

Deeper dive

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## Market moves

	CIO view	-1w	-3m	ytd
S&P 500	OW	-1.5%	-1.6%	5.2%
Euro Stoxx 50		-2.6%	3.6%	-4.6%
MSCI EM	OW	-0.9%	3.4%	16.3%
FTSE 100		-1.1%	4.7%	14.2%
SMI	UW	-1.7%	-3.1%	-8.8%
NIKKEI 225		-1.5%	5.3%	-8.4%
US high grade bonds	UW	-0.1%	-0.6%	5.1%
Euro high grade bonds	UW	-1.2%	-1.3%	5.2%
US investment grade bonds	OW	-0.3%	-0.1%	8.3%
Euro investment grade bonds		-0.3%	-0.4%	5.1%
US high yield bonds		-1.7%	2.4%	13.1%
European high yield bonds		-0.4%	1.9%	7.9%
EM sovereign bonds		-1.2%	0.8%	13.1%
EM corporate bonds		-0.4%	1.4%	11.9%

Source: Bloomberg, UBS as of 3 November 2016

OW = tactical overweight

UW = tactical underweight

## Market comments

Calculations are based on the past five days

- **Equities** were on the defensive over the past week as tensions built ahead of the US presidential election. The S&P 500 fell 1.5%, and the Euro Stoxx 50 was down by 2.6%. Swiss stocks declined by 1.7%.
- **Fixed income** markets also sustained losses. Euro and US high grade bonds fell 1.2% and 0.1% respectively. US high yield bonds were down 1.7%.
- **Currency trading** was marked by a 2.7% decline in the Mexican peso versus the US dollar. This appeared to be driven by a recovery in the polls for Republican nominee Donald Trump, who has pledged to take a hard line in trade talks with Mexico.

## In focus

**Clinton e-mail probe boosts fear gauge.** The VIX index of US equity volatility jumped by close to 10% in the wake of reports last Friday that the FBI had launched a fresh probe into the Democratic presidential nominee's use of a private e-mail server as Secretary of State. The concern is that this may erode Clinton's polling lead, boosting the chances of a victory for Republican Donald Trump. *CIO is overweight US equities against high grade bonds – US economic growth should remain underpinned by domestic demand, and earnings results for 3Q should indicate a return to growth.*

**Eurozone sentiment hits 2016 high.** An index tracking confidence for the Eurozone climbed in October to its highest level since last December. The gauge, produced by the European Commission, draws on feedback from firms in manufacturing, services, retail, and construction, as well as from consumers. *CIO remains neutral on Eurozone equities.*

**Peppy PMIs.** The PMI for Eurozone manufacturers rose last month to a level unseen since January 2014. The 53.5 print, ahead of expectations, hid some country-level divergence under the hood. German and French industrial sentiment hit multi-month highs, but Italian and Greek gauges plumbed two and five-month lows. *CIO still expects Eurozone GDP growth to moderate from 1.5% this year to 1.3% next.*

**A vote of confidence?** The British pound got a lift on Tuesday after news that Mark Carney plans to stay as Bank of England governor until 2019. He is resisting calls for his resignation from some pro-Brexit politicians, who

resented his warnings about the potential economic damage from a vote to leave the EU. Sterling extended gains on Wednesday against the US dollar, as election uncertainty hit the US currency. *CIO is neutral on UK equities and the pound in global portfolios.*

**China activity strengthens.** China official manufacturing PMI rose to 51.2 last month, exceeding expectations and posting its highest reading since August 2014. Meanwhile, services activity improved, with the gauge reaching 54.0 versus 53.7 in September. The data suggests the economy continues to stabilize; *CIO is overweight Chinese equities in its regional tactical asset allocation strategy.*

**Pricing underpins profits.** Chinese firms' industrial profits climbed 7.7% y/y in September, reversing the base-effect spike of 19.5% y/y in August. Industrial profits this year have grown 8.4% as of September, unchanged from August. *CIO expects industrial profits to maintain high single digit growth as producer pricing power recovers.*

**Inflation recedes over horizon in Japan.** The Bank of Japan is getting used to disappointment. It first set a 2% inflation goal in 2013. Now it thinks the "earliest possible time" it will hit the goal is around fiscal year 2018, which starts in April of that year. It scaled back its 2017 inflation forecast from 1.7% to 1.5% at its latest monetary meeting, though changed nothing else. *CIO forecasts USDJPY at 104, 102 and 98 in three, six and 12 months respectively.*

Deeper dive

# Final countdown

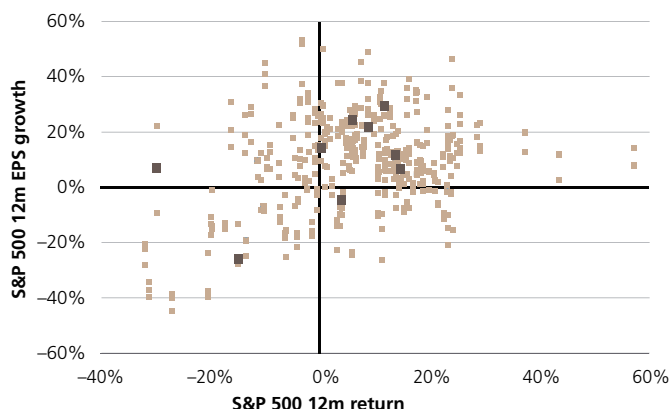
We are now less than a week from concluding one of the most divisive and dispiriting elections in US history. For the first time since pollsters began seriously collecting voter preferences, the nation must choose between two candidates whose unfavorable ratings exceed their favorable ratings. So no matter who wins next Tuesday, more people will likely be displeased by the outcome than pleased. Small wonder that this entire campaign has cast a pall over the electorate.

