

August 2019

Interest rates & bonds

Central bank easing: when, not if

USA

- Economic sentiment indicators are softening but remain higher than in other developed regions. Meanwhile, core inflation is around 2% and the labor market continues to tighten
- Nonetheless, the Federal Reserve seems to be worried about the global outlook. We expect the Fed to cut policy rates by a total of 50 basis points this year

Eurozone

- The economic environment in the Eurozone remains sluggish as inflation continues to hover just above 1%, while leading indicators continue to weaken, mainly driven by Germany and Italy
- In their July meeting, the European Central Bank reiterated its dovish stance, putting both rate cuts and renewed asset purchases firmly on the table

UK

- As expected, Boris Johnson is the UK's new prime minister. Hence, a "no-deal Brexit" scenario remains a non-negligible risk
- The Bank of England is currently stuck between a rock and a hard place as economic conditions are faltering, while inflationary pressures have increased due to Sterling depreciation and wage growth

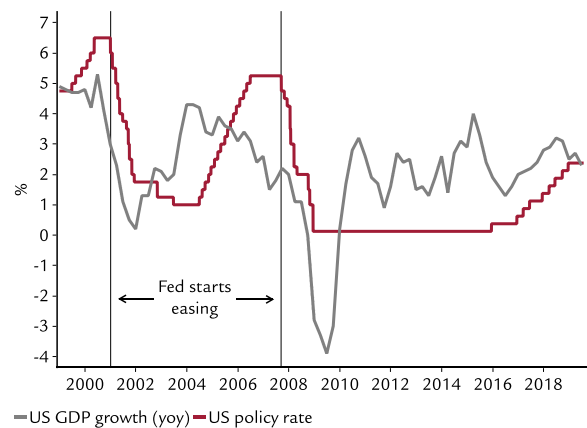
Switzerland

- As in the Eurozone, the manufacturing sector is slowing while the labor market remains solid
- The expected easing by the ECB will put pressure on the Swiss National Bank to consider loosening monetary policy too

Japan

- Japan implemented export curbs for certain chemicals vital for South Korea's electronic industry, which has the potential for another trade dispute amid already sluggish exports
- Weak inflation and the stronger JPY put additional pressure on the Bank of Japan to increase the monetary stimulus yet again

Looming US policy rate cuts despite solid economy



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It is becoming increasingly difficult to distinguish whether markets react to central banks or vice versa, given the coordinated monetary policy easing around the globe absent an actual recession. Arguably, we have several risks looming all around the globe, ranging from Brexit, trade disputes or the tensions in the Persian Gulf. We also acknowledge the widespread weakness in global manufacturing and the persistent low growth and inflation in many developed economies, particularly in Europe and Japan. Yet, solid US GDP growth, an unemployment rate of 3.7% and inflation near 2% hardly make a strong case for a policy rate cut, not to mention the four cuts the futures market is currently pricing over the next 12 months. In Europe, the need for more monetary easing seems more understandable. However, it is hard to imagine how lower rates will help to boost the economy at this point and how much firepower will be left in an economic downturn. What is clear, however, is that it will likely support financial assets further, driving credit spreads ever tighter and keeping government bond yields around record lows. We expect the technical picture to remain very strong, outweighing weaker credit fundamentals. Hence, we keep a modest overweight in credit risk and remain neutral to slightly long duration in our portfolios.

Equities

Time to shift to defensive strategies?

USA

- US equity markets have substantially recovered from the May setback and have reached new all-time highs both for the Nasdaq and the S&P 500
- In the near-term, the focus will be on the US earnings season, which is still ongoing at the time of writing, as well as the US monetary policy outlook
- While economic conditions are mixed, we expect US equities to remain supported by looser monetary policy as well as the fact that the US economy should continue to outperform other developed markets

Eurozone

- On the backdrop of a “worse and worse” economic outlook, the European Central Bank indicated the possibility of renewed net asset purchases.
- Hence, European equities will, in the months to come, be in a tug-of-war between a deteriorating economic environment and the support from looser monetary policy

UK

- The FTSE 100 has strongly underperformed global equities this year amid Brexit uncertainties. The latter will remain elevated now that Boris Johnson, a Brexit hardliner, has become Prime Minister
- We see a lot more risk than reward and consequently stick to our underweight for UK equities

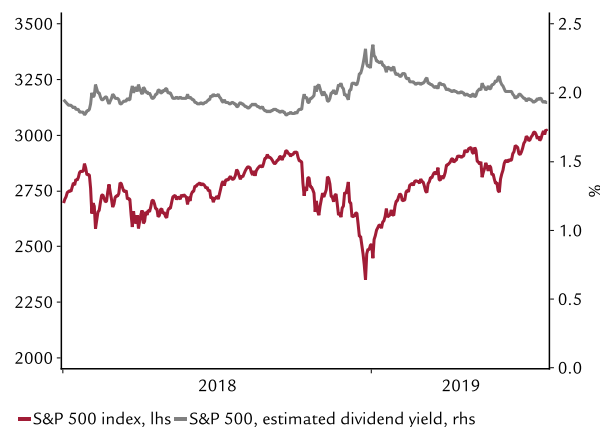
Switzerland

- Due to the strong appreciation of the CHF, small caps have significantly underperformed large caps in Switzerland. The reason is that small-caps are generally more export-oriented and thus vulnerable to a stronger currency
- Given that we do not expect the CHF to depreciate anytime soon, we would expect this underperformance to persist for the time being

