Perspectives
Financial Markets

February 2025

Interest rates & bonds
Eurozone: 10-year yields up and credit spreads down

Overview of bond yields and investment-grade credit spreads

	10-year government bond yield			Investment grade credit spread		
	Current	**Jan. 2025***	**Year-to-date***	**Current**	**Jan. 2025***	**Year-to-date***
US	4.5%	-5 bps	-5 bps	79 bps	-1 bps	-1 bps
Eurozone	2.5%	15 bps	15 bps	92 bps	-10 bps	-10 bps
UK	4.6%	-1 bps	-1 bps	92 bps	-4 bps	-4 bps
CH	0.4%	15 bps	15 bps	68 bps	-1 bps	-1 bps

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

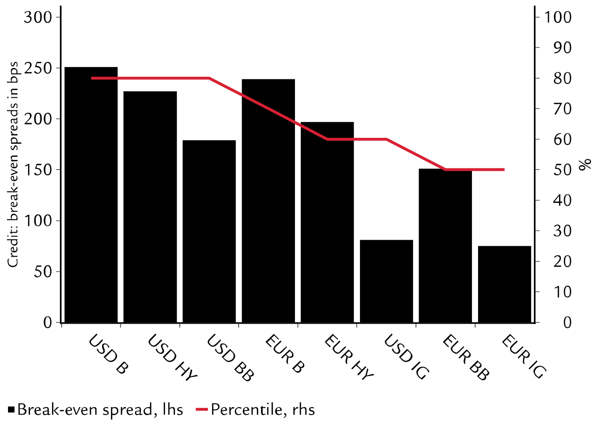
USA
- After 10-year US Treasury yields rose in the first half of January, they dropped mid-month as a reaction to lower-than-expected inflation data.
- We have a somewhat more constructive outlook on US inflation than the consensus and thus still expect four policy rate cuts in 2025, which is more than current market expectations.

Eurozone
- We expect a re-acceleration of real GDP growth in 2025 but remain more cautious than the consensus.
- After the ECB policy rate cut on 30 January, we expect five more cuts in 2025. The ECB monetary policy would thus become expansionary, which is necessary to counterbalance weak growth and higher policy uncertainty due to potential US tariffs.

UK
- UK gilt yields continued to move up at the beginning of January but came down from their recent highs mid-month after lower-than-expected inflation data.
- We regard the Bank of England's (BoE) and the Office of Budget Responsibility's growth projections as too optimistic. Risks are skewed to a faster and deeper policy rate-cutting cycle. We expect the BoE to cut its rate five times in 2025.

Switzerland
- Since March 2024, the SNB has cut its policy rate by 125 bps. We expect inflation to drop towards 0% in 2025, triggering another 25 bps cut in 2025.

Above-average break-even spreads for IG and HY



Sources: Macrobond, Swiss Life Asset Managers. Last data point: 27.01.2025

Due to central bank rate hikes in 2022 and 2023, break-even spreads on corporate bonds have increased and are now in the higher historical percentiles (see chart). Break-even spreads indicate how much bond yields can rise before the investment stops being profitable. A higher break-even spread means the bond can withstand a larger yield increase while maintaining a positive return. It is calculated as yield divided by duration. In developed markets, break-even spreads for high-yield (HY) bond indices in USD and EUR are at historically high levels compared to investment-grade (IG) indices. This is due to a significant decrease in HY index duration since 2022, caused by fewer mergers and acquisitions (M&A) and leveraged buyout activities, which typically involve issuing long-term bonds. Additionally, increased competition from private credit markets and the issuance of shorter-dated bonds have also contributed to the reduced duration. Meanwhile, USD HY indices offer the highest break-even spreads (70th to 80th percentile), while IG and EUR BB indices also provide respectable break-even spreads (40th to 60th percentile), indicating these bonds can still perform well even if there are unexpected rate hikes or market volatility. For February, we expect wider spreads for EUR HY but are neutral on USD HY and IG credit spreads. We expect lower yields in Germany at the shorter end and have a neutral view on government bond yields in the US and Switzerland.

