UBS House View

Europe
Chief Investment Office WM

Weekly

15 October 2015

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Market moves

	CIO view	*–1w*	*– 3m*	*ytd*
S&P 500		–0.1%	–4.9%	–1.5%
Euro Stoxx 50	OW	0.3%	–10.5%	5.9%
MSCI EM	UW	0.1%	–8.8%	–9.1%
FTSE 100	UW	–0.6%	–5.1%	–0.2%
SMI		–0.8%	–7.5%	–1.3%
NIKKEI 225	OW	–1.2%	–11.0%	5.2%
US high grade bonds	UW	0.6%	2.4%	3.7%
Euro high grade bonds	UW	0.5%	2.1%	1.3%
US investment grade bonds	OW	0.6%	1.9%	0.9%
Euro investment grade bonds	OW	0.3%	0.2%	–1.0%
US high yield bonds		1.7%	–3.1%	–1.2%
European high yield bonds	OW	0.3%	–1.1%	1.1%
EM sovereign bonds		0.4%	0.2%	2.1%
EM corporate bonds		0.5%	–1.5%	2.5%

Source: Bloomberg, UBS as of 15 October 2015
OW = tactical overweight
UW = tactical underweight

Market comments
Calculations are based on the past five days

- **Global equities** were mixed, giving up part of the ground gained in the previous week.
- In **fixed income**, the yield on the US 10-year Treasury fell 11 basis points to 1.9%. Yields also fell across Europe, with the exception of Portugal and Greece.
- Commodities joined the rally in risk assets with **crude oil (Brent +7.6%, WTI +7.1%)** standing out.
- In **foreign exchange**, the EUR strengthened 1.4% against the USD to 1.14. The GBP gained almost 1% versus the USD to 1.55.

In focus

Key Federal Reserve officials indicated that a rate hike was on the cards this year. New York Fed President Bill Dudley commented on monetary policy for the first time since September's disappointing employment data, advocating higher rates this year. Atlanta's Fed President Dennis Lockhart also indicated that he expects a rate hike "later this year at the October or December FOMC meetings as likely appropriate," but noted the need to closely monitor upcoming data for consumer activity. *CIO continues to expect a liftoff in December.*

OPEC believes rival US oil producers will reduce production further. Slower output growth outside the cartel would help support higher oil prices. *CIO expects Brent to reach USD 72/bbl over the coming 6–12 months.* OPEC forecasts US production will drop to 13.4mbpd in 4Q 2015, down from 13.8mbpd in 2Q and 13.5mbpd in 3Q. The cartel revised lower its forecast for both 2015 and 2016 non-OPEC supply by 200,000bpd and 500,000bpd respectively from last month's report.

China's central bank expanded its bank lending program. This should help lower funding costs and support the real economy; CIO still expects further easing measures to support China's growth. After last year's introduction of the bank lending program in Shandong and Guangdong provinces, the latest program means lenders in more Chinese cities and provinces, including Beijing and Shanghai, will be able to borrow from the central bank using loan assets as collateral.

The VIX index, which measures the expected implied volatility of US stocks from options values, managed its 10th consecutive daily fall. That is only the third time in the past decade we have seen a downhill run lasting this long. In the six months after the last such spree – in October 2009 – the S&P 500 climbed almost 10%. The prior occasion, in May 2005, was followed by a 6% rise in the US equity index. *CIO is neutral US equities, believing that Eurozone and Japanese markets will offer superior risk-adjusted rates of return.* But the fall in the VIX is nonetheless an encouraging sign that global sentiment may be recovering.

India's inflation accelerated in September while industrial output beat forecasts. Despite the rise, inflation was well below the RBI's 6% target by January 2016, suggesting the central bank still has room for more easing measures. *CIO is overweight on Indian stocks.* India's CPI rose 4.4% y/y in September, versus August's revised 3.7% rise, while industrial production grew 6.4% y/y in August, above expectations for a 4.8% rise.

Deflation resurfaced in the UK, with prices falling 0.1% in September. In combination with a soft 1% rise in ex-food and energy consumer price index, the data confirms that there is little pressure on the Bank of England to raise rates in a rush. Headline inflation was last negative in April.

Deeper dive

Will the rebound continue?

Watch this week's
UBS House View Weekly Video

Christopher Swann

Optimism seems to have returned as mysteriously as it had vanished. With no clear catalyst, risk assets have enjoyed one of the fastest revivals since the collapse of Lehman in 2008. The MSCI All Country World Index, the broadest gauge of global equities, has jumped 7% since sentiment suddenly improved on 29 September. The VIX measure of equity market volatility declined for 10 consecutive days, the most consistent fall since 2009 and only the third such stretch over the past decade.

After a punishing summer, the main question for investors is whether this revival can last. With a few caveats, we believe it can.

