Perspectives
Financial Markets

Swiss Life Asset Managers

November / December 2023

Interest rates & bonds
The un-inversion of the yield curve

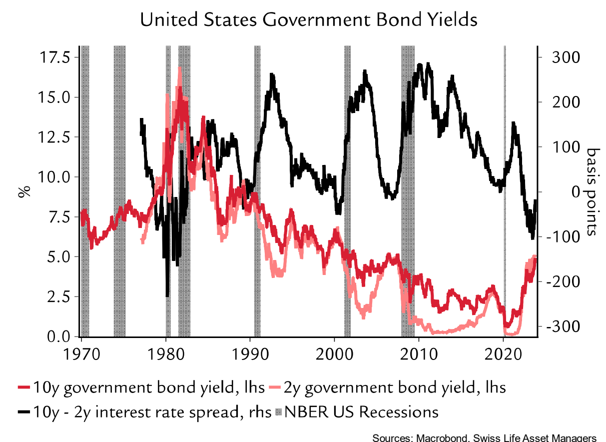
USA
- The continued glut in Treasury bond supply has pushed 10-year Treasury yields higher by another 33 basis points (bps) in October, adversely impacting corporate credit spreads, which widened by 8 bps.
- The US Federal Reserve kept policy rates unchanged but reiterated its "higher policy rates for longer" outlook as the US economy remains resilient and inflation pressures are still elevated.

Eurozone
- Credit spreads in the Eurozone widened by 7 bps in October, influenced by weakening economic data and the latest inflation figures, which suggest a substantial economic slowdown. Consequently, 10-year German Bund yields decreased by 3 bps.
- The European Central Bank left policy rates unchanged. Given the current economic challenges, including sluggish growth and a precarious geopolitical climate, combined with rapidly slowing inflation, we anticipate that the rate-hiking cycle has come to an end.

UK
- UK 10-year Gilt yields experienced an uptick of 7 bps, echoing movements in the US, amidst persistently high inflation.
- Market consensus currently does not foresee any further policy rate increases from the Bank of England, considering the existing economic frailty.

Switzerland
- Swiss government bond yields remained stable in October, as the strength of the currency effectively mitigates most external inflationary pressures.
- However, leading economic indicators are signalling an economic slowdown. Combined with inflation remaining below 2%, this scenario could set the stage for the Swiss National Bank to consider policy rate cuts in the course of 2024.

The "bear steepening" can still cause a recession



A negative spread between the 10-year and 2-year Treasury yield is traditionally viewed as a precursor to a recession. Yet, the yield curve has been inverted for 484 days, while the US economy demonstrates remarkable strength. Q3 GDP growth stood at 4.9% annualised and the labour market remains tight. However, it is crucial to note that recessions typically commence when the yield curve steepens following an inversion. Since reaching a spread of -108 bps in June, the curve has steepened by 90 bps. So, is this a signal of an impending recession? Our perspective is mixed. In previous cycles, a steepening into recession usually resulted from the short end of the yield curve falling faster than the long end due to central bank rate cuts. Currently, we are experiencing a "bear steepening", with the long end rising faster than the short end, reflecting a re-evaluation of growth and inflation expectations. Although this diverges from the patterns seen in the last recessions, it could still lead to an economic downturn, reminiscent of the 1970s' high inflation environment. We anticipate that the tightening financial conditions caused by the bear steepening will lead to lower prices for risk assets and increase the risk of a credit default cycle. We maintain a short position on credit risk and a long position on duration, particularly focusing on the eurozone, where the economy is contracting more swiftly and inflation pressures are subsiding.

Equities

Significant correction in October

USA

- The US equity market lost 2.3% in October leading to a year-to-date performance of 10.5%.
- The Q3 earnings season started with mixed results. The earnings growth relative to Q3 2022 currently stands at 2.7%. Companies with weaker-than-expected results are experiencing significant losses while companies with better-than-expected results are experiencing sharply rising share prices. For the first time in a while, however, quarterly results failed to stimulate the market.
- The US equity market valuation remains above historical averages. The market is skewed towards the so-called "magnificent seven" tech stocks that have rallied year-to-date and whose valuation remains very rich, despite some recent losses.

Eurozone

- The market lost 3.3% in October and the year-to-date performance is 6.6%.
- The earnings season has delivered rather disappointing results so far.
- The European market is still very attractively valued from a longer-term perspective.

UK

- The UK market delivered a performance of -3.6% in October. Year-to-date the market gained 1.4%.
- The UK market still benefits from the lowest valuation and the highest dividend yield of all major developed markets. A high exposure to energy companies helps the market in an environment of high oil prices.

Switzerland

- The Swiss equity market declined 5.1% in October bringing the year-to-date performance to -1.4%.
- The performance of Pharmaceuticals and Nestlé stocks is still weak. They account for more than 40% of the Swiss stock market. In the current downturn, the Swiss market is not showing its usually defensive character. The Swiss equity market is the second-most expensive after the US.

Emerging markets

- October was another weak month with a performance of -3.9%. Year-to-date the market has lost 2.1% and thus lags the other stock markets.
- China has stimulated its economy recently. However, there is no discernible market impact so far.

