Perspectives
Financial Markets

April 2018

Interest rates & bonds
Rate rise came to a halt

USA
- Concerns that 10-year yields would rise beyond the 3% mark proved exaggerated so far – they have stabilised in March and remained between 2.8% and 2.9%
- Fed hiked for the sixth time in the current cycle that started in late 2015 – according to the Fed, two more hikes until year-end seem appropriate
- Jerome Powell held his first press conference as Fed chairman and signalled policy continuity

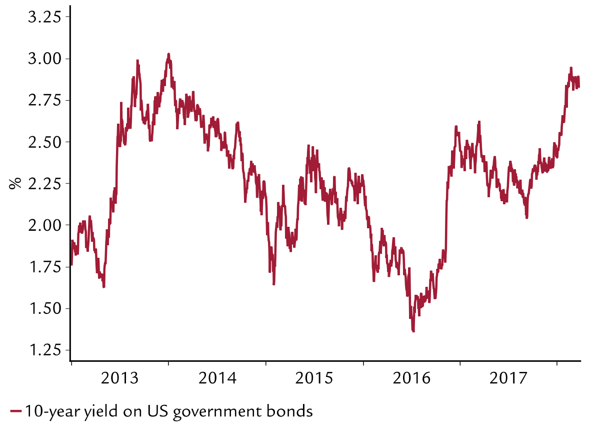
Eurozone
- For investors, expectations as regards the end of the asset purchase programme of the European Central Bank (ECB) are taking centre stage – we adapted our view and expect the ECB to end its programme already by year-end
- As deflation risks are clearly overcome, the ECB can slowly lower its purchases – yet, inflation does not force the ECB to hike policy rates anytime soon

Japan
- With the ECB slowly approaching the end of asset purchases, the Bank of Japan remains the most accommodative central bank
- 10-year yields may move to the zero line towards end of March – since late 2016, yields have not really moved out of the range of between 0% and 0.1%

UK
- Inflation has peaked as the impact of the currency depreciation is fading out – nevertheless we expect one hike by the Bank of England until year-end

Switzerland
- We expect 10-year yields to climb slowly higher in coming weeks, together with German Bunds
- Although export-oriented Switzerland is exposed to tensions of the global trade system, Swiss government paper would serve as a safe haven in case such concerns arise

Inflation fears have stalled



Source: MACROBOND

The year 2018 has started with a rapid rise of US long-term yields. The main driver were concerns that inflation in the US could rise more rapidly than expected. Given the tightness of the US labour market and given the length of the business cycle, textbooks suggest that inflationary pressures will start to build at some point. In addition, the expansionary US fiscal policy could pose an upside risk to inflation. A few data points in early 2018 supported these concerns. Market participants started to revise their expectations with respect to the pace of monetary policy normalisation. Yet, in recent weeks these fears have abated and 10-year yields have stabilised in a range between 2.8% and 2.9%. February inflation data was contained and confirmed our view that inflation in the US will be higher in 2018 than in 2017, yet without getting out of hands. In addition, Jerome Powell held his first press conference and indicated the policy stance for the remainder of the year. The new chairman of the Fed signalled that after the fully expected rate hike of March, another two hikes should be expected until year-end. Until mid-year, we expect 10-year yields to climb somewhat higher amid policy normalisation. The risk is rising concerns about protectionism. In such a risk-off environment yields would grind lower.

Equities

More realistic valuations should provide support

USA

- Among the indices discussed here, S&P 500 is the only one with a positive performance so far in 2018
- Earnings dynamics are still positive, with expected double digit earnings growth through 2018
- Market correction in the first quarter resulted in more realistic valuations, which should attract institutional investors in the weeks ahead

Eurozone

- Business sentiment indicators suggest that Euro appreciation of the past 18 months starts to bite
- Nevertheless, given the strong economic dynamics and recovering price setting power, earnings growth should be near double digit rate this year
- Relative valuation compared with sovereign bond yields remains remarkably attractive

Japan

- Yen appreciated by 5% so far this year on a trade weighted basis
- Despite strong economic growth and a tight labour market, cabinet approval ratings are suffering from a domestic scandal
- Monetary policy remains supportive for risky assets in Japan

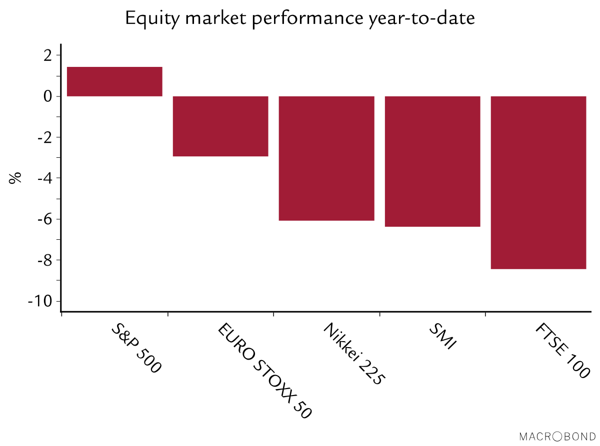
UK

- FTSE 100 is the index that lost the most since the beginning of the year among the ones discussed here
- Agreement with EU on transition period should provide entrepreneurs with a minimum of planning security
- Less monetary policy support for the stock market as we expect the Bank of England to lift rates in the third quarter of this year

