UBS House View

Monthly Letter

Chief Investment Office WM
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Brexit lessons
Although opinion is divided on the significance of Brexit, we believe there are key insights that investors can glean from the UK referendum.

Political risk
As the results of political events become harder to predict, and as globalization faces increasing electoral pushback, investors must prepare for bouts of currency volatility.

Fundamental focus
We continue to believe that economic growth and earnings momentum are more sustainable drivers of markets than political events. These fundamentals remain positive.

Asset allocation
We have increased our overweight on US equities versus high grade bonds. We are opening an overweight position in emerging market equities, and we are removing our overweight on euro-denominated high yield bonds.

Mark Haefele
Global Chief Investment Officer
Wealth Management

Follow me on LinkedIn
linkedin.com/in/markhaefele

Five investment lessons from Brexit

About a month has passed since the UK's vote to leave the EU, and much has been written on the subject. Is Brexit important for markets? After talking to investors around the world, I can tell you that opinions continue to vary on the significance of the UK's decision. In the US, for example, many think that this is just politics, and has little to do with markets. Yet, I believe we can learn from Brexit, and in this letter I outline five key lessons for investors.

1) It is not going to get easier to forecast political outcomes over the next 12 months.
2) "The future" matters today as globalization and technology have major consequences.
3) Investors in developed markets cannot afford to ignore currency volatility.
4) Diversification is becoming even more important to combat price swings.
5) Longer term, central bank policy and economics still trump political risk.

These lessons are at the heart of both our long-term strategic and our short-term tactical asset allocations. We have made three changes to our tactical asset allocation this month. We are increasing our overweight in US equities versus high grade bonds, introducing an overweight in emerging market equities versus Swiss equities, and taking profits on our successful overweight on euro-denominated high yield bonds.

Polling results have become less useful in predicting political outcomes, partly due to changes in technology use.

Globalization has contributed to rising inequality and faces pushback from voters.

Less than 40% of US manufacturing jobs lost since 2008 have been regained.

1) It is not going to get easier to forecast political outcomes over the next 12 months

Brexit has demonstrated the increasing difficulty in accurately predicting political outcomes. Markets, experts, and pollsters all got it wrong.

Betting markets predicted just a 25% chance of Brexit the night before the result, and political forecasters overestimated the importance of economics in the population's voting decisions. In the event, regions with a higher share of exports to the EU actually tended to vote to leave. An increasingly polarized global electorate presents a challenge for urban elites who think in terms of "textbook" economic rationalism.

As polling methodologies have fallen behind technological developments, the prognoses from polls appear to have become less reliable. For instance, the rise of cell phones means response rates for telephone pollsters have fallen from around 80% in the 1970s to as little as 8% in recent years, according to a former president of the American Association for Public Opinion Research. Pollsters have been shown to be wide of the mark in predicting the scale of US President Barack Obama's victory in 2012, the outcome of the Scottish independence referendum in 2014, and the result of the UK general election last year.

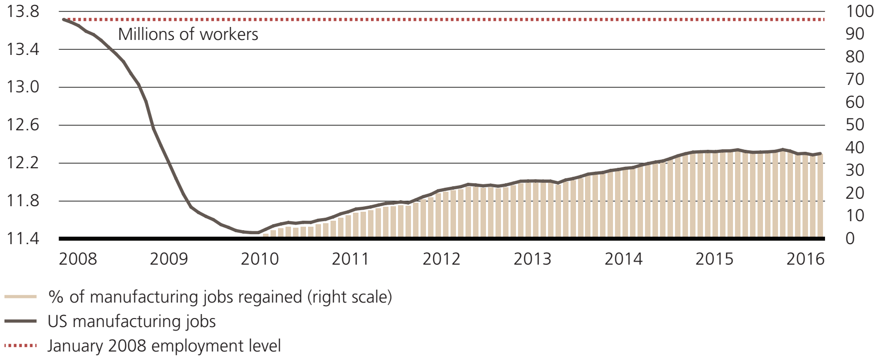
Investors would do well to avoid placing too much significance on political predictions until these issues are resolved. Ahead of the US presidential election in November and the vote on the Italian constitution in October, overconfidence in victories for the established political parties may come unstuck.

2) "The future" matters today as globalization and technology have major consequences

The UK vote illustrates that while markets and investors might tend to focus on the mean, the median cannot be ignored. The forces of globalization and technology are positive for aggregate growth, but they have also contributed to inequality and industrial disruption, polarizing the electorate. Surveys indicate that people who identify globalization and the internet as forces for ill were more than twice as likely to vote Leave than Remain.

