Perspectives
Financial Markets

March 2024

Interest rates & bonds
Investment grade bonds continue to perform

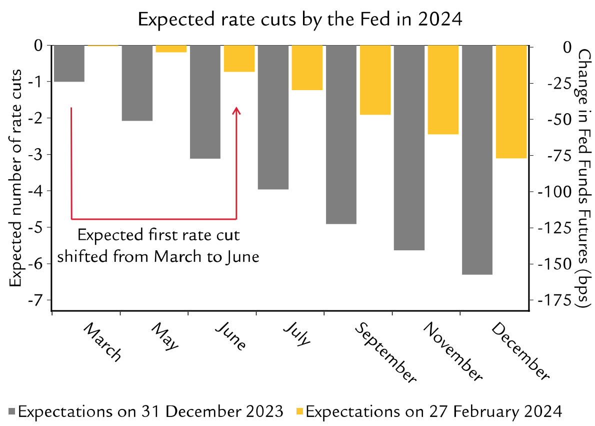
USA
- The upside surprise in US inflation numbers for January has reduced expectations of Fed policy rate cuts and pushed US 2-year government bond yields about 40 bps higher in February.
- The credit market nevertheless remained strong, the US Investment Grade Corporate Bond Index tightened by 6 bps to 96 bps and new issues were well absorbed. Demand remains solid as institutional investors are looking to lock in the relatively high yield.
- A key topic in the financial sector was the development in the US Commercial Real Estate (CRE) market. However, large write-downs due to steep falling valuations are mainly an issue for smaller regional banks as large institutions are less exposed.

Eurozone
- Europe finds itself in an economic environment in which disinflationary trends are emerging alongside economic stagnation. We think that the ECB might cut rates as early as April 2024.
- Undeterred by economic developments, credit spreads in the Eurozone narrowed in line with their US counterparts.

UK
- Core inflation, though falling from its peak, has remained stubbornly above the target at 5.1% over the last three months, and GDP data showed that the UK was in a technical recession in H2 2024.
- Inflation data was also reflected in the shift of the UK Gilts sovereign curve, which has risen more sharply year-to-date, particularly for tenors longer than 2 years.

Switzerland
- Swiss core inflation for January 2024 came in at 1.2%, lower than expected by consensus. This has led to a substantial fall in government yields as the chances have increased that the SNB might cut interest rates earlier than previously expected.
- The Swiss bond market outperformed other markets in February due to the benign inflation data.

Expectations for Fed rate cuts are shifted out



The bond market narrative is undeniably shaped by inflation. 2023 began with inflation anxieties, but ended with a surprisingly swift deceleration, which led to outsized hopes for large rate cuts this year. The FOMC meeting in January 2024 marked another pivot. The Fed recognized the stickiness of inflation and emphasized the need for continued vigilance. In addition, strong US labour market data in February caused a spike in US Treasury yields, especially for short tenors. The 10-year US Treasury yield also moved higher and exceeded 4.3% in February. The strong economic data tempered expectations of an early rate cut by the Fed. The market expectation back in December of a first cut in March 2024 has moved to June 2024, and the anticipated six cuts for the entire year have been halved to three (see chart). We do not expect a rate cut in March and remain neutral on 10-year US Treasuries and expect lower rates in the Eurozone. The robust economic fundamentals have provided some support for financial markets to remain optimistic, leading to a further tightening of US investment grade (IG) corporate bond spreads. We expect the constructive environment to continue over the coming month and have a neutral stance on IG spreads in the US and the eurozone. It seems that the credit market is not too sensitive to the timing of the first cut, as long as it ultimately materialises and the macro backdrop remains supportive.

Equities

Strong US earnings season

US

- The US market gained 4.9% in February and 6.5% since the beginning of the year. The Magnificent 7 stocks were again the key driver of the positive performance (+11.4% in February).
- The positive market performance occurred despite rising US Treasury yields and much lower expectations for central bank rate cuts. The market is still pricing in a goldilocks scenario with a strong economy and significantly lower interest rates.
- The US valuation is still far above historical averages and much higher than the other markets. The price-to-earnings ratio (P/E) has risen again this year. The equity risk premium is close to zero.

Eurozone

- The European market gained 3.6% in February and 5.9% year-to-date.
- Surprisingly, the gap to the US market is small, despite a very low technology weight. The earnings season was much weaker than in the US.
- The European market is still very attractively valued from a longer-term perspective. The equity risk premium is much higher than in the US.

