Perspectives
Financial Markets

May 2020

Interest rates & bonds
Nothing is off-limits anymore

USA
- 30 million jobless claims were filed over the past six weeks, while sentiment indicators in the US plunged to unprecedented levels.
- A combination of large-scale fiscal and monetary packages along with steps to gradually open the economy again have nonetheless calmed fixed income markets for now.

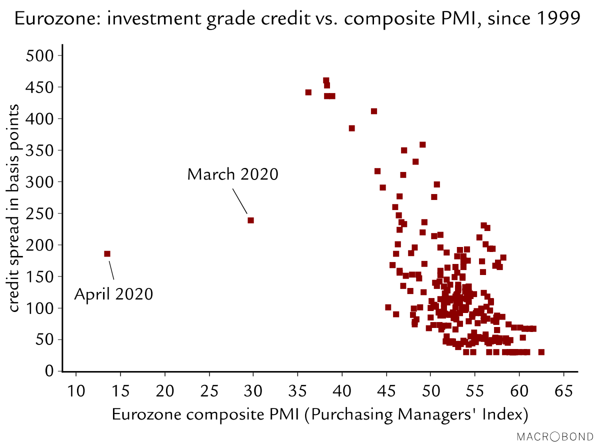
Eurozone
- We have yet to see hard economic data, but sentiment indicators signal a deep economic contraction, with the service sectors being the hardest hit.
- The ECB continues to buy bonds under its various asset purchase programmes, while the fiscal stimulus dampens the negative effect on the real economy.

UK
- April Purchasing Managers' Indices dropped to 13.4 for services and 32.6 for manufacturing, highlighting the unprecedented economic shock from the measures taken to contain the Covid-19 outbreak.
- The BoE announced GBP 200 billion of asset purchases alongside a 65 basis points cut in policy rates, which should help to mitigate the economic fallout.

Switzerland
- While we expect the Swiss economy to prove more resilient than its European neighbours due to a swift fiscal response and a favourable sector composition, it will nevertheless experience a sharp contraction.
- The SNB will continue to focus on currency interventions, while we view policy rate cuts as unlikely.

Japan
- Although Japan is less severely impacted by the pandemic, economic activity is expected to slow down materially.
- The Bank of Japan has further expanded its quantitative easing programme by removing the limit on government bond purchases.

April 2020 – weaker economy, but tighter spreads



Nothing seems to be off-limits anymore for central banks in order to dampen the economic fallout from the pandemic. Unlimited quantitative easing by the Bank of Japan, direct lending by the US Federal Reserve to corporate credit issuers and even purchases of "fallen angels" (i.e. bonds that were downgraded from investment grade to high yield) are now part of the toolbox. While credit markets calmed in April, with EUR and USD credit spreads tightening by 53 and 71 basis points respectively, we remain sceptical about the latest market moves. The earnings season is in full swing. So far, earnings have fallen by 25% in Europe and 15% in the US, while most companies withdrew their forward guidance. We believe that investors who still believe in a V-shaped recovery are in for a disappointment. Rather we expect a U-shaped recovery, with still big uncertainties regarding the extent of the current decline as well as the duration of the subsequent recovery. Under these circumstances, we think it is prudent to stay defensive over the coming month. We remain underweight credit risk and seek shelter in areas supported by central banks, namely short-dated USD corporate bonds and securities eligible for the ECB's CSPP (corporate sector purchase programme). We expect government bond yields to be range-bound, hence our neutral to slightly long duration position.

Equities

Another milestone passed but challenges ahead

USA

- The US is lagging other developed economies regarding the slowdown of new Covid-19 infections, but it is nevertheless easing the lockdown in order to restart the economy.
- The historically low oil price is putting pressure on the US oil industry and related sectors, but broader negative spill-overs should be limited.
- Despite the weak fundamentals, the broad diversification of the US equity market and its very significant share of sectors less impacted by the virus (for example Technology) lead us to keep our slight overweight in US stocks.

Eurozone

- The good progress in reversing the infection trend is allowing most countries to start a stepwise reduction of lockdown measures.
- However, this process will be slower than in Asia or the US. In combination with the strong reliance on international trade and the still unresolved debt problem in the periphery, the Eurozone economy will take longer to reach pre-crisis levels. We therefore stick to our underweight position in Eurozone equities.

UK

- In the fog of the Covid-19 crisis it is easy to miss that the Brexit discussion has not advanced at all.
- We do not expect any swift progress on this issue, while the economy is still battered by the coronavirus pandemic. We stay underweight UK equities.

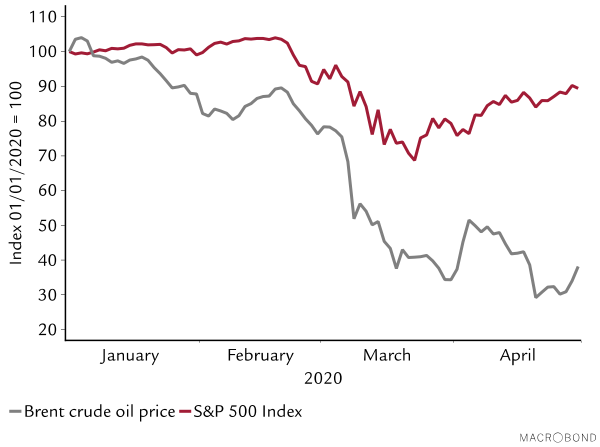
Switzerland

- While Swiss stocks are not cheap, the defensive nature of this equity market makes it a very attractive choice in the current uncertain environment.
- We therefore continue to be neutral Swiss equities.

