UBS House View

Europe
Chief Investment Office WM

Weekly

17 March 2016

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Market moves

	CIO view	–1w	– 3m	ytd
S&P 500		1.9%	–0.1%	–0.3%
Euro Stoxx 50	OW	3.0%	–7.1%	–6.1%
MSCI EM	UW	0.1%	–0.4%	–0.1%
FTSE 100		2.6%	2.7%	0.3%
SMI		–0.1%	–7.7%	–9.4%
NIKKEI 225		0.5%	–12.3%	–10.9%
US high grade bonds	UW	0.4%	2.2%	2.2%
Euro high grade bonds	UW	–0.4%	2.7%	3.0%
US investment grade bonds	OW	0.8%	2.1%	2.3%
Euro investment grade bonds		0.8%	1.8%	1.8%
US high yield bonds	OW	0.7%	3.1%	2.6%
European high yield bonds	OW	1.7%	1.0%	1.6%
EM sovereign bonds		0.2%	3.2%	3.2%
EM corporate bonds		0.3%	2.7%	2.6%

Source: Bloomberg, UBS as of 17 March 2016
OW = tactical overweight
UW = tactical underweight

Market comments

Calculations are based on the past five days

- **European equities (+3%)** rallied on further ECB easing, and outpaced other major markets. Global stocks continued to pare losses, and now stand 1.8% lower year-to-date (USD total return terms).
- In commodity markets, **WTI and Brent crude oil rallied 4.5% and 3.2% respectively,** as major producers committed to production cuts even if Iran refuses to participate. Despite a post-Fed bounce, gold shed 0.6% over the last five days.
- **European high yield (+1.7%)** gained from ECB easing measures. Credit spreads should continue tightening, given strong fundamentals and near-zero trailing default rates.

In focus

All quiet on the US Fed front. Although the central bank kept a 0.25–0.5% target fed funds range, the tone of its statement was dovish. It appears that the Fed wants to see further improvement in the economy and the markets before raising rates again. Global markets may remain turbulent as the Fed's tightening path diverges from other major central banks. *CIO stays neutral on equities, preferring tactical overweight positions in European and US high yield credit.*

The Bank of Japan (BoJ) kept its powder dry this month, despite weak growth. The BoJ maintained a –0.1% rate on excess reserves and confirmed its existing quantitative and qualitative easing program. BoJ Governor Haruhiko Kuroda noted to parliament that deposit rates could fall as far as –0.5%, if judged necessary to meet the price stability target. *CIO expects the BoJ to ease again at either its April or June monetary policy meeting, supporting a tactical long USD versus short JPY position in global portfolios.*

China kept its foot on the fiscal accelerator, as government spending climbed 12% in the first two months of this year from the same period last year. This compares to a 10.5% y/y rise in January-February last year. *The figures underline CIO's view that China is willing and able to use its government budget to stabilize economic growth. CIO expects additional pro-growth measures in coming months, including selective monetary easing, further fiscal spending, and supply-side reforms.*

US shopping stalled. Retail sales, which account for about 25% of overall consumer spending, declined 0.1% month-on-month. Data for January was also revised down. US shoppers have been a key source of strength for the economy over recent quarters, with household spending rising 2% in the last three months of 2015, faster than the 1% expansion of GDP. *CIO believes that the strength of the US labor market should ensure healthy consumer spending.*

Commodity-dependent economies are not created equal. Oil-dependent Canada has benefited from recent crude price strength, export channels into a healing US economy, and stronger domestic growth conditions. Conversely, Australia's economy may slow as China demands fewer base metals. And domestic conditions seem less favorable, with rising household debt and near-zero real wage growth. *CIO opened a long CAD versus short AUD currency position in global portfolios to position for relatively better Canadian conditions, and a recovery of the Canadian dollar.*

UBS

Deeper dive

Off to the races

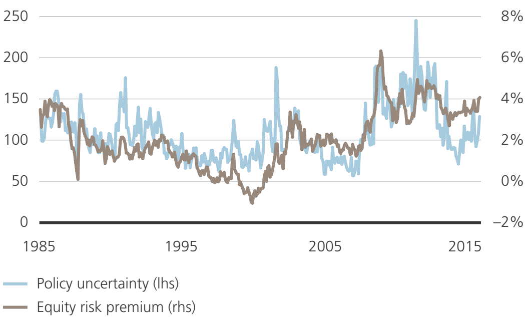
The US presidential primaries are receiving blanket coverage worldwide. This is due in large part to the unexpected success of unconventional candidates in both the Republican and Democratic parties. While it's still too early to draw definitive conclusions on potential policy changes, we can offer some perspective on the market impact that divided government has had.

Passions Trump party leadership
This week's presidential primaries were the latest in a long string of political contests to determine the nominees for the US presidency. The results suggest that former Secretary of State Hillary Clinton is on a course to win an outright majority of delegates at the July Democratic convention. On the Republican side, businessman Donald Trump leads the delegate count but is less certain to claim the needed majority as a handful of other candidates remain in the race.

