Perspectives
Financial Markets

SwissLife Asset Managers

October 2018

Interest rates & bonds
Rising real yields in the US

USA
- Compared with last month, we now expect the Fed to normalise monetary policy at a slightly faster pace
- One more rate hike expected in last quarter 2018 and total of three hikes in 2019
- As headline inflation starts falling from current levels, real rates are expected to edge gradually higher

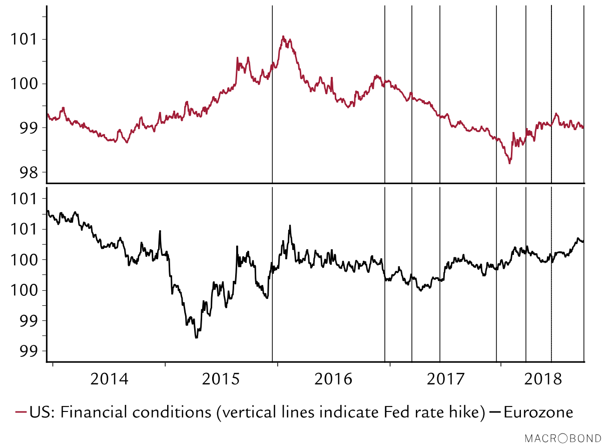
Eurozone
- European politics are back in centre stage of financial markets, with Brexit in particular far from being solved
- We expect the European Central Bank (ECB) to end asset purchases by end of the year
- Thus, there is room for yields to rise in the medium term, in particular in the periphery and in parts of the corporate space

Japan
- Abe has won a third term as head of the ruling LDP and with that also as prime minister
- That should mean continued reflation measures by fiscal and monetary policies going forward
- Although wage growth is gradually kicking in, the 2% inflation target remains out of reach for the BoJ

UK
- Brexit stays in the way of any further monetary policy normalisation by the Bank of England until March next year
- We expect 10-year Gilt yields to move sideways until year end
- A "Blind Brexit" resolution should trigger a rise in log-term yields in 2019

Switzerland
- Renewed Swiss Franc strength means that chances for an independent monetary policy step by the SNB have diminished even further
- We still expect 10-year yields on Swiss confederation bonds to rise to just 0.1% until year end

The Fed lifts rates and financial conditions ease



Since December 2015, the Fed delivered eight rate hikes and progressed far more on monetary policy normalisation than any other central bank in the developed world. Given the strength of the US economy, we expect the Fed to add further rate hikes more quickly than we previously expected. We now expect one further rate hike to come this year and three more steps in 2019. Should our assessment for monetary policy in the US prove correct, the upper end of the Fed Fund Target Rate band would rise to 3.25% until the third quarter 2019. The last time, this policy rate stood above 3% was in spring 2008. The Fed's attempt to normalise monetary policy is a success story: Realised inflation and inflation expectations remain well within the central bank's comfort zone. In broader terms, the rate hikes undertaken so far did no damage to the US economy, as financial conditions have even eased over the last three years thanks to rising US equity markets and a stable external value of the Dollar. Comparably tight financial conditions complicate the task for the European Central Bank (ECB): Financial conditions tightened since 2015 despite ongoing monetary policy accommodation. Thus, even though we expect the ECB to end their asset purchases by the end of this year, they will wait at least until the third quarter 2019 before starting to raise interest rates.

Equities

A great quarter except for the UK stock market

USA

- During September, the US economy and its stock market continued to benefit from the tax reforms by the Trump administration
- Recent increase in Treasury yields and prospects of a slightly faster monetary policy normalisation mean that valuation of US stocks relative to fixed income investments turns less favourable than in recent past
- We maintain our positive outlook for stock markets on the back of sound corporate earnings dynamics

Eurozone

- In contrast to the US, our models suggest that European investors are in risk-off mood
- A solution on Brexit and a recovery in emerging markets should result in renewed appetite of investors for European equities as the fundamental economic situation remains favourable and the earnings outlook has improved compared to last month

Japan

- Domestic dynamics have improved as of late and fears of a less accommodative monetary policy by the Bank of Japan proved premature
- Japan's machinery and pharmaceutical sectors may be beneficiaries of US trade policy as long as it targets China alone

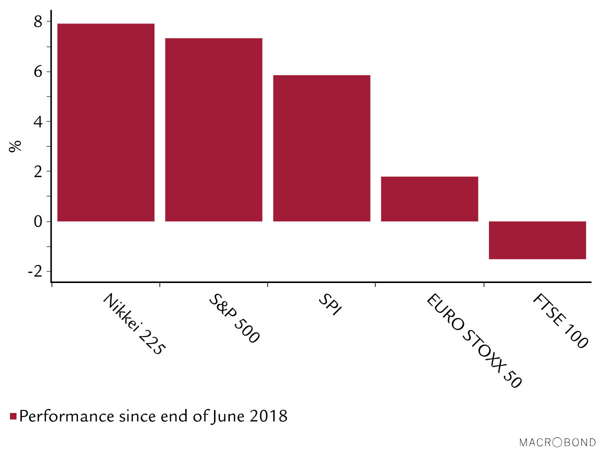
UK

- Brexit is to stay a major market driver at least until the end of the year
- Despite recent Pound weakening, the UK stock market was a clear underperformer during the third quarter 2018
- Adverse "No Deal Brexit" scenario could prove beneficiary for UK stocks in case of monetary policy response by BoE and further Pound weakening

