Perspectives
Financial Markets

July 2021

Interest rates & bonds
Is inflation decelerating fast enough?

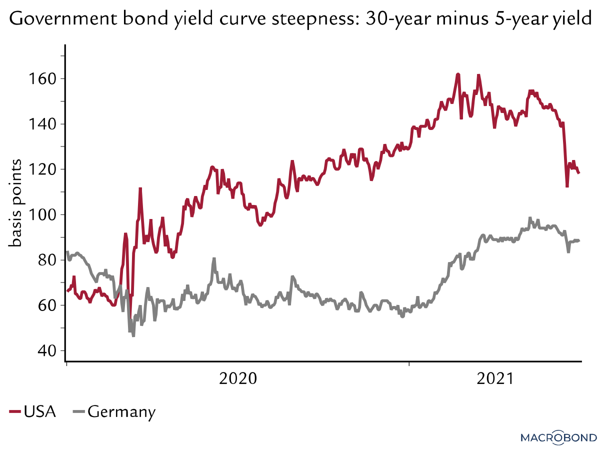
US
- US yield curves flattened materially, with the 30-year Treasury yield falling 20 basis points in June, briefly moving as low as 1.92%, while the front end rose following the FOMC meeting.
- The FOMC members' policy rate projections (so-called "dot plot") surprised markets, as the median projection implies two policy rate hikes by 25 basis points each by 2023. The more hawkish projection follows a series of inflation surprises, with headline inflation jumping as high as 5% in May.

Eurozone
- As inflation in Europe is more contained than in the US, the movement in interest rates was less pronounced. While the German yield curves flattened slightly in June, the 10-year point was largely unchanged over the month.
- We see less pressure on the ECB to tighten monetary conditions and expect the bond purchase programme to remain in place for the time being.

UK
- The UK economy's full reopening was postponed due to resurging Covid-19 infection numbers. This likely contributed to the flattening of UK yield curves. While the short end was anchored, the 10-year government bond yield declined 8 bps in June.
- Among the big central banks, we see the Bank of England to be among the first ones to move to a more hawkish stance.

Switzerland
- The Swiss government interest rate curve flattened slightly as the very long end came down some 5 bps, while the rest of the curve was largely unchanged.
- Despite the relatively strong recovery of the Swiss economy, inflationary pressure remains low, with headline inflation likely to remain below 1% in the months ahead. We therefore see little pressure on the SNB to change its policy stance at this point.

The curves are flattening, most significantly in the US



How transitory is inflation and how much inflation target overshooting is acceptable before central banks have to act? Those are currently the most pressing questions for bond investors. We would agree that inflation will ultimately turn out to be transitory, with the peak in the US likely already behind us. However, we also think that the current monetary policy might be too loose for the present environment. We could therefore see central banks preparing markets for a gradual tightening of financial conditions over the next few months. That was already shown by the US Fed in the June meeting, when policy rate projections were revised up. So far, the Fed seems to be managing the situation well, as bond markets priced in a largely orderly exit from the ultra-expansionary monetary policy. The short end of the yield curve was lifted, while longer-term inflation expectations came down, leading to a flatter curve. Credit spreads have barely moved. However, if inflation does not decelerate substantially over the next few months, we could see a very different reaction. While we do not envision a policy error by the Fed as in 2013 ("taper tantrum"), markets might still start to price in a faster withdrawal of central bank stimulus. The next few weeks will provide more clarity as we await US jobs and inflation data. Against this backdrop, we maintain a short duration bias and keep a neutral stance on credit risk.

Equities

Will Eurozone equities stage a comeback?

US

- The US equity market had a volatile June but closed the month on a positive note. The change in mood was prompted by the US Fed's reassurance of an unchanged monetary policy for the time being. The positive economic data flow also supported the continued recovery of the IT sector, which outperformed the broad market after a period of weakness.
- The US market, in our opinion, still has upside potential. However, as economic growth might have peaked, we expect returns to be more moderate and volatile going forward.

Eurozone

- After having outperformed for most of this year, Eurozone equities slightly lagged the rest of the world in June. Most of this underperformance happened after the Fed's comments and probably reflects a temporary shift in momentum in favour of the US market.
- The fundamentals, however, continue to speak for the Eurozone. Economic growth has yet to peak and the valuation is significantly lower than in the US, while company earnings have a similar dynamic. The Eurozone should therefore outperform the rest of the world going forward.

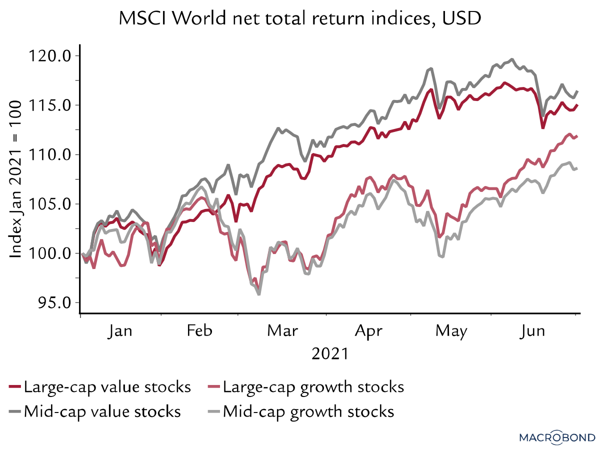
UK

- The UK market lagged the rest of the world in June. After the euphoria created by the vaccination progress, the mood soured last month due to a surge in Covid-19 cases, signs that Brexit's economic pains are far from over and the expectation that the central bank might be among the first ones to adjust its policy.
- These themes will continue to impact the UK market. Despite the relatively cheap valuation of this market, we expect it to perform in line with the rest of the world at best.

