Perspectives
Financial Markets

Swiss Life Asset Managers

April 2023

Interest rates & bonds

Between a rock and a hard place

USA

- In March, the US experienced significant volatility in interest rates, with several intraday moves of more than 50 basis points (bps) in US 2-year Treasury yields. While US 10-year yields ultimately dropped by about 40 bps, this move disguised the volatility that took place, which in turn led to a rise of credit spreads by 34 bps.
- The Fed decided to hike policy rates by another 25 bps in March, despite the significant stress in the banking sector, as the still relatively solid economy with the tight labour market keeps inflation elevated.

Eurozone

- In the Eurozone, credit spreads widened materially in March, led by financials, which were up by 55 bps. Government bond yields dropped by 23 bps as the fear of a new banking crisis resurfaced.
- Nonetheless, the ECB delivered a 50 bps rate hike as core inflation continues to increase and survey data points to solid economic growth despite the record increase in interest rates over the past year.

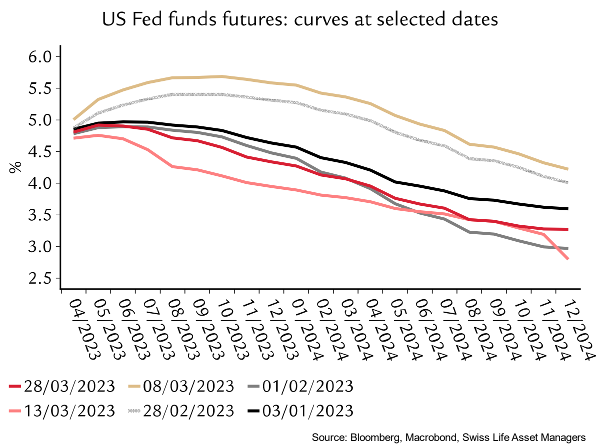
UK

- In the UK, government bond yields also plummeted by 46 bps in March, but had a similar erratic path on the way down, which led to a widening of credit spreads.
- The Bank of England delivered a 25 bps rate hike, as inflation remains sticky and economic data has surprised positively.

Switzerland

- In Switzerland, government bond yields fell by 26 bps as the country witnessed its biggest banking sector stress since the global financial crisis.
- After orchestrating an unprecedented emergency merger between the country's largest banks over the weekend, the SNB nonetheless hiked rates by 50 bps as inflation continues to tick up.

Interest rates: uncertainty is on the rise



Risks unfold slowly and then burst all at once. Nowhere is that truer than in the banking sector, where the jump to default risk can occur swiftly in times of financial stress. With the default of US regional banks and the forced merger of the two largest Swiss banks, credit spreads soared, and rates volatility went berserk. The MOVE index – the implied volatility index for bonds – reached levels last seen at the height of the global financial crisis. The cumulative intraday moves of government bond yields at times surpassed 100 basis points. Consequently, investors got whipsawed as markets tried to digest the robust economic and high inflation data on the one hand, and the prospect of a deeper recession and possible banking crisis on the other. Although the emergency interventions by the Fed and SNB saved the system from contagion, the damage might already be done. Lending standards are almost guaranteed to tighten further, which will weigh on future economic growth and could lead to defaults of weaker companies. At the same time, central banks may hike policy rates higher in the near term with inflation becoming more entrenched. We thus foresee further credit spread widening ahead and remain defensively positioned. With the interest rate path being uncertain at this point, we prefer duration to stay close to benchmark but expect rates to eventually fall throughout the year as the economies weaken.

Equities

Cracks appear in the equity market

USA

- The US market lost 0.1% in March leading to a year-to-date performance of +3.9% (all data in this column as of 28 March, MSCI indices used). "Big tech" contributed positively to the performance while the banking sector contributed negatively.
- The US stock market held up remarkably well given the stress in the banking system including the default of two regional banks. The subindex for regional banks lost 26% in March.
- The US stock market valuation is still above historical averages. We continue to prefer non-US markets.

Eurozone

- In March, the European stock market underperformed the US market. It lost 2.6% and the year-to-date performance is +8.6%.
- Stress in the banking sector had a clear negative effect on performance (the sector lost 12%)
- The European market profits from a much lower valuation

UK

- The UK market was the worst performer in March with a performance of -4.5%. Year-to-date, the market just gained 1.3%.
- The UK market benefits from the lowest valuation of all major markets. However, the economy is weak, and financials have a large index weight.

Switzerland

- The Swiss market lost 1.0% in March bringing the year-to-date performance to +2.8%.
- The stress in the banking sector with the merger of UBS and CS and the still weak performance of the three index heavyweights weighed on the market.
- The Swiss equity market is the most expensive market after the US market.

Emerging markets

- March was another weak month with a performance of -0.9%. Year-to-date the market has gained only marginally (+1.8%) and thus lags behind the other stock markets. So far, the reopening in China and the end of the rate hiking cycle did not have a visible positive effect.
- Both in relative and absolute terms, Emerging Markets are attractively valued.

Learnings from the banking sector turmoil

In March, two US regional banks had to be rescued by the central bank and the state. Just a week later Credit Suisse (CS) had to be taken over by UBS, while the Swiss National Bank and the state had to grant guarantees and provide liquidity. In all three cases, the emergency was caused by a bank run: depositors rapidly withdrew a large amount of money. The bank run in turn was caused by a loss of trust in the healthiness of the banks. In the case of Silicon Valley Bank (SVB), the deposit outflow was partly due to cash needs of venture capital firms as they are faced with much higher financing costs and increasing cash burn rates. In the case of Credit Suisse, the outflows were due to doubts about the viability of the business model. Due to the outflows, Credit Suisse was increasingly confronted with a liquidity problem while SVB had to revalue their holdings in US treasuries and become insolvent.

