UBS House View

Europe
Chief Investment Office WM

Weekly

16 June 2016

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Market moves

	CIO view	–1w	– 3m	ytd
S&P 500	OW	–2.2%	2.7%	2.4%
Euro Stoxx 50		–6.1%	–5.7%	–11.4%
MSCI EM		–3.4%	2.9%	2.8%
FTSE 100		–4.8%	–2.6%	–2.7%
SMI		–5.5%	–1.6%	–10.5%
NIKKEI 225		–7.4%	–8.4%	–18.2%
US high grade bonds	UW	0.4%	2.5%	4.8%
Euro high grade bonds	UW	0.3%	2.1%	5.1%
US investment grade bonds	OW	0.1%	4.3%	6.7%
Euro investment grade bonds		0.0%	1.9%	3.7%
US high yield bonds		–1.2%	4.7%	7.4%
European high yield bonds	OW	–1.0%	2.3%	4.0%
EM sovereign bonds		–0.8%	4.5%	7.8%
EM corporate bonds		–0.4%	4.6%	7.3%

Source: Bloomberg, UBS as of 16 June 2016
OW = tactical overweight
UW = tactical underweight

Market comments

Calculations are based on the past five days

- **Equities** broadly declined on the week on heightened global risk aversion. **US stocks** shed 2.2% and **European equities** 6.1%. **Japanese shares** slid 7.4%, hurt by a stronger yen.
- In **fixed income**, high grade debt made gains as longer-dated yields in Germany, the UK and Japan plumbed new lows. **High yield bonds** declined in Europe (1%) and the US (1.2%).
- In **foreign exchange** markets, the Japanese yen rose 2.4% against the US dollar due to monetary policy inaction. **Gold** climbed 3.4%, helped by falling US Treasury yields and dovish US Federal Reserve commentary.

In focus

Steady at the Fed. The US central bank decided to leave interest rates unchanged, in line with market expectations. Perhaps the biggest change was to the dot plot, which shows each committee member's views on appropriate future interest rates. It now indicates a more gradual pace of rate hikes, though the majority still foresees two hikes this year. *CIO agrees – the Federal Reserve will likely raise rates by 25 basis points in both September and December.*

Little relief for the yen as the Bank of Japan (BoJ) made no changes to monetary policy. USDJPY fell from 105.6 before the announcement to settle around 104 after Governor Haruhiko Kuroda's press conference. The uncertain global outlook may have stayed the hand of the BoJ, which judged Japan's economy to be on a "moderate recovery trend." *CIO maintains its USDJPY target at 105 (three and six months) and 110 (12 months).*

MSCI shuns China again. The world's largest index provider has refused to include China's domestic A-shares in its international benchmark for the third year in a row. MSCI indicated that international institutional investors wanted to see further progress toward accessibility. Given the size of China's market, which is second only to New York, *CIO believes inclusion in the index is a matter of "when" and not "if."*

ECB explores blurred line of investment grade. Just one day into its corporate bond buying program, the European Central Bank (ECB) was already pushing the limits of its self-imposed rules by interpreting "investment grade" to mean debt rated so by only one agency. Reported purchases included the bonds of an Italian telecom company rated high yield by Moody's and S&P but investment grade by Fitch. That underlines ECB President Mario Draghi's reputation for doing whatever it takes. *CIO is overweight euro-denominated high yield credit.*

Robust US consumption. Since the release of weak jobs figures earlier this month, US economic data has been positive. The latest encouragement came from a 0.5% rise in retail sales for May following a bumper 1.3% gain in April. That sets the US up for a rebound after a weak first quarter. *CIO is overweight on US equities and with a preference for the consumer discretionary sector.*

Decline and fall. 10-year German Bund yields joined the company of bonds from Japan and Switzerland by falling below 0% on Tuesday. Yields on global sovereign debt securities have fallen following a lackluster US jobs report earlier this month, and ahead of a busy summer of uncertain political events in Europe. UK 10-year gilt yields also plumbed new lows this week. Sub-zero yields offer investors little cushion when global growth and inflation stage a firmer recovery. *CIO is underweight on high grade debt in global portfolios.*

Oil's balancing act not yet done. The International Energy Agency (IEA) expects a balanced oil market in the second half of this year, followed by a return to surplus in the first half of next year. High inventory overhangs and possible returns to production in Canada may weigh on crude prices in coming quarters. *CIO believes that oil is vulnerable to short-run price pullbacks as temporary supply disruptions abate, and extended long speculative positioning normalizes.*

UBS

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Deeper dive

UK EU referendum – one week to go

Mark Haefele

Dean Turner

Watch this week's UBS House View Weekly Video

One week out, the event on every investor's mind is the UK referendum. The concerns about its outcome are not only being felt in the various markets – sterling is reacting to every opinion poll – but the potential for the UK public to deliver a surprise has likely been at the front of central bankers' minds this week as well. Indeed, the US Federal Reserve, the Bank of England (BoE), and the Swiss National Bank explicitly discussed their concerns at recent policy setting meetings.

