# Perspectives
## *Financial Markets*

Swiss Life Asset Managers

*March 2023*

## Interest rates & bonds

The inflation fight is not over yet

*USA*

- February saw somewhat of a countermove to January with 10-year Treasury yields rising by 40 basis points (bps) and corporate credit spreads widening by 7 bps.
- With both inflation and economic growth remaining robust the market started to reevaluate the US Fed's policy path with no more policy rate cuts being priced in 2023.

*Eurozone*

- 10-year government bond yields in the Eurozone likewise rose by more than 30 bps, with German Bunds reaching a new cycle high of 2.65%, which surprisingly did not hurt credit spreads. The latter tightened by 5 bps.
- Having avoided an energy crisis this winter, Europe's economy reaccelerated with Purchasing Managers' Indices (PMI) crossing back into expansionary territory. This will likely force the ECB to tighten monetary policy further to rein in inflation.

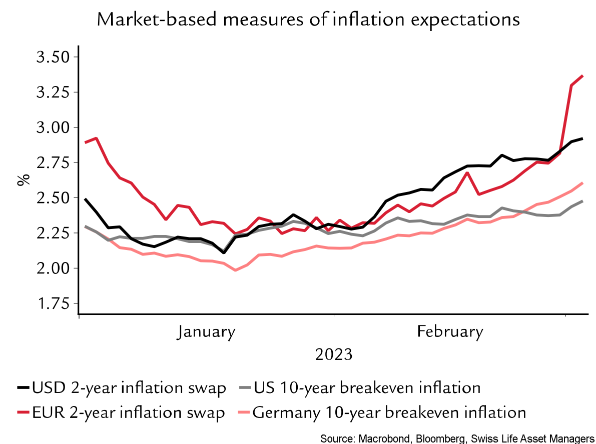
*UK*

- UK 10-year yields rose even more (+53 bps) and are starting to approach the levels at which the Bank of England (BoE) had to intervene in September, although the current widening is much more orderly.
- PMIs and retail sales also showed an unexpected reacceleration with the services sector being especially strong. This also puts more pressure on the BoE to tighten monetary conditions.

*Switzerland*

- 10-year government bond yields rose 20 bps in February, while credit spreads are more or less flat as the initial tightening faded in the second half of the month.
- Swiss economic data remains mixed, while inflation in January re-accelerated more strongly than expected by the consensus.

*Inflation expectations on the rise*




Having had one of the strongest starts to the year in recent history, fixed income investors saw their returns diminish again in February as government bond yields rose markedly. Corporate bonds, however, held up better with USD credit spreads widening and EUR spreads slightly tightening despite much more hawkish central bank expectations. In the US, investors are now seeing a terminal rate of 5.6% while the ECB is expected to reach 4.0% at the time of writing. While tighter financial conditions are negatively affecting asset prices, the improving macroeconomic picture seems to offset those for the moment. In Europe especially, investors appear to be comfortable amid very attractive all-in yields, corporate earnings holding up well, sentiment improving and a more benign energy situation. While we find investment grade credit to be one of the most attractive asset classes in the current environment, we still see risks ahead that could stem from increased risk aversion. Looking at recent data, it seems clear that financial conditions need to become tighter, and growth needs to slow further for inflation to get back to the central banks' 2% target. We do not think this will be possible without causing harm to financial assets. We therefore still see credit spreads widening. Government bond yields are closer to their peak levels in our view and should fall as the tighter monetary conditions negatively affect the economic growth outlook.

# Equities

Upward trend broken

*USA*

- The US equity market lost 2.4% in February leading to a year-to-date performance of +4.0%. Rising bond yields due to inflation concerns and better-than-expected economic data were the main reasons for the negative performance in February.
- The earnings season ended better than expected, but with negative earnings growth (see details in the article on the right-hand side).
- The valuation of the market is still above the historical average. We continue to prefer non-US markets.

*Eurozone*

- As in January, the European stock market outperformed the US market. It gained 1.6% and the year-to-date performance is +11.4%.
- The European market is benefitting from a much lower valuation and a short-term tailwind from lower-than-expected energy prices.

*UK*

- The UK market was the best performer in February with a performance of 1.9%. For the year-to-date, the market gained 6.1%.
- The UK market is benefitting from the lowest valuation of all major markets. However, the economy is weak, and inflation remains a major concern.

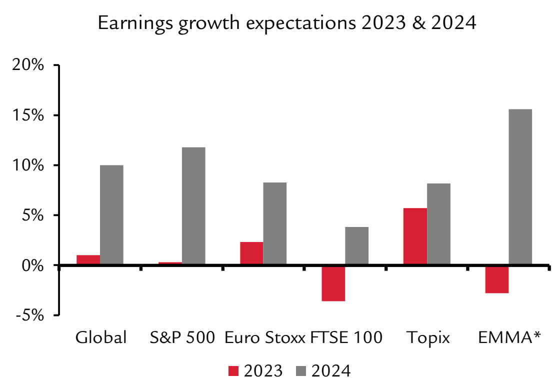
*Switzerland*

- The Swiss market lost 1.5% in February bringing the year-to-date performance to +3.8%.
- As in January, the three index heavyweights Nestlé, Roche and Novartis were responsible for the weak result. They had a performance between –3.9% and –4.8%.
- The Swiss equity market is the most expensive market after the US-market.

*Emerging markets*

- February was a weak month with a performance of –6.5%. For the year-to-date, the market has gained only marginally (+0.9%) and is thus lagging behind the other stock markets once again.
- The European subindex gained 3.7% in February, while the Asian and the Latin American indices lost 6.9% and 6.2%, respectively.
- A stronger dollar and higher interest rate expectations were the reasons for this weak performance.

