Outlook for Financial Markets
June 2016

Interest rates/Bond markets
Repricing again

USA

- The Fed changed its communication and sounds clearly more hawkish than a few weeks ago
- Several FOMC members indicated that two hikes until year-end are possible
- 10-year rates rose from the low of 1.70% to around 1.85% in late May

Euro Area

- The publication of the new growth and inflation forecasts of the ECB staff will obtain attention by market participants
- Yields in the Euro Area have not followed the uptick of US rates in the second half of May

Japan

- The monetary policy of the Bank of Japan is losing its impact on the currency – despite further easing measures the Yen appreciated on a trade-weighted basis by almost 8% since the beginning of the year
- Japanese long-term rates moved sideways during the month of May and hovered around minus 0.1%

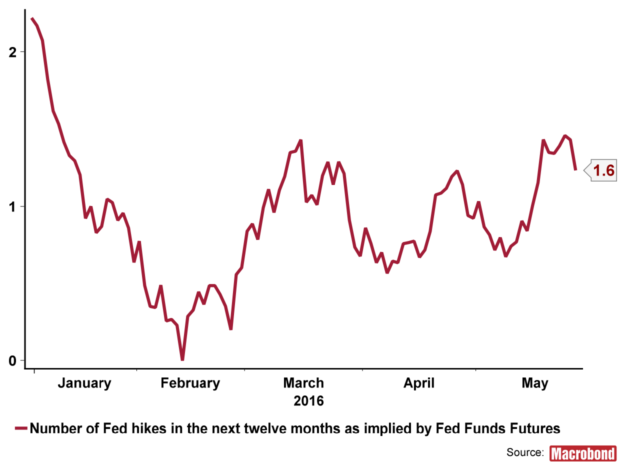
United Kingdom

- The Bank of England will follow the vote count of the EU referendum on June 23 with the greatest attention
- We expect the United Kingdom to remain in the European Union
- If Britain stays within the European Union, the Bank of England should prepare monetary tightening over the next quarters to tame inflationary pressures, especially from wages

Switzerland

- We do not expect a change in monetary policy from the SNB on June 16
- The CHF is on a tolerable level for the SNB thanks to interventions on the currency market
- We expect 10-year rates to move lower in line with the German ones over the next few weeks

The Fed puts a hike in summer on the table again



Investors still pose the question whether the Fed will hike again in June or not. Since several weeks, it is clear that the US economy is solid enough for a next rate hike and that financial conditions have eased enough for a next step in the hiking cycle. The reason why most analysts, us included, did not expect a hike in summer anymore was the missing communication to do so of the Fed. This has changed during the month of May. The FOMC minutes of the April meeting were more hawkish than expected. More importantly, several FOMC members indicated that a hike in summer still is on the table. We still expect two Fed hikes until year-end. The timing is tricky. The meetings in June, September and December are more suitable for changes in monetary policy. They are followed by a press conference and hence offer a platform for the Fed to explain the change and indicate the further path of monetary policy. The June meeting is unfavourable as it is one week prior to the EU referendum in the UK. The recent survey results, which indicate that Britain should remain in the EU, are an additional reason why financial markets are preparing for more and earlier rate hikes. Consequently, we expect US long-term interest rates to move higher in the coming weeks. In contrast, we see downward pressure on yields in the Euro Area. The asset purchase programme of the ECB still pushes interest rates lower. Moreover, political uncertainty around Greece, Spain and the UK can lead to safe haven flows, particularly so for German sovereign bonds

Stock markets

Fed has confirmed: We are in a tightening cycle

USA

- Communication by Fed members made it clear that monetary policy normalisation will continue
- Equity markets have in our view not yet fully priced in the consequences of further tightening
- P/E ratio stands at its peak for the last three years
- Yet, valuation multiples typically contract in Fed tightening cycles

Euro Area

- Macroeconomic environment is intact and should support markets for risky assets
- Likelihood for UK to remain in EU is increasingly priced into financial markets
- Seasonalities and changing market expectations as regards future Fed policy should weigh on markets until mid-summer

Japan

- We expect a combined package of fiscal and monetary policy to support domestic demand
- Likely delay of consumption tax rate hike should support producers of consumer goods

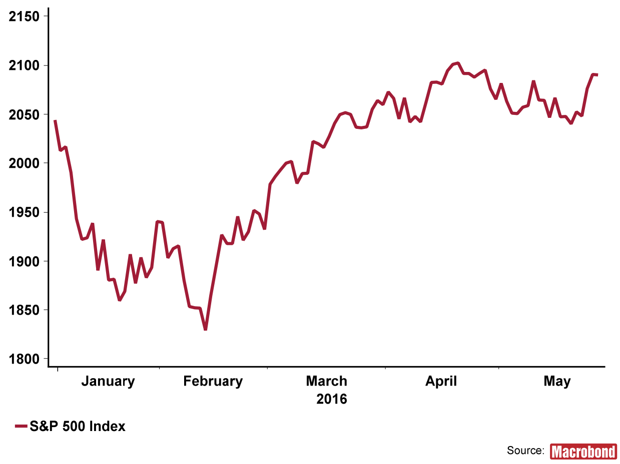
United Kingdom

- Potential for relief rally after voters' likely decision to stay in the EU is limited as "Bremain" would mean stronger Sterling
- Moreover, the less likely a victory of the "Leave" campaign gets, the more markets should start preparing for a normalisation of monetary policy by the Bank of England over the next twelve months

