Outlook for Financial Markets
October 2017

SwissLife
Asset Managers

Interest rates/Bond markets

A further step towards normalisation

USA

- After having touched a new low for 2017 at 2.04% in early September, 10-year yields have risen roughly 30 basis points until the end of the month
- Recent rise of yields was driven by firmer inflation numbers and more hawkish central bank communication
- The Fed has confirmed to start to reduce its balance sheet in October and to intend to hike in December – it was no surprise for us, yet markets had to reprice their expectations

Eurozone

- We expect the ECB to announce in October to further decrease its asset purchases in 2018
- ECB announces one reduction of asset purchases at a time rather than the full schedule of how to stabilise the balance sheet – ECB keeps higher flexibility to adapt in case the environment changes

Japan

- In early September, 10-year yields of government bonds turned negative for the first time in 2017 – followed by a bounce back to 0.06% at the end of the month
- Although Japan is particularly exposed to risks stemming from North Korea its government bonds serve as a safe haven during times of market concern

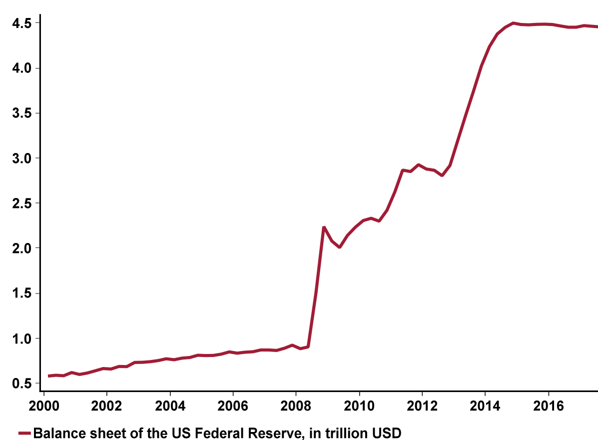
United Kingdom

- Bank of England turned more hawkish as inflation numbers came in higher than expected
- We do not expect a proper rate hiking cycle but rather think that a one-off hike correcting the emergency cut in mid-2016 is more likely

Switzerland

- 10-year government yields in Switzerland followed the moves in the US and Eurozone
- 10-year yields are approaching the zero line – we expect the year to close slightly positive

The Fed starts to reduce its balance sheet



October 2017 will mark a seminal turning point for monetary policy. The Fed will start to reduce its balance sheet. That is the unwinding of quantitative easing measures taken after the financial crisis. Overall, the asset purchase programme is characterised by four phases: The first step is the build-up of the balance sheet. It has risen from roughly 1 trillion USD in 2008 to roughly 4.5 trillion USD in late 2014. The second step is called tapering. During the year 2014, the Fed has reduced the amount of net purchases. During that episode, the balance sheet still increases, yet at a slower pace. In a third phase, the amount of assets is stable. From late 2014 until late 2017 there were no net asset purchases. The fourth step is the reduction of the balance sheet. During that phase, some maturing bonds are not reinvested. As a consequence, the size of the balance sheet falls. We are about to enter this last phase. The Fed has communicated the schedule of the reduction of its balance sheet. It starts in October 2017. Initially assets are reduced by 10 billion per month. The pace will increase to 50 billion per month until late 2018. As a consequence, liquidity becomes less abundant at the margin. At the same time, the Fed confirmed its intention to continue its gradual hiking cycle. We expect one more rate hike in December 2017 and three hikes in 2018. As both, the reduction of the balance sheet and the hiking cycle are gradual and well anticipated, we do not expect them to push interest rates up sharply. In our view, long-term rates in the US will rise moderately until year-end. Rates in the Eurozone and Switzerland should follow the ones in the US.

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Stock markets

Risk appetite remains firm despite political concerns

USA

- Expected earnings per share continue to appear solid also into 2018
- Monetary conditions remain favourable but are expected to tighten at the margin
- Gradually slowing global growth dynamics, political tensions and monetary policy normalisation should weigh on stock markets until end of year

Eurozone

- First indicators from the corporate sector suggest that economic momentum has peaked at the start of the third quarter
- Strong Euro weighs on exporters, but financials are supported by rising interest rates
- German election result adds to political uncertainties and puts question mark behind joint Franco-German push to reform the EU

Japan

- Economic recovery is increasingly broad based and lending activity picks up
- Nikkei was one of the best performing indices over the last month despite North Korean missile tests
- Politics remain the elephant in the room, but snap election should not move Japan's stock market in our view

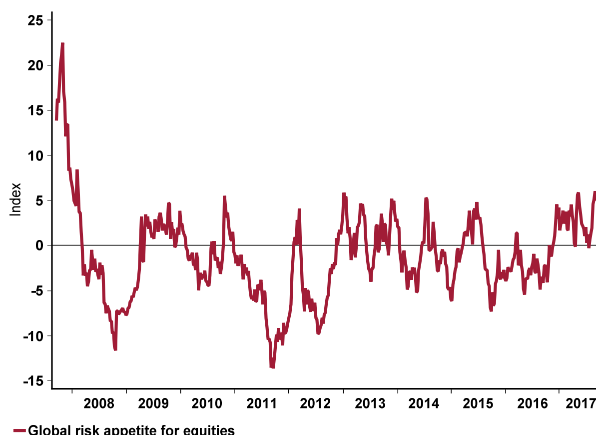
United Kingdom

- UK stocks were the relative underperformer over the past month as best effects of weaker currency should by now be priced into equity valuations
- Political uncertainties around Brexit have not eased since the summer break and risk of another snap election in 2018 remains noteworthy