*Learnings from the earning season*




Source: JP Morgan, Swiss life Asset Managers. * EMMA = emerging markets

The Q4 2022 earnings season has ended. Overall, the results were slightly better than expected. These expectations, however, had been corrected downwards over several months and were quite soft. Overall year-on-year earnings growth in Q4 2022 in the US was–2% (ex-Energy –6%) while in the Eurozone earnings grew by 2% (ex-Energy –2%). The strong positive influence from the energy sector will vanish over the next quarters if oil and gas prices stay at current levels. Nominal revenue growth was much stronger (5% in the US and 16% in Eurozone). This implies that sales volumes are more or less flat compared with the previous year in the US, but are positive in Europe. Another implication is that margins have declined from their all-time highs. Positive surprises have been much lower than in previous quarters and are below historical averages. Earnings estimates for the full year 2023 have been revised significantly down again. Currently, earnings growth for developed equity markets is estimated to be 1.0% in 2023. The highest growth rate is expected for Japan (5.7%) and the lowest for the UK (–3.6%). These estimates still imply a soft landing for the global economy. During a recession, earnings in the US have declined by around 15% on average. Even a mild recession, as we still expect, would involve a single digit earnings decline. The estimates for 2023 also imply that a positive performance would be accompanied by an increase in valuations. The estimates for 2024 are much more positive, especially for Emerging Markets, and are above long-term averages. If the global economy recovers and central banks start to lower rates, these estimates could be realistic. We retain a cautious view and believe that a further short-term correction is likely.

# Currencies

Central bank expectations in the driver's seat

*USA*

- In February 2023, the USD gained 3% on a trade-weighted basis, more than recovering the losses from the previous month due to better-than-expected economic data out of the US. The USD was stronger against all major currencies, except for the MXN.
- We believe that the USD will remain strong in March, but expect a renewed weakening of the trade-weighted USD later in 2023 as the US economy is likely to cool over the course of the year.

*Eurozone*

- The EUR performance was mixed in February. The EUR appreciated against lower-yielding currencies such as CHF and JPY, but lost against SEK and the USD.
- While we are seeing further downside in EUR/USD in the short-term, the EUR should continue to be supported in 2023 due to more persistent inflation and a delayed hiking cycle compared to other economies.

*UK*

- While the GBP reversed its January gains against the USD in February, it remained stable against the EUR.
- We remain negative on the GBP vs. the USD in the short-term. Despite the UK closely avoiding a technical recession in Q4 2022, the growth-inflation-mix in the UK still looks very unfavourable in 2023.

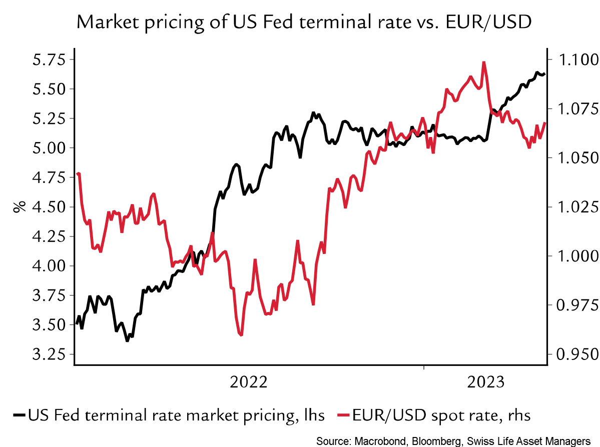
*Switzerland*

- The CHF lost another 0.5% on a trade-weighted basis in February, with the SNB continuing to sell foreign currency.
- Inflation risks remain higher in Europe than in Switzerland, giving the SNB enough arguments to pressure down EUR/CHF in order to prevent imported inflation in the near term. For 2023, however, we still expect the CHF to weaken vs. the EUR given the widening interest rate differential.

*Japan*

- The USD also strengthened against the JPY in February, with USD/JPY up 4.7% over the month.
- Kazuo Ueda is poised to become the next Bank of Japan Governor. With inflation above 4%, the yield-curve control policy is looking unsustainable. This means upside pressure for Japanese bond yields and supports our negative view on USD/JPY for 2023.

*Markets expect more Fed rate hikes, pushing up USD*




February has been yet another month of markets strongly repricing central bank policy rates, which was the focal point for FX markets. With very strong labour market data in the US as well as still firm inflation, especially on the core measure that excludes food and energy, the market pricing for the Fed's terminal rate has risen to 5.6% at the time of writing. Not only did we see higher US bond yields, but most terminal rates in developed markets – i.e. the highest expected policy rate of the tightening cycle – were repriced higher. Economic momentum remains stronger than expected, with Purchasing Managers' Indices (PMI) surprising to the upside in the US, the Eurozone and the UK. February inflation figures released for the Eurozone also came in higher than expected, increasing worries of a renewed broadening of price pressures. This has raised the market pressure on the ECB to remain forceful in its fight against inflation, prompting the market to price in 50 basis points of additional hikes by the ECB since the beginning of February, raising the expected terminal rate to 4.0% at the time of writing. We are expecting economic momentum to slow towards the end of the year because of tighter monetary conditions. We therefore expect the US Fed to reach its peak policy rate of 5.25% in Q2 2023, which is lower than the market's current pricing of the terminal rate. While the carry advantage of the USD remains large compared to other major currencies, supporting the USD in the short term, European rates are likely to reduce their spread to US rates over the course of the year as the ECB's hiking cycle is somewhat lagging behind the Fed's. We therefore see the USD's strength subsiding over the course of the year and are holding on to our expectation of a higher EUR/USD pair for this year.

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