Perspectives
Financial Markets

Swiss Life Asset Managers

June 2023

Interest rates & bonds
Stealth QE might end soon

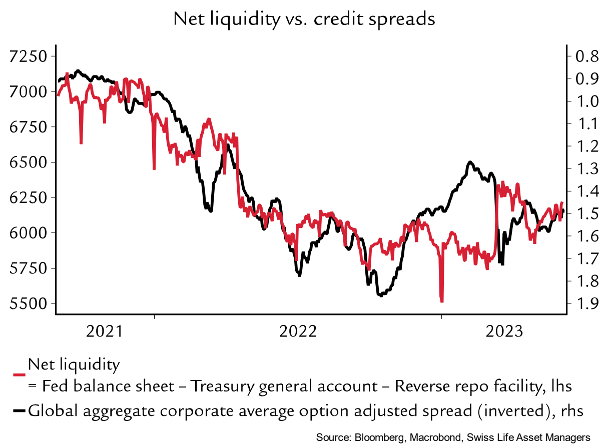
USA
- Despite the impending debt ceiling discussions, fluctuations in interest rates and spreads remained modest. 10-year Treasury yields rose by 28 basis points in May, while spreads held steady after an initial mid-month surge.
- Now that the debt ceiling quandary has largely been settled, markets are figuring out whether the Federal Reserve might consider further rate hikes, given the persistent inflationary pressures.

Eurozone
- Both interest rates and spreads witnessed an upward movement in May, increasing by 8 and 5 basis points respectively, triggered by bustling primary markets.
- There is a discernible indication that inflationary pressures are normalising further, mirrored by a significant drop in producer prices. This might reassure the European Central Bank that it is getting closer to setting its terminal interest rate.

UK
- The UK continues to grapple with surging inflation, with its core elements unexpectedly gaining momentum, leading to a drastic surge in interest rates. Rates climbed by 38 basis points in May, approaching the levels last seen during the October sell-off of the previous year.
- With the renewed inflation pressures investors reassessed their rate hike expectations to price in four more hikes this year for the Bank of England.

Switzerland
- Swiss interest rates deviated from the general trend in May, falling by 8 basis points, as inflationary pressures appear to be dissipating faster than investors had anticipated.
- Concurrently, the economic deceleration persists, with the manufacturing Purchasing Managers' Index (PMI) dropping to 45.3. Given the lower-than-expected inflation, the Swiss National Bank may not need to raise rates as aggressively, potentially leading to a lower terminal rate than initially anticipated.

Net liquidity increased over past months



"Markets are not the economy" is a frequently cited mantra and it holds particularly true during periods of quantitative easing. While central banks have tightened monetary policy by raising interest rates and trimming their balance sheets, the journey to tightened financial conditions has not been linear. From the Bank of Japan maintaining its yield curve control programme, to the Bank of China injecting liquidity in response to the Covid-induced lockdown, and the Fed and the Swiss National Bank extending emergency loans to banks, effectively counteracting the effects of much of the quantitative tightening. It is hardly surprising that markets have largely disregarded rate hikes and deteriorating economic indicators fuelling a risk rally that has caused credit spreads to steadily tighten. However, it is important to note that central banks were not the sole providers of liquidity. The ongoing debate around the debt ceiling has unintentionally triggered a sort of stealth quantitative easing as the US Treasury found itself unable to issue new debt on the scale required. Now that the debt ceiling is likely to be suspended, we expect this process to reverse. Reflecting on the previous debt ceiling discourse in 2011, a sharp depreciation in risky assets followed the resolution, while interest rates fell. The outcome could be similar this time. Hence, we are maintaining our position: short on risk and long on duration.

Equities

Large cap tech drives performance

USA

- The US market gained 0.6% in May leading to a year-to-date performance of +9.6%.
- Like in Q4 2022, the earnings season delivered better-than-expected results. Earnings declined by 3% vs. Q1 2022, however this was 7% above expectations. Sales grew by 4% and came in 3% above expectations.
- The US valuation is neutral while the rest of the world is trading slightly below historical average. The unbalanced performance this year (see text) is a cause of concern.

Eurozone

- The market lost 2.5% in May and the year-to-date performance is 9.3%.
- The earnings season delivered remarkably good results. Earnings grew by 5%, which is 11% above expectations. Sales advanced by 4% (in line with expectations).
- The European market is still very attractively valued from a longer-term perspective.

UK

- The UK market was weak in May with a performance of -5.2%. Year-to-date the market lost 0.1%.
- The UK market is still benefiting from the lowest valuation of all major markets. However, we feel that the market is cheap for good reason as the economic uncertainty in the UK is elevated.

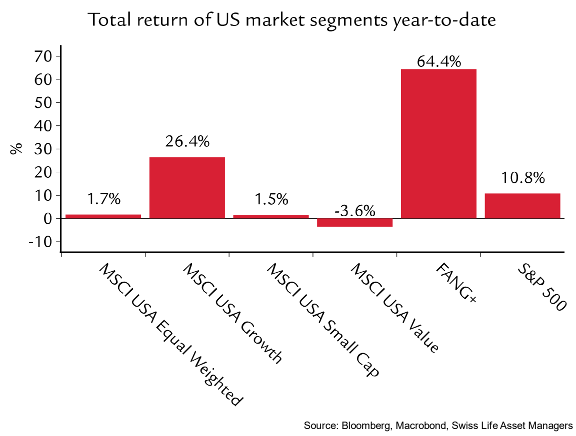
Switzerland

- The Swiss market declined by 2.0% in May bringing the year-to-date performance to 6.9%.
- After a weak start to the year, pharmaceuticals recently staged a comeback supporting the catch up on the Swiss equity market.
- The Swiss equity market is the most expensive market after the US-market.

