Baloise Asset Management

Market Outlook 1st Quarter 2018

Strong momentum continues into the new year

Market Outlook 1st Quarter 2018

Strong momentum continues into the new year

Outlook

- Synchronised global economic growth is set to continue
- Due to base effects, inflation in the Eurozone, the USA and Switzerland is expected to soften in the first months of the year, although core inflation rates should to remain stable or increase slightly
- Monetary policy in developed markets is turning less expansionary, but not yet restrictive overall

Implications

- For equity markets the party is not over yet, as robust global growth and a persistently low interest rate environment continue to support earnings growth and share buybacks
- The Federal Reserve is expected to raise its key interest rates by a further 25 basis points, to a range of 1.50-1.75 %, this spring
- The upside to long-term interest rates is limited due to moderate inflation expectations and structural factors

Risks

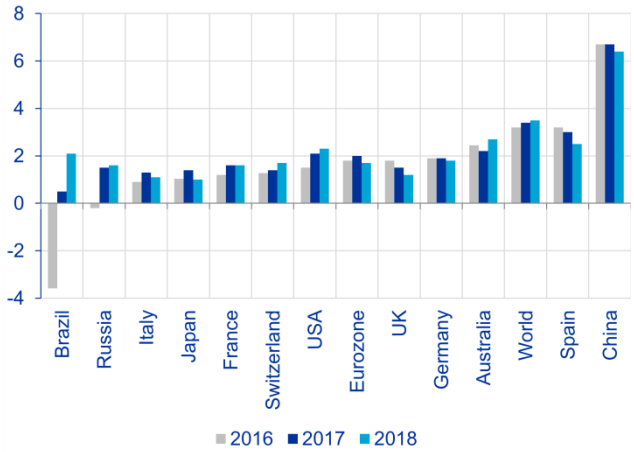
- Political uncertainty (parliamentary elections in Italy, the US debt ceiling, etc.) may cause some bouts of volatility during the first quarter of 2018
- A greater risk to markets, however, would be a surge in inflation, as investors expect only a modest rise and consequently a very gradual withdrawal of monetary stimulus by central banks

Economy: Robust growth with low but rising inflation

Global growth

The global upturn remains solid and broad-based. The global Purchasing Managers' Index (PMI) ended 2017 on a high, as industrial demand gained momentum again. Geographically, the strongest boost came from the Eurozone, but stronger than expected data was also recorded in China, India and Australia. With a growth rate of 3.6 % in 2017, the global economy is expected to experience the strongest expansion in three years. We expect this upturn to continue in the first half of 2018 as well.

Consensus GDP forecasts



Source: Baloise Asset Management, Bloomberg Finance L.P. as of 12 January 2018

Despite fears of heightened protectionism in early 2017, the volume of world trade grew by around 4 % last year, a significant increase compared to the 1.5 % in 2016 and also the strongest growth in six years. However, this recovery in world trade is mostly driven by increased global demand and a weaker US dollar, rather than reduced protectionism.

Switzerland: Recovery gathers pace

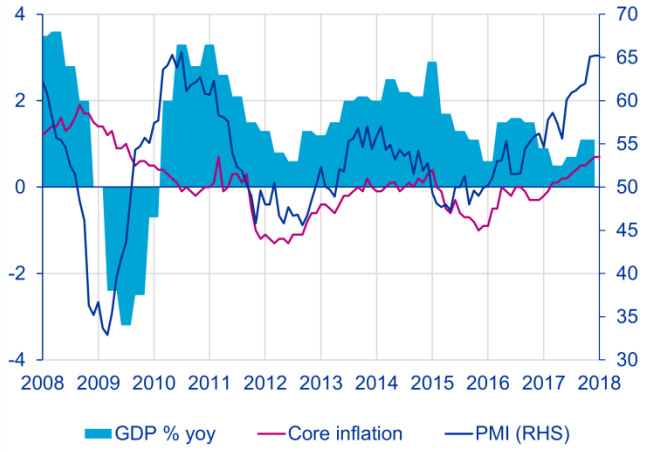
Growth: The Swiss economy is finally gaining momentum, and hard data now follows the strong sentiment data. The latest estimate from the State Secretariat for Economic Affairs for the gross domestic product (GDP) not only showed that growth has strengthened, but that it is increasingly broad-based. The latest indicators suggest this upward trend is set to continue in the coming months as the economic barometer of the KOF Swiss Economic Institute just reached its highest level in seven and a half years.

