UBS House View

Europe
Chief Investment Office WM

Weekly

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Market moves

	CIO view	–1w	– 3m	ytd
S&P 500	OW	–0.8%	7.3%	1.1%
Euro Stoxx 50		–0.5%	3.8%	–8.5%
MSCI EM		–1.5%	7.7%	0.6%
FTSE 100		–0.4%	3.7%	–0.6%
SMI		–0.1%	4.3%	–7.0%
NIKKEI 225		0.0%	5.1%	–11.8%
US high grade bonds	UW	–0.7%	0.9%	3.2%
Euro high grade bonds	UW	–0.3%	1.0%	4.2%
US investment grade bonds	OW	–0.7%	4.0%	4.6%
Euro investment grade bonds		–0.1%	2.3%	2.8%
US high yield bonds		0.2%	9.5%	6.5%
European high yield bonds	OW	0.1%	6.3%	3.5%
EM sovereign bonds		0.0%	6.4%	7.0%
EM corporate bonds		0.1%	6.3%	6.5%

Source: Bloomberg, UBS as of 19 May 2016
OW = tactical overweight
UW = tactical underweight

Market comments

Calculations are based on the past five days

- **Equities** were weak across the board, with the S&P retreating 0.8%. Indices in Europe also fell. Only Japan managed to stay flat. But the Nikkei 225 remains the biggest loser, down 11.8% year-to-date.
- **High grade bonds** fell 0.7% in the US and 0.3% in Europe. European high yield bonds advanced 0.1% and US high yield was up 0.2%.
- **The US dollar** was stronger against 9 of the major G10 currencies over the past 5 days. The British pound was the exception, gaining 1.3% vs the dollar.

In focus

Fed puts June rate hike on the cards. The April FOMC minutes showed most participants had felt that, subject to continued strong data, it would likely be appropriate to tighten policy in June. Fed funds futures now imply around a one in three chance of a hike next month, from a mere 4% at the start of the week. *CIO expects two Fed rate hikes in 2016.*

Japanese growth leaps up on Leap Year. The economy expanded by an annualized pace of 1.7% quarter-on-quarter in 1Q16, mainly due to the leap year effect. Otherwise, the economy would have expanded by just 0.1% q/q. Although the data was stronger than the 1.7% revised annualized contraction in the October-December quarter, *CIO believes that the Japanese economy remains weak. The government may have to delay the next VAT hike and deploy more monetary and fiscal firepower. We are neutral on Japanese equities in our global asset allocation.*

China property: hot for now, but to cool through 2016. Month-on-month, new house prices rose in 65 out of 70 Chinese cities in April, versus 62 cities in March. Top-tier cities led the gains. *CIO expects the housing market to face downward pressure this year given the inventory overhang in tier-3 and tier-4 cities and an expected cooling in tier-1 cities after tightening policies take effect.*

US retailers rebound in April. US retail sales figures rose 1.3% m/m after a 0.3% drop in March. The Street had expected a 0.8% gain. Core retail sales climbed 0.9% m/m, and February and March data was upwardly revised. *CIO expects domestic demand to drive 1.5% real GDP growth this year, and rising inflation should warrant two US rate hikes in 2016, albeit in the second half of the year.*

US housing: foundations firm. The May Housing Market Index from the National Association of Home Builders was unchanged from April, at 58. Housing starts and building permits data confirmed that low mortgage rates and a jobs market recovery are helping US housing to heal, moderately supporting the US growth outlook through 2016.

ECB fleshes out corporate bond plans. The central bank says it will limit purchases to a maximum of 70% of any single bond. Additional limits will apply to the bonds of any particular company, and the ECB said it would "be mindful of the potential impact on liquidity." *CIO believes the addition of corporate bonds to QE increases the appeal of the Eurozone's high yield bonds, and we're overweight on the asset class in global portfolios.*

Eurozone GDP falls short. The area's economy grew by 0.5% q/q in the first quarter, below the expected 0.6% rise. The year-on-year growth rate slowed to 1.5% from 1.6%. Germany was among the growth stars, with a 0.7% expansion on the quarter. Spain was the fastest growing large economy at 0.8%.

China wins from MSCI rejig. China will likely attract large passive fund net inflows (about USD 5bn) into its MSCI China index, and the index weightings of IT and "new China" sectors will increase at the expense of state-owned enterprises and "old China" industries. *CIO believes China will avoid an economic hard landing.*

UBS

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Deeper dive

Do rewards outweigh the risks in high yield debt?

Matthew Carter **Carolina Corvalan**

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Government debt securities in developed countries now offer investors slim pickings. Nearly 40% trade at zero or negative yields, offering investors scant income and even a capital loss if bought today and held to maturity. Equities have not benefited, however, in the hunt for favorable risk-adjusted returns. Investors pulled around USD 90bn out of global stock funds year-to-date, the fastest pace of redemptions since 2011.

Can investors look to high yield (HY) corporate bonds instead for attractive risk-adjusted returns? The answer depends on where you look.

There is no question that spreads are attractive. US HY now trades at roughly 626 basis points (bps) above Treasuries, higher than the median of 510bps over the past two decades. Euro HY, meanwhile, offers a 472bps yield premium over sovereigns, about a third higher than five-year lows seen in 2014. Overall, high yield bond yields are attractive, particularly against higher quality bonds, with US HY offering a yield of 7.9% and Euro HY 4.8%.

