Perspectives
Financial Markets

October 2021

Interest rates & bonds
Reflation is back on the menu

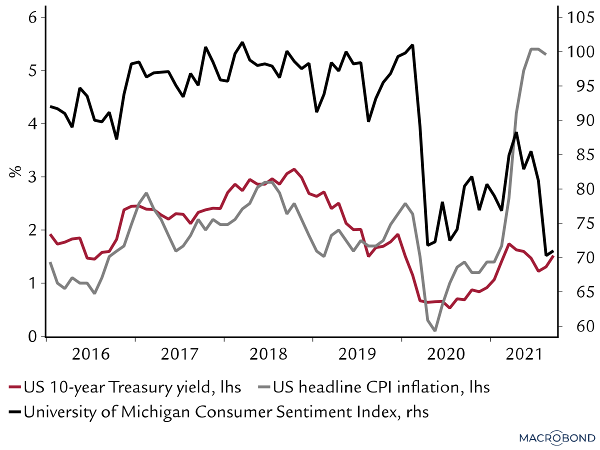
US
- US bond yields surged in September with the 10-year point moving up by 20 basis points (bps), and even the well-anchored short end increased by 9 bps as yield curves steepened.
- The September FOMC meeting was more hawkish than expected with chairman Powell all but assuring the start of tapering before the end of this year.

Eurozone
- German government bond yields likewise moved higher in sympathy with their US counterparts. In addition, the German election tail risk of a very left leaning government was removed. The yield on the 10-year bond was up 24 bps as curves steepened.
- ECB president Lagarde meanwhile emphasised that much of the inflation is due to temporary supply shocks and central banks should not overreact, thereby dampening any expectations for policy rate hikes in the near future.

UK
- UK government bonds were the clear underperformer in September with the 10-year yield hitting a new cycle high of around 1%, up almost 40 bps from the end of August.
- The Bank of England surprised markets by its overly hawkish statements with potential rate hikes only months away as the minutes showed that members had become increasingly worried about inflation.

Switzerland
- Bond yields in Switzerland maintained their strong correlation to EUR yields and moved up by 20 bps. The 5-year point reached its high from earlier this year at –0.5%.
- Compared to most other economies, Switzerland currently enjoys a healthy recovery without the flare up in inflation, putting no pressure on the SNB to tighten monetary policy.

Inflation spike depresses consumer sentiment



As credit spreads hibernate around record lows, interest rates globally continue their rollercoaster ride. Bond yields generally surged at the end of September, driven by increasingly hawkish central bankers on the back of heightened inflation fears. The high commodity prices especially and the bottlenecks on the supply side, from the shortage of semiconductors to the empty petrol stations in the UK, are creating very visible inflation examples. That said, many of these inflation drivers will likely prove temporary. Frictions in the economy make good headlines but are usually short-lived and resolve themselves through market forces. Moreover, given the strong fall in US consumer sentiment (see chart), we expect growth momentum to slow down. This should alleviate the pressure on the inflation front, even though inflation readings should settle above the US Federal Reserve target of 2% for the foreseeable future. As we have likely already passed the inflation peak in the US, we do not believe in a prolonged uptrend in bond yields. We rather see the latest move as an adjustment from the lows in the summer and expect the establishment of a new range. For risky assets, we believe that we could see another reflation-fuelled rally, albeit nothing of the sort we have seen over the last year. We have a cautious stance on duration while maintaining a neutral view on credit spreads, given the already tight levels.

Equities

Weak September, but positive mid-term outlook intact

US

- The US market was down 4.8% in September, thus recording the first negative month since January. The main causes for the correction were the uncertainty around economic developments in China, rising interest rates and political developments in the US. However, since the start of the year, the total return of the US market is still 16.7%.
- Due to the strong earnings season and the recent correction, the ratio of price to earnings came down from 30 to about 26. Nevertheless, the US market is still the most expensive of all major markets and we thus see only limited upside.

Eurozone

- The market was down 3.4% in September, while the year-to-date performance is still around 16.5%.
- Valuation and current economic dynamics favour the European over the US equity market.

UK

- In September, the UK equity market lost 0.5%, while the year-to-date performance is 11.4%.
- The UK equity market is a defensive market with the highest dividend yield of all major markets.

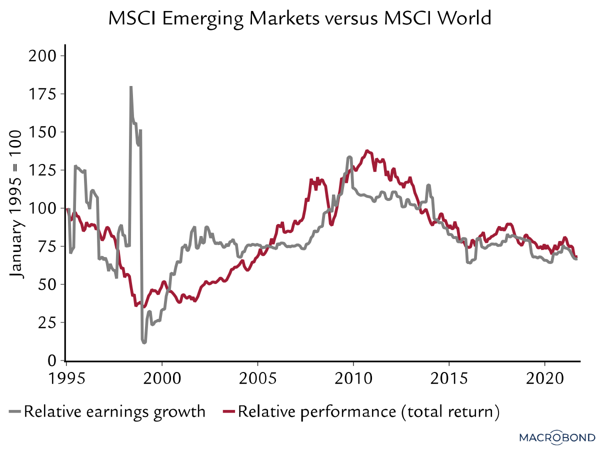
Switzerland

- The Swiss market had a return of –6.8% in September and its year-to-date performance is 12.9%.
- The main performance drag for Swiss equities was the pharmaceutical sector, which is an index heavyweight.

Emerging markets

- With a loss of 4.0%, emerging markets performed in line with developed markets in September. However, with a year-to-date performance of –1.1%, emerging markets are a long way behind developed market equities (14.2%).
- The valuation of emerging market equities relative to developed markets is attractive, but the political situation in China especially remains a cause for concern at this stage.

