UBS House View

Monthly Letter

Chief Investment Office WM
25 August 2016

Post-Brexit rally
Many feared the UK vote to exit the EU would represent a setback for global markets. Instead we have seen price gains for assets across the risk spectrum.

Bond yields
The UK's shift back toward monetary easing has contributed to lower global yields. This can help restrain the pace of US rate rises, since the Fed is eager to avoid a harmful appreciation of the US dollar.

Fiscal options
The Brexit vote has also promoted renewed debate about the limits of monetary policy and the need for alternative means to stimulate faster economic growth.

Asset allocation
We remain overweight US and emerging market equities. We have closed our short Australian dollar position versus the US dollar.

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The bright side of Brexit?

What was initially reported as armed robbery turns out to be a misunderstood negotiation. No, I am not talking about what occurred in Brazil with four US Olympic swimmers. I am talking about Brexit. Many had feared that a UK vote to exit the EU would represent a significant setback for global markets. Instead, aside from the impact on the UK pound, the post-Brexit plunge lasted only a few days, as the reassuring Bank of England (BoE) response and stronger data elsewhere have allowed markets to focus on global growth. Now, all three US stock benchmarks are near record highs. Emerging market (EM) equities are at one-year peaks. High yield bonds have held up in spite of volatile oil prices. And, at the other end of the risk spectrum, the demand for developed market government debt is such that 40% of it now trades with a yield below zero.

Our diversified portfolios and overweight positioning in US equities have benefited from the post-Brexit rally. Over our six-month tactical investment horizon we remain confident that markets still hold upside. We are overweight US equities and US investment grade debt over high grade debt, as well as emerging market equities over Swiss equities.

But can we go further and point to something beyond a neutralization of the Brexit concerns? What might it take to see a potential bright side to the much-discussed vote? At a global level, the Brexit experience is promoting the debate on the limits of monetary policy, which could prove beneficial if it leads to more coordinated monetary and fiscal stimulus. And for the UK itself, Brexit might offer a historic opportunity to improve its economic fortunes, if the country follows the right role models.

UBS

Britzerland?

The UK must choose its own path toward the brighter economic future promised by pro-Brexit politicians. However, there are proven roadmaps for successfully negotiating with the EU and improving economic prosperity.

Switzerland has proven it is possible to succeed outside the EU club.

When Swiss voters opted to remain outside the European Economic Area in 1992, the pro-European economy minister described it as a "dark day" for the nation. Yet, economically, Switzerland has shown itself to be a success story. It now occupies the top spot in the World Economic Forum's Global Competitiveness report, up seven notches since 2004. The Swiss model of light regulation and a focus on skills has helped make the Alpine state a magnet for multinationals and start-ups alike. It filed more patents per capita last year than any other country in the world (Fig. 1). And it also leads the EU in the adaptability of its workforce.

If UK politicians want to follow Switzerland's lead, some uncomfortable choices likely loom. For instance, while rejecting membership in the European club, Switzerland remained open to foreign workers, helping it secure access to the common market and fuel economic growth. Switzerland also runs what in the UK might be seen as permanent austerity. Between 2006 and 2014, the Swiss have run an average general government surplus of 0.5% of GDP, relative to the UK's average deficit of 6.5% of GDP, according to OECD data.

The UK and Swiss economies have much in common, including a heritage of business-friendly regulation.

But the UK has many of the basic ingredients needed to follow Switzerland's path if it chooses. Like Switzerland, it benefits from relatively light business regulation, a highly skilled workforce, and a tradition of innovation. And outside the EU, the UK will have even greater freedom to create the kind of business-friendly climate that helps explain Switzerland's success.

If UK politicians make the right policy choices, the UK might just realize and enjoy a sustained "bright side to Brexit."

