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Market moves

	<i>CIO view</i>	<i>-1w</i>	<i>-3m</i>	<i>ytd</i>
S&P 500		-2.7%	-10.5%	-9.2%
Euro Stoxx 50	OW	-2.9%	-17.4%	-13.6%
MSCI EM	UW	1.1%	-12.1%	-8.0%
FTSE 100	UW	-2.3%	-8.6%	-8.6%
SMI		-4.4%	-12.3%	-11.9%
NIKKEI 225		-8.6%	-20.0%	-17.4%
US high grade bonds	UW	0.5%	2.7%	2.6%
Euro high grade bonds	UW	0.2%	2.4%	2.8%
US investment grade bonds	OW	0.4%	0.5%	0.7%
Euro investment grade bonds		-0.3%	0.1%	0.2%
US high yield bonds		-2.5%	-7.9%	-4.4%
European high yield bonds	OW	-1.7%	-5.0%	-3.2%
EM sovereign bonds		-0.3%	-1.9%	-0.9%
EM corporate bonds		0.3%	-1.8%	0.0%

Source: Bloomberg, UBS as of 11 February 2016

OW = tactical overweight

UW = tactical underweight

Market comments

Calculations are based on the past five days

- **Global equity markets** declined further this week, with the Euro Stoxx 50 heading toward its lowest level since September 2013. Emerging market stocks have outperformed developed markets by some 2.5% this year.
- A flight to quality led to **US and European high grade bonds rallying 0.5% and 0.2%, respectively**. Riskier credit, such as US and European high yield debt, lost value as spreads in energy and financials widened further. 10-year government yields in Japan and the UK hit new lows.
- In **commodity and currency markets**, the Japanese yen strengthened toward 111 against the US dollar, and gold climbed above USD 1,200 as global risk aversion rose.

In focus

Global stock markets dropped in turbulent trading conditions this week due to ongoing concerns about volatile oil prices, uncertain Chinese policymaking and fears of a US recession. European banks declined and credit insurance costs climbed. Selected banks' results disappointed expectations, but the principal driver was spreading concern over bank profitability in a negative interest rate environment. *CIO* thinks equity valuations largely reflect these concerns. *CIO* maintains a neutral tactical stance on equities in its global tactical asset allocation (TAA).

US Federal Reserve Chair Janet Yellen testified before the House Financial Services Committee, stating that financial conditions had become less supportive of growth, noting the drop in stock markets, higher borrowing rates for riskier borrowers and the strong dollar. If these persist, Yellen said US economic growth and labor market improvements may come under pressure; meanwhile lower oil and other commodity prices will keep inflation low. Yellen's testimony left the Fed's basic stance unchanged: the Committee expects to raise rates gradually, and will remain data-dependent. *CIO* maintains that the Fed will hike interest rates once or twice in 2016, a more accommodative stance than expected at the beginning of the year.

The Fed's Labor Market Conditions Index made gains on the month, but below expectations. The headline index rose 0.4 points in January, its

slowest increase since April last year and below consensus forecasts for a two-point gain. However, recent US labor data still point to a recovery in the US jobs market. Unemployment dipped to 4.9% (below the Fed's 5% estimate of "full employment") and average hourly earnings increased 2.5% y/y, potentially contributing to stronger US inflation.

Lower demand for German factory output led to weaker-than-expected domestic industrial production. Real output slid 1.2% m/m in December (seasonally adjusted), marking the second straight month of slowdown (pending revision). Tighter labor markets and greater consumption are partly offsetting weaker external demand. *CIO* maintains its overweight Eurozone equity positioning in its global TAA, but has a neutral country preference for German stocks.

China's FX reserves declined by USD 99.5bn in January, less than expected. This compares with the USD 107.9bn fall in December, the largest on record. Financial markets are still focused on whether China can balance a set of competing claims, including managing a growth slowdown and easing domestic monetary conditions, while preventing further capital outflows. *CIO* still believes the scale of Chinese yuan depreciation against the US dollar will be moderate and controlled. We expect a USDCNY rate of 6.80 in 12 months' time.

Deeper dive

Negative thinking: What are the benefits and limits of sub-zero interest rates?

How low can central banks go? Until recently it was assumed that policy makers had to stop once they had cut nominal interest rates to zero. But negative interest rates – charging commercial banks for the privilege of holding reserves with the central bank – are being more widely deployed. Countries accounting for almost a quarter of global GDP now have sub-zero interest rates – including the Eurozone, Switzerland, and most recently Japan.

Even in the US, where 100bps of rate hikes were priced in at end-2015, markets now attach a 10% chance (four times higher than the start of this year) that the Fed will impose negative rates over the next 12 months, in response to softer current economic activity indicators.

