Perspectives
Financial Markets

August 2022

Interest rates & bonds
Market bottom or further pain?

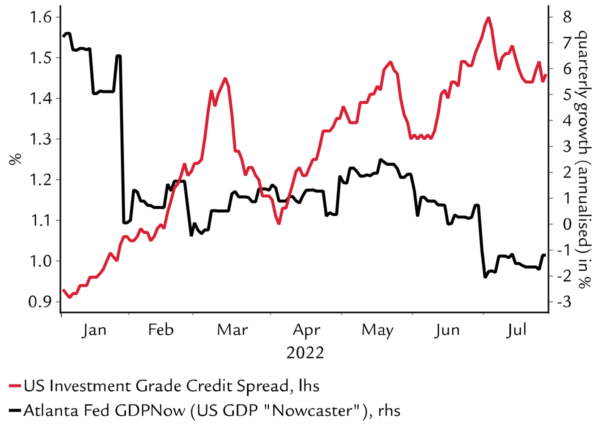
USA
- Despite yet another higher CPI inflation print, 10-year Treasury yields fell by more than 30 basis points (bps) in July as weak macroeconomic data and falling commodity prices suggest that the peak in inflation might be reached soon while economic growth is slowing.
- The market continues to price in an earlier peak in the Fed funds rate and more aggressive policy rate cuts thereafter, with a reduction by 50 bps already priced in for 2023.

Eurozone
- The ECB delivered its first policy rate hike in more than 10 years, yet German 10-year government bond yields fell by 50 bps on the back of weak economic data and recession fears related to the European energy crisis.
- The announcement of the ECB's new "anti-fragmentation tool", the so-called Transmission Protection Instrument (TPI), did not help to contain the spread between Italian and German government bonds, which increased by 40 bps in July on the back of Draghi's resignation.

UK
- In July, UK government bond yields fell by more than 30 bps at the 10-year point while 2-year yields fell by around 10 bps.
- Markets are still seeing a higher chance for a 50 bps rather than a 25 bps hike in by the Bank of England in August notwithstanding the apparent slowdown of the economy.

Switzerland
- The flattening of yield curves on the back of global recessionary fears was also witnessed in Switzerland as the spread between 2-year and 10-year government bond yields tightened by around 50 bps.
- After a first aggressive 50 bps policy rate hike by the SNB, markets now expect a very shallow hiking cycle.

US credit spreads widen as a trend amid slowing economy



Source: Macrobond, Bloomberg, Swiss Life Asset Managers

According to central bankers and politicians, developed market economies and consumers are healthy and corporate balance sheets are strong, and can thus deal with tightening financial conditions. It is a mantra that has come up often in the past few months and might soon be remembered the same way as "transitory inflation". Purchasing Managers' Indices (PMI) have just dropped below 50, indicating contraction of the manufacturing sector, and consumer sentiment has been abysmal for some time amid soaring inflation and negative real wage growth. Company earnings for the second quarter are so far down 6% and 41% in the US and Europe, respectively, while US GDP contracted in the first half of 2022. Yet inflation has not even started to roll over and markets still expect the Fed and ECB to deliver another 90 bps and 100 bps of policy rate hikes, respectively, until year end while simultaneously reducing their balance sheets. This is hardly a set-up for markets to find a durable bottom, especially when adding geopolitical uncertainties on top of it. While bear-market rallies are common and can last for some time, we ultimately believe that credit spreads will widen further from here. Regarding government bond yields, we think that we might have seen the peaks already, but given the recent decline, we could see yields moving higher in the short term.

Equities

Recovery in July

USA

- After a terrible month in June, the US stock market recovered in July but has still lost 16.6% so far this year (all data in this column as at 25 July).
- The earnings season is, with a few exceptions, so far in line with expectations. Many companies have become more pessimistic for the coming quarters.
- Analysts still expect earnings to rise by 5–10% in 2022 and 2023. During recessions, however, earnings decline by around 15% on average (see main article). The valuation of the market does therefore not yet reflect the risk of even a moderate recession.

Eurozone

- The Eurozone equity market had a positive return in July and lost 15.2% year-to-date.
- The valuation is attractive, but the repercussions of the Ukraine war and the political situation in Italy are strong headwinds for the market. The weakening euro enhances competitiveness, but also raises prices for imported input goods.

UK

- The UK market is still by far the best performer this year. It has gained 3.0% since the start of the year and the July performance was positive, although below the global average.
- The UK market is still the market with the lowest valuation with a forward P/E-ratio of around 10 and a dividend yield of 4.1%.

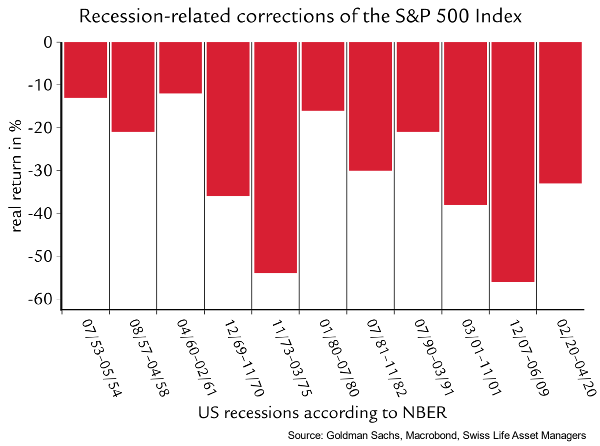
Switzerland

- The market is up in July so far. The year-to-date performance, however, remains negative at –12.8%. Overall, the Swiss market has done better than the US and the European market, but worse than UK and Japan since the start of the year.
- Valuation has improved this year, and some index heavyweights can now be bought at valuation levels not seen in many years.

