UBS House View

Europe
Chief Investment Office WM

Weekly

5 November 2015

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Market moves

	CIO view	*–1w*	*– 3m*	*ytd*
S&P 500		0.6%	0.7%	3.9%
Euro Stoxx 50	OW	1.1%	–5.8%	13.1%
MSCI EM		2.6%	–2.1%	–7.0%
FTSE 100	UW	–0.3%	–4.3%	0.6%
SMI		0.2%	–5.7%	3.0%
NIKKEI 225	OW	1.1%	–6.6%	11.3%
US high grade bonds	UW	–0.4%	1.1%	2.4%
Euro high grade bonds	UW	–0.9%	1.5%	1.6%
US investment grade bonds	OW	–0.2%	0.6%	0.0%
Euro investment grade bonds	OW	0.0%	0.1%	–0.5%
US high yield bonds		0.4%	–1.0%	0.0%
European high yield bonds	OW	0.6%	0.5%	3.0%
EM sovereign bonds		0.3%	1.3%	3.3%
EM corporate bonds		0.2%	0.1%	3.8%

Source: Bloomberg, UBS as of 5 November 2015
OW = tactical overweight
UW = tactical underweight

Market comments

Calculations are based on the past five days

- **Global equities** continued their rise, with the S&P index up 0.6% and the Euro Stoxx 50 and Nikkei 225 both climbing 1.1%.
- **Fixed income** was mixed. High grade US bonds fell 0.4% while high yield bonds in the US rose 0.4% and European high yield bonds climbed 0.6%.
- Crude oil prices inched higher, with **Brent rising 0.4% to USD 48.7.** US WTI was flat at USD 46.3.
- In **foreign exchange markets**, the EURUSD fell 1% to 1.09 amid further indications that a rise in the fed funds rate may come soon.

In focus

Federal Reserve Chair Janet Yellen hinted that a rate hike this year remained possible. *CIO is neutral on US equities and high yield bonds.* In a speech this week, she said she saw the "US economy as performing well," and that "spending has been growing at a solid pace." She added that "with this economic backdrop in mind, the committee indicated in our most recent statement that it could be appropriate to adjust rates in our next meeting." It will be held December 16–17.

Activity in the Eurozone services sector remained high, pointing to an ongoing economic upswing. *CIO is overweight Eurozone equities.* The respective purchasing manager index (PMI) increased to 54.1 in October, up from 53.7 and only slightly below the 54.2 preliminary indication. Germany (54.5), France (52.6) and Spain (55.9) led the advance. Combined with the corresponding manufacturing gauge, the composite PMI edged up to 53.9 from 53.6.

New car sales in the US hit a 10-year high, suggesting that US consumer spending remains solid. This is a reassuring data point since some retailers had indicated that business conditions had softened, especially in apparel. It looks increasingly likely that the softer environment for apparel stems from unusually warm weather and does not indicate a broader slowdown in consumer spending.

The Reserve Bank of Australia (RBA) kept interest rates unchanged, but signaled a greater chance that it would cut rates further in the months ahead. After weak September inflation data, the RBA adopted an easing bias in its November statement by stating that "the outlook for inflation may afford scope for further easing of policy, should that be appropriate to lend support to demand."

UK builders are enjoying a period of strong expansion. Employment growth hit a 12-month high and Markit's purchasing managers' index, which reached 59.9 in September, was down only slightly to 58.8 last month. Overall this was the 29th consecutive month of UK construction growth, and commercial building work increased at its fastest pace in eight months.

China's economic indicators point to stabilization. *CIO remains neutral on Chinese equities.* The official PMI for October released over the weekend stood at 49.8, signaling a contraction in the activity of large manufacturers. But the reading was unchanged from September and slightly up from the three-year low in August.

The Bank of Japan (BoJ) refrained from adding stimulus. *We still think more easing is likely and we are overweight Japanese equities.* Core-core CPI inflation, the BoJ's preferred measure, rose 0.9% y/y in September from 0.8% in August. Coupled with steady unemployment in September (unchanged at 3.4%) and yesterday's better-than-expected industrial production figures, this may partly explain the BoJ's decision.

UBS

Deeper dive

Do M&A mega-deals mark the top of the market?

Watch this week's
UBS House View Weekly Video

Christopher Swann

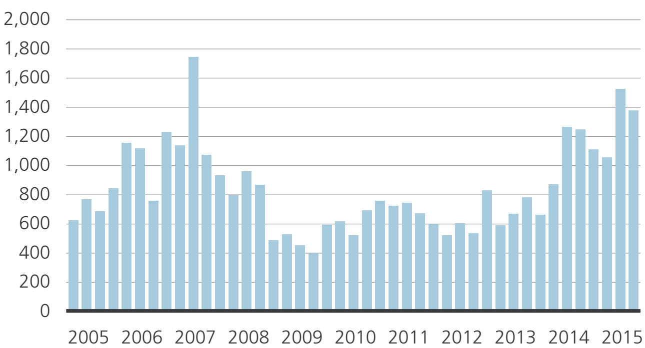
Big mergers and acquisitions (M&A) can fill investors with trepidation. Major transactions have often been followed by broader market declines; AOL's USD 112bn purchase of Time Warner in 2000 preceded the dotcom bust by a matter of months. Similarly, the aborted USD 147bn BHP bid for mining rival Rio Tinto was launched suspiciously close to the 2007 market crash.

