Perspectives

Economics

Swiss Life
Asset Managers

October 2020

Key messages

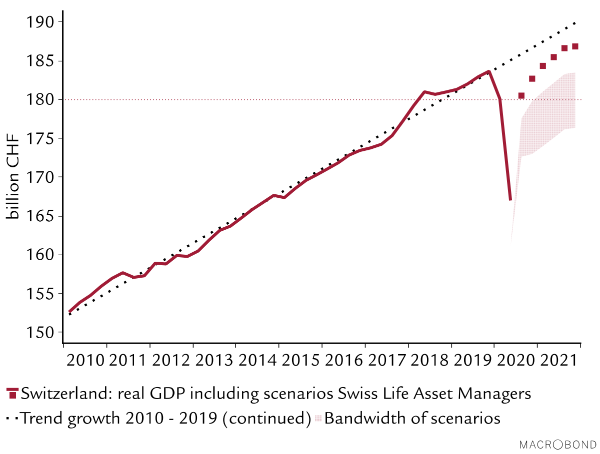
- Substantial upward revisions in the consensus GDP growth forecasts in the US and Switzerland
- Partial expiry of fiscal stimulus measures dampens the pace of economic recovery in the UK and elsewhere
- New Japanese prime minister likely to stick to predecessor's economic policy

Comparison of forecasts

	2020 GDP growth		2021 GDP growth		2020 inflation rate		2021 inflation rate	
	Swiss Life AM	Consensus	Swiss Life AM	Consensus	Swiss Life AM	Consensus	Swiss Life AM	Consensus
USA	-3.5% ↑	-4.4% ↑	4.0%	3.8% ↓	1.2%	1.1% ↑	1.9% ↑	1.9% ↑
Eurozone	-6.6% ↓	-7.7% ↑	5.3%	5.5% ↓	0.4% ↓	0.4%	1.1% ↓	1.0% ↓
Germany	-5.0% ↓	-5.7% ↑	4.1% ↑	4.6% ↓	0.6%	0.5%	1.6%	1.5% ↓
France	-8.0%	-9.5% ↑	7.2% ↓	6.9% ↓	0.6% ↓	0.5%	1.2% ↓	1.0%
UK	-8.9% ↓	-10.1% ↓	7.4% ↑	6.5% ↑	0.8% ↓	0.8% ↑	1.5% ↓	1.5% ↑
Switzerland	-3.8%	-5.1% ↑	4.4%	4.1% ↓	-0.5%	-0.7%	0.6%	0.2%
Japan	-4.8% ↓	-5.6% ↓	2.6%	2.6% ↑	0.1% ↓	-0.1%	0.2%	0.1% ↓
China	2.5% ↑	2.2% ↑	7.4% ↓	7.9% ↑	2.7%	2.8% ↑	1.9%	2.0%

Arrows indicate difference from previous month
Source: Consensus Economics Inc. London, 14 September 2020

Chart of the month



The world economy has recovered since May. In the US and Switzerland, "peak pessimism" is clearly behind us, with consensus forecasts for 2020 GDP growth moving up and the gap to our own projections narrowing this month. It is becoming increasingly clear that Switzerland is getting away from the COVID-19 crisis with a black eye. Yet, the recession has a lasting impact and we think it is important to highlight that even Switzerland's GDP will not return to its pre-crisis level before the final quarter 2021. In our base case scenario, GDP in Switzerland will fall three percentage points short of its underlying trend seen from 2010 until 2019. Welcome to the "97% economy"!

US
Bracing for election day

GDP growth	
Swiss Life Asset Managers	Consensus
2020: -3.5 %	2020: -4.4 %
2021: 4.0 %	2021: 3.8 %

Incoming data confirm that the US economy recovered significantly in the third quarter, in line with our above-consensus view. Notably, the unemployment rate dropped again spectacularly, from 10.2% to 8.4%. In our view, higher employment will outweigh the negative effect on consumption stemming from lower unemployment benefits. On that front, executive orders by the president have averted a "fiscal cliff", but a permanent solution in the form of a second stimulus package is needed. With no progress so far in Congress, we only expect a compromise to emerge after the elections. On the latter, polls are currently only confident about one outcome, namely that Democrats will keep control of the House of Representatives. If President Trump is re-elected, he would thus still face limited room to manoeuvre, which implies continuity on economic policy. The same is true if a new President Biden faced a Republican Senate. In our view, the only gamechanger for the economic outlook would be a Democratic landslide, i.e. Joe Biden as president enjoying full support in Congress. This would pose an upward risk to our 2021 GDP forecast, as front-loaded fiscal spending is likely to outweigh negative effects from Biden's tax plans. The only result we should truly worry about is "no result at all", i.e. a lengthy, disorderly dispute about the outcome of the presidential race.

Inflation	
Swiss Life Asset Managers	Consensus
2020: 1.2 %	2020: 1.1 %
2021: 1.9 %	2021: 1.9 %

In August, US consumer prices normalised further from the crisis-induced slump that occurred between March and June. Similar to economic data, however, the speed of the recovery has slowed, and annual inflation rates are thus set to stabilise over the period ahead. We expect core inflation to remain at around 1.7% until year end, while headline inflation should edge lower due to slightly lower energy price base effects until December. We expect headline inflation to (temporarily) surpass the 2% mark in the second quarter 2021 only.

