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MarketView

Outlook 2018

- World economy: Solid broad-based growth to continue
- Inflation: To remain below the central banks’ targets in key developed countries, except in the USA
- Monetary policy: Fed the only leading central bank to get real interest rates close to a neutral level
- Currencies: Euro expected modestly stronger, despite continued rate increases in the USA
- Equity markets: Earnings to grow and global economic trends supportive.

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Global economic outlook

The world economy in 2018

Global economic growth will remain comparatively strong in 2018, driven by supportive monetary conditions, rising employment and positive economic sentiment.

In addition, it is worth noting that meaningful drags on activity in recent years – notably the lagged effects of the eurozone debt crisis and the negative consequences of the sharp drop in oil prices on investment spending in the energy sector and the economies of key emerging markets – are now largely absent. Moreover, the Fed has not yet tightened enough to slow down the U.S. economy appreciably in 2018.

Consumer spending will increase, even though the higher oil prices in the second half of 2017 may cause a temporary dip. As in 2017, we anticipate good momentum in global investment spending and industrial output, driven by rising corporate profits and positive demand trends.

We expect core inflation in key developed economies, notably in the euro area and in Japan, to increase only modestly and remain below central bank targets, while core inflation in the USA (as measured by the consumer expenditure deflator) will get close to the Fed's 2%-target.

Source: National statistics, own calculations

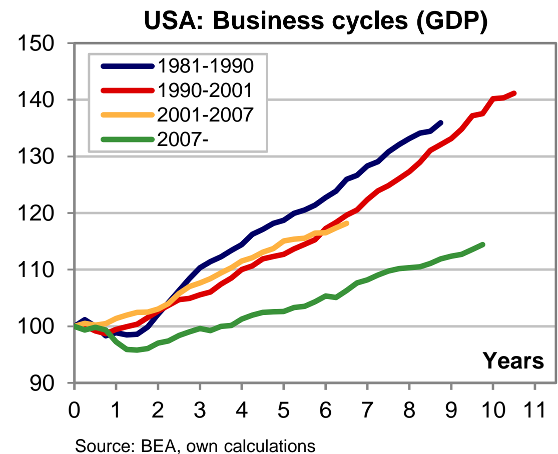
World economy: Overview and forecast

	World share		GDP growth			Inflation			Current	Government*		Popul.
	GDP	Growth	2016	2017	2018	2016	2017	2018	acc.*	Budget	Debt	mill.
Euro area	**16.8**	**10.7**	**1.9**	**2.1**	**2.1**	**0.2**	**1.5**	**1.6**	**3.1**	**-1.3**	**87.4**	**335**
Germany	4.9	3.1	1.9	2.2	2.1	0.4	1.7	1.7	8.1	0.0	65.0	81
France	3.5	2.0	1.1	1.7	1.9	0.1	1.1	1.4	-1.1	-3.0	96.8	67
Italy	2.6	1.2	1.1	1.4	1.5	-0.1	1.3	1.3	2.8	-2.2	133.0	62
Britain	3.4	1.7	1.8	1.5	1.6	0.6	2.7	2.6	-3.6	-2.9	89.5	65
Switzerland	0.9	0.4	1.4	0.9	1.5	-0.4	0.5	0.6	9.9	-0.1	42.8	8
Emerging Europe	**6.2**	**7.0**	**1.8**	**3.7**	**2.7**	**4.9**	**5.1**	**4.8**	**-2.4**	**-**	**42.3**	**473**
Russia	2.0	1.0	-0.2	1.7	1.7	7.0	3.7	3.6	2.8	-2.1	17.4	142
United States	**26.0**	**17.3**	**1.5**	**2.2**	**2.2**	**1.3**	**2.2**	**2.4**	**-2.4**	**-4.3**	**108.1**	**327**
Latin America	**7.3**	**6.2**	**-0.9**	**1.7**	**2.8**	**10.7**	**6.8**	**5.3**	**-2.0**	**-6.1**	**59.8**	**630**
Brazil	2.8	2.4	-3.6	0.9	2.8	8.7	3.5	3.8	-1.4	-9.2	83.4	207
Japan	**6.6**	**2.8**	**1.0**	**1.6**	**1.4**	**-0.1**	**0.6**	**0.9**	**1.2**	**-4.1**	**240.3**	**126**
Asia (excl. Japan)	**27.1**	**48.5**	**5.9**	**6.1**	**5.9**	**2.2**	**1.9**	**2.7**	**5.5**	**-**	**-**	**3878**
China	16.0	30.6	6.7	6.7	6.3	2.0	1.5	2.4	6.1	-3.7	47.6	1379
India	3.3	6.8	7.1	6.7	6.9	4.5	3.6	4.9	-1.4	-6.4	68.7	1282
Africa/Middle East	**5.5**	**5.4**	**3.7**	**2.4**	**3.3**	**7.5**	**8.5**	**8.6**	**-2.3**	**-5.3**	**43.3**	**1436**
World	**100.0**	**100.0**	**2.6**	**3.2**	**3.2**	**2.5**	**2.7**	**2.8**	**-**	**-**	**-**	**7358**

