J. Safra Sarasin

Cross-Asset Weekly

22 November 2024

Emerging market credit is coming of age

Emerging market (EM) credit as an asset class has come a long way. In the past, governments and firms in EM had to rely on hard currency borrowing as they were not able to borrow in their own currency. This made them vulnerable to a rise in US interest rates and a strong US dollar, often leading to financial distress. In the last ten years, domestic financial markets in major EMs have matured, allowing governments and firms to increasingly borrow in local currency. As a result, EM borrowers have been much more resilient to the US rate moves over the last two years. Going forward, falling US rates and a benign growth outlook would be positive for EM credit. A new round of trade wars, however, could dent growth in EM and weigh on corporate profitability.

Over in Switzerland, we note that CHF bond yields have dropped substantially over the past two years, more than in other developed markets, thus providing investors with attractive total returns. That said, the way forward for the broad market looks more challenging, given the very low nominal yields. Without the return to a negative short-term interest rate environment, which is not our base case, investors will need to focus on other ways to generate excess returns versus the broad market.

Finally, turning to US equities, we think US small caps continue to look attractive versus US large caps for various reasons: Higher rates are not as much of a threat as they were in 2022/23, lending conditions have eased, cyclical data point to further relative upside and Trump's policies should be more favourable for small caps than large caps.

This week's highlights

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Emerging markets fixed income

The coming of age of EM credit

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Emerging market (EM) credit as an asset class has come a long way. In the past, governments and firms in EM had to rely on hard currency borrowing as they were not able to borrow in their own currency. This made them vulnerable to a rise in US interest rates and a strong US dollar. Both often led to financial distress. In the last ten years, domestic financial markets in major EMs have matured, allowing both governments and firms to increasingly borrow in their own currency. As a result, EM borrowers have been much more resilient to US rate moves over the last two years. Falling US rates and a benign growth outlook would positive for EM credit. A new round of trade wars, however, could dent growth in EM and weigh on corporate profitability.

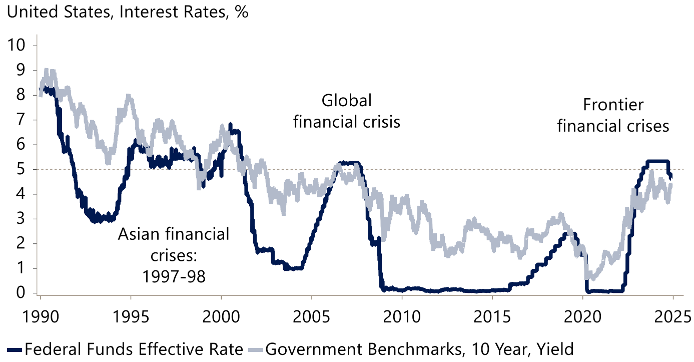
High global interest rates usually push capital away from EM

High global (and especially US) interest rates generally drive capital away from Emerging Markets (EM) as Developed Markets (DM) investors can realise higher risk-adjusted returns at home. There is strong empirical evidence that higher US rates and the associated strengthening of the US dollar lead to a tightening in global financial conditions and a decline in cross-border and dollar lending. The sudden reversal of capital flows has repeatedly caused financial crises in EMs (Figure 1). EM external borrowers, both public and private, were usually caught with a depreciating local currency and a weaker economy, limiting their ability to repay their debt in foreign currency.

More developed domestic financial markets have allowed borrowers in major EMs to become less sensitive to global factors

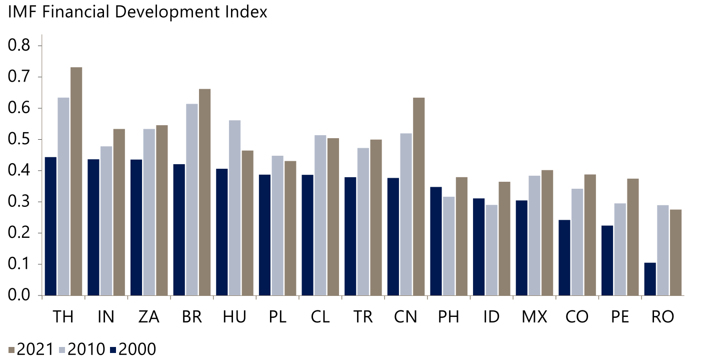
EM economies have evolved over the years, however. Greater domestic financial market depth as well as increased access and efficiency (as measured by the IMF's Financial Development Index, Exhibit 2) have allowed major EMs to overcome the so-called "original sin", or a country's inability to borrow from abroad in its own currency. As a result, they have become less sensitive to US rates and the US dollar as local market borrowing acts as a cushion for these EM borrowers. Not every EM borrower can borrow in his own currency, however. Smaller firms and lower-income countries with less developed capital markets continue to rely on external borrowing in hard currency. Defaults and financial distress among frontier borrowers are a testament that high US rates are still a binding constraint for less-developed EMs.

