Perspectives
Financial Markets

June 2021

Interest rates & bonds
Inflation is just transitory

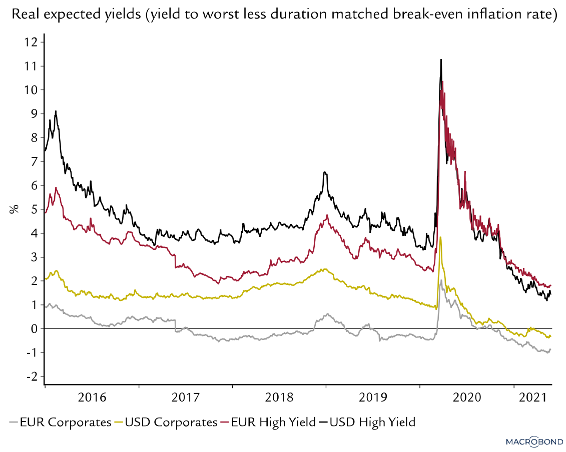
USA
- US 10-year treasury rates were range bound in May but saw a sharp decline following disappointing labor market data and reversed up again as April's numbers showed an increase in the inflation rate to 4.2%, the highest rate in more than a decade.
- The Fed maintains its dovish stance, reinforcing its view that inflation is transitory. Meanwhile taper talks are becoming more prominent in the market given current inflation scares.

Eurozone
- As Europe's vaccination campaign is gaining traction, sentiment indicators are ramping up, which is driving interest rates higher with German 10-year Bunds yield up another 5 basis points.
- The ECB maintains its pace of higher bond purchases but seems to become more comfortable with higher government interest rates.

UK
- Readings of Purchasing Managers' Indices are increasing at an accelerating pace and hard data such as retail sales is soaring.
- 10-year Gilts seem unimpressed by accelerating growth dynamics and continue to trade range bound since the end of February.
- The latest inflation numbers should give the Bank of England more time to maintain its dovish monetary policy.

Switzerland
- Headline inflation in Switzerland is still relatively muted with April annual consumer price inflation of just 0.3%, but 10y government yields moved slightly higher as of late.
- Inflation is still comfortably in line with price stability and thus we do not envision the SNB to change its monetary policy any time soon.

Real interest rates at depressed levels



Corporate credit spreads around the world continue to hover around record lows, despite the deterioration in overall credit quality and the longer average duration of the newly issued bonds. Over the past month spreads even declined another 3 basis points for USD corporate bonds and are just marginally up (+2 basis points) for their EUR counterparts. Long-term bond yields, although significantly higher than at the beginning of the year, are still relatively low compared to economic growth and inflation numbers as it becomes apparent in the continuous decline in real rates (interest rates less inflation). The ongoing repetition of central banks' mantra of transitory inflation as a justification for unparalleled monetary stimulus is eating up returns for bond investors who are facing -1.65% in real rate terms in Euro denominated sovereign bonds and -0.87% in the US. Even corporate bonds don't generate positive yields after inflation and duration matched EUR and USD high yield papers offer a meagre 1.8% and 1.4% compensation, respectively. With further spread compression potential being limited and interest rates see to rise further rising, we continue to maintain our short duration and short credit risk stance.

Equities

Inflation fears dominate the US market

USA

- The US equity market in May was been driven by fears about inflation. This nervousness was soothed towards the end of the month by the Fed's comments and by economic data suggesting less pressure on this front.
- Notwithstanding the volatility caused by these fears, the strong rotation towards smaller, more cyclical companies and away from larger companies linked to the digitalization trend has continued to characterize the market.
- While the market mood is not as upbeat as in Q1, we still believe that the market will continue to growth, although the high valuation will limit the upside potential.

Eurozone

- The Eurozone equity market has outperformed the rest of the world in May.
- This reflects the better valuation and the bigger economic catch-up potential and smaller inflation risks of this economy relative to the US.
- While we still see a number of specific risks, including the improving but still slow vaccination progress and its economic implications, the improvement rate is good and therefore we expect the Eurozone equity market to perform as least as well or better than the rest of the world.

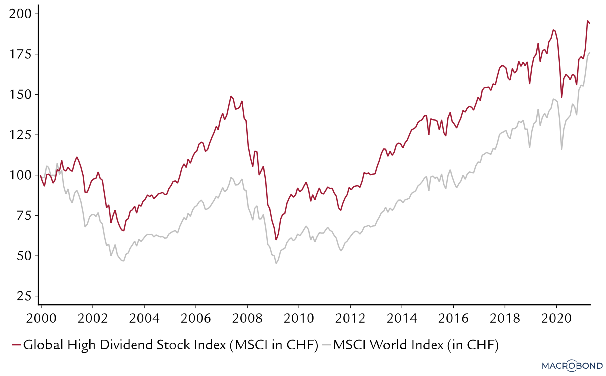
UK

- The UK market has continued to perform well in May.
- The bonus created by the successful vaccine deployment is probably consumed and the current political stresses are not helping the overall sentiment.
- However, the UK economic prospects are good and comparable to the US. As the UK's valuation is significantly cheaper than the US, we expect this market to continue to perform at least in line with the world market or a bit better.

