UBS House View

Monthly Letter

Chief Investment Office WM
22 October 2015

Diversification
The recent steep falls in Volkswagen and Glencore shares are a reminder of single stock risk.

Risks ahead
Despite a rebound in October, markets have remained volatile, with uncertainty focused around the Chinese economy, the outlook for US policy, and third quarter earnings.

Global economy
The recent growth slowdown looks like a mid-cycle lull, rather than the onset of recession. China's economy shows signs of stabilizing, while consumption remains positive in the US and Eurozone.

Emerging markets
We are shifting our underweight position in emerging market equities to neutral. Depressed valuations mean that it will only require moderately good news to boost the market.

Mark Haefele
Global Chief Investment Officer
Wealth Management

Focus and diversify

In last year's *CIO Year Ahead: A Diverging World,* we detailed why investors were likely to face lower returns and higher volatility in 2015. But it is one thing to make a forecast, and another to live through such challenging times.

While developed market equities have delivered positive total returns over the past 12 months, the third quarter of 2015 brought us the sharpest quarterly decline in equities and weakest performance for diversified portfolios since 2011, and the biggest spike in volatility since 2008. Markets have since rebounded, but I believe higher volatility and more modest returns are here to stay. Our world is in the process of transition in many areas – from central bank policy in the US, to a shift in drivers of growth in emerging markets.

Corporate capitalism is also in transition: government and regulatory tolerance for corporate failure has plummeted. Some listed companies have shown the concentrated risks that investors assume when they over-allocate money to single stocks. At a minimum, the deep selloffs in Volkswagen and Glencore should make every investor double (and triple) check their conviction in individual positions.

In the face of all this, investors will need to: a) maintain a long-term focus to avoid getting caught up in month-to-month moves, and b) avoid overexposure to single company risks, which are arguably higher than ever.

In our tactical asset allocation this month, we are shifting our underweight in emerging markets to neutral. We believe that while the fundamental situation remains challenging, much bad news has now been priced in, and the potential for positive surprises from China has risen.

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Regulatory intolerance of poor behavior by companies is increasing the risk involved in holding single company stocks.

Corporate capitalism in transition

Financial theorists have long extolled the virtues of a widely diversified portfolio of individual stocks, to avoid overexposure to single company risks. But I believe the political and legal environment today makes this more crucial than ever. *Laissez-faire* capitalism is out. Regulatory and public intolerance for corporate misbehavior or mishaps increases the threat of permanent value destruction for global companies.

Back in the 1970s and 1980s, corporate punishments were relatively light...

Some of you may remember the Ford *Pinto*, a small car made of compressed rust that had a fuel tank prone to exploding. The company was shown to be aware of the fuel tank defects, which were linked to over 20 deaths, but failed to fix the problem. After all was revealed, around 1977, Ford paid punitive damages of USD 3.5 million, less than 0.01% of the company's revenue at the time. Exxon's settlement for the 1989 Valdez oil spill ultimately came in at just over USD 1 billion, or 1% of 1989 revenues.

...now markets are anticipating long-term damage from Volkswagen's emissions test controversy.

That stands in contrast to the larger punishments meted out to other companies in recent years for a range of infractions. BP's deep water oil spill in 2010 has resulted in a draft settlement of USD 20.8 billion, equivalent to 7% of 2010 revenues. Volkswagen, meanwhile, has shed almost 32% of its value, or just over 24 billion euros in market capitalization, since it was shown to be evading emissions tests – an indication of the market's estimate of the fines, costs, and reputational damage the company faces.

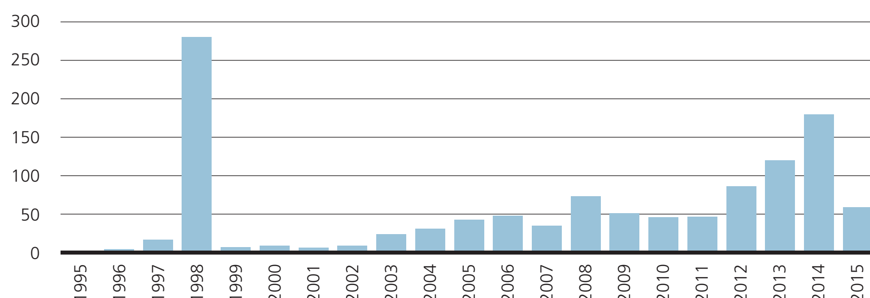
Over the past five years, the number of corporate fines and settlements in excess of USD 1bn has doubled in the US.