Equities

Positive start to 2025 despite DeepSeek

Overview of equity market performance

	Jan. 2025*	Year-to-date*
USA	3.5%	3.5%
Eurozone	7.2%	7.2%
UK	5.7%	5.7%
Switzerland	8.5%	8.5%
Emerging markets	2.0%	2.0%

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

US

- US equity market returns are often positive in January, and this year was no exception.
- After the DeepSeek announcement, technology, energy, and utility stocks, including Nvidia (down 17%, losing USD 600 bn in market cap), corrected sharply and have only partially recovered. Positive factors include a strong start to the earnings season and no tariffs imposed by President Trump.
- The US market is expensive with valuations much higher than all the other markets.

Eurozone

- For once, the European stock market outperformed other global markets.
- The earnings season met expectations, and tariff threats have not yet materialised.
- The valuation of the European market is still neutral, and there is no strong trigger for a higher valuation (absolute and relative to the US market).

UK

- Like the other European markets, the UK got off to a very good start to the year.
- The UK market is still benefiting from a low valuation.

Switzerland

- The big three (Nestlé, Roche, Novartis) started the year reasonably well and supported the significant outperformance of the Swiss market.
- The Swiss equity market valuation is at the upper end of the neutral range.

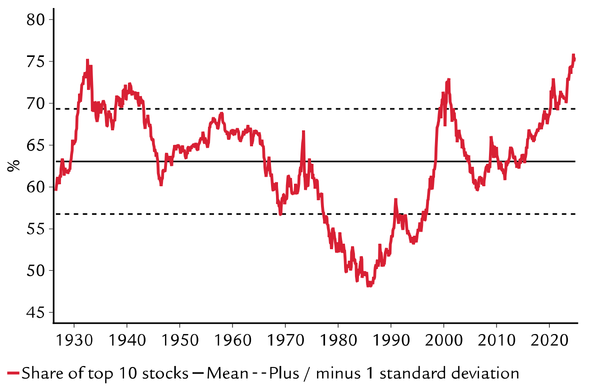
Emerging markets

- 2025 started much like the end of 2024, with underperformance. The Indian market in particular has been very weak, losing nearly 4% so far.
- The valuation discount of emerging market stocks is big, but at the moment there is no trigger in sight.

Concentration and its consequences

The US stock market, and consequently the global market, is currently experiencing unprecedented concentration levels. The US share in global indices has reached an all-time high and stands at 70% of MSCI World, an index of developed market equities. Notably, the top 10 stocks in the US account for around 40% of the US market's total value. This high concentration results in reduced diversification. Historically, similar periods of extreme concentration in 1929 and 2000 preceded significant market downturns.

US market concentration (share of top 10% stocks)



Sources: Macrobond, Swiss Life Asset Managers. Last data point: 11/2024

The high degree of concentration in the market has several negative implications. First, the performance of the global and US markets is dominated by a few stocks from just two sectors: IT and communication services. All top 10 stocks in the MSCI All Country World Index are from these sectors, which have high valuations and challenging earnings growth expectations. Second, this concentration makes it difficult for active managers to outperform, as relative performance is largely driven by positions in about 5-10 stocks, while many other potentially good stock picks play only a minor role. Lastly, high concentration coupled with high valuations may lead to very low expected returns. Estimates suggest that if this concentration normalises, US equity returns could be reduced by several percentage points. What can investors do? One solution is to invest in equity styles or indices that are less concentrated, such as value, dividend, or equal-weight indices. These indices benefit from significantly lower valuations and broader diversification. Notably, a US equal-weight index has historically outperformed its cap-weighted equivalent, despite underperformance since 2010.

