Perspectives
Financial Markets

January 2021

Interest rates & bonds

Real losers

USA

- US economic data continues to surprise to the upside, despite record infection numbers and the increase in regional containment measures.
- With Joe Biden confirmed as President-elect and Janet Yellen becoming the new head of the US Treasury, we expect continuously strong monetary and fiscal support, largely aligned with one another.

Eurozone

- While containment measures are becoming harsher, the more targeted approach has helped to prevent a sharp drop in economic activity, with Purchasing Managers' Indices already bouncing back towards expansionary territory in December.
- As expected, the ECB increased its emergency bond buying program by EUR 500 bn and did minor tweaks to its other instruments in December. Meanwhile the EU is still working on the implementation of its support package.

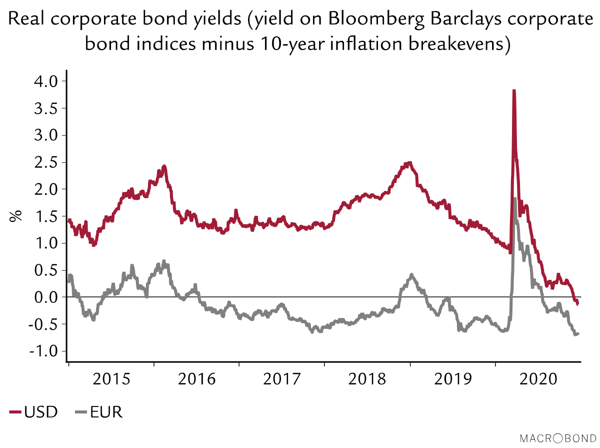
UK

- The near-term economic outlook for the UK remains bleak. Even if the EU and UK strike a last-minute trade deal, some hiccups to trade are likely in the first quarter. Also, COVID-19 infection numbers remain elevated, creating the need for further containment measures.
- While the BoE lifted its ban on bank dividends, showing that it has more confidence in the recovery, we would expect additional stimulus in case EU-UK trade negotiations were to break down.

Switzerland

- Although the second wave of the pandemic has been severe, the relatively light and targeted measures have dampened the impact on the economy and labour market so far.
- Due to the strong recovery of the world economy in the second half, appreciation pressure on the CHF has abated, reducing the need for SNB currency interventions.

No juice left if expected inflation is considered



Back in March, it was hard to imagine that 2020 would turn out to be a good year for bond investors amid a pandemic that caused an unprecedented economic downturn. Yet here we are just nine months later. Corporate credit spreads are within earshot of their tight February levels with all-in yields already far below. US corporate bond yields – for the first time ever – do not compensate investors for the expected inflation anymore (see chart). Meanwhile, the pile of negative-yielding debt is at a record-setting USD 18.3 trillion worldwide. While bonds are arguably expensive, we think they could become ever more so as central banks keep the monetary floodgates open and new fiscal packages are being hammered out in developed markets. Furthermore, we see real economic growth accelerating globally, and with large amounts of money still being parked in money market funds, technicals and fundamentals align in favour of further yield compression. However, risks for the bond market are rising. Should growth and especially inflation increase meaningfully, investors will start to question the seemingly unlimited central bank support ("central bank put"). With the market hooked on that liquidity, the potential for sharp corrections cannot be ignored. That said, we remain overweight credit risk and short duration as the good times are likely to continue at least for the next three months.

Equities

A rally and a sector rotation

USA

- The immediate uncertainties linked to the US elections are now mostly behind us and economic data suggest that the US is in better shape than other countries, with Purchasing Managers' Indices still pointing toward expansion.
- More restrictions due to surging COVID-19 cases, as well as the Georgia run-off elections on 5 January could lead to short-term volatility. However, markets are likely to look through the noise and to remain in a "buy the dip" mode.
- The economic recovery in 2021 should benefit equity market sectors that have suffered most during the pandemic, i.e. small and medium enterprises as well as the non-IT sectors.

Eurozone

- The increasingly severe restrictions to fight the pandemic will dampen economic activity in the Eurozone in the short-term. However, the prospect of broad-based vaccination has significantly improved the economic outlook after the winter months, which should support the equity market.
- The Eurozone market should especially benefit from the ongoing sector rotation, due to its high share of sectors that were particularly affected by the pandemic.

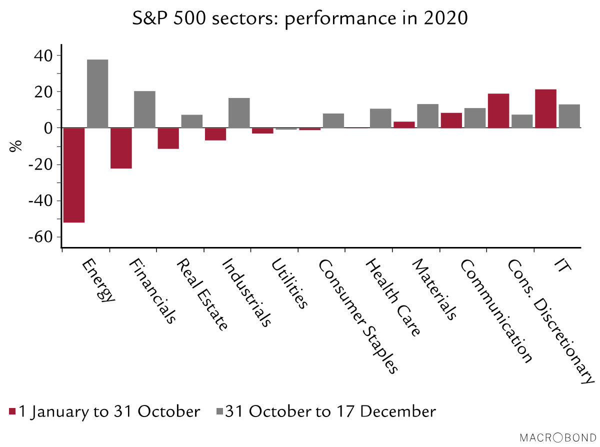
UK

- Financial markets are still mostly expecting a benign outcome of EU-UK negotiations, and the UK is the first developed economy to start broad-based vaccination. UK equities have thus reduced some of their massive year-to-date underperformance.
- Despite the expected recovery in 2021, the UK economy will remain the developed country with the largest output gap, apart maybe from Spain. We therefore keep a cautious view on the UK market.

