Outlook for Financial Markets
December 2017

Interest rates/Bond markets

The art of exiting QE

USA

- The 5th policy rate hike in this cycle, which will be the 3rd increase this year, is fully priced by the futures market for December 2017 – w estick to our view of 3 more hikes in 2018
- The balance sheet reduction of the Fed is likely to exert upward pressure on the yield curve
- The yield curve has flattened a lot and may flatten even further in 2018

Eurozone

- Given the robust growth environment, quantitative easing looks increasingly out of place – the ECB will start to curb asset purchases in January 2018
- Even though inflation momentum remains low, current yield levels on sovereign bonds do not reflect the economic outlook
- We expect yields in the Eurozone to follow those in the US and increase over the next 4 months

Japan

- Optimism for the Japanese economy has risen notably over past weeks – we remain more cautious than the consensus as regards the economy's ability to create inflationary pressure
- The 10-year yield on government bonds has been below 1% since the beginning of 2012 and remains anchored close to 0% since many months now

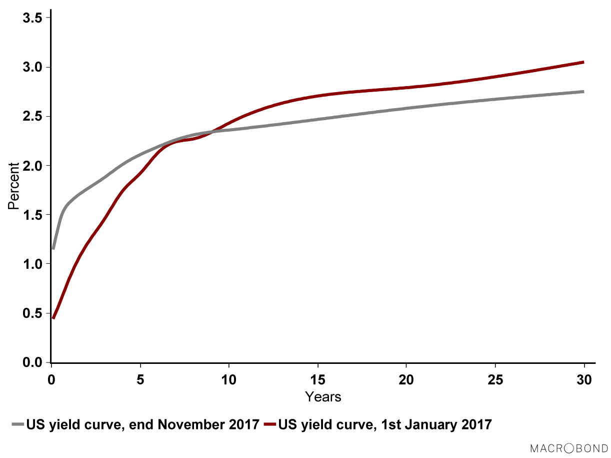
United Kingdom

- The budget underlined the readiness to use fiscal policy as an offset for Brexit-related headwinds
- As the Chancellor seems ready to loosen the fiscal stance, increased supply of Gilts is to be expected

Switzerland

- Except for brief periods in March and July of this year, the 10-year sovereign rate hovered in negative territory
- Long-term yields are to rise only modestly

Flattening of the US yield curve mainly driven by short rates



Now that the global cyclical upswing has asserted itself, the value of ultra-loose monetary policy at this stage of the cycle is increasingly questioned among analysts, academics and even by certain central bankers. Arguably, negative rates are part of the explanation why developed economies are plagued by low productivity rates. The argument is that negative rates distort allocation decisions by entrepreneurs. Investment decisions are thus based on ultra-low rates and easy money has flown into projects, which would not be viable otherwise. Quantitative easing, ultimately designed to fight deflation and push economic growth, thus depresses productivity and may have created its own long-term growth slowdown. Over past weeks, Bank of Japan governor Kuroda repeatedly mentioned the "reversal rate" which is the point where accommodative monetary policy does more harm than good. He was interpreted to imply that the Bank of Japan too would join others edging away from crisis-mode stimulus. However, the Bank of Japan is far from reaching their target of 2% inflation, as is the ECB in fact. In the US, where another policy rate hike in December 2017 is fully priced into futures markets, certain leading indicators point to rising underlying inflationary pressures. We thus stick to our expectation of three more hikes to come next year. The yield curve, which has flattened substantially may yet flatten further driven by the short end of the curve. This is an expression mainly of the sound economic growth environment. We do not rate that flattening of the curve as a sign of an impending recession any time soon. We expect long rates to move higher too over the coming four months.

Stock markets

US tax reform progress acknowledged by markets

USA

- For the coming year, earnings growth is again expected to settle in double-digit territory – earnings revisions have been positive as well
- The upcoming tax reform package and its positive impact on corporate profits is not yet fully incorporated in analysts' expectations
- Sentiment indices among investors do not indicate euphoria which would be a worrying sign

Eurozone

- Relative valuation as compared to risk-free assets still looks very attractive and even more so than for US stocks
- Strong Euro has not left any traces in business sentiment at all – on the contrary, entrepreneurs seem very optimistic regarding future business

Japan

- On the back of heightened economic optimism, the Nikkei outperformed other major indices since the beginning of the current quarter
- The Japanese economy and export-oriented companies above all benefit from the global upswing

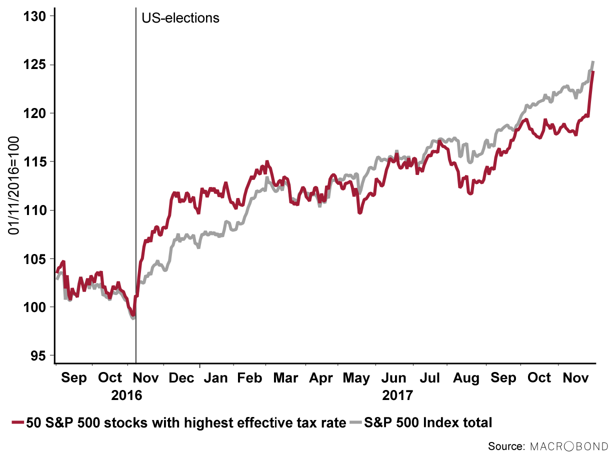
United Kingdom

- Political uncertainties around Brexit persist and the European summit of Heads of States mid-December marks an important date for negotiations to move forward
- Unsurprisingly, the FTSE100 is the underperformer of this year

