

Deeper dive

So what's the worst that can happen?

— p. 2

Regional view

Gold's shine lost in the vault

— p. 3

Market moves

	CIO view	-1w	-3m	ytd
S&P 500	OW	0.3%	10.9%	1.5%
Euro Stoxx 50		-0.3%	8.3%	-8.4%
MSCI EM		-0.2%	14.2%	2.3%
FTSE 100		-0.3%	8.5%	-0.6%
SMI		1.7%	6.1%	-7.8%
NIKKEI 225		3.1%	12.2%	-11.8%
US high grade bonds	UW	0.1%	1.9%	4.2%
Euro high grade bonds	UW	0.6%	1.9%	4.5%
US investment grade bonds	OW	0.0%	5.5%	5.7%
Euro investment grade bonds		0.0%	3.1%	3.0%
US high yield bonds		0.2%	11.3%	6.3%
European high yield bonds	OW	-0.3%	7.7%	3.4%
EM sovereign bonds		0.6%	7.9%	7.0%
EM corporate bonds		0.2%	6.7%	6.4%

Source: Bloomberg, UBS as of 12 May 2016

OW = tactical overweight

UW = tactical underweight

Market comments

Calculations are based on the past five days

- **Equities** were mixed, with Japanese stocks climbing 3.1% on a weaker yen. Euro Stoxx 50 retreated 0.3%, taking the loss for the year so far to 8.4%. The S&P 500 was up 0.3%, for a year-to-date gain of 1.5%.
- **Fixed income** markets had a relatively uneventful week. European high yield bonds were down -0.3%, while US high yield moved 0.2% higher. US investment grade bonds were flat.
- **Foreign exchange** markets were marked by a stronger US dollar, which gained against 8 of the G10 currencies. The US currency gained 2% against the Australian dollar, following a rate cut earlier this month. The dollar also gained ground against the yen. The euro was flat on the week.

In focus

Slow and steady wins the jobs recovery race. US nonfarm payrolls growth came in below expectations in April, posting a 160,000 gain versus 200,000 expected. The jobless rate held steady at 5%. But average hourly earnings climbed 2.5% year-on-year, suggesting US inflation pressures may gradually build. *CIO expects slow and steady US jobs growth to underpin gradual economic recovery, and anticipates the next Fed rate hike only in the second half of this year.*

Foreign friends boost German industry. Factory orders jumped 1.9% month-on-month in March, the strongest reading since last June and above the 0.6% gain forecast by economists. A 6.2% rise in non-EU orders suggests global growth may not be as dour as feared. *Fading weakness for German industry supports CIO's expectation of solid GDP growth of 1.6% this year.*

Beginning of the end for Greek drama? The Greek government signed off on a reform program demanded by creditors, and Germany has eased its objections to debt relief talks. A final deal could come as soon as the 24 May finance ministers' meeting. That pushed Greek 10-year bond yields to the lowest in a year, below 8%.

Inflation stagnation Down Under? The Reserve Bank of Australia (RBA) clipped inflation forecasts to 1–2% for 2016, down from 2%, in its May Statement on Monetary Policy. Low wage growth over the longer term was cited as a possible price drag. *CIO expects further AUD weakness ahead, especially against the greenback and the Canadian dollar; we are underweight in global portfolios.*

Chinese services' sentiment still sound. The Caixin/Markit purchasing managers' index fell to 51.8 in April, from 52.2 in the previous month – a slight slowdown, but still suggesting services strength is offsetting manufacturing weakness. *CIO expects 2016 to be a challenging year for China, but a hard landing is unlikely due to continued credit and fiscal accommodation.*

Switzerland jumps on long-bond bandwagon. The country is issuing bonds maturing in 2058, the latest in a series of long-dated European sovereign bonds. Ireland and Belgium have already issued 100-year bonds this year. The coupon is a modest 0.5%.

And then there was one... Donald Trump seemed to have cemented the Republican nomination following the Indiana primary results, after which both John Kasich and Ted Cruz suspended their campaigns. Now all eyes will be on the degree of support that the divided Republican Party offers its nominee. *CIO thinks earnings and the economy pip politics for now; CIO remains invested, and overweight in US stocks.*

Top aide draws a line in the sand on yen. Koichi Hamada, a key economic advisor to Prime Minister Shinzo Abe, has said Japan would intervene to reverse yen strength if the currency rose to 90–95 versus the US dollar “even if it angers the United States.” *CIO expects the yen to remain strong in the near term; the three- and six-month forecast is for the USDJPY at 105.*

Deeper dive

So what's the worst that can happen?

We are now just six months away from what promises to be one of the most contentious presidential elections in the history of American politics. While neither party has settled upon a nominee just yet, the electoral calculus behind the nominating process provides a formidable advantage to the two front runners – Hillary Clinton and Donald Trump.

Keep in mind however, that this election marks the first time that the two presumptive party nominees' disapproval ratings are higher than their approval ratings. So in contrast to prior election cycles where a presidential candidate's popularity at the polls could also be expected to translate into electoral gains in Congress, the disaffection within both parties for two front runners makes the electoral outcome far less predictable this time around.

Market participants must therefore try to sort through a range of potential scenarios to assess what impact the results could have upon both the global economy and financial markets. While there are a seemingly infinite number of possible outcomes between the presidential and congressional races, we will have narrowed our focus to just one: what we perceive as the "worst-case" scenario for the 2016 elections.