Note: *in % of GDP (current year, unless noted otherwise). Source: National statistics, IMF, OECD, Bloomberg-consensus, own forecasts and calculations

A long business cycle

In the course of 2018, the world economy will enter its tenth year of expansion (as economic activity fell to a low during the financial crisis in the first half of 2009 in most countries). While the length of the current business cycle is not atypical historically, investor concerns most often stem from the observation that the current cycle has already lasted a good deal longer than the previous one, which ended after only six years (2002-2008). On the other hand, it is often forgotten that business cycles in the 1980s and 1990s were considerably longer. The current cycle might even become the longest in the post-war period. This can in part be explained by the phenomenon that the Great Recession was unusually deep, which implies that it is taking longer to re-establish normal levels of activity and employment.



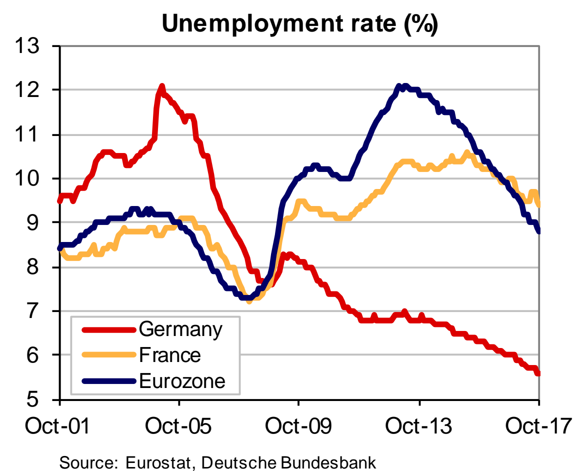
Source: BEA, own calculations

Euro area: Good growth

Since the recovery from the debt crisis started in the second half of 2014, the euro area economy has been growing steadily at a rate of around 2% (in real terms, i.e. after adjusting for inflation), with 2017 even seeing an acceleration. While momentum in 2018 may be not be as strong as in 2017, we expect growth to remain at 2% or higher.

Recent data has been positive. Purchasing manager indices have remained firmly in growth territory. That the corporate sector has been regaining confidence is evidenced in an increase in corporate investment spending, also in relation to GDP, and continued hiring.

In the U.K., we expect GDP growth in 2018 at least to match the 1.6% recorded in 2017. This assumes a Brexit transition deal with the EU, however, which would help to maintain confidence in the corporate sector.



Source: Eurostat, Deutsche Bundesbank

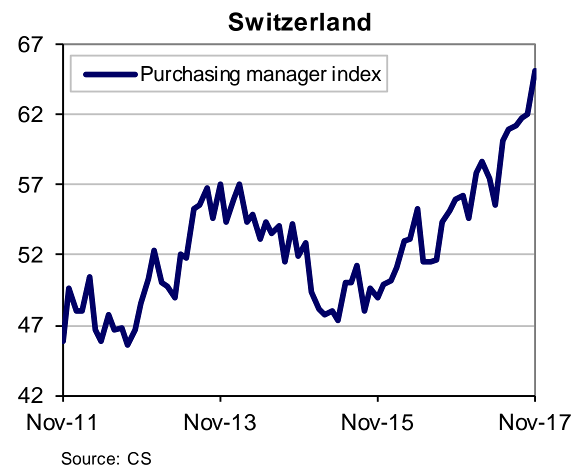
Switzerland: Economy improving

In Switzerland, economic data have been mixed since early 2015, though growth has picked up in the course of 2017. Personal consumption has grown 1.3% over the latest four quarters on average (which is however lower than the 2% recorded in the euro area). Corporate investment spending growth has been fairly muted as well. Nevertheless, a solid increase in the purchasing manager index points to positive trends in manufacturing, despite ongoing Swiss franc strength. We expect the Swiss economy to grow faster in 2018 than in 2017, though still slower than the euro area.

