Perspectives
Financial Markets

May 2018

Interest rates & bonds

Negative surprises of economic data

USA

- After the recent correction of yields to the downside, most of the indicators which we take into consideration point to rising yields from here
- The latest Fed minutes confirmed a gradual hiking path
- Given renewed fiscal exuberance in the US, the budget deficit will rise far beyond the long-term average – this entails a pronounced increase of net issuance of government bonds along the yield curve

Eurozone

- The economic surprise index for the Eurozone turned decidedly negative, meaning that high expectations of market participants as regards published economic data have been clearly missed
- We expect the ECB to complete the asset purchase programme by year-end 2018 and to hike the target rate for the first time a year later

Japan

- Monetary policy support remains ample in Japan
- Yet, the Bank of Japan is beginning to talk about the need for an exit strategy – its start remains conditional on a more significant pickup in inflation than looks likely over the coming year

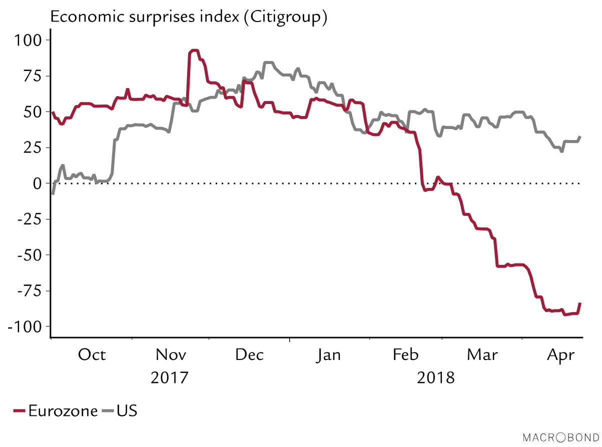
UK

- Inflation surprised to the downside for the second consecutive month in March
- Since wage growth has proven to be sturdy at the same time, real wages show upwards momentum and support rate hike expectations

Switzerland

- The yield on a 10-year government bond has dropped back into mildly negative territory
- Expectations as regards interest rates hikes by the SNB have moderated again in the market

Data disappoint but the cycle remains intact



Over the past four weeks, yields on government bonds in major markets have corrected slightly to the downside again. First of all, certain economic data series disappointed throughout the developed world. Among these downside surprises were purchasing managers' indices, which softened from elevated levels, above all in Europe. Secondly, investors were unsettled by political developments: the US-China trade dispute, US sanctions on several Russian individuals and companies and geopolitical tensions including military intervention by the US, UK and France in Syria. Finally, inflation readings remain more benign than the mature stage of the business cycle would normally entail. From these levels, we expect interest rates to grind higher in all major economies. Despite the observed moderation of economic data, the growth environment remains sturdy. Given the fiscal boost in the US, net issuance of government bills and bonds should rise, putting upward pressure on rates. Rising issuance meets the Fed's policy of shrinking its balance sheet by unwinding their holdings of bonds. Corporate credit remains well supported. April brings only subdued supply of corporate paper while dealer inventories are at a 12-month low. We expect a moderate tightening of credit spreads.

Equities

Corrections have become more pronounced

USA

- Among the indices discussed in this paper, the S&P 500 is the only one with a positive year-to-date performance
- We remain positive for equities, in particular in the US, as political tensions have eased somewhat
- Analysts' expectations for corporate earnings are particularly high for US companies

Eurozone

- While we do not expect the Eurozone economy to accelerate further, growth rates should remain solid and well above potential throughout 2018
- Monetary conditions will remain very accommodative despite the upcoming reduction of asset purchases by the ECB – as inflation remains well below the ECB's target, the central bank is not in a rush to normalise policy rates
- EURO STOXX 50 rebounded markedly after the low in March, despite negative data surprises and a gradual strengthening of the Euro

Japan

- Due to its strong links to other Asian economies, Japan is particularly exposed to an escalation of protectionist trade measures between the US and China
- Recent strengthening of the Yen was a drag for export-oriented companies

UK

- With almost -5%, FTSE 100 is the index with the worst year-to-date performance among the markets discussed here
- As we see room for weakening of the Sterling, equity values should recover going forward

