UBS House View

Weekly

17 December 2015

Europe
Chief Investment Office WM

The next issue of *UBS House Weekly* will appear on 7 January 2016.

We wish you a happy holiday season and a prosperous New Year.

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Market moves

	CIO view	–1w	– 3m	ytd
S&P 500		1.2%	4.7%	2.8%
Euro Stoxx 50	OW	2.0%	2.9%	9.5%
MSCI EM		0.2%	-4.2%	-15.3%
FTSE 100	UW	0.9%	0.1%	-2.6%
SMI		1.7%	-0.7%	0.7%
NIKKEI 225	OW	1.6%	5.7%	12.7%
US high grade bonds	UW	-0.4%	-0.2%	2.1%
Euro high grade bonds	UW	-0.6%	1.6%	1.3%
US investment grade bonds	OW	-0.8%	-0.4%	-0.9%
Euro investment grade bonds	OW	-0.5%	0.7%	-0.7%
US high yield bonds		-1.5%	-5.1%	-5.5%
European high yield bonds	OW	-0.9%	-0.1%	1.4%
EM sovereign bonds		-1.2%	-1.1%	0.8%
EM corporate bonds		-0.9%	-1.1%	0.9%

Source: Bloomberg, UBS as of 17 December 2015
OW = tactical overweight
UW = tactical underweight

Market comments

Calculations are based on the past five days

- **Global equities rose 0.3% (in USD) on the week.** The initial negative reaction to oil price volatility was replaced by positive equity performance towards week end after the Federal Reserve's interest rate hike.
- **Oil benchmarks in the US (WTI -4.3%) and Europe (Brent – 6.3%) were vulnerable** to short-run price tumbles given no OPEC production ceiling, and record high US inventories.
- **The US dollar generally strengthened against major peers** as the Fed's rate hike cycle was confirmed. The euro declined 0.8% against the greenback, while the Swiss franc shed 0.7%.
- **Long-dated high grade yields** were little changed over the week, as bond traders balanced lower short-run inflation pressures against a hiking Fed.

In focus

The US Federal Open Market Committee (FOMC) raised interest rates from near zero, where they have been since December 2008. Markets interpreted the unanimous decision as mildly dovish, despite FOMC members expecting 100 basis points worth of additional hikes next year; Fed funds futures currently predict only an additional 50 basis points. The FOMC language emphasized gradual hikes and displayed a commitment to further normalization. *CIO reaffirms its expectations for a gradual acceleration in global economic growth next year and is keeping its positive stance on risk assets.*

Both the Swiss National Bank (SNB) and Bank of England (BoE) kept their policies unchanged. The SNB left rates firmly in negative territory on franc deposits. The BoE's Monetary Policy Committee also kept rates the same and indicated no urgency to raise them. *CIO expects the SNB to cut rates further only if the franc strengthens enough to send the EURCHF below 1.05 and direct FX interventions become unsustainable. On the other hand, we expect the BoE to be the next major central bank to raise interest rates after the US Federal Reserve, with May of next year as our base case for liftoff.*

China repeatedly lowered the yuan reference rate, giving additional evidence to market participants who believe the People's Bank of China (PBoC) is seeking to improve export competitiveness. The PBoC set the yuan reference rate lower for the eighth straight day, at 6.46 to the US dollar. It has been trying to shift the market from focusing on the USDCNY cross rate to looking at the CNY against a host of major currencies. Indeed, it recently introduced a new trade-weighted CNY index comprised principally of the US dollar, the euro and the Japanese yen. *CIO still sees the USDCNY exchange rate at 6.50 in three months and 6.80 in 12 months, implying further gradual yuan depreciation.*

French and German "flash" PMIs for December remain in expansionary territory. The French composite PMI fell modestly compared to last month, and missed expectations with a 50.3 reading. But the manufacturing gauge beat market forecasts at 51.6. In Germany, the composite indicator was 54.9, versus last month's 55.2 reading. German services measures remain robust at 55.4. *Overall European activity data is consistent with CIO's view for a gradual and modest acceleration of Eurozone economic growth.*

Japan's December Tankan survey of business sentiment beat estimates. The headline index for large manufacturers' sentiment stood at +12 in December, unchanged from September, beating economists' estimate of +11. This comes on top of last week's positive data showing that Japan avoided a recession and the surprise increase in machinery orders, which suggest that the Japanese economy may be gaining momentum heading into the new year. *CIO is overweight Japanese equities within our global tactical asset allocation strategy.*

The data calendar is light next week. Main points of interest will be the third reading of US 3Q GDP on Tuesday, Turkey's monetary policy committee meeting on Tuesday, and French 3Q GDP numbers on Wednesday. This is the last Weekly of the year, with the next publication scheduled for Thursday, 7 January. Happy holiday season to all our readers!

UBS

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Deeper dive

Why we like Zuckerberg's gift

Andreas Ernst **Juliette Vartikar**

Watch this week's UBS House View Weekly Video

Mark Zuckerberg's recent announcement that he would commit the majority of his USD 45bn fortune to philanthropy and impact investment represents a landmark in the annals of both. It breaks new ground in terms of the size of the endowment, his age when creating it and how he has designed the transfer of his wealth.