Exhibit 1: High US rates usually mean capital outflows from EM



Source: Macrobond, Bank J. Safra Sarasin, 21.11.2024

Exhibit 2: Significant improvement in financial development in EM

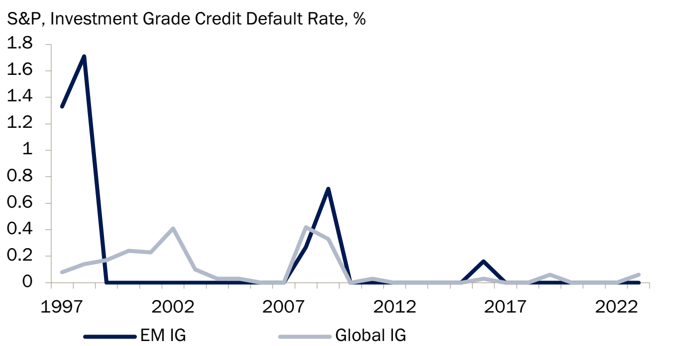


Source: Macrobond, Bank J. Safra Sarasin, 21.11.2024

EM corporate borrowers have been more resilient to US rates in the last two years

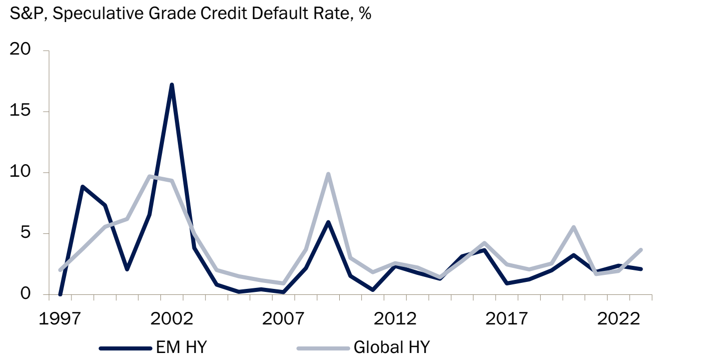
During the latest bout of US rate increases over the last two years, borrowers in major EMs have been remarkably resilient. On the corporate side, there was a clear shift towards local currency issuance. India, Thailand and Brazil accounted for more than two thirds of all local-currency corporate bond issuance since 2022 in EM, according to an IFC study. The trend towards local currency borrowing was already apparent among Asian corporates even before the pandemic. The new borrowing pattern has partly shielded these firms from a tightening of global financial conditions. It is therefore not surprising that EM hard currency bond issuance has fallen significantly in the last two years. Issuance picked up again in September when the Fed started its rate-cut cycle.

Exhibit 3: EM corporates weathered the last two years very well



Source: S&P, Bank J. Safra Sarasin, 21.11.2024

Exhibit 4: Lower high-yield default rate in EMs than in global bonds



Source: S&P, Bank J. Safra Sarasin, 21.11.2024

Default rates were lower in EMs than in global bonds in 2023

Default data from S&P indeed suggest that EM corporates have weathered the tightening of global financial conditions in the last two years very well, especially when compared to the 1990s and the global financial crisis period (Exhibits 3 and 4). There has been no default among EM investment-grade bonds since 2016. More recently, for speculative-grade bonds, the default rate in EM only exceeded that of global high-yield bonds in 2022. In 2023, the EM corporate bond default rate at 2.1% was much lower than global high-yield's default rate at 3.7%. The overall default rate of 1% in EM (against 1.9% in global bonds) in 2023 is a good evidence of EM resilience.

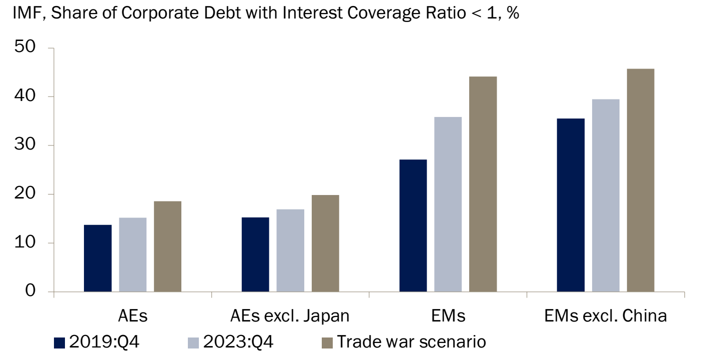
Large EM firms are on average healthy, but higher debt could make them vulnerable to future shocks

Do we expect EM firms to continue to be robust? This will depend on: (i) the health of EM firms; and (ii) the global macro outlook. Currently, larger EM firms appear financially healthy. The IFC study, which covers publicly traded companies in EM, finds that interest coverage ratios have returned to a level comparable to the pre-pandemic level despite higher interest payments as a share of total debt. Another study by the IMF suggests that the share of EM corporate debt with an interest coverage ratio below one has grown over the last two years, implying that there is a growing pocket of firms that are struggling (Exhibit 3). The increase is lower for EMs outside China, suggesting that Chinese real estate debt may account for some of the increase. At the aggregate level, EM financial leverage has increased with corporate debt as a share of GDP rising since 2019 in most EMs (Exhibit 4). Higher debt could make them more vulnerable to external shocks.

