Perspectives
Financial Markets

Swiss Life Asset Managers

November/December 2021

Interest rates & bonds
Will inflation force the central bankers' hand?

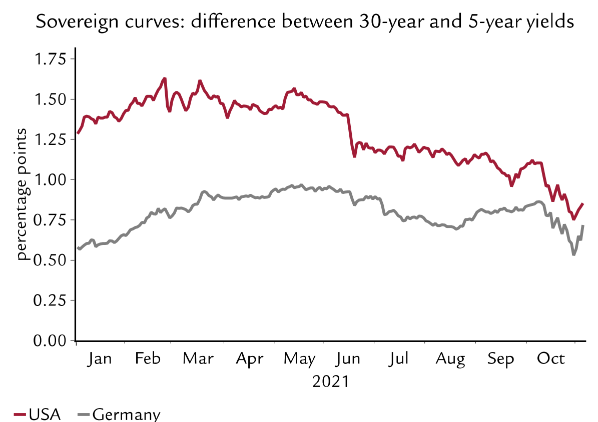
US
- The US Treasury curve flattened in October, with five-year yields rising by about 20 bps, while their 30-year counterparts fell by 11 bps. Financial markets are expecting the US Federal Reserve to hike twice by the end of 2022.
- We expect the Fed to hike policy rates only once next year, with the risk of a second hike if inflation fails to moderate.

Eurozone
- The gas crisis in the old continent and positive correlation with US Treasuries led to a flattening of the German government bond yield curve. Five-year yields climbed by 17 bps in October.
- The ECB believes that the current relatively hawkish market pricing for rate hikes is not aligned with its forward guidance. We expect it to announce a new asset purchase programme in December, which should expand the current one while adding some flexibility features from the PEPP (pandemic emergency purchase programme).

UK
- UK government bonds saw the most dramatic moves in October. Five-year yields climbed by around 20 bps, while 30-year yields were down by 26 bps.
- The Bank of England is one of the most hawkish G10 central banks. Several members see hiking as a possibility in 2021 already. We see a first hike in Q1 2022 as more likely.

Switzerland
- Interest rates in Switzerland moved largely in line with their EUR counterparts, except for the two-year maturity, which was flat month-on-month.
- Although Switzerland is not seeing a flare up in inflation, the SNB could still decide to start tightening monetary policy if its peers in Europe do the same. This should, however, only be a topic for 2023 at the earliest.

Curves flatten on fears of inflation and slowing growth



Fears of stubborn inflationary pressures in developed markets led financial markets to price in an earlier start of the interest rate hiking cycle in October. As a result, government bond yield curves flattened quite meaningfully (see chart), with short-end yields rising and the very long end of the curve falling. Many investors are worried that inflation persistently above target will force central banks to hike policy rates against a background of slowing economic growth. We continue to believe that inflation will prove transitory and expect central bankers to push back against market pricing that looks too hawkish, in our view. In the short term, many investors are also worried about the impact of higher commodity prices and supply chain bottlenecks on company earnings. Third-quarter results have exceeded expectations so far, with corporates largely offsetting increased input costs with higher output prices, with little impact on sales volumes. Better-than-expected earnings, an extension of the US debt ceiling deadline and moderating fears around China led the "buy-the-dip" mentality in equities to resurface. Despite that, credit spreads widened slightly in October, as interest rate volatility weighed on the asset class. Looking ahead, we expect credit spreads to move largely sideways. As for interest rates, we expect longer-term ones to rise moderately, while short-end rates should stabilise after the recent spike.

Equities

All losses from September recovered

US

- The S&P 500 Index was up 7.1% in October and finished the month on an all-time high, slightly above 4600. The US market outperformed the other markets by 2-3% due to the extraordinary performance of large technology companies. Year-to-date, the performance is now about 25%.
- The US earnings season started with excellent results. Third-quarter earnings are up 37% and revenues 16% year-on-year. Earnings growth is almost 10% higher than expected a month ago and more than 80% of the companies exceeded expectations.

Eurozone

- The market was up 4.7% in October, while the year-to-date performance is now 21%.
- The European equity market is currently the most attractive market on our scorecard, which combines valuation and technical indicators.

UK

- In October, the UK equity market gained 2.1%, while the year-to-date performance is 13.9%.
- The UK market is very attractive from a valuation perspective, but Brexit and the high exposure to value stocks still weigh on the market.

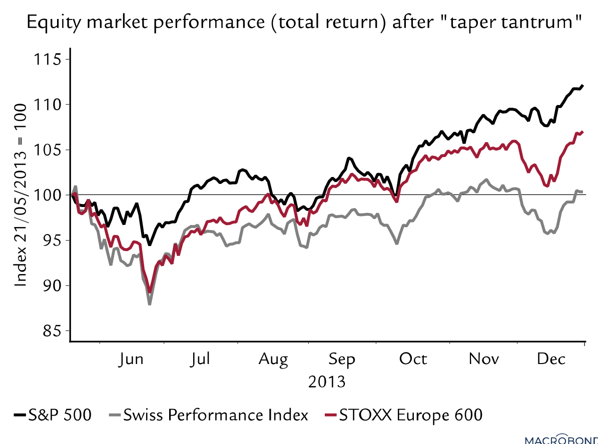
Switzerland

- The Swiss market had a return of 3.8% in October and its year-to-date performance is 17.2%.
- Financials had a strong October while the healthcare sector performed in line with the index.
- The Swiss equity market is the most expensive market after the US. However, it is a defensive market which is likely to outperform in a choppier environment.