Source: Eurostat

USA: Business cycle not yet over

The U.S. economy continues to experience stable growth and comparatively low inflation. One positive factor is that labor productivity growth has accelerated in 2017, driven by good growth-momentum in the manufacturing sector (where productivity has traditionally been high). We do not, however, expect a shift to a structurally higher level of productivity growth.



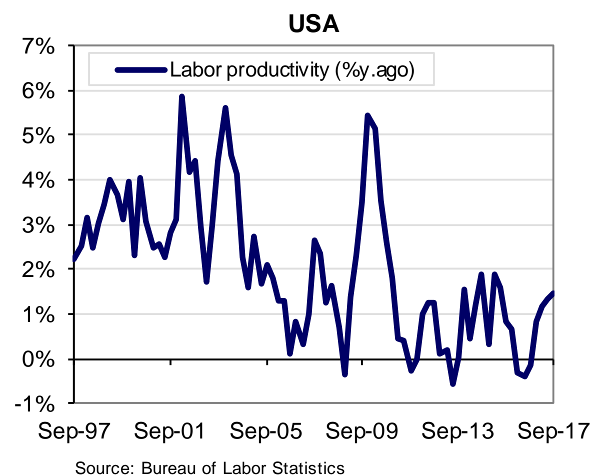
Source: CS

Asia fairly steady

In line with global trends, Japan's economy has been performing comparatively well in 2017. We expect the current positive momentum to be maintained in 2018.

Economic growth in emerging Asia has been quite stable at around 6% in recent years. We expect a modest slowdown in 2018, with China continuing to rein in credit growth to reduce high debt levels in the corporate sector and India's economy cooling somewhat, given a lack of reform-momentum.

Emerging economies in general are benefiting from benign credit conditions and comparatively stable commodity prices (a positive for Brazil, where we see growth improving materially, and also for Russia).

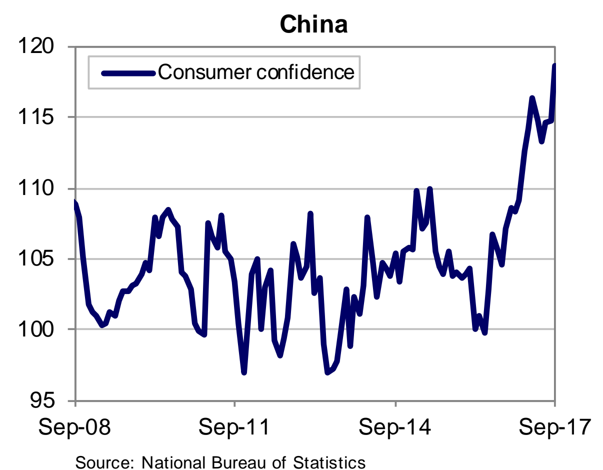


Source: Bureau of Labor Statistics

Political imponderables

Many of the political themes of 2017 – e.g., a politically inexperienced and potentially unpredictable U.S. president, French elections, Brexit talks, North Korean nuclear tensions or the separatist Catalan vote – barely moved financial markets. While the impact of political events on financial markets is indeed often overestimated, some have the potential to alter the course of an economy in a meaningful way. These include elections in the euro area whenever there is a risk that an anti-euro party will come to power. In Italy, there will be a general election no later than May 2018.

The worst case would be a referendum on euro area membership and, ultimately, exit from the single currency. We continue to view such an outcome as very improbable, even though market volatility may increase as the elections move closer.



Source: National Bureau of Statistics

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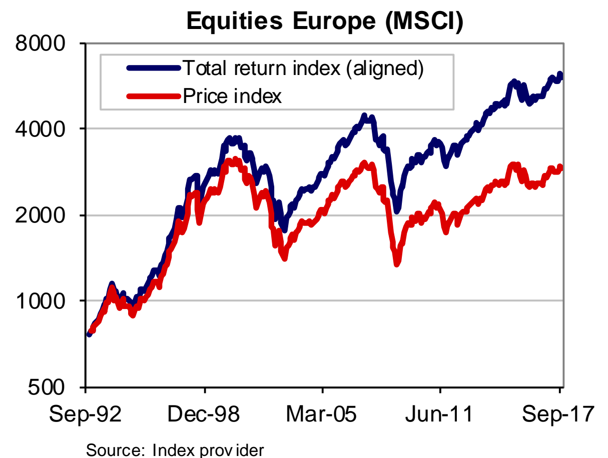
Equity markets