Eurozone
Inflation (mis)-perceptions

GDP growth	
Swiss Life Asset Managers	Consensus
2020: -6.6 %	2020: -7.7 %
2021: 5.3 %	2021: 5.5 %

The renewed increase in COVID-19 infection cases across Europe is reflected in weaker Purchasing Managers' Indices (PMI) for the services sector in September. While this indicates a stuttering economy at the end of the third quarter, high frequency data like Google's mobility indicators suggest that individual activity is not impacted by locally imposed, targeted containment measures. A second wave of infections has always been part of our base scenario. A tipping point in the recovery path for the economy would only occur if Europe's health care systems were overwhelmed, triggering renewed massive containment measures on a nationwide scale. Despite the recent negative news flow, such a scenario remains out of sight, in our view. Yet, as fiscal emergency measures will expire over time, the momentum of the economic recovery will slow into the final quarter 2020. Certain jobs will be lost permanently, and certain firms will disappear over the next quarters. We expect unemployment numbers to rise across Europe, an anticipation which is also reflected in consumer sentiment, which remains well below pre-crisis levels in all member states. A second look at the impressive annual growth rates projected for 2021 reveals that we expect an underlying average quarterly growth rate of just 0.5% throughout next year.

Inflation	
Swiss Life Asset Managers	Consensus
2020: 0.4 %	2020: 0.4 %
2021: 1.1 %	2021: 1.0 %

A wide gap has opened between official inflation statistics and the public's actual inflation perception. According to the EU Commission's consumer confidence survey, the perceived inflation rate in the Eurozone is currently exceeding 6%, while official consumer price inflation was below 1.8% for all 19 EMU member states in August. Whether the combination of coordinated massive monetary and fiscal policy impulses and high individual inflation perceptions eventually result in a structural upward shift of long-term inflation expectations of economic agents remains an open question.

Germany
Manufacturing, the latecomer

GDP growth

Swiss Life Asset Managers	Consensus
2020: -5.0 %	2020: -5.7 %
2021: 4.1 %	2021: 4.6 %

While the increase in new COVID-19 cases has been less drastic in Germany compared to other European countries, on a local level some stricter containment measures are still being implemented. For example, Munich, a virus hotspot, has announced stricter social distancing rules and new masks requirements at the end of September. Such announcements could impede the recovery heading into the final quarter of the year as they weigh on consumer confidence, which once again missed consensus expectations in its October print. Likewise, the September services Purchasing Managers' Index (PMI) disappointed. It dropped below the 50 mark and recorded weaker dynamics in the forward-looking subcomponents business expectations and actual incoming business. Meanwhile, activity data revealed that already the third quarter started on a weaker footing than expected. July industrial production confirmed what manufacturing PMI had already foreshadowed: the recovery is slower in Germany's manufacturing sector compared to its peers, as production remains 12% below its pre-crisis level. We thus slightly downgraded our 2020 GDP growth forecast. However, the catch-up potential for manufacturing looks substantial. In a large upside surprise, the September manufacturing PMI increased to 56.6 points, driven by new orders that reached the highest level since March 2010. Other leading indicators such as the truck toll mileage index also look solid.

Inflation

Swiss Life Asset Managers	Consensus
2020: 0.6 %	2020: 0.5 %
2021: 1.6 %	2021: 1.5 %

August harmonised consumer price inflation fell slightly into negative territory (-0.1%) for the first time since 2016. The VAT cut implemented in July thus left a clear mark on headline inflation, which had stood at close to 1% during the second quarter. We expect headline inflation to hover at around zero until year-end, before energy price base effects and the reversal of the tax cut drive it towards 2% in the course of 2021.

France
The pandemic strikes back

GDP growth

Swiss Life Asset Managers	Consensus
2020: -8.0 %	2020: -9.5 %
2021: 7.2 %	2021: 6.9 %

After the strong rebound in May and June, the economic recovery lost steam in the third quarter. Industrial production increased less than expected in July, reaching 93% of its pre-crisis level. According to the Purchasing Managers' Index (PMI), both manufacturing output and new orders increased only moderately in August and September, certainly much less than in neighbouring Germany and Italy. Even more problematic is the significant drop of the services PMI below the 50-points mark in September. Especially incoming business has slowed, which might reflect worries surrounding the recent surge in COVID-19 cases way above the highs seen back in April. Among Eurozone economies, only Spain is currently seeing more infections per capita than France. Nevertheless, the number of hospitalisations and intensive care unit admissions for COVID-19 patients remains well below previous peaks, by a factor of 6 and 8, respectively, likely reflecting more testing capacities and more positive test results among younger people. Hence, the health care system looks far from being overwhelmed, and the government's strategy will likely remain unchanged, namely targeted and local measures to contain the pandemic, thus limiting the economic damage. Indeed, contrary to the services PMI, the Google Mobility Index for retail, leisure and work has continued to slowly improve during the month of September, not yet indicating any change in individuals' behaviour.

Inflation

Swiss Life Asset Managers	Consensus
2020: 0.6 %	2020: 0.5 %
2021: 1.2 %	2021: 1.0 %

Inflation numbers between June and August were very volatile, a major driver being the different timing of summer sales compared to last year. Annual clothing inflation for example surged to 11.6% in July, before dropping to -0.8% in August. We expect headline inflation rates to be less volatile in the months ahead, remaining in a 0.3-0.5% range until year-end.

