Perspectives
Financial Markets

August 2020

Interest rates & bonds
Markets are not the economy

USA
- As infection numbers in the US increased in July, some states paused or partially reversed reopening plans, while California went into a partial lockdown. This has started to weigh on consumer sentiment while initial jobless claims increased again.
- The Fed will likely wrap up its policy review by September, which could lead to explicit yield curve control and a more active use of credit facilities.

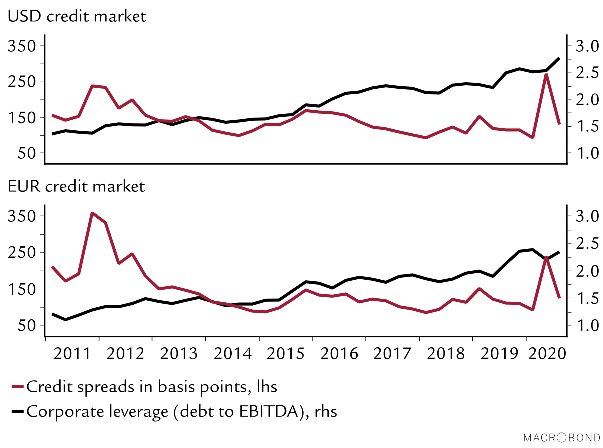
Eurozone
- Europe continues to recover from the recession with Purchasing Managers' Indices moving firmly above 50 in July amid relatively subdued infection rates.
- In an unprecedented step towards a fiscal union, the EU will for the first time issue bonds to fund its budget while allocating grants to countries most affected by the pandemic.

UK
- While the UK's economic data is improving, the looming risk of failing EU-UK trade negotiations could stall the recovery.
- The Bank of England has sent mixed signals regarding further monetary easing. Governor Bailey keeps the option of negative interest rate on the table.

Switzerland
- We still expect the Swiss economy to outperform its European peers in 2020.
- Pressure on the CHF has eased over the past weeks, but we expect the SNB to continue to intervene should it become necessary. We currently do not foresee rate cuts.

Japan
- Japan has dealt relatively well with the pandemic, but the economy is still in deep recession. This resulted in rating downgrades by two agencies.
- The Bank of Japan faces the challenge of rising COVID-19 cases causing further damage to the economy. If needed, the BoJ is ready for additional monetary easing.

Leverage rising, credit spreads again tightening



"The markets are not the economy" is an often-cited mantra when both are at odds, which seems to be the case today. Some equity indices are setting new all-time highs and credit spreads have approached levels commensurate with only a mild slowdown in economic activity, tightening another 24 bps in EUR and 18 bps in USD in July. All the while company earnings have suffered, leverage is going through the roof, global political tensions are on the rise and a pandemic is still raging around the globe. However, it is not just risky assets that have performed well. Safe assets such as government bonds and gold were also sought after. Of course, we do not have to look far for an explanation. When central banks pump trillions into financial markets, asset price inflation is a logical consequence. While the technical tailwind will likely keep a lid on spreads, we think that the recent tightening has gotten too detached from fundamentals and we are wary of the long-term consequences entailed in expanding the monetary base. Inflation, should it accelerate, would force central banks to turn hawkish, spelling disaster for financial markets hooked on stimulus. That said, we think this is unlikely to materialise in the short-term, although, given the discrepancy between valuation and fundamentals, we like to err on the side of caution and maintain a defensive position.

Equities

Treading in increasingly challenging waters

USA

- US equity markets have been performing very strongly during the second quarter. This remarkable recovery has been driven by the strong monetary and fiscal support, the early reopening of businesses and the so far better-than-expected quarterly earnings releases.
- However, most good news seems to be priced in, leaving the market exposed to negative shocks. In particular, the recent COVID-19 developments in the US and the increasing tensions with China could sour the mood of the market. So, while we still see the US equity market outperforming the rest of the world, we are becoming more cautious.

Eurozone

- The rebound in activity as measured by the Purchasing Managers' Indices is very good economic news. The stock market, however, has only partially reflected these improvements and has underperformed the US.
- This is likely the result of a monetary policy seen as being less effective than in the US, of a stronger EUR and of the equity market composition. Compared to the US, the Eurozone market has a lower share of technology companies, which are profiting from the current situation. It is therefore unlikely that the Eurozone equity market will be able to catch up with the US soon.

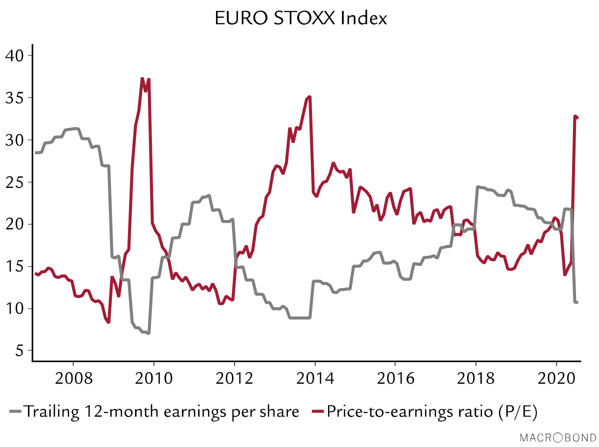
UK

- The UK economy has been hit hard by COVID-19 and the related painful lockdown as well as continued uncertainty regarding EU-UK trade relations.
- In addition, the UK equity market has a significant weight of sectors negatively impacted by the effect of the pandemic. Hence, we expect this market to lag the rest of the world for the time being.