Positive earnings trends

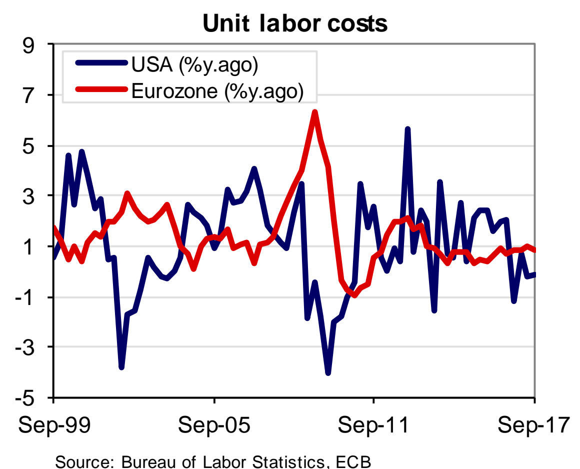
Despite delivering positive returns in 2017, European equity markets have performed a little worse than anticipated, while U.S. equities have risen significantly more than forecast, in part driven by expectations of a cut in the U.S. corporate tax rate. We note, however, that the strengthening euro has weighed on both earnings expectations and equity markets in Europe in 2017. For 2018, we see at least mid-single digit earnings growth in key developed markets (under the assumption of no major changes in exchange rates). With unit labor costs contained both in Europe and in the USA and the world economy delivering another solid year of growth in 2018, these earnings estimates appear well underpinned. In addition, earnings for the S&P 500 will get a boost of 6-8% from the cut in the corporate tax rate from 35% to 20%, with a number of European companies active in the USA benefiting as well. Among industrialized country markets, Japan impressed in 2017 with double-digit earnings growth, though we expect this pace to slow down in 2018.



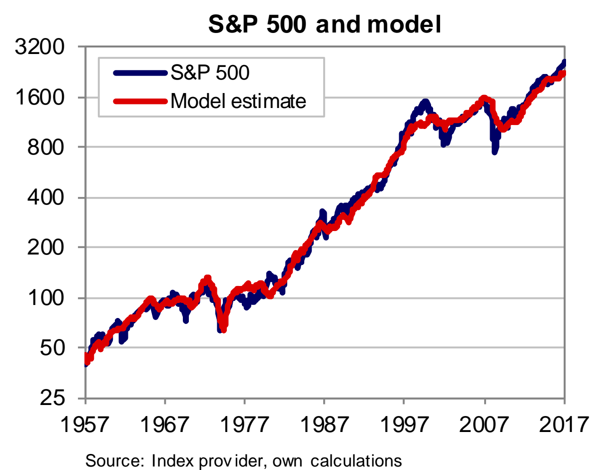
Source: Index provider

Risks and opportunities

Risks will be plentiful in 2018, particularly as the U.S. economy may move closer to overheating in the next couple of years. In our baseline scenario we see this to be a risk only in 2019 or even 2020 rather than in 2018, however. Removing monetary stimulus is less of an issue than often perceived, at least as long as central banks do not actually curtail growth, which we do not even consider likely in the USA, as the real Fed funds rate has yet to turn positive. Were the U.S. yield curve to start inverting, however, this would presage an earlier-than-expected end to the business cycle. At this stage of the cycle, a financial market sell-off could become a self-fulfilling prophecy, as monetary conditions would undoubtedly tighten in that event, though there is little historic precedent for such a scenario. We consider high valuations (of both of equities and corporate bonds) a late-cycle phenomenon providing hardly any timing information, though there is no doubt that valuations will drop once the global economy slows down significantly. In fact, when looking at our model for the S&P 500 we note that the index' level is about in line with fundamentals (even without accounting for any corporate tax cut). Finally, from a European perspective, a strengthening euro may again weigh on returns, notably in the second half of 2018.



Source: Bureau of Labor Statistics, ECB



Source: Index provider, own calculations

Among the more positive scenarios would be a combination of solid earnings growth, a stable U.S. dollar and a U.S. economy characterized by slightly slower growth and only limited inflationary pressures.

Yield gap argues for equities in Europe

Underpinned by positive economic and earnings trends, equities have performed better than bonds in 2017. However, a clear pattern of equity outperformance, which would be typical in phases of economic expansion, has yet to establish itself in Europe. Nevertheless, we expect European equities to start outperforming visibly in the years ahead, supported also by the significant yield advantage equities enjoy over bonds.

Regional equity market outlook

U.S. equities have outperformed the global market (MSCI World) in most of the past ten years. With earnings growth continuing and the market's uptrend intact we continue to see no way around the world's leading equity market.

