Perspectives
Financial Markets

November 2018

Interest rates & bonds
Politics still in the driving seat

USA
- Strong economic data and hawkish comments from the FED caused a spike in 10-year treasury yields, which rose to above 3.20% - a level last seen in 2011
- Ahead of the mid-term elections we expect further volatility, but believe both credit spreads and interest rates will stay range bound around current levels
- We maintain our view for one more rate hike this year with another three expected for 2019

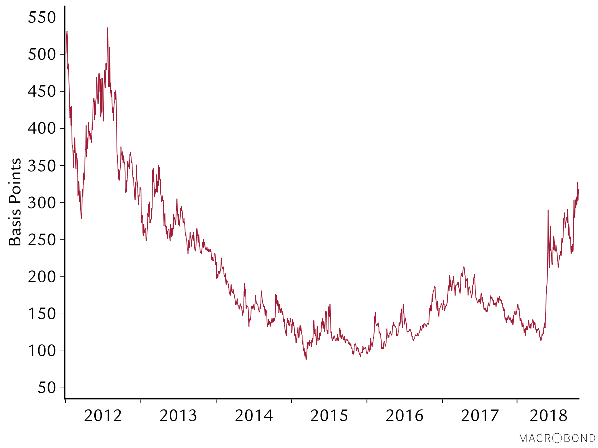
Eurozone
- European Brexit negotiations and Italian politics continue to dominate the markets in the EU, keeping a potential rise of German Bund yields limited while periphery spreads experience large swings depending on the news flows
- We view the end of QE as a well flagged event and are expecting yields to gradually move upwards
- A rise in central bank rates is unlikely to happen before the end of the second quarter next year

Japan
- The Japanese yield curve has continued to steepen as the BOJ focused purchases on shorter maturities
- While we don't expect a material shift in the monetary policy, speculations about a reduction of the central bank's monetary easing program, could put further pressure on rates

UK
- A hard Brexit, while not our base case, becomes an ever more likely scenario as negotiations are dragging on without a solution in sight
- Higher uncertainties continue to weigh on consumer sentiment, causing the market to increasingly price out a rate hike before mid-2019

Switzerland
- Recent economic data confirm our view that the business cycle has peaked in the first half 2018
- 10-year yields move in tandem with German bunds and should end the year in positive territory

Italy-Germany spreads 10-year bonds



While the goldilocks period for bond investors is likely over, we still see the market backdrop as supportive although a string of political fires continues to keep investors on their toes. The latest example is Italy. The country's anti-EU government, bent on fulfilling populistic campaign promises, is expected to increase the budget deficit again, risking a rift with the EU. In combination with the already high debt to GDP ratio and an expected end of the ECB's lose monetary policy, investor support is quickly fading causing risk premia to surge. The yield difference between German and Italian government bonds has increased to more than 3% and a reaction by Moody's followed quickly. Although we remain comfortable with Italian's solvency for the time being, we expect the situation to remain fluid, which will keep bond price volatility elevated. We would also expect a renewed divergence between the performance of core and peripheral European bonds. In addition, we also remain concerned with a No-Deal Brexit scenario and cannot rule out a renewed escalation of the US trade war rhetoric around the mid-term elections. We therefore remain cautious on taking on more credit risk and expect rates to remain range bound around current levels.

Equities

Volatility to remain

USA

- The continued strength of the US economy confirms our expectation of further rate increases by the central bank
- The remaining uncertainty about how fast and far the Fed will go, starts to make markets nervous, despite the good earnings season so far

Eurozone

- Eurozone equity markets continued on their unsteady performance path with the developments on the US market accelerating the downside trend
- The deteriorating investment sentiment and the weakening economic dynamics limit the short-term upside of this market
- Italy's budget discussions and Brexit remain the key political topics that will keep equity markets volatile

Japan

- Whether the rumours about a change of monetary policy materialise or not will be decisive for stocks
- Prior to the recent sell-off, Nikkei 225 reached levels last seen in 1991
- The Japanese reform path and the potentially positive spill-over effects for the country of a Chinese-US trade war, make this market the relatively most attractive one after the US

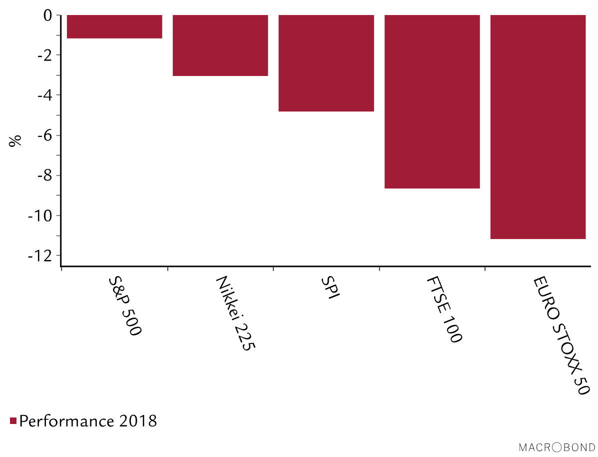
UK

- FTSE 100 lags the S&P 500 markedly in 2018
- The decreasing likelihood of a Brexit deal did not weigh on UK large caps so far
- What seems more relevant are the prospects for companies to offer their goods and services at competitive prices. Hence, the GBP evolution seems more relevant for the UK large cap market. Small caps will be more affected in case of a hard Brexit

