UBS House View

Monthly Letter

Chief Investment Office WM
28 April 2016

Sub-zero rates
Stock markets responded positively to the introduction of quantitative easing. But investors have been more skeptical of negative rates, fearing that unintended consequences may overwhelm any positive effects.

Here to stay
Low or negative rates are here to stay in many parts of the world. That further reduces the appeal of high grade bonds over coming years.

Investment concepts
Some alternative investment concepts, pioneered by institutions such as hedge funds or endowments, can be applied by private investors to help achieve their objectives in this low yield environment.

Asset allocation
We remove our underweight position in emerging market equities relative to Eurozone stocks. We also close an underweight position in the Japanese yen, and add an underweight position in the Australian dollar.

Mark Haefele
Global Chief Investment Officer
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Meeting the challenge of negative rates

Negative rates in Denmark mean that some people are *receiving* mortgage payments from their bank. Certain cantons in Switzerland are asking residents *not* to make monthly tax payments. And in Japan, people have taken to buying home safes for fear of *paying* interest on their bank deposits. But this era will be remembered for more than a few quirky anecdotes.

The unexpected decision by the Bank of Japan (BoJ) to push rates below zero rekindled fears that central banks are running out of ideas to stimulate growth and inflation. While central banks in Europe had taken that route before, the move led to a market perception of desperation – and perhaps helplessness – among policymakers after more than half a decade of quantitative easing. Investors are no longer just worried about the tenacity of slow growth; they have also become concerned about the potential effects of negative rates on financial stability.

In the months and years ahead, negative interest rate policy will present both a key danger and opportunity for investors. The short-term outlook will be driven by the success or failure of such unconventional measures to revitalize growth, and long-term return assumptions are changing as markets price an increasing likelihood that rates will remain low or negative long into the future.

In our Strategic Asset Allocation (SAA) models, which have a time horizon of five-plus years, the plunge in yields across the maturity curve means that the already muted long-term outlook for high grade bonds has worsened. Hedge funds are likely to provide higher returns over the long term while adding only limited risk. We diversify our bond holdings across a wider range of monetary regimes to mitigate portfolio risks that result from the experimental new policies central banks are adopting.

Alternative investment concepts can help investors find better returns without taking on unacceptable risk, a growing challenge in the face of negative rates. These concepts can: a) provide investors with exposure to stocks in normal markets, but reduce allocations sharply when we determine risks are elevated; b) enable investors to harvest illiquidity premia; and c) utilize the whole fixed income spectrum to offer bond investors greater returns.

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Responding wisely to the conundrums presented by negative rates will largely determine investment success in the years ahead.

QE was well received by markets. Sub-zero rates have drawn a more skeptical response.

Unexpected reactions

Markets reacted positively to quantitative easing when it was first deployed by the US Federal Reserve during the global crisis. And when the European Central Bank (ECB) and the Swiss National Bank introduced negative interest rates in 2014, it caused little upset in financial markets. But the Bank of Japan's surprise move to sub-zero interest rates in January marked a change in the historical reaction function to central bank policy.

Usually greeted with equity market cheer, the rate cut precipitated a sharp decline in Japanese banking stocks. This reaction was repeated in March, when Eurozone financial stocks fell after the ECB cut rates more deeply into negative territory. This demonstrates growing unease about the impact of negative interest rates on bank profitability. Lower long-term yields are also now raising questions about the health of the insurance and pension industries, which may need to take excess risks to meet their obligations.

On the other hand, the bond market reacted with perhaps too much cheer. Short-maturity bonds received a boost, as can be expected, but long-dated bonds staged an even sharper rally (Fig.1). This suggests that markets are skeptical about the long-term positive effect of negative rates on growth and inflation.

Currencies have also stopped behaving by the book. Instead of depreciating, the Japanese yen appreciated in response to the BoJ's rate cut (Fig.2), while the euro is up 4% against the US dollar since the start of the year. A variety of factors are at play, but part of this unusual performance could be down to action from the central banks themselves. The Eurozone's targeted long-term refinancing operations – which now reward banks for borrowing from the ECB – and the potential for a similar measure in Japan, designed to help support bank profitability, might act as *de facto* capital controls given that loans made domestically are subsidized, while those made overseas are not.

Despite the uncertainty over the positive impact of negative rates, we expect neither the BoJ nor the ECB to reverse course anytime soon.