Emerging markets

- Emerging markets performed negatively in July. The year-to-date performance is –18.1%.
- Weak economic data and negative news from the property sector in China weighed on the market in July. However, China is now deploying fiscal and monetary stimulus. Without further lockdowns, the stock market has a very attractive valuation and catch-up potential, although risks remain high.

US recessions led to an average 30% correction of equities



The US equity market has corrected by more than 20% since the peak and is thus currently a bear market. Historically, bear markets have in most cases occurred around recessions. Based on our economic outlook, which incorporates a US recession in 2023, we expect that this time will be no different. In the 11 recession-related corrections since the Second World War, the US equity market lost 30% on average in inflation-adjusted terms (see chart). Thus, the current decline is close to the historical average. The worst loss (–56%) occurred during the global financial crisis 2007–2009, the smallest decline happened in the 1960 recession (–12%). Company earnings declined only by around 15% on average and the equity market began its decline typically around seven months before the start of the recession. The period between the peak and the trough lasted around 14 months on average. In the four quarters after the end of the recession, earnings grew by 17% on average, implying that earnings recovered to pre-recession levels within a year after the recession ended. The current situation is special in several aspects. Firstly, we are currently in a rate hiking cycle with the highest inflation rates in more than 40 years. Secondly, analysts expect earnings to rise over the coming year and margins are expected to remain at record high levels. Historically, however, margins have declined by several percentage points in a recession. The current equity market valuation is in line with or slightly below historical averages, but still much higher than at previous bear market lows and recession lows. This limits the upside potential for equities at this stage, although a temporary rally is possible if interest rate expectations change, or if the geopolitical tensions subside.

Currencies

No end to EUR weakness in sight

USA

- The USD had another strong month in July, appreciating against most developed market currencies except for currencies of significant commodity exporters (CAD, AUD or NOK).
- The USD benefitted from increasing interest rate differentials across the yield curve as financial markets dialled back monetary policy expectations in many economies, especially in Europe.
- In our view, the Fed remains more committed to fighting inflation than its peers on the European continent and in Japan, which explains our call for a stronger USD in the upcoming month.

Eurozone

- Among developed market currencies, the EUR showed by far the weakest July performance (–2.7%) on a trade-weighted basis.
- Rising recession risks due to the European energy crisis as well as political uncertainty in Italy will likely lead to an even lower EUR/USD exchange rate over the coming weeks.

UK

- Sterling was unchanged against USD in July but strengthened against EUR.
- Incoming economic data was better than expected while inflation remains very elevated. This should lead to more rapid monetary policy tightening by the Bank of England than previously expected. We are changing our view on GBP/USD from negative to neutral.

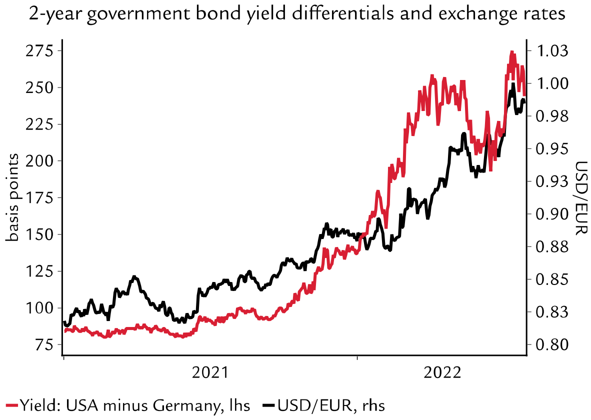
Switzerland

- The CHF appreciated 1.4% on a trade-weighted basis in July. EUR/CHF dropped to new all-time lows.
- At these levels, we change our view on EUR/CHF from negative to neutral.

Japan

- The relentless uptrend in USD/JPY took a breather in July, with the exchange rate fluctuating in the 135–140 range.
- The Bank of Japan is sticking stubbornly to its ultra-expansionary monetary policy, which could trigger more JPY weakness in the upcoming month as interest rate differentials especially to the US are set to widen further.

US-European yield differentials in the driver's seat



Source: Macrobond, Swiss Life Asset Managers

Like the Swiss National Bank (SNB) in the month before, the European Central Bank (ECB) managed to stage a surprise in its 21 July announcement by hiking the policy rate by 50 basis points (bps) versus expectations of a 25 bps hike. ECB President Lagarde also mentioned the euro as an additional inflation driver in the press conference after the meeting, which hints at unease in the Governing Council regarding the strong euro depreciation year-to-date. Meanwhile, the July FOMC meeting was uneventful, and the Fed delivered the 75 bps hike that markets had expected.

Perfect conditions for the EUR to rebound against the USD? Not really. EUR/USD remained stuck at levels close to parity in the second half of the month. We also expect USD to appreciate in the next few weeks against the EUR, JPY and CHF. As in the previous months, the interest rate differential ("carry") is set to remain the most important driver for USD strength (see chart). Despite the positive surprise by the ECB, markets still question its ability to deliver a meaningful hiking cycle due to significant recession risks related to the European energy crisis. We would agree with that view but think that financial markets still underestimate somewhat the extent of the US rate hiking cycle. The Fed may have to deliver more hikes than currently expected to fight still elevated inflationary pressure. Hence, the carry, which already favours the USD, might even increase further and support the greenback over the coming month. Regarding EUR/CHF, we have adopted a neutral view after the significant drop through parity in June and July.

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