AQUILAVIEWPOINTS

Market Outlook | 1st Quarter 2017

Tactical Perspective: Macro ▶ Bonds ▶ Equities▶ Other Asset Classes ▶

Executive Summary

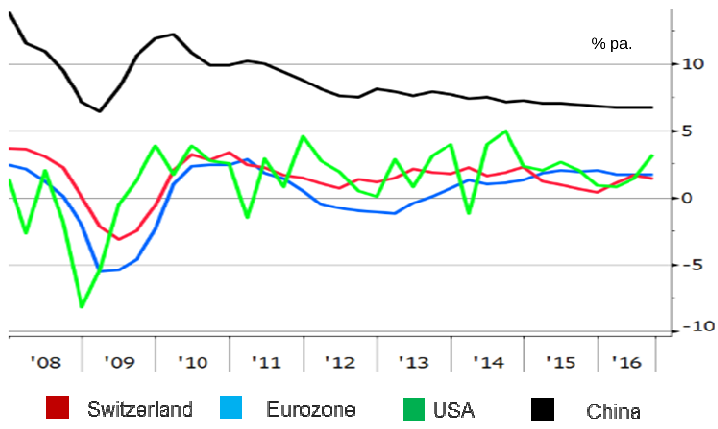
- The world economy will grow around 3.5% in 2017.
- The US is likely to drive world economic growth in the year to come.
- The Eurozone will expand by around 1.8% in 2017.
- The Fed will raise policy interest rates by 0.75% overall in 2017.
- The ECB will continue with its expansionary policy stance.
- We now have a neutral position in equities but will view market setbacks as an opportunity to add to positions.
- Bond yields in “core markets” are now consolidating.
- We remain invested in high yield and emerging market bonds.
- Interest rate differentials, and monetary policy divergence between the US and elsewhere, support a rising dollar.
- Are we the end of the “bear market” in commodities?

Our macroeconomic assessment

Business cycle

- We forecast US economic growth to accelerate somewhat, to around 3%, in 2017. Mr. Trump’s expected policies of stimulus are likely to lead to higher inflation because the US economy is already operating near full capacity. In this environment, wage inflation is likely to pick up. Such a scenario has already been “priced in” by the bond market. Based on the Treasury’s inflation-protected bonds, the implicit average 5 year US annual inflation rate, starting 5 years from now, has risen from 1.7% to 2%.
- In the Eurozone, Markit Economics’ PMI readings remain at a high level for both manufacturing and the services sector. Assuming no serious political crises we forecast a rather steady rate of expansion (1.8%) for the Eurozone in 2017.
- Overall, the world economy should grow around 3.5% in 2017.

Growth - US, Japan, Eurozone, Switzerland & China since 2008



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Monetary policy

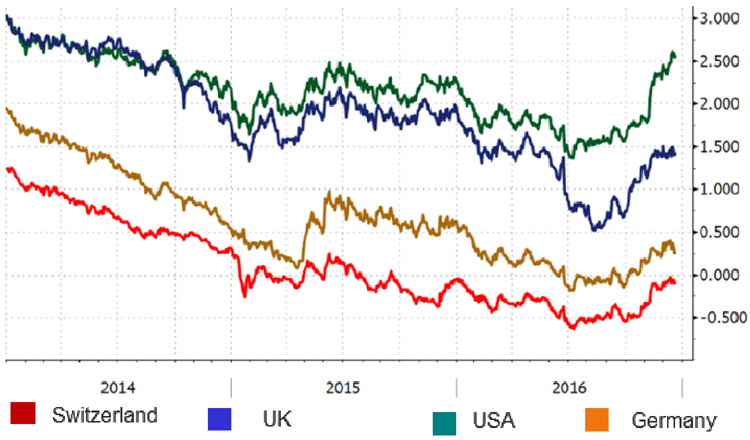
- In December the Fed finally made its long-awaited ¼ point interest rate move. The direct effects of this increase were negligible although the median of FOMC members’ rate forecasts has shifted, with implications for the future path of interest rates.
- Indeed, the divergence between FOMC members’ rate forecasts and the implicit rate forecasts of the market has almost disappeared. The two series now suggest that the Fed funds rate will be around 1.375% at the end of 2017 and nearly 2% at the end of 2018.
- The ECB surprised the markets at its December monetary policy meeting. But the reduction in the scale of monthly bond purchases, from Euro 80bn to Euro 60bn., was accompanied by the announcement that the purchase program itself would be extended until at least December 2017. Moreover, the criteria for bond purchases were relaxed so the ECB will now be able to buy bonds with yields below minus 0.4%. Analysts have characterized the entire package of measures as a “camouflaged interest rate cut”.