A benign global backdrop for EM without a potential trade war

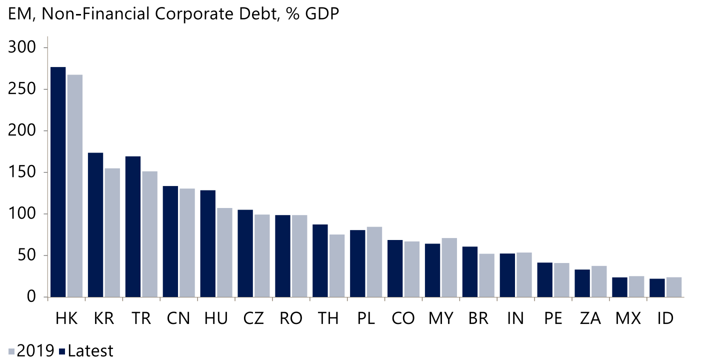
While the global backdrop continues to be supportive of EM corporates, there are a number of risks on the horizon. A soft landing in the US (and falling rates), a slight improvement in Europe, and the policy pivot in China are positive for EM. Of course, the elephant in the room is a potential new trade war, to the detriment of global growth and corporate profitability. EMs in particular are vulnerable to tariffs as they usually depend more on trade to grow. Higher tariffs would add to input costs and reduce firm profitability. The IMF's recent simulation (Exhibit 3) suggests that a global trade war could lead to a higher share of debt with the interest coverage (ICR) ratio below one.

Exhibit 3: Share of EM corporate debt with ICR<1 has risen



Source: IMF, Bank J. Safra Sarasin, 21.11.2024

Exhibit 4: Corporate debt has increased in most EMs



Source: Macrobond, Bank J. Safra Sarasin, 21.11.2024

A new round of trade wars would likely dent EM growth and corporate profitability

Indeed, not all EM firms will be affected equally. As we wrote in a recent EM weekly, China, Mexican and Asian manufacturers (Korea, Malaysia, Taiwan, Thailand, and Vietnam) would be impacted the most by a new global trade war, while commodity producers in Latin America are less affected. Tradeable sectors will be more affected than non-tradeable sectors or services sectors.

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Swiss franc fixed income

Time to focus on excess returns

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Unlike in other currency spaces, Swiss franc bond yields have dropped substantially since the highs reached at the end of 2022. The Swiss bond market has provided returns in the order of 5% to 6% p.a. over the past two years, depending on the maturity and credit profile of the respective indices. That said, the way forward for the broad market looks more challenging, given current very low nominal yields. In the absence of a return to negative short-term interest rates, which is not our base case, investors will need to focus on other ways to generate excess returns.

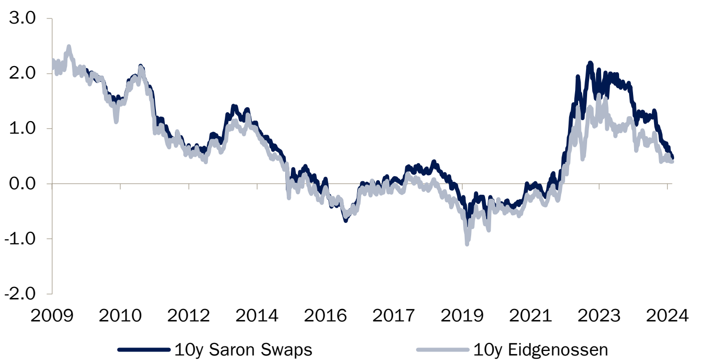
Swiss fixed income markets have outperformed other DM markets...

Since the end of 2022, when developed market (DM) rate expectations reached their first peak, DM implied policy rates have essentially moved sideways within a relatively wide band. The clear exception has been Switzerland, where market pricing for Swiss National Bank (SNB) policy rates started to diverge meaningfully in mid-2023 and has since dropped from the peak of roughly 2% to just 30bp currently. In fact, Swiss long-term yields have already retraced most of the 2022 surge (Exhibit 1).

