J. SAFRA SARASIN
ASSET MANAGEMENT

Cross-Asset Weekly

21 February 2020

Bond yields are grinding lower

Uncertainty about the extent and the duration of the current disruption caused by the Coronavirus outbreak continues to drive global fixed income markets. Investors are buying government bonds, and in particular US Treasury securities, as doubts about the global economic recovery are rising. This is highlighted by deeply negative term premiums on government bonds. Once the outbreak is perceived to be under control, we would expect that trend to be reversed. For now, government bond markets will continue to trade as a preferred asset of choice for hedging risk and yields will likely grind even lower.

In the FX-space, we expect the euro to remain under pressure in the near term as the current flight to safety favors the USD. We expect EURUSD to recover to 1.15 when the current disruption from the outbreak eases, while the South African rand should outperform the Brazilian real once the tide against EM eventually turns.

This week's highlights

Contacts

Dr. Karsten Junius, CFA
Chief Economist
karsten.junius@jsafrasarasin.com
+41 58 317 32 79

Raphael Olszyna-Marzys
International Economist
raphael.olszyna-marzys@jsafrasarasin.com
+41 58 317 32 69

Cédric Spahr, CFA
Equity Strategist
cedric.spahr@jsafrasarasin.com
+41 58 317 31 28

Alex Rohner
Fixed Income Strategist
alex.rohner@jsafrasarasin.com
+41 58 317 32 24

Dr. Claudio Wewel
FX Strategist
claudio.wewel@jsafrasarasin.com
+41 58 317 32 26

David Rees
Emerging Market Strategist
david.rees@jsafrasarasin.com
+41 58 317 51 36

Kunal Singh, CFA
Emerging Market Credit Analyst
kunal.singh@jsafrasarasin.com
+41 58 317 31 21

Thilina Hewage, CFA
Emerging Market Credit Analyst
thilina.hewage@jsafrasarasin.com
+65 6230 66 61

Walid Bellaha
Emerging Market Credit Analyst
walid.bellaha@jsafrasarasin.com
+41 58 317 51 57

Global Fixed Income

The premium that is negative

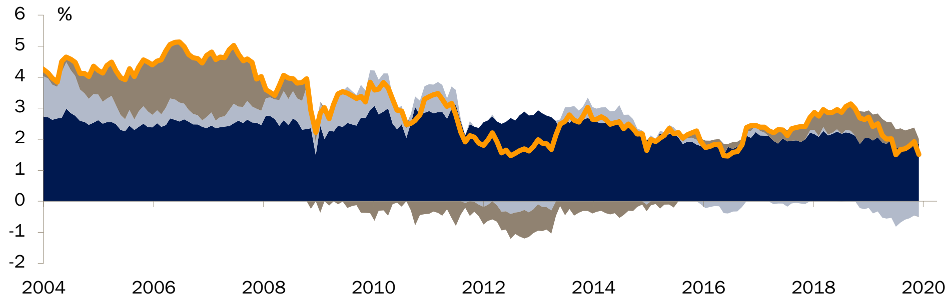
Alex Rohner
Fixed Income Strategist
alex.rohner@jsafrasarasin.com
+41 58 317 32 24

Term premiums for global government bonds have fallen substantially and are currently at deeply negative levels. Investors are prepared to buy these securities for insurance purposes as doubts about the effectiveness of monetary policy and geo-political risks are rising. The nascent global economic recovery should ultimately push the term premium and bond yields up. For now, government bond markets will continue to trade as an asset of choice for hedging risk and yields will likely grind even lower.

