# Outlook for Financial Markets
## *November 2017*

## Interest rates/Bond markets

Jerome Powell stands for continuity

### USA

- Nomination of Jerome Powell as the new Fed President is not a market mover – he should continue the gradual tightening of monetary policy that Janet Yellen has initiated
- Financial markets have fully priced in a hike of 25 basis points on 13 December
- There is still a large gap regarding expectations for the hiking path in 2018 – we anticipate three hikes, markets price only one hike
- We anticipate a gradual rise of long-term yields until year-end

### Eurozone

- ECB announced to reduce its monthly asset purchases to 30 billion in January 2018 – purchases are continued at least until September 2018
- ECB's exit of QE is called re-calibration as reduction of asset purchases is done step-by-step – the Fed announced the full schedule how to reduce purchases to zero before it started to taper
- We expect yields in the Eurozone to follow those in the US over coming weeks

### Japan

- Abe is in a stronger position after the snap election – this bodes well for continued large monetary stimulus by the Bank of Japan
- 10-year yields of government bonds are heading towards zero since late October

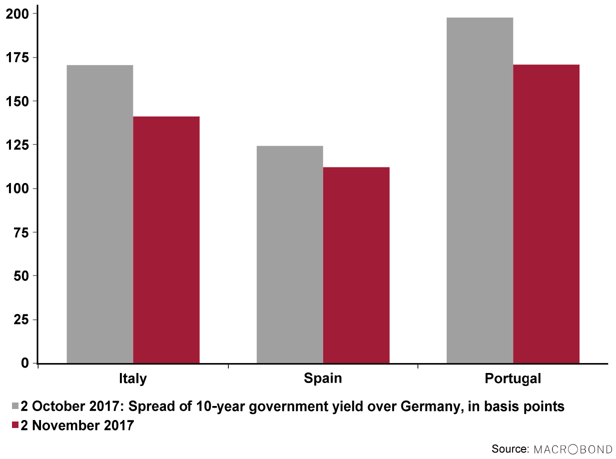
### United Kingdom

- Bank of England hiked target rate for the first time in a decade – rather undoing the emergency cut after Brexit vote than the start of a proper hiking cycle

### Switzerland

- Swiss government yields follow the ones in the Eurozone
- The ECB will not hike target rates anytime soon, neither will the SNB

*Relief for the periphery despite reduction of QE*




Mario Draghi killed two birds with one stone: He announced to cut the ECB's monthly asset purchases by half in January 2018 without triggering a rise of long-term interest rates. Why does the ECB aim to lower its asset purchases? The central bank approaches the issuer limits. The ECB is committed not to hold more than 33% of a country's outstanding debt. For some countries, the limit will be reached soon at the current pace of purchases. Why does the ECB want to avoid a distinct rise of interest rates? Debt mountains are still large in many member countries, in particular in the periphery. Several countries have high fiscal deficits. A significant rise of interest rates would clearly complicate the refinancing of these countries. Thus, although the Eurozone is in much better shape, the ECB reduces the monetary stimulus only gradually. Finally, the depreciation of the Euro following the ECB meeting was the icing on the cake. Financial markets usually react to surprises. A reduction of the monthly asset purchases from 60 to 30 billion and a continuation of the programme until September 2018 was commonly anticipated. Mario Draghi stated that QE can be extended if needed, that reinvestments will be continued for a long time and that target rates will only be hiked well after the end of QE. This was the dovish message. It triggered a decline of long-term yields and a weakening of the Euro. On the other side of the Atlantic, Donald Trump nominated Jerome Powell as the new Fed President. Powell should be confirmed by the Senate. His nomination is not a game changer as he should continue the gradual tightening path of Janet Yellen.

## Stock markets

Positive seasonality in the last quarter of the year

### USA

- Third quarter GDP growth was higher than expected – not least due to business investments
- Monetary conditions remain favourable but are expected to tighten at the margin with another Fed hike in December of this year
- Earnings growth is expected in double digit area which will support stocks despite high valuations

### Eurozone

- Macro data support the notion that top-line growth of enterprises remains sound
- Strong Euro has not left any traces in business sentiment so far - order books are brimmed
- Relative valuation in terms of equity risk premium still looks attractive

### Japan

- Prime Minister Abe gained a big victory in the snap election - fiscal impulse next year has become likely
- The Japanese economy and export-oriented companies above all benefit from the global upswing
- Since the start of the fourth quarter, Nikkei has gained almost 11% - a clear outperformer

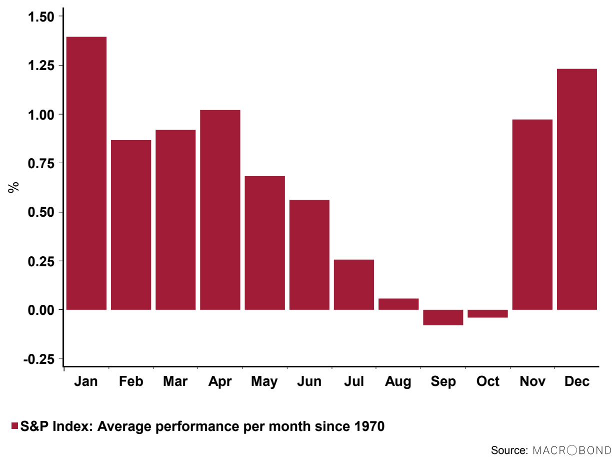
### United Kingdom

- The BoE undoes the rate cut of last year being alarmed by inflation creeping above 3%
- Political uncertainties around Brexit have not eased since the summer break and risk of another snap election in 2018 remains noteworthy
- The FTSE100 is the underperformer of this year

