Outlook for Financial Markets
August 2016

Interest rates/Bond markets

Repricing of Fed policy yet again

USA

- The economic surprise index has clearly turned into positive territory over the past month – solid economic data caused market participants to reprice monetary policy by the Fed going forward
- We expect a resumption of the cautious rate hike cycle in December 2016
- After a strong correction of the 10-year yield in the wake of the Brexit vote, rates quickly climbed up again

Euro Area

- The ECB's press conference made clear that they await more information including new staff projections in September before taking a decision on additional policy action
- Yield levels are so unattractive that fixed income investors turn to emerging market credit or US treasuries instead

Japan

- Although BoJ Governor Kuroda strongly rejected the idea of helicopter money, market expectations of additional QE are high

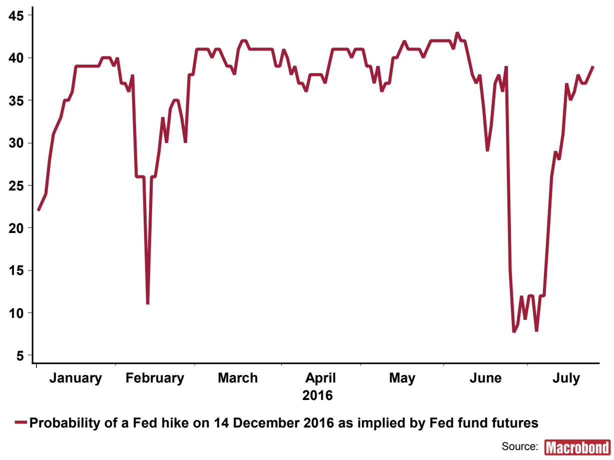
United Kingdom

- The BoE abstained from loosening policy in July, is however expected to ease policy in August
- Post-Brexit PMI data indicate a big loss of economic momentum
- The British Pound has partly done the job of the BoE by substantially easing financial conditions - this puts a question mark behind markets' expectations of much more easier policy to come

Switzerland

- Even a 30-year Swiss government bond has a negative yield
- The SNB remains dependent on ECB action going forward – FX interventions continue

The ups and downs of Fed rate hike expectations



The initial shock after the EU referendum in UK was quickly digested by financial markets. Maybe the rise in yields since the low point on 8 July in almost all developed markets was too quick signalling a certain complacency regarding the still uncertain impact of the Brexit vote. In our view, rates may well move lower again over the coming weeks mainly for technical reasons. Some of the political uncertainty however has been reduced due to the swift nomination of the new UK Prime Minister Theresa May who seems determined to proceed with an orderly exit from the EU. Contagion risks in the sense that other EU countries may strive to follow the UK into sovereignty did not materialise given survey results in other member countries after the referendum in UK. These developments in the political arena helped to stabilise financial markets. Furthermore, market participants were quick to anticipate support from monetary policy yet again. BoE governor Carney immediately made a rather firm statement that the central bank would be willing to support the economy with interest rate cuts. More monetary easing is also expected by the ECB and the BoJ. At this stage, central banks hardly have hard economic data in their hands to gauge the economic impact of Brexit. We stick to our view that the Federal Reserve will resume its hiking path in December of this year. Yield levels in the US are much more attractive than in European government paper so that demand for Treasuries is well supported. In Europe, on the other hand, demand for government paper is almost guaranteed by central bank purchases on the basis of QE programmes.

Stock markets

Earnings season supports rally

USA

- After a short correction post-Brexit, the S&P500 has climbed to a new historical high
- Second quarter earnings season boosted stock prices – regarding top line growth, 60% of companies beat expectations
- Valuations are stretched – the US stock market looks overbought

Euro Area

- The EuroStoxx 50 is lagging its peers in the post-Brexit recovery, however had also corrected the most after the vote
- European indices are facing the unique obstacle of the bank stress tests and the potential recapitalisation of Italian banks
- Political risks remain a burden on stock performance in Europe

Japan

- The notion that authorities will dynamise the economy with a monetary and fiscal package gave wings to the Nikkei
- A slight depreciation of the Yen helped performance in particular of exporting companies

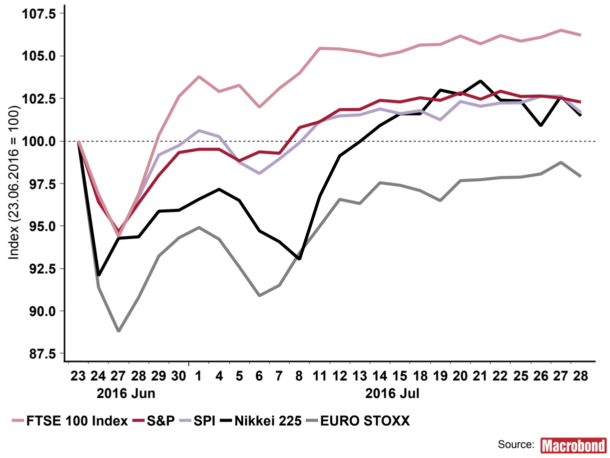
United Kingdom

- The FTSE 100 continues to outperform its peers – the index gained almost 7% since the Brexit vote
- Equities benefit from the notion that monetary as well as fiscal easing measures will be adopted to support the economy
- The strong performance of stocks of small and medium-sized companies is doubtful since they hardly profit from the weaker Pound