The labour market recovery and above-average consumer sentiment will support private consumption during the coming months. The depreciation of the Swiss franc is also likely to boost the hospitality industry as well as exports. The latter also benefits from the greater demand in the USA and the Eurozone. Consequently, exports to these regions have risen recently.

Labour market: The upswing is improving labour market conditions. Although the unemployment rate increased in December, to 3.3 %, it is still 0.2 percentage points lower than in the previous year.

Inflation: In December 2017 Swiss consumer prices rose 0.8 % year-on-year. This is the strongest increase since 2011 and a development mainly driven by the weak Swiss franc. Due to base effects relating to energy prices, inflation should soften slightly in early 2018. Inflation excluding energy and food prices, known as core inflation, should remain around 0.7 %. Inflation rates are therefore in line with the Swiss National Bank's (SNB) definition of price stability.

State of the economy: Switzerland



Source: Baloise Asset Management, Bloomberg Finance L.P. as of 12 January 2018

Eurozone: above-trend growth continues

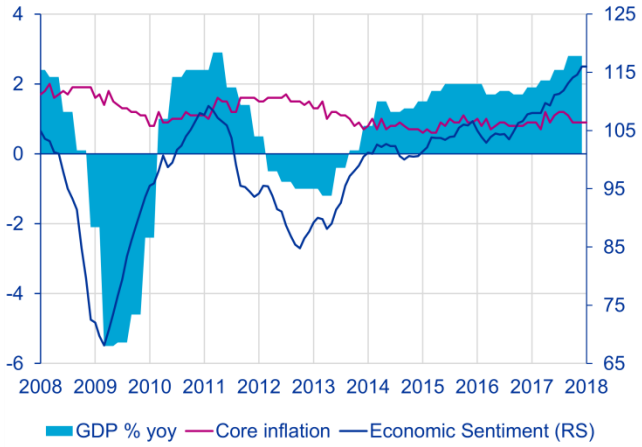
Growth: The strong growth in the Eurozone last year surprised many analysts, prompting them to continually revise their forecasts upwards. The 2017 consensus forecast for GDP growth in the Eurozone was only 1.4 % in January 2017 and yet, in December, analysts estimated full-year growth to be 2.3 %. The latest leading indicators point to a continuation of the upwards trend, at least in the short term. For example, the PMI for the Eurozone reached a six-year high in December. The European Commission's Economic Sentiment Index also shows that consumers and producers were as confident in December as they were at the end of 2000.

For 2018, however, a slight slowdown in growth is expected. This is partly a consequence of the stronger euro, which has gained more than 11 % on a trade-weighted basis since April 2017. And a gradual convergence back to normal growth will also begin. With a predicted 2.1 %, expectations are still well above the normal growth rate of around one percent.

Labour market: Although the labour market is recovering, there is still some slack as the unemployment rate of 8.7 % is still 1.4 percentage points higher than its pre-crisis levels. There are thus few signs of strong wage pressures in most member states of the currency area. An exception is Germany, where the business cycle is most advanced and wage negotiations for workers in the metal electrical industries could put pressure on German wages.

Inflation: Base effects related to energy price developments counteract any potential wage inflation in the first quarter and headline inflation is expected to somewhat decline. If energy and food prices are excluded from the calculation, a moderate increase in inflation is to be expected. Although currency appreciation generally lowers inflation, the disinflationary effect of the strong euro is limited, as the main reason for the appreciation is increased demand in the Eurozone. In such cases, higher price pressures created by stronger demand can offset the disinflationary currency effect, as a study[1] published by the European Central Bank (ECB) suggests.

