UBS House View

Europe
Chief Investment Office WM

Weekly

8 October 2015

Market moves

	CIO view	*–1w*	*– 3m*	*ytd*
S&P 500		3.5%	–2.2%	–1.7%
Euro Stoxx 50	OW	5.2%	–2.7%	5.7%
MSCI EM	UW	6.7%	–5.1%	–8.9%
FTSE 100	UW	4.9%	–0.8%	0.2%
SMI		2.1%	–1.7%	–0.3%
NIKKEI 225	OW	2.4%	–7.5%	5.5%
US high grade bonds	UW	0.1%	1.3%	3.1%
Euro high grade bonds	UW	0.1%	1.6%	0.8%
US investment grade bonds	OW	0.4%	0.3%	0.3%
Euro investment grade bonds	OW	0.3%	0.1%	–1.3%
US high yield bonds		1.4%	–3.2%	–1.1%
European high yield bonds	OW	1.2%	–0.1%	0.8%
EM sovereign bonds		1.8%	0.0%	1.8%
EM corporate bonds		1.2%	–1.9%	2.0%

Source: Bloomberg, UBS as of 8 October 2015
OW = tactical overweight
UW = tactical underweight

Market comments

Calculations are based on the past five days

- **Global equities** rebounded, with emerging market stocks (+6.7%) outperforming.
- In **fixed income**, riskier bonds such as US and European HY as well as emerging market debt rallied strongly.
- Commodities joined the rally in risk assets with **crude oil (Brent +7.6%, WTI +7.1%)** standing out.
- In **foreign exchange**, the US dollar declined against all G10 currencies while commodity-related currencies enjoyed a relief rally.

In focus

US labor market data disappointed. The economy created 142,000 new jobs in September, significantly fewer than the expected 201,000. In a second disappointment, gains for July and August were revised down by 59,000 jobs in total. Wage growth remained unchanged at an annual pace of 2.2%; the unemployment rate stayed at its 7.5-year low of 5.1%. The market responded by pricing out a rate hike to March next year. Expectations of low-for-longer interest rates led the US dollar to decline relative to all major currencies, while global equity and bond markets rebounded. *CIO is overweight risk assets with a regional preference in the Eurozone and Japan.*

Sentiment among purchasing managers in the Eurozone services sector stayed upbeat. The area's index (PMI) slipped to 53.7 from 54.4, a value well above 50, pointing to a healthy near term. Brighter sentiment in France (51.9 from 50.6) could partially offset the worse mood of German (54.1 from 54.9), Italian (53.3 from 54.6) and Spanish (55.1 from 59.6) managers. A composite PMI, including sentiment in the manufacturing sector, of 53.6, down from 54.3, still bodes well for the currency area. *CIO is overweight on Eurozone stocks.*

The ruling center-right coalition won the Portuguese election, capturing around 38.3% of the votes but losing its majority. Incumbent Prime Minister Pedro Passos Coelho is the first Eurozone leader to be re-elected after steering his country through a punishing bailout. We expect coalition-forming to be difficult since the only eligible partner is the Socialist party, which took 32% of the vote. For now a "grand coalition" or a hung parliament are the most likely scenarios.

The US, Japan, Australia, Canada and eight other nations signed the largest trade pact in two decades. The Trans-Pacific Partnership, seen as a political victory for Japanese and US leaders, could be responsible for 40% of world trade and will reduce barriers for numerous goods and services. We believe Vietnam and Malaysia could profit most and China and Thailand, who were left out, least. The next step is ratification by lawmakers in the signing countries.

Investors lent funds for free to the US government for the first time. The current low-inflation environment and concerns over global growth led to the zero-yielding 3-month Treasury bills.

Global growth and the IMF/World Bank meeting in focus. We'll be following the annual meeting of the two supranational financial institutions between 9–11 October. Hard data on the state of the global economy will come from China, reporting trade figures on 13 October, and from the US, reporting retail sales figures the day after.

Deeper dive

Why high yield bonds look better in the Eurozone than the US

Watch this week's
UBS House View Weekly Video

Philipp Schöttler

The high yield (HY) market in the US has done investors proud in recent years. Since late 2011, when CIO first recommended the asset class, it has delivered an average annual total return of 6.5%. Even during the latest market downturn, US high yield fell less than stocks.

