Perspectives
Financial Markets

Swiss Life Asset Managers

June 2018

Interest rates & bonds
The 3 percent mark has been broken

USA
- Fed's main inflation measure has risen to close to 2%
- Rate hike in June is fully priced in financial markets; we agree and expect an additional hike in September or December
- Some analysts even expect three more hikes in total until the end of the year

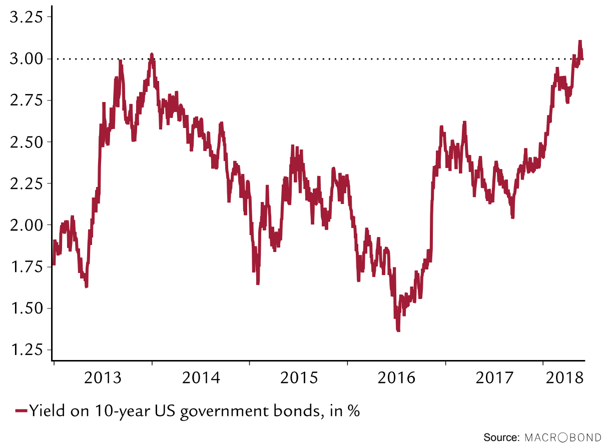
Eurozone
- ECB sounds more dovish as economic data have disappointed in recent months
- ECB's meeting on June 14 should give clarification on whether asset purchases continue or not after September – we expect an extension of the purchase programme until December and the first rate hike to take place in the last quarter of 2019
- Italian politics are a concern for the stability of the Eurozone and exert downward pressure on Bund yields

Japan
- Since December 2016, 10-year rates have remained in the trading range of 0 to 10 basis points
- Trend to surprisingly high inflation prints by the end of 2017 was reversed in March and April 2018

UK
- As the currency impact vanishes inflation has declined markedly in recent months – it fell from 3% in January to 2.4% in April
- The Bank of England is less under pressure to hike

Switzerland
- When EUR/CHF approached 1.20, some analysts discussed whether the SNB could hike earlier than expected – recent weeks have shown that the currency situation can change quickly and it is too early for the SNB to act
- We expect inflation to surpass 1% in June – inflation has been below 1% since March 2011

US 10-year yields rose above 3%



In late April, 10-year US interest rates broke the 3 percent mark. The last time, yields were above this psychologically important mark was early 2014. An important question for investors is, how much further interest rates will rise. In our view, the upside potential is rather limited. Economic activity has reached the peak. We expect a gradual moderation for the US and the world economy going forward. Nor do we expect inflation to push interest rates markedly upwards. It is commonly expected that headline inflation rises towards three percent by mid-year and declines thereafter as the base effect of energy prices vanishes assuming the oil price does not climb further from current levels. In our view, the main arguments for slightly rising rates are monetary and fiscal policy in the US. We expect two further hikes by the Fed until year-end. This is priced in financial markets. There is a risk that markets start to price an additional hike for this year. Recent changes to the fiscal policy imply more supply of US government bonds. In Europe, the situation is different: The ECB made some rather dovish statements and expectations regarding the first hike are pushed further out. In addition, the coalition agreement in Italy poses uncertainty. We therefore expect German Bund yields to grind lower over coming weeks.

Equities

Supported by earnings and limited rate increases

USA

- We expect equity markets to recover from weakness seen earlier this year as valuations have improved and risk appetite indicators are at reasonable levels
- Politics remain the elephant in the room with daily changes in direction as regards trade policy weighing on planning security for corporates
- Institutional investors continue to add exposure whenever stock markets correct

Eurozone

- Despite some moderation in economic activity since the start of the year, the Eurozone continues to grow above its potential through 2018
- As the ECB will continue to miss the inflation target at least until 2020, the central bank is not in a rush to normalise policy rates
- Thus, equity market valuation remains attractive relative to fixed income assets

Japan

- Nikkei 225 index recovered by 10% from this year's low at the end of March
- Negative GDP print for first quarter did not weigh on investors' sentiment, which seems more dependent on US trade and foreign policy announcements

UK

- Among markets discussed here, FTSE 100 Index was the clear outperformer over the past month as Bank of England abstained from hiking interest rates
- Economy is likely to continue to grow below its long-term potential as uncertainties related to Brexit still weigh on investment decisions

Switzerland

- Honeymoon with Macron on FX markets seems to have ended with new coalition government in Italy causing Swiss Franc to appreciate again versus Euro
- Compared with the Eurozone, Switzerland's stock market valuation looks less attractive

