Perspectives
Financial Markets

SwissLife
Asset Managers

September 2022

Interest rates & bonds
Reiterating the commitment to fight inflation

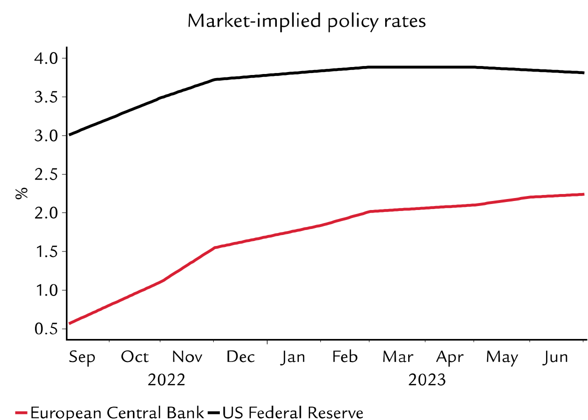
USA
- Better-than-expected macroeconomic data and a plethora of hawkish Fed speakers let to a sharp repricing of interest rates with the 10-year government bond yield up 40 bps in August.
- Markets had interpreted the July's FOMC meeting as a dovish pivot by the Fed despite numerous speakers suggesting the opposite. Investors finally pivoted after Chair Powell's Jackson Hole speech, which led to a sharp repricing of rates and risky assets.

Eurozone
- While the US might have seen the peak in inflation, Europe is still struggling with rising prices causing German Bund 10-year yields to increase by almost 70 bps in August.
- Soaring inflation rates put the ECB in a difficult position as it must tighten into an economic slowdown and eventually re-evaluate its bond buying programmes.

UK
- Inflation soared to more than 10% in July. We expect it to peak in Q4 at almost 12%. In this environment investors are shunning government bonds which drove yields up by more than 80 bps in August.
- The BoE hiked rates by 50bps in August and is simultaneously forecasting a protracted recession starting later this year, with inflation unlikely to come down to 2% in the foreseeable future.

Switzerland
- 10-year Swiss government bond yields increased by 35bps in August as inflation printed at 3.4% in July.
- Despite a comparatively more modest inflation picture, the SNB acknowledges that more needs to be done in terms of rate hikes to prevent second-round effects from higher energy prices.

Fed and ECB rate expectations



Source: Bloomberg, Swiss Life Asset Managers

Risky assets rallied strongly over the past few weeks on the back of extremely bearish positioning, improving economic data and investors' expectations of a Fed pivot in early 2023. While the July inflation data was slightly lower than expected, a 8.5% inflation rate and a 3.5% unemployment rate are hardly preconditions for a dovish pivot by the Fed. Yet, investors seemed to ignore all warnings until Chair Powell delivered another hawkish speech at the Jackson Hole conference, reiterating the commitment to bring down inflation to 2%. Similar comments were also made by central bank speakers of the ECB and the BoE who face a more difficult situation. Spiralling energy prices continue to fuel inflationary pressures while the growth momentum deteriorates. Having to fight inflation while risking a steep recession or worse – a fragmentation of the Eurozone – makes the ECB's policy less predictable. For now, we think that bringing down inflation will remain the priority, forcing central banks to continue their monetary tightening. We therefore remain cautious on risky assets and neutral on longer-dated government bond yields. We continue to expect short term rates to rise and are positioned accordingly.

Equities

Central bankers spoil the party

USA

- After a bear market rally in July and a strong start in August, the US stock market lost 3.2% in August. Year-to-date the loss amounts to -16.7%.
- The earnings results in Q2 were very solid with earnings growth of 9% over one year. However, if the energy sector is excluded, earnings growth was negative (see analysis on the right-hand side). The quarterly earnings growth rate was negative as well.
- Valuation is around historical averages and thus higher than during past recessions. Rising yields have increased the relative attractiveness of bonds.
- Positioning remains similarly bearish as during the Covid pandemic. Historically, this pessimism has often been followed by an equity market rebound.

Eurozone

- The Eurozone equity market lost 4.0% in August and 16.2% year-to-date.
- Valuation remains attractive, but the repercussions of the war in Ukraine with still-rising energy prices are weighing on 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 gained 5.0% since the start of the year and was down by only 0.2% in August. One reason is the comparatively high weight of the energy sector.
- The UK market still has the lowest valuation with a forward P/E-ratio of around 9.5 and an expected dividend yield of 4.1%.

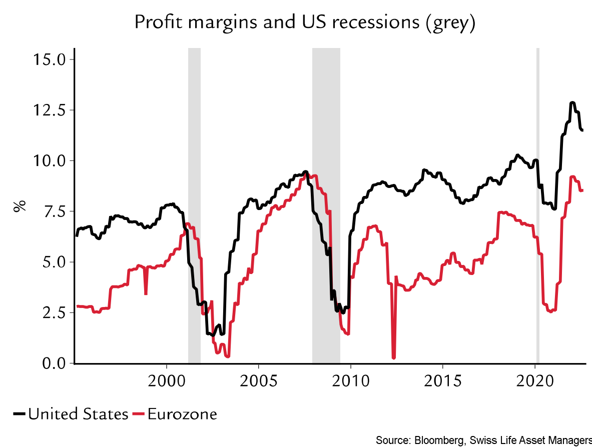
Switzerland

- The Swiss market lost 2.9% in August and 14.9% year-to-date and has thus not profited from its generally defensive character this year.
- One reason is that the pharmaceutical sector seems to be out of favour despite valuations at the lower end of recent history. In addition, more cyclical stocks have lost between 20% and 40% this year.