State of the economy: Eurozone



Source: Baloise Asset Management, Bloomberg Finance L.P. as of 12 January 2018

USA: a limited tax reform boost

Growth: The US economy remains robust. For 2017, GDP growth is estimated at 2.3 %. The most important growth driver remains private consumption, which is supported by favourable financing and labour market conditions. This year, private consumption is expected to contribute slightly less to GDP, while investment should make an even greater contribution, as a result of the US tax reform that was adopted last December. Overall, GDP growth of 2.6 % is forecast for 2018.

Tax reform: The tax reform will provide the US economy with a short-term boost, but its long-term effect is uncertain. Most studies assume modest additional GDP growth of around 0.06-0.12 percentage points per year over the next ten years. The key piece of the reform is the indefinite reduction of the tax rate on corporate profits, from 35 % to 21 %. Taxes for private individuals have also been cut for every tax bracket. However, the latter changes only apply until the end of 2025 and with the top earners benefitting the most any boost to private consumption is limited. The ability to fully write off investment in

[1] Comunale, M., Kunovac,D. (2017). Exchange rate pass-through in the euro area. (ECB Working Paper No. 2003). https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp2003.en.pdf

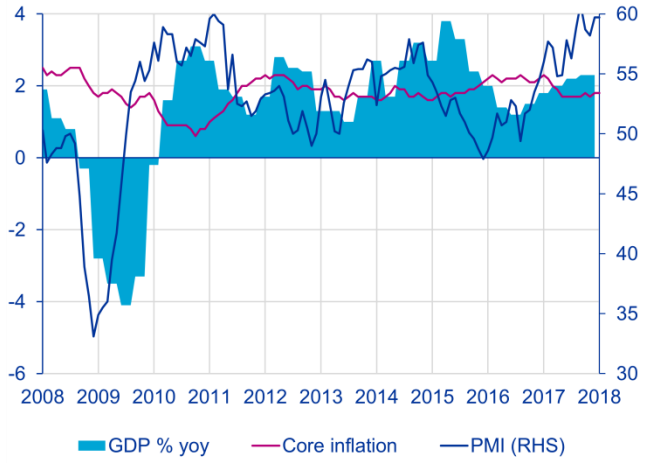
equipment over the next five years will primarily benefit companies in capital-intensive sectors in the short term. Whether other companies significantly invest more and thereby increase US potential growth, or instead more capital ultimately flows to investors in the form of dividends and share buy-backs, remains to be seen.

Labour market: Although nonfarm payrolls in December were below analyst expectations (148,000 actual vs. 190,000 expected), the unemployment rate has remained at 4.1 % since October, the lowest level in almost two decades. The US Federal Reserve (Fed) expects that the rate for 2018 to fall to 3.9 %.

Despite historically low levels of unemployment, wages have remained subdued so far. Since the beginning of 2016, wage growth averaged around 2.5 % year-on-year. Although this is about one percentage point higher than at the end of 2012, it is still below the pre-crisis level of 3-3.5 %. However, there are increasing signs of impending wage inflation. Small businesses, for example, which employ 48 % of the labour force, are planning to hire more people, according to recent surveys. At the same time, they say it is increasingly difficult to find qualified workers, which gives jobs seekers greater bargaining power.

Inflation: US inflation has bottomed out and inflationary pressures are expected to gradually increase thanks to rising wages and a positive output gap. Inflation, as measured by the personal consumption deflator, the US Federal Reserve's preferred indicator, was most recently close to 1.8 %, or 1.5 % excluding energy and food prices. The core rate is expected to remain around 1.5 % in the first quarter, while headline inflation is likely to decrease slightly, due to base effects. However, even financial markets are beginning to price in higher inflation. Investors' inflation expectations, measured using the break-even inflation rate over 10 years, exceeded 2 % at the beginning of January. In June, it was around 1.6 %.

