

March 2022

Interest rates & bonds

Risk premia are back

USA

- The “bear flattening” of the yield curve (i.e. yields at the short end increasing faster than at the long end) continued in February. 2-year Treasury yields rose 31 basis points as a more aggressive rate hike path was being priced in amid surging inflation.
- Temporarily, markets were pricing in up to seven rate increases (by 25 bps each) this year and even a 50 bps hike for the March FOMC meeting. Market pricing receded to 5-6 rate hikes as the Ukraine conflict slid into outright war.

Eurozone

- The upward move in European yields was slightly less pronounced. Yield curves shifted up in an almost parallel fashion by 30 bps before moving down again amid the outbreak of war in Ukraine.
- With inflation also surging in Europe, the ECB made a hawkish pivot in the February meeting. Markets, however, quickly priced out significant policy rate hikes this year as the geopolitical situation worsened.

UK

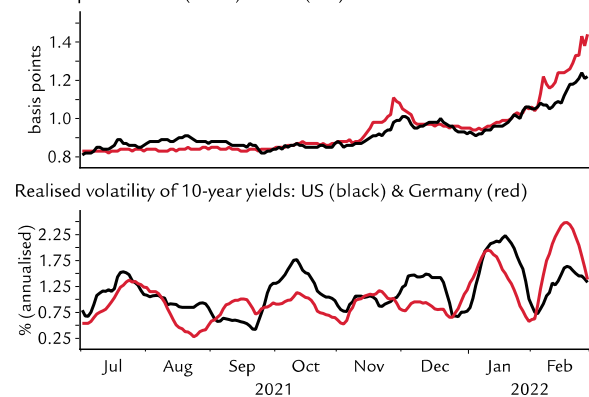
- Yield curves temporarily flattened in February. The 2-year point moved up by more than 50 bps before dropping again 40 bps towards the end of the month, while the long end of the curve moved up by 20 bps.
- The Bank of England hiked rates again in February, and we expect additional policy rate hikes at subsequent meetings.

Switzerland

- Switzerland was again a bit of an outlier as the rate moves were less pronounced. 10-year yields increased 10-15 bps, and the curve steepened slightly.
- The SNB remains in a relatively more comfortable position as inflation is less of an issue in Switzerland.

EUR spreads widen more than USD spreads in this crisis

Credit spreads: USD (black) & EUR (red)



Source: Macrobond, Bloomberg, Swiss Life Asset Managers

In the last edition, we highlighted the relatively benign reaction of credit spreads compared to the drawdown of the equity market. This month, spreads started to play catch-up amid the escalation in the Ukraine conflict and hawkish comments from major central banks. Regarding the ECB, an earlier exit from the pandemic asset purchase programmes and even a policy rate hike in 2022 seem possible, a scenario that financial markets deemed unlikely just a few weeks ago. Unsurprisingly, the increase in rates volatility in combination with the expectation of less central bank support led to a sharp repricing in risk: credit spreads widened by 33 bps in EUR and 15 bps in USD. With EUR credit spreads now at 138 bps we think the current level seems elevated for the underlying risk as economic data is still robust. While the geopolitical risk remains elevated, the impact of wars on financial markets has mostly been relatively short lived historically. If the war remains limited to Ukraine and Russia does not retaliate sanctions by halting gas deliveries to Europe, we could therefore see a rebound in risky assets at some point. On the negative side, strong primary market issuance might put renewed upward pressure on credit spreads in March. Hence, we would use any tightening of credit spreads as an opportunity to reduce risk. On duration we remain neutral as the volatile geopolitical situation counteracts the effect of inflation on rates.

Equities

Looking for direction

USA

- In February, the US market lost 2.8%. The year-to-date performance is -8.6%. For the first time in many years, the US market is the weakest of all the major markets.
- The main reason for the weak start to the year is the major change in market expectations for US monetary policy. In late December 2021, three policy rate hikes (of 25 basis points each) were expected, while now the market is pricing in five to six hikes. Over the past week, the Ukraine war was the driving force for the equity market losses.

Eurozone

- The Eurozone equity market lost 4.5% in February and approximately 7.9% in 2022 to date.
- The change in expectations of central bank policy was a key driver in the Eurozone as well. Contrary to the end of last year, markets are now pricing in a first small rate hike already at the end of 2022. The escalation in the Ukraine conflict is more negative for the European market than for the others.

UK

- After several weak years, the UK market has outperformed its peers this year. It gained 1.2% in February and 2.8% since the beginning of the year.
- The UK market still has the lowest valuation of the major developed markets.

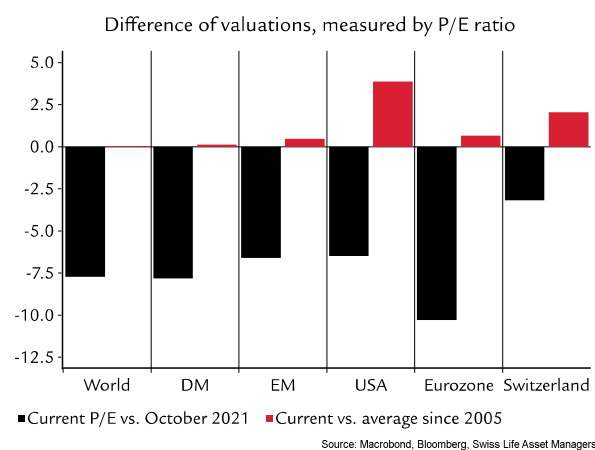
Switzerland

- The weak performance of the Swiss market continued in February. The market lost 2.3% this month and 7.9% since the start of the year.
- Within the SMI, cyclical industrial companies had the weakest performance.

