UBS House View

Europe
Chief Investment Office WM

Weekly

7 July 2016

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Market moves

	CIO view	–1w	– 3m	ytd
S&P 500	OW	3.1%	3.4%	4.0%
Euro Stoxx 50		–3.6%	–1.2%	–12.6%
MSCI EM		–1.8%	2.4%	4.7%
FTSE 100		–0.6%	6.4%	6.0%
SMI		–1.5%	3.5%	–7.4%
NIKKEI 225		–1.9%	–2.9%	–19.0%
US high grade bonds	UW	0.5%	1.9%	6.0%
Euro high grade bonds	UW	0.8%	2.5%	6.9%
US investment grade bonds	OW	0.9%	3.8%	8.8%
Euro investment grade bonds		0.6%	1.7%	4.6%
US high yield bonds		1.8%	5.2%	8.8%
European high yield bonds	OW	0.3%	1.6%	3.9%
EM sovereign bonds		1.1%	5.9%	11.3%
EM corporate bonds		0.9%	4.7%	9.4%

Source: Bloomberg, UBS as of 7 July 2016
OW = tactical overweight
UW = tactical underweight

Market comments

Calculations are based on the past five days

- **Equities** generally fell on fears about post-Brexit growth and profits. **Eurozone stocks (–3.6%)** were the underperformers. **US stocks (+3.1%)** bucked the trend on stronger economic data in June and dovish Fed commentary.
- **Fixed income** made gains across the board. **High grade debt** in the **US (+0.5%)** and **Europe (+0.8%)** rose on continued risk aversion. **European high yield (+0.3%)** climbed as corporate financial conditions remain loose.
- In **currencies**, the **JPY (+2.1%)** was the top performer versus the USD, while the **GBP** shed 2.2%. **Gold** climbed 3.1%, clocking year-to-date gains of 29%.

In focus

Keep calm and carry on. Investors shunned riskier assets last week, fearing Brexit aftershocks may hurt global growth, European bank earnings, and global financial conditions. Equities generally fell and bonds were well-bid. Sterling briefly touched a fresh 31-year low against the US dollar, while gold ascended towards USD 1,370/oz. *CIO believes Brexit raises political risks, but has yet to produce lasting contagion. Continued global growth, rising earnings, and central bank accommodation can support risk assets into year-end.*

Deep yield diving. Political uncertainty following the Brexit vote and expectations for further central bank easing powered deeper declines in sovereign bond yields. UK 10-year Gilt yields slipped to new lows of 0.73%, 10-year Treasuries hit a fresh nadir of 1.32% and Swiss government bonds traded at negative yields out to 50 years. *CIO is underweight high grade debt in global portfolios: higher expected yields and negative carry mean potential negative returns. See this week's "Deeper dive" for more details.*

US: Services strong, spending solid, Fed steady. Service sector sentiment improved in June (as measured by the ISM non-manufacturing gauge). The 56.6 headline print (the best monthly reading since November) beat May's 52.9 and the expected 53.3 result. US personal spending climbed 0.4% m/m in May, in line with consensus. Stronger US consumption should boost US growth and inflation in 2H16, but the Fed will likely only hike rates once in December, given Brexit uncertainties. *CIO is sticking with its US equity overweight in global portfolios.*

Back in black for Eurozone inflation. Headline inflation in the Eurozone increased 0.1% y/y in June, above the –0.1% figure recorded in May and beating economist forecasts that it would flat-line. Energy price changes compared to last year contributed most to the small up-tick. Core inflation (ex-energy, food, alcohol, and tobacco) crept up to 0.9%. *CIO expects continued easy policy from the ECB to support an overweight position in European high yield credit.*

Weak Japanese data piles pressure on the BoJ. Core CPI fell 0.4% y/y in May, declining for a third straight month. Japanese corporates also lowered inflation expectations in June, expecting prices to rise by an average of 0.7% in a year's time, down from 1.0% last December. Japan's service sector PMI fell back into contraction, coming in at 49.4 in June (a 13-month low). Markets are expecting the Bank of Japan to move at its July meeting. *CIO forecasts USDJPY at 107 in 12 months, and is neutral on Japanese stocks in global portfolios.*

Holding steady Down Under. The Reserve Bank of Australia (RBA) left its cash rate unchanged at its 5 July meeting, in line with consensus expectations. However, RBA Governor Glenn Stevens offered more dovish guidance, suggesting that a low 2Q inflation print on 27 July may open the door for further rate cuts. *CIO expects another 25bp cut in August, and remains short AUD vs long USD in global tactical asset allocations.*

UBS

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Deeper dive

Deeper underground

Mark Haefele

Matthew Carter

Watch this week's [UBS House View Weekly Video]

In 1998, the British band Jamiroquai released the number one song "Deeper Underground."

Eighteen years on, "Deeper Underground" is a number one description for how global high grade bond yields have reacted to the UK referendum result. By the end of June, EUR 10.6trn of developed market government debt traded at zero or negative yields. Just in the last week, 10-year yields on UK, US, and German government bonds touched record lows – 0.73%, 1.32%, and –0.2% respectively at the time of writing. Even more extreme, high demand drove the whole Swiss government bond curve into negative-yielding territory, with the discount rate on 50-year Swiss debt slipping to –0.03%.

