Perspectives
Financial Markets

SwissLife Asset Managers

October 2022

Interest rates & bonds
Signs of distress

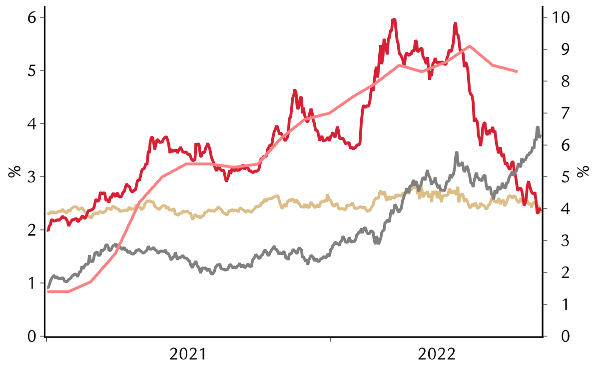
USA
- Government bond yields increased strongly over the past two months and the yield curve inverted ever more deeply with 10-year yields up 64 basis points (bps) and the spread to the 2-year yield inverting further to –44 bps.
- In September, the US Federal Reserve raised its policy rate by 75 bps in line with market expectations, but the forward guidance was very hawkish as Fed Chair Powell indicated further hikes and a potentially higher rate even in the event of a recession.

Eurozone
- 10-year German Bund yields soared 55 bps in September as the yield curve flattened further. The “risk-off” sentiment in financial markets and political risks in Italy increased the yields for Italian debt even more, topping the critical 250 bps spread level vs German Bund yields.
- The ECB is finally taking inflation seriously and raised rates by 75 bps in September while indicating more hikes to come. Markets are pricing in a policy rate peak at around 3% in 2023 despite the dire outlook for the European economy.

UK
- UK yields went haywire following the announcement of a fiscal spending spree, which markets did not take well. Bond yields soared, and sterling plunged to a record low against the USD.
- The Bank of England’s policy rate hike by 50 bps was merely a drop in the ocean as the government poured oil into the inflation fire with tax cuts for the rich and a huge stimulus package to offset the impact of high energy prices.

Switzerland
- While Switzerland remains the exception with a relatively modest 3.5% inflation rate, bond yields still increased by around 50 bps in September.
- The SNB continues to proactively tackle the inflation problem and recently raised the policy rate by 75 bps bringing it back into positive territory.

US inflation expectations drop while interest rates rise



Source: Macrobond, Bloomberg, Swiss Life Asset Managers

September is not usually a good month for bond investors and this month proved to be no exception. Total returns for EUR investment grade (IG) and USD IG bonds were deeply negative at –2.8% and –4.7%, respectively as central banks are committed to bringing down inflation no matter the costs for financial markets or the global economy. Given the central banks’ focus on inflation and the labour market, both lagging economic indicators, the US Fed in particular might choose to overlook the first signs of easing inflationary pressure. Such signs can already be seen in commodity markets and market-implied inflation expectations, which have been in a downward trend since June (see chart). In Europe, the inflation story remains highly unpredictable due to the energy crisis and the ongoing fiscal response to it. Given the ongoing monetary policy tightening despite elevated recession risks, financial markets have started to show signs of distress in recent days with outsized daily moves especially in foreign exchange and fixed income markets. While credit markets are still holding up relatively well amidst very low new issue volumes and conservatively positioned investors, the prospect of a deeper and longer slowdown could start to weigh on credit spreads again. We are therefore maintaining our defensive stance on credit risk and keeping a short duration bias, as pressure on central banks to raise policy rates remains high.

Equities

Hawkish central banks put pressure on markets

USA

- The US equity market lost 7.8% in September and the year-to-date performance is now –23.8% (all data in this column as of 27 September). The main drivers of the negative performance were hawkish central bank statements coupled with substantial rate hikes and inflation prints above expectations.
- The valuation is still high (see extended analysis in the column on the right). This contrasts with the other main equity markets, where valuation is now below historical averages in many cases.
- Investors' positioning is very bearish and comparable to the lows seen during the Covid crisis.

Eurozone

- The Eurozone equity market lost 6.0% in September and has lost 22.1% year-to-date. Geopolitical risks have increased substantially.
- The valuation of Eurozone equities is low and value stocks are trading at around a P/E-ratio of 9.

UK

- The UK market is still by far the best performer this year. It has only lost 0.1% since the start of the year while the September performance was –3.8%.
- The UK market is still the market with the lowest valuation. Its forward P/E-ratio is around 8 and the dividend yield is 4.1%.

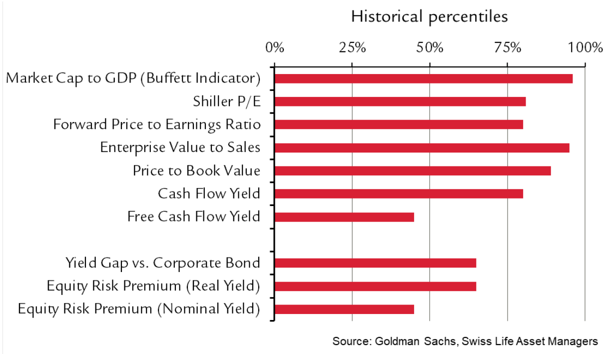
Switzerland

- The Swiss market was down 7.0% in September. The year-to-date performance is –21.1%. The generally defensive character of the Swiss equity market has not worked out this year.
- Losses of more than 40% of several equities that had performed strongly in the past, such as Geberit or Partners Group, are one explanation. Also, out of the big three only Novartis did comparatively well.