Fig. 1: Globalization and technology have changed the US industrial landscape

Number of US manufacturing jobs (seasonally adjusted) and the post-crisis recovery, in %



Source: Bureau of Labor Statistics (BLS), UBS. Data as of 19 July 2016

A similar polarization is taking place in the US. Almost three-quarters of the jobs created since the 2008 crisis have gone to workers with a bachelor's degree or higher, and only 38% of manufacturing jobs lost since 2008 have been regained (Fig.1). Among white voters without a college degree, Donald Trump leads Hillary Clinton by an average 57%–31% margin, a larger share than that claimed by the last Republican nominee, Mitt Romney, in 2012.

The lesson here is that longer-term trends matter today. And while a pushback against globalization and technology could drive volatility, these trends also present investment opportunities, particularly in the fields of automation and digital data.

Brexit reminds investors of the risks posed by developed-market currency volatility.

3) Investors in developed markets cannot afford to ignore currency volatility

Brexit reminds us that currency volatility is not something that only emerging market investors need to worry about. Following the referendum vote, the British pound sustained its sharpest one-day drop against the US dollar in 40 years. Disruptive currency swings have not been confined to sterling. The yen has rallied 14% this year versus the USD amid rising global risk aversion and worries that the Bank of Japan is running short of effective stimulus tools. In recent months, broad measures of G7 currency swings have been higher than the emerging market equivalent for the first time since February 2015 (Fig.2).

Currency volatility is particularly important because it is often overlooked by investors, while still having the potential to significantly damage returns. The lesson is that investors should only take currency risk intentionally, not as a side effect of holding international assets. We recommend hedging currency exposure in our global portfolios. On a tactical basis, it can be appropriate to take advantage of currency misalignments, and we take currency positions in our tactical asset allocations to exploit such mispricing.

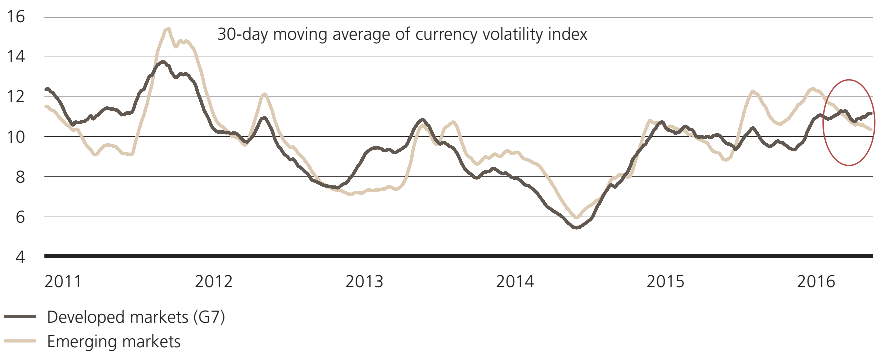
4) Diversification is becoming even more important to combat price swings

Despite the uncertainty and the volatility, Brexit also reminds us that we can take various actions to mitigate the investment damage caused by turbulent markets. Geographical, political, and cross-asset class diversifications have shown their worth following the UK vote.

Investors need to manage currency risks, hedging where appropriate.

Fig. 2: Currency volatility in developed markets outpacing emerging FX

30-day moving average of currency volatility indices (JP Morgan)



Source: Bloomberg L.P., JP Morgan, UBS. Data as of 19 July 2016

Home bias has proven costly. The FTSE 250, with a large exposure to the UK domestic economy, is down 3% since the day of the UK referendum, with a maximum fall of 13.6%. Similarly, Italian equity investors with home bias may have suffered most as local stocks are down 7%, with a 16% maximum drawdown since the referendum. A more globally minded investor could have fared better. US and Japanese stocks have risen 3% and 4%, respectively.

High grade bonds still have a diversifying role in portfolios, despite a negative return outlook over the coming six months.

The same principle is true across asset classes. Overall, we believe the returns for high grade bonds will be negative over the coming six months. Yet, as we saw again around Brexit, the days when bond prices rallied the most coincided with the worst equity performances, justifying a continued place for government debt as a portfolio ballast when equity markets stumble. This is illustrated by the decent performance of balanced portfolios of equities and bonds in a turbulent year. A balanced USD portfolio has returned about 4% this year, with a maximum monthly drawdown of around 3%. Meanwhile, a pure equity USD portfolio, with a return of about 5%, has had a maximum monthly drawdown of 6%.

5) Longer term, central bank policy and economics still trump political risk

Last month, before the UK vote, we said that we would not try to trade the instant reaction, and would instead look through the political noise to monitor changes in longer-term trends like corporate borrowing costs, central bank responses, and earnings data. This strategy worked out well: after the UK vote, central banks' commitment to provide liquidity prevented a major tightening in global corporate credit spreads, allowing market focus to return to business and economic fundamentals.