But while we still see the appeal of US high yield bonds, the risks surrounding the asset class have increased. By contrast, high yield issuers in the Eurozone offer appealing returns with a higher degree of safety.

Let's start with the positives. As part of a long-term strategic portfolio, US high yield bonds remain attractive – offering an 8.1% yield-to-maturity with a volatility that is about half that of the S&P 500. The market also has a history of recovering swiftly from setbacks. It took US HY just eight months to return to its previous peak following the 2008 crisis, compared to about four years for the S&P 500.

Even the short-term outlook is far from grim. The recent bout of risk aversion has left US HY trading at a relatively generous 650 basis point spread over equivalent government bonds, against an 18-year average of roughly 500 basis points. We believe this will fall back to 525bps as investors recover their appetite for risk assets over the coming six months. The average US high yield issuer currently is not struggling to service debt – trailing EBITA (a measure of available cash flow) of 3.3 times average interest costs is still above its 15-year average.

So why fret? The main concern is that US companies have been taking on more debt – a sign of a mature credit cycle. Net debt has climbed to 4.5 times 12-month trailing EBITDA, its highest level since 2008. More of this borrowed money is also being used to finance corporate takeovers – about 30% at present compared to just 13% in 2013 – as opposed to strengthening balance sheets by refinancing existing debt.

Also, the heavy exposure of US HY to energy – about 14% of the index against 5% in the Eurozone – has become a heavier drag. Crude prices have remained lower for longer than many forecasters expected, increasing the danger of default – which for US HY we expect to rise to 4.5% over the coming 12 months from 2.8% over the past 12 months.

Both of these headwinds explain why we no longer believe investors should hold positions above their longer term strategic exposure.

However, as mentioned above, the Eurozone outlook is less cloudy. Issuers in the Eurozone have been cautious about taking on fresh debt. The leverage ratio has remained remarkably stable at around 3 times since the 2008 crisis. Credit ratings for the Eurozone are correspondingly higher, with just 8% of outstanding bonds rated CCC and lower, against 17% in the US index. With an attractive 530bps spread and a yield-to-maturity of 5.7%, the asset class should deliver a return of 2–3% over the coming six months with a lower level of risk.

Philipp Schöttler
Global Investment Office

Bottom line

US high yield bonds remain an appealing long-term investment. But short-term risks have risen as US issuers continue taking on higher debt loads, often to buy other companies rather than to finance existing debt. With oil prices still low, the large weighting of the group to energy heightens the risk of defaults. Eurozone high yield, by contrast, offers the prospect of strong returns with less risk.

Podcast
www.ubs.com/podcast

In memoriam

Missing postcards

Mike Ryan, Regional CIO WM US

Andreas Hoefert, 1967–2015

Andreas Hoefert, our Chief Global Economist and dear friend, passed away on the morning of Tuesday, October 6 2015, after suffering an apparent heart attack, at the tragically tender age of 48.

Andreas was not only a trusted colleague but a valued mentor – a role he served both for investment professionals and for the many investors around the world who followed his sage advice. Those of us who had the great fortune to work side by side with Andreas over these many years were amazed by the strength and scope of his intellect. By simply stepping into Andreas's office, you were able to glimpse both the depth and breadth of his intellectual pursuits. Texts on macroeconomic theory, behavioral finance, and geopolitics would share shelf space with books on quantum physics, molecular biology, and statistical analysis. The classical works of Plato and Aristotle sat side by side on his desk with Joyce's *Ulysses* and Whitman's *Leaves of Grass*.

But Andreas did not just read books; he devoured them with a seemingly insatiable appetite. His grasp of the material – almost regardless of the subject matter – was always commanding and deep, and his reasoning flawless. But Andreas was not a selfish intellectual. He joyously shared his insights and passed along his passions to anyone fortunate enough to cross paths with him. He would often stroll into my office with a book he had recently purchased for me that he thought I might find interesting. I learned very quickly that if Andreas was recommending it, then I was interested in reading it. Because while my own intellect is undisciplined and prone to distraction, his was focused and committed. He was among the most brilliant and insightful men I have ever met.

