Perspectives
Financial Markets

Swiss Life Asset Managers

July 2019

Interest rates & bonds

Better safe than sorry

USA

- After a brief tariff threat against Mexico, US President Trump reversed his decision while also striking a more conciliatory tone with China
- Nonetheless, political risks have increased, while inflation expectations have slumped. Hence, the US Federal Reserve has adopted a more dovish stance and is likely to cut policy rates this year

Eurozone

- Following very weak inflation data, European Central Bank President Mario Draghi delivered another very dovish speech in Sintra hinting at more monetary stimulus
- Unsurprisingly, risky assets performed well, while government bond yields were hitting new all-time lows

UK

- Boris Johnson is currently the front-runner to become the next prime minister, which has increased the risk of a hard Brexit in October, in our view
- The Bank of England is currently one of the few central banks that is achieving its inflation target of around 2%, which is why we do not expect a policy change as of now

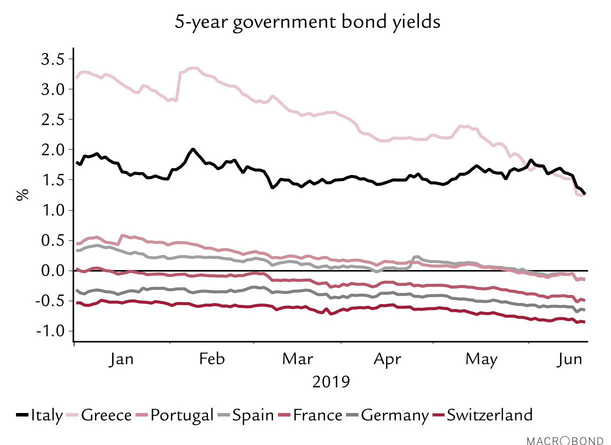
Switzerland

- While economic activity in Switzerland holds up relatively well, manufacturing sentiment remains subdued with the Purchasing Managers' Index hovering below the expansion threshold of 50 points
- We expect the policy stance of the Swiss National Bank to remain closely aligned with the ECB

Japan

- Japanese exports are suffering amid ongoing trade tensions while core inflation remains sluggish
- The Bank of Japan has limited scope to ease monetary policy further, but we might see tweaks to its "yield curve control" to limit downside risks

Positive yields only for Italian and Greek bonds



Better be safe than sorry seems to be the opinion of central bankers around the globe. Following ECB President Draghi's dovish speech in Sintra, the June meeting of the US Fed opened the door for policy rate cuts this year. In Europe, equities and corporate bonds subsequently rallied while more and more fixed income assets were pushed into negative-yielding territory. Only the Italian and Greek governments are not yet getting paid for issuing debt in the 5-year maturity bracket, and the global stock pile of negative-yielding bonds has reached an eye-watering USD 12.5 trn. Similarly, the dovish US Fed sent 10-year treasury yields below the 2% mark despite a still robust economic outlook. That said, manufacturing activity has been cooling and the trade dispute remains a significant downside risk to the outlook, while inflation expectations have continued to decline especially in Europe. It is therefore understandable that central banks are becoming more cautious, which limits the downside risks for corporate bonds. Hence, we have become less pessimistic although we still view credit fundamentals as weak. We are therefore neutrally positioned but take on more risk in certain segments such as European corporate bonds. Regarding government bonds, yields are already at depressed levels, but could decline further due to expansionary signals and actions by central banks.

Equities

More cautious after the strong rally

USA

- The equity market correction in May proved short-lived. Increased expectations for policy rate cuts in the US led to a sharp rebound of global equities in general and US equities in particular
- Overall, we stay constructive on US equities due to the combination of a more dovish Federal Reserve and continued outperformance of the US economy compared to the rest of the world

Eurozone

- Eurozone equities have been underperforming global equities year-to-date, also due to investor concerns regarding weak Eurozone growth

UK

- The UK is still preoccupied with itself and Brexit uncertainty is set to continue over the next three months
- The impact of the uncertainty will weigh heavier on more domestically-oriented stocks (small caps) than on large internationally-oriented stocks (large caps)

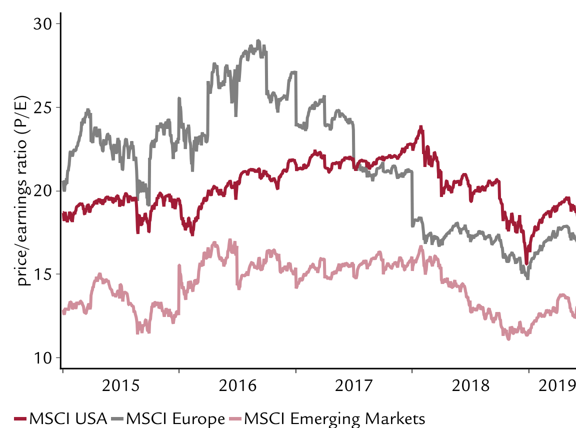
Switzerland

- In the light of increased geopolitical uncertainty many equity investors seem to have favoured the Swiss equity market, as indicated by its stellar year-to-date performance
- At the same time, economic perspectives have also deteriorated for Switzerland. We are still moderately positive for Swiss stocks, while monitoring closely the incoming economic data