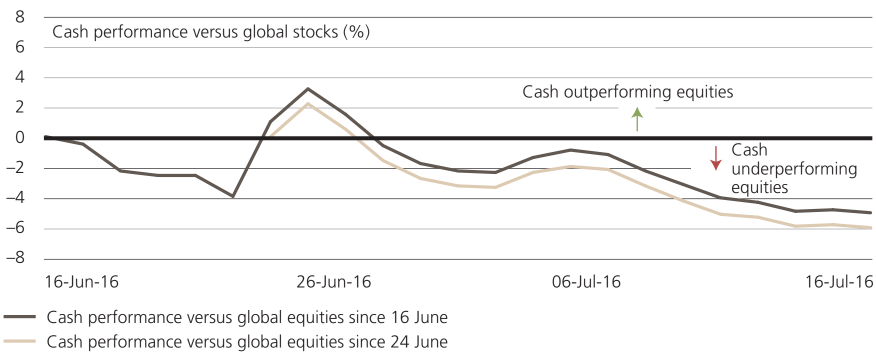
The chart below illustrates how portfolio performance can be harmed by panic selling (Fig.3). Investors who exited global equity markets the week before the UK vote would have missed out on a 5% gain on a USD basis, and 6% for those selling on the day of the referendum result.

Long-term investment value is created by assessing changes not primarily in political risks, but in economic growth, central bank policy reactions, and earnings trends. The highest returns should accrue to investors who respond to sudden events in a disciplined way, rather than to those taking hasty action when the noise is at its peak.

Investors should remain focused on corporate and economic fundamentals.

Fig. 3: Panic selling and flocking to cash can hurt portfolio performance

Performance of yieldless cash versus global equities in USD terms, in %



Source: Thomson Reuters, UBS. Data as of 18 July 2016

That does not mean that headline events don't create opportunities. For example, sophisticated investors particularly concerned about drawdowns can deploy systematic hedging strategies. Implemented well ahead of events when the cost of protection is cheapest, this type of strategy can help lessen short-term swings in performance at a reasonable "insurance" cost.

And more opportunistic investors wanting to exploit market dislocations could consider following the approach of our Short Term Investment Opportunities team. The group identifies relative value trades that exploit near-term mispricing through an institutional-style, risk-controlled investment approach.

Tactical asset allocation

We are increasing our overweight on US equities, reflecting an improving profits outlook.

We have made three changes to our tactical asset allocation this month. We are increasing the size of our overweight position in US equities relative to high grade bonds. The US economy is gathering momentum. Firmer economic data should promote stronger profit growth. We expect the US second-quarter earnings season to beat consensus expectations of a 5% year-on-year decline. And profits per share should grow in the second half as headwinds fade from the strong US dollar and lower oil prices.

We are introducing an overweight on emerging market equities as leading indicators stabilize.

We are also adding an overweight in emerging market equities versus Swiss equities. Despite the strength of the US economy, international uncertainty following the Brexit vote is likely to delay a US Federal Reserve rate rise until December, at the earliest. Continued low US rates and abundant liquidity are positive for emerging markets. Added to this, commodity prices have stabilized and purchasing managers' indices have turned positive in emerging Asia and Europe. There are further signs of an earnings turnaround. Over the past three months, earnings per share for the MSCI EM index have stabilized, after falling 33% since early 2012. However, given its high weighting toward defensive sectors, the Swiss index is poorly placed to benefit from improving global growth in the second half of the year and the acceleration in manufacturing activity.

We have removed our overweight on euro-denominated high yield credit.

Finally, we are taking profits on our euro-denominated high yield position. The spread has fallen by 100 basis points this year, as the European Central Bank's (ECB) quantitative easing program has pushed down the risk-free rate, and increased the relative appeal of high yield. The asset class yield of 4.3% is now approaching the all-time low of February 2015. While we still only expect defaults of 2% over the coming 12 months, this yield is no longer sufficiently compelling to justify an overweight position.

In currencies, we remain overweight the Norwegian krone versus the euro. Inflation in Norway firmed to 3.7% in June, the highest level in close to eight years. We do not share the market's view of further rate cuts in Norway, while additional ECB easing remains possible.

We are also overweight the US dollar versus the Australian dollar. While the Fed is on track for only gradual rate hikes, the market has become too dovish, assigning only a 43% chance to US rate hikes this year. By contrast, weak domestic growth and China's economic slowdown have dampened Australian inflation. We expect the AUD to weaken ahead of an August rate cut by the Reserve Bank of Australia.

Mark Haefele
Global Chief Investment Officer
Wealth Management

linkedin.com/in/markhaefele

UBS Investor Forum Insights

At this monthly gathering, we invite thought leaders to debate the key topics affecting financial markets, and to challenge the UBS House View.

- Participants agreed that Brexit has sent tremors through financial markets. The UK markets, specifically Gilt yields and the British pound, experienced large declines, and potentially have further to fall.
- However, after an initial shock, risk assets have recovered strongly with the S&P 500 even hitting record highs.
- Participants felt it was too early to fully assess the impact of Brexit on the global economy, but agreed that separating politics from economic fundamentals was essential.