

June 2019

## Interest rates & bonds

Who blinks first?

### USA

- In May, the sudden breakdown of the US-China trade negotiations and the announcement of higher tariffs on Chinese goods pushed markets into renewed “risk-off” mode. Interest rates fell, and credit spreads widened
- Amid elevated political risks and no signs of overheating of the economy, we do not expect additional policy rate hikes by the US Federal Reserve

### Eurozone

- Survey data in the Eurozone continues to be relatively weak, while economic activity data has held up much better
- Equities and corporate bonds underperformed in the Eurozone last month, while German government bond yields are close to their all-time lows

### UK

- The victory of the Brexit party at the European Election will likely push the Conservative Party to pick a more hawkish successor to Theresa May as Party leader. Hence, we now see a higher chance for a no-deal Brexit
- As long as the Brexit situation remains unclear, we do not expect any action by the Bank of England

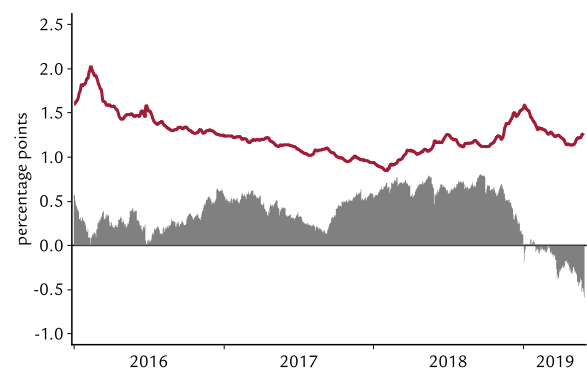
### Switzerland

- As in the Eurozone, strong activity data defied relatively weak sentiment indicators
- Swiss government bond yields continue to plunge, with interest rates up to five years being even below the -0.75% deposit rate

### Japan

- Economic prospects in Japan remain clouded by the ongoing trade dispute and the planned consumption tax hike in October
- The Bank of Japan will maintain a very expansionary monetary policy for the foreseeable future

### Rates market appears more cautious than credit market



■ 1y change in US policy rates expected by market  
■ Corporate credit spread (global)

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For months, markets have been expecting the conclusion of the US-China trade negotiations, before the US President destroyed these hopes with just one tweet. Moreover, weak survey data across developed markets are a reminder that the surprisingly strong first-quarter GDP data were likely boosted by temporary factors. Yet markets seem to be relatively complacent about it, especially in the US. While European and US corporate bond spreads widened by 18 bps and 11 bps in May, respectively, we are far from the spread levels seen just five months ago. Yet, if we look at safe-haven assets, the picture looks differently. Yields on 10-year US Treasuries have dipped below 2.3%, a level last seen in 2017. Similarly, German government bond yields are at -15 bps, just shy of their all-time low. Arguably, the huge amount of liquidity is distorting assets prices to some extent, but we still feel that one side of the market has to be wrong. Either government bond investors are too gloomy or corporate spreads do not adequately reflect the risks. We believe in the latter scenario, especially as we do not foresee a solution in the trade dispute soon. We therefore expect further spread widening and position ourselves accordingly. Duration-wise we remain neutral. While interest rates are arguably already very low, we cannot rule out further declines in a continued risk-off scenario.

## Equities

Investing in “political markets”

### USA

- As a result of escalating trade tensions in May, the S&P 500 reversed all of April's gains, while US economic data remained rather robust
- Overall, we stay constructive on US equities, also because the more flexible stance of the Federal Reserve has reduced recession risks

### Eurozone

- The European Elections led to a more fragmented political party landscape. While this might make it even more complicated to align interests across Europe, stock markets did not show a significant reaction right after the vote
- Year-to-date, Eurozone equities performed in line, if not marginally better, than global equities, also driven by better-than-expected activity data

### UK

- Uncertainty is probably the most problematic side effect of the ongoing Brexit discussion, as UK companies scale back their investment intentions
- 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

