Perspectives
Financial Markets

May 2021

Interest rates & bonds
Inflation is just transitory

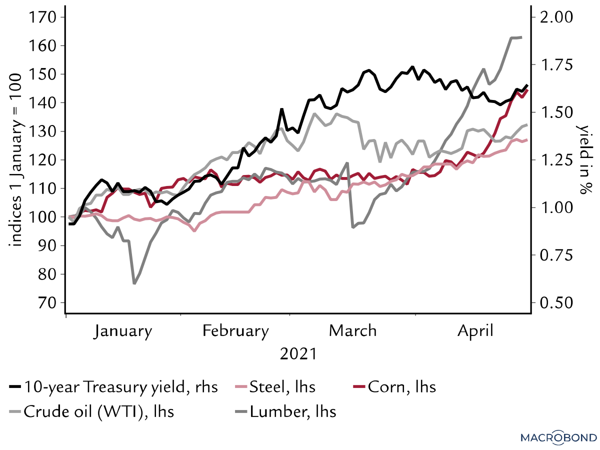
USA
- Economic activity is accelerating in the US on the back of vast fiscal stimulus and an ever increasing share of the population being vaccinated.
- The US Federal Reserve reiterates its dovish stance and sees inflation as largely transitory despite certain areas such as housing or commodity prices starting to show signs of overheating.

Eurozone
- Although sentiment indicators continue to improve, Europe has been lagging in terms of vaccinations and continues to have restrictive containment measures in place, delaying the recovery of the economy.
- As previously announced, the European Central Bank stepped up its bond buying programme to keep financial conditions accommodative.

UK
- Purchasing Managers' Indices continue to rise sequentially in both the manufacturing and services sectors, while retail sales surge as restrictions are being lifted.
- The Bank of Canada was the first major central bank to announce a reduction in the pace of its asset purchases. The Bank of England could be the next central bank to announce a similar measure as the UK economic recovery is set to gather pace.

Switzerland
- Switzerland has a slow vaccination campaign – like elsewhere in Europe – but a fast pace in the reopening of its economy, which has brought GDP almost back to pre-crisis levels.
- The Swiss National Bank is unlikely to change its monetary policy over the period ahead, with consumer prices just about to move out of a deflationary period into marginally positive territory.

April: inflationary pressures rising, US yield falling



We are entering the period in which we will likely see the highest annual or – as a former US president would say – "the most tremendous" economic growth numbers in our lifetime. Sure, it comes on the back of a large base effect, but even month-over-month comparisons of activity data show sequential improvements. Unsurprisingly, risky assets continue to surge. The S&P 500 is reaching new all-time highs almost daily and credit spreads are firmly anchored with EUR and USD credit spreads tightening by 5 bps and 3 bps, respectively, in April. Yet, the ECB is stepping up its bond buying programme because inflation is apparently nowhere to be found and anyway just transitory unless one eats corn, needs lumber for housing or steel to build a car (see chart). The only major asset that was going against the reflation trend was US Treasuries with 10-year yields falling 12 bps in April, while the yield on their German counterparts rose 4 bps. However, given the 83 bps increase in the US 10-year Treasury yield since the beginning of the year, it is likely more of a consolidation than a trend change. Hence, we reaffirm our short duration call, albeit with a reduced position. On credit risk we take a more defensive stance as valuations are elevated, resulting in unfavourable risk/return characteristics for this asset class.

Equities

Pausing to reconsider the situation

USA

- The rapid vaccination progress and the infrastructure programme currently being discussed by the US administration is likely to push the economic recovery further. This is good news for earnings, but the high equity market valuation is starting to become an issue, and investors are demanding great rather than just good earnings from companies.
- Markets haven't yet settled on what to expect on inflation and interest rates and react nervously to any increase in bond yields. While we still expect the US equity market to outperform, we believe that risks have increased to an extent not fully priced in by equity markets.

Eurozone

- After the very good start to 2021, Eurozone equities have lost a bit of their momentum.
- Although cheaper than the US equity market, earnings recovery is slower, and the outlook is mixed. Part of the problem is probably the recent strengthening of the EUR, which we think is, however, a temporary phenomenon (see page 3 of this publication).
- The slow progress of the vaccination campaign in the region and the uncertainties generated by the political outlook in Germany and France are not helping the market, which we expect to underperform the US.

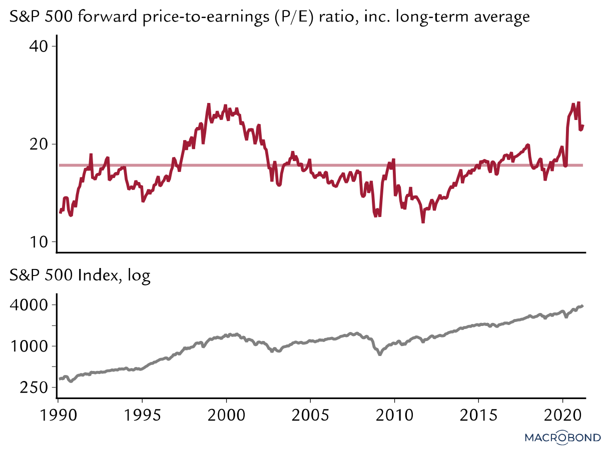
UK

- The UK equity market has been enjoying a good run thanks to its successful vaccination campaign and, to a lesser extent, the recovery in commodity prices.
- However, most good news is now priced in and the expected growth in company earnings does not compare well with other markets. We therefore expect the UK market to lose momentum and perform in line with the Eurozone but behind the US market in local currency terms.

