UBS House View

Europe
Chief Investment Office WM

Weekly

3 March 2016

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Market moves

	CIO view	–1w	– 3m	ytd
S&P 500		2.9%	–2.5%	–2.4%
Euro Stoxx 50	OW	4.7%	–9.5%	–7.5%
MSCI EM	UW	4.6%	–5.7%	–3.0%
FTSE 100		2.4%	–0.9%	–0.4%
SMI		2.3%	–8.7%	–8.4%
NIKKEI 225		5.1%	–14.7%	–10.8%
US high grade bonds	UW	–0.7%	2.2%	2.0%
Euro high grade bonds	UW	0.0%	3.4%	3.4%
US investment grade bonds	OW	–0.3%	0.7%	0.9%
Euro investment grade bonds	OW	0.3%	0.9%	1.1%
US high yield bonds	OW	3.7%	–1.4%	1.2%
European high yield bonds	OW	1.6%	–2.7%	–0.8%
EM sovereign bonds		1.4%	1.5%	2.3%
EM corporate bonds		0.8%	0.2%	1.4%

Source: Bloomberg, UBS as of 3 March 2016
OW = tactical overweight
UW = tactical underweight

Market comments

Calculations are based on the past five days

- Global stock prices climbed higher over the past five days, with **European equities (+4.7%)** and **Japanese stocks (+5.1%)** particularly strong. Emerging market stocks are now outperforming developed market counterparts this year (by around 1%), but we expect this trend to reverse given relative earnings expectations.
- In commodity markets, **WTI oil prices climbed 8%**, as data pointed to a sixth-straight week of US production cuts and the lowest level of output since November 2014.
- Investor risk appetite improved thanks to stabilization in economic lead indicators. Higher-rated fixed income was less sought after, with **US high grade bonds declining 0.7%**.

In focus

Eurozone inflation numbers were weaker than expected on Monday, increasing the likelihood of European Central Bank action on 10 March. The estimate of Eurozone consumer prices slipped 0.2% year-on-year in January versus the prior month's 0.3% gain, missing expectations for a flat headline figure. Core prices rose 0.7% y/y in January vs a 1% y/y gain in December, below consensus expectations of a 0.9% rise. *CIO believes it highly likely that the ECB will take further easing measures at its March policy meeting to support recovery in economic growth and bring prices back towards the central bank's target of inflation at or below 2%.*

On a brighter note, European unemployment data releases were positive. The region's seasonally adjusted unemployment rate dropped to 10.3%, its lowest since August 2011. Recuperating labor markets and stronger private consumption should continue to boost economic recovery in the Eurozone.

European manufacturing PMIs softened at the final reading. The headline Eurozone composite PMI reading was slightly ahead of the flash reading on 22 February (51.2 vs 51) but below the 52.3 level in January. Along with indicating a possible deceleration in manufacturing growth, the output price measure fell to its lowest level since June 2013.

Although still in contraction territory, the US ISM manufacturing index beat market expectations in February, with a headline reading of 49.5, ahead of the 48.2 print in January. The production sub-index was particularly positive, as the reading increased to 52.8 from 50.2. For the first time in seven months, producers also indicated that their customer inventories were "too low." *CIO believes US economic growth is moderating, but that the economy is not headed towards recession.*

Moody's lowered China's credit rating outlook from stable to negative on rising government debt, falling currency reserves and uncertainty over the authorities' ability to carry out reforms. Last week PBoC Governor Zhou sought to raise confidence in China's ability to manage its economy, emphasizing that policymakers have monetary policy tools available and that fiscal policy will be more proactive.

China delivered additional monetary support on Tuesday, in line with Governor Zhou's comments. Policymakers decided to cut bank reserve requirement ratios by 50bps in a bid to boost domestic liquidity conditions. *CIO still believes that China can use monetary and fiscal easing to avert a growth hard landing, and will not aggressively devalue the Chinese yuan.*

Japanese consumer prices were flat y/y in January, in line with forecasts but far from the 2% target. The nation's industrial output declined 3.8% y/y in January, below the prior month's reading, and retail trade data missed expectations of a 0.1% expansion, posting a 0.1% y/y decline in January. *CIO is neutral on Japanese equities, as more mixed economic data and an earnings drag from recent yen strength may weigh on the market over the next six months.*

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Deeper dive

"Should I stay or should I go?" – the Brexit debate

Dean Turner

Matthew Carter

Watch this week's [UBS House View Weekly Video]

The date of the UK's referendum on EU membership has been set for June 23. Campaigning has now begun in earnest, and key political figures have declared whether they want to stay in or leave the EU (the so-called British exit or Brexit). Global investors are asking two key questions:

1. Has the likelihood of a Brexit risen?

In our view, no. We still assign it a 30% probability, though we remain watchful as public opinion will likely shift during the campaign. Our base case is for the UK to stay in the EU. At this stage, the opinion polls still show more UK voters wishing to remain than leave. And just under one-fifth of the voting population has yet to pick a side of the battle. These "don't know" voters could swing the results day, and are likely to choose the status quo, in our view. We expect UK economic momentum to slow ahead of the referendum (as uncertainty weighs on confidence) but rebound once the votes are counted.

