Perspectives
Financial Markets

Swiss Life Asset Managers

May 2023

Interest rates & bonds

Cruising along

USA

- Following the turbulent month of March, April proved comparatively stable with subdued interest rate volatility. US 10-year Treasury yields traded within a narrow range, declining by 12 basis points (bps), while credit spreads remained mostly unchanged (all data as of 25 April).
- Although the US economy is exhibiting weakness in the manufacturing sector, the services sector is holding steady. Inflation continues to significantly surpass the Federal Reserve's target.

Eurozone

- Eurozone credit spreads tightened by 12 bps in April as concerns about a potential banking crisis subsided. The focus shifted back to inflation, causing a 10 bps rise for 10-year German bond yields.
- While headline inflation in the Eurozone has eased, core inflation remains on an upward trajectory, putting pressure on the ECB to increase policy rates further.

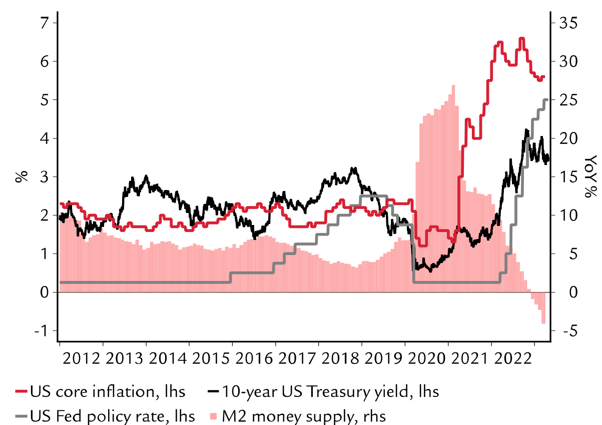
UK

- The UK's persistent inflation problem has caused headline inflation to remain above 10% for the seventh consecutive month. This is putting pressure on government bonds, with yields increasing by 20 bps.
- Despite high inflation, investors seem to believe that the Bank of England (BoE) will not be able to raise policy rates much further, expecting only two more 25 bps hikes before initiating cuts in 2024.

Switzerland

- Contrary to the European trend, Swiss interest rates fell by 17 bps in April as inflation unexpectedly dropped to 2.9% in the latest March report, from 3.4% in the previous month.
- The repercussions from the emergency merger of Switzerland's two largest banks, coupled with lackluster survey data, are likely to prevent the Swiss National Bank (SNB) from hiking rates too aggressively in upcoming meetings. The market anticipates two more rate hikes in 2023.

Tightening of US financial conditions still insufficient



Source: Macrobond, Bloomberg, Swiss Life Asset Managers

Despite a rapid interest rate hiking cycle and an unprecedented decline in M2, the broadest money supply measure in the US, inflation has not fallen sufficiently. While certain areas in manufacturing are experiencing disinflation and commodity prices have come down, it seems that current monetary conditions are not restrictive enough. In addition, the US labour market remains tight and while tech sector layoffs are making attention-grabbing headlines, the overall economy is still resilient. This is still leading to elevated nominal growth which supports earnings and risky assets. As a result, sentiment in the financial markets has improved. Market dips continue to be bought and credit spreads have eased from their March highs by 40 bps (EUR) and 30 bps (USD). Interest rate volatility has decreased, and a benign primary market issuance has left investors with ample cash to accommodate new deals and assume greater risk. However, we are maintaining a cautious outlook. Not only do the effects of financial tightening usually work with considerable time lags on the economy, but we also believe that the central banks acknowledge the necessity of a meaningful economic downturn to curb inflation. We are therefore maintaining our defensive positioning and largely neutral duration stance, which is also driven by the uncertainty surrounding the debt ceiling extension which could increase interest rate volatility again in the near term.

Equities

Long hope, short reality

USA

- The US market lost 1.0% in April and the year-to-date performance is +6.4% (all data as of 25 April).
- The market development this year has been very special: growth stocks outperformed value stocks by 15%, large cap tech stocks are up by around 29%, and large caps once again outperformed small caps. More than half of the market performance is attributable to Big Tech.
- Earnings are expected to decline by 7% in Q1/2023 and 8% in Q2/2023 relative to the previous year. The earnings season has just started, and results are above expectations. The US stock market valuation is still above historical averages. We continue to prefer non-US markets.

Eurozone

- The market gained 1.5% in April and the year-to-date performance is 13.9%.
- The Eurozone market outperformed the US market for the first time in many years due to its more attractive valuation and lower-than-expected energy prices. The earnings season started well with companies beating earnings expectations by 4%.

UK

- The UK market was the second-best performer in April with a performance of 3.8%. For the year to date, the market gained 7.1%.
- The UK market is still benefiting from the lowest valuation of all the major markets. However, the economy is weak and the share of cyclical stocks comparatively high.

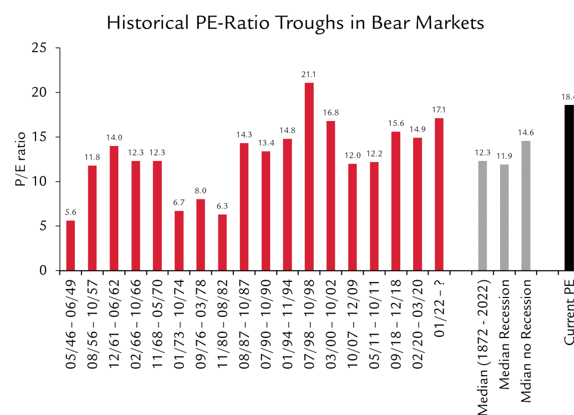
Switzerland

- The Swiss market gained 4.1% in April and the year-to-date performance is 9.7%. After a weak start to the year, pharmaceuticals staged a comeback in April.
- The Swiss equity market is the most expensive market after the US market.