UK
Brexit woes add insult to injury

GDP growth	
Swiss Life Asset Managers	Consensus
2020: -8.9 %	2020: -10.1 %
2021: 7.4 %	2021: 6.5 %

Our view on UK-EU trade negotiations has always been that "things need to get worse before they get better", a pattern we had already seen in previous years before critical Brexit deadlines. Currently, things are going according to script. This time, the government pulled the so-called Internal Market Bill out of the hat, a bill that should officially safeguard UK domestic interests if negotiations with the EU fail, but that directly contradicts the Withdrawal Agreement signed just months ago. Most probably, it is a means to put additional pressure on the EU in the trade negotiations that have yielded no progress so far. We indeed still believe that a narrow deal on goods trade should ultimately emerge. Both sides have a strong interest not to erect trade barriers, and despite contentious issues such as fishing rights, it should be easier to find common ground on goods trade than on the complicated Northern Ireland issue that was settled at the eleventh-hour last year. Nevertheless, a compromise will likely only be reached shortly before the end of December deadline, which implies continued uncertainty for businesses that are already confronted with a surprisingly sluggish recovery and uncertainty whether the job retention scheme will be prolonged beyond October 2020. Contrary to most other developed economies, "peak pessimism" has not yet been left behind. The 2020 GDP consensus estimate and our own forecast were revised down in each monthly forecast round since March and December, respectively.

Inflation	
Swiss Life Asset Managers	Consensus
2020: 0.8 %	2020: 0.8 %
2021: 1.5 %	2021: 1.5 %

The value-added tax (VAT) cut as well as the "eat out to help out" programme left its mark in the August consumer price inflation report. Annual headline inflation fell from 1.0% to 0.2%. We expect inflation to recover somewhat until year-end, before the unwinding of the temporary VAT cut will lead to a jump above the 1%-mark at the beginning of 2021.

Switzerland
Consensus forecast moves higher

GDP growth	
Swiss Life Asset Managers	Consensus
2020: -3.8 %	2020: -5.1 %
2021: 4.4 %	2021: 4.1 %

Switzerland's real GDP shrunk by 8.2% in the second quarter, which was exactly in line with our own projection. High frequency indicators and an accurate assessment of the impact of social distancing and lockdown measures on individual sectors allowed a precision landing despite the lack of visibility at the start of the quarter. It allows us to leave our forecast for 2020 at -3.8% for the fourth consecutive month. As incoming indicators came in better than feared by most analysts, the consensus estimate saw a noteworthy upward revision from -5.6% to -5.1% over the last month. The large exposure to the pharmaceutical industry, a comparably early reopening of the economy and a sweeping fiscal response to fight the recession help Switzerland to get away from the COVID-19 crisis with a black eye. All these factors remain in place, with the pharmaceutical industry benefiting from rising demand related to the search for treatments and vaccines to fight the pandemic. Potential renewed targeted containment measures to cope with a second wave of new infections may temporarily have a dampening impact on domestic economic activity in the services sectors. Meanwhile, as social life normalises gradually, the longer-term impacts of the crisis are coming to the surface: among them are the weak orders intake in the mechanical and electrical engineering industries and prospects of rising unemployment and corporate bankruptcies in the aftermath of the crisis.

Inflation	
Swiss Life Asset Managers	Consensus
2020: -0.5 %	2020: -0.7 %
2021: 0.6 %	2021: 0.2 %

Annual consumer price inflation is set to stay negative until early 2021, when base effects from very low energy prices will fade. While hotels were in the position to raise prices during the summer months, falling import prices are still offsetting price pressure in the domestic services sectors. At 0.6%, our inflation forecast for the coming year is the highest in the sample of 18 institutions polled by Consensus Economics Inc.

Japan
Suganomics follows Abenomics

GDP growth

Swiss Life Asset Managers	Consensus
2020: -4.8 %	2020: -5.6 %
2021: 2.6 %	2021: 2.6 %

Due to health reasons, Shinzo Abe stepped down as the longest-serving Japanese prime minister, handing over to Yoshihide Suga who was elected leader of the ruling Liberal Democratic Party on 14 September. Shinzo Abe's economic policies ("Abenomics") were pivotal in reviving economic growth and ending three decades of deflation. Following years of economic underperformance, Japan's real GDP per capita increased by 1.3% p.a. during the Abenomics years 2012-2019, twice as fast as in Switzerland and higher than in Germany or the UK. The track record on inflation might seem disappointing when looking at consumer prices, but much more important is the fact that pricing power of companies has risen. The GDP deflator, which also captures prices of investment spending and external trade, declined by a whopping 16% between 1994 and 2012, when Abe took power. Since then, it has recovered by 4%, supported by extremely loose monetary policy and structural reforms, which also helped to push growth of base wages into positive territory again. As reflected in the benign market reaction, we expect continuity in both monetary and economic policy under Prime Minister Suga. According to political analysts, the only potential change might be a slight shift of "Suganomics" from "macro" to "micro", i.e. a more industry-specific approach to reform (e.g. banking sector reform, sector-specific digitisation push).

Inflation

Swiss Life Asset Managers	Consensus
2020: 0.1 %	2020: -0.1 %
2021: 0.2 %	2021: 0.1 %

Shinzo Abe's resignation just precedes a renewed dip of consumer price inflation into negative territory, as positive base effects from last year's consumption tax hike drop out of the calculation in October. Underlying inflation has been weak due to underutilised capacities and a stronger yen, but the ongoing recovery should ultimately push inflation back above zero in the second quarter 2021.