...mainly due to much lower inflation rates and no fiscal risk

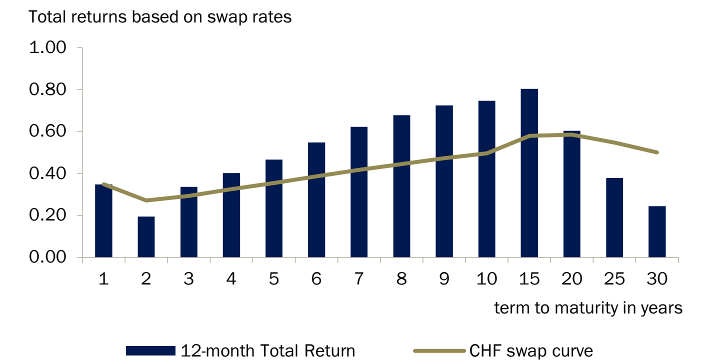
Apart from moderating growth, the reason for the divergence is Switzerland's much lower and less sticky inflation pressure than in other currency spaces. The strength of the Swiss franc has been an important driver of faster disinflation over the past few years. For example, Swiss core inflation ex-rent is already uncomfortably close to zero. This has allowed the SNB to be much more proactive in cutting policy rates. In addition, Switzerland is in a much better fiscal situation than other DMs. Hence the fiscal premium present in long-term bond yields of other government issuers is widely absent in Switzerland.

Exhibit 1: Swiss yields have retraced most of the 2022 surge



Source: Macrobond, Bank J. Safra Sarasin, 21.11.2024

Exhibit 2: Only modest expected total returns given low CHF rates



Source: Macrobond, Bank J. Safra Sarasin, 21.11.2024

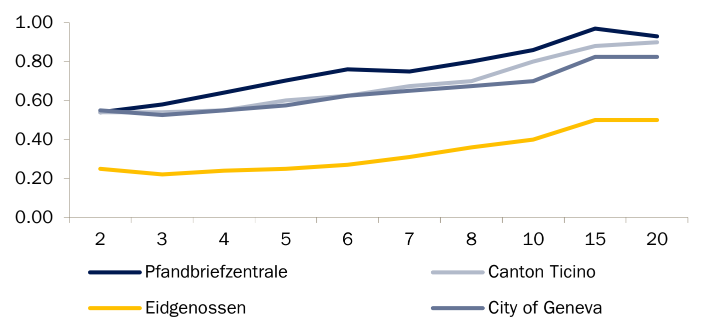
In the absence of a return to negative interest rates, it will be mainly about generating excess returns versus the broad market

Consequently, the Swiss bond market has provided substantial returns in the order of 5% to 6% p.a. over the past two years, depending on the maturity and credit profile of the respective indices. Given the low nominal yields, the way forward is more challenging. The comparatively flat CHF yield curves provide little extra return for taking additional duration risk. They imply a small cushion against adverse yield moves in long duration instruments and comparatively small roll-down returns. If we use the current swap curve as a starting point, we note that expected 12-month total returns will be modest even in a scenario of unchanged yields (Exhibit 2). In the absence of a return to negative short-term interest rates, which is not our base case, the focus will need to shift to identifying opportunities to generate excess returns. Here are a few:

Even after the latest spread tightening, there are still opportunities left

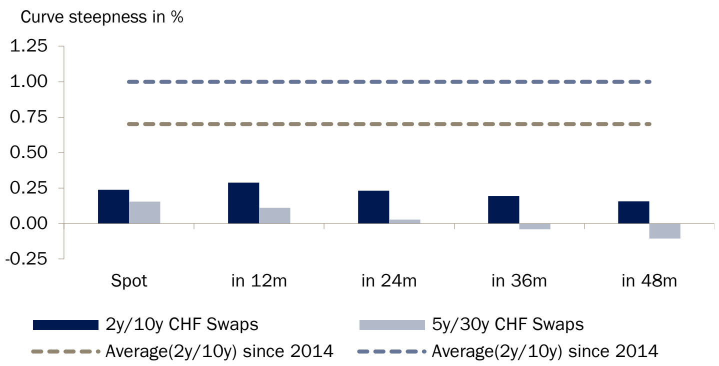
1) **Increase yield**: Governmental issuers, such as cantons, cities and cantonal banks, which have similar credit risk profiles as Eidgenossen, provide attractive spreads to Swiss government bonds. Although their spreads have tightened as well, bonds of selected issuers still provide value (Exhibit 3). By the same argument, covered bonds, from both domestic and selected foreign issuers, still look attractive. Corporate credit spreads in the Swiss market have tightened close to historic lows, as they have in other currency spaces. Nevertheless, a focus on carefully selected corporate credit exposure, primarily at the shorter end of the curve, is an efficient way to quickly boost yield without excessive additional risk.
2) **Optimise roll-down:** Positioning on steeper parts of the curves can lead to meaningful additional returns, in particular for longer duration instruments. Swiss covered bonds are a case in point. Apart from higher-than-average yield spreads, they benefit from steeper curves and are probably one of the most attractive instruments in the top rating bucket.
3) **Curve strategies**: CHF yield curves are very flat compared to history. Forward markets price only very modest steepening of the swap curve over coming years, significantly below historic averages (Exhibit 4). Hence, positioning for steeper yield curves is likely a source of excess return over the medium term.
4) **Active duration management:** Consistent and disciplined duration management, particularly after outsized moves in either direction, can sustainably add value.
5) **Off-benchmark exposure:** Where applicable, limited exposure to selective off-benchmark instruments can make a difference, e.g., high yield bonds with short terms to maturity or solid cross over names.

