Outlook for Financial Markets
September 2017

Interest rates/Bond markets
Heading into an exciting autumn

USA

- Since the end of July, sovereign yields have moved lower again – a development which we had anticipated as stated in last month's paper
- Inflation readings surprised to the downside yet another month while the political mess added to the downward pressure on interest rates
- We expect the Fed to announce balance sheet adjustment in September and to hike in December

Eurozone

- The Eurozone's inflation readings did not disappoint but were reported slightly higher than expected for the month of July
- The central bank is bound to decrease the Euro amount of monthly asset purchases in 2018 and will start to talk about it in autumn this year

Japan

- Despite a very strong GDP growth figure reported for the second quarter, interest rates corrected to the downside over the past four weeks
- Two key targets of Abenomics remain out of reach: Balanced primary household and reflation of the domestic economy

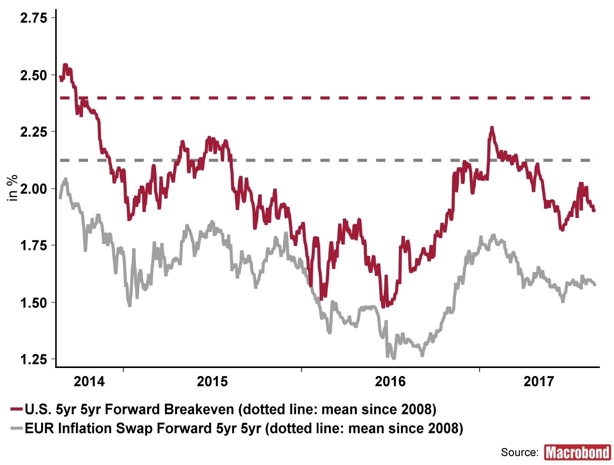
United Kingdom

- Expectations that the BoE may start to hike interest rates soon have faded
- Inflation data came in weaker as well and led to another depreciation phase of the British Pound
- The British are increasingly under pressure to make concessions in Brexit negotiations

Switzerland

- As elsewhere, 10-year Confederation bond yields corrected to the downside again over the past month
- Risk aversion usually favours Swiss assets

Inflation expectations far from their respective means



This autumn will probably mark another important turning point for monetary policy in the US and the Eurozone. The US Federal Reserve is commonly expected to announce the balance sheet reduction at the central bank's September meeting. We would expect the implementation to start in the last quarter of this year. In our view, this will be accompanied by an interest rate hike in December 2017, the fifth rate increase in this cautious cycle, which will lift the target rate to 1.5%. The ECB too is likely to specify its exit from ultra-loose monetary policy, in the sense that they will lower the monthly purchases of assets to a smaller amount from currently 60 billion Euro at beginning of 2018. In other words, monetary easing will continue in the Eurozone, but to a smaller extent. In our view, however, the ECB is not in a position to consider rate hikes any time soon. Inflation readings are bound to remain well below the central bank's target and the current Euro appreciation poses risks to the growth as well as inflation outlook in the medium-term. Consequently, the Swiss National Bank's situation should feel more comfortable. They are able to reduce their Euro purchases to zero, but are equally far from thinking about changing their rate policy in our opinion. After the latest pronounced correction of long-term sovereign yields to the downside, we expect them to grind higher for the remainder of this year. Given geopolitical uncertainties, this moderate uptrend will not be a straight line.

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Stock markets

Markets are still in "buy the dip" mode

USA

- S&P 500 has revealed a pronounced "buy the dip" pattern this year – corrections of a few percent were followed by a rally
- "Buy the dip" to continue – we expect a slight upward move after the correction in August
- Earnings growth has been revised to the upside, which is a support for US stocks

Eurozone

- The downward move in August was nothing new for EURO STOXX 50 – the index has been on a downward trend since early May
- Strengthening of the Euro has been and still is a headwind for European equities
- Monetary policy stance of the ECB and its implications for the Euro will be a major driver for European stocks going forward
- Elections in Austria and Italy may stir market concerns again

Japan

- Nikkei 225 was the underperformer of the indices discussed here in the month of August – Japan is particularly prone to risks of North Korea due to its geographical location and its safe haven currency
- Among the indices discussed in this paper, the Nikkei 225 has had the weakest year-to-date performance (+1.3%)

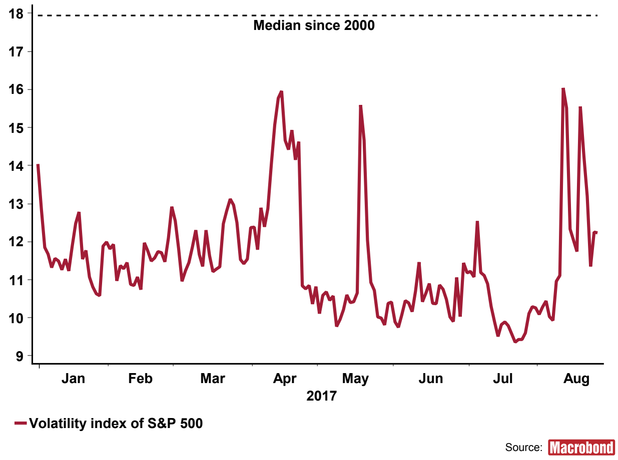
United Kingdom

- UK stocks have done comparably well in August – renewed weakness of the Pound has countered downward pressure caused by geopolitical tensions
- We expect Pound to remain weak given difficult Brexit negotiations, which is a support for stocks