The global bright side

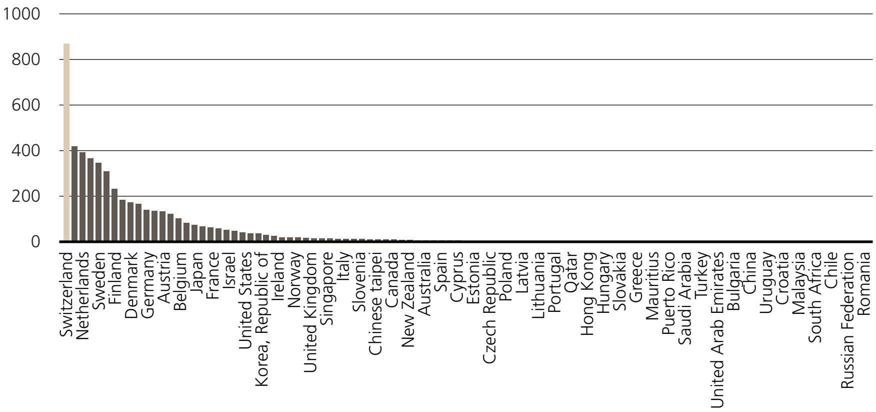
For now

The "bright side to Brexit" we've seen in the markets is not based on better-than-expected UK economic data; it will take months before data clearly indi-

Swiss companies benefit from light regulation and an adaptable workforce.

Fig. 1: Switzerland is an innovation hub, filing more patents per head than any other country.

European patent applications per million inhabitants in 2015.



Source: European Patent Office, UBS. Data as of March 2016 cates how the nation's economy is coping with the vote. More important has been the outsized effect of the BoE's actions on global yields. In effectively ending carry trades in gilts by announcing renewed quantitative easing, the BoE has contributed to a revived global "hunt for yield." Subsequent downward pressure on US Treasury yields in particular has supported asset prices.

Post-Brexit declines in global high grade bond yields favor US companies, and lower debt costs in emerging markets.

Lower yields reduce the cost of corporate debt in the US, boosting profit margins in the world's largest economy. Emerging markets are also enjoying lower servicing costs on their foreign-currency liabilities; the yield on the JP Morgan EMBI and CEMBI indices for governments and corporates recently touched 4.81% and 4.92%, their lowest levels in three years (Fig. 2). And stronger EM exchange rates relative to a weaker US dollar contain EM inflation, reducing the need for local central banks to hike rates.

Lower global yields might also restrain the pace of US Federal Reserve tightening, since officials will be keen to avoid a damaging appreciation of the dollar. We expect only one Fed rate rise this year, and not until December.

For later

BoE chief Carney boosted market sentiment by ruling out sub-zero rates in the UK.

Although markets were reassured that another round of central bank stimulus managed to push risk assets higher, this post-Brexit easing has underlined the fact that we are approaching the limits of this plan. BoE Governor Mark Carney was keen to stress that the lower bound for rates will remain positive in the UK even though 40% of developed market government debt now carries a negative yield. Markets looked favorably on his disavowal of negative rates as an effective policy measure, which in turn will pressure Europe and Japan in particular to move beyond further rate cuts to stimulate growth.

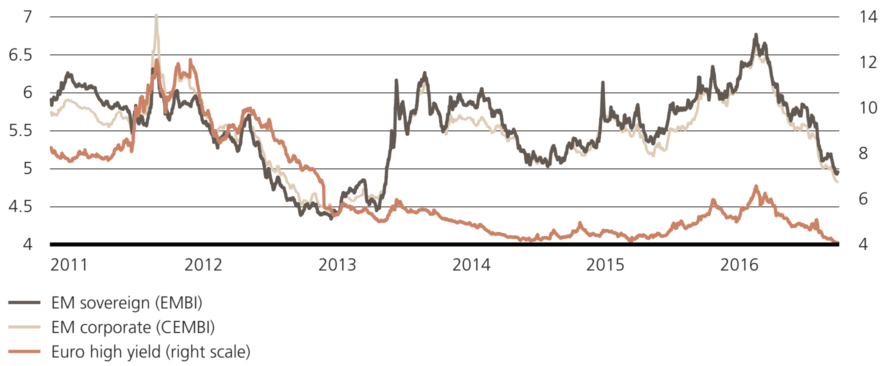
The UK referendum result has encouraged lawmakers to revisit the case for fiscal stimulus.

Already, UK Chancellor Philip Hammond has flagged an end to the fiscal belt-tightening espoused by his predecessor, George Osborne. The European Commission's post-Brexit decision not to levy fines on deficit-limit breakers Spain and Portugal implies some fiscal leniency on the part of European policymakers, potentially linked to concerns about European unity. And Japan, also facing the limits of monetary policy, has introduced a JPY 28trn (USD 276bn) spending package.

EM nations can borrow in dollars at the cheapest rate in around three years.