Japan

- Over recent months, the Japanese stock market experienced similar losses during equity market corrections as other major world indices, but underperformed in the subsequent upturns
- We feel confirmed that our Japanese equity underweight is still correct and see no catalyst to change our view at the present stage

Elevated P/E ratios given the lack of alternatives to equities



Equity markets were again on fire in June as market participants significantly increased their bets for central bank easing in developed markets. Concerns regarding the US-China trade conflict have been put on the back burner, even though they remain as pertinent as before the recent rally. Both nations are said to continue discussions during the next G20 summit in Osaka. However, as the US administration started to restrict business for a major Chinese technology company (Huawei), the conflict certainly has the potential to escalate further, especially if China were to retaliate against single US companies to prevent them from selling in the Chinese market. Due to increased risk of escalation in this conflict amid an already impressive year-to-date rally of equities, we have turned more cautious on equities. On the positive side, equities remain attractive compared to other asset classes due to the ultra-low interest rate environment in Europe and Japan, as well as the significant currency hedging costs for US assets from a European investor's point of view. While equity multiples such as the price/earnings ratio have already expanded quite significantly on the back of large buyback programs, low financing costs and simply the lack of alternatives, a reversion appears unlikely as long as interest rate remain low. On the negative side (besides the aforementioned politics), there is the risk that market participants price in more policy rate cuts than the central banks are prepared to offer, hence, equity markets could correct quickly. We address this downside potential with risk-reducing strategies such as minimum volatility or option strategies.

Currencies

Strong USD despite policy rate cuts

USA

- The USD overall weakened last month as markets heavily increased their bets for policy rate cuts by the US Federal Reserve
- We expect a total of 50 basis points "insurance rate cuts" by the Fed this year, which is, however, less than markets are currently pricing. The USD should also remain supported by the continued outperformance of the US economy and occasional bouts of risk aversion in financial markets

Eurozone

- The EUR briefly depreciated in June following very dovish comments in the Sintra speech of ECB President Mario Draghi, but overall, the interest rate differential between US and Germany narrowed, which supported EUR against USD
- The ECB's cautiousness as well as the fact that the trade conflict continues to cloud prospects for the export-oriented Eurozone economy should lead to renewed EUR depreciation, in our view

UK

- Sterling remained rather weak last month as the leading candidates for Theresa May's leadership succession did not rule out a no-deal outcome if renegotiation attempts with the EU fail
- We continue to attach a 30% probability of a no-deal Brexit scenario and stay neutral on GBP/USD at the current depressed levels

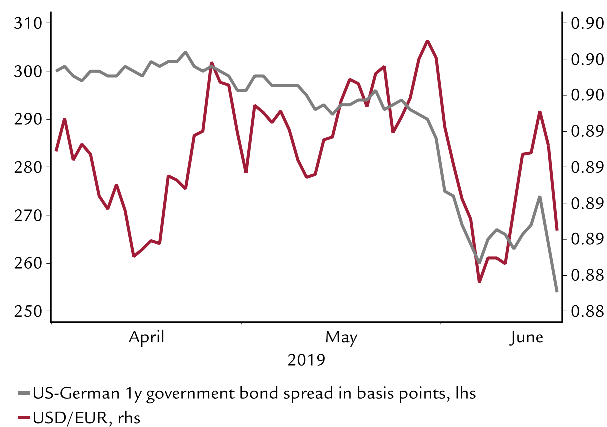
Switzerland

- Over the past month, the CHF strengthened somewhat further against EUR and USD
- Dovish central bank expectations lifted global risk sentiment in June, but we expect volatility to return once political risks come again to the fore. Hence, we keep a positive view on CHF against cyclical currencies such as the EUR

Japan

- Until the US Fed meeting, JPY traded sideways against USD, but the dovish Fed pivot sent USD/JPY another leg lower
- We keep a positive view on JPY against all major currencies as we expect global political risks to remain elevated

Interest rates differentials moved USD/EUR in June



Following a month where political risks were the main market mover in foreign exchange, markets again turned their attention to central bank developments in June. Market participants increased their expectation for policy rate cuts in the US, and the Federal Reserve delivered by sending out a very dovish message at its June meeting. With a bit of delay, easing expectation also started to pile up for the ECB, which however only temporarily reversed the strength of EUR/USD. We do not expect a proper easing cycle by the Fed, but around 50 basis points policy rate cuts this year as an "insurance" against trade war risks. Current market pricing is more aggressive than that and might re-price at some point, which limits the potential for USD weakness. In combination with a dovish ECB and continued US economic outperformance, we rather expect further USD strength against EUR going forward.

Regarding political risks, we expect further escalation in the trade conflict and no positive news on Brexit developments in the near term. The former will likely lead to renewed bouts of risk aversion in financial markets, and we thus hold on to our positive view on JPY against all major currencies and expect CHF to appreciate against EUR (both the JPY and CHF are considered safe haven currencies). Regarding Brexit, a lot of negativity already seems to be priced into Sterling exchange rates. Still, we prefer a neutral stance on GBP/USD at the present stage as uncertainty will remain very high over the course of the next three months.

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