

# Straight talk

From the UBS Asset Management Investment Committee  
April 2016

## Market expectations diverge as central banks converge



**Bruce Amlicke**, Chief Investment Officer, UBS Hedge Fund Solutions, highlights the key themes of discussion at the April Asset Management Investment Committee (AMIC) meeting.

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.

### Key Points

- Economic data has improved with central bank support, although the US looks slightly rich from a valuation perspective – we are starting to favor Asia and Europe.
- China's data is improving, and we think the market is under-positioned for this, especially compared to the US.
- High-yield liquidity remains difficult but has picked up into the rally. Spreads will be tested by a few large financing deals related to corporate merger activity. We continue to favor investment-grade debt.
- Equity long/short and medium-term momentum factor underperformance shows the perils of crowded consensus positioning in liquidity challenged markets. We think a lot of de-risking has been done which bodes well for the forward opportunity set.
- Energy recapitalizations have been a huge and profitable theme, though painful for both equity and credit shorts.

### Macroeconomic turnaround

From a macroeconomic perspective, we have seen a remarkable turnaround from the middle of the first quarter. Economic data has improved versus market expectations and central banks globally have provided high-visibility support. We expect the Bank of Japan (BoJ) to continue to add support after initiating negative interest rates in January. The European Central Bank (ECB) aggressively increased its asset purchase program adding corporate securities to its 'buy list'. Even the Federal Reserve has offered much more dovish comments in recent days. These moves are all supportive of risk assets and are likely to provide us with greater currency stability.

However, our team has a cautious view of the US equity market in favor of Asia and the EU, in that order. Though sentiment has improved from mid-quarter recession fears, recent data points remain mixed.

Disappointing first-quarter earnings make price/earnings levels suspect. The US market is a huge outperformer and needs continued improvement in economic data and earnings to remain outperforming. Asia and the EU are beginning to look like better bets given their valuation support.

China is producing better marginal data points, which signal that the country could be a short-to-medium term outperformance trade. The key drivers of our view are investor skepticism coupled with improved policy and communication. Longer-term, we expect moderate devaluation of the renminbi and fiscal stimulus. Improved data points range from increased excavator sales to better electricity consumption data. We like indirect China exposure through global industrials and some consumer media names, and think the market is dramatically under-positioned for this.

### Harsh trading lessons

Some investors and managers learned a harsh lesson last month about the volatility that can result from style factors and relative value trades when they lead to crowded and consensus positioning.

Large pools of invested capital in trend-following commodity trading advisors' (CTAs) risk-parity and volatility-targeting strategies are amplifying market moves due to the lack of liquidity. In equity markets alone, the equity rally from the depths of the first-quarter selloff was bolstered by an estimated \$100 billion in inflows from these systematic strategies.

At the micro-level, consensus positioning is having a profound effect on individual securities. Coming into 2016, medium-term momentum trades particularly in equities became overcrowded. As the slow growth economic backdrop came into question, unwound trades created a vicious negative feedback loop both on the long and short side, which contributed to lackluster alpha generation for long-only and long/short managers.

Energy company recapitalizations (the issuance of new equity into public markets), coupled with a crude trading range of \$26/barrel to \$40/barrel also caused some turmoil among both long-only and long /short investors. Energy equities rallied massively and there was disproportionate positive price action for lower quality companies. Long-only investors have been underweight energy and been rewarded for this positioning prior to mid-quarter. In the hedge fund community, there were sizable Merton-style<sup>1</sup> long energy corporate credit short-equity trades. Even though credit rallied, the moves were dwarfed by the equity moves. Our view is that energy equities are pricing in too high a forward crude price at these levels but the technicals

of market participants remaining underweight could sustain a further rally. Balancing these, we have a neutral outlook at current levels.

Looking at less-liquid trades like corporate credit, the market is very technical and the same effect is bleeding into residential mortgage-backed securities (RMBS) and collateralized loan obligations (CLOs). It doesn't take much selling (buying) to start pushing prices materially down (up).

Across asset classes, there was material de-risking in the first quarter which should create a more robust opportunity set in the second quarter. However, we believe there continues to be a liquidity re-rating across asset classes, therefore it is too early to buy down the liquidity curve.

### Widened credit spreads persist

Liquidity is still tough in high yield and convertible credit markets, but has improved into the latter part of the quarter. We expected normalization to outperformance for indices as people look to buy index-based credit products, albeit single bonds have outperformed in this rally, which tells us we have seen real money put to work.

We have been underweight for the better part of the last six months, which was a liquidity call, not a valuation call. A couple of big deals on the market will likely test spread levels in the high-yield market. The funding for the Western Digital (WDC) / SanDisk (SNDK) merger, about \$7 billion total, is the first test. The secured debt portion of the deal is going well. We anticipate the unsecured piece will price as high as 10.5% or 11%, which is a remarkably high coupon. It will be a good tell for the tone in the high yield market. The Dell Inc. / EMC (EMC) proposed merger package, consisting of around \$40 billion in secured and unsecured debt, is rumored to be coming in the second

quarter. There is a lot of anxiety in financial markets about the issuing banks' ability to price and distribute that debt.

We have been aggressively putting capital to work in investment grade credit. We have taken advantage of relatively wide spreads in the investment grade space and robust new issuance, but we believe investors should be thoughtful about where capital is deployed.

### UK more likely to remain in the European Union

On June 23, the UK votes on 'Brexit', or the impending decision to leave or remain a part of the EU. We continue to believe that it is more likely than not that they will remain in the EU, but there are risks to this view if we see significant migration and/or terrorism events. Any potential exit would occur over two years. In theory, it could be a smooth transition if politicians globally make rational economic policy decisions, but our view is this is unlikely in aggregate. We think that there would be material economic fallout following a UK exit (with the UK's economy suffering the most), and we would clearly expect some impact on overall global growth.

<sup>1</sup> The Merton Model developed by Robert C. Merton in 1974 is a quantitative modelling of credit risk showing how the probability of a company default can be inferred from the market valuation of a company's assets in conjunction with the liability structure of the firm.

## The Asset Management Investment Committee (AMIC) comprises:

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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  
ad interim Head of Product

**Barry Gill**

Head of Active Equities

**Bill Hughes**

Global Head of Real Estate Research  
& Strategy

**William Kennedy**

Head of Distribution

**Ulrich Koerner**

President Asset Management;  
President Europe, Middle East  
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**Andreas Koester**

Head of Multi Asset

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