Exhibit 3: Meaningful yield pick-up for other top rated issuers



Source: Bloomberg, Bank J. Safra Sarasin, 21.11.2024

Exhibit 4: Forward markets price very flat yield curves



Source: Bloomberg, Bank J. Safra Sarasin, 21.11.2024

Time to focus on excess returns

Low expected total returns for broad market bond indices, absent a replay of the negative interest rate environment, increase the need to focus on opportunities to generate excess returns. Although various risk spreads have already tightened significantly, there are still opportunities for experienced portfolio managers. In such an environment, a few tenths of a percent of consistent excess return can already meaningfully increase the overall total return.

J. Safra Sarasin
Cross-Asset Weekly

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US equities

Revisiting the small cap trade

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The past 12 months felt like a difficult period for US small caps, even though they have delivered the same return as US large caps. The elevated levels of volatility in small caps, however, made market timing much more important in order to generate performance. Looking ahead, we think US small caps continue to look attractive versus US large caps, for various reasons: Higher rates are not as much of a threat as they were in 2022/23, lending conditions have eased, cyclical data point to further relative upside and Trump's policies should be more favourable for small caps than large caps.

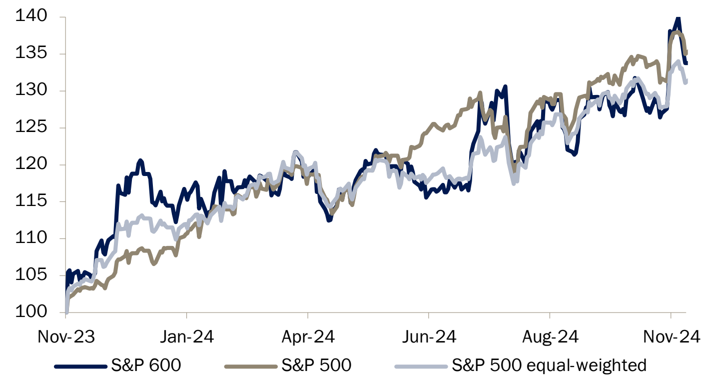
US small cap performance has been on par with US large caps over past 12 months

Despite the perception that small caps have been in a particularly rough spot in recent months, it may come as a surprise that they have managed to keep up with their large-cap peers over the past year. Small caps roughly matched S&P 500 returns over 12 months, and even outperformed the equal-weighted version of the S&P 500 (Exhibit 1).

High volatility means that timing is much more important in small caps

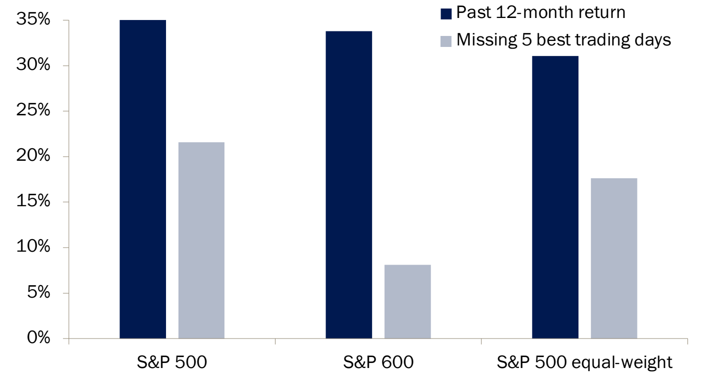
What has spoiled the experience of holding small caps, however, was the elevated level of volatility. While the S&P 500 provided a fairly stable climb higher, small caps experienced significantly larger daily moves, making market timing and a steady hand much more important in order to generate performance. Missing the best five days over the past 12 months would have led small caps to underperform by 17% vs large caps, while they only trailed by 1% if no days were missed (Exhibit 2).

