UBS House View

Europe
Chief Investment Office WM

Weekly

7 April 2016

Market moves

	CIO view	–1w	– 3m	ytd
S&P 500	OW	0.1%	7.0%	1.8%
Euro Stoxx 50	OW	–3.2%	–5.1%	–10.4%
MSCI EM	UW	–3.3%	9.9%	2.2%
FTSE 100		–0.2%	4.9%	0.1%
SMI		–0.5%	–6.5%	–10.4%
NIKKEI 225		–6.0%	–10.6%	–16.6%
US high grade bonds	UW	0.1%	2.9%	3.6%
Euro high grade bonds	UW	0.4%	3.6%	4.2%
US investment grade bonds	OW	0.3%	3.8%	4.3%
Euro investment grade bonds		0.4%	2.8%	2.8%
US high yield bonds		0.6%	3.8%	3.6%
European high yield bonds	OW	0.4%	2.9%	2.3%
EM sovereign bonds		0.4%	5.3%	5.2%
EM corporate bonds		0.4%	4.5%	4.5%

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

Market comments

Calculations are based on the past five days

- **Japanese equities (–6%)** lost the most ground last week, as weaker data and a stronger yen hurt exporters. **European stocks fell 3.2%** and **EM equities slipped 3.3%**. In USD terms, **global stocks are 12% above February lows**.
- In currencies, the **JPY gained 3%** against the USD, posting its longest rally since January. Dovish Fed minutes led the **EUR (flat on the week)** towards five-month highs against the USD.
- In commodities, **gold (+0.4%)** gained from a weaker USD after the Fed minutes and continued global monetary policy accommodation.

In focus

Moderate US growth should open door for second-half hikes. Improving labor data implies consumption should power US growth. And inflation is edging closer to the Federal Reserve's 2% target. Minutes from the March Federal Open Market Committee meeting suggested the pace of US rate hikes will be gradual, given continued risks to global growth and financial conditions. *CIO expects the US Federal Reserve to resume interest rate hikes in September of this year, with a second hike possible in December.*

US business sentiment improved in March. The manufacturing index from the Institute for Supply Management climbed above 50 for the first time since September last year (rising in March to 51.8 from 49.5). Non-manufacturing measures for the service sector strengthened to 54.5 last month, from 53.4 in February. *Stabilizing industrial activity should lead to resumed earnings growth for US equities in the second half of the year. CIO is overweight US equities versus high grade bonds in global portfolios.*

Eurozone purchasing managers' data was more mixed. The Markit manufacturing purchasing managers' index (PMI) rose to 51.6, up from an initial 51.4 and from February's 51.2. Manufacturing employment rose for the 19th consecutive month. The Eurozone services gauge declined to 53.1, its lowest reading since January 2015, but the indicator remains in expansionary territory. We expect easier monetary policy in the Eurozone to ease financial conditions further, and provide a gradual boost to growth, inflation, and earnings. *CIO is overweight Eurozone equities and European high yield bonds in global tactical asset allocations.*

Yen strength is on the radar of Japan's Ministry of Finance. The yen strengthened below 109 against the US dollar, raising suggestions that Japanese policymakers may step in to weaken the currency. Reasons for yen gains include the recent dovish messaging from Fed Chair Janet Yellen and Japanese corporate hedging purchases at the start of the new fiscal year. We expect the Bank of Japan to ease more, in tandem with further fiscal spending, and yen portfolio outflows should resume in search of higher overseas yields. *CIO forecasts USDJPY to rise to 122 in 12 months, given divergent US and Japanese monetary policy.*

A steadier ship in China? March's official manufacturing PMI climbed to 50.2 from 49.0 in February, posting its first reading above the 50 watermark since July. Services sentiment also improved, with the Caixin China services PMI print strengthening to 52.2 from 51.2. Last, China's FX reserves posted their first month-on-month gain since October, rising to USD 3.21trn. We will be watching next week's data releases on credit and money supply growth for signs of easier liquidity conditions. *CIO expects further fiscal stimulus and a brightening service sector outlook to support Chinese GDP growth of 6.2% this year.*

Deeper dive

Dollar on the move: Implications for investors

Watch this week's
UBS House View Weekly Video

Matthew Carter

Investors have started to wonder whether a weaker US dollar is here to stay. March was the worst month since September 2010 for the dollar, which fell 3.8% on a trade-weighted basis. Though the currency remains around 30% higher on a trade-weighted basis than its 2008 low, it remains important to ask whether this recent weakening is justified.

We believe that recent better US economic data actually warrants a stronger dollar in the coming months, as the US Federal Reserve raises interest rates. Nonfarm payroll growth of 215,000 in February surpassed expectations. Wages have been rising above 2% over the prior year. And stabilizing manufacturing and non-manufacturing ISM data (including the services' employment gauge moving back into expansionary territory) implies further labor market tightening.