Switzerland

- Domestic economic activity is accelerating
- We expect Swiss Franc to depreciate slightly further until year-end which should support export industries

Only one market up so far this year



Equity markets had a bumpy start this year. Among the five regions discussed in this paper, only the reference index for the US delivered a positive performance so far in 2018. The main reason for the recent market correction was a shift in investors' perceptions of the balance between global growth and inflation: In the view of a majority of analysts the fact that deflation fears are taking a back seat allows a normalisation of monetary policies. Most importantly, liquidity injection via quantitative easing is clearly past its peak. Markets adapt to this regime change with the return of volatility, which in our view will remain elevated in the months and quarters ahead. Nevertheless, we weigh a list of arguments which speak in favour of rising stock markets somewhat higher than the risk factors over the next three months: First of all, we are observing solid earnings dynamics, both in the US and Europe. Moreover, analysts continue to upgrade their earnings forecasts. As a consequence, valuations like price to earnings ratios have become less stretched since the start of the year. At the same time, valuations of equity markets relative to the fixed income asset universe remain favourable. Yet, it is worth mentioning that the return of volatility calls for prudence in investing in the stock market. We thus stick to our risk controlling strategies when it comes to implementing a slightly overweight allocation into equities over the coming month.

Currencies

We are neutral on the USD

USA

- The US interest rate curve remains suspiciously flat which constitutes a latent problem for the USD
- Cyclical forces and central bank divergence on the other hand act as a support for the USD
- Due to these conflicting influences, we expect the USD exchange rate to hardly fluctuate against the other main currencies over the next three months

Eurozone

- A rather dovish ECB and peak levels of the purchasing managers indices in the Eurozone have stopped the appreciation of the single currency
- The interest rate curve is relatively steep and may actually steepen further which should be a support for the EUR
- A continuation of the goldilocks scenario – strong growth and no inflation fears – lead to further upside potential of the EUR

Japan

- The intermediate appreciation of the Yen has come to a halt in our view – the Bank of Japan remains extremely accommodative
- Yet, due to its undervaluation and ongoing strong economic data, we expect the Yen to appreciate again in the medium to longer term

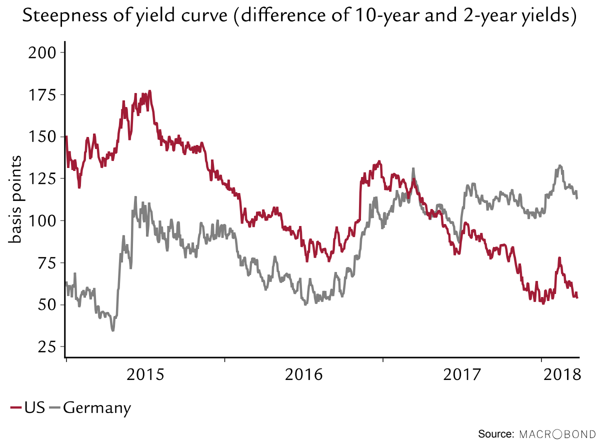
UK

- The transition agreement between the EU and the UK is an unexpected positive development and supported the value of the GBP
- Economic activity data and ongoing uncertainties as regards the Brexit are bound to be a drag on the Pound – for the time being we remain neutral

Switzerland

- Expectations that the Swiss National Bank (SNB) may hike rates before the ECB does have been largely priced out again – forward carry is slightly in favour of EUR rather than CHF
- Positive risk sentiment and valuation arguments allow for further CHF weakness – we expect EUR/CHF to move closer to 1.20 until year-end

A flat US yield curve weighs on the USD



Despite concerns of a deterioration in global trade relations, the positive global growth backdrop coupled with relatively tame inflation is expected to support risk sentiment. Volatility has picked up somewhat in currency markets but not as much as in other asset classes. As risk sentiment has recovered, CHF and JPY have been under devaluation pressure. These two safe havens usually benefit from rising risk aversion in financial markets. As regards the fate of the USD, expectations of a more hawkish Federal Reserve, a continued tightening of the labour market and a late-cycle fiscal boost should actually push the Greenback higher. Since the relative steepness of the US yield curve looks rather flat, the USD looks less attractive than the EUR for instance where the yield curve is rather steep (see chart above). Furthermore, twin deficit fears and high hedging costs of the Greenback could incite portfolio diversification away from the reserve currency. We therefore acknowledge these opposing forces and assume hardly any change of the USD exchange rate versus other major currencies. Although Eurozone growth dynamics seem to have peaked - our long-term call - we maintain our view that the EUR still has upside potential against the CHF. The Swiss Franc remains overvalued and we see very little chance that the SNB would normalise monetary policy before the ECB does. This has been the speculation over past weeks and had temporarily lifted the value of the CHF.

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