Outlook for Financial Markets
March 2017

Interest rates/Bond markets

Moderate rise of long-term rates

USA

- The so called reflation trade has lost steam since the beginning of the year - yields are slightly lower today
- Long-term yields should rise moderately in the coming weeks, we do not expect large moves
- We still expect two hikes by the Fed for the year 2017 – in June and December

Eurozone

- The risk premium of France, Italy and Spain increased significantly during last weeks – the difference to German yields widened
- The higher spreads (difference to German yields) are due to the risk of a presidency of Marine Le Pen
- In our base case scenario, Marine Le Pen wins the first but not the second round of the presidential elections

Japan

- 10-year yields have a slight upward tendency since mid-November – with just under 10 basis points they are slightly above the central bank's target for long-term rates of 0%
- The inflation rate left negative territory with a lot of help from energy and a weak currency, yet our inflation forecast for 2017 remains below 1%

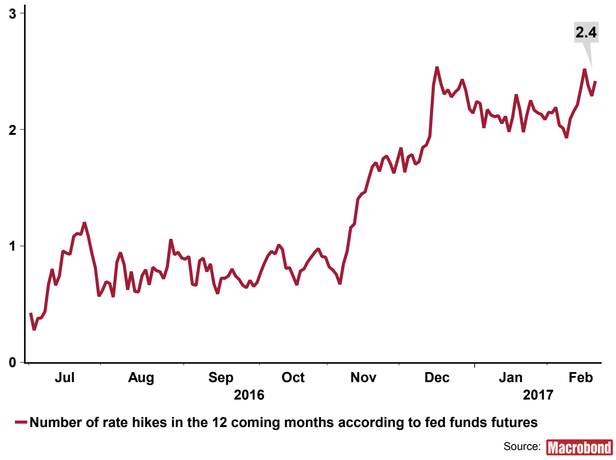
United Kingdom

- 10-year yields are currently at 1.2%, they have fallen by 30 basis points since end of January
- Although economic data still surprise on the positive side, the hard Brexit will raise uncertainty, in particular when it comes to the monetary policy outlook

Switzerland

- Since mid-November, yields on 10-year government bonds fluctuate in a band of -20 to 0 basis points
- The annual inflation rate came back into positive territory in January, after more than two years of negative inflation

Will the Fed hike two or three times in 2017?



Statements of several representatives of the US Fed provoked the question whether the Fed will hike three times in 2017 instead of two times. The discussion was fuelled by higher than anticipated US inflation numbers for the month of January. We expect the annual inflation rate in the US to rise somewhat further. Yet, according to our forecast, the peak will already be reached in spring and towards year-end, inflation will already show a slight downward tendency. At present, energy prices push inflation upwards. This effect is only temporary however. We still believe that the US central bank will hike its target rate twice in 2017. Yet, the probability that there will be three hikes has increased in recent weeks. After the statements of Janet Yellen about potential inflation pressure there has been a repricing at financial markets. The number of rate hikes which is priced in – according to fed funds futures – has increased from 2 in early February to currently 2.4. In our view, long-term yields in the US will rise slightly over coming weeks. The above mentioned further increase of inflation until spring should support this. In addition, confidence regarding future economic data remains high. We do not expect interest rates in Europe to decouple from the ones in the US. This is why we also expect slightly higher rates in Europe. Within the Eurozone, there has been a large divergence in the evolution of interest rates. The risk premium for French government bonds increased drastically. This reflects the risk of a victory of Marine Le Pen in the presidential elections. The difference between long-term yields in France and Germany has risen by 30 basis points since the beginning of the year.

Stock markets

Strong rally in February

USA

- Among the indices discussed in this paper, the S&P 500 had the highest performance since the beginning of the year – the rally in February led to new all-time highs
- The guidelines of the tax reform promised by the Trump administration are crucial for future stock performance
- We are positive for US equities over the coming weeks due to good sentiment indicators

Eurozone

- Thanks to the rally in February, the Euro Stoxx 50 has a positive year-to-date performance
- Uncertainty about the French elections weighs on stocks of the Eurozone – the performance of the Euro Stoxx 50 is smaller than elsewhere
- In our base case scenario, Le Pen does not become the next French president – in this scenario equity markets in the Eurozone would be clearly supported

Japan

- Strengthening of the Yen against major trading partners weighs on the Nikkei – we expect a weaker Yen in coming weeks, in particular against the USD
- The meeting between President Abe and President Trump dampened fears regarding a trade war

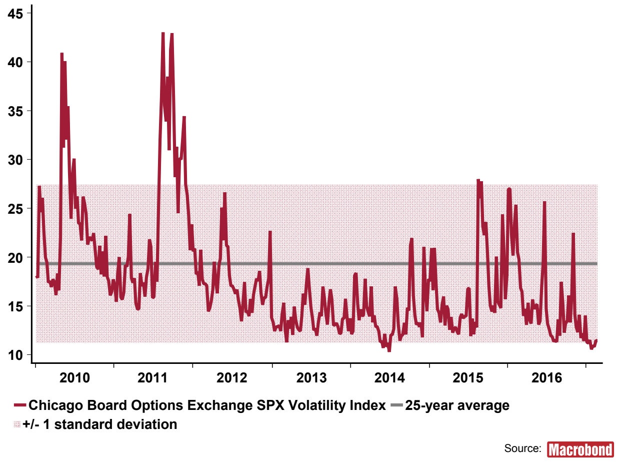
United Kingdom

- Even in the weeks following Theresa May's announcement of a hard Brexit, the FTSE 100 did not suffer – the general equity rally also drove British stocks higher
- With roughly 2% since the beginning of the year, the FTSE 100 had a stronger performance than the Euro Stoxx 50
- We expect a stable Pound over the coming weeks, i.e. the currency should neither be a burden nor a support for stocks in UK