Emerging markets

- Emerging markets lost a whopping 10.1% in September in USD terms. The year-to-date performance is –25.9%.
- Asian emerging markets with a weight in the overall index above 70% were again the key driver of this weak performance. Hence, the fairly good relative performance of European and Latin American emerging markets (both –3.7%) could not compensate for the weakness in Asia. The Chinese market lost around 12% in September.

Current valuation of US equities in historical comparison



Depending on the valuation metric, the valuation of the US stock market is between neutral and expensive in the historical context. Looking at absolute valuations (the first seven indicators in the chart above), the current price-to-earnings-ratio based on the methodology of Nobel laureate Robert Shiller ("Shiller PE") is in the highest 20% bracket, while the Warren Buffett metric (market cap to GDP) is at the 96th percentile, i.e. it has only been higher in 4% of all historical observations. The free cash flow yield, however, is currently lower than over 50% of past observations. The free cash flow indicates how much money a company has left for cash distributions (e.g. dividends). The relative valuation metrics of equities vs. bonds (the last three indicators in the chart) look significantly better and indicate a broadly neutral valuation.
The current valuation is rather high given the increasing likelihood of a recession in the US. Historically, the low point of the forward P/E during recessions has been around 12 while the current value stands at around 17 for the US market. If we add in the risk of corporate margin compression and declining earnings, one may conclude that the outlook is indeed not great. We note that the valuation of the other major equity markets is much lower and, in many cases, now below the historical average. European and emerging market equities are now outright cheap. Nevertheless, valuation is a mid-term indicator which is not useful for timing decisions. Even though the mood of investors is very negative, net flows into equities are much higher than the bleak picture may suggest. We are retaining a negative outlook for equities for now, but we would use excess pessimism as a buying opportunity.

Currencies

CHF solid as a rock in a sea of European weakness

USA

- After a strong month in August, the USD appreciated further in September, gaining 4% on a trade-weighted basis.
- We still think that the Fed remains the most committed central bank in fighting inflation. In combination with an already attractive interest rate advantage ("carry"), we expect the USD to remain strong.

Eurozone

- The ECB delivered additional policy rate hikes in September, with more hikes likely to come as inflation in the Eurozone continues to surge.
- However, the energy crisis is deepening, and surveys suggest that the Eurozone might have already entered a recession. In combination with (geo-)political risks, we think that EUR/USD will remain on a downward trend until the end of the year.

UK

- Sterling collapsed after the announcement of the expansionary "mini budget" by the new government.
- Emergency interventions by the Bank of England helped to restore order on the bond market and also led to a temporary stabilisation of GBP exchange rates. However, Prime Minister Liz Truss reiterated her intention to move ahead with the proposed tax cuts, and we think the GBP will remain under pressure in the upcoming months due to the rapid deterioration of public finances.

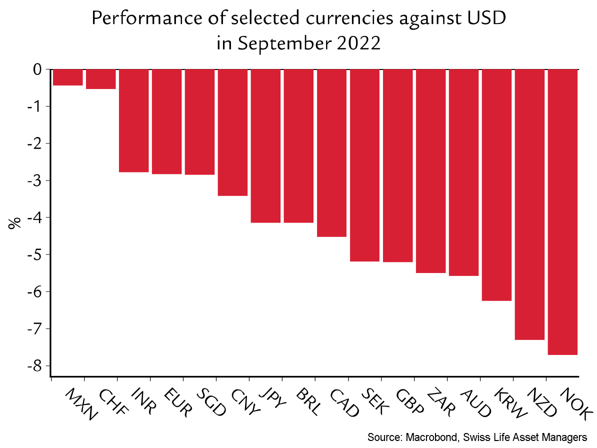
Switzerland

- CHF was the best-performing major currency in September just after the USD.
- Even though the SNB is now merely following other central banks in terms of policy rate hikes, we expect the CHF to be a sought-after currency in the current "risk-off" market environment. We are thus reiterating our negative view of EUR/CHF.

Japan

- USD/JPY moved higher in early September before stabilising at around 145.
- We have a neutral view of USD/JPY. The Bank of Japan will likely stick to its ultra-expansionary monetary policy, but the JPY is now so drastically undervalued that further depreciation potential appears limited.

USD gains against all major currencies in September



September brought another month of USD strength as the US Federal Reserve stepped up its hawkish rhetoric and remains on a rapid tightening course to curb inflation. Central banks in Europe also delivered substantial policy rate hikes in September, but many investors (us included) appear to question their resolve as many European economies are about to enter recession caused by the energy crisis. The EUR additionally suffered from increased geopolitical risks and sharply rising borrowing costs for Italy that may limit the ECB's room for manoeuvre. The worst performers in Europe were GBP and NOK. The GBP collapsed as investors lost confidence in the new government following the presentation of its "mini budget", which includes significant unfunded tax cuts and will boost debt issuance already in the current fiscal year. Significant rate hikes by the Bank of England and/or some backpedalling on the budget will likely be needed to restore confidence in the British currency. The weakness of the NOK meanwhile was a result of hints by the Norges Bank that it may slow the pace of monetary tightening and the result of lower oil prices. We think that the fundamental drivers for foreign exchange markets will remain broadly unchanged until the end of the year. Hence, we continue to expect a strong USD driven by monetary policy tightening and weak European currencies due to a deepening energy crisis. Within Europe, the CHF will likely remain the outlier, as rising geopolitical risks should continue to support it.

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