UK

- The UK market remains a weak performer. In February it was up 1.2% and since the start of the year the performance has been 0.0%.
- The UK market still benefits from the lowest valuation and the highest dividend yield of all major developed markets (4.0%).

Switzerland

- The performance in February has been a meagre 0.6% and year-to-date the market has been up 2.2%.
- The Nestlé stock lost significantly after the earnings release.
- The Swiss equity market is the second most expensive market after the US market.

Emerging Markets

- February was a strong month with a performance of 5.4%, which leaves a year-to-date performance of 0.5%.
- As was the case last year, the key driver has been the Chinese stock market. After losing almost 8% in January, a recovery started, and the market gained 10% from its low.

Earnings season & Magnificent 7

The earnings season delivered mixed results. In the US, earnings grew by 7% in Q4 2023 (vs. Q4 2022) while in the eurozone they declined by 7% (+3% if energy stocks are excluded). In both cases, earnings exceeded expectations. Sales growth came in at 4% in the US and at -2% in the eurozone. Japan delivered good results. In terms of sectors, two developments stand out. First, in both the eurozone and the US, the energy sector earnings declined by around 30%. The major positive growth contributors in the eurozone were Consumer Discretionary and Staples. Earnings in the IT sector declined. Second, in the US, the picture was quite different. IT and Communication Services increased their profits by 26% and 44%, respectively. The Magnificent 7 once again drove this development.

Summary of Q4 2023 earnings season results

	Earnings Growth	Sales Growth	Earnings Surprise	Sales Surprise	Earnings Beats	Sales Beats
USA	7%	1%	8%	1%	77%	57%
Eurozone	-7%	-6%	3%	-3%	58%	33%
Japan	10%	2%	1%	1%	55%	50%

Source: J.P. Morgan, Swiss Life Asset Managers

In recent weeks, the Magnificent 7 stocks have witnessed robust earnings growth, propelling their combined market capitalisation to a staggering USD 12 trillion. To put this into perspective, the Magnificent 7's market capitalisation now surpasses that of the entire Chinese stock market, as well as the combined market capitalisations of Japan, Germany and the UK. Notably, the *increase* of Nvidia's market capitalisation after the impressive earnings announcement was higher than the total market capitalisation of Coca-Cola. Meanwhile, the earnings of the Magnificent 7 are between USD 300 and 400 billion. This is less than half of the earnings of the Chinese stock market and about half of the combined stock market earnings of Japan, the UK and Germany. It thus needs to be recognised that the priced-in earnings growth rates are exceptionally high, leading to rich valuations. The current P/E-ratio stands at 38 and the price-to-sales-ratio exceeds 7.5. However, unlike the dot-com bubble of 2000, all Magnificent 7 stocks are profitable and rank among the largest global firms. Moreover, they have higher margins compared to other companies in the S&P 500.

Currencies

Fed patience and positive data surprises support USD

USA

- The USD had a slightly positive performance in February on a trade-weighted basis. The greenback appreciated against CHF, JPY, CAD, AUD and NOK, but moved roughly sideways against most other developed market currencies.
- For the month of March, we have a positive view on the USD against EUR, GBP and JPY but a neutral view against CHF.

Eurozone

- The EUR appreciated in February on a trade-weighted basis. Comments of ECB officials that point to a wait-and-see attitude led markets to remove some rate cut expectations this year (see chart).
- We now think that the market might have become a bit too hawkish regarding ECB policy expectations given the still weak economic data in the eurozone and continued progress on the inflation front. We thus choose to have a negative view on the EUR vs. USD and CHF.

UK

- The GBP had an uneventful month in February, moving broadly sideways against USD and EUR.
- Nevertheless, we expect GBP/USD to weaken somewhat in March, in line with our view of a generally strong USD.

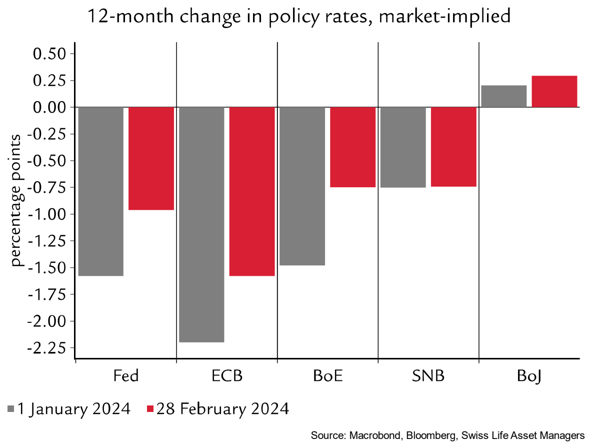
Switzerland

- The CHF was among the worst-performing currencies in February (see text in the right column).
- We have a negative view on EUR/CHF and a neutral view on USD/CHF for the month of March.

