Perspectives
Financial Markets

March 2021

Interest rates & bonds
Interest rates are soaring

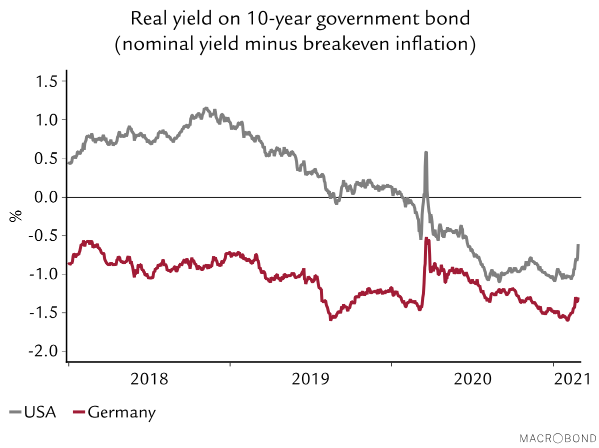
USA
- US economic growth continues to accelerate. Stimulus checks from the December fiscal package led to a surge in January retail sales, and another fiscal package is in the pipeline. Purchasing Managers' Indices remained firmly in expansionary territory.
- The Federal Reserve continues to emphasize that the upcoming rise in inflation is just transitory and does not warrant a change of policy.

Eurozone
- We expect European economic activity to strengthen in March already as containment measures are gradually eased. Meanwhile, inflation accelerated much more strongly than expected at the start of 2021 but was mostly driven by temporary and technical factors, with no monetary policy implications.
- As yield curves steepened relatively quickly over the past weeks, the European Central Bank has started to verbally intervene, trying to keep financial conditions as loose as possible.

UK
- COVID-19 restrictions in the UK remain among the most stringent in Europe. January retail sales disappointed, while more forward-looking sentiment indicators surprised to the upside.
- Sterling has appreciated materially, thus tightening financial conditions in the UK. This could increase the pressure on the Bank of England to intervene. Nevertheless, we still view negative policy rates as unlikely.

Switzerland
- We expect the Swiss economy to return to pre-crisis levels in 2021 already, faster than most other European countries.
- In combination with normalising inflation and the weaker CHF, we see no need for the SNB to change its monetary policy stance.

Real interest rates have bottomed out



After January's brief volatility spike, credit spreads continued their relentless march tighter. In February, EUR and USD-denominated credit spreads fell by 6 and 5 basis points (bps), respectively. While the move in credit spreads has basically been a one-way street since April 2020, interest rates have soared in recent weeks. Yields on US 10-year Treasuries and German 10-year Bunds are up 30 bps and 20 bps so far in February, respectively. While that seems a lot, we argue that the move can continue some more over the next weeks. We expect developed economies to gradually reopen and post strong and largely synchronised growth during the second quarter 2021. On top of that, we are likely to see the approval of a sizeable US fiscal package soon, while cheap central bank money keeps flowing to the economy. With this powerful trifecta, inflation is starting to make a comeback. Even though inflation numbers are partially boosted by transitory factors and a sizeable positive base effect from energy prices during the second quarter, we still see further upside risk for government bond yields as we think that interest rates are too low compared to inflation expectations. We therefore keep our short duration stance and expect further steepening of yield curves. Regarding corporate bonds, we expect credit spreads to remain range bound, but maintain a slight overweight position for carry purposes.

Equities

Technical factors positive, risk from rising real yields

USA

- The US market saw a sector rotation in February. The technology sector underperformed despite a decent earnings picture (see chart), while the cyclical small and mid-cap stocks outperformed. Overall, the US market has performed broadly in line with global equities since beginning of the year.
- Current valuations already price in a lot of positive news, making the market vulnerable for bouts of volatility. Nevertheless, we expect the positive US equity market trend to continue.

Eurozone

- Even though the vaccination speed is much slower than in the US and the Eurozone might be a laggard in the reopening of its economies, the most recent news flow on these issues has improved, leading to an outperformance of EMU equities in February.
- Going forward, we expect the Eurozone equity market to move in sync with the rest of the world thanks to the global economic recovery and supportive monetary policy conditions.

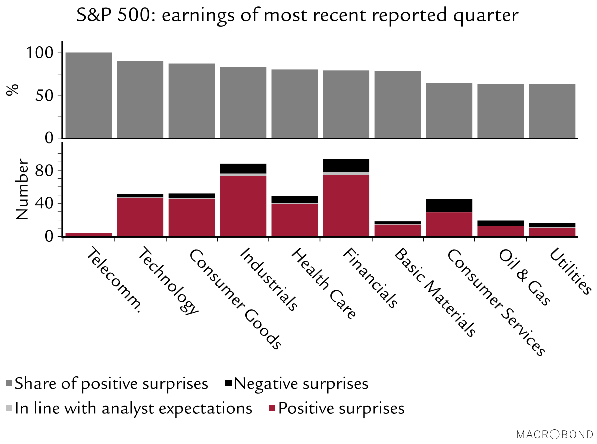
UK

- Despite the strong appreciation of sterling, the UK stock market has performed surprisingly well so far this year as its cyclical market benefited from improving economic growth prospects.
- However, UK companies experience more and more Brexit-related hurdles, especially when export business is involved. Going forward, we do not expect the UK equity market to sustain the recent pace and expect it to fall behind the rest of the world.

