Outlook for Financial Markets
May 2017

Interest rates/Bond markets

Relief for French sovereign debt

USA

- 10-year Treasury yields rose slightly after first round of French presidential elections, but are still 30 basis points below the peak seen mid-March
- Low core inflation took market participants by surprise – implied future inflation expectations came down accordingly
- Given the loose financial conditions, the Fed will lift interest rates two more times this year

Eurozone

- Economy grew by 0.5% in the first quarter, adding the 16th straight quarter with positive GDP growth
- First round of presidential elections brought relief to French sovereign debt with spread over 10-year German Bunds narrowing by 30 basis points
- April spike in service prices should not be seen as signalling rising inflation pressure – it rather goes back to this year's late Easter holidays

Japan

- Bank of Japan governor Kuroda admits that the 2% inflation target will be missed this year
- Since we expect inflation to stay below 1% also in 2018, Kuroda's statement reads as a promise to continue quantitative easing for a very long time

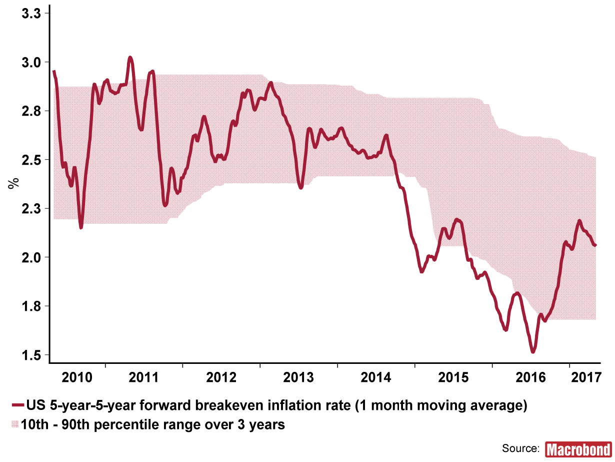
United Kingdom

- Snap election buys prime minister May time to complete an orderly Brexit before going to the polls again in 2022
- Bank of England will see through the temporary overshoot in inflation and maintain its accommodative policy

Switzerland

- The French election outcome reduces the need for safe havens and resulted in higher government bond yields in Switzerland
- We expect 10-year government bond yields to move slightly above 0% until year-end

The reflation trade went ahead of itself



It has been a central element in our economic base case that headline inflation in the US will pass its cyclical peak in the first quarter. Still, the confirmation to this assumption apparently took markets by surprise, also because of the fact that core inflation dropped from 2.3% in January to currently 2.0%. Seemingly, the reflation trade induced by Donald Trump's election victory went too far given economic and political realities. We still lack any clear guidance as far as tax reform and infrastructure investment plans of the new US administration are concerned. Meanwhile, financial conditions for the US economy have not tightened after the rate hike by the Fed in March. In our view, the Fed can afford two more hikes this year in its attempt to regain room to manoeuvre without seriously harming the US economy. In Europe, the risk of populist parties winning elections has diminished after the first round of the presidential election in France. Consequently, bond spreads moved in favour of France with the risk premium over German Bunds narrowing by 30 basis points ahead of the final round on May 7. Sovereign bond yields of safe havens like Germany or Switzerland moved gradually higher at the same time and should continue to do so until year-end. Yet, we stick to our assessment that nominal bond yields remain capped by instruments of financial repression applied by central banks and financial authorities. In Europe, the ECB's bond purchase program ensures favourable refinancing conditions for Italy, where parliamentary elections will take place in May 2018. Thus, once the French elections are history, markets will turn their eyes to Italy.

Stock markets

Positivity abound?

USA

- Equity investors can hardly be troubled by the new administration's lack of piercing force – even little progress made regarding the important topic of tax reform does not depress optimism for too long
- As two thirds of S&P500 companies have released their Q1 earnings, an above-average number have beat expectations and improved forward guidance
- Corporate investment spending constituted a strong positive contributor to GDP growth in Q1

Eurozone

- Earnings season in Europe is also off to a very strong start with the numbers even looking stronger than in the US – upside EPS revisions are massive
- The risk of Marine le Pen being elected as the next French president has receded since the "big debate"
- Economic momentum is strong and justifies a strong performance of European stocks

Japan

- Japan's export values profit from the synchronous global upswing and in particular from rising demand out of neighbouring Asian economies
- The Yen has depreciated over the past four weeks on a trade-weighted basis buffering competitiveness

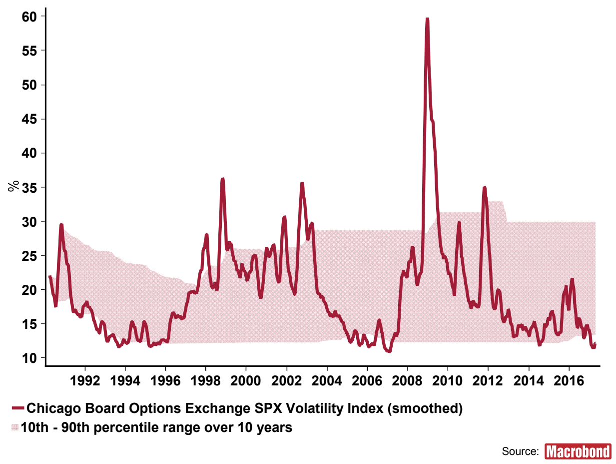
United Kingdom

- The remaining EU member states stand united as they agreed on a common strategy for the Brexit negotiations within 15 minutes – a record
- The start of the negotiations with the EU on the future relationship is accompanied by restrained corporate investments and a loss of purchasing power of private households