Japan

- In February, the JPY extended its depreciation trend against the USD that had been in place since the start of the year.
- We do not expect monetary policy to be normalised enough in 2024 to make the JPY an attractive proposition due to its significant carry disadvantage. We thus reiterate our positive view on USD/JPY.

Markets keep their expectations for SNB and BoJ stable



Apart from the Turkish lira and the South African rand, it was the two classical safe haven currencies CHF and JPY which had the worst performance in February among major currencies. Both depreciated 2% on a trade-weighted basis. We see two main reasons for that development. First, February was marked by very risk-friendly sentiment among financial market participants. Equities rallied and credit spreads tightened as recession risks were dialled back amid still robust macroeconomic data. Not even the string of negative news regarding the ongoing crisis in the US commercial real estate sector and regarding the wars in Ukraine and the Middle East were able to unsettle market participants. In this "risk-on" environment, the low-yielding safe havens CHF and JPY were punished by currency markets. Second, market expectations regarding monetary policy in Switzerland and Japan have barely moved. To be sure, there was a bit of back and forth regarding the timing of the first rate cut by the SNB and the first rate hike by the Bank of Japan (BoJ), but the sum of moves over a rolling 12-month horizon remained roughly stable (see chart). This was not the case for the US Federal Reserve and the ECB, for which easing expectations were dialled back, adding to the appreciation pressure of USD and EUR vis-à-vis the JPY and CHF. We expect investors to re-focus again more on the economic and geopolitical risks in March, a change in sentiment that should mostly benefit the USD and the CHF and less the still very low-yielding JPY, in our view.

Asset Allocation

Good returns thanks to strong equity markets

Review

– February was a good month for multi asset strategies, as absolute returns were robust.
– These good returns were mainly the result of the strong equity markets, as higher rates led to negative returns in bonds across most segments – high yield and emerging markets bonds being the notable exceptions.
– The main drivers were the resilience of the US economy and the strong results of a few companies which lightened an otherwise unremarkable US earnings season. Expectations about changes in monetary policy played a minor role in February, as the stronger than expected US economy limits the scope for the Fed to become less restrictive.

Current asset allocation views

Asset Class	Active Weight
Global Government Bonds	overweight
Global Investment Grade Credit	underweight
Emerging Market Bonds	neutral
Global Equities	neutral

Source: Swiss Life Asset Managers

– Equities continue to be expensive, especially after the strong returns in February and the more conservative earnings outlook presented in recent earnings announcements.
– 10-year real government bond yields have continued to increase, nearing the highs registered in late summer 2023, while credit spreads have tightened again, despite increasing signs of distress in some segments.
– We are therefore cautious and underweight at this point in corporate bonds, which at these levels offer little upside potential but significant downside risk.
– While the high equity valuation would suggest a defensive positioning on equities, we currently prefer to stay neutral, as market momentum is still strong.
– On the other hand, the high government bond yields look attractive, despite the risk of further increases. We therefore overweight this asset class.

Waiting for a fall in equity market momentum

The well-known economist John Maynard Keynes once said that "markets can remain irrational for longer than you can stay solvent". What Keynes, an aggressive and successful investor himself, meant is that markets can ignore fundamentals for a very long period before adjusting, often in a very dramatic fashion. Keynes reached this conclusion after a significant loss in a currency investment, where the currencies moved against economic logic.

Arguably, we are in one of these periods: equity market valuations, especially in the US, are very high and imply very optimistic expectations about the economy and the earnings of the traded companies. Meanwhile, credit spreads are close to historical lows despite increasing signals of distress in some segments of the market. To be sure, the positive market mood is supported by a more resilient economy than expected in the US and the hope that the emergence of artificial intelligence might boost productivity. Also, many companies profited from the low yields of two years ago to refinance, therefore being less sensitive to higher interest rates for the time being. Finally, central banks might start cutting rates in the coming months.

The intuitively obvious thing to do is to position the portfolio for the correction and wait. However, as Keynes realised, this can be quite costly, especially when markets have strong momentum.

So, while we currently think that equities and corporate credit are, on average, quite expensive, we also realise that the equity markets have good momentum, which is mostly fuelled by a narrative focusing on technological advances (AI) and the anticipated shift in monetary policy. Hence, for the time being we swim with the current and keep a neutral allocation to equities and focus on reducing our exposure to corporate debt, where the very low spreads leave little upside potential.

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