Switzerland

- Pronounced depreciation of Swiss Franc and gradual rate increase should benefit Swiss exporters and financials
- The Swiss economy finally participates in the global upswing, impressively illustrated by strong GDP growth in Q3 of this year and upward revisions to prior quarters

Tax reform progress seems to convince recently again



The momentum of equity markets was very strong in 2017. The macroeconomic environment was robust with a synchronised upswing in the developed and emerging countries. Earnings were strong, interest rates in the US and Europe remained low and the stimulus from monetary policy was large. Investors wonder whether the positive price momentum of 2017 will continue next year. We have a positive view for the first quarter of 2018. The supportive global growth momentum will continue into early 2018. Earnings growth forecasts are in double-digit territory. Seasonality is typically strong in December, January and February. We expect only a gradual rise of long-term interest rates. In such an environment, the "buy the dip mentality" should continue. Thus, whenever equity markets correct, investors re-enter the market as valuations become attractive. Many investors ask themselves whether equity markets can continue to climb higher given the current valuations. On an absolute level, valuations are expensive in the US. Yet, asset allocation is a relative decision across asset classes. On a relative basis, equity markets remain attractive. What are the risks to our positive call? Quantitative easing has been a powerful support in the past. Its reduction in the US and the Eurozone (at least at the margin) have not left traces so far. If the sentiment would reach exaggerated levels, this would be a warning signal for us. So far, this has not happened. Politics remain of course a risk, for both sides of the Atlantic. In recent days, the expectations regarding a US tax reform have increased. This is also reflected in stock prices. The share price of companies with a high effective tax rate has spiked in expectation of a reduction of the corporate tax rate.

Currencies

EUR/CHF above 1.17

USA

- Core inflation in the US increased after many months with disappointing momentum
- Jerome Powell has been confirmed as the new Fed chair – he stands for policy continuity and thus did not materially change the expectations regarding the pace of the hiking cycle
- We turned more cautious regarding the USD given the stronger economic environment in the Eurozone

Eurozone

- Core inflation has disappointed once again and remains below 1%
- EUR strongly gained against USD, yet without reaching 1.20
- Italian elections are not yet in the focus of investors, this will change heading into the new year – Eurosceptic parties, such as Cinque Stelle, account for 46% of the votes in the polls

Japan

- We turn neutral on the outlook for JPY/USD given the improving economic environment and particularly as the Yen remains significantly undervalued
- The BoJ remains the most accommodative central bank among the ones discussed here

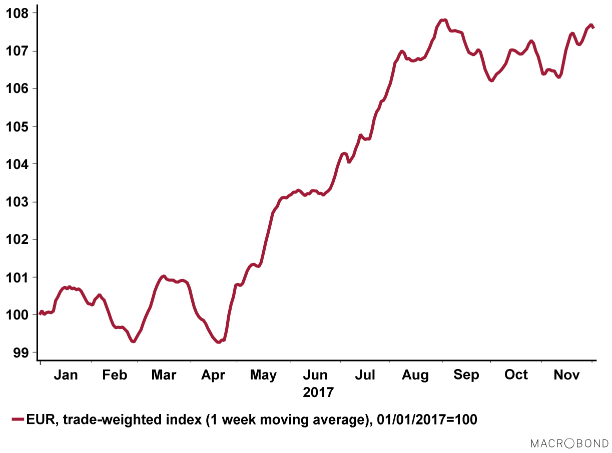
United Kingdom

- As expected, the BoE delivered the rate hike which corrected the emergency cut shortly after the Brexit vote
- Headline inflation has reached the peak at 3.0% in October according to our forecast path

Switzerland

- Swiss Franc overvaluation continued to correct towards fair levels
- We expect the EUR/CHF to be able to remain above 1.17 over the next weeks – Italian elections are the risk factor

Euro strength despite German elections



For foreign exchange markets, the year 2017 was marked by a strengthening of the Euro. The French election outcome, the economic recovery of the currency union and the ECB's indication to sequentially exit unconventional monetary policy led to an appreciation of roughly 8% since the beginning of the year. Even during the month of November, the Euro managed to climb higher. The uncertain situation around the German government formation did not really leave traces in the evolution of the Euro. Against the Dollar, the Euro has risen from roughly 1.16 to 1.19 during the month of November. We expect the Euro to be able to remain at current levels. The single currency is supported by the positive economic environment and the sequential reduction of monetary stimulus. There are also arguments speaking in favour of a stronger Dollar, such as underestimated monetary policy normalisation by the Fed. An exchange rate is always a relative game. We expect the two sides to cancel each other out, i.e. a neutral EUR/USD evolution over the next few weeks. The Euro also made further gains against the Swiss Franc. In November, EUR/CHF surpassed the level of 1.17 for the first time since the removal of the floor. We see a slight upward potential until year-end. The Swiss Franc strengthened, however, against the Dollar in November. USD/CHF was slightly above parity at the beginning of the month, a level that has not been reached since May. USD/CHF came down to 0.98. Thus, the CHF strengthened against the Greenback just as other major currencies did. We see a slight correction until year-end.