The term premium as a residual

A nominal bond yield can be decomposed into an expected path of short-term policy rates (risk neutral rate), compensation for expected inflation and a residual (term premium), which in the case of liquid government bonds concerns mainly duration risk. When this risk premium becomes negative, investors are prepared accept negative excess returns in exchange for the insurance properties and liquidity of the instrument

Exhibit 1: Decomposition of a 10y nominal Treasury yield



Source: Macrobond, J. Safra Sarasin, 20.02.2020

Term premiums on government bonds have dropped since the financial crisis

Term premiums on global government bonds have fallen substantially since the advent of the global financial crisis (GFC) and are currently at deeply negative levels. The unconventional monetary policy measures, instituted by major central banks (with the Fed starting to buy assets on an unsterilized basis at the end of 2010), have marked a structural break in the evolution of government bonds' term premiums (Exhibit 1). This erosion happened initially through several channels:

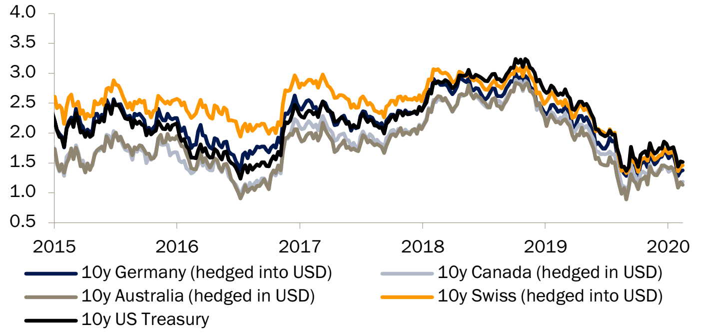
1) Explicit forward guidance removed much of the uncertainty with regards to future monetary policy and thus lowered the term premium on longer term government bonds.

2) The asset purchase programs reduced the supply of government bonds and extracted duration from markets. Portfolio re-balancing implied increased demand for longer term government bonds, which in turn reduced term premiums. In addition to that, increased financial regulation and the need to hold riskless and liquid assets on financial institutions' balance sheets has created additional demand for government bonds.

3) Unconventional policy measures have taken place in different parts of the world at different times. International portfolio shifts into higher yielding assets within a low-yield environment has led to increased interconnectedness of global bond markets,

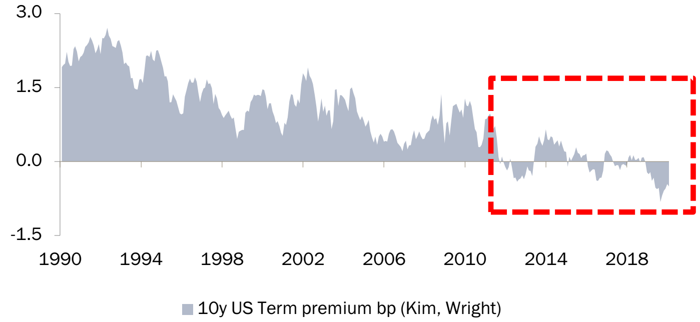
which has particularly exerted pressure on US yields, still the highest in the developed world (Exhibit 2).

Exhibit 2: International portfolio shifts have led to a higher degree of interconnectedness of global government bond yields



Source: Macrobond, J. Safra Sarasin, 19.02.2020

Exhibit 3: A structural fall in the US term premium has taken place

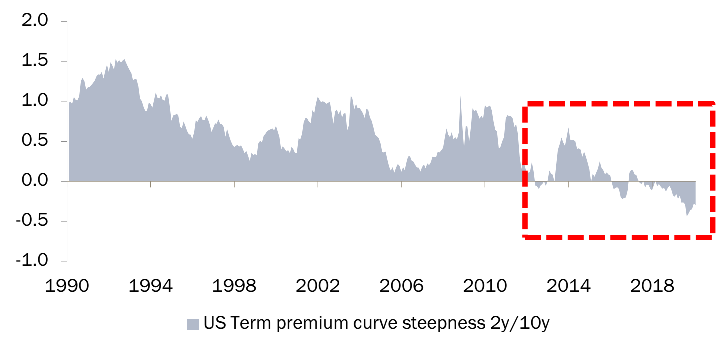


Source: Macrobond, J. Safra Sarasin, 19.02.2020

Geo political risks and doubts about central banks' effectiveness are also lowering term premiums

