UBS House View

Europe
Chief Investment Office WM

Weekly

24 November 2016

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Market moves

	CIO view	–1w	– 3m	ytd
S&P 500	OW	1.3%	1.9%	10.0%
Euro Stoxx 50		0.0%	1.5%	–3.2%
MSCI EM	OW	1.0%	–4.2%	10.3%
FTSE 100		0.3%	0.5%	13.6%
SMI	UW	–2.5%	–5.2%	–8.7%
NIKKEI 225		2.6%	11.3%	–2.0%
US high grade bonds	UW	–0.8%	–3.3%	2.3%
Euro high grade bonds	UW	0.3%	–2.9%	3.9%
US investment grade bonds		–0.8%	–3.9%	5.3%
Euro investment grade bonds		–0.1%	–1.9%	4.0%
US high yield bonds		0.6%	–0.2%	12.9%
European high yield bonds		0.0%	–0.5%	6.8%
EM sovereign bonds		–0.4%	–4.9%	8.7%
EM corporate bonds		–0.1%	–2.3%	9.4%

Source: Bloomberg, UBS as of 24 November 2016
OW = tactical overweight
UW = tactical underweight

Market comments

Calculations are based on the past five days

- **Equities** rose almost across the board, with the S&P 500 hitting a record high and emerging stocks rebounding. Swiss stocks were the big loser, with the SMI down 2.5%.
- **Fixed income** remained under pressure. High grade bonds declined 0.8% in the US as investors continued to expect higher inflation resulting from the policies of the incoming Donald Trump administration.
- **Foreign exchange** markets were marked by gains for the US dollar. The yen fell 2.6% and the Swiss franc 1% versus the US currency.

In focus

All systems go for Fed. In testimony before the US Congress, Federal Reserve Chair Janet Yellen appeared to confirm that a December rate hike was likely, stating that a rate hike "could well become appropriate relatively soon." Economic data was also supportive, with housing starts jumping 25% month on month and jobless claims hitting their lowest level in more than 40 years. Markets are now pricing in a 100% chance of a December rate hike. *CIO expects the Fed to raise rates in December and twice more next year.*

US equity hat-trick…plus one. All four major US stock benchmarks hit record highs on the same day (Monday) for the first time since 1999. This included the most closely followed S&P 500, along with the older Dow Jones Industrial average, the technology-focused Nasdaq and the smaller-cap Russell 2000. US equities have been driven higher by hopes of a fiscal boost from the incoming Donald Trump administration. Meanwhile energy companies have been helped by a rebound in crude prices. *CIO is overweight US stocks versus high grade bonds and overweight emerging market equities versus Swiss stocks in global portfolios.*

India's cash bonfire. Narendra Modi's unexpected decision to scrap large denomination banknotes is likely to hurt the economy, according to rating agency Fitch. Ultimately the move could help India's public finances by reducing the size of the informal economy and boosting tax collection. But Fitch argued that participants in the informal economy could seek alternative stores of wealth. In the meantime the move is causing considerable disruption. *Despite this CIO maintains India equities as among its most preferred within emerging market portfolios.*

Au revoir, Sarkozy. The former French president has bowed out of the race to get his old job back. François Fillon is now the front runner in the Republican party's primary, followed by fellow former prime minister Alain Juppé. The ultimate winner is expected to face National Front leader Marine Le Pen in France's presidential election next spring. *CIO is neutral on Eurozone equities in global portfolios.*

China's housing market cools. New-home prices rose in 62 cities in China in October, down from 63 in September. The statistics bureau said that home prices in tier-1 and tier-2 cities "apparently" stabilized in the second half of October, following cooling measures. Prices in the red-hot city of Shenzhen fell month on month for the first time in two years. *As cooling measures have started to take effect, CIO believes there is only limited risk of a near-term property market crash.*

Europe shares Thanksgiving cheer. In data released ahead of the US turkey-gobbling break, Europeans also had something to celebrate. The Eurozone purchasing managers' index for manufacturing and services climbed to a high this year, hitting 54.1 for November – comfortably in expansionary territory. The survey implies that the manufacturing sector is growing at its fastest rate in 34 months. *CIO is overweight the euro versus the US dollar in global portfolios.*

OPEC hopes. WTI crude rebounded from an eight-week low on November 14 amid renewed efforts by the OPEC cartel to strike a deal to cut output. The price of Brent has climbed over 4% over the past five sessions, as expectations of a deal mounted. As of writing, however, OPEC members have failed to agree on the role Iraq and Iran will play in production cuts. Both countries have sought exemptions. *CIO believes that, with or without OPEC's help, the oil price will rise in the coming year, and we have a 12-month forecast of USD 60 per barrel.*

UBS

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Deeper dive

Remember, it's not all the same

Mark Haefele **Andrew Lee**

Public equity markets initially fell in lockstep after Donald Trump's US election victory. Yet performance has become more differentiated since. Some sectors rallied in anticipation of greater growth and profits. Others declined on expectations of higher inflation. Investors were reminded that, over time, responses to a market-moving event are seldom the same.

And it's not all the same either when it comes to private markets, the umbrella term for investments in unlisted companies and assets. Characteristics and performance drivers differ widely within this varied asset class.

