Perspectives
Financial Markets

August 2018

Interest rates & bonds
Politics still in the driving seat

USA
- We stick to our call of a gradual monetary policy normalisation – i.e. one further hike by the Fed in 2018 and three hikes in 2019
- While US-China trade dispute has escalated further, a full-blown trade war with serious impacts on economic growth is still a risk scenario to us, not the base case – yet, the risk scenario has become more likely
- We see long-term yields gradually rising to the upper end of the trading-range of 3.10% until year-end

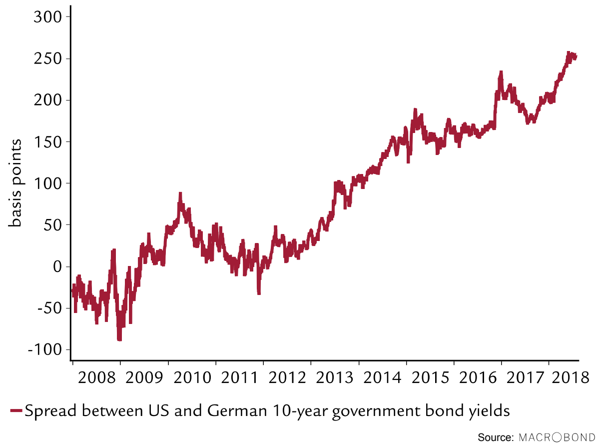
Eurozone
- Energy prices are again an important driver of inflation – headline inflation has reached 2% in June
- Core inflation should move clearly above 1% towards year-end – output gaps are closing
- With the European Central Bank (ECB) slowly ending its asset purchases, there is room for yields to rise – upward move should be gradual as the ECB will keep reinvesting maturing bonds for a long time

Japan
- Speculation about the Bank of Japan changing its utterly accommodative monetary policy pushed 10-year yields higher
- Despite the comparably big move of five basis points in a day, 10-year yield remained in the trading range of 0 to 10 basis points

UK
- Futures markets have priced a hike by the Bank of England on August 2
- Easing inflation pressure and once again higher uncertainties stemming from Brexit negotiations speak against a rate hike

Switzerland
- Despite the most recent uptick, 10-year sovereign yields have been in negative territory since mid-June
- We see 10-year yields closing the year in positive territory

US-Germany spread remains on multi-year high



It has been a hot summer so far, not only in terms of temperatures but also regarding political headlines. Over recent weeks, the Trump administration took a tougher stance on trade policy. Yet, US trade policy is not the only political obstacle. There is a non-negligible risk that Brexit negotiations fail. In addition, the new Italian government will present its budget in September. Political risks are one of the reasons why long-term government yields are comparably low in core European countries. The German Bund is around 40 basis points as of late July. This is the same level as at the beginning of the year. In the US, however, long-term yields have risen by more than 50 basis points since the beginning of the year. They are currently slightly below 3%. As a result, the spread between 10-year sovereign yields in the US and Germany has increased to a multi-year high of roughly 250 basis points. We expect this spread to decline over coming months and quarters. In our view, there is quite some room to the upside for core European yields, whereas we do not see a lot of upside potential for yields in the US. Despite the above mentioned political risks, we stick to our call for generally higher rates in the US and Europe over coming weeks and also until year-end. Yet, we assign a higher probability to a risk scenario (e.g. trade war) in which long-term yields are compressed.

Equities

Volatility to remain

USA

- Earnings remain a major support factor – valuations have become more attractive since the beginning of the year as earnings have risen more than prices
- According to futures markets, there is no consensus for significantly higher long-term yields in the US – equities remain relatively attractive
- Economic data remained strong in the second quarter – we expect a gradual slowdown during the second half of the year

Eurozone

- Purchasing managers' indices illustrate the type of growth moderation the Eurozone is undergoing – a decline from exceptionally high levels (around 60 points) to solid levels (around 55 points)
- Expectations are adapting to the reality of growth moderation – surprises of economic data have normalised but remain in negative territory

Japan

- Whether or not rumours about a change of monetary policy materialise will be decisive for stocks
- On a year-to-date basis, Nikkei 225 is with -0.7% the underperformer among the indices discussed here

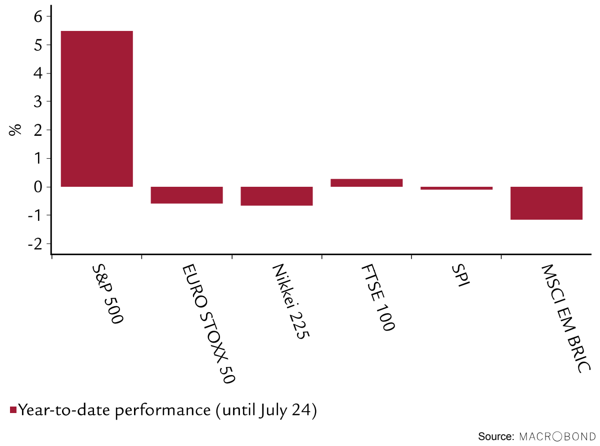
UK

- With 0.9% month-to-date performance, the FTSE 100 is the underperformer of the indices discussed here
- Pound has weakened further in July and has reached the lowest level so far this year – a support for exporting firms
- Bank of England meeting on August 2 should give some guidance on future monetary policy path