Emerging markets

- Emerging markets continued to underperform in October with a performance of 1.0%. Year-to-date, the performance is zero due to the weak Chinese market which makes up more than 35% of the index.

Rising yields and equity markets



The increase in government bond yields since August, which has also been the result of tentative announcements by several central banks to reduce and ultimately stop purchases of government bonds, has spurred fears of another "taper tantrum" as in 2013. When the US Fed announced reduced asset purchases ("tapering") in May 2013, the equity markets reacted with a correction of 5% in the USA, and about 11% and 13% in Switzerland and the Eurozone, respectively, within a few days (see chart). 10-year bond yields rose by about 0.3 to 1.0 percentage point over the same period. By the end of 2013, however, the US equity market was up 13% since the correction started in May, while the European market was up 7% and the Swiss market down 0.7%. Other episodes of rising bond yields show a similar picture: since 1990, we have had eight periods of sharply rising bond yields. Only in one case, in 1993/1994, were equity returns negative in the period from the trough to the peak of the 10-year Treasury yield. On average, the equity market rose more than 20% during these phases while the 10-year Treasury yield increased by almost 2 percentage points. The current situation is, however, different from past episodes in two respects: first, the starting level of bond yield is much lower and second, all asset classes exhibit high valuations. Therefore, we expect that a substantial further increase in bond yields over a short period of time would impact equity markets more than in the past. But as long as economic and earnings growth remain robust (as we expect) and central banks keep monetary policy loose, we believe that equity markets can also this time withstand moderately and not-too-fast rising yields.

Currencies

CHF to remain relatively strong against EUR

US

- The USD was more or less unchanged on a trade-weighted basis in October.
- Inflation fears intensified, which contributed to a hawkish repricing of Fed policy rate expectations. As the same happened in almost all developed economies, it did not have a major impact on USD exchange rates.
- Nevertheless, interest rate differentials ("carry") remain favourable to the USD, especially against the low-yielding currencies EUR, CHF and JPY. We thus expect the USD to appreciate against these currencies over the medium term.

Eurozone

- Despite solid economic data, significant inflation surprises and increased market expectations for ECB policy rate hikes, the EUR remained weak in October, especially losing against other European currencies such as CHF, GBP, SEK and NOK.
- We think the markets overreacted to the ECB's October meeting, and indeed, rate hike expectations have already moderated in the first days of November. We therefore reiterate our negative view on EUR/USD.

UK

- In line with our view, GBP appreciated against USD in October due to increased market expectations for policy rate hikes by the Bank of England.
- We now turn neutral GBP/USD as we think these expectations are fairly priced.

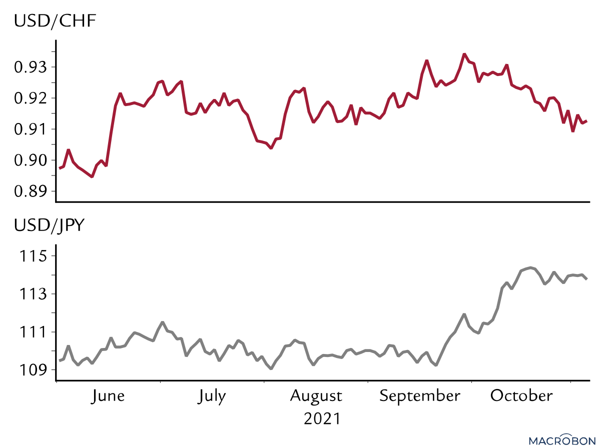
Switzerland

- In a surprising move, CHF appreciated almost 2% against EUR in October (see main text).
- As yield differentials between Switzerland and Germany are narrow and unlikely to change given the alignment of the SNB's and ECB's monetary policy, we reiterate our neutral view on EUR/CHF.

Japan

- JPY continued to depreciate against USD in the first half of October. USD/JPY then settled at a level of around 114.
- We expect the JPY to remain relatively weak against USD, as the low-growth and low-inflation environment will keep interest rates depressed in Japan.

Safe haven currencies CHF and JPY on different trajectories



In October, the CHF showed the third-strongest performance among developed market currencies. Only AUD and NZD had a better performance, both benefitting from a significant repricing of monetary policy expectations. The move was especially striking against the single currency, with EUR/CHF dropping below 1.06 at the end of October and thus approaching the cyclical low from May 2020, when gloom was dominating the economic outlook. This time, however, the franc's strength is not reflective of a "risk-off" mood among investors. Quite to the contrary, risky assets had a fabulous month and the other notorious safe-haven currency, the JPY, lost 2.5% on a trade-weighted basis. The "risk-on" sentiment certainly contributed to the weakness, and the political environment is also conducive to more JPY weakness going forward as the recent general election cemented the absolute majority for the ruling LDP party. The continuation of relatively loose monetary and fiscal policy is thus likely in Japan. Absent safe-haven flows, the best explanation for the good performance of CHF against EUR is thus the lack of "carry". At various maturities, Swiss government bond yields are higher than their German counterparts, and financial markets continue to attach a higher probability of a policy rate hike by the SNB than the ECB over the next 12 months (8 bps increase for the ECB vs 18 bps for the SNB at the time of writing). While this seems odd given substantially lower inflation in Switzerland, we do not think that a positive EUR "carry" is likely to return soon. We thus stick to our neutral view on EUR/CHF, even though we acknowledge that risks to the view are asymmetric in the very short term, i.e. a recovery is more likely than a further sell-off of EUR/CHF.

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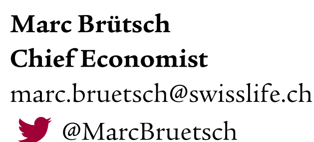
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