Exhibit 1: Small caps in line with large caps over 12 months



Source: LSEG, Bank J. Safra Sarasin, 19.11.2024

Exhibit 2: Missing the 5 best days sharply lowered small cap returns



Source: LSEG, Bank J. Safra Sarasin, 19.11.2024

We remain constructive on small caps for three reasons:

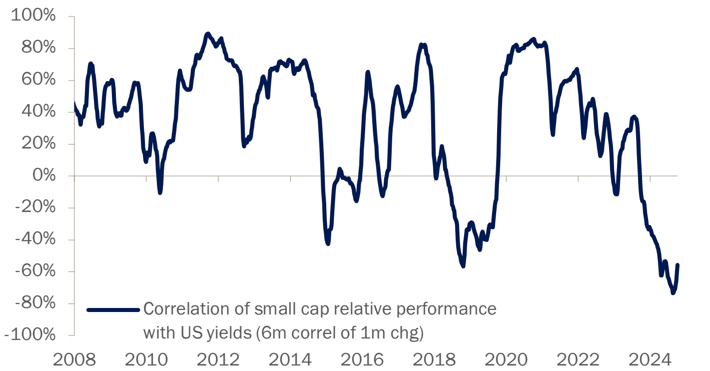
Despite the (sometimes) unnerving experience of holding small caps, we continue to believe that the market segment holds value and would reiterate our constructive view after the US elections. There are three considerations which we think are relevant:

1) Rates are no longer a major headwind for small-cap performance
2) Cyclical data are supportive for small caps
3) Small caps are key beneficiaries of Trump's policies

1) Rates are no longer a major headwind for small-cap performance

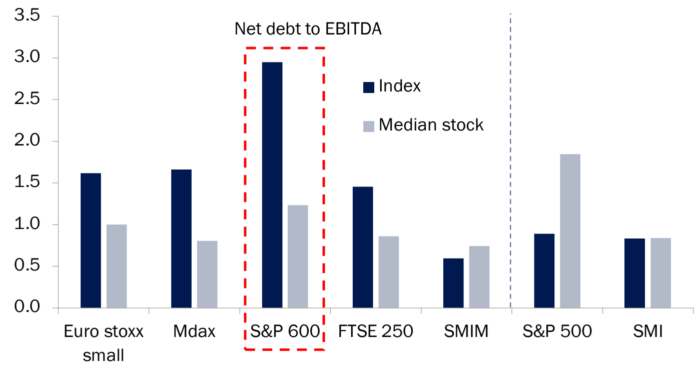
While higher rates hurt small caps performance in recent years, we think that this period should be treated as an outlier (Exhibit 3). The sharp counter-cyclical surge in rates in 2022 and 2023 came unexpectedly and created cliff effects which resulted in the failure of Silicon Valley Bank. This was followed by a deterioration in lending conditions for small caps, which tend to rely much more on bank financing than their large-cap peers. Leverage in the small-cap space is less of an issue, in our view, as it is quite concentrated in a few companies. A look at the median stock in S&P 600 shows, that it is no more leveraged than the median stock in the S&P 500. If anything, aggregate leverage ratios for S&P 500 may understate the index's actual debt exposure, as some of its largest constituents are net creditors (Exhibit 4).

