Outlook for Financial Markets
February 2017

Interest rates/Bond markets
Interruption of the reflation trade

USA
- Since the middle of December, the reflation trade has reversed somewhat with 10-year yields being 15 basis points lower again
- Headline inflation has climbed above 2% with the December reading, will however peak in spring at 2.7% just to decelerate towards year-end
- Positive risk sentiment and expectation for higher growth and inflation may lift rates up again

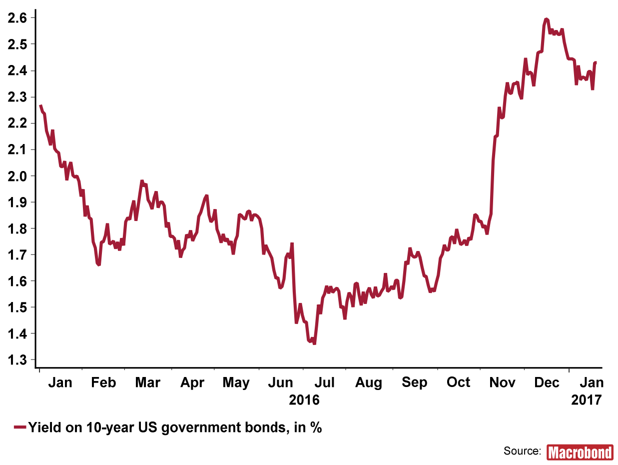
Eurozone
- ECB managed to engineer a steepening of the yield curve thanks to enlargement of its investment opportunities to shorter-term maturities
- Yet, the extent of the reflation trade in the Eurozone is dampened by ongoing purchases of the ECB – in fact the central bank actually stepped up purchases recently to keep yields in check

Japan
- Although the reflation trade also unfolds in Japan, 10-year yields hardly detach from the zero line which is in the interest of the central bank
- The inflation rate left negative territory with a lot of help from energy and a weak currency, but our longer term inflation outlook remains modest

United Kingdom
- Although economic data continue to surprise to the upside, a hard Brexit increases uncertainty not least as regards the future monetary policy path
- At this stage, the yield on a 10-year Gilt is back on the level before May's hard Brexit announcement, after an initial correction to the downside

Switzerland
- On the back of modestly reviving domestic demand, we revised our growth outlook slightly to the upside
- Since mid-November, 10-year yields have hardly budged and stubbornly remain below the zero line

Is the reflation trade already over?



The most important question investors have to answer at the beginning of the year is, whether the reflation trade will continue or not. We believe that the election of Donald Trump acted as a catalyst such that financial market participants acknowledged the theme of reflation. Yet, the new US president is not the cause of reflation. Inflation has increased markedly since mid-2016 due to the fading of the base effect of energy prices. At the same time, economic momentum has accelerated in both the developed and emerging world. Thus, all of this happened before the election of Donald Trump. Many market participants focused on the positive implications of Trump's election: A growth support from the government due to hopes for lower taxes and higher fiscal spending. This should lift inflation as well. Inflation expectations adjusted to the upside and finally deflation fears disappeared. Towards late December the reflation trade – i.e. higher long-term interest rates, higher equities and a stronger Dollar on the back of higher expectations of growth and inflation – lost steam. Long-term yields in the US have corrected. As we do not expect a huge fiscal stimulus of Trump's administration, we believe that a large part of the reflation theme is already reflected in current prices. Therefore, we do not expect a further sharp increase of rates. We rather anticipate a moderate increase of long-term rates as the overall sentiment should remain positive and as we expect economic data to remain solid.

Stock markets

We remain cautious

USA

- Already in the first week of January, the S&P 500 reached a new all-time
- As the S&P 500 has already gained 6% since US elections, we remain cautious
- Market participants seem to realise that Donald Trump cannot perform a miracle

Eurozone

- EURO STOXX 50 moved roughly sideways in January
- Strengthening of the Euro has been a headwind
- We remain cautious in the short-term as the reflation trade seems to sober – yet solid macro data, weak Euro and ECB's asset purchase programme are supportive in the longer term

Japan

- Nikkei 225 has been quite volatile on the back of large currency moves
- Performance over first three weeks of January was zero
- We expect a somewhat weaker Yen, which is supportive – yet, the Nikkei should move together with other major indices

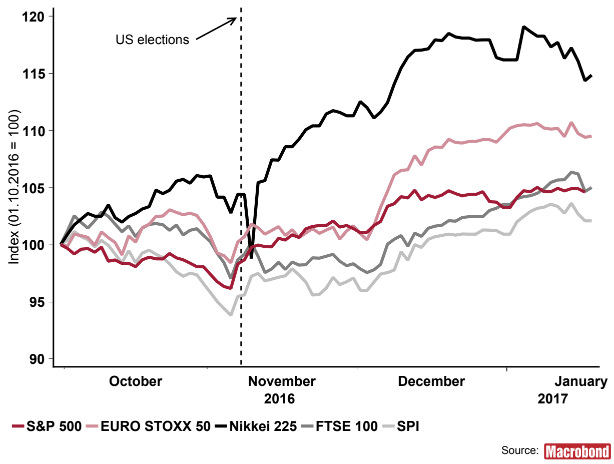
United Kingdom

- FTSE 100 had a relatively strong start into 2017 – it gained almost 3% in the first two weeks of January
- Strengthening of the Pound after Theresa May's speech on how to proceed with Brexit weighed on UK stocks

