Perspectives
Financial Markets

Swiss Life Asset Managers

June 2024

Interest rates & bonds
How low can spreads go?

Overview of bond yields and investment grade credit spreads

	10-year government bond yield			Investment grade credit spread		
	Current	May 2024*	Year-to-date*	Current	May 2024*	Year-to-date*
US	4.6%	-11 bps	69 bps	86 bps	-1 bps	-13 bps
Eurozone	2.6%	6 bps	63 bps	109 bps	-3 bps	-29 bps
UK	4.3%	0 bps	82 bps	114 bps	-7 bps	-25 bps
CH	0.8%	14 bps	18 bps	78 bps	0 bps	-4 bps

10-year government bond yield eurozone = DE. * Change as at 28 May.
Source: Bloomberg

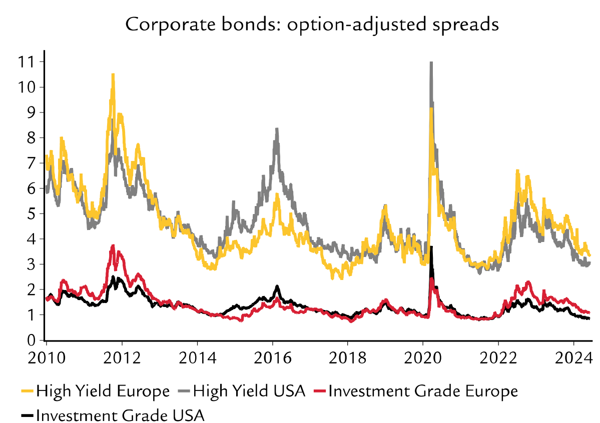
USA
- US economic data has disappointed market expectations in May, but still shows resilience.
- The first policy rate cut that the market has fully priced in was postponed from June to December.

Eurozone
- The eurozone seems to have bottomed out as economic activity continues to surprise to the upside, although coming from low levels.
- Most ECB speakers have largely confirmed a first rate cut in June, and investors are pricing in a second cut later this year, given a much more muted inflation and growth outlook for the eurozone.

UK
- The UK economy is recovering, with the manufacturing PMI back in expansionary territory and overall economic surprises skyrocketing.
- Inflation likewise surprised to the upside, as both consumer and producer price inflation still lie above the 2% target. Market participants now expect only one rate cut from the Bank of England for this year.

Switzerland
- Switzerland saw a surprisingly sharp drop in the manufacturing PMI, while both producer and import prices surprised to the upside.
- Investors adjusted their outlook for the SNB's policy path and now only expect one more rate cut in 2024.

Credit investors still hungry for risky assets



Credit investors continue to buy up risky assets, compressing US credit spreads to levels last seen in the second half of 2021 when interest rates were largely negative. European investment grade credit spreads remain above these levels due to a relatively weaker economic outlook, but investor appetite for risk persists, as evidenced by the aggressive bid for high beta segments such as corporate hybrids and subordinated financials. Despite high issuance levels in Europe and the US, new bonds are well absorbed and continue to outperform in secondary trading. While acknowledging the favourable economic backdrop combined with expected monetary easing, we find little value in the current market pricing and maintain a neutral stance on credit risk. The USD segment appears rich, with high yield spreads trading at the 6th percentile, just below 300bps. While an outright recession remains unlikely in the near term, renewed inflation acceleration poses a substantial risk. Should central banks be forced to pivot from their dovish stance, we could see fresh spikes of volatility and spread widening. Rates markets similarly seem complacent about the risks, with the MOVE index (the volatility index for US interest rates) having reached levels last seen before the Fed started its hiking cycle. Overall yield levels remain attractive, and we recommend a neutral duration position.

Equities

April dip, May peak: supposed market resilience?

Overview of equity market performance

	May 2024*	Year-to-date*
USA	5.4%	11.4%
Eurozone	3.6%	12.0%
UK	1.6%	8.7%
Switzerland	5.2%	7.9%
Emerging Markets	4.3%	7.2%

MSCI net total return indices in local currency.
* Performance as at 28 May. Source: Bloomberg

US

- The US equity market posted a strong month and gained 5.4% in May. The market rallied shortly after the Fed voted unanimously to hold policy rates steady for the sixth consecutive time.
- The US equity market valuation remains far above historical averages and that of other markets.

Eurozone

- Even tough eurozone business activity has expanded at its fastest pace in a year in May, the European equity market only posted a gain of 3.6% and underperformed the US market in May.
- The current valuation of the European market is less expensive than the US market.

UK

- After a strong April, the UK market significantly underperformed all other markets in May, though its year-to-date performance is still solid.
- The UK market continues to benefit from a low valuation and a high dividend yield of 3.9%.

Switzerland

- The Swiss equity market gained 5.2% in May, making it the second-best performer for the month. However, year to date, it is still lagging other developed markets.
- The Swiss equity market is the second most expensive after the US market.