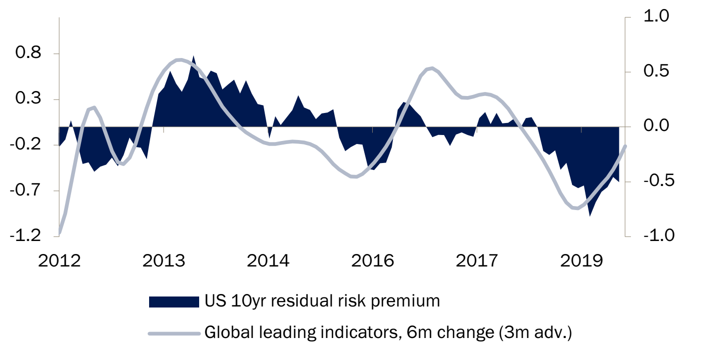
The US-China trade war and its wider implications with regard to geo-political tensions has raised uncertainty about the future architecture of global trade, while other political trouble-spots across the world have multiplied over the past years. These additional layers of uncertainty along with increasing doubts about the effectiveness of monetary policy have increased the attractiveness of long-term government bonds, also as a hedge against a sell-off in highly priced risk assets. The outbreak of the Coronavirus and the ensuing flight to safety is just the latest example of this general unease. Consequently, a structural fall in term premiums has taken place, both in absolute levels and the steepness of the term premium curve (Exhibits 3, 4).

Exhibit 4: The term premium curve 2y/10y is distinctly inverted



Source: Macrobond. J. Safra Sarasin, 18.02.2020

Exhibit 5: The global recovery should ultimately lift the term premium



Source: Macrobond. J. Safra Sarasin, 18.02.2020

Cyclical forces still have their role to play

In spite of the structural reasons for the compression of the term premium, which are unlikely to go away any time soon, cyclical forces are still important drivers for risk premiums (Exhibit 5). Loose monetary policy conditions and improving growth expectations are usually associated with rising (or less negative) term premiums. As the current recovery is likely to gain traction after the temporary effects of the virus outbreak have abated, we would expect this pattern to play out and bond yields to rise moderately. Until then, government bond markets will continue to trade as a preferred asset of choice for hedging risk with yields likely to grind lower.

FX Markets

The euro should hit its trough soon

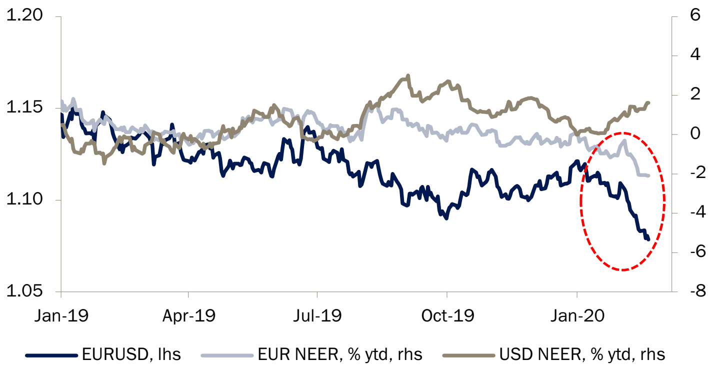
Dr. Claudio Wewel
FX Strategist
claudio.wewel@jsafrasarasin.com

The euro is likely to remain under pressure in the near term, but the trend should reverse once the spread of the Coronavirus becomes contained and concerns about the global recovery ease. We continue to see EURUSD at 1.15 towards the end of 2020.

Since January, the euro is down 3.5% against the US-dollar

The euro (EUR) has been under massive pressure in recent weeks. While the currency trended lower across the board, it exhibited particular weakness against the US dollar (USD). This week, EURUSD temporarily dropped below 1.08, down by 3.5% YTD and even on a trade-weighted basis, the euro has declined by 2% YTD (Exhibit 1).

