UBS House View

Europe
Chief Investment Office WM

Weekly

8 September 2016

Market moves

	CIO view	–1w	– 3m	ytd
S&P 500	OW	0.5%	3.7%	8.6%
Euro Stoxx 50		2.7%	3.1%	–1.8%
MSCI EM	OW	3.9%	11.4%	19.1%
FTSE 100		2.0%	10.4%	13.8%
SMI	UW	2.4%	2.5%	–2.1%
NIKKEI 225		0.2%	1.0%	–9.9%
US high grade bonds	UW	0.2%	1.6%	5.9%
Euro high grade bonds	UW	0.6%	2.6%	7.5%
US investment grade bonds	OW	0.1%	3.0%	9.6%
Euro investment grade bonds		0.3%	2.7%	6.4%
US high yield bonds		0.2%	4.4%	13.5%
European high yield bonds		0.3%	2.9%	8.0%
EM sovereign bonds		0.8%	5.9%	15.2%
EM corporate bonds		0.4%	4.3%	12.4%

Source: Bloomberg, UBS as of 8 September 2016
OW = tactical overweight
UW = tactical underweight

Market comments

Calculations are based on the past five days

- **Emerging market equities (+3.9%)** led global bourses up last week, and **Swiss stocks (+2.4%)** made decent gains. The major laggard markets were the **US (+0.5%)** and **Japan (+0.2%)**.
- There was little performance difference among fixed income assets in the week's trading – top of the tree were **emerging market sovereigns (+0.8%)** and **Euro high grade bonds (+0.6%)**.
- All other G10 currencies rallied against the US dollar. The **New Zealand dollar (+2.3%)** enjoyed the biggest bounce, followed by the **Swiss franc (+1.1%)** and the **British pound (+0.5%)**.

In focus

Making in America not great, again. The US manufacturing PMI fell below 50 for the first time since March, registering an August print of 49.4 that undershot the consensus 52.0 and was down from 52.6 in July (the largest month-to-month drop in two years). Details of the report were weak, with production (49.6 vs. 55.4 in July) and new orders (49.1 vs. 56.9) both declining below 50. *CIO expects the strong dollar and global overcapacity to continue to weigh on the US manufacturing sector.*

Non-manufacturing not a non-event. The US ISM non-manufacturing PMI surprised markets by falling to 51.4 in August (consensus 54.0) from 55.5 in July. This is the lowest reading since February 2010, and its particulars were weak. The Federal Reserve has never raised rates when the ISM composite is below 54.9 (based on data since 1997). *CIO expects sentiment to bounce back, and the Fed to hike rates by 25bps in December.*

Eurozone retail: no need for therapy. July spending data for the single currency area was robust, rising 2.9% year on year and well ahead of consensus forecasts for a 1.8% gain. The release signaled the strongest rate of growth since last September. *CIO expect the Eurozone to grow 1.5% this year and 1.3% next year, chiefly driven by demand at home.*

Touching a trillion. The European Central Bank's (ECB) quantitative easing (QE) program surpassed EUR 1trn of government bond purchases, according to data released Monday. Half of the bonds bought in this bonanza has come from Germany (EUR 238bn) and France (EUR 189bn) since QE kicked off in March 2015. The trillion euro question – will the ECB extend purchases beyond next March? *CIO thinks investors will have to wait until the December policy meeting to find out.*

Out of the valley but not out of the woods. Swiss consumer prices were flat in August when using an EU-harmonized inflation measure. This is up from a 0.5% year-on-year decline in July. For the first time in 20 months, Swiss CPI has left the valley of deflation and is beginning to brush off the price-dampening effects of last January's "frankenshock." *CIO is underweight Swiss equities in global portfolios, given the index's defensive tilt.*

Brexcellent. The UK's manufacturing PMI tallied a healthy tick-up in August, defying market expectations for further post-Brexit weakness. The headline figure of 53.3 hit a 10-month high, surpassing the 49 expected by pundits and clocking the fastest one-month rise in a quarter century. The corresponding services indicator also rebounded to 52.9 this month, ahead of July's 47.4 print. *CIO still expects uncertainty to knock UK output growth to 1.3% this year, and 0.5% next.*

Easier policy no done deal in Japan. Bank of Japan (BoJ) Governor Haruhito Kuroda called for a comprehensive review of monetary policy in September, and signaled willingness to add to stimulus measures. Meanwhile, Prime Minister Shinzo Abe's advisor Koichi Hamada said policymakers should refrain from taking rates deeper into negative territory for now. The BoJ should wait for the Fed's exit policy to reduce the risk of its easing efforts being overshadowed. *Further easing in September is still possible, but CIO believes the probability has fallen slightly.*

UBS

Deeper dive

US election: Not a done deal!

Mark Haefele

Dirk Effenberger

Less than two months remain until one of the most unconventional presidential elections in the history of US politics takes place. Most current polls still indicate a lead for Hillary Clinton over Donald Trump.

