Perspectives
Financial Markets

SwissLife Asset Managers

July 2018

Interest rates & bonds
Political noise causes up and down

USA
- The Fed confirmed the continuation of a gradual hiking path and the committee recognized that inflation is close to target
- The rising fiscal deficit and its impact on the supply of government bonds is increasingly in markets' focus
- After rates have moderated again since the peak reached in mid-May, we expect them to move slightly higher in the second half of 2018

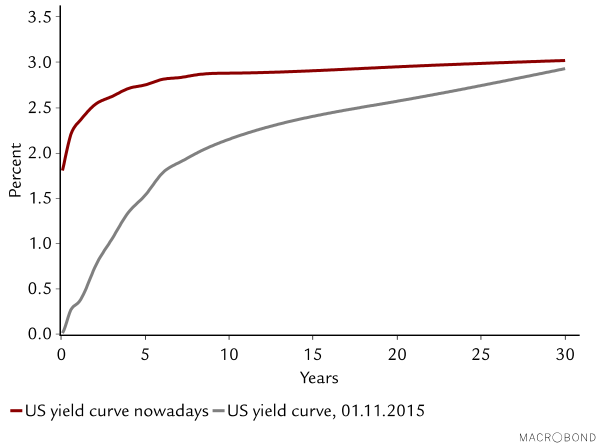
Eurozone
- The ECB's dovish statements after recent weakness of economic data increases the risk of a prolonged period without any rate hike
- Notwithstanding the dovish tilt, the ECB will stop its asset purchase programme by the end of this year
- They will not start to shorten the balance sheet quickly but rather replace maturing securities

Japan
- In the latest statement, the BoJ downgraded its assessment of the inflation outlook – the weakness of price pressures is frustrating for the central bank
- The 10-year government bond yield has fluctuated between 0.02% and 0.1% this year – a narrow range

UK
- According to our forecast, inflation will drop below 2% by the end of the year – the BoE should not be in a hurry to hike rates
- Second quarter growth should recover on the back of sound consumer spending

Switzerland
- The SNB left no doubt that policy normalisation is still far in the future – they still stress that the CHF is overvalued
- We expect inflation to surpass 1% in June and to remain there – inflation has been below 1% since March 2011

A much flatter US-yield curve



Common drivers for asset classes in these days are developments on the political scene. Investor sentiment is dented once again by trade war fears leaving their imprint on rates as well as on risky assets. The coalition crisis in Germany, the Eurosceptic government in Italy and a slow process in Brexit negotiations added to the notion of declining global risk appetite. Therefore, interest rates reached an intermediate peak in May of this year, recovered somewhat but have declined again starting early June. The Fed confirmed its hawkish stance and continued to tighten policy via rate hikes. The yield differentials widened further. Disappointing growth and inflation developments in the rest of the world have led other central banks to be cautious and to sound more reluctant as regards the removal of policy accommodation. This central bank divergence continues to be a theme on markets. The flatness of the US yield curve as illustrated above is taken as a warning signal as regards economic momentum ahead. Crucial for our rate outlook is the assumption that the trade dispute is not going to escalate into an outright trade war among the big economic players. Strong fundamentals will thus outweigh political noise and allow interest rates to move moderately higher. In our view, the upward move will be led again by US yields.

Equities

Supported by earnings and limited rate increases

USA

- Earnings-per-share growth remains well above the long-term average – earnings revisions are on the positive side as well
- The relative valuation of stocks is still attractive
- Macro risk models opt for caution while risk appetite has suffered due to politics

Eurozone

- Despite some moderation in economic activity since the start of the year, the Eurozone continues to grow above its potential through 2018
- As the ECB underlined once more that they are not in a rush to normalise policy rates, monetary tightening is not a risk for stock performance
- Despite lower EPS growth than in the US, equity market valuation remains attractive

Japan

- The Nikkei 225 index managed to gain more than 5% over the past three months despite fears of an escalation of the trade dispute – the Japanese car industry would be affected as well
- The trade-weighted Yen has weakened since a peak reached at the end of March which supports the attractiveness of export-oriented companies