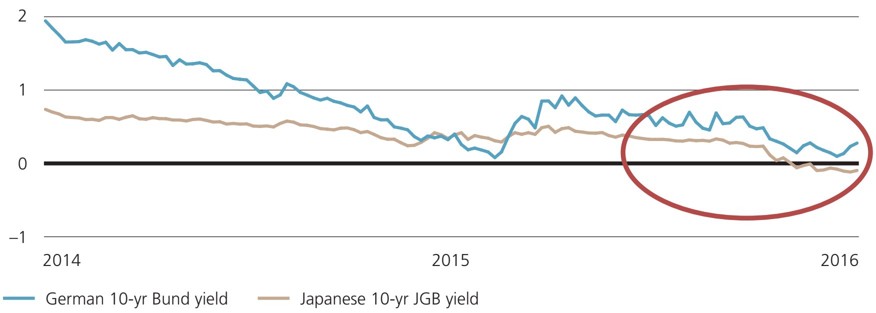
Dealing with an uncertain world

The interplay between negative rate policy, its second-order effects, and the central bank reaction to those effects is complex, and requires a careful investor response.

Zero or negative bond yields indicate markets are not priced for a pick-up in growth or inflation.

Fig. 1: Ultra-low high grade yields imply skepticism about central banks' effectiveness

German and Japanese 10-year bond yields to maturity, in percentage



Source: Thomson Reuters, UBS. Data as of 26 April 2016.

We are increasing our long-term exposure to EUR-denominated corporate bonds at the expense of USD fixed income.

The principles of currency hedging, limiting home bias, and diversifying across regions and within asset classes will be important in managing uncertain policies, effects, and responses. We are therefore increasing our allocations to EUR-denominated corporate bonds at the expense of USD-denominated ones in model portfolios to avoid overexposure to the US at a time when its cycle is getting long in the tooth. We also are raising allocations to corporate emerging market bonds in our balanced model portfolio.

The decline in high grade bond yields means we now expect euro and Swiss franc AA+ bonds to deliver negative returns in the coming five years. High grade bonds have insurance value, but it now comes at a high price. As such, we are also reducing our strategic allocation to high grade bonds in favor of hedge funds. Though buffeted of late by regulatory changes, stock-specific issues, and sudden reversals of market trends, diversified hedge funds, over the longer term, should deliver normalized returns in the 4-6% range, in our view.

Alternative investment concepts

Portfolio shifts can assist investors in adjusting to this uncertain world. But the fundamental issue of finding desirable returns in a low-return world, without taking unacceptable risks, remains.

Alternative investment concepts can be applied by investors to help achieve their objectives.

Quantitative approach

To earn higher returns over the long run, investors need to take more risk. Doing so with traditional investments tends to mean buying equities. In normal times, equities can deliver good returns with relatively limited volatility. But when markets are turbulent, stocks can introduce volatility that is intolerable for investors accustomed to bond investing.

One investment concept allows investors to shift between equities and bonds as levels of market risk fluctuate.

One way of overcoming this is to use risk management tools, similar to those used by leading institutional investors to assess the level of risk in equity markets, and allocate between bonds and stocks accordingly. The approach would allow investors to invest heavily in equities during periods of normal or particularly low risk, but tilt the portfolio markedly toward bonds in times of elevated risk.

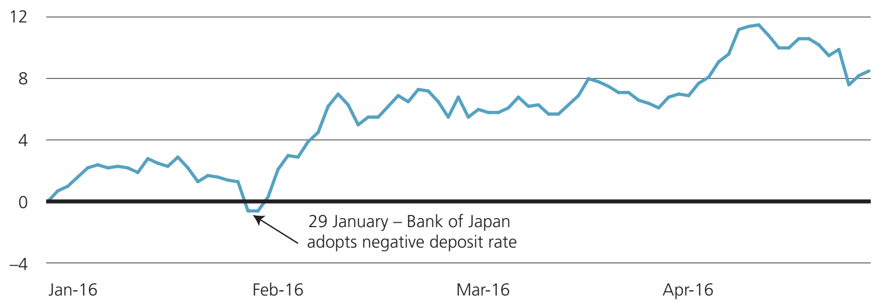
"Illiquidity premium" approach

Investors uncomfortable with taking any equity risk at all have very limited options for earning desirable returns in the traditional fixed income universe.

The recent rise of the yen has marked a shift in the market reaction to additional monetary easing.

Fig. 2: The yen has rallied, not depreciated, since the adoption of sub-zero rates

Year-to-date %-change in the value of the Japanese yen against the US dollar (inverse of USDJPY exchange rate)



Source: Thomson Reuters, UBS. Data as of 26 April 2016.

In US dollars, we expect high grade bonds to return 2.1% annually over the next five to seven years, and corporate bonds to generate 2.7%. Our expectations in Swiss francs and euros are even lower.

Fixed income investors have the potential to increase returns through greater diversification...

