Perspectives
Financial Markets

Swiss Life Asset Managers

July 2020

Interest rates & bonds

At rock bottom, the only way is up

USA

- The bounce back in economic data and sentiment indicators has been exceptionally strong but has also coincided with a flare up in COVID-19 infections in large parts of the United States.
- The US Federal Reserve continues to buy unprecedented amounts of US treasuries and has now started to purchase corporate bonds outright.

Eurozone

- Purchasing Managers' Indices out of the Eurozone have nicely beaten expectations as economies are opening, while new infections seem to be under control for now.
- The ECB increased its bond purchasing by another EUR 600 bn and prolonged the program until at least June 2021.

UK

- Like the rest of Europe, the UK's sentiment and hard economic data recently beat consensus expectations as the country starts to reopen.
- The Bank of England increased its total bond purchase target at the June meeting, but the pace of purchases will slow in the second half of this year

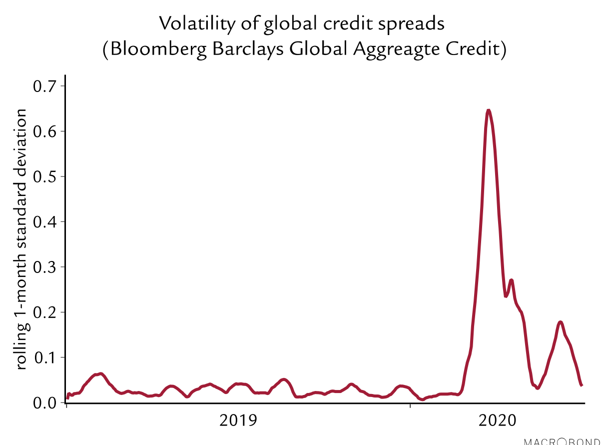
Switzerland

- Switzerland's domestic economy is recovering rapidly from the crisis, but foreign demand has remained weak.
- Pressure on the CHF has eased over the past weeks, but we expect the SNB to continue to intervene should it become necessary. We currently do not foresee further rate cuts.

Japan

- Japan's services sector is recovering as the state of emergency is over, but the manufacturing sector remains in the doldrums.
- The Bank of Japan has left its monetary policy unchanged. We do not expect any major policy innovations over the next months.

Volatility not back to normal yet



The global "COVID-19 recession" will likely enter history books as the most severe, but possibly also as the shortest recession ever. In June, credit spreads tightened another 22 basis points (bps) in EUR and 23 bps in USD, but the ride was not smooth with daily moves of as much as 14 bps. Monthly spread volatility is still 5 times higher compared to last year, despite all the central bank support in place. If you are at the bottom, the only way is up. In that sense, economic dynamics has improved, but activity levels remain weak. For now, it looks as if weak fundamentals are trumped by strong technicals in the form of fiscal and monetary support. But it is a tightrope walk. While the peak in spreads is likely behind us, the speed of the compression and overall levels hardly reflect economic reality. We entered this downturn with corporate leverage at a peak, and to shore up liquidity companies have added trillions of debt to their already stretched balance sheet. Combined with lower earnings due to faltering demand, we see the risk of a renewed series of downgrades and defaults in the second half of the year. We therefore continue to remain cautious on credit risk, especially in highly exposed sectors that depend on social interaction such as travel and leisure. Interest rates will likely remain lower for longer within a certain range, which explains our neutral to slightly long duration view.

Equities

A bumpy ride ahead

USA

- Recent economic data have surprised on the upside, cheering the equity market. The recent re-acceleration of COVID-19 infections might spoil the party, although it will take a few weeks to register the effect in the economic data.
- Investors, however, will also take into consideration the clearly dovish message from the US Federal Reserve, which should support the market.
- Overall, we expect these two factors to mostly cancel each other out, although the strong Fed support could tilt the odds slightly in favour of the US market.

Eurozone

- Eurozone economies have generally been able to ease their lockdown measures as planned. However, the far less positive economic data surprises than for the US and the perception that the ECB is less accommodating than the US Fed are headwinds for the equity market.
- On the other hand, the slower market recovery leaves the Eurozone with more potential to catch up with the US equity market.

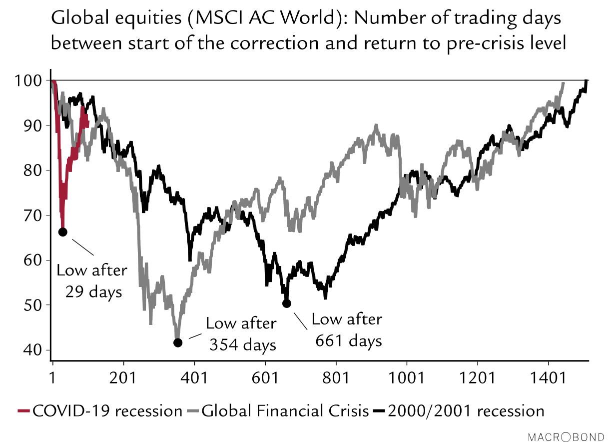
UK

- The underperformance of the UK market reflects a combination of problems such as the unresolved Brexit situation and the less effective management of the pandemic as comparable countries.
- As the situation is unlikely to change significantly in the near future, we see little room for the UK stock market to shine, as, in addition, its sectoral structure puts it at an additional disadvantage in the current economic environment.

Switzerland

- The defensive character, which has served the Swiss equity market well in the first quarter, is now the main reason for its more modest performance relative to peers.
- Although the increasing global economic uncertainty might support the Swiss market a little going forward, it will continue to underperform as long as global investors' sentiment stays positive.

Is this time different?