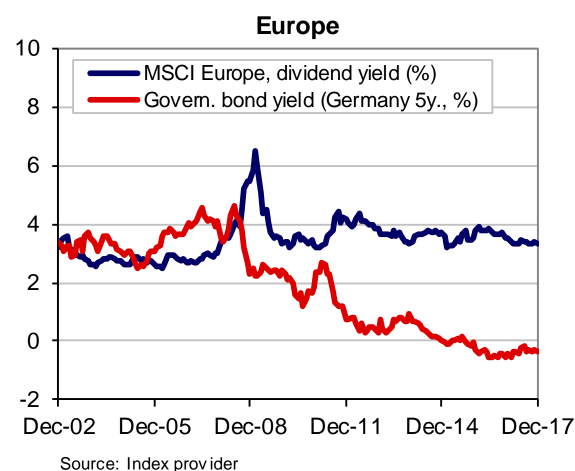
While underlying earnings growth in Europe and the USA is similar, U.S. companies get an additional one-off boost from lower taxes. As European markets have been getting ever cheaper (based on relative price/book-ratios), Europe's relative potential for 2018 remains intact.

As far as non-core markets are concerned, wee see further upside in Emerging Markets, while Japanese equities will continue to benefit from earnings growth.

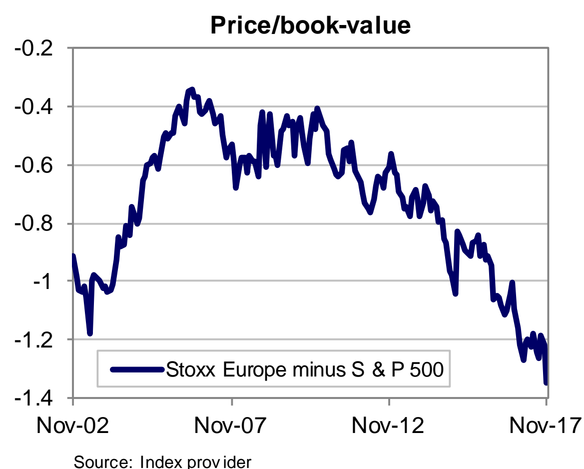
Economy argues for cyclicals

Economically sensitive sectors (cyclical sectors) have shown modest relative strength in 2017, both in the USA and in Europe, with technology shares showing by far the best performance. Financials, on the other hand, were not quite as strong as cyclicals, despite good economic momentum.

As we expect economic momentum to remain solid and in particular also see further gains in corporate investment spending, we continue to advocate a bias towards cyclical companies. A small warning signal comes from the continued flattening of the U.S. yield curve (the difference between long- and short-maturity bonds), although we would not overly emphasize this at present.



Source: Index provider



Source: Index provider

Equity sector performance

	Perform. 2017*	
	Europe	USA
Stable demand sectors	**4.8**	**10.1**
Consumer staples	10.4	9.3
Healthcare	1.5	20.2
Telecommunications	-2.1	-10.5
Energy	-3.7	-8.1
Utilities	10.4	14.1
Financials	**8.7**	**19.9**
Cyclical sectors	**11.5**	**27.0**
Durable consumer goods	5.8	19.2
Industrial companies	13.5	16.7
Technology	19.7	36.3
Basic industries	10.5	18.9
Market	**7.7**	**18.4**

*As per 11-Dec-17, in %. Source: Index provider

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Central bank policy and bond markets

Real central bank rates still negative

Central banks are now a lot more transparent in their communication than in the past. As a result, the degree of surprise caused by changes in monetary policy has been greatly reduced. We expect a quiet year from the ECB in 2018, with bond purchases ending in September and a first increase in official rates following only in 2019 (before president Draghi's term ends in November). The Swiss National Bank's policy remains focused on the currency, which makes a rate increase ahead of the ECB highly unlikely, at least as long as inflation does not rise materially. We expect the Bank of England to continue its slow rate normalization process (with one or possibly two rate hikes in 2018).

The Fed will continue to become less accommodating, with outright tightening to start only once real rates rise above 0.5% (our estimate of the growth-neutral real rate). Solid economic trends skew the risks towards higher-than-expected rates (i.e. four rate increases in 2018, with the pace slowing down in 2019, however). The Bank of Japan has recently reiterated that it is too early even to debate policy normalization.

