Outlook for Financial Markets
June 2017

Interest rates/Bond markets

Investors turn their eyes on Italy

USA

- Treasury yields fell to their lowest levels for the last three months as inflation pressure eased further
- We continue to expect two rate hikes by the Fed this year and more guidance on how the central bank attempts to shrink its balance sheet
- The long end of the yield curve is expected to correct slightly to the upside as markets currently are pricing in less Fed action than what we assume

Eurozone

- While spread over 10-year German Bunds narrowed for France since the presidential election, the risk premium for Italy widened over the past few weeks
- Pressure on the ECB to take action on the back of rising inflation pressure will ease as headline inflation rate has peaked

Japan

- Despite strong economic fundamentals, the Bank of Japan's 2% inflation target remains out of reach
- We expect that quantitative easing by the central bank will continue for a very long time

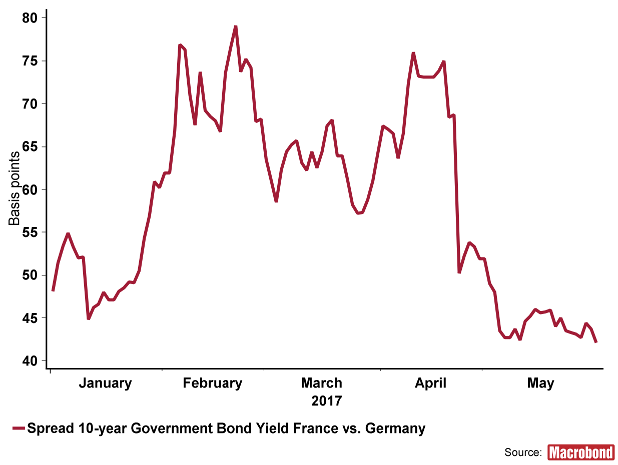
United Kingdom

- 10-year yields on Gilts dropped to their lowest level so far this year in response to a mix of alarming news such as weak growth, terror and polls ahead of the snap election on June 8
- Bank of England will see through the temporary overshoot in inflation and maintain its accommodative policy

Switzerland

- After a short episode of gradually rising yields, Swiss government bond yields again approach their lows for 2017 in a renewed downward move
- In response to normalisation of monetary policy in the US, we continue to expect 10-year government bond yields to move slightly above 0% until year-end

Investors welcome president Macron



Our conviction that low interest rates will be here to stay for a prolonged period has been the central thread in our comments for the past few years. Thus, in our view the reflation trade, which started after the US presidential election last year, was never indicative of a sell-off on government bond markets around the corner. Moreover, our judgement that the inflation cycle would peak during the first quarter 2017 is confirmed by incoming inflation data for the US, Germany or France. In the case of France, lower inflation is only one explanation for the recent downward move of sovereign bond yields. The presidential election result brought additional relief and caused a narrowing of the risk premium relative to German bunds by 30 basis points. Instead of France, markets are now worrying about Italy, where general elections will take place until May next year the latest. Recent market moves fit well into our long-term assessment that nominal sovereign bond yields stay capped for a very long time and that monetary policy will only normalise very gradually. Nevertheless, we believe that yields have dropped to the lower end of their trading range for the current year. In our view, the synchronous global upswing results in the closing of the output gap in major developed economies like the US, Germany or even Japan. Thus, deflation fears will fade. As markets currently only price in one full rate hike by the US central bank over the next twelve months, a slightly more active Fed should trigger a modest upward move in sovereign bond yields on both sides of the Atlantic until end of the year.

Stock markets

Impeachment concerns only caused temporary drop

USA

- Uncertainty around Donald Trump's connection to Russia caused a drop in the S&P 500 in mid-May
- Concerns regarding an impeachment weighed only shortly on the S&P – followed by a rally
- Valuations are very high in the US – US is less attractive than Europe when it comes to valuations

Eurozone

- Earnings recover around the globe, earnings growth is particularly high in the Eurozone
- EURO STOXX 50 did not recover from the fall in mid-May driven by worries regarding an impeachment of Donald Trump
- Stronger Euro weighs on stocks in the Eurozone – Euro gained almost 7% against USD since the beginning of the year

Japan

- Nikkei 225 surpassed the level of 20'000 for the first time since December 2015
- Recent rally of Nikkei 225 was supported by global risk appetite and stronger economic data out of Japan

