Perspectives
Financial Markets

May 2024

Interest rates & bonds

Inflation calls interest rate cuts into question

Overview of bond yields and investment grade credit spreads

	10-year government bond yield			Investment grade credit spread		
	Current	April 2024*	Year-to-date*	Current	April 2024*	Year-to-date*
US	4.6%	44 bps	76 bps	90 bps	0 bps	-9 bps
Eurozone	2.6%	29 bps	57 bps	112 bps	-2 bps	-26 bps
UK	4.3%	40 bps	80 bps	121 bps	2 bps	-18 bps
CH	0.7%	12 bps	9 bps	78 bps	-1 bps	-5 bps

10-year government bond yield eurozone = DE. * Change as at 24 April.
Source: Bloomberg

USA

- Renewed upside surprises in inflation and economic data drove government bond yields up, while credit spreads remained stable in the hope that higher nominal growth will benefit corporate profits.
- The Federal Reserve has retracted some of its previously dovish comments.

Eurozone

- The picture was similar in Europe, with higher government bond yields but relatively stable credit spreads, despite the sell-off in equities due to geopolitical tensions in the Middle East.
- We still anticipate the ECB's first rate cut in June, given the subdued growth and falling inflation.

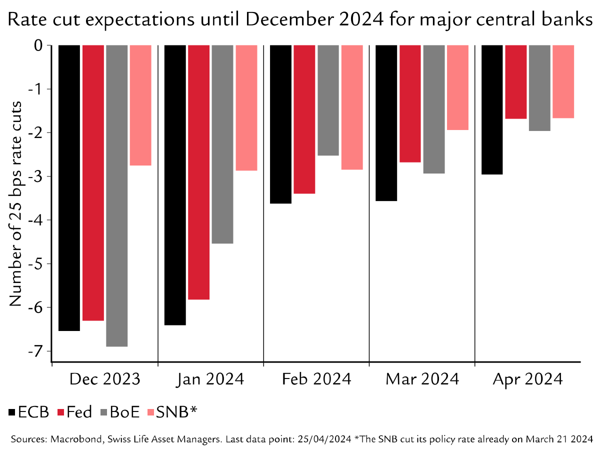
UK

- A much stronger than expected services Purchasing Managers' Index and a positive inflation surprise caused a sharp increase in government bond yields, as markets lowered their expectations to just two rate cuts by the Bank of England this year.
- Meanwhile, credit spreads only increased slightly.

Switzerland

- In conjunction with their global peers, Swiss government bond yields increased in April, while credit spreads remained basically unchanged.
- At 1%, the March inflation print supported the Swiss National Bank's (SNB) rate cut decision, and we anticipate one further cut later this year.

Markets expect interest rate cuts despite rising inflation



Despite inflation still running clearly above the 2% target at the beginning of 2024, investors initially optimistically priced in up to seven rate cuts in 2024 by the Fed, BoE and ECB. Financial assets rallied across the board as they reacted favourably to easing financial conditions and signs of robust nominal growth. However, you can't have your cake and eat it too. In April, against the backdrop of stubborn US inflation dynamics, 10-year US Treasury yields increased by 50 basis points. At the same time, the markets had to absorb a large amount of new Treasury issuance to finance the US government's large deficit. Further yield increases would eventually hit risky assets and economic growth. However, at current levels this is not our base case. The Treasury still has levers to adjust its issuance composition in order to ease the pressure on government bonds. In view of the US elections later this year, it is in the incumbent government's interest to maintain stability in the markets and the economy. Consequently, we do not recommend a substantial underweight in risk, and are maintaining a neutral positioning. However, another potential test of last year's interest rate highs, mounting inflationary pressure and increasing debt issuance pose risks to our view. With regard to duration, we believe that some of these risks are already priced in at the current levels.

Equities

Setback in April, more to come?

Overview of equity market performance

	April 2024*	Year-to-date*
USA	-3.5%	6.4%
Eurozone	-1.2%	8.9%
UK	1.4%	5.5%
Switzerland	-2.2%	3.3%
Emerging Markets	-0.7%	1.7%

MSCI net total return indices in local currency.
* Performance as at 24 April. Source: Bloomberg

US

- Amid higher inflation, fewer expected rate cuts, rising interest rates and heightened geopolitical uncertainty, the US equity market lost 3.5% in April.
- The first results of the earning season just started were good, but not overly impressive to investors.
- The US market valuation remains far above historical averages and that of other markets.

Eurozone

- With a loss of 1.2%, the European equity market outperformed the US market again in April.
- The valuation of the European market is now neutral.

UK

- The UK market once again showed its defensive nature with a small gain in April. The market has now also caught up on its year-to-date performance.
- The UK market is still benefiting from a low valuation and a high dividend yield, currently at 3.9%.

Switzerland

- The Swiss market lost 2.2% in April. Year to date, it is still lagging behind the other main markets.
- In the second half of April, Novartis and Nestlé held up well and supported the market.
- The Swiss equity market is the second most expensive after the US market.