Emerging markets

- Emerging markets gained 0.3% in August in USD terms but lost 17.6% year-to-date.
- Weak data out of China is till weighing on the market despite measures taken by the government and the central bank. Central banks in emerging markets are currently under less pressure to raise rates.

Q2 earnings season & outlook



Companies recently reported their Q2 results. Overall, the results were better than expected, but the outlook has become much more pessimistic. Earnings growth came in close to 10% while revenue growth, which is (more) directly linked to the inflation rate, was between 15% and 25% (both relative to Q2 2021). Both growth rates were between 1 and 6pp above expectations. Earnings growth has, however, been unevenly distributed. For example, in the US, the market minus the energy sector saw a decline in earnings per share of 3%. The energy sector (around 4.5% weight in the US index) recorded an exceptional growth rate of more than 300% which moved index earnings higher by a whopping 12% (the impact on sales growth was 9%). In Europe and Japan, the effects are the same but smaller in magnitude. Profit margins remain close to their all-time highs. Historically, they have declined strongly during recessions (shaded in grey in the chart above). The outlook has become less optimistic. Many companies have announced a hiring freeze and some have started with layoffs. CEO confidence is low, and many CEOs have mentioned that they are wary of a recession in the US and in Europe. Nevertheless, analysts have still not markedly lowered their earnings estimates for 2023 and beyond. Currently, the market expects earnings to grow by 10-20% in 2022 and 0-8% in 2023. Historically, earnings have declined by 15-20% in recessions, and margins have halved. Therefore, we think that current earnings estimates are too sanguine. This implies that current valuations as measured by expected PE based on earnings in 12 months paint an overly optimistic picture. The current market environment makes risk-controlled strategies such as Minimum Volatility and Protect interesting.

Currencies

Energy crisis weighing on EUR, JPY and GBP

USA

- The USD had another strong month in August, appreciating almost 3% on a trade-weighted basis.
- We still think that the Fed remains the most committed central bank in fighting inflation, a view that was confirmed by the hawkish statements of Fed Chair Powell at the Jackson Hole Conference. In combination with an already attractive interest rate advantage ("carry"), we expect the USD to remain strong.

Eurozone

- Even though financial markets now expect a more aggressive rate hike path by the ECB, the EUR depreciated further against USD as the energy crisis intensified in August (see main text).
- 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 had the weakest performance among major developed market currencies in August on the back of increasing economic and political uncertainty.
- This is unlikely to change in September and we have thus adopted a negative view on GBP/USD.

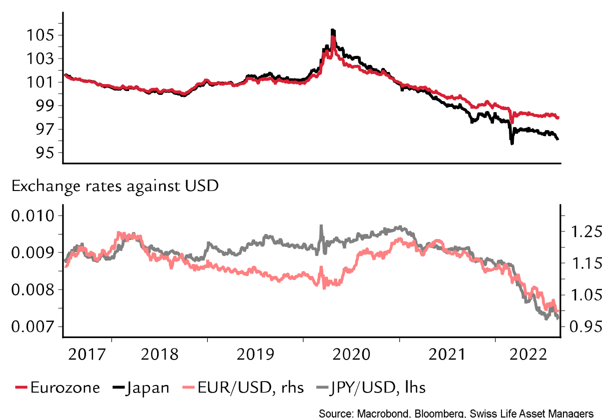
Switzerland

- After having dropped to a new all-time low of 0.96, EUR/CHF managed to recover at the end of August.
- We expect this recovery to be short-lived and expect EUR/CHF to return to its downward trend in September as the SNB does not seem to be concerned yet by the strong nominal appreciation of CHF.

Japan

- After a sharp drop at the end of July, USD/JPY increased by roughly 4% in August, overall remaining in the wide 130-140 trading range that has been in place since early June.
- We expect USD/JPY to remain in that range and thus have a neutral view. The Bank of Japan will certainly stick to its ultra-expansionary monetary policy, but the JPY is now so drastically undervalued that further depreciation potential appears limited.

Terms of trade shock adds to weakness of EUR and JPY



Europe is in the grip of an unprecedented energy crisis, which is undermining investors' confidence in the EUR. The significant spike in headline inflation, which is moving towards the 10% mark, has increased market expectations regarding upcoming policy rate hikes. Nevertheless, the EUR was not able to benefit from that repricing and fell to parity against USD in August. As the energy price shock is an external one, import prices are spiking and export prices are not keeping pace, leading to a significant deterioration of the terms of trade. The ballooning import bill has also led to a collapse in the Eurozone's current account balance, which even turned negative during the second quarter of 2022. Deteriorating terms of trade and current account balances are usually a negative contributor to currency performance and might thus help to explain the ongoing weakness of the EUR. The same argument might apply to Japan as well, a country that is very dependent on energy imports and where the currency has not benefitted from its safe haven status this turbulent year. Admittedly, the Bank of Japan's ultra-expansionary monetary policy is still largely to blame for this year's JPY weakness, but the terms of trade shock has certainly added to negative investor sentiment vis-à-vis the JPY. A bit of an odd case is the UK, a major energy producer that is nevertheless confronted with an unprecedented spike in gas and electricity prices. The recent sell-off in GBP might be the result of a combination of both economic and political uncertainty, as the current leadership battle delays any forceful response to the looming energy crisis.

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