So is the recent spate of mega-deals – including the potential USD 300bn hook-up between Pfizer and Allergan – a cause for concern about the markets in general? We believe not.

Transactions are no cause for concern
The number of large transactions has certainly been on the rise. In October alone there were two proposed deals in excess of USD 100bn; the aforementioned Pfizer merger and Anheuser-Busch InBev's USD 117.4bn bid for SABMiller. Both, if consummated, would rank among the top five M&A deals in history. Overall this year companies have announced 54 deals in excess of USD 10bn, taking the total volume of all transactions to a record USD 4trn.

Global M&A deal making has taken off

Volume in USD bn



Source: Bloomberg, UBS, as of Q3 2015

But while historical data suggests a strong market is linked to more deal activity, M&A volumes and values have not been a good predictor of subsequent stock performance.

For example, in March 2006 deal activity hit a then-record USD 1.1trn. Investors who took that as a sign of a market tipping point would have missed out on a 30% rally in the MSCI All Country World Index up to October 2007. Similarly, M&A volumes in 2Q14 surpassed the USD 1trn mark – well above the 10-year average of USD 830bn – yet the Nikkei, Euro Stoxx 50 and S&P 500 indices have all delivered a positive total return since then.

In short, there is no statistically significant relationship between M&A values or deal volumes and market outcomes. To the extent it exists, the relationship is actually positive: after all, an environment of high confidence, cheap financing and a desire to invest should boost M&A and the market in general.

Remain positive on equities
While stock returns overall may be unlikely to match the strength of recent years, there are good reasons to expect equities to rise.

The outlook for corporate earnings remains good, with particular strength in the Eurozone and Japan. The third-quarter earnings season has topped expectations in the US. And even in emerging markets, where business conditions have been deteriorating in recent years, profit margins have shown recent signs of stabilization.

Meanwhile, worries about a possible hard landing in China have abated somewhat.

Finally, with inflation remaining low, accommodative central bank monetary policies will continue to push investors into risk assets such as equities.

Christopher Swann
Global Investment Office

Bottom line

Accelerating M&A activity and a greater number of mega-deals are often seen as an ominous sign for markets, presaging a slump in equities. But corporate transactions are a poor market predictor. The recent flurry of large deals should not alarm investors. The case for risk assets remains strong and we believe that equity markets have further to rise.

Regional view

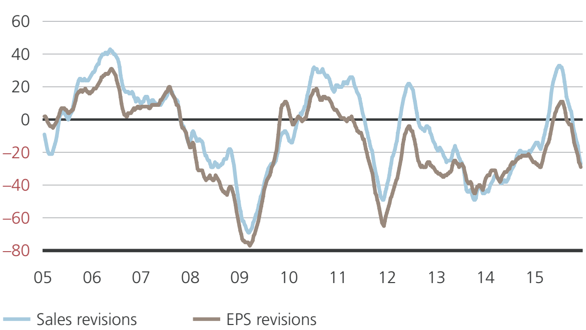
A disappointing earnings season – so what else is new?

Podcast
www.ubs.com/podcast

Bert Jansen
European Equity Strategist

European companies were busy reporting third-quarter earnings this week and last. Around 60% of Euro Stoxx constituents have published their results, and more than half of them missed their EPS consensus estimates. This is disappointing, especially when taking into account that the estimates were lowered ahead of the earnings season (see chart below). However, a quarter of lackluster results does not change our positive view on the asset class as a whole.

MSCI Eurozone earnings and sales revisions, 12-month forward (%)*



*Consensus estimates, based on the number of revisions (Up-Down)/(Up+Down).

Source: Thomson Reuters, UBS

> "Results thus far, underwhelming as they are, do not deeply trouble us."

So the results thus far, underwhelming as they are, do not deeply trouble us for several reasons.

First, reporting seasons are largely backward-looking exercises, while financial markets look forward. The earnings downgrades over the past few months have come about largely because of slowing growth in China and a significant drop in emerging market currencies. But these factors were already priced in given the major market setback this summer.

Why not? Because earnings downgrades are far from unusual: consensus earnings estimates have been raised in only four out of the past 27 years (including in 1999, at the peak of the technology bubble, and in 2005–07 during the height of the credit bubble). Yet this situation has not prevented European equity markets from quadrupling in value over that period.

Second, forward-looking economic indicators, such as the latest Eurozone PMI data, point to a pick-up in activity. We expect Eurozone equities to post 8–12% earnings growth in the coming 12 months, more than that of most other regions.

Similarly, Eurozone equity markets have risen 10% in the past month despite lowered earnings expectations. Stock prices have been boosted by a weaker euro, the prospect of additional European Central Bank (ECB) policy easing, improving economic indicators – the Eurozone PMI for October showed a further pick-up in activity – and tentative signs of Asia stabilizing.

Finally, the prospect of additional ECB policy easing should keep the euro weak and provide further underpinning to corporate earnings.

In short, the Eurozone remains our favorite equity market in our tactical asset allocation.

Kind regards,
Bert Jansen

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