Exhibit 1: EUR weakened particularly against USD



Source: Bloomberg, Bank J. Safra Sarasin, 20.02.2020

Exhibit 2: Recent market turbulence also caused yields to drop

Source: Macrobond, Bank J. Safra Sarasin, 20.02.2020

The euro suffered substantially from the unfolding Coronavirus outbreak

The reasons for this weakness are multi-fold. During the first two weeks of the year, the euro suffered from mounting tensions in the US-Iran conflict. In late January, the Coronavirus pandemic unfolded, causing equity markets to dip and global yields to drop substantially (Exhibit 2). In the FX space, USD and CHF benefitted from the flight in safety. While both currencies extended their gains vs EUR, yields remained at depressed levels.

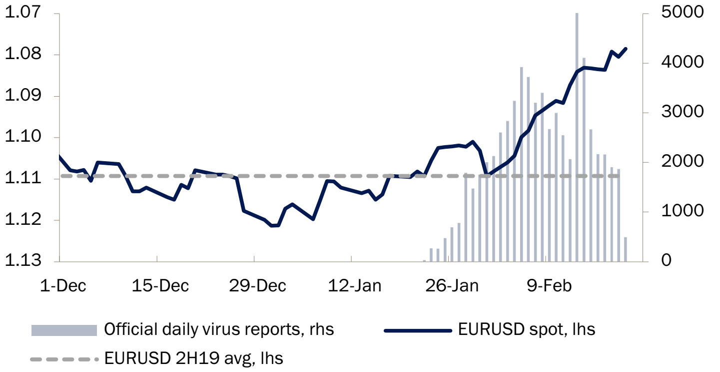
Beyond domestic production, quarantine measures are increasingly affecting export-led European firms' supply chains

Further EUR weakness seems possible in the near term. As WHO statistics indicate that the number of Coronavirus infections is currently still rising by 2'000 per day (Exhibit 3), Chinese authorities will likely extend their restrictive measures for longer. The quarantine shutdowns currently affect businesses in more than 20 provinces that account for over 80% of national GDP and should become clearly visible in weak Chinese Q1 industrial production figures. Moreover, the provinces under quarantine account for 90% of exports, which is disruptive for both new orders and supply chain channels of export-led European firms. Thus, how long the current EUR weakness is to persist should largely depend on the virus' containment. Though the February euro area manufacturing PMI came in stronger today, stronger evidence for a global recovery will be needed to reverse the current trend. Hence, markets will focus on the next releases.

Yet, the market's sudden revision of near-term EURUSD expectations looks overdone

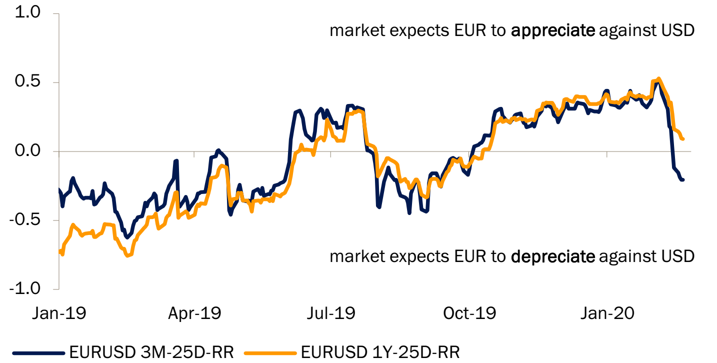
Risk reversals (RR) are an efficient way to understand the market's view on EURUSD. By construction, positive values indicate that the market perceives the odds for an upward move greater than for a corresponding downward move. Exhibit 4 shows the evolution of 25-delta risk reversals with maturities 3 months (3M-25D-RR) and 1 year (1Y-25D-RR) throughout 2019. The series reveal that from October 2019 to the end of January 2020, market expectations regarding EURUSD were predominantly positive and suddenly turned negative last week amid mounting concerns about the global recovery. Yet, the substantial drop seems exaggerated in our eyes. As the market continues to price some appreciation in the longer term, near-term expectations should unwind again.

