UBS House View

Europe
Chief Investment Office WM

Weekly

31 March 2016

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Market moves

	CIO view	–1w	– 3m	ytd
S&P 500	OW	–0.6%	–1.4%	0.2%
Euro Stoxx 50	OW	–2.4%	–9.5%	–8.2%
MSCI EM	UW	–2.1%	2.0%	2.7%
FTSE 100		–1.3%	–2.1%	–1.0%
SMI		–0.5%	–11.2%	–10.6%
NIKKEI 225		0.3%	–9.1%	–9.4%
US high grade bonds	UW	0.2%	2.9%	2.7%
Euro high grade bonds	UW	0.2%	3.6%	3.5%
US investment grade bonds	OW	0.6%	3.7%	3.4%
Euro investment grade bonds		0.3%	2.4%	2.3%
US high yield bonds		–1.1%	2.9%	2.8%
European high yield bonds	OW	0.2%	1.2%	1.8%
EM sovereign bonds		–0.4%	4.3%	4.3%
EM corporate bonds		0.0%	3.6%	3.6%

Source: Bloomberg, UBS as of 31 March 2016
OW = tactical overweight
UW = tactical underweight

Market comments

Calculations are based on the past five days

- **Equity markets** moved lower over the past week. The Euro Stoxx 50 index gave up part of its recent rally, declining 2.4%. US equities fell 0.6%, leaving them nearly flat this year, and emerging market stocks lost 2.1%. The Nikkei 225 was an exception and managed a 0.3% rise.
- **Investment grade bonds** in the US rose 0.6% while US high yield credit retreated, sliding 1.1%. European high yield bonds climbed 0.2%, taking their gains this year to 1.8%. Euro investment grade bonds rose 0.3%.
- **Crude oil** declined by nearly 4%, falling back below USD 40 a barrel to USD 38.9. The International Energy Agency said it was expecting Iran to add half a million barrels a day to global supply within a year.
- **The dollar** weakened amid dovish signals from the Federal Reserve over the expected course of US interest rates. The Bloomberg dollar spot index lost 1.5%, taking its decline for the month to 2.8%.

In focus

US inflation is on the up. The core personal consumption expenditures price index, the US Federal Reserve's favorite inflation gauge, climbed 1.7% in February from a year earlier – hitting the upper end of the Fed's forecast range. The increase was broad-based and came despite 8%-plus dollar appreciation in the year to February. A 1.7% year-on-year rate is still low enough for comfort, and we are overweight US equities in our tactical asset allocation. But markets will not want to see the Fed falling behind the inflation curve.

The Fed stresses the risks to global growth. Despite rising inflation, Fed chair Janet Yellen gave a speech emphasizing slower Chinese and global growth along with the dollar's strength – an indication that events outside the US are having a larger impact on monetary policy than usual. She mentioned such key words as "global," "China" and "dollar" more often on Tuesday than she did in her three previous speeches combined. We expect two rate hikes this year, likely in the second half.

China's industrial profits grew at their fastest pace in 19 months. The 4.8% rise between January and February beat market expectations, which ranged from flat to 2% higher. Revenue growth edged up 2 percentage points to 1%, suggesting that the industrial sector is stabilizing. This should ease concerns that China's heavy industries will cause the economy to land hard. *CIO expects Chinese GDP to expand by 6.2% this year and 5.8% next.*

Japan's core inflation remained far below target. The core consumer price index, which excludes volatile fresh food prices, came in flat, missing economist expectations of a 0.1% y/y rise. Even the core-core measure preferred by the Bank of Japan (BoJ), which excludes food and energy, rose only 0.8% y/y in February, less than half the government's 2% target. That will add to pressure on the BoJ to roll out more stimulus. *CIO is neutral on Japanese equities and underweight the yen versus the US dollar.*

Abe turns to tourism. With domestic growth remaining weak, Japanese Prime Minister Shinzo Abe has outlined plans to double the number of visitors to Japan by 2020 (to 40 million) and add another 50% by 2030. We like the tourism theme for the long term, but arrivals may slow this year as the impact of a slower Chinese economy and a stronger yen vs. yuan is felt.

Germany escapes deflation…at least in March. The nation's consumer price index ticked 0.1% higher y/y for the month on an EU-harmonized basis, following a 0.2% decline in February. Economists had expected a "no-flation" outcome, with prices flat. *CIO believes that the raft of easing measures announced by the European Central Bank at its March meeting will boost inflation closer to the 2% official target this year. CIO is overweight Eurozone equities vs. emerging market stocks.*

Deeper dive

Does terrorism pose a threat to markets?

Visit this week's
UBS House View Weekly Video

Mark Haefele

Along with causing chaos and loss of life, terrorists often seek to inflict economic and financial damage. So will the recent upsurge in terrorist activity, marked by the recent attacks in Brussels and Pakistan, achieve this goal?

Acts of violence have the potential to harm economies in several ways: consumers may delay or abandon purchases or trips; risk aversion can rise in financial markets; more populist politicians may gain power, limiting the free movement of people and goods and so reducing long-term growth.

