Perspectives
Financial Markets

SwissLife
Asset Managers

September 2018

Interest rates & bonds

Watch out for political event risks in Europe

USA

- We stick to our call of a gradual monetary policy normalisation and see one further hike by the Fed in 2018 followed by three hikes in 2019
- Long-term yields should gradually rise to the upper end of the trading-range at 3.10% until year-end
- Headline inflation is likely to start a gradual descent from current levels

Eurozone

- Eurozone inflation has reached 2.1% this summer, but with 0.9% contribution from energy, these levels are not yet self-sustainable in the ECB's view
- European politics will move back in centre stage of financial markets, with Brexit in particular far from being solved
- With the European Central Bank (ECB) slowly ending its asset purchases, there is room for yields to rise in the medium term, in particular in the periphery

Japan

- Bank of Japan (BoJ) did only adjust its monetary policy slightly, which stopped the recent trend towards higher sovereign bond yields
- Although wage growth is gradually kicking in, the 2% inflation target remains out of reach for the BoJ

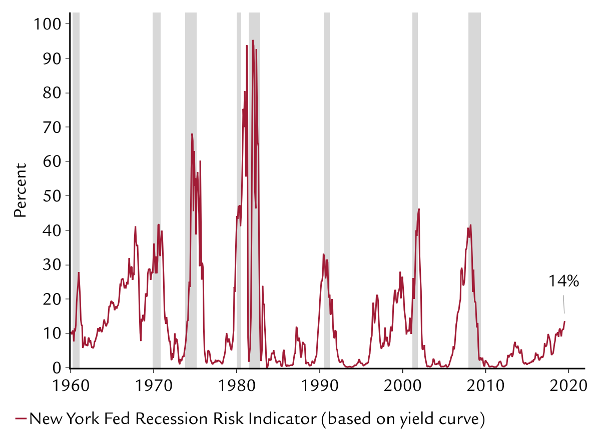
UK

- Bank of England delivered the expected rate hike
- Yet with the fall of Sterling's external value against most other currencies after Carney's remarks on "no deal Brexit", financial conditions remain ultra-loose

Switzerland

- Renewed strength of Swiss Franc means that the chances for an independent monetary policy step by the SNB remain negligible
- We currently expect 10-year yields on Swiss confederation bonds to rise to just 0.1% until year end

What the yield curve currently really is saying



Fears of an abrupt economic slowdown triggered by US trade policies did not materialise so far. Second quarter GDP growth came in at the higher side of expectations, namely so in the US, where a tax stimulus ensures a strong pro-cyclical impulse on activity. Headline inflation rates climbed higher, yet an overshoot above central banks' targets is not in sight. Robust growth and rising inflation combined did not trigger a rise in nominal bond yields so far. Rather, considering the monetary policy normalisation by the Fed, investors start to worry about the signals sent out by a flattening US yield curve. In the view of many analysts, a flat yield curve suggests that the US economy is at risk to enter recession. Yet, the Federal Reserve Bank of New York's own model based on the yield curve steepness alone suggests that the current risk for the US to be in recession in one year's time stands currently at 14%. Politics remain the key risk for markets in our view, with Brexit and Italy's budget plans probably making most headlines over the next month. In the context of the crisis in Turkey, it is noteworthy that emerging markets bonds in hard currencies have performed in line with corporate bonds in developed regions. This demonstrates the resilience to the US trade policy and adjustment to monetary policies in the developed world.

Equities

US stock market running on drugs

USA

- US stock market valuations remain relatively attractive as there is still no consensus for significantly higher long-term bond market yields
- The US economy and its stock market benefit from the tax reforms by the Trump administration
- We are positive for stock markets over a one month view, mainly because our quantitative models have again turned more constructive for this asset class

Eurozone

- Divergence to the US stock market is explained by the tax reform boost for the US economy and political tensions in Europe
- Brexit and uncertainties related to Italy's budget may still weigh on investors' sentiment in Europe
- Yet, business sentiment and real economic data have stabilised in Europe and disproved fears of an abrupt slowdown into the second half 2018

Japan

- In contrast to certain fears, the Bank of Japan did not declare a full-fledged regime shift and will continue with its accommodative policy
- Combined with economic data, this triggered a mild relief rally over the last four weeks

UK

- Bank of England's (BoE) rate hike means higher credit costs for the domestic economy and is slightly beneficiary for financials
- Meanwhile, BoE governor Carney's statement on "No deal Brexit" danger pushed Sterling's value to new lows for 2018, providing headwinds for exporting sectors
- Brexit will again become a major concern on European financial markets in the weeks to come