Our investment policy conclusions

Bonds

- Donald Trump's victory prompted a rapid rise in yields in key bond markets. While this trend has paused for now, the move has been so violent as to suggest a massive repositioning on the part of investors. The bond mantra "lower for longer" had probably held sway for too long.
- Bond investor repositioning may well not yet have run its course, implying further rises in yields. However, Administration policy under Mr. Trump does not necessarily mean an unbroken trend to higher yields. Also, should economic growth fail to accelerate, confounding widespread expectations, and the Fed turn "dovish" once more, yields at current levels could well represent an attractive buying opportunity, at least on a selective basis.
- We remain invested, in both hard and local currencies, in high yield and emerging market bonds. These types of bond provide good diversification opportunities within the bond asset class.

Yields on 10 year government bonds since 2014, %



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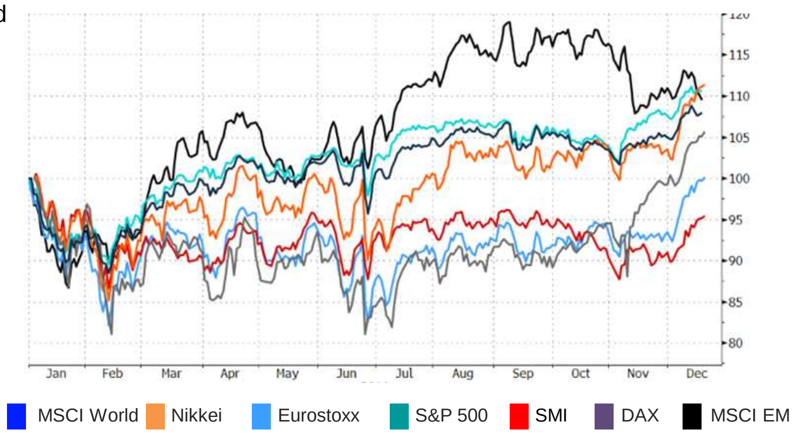
Equities

- In a year-end rally European markets have recouped a good part of their former relative underperformance. The SMI is still at the rear, but the distance between the Swiss market and leading markets has narrowed. Recent market performance needs to be validated by future developments. We believe that recent market gains partly reflect a rebalancing by investment professionals, previously under-weight in stocks on account of the widely-perceived risks.
- Emerging market equities have given back some of their previous strong gains as investors worried about increasing protectionism in the US and a rising US dollar.
- With the US stock market setting all-time highs, the valuation question is now center stage. The upcoming reporting season may provide some answers as to whether recent market gains are justifiable or not.
- We remain neutrally weighted in equities, slightly favoring Europe at the expense of the US.

Major equity markets, indexed performance in 2016



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Forex

- Speculation as to a deficit-financed infrastructure program under President Trump, and the upward shift in US inflation expectations, have boosted US interest rate differentials. In turn, this has accentuated a US dollar appreciating trend against the euro and the Swiss franc.
- Meanwhile, monetary policies in the US and Europe continue to diverge. In the US, many expect that the Fed will need to react to increasing inflationary pressure by raising interest rates more aggressively. In Europe, on the other hand, the ECB is likely to maintain a strongly expansionary policy stance for the foreseeable future.
- While many analysts predict further gains for the US dollar, there are those who suggest that purchasing power parities point to the need for the dollar to depreciate. The dollar-yuan rate is also important for policy-makers. Neither the US nor China wishes to see a significant increase in exchange rate volatility as a result of a sharp decline in the value of the yuan.

USD/CHF since 2006

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