Over the last weeks, we could often hear and read statements of surprise about the speedy recovery of the equity markets after the correction in the first quarter of this year: How can equity markets rally, when global economic fundamentals look so weak? Many also have compared this episode with other crises (for example 2001 and 2008, see the chart), concluding that we might not have seen the worst yet.

While the episodes of 2001 and 2008 were the result of financial market excesses and ended up clogging the financial system (although in different ways), the crisis unleashed by COVID-19 is more like a natural disaster. So, as long as the medical situation does not get out of control and the short-term economic fallout can be mitigated with monetary and fiscal policy measures, it is rational for the market to look through the current situation and focus on the future. Arguably, however, equity markets are currently overly optimistic. So, over the next few weeks the ride will not be smooth, and we need to brace for episodes of increased volatility, not least because markets will additionally need to return to worry about the many problems (as for example global trade and Brexit) left unresolved before the lockdown began.

Currencies

Political risks for once favouring the EUR

USA

- In June, risk aversion rose in financial markets and safe haven currencies were supported. The big exception was the USD, as many of the risks in focus were perceived to be negative for the US outlook (US politics, COVID-19 infection dynamics).
- We believe that these risks will remain in place for the next three months, which will likely keep the USD under pressure even if actual economic data confirmed our constructive view of a gradual economy recovery in the third quarter.

Eurozone

- After a strong rally in May, EUR/USD settled in a 1.12 to 1.13 range in June.
- We have a positive bias on EUR/USD as we see political risks to be somewhat higher in the USA than in Europe. In Europe, an agreement over the proposed recovery plan at the Special European Council in July seems to be becoming more and more likely.

UK

- As good and negative news from the economic front were rather balanced in June, GBP/USD fluctuated around the 1.25 mark.
- We do not expect major progress on EU-UK trade negotiation over the next three months and believe that, as was the case last year already, the situation needs to get worse before it gets better. Hence, we have a negative view on GBP against USD and EUR.

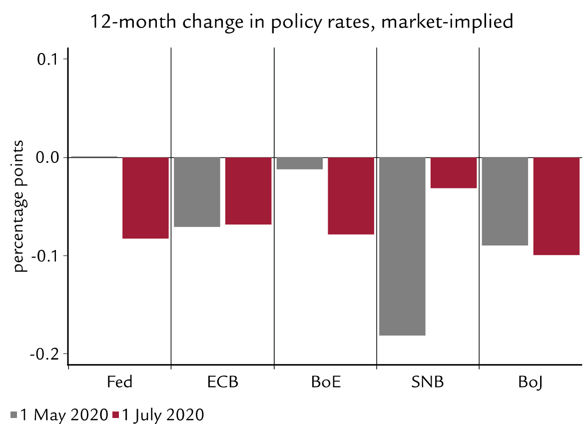
Switzerland

- Amid the general "risk-off" environment, CHF was one of the best-performing currencies in June on a trade-weighted basis.
- While the CHF will remain under appreciation pressure against EUR, SNB currency intervention will likely limit any upside. Hence, we prefer a neutral view at current levels.

Japan

- Like the CHF, the JPY (considered a safe haven) appreciated on a trade-weighted basis in June.
- As political risks are likely to remain high over the next three months, we opt for a negative view on USD/JPY.

SNB policy rate cuts have been priced out



Rising political risks (e.g. US-China tensions) and a surge in COVID-19 cases in the US led to a bumpy ride for risky assets in June, supported safe havens instruments such as gold or CHF and put an end to the rally of the cyclical EUR. In June, EUR traded sideways against USD but came under pressure against CHF. The CHF was not only supported by its safe haven characteristics, it also benefited from the fact that policy rate cuts were most dramatically priced out for the Swiss National Bank over the past two months (see chart). For other central banks, market-implied policy rate expectations were more or less stable or turned even slightly more negative.
Narrowing interest rate differentials has not only reduced the opportunity cost of holding CHF, it has also led to a fading carry advantage of holding USD against other developed market currencies. Amid this already less favourable backdrop for the USD, we actually see potential for a higher EUR/USD exchange rate over the next three months. Rising COVID-19 cases and the approaching US presidential elections will likely lead to a deteriorating political climate in the US, whereas European politics might surprise positively as we see a good chance that the proposed EU recovery plan will be concluded in July. Admittedly, EU-UK trade negotiations will likely get worse before they ultimately get better at the end of 2020 (our base case assumption), but we believe that GBP will suffer more than EUR under this tenser climate. We thus turn negative on Sterling over the next three months.

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

Released and approved by the Economics Department, Swiss Life Asset Management Ltd, Zurich
Swiss Life Asset Managers may have acted upon or used research recommendations before they were published. The contents of this document are based upon sources of information believed to be reliable but no guarantee is given as to their accuracy or completeness. This document includes forward-looking statements, which are based on our current opinions, expectations and projections. We undertake no obligation to update or revise any forward-looking statements. Actual results could differ materially from those anticipated in the forward-looking statements.
France: This publication is distributed in France by Swiss Life Asset Managers France, 153 rue Saint-Honoré, 75001 Paris to its clients and prospects. **Germany:** This publication is distributed in Germany by Corpus Sireo Real Estate GmbH, Aachenerstrasse 186, D-50931 Köln; Swiss Life Asset Managers Luxembourg, Niederlassung Deutschland, Hochstrasse 53, D-60313 Frankfurt am Main and Zeppelinstrasse 1, D-85748 Garching b. München and BEOS AG, Kurfürstendamm 188, D-10707 Berlin. **UK:** This publication is distributed by Mayfair Capital Investment Management Ltd., 55 Wells St, London W1T 3PT. **Switzerland:** This publication is distributed by Swiss Life Asset Management Ltd., General Guisan Quai 40, CH-8022 Zurich.