State of the economy: USA



Source: Baloise Asset Management, Bloomberg Finance L.P. as of 12 January 2018

In focus: The Fed raises rates, but long-term interest rates trade sideways

At the end of 2015, the US Federal Reserve raised interest rates for the first time since the global financial crisis. Overall, short-term rates have since risen by 125 basis points (bp), but yields on 10-year US government bonds have risen by only 20 bp over the same period.

US monetary policy tightening cycles

From	Duration	Δ Policy rate	Δ US 10y yield (% of policy rate change)
	months	bps	bps (%)
Apr-83	16	325	215 (66%)
Dez-86	26	387	216 (56%)
Feb-94	12	300	156 (52%)
Jun-99	11	175	65 (37%)
Jun-04	24	425	49 (12%)
Dez-15	24	125	20 (16%)
ø	*19*	*290*	*120 (40%)*

Source: Baloise Asset Management, Bloomberg Finance L.P. as of 12 January 2018

In fact, interest rate moves seem to have had less and less impact on long-term interest rates. For example, the Fed's rate hike cycles in the 1980s had a greater impact on long-term interest rates; at that time, when key interest rates were raised by one percentage point, ten-year government bond yields rose on average 60 bp. In the two cycles over the past fifteen years, the effect has been significantly lower, at only 12 or 16 bp.

The decoupling of short-term and long-term interest rates is a consequence of the ultra-loose monetary policy deployed in the wake of the financial crisis. For almost seven years, policy rates in the US remained at 0.25 %. During this period, quantitative easing (QE) was the Fed's main monetary policy instrument. With the reduction of the balance sheet, this factor is likely to fade. However, this is not the only driver. The relationship between short-term and long-term interest rates had already weakened in the run-up to the financial crisis. There seems to have been a structural change in long-term interest rates that extends beyond the USA. Long-term interest rates have fallen sharply worldwide in recent decades and have become increasingly correlated. In this context, the Bank for International Settlements (BIS)[2] speaks of a global long-term interest rate, as long-term interest rates are increasingly being driven by global forces. An important driver is the increase in international capital flows, resulting from the improved integration of financial markets worldwide. As a result, central banks have somewhat less control over the long end of the yield curve. For example, even though US

[2] Hördahl, P, Sobrun, J, Turner, P. (2016). Low long-term interest rates as a global phenomenon. (BIS Working Paper, No. 574). https://www.bis.org/publ/work574.pdf

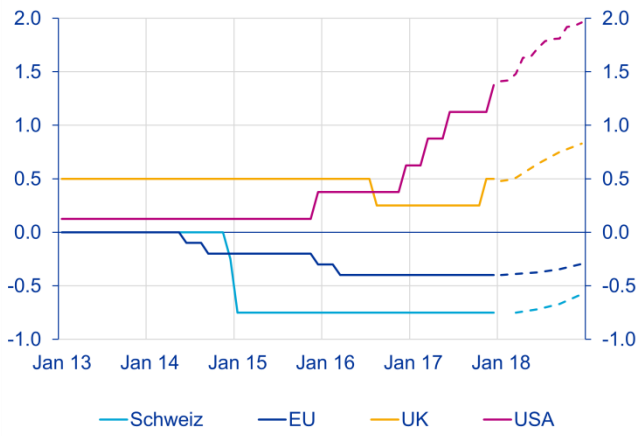
economic momentum strengthened and the Fed tapered its QE programme, US yields came under pressure because the ECB expanded its securities purchases.

What does this mean for the financial markets in 2018? Despite the three interest rate moves telegraphed by the Fed, the ten-year Treasury rate is expected to rise only moderately, further flattening the US yield curve. However, the modest increase at the long end should be a reassuring sign for emerging markets, because as long as US long-term rates do not rise sharply, financing conditions in these regions remain favourable and the risk of another taper tantrum akin the 2013 event is limited.

Interest rate: Only moderate increase

Review: In the fourth quarter of 2017, yields on ten-year government bonds in Switzerland and Germany fell from 0.00 % and 0.48 %, respectively, to -0.19 % and 0.29 % by mid-November, after peaking at the end of October. Subsequently, a countermovement set in, due to the upcoming Fed rate hike, which caused yields to rise to -0.15 % in Switzerland and 0.43 % in Germany by the end of the quarter. In the USA, the 10-year yields ended the year at 2.41 %, around where they stood at the beginning of this year.

