

September 2023

Interest rates & bonds

Who will buy all those bonds?

USA

- US interest rates hit a new cycle peak due to strong economic data, increased US Treasury funding needs, and a credit rating downgrade of US government debt, leading investors to shed US Treasuries while corporate credit spreads increased by 7 basis points (bps) in August.
- Fed Chair Powell kept a hawkish tone in his speech at the annual Jackson Hole meeting, even though headline inflation has come down considerably.

Eurozone

- Despite a subdued economic outlook and deteriorating business surveys, especially in the services sector, German Bund yields rose in August, mirroring US Treasuries. Credit spreads similarly increased by 8 bps to reflect the more subdued environment for European corporates.
- The ECB appears to be near the end of its rate-hiking cycle, with producer prices retracting, which is likely leading to a slowdown in consumer price inflation.

UK

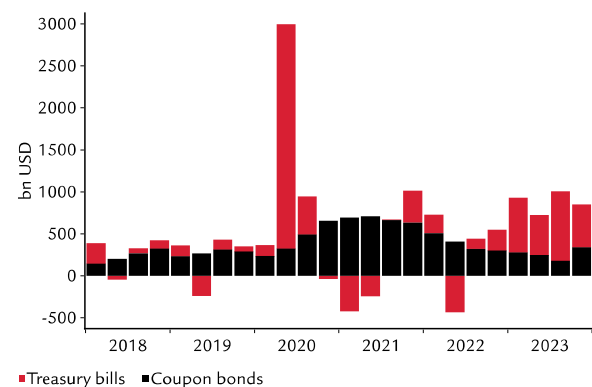
- Stagflationary risks continue to grow in the UK as core inflation remains at an elevated 6.9%, while the Purchasing Managers' Index (PMI) for the services sector unexpectedly plunged into contractionary territory.
- The Bank of England raised its policy rate by 25 bps in August. Coupled with high inflation data, this led to a surge in long-term interest rates to a new cycle peak before declining towards the month's end.

Switzerland

- Long-term interest rates remain relatively low and range-bound given Switzerland's subdued 1.6% inflation rate, defying the yield surge observed in August in other economies.
- The Swiss manufacturing PMI unexpectedly dropped to 38, a level not seen even at the peak of the pandemic. This, combined with low inflation, should allow the SNB to “wait and see”, which is why we do not foresee another rate hike for now.

US debt: T-bills have dominated new issuance recently

United States: Treasury bills vs. coupon bonds issuance, quarterly



Source: Macrobond, US Treasury, Swiss Life Asset Managers

Despite a robust economy and persistent inflation, the US government is grappling with a deficit of 8.4% of GDP – a record outside of recession and war periods. The Congressional Budget Office expects the debt-to-GDP ratio to balloon to an unsustainable 181% by 2053. The precarious fiscal path contributed to Fitch's removal of the US AAA credit rating. While the rating downgrade alone may not be a cause for immediate investor concern, the real issue lies in the necessity to finance the ever-expanding deficit. For H2 2023, the government aims to raise \$1.9 trillion in new debt. With central banks contracting their balance sheets and the broad money supply shrinking, the onus falls on the private sector to absorb these new bonds, which could crowd out other assets. Currently, the US Treasury is mitigating the impact by predominantly issuing short-term debt, or T-bills. However, this tactic has its limitations. Bills, which have historically constituted only 23% of total debt, now make up around 70% of new issuance. Once this ratio reverts to historical norms, both risk assets and government bonds could face renewed pressure. Hence, we maintain a cautious stance on credit risk, as we feel the market has yet to fully account for these uncertainties. Interest rates have already priced in some of those issues in our view, and given the modest scale of coupon bond issuance, longer-term yields could even decline in the near term.

Equities

Correction after strong market performance

USA

- The US market lost 2.1% in August, leading to a year-to-date performance of 18.3% (all data as of 29 August).
- The earnings season again delivered better-than-expected results. Earnings growth (relative to Q2 2022) came to -8% and sales growth -1%. The earnings surprise was 4%, and 80% of the companies beat expectations. Analysts have increased their projections for 2023 and 2024 full-year earnings.
- The US equity market valuation is above historical averages. The performance since the start of the year can be entirely explained by the expansion of equity multiples, i.e. higher valuation.

Eurozone

- The market lost 2.6% in August, and the year-to-date performance amounted to 14.4%.
- The earnings season was also better than expected. Earnings growth came in at -8% while sales growth was -7%. 60% of the companies exceeded earnings expectations, and the earnings surprise was 4%.
- The European market is still very attractively valued from a longer-term perspective.

UK

- The UK delivered a performance of -2.3% in August. For the year to date, the market gained 2.8%.
- The UK market still benefits from the lowest valuation and the highest dividend yield of all the major developed markets. It appears, though, that the UK is currently a “value trap”.

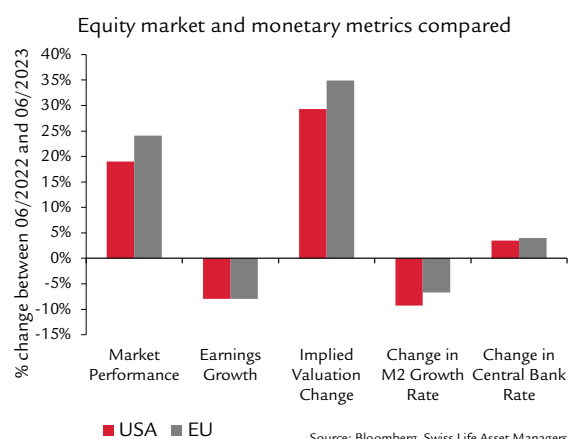
Switzerland

- The Swiss market declined by 1.9% in August, bringing the year-to-date performance to 5.8%.
- Pharmaceutical stocks and the Nestlé stock in particular delivered a weak performance. They account for more than 40% of the Swiss market.
- The Swiss equity market is the second most expensive market after the US market.

