UBS House View

Monthly Letter

Chief Investment Office WM
22 June 2016

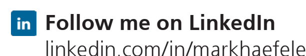
Political risks
Many investors have been focused on uncertainty over votes in the UK, Spain, and the US. Those hoping for greater political clarity before returning to risk assets may face a long wait.

Fundamentals
We prefer to mitigate political risk through diversification, while concentrating on long-term trends in economic performance, earnings growth, and the outlook for central bank policies.

Positive backdrop
The prospects for the US economy remain positive, and earnings growth should rebound in the second half of the year. Meanwhile, financial easing continues in the Eurozone.

Asset allocation
We are overweight in US equities, European high yield credit, and US investment grade credit relative to high grade bonds. In currencies, we are overweight the US dollar and Norwegian krone relative to the Australian dollar and euro, respectively.

Mark Haefele
Global Chief Investment Officer
Wealth Management



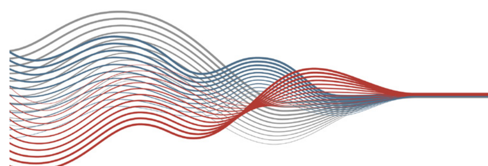
Navigating the politics of 2016

It's easy to get hooked on politics. By March, still the early stages of the US presidential campaign, people had already viewed 110 million hours of election material on YouTube alone – equivalent to the time needed to work 75,000 full-time jobs.

Politics has taken center stage around the world, with votes also approaching in the UK and Spain. Within two days of the publication of this letter we will know the outcome of the British referendum on EU membership – a vote likely to have significant short-term effects on markets.

At such times it can be difficult for investors to hold their nerve. Plenty cut their equity positions at the beginning of the year and didn't return to the market – even as the S&P 500 rallied toward all-time highs. Some have moved to safe-haven assets like high grade bonds, which are now more expensive than ever.

To those waiting for greater political clarity, I say "good luck." Once the UK vote is out of the way, the upcoming Spanish election will be seen by many as a mini-referendum on EU austerity policies. And in the US presidential race, the vote is already being presented to the American people and the world as a Judgment Day with far-reaching historical implications.



Live conference – Future of Europe

CIO experts will debate Europe's political and economic landscape the day after the UK referendum.

UBS Forum Digital – June 24, at 1 pm CET on www.ubs.com/cio-digital

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We favor remaining engaged with markets despite the continued political uncertainty. We prefer to focus on bedrock forces: economic performance, earnings growth, and the realities of central bank stimulus. Our strategic asset allocation is well-diversified across regions, asset classes, and sectors. It enables investors to benefit from encouraging developments in the global economy while mitigating losses from individual events that could take a long time to recoup in a low-return environment.

We see a number of persistent developments in global markets that should guide investors: the recovery and strength of the US consumer, a growing likelihood of US Federal Reserve rate hikes as the US economy continues to reflate, and ongoing easy financial conditions in the Eurozone. Our current tactical positioning seeks to take advantage of these trends and includes an overweight in US equities, European high yield credit, and US investment grade credit relative to high grade bonds. In currencies, we are overweight the US dollar and Norwegian krone relative to the Australian dollar and euro, respectively.

I want to touch on some of the looming political events before exploring the most meaningful underlying trends for investors.

Decisive political events?

If the UK public votes to leave the EU, we would anticipate a weakening of sterling...

The UK referendum

According to Bloomberg the FX market is pricing in a 20% chance of a "leave" decision, and the Oddschecker market appears to be signaling a 25% chance of a "leave" result (Fig. 1). Were this to arise, it can be expected that the pound may fall in a range as low as 1.30 against the US dollar, and decline toward 1.25 against the Swiss franc, around a 10% depreciation. In the event of a "leave," we would also expect the yen to rise against the dollar, perhaps testing and breaching the psychological 100 barrier, in response to short-term uncertainty. UK mid-cap stocks would likely underperform large caps, which derive more of their revenue from overseas. UK gilt yields could be expected to fall, reflecting a likely "flight to quality", and the possibility of further monetary stimulus from central banks.

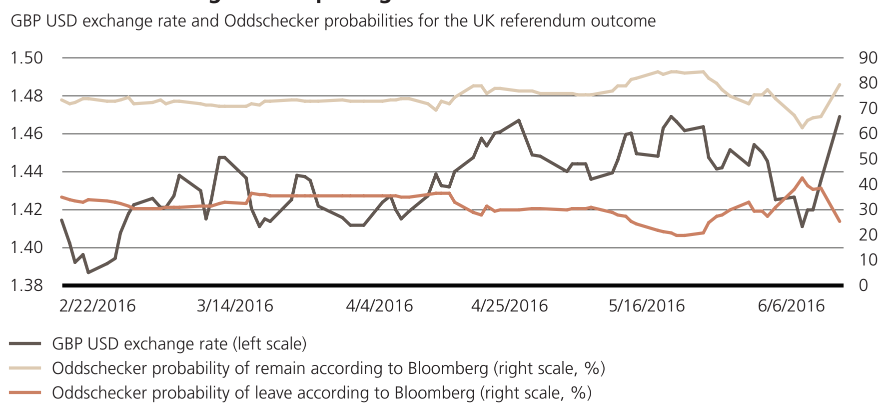
...while a "remain" vote could be expected to boost the pound.

