November/December 2022

Interest rates & bonds

It is not a pivot

USA

– Interest rates increased again in October with 10-year Treasury yields temporarily rising almost 60 basis points (bps) before ending the month up 27 bps.
– The US Federal Reserve raised policy rates again by 75 bps in November. We expect the Fed to go for smaller increases in the next meetings with the terminal rate expected to reach around 5% by next year.

Eurozone

– The German 10-year Bund yield ended October largely unchanged although it temporarily reached a new cycle high at 2.42%, before falling again sharply.
– As expected, the ECB delivered a 75 bps policy rate hike in October and made some adjustments to other policy tools, while also highlighting the downside risk to growth. Financial markets' expectations about future ECB hikes are quite volatile amid the tug-of-war between double-digit inflation rates and flashing recession signals.

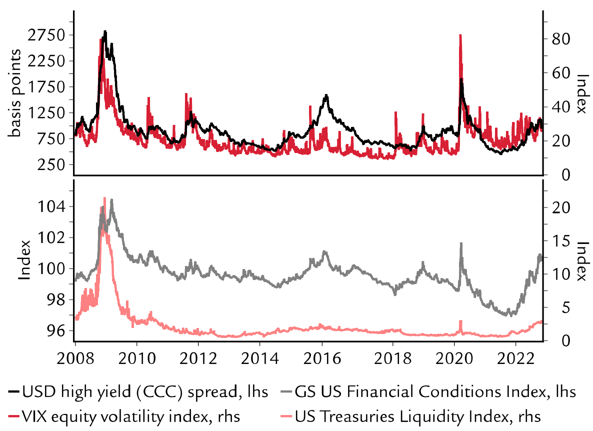
UK

– UK 10-year yields dropped by 60 bps as the political situation calmed down with the election of a new prime minister and a more restrictive fiscal policy outlook.
– The Bank of England will become the first central bank to actively sell assets as part of QT (quantitative tightening), despite only recently having had to buy bonds again to prevent a meltdown in the UK Gilts market.

Switzerland

– Swiss 10-year government bond yields fell 7 bps over the month as inflation is expected to have eased again in October.
– Given the comparatively low inflation, we expect the SNB to hike less aggressively than other central banks. Nevertheless, the SNB will likely hike its policy rate by 75 bps in December to make up for the fact that it only meets on a quarterly basis, less frequently than other central banks.

Gauges of stress in financial markets



The talk of a "central bank pivot", i.e. a turnaround in central bank policies, is becoming louder again amid slowing economic growth and supposed stress in financial markets. While financial conditions have tightened and growth is arguably slowing, the situation is not dire, nor inflation low enough to call for an end of monetary policy tightening. Inflation in the Eurozone is above 10% and increasing, with the average month-on-month inflation rate over the past three months pointing to 14% inflation on an annualised basis. While the US might have seen the peak in inflation, the more important core inflation measure, which excludes energy and food, is still trending upwards. In addition, we continue to see robust US labour market conditions. Looking at gauges of financial stress, we currently don't see signs of severe stress either. Neither CCC credit spreads, implied equity volatility (VIX), treasury liquidity or overall financial conditions indices are showing extreme values (see chart). That said, we think that we are approaching an end in the hike cycle, but that should not be misunderstood as a pivot. Central banks are still aiming to reduce their balance sheets and keep policy rates higher for longer to fight inflation. Ultimately, that will lead to higher unemployment rates and lower growth. We therefore favour a defensive position on credit risk and are maintaining a short duration bias.

Equities

Hope of a "central bank pivot" spurs markets

USA

- The US equity market gained 7.9% in October (the Dow Jones Index even rose by more than 14%) thereby compensating for the weak September. The year-to-date performance is now -19.2%.
- The main driver of the positive performance was the market participants' belief that the Fed will soon stop raising rates.
- The earnings results exceed expectations, but both year-over-year and quarter-over-quarter earnings growth are negative. Companies which reported results below expectations (e.g. Meta) saw their share prices declining substantially.

Eurozone

- The Eurozone equity market gained 7.9% in October and lost 16.2% year-to-date.
- The earnings season in Europe looks better than in the US. Despite the challenging economic backdrop, earnings increased compared to the previous year.

UK

- The UK market is still by far the best performer this year. It gained 1.5% since the start of the year and 2.8% in October.
- The UK currently faces an extremely challenging macroeconomic environment which led to the resignation of the prime minister and wild interest-rate fluctuations which had to be contained through Bank of England intervention.

Switzerland

- The market was up 4.8% in October. The year-to-date performance is -16.2%. In October, Switzerland underperformed the global equity market by 4.2%.
- Smaller companies have had a very difficult year so far. The small and midcap benchmark SMIM is down by 28.3% since the beginning of the year. These companies are much more cyclical on average than those in the SMI large-cap index.

Emerging markets

- Emerging markets lost another 3.1% in October in USD terms. The year-to-date performance is -29.4%.
- The key driver behind the weak performance is China. Trust in the Chinese government has been declining already for quite some time, and the latest party congress reinforced the doubts. The Chinese stock market lost 15.6% in October and is down by 40% year-to-date.

