

UBS House View

Chief Investment Office WM
19 November 2015

Monthly Letter

Government bonds

Norway's sovereign wealth fund is swapping government bonds for more real estate. We share this concern over sovereign bonds but also see drawbacks to property, which looks bubbly in several major cities.

Central banks

Global monetary policy is nearing an inflection point, with higher rates coming in the US and more easing likely in the Eurozone and Japan. But the rate environment remains supportive for growth, and risk assets.

China's consumption

Improving sentiment over China has led to a rebound in equity markets. The most encouraging news has come from accelerating consumer spending growth, which is helping to offset an industrial and investment slowdown.

Asset allocation

We are overweight in the Norwegian krone against the euro. Additional ECB easing will keep the euro under pressure, while the krone will benefit from a rising oil price and hawkish central bank.



Mark Haeefe

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Shifting the balance

Norway's sovereign wealth fund, the world's largest, announced this month that it will sell government bonds to buy more real estate. This represents a shift away from securities that have been brought to record highs by central bank policy and are vulnerable as US interest rates rise.

Many of the clients I speak to say they are considering changes to their asset allocations too. But what to do?

Equity markets are volatile, many bonds are overpriced, and real estate is not only illiquid but also offers poor value in many major global cities: our recently published UBS Global Real Estate Bubble Index highlights how some property markets are in bubble-risk territory. An alternative we recommend to clients looking for longer term investments is exposure to structural trends, such as oncology, clean air, or emerging market healthcare.

With a limited menu of attractively priced assets, we still believe that equities are the best choice, and we are overweight the Eurozone and Japanese markets. For more risk-averse investors looking to trim equity volatility, we have launched a new strategy that systematically switches out of equities as draw-down signals increase.

We are initiating one new global tactical asset allocation position this month: an overweight position in the Norwegian krone relative to the euro. The Norwegian currency has been battered in recent months by the depressed oil price and is now trading close to its lowest level since 2000 on a trade-weighted basis. We believe that the economy is bottoming, and the Norges Bank is unlikely to cut interest rates anytime soon. This should drive a wider differential between the yields on offer in Norway and the Eurozone, where additional European Central Bank (ECB) easing could weigh further on the euro.

Central bankers face a trade-off between consistency and flexibility.

...while ECB President Mario Draghi has pointed to further easing.

Weak economic data from Japan is also likely to lead to additional stimulus.

For the first time in about 15 years in China, retail sales are growing faster than fixed investment.

The central bank dilemma: Authenticity or adaptability

Around the world, monetary policy makers are nearing inflection points, with a rate rise looming in the US, and further easing likely in Japan and the Eurozone. At such times it becomes harder for central bankers to communicate with the right balance between authenticity and adaptability. The former is when policy makers remain consistent in their narrative and their response to economic data, while the latter is when they show an ability to adjust to changing circumstances.

Repeated remarks by Federal Reserve voting members that they are aiming for a liftoff this year, combined with strong labor market data in October, now mean that delaying a hike beyond December would undermine the authenticity of recent Fed communications. Still, we think that adaptability will prevail after December, with the Fed tightening more gradually than in previous cycles. A risk is that the Fed backs itself into a corner, justifying initial hikes by pointing to diminishing slack in the labor market and rising inflationary pressures, and then tightening aggressively through next year to remain consistent with this narrative.

Markets are also looking for the ECB to back words with actions. At last month's meeting, President Mario Draghi hinted that decelerating growth and weak inflation may warrant further stimulus. That sent the euro lower and helped risk assets. We think Draghi will follow through on this statement, pushing the deposit rate further into negative territory, and extending the duration of the bonds purchased in the ECB's quantitative easing program. This is likely to support Eurozone equities through increased liquidity.

The Bank of Japan (BoJ) is adapting its story that the economy is doing just fine, suggesting action ahead. The minutes of its latest meeting indicate increasing concern about the weak inflation outlook. After the recent run of disappointing price and growth data, we expect further fiscal and/or monetary stimulus. The BoJ may add to its exchange traded fund (ETF) holdings, despite already owning 54% of this market. We are overweight Japanese equities.