Emerging markets

- Emerging market equities held up reasonably well in May, but on a year-to-date basis, they remain very weak.
- Despite strong performance in April and initial optimism in the Chinese equity market, the positive trajectory did not continue in May.
- The valuation of emerging market equities is close to neutral.

From April's tumble to May's historic highs

In a dramatic reversal of fortunes, equity markets that faced significant downturns in April 2024 bounced back in May, reaching new all-time highs. Market analysts attributed the downturn in April to a cocktail of rising interest rates, geopolitical tensions, and investor uncertainty over global economic health and sticky inflation. In May, equity market performance was mainly strong due to better-than-expected results from the Q1 earnings season and easing inflation concerns, which boosted investor confidence and market buying. Despite the remarkable recovery, notable companies like Nvidia have not followed this trend in their previously established market influence, even while reporting robust financial results. The company announced a more than 265% increase in quarterly revenue year-over-year, driven by continued demand for its AI products. However, Nvidia's success did not translate into broader market leverage. After the strong earnings report, Nvidia’s stock price surged by 15%, but this increase did not significantly affect the overall market indices.

Powerhouse companies with less market sway

Name	Currency	1-Day-Performance on 23/05/2024
NVIDIA	USD	9.3%
MSCI World Index	USD	-0.6%
MSCI World Equal Weighted Index	USD	-0.7%

Source: Bloomberg

The equity market's recovery in May 2024 to new all-time highs reflects a complex interplay of investor sentiment and economic indicators. Despite Nvidia’s strong showing, its influence on the broader market has been muted, suggesting that even powerhouse companies face limits in their market sway. Notably, Nvidia has recently taken the second place in MSCI World Index weighting, surpassing Apple and now trailing only Microsoft. Moving forward, investors would be wise to keep an eye on broader economic trends alongside individual stock performances to navigate the equity landscape effectively and to adopt a more cautious approach in response to potential market uncertainties and shifts in economic indicators. Additionally, fundamental valuation remains clearly above historical averages, as valuation multiples have increased further year-to-date given the strong equity market rally. Hence the relative attractiveness of equities in comparison to fixed income has not improved, leaving us with a negative view on the asset class.

Currencies

USD strength takes a pause

Overview of major currencies

	May 2024*	Year-to-date*	1-month view
EUR/USD	1.6%	-1.8%	➔
EUR/CHF	0.8%	6.4%	➔
GBP/USD	2.0%	0.1%	➔
USD/JPY	-0.3%	11.5%	➔

* Performance as at 28 May. Source: Bloomberg

USA

– In May, USD weakened across the board, depreciating against all major currencies. The USD depreciation was the strongest against NOK (-5.2%).
– EUR managed to regain some ground against the USD in May as market expectations for Fed cuts in 2024 and 2025 remained stable while markets now expect less cuts from the ECB until year-end.

Eurozone

– The EUR appreciated 1.4% against the USD in May. EUR/CHF climbed above 0.99 in the second half of May, but EUR gave up part of the gains at the end of the month.
– We continue to hold a neutral view of the EUR vs. USD and now also hold a neutral view of the EUR vs. CHF (see text column on the right).

UK

– GBP appreciated against the USD in May as stronger-than-expected inflation data out of the UK and still high labour market pressure led the market to question the ability of the Bank of England to cut interest rates as early as this summer.
– We continue to hold a neutral view of GBP vs. USD over the next month.

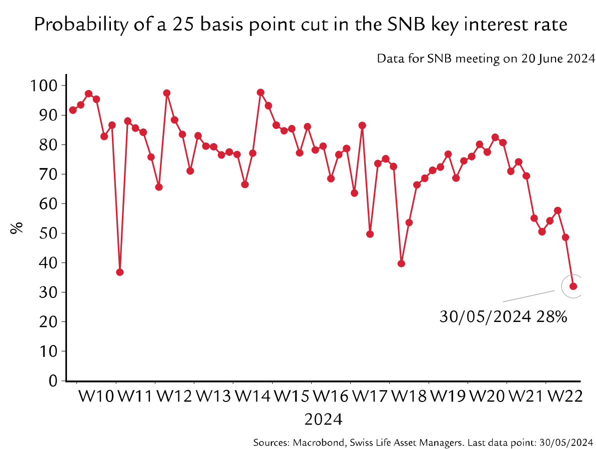
Switzerland

– CHF appreciated by 1.3% against the USD in May, while losing some ground against EUR.
– We now hold a neutral view of the EUR vs. CHF.

Japan

– JPY weakness stabilised in May with JPY only losing 0.5% against the USD, making it the second-best performer vs. USD.
– We keep our neutral stance on JPY vs. USD unchanged.