If the opinion polls are to be believed as we enter the final days of the campaign, the results could literally go either way. So investors are rightly concerned. The confusion is increased by the different forecasts that polls conducted online are offering compared to those done over the telephone. Online polls typically reveal stronger support for the leave campaign, although it should be noted that the share of undecided voters is also higher. Telephone polls have up until recently shown the opposite, although this is starting to change. The late surge in support for leaving the EU has come as a surprise, but as yet it is far from clear that a victory is assured. Unfortunately, we aren't going to know if the polls are reliable or fallible until after the official result is declared, by which time markets will have already reacted.

What is an investor to do ahead of such an uncertain event sure to move markets whatever the outcome? Diversification in such times is a must, but in this instance extra attention should be paid to sterling exposure in assets and liabilities both. Beyond this, it may be prudent for investors to think about specific positioning.

Should the UK vote to leave the EU, the only certainty for the markets will be more uncertainty. History tells us that investors tend not to reward greater uncertainty, so we would expect the initial reaction to be negative for the pound and UK equities. We see potential for the FTSE 100, with its large international exposure, to outperform the domestically focused FTSE 250. Negative sentiment in the banking sector could spread across the continent, in our view, and hit those markets with a large exposure to it, such as Italy and Spain. Gilts are likely to outperform under a leave scenario, as questions about the economy and the path of interest rates come into question.

If the UK decides to remain in the EU, it seems likely that uncertainty would decline, which should in turn lead to a recovery for sterling in the first instance. Elsewhere, we would expect the opposite reaction in markets to those mentioned above, but some of the moves may be tempered by the size of the victory. A narrow one may lead many to ask whether the question really has been settled.

Whatever the result, questions will likely cloud the UK outlook for the time being. Even if the UK does choose to stay, domestic politics is likely to remain challenging, and markets will be looking to ascertain whether the referendum-related slowdown in the first half of the year is something more permanent. Our sense is that there should be a reasonably vigorous rebound in activity as delayed business investment and hiring resumes. If it doesn't, then any gains in sterling may prove relatively short lived as markets start to question the direction of BoE policy.

Mark Haefele
Global Chief Investment Officer
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Economist

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Bottom line

With just days of campaigning left before the UK referendum, the outcome of it remains highly uncertain. While this situation creates trading opportunities for investors with a high level of conviction, the event resists rational economic analysis. We believe the best way to mitigate risk from such events is an internationally diversified, multi-asset portfolio.

Regional view

Podcast
www.ubs.com/cio-podcast

No breakthrough in sight in Spanish politics

Roberto Scholtes Ruiz
Head Investment Office Spain

On Sunday, June 26, three days after the UK referendum, Spain will hold its repeat elections after the Congress that resulted from the 20 December election failed to name a prime minister. Six months of political stalemate seem to have barely changed voter minds; most opinion polls point to roughly stable support for the ruling Popular Party (PP), the Socialist party (PSOE), the center-right Ciudadanos (C's) and Podemos.

The main change next Sunday's vote promises is for the new coalition of Podemos and United Left to surpass PSOE as the primary left political force. This coalition will enable Podemos to increase its number of congressional seats at the expense of all the other parties. As a result, the chances of a left coalition have undoubtedly risen.

Nevertheless, two factors have led us to keep a PP-led government as our base case. First, around 30% of voters remain undecided, and the good performance of Podemos (whose voters seem more mobilized at this point) in the opinion polls could increase turnout, which would favor PP and PSOE most.

Second, if Podemos does overtake PSOE, the latter might be reluctant to join a left coalition as a junior partner. It could face strong internal opposition about embracing radical policies and risk shrinking further, as have social-democratic parties in other countries. So PSOE is likelier than not to opt for abstaining at the parliamentary investiture vote and allow PP, supported by C's, to govern, remaining in opposition itself.

"Whatever the election outcome, Spanish politics look to remain troubled."

Our base case of a weak PP-led government would be a moderately market-friendly outcome, although little progress could be expected in pushing through structural reforms and achieving fiscal restraint. Laws proposed by the PP government could be blocked frequently by the opposition, and the legislature would probably be short-lived.

A left coalition, if formed, would likely seek to undo some reforms already passed (namely labor market reform). Podemos' election program calls for tax hikes to fund a public expenditure increase equal to 5.5% of GDP, which would harm the economy, in my view, and put Spain on a collision course with the European Commission (EC).

But PSOE would be part of the government too, and wouldn't support a budgetary policy that could endanger fiscal sustainability. Besides, PP will probably retain an absolute majority in the Senate and be able to veto any such fiscal measures. Last but not least, having exceeded its targets every year since 2009, Spain faces a real threat of material fines from the EC that would force the government to proceed with its fiscal consolidation effort.

In conclusion, whatever the election outcome, Spanish politics look to remain troubled. The additional structural reforms needed to enhance growth and fiscal sustainability will probably remain in limbo. Political instability could become entrenched, which would further damage the nascent economic recovery. Despite this situation, Spanish bond risk premiums should remain well shielded from sharp corrections as long as the European Central Bank pursues its bond-buying program.

Kind regards,
Roberto Scholtes Ruiz

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