Perspectives
Financial Markets

SwissLife Asset Managers

September 2024

Interest rates & bonds

Supportive credit metrics and tight spreads

Overview of bond yields and investment-grade credit spreads

	10-year government bond yield			Investment grade credit spread		
	Current	Aug. 2024*	Year-to-date*	Current	Aug. 2024*	Year-to-date*
US	3.8%	-18 bps	-3 bps	94 bps	1 bps	-5 bps
Eurozone	2.3%	-1 bps	27 bps	116 bps	6 bps	-22 bps
UK	4.0%	4 bps	48 bps	120 bps	6 bps	-19 bps
CH	0.5%	4 bps	-20 bps	76 bps	4 bps	-7 bps

10-year government bond yield eurozone = DE, bps = basis points.
* Change as at 28 August. Source: Bloomberg

USA

- US recession fears spiked at the beginning of August but have abated quickly. As a result, markets have priced out around half a rate cut since 2 August.
- Nevertheless, we expect US economic growth to moderate and now anticipate three rate cuts by the Fed by the end of this year.

Eurozone

- Eurozone economic growth remains sluggish and forward-looking indicators still point towards lower inflation.
- Given that the Fed is now more likely to cut policy rates at each meeting this year, we also expect three rate cuts by the ECB.

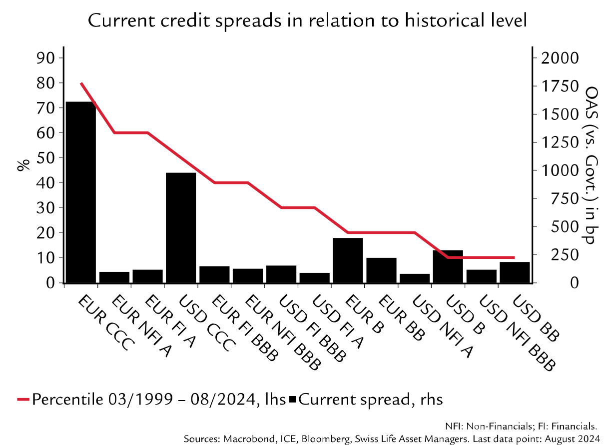
UK

- In August, the British economy delivered positive economic surprises, such a further increase above the growth threshold in as Purchasing Managers' Indices (PMI) for both manufacturing and services.
- We expect the Bank of England to cut rates once more this year.

Switzerland

- July's Manufacturing PMI again dropped more than expected. Our 2025 GDP and inflation forecasts remain below consensus forecasts.
- We think that the SNB's monetary policy stance is now around neutral. Hence, unlike the markets, we expect no further rate cuts.

Majority of credit segments trading in a rich range



NFI: Non-Financials; FI: Financials.
Sources: Macrobond, ICE, Bloomberg, Swiss Life Asset Managers. Last data point: August 2024

According to a Bloomberg survey, analysts assess the likelihood of a recession within the next year in both the US and the eurozone as relatively low (around 30%). Credit metrics of high-yield (HY)-rated companies such as interest coverage or debt leverage are still strong. Moreover, defaults in the US and Europe have declined since their peak some months ago. As a result, credit spreads are mostly low in historical comparison. The chart above shows in which percentile the current credit spread levels are trading in a historical comparison (between March 1999 and August 2024). We can make the following observations. Firstly, around 70% of all credit segments are trading at historically low spread levels (percentiles <50%) and are thus highly valued. Secondly, in relative terms, CCCs and single-A's are the cheapest pockets based on historical percentiles. Thirdly, EUR spreads look more attractive compared to USD spreads in all credit segments. Fourthly, USD BBs, Bs and Non-Financial BBBs are the most highly valued segments. Given the outlook of a moderating US economy, coupled with non-negligible recession risks, many credit investors seem to prefer the stronger BB credit quality in HY, but also the higher yielding BBB segment in the more stable Investment Grade (IG) segment. For September, we are adopting a neutral view on HY and IG credit spreads and a neutral view regarding US, EU and Swiss bond yields.

Equities

Rollercoaster ride with a positive end

Overview of equity market performance

	Aug. 2024*	Year-to-date*
USA	1.8%	18.1%
Eurozone	0.3%	9.1%
UK	0.2%	10.8%
Switzerland	0.3%	11.9%
Emerging Markets	2.0%	10.0%

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

US

- The month started with a quick, but sharp correction. In the first few trading days the market lost more than 5% (Japan lost even 20%). Since then, the US market has recovered and is up for the month.
- The primary cause of the correction was weaker-than-expected labour market data. Following some better economic data and an increased likelihood of rate cuts, the market began to recover. However, the most recent data has fallen short of expectations.
- The earnings season was again very good. The recovery of lagging equity styles stalled in August.
- The US market remains expensive with a valuation much higher than that of other markets.

Eurozone

- The initial decline of the European and the US equity markets was comparable, but the subsequent European recovery was weaker.
- Key issues in Europe are weak economic data, especially in Germany, and political uncertainty.
- The European market valuation is still neutral.