Switzerland

- Combined effect of most pronounced depreciation of Swiss Franc since 1996 and gradual rate increase should benefit Swiss exporters and financials
- If Swiss stock market indices can hold current levels or even rise slightly further until year-end, 2017 would end as the best year for Swiss equity investors since 2014

Investors' risk appetite remains elevated



We anticipate the first synchronous global upswing since 2009 to continue at a slower pace and the support from monetary policy to fade gradually going forward. In our view, quantitative easing was a major reason for the stunning rally of risky assets over the last years. After the French election earlier this year, financial markets have priced out political risks as regards a potential break-up of the Eurozone. Yet in our view, political uncertainty has risen again after elections in Germany and the call for snap elections in Japan, notwithstanding the tensions with North Korea. Thus, the analysis of fundamental developments including elevated equity valuations and future earnings growth dynamics recommend a rather prudent stance on risky assets going forward. Meanwhile, quantitative approaches such as risk parity and trend following models continue to send out bullish signals for equities and recommend an overweight in this asset class. Is the glass half full or half empty? Admittedly, staying on the side-lines never paid off in past years. Assessing the market potential until the end of the year, we thus believe that economic growth and valuation of equities relative to fixed income assets remain attractive enough to expect continued inflows and reinvestments into the stock market. We expect equity markets to trend sideways or slightly higher over the next three months. A transition period for financial markets with slowing growth dynamics and less monetary stimulus in sight warrants a defensive tactical positioning. At this stage of the cycle we employ risk controlled equity investment solutions and look for opportunities in regions or sectors which were latecomers in the global economic upswing.

Currencies

German election surprise keeps EUR in check

USA

- A convergence of interest rate market pricing towards the Fed rate path (dot plot) should allow the USD to appreciate
- The Fed's balance sheet normalisation will commence in October, as the Fed is willing to look through the weak inflation prints – a hike in December will support USD
- US political uncertainty persists even with a new tax reform plan and this continues to weigh on the Greenback

Eurozone

- The undervaluation of the EUR has been corrected to a large extent by now and the EUR is closer to fair value
- After the election in Germany, a German/French-led coalition for Eurozone reform looks more difficult and limits further appreciation of the EUR
- ECB must be worried that strong EUR becomes a headwind for financial conditions and inflation

Japan

- Prime Minister Abe calls a snap election which should increase his position and hence cement the BoJ's dovish stance
- Given renewed central bank divergence, we see no room for the Yen to appreciate from here

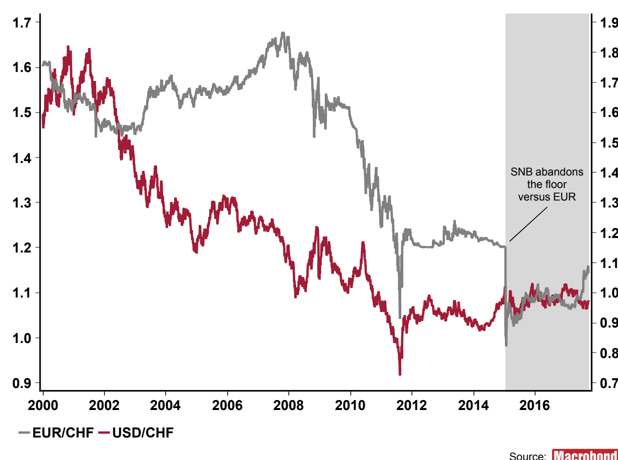
United Kingdom

- Stronger than expected inflation triggered a hawkish shift by the BoE – GBP outperformed against USD and CHF
- Yet, fruitless Brexit negotiations remain a burden for GBP

Switzerland

- As risk reversion receded, CHF depreciated significantly to levels not seen since the removal of the floor
- We expect the SNB to remain relatively dovish

Relief for the Swiss Franc



Four consecutive weak inflation prints led market participants increasingly doubt the communicated rate path by the Fed. Therefore the USD lost around 5% of its value on a trade-weighted basis. The slide was only stopped after the latest positive surprise for inflation for the month of August and a more hawkish Fed communication at its September meeting. The US central bank will start shrinking its balance sheet in October. We expect that a convergence of interest rate market pricing on the one hand and the target rate path as put forward by the Fed, the so-called dot plot, on the other hand, should allow the USD to appreciate. At the same time, however, one needs to stress that ongoing political uncertainty in the US as regards tax reform or debt limit discussions could prove to be a renewed burden for the Greenback. Meanwhile in Europe, the results of the German election put a halt to EUR appreciation. Prior to the election, the EUR had outperformed against most other main currencies. This move was supported by large reallocation flows into EUR, visible in record high speculative long positions. Yet, the election outcome diminished the positive outlook for a French/German-led Eurozone reform and hence puts a cap on EUR appreciation going forward. Furthermore, the Euro still needs to take the hurdle of upcoming elections in Italy in 2018, where we see a non-negligible risk that populist and thus Euro-averse parties may succeed in gaining government participation. For the time being, we consider the EUR appreciation to have come to a halt.

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