# Outlook for Financial Markets
## *July 2016*

Swiss Life
Asset Managers

## Interest rates/Bond markets

Policy normalisation postponed

### USA

- Although we expect only a minor impact of the Brexit vote on the US economy, the Fed will pursue an even more cautious hiking cycle
- We expect one hike in 2016 and two hikes in 2017
- In the last two years, the Fed paid a lot of attention to uncertainties in other regions
- The yield on 10-year US treasuries fell below 1.40%

### Euro Area

- We expect the ECB to remain very dovish and to extend its asset purchase programme
- The ECB will closely watch the spreads of peripheral countries over Germany and, if needed, use the asset purchase programme to keep them in check

### Japan

- With a more dovish Fed and ECB, the Bank of Japan might also extend the purchase programme to keep its relative position unchanged
- 10-year government bond yields fell less than in other countries

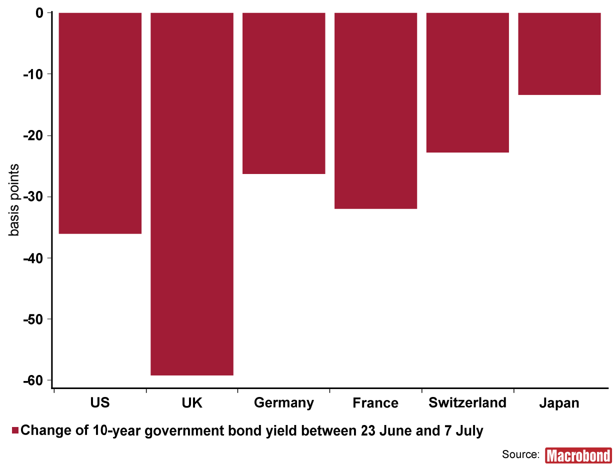
### United Kingdom

- The big drop of the yield on UK Gilts was surprising, due to the higher risk premium one could have expected higher yields in the UK
- In anticipation of a rapid and clear monetary policy action to support the economy and the banking sector, interest rates declined substantially
- The BoE should not have to worry too much about rising inflation, despite the strong depreciation of the Pound

### Switzerland

- We expect the SNB to continue to fight against CHF appreciation with FX interventions being the preferred measure rather than rate cuts
- Each and every government bond of Switzerland has a negative yield

*A free fall of interest rates after the Brexit vote*




The “Leave” vote of Britain was a big surprise for financial market participants. As a consequence, there were sharp reactions of interest rates in the days following the vote. Demand for safe haven assets such as US, German or Swiss government bonds spiked and their yields collapsed accordingly. The yield on 10-year US Treasuries fell by almost 40 basis points since the vote. The yield on 10-year German Bunds turned negative for the first time in mid-June and is at -0.18% at the time of writing this paper. Since 23 June, yields on 10-year government bonds fell between 25 and 30 basis points in Germany, France and Switzerland. In the UK, interest rates corrected the most: They declined by almost 60 basis points. This drop reflects the anticipation of a more accommodative Bank of England (BoE) after the Brexit vote. An extension of the asset purchase programme is likely in order to support ample liquidity to the financial sector. A cut of the target rate, which currently amounts to 0.50%, is also possible. This sharp decline of UK interest rates is at first sight counterintuitive, as it does not reflect the increased risk premium. With the heightened uncertainty in the UK and Europe, policy normalisation will be postponed. Regarding the Fed hiking cycle, we only expect one hike for 2016 – in December – and two hikes for 2017. It is very likely that the ECB extends its asset purchase programme. In the current uncertain environment, we expect long-term rates to stay low. They might even decline slightly. Yet, unless there are important negative news, we do not expect a substantial further drop.

## Stock markets

Brexit shock was quickly digested

### USA

- The damage to the US growth outlook caused by Brexit should be relatively small
- Equity investors bet on an even more dovish Fed and have thus quickly priced in less of a drag from monetary policy
- EPS growth expectations harbour room for disappointments – corporate margins are contracting not least due to stronger wage growth

### Euro Area

- Major equity indices of the peripheral countries immediately experienced a substantial correction after the Brexit vote
- The EuroStoxx index got hit the most by risk-off trades following the referendum vote
- Apart from the Brexit woes, Italian stocks suffer from fears of a banking crisis – Italian banks are weighed down by about 360 bn Euros in bad loans

### Japan

- The economy as well as equities feel the weight of a Yen which has yet again depreciated and acts as a safe haven
- The Nikkei is still the worst performing index among the major ones, having lost approximately 20% since the beginning of the year

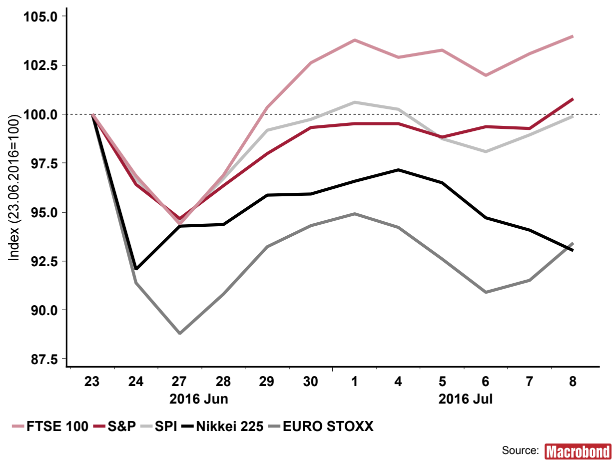
### United Kingdom

- The Brexit vote led to an immediate and profound plunge of the GBP – this leads to a pattern where the FTSE 100 is the only major European index which is in positive territory year-to-date (see chart)
- Should the UK enter a recessionary period, which is our base case, we doubt that this outperformance proves sustainable