Policy rates and market expectations



Source: Baloise Asset Management, Bloomberg Finance L.P. as of 12 January 2018

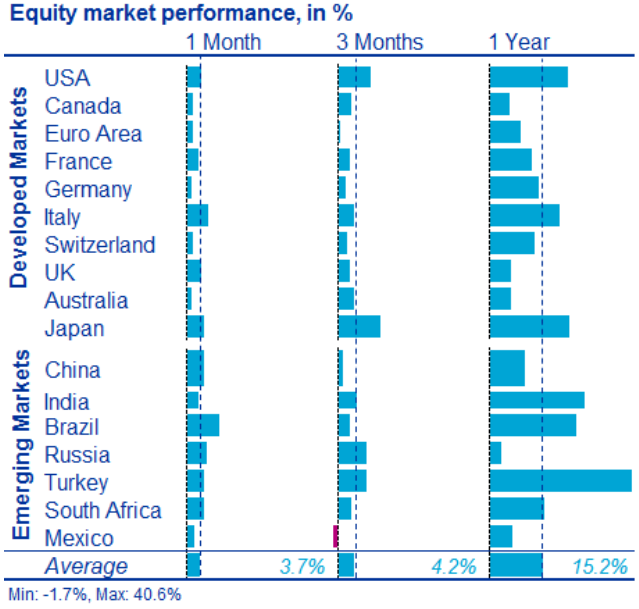
Outlook: The US Federal Reserve telegraphed three interest rate hikes for 2018, bringing the target range to 2.00-2.25 % by the end of the year. The Chair of the US Federal Reserve (Fed), Janet Yellen, will leave the central bank in February and be replaced by like-minded Jerome Powell. It is under his leadership that the next rate hike will probably take place on 21 March. This is already priced in by the futures markets.
As announced, the European Central Bank reduced its monthly asset purchases at the beginning of January, from EUR 60 billion to EUR 30 billion. On 11 January 2018, the minutes of the ECB's December meeting were also published. They stated that "It was suggested that the ECB Governing Council's communication should change in due course, to avoid sudden and undesirable developments in funding conditions." This sentence is a further indication that the ECB could soon make its forward guidance less expansive. According to the ECB, however, a first rate hike will take place only after the QE programme has been successfully completed, which is at the earliest by the end of 2018. With asset purchases ending, market participants shift their focus on initial interest rate hikes which would have the potential to widen the record-low credit spreads of corporate bonds. Major turbulence should be avoided, however, as the central bank is expected to proceed very cautiously.

The strong upturn in the Eurozone and the associated appreciation of the euro against the Swiss franc should support the economic recovery in Switzerland and reinforce inflationary pressures. The SNB will, however, be careful not to counteract the easing of conditions with a premature interest rate rise.

Equities: The party is not over yet

Review: 2017 was an excellent year for equities globally. The MSCI World Stock Index gained 21.6 % and investors enjoyed gains every month, with very low volatility. US equities, as measured by the S&P 500 Index, impressed with an increase of 19.4 %. Gians were somewhat more restrained in Europe. The European Euro Stoxx 50 rose by 6.5 % and the Swiss Market Index (SMI) by 14.1 %. For all three regions and globally, 2017 was the best year for equities since 2013. The strong momentum continued in most markets during the first days of 2018.

