# AQUILA VIEWPOINTS

Market Outlook | 4th Quarter 2016

Tactical Perspective: Macro ▶ Bonds ▶ Equities ▶ Other Asset Classes ▶

## Executive Summary

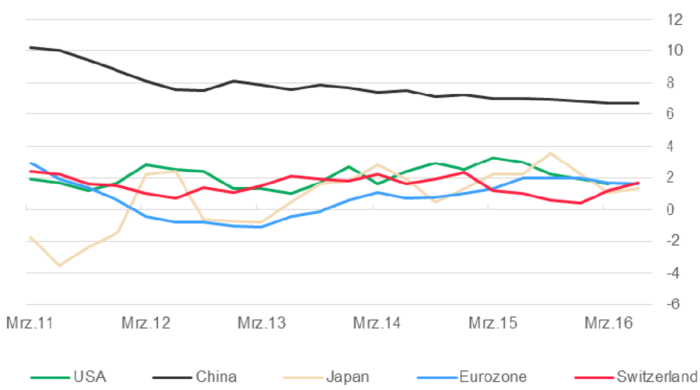
- We see only limited risks of a recession and expect the world economy to grow by 3% this year.
- While the US economy has lost some momentum, it is supported by the consumer and remains healthy.
- We forecast Eurozone growth at around 1.5% for 2016.
- Fed monetary policy continues to be “data-dependent”.
- The ECB will extend its bond purchase program before the end of the year – increasing the rate of monthly purchases or extending the program's timescale.
- We are now slightly overweight in equities and will view market setbacks as an opportunity to add to positions.
- Much of the world’s bond market now trades at a negative yield.
- We remain invested in high yield and emerging market bonds.
- The US dollar continues to move sideways, neither rising nor falling much.
- Gold has lost some ground recently.

## Our macroeconomic assessment

**Business cycle**

- The US economy is growing at a moderate pace. While the US labor market is strong, the industrial sector shows signs of weakness. The ISM Manufacturing index surprisingly fell from 52.6 to 49.4 – or below the 50 mark which separates expansion from contraction. This is the weakest reading since the start of the year. But the US consumer sector looks healthy. Indeed the index of consumer confidence now shows the highest reading since 2007. We expect the US economy to grow 2% in 2016.
- The risks involved in the UK’s Brexit decision are now showing up in Eurozone data. Thus German industrial production has recently shown the sharpest monthly decline in almost two years. Despite this, we still expect the Eurozone economy to grow by 1.5% in 2016.
- It is realistic to forecast an overall growth rate for the world economy of 3% for 2016.

**GDP growth - USA, China, JP, EU, and CH since 2011, %pa.**

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**Monetary policy**

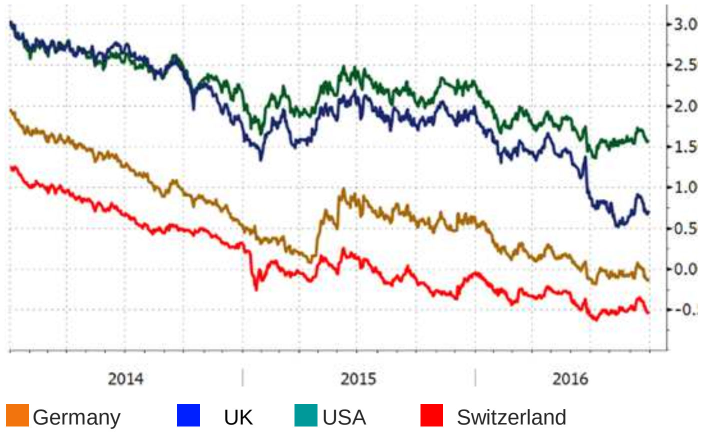
- While the US economy is healthy, conflicting data suggest its growth rate is moderate. So it’s unlikely the Fed will raise rates before December, not least because it may want to assess the reaction to November’s US elections before acting. The Fed remains “data dependent”, i.e. it will react as required by its assessment of published macro data.
- ECB President Mario Draghi is likely to announce before the year-end that the ECB’s bond purchase program will be extended – either in terms of time-scale or size.
- The SNB’s room for maneuver is very limited by the policies of the ECB, and it has been forced into buying forex even more heavily after the UK’s Brexit vote. The SNB will try very hard to avoid pushing Swiss rates further into negative territory.
- The Bank of England is likely to announce another reduction in its policy rate and, if need be, a new program of bond purchases.