A "remain" vote is likely to lead to a more muted appreciation of the pound and risk assets. The extent of any rebound depends on how quickly the UK economy

We will not trade the referendum's immediate outcome, but look for potential market mispricing of the medium-term impact.

Fig. 1: Sterling can be expected to fall if outcome of UK referendum contradicts betting market pricing

GBP USD exchange rate and Oddschecker probabilities for the UK referendum outcome



Source: Bloomberg L.P. Data as of 20 June 2016

can recover from its sluggish first-quarter economic growth and how soon markets re-price for possible Bank of England rate hikes.

We will not try to trade the instant reaction to the vote. Instead we will be watching the safe-haven currencies (USD, CHF, JPY) and official responses, to understand if markets are mispricing the impact of the referendum over the medium term.

If markets over-react to the result, this could create opportunities.

If European high yield spreads were to widen by 100 basis points or more following the UK referendum result, we may consider adding to our overweight position. Equally, global stock declines of 8–10% could open up opportunities to increase our equity overweight, although the preferred market for investment would depend on how aggressively central banks responded. Spread widening in emerging market sovereign and corporate bonds may also offer opportunities.

The UK referendum seems particularly pivotal for investors because it is meant to be a one-time decisive vote on "the future of Europe." But the reality is far more complex than that. Shortly after the UK votes are counted, the Spanish election will again raise the question of "Whose Europe is it, anyway?" The anti-austerity Podemos party gaining influence could be seen as a rebuke to proponents of fiscal restraint, which would drive another wedge between creditor and debtor nations in Europe.

In the US, Donald Trump's rise to become the presumptive Republican nominee has surprised many global investors, making the world seem even less predictable. Investors would do well to remember that US presidential races have not tended to have significant impact on markets. Even though this year's candidates are more divisive than usual, the US system of checks and balances makes radical changes in policy less likely.

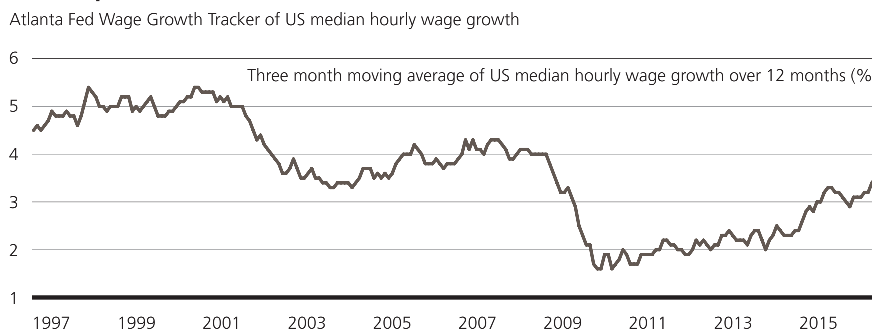
Sorry, politics; it's still about the economy

We think the global recovery and central bank policies will still be more important for determining asset prices in the second half of the year than the series of "(un)decisive" elections outlined above. Among the most important factors in the global economy at present are the health of the US consumer and the outlook for Fed policy, ongoing easy financial conditions in the Eurozone, and a growth stabilization in China.

The Atlanta Fed's measure of US wages points to the strongest rate of growth since 2009.

Fig. 2: Tightening US labor markets are leading to rising wages and stronger consumption

Atlanta Fed Wage Growth Tracker of US median hourly wage growth



Source: Current Population Survey, Bureau of Labor Statistics and Federal Reserve Bank of Atlanta. Data as of 20 June 2016

US economic fundamentals look more positive than the outlook priced into interest rate futures markets.

US economic fundamentals look more positive to us than the outlook currently priced into interest rate futures markets (which expect just two Fed rate hikes in the next three years). Personal consumption expenditure climbed more than 4% year-on-year in April for the first time since November 2014. Aggregate wage growth, as measured by the Atlanta Fed's Wage Growth Tracker, is at its highest level since 2009 (Fig. 2). And personal consumption expenditure inflation has increased from 1.3% to 1.6% in the past six months. Alongside greater consumer momentum, US manufacturing may also be bottoming, as suggested by the recent improvement in the ISM new orders index.

Improving economic activity supports our overweight position in US equities, since the market is priced neither for such improvements nor for the potential of 6% earnings growth in the remainder of the year. We expect profit margins to recover due to the year-over-year recovery in the oil price and less US dollar strength. US equities still look attractively valued compared to high grade bonds.

We expect two rate hikes for the remainder of 2016.

