

May 2022

Interest rates & bonds

The upward trend of interest rates is likely to continue

USA

- In the US, long-term interest rates continued to trend higher in April given solid economic activity and soaring inflation. Expected 10-year real yields returned to the zero line. Short-term interest rates increased as a faster tightening of monetary policy has become more likely.
- The market expects the federal funds rate to increase to 2.25% by year-end. We expect the Federal Reserve to hike the policy rate by 50 basis points each at their May and June meeting.

Eurozone

- Increasing energy prices are driving inflation higher in Europe. Government bond yields increased substantially in the first months of the year. The war in Ukraine is affecting the economy, but the Purchasing Managers' Indices (PMI) for April indicate that the effect is rather limited so far. Germany is the most affected country.
- The European Central Bank (ECB) is winding down the Asset Purchase Programme (APP) and expects it to end in the third quarter of 2022. Recent comments by ECB officials suggested that the rate lift-off could already take place in July. We deem this unlikely and expect the first hike in September followed by another in December.

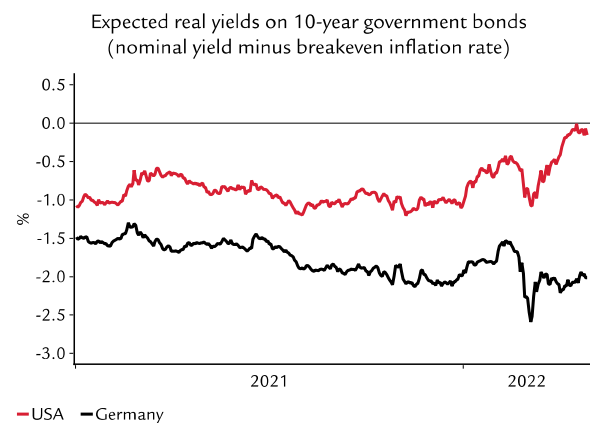
UK

- In the UK, government bond yields also increased but to a lesser extent than in the Eurozone.
- We expect the Bank of England (BoE) to hike rates another two times this year. This would bring the total amount to four in 2022.

Switzerland

- In Switzerland, interest rates increased along with their European counterparts. Bonds with a negative yield have almost disappeared.
- We think that the Swiss National Bank (SNB) will not increase interest rates before the ECB. We expect the SNB to increase the policy rate in December.

Expected real yields have returned to zero in the US



The first months of the year have seen a forceful increase of government bond yields driven by higher inflation, exacerbated by the spike in energy and raw material prices following Russia's invasion of Ukraine. In the US, expected real yields also climbed and are now close to zero. This reflects the good business conditions in the country. In Europe, real yields are still deeply negative. Europe is economically more affected by the war in Ukraine. The Purchasing Managers' Indices (PMI) for April, however, indicate that the effect is limited so far. It is too early for a final assessment as the war could drag on for a long time. Economic uncertainties remain high as a halt of Russian gas deliveries is a looming risk that would hit the German economy especially. In China, the zero-Covid strategy is leading to lockdowns of major cities. As a result, supply chains could become distorted again. Both could push inflation rates higher and dampen economic growth. The soaring inflation rates led to a dramatic change of monetary policy by central banks. The tightening of financial conditions will likely reduce bank lending. This increases the risk of a recession in 2023 and keeps us cautious on credit risks. We also think that government bond yields will continue to increase in the near term but at a slower pace than recently. As central banks increase policy rates, we expect yield curves to flatten.

Equities

Higher inflation and lower growth weigh on markets

USA

- In April, the US market lost a whopping 7.9%. The year-to-date performance is -12.8%. Profit margins started to decline in Q3 2021, and the likelihood of a further decrease is high. Nevertheless, market consensus expects margins to increase to all-time highs in Q3 2022. The earnings season started well.
- The US market is still more expensive than the other markets (price-to-earnings ratio P/E: 21) and the surge in nominal and real yields increases the relative attractiveness of bonds vs. US equities.

Eurozone

- The Eurozone equity market lost 3.5% in April and 12.3% so far in 2022.
- As in the US, expectations for earnings growth appear too high to us. However, in contrast to the US market, real interest rates are still negative, and valuation is close to historical averages (P/E: 15).

UK

- After several weak years, the UK market is outperforming its peers this year. It lost 0.7% in April and has gained 4.0% since the beginning of the year. It is the only major market in positive territory year-to-date.
- The UK market still has the lowest valuation of the major developed markets and the largest sector weights in energy and materials.

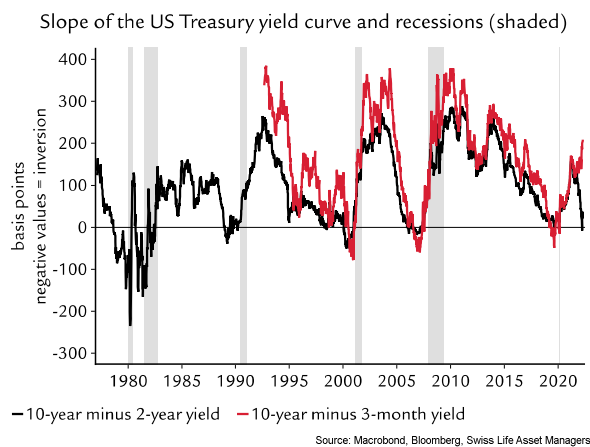
Switzerland

- The Swiss market is down 0.5% in April and 6.4% since the start of the year.
- The market benefitted from the strong performance of pharmaceuticals in the first half of April and its generally defensive character.
- In terms of valuation, the Swiss market is the second-most expensive after the US (P/E: 16.5). We think that its defensive character justifies a valuation premium in the current market environment.

