UBS House View

Europe
Chief Investment Office WM

Weekly

10 November 2016

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Market moves

	CIO view	–1w	– 3m	ytd
S&P 500	OW	3.1%	0.0%	7.8%
Euro Stoxx 50		4.2%	3.0%	–1.5%
MSCI EM	OW	–0.5%	–2.1%	13.4%
FTSE 100		2.9%	3.0%	16.3%
SMI	UW	4.5%	–2.7%	–6.2%
NIKKEI 225		1.2%	4.5%	–7.2%
US high grade bonds	UW	–1.1%	–1.8%	4.1%
Euro high grade bonds	UW	–0.3%	–2.0%	5.2%
US investment grade bonds	OW	–1.4%	–2.4%	6.7%
Euro investment grade bonds		–0.1%	–1.0%	5.0%
US high yield bonds		0.3%	0.7%	13.0%
European high yield bonds		–0.1%	0.8%	7.6%
EM sovereign bonds		–0.5%	–1.1%	12.5%
EM corporate bonds		–0.4%	0.1%	11.4%

Source: Bloomberg, UBS as of 10 November 2016
OW = tactical overweight
UW = tactical underweight

Market comments

Calculations are based on the past five days

- **Equity markets** moved higher as investors digested the US political upset. The S&P 500 was up 3.1% after a brief dip following Donald Trump's election turned into a rally. Only emerging market stocks dipped, falling 0.5%.
- **Bond markets** sold off as investors braced for US fiscal stimulus and higher inflation. US high grade bonds lost 1.1%. US investment grade bonds were down 1.4%. But US high yield bonds rose 0.3% as risk appetites improved.
- **Currency markets** had a turbulent week. The Mexican peso was tossed around by political waves from the US and, over a five-day period, lost 3.2% against the US dollar. This reflects worries that Trump will renegotiate trade agreements.

In focus

New digs for Donald. The Republican nominee claimed an unexpected victory in the race for the US presidency. The President-elect's party will also hold a majority in both chambers of the US Congress. Betting markets had given Trump just a 25% chance of prevailing. *See this week's Deeper Dive for analysis of what a Trump presidency may mean for markets.*

What goes down… A swift flight to safety on news of the surprise US election outturn partly reversed on Wednesday, as some calm returned to markets. A 5% fall in S&P 500 futures, as the scale of Donald Trump's victory became clear, moderated into a 1.1% rise in cash trading by Wednesday's close. A fall in 10-year US Treasury yields reversed entirely, with the yield standing at 2.0% when we went to print. *CIO is overweight US equities versus high grade bonds – favorable fundamentals should prevail over political concerns.*

US payrolls on track in October. The October labor report showed continued growth. Nonfarm payrolls increased by 161,000, just shy of consensus estimates, and the unemployment rate fell to 4.9%. Average hourly earnings rose 2.8% year over year, the highest reading this cycle. *October's labor report supports CIO's expectation for a 25-bps US rate increase in December.*

Je ne regrette rien? France's budget deficit unexpectedly widened to EUR 83bn in September, due mainly to an increase in special accounts that include local government receipts. The state of France's economy may dominate next year's presidential election. And the French population already has regrets about President François Hollande – his approval rating recently fell to 4%. *But growth should hold steady – CIO expects French GDP to expand 1.4% both this year and next.*

Switzerland's reserve mountain. The nation's currency stockpile is looking as imposing as the iconic Matterhorn. Reserves hit a record CHF 630bn (USD 644bn) for October, as the Swiss National Bank struggles to curb unwanted currency strength. *CIO is underweight Swiss equities versus emerging market stocks in global portfolios.*

High Court, high stakes, high noon. The UK High Court ruled that the British government cannot invoke Article 50 to leave the EU without a parliamentary vote. Prime Minister Theresa May's administration announced it would appeal the ruling in the Supreme Court. But currency markets responded favorably on the assumption that the decision reduces the likelihood of a "hard Brexit." GBP climbed and stood close to USD 1.25 at the time of writing. *CIO is neutral UK equities in global portfolios.*

Some don't like it hot. The government of Hong Kong is taking steps to cool the property market, raising the stamp duty to 15% for all residents except first-time buyers. House prices have been boosted recently by buyers from mainland China who fear a falling yuan. *CIO expects USDCNY to climb to 7.00 in 12 months.*

Deeper dive

What does a Trump presidency mean for markets?


Mark Haefele


Mike Ryan

The election of Donald Trump added to a year of political surprises around the world, and his policy agenda is a key focus.

With a Republican majority in both houses of Congress, the President-elect will have some latitude to implement executive decisions that can alter the status quo of US economic and social policy. Senate Democrats will also need to defend twice as many seats as Republicans in the next election, suggesting that the Republicans have a high probability of preserving their majority for the next four years.