Exhibit 3: EURUSD weakness catalysed amid the virus outbreak



Source: Bloomberg, WHO, Bank J. Safra Sarasin, 20.02.2020

Exhibit 4: Recent drop in near-term EURUSD RR looks exaggerated



Source: Bloomberg, Bank J. Safra Sarasin, 20.02.2020

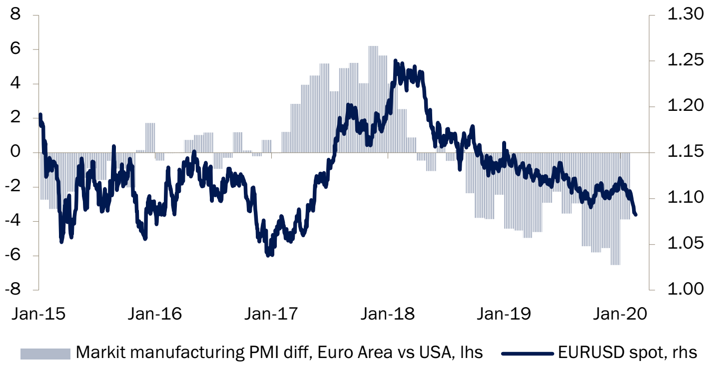
We expect EURUSD to recover once near-term disruptions fade

We consider the market's assessment to be too negative and continue to expect EURUSD at 1.15 towards the end of 2020. In particular, we expect that the euro should benefit from the following two tailwinds:

1. While current manufacturing PMIs for the Euro Area are still relatively weak compared to the US, both January and today's February figures support our view that the global economy has passed its trough (Exhibits 5 and 6). Given that February data surprised to the upside, markets will be scrutinizing March figures in order to rule out the possibility that the Coronavirus outbreak puts the recovery path at risk. We expect the recovery to gain more traction once the spread of the Coronavirus is contained. More positive news on lower daily infections should ultimately lend support to European manufacturing PMIs and close the gap to US data.

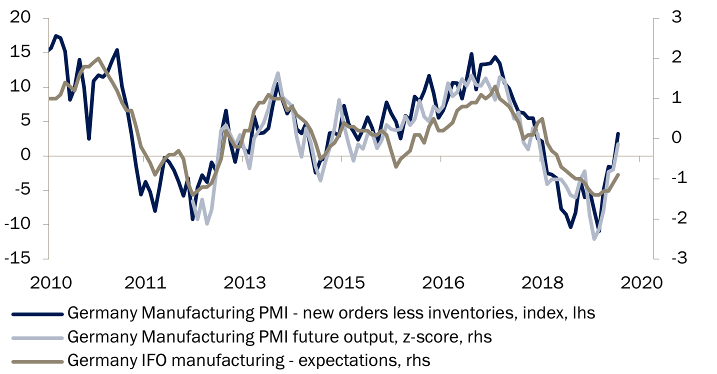
2. Although previous signals have been muted, we expect euro area finance ministers to commit to more growth friendly fiscal policies in 2020. The move has become more likely in the light of repeated calls from the ECB and the low interest environment, which allows for more budgetary flexibility. In any case, the measures should ensure that euro area recovery is on track.

Exhibit 5: The gap between Euro Area and US PMIs is closing…



Source: Macrobond, Bank J. Safra Sarasin, 20.02.2020

Exhibit 6: …as German indicators are rebounding



Source: Refinitiv, Bank J. Safra Sarasin, 20.02.2020

Emerging Markets

Rand or real?

