Perspectives
Financial Markets

SwissLife
Asset Managers

Annual outlook 2023

Interest rates & bonds

TINA is dead, long live TIAA

USA

- As central banks tightened monetary policies to fight decades-high inflation in 2022, fixed-income investors had the worst year on record as interest rates and spreads moved higher in unison.
- With the US inflation peak likely behind us, we see less volatility and less upward pressure on interest rates, which should bode well for investment-grade credit in 2023. While credit spreads could widen from current levels based on our recession outlook, we think the higher yield of the asset class should lead to attractive total returns in 2023.

Eurozone

- The ECB's tightening path was less pronounced than the Fed's, but European spreads widened more than US spreads due to the proximity of the Ukraine war and the dire energy situation in Europe.
- Europe is lagging the US on the inflation fight with higher peak inflation and lower growth. Nonetheless, EUR credit is supported by higher spread levels and more attractive FX-hedged yields, which should still attract inflows and lead to positive total returns.

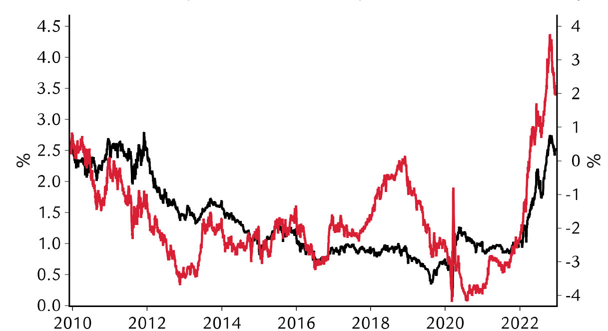
UK

- UK corporate bonds were amongst the worst performers in 2022 due to weaker economic growth, higher inflation, and a somewhat erratic interplay between fiscal and monetary policy.
- We expect the UK economy to remain the laggard in 2023 as well, while the labour shortage could keep inflation elevated. We therefore expect UK credit to underperform US and European credit.

Switzerland

- While total returns were negative, Swiss bonds outperformed most peers in 2022 due to the higher rating quality, better economic backdrop and most importantly the benign inflation situation that puts less pressure on the SNB to tighten monetary policy.
- Therefore, monetary policy is less of a drag on economic growth in 2023 than abroad, which should also support the Swiss credit market.

Credit offers an attractive yield again compared to stocks



TINA ("there is no alternative") was the primary argument for equities over bonds during the last years. That has changed now. While 2022 was an abysmal year for bond investors by a wide margin, it also made investment-grade credit very attractive again. EUR corporate bonds currently yield 3.7% vs. a low of just 0.1% in mid-2021 while US corporate bonds now yield 5.1% vs. a low of 1.7% at the end of 2020. In comparison, the EUR Stoxx 600 and the S&P 500 currently offer dividend yields of 3.4% and 1.6%, respectively, while exhibiting much higher volatility. So, there is an alternative again ("TIAA") to equities. Even though higher spreads are possible, credit now offers some protection in the form of a higher carry and a rates component that acts as a hedge in a risk-off environment. In addition, corporate bonds benefit from solid fundamentals and the supply glut of the past years has pushed out refinancing needs of companies even further. The current high nominal growth environment also tends to be beneficial to bond issuers whose revenues and earnings grow with inflation, while the debt level stays the same. We could therefore still see improving fundamentals despite low real economic growth. For government bonds, we still see risks as the central bank pivot might not come as early as investors currently expect. We therefore see higher bond yields rates and flatter curves especially in the first half of the year.

Equities

Short-term pain, long-term gain

USA

- The US market experienced a bear market in 2022, with the maximum loss amounting to -24% in mid-October. Since then, the market has recovered and closes the year with a minus of 17% (all data as at 13 December). In 2022, the US market underperformed the European equity market for the first time in more than 10 years in local-currency terms.
- The valuation of the US market is still much higher than for other developed and emerging markets. The US valuation is around neutral while other markets are trading below their historical average valuations.

Eurozone

- Despite the Ukraine war and its repercussions, the European equity market lost merely 10% in 2022. Between mid-October and mid-December, the market gained a whopping 14%.
- The valuation of the European stock market is very attractive on a standalone basis as well as relative to the US market. The valuation discount to the US market is still close to its all-time-high.

UK

- The UK is the only major equity market that will likely end 2022 with a positive performance (around 7%).
- Like continental European markets, the valuation is very attractive, and the UK market has the highest dividend yield (almost 4%).

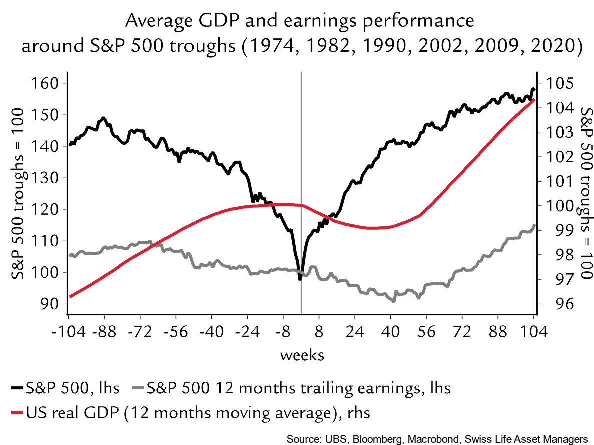
Switzerland

- In 2022, the Swiss equity market did not fully benefit from its defensive nature. The market lost 15% year-to-date. A key reason is that healthcare companies except Novartis lost between 19 and 37%. In addition, financials and some cyclical companies also underperformed strongly.
- The Swiss market is not cheap relative to other markets.

