Perspectives
Financial Markets

April 2020

Interest rates & bonds
The month of superlatives

USA
- As the coronavirus crisis unfolds, we are starting to see the first signs of its impact on the US economy with a record high number of initial jobless claims and a plunge in sentiment indicators.
- The US Fed cut its policy rates by 150 basis points and introduced unlimited quantitative easing. At the same time, the government signed off on a fiscal stimulus program worth USD 2 trillion.

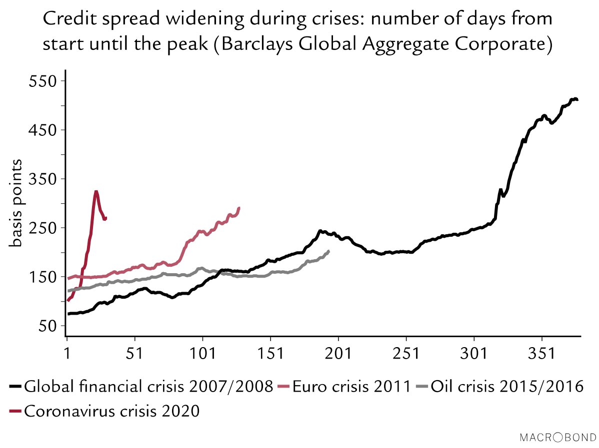
Eurozone
- Exponentially rising infections forced governments to implement strict lockdown measures. Unsurprisingly, economic data signal a sharp recession.
- Fiscal rescue packages have been implemented to dampen the economic impact from the pandemic, while the significant increase in asset purchases by the ECB and more flexibility regarding their implementation has so far prevented a blowout in peripheral bond spreads.

UK
- The UK's infection numbers are bound to rise sharply in the coming weeks given the late implementation of lockdown measures.
- The BOE cut rates by 65 basis points and launched a GBP 200 billion bond purchase program.

Switzerland
- Switzerland has one of the highest infections per capita and will likely see a severe economic impact.
- The SNB has so far not put out any extraordinary measures apart from FX interventions, but the government issued loan guarantees for firms and extended the reach of its short-term work scheme.

Japan
- So far, Japan seems to handle the spread of the virus better than other countries, but the economy is nevertheless going to contract significantly this year.
- The BOJ kept interest rates unchanged but increased the purchases of equity ETFs.

The sudden recession



Recessions usually hit financial markets by surprise, and this time is no different. However, the speed at which this correction unfolded is unprecedented. Equities, corporate bonds and even gold all sold off in unison as investors struggled to find the cash to serve outflows and margin calls. Markets became heavily distorted as we witnessed a severe liquidity crunch. Even safe haven government bonds sold off and bond market credit curves inverted as investors tried to sell what they could, not what they wanted. Only after central banks opened the flood gates, volatilities decreased, and markets started to function properly again. During the month of March, EUR and USD corporate bond spreads widened sharply by 125 and 150 basis points, respectively. Total returns for the month were deeply negative with -6.9% and -7.1%, respectively. While we ultimately expect a U-shaped economic recovery to unfold in the second half of this year in developed markets, the next three months will remain challenging and uncertain. We therefore remain defensively positioned within credit, with a bias to sectors such as utilities and telecommunication, while we remain wary of consumer cyclicals and financials. We also keep our slight overweight position in duration.

Equities

Volatility is here to stay

USA

- Economic prospects have deteriorated sharply in the US as the country has become the hotspot of the coronavirus pandemic. While the number of new infections is stabilising in Europe, growth of new cases in the US is still exponential.
- The fiscal response has been impressive in the form of a USD 2 trillion package, which helped to calm the equity market at the end of March. Nevertheless, the US unemployment rate is set to rise sharply to around 10-15% in April and May due to the lack of a nationwide short-time work scheme.
- Given the bleak near-term prospects, we do not expect US stocks to outperform for the time being and have thus downgraded the US to a neutral stance.

Eurozone

- Widespread lockdown measures in the Eurozone will lead to a sharp recession in the first half of 2020. Equity markets dropped by 20% in March. Equity markets in Italy and Spain, countries particularly hit by the epidemic, underperformed.
- It is still unclear when the economic situation will start to normalise, but at least the number of new infections appears to be stabilising. We expect EMU stocks to perform at least in line with global equities.

UK

- The strategy to achieve herd immunity as soon as possible has been abandoned, and – with a delay – the UK adopted strict lockdown measures as on the Continent.
- Hence, it might take a bit longer to bring the epidemic under control in the UK. We thus expect UK stocks to extend their year-to-date underperformance in the coming months, despite attractive valuations and dividend yields.

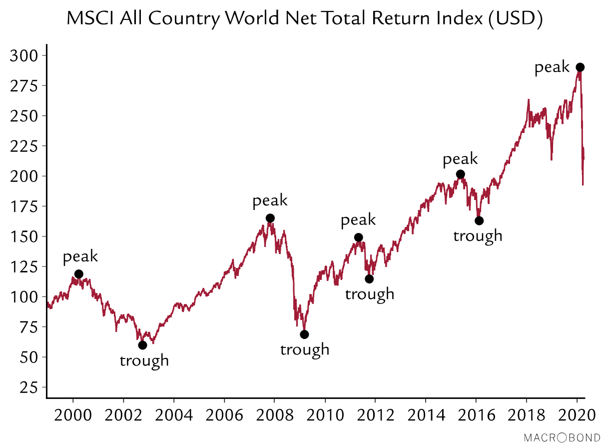
Switzerland

- Swiss stocks significantly outperformed global equities year-to-date due to their defensive character.
- We do not expect this to change anytime soon amid high uncertainty.

