Perspectives
Financial Markets

February 2018

Interest rates & bonds
Less accommodative monetary policy going forward

USA
- Global economic upswing and rising commodity prices result in higher inflation expectations on markets for inflation-linked products
- Upward move in nominal US treasury yields thus looks sustainable and is set to gradually continue
- Fed funds futures pricing suggests that market's expectations as regards number of Fed rate hikes in 2018 move closer to our own view of three steps

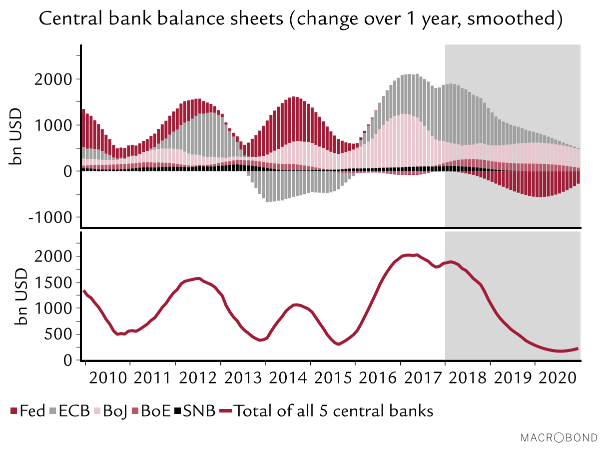
Eurozone
- Europe's economic recovery accelerated further in final quarter 2017
- Calls for an end of asset purchases by ECB seem premature given the fact that central bank's inflation target will be missed until 2020

Japan
- Japanese economic data have firmed further as of late with annual inflation rate surpassing 1% for first time since 2015
- Yet, with wage growth still missing and the Yen being markedly undervalued, we do not expect inflation to return to 2% on a sustained base as is the declared goal of Japan's monetary policy

UK
- The post Brexit surge in annual inflation should be behind us, allowing the Bank of England to adopt "wait and see" policy stance
- More accommodative fiscal policy is expected to result in higher Gilts supply this year, which needs to find investors in times of Brexit uncertainty

Switzerland
- Yield on 10-year Confederation bond has climbed above the zero line in the first month of 2018
- Yet, with inflation rising to a high for more than seven years, real rates remain negative all along Switzerland's sovereign bond yield curve

Slowly coming off the drugs



What drove markets in recent weeks to push sovereign bond yields in the US, the UK, Germany and also Switzerland to their highest level in twelve months? First of all, markets have started to finally price in a total of three rate hikes by the US central bank this year as has been our base case since long. Monetary policy will become less accommodative not only in the USA: Our chart above illustrates that the peak in total asset purchases by major central banks was reached in 2017. The second market driver were rising inflation expectations. In this light, the recent rise in sovereign bond yields in developed economies is justified in our view. On the other hand, we continue to expect limited upside for 10-year government bond yields, with some additional 20 to 30 basis points increase to go from here until year-end. Financial repression exerted by central banks and regulators aims at capping nominal bond yields in order to ensure cheap refinancing for sovereign debtors in Europe and also Japan. Medium-term, we continue to expect 10-year US-Treasury yields fluctuating in a trading range with its upper band defined at 2.8%. A sudden break-out above this level in the coming weeks would force us to adjust our projections for the time horizon until the end of 2018.

Equities

Earnings are a key driver

USA

- Performance of the S&P 500 since the start of the year was exceptionally high – more than 6% until 25 January
- Last time the monthly performance was more than 6% were March 2016 and October 2015, i.e. periods of rebound at equity markets
- Positive earnings revisions after the passing of the tax reform were an important support factor

Eurozone

- Solid economic environment is a support
- Euro strength is a major headwind for Eurozone equities – there is no clear trend in the Euro Stoxx 50 since mid-2017, when the Euro started to appreciate
- Euro has appreciated significantly against USD in recent weeks – it is a combination of USD weakness and Euro strength

Japan

- After an impressive rally in the fourth quarter 2017, Nikkei 225 started the new year with another rapid price increase – 4% until 25 January
- Economic dynamics are a support
- On a trade weighted basis, the Yen has not moved a lot over recent weeks – despite its substantial undervaluation

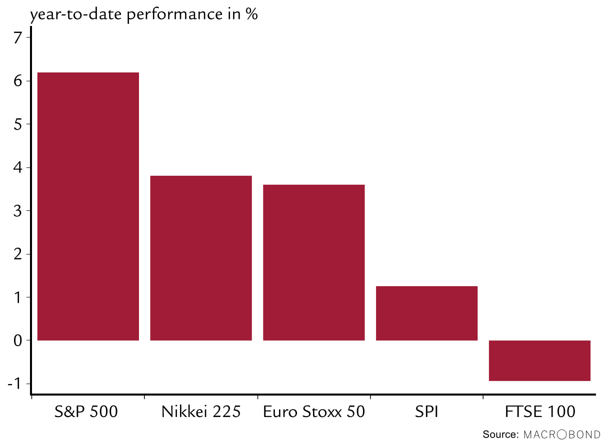
UK

- FTSE 100 is the only index among the ones discussed in this paper that had a negative performance since the beginning of the year
- Stronger Pound was a headwind – trade-weighted GBP climbed to the upper end of its trading range since mid-2016