UK

- The UK and US markets saw a similar August performance.
- The UK market is still benefiting from a low valuation, although the impact of the new government on equity markets remains to be seen.

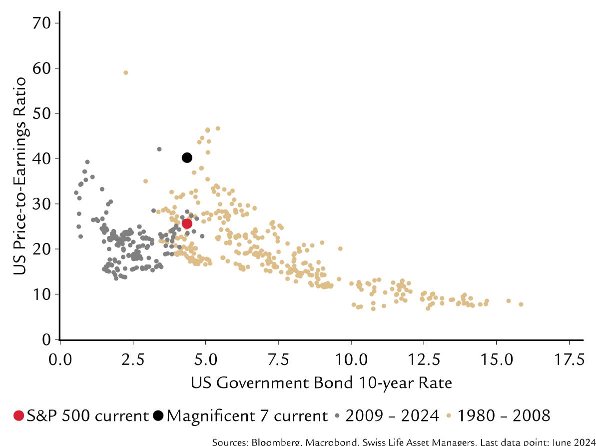
Switzerland

- The Swiss market also followed the US market closely in August.
- The market remains the second most expensive.

Emerging markets

- The performance of Emerging Market stocks was comparable to that of developed markets in August, which is – in contrast to previous years – also true for the year-to-date development.

Stock markets valuation and interest rates



Sources: Bloomberg, Macrobond, Swiss Life Asset Managers. Last data point: June 2024

The relationship between stock market valuation and interest rates was negative until the structural change in monetary policy following the great financial crisis of 2008. Since then, central banks have engaged in quantitative easing and adopted a zero-interest rate policy, creating an unprecedented period, which ended about two years ago. In 2022 and 2023, major central banks raised their policy rates. The chart above illustrates how the relationship between stock market valuation (price-earnings ratio) and interest rates (10-year US Treasury yield) has evolved in the US.
From 2008 to 2024, the inverse relationship between interest rates and stock market valuation has disappeared. Economically, this is puzzling. Higher interest rates typically make bonds and cash more attractive, and the "yield" of equities (earnings divided by price) should thus increase to maintain their appeal. A higher "yield" implies a lower price-earnings ratio, reflecting the negative relationship seen before the great financial crisis (yellow points). Remarkably, even after two years of rising interest rates, this relationship has not normalised. In fact, the stock market's price-earnings ratio is 15% higher than in March 2022. Current valuations are high both historically and relative to interest rates, as indicated by the black dot for the Magnificent 7 and the red dot for the S&P 500 in the chart above. We anticipate that US 10-year bond yields will remain well anchored at the current relatively high levels, which implies a significant risk for a valuation adjustment going forward.

Currencies

The USD's cruel summer

Overview of major currencies

	Aug. 2024*	Year-to-date*	1-month view
EUR/USD	3.1%	1.1%	↘
EUR/CHF	-0.7%	1.7%	→
GBP/USD	2.8%	3.8%	↘
USD/JPY	-3.6%	2.5%	↗

* Performance as at 28 August. Source: Bloomberg

USA

- USD weakness continued in August. The USD lost 3.4% month-to-date on a trade-weighted basis. All major currencies managed to appreciate against the USD, with SEK, NZD and AUD making the greatest gains.
- We expect USD strength to return in September as we think the US growth outlook priced by markets is currently too negative (see text on the right).

Eurozone

- The EUR moved another leg higher against the USD in August, while also appreciating on a trade-weighted basis. The upwards move in EUR/USD looks stretched to us as it is not representative of fundamentals.
- We expect the EUR to retract against the USD in September as economic divergence should come back into focus.

UK

- The GBP has staged a rapid recovery from its losses in early August with GBP/USD moving above 1.32, profiting from the improved risk sentiment.
- Consistent with our view of general USD strength, our one-month view on GBP/USD is negative.

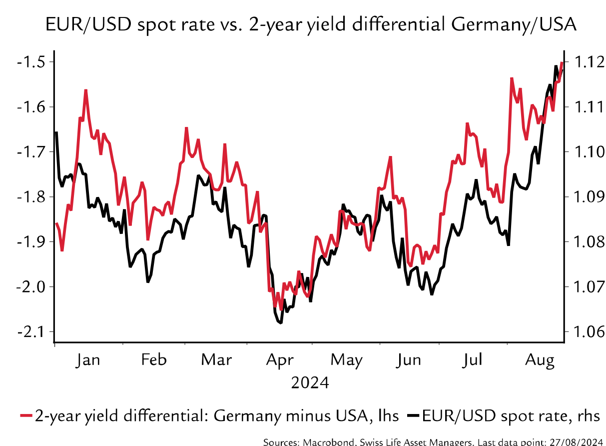
Switzerland

- EUR/CHF scratched the 0.92-mark at the beginning of August, as US recession worries led to a flight into safe-haven assets such as the CHF.
- At the current level, we take a neutral view on EUR/CHF on a one-month horizon.

Japan

- The JPY rally continued in August, which coincided with a spike in volatility across all asset classes.
- Nevertheless, we expect renewed JPY weakness from here as we do not expect the Bank of Japan to embark on a credible interest rate hiking path.

