Perspectives
Financial Markets

SwissLife Asset Managers

August 2024 – Update on the recent market turbulences in the Flash Comment on page 6

Interest rates & bonds

US election headlines move rates and spreads

Overview of bond yields and investment-grade credit spreads

	10-year government bond yield			Investment grade credit spread		
	Current	July 2024*	Year-to-date*	Current	July 2024*	Year-to-date*
US	4.1%	-26 bps	26 bps	94 bps	0 bps	-5 bps
Eurozone	2.3%	-16 bps	32 bps	111 bps	-9 bps	-27 bps
UK	4.0%	-13 bps	51 bps	114 bps	-9 bps	-25 bps
CH	0.4%	-8 bps	-21 bps	73 bps	-10 bps	-10 bps

10-year government bond yield eurozone = DE, bps = basis points.
* Change as at 30 July. Source: Bloomberg

USA

- Economic growth in the US remains relatively steady. However, rates and spreads were mainly driven by headlines around the US election.
- Based on our outlook for a further decline in inflation, we expect two policy rate cuts in 2024.

Eurozone

- The eurozone economy seems to have bottomed out with the consensus GDP growth estimates for 2024 being revised up since May.
- As expected, the ECB left its policy rates unchanged at the 18 July meeting. We expect slightly improving GDP growth but also a decline in inflation and, as a result, policy rate cuts in September and December.

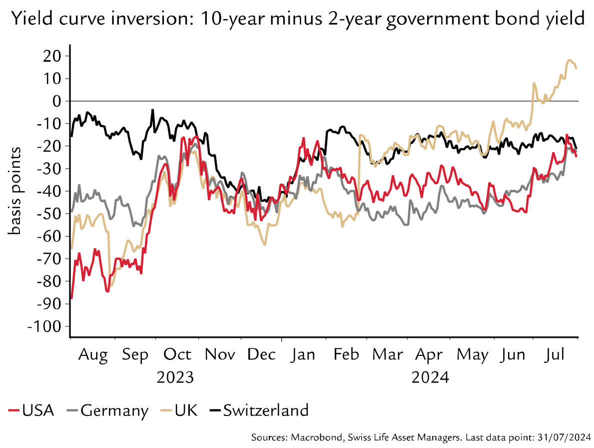
UK

- The consensus forecast for UK 2024 GDP growth has increased since May, and Bloomberg's one-year UK recession probability has declined to 20%.
- The Bank of England held its policy rate stable on 20 June. Despite a recovering economy and a still elevated inflation rate, we expect a total of two policy rate cuts from the Bank of England for this year.

Switzerland

- Inflation and the manufacturing Purchasing Managers' Index dropped more than expected in June. The strong CHF is adding to disinflationary trends.
- After the SNB delivered a 25 basis point cut on 20 June, we expect it to keep the policy rate unchanged in H2 2024.

US yield curve inversion has declined since the end of June



The US presidential debate on 27 June and subsequent events led to a temporary rise in the odds of a second Trump presidency and initiated a market reaction known as the "Trump trade" that was longer-lasting. On the rates side, markets increasingly bet on higher long-term US bond yields. Investors bought shorter-maturity notes and sold longer-term ones (so-called curve steepener trade). In terms of EUR credit spreads, we note the significant volatility both in investment-grade (IG) and high yield (HY) until the beginning of July, given French election headlines. Regarding USD credit spreads, IG was stable in July. Nevertheless, US HY bonds profited from the Trump trade and outperformed European HY. The creditworthiness of weaker US companies is seen to profit from tax cuts, tariffs and looser regulations. Moreover, US HY bond issuers have a high share of domestic revenues. This contrasts with US IG, where the share of US revenues is usually lower. We take a neutral view on EUR IG and HY credit but expect wider spreads for USD IG and HY credit. Regarding duration, we expect lower 10-year bond yields in the US and Germany in August as the ECB and Fed are likely to cut interest rates in the autumn. After the strong rally in Swiss government bonds, we take a neutral view regarding 10-year bond yields. Forecast risks include sticky inflation, a continuously stronger-than-expected US economy and potential US policy changes after the 2024 US presidential election.

Equities

Strong start, weaker second half in July

Overview of equity market performance

	July 2024*	Year-to-date*
USA	-0.4%	14.2%
Eurozone	-0.2%	8.1%
UK	1.4%	9.3%
Switzerland	2.3%	11.2%
Emerging Markets	-0.9%	6.5%

MSCI net total return indices in local currency.
* Performance as at 30 July. Source: Bloomberg

US

- July started strong with a gain of 4% until mid-month, but the market then relinquished these gains, ending the month faintly negatively. The year-to-date performance is, however, still much higher than our upper estimate of around 7% for 2024.
- The earnings season has so far beat expectations. However, some of the "Magnificent 7" stocks delivered disappointing results, which led to a correction.
- July saw a sharp recovery of the styles that were lagging before. Value is up 4.2% and small caps are up 7.1% in July, thus beating the broad market. Growth stocks underperformed with a return of -4.4%.
- The US market is expensive and valuation much higher than all the other markets.