Switzerland

- SPI progressed by an impressive 4% on a month-to-date basis and thereby surpassed the temporary high reached in mid-May
- As a small open economy, Switzerland is relatively exposed to risks of an escalating trade dispute
- Swiss industrial sector is still in recovery phase – yet we expect a plateau to be reached soon

The US stand out



The US are the clear outperformer at equity markets so far this year. The S&P 500 is up by 5.5% since the beginning of the year. In contrast, European equity markets are roughly at the same level or slightly lower than in early January. The same is true for the Nikkei 225. Emerging markets have suffered the most. Concerns around US trade policy seem to weigh on stocks in emerging markets – in particular in China –, Europe and Japan. Economies in these regions would disproportionately suffer from a more protectionist US trade policy. European markets have additionally weakened after the Italian government formation. In contrast, US equities continue to benefit from the tax reform as earnings are still strong. Political risks regarding a protectionist trade policy, the new Italian government and Brexit negotiations are by no means overcome. Given the positive month-to-date performance around the globe – 3.8% for the S&P 500, 2.6% for the EURO STOXX 50 and 1.4% for the Nikkei 225 –, are equity markets complacent? Stocks have reacted to changes in the political landscape over the course of this year. Yet, it also seems to be the case that they are getting used to longer-term risks. It is unlikely that the trade dispute between the US and China will be solved any time soon nor that there is clarity about economic policies in Italy. Apart from any big changes in politics, we remain cautiously optimistic for equity markets in the near future. The global macroeconomic environment as well as earnings dynamics remain supportive and on a relative basis, equity valuations are attractive (compared to fixed income).

Currencies

Another month of Dollar strength

USA

- Trade-weighted USD reacts strongly to moves in CNY/USD – China's share in the trade-weighted USD index is 22%
- Expectations regarding Fed policy is currently no major driver for USD – we agree with futures markets that there will follow one further hike until year-end
- EUR/USD has not moved above 1.18 since mid-May

Eurozone

- We see room to the upside for EUR/USD – our base case does not include US tariffs on European car imports, which would be a drag for the Euro
- Meeting of the European Central Bank (ECB) in July should not be a major market driver – key announcement to end asset purchase programme in December was already made in June

Japan

- Speculation about a less accommodative monetary policy in the future supported the Yen
- Yen is a safe-haven currency as well as particularly exposed to risks of a trade war
- We expect headline inflation to temporarily drop below zero by year-end

UK

- Pound has been on a downward trend since mid-April
- Most recently, complicated Brexit negotiations have again weighed on GBP
- Bank of England meeting on August 2 should give some guidance on future monetary policy path

Switzerland

- CHF/USD has remained at, or slightly below, parity since May – we expect CHF/USD to remain at current levels
- We see CHF/EUR to move gradually higher until year-end – from currently 1.16 to 1.18
- Swiss National Bank is not about to start to hike rates before the ECB does – futures markets still have room to adapt to this view

Rapid fall of Chinese Yuan

There are two interpretations of the comparably sharp drop of the Chinese Yuan against the dollar. For some market participants it is a political message from Chinese authorities. As Donald Trump is threatening to impose more and more tariffs on imports from China, the Middle Kingdom demonstrates that it can devalue its currency if needed. Other observers interpret the most recent depreciation as a market reaction. The Chinese exchange rate regime has become more flexible. Hence, the currency reacts stronger to a changing sentiment. In our view, the second interpretation is more credible as it is too early for China to use the currency as a trump card against the US. A devaluation of the currency – as well as the sale of US treasuries – are very powerful tools. Yet, they also hurt the Chinese economy. Therefore, we expect them to be used only once all other options are exhausted. A priori, it is not clear what reaction of the Greenback is to be expected in a trade war scenario. There are arguments for a higher and a weaker Dollar. So far, concerns regarding a more protectionist US trade policy have pushed the Greenback up. On a trade-weighted basis, it has risen by 0.8% since the beginning of July and by 5% since the beginning of the year. Yet, trade policy was not the only driver for this Dollar strength. The US economy is relatively strong compared to other economies and the Fed is the only major central bank that is in a hiking cycle. Going forward, we do not expect a broad-based Dollar strength. We see for example upside potential for EUR/USD.

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