

September 2020

Interest rates & bonds

Path of least resistance

USA

- Recent US activity data as well as business surveys have mostly surprised positively, suggesting that a healthy economic recovery is underway in the third quarter.
- At the occasion of the “Jackson Hole” Economic Policy Symposium, the US Federal Reserve published the conclusion of its strategic monetary policy review.
- As expected, the Fed now opts for an average inflation target of 2%, meaning that it will accept temporarily higher inflation following periods of below 2% inflation.

Eurozone

- Industrial data continue to improve, whereas the recovery in the services sector slowed in August according to survey data, likely the result of new targeted measures to cope with rising COVID-19 infections.
- We do not expect any major changes during the ECB’s next meeting, but minor tweaks in the implementation of the various programs are likely.

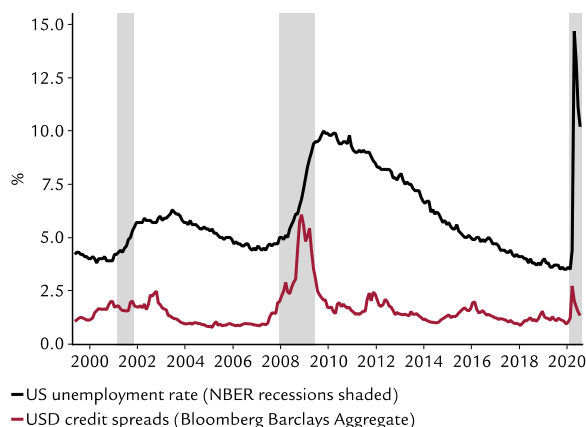
UK

- Purchasing Managers’ Indices and retail sales figures continue to improve in the UK as the economy is still in an earlier phase of the reopening compared to Continental Europe and the US.
- The Bank of England emphasized that although negative rates remain part of the toolbox, it currently does not see enough benefits for this step, a significant change in tone.

Switzerland

- Switzerland seems to weather the crisis comparatively well, as evident by second-quarter GDP that dropped less than in other developed economies.
- We currently do not envision any major policy moves by the SNB, although sight deposits continue to rise as the SNB intervenes in the FX market.

A deep recession but credit spreads almost back to normal



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August is generally one of the quieter months. While the looming deadline for the expected US fiscal package has come and passed without a deal, and infection numbers in Europe are on the rise again, markets just shrugged it off altogether. Some positive news on the vaccination front coupled with a de-escalation of the China-US trade war and the continued tailwind of monetary stimulus was all that was needed. In August, EUR credit spreads tightened by 14 basis points (bps) to 114 bps as new supply all but vanished, while USD spreads fell 3 bps to 130 bps despite a heavy new issue pipeline for this time of the year. 10-year government bond yields in the US and Germany rose by 11 bps and 18 bps, respectively. With the earnings season all but over and companies having beaten the low expectations quite handily, it seems that the path of least resistance for corporate bond spreads is lower. However, while we arguably underestimated the magnitude and speed of the initial spread tightening, we remain defensive given how stretched valuations are at current levels. As a comparison, the average spread level during the last two recession was 300 bps for USD corporates, when fundamentals were much healthier and duration significantly shorter. Regarding government bonds, we opted for a long position as yields backed up to the upper bound of our expected range.

Equities

US information technology sector shines

USA

- While most equity regions have lost momentum, US markets have continued their tremendous recovery into August. This can be mostly attributed to the large weight of IT firms within US equity indices.
- Unless the tech sector reverts, for which we currently see no catalysts, US stocks will likely continue to outperform.

Eurozone

- The Citi Economic Surprise Index, which measures incoming data against expectations, has improved significantly, and the Eurozone Purchasing Managers' Indices imply a strong recovery during the third quarter.
- The performance of Eurozone equities does not yet reflect the improvement in economic momentum as they have underperformed other regions for two months now. We think that there is room for positive surprises in the Eurozone equity market for the weeks to come.

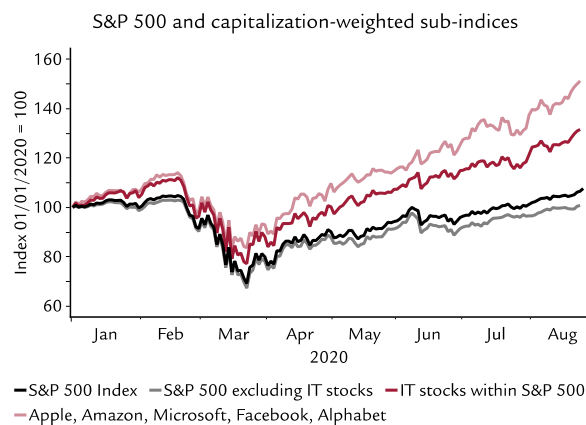
UK

- In this global recession, the UK is among the hardest hit developed economies. In addition, no material progress has been achieved regarding EU-UK trade negotiations. UK equities extended their significant underperformance in August.
- We see limited room for optimism and expect continued underperformance of the UK equity market.

Switzerland

- In this crisis, the Swiss economy got away with a black eye. As expected, GDP dropped by 8.2% in the second quarter, which is less than the decline in other major developed economies except Japan.
- Consequently, the stock market has been quite robust during the past months and we do not expect this to change going forward. In particular we expect Swiss stocks to outperform in any potential market downturn.

