

UBS Asset Management Flash Commentary

ECB raises hopes of further monetary easing but sentiment remains fragile

- Global investor sentiment remains fragile, but ECB president Draghi delivers some respite by signalling further monetary easing ahead
- Oil and other commodity price weakness, uncertainty about Chinese economic and financial market developments and the behavior of market participants continue to weigh on risk appetite

Draghi seeks to reassure investors

In a week which saw many equity markets, including the US and Japan, hover in correction territory, European Central Bank (ECB) president Mario Draghi gave troubled investors some relief at the 21 January meeting of the ECB's Governing Council. With interest rates left unchanged, both the statement and press conference clearly leaned towards the dovish side.

President Draghi acknowledged that since December's meeting, further drops in the price of oil, the appreciation in the euro and signs of weakness in emerging markets have substantially increased the downside risks to growth, particularly inflation. On the back of such a deteriorating outlook Draghi raised the prospect of further monetary easing, hinting at more policy enhancements to come, possibly in March. Sentiment is also being supported by the prospect of a better than expected US earnings season.

Many riskier assets rose sharply in the immediate aftermath of Draghi's press conference, having fallen to multi-year lows in earlier trading sessions.

The broader landscape remains challenging for investors, however. Headwinds include the declining oil price, concerns about global growth and a Chinese hard landing, as well as the current, unpredictable investment environment that is characterized by often price-insensitive selling and liquidity constraints in market segments such as US high yield. At least in

the very short term, there appears to have been a shift in focus away from the fundamental drivers of asset prices.

Against this backdrop, investors from across UBS Asset Management share some of the potential implications on their strategies of the relatively tumultuous start to 2016.

Implications for our Fixed Income portfolios

Not surprisingly, sovereign bond markets have benefited from general risk aversion and yields have moved lower in many developed markets. Following the equity sell-off and a slightly softer consumer price inflation reading yesterday, the 10-year US Treasury yield, for example, dropped below 2% for the first time since the fall. Meanwhile, on the heels of the ECB meeting and Draghi's dovish press conference comments, the 10-year Bund moved to 38 basis points.

Credit assets have generally underperformed. Credit markets remain extremely bifurcated with oil and commodity segments under severe pressure while the broader market is affected by general risk aversion. The good news is we have started to see some non-traditional buyers enter the high yield market.

For now, in our US and EUR high yield strategies we continue to hold cash as a liquidity buffer, but may look to add risk. With option-adjusted spreads (OAS) over 8% and 6% for the broad US and EUR

high yield markets, respectively, we see the potential for select buying opportunities.

Implications for our Multi-Asset portfolios

Such sharp market movements have led us to become concerned about the growing impact of non-fundamental drivers of asset prices. We believe that one factor behind the corrections in several markets could be the large-scale disposal of assets by non-economic sellers, such as investment vehicles that are forced to sell if the price of a certain asset crosses a specific threshold.

Economic fundamentals remain in place for many of the trades that we hold across our portfolios, but we have entered 2016 with a cautious stance. While in recent years we have been either directionally long or neutral on risk assets, we may look to implement more relative value trades, particularly positions that offer diversification benefits. Our portfolios have benefited from diversifying trades,

including a long Japanese yen vs. US dollar position.

Implications for our Equity portfolios

Equity markets have been particularly hard hit by recent events with a decline of around 10%, and the broad Global equity index technically entering a bear market (defined as a fall of 20% from the peak). Volatility has also increased to above average levels with the VIX hitting close to 30%.

The sell-off has been broadly based with emerging markets especially hard hit. Cyclical stocks have underperformed defensives, value has underperformed growth, and there has been a pronounced decline in mining and energy shares influenced by the further fall in commodity prices.

Equity market valuations have fallen to attractive levels, both against history and other asset classes, while valuation spreads have widened. Even though we may be entering a period of higher volatility, this does provide excellent opportunities for active investors to take advantage of the short-term dislocation.

For more information, please contact your regular UBS Asset Management representative

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