Those central banks that have gone negative believe it could boost growth and markets in several ways. First, the policy should encourage commercial banks to make loans to avoid charges on cash in excess of mandatory reserves. Second, sub-zero rates also have the potential to weaken a nation's currency, making exports more competitive and boosting inflation as imports become more expensive. In addition, by lowering short-dated government bond yields, negative rates should increase the relative appeal of equities, helping that market. Finally, negative rates may complement other easing measures (like QE), and signal central bank resolve to tackle persistently below-target inflation.

That is the theory. But the brief history of negative rates shows things haven't always gone according to plan. So what are the limits of the policy and its possible unintended consequences?



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Christopher Swann

Credit conditions might actually tighten: For negative rates to boost bank lending, commercial banks must become willing to lend more, and/or at lower costs. A sticking point is that negative rates tend to squeeze bank profits – trimming the gap between the rates at which they borrow and offer loans. If profits suffer too much, banks may even scale back lending. Difficulties in imposing negative rates on depositors may mean debt costs rise for other consumers; Swiss and Danish banks have hiked borrowing costs for homeowners since negative rates were introduced.

Equities don't always respond: Negative rates can promote a shift from bonds to stocks. But this effect has not been clear recently. Since banks form a large proportion of equity market capitalization, as in the US and Japan, shrinking bank profitability may drag on stock indices.

Foreign exchange rates not playing ball: Negative rates should lead to currency depreciation. This link too appears to have broken recently. The yen has appreciated 5.4% against the US dollar since Japan's policy move, with rising risk aversion over-riding interest rate differentials.

Central banks go too far: President Mario Draghi has said there are no limits to the ECB's potential easing. But there is a limit to how negative rates can go. At a certain point, commercial banks could be forced to charge clients to hold deposits, which could lead many to convert savings into physical cash.

Christopher Swann
Global Investment Office

Bottom line

Central banks are determined to do what it takes to boost growth and inflation. With interest rates already at zero, more central banks have been resorting to negative

interest rates to fulfill their objective. But as policy becomes more unorthodox, investors will need to monitor potential unintended consequences more closely.

Regional view

Politics is back

 Podcast
www.ubs.com/podcast



Ricardo Garcia
 Head, European Macroeconomics

Heightened market volatility is making big news this year. But political noise is also on the rise again in Europe, grabbing headlines. Unfortunately, we think that it will be June at the earliest before political uncertainty subsides given the market's current sensitivity to risks.

The outright monetary transactions (OMT) lawsuit – a high-profile case critical for the long-term future of Europe – is moving back into the spotlight. On Tuesday the German Constitutional Court will hold another hearing on it, but it is still unclear when the court will rule conclusively on the case. We expect a “yes, but...” ruling, but an outright negative one that severely restricted asset purchases could roil markets. National courts tend to follow the European Court of Justice, which has issued a market-friendly “preliminary ruling,” but that is not a given.

A few days later, the European Council will focus on immigration and a British exit from the EU. Everything points to further turmoil on the thorny immigration issue, and the Schengen treaty, which mandates passport-free movement across member states, remains at risk. The political order tends to favor pragmatic approaches rather

than outright disarray, so expectations are that border controls will remain temporary.

“Although event risks can undoubtedly weigh on market sentiment, they also act as a support for it when they are positively resolved.”

The UK's referendum on EU membership meanwhile appears increasingly likely to be held in June. In our view, UK Prime Minister David Cameron will soon be in a position to lead the “remain” camp, which should prevail over a divided and fragmented “leave” campaign. We currently assign a 70–80% probability to the UK voting to stay in the EU.

Later this month, on February 26, Ireland will hold elections. The risk of a political stalemate, with no party able to form a majority in the Dail, is currently high, and raises the prospect that either a minority government would have to rely on a number of independent members or another election would be needed. This could harm the domestic economy, which has staged a strong recovery. One only has to look at the inconclusive Spanish election results to see the ill effects of a stalemate, which is hampering Spain's recovery. The situation remains highly fluid in Spain, and we assign a 40% probability to a left coalition emerging there.

Greece, never long out of the news, is working with its creditors to complete the first bailout review in the coming weeks. The government has

considerable incentive to do so as a successful review opens the door to better bailout terms. Creditors keep

asking for additional steps, such as pension reform and more fiscal measures, which have triggered street protests. But the gaps between the two sides appear manageable, in our view, even if negotiations will likely go on longer than expected.

Although these event risks can undoubtedly weigh on market sentiment, they also act as a support for it when they are positively resolved. We expect the most important of these issues to meet with market-friendly resolutions, which would mean that the UK remains in the EU, Greece obtains better bailout terms from its creditors and the German legal system rules that OMT are constitutional.

Kind regards,
Ricardo Garcia

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