Perspectives
Financial Markets

October 2019

Interest rates & bonds

Central banks in motion

USA

- The Fed lowered rates as expected by 25 basis points and made additional rate cuts dependent on the evolution of the economy. This was taken as slightly hawkish by markets
- We expect another rate cut by the Fed until year-end

Eurozone

- Monetary policy in the Eurozone remains very accommodative
- The ECB introduced a two-tier system, in which part of banks' holdings of excess liquidity will be exempt from the negative deposit rate
- Slowing economic momentum provides room for long-term sovereign bond yields to edge lower until end of the year

UK

- The BoE kept the policy rate unchanged as widely expected by markets
- The central bank thinks that if the departure of the country from the EU goes smoothly a series of gradual rate hikes will be needed over the next years. In case of a Hard Brexit the BoE will decide on the necessary measures

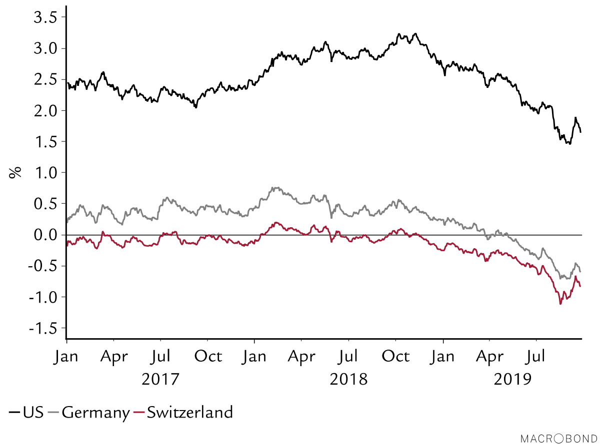
Switzerland

- The SNB kept monetary policy unchanged, yet they reiterated their willingness to intervene on foreign exchange markets
- Changes in the exemption threshold for negative interest rates lead to a higher volume of banks' sight deposits not being charged
- The SNB needed to intervene only little on the foreign exchange market post the ECB rate cut

Japan

- The BoJ stood pat on policy, but a rate cut in October becomes more likely. This could help to offset potentially harmful effects of the consumption tax hike

10-year sovereign bond yields



The monetary policy assessments by the Fed, the ECB and other central banks were in the spotlight in September. At the beginning of the month the expectations for very accommodative measures, especially from the ECB, were trimmed, which led to an increase of long-term interest rates. Indeed, the decisions did not turn out as aggressive as originally thought, but monetary policy remains highly accommodative. The ECB reduced the deposit rate, announced an open-ended asset purchase program and changed the modalities of the targeted longer-term refinancing operations (TLTRO III) to facilitate bank lending. In the trade dispute between US and China, both sides showed gestures of goodwill. There are chances of an interim deal, but the trade dispute remains far from being resolved. The latest economic data show signs of weakness, for the Eurozone in particular, and the risks are tilted to the downside. From a historical perspective interest rates are on record low levels and we expect them to stay low for longer. We also remain cautious for credit risk. Current levels seem expensive given the fundamental data of corporates and the economic conditions. Corporate credit though profits from the low interest rate environment and the buying program of the ECB. Therefore, we expect corporate spreads to trend sideways in the final quarter 2019.

Equities

Mind the tail risks

USA

- Equities remain well supported by accommodative monetary policy
- Growth is set to moderate, but the corporate sector still delivers on earnings expectations
- Funding pressure in certain sectors is apparently on the rise
- Rising tensions in the Middle East adds to a series of geopolitical risks

Eurozone

- ECB action is considered as supportive for equities
- Equities remain attractively valued compared with fixed income investments
- Germany's economic slowdown is mirrored on the stock market with the DAX underperforming the MSCI Eurozone Index by around 3% so far this year

UK

- Brexit, and the related multi-year unclarity is distracting companies from taking investment decisions in the UK
- Small- to medium sized firms are feeling the damage and suffer from rising margin pressure
- As an extension of negotiations and snap elections seem likely, we do not expect a major relief for the stock market in the short-term

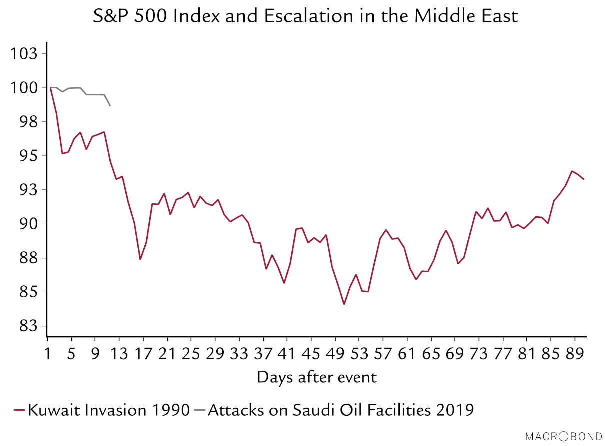
Switzerland

- Export oriented manufacturers in the mechanical and engineering sectors suffer from a drastic fall in orders intake
- Weak global demand does more damage than the strengthening of the Swiss Franc
- We continue to prefer large caps, which has been beneficiary since the start of the year
- Swiss large caps tend to be more robust in times of market disruptions

