UBS House View

Europe
Chief Investment Office WM

Weekly

14 July 2016

Deeper dive

Should we worry about the yuan?

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Market moves

	CIO view	–1w	– 3m	ytd
S&P 500	OW	2.5%	3.9%	6.6%
Euro Stoxx 50		6.5%	–0.6%	–6.3%
MSCI EM		3.6%	2.5%	9.6%
FTSE 100		2.8%	6.6%	10.2%
SMI		2.6%	2.8%	–4.1%
NIKKEI 225		7.3%	–3.0%	–13.1%
US high grade bonds	UW	–0.3%	2.0%	5.7%
Euro high grade bonds	UW	0.0%	2.9%	7.0%
US investment grade bonds	OW	0.2%	4.4%	9.2%
Euro investment grade bonds		0.6%	2.5%	5.2%
US high yield bonds		1.9%	5.3%	10.9%
European high yield bonds	OW	1.2%	1.9%	5.1%
EM sovereign bonds		1.1%	5.8%	12.6%
EM corporate bonds		0.7%	4.5%	10.2%

Source: Bloomberg, UBS as of 14 July 2016
OW = tactical overweight
UW = tactical underweight

Market comments

Calculations are based on the past five days

- **Equities** had a strong week, with the S&P 500 climbing 2.5% to a record high. All other major markets rose too, including the Swiss SMI, up 2.6%.
- **Fixed income** markets were also positive, with the exception of US high grade bonds, which lost 0.3%. European high yield bonds gained 1.2%, for a rise of 5.1% this year.
- Currency traders pushed the **yen 4.6%** lower versus the US dollar. The **British pound** recovered some of the ground lost after the Brexit vote, appreciating 2.5% over the past five sessions.

In focus

The S&P 500 hits record highs. The 0.3% gain on Monday pushed the US index to its first record-high closing price in over a year, followed by another on Tuesday, and an all-time closing peak of 2,152.43 on Wednesday. But investors shouldn't fear such peaks. Since 1940, investing at all-time-high closing prices has produced returns over the following three to 36 months similar to investing when prices are not at record highs. *CIO expects S&P 500 EPS to hit an all-time high within the next six months, and is staying overweight US equities in global portfolios.*

Job growth rebounds in US. The US economy created 287,000 net positions in June, the most since October. The outcome could help assuage fears of a growth slowdown after a poor payroll release for May.

Currency traders applaud new UK leader. The appointment of Theresa May as the new British prime minister, ending weeks of uncertainty, caused sterling to shoot over 1% higher to USD 1.31 on Tuesday. That's still almost 12% below the pre-referendum high. *CIO has a six-month forecast for sterling of 1.32 against the US dollar.*

Brexit to take a toll on Eurozone, Moscovici warns. The EU economy commissioner said that the UK vote could knock 1–1.25% off UK growth between now and 2017 and 0.2–0.5% from Eurozone growth. *CIO has reduced its Eurozone forecast from 1.7% to 1.3% for 2017 given Brexit and higher oil prices; continued monetary support from the ECB underpins our overweight in euro-denominated high yield bonds.*

UK consumer sentiment falls most since 1994. GfK's core index slid to minus 9 in a post-Brexit survey from June 30 to July 5, from minus 1 earlier in June. That was the fastest slide in 22 years.

Soft Chinese data, easy Chinese policy. CPI inflation edged down to 1.9% year on year in June from 2.0% in May due to lower inflation in vegetable and pork prices. PPI deflation narrowed to –2.6% y/y from –2.8% in May. Weaker-than-forecast Chinese trade data, especially on imports, means that China is likely to maintain an accommodative monetary policy stance. *See this week's "Deeper dive" for details on what this means for the CNY.*

Abenomics back on track? Japan's reforming PM won a fresh mandate in the Upper House elections, falling just one seat short of a super majority. The Nikkei 225 surged 4% on Monday and had made post-election gains of 7.4% by Wednesday's close, as markets looked forward to fresh stimulus measures. *CIO is neutral on Japanese equities and the yen.*

A new member for the negative rates club. The yield on the Dutch 10-year government bond fell below zero for the first time on Monday, amid expectations of further ECB easing following the UK's Brexit vote. *CIO is overweight euro-denominated high yield bonds, due to easy corporate financing conditions and a moderate expected default rate over the next 12 months.*

UBS

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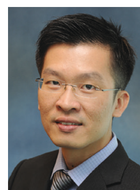
Deeper dive

Should we worry about the yuan?



Mark Haefele **Teck Leng Tan**

Watch this week's
UBS House View Weekly Video

The Chinese yuan (CNY) has fallen by around 3% this year versus the US dollar, making it the worst-performing currency within the Asia Pacific region. We believe USDCNY will weaken further to 6.80 in the next three to six months. Despite a slower anticipated pace to US Federal Reserve interest rate hikes, the ongoing deceleration of the Chinese economy will necessitate a prolonged accommodative monetary policy, which should keep the yuan under pressure.

