

UBS House View

Chief Investment Office WM
26 May 2016

Monthly Letter

Lack of conviction

Many investors believe there are few attractive investment opportunities in markets at the moment, and there is a wide divergence of views on which assets will perform well or badly.

Profits disappoint

Low investor confidence is partly due to heightened political risk. Earnings setbacks in the US, Eurozone, and Japan have contributed to this caution.

Opportunities

Despite challenges, we expect a pick-up in earnings growth in the US to support equities, while an easing of financial conditions will underpin euro-denominated high yield credit.


Asset allocation

We have closed our underweight Australian dollar position relative to the Canadian dollar. The Canadian economy may have slowed due to the effects of recent wildfires. We remain underweight the Aussie versus the US dollar.



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The bottom line

Today the majority of US voters disapprove of both prospective presidential candidates. Investors seem to dislike all of their choices too, be it bonds, cash, or equities. In the five years we have been hosting our April UBS Davos summit, which once again brought together global fund managers representing over 10 trillion US dollars of assets, we have never heard such a lack of conviction about markets or such a divergence of views about which asset classes will perform well or badly.

Political events will continue driving uncertainty and volatility for the foreseeable future. The UK referendum on its continued membership in the EU, now less than a month away, could impact assets in Europe. In the US, both the Democratic and Republican parties are poised to choose polarizing candidates as their presidential nominees. Adding to the mix, political vacuums in Spain and Brazil could unsettle European and emerging markets respectively. And moving into next year, changes in the composition of China's politburo could affect the pace of economic reform.

In addition, investor conviction has been undermined by weaker corporate earnings in the US, Eurozone, and Japan, along with continued sluggishness in emerging markets. As a result of this combination of political risk and disappointing earnings, we believe it is advisable to take only modest levels of risk in our global tactical asset allocation.

Yet while investors must continue adapting to a world of slower growth, there are still enough areas of profit resilience to support investment cases for certain regions. In the US, we believe that the headwinds for earnings are turning into tailwinds as pressures from a strengthening dollar and weakening oil prices abate. That justifies an overweight position in US equities. In the Eurozone, profit growth has been curbed by the recent rise in the euro and hence the outlook for equities looks less attractive than at the start of the year. Still, we do not believe the deterioration is sufficient to cause investors to flee risk assets altogether. We are still holding an overweight in European high yield credit, which benefits from improving financial conditions, low default rates, and central bank bond purchases.

Political and economic integration in Europe is coming under pressure.

Both of the leading US presidential candidates have high disapproval ratings.

But the outlook for companies will ultimately prove a more important determinant of returns.

Political events, including in the UK, may lead to market uncertainty and volatility.

Political risks

Mainstream parties and politicians in many parts of the world are facing populist pressures from both left and right. This raises the possibility of a shift away from free trade, immigration, and globalization more broadly.

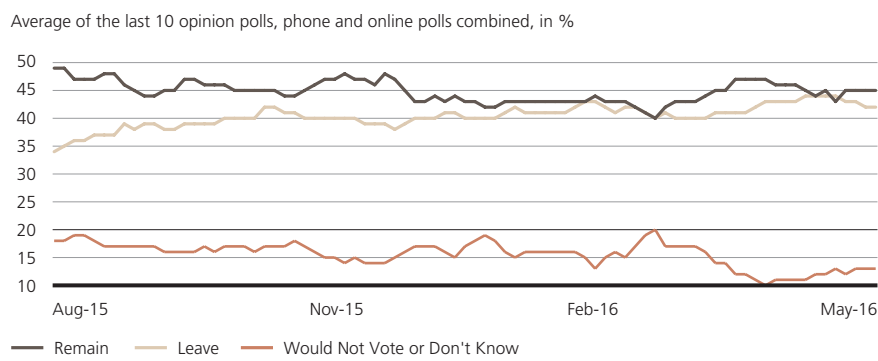
In Europe, political and economic integration are increasingly being challenged. A significant share of the British public appears inclined to vote to leave the EU in the upcoming referendum, and high levels of volatility in the polls mean that the result could swing either way (Fig. 1). This is only one manifestation of the centrifugal forces at work in the region. In France too, the National Front of Marine Le Pen, which wants to pull out of the Eurozone, has been gaining popularity. Centrist parties have been under pressure in Spain, where the election in December failed to produce a stable government. Investors are concerned that a fresh vote next month could lead to a coalition government that includes Podemos, a party that favors greater fiscal stimulus. Populists have also been on the rise in Austria and the Netherlands.

In the US, presidential elections are often popularity contests, with the winner helping their party gain seats in Congress. This time, the two most likely contenders both have negative net approval ratings, with -14% for Hillary Clinton and -27% for Donald Trump (Fig. 2). They are the most disliked nominees in the last 10 elections, and no candidate has ever secured the White House with such low scores. This makes policy choices harder to predict, increasing investor uncertainty.

Emerging markets have problems too. Brazilian assets rallied in expectation that the impeachment of President Dilma Rousseff would lead to her replacement by a more market-friendly alternative. Still, the nation has many obstacles to overcome to reduce its fiscal deficit and pull the country out of recession. In China, political transition in 2017 may lead to uncertainty about the course of economic policy.

