UBS House View

Europe
Chief Investment Office WM

Weekly

30 June 2016

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Market moves

	CIO view	–1w	– 3m	ytd
S&P 500	OW	–0.7%	1.1%	2.4%
Euro Stoxx 50		–4.9%	–3.0%	–10.4%
MSCI EM		–1.6%	–0.7%	5.0%
FTSE 100		1.6%	4.2%	4.3%
SMI		0.1%	4.2%	–6.4%
NIKKEI 225		–4.1%	–7.0%	–17.4%
US high grade bonds	UW	1.0%	1.9%	5.4%
Euro high grade bonds	UW	1.0%	2.2%	6.1%
US investment grade bonds	OW	1.3%	3.6%	7.7%
Euro investment grade bonds		0.2%	1.4%	3.9%
US high yield bonds		–0.4%	4.4%	7.8%
European high yield bonds	OW	–1.2%	1.4%	3.5%
EM sovereign bonds		1.3%	4.8%	10.1%
EM corporate bonds		0.5%	3.9%	8.4%

Source: Bloomberg, UBS as of 30 June 2016
OW = tactical overweight
UW = tactical underweight

Market comments

Calculations are based on the past five days

- **Equities** retreated as markets reacted to the unexpected outcome of the UK referendum. The Euro Stoxx 50 index fell 4.9% over the past five trading days. The S&P 500 is down 0.7%.
- **High grade bonds** gained ground amid heightened risk aversion. European high grade bonds gained 1%, pushing their rally this year to 6.1%, while US high grade bonds also advanced 1%, up 5.4% on the year.
- **High yield credit** was pushed back. Euro-denominated high yield fell 1.2% as investors fled to the safety of high grade bonds. Even so, it remains up 3.5% this year.

In focus

Brexit – the fallout continues. UK Chancellor of the Exchequer George Osborne claimed the UK economy was "about as strong as it could be" to confront the post-Brexit world. But with the UK Conservative and Labour parties both fighting internally, no clear and common line as yet communicated from European policy makers, and no indication on when (if at all) the UK will invoke Article 50, uncertainty remains high.

Markets go full circle. After a record breaking USD 2.1 trillion was wiped from global stock markets Friday, and a further USD 900 billion Monday, equity markets recovered losses through the week on optimism that political and financial contagion from Brexit might be limited. *CIO is overweight US equities and European high yield credit.*

UK loses last investment grade rating. Moody's stripped the UK of its top tier rating on Friday. S&P and Fitch have now followed. S&P said the results of the referendum on EU membership threatened the constitutional and economic integrity of the nation, and signaled the potential for further downgrades.

Danish getting paid more to take home loans. Risk aversion stemming from Brexit is driving Danish yields, and the cost of home loans, even lower. Mortgage rates have fallen as low as a record –0.31%, with thousands of home owners now being paid interest to borrow. While homeowners still have to pay lending fees, that's quite a bargain.

Swiss aren't hoarding cash…yet. The Swiss National Bank has said that, despite some increase in demand for cash, there are few signs that negative rates are leading to money being stashed under mattresses, or in safes. The central bank also reiterated its willingness to intervene if the fallout from Brexit continued to put upward pressure on the Swiss franc. *CIO is neutral on Swiss equities and the franc.*

Spain sticks to what it knows. In Sunday's election, Spanish voters eschewed support for populist Podemos, and plumped for the ruling Popular Party. The center-right incumbents increased their number of seats to 137, and a minority PP-led government looks to be the most likely eventual outcome. *CIO expects political horse-trading to take time in Spain, with no government formation likely before summer's end.*

Growth not so grim in the US. US 1Q GDP growth was revised higher than expected to 1.1% q/q SAAR (from 0.8%), driven by strong capex and exports. GDP growth in 2Q is tracking around 2.6%, according to the Atlanta Fed. *CIO expects US growth of around 2% in 2H16 and is overweight US equities.*

Sluggish Japanese retail sales. Retail trade contracted for a third straight month in May by 1.9% y/y, and was flat from the previous month as Prime Minister Shinzo Abe continues attempting to prop up consumer spending in the struggling economy.

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Deeper dive

Life after Brexit

Mark Haefele **Dean Turner**

Watch this week's UBS House View Weekly Video

The fallout from the surprise UK referendum result continues to reverberate around the world, although as the week draws to a close there is sense that markets are finding their feet. Reassuringly, they have settled around levels we expected before the referendum, and there are no signs yet that this localized event could become something more global.