Switzerland

- SPI gained almost 3% in the first two weeks of the new year, i.e. a relatively strong start
- SPI corrected in the third week of January, suffering from weaker global sentiment
- The appreciation of trade-weighted CHF since December does not seem to be an important driver for Swiss stocks

Sobering after the reflation trade



Equity markets had a rather quiet start into the new year. Towards the end of last year, all indices, which we discuss in this paper, moved markedly higher. The general upward move of stock markets was supported by anticipations as regards the Trump administration's agenda. Equity markets would particularly welcome a corporate tax cut as well as a tax repatriation scheme. Recently, equity markets have moved broadly sideways as the euphoria about Donald Trump's election victory has abated. Last month, we have already warned about too much applause for the new US president. Therefore, we are not surprised by the slow start into 2017. We remain cautious for the coming weeks. A lot of good news, which could emanate from the Trump administration, is already in the price. Moreover, volatility at stock markets is overly low. This is a sign of complacency in an environment with a lot of uncertainty. In particular, the policy outlook in the US – and of course also in Europe – is far from certain. There has been a second important driver for equity markets since the US elections: Currencies. In Japan, the Eurozone and to some extent also the UK, the currency has depreciated against the US Dollar but also on a broader basis. This has supported corresponding stock markets as a weaker currency helps the export sector. The Japanese Nikkei 225 index has almost moved as a mirror image with the value of the Yen. The recent decline of the Nikkei 225 reflects the turnaround in the Dollar. Since late December, the US Dollar has been depreciating on a broad basis, which led to an appreciation of the Yen, amongst others.

Currencies

USD appreciation has temporarily come to a halt

USA

- Our constructive call for the USD turned out to be correct until the start of the year – recently ,however, the USD appreciation came to a halt
- The rate hike of the Fed in December and their hawkish outlook fuelled the USD appreciation
- We remain moderately positive for a stronger USD, driven by wider yield differentials and higher inflation expectations in the US

Eurozone

- EUR turned out to be the sturdiest currency on a trade-weigthed basis among the G4 thus far in 2017
- Given the strong macroeconomic performance, potential ECB tapering rhetoric remains a risk factor for our view of a weaker EUR versus USD
- Ample political risks such as upcoming elections in the Netherlands and France may adversely affect the external value of the EUR

Japan

- Since the start of the year, the Yen appreciated slightly on a trade-weighted basis
- While fiscal policy remains expansionary, the Bank of Japan's yield targeting measures support interest rate differentials to other main currencies

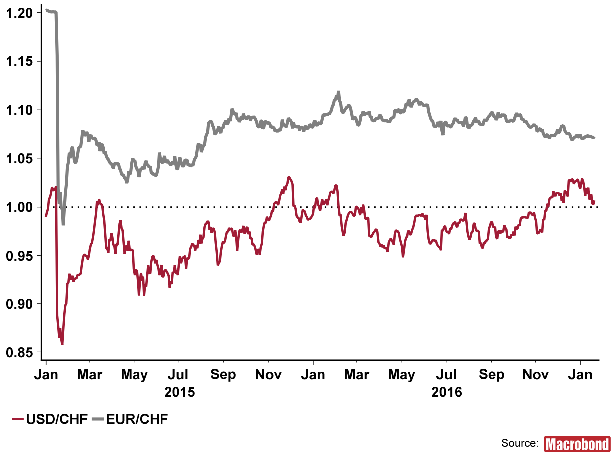
United Kingdom

- From mid-December on, the GBP came under renewed pressure due to continued uncertainty as regards the UK government's negotiation strategy
- Since prime minister May reiterated her Brexit vision to put migration policy ahead of the access to the EU single market – a hard Brexit – markets are unsure how to trade the currency

Switzerland

- Adverse election outcomes in the Eurozone could increase the pressure on the SNB to deter inflows
- The USD appreciation gave the SNB some breathing space last year – recently the CHF appreciated again

USD/CHF is back to parity



The Federal Reserve delivered the commonly expected rate hike in December accompanied by a rather hawkish outlook, which fuelled the USD appreciation further. However, the USD strength came to a halt in January. During his first appearance in 2017, Donald Trump failed to provide clarity on his fiscal policy goals. Instead, he focused his deliberations mainly on protectionism, geopolitical issues and fending off rumours around compromising evidence against his person. Since we expect widening yield differentials between US rates and others, as well as higher inflation expectations in the US, we stick to the view of a stronger USD versus other main currencies. Given political uncertainty, however, this view is a cautious one. The Eurozone economy, on the other hand, continues to deliver surprisingly strong macroeconomic data. Notwithstanding, the ECB announced an extension of the asset purchase programme last month albeit at lower purchase amounts. Although we expect a somewhat lower EUR against USD and stability versus CHF, a change of mind of the ECB in view of recent economic strength remains a risk factor. On the other side of the risk balance, the EUR may well suffer if the upcoming elections in various member countries generate adverse outcomes. Meanwhile, prime minister May announced a hard Brexit and confirmed the triggering of Article 50 by end of March. Generally, however, the political uncertainty remains high in absence of a clear negotiation guidance. Although the initial reaction to May's statement was a stronger Pound, we still opt for a lower external value of the British currency going forward.