

August 2023

Interest rates & bonds

Peak rates?

USA

- The US macroeconomic data surprised mostly to the upside as the job market remained firm, bolstering consumer confidence. Manufacturing showed signs of stabilisation in July.
- US Treasury yields remained range-bound with the 10-year government bond yield briefly crossing the 4% mark before falling again as headline inflation moderated, despite core inflation staying elevated.
- The US Federal Reserve increased the policy rate to a range of 5.25-5.5%. Fed guidance is towards further rate hikes depending on the development of inflation and growth data.

Eurozone

- Government bond yields traded sideways as weak PMIs for July only had a temporary impact on markets. Interest rates rose during the first ten days of July and subsequently declined throughout the month, while corporate bond spreads narrowed as investor sentiment improved further.
- The ECB raised policy rates by 25 basis points (bps) and hinted that future monetary policy decisions would be data dependent. The ECB is increasingly optimistic that policy rates are already quite restrictive, with signs of disinflation increasing.

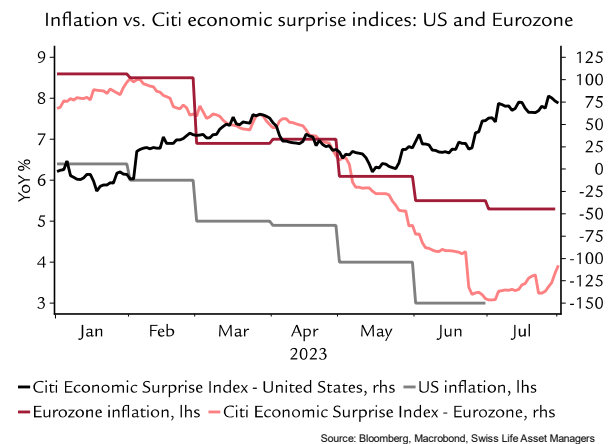
UK

- UK government bond yields fell substantially in July as the inflation outlook improved, while at the same time the growth outlook deteriorated further. This led to a repricing for a less aggressive monetary tightening path by the Bank of England.

Switzerland

- Swiss government bond yields remained range-bound with the 10-year yield hovering around 1%. It remains unclear whether the SNB will hike its policy rate further in the second half of 2023.
- Inflation is still on a decelerating path, but there is a lagged effect from the mortgage reference rate which will drive rents higher in the coming months. Hence, inflation will likely stay close to 2% into 2024.

Divergence in economic data between the US and Eurozone



Looking at economic data in July, the divergence in growth performance between the US and Europe has increased further. A good indication of the different trends in macro data is given by the Citigroup Economic Surprise Index. It shows clear negative momentum in the Eurozone, but at the same time positive developments in the US – a divergence that could affect market expectations of future monetary policy decisions. Interestingly, markets are currently only pricing one more hike by the ECB in September and only a 40% chance of another hike by the Fed for the rest of the year. Therefore, the peak rates narrative has gained momentum, as investors hope that central bank tightening will end soon and government bond yields have finally reached their peaks. Even though we share the view that inflation pressures should ease further over the medium term, it is too early to celebrate victory on the inflation front. Unemployment rates in Europe and the US remain at multi-decade lows and core inflation is still running high. There is therefore a decent chance that the Fed will have to hike further as US growth remains robust and inflation sticky. Summing up, the risk of a recession in Europe is increasing and the economic downturn in the US is postponed. We stick to our cautious view on credit risk and would add duration if inflation pressures ease further.

Equities

Stock market rally broadens

USA

- The US market gained 2.8% in July leading to a year-to-date performance of 20.1%.
- In July, the US market rally broadened beyond the largest tech stocks. The next important event is the earnings season for which expectations are quite low. So far, the reported earnings and sales mostly exceeded forecasts.
- The US valuation is above historical averages. We continue to prefer non-US markets.

Eurozone

- The market gained 0.7% in July and the year-to-date performance is 16.1%.
- For about three months, Eurozone equities no longer outperformed US equities. This coincides with weaker economic data compared to the US.
- The European equity market is still very attractively valued from a longer-term perspective.

UK

- The UK delivered a performance of 2.2% in July. Year-to-date the market gained 4.9%.
- The UK market still benefits from the lowest valuation of all major markets. However, we feel that the market is cheap for a reason as the UK is confronted with elevated economic uncertainty.

Switzerland

- The Swiss equity market declined by 0.4% in July, bringing the year-to-date performance to 6.9%.
- Pharmaceuticals and Nestlé in particular have been weak since the start of the year. They account for more than 40% of the Swiss stock market.
- The Swiss equity market is the most expensive market after the US market.

Emerging markets

- July was a very positive month with a performance of 4.7%. Year-to-date the market has gained 9.8% and thus lags the other stock markets.
- Chinese economic data continues to disappoint while the weak US dollar supports emerging markets. The Chinese government is expected to stimulate the domestic economy. This, together with a weaker USD, has led to a short-term rally.

