UBS House View

Europe
Chief Investment Office WM

Weekly

18 August 2016

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Market moves

	CIO view	*–1w*	*– 3m*	*ytd*
S&P 500	OW	0.3%	7.2%	8.3%
Euro Stoxx 50		–1.9%	2.3%	–5.2%
MSCI EM	OW	0.2%	16.1%	16.8%
FTSE 100		–0.6%	13.1%	13.7%
SMI	UW	–1.6%	2.7%	–4.2%
NIKKEI 225		–1.5%	–0.8%	–12.5%
US high grade bonds	UW	0.1%	2.4%	5.7%
Euro high grade bonds	UW	–0.5%	2.6%	6.9%
US investment grade bonds	OW	0.3%	4.3%	9.1%
Euro investment grade bonds		–0.2%	3.0%	5.9%
US high yield bonds		0.5%	5.9%	12.8%
European high yield bonds		0.2%	3.4%	7.1%
EM sovereign bonds		0.5%	6.9%	14.4%
EM corporate bonds		0.4%	4.9%	11.7%

Source: Bloomberg, UBS as of 18 August 2016
OW = tactical overweight
UW = tactical underweight

Market comments

Calculations are based on the past five days

- **Equities** had a mixed week, with the US and emerging markets nudging up 0.3% and 0.2% respectively. Meanwhile Eurozone, Swiss, and Japanese stocks fell.
- **Fixed income** traders pushed US investment grade bonds 0.3% higher. Euro high grade bonds lost 0.5%.
- **Currency markets** were characterized by a weaker US dollar, with the yen gaining 2% and the Swiss franc also rising strongly.

In focus

Fretting the Fed. NY Federal Reserve Chair Bill Dudley said that "the market is complacent" about the likelihood for rate increases "over the next year or so." On Wednesday, federal funds futures priced in a 22% chance of a rate hike in September, and a 51% chance of a rate hike by the December meeting. These probabilities are up from 18% and 44.8% respectively, before Dudley's comments. *CIO expects the Fed to initiate a 25bps rate increase in December.*

US inflation flatlines. July CPI data was flat (in line with consensus), while core CPI rose 0.1% (vs. consensus 0.2%). This reading was one of the weaker over the past 18 months. A large divergence remains between core goods price inflation, which fell 0.1% in July, and core services inflation, which rose 0.2% in July. *CIO expects the core PCE inflation rate to remain at 1.6% y/y in July, below the Fed's 2% target.*

German sentiment sunnier. After July's Brexit-inspired blues, the German ZEW indices of economist sentiment posted sunnier figures this month. The current conditions indicator rose to 57.6 in August (consensus 50.2, headline 49.8 in July). And economic sentiment perked up to 0.5, from a near-four-year low of –6.5 in July. *CIO forecasts steady Eurozone GDP growth of 1.5%, with limited Brexit spillovers to the bloc.*

Running ahead...or still in the blocks? July inflation data in Germany and Spain suggest general prices are running at two very different speeds. The 0.4% m/m and y/y rise in German CPI is the strongest since January. ECB easy money hasn't pushed Spanish inflation out of the starter's blocks. Consumer prices fell 0.7% y/y in July, below the –0.6% report expected by economists, marking the 26th consecutive month of flat or falling prices. *CIO forecasts Eurozone inflation of 0.3% this year, and 1.8% next year.*

Growth liftoff eludes Japan. GDP grew by just 0.2% annualized in the second quarter, a disappointing comedown after 1.7% in the first three months of the year. That will add to pressure on the Bank of Japan for additional stimulus. *CIO is neutral on Japanese equities and the yen.*

Slow and steady wins the race? Chinese activity and credit data indicated slower output growth and less stimulus support for the world's second-largest economy. Growth rates in industrial production, retail sales, and fixed asset investment all decelerated in July. And new CNY bank loans fell 69% y/y in July, suggesting the government is reining in debt creation. *Still, CIO believes China's growth slowdown will be gradual, and the economy's rebalancing toward consumption is on track.*

Shenzhen-Hong Kong Stock Connect gets go-ahead. After Tuesday's market close, China's State Council approved the long-awaited Shenzhen-Hong Kong Stock Connect. This initiative creates the second-largest equity market globally by market capitalization (first by turnover). It also helps China's bid for inclusion of Chinese A-shares in MSCI indices. It will take about four months for the program to be officially launched.

What we're watching next week: Eurozone flash consumer confidence (Tuesday), flash global manufacturing purchasing managers' indices (Wednesday), Janet Yellen's speech at Jackson Hole and Eurozone lending data (both Friday).

UBS

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Deeper dive

Are earnings turning in Europe?

Mark Haefele **Rolf Ganter**

In a recent *Deeper dive* on US second-quarter earnings (4 August), we wrote "Less worse is a good start." The same could be said for Eurozone earnings. Looking at bottom-up profits and earnings estimates, i.e. company by company, our CIO equity strategists see the first signs of light at the end of the tunnel, with some stabilization at low levels.