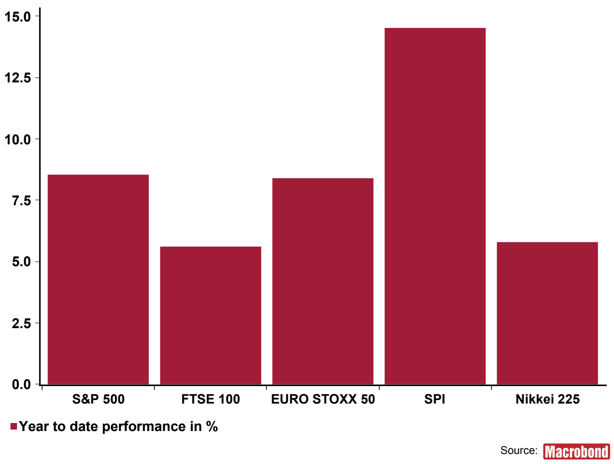
United Kingdom

- FTSE 100 gained more than 4% in May – despite negative news such as weak growth, terror and polls ahead of the snap election on June 8
- Weakening of the Pound against the Euro has been a support for UK's exporting firms

Switzerland

- SPI has gained almost 7% since the first round of the French elections, when a presidency of Macron became likely
- French elections are good news for Swiss stocks as the CHF weakened and as risks in neighbouring Europe have declined
- Similar to the EURO STOXX 50, the SPI could not climb back to the levels reached in mid-May after the drop caused by politics in the US

How much further can equities rise this year?



Since the beginning of this year, equity markets have shown a very strong performance. The positive sentiment since the election of Donald Trump has been revived by the market-friendly election outcome in France. Year to date performances are impressive: 8.5% for the S&P 500, 8.5% for the EURO STOXX 50 and 14.5% for the SPI. Precisely because stock markets have performed so well this year, we are cautious with our outlook. Current levels provide an attractive opportunity to lock in profits. In addition, equity markets typically have a weak performance in summer months. This seasonal pattern is even stronger than the one in December, when stock markets usually perform well. Many investors summarise it by "sell in May and go away". Moreover, we observe a lot of complacency in equity markets. There is a striking difference between fixed income and stock markets: After an initial boost right after the US elections, long-term yields have broadly moved sideways. US treasury yields have even declined. In contrast, the S&P 500 has constantly climbed upwards since the day of election. Thus, fixed income markets have priced out, to a large degree, the hopes around Trump's presidency, whereas equity markets have not. Given the high levels of stock indices and the long list of risks, we expect a correction of equity markets over the coming months. Yet, we only expect a correction, not the end of the bull market. The relative attractiveness of stocks compared to other asset classes prevents a large fall. Given the sound economic environment, small corrections have been attractive entry levels in the recent past. In our view, this "buy-the-dip" mentality will prevent large corrections.

Currencies

The rise of the Euro

USA

- Weakness of USD is driven by fading hopes regarding Donald Trump as well as strength of the Euro
- USD lost 3% against EUR in May, and almost 7% since the beginning of the year
- We expect a correction to the downside for EUR/USD from current levels (around 1.12)

Eurozone

- Euro gained 4% on a trade-weighted basis since the first round election result in France
- EUR gained too much against USD in our view
- France's parliamentary elections in June will be decisive for Macron's vigour

Japan

- Yen served as a safe haven when global risk sentiment suffered due to concerns regarding an impeachment in the US and in Brazil
- We expect higher JPY/USD in coming weeks – in case of risk-off sentiment, the Yen would appreciate

United Kingdom

- Pound weakened after polls pointing to a decreasing Tory lead and soft economic data
- We expect neutral GBP/USD in coming weeks as USD strength and rebound in Sterling might offset each other

Switzerland

- EUR/CHF climbed back to 1.09 – this level has not been reached since October 2016
- Weakening of CHF against EUR is a relief for the Swiss National Bank, which is currently less under pressure to intervene in FX markets
- While CHF lost against EUR, it gained against USD – USD/CHF fell way below parity (0.97) due to weakness of the Greenback

USD heads back to before election levels

The fading of hopes around Donald Trump's presidency are most visible in the US Dollar. On a trade-weighted basis, the value of the Greenback has fallen throughout this year and is almost back at the level of early November. Fixed income markets also reveal a sobering of expectations towards the new US administration. Yet, long-term US treasury yields have not declined to the same extent as the US Dollar. The recent weakness of the Greenback is, however, also partly driven by the strength of the Euro. Currency markets are always a relative game. Since the pro-Europe election outcome in France, the Euro gained on a broad basis. The EUR/USD exchange rate climbed back to 1.12. This is roughly the level of the second quarter of 2016. In our view, the recent strength of the Euro against the Dollar was exaggerated. We expect EUR/USD to correct to the downside. The Euro also gained considerably against the Swiss Franc. Since the election result of the first round in France, when a Macron presidency became likely, the EUR/CHF exchange rate climbed from 1.07 to 1.09. We expect the EUR/CHF to remain around 1.09 over the coming months. Thus, in our view, the recent strength of the Euro against the Swiss Franc is justified as the CHF is less of a safe haven after the French elections. Yet, we believe that the Euro's gain against the US Dollar went a bit too far.