Perspectives
Financial Markets

Swiss Life Asset Managers

July 2023

Interest rates & bonds

Will central banks hike us into recession?

USA

- The US saw relatively benign movements in government bonds and credit in June. Bond yields ticked up slightly, while corporate bond spreads narrowed, reflecting a healthy demand for risky assets.
- The US Federal Reserve held steady on policy rates, aligning with their earlier communications. This pause allows the Fed to observe the delayed impact of higher borrowing costs on the economy. Market expectations lean towards one more rate hike this year, followed by potential rate cuts in 2024.

Eurozone

- Government bond yields continue to trade in a narrow range. They rose during the first half of June and subsequently declined, while corporate bond spreads narrowed.
- The ECB raised policy rates by 25 basis points (bps) while updating its inflation forecast upwards and delivering a hawkish message. This move came amid signs of an economic slowdown, with survey data dropping significantly, hinting at a possible recession. Despite this, investors are predicting two more rate hikes this year.

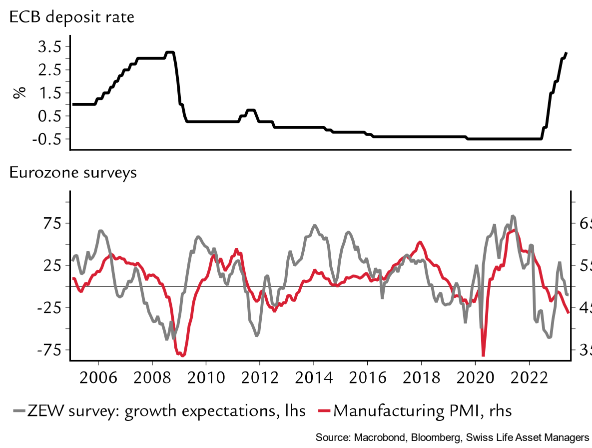
UK

- The UK is confronted with potential stagflation, a situation characterised by high inflation co-existing with slow economic growth. Consumers are feeling the pinch as their purchasing power erodes and as they bear the brunt of increasing interest rates.
- The Bank of England (BoE) surprised the market with a 50 bps rate hike. The market is still pricing in 100 bps of additional hikes until year-end, driven by the UK's persistently high inflation.

Switzerland

- Swiss yields remained stable despite the anticipated 25 bps policy rate hike by the SNB.
- Inflation appears to be on a decelerating path, currently at 2.2%, slightly above the SNB's target. However, there could be an upturn, as rent increases are expected to come into effect later this year.

Leading economic indicators hint at more pain to come



In June, the ECB delivered its eighth consecutive rate hike; policy rates rose by a cumulative 4% in less than a year. However, Eurozone core inflation remained sticky at 5.3%, indicating that the unprecedented tightening cycle only had a limited economic impact. The unemployment rate is at multi-decade lows and corporate earnings near record highs, not signalling an imminent recession, and therein lies the challenge. The ECB's primary objective is to maintain inflation around 2%, and it relies on rate hikes and quantitative tightening (QT) to achieve this. Both these tools, however, are quite blunt and have substantial lag effects on economic growth and inflation. This makes it difficult to engineer a soft landing. Further complicating the picture is the fact that inflation is a lagging economic indicator itself, often peaking in or just before a recession. Given these complexities, we perceive a high risk that central banks might over-tighten monetary policy for an extended period, potentially missing the crucial signs of an economic downturn. Purchasing Managers' Indices (PMI) and producer prices are already falling sharply, yet the ECB is likely to continue with its rate hikes and balance sheet reduction, possibly exacerbating the economic downturn down the line. Given this outlook, we remain cautious on credit risk and are moving to increase our duration, placing a bet on a decline in longer-term rates.

Equities

US tech stocks still drive the market

USA

- The US equity market gained 4.9% in June leading to a year-to-date performance of +14.9% (all data in this text as of 27 June).
- The recent rally is confined to a small set of stocks. The FANG+ index, which includes the big tech companies, is up 70% year-to-date. In comparison, the index which weighs each stock in the S&P 500 equally is up only 5.4%.
- The US equity market valuation is still above historical averages. We continue to prefer non-US markets. The unbalanced performance this year is a cause for concern.

Eurozone

- The European equity market gained 1.5% in June and the year-to-date performance is 10.9%.
- Recent economic data in the Eurozone was weaker than expected while the data in the US was in line with expectations.
- The European market is still very attractively valued from a historical perspective.

UK

- The UK delivered a performance of 0.3% in June. Year-to-date the market has gained 0.3%.
- The UK equity market still benefits from the lowest valuation of all major markets. However, we feel that the market is cheap for a reason as the UK is currently facing elevated economic uncertainty.

Switzerland

- The Swiss equity market declined 0.8% in June bringing the year-to-date performance to 6%.
- The Swiss equity market is the most expensively valued market after the US market.

Emerging markets

- June was a very positive month for emerging market equities with a performance of 4.2%. Year-to-date the market has gained 5.4% and thus lags the other stock markets.
- Chinese economic data continues to disappoint, which weighs on sentiment.

