Straight talk

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From the UBS Asset Management Investment Committee
November 2016

Dawn Fitzpatrick, Head of Equities, Multi Asset and O'Connor, highlights the key themes of discussion at the October Asset Management Investment Committee(AMIC).

The AMIC comprises the most senior investors from each investment area, providing a key forum for the sharing of cross asset expertise and debate on the major factors impacting client outcomes.

With one week to go until the US election, uncertainty remains high with respect to the outcome of the US Presidential and Congressional elections. While our base case remains that Secretary Clinton will win the Presidential election, recent revelations that the FBI is working to review a cache of newly discovered emails potentially tied to the agency's probe of her private email server has injected volatility into the markets and the polls. Additionally, while a Democratic sweep looks increasingly less likely, the composition of the Legislative branches remains unclear, and will be an important driver for the President's ability to pass much needed legislation over the next four years.

Many credible national polls have Democrat nominee Hillary Clinton as the slight favourite for the presidency. We would note that most of the polls are taken of 'likely' voters based on individual past participation in elections. Given Trump's atypical conservative populous base, it is likely that a portion of them are not being captured by traditional polls and that while our view is Clinton will still win, it will be by a closer margin than expected.

The perceived ability of a Clinton presidency to pursue its legislative agenda will almost certainly impact markets. With the House likely to remain in Republican hands and no clear majority in the Senate (the UBS Policy Unit currently predicts a precise 50:50 party split in the 100-seat Senate), Clinton will likely enter 100 Pennsylvania Avenue with a weak mandate driven by low popularity and a divided Congress that will make major policy changes difficult. To be clear, a divided Congress that offers a check and balance on a Clinton Presidency is the market's preferred outcome.

That said, perhaps the one issue in which there seems to be clear bi-partisan support is a US corporate cash repatriation agreement where expected tax proceeds will be spent on a sizable infrastructure improvement program. The estimated size of the foreign trapped cash is USD 2.6trn where a 10% tax could yield as much as USD 260bn if the repatriation is mandatory.

We will be updating clients with a Straight Talk Election Special on November 9.

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Fiscal policy ahead

It is the prospect of higher fiscal spending and low inflation expectations that continue to frame our outlook for markets. In the weeks immediately following the UK's Brexit vote, the theme of 'lower for longer' became even more entrenched in markets. Global bond yields dropped to new record lows by mid-July, and investors were pushed to even greater extremes to find plays on a low growth, low inflation and loose policy backdrop.

It is precisely when the market narrative becomes so consensual that opportunities and risk are magnified. Rhetoric on the efficacy of monetary policy and the need for fiscal spending has dominated market discussion, as have signs that inflation is improving driven by wage growth and a rebound in energy prices. We believe this reflects the economic reality that monetary policy stimulus has reached the point of diminishing returns, and is creating socio-political challenges by widening the income gap to a degree that simply cannot be ignored. The Bank of Japan's recent targeting of price over quantity in its Quantitative Easing programme further demonstrated that central banks are beginning to think differently. There was also a notable narrative in Washington around the IMF meetings against the use of negative deposit rates.

The result has been a small rise in developed world government bond yields, a steepening of yield curves and at least a partial rotation within equity markets towards long-forgotten inflation beneficiaries, including banks and cyclicals, and away from consumer staples and other 'safe' yield plays.

If global governments are successful in delivering meaningful stimulus packages, there is a risk that it could push inflation to rise at a faster pace than corporate earnings growth. Indeed, recent market analysis shows that institutional equity investors believe the greatest risk to markets lies in a sharp back-up in bond yields and broader repricing of risk. However, the same market analysis also reveals that global investors are already conservatively positioned via high cash balances. It would therefore seem that there is little of the complacency that usually characterises markets before a sharp sell-off.

Of course, neither the economic nor social imbalances created, in part, by monetary policy have to be addressed in a disorderly way. Economists may argue whether government spending in isolation can have a lasting impact on demand growth, but we see its success as more dependent on the ability of politicians to present fiscal initiatives that are sufficiently credible to persuade corporates to open their purse strings and invest.

Low vol: a crowded trade

We do see material risks in a number of still crowded trades along the lower for longer narrative across asset classes. Within equity markets these include bond proxies and products that target low volatility baskets of stocks.

In our view, the degree of crowding in minimum volatility in particular now presents an asymmetric risk – one that will not require a material shift in inflation or rate expectations to see the realized return significantly lower and realized volatility significantly higher than investors expect. In short: investors beware.

So where might investors turn in equity markets? Generating excess returns when factor exposures are at such extremes and where a small adjustment to the cost of capital can drive huge swings in fair value certainly has its challenges. But we believe the key for active investors in this environment will be a focus on idiosyncratic alpha sources which are uncorrelated to market beta and have little sensitivity to a fast changing equity risk premium or risk free rate.

China to surprise on the upside

2016 started with investors expressing major concerns about the Chinese authorities' ability to smoothly manage China's structural transition from a manufacturing- to a service-led economy in the context of a high debt burden. As 2016 draws to a close, however, those worries have proven largely unfounded (for now). We believe that the cyclical growth momentum in China will continue, and that the broader market still remains too pessimistic on China's ability to sustain its current pace of growth at around 6.5%.

While housing indicators are slowing from very strong growth rates, low real interest rates continue to underpin credit growth elsewhere in the economy and there is clear evidence of a pick-up in infrastructure spending. Importantly, there are also signs of private sector growth starting to improve - supported by pricing power that has been largely absent for the past four years. Given operational leverage, higher prices are driving a strong recovery in industrial profits in China which are now growing at an annualized year-to-date pace of 8.4%. With a significant transition of political leadership slated for late 2017, we believe the Chinese authorities are strongly motivated to ensure recent demand momentum continues.

The Asset Management Investment Committee (AMIC) comprises:

Bruce Amlicke
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UBS Hedge Fund Solutions

John Dugenske
Global Head of Fixed Income

Dawn Fitzpatrick
(AMIC Chair) Head of Equities, Multi Asset and O'Connor

Bill Ferri
Head of Solutions and Head of Products

Barry Gill
Head of Active Equities

Bill Hughes
Global Head of Real Estate Research & Strategy

William Kennedy
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Ulrich Koerner
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Andreas Koester
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