Switzerland

- The Swiss equity market has seen a strong May.
- The defensive nature of the market and the high valuation of the few dominant large caps, however, suggests that this market is likely to underperform going forward, unless there is a global correction.
- The medium and smaller capitalized companies, which are also more cyclical, are likely to perform better.

The comeback of the high dividend yield stocks?



High dividend stocks have been long a favourite of more defensive equity investors. The combination of a relatively steady income paid-out as dividends and the fact that companies able and willing to pay high dividends tend to be more mature has been an attractive mix for example for private investors. In fact, over the longer term, high dividend stocks have outperformed "normal" stocks and were less volatile (see chart). The last few years, however, have been painful, as high dividend yield stocks have on average significantly underperformed the market overall. There are many reasons which can be mentioned to explain this, as for example the disruptive impact of digitalization on many economic sectors which has favoured "growth"-oriented companies, which normally don't pay much dividends. More recently, dividends have been significantly reduced as companies receiving government support during the pandemic have been prevented from paying dividends. This year high dividend stocks have been performing in line with the market or better. There are probably many reasons for this, the fact that "growth"-oriented companies are now very expensive and market volatility has been increasing and is likely to stay higher than in the previous years. The more defensive nature of high dividend stocks and their attractive yield (even relative to the corporate bond market) suggest that this is likely the comeback of this equity strategy.

Currencies

We continue to expect stronger USD until year-end

USA

- Despite an upside inflation surprise, the Fed managed to play down market fears of early monetary policy intervention.
- Nevertheless, we continue to expect a Dollar strengthening towards the second half of the year, as Fed representatives are expected to sound more hawkish in weeks to come.
- This view is out of consensus, yet consistent with our assessment that the US economy is currently the World's growth engine.

Eurozone

- Out of consensus is also our view that the Euro should not appreciate further against USD or Swiss Franc.
- The Eurozone is 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

- GBP continued to trend sideways versus EUR after a noteworthy appreciation earlier in the year thanks to the UK's fast vaccination progress.
- We think that a lot of positive news with respect to the economic recovery is already priced in.
- Risks with respect to post-Brexit developments or calls for a second Scottish independence referendum are not negligible.

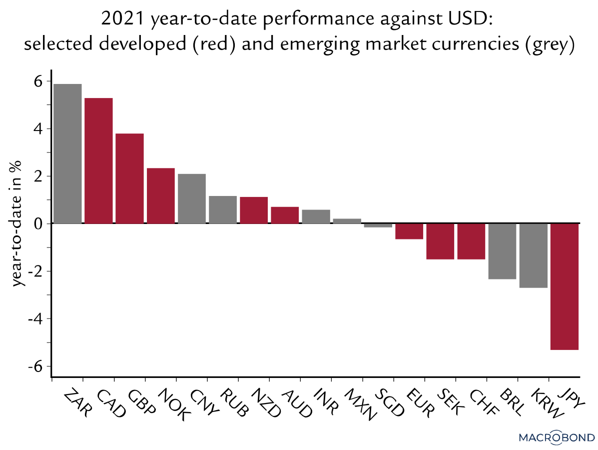
Switzerland

- We maintain our neutral call on EURCHF. In contrast to most other analysts we remain as regards material Euro appreciation potential given the interest rate differential and the ECB's dovish stance.
- Meanwhile the Swiss Franc is likely to depreciate against USD, in line with our view of general USD strength.

Japan

- As one of the most important net commodity importers, Japan's currency is underperforming against most other currencies so far this year (see chart).
- We stick to our positive USD/JPY call as we expect the global growth picture to improve further until mid-year.

Commodity-related currencies have performed best in 2021



Most of the times, we discuss interest rate differential and the closely related assessment of central bank policy making to assess the prospects on foreign exchange markets. So far in 2021, surging commodity prices are at least as important as market drivers as rate differentials. The chart above shows that as a rule, the currency of a net exporting country of commodities appreciated to the USD year to date, while net commodity importers saw their currency devaluing. The appreciation of the British Pound is a particular case as its appreciation is probably the reversal of earlier Brexit related depreciation. Since December 2020, we have a positive view for the USD. This assessment stands out versus the consensus trade which favours the Euro versus both US Dollar and Swiss Franc. Despite the interesting impact of commodity market moves, interest rate differentials, the so-called "carry", remain the major driver foreign exchange markets going forward. 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 re-acceleration, while the Anglo-Saxon world will at some point seek exit from ultra-expansionary policy. To monitor whether this judgement is correct, readers are invited to observe if Fed representatives start to sound more hawkish in weeks to come as we would expect.

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