China
Recovery gaining steam

GDP growth

Swiss Life Asset Managers	Consensus
2020: 2.5 %	2020: 2.2 %
2021: 7.4 %	2021: 7.9 %

China's economic recovery is gaining steam. Since the country has been successful in containing the spread of the pandemic, it has substantially eased its social-distancing measures. This shift has been evident in recent economic indicators. August retails sales have reached year-ago levels for the first time this year, while the official NBS Purchasing Managers' Index (PMI) for the services sector remained well in expansionary territory. Therefore, we expect the recovery in the services sector to pick up speed and revise up our annual GDP forecast to 2.5%, from 2.3% previously. However, headwinds remain: On the one hand, the government is determined to cool the property market, as housing prices in tier-1 cities started to soar. On the other hand, the US-China conflict is not abating. With multiple threats looming, such as restrictions of US technology exports to Chinese semiconductor company SMIC, the risk of a decoupling between the two superpowers has increased. This in turn would not only dent Chinese growth in the short-term, but also weigh on China's potential growth due to weaker productivity growth if technology transfer comes to an end. Moreover, a potential shift to the Democrats in the upcoming US elections would not necessarily be a boon for China, since the hawkish view towards the country is not limited to the Trump administration.

Inflation

Swiss Life Asset Managers	Consensus
2020: 2.7 %	2020: 2.8 %
2021: 1.9 %	2021: 2.0 %

Food prices in China continue to decelerate, as the country's pork supply continues to recover from the destruction the African Swine Fever caused. As we expect pork price inflation to continue to decelerate, Chinese consumer prices should continue to ease in the upcoming months. Meanwhile, core prices remained very low at 0.5%, showing that the demand recovery still has some way to go.

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Perspectives
Emerging Markets

Fourth quarter 2020

Key messages

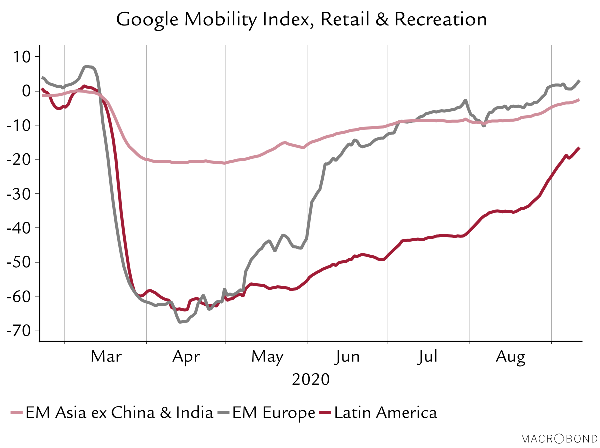
- China's economic recovery gains steam as consumption joins industrial recovery
- The economic recovery in Latin America lags other regions, as lockdown measures remain strict
- Monetary policy to remain supportive, but room for further rate cuts is limited

Number in focus

295

Emerging central banks slashed their interest rates by cumulative 295 basis points so far this year, to counter the hit the pandemic has caused to their economies. However, the easing cycle is coming to an end for most of the countries, as they await the impact of their record interest rate reductions to yet filter through to the economies. Still, monetary policy will remain supportive and will not be revoked any time soon, despite a slight uptick in inflation, triggered by currency depreciation and supply distortions.

Chart in focus



After a very sharp slump of economic activity due to containment measures to rein in the virus spread, emerging economies are gradually recovering. Based on Google mobility indices that measure visitor numbers in specific locations and compare them to the situation before the pandemic broke out, the recovery progress is, however, uneven. While emerging Asia (India excluded) and emerging Europe recovered rather swiftly, Latin America remains the laggard and will likely report among the weakest third quarter GDP prints this year.

Sharpest GDP contractions ever recorded

Emerging economies experienced their biggest contraction ever recorded in the second quarter this year, as lockdown measures to rein in the pandemic led to a virtual standstill of economic activity in some sectors. Not surprisingly, those countries that implemented the strictest lockdown measures, also suffered their sharpest GDP contractions. With its GDP shrinking by 23.9% compared to a year ago, 3.4 percentage points below consensus estimates India reported the second largest contraction in the emerging world, right after Peru. While first economic indicators point to a gradual improvement of economic activity in the third quarter, the pace of the recovery remains very uncertain. On the one hand, fiscal stimulus has been and is likely to remain limited, due to budget constraints. Moreover, on the pandemic front, developments are not encouraging, as India has the world's highest daily infection rate, which is not expected to decline any time soon. South Africa's strict nationwide lockdown implemented on March 27 delivered a big blow to its already ailing economy, with its GDP contracting by 17.1% in the second quarter. Meanwhile, a record-high unemployment rate of above 30%, weak confidence as well as longstanding issues, such as electricity outages that intensified, will constrain the country's recovery. Besides India and South Africa, the crisis dealt a violent blow to a number of Latin American economies, such as Peru, Mexico and Chile. This comes as no surprise, given that this region has experienced the pandemic in a particularly painful way, recording the highest mortality rates among emerging countries, while daily new deaths remain at elevated levels. As a result, in those countries containment measures remain among the strictest, according to the Oxford University's Containment Stringency Index, which will weigh on the future recovery progress in the last quarter of this year.

