Perspectives
Financial Markets

SwissLife Asset Managers

March 2020

Interest rates & bonds
Markets cannot shrug it off anymore

USA
- Economic data from the US came in strong in February, adding fuel to the rally in risky assets. The rally came to a grinding halt following a very weak services purchasing managers' index (PMI) and a significant spread of the coronavirus outside of China.
- Interest rates plummeted with markets pricing in four Fed policy rates cut over the next 12 months. We still view this as unlikely as long as the coronavirus remains a temporary shock to the economy.

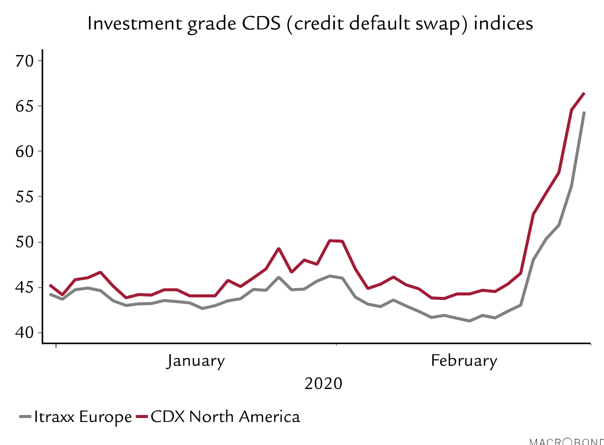
Eurozone
- Europe's economic data has been more mixed, but surveys have surprised positively. In Germany, both the manufacturing PMI and the Ifo sentiment indicator saw an improvement.
- However, towards the end of February, the spread of the coronavirus made a profound change on investor sentiment, which increased corporate bond spreads and drove down government bond yields.

UK
- The improved political stability in the UK and expectations for an expansionary budget led to an improvement of economic sentiment. Manufacturing PMIs moved into expansionary territory.
- Given the better data and recent rebound in inflation, we would expect the BoE to leave interest rates unchanged.

Switzerland
- The Swiss franc's strong appreciation year-to-date is putting pressure on the SNB, but we believe that the hurdle for FX interventions has increased as Switzerland was again put on the US Treasury's monitoring list for currency manipulation.

Japan
- The Japanese economy took a severe blow from the consumption tax hike and the coronavirus outbreak, which could trigger more monetary stimulus.

CDS indices react to the spread of the coronavirus



If the last few days have taught us anything, it is that sentiment in financial markets is a feeble thing. The threat of the coronavirus was largely discarded as equity markets reached one new high after another and corporate credit spreads grinded ever tighter. In light of an abundance of liquidity, complacency and the hunt for yield seemed to have driven investors ever more into risky assets. AT1 (Additional Tier-1) securities) and corporate hybrid bonds, some of the riskiest fixed income securities, performed increasingly well despite diminutive yields. The 10-year government bond of Greece, a country not so long ago on the brink of bankruptcy, was offering yields of less than 1%. In short, risk was mispriced and the latest news about the spread of the coronavirus outside of China tipped the balance. Now, at the end of February, safe haven flows are weighing on equity and credit markets as investor sentiment has profoundly changed. Those same securities sought after some days back have fallen in value again already. Greek government bonds are plunging, and equity markets' year-to-date performance was erased in just two to three days. At this point, it is very difficult to predict where and to what extent the coronavirus will spread further. We therefore refrain from having a directional view both on the government bond and corporate credit side.

Equities

A hangover for complacent investors

USA

- At the time of writing, the spread of the coronavirus has so far been largely contained in the US. Nevertheless, investors have realised that US companies are not shielded from the fallout of the epidemic.
- US companies are not only being hit by lower sales in China, but also affected by supply chain disruptions, which will become more problematic the longer the crisis persists.
- Earnings consensus for the S&P 500 has been revised down by around 3% on average as nearly half of the listed companies are likely to deliver lower earnings as compared to the expectations at the beginning of 2020.

Eurozone

- The Eurozone stock markets took a large hit with the virus arriving in Italy and further dropped when the virus spread to other European countries shortly thereafter.
- We reiterate our cautious stance regarding Eurozone equities.

UK

- UK stocks extended their significant 2019 underperformance in the new year.
- In addition to coronavirus worries, the UK stock market is suffering from the big political uncertainty related to UK-EU trade relations that will continue to linger on over the coming months.

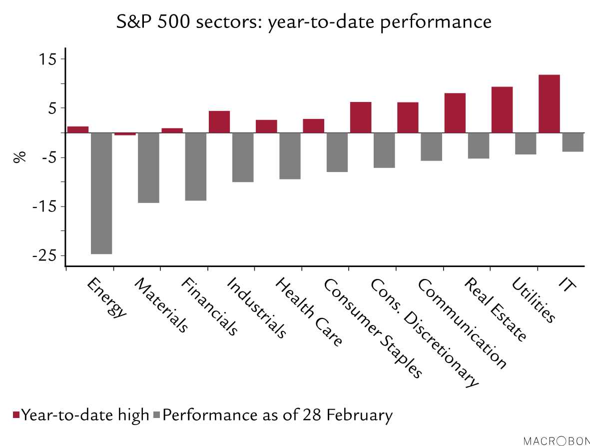
Switzerland

- Swiss stocks also suffered from the arrival of the coronavirus in Europe, but the market declined less than European indices year-to-date.
- Among Swiss stocks, we expect the rather conservative sectors Telecommunication and Health Care to continue their outperformance, while the Luxury Goods segment remains severely affected by the virus.