Emerging markets – risks and opportunities



Emerging market equities have performed poorly since the 2009 financial crisis as well as in 2021. Since 2009, they have underperformed the developed market index (MSCI World) by a staggering 160%, and the year-to-date performance differential is more than 15%. Even the long-term performance since 1995 is now below that of the developed markets. Since the inception of the emerging markets index in 1987, however, there is still an outperformance of almost 2% p.a. As the chart above shows, the relative long-term performance is closely linked to the relative earnings development. Hence, for emerging markets to stage a comeback over the coming years, strong earnings growth is key. The conditions are in place: productivity and population are expected to grow further, the current earnings and profitability levels are fairly low and an end to the pandemic would give these economies a boost. In addition, most currencies are undervalued. Over the short term, however, prospects are less clear. Chinese economic data is currently rather weak (e.g. credit growth has slowed, but seems to have bottomed out now), and the authorities have taken a much more restrictive approach in regulating technology companies and the property market. Since February, Chinese tech stocks (15% of the MSCI Emerging Markets Index) have underperformed their global peers by almost 50%. In other emerging economies, the pandemic is still virulent and vaccination rates are low. Any improvement in these indicators would warrant to move to an overweight in emerging market equities.

Currencies

Stronger USD and GBP due to early policy tightening

US

- Even though US economic data, notably the August labour market report, surprised negatively in September and the inflation data seemed to confirm the Fed's narrative of "transitory inflation", the Fed concluded its September meeting with a hawkish message (see main text).
- The resulting increase in bond yields led to a strengthening of the USD against all major developed and emerging market currencies in September, with RUB and CNY being the major exceptions.
- We expect continuous USD strength until the end of the year due to the USD interest rate advantage ("carry").

Eurozone

- In September, EUR lost 2% against USD but was broadly stable against CHF.
- Inflation surprises have now moved from the US to Europe, where spiralling gas and electricity prices are adding to inflation over the next few months.
- As the rise in inflation is likely to be temporary, we do not expect any hawkish shift by the ECB and reiterate our negative view on EUR/USD.

UK

- Despite ongoing supply chain issues in the UK, the Bank of England expects continuous progress of the economic recovery and signalled monetary policy tightening sooner rather than later.
- The hawkish shift was not reflected in exchange rates, with GBP/EUR moving sideways in September and GBP/USD heading lower. The latter should reverse its course in the next three months, in our view.

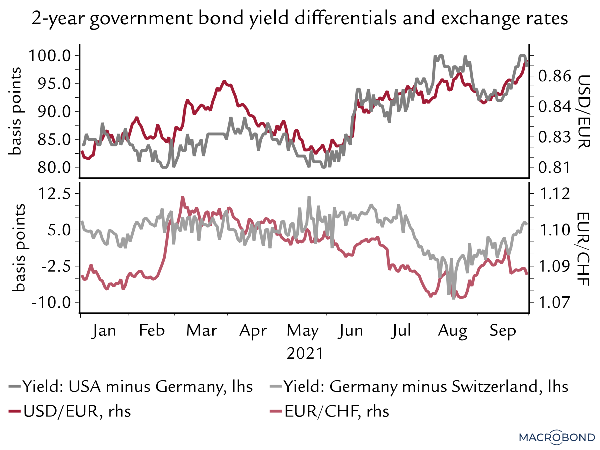
Switzerland

- EUR/CHF fluctuated between 1.08 and 1.09 in September.
- As yield differentials between Switzerland and Germany are narrow and unlikely to change given the alignment of the SNB's and ECB's monetary policy, we reiterate our neutral view on EUR/CHF for the next three months.

Japan

- JPY lost around 1% against USD in September.
- In line with our generally positive view on USD, we also have a positive view on USD/JPY for the next three months.

Yield differentials remain major driver for FX



In September, market expectations for monetary policy were again the most important driver for FX markets. Even though it was widely expected that the US Fed would verbally prepare markets for the upcoming reduction of asset purchase ("tapering"), the September FOMC meeting still managed to surprise investors on the hawkish side. The reason was the FOMC members' updated projections for policy rates (so-called "dot plot") that showed appetite for earlier and steeper rate hikes by most members. The current median projection for the end of 2022 is one 25 basis point hike, followed by two or even three more hikes in 2023. The two-year US treasury yield spiked as a result, while European 2-year yields moved much less, leading to a widening interest rate differential and a lower EUR/USD. Indeed, the interest rate differential ("carry") has worked best this year to explain moves in EUR/USD (see chart), and we expect the carry argument to lend continuous support to USD vs. all major currencies. Carry, or rather the absence of it, also remains the main argument for our neutral call on EUR/CHF. The only major currency that we expect to appreciate vs. USD is sterling. Following a hawkish shift by the Bank of England, which is in our view likely to hike its policy rate in Q1/2022 already, UK 2-year bond yields surged above the level of its US counterpart for the first time since 2015. Despite that shift in carry, GBP/USD sold off in September, a move that is likely to be reversed, at least partially, over the next three months.

Swiss Life Asset Managers

Marc Brütsch
Chief Economist
marc.bruetsch@swisslife.ch
@MarcBruetsch

José Antonio Blanco
Head Investment Management
joseantonio.blanco@swisslife.ch

Do you have any questions or would you like to subscribe to this publication?
Please send an e-mail to: info@swisslife-am.com.
For more information visit our website at: www.swisslife-am.com/research