Market impact of geopolitical events

Markets and geopolitical events, 3 months subsequent returns

Event	Date	S&P500	US Treasury	Crude Oil	Gold
Invasion Kuwait	Aug 90	-10%	1%	38%	-1%
Gulf War I	Jan 91	20%	2%	-24%	-8%
9/11 Attacks	Sep 01	4%	0%	-30%	2%
Gulf War II	Mar 03	12%	7%	2%	6%
Lebanon War	Jun 06	7%	3%	-10%	-6%
Crimea Annexation	Mar 14	5%	3%	6%	-2%
Paris Attacks	Nov 15	-5%	5%	-21%	10%
Ukraine Invasion	Feb 22	-4%	-8%	24%	-5%
Median		5%	3%	-4%	-2%

Source: Goldman Sachs, Swiss Life Asset Managers

The wars in Ukraine and the Middle East have dramatically increased geopolitical risks. This raises the question of how markets react to geopolitical risks and wars. Is there a longer-lasting negative response or is the response rather muted? Perhaps surprisingly, the reaction to geopolitical events is indeed rather muted as the impact for the global economy and capital markets is often limited. The table above shows the returns of different asset classes for the three months following the outbreak of a geopolitical crisis.

Equity markets have shown on balance a positive development in the three months after the outbreak of a war. Especially in the first Gulf War, the market went up 20% in the next three months. Only in one case (Kuwait invasion) did a double-digit loss occur. US Treasuries gained on average as well. There was only one case where the 3-month return for Treasuries was negative (Ukraine war). The explanation for that is, however, rising inflation and central bank rates that were a stronger factor than demand for safe haven assets. Crude oil returns around crisis outbreaks are clearly the most volatile. The median return is actually negative, but there are strongly positive cases as well. When a war in the Middle East was the cause of the turmoil, the return was in the double digits (the case of Gulf War I must be looked at in conjunction with the Kuwait invasion and the net result was positive). The reaction of gold is somewhat surprising as it is considered a safe haven asset in such an environment. Gold did in most cases have a positive performance, but the magnitude is quite small.

In summary we can say that wars and other geopolitical events have had a surprisingly small effect on financial markets and in most cases, risk assets actually performed positively.

Currencies

War in the Middle East: only limited impact on CHF

USA

- The USD had another strong month in October amid very strong US economic data and higher US government bond yields. The USD gained 1% on a trade-weighted basis.
- We are sticking to our positive view of the USD for the next month. The US interest rate advantage ("carry") is likely to remain significant, supporting the USD, and even though we expect the US economy to slow in the fourth quarter 2023, it is likely to outperform other developed market economies.

Eurozone

- The EUR unexpectedly appreciated slightly on a trade-weighted basis in October. EUR/USD ended the month unchanged, and the EUR depreciation against CHF was counterbalanced by an appreciation against GBP and a significant move higher against the Nordic currencies SEK and NOK.
- We reiterate our negative view on EUR/USD and still expect the EUR to move sideways against GBP and CHF.

UK

- After a very weak month of September due to the Bank of England's inaction, Sterling had a calmer month of October, only slightly depreciating against USD and EUR.
- In line with our view of USD strength, we expect a lower GBP/USD exchange rate until year-end.

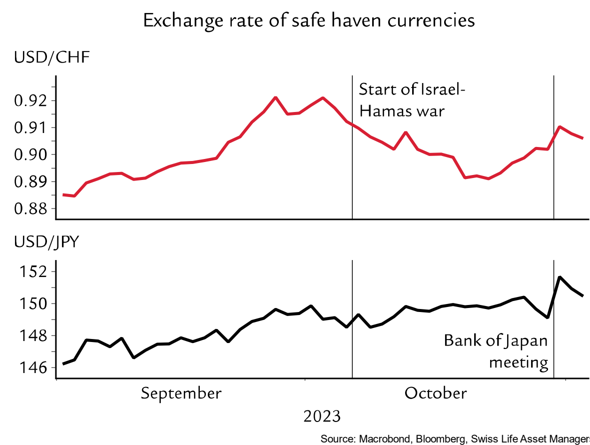
Switzerland

- The CHF appreciated 0.7% on a trade-weighted basis in October, benefitting from its status as a safe haven currency amid geopolitical turmoil.
- At the current levels, we think further appreciation potential is limited, and reiterate our neutral view on EUR/CHF and positive view on USD/CHF.

Japan

- The JPY sell-off continued in October, fostered by the very cautious approach to monetary policy normalisation by the Bank of Japan.
- Nevertheless, the Bank of Japan will probably have no alternative to further policy normalisation, and as the JPY is significantly undervalued, we would still expect USD/JPY to mover lower until year-end.

The Bank of Japan, not geopolitics, drove JPY performance



A new geopolitical shock hit markets on 7 October when Hamas attacked Israel. The effect on financial markets, however, has been short-lived. Oil prices rose initially and the CHF, which is considered a safe haven currency, strengthened until mid-October (see chart). Both developments partially reversed in the second half of the month, even as the situation in the Middle East remained very tense. The JPY, the other classic safe-haven currency, even continued its depreciation against the USD in October. Here, the Bank of Japan meeting on 31 October was the more important performance driver than geopolitics, as the half-hearted attempt to normalise monetary policy disappointed investors and led to a sell-off of the JPY.

Regarding the Middle East, we have formulated three scenarios: (1) A war that remains confined to Israel and the Palestinian territories, with barely any effect on the world economy and financial markets. (2) A second scenario, which is already partially materialising, where neighbouring countries such as Lebanon and Syria are drawn in and which can be seen as a proxy war between Israel and Iran. In that scenario, we would expect a risk premium to be built into energy prices and into the CHF as a safe-haven currency. (3) Only in the worst-case scenario, an escalation into a direct confrontation between the regional powers Israel and Iran, would we expect a material rise in energy prices, significant CHF appreciation and a large negative impact on the world economy and risky assets. However, we deem this scenario to be rather unlikely.

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