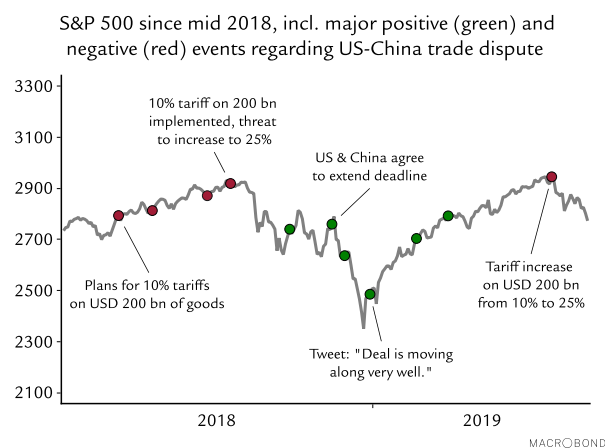
### Switzerland

- Unsurprisingly to us, the Swiss stock market has held up well in the current environment of increased volatility, due to its defensive nature
- We remain positive for Swiss equities as we expect volatility to persist

### Japan

- The Japanese equity market is lagging all major equity markets so far this year
- As mentioned in previous publications, we still do not see any catalyst which could reverse the underperformance

### Politics as an important short-term market driver



The back and forth in the trade dispute between the US and China has added to equity market volatility over the past months (see chart). In some instances, such as in May 2019, single tweets by President Trump regarding the trade dispute were able to significantly move the market. While this entails a lot of trading opportunities for long-and-short traders, it brings a lot of undesired volatility for long-term investors.

To us, this market regime has a few important implications. First, we are certainly convinced that, in the long run, stock markets cannot decouple from the underlying economic fundamentals (which still look favourable). Still, in the current environment, we believe that investors are well advised to look at risk-adjusted returns rather than absolute returns only. Hence, we prefer strategies such as put-protected or minimum volatility equity strategies. These are intended to reduce drawdowns and are expected to outperform in the late stage of the economic cycle. Second, the politically induced volatility is often concentrated to certain sectors or even hits individual names. Hence, it is wise to stay as diversified as possible, i.e. more diversified than the highly concentrated market capitalization-weighted indices.

# Currencies

Politics in the driver's seat

## USA

- Following the escalation in the trade conflict, the USD strengthened against EUR and emerging market currencies, but weakened against the safe-haven currencies JPY and CHF in May
- We keep a neutral view on the USD against EUR, but expect further weakness against JPY amid potential further escalation of trade tensions

## Eurozone

- Even though activity data came in stronger than expected, forward-looking survey data remained weak and kept the EUR under pressure in May
- In terms of growth indicators and political risks, we neither expect positive nor negative near-term catalysts for the EUR and prefer a neutral stance against USD and CHF

## UK

- A constant stream of negative news on Brexit led to a sharp correction of GBP in May
- Risks of a no-deal Brexit have increased significantly, but we think that a lot of negativity is already priced into GBP and turn tactically positive on the currency at the currently depressed levels

## Switzerland

- Risk aversion dominated markets in May and bolstered safe-haven currencies such as CHF
- We keep a neutral view on CHF against USD and EUR

## Japan

- Similar to the CHF, JPY has strengthened on a trade-weighted basis
- We reiterate our positive view on JPY, which is significantly undervalued and stands ready to benefit if political risks increase further

## *Sterling almost back at December 2018 lows*



— GBP/USD spot exchange rate

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Political developments were again the driving force for currency markets in the month of May. Trade tensions unexpectedly escalated, which led to renewed risk aversion among market participants. Consequently, JPY and to a lesser extent CHF (both considered safe-haven currencies) strengthened on a trade-weighted basis, while emerging market currencies suffered. A solution to the trade dispute now seems to be a distant prospect, with further escalation being the more likely scenario in the near term. Hence, we reiterate our positive view on JPY against USD, while keeping a neutral view on CHF against USD and EUR. Contrary to the strongly undervalued JPY, the CHF is still considered overvalued, which should limit the room for appreciation.

The other notable political development happened in the UK. Sterling sold off in May as markets are attaching a higher risk to a no-deal Brexit scenario following the breakdown of cross-party Brexit talks, the resignation of Prime Minister Theresa May and the landslide victory of the Brexit Party in the European Election. We agree that the probability of a no-deal Brexit has risen significantly, to around 30% from today's point of view, as the next Conservative Prime Minister will likely come from the hard-line "Brexiteer" faction of the Conservative Party. However, we still see an orderly Brexit as the more likely scenario, potentially involving yet another extension of the October 31 deadline. Volatility is set to remain high, but we think that a lot of negativity is already priced into GBP/USD and thus turn more constructive on Sterling at current levels.

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