UK

- FTSE 100 Index is back at the level of the beginning of the year – after a big correction and a rally
- The economy should be cooling down as uncertainties related to Brexit still weigh on sentiment and thus on investment decisions

Switzerland

- After renewed CHF appreciation against EUR following the Italian election, the exchange rate has hovered between 1.15 and 1.16
- In the meantime, earnings dynamics look somewhat weaker compared to European peers and earnings revisions remain in negative territory

Volatility indices reflect rising scepticism

The overwhelming topic for investors over past weeks has been the renewed intensification of the trade dispute between the US and China as well as worsening rhetoric between the US and European partners. Global risk appetite retreated as a consequence and risky assets suffered price declines. Volatility indices around the globe detached from the calm waters witnessed in 2017. Going forward, the decisive question for forecasters is if this trade dispute will evolve into an outright trade war, where more and more countries would be negatively impacted and which would not only hit sentiment but would consequently dampen global growth further. This is not our base case scenario. We do not expect the trade conflict to become an economically significant trade war. Thus, the risk-off mode in financial markets should turn the corner, once the rhetoric tames down and fundamentals should be the main drivers of stock market performance. We are thus cautiously optimistic that risky assets will generate positive returns over the next three months and beyond. At the same time however, we are also convinced that the growth-inflation mix will continue to worsen and thus put a lid on equity performance also in the medium and long term. The year 2017 with double-digit performance will not be repeated. As we expect volatility at equity markets to remain high, we recommend to engage in equity investments with inbuilt protection against large drawdowns.

Currencies

EUR to gradually regain strength

USA

- The relative monetary policy stance was a support for USD – in the much awaited June meetings the Fed sounded rather hawkish while the ECB surprised on the dovish side
- We stick to our call of one further hike by the Fed in 2018 and three hikes in 2019 – until year-end 2018, financial markets price between one and two hikes

Eurozone

- After ECB's dovish statements regarding the end of the asset purchase programme in December 2018, financial market participants have shifted the focus on the timing of the first rate hike – which will not happen before late 2019 in our view
- EUR was broadly stable in June – due to ongoing political uncertainties in Italy, we expect EUR/USD to remain below 1.20 until year-end

Japan

- Due to its economic links within Asia, Japan is particularly exposed to risks stemming from a trade dispute between the US and China
- In our view, Yen will weaken versus USD in coming weeks as central bank policy is back in focus – while the Fed continues its gradual hiking cycle, the BoJ remains the most accommodative major central bank

UK

- Financial markets still price one hike by the BoE until year-end – as inflationary pressures are easing and economic momentum is cooling it is becoming more and more likely that the BoE will refrain from hiking

Switzerland

- June was a comparably calm month for CHF
- We expect a gradual upward move of EUR/CHF until year-end – without moving above 1.20 as European politics remain complicated
- Speculations that the SNB could hike rates ahead of the ECB have faded after the monetary policy meetings in June

USD rise continued in June

The US-Dollar rally that has started in April has continued in June. On a trade-weighted basis, the Greenback climbed another 1.5%. The uptrend during the second quarter has however started from a comparably low level. Even after the recent rally, the US-Dollar is not on a particularly high level compared to recent years. The Dollar strength during the second quarter was broad-based. The Greenback outperformed all major currencies, in particular the Euro, and has put a lot of pressure on emerging markets currencies. We do not expect the Dollar rally to continue throughout the third quarter. In particular, the Euro should regain ground against the Dollar: Negative surprises from politics, dovish surprises from the ECB and growth disappointments should not be repeated in the third quarter. Moreover, economic fundamentals of emerging markets do not suggest a further weakening of their currencies. The key risk to our call is politics: In our base case scenario, the peak of political uncertainty has been reached with regards to US-China relations as well as with regards to European politics. We expect the trade dispute as well as Italian politics to remain complicated and to resurge regularly over coming quarters. Yet, we do not believe that the negative surprises for financial markets will continue at the pace seen in recent weeks and months. Therefore, our base case foresees that the peak of political uncertainty has been reached.

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