Switzerland

- Swiss stock markets continue to benefit from the depreciation of the Franc that started in mid-2017
- Depreciation of trade-weighted Franc came to a halt in January due to appreciation of CHF against USD
- Business cycle has further room to go as Switzerland has been a laggard in the global economic upswing

An impressive start into 2018



The year 2018 started with impressive price increases in the first few trading days. Among the indices that we discuss in this paper, the S&P 500 is the leader. In less than 20 trading days it gained 6%. The Euro Stoxx 50 and the Nikkei 225 have followed the upward momentum in the US and have risen by 3-4% in this very short period of time. The passing of the tax reform in late 2017 was an important support factor for US equity markets as analysts have thereon significantly increased their earnings expectations for 2018. In addition, the world economy is in good shape. The economic data published so far in 2018 has underpinned this assessment. At the same time, inflation is contained and the major central banks still provide ample liquidity. Thus, the environment is a favourable one for equity markets. We flag three risk factors: First, central banks gradually lower their monetary stimulus which has been a powerful support for asset prices in the past few years. Second, valuations of many major stock markets are elevated. Third, the sentiment of investors seems very bullish. We will observe these risk factors attentively. For the coming weeks, we remain positive on equity markets. We believe that the positive price momentum can continue. The main argument is the strong fundamental backdrop which is a combination of solid global GDP growth and high earnings growth expectations. Apart from the three risks factors above, we will closely watch earnings revisions. Should analysts revise their expectations downwards, a support factor of US stock markets diminishes.

Currencies

Central banks and politics move the markets

USA

- Greenback lost ground against most currencies and particularly strongly against Euro and Pound – on a trade-weighted basis, USD lost 3% so far this year
- US Treasury secretary Steven Mnuchin said at the WEF in Davos that a weak Dollar is good for the US, currency markets reacted strongly thereafter
- According to our estimations, the USD is now broadly fairly valued

Eurozone

- Euro started the year 2018 on a strong note – the economy and speculation that the ECB would start to normalise monetary policy earlier than expected were a support
- ECB becomes increasingly worried about a stronger Euro
- EUR/USD climbed to almost 1.25 – such levels have last been reached in late 2014

Japan

- Bank of Japan is and remains the most accommodative major central bank, independent of whether the ECB normalises a bit earlier than expected or not
- We forecast inflation in 2018 to be slightly above the one percent mark
- According to our estimations, the Yen is still significantly undervalued

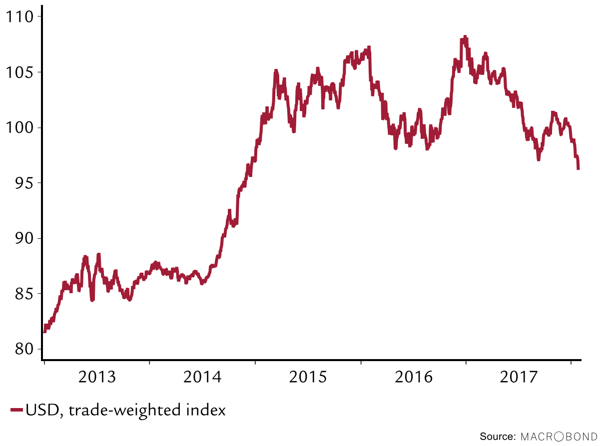
UK

- GBP/USD has risen from roughly 1.35 to around 1.42 in the first few weeks of this year – at 1.42 the cross is back at the levels of the first half year 2016
- Trade-weighted Sterling climbed to the upper end of the trading range in which it has fluctuated since the Brexit referendum

Switzerland

- Evolution of CHF so far this year was very different across currencies – Swiss Franc gained 4% against USD and 0% against EUR
- In the first two weeks, CHF lost further against EUR, this move was reversed towards late January
- We maintain our call of a gradual upward appreciation versus Euro in 2018

Another wave of USD weakness



The value of the Greenback has fallen substantially since mid-December 2017. On a trade-weighted basis, the loss was more than 4% from mid-December until the time of writing this paper. The trade-weighted index is currently back at a level last seen in late 2014. This weakening is surprising in an environment where the US has higher GDP growth, higher inflation and higher interest rates compared to other major developed economies. Moreover, the passing of the tax reform should increase the demand for Dollars. These factors remain supportive for the USD going forward. Yet, there is currently a bearish sentiment towards the Greenback. US politics intensified it during the first weeks of the year. Not only was there a temporary government shut-down but US Treasury secretary Steven Mnuchin stated that a weaker Dollar is good for the US. Currency markets reacted strongly to that statement despite the controversy whether or not it was quoted out of context. In addition, financial market participants have interpreted the communication of the European Central Bank (ECB) as rather hawkish in recent weeks. This has pushed the Euro upwards. EUR/USD has risen from roughly 1.20 at the beginning of the year to roughly 1.25 on 25 January when the ECB had its meeting. What is the role of the Fed tightening cycle for the Dollar? One would expect a strengthening of the USD in a period where the central bank raises short-term policy rates. Yet, it would not be the first time that the USD weakens or moves sideways during a rate hiking cycle. This has happened during the tightening phases in 1994-1995 and 2004-2006.

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