Perspectives
Financial Markets

Swiss Life Asset Managers

October 2020

Interest rates & bonds

Tempest in a teapot or beginning of a correction?

USA

- With the next fiscal stimulus bill unlikely to pass before the November election and support programs running out of money, the risks for the ongoing robust economic recovery are rising.
- Although the Federal Reserve reiterates that interest rates won't be raised anytime soon, Fed officials continue to emphasise the need for more fiscal spending.

Eurozone

- With the recent spike in infection numbers and renewed targeted containment measures, sentiment in the services sector started to decline again, showing the still fragile state of the economies.
- The ECB will not change its dovish stance anytime soon and we expect it to increase its various programs should financial conditions deteriorate.

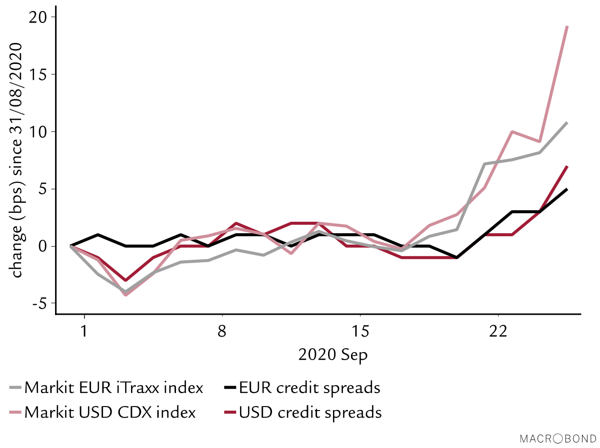
UK

- The UK economy is confronted with continued uncertainty regarding UK-EU trade negotiations and new containment measures to check the recent sharp rise in COVID-19 cases.
- We believe the Bank of England could ultimately be forced to do more given the weak performance of the UK economy.

Switzerland

- In line with our view, Switzerland's economy performed better than most other developed nations and better than consensus had expected during the second quarter.
- Third-quarter data are encouraging so far, with the KOF leading indicator for August increasing sharply to 110.2 points.
- The SNB kept its policy rate unchanged at -0.75%, while sight deposits increased only moderately in September despite the "risk-off" environment in financial markets.

Credit: divergence between cash and derivatives market



So, it seems that there is a different direction for asset prices than just up. Especially for everybody's darling, the big US tech stocks, the rally came to an abrupt halt. While the September equity market dip spilled over to other markets to some degree, it remains to be seen whether this was just a tempest in a teapot or a prolonged correction. So far, credit spreads have not reacted too much. EUR and USD corporate bond spreads widened by about 5 basis points (bps, see chart) while government bond yields continue to fluctuate within the ranges seen over the past few months. However, looking at the credit derivatives market, the picture looks a bit more worrisome. The US CDX index is already 18 bps higher while the European iTraxx index is 10 bps wider. This shows us that investors are hedging their downside risk but are not willing to part with their long positions. However, that is something that can change quickly, and we are starting to see first outflows from investment grade credit ETFs. So, while it is not exactly a disorderly sell-off, one must tread carefully, especially with the plethora of political risks such as the US elections and the looming Brexit deadline. Technicals are still supportive, but this can change quickly. And in the bond market, one does not want to become a seller when everybody is running for the door. We therefore remain defensively positioned in credit and keep a long-duration bias.

Equities

How to prepare for the risks around the US election?

USA

- September was the first month since March 2020 with a negative performance of the S&P 500. Notably, information technology ("tech") stocks strongly underperformed the broad market, which reversed the outperformance of US equities vs. other regions during September.
- Idiosyncratic company news, a growing divergence between very strong equity markets and an economy still confronted with underutilised capacities as well as risks related to US elections might have contributed to profit-taking in September. We expect markets to trend sideways ahead of the elections.

Eurozone

- News about rising infection rates and new targeted containment measures, mostly in large European cities, weighed on Eurozone equities. But overall, Eurozone equities performed less negatively than US equities.
- Whether or not Eurozone equities will outperform US equities going forward will very much depend on one's view on the tech sector, which has a disproportionately higher weight in US indices.

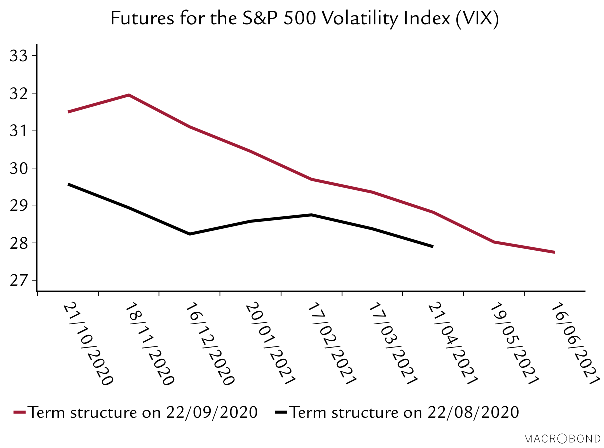
UK

- At the time of writing, UK equities posted a slightly less negative performance in September than global equities. Nevertheless, challenges abound. The recovery of the UK economy is still fragile and the uncertainty regarding EU-UK negotiations remains high, especially after the government's launch of the Internal Market Bill which increased tensions between the parties.
- We keep a cautious view on UK equities, as we think that both the economic and political risks are not fully discounted in current valuations of UK equities.

