UBS House View

Europe
Chief Investment Office WM

Weekly

1 September 2016

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Market moves

	CIO view	*–1w*	*– 3m*	*ytd*
S&P 500	OW	–0.2%	4.0%	7.8%
Euro Stoxx 50		1.8%	0.8%	–3.6%
MSCI EM	OW	–0.5%	12.3%	14.9%
FTSE 100		–0.2%	11.5%	12.8%
SMI		1.2%	0.8%	–3.2%
NIKKEI 225		2.2%	0.1%	–10.1%
US high grade bonds	UW	0.0%	2.1%	5.7%
Euro high grade bonds	UW	–0.1%	2.3%	6.9%
US investment grade bonds	OW	0.1%	4.0%	9.5%
Euro investment grade bonds		0.0%	2.8%	6.1%
US high yield bonds		0.1%	5.7%	13.2%
European high yield bonds		0.3%	3.3%	7.7%
EM sovereign bonds		–0.1%	7.0%	14.3%
EM corporate bonds		–0.1%	5.0%	11.9%

Source: Bloomberg, UBS as of 1 September 2016
OW = tactical overweight
UW = tactical underweight

Market comments

Calculations are based on the past five days

- **Equities** in **Japan** (+2.2%) and **Switzerland** (+1.2%) were the star performers last week, while **emerging markets (EM)** lagged (–0.5%). But developing world stocks have still rallied 14.9% this year.
- **Credit** outperformed **high grade bonds** over the last five days. **European high yield** rose 0.3%, whereas top-rated debt in the region slipped 0.1%. EM government and corporate debt both declined 0.1%.
- In **foreign exchange**, all other G10 currencies lost ground against the US dollar. The **British pound** (–0.4%) was most resilient, while the **Japanese yen** (–2.8%) fell the most.

In focus

Yellen hints at hike over coming months. Speaking at Jackson Hole, the Fed chair said, "In light of the continued solid performance of the labor market and our outlook for economic activity and inflation, I believe the case for an increase in the federal funds rate has strengthened in recent months." *CIO believes the next Fed rate increase will be in December, and 10-year Treasury yields should grind higher.*

US prices no push for Fed. The core PCE price index rose 1.6% y/y in July, below the Fed's 2.0% target, while the three-month annualized inflation rate has slowed to 1.35%, the lowest since December 2015. These factors may preclude a September rate hike.

Incomes in good shape. US personal income rose 0.4% m/m in July, and personal spending rose 0.3% m/m. While the savings rate rose slightly as a result, persistent income growth is still underpinning consumer-led economic growth. *CIO expects spending to rise in line with income over coming months.*

Eurozone lending on the rise. Credit to households accelerated to an annual 3.9% in July, up from 3.8% in June. Meanwhile bank loans to businesses picked up to 1.9% from 1.7% in June. The data should add to confidence that credit creation has been immune to the UK vote to exit the EU. *CIO is neutral on Eurozone equities and euro-denominated high yield credit.*

Fall comes early in Eurozone. Business sentiment in the Eurozone fell to the lowest level in close to three years in August. The European Commission barometer ticked lower to 0.02 this month, from 0.38 in July. Industry was hardest hit – current orders slid to the lowest level since the height of the financial crisis in 2009. *Despite post-Brexit bruising, CIO expects the Eurozone economy to grow 1.5% this year.*

UK homebuyers shrug off Brexit worries. Prices rose 5.6% in August compared to the same month a year earlier, according to lender Nationwide. That was a rise from 5.2% growth in June. The strength contradicts other data pointing to a slowdown, including the latest RICS Residential Market Survey. *CIO is neutral on UK equities.*

Inflation pickup eludes Japan. The Bank of Japan's favorite price gauge, the core consumer price index, which excludes fresh food, declined by 0.5% y/y. That was the fifth consecutive month of deflation and the lowest reading since March 2013. This has also been the longest stretch of deflation since Shinzo Abe took over as prime minister on December 26, 2013. *CIO is neutral on Japanese equities.*

It's not you…it's the house. Chinese couples keen to share in Shanghai's booming property market have flocked to file for divorce, on speculation that property down payments could rise. Facing price rises of 27.3% y/y in July, according to the National Bureau of Statistics, a 30% deposit for single first-time buyers against a mooted 70% for a second property has led some spouses to scrap their official vows.

What we're watching in the week ahead: US employment report (Friday 2 September), G20 leaders' summit in Hangzhou, China (Sunday 4 – Monday 5 September), Eurozone retail sales (Tuesday 6 September), Chinese FX reserves data (Wednesday 7 September), and the ECB's monetary policy decision (Thursday 8 September).

Deeper dive

Consider private markets in a low-yield environment

Mark Haefele **Andrew Lee**

As mentioned in my most recent letter, the Bank of England's actions after Brexit have exerted downward pressure on global yields. While this has clearly benefited risk assets, the persistent low-yield environment poses challenges for investors.