UK: Positive stock market response to rate hike delay

A broad range of factors entering the evaluation of stock markets remain supportive or have even improved compared to last month: In the US, the corporate sector continues to deliver strong results. Relative to analysts' expectations, reported earnings through the first quarter were a major positive surprise. In recent years, only in 2009 more S&P 500 firms managed to surprise more strongly than through the last quarter. Yet, back then, expectations were so depressed as a consequence of the financial crisis, that this period is not comparable with the current situation when the economic expansion is about to become the longest on record since 1900. Another supportive factor is the shift towards a more dovish monetary policy stance by the Bank of England and also the ECB. As we expect long-term interest rates to move only very gradually higher from current levels, valuations of equity markets remain favourable compared to fixed income assets. Despite this robust fundamental background, investors will have to get used to higher volatility going forward as political uncertainty has increased again. So far this year, markets have reacted in a sensitive way to all directional shifts by the Trump administration as regards trade policy but also foreign policy with Iran and North Korea. Politics are also the elephant in the room in Europe, with the anti-establishment coalition in Italy reminding everybody that Europe's debt crisis is far from being solved.

Currencies

USD up, EUR down

USA

- The past month was characterised by an uptrending USD and odds are for a continuation of this trend
- The relative monetary policy stance supports a stronger USD, as the Fed will continue hiking while the ECB and BoJ strike a rather dovish tone again
- Late cycle fiscal stimulus could provide additional support for the US Dollar versus Euro and Yen

Eurozone

- The ECB continues to miss its inflation target and risks of dovish disappointments as regards monetary policy normalisation have risen
- The formation of a populist coalition in Italy causes markets to jitter and led the Euro lower
- Uncertainties regarding the new government programme in Italy will persist – the EUR is bound to remain under pressure

Japan

- Pronounced negative surprises of macroeconomic data led to downgrades of the economic outlook and caused the Yen to weaken
- Spot as well as forward carry point to Yen weakness as compared to USD engagements
- In our view, Yen will weaken versus USD next month

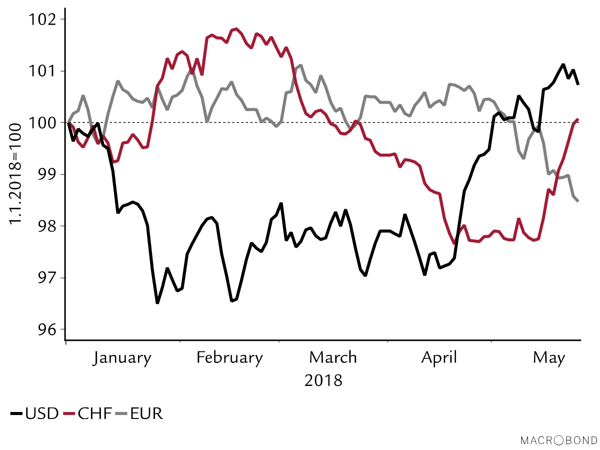
UK

- First quarter growth disappointed and the BoE refrained from hiking the target rate in May which some analysts had expected – Sterling depreciated against USD over the past month and was almost unchanged versus CHF
- The pressure for the BoE to tighten policy this year is declining given lower growth and inflation

Switzerland

- EUR/CHF has moved away from the 1.20 threshold as political risks in Italy caused the single currency to depreciate
- The latest moves of the CHF versus other major currencies is more the story of a stronger USD and a weaker EUR rather than a development that would be driven by Swiss circumstances

Trade-weighted currencies: CHF back at 100



Over the past month, the USD rally continued and was the defining characteristic of the FX environment. The Greenback not only appreciated against currencies of emerging markets, but the rally is a rather broad-based phenomenon. USD gained more than 4% against each of the main currencies, i.e. EUR, Yen, GBP and CHF over the past four weeks. The strength of the USD is to a large extent driven by the relative monetary policy stance of other major central banks as compared to the US Federal Reserve. Economic surprise indices for the different countries and regions equally reflect a more favourable economic dataflow in the US than in Europe or Japan. Given a sturdy economic backdrop, the Fed is expected to hike two or three more times this year whilst both, the European Central Bank and the Bank of Japan, have struck a rather more dovish tone lately than they did before. The Swiss National Bank will probably not move before the ECB does. The Bank of England is confronted with almost stagnation of GDP in the first quarter and a downward sloping inflation path which tames their eagerness to lift rates. USD strength is therefore driven by monetary policy and carry. More recently, the Euro lost ground due to renewed concerns as regards the European project given that the third largest EMU member, Italy, will be governed by a populist coalition. Uncertainties regarding the government programme will persist and potentially be a burden on the external value of the Euro.

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