Fig. 2: Lower US yields pushed down borrowing costs on EM debt and European high yield.

Yield to maturity for EM sovereign and corporate debt (USD), and for euro high yield.



Source: Bloomberg L.P., UBS. Data as of 22 August 2016

I am not suggesting that fiscal spending is a panacea for low growth and productivity, but I can see signs that Brexit could serve as the catalyst for politicians to engage in more growth-friendly policies, giving their central bank counterparts a break.

The door remains open for a Brexit outcome that is positive for both the UK and global markets. But it won't stay open forever.

Tactical asset allocation

Trends in global economic growth, central bank policy, and corporate profits have justified our risk-on stance.

US economic growth remains well supported by strong domestic consumption.

US consumers remain in good health; average wages are growing at 3.4% according to the Atlanta Fed, close to the highest level since March 2009, and US household net worth is at a historical peak. Domestic demand growth in the second half of the year should help revive earnings per share growth to 3% for the full year. An end to the energy sector's capital expenditure destruction also bodes well for US industrial activity.

Since US borrowing costs should rise gradually, corporate debt costs will remain low for US and EM firms. This supports our overweight positions in US and EM equities in global portfolios. US stocks still look attractive relative to high grade bonds, despite trading at a trailing price/earnings ratio premium of 15% versus the average since 1960. In credit markets, we remain overweight US investment grade debt, whose spreads of 109 basis points still offer attractive carry versus high grade bonds.

EM stocks benefit from stronger leading indicators of growth, and more stable earnings. More defensive Swiss stocks look set to underperform.

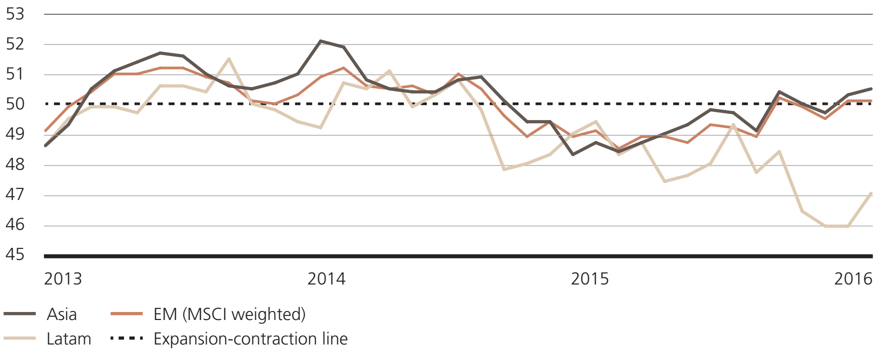
We also remain overweight EM equities relative to Swiss stocks. We have seen encouraging signs of stabilization in emerging economies, with purchasing managers' indices pointing to rising activity in emerging Asia and Latin America (Fig. 3). Earnings also appear to have leveled off after a 30% slide since early 2012. In contrast, Swiss equities, which are heavily weighted toward defensive sectors, stand to benefit less from reviving global growth.

We made one change to our global tactical asset allocation this month, removing our underweight in the Australian dollar versus the US dollar. In the wake of the Reserve Bank of Australia's second rate cut in early August, the near-term risks for

Stronger economic growth should benefit our overweight EM equities position.

Fig. 3: Leading indicators of emerging market growth are stabilizing.

Manufacturing purchasing managers' indices for EM, Asia, and Latin America.



Source: Thomson Reuters Datastream, UBS. Data as of 2 August 2016.

AUDUSD look more balanced. The Australian dollar held its value due to stronger-than-expected industrial performance in China and other emerging markets, signs that Australia will face fewer short-term setbacks to domestic growth, and the perceived Fed reluctance to raise rates at a time when other central banks remain in easing mode.

We are maintaining our six-month AUDUSD forecast at 0.71, and have raised our 12-month view to 0.71 (from 0.68). We would consider reinitiating this position if the AUD appreciated further, China's "old economy" suffered a more abrupt slowdown, or the market brought forward its expectations for the next Fed rate hike.

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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.

- Our panel agreed that debate about the timing of the Fed's next policy move dominated an otherwise benign summer.
- Participants concurred that fiscal policy may increasingly become more important as a driver of global growth and profits.
- The global hunt for income looks set to continue, favoring higher-yielding fixed income and emerging market equities.

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