### Switzerland

- Post-Brexit, investors in Swiss equities may have been relieved to see that the Swiss Franc appreciated much less than one may have expected – some of the pressure was alleviated by the SNB
- EPS growth is still low and revisions are rather to the downside

*Post-Brexit performance: Look which index suffered the least*




Brexit caught markets wrong-footed, having rallied in the run-up to the referendum. After the initial plunge on 24 June and the days after, many markets recovered relatively quickly, taking comfort from expected central bank policy action, potential fiscal stimulus measures and possible easing in bank capital requirements. Shrugging of the fact that UK politics are in complete disarray, the FTSE 100 actually outperformed its peer indices based on the fact that the British Pound lost approximately 11% of its external value against all other major currencies ever since the result of the referendum became evident. We agree with the markets' assessment that major central banks will adopt an even more accommodative stance since it is very difficult to judge the fallout from Brexit on the economic outlook. Furthermore, the Bank of England already took measures in order to offer relief to commercial banks by lowering the capital requirements. Nevertheless we are also of the opinion, that equity markets, unlike fixed income, may be too complacent regarding the risks emanating from Brexit. Volatility indices shot up temporarily only but have yet again fallen below their 25 year average level. As regards US stocks, which rightfully corrected relatively little in the wake of the referendum, other obstacles for a further rally are luring. Earnings growth expectations are exaggerated and offer room for disappointment. Corporate margins are decreasing in the US which has been in an earnings recession ever since the last quarter of 2015. Valuations do not look justified in such an environment, even though the relative valuation compared to fixed income securities still looks attractive. Given potential disruptions from the political sphere and insecurities as regards post-Brexit negotiations, we maintain our cautious stance vis-à-vis equity engagements.

## Currencies

Brexit triggers renewed safe haven flows

### USA

- The Greenback is among the currencies which are sought after in a risk-off environment and thus appreciated against other major currencies with the exception of the Japanese Yen after the Brexit vote
- Following UK's referendum, the US money market curve priced out any rate hike in the next year
- After a pronounced appreciation phase since mid-2014, the USD is now still weaker than at the start of this year

### Euro Area

- On a trade-weighted basis, the EUR appreciated after the Brexit vote, however traded lower against USD and CHF
- The persistent current account surplus of the Euro Area provides support for the single currency
- We expect EUR to move lower against USD and CHF over coming weeks

### Japan

- The Yen has appreciated by almost 20% against other major currencies since the start of the year
- Monetary policy proves completely ineffective
- As long as risk-off sentiment prevails, the Yen may appreciate even further

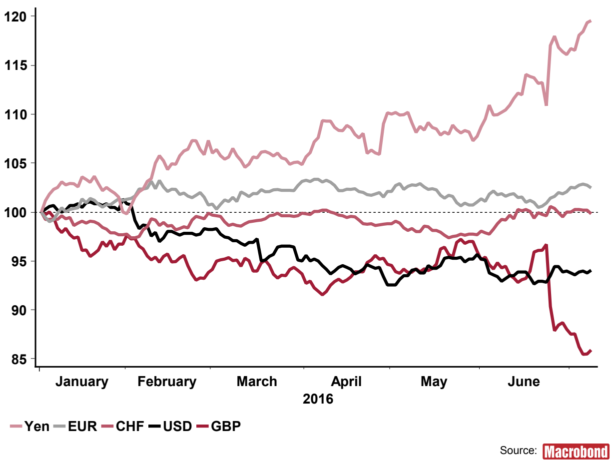
### United Kingdom

- The Pound took the full hit of the surprising vote by the British electorate
- The post-Brexit weak growth outlook, further BoE accomodation, political instability and a large current account deficit all point to an even weaker GBP going forward

### Switzerland

- EUR/CHF did not move materially lower after the referendum on the back of renewed FX interventions by the SNB
- The SNB will be forced to act further with FX interventions remaining the main policy tool

*Currencies on a trade-weighted basis (01.01.2016=100)*




The UK's surprising referendum result dominated events since 24 June. In the immediate aftermath, risk-off sentiment caused significant moves in currency markets within a short timeframe. However, the direction of where the different currencies were heading and the magnitude of the moves were in line with our expectations in case of a vote for "leave". Needless to say, we were convinced that the British population would prefer the status quo. As depicted in the chart above, the Japanese Yen is the clear outperformer of this year and got another boost after the vote, serving as a classical safe haven currency. The mirror image of the Yen is the external value of the Pound which took the full brunt of the post Brexit jitters. Investors question the ability of a post-Brexit UK to attract the capital needed to finance its massive current account deficit, currently at around 7% of GDP. Moreover, the political as well as economic environment will keep the Pound under pressure. For better or worse, we expect the major central banks to remain accommodative in order to support growth and calm financial markets. Although less impacted by the turmoil in Europe, the US Federal Reserve will in our view abstain from a hike until December. With the ECB ready to ease further, the SNB remains under pressure to intervene in FX markets and keep the CHF from appreciating further against EUR. Although the SNB thus continues to grow its balance sheet, the amount they had to invest to keep EUR/CHF close to 1.08 in the week after the Brexit decision was actually smaller than we would have expected under the given circumstances.