

Deeper dive

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Market moves

	CIO view	-1w	-3m	ytd
S&P 500		-0.6%	7.0%	2.8%
Euro Stoxx 50	OW	-3.9%	3.2%	10.3%
MSCI EM		-1.9%	2.9%	-11.9%
FTSE 100	UW	-1.5%	2.5%	-0.2%
SMI		-1.2%	1.0%	1.6%
NIKKEI 225	OW	0.0%	10.4%	16.1%
US high grade bonds	UW	0.2%	0.6%	2.8%
Euro high grade bonds	UW	0.3%	3.1%	3.2%
US investment grade bonds	OW	0.5%	1.1%	0.5%
Euro investment grade bonds	OW	0.1%	1.4%	0.4%
US high yield bonds		1.0%	-1.8%	-2.2%
European high yield bonds	OW	0.2%	1.5%	3.1%
EM sovereign bonds		-0.3%	1.4%	2.5%
EM corporate bonds		-0.3%	0.6%	2.6%

Source: Bloomberg, UBS as of 3 December 2015

OW = tactical overweight

UW = tactical underweight

Market comments

Calculations are based on the past five days

- **Global equities** spent another week trading water but fell sharply in the immediate aftermath of the European Central Bank’s monetary policy announcement, as the measures outlined fell short of high market expectations.
- **Emerging market (EM) stocks** suffered as the political turmoil in Brazil deepened and US Federal Reserve Chair Janet Yellen commented that higher US interest rates are imminent.
- It was a decent week for **bonds**, save for EM ones affected by the same factors as EM equities.
- The **British pound** performed poorly for the second consecutive week, dipping below 1.50 against the US dollar for the first time since April.

## In focus

**The European Central Bank (ECB) elected to loosen monetary policy further.** ECB President Mario Draghi announced a suite of measures. They include a lowering in the deposit rate to -0.3%; an extension of the quantitative easing program by six months; a widening of the securities eligible for purchase; an extension of several refinancing operations until at least end-2017; and a reinvestment of the principle payments of the asset purchase program. *Overall CIO expects this loosening of monetary policy to support European equity and high yield debt prices into next year. CIO maintains overweights in both asset classes.*

**Eurozone inflation data came in below consensus, adding to expectations that the ECB would take action on Thursday.** The flash estimate for headline CPI stayed at 0.1% y/y in November, a tad below the 0.2% forecast. Core inflation, excluding food and energy, rose 0.9%, against forecasts for no change at 1.1%. *CIO remains overweight on Eurozone stocks.*

**The IMF announced the Chinese yuan’s inclusion in its basket of reserve currencies.** *CIO does not believe this will trigger meaningful near-term flows into the CNY and out of other currencies, but China is unlikely to significantly devalue its currency now that it has achieved this status.* The CNY, the only new joiner since 1999, will have a 10.92% weighting from October 2016. Most of this will come at the expense of the euro and the British pound.

**In Europe, German unemployment fell to an all-time low and Eurozone manufacturing PMIs were generally in line.** German jobless claims in November fell 13,000 from the previous month, and the adjusted unemployment rate

edged down to 6.3% from 6.4%. The Eurozone’s final manufacturing PMI in November stood at 52.8, in expansion territory, while Germany’s manufacturing measure was modestly higher than the first reading (52.9 versus 52.6 expected). The French manufacturing PMI held above the 50 threshold, whereas UK manufacturing sentiment was below expectations (52.7 versus 53.6 expected).

**US manufacturing data dropped; construction spending remained strong.** The November ISM Manufacturing index fell to its lowest reading since June 2009 at 48.6, from October’s 50.1. At the margin, this is a negative, but manufacturing accounts for just 12% of the US economy and has been weak all year. Other recent data on the manufacturing sector has been mixed.

**Sentiment in China’s manufacturing sector edged lower,** with the official manufacturing PMI dropping in November to 49.6. To help stimulate growth, *CIO expects the reserve requirement ratio (RRR) to decline by 200–300bps and deposit rates to fall to 1% by the end of next year.* That said, after six central bank interest rate cuts this year, a recovery in manufacturing remains elusive. On the upside, the official services PMI rose to 53.6 in November from 53.1 in October, underscoring China’s structural shift towards a more service-oriented economy.

**China industrial profits declined for the fifth straight month.** Industrial profits retreated 4.6% y/y in October, after rising 0.1% the month before. *CIO is overweight on China and we continue to expect further easing measures to support economic growth.* Profits fell 2% in the first 10 months of the year from a year ago.

## Deeper dive

# How do the markets typically respond to “Draghi days”?

European Central Bank (ECB) President Mario Draghi made good on his November commitment to further ease monetary policy (and responded to this week’s softer Eurozone inflation data) by lowering the main deposit rate 10 basis points and extending quantitative easing (QE) until March 2017. The ECB also widened the scope of securities eligible for purchase, extended a number of refinancing operations until at least end-2017 and announced the reinvestment of principle payments from the asset purchase program.

To gauge how the market might react in this instance, we took a brief look at historical asset market responses to ECB policy action.

## Lessons from history

The ECB announced its QE program in January but had already used its communication toolbox to signal a wave of loosening measures to support growth and boost inflation.