We expect central banks to respond to post-Brexit economic and political uncertainty with more policy easing. The Bank of England will likely cut its base rate to zero before year end to try to avert recession. Further financial market declines could lead the European Central Bank to increase monthly asset purchases from EUR 80bn/month or extend quantitative easing beyond next March. And the US Federal Reserve must assess how a stronger US dollar affects conditions at home and abroad before raising rates.

Our developed market interest rate forecasts have been marked down across the board to reflect "lower for longer" central bank policy. High grade yields could move even deeper underground. So if buying negative-yielding bonds and holding them to maturity guarantees losses, does high grade debt still have a place in portfolios?

It does by continuing to play an important role as a diversifier, typically mitigating portfolio losses when stocks decline and smoothing portfolio volatility.

Since 1996, 5–7 year Treasury bonds have risen an average 0.7% in months when US stocks have posted losses. But we are underweight high grade debt on a tactical basis, as continued global growth should cause interest rates to gradually rebound from these historic lows.

Ultra-low bond yields increase the attractiveness of other global asset classes. US investment grade debt offers similar diversifying effects to US Treasuries – but pays around 130 basis points (bps) more yield. We maintain a modest overweight in the asset class.

Similarly, our tactical overweight in euro high yield credit looks even more attractive as sovereign yields decline. Easy corporate financing conditions should curb expected defaults to just 2% over the next 12 months. And spreads of around 480bps look appealing for income investors.

Dividend growth stocks in Europe and Asia Pacific also retain their allure. The spread between German Bunds and the 12-month forward dividend yield of the MSCI EMU index, now around 4%, is close to all-time highs. Our analysts' selected stocks, focused on high-quality names with dividend-growth potential, are expected to outperform both high grade debt and the broader Eurozone equity market.

Mark Haefele
Global Chief Investment Officer
Wealth Management

Matthew Carter
Global Investment Office

Bottom line

Economic uncertainty in the wake of the UK referendum has pushed high grade yields toward all-time lows. While easier central bank policies may cause them to fall even further, high grade debt still has a diversifying role to play in portfolios. But we see better tactical opportunities elsewhere, especially in euro high yield credit and US investment grade debt.

Regional view

Podcast
www.ubs.com/cio-podcast

Pension deficits – a ticking time bomb

Bert Jansen
European Equity Strategist

"The measures needed to prevent this ticking time bomb from going off are fairly straightforward, but politically very difficult to implement."

"Retirement is like a long vacation in Las Vegas. The goal is to enjoy it to the fullest, but not so fully that you run out of money."

Jonathan Clements, British author and scriptwriter

"You can be young without money but you can't be old without it."

Tennessee Williams, late American playwright and author

One of the consequences of Brexit has been another leg down in sovereign bond yields. There is currently USD 12trn of debt worldwide yielding a negative return when held to maturity. In the UK, short-dated Gilts briefly turned negative last week, while 10-year benchmark Gilt yields hit a record low of 0.8%. In Switzerland, sovereign bond yields have turned negative all the way out to 50-year maturities, which is unprecedented even by Swiss standards.

This grim message from the fixed income markets is somewhat at odds with rising commodity prices, reflecting weaker growth and further central bank easing. Whatever the message, this low-to-negative yielding environment has dire consequences for European pension funds, both public and private.

Lower bond yields mean that the present value of future pension obligations is rising dramatically. For a typical UK pension fund, a 10bp reduction in the discount rate increases the gross pension liability by 1.7%, according to Citi estimates. To put this in the context of the impact aging has on retirement costs, the Society of Actuaries (SOA) in the US recently updated its mortality tables. It shows that among 65-year-old men, overall longevity rose two years from 84.6 in 2000 to 86.6 in 2014. Based on the data, the SOA estimates that there could be, on average, a 4–8% increase in private pension plan liabilities. This is less than the impact of the 50bp drop in UK Gilts over the last two weeks, let alone the impact of the 200bp fall in yields over the last two years.

In Europe, the high and rising levels of government debt are well documented. What is less well known is the amount of future obligations related to pension benefits and healthcare services. "Stiftung Marktwirtschaft," a German economic think tank, has made estimates about what it calls implicit public debt. The data is staggering: most European countries fail to make adequate provisions for these contingent liabilities. For instance, France's explicit government debt stands at 94% of GDP, but this pales in comparison with its implicit debt, estimated at 359% of GDP. But there is worse news. In the UK and the Netherlands, the implicit debt is estimated at more than 500% of GDP. Germany scores relatively well (implicit debt of 73%), but many German private pension funds are heavily underfunded.

A pension which amounts to half of an employee's final salary is generally considered a reasonable retirement income. Without structural reforms of Europe's social security system (including the UK and Switzerland), this is simply not attainable. The measures needed to prevent this ticking time bomb from going off are fairly straightforward, but politically very difficult to implement. The only way out, in my view, is to raise taxes and/or social security contributions, increase the retirement age, or significantly cut existing and future pension benefits. But good luck explaining that to the European electorate.

Kind regards,
Bert Jansen

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