Perspectives
Financial Markets

Swiss Life Asset Managers

July 2022

Interest rates & bonds
Shock and awe

USA

– US government bond yields had a rollercoaster ride in June after a higher-than-expected inflation print sent the 10-year yield up by more than 60 basis points (bps) to 3.5% before it fell again towards the end of the month. Credit spreads widened by 18 bps as the economic outlook deteriorated.
– The US Federal Reserve surprised markets with an outsized 75 bps hike in June to bring inflation back under control. Markets currently expect Fed funds rates to peak at 3.5% early next year but forecast policy rate cuts for the second half of 2023 as economic growth and inflation are expected to slow down.

Eurozone

– Credit spreads widened materially by 38 bps, spurred by both weakening economic fundamentals as well as waning technical support from central banks. Interest rates likewise rose sharply.
– Despite soaring inflation rates, the ECB is still committed to its communicated schedule of ending asset purchases now and starting to hike policy rates in July. Given strong increases in yields for Italian and Greek government bonds, the ECB is working on an anti-fragmentation tool to keep peripheral risk premia from soaring too much.

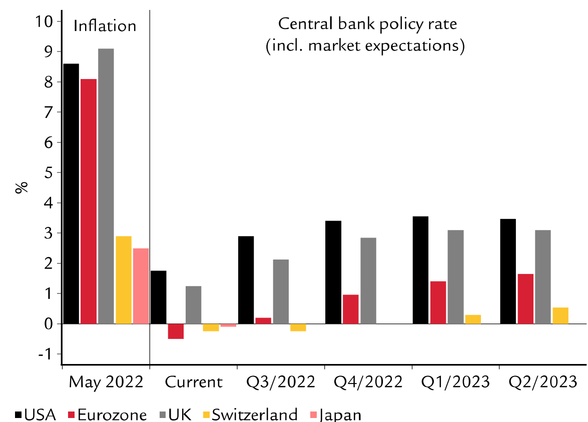
UK

– UK 10-year yields were equally volatile in June, increasing as much as 55 bps before falling again, ending the month 25 bps higher than at the beginning.
– The Bank of England (BoE) raised policy rates by another 25 bps with six more hikes being priced in by the end of the year.

Switzerland

– In line with global rates, Swiss government bond yields saw a sharp spike until the middle of the month before declining again.
– The SNB surprisingly hiked policy rates by 50 bps to lean against inflationary pressures before they become too elevated. The central bank is expected to increase the policy rate again in September.

Markets already expect a first rate cut in 2023 in the US



Source: Macrobond, Bloomberg, Swiss Life Asset Managers

After misjudging inflation for almost a year, central banks are now facing the difficult reality of tightening financial conditions into a decelerating global economy. Due to different central bank mandates and dissimilar economic backdrops, monetary policy responses have diverged quite substantially. The BoE, Fed and SNB have become more aggressive and are willing to bring down demand to achieve their 2% inflation target. Others like the ECB are already discussing new bond buying or anti-fragmentation tools before the first hike has even materialised. The Bank of Japan is even less concerned and is sticking to its yield curve control even if it means putting additional pressure on the yen. Nonetheless, higher rates and the end of asset purchases have already affected financial markets, which have lost trillions in value over the past months. In addition, the mantra of a strong economy that can handle higher rates is showing some cracks with incoming data indicating a deceleration while inflation will remain elevated for longer. We therefore think central banks will have to tighten financial conditions further and see an increasing likelihood of a recession both in Europe and the US. Given the weaker macroeconomic backdrop we see only limited room for 10-year yields to move higher and would start to reduce our short duration position. Regarding corporate bonds, we expect credit spreads to move higher.

Equities

Recession worries drag market down

USA

- June was another terrible month for the US equity market, which has entered bear market territory. The market lost 7.4% in June and is down 20.5% year-to-date.
- The decline in market valuation is one of the fastest in history. However, with an expected PE ratio (current price divided by expected earnings in one year) of 16.8, the market is in neutral valuation territory and not yet cheap.
- Estimates for earnings growth and margins have not come down meaningfully yet despite increasing recession risks.

Eurozone

- The Eurozone equity market lost 6.6% in June and 16.3% year-to-date.
- With a forward PE of around 12, the market is now attractively valued. However, the ECB will start to raise rates in July and the Ukraine war is taking its toll on the economy.

UK

- The UK market could not disentangle itself from other markets in June. It lost 3.2% but is still up 3.8% in 2022.
- The UK market is the cheapest major market. However, the Bank of England is raising rates quickly and the growth expectations for 2023 are very low.

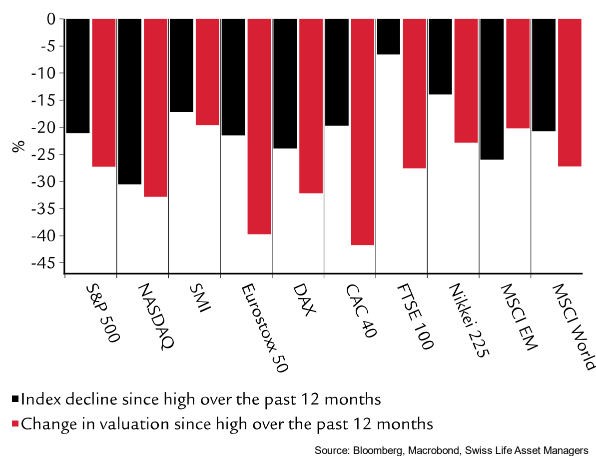
Switzerland

- The market is down 6.7% in June and 15.4% since the start of the year. The defensive character of the market did not materialise in better returns this year.
- Some index heavyweights can now be bought at valuation levels not seen for many years.

