

Interest rates/Bond markets

Fed in the spotlight

USA

- Fed delivers expected rate hike – yet its newly projected three more steps next year surprised markets
- We continue to expect two rate hikes of 25 basis points through 2017; risks now lean towards one more hike depending on implementation of tax reforms and infrastructure spending
- Reflation trade continues with 10-year breakeven inflation rate up by 80 basis points since February

Euro Area

- ECB managed to engineer a steepening of the yield curve thanks to enlargement of its investment opportunities to shorter-term maturities
- Despite the announcement to taper its bond purchase program, the ECB has de facto extended QE slightly with its latest measures
- Diverging monetary policies between Fed and ECB will persist until 2018

Japan

- Of all major central banks in the developed world, the Bank of Japan will be the last one to consider a normalisation of its ultra-loose policy
- Weaker currency, higher energy prices and global growth support the central bank's efforts to reflate the economy

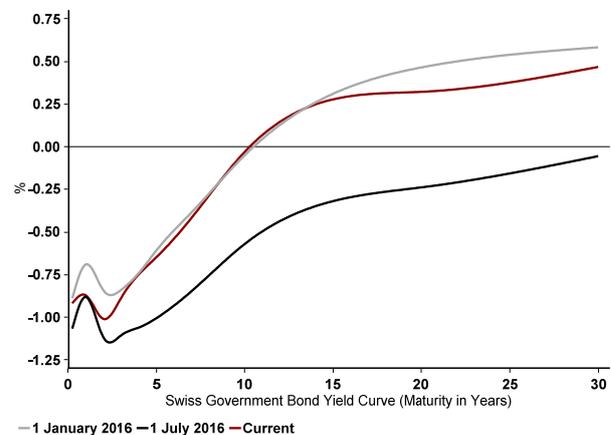
United Kingdom

- A further rate cut becomes increasingly unlikely given the strength of the economy
- In our view, the Bank of England will keep its powder dry for more turbulent times during Brexit negotiations

Switzerland

- Riding on the global reflation trade wave, Swiss 10-year sovereign bond yields approach the zero line
- Monetary policy stance by the SNB expected to remain unchanged through 2017

Swiss sovereign bond yields: Back to the start



Source: **Macrobond**

The Fed has delivered the widely expected 25 basis points rate hike at its last meeting in 2016. Over the past weeks, markets were well prepared for this measure as central bank rhetoric and economic data spoke the same language: A normalisation of monetary policy was overdue. And yet, Janet Yellen and the open market committee members at the Fed went one step further and revised the projected number of rate hikes in 2017 from two to three. The immediate market reaction was further rising sovereign bond yields and a strengthening of the Dollar. The broad concept of financial conditions for the entire US economy will be a decisive factor determining future monetary policy action by the Federal Reserve. We expect US treasury yields to rise further in the first quarter 2017 and the US Dollar to strengthen moderately versus all other major currencies in 2017. Additionally, we think that the US equity market is ripe for a correction. Should our assessment turn out to be correct over the coming months, the FOMC could reconsider its monetary policy normalisation plans for 2017 and finally be content with only two hikes. This remains the most likely scenario in our view. From Japan to the US, 10-year sovereign bond yields rose between 13 and 93 basis points over the last three months. How much further can yields go from here? With the inflation cycle in US likely to peak in the first half of 2017 and given the strong institutional demand for fixed income investment at increasingly attractive yield levels, we believe that government bond yields in Europe and the US will end the next year around 30 to 40 basis points higher from today's levels.

Stock markets

We expect a setback after the rally

USA

- After the rally of the S&P 500 towards year end, we would not be surprised if the slightly more hawkish Fed would cause a setback
- Risk measures are on very high levels and signal the potential for a temporary correction of stocks

Euro Area

- EURO STOXX 50 gained 6% in the first half of December thanks to the ECB's extension of the asset purchase programme and the weakening of the Euro
- We are convinced that monetary policy of the Fed and the ECB remains divergent – the resulting weakness of the Euro will continue to support stocks of exporting firms
- Stocks of the financial sector could particularly benefit after the ECB meeting due to the steepening of the yield curve

Japan

- The Nikkei 225 gained 11% since the start of November on the back of a 9% depreciation of the trade-weighted Yen
- In 2016, the Nikkei 225 has been the most volatile equity index of the ones discussed in this paper

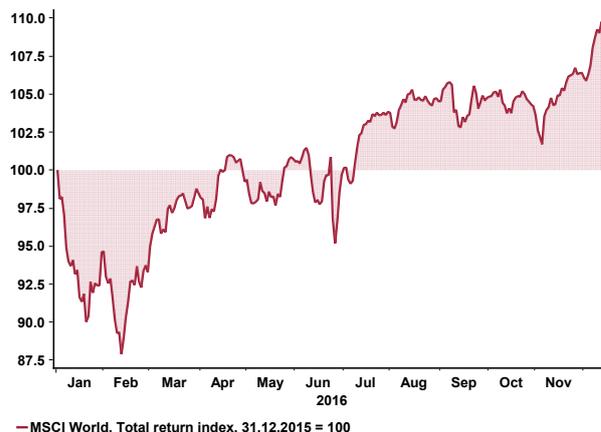
United Kingdom

- FTSE 100 gained 2.5% in the first half of December despite the appreciation of the Pound
- Financial conditions remain loose however as the Pound is still as weak as in the weeks following the Brexit vote