Switzerland

- Bottom-up analysts have revised earnings markedly up for 2019
- Meanwhile, the renewed strength of the Swiss Franc relative to the Euro may not yet be fully incorporated into such calculations
- As a small open economy, Switzerland is relatively exposed to risks of an escalating trade dispute

The US stock market on the drug called tax reform

The divergence between stock markets in the US and Europe even amplified over the past month. Over that time, America's S&P 500 index outperformed its UK peer, the FTSE 100 index by 6%. In these two cases, politics may explain the divergence to a large degree: While second quarter GDP data for the US suggest that the tax reforms provided a strong fiscal stimulus for the domestic economy, Brexit uncertainties continue to weigh on economic activity in the UK. At least until the Conservative Party Convention by the end of September, we do not expect any clarification on the design of Brexit. Thus we expect the UK departure from the EU to resurface as major theme for Europe's financial markets. Meanwhile, corporate results continue to come in on the strong side and manage to beat analysts' expectations. This has triggered upward revisions in earnings forecasts for 2019. Despite the fact that the S&P 500 index has reached all-time high levels, investors' risk appetite is low and has even declined further according to our measures. In the short-term, we thus see little risk for stock markets from excessive investor euphoria vis à vis this asset class. But what if equity investors miss signals from other asset classes? Should they worry about the flattening of the yield curve in the US? Not yet, according to our own analysis: Historically, the current shape of the yield curve is consistent with robust equity markets as the corporate sector typically enjoys strong price setting power in the mature stage of a business cycle.

Currencies

A hot summer on the political front

USA

- Broad-based USD strength in August – Greenback rose against emerging markets currencies, Sterling and in the first half of the month also against Euro
- We stay positive on USD as politics remain complicated in coming weeks in Eurozone, UK and Turkey – signs of more protectionist measures have so far been supportive for USD
- Strong economy is also positive for Greenback

Eurozone

- Concerns around Italy and Turkey will continue to weigh on Euro
- Presentation of Italian budget will shed light on fiscal stance and political priorities of new government
- Agreement between Donald Trump and Jean-Claude Juncker was a relief for the European car industry

Japan

- We are neutral on JPY/USD over coming weeks
- Yen is a safe-haven currency, but at the same time particularly exposed to risks of a trade war
- We expect headline inflation to temporarily drop below zero by year-end

UK

- Pound took a big hit in the first half of August as risk that Britain leaves EU without a deal increased
- GBP/USD fell to 1.27 – a level not seen since summer 2017
- Pound to continue to suffer from Brexit worries
- Bank of England hiked target rate by 25 basis points – this marks the first real rate hike in a decade as the hike in late 2017 was offsetting the cut after Brexit

Switzerland

- Swiss currency situation remains fragile – CHF reacts immediately as safe haven to uncertainties regarding the stability of the Eurozone
- We expect CHF/EUR to remain around 1.14 over coming weeks and to climb slightly higher to 1.15 by year-end
- Sight deposits of Swiss National Bank have slightly risen since March

Swiss Franc is still sensitive to risks

The Swiss Franc is a good indicator for the perception of risks relating to the stability of the Eurozone. In spring 2017, the French elections initiated a period of broad-based Euro appreciation. Also from a business cycle point of view, the year 2017 has been very strong which additionally supported the single currency. In April 2018, the EUR/CHF exchange rate has even broken the 1.20 mark (the former minimum floor) briefly. With the formation of the new Italian government, the upward trend of EUR/CHF came to an end. Fears of a break-up of the monetary union as well as a deteriorating fiscal situation in Italy substantially weakened the Euro. The Swiss Franc acted again as a safe haven. During the summer weeks, Turkey's currency crisis led to worries about the stability of the European banking sector. At the same time, the risk that the United Kingdom leaves the EU without a deal has increased markedly. Finally, investors are focusing even more on Italian politics as the presentation of the budget for 2019 is approaching. For the coming weeks, we are neutral on the EUR/CHF exchange rate. We do not expect concerns around Italy – the budget will be presented on 27 September –, the UK or Turkey to disappear quickly. In our view, the Euro should weaken somewhat further against the USD. There is not only divergence in central bank policy but also in the growth momentum. The Dollar should strengthen in an environment of political risks in Europe, headlines about protectionism and a strong US economy.

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 Management (France), 7 rue Belgrand, F-92682 Levallois-Perret cedex and Swiss Life Real Estate Management, 153 rue Saint Honoré, F-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 and Swiss Life Invest GmbH, Zeppelinstrasse 1, D-85748 Garching b. München. **UK:** This publication is distributed by Mayfair Capital Investment Management Ltd., 2 Cavendish Square, London W1G 0PU. **Switzerland:** This publication is distributed by Swiss Life Asset Management Ltd., General Guisan Quai 40, CH-8022 Zurich.