Exhibit 3: Small caps' inverse correlation to rates is an anomaly



Source: LSEG, Bank J. Safra Sarasin, 19.11.2024

Exhibit 4: Leverage less of an issue than aggregate data suggest

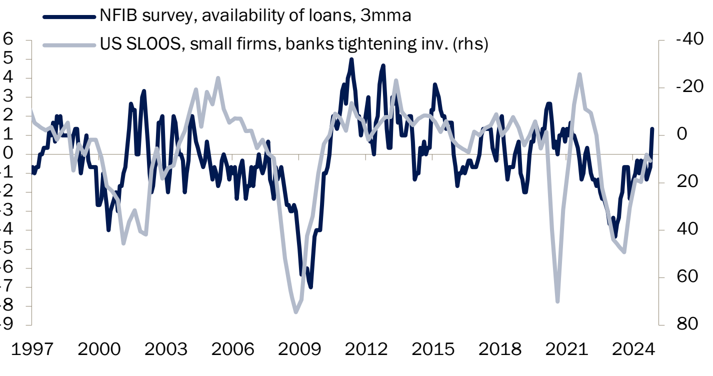


Source: LSEG, Bank J. Safra Sarasin, 19.11.2024

2) Cyclical data are supportive for small caps

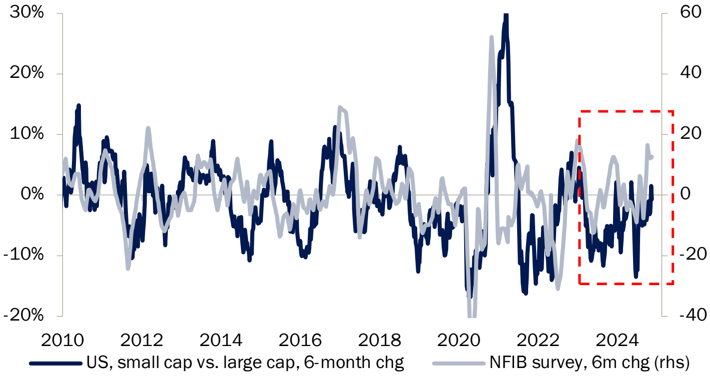
Meanwhile, funding conditions for small- and mid-sized companies have started to improve, as indicated by the NFIB survey of small businesses. For the first time since mid-2021, the NFIB component "availability of loans" has turned positive over 12 months, a measure which correlates well with the senior loan officer survey's bank lending conditions for small firms (Exhibit 5). Lending conditions have also improved in October, to the most supportive level since June 2022 and in line with a broader acceleration of the US cycle. Small caps should continue to benefit from this macro backdrop. NFIB momentum has risen to the highest since late 2022, suggesting room for small caps to outperform (Exhibit 6).

Exhibit 5: Lending conditions most favourable since 2021



Source: LSEG, Bank J. Safra Sarasin, 19.11.2024

Exhibit 6: NFIB survey also points to more optimism

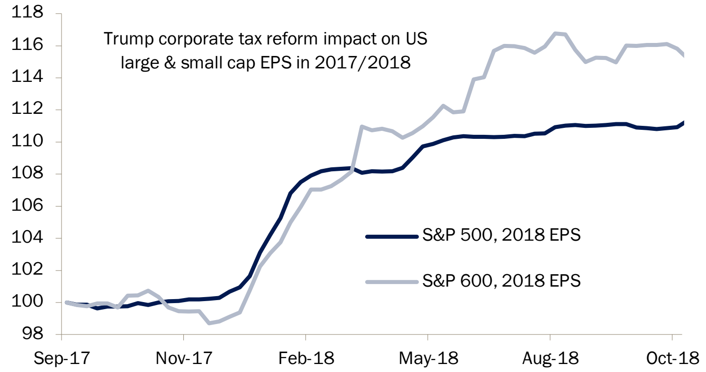


Source: LSEG, Bank J. Safra Sarasin, 19.11.2024

3) Small caps are beneficiaries of Trump's policies

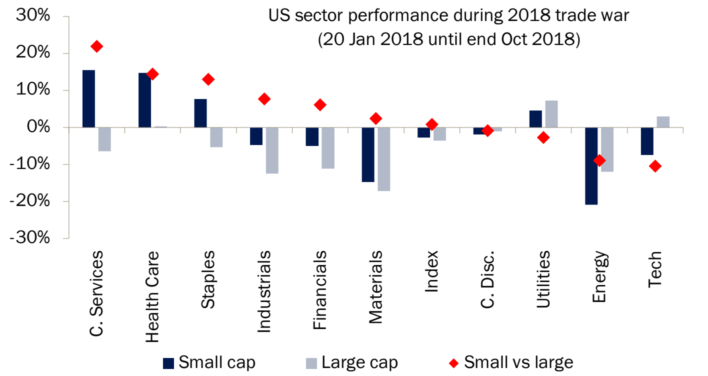
Adding to the cyclical support is the political backdrop. In our view, small caps stand to benefit more than large caps from potential corporate tax rate reductions and are less sensitive to the introduction of tariffs. A look at the first Trump term in 2017/18 is instructive. While S&P 500 consensus earnings rose by around 8% in response to the 14 percentage point corporate tax rate reduction in 2017, S&P 600 earnings rose by 12%. Given that the corporate tax rate is applied to domestic earnings, part of this can be explained by the fact that small caps' foreign sales exposure of around 20% is only about half of large caps' exposure. The smaller foreign exposure also limits the sensitivity of small caps to tariffs. Despite their cyclicality, small caps outperformed slightly during the most heated period of the trade war in 2018, with six out of ten S&P 600 sectors holding up better than corresponding large cap sectors.

Exhibit 7: Small cap earnings saw strong gains in response to tax cuts



Source: LSEG, Bank J. Safra Sarasin, 19.11.2024

Exhibit 8: Small caps outperformed during the 2018 trade war



Source: LSEG, Bank J. Safra Sarasin, 19.11.2024

Some smaller names may benefit from less competition through higher tariffs

For some smaller companies, tariffs may even be a net positive, as they may keep competition away, effectively achieving Trump's promise even if it may come at the expense of the US consumer.

Remain constructive on small caps vs large caps

Bottom-line, the backdrop for small caps remains favourable relative to large caps in our view. Higher rates are unlikely to be as destructive as they were in 2022/23, lending conditions have improved, cyclical data point to further relative upside and Trump's policies should at the margin be more favourable for small caps than for large caps.