Switzerland

- Since the start of the “reflation trade”, Swiss equities have significantly underperformed global equities due to their defensive character.
- This is unlikely to change soon, although the more cyclical mid- and small-capitalisation stocks should continue to outperform the blue chips.

US: a solid earnings picture notably for the IT sector



Despite elevated volatility, global equity markets have continued their upward trend in February. There are indeed many reasons to be positive on equities, notably improved global growth prospects as vaccination campaigns gain traction as well as continued fiscal and monetary policy support. Another fundamental reason, which has been less in the spotlight, is a relatively solid earnings picture. In the current US earnings season, a large majority of companies beat analyst expectations (see chart). While the average earnings surprise was marginally lower compared to the previous reporting season (17.9% vs. 18.7%), the average sales surprise increased significantly (to 3.0% from 2.5%), reflecting improving economic dynamics. Technology, the sector heavyweight in the S&P 500, reported especially strong figures, with 90% of companies beating earnings estimates (by 18.7%) and a sales surprise of 6.0% on average. Despite improving fundamentals, stock valuations have remained very elevated on the back of low interest rates and a lack of alternatives. On that front, the situation has become more challenging. Real, i.e. inflation-adjusted, government bond yields have rebounded from very depressed levels in both the US and Europe, thus increasing the relative attractiveness of that asset class somewhat. The higher discount rate is especially problematic for “growth stocks”, hence the recent underperformance of the IT sector. Nevertheless, we expect that the technical drivers are strong enough for equities to remain on a moderately positive uptrend.

Currencies

USD to benefit from economic outperformance

USA

- In February, the USD depreciated on a trade-weighted basis as cyclical currencies (e.g. EUR, GBP) and commodity-related currencies (e.g. AUD, CAD) benefited from improved global growth expectations.
- We do not expect the USD weakness to persist in March as the US economy will likely outperform other developed nations in terms of growth. Also, market expectations for monetary policy tightening by the Fed have been brought forward, with at least two 25 basis points hikes now priced in over three years. These developments are likely to persist and to lend renewed support for the greenback.

Eurozone

- Financial markets' sentiment towards Eurozone assets and the EUR improved in February. The election of Mario Draghi as new Italian prime minister also added to the positive environment.
- We see the dovish ECB amid elevated economic slack as a limiting factor for further appreciation. Over one month, we even have a negative view on EUR/USD and a neutral view on EUR/CHF.

UK

- Sterling continued its rally amid improved growth expectations and higher oil prices.
- However, we think that the latest move is overdone and have a neutral view on sterling against USD.

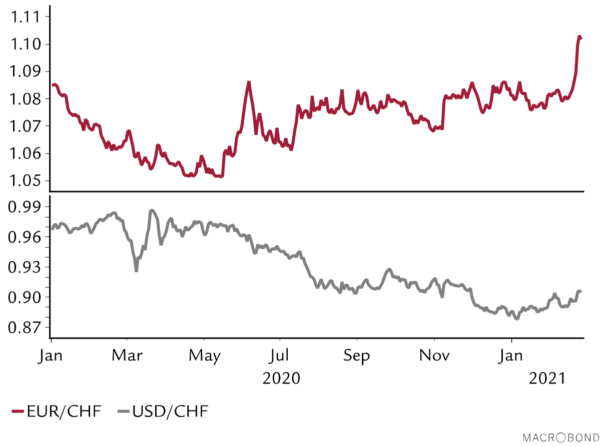
Switzerland

- The CHF was the worst-performing developed market currency in February as the "reflation trade" (see main text) gained momentum.
- Nevertheless, the structural drivers for a strong CHF remain in place, and we thus do not expect a continuation of the rising EUR/CHF trend. For the upcoming month, we have a neutral view on EUR/CHF.

Japan

- JPY – a safe haven currency like CHF – was another victim of the "reflation trade", having lost around 3.5% so far in 2021 on a trade-weighted basis.
- We expect USD/JPY to edge lower over the coming, weeks, mainly as a result of general USD strength.

Swiss Franc finally selling off in global "reflation trade"



We have seen two surprising developments over the past month in currency markets. First, the EUR/CHF exchange rate broke out of its recent 1.075-1.085 trading range and shot above the 1.10 mark for the first time since November 2019. The timing and the extent of the move in late February came as a surprise. To be sure, EUR/CHF had broadly moved in line with global risk sentiment, with the "safe haven" Swiss franc appreciating during the worst part of the crisis last year and depreciating as a trend since May 2020 as animal spirits gradually returned among investors. But overall, the moves were tiny given the astonishing news flow (e.g. US elections or vaccine announcements). Hence, the surge in EUR/CHF can be read as a delayed reaction to the powerful macroeconomic drivers globally – higher inflation and growth expectations – that have led to higher bond yields and booming equity markets since beginning of the year (the so-called "reflation trade"). The second surprising development was the acceleration of GBP appreciation in February. On a trade-weighted basis, sterling has seen the second-best year-to-date performance among developed market currencies, just after the AUD. GBP has benefited from surging oil prices and the fast progress on the vaccination front, which has lifted growth expectations for 2021. However, we think that the latest move is overdone and have a neutral view on sterling against USD.

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