Predicting shorter-term moves is harder in a market that has become detached from fundamentals. Markets gave up some of the recent gains on Monday – even before the release of disappointing import figures from China that might have justified a more sober mood. This is in keeping with recent months. Neither the sharp slide in risk assets in August nor the October revival has been driven by economic data surprises.

That said, we believe that economic and earnings data for the third quarter from the US, the Eurozone and Japan will be relatively positive. This should promote the market rebound and refocus attention on the fundamentals.

The drivers of the rebound
The anatomy of the rebound is likely to change from here. The biggest gainers so far have been emerging markets and commodities. Brazil's benchmark equity index, the Bovespa, has been close to the top of the rankings with a gain of 13% in dollar terms along with Hong Kong's Hang Seng, which has added 11%.

Among raw materials, industrial metals are up, explaining a 7% rally in the basic resources sector in the European Stoxx 600, which has climbed 24%.

We attribute this mostly to a normalization from an extreme level of negativity. We would not expect the pace of improvement to be maintained. The outlook for emerging markets continues to be clouded by weak corporate earnings growth along with slow economic growth for many. Earnings growth for the MSCI, we believe, is likely to be just 4–6% over the coming 12 months, with even worse prospects for commodity-reliant nations like Brazil and Malaysia. We remain underweight on emerging markets and UK equities.

Which assets are likely to rise further?
While Eurozone and Japanese equities have both rebounded by 7% since 29 September, they have lagged emerging markets. That pecking order should reverse if the rally matures. The economies of both the Eurozone and Japan are backed by highly supportive monetary policy and we are expecting corporate earnings growth of 12–15% and 18% respectively – far faster than for emerging markets. We overweight both Eurozone and Japanese equities.

A more exotic area where we remain positive is in the Eurozone dividend futures market, which also suffered from a sell-off during the recent market volatility. Fundamentally, we still expect companies to raise their dividends in the years ahead. However, the market is currently expecting dividend cuts. While there are risks, we forecast a return of 7–12% over the next 15 months in Euro Stoxx 50 dividend futures.

Christopher Swann
Global Investment Office

Bottom line

CIO believes that the drop in risk assets reflected excessive pessimism over the global outlook. The rebound suggests that markets may be returning to a more realistic assessment of fundamentals. But investors should still expect volatility and temporary setbacks. The principal beneficiaries of the recovery in risk appetite are also likely to shift, with Eurozone and Japanese equities taking over from emerging markets.

Regional view

No rate hikes without inflationary pressure

Podcast
www.ubs.com/podcast

Daniel Kalt
Regional CIO Switzerland

Seven years ago amid the global financial crisis, the US Federal Reserve as the first of the major central banks opened the monetary floodgates and began pumping liquidity into the financial system on an unprecedented scale. Since the end of 2008, the Fed has quintupled the US money supply, while the European Central Bank has doubled the supply of euros. The Swiss National Bank has increased the money supply by a factor of 10 as a result of its interventions in the foreign exchange market. Textbook economics suggest inflation should have risen significantly at the very latest three to four years following such a dramatic global expansion of money supply. But we've seen nothing of the kind. In the US, the personal consumption expenditures core rate remains stuck at a low 1.3%. Core inflation is running at a mere 0.9% in the Eurozone as well, and at –0.7% in Switzerland.

Signs of rising inflation would be a clear reason for central banks to abandon their years-long zero-interest rate policy and cautiously lift key rates off the zero bound. But even in the US, the country that has enjoyed the most sustained recovery since the financial crisis, indications of higher inflation have not been compelling enough to date to prompt the Fed to normalize the interest rate environment.

The labor market, however, has been the key restraint to global inflation. With unemployment rates still high across much of Europe, the price of labor (its cost) remains under pressure. We would need to see workforce shortages prevailing in labor markets worldwide in order for inflationary pressures to build and a wage-price spiral to ensue.

"There are good reasons that inflation has not yet risen, despite the historical flood of money."

There are good reasons that inflation has not yet risen, despite the historical flood of money. Commodity prices have been in a sharp decline for some time, in particular with the price of crude oil tumbling. But even if we strip out the effects of the commodity price collapse on consumer price indices and observe the core inflation rates, inflation still remains well below the critical 2% level. So other forces must also be at work. Healthcare system reform in the US initiated by President Barack Obama is slowing the pace at which healthcare costs rise, but this is expected to have only a temporary dampening effect on the trend observed in most developed countries toward massively rising healthcare costs. Furthermore, the aging of Western societies is exerting downward pressure on economic momentum, in turn making price increases more difficult.

In the US as well as in the UK, where the labor market recovery has progressed the furthest, the first signs are emerging that such a development could soon be set in motion. This explains the considerable emphasis that the Fed is placing on the labor market trend and that undoubtedly will soon persuade the Fed to deliver an initial rate hike despite international uncertainty, assuming that nothing goes dramatically awry in the global economy.

Kind regards,
Daniel Kalt

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