Switzerland

- The defensive character of the Swiss equity market has led to a significant underperformance since the beginning of the year. The market has suffered additionally from the negative surprises in the financial sector.
- Swiss equities are now less expensive, but unless market sentiment turns very negative, the market is unlikely to shine in the short term.

The importance of valuation and its limit



When discussing equity markets, we often mention their valuation. So, what is valuation and why can it not be exploited to spot the right moment to go in or out of a market? Investors buying stocks are effectively buying a share of the future earnings of these companies. This means that to estimate the "fair" price of a single stock or of an equity market, investors need to estimate what the future earnings will be. This is not an easy task, as many things can happen over the life of a company: products and services doing very well today might become obsolete in the future, the company might unexpectedly develop a great solution which generates huge profits, etc. Therefore, the estimation of future earnings is fraught with considerable uncertainty and different investors will have widely different opinions about future earnings. Valuations, which correspond approximately to the present value of future earnings, will likewise differ significantly depending on the earnings assumptions of the investors. Therefore, markets will only start to take notice of valuations when they become extreme. Experience shows that even then, it might take considerable time until investors react, as for example during the so-called "dot-com bubble" around the turn of the millennium (see chart). This is often because investors fall in love with the potential of some companies and forget to check if the price they are paying for the stock reflects a realistic evolution of future company earnings. During the "dot-com bubble", investors overestimated the potential of many internet start-ups, today, the same might be true in sectors such as electric mobility and IT. Valuation is therefore a useful tool to assess risks and opportunities but should not be used to time markets.

Currencies

USD weakness likely only temporary

USA

- April showed the opposite picture of March, with the USD depreciating against all major currencies including emerging market currencies – the Indian rupee being the sole exception.
- The move was driven by the moderation of US bond yields in April, which should be a temporary phenomenon, in our view. We expect the USD to remain supported against EUR and CHF due to the still substantial US interest rate advantage.

Eurozone

- In April, the EUR fully recovered from its drop against the USD in the previous month. The acceleration of the European vaccination campaign in April has certainly added to investors' more constructive stance towards the EUR.
- Nevertheless, the Eurozone will remain the laggard in this recovery, with pre-crisis levels still out of reach in most member states this year and monetary policy set to remain ultra-expansionary over the medium term. We thus maintain our negative view for EUR/USD.

UK

- In April, GBP moved rather sideways against USD, but corrected against EUR after a very strong year-to-date rally that had been fuelled by rapidly improving UK growth prospects.
- We think that a lot of positive news is already priced in and expect GBP to depreciate against USD over the next two months.

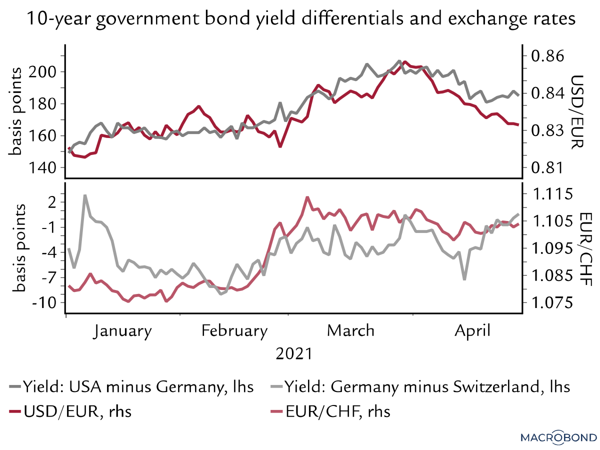
Switzerland

- The CHF barely moved against EUR in April, as financial markets remained somewhat in limbo, neither in full "risk-on" or "risk-off" mode.
- Our neutral EUR/CHF position has thus proved to be correct, and we stick to that view over the next two months. We expect, however, renewed depreciation against USD, in line with our view of general USD strength.

Japan

- In April, the JPY appreciated against the USD, but to a lesser extent than the EUR or CHF.
- We stick to our positive USD/JPY call as we expect the global growth and inflation picture ("reflation") to improve further during the second quarter.

Yield differentials a key driver for FX so far in 2021



Avid readers of this publication will remember that we switched our view on the USD from negative to positive back in December 2020, a view that was against consensus for quite some time, but paid off in the first quarter of 2021. In line with the rising interest rate differential, the USD appreciated 4% against the EUR during that period (see chart). Yield differentials for longer maturities have also played a role in the moves of the EUR/CHF exchange rate since the beginning of the year. Interest rate differentials, the so-called "carry", are thus back to being a major driver for FX, and we think this will remain the case going forward. Unfortunately, the moves in government bond yields went against our view in April, with US yields retreating despite a continuous stream of upbeat economic data and rising inflationary pressure. Yield differentials thus narrowed and led to a weaker USD. We think that this move should prove temporary and stick to our view of a stronger USD over the next two months. Even though the Eurozone will gather speed during the second quarter, the output gap of the monetary union will remain much wider and inflationary pressure thus lower than in the US. Hence, we think that the pre-pandemic situation might repeat itself, i.e. a European Central Bank stuck near the lower bound, not being able to lift policy rates despite the global economic reacceleration, while the Anglo-Saxon world will at some point seek exit from ultra-expansionary policy. In that regard, the Bank of Canada was the early mover, already announcing the tapering of its asset purchases in the April monetary policy meeting.

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