

### Interest rates/Bond markets

Rapid rate rise around the globe

#### USA

- 10 year Treasury yield has risen by 25 basis points since 26 June – after this increase, it is back at the level of the beginning of the year
- We continue to expect one further rate hike by the Federal Reserve this year – this is a source for gradually higher rates until year-end

#### Eurozone

- The music of fixed income markets played in the Eurozone – Mario Draghi's comments about the strengthening economic recovery have caused long-term yields to rise around the globe
- German Bund yields have risen to almost 0.6%, a level not seen since early 2016 – in our view, there is only limited upside potential until year-end

#### Japan

- Long-term yields have risen to roughly 0.1% – this is still in line with the central banks' target of around zero percent for 10-year government bond yields
- While a normalisation of monetary policy is approaching in the Eurozone, we do not see such a shift in Japan

#### United Kingdom

- Bank of England also struck a more hawkish tone – 10-year yields rose by 30 basis points since late June
- We expect inflation to remain close to 3% until year-end and to decline thereafter as the impact of higher import prices will fade

#### Switzerland

- 10-year yields in Switzerland joined the general upward move in Europe – 10-year yields are approaching the zero line
- We expect yields to gradually climb up and to end the year at slightly positive levels

*Are central banks changing gears?*



Since late June, long-term interest rates have risen rapidly in all major markets. For a change, the origin lies in Europe and not in the US. The upward move of interest rates was caused by statements of ECB President Draghi. He said that the recovery in the Eurozone has strengthened and that risks of deflation have vanished. Many market participants have interpreted these comments as a preparation for a monetary policy normalisation. As a consequence, rising yields of the Eurozone pulled rates upwards in the Anglo-Saxon world, Japan and Switzerland. Janet Yellen additionally supported these moves. She stated that the Federal Reserve is not concerned by the recently falling inflation rate in the US. One interpretation is that the Fed de facto adjusts its inflation target to the downside. Moreover, market participants are speculating about the timing of the balance sheet reduction of the Fed. In our view, it is appropriate to prepare for a further normalisation of monetary policy in the US and the Eurozone. Yet, we are still of the view that the process of normalisation will be very gradual. This translates into a further rise of interest rates until year-end, yet at a much more moderate pace than in recent days. In the Eurozone, favourable politics are an additional driver for higher rates over the next few weeks. Political risks have significantly declined since the French elections and the Italian elections – the next source of worry – are not yet in focus. Finally, interest rates have also risen in Switzerland. The 10-year government bond yield should soon turn positive.

## Stock markets

Bets on higher volatility do not pay out

### USA

- Although current growth of earnings-per-share remains in double digit territory, net revisions for next year's EPS growth have turned negative
- Valuations have not risen further over the past month, but remain elevated – US equities look less attractive compared to their European peers
- The Federal Reserve seems determined to continue normalising monetary policy

### Eurozone

- Relative to US equities, fundamental valuations of Eurozone stocks look attractive
- Mr. Draghi's hawkish statements at the ECB Forum in Sintra caught markets by surprise – stocks declined in anticipation of monetary policy normalisation
- The appreciation of the Euro is an additional headwind for stocks to move higher – however elections in Austria and Italy later this year may put an end to Euro appreciation

### Japan

- Over the past four weeks the Yen depreciated by almost 4% on a trade-weighted basis and supported stock performance – thanks to an explicitly loose stance of the central bank relative to the hawkish tone of others

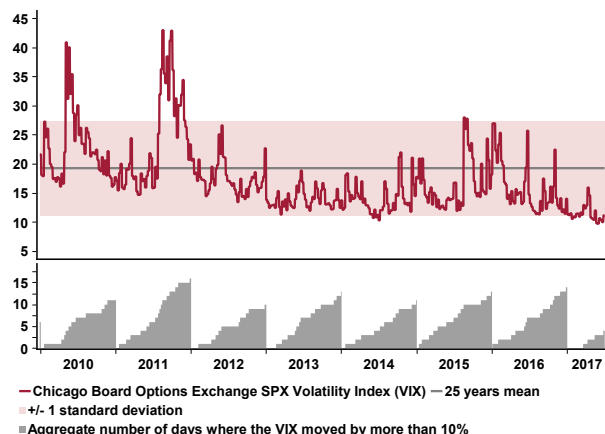
### United Kingdom

- The political debacle increased uncertainty not least for corporate decision-making and thus erodes investor confidence in certain British stocks
- Higher inflation led the Bank of England to strike a hawkish tone – no good news for equities

### Switzerland

- After a strong rally in April and May of this year, the SPI remains the outperformer among the main indices since the start of 2017
- Relief based on the depreciation of the Swiss Franc is visible – export-oriented companies should find it somewhat easier to compete internationally

