

September 2019

Interest rates & bonds

Far from a summer lull

USA

- As the trade war escalates, first cracks appear in the US economy. Sentiment indicators have deteriorated on balance and the sovereign yield curve has inverted further
- Following the US Federal Reserve's interest rate cut in July, we expect two more 25 basis points cuts until the end of the year

Eurozone

- Macroeconomic data in the Eurozone remain weak. Germany is close to a technical recession, while the French economy holds up much better
- Even though government bond yields are near all-time lows, we expect the European Central Bank to deliver a rate cut in September, with a high probability of a renewed quantitative easing program

UK

- A no-deal Brexit at the end of October is becoming more likely as the EU and UK seem to be unable to find common ground on the Irish border backstop issue
- A monetary policy response by the Bank of England largely depends on the Brexit outcome. We do not foresee any actions before the end of October deadline

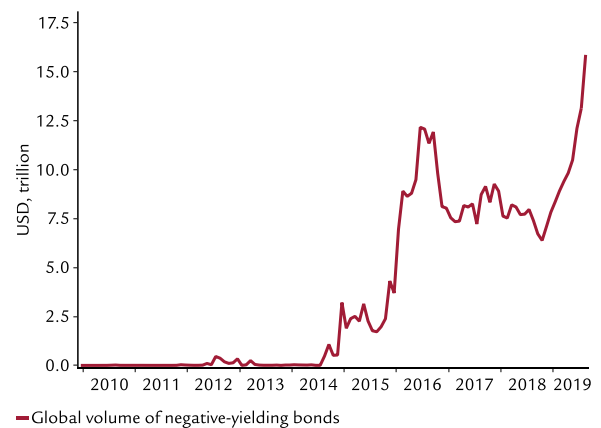
Switzerland

- Business sentiment is suffering from weak external demand and the stronger currency
- To counteract these headwinds, we expect the SNB to follow the ECB in cutting policy rates

Japan

- Macroeconomic data in Japan has surprised to the upside recently, while inflation remained largely unchanged at low levels
- Despite the rally in the Japanese yen, we do not expect the Bank of Japan to change its monetary policy stance materially

More than USD 16 trn of bonds yield negatively



August is usually a relatively calm month with most of the market participants enjoying their summer vacations. Not so this year. The constant barrage of often conflicting news has kept investors struggling to find direction in a market driven by weak fundamentals, strong technicals and Trump tweets. High volatility was the result. Although US and European credit spreads widened by only 11 and 8 basis points on an index level, respectively, intraday swings were often much larger with trading conditions varying significantly on a day-to-day basis. If there is one thing that bond investors do not like, it is uncertainty. The political risks created a flight to quality, sending interest rates ever lower. Negative-yielding debt around the globe now stands at more than USD 16 trn, including more than half of the EUR investment grade market. Although credit spreads are still relatively tight and interest rates are around all-time lows, we still see room for further declines largely due to the strong technical backdrop. We expect bumps along the road but would use temporary credit spread widenings as a buying opportunity. Overall, we are overweight credit risk in EUR, where we expect a renewed quantitative easing program by the ECB to further compress spreads. In government bonds, we favour the US given the higher overall yield levels.

Equities

Volatility to persist

USA

- August is the second month of this year where US stocks are likely to finish in the red. All other months except May showed positive performance
- We do not believe that the turning point for the US market is already reached. As long as recession fears do not become more substantiated by real data, US equity markets will continue to offer a relatively attractive return compared to government bonds

Eurozone

- The economic downturn and political risks have weighed heavily on the Eurozone equity market
- Valuations are more attractive now and with deeply negative interest rates, investors are likely to keep holding on to their European equities. Nevertheless, we still have a slight preference for US equities as they are less affected by political and economic risks

UK

- Near-term Brexit uncertainties remain very elevated, and we only expect a clearer picture regarding the UK equity market outlook to unfold in October
- What is clear, however, is that volatility will remain elevated, making UK equities less attractive for us in risk-adjusted terms

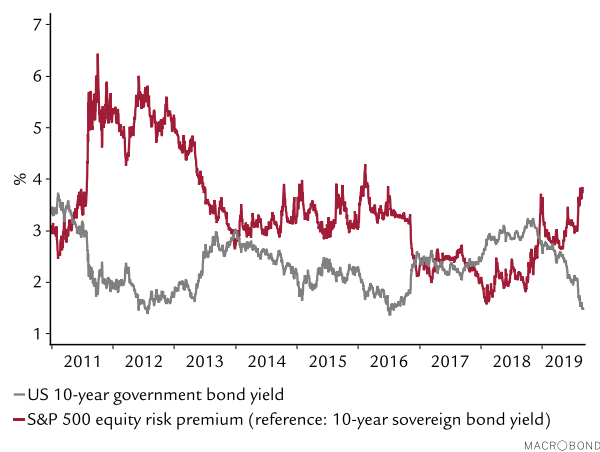
Switzerland

- The Swiss equity market has outperformed most other markets in August, as the bulk of the larger Swiss companies are in defensive sectors
- Smaller companies, which rely heavily on exports and are less able to shield themselves from an appreciating CHF, have done significantly worse