Switzerland

- Three factors should support Swiss equity markets going forward: weakening of the Franc (supporting export-oriented companies), solid growth outlook after a long period of weakness and particularly high earnings forecasts for Swiss corporates
- As a small and export-oriented economy, Switzerland is particularly exposed to the risk of an escalation of protectionist trade measures between the US and China

"Buy the dip" mode is still in place

"Buy the dip" has been a profitable strategy in recent years. Whenever equity markets corrected, valuations became more attractive, investors reinforced their positions and the market recovered. As the above chart illustrates, this strategy is still in place in 2018: The first correction of this year was caused by concerns about rising inflation. After a short recovery, major equity indices dropped again as US-China relations became more strained and geopolitical tensions rose. Yet, the S&P 500 recovered once again. Thus, the "buy the dip" mode is still in place. Yet, the "dips" have become larger. The environment at equity market has changed markedly since the turn of the year: Volatility came back in 2018 after a year with exceptionally low volatility. Which factors are supportive for equities and cause markets to recover after corrections? First, the macroeconomic environment remains favourable. It is less favourable than last year as the global upswing has run its course and growth is stabilising or even moderating in the major world regions. However, growth levels remain solid. Second, corporate earnings remain high, in particular in the US and Switzerland. Third, valuations are roughly at long-term averages as earnings have improved and prices came back somewhat. Fourth, monetary conditions remain supportive. The sentiment will be a decisive factor going forward. It is currently quite depressed as geopolitical risks have increased. If these tensions ease, sentiment should recover. In our view, this is the likely scenario. A trade war between the US and China is a risk scenario, but not our base case. Various signs point towards an easing of tensions between the two biggest economies.

Currencies

EUR/CHF back at around 1.20

USA

- US Dollar is supported by global trade tensions
- Fed seen to continue its gradual monetary policy normalisation with two more rate hikes this year
- Late cycle fiscal stimulus could provide additional support for the US Dollar versus Euro and Yen

Eurozone

- The ECB continues to miss its inflation target and risks of dovish disappointments as regards monetary policy normalisation are rising
- We still expect a prolongation of quantitative easing until end of 2018, with monthly purchase volume lowered to 15 billion Euro through the final quarter
- Economic data surprise heavily to the downside relative to market expectations, this could be a risk for Euro long positions

Japan

- Yen appreciated in light of speculation that Bank of Japan could abandon its ultra-loose monetary policy
- Such speculations are related to falling approval ratings for prime minister Abe
- In our view, Yen will weaken versus USD next month

UK

- While markets are pricing in two rate hikes by the Bank of England this year, the downward trend in inflation removes pressure on the central bank
- We expect only one rate hike in 2018 and thus see room for a weakening of the Sterling
- Brexit uncertainties remain a downside risk for Sterling in months to come

Switzerland

- Switzerland has overcome the currency shock, EUR/CHF trades around 1.20 levels
- In our view, Swiss Franc remains slightly overvalued versus the Euro, thus we expect depreciation to continue to around 1.21 until year end
- Swiss Franc weakness should be seen as a result of markets' perceptions as regards SNB's monetary policy from here until 2019

Switzerland's currency shock is history

What a relief this must be for the Swiss National Bank (SNB). Three years and a quarter after they decided to abandon the minimum exchange rate policy versus the Euro, the EUR/CHF exchange rate returned to its temporary floor of 1.20. The Swiss Franc's trade-weighted external value lost 6% during 2017 and fell by another 1.4% so far in 2018. As a consequence, Switzerland's inflation rate is grinding higher to around 1% by the end of the second quarter. With the SNB pursuing an inflation level of between 0% and 2%, they must feel in the perfect comfort zone. From investors' perspectives, the SNB is seen as the very last of all major central banks to normalise monetary policy. More recently, markets have even begun to reassess the likelihood of a policy shift in Japan, which may explain the Yen's recent rally. Arguably, the Yen was also supported by its function as a safe haven currency, a role, which the Franc seems to be playing less than in previous years. Meanwhile the Swiss Franc seems to be used as a funding currency in so called carry trades which explains the continued depreciation. We expect the Swiss Franc to weaken further until the end of the year. An exchange rate of 1.21 versus the Euro by then remains our base case. Risks to this scenario are an extension of unconventional measures by the European Central Bank and the Bank of Japan. In both these adverse cases, the Swiss Franc would come back in demand and make up for some of its losses of the past twelve months.

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