Outlook for Financial Markets
September 2016

SwissLife
Asset Managers

Interest rates/Bond markets

All eyes on Jackson Hole

USA

- Several members of the Fed's Open Market Committee struck a rather hawkish tone as of late – this may be a first indication of Mrs. Yellen's bias in her Jackson Hole speech
- We expect a resumption of the cautious rate hike cycle in December 2016 – market participants increasingly share this view
- Since beginning of July, 10-year yields climbed by 20 basis points

Euro Area

- The ECB's purchase programme of corporate bonds has yet again lowered financing cost for companies dramatically
- The weight of the ECB in the market will keep rates low – we do not see a pertinent reason why yields should go higher over the next four weeks

Japan

- As the Bank of Japan eased monetary policy less than expected end of July, long-term rates increased notably
- 10-year rates jumped by about 20 basis points right after the announcement and held the level ever since

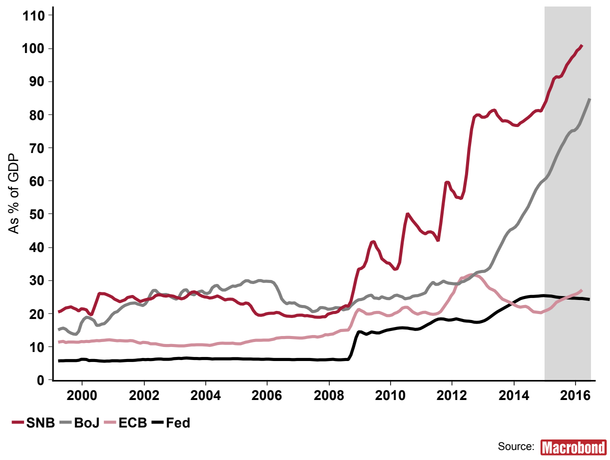
United Kingdom

- 10-year Gilts are still around 80bp lower than before the Brexit vote in June
- Survey data confirm a pronounced slowing of economic momentum
- Financial conditions have partly done the job of the BoE by easing substantially – it remains to be seen if the BoE eases another time this year

Switzerland

- We expect the SNB to leave the target range for the 3-month Libor unchanged for an extended period
- Due to continued FX intervention, the size of the SNB's balance sheet surpasses 100% of GDP

Size of central banks' balance sheet: SNB well ahead



As we are writing this document, central bankers from around the world are gathering in Jackson Hole in Wyoming to discuss the most pertinent issues as regards economics and the monetary policy framework. The Fed chairwoman's speech in particular will be drawing a lot of attention, not least by the investment community. Low productivity growth in the developed world and its implication for the neutral level of rates feature prominently on the agenda. More recently, a couple of Fed representatives have struck a rather hawkish tone regarding the need to normalise interest rates further. It remains to be seen if Janet Yellen will take up that lead. We stick to our view that the second rate hike in this cycle is due in December 2016, followed by a very moderate normalisation path. The ECB's next meeting in early September with a new set of ECB staff projections could provide the rationale for an extension of its asset purchase programme beyond March 2017. We expect the extension and have consequently incorporated this into our long-term economic scenarios. Furthermore, the Bank of Japan's thorough policy assessment in September is expected with a certain degree of scepticism as regards remaining options to add stimulus. In terms of inflation, the often cited base effect is about to kick in over coming months and will thus push headline inflation readings closer to central banks' targets until end of this year. In our view, markets will hardly be impressed. Notwithstanding, inflation expectations hover on extremely low levels. As central banks are buying huge amounts of long-dated bonds, yields remain depressed and will hardly have a chance to move higher in the short term.

Stock markets

Ultra-low stock market volatility

USA

- The air seems to get thin for the S&P500 index after having reached a new all-time high by mid August
- In international comparison, the US stock market is holding up well as financial conditions remain extremely favourable
- Stock market volatility measures are at extremely low levels, we expect this to change

Euro Area

- The EuroStoxx 50 is still lagging its peers in the post-Brexit recovery
- European indices are facing the unique obstacle of ongoing tension in the banking sector
- Political risks equally remain a burden on stock performance in Europe with next year's elections in France and Germany starting to make headlines

Japan

- All eyes on decision makers expected to prepare a monetary and fiscal package
- Markets anticipate a greater deal of new measures to be announced by the Bank of Japan in September than what we would expect
- On the positive side, we notice a modest improvement in cyclical economic indicators

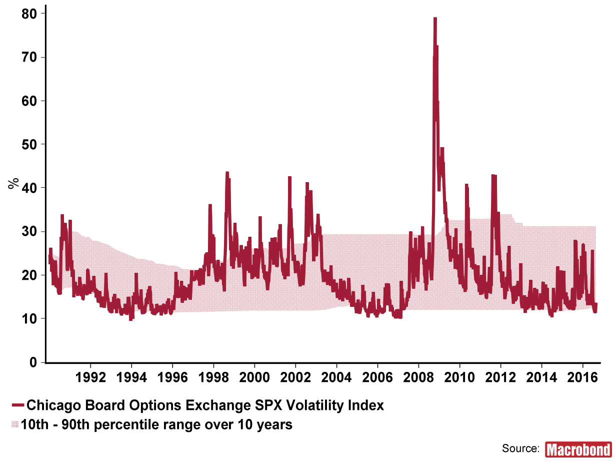
United Kingdom

- The FTSE 100 continues to outperform its peers – the index gained almost 11% since the Brexit vote
- As long as the Pound does not appreciate, financial conditions are sufficiently loose for corporate UK
- To cope with Brexit, fiscal policy measures would probably be more efficient for British firms than further monetary stimulus

