AQUILA VIEWPOINTS

Market Outlook | 3rd Quarter 2017

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

Executive Summary

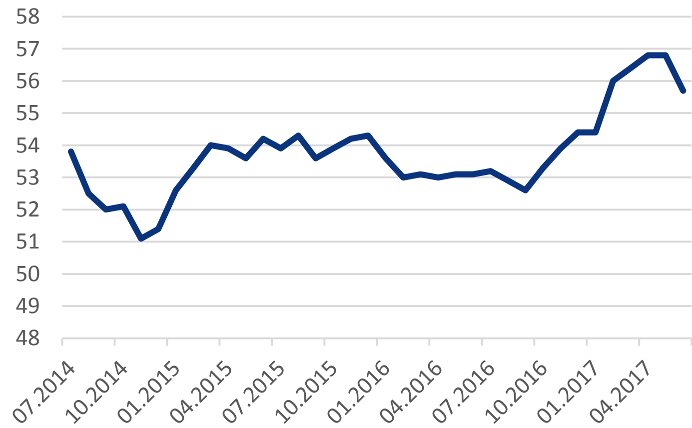
- The US unemployment rate has fallen further to 4.3%. As expected, the Fed raised its key interest rate by ¼ point in June. We forecast one further rate rise out of the Fed this year.
- We estimate Eurozone economic growth at 1.9% for this year and expect the ECB to stick with its expansionary policy stance at least until the year-end.
- We continue to forecast world real economic growth at 3.5% for 2017.
- We remain overweight in equities but expect to realize profit on some equity positions over the summer.
- Following their recent consolidation phase bond yields are likely to rise slowly once again.
- High yield and emerging market bonds are still attractive.
- Rising interest rate differentials speak in favor of the US dollar, although the American currency is being negatively impacted by perceived political risk.
- We expect the gold price to move sideways.

Our macroeconomic assessment

Business cycle

- The Eurozone Purchasing Managers' index fell in June from 56.8 to 55.7. Even so, this index remains at a high level and continues to indicate an acceleration of growth this year.
- French President, Emmanuel Macron, has won a clear majority in the elections for the French Parliament and has a clear mandate to implement his plans for structural reform.
- The German economy is approaching "full capacity". The country's huge trade surpluses are starting to look like a problem.
- Recent business cycle indicators for the US economy have been somewhat disappointing. President Trump would like to see America return to being a net energy exporter. The low oil price is on balance positive for the global economy.

Eurozone Purchasing Managers' index has fallen slightly



Source: Bloomberg

Monetary policy

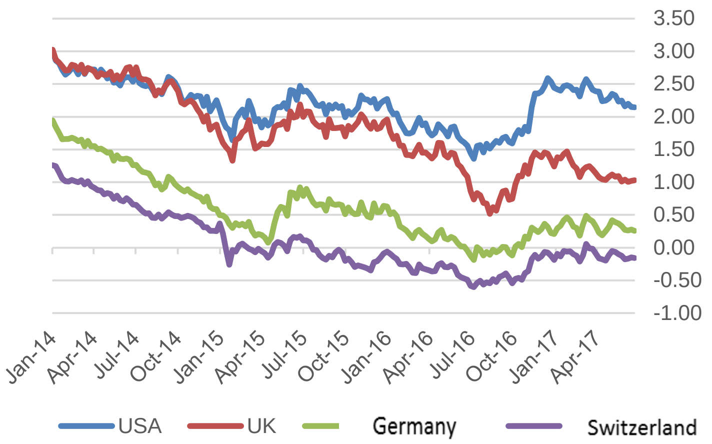
- The US unemployment rate now stands at just 4.3% and employers are finding it harder to engage qualified staff. Unit labor costs will probably continue to rise slowly in this context. Set against this, the sharp decline in the oil price means the risk of an immediate rise in inflation has been reduced. But we believe, like the Fed, that this shift towards deflation will be only temporary. Hence the Fed's June move to raise its interest rate target band by ¼ point to 1%-1.25%. We expect one more US interest rate rise over the balance of this year.
- The Fed has also announced that it will make a start this year in reducing its balance sheet. If it implements this move, the Fed will stand apart from the other major central banks in that it will be restocking its monetary policy arsenal.
- The chances are good that the ECB will feel able before the year end to start preparing markets for a gradual run down of its massive bond portfolio. A less expansive Federal Reserve opens the way for the ECB to begin slowly dialing back its current highly expansionary policy stance.

Our investment policy conclusions

Bonds

- Yields on 10 year US government bonds remain – at 2.15% – stubbornly low. What is the bond market trying to tell us? Was there a slowdown in the US economy in the second quarter? Or does the weak oil price point to some general strengthening of deflationary forces?
- We expect a second phase of slightly rising US bond yields and advise using current trading conditions to implement a gradual shortening of duration.
- Official comments following the most recent ECB monetary policy meeting seem to support the very low level of European government bond yields. Mr. Draghi and his economists at the ECB say they see no reason for the ECB to change its current highly expansionary policy stance. Critics within ECB policy-making circles find themselves in a minority.
- High yield and emerging market bonds are still attractive and we continue to be positioned in these markets in both local and hard currency issues.

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



Source: Bloomberg

Equities

- Although US indices continue to set new record highs, these advances are not being confirmed by indicators of market breadth. High valuations are certainly part of the explanation.
- The upcoming European earnings results are keenly awaited. Economic fundamentals in Europe have continued to improve but investors are still cautious. In the much criticized banking sector there is a good chance of (positive) earnings surprises.
- We remain overweight in equities but expect to realize profit on some positions over the summer. Our focus is on Switzerland and the rest of Europe. We are underweight in US stocks.

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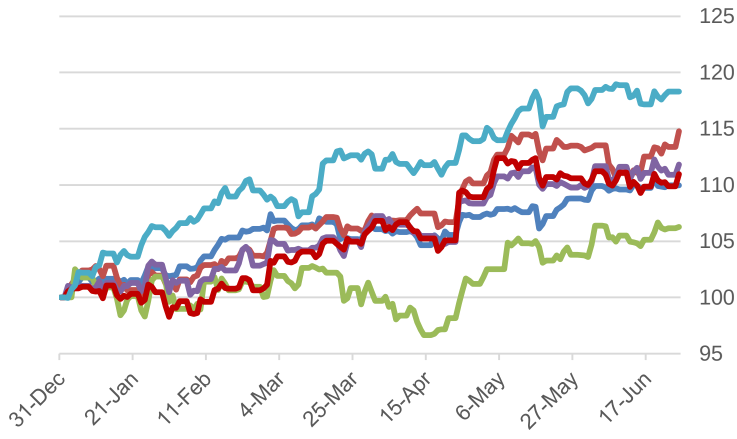
Equity markets, rebased performance since Jan. 1 2017



Source: Bloomberg

Forex

- The US dollar has weakened somewhat of late – against, for example, the euro, the Swiss franc and the yen. In recent months this trend has also been apparent vis-à-vis the Chinese yuan, reflecting the impact of tighter credit conditions in China.
- A recovery of the USD/Yuan is already underway and, on this basis, we expect that the US dollar will start to rally somewhat against other G7 currencies.
- The SNB continues to monitor CHF cross rates carefully, buying forex as it sees fit. The CHF has strengthened a bit against the EUR. As the ECB seems determined to stick with its policy stance, despite the improving fundamentals in Europe, the SNB is rather in the position of having to sit and wait.
- The British pound is under pressure in the context of Brexit negotiations now being led on the UK side by a politically weakened government. But with UK inflation rising quite strongly the Bank of England is in an awkward position.

USD/offshore Yuan, last 12 months