CIO believes that investors are well-advised to consider three broad policy areas:

1) **The promise of an expansionary fiscal policy.** Trump ran on a platform of tax cuts and higher public spending. He pledged to invest USD 1trn in American infrastructure over the coming decade, and reiterated his commitment in his first speech as President-elect. The fiscal stimulus provided by lower taxation and higher federal spending will have broad macroeconomic and investment implications. Military contractors and construction firms stand to benefit, for example. *We also expect to see incremental pressure on wage inflation, increasing the appeal of Treasury Inflation Protected Securities (TIPS) versus other US government* bonds.

2) **The pledge to enact pro-business policies, reducing regulation and the tax burden.** The president-elect has promised to boost economic growth by scrapping intrusive federal regulations, reducing the cost of regulatory compliance, and lowering corporate taxes. We believe the US energy sector stands to benefit from operating in a more lenient regulatory environment. The elimination of a risk premium assessed on financial services and pharmaceutical stocks should also free these sectors for better performance next year. Headline risk over drug prices will persist but government intervention is far less likely under the next administration. And companies more broadly could see their tax bill reduced as part of a larger tax reform. *Pro-business legislation, lower taxes, and reduced regulation are likely to support US equities, where we already expect 8% earnings growth next year.*

3) **The threat to trade and immigration.** Trump vowed to adopt a tougher negotiating stance with US trading partners. If this translates into policy, it could prove to be a serious economic challenge for Mexico, which relies on the US for 80% of its exports and 98% of the remittances it receives from Mexican workers abroad. CIO believes that a Trump presidency will create some volatility. However, while the shift may pose challenges for some trade-focused emerging nations – such as Mexico, South Korea and Colombia – countries with larger domestic economies like Brazil and India should be less vulnerable. Added to this, US relations with Russia may improve, given indications of mutual respect between Vladimir Putin and Trump. Barring radical policy development, we believe the economic and earnings revival now underway in most emerging markets (EM) can continue. *We are overweight EM equities and select EM currencies.*

Mark Haefele
Global Chief Investment Officer
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Mike Ryan
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Bottom line

After the initial uncertainty over Trump's unorthodox trade and immigration policies abated, equity markets improved on optimism that fiscal stimulus and reduced regulation will promote economic growth. CIO believes that TIPS, US equities, and EM equities can continue to advance through next year. We remain overweight them in our global asset allocations.

Regional view

The Trump win and Europe

Podcast
www.ubs.com/cio-podcast

Bert Jansen
European Equity Strategist

"In the end, you're measured not by how much you undertake but by what you finally accomplish."
Donald Trump, US President-elect

"It's always good to be underestimated."
Donald Trump, US President-elect

The opinion polls again failed to gauge the depth of opposition to mainstream politics, and discontent with elements of globalization. Trump's win in the US presidential election heralds a period of uncertainty in US policy. His lack of governing experience, potential difficulties building relationships with congressional leaders, and inconsistent policy pronouncements during the race make it hard to predict his policy initiatives or effectiveness in driving them through Congress. Near-term financial market volatility could consequently persist.

But beyond the short term, what does the Trump win mean for Europe?

The political risks in Europe are likely to increase after the US elections amid a very busy schedule. On 4 December, the Italian referendum will take place, and may soon draw the market's attention. Whatever the referendum's outcome, we expect it to be manageable for the economy.

"The political risks in Europe are likely to increase after the US election."

Next year, general elections in the Netherlands, France and Germany all have the potential to affect markets too, let alone negotiations with the UK on its exit. Although we do expect populist parties to gain more seats in parliament in all three elections, we don't think that they will become part of the respective governments.

At a market level, European equities remain highly sensitive to currency movements, as witnessed again on Wednesday. While the market setback in the morning saw the euro strengthen, the market recovered in the afternoon as the currency weakened.

On a 12-month view, we expect the euro to appreciate and have a EURUSD target of 1.20. The Trump presidency with full Republican control over Congress suggests a rising fiscal deficit in the US. But the Federal Reserve might nevertheless go for a softer stance, given Trump's proposals to cancel the North American Free Trade Agreement and alter the US's trade relationship with China. Such a scenario of a rising euro is likely to drag on Eurozone equities. Consumer discretionary, where we are underweight, looks particularly exposed amid fears of rising protectionism.

Although I doubt that higher inflation is the start of a new secular trend, we cannot rule out a further rise of bond yields in the months ahead, especially with the prospect of US fiscal stimulus. In this context, we reiterate our underweight stance on consumer staples, a sector considered as a bond proxy that we downgraded last week (please refer to "European equities; Eurozone sector rotation – consumer staples," published on 4 November).

The winners of rising inflation expectations are commodity-related plays, such as energy and materials. We are overweight both sectors in the Eurozone.

In bond markets, we see selective opportunities in corporate hybrids, investment grade and high yield bonds. Please refer to our Bond Top List and our High Yield Bond List for specific recommendations.

Kind regards,
Bert Jansen

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