Thanks to the January “pre-announcement,” the euro and sovereign fixed income market actually moved more in the run-up to the announcement than after it – an example of the adage “buy the rumor, sell the fact.” Conversely, European risk assets like equities and high yield credit reacted most after the ECB press conference (with European stocks up 9% 30 days and 9.4% 90 days in the wake of it).

We see a similar pattern when we extend the analysis to all the occasions when Draghi and his predecessors have moved monetary policy since 1999. Sovereign bond yields tend to fall more in the run-up to an interest cut than in the aftermath. Similarly, the euro’s average decline against the greenback is 0.3% in the month before a rate cut announcement and a mere 0.05% the month after.



Kiran Ganesh

However, equity and high yield debt markets in Europe have historically rallied more after a rate cut than before one. A possible explanation is that monetary policy affects money supply and corporate earnings with a lag, typically of six to nine months. Yet, just three months after an interest rate cut, our analysis shows the median move of European stocks is already positive, at 3.6%.

## European asset class implications of today’s move

Despite the initial market disappointment that the ECB did not surpass expectations in terms of easing, we see the following results from today’s move applying next year:

**Equities:** Today’s move should underpin Eurozone money growth and corporate earnings, particularly as the latest loan data suggests that European credit channels are unblocking. *CIO remains overweight on Eurozone stocks.* Financials, in particular, should benefit from higher lending volumes and profits as loan demand and supply improve.

**Bonds (high grade and high yield):** High grade debt has perhaps overpriced ECB action as core yields fell deeper into negative territory. Yet stronger growth and the hunt for yield should cause Eurozone high yield credit spreads to tighten further. *CIO maintains its tactical overweight on European high yield credit and its underweight on high grade bonds.*

**Currency (euro vs. US dollar):** In line with the lessons from history, we see limited scope for today’s announcement to push EURUSD much below 1.05 in three months. In fact, the ramifications of today’s move on European growth and investor demand for Eurozone assets lead us to forecast exchange rates of 1.08 in six months and 1.10 in 12 months.

**Kiran Ganesh**  
Global Investment Office

## Bottom line

Further ECB easing measures should help bolster Eurozone growth and inflation. But recent moves in the euro and high grade debt suggest the ECB’s actions may have already been overpriced. Upside remains in Eurozone equities and high yield debt, which have histori-

cally tended to be slower to price in new policy than currency and sovereign fixed income. CIO is tactically overweight both Eurozone equities and high yield credit in global portfolios.

## Regional view

# The ECB acts but disappoints markets



**Patrik Ryff**  
CIO European Economist

As was widely expected, the European Central Bank (ECB) delivered more monetary stimulus at its 3 December Governing Council meeting. ECB President Mario Draghi has acquired a reputation for delivering policy measures that surpass expectations, but in this case he didn't live up to his billing as "Super Mario."

The package announced by Draghi includes a 10-basis point cut in the deposit rate and a six-month extension of the QE program to March 2017 or beyond if necessary. While in line with CIO's baseline view, markets reacted with disappointment.

In a UBS House View Weekly article on 26 November, "Squaring the circle," we laid out why we thought high market expectations were doomed to be disappointed. In a Bloomberg survey ahead of the meeting, 65% of respondents indicated that they anticipated the ECB increasing the size of its monthly asset purchases, and money markets had priced in a 90% chance of a 15bps cut in the deposit rate.

Since Draghi failed to meet such expectations, European equity markets unsurprisingly closed the day in the red, while EURUSD gained sharply. EURCHF also rose, so that the pressure on the Swiss National Bank, which will hold its quarterly monetary policy meeting on 12 December, ebbed down, in my view.

**"There will be little time for markets to digest today's action, as all eyes are set to turn to the next central bank meetings – those of the Swiss National Bank and the US Federal Reserve."**

So what action did the ECB take exactly? It elected to reduce the deposit rate (the interest paid on excess reserves held at the ECB) by 10 basis points to  $-0.3\%$ , while keeping the main refinancing rate at  $0.05\%$ . The lowered deposit rate removes what was originally the floor to the ECB's key policy rates and implicitly leaves open the option of reducing it further if necessary. In addition, it extended the QE program to March 2017 and expanded the universe of assets eligible to be bought.

However, it refrained from expanding the size of monthly asset purchases from the current EUR 60bn. In addition, Draghi announced that the full allotment policy on three-month long-term refinancing operations (LTROs) will be prolonged until the end of 2017 and the principal of bond holdings will be

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reinvested, even if the latter was not exactly a surprise.

Eurozone economic data, such as the purchasing managers' indices, has improved as of late. And while inflation in November was lower than most economists expected, the recent uptrend should remain intact as base effects from lower

oil prices fall out. In fact, I expect inflation to move toward  $1\%$  as the new year begins, which would imply a shift of around  $1.5\%$  in a year's time span.

Risks to this positive outlook have been addressed with the additional easing measures announced, barring a substantial worsening of the risk environment, which at this moment we do not have in our base-case scenario. So I expect the ECB to revert to wait-and-see mode. However, there will be little time for markets to digest today's action, as all eyes are set to turn to the next central bank meetings – those of the Swiss National Bank on 12 December and the US Federal Reserve on 16 December. And expectations for the latter are high again.

Kind regards,  
**Patrik Ryff**

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Version May 2015.

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