By accessing less traditional and less liquid instruments, however, investors committed solely to fixed income have the potential to achieve better returns. The wider fixed income universe includes asset-backed securities, subordinated financial bonds, senior loans, and private debt, alongside corporate and sovereign bonds. It is important to ensure exposure to a wide range of markets and monetary regimes to ensure necessary diversification.

Endowment approach

...and an endowment approach can deliver an illiquidity premium.

Private investors can also draw upon the approach of some of the most successful university and pension fund managers. Investors can allocate a higher proportion of portfolio assets to illiquid alternative asset classes, including hedge funds, private equity, private debt, and real assets.

Taking advantage of such asset classes enables investors to harvest an illiquidity premium, which we estimate could be as large as 1.6 percentage points of extra return, for the same level of asset volatility.

Tactical asset allocation

In the months ahead, the questions and concerns raised by negative interest rates will be a key market driver, as will the evolution of Federal Reserve policy. Our tactical view remains that negative rates may be imperfect, but they demonstrate central bank willingness to continue to innovate and supply liquidity to global markets. We believe, overall, that the commitment of central banks supports risky assets.

We remain overweight US equities...

We maintain an overweight in US equities relative to high grade bonds. US profits should improve after the current earnings season, helped by the oil price recovery, dollar weakness, and ongoing strength in consumption.

We also maintain an overweight in European high yield credit relative to high grade bonds. Negative rates will continue to drive a thirst for yield, and liquidity from the ECB should help keep default rates low.

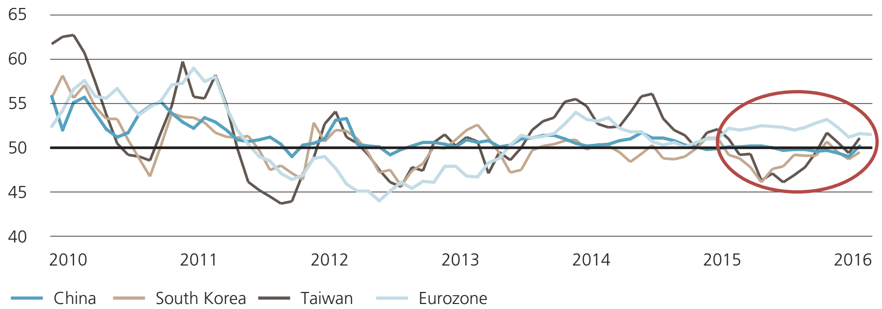
We are making three changes to our tactical allocation this month:

First, we neutralize our underweight position in emerging market equities relative to Eurozone equities.

Economic data is improving in EM, but has softened in the Eurozone, where headwinds are increasing.

Fig. 3: Improving leading indicators in EM Asia favor neutral EM equity stance

Manufacturing purchasing managers' indices (PMI), index level, reading above 50 signals expansion



Source: Thomson Reuters Datastream, UBS. Data as of 27 April 2016.

...and remove our underweight position on emerging market equities relative to Eurozone stocks.

China's policy traction, a more dovish US Federal Reserve, and progress in Brazil's political saga have improved sentiment and led to more positive leading indicator readings in emerging markets (Fig. 3). We have reservations about earnings growth in EM and about the long-term impact of China's stimulus, but the rally has scope to continue in our view, and we are moving to neutral from underweight.

While the outlook has improved for emerging markets, the Eurozone is facing marginally greater headwinds. The positive effects from a weaker euro through last year are fading, especially as the currency has appreciated over recent months. Negative rates and a flat yield curve will continue to pose challenges for the region's banks, which account for about 12% of the MSCI EMU Index. That represents a drag on overall earnings growth. Economic growth remains decent, but with prospects for earnings growth now more limited, we are moving from overweight to neutral.

We are introducing an underweight position in AUD versus USD.

Second, we are introducing an underweight position in the Australian dollar versus the US dollar. We believe that the recent recovery in the Australian economy is unsustainable, while US growth is likely to rebound after a soft patch over the last two quarters. This divergence in economic performance is likely to be reflected in monetary policy decisions, which we expect to weaken the Australian dollar.

Finally, we neutralize our underweight position in the Japanese yen relative to the US dollar. The latest Bank of Japan meeting suggests that the central bank is in a wait-and-see mode, in spite of weakening economic data. The recent strength in the yen means that Japanese investors in foreign assets, including the government's pension fund, are now considering whether to hedge their foreign exchange exposure. Such risk management measures could prevent the yen from weakening in the near future, and we move to neutral.

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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.

- This month, our guests were asked where they saw bubbles in global markets and where there were still opportunities. Participants argued that while no large or dangerous bubbles were forming in any of the major asset classes, mis-pricing had developed in numerous sub-asset classes.
- Our panel agreed, however, that opportunities remain in selected segments of credit and equity markets, mostly in the United States.

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