Outlook for Financial Markets
October 2016

SwissLife Asset Managers

Interest rates/Bond markets

BoJ delivers but leaves no traces

USA

- The latest FOMC decision to leave the target rate unchanged seems to have been a close call – 3 committee members voted for a hike
- We expect a resumption of the cautious rate hike cycle in December 2016 – unless the presidential election in November delivers a surprise and rattles financial markets

Euro Area

- Rollercoaster for 10-year yields in September – the spike until mid-month was eroded again thereafter
- The weight of the ECB in the market will keep rates low – we do not see a pertinent reason why yields should go higher over the next four weeks
- The ECB is likely to anounce the extension of its QE programme before year-end

Japan

- The Bank of Japan went yet another step further – they aim to control the entire yield curve and to keep long-term rates below or close to zero in order to generate above 2% inflation
- Right after the announcement, yields started to correct to the downside

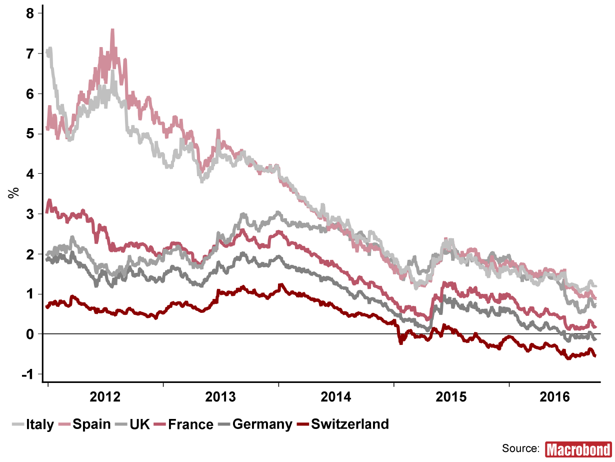
United Kingdom

- From the low reached in August this year, 10-year Gilts moved somewhat higher in line with the rest of the market, remain however clearly below the level reached before the Brexit vote
- As concerns the macroeconomic surprise index, UK is the clear outperformer as data largely surprised to the upside – growth weakness will only fully unfold next year

Switzerland

- Growth dynamics in the first half of this year were stronger than expected – although the quality of the growth composition in Q2 is rather poor

10-year yield levels in Europe: Nicely stacked



Financial markets are holding their breath as US presidential elections move closer. Until the dice for either Mrs. Clinton or Mr. Trump fall, monetary policy seems to be taking a backseat. Almost all major central banks left their current policy stance unchanged, with one prominent exception, which is the Bank of Japan. They introduced QQE – quantitative and qualitative monetary easing – with short- as well as long-term interest rates as policy instruments. They left the short-term policy rate in negative territory and want to control the whole length of the yield curve in such a way that the 10-year yield remains at 0%. By way of flexible purchases of Japanese government bonds, they want to manage the yield curve with the ultimate goal of lifting the inflation rate above 2%. It remains highly doubtful whether they will achieve this goal. Inflation expectations have hardly budged. The trade-weighted Yen did anything but weaken. Thus far, the announcement seems ineffective. Pressure on the Bank of England, on the other hand, to ease monetary policy further, has abated a lot. The continued weak level of the trade-weighted British Pound keeps financial conditions on an extremely low level, thus partly doing the job of the central bank. Furthermore, macroeconomic data still come in a lot stronger than could have been expected after the Brexit vote. The GFK consumer confidence has rebounded substantially in the last reading, reaching the level of before the referendum. In all of the developed countries, we expect long-term rates to hardly move until year-end. US presidential elections have the potential to disrupt that view, should the Republican candidate prevail against all odds.

Editorial deadline: 30.09.2016

Stock markets

Still very low volatility levels

USA

- Purchasing managers indices in the manufacturing as well as services sector weakened substantially causing growth worries to re-emerge
- Analysts expectations for EPS growth seem exaggerated given falling margins and the relatively weak macro environment
- We expect volatility to pick up ahead of the presidential elections

Euro Area

- The EuroStoxx 50 is still lagging its peers having performed almost minus 10% year-to-date
- European indices are facing the unique obstacle of renewed tensions in the banking sector
- Political risks equally remain a hurdle to take still this year as Spain may be faced with yet another election and Italy's Prime Minister may well lose the decisive referendum on 4 December

Japan

- The Nikkei was hardly impressed by the BoJ's announcement of a new monetary easing package and corrected again after an initial spike up
- The Yen refuses to weaken and the competitive environment for export-oriented companies remains tough

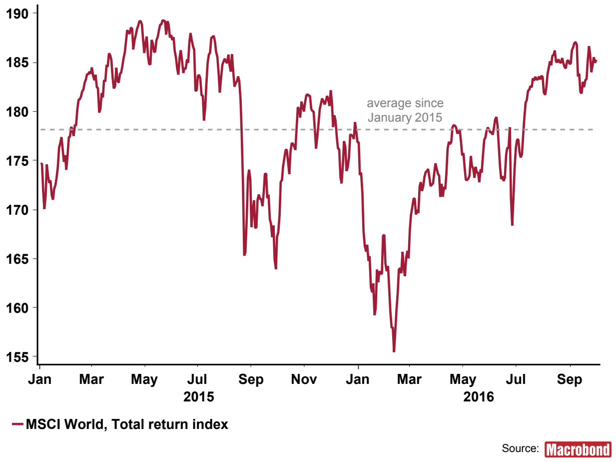
United Kingdom

- The FTSE 100 gained almost 10% since the start of the year and continues to outperform its peers
- As long as the Pound does not appreciate, financial conditions are sufficiently loose for corporate UK
- Fiscal easing may well be expected to dampen the effects of the Brexit vote and could stem the potential tide of relocation of companies