Emerging markets

- April was a weak month (–2.4%). For the year to date, the market has gained only marginally (1.5%).
- Despite much better economic data from China and a less restrictive monetary policy, the emerging markets have not yet started to outperform.
- Both in relative and absolute terms, emerging markets are attractively valued.

Something has to give



Source: Fidelity, Swiss Life Asset Managers

The continuing uptrend of equities is remarkable. The odds of a (mild) recession are rising, and monetary policy is restrictive. In the Eurozone and the USA, the growth of broad money aggregates is negative, and the signs of tightening loan supply are becoming stronger. Earnings growth is stalling or negative and margins are declining. On top of this, we have banking sector stress, worries about US commercial real estate, negative earnings revisions and geopolitical tensions. It appears that stock markets are "long hope" and "short reality". There are five factors causing this sanguine view: 1. The hope that the US Fed will stop raising rates soon and start to cut them in H2/2023 already. 2. The stock market turns before company earnings and the economy. 3. Valuations are low outside the US (but still significantly higher than during historical bear market troughs, see chart). 4. Negative sentiment and earnings revisions imply that a lot of negative factors are accounted for. 5. Earnings results and economic data remain better than expected. These are valid points, but there is an inconsistency. If the Fed were to lower rates, it would most likely be due to a recession. In that case, margins and earnings would come under pressure more than is currently priced in. Something has to give: either the economy and earnings stay strong, in which case the Fed likely does not lower rates, or vice versa. Therefore, we believe that the markets are too sanguine in their assessment. With unchanged earnings, the US market would need to correct significantly to have a P/E ratio consistent with the historical bear market troughs. We are retaining a cautious view and think that a mild recession will be unavoidable, and that market conditions will worsen. At least a short-term correction is overdue.

Currencies

Volatility receding

USA

- After a turbulent March, the USD lost another 0.6% on a trade-weighted basis in April, while gaining against a few commodity-related currencies (all performance numbers in this column as of 26 April)
- The move was driven by mixed economic data from the US, which has increased the perceived recession probability in the market.
- We expect that the USD might be prone to further weakness over the next months as we expect a US recession in the second half of the year and the start of a Fed easing cycle.

Eurozone

- The EUR reached a new one-year high against the USD and appreciated against all G10 currencies except the CHF in April.
- We expect the EUR to remain supported in 2023 due to more persistent inflation and a delayed hiking cycle in the Eurozone compared to other economies.

UK

- The GBP depreciated vs. the EUR in April but managed to gain against the USD.
- Our one-month view of GBP is positive vs. USD and neutral vs. EUR.

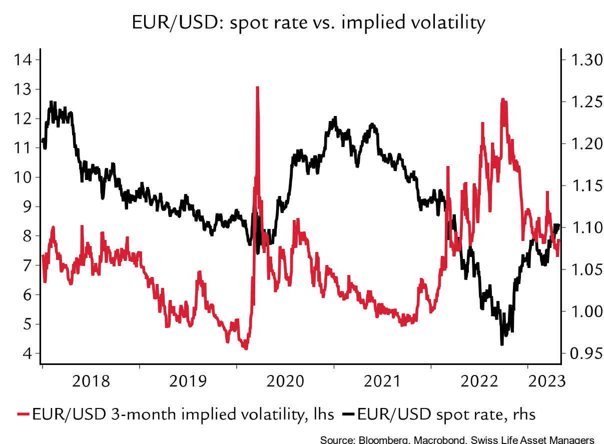
Switzerland

- CHF strength continued in April, with the CHF appreciating 3% vs. the USD and around 1% against the EUR.
- We expect EUR/CHF to move sideways in May, with some upside risks for EUR/CHF thereafter as the ECB remains under more pressure to increase interest rates than the SNB.

Japan

- The JPY moved sideways against the USD in April, while CHF/JPY reached a four-decade high.
- Our view of USD/JPY remains negative. The reasons are not only our view regarding general USD weakness, but also the risk that Japan will speed up monetary policy normalisation under the incoming Bank of Japan Governor Kazuo Ueda.

Fundamentals back in focus



After a volatile March, implied volatility levels in EUR/USD across all tenors have started to decline. The problems in the banking sector have moved into the background. The emergency measures implemented by the central banks and the government seem to have achieved their goal of calming the financial markets for now.

With the calmer market environment, there is room for fundamental drivers to move to the forefront again. The USD has continued to weaken against the EUR in April driven by diverging economic momentum. Expectations that the US is at the end of its economic cycle are firming up. Economic data out of the US has been more mixed lately, while a continuation of the robust economic momentum for the Eurozone into the second quarter is being confirmed. If this backdrop continues to persist in the absence of further banking turbulence, we expect to see a continuation of USD weakness vs. the EUR over the next months. Our view is further supported by diverging monetary policy expectations, which are also reinforced by the gap opening on the economic side. The Fed is expected to end its hiking cycle soon, while the ECB has some room left for further tightening, as inflation in the Eurozone remains more persistent. The upcoming debt ceiling debate in the US could put further pressure on the USD if not resolved quickly, and therefore further complicates the USD outlook.

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