Japan

- The Japanese equity market has disappointed and is even close to a negative year-to-date performance
- So far, we have not seen any reason to get overly excited about Japanese equities, but given the very large performance gap to global equities, this might change at some point

Falling bond yields boost the equity risk premium



A key challenge to managing equities is the trade-off between return potential and setbacks risks. Managing this trade-off becomes particularly difficult in times when the risks are mostly the result of political conflicts of a scale rarely seen in the past. While increasing expectations of an economic slowdown, for example, will generally lead to a relatively slow market downturn, fears linked to political events usually lead to large, fast and unexpected market corrections.

In this environment, systematically protecting the equity portfolio against major downside risks is an effective strategy in our view, especially for investors with limited risk budgets. Such protection strategies have a very attractive property, namely helping to buffer large swings to the downside while keeping the upside potential in place.

Currencies

No end to USD strength in sight

USA

- The escalation of the trade conflict led to a broad-based appreciation of the USD in August. Among major currencies, only the CHF and JPY performed better over that period
- The fundamental drivers which have supported the USD this year should remain in place going forward. The expected interest rate cuts by the US Fed are unlikely to weaken the USD, as these actions are already priced and monetary policy is easing in other economies as well

Eurozone

- Recent data releases confirmed that Germany is close to a technical recession, while communication by the European Central Bank remained firmly dovish. The EUR depreciated further against this backdrop
- We reiterate our negative view on EUR against CHF and USD, as we expect economic momentum to remain weak over the period ahead

UK

- During August, a somewhat more constructive tone on both sides of the Channel led to renewed hopes that a Brexit deal could be struck, and GBP recovered temporarily
- Nevertheless, the risk of a no-deal outcome remains elevated, reinforced by Boris Johnson's recent decision to limit parliament's time for the Brexit debate. We expect GBP to come under renewed pressure over the coming month

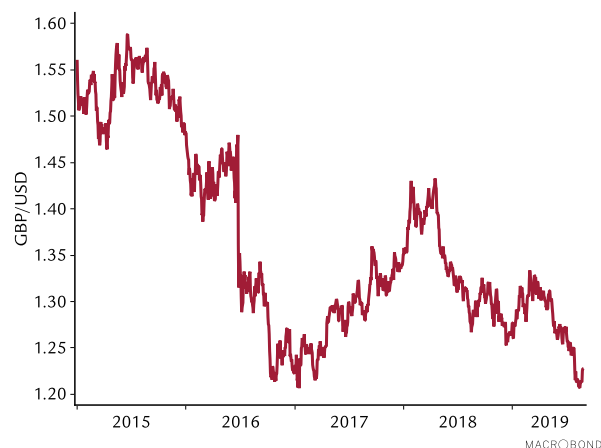
Switzerland

- Renewed FX interventions by the Swiss National Bank were unable to halt CHF appreciation in August
- Given the myriad of political risks and increased recession fears, we retain our positive view on CHF against EUR

Japan

- Like the CHF, the JPY was sought by investors in August due to its safe haven status
- We still see room for JPY appreciation against all major currencies going forward

We expect renewed pressure on Sterling



US President Trump is railing against allegedly excessive strength of the USD and has increased the pressure on the US Fed to ease policy. Yet, it is the President's own actions which have kept the USD supported over recent months. If a country imposes additional tariffs and thus changes the relative pricing of goods, economic theory unequivocally proposes that its currency should strengthen to at least partly offset higher prices. This is exactly what happened. In addition, the re-escalation of trade tensions has reinforced recession fears among investors and supported safe haven currencies such as USD and to a larger extent JPY and CHF. We do not expect this picture to change over the coming month. Cyclical currencies such as the EUR, emerging market and commodity-related currencies are suffering in this environment. The US Federal Reserve will likely cut the policy rate by another 50 basis points in total until year-end, but as other central banks have also embarked on an easing course, the expected Fed action is unlikely to weaken the USD. Regarding Sterling, we expect the small recovery in mid-August to have been a temporary phenomenon only. Risks of a no-deal Brexit remain elevated and any potential deal, which represents the biggest upside risk to GBP, would likely only be struck close to the 31 October deadline. In the meantime, we expect news flow regarding Brexit to be mainly negative and have thus adopted a negative view on GBP/USD for the upcoming month.

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