Switzerland

- SPI gained more than 3.5% since the beginning of the month and 5% since the beginning of the year
- Renewed strength of the Swiss Franc does not seem to be a concern for Swiss stock markets

Volatility: Investors seem extremely relaxed



After a fairly retained development in January, which signalled a certain sobering of financial markets, February brought another substantial upturn in equity markets. The reporting season of corporate earnings justifies higher prices to a certain extent. The companies were able to expand their margins last quarter, in the US as well as in Europe. Furthermore, the expectations of analysts regarding future earnings, in particular of US companies, were revised clearly to the upside. The M&A activity of companies is lively which acts as a support for equity prices. At the same time, one has to mention that price-earnings-ratios (PE) on both sides of the Atlantic have reached dizzying levels. The PE of S&P 500 companies has reached a factor of 17.9, which is clearly above its 20-year average. Moreover, volatility indices have plunged to extremely low levels, which signals undue complacency of investors. The risks, especially the political ones, are not being priced into markets. The global risk appetite, which actually serves as a contra-indicator, has thus reached a very high level. Yet, the positive dynamic in financial markets is very pronounced and reflects the economic optimism, which business surveys convey. The Trump administration plans to reveal more details on the planned corporate tax cuts during the next two weeks. Given this tailwind, we thus expect further price rises in global equity markets over the next four weeks.

Currencies

SNB is buying EUR again

USA

- The risks emanating from the new administration have unfolded their effect – other than expected, USD has depreciated over the past month
- Despite the political risks in Europe, USD did not manage to appreciate versus EUR – the exchange rate remained broadly stable
- We expect a modest appreciation of the USD due to further tightening of monetary policy and resulting interest rate differentials

Eurozone

- After a temporary appreciation phase, the trade-weighted EUR is now back on the level of December
- The pressure on the EUR remains moderate thus far given the political risks – elections in the Netherlands and France – will however aggravate going forward in our opinion

Japan

- On a trade-weighted basis, JPY moves in a relatively narrow band since the start of the year, having depreciated notably in the last quarter of 2016
- While fiscal policy remains expansionary, the Bank of Japan's yield targeting measures support interest rate differentials to other main currencies

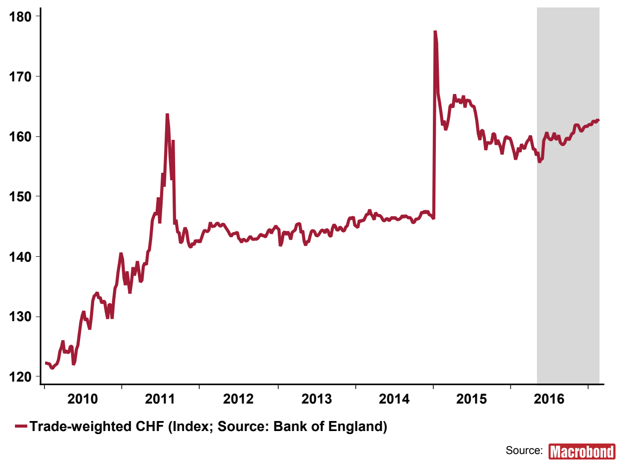
United Kingdom

- We do not expect a noteworthy move of the British Pound over the next four weeks
- Very strong economic growth and the massive undervaluation of the Pound act as a protection against further depreciation

Switzerland

- The fear of spreading populism in Europe puts renewed upward pressure on the CHF – the SNB again has to go against this move
- Switzerland is on the list of the US Treasury of currency manipulators

Renewed appreciation phase of the CHF



In the last issue of this paper, we highlighted our expectation of USD appreciation, not without mentioning the risks to this view however. These risk factors have indeed played out and the Greenback depreciated over the past four weeks on a trade-weighted basis. Neither the strong economic data nor the rhetoric of the Federal Reserve pointing to tighter monetary policy prevented the depreciation. Obviously, the euphoria regarding Trumponomics is finally phasing out. This was and remains our main risk factor. Even though business sentiment data signal pronounced economic optimism, the sobering at currency markets seems to have started. An appreciation of the EUR equally faces ample political hindrances. The election in the Netherlands in mid-March is highly anticipated since it may serve as a precursor for the French elections in April and May. These political uncertainties are a burden on the single currency whose survival will be questioned should Marine le Pen win the race. This is not our base case however. The worries of investors due to the poll results out of France not least caused headaches for the Swiss National Bank (SNB). As is visible from the published sight deposits, the SNB had to intervene heavily in currency markets over the past weeks, in order to prevent a strong appreciation of the CHF. Despite these interventions, the currency pair EUR/CHF did not manage to move above the level of 1.07. The pressure on the currency pair must have been massive. Before the political hurdles have not been taken, we do not believe in a sustainable appreciation of the EUR.

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