Equity market performance, in %



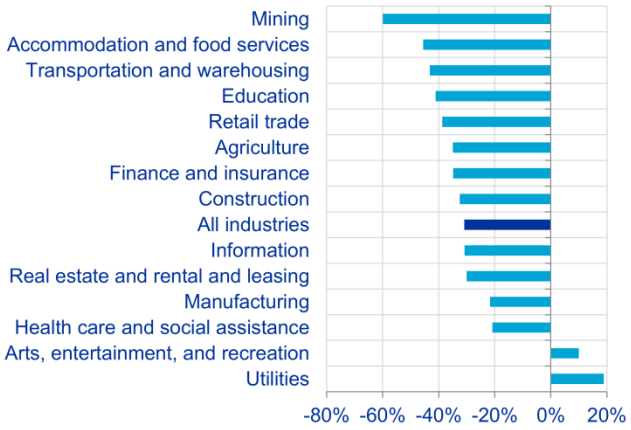
Source: Baloise Asset Management, Bloomberg Finance L.P. as of 12 January 2018

Outlook: With the drivers of the equity rally still in place, we expect global equities to continue to perform well, though to lesser degree than in 2017.

The global economic upswing and low inflationary pressures in developed markets continue to support earnings growth. Monetary policy in developed countries is turning less expansionary, but by no means restrictive. In addition, the US tax reform should further boost lead to share buybacks. In view of the positive macroeconomic environment, investors will likely use minor corrections to build up their equity portfolios – "buy the dip".

Thanks to the tax reform, US shares still have room to run despite stretched valuations. The reform will bring significant tax relief. On average, companies are expected to save around 30 % in taxes over the next ten years. However, a study by the Penn Wharton Budget Model shows that the tax savings are very heterogeneous. The tax burden for the mining sector will be reduced by up to 60 %, while the tax burden for the utilities sector will actually increase by 20 % in the long term.

US tax reform across industries
Change in expected tax paid 2018-2027, in %

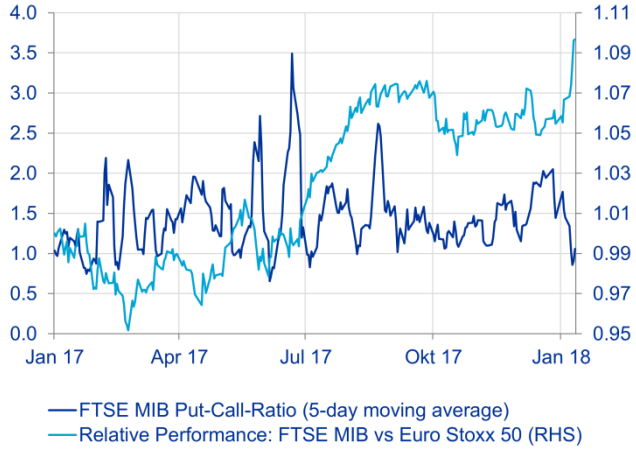


Source: Baloise Asset Management, Penn Wharton Budget Model, as of 15 December 2017

As in previous quarters, (geo)political events are likely to spark some volatility. Italy's parliamentary elections on 4 March 2018 could weigh on European markets. For now however, the Italian stock market is still outperforming the Euro Stoxx 50 and investors are not yet worrying about major political risks as the falling put-call ratio suggests.

While politics could cause short-term market volatility, markets remain at the mercy of central banks in the medium-term. We thus also see an unexpectedly strong tightening of monetary policy as one of the risks that would lead to a risk-off environment. Inflation dynamics will therefore be the key developments to watch. This is especially true of the USA, where inflationary pressures and monetary policy normalisation have advanced furthest.

Italian equities: the calm before the storm?

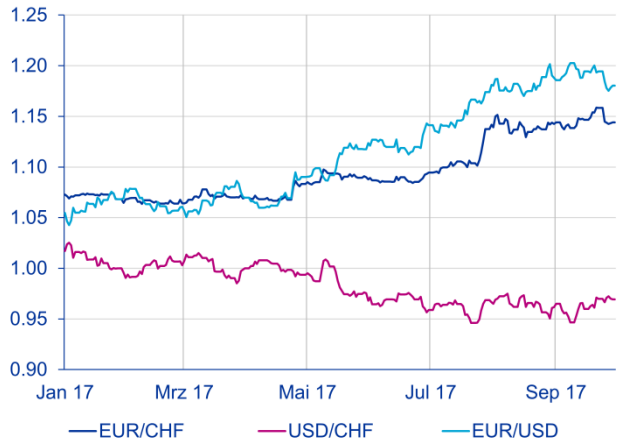


Source: Baloise Asset Management, Bloomberg Finance L.P. as of 12 January 2018

Currencies: Test for the euro

Review: 2017 was a year of dollar weakness and euro strength. Over the course of 2017, the euro gained 9.1 % against the Swiss franc. This reflects above all the economic recovery in the European Monetary Union and the decline in political uncertainty following the presidential election in France. While the SNB had to intervene in the foreign exchange market in early 2017 to curb the appreciation of the Swiss franc, sight deposits stabilised in the autumn.