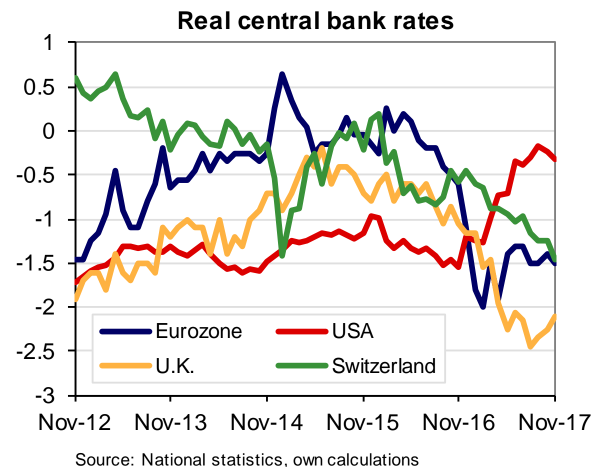
Yields seen only modestly higher

Given a stable growth outlook and inflation expected to pick up only modestly, we anticipate upward pressure on U.S. bond yields to remain limited, despite the Fed shrinking its balance sheet and more rate hikes in the offing. Our model-based fair-value range is likely to remain at 2.25-2.75% for 10-year U.S. Treasury bonds for quite some time.

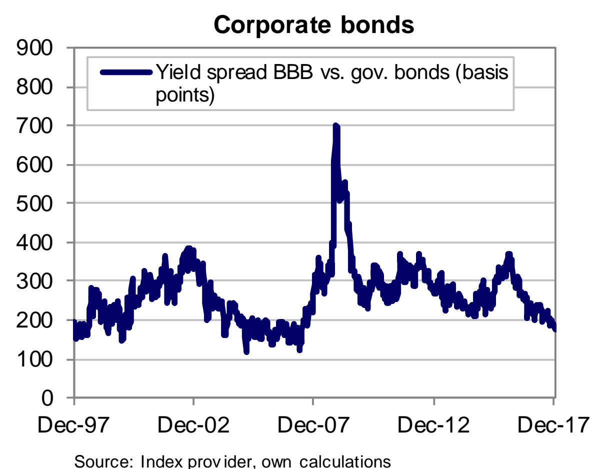
Conversely, German yields are clearly lower than our fair-value model implies for the medium term, which is also reflected in a historically wide yield difference to the USA. Our fair-value range for 10-year German yields stays at 0.5-1.0% for the time being, though we see this range moving higher over the coming years.

Driven by positive economic trends, corporate bond spreads have narrowed in recent years, interrupted only in 2015, when oil prices (and credit ratings in the U.S. oil and resources sector) fell sharply.

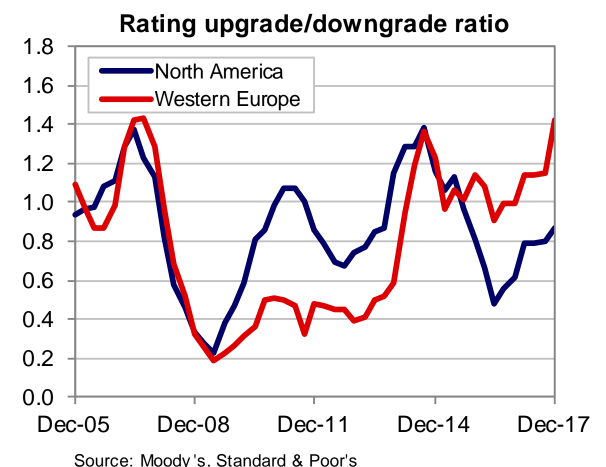
The corporate bond segment in Europe is deriving additional support from improving credit trends (a rating upgrade-to-downgrade ratio above 1 points to a net improvement in ratings).



Source: National statistics, own calculations



Source: Index provider, own calculations



Source: Moody's, Standard & Poor's

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World currencies and commodities

Euro tends to strengthen

A strengthening euro remains the key currency trend over the coming 2-3 years. A strengthening euro remains the key currency trend over the coming 2-3 years. We expect further U.S. interest rate increases to continue moderating the euro's appreciation against the dollar for now, with the dollar possibly even strengthening in the coming months. Similarly, rising uncertainties ahead of the elections in Italy in the spring may temporarily weigh on the euro, even though we do not currently expect an outright market-negative election result. As the U.S. economic cycle will eventually end, we see the dollar weakening medium term, however.

