Perspectives
Financial Markets

Swiss Life Asset Managers

April 2021

Interest rates & bonds
Once in a lifetime

USA
- Economic data coming out of the US is improving sequentially with sentiment indicators trending higher.
- The US Federal Reserve remained dovish in its recent meetings and seemed to be unconcerned with the rise in long-term interest rates. Regarding bank regulations, it even decided not to extend the relief for banks regarding the supplementary leverage ratio (SLR).

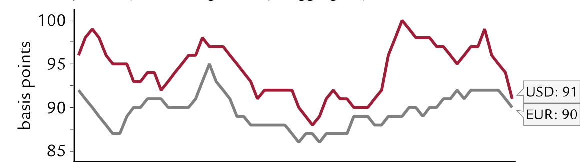
Eurozone
- Although the Eurozone is lagging the US on the vaccination front and is still largely in some form of lockdown, business sentiment has improved while pent-up demand is waiting to be unleashed.
- The ECB is more vocal about rising government bond yields and announced that it would step in should this lead to a tightening of financial conditions.

UK
- Incoming activity data for the first quarter still paint a bleak picture for the economy, but as the UK is leading other European nations in vaccinating its population, forward-looking data such as business and consumer sentiment has improved markedly.
- Similar to the US Fed, the Bank of England sees the rise in government bond yields as justified as it reflects improving prospects for economic growth.

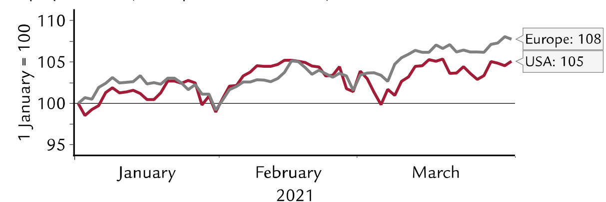
Switzerland
- With lockdowns in Switzerland being less stringent, economic activity is picking up. In March, the manufacturing Purchasing Managers' Index even reached its highest level since December 2006.
- The CHF has depreciated significantly year-to-date, removing the pressure for the SNB to intervene in the currency market.

Corporate bonds have not benefitted from "reflation trade"

Credit spreads (Bloomberg Barclays Aggregate)



Equity markets (MSCI price return indices)



It has been more than a year since the COVID-19 pandemic engulfed the globe and forced the world into an unprecedented lockdown. The economic fallout was devastating, but with the slump having been so steep we are now looking at the fastest and greatest recovery since at least World War II. Inflation, long believed to be a fabled myth from the old days, will stage a comeback as well in the second quarter 2021 and likely exceed 3% in the US for the first time since 2011. But what does that mean for risky assets? Credit spreads are already very tight, trading within the 10% percentile rank from a historical perspective. Hence, credit spreads have not been able to tighten materially even as equities have continued to rise in the first quarter 2021 (see chart). In March, USD and EUR credit spreads even widened temporarily, while 10-year government bond yields climbed 33 bps in the US but declined 3 bps in Germany. So, although we are expecting a strong fundamental tailwind from the reopening of the global economy, it is always best to quit while you are ahead. We are therefore starting to take chips off the table and take a more cautious stance on credit risk. On rates we remain short duration as government bond yields are still relatively low compared to inflation and growth expectations, with further room to rise.

Equities

Positive trend in a volatile environment

USA

- US equities underperformed most other markets in March despite the good absolute return, mainly due to a sector rotation favouring value-oriented stocks and hitting technology companies.
- Expected earnings have also been revised up to reflect the positive economic trend and are now roughly back at the pre-pandemic levels.
- The US equity market should be able to increase further from here, although the environment is becoming more challenging, especially as we expect government bond yields to increase further. The ongoing support from monetary and fiscal policy, however, will continue to support equities.

Eurozone

- Eurozone equities have performed better than most markets in March. This compensates for the weaker performance in 2020 and reflects the global recovery and the more attractive valuation of this market.
- However, the stuttering vaccination campaign could negatively impact market sentiment. Additionally, analysts expect the recovery in earnings to be relatively slow. Hence, performance going forward should be more in line with the rest of the world.

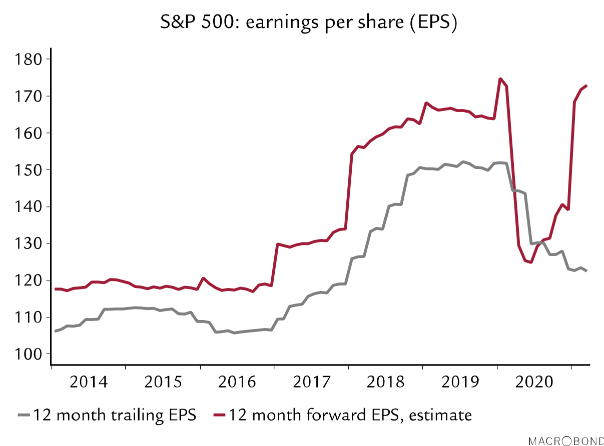
UK

- After a series of "faux-pas", the UK has been very successful in implementing its vaccination campaign. On the negative side, the industrial recovery remains muted, likely reflecting Brexit-related trade hurdles. Overall, UK equites have underperformed Eurozone and US equities year-to-date.
- As the positive vaccination news is already priced in, we expect the UK equity market to continue lagging the other markets.