Emerging markets

- Emerging markets had the worst performance of all major markets in 2022 (-20%). China was the main drag as it suffered from property market woes, the zero-COVID policy and political uncertainty.
- From a valuation perspective, emerging markets are attractive. A weaker dollar could support the market in 2023. However, for a substantial outperformance, the doubts about China need to recede.

Equity market recovers ahead of the economic rebound



There are positive aspects for equities going into 2023: firstly, valuations have become much more attractive. Secondly, inflation has most likely peaked, and central banks may end the hiking cycle in 2023. We even expect that the US Federal Reserve will start reducing interest rates at the end of 2023. Thirdly, recent earnings results have been much more resilient than expected. Fourthly, the equity market bottoms out on average 6-9 months ahead of the economy (see chart). Assuming a US recession in 2023 that lasts 2-3 quarters, this implies that we might be close to a stock market bottom. Fifthly, sentiment is currently very bearish, usually a contrarian indicator.

On the negative side, we have, firstly, a recession and a commensurate decline in earnings that is currently not priced in. The average earnings decline during recessions is around 15%. For 2023, the market consensus is still single-digit growth in earnings. Secondly, valuations are indeed much lower than a year ago, but they are still above the levels seen in recession troughs. Thirdly, monetary policy is still tightening, and inflation and central bank rates may stay high for longer than currently expected. Fourthly, the relative attractiveness of stocks versus bonds has decreased significantly. Fifthly, geopolitical risks remain elevated.

We conclude that a negative stance towards equities is justified over the next quarter as the effects of the upcoming recession are not yet fully reflected in market prices. Over the medium term, stock valuations suggest an attractive return potential broadly in line with historical averages. In our view, investment styles like Minimum Volatility and High Dividend could do particularly well in the current market environment.

Currencies

Will the "USD supercycle" end in 2023?

USA

– In 2022, the USD had another exceptional year. Among major currencies, only the Brazilian real and the Mexican peso performed better, with central banks in both countries hiking interest rates more aggressively than the US Federal Reserve to rein in inflation risks.
– We expect the trade-weighted USD to weaken in the course of 2023 as the expected US recession and falling US inflation will likely bring the Fed into a position to cut policy rates again towards year-end (see main text).

Eurozone

– The EUR lost 6% against the USD in 2022 (data as at 15 December), but performed somewhat better than Nordic currencies or the GBP.
– We expect the Eurozone to be in a different economic cycle in 2023 than the US. Following the winter recession, we would expect some recovery, with China providing some tailwind. In combination with sticky inflation and an ECB that has delivered fewer hikes than the US Fed, we do not expect markets to price in rate cuts to the same extent as in the US. All of these factors are likely to support the EUR in 2023.

UK

– Despite the significant political turbulence in the UK, sterling remained in a relatively tight trading range against EUR in 2022.
– We expect this to remain the case in 2023. Our view is neutral on GBP/EUR and positive on GBP/USD.

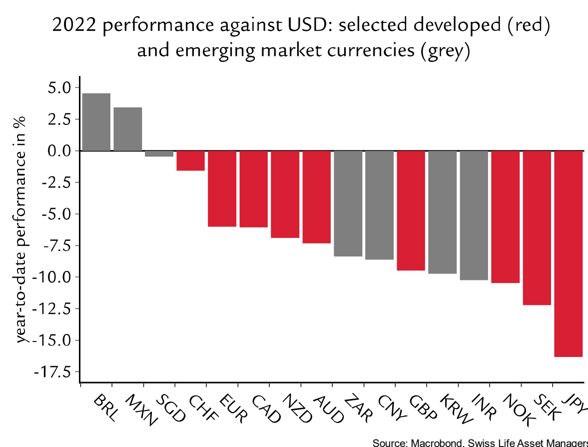
Switzerland

– CHF lost only marginally against USD in 2022 and appreciated 5% on a trade-weighted basis.
– We expect the SNB to end its rate hike cycle soon. In combination with a potential recovery of cyclical currencies such as GBP or EUR in 2023 (see above), we could see some appreciation of EUR/CHF in 2023. Opportunistic selling of FX reserves by the SNB will, however, limit the upside.

Japan

– JPY had the weakest 2022 performance of all major currencies as the Bank of Japan stubbornly stuck to its ultra-expansionary monetary policy
– In line with the expected general USD weakness, we have a negative view on USD/JPY in 2023.

2022: higher interest rates have supported the USD



The USD was the best-performing developed market currency in 2022 (see chart, data as at 15 December), following an already strong year 2021 when "king dollar" was only beaten by CAD and CNY. This "USD supercycle" was fuelled by a strong economy in both years and a Federal Reserve that was one of the central banks most committed in 2022 to fighting inflation, initiating the fastest rate-hike cycle since the years under chairman Paul Volcker. We believe, however, that the USD cycle will end in 2023. The past two months of 2022 already saw significant USD weakness as a result of a general risk-friendly market environment and the market dialling back some of the Fed rate-hike expectations. We believe that the recent move was outsized and see near-term risks of a hawkish re-pricing of Fed rate-hike expectations and equity market weakness. Hence, we head into the new year with a neutral view on the USD but expect renewed USD weakness in the course of 2023. As soon as the US economy plunges into recession in 2023, a clearer picture about the timing and extent of policy rate cuts will most likely emerge. This will also be the moment when risky assets will likely be back on a more sustainable recovery path. The combination of a turnaround in US monetary policy and an improvement in risk sentiment will be negative for the greenback, especially in a situation when the inflation problem will most likely remain more pertinent in the Eurozone and the UK, keeping some monetary policy tightening expectation alive in these economies.

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