But this sense of despondency resonates well beyond the voting booth.

In a special pre-election edition of the Investor Watch survey, our colleagues in the US Client Strategy Office found that the anxiety surrounding this election has also affected investor sentiment. Of those investors surveyed, 55% responded that they have taken action to limit their risk exposure in advance of the election, with 30% increasing their cash holdings and 25% shifting to a more conservative allocation. What's more, the level of angst does not appear to be "partisan," with Republicans, Democrats and Independents all expressing similar levels of anxiety.

## Fundamentals matter more than politics for US equity returns

Trailing 12m EPS growth and trailing 12m price return – S&P 500, 1980 to 2016 (dark brown markers indicate the 12 months following a presidential election)



Source: Factset, UBS. Data of end October 2016



Mark Haefele



Mike Ryan

### What should investors focus on in the moments before the election, given uncertainty about the outcome and anxiety over the impact?

1. The separation of powers ensures that no individual or institution could unilaterally dominate the nation's governing process. Thus the president – regardless of who that might be – will be forced to work with Congress to implement any substantial legislative initiatives. Given the low probability of either party sweeping both the executive and legislative branches (20% probability for the Republican sweep, 5% for the Democratic sweep) the more market-friendly "status quo" divided government will likely endure following the election.
2. The choice of president generally does not alter investment outcomes. Instead, market returns tend to be determined more by fundamental factors such as relative valuations and earnings growth (see figure). So with risk premiums still high by historical standards and earnings growth poised to reaccelerate, equity markets are unlikely to suffer a material and sustained drawdown following the election.
3. Our work indicates that making investment decisions based solely upon political preferences or emotional reactions can lead to sub-optimal outcomes. We estimate that common behavioral biases can cost investors 100–400 basis points in annual performance. Given the current low return environment, making an investment plan in advance that helps prevent just some of these behavioral pitfalls could contribute markedly to overall portfolio performance.

**Mark Haefele**

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Wealth Management

**Mike Ryan**

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## Bottom line

The upcoming US election will be like none that have come before. Markets are therefore apt to remain volatile until the results are fully known, and perhaps even after depending upon the outcome. But experience tells us that making investment decisions based solely upon electoral

events has rarely yielded benefits. Instead, the best way to make sure that we are prepared for November 8 is to maintain a well-structured and broadly diversified portfolio, stay focused on long-term financial goals, and have a plan in place to take advantage of any market dislocations.

## Regional view

# Important, but no game changer for Europe



**Themis Themistocleous**  
Head CIO European Investment Office

The US is the single-largest export market for the EU. It accounted for EUR 371bn, or 20.7%, of all exports, last year. As such, US presidential elections are of particular interest to European companies and investors.

We assign a 75% probability to a scenario of Democrat Hillary Clinton winning the presidency and the Congress either being split between the Democrats and Republicans or remaining fully in Republican hands. Under these scenarios we see little likely change in terms of the economic and the regulatory environment. We expect both to be moderately positive for European equities (uncertainty removed) and neutral for European fixed income markets (regional issues are a bigger driver here). Higher infrastructure spending should benefit European construction and engineering companies with significant exposure to the US.

We assign a low probability to a Donald Trump win or a Democratic clean sweep (including control of

both the Senate and the House of Representatives), but their potential impact is more significant.

As we saw with Brexit, currencies are among the first asset classes to react to unexpected outcomes. The euro has been remarkably stable versus the USD over the last 18 months, trading in a 1.05–1.15 range. In our base case, we expect it to strengthen over the next six to 12 months as the

**“US presidential elections are of particular interest to European companies and investors.”**

debate over European Central Bank (ECB) monetary policy and the possibility of tapering intensifies.

If Trump wins, we see the USD weakening more quickly versus the euro in the short term, as investors assess the election impact and gird themselves for wider deficits. A sharp appreciation of the euro versus the dollar would hurt Eurozone equities as exports to the US and other markets whose currency is linked to the USD became less competitive. But such an outcome could also influence ECB policy and the timing of any tapering.

Under a Trump-win scenario, the other big worry would be restricted trade. Significant exporters to the US include auto and aerospace and defense companies, which could

 **Podcast**  
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suffer from such developments. Financial services and the energy sector could find some support from less severe regulation. But European banks still face numerous challenges at home, including low interest rates, margin pressure, and anemic credit growth, at a time when regulators still demand more capital and lower leverage. Any relief from the US side is likely to aid European lenders only marginally.

If Clinton wins and the Democrats take both the Senate and the House, she will be in a stronger position to introduce further reforms in the healthcare, financial and energy sectors. The healthcare sector has already underperformed, so some bad news is priced in. The impact on the other two sectors would be incrementally negative, but domestic issues for the banks and crude prices for the oil sector are bigger determinants of share price performance.

Kind regards,  
**Themis Themistocleous**

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