Outlook for Financial Markets
August 2017

Swiss Life
Asset Managers

Interest rates/Bond markets

In pursuit of inflation

USA

- The increase in 10-year Treasury yields came to a sudden end as inflation surprised to the downside
- As Janet Yellen takes a more dovish stance, markets start to price out an additional rate hike for 2017
- Short-term, Fed policy timing will depend on inflation data through the third quarter 2017

Eurozone

- The recent Euro appreciation means that Mario Draghi's ECB will miss the inflation target by large amounts this year and even more so in 2018
- While redesign of quantitative easing program or even tapering still is in the cards, we exclude the normalisation of interest rates for the time being

Japan

- Two key targets of Abenomics remain out of reach: Balanced primary household and reflation of the domestic economy
- We do not expect any change in Japan's monetary policy over a period of three or even more years

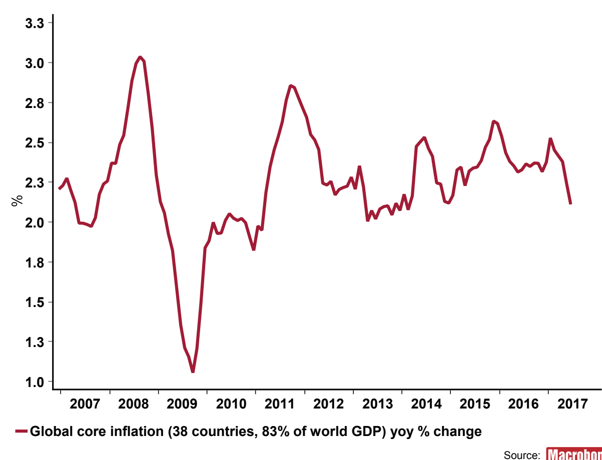
United Kingdom

- Like elsewhere in the developed world, inflation surprised to the downside as of late; we expect the UK inflation cycle to reach a peak by October this year
- This and a potential delay in action by the Fed and the ECB removes pressure from the Bank of England to embark on policy normalisation soon

Switzerland

- While sovereign yields corrected to the downside elsewhere, 10-year Confederation bond yields stay around the zero line for the time being
- Demand for safe havens is in decline given the synchronous upswing of the global economy
- We continue to expect yields to gradually climb further up and to end the year at slightly positive levels

Strong setback of global core inflation rate



Central bank rhetoric took bond markets on a roller coaster over the past weeks. While interest rates rose strongly during most of June, we observed a partial correction of this move in July. The main reason for the latest development was the downward trend in inflation which took investors by surprise. Our proprietary measure of global core inflation dropped to its lowest level since February 2011. Developments on financial markets through the second half of 2017 will predominately depend on central bank's response to their apparent miss in bringing inflation back into the system. As a rule of thumb, one can expect that the recent Euro appreciation lowers Eurozone headline inflation by around 0.3 percentage points over the next twelve months. In our view, this increases the probability that any monetary policy normalisation by the ECB beyond a reduction or redesign of their asset purchase program will be delayed. The drop in inflation could be seen as more temporary in the case of the US, where we expect headline inflation to return above 2% by mid next year. Financial conditions for the US economy have eased since the start of the current monetary policy normalisation cycle in 2015. Thus, a further rate hike by the end of the year and the announcement of measures to shrink the Fed's balance sheet remain likely in our view. Yet, FOMC members will watch inflationary tendencies and wage developments carefully over the coming months and so should global investors.

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Stock markets

The air is getting thinner

USA

- After almost 200 of S&P500 constituents reported earnings for the second quarter, more than 80% of those companies presented positive surprises – at first glance the ongoing rally seems well supported
- However, analysts continue to revise down their expectations for earnings growth in 2018
- Extremely low volatility rings a warning bell together with record high allocations in stocks

Eurozone

- Relative to US equities, fundamental valuations of Eurozone stocks look attractive
- Although Mr. Draghi softened his tone regarding future policy normalisation, most major stock indices have corrected over the past four weeks
- The ongoing appreciation of the Euro is a headwind for stocks to move higher
- Elections in Austria and Italy later this year may stir market concerns again

Japan

- Supported by global tailwinds, economic fundamentals appear solid by mid-year 2017
- Global investors have been flocking to Japan for yield, making its stock market one of the best performers among developed regions over the past 12 months
- Prime Minister Abe has lost popularity since Abenomics fail to hit target and due to scandals

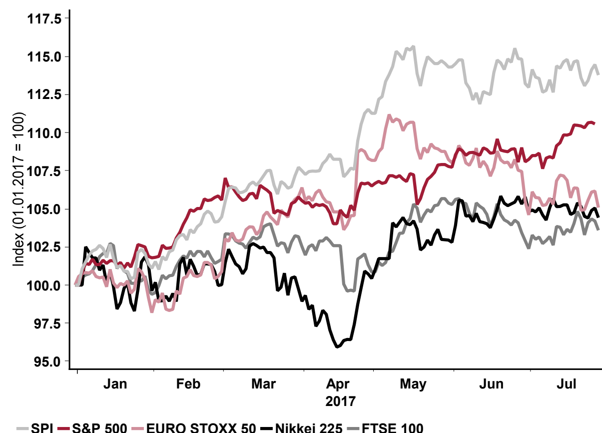
United Kingdom

- Over the past 12 months, the FTSE 100 has been one of the worst performers among developed markets stock indices – the financial sector has taken the biggest hit