Switzerland

- The solid performance of the Swiss equity market year-to-date reflects its defensive nature, as the reactions during the brief bouts of volatility in the past month have shown.
- Going forward, this market should profit from the more stable currency situation as well as the economic improvements in the Eurozone and perform in line with equity markets in that region

Impact of a sudden drop in earnings on the P/E ratio



Valuation is a hotly debated metric for investments, with some people strongly relying on it, while others arguing that it is basically useless. In theory, it is difficult to argue against using the fair value of an asset as the base for an investment decision: Why should one, for example, pay significantly more for something than its properly assessed value?

However, estimating the value of a financial asset is a difficult task, as a robust valuation must among other things consider the development of company earnings over the next few years. As an approximation, investors therefore use simplified indicators like the price-to-earnings ratio (P/E) based on historical earnings or based on next year's earnings expectations generated by financial analysts. As earnings tend to develop smoothly over time, this rough metric gives a reasonable value indication during normal times. However, it can fail spectacularly in times of sudden and dramatic economic slumps as for example now, as current earnings and short-term expectations become unusable as a guide for the next few years. It is, however, exactly during crisis periods that the discipline imposed by valuation is especially valuable. So, what can you do under these circumstances? Unfortunately, investors need to go back to fundamentals and assess how realistic the mid-term earnings expectations implied by the current prices are. In such an environment, simple ratios like the P/E ratio are just not good enough.

Currencies

Reiterating our negative view on USD

USA

- Except for a few cyclical emerging market currencies, the USD lost against all major currencies in July, in line with our generally negative view on the USD
- We expect the negative factors that have weighed on the USD (see main text) to remain in place in August. Hence, we see the USD depreciating further against EUR, CHF and JPY, with GBP being the only exception.

Eurozone

- EUR/USD had a very strong run in July, not only due to general USD weakness, but also due to a surprisingly rapid recovery from the recession and a successful EU summit which broke the former taboo of common debt issuance. This has also supported EUR somewhat against CHF in July.
- We reiterate our positive view on EUR/USD but see EUR/CHF in a neutral range in August.

UK

- The rally of GBP/USD in July reflects USD weakness rather than GBP strength. Economic data out of the UK was rather mixed and EU-UK trade negotiations remained stuck.
- We do not expect any major progress on EU-UK trade negotiation in the third quarter and believe that, as was the case last year already, the situation needs to get worse before it gets better. Hence, we have a negative view on GBP against USD and EUR.

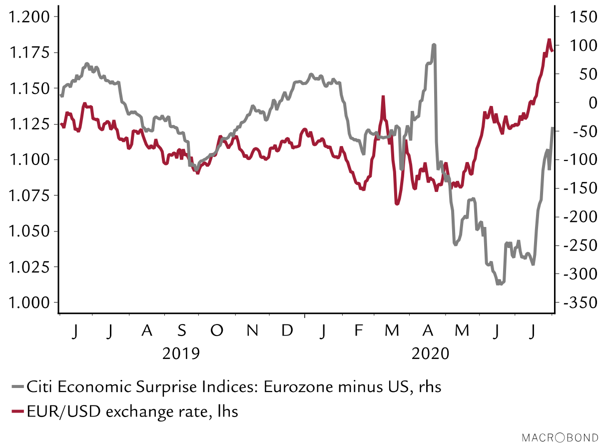
Switzerland

- The external value of the CHF (trade-weighted basis) remained stable in July, as the significant appreciation against USD was compensated by a modest depreciation against EUR, by far the most important trading currency of Switzerland.
- We expect geopolitical risks to increase, which might put safe-haven currencies such as CHF again under appreciation pressure. However, SNB currency intervention will likely limit any upside against EUR. Hence, we prefer a neutral view on EUR/CHF.

Japan

- Amid the general USD weakness, USD/JPY broke below the 105 mark at the end of July
- We reiterate our negative view on USD/JPY. Apart from the USD weakness, the JPY stands ready to benefit from any increase in geopolitical risks.

Shifting economic momentum favoring EUR against USD



In July, the USD had its worst month since September 2010. The US Dollar Index (DXY), which is measured against a basket of major developed market currencies, lost a whopping 4.6%, aggravating the slide that had already started in May 2020. The reasons are threefold: First, as repeatedly mentioned in former editions of this publication, the USD has significantly lost appeal from a carry perspective, as interest rate differentials to other currencies collapsed. Second, the US presidential campaign is heating up and domestic political risks are rising. Also, a democratic sweep in Congress and a Biden presidency have become more likely, a scenario that many investors view as negative for the USD. Lastly, and more recently, the economic momentum in the third quarter is shifting from the US to the Eurozone, as the US is struggling with a deteriorating COVID-19 situation. The Citi Economic Surprise Index, which measures incoming data against economists' expectations, is rapidly recovering for the Eurozone, but has likely left its peak behind in the US (see chart). We do not expect these three trends to reverse in August and thus keep a negative view on the USD against EUR, JPY and CHF. In July, the EUR has additionally benefited from the EU's successful adoption of the recovery fund, which has reduced the tail risk of a euro break-up. Even though investor sentiment might continue to support the EUR against USD and GBP, we have a neutral on EUR/CHF as geopolitical risks have increased again. In such an environment, we believe that the CHF will again be the safe haven currency of choice for investors as the USD has lost its safe-haven appeal recently.

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