What are the learnings from the crisis? First, it shows that bank runs that are caused by a decline of trust cannot be avoided with the current regulation. Not even higher equity ratios and Too Big To Fail (TBTF) regulations for systemically relevant banks helped. In fact, bank runs could only be avoided by a full match of deposits with liquidity and thus an abolition of the fractional reserve banking system. Secondly, the TBTF regulations have either failed or were deemed too risky to be applied in the current environment. Thirdly, we have seen that regulatory oversight was not tight enough. In the case of SVB, the regulators did not act despite having received several warnings about the problems.

The key open points that will be debated now are: 1. Are banks too big to ensure an orderly wind down in a crisis? 2. Can regulations be tightened such that the risk of bank runs and insolvency is reduced much further? 3. How can the moral hazard resulting from state rescues be addressed?

Whatever the results of the discussions will be, three points are important for investors: 1. The banking system is not as safe and well-regulated as we thought. 2. It is very likely that regulatory costs for banks will increase further and thus put pressure on profitability. 3. There is a risk that banks will tighten lending standards or lend less, which would increase recession risks.

Currencies

Monetary policy re-pricing drives USD lower

USA

- In March, the USD declined against most major global currencies, losing around 2% on a trade-weighted basis.
- The move was driven by a significant re-pricing of US monetary policy with financial markets now pricing in policy rate cuts already in the second half of this year (see page 1).
- We indeed expect that the US will be the first major developed economy where the interest rate cycle turns and thus think that the USD might be prone to further weakness over the next three months.

Eurozone

- The EUR increased 3% against the USD and also appreciated against Nordic currencies in March, while moving sideways against CHF and GBP.
- We expect the EUR to remain supported in 2023 due to more persistent inflation and a delayed hiking cycle in the Eurozone compared to other economies.

UK

- The GBP moved broadly in line with the EUR in the month of March.
- Our three-month view on GBP/USD is neutral, while we expect some GBP weakness against EUR as economic prospects remain more muted in the UK.

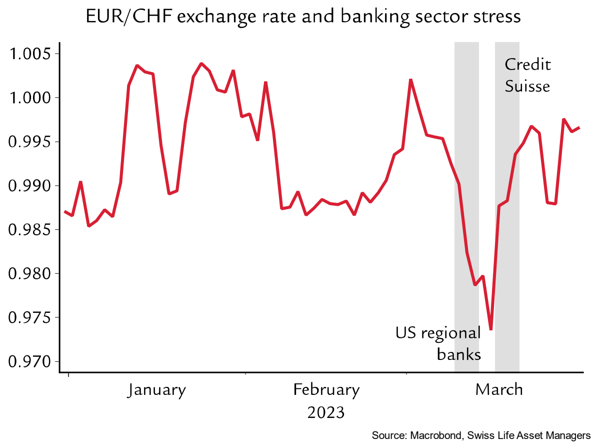
Switzerland

- After significant moves, EUR/CHF ended the month at broadly the same level as at the beginning of March. Against USD, the CHF appreciated by around 3%.
- Our three-month view on EUR/CHF is positive, implying a neutral view on USD/CHF (see main text).

Japan

- Similar to other developed market currencies, the JPY appreciated significantly against USD in March.
- Our view on USD/JPY remains negative. The reason is not only our view regarding general USD weakness, but also the risk that Japan will speed up monetary policy normalisation under the incoming Bank of Japan Governor Kazuo Ueda .

Swiss franc still a safe haven currency?



March has been a rollercoaster ride for the Swiss franc. As the stress in the US banking sector intensified and led to a significant risk-averse sentiment among investors, the CHF played its role as a safe haven currency and appreciated against USD and EUR (see chart). The same was true for the JPY, the other traditional global safe haven currency. The CHF and JPY parted ways in the following week when Credit Suisse (CS) became the focal point of global financial market worries. The shock of having a Swiss systemically important bank at the brink of collapse and the regulatory uncertainty created by the emergency measures including the wipe-out of CS AT1 bonds led some market participants to question the stability of the Swiss financial system and the related status of the CHF as a safe haven currency. While these worries are likely overdone, we see some other reasons for the CHF to weaken somewhat in the months ahead, especially against EUR. As central banks have put out the recent fires in financial markets and basically provided a liquidity backstop, financial market volatility might normalise somewhat, benefitting cyclical currencies like the EUR. Also, the SNB's focus might shift from imported inflation to domestically generated inflation, which implies that the SNB might not actively be pushing for a stronger CHF. Meanwhile, inflationary pressure still remains more elevated in the Eurozone than in Switzerland, which could lead to wider interest rate differentials and thus support EUR/CHF.

Swiss Life Asset Managers

Thomas Rauh
Portfolio Manager Fixed Income
thomas.rauh@swisslife-am.com

Andreas Homberger
Head Quantitative Equities
andreas.homberger@swisslife-am.com
@Homberger_A

Damian Künzi
Head Macroeconomic Research
damian.kuenzi@swisslife-am.com
@kunzi_damian

Florence Hartmann
Economist Developed Markets
florence.hartmann@swisslife-am.com

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