This political backdrop is contributing to caution among investors. However, I believe that concern over political risks can be overdone, and that the outlook for companies – both their bottom lines and balance sheets – will ultimately prove more important for returns. This corporate outlook affects our asset class preferences in the US and Eurozone.

Fig. 1: Volatile UK referendum polls are adding to investor uncertainty



Source: www.ukpollingreport.co.uk, www.ft.com, UBS. Data as of 19 May 2016

US – risk on, equities rather than credit

Amid rising bankruptcies, earnings downgrades, and concerns about margin erosion, the US has not looked like the most appealing investment destination of late. The first quarter earnings season was the worst since 2009. The strong dollar in 2015 hurt exporters and US multinationals, while falling oil prices knocked another 5% off earnings. Profits ended the quarter down 6% year-over-year.

US profit headwinds are turning into tailwinds.

But headwinds have now turned to tailwinds – the trade-weighted dollar has fallen 4% since late January, and oil is up around 80% from a recent low of USD 27 a barrel. Profit margins are set to rebound after a first-quarter decline, and we still forecast 3% earnings growth for 2016 and 7% next year.

Stocks tend to benefit from the type of earnings momentum revival we expect to see in the US. Share buybacks could provide ongoing support as well. Since 2011, S&P 500 companies have returned nearly 40% of earnings to shareholders via share repurchases, which has boosted earnings-per-share growth by about 1.5% annually over this period. We expect buybacks to continue adding 1%–1.5% to earnings growth in 2016. And while shares are no longer cheap based on price-to-earnings ratios, they look attractive compared to high grade bonds. The S&P 500's earnings yield is 540 basis points higher than real Treasury yields, wider than the median spread of 380 basis points since 1960.

We are overweight US equities and investment grade bonds.

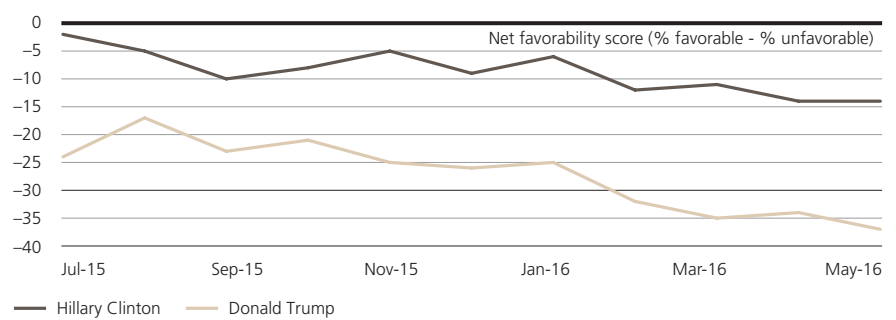
We also have an overweight position in US investment grade bonds. While the debt of these high-quality companies typically benefits less from a profit recovery, the yield-to-maturity of around 2.5% offers an attractive premium to sovereign debt. In investment grade, we prefer bonds with durations of up to 10 years, as they are not so vulnerable to rising federal funds rates. This asset class offers a useful yield pick-up while providing an element of portfolio stability. US senior loans are appealing too. They offer an attractive yield, low exposure to energy, and are secured, providing protection against defaults.

By contrast, conditions are less favorable for US high yield credit relative to European high yield. The US credit cycle has advanced as companies have borrowed to fund mergers and acquisitions as well as share buybacks. Increased leverage has contributed to the rise in US default rates, which are now more than twice that of Europe. And with a large weighting to energy issuers, US high yield credit is also far more exposed than Europe to any renewed weakness in oil prices.

Polls suggest that both presumptive presidential nominees are more disliked than liked.

Fig. 2: US presidential election - an unpopularity contest?

Net favorability scores for Hillary Clinton and Donald Trump, in %



Source: Gallup. Data as of May 2016

Despite a profit slowdown in the Eurozone, high yield credit remains attractive – supported by low defaults and ECB policy.

Eurozone – risk on, credit rather than equities

In the Eurozone, the outlook for earnings has deteriorated. The 6% rise in the euro against the US dollar over the past six months, if sustained, should knock about 2.4 percentage points off earnings growth. A flatter yield curve has compressed banks' margins from new lending, and market uncertainty has depressed trading revenues. Earnings declined in the first quarter. Overall, full-year consensus profit growth forecasts have been cut from 10–12% six months ago to just 2–3% today.

Such negative earnings momentum creates a headwind for equities. But it does not mean investors should abandon risk assets in the region altogether. The fundamentals are still strong for high yield bonds, which can perform well even during times of more muted bottom-line growth. Europe is at an earlier stage in the credit cycle than the US. Many European companies are still set up for high borrowing costs, so cheap financing now means exceptionally low default rates (under 2%). The latest bank lending survey by the European Central Bank (ECB) points to easing credit standards for businesses, making refinancing more straightforward. Given this backdrop of low defaults and ample credit, yields still look attractive. And the ECB's move to add investment grade corporate bonds to its quantitative easing program should push investors toward riskier corporate issues, benefiting high yield credit.