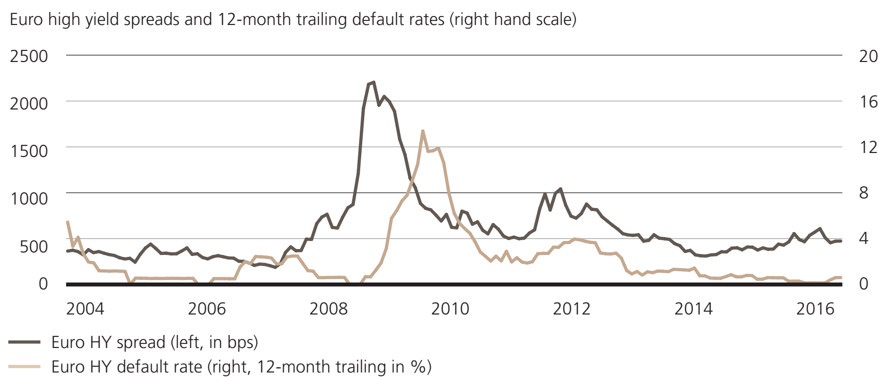
As a result of this positive backdrop, we expect the Fed to hike rates twice this year, beyond the eight basis points (bps) of tightening priced in by the market. This supports our overweight in the US dollar against the Australian dollar. But this moderate pace of tightening would be insufficient to raise corporate borrowing costs, so it should be digested by US equity markets. We also retain an overweight in US investment grade bonds, which offer an attractive yield versus high grade debt. Spreads are unlikely to widen in the event of a gradual Fed hiking path, and the scope for more aggressive tightening should be limited by the risk of a sharp dollar appreciation at a time of continued monetary easing in other developed economies.

We expect the European Central Bank (ECB) to continue to support credit conditions in the Eurozone. Already, corporate bond buying has helped reduce borrowing costs for companies that finance themselves through public markets. And the new series of Targeted Long Term Financing Operations (TLTRO) should also cut debt costs for smaller businesses that rely on banks for funding. Markets see the easing in financial conditions, but they have failed to price for lower default rates, particularly within the European high yield space (Fig. 3). These credits still offer spreads of 480bps over German Bunds, a level we deem attractive in the context of expected default rates of 2%, and the ECB's ongoing support.

Easy financing conditions due to European Central Bank policy support our EUR high yield overweight.

Fig. 3: European high yield spreads look attractive compared to a benign default environment

Euro high yield spreads and 12-month trailing default rates (right hand scale)



Source: Bank of America Merrill Lynch, UBS WM CIO. Data as of 20 June 2016

Easier financial conditions should underpin a gradual improvement in the Eurozone economy.

Easier financial conditions should underpin a gradual improvement in Eurozone economic growth. But for now the euro, constrained by negative deposit rates and tepid inflation, is unlikely to follow economic activity higher. Improving Eurozone growth should continue to benefit Norway, and markets should reduce their expectations for further easing from the Norwegian central bank. This supports our overweight position on the Norwegian krone relative to the euro.

Economic and policy trends are not so clear in China and Japan, so we have less conviction in direct overweight positions in Asian assets for our global tactical asset allocation. In recent months China's economic growth has been stabilizing, which comforted emerging markets and commodity producers. Along with a more dovish Fed, China's central bank has given better guidance on its policy for a more stable CNY versus a basket of currencies. Policy makers have also increased capital controls to prevent funds from flowing offshore. China's near-term outlook remains conducive to a modest risk-on stance in global portfolios, but we recognize markets are looking for greater visibility on how China will tackle its rising domestic debt burden. We maintain a neutral position on emerging market equities.

Policy uncertainty makes us reluctant to add to tactical exposure in Japan at present.

Policy uncertainty is also a worry in Japan. Bank of Japan (BoJ) officials seem to favor surprise over consistency: inflation target measures have been arbitrarily adjusted, and the BoJ moved to sub-zero rates in January, just weeks after Governor Haruhiko Kuroda had dismissed the idea. Market reactions to policy surprises are unpredictable too: the yen has *strengthened* by 15% against the US dollar after the move to negative rates. More monetary or fiscal stimulus may come later this year, but without additional effective policy action, we are holding back on tactical positions in Japanese equities or the yen.

The bottom line

Even after the UK referendum is settled, there is no immediate respite from event risk on the horizon. But as I have explained above, this should not push investors to the sidelines or distract them from acting on enduring investment trends. We do not intend to take strong positions directly linked to each event risk. However, we will monitor such events for signs that markets have over-reacted to their outcomes, especially in the asset classes we deem most attractive at present (for more information see our recent research piece *"Risk Radar Special: Binary outcomes in 2016"*).

The next few months could prove both tempting and terrifying for investors in equal measure. Just remember, watching Hilary Clinton and Donald Trump on YouTube may satisfy a craving for politics, but it is not an investment strategy.

Mark Haefele
Global Chief Investment Officer
Wealth Management

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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.

- Risks, whether from political events or central bank policy action, remain at the center of investors' minds. Uncertainty continues to prevail.
- Hedging against sudden shocks is more important than ever. Participants saw numerous sources of risk on the horizon, including high debt burdens, especially in emerging markets, the threat that monetary stimulus is reaching its limits, and the possibility that votes around the world will disrupt markets.
- However, investors can lose out if overly cautious. Relative value trades could protect investors while still providing sources of return.

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