USD on vacation



Contrary to our expectations, USD weakness continued in August. The July US labour market report, which came in weaker than expected, rattled financial markets in early August and led to a repricing of monetary policy expectations for the Fed. The resulting drop in US short-term bond yields combined with the return of "risk-on" sentiment among market participants weighed on the greenback. EUR/USD reached levels of 1.12 over the course of the month. We still see this USD weakness as temporary and expect USD strength to return in September for various reasons. The monetary policy expectations for the Fed for this year priced by the market are currently more aggressive than our forecast. Markets are now pricing in four cuts of 25 basis points (bp) each until year-end. We on the other hand forecast three cuts by the Fed until year-end, which would leave the Fed funds rate at 4.50-4.75% by December. Additionally, we believe that the scenario for the US economy currently priced in FX markets is too pessimistic, especially against the EUR, as eurozone GDP growth remains weaker than in the US. Our base case scenario for the US economy is still for some weakening, but no outright recession. If incoming data confirms our scenario, Fed monetary policy expectations should reprice towards our scenario, which would be US dollar supportive, i.e. leaving the USD with a higher interest rate differential. Even with the current pricing, interest rate differentials ("carry") and high real rates are still USD supportive, especially relative to the EUR. Risks to our USD outlook are a faster deterioration in the US growth picture than we expect, leading the Fed to cut interest rates more aggressively.

Asset allocation

Market turmoil and Fed-driven recovery

Review

- In August 2024, financial markets experienced significant turmoil, beginning with a sharp downturn in equity markets. The primary catalyst was the unwinding of the yen carry trade and weaker-than-expected US labour market data. The yen's unexpected appreciation forced investors to adjust their positions rapidly, amplifying already preexisting selling pressure across global markets.
- In this environment, government bonds saw yields decline as demand for safe-haven assets increased. Conversely, credit markets faced widening spreads, particularly in corporate bonds, as concerns about economic conditions and corporate creditworthiness heightened.
- By mid-August, markets began to recover, supported by the US Federal Reserve's dovish communication. The Fed indicated that it intends to start cutting rates in September. This calmed investors and sparked a partial rebound in equity markets, along with stabilization across other asset classes.

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

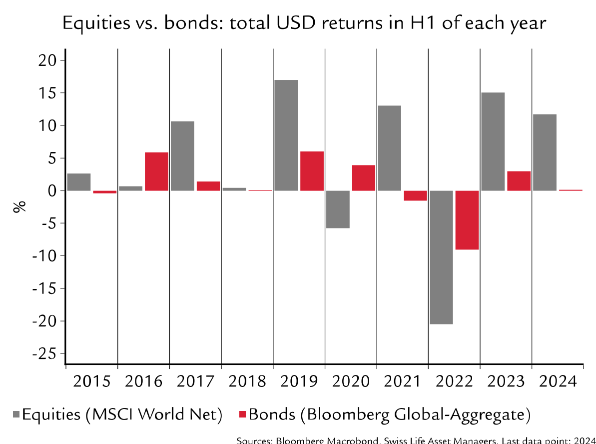
- However, risks remain elevated as we look ahead. Uncertainty surrounding the global economic outlook, ongoing geopolitical risks, and inflation trends could continue to fuel market volatility. There is also scepticism about the sustainability of the recent recovery, as it may be a temporary relief rally rather than a long-term turnaround. Investors must remain cautious and consider diversifying their portfolios accordingly.
- Although bond yields have already declined, they remain at attractive levels, especially for additional protection in a multi-asset portfolio. In contrast, credit spreads, particularly in USD, continue to be at very low levels.
- We maintain a neutral stance on equities and are underweighting corporate bonds in favour of government debt.

Can bonds mitigate equity market corrections?

As markets enter a phase of heightened volatility, it is essential to revisit whether bonds can help mitigate an equity market correction, unlike in 2022. In a previous issue of the Perspectives, we highlighted that high-quality bonds can only reduce the impact of an equity downturn if rising bond yields are not the root cause of the problem, as was the case in 2022.

Currently, market concerns have shifted. The focus is now on the possibility that the US economy might weaken faster than expected and that the Federal Reserve may wait too long to reduce interest rates. In this environment, economic data signalling weakness in the US will likely be negative for equity markets but positive for US Treasuries, as investors seek safety. Conversely, stronger-than-expected economic data could lead to higher bond yields and pressure both equities and bonds. However, in comparison to previous years, it is important to note that interest rates are already high this year, both in nominal terms and after adjusting for inflation. If the economy remains robust and we face the prospect of even higher rates, we anticipate only a limited impact on bonds, meaning they should only underperform moderately.

In our base scenario of a gradual US economic slowdown, the current elevated rates could lead to bonds outperforming equities. While bonds may not offer a complete hedge in all scenarios, they still provide valuable diversification and may cushion portfolios in a well-constructed investment strategy. In conclusion, while the dynamics between equities and bonds continue to evolve, bonds can still play a crucial role in mitigating market volatility.



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