Brazil: recovering swiftly but at the backdrop of higher debt

While South American economies are suffering quite a bit from the pandemic, in Brazil economic activity is rebounding quickly. Brazil's second quarter economic contraction of 10% has been much less severe compared to peers. Moreover, retail sales reached pre-crisis levels already in the month of June and expanded by 5.5% in July from a year ago. Consumption in Brazil has been boosted by cash handouts to the informal sector and job protection programs. These monthly payments are to be extended until end of year, will however be cut by half. Therefore, although further readings are expected to show positive growth, the recovery progress will likely moderate. Meanwhile, Brazil's steady recovery in goods demand comes unfortunately at the cost of a considerably higher debt burden that is piling up rapidly and is widely expected to exceed 100% of GDP this year. While Economy Minister Guedes remains determined to keep governmental finances in check, he will likely be pressured by President Bolsonaro to keep fiscal aid ample. Despite the fact that Brazil suffers its deepest recession since record began, and although the very high coronavirus death toll continues to rise, Bolsonaro is enjoying all-time high popularity ratings that were boosted by the monthly cash handouts. If the debt burden is not contained later on, it could raise fiscal solvency concerns and dent investor confidence, which would result in higher interest rates and then again weigh on economic activity.

Chart 1: The stronger the lockdown measures, the sharper the economic slump

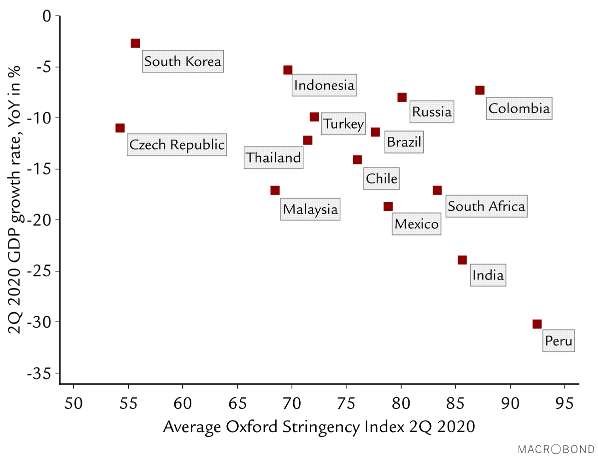
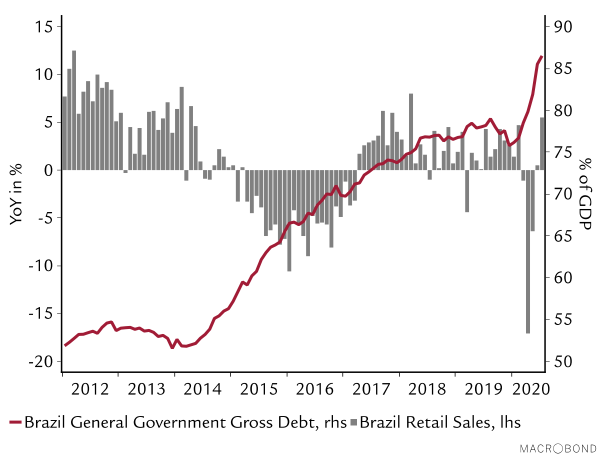


Chart 2: Brazil: Cash handouts boost retail sales, but fiscal position deteriorates



Turkey's fundamentals deteriorate sharply

Already before the pandemic outbreak, Turkey's economic fundamental situation has been weak, with a chronic current account deficit as well as a high burden of foreign currency debt, which both could not be covered with its foreign exchange reserves – leaving the country with a substantial need of foreign financing. Meanwhile, the pandemic has made this fundamental vulnerability much worse. The current account deficit is soaring once again, with exports and tourism revenue collapsing. At the same time, the country has wiped out a large amount of its foreign currency buffer in order to defend the Turkish lira. These developments are spooking investors and exert even more downward pressure on the lira, which already lost roughly 20% of its value against the US dollar so far this year. As lockdown measures have continuously been eased, and as the government rushed through a strong credit push, economic activity is recovering. Nevertheless, ongoing downward pressure on the currency is leading to inflationary pressure, which could hit economic activity once again.

China: demand follows supply side recovery

China's economy rebounded in the second quarter this year and expanded by astonishing 3.2% from a year ago. This strong rebound has been supported on the one hand by strong global demand for Chinese goods, such as medical equipment as well electronic devices, that kept exports buoyant. On the other hand, government stimulus measures have pushed real estate and infrastructure investments. Therefore, China's initial recovery path has been very much industry-driven, consumption and services have lagged. Meanwhile, however, China's economic progress is getting more even. While the country experienced new regional clusters of coronavirus infections, it has been able to avoid a further spread across the country. Therefore, it has substantially eased its social-distancing measures. This new shift has been evident in recent economic indicators. August retails sales surpassed year-ago levels for the first time this year, while also the official NBS non-manufacturing PMI remained well in expansionary territory, with a reading of 55.2. Therefore, we expect the recovery in the services sector to gain steam and revise up our annual GDP forecast to 2.5%, from 2.3% previously. However, headwinds remain, with pent-up demand for certain goods that will likely lose steam, and Beijing that is determined to cool the property market, as housing prices in Tier-1 cities started to soar. Moreover, the US-China conflict over a large range of topics, including financials, technology and geopolitics, is not abating. With multiple threats looming, such as bans of various Chinese applications as well as restrictions of US technology exports to Chinese semiconductor company SMIC, the risk of a decoupling between the two superpowers has increased. This on the other hand, would not only dent Chinese growth in the short-term via dented manufacturing investments and weaker exports, but also in the long-term, since China's potential growth would be hit due to weaker productivity growth if technology transfer comes to an end. Also, a potential democratic shift in the upcoming US elections would not be a boon for China, since the hawkish view towards China is not limited to the Trump administration. What could change however, is that policies under Joe Biden would likely be less unpredictable and shift away from trade and technology barriers towards human rights issues.

