AQUILA VIEWPOINTS

Market Outlook | 1st Quarter 2018

Tactical Perspective: Macro ▲ Bonds ▼ Equities ► Other Asset Classes ►

Executive Summary

- The global business cycle is running smoothly on all cylinders. We forecast world economic growth at around 3.5% for 2018.
- We rate the performance of the Eurozone economy with a 5 (using the Swiss marking system) or a 2 (using the German marking system). With 2.2% growth forecast for 2018, Switzerland should grow appreciably faster in the coming year than in 2017.
- The Fed raised rates again this December and we expect a further four US rate rises over the course of 2018.
- In January the ECB is set to cut in half its monthly bond purchase target – from EUR60bn. to EUR30bn.
- Given the good performance of the world economy, 10 year yields in government bond markets seem too low to us and yield curves too flat.
- Further stock price gains 2018 will probably depend on good news with respect to corporate earnings.
- We remain neutrally positioned in equities as an asset class.

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Our macroeconomic assessment

Business cycle

- The first strong global upswing since the Great Financial Crisis is set to continue in 2018. We forecast 3.5% real growth for the world economy based on the following forecasts – US: 2.3%, Euroland: 2.2%, China: 5.5% to 6.5% and Japan: 1.3%.
- Not since 1960 have the growth trajectories of the various economies been as similar as they are today.
- But the US and Germany are in danger of overheating. The unemployment rate in Germany is now at its lowest level in 25 years.
- Switzerland is benefitting from the strength of the European economy. Meanwhile CHF weakness against the EUR has enhanced noticeably the price competitiveness of Swiss producers. The Swiss economy should grow 2.2% in 2018, significantly faster than in 2017.

Eurozone Purchasing Managers' index has increased slightly

Source: Bloomberg

Monetary policy

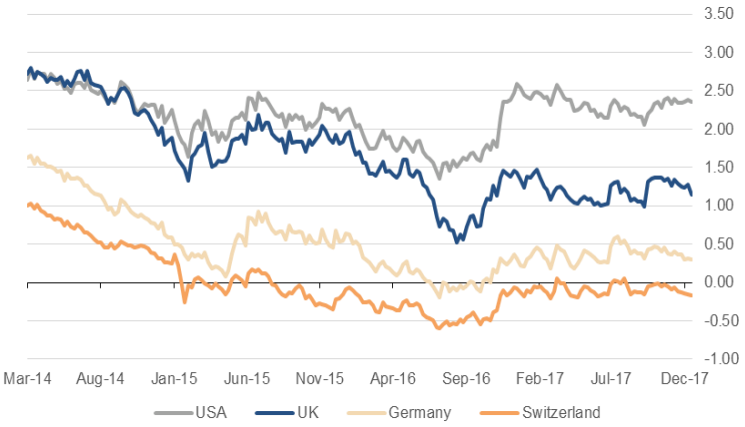
- The Fed pushed US interest rates up again this December and we expect four further rate increases from the US central bank in 2018.
- The ECB will cut the monthly volume of its bond purchases from EUR60bn. to EUR30bn. in January 2018. We expect regular ECB bond purchases will be terminated altogether around the end of 2018.
- The Bank of Japan will remain the most expansionary of all the major central banks
- The total balance sheet of G10 central banks has been growing strongly, reflecting in particular the stimulative policies of the ECB, the BoJ and the SNB. Thus the Fed's move to restrict its balance sheet is being more than offset by the still expansionary policies of the other central banks. We still view the level of monetary policy support for the investment markets as "very strong".
- During the coming year shorter-term interest rates should rise somewhat due to more restrictive monetary policies. Moreover, as the economy starts to lose momentum later in 2018, yield curves should in general flatten.

Our investment policy conclusions

Bonds

- In recent weeks the Fed has surprised the markets in that it clearly forecast the interest rate rise it delivered in December. On the other hand, the dots showing Fed interest rate forecasts have shown a slightly lower tendency linked to persistent very low US inflation. Yields on 10 year government paper in the major bond markets have risen slightly of late but still seem too low to us given the very good performance of economies on both sides of the Atlantic.
- With the Fed now providing detail on its planned balance sheet reduction, the way is open for the ECB to move in the same direction. We expect the ECB to start scaling back its bond purchase program (SMPP) sometime in 2018.
- We continue to have exposure to emerging market and high yield bonds but recognize that valuations are stretched. In view of this, we have started to reduce our exposure in European high yield bonds.

10 year govt. bond yields, major markets since 2014, %



Source: Bloomberg

Equities

- The US stock market seems to go in one direction only right now – upwards. In recent weeks, regular small advances have meant successive all-time highs for several indices. Chaos in the White House does not seem to disturb the markets which are being supported by good economic data as well as the Fed's caution when it comes to raising interest rates.
- But it is not only the US macro data which are good; the world economy is enjoying a synchronized upswing. And that is supporting equity markets on a global basis. European stock markets remain more attractively valued than US equities and their exposure to global trade flows in particular could well support further price gains.
- We are neutrally positioned with our equity exposure and have a focus on Europe and Japan at the expense of the US.

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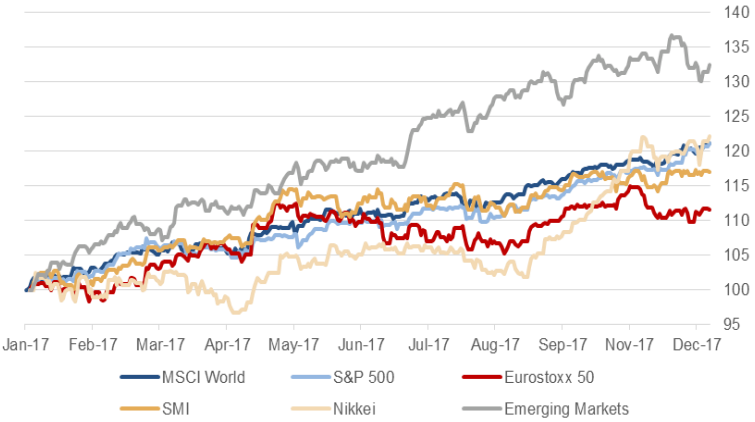
Equity markets, rebased performance since Jan. 1 2017



Source: Bloomberg

Forex

- The EUR has been trading near the 1.20 mark against the dollar. At least the latest comments from the Fed should limit the dollar's potential for further falls. Interest rate differentials are once more in favor of the US Dollar, while the Fed is several years ahead of the ECB in terms of the interest rate cycle. The ECB, in its turn, will be concerned that its communication with the markets does not push the Euro too high. Europe's export industries are already making their case known.
- The US Dollar has gained ground against the Yuan after the People's Bank of China made clear that it was unhappy about the extent to which the Yuan had been strengthening.
- Switzerland's currency guardians at Bürkliplatz will be pleased that the Franc now stands almost at 1.16. Franc depreciation reflects slightly weaker economic numbers for Switzerland as well as clear evidence of a solid economic upswing in Euroland. But the Franc's reaction to recent developments in the ongoing Korean crisis show the Swiss currency has not lost its "safe haven" status.

EUR/USD last 2 years

Source: Bloomberg