# Our investment policy conclusions

**Bonds**

- Yield curves in the major currencies continue broadly flat, though comparisons with a month ago show a slight steepening. This probably reflects recent signs of caution from some central banks. So far the ECB has yet to announce an expansion of its securities purchase program.
- The ECB is a powerful influence on European bond markets and ECB bond purchases mean that, alongside government bonds, a large part of Europe's high grade corporate bond market carries a negative yield. Indeed, some EUR 5 trillion worth of bonds now post negative yields. Certain issues are being "crowded out". In illiquid markets bond owners are not selling as they expect the ECB to offer still higher prices in future.

**Yields on 10 year government bonds since 2014, %**

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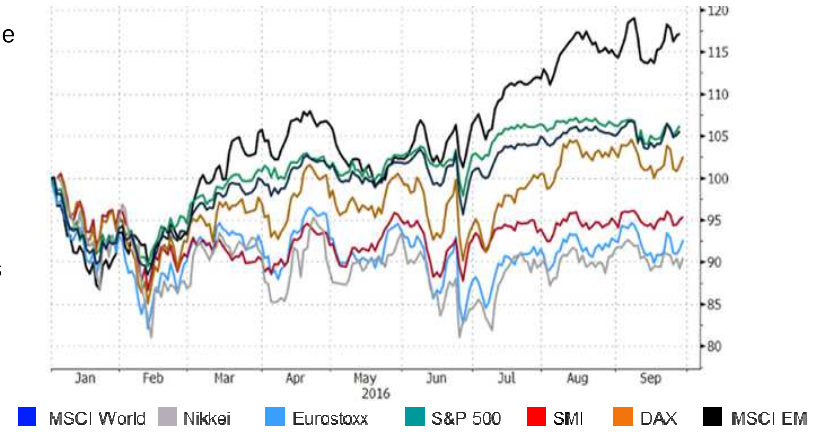
**Equities**

- Following their post-Brexit recovery equities have for some weeks been in a sideways channel. On the positive side, the equity markets are supported by the flow of basically-solid macro data as well as the likelihood that the major central banks will continue to supply liquidity on very cheap terms. Among potential negative factors are the upcoming Presidential and Congressional elections in the US and the impending referendum in Italy on Senate reform.
- The third quarter earnings season for US companies is about to start and reports will be closely followed. Investors are likely to pay particular attention to the comments of corporate executives on business prospects for next year.
- We have decided to run a slightly overweight position in equities. We believe that equities are currently the most attractive of the major asset classes and will view any market setbacks as an opportunity to add to positions in quality companies in Switzerland and elsewhere in Europe.

**Equity markets, performance 2016, indexed**

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**Currencies**

- A rising US dollar hits the dollar value of the international earnings of US companies. This point has not been lost on the Fed. Also, G7 countries are not keen to have the Chinese yuan under too much pressure. With the Fed likely to raise interest rates only gradually, it seems probable that any appreciating trend for the US dollar will also only be gradual.
- The divergence of the monetary policy paths of the US and Europe is increasing, but the Fed is continually present in the markets through its commentary which is designed to prevent a sharp appreciation of the dollar.
- SNB statistics for commercial bank sight deposits with the Swiss central bank show these deposits rose from CHF 402bn. to CHF 462bn. over the course of 2015. So far this year these sight deposits have risen further – to significantly above CHF 500bn. A EUR/CHF rate around 1.10 seems to be the "new normal" and the efforts of the SNB in managing to achieve this appear unappreciated by the markets. We are keeping our EUR/CHF hedges in place.

**USD/CHF, since 2015**


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