EUR/CHF without clear directionality



EUR/CHF moved another leg higher in May, rising briefly above the level of 0.99 and to the highest level in over a year, before reversing some of the gains in the last days of May. The upward move was on the one hand driven by the current risk environment, which is characterised by low volatility. In the current environment, the typical safe haven currency CHF is an attractive funding currency given its relatively low interest rate despite already stretched short positioning. On the other hand, strong economic readings in developed markets foster the low-risk environment. Both the eurozone as well as Switzerland reported solid Q1 GDP figures, indicating that the eurozone found its way out of the technical recession of 2023. Additionally, most recent surveys such as the Purchasing Managers' Indices (PMI) point towards improving forward-looking sentiment. Inflation is also continuing to decline, paving the way for a first interest rate cut by the European Central Bank (ECB) in June. Two interest rate cuts by the ECB for this year are already fully priced in by markets. The SNB has already moved ahead in March, lowering its policy rate by 25bps. While markets had until recently expected two more rate cuts by the SNB for 2024, market pricing has moved towards and even undershot our expectations of only one additional cut in 2024 at the end of May. This has led CHF to regain some of the losses against EUR. However, despite the recent repricing in monetary policy expectation for the SNB, the EUR interest rate advantage has not diminished significantly as EUR rates have also moved up. For June, EUR/CHF lacks a clear directional driver in our opinion, and we hold a neutral view on the currency pair.

Asset allocation

Sell in May?

Review

- May was a "risk-on" month. Equity markets did quite well across regions and styles, although large growth companies outperformed the rest.
- This positive development was mostly the result of the positive Q1 earnings season in the US. Economic data were mixed but indicated that the US economy is still strong and that continental Europe has noticeably improved. Consequently, the second half of the month was more volatile, as doubts about an upcoming relaxation in monetary policy were re-ignited.
- The ensuing rise in yields had a negative impact on bonds, particularly for CHF bonds, but credit spreads compressed further. Corporate bonds, including high yield and emerging markets, therefore outperformed government bonds.
- Currency wise, the CHF appreciated relative to the USD but depreciated relative to the EUR, while the GBP appreciated sharply relative to the USD.

Current asset allocation views

Asset class	Active weight
Global Government Bonds	overweight
Global Investment Grade Credit	underweight
Emerging Market Bonds	underweight
Global Equities	neutral

Source: Swiss Life Asset Managers

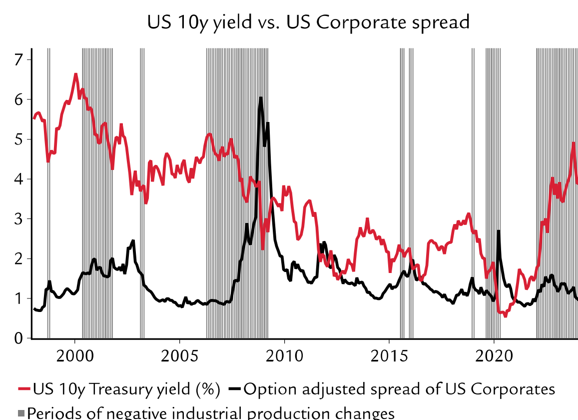
- Our view has not changed: fundamentally we think that markets are underestimating risk and are therefore expensive both historically and relative to current prospects.
- However, we continue to be hesitant to underweight equities, as economic and market momentum is still good. On the other hand, we underweight corporate and other risky bonds, as the upside is too low compared to downside risk.
- We still overweight government bonds, although recent dynamics have been working against us. But we expect the economies to normalise in terms of both growth and inflation. The real rates, particularly in the US, are still too high for this scenario.
- The decision of the European Central Bank later in June and its guidance is the next beacon in this difficult navigation.

Why are investors accepting low credit spreads?

A commonly heard explanation for the current low credit spreads is the elevated yields levels. The argument is that investors are pleased by the currently high yields and therefore even low spreads are a welcome top-up to these already attractive levels. As we currently prefer government bonds to corporate bonds, we will have a closer look at this argument.

Credit spreads are meant to compensate investors for the risk of a default. This risk will depend on the financial strength of the debtor and on economic conditions: if the economy slows down, earnings growth will fall, and credit risk will increase even for financially solid issuers. Low credit spreads therefore implicitly signal that investors expect the economy to continue to do well.

US 10y yield vs. US Corporate spread



Sources: Macrobond, Swiss Life Asset Managers. Last data point: 04/2024

At first glance, the historical evidence (see the chart) supports the argument, as in times of higher yields, spreads are often low. However, concluding that spreads are tight because yields are high might confuse correlation for causality. Significant increases in interest rates are mostly the result of a tighter monetary policy aiming to slow down an overheating economy. Spreads are low because of the strong economy and the expectation that it will continue to be strong. However, higher yields will eventually slow the economy down and increase future credit risk. Consequently, as the chart suggests, credit spreads tend to widen significantly after a period of higher yields. We agree therefore that credit spreads are more likely to widen once yields start to fall. However, the reason will be the increasing credit risk created by the slowing economy. In this sense, the currently tight credit spreads suggest that the market is underestimating the risk ahead.

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