Tech sector driving the S&P 500



MACROBOND

The US equity market has delivered a stunning outperformance year-to-date, despite all the negative noise stemming from the COVID-19 pandemic, domestic politics and geopolitical tensions. The reason for the outperformance is the high weight of the information technology (“tech”) sector within the major capitalization-weighted US equity indices. Without tech, the S&P 500 would still be well below pre-crisis levels, as the chart above illustrates. How sustainable is the rally of the US tech sector? Valuations have indeed skyrocketed. The price-to-earnings ratio (P/E) of the Nasdaq was moving in a range of 13-23 in the past decade and has now surged to around 32. However, as mentioned in last month’s edition of this publication, valuation metrics are a less meaningful gauge for investors in crisis times, when earnings expectations are moving rapidly. There are also some fundamental reasons for these lofty valuations. First and foremost, the crisis is turbo-charging the digital transformation. Tech companies are the big winner of the crisis, which is also reflected in relatively solid company earnings. Tech stocks in the S&P 500 have overshot earnings expectations in the second quarter by 13%, while sales figures have exceeded expectations by 6%. Given this solid earnings situation, a correction in tech stocks, which would be the most likely trigger of a broader market correction, does not seem to be around the corner. On top, the persistent low interest rate environment supports these “growth stocks” from a business perspective (they have more growth projects to finance as compared to traditional “value stocks”) and valuation perspective (their cash flows lie further in the future and are discounted to higher present values).

Currencies

Turning neutral on EUR/USD

USA

- After a big drop in July, the USD only depreciated marginally on a trade-weighted basis in August. The USD mainly lost against the renminbi and commodity-related currencies such as CAD.
- For the rest of the third quarter, we expect the USD to move sideways against EUR, CHF and JPY. Economic data should remain solid, mitigating the potential negative influence stemming from domestic political risks.

Eurozone

- The EUR appreciation trend, which had been supported by a sharp rebound in economic activity in July, was halted in August as economic data came in again more mixed.
- We have turned neutral on EUR/USD and see EUR/CHF trading around the current 1.075 level in the near-term.

UK

- Sterling was the surprising outperformer in August. Contrary to our expectations, GBP continued to appreciate against USD and even gained against EUR.
- Sterling was likely supported by upbeat business survey data. We indeed expect a strong rebound of activity in the third quarter after a horrid second quarter, but remain cautious regarding the medium-term economic prospects. In addition, EU-UK trade negotiation are unlikely to advance in September, hence our negative view on GBP/USD.

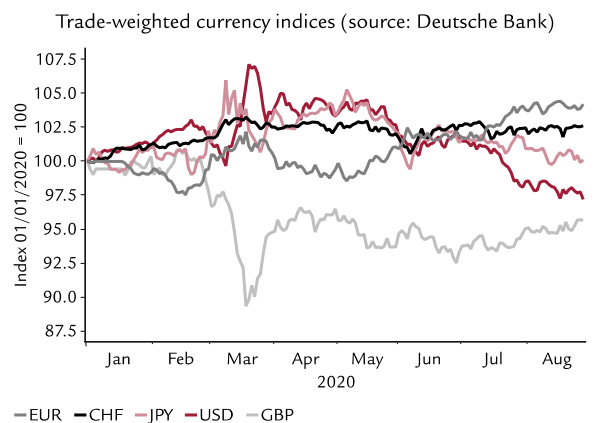
Switzerland

- On a trade-weighted basis, the CHF remained stable in August.
- We reiterate our neutral view on EUR/CHF. As the past months have shown, the SNB stands ready to counteract any potential appreciation pressure on CHF by intervening in the currency market.

Japan

- Usually a rather volatile currency, JPY barely budged against USD in August.
- We think this is unlikely to change in the near-term and have thus adopted a neutral view on USD/JPY.

A rare occurrence: EUR leading the pack



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After a three-month rally that made the EUR the world's best-performing major currency this year, EUR exchange rates lost steam in August. EUR/USD stabilised at around 1.185 and EUR/CHF at around 1.075. However, the latter still enjoyed support from the SNB, as indicated by the continuous increase in sight deposits at an average weekly pace of CHF 2 billion. At this point, we see further EUR appreciation against USD as rather unlikely and opt for a neutral view on the currency pair. While domestic political risks persist in the US (a potential negative for USD), the situation regarding economic momentum looks more balanced now. In July, we saw a strong rebound of activity in Europe, but August surveys indicate a slower recovery going forward. One reason might be new targeted restrictions that were imposed in many European economies due to a re-acceleration of COVID-19 infections. We also have a neutral view on EUR/CHF and USD/JPY but with a negative bias on both pairs. Risky assets are currently pricing in a lot of positive developments. Hence, any setback on economic data or flare-up of political risk could swiftly put the safe-havens CHF and JPY back into investors' focus and lead to appreciation pressure.

Meanwhile, the most surprising recent currency move pertains to sterling, which appreciated against EUR and USD in August. Admittedly, UK survey data indicate a rapid recovery in the third quarter, but we still expect the UK economy to be among the last major economies to return to pre-crisis levels, while no near-term progress on EU-UK trade negotiations is in the cards. Hence, we reiterate our negative view on GBP/USD.

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