The aggregate level of fines and settlements in the US hit USD 180 billion in 2014 (see Fig. 1). This represented a more-than-threefold increase in just half a decade and was a record, with the exception of 1998, the year of a master settlement with the tobacco industry. It is not just the scale: the volume of fines is on the up too. A record 24 fines in excess of USD 1 billion were issued in 2013 and 2014, twice the number of five years before. And it doesn't appear that investors can avoid this risk by hiding in particular sectors: the fines were broadly spread. Financial services companies may be in the news, but penalties of more than USD 1 billion have been imposed on a diverse group of firms in chip making, the auto industry, pharmaceuticals, and energy. The range of possible infractions that have resulted in large damage is also broad, from environmental damage and sanctions breaches to anti-trust behavior and tax violations.

With the exception of the 1998 tobacco settlement, financial penalties for companies in the US hit a record last year.

Fig. 1: Corporate fines and settlements have risen dramatically

Total US corporate fines and settlements (USD bn)



Source: Jon Morse, UBS, as of 21 October 2015

Investors face enough unavoidable risks without assuming the voluntary risks involved in over-concentration in single stocks.

The idea that companies should be more accountable is not a threat to capitalism overall. However, as I discuss below, I believe that investors have enough "involuntary" risks to deal with that they would do well to avoid such "voluntary" risks associated with over-concentration in individual stocks. Nonetheless, around 16% of our clients currently have more than 20% of their portfolio in the securities of a single company.

Uncertainty ahead

Even assuming investors avoided some of the individual company issues, it has still been a challenging few months for financial market returns. The simplest reason for the market swoon – that stocks don't go up in a straight line – may also be best. But there are three big issues related to the drop that we continue to monitor closely.

The outlook for Chinese capital flows remains a concern for markets...

- **China's capital account:** While the depreciation of China's currency in August was relatively small (around 3%), the potential implications remain a cause for concern. First, suspicions linger that China may be tempted to use currency devaluation as a form of economic stimulus. A more rapid devaluation would export deflation to the rest of the world, and impair the economies of export rivals in Asia. Second, even if China does not pursue such an approach and is merely looking to liberalize its capital account, uncertainty remains about the potential direction of capital flows. This has important implications: persistent capital outflows could increase China's domestic interest rates and spark credit concerns. A drawdown of foreign exchange reserves (see Fig. 2) could leave the country less well prepared for any future crisis. We will be monitoring announcements on capital account policy at the upcoming Fifth Plenum, between October 26–29.

... along with uncertainty about US monetary policy or the chance of a government shutdown.

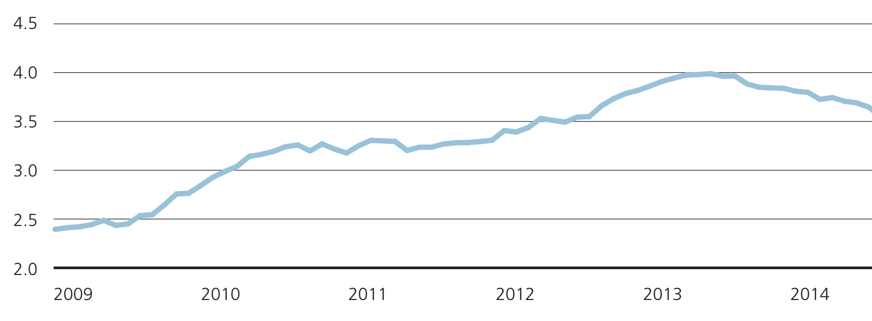
- **US policy:** Policy direction is increasingly uncertain in the US. While we hope Congress will help the long-term global outlook by ratifying the historic Trans-Pacific Partnership, there is a chance US lawmakers will throw a curveball at markets by forcing another government shutdown.

