UBS House View

Europe
Chief Investment Office WM

Weekly

11 August 2016

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Market moves

	CIO view	*–1w*	*– 3m*	*ytd*
S&P 500	OW	0.5%	6.0%	7.9%
Euro Stoxx 50		3.0%	3.6%	–4.3%
MSCI EM	OW	3.1%	13.3%	15.8%
FTSE 100		1.1%	12.2%	12.6%
SMI	UW	1.7%	4.1%	–3.5%
NIKKEI 225		4.1%	1.1%	–11.2%
US high grade bonds	UW	0.0%	1.7%	6.0%
Euro high grade bonds	UW	0.7%	2.8%	7.4%
US investment grade bonds	OW	0.4%	3.4%	9.3%
Euro investment grade bonds		0.3%	3.0%	6.1%
US high yield bonds		1.6%	5.6%	12.2%
European high yield bonds		0.7%	3.2%	6.8%
EM sovereign bonds		1.4%	6.3%	13.8%
EM corporate bonds		0.9%	4.6%	11.3%

Source: Bloomberg, UBS as of 11 August 2016
OW = tactical overweight
UW = tactical underweight

Market comments

Calculations are based on the past five days

- **Equity markets** had a positive week, with the biggest gains for Japanese stocks. The Nikkei 225 was up 4.1%, trimming the loss year-to-date to 11.2%.
- **Emerging market assets** continued to advance. The MSCI EM index climbed 3.1%, taking gains for the year to 15.8%. EM sovereign bonds and corporate bonds also advanced.
- **US investment grade bonds** rose 0.4%. Euro-denominated investment grade bonds rose by 0.3%.

In focus

Bank of England (lets) loose. The UK central bank cut interest rates by 25bps at its August meeting last Thursday and announced a package of measures to boost growth and inflation in the wake of Brexit. The BoE expanded its asset purchase program (now GBP 435bn), focusing on gilt buying. It also announced GBP 10bn of corporate bond buying and other measures designed to help the banking sector. Sterling fell 2% against the USD by Wednesday morning, and UK 10-year gilt yields plumbed new lows of 0.53% on expectations of further easing later in 2016. *CIO is neutral on the British pound and UK equities in global portfolios.*

US jobs jump. Nonfarm payrolls grew by 255,000 in July, above consensus expectations of a 180,000 rise. And prior months' payrolls were revised higher. June job creation was 292,000 (previously 287,000), and May's disappointing figure of 11,000 was marked up to 24,000. *CIO still expects the Fed's next rate hike to be in December – policymakers will likely want to see strength in a broader range of economic indicators before raising borrowing costs once again.*

Stronger US inventory figures positive for growth. June wholesale inventories rose 0.3%, versus consensus estimates for a flat figure. And May inventories were revised up from 0.1% to 0.2%. Inventory weakness was a significant drag on GDP in the second quarter, so the improvement could have led to upward growth revisions. Unfortunately, other economic data has been weak, so 2Q growth may remain close to the disappointing 1.2% level initially estimated. *CIO expects US real GDP growth of 1.4% in 2016 and 2.4% in 2017.*

Who needs a government? Spain's political deadlock doesn't seem to be bothering fixed income investors. The yield on the nation's 10-year government bond fell below 1% for the first time on Tuesday. Spanish bonds have also received a boost from the ECB's decision to step up its asset purchases ahead of the summer lull. *CIO is neutral on Eurozone equities and euro-denominated high yield bonds.*

China's trade data signals weak demand. China's exports declined 4.4% y/y in USD terms in July from –4.8% in June due to weak external demand, echoing the decline in the new export orders sub-index in the PMI. Imports also dropped 12.5% after decreasing 8.4% in June, mainly due to lower commodity prices. *CIO expects Chinese trade to face continuous downward pressure and forecasts single-digit declines for both exports and imports this year.*

Bringing home the *daikon*. Japanese nominal cash wages rose 1.3% y/y in June from –0.1% in May, boosted by summer bonuses. Adjusted for inflation, pay rose 1.8% y/y from 0.4% in May, the fifth consecutive month of gains. But the speed of wage rises may not be enough to bring inflation back to the BoJ's target, which should prompt additional policy easing measures. *CIO is currently neutral on Japanese equities.*

Deeper dive

Trading oil? Beware of slicks!

Mark Haefele **Giovanni Staunovo**

Crude oil prices have been on a rollercoaster ride this year, similar to the experience of 2015. Brent started the year at USD 37/bbl, falling to a low of USD 28/bbl in mid-January before rallying to a peak of USD 52/bbl in early June. Oil's second quarter rally was largely driven by large-scale production disruptions due to wildfires in Canada, militant attacks on infrastructure in Nigeria and Libya, and strike-related shutdowns in Kuwait. Unplanned global supply outages hit a record 3.65mbpd in May, according to the Energy Information Administration, around 4% of global consumption.