Currencies

A weaker USD in January, but brace for a rebound

Overview of major currencies

	Jan. 2025*	Year-to-date*	1-month view
EUR/USD	0.4%	0.4%	↘
EUR/CHF	0.6%	0.6%	→
GBP/USD	-0.8%	-0.8%	↘
USD/JPY	-1.9%	-1.9%	↗

* Performance as at 30 January. Source: Bloomberg

USA

- The USD rally that started in October 2024 took a breather in January. The lack of immediate tariff announcements after Donald Trump's inauguration was a major reason for the reversal. The biggest beneficiaries were emerging market currencies and the JPY.
- We expect renewed appreciation of the USD as the tariff discussion gains traction over the next weeks and as interest rate differentials, the so-called "carry", remain favourable for the USD.

Eurozone

- In January, the EUR appreciated against the USD, but remained broadly unchanged against major European currencies such as CHF, NOK or SEK.
- Eurozone business surveys surprised positively in January, indicating that the economic pessimism was likely excessive. Nevertheless, we still expect 2025 economic growth to be much lower than in the US. In combination with continued monetary policy easing by the ECB and trade uncertainty, we expect the EUR to weaken against the USD.

UK

- GBP dropped to a 5-month low against EUR in January as unfavourable economic data led to higher rate cut expectations for the Bank of England.
- Over the next month, we expect stabilisation in EUR/GBP and a decrease in GBP/USD.

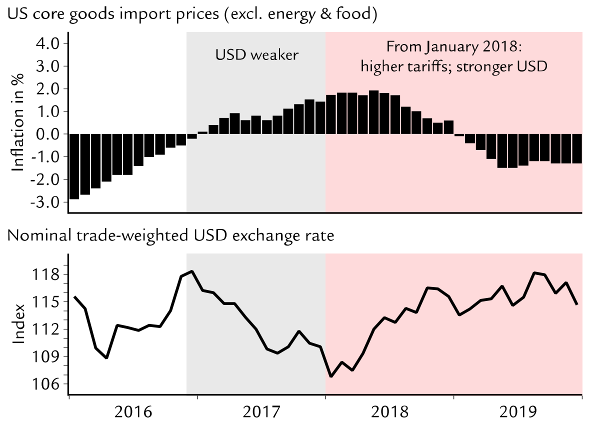
Switzerland

- EUR/CHF remained on a gradual uptrend in January, supported by dovish commentary from SNB President Schlegel.
- We maintain a neutral view on EUR/CHF.

Japan

- USD/JPY declined in January, driven by general USD weakness, but as for other currencies, we expect this move to be reversed over the next few weeks.

Why tariffs are positive for the USD



Sources: Macrobond, Swiss Life Asset Managers. Last data point: December 2019

If there is one certainty amidst all the uncertainty that the second term of Donald Trump is inflicting on the economic outlook, it is that some form of tariffs will be imposed and that tariffs are positive for the USD. Why is that? According to the textbook, if imported goods become more expensive due to tariffs compared to similar domestic goods, demand for imported goods drops and the domestic currency appreciates in response, thereby reducing the price difference between imported and domestically produced goods. The economic textbook proved to be correct during Donald Trump's first term when the USD started to rally from January 2018 when the US-China trade war heated up (see chart). In anticipation of Trump's second inauguration, the USD index (DXY) has gained 9% since the end of September 2024, when financial markets started to increasingly bet on a Trump victory. The lack of actual tariff announcements in the first week of Trump's second term led to a weaker USD. Nevertheless, the tariff debate is set to heat up over the coming weeks, and we thus stick to our view of a strong USD. In the medium term, much will depend on the inflationary impact of tariffs and the monetary policy reaction. If tariffs are targeted (our base case) rather than broad and elevated, the inflationary impact might be limited, also boosted by a stronger USD. In 2019, the stronger USD even led to an outright decline of import prices, partly undoing the previous import price inflation. We thus still expect policy rate cuts in the US in 2025. Even if our dovish scenario turns out to be correct, we expect the USD to remain well supported by the interest rate differential ("carry"), leaving our full-year view of general USD appreciation intact.