Exchange rate developments

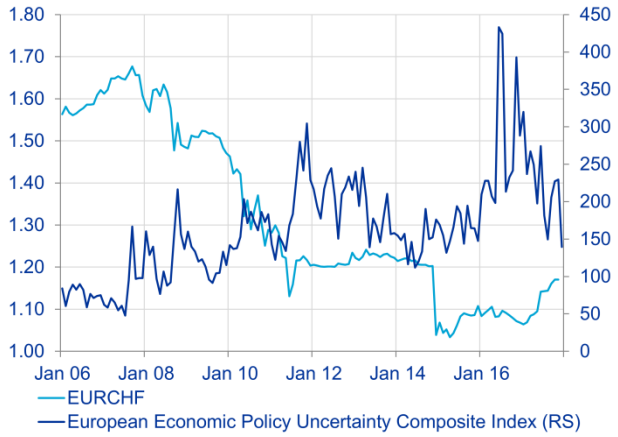


Source: Baloise Asset Management, Bloomberg Finance L.P. as of 12 January 2018

Outlook: In the middle of the first quarter, parliamentary elections in Italy could weigh on the euro. It is expected that the growing political uncertainty in the Eurozone will lead to an appreciation of the Swiss franc, as has been the case in the past. If need be, this could induce the SNB to become more active again in the foreign exchange market. Once the uncertainty subsides, the euro is likely to strengthen again somewhat. Compared to the Swiss franc, however, the potential for appreciation is limited, because the euro/CHF exchange rate is already relatively close to its fair value (around 1.22) in terms

of purchasing power parity. The franc is still valued somewhat too high, but it has not been as "weak" as it currently is since 2014.

European policy uncertainty weighs on EUR/CHF



Source: Baloise Asset Management, Bloomberg Finance L.P. as of 12 January 2018

US monetary policy and hence the widening interest rate differential compared to other developed countries should strengthen the US dollar. At the same time, however, the greenback remains overvalued. The weakness of the dollar could therefore definitely continue for longer than expected.

Market-relevant dates

2018

Jan

- **From January:** ECB reduces its asset purchase programme from 60 billion to 30 billion euros per month, until September 2018
- **From January:** Fed increases its balance sheet reduction from a max. of USD 10 billion to a max. of USD 20 billion per month
- **19 January:** New stopgap spending bill is required to prevent government shutdown in the US
- **20 January:** One year anniversary of Donald Trump taking office
- **23-26 January**: World Economic Forum Dave
- **25 January**: ECB interest rate decision
- **30-31 January:** FOMC interest rate decision

Feb

- **03 February**: Jerome Powell takes over as the FOMC chair

Mar

- **04 March:** Parliamentary election in Italy
- **08 March:** ECB interest rate decision
- **15 March:** SNB interest rate decision
- **18 March:** Presidential election in Russia
- **20-21 March**: FOMC interest rate decision

Legend:

Politics | Monetary policy | Fiscal policy

Impressum

Authors

Melanie Rama
Economist, Asset Strategy
melanie.rama@baloise.com

Hagen Fuchs
Credit Analyst, Fixed Income
hagen.fuchs@baloise.com

Dominik Schmidlin
Head of Asset Strategy
dominik.schmidlin@baloise.com

Baloise Asset Management Schweiz AG
Aeschengraben 21, 4002 Basel
www.baloise-asset-management.com

Publication
4x per year, editorial deadline 12.01.2018