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UBS Asset Management Flash Commentary

Market Update from the Multi Asset team

Since January, investors' appetite for risk assets has diminished significantly – reflected in a sharp sell-off in both equity and credit markets.

Andreas Koester, Head of Multi Asset reviews investors' concerns.

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What has changed in markets?

Perhaps the biggest concern driving investors' behaviour at present is the financial sector. In the past few weeks the spotlight has turned on the weak capital position of a number of European banks and the broader sector's exposure to both Asian and high yield default risk.

Clearly, banks remain the primary transmission mechanism for capital to the wider economy and any impairment to their ability to lend has obvious implications for broader demand.

To be clear, we do not ascribe a high probability of a repeat of 2007/8, but the risks of a more significant negative event have clearly risen.

Meanwhile, the sell-off in credit markets that started in December has accelerated. Initially the focus was just on high yield where energy-related borrowers constitute a large part of the investment universe. But concerns have now broadened to include higher quality Investment Grade borrowers. The sharpness and breadth of the credit sell-off is itself worrying equity investors.

Other investor fears impacting markets have been around a little longer, but have become heightened in recent weeks. These include

- The negative feedback loop from lower oil and its implications for global growth and for the further selling of risk assets by petro-Sovereign Wealth Funds.
- In Asia, high levels of indebtedness are also causing concern and clouding the outlook for growth as the necessary process of deleveraging takes place. Emerging market currency weakness v USD is also increasing the cost of servicing this debt.
- Continued uncertainty about China's transition from a manufacturing- to a consumption-led economy.
- The slowdown in global manufacturing activity.
- A growing consensus that the effectiveness of central banks' quantitative easing programs in boosting consumer price inflation and economic growth may be waning.
- The influence of Target Risk and Risk Parity funds that are effectively forced sellers of risk assets as volatility and correlations rise with market falls.
- Illiquidity which means the price impact of these concerns is exacerbated. Illiquidity is more noticeable in credit markets than equity markets but is still prevalent in both.

Equities

It is important to note that the fundamental backdrop to equities has not suddenly become outright negative. Broadly, equity markets are fair value within an historical context with selected markets outright attractive. Central bank policy remains supportive.

But there are now more material headwinds to progress. In recent weeks the corporate earnings season in developed markets has disappointed. Reported profits from companies have been lower than expected, reinforcing the notion of slowing demand growth and profits momentum.

By definition, equity investors pay for growth. And with the outlook for profits diminishing with the economic backdrop, investors are questioning:

- Their earnings forecasts.
- The price - or multiple – that they should be paying if growth is likely to stay low for a protracted period or is impacted more significantly by financial sector stress.

In short, equity investors are demanding a higher risk premium for investing. Moreover, with the significant widening of corporate bond yields, equities are not as attractively valued on a relative basis as has been the case for most of the past six years.

Government bonds

In a historical context, developed market government bonds are expensive – but their attractions to investors are obvious when risk aversion is so high and the focus is on capital preservation rather than capital growth.

Investment Grade and High Yield debt

Once again we would highlight that in a long-term context, both High Yield (HY) and Investment Grade (IG) debt now look attractive.

But with such uncertainty surrounding the likelihood of default in HY in particular, returns on a shorter-term horizon are difficult to estimate regardless of the longer-term valuation case.

Our view is that much of the IG universe has been unfairly tarred with the same brush as HY and arguably now has a more negative outlook priced in than equities.

Conclusions

To reiterate, we do not believe that the fundamental backdrop to risk assets is outright negative. Yes, the backdrop is slowing. But valuations are generally supportive in a long-term context based on current cash rates.

What has changed is the likelihood of more significant market drawdowns and the risks to investors' portfolios in the shorter- term.

We will continue to assess the changing probability of this outturn closely and position clients' Multi Asset portfolios accordingly.

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

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