Most investor portfolios can benefit from the addition of a broad private market allocation as a return and risk diversifier. But it makes sense to dive into the assorted types of private market investment and ask: How can private markets fit into long-term, multi-asset portfolios?

- **Private equity** makes up the majority (70%) of invested capital. It consists of non-traded equity interests in unlisted companies, and represents equity-like risk in portfolios. The key sub-strategies differ according to the stage of the corporate life-cycle they target. Buyout targets leveraged control positions in mature companies generating consistent cash flows. Venture funds make high-risk, early-stage investments in startup companies. Another, often-overlooked strategy is growth equity, which makes unleveraged minority investments in proven companies to fund expansion or acquisition. Private equity strategies are actively managed and generate returns primarily through capital appreciation.
- **Private debt** offers credit-like risk, and can complement public bond holdings in portfolios. Managers of these assets source, negotiate, and originate debt instruments with borrowers. The key sub-strategies target different seniority levels in companies' capital structure. Direct lending focuses on senior secured debt; mezzanine targets subordinated debt with equity-like upside; and distressed focuses on control of over-leveraged firms through specific debt securities. Private debt returns largely consist of interest payments and other fees, though mezzanine and distressed provide potential for capital appreciation.
- **Private real estate** strategies look to buy property, particularly in areas where active management can add value by improving asset quality. Sub-strategies differ according to how stable the targeted properties are. Core real estate targets highly stable, fully leased assets; value-add concentrates on assets with some scope for re-leasing or repositioning; and opportunistic selects development opportunities or properties that need major refurbishment, change of use, or repositioning. Private real estate generates returns from income and capital gains, less correlated to those from traditional asset classes.

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Bottom line

Investors should look beyond private markets as a whole and understand the different sub-approaches. Most will find that core private market exposure across all strategies can improve portfolio risk-adjusted returns. But a more granular approach offers investors the opportunity to further tailor their private market allocation for the stage of the market cycle, differing growth and income needs, and varying portfolio diversification requirements.

Regional view

Never-ending politics

Podcast
www.ubs.com/cio-podcast

Matteo Ramenghi
Chief Investment Officer UBS WM Italy

With the market still digesting the surprises of the US presidential election and the Brexit referendum, we return to analyzing polls. The electoral calendar moves back to Europe on December 4, when both the Austrian presidential elections and the Italian constitutional referendum are scheduled to take place. In this article, we'll focus on the latter.

The Italian referendum will confirm or reject constitution reform aimed at shrinking the size and powers of the Senate to speed up the legislative process. If it is rejected, the status quo will prevail. But the political agenda will remain crowded even after this vote, as the government has announced a revision of the recently approved electoral law to reduce the premium allocated to the largest party – a contentious matter designed to limit the effects of a possible strong populist vote.

Initially, Prime Minister Matteo Renzi of the Partito Democratico (PD) had personalized the referendum by suggesting he'd resign if the reform is not approved, which could lead to snap elections before 2018 and a period of political uncertainty. The political arena has split on the reform: Forza Italia (the Silvio Berlusconi-led party), Lega Nord and the anti-establishment Five Stars movement, along with some PD detractors, are campaigning fiercely against it.

The vote is too close to call. Most recent survey headlines suggest "no" is ahead, but a high share of undecided voters remains and abstention will likely run high. While the government is intensifying its persuasion efforts, it is also preparing for a negative result. Recently, Renzi dismissed the idea of early elections, and it now seems possible that if "no" wins he'll resign and then be re-appointed.

Nevertheless, market perception can sometimes turn into self-fulfilling prophecy. The spread between Italian government bonds (BTPs) and the Spanish counterparts (Bonos) has widened by nearly 60 basis points in the last six months as the referendum drew closer and Spain managed to form a government after nearly a year of vacuum.

A "no" victory could pressure equities and cause government bond spreads to widen. And rating agencies could review their position on Italy, making the capital increases planned by some banks more difficult to execute and leading to credit rationing in the midst of an already feeble economic recovery. While the European Central Bank's next steps will likely decide the overall direction of spreads next year, a "yes" vote would probably trigger meaningful tightening and a rebound of bank stocks.

"The Italian constitutional referendum kicks off a busy electoral season in Europe. We remain neutral Eurozone equities."

Given recent political events, some media commentators and international investors have suggested that rejecting the reform could lead to an Italian attempt to exit the EU or the euro. I'd argue that the importance of the referendum is probably overstated by the markets.

Unlike Brexit, a "no" vote implies maintaining the status quo. Similarly, the concerns that it could pave the way to an exit from the euro appear exaggerated. Italy's constitution only allows abrogative referendums, and rules out popular votes on international treaties and fiscal matters. Also, while there is widespread criticism of economic policies, surveys suggest strong support for both the EU and the euro; even the Five Stars movement does not appear to have a consistent view in favor of leaving either.

The Austrian presidential elections and the Italian referendum will kick off a busy European electoral calendar that will culminate in the German, French and Dutch votes next year. Election outcomes are difficult to forecast and might lead to temporary volatility. We are neutral Eurozone equities in our global portfolio and we hold a neutral position on Italian equities in our Eurozone country strategy.

Kind regards,
Matteo Ramenghi

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