Outlook for Financial Markets
November 2016

Interest rates/Bond markets
Global rebound in yields

USA

- Futures markets increasingly price a hike by the Fed in December given the rise in inflation and inflation expectations
- Mrs Yellen in her latest speech however stressed the advantages of letting the economy move to a "high pressure" state
- In fact, according to our own forecast, headline inflation will surpass 2% by January 2017, for the first time since spring 2014

Euro Area

- The ECB's Governing Council postponed the decision on changes to the QE programme to December of this year when updated economic forecasts will be available
- However, rumours that QE tapering was discussed within the ECB helped to lift rates

Japan

- The Bank of Japan went yet another step further – they aim to control the entire yield curve and to keep long-term rates below or close to zero in order to generate above 2% inflation
- Over the past month, Japanese yields have risen the least of all markets commented in this paper

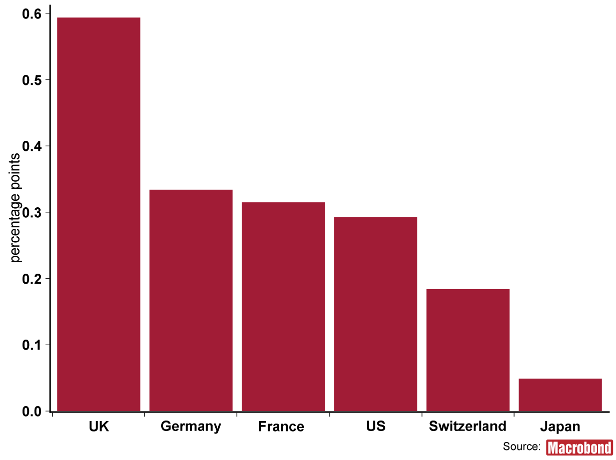
United Kingdom

- Financial conditions have loosened so much on the back of the weaker Pound that the Bank of England hardly needs to cut the target rate any further
- The 10-year yield rose by almost 55 basis points over the last four weeks, boosted also by the strong Q3 GDP report

Switzerland

- Despite a fairly strong rise in rates over the past month, the 10-year yield remains firmly grounded in negative territory
- Inflation will only slightly move above the zero line next year

Change in 10-year yields over the past month



Given the strong trend of sovereign yields to the downside yet again since the beginning of the year, the latest rebound looks respectable (see chart above). Several common reasons can be listed for the increase: 1. The increase of commodity prices specifically of crude oil which renders the base effect on headline inflation even more powerful (our faithful readers were forewarned on the base effect in previous issues of this paper); 2. The ensuing rise in inflation expectations; 3. The pricing in of a Fed hike in futures markets for December 2016; and 4. Tapering rumours related to the ECB. As regards the impressive rally of interest rates in the UK, the formerly mentioned drivers were accompanied by continuous macroeconomic surprises to the upside with the latest being the GDP growth rate for the third quarter - and thus post-Brexit - which surpassed common expectations. Quarterly growth reached 0.5%, which compares to a consensus expectation of 0.3%. We consider the latest increase in yields as somewhat overdone and expect a slight correction to the downside over the next four weeks within an otherwise rising trend however. The correction would be more technical in nature. We remain constructive for a further tightening of corporate bonds. Although issuance is fairly strong, it is met by firm demand. Furthermore, the end of the earnings recession serves as a support to the credit market and default rates are actually declining. Finally, continued purchases by the ECB is a positive factor for the European market.

Stock markets

Short-term positive but hurdles ahead

USA

- The resumption of the Fed hiking path in December has been priced in to a large degree - equity markets are not terribly impressed by this
- With the current earnings season for Q3 ongoing, one can call the end of the earnings recession
- Yet, valuations are stretched and corporate margins peaked six months ago

Euro Area

- The ongoing Q3 earnings season tops expectations – but earnings expectations for next year look too demanding
- The seasonal pattern signals support for stock markets – the blackout period will end soon and companies tend to buy back most shares in the last quarter of the year

Japan

- The Nikkei climbed throughout the month of October
- Corporate inflation expectations continue to slide suggesting that the BoJ's efforts have done little to erase pessimism on future price developments
- Over past years, Japanese companies have increasingly moved production abroad such that a strong Yen has a smaller impact than before

