UBS House View

Europe
Chief Investment Office WM

Weekly

12 November 2015

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Market moves

	CIO view	–1w	– 3m	ytd
S&P 500		–1.3%	0.0%	2.6%
Euro Stoxx 50	OW	–0.2%	–1.0%	12.8%
MSCI EM		–3.6%	–2.8%	–10.7%
FTSE 100	UW	–1.6%	–3.3%	–0.9%
SMI		–1.2%	–3.2%	1.9%
NIKKEI 225	OW	3.0%	–2.7%	14.7%
US high grade bonds	UW	–0.3%	0.1%	2.1%
Euro high grade bonds	UW	0.3%	1.0%	1.9%
US investment grade bonds	OW	–0.5%	–0.5%	–0.5%
Euro investment grade bonds	OW	0.1%	–0.2%	–0.4%
US high yield bonds		–1.4%	–0.8%	–1.4%
European high yield bonds	OW	0.0%	0.8%	2.9%
EM sovereign bonds		–1.0%	0.5%	2.2%
EM corporate bonds		–0.5%	–0.5%	3.0%

Source: Bloomberg, UBS as of 12 November 2015
OW = tactical overweight
UW = tactical underweight

Market comments

Calculations are based on the past five days

- **Global equities** gave up some of their recent gains. The S&P 500 lost 1.3% and the Euro Stoxx 50 retreated 0.2%. The FTSE 100 sunk 1.6%. Emerging market equities fell 3.6%.
- **Japanese stocks** were the exception – the Nikkei 225 was up 3% over the past five trading days.
- In **fixed income**, US high yield bonds fell 1.4% while European high yield held steady. US high grade bonds declined 0.3%.
- In **foreign exchange markets**, the euro continued to fall with EURUSD down 1.3% to 1.07. Mounting expectations for a December rate hike by the Federal Reserve and further easing from the European Central Bank contributed to the euro's weakness.

In focus

US employment growth surpassed expectations, with 271,000 net new jobs created in October. The labor market improvement boosts the chances of a December Federal Reserve rate hike. *CIO is neutral on US equities.* Worker pay also climbed by 2.5% in the year to October, the most in six years. This figure had been stuck close to 2% since the US emerged from recession in mid-2009. Unemployment fell to 5% from 5.1%, a rate not seen since April 2008. Under-employment, which includes part-time workers who would prefer full-time positions, fell to 9.8%, its lowest level since May 2008.

Chinese data for October reveals a two-speed economy, with accelerating retail sales and slowing industrial production. Industrial output climbed just 5.6%, matching the slowest release since 2008. Retail sales beat expectations by expanding 11%, their fastest pace this year. Sales for internet retailer Alibaba exceeded USD 14bn on "Single's Day" (11/11), a record that more than doubled the USD 6bn in 2013. "Single's Day" is now the largest online shopping day in the world (overtaking the US's Black Friday).

Trade figures for China showed continued weakness. Exports fell 6.9% and imports slumped 18.8% y/y in October, leaving the country with a record trade surplus of USD 61.64bn, according to official figures. *CIO does not expect a hard landing in China.*

ECB President Mario Draghi stressed "downside risks" from the global economy. Speaking in Brussels on regulation, he also offered some thoughts on the outlook for growth. He argued that "downside risks stemming from global growth and trade are clearly visible. Moreover, inflation dynamics have somewhat weakened." Draghi added that the ECB stood ready to take action if necessary, hinting that quantitative easing (QE) could be expanded. "We have always said that our purchases would run beyond end-September 2016 [the provisional end date for QE] in case we do not see a sustained adjustment in the path of inflation."

French industrial production rose by 1.8% in the year to September. Month-on-month output growth beat expectations, climbing 0.1% rather than falling 0.4% as analysts had expected. The solid figures were a positive signal from Europe's second-largest economy.

Copper fell to a near six-year low on weak Chinese data. The red metal hit USD 4,944 a tonne, only slightly above the multi-year nadir of USD 4,920 reached in August. Copper has been under pressure partly as a result of slowing demand growth as China's housing construction surge has come to an end.

UK house prices could rise by 25% over the coming five years, according to an estimate by the Royal Institute of Chartered Surveyors. In October, 49% of surveyors reported house prices rising rather than falling in the country, up from 44% in September. The institute's chief economist Simon Rubinsohn said that rising house prices stemmed from reduced supply, the legacy of a drop in building activity following the global financial crisis in 2008.

UBS

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Deeper dive

Why we are still fond of funds

Watch this week's
UBS House View Weekly Video

Karim Cherif

Hedge funds started the fourth quarter on a strong footing, partially recouping some of the losses recorded during the summer.