David Rees
Emerging Market Strategist
david.rees@jsafrasarasin.com
+41 58 317 51 36

The Brazilian real and South African rand should stage some recovery once it becomes clear that the disruption from the outbreak of Coronavirus has eased. But historically low interest rates have made the real less attractive on a relative basis, suggesting that the rand will outperform when the tide against EM eventually turns.

Brazilian real and South African rand have underperformed in the recent EM sell-off

Emerging Market (EM) currencies have been under heavy pressure ever since the outbreak of Coronavirus in China. The Brazilian real and South African rand have been hit hard, and each have suffered year-to-date losses of 7% on a total return basis (Exhibit 1).

Both are high beta currencies and linked to commodity prices

It is not unusual for the rand and real to mirror each other's performance. After all, short-term movements in both currencies are closely linked to shifts in global commodity prices and these help to explain some of the recent sell-off. In addition, both are "high beta" currencies which means they tend to outperform during risk-on periods and underperform when sentiment sours as has been the case in recent weeks. With obvious evidence yet to emerge that activity in China is normalising, both currencies may continue to suffer in the face of risk aversions in the near term.

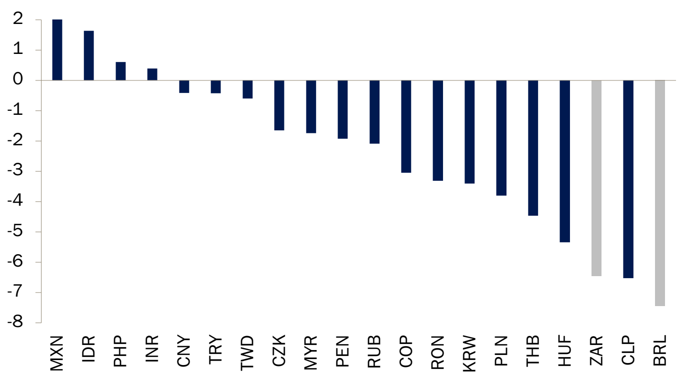
Structural economic problems means that the real and rand suffer trend depreciation

More generally, structural economic problems mean that the rand and real tend to suffer trend depreciation over the medium and long term. In particular, chronically low savings and investment rates mean that both economies have high public debt, while supply-side constraints manifest themselves in external deficits, low productivity and structurally high inflation. The consequence is that both the real and rand weaken over time in order to maintain external competitiveness and this explains why the two currencies have moved in almost lock-step for more than two decades (Exhibit 2).

Brazil's pension reform was a first step to tackling structural problems

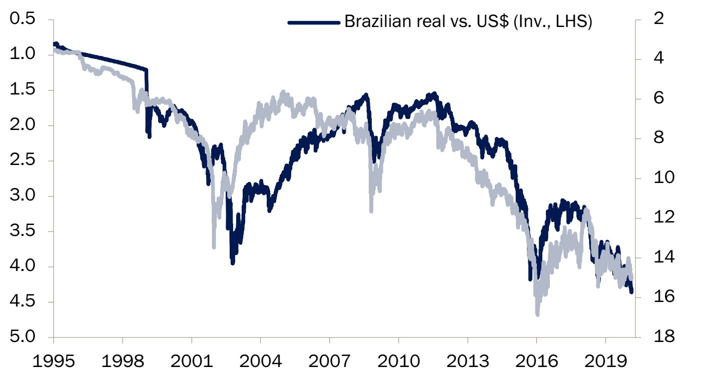
The Bolsonaro government in Brazil has of course taken some steps towards tackling these structural economic problems, in particular the pension reform that was passed last year. (See our Cross Asset Weekly, "*Brazil: Pension reform is only the first step to redemption*", 12th July.) The measures included in the pension reform ought to eventually raise domestic savings, lower public debt and ease external vulnerabilities all of which would support the real in the long term.