Japan

- The Japanese equity market has shown a very disappointing performance this year.
- We do not see any strong catalyst for a turnaround and therefore wait for a significant positive trend to unfold before we change our negative view on the Japanese market

Still attractive dividend yields, despite the strong rally



Global equity markets experienced a bumpy second quarter but resumed the upward trend in June while recording new record highs in the US in July. Given the strong year-to-date performance, the question is obviously if the equity rally can be sustained during the second half of the year or whether investor support will be pulled at some point.

The investors' expectations will be shaped by several factors. On a relative basis, equities still look attractive, as they return an average dividend yield of 2-4% depending on the market segment and region. Regarding price yields, growth expectations for companies over the medium-term horizon play a crucial role in the assessment. The macroeconomic environment is becoming more challenging, but is still suggesting positive, albeit presumably modest growth. Nevertheless, the shallow return expectations for equities still appear more attractive than the prospect of low or even negative bond yields.

Event risks, especially in the form of political risks can, however, radically change the picture. We are therefore increasingly focusing on defensive equity strategies that offer a risk buffer in volatile times.

Currencies

Still constructive on safe-haven currencies

USA

- The USD strengthened over the last month as data releases again showed that economic dynamics are better than elsewhere in the developed world
- We expect a total of 50 basis points “insurance rate cuts” by the US Federal Reserve this year. Market pricing remains more aggressive and could be adjusted at some point. In combination with continued economic outperformance, this should keep the USD supported going forward

Eurozone

- A continuous stream of disappointing data releases, especially in Germany, reinforced expectations for monetary policy easing by the European Central Bank and kept the EUR under pressure in July
- The ECB indeed delivered a dovish message at the July meeting, and we expect further easing to be announced at the September meeting. We keep a negative view on EUR against USD and CHF

UK

- As expected, Brexit hardliner Boris Johnson follows Theresa May as prime minister. He will soon start a new attempt to re-negotiate the Brexit deal, and we neither expect major positive nor negative news in the upcoming month regarding Brexit.
- At the current depressed levels, a significant “no-deal Brexit” risk already seems to be priced, and we prefer a neutral stance on GBP/USD at this stage

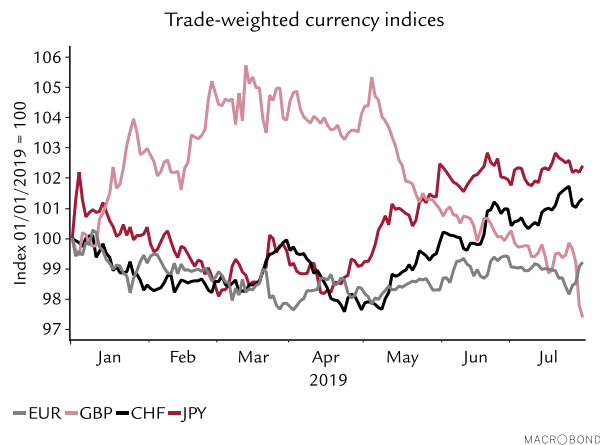
Switzerland

- Over the past month, the CHF strengthened further, temporarily falling below 1.10 against the EUR
- Investor’s risk sentiment was rather upbeat in June and July, 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

- Similar to the CHF, the JPY remained strong in July
- We keep a positive view on JPY against all major currencies as we expect global political risks to remain elevated

CHF and JPY have outperformed this year-



The month of May saw a trough in global equity markets, which was followed by an impressive recovery over the past two months. This apparent risk-friendly sentiment among investors was not reflected in currency markets. Defensive currencies such as CHF and JPY appreciated further and are among the best-performing currencies year-to-date. We still think that cautiousness is warranted amid a deteriorating economic outlook and elevated political risks globally and keep a positive view on CHF (against EUR) and JPY (against all major currencies). Economic prospects have especially darkened in the Eurozone where only a fiscal boost and solid private consumption are currently preventing the economy from a slide into recession. Easing expectations for the ECB have thus piled up and put the EUR under pressure against USD. Following the dovish July ECB meeting, we expect the ECB to deliver additional easing measures in September and thus keep a negative view on EUR/USD. The US Federal Reserve is also set to cut policy rates this year, but we believe that current market pricing is too aggressive. We expect the US economy to steer clear of a recession over the next 12 months and it should continue to outperform other developed markets, which is one major reason why we retain our constructive view on the USD. Meanwhile, Sterling has continued to weaken in July as it became clear that Brexit-hardliner Boris Johnson will be the next prime minister. At these levels, a significant “no-deal Brexit” risk already seems to be priced, and we prefer a neutral stance on GBP/USD at this stage.

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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