Outlook for Financial Markets
December 2016

Interest rates/Bond markets
Some steps further to go in yield normalisation trade

USA
- Investors took the election result as catalyst to jump on the inflation cycle
- A Fed rate hike in December is now priced in, but markets are not yet fully prepared for the two additional steps we expect through 2017
- With inflation moving above 2.5% in the first half of 2017, we believe that 10-year Treasury yields are left with some more upside potential until next spring

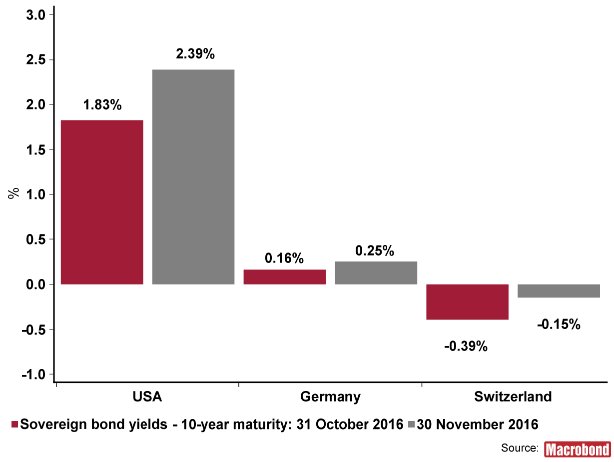
Euro Area
- Interest rates in Europe turned already before the US election, pushing 10-year German Bund yields back above the zero line
- While this normalisation in yields makes sense the more it gets clear that deflation scare was overdone, political risks in the Euro Area remain plentiful

Japan
- Recently, inflation and economic growth surprised to the upside taking some pressure away from the Bank of Japan to add more monetary stimulus
- Yet, in the global bond market sell-off during the past month, the Bank of Japan fulfilled its promise to progressively purchase sovereign debt

United Kingdom
- Financial conditions have tightened as 10-year bond yields rose by 30 basis points through November and the Sterling recovered against the Euro
- Yet, given the solid economic dynamics we think that the BOE wants to keep its powder dry for more difficult times during Brexit negotiations

Switzerland
- Judging by forward rates, market participants expect 10-year sovereign bond yields to return into positive territory by the second half next year
- With political risks in Europe in mind and given the inflation rate near zero, we rather expect the negative yield environment to persist throughout 2017

November 2016 the worst month for US treasuries since 2009



Looking at market moves since the US election, one could conclude that President-elect Donald Trump's ideas are a game changer for financial markets and the global economic outlook. Yet, our interpretation is slightly different: Typically, markets dislike uncertainty. The election result with both a Republican president in charge and Congress in the hands of the same party removed parts of the uncertainty about the future shape of fiscal policy in the US. Investors used the opportunity to give up earlier recession fears. Suddenly, markets inflation expectations were brought in alignment to the reality of an inflation cycle, which was already under way without any further help from Donald Trump. Incoming economic data confirm our view that the world economy has entered a period of a synchronous global upswing. Sovereign bond yields surged in all major economies, with the exception of Japan, where the central bank is actively purchasing bonds in order to prevent yields from moving higher. In the US, November was the worst month for the Treasury market since 2009. Although we think that headline inflation rates peak by mid next year, we see some further upside for bond yields in the weeks ahead. In our view, markets have not yet fully priced in the three rate hikes by the US central bank from today until end of 2017, which we continue to expect. Emerging markets are exposed to the risk of a more protectionist stance by the US government and the strengthening of the US Dollar. We therefore expect a further widening of emerging market sovereign bond yield spreads.

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Stock markets

Upbeat reaction to Trump election

USA

- The victory of Donald Trump unexpectedly boosted stock market performance and lifted the S&P 500 to an all time high
- In line with growth optimism and rising inflation expectations, investors bet on corporate tax cuts and a corporate income repatriation programme at a reduced tax rate
- If earnings are repatriated, this may lead to share buybacks, takeovers and higher dividend payments

Euro Area

- The improving global economic cycle and a weaker EUR should give tailwind to corporate earnings
- European markets remain under the spell of various political risks which may cause higher volatility going forward
- The elevated equity risk premium underlines the ongoing attractivenesss of stocks

Japan

- Further weakening of the Yen on a trade-weighted basis helped the Nikkei to climb higher over the past four weeks
- The corporate survey of the Ministry of Finance revealed the first rise in sales in seven quarters in Q3 2016 – profit growth remains tepid however