Exhibit 1: Total returns of EM currencies (%, Year-to-Date)



Source: Bloomberg, J. Safra Sarasin, 20.02.2020

Exhibit 2: The Brazilian real and South African rand have moved in lock-step for the past two decades

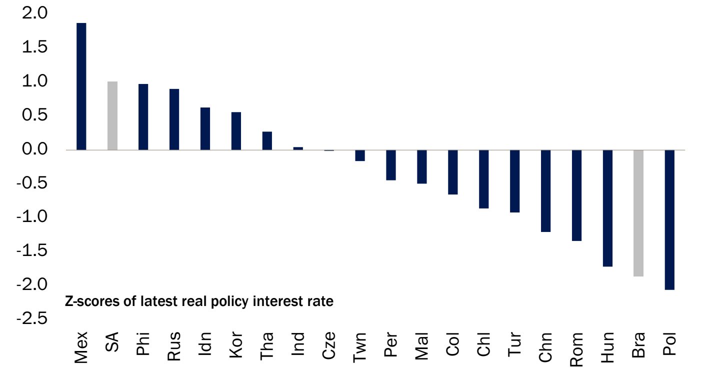


Source: Datastream, J. Safra Sarasin, 20.02.2020

Exhibit 3: Brazil's GDP growth remain unspectacular

Source: Datastream, J. Safra Sarasin, 20.02.2020

Exhibit 4: Real interest rates in Brazil are at historically low levels



Source: Datastream, J. Safra Sarasin, 20.02.2020

Brazil's central bank has cut interest rates to historic lows…

However, as we argued at the time, the pension reform has not unleashed a period of significantly stronger economic growth (Exhibit 3). The central bank has responded by cutting interest rates to historically low levels. But by removing the carry that investors had relied on in the past (Exhibit 4), the real has become less attractive. The Economy Minister, Paulo Guedes, recently noted that low interest rates and a weak currency are the "new normal" for Brazil which suggests that, while the central bank may step in to smooth the process, the government is happy to allow the real to weaken further.

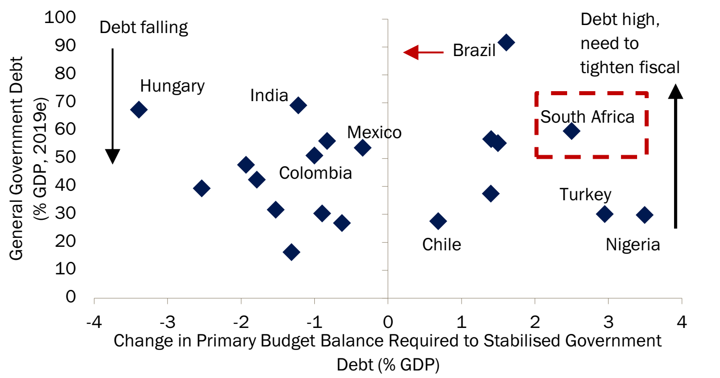
…which may continue to weigh on the performance of the real

EM currencies are likely to recover if, as we expect, China's economy rebounds from near-term disruptions. But while the real would benefit from a more supportive backdrop, low real rates mean it is unlikely to outperform in the way that it would have in the past.

South Africa also faces economic problems, but high real rates should ultimately underpin returns from the rand

