Perspectives
Financial Markets

February 2022

Interest rates & bonds

January as a blueprint for the rest of 2022?

USA

- Yield curves flattened in January as yields on the short end of the curve increased more than at the long end. Additional policy rate hikes were being priced into the market due to persistently high inflation readings.
- The Fed is all but guaranteed to start hiking policy rates in March. We now expect a total of four rate hikes by 25 basis points (bps) each in 2022 and also expect the Fed to start reducing its balance sheet later this year.

Eurozone

- Interest rates in the Eurozone went "belly up" in January, i.e. the medium part of the yield curves moved higher while the very short and long ends remained largely unchanged.
- While the ECB is starting to become more hawkish, we think interest rate hikes are unlikely this year. However, the end of TLTRO (targeted longer-term refinancing operations) is still going to shrink the balance sheet for the first time in almost ten years.

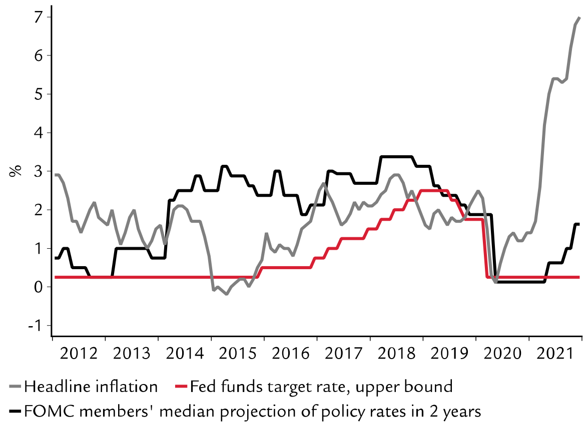
UK

- UK rates shifted higher in January in an almost parallel fashion.
- With Omicron-related risk decreasing we think that the Bank of England will continue its policy rate hiking path after the surprise non-hike in November and the equally surprising hike in December.

Switzerland

- Interest rates in Switzerland also increased over the past month and the yield curve flattened.
- With CHF strength being a bigger issue for the SNB than inflation, we expect no change in the easy monetary policy in 2022 and possibly even in 2023 to allow for a widening of the interest rate differential with the Eurozone.

How aggressive can the Fed become?



Source: Macrobond, Bloomberg, Swiss Life Asset Managers

January often sets the tone for the rest of the year. So far, 2022 has been off to a bad start with both sovereign bond yields and credit spreads rising. Hence, total returns are negative with EUR corporate bonds down 66 bps and USD corporate bonds suffering a more pronounced 346 bps loss due to the stronger rates move and longer duration in the USD segment. Expectations of faster monetary policy tightening clearly did not sit well with investors even though we are still currently in the easing mode as central bank balance sheets are increasing. While certainly not a good start to the year, the reaction of credit spreads was quite muted with EUR and USD spreads only widening by 7 and 8 bps respectively. Especially given the sell-off seen in the equity market, corporate bonds were relatively well supported. That said, it might have given us a glimpse into what awaits us in 2022. One thing that is almost certain is the comeback of spread volatility now that the central bank tailwind is fading. We would therefore expect spreads to widen from here. In the short term we also see more upside in interest rates as inflation remains elevated and central banks might be forced to adjust their policy more aggressively. We therefore remain cautious on credit risk, while keeping a short duration stance in our portfolios.

Equities

Rotation from growth to value stocks

USA

- The US market has lost 8.8% so far in 2022 (all data as of 25 January). It is the weakest start to the year since 2009 when the S&P 500 lost 8.6% in January. The prospect of four rate hikes by the US Fed and rising treasury yields were the main factors for the sell-off.
- The US-market is expensive and more oriented towards growth stocks than other developed markets (see main text). Therefore, we think that this could be the first time in many years that the US market underperforms its peers.

Eurozone

- The Eurozone equity market lost 5.9% in the first weeks of 2022.
- The market is more attractively valued and has a more value-oriented sector structure than the US market. Also in favour of Eurozone equities is the fact that the ECB is not expected to raise policy rates this year.

UK

- After several weak years, the UK market has outperformed its peers so far in 2022. The FTSE 100 only lost 0.4%. The last full year that the UK market outperformed the global market was in 2011.
- Among the main developed markets, the UK market has the lowest valuation and the highest dividend yield. The UK market is more cyclical than other markets and has a comparatively high exposure to stocks that do well in the current environment (financials, energy, consumer staples).

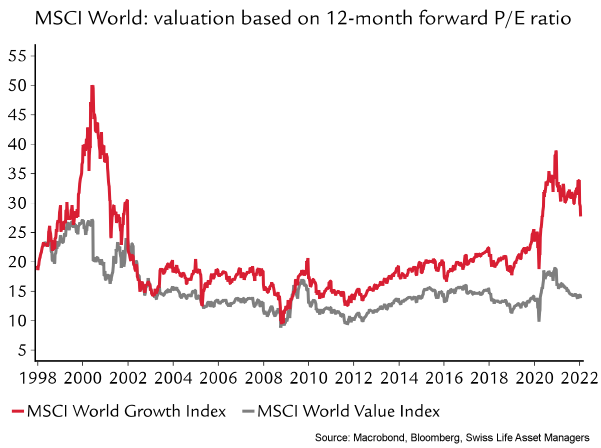
Switzerland

- The Swiss market also had a weak start to 2022 and is down 7.8%. Index heavyweights such as Roche and Lonza had a significant impact, but many smaller names in the technology and pharmaceutical sectors have also come under pressure.
- Swiss stocks profit from global growth, but valuations are elevated.