Emerging markets

- Despite their rather cyclical nature, the emerging markets were relatively robust in April but still look weak for the year to date.
- With the Turkish market up nearly 30% and the Brazilian market down more than 5%, the performance dispersion across the emerging markets is high.
- The valuation of the emerging markets is close to neutral.

Markets and first policy rate cuts

The SNB has already cut policy rates by 25 basis points. The ECB is expected to begin its rate-cutting cycle in June, and in the US, Fed funds futures currently imply two rate cuts in 2024. The economic impact of these rate cuts on the stock market remains unclear. Typically, rate cuts occur during economic slowdowns and subsiding inflation. Consequently, there is a positive effect from lower discount rates, but this must be weighed against the negative impact of potentially weaker or even negative earnings growth. Moreover, we must consider how valuation might respond. Historically, the market's reaction to the first rate cut has been contingent on the prevailing economic conditions (see table below). If the initial rate cut was linked to a recession, the average market reaction (equity vs. bond performance) was negative. Conversely, if there was a soft landing, the market reaction was positive on average.

Equity vs. Bond Performance Around First Rate Cut (USA)

First cut	Last cut	Recession	Equity – bond performance 12M after first cut
Sep-84	Feb-88	No	-7%
Jun-89	Sep-92	Yes	12%
Jul-95	Nov-98	No	26%
Jan-01	Jun-03	Yes	-9%
Sep-07	Dec-08	Yes	-24%
Aug-19	Mar-20	Yes	-5%

Source: Goldman Sachs

The average relative performance with an ensuing recession was -7% while the average performance without a recession was 10%. Notably, in only one of the two cases, the 12-month relative performance of equities was positive. So, on balance, the reaction to the first rate cut does not favour stocks over bonds. However, it is worth noting that since 1970, stocks have typically gained an average of 9% in the six months following the first rate cut. The valuation of the US equity market over the subsequent 12 months also depends on the prevailing economic conditions. In cases without a recession, the valuation increased by 18%, while surprisingly, during recessionary periods, it still rose by 5%. Similarly, in the eurozone, valuation increased by 19% (in all three cases, the rate cut was associated with a recession). This suggests that earnings decline significantly during a recession, and the subsequent increase in valuation cannot fully offset the positive impact of lower rates. In summary, during times when rate cuts start, a cautious view on equity markets is warranted for the very short-term.

Currencies

Policy divergence has taken the USD far

Overview of major currencies

	April 2024*	Year-to-date*	1-month view
EUR/USD	-0.8%	-3.1%	➔
EUR/CHF	0.6%	5.4%	➘
GBP/USD	-1.3%	-2.1%	➔
USD/JPY	2.6%	10.1%	➔

* Performance as at 24 April. Source: Bloomberg

USA

- April was characterised by USD strength. The greenback appreciated against all the major currencies and gained 1.3% on a trade-weighted basis.
- We see the potential for further USD strength in May as limited (see text in the right-hand column).

Eurozone

- The EUR depreciated against the USD in April but managed to appreciate against the CHF after some mid-month weakness.
- The ECB seems committed to delivering its first interest rate cut in June. This is already fully priced-in by the financial markets. We have therefore now turned to a neutral view of the EUR vs. USD while we continue to hold a negative view of the EUR vs. CHF.

UK

- Sterling weakened against the USD in April and was also affected by the issue of monetary policy divergence. The ability of the Bank of England to cut rates before the Fed was questioned by the market, but recent comments from Governor Bailey stressed the BoE's independence from other central banks.
- We also expect the USD's strength against the GBP to fade in May, and therefore now hold a neutral view of GBP vs. USD.

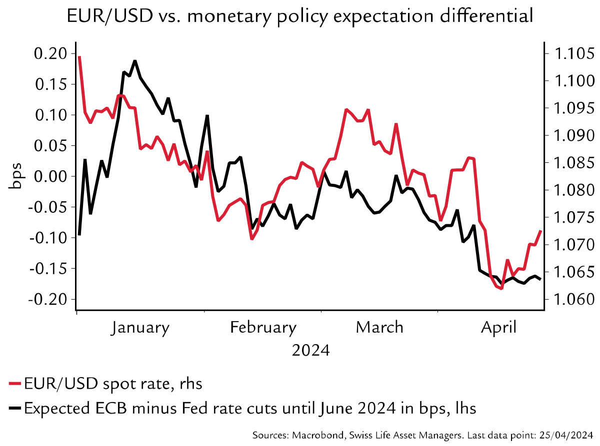
Switzerland

- We are questioning the market pricing of another SNB cut in June, and therefore expect the EUR interest rate advantage to diminish. We thus expect EUR/CHF to move lower in May.

Japan

- The JPY weakness continued in April with JPY being the worst performer among major currencies against the USD. We are changing our one-month USD/JPY view to neutral from higher, but on limited USD strength rather than expected JPY strength.