Trajectories of earnings expectations

As we have stressed for several months now, the earnings estimates were and are most likely still too optimistic, even though estimates have declined significantly in recent weeks. The earnings results of Q3 2022 clearly show that companies struggle to increase their earnings, especially in the US, where earnings declined by 3% year-over-year while revenues (also due to inflation) grew by 9%. Both growth rates were above expectations, however. In the Financials, Materials and Communication Services sectors, earnings declined by more than 10%. By contrast, the Energy sector achieved earnings growth of 200%. Despite the weak results, the US equity market has gained around 9% since the beginning of the earnings season. The Eurozone did surprisingly well in comparison. Earnings rose by 6% and revenues by 23%. As in the US, the energy sector had the highest earnings growth rate (57%). Earnings declined in only two sectors (IT and Materials). The market consensus still expects earnings to grow in 2023 and 2024 in the high single digit range (see chart). Furthermore, earnings estimates for 2023 are still higher than at the beginning of 2022. If – as we still expect – the Eurozone experiences a winter recession and the US goes into a (relatively mild) recession next year, these expectations are still too optimistic. Since the Second World War, earnings have declined by 16% on average during recessions. There has not been a single recession with positive earnings growth, but in 3 out of 11 cases, the earnings decline was less than 10%. Also, the earnings decline has been smaller when a recession occurred in a period of high inflation. Still, when looking at current earnings expectations, the market seems to price in a soft landing of the economy in 2023, a scenario that is too optimistic in our view.

Currencies

Only a temporary respite for EUR/CHF

USA

- The USD depreciated on a trade-weighted basis in October, losing against cyclical currencies such as EUR and GBP, but gaining against JPY and CNY, the United States' main trading partners in Asia.
- We think that the recent talk of a "Fed pivot", i.e. a turnaround in US monetary policy that undermined the USD in October, is premature. In combination with an already attractive interest rate advantage ("carry"), we expect the USD to remain strong until year-end.

Eurozone

- The EUR benefited from a generally risk-friendly market environment in October and higher market expectations regarding ECB policy tightening. The strong decline in spot electricity and gas prices may also have contributed to the EUR recovery, as the previous surge in energy prices has led to a collapse in the Eurozone's current account balance.
- However, with the approaching winter recession, we question the ECB's resolve in fighting inflation and expect the EUR to depreciate again against USD and CHF until year-end.

UK

- The change in government and the respective U-turn in the UK's fiscal policy outlook has led to a strong recovery of GBP since the end-of September low.
- Despite the restored trust, weak economic fundamentals (current account deficit and an upcoming recession) still speak for a lower GBP/USD exchange rate going forward.

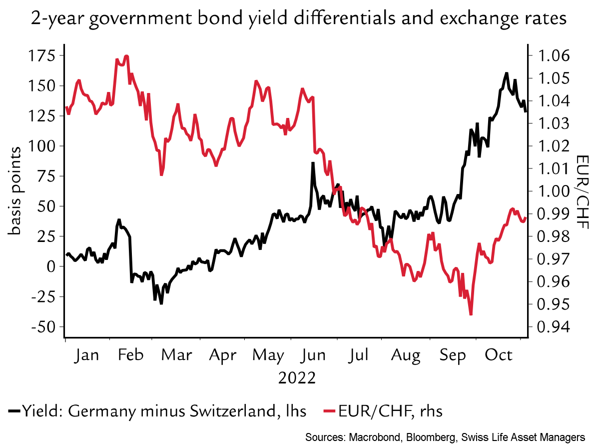
Switzerland

- CHF depreciated against most major currencies in October.
- Nevertheless, we expect the CHF to be a sought-after currency given low inflation, credible fiscal policy and relatively low recession risks. As soon as the risk-friendly market mood sours again, we expect renewed CHF appreciation, notably against EUR.

Japan

- USD/JPY moved another leg higher in October.
- We have a neutral view of USD/JPY. The Bank of Japan will likely stick to its ultra-expansionary monetary policy in the near term, but the JPY is now so drastically undervalued that further depreciation potential appears limited.

Interest rate advantage has supported EUR against CHF



Apart from the JPY, the CHF saw the largest depreciation among major currencies on a trade-weighted basis in October. The move was particularly strong against EUR, with EUR/CHF posting the largest monthly increase (+2.6%) since July 2017. The SNB used this window of opportunity to reduce CHF liquidity. Total sight deposits fell from CHF 754 bn in mid-September to CHF 582 bn at the end of October, mostly the result of repo transactions and issuance of SNB bills, but also to a minor extent to outright sales of foreign exchange. What certainly supported the EUR against CHF in October was the generally risk-friendly market environment as well as widening interest rate differentials. The German 2-year government bond yield was more or less equal to its Swiss counterpart in Q1/2022. The interest rate differential ("carry") has, however, increased significantly since mid-September, from around 50 basis points to 150 basis points at the end of October. This reflects the financial markets' view that the ECB will have to deliver more policy rate hikes than the SNB to bring inflation under control. While this is certainly true, we still believe that the current financial market pricing regarding ECB policy hikes is too aggressive given the ECB's many constraints, notably the upcoming recession and an elevated risk premium on Italian government bonds. In combination with a high and increasing inflation differential between Switzerland and the Eurozone, which undermines the value of EUR, we still think that the path of least resistance for EUR/CHF is down until year-end.

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