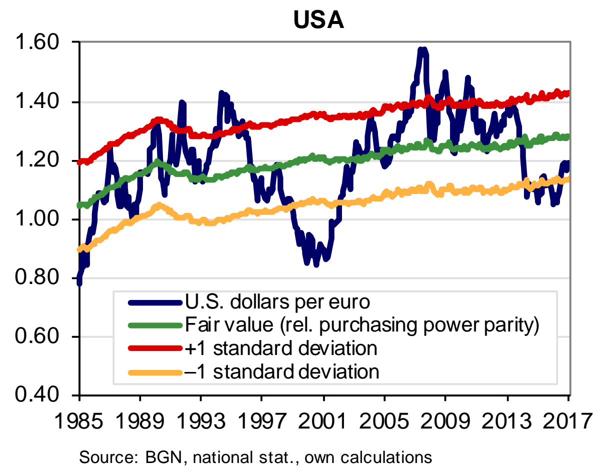
Other currencies – be this the Swiss franc, sterling or the Japanese yen – will also modestly shed ground against the euro over the medium term.

Commodities: World economy supportive

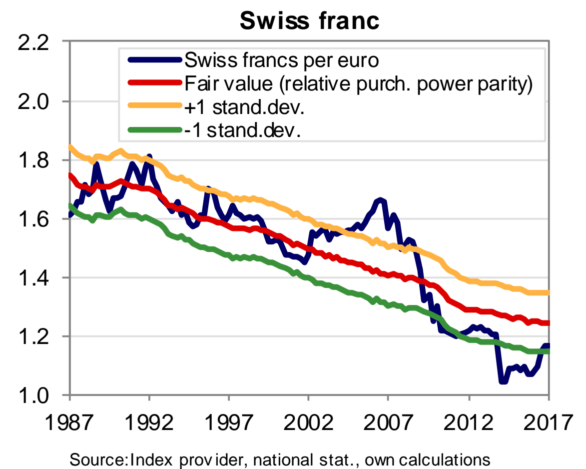
Oil prices have recovered more than anticipated in recent months, given a combination of strong demand growth, production discipline in OPEC countries and Russia and a more cautious supply-response from U.S. shale producers. As this constellation may well persist, our projection is that prices (which are currently above marginal U.S. shale-production costs) will remain stable in 2018.

Industrial metals prices remain supported, given supply constraints in China (for aluminum) and continued demand growth from the industrial sector worldwide. We nevertheless expect last year's rally to fade.

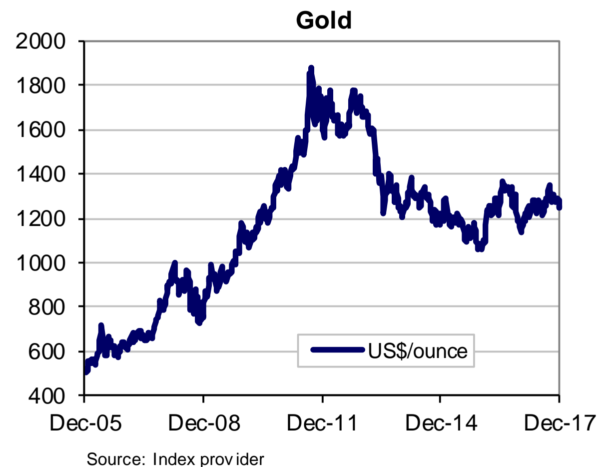
Gold was about flat in 2017 in euros and has risen in dollar-terms, roughly in line with the dollar's depreciation. We see no clear trend going into 2018.



Source: BGN, national stat., own calculations



Source: Index provider, national stat., own calculations



Source: Index provider

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Investment strategy

General framework positive

Our strategy for 2018, at least for the first half the year, remains based on a positive economic scenario. After picking up in 2017, notably also in the euro area, worldwide economic growth is set to remain at its highest level in years. Importantly, economic expansion will remain broad based and will also be supported by the industrial sector and corporate investment spending. With most economic trends already gaining shape in 2017, 2018 will see more continuation than change from an economic point of view, though investors may become more jittery as we enter the 10th year of market recovery after the Great Recession.

Keeping an eye on risks

Risks remain plentiful, though we note that fears of the U.S. business cycle ending have been mitigated somewhat, as labor productivity growth has picked up in the course of 2017. This in turn has reduced the increase in unit labor costs, a development which is atypical, though positive, at the present late stage in the business cycle. Stumbling stones could also be an adverse outcome in Italy’s general election (which would put the country’s euro membership into question), a strong rise in the oil price (which could end the U.S. business cycle) or an inverting U.S. yield curve (which has often been a harbinger of market trouble). We do not view the probability of such risks materializing as sufficiently high at present to alter our investment stance, however. We are also keeping an eye on China for any policy missteps (similar to the failed renminbi devaluation in August 2015), NAFTA talks and developments in North Korea.