How can investors deal with this dynamic? One option for long-term oriented investors to consider is allocating capital to private markets. These investments, which include private equity, private debt, and private real estate, require tolerance for significant illiquidity. This is necessary given the unlisted nature of the assets they target, which range from startup companies to distressed firms to buildings, and to provide fund managers with time and flexibility to add active value. In return, private markets enhance portfolios through diversification and return premiums to compensate for the illiquidity.

Why private markets?

- *Attractive returns in a low-yield, low-return world.* Private markets have generated premiums to traditional asset returns over the long term. For example, pooled internal rates of return for US private equity over the 20 years that ended March 31 were 12.6%[1]. While not directly comparable, the S&P 500's time-weighted return for this period was 8.0%. Against a backdrop of low yields and returns, our long-term expected returns of 8–12% for private markets are attractive in a portfolio context.
- *Better risk-adjusted returns.* Volatility and Sharpe ratios for private markets compare favorably to those of equities and bonds, so adding diversified private market exposure should enhance portfolios.
- *Additional sources of return and alpha potential.* Investing in non-traded assets requires a different approach and skill set. No continuous market or pricing exists, information is limited, and buying assets takes time. These inefficiencies are what make the opportunity set compelling. There is more potential for mispricing (and thus differentiated returns and manager alpha) because most investors simply don't have the skill or patience to realize the true value of these assets.

The rub is that successful investing in private markets requires expertise, tolerance for complexity, and a long-term mindset.

- *Manager selection is critical.* The gap between the top and bottom-performing fund managers is far wider than for equities or bonds. Investors must have access to top-quartile managers and a disciplined evaluation and selection process.
- *Portfolio management is complex.* It takes time and a strong network of relationships to build up diversified private market exposure. Funds are not always open and can be selective about their investors. Cash flow timing is unpredictable, as funds invest only as opportunities arise over multiple years and return capital as they exit underlying investments. Investors therefore must continually commit to new funds to maintain consistent portfolio exposure.

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[1] Cambridge Associates LLC.

Bottom line

Low yields globally are a problem for all investors. Those who can afford to give up some near-term liquidity can improve their long-term prospects by adding a diversified private market allocation to their portfolio. This should position them for better risk-adjusted returns and enable them to seize opportunities unavailable in public markets. Successful private market investing requires a strong network, due diligence capabilities, an understanding of fund and portfolio dynamics, and the willingness to commit capital for the long term.

Regional view

Globalization: High noon in Hangzhou

Podcast
www.ubs.com/cio-podcast

Geoffrey Yu
Head of UK Investment Office

The 2016 G20 summit kicks off in Hangzhou, China on Sunday. The theme of the summit will be "Toward an Innovative, Invigorated, Interconnected and Inclusive World Economy." In short, globalization must continue. Judging by the rhetoric from politicians across the globe right now though, the choice of theme doesn't seem fitting as words like "interconnected" and "inclusive" don't exactly resonate in times of rising populism and protectionism.

The UK's decision to leave the EU was widely interpreted as one of the strongest rejections of globalization in recent years. However, we hope that UK Prime Minister Theresa May will deliver the exact opposite message in her first G20 summit and endorse the G20 theme. On a multilateral level, she should affirm that Britain will remain an active participant in institutions such as the G20, work closely with global partners and continue to welcome inbound investment. On a bilateral level, the summit also represents an opportunity to establish stronger relationships with key global leaders – especially non-EU individuals – to help set foundations for free trade agreements post-Brexit.

In this month's CIO Letter we explored the strengths of Switzerland and how they could apply to the UK. Switzerland's openness, light regulation, acceptance of foreign workers (though the 2014 referendum has admittedly challenged this) and tradition of innovation have all contributed to the country's success. One conventional measure of openness is a country's trade (goods and services) to GDP ratio. According to World Trade Organization figures, Switzerland had a ratio of 122.7% between 2012 and 2014: nearly 20pp higher than South Korea (104.2%) and Germany (98.9%), the best G20 performers. The figure for the UK is 60.3%, just below France (60.9%) but above the US (29.9%), China (46.9%) and the EU aggregate (33.9%).

> "The UK is in a position of strength when it comes to trade and openness, but could do more to emulate the likes of Switzerland and South Korea."

Given these numbers, May should acknowledge that the UK is in a position of strength when it comes to trade and openness, but could do more to emulate the likes of Switzerland and South Korea. The G20 is an opportunity to learn from success stories. At the same time, there is much the world wants from the UK aside from tradable goods and services, such as regulatory expertise. China's central bank has, for example, explicitly referred to the UK's financial regulation framework as the "preferable" option for China in the future.

As G20 leaders sit down for tea by the majestic West Lake (a must-see for clients visiting China), its serenity cannot disguise the fact that stormy waters still lurk. The institution now faces a different set of challenges than it did during the financial turbulences that led to its creation. Post-Brexit, the UK could help lead the G20 in tackling them head-on; the alternative is that every participant chooses to retrench and pursue beggar-thy-neighbor policies. This might be the easier way out, but the most likely result is that everyone loses.

Kind regards,
Geoffrey Yu