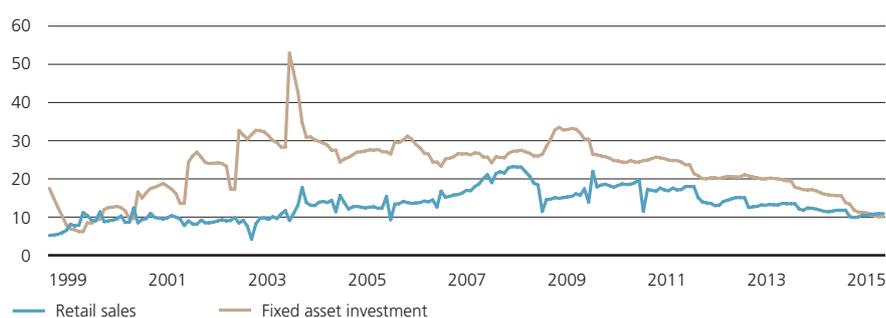
China: Producer or consumer

Over the past month, China's manufacturing purchasing managers' indices have shown signs of stabilizing, the stock market is up around 25% from its lows in August, and the sixth interest rate cut in 12 months should support growth.

But I believe the most interesting aspects of the China story in the past month are those which illustrate the nation's transition away from a producer-economy toward a consumer-economy.

Fig.1: Chinese consumers are picking up the slack as investment slows

Retail sales and fixed asset investment, year-on-year growth in %



Source: Bloomberg, UBS, as of 18 November 2015

China's consumers are showing increasing confidence...

...and are helping to offset the slowdown in fixed asset investment.

Real estate is often an appealing option for many investors...

...but property markets look frothy in many of the world's top cities.

Hong Kong and London appear particularly vulnerable to a correction.

The location of real estate investments is crucial.

Alibaba's sales on "Singles' Day" (11/11), a relatively newly created (and capitalist) holiday, have gone from less than USD 6bn in 2013 to more than USD 14bn this year. Singles' Day is now the highest-volume online shopping day in the world (surpassing the US's Black Friday).

The data shows that consumption is now taking over as the most important driver of growth: in the past two months, retail sales growth has outstripped fixed asset investment growth for the first time in about 15 years. This will have to continue apace if it is to make up for the slowing growth rate of heavy industry, and reduce the need for government stimulus.

A further sign of China's increasing capitalist maturity came this month when the International Monetary Fund (IMF) staff recommended adding the yuan to the Special Drawing Rights (SDR) basket – a global reserve benchmark. Assuming ratification by IMF member nations, this "stamp of approval" would reward China for making its currency more freely usable internationally, and should pave the way for other nations to hold more yuan as part of their reserves. At present, the Chinese currency accounts for just 1% of global reserves. We estimate this could rise to about 5% over the next five years, which could result in an inflow of USD 80–100bn annually into yuan.

Location, location, location

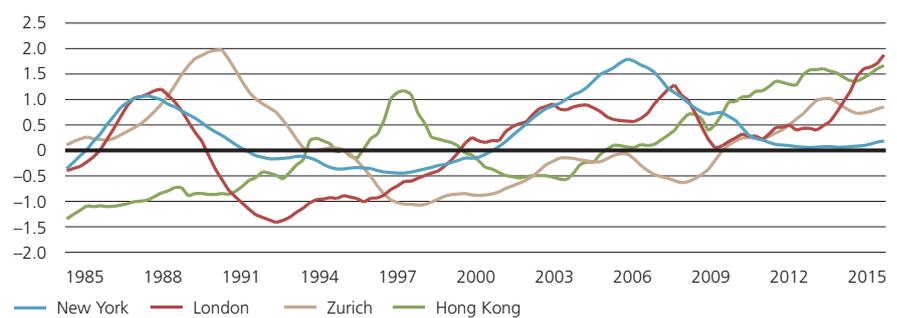
Those who follow our asset allocation approach know we have advocated a reduced exposure to bonds in favor of alternatives. We view the shift of Norway's sovereign wealth fund toward real estate as a comparable move. Given the low yield of government bonds and the proximity of rate rises, a shift away from bonds is logical. And for many clients, property is an attractive option, since it permits leverage and has a certain emotional appeal. But location is still important to successful investment.

Property valuations in many cities of the world look expensive. Our real estate team has recently released its UBS Global Real Estate Bubble Index, utilizing a successful investment methodology we have deployed in Switzerland for a number of years. The results indicate an elevated risk of a significant correction in housing prices in London and Hong Kong, to name just two examples.

In terms of real estate, Hong Kong is the least-affordable city in the world. Property prices are almost 200% higher than in 2003, while rents and incomes have both been stagnant in real terms over that period. In London, real home prices are up 40% since the beginning of 2013: it would now cost a skilled service sector worker 14 years of gross earnings to buy a 60-square-meter property. In fact, among the 15 international cities we analyzed, only Chicago appears undervalued.