There is little reason for investors to lean back, however. First, the recent vote by the UK to leave the EU is a stark reminder that outcomes of popular votes can be difficult to forecast. Second, there have been large swings in US election campaigns in the past. For example, in 1988 Michael Dukakis lost by seven percentage points to George W. Bush Sr. Two months before, the Democrat had led by the same margin. And third, this US election represents the first one in which both main candidates' disapproval ratings are higher than their approval ratings. In our view, the disaffection with the two major parties' nominees makes the outcome far less predictable than usual. Investors would do well to prepare for alternative outcomes.

We've identified investment ideas that can shine under a Clinton presidency, others that may benefit from a Trump presidency, and a final group expected to perform well regardless of who wins the White House.

- **Investment ideas for a Clinton presidency and split congress:** This scenario is CIO's base case. In general, the environment should remain supportive for US equities and investment grade bonds. We would expect a modestly positive market reaction as economic policy uncertainty fades, and markets rule out more extreme scenarios. This outcome would also support our long-term Energy Efficiency investment theme. Clinton is a declared supporter of renewables and CO_2-reducing technologies in general.
- **Investment ideas for a Trump presidency and Republican congress:** We regard this scenario as a less likely risk case. At first, the effect of a Trump victory would probably resemble that of the UK "leave" vote: gold would likely rise, and capital could flow out of the US dollar and into the Swiss franc. At the same time, fear of increased protectionism could hurt equity markets or sectors with high sales exposure to the US like the Eurozone consumer discretionary sector.
- **Investment ideas for either scenario:** In our view, investors can weather the US election by holding more European dividend stocks (EMU, UK, and Switzerland), focusing on a combination of dividend quality and sustainability. And our Security and Safety investment theme seems well-positioned to benefit from both candidates' promise to increase security spending. On the other hand, lackluster economic growth in Mexico is likely to weigh on Mexican equities and the peso. Tepid activity should persist under Clinton, and would only be exacerbated in the case of a Trump victory, as uncertainty rises about punchier protectionism.

For an in-depth discussion of our US election scenarios, please see the "Global Risk Radar: US election – Investment ideas".

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Bottom line

The US election is far from a done deal, despite Hillary Clinton's current sizable lead over Donald Trump. Investors should prepare for different election outcomes. This can be achieved by hedging portfolio exposure to an unexpected election result, or by leaning toward investments that can shine regardless of who wins the White House.

Regional view

Politics and its discontents

Podcast
www.ubs.com/cio-podcast

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Investors began the summer confronting the shock result of the UK referendum on EU membership. They are concluding it by witnessing the less momentous but still notable defeat of German Chancellor Angela Merkel's CDU party by the anti-establishment AfD in her home state of Mecklenburg-Western Pomerania In the US, the intensification of the presidential election race after Labor Day has accompanied a rise in opinion poll support for Donald Trump.

Such political events have local causes, but there is a global theme to the rise of anti-establishment politics. Economic developments in the 1990s and the early 2000s increased average living standards in developed economies, but they did so unevenly. Parts of society, made up of its generally less well-educated and older members, have been left behind by the effects of globalization.

This was not immediately apparent when the trend toward globalization was gaining traction. The ready availability of consumer credit before the 2007–08 financial crisis maintained an illusion of equality or near equality in many societies (credit allows one to spend money one does not have, and so permits relative consumption equality despite growing income inequality). The subsequent economic recovery has not addressed these imbalances, and the loss of credit has laid bare the pre-existing realities of inequality.

> "The German vote this month is another reminder to investors of the market consequences and the rising importance of political economics."

The result has been that a part of the electorate in many countries is disaffected by circumstances and distrustful of conventional parties. Establishment politicians, whose view of the economy is all too often shaped by aggregated data, have perhaps underestimated the issue and appear out of touch with certain segments of society. Coupled with low growth, this situation has encouraged anti-establishment politics.

The German vote this month is another reminder to investors of the market consequences and the rising importance of political economics. In its pure form, economics is a relatively universal and global concept. While local quirks and variations exist, the concepts that underlie the discipline apply across the board and around the world for the most part.

Politics, by contrast, is intrinsically local, intimately bound up with a country's history and culture. While international investors feel comfortable understanding the economics of another country from a distance, they are less likely to have the same feel for the political forces at work in markets.

The rise of political economics has already led to a parochialization of global capital flows since 2008. These flows now register roughly one-third of their pre-crisis peak (as a share of the global economy). Recently, international investors have been withdrawing money from Europe – perhaps due to post-Brexit vote uncertainty and their incomprehension about European politics as opposed to changed expectations of Europe's economic direction.

The parochialization of capital in response to political risk could, perversely, increase investment risk. Home country bias reduces portfolio diversification and increases exposure to specific country risks. The reaction of investors to the rise of political economics, in Europe and in the US, is unlikely to lead to optimal asset allocation. Fear of political risk seems to be becoming as big a threat to investors as political risk itself.

Kind regards,
Paul Donovan