Eurozone

- July was another weak month for the eurozone market. Year-to-date, it is again showing a much weaker performance than the US market.
- As in the US, the earnings season has so far delivered better-than-expected results. The valuation of the European market is still neutral.

UK

- The UK market gained slightly in July and has outperformed the eurozone market year to date.
- The UK market still benefits from a low valuation and may get a tailwind with the new government.

Switzerland

- The Swiss market had a positive month in July and has outperformed the eurozone market year to date.
- The Swiss equity market is the second-most expensive after the US market.

Emerging markets

- After a strong June, Emerging Markets were weaker in July and lost 0.9%. The year-to-date performance is now 6.5%

Style rotation beginning?

The last 15 years have seen a structural break in the return patterns of different investment styles. Growth outperformed Value more than ever before (the performance is 765% vs. 283% in the US since the end of 2009 and 427% vs. 183% globally), small caps underperformed large caps by a wide margin and more defensive styles like Minimum Volatility or High Dividend could not keep up with the broad market. In addition, the US market and the IT sector have performed much better than the global benchmarks. The same picture was also seen over the past 5 and 10 years as well as year-to-date (see table). Before 2009, the pattern was the opposite: Value outperformed Growth, small caps outperformed large caps and defensive styles kept up very well with the broad market.

MSCI World	2009 to June 2024	5 years	10 years	Year-to-date*	July 2024*
Total	295%	74%	140%	12%	0.1%
Small Cap	249%	39%	84%	7%	5.6%
Growth	427%	104%	214%	13%	-3.3%
Value	183%	44%	76%	10%	3.9%
Momentum	478%	82%	209%	21%	-4.3%
Quality	486%	111%	237%	15%	-2.4%
Min Vol	226%	26%	98%	9%	4.2%
High Dividend	176%	35%	69%	8%	4.3%
IT	948%	189%	522%	18%	-5.8%

*Changes as at 30 July. Sources: Bloomberg, Swiss Life Asset Managers

These developments have led to an extreme concentration of stock markets (the US market is more concentrated than in 1929 and 1999) and to very large valuation differences. For example, the MSCI World Growth currently has a price-to-earnings (PE) ratio of 30.8 while the MSCI World Value has a PE-ratio of 15.1, i.e. Growth is twice as expensive as Value. This is the most extreme valuation difference in this century. Put together, we are confronted with three extreme situations: historical performance differences, concentration and relative valuations. The big question now is whether July marks the beginning of a countertrend or even of a restoration of the pre-2009 patterns or whether this is just a short-term move resulting from the earnings season and political developments. A prediction is very difficult, but one thing is clear: the extreme divergences of performance, valuation and the concentration problem have never been so strong. Sooner or later, these extremes will need to be corrected. It would be healthy for stock markets if July marks the beginning of a normalisation.

Currencies

The greenback takes a breather

Overview of major currencies

	July 2024*	Year-to-date*	1-month view
EUR/USD	1.0%	-2.0%	↘
EUR/CHF	-0.8%	2.8%	→
GBP/USD	1.5%	0.8%	↘
USD/JPY	-5.0%	8.3%	↗

* Performance as at 30 July. Source: Bloomberg

USA

- July marked a rare month of USD weakness. The greenback depreciated around 1% on a trade-weighted basis. Among major currencies, the USD depreciated the most against the JPY, GBP and CHF.
- We expect USD strength to return in August as the US economic growth outlook still favours the USD, especially compared to the EUR.

Eurozone

- The EUR appreciated against the USD but lost 0.2% on a trade-weighted basis. The Purchasing Managers' Indices are indicating that the growth optimism of the first half of the year is already fading in the eurozone, weighing on the EUR.
- We expect the EUR to remain under pressure vs USD but have a neutral view against the GBP and CHF.

UK

- The GBP rallied well in the first half of July, driven by stronger-than-expected growth and inflation, which led the market to price in fewer interest rate cuts from the Bank of England this year.
- Consistent with our view of general USD strength, our one-month view on GBP/USD is negative.