Japan

- Japan is confronted with a second wave of infections and the government has reinforced its social distancing recommendations to contain the epidemic.
- Economic prospects have thus darkened compared to one month ago. We remain underweight Japanese equities.

Equities recovering, while oil is at 21-year lows



The month of April saw a continuation of the equity market recovery that started at the end of March as we passed another milestone of our “epidemic playbook” that we described in the last edition of this publication: daily new infection numbers peaked, which was followed by discussions around the globe on how and when to lift lockdown measures. Nevertheless, the recovery was based on relatively weak fundamentals, as survey data dropped to unprecedented levels and companies retracted their future earnings guidance due to high economic uncertainty. The massive drop of the Brent crude oil price to levels last seen in the late 1990ies and the temporary negative spot prices for US crude (WTI) are further negative signs, indicating a severe global demand shortfall amid full storage capacities. Lastly, the equity market rally in April was based on relatively thin trading volumes, indicating that many investors refrained from increasing their equity exposure.

Uncertainties will prevail over the next month and keep equity markets volatile. These uncertainties relate to the pandemic (risk of a second wave once lockdowns are eased), the medical response (potential positive and negative news regarding vaccines and treatments) and the economic outlook in general. Our overall equity view is thus biased towards being defensive.

Currencies

JPY should outperform among the safe havens

USA

- In April, the USD appreciated against the cyclical EUR and emerging market currencies, but lost somewhat against the JPY and commodity-related currencies such as GBP or CAD.
- The interest rate advantage of USD has faded, removing an important reason that had kept us positive on the greenback for a long time. We now prefer a neutral view on the USD against EUR, GBP and CHF.

Eurozone

- The EUR was under pressure in April, as economic data plunged more than in other developed markets and as EU policy-makers failed to come up with a coherent response to medium-term risks for highly-indebted countries such as Italy and Spain.
- The EUR reduced some of the losses on the last day of April when the ECB disappointed markets by not stepping up its asset purchase programme. We have a neutral view on both EUR/CHF and EUR/USD.

UK

- After an up and down in April, GBP ended the month somewhat stronger against the USD, in line with other currencies that are sensitive to commodity prices.
- We change our view on GBP/USD from positive to neutral.

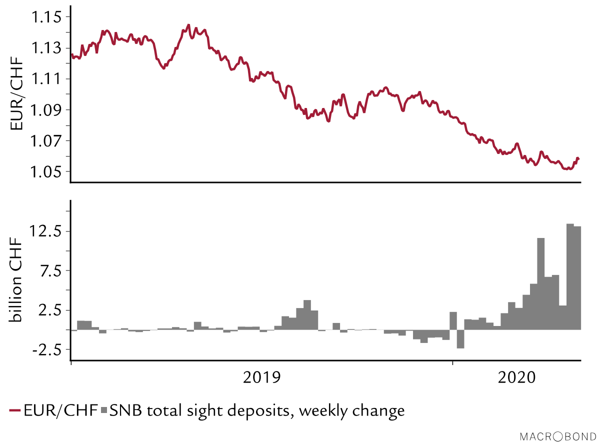
Switzerland

- In April, generous SNB interventions contributed to keeping EUR/CHF above the 1.05 mark.
- While the CHF remains under appreciation pressure, not least due to fading interest rate differentials to other economies, ongoing SNB currency interventions should limit the downside on EUR/CHF.

Japan

- Among safe haven currencies, JPY showed the strongest appreciation in April.
- We expect this to remain the case over the coming month and reiterate our negative view on USD/JPY.

SNB interventions so-far successful in stabilizing EUR/CHF



After a very volatile month of March, currency markets calmed in April, and a familiar pattern well-known from 2019 was re-established – appreciation of USD and JPY (both considered safe haven currencies) despite a rally in risky assets. Our positive view on EUR/USD expressed last month, which was based on the argument of a fading carry advantage, was thus proven wrong. Markets probably focused more on economic prospects, which are indeed worse for the Eurozone as compared to the US, in our view. Also, the medium-term risk of a "euro crisis 2.0" is still not off the table, as policy-makers failed to resort to a credible form of risk-sharing between Eurozone member states, e.g. in the form of "coronabonds". We opt for a neutral view on EUR/USD over the coming month but see the JPY stronger against all major currencies amid high uncertainty.

In April, the odd-one out amongst safe haven currencies was the CHF, which only appreciated marginally against EUR and lost around 1% against the USD. This is even more surprising as interest rates between Switzerland and Germany have converged, decreasing the carry cost of holding CHF. Hence, it appears that the ongoing foreign exchange interventions by the Swiss National Bank (SNB) were successful in absorbing CHF appreciation pressure in April. EUR/CHF indeed never dropped below 1.05, at the "cost" of sight deposits at the SNB increasing by CHF 30 billion in the month of April. We keep a neutral view on EUR/CHF.

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