Perspectives
Financial Markets

Swiss Life Asset Managers

August 2021

Interest rates & bonds

All eyes on US inflation and job market

US

- US interest rate curves continued to flatten in July, while real yields of 10-year Treasuries are back to historic lows of around –1.1%.
- The US Fed wants to see more progress on US employment before it considers tapering its bond purchases. It deems current inflation dynamics as largely transitory.

Eurozone

- European government bond yields followed their US counterparts' downtrend, and curves flattened. German 30-year yields are about 25 bps lower month-on-month.
- The ECB sent a dovish message at its last meeting, which followed its strategy review. Policy stimulus will be persistent until inflation reaches its new symmetric 2% target on a sustainable basis.

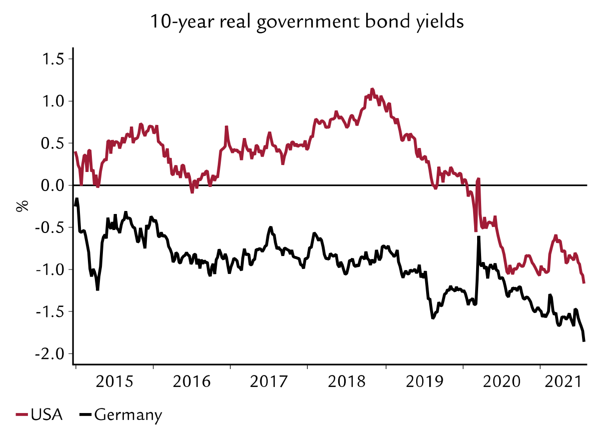
UK

- Similar to US and European government bond yields, the UK term structure flattened, with lower yields across the curve in July. 10-year Gilt yields fell about 16 bps in July.
- Further rumours emerged about a potential shift towards a more hawkish stance of the Bank of England.

Switzerland

- Swiss government bond yields dropped significantly in July. Bonds of longer maturities outperformed and the yield curve flattened further.
- Sight deposits increased slightly to CHF 712 bn while the Swiss franc rallied. The EUR/CHF rate moved below 1.08, a level not seen since February. In combination with lower-than-expected June inflation data of 0.6%, the SNB is set to maintain its loose monetary policy stance.

Real bond yields move to historic lows



Nominal government bond yields declined over the past two months, but the drivers changed: In June, investors' inflation expectations fell after the FOMC meeting, whereas in July, lower real yields were to blame. Markets probably began pricing in slower economic growth due to the Delta wave. Although harsh lockdown measures are unlikely in developed markets, targeted mobility restrictions could still impact growth, whereas risks are highest in emerging economies where vaccination rates are lower. Credit spreads widened only slightly, probably because slowing growth justifies a delayed reduction of monetary stimulus. Meanwhile, US inflation numbers keep producing positive surprises. The US Fed thinks this is transitory and will start withdrawing stimulus measures only once it sees more progress on the job market. The latter might have reached a critical juncture, as more people could decide to seek jobs when enhanced unemployment benefits end in September. If inflation were to remain high when US job numbers are generating upside surprises, markets might start to price in a faster withdrawal of monetary stimulus. We believe that real yields at historic lows are inconsistent with the still favourable macroeconomic backdrop and are maintaining a short bias on duration in our portfolios. We are neutral on credit risk, as valuations are elevated but technical factors should remain supportive.

Equities

Delta variant causes more volatility

US

- Around mid-July, investors started to nurture doubts about the post-pandemic economic recovery, leading to a simultaneous fall in bond yields and an equity market setback.
- The forceful statements by the US Fed that monetary policy would provide support for longer once again saved the day, leading to a recovery which was also fuelled by robust earnings announcements and positive company outlooks.
- While the situation has not changed substantially and the equity market is still expensive in absolute terms, the support by the Fed and the positive earnings news are likely to continue to shore up the US market for the time being.

Eurozone

- The equity markets in the Eurozone continued to lose momentum in July, even though Eurozone economies are currently producing more positive surprises than the US.
- The significant increase in cases of the COVID-19 Delta variant and political uncertainties in France and Germany have contributed to a worse investor mood in this market, at least temporarily.
- However, both the economic and the market fundamentals still militate in favour of this region and more recently, the dovish message from the ECB set the stage for a recovery.

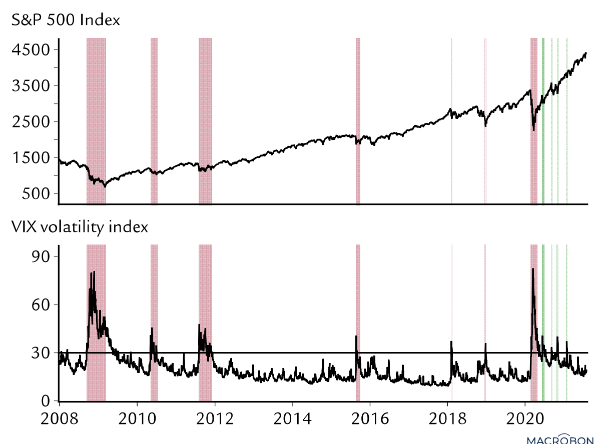
UK

- The UK market continued to lag the rest of the world in July. The surge in COVID-19 infections certainly had a negative impact. The increasing tension between the UK and the EU over custom controls in Northern Ireland likely also weighed on the market, as the risk of trade retaliations by the EU has increased.
- We expect the UK market to continue its underperformance in the near future.

