Perspectives
Financial Markets

Swiss Life Asset Managers

April 2024

Interest rates & bonds
Central bank easing cycle is commencing

Overview of bond yields and investment grade credit spreads

	10-year government bond yield			Investment grade credit spread		
	Current	March 2024*	Year-to-date*	Current	March 2024*	Year-to-date*
US	4.2%	-6 bps	31 bps	90 bps	-6 bps	-9 bps
Eurozone	2.3%	-12 bps	27 bps	114 bps	-7 bps	-24 bps
UK	3.9%	-19 bps	40 bps	118 bps	-7 bps	-21 bps
CH	0.6%	-13 bps	-3 bps	79 bps	2 bps	-3 bps

10-year government bond yield eurozone = DE. * Change as at 27 March.
Source: Bloomberg

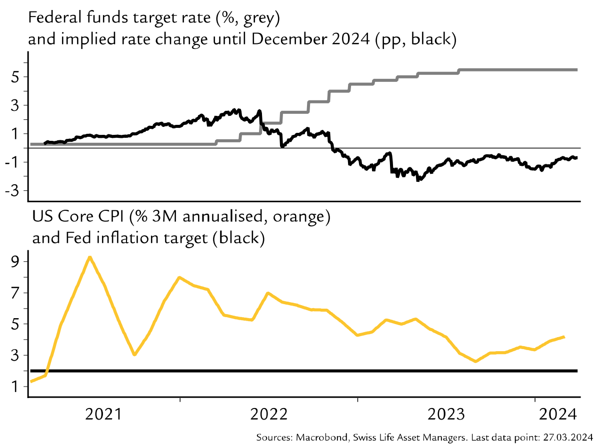
USA
– The 10y-2y government bond yield curve remained inverted at -35 basis points (bps) in March. Credit spreads tightened despite high new issue volumes.
– The Federal Reserve kept rates unchanged, adhering to its guidance of three rate cuts this year, despite raising its own forecasts for growth and inflation, with the latter expected to stay above its 2% target.

Eurozone
– The German 10y-2y yield curve inverted further to -52 bps, extending its inversion of over 500 days.
– The European Central Bank kept interest rates unchanged, but hinted at a potential cut in June, with the market anticipating three more cuts by year-end.

UK
– The market now expects the Bank of England to make the first rate cut in June, given the declining inflation and dovish communication.
– Uncertainty remains high, as inflation is at 3.4% and economic data is improving, with Purchasing Managers' Indices back in expansionary territory.

Switzerland
– The Swiss 10y-2y government bond yield curve remained inverted at -20 bps.
– The Swiss National Bank unexpectedly cut rates under the assumption that the currently sustained low inflationary pressure will persist in the future, leading to the CHF weakening against major currencies.

Markets expect rate cuts despite rising inflation



"Transitory inflation" served as the primary justification for the late start of rate hikes by developed market central banks, despite witnessing the fastest price increases in decades. Two years on, the central banks, particularly the Federal Reserve (Fed), appear overly keen to lower rates again, despite not having reached their 2% inflation target. The US core inflation on a three-month annualised basis has risen back to 4.2% since the previous summer without ever touching the 2% target. With the US unemployment rate hovering near historic lows, wage growth remaining at around 5%, and GDP growth projected to surpass potential, even the Fed's forecasts do not anticipate inflation hitting the target anytime soon. The market, aligning with the Fed's guidance, anticipates three rate cuts this year. Equities and speculative assets such as cryptocurrencies have experienced a surge, and the decline in long-term yields has significantly eased financial conditions. For the time being, the central banks' readiness to ease financial conditions is beneficial for risk assets, but we recommend exercising caution due to the current high valuations. In terms of government bonds we have a long duration stance but see potential in a steepening position, given the increased risk of headwinds for long-term interest rates should inflationary pressures persist.

Equities

Strong markets in March

Overview of equity market performance

	March 2024*	Year-to-date*
USA	3.0%	10.2%
Eurozone	4.4%	10.2%
UK	4.3%	3.8%
Switzerland	3.3%	5.4%
Emerging Markets	1.8%	1.7%

MSCI net total return indices in local currency.
* Performance as at 27 March. Source: Bloomberg

US

– The Magnificent 7 stocks were again the primary contributors to the positive market performance in March (+17.8% since the start of the year).
– The dovish tone from the Fed at its recent meeting supported the market, as three to four rate cuts this year have become more likely.
– The US market valuation still remains far above historical averages and that of other markets. Technical indicators are stretched, but not extreme.

Eurozone

– Earnings growth has been zero so far this year, meaning that the market increase since January can be entirely attributed to higher valuations.
– The valuation of the European market is now roughly neutral.

UK

– The UK remains a weak performer, despite its outperformance of other developed markets in March.
– The UK market still benefits from the lowest valuation and the highest dividend yield (3.9%) of all the major developed markets.