Emerging markets

- Emerging markets posted a less negative performance and are down 4.0% since the start of the year and 2.9% in February. Since the beginning of the year, emerging market equities have outperformed developed markets by 2.9%.
- Valuation is attractive, and tentative signs that fiscal and monetary policy in China are becoming more accommodating support the market.

Equity valuations have come down to historical averages



Company earnings results for Q4 2021 are very good. In the US, earnings growth is 28% and revenue growth 16% vs. Q4 2020. In the Eurozone, where pandemic-related restrictions in late 2020 were more severe, earnings even grew by 99% while revenues increased by 27% in Q4 2021 on a year-on-year basis. In both markets, analysts' expectations were beaten by around 5-10% for earnings and 3-12% for revenues. Forecasts for 2022 are broadly unchanged and call for earnings growth rates of 5-10%. Strong earnings growth and the recent correction of global equity markets have led to a normalization of valuations. The price-to-earnings ratios (P/E) declined by 5-10 points on an absolute basis. The current P/E ratios for developed markets (excl. US) and emerging market equities are now around historical averages. For the US market, the current forward P/E is 21 while in the Eurozone it is much lower at 15. While valuations have become more attractive, rising interest rates and the prospect of waning support from monetary policy are clearly headwinds for the markets in the coming months. Historically, in episodes of rising interest rates, equity valuations have come down, so the current picture is broadly in line with historical experience. In addition, the escalation of the Ukraine conflict has recently weighed on stock markets. Historically, geopolitical events have only had a limited and short-lived effect on equity markets (see "Perspectives Asset Allocation"). As we might not have reached the low point in investor angst regarding the Ukraine conflict, we are temporarily adopting a cautious stance on equities, but are retaining a constructive view over the medium term.

Currencies

USD to remain well supported in March

USA

- The initial weakness of the USD at the beginning of February was swiftly reversed as the situation in Ukraine escalated rapidly. The USD played its role as a safe haven currency in geopolitical risk events and appreciated against the more cyclical EUR and GBP in February.
- The uncertainty of the geopolitical situation as well as the fact that the US Federal Reserve is unlikely to veer off its tightening course will keep the USD supported against all major developed market currencies in March, in our view.

Eurozone

- Among the major developed market currencies, the EUR is most vulnerable to the war in Ukraine. The issue is not only proximity, but more importantly dependency from Russian gas imports.
- In addition, the ECB might temporarily adopt a slightly more dovish tone, which could also weaken the EUR. We are thus reiterating our negative view of EUR/USD.

UK

- GBP/USD saw both ups and downs in February and ended the month nearly unchanged.
- In line with our general view of a strong USD, we have shifted our view on GBP/USD from neutral to negative.

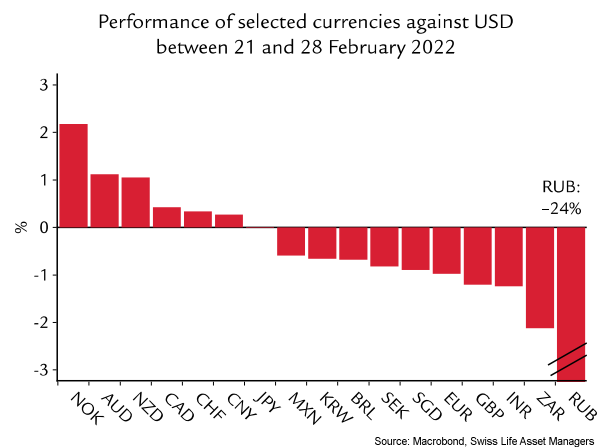
Switzerland

- EUR/CHF fell to 1.03 in the course of February as investors sought refuge in safe haven currencies.
- At these low levels, we prefer a neutral view on EUR/CHF, as considerable uncertainty might already be priced in. In case of a significant escalation including military threats to Western countries, EUR/CHF could, however, move towards parity and trigger renewed SNB intervention.

Japan

- USD/JPY has been fluctuating around the 115 mark since the start of the year.
- We expect the JPY to be a sub-par safe haven currency in this crisis and to underperform USD in the month ahead, for reasons mentioned in the main text. In addition, the interest rate differential remains in favour of a higher USD/JPY.

Russian rouble loses a quarter of its value in one week



The rapid escalation of the Ukraine tensions into outright war in the last week of February left its mark on currency markets. Unsurprisingly, the Russian rouble bore the brunt of the harsh sanction regime and lost a quarter of its value. Also unsurprisingly, the currencies of major commodity exporters – Norway, Australia, New Zealand and Canada – rallied as a result of higher commodity prices. Sterling was an outlier. Even though the UK is a major oil and gas producer and is much less dependent on exports to Russia than the Continent, GBP was surprisingly the worst-performing major developed market currency. The “place to hide” in geopolitical risk events are usually the safe haven currencies CHF and JPY, and very often also the USD. The CHF played its role as expected, but USD/JPY was basically unchanged over the crisis period. This is not too surprising given the nature of the shock. The biggest impact of sanctions against Russia is via higher commodity prices, and here, Japan is very exposed as a major net importer of fossil fuels, especially crude oil and LNG. Thus, the crisis is a negative terms of trade shock for Japan, which tends to weaken a currency. In the US, which has become a major oil and gas producer since the shale revolution, the biggest economic impact of the crisis is higher consumer price inflation, which will likely keep the US Federal Reserve on a tightening course. The USD interest rate advantage will thus remain in place and support the USD against EUR, JPY, CHF and GBP. A negative view on EUR/USD is also warranted because any geopolitical escalation will first and foremost hit Continental Europe, not only due to its proximity to the war, but also to its gas dependency on Russia. Investors will thus likely build in a risk premium into the EUR/USD exchange rate.

Swiss Life Asset Managers



Marc Brütsch
Chief Economist
marc.bruetsch@swisslife-am.com
@MarcBruetsch



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

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