He became my intellectual North Star, and I will miss that guiding presence in my life.

Of course, someone as gifted and passionate as Andreas could never be defined merely by what he read, but rather by what he did. Andreas's many varied interests included jazz, photography, cooking, sports, wine, and – my own personal favorite – beer. He had multiple iPods loaded with his extensive jazz collection, and would also somehow include in his exhaustive travel schedule a visit to a local jazz club in whatever city he happened to be. Andreas would often show up at events with a camera in tow to document seemingly ordinary milestones the import of which would only become apparent to the rest of us with time. He could cook a mean ratatouille, select the perfect cabernet sauvignon, and identify the best craft IPA in any American city – you could say he was the "most interesting man in the world" long before there ever was a "most interesting man in the world."

But perhaps Andreas's greatest passion was his love of sport. His interest ran so deep that he once built an econometric model and framework for selecting the World Cup champions. I recall watching the pundits scoff when Andreas predicted in 2006 that Italy would win the Cup, and later enjoyed seeing them all try to sheepishly explain how they really knew the Italians would win all along. Others might have beaten their chests in vindication, but Andreas simply smiled. I once tested just how far his love of sport would extend by inviting him to my home for Super Bowl Sunday. Despite his protestations that there was simply no comparison to "the beautiful game," Andreas was soon sucked in by the moment, cheering with full throat for the Pittsburgh Steelers. In the years that followed, he developed an appreciation for the New England Patriots that he shared with my wife. I can't tell you how much I enjoyed listening to Andreas and Tracy lament how all the experts still were underrating Tom Brady as a quarterback.

Andreas taught me the importance of living a full and robust life beyond the office – a lesson I am still working to perfect.

But it is neither his intellect nor his interests that ultimately defines Andreas's legacy; rather, it was his

Missing postcards

humility, his humanity and his sense of humor. Despite his soaring intellect and broad interests, the thing that always struck me most about Andreas was his genuinely humble nature. He was, to anyone who came in contact with him, a "regular guy." He had neither a pretentious nor a condescending bone in his body. Doormen and mailroom clerks were afforded the same level of respect as corporate CEOs and central bank heads. What's more, he was – in all ways and at all times – comfortable in his own skin. Andreas never sought to be anybody but himself. He was simply the "big man" – caring, gentle and kind.

Andreas also loved deeply and fearlessly: he admired his parents, adored his wife, and embraced his many friends. He looked up to his father with pride, and cared for his mother with devotion. Jacqueline was the love of his life, and the enduring nature of their relationship somehow defied both time and distance. He was also as dedicated and loyal a friend as you could ever hope to find. He was wise in his counsel, generous with his time, and unwavering in his support for his friends. Among the Irish, we call that type of man a "solid man."

Andreas was indeed a "solid man."

There is so much more that I and others could share, but I thought it more appropriate to close with one story that captures so much of who Andreas was. During his extensive travels, both personal and professional, Andreas would always take time out to send postcards to friends and family. They would be short notes that helped you track where he had been and what he had been doing. My family and I were fortunate enough to be included as part of this little ritual. My girls, who were still young when they first met Andreas, loved to get the colorful postcards from exotic locales and dream destinations. Whenever we received a card, the girls would break out the map (mind you, this was before Google Earth) to track where Andreas had been. He taught my girls more about geography than any teacher ever could – he made it personal for them.

Once when we were both at an offsite event in Singapore, I was headed to join the rest of the group for cocktails at the bar after a long and eventful day. As I passed the front desk, I ran into Andreas who was still poring over postcards. When I asked him whom they were for, he simply told me that he was sending them to "Tracy and the girls" – my wife and daughters. I asked him to send along my regards as well – and he did.

Although he was eight years my junior, there was so much that I learned from Andreas in the years that we worked together. He taught me how to be more disciplined intellectually, while also being more actively engaged in the world around me. He helped me learn what true humility is all about and just how important it is to embrace our humanity. There is still so much I needed to learn from him, but will now never get the chance.

I will miss the postcards. I will miss my friend.

Kind regards,

Mike Ryan, CFA
Chief Investment Strategist, WMA

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