Switzerland

- As elsewhere, we think that the Swiss market may be due for a mild correction until year-end – yet Q4 usually delivers fairly strong equity performance
- The Pharma sector is the only major sector in the Swiss industrial world which is still able to deliver positive export growth

Global equities: Still searching for a trend



If we consider the full period since the beginning of the year 2015, the MSCI World Index has moved sideways (see graph above). The big losses of January and February of this year were recovered by May. The rally that followed in the post-Brexit period, characterised by an even stronger hunt for yield, resulted in a year-to-date performance of 6%. We are currently at similar levels as in the second quarter of 2015. The barrier of 190 has not been broken so far. Until year-end, we do not see much upside potential for equity markets from current levels. Volatility still is very low. Yet, there was some increase around the September Fed meeting. We believe that volatility will increase in coming weeks and months and that this will rather lead to lower than higher prices. On the one hand, volatility is currently simply on very low levels. On the other hand, there are important political events in the US and Europe, which could heighten uncertainty and hence lead to more volatile markets. In US election years, volatility usually increases in October. Furthermore, valuations are high. In the US for example, equity prices have increased over the last quarters and at the same time earnings decreased. The result is higher Price-Earnings-Ratios. Yet, on a relative basis, equities are still attractive, in particular compared to fixed income. Moreover, over recent weeks, the European banking sector re-emerged as a negative risk factor for equity markets and sentiment in general. The risk to our prudent outlook is seasonality. The fourth quarter is generally a strong one. This is particularly true after a positive performance of the first three quarters.

Currencies

Surprisingly low volatility compared to other markets

USA

- We stick to our expectation of a Fed hike in December, followed by two more hikes in 2017
- As a December hike is only partly reflected in current prices, we expect some appreciation of the US Dollar until year-end

Euro Area

- EUR/USD moved surprisingly little during the month of September given the renewed volatility in long-term interest rates related to the September meeting of the Fed
- Relative economic data surprises have been slightly positive for the EUR against USD lately

Japan

- The Bank of Japan (BoJ) changed its monetary policy framework, yet remains under pressure to cut short-term interest rates again as the Yen has only stabilised but not reversed
- We do not expect the BoJ to reach its inflation target of 2% over the next quarters

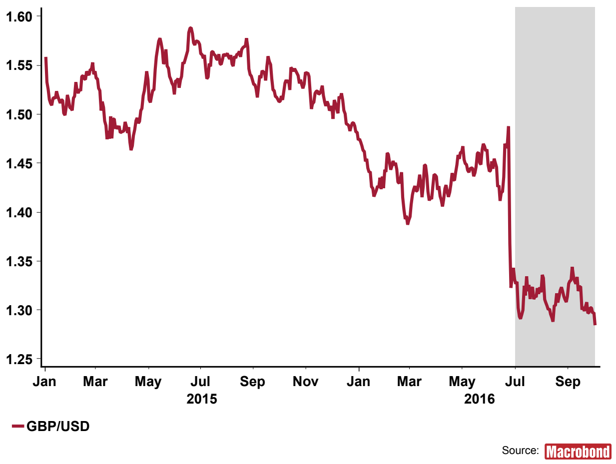
United Kingdom

- On a trade-weighted basis, the Pound continued to depreciate slightly but steadily after the free fall in late June
- As the initial impact on the UK economy was rather benign due to loose financial conditions, we expect the Bank of England to hold its ammunition and thus not cut again this year

Switzerland

- In recent weeks economic fundamentals had at least some impact on EUR/CHF
- The Swiss Franc appreciated against the Euro after the upside surprise of second quarter GDP data out of Switzerland
- We do not see EUR/CHF to break out of the 1.08-1.10 trading range, SNB will continue to intervene

GBP/USD: Surprisingly stable in the third quarter



The recent weeks were surprisingly calm at FX markets. Many of the major currency pairs moved sideways. A striking example is GBP/USD. The cross moved sideways and hovered around 1.32 during the full third quarter of 2016. Going forward, we see depreciation pressure on the Pound. Currently, the political situation is relatively calm but this will change as soon as we move closer to triggering Article 50. Politics will also be an important determinant for the Euro. Over the next quarters, there are elections in Germany, France and possibly Spain. Moreover, Italy will vote on the constitutional referendum. We believe that the Euro will suffer somewhat from the uncertainty related to these political events. In particular, we see a slight depreciation until year-end against the US Dollar. The Fed made it clear in its September meeting that the hiking cycle will be very slow. In fact, according to FOMC members one hike in 2016 and two hikes in 2017 are appropriate. This perfectly matches our own expectations. Yet, even a gradual hiking cycle implies a divergence of monetary policy relative to the Euro Area. We believe that the European Central Bank will announce an extension of its asset purchase programme in December. The same logic applies to the Japanese Yen. The divergence in monetary policy between the Fed – even if hiking slowly – and the accommodative Bank of Japan (BoJ) should finally break the appreciation trend of the Yen against the Dollar. The risk is however a loss of credibility of the BoJ. Financial market participants have already lost some confidence in the BoJ to achieve its targets.

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