Its economic consequences for the UK are as yet unknown, but our sense is that activity will grind to a halt in the short term, and maybe even go into reverse as businesses and consumers react unfavorably to the rise in uncertainty. The political consequences, by contrast, are clear. A vacuum has opened up with a powerless prime minister holding the fort until a successor arrives. And in the opposition party, plans are afoot to unseat their leader. The good news is that the successors should be in place by September, which should enable the political establishment to focus on the task at hand.

At this stage, it is hard to imagine that the result of the referendum will be overturned; an "exit from Brexit" seems unlikely. To be sure, there are many events that could bring it about, but to our mind it is more sensible to think about what comes next. While little is known, our sense is that the UK will look to broker a deal along the lines of a European Economic Area arrangement, similar to Norway's. If this is the case and the plans are announced soon, it should provide some clarity to businesses, investors, and consumers in the UK.

The economic reality of such a deal is that very little would change, so it should lift the veil of uncertainty and enable the UK economy to return to some semblance of normality. The hit to economic activity wouldn't be reversed, but neither should it persist for long, allowing investors to turn their attention away from the UK and focus on the bigger picture.

And this bigger picture is one where the US economy continues to show resilience. Some signs of easing in the pace of hiring and yet another unwelcome hit to markets are likely to keep the Federal Reserve in cautious mode for the time being, but unlikely to lead to a change in direction. And in Asia, which feels off the radar with all eyes on Europe now, the story remains one of stabilization, with pockets of strength emerging. For Europe itself, caught in the eye of the Brexit storm, the economy is unlikely to escape unscathed, but we shouldn't become too fatalistic as the domestic recovery, supported by an active central bank, will continue.

Brexit has presented investors with yet another hurdle to overcome, and emphasizes the need to maintain a diversified portfolio. Political risk feels higher today than it has for some time, and it isn't going to get any easier over the next 18 months. But we should also remember that volatility often presents opportunities that we should not shy away from in a world where economic growth is set to continue.

Mark Haefele
Global Chief Investment Officer
Wealth Management

Dean Turner
Economist

Bottom line

Brexit has rocked the UK political establishment, which now faces a period of soul searching. Economic growth in the UK will be hit, but our sense is that the broader global ramifications will be less severe. Thus, recent market volatility offers opportunities for investors to investigate in the context of a diversified portfolio.

Regional view

Mixing politics and markets

Podcast
www.ubs.com/cio-podcast

Themis Themistocleous
Head CIO European Investment Office

Last week we felt again how politics can influence markets and the wider economy. Against the expectations of most market commentators, the UK population voted to leave the EU. As late polls tilted toward the Remain campaign, markets all but discounted the possibility of a Brexit. So when the results were announced, the market reacted violently, with equity markets in the UK and the rest of Europe down sharply, and increased volatility across most asset classes.

But as always with investing, we need to keep an eye on the underlying economy and how events can impact fundamentals. The UK economy will feel the main impact. We expect GDP growth in the next nine months to be around zero, and only a marginal recovery for the following quarter, as uncertainty on the future relationship of the UK with the EU dissuades companies from making significant investment decisions and consumer confidence takes a knock. And if political uncertainty escalates and the negotiations with Europe become acrimonious, the outcome could worsen.

"As always with investing, we need to keep an eye on the underlying economy and how events can impact fundamentals."

In the Eurozone, we expect less severe effects, with the economy growing at 1.5% this year instead of 1.6%, and 2017 growing 1.3% instead of 1.7%. This still implies a relatively healthy growth rate. The final outcome may depend on how smoothly negotiations with the UK proceed, and whether anti-EU parties in other countries are emboldened and seek their own referenda, or gain ground among the electorate. Comments from EU officials on negotiation strategy with the UK are presently varied, but the majority indicates a tough, but realistic stance. There is limited evidence of credible moves for referenda on EU membership in the short term in other nations; a sharp slowdown in the UK economy might make such moves less appealing.

The UK referendum was one of a number of events on the political calendar for the next 18 months. In Spain, recent elections gave an inconclusive result. We expect the Popular Party to lead a new government, but one that is likely to be either a coalition or a minority. In the latter case, the pace of reforms may slow.

Italy will hold a referendum on constitutional reforms in October this year, and then in November is the US presidential election. Next year, Germany, France and the Netherlands will hold elections. Any of these events could stir further uncertainty and volatility for the markets. We therefore remain alert, advocating fully diversified portfolios, both across asset classes and regions.

Kind regards,
Themis Themistocleous

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