Switzerland

- Even though the Swiss equity market lost momentum, it was the clear outperformer in the month of September and remains one of the strongest markets year-to-date.
- The economic backdrop for Swiss equities remains more favourable than elsewhere. The Swiss economy was hit much less by the crisis than its neighbours and has huge fiscal headroom to respond to any deterioration of the situation.

The "election put" is not first choice – unless you want to sell



At this stage, the race between Donald Trump and Joe Biden for the US presidency is too close to call, and polls are also divided about the Senate race. In the likely event that the new president is confronted with a divided or even hostile Congress, the former already being the case now, continuity is quite likely and the impact on equity markets probably marginal. Meanwhile, a Democratic sweep, i.e. Joe Biden as president enjoying full support in Congress, is seen by many market participants as negative for equities due to Biden's plan for higher corporate taxes. However, the only result we should truly worry about is "no result at all", i.e. a lengthy, disorderly dispute about the outcome of the presidential race. This could leave markets in unchartered territory for an extended period resulting in a major drawdown. Even though a disorderly election is a worst rather than our base case scenario, it is certainly a situation many investors want to be prepared for. One way to do this is to cut off the tail risks to the downside at the expense of a lower participation to the upside. This calls for a solution based on equity put options. It is important to consider the volatility term structure to set up this "tail risk hedge" efficiently. Unfortunately, as can be seen in the VIX term structure above, the options which mature around the election date are the most expensive ones. Hence, this is good for premia collection, i.e. selling of options to finance the purchase of put options. As the latter are expensive around the election date, we would opt for longer maturities, as a "disorderly election" scenario likely has negative implications for equities beyond just the election date.

Currencies

USD might come again under pressure

USA

- Amid the general "risk-off" sentiment in financial markets, the USD strengthened in September, especially against cyclical currencies such as EUR, GBP and commodities-related currencies such as AUD or CAD.
- Nevertheless, we expect renewed USD weakness going forward. Interest rate differentials remain too narrow to lend any significant USD support. Also, we expect many potential outcomes of the US election to be rather negative for the greenback (see main text).

Eurozone

- After having hovered at around the 1.18 mark for one-and-a-half months, EUR/USD dropped in the second half of September. News about rising COVID-19 infections and new containment measures in the Eurozone have likely contributed to investors' caution regarding EUR.
- Our positive view on EUR/USD mainly reflects our expectation of general USD weakness until year-end (see above).

UK

- In line with our view, Sterling depreciated significantly in September, as tensions regarding EU-UK trade negotiations increased with the government's announcement of the Internal Market Bill.
- With these risks now better reflected in GBP exchange rates, we move to a neutral view on sterling against USD, but expect continued weakness against EUR.

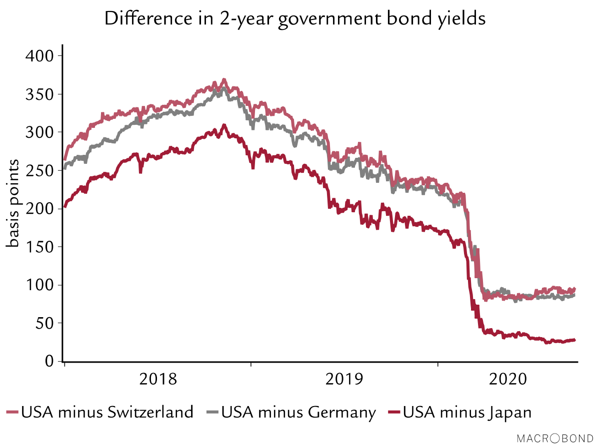
Switzerland

- Despite negative risk sentiment in financial markets, CHF traded in a very tight range against EUR in September. Meanwhile, the CHF depreciation against USD allowed the SNB to scale back currency interventions.
- We stick to our neutral view on EUR/CHF but expect the CHF to appreciate again versus USD.

Japan

- JPY showed broad-based appreciation in September.
- With many event risks, especially the US election, ahead of us, we opt for a positive view on JPY against USD.

Fading USD interest rate advantage



The US election is the dominating "known unknown" in the third quarter. There is not only huge uncertainty about the outcome, but also on the potential impact on asset classes and the USD. Generally, many analysts believe that an election of Joe Biden, who currently leads the polls, would be negative for the USD, especially if he were to enjoy full support in Congress. We tend to agree. In this constellation, we should especially prepare for a combination of even higher fiscal deficits due to generous fiscal stimulus plans amid continuously low interest rates. While Joe Biden will likely keep a hawkish stance on China, markets might still see less risks of a significant escalation of trade tensions due to a less confrontational approach to the trade issue. However, investors might move to a more cautious view on US equities due to Joe Biden's tax plans. All these arguments speak in favour of a weaker USD. If a President Joe Biden were to face a hostile Senate, the potential for USD weakness would obviously be somewhat lower. Meanwhile, a re-election of President Trump is unlikely to have any material impact on USD. The worst case of a disorderly election could ironically strengthen the USD as the greenback remains an important safe haven currency, but our conviction on that view is admittedly low.

All in all, we prefer a negative view on USD at this stage, also because a crucial support, namely the USD's interest rate advantage, has faded during the crisis and is unlikely to return anytime soon amid the very dovish stance of the US Federal Reserve (see chart).

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