AQUILA VIEWPOINTS

Market Outlook | 2nd Quarter 2018

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

Executive Summary

- We expect the world economy to grow around 3.5% this year. But growth momentum will soon pass its peak. The upswing is losing force, especially in Europe.
- Switzerland should grow around 2% in 2018.
- The Trump Administration is actively discussing the imposition of import tariffs.US fiscal policy is now pro-cyclical and will have a severely detrimental medium-term impact on the financial position of the US government. Investors are taking note of America's twin deficits.
- We expect four interest rate rises out of the Fed this year.
- We expect the ECB to implement the first cyclical rise in European interest rates in the second half of 2019. In its commentary, the Eurozone central bank is already preparing markets for a more restrictive stance. It no longer talks of an "easing bias".
- We are currently underweight in equities. A higher than usual allocation to cash should enable us to buy equities again at lower levels.

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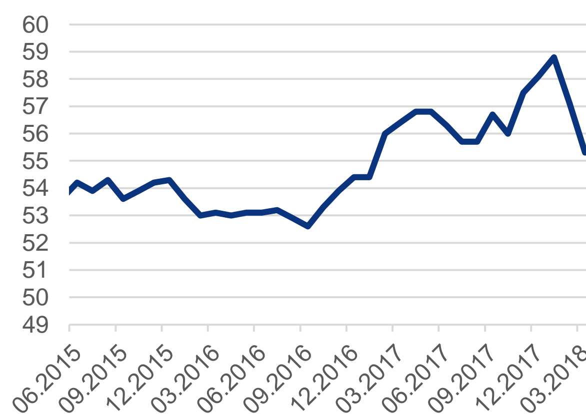
Our macroeconomic assessment

Business cycle

- The strong global upswing will continue in 2018. Our forecast of 3.5% real growth for the world economy assumes the following real growth forecasts - US (2.3%), Euroland (2.1%), Switzerland (2.0%), China (6.5%) and Japan (1.2%).
- While US economic growth might accelerate further, we don't expect an acceleration in the other major economies.
- Rather the reverse: In the coming months we expect a slight decline, from very high levels, in sentiment indicators and thereafter a moderate decline in real growth rates.
- The Swiss economy is benefitting from the current cyclical strength of the Eurozone economy. We expect Switzerland's economy to grow 2% in real terms this year.
- Emerging market economies will grow strongly in 2018, although we expect a slight decline in China's growth rate.

Eurozone Purchasing Managers' index



Source: Bloomberg

Monetary policy

- The US economy is now growing very strongly. But the Trump Administration's pro-cyclical fiscal policy could push the Fed in the direction of a more restrictive monetary policy. That said, a serious trade war, were one to break out, would depress growth estimates and could encourage the Fed to remain relatively accommodative. We expect four rate rises out of the Fed this year.
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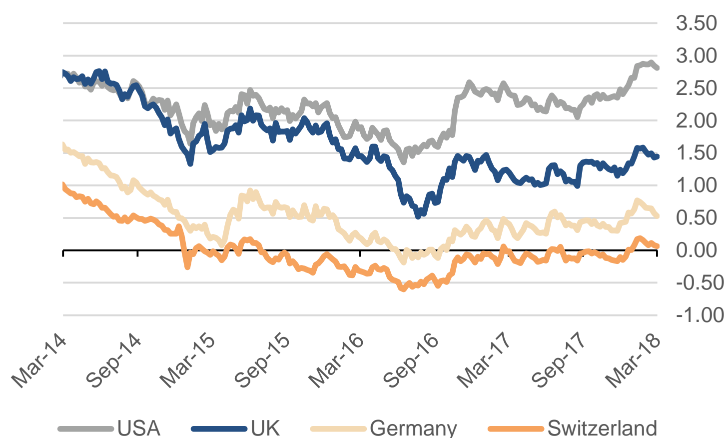
- We expect a rate rise out of the Bank of England in the second quarter.
- We look for the ECB to phase out its bond buying program around the end of this year and to implement the first cyclical rise in Eurozone interest rates in the second half of 2019. These steps will open the way for the Swiss National Bank to move away from its policy of negative interest rates.

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 corporate earnings reporting season for the first quarter of 2018 will soon be upon us. In the US aggregate estimates for the earnings growth to be reported are already at a very high level (+17%). The danger of events failing to match expectations is certainly greater than before. The situation in Europe is different, with expectations in general less high. But we note that European stock markets punished severely those companies that failed to match expectations last time around.
- But the generally optimistic forecasts only make sense if the protectionist forces in the Trump Administration can be kept within limits. A serious outbreak of global protectionism could quickly invalidate current growth projections. Given the recent rise in uncertainty we have reduced slightly our allocation to equities.

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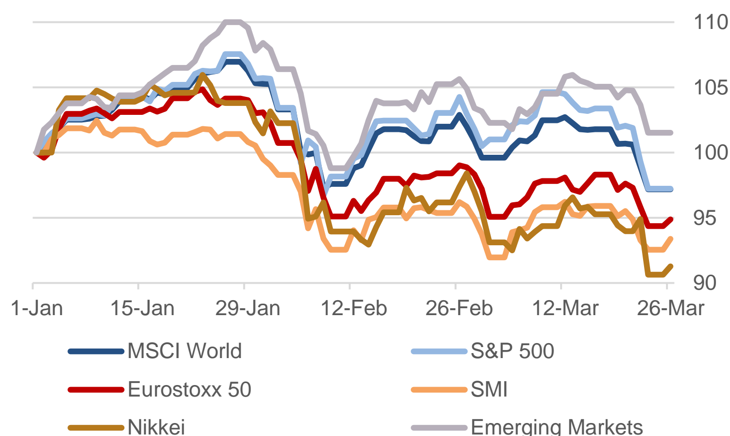
Equity markets, rebased performance since Jan. 1 2017



Source: Bloomberg

Forex

- The US now has a pro-cyclical fiscal policy with President Trump's fiscal stimulus coming at the worst possible time, if the goal of fiscal policy is to smooth the economic cycle. The American economy is thus at risk of overheating in 2018, and the first signs of quickening inflation are already to be seen in the labor market, where the US unemployment rate seems stuck around 4.1%. One consequence is upward pressure on the euro, which is supported by the Eurozone's chronic current account surplus. This contrasts with America's twin deficits and the consequent increase in US indebtedness which combine to cast the dollar in an unfavorable light.
- The EUR/CHF cross has established a new trading range, moving fairly narrowly around the 1.15 mark. The sharp fall in equity markets in early February did not disturb this trading pattern. We continue to believe that SNB policies are very dependent on those of the ECB. While the modest weakening of the Swiss franc probably gives the Swiss central bank somewhat more freedom, we are far away from a situation in which it can act autonomously.

USD/CHF, last 2 years

Source: Bloomberg

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