Switzerland

- The Swiss market performed on a par with global equities in July.
- Mid and small caps did well, in line with the improving overall global economic situation.

Sell on volatility spikes? No, buy the dip!



When equity markets correct, their implied volatility normally rises notably. Implied volatility is the level of volatility traders use to price instruments such as options and is therefore an indicator of how the market is pricing risk. Investors often look at spikes in implied volatility to detect a potentially dangerous market condition and therefore reduce risk. This worked well in the past, as after a significant market correction markets remained weak for a while (see red areas in the chart above). More recently, however, the fast and significant interventions by central banks have apparently reduced the usefulness of this volatility indicator, as investors will often "buy the dip" as they anticipate that the central banks will react and indirectly support the market. As can be seen from the graph (green areas), the equity markets recovered very quickly after recent volatility spikes, punishing investors who used this signal to reduce their equity exposure.

Does this mean that we will no longer see a significant correction? No. As soon as investors start to nurture doubts about the immediate positive impact of monetary easing on equity markets, the mood will change, and the volatility indicator will be useful again. This might happen if investors focus again on the inflationary impact of monetary policy. In the meantime, however, one should be careful on relying too much on volatility spikes to guide the equity allocation.

Currencies

Waiting for the dust to settle

US

- After an initial phase of USD strength due to "risk-off" sentiment among investors, the USD weakened at the end of July, following a FOMC meeting that was more dovish than expected and a lacklustre second-quarter GDP release for the US.
- While a re-pricing of overly optimistic growth expectations was warranted, the continued plunge of 10-year US bond yields in July went too far, in our view. We expect US yields to recover over the next few months, which should keep the US interest rate advantage against other developed markets intact.
- We thus expect the USD to remain fundamentally supported during the second half of this year, even if we opt for a tactically neutral view for the month of August.

Eurozone

- The ECB maintained a very dovish stance in its July meeting, but the latest sentiment and inflation data out of the Eurozone produced a positive surprise, which supported the EUR against USD in the last week of July.
- While economic momentum should remain positive in the third quarter, we remain more cautious than the consensus for 2022 growth, not least due to fading fiscal support. The ECB will thus remain stuck in its ultra-expansionary monetary policy, which warrants a medium-term negative outlook for the EUR against the USD.

UK

- The surprising outperformer in July was GBP, as markets looked beyond rising infection numbers and adhered to their expectation regarding policy rate hikes by the Bank of England intact (see chart).
- We have a neutral one-month view on GBP/USD.

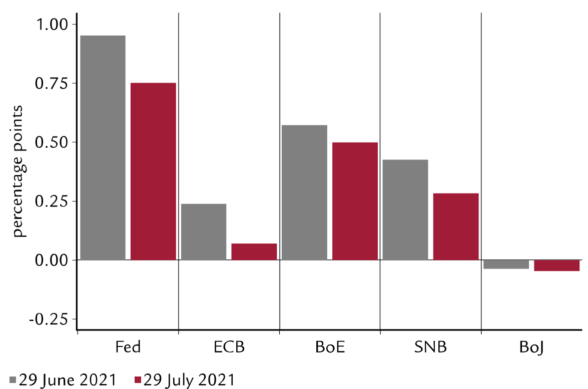
Switzerland

- CHF appreciated almost 2% in July against the EUR, as investors rushed into safe-haven-currencies.
- As risk sentiment among investors might remain cautious in August, we are opting for a neutral view on EUR/CHF.

Japan

- Similar to CHF, investors sought refuge in the safe-haven currency JPY in July.
- We have a neutral one-month view on USD/JPY.

US Fed still seen as early-mover even after recent re-pricing



July saw quite a re-assessment of economic risks. During the second quarter, the rapid vaccination progress and re-openings of the economies led to – in our view – somewhat exaggerated optimism regarding economic growth, especially in the US. Indeed, for the first time since October 2020, consensus expectations for 2021 US GDP growth were revised down in July, and surging COVID-19 cases in the UK reminded investors that the pandemic is not over yet. In addition, the regulatory crackdown and resulting equity market sell-off in China made it clear that the Middle Kingdom will not step up to fill the gap as a "global growth engine" should the US economy weaken significantly more than expected. Hence, the first 20 days in July were characterised by sour investor mood and jittery markets for risky assets, which supported the safe-haven currencies CHF, JPY and USD. Sentiment then improved somewhat, also supported later in July by a Fed meeting that was ultimately more dovish than expected. Markets thus priced out one 25 basis points policy rate hike by the Fed over the next three years – more than for other major central banks (see chart) – which led to a weaker USD at month-end. However, the CHF remained in high demand throughout the month, a clear sign that markets are not yet back to full "risk-on" sentiment. For the upcoming month, we are opting for a neutral view on all major exchange rates, as it is unclear yet how the "Delta wave" will hit the various economies, and investors might remain in a wait-and-see mode. Once the dust has settled, however, we expect the USD to embark on a positive trend again as prospects for the US economy and Fed tightening remain intact.

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