

October 2024

Interest rates & bonds

The Fed delivered a 50 bps rates cut

Overview of bond yields and investment-grade credit spreads

	10-year government bond yield			Investment grade credit spread		
	Current	Sep. 2024*	Year-to-date*	Current	Sep. 2024*	Year-to-date*
US	3.8%	-13 bps	-10 bps	90 bps	-3 bps	-9 bps
Eurozone	2.2%	-13 bps	15 bps	117 bps	0 bps	-21 bps
UK	4.0%	-3 bps	46 bps	122 bps	2 bps	-17 bps
CH	0.4%	-1 bps	-23 bps	72 bps	-2 bps	-11 bps

10-year government bond yield eurozone = DE, bps = basis points.
* Change as at 26 September. Source: Bloomberg

USA

- In our base case, we predict a slowdown in economic momentum and a further modest rise in the unemployment rate, but no recession. Inflation dynamics should continue to normalise.
- The Fed initiated its rate cutting cycle on 18 September with a higher-than-expected 50 bps rate cut. We expect two further cuts in 2024.

Eurozone

- We expect the quarterly GDP growth dynamics to pick up somewhat in 2025. However, the risks remain skewed to the downside, particularly for Germany, where the Bloomberg recession probability over 12 months has increased from 30% to 42.5%.
- As expected, the ECB delivered another rate cut in September and we see two further cuts this year.

UK

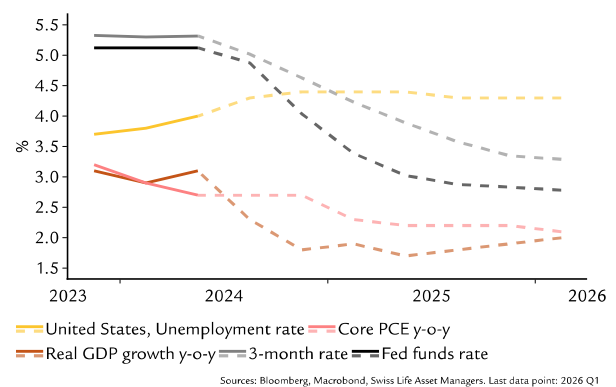
- After a positive August, Bloomberg's ECO UK Surprise index turned negative again in September.
- We expect only one rate cut from the Bank of England for the remainder of 2024.

Switzerland

- In August, the Purchasing Managers' Index (PMI) came in above expectations, but inflation was below consensus expectations. Our GDP and inflation forecasts for 2025 remain below consensus forecasts.
- The SNB cut its policy rate again by 25 bps in September and hinted at the potential for further cuts. The risk to our view of unchanged policy rates is therefore skewed to the downside.

More rate cuts by the Fed and a soft landing are priced in

United States: Bloomberg consensus economic forecasts and market implied interest rates



Following the first 50 bps cut by the Fed in September, the futures market currently prices in seven further cuts by the end of June 2025 and one more cut by the end of June 2026. We currently expect one rate cut less than the market. Markets also seem to expect some sort of “soft landing” of the US economy, i.e. moderate real GDP growth and inflation and only a moderate uptick in the unemployment rate (see chart above). These expectations are relatively close to our own base case, which we call “monetary policy goes neutral as inflation and growth reach equilibrium”. We think that the market pricing of this scenario is one of the reasons for the low credit spread levels currently. Spreads discount the consensus scenario of declining rates and a period of weaker macroeconomic indicators, before lower rates unfold their stimulus for the US economy. This scenario is positive for credits as (1) fixed-coupon bond prices and long-duration credit positions can profit from a decline in rates, (2) companies and consumers (who have a high share of variable debt) pay lower interest expenses and (3) lower rates over time stimulate economic growth. For October, we have a neutral view on high-yield (HY) and investment-grade (IG) credit spreads. Regarding duration, we expect lower yields in the US and Germany into year-end and have a neutral view regarding Swiss bond yields.

Equities

All-time high for US stocks

Overview of equity market performance

	Sep. 2024*	Year-to-date*
USA	1.4%	20.5%
Eurozone	-0.5%	10.0%
UK	-1.5%	10.0%
Switzerland	-2.1%	10.3%
Emerging Markets	3.5%	13.4%

MSCI net total return indices in local currency.
* Performance as at 26 September. Source: Bloomberg

US

- As in August, the market started September with a correction. On the first trading day, the US market lost over 4%. Over the month however, the return was positive.
- The magnitude of the US Fed rate cut surprised markets positively and led to a new all-time high.
- The US market is expensive and valuation much higher than for all the other markets.

Eurozone

- The European market once again underperformed the US market. Year-to-date, the underperformance is now around 10 percentage points.
- In Europe, styles like Value and Low Volatility are performing much better than in the US where Growth and Momentum are still dominating.
- The valuation of the European market is still neutral, but a trigger for a higher valuation (absolute and relative to the US market) is missing.