It also offers a glimpse into the mindset of a new generation of business owners and its approach to investing sustainably and building an enduring legacy. However, the move has been met with mixed reviews. Some journalists question impact investing – the social benefits it offers and its investment potential.

We think this skepticism is unfounded.

The view that a good impact investment has to be a bad investment is erroneous. Impact investments first and foremost must be fundamentally sound. They typically build on megatrends, capitalizing on market anomalies and translating them into commercial opportunities. Additionally, impact investors often operate in undervalued markets whose risk the global investment community overestimates or whose growth potential it underestimates. The scarcity of capital in these markets enables impact investors to generate high risk-adjusted returns while simultaneously making a "double-bottom-line" contribution to a country's development.

These ideas are reflected in recent Cambridge Associates and Wharton School studies. Both conclude that impact private equity performs on par with conventional private equity funds. For funds analyzed with vintage years 1998-2010, the impact investment fund universe returned 8.1%, beating the conventional fund benchmark of 6.9%.

To be fair, not all impact investments have been successful. Microfinance, for example, has failed to live up to expectations. UBS's view on microfinance has been consistently cautious due to: 1) the limited capacity – and number – of best-in-class local microfinance institutions; and 2) the fact that it is often limited to marginally improving lives in low-income communities and cannot systematically reduce the excessive reliance of the people in these communities on jobs in the informal economy.

However, we see promising opportunities across many underfunded yet profitable investment areas. They range from affordable housing and sustainable consumption to infrastructure and disease research. Specifically, healthcare can have a powerful societal impact while offering high returns: cutting-edge oncology research can advance cancer treatment for developing and developed world markets alike, while achieving traditional venture capital returns. Additionally, social impact bonds can help prevent certain health-related risks for people who suffer from diabetes and other diseases, and offer returns above fixed income market rates based on patient success rates.

While impact investing has come under the media spotlight in recent weeks, we see it as an increasing area of focus and opportunity for UBS. We look forward to updating you with additional views and investment themes on this topic, which occupies a growing role in our research as it begins to feature in the mindset of the next generation of investors.

Andreas Ernst and **Juliette Vartikar**
Global Investment Office

Bottom line

The Facebook founder's decision to devote the bulk of his wealth to philanthropy and impact investing has drawn criticism as well as praise. In particular, some critics have questioned the effectiveness of impact investing. CIO believes that impact investing has potential both to generate strong financial returns and to benefit society, and will be increasingly prominent in the portfolios of current and next generation investors.

Regional view

Europe, the year ahead

Podcast
www.ubs.com/podcast

Themis Themistocleous
Head CIO European Investment Office

As it draws to a close, we look back on a year that featured a significant degree of volatility across most asset classes and regions. Europe was no exception. But we also look forward to next year with measured optimism: while volatility is likely to continue, we expect global and European growth to increase and are positive on risky assets. Within Europe we like Eurozone equities and high yield.

The European Central Bank's recent extension of quantitative easing and its cut to the deposit rate disappointed the market. The euro strengthened and the equity market dropped, reminding us of the crucial role that central banks play in supporting the economy and how they affect market expectations.

As we look towards 2016 the starting point is one of improving growth across most European countries. The latest PMIs point in that direction, and we foresee Eurozone GDP expanding by 1.8%. Most of the growth will come from more robust domestic demand and a greater contribution from investment, in our view. Trade is likely to prove a drag as emerging markets continue to struggle with weak economic conditions.

The latest decline in oil and other commodity prices should also benefit Europe. The EU imports 3.8 billion barrels of oil annually, which in 2014 accounted for 2% of GDP. Energy accounts for 10% of consumer consumption, so depressed oil prices should boost consumer disposable income and ultimately consumption.

Our commodities team expects the market for oil to balance in the second half of next year, by which time prices should rise, but in the short term we expect prices to remain depressed and we have a range of USD 30-50/bbl for Brent.

> "As we look towards 2016 the starting point is one of improving growth across most European countries."

The market appears to expect no further ECB action for now. But the low commodity prices are pressuring spot inflation, which in turn could influence inflation expectations. We would not exclude the possibility of another ECB move (although it is not our base case) sometime next year.

Geopolitics also fueled market volatility this year, and a busy political calendar in Europe beckons. In the second half of next year, the UK referendum looms as probably the most important event for European markets. We still assign a low probability to the UK leaving the EU, but if the polls are to be believed, public opinion is moving fast. We will likely have to revisit our view once we have a clearer idea of how the EU negotiations are evolving. In the meantime, Spanish elections and resurgence of the Greece issue could also spark volatility.

Eurozone companies strengthened their corporate balance sheets even more in the past 12 months, which positions them well to expand their investment in the coming years and support their dividend payments. Next year we forecast 8-12% earnings growth for Eurozone equities, which represents one of the better potential performances among the major regions. Such earnings growth should be the main driver behind the market performance.

I would like to wish all of our clients Season Greetings and a healthy and prosperous New Year.

Kind regards,
Themis Themistocleous

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