Outlook for Financial Markets
January 2018

Interest rates/Bond markets

Gradual rate increase in 2018

USA

- In December, the Fed hiked its target rate for the third time this year – and they continue to signal to markets that three more hikes will follow in 2018
- Despite the tightening of monetary policy, financial conditions have continued to loosen – quite an achievement for a central bank
- The spread between a 10-year Treasury and a 10-year German Bund is on historically high levels

Eurozone

- Given the robust growth environment, quantitative easing looks increasingly out of place – the ECB will start to curb asset purchases in January 2018
- The ECB upgraded their own growth outlook substantially, while the upwards revision to the inflation projection was small
- We expect yields in the Eurozone to follow those in the US and to climb modestly higher in 2018

Japan

- The real economy continues to do well – Tankan business sentiment ratchets higher again which bodes well for activity into 2018
- The 10-year yield on government bonds has been below 1% since the beginning of 2012 and remains anchored close to 0% since many months now

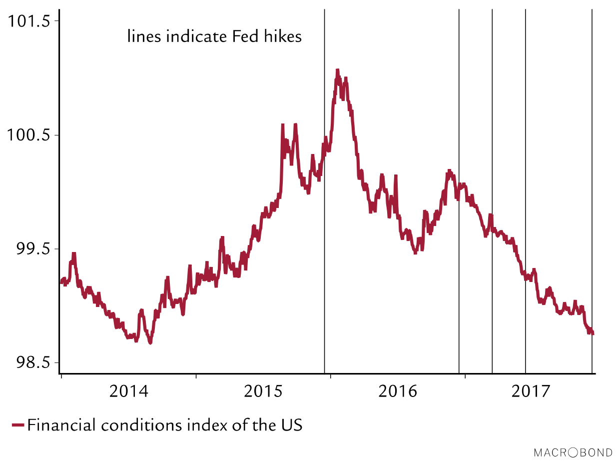
United Kingdom

- Following the latest developments, a soft Brexit has become more likely
- According to the latest budget, the fiscal stance will become more accommodative next year – increased supply of Gilts is to be expected in 2018

Switzerland

- The Swiss National Bank suggested in its latest communiqué to continue its cautious stance – despite their own forecast that inflation would reach 2% in 2020

Loose financial conditions in the US



The central bank meetings of December 2017 did not bring about big surprises. The Fed hiked the target rate by 25 basis points on December 13. The fifth step of the current hiking cycle was widely expected. It is however quite astonishing that US financial conditions are currently as loose as in mid-2014. Back then, financial market participants started to price in the hiking cycle which caused a distinct tightening of financial conditions thereafter. Regarding the rate outlook for 2018, the Fed did not surprise either. The "dot plot" indicates how many rate hikes FOMC members find appropriate. It remained unchanged and is in line with our expectation of three hikes in 2018. In our view, this will translate into a gradual rise of US long-term rates. As we do not foresee a pick-up of inflation or growth and as we do not expect the "reflation trade" to resume after the probable passing of the tax reform we only expect a modest rise of US long-term rates in 2018. On December 14, Mario Draghi left, the target rates and the asset purchase plan unchanged as expected. The interesting part of the meeting were the ECB's macroeconomic projections. The central bank substantially raised its GDP growth outlook for 2018 from 1.8% to 2.3%. At the same time it introduced its 2020 inflation forecast. The ECB expects core inflation to be at 1.8% in 2020. This has been interpreted as a signal for continued ample monetary stimulus. In 2018, we expect long-term rates in Germany and France to rise only gradually. The monetary stimulus is still too large to cause a distinct upward move of rates. The SNB remains dependent on the ECB. Thus, Swiss long-term rates should follow the ones in the Eurozone.

Editorial deadline: 15.12.2017

Stock markets

One-way street through 2017

USA

- Earnings growth in 2018 is again expected to settle in double-digit territory
- Stock market welcomes the tax reform deal, which will likely be agreed upon before Christmas
- Fundamental outlook and expected monetary policy actions in 2018 allow for a positive outlook for US stock markets through 2018

Eurozone

- In Europe, relative valuation as compared to risk-free assets looks even more attractive than in US
- Preliminary data show manufacturing sector PMIs in Germany, France and the entire Eurozone remained in boom territory by the end of 2017

Japan

- Global investors continue to add exposure to Japanese equity market in search for yield
- Going into 2018, a pro-cyclical fiscal programme ensures an ongoing economic upswing above the economy's non-inflationary potential rate

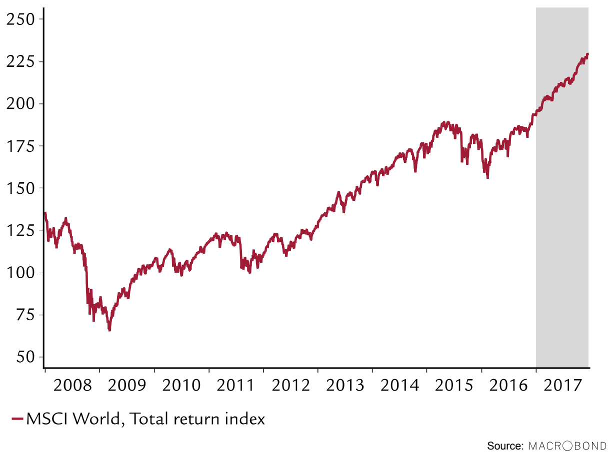
United Kingdom

- Outcome of negotiations with EU 27 remains very uncertain, but most recent developments have shifted probability to a soft Brexit scenario with UK accepting the role of a rule taker
- Unsurprisingly, the FTSE100 is the underperformer of this year