Switzerland

- Relief trades after the first round of the Presidential election in France alleviated the upward pressure on the CHF – good news for Swiss companies
- Compared to fixed income instruments, dividend papers remain attractive

Extremely low volatility signals complacency



During the month of April, the equity market rally gained in momentum yet again. What the major markets have in common and what justifies the renewed upward trend of stock prices is an excellent earnings season during the first quarter of this year. While two thirds of the S&P500 companies have reported, positive surprises are clearly in the majority. Earnings of US companies were expected to have grown at a rate of 5% from the first quarter 2016, the actual result came in at 10% thus far. For European markets the upside surprise was even more pronounced as earnings growth was reported at almost 20% from the previous year. At the same time, earnings revisions to the upside are a common theme across markets as well. To a certain extent, positive earnings revisions make valuations look more attractive. But not quite. Valuations are stretched on an absolute level. After eight years of equity rally, stocks are expensive, though from a relative point of view compared with other asset classes still offer an attractive risk premium. However, extremely low levels of volatility, implied as well as realised, raise a red flag. Investors have been buying call options over the past weeks and hardly any put options. Optimism reigns and investors around the globe seem to disregard potential adverse developments in the political and economic sphere. Such a degree of complacency makes us cautious as regards the short-term outlook for equity markets. Sentiment indicators reflect a degree of economic optimism which hard data, above all in the US, is not able to keep up with. It is hard to imagine where a renewed push for stocks should come from for the time being.

Currencies

Politics in the driving seat

USA

- Greenback lost against EUR and GBP, which both strengthened due to politics, and gained relative to Yen on the back of improved risk sentiment
- We are still constructive for USD, yet we only see limited upside potential

Eurozone

- Euro gained roughly 2% in the days following the first round presidential election results in France
- As the polls correctly predicted the first round election outcome in France, investors are confident that Macron's lead in the second round polls will materialise on May 7
- Strong growth momentum in the Eurozone is supportive for the Euro

Japan

- Yen weakened in recent weeks – the general risk-on sentiment at financial markets led to lower demand for safe haven assets
- We expect neutral JPY/USD in coming weeks – in case of risk-off sentiment, the Yen would appreciate

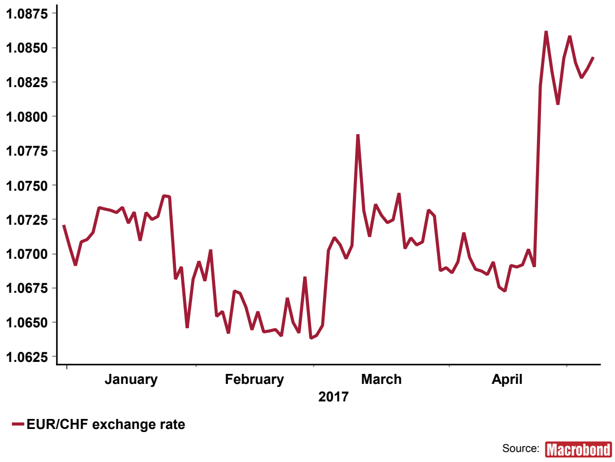
United Kingdom

- Pound gained 3% against USD after Theresa May announced new elections – after the elections she should have more negotiating power vis-à-vis the EU
- We do not see further upside potential for the Pound – weaker economic data going forward pose a headwind

Switzerland

- After the first round of French elections, EUR/CHF moved above 1.08 for the first time in 2017 – SNB is less under pressure to intervene
- After the recent move of EUR/CHF we do not see much room to the upside

Relief for the Swiss Franc after first round of French elections



The French elections demonstrated once again how concerns about the cohesion of the Eurozone influence the value of the Swiss Franc. In January, when the scandal around François Fillon entered the headlines, the Euro started to weaken. This exerted upward pressure on the Swiss Franc. The Swiss National Bank (SNB) intervened heavily to avoid the EUR/CHF exchange rate to drop to 1.06. As soon as the results of the first round of the French presidential elections were announced the Euro strengthened by roughly 2% as the probability of a Le Pen victory declined sharply. As a consequence, the EUR/CHF exchange rate moved from below 1.07 to roughly 1.085 in the week after the first round. Also the British Pound was heavily driven by politics in recent weeks. The call for snap elections by Theresa May has been welcomed by markets. She should be able to secure a larger majority in parliament which strengthens her position in the negotiations with the EU. On the other side of the Pond, political developments could not induce excitement among investors. It is still unclear to what extent the new US administration will be able to deliver on their promises. Going forward, we believe that monetary policy remains an important driver. There is still room for the Greenback to move higher due to the Fed hiking cycle while other major central banks remain accommodative. Yet, as the Euro is supported by stronger economic data and easing political risks, we only expect a moderate upward move of the US Dollar against the Euro.