Switzerland

- Given its defensive nature and rich valuation, the Swiss equity market should be lagging the rest of the world. March, however, surprised positively. The ongoing depreciation of the Swiss franc has likely added to the positive performance.
- We expect the positive global equity market trend to continue, suggesting a relative underperformance of the Swiss market.

Equity markets are forward-looking



It is often seen as counterintuitive that "bad" news can lead to very positive reactions in the equity market and that "good" news has repeatedly led to significant corrections. How can this seemingly weird investor behaviour be explained? Financial markets are forward-looking, meaning that today's prices reflect what market participants on average expect to happen in the future. In this sense, news is likely to impact equity prices only if it deviates from what was already expected. Company earnings are one good example. Earnings are an important factor impacting the price of equities. In times like these, when external factors (in this case the various "lockdowns") have had a significant impact on the profitability of companies, past earnings are meaningless as the future is very likely to differ from the recent past. Equity markets therefore focus on expected future earnings, which analysts estimate using both information obtained from the companies themselves and other indicators, including economic forecasts. In general, as can be seen from the chart above, expected earnings have been recovering quite rapidly and, in the case of the S&P 500, are now comparable to pre-pandemic levels. This explains the strong recovery of the equity markets over the last few quarters but also shows that we might be entering a more difficult period when earnings growth is going to slow down.

Currencies

The greenback strikes back

USA

- In line with our view, the USD appreciated against all major currencies in March, driven by improving growth prospects and an increasing USD interest rate advantage.
- We expect government bond yields to rise further in the US, not least due to continued economic outperformance and the related expectations of earlier monetary policy tightening than elsewhere. Financial markets now expect four 25 basis points policy rate hikes by the US Fed over the next three years. This should keep the carry advantage of the USD intact and support the greenback going forward.

Eurozone

- A raft of negative news regarding the vaccination campaign in Europe has added to EUR/USD weakness. The pair lost 2.9% in March.
- We maintain our negative view for EUR/USD and a neutral view for EUR/CHF over the next three months.

UK

- Even though the UK still had one of the most restrictive lockdown regimes in March, the rapid vaccination drive led to improved investor sentiment and another rally of sterling against EUR. Amid general USD strength, GBP/USD depreciated by 1.3%.
- With a lot of positive news already priced in and markets largely ignoring the negative fallout from Brexit disruptions in the industrial sector, we expect GBP to depreciate further against USD over the next three months.

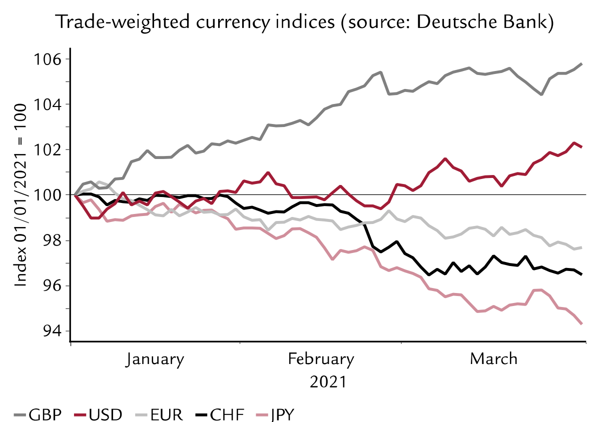
Switzerland

- The CHF weakness continued in March amid a generally risk-friendly market sentiment.
- Nevertheless, the structural drivers for a strong CHF remain in place, and we thus do not expect a continuation of the positive EUR/CHF trend. We maintain a neutral view on EUR/CHF and a positive view on USD/CHF for the next three months.

Japan

- In March, the trade-weighted JPY saw the largest depreciation among major currencies.
- 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.

The faster the vaccination drive, the stronger the currency?



If we look at the performance of the major developed market currencies since beginning of the year, an interesting pattern emerges: the performance seems to mirror the vaccination progress in the respective economies. At least for the UK, this is no coincidence. The rapid vaccination drive has led to a significant improvement in investor sentiment, with GBP appreciating 5.8% on a trade-weighted basis (see chart). We indeed think that the UK will grow faster in the second quarter than any other developed economy but believe that a lot of positive news is now already priced into sterling. Meanwhile, our positive view on USD, which was based on our expectation of US economic outperformance and an increasing interest rate advantage ("carry"), played out well in the first quarter. The rapid vaccination drive in the US has certainly added to the improved economic prospects and the related increase in bond yields, but the main driver was clearly the approval of Joe Biden's huge fiscal stimulus package. We expect the USD to maintain its carry advantage and see further USD strength ahead. Meanwhile, the low-yielding "safe haven" currencies JPY and CHF lost further ground in March as investors remained in "risk-on" mood. In such an environment, the cyclical EUR is usually a beneficiary. The weak performance of EUR, especially in February and March, is best explained by continuous downgrades of Eurozone growth forecasts as the vaccination campaign has stumbled from one disaster to the next.

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