- The HFRI Fund Weighted Index: +1.7% in October, making year-to-date (YTD) performance just about flat.
- Equity-hedge managers: + 3.16% on the month (+0.65% YTD)
- Event-driven: +1.72% (–1.41% YTD); CIO-preferred strategies merger arbitrage and special situations are up 1.33% (+2.56% YTD) and 2.42% (–1.91% YTD), respectively.
- Relative-value strategies: +1.75% (+1.76% YTD).
- Macro managers underperformed: –0.51% on the month and –1.54% for the year.

October's performance can be mainly attributed to the sharp rebound in global financial markets, particularly in risky assets, thanks to healthy economic data and supportive central bank action. However, compared to other asset classes (e.g. equities) hedge funds only partially captured the strong market rally, suggesting that, on average, managers are still running low net exposures and are generally defensively positioned. This in combination with this year's flat performance has led to renewed discussion among investors about the role of hedge funds within a multi-asset class portfolio.

In our view, comparing long-only equity performance to broad hedge fund performance on an absolute basis is misleading. Many hedge fund strategies have no, or only limited, exposure to equities. Also, in terms of volatility, hedge funds are more like bonds than equities. Importantly, investors often forget that the true value of a hedge fund within an asset allocation emerges in times when markets are less predictable and certain. We've said before that hedge funds, because they are actively managed and target asymmetric returns, are unique diversifiers/stabilizers in a portfolio. This was also the case in the most recent market correction. From May to September, a broad hedge fund index declined by about 5% while global equities lost about 10% and US high yield bonds lost about 6.5%.

In future, returns should become increasingly difficult to generate and volatility should also increase slightly, making active risk management ever more crucial. Investors should therefore keep a portion of their portfolio active to serve as a hedge against downside risks which long-only investment instruments cannot provide on their own. However, not all hedge fund strategies are alike, and any individual strategy could underperform in a particular period. For this reason, a hedge fund portfolio diversified across various managers and strategies is the best way to achieve stability.

Karim Cherif
Hedge fund analyst

Bottom line

Hedge funds have had a flat year, even after a strong showing in October. This has caused some to question the value of holding the asset class. We think hedge funds continue to provide an attractive source of return, and also help stabilize portfolios in volatile times. Given the disparate performance among different investment styles and managers, diversification is key to getting the most out of hedge funds.

Regional view

The UK's referendum debate enters the next phase

Podcast
www.ubs.com/podcast

Dean Turner, CFA
Economist, UBS AG

"We are leaving our BREXIT risk probability at 10–20%."

This week UK Prime Minister David Cameron submitted his long-awaited list of proposed EU reforms to Donald Tusk, president of the European Council (EC). Cameron has strongly implied that his support for the UK remaining in the EU depends on reaching agreement on all of them. Much as expected, he highlighted in his letter:

- Economic governance: ensuring fair and equal treatment of countries not part of the euro.
- Competitiveness: increasing it by reducing bureaucracy and promoting the free flow of capital, goods and services.
- Sovereignty: hammering out a legally binding and irreversible end to the UK's commitment to "ever closer union."
- Immigration: reducing welfare benefits to new EU migrants, and limits on immigration from any new member states.

The proposals are likely to be discussed at the December EC meeting, which raises two important questions: Will there be agreement on them? And, if adopted, are they enough for Cameron to win the referendum on the UK's EU membership?

We are cautiously optimistic that agreement will be reached, especially with regard to the first three proposals. Only the UK and Denmark have formal opt-outs of the single currency, but nine of the current 28 EU member states are outside the euro, and are unlikely to join soon. More than one currency in the EU is going to be a reality for many years to come; so safeguards for non-members should not prove too controversial. As for competitiveness, again we think there will be little opposition as this builds on plans already proposed by Eurogroup President Jerome Dijsselbloem. When it comes to sovereignty, the UK should find support from a number of fellow member states, so formalizing this proposal should not be the most contentious issue. Immigration may be the toughest area of negotiation, especially with some of the newer, eastern European members. But Cameron has offered some flexibility here as he is willing to engage in further discussions to find a solution. So it seems that even this point may not represent too high a hurdle.

From a European perspective, it seems that the UK's proposals are not insurmountable even if they may appear, to some, unnecessary. It is widely recognized on both sides that the benefits of the UK remaining in the EU far outweigh what look to be relatively small costs. An EU without the UK would be weaker not just economically but politically. To us, this implies that an agreement could be concluded relatively soon, paving the way for the referendum to take place next year.

The second question, regarding eventual victory, is much harder to answer. In our view, much will depend on whether Cameron campaigns to remain in. Recent polling indicates a rising share of UK citizens wishing to leave the EU. But support for staying put increases if the Prime Minister favors it. Taking the most recent developments into account, we are leaving our BREXIT risk probability at 10–20%, but appreciate that things can change swiftly.

Kind regards,
Dean Turner

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