Emerging markets

- Emerging markets lost 4.1% in June. The year-to-date performance is –15.4% in USD and –11.6% in local currency.
- After a long period of underperformance, we observe signs of stabilisation and recently the market has slightly outperformed developed markets.
- There is less pressure to raise rates in emerging markets as real rates are mostly positive and China has embarked on monetary and fiscal stimulus because of the severe repercussions of the zero-covid policy. We have now established an overweight in emerging market equities.

Many indices have entered bear market territory



Most global equity markets have entered bear market territory in the last few weeks (defined as a loss of 20% or more from peak to bottom). The global equity market is down around 20% while the Nasdaq Composite Index even lost more than 28%. Valuations as measured by the expected price-to-earnings (PE) ratio have come down at least as much as prices. The decline in valuation is between 25% and 45% when measured by the expected PE ratio. This means that this bear market, contrary to many others, has so far not been driven by declining earnings expectations. Current valuations are now in line with historical averages implying a neutral valuation of equities if there are no downward adjustments to earnings. However, compared to low points in bear markets as well as previous phases of recession and high inflation, current valuations are still elevated. In the last two US bear markets in 2001-2003 and in 2008-2009, the valuation troughs (expected PE ratio) were 15 and 12, respectively. The current ratio is 16.8. However, back then, real interest rates were significantly higher. Another risk is that profit margins are currently at all-time highs and earnings growth estimates are around 10% for 2022 and 2023. In a mild recession, which is our base case scenario, such earnings growth expectations are too high and profit margins are set to contract. The earnings results for Q2/2022 that will start to be published in July will give an indication on what to expect in this regard. On the one hand, the current equity market valuation looks much more attractive than a while ago. On the other, we think a mild recession is not fully priced into markets yet. On balance, this calls for a moderately defensive stance, even if a short-term relief rally could happen anytime.

Currencies

EUR/CHF: parity is the new reality

USA

- In June, the USD was – together with the CHF – the best-performing developed market currency, appreciating almost 3% on a trade-weighted basis.
- Increased expectations regarding Fed monetary policy tightening and the general risk-off sentiment among investors contributed to USD strength.
- In our view, the Fed remains more committed to fighting inflation than its peers on the European continent and in Japan, which explains our call for a stronger USD over the next three months.

Eurozone

- The EUR weakened against the USD and CHF in June but appreciated against GBP and Nordic currencies.
- Rising recession risks and worries around bond spreads of Southern European economies will likely keep ECB policy makers relatively cautious despite elevated inflation. We expect further EUR weakness against USD and CHF over the next three months.

UK

- Sterling had a weak June as incoming data pointed to deteriorating momentum of the UK economy.
- We have a negative view on GBP/USD over the next three months, but expect GBP to move broadly sideways against the EUR.

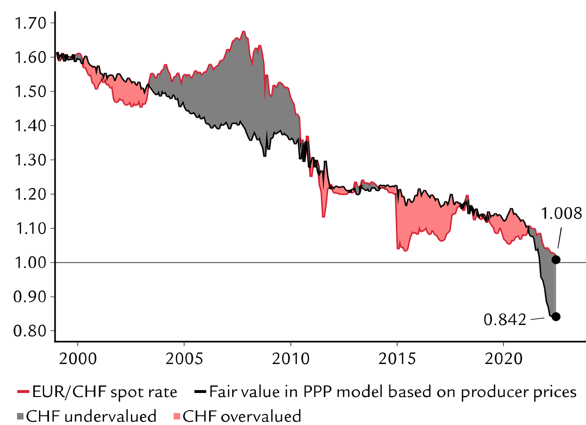
Switzerland

- CHF benefitted from the surprising SNB policy rate hike and reached parity against EUR at the end of June.
- The current risk-off sentiment among investors, geopolitical tensions, recession risks and a proactive SNB all speak in favour of further CHF appreciation against the EUR in the next three months.

Japan

- The Bank of Japan defended itself against speculative attacks on its yield curve control policy. Yield differentials to other developed markets thus widened and the JPY continued to depreciate.
- USD/JPY reached its highest level since 1998 and could continue to move higher in the near term given the Bank of Japan's willingness to maintain its ultra-expansionary monetary policy. On a three-month horizon, we expect, however, USD/JPY to trade somewhat lower as the JPY is now significantly undervalued.

EUR/CHF at parity, but possibly still undervalued



Source: Bloomberg, Macrobond, Swiss Life Asset Managers

The Swiss National Bank (SNB) provided the biggest surprise last month by increasing the policy rate by 50 basis points at its quarterly meeting on 16 June. The move came earlier than we and most market participants had expected, and the CHF thus strengthened around 2% against all major currencies just after the announcement. The CHF continued to strengthen during the rest of the month and reached parity against the EUR on 29 June. The most interesting element of the SNB's communication was not the rate hike per se, but the change in communication regarding the currency. Gone are the days when the SNB complained about the strong CHF. A stronger CHF seems now to even be welcomed by the SNB as it is a safeguard against imported inflation. This significant policy shift was made possible by the huge inflation differential between Switzerland and the Eurozone that has brought down the fair value of the EUR/CHF exchange rate. One way to assess the fair value of a currency is to look at purchasing power parity (PPP), i.e. the exchange rate that buys the same amount of goods in both economies. According to consumer prices, the CHF is still overvalued against EUR, implying that the price level in Switzerland is on average higher than in the Eurozone. If we look, however, at average producer prices, which contain more tradeable goods and are more relevant to assess the competitiveness of Swiss exporters than consumer prices, the CHF is now even significantly undervalued according to Bloomberg data (see chart). Hence, the CHF might appreciate further without triggering nervousness among SNB policymakers.

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