Switzerland

- As a small open economy, Switzerland is relatively exposed to risks of an escalating trade dispute
- The Swiss industrial sector is still in a recovery phase, yet we expect a plateau to be reached soon

Stock market performance 2018



Despite its recent fall into negative performance numbers for 2018 so far, the US remains the comparably strongest equity market this year. The S&P 500 is down by 1.0% since the beginning of the year while the Nikkei 225 is down by around 3%. In contrast, the SPI in Switzerland is down by 4.8%, European equity markets as measured by the EURO STOXX 50 lost 11% and Emerging Markets have suffered the most (-18% as measured by the MSCI Index). Political risks regarding a protectionist trade policy, the populist Italian government and Brexit negotiations are not overcome in Europe. However, US equities in particular should continue to benefit from the tax reform effects and corporate earnings data come still in very strong even if the peak might be reached according to analysts' earnings forecasts. Concerns around US trade and monetary policy continue to weigh on stocks in emerging markets – in particular in China –, Europe and Japan. Economies in these regions would disproportionately suffer from an even more protectionist US trade policy. Given the negative month-to-date performance around the globe, equity market valuations have become more attractive again. Investors seem to have adjusted the risk premium they demand given that quantitative easing policies by central banks in the developed World are behind their peak. European politics, the trade dispute and uncertainties about future monetary policy all suggest that volatility is likely to remain elevated.

Currencies

Maintaining our bullish Dollar view

USA

- Repricing in fixed income markets towards more restrictive Fed policy supported the USD as expected
- Despite tighter financial conditions via stronger Dollar and weaker stock market, we continue to expect one further rate hike by the Fed in 2018
- A recovery in emerging markets and a fast increase in inflation in the Eurozone form risks to our bullish USD call

Eurozone

- The Euro took a hit versus the US Dollar as the budget conflict between Italy and the EU escalated
- Even though ECB ends its asset purchase program soon, rate hikes are not expected before mid-2019
- Deepening of emerging market crisis could put Euro under further pressure versus USD and CHF

Japan

- In contrast to market rumours, we believe that Abe's renewed mandate cements the Bank of Japan's accommodative monetary policy
- On the back of renewed risk aversion, Yen slightly outperformed other major currencies except the USD last month

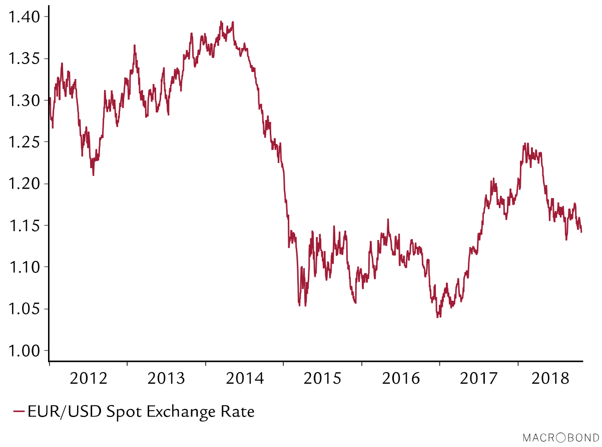
UK

- Likelihood of a "No Deal" Brexit has further increased through October
- The Pound weakened mainly against the US Dollar as EU summit did not produce a breakthrough
- Thus, the risk of renewed substantial Pound weakening remains elevated until next Spring

Switzerland

- Swiss Franc again acts as a safe haven in Europe as uncertainties around Brexit, Italy's public finances and Germany's coalition government likely to set the tone on markets in months to come
- We stick to our year-end 2018 forecast for EUR/CHF of 1.14
- SNB's conditional inflation forecast suggests no increase of inflation above target range until 2020 even with unchanged monetary policy

A more hawkish Fed strengthens the Dollar



We reiterate our call towards a weaker Euro versus the US Dollar. The same themes, which dominated foreign exchange markets last month, will remain in investors' focus until the end of the year: As the Fed sounds more hawkish compared with the first half of 2018, yield differentials are likely to continue provide support for the US Dollar. The same can be expected by the outperformance of US economic data relative to moderating dynamics in Europe. Additionally, political risks in Europe have risen again, which warrants a risk premium on Euro investments. In our view, Italy's budget conflict with the EU and elevated risks of a "No Deal" Brexit will persist until well into the first half of next year. Under these circumstances, we see an increasing risk for the ECB to postpone any monetary policy normalisation beyond the end of its asset purchase program even further into the future. In this context, the situation for the Swiss Franc remains fragile and the risk of a renewed appreciation versus the Euro and the British Pound should be taken seriously into considerations by investors. As regards Brexit, we attribute the highest likelihood to a scenario in which the transition period is extended. We call this scenario a "Blind Brexit". Thus, uncertainties about the final design of Brexit are here to stay. Elsewhere, Japan's Yen has its own life, as discussions continue on whether the Bank of Japan is ready to relax its yield curve control (YCC) program in order to start a certain normalisation of its monetary policy.

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