The yuan's slide this year has not concerned global financial markets, in stark contrast to last summer, when a sudden CNY devaluation triggered a sell-off. Should investors still worry about the yuan and its spillover effect on global financial markets? In our view, there are two key differences between now and last summer, which explains the relaxed market attitude to the risk of further yuan depreciation.

First, Chinese authorities have taken pains to improve their communication with market participants with regard to their policy intentions. Last summer's abrupt CNY devaluation caught markets by surprise, and raised concerns about whether further rounds of devaluation might be in the making. This shroud of uncertainty fueled capital outflows last summer.

Since then top Chinese officials, including President Xi Jinping and People's Bank of China Governor Zhou Xiaochuan, have repeatedly stressed that a one-off CNY depreciation should not be expected. Calmer nerves, coupled with stricter restrictions on capital movements, have helped to slow capital outflows from a peak of USD 170bn last December to a manageable pace of around USD 50bn in the last few months.

Second, proponents of a sharp CNY devaluation versus the USD have also been caught by the change in US Federal Reserve policy signals. Fed Chair Janet Yellen has messaged that excessive USD strength is unwelcome, stating in early June that "as long as…the dollar does not rise substantially further, my expectation is that inflation will move up to 2% over the next one to two years." This implies that a much weaker yuan (which pushes up the USD in trade-weighted terms) will make the Fed dial back on its hawkish rhetoric.

Moreover, the Fed has consistently emphasized that rate hikes will be gradual; at the recent June Federal Open Market Committee (FOMC) meeting, the dot plot for FOMC staff projections of the fed funds rate showed a reduced pace of rate hikes (to 75 bps total by the end of 2017, down from 100bps in March). With the Fed likely to move slowly and inflation likely to rise, real interest rates could become less attractive and act as a constraint on further USD strength.

Mark Haefele
Global Chief Investment Officer
Wealth Management

Teck Leng Tan
Global Investment Office

Bottom line

The Chinese yuan has been the worst performer in Asia Pacific this year, weakening by 3% versus the USD. However, it has not unsettled global markets, unlike last summer. We attribute this to Chinese policymakers' improved communication with market participants, as well as an implicit cap on USD strength due to the Fed's gradualist approach to tightening. As such, we are now less worried about the yuan than we were six months ago.

Regional view

ECB in the fog

Podcast
www.ubs.com/cio-podcast

Ricardo Garcia
Head, European Macroeconomics

"We think the economic impact of the UK's decision will be moderate for the Eurozone."

The UK vote to leave the EU has made planning at the European Central Bank (ECB) more difficult. Originally, its June economic forecasts painted a rosy outlook of solid growth with a major inflation rebound occurring from summer on. As oil rose to around USD 50 a barrel, the governing council's confidence in its inflation forecast improved. This prompted ECB President Mario Draghi to talk about a new and more positive balance of risks, coupled with an increase in the short-term inflation outlook, at the June ECB press conference.

His comments sparked questions about the intended end date of quantitative easing (QE) in March. Indeed, energy base effects are turning sharply positive this summer. In addition, retail energy prices for diesel and gasoline have increased in sync with oil prices. Industrial producer prices, too, have turned around, even in a broad-based way.

However, Britain's decision to leave the EU has shifted the balance of risks to the downside. With the UK economy likely facing a hit, Eurozone exports are also likely to suffer since the UK, along with the US, is the currency union's most important export destination. Nonetheless, the Eurozone is not as open an economy as Switzerland or Singapore, for example. So we see the direct trade impact shaving off no more than 0.1–0.2%.

The greater risks stem from the uncertainty factor. The latest economic policy uncertainty index shows a huge spike in the UK. Although the spike is much smaller in the Eurozone, it is now close to euro crisis peaks. What kind of impact could higher uncertainty have on the economy?

Typically, shocks like September 11 or the Iraq war have had little. Economies tend to be affected more by fundamentals. Those remain solid, so we think the economic impact of the UK's decision will be moderate for the Eurozone. Draghi expressed a similar view to heads of state at the last European Council meeting, foreseeing only up to 0.5% less growth cumulatively for the Eurozone over the next three years.

Ultimately, the actual economic impact is what will drive ECB decisions. Unfortunately, the vast majority of the immediate post-Brexit economic data will come after the 21 July ECB press conference. Accordingly, we do not expect a major policy decision next week, even if technical tweaks to the QE program are possible (such as a change in the issuer limit).

We now view the probability of more easing at 40%, given the downside risks following the UK vote. It could take the form of more QE and a deposit rate cut. In any event, the ECB will likely have to address its QE program anyway in the second half of the year, since it intends to end it in March. Given the greater uncertainty, we think the program will be extended beyond March, at EUR 80bn or less per month, despite inflation remaining on track to rise sharply before winter. Unless the economic impact of Brexit turns out better than expected, a full extension at EUR 80bn is more likely than a tapering, in our view. Economic data in July and August will be key to confirming this outlook.

Kind regards,
Ricardo Garcia

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