UBS House View

Monthly Letter

Chief Investment Office WM
25 February 2016

Central banks
Investors have become concerned that monetary policymakers are out of ammunition, and further efforts to stimulate growth may prove counterproductive.

Data worries
Recent economic releases have pointed to a slowdown in the US services sector, weakness in Eurozone leading indicators, and a continued growth deceleration in China.

Consumer strength
Household spending and confidence have been holding up in the US, Eurozone, and China. As a result, the slowdown is unlikely to lead to recession.

Asset allocation
We are initiating an overweight position in US high yield bonds. We are removing our underweight position in UK equities relative to Eurozone equities.

Mark Haefele
Global Chief Investment Officer
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Gravitational waves

Scientists announced earlier this month that giant lasers had enabled them to observe gravitational waves for the first time. So far in 2016, investors have only needed a stock chart to observe the effects of gravity, amid slowing growth and heightened uncertainty.

Weakening economic data, volatility in oil prices, and concerns about a financial crisis in China have contributed to a difficult start to the year. With trillions of dollars' worth of bonds trading at negative interest rates, and trillions more printed in quantitative easing around the globe, markets have become worried that policymakers may have "run out of ammo," to fix economic woes.

We share the market's concerns about the slowing pace of growth and the diminishing marginal returns of monetary policy in some regions. And until we see an uptick in economic data, stable oil prices, tighter credit spreads, and better news on capital flows in China, volatility is likely to remain high. We are maintaining a neutral stance on equities in our global tactical asset allocation.

That said, we still believe that the world is not heading for recession, and that policymakers have not lost the willingness or ability to avert crisis.

The sell-off has created new opportunities. For instance, even excluding the troubled energy sector, US high yield debt has a credit spread of more than 700bps, effectively pricing in recession. We believe investors with limited exposure to the asset class could see this as a good opportunity to build up long-term holdings, and we move to overweight this month. We are also closing our underweight position in UK equities. After years of relative underperformance, we believe the prospects are good for an earnings growth revival for UK firms. A weak pound and a diminished share of commodities within the index should boost profits. We are funding this move by reducing the size of our overweight position in Eurozone equities.

UBS

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Are we headed for recession?

US – strong labor markets to help growth

Activity in the US services sector has weakened...

In my last letter, I highlighted the record gap in sentiment between the manufacturing and services sectors of the US economy. Since then, it has closed marginally, but only thanks to a deteriorating services sector. This has led to worries that services, which account for around 80% of the gross value added in the US economy, could join manufacturing in recession.

Financial markets are right to be concerned about a slowdown in the world's largest economy. We expect just 1.5% growth for the US this year, reflecting a contraction in manufacturing activity, tighter credit conditions, the effects of a strong dollar in weaker international markets, and wealth losses due to recent stock market volatility.

...but strength in consumption and the labor market look likely to ensure that a recession will be averted.

But markets would be wrong, in our view, to assume that this deceleration represents the start of a recession. Unemployment is under 5%. Average hourly earnings are growing at their fastest pace since 2009 (Fig. 1). Mortgage rates are just 3.7%, and gasoline prices are the cheapest they've been in years. Household debt relative to GDP has dropped a full 20 percentage points over the past six years. These factors should enable real disposable incomes to increase at a sufficient pace to sustain consumption growth, and keep the US out of recession. Furthermore, with unemployment now so low, improved wage-bargaining power should translate into continued income growth, even if jobs growth slows from last year's 221,000 per month pace.

Overall, it would be highly unusual for the US economy to contract against a backdrop of such strong labor markets.

Europe – strong fundamentals mitigating global turbulence

In common with the US, Eurozone leading indicators have begun to weaken in recent weeks, raising concerns about the durability of the region's economic recovery. Strong fundamentals – such as the ECB's monetary impulse, low oil prices, and an increase in fiscal spending following the recent influx of refugees – are likely to mitigate this.

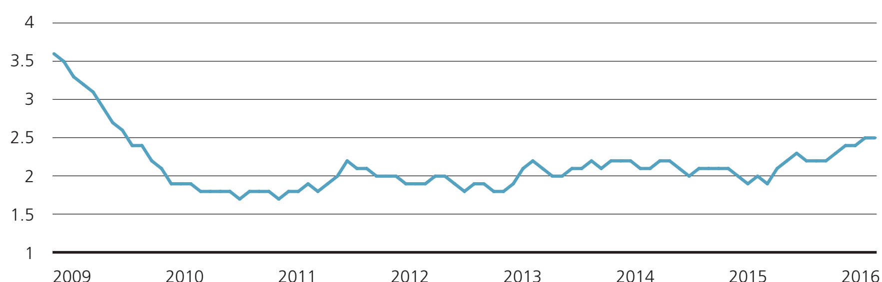
In the Eurozone, unemployment has declined and wage growth is improving.