Switzerland

- Pronounced depreciation of the Swiss Franc in July and August did not really push the SMI higher
- Among the indices discussed here, the SMI is the clear outperformer in 2017 with a year-to-date performance of 14%

Volatility detached from ultra low levels



Given the numerous political events this year, the persistence of the ultra low volatility has taken many by surprise. The heightening of geopolitical tensions around North Korea led to a detachment from extremely low volatility levels in August. In our view, it is a good sign that volatility is not anymore on very low levels. It shows that investors are not overly complacent. Yet, it is worth emphasising that volatility remains on comparably low levels. It has simply detached from ultra low levels. Since 8 August, when Donald Trump threatened North Korea with "fire and fury" all indices discussed here have started to correct to the downside. We do not believe that this has been the start of a new downward trend. We expect slightly upward moving equity markets over the coming weeks. In the recent past, many investors pursued a "buy the dip" strategy: When equities have corrected by a few percent, market participants have invested again, thereby benefitting of attractive entry values. We expect this mechanism to take effect also this time. Earnings and economic growth are supportive. Earnings growth is expected to remain in double digit territory. The synchronous global cyclical upswing is still unfolding. Yet both the earnings as well as the growth dynamics are losing momentum. In our view, the peak of the global growth upswing will be reached soon. Together with gradually lower monetary stimulus this speaks for a limited upside for equity markets in the near future. Last but not least, we take a look back. How well did the "sell in May and go away" strategy work this year? It was the right strategy for the EURO STOXX 50, Nikkei 225 and FTSE 100. They have lost between 1 and 3% since the end of May. The performance of the SPI was roughly zero. Yet, this strategy was not the right one for US equities. The S&P 500 has gained 1% since the end of May.

Currencies

The end of the rise of the Euro?

USA

- The rapid and broad-based depreciation of the Greenback came to a halt in August
- Market participants are not convinced that the Fed will deliver another hike in December – we expect a repricing and thus a somewhat higher USD over coming weeks
- It is broadly expected that the Fed will announce a gradual balance sheet reduction in September

Eurozone

- Appreciation of the EUR against USD came to a halt – EUR/USD hovered around 1.18 during the month of August, a level not seen in more than 2.5 years
- Limited upside potential for the EUR from current levels
- ECB is uncomfortable with recent EUR appreciation, the central bank mentioned risks of financial stability in case of an overshoot

Japan

- Geopolitical worries around North Korea triggered a broad-based appreciation of the Yen – a safe haven currency – since early July
- We expect higher USD/JPY in coming weeks as the divergence of monetary policies gains in importance with somewhat lower geopolitical tensions

United Kingdom

- Pronounced and broad-based depreciation of the Pound as expectations of a hawkish Bank of England fade and uncertainty around Brexit remains
- Trade-weighted Pound has reached a new low for 2017

Switzerland

- After having surpassed 1.15 shortly, EUR/CHF is grinding lower – small further downside potential
- Besides the EUR-strength, worries around North Korea were the other big theme for CHF

Appreciation pressure on the Swiss Franc easing

What a relief for the Swiss economy and the Swiss National Bank (SNB): The exchange rate of the CHF against the EUR has, for the first time since the SNB abandoned the floor, significantly detached from 1.10. In early August, EUR/CHF moved even above 1.15 for a few days. It is rather a Euro strength than a Swiss Franc weakness. The rise of the Euro started after the French elections and was fuelled by strong economic data and most importantly by a speech of Mario Draghi in July. The Governor of the European Central Bank said that the recovery in the Eurozone has strengthened and that deflation risks have vanished. There is also a fundamental reason for a firmer Euro: Since 2011, the current account balance has increased from 0% of GDP to 3.5% of GDP. Thus, demand for Euro has risen as other countries buy more Eurozone exports. Yet, this fundamental factor has been overshadowed by debt mountains, economic weakness, monetary accommodation and political uncertainties for many years. It is worth mentioning that there is no relation between the SNB's currency interventions and the recent depreciation of the Swiss Franc against the Euro. In fact, there were only minor interventions of the SNB since June. Going forward, we expect the momentum of the Euro to fade. In our view, financial market participants anticipate a too fast cut down of monetary stimulus. Therefore, we believe that EUR/CHF has overshot a bit and will grind lower from the current level of 1.14. Similarly, we expect that EUR/USD will correct somewhat to the downside in coming weeks.

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