Switzerland

- SPI could benefit of the general positive sentiment and gained 3% in the first two weeks of December
- SPI has had the weakest year-to-date performance of the indices discussed in this paper – it dropped by 2.5% until mid-December
- SPI was the least volatile index of the ones discussed here in 2016

MSCI world: An impressive rally towards year-end



Source: **Macrobond**

The MSCI world index has shown an impressive rally towards the end of this year. The positive market sentiment after the election of Donald Trump has pushed the MSCI world index higher. The performance from January until November was 6%. This is slightly higher than our initial forecast for the full year 2016. After the most recent rally, the performance from January until mid-December is 10%. We were surprised by the rapid increase of equity markets in the first half of December. Financial markets have in general interpreted the consequences of a Trump presidency in a very positive way. In our view, the market has gone too far and we are prepared to see a setback. The risk appetite at equity markets is high. Many investors are looking for upside potential and do not protect themselves against potential downside moves. The US and European markets seem overbought. Therefore, we would not be surprised to see a correction. Yet, we only expect a short-term correction. We agree with the predominant opinion that Donald Trump's tax policy can fundamentally change the outlook for US equities. He has announced tax cuts and tax repatriation holidays for firms. If he implements these measures, they will act as a substantial support for US equities. When looking back on the year 2016, the S&P 500 belongs to the best performing indices among those discussed in this paper. The S&P 500 gained 10%. The other outperformer is the FTSE 100, and thus also an Anglo-Saxon index. Its performance since the beginning of the year is 11% and has been supported by the weak Pound to a large degree. The EURO STOXX 50 and the SPI have had a slightly negative year-to-date performance. Finally, the Nikkei 225 has risen by 1% since the beginning of the year.

Currencies

Yen and Pound generate most excitement in 2016

USA

- The expected Fed hike materialised and the Fed held out the prospect of three more hikes in 2017 – given ample political uncertainties, we stick to our view of two more hikes next year
- The USD benefitted from Fed communication and appreciated further against other main currencies
- We remain moderately positive for a stronger USD, although markets price in too much optimism

Euro Area

- EUR/USD fell below 1.05 – this has not happened since March 2015 – it was below parity in 2002
- The macroeconomic picture in the Euro Area looks very strong – that should prevent further pronounced weakening of the EUR
- The theme of diverging monetary policies and political risks in the Euro Area will continue to influence currency moves in the medium term

Japan

- Yen lost almost 13% against USD since US elections
- The depreciation phase of the Yen is very welcomed by policymakers and corporates alike
- Diverging central bank policies should drive JPY/USD even somewhat lower in coming weeks

United Kingdom

- The trade-weighted Pound gained around 7% since its low point in October of this year
- BoE is not under pressure to change their monetary stance as economic data still are very solid while services inflation seems to have peaked
- Once Brexit negotiations start in earnest the Pound may yet again come under pressure

Switzerland

- The SNB continues to intervene in FX markets as EUR/CHF holds close to 1.07
- The USD appreciation gives the SNB some breathing space however

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Winners and losers of the year



Source: **Macrobond**

The reflation trade triggered by the US election continued in December. OPEC finally arrived at an agreement to temporarily cut production of crude oil in 2017, which lifted inflation expectations further. This production cut and the boost for the oil price lifted the currencies of oil exporting economies. At the same time, metal exporters benefit from the expected infrastructure spending of Donald Trump, as illustrated by the strong rise of the Chilean Peso for instance. Moreover, the Fed implemented the second rate hike in this “cycle” after a one-year pause, however at the same time struck a rather more hawkish tone than market participants had expected. The US Dollar was one of the beneficiaries. Although the majority of Fed officials now see at least three rate increases in 2017, we stick to our expectation of two more hikes next year. Throughout asset classes, a lot of growth optimism and reflation is now reflected in price levels, which do not seem sustainable to us. This also holds true for the USD where we would expect a certain exhaustion of the appreciation trend in the medium term. The ranking list of major currencies according to their year-to-date performance is illustrated in the chart above. For the better part of the year 2016, Yen and British Pound were the mirror image of each other. Despite recent depreciation, the Yen is likely to close the year as the outperformer, holding well above the level of the beginning of the year. The Pound, on the other hand, will head into the New Year a lot cheaper than a year before. The most boring performance must be attributed to the CHF for the obvious reason of ongoing interventions by the SNB, which kept our home currency in a narrow range.