Perspectives
Financial Markets

January 2019

Interest rates & bonds
Political uncertainty drives the bond market

USA
- The Fed is signalling further tightening of monetary policy in 2019. We expect two to three rate hikes in the course of 2019
- Economic data is softening, but sentiment indicators remain at elevated levels
- Fundamental data from corporates is still sound, but the outlook is deteriorating. The adverse market sentiment led to a strong widening of credit spreads

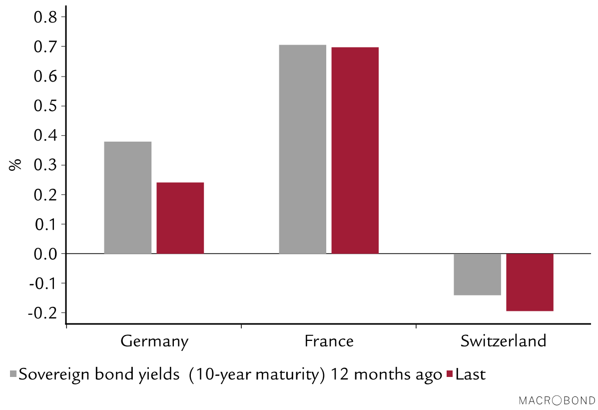
Eurozone
- ECB will end net asset purchases by the end of 2018, but will continue to reinvest the principal payments from maturing securities. We do not expect a change of the deposit rate before late 2019
- There is a broad-based weakening of economic growth. Leading indicators are also declining in core countries
- Fundamental data of corporates is better than in the US, but Euro credit was also hit by the recent sell-off

Japan
- Bank of Japan is expected to keep monetary policy unchanged and to gradually reduce bond purchases in 2019

UK
- While opposition against the Brexit deal remains high in parliament, we believe that the probability of a "No Deal" scenario has fallen over the past weeks
- We do not expect the BoE to change its monetary policy until there is clarity on Brexit. Gilts could benefit from a demand for safe assets

Switzerland
- The SNB kept monetary policy unchanged. We do not expect an increase of the deposit rate before the ECB
- Economic conditions in Switzerland are softening. GDP growth for the third quarter was negative. We do not expect a technical recession as incoming data points towards a stabilisation

2018: Another year of financial repression in Europe



Political risks and weakening economic conditions have led to a sell-off in risky assets this month. Credit spreads widened and government bond yields declined as risk sentiment deteriorated. The trade dispute between the US and China is far from being resolved, despite the fact that there is some rapprochement between the two countries. The US decided to postpone the increase of tariffs on imports from China. In Europe, the governments of Italy and France intend to increase spending for social welfare. This could lead to a violation of the European fiscal compact. Furthermore, there is much uncertainty regarding Brexit: Although the risk has fallen a bit in our view, the UK could still leave the EU without a deal. These topics will also be the major drivers for financial markets beginning of 2019. Risky assets have corrected strongly and we see room for a technical rebound if political tensions were to ease. A trend reversal though would require an improvement of economic conditions as well. Interest rates could increase on the back of a better risk sentiment. Given the weaker economic data, a sustainable upward trend is rather unlikely. Leading indicators in Europe are declining and point towards a broad-based decline of economic momentum. Furthermore, inflation pressures are still subdued. In any case we expect financial markets to remain volatile given the high uncertainty.

Equities

More of the same

USA

- US-Sino relations remain difficult, with potential for having an increasing impact on volatility as illustrated by the recent arrest of Huawei's CFO
- Fed policy also remains an important market theme with potential for major drops if the Fed takes unexpected and significant further steps towards higher interest rates
- Company fundamentals remain stable, even if high levels of EPS growth will not be repeated in 2019

Eurozone

- Budget discussions in Italy may calm down with Italy signalling to send a 2% budget deficit proposal to Brussels
- Valuations have become more attractive and support our view to remain invested in European equities

Japan

- While the US moves towards protectionism, Japan and the EU are sending out a different signal by signing a free trade agreement
- Another positive news for Japanese equity markets is the opening of the economy for more work-related immigration which could increase potential growth

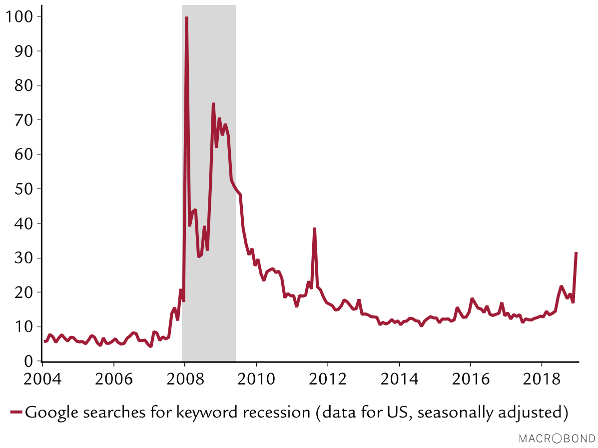
UK

- Small and mid-caps in the UK suffer most from the ongoing Brexit uncertainty as large companies are less dependent on the UK economy