Switzerland

- Domestic demand continues to be lacklustre – the fruits of low interest rates and cheap imports have been reaped and the impulse is weakening
- EUR/CHF exchange rate continues to move up which should lend support to gains of Swiss exporters

Relative performance since the start of the year



For yet another month, major European indices have a hard time rendering a positive performance. US stocks on the other hand managed to move higher, spurred by an earnings season which rendered mainly positive earnings surprises. More than 80% of S&P500 companies which have reported on second quarter numbers so far delivered higher than expected profits. Thus, investors have digested the latest indications from the Federal Reserve that they may launch a reduction of their balance sheet as early as in September of this year. At the same time they pointed to the fact that consumer price inflation was way below their target and they do not seem to be in a rush to change interest rate policy anytime soon. Across the Atlantic, European indices were not able to climb after Mario Draghi shocked markets the month before indicating that a normalisation of monetary policy may be immanent. His perceived hawkishness sent the Euro on an appreciation trend which is still ongoing and which will hurt economic as well as inflationary dynamics further down the road. Equity indices are being punished for that. All in all, our cautious stance vis-à-vis equity investments seems increasingly justified. Fundamental valuations of stocks look stretched, particularly so in the US, earnings revisions for the year 2018 have plunged massively for US as well as European stocks, volatility indices remain on ultra-low levels indicating investors' complacency and with a view to positionings, one cannot help but notice that equity allocations have reached record highs on a global scale. Adding up our view that macro momentum will be losing steam, a very careful hand in steering allocations in risky assets seems warranted.

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Currencies

Two G10 currencies stand out

USA

- The Greenback lost ground again against other major currencies
- Weak inflation as well as retail sales data puts the Fed's hiking path into question and exert downward pressure on the currency
- Political stillstand in Washington slowly undermines the economic optimism

Eurozone

- The EUR was boosted by the ECB's move towards removing some accommodation in light of an upgraded growth outlook
- Speculative positions in the single currency are very strong and underpin further appreciation
- With populists gaining ground, the election in Italy constitutes a main risk to a stronger Euro

Japan

- The Bank of Japan recently reiterated its determination to control the yield curve and to remain highly accommodative
- As economic data come in stronger we do not expect the depreciation phase to continue

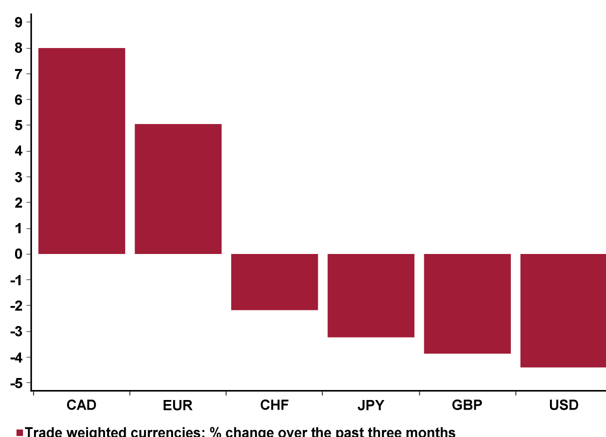
United Kingdom

- The weaker inflation data has removed some urge by the Bank of England to adopt a hawkish stance
- GBP may come under pressure again as the economic outlook deteriorates and Brexit negotiations are expected to be painful

Switzerland

- Over the past month, EUR appreciated by more than 4% versus CHF – yet the scope for this trend to continue looks limited
- However, CHF appreciated versus USD, British Pound, Yen and Chinese Yuan
- CHF remains clearly overvalued

Canadian Dollar is the clear outperformer



Among G10 currencies, the development of two currencies certainly stands out over the past four weeks: The Canadian Dollar and the Euro. Both appreciated notably against other main currencies and both were lifted by the communication of their respective central bank. The Canadian Dollar appreciated by more than seven percent versus USD and by almost five percent versus CHF. An unexpected hike by the Bank of Canada and a rapid shift in financial markets as regards the future hiking path were the main drivers behind the appreciation. Furthermore, the White House has softened the tone related to upcoming NAFTA renegotiations so that earlier fears that large trade disruptions would occur were priced out of the Canadian exchange rate. The second currency which deserves special mentioning is the one which proves that "the condemned live longer": the Euro. Although Mario Draghi was interpreted to have struck a more dovish tone that at the ECB's meeting in Portugal, the single currency still showed resilience versus other main currencies. On a trade-weighted basis, the Euro appreciated by six percent over the past three months. This is certainly a pace that the ECB does not appreciate a lot, but the question if this would suppress their determination to normalise monetary policy remains open. We view the scope for further EUR appreciation from current levels as limited. Should the ECB stick to its removal of accommodation in upcoming communication, paired with an SNB which remains dovish, room for further upside is given however.

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