Emerging markets

- With a loss of 1.0%, emerging market stocks held up well, clearly outperforming developed markets.
- Valuation is attractive, and tentative signs that fiscal and monetary policy in China is becoming more accommodative have supported the market.

Growth vs. Value: valuation gap likely to narrow further



Over the last 12 months, global value stocks have strongly outperformed growth stocks (17% vs. 2%). This is mainly due to the performance this year where value stocks have outperformed by 11% so far. However, the long-lasting outperformance of growth stocks had already stopped in July 2021. We think that there are two reasons for this development: First, it has become clear over the last months that central bank policies around the world will become less accommodative. Rising interest rates are a bigger problem for highly levered companies with low current profitability, e.g., technology, biotech or SPAC (special-purpose acquisition companies) stocks. Second, the valuation gap between value and growth stocks was at an all-time high recently: the difference in the forward price-to-earnings ratio (P/E) was above 20 at the end of last year (39.5 for growth vs. 18.8 for value stocks, see chart). Going forward, we expect the performance and valuation gap between growth and value stocks to narrow. The interest rate environment will continue to become less favourable for growth stocks and the current valuation gap is still too big. In addition, expected revenue and earnings growth rates for growth stocks are still very elevated and likely to be overambitious. For example, Tesla is worth more than the next 10 biggest car producers combined despite a market share of well below 5% and almost no profits. Tesla would probably need to conquer 50% of the car market to justify current valuations. If our assessment turns out to be correct, value and fundamental-oriented investors should benefit. It could also mean that non-US equity markets will outperform in 2022.

Currencies

Increased monetary policy divergence

USA

- The hawkish Fed meeting on 26 January has led to renewed USD strength, with the trade-weighted USD up around 1% since the beginning of the year.
- We are sticking to our view of an appreciating USD against EUR and JPY over the next month, the main reason being the widening interest rate differentials ("carry").

Eurozone

- The EUR has had a mixed year-to-date performance, losing against USD and GBP, stagnating against CHF but gaining 1.7% against SEK.
- We expect inflation to come down faster in the Eurozone than in the US. Higher energy prices due to rising geopolitical tensions are an upside risk to our inflation forecasts, but are unlikely to trigger any ECB reaction. We are therefore reiterating our negative view of EUR/USD.

UK

- Sterling has been relatively well supported since the beginning of the year, only receding marginally against USD and gaining almost 1% against EUR.
- We continue to expect more policy rate hikes by the Bank of England this year, which should lead to additional appreciation against the EUR. Our view of GBP/USD remains neutral.

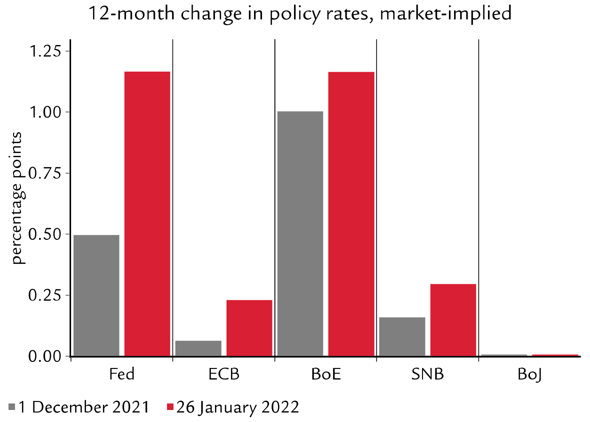
Switzerland

- EUR/CHF briefly scratched at the 1.05 mark in January, but swiftly fell back below the 1.04 mark.
- We see further appreciation potential for CHF against EUR over the medium term due to the almost non-existing interest rate differential to Germany. Geopolitical risks related to the tensions between Russia and Ukraine could add to the EUR/CHF weakness.

Japan

- USD/JPY has been fluctuating around the 115 mark since the start of the year.
- In line with our view of general USD strength, we expect USD/JPY to move somewhat higher over the next months.

Markets now price 4 to 5 Fed hikes over 12 months



Source: Macrobond, Bloomberg, Swiss Life Asset Managers

In our view, monetary policy divergence will be a decisive factor for FX markets this year. Market expectations for monetary policy tightening in the US have been piling up. Whereas interest rate markets priced in two Fed hikes (by 25 basis points each) over a 12-month period at the beginning of December 2021, they moved to four to five hikes just after the hawkish FOMC meeting on 26 January (see chart). The policy rate expectations for other major developed central banks have only increased marginally or not at all in the case of the Bank of Japan (BoJ), despite temporary rumours that the BoJ might move away from its ultra-expansionary monetary policy. The biggest surprise was the muted reaction of the USD to the increased monetary policy divergence since the beginning of December. EUR/USD has fluctuated around the 1.13 mark and USD/JPY has only increased moderately. Only the hawkish comments of Fed Chair Powell on 26 January, in the press conference after the FOMC meeting, instilled renewed strength in the greenback. One explanation for the muted reaction could be the fact that our view of USD strength already became a consensus call in the course of 2021, and speculative positioning of FX traders has been heavily in favour of the USD for quite some time. Also surprisingly, the rising geopolitical risks related to the tensions between Russia and Ukraine have not led to a significant rally of safe-haven currencies such as CHF and JPY. Nevertheless, we are sticking to our core views for 2022 expressed one month ago, i.e. continuation of USD appreciation on a trade-weighted basis as well as continued strength of CHF against EUR.

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