By contrast, we have a neutral position in euro-denominated investment grade bonds. Unlike in the US, the yield offered by these investment grade credits – just 1% at present – is not appealing, in our view.

Asset allocation

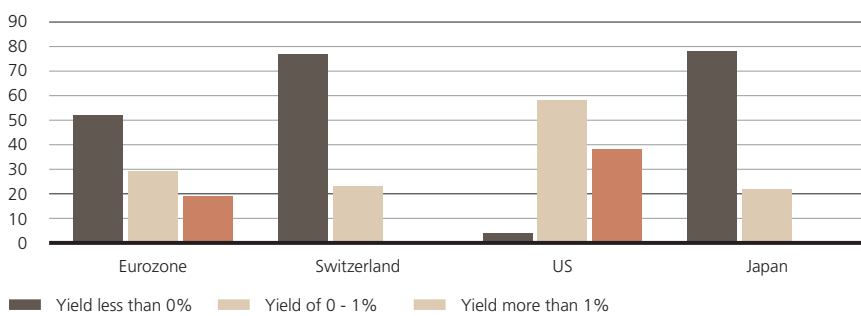
Plenty of challenges lie ahead for the remainder of 2016. As mentioned above, a host of political developments pose potential tail risks for investors. We remain on the alert for any sign of renewed economic weakness or financial fragility in China. Central bank policies in Europe and Japan continue venturing into uncharted territory, keeping a lid on the yields of their sovereign debt (Fig. 3). By contrast, we expect the US Federal Reserve to raise rates in the second half of the year at least once, and recognize that Fed officials may struggle to communicate this without disrupting markets.

Still, we believe there are regions where risk assets will perform well. We maintain an overweight on US equities, given our expectation for bottom-line growth to

Negative yielding high grade debt in the Eurozone, Switzerland, and Japan looks unappealing.

Fig. 3: Central bank easing has pushed a high proportion of developed market debt yields below zero

Percentage of selected developed market countries' debt trading within different yield ranges

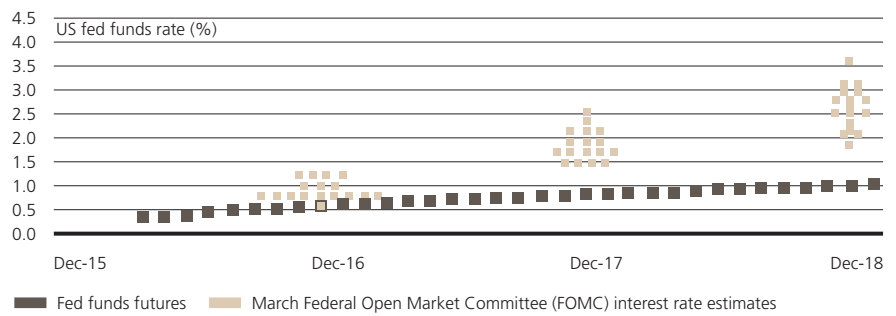


Source: Bloomberg, UBS. Data as of 17 May 2016

recover. Meanwhile, we are positive on European high yield due to easy refinancing conditions and central bank bond buying. We are underweight on high grade bonds, which we expect to produce a negative return over the coming six months, as markets adjust to a somewhat faster pace of rate hikes by the Fed (Fig. 4).

Fig. 4: Markets still expect fewer US rate hikes than Fed officials

US Federal Reserve and market-based estimates for the fed funds rate



Source: US Federal Reserve, Bloomberg, UBS. Data as of 23 May 2016

Markets may need to adjust to a faster pace of US rate hikes, which may cause market volatility.

We have closed our underweight Australian dollar position versus the Canadian dollar. We remain underweight the AUD against the US dollar.

Within currencies, we have made one change this month, and closed our underweight Australian dollar position versus the Canadian dollar. We have taken profits on this position, as Canada's economic activity may have slowed as a result of recent wildfires. However, we maintain our underweight Australian dollar position against the US dollar. The Aussie is likely to stay under pressure, as low inflation and fading momentum from Chinese stimulus are likely to prompt a further Australian central bank rate cut. Meanwhile, the minutes from the latest US Fed meeting have led markets to increase expectations of further Fed rate hikes, and have contributed to renewed strength in the US dollar. We believe the Fed's tightening bias will further support the US dollar.

Both prospective presidential candidates in the US have until November to turn electoral disapproval into favor, and favor into action at the ballot. In the end, unpopularity will not prevent a winner from being declared. Similarly, we acknowledge that many asset classes have high disapproval ratings. But markets will have winners too. In our view, focusing on the corporate bottom line will be crucial to finding them.

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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.

- The lack of conviction in markets was the focus of discussion at our Investor Forum this month. After a volatile start to the year, markets have entered a calmer period with no obvious winners or losers.
- For the most part, there was no clear consensus on the outlook for any asset class or investment theme. Investors are reducing risk in the face of short-term worries.
- However, some out-of-consensus views were raised, with several participants expressing greater optimism over Brazil, peripheral Europe, and emerging market foreign exchange.

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