Is the time ripe to call the turning point of Eurozone earnings growth? In our view, visibility is too low to give a definite answer. Brexit has created uncertainty. Oil prices are fluctuating in the mid-40s. Strength in the trade-weighted euro is a headwind for exporters. And negative interest rates are taking their toll on financial sector earnings.

To call the inflection point, we need to see the following:

1.) Continued strong business and consumer confidence readings, as reflected in retail and auto sales.

2.) Oil price momentum and a moderation of trade-weighted euro appreciation, which would help the export-oriented and energy sectors.

3.) Confidence in the return of top-line growth across industries, as companies' ability to cut costs further is limited. Improvements on the revenue side could be the decisive lever for earnings growth. A pick-up in inflation would help too by not only enabling companies to increase prices (at least in theory) but by potentially boosting sovereign bond yields slightly. Higher rates would aid the financials and do little harm to other sectors.

4.) A halt in the earnings deterioration of the financial sector. Banks and diversified financials account for slightly more than 10% of the Eurozone market. The continuous fall in interest rates has led to lending margins trending downward and, coupled with low credit growth, has significantly constrained bank profitability. Market expectations for financials' 2017 earnings still look too optimistic and need to be lowered before recovery can begin.

5.) Reaccelerating credit growth, which would indicate, not least, an increase in corporate investment and/or consumer spending. Higher lending growth could help the Eurozone economic cycle regain speed, and boost earnings.

We need clarity on at least some of the above points to determine whether earnings are turning in Europe. Our regular meetings with companies should aid us in pinpointing the turning point when it comes. But we believe it is too early, for now, to shift our neutral Eurozone equities stance in global portfolios.

Mark Haefele
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Wealth Management

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Bottom line

To determine the turning point of Eurozone earnings, we need to see more signs that top-line growth is returning, expectations for the financial sector are being reset lower and/or credit growth is reaccelerating to compensate for lower profit margins. Our bottom-up analysts are also focusing on the oil price and euro movements. But for now we consider it too early to shift our neutral Eurozone equities stance in global portfolios.

Regional view

European earnings season better than feared but not rosy

Podcast
www.ubs.com/cio-podcast

Carsten Schlufter
Head Financials and Utilities

European equities performed unsteadily in 1H2016, impacted by a weaker corporate earnings outlook. Forecasts had been revised from high single-digit growth rates earlier this year to low single-digits in the Eurozone. In Switzerland, the earnings outlook dropped from low-single-digit to losses, while the UK view improved as the British pound fell and commodity prices recovered from very low levels.

After 1Q reports disappointed, consensus and I reduced expectations for 2Q. However, despite headline sales and earnings numbers of –3%, the detailed numbers look more promising. More than 60% of companies in the Eurozone beat expectations by about 6% on average, making it a reasonably strong season, in my view. In Switzerland about half of the companies surprised positively, one fifth negatively. UK companies, on the other hand, generally missed expectations slightly.

What have I learned from the 2Q reporting season?
Bottom-line stabilized but top-line weak. The 2Q reporting season has shown that despite positive surprises and stabilizing trends since spring, underlying earnings growth remains weak. I think that companies still have a strong focus on cost reductions and restructuring measures. That said, revenue trends remain weak due to lower commodity prices, less favorable currency movements, and subdued investment activity.

"I think investors will begin focusing on next year's earnings."

European earnings trends muted this year. Heightened political uncertainty and reduced benefits from euro weakness mean that companies are on track to deliver low single-digit earnings growth rates in the Eurozone and slightly weaker profits than last year in Switzerland and in the UK.

As the summer season concludes, I think investors will begin focusing on next year's earnings. For 2017 we have a positive outlook, as some current hindrances (low commodity prices, weak profitability of banks) may either diminish or transform into spurs of optimism.

What am I watching for the coming seasons?
Improving energy prices. The oil price reached its low earlier this year and then quickly recovered. With energy companies cutting costs aggressively, I believe sector profit could benefit from both higher oil prices and lower costs in the coming quarters. UK earnings would benefit most due to a higher share of energy companies in the index, followed by Eurozone equities, while earnings for Swiss equities would not be affected.

Forex an important driver. Following the Brexit decision, our economists lowered their forecasts for the Eurozone slightly and for the UK more drastically. However, UK companies generate a large share of income abroad and their earnings benefit from the lower the British pound. Also, it appears to me that forex remains an important factor for Eurozone companies' earnings trends.

Lower interest rates. European companies have benefited from lower financing costs for some time. However, the ECB's corporate sector bond purchase program compressed, and I expect companies to further increase interest savings, which should help earnings and margins.

Kind regards,
Carsten Schlufter

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