UK

- As in August, the UK market performed rather poorly compared to the US market in September.
- However, the UK market still benefits from a low valuation.

Switzerland

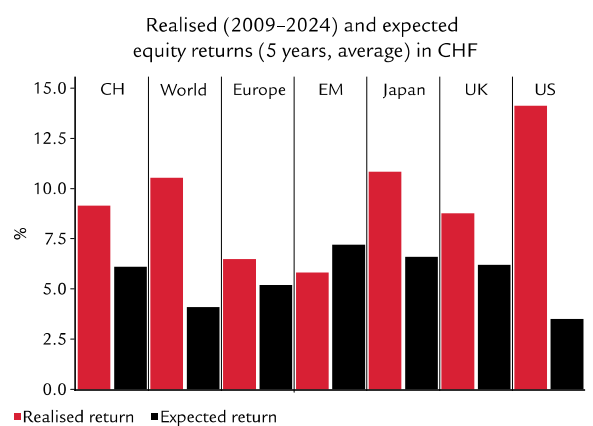
- The Swiss market clearly underperformed the other markets in September. The key reason for the underperformance was the weak performance of the “big three” (Nestlé, Roche, Novartis).
- The Swiss equity market valuation is at the upper end of the neutral range.

Emerging markets

- Emerging market stocks outperformed those of developed markets in September, driven by China’s recent measures aimed at stimulating the property and stock markets.

Expected normalisation in equity returns over next five years

A confluence of factors has led to the strong equity bull market between 2009 and 2024. Key drivers were low/zero interest rates and quantitative easing, a low starting valuation and an IT and artificial intelligence boom. Aside from the brief disruption caused by the pandemic, there was no bear market from 2009 to 2022. Realised equity returns are exceptionally high if we compare them to the longer-term history. The question is whether such high returns can be achieved going forward when the key factors that have caused these high returns in the past are either no longer in place or less strong. In the chart below we show our proprietary expected returns for the next five years for the major equity markets.



For all regions and countries, except emerging markets, expected returns are lower than past realised returns. In the US, the expected return is around 11 percentage points (pp) lower than the realised return. Conversely, in Europe and the UK, expected returns are only 2-3.5 pp lower than historical returns. Emerging markets stand out as the only region where expected returns exceed historical returns with the highest expected return of all markets (at around 6.5% in CHF). The key factors driving these significant differences between historical and expected returns are a normalised interest rate environment and initial valuations. Low interest rates in developed countries have been a permanent tailwind boosting returns in all equity markets except in emerging markets where there was no zero-interest rate environment. This disparity is the main reason for the lower expected returns in developed markets. In the US, the relatively low expected return is largely due to the high current valuation, both in absolute terms and relative to other markets.

Currencies

We move to a negative view on the USD

Overview of major currencies

	Sep. 2024*	Year-to-date*	1-month view
EUR/USD	0.9%	1.0%	↗
EUR/CHF	1.1%	2.2%	↘
GBP/USD	1.7%	4.8%	↗
USD/JPY	-0.7%	2.9%	↗

* Performance as at 26 September. Source: Bloomberg

USA

- The USD had another weak month in September, depreciating 0.7% on a trade-weighted basis, as financial markets continue to expect a convincing monetary policy easing cycle by the US Fed.
- We think that financial markets will cling to this pricing, as US labour market data should remain soft and as recession risks have risen. We thus expect the USD to remain weak over the next three months.

Eurozone

- The EUR moved another leg higher against the USD in September. The ECB cut policy rates less than the Fed in September and remained vague about the future policy rate path, which also contributed to the weakness.
- We have a positive view on EUR/USD and a neutral view on EUR/CHF until year-end.

UK

- The GBP appreciated further against USD and EUR in September as the Bank of England kept its policy rate unchanged and economic data remained solid.
- Until year-end, we have a positive view on GBP/USD and a neutral view on GBP/EUR.

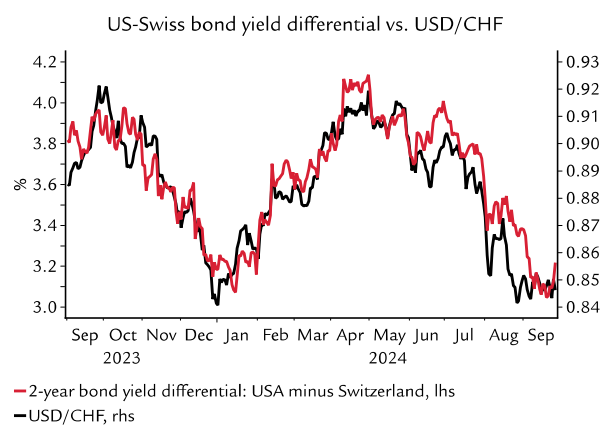
Switzerland

- CHF depreciated slightly against EUR in September and remained stable against USD. The policy rate cut by the SNB and its dovish bias had little impact on the CHF exchange rate at the time of writing as it was already expected by financial markets.
- We have a neutral view on EUR/CHF and a negative view on USD/CHF over three months

Japan

- USD/JPY declined somewhat further in September.
- After the strong move since July 2024, we expect, however, renewed JPY weakness from here as we do not expect the Bank of Japan to embark on a credible interest rate hiking path.

