Perspectives
Financial Markets

June 2022

Interest rates & bonds
Yields are becoming attractive

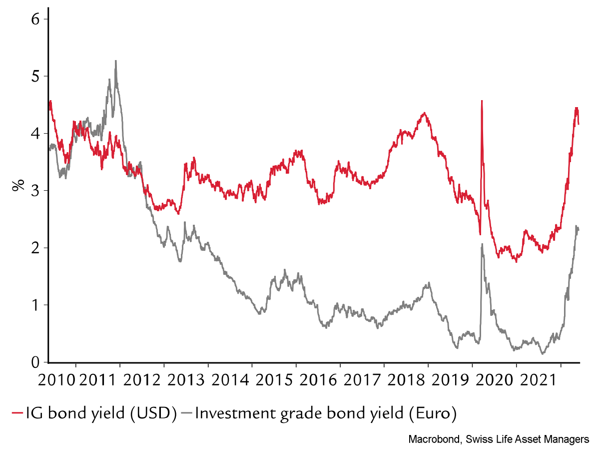
USA
- 10-year treasury yields peaked in May just north of 3.1% before the downturn in risky assets saw them drop to around 2.7%, while credit spreads initially widened by 14 basis points before ending the month largely unchanged.
- Should inflation fail to slow down over the coming months, the Fed might well have to accelerate its monetary policy tightening pace.

Eurozone
- EUR credit market continues to underperform its US counterpart as the ECB is more cautious. Credit spreads widened by 16 basis points in May while interest rates rose slightly.
- Markets are currently pricing in the first ECB rate hike for July and subsequent steps at the following meetings amid soaring inflation. Medium term it remains unclear whether the ECB will act as rigorously as the US central bank.

UK
- Interest rates in the UK dipped slightly in the first two weeks of the month but ended up largely flat.
- The BoE raising its key interest rate to 1% while simultaneously warning about looming recession risks was difficult for markets to digest. The BoE expects five more rate hikes in 2022 to curb inflation pressure which will also slow down the economy.

Switzerland
- Swiss government bond yields were the outlier as they continued to drop throughout the month of May. The spread versus German bunds is now back to -27 basis points, a level last seen before the pandemic.
- The SNB is likewise becoming more hawkish despite inflation still being relatively contained in Switzerland.

Yield of EUR and USD investment grade bonds



With the sharp increase in both interest rates and credit spreads, fixed income funds had their worst ever start to a year. Total returns for US investment grade (IG) bonds stood at -11.5% end of May, while the EUR counterparts gave up slightly less with -8.2%. Meanwhile, inflation is still way above central bank targets, geopolitical tensions are high and recession fears are mounting, making it difficult to become too excited about risky assets. However, investment grade credit is starting to look attractive again. EUR investment grade bonds currently yield 2.3%, a level not seen since 2013. US IG also offers attractive yields of 4.15%, almost equivalent to the peaks reached in December 2018 or at the Coronavirus pandemic outbreak in March 2020. While credit spreads could widen further in a slowing growth environment, interest rates should start to provide a hedge again against a downturn in risky assets. In addition, we expect to have reached a peak in both inflation and growth, which has historically been a good time to invest in government bonds. For the time being, however, we are still cautious on both duration and risk. While we expect a short-term dip in credit spreads, we would still use this market development to reduce exposure to lower rated or cyclical issuers and rather look for higher quality bonds out the curve.

Equities

Decent earnings season, attractivity vs. bonds reduced

USA

– In May, the US market was very volatile. It was down by 5% until 20 May, but a strong rally led to a much-reduced loss of 0.3% at the end of the month, leading to a year-to-date performance of -14.1%.
– Valuation has come down over the last months, but the US market is still expensive on an absolute and relative basis (against other equity markets).
– On a relative basis, the US monetary policy is the least accommodative.

Eurozone

– The Eurozone equity market gained 0.6% in May and has lost 10.4% so far in 2022.
– The earnings season delivered excellent results, despite the impact of the Ukraine war.
– Monetary policy is a two-edged sword for the Eurozone: on the one hand it is much looser than in the US, on the other hand there is a clear need for the ECB to tighten.

UK

– The UK market is still the best performing equity market this year. It gained 1.3% in May and 7.2% in 2022.
– The UK market has the lowest valuation and the most cyclical sector allocation of all major markets. For example, the weight of the energy sector is 14% while in developed countries it is only 5%.

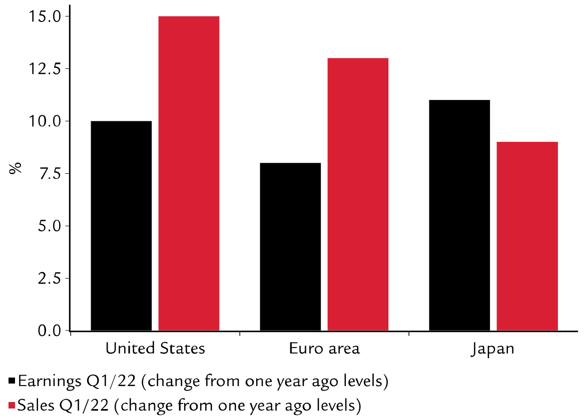
Switzerland

– The market was down 4.5% in May and is down 9.4% since the start of the year. In May, the market did not participate in the late month recovery elsewhere.
– The weak performance compared to other markets is mainly due to a very weak month for Roche and Nestlé. These two stocks have a weight of 32% in the SPI and they lost 7% and 10% in May, respectively.