Asset allocation

Positive but volatile start in the new year

Review

- Until 30 January equity markets generally experienced positive returns, while government bonds saw declines, and credit markets posted moderate gains.
- However, market volatility increased due to evolving US political dynamics and the recent introduction of a more efficient Chinese AI model. This development could potentially lead to a revaluation of the "magnificent 7" US companies, posing a risk to the global equity market.

Current asset allocation views

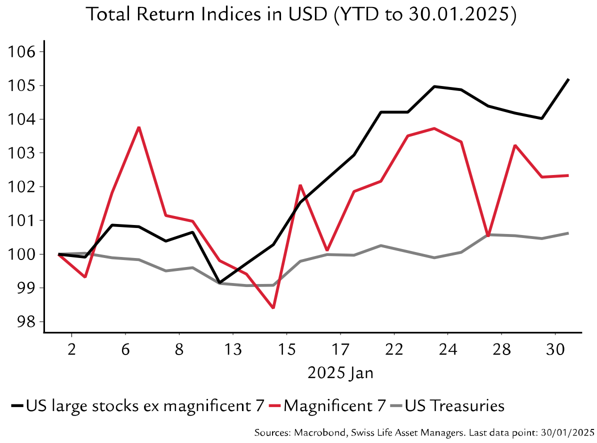
Asset class	Active weight
Global government bonds	neutral
Global investment grade credit	underweight
Emerging market bonds	underweight
Global equities	overweight

Source: Swiss Life Asset Managers

- Despite these developments, we maintain our current asset allocation views. The economic outlook remains solid for the US and shows marginal improvement for Europe.
- Equities appear resilient to some disappointing news. However, the reaction to the AI developments from China indicates that investors have become more cautious regarding technology-related stocks.
- Credit spreads have nearly returned to the low levels observed in December. Consequently, we remain cautious on corporate bonds, as their risk/return profile is skewed to the downside.
- We have not altered our view on government bonds. Yields remain attractive in both the US and Europe, and upcoming monetary policy actions should support a decline in yields. However, given the current economic dynamics in the US, this adjustment may take time. In the event of a significant equity market correction, we expect government bonds to serve as a buffer.

Exploring the AI correction of 27 January

In our 2025 Outlook, we noted that global equity markets appeared overvalued, primarily due to the significant weight of large technology-related stocks. A correction in these stocks would likely impact the entire market; however, non-technology stocks should recover more quickly due to stronger fundamentals. We also suggested that high US bond yields could position US Treasuries as a buffer against an equity market decline. On 27 January , equity markets were jolted by the announcement of an innovative Chinese AI model, leading to a correction in US equity markets (see the graph).



The strong initial negative reaction of the "magnificent 7" compared to the broader market reflects investors' anxiety about the valuation of these stocks and their willingness to shift to cheaper market segments. Conversely, the limited reaction of US Treasuries, with a positive response too small to meaningfully hedge against the correction, was notable. While this episode alone is insufficient to validate our views, it underscores the vulnerability of technology-related stocks and highlights the need for ongoing evaluation of hedging strategies.

Swiss Life Asset Managers

Sven Kreitmair
Portfolio Manager Fixed Income
sven.kreitmair@swisslife-am.com

Andreas Homberger
Head Quantitative Equities
andreas.homberger@swisslife-am.com
@Homberger_A

Damian Künzi
Head Macroeconomic Research
damian.kuenzi@swisslife-am.com
@kunzi_damian

Florence Hartmann
Economist Developed Markets
florence.hartmann@swisslife-am.com

José Antonio Blanco
CIO Third Party Asset Management
Head Multi Asset
joseantonio.blanco@swisslife-am.com

If you have any questions or if you would like to subscribe to this publication,
please send an e-mail to: info@swisslife-am.com.
For more information visit our website at: www.swisslife-am.com/research