In July, crude oil prices fell sharply again as Canadian production resumed, and as OPEC crude output rose to an eight-year high. Brent touched USD 42/bbl in early August.

Roll costs – a pain for oil investors
Our recommendation this year has been to avoid direct long positions in crude oil and instead focus on energy equities, which have delivered returns of 14–16%. Why? Holding direct long exposure to crude oil is not attractive when adjusted for price swings – returns have ranged from –11% to 4%, with volatility around 40%. Investors could have potentially generated better returns of 25–41% if and only if their market timing was perfect, buying at the lows in January/February.

The weak returns were mainly due to elevated roll costs, which eroded direct oil investment returns. Buying physical crude oil is cumbersome – who wants to store oil barrels at home? – so investments are typically made through futures contracts. Unfortunately, these contracts expire, unlike equities. To maintain constant exposure, commodity investors need to roll futures contracts, selling close to expiry and rolling into a new contract. As the crude oil futures curve has been upward sloping (in "contango") due to storage costs and rising inventories, investors have repeatedly had to buy the next oil future contract above the spot price.

Higher prices ahead
CIO believes the oversupplied oil market, which started in 2014, is soon coming to an end. We remain confident that the market will balance out next year through a combination of contracting non-OPEC production and rising demand in emerging markets.

As such, we feel comfortable calling for a Brent price of USD 55/bbl in 12 months. What does this mean for investors? At current prices near USD 40/bbl, investors with a horizon of more than six months could consider buying energy equities. In our global tactical asset allocation, a rebound in oil prices should support a return to growth for US earnings, underpinning our overweight position on US equities. And from a longer-term perspective, energy remains a preferred sector in the US and Europe thanks to improving cashflows and attractive dividend yields.

Mark Haefele
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Bottom line

Oil prices are up by 12–18% this year, but investors would have hit an oil slick by buying crude directly due to high roll costs. CIO expects oil to climb toward USD 55/bbl in 12 months as supply and demand balance out. We are still avoiding direct long oil investment, and prefer US equities and global energy stocks instead.

Regional view

The problem with Eurozone banks is profitability, not capital

Podcast
www.ubs.com/cio-podcast

Themis Themistocleous
Head CIO European Investment Office

One of the clouds over the European market recently has been the future of the European banks, particularly the viability of the Italian banking sector and the potential need for additional capital. On this topic, the market was looking to the ECB stress test to get more guidance.

The results published at the end of July confirmed our view that the challenge for the sector is not capital, but profitability. With interest rates expected to remain low for some time to come, and credit growth in Europe subdued, we expect the pressure on bank profitability to remain and cap share price performance.

Overall, the stress test results focused on a sample of 51 banks representing 70% of the European banks assets, and confirmed that the sector doesn't have a capital problem, as the aggregate fully loaded Core Equity Tier 1 ratio declined to 9.2% in the adverse scenario – a good outcome – starting from 12.6%.

The sector's profitability was significantly impacted in the adverse scenario, with earnings falling to broadly zero in 2018 due to roughly 20% lower revenues and double credit provisions compared to the 2015 levels.

The Italian banking sector was under heavy scrutiny going into the stress test due to market concerns about Monte dei Paschi and the stock of non-performing loans. Excluding Monte dei Paschi, which will undergo a new restructuring plan and capital increase, the actual Italian results have proven reassuring overall, with Intesa Sanpaolo producing one of the best results among the large banks.

> "The main lever banks have to improve their profitability, at similar risk levels, is cost containment."

We expect the sector's profitability to remain under pressure due to the low interest rate environment associated with muted loan growth and limited economic activity. Based on our calculations, a credit growth of roughly 5%, compared to the actual 1% growth rate, would be needed to offset the ongoing credit and assets margin pressure. For example, 15% of banks' assets are invested in sovereign bonds with an average duration of 4.5 years; as these assets expire, banks will earn a lower yield unless they re-invest the proceeds at a higher risk.

While the market expectations point to double-digit earnings growth for the next two years, we think that investors will be disappointed, as banks have limited levers to offset the revenue pressure and improve their earnings. Year-to-date, the one-year EPS forward consensus has already declined by 12%, and we expect this trend to continue. The main lever banks have to improve their profitability, at similar risk levels, is cost containment mainly through digitization, enabling leaner branch networks. However, this requires a different client attitude and way of interaction with the bank, which we view as a long-term process rather than a short-term achievement.

Despite the current low price-to-book valuation, we think the sector can turn into a value trap for equity investors.

Kind regards,
Themis Themistocleous

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