Japan

- Japan is strongly affected by coronavirus, both directly and indirectly via China. Japanese stocks have thus underperformed materially year-to-date.
- We see no catalysts that could turn us positive on this market. We thus keep our underweight position for Japanese stocks.

Is it all bad? Large deviations across sectors



Until mid-February 2020, the equity market appears to have traded on different fundamentals than many other markets. While investors increasingly sought assets such as government bonds and gold, indicating a flight to safety, equity markets only started to correct once the coronavirus spread significantly in Europe in the last week of February. Given that the coronavirus impact is substantial across all regions, geographic diversification does not help much in the current situation. The picture looks, however, very different when considering equity market sectors. The US energy sector for example, which is suffering from the huge drop in oil prices, is down by more than 20% year-to-date at the time of writing, whereas the IT sector within the S&P 500 is relatively unscathed. Many investors, however, have restrictions regarding deviation in sector weights and market timing regarding sector allocation is obviously very tricky.

Our focus on defensive strategies is beneficial in this market environment. Put-options-protected strategies have helped to limit the recent drawdown. What we also recommend in the current uncertain market environment are minimum-volatility strategies. History shows that they let investor participate well in a recovery after significant corrections. Hence, the key question is for how long the coronavirus will keep investors nervous. The inherent unpredictability of an epidemic makes it very difficult to answer that question. What we know is, however, that business flows around the globe will remain distorted over the coming weeks and that uncertainty on the economic repercussions remains high. Hence, we extend our call for defensive positioning in equities for the month of March.

Currencies

We expect USD strength to resume

USA

- The USD did not benefit from the flight into safe haven assets at the end of February. As the virus started to spread significantly in Europe, US policy rate cut expectations piled up, narrowing interest rate differentials and thus weighing on the USD.
- We think that these rate cut expectations are exaggerated and see upside for the USD once markets reprice expectations for the Fed. Also, the outperformance of the US economy compared to Europe should continue to support the greenback.

Eurozone

- Even though coronavirus risks increased in Europe, the EUR staged a surprising rebound against USD as interest rate differentials narrowed.
- We reiterate our negative view on EUR/USD. The Eurozone economy will face even more downward pressure in the near-term due to the coronavirus fallout, which should ultimately weigh on the currency.

UK

- The first month of the UK outside the EU brought renewed weakness in GBP exchange rates.
- We have a neutral view on GBP/USD. While looser fiscal policy will be a tailwind for the UK economy in 2020, the tight schedule for EU-UK trade negotiations will keep uncertainty elevated.

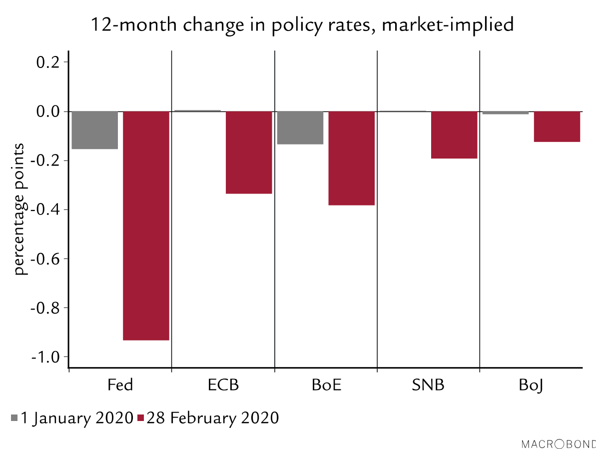
Switzerland

- The appreciation of CHF against EUR came to a halt around mid-February, with the exchange stabilising slightly above the 1.06 mark.
- At these levels, we see further appreciation against EUR as unlikely and thus keep our neutral view on the pair.

Japan

- USD/JPY was very volatile in February, reflecting investors' nervousness as they tried to assess the impact of weak economic data and the ongoing coronavirus epidemic in Japan.
- We expect more negative news regarding the Japanese economy, which is now likely to be in technical recession. We thus reiterate our positive view on USD/JPY.

Rate-cut expectations have weighed on USD



The dominating financial market topic is the spread of the coronavirus, where infection rates in Europe increased massively in the last week of February. While safe assets such as government bonds and gold surged, safe haven currencies such as CHF and USD weakened over the past few days. The most likely explanation for this counterintuitive move is the narrowing of interest rate differentials. Market expectations for policy rates over the coming 12 months dropped most in the US, outpacing the shift in expectations for other developed market central banks, which are already facing rock-bottom policy rates (see chart). We believe that the current market pricing for the US Federal Reserve is too aggressive and thus see potential for a rebound in market-implied policy rates once coronavirus risks subside. This should put again upward pressure on the USD, which should also remain supported against EUR and CHF by the ongoing outperformance of the US economy as compared to Europe. At the current low levels, we do not expect further appreciation of the CHF against the EUR and reiterate our neutral view on EUR/CHF. Meanwhile, Japan is experiencing a double-whammy of weak economic momentum following the consumption tax hike and repercussion of the coronavirus epidemic. Against this weak economic backdrop, the JPY already lost its "safe haven appeal" in February, in line with our previous view. We continue to expect further JPY weakness against the USD on a one-month horizon.

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