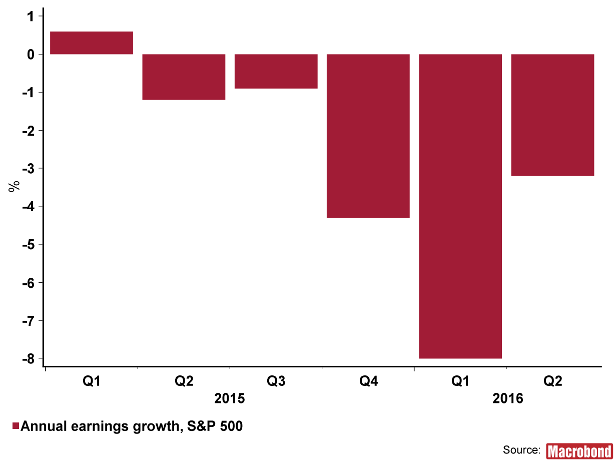
United Kingdom

- The trade-weighted Pound has finally stabilised somewhat during the month of October – as long as the Pound does not appreciate, financial conditions are sufficiently loose for corporate UK
- Fiscal easing may well be expected to dampen the effects of the Brexit vote and could stem the potential tide of relocation of companies

Switzerland

- As elsewhere, we think that the Swiss market may yield a mild positive return over the coming four weeks – however in the longer term, valuations look stretched
- Many companies are still looking into relocating their activities abroad

Has the US earnings recession ended?



The third quarter 2016 could mark a turning point: It is likely that the earnings recession of the US corporate sector comes to an end. The fall of commodity prices has substantially weighed on earnings of the US commodity producing sector. This impact is fading out and earnings are recovering. Yet, analysts' expectations for earnings in 2017 are too optimistic in our view. They are likely to be downgraded in the next months. For the coming weeks we have a slightly positive view on equity markets. The turning point in the earnings season as described above should give some support. Moreover, the seasonality after the earnings season of the third quarter is usually favourable. After the so called blackout period firms are again allowed to buy their own shares. Towards year-end this effect is usually even stronger than in other quarters. Until year-end, there are four important events for stock markets: First, US elections. Our base case still is a Clinton victory. After the recent events, this probability has clearly increased. Should Donald Trump win the election, we expect a drop of equity markets. As we do not believe that Donald Trump can implement his campaign pledges, we think that stock markets would recover from the initial drop. Second, the Italian referendum is a critical event. If Matteo Renzi loses this vote, this could substantially spur Euro Area breakup fears. Third, on 8 December the ECB needs to inform about the asset purchase programme. The programme is planned to end by March 2017. In our view, the ECB will prolong it for at least half a year. Finally, we expect the US Fed to hike rates again on 14 December. This is mostly priced in. We believe the Fed will emphasize the cycle to be moderate. Therefore, this rate hike should not hit equity markets.

Currencies

The resurgence of the US Dollar

USA

- The USD appreciated substantially against all other currencies discussed in this paper
- The USD strength was driven by Fed expectations, macro data and easing uncertainty about US elections
- Given the recent USD strength, we see some potential for a technical correction

Euro Area

- EUR/USD fell clearly below 1.10
- The fall of EUR/USD was mostly driven by USD strength, however, political uncertainty around Brexit negotiations and the Italian referendum might soon weigh somewhat on EUR
- We see EUR/USD in neutral territory for coming weeks as we are already on a low level

Japan

- Since July, there is no trend anymore for JPY/USD – the cross has broadly been moving sideways
- After the recent depreciation of the JPY against USD, we see JPY/USD in neutral territory
- A somewhat weaker USD due to a technical correction could be outweighed by some accommodation of the Bank of Japan

United Kingdom

- After its large correction, GBP/USD should have bottomed out
- We do not expect the Bank of England to ease monetary policy on 3 November as financial conditions are still very loose and the economy has not yet suffered a lot

Switzerland

- The CHF, too, has depreciated against the USD, CHF/USD is approaching parity
- We do not see EUR/CHF to break out of the 1.08-1.10 trading range, SNB will continue to intervene

Did the US Dollar go too far?

The Greenback appreciated substantially and steadily during the month of October. Moreover, the appreciation was broad-based: The Dollar strengthened by 3% on a trade-weighted basis since the beginning of the month. There are two main drivers: First, financial markets have further priced in a hike of the US Fed in December 2016. According to futures prices, there is a 73% probability of a December Fed hike. Back in September, this probability lay between 50% and 60%. This change in expectations of financial market participants was driven by speeches of several Fed members. Second, macroeconomic data, such as the PMI, have improved compared to September. The strengthening of the US Dollar had a clear impact on Chinese policy making. The Chinese central bank steers the value of the Yuan primarily against the US Dollar. The central bank allowed the Yuan to depreciate against the USD in order to avoid a broad-based appreciation together with the USD. On a trade-weighted basis, the Yuan has been moving sideways since July. Yet, from November 2015 until June 2016, the Chinese currency depreciated by 7% on a trade-weighted basis. Thus, the recent moves underline the general depreciation trend of the Renminbi. The other major event at FX markets was the fall of the British Pound. The trade-weighted Pound depreciated by 4% since the beginning of the month. This weakening was driven by politics. We believe that the Pound has stabilised and we see a neutral GBP/USD for the next few weeks. However, we think that the USD rally has gone quite far. We therefore see the risk of a technical correction.