Perspectives
Financial Markets

December 2018

Interest rates & bonds

Still expecting a rate hike by the Fed in December

USA

- US economy and underlying corporate fundamentals have started to show pockets of weakness, which in combination with more pessimistic forward guidance caused credit spreads to spike
- Reduced liquidity in the market ahead of the year end and a plethora of risks will likely keep volatility at an elevated level. We see 10 year treasury yields to stay range bound
- We still expect a Fed rate hike in December 2018

Eurozone

- Third quarter results were a mixed bag with good top line growth, but lower margins and weaker forward guidance
- Although the EU signed off on the Brexit deal and Italy seems to soften its stance on the budget we do not expect a quick solution for either
- Given political risks and weaker fundamental data, ECB's forward guidance likely to turn more cautious

Japan

- 10 year government bond yields were dragged down by the deteriorating macroeconomic picture and the continued accommodative monetary policy

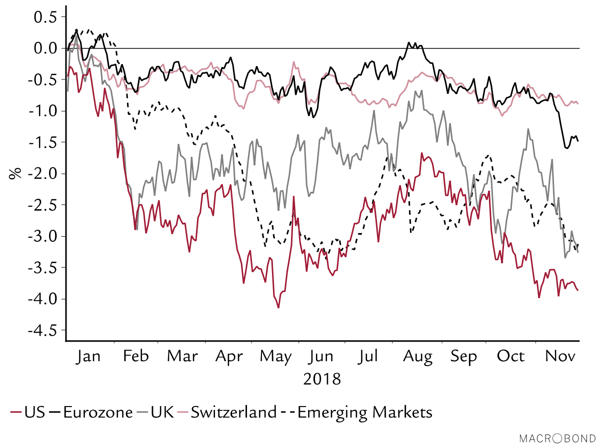
UK

- Monetary policy and risk sentiment all currently depend on whether or not Brexit deal finds a majority in parliament
- With the political situation still being in flux, risk premia will likely stay elevated

Switzerland

- Economic data in Switzerland have weakened with significant drop in industrial output and retail sales
- 10-year yields dropped below zero again and will likely stay range bound until year end

2018 in the credit segment (total return)



2018 will likely be a year that global bond investors would like to forget as the majority of corporate credit segments are currently posting negative total returns. Weakening macroeconomic data, less accommodative central banks and a flare up of political risks all contributed to the underperformance. Third quarter corporate results, while having been solid overall, still showed early signs that the peak of the cycle has been reached. A number of earnings revisions and weaker than expected forward guidance, have started to erode investor confidence. Added to the mix were a number of negative headlines such as the downgrade of GE, or the corporate governance failings at Nissan/Renault. In combination with other factors, such as the rapidly declining oil price and the ongoing trade war tension, we saw a swift deterioration of risk sentiment. The ongoing political uncertainties such as Brexit and the budget discussions in Italy further did their part making GBP and Euro corporates the worst performing segments in November. Since none of the aforementioned risks have disappeared, we expect volatility to remain elevated and a see greater divergence between regions, sectors and issuers.

Equities

Correction leads to more reasonable valuations

USA

- US-Sino trade dispute talks keep markets nervous and have overcompensated any positive effects coming out of the most recent earnings announcements that have mostly been strong
- Recent market downturn improves valuation of the equity market

Eurozone

- Recently, the Eurozone market behaved more synchronously with the US market over the last month compared with the first half of the year
- Budget discussions in Italy continue and markets will keep an eye on it
- Brexit still once in a while a source of uncertainty

Japan

- Japan's equity markets behaved similarly to other markets while dragging slowly down during the last month on a less volatile path than other markets
- Abe's reform path will be challenged next year, and what will be key for markets is whether the benign economic growth forecasts can be maintained and monetary policy remains accommodative

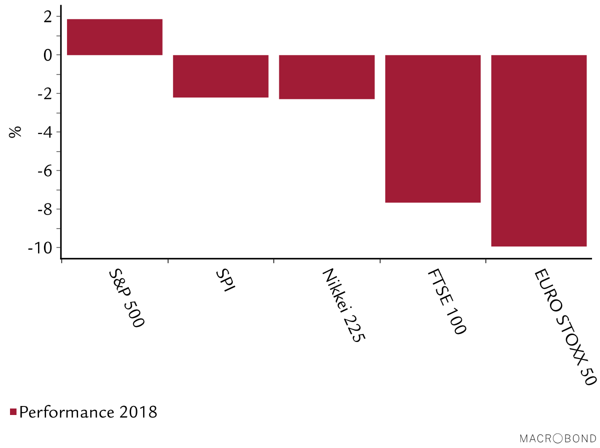
UK

- Ongoing Brexit uncertainty remains a threat especially for UK mid- and small-caps
- If Theresa May has to step back this will almost surely increase volatility significantly

