CIO Note

4 January 2016

Chief Investment Office WM

A volatile start to 2016

What has happened?

2016 began on a sour note for global equity markets. A 7% fall in onshore Chinese shares triggered a halt to trading and led to broader equity weakness across Asia. Meanwhile, rising tensions between Saudi Arabia and Iran have added to global risk aversion. Additionally, data from the US pointed to the slowest pace of manufacturing activity since 2009. These developments overshadowed more positive news from the Eurozone, leading to a sell-off in global risk assets and a rise in safe-haven investments such as government bonds.

CIO believes that the six month outlook for equities remains positive, supported by solid economic growth in the large developed nations, and rising corporate profits. But the unusually turbulent start to 2016 trading sets the tone for what is likely to be another volatile year. In a low growth environment, markets are still evaluating the ability of global central banks to help stimulate growth now that the US Federal Reserve has begun to hike interest rates. This uncertainty is likely to accentuate volatility in 2016. We will need to remain vigilant for signs of deterioration in the prospects for global markets, with credit spreads, global economic indicators, the path of the Chinese renminbi, and the Middle East in particular focus. But for now, we do not believe the fundamental situation has materially changed enough to warrant a shift in positioning. In our global Tactical Asset Allocation (TAA), we remain overweight in Eurozone equities, Japanese equities, and European high yield credit against high grade bonds.

What is driving current price moves?

China: The 7% slump in onshore Chinese equities appears to have been led by technical factors, as government efforts to prop up the market from the summer of 2015 now lapse. In particular, a rule preventing investors who hold more than 5% of a company's free-float stock from selling is scheduled to expire on Friday, having been in place since the middle of last year. This may have driven some retail investors to reduce exposure ahead of potentially large institutional sales later in the week. A sharp fall in the Chinese currency against the US dollar added to investor anxiety.

Mixed economic data may have also contributed to negative sentiment. The Caixin manufacturing purchasing managers' index (PMI) fell below expectations, signaling the 10^{th} consecutive month of contraction. Still, the data did not mark a significant deterioration, and the official non-manufacturing PMI pointed to the strongest level of activity since August 2014. Other measures, such as retail sales, remain robust.

Oil / the Middle East: Markets were further unsettled by Saudi Arabia's decision to sever diplomatic links with Iran following demonstrations over the execution of a Shia cleric. Bahrain, Sudan, and the United Arab Emirates also scaled back diplomatic ties with Iran. Investors were further troubled by the Islamic State's territorial encroachments in Libya, which are nearing oil installations.

Economic data: The soft tone was reinforced by US economic figures that showed the manufacturing sector slowing to its weakest pace since 2009. That said, the details of the report were more favorable, with production and new orders components both edging up. In the Eurozone, Markit's manufacturing PMI hit its highest level since April 2014. Every country in the zone registered rising output and job creation in December.

Where do we stand?

We do not believe that the fundamental economic backdrop has materially changed. At a global level, services sectors continue to perform well, while manufacturing remains troubled. China's growth is slowing, but it is transitioning toward a consumer-led economy. Growth in the developed markets is uninspiring but positive. The sharp decline in oil prices is creating dislocations in some credit markets, but ultimately should benefit consumers. Emerging markets remain beset by political concerns and issues with their cost of financing, but the malaise is not translating into crisis.

As such, we keep our investment positioning unchanged. We remain overweight in Eurozone and Japanese equities, and in European high yield credit, within our global Tactical Asset Allocation (TAA).

However, we acknowledge that the market's assessment of potential downside risks, particularly with respect to China, has changed. Consequently, the price the market is willing to pay for future earnings has, for now, fallen.

From here, we will be watching a number of factors which will determine whether our more positive view, or the market's more pessimistic take, is correct:

- **Credit spreads:** A key transmission mechanism between market uncertainty and fundamental economic factors is the change in credit market pricing. Weakness in oil markets is leading to higher credit spreads for energy-linked companies. There are signs, in the US in particular, that this could spread beyond the energy sector. Disappointments in growth or policy accommodation in China could lead to a higher rate of debt defaults and restructuring across global emerging markets.

  In our base case, we expect only a modest rise in US high yield defaults, and we believe that markets provide sufficient compensation for downside risks, while in the Eurozone, accommodative central bank policy should keep credit conditions favorable. We remain overweight in European high yield credit in our global TAA. However, we will watch for signs that higher corporate borrowing costs, in both developed and emerging markets, are having a lasting negative impact on growth.

- **Global economic indicators:** Part of the concern in markets today, and in recent weeks, has been over global growth, with manufacturing indices signaling weakness. We believe that this poor manufacturing data, driven largely by commodity price volatility and uncertainty in China, will not lead to weaker performance for the larger, and more economically significant, services sectors. We believe that strong services and jobs growth data justify our positive stance on equities. However we will continue to monitor these data points closely.

- **The Chinese renminbi:** In our base case, we expect the Chinese currency to weaken, but only modestly, toward 6.80 against the US dollar in 12 months. In this scenario, we do not believe that the yuan would act as a major driver for financial markets. However, a key risk to this view is the possibility that a disorderly depreciation of the Chinese renminbi, or uncertainty over its management, drives greater regional currency volatility and global deflationary pressure.

- **The Middle East / oil:** We do not believe this latest rise in tensions between Saudi Arabia and Iran is severe enough to alter the outlook for global oil markets in 2016. That said, investors will need to continue to watch the situation in case of a more serious worsening in relations.

Bottom line

We are keeping our positioning unchanged and believe that global growth will ultimately support current valuations, and even an additional appreciation of risk assets. However, further deterioration in credit spreads, currency moves in China, and developments in the Middle East are areas where we see a need for heightened risk monitoring.

Should you have any comments or questions, please email ubs-cio-wm@ubs.com.

Best,
Mark Haefele

Appendix

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