Switzerland

- Switzerland's stock market was the outperformer among the regions covered in this paper over the last four weeks
- Pick-up in industrial activity through the first quarter and weakening of the Franc suggests that the worst of last year's currency shock is over

S&P 500 index near record high level for 2016



After a correction at the beginning of May, stock markets in the developed world have recovered somewhat and are currently testing new highs for the current year. Regardless of the latest recovery, we stick to our prudent assessment for the potential on global stock markets in the short-term. Over the past few weeks, representatives of the US central bank have made it clear that further monetary policy normalisation remains the base case for the Fed. We thus continue to expect two rate hikes by the Fed until the end of this year. In our view, equity market valuations do not yet reflect the reality of even a mild monetary policy tightening regime. As usually observed in a late economic cycle environment, corporate earnings are under pressure. For price/earnings ratios to normalise from their current high levels and to reflect the looming gradual monetary policy tightening, the adjustment is likely to come via lower prices. Meanwhile, polls and bookmakers odds suggest a growing likelihood that a majority of UK voters will decide to stay members of the EU. Thus, we believe that the potential for a relief rally following such an outcome is limited. In the UK, "Bremain" would mean that the currency appreciates, providing headwinds for exporters. Risky asset classes in the Euro Area are supported by a combined effect of quantitative easing by the European Central Bank and moderating fears of a disintegrating EU. A general negative factor for all regions is the seasonal pattern of weak stock market performance through the summer months.

Currencies

Fed between a rock and a hard place

USA

- Yield spread developments should support a slight appreciation of the USD – the divergence theme is still valid
- The hawkish undertone of the FOMC minutes and statements of Fed representatives led to a re-pricing of monetary policy expectations
- Macroeconomic data point to a clear acceleration of economic momentum in the current quarter

Euro Area

- The Euro appreciated versus CHF as risk sentiment recovered and Euro Area economic data came in stronger than expected
- GDP of the currency union grew at a fast pace in the first quarter, but will not be able to sustain such a strong momentum
- EUR should also move lower versus USD given the expectation of widening yield differentials

Japan

- Over the past month, JPY appreciated markedly again despite accommodative monetary policy
- Implied carry and correlation point to weakness of JPY against USD
- Expectations as regards further accommodation by the Bank of Japan are building especially after inactivity at the previous meeting

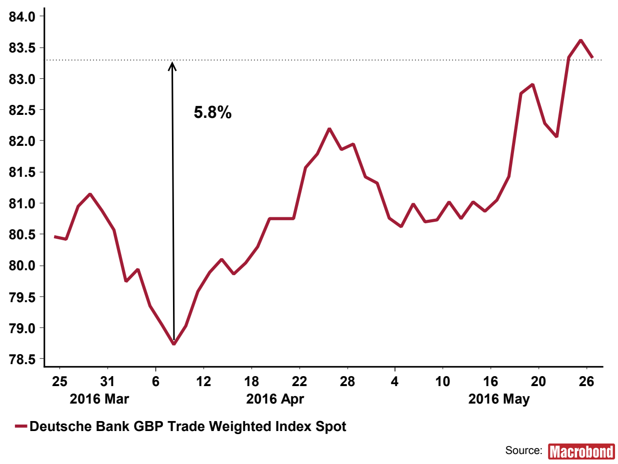
United Kingdom

- As Brexit fears have clearly calmed down, the Pound appreciated again recently
- The potential for further appreciation remains limited as the economy is slowing down

Switzerland

- The close alignment of SNB with ECB points to little movement in the EUR/CHF currency pair
- The SNB continues to intervene in FX markets and sight deposits keep growing

Early relief rally of the British Pound



The Federal Reserve continues to walk the tightrope. The difficulty is to pursue the tightening cycle, which began last December without triggering a renewed and pronounced USD appreciation phase. In fact, currency appreciation would strangle financial conditions and would in principle argue for less tightening going forward. The central bank thus directly influences the variables, which flow into their policy-making decisions. They also need to avoid a relapse into risk aversion, which would trigger a rather broad-based tightening of financial conditions. We nevertheless expect them to dare two more rate hikes this year, the first one taking place this summer. A hurdle to take still is the EU referendum in UK on 23 June, although the odds of an exit have diminished dramatically over past weeks. This development is also reflected in the appreciation of the Pound, having strengthened by almost 6% against the currencies of its trading partners since the beginning of April. In that sense, part of the relief rally of the Pound has taken place earlier than we expected. We view some more room for appreciation of the Sterling, however, given the decline of economic momentum currently visible above all in the corporate sector, that upside potential seems somewhat limited. The Euro Area economy generated a much stronger GDP growth rate in the first quarter than many had expected. Unusually warm winter weather made this possible. That growth momentum is not sustainable. Monetary policy divergence between the US and Europe remains a main theme for our currency outlook.