

January 2022

Interest rates & bonds

The bond market ignores the Fed

USA

- US bond yield curves flattened in November amid news of the emerging Covid variant Omicron, while credit spreads woke up from their hibernation and widened by 12 bps.
- With inflation continuing to accelerate, the US Federal Reserve has become ever more hawkish, finally putting their wording of “transitory inflation” to rest. The Fed announced its plans to accelerate the tapering of asset purchases at its December meeting, and we expect the first policy rate hike in June 2022.

Eurozone

- German government bond yields fell in November, with the 5-year segment experiencing a decline of 24 bps. EUR credit spreads repriced sharply, widening by 20 bps.
- The ECB has also become more hawkish, and we could see an end to some of the bond buying programmes. Nevertheless, we expect a slower withdrawal of the monetary stimulus than in the US, and do not foresee any ECB policy rate hikes in 2022.

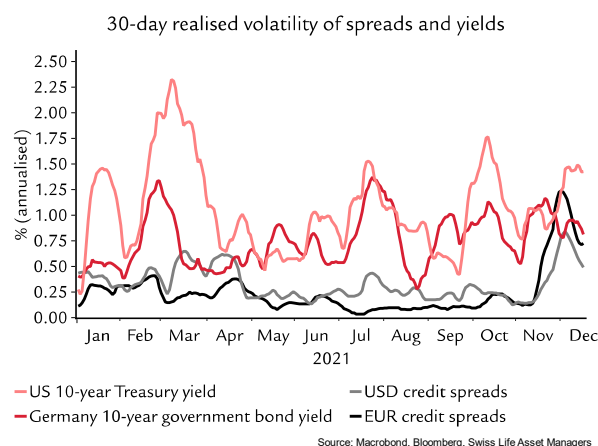
UK

- UK credit spreads widened by 10 bps in November, while the yield curve continues to flatten with the spread between the 10-year and 30-year tenor being just 8 bps.
- After not hiking its policy rate in the November policy meeting, the Bank of England unexpectedly raised it by 15 bps in the December meeting, as the BoE sees inflationary pressure as a larger threat than the economic impact of the Omicron variant.

Switzerland

- Swiss government bond yields decreased in November, albeit on a smaller scale than their German counterparts, with the 10-year and 30-year points only down by around 10 bps.
- The SNB – although it does not have to worry about inflation – is again coming under pressure to intervene in FX markets amid a drive for safe haven currencies.

Depressed volatility on average in 2021



2021 showed what financial repression by central banks means. As a result of vast bond buying programmes, the volatility of credit spreads collapsed with the average in EUR being about a third, and the average in USD roughly half of its historical average. Credit spreads were tight in 2021 with minimal dispersion as credit curves flattened along the risk and duration dimension. Investors were forced to load up on risk to hope for any kind of positive returns, especially given the significant rise in interest rates seen in the first few months of the year. However, while credit spreads remained mostly unchanged, rates had quite a rollercoaster ride as the economic slowdown induced by the Delta variant in the summer relentlessly drove yield lower despite soaring inflation numbers, before settling in a relatively wide range. We believe that 2022 will be different, as bond-buying programmes are gradually phased out. Credit dispersion and volatility will likely increase, making issuer selection and sector allocation important performance drivers again. That should also lead to higher credit spreads. With regard to government bond yields, we expect an increase in 2022 given how non-transitory inflation turned out. That said, the move should be most pronounced on the front-end. Should we see a meaningful correction in risky assets or sharper deceleration in growth and inflation, we would also expect rates to trade lower.

Equities

Excellent year in 2021, despite a bumpy ride recently

USA

- The US equity market is up 25% for the year-to-date, making it the best-performing developed equity market. Since early November, the market has gained 2.5% despite a correction in late November.
- The US performance is again closely linked to tech stocks, notably the FAANGM stocks (Facebook, Apple, Amazon, Netflix, Google, Microsoft). These stocks alone have contributed 15% to the 20% performance of the Nasdaq this year.
- The US market is very expensive and the valuation differential to other markets is at the highest level ever seen.

Eurozone

- The European market is up around 20% for 2021 and thus once again underperforming the US market. Since the end of October 2021, the performance has been flat.
- Compared to historical averages, the market valuation is neutral. Earnings and revenue growth in Europe should be similar to the US-market in 2022.

UK

- The UK market gained 18% in 2021 (year-to-date) and 1.1% since the end of October.
- The UK market is very attractive from a valuation perspective, but political risks related to Brexit, potential further policy rate hikes and the exposure to value stocks could continue to weigh on the market.

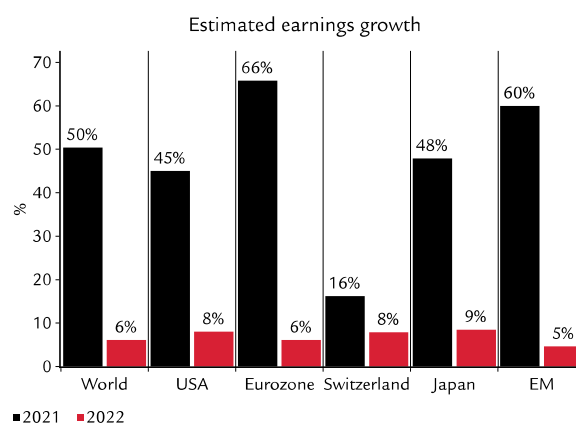
Switzerland

- The Swiss market's year-to-date total return is 21%. It has outperformed the US market by 0.5% since the end of October.
- The Swiss equity market is the second-most expensive market globally. However, index heavyweights from the pharma and financial sectors are not excessively valued, and the Swiss market traditionally does well in an environment of higher volatility.

