AQUILAVIEWPOINTS

Market Outlook | 4th Quarter 2017

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

Executive Summary

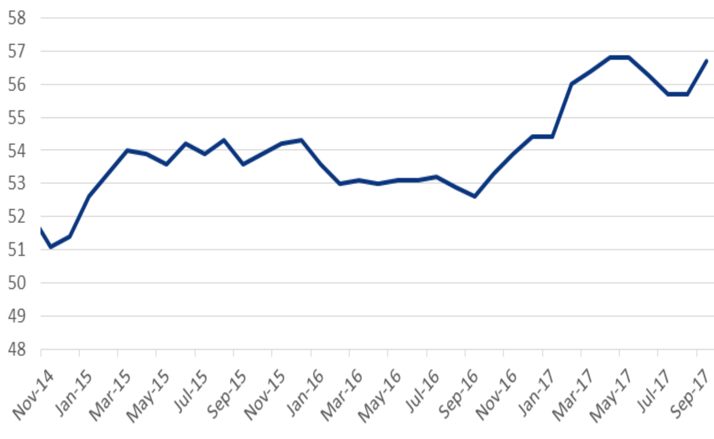
- The Fed will begin reducing its balance sheet in October. The ECB will start its tapering program at the latest by end 2018 Q1 (i.e. after the Italian elections).
- The world economy will grow by 3.5% in real terms in both 2017 and 2018. The current upswing is synchronized with almost all countries and economic sectors taking part.
- Fed balance sheet reduction will likely push yields higher on a global basis.
- European banks and insurance companies have the most to gain from a normalization of interest rates.
- The euro has been able to make further gains against the Swiss franc. Expectations of a less expansionary policy stance on the part of the ECB have helped the euro.
- A string of natural disasters has hit insurance companies and insurance-linked products.
- Gold is weaker on announced Fed balance sheet reduction.
- We remain neutrally positioned.

Our macroeconomic assessment

Business cycle

- Growth continues to strengthen in the Eurozone, spreading to more and more areas. We now forecast an overall growth rate of 1.9% for this year. In Q2, the French economy grew 1.8% on a year on year basis. The French Purchasing Managers index for Manufacturing rose slightly from 55.8 to 56 (consensus was for a decline to 55.5). The corresponding index for the service sector rose strongly from 54.9 to 57.1 (versus a consensus 55). Even in Germany, already very optimistic projections have again been exceeded.
- In the US, this year's hurricane season makes it hard to draw firm conclusions from the current data, but it would seem that growth is accelerating there as well.
- We continue to believe that the world economy is experiencing a strong and synchronized upswing.

Eurozone Purchasing Managers' index has increased slightly



Source: Bloomberg

Monetary policy

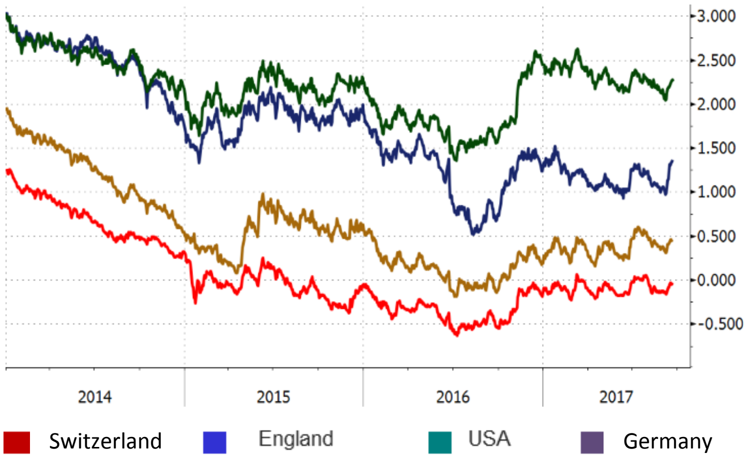
- The Fed wants to raise interest rates once more this year and will begin reducing its balance sheet (albeit at a snail's pace) from October. Three interest rate increases are "expected" for 2018. Rather exceptionally, we agree with the Fed's interest rate forecast for next year.
- There is no end in sight to the Japanese central bank's ultra-expansionary monetary policy stance. The BoJ will be the most aggressively expansionary of all the central banks in terms of both scale and time.
- While the Fed will be reducing its balance sheet, the ECB and BoJ will continue to expand theirs. And these two central banks will expand their balance sheets by more than the Fed's planned reduction. Thus, on a global basis, monetary policy is set to remain expansionary and "market-friendly".
- We expect that the ECB will at the latest begin tapering (cutting the rate of balance sheet expansion) soon after the Italian elections in Q1 2018. For investors, the monetary policy "traffic lights" are now at amber.

Our investment policy conclusions

Bonds

- With its latest announcement the Fed surprised the markets in that it clearly forecast an interest rate rise in December. On the other hand, the dots showing Fed interest rate forecasts showed a slightly lower tendency, which is linked to the persistent trend to very low inflation. Yields on 10 year government paper in the major bond markets have risen slightly of late but still seem to us to be too low in view of 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 made a start on reducing our exposure to European high yield bonds.

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



Source: Bloomberg

Equities

- The US stock market only seems to go in one direction right now – upwards. In recent weeks, regular small advances have meant successive new 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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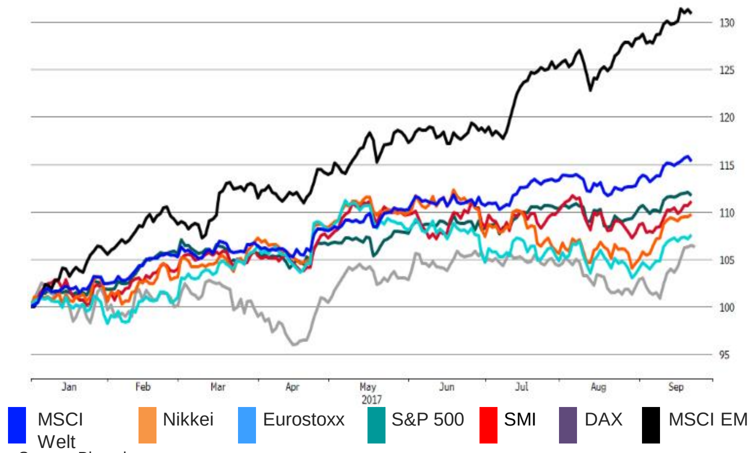
Equity markets, rebased performance since Jan. 1 2017



Source: Bloomberg

Forex

- The EUR has been trading near the 1.20 mark against the dollar. At least the latest comments out of 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 in 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