Switzerland

- The Swiss equity market again performed strongly in June, with a single healthcare stock making a significant contribution to overall performance. The market also profited from the improved earnings expectations for large caps. Mid and small caps, however, performed in line with global equities.
- We do not see these developments as sustainable and expect a reversal in favour of the smaller stocks.

Valuation factor more important than size in H1/2021



Equity market commentators often mention that equity markets are currently driven by certain factors. But what is a "factor" and why should we care about it? Loosely speaking, a factor is a characteristic shared by many stocks which impacts their performance. A well-known factor is market capitalisation (or size): there is a significant amount of empirical evidence that smaller (capitalisation) companies behave differently than large (capitalisation) companies. Size is just one factor in a very long list, which also includes for example valuation ("value" for cheaper and "growth" for more expensive stocks as measured for example with the P/E) and "momentum".

Should we care about factors? Yes. Factors can have a very strong effect on performance and what is seen as value added by an equity portfolio manager is often driven to a large extent by a strategic focus on stocks sharing the same factors. To illustrate this, we have graphed the year-to-date performance of four global factor indices: World Large-Cap Value, World Large-Cap Growth, World Mid-Cap Value and World Mid-Cap Growth. As can be seen from the chart, value stocks have been significantly outperforming growth stocks this year. This means that so far in 2021, it has been more important to focus on stocks with low P/E than deciding between stocks with different levels of capitalisation. This is typical for periods of economic recovery after a significant shock like the pandemic in 2020. However, forecasting when a certain factor is likely to outperform remains quite difficult.

Currencies

Carry remains king

US

- In line with our view, the USD appreciated against all major currencies in June as higher-than-expected inflation, strong economic data and a hawkish message by the Fed led to a shift in market expectations regarding monetary policy tightening.
- We expect the US interest rate advantage to remain in place or even increase further over the next three months, which should lend support to the USD.

Eurozone

- Apart from the strong depreciation against USD, the EUR had an uneventful month in June, as the exchange rates to other developed countries in Europe (Switzerland, UK, Sweden, Norway) remained stable.
- Contrary to the US Fed, the ECB will likely remain stuck in its ultra-expansionary monetary policy. Clearly, Eurozone economic momentum will increase during the third quarter, but the output gap remains much wider than in the US, keeping inflationary pressures in check. We thus maintain our negative view for EUR/USD.

UK

- GBP/EUR has been fluctuating around the 1.60 mark since March, barely moving in June.
- Due to the rapid vaccination progress and early reopenings, UK economic momentum already peaked in the second quarter, while political risks are plentiful and could make more headlines during the second half of the year. We thus expect GBP to depreciate against USD in the next three months and to move sideways against EUR.

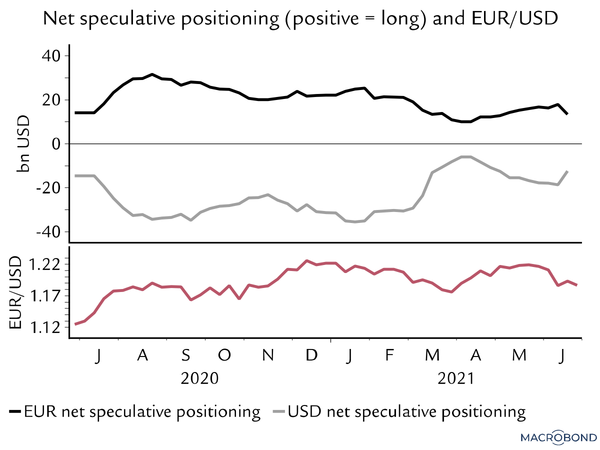
Switzerland

- Our neutral call on EUR/CHF has turned out to be correct over the past two months, and we reiterate the call for the next three months.
- We think that the interest rate differential (carry) remains too narrow to bring EUR/CHF higher, despite the risk-on sentiment among investors.

Japan

- The JPY has shown the largest depreciation among developed market currencies in 2021.
- This is unlikely to change in the next three months due to the ongoing risk-friendly global market environment, which renders low-yielding currencies such as JPY very unattractive.

USD rally in June caught many speculators off-guard



The month of June was marked by a strong appreciation of the trade-weighted USD, following two months of weakness. Finally, our view of a stronger USD gained traction, and it did so for the right reason, namely a shift in relative monetary policy expectations. In its June meeting, the US Federal Open Market Committee (FOMC) surprised markets on the hawkish side by revising up the median projection for the policy rate in 2023 by 50 basis points. This is quite a change to the March projection, when the average FOMC member expected policy rates to remain unchanged over the two-year forecast horizon. Even though the hawkish shift was subsequently downplayed in speeches by FOMC members, interest rate markets reacted to the new projections and the continued upbeat economic data flow by pricing in earlier Fed hikes. The two-year yield differential (carry) between the US and Eurozone government bonds increased, sending EUR/USD almost 3% lower during the month of June. What likely also contributed to the USD rally was the fact that speculative investors were predominately positioned short USD ahead of the Fed meeting and subsequently squeezed out of their positions when the tide turned in favour of the greenback (see chart, based on CFTC data on non-commercial investors' positioning in futures). Overall, we stubbornly stick to our key views for the next three months. Hence, we expect the carry advantage and the rapidly closing output gap in the US to support the USD, while EUR/CHF will likely continue to move sideways due to stable interest rate differentials between Switzerland and the Eurozone.

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