Perspectives
Financial Markets

February 2023

Interest rates & bonds

Fixed-income stages comeback

USA

- 10y treasury yields fell by 35bps while corporate credit spreads have compressed 11bps since the beginning of the year, compensating fixed-income investors in some part for the poor performance in 2022.
- The Fed is close to the end of its hiking cycle but will likely not cut the policy rate before the end of 2023 in order to see whether inflation is falling towards its target of 2%.

Eurozone

- European fixed-income likewise benefited from a strong performance as 10y government bond rates fell by 26bps and spreads compressed by 16bps.
- Core inflation in Europe is still rising, which puts more pressure on the ECB to tighten financial conditions, especially given the latest rally in risky assets.

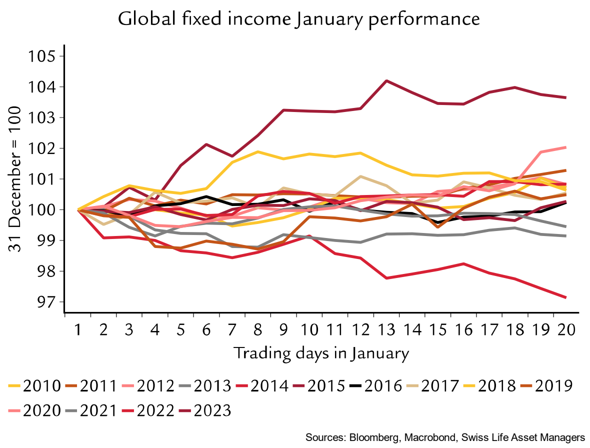
UK

- Government bond rates in the UK have also fallen since the beginning of the year but have not rebounded as much in the second half of January as their European peers.
- Despite the PMIs signalling a contraction in economic activity, the BoE will likely have to deliver several more hikes to rein in inflation, which is still above 10%.

Switzerland

- Swiss 10y government bond yields continue to march in lockstep with German bund yields and have fallen 50bps in the first few weeks of the year before rebounding in the later part of January.
- Although the KOF leading indicator improved markedly, growth is expected to remain anaemic for the rest of the year with inflation likely to fall below 2% already in the third quarter. We therefore only foresee one more hike by the SNB for this cycle.

Strong bond rally in January



Fixed-income had a great start to the year with EUR and USD investment-grade credit returning 2.1% and 3.5% respectively in January. Historically high all-in yields, an improving macro picture, falling inflation and the end of the global hiking cycle in sight offered an attractive investment proposition for the asset class. The question is now where do we go from here? This will largely depend on whether growth can hold up as expected while inflation continues to fall towards the central banks' magical 2% target. While the latest data supports that, the soft-landing scenario remains a difficult path to achieve as inflation has historically never fallen that fast outside of a recession. Moreover, the US is starting to show the first cracks that could deepen, the longer the Fed keeps interest rates elevated. While the European economy seems to be improving, the macro fundamentals still look shaky and might not be able to hold should US growth falter. Given the strong rally in credit spreads, we therefore remain rather cautious. We believe rates might see one last move upwards as central banks need to enforce their hawkish message following the massive loosening of financial conditions. However, going forward we see them going down or moving sideways as the economy continues to slow.

Equities

Good start to the year, but what comes next?

USA

- US equities started the year positively and gained 6.5% in January 2023 (all return data for regional MSCI Net Total Return indices). The key reasons for the strong start are lower inflation and interest rates as well as better-than-expected growth.
- The earnings season started with mixed results.
- The US market is still by far the most expensive. We continue to prefer non-US markets.

Eurozone

- The market was up 9.6% in January 2023 and the best performer among the major global indices.
- Lower gas prices and a clear reduction in inflation in December were key drivers for the positive development.
- The European equity market has an attractive valuation which is not much higher than in previous market troughs. Several sectors (e.g. carmakers) trade at PE ratios well below 10.

UK

- In January 2023, the UK equity market gained 4.1% – the weakest performance of all major markets. This underperformance must be put into perspective as the UK strongly outperformed all other markets last year.
- The UK market is still very attractive from a valuation perspective, but the economic fundamentals look very weak and political risks remain.

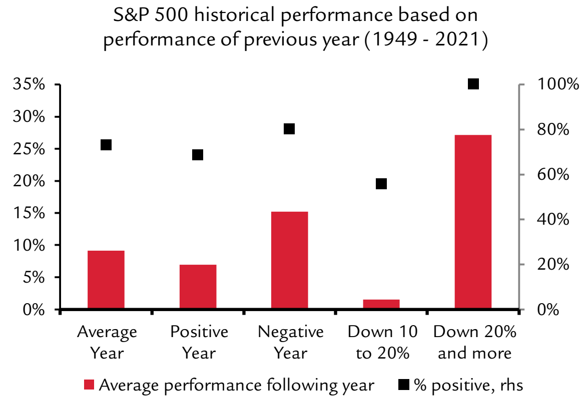
Switzerland

- The Swiss market gained 5.4% in January 2023.
- The Swiss market underperformed other equity markets due to the weak performance of the three index heavyweights Nestlé, Roche and Novartis. They had returns between -0.7 and 3%.
- The Swiss equity market is the most expensive after the US market. However, it is a defensive market which is likely to outperform in a choppier environment.