  In addition, with the Fed due to meet on October 27–28, the long anticipated Fed interest rate move remains elusive. Author Milan Kundera described "flirting" as the promise of sex without the guarantee. By this definition, the Federal Reserve is flirting with rate hikes. Although top Fed

China has been drawing down its foreign currency war chest.

Fig. 2: China FX reserves have dropped, reflecting capital outflows

People's Bank of China reserves (USD trn)



Source: Bloomberg, UBS, as of 21 October 2015

officials have said they expect to hike rates before the end of the year, futures suggest that traders have paid most attention to the Fed's "data dependent" message and are betting there will be no hike until 2016. Such communication fumbles tend to increase market volatility.

We will be alert for signs of weakness in 3Q earnings.

- **Earnings:** Developed markets can only "decouple" so far from an emerging market slowdown. Manufacturing purchasing managers' indices, while still in positive territory, have weakened in recent months. Although manufacturing is a small part of most developed economies, it has often proved to be a leading indicator for other sectors. We will closely follow third quarter earnings releases for signs of a broader based deceleration.

Reasons for cautious optimism

Despite lingering questions, we believe that events in August and September likely represented a correction, rather than the early stages of a global recession.

This is based on three main observations:

On the upside, recent data suggests that the Chinese economy is stabilizing...

- **There are signs of stability in China:** GDP growth held steady at 6.9% year-over-year in the third quarter, topping expectations. The data provided some reassurance that the slowdown in industry, which grew by just 6.0% in the year to September, is being partly offset by an acceleration for services, which expanded by 8.4%. While purchasing managers' indices remain below 50, indicating contraction, they are showing signs of stabilizing too. In addition, export data has begun to improve, and the renminbi is now relatively steady, as capital outflows have abated. Meanwhile, property sales in the 30 largest cities increased by 21.6% in September, helping calm fears of a renewed housing slump, and auto sales climbed by 6% in September, the first positive number since June. In summary, recent evidence points to a slowdown rather than a crash.

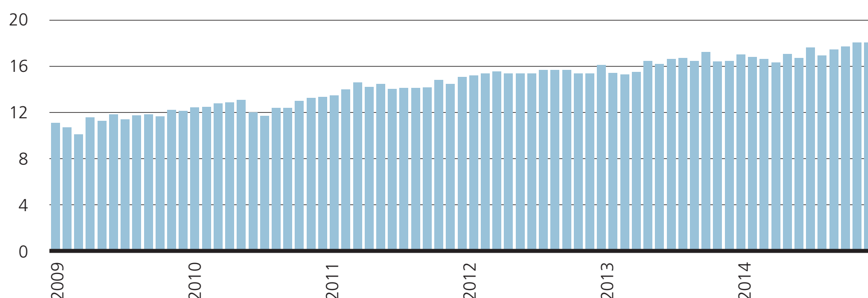
...and consumer demand in most of the world is holding up.

- **Consumers are still spending:** As mentioned above, manufacturing data has weakened. But it is a small part of most developed economies, and while services data remains strong, we can be relatively confident in the overall outlook. In the US, for example, auto sales hit an annualized 18.1 million in September (see Fig. 3), the fastest pace in a decade. Con-

US auto sales are at the strongest level in a decade.

Fig. 3: Car sales suggest US consumers are in buoyant spirits

US total auto sales (m, annualized)



Source: Bloomberg, UBS, as of 21 October 2015

sumer confidence in the Eurozone remains high. And whatever the doubts about China's industrial sector, retail sales growth has remained over 10%, helping to offset the gloom in other parts of the economy.

Finally, central bankers remain willing and able to support growth in the US, Eurozone and Japan.

- **Central banks remain willing and able to support growth and stabilize markets:** The Federal Reserve, Bank of Japan, and European Central Bank have all indicated that they would respond to deteriorating fundamentals or undesirable market trends. Importantly, it now appears as though investors are listening. Bond yields did not rise in the recent equity rally – a potential sign that investors expect further intervention to keep rates low.