It's important to keep in mind that this analysis is based upon likely market reactions, and is not intended to express any bias or preference for either candidate or party.

Divisive politics and a legal threat

As stewards of wealth, our primary responsibility always rests with the effective and prudent management of risk within client portfolios. This suggests that our analysis must begin with an assessment of what we view as the most likely worst-case risk scenario. While some countries must deal with potential coups and/or suspension of civilian control of government, no such event is likely in the US. We can therefore exclude any "extra-constitutional" outcomes for the 2016 general elections in our analysis.

So a worst-case (but not "base-case") scenario for the US election is one that likely incorporates both a bitterly contested ballot and some sort of legal action that detracts from the perceived legitimacy of the outcome. This would entail Hillary Clinton being indicted on charges stemming



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Mike Ryan, CFA
Chief Investment Strategist, WMA

from the current FBI investigation and Donald Trump then winning the presidential election in a divisive campaign but without a clear governing mandate. In this case, we would expect both the economic impact and market reaction to be negative.

Keep in mind that very little is known about Donald Trump's actual policy priorities, so a Trump Administration would be something of a wildcard for markets. What's more, some of Trump's more charged rhetoric with regard to trade, immigration, Fed policy and even debt management would be viewed negatively by global market participants. Meanwhile, a polarized Congress may be unable or unwilling to address other pressing issues such as infrastructure spending, tax reform and entitlement fixes.

In this "worst case" scenario, the dollar would likely come under pressure, equity markets could see significant draw-downs amid a heightened sense of uncertainty and increased volatility and treasury bonds may even begin to price in an "event risk premium" – at least in the near term. Business owners would not expect to find relief from the current byzantine tax code that places US firms at a competitive disadvantage globally. Meanwhile, the populist under-current that has been so pervasive during this campaign not only threatens progress made on free trade initiatives but could also lead to increases in labor costs. This hardly paints a constructive picture for corporate profitability.

A Trump Administration's longer-term impact on the real economy and financial markets is uncertain but there is some room for optimism. Much would depend upon how a President Trump administration would learn to adapt to the job of governing and the manner in which he was able to engage with both Congress and the international community. If a Trump Administration were to focus upon pragmatic legislative goals where there is common ground with Congress, it could create a much more constructive environment for progress on a whole host of business-critical reform measures ranging from taxes, to immigration, to entitlements.

Mike Ryan, CFA
Chief Investment Strategist, WMA

Bottom line

The worst-case scenario of a divisive general election that is immediately preceded by legal action remains a low-probability outcome, in our view. However, given just how benignly markets have reacted to developments on the polit-

ical front thus far, we have a responsibility to consider the disruptive impact that it could have on both the real economy and financial markets.

Regional view

Gold's shine lost in the vault



Bert Jansen
European Equity Strategist

"Gold gets dug out of the ground in Africa, or someplace. Then we melt it down, dig another hole, bury it again and pay people to stand around guarding it. It has no utility. Anyone watching from Mars would be scratching their head."

Warren Buffett

"A gold mine is a hole in the ground with a liar at the top."

Mark Twain

Over the past couple of months, a few clients have asked me about the renewed interest in gold, while some brokers are again making an investment case.

Gold's rebound since the start of the year is one reason for renewed interest. At this writing it is up 20% in USD (+14% in EUR), following a 10% drop in 2015. The opportunity cost of holding it has been a driver over the last few years. Indeed, the close inverse relationship between the gold price and real US bond yields (a correlation of -0.8 over the past five years) has been impressive.

But making a fundamental investment case for gold is difficult despite the recent bounce. As an unproductive asset – gold's industrial and decorative use is limited – it yields no income. Only the hope that someone will pay more for it in the future makes it alluring. This is unlike a stock that pays a dividend, a bond that pays a coupon, or real estate that pays rent.

Moreover, the cost and waste of digging it out of the ground, only to store it underground in secure bank vaults is considerable.

"While gold has proven a reasonable hedge against rising prices, it remains an asset that will never produce anything."

But if we define investing as foregoing consumption now in order to be able to consume more at a later date, then, yes, gold has not done that badly, but investors have paid in patience. Over the last 20 and 40 years, the price of gold has risen at a compound annual growth rate (CAGR) of 5.2% over both periods, vs. US inflation CAGR of 3.7% and 2.2%, respectively. In other words, gold has gained in purchasing power.

This compares poorly, however, with the total returns made on US equities, with CAGR over the past 40 years of more than 11% including dividends: a total return more than double that of gold. The CAGR for the S&P 500 has been very similar over the last five years,

while the gold price is actually lower today than five years ago (CAGR $-3.4%$).

Moreover, gold has been a riskier and more volatile investment since President Richard Nixon took the US off the gold standard in 1971: The average volatility of gold's five-year returns of 21% compares with a mere 15% for the S&P 500.

So while gold has proven a reasonable hedge against rising prices, and has diversification appeal given the negligible correlation between

gold and equities, it remains an asset that will never produce anything. Gold can, however, be considered an attractive alternative to zero-yielding paper money, the value of which depends on the whims of central banks. Their much enlarged balance sheets remain a medium to long-term threat of higher inflation.

Kind regards,
Bert Jansen

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