Switzerland

- The renewed strengthening of the Swiss Franc might have a small negative impact on companies' earnings
- Swiss small caps reversed their mid-year outperformance over large caps to now lag the MSCI Switzerland by nearly 20%

Recession risks are coming back to investors' minds



Following years of solid economic conditions, people increasingly discuss when the next recession might occur (see chart above). A high number of searches occurred around the October selloff, reflecting people's concerns that have also fed back into markets with an increase in volatility during the last quarter of the year. Over the full year, the US remains the comparably strongest equity market this year, even if December returns have been worse than those of other major markets we cover. As per 17 December, the S&P 500 is slightly negative year-to-date (–2.5%), while other major indices seem to end the year in clearly negative territory. Somewhat outstanding this year are Emerging Markets which are down by 16% as measured in USD terms. The whole year 2018 has been, apart from discussions about quantitative tightening and the question of how long the economic cycle will last, characterized by the influence of politics. While US President Trump's policies have had a dominant influence on stocks, Italy's budget discussions, the ongoing Brexit discussions and the French "Gilet Jaunes" protest have influenced equity markets as well. We believe that the political tensions in Europe will persist for some more months or might even increase as the supportive economic environment, which tends to calm down markets, might fade. In summary, we would not be surprised to see another "political year" in stock markets for 2019. Hence, volatility is here to stay.

Currencies

US dollar benefits from economic outperformance

USA

- Amid elevated financial market volatility and ongoing political risks, the USD benefits from safe-have flows as well as strong US economic data
- Markets have continued to price out policy tightening by the Fed, to an extent we find excessive
- Re-pricing of Fed policy rate hikes might provide further support for USD going forward

Eurozone

- Leading indicators for the Eurozone have weakened further and France has recently been added to the long list of political risks, weighing on EUR against USD and CHF
- The ECB declared the end of net asset purchases at the December meeting, but has otherwise reiterated its rather dovish stance
- We keep a negative view on EUR versus USD as political risks are unlikely to be resolved anytime soon and growth is expected to remain sluggish

Japan

- JPY has moved sideways against the USD over the past few weeks
- Monetary policy divergence favours USD, but risk sentiment is fragile and could support JPY

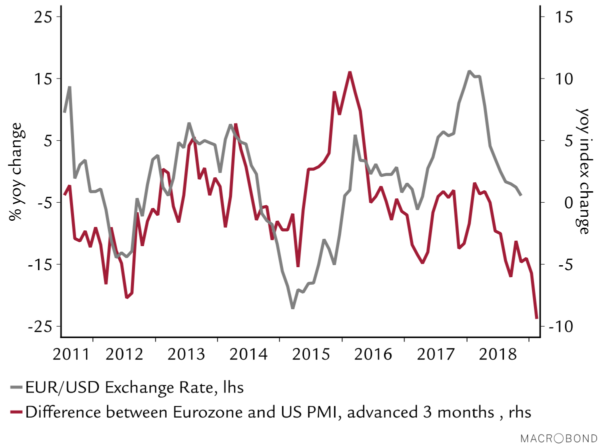
UK

- The deferral of the parliament vote on the Brexit deal led GBP another leg lower, but the currency has since stabilised at depressed levels
- With no resolution of the Brexit deadlock expected over the next month, we keep a negative view on GBP

Switzerland

- CHF was rather stable against USD, but appreciated against EUR recently
- SNB remains firmly dovish and is not expected to lift interest rates ahead of the ECB
- With a lot of negative expectations probably already priced, we keep a neutral view on EUR/CHF

US dollar strength also driven by strong US economy



Apart from the myriad of political risks (trade war, Italy budget dispute), which played out in favour of the US Dollar in 2018, the substantial US economic outperformance also supported the currency. The divergence remained in place at the turn of the year. Leading indicators as well as hard economic data surprised to the upside in the US, while Eurozone and to a lesser extent Japan were still confronted with weak external demand. While we expect all major economies to slow significantly in 2019, US growth should – at least through the first half of the year – remain supported by a positive fiscal boost. Additional support for the US dollar versus Euro should result from ongoing monetary policy divergence. We expect the US Fed to proceed with policy normalization, while the ECB will likely keep a dovish stance. While all of the these factors should also play to the disadvantage of the Japanese Yen, we keep a neutral view on USD/JPY as the Yen remains undervalued and stands ready to benefit in case of renewed financial market turbulence. Sterling is still driven by the Brexit news flow. Although we think a "soft Brexit" is the most likely final outcome, the path to a transition period remains extremely rocky, probably again triggering increased market and political pressure before any resolution is made. Hence, we keep a negative view on GBP/USD for the near future. The Swiss Franc has continued to benefit from political risks in the Eurozone, but we think a lot of negativity is already priced into the currency and thus keep a neutral view on EUR/CHF.

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