AQUILA VIEWPOINTS

Market Outlook | 2nd Quarter 2017

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

Executive Summary

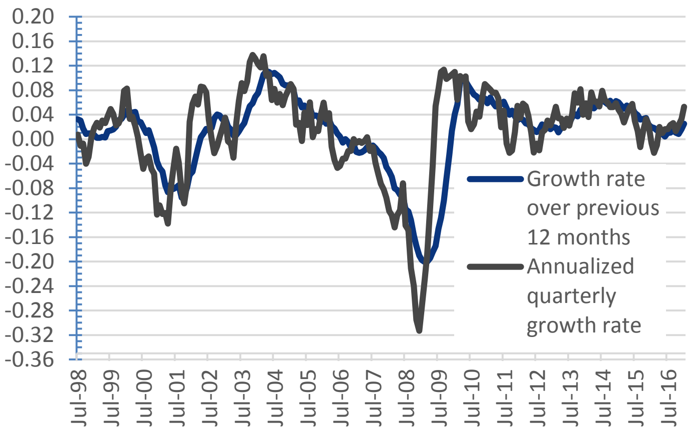
- Data confirm this year's pick up in world growth – to around 3.5% pa.
- Mr. Trump has inherited a robust US economy. Fiscal stimulus isn't needed. Growing around 3% pa., the US will remain the locomotive for industrialized country growth.
- It's nice to report there is even a pick up in Eurozone growth. We now expect 1.9% growth for the Eurozone in 2017.
- We expect at least two more rate rises from the Fed in 2017.
- We remain overweighted in equities.
- Bond yields will rise further after their present consolidation phase.
- In the bond markets we see less risk in credit than in duration.
- Increasing interest rate differentials, reflecting divergent trends in monetary policy, favor the US dollar. We expect the US currency to make further gains once its present consolidation phase is over.

Our macroeconomic assessment

Business cycle

- OECD leading indicators confirm a pick up in world economic growth. We expect growth around 3.5% in 2017.
- US unemployment has now fallen below 4.7%. Full employment has therefore now been reached in the US and no further stimulus is needed.
- European growth is also picking up and even France is joining the party. We now think that the Eurozone may grow up to 2% this year.
- Switzerland is benefitting from faster growth in the world economy and should manage 1.9% growth this year.
- With the Indian economy recovering from Mr. Modi's war against high value bank notes, Mr Modi's party should do well in upcoming elections. Brazil is coming out of recession and Economic growth is picking up a bit in Russia and China.

US Conference Board - Leading indicator



Source: Bloomberg

Monetary policy

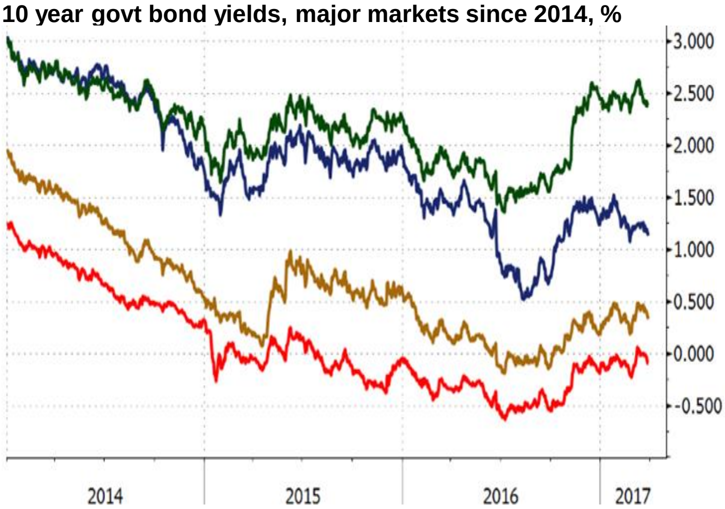
- We expect at least three interest rate rises out of the Fed this year. The Fed's target rate of inflation – 2% – looks set to be breached on the upside, at least for a while. Towards the end of the year the Fed might make a sort of palliative attempt to prepare the markets for a reduction in its massive balance sheet. Probably, by the end of the year also, the ECB will feel able to start preparing the market for a measured process of tapering. A less expansionary Fed gives the ECB more lee-way to become less expansionary in its turn.
- The Bank of England faces a very uncertain economic situation given the impending negotiations over Brexit and the associated weakness of the pound and higher UK inflation. Probably, the BoE will leave rates unchanged this year.
- Central bank balance sheets stand at a new record in total. Given the extent of asset price inflation, financial market stability is likely to become a more important consideration in future monetary policy decisions.
- With a more stable ruble and higher oil prices, the Russian central bank can probably start cutting interest rates.