### Switzerland

- Pronounced depreciation of Swiss Franc and gradual rate increase should benefit Swiss exporters and financials
- With a lag to other European economies, the global economic recovery increasingly benefits the Swiss economy which is supportive for future performance

*Last quarter of the year usually generates positive returns*




Gradual normalisation of monetary policy in the US and the Eurozone, participation of a populist party in the German Bundestag, the Catalonia crisis, North Korean missiles: Developments which would usually lead to a correction of risky assets hardly leave any traces in financial markets at all anymore. Global risk appetite is stalwart and historical evidence tells us that the last quarter of the year tends to be associated with positive returns on stock markets. The global economic recovery is still in full swing and if it did not pay off to stay at the sidelines over the past months and quarters, it will be even less advisable at this point in time. We assume that equities will still be able to outperform other asset classes over the coming weeks. Moreover valuation of equities relative to fixed income assets remains attractive enough to attract further inflows. Finally, all of our quantitative models support the view that an overweight in equities is still warranted. However, based on our expectation that growth dynamics are bound to slow in the future and given the withdrawal of monetary stimulus, a defensive tactical positioning should be adopted to minimise risk. We thus deploy risk controlled equity investments at this stage of the cycle. The Swiss performance index has outperformed other indices since the start of the year, supported since April by the depreciation of the Swiss Franc. Yet, the market is showing signs of being overbought. 90% of Swiss equities trade above their own 50-day moving average which is a clear warning signal. Volatility indices in all the markets remain 1.1 to 1.3 standard deviations below their historical average.

## Currencies

CHF as cheap as never before since January 2015

### USA

- Inflation data in the US finally turned the corner after five consecutive months with downside surprises
- Fed communication regarding the future path of rate hikes supported the USD
- We renew our call for USD appreciation as central bank policy divergence is a major driver short-term

### Eurozone

- ECB's dovish guidance moves central bank divergence back into focus
- We expect the ECB to prolong their asset purchase programme until mid-2019
- With Euro-sceptic Cinque Stelle leading polls in Italy, EMU break-up fears could resurface in coming weeks

### Japan

- After Abe's victory in snap election, Bank of Japan was quick to promise ongoing support via ultra-loose monetary policy
- Despite inflows from portfolio allocation shifts by international investors, the Yen remains significantly undervalued

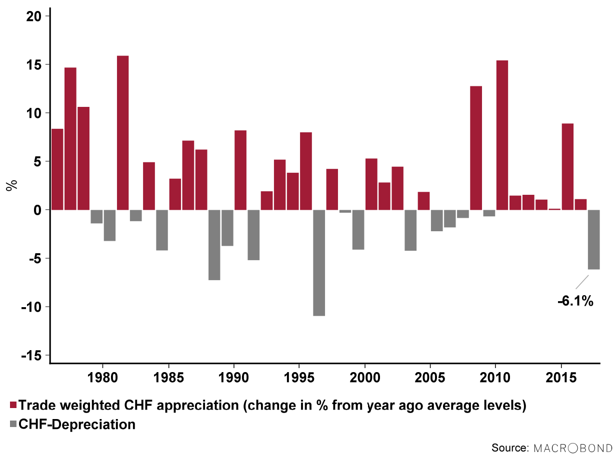
### United Kingdom

- We see the BoE rate hike as a reversal of the emergency cut following to the Brexit referendum rather than as the beginning of a tightening cycle
- Fruitless Brexit negotiations remain a burden for the Sterling

### Switzerland

- Swiss Franc overvaluation continues to correct sizeably towards fair levels
- Once elections in Italy start to become a market topic, risk appetite could reverse back in favour of Swiss Franc versus the Euro

*Most marked CHF depreciation since 1996*




Last month, we changed our call towards renewed US Dollar strength. Yet, we still have underestimated the Dollar momentum, fuelled by diverging central bank rhetoric. Continued market repricing in direction of the Fed's "dot plot" means further upside potential for the Greenback in our view. The "dot plot" illustrates the central bank's view of the Fed funds target rate going forward. There is still room between Fed members' median assumption of four rate hikes until end of 2018 and the two steps currently priced in by the market. The biggest surprise on foreign exchange markets so far in 2017 was the broad-based weakening of the Swiss Franc since the presidential election in France. On a trade weighted basis, the Franc's external value is now 6% below last year's average. While we see room for further depreciation versus the US Dollar, we think that 1.16 is currently close to a fair value against the Euro. Despite the tapering of its quantitative easing (QE) measures, the European Central Bank (ECB) maintains a dovish stance. As the ECB will miss its inflation target in 2018, an extension of asset purchases into 2019 remains likely. Politics provide a certain downside for the Euro: Uncertainties about the future of the monetary union could resurface as the general elections in Italy approach. In an initial reaction, the British Pound weakened after the first interest rate hike by the Bank of England in more than 10 years. The move should not be seen as the beginning of a monetary policy tightening cycle, but rather as the removal of an emergency measure after the Brexit vote in summer 2016.