In an alternate scenario, a UK economic recession before year's end may follow from postponed business investment and hiring, and more cautious consumers. Uncertainty about trade channels across the channel could dampen external demand too – the EU, by far Britain's largest trading partner, is the end destination for 44% of UK exports. And longer term, we think that potential growth would suffer.

2. What are the portfolio implications of "staying" or "going"?

Volatility: In our view, UK-linked assets may experience higher price turbulence over the next four months, as investors demand a premium for uncertainty. Sterling has already borne the brunt of such price swings.

Currencies: The pound has declined 4%–5% against the US dollar, euro and Swiss franc this year. Sterling exchange rates seem to have overshot interest rate differences, implying that a risk premium is already in the price. Under our base case of a vote to remain, sterling should start to recover some lost ground after June 23. But additional downside is likely if the UK leaves.

A further consideration is the reaction of the euro. Markets seem to have not yet priced in the potential consequences of the EU losing its second-largest economy, implying that downside risks to the euro could increase if the UK opts to leave.

Equities: We recently moved to a neutral UK stock stance in our global tactical asset allocation, funded by reducing the size of our Eurozone equities overweight position. UK earnings revisions are improving relative to European and global stocks, and a cheaper pound means that foreign exchange is no longer hindering internationally exposed UK large cap stocks.

In the event of a Brexit, the domestically biased FTSE 250 Index (which generates 49% of its sales at home) could underperform if domestic activity suffers. Given the possibility that European end demand may suffer too, investors might look to avoid Brexit risk by investing in UK equities that rely most on US sales or generate the lion's share of their revenues in US dollars.

Dean Turner and **Matthew Carter**
Global Investment Office

Bottom line

The UK has set a date for its referendum on EU membership, and at this stage polls suggest that Britain prefers to "stay" rather than "go." CIO attaches a 30% probability to a Brexit and is keeping a watchful eye on the polls. Short term, economic confidence may soften on uncertainty, and UK asset prices may stay volatile. But sterling has already re-priced to reflect the risks, and opportunities may arise for UK stocks relative to other global equities. For more information, please see CIO's latest cross-asset report: "BREXIT – into the final furlong," 22 February 2016, and CIO's UK equity update: "BREXIT risk – what it means for UK equities," 24 February 2016.

Regional view

ECB to respond to global slowdown

Podcast
www.ubs.com/cio-podcast

Ricardo Garcia
Head, European Macroeconomics

Amid the global slowdown last year, the Eurozone economy stood out for its firmness. But the decline of equity markets since December has taken its toll as investors suffered losses in wealth, and consequently business and consumer surveys gave lackluster readings. There has been evidence of spillover effects that suggest real activity might be decelerating as companies adjust their inventory management, orders and hiring plans.

But all is not lost. The survey readings remain at comfortable levels, and consumption has started the year strongly. Still, downside risks have intensified, warranting a more cautious policy. European Central Bank (ECB) President Mario Draghi recently confirmed these concerns before the European Parliament. The ECB reacted to downside risks in December, suggesting that it is not looking through them. Accordingly, further easing is now widely expected when the ECB meets on 10 March. There is less consensus on the degree of its response in the key areas of inflation expectations, currency and credit conditions.

On inflation expectations, the renewed slide in oil should keep consumer prices declining in the coming months, although they should recover come summer. The ECB will need to protect inflation expectations by means of its short-term response. The general uncertainty regarding oil prices, however, may extend the need for measures into next year. We think that the ECB will increase its monthly quantitative easing (QE) purchases to tackle inflation expectations by EUR 10bn or more, and corporate bonds may now be included among the assets eligible for purchase. If deemed necessary, the ECB may even lengthen the QE program beyond March of next year should its new quarterly inflation outlook, to be presented at the upcoming meeting, fail to show a fast recovery by next year.

Regarding the currency, inflation data has shown that the benefits for manufacturers' pricing power from the euro's decline are fizzling out. So we expect at least a 0.1% deposit rate cut. A greater reduction would depend on the ECB finding solutions to mitigate the impact of the cut on banks. And as for credit conditions, the ECB must prevent the effects of higher bank bond spreads from spilling over to bank loan rates to safeguard the economic recovery. The easing package may therefore contain an extension of the TLTRO program to at least March of next year.

"In contrast to our cautious stance before the [ECB's] December press conference, this time we think that the chances for a market-friendly surprise are substantial."

Investors have been asking us what our base case for this meeting is. We expect EUR 10bn or more in additional asset purchases per month, and at least a 0.1% cut in the deposit rate, although more measures are likely. In contrast to our cautious stance before the December press conference, this time we think that the chances for a market-friendly surprise are substantial.

Kind regards,
Ricardo Garcia

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