Our investment policy conclusions

Bonds

- In the US bond market yield curves have flattened noticeably. At the short end, rates have risen as expected by 25 basis points while yields at the long end have only risen minimally. Is the bond market suggesting some slowdown in the US economy in the second quarter?
- In Europe yields have dropped slightly in recent trading but the environment differs from the US. Rising bond prices in "core" European countries are rather related to risks associated with the upcoming Presidential elections in France. In this context, yields on government bonds in "peripheral" European countries have risen slightly.
- We remain invested in high yield and emerging market bonds in both local and hard currencies. Performance has been strong, especially for emerging market bonds.

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



Source: Bloomberg

Equities

- The major equity markets still have a favorable trend.
- Emerging markets continue to post a very strong performance. So far this year's outsider to the downside is Japan. Tokyo's Nikkei index is broadly unchanged for the year.
- The US stock market in particular has very high expectations regarding the Trump administration. If events fail to match those expectations, US stocks could well correct. In Europe the situation is somewhat different. The "economic fundamentals" are improving but investors are nervous about upcoming political events. We think this could turn out to be fertile ground for a rising trend in European stocks later in the year
- We remain overweighted in equities although we are also increasingly inclined to take profits, cutting the allocation somewhat on a stock by stock basis.

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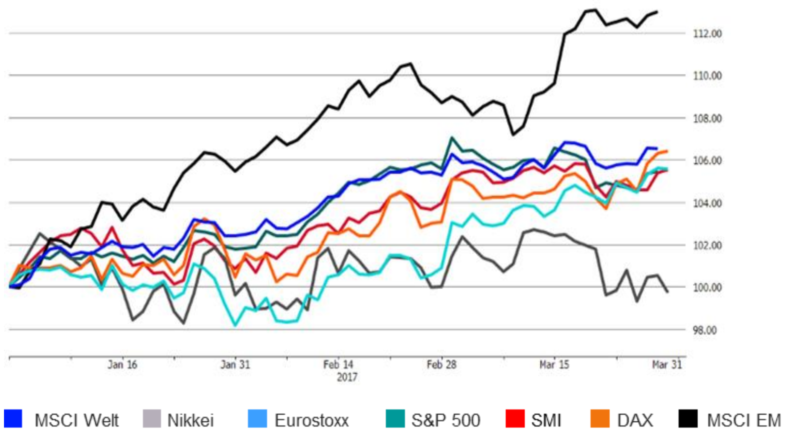
Equity markets, rebased performance since Jan. 1 2017



Source: Bloomberg

Currencies

- The US dollar has been trading in a very narrow band against both the euro and the Swiss franc. On the one hand, the US unit is pressured by statements from the American President that a strong dollar is not in the interests of the US economy. Set against this, uncertainty regarding upcoming big political events in Europe is tending to push European currencies lower, thus supporting the US dollar.
- In the end, this constellation of forces keeps everyone more or less happy because we are in an age of competitive devaluation. No government has an interest in having a strong currency.
- The Swiss National Bank continues to be an active buyer of foreign currencies. This is clear from the data for commercial bank sight deposits at the Swiss central bank. Recent statements by SNB officials suggest no change in the exchange rate policy of the Swiss central bank is likely in the foreseeable future. In this respect, the SNB finds its hands tied by very low European interest rates.

EUR/USD since 2015

Sourec: Bloomberg