Switzerland

- Price-earnings ratio is clearly above its 20-year average – equities are expensive in historical comparison
- As volatility is set to increase with investors focussing on inflation rates and monetary policy action in the US, we believe that Switzerland's stock market is ready for a mild correction until year end

Volatility at ultra-low levels



Like last month, our fundamental analysis and the quantitative models used as input for our short-term asset allocation decisions are sending out diverging messages. From a fundamental viewpoint, we think that financial markets are underestimating the upward move in headline inflation rates as well as the probability of monetary policy normalisation by the US central bank. As we expect these developments to make headlines until the end of the year, we think that the currently low stock market volatility will not prove sustainable. In contrast to implied market expectations, we still anticipate a rate hike by the Fed as early as in December this year. As regards additional market support from other central banks, we see risks that the ECB and the Bank of Japan will disappoint market expectations. Stretched valuations pose an additional risk to equity markets in case that third quarter corporate earnings would disappoint investors: While equities are attractive relative to bonds in a negative interest rates environment, price/earnings ratios suggest that equities are expensive in historic comparison. Additional risk factors for the short-term outlook are increased political tensions ahead of the US presidential election and autumn's seasonal pattern, which tends to be negative for stock markets. Our forward-looking fundamental assessment is based on probabilities attributed to any of the above-mentioned risks in the near future. In contrast to our prudent stance on equity markets' potential, our quantitative models based on past economic data and market trends are currently more constructive. This holds true for models based on recent macroeconomic trends as well as trend-following indicators and risk-parity models.

Currencies

Monetary policy divergence as the main driver

USA

- The weak GDP print for Q2 caused the USD to get under selling pressure – the Greenback depreciated against all major currencies (with the exception of GBP) over the past 4 weeks
- The future path of Fed policy is being questioned – the Jackson Hole summit may clarify the stance
- As we expect a rate hike in December, we expect a stronger Greenback until the end of this year

Euro Area

- Relative economic data surprises have been positive for EUR against USD lately – however the market shows little appetite to bet on a stronger EUR
- EU break-up fears have receded enabling the EUR to appreciate on a trade-weighted basis since 23 June

Japan

- After yet another strong upmove of the Yen end of July, its external value was mostly moving sideways on a trade-weighted basis in August
- Economic data continue to largely disappoint and put the BoJ under pressure to act

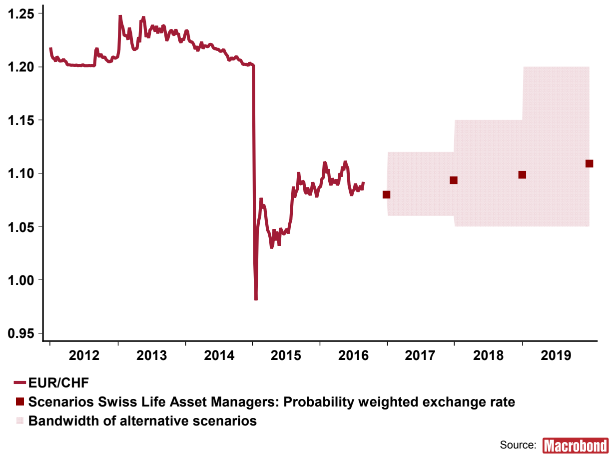
United Kingdom

- Even though some hard economic data surprised to the upside after the EU referendum, we expect the BoE to keep its accommodative stance
- The Pound actually managed to appreciate slightly since the low reached on 15 August
- Structural weakness in UK's large current account deficit and declining growth momentum will cause the GBP to depreciate further in our view

Switzerland

- Receding contagion fears and improving risk sentiment should support EUR/CHF at current levels
- Even with the SNB intervening in the FX market, we see little prospect for a weaker CHF without a change in the macro environment

Medium term scenarios for EUR/CHF exchange rate



The receding contagion fears of a post-Brexit EU breakup and improving risk sentiment among global investors supports the EUR/CHF exchange rate at current levels. However, the fact that the Swiss National Bank is continuously intervening in the market indicates that there is little room for the Swiss Franc to weaken in the medium term. The chart above illustrates our alternative scenarios for EUR/CHF over the next three years and the resulting probability weighted path. More globally, we expect a rebound of the US Dollar over the coming months. Most recently, Fed representatives sounded more hawkish hinting at a rising likelihood of a rate hike already in December. Financial markets still need to price in such an early step towards monetary policy normalisation. Monetary policy divergence is the major factor in our assessment that the Dollar is set to appreciate versus Euro, Japanese Yen and Sterling. As we expect US GDP growth dynamics to improve in the second half this year, the growth differential between the US and the Euro Area should become a driver for a strengthening of the Greenback against the Euro. Additional monetary and fiscal stimulus announced by Japanese authorities in the course of next month should result in a weakening of the Yen. The Bank of England has any incentive to tolerate a weak currency and even a temporary overshooting of its inflation target because of rising import prices. The structural weakness in the United Kingdom's current account deficit and its dependency on external financing should be a drag for the British Pound.