Still, historical data suggests that terror incidents have only fleeting effects on consumer spending. For example, France's INSEE consumer confidence index is down just 2.5 points since the Paris tragedy on 13 November. In comparison, the index lost 27 points in the wake of the US sub-prime crisis.

Market sentiment has also tended to recover quickly. It took the S&P 500 just one month to regain the ground lost after the 9/11 attacks, and UK stocks rebounded within days of the July 2005 London terrorist acts. While the effect on some sectors like airlines and hotels can be more acute, Europe's leisure and transport sectors have actually outperformed the MSCI index by three percentage points on a total return basis since the Paris attacks.

The political effects of terrorism are harder to quantify. But we have seen some warning signs. Proponents of Brexit argue that the Brussels attacks show that Britain would be safer outside the EU. The odds of a British exit, as measured by bookmaker Paddy Power, did nudge higher from 33% to 36%. And the pound was also the worst-performing major currency on the day of the attacks, shedding about 1% against both the euro and the dollar. In the US, Donald Trump, who leads the race for the Republican presidential nomination, claims the events in Europe prove the need for immigration restrictions, which could reduce the supply of labor to the US economy. And in Europe, further attacks could weaken public support for the free movement of people within the EU, reducing labor mobility and hence economic efficiency.

An immigration clampdown would likely be a net negative. Migrants accounted for about half the increase in the workforce in the US over the past decade and roughly 70% of the rise in Europe, according to OECD data. Migrants, usually young, frequently fill important niches in fast-growing sectors and boost the working-age population.

Still, such political shifts, if any, would only materialize over a long period of time, and it is far too soon for investors to change their positioning. And while opponents of free trade and immigration have gained ground, the power in developed nations is still held by pro-globalization politicians. Institutional checks and balances also limit the ability of proponents of radical shifts to make changes. Meanwhile in the UK, the pro-EU campaign still leads in the polls.

The bottom line is that while terrorism is a human catastrophe, economies and financial markets in developed nations do not exhibit a high degree of sensitivity to such events. Barring a sharp spike in terror activity, we expect it to remain that way.

Mark Haefele
Global Chief Investment Officer
Wealth Management

Bottom line

Terrorists often seek to cause economic disruption along with loss of life. There is a threat that the recent upsurge in attacks could shift political power to opponents of immigration and free trade, which could harm long-term growth. But we believe pro-globalization politicians will remain in charge. Meanwhile, historically the impact of terror attacks on economic growth and markets has been limited in developed nations.

Regional view

Podcast
www.ubs.com/cio-podcast

NIRP – Not Intuitively Reliable Policy

Bert Jansen
European Equity Strategist

In the past few years, five central banks – the European Central Bank (ECB) and the Danish, Swedish, Swiss and Japanese central banks – have engaged in what many economists consider a high-risk experiment by moving their policy rates below zero, traditionally seen as the lower bound for nominal interest rates.

The aim of zero and negative interest rate policy (ZIRP or NIRP), when employed alongside a wider set of tools such as quantitative easing, is to raise inflation and growth by boosting consumption and investment. The results of this experiment so far have been disappointing, though. Inflation rates and expectations in most developed countries remain well below central banks' mandates, while subpar economic growth is the rule rather than the exception.

The proponents of widespread, exceedingly loose monetary policy argue that, without it, the world economy would be in a considerably worse state than it is now. The absence of counterfactual evidence makes this, of course, easy to say and impossible to substantiate or refute. In any event, it is becoming increasingly clear that NIRP is having several unintended consequences.

Apart from distorting the credit markets' traditional signaling function, artificially suppressing interest rates is hurting the financial system. The combination of negative rates and a flat yield curve is a potent recipe for decimating bank profitability, which may hamper rather than stimulate lending.

To mitigate this effect, the ECB announced on 10 March that it would launch targeted longer-term refinancing operations (TLTRO II). They will enable Eurozone banks to borrow money at rates as low as minus 0.4%. But this measure is likely to increase the sector's annual earnings by a limited 1.6% over the next four years, according to calculations from our banking sector strategist.

Buoyant consumption suggests that ZIRP (NIRP's predecessor) has encouraged spending instead of saving. But whether the spending stems primarily from ZIRP or from other factors that have had a positive impact on consumers, such as lower oil prices and falling unemployment, is difficult to disentangle and gauge. Corporate and household credit growth has picked up in the Eurozone in recent months, but the rate of barely 1% remains disappointingly low.

Another unintended consequence of central bank interference in money markets is a misallocation of capital. Companies in some countries are being kept on artificial life support despite being insolvent or nearly bankrupt, which intensifies deflationary tendencies instead of reducing them.

> "It is becoming increasingly clear that NIRP is having several unintended consequences."

Finally, recent evidence in the Eurozone and in Japan shows that NIRP does not necessarily lead to a weaker currency, which is supposed to improve competitiveness and feed inflation.

All in all, central banks have been operating under the assumption that NIRP boosts growth and/or inflation, but its unintended consequences suggest that it may pose more economic risks than benefits. This, in my view, goes a long way toward explaining the uninspiring performance of equity markets over the past five months.

Kind regards,
Bert Jansen