Economic Calendar

Week of 25/11 – 29/11/2024

Country	Time	Item	Date	Unit	Consensus Forecast	Prev.
Monday, 25.11.2024						
GE	10:00	IFO Expectations	Nov	Index	--	87.30
US	16:30	Dallas Fed Manf. Activity	Nov	Index		-3.00
Tuesday, 26.11.2024						
US	14:30	Philly Fed Non-Manuf. Activity	Nov	Index	--	6.00
	14:30	New Home Sales	Oct	1'000	725k	738k
	16:00	Conf. Board Expectations	Nov	Index	--	89.10
	16:00	Richmond Fed Manufact. Index	Nov	Index	--	-14.00
	16:30	Dallas Fed Services Activity	Nov	Index	--	2.00
	20:00	FOMC Meeting Minutes				
Wednesday, 27.11.2024						
GE	10:30	GfK Consumer Confidence	Dec	Index	--	-18.30
US	14:30	Durables Ex Transportation	Oct	mom	--	-1.40%
	14:30	Cap Goods Ship Nondef Ex Air	Oct	mom	--	0.00%
	14:30	Initial Jobless Claims	Nov23	1'000	--	--
	14:30	Continuing Claims	Nov16	1'000	--	--
	16:00	Core PCE Price Index MoM	Oct	mom	0.20%	0.20%
	16:00	Core PCE Price Index YoY	Oct	yoy	2.80%	2.70%
	16:00	Pending Home Sales MoM	Oct	mom	--	7.40%
Thursday, 28.11.2024						
GE	14:00	CPI EU Harmonized MoM	Nov	mom	--	0.40%
	14:00	CPI EU Harmonized YoY	Nov	yoy	--	2.40%
Friday, 29.11.2024						
JN	00:30	Tokyo CPI Ex Food, Energy YoY	Nov	yoy	1.90%	1.80%
EU	10:00	ECB 1 Year CPI Expectations	Oct	%	--	2.40%
	10:00	ECB 3 Year CPI Expectations	Oct	%	--	2.10%
	11:00	CPI Estimate YoY	Nov	yoy	--	2.00%
	11:00	CPI MoM	Nov	mom	--	0.30%
	11:00	CPI Core YoY	Nov	yoy	--	2.70%
US	15:45	MNI Chicago PMI	Nov	Index	--	41.60

Source: Bloomberg, J. Safra Sarasin as of 21.11.2024

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Market Performance

Global Markets in Local Currencies

Government Bonds	Current value	Δ 1W (bp)	Δ YTD (bp)	TR YTD in %
Swiss Eidgenosse 10 year (%)	0.40	-1	-30	3.2
German Bund 10 year (%)	2.32	-4	29	0.1
UK Gilt 10 year (%)	4.44	-8	91	-2.7
US Treasury 10 year (%)	4.41	-3	53	0.0
French OAT - Bund, spread (bp)	79	6	25	
Italian BTP - Bund, spread (bp)	125	5	-42	

Stock Markets	Level	P/E ratio	1W TR in %	TR YTD in %
SMI - Switzerland	11'592	17.7	-1.6	7.5
DAX - Germany	19'146	14.7	-0.6	14.3
MSCI Italy	1'067	9.8	-3.0	11.4
IBEX - Spain	11'612	11.0	0.8	19.9
DJ Euro Stoxx 50 - Eurozone	4'756	14.0	-1.5	8.6
MSCI UK	2'327	12.0	1.1	9.0
S&P 500 - USA	5'949	25.2	0.0	26.2
Nasdaq 100 - USA	20'741	32.8	-0.7	24.2
MSCI Emerging Markets	1'085	13.5	0.1	8.8

Forex - Crossrates	Level	3M implied volatility	1W in %	YTD in %
USD-CHF	0.89	7.2	-0.1	5.4
EUR-CHF	0.93	5.8	-0.8	0.0
GBP-CHF	1.11	7.0	-0.6	4.0
EUR-USD	1.05	7.7	-0.7	-5.2
GBP-USD	1.26	7.7	-0.4	-1.3
USD-JPY	154.8	10.9	0.3	9.8
EUR-GBP	0.83	4.9	-0.2	-3.9
EUR-SEK	11.60	5.9	0.3	4.2
EUR-NOK	11.60	7.5	-0.7	3.4

Commodities	Level	3M realised volatility	1W in %	YTD in %
Bloomberg Commodity Index	99	13.0	2.4	0.4
Brent crude oil - USD / barrel	75	32.6	2.5	-3.1
Gold bullion - USD / Troy ounce	2'692	18.5	5.0	30.5

Source: J. Safra Sarasin, Bloomberg as of 21.11.2024

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