Chart 3: Turkish lira in free-fall amid depleted foreign currency reserves

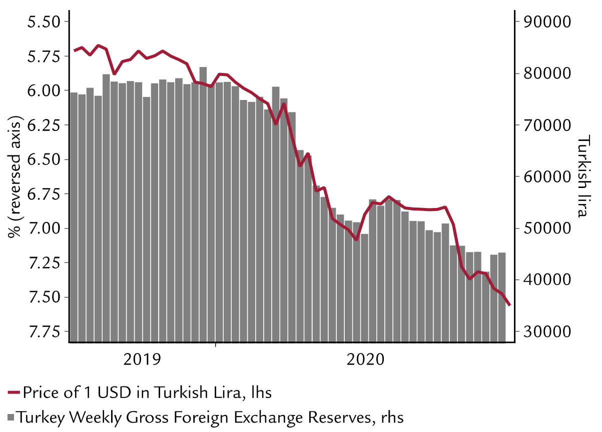
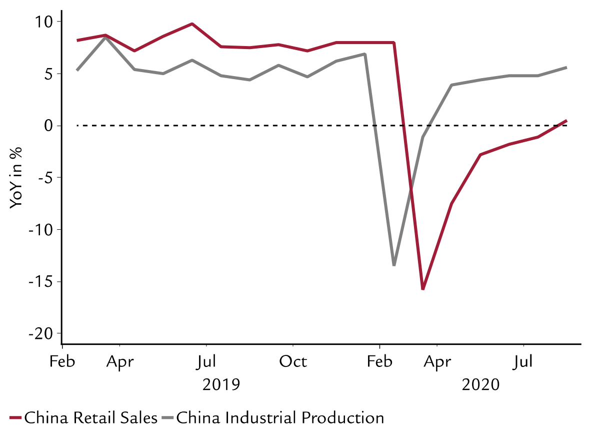


Chart 4: Consumption recovery joins the industrial expansion



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Perspectives
Financial Markets

Swiss Life Asset Managers

October 2020

Interest rates & bonds
Tempest in a teapot or beginning of a correction?

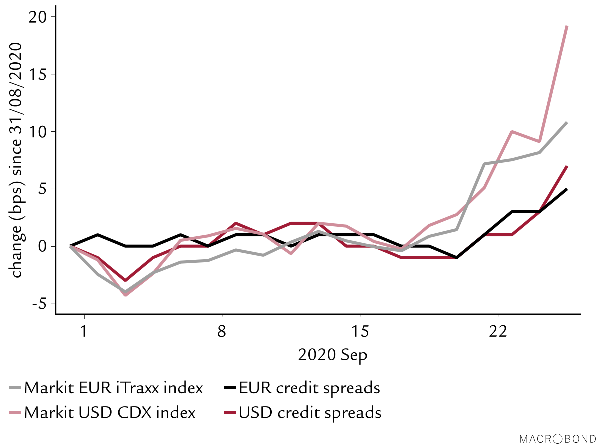
USA
- With the next fiscal stimulus bill unlikely to pass before the November election and support programs running out of money, the risks for the ongoing robust economic recovery are rising.
- Although the Federal Reserve reiterates that interest rates won't be raised anytime soon, Fed officials continue to emphasise the need for more fiscal spending.

Eurozone
- With the recent spike in infection numbers and renewed targeted containment measures, sentiment in the services sector started to decline again, showing the still fragile state of the economies.
- The ECB will not change its dovish stance anytime soon and we expect it to increase its various programs should financial conditions deteriorate.

UK
- The UK economy is confronted with continued uncertainty regarding UK-EU trade negotiations and new containment measures to check the recent sharp rise in COVID-19 cases.
- We believe the Bank of England could ultimately be forced to do more given the weak performance of the UK economy.

Switzerland
- In line with our view, Switzerland's economy performed better than most other developed nations and better than consensus had expected during the second quarter.
- Third-quarter data are encouraging so far, with the KOF leading indicator for August increasing sharply to 110.2 points.
- The SNB kept its policy rate unchanged at -0.75%, while sight deposits increased only moderately in September despite the "risk-off" environment in financial markets.

Credit: divergence between cash and derivatives market



So, it seems that there is a different direction for asset prices than just up. Especially for everybody's darling, the big US tech stocks, the rally came to an abrupt halt. While the September equity market dip spilled over to other markets to some degree, it remains to be seen whether this was just a tempest in a teapot or a prolonged correction. So far, credit spreads have not reacted too much. EUR and USD corporate bond spreads widened by about 5 basis points (bps, see chart) while government bond yields continue to fluctuate within the ranges seen over the past few months. However, looking at the credit derivatives market, the picture looks a bit more worrisome. The US CDX index is already 18 bps higher while the European iTraxx index is 10 bps wider. This shows us that investors are hedging their downside risk but are not willing to part with their long positions. However, that is something that can change quickly, and we are starting to see first outflows from investment grade credit ETFs. So, while it is not exactly a disorderly sell-off, one must tread carefully, especially with the plethora of political risks such as the US elections and the looming Brexit deadline. Technicals are still supportive, but this can change quickly. And in the bond market, one does not want to become a seller when everybody is running for the door. We therefore remain defensively positioned in credit and keep a long-duration bias.