Style performance in the US equity market

Index	Ytd (%)	Mtd (%)	3Y (%)	5Y (%)
MSCI USA	19.8	2.5	44.9	70.0
MSCI USA Equal Weight	12.4	3.6	41.8	49.5
MSCI USA Small Cap	13.2	3.7	46.9	37.2
MSCI USA Growth	36.7	2.3	43.4	96.2
MSCI USA Value	5.1	3.4	42.5	40.8
MSCI USA Momentum	0.3	0.7	10.1	34.2
MSCI USA Quality	26.8	3.0	44.9	84.8
FANG+	76.6	1.4	73.5	163.3

Source: Bloomberg, Swiss Life Asset Managers

The last five years were characterised by huge differences in the performance of different US equity investment styles such as value, growth, small cap, quality, momentum and sentiment. In Europe, the differences were much smaller. This year is no exception. The most extreme difference among US equity styles is between value and growth (which includes the big tech companies). Year-to-date, growth gained 36.7% vs. only 5.1% for value. Surprisingly, momentum is also very weak with a performance of just 0.3%. Over the last few weeks, the US equity market rally has broadened, and small caps in particular have started to perform well. As in previous years, the clear leaders this year are, however, the FANG+ (Microsoft, Amazon, Google, Netflix etc.) stocks which have a total return of 77% since the start of the year. A key reason mentioned for this spectacular performance is the advent of intensive use of artificial intelligence. The only “traditional” style which has worked well this year is quality. Over the last three and five years, the patterns are somewhat different. Over three years, the difference in style performance is small. Only momentum lags significantly behind the other styles. Over five years, the differences are larger again. The laggards are small cap, value and momentum, while the leaders are FANG+ and growth. It is somewhat surprising that momentum is not performing well despite a market development with strong (short-term) trends. One reason could be that MSCI changes the composition of the index only semi-annually and this was too slow in recent years. The large differences imply that traditional investment styles such as small cap and value have not worked. This is also the reason for the “quant winter” (quant funds relying on these factors have had a very difficult past five years).

Currencies

USD weakness expected to be temporary

USA

- The USD weakness continued in July, with the USD depreciating on a trade-weighted basis by 1.4% over the month (all data as of 26 July 2023). The USD saw the strongest depreciation vs. NOK, SEK and CHF.
- We expect the USD to appreciate again over the next month. In terms of economic data, the US is outperforming Europe, where the outlook is worsening. We thus hold a negative view on EUR/USD for the next month as well as over three months.

Eurozone

- The EUR has been nearly flat on a trade-weighted basis in July, as the EUR lost all its gains from the first half of the month over the second half.
- In addition to the fundamental argument, we also expect the carry advantage of the USD to lead to a weaker EUR/USD over the next few months. Additionally, investors are still long EUR positioned, which looks stretched and is at risk of a reversal.

UK

- The GBP managed to continue its upward trend vs. the USD in July, gaining 1.65% vs. the USD, whereas its performance against the EUR was basically flat.
- After the downward surprise in UK inflation for June, market expectations regarding Bank of England hikes have come down from their peak but still look stretched. We therefore continue to hold a negative view on GBP/USD over the next few months.

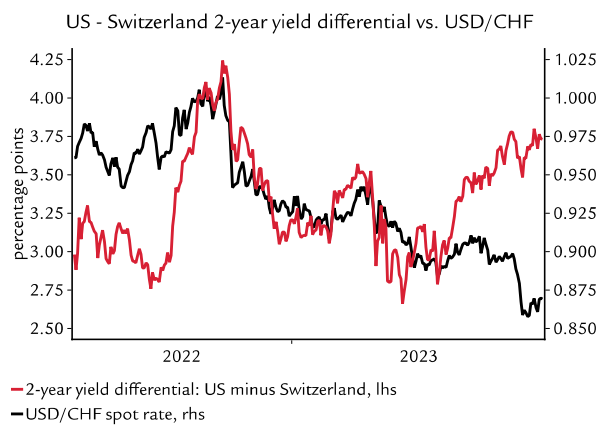
Switzerland

- CHF performance was strong in July. The CHF appreciated against all major currencies except for the Norwegian krona. USD/CHF even reached a new low at 0.8577 in the middle of the month.
- Analogous to our three-month view, we have a neutral view on EUR/CHF for the next month. The SNB is sticking to its hawkish rhetoric, which makes another hike in September look likely, but given the strong CHF performance in July, further upside seems limited considering fair value.

Japan

- The sharp upward move of USD/JPY from June was reversed in the first half of July with USD/JPY losing 2.8% over the month.
- We have moved our short-term outlook for USD/JPY from neutral to higher, while sticking to our neutral view on a three-month horizon.

Turbulent July for USD



Source: Bloomberg, Macrobond, Swiss Life Asset Managers

The USD depreciated sharply in trade-weighted terms and against all major currencies in the first half of July. The USD weakness was mainly driven by the weaker-than-expected US inflation print for June. This downward surprise led to a stronger belief in the market that the July Fed hike was indeed the last one in the current hiking cycle and has also increased expectations of a more aggressive easing cycle in 2024. Interest rate cuts adding up to around 100 basis points are currently priced in for the Fed over the course of next year. This has also led to a temporary drop in the 2-year yield differential between US and Swiss government bonds, which can be seen as an approximation of the so-called carry. With that, the CHF also appreciated significantly vs. the USD and USD/CHF reached a new all-time low. Much of the future dynamic in the USD will depend on the upcoming inflation prints between now and September when the next Fed meeting will take place. If the slowdown in US inflation continues, the Fed could indeed stop hiking in September and change its forward guidance towards a more supportive stance with regard to next year. However, the risk of spreading that constructive message prematurely is high. Additionally, US activity data has also continued to surprise to the upside. While employment growth in June was softer than expected, it still shows a solid labour market. Also, consumer confidence improved more than expected in July. Considering EUR/USD, we still see the relative economic dynamic in favour of the USD. While US data continues to surprise positively, economic data for the Eurozone disappoints. Additional headwinds for the Eurozone come from weak growth reacceleration in China. This leaves us with a negative view on EUR/USD for the short- and medium-term.

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