Emerging markets

- Emerging markets are flat for the year-to-date and down 2% since the end of October. China, which makes up 35% of the index, has lost almost 20% for the year-to-date.
- From a valuation perspective, emerging market equities are attractive and the recent monetary policy easing in China may trigger a catch-up phase.

2022: positive outlook due to decent earnings growth



Source: Macrobond, Swiss Life Asset Managers

After the strong performance in 2021 and earnings growth rates of 50% and more, the return potential for equities in 2022 is lower. However, we still see potential for high single-digit returns. The reasons for this view are as follows: First, economic growth will remain strong and above normal rates for most economies. While a correction can happen at any time, a prolonged slump in equity markets has historically almost always coincided with a recession, a scenario that is very unlikely. Second, we expect inflation to decline in 2022 leading to reduced pressure on central banks to tighten monetary policy. Third, company earnings are expected to grow by a high single-digit figure in all important markets. If valuations remain at today's level, this would imply a 5-10% equity market return in 2022. Fourth, the TINA argument ("there is no alternative") is still valid as nominal and real interest rates are negative in Europe and Switzerland.

Of course, there are several risk factors we should monitor. If inflation remains substantially above 2%, central banks could be forced to raise policy rates faster than currently anticipated. In such a scenario, the high equity market valuations – especially in the US – would likely come under pressure. Most other important short-term risks are political. For example, both a potential resurgence in the US-China trade conflict and the tensions between Russia and the Ukraine remain on our watchlist. Finally, Covid-19 could also cause short-term stress for the equity market. We therefore expect volatility to be elevated next year.

Currencies

USD and CHF to remain strong in 2022

USA

- In line with our view, the trade-weighted USD appreciated almost 2% in November and stabilised in the first two weeks of December. Renewed inflation surprises and expectations of more aggressive monetary tightening contributed to USD strength.
- The initial reaction to the FOMC meeting in December showed a “buy the rumour, sell the fact” pattern. The US Fed indeed became more hawkish, but the USD slightly lost ground just after the meeting. Nevertheless, we expect the widening interest rate differentials to again lend support to the USD in the next three months.

Eurozone

- Since the last edition of this publication, the EUR depreciation against the USD and CHF has continued. Meanwhile, the EUR has regained lost ground against the Nordic currencies SEK and NOK, while moving broadly sideways against the GBP.
- We are still convinced that the spike in Eurozone inflation is a transitory phenomenon, sharply driven by energy prices, and that the ECB’s policy will remain relatively expansionary in 2022. We therefore reiterate our negative view on EUR/USD.

UK

- GBP/USD temporarily lost 3.5% as expectations of a rate hike by the Bank of England were dialled back in November. The surprising rate hike in December lent renewed support to GBP.
- We are keeping a neutral view of GBP/USD for the next three months.

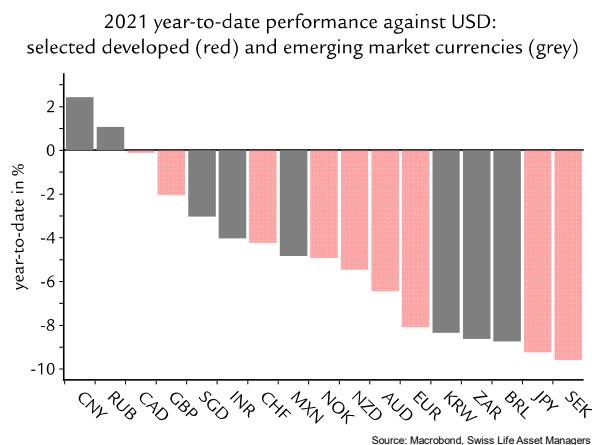
Switzerland

- EUR/CHF continued to slide in November, and briefly fell below 1.04 at the beginning of December, a level last seen in 2015.
- We see further appreciation potential for CHF against EUR over the next three months (see main text). In the short term, geopolitical risks related to the tensions between Russia and Ukraine could add to the EUR/CHF weakness.

Japan

- USD/JPY continued to fluctuate around the 114 mark in November and early December.
- In line with our view of general USD strength, we expect USD/JPY to move higher over the next three months.

Strong USD performance so far in 2021




2021 was the year of the USD. At the time of writing, the greenback had outperformed all major developed and emerging market currencies except CNY and RUB. The CNY certainly benefited from the strong recovery in exports and the relatively restrictive monetary policy of the People’s Bank of China. The Russian currency benefited from the significant rise in energy prices, in line with other commodity-sensitive currencies such as CAD and NOK that dropped less sharply against the USD than other cyclical currencies. Among the latter, EUR, JPY and SEK were the worst performers in 2021 in developed markets, losing up to 10% against the USD. In addition to their cyclical nature, these currencies were also under pressure due to widening interest rate differentials (“carry”) against the USD. The exception to the rule was the CHF, which notably strengthened against the EUR in 2021.

For 2022, we have two major calls: First, we continue to expect a strong USD, notably against the EUR. The US Federal Reserve shifted to a more hawkish stance in its December FOMC meeting and is now signalling three 25 basis point hikes in 2022, which will further increase the USD interest rate advantage. Second, we think that further appreciation of the CHF against the EUR is quite likely. The SNB seems to have become more tolerant regarding CHF appreciation, probably because the CHF is not as overvalued as in the past. The large inflation differential between Switzerland and the Eurozone has contributed to a fairer CHF valuation, as measured by purchasing power parity (PPP) models. Also, Swiss net exports have reached new highs in 2021, implying that many sectors are able to cope with the current levels of exchange rates.

Swiss Life Asset Managers



Marc Brütsch
Chief Economist
marc.bruetsch@swisslife.ch
 @MarcBruetsch



José Antonio Blanco
Head Investment Management
joseantonio.blanco@swisslife.ch

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