Switzerland

- The renewed strengthening of the Swiss Franc might a small negative impact on companies' earnings

Stock market performance 2018



The US remains the comparably strongest equity market this year, even if the previous month has been bumpier for the S&P 500 than for the other markets. The S&P 500 gained 2.6% since the beginning of the year while the Nikkei 225 and SPI are down by around 2%. Eurozone equity markets represented by the EURO STOXX 50 lost 9% and Emerging Markets have suffered the most (down by 18% as measured by the MSCI Index). UK large caps have been relatively resilient to the Brexit talks and perform in line with the Eurozone. Those market themes which have caused higher volatility remain important drivers: Most importantly the trade dispute, Brexit uncertainties and Italy's budget struggle with the EU Commission. In contrast to the first half of the year, US markets have also been dragged down more recently. This correction resulted in more reasonable fundamental valuations. Given the strong earnings situation, chances are high that markets will remain at current levels until the end of the year. Exceeding the levels of early November in a significant way seems rather unlikely in our view. Over the past month, our quantitative models have turned slightly less constructive as regards exposure into equities. Meanwhile, Asian markets and especially China seem to have bottomed out in terms of the economic slow-down and lower company growth expectations. However, the timing of a potential recovery in this region is difficult to predict and depends strongly on the negotiations on trade between the US and China.

Currencies

No relief for Euro and Sterling

USA

- USD appreciated against most currencies, driven by continued US economic outperformance, the prospect of further Fed tightening and the ongoing trade dispute
- December rate hike is broadly expected, but we believe Fed tightening in 2019 is under-priced by markets, providing further support for USD

Eurozone

- EUR weakened against USD and CHF due to simmering political risks in Italy and negative surprises in economic data
- ECB ends net asset purchases soon, but markets are increasingly questioning the ECB's ability to raise interest rates in 2019
- We keep a negative view on EUR versus USD as political risks are unlikely to be resolved anytime soon and growth is expected to remain sluggish

Japan

- JPY moved lower against USD as yield differentials widened
- Monetary policy divergence favours USD, but risk sentiment is fragile and could support JPY

UK

- Uncertainty whether the Brexit deal would stand a chance in parliament weighed on GBP last month
- While we ultimately expect some form of transition period, the path to a final agreement remains very rocky and will likely keep GBP under pressure

Switzerland

- CHF appreciated on a trade-weighted basis amid subdued global risk sentiment
- SNB remains firmly dovish and is not expected to lift interest rates ahead of the ECB
- With a lot of negative expectations probably already priced, we keep a neutral view on EUR/CHF

Brexit uncertainty keeps Sterling under pressure

Politics have played an outsized role for the major currency pairs this year. Sterling is again approaching this year's low as markets are attaching a higher probability to a "no-deal" Brexit. This outcome represents a tail risk, in our view, but we still expect more political noise and more Sterling weakness before UK parliament ultimately agrees on a transition period. Political risks in Italy have receded most recently as the government signalled some willingness to amend the budget draft. We expect, however, the stand-off between Italy and the EU to extend into next year. In addition to the political risk premium, the Euro will probably continue to suffer from extended monetary policy divergence. The Fed is unlikely to veer off its tightening path – at least in the first half of 2019 – while the ECB remains firmly dovish and is even expected to launch a third round of bank re-financing operations (so-called TLTRO). Apart from these fundamentals, the US Dollar also stands ready to benefit from increased trade tensions and safe-haven flows in the risk case of renewed market turbulence. The Swiss Franc's fate remains tied to developments in the Eurozone. A lot of negativity already seems to be priced into EUR/CHF, but we would still assess the risks for the cross to be skewed to the downside. Elsewhere, the Japanese Yen has been caught in a tug of war between widening interest rate differentials to the US and rising risk aversion globally. The former has prevailed for the time being, pushing USD/JPY close to the previous high of 2018. We keep a neutral view on the currency pair.

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