Emerging markets

- August was a bad month with a performance of -5.5%. For the year to date, the market has gained 5.2% and is thus lagging behind the other markets.
- Chinese economic data continues to disappoint, the country is experiencing deflation and, so far, the government’s stimulus efforts have been limited.

Higher valuations despite higher rates and less liquidity



Since mid-2022, the equity markets have gained around 20%. The positive development this year can be largely explained by higher valuations. This development is quite surprising given the economic development and the earnings dynamics. From Q2 2022 to Q2 2023, earnings declined by 8% in Europe and the US. At the same time, monetary policy became quite restrictive as the growth rate of the money supply declined and is now negative in the US. In addition, central banks raised policy rates by around 4-5 percentage points – one of the fastest and biggest increases in history. Rising equity markets and declining earnings led to an implied increase in valuation of around 30%. Such an expansion in an environment of restrictive monetary policy and declining growth rates has rarely happened in history. Due to this development, the US market now has a valuation that is rich on both an absolute and a relative basis against bonds. The situation is different in Europe. Despite the increase, current valuations are still below historical averages. Based on this evaluation, one can conclude that the recent correction was overdue and there may be more to come. However, there are also positive aspects. The two most important ones are: Firstly, earnings have been very resilient and exceeded expectations in the past two quarters. In addition, analysts expect earnings to grow by about 10% in 2024 and, and due to lower inflation and a weakening of the economy, interest rate cuts by the central banks are possible. Secondly, there is the chance that artificial intelligence may lead to a significant boost in productivity. Overall, we have a neutral view and a neutral allocation to equities in the near term.

Currencies

USD weakness expected to be temporary

USA

- In line with our view, the USD appreciated against most major currencies in August following two months of weakness. This was due to continued US economic outperformance – especially compared to Europe – as well as the Federal Reserve still leaning towards a hawkish tone in its communication. The weak risk sentiment in the financial markets also supported the greenback in August.
- We are sticking to our positive view of the USD for the remaining month of the quarter. While we expect inflation to trend lower in the US, economic data is likely to remain strong enough to keep the US Federal Reserve worried about inflation risks. The US interest rate advantage (“carry”) is thus likely to remain significant, supporting the USD.

Eurozone

- The EUR/USD exchange rate again moved below 1.10 in August. Weak economic data, notably a significant drop in Purchasing Managers’ Indices towards the end of the month, was the main reason for the EUR depreciation.
- We remain negative on EUR/USD and expect the EUR to move sideways against GBP and CHF over the next four weeks.

UK

- Following two positive months, GBP lost 1.5% against USD in August. For the third month in a row, the GBP performance against EUR was flat.
- While we expect another policy rate hike by the Bank of England, this move is already well priced by markets. We reiterate our call for a lower GBP/USD.

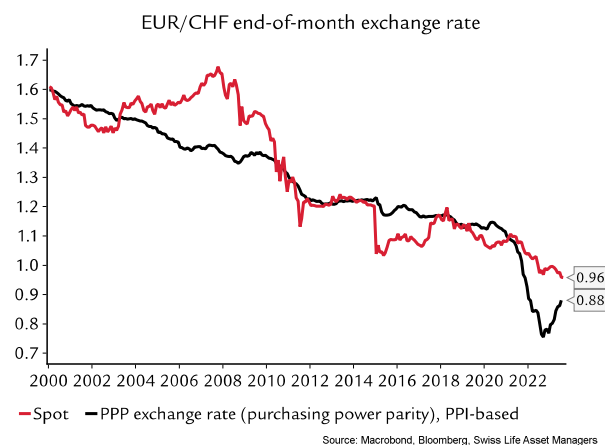
Switzerland

- In August, USD/CHF recovered from its lows in July, while a “relief rally” at the end of the month led to a slightly positive performance for EUR/CHF in August.
- We are reiterating our neutral view of EUR/CHF and our positive view of USD/CHF.

Japan

- USD/JPY increased by 2.5% in August. The dip in July was thus only a short episode in a seemingly unbroken upward trend for USD/JPY.
- We are expecting another month of JPY weakness against USD as the interest rate differentials remain very elevated, to the detriment of JPY.

The CHF is becoming less undervalued



One of the most surprising elements of the post-pandemic normalisation of central bank policies has been the Swiss National Bank’s tolerance for a stronger CHF. Not only did the SNB move away from its mantra of an overvalued currency, it actually seemed to embrace a stronger CHF as a means of keeping imported inflation at bay. The SNB’s relaxed attitude was justified by the significantly widening inflation differential between Switzerland and the rest of the developed world, which led to a drop in the “fair value” of foreign currencies. If a purchasing power model (PPP) based on producer price inflation is applied, some estimates even suggested that the fair value of EUR/CHF dropped to 0.80 in the course of 2022, thus making CHF an undervalued currency compared to EUR. Admittedly, if a consumer price PPP model is applied, the CHF is still considered overvalued, but in order to gauge the competitiveness of the economy, notably of exporters, producer prices might be the more appropriate input for a fair value model.

Over the past months, however, the situation has changed quickly. While inflation in Switzerland is likely to remain sticky at close to 2% over the coming months, inflation is falling rapidly elsewhere from the elevated 2022 levels. The declining inflation differential implies a rising “fair value” of EUR/CHF (see chart) and USD/CHF. In combination with deteriorating business surveys, especially in the manufacturing sector, calls from the Swiss export economy to the SNB to move more carefully in its tightening cycle might return, making the SNB’s job of reining in inflation somewhat more delicate again.

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