The rally since the beginning of the fourth quarter suggests that markets may be starting to adhere to our view, but we will continue to watch the data and market sentiment closely.

We have shifted our underweight emerging market equity position to neutral.

Tactical changes

With recent signs of stability in China and renewed market faith in central bank policy, we are overweight risk assets. We have, however, made one change to our tactical asset allocation this month. We move our underweight position in emerging markets to neutral, and fund this by reducing the size of our overweight position in Eurozone equities. Despite the move, Eurozone equities remain our preferred global equity market.

Following a decade of excessively high expectations for EM, recent years have seen a "wash out" of positive views, with once unthinkable recessions hitting Brazil and Russia. Investors have shifted funds away from the region, with portfolio allocations to emerging market bonds and equities falling from about 17.3% in 2013 to about 15.6% at present, below the average since 2008 (see Fig. 4).

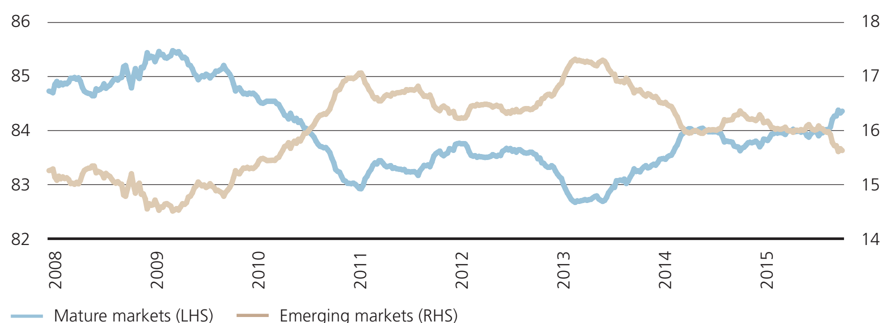
At current depressed valuation levels even incrementally good news could boost performance.

We believe that emerging market equities have fallen far enough that it may only require incremental good news to lead to stronger performance. As an example, the MSCI emerging markets index is trading at 1.4 times price-to-book, against a historical average of 1.9x, with valuations well below the lows seen after the 2008 crisis.

Capital has been flowing out of emerging markets into mature markets.

Fig. 4: Investors have lost faith in EM in recent years

Value-adjusted portfolio allocations, % of total bond and equity allocations



Source: Bloomberg, UBS, as of 21 October 2015

Net profit margins in emerging markets show signs of stabilizing and the headwind from lower commodity prices is abating.

Potential sources of improved news could include stabilizing net profit margins, which have been on a downward trend since 2007 but are showing some signs of settling. Headwinds from falling commodity prices appear to be abating too, and industrial production growth in emerging markets is outpacing that of developed markets by the greatest margin in more than two years.

All that said, the fundamental situation remains challenging, and we are cautious about the way the higher US interest rates might impact those emerging markets most reliant on foreign funding. We are expecting earnings growth in emerging markets of 4–6% for the coming 12 months, still far below the 8–12% we forecast for Eurozone companies. As such we move to neutral, rather than overweight.

We have also closed our underweight Australian dollar position.

Finally, we recently closed our overweight in the British pound relative to an underweight Australian dollar, a position which has returned close to 8% since May. We believe that the downward pressure on the Australian economy is likely to moderate in coming months as conditions in China stabilize. The fall in the price of iron ore, Australia's biggest source of foreign income, has started to abate. In addition, the Australian dollar now looks fairly valued against the British pound on a purchasing power parity basis.

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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.

- Deflation was a key topic this month, and one cited by numerous guests as a threat to global markets. In the short term, most agreed that deflation would remain a concern.
- However, most felt that this is not a global phenomenon and that certain countries and sectors have continued to experience healthy levels of inflation.
- Over the medium and long-term, with the base effects of lower oil prices coming through, deflation should dissipate, and ultimately the main worry will become a pick up in price pressures.

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