Emerging markets

– Emerging markets gained 0.4% in May, with a year-to-date performance of -11.8%.
– Emerging markets suffer from several problems: a weak Chinese economy, high food and agriculture prices, rising US yields and severe repercussions from the Ukraine war.
– The valuation is attractive but concerns around the Chinese economy warrant a cautious stance for the time being.

Earnings Season, Earnings Outlook & Valuation



Sources: Macrobond, JP Morgan, Swiss Life Asset Managers

The earnings reporting season for the first quarter 2022 has just ended with very good results overall. Earnings grew between 8% and 11% versus first quarter 2021 and revenue growth was even stronger. As such, earning reports beat expectations by between 2% and 14%. The expectations for the full 2022 calendar year have profited from these positive surprises and they are higher than at the beginning of the year despite worries about rising inflation, interest rates and the Ukraine war. As analysts increased their full year earnings growth estimates, earnings revisions (upgrades less downgrades) have turned positive again. For 2023, expectations have only been reduced marginally. If these growth rates materialise, most equity markets would be currently priced at or below the historical average based on the P/E-ratio. Taken together, earnings outlook and valuation point to reasonably valued equity markets which could see a relief rally once the fears around persistently high inflation, stagflation and the war abate. On the other hand, bonds have become much more attractive relative to equities so that the TINA (there is no alternative) argument has less appeal than some months ago.

Currencies

A more committed Fed causes USD strength

USA

- In May, the USD weakened slightly versus Euro and Swiss Franc as markets started to price in an earlier start of monetary policy normalisation by the ECB and SNB than previously thought.
- In our view, the Fed remains more committed to fight inflation than its peers on the European continent which explains our call for a stronger Dollar in coming quarters.

Eurozone

- Given the renewed acceleration in inflation in May, the ECB needs to start its monetary policy normalisation earlier than previously expected. First rate hikes are fully priced in by now.
- However, the ECB is less committed to fight inflation rigorously than the Fed. We thus expect a renewed Euro weakness to follow once ECB has started to lift rates.

UK

- GBP/USD will decline in parallel to the anticipated Dollar strengthening in the weeks ahead.
- Risks to the upside for the Sterling would be a more hawkish stance by the Bank of England or improved risk sentiment amongst investors.

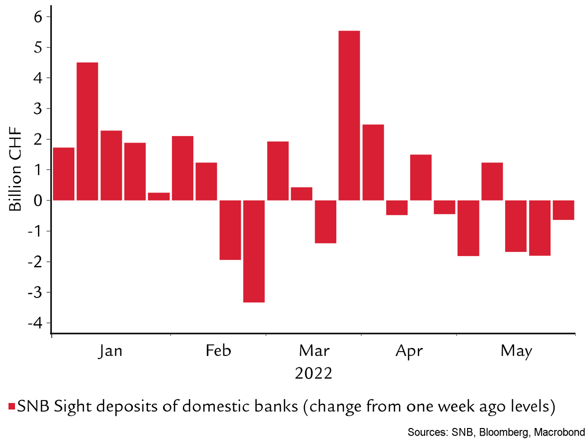
Switzerland

- Judging by the drop in sight deposits held by domestic banks, the SNB apparently has refrained from intervening in the FX markets in May.
- As the CHF is likely to remain a sought-after currency in the current geopolitical environment, we reiterate our negative view on EUR/CHF.

Japan

- The Bank of Japan is the last dovish central bank standing. Their rhetoric regarding its monetary policy outlook remains unchanged.
- USD/JPY stands near a 20-year high. At these elevated levels, we have a neutral view on USD/JPY.

Switzerland: Decreasing sight deposits



A development we have expected to happen earlier in the quarter, finally materialised in May: the USD weakened versus all major developed currencies. The reason was a repricing of market expectations with respect to monetary policy normalisation by the ECB and the SNB. In our view, the Euro appreciation should prove temporary even if deposit rates in the Eurozone are to turn positive in the next twelve months. The ECB is less determined in the fight against inflation than the Fed. Real interest rate differentials thus should support the USD going forward. In noteworthy contrast to our assumptions at the start of the year, we now expect the Swiss National Bank to also lift rates in the second half of 2022. This would be the first rate hike since 2007. Most recently, SNB interventions to prevent CHF from appreciating versus the Euro have become rare. Judging by the size of sight deposits held by domestic banks, the SNB abstained from intervening in May (see chart). We conclude that the SNB has a certain tolerance to let the CHF appreciate versus the Euro and continue to expect EUR/CHF to trend towards parity. The stubbornly high inflation differential between Switzerland and the Eurozone is driving the “fair” value of the EUR/CHF exchange rate ever lower. The Euro could come under additional pressure in case of more negative news flow regarding the Ukraine war and the latent risk of a sudden stop of gas deliveries that could plunge the Eurozone into recession. Risks to our call for a weaker euro versus US dollar and Swiss franc are related to an de-escalation of the war in Ukraine or cyclical tailwinds for Europe’s economies should China abandon its “zero-covid” policy. Both are unlikely events to happen, at least in the short-term.

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