Equities the most promising asset class

Overall, the general environment points to maintaining an overweight position in risk assets, i.e. equities and corporate bonds. With quality bonds expected to yield slightly negative or flat returns at best in 2018, equities will be the primary source of any positive investment returns. This argument holds particularly true in Europe, where the dividend yield of equities is markedly higher than the yield of bonds. We maintain our focus on European and U.S. equities and see upside in non-core equity markets (Japan and emerging markets). Our bond allocation contains a higher-than-usual share of the riskier segments (i.e. corporate and emerging market borrowers, convertible bonds and cat bonds).

Financial market review

Equities and high yield bonds did best

With the global economy exhibiting broad-based growth, inflation remaining contained and central banks generally supportive of the economy and financial markets, risk assets (i.e. equities and corporate bonds) delivered a better performance than government bonds and cash in 2017.

The key currency theme in 2017 was euro strength (e.g., against the dollar and the Swiss franc). This also explains why euro-returns from investments outside the euro area were comparatively low.

Key currencies (trade weighted)

	Performance	
	4Q17*	**2017***
Euro	-0.1%	5.7%
U.S. dollar	0.8%	-6.1%
Swiss franc	-2.1%	-5.1%
Pound sterling	0.2%	0.7%
Japanese yen	-1.2%	-2.5%
Chinese renminbi	0.4%	-0.8%
Indian rupee	1.4%	-0.3%
Brazilian real	-4.3%	-5.7%
Russian ruble	-2.4%	-4.1%

*Data as per 11-Dec-17. Source: Index provider

Global financial markets

	Latest	EUR-Performance		CHF-Performance		USD-Performance	
	price	**4Q17***	**2017***	**4Q17***	**2017***	**4Q17***	**2017***
Equity markets							
MSCI World	**2073**	**4.1%**	**5.9%**	**6.4%**	**15.5%**	**3.6%**	**18.4%**
MSCI Small Cap	412	3.0%	5.7%	5.3%	15.3%	2.6%	18.2%
StoxxEurope600	389	0.3%	7.7%	2.5%	17.5%	-0.1%	20.4%
EuroStoxx50	3591	-0.1%	9.1%	2.1%	19.1%	-0.5%	22.1%
DAX	13154	2.5%	14.6%	4.8%	25.0%	2.1%	28.1%
Swiss Market Index	9319	-0.5%	3.9%	1.8%	13.4%	-0.9%	16.2%
USA S&P 500	2652	5.7%	5.9%	8.0%	15.5%	5.2%	18.4%
Japan (Topix)	1804	7.2%	9.4%	9.6%	19.4%	6.7%	22.4%
MSCI Em.Markets	**1111**	**3.1%**	**15.2%**	**5.4%**	**25.7%**	**2.7%**	**28.8%**
Emerging Asia	568	5.1%	21.3%	7.5%	32.3%	4.7%	35.6%
Emerging Europe	329	0.0%	-0.8%	2.3%	8.2%	-0.4%	10.9%
Latin America	2702	-7.0%	3.2%	-4.9%	12.6%	-7.4%	15.4%
Bond markets							
Germany (5-7 y.)	450	0.6%	-0.2%	2.8%	8.9%	0.2%	11.6%
Switzerland (5-7 y.)	245	-1.9%	-8.7%	0.3%	-0.4%	-2.3%	2.1%
Italy (5-7 y.)	766	2.7%	3.6%	5.0%	13.1%	2.2%	15.9%
Euro corporates inv. grade	248	1.3%	3.1%	3.5%	12.4%	0.8%	15.2%
Eur. high yield	317	0.7%	6.8%	3.0%	16.5%	0.3%	19.5%
Emerg. sovereigns (EMBI)	833	-0.3%	-3.6%	1.9%	5.2%	-0.7%	7.8%
Commodities							
Crude oil (Brent)	64	13.1%	2.7%	15.6%	12.1%	12.6%	14.9%
Industrial metals	306	-0.6%	6.1%	1.6%	15.7%	-1.0%	18.6%
Gold ($/ounce)	1249	-2.1%	-3.1%	0.1%	5.7%	-2.5%	8.4%
Agric. commodities	375	-2.8%	-22.2%	-0.6%	-15.1%	-3.2%	-13.0%
Hedge Funds							
Hedge fund of funds	6089	1.7%	-4.3%	4.0%	4.4%	1.3%	7.0%

*Data as per 11-Dec-17. Hedge Funds as per latest available month-end. Source: Index provider

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