Switzerland

- Most pronounced depreciation of Swiss Franc since 1996 and gradual rate increase should benefit Swiss exporters and financials
- Like in other markets, we expect the "buy the dip" mentality to persist in the first months of 2018
- Institutional investors lack liquid alternatives since sovereign bond yields have dropped back to levels seen at the start of 2017 already

Closing yet another excellent year for stock market investors



Equity markets drove on a one-way street through most of 2017. Market jitters ahead of the French elections, or in summer when North Korea conducted a series of missile tests, are difficult to spot on the chart above. Excluding a major setback on one of the last trading days, 2017 saw double digit returns on most of the developed stock markets. The exception to the rule are UK stocks, where Brexit uncertainties weigh on appetite of foreign investors. For 2018, we maintain our constructive outlook based on strong economic fundamentals resulting in firm corporate earnings and dividend pay-out. In the age of negative interest rates, investors continue to lack liquid alternatives to the stock market. The current stock market rally started in March 2009 and we attach a high chance to finish its ninth year by the end of next quarter. What could go wrong with our call? Yes, valuations look ambitious, especially in the US. Yet, asset allocation is a relative decision across asset classes. On a relative basis, equity markets remain attractive. The reduction of quantitative easing in the US and the Eurozone (at least at the margin) poses a risk, as it implies an absorption of liquidity. Yet, so far monetary policy normalisation has not left traces in the equity market. Forward guidance by central banks helps investors to navigate through the long process of balance sheet reduction by major central banks. Politics are the elephant in the room, which could cause abrupt market moves and the return of volatility: Apart from Brexit and tensions between North Korea and US, we are monitoring the risks of an escalation in the conflict between Iran and Saudi Arabia. Elections in Italy and the US will also attract investors' attention in the course of 2018.

Currencies

The year of the Euro comes to a close

USA

- The Greenback's rollercoaster ride over the past two years was mainly driven by politics and implied hopes – latest appreciation is based on expectations of dramatic tax cuts in the US
- Growth outlook remains promising for 2018 and Fed sticks to its plan of three more hikes next year – this should support USD in the first half of 2018
- The 10-year interest rate spread over the German Bund in real terms has hardly been any wider, which makes it prone to tighten – this would be USD negative – mid-term elections may weaken USD further

Eurozone

- The Euro is the "success story" of the year 2017 having appreciated by almost 7% on a trade-weighted basis until now
- We expect the single currency to appreciate further versus CHF throughout the year 2018
- EUR may appreciate against USD if the record-high interest rate spread starts to tighten as expected

Japan

- The strong undervaluation of the Yen today makes it prone for appreciation going forward
- The big plunge of the Yen in 2016 equalled the one of the GBP and has not been corrected in 2017

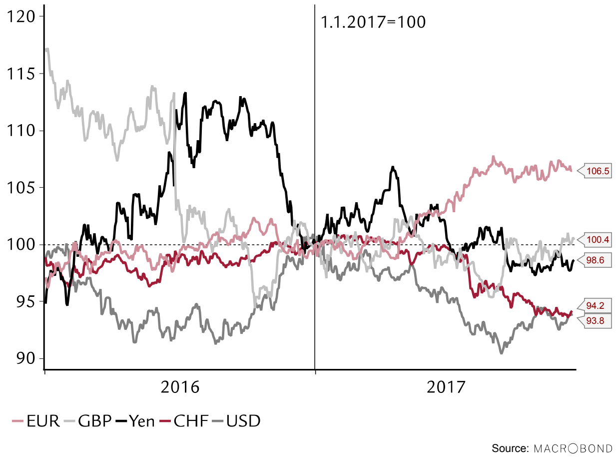
United Kingdom

- After a turbulent 2016, the GBP had a rather uneventful year in 2017 compared to other currencies – Sterling closes the year almost where it started
- Assuming satisfactory Brexit negotiations, we expect the Pound to appreciate slightly in 2018

Switzerland

- Swiss Franc overvaluation will continue to correct throughout 2018 in a positive risk environment
- EUR/CHF may even reach an exchange rate of 1.20 or slightly higher towards end of 2018

Ups and downs of trade-weighted currencies (indexed)



To gauge developments in exchange rates is always a relative game. It takes two to tango. Relatively speaking, the Euro outperformed all of its peers treated in this document in the year 2017. Some of the political burdens keeping a lid on the single currency had evaporated, while economic momentum in the Eurozone surpassed even the most optimistic forecasts at the start of the year. The economic recovery broadened out in terms of sectors as well as member countries it entrained. Going forward, we see upwards potential for the Greenback in line with rate increase expectations at the short end of the yield curve, which are more pronounced for US Treasuries than the German Bund or the Swiss Confederation Bond. We will closely watch the Treasury-Bund spread to adjust our currency forecast accordingly. The US Dollar may also profit from a tax package driving business optimism higher as was the case at the end of 2016 and over the past couple of weeks. However, once mid-term elections, scheduled for November 2018, approach, the odds may well turn against the US Dollar. We would expect the Greenback to slide somewhat lower towards the end of the year against other main currencies. Should Brexit negotiations evolve and progress according to schedule, we see appreciation potential for the GBP until the end of 2018. Regarding the CHF, its trend towards a fair value against Euro should continue in 2018 if the positive risk environment persists. We would thus expect an exchange rate closer to or above 1.20 by the end of 2018.

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