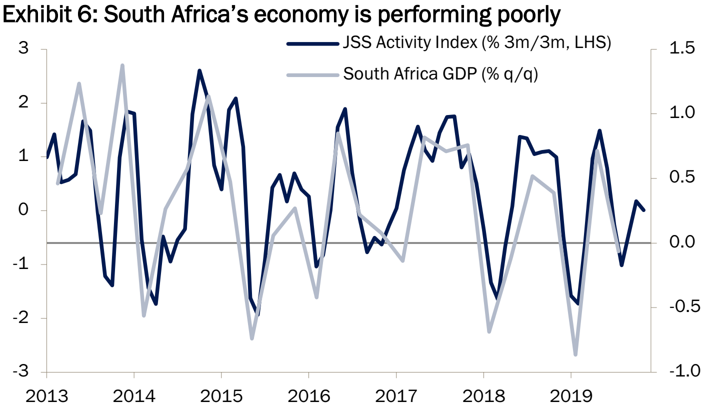
The rand also faces local headwinds. In contrast to his Brazilian counterpart, President Ramaphosa has so far failed to deliver on his election promise to implement major reform. South Africa's awful debt dynamics mean that the government is on a collision course with the rating agencies (Exhibit 5). Finance Minister Mboweni will have a hard time in next week's budget convincing Moody's, the only agency to still rank the government's debt as investment grade, to not downgrade the sovereign to "junk" during its March review. A downgrade could potentially unleash another wave of selling pressure on the rand. The good news for investors, though, is that the central bank has continued to operate tight monetary policy despite weak economic activity (Exhibit 6) and the large carry on offer should eventually drive solid returns.

Exhibit 5: South Africa's poor debt dynamics cloud outlook for the rand



Source: Datastream, J. Safra Sarasin, 20.02.2020

Exhibit 6: South Africa's economy is performing poorly



Source: Datastream, J. Safra Sarasin, 20.02.2020

Economic Calendar

Week of 24/02 – 28/02/2020

Country	Time	Item	Date	Unit	Consensus Forecast	Prev.
Monday, 24.02.2020						
US	16:30	Dallas Fed Manf. Activity	Feb	index	-	-0.2
Tuesday, 25.02.2020						
DE	08:00	GDP nsa, final	4Q19	yoy	-	+0.3%
	08:00	GDP wda, final	4Q19	yoy	-	+0.4%
US	15:00	FHFA House Price Index	Dec	mom	-	+0.2%
	16:00	Consumer Confidence	Feb	index	132.3	131.6
	16:00	Expectations	Feb	index	-	102.5
	16:00	Richmond Fed Manufacturing	Feb	index	-	20.0
Wednesday, 26.02.2020						
US	16:00	New Home Sales	Jan	1 000	709	694
Thursday, 27.02.2020						
DE	00:00	Retail Sales	Jan	yoy	-	+0.8%
US	14:30	GDP	4Q19	qoq	-	+1.4%
	14:30	GDP Annualized	4Q19	qoq	+2.2%	+2.1%
	14:30	Durable Goods Orders, prel.	Jan	mom	-1.5%	+2.4%
	15:45	Consumer Comfort	Feb 23	index	-	-
	16:00	Pending Home Sales	Jan	mom	+2.0%	-4.9%
	16:00	Pending Home Sales	Jan	yoy	-	+6.8%
Friday, 28.02.2020						
JP	00:30	Jobless Rate	Jan	%	2.2%	2.2%
	00:30	Job-To-Applicant Ratio	Jan	ratio	1.57	1.57
	00:50	Retail Sales	Jan	yoy	-0.9%	-2.6%
CH	08:30	Retail Sales Real	Jan	yoy	-	+0.1%
EMU	11:00	CPI Estimate	Feb	yoy	-	+1.4%
DE	14:00	CPI, prel.	Feb	yoy	-	+1.7%
US	14:30	Wholesale Inventories, prel.	Jan	mom	-	-0.2%
	14:30	Personal Income	Jan	mom	+0.3%	+0.2%
	14:30	Personal Spending	Jan	mom	+0.3%	+0.3%
	15:45	Chicago PMI	Feb	index	46.3	42.9
	16:00	U. of Mich. Expectations, final	Feb	index	-	92.6

Source: Bloomberg, J. Safra Sarasin as of 21.02.2020

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Bank J. Safra Sarasin Ltd
J. Safra Sarasin Research
General Guisan-Quai 26
P.O. Box
CH-8022 Zürich
Switzerland
T: +41 (0)58 317 33 33
F: +41 (0)58 317 33 00