United Kingdom

- With the pronounced depreciation of the Pound, a broad range of sectors is confronted with rising cost pressures – the manufacturing PMI starts to reflect a weaker outlook for corporate margins
- Manufacturing companies are confronted with a rise of input prices of more than 12% from the previous year

Switzerland

- Swiss equity indices this year performed only slightly better than their Euro Area counterparts
- The SPI actually closed the month of November at a similar level as at the start of that month – the same can be said about the EuroStoxx 50 – Trump's tax plans may actually hurt European values

The S&P 500 reached a new all-time high

Who would have guessed that the S&P 500 reaches a new all-time high right after the surprise victory of Donald Trump. We are surprised too. One can identify three main drivers for this move: First, investor sentiment did generally not suffer after the election. Quite the contrary, many asset classes reacted positively to Donald Trump's victory. Second, in the speeches after the election, Donald Trump sounded clearly less extreme than during the campaign. Moreover, the checks and balances and well-functioning institutions in the US will "tame" some of the plans of the President-elect. Third, Donald Trump plans tax cuts as well as tax repatriation holidays for US firms. If these modifications of the tax system will be implemented they will work as a game-changer for US stock markets. Tax cuts would clearly support earnings of US corporates. This could fire expectations, or hopes, in particular after a longer period of an earnings recession. The earnings recession ended, as discussed in this paper, in the third quarter of 2016. A tax repatriation holiday is easier to implement since it does not weigh on the fiscal budget. During such a holiday, multinational firms can bring money, which they earned in other countries, back to the US at a reduced tax rate. Back in 2004, the US administration offered this opportunity to its firms as well. Companies repatriated a lot of cash and used it for share buyback programmes. This in turn supported US equity markets. We are generally positive for US stocks over the coming months as we believe that expectations regarding such tax changes will continue. In the very short-term, we would however not be surprised to see some setbacks as the sentiment turned overly bullish in our view.

Currencies

Diverging monetary policies back in the spotlight

USA

- Reflation expectations after Donald Trump's victory have fired expectations regarding growth, inflation and rate hikes in the US
- The USD appreciated substantially on a broad-based basis
- The repricing of Fed hikes in 2017 should support the Dollar further – in particular, as the ECB and BoJ remain very accommodative

Euro Area

- EUR lost 3.5% against USD since US elections
- EUR/USD fell shortly below 1.06 – this has not happened since late 2015
- November is the first month of this year, where EUR/USD is clearly below 1.08
- We expect EUR/USD to fall in coming weeks due to diverging monetary policies and political risks in the Euro Area

Japan

- Yen lost 7% against USD since US elections
- This was the first clear downward move of JPY/USD in this year
- Diverging central bank policies should drive JPY/USD even lower in coming weeks

United Kingdom

- GBP/USD barely moved during the month of November
- BoE is not under pressure to ease policy further as economic data are still solid
- We see downside potential for GBP/USD as uncertainty around Brexit negotiations remain

Switzerland

- The SNB had to intervene heavily in FX markets to prevent too much of an appreciation of the CHF
- EUR/CHF was close to 1.07, the lowest level since September 2015
- USD/CHF is back above parity

The US Dollar takes off

Reflation of the US economy was also the key theme for FX markets in November. After the victory of Donald Trump the US Dollar appreciated by roughly 4% on a trade-weighted basis. There were two main drivers for this strength: First, higher expectations regarding growth and inflation in the US. In other words, anticipation of a so-called reflation. Second, resurgence of diverging monetary policies between the US and other major central banks. There has been a repricing in financial markets with respect to Fed hikes. A normalisation of US monetary policy is now expected. As central banks in the Euro Area and Japan are still very accommodative, there is a divergence in monetary policy, which pushes the Dollar to the upside. We believe that the theme of diverging monetary policies will remain over the next few months. Therefore, we expect further appreciation of the US Dollar. Yet, we believe the pace of appreciation to be much slower than in the month of November. Moreover, there are several risks to this forecast: After this major move, a technical correction could occur. As expectations are high, economic data, policy announcements and indications of the central bank need to be supportive in order to push the US Dollar further. This renewed and rapid appreciation of the Dollar implied a weakness for emerging markets currencies. Higher US long-term yields and a stronger Dollar typically create difficulties for emerging markets with imbalances. The large current account deficits in Turkey, South Africa and Colombia have pressured the respective currencies for instance.