Switzerland

- Post-Brexit, investors in Swiss equities may have been relieved to see that the Swiss Franc appreciated much less than one may have expected – some of the pressure was alleviated by the SNB
- The price-earnings ratio is clearly above its 20-year average – equities are expensive

Post-Brexit performance: Losses recouped almost everywhere



The earnings season has turned out to be a support for stock performance over the last weeks, in the US as well as in Europe. Among US companies which reported for the second quarter, 84% were actually able to beat earnings-per-share estimates of analysts, which is a fairly hefty number. In line with strong consumption growth in the US throughout the second quarter, 60% of the companies reported higher top line growth than commonly estimated. Consequently the US corporate world may have shaken off the earnings recession. Unsurprisingly, investors became fairly euphoric. This translates into a US stock market which is currently overbought in our view. 87% of the US stocks have surpassed their 50-day moving average, a sign to us that we may face a technical correction in the weeks to come. Furthermore, once the Brexit uncertainty recedes, market participants may turn their attention to the upcoming US election and the risk of a Republican President Trump. Across the Atlantic, investors dread the publication of the bank stress test results on 29 July and the implications for finance related stocks in general. The stress tests will also reveal the condition of the five major Italian banks, some of which are prone to need recapitalisation. Consequently, the EuroStoxx 50 has not yet reached its pre-Brexit level. Valuations of European stocks are not as stretched as the ones in the US. In general, one cannot help but notice that many investors replace fixed income investments by dividend paying stocks which looks like a risky strategy to adopt in times of elevated economic as well as political uncertainties. Given these risks as well as the over-euphoric sentiment, we maintain our cautious stance vis-à-vis equity engagements.

Currencies

Stabilisation over past weeks

USA

- Market participants have started to price in more rate hikes by the Fed again – this helped to sustain the USD appreciation over the past four weeks
- Sturdy macroeconomic data caused the rate differentials between EUR and USD to widen again – this theme should persist in H2 2016
- The relatively strong economic momentum is also reflected in long USD speculative positioning

Euro Area

- The ECB kept its powder dry in the last meeting, signalled however a bias towards further easing
- EU break-up fears have receded enabling the EUR to appreciate on a trade-weighted basis since 23 June
- We expect EUR to weaken versus USD over the weeks to come

Japan

- The Yen finally managed to depreciate on a trade-weighted basis since 8 July – investors expect yet another easing package by the BoJ
- Improving risk sentiment usually translates into a weaker Yen

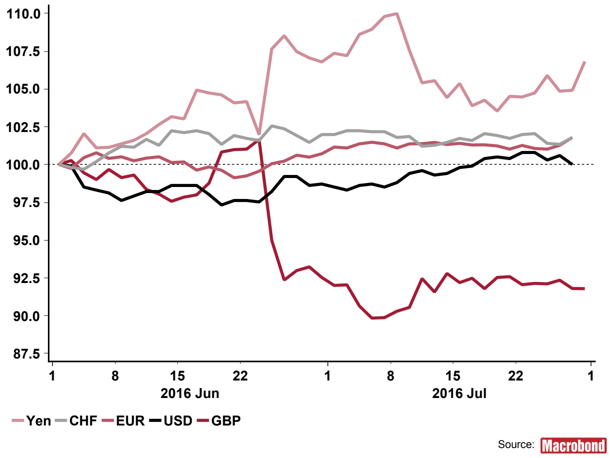
United Kingdom

- After the intitial strong hit, GBP has managed to stabilise since mid July – the swift nomination of the new Prime Minister helped to establish a floor
- Given that the Brexit vote impairs economic prospects, we expect the GBP to remain under downward pressure, especially if the BoE decides to cut rates in August

Switzerland

- Receding contagion fears and improving risk sentiment should support EUR/CHF at current levels
- The SNB may be forced to act further with FX interventions remaining the main policy tool

Currencies on a trade-weighted basis (01.06.2016=100)



In line with macroeconomic momentum and the move of yield differentials, the USD managed to appreciate against all other major currencies. The repricing of the Fed's future monetary policy supported the Greenback over the past weeks. Monetary policy divergence is thus staging a comeback as a major driver for exchange rates. All other major central banks are rather expected to ease monetary policy further. While the ECB and BoJ kept their powder dry in their last meetings, both central banks are expected to ease monetary policy further. After Ben Bernanke's visit to Japan, some analysts even argued that helicopter money was but the logical next step for the BoJ to take in order to revive economic momentum and to create inflation. BoJ governor Kuroda rejected this notion vehemently. Nevertheless and to the great relief of the BoJ, the Japanese Yen finally depreciated while its future path is highly dependent on the central banks's long-awaited announcement on 29 July. Meanwhile a huge fiscal package was announced by Prime Minister Abe to support the economy. The British Pound, on the other hand, which had taken a big hit after the Brexit vote managed to stabilise for the time being on a trade-weighted basis. Even though the swift change of the UK government reduced political risk, we expect that the Brexit vote will impair economic prospects in a prolonged way. Furthermore, we expect the BoE to implement easing measures in its upcoming August meeting. The currency pair EUR/CHF hardly moved and looks rather boring. This will remain so in our view.