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Market moves

	CIO view	-1w	-3m	ytd
S&P 500		0.3%	8.2%	3.4%
Euro Stoxx 50	OW	1.1%	10.4%	14.4%
MSCI EM		-0.1%	6.7%	-10.4%
FTSE 100	UW	0.5%	7.3%	0.8%
SMI		-0.5%	4.9%	2.8%
NIKKEI 225	OW	1.5%	9.4%	16.2%
US high grade bonds	UW	0.2%	0.6%	2.5%
Euro high grade bonds	UW	0.4%	2.8%	2.9%
US investment grade bonds	OW	0.3%	1.1%	0.0%
Euro investment grade bonds	OW	0.1%	1.2%	0.2%
US high yield bonds		-0.8%	-1.5%	-3.0%
European high yield bonds	OW	0.0%	1.7%	3.0%
EM sovereign bonds		0.3%	3.1%	2.8%
EM corporate bonds		0.0%	1.3%	2.8%

Source: Bloomberg, UBS as of 26 November 2015

OW = tactical overweight

UW = tactical underweight

Market comments

Calculations are based on the past five days

- After strong performance at the end of last week, **global equities** were flat, torn between geopolitical concerns and the prospect of ECB easing next week.
- **Eurozone stocks** saw among the best performance of the week, particularly following a Reuters report on Wednesday suggesting the ECB could go further than expected in its easing.
- In fixed income, **US high yield bonds** continued to retreat (-0.8%) as the falling oil price continues affecting the energy sector.
- The **British pound** was the worst performing G10 currency after more comments from the Bank of England suggesting that rates are unlikely to rise soon.

In focus

The Turkish military shot down a Russian warplane near its border with Syria on Tuesday. Turkey and Russia have continued to dispute whether the jet was in Syrian or Turkish airspace. A potential consequence of this event may be a wider conflict between NATO member Turkey and Russia, but this is not our base case scenario. In the short term, Russian and Turkish asset prices may face price volatility on jittery investor sentiment. *In a global portfolio context, however, we keep our pro-risk positioning unchanged.*

The US economy expanded more in 3Q15 than initially reported. GDP growth was revised up from 1.5% to 2.1% on 24 November, largely due to changes in inventories that may reverse in the final quarter of 2015. CIO continues to expect solid US GDP growth of 2.8% in 2016 and probable boosts to US equity earnings growth. *Nevertheless, more favorable stock market opportunities in Japan and the Eurozone lead CIO to maintain a neutral US equity stance.*

The euro dropped and bonds rallied as the ECB reaffirmed a commitment to boost inflation. Speaking in Frankfurt last week, ECB President Draghi said that the ECB would thoroughly assess the "factors that are slowing the return of inflation towards 2%" at the next meeting of the Governing Council on 3 December. "If we decide that the current trajectory of our policy is not sufficient to achieve our objective, we will do what we must to raise inflation as quickly as possible."

European purchasing managers' indices suggest an ongoing recovery in Eurozone economic activity. Preliminary readings indicate that the

Eurozone composite index rose to 54.4 in November, from 53.9 in October. We await the ECB meeting early next month to see if this data is strong enough to dissuade Draghi from cutting interest rates again and expanding Europe's QE program. We believe the ECB will loosen further by both methods. *CIO is overweight on Eurozone equities*, given the improving economic momentum, expected additional monetary policy support and anticipated equity market EPS growth of 8–12% over the next 12 months.

Japan's manufacturing sector health continued to improve. The flash reading of the Nikkei/Markit manufacturing PMI edged up to 52.8 in November, from 52.4 in October. Behind the headline reading, data for both output and new export orders rose. Japanese core CPI data on Friday will be closely watched for clues of whether further monetary policy loosening may be seen in December. *CIO is overweight on Japanese equities, driven by improved global demand for Japanese corporate output, an attractive earnings growth profile and encouraging share buy-back activity.*

A People's Bank of China (PBoC) official said the Chinese yuan's value will remain stable if included in the International Monetary Fund's special drawing rights (SDR) basket. Yi Gang, deputy governor of the PBoC, said that the yuan would be kept "basically stable at a reasonable and balanced level" upon inclusion in the basket. His comments were made ahead of the IMF meeting on 30 November, when the yuan's inclusion in the basket of reserve currencies will be decided.

Deeper dive

Global security fears = global market fears?

In the past two weeks, we have witnessed the deadliest terrorist attacks in France and Western Europe in more than a decade, a near shutdown of the Belgian – and unofficial EU – capital on security fears, and the first military incident between Russia and NATO in years.

Global security worries are at their most intense in years, and, given the complexity of the situation in Syria in particular, these concerns may stay with us for some time yet.

This has raised questions over the potential consequences for the global economy and markets.

Economic implications

While all the recent security incidents are likely to have an economic impact, we do not expect the impact to be large.