Emerging markets

- Emerging markets are lagging once again with a year-to-date performance of -14.8% and a loss in April of 8.4%.
- Many emerging market countries suffer badly from the high prices of food, energy and agriculture goods. In China, further lockdowns weigh on economic activity and shipments.

Yield curve inversions typically precede US recessions



Historically, an inverted yield curve has been the best market-based indicator for an upcoming recession. Since 1967, all recessions have followed an inversion of the yield curve (but not all inversions have led to a recession). An inverted yield curve signals that market participants expect policy rates to decline going forward – a typical recession development. However, as is currently the case, a short temporary inversion in only one tenor (10-year minus 2-year yield) is not enough. The yield curve needs to be inverted for at least 1-3 months and both the 10-year minus 2-year curve and the 10-year minus 3-month curve need to be inverted. Neither condition is currently in place (see chart). Note, however, that the comparison with the 3-month rate is currently somewhat misleading as the Federal Reserve is behind the curve in terms of setting an appropriate money market rate. Contrary to intuition, an inversion of the yield curve does not lead to negative equity returns over the following 6-12 months. Since 1967, the US equity market has peaked on average only 11 months after the inversion and the peak of the equity market was on average five months before the recession started. Thus, the time interval between yield curve inversion and the recession is on average 16 months. The average return of the equity market between the start of the inversion and the equity market peak was 15% and only negative in one instance (Arab oil embargo in 1973. In that instance, the equity market peaked before inversion).

The conclusions of this analysis are as follows: (1) The current inversion is not yet significant, in our view. (2) A lot of performance can be lost if equities are sold prematurely.

Currencies

USD strength and no end in sight?

USA

- The USD strengthened against all major currencies in April on the back of higher government bond yields, more hawkish pricing of the Fed's monetary policy outlook and ongoing geopolitical risks.
- The US Dollar Index DXY, which is measured against a basket of major currencies, has increased by more than 8% since the beginning of the year and has reached the highest level since 2002.

Eurozone

- The EUR lost roughly 5% against the USD in April but was surprisingly stable against other European currencies such as GBP, CHF, SEK or NOK.
- Inflation continues to surge in the Eurozone and we now expect an even earlier start to policy normalisation, with a first rate hike likely in the third quarter. Contrary to the US, we also see further upside potential for long-term bond yields. This should limit the downside on EUR/USD despite elevated risks emanating from the Ukraine war. We have a neutral view on EUR/USD over the next four weeks.

UK

- GBP/USD also fell victim to broad-based USD strength and declined around 5% in April.
- We have a neutral view on both GBP/USD and GBP/EUR for the next four weeks.

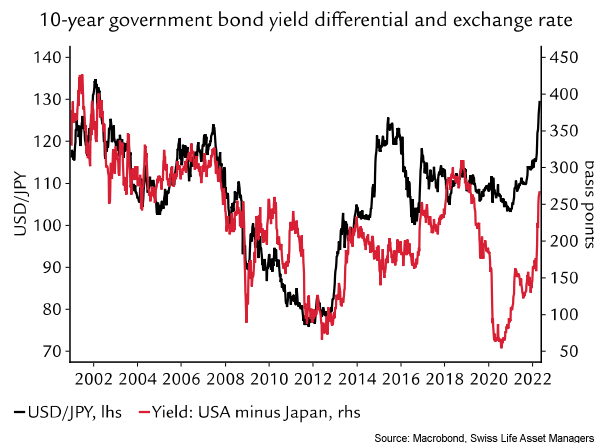
Switzerland

- In April, EUR/CHF fluctuated around the 1.02 mark. In line with other European currencies, CHF lost around 5% against the USD.
- As the CHF is likely to remain a sought-after currency in the current geopolitical environment, we reiterate our negative view on EUR/CHF.

Japan

- As in March, JPY was again the worst-performing developed market currency in April as the Bank of Japan surprised the market with extremely dovish rhetoric regarding its monetary policy outlook.
- USD/JPY reached a 20-year high. At these elevated levels, we have a neutral view on USD/JPY.

USD/JPY has spiked at a 20-year high



Our call for a neutral USD in the last edition was premature. The USD kept strengthening in April, outperforming all major developed and emerging market currencies. The move was again especially strong against JPY. In its 28 April monetary policy decision, the Bank of Japan reiterated its yield curve control policy that aims to cap the 10-year government bond yield at 0.25%. Many observers had expected at least some rhetorical pushback of the central bank against the significant JPY sell-off that has started to worry politicians and households. With 10-year yields in Japan thus frozen close to zero and 10-year yields in the US rising relentlessly, the yield differential (carry) has increased further and pushed the USD/JPY exchange rate above the 130 mark for the first time since April 2002. The USD also strengthened against the EUR, even though government bond yields in the Eurozone moved up amid increased expectations regarding ECB tightening. A likely reason for the continued weakness of the EUR is the negative news flow regarding the Ukraine war and the latent risk of a sudden stop of gas deliveries that could plunge the Eurozone into recession. At the current level of USD exchange rates, we still prefer a neutral view against EUR, GBP and JPY for the upcoming month as we believe that the move in US yields has already gone far enough and that market expectations for the Fed's policy rate path may have even overshot a bit. Regarding EUR/CHF, we reiterate our negative view as the stubbornly high inflation differential between Switzerland and the Eurozone is driving the "fair" value of the EUR/CHF exchange rate ever lower. Also, the CHF is likely to remain an attractive currency in the current geopolitical risk environment.

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