Fig. 2: Property markets in many leading cities are vulnerable to a correction

UBS Global Real Estate Bubble Index: Readings over 1 point to a heightened risk



Source: UBS, as of 18 November 2015

Investing in long-term structural trends can offer a compelling alternative.

Oncology drugs are one such possibility, offering the promise of attractive returns.

Our thoughts were with the people of Paris this month.

Switching swiftly from risky to safe assets can protect investors from the worst episodes in the market.

We have recommended other destinations for money currently earning meager yields in government bonds – such as hedge funds and private equity. Longer term investment themes can be added to this list.

Thinking long term

A particular focus for us is oncology, the field of medicine associated with cancer treatment.

Several oncology drugs based on the new science of immunotherapy have already hit the market and another 300 clinical trials are underway. Aside from improving the length and quality of life for cancer sufferers, this emerging science offers the potential for attractive returns.

The market for cancer treatments is expanding rapidly as populations age, and governments, insurers, and individuals are spending more on treatments that can extend life. The spending per cancer patient rose by about 60% between 2010 and 2014 in the US, Germany, and Canada. Early versions of immunotherapies can be expected to command a high price – upwards of USD 100,000 per patient per year.

We believe some of these drugs will hit the market in the coming two years with multi-billion dollar sales potential. Companies highly exposed to successful immunotherapy drugs are likely to offer above-GDP earnings growth, elevated returns on capital, and growing dividends.

Thinking systematic

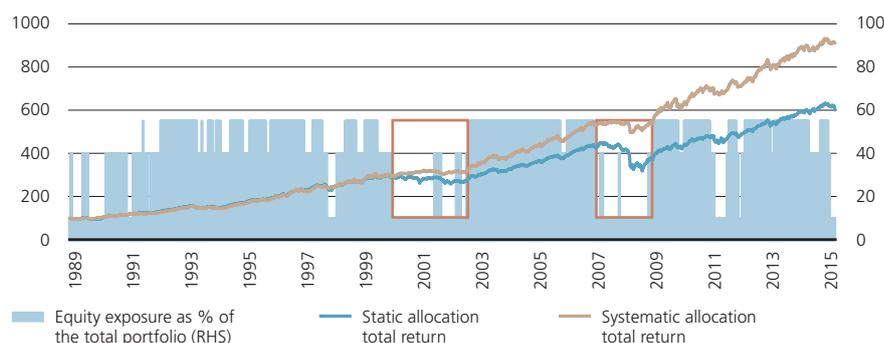
Amid the recent market volatility, many investors have asked us for options that will enable them to manage the tail risk of a plunge in equity markets. We have developed an approach utilizing our World Equity Model signal, which aims to detect when markets are vulnerable to sharp sell-offs. At times of greater risk, our approach would shift a portion of a portfolio out of risky assets and into safer securities, thus reducing the danger of significant losses from large market slides like that of 2008. This could be especially advantageous for more cautious investors who still want to participate in equity markets in more normal periods.

Europe: Inward or outward

Our thoughts this month are with the people of Paris after the horrific terrorist attacks on the city.

Fig. 3: Example of how disciplined use of a quantitative model can protect against downside

Illustrative example of potential benefits of a systematic allocation approach in an equity-bond portfolio



Source: UBS, as of 17 November 2015

We will be alert for signs that the tragedy is likely to have an adverse economic and market impact.

It's too early to determine whether this attack will have a major economic or political impact on Europe. The economies and markets of both Spain and the UK demonstrated remarkable resilience following the bombings in Madrid and London in 2004 and 2005, respectively. In both cases consumer confidence rebounded within a few months.

The potentially greater risk today is that security concerns could impede the path to further European integration, at a time when relations between member states are becoming strained. Poland was quick to indicate that, without security guarantees, it cannot accept migrants from the EU after the events in Paris. Europe still needs to integrate its fiscal and banking systems to better protect itself against future crises. If concerns about security lead to rollbacks in the free movement of people and trade, a greater level of financial integration could be more difficult to achieve.

Europe's future is a topic we will be writing more about in the months ahead, but at present the Eurozone remains our preferred global equity market.



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UBS Investor Forum *Insights*

At this monthly gathering, CIO invites thought leaders to debate the key topics affecting financial markets, and to challenge the UBS House View.

- The main focus of the meeting was on the outlook for energy and the potential impact of the Chinese renminbi's inclusion into the IMF's Special Drawing Rights basket of currencies.
- Most investors felt that oil prices have now bottomed out, but that it is too soon to invest in distressed energy debt. However, energy equities are showing potential.
- The yuan's inclusion in the SDR is primarily a political victory for China. Government policy and earnings will be the primary driver behind valuations.

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