

October 2023

Interest rates & bonds

When will the rate hikes bite?

USA

- Interest rates remain on their upward trajectory with the yield curve witnessing a pronounced steepening; the 30-year bond yield rose by 45 bps in September, just as central banks began hinting at the end of the hiking cycle. While investment grade (IG) spreads narrowed by 2 bps, high yield (HY) spreads widened by 8 bps.
- The US Federal Reserve kept policy rates steady, yet Chairman Powell underscored the "higher policy rates for longer" policy, which markets seem to be factoring in by pricing out more policy rate cuts for next year.

Eurozone

- German 10-year Bunds yields reached a new cycle peak at 2.8%, rising by 30 bps, accompanied by a noticeable yield curve steepening. Despite the surge in yields, investment grade and high yield spreads were fairly resilient, tightening by 6 bps and 19 bps, respectively.
- The ECB surprised the markets with a 25 bps policy rate hike, followed by a comparatively dovish message in light of prevailing high core inflation.

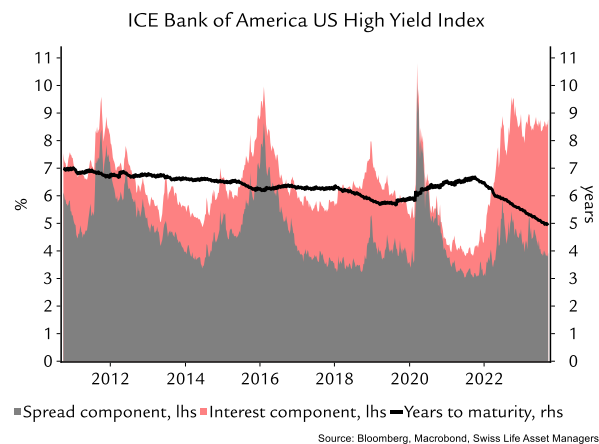
UK

- Contrary to global trends, UK Gilt yields dipped 12 bps at the 10-year mark. This is attributed to an ailing economy, with both manufacturing and service Purchasing Managers' Indices indicating potential contraction.
- In September, the Bank of England kept policy rates constant, a move which caught the markets off guard given the persistently high inflation rates.

Switzerland

- Swiss 10-year government bond yields remained anchored between 0.8% and 1.1% – a pattern that has been observed for half a year now – as the economy trudges forward with an inflation rate below 2%.
- The SNB kept its policy rate unchanged, with both core and headline inflation rates below 2%.

Bond maturities loom while borrowing costs surge



In a bid to combat inflation, central banks have predominantly relied on rate hikes to increase borrowing costs, reduce investment and spending, and thus temper growth and, subsequently, inflation. Yet, so far, growth has remained robust and inflation elevated. A significant factor in the lagging transmission has been the extensive refinancing activities during the previous ultra-low yield environment, enabling businesses and households to borrow cheaply at extended maturities while simultaneously boosting their cash reserves. As a result, the need to borrow at the current high costs has been low. With little reason to borrow, new issuance, particularly in the high yield sector, has decreased markedly, with the average maturity hitting a record low. However, as more maturities loom ("maturity wall"), more issuers might have to refinance at the current very elevated all-in yields. Given the Fed's restrictive policy stance, marked rate reductions might only materialise after pronounced credit spread increases, which, notably, have not occurred so far. We continue to hold a net short position in credit risk, especially after the recent rate surges that could render financing unfeasible for many weaker issuers. In terms of duration, we are leaning towards a long position. While further short-term yield spikes cannot be ruled out, we believe that any emerging credit events could trigger a decline in interest rates.

Equities

Correction deepens after hawkish Fed stance

USA

- The US market lost 5.2% in September, leading to a year-to-date performance of 12.6% (all data as at 26 September).
- After a strong earnings season with better-than-expected results driving equities higher, US stocks retreated significantly from their previous highs.
- US equities faced some headwinds after the Fed confirmed a rather hawkish stance, sending the US 10-year yield even higher. The US equity market valuation is still above historical averages.

Eurozone

- The market lost 4.0% in September and the year-to-date performance is 9.3%.
- The earnings season delivered better-than-expected results as well. However, the eurozone disappointed with weak economic data, with several economies being at the brink of recession, notably Germany. From a longer-term perspective, the European market is still very attractively valued.

UK

- The UK market delivered a positive performance of 3.1% in September after the Bank of England refrained from further interest rate hikes. For the year to date, the market gained 5.4%.
- The UK market still shows the lowest valuation of all the major developed markets, although we see this as a “value trap”.

Switzerland

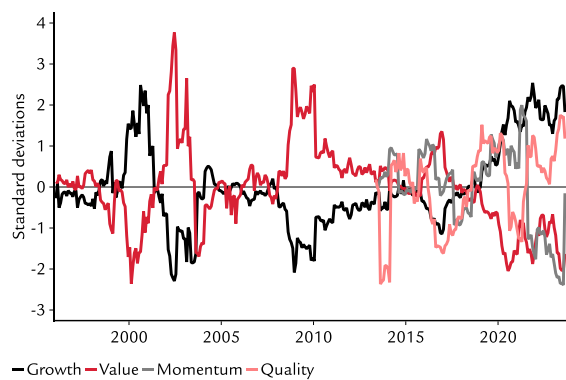
- The Swiss market declined by 1.9% in September bringing the year-to-date performance to 3.9%.
- Swiss equities outperformed their European counterparts, mainly due to less exposure to cyclically dependent stocks.
- The Swiss equity market is the second most expensive market after the US.