Switzerland

– Measured in CHF, the Swiss market has significantly underperformed the eurozone and US markets in March, as the CHF has depreciated against the EUR and USD.
– The Swiss equity market is the second most expensive after the US market.

Emerging markets

– The relatively weak performance of the equity markets in the emerging world is broad-based.
– The Indian stock market has only gained 4.9% for the year to date in local currency, while the Chinese market is down 1.8% as measured in HKD.

What is going on in Japan?

The Japanese equity market reached a new all-time high in 34 (!) years a few weeks ago. In 2023 and so far this year, it has outperformed all major markets when measured in local currency. This begs the question: Is this merely another short-term rally, or are there structural changes underway that could enhance the mid- and long-term performance of the Japanese market?

Equity Market Total Returns & Profitability

	In local currency			In CHF			Return on equity
	2023	Year-to-date*	10 Years	2023	Year-to-date*	10 Years	
JP	29%	20%	168%	9%	19%	83%	9%
US	26%	10%	210%	15%	18%	212%	18%
Eurozone	19%	9%	91%	12%	15%	50%	11%
CH	5%	5%	65%	5%	5%	65%	23%

* Performance as at 26 March. Sources: Bloomberg, Swiss Life Asset Managers

Several recent developments have contributed to the strong performance of the Japanese stock market. First, a weak yen has provided a dual benefit to Japanese exporters: their products become more competitive from the perspective of foreigners, and global sales are worth more in yen terms. Second, persistently low and negative interest rates have given Japan a relative advantage. Unlike other central banks, the Bank of Japan did not raise rates until its most recent meeting in March. Third, the Japanese stock market organisation has implemented several structural reforms aimed at improving corporate governance and focusing more on profitability. It is worth noting that about half of Japanese stocks are still trading below book value. Fourth, anecdotal evidence suggests that Chinese investor have discovered Japan for speculative investments. In the short term, the momentum of the Japanese market may continue. Valuations remain within the fair value range, the yen is still weak, and the positive effects of the structural reforms may continue to bolster the profitability of Japanese companies. However, risks loom in the longer term. The yen is significantly undervalued and may appreciate at some point. The return on equity, a measure of profitability, is still much lower than in other markets. Competition from China is also intensifying, and Japan's long-term structural issues — unfavourable demographics, insufficient immigration, and low potential growth — persist. Japan needs to do more to address these challenges.

Currencies

We expect the Swiss franc depreciation to be temporary

Overview of major currencies

	March 2024*	Year-to-date*	1-month view
EUR/USD	0.2%	-1.9%	↘
EUR/CHF	2.4%	5.4%	↘
GBP/USD	0.1%	-0.7%	↘
USD/JPY	0.9%	7.3%	↗

* Performance as at 27 March. Source: Bloomberg

USA

- March was an uneventful month for the USD. Monetary policy expectations remained stable and the trade-weighted USD ended the month at almost the same level as at the beginning.
- Financial markets are now firmly expecting a first rate cut in June, and these expectations should remain well-anchored in April as well. Other factors such as the US interest rate advantage, the prospect of a second Trump presidency, or a less-friendly risk environment could thus reignite USD appreciation.

Eurozone

- The EUR had another strong month in March, as the ECB retained its wait-and-see attitude.
- We still believe that the markets are somewhat underappreciating the potential for rate cuts this year, as economic dynamics remain weak and progress on the inflation front should continue. We thus have a negative view of the EUR vs. USD and CHF.

UK

- In March, sterling was unmoved by the prospect of earlier rate cuts by the Bank of England, but we expect some weakness in April, notably against the USD.

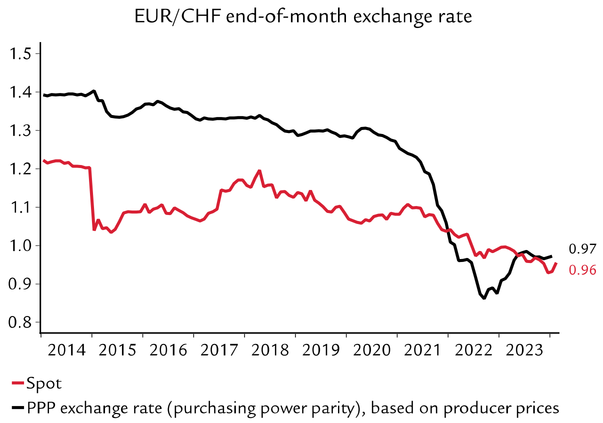
Switzerland

- The CHF was among the worst-performing currencies in March, although we caution against extrapolating this weakness (see text in the right-hand column).

Japan

- Despite the first interest rate hike by the Bank of Japan, JPY remained weak in March.
- The markets are not expecting a "proper" rate hike cycle by the Bank of Japan, but merely an exit from its ultra-expansionary monetary policy. We thus expect JPY to continue to suffer from its significant carry disadvantage.