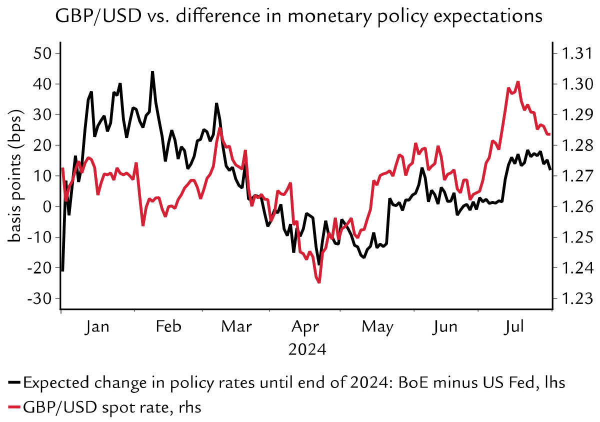
Switzerland

- CHF strength continued in July, as European growth concerns and elevated political uncertainty led to increased demand for safe-haven currencies.
- At the current level, we take a neutral view on EUR/CHF on a one-month horizon.

Japan

- The JPY rallied strongly in July, amplified by the surprising rate hike on 31 July by the Bank of Japan (BoJ). This is a welcome relief for the worst-performing major currency year-to-date.
- Nevertheless, we expect renewed JPY weakness from here as we do not expect the BoJ to embark on a credible interest rate hiking path.

A strong USD, an even stronger GBP



Sources: Macrobond, Swiss Life Asset Managers. Last data point: 31/07/2024

The GBP is the only developed market currency that has managed to appreciate against the USD year-to-date. Relatively strong economic momentum and sticky inflation have supported the GBP. The British economy has been doing better than expected this year. In the first quarter, GDP grew by 0.7% compared to the previous quarter, and monthly GDP numbers for the second quarter indicate a continuation of this trend. Economic expectations for the UK received a renewed boost as preliminary Purchasing Managers' Indices for July showed improving sentiment among both manufacturing and services firms, which stands in stark contrast to disappointing numbers in the eurozone. Inflation pressures are also declining in the UK but remain stickier than the Bank of England (BoE) had expected, which is mostly due to services inflation. Both of these factors, better-than-expected growth and stickier inflation, have led financial markets to price monetary policy by the BoE to remain tighter for longer. Currently, a total of two interest rate cuts of 25 basis points (bps) are priced in for this year. For the Fed, slightly more is priced in in terms of monetary policy easing. The difference in monetary policy pricing was an important driver of the GBP/USD exchange rate this year (see chart). However, we believe the upward move of the GBP is stretched as investors have accumulated a lot of long positions on GBP/USD (a so-called "crowded trade"). We expect the reversal of GBP/USD, which already started in the middle of July, to continue in August as we expect structural USD strength to return over a one-month horizon.

Asset allocation

A moment of self-reflection in the summer lull

Review

- After a strong but somewhat volatile H1 2024, equity markets were weaker in July, with only a few markets showing a significant positive performance.
- Bonds profited from lower rates and relatively stable credit spreads, so that multi-asset portfolios with high fixed-income allocations outperformed those with higher equity weights.
- Most equity markets had a negative return in local currency in the month to July 30, with the notable exceptions of Switzerland and the UK, which were supported by their lower weights in technology-related stocks.
- Currencies were volatile and especially in the second half of the month the CHF appreciated a little thanks to a move towards safe havens.

Current asset allocation views

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

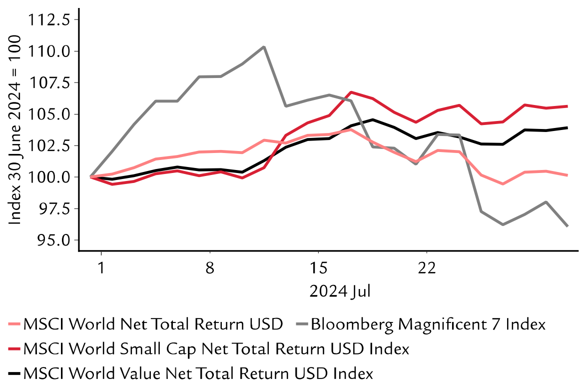
Source: Swiss Life Asset Managers

- The current earnings seasons in the US has led investors to reconsider the value of the most successful stocks in 2024 so far. This could be the beginning of a normalisation but might also be a mirage as the summer lull tends to amplify temporary events due to thinner liquidity. Still, we are starting to diversify away from the big, technology-related stocks towards more attractive segments.
- Long-term yields have fallen a little, but are, especially in the US, still high. We therefore think that government and highest-quality bonds are attractive. A notable exception are CHF bonds: the low Swiss rates look less attractive despite the good returns this year and low inflation in Switzerland.
- Credit spreads have not moved much, meaning that they offer little protection should the financial conditions of the issuers worsen. We therefore continue to prefer government bonds to corporate bonds despite their higher yield.

Does it still make sense to be neutral on equities?