Equities

How to prepare for the risks around the US election?

USA

- September was the first month since March 2020 with a negative performance of the S&P 500. Notably, information technology ("tech") stocks strongly underperformed the broad market, which reversed the outperformance of US equities vs. other regions during September.
- Idiosyncratic company news, a growing divergence between very strong equity markets and an economy still confronted with underutilised capacities as well as risks related to US elections might have contributed to profit-taking in September. We expect markets to trend sideways ahead of the elections.

Eurozone

- News about rising infection rates and new targeted containment measures, mostly in large European cities, weighed on Eurozone equities. But overall, Eurozone equities performed less negatively than US equities.
- Whether or not Eurozone equities will outperform US equities going forward will very much depend on one's view on the tech sector, which has a disproportionately higher weight in US indices.

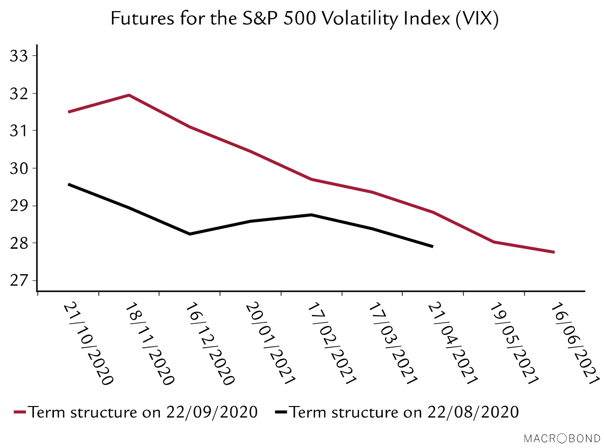
UK

- At the time of writing, UK equities posted a slightly less negative performance in September than global equities. Nevertheless, challenges abound. The recovery of the UK economy is still fragile and the uncertainty regarding EU-UK negotiations remains high, especially after the government's launch of the Internal Market Bill which increased tensions between the parties.
- We keep a cautious view on UK equities, as we think that both the economic and political risks are not fully discounted in current valuations of UK equities.

Switzerland

- Even though the Swiss equity market lost momentum, it was the clear outperformer in the month of September and remains one of the strongest markets year-to-date.
- The economic backdrop for Swiss equities remains more favourable than elsewhere. The Swiss economy was hit much less by the crisis than its neighbours and has huge fiscal headroom to respond to any deterioration of the situation.

The "election put" is not first choice – unless you want to sell



At this stage, the race between Donald Trump and Joe Biden for the US presidency is too close to call, and polls are also divided about the Senate race. In the likely event that the new president is confronted with a divided or even hostile Congress, the former already being the case now, continuity is quite likely and the impact on equity markets probably marginal. Meanwhile, a Democratic sweep, i.e. Joe Biden as president enjoying full support in Congress, is seen by many market participants as negative for equities due to Biden's plan for higher corporate taxes. However, the only result we should truly worry about is "no result at all", i.e. a lengthy, disorderly dispute about the outcome of the presidential race. This could leave markets in unchartered territory for an extended period resulting in a major drawdown. Even though a disorderly election is a worst rather than our base case scenario, it is certainly a situation many investors want to be prepared for. One way to do this is to cut off the tail risks to the downside at the expense of a lower participation to the upside. This calls for a solution based on equity put options. It is important to consider the volatility term structure to set up this "tail risk hedge" efficiently. Unfortunately, as can be seen in the VIX term structure above, the options which mature around the election date are the most expensive ones. Hence, this is good for premia collection, i.e. selling of options to finance the purchase of put options. As the latter are expensive around the election date, we would opt for longer maturities, as a "disorderly election" scenario likely has negative implications for equities beyond just the election date.

Currencies

USD might come again under pressure

USA

- Amid the general "risk-off" sentiment in financial markets, the USD strengthened in September, especially against cyclical currencies such as EUR, GBP and commodities-related currencies such as AUD or CAD.
- Nevertheless, we expect renewed USD weakness going forward. Interest rate differentials remain too narrow to lend any significant USD support. Also, we expect many potential outcomes of the US election to be rather negative for the greenback (see main text).

Eurozone

- After having hovered at around the 1.18 mark for one-and-a-half months, EUR/USD dropped in the second half of September. News about rising COVID-19 infections and new containment measures in the Eurozone have likely contributed to investors' caution regarding EUR.
- Our positive view on EUR/USD mainly reflects our expectation of general USD weakness until year-end (see above).

UK

- In line with our view, Sterling depreciated significantly in September, as tensions regarding EU-UK trade negotiations increased with the government's announcement of the Internal Market Bill.
- With these risks now better reflected in GBP exchange rates, we move to a neutral view on sterling against USD, but expect continued weakness against EUR.