Hard data suggests the recovery is continuing. Unemployment has declined to 10.4% from its peak of 12.1%. Wage growth is improving, especially in Germany, and lower

US average hourly earnings are climbing at their fastest pace since 2009.

Fig. 1: US labor earnings are rising, which should support consumption

Three-month average of year-on-year growth rate, %



Source: Thomson Reuters, UBS. Data as of 31 January 2016

oil prices are also boosting spending power. This higher real income growth is directly fueling consumption, since savings rates have remained flat.

Loan growth also appears to be good. Although data was collected prior to the recent sell-off, the European Central Bank's (ECB) 4Q Bank Lending Survey showed that loan demand was rising at its fastest clip since the financial crisis, while credit standards continued to ease.

Raw economics aside, political risks will be important to monitor, with the Brexit referendum on June 23 likely to affect assets in the region in the months ahead. Our base case remains for the UK to stay in the EU; we believe fears of the potential consequences of a Brexit will weigh on voters' minds as decision day approaches.

China – targeted stimulus

The growth outlook in China is not as bleak as newspaper headlines suggest.

Growth is slowing, but the outlook is not as bad as might be inferred from headlines. Retail sales climbed 11.2% over the Spring Festival holiday, compared to the same period last year. Home prices are rising in 60% of cities. And the economy is showing signs of responding to the targeted stimulus measures enacted in recent months (Fig. 2): Chinese banks made a record CNY 2.51trn (USD 390bn) in new loans in January. Whether more credit is in China's long-term interest is debatable, but its growth is a signal of greater activity in the economy.

The outlook for China will be dependent on the country solving its capital flight issue. As we discuss in more detail below, our base case remains that government measures should be sufficient to contain capital, without needing to resort to a sharp devaluation of the yuan.

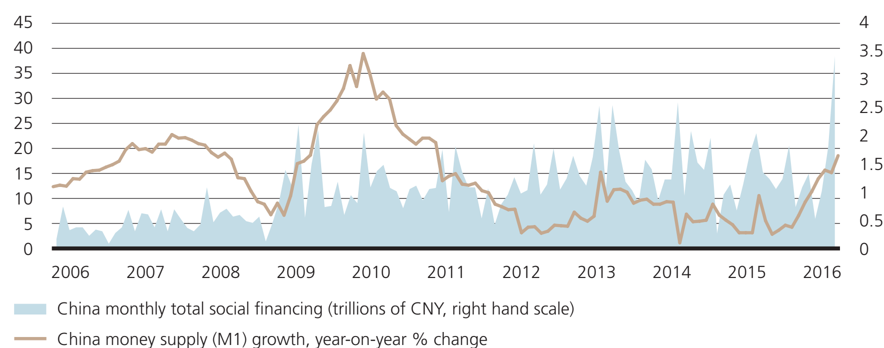
What can central banks do?

Markets have reacted badly to growth concerns this year due in part to worries that the effectiveness of central bank policy may be waning. A clear example came this month in Japan after the Bank of Japan's (BoJ) move to negative interest rates; an initially positive reaction swiftly turned negative, in terms of a strengthening yen.

While I have some sympathy for the notion that the marginal returns of central bank policy are diminishing, I don't believe policymakers will abandon their efforts to impact markets. Central banks still have a range of options available to them in the event of further market instability.

Chinese banks made a record amount of new loans in January, and the central bank is injecting liquidity.

Fig. 2: China has enacted targeted stimulus in recent months



Source: Thomson Reuters, UBS. Data as of 31 January 2016

The Fed

Having already increased rates and signaled that further hikes are likely this year, Federal Reserve policymakers still have scope to talk down expectations of further tightening, or even reverse course.

Although the health of the US labor market probably warrants higher rates, US policymakers, as they demonstrated last September (and most likely will again in March), are willing to delay tightening if they fear that dollar strength would push China toward a large and destabilizing yuan depreciation or contribute to a global economic slowdown.

Interest rate markets have already moved to reflect a "lower for longer" view for Fed policy. And if the Fed meets market expectations, we should not underestimate the positive effect a weaker dollar could have in easing global financial conditions.

ECB

With deposit rates already at –0.3%, the ECB currently does not have a lot of scope to cut further. The ECB is aware that deeply negative deposit rates could unduly penalize the banking sector, and have the unintended consequence of reducing lending. The concern that the ECB has nowhere left to turn has contributed to the market's broader uncertainty about central bank policy in recent weeks.

The ECB still has options to support growth and markets, including widening the scope of assets purchased under its QE program.

