character of the market and the fact that the largest chunk of the economic slowdown is likely behind us in Switzerland

Japan

- The Japanese equity market, one of last year's underperformer, is lagging the global equity rally substantially, and a significant positive news flow would be needed to bring it back into investors' focus

A severe downturn, but not an unusual rebound



In March, the equity rally went on for a third month without a major setback. Compared to other drawdowns of the past years, the December 2018 sell-off looks extraordinary, while the subsequent recovery is broadly in line with other past instances (see chart above).

We keep a moderately positive view on global equities. From the macroeconomic perspective, we expect the global economy to perform a "soft landing" this year rather than falling into outright recession. The dovish shift of the ECB and especially the US Federal Reserve in March supports that scenario. In addition, a key reason to stay optimistic is that both the equity market drawdown end of 2018 and the rebound in 2019 happened against a backdrop of very low liquidity. In fact, the volume of S&P 500 E-mini futures traded in the Q4/2018 sell-off was only at around one third the volume registered in former downturns. Also, large institutional investors remained rather cautious during the recovery of the past few weeks. Hence, we expect that there remain a lot of funds at the sidelines that could enter the market and support a continuation of the rally. Moreover, large equity buyback programs still continue to lend support to the market.

Currencies

Removing our positive bias on USD

USA

- The US Federal Reserve has turned decisively dovish and US economic momentum has slowed further, in line with other economies. The USD has remained surprisingly resilient under these circumstances
- Still, the narrowing interest rate differential to other currencies removes an important support for the USD and we thus shift from a positive to a neutral stance against EUR and CHF

Eurozone

- The EUR has remained weak as economic data have shown few signs of stabilization and political risks (Brexit, potential US auto tariffs) linger on
- We still think that the biggest chunk of the economic slowdown in the Eurozone is behind us, but are still awaiting confirmation of that scenario. At this stage, we prefer to be neutral on EUR against USD and CHF

UK

- GBP has not rallied any further over the past month as the political deadlock in the UK has intensified again
- While uncertainty is very elevated, a transitional period ("blind Brexit") remains our base case. The probability of a softer outcome (customs union or even no Brexit at all) has even increased somewhat, prompting us to shift to a positive view on GBP

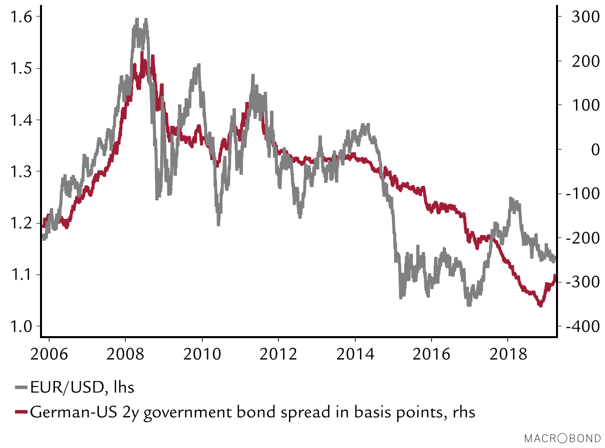
Switzerland

- Soft global economic data and the US yield curve inversion have stoked recession fears, driving investors into the safe-haven currencies such as CHF
- We continue to expect a "soft landing" for the global economy and keep a neutral view on CHF against USD and EUR

Japan

- Similar to the CHF, JPY has appreciated somewhat on a trade-weighted basis in March
- As we have turned less constructive on USD in general and the JPY remains significantly undervalued, we recently turned negative USD/JPY

US-German interest rate differential has narrowed again



In March, we experienced another significant dovish shift by major central banks. The ECB pressed ahead beginning of March by slashing economic forecast, delaying the prospect for a first interest rate hike and announcing a new round of bank refinancing operations (TLTRO). The US Fed followed suit by signalling a pause of their hiking cycle this year. For the first time since 2011, the 2-year interest rate spread between the US and Germany has narrowed significantly (see chart). "Monetary policy divergence", one of the dominating themes for FX markets over the past years, has suddenly lost relevance. As a result, we removed our positive bias on the USD and adopted a neutral view on USD/CHF and EUR/USD.

The flattening and in some segments of the US market even inverting yield curve has started to invoke recession fears among investors. Hence, investors sought refuge in safe-haven currencies such as CHF and JPY, which both appreciated slightly in March on a trade-weighted basis. An imminent global recession is not our base case scenario. We keep a neutral view on CHF, but have turned constructive on the JPY against USD, not least due to very favourable valuations.

Lastly, uncertainty regarding Brexit is set to remain elevated, but we still expect a no-deal Brexit to be a tail risk only. At the time of writing, the probability of softer versions of Brexit (customs union, second referendum) has even increased somewhat. Hence, we now expect GBP to appreciate against USD going forward.

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