Japan

- So far, Japan has managed the pandemic better than other developed markets and additionally benefits from the ongoing economic recovery in China.
- Japanese equities thus outperformed in March.

Up and down. And up?



The coronavirus pandemic caused one of the fastest equity market corrections in history and led to a spike in volatility not seen since the global financial crisis. While the recession is just starting to become visible in economic data, investors are already pondering whether they should increase their equity exposure. This is not surprising as markets usually turn positive way before economic data bottom out. We have defined a few milestones that we need to see before turning more constructive. First, credible measures to contain the pandemic. The UK and the US have been laggards in that respect, but lockdown measures are now in place almost everywhere. Second, targeted fiscal and monetary measures to contain the economic fallout. Here, we can also tick the box. The US fiscal package was the latest addition and the most important reason why equity markets stabilised in March. The next milestone is medical in nature. We need to see a "flattening of the curve" in Europe and the US followed by a testing and tracing regime that will allow a gradual easing of restrictions (China being the blueprint). Here, uncertainties are elevated in the near term, and the risk of a second infection wave in Asia is not yet off the table. Hence, we expect volatility to remain elevated and stay underweight equities on a one-month horizon.

A long-term investor may, however, be tempted to look through these short-term uncertainties. The last two decades have delivered a few significant equity market drawdowns (see chart). They all have one thing in common: in the long run, indices always recovered and ultimately moved above the pre-crisis peaks. We do not think that the "coronavirus crisis" will be any different.

Currencies

More cautious on the USD as carry advantage fades

USA

- USD exchange rates were unusually volatile in March. The emergency policy rate cuts by the US Fed weighed on USD up until early March, before stress in USD funding markets temporarily pushed up the greenback.
- Due to the significant Fed rate cuts, the interest rate advantage of USD has faded. This is the main reason why we have turned tactically negative on the USD.

Eurozone

- After a significant up and down, EUR/USD ended the month of March exactly at the same level as at the beginning of the month.
- We have turned constructive on EUR/USD for the next three months. Besides lower interest rate differentials, dynamics on the coronavirus front have also shifted. The relative outlook has recently worsened significantly for the US, as cases are still surging while Europe has recently seen a stabilisation in new infections.

UK

- In March, GBP temporarily lost almost 13% against USD, driven by lower oil prices, the worsening coronavirus epidemic in the UK and the announcement of a massive fiscal boost amid a chronic current account deficit.
- Even though GBP already recovered somewhat at the end of March, we see further upside potential for GBP/USD, in line with our generally negative near-term view on the USD.

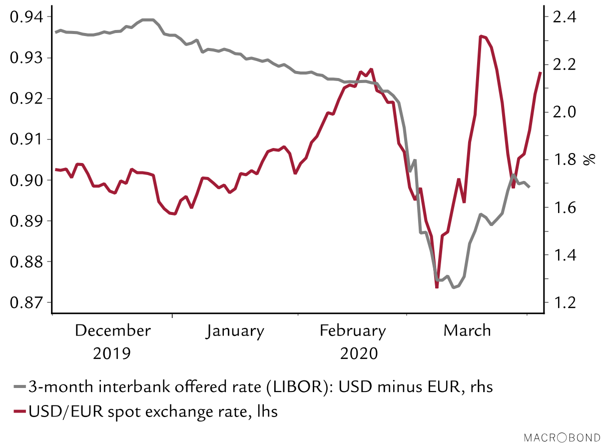
Switzerland

- In March, CHF remained under appreciation pressure against EUR.
- Continued SNB currency intervention limits the downside on EUR/CHF, in our view.

Japan

- Like other USD exchange rates, USD/JPY was very volatile in March. Nevertheless, JPY appreciation has been surprisingly limited year-to-date despite the turmoil in equity markets.
- In line with our generally cautious three-month outlook on the USD, we have turned negative on USD/JPY.

USD funding stress led to temporary USD surge in March



From 2017 to 2019, implied volatility in foreign exchange markets had been constantly declining before hitting a multi-year low in mid-February 2020. Even in times when great uncertainty hit risky assets (e.g. end of 2018), FX markets remained surprisingly calm. The coronavirus epidemic brought about a sudden change. Since mid-February, implied volatility has surged and notably USD exchange rates have been on a roller-coaster ride. The first shock to markets were two emergency decisions by the US Federal Reserve which brought policy rates back to almost zero and narrowed or even erased the interest rate advantage of holding USD against other major currencies. The resulting depreciation of the USD was quickly reversed due to stress in the USD funding market, which led to higher interest rate differentials in unsecured markets (LIBOR) and a wider USD cross-currency basis. The USD funding issue has been addressed by coordinated global central bank action, and we believe that the first issue – the faded USD carry advantage – will dominate over the next three months. Hence, we have turned negative on USD against EUR, CHF, GBP and JPY. In addition, the US economy is now also hit significantly by the coronavirus pandemic, which might make the USD a somewhat less attractive safe haven currency as compared to CHF and JPY (in Switzerland and Japan, we are already seeing a flattening of the infection curve). The CHF has indeed remained under appreciation pressure in March, especially against EUR, and this is unlikely to change as long as the economic outlook remains uncertain. However, the extent should be limited due to ongoing currency intervention by the Swiss National Bank.

Swiss Life Asset Managers

Marc Brütsch
Chief Economist
marc.bruetsch@swisslife.ch
@MarcBruetsch

Michael Klose
CEO Third-Party Asset Management
michael.klose@swisslife.ch

Do you have any questions or would you like to subscribe to this publication?
Please send an email to: info@swisslife-am.com.
For more information visit our website at: www.swisslife-am.com/research