But US companies are far more advanced in the credit cycle than Eurozone counterparts. Leverage has steadily increased in recent quarters, with issuance to fund corporate acquisitions rising. This leaves balance sheets vulnerable at a time of declining growth of corporate profits, which softened in late 2015 through 1Q 2016. We expect US earnings to recover in the second half of 2016, but the HY market's net debt to earnings before interest, tax, depreciation, and amortization (EBITDA) ratio looks elevated. At 4.8 times in the last quarter of 2015 (ex-commodities), this measure stands above the average of 4x seen since 1998.

US lending standards also tightened for a third consecutive quarter in 1Q 2016, according to the Fed's Senior Loan Officers' Survey. This trend could spur a rise in defaults (which CIO expects), from 4% today on a trailing 12-month basis towards 4–5% over the coming 12 months. Weighing return potential against risks, *we are neutral on US HY in global portfolios at this stage.*

By contrast, European firms have been far more cautious in taking on debt, leaving balance sheets in far better shape. Debt-to-earnings levels stand at about 3x, close to the post-crisis low of 2.5x.

Companies should find it even easier to access further financing in the Eurozone. The European Central Bank's (ECB) 1Q 2016 Bank Lending Survey indicated a net 6% of banks eased standards on loans to businesses, above the average since 2003. Central bank easing has helped lower borrowing costs, and the ECB's decision to expand its quantitative easing purchases to investment grade corporate bonds could push investors out the risk curve, also boosting demand for HY bonds.

With default rates expected to rise only slightly over the coming 12 months to around 2%, and lower exposure to oil-price sensitive energy issuers (6% in the Euro Index versus 17% in the US), the risk-return profile of Eurozone HY still looks attractive. *CIO is overweight on Euro HY in global portfolios.*

Investors question liquidity in HY markets. Dealer inventories have fallen in the post-financial crisis world of stricter bank regulation. However, secondary bid-ask spreads in the US market of 1.04 price points are in line with the five-year average of 1.03, and for Euro HY, the current 1.31 spread is only around 15% higher than average. Investors should prudently consider a well-diversified portfolio of HY debt to avoid company-specific risks. However, we think that liquidity concerns do not outweigh potential HY rewards, especially in the euro market.

Matthew Carter and **Carolina Corvalan**
Global Investment Office

Bottom line

Investors can expect slim pickings from the government debt issued by developed nations. Some 40% of developed market sovereign debt now offers a zero or negative yield. High yield bonds are part of the answer for investors. But better corporate fundamentals, the ongoing Eurozone economic recovery and the ECB easing bias makes the Eurozone sector a more attractive option than US high yield.

Regional view

Lies, damned lies and the new economy

Bill O'Neill
Head Investment Office UK

"Reliable data and analysis are important public goods."

An issue confronting modern finance and policymaking is statisticians' capacity to capture the rapidly evolving digital, "new economy." At risk of sounding esoteric, reliable data and analysis are important public goods. Is the current angst on weak productivity, for instance, largely explained by consistently underestimated output? Central banks undoubtedly have an interest in the conclusion.

So the recent report of the Independent Review of UK Economic Statistics[1], led by Prof Sir Charles Bean, could be seen as excellently timed; it may throw some light on the demands of number-crunchers across the industrialized world.

The report sets out that Internet traffic has expanded in an explosive manner; time online has doubled in the last decade. At the 2016 Davos World Economic Forum, UBS AG focused on the Fourth Industrial Revolution[2], stating *"…the global economy is on the cusp of profound changes that are comparable in magnitude to the advent of the first industrial revolution, the development of assembly line production, or the invention of the microchip."* Digital products are supplied at close to zero cost, relying heavily on advertising for revenues. Households have become "producers" as well consumers; homes are often also workplaces. Intangible capital has expanded in the same way. Meanwhile, certain intermediary services are contracting, while the activities that replace them may be underrecognized. Adjusting for such effects could boost annual GDP growth beyond the normal pattern of revisions.

Agencies like the UK Office of National Statistics (ONS) are therefore challenged by the perception of incomplete, lagging data especially with respect to the services sector. How useful are phone-based surveys in the era of Big Data? Surely there is scope to deploy new electronic techniques.

Recommendations offer some guidance on how limitations in data are confronted and appropriately addressed. Alternative sources of data must be drawn on wherever possible. The report recommends specifically, for instance, establishing a centre for economic measurement that brings users, academics and statisticians together to improve techniques and design, particularly regarding activities in the digital economy.

For me though, what shines through the report is a call for far greater curiosity about the data that pours across our societies. That and the need for a more micro, "bottom up" approach that digital transaction data in turn facilitates, and in a much more timely fashion than currently. This would involve the ONS having greater access to data sources than it does today, but the reward for society as a whole would ultimately be worth the price.

Bill O'Neill

[1] Independent Review of UK Economic Statistics, Professor Sir Charles Bean. March 2016

[2] Extreme automation and connectivity: The global, regional, and investment implications of the Fourth Industrial Revolution, January 2016 (UBS White Paper for the World Economic Forum Annual Meeting 2016)

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