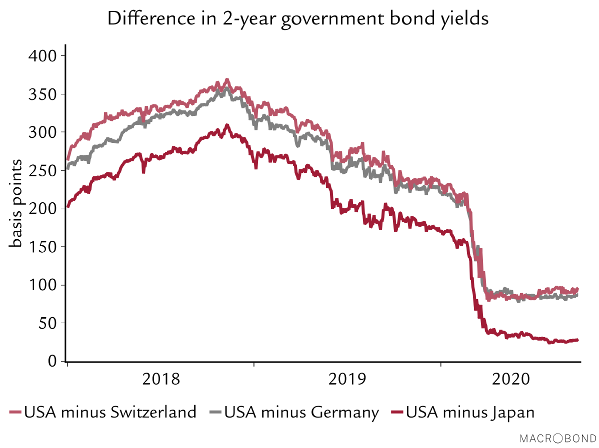
Switzerland

- Despite negative risk sentiment in financial markets, CHF traded in a very tight range against EUR in September. Meanwhile, the CHF depreciation against USD allowed the SNB to scale back currency interventions.
- We stick to our neutral view on EUR/CHF but expect the CHF to appreciate again versus USD.

Japan

- JPY showed broad-based appreciation in September.
- With many event risks, especially the US election, ahead of us, we opt for a positive view on JPY against USD.

Fading USD interest rate advantage



The US election is the dominating "known unknown" in the third quarter. There is not only huge uncertainty about the outcome, but also on the potential impact on asset classes and the USD. Generally, many analysts believe that an election of Joe Biden, who currently leads the polls, would be negative for the USD, especially if he were to enjoy full support in Congress. We tend to agree. In this constellation, we should especially prepare for a combination of even higher fiscal deficits due to generous fiscal stimulus plans amid continuously low interest rates. While Joe Biden will likely keep a hawkish stance on China, markets might still see less risks of a significant escalation of trade tensions due to a less confrontational approach to the trade issue. However, investors might move to a more cautious view on US equities due to Joe Biden's tax plans. All these arguments speak in favour of a weaker USD. If a President Joe Biden were to face a hostile Senate, the potential for USD weakness would obviously be somewhat lower. Meanwhile, a re-election of President Trump is unlikely to have any material impact on USD. The worst case of a disorderly election could ironically strengthen the USD as the greenback remains an important safe haven currency, but our conviction on that view is admittedly low.

All in all, we prefer a negative view on USD at this stage, also because a crucial support, namely the USD's interest rate advantage, has faded during the crisis and is unlikely to return anytime soon amid the very dovish stance of the US Federal Reserve (see chart).

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Perspectives
Asset Allocation

October 2020 – Third-Party Asset Management

Asset allocation
Cautious positioning ahead of the US elections

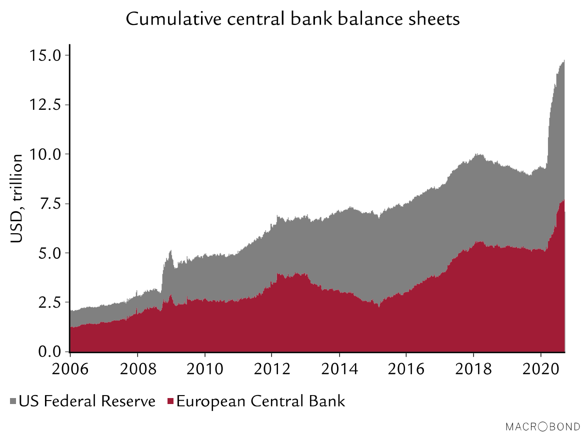
Summary
- Over the next few weeks, we expect a minor drop in long-term interest rates, with at least a partial reversal after the US elections.
- We are cautious on corporate bonds given that credit spreads are almost back at pre-crisis levels.
- We are also cautious on equities and prepare for tail risks related to the US elections.

Interest Rates & Bonds
- US treasuries continue to trade range-bound, with 10-year yields remaining in the 0.5-0.8% range that has persisted over the past six months. Given the uncertainty with respect to the US elections, we expect 10-year yields to decline somewhat in the short term, before they are likely to move up in the months after the election.
- While credit default swap (CDS) spreads have almost reverted to pre-crisis levels, we do not expect this to be of persistence. We think that the structural damage to certain sectors (e.g. travel & leisure) will leave its mark on credit sooner or later.

Equities
- Following the dip in September, we expect equity markets to move sideways ahead of the US elections.
- While the risk event of a contested election, i.e. a lengthy and disorderly dispute about the outcome of the presidential race, is not our base case scenario, it is a scenario that investors should be prepared for. Hence, we implement equity strategies with asymmetric pay-out structures, which allow us to dampen potential downside moves while participation to the upside remains intact.

Call for caution
With respect to our asset allocation, we would like to comment on a few hotly debated issues: First, even though central banks are flooding the market with liquidity (see chart), we do not think that an inflation surge is around the corner. However, it will remain a topic in the marketplace and it is a mid-term risk we are monitoring closely. Second, the recent rise in COVID-19 cases in Europe and the US are reminding us that downside risks to the ongoing economic recovery persist, risks not discounted in the lofty valuations of equities and credit. In our view, this calls for caution on risky assets. Third, the race for the US presidential and Congress elections remains wide open. Hence, it is too early to position for a certain outcome, but investors should hedge the risk of a contested election (see comment in the equity section).

Central banks' stimulus is dwarfing the response in 2008



Portfolio Implications
Hence, our current positioning is as follows: long duration, short credit, neutral on equities with protection to tail risks.

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