Eroding carry advantage has weakened the USD



Sources: Macrobond, Swiss Life Asset Managers. Last data point: 26/10/2024

Even though US macroeconomic data has generally been solid in September, notably consumer spending, labour market data has remained worrisome overall. This has not gone unnoticed by US consumers, who indicated in the latest Conference Board Survey that job offerings are getting scarcer, typically an early warning sign for recessionary developments. This was also noted by the US Federal Reserve, which implicitly admitted that it initiated its easing cycle a bit too late by delivering a surprising 50 basis points policy rate cut in September. While we still think that the US economy should avoid a recession, the risk for an adverse scenario has risen since the middle of the year and we thus expect the Fed to lower policy rates at each upcoming meeting. This also seems to be the market's perception and even though a very dovish scenario is already priced in, the distance to the so-called neutral rate where the economy is in equilibrium is longer in the US than elsewhere. This implies that the carry advantage of the USD will gradually erode, notably against low-yielding currencies such as CHF where the potential for further cuts is much more limited. This eroding carry advantage (see chart) was the main reason for the depreciation of the USD recently, not only against CHF, but also against other developed market currencies. Given the more vulnerable situation of the US economy and the Fed's changing focus from inflation to recession risks, we move towards a negative view on the USD until year-end vis-à-vis EUR and GBP, where central banks still seem to be somewhat more worried about inflation risks.

Asset allocation

Positive market returns mask dispersion

Review

- Financial markets in the month to 24 September had positive aggregate returns, although dispersion was significant, especially within equities.
- Bonds benefited from falling yields and had solid positive returns. Investment-grade corporate bonds outperformed government bonds as spreads tightened further. High-yield returns were slightly lower than investment-grade returns as the spread tightening was more modest in this segment.
- The overall positive return of global equities masks the fact that while the US equity market and emerging markets did well, Europe and Japan registered a negative return.
- While the CHF moved little relative to both USD and EUR, the GBP saw a significant appreciation relative to the USD, while the JPY was volatile.

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 disappointments of the last earnings season have been digested by the investors in the US equity market, which has outperformed on the back of a recovery of the “Magnificent 7” stocks. The main drivers have been a surprising increase in expected earnings growth for the market as well as the still solid economic performance of the US and the expectation of further rate cuts by the Fed. Consequently, our fundamentally sceptical view on equities has not changed, although we stay neutral as we are aware of the US market’s ability to recover despite the very rich valuation.
- Government bond yields have fallen but are still at attractive levels, whereas credit spreads are clearly too tight. Therefore, we stay overweight government bonds (except for Switzerland) and underweight corporate, high-yield and emerging market bonds. Credit spreads are too tight to offer effective protection from a deteriorating credit quality, while government bonds have still an attractive yield and could help to diversify some of the equity market risk, should volatility increase.

Is a rate cut good or bad for markets?

The US Federal Reserve finally initiated its cutting cycle in September. Should this have a positive effect on risky assets like equities and corporate bonds? While intuitively one might answer yes, history shows that rate cuts have often (but not always) been followed by a negative 12-month period for such assets, as can be seen for the US in the table below.

12-month period after initial rate cut by Fed	S&P 500 price return	US corporate bond index total return
05/1981 – 05/1982	-15.6%	14.6%
09/1984 – 09/1985	9.6%	23.8%
05/1989 – 05/1990	12.7%	8.9%
06/1995 – 06/1996	23.1%	5.1%
12/2000 – 12/2001	-13.0%	10.3%
08/2007 – 08/2008	-13.0%	1.9%
06/2019 – 06/2020	5.4%	9.5%

Source: Bloomberg, Swiss Life Asset Managers

After periods of high interest rates to fight high inflation, central banks start to reduce rates to prevent or at least soften the impact of a recession once inflation is under control. Usually, if the Fed cuts into a recession, risky assets react negatively. In such cases, the positive impact of lower rates is overcompensated by the negative impact of the weaker business outlook and the higher risk of defaults in an economic slowdown.

However, in periods when the Fed managed to bring inflation under control without causing a recession, risky assets did not experience a significant correction. These “soft landings” are no easy feat and happen rarely. For example, since 1980 there have been only two such episodes in the US: in 1984–1986 and in 1994–1995. While the initial cut in the central bank’s rate had a negative impact on stocks and corporate bonds, the decline was modest and returns in the following years were solid, although markets later experienced the infamous “October 1987” correction.

The current economic developments in the US have some of the hallmarks of a “soft landing”. Note however, that the very high valuation of many risky assets like the large, technology-oriented stocks and most of the credit instruments leaves them vulnerable to negative shocks.

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