Emerging markets

- May was another weak month with a performance of -1.7%. Year-to-date the market has gained only marginally (1.1%) and thus lags behind the other stock markets.
- Chinese economic data was weaker than expected.

Developments in the US stock markets and consequences



The performance of the US stock market this year has been driven once again by large-cap tech stocks. The FANG+ index which reflects the performance of Meta (Facebook), Amazon, Netflix and Alphabet (Google), Apple and several other tech companies is up more than 60% since the start of the year. Due to this development, large caps have significantly outperformed small caps (by around 9%), growth has outperformed value (by around 30%) and the Nasdaq has beaten the S&P 500. The equally weighted US equity index has underperformed the capitalisation weighted index by around 9% and is flat for the year. Many of the developments seen last year have thus been reversed. One cause for these remarkable developments is the decline in long rates in the past few months. The yield of US Treasuries has declined from a high of 4.2% late last year to around 3.7% now. Tech stocks are considered to be long duration stocks because a large part of the earnings is expected to occur in the distant future. The FANG+ stocks contributed about 80% to the total performance of the US stock market this year. The remaining 490 stocks in the index thus contributed around 20% and are on average flat this year. Apple, Microsoft and Nvidia contributed 50%. These developments are concerning. The US stock market concentration as measured by the weight of the top 5 stocks is at an all-time high (25%). Former all-time highs occurred in 1999 and 2007, i.e., right before stock market crashes. We do not currently expect such a crash, but based on our mild recession economic scenario, we see markets correcting soon. The valuations of FANG+ stocks are very rich, and we see little room for significant further advances.

Currencies

USD strength is back

USA

– After general USD weakness since the beginning of the year, the trade-weighted USD index has recovered some of the losses since mid-May. In May, the USD managed to appreciate against all major currencies, the most against SEK (+5.4%) and NOK (+3.9%).
– We now expect that the USD strength will continue over the next month as USD carry once again provides support and the US debt ceiling debate has largely been resolved for now.

Eurozone

– The EUR has consolidated from its recent high since the beginning of May, depreciating 3% vs. the USD.
– We expect the EUR to remain under pressure over the next four weeks as economic momentum in the Eurozone is weakening and the risk of stagflation in the Eurozone is higher relative to the US.

UK

– The GBP depreciated vs. the USD in May but managed to gain 2% against the EUR.
– Our one-month view of GBP is negative vs. the USD and neutral vs. EUR. The British economy is holding up better than expected, but inflation remains very sticky. This also increases the risk for a stagflation scenario in the United Kingdom and should put pressure on the Bank of England to raise interest rates further than previously expected.

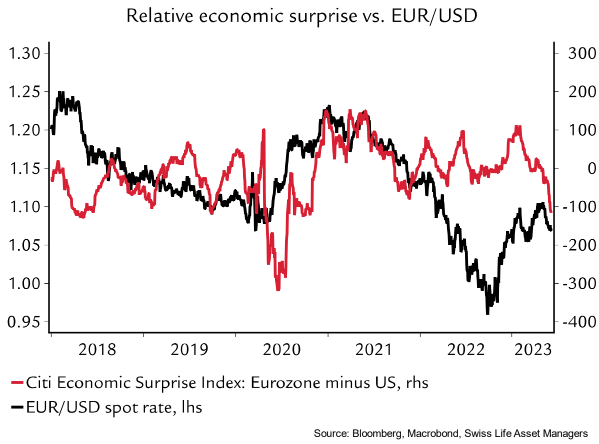
Switzerland

– The CHF remained strong against the EUR in May, while USD/CHF has started to rise again from recent lows, with the CHF depreciating by 1.8% against the USD in May.
– We expect EUR/CHF to move sideways in June, as the need for further SNB hikes has been reduced given recent inflation data from Switzerland.

Japan

– USD/JPY has seen a sharp upward move in May, with JPY depreciating by 2.2% vs. the USD.
– We expect USD/JPY to continue to move higher over the next month as the monetary policy outlook remains dovish.

Turning economic momentum favouring USD



After a weak start to the year, the USD has started to regain some footing. This trend is particularly visible against the EUR. While the EUR had benefited from hawkish ECB repricing and a better-than-expected energy situation at the start of the year, this pattern has started to reverse. Economic momentum in Europe has started to turn, while US data is outperforming. The final data release for GDP growth in the first quarter in Germany has shown that the country had been in a technical recession after all. While this data point is arguably backward-looking, survey indicators such as the manufacturing Purchasing Managers' Indices (PMI) for Germany and the Eurozone have also disappointed of late and are indicating a rather pessimistic outlook. The market was hoping for some support from China's recovery for Europe. Most recent data out of China, however, is suggesting that the economic rebound is already losing steam. As China is a major trading partner for Germany, these developments are not likely to be beneficial for Germany's export industry. Additionally, ECB expectations now seem well priced. Inflation in the US has been declining faster than in the Eurozone, where core inflation still looks particularly sticky. This should lead to higher real rates in the US, therefore making the USD carry advantage more attractive again, which even a pause by the Federal Reserve won't change. On the technical front, EUR long positioning looks stretched and is at risk of a reversal. With a debt ceiling resolution on the table, other risks should be off the cards for the time being. This should reduce volatility and let the market refocus on fundamentals over the next month. We have therefore changed our one-month outlook for EUR/USD from higher to lower.

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