When the nominees of the two major parties are determined, it should become easier to discern clear policy differences and gauge the likely outcome of the election. In addition to the presidency, control of both houses of Congress is up for grabs, and the ultimate balance of power will dictate next year's legislative activity.

Perceived risk to owning equities rises amid policy uncertainty

Policy uncertainty index vs. cyclically-adjusted equity risk premium



Source: Scott Baker, Nicholas Bloom, and Steven J. Davis at policyuncertainty.com, UBS, as of 26 February 2016

Watch this week's
UBS House View Weekly Video

Brian Nick

Will markets feel the Bern?
Are investors right to worry about how the election's outcome could affect the US economy and financial markets, given the popularity of unconventional candidates like Trump and Senator Bernie Sanders? We think any alarm is premature at this early stage of the election process.

While there will certainly be clear differences between the two parties' candidates on important issues like tax reform, trade policy and regulation, control of the US government is likely to remain divided in some way between Republicans and Democrats. A shared power arrangement leads either to compromise or gridlock on contentious issues, and the latter can indeed roil the economy and/or markets.

The statistics suggest an election year alone does not derail US stock performance – S&P 500 annual total returns during voting years (11.2%) differ little from the long-run 12% yearly average since 1926.

High policy uncertainty is a different risk, and has historically affected asset market performance. Equities performed poorly when US credit was downgraded by Standard & Poor's in 2011 and in the lead-up to the fiscal cliff negotiations in late 2012.

The figure to the left shows a quantitative measure of policy uncertainty developed by social scientists at Stanford University and the University of Chicago. Current policy uncertainty is muted, and the perceived risk of owning stocks versus bonds (equity risk premium) is high. US equities look attractively valued compared to bonds, though not as starkly as they did during recent spikes in policy uncertainty.

Brian Nick
Head of Tactical Asset Allocation U.S.

Bottom line

A volatile US election with an uncertain outcome should not deter investors from holding diversified risk assets. We expect some degree of divided government next year and few sweeping changes that could cause the US economy or asset prices to suffer greatly. We see little reason to expect lower US equity returns solely due to the election.

Regional view

"Super Sunday" was anything but for mainstream German parties

Podcast
www.ubs.com/cio-podcast

Patrik Ryff
CIO European Economist

German journalists, borrowing from the typically exuberant jargon of their US counterparts, dubbed last Sunday's regional elections "Super Sunday." But for the mainstream parties, the CDU and SPD, the vote in the federal states of Baden-Württemberg, Rhineland-Palatinate and Saxony-Anhalt was anything but super. Chancellor Angela Merkel's CDU lost 12% of its 2013 vote total in the industrial powerhouse Baden-Württemberg. For the first time in its history, it is no longer the strongest party in its traditional stronghold.

The SPD meanwhile fared little better. It lost sharply in two of the three states. Instead, election day belonged to the populist anti-immigration movement Alternative für Deutschland (AfD), which swept for the first time into all three state parliaments.

Merkel was not up for election in any of the three states, but it was her immigration policy that was at the center of the debate ahead of the vote. So much so that even Donald Trump felt compelled to chime in via Twitter earlier this year. So should we take Sunday's election result as a vote of confidence on Merkel's "Willkomenskultur," as some claim? And, if so, will she change course now? The answer to the first question is "not entirely," and the answer to the second "no."

"Right-wing populism has arrived in German politics."

There is no denying that the immigration debate has favored the AfD. It became the second-strongest party in the Saxony-Anhalt parliament, winning 24.2% of the vote. Among AfD voters there, 64% say their support stemmed from disappointment in or protest against the other parties – even if a high percentage of them agree that the AfD doesn't offer any solutions.

In Baden-Württemberg and Rhineland-Palatinate, the share of AfD voters also lodging protest votes exceeded 90%. But distancing themselves from Merkel's refugee policy didn't do the CDU candidates for prime minister in Baden-Württemberg and Rhineland-Palatinate any good. The non-CDU incumbents, who back Merkel's immigration policies, outdistanced them easily.

The German chancellor has no intention of changing course in any case. She reiterated in a press conference the day after the elections that she remains committed to a European solution, and she again rejected adopting a ceiling on refugee intake. And why would she? Her popularity is on the rise again of late, with a recent poll showing that 50% of the population would vote for her next year if elections for chancellor were held by direct vote. And alternatives to her within the CDU are scant, possibly even more so after Sunday's elections.

There are five more electoral tests before the Bundestag elections in the fall of next year, starting with Mecklenburg-West Pomerania and Berlin in September. But one thing is clear already, right-wing populism has arrived in German politics, as it has in most of Europe years ago.

Kind regards,
Patrik Ryff

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