Perspectives
Financial Markets

May 2019

Interest rates & bonds
Central bank backstop causes euphoria

USA
- After a pronounced deterioration of US economic data, recent figures were somewhat more encouraging, diminishing the risk of a near-term recession
- Interest rates rebounded over the past few weeks as markets started to price out Fed policy rate cuts
- We continue to believe that the US Federal Reserve will keep the policy rate unchanged both this year and next

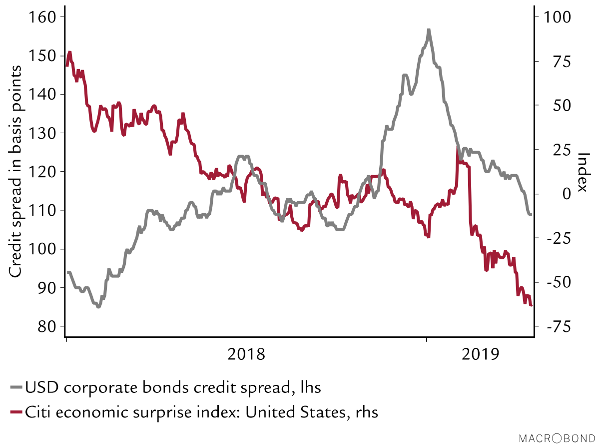
Eurozone
- While we are seeing first signs of stabilisation in European macroeconomic data, the situation remains fragile amid elevated political risks
- Despite a bleak economic backdrop, the very dovish stance of the ECB has improved investor sentiment, supporting risky assets. German government bond yield recovered somewhat from recent lows

Japan
- Both survey data and activity indicators have remained weak so far this year
- In combination with surprisingly soft inflation figures, this may prompt the Bank of Japan to maintain or even increase its monetary stimulus

UK
- The UK economy has been surprisingly resilient year-to-date, which is, however, related to excessive stock building
- The EU extended the Brexit deadline to October 2019, but political uncertainty will persist and likely weigh again on economic growth

Switzerland
- Switzerland's economy is starting to show some cracks as leading indicators have dropped significantly
- The ECB's continued dovish stance will likely prevent any monetary tightening by the SNB in 2019 and 2020

Credit spreads tighten despite negative data surprises



Seven months ago, investors speculated on whether the US Fed would hike interest rates three or four times in 2019 and when (not if) the ECB would lift deposit rates above zero again. Five months ago equities and corporate bonds sold off materially amid a glut of negative macroeconomic data and bleak forward guidance by corporations. Fast forward to now and all seems forgotten. Bad news is good news again, as fundamentals take a backseat and technicals dominate the market. The backstop provided by central banks has helped to prop up risky assets, with year-to-date total returns for USD and EUR corporate bonds standing at 5.3% and 4.1%, respectively. New issue volumes remain high, volatility is low and investors continue to pour money into risky assets. Although we see a chance that the rally has a bit more room to run, we remain cautious and keep our defensive position from a credit risk perspective. We feel that fundamentals do not warrant current credit spread levels and see increasing risks for a correction. On government bond yields, we have a lower conviction view. Despite the recent increase in yields, we feel that absolute levels are still fairly low. However, the dovish stance of central banks around the world and our cautious economic outlook will likely limit any material increase, keeping interest rates range-bound. We therefore prefer a neutral to slightly short duration position.

Equities

Supported by the lack of alternatives

USA

- The S&P 500 has gained 23% since the December lows, missing out only few points to reach a new all-time high
- A good earnings season would support this trend. In fact, latest Q1 company earnings (e.g. Citigroup, Goldman Sachs) have been promising
- We stay constructive on US equities, also because the more dovish stance of the Federal Reserve has reduced recession risks

Eurozone

- In Eurozone markets, the investment style has had a significant impact. Last year, both value and small cap stocks performed poorly
- Year-to-date, value stocks are lagging again (13% YTD) whereas small caps are amongst the best performing stocks (18% YTD) in the MSCI EMU universe (16% YTD)

UK

- The Brexit delay will keep uncertainty elevated. Hence, corporate investment intentions, which have already plunged, are set to decline further
- This increases the likelihood that the UK market will underperform, even if the risk is smaller for large caps than the rest of the market

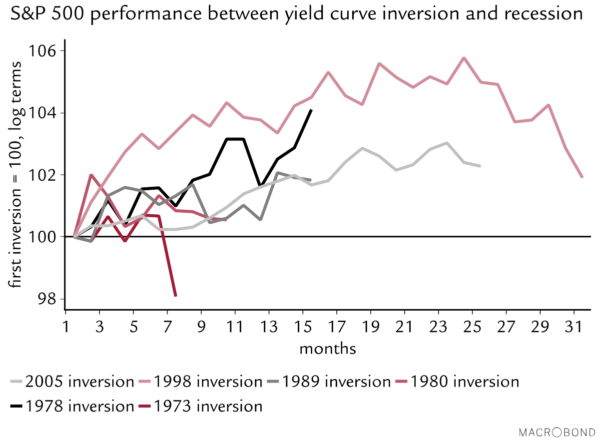
Switzerland

- Both Swiss small and large caps have shown a strong performance year-to-date
- Moreover, Swiss stocks have played their defensive card during the sell-off in Q4/2018, outperforming other markets. Swiss stocks are a solid investment and we do not expect this to change anytime soon