Paris: We believe the French economy will remain resilient overall despite the attacks. Previous such episodes showed that European economies continued to perform after such events.

After the Madrid train bombings in 2004, Spanish retail sales volumes initially stalled, but recovered by the following month, and the impact on the overall economy was not discernible.

The UK saw a similar pattern after the London terrorist attacks in 2005, with retail sales growth stalling for two months, but recovering soon after.

However, tourism, which accounts for around 7% of French GDP, could be affected more (it took some six years for foreign arrivals in the US to recover to levels reached before the 11 September attacks).

Bottom line

Security fears are rising due to the Paris attacks, the security shutdown in Brussels, and Turkey's downing of a Russian military plane. Overall, however, we do not expect severe economic consequences. Financial markets, particularly in the affected countries, could see greater volatility



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Kiran Ganesh

Belgium: The security shutdown in Brussels is likely to prove more severe from an overall economic perspective, given its dual effect on both consumer and tourist confidence, and the ability of residents and visitors to go on with their regular activities. Also, the approaching Christmas shopping season may amplify the impact. However, the shutdown is unlikely to completely derail the Belgian economy as momentum in key trading partners France and Germany is relatively good.

Turkey/Russia: Turkey and Russia are important trading partners – Turkey is the second-largest buyer of Russian natural gas, while Russia represents the second-largest source of tourists for Turkey. These relations have been put at risk by the rising tensions. However, we believe these economic ties will help de-escalate tensions, and Turkey's NATO membership should act as a further deterrent.

Market implications

Europe: We do not believe that the increased security worries and any possible negative economic consequences are large enough – for now – to offset the various positive factors for Eurozone equities and high yield credit in the months ahead. These include low oil prices and borrowing costs, and the potential for further easing by the European Central Bank on 3 December. At the margin, the greater unity brought about by security worries and the tolerance for deficits among European member states could be seen as positives.

Emerging markets: With the situation in Syria growing increasingly complex due to growing international involvement, markets should not be complacent about pricing geopolitical risks, in particular in relation to Russia and Turkey. We expect higher volatility in Russian and Turkish markets, and remain neutral on both.

Kiran Ganesh
Global Investment Office

as they move to price higher geopolitical risks. But we do not think the increased security worries are large enough – for now – to offset the various positive factors for markets in the months ahead.

Regional view

Squaring the circle: The ECB's challenge on 3 December

Podcast
www.ubs.com/podcast



Ricardo Garcia
Head European Economics

The Governing Council of the European Central Bank (ECB) will hold its next meeting on 3 December. Since ECB President Mario Draghi's dovish press conference on 22 October, market expectations have been high, and the euro has depreciated substantially. But the decision to be made at the upcoming meeting is not a given and entails certain risks.

Eurozone economic data has improved of late. Inflation has reappeared – it is set for a large one-percentage-point rebound unless oil prices retreat again – and core inflation has risen to its highest level in over two years. The composite PMI in turn reached a strong 54.4 in November, its highest mark since 2011, while consumer confidence is near its all-time peak. Accordingly, we expect the new ECB projections to forecast economic acceleration in the coming years, while the inflation outlook might be marginally lowered due to the depressed oil price.

ECB Governing Council members have made clear that the decision about whether to ease further will depend on the new Eurosystem projections to be published on 3 December. Without a large downward revision in them, a major ECB easing package is unlikely, in my view. Yet Draghi's previous statements pretty much constituted a pre-commitment to at least a moderate package. So the Governing Council has little choice but to square the circle by not disappointing markets and not easing too much. It is analyzing a variety of options, even if most focus on the quantitative easing (QE) program and the deposit rate.

"I see the QE program being lengthened and the deposit rate being cut by at least 0.1%."

The QE program can be modified in multiple ways, via its size, pace and composition. We expect it to be extended by three to six months to appease the markets. Given that the numbers will likely indicate that more time is needed for inflation to reach the ECB's target of below but close to 2%, a longer QE program would help in that regard. Extending or increasing the monthly purchases is a trade-off given the restraints posed by market (il)liquidity. But a moderate increase in purchases could be combined with an extension by adding segments like municipal and regional bonds.

As far as the deposit rate goes, the lower bound of the ECB's interest rate is already at –0.2%. Draghi did point out that the experience of other central banks has shown that rates can be reduced even more. Hence, the ECB is also considering lowering the deposit rate further into negative territory.

Overall, I see the QE program being lengthened and the deposit rate being cut by at least 0.1%. But it's possible that market participants have overestimated what's coming. Following a four-year easing cycle, the Eurozone economy is on the mend, with inflation turning around. So markets will no longer

be able to rely on more and more easing. Given the high expectations, Draghi might have to use the full arsenal of his communication skills to keep them in check.

Kind regards,
Ricardo Garcia

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