USD strengthening expected to pause in May



The foreign exchange rate markets were driven by the widening divergence in monetary policy expectations between the US Fed and other major central banks, most importantly the European Central Bank. The April US CPI inflation release was a pivotal event for the markets as it showed stronger price pressure than expected. Roughly 70 basis points of Fed cuts for this year were priced in before the release of the CPI print compared to around 40 bps today. While interest rate cut expectations for the Fed were dialled back, the ECB's president Lagarde has communicated quite clearly that the ECB is ready to cut its policy rate for the first time in June. This widening gap in expected interest rates between the US and the eurozone has led to a further strengthening of the USD as the higher expected interest rate return, known as the carry, is boosting demand for the currency. Alongside the carry advantage, the USD also profited from safe haven flows as geopolitical tensions remained high. This led to a build-up of substantial USD long positions in the market. We thus see the potential for further USD strength in the upcoming month of May as limited given the already stretched USD long positioning. We are therefore changing our one-month view of EUR/USD from lower to neutral. The market will most likely need further validation of the monetary policy expectations currently priced in to generate further USD appreciation in a significant manner. The risk to our view is a reversal of the policy divergence, namely the ECB taking the June cut off the table. A surprisingly strong softening in US data could have a similar effect.

Asset allocation

Is sentiment turning negative?

Review

- After the strong performance in March, the equity markets corrected noticeably in April.
- While the increased risk of the Israel and Iran conflict certainly played a role, the main driver for this correction was the realisation that the Fed is unlikely to cut rates any time soon, given the strong economic data.
- The correction did not help government bonds, as strong economic data also pushed bond yields higher. Returns were therefore also negative but less so than for equities.
- Credit spreads were volatile but increased only modestly. While global investment grade corporate bonds underperformed government bonds, high-yield bonds surprisingly outperformed both government and investment grade bonds, due to the lower duration and the very small widening of the spreads.

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

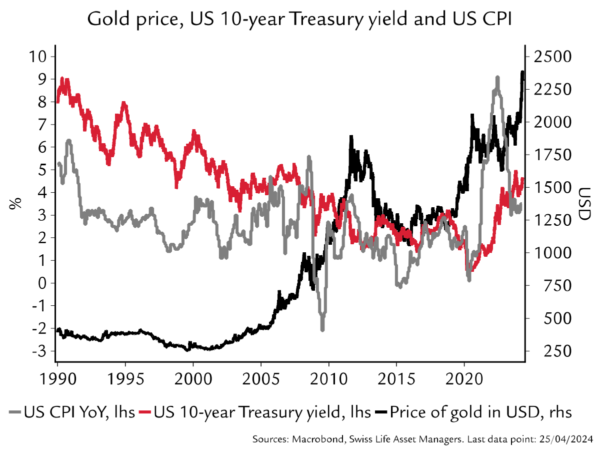
- While the modest correction registered so far in April has reduced the overvaluation in the equity market, its impact remains minimal. Moreover, the higher bond yields have diminished the relative attractiveness of equities vs. bonds. Simultaneously, government bonds in the US and particularly in the eurozone have become more appealing due to the weaker economy, potentially prompting an earlier shift in monetary policy. Notably, there is an increase in expectations for a Fed rate hike rather than a rate cut. However, we find this scenario as unlikely as the previous anticipation of an earlier and more substantial rate reduction.
- Credit spreads surprised us by widening very little. Hence, this asset class remains unattractive to us.
- Overall, we remain neutral on equities and are underweighting corporate bonds in favour of government debt. Equities continue to look vulnerable. The market reaction to, for example, the disappointing earnings announcement by Tesla suggest that sentiment has become weaker but has not turned yet.

Should we look at gold?

In a world of political crises, gold is often seen as the ultimate "safe haven". The recent price developments seem to confirm this: Since the beginning of the year, the price of gold has increased between 12% and 18%, depending on the currency. So, should we look at gold? Before going into this discussion, it is important to understand gold from a financial point of view. Although technically a commodity, gold should be viewed as a currency. However, compared to "normal" currencies like CHF, EUR and USD, gold has some specific properties:

1. It is not issued by a central bank and the amounts are given, although not completely known.
2. Central banks hold significant amounts as reserves and can temporarily impact prices by changing these reserves, as supply is limited.
3. Excluding the income that can be generated by lending, gold neither has an interest return nor does it generate a long-term positive real return like equities and bonds.

All in all, this means that gold should do well in an environment with increasing global inflation and central banks either unwilling or incapable of controlling it. There are exceptions to this, but such environments tend to be specific and temporary, and we have not been in one this year.



Rates, especially in USD, have increased significantly, and while the fall of inflation has now partially stopped, it is unlikely that it will change direction in a dramatic way. The situation reminds us of what happened in 2011, when rates were falling while inflation had a temporary peak. We therefore expect the positive gold trend to stop or even to correct unless there is a significant surprise in inflation and monetary policy.

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