Japan

- Weak economic data coming out of Japan are the main reason for a relatively weak performance of Japanese stocks year-to-date
- We do not expect that backdrop to change anytime soon, which makes Japan clearly a less attractive market

US yield curve inversion is not a sell-signal for equities



Albeit not enthusiastically, we stay positive on equities for a number of reasons. First, although the flattish US government bond yield curve could be a warning sign that a recession might be ahead, equity markets still performed well for quite some time after the first inversion of the yield curve. The latter should thus not be interpreted as a selling trigger as some good equity returns might be missed out (see chart above). Secondly, with global bond yields overall falling since the beginning of the year and no material upturn to be expected, the hunt for yield is still focused on equities. Additionally, given the latest tightening of credit spreads, we also expect some funds to shift from the credit to the equity market as the latter is far more liquid; a key advantage in case a recession would indeed materialise. Finally, expectations for the Q1/2019 corporate earnings season are rather low, which increases the potential for positive earnings surprises.

Nonetheless, we see two factors, which might have a negative impact on stocks for the weeks to come. First, while we do not consider equity markets to be expensive, the market rally has been accompanied by an overall weaker macro environment. This might raise some questions going forward. Second, we would not be surprised to see some investors taking profits. This might, however, be mitigated by the fact that we expect the "buy the dip" mentality to remain alive among investors. The low trading volume in Q1/2019 indicates that many investors did not participated in the rally, potentially waiting for a retracement to increase their equity exposure.

Currencies

Neutral on most major currency pairs

USA

- The USD has remained fairly strong recently as economic data came in solid and markets have begun to price out rate cuts by the US Federal Reserve
- We keep a neutral view on the USD against most major currencies, the notable exception being the JPY, which we expect to appreciate

Eurozone

- The EUR recovered somewhat from its recent lows amid first signs of stabilisation in Eurozone economic data
- While we indeed expect the worst to be behind us, the improvement in economic momentum will likely be bumpy and the myriad of political risks (trade war, Brexit, European elections) persist. Hence, we currently prefer to be neutral on EUR against USD and CHF

UK

- Contrary to our expectation, GBP has depreciated over the past month as no progress has been achieved on the cross-party Brexit negotiations
- We have turned neutral on GBP. While we still expect an orderly Brexit to happen until the October 2019 deadline, the political noise is set to increase as we steer towards the European elections

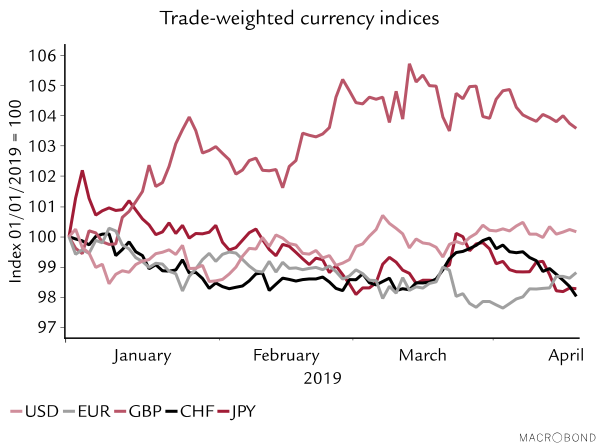
Switzerland

- Amid very positive investor sentiment, safe-haven currencies such as the CHF have recently depreciated on a trade-weighted basis
- We keep a neutral view on CHF against USD and EUR

Japan

- Similar to the CHF, JPY has weakened on a trade-weighted basis
- We remain constructive on the JPY, which is significantly undervalued and stands ready to benefit in a variety of growth scenarios for the global economy

Safe-haven currencies lost ground in April



In the absence of major catalysts, foreign exchange markets have remained rather calm over the past month. The rally in risky assets continued amid surprisingly soft inflation prints, dovish central banks as well as better macroeconomic data out of China. Recession risks in the US have been priced out further. In this environment, safe-haven currencies such as JPY and CHF have depreciated on a trade-weighted basis (see chart). In principal, cyclical currencies such as the EUR should benefit from an improved sentiment regarding the economic outlook. Nevertheless, we think that it is too early to turn positive on EUR/USD due to the looming political risks, namely potential US tariffs on European autos, Brexit as well as the upcoming European elections. We also stay neutral on CHF against both USD and EUR.

We keep, however, a positive view on JPY against USD. As long as the US Fed remains dovish, which is our base case, JPY stands ready to gain in various growth scenarios. On the one hand, the export-oriented Japanese economy and its currency would likely benefit in an environment of improving global growth. On the other, the JPY could play its card as a safe-haven currency in case of an outright recession scenario.

In the UK, the political noise has increased as cross-party talks on a Brexit deal broke down and as it is now likely that the UK will have to participate at the European elections. GBP thus gave away some of its substantial year-to-date gains. While we remain convinced that an orderly Brexit will ultimately happen, we do not expect any short-term improvement of the political situation and have thus removed our positive bias on GBP/USD.

Swiss Life Asset Managers

Marc Brütsch
Chief Economist
marc.bruetsch@swisslife.ch
@MarcBruetsch

Michael Klose
CEO Third-Party Asset Management
michael.klose@swisslife.ch

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