Emerging markets

- In January 2023, emerging market equities delivered a return of 7.9% making it the second-biggest winner after the Eurozone.
- The main reason for this positive performance is the reopening in the index heavyweight China which will support the economic development domestically and in emerging markets generally.

Rate hikes and recessions: implications for 2023



Source: Carson Investment Research, Swiss life Asset Managers

The historical pattern is fairly clear: bad equity market years coincide with recessions which are usually preceded by substantial central bank rate hikes. A loss of 15-20% in the S&P 500 as we experienced last year is normal in such circumstances. Historically, central bank rate hikes stopped in the following year and the S&P 500 recovered. The chart above shows that since 1950 every year with losses in excess of 20% was followed by a year of very strong gains in the S&P 500 on average. In a year like last year, in which the S&P 500 lost around 18%, the subsequent year was historically the weakest among the scenarios above and only in around 56% of the cases positive with an average return in the low single digits.

Achieving a performance above the historical track record will not be easy this year in our opinion. There are several reasons for our concerns: First, in the six months leading up to the end of the central bank hiking cycle, the equity market historically had a negative performance on average. Second, earnings estimates still call for earnings to grow – which has never happened in a recession post World War II . Third, earnings revisions and outlook are weak. However, there are also some positive signs: First, valuations are much more attractive compared to a year ago and non-US markets are outright cheap while pricing is not far away from typical recession floors. Second, sentiment is bearish. Third, many investors have already reallocated significant amounts to fixed income and fourth, inflation is declining, and the Fed may soon be able to stop raising rates. All in all, we still expect single-digit equity returns for the full year with another short-term correction upcoming.

Currencies

The euro is staging a comeback

USA

- In January 2023, the USD lost 1.5% on a trade-weighted basis as cyclical currencies such as EUR, GBP and all major emerging market currencies staged a comeback amid a risk-friendly market environment.
- While we stick to our view that the positive USD cycle ended as we approach a US recession in 2023 and rate cuts thereafter, we think that the recent moves have been somewhat excessive. If our view of a less risk-friendly environment in the near-term materialises, the USD might be in for a temporary recovery.

Eurozone

- The EUR not only appreciated against the USD in January, but also against European currencies on the back of more hawkish market expectations for the ECB. The move was particularly strong vs. SEK (+1.9%) and NOK (+3.4%).
- While EUR appreciation might pause or revert in the near term, we still expect the EUR to be supported in 2023 due to a delayed hiking cycle compared to other economies and sticky inflation.

UK

- Sterling had a strong start to the year, appreciating against the USD and holding its ground against EUR in January.
- We turned negative on the GBP vs. the USD after the rally in January, also due to the deteriorating growth/inflation mix in the UK.

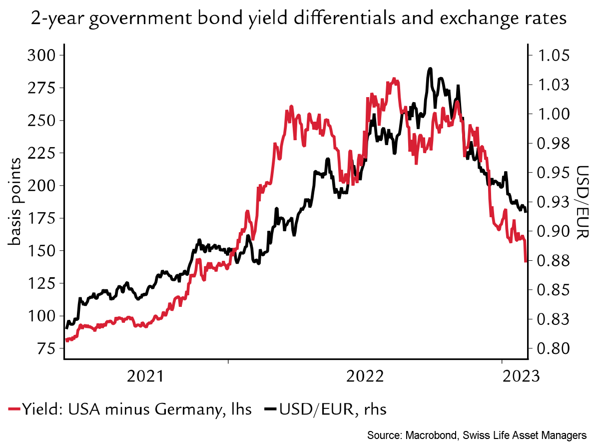
Switzerland

- The CHF lost around 0.5% on a trade-weighted basis in January, allowing the SNB to sell foreign currency.
- After the rally in EUR/CHF above parity, we expect some moderation in the near term.

Japan

- Since the peak in mid-October, USD/JPY has fallen by a whopping 14%. The Bank of Japan (BoJ) stuck to its revised yield-curve control policy in January, but markets are increasingly questioning the sustainability of the policy that could potentially be scrapped under a new BoJ governor.
- This could mean higher Japanese bond yields down the road, corroborating our negative view on USD/JPY for 2023.

Narrowing interest rate differentials support EUR vs. USD



2023 started like 2022 ended: a risk-friendly market environment supported cyclical currencies like the EUR and the GBP at the expense of the safe-haven currencies USD and CHF. A very important driver was also the narrowing of interest rate differentials. In the US, inflation and activity data generally confirmed the consensus view of a slowing economy and continued disinflation, which held monetary policy expectations (and thus government bond yields) over a two-year horizon relatively stable. In the Eurozone, however, activity data produced some upside surprises as the widely feared winter recession is likely to be more of a winter lull due to the much better-than-expected energy situation. Meanwhile, continued labour market strength and surprisingly solid consumption contributed to a broadening of inflation pressures. Contrary to the US, core inflation rose further in December and was unchanged in January, surpassing market expectations in both months. As a result, markets increased their expectations regarding ECB policy rate hikes, contributing to the narrowing of interest rate differentials between the US and the Eurozone. While this is consistent with our 2023 full-year outlook described in the previous edition of this publication, we believe that the recent moves might have gone a bit too far and that the EUR might be prone to a near-term moderation vis-à-vis the USD and the CHF, also considering the elevated speculative long positioning in the EUR and our view of a less friendly environment for risky assets in the months ahead.

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