Why are emerging market equities not performing better?

2023 is another year where emerging market equities are underperforming their developed market peers. Over the last 10 years, the underperformance was more than 100% and developed market equities outperformed in 7 out of these 10 years. Only over the period since 2000, emerging market equities were able to beat developed markets by around 50%. Emerging market equities have appeared quite attractive recently from a valuation perspective. At present, the forward P/E ratio is around 12.1 and thus slightly above the 17-year median. In contrast, the same ratio for developed market equities is currently 16.9. The difference between the two is higher than its hisftorical average. The key to understanding emerging market equity performance is China. Its stock market has driven emerging market equity performance over the past 10 years, and it is by far the biggest constituent of the market index (29% weight). China's problem is that economic growth and markets' trust in its institutions have deteriorated over the past 10 years, especially since the pandemic. Economic growth has come down from more than 10% in 2010 to about 5% now. Investors are worried about domestic (especially the real estate sector), demographic and geopolitical issues. We expect these issues to weigh on the Chinese stock market going forward. They are likely to outweigh the attractive valuation of emerging market equities and the much more accommodative monetary policy in China. We therefore currently see no trigger for emerging market equities to outperform consistently. The expectation of a mild global recession does also not support additional exposure to emerging market equities.

Currencies

Deteriorating Eurozone outlook to weigh on EUR

USA

- After a strong month of May, the USD weakened against most major currencies in June, with the Chinese and the Turkish currencies being major exceptions.
- Nevertheless, we expect the USD to appreciate again in the third quarter 2023. Recession risks already seem sufficiently priced for the United States, whereas the economic outlook in Europe is likely deteriorating a bit faster than markets had anticipated. We thus have a negative view on EUR/USD for the next three months.

Eurozone

- At the time of writing, the EUR had appreciated 1.7% on a trade-weighted basis in June.
- In addition to the fundamental argument made above, we also expect a technical factor to contribute to a weaker EUR/USD over three months. Speculative positioning is still in favour of the EUR, and any unwinding of these positions might add to EUR weakness in the near term.

UK

- The GBP appreciated against USD and EUR in the first half of June, but lost ground again in the second half.
- Market expectations regarding Bank of England hikes have increased significantly and may have overshot. We have thus adopted a negative view on GBP/USD over three months.

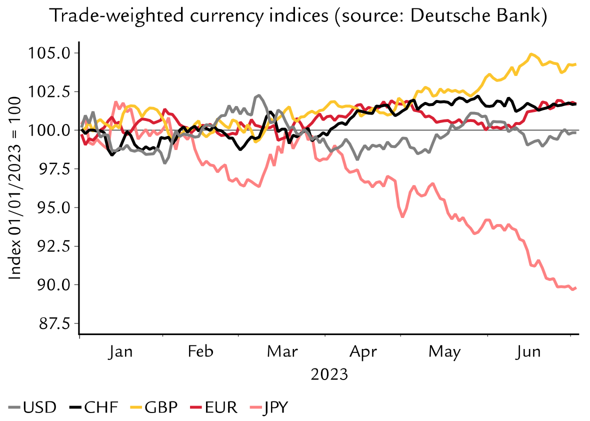
Switzerland

- On a trade-weighted basis, the CHF performance was flat in June.
- We have a neutral view on EUR/CHF for the third quarter 2023. The surprisingly hawkish SNB rhetoric despite low inflation numbers might suggest that the SNB is unwilling to accept a weaker CHF.

Japan

- USD/JPY has seen another sharp upward move of 4% in June.
- Given the significant undervaluation of the JPY at the current levels, we have moved to a neutral view on USD/JPY for the next three months.

A lost year so far for the JPY



Source: Macrobond, Bloomberg, Swiss Life Asset Managers

Taking stock after the first half of 2023, we can identify a few winners and one major loser among major developed market currencies (see chart). On a trade-weighted basis, the JPY lost around 10% in the first half of the year. Even though inflation has also gained traction in Japan and is now well above the Bank of Japan's (BoJ) 2% target, expectations of a hawkish policy shift by the new BoJ Governor Kazuo Ueda were disappointed. He chose continuity with his predecessor Haruhiko Kuroda, who had engineered a prolonged period of ultra-loose monetary policy and reiterated in June that the BoJ would only perform a policy shift if they were "reasonably sure" that inflation will accelerate into 2024. These statements reinforced the ongoing JPY selloff as interest rate differentials to all other major developed markets widened.

Meanwhile, the unlikely best-performer so far in 2023 has been sterling. Despite a stagnating economy, the UK currency has appreciated almost 4% on a trade-weighted basis. The main reason is the significant widening of interest rate differentials as markets have increased their expectations for additional rate hikes by the Bank of England to combat high and rising inflation. It clearly seems that interest rate differentials are currently in the driver's seat regarding currency performance, a fact that may not have gone unnoticed by the Swiss National Bank and may have contributed to their hawkish rhetoric in June, as a weakening currency would pose an additional inflationary risk.

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