Switzerland

- Momentum of analysts' earnings revisions has turned negative as the renewed strength of the Swiss Franc weighs on corporate results
- Relative valuation versus fixed income investments remains favourable for equities
- As a small open economy, Switzerland remains exposed to risks of an escalating trade dispute

Stock market performance since mid-year 2018



The stock market performance gap between the US and Europe widened further in September. Yet, the best performing developed equity market was Japan. The Nikkei 225 index' gain of 6% in just one month warrants a closer look at possible explanations: First, fears of a less accommodative monetary policy stance by the Bank of Japan were being priced out. Secondly, incoming data suggest that economic momentum has accelerated further into the second half of the year. Prime minister Abe's success to secure a third term means that he can progress with his reform policy and finally undertake important tax and labour market reforms. Brexit uncertainties continue to weigh on economic activity in the UK and explain the local stock market's weak performance as of late. In the US, corporate results come in on the strong side and continue to trigger upward revisions in earnings forecasts for 2019. Robust corporate earnings are the main reason for us to stay constructive for equities in all regions, not only the US. The S&P 500 index has reached new all-time high levels, and yet investors' risk appetite remains low according to our measures. In the short-term, we thus see little risk for stock markets from excessive investor euphoria vis à vis this asset class. Yet, rising US Treasury yields mean that the US stock market valuation is starting to lose comparative attractiveness relative to fixed income investments. Judging by this measure, stock markets in the Eurozone and Switzerland continue to look more attractive. Yet, resurfacing political worries weigh on financial markets in the Eurozone since the return from the summer break.

Currencies

Bullish Dollar view until end of the year

USA

- Repricing in fixed income markets towards more restrictive Fed policy should support the USD
- Other than the rest of the developed world, US economic growth continues to exceed its potential rate
- A recovery in emerging markets and a fast increase in inflation in the Eurozone form risks to our bullish USD call

Eurozone

- Euro expected to weaken again versus the Dollar as worries regarding Italy's budget, Brexit or the future of Germany's grand coalition are set to resurface
- While ECB ends its asset purchase program, rate hikes are not expected for at least the next nine months
- Deepening of emerging market crisis could put Euro under further pressure versus USD and CHF

Japan

- We believe that Abe's renewed mandate cements the Bank of Japan's accommodative monetary policy
- As the Fed is seen to normalise monetary policy in the US faster than previously expected, we expect the Yen to soften against the USD until year-end

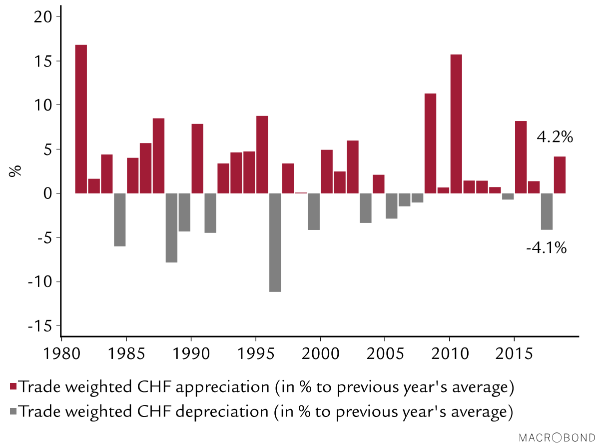
UK

- Likelihood of a "No Deal" Brexit has increased in recent weeks
- Although we expect a resolution resulting in a "Blind Brexit" by March 2019, a further deterioration of the situation in the weeks ahead is likely
- Thus, we expect the Pound to weaken versus all other major currencies in the short-term

Switzerland

- Swiss Franc again acts as a safe haven as uncertainties around Brexit, Italy's public finances and Germany's coalition government resurface
- We lower our year-end forecast for EUR/CHF yet again to now 1.14
- SNB's conditional inflation forecast suggests no increase of inflation above target range until 2020 even with unchanged monetary policy

Last year's Swiss Franc devaluation offset



Gone are the tailwinds for Switzerland's economy in the form of a weaker currency: While the Franc depreciated by around 4% on a trade weighted base in 2017, it regained all of its previous loss this year. After temporarily trading above the SNB's former minimum policy floor of 1.20 in April, the EUR/CHF exchange rate fell to now less than 1.14. Given the intensifying tensions as regards Brexit and Italy's public finances, we see little room for the Euro to recover quickly from current levels. This assessment could prove wrong in any of the following events: A surge in Eurozone inflation rates, triggering a more rapid monetary policy normalisation by the ECB, a recovery in investors' sentiment vis-à-vis emerging markets, or finally, a convincing agreement on Brexit before end of the year. The last of these three, rather unlikely, cases would also allow the Pound to appreciate. Yet, a quick solution for Brexit is not our base case. Rather, we expect a last minute agreement on a transition period, clarifying only a limited set of open issues. UK media have started to label such an outcome as "Blind Brexit". Until all involved sides ratify an agreement, we expect Sterling to remain weak. Meanwhile, the risks for extreme scenarios (e.g. "No Deal Brexit", or no Brexit at all), has at least temporarily risen over the last few days. The strong domestic economy running on the drugs of the tax reform and the Fed's ongoing monetary policy tightening speak in our view for a strengthening of the US Dollar during the final quarter 2018.

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