Japan

- While, on a year to date basis, Japan's stocks are underperforming, its leading index was among the best in global comparison in September
- A higher consumption tax and trade worries weigh on the economic outlook for Japan

Middle East tensions are not worrying equity investors



Equities remain well supported by the recent central bank measures on both sides of the Atlantic. We continue to observe a "buy the dip mentality" among institutional investors given the absence of meaningful liquid alternatives to equities. In times of negative interest rates, dividends continue to attract investors. Earnings expectations have been adapted to a more adverse global economic environment and the corporate sector is so far capable to match expectations. Most recent data from the Eurozone suggest that spill-overs from Germany's ailing manufacturing industries into other sectors and other EMU member states form a rising risk for Europe's stock markets. The increasing tension in the Middle East adds to other, long-known, geopolitical risks like the trade conflict, Brexit or Italy's unstable political situation. Yet, so far, the attack which has cut Saudi Arabia's oil production into half, and which is thought to temporarily cut off 5% of global production, did not have a larger impact on equity markets. Analysts compare the attack with the Iraqi invasion in Kuwait in 1990, which was cutting off only 2% of global supply. The belief in a mutual interest of all involved parties in a continued supply of the global economy plus the comparably lower energy dependency of the Western economies seem to prevail over fears of an ever-escalating situation in this politically sensitive region.

Currencies

We expect the Swiss Franc to strengthen again

USA

- The US Federal Reserve delivered the broadly expected policy rate cut in September, but market participants had expected a somewhat more dovish guidance. Nevertheless, the USD generally weakened in September as renewed hopes regarding the trade dispute led to a more risk-friendly environment in financial markets
- Still, we believe that political risks will remain elevated and expect continued US economic outperformance. Hence, we reiterate our positive view on the USD

Eurozone

- In a volatile month, the EUR overall strengthened against USD and CHF in September despite more monetary policy easing from the European Central Bank
- We expect, however, renewed pressure on the EUR as economic momentum will likely remain weak over the month ahead

UK

- Sterling continued its recovery in September as parliamentary action reduced the risk of a No Deal Brexit on 31 October. Also, hopes for an early deal were revived by favourable comments from EU Commission President Juncker
- Nevertheless, our base case remains an extension of the Brexit deadline followed by an early election later in the year, which should keep uncertainty high and put GBP under renewed pressure

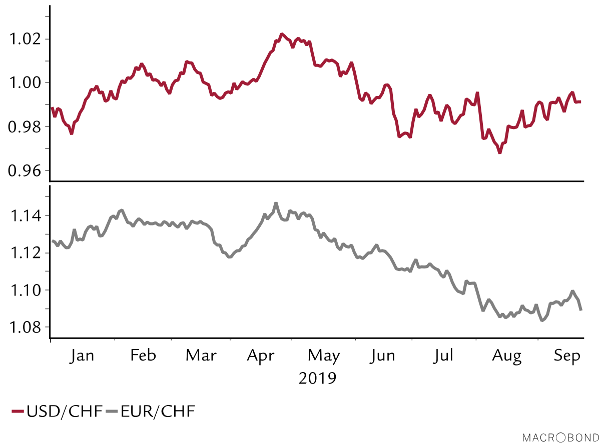
Switzerland

- Better risk sentiment in financial markets removed appreciation pressure on the CHF in September
- Given the myriad of political risks and lingering recession fears, we retain our positive view on CHF against EUR

Japan

- As markets returned to "risk-on" mood in September, JPY reversed some of its previous strength
- Nevertheless, we reiterate our positive view on JPY for the same reasons mentioned above for the CHF

CHF weakened in September despite unchanged SNB policy



In September, a series of central bank meetings and political events led to strong crosscurrents within currency market and thus elevated volatility. Even though the US Federal Reserve and the European Central Bank (ECB) delivered the expected easing measures, both the USD and EUR strengthened after the respective meetings. In the case of the Fed, the guidance was perceived to be less dovish than hoped by market participants. Meanwhile, the ECB delivered prudent forward guidance, which initially led to some deprecation of the EUR. However, this was quickly reversed, as a general sense emerged among market participants that the ECB is left with very little firepower compared to other central banks, most notably the Fed. As the EUR/CHF exchange rate also grinded higher in September, this took significant pressure off the SNB to ease monetary policy further at its quarterly meeting. On the political side, optimism crept in regarding the trade dispute and Brexit, which weighed on safe-haven currencies (USD, CHF and JPY) and reversed previous weakness in both EUR and GBP. Nevertheless, political risks will likely increase again, as we neither expect any comprehensive near-term solution on the trade dispute nor a Brexit deal ahead of the October 31 deadline. Hence, we reiterate our view that USD, JPY and CHF should appreciate again versus cyclical currencies such as EUR and GBP.

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