EUR/CHF fairly valued according to producer prices



Sources: Macrobond, Swiss Life Asset Managers. Last data point: February 2024

The main event on the foreign exchange markets in March was the rate cut by the Swiss National Bank (SNB). This policy action came as a surprise to financial market participants, and thus led to another leg of CHF depreciation. Among the major currencies, only the Turkish lira (-7.7% year-to-date) and JPY (-5.7%) performed worse than CHF (-5.3%) on a trade-weighted basis. Interestingly, the SNB not only justified the move with reduced inflationary pressure. It also explicitly stated "the appreciation of the Swiss franc in real terms over the past year" as a reason in its press release. This argument is somewhat surprising, as part of the appreciation of the real effective CHF exchange rate in 2023 was reversed by the depreciation in February and March 2024. While it is true that opinions in the Swiss export-oriented sector have become more alarming regarding the exchange rate, the CHF is still not overvalued according to some models. If producer prices are used for comparison, Bloomberg estimates that the CHF is now fairly valued against the EUR (see chart). The narrowing inflation differential and the appreciation of the CHF in 2023 have thus not led to an overvaluation, but have merely removed a temporary undervaluation of the CHF. This model also suggests that the CHF remains undervalued against the USD. In any case, we would caution against extrapolating the current CHF weakness. While the SNB has acted early, we do not expect it to deliver more rate cuts than previously expected, and see 1.25% as the terminal rate in this "easing cycle", which will be reached by the end of the year. We also expect the SNB to tolerate moderate CHF appreciation again after the recent sell-off.

Asset allocation

Strong equity market rally after a slow start

Review

- After a slow start, the equity markets gained momentum in the latter half of the month. However, they experienced increased volatility in the wake of the US Federal Reserve meeting, yet concluded the month on a robustly positive note. The credit markets also had a favourable month, albeit more modest in comparison. Meanwhile, government bonds were able to yield only slighty positive returns.
- The US central bank's relatively dovish communication, which hinted at the potential easing of its monetary policy in the coming months despite the persistently solid economic data, had a minimal impact on the market.
- The Swiss National Bank (SNB) surprised the markets with an early policy rate cut. The timing can probably be explained by the less frequent meetings of the SNB, wanting to reduce the risk of lower interest rates in the US and the eurozone leading to the strong appreciation of the Swiss franc. The cut supported the Swiss Franc bond market, which performed well. The Swiss equity market's reaction was more muted, although the return in March was relatively strong. However, due to the significant depreciation of the Swiss franc after the cut, the Swiss equity market ended up being one of the weaker markets once returns were converted into Swiss francs.

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

- The strong equity market returns, still dominated by a fairly narrow group of sectors and companies, has pushed equity markets even further away from the fundamentals, rendering them even more expensive. However, momentum continues to be very strong, despite signs of weakness.
- While bond yields declined slightly, their levels continue to be attractive, whereas credit spreads, especially in USD, are at historically low levels.
- We remain (nervously) neutral on equities and are underweighting corporate bonds in favour of government debt.

Why are we underweighting corporate bonds?

In short, we find them unappealing. However, we also believe that equities are overpriced, so why only underweight credit? The primary reason is that bonds have a capped appreciation potential, unlike equities. If investors chose to entirely disregard risks and interest rate levels remained constant, the appreciation of a corporate bond would be limited by how much its spread, i.e., the additional yield paid to compensate investors for the risk of default, could decrease.

Currently, spreads are at historically low levels, indicating that there is minimal appreciation potential left in such bonds, even if market sentiment remains positive or becomes even more optimistic. On the contrary, equities, in theory, can continue to appreciate indefinitely, although their prices would increasingly deviate from their fundamental value and become more prone to correction. The following table outlines the probable responses of corporate bonds and equity markets under various market sentiment scenarios.

Market sentiment scenario	Corporate bonds	Equity markets
Strong positive	Small upside potential	Significant postive potential
Neutral	Stable return (yield)	Small positive return, volatility
Strong negative	Significant negative potential	Strong negative potential

Source: Swiss Life Asset Managers

If our assumptions are incorrect and the financial markets are indeed justified in their optimism, the cost in terms of return for underweighting equities will be significantly higher than for underweighting corporate bonds. Conversely, if our predictions are accurate and the market eventually adjusts, an underweight position in corporate bonds will offer less portfolio protection than an underweight position in equities. However, even in such a scenario, we could still reduce the weight of equities, albeit with some delay.

The risks, therefore, are asymmetric and slightly skewed in favour of equities, despite the unfavourable fundamental backdrop. But let's not deceive ourselves: If the financial markets undergo a significant correction, the current strategy will initially provide limited downside protection.

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