*Ignoring risks – fairly calm and stable 2017*



Source: **Macrobond**

Given that central banks usually aim at being boring, the Federal Reserve, the Bank of England and above all the ECB have diverged from this objective over past weeks. Their unexpected hawkish tone left traces in financial markets. Most developed market equity indices therefore display a negative performance over the past month since investors suspect that the pillar of ultra-loose monetary policy may crumble. Even before that surprising twist of central bank communication, we assessed the probability of short-term weakness in stock markets as being high. While we opted for caution over past months already, a major positive factor for future performance has faded in the meantime: expectations for future earnings growth. Over the past weeks, earnings-per-share (EPS) revisions displayed a dramatic decline, especially so for the US market, where earnings revisions even dropped into negative territory. Once again, given the temporary decline of the oil price, energy-related companies were in the focus. As regards European markets, we also expect EPS growth expectations to pursue a trend to lower levels over coming months. However, fundamental valuation measures point to a relative advantage of European stocks, even though absolute valuation looks rich for all of the developed markets. In the meantime, equity investors can hardly be shocked anymore. Geopolitics and other risks are being ignored. The complacency of market participants is impressively illustrated by the volatility chart of the S&P500 above. Finally, seasonality plays a role for our short-term cautious stance: as we enter pre-earnings season, companies are confronted with the black-out period forbidding them to buy back own stocks. This support for equity prices will fall off over the coming weeks.

## Currencies

### Surprising central bank talk

#### USA

- Weakness of the US administration is also reflected in the development of the USD
- Market participants still do not believe in the indicated hiking path of the Fed – forward rates clearly remain below the Fed's indicated levels
- ECB and Bank of England surprised with hawkish talk causing the USD to depreciate versus EUR and GBP

#### Eurozone

- Supported by strong economic data and a hawkish stance of the ECB, the EUR temporarily appreciated by approximately 1% on a trade-weighted basis since the beginning of June
- We do not anticipate a much stronger EUR versus USD over the next month
- Political risks have not vanished completely – elections in Austria and Italy may weigh on the EUR

#### Japan

- The Bank of Japan recently reiterated its accommodative stance which led to pronounced depreciation of Yen versus USD, EUR and CHF
- As economic data come in stronger we do not expect this depreciation phase to continue

#### United Kingdom

- BoE Governor Carney struck a hawkish tone which made the Pound appreciate despite political uncertainty and weaker economic data
- We do not think that GBP strength will persist as the economic outlook deteriorates and Brexit negotiations are expected to be painful

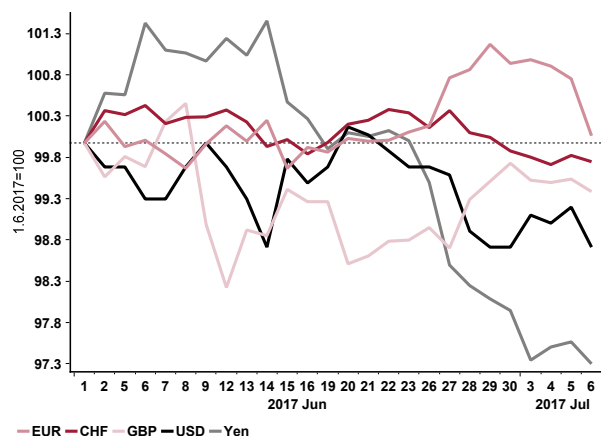
#### Switzerland

- EUR/CHF was boosted by hawkish ECB talk – but the upside is limited by political risks
- Weakening of CHF against EUR is a relief for the Swiss National Bank – yet the CHF remains largely overvalued

#### Released and approved by the Economics Department, Swiss Life Asset Management AG, Zurich

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#### Trade-weighted currencies under the spell of central banks



Source: **Macrobond**

The relative evolution of trade-weighted currencies since the beginning of June (see chart above) nicely reflects the communication paths taken by the respective central banks. The EUR has been under appreciation pressure ever since ECB Governor Draghi struck a surprisingly hawkish tone at the ECB Forum in Portugal. Equally so, the Federal Reserve as well as the Bank of England underlined their willingness to withdraw some of the monetary policy support. To certain observers, this looked like a concerted action and indeed markets took it as that. Meanwhile the Bank of Japan reiterated their determination to stick to the ultra-loose monetary stance until the inflation goal has been reached. Apart from central bank communication, the appreciation of the EUR is justified given the sturdy economic backdrop in the currency region. From this level however, we see only limited upside for EUR appreciation versus USD with the Fed being in a tightening cycle. Moreover, the ECB will want to avoid further pronounced and quick appreciation of the EUR due to the adverse effect on economic growth. Against CHF, on the other hand, the relative monetary policy stance points to more room for the EUR to appreciate, albeit moderately so. Still, a big relief for the Swiss National Bank who can afford to curb FX interventions. In any case, the CHF remains overvalued according to all of the prominent valuation models.