Emerging markets

- September disappointed with a performance of -3.2%. For the year to date, the market stands at 1.2% and is thus lagging the other stock markets.
- With still-subdued Chinese economic growth, renewed weaknesses in the Chinese real estate market and the strengthening of the US dollar, Chinese equities drove the negative EM performance. The stimulus measures announced by the Chinese government have been rather insufficient so far.

Large differences in style valuation

MSCI USA: style valuations (normalised) relative to market (USA)



This year, the differences in the performance of different investment styles¹ such as “growth”, “value”, “quality” and “momentum” are extraordinarily large. In the US, for example, the “growth” factor has a year-to-date performance of 35% while “value” is only up 3%, and thus continued the outperformance of other styles witnessed since the great financial crisis. Since 2010, “growth” has outperformed “value” in 11 out of 14 years.

However, it is not only performance that shows a large divergence – relative valuation has developed very differently as well, and is now at very extreme levels. The relative valuation of “growth” (vs. the US broad market) is currently almost two standard deviations above its historical average of zero, while the relative valuation of “value” is two standard deviations below the historical average leading to a combined differential of 4.5 standard deviations.

As the chart shows, this has only previously happened in crisis periods, but never in “normal” markets. It is also apparent that extreme valuation differences have been mean-reverting in the past: any particularly high or low valuation has corrected itself towards the historical average. The differences have started to increase more significantly since 2018. If history is any guide (which we believe to be the case), the probability that “value” and “momentum” perform better than “growth” and “quality” over the next business cycle is clearly higher than 50%.

¹ **Growth:** focusing on a stock’s future prospects and the overall financial health and strength of a company. **Value:** discovering which companies are trading under their true value before the broader market catches on. **Quality:** focusing on companies with strong fundamentals, such as high return on equity, low leverage, and stable earnings growth. **Momentum:** taking advantage of upward or downward trends in a stock’s price and earnings outlook.

Currencies

Stronger USD for longer

USA

- The strength of the USD continued throughout the month of September. The USD appreciated against all major currencies, gaining the most against the GBP and the CHF.
- We are sticking to our positive view of the USD for the next month and for the next quarter. The US interest rate advantage (“carry”) is likely to remain significant, supporting the USD.

Eurozone

- The EUR/USD exchange rate continued its downward trend in September and dropped below 1.06. Economic data out of the eurozone continues to disappoint. Despite the ECB’s policy rate hike and the pause by the Federal Reserve in September, the US real yield carry remains supportive of the USD.
- We remain negative on EUR/USD over the next one month and three months and expect the EUR to move sideways against GBP and CHF over the next quarter.

UK

- GBP lost around 4% against the USD over the month of September and was the worst performer among the G10 currencies. GBP came under selling pressure after the Bank of England unexpectedly left interest rate unchanged in their September meeting. The market had priced in one more rate hike.
- We now expect GBP/USD to trend lower over the next one and three months.

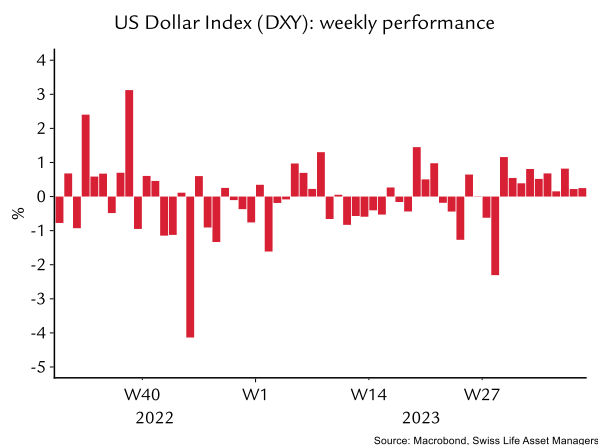
Switzerland

- USD/CHF continued its upward trend in September and went above 0.90 again. EUR/CHF saw a sharp upward move after the SNB meeting, where the SNB kept interest rates unchanged. The market had expected the SNB to follow the ECB with another rate hike.
- We are sticking to our neutral view of EUR/CHF over the next one and three months.

Japan

- USD/JPY increased by another 2.5% in September. The dip in July was thus only a short episode in a seemingly unbroken upward trend for USD/JPY.
- However, we see this upward move as stretched, and expect some reversal over the next quarter. We have therefore changed our one-month and three-months view of USD/JPY to negative.

“King Dollar” reigns on



The strength of the USD has seen a remarkable run over the last few months with the USD index appreciating for the last ten consecutive weeks. One defining factor has been the wide yield differentials between the highest and lowest yielding currencies, meaning that a “carry-seeking” environment has prevailed among investors. Within that environment, the USD has looked attractive, as it combines a high yield with defensive properties, making it attractive during periods of fragile risk sentiment too. Additionally, the USD has been supported by relative benign economic data out of the US. The most recent central bank decisions have also supported the USD, even though the US Fed kept its rate on hold in their last meeting, a decision that had been widely expected by the market. The Swiss National Bank and the Bank of England followed suit, leaving their rates unchanged. In contrast to the Fed, the market had priced in a hike by these central banks, which led to sell-offs in both CHF and GBP against the USD. Even though the ECB lifted its policy rates again by 25 bps in September as expected by the market, the increased carry failed to lift the EUR vs. the USD. The tightening of monetary conditions in the context of weakening growth in the eurozone outweighed the positive effects of a narrowing yield differential between the US and the eurozone. Looking ahead, we see the USD remaining stronger for longer as we expect the above-mentioned supporting factors for the USD to remain in place over the next quarter. Additionally, China’s deflation risks could impact the eurozone inflation trajectory more than that of the US, enabling the ECB to turn more dovish more quickly. While this will be supportive for the weakening economy, it will widen the yield differential again.

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