Rising pay demands are pushing US core inflation closer to the Fed's 2% target. February's 1.7% year-on-year gain in the core personal consumption expenditure (PCE) price index was the highest since January 2013. That should eventually justify a less dovish tone from the Federal Open Market Committee (FOMC), and a market re-pricing of the path for the fed funds rate. Futures are pricing in between zero and one rate hike this year. We expect two second-half rate increases, and a stronger US dollar as markets reset for tighter US monetary policy relative to other major central banks.

A stronger greenback could reverse the recent rallies in commodities and certain emerging market (EM) currencies. First-quarter performance data for oil suggests the recent price bounce was chiefly driven by dollar weakness. Brent crude oil climbed 6% when measured in dollars, yet prices fell 2% for major producer Russia in ruble terms.

We don't advise holding commodities in global portfolios, and expect oversupply (especially in oil markets) to clear only in the second half of the year. Conversely, a brighter US growth and inflation outlook, in conjunction with an expected resumption in US profit growth in the second half of the year, supports our tactical US equity overweight versus high grade bonds.

Longer term, the path of the dollar may depend more on the actions of other major central banks, and how successful they are in achieving policy objectives. A combination of tepid growth and sub-par inflation will likely lead Asian central banks to loosen monetary settings, and we expect EM Asian currencies to depreciate on average by 4–6% against the USD over 12 months. Ongoing monetary and fiscal support in Japan should weaken the yen from 18-month highs, so we are maintaining our long USD versus short JPY position in global tactical asset allocations.

Against the euro, though, we think the dollar could lose ground over the next 12 months. As the European Central Bank (ECB) easing in March feeds through into more robust activity and a firming in Eurozone inflation, talk may turn toward ECB policy normalization. We expect the single currency to rise toward 1.16 against the USD in 12 months' time, but for it to do so a period of stronger US growth that supports the global recovery and less-divergent monetary policies is necessary, in our view.

Matthew Carter
Global Investment Office

Bottom line

We believe the greenback should strengthen in the coming months as markets re-price for higher inflation and more Fed rate hikes. US economic improvement and a pick-up in second-half earnings growth should support our tactical US equity overweight in global asset allocations. But a dollar rally could leave USD-sensitive commodities vulnerable to setbacks. On a 12-month time horizon, the US dollar may weaken against the EUR.

Regional view

Greece: Back to 2015?

Podcast
www.ubs.com/cio-podcast

Ricardo Garcia
Head, European Macroeconomics

In light of the continued stalemate in Greece's negotiations with its creditors, I get a lot of questions on what's ahead for the country. The much feared deterrent of economic implosion following the introduction of capital controls wasn't as bad as creditors had thought (or hoped for). Despite having a foot out of the Eurozone, Greece's economic growth only fell 0.2% in 2015, while unemployment improved to 24%, its lowest level since spring 2012. This can partly be explained by the quick resolution of the crisis after capital controls were introduced and by European subsidies, as well as the rise of the shadow economy.

However, the new program cannot be seen as a success so far. The government's plan was to push hard for a longer program to take the country out of continued funding stress. But Greece remains on a knife's edge awaiting the much delayed first bailout review. Recent leaks from the negotiations suggest tension among the parties, which was confirmed in IMF Chairwoman Christine Lagarde's letter to Greek Prime Minister Alexis Tsipras on 2 April in which she wrote that she was "concerned as to whether we can indeed achieve progress." The key issue is the conditions required to make the program sustainable, which means a reasonable combination of debt relief and fiscal measures. Hence, the negotiations are mired in disagreement about the extent of fiscal measures and reforms, such as the liberalization of NPL sales, according to Economy Minister Giorgos Stathakis. Room for higher taxes is very limited, so more debt relief is in any event required to appease the IMF's member states, including the US. Indeed, US Treasury Secretary Jack Lew recently confirmed that the IMF will not start a new program with Greece unless there is substantial debt relief, which would hurt European creditors. And time is running out: Greece faces major bond redemptions on 20 July, mainly to the ECB.

"…time is running out: Greece faces major bond redemptions on 20 July, mainly to the ECB."

Is it 2015 all over again for Greece then? We don't think so. Tsipras has moved the Syriza party more to the center following the Popular Unity split-off, and polls suggest increased momentum for New Democracy against the backdrop of a razor thin government majority, so this time should be different. For example, the German finance ministry is now more optimistic and says that the review could be completed by the end of April, a view shared by US Vice President Joe Biden. We think the 22 April Eurogroup deadline for the first program review is the best case scenario. But ultimately, a deal should materialize by the 20 July deadline, with a fair chance of having the IMF on board in the new program. As Tsipras once put it, "it's not time for exits in Europe, it's time for more cooperation." So we maintain our exit risk estimate at 20–30% until the first review is completed.

Kind regards,
Ricardo Garcia

UBS