In February, we decided to increase the equity weight and be "neutral". We argued that the positive market momentum was strong and likely to overpower the negative equity fundamentals. Momentum has been strong indeed! Since the end of February, global developed equity markets have returned 6.9% (MSCI World Developed with net income reinvested in CHF) whereas global government bonds have returned only 0.4% (Bloomberg Global Treasury Total Return Index hedged in CHF). During this period, the equity market saw a few corrections but recovered swiftly. The most recent episode started on 16 July with a maximum correction of about 6% as of 29 July. So, in retrospect it was a good decision to increase the equity weight to neutral. Should we maintain our neutral view? While most markets have done well, this year's performance has been driven by a few very large US tech stocks (the "Magnificent 7"). These stocks have benefitted not only from solid earnings growth but also from even stronger expectations about the benefits artificial intelligence would bring to them. However, the earnings being announced in the current season, while still solid, seem to be disappointing investors, and the market has been severely punishing companies with weak earnings and outlooks, a development hitting the expensive large tech companies in particular (see the chart). Therefore, the recovery this time around might be more difficult, also because 1) the Federal Reserve is delaying its first rate cut as the economy is still strong and 2) the US presidential race is creating uncertainty, which markets dislike. The equity market has lost some momentum. It is too early to call the turning point, but it may be nearer. Therefore, we remain neutral but are reducing exposure to the winning US large stocks in favour of smaller, cheaper stocks.

Equity total returns in July 2024 compared



Sources: Macrobond, Swiss Life Asset Managers. Last data point: 30.07.2024

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Perspectives
Flash Comment

7 August 2024

Summer storm on financial markets

What has happened?

- After a positive July, financial market sentiment reversed abruptly at the beginning of August.
- What started with a correction on the Japanese equity market on 1 August ended up engulfing global financial markets.
- Although no single event triggered this correction, the combination of weaker-than-expected US labour market data, uninspiring earnings and outlooks by US companies and the unexpected policy rate increase in Japan rattled investors and led to a sharp correction on equity markets, wider credit spreads and a significant fall in bond yields.

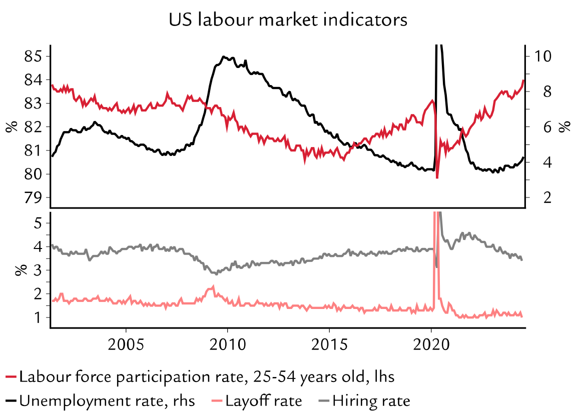
Our economic assessment

- The unexpected increase in the US unemployment rate from 4.1% in June to 4.3% in July led to worries that the US economy is on the brink of recession.
- A moderation of the excessively high US consumption growth and a looser labour market have always been part of our base case scenario for 2024. So it is not rising unemployment per se that is concerning, but rather the recent speed at which it has increased.
- Encouragingly, it is not increased "firing" that is pushing up unemployment, but reduced hiring amid a surge in labour force participation (see chart). The latter is not necessarily a bad sign for the economy. Furthermore, negative effects from Hurricane Beryl might have impacted the July data.
- Also, the unemployment rate is currently the only indicator showing pronounced weakness. The payrolls survey indicated that the US economy was adding jobs in July, although at a slow pace. Meanwhile, purchasing managers' indices suggest that the services sector was still doing fine in July.
- The biggest risk is that the "recession scare" might start to weigh on consumer and corporate sentiment and thus initiate a negative economic feedback loop. Monetary policy easing is key to alleviate these concerns. We expect the US central bank to start a policy rate cutting cycle in September.

Our market assessment

- The ongoing correction has potentially been amplified by the seasonal thin market liquidity, implying that we could see a rebound in the short term. However, the fundamentals remain weak, as the moves were insufficient to correct the high valuation of equities and credits.
- We therefore expect continued volatility on financial markets. Equity markets are likely to continue their rotation in favour of cheaper regions, sectors, and market segments. Corporate bonds and high yield spreads might widen further. Yield levels are likely to fall slightly, although the significant drop over the last days might limit the downside potential. On the currency front, we see limits to a further appreciation of CHF relative to EUR and USD, as the SNB might intervene. After the move up, we see no further upside potential for EUR/USD as lower rates in USD will likely be matched by lower EUR rates.
- The market's focus on the risk of an economic slowdown led to a modest decline in oil prices, despite the risk of a further escalation in the Middle East. Any such escalation would introduce an additional element of volatility that would, in our view, hurt European markets in particular.

US labour market: less hiring amid rising participation



Sources: Macrobond, Swiss Life Asset Managers. Last data point: 07/2024

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