But the ECB is hardly out of options. One major step still open to it would be to widen the scope of its asset purchase program to include corporate bonds. It could also extend its long-term refinancing operations beyond June 2016. Finally, the Bundesbank's Jens Weidmann has not ruled out the possibility of the ECB buying bonds with yields below the deposit rate. Such a step could help push longer-term borrowing rates lower still.

Additional unorthodox measures may prompt further legal challenges, similar to those the ECB has faced before. But if enacted, they could improve the transmission of ECB policy into the wider economy.

China

For many years, China has used policy to manage its economy. After aborted stock market controls in January, and more volatility in China's currency, markets have begun to doubt whether China can maintain economic control.

Capital flight has become a challenge for China.

The key issue confronting the authorities in the months ahead will be managing capital flight. Concerns about rising bad debts, among other worries, are causing funds to leave China. The nation has sufficient savings and reserves to cope with this for a while, but it will need to slow the exodus if it is to avoid a sharp yuan devaluation. Given that a large depreciation would not help China's economic position, and could actually trigger more capital flight, the government has two main options:

The government could address this through fiscal and monetary stimulus...

The first is to use a combination of fiscal stimulus and selective monetary easing to support growth, while allowing a steady yuan depreciation. Infrastructure and social spending would help support growth, while lower interest rates would ease repayment pressures. A slightly cheaper yuan would increase the relative attractiveness of investment in the country (provided investors are confident of stability).

...or by tightening capital controls.

The second is the introduction of tighter capital controls. China already has capital controls in place, but the pace of outflows suggests that the government can strengthen enforcement. These measures could include more active policing of trade orders (to prevent capital flows being disguised as trade flows), stricter controls on unregulated foreign exchange dealers, or higher reserve requirements on FX forward purchases. Admittedly, capital controls introduce distortions in the FX market and

the economy at large, and run counter to China's goal of making the yuan a global reserve currency.

Ultimately, greater confidence in growth and policy would do the most to stem capital flight. However, capital controls could help reduce the pace of outflows and buy China more time than some of the bears currently assume.

Global asset allocation

We are maintaining a neutral stance on equities in our global asset allocation. On the one hand, markets have already corrected, and we do not expect the current global growth slowdown to become a recession. But volatility is likely to remain high, until we see an uptick in economic data, stable oil prices, tighter credit spreads, and a resolution to capital flow concerns in China.

We are closing our relative underweight in UK equities to Eurozone equities.

Within equities, we are making one change this month, closing our underweight in UK equities relative to Eurozone stocks. After years of underperforming global markets, UK shares are now more attractively valued, and the fall in sterling should boost profits. Brexit is a concern, but the impact on equities is likely to be mitigated by a weaker pound.

We maintain our relative preference for Eurozone over emerging market equities. Eurozone profits growth is stronger than in other regions, and emerging market earnings are under pressure from troubled domestic economies as well as weak commodity prices.

In currencies, we are keeping our overweight positions in the US dollar and Norwegian krone relative to the Japanese yen and the euro. We believe the recent rally in the yen is overdone, and think it increases the probability of even more BoJ easing, or even FX intervention, in the next month (Fig. 3).

Within fixed income, we have moved overweight in US high yield credit.

Within fixed income, we have opened a tactical overweight position in US high yield credit, funded through a larger underweight position in high grade bonds. US high yield credit has performed poorly in recent months, and we expect default rates to rise to 6% this year. But with spreads over Treasuries at more than 7%, investors are being well compensated for the risk they assume (we expect a recovery rate of 30% on defaulted debt). Investors with limited exposure to US high yield might see this as an opportunity to build up positions.

The probability of further Bank of Japan action to weaken the currency is high, in our view.

Fig. 3: We believe the recent rally in the Japanese yen is overdone

JPY per USD

Source: Thomson Reuters, UBS. Data as of 24 February 2016

We are still holding an overweight position in European high yield relative to high grade bonds. European high yield spreads have widened in recent weeks, despite signs of ongoing economic recovery in the Eurozone. We expect this trend to reverse, as higher-yielding asset classes stand to benefit from any further ECB rate cuts and an extension or expansion of quantitative easing at its upcoming policy meeting in March.

No laser beam pointed at the gaps between the growth and policy outlooks will reveal the future direction of markets. Yet some of the issues contributing to lower-than-usual visibility should begin to clear in the months ahead. Then, we'll be better able to determine the center of gravity for equity markets. In the meantime, we want to focus on opportunities we see in credit and foreign exchange markets.

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UBS Investor Forum Insights

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

- This month we asked investors whether the current choppy markets were being driven by market fears or a fundamental deterioration of economic conditions.
- Although most investors felt that fear had pushed markets too far, there were some bears in the room; the US economy, Chinese debt, and the price of oil were all cited as concerns.
- We also discussed the potential implications of a Brexit on markets. Many guests felt that Angela Merkel losing power in Germany posed a greater risk to markets.

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