Switzerland

- The defensive character of the Swiss equity market has led to an underperformance over the last two months amid strong "risk-on" sentiment in financial markets.
- This is unlikely to change anytime soon, suggesting that the Swiss equity market is likely to lag other regions. Cyclical stocks, however, are likely to show a high correlation with the rest of the world and should participate in the expected positive trend.

Vaccine news has initiated a massive sector rotation



A stunning equity market rally unfolded after the US elections and the positive vaccine news. In November, Europe saw the strongest monthly performance ever, with the Euro Stoxx 50 jumping by 18%. US equity markets rallied less, but we still have to go back to the year 1928 to find a better November performance than this year. Particularly impressive was the sector rotation that was initiated by the positive vaccine news. In the US, the divergence in sector performance up until the end of October had accumulated to a whopping 73 percentage points, with energy losing 52% and the IT sector surging by 21% (see chart). This divergence was reduced in the past weeks. Almost everything that had been sold off during the COVID-19 crisis was revived after the vaccine news.

The rally in equites continued in the first half of December, and we expect the positive momentum to continue over the next three months. Admittedly, equity market valuations have become lofty, but all the positive drivers remain in place: strong monetary and fiscal policy support, reduced political risks, lack of substantially yielding alternatives in the investment universe and especially better economic growth prospects for 2021. The problem is that this has become a consensus view among market participants, bringing a substantial risk of a correction in case of potential negative news (e.g. hiccups in the vaccination programs). However, given ample liquidity among investors and strong monetary policy support, we expect any correction to be viewed as a buying opportunity by investors. Hence, the "buy the dip" mentality is unlikely to disappear anytime soon.

Currencies

End of USD sell-off expected

USA

- The month of December started as November had ended, with an unabated USD sell-off that brought the USD index (DXY) back to its early 2018 levels at the time of writing.
- A continuously dovish Fed, strong "risk-on" sentiment in financial markets and somewhat weaker US economic data in December have added to USD weakness. However, we expect the tide in economic dynamics to turn again in the first quarter, which should bring renewed USD strength.

Eurozone

- Since beginning of November, cyclical currencies have given a comeback amid improved global growth prospects. Among developed market currencies, only the AUD and NZD performed better than the EUR during that period.
- The EUR also benefitted from economic data, notably better-than-expected Purchasing Managers' Indices in December. However, the output gap in the Eurozone is still huge, and we expect renewed economic underperformance against the US in 2021, which should lead to renewed pressure on the EUR.

UK

- GBP remains well supported as markets are still betting on a last-minute trade deal between the EU and the UK, which is also our base case.
- Over the next three months, we expect GBP to stabilise against EUR but to depreciate against USD, the latter primarily reflecting our positive view on USD.

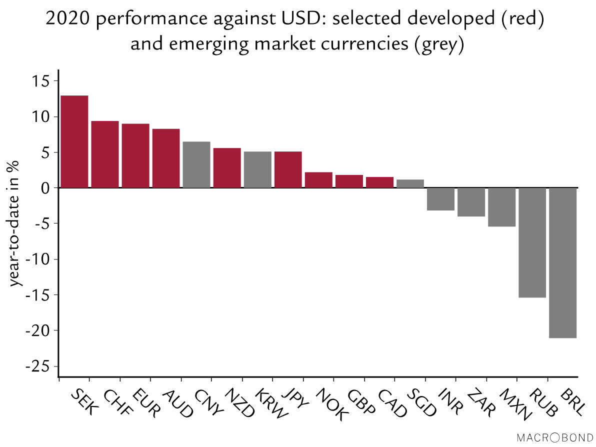
Switzerland

- The CHF is range-bound against EUR. The decrease in global political risks, more growth optimism and even the news that Switzerland was labelled a currency manipulator by the US Treasury all had surprisingly little effect on the exchange rate.
- We keep a neutral view on EUR/CHF but expect some reversal of CHF strength against USD

Japan

- After the strong appreciation against USD, we expect a turnaround in the first quarter, in line with our generally positive view on USD overt that period.

USD to end 2020 as weakest developed market currency



2020 was an extraordinary year in foreign exchange markets. Following two years of appreciation, the USD index (DXY) hit its peak in March 2020 and then sold off for the rest of the year, reaching its early 2018 levels at the time of writing. Our shift from "USD bulls" to "USD bears" in March 2020, which we primarily based on the evaporated USD interest rate advantage ("carry"), has thus been proven correct. In fact, the USD has lost against all major developed market currencies, with SEK, CHF and EUR being the outperformers year-to-date. The GBP, CAD and NOK have been the weakest performers in developed markets apart from the USD, suffering from low energy prices and – in the case of GBP – from ongoing Brexit uncertainty. 2020 was also a tough year for emerging market currencies, except for Asian currencies such as CNY, KRW and SGD that all appreciated against USD. These economies benefited structurally from their external position (i.e. current account surplus) and cyclically from their strong economic outperformance.

Looking ahead, most analysts assume persistent USD weakness in 2021. We take a different view. After the strong sell-off, we expect the USD to stabilise in the near term and to appreciate somewhat for the remainder of the first quarter. The main reason is our expectation of US economic outperformance, especially against Europe. This means that the US Federal Reserve might be the first central bank to signal, at some point, the need for less accommodation in the medium term, while the ECB appears stuck with its ultra-expansionary monetary policy. Finally, speculative USD positioning in FX markets is strongly negative, which is usually seen as a contrarian indicator.

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