UBS House View

Europe
Chief Investment Office WM

Weekly

28 January 2016

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Market moves

	CIO view	–1w	– 3m	ytd
S&P 500		1.3%	–9.4%	–7.8%
Euro Stoxx 50	OW	3.6%	–10.4%	–6.5%
MSCI EM	UW	4.0%	–16.6%	–9.8%
FTSE 100	UW	3.9%	–6.2%	–3.8%
SMI		2.9%	–7.4%	–6.2%
NIKKEI 225		6.4%	–9.7%	–10.5%
US high grade bonds	UW	0.1%	0.5%	1.3%
Euro high grade bonds	UW	0.6%	0.7%	1.8%
US investment grade bonds	OW	0.1%	–1.4%	0.0%
Euro investment grade bonds	OW	0.4%	–0.4%	0.0%
US high yield bonds		2.6%	–6.4%	–1.9%
European high yield bonds	OW	1.3%	–3.0%	–1.7%
EM sovereign bonds		1.4%	–2.6%	–0.8%
EM corporate bonds		0.6%	–3.2%	–0.9%

Source: Bloomberg, UBS as of 28 January 2016
OW = tactical overweight
UW = tactical underweight

Market comments

Calculations are based on the past five days

- **Global equities rose 2.4%** in USD terms on the week, with emerging market equities (+4%) outperforming their developed peers (+2.3%). The Eurozone (+3.9%) and Japan (+5.5%) surpassed the US (+0.8%), while Shanghai stocks (–7.8%) fell due to poor industrial profits data and concerns about China's slowdown.
- **Brent and West Texas Intermediate oil jumped 13% and 9%** on the week thanks to rising speculation on possible production cuts and a lower-than-anticipated US inventory build. More dovish Fed commentary pushed gold 1.9% higher.
- **The largest five-day currency moves against the USD** were commodity-linked currencies, such as the Norwegian krone (+1.6%) and the Australian dollar (+1.1%). The Japanese yen (–0.9%) and Swiss franc (–0.7%) lost ground to the greenback.

In focus

The US Federal Reserve largely delivered on expectations. It made no change to policy but neither closed the door to a rate hike in March nor opened it further. Uncertainty out of China and elsewhere is clearly on committee members' minds based on this new statement: "The Committee is closely monitoring global economic and financial developments and is assessing their implications for the labor market and inflation, and for the balance of risks to the outlook." Inflation would remain "low in the near term," the committee reported; and by not mentioning that risks to growth and inflation were "balanced," the committee implied that it is more concerned about inflation reaching its 2% target. *In the near term, CIO expects to see continued higher risk premiums on equities, obstacles to interest rates rising, and large currency fluctuations based on incoming economic data.*

ECB President Mario Draghi announced that the ECB will "review and possibly reconsider" its monetary policy stance on 10 March. It will also release new macroeconomic projections that will cover 2018 for the first time. Although the ECB enhanced its stimulus measures just six weeks ago, Draghi said that the global environment has changed markedly since then. *CIO expects the ECB to increase its monthly QE purchases by EUR 10–20bn.*

Eurozone purchasing managers' indices cooled last month. The preliminary Markit reading for the services sector fell to 53.6 from 54.2, its lowest level in 12 months. The manufacturing component dropped to 52.3 from 53.2, and the composite was at 53.5, down from 54.3, to an 11-month low. The silver lining was that the indices all remain above the 50 mark, pointing to continued expansion in activity. In addition, the services sector created jobs at a pace beaten only once since 2008.

In the US in January, the Dallas Fed Manufacturing Index hit its lowest level since early 2009, hinting at the damage being inflicted on oil-dependent states by the sliding crude price. The index, based on data collected over the week ending January 20, declined from 12.7 in December to –10.2 in January. Given the importance of the oil industry to Texas, it should come as no surprise that activity decelerated there.

China's industrial profits declined for the seventh month in a row. Industrial profits fell 4.7% year on year in December versus November's 1.4% contraction. The slump followed weak production and sales, as demand remained tepid. Given China's overcapacity problems in the manufacturing and property sectors and the overall deflationary pressure, industrial profits and employment are likely to continue to suffer.

UK house prices rose for a seventh consecutive month in January, according to the latest data from the Nationwide Building Society. The average house price climbed 0.3% month on month to GBP 196,829 (USD 282,100). The annual pace of growth slowed to 4.4% from 4.5% in December, however. Given ongoing supply-demand imbalances and the likelihood of the Bank of England postponing its first interest rate hike, today's data is consistent with *CIO expectations for 6% average UK house price growth in the next 12 months.*

UBS

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Deeper dive

The petro tipping point: How falling oil became bad news for global markets

Watch this week's
UBS House View Weekly Video

Christopher Swann

Most investors are used to cheap oil prices being a blessing, and price spikes a cause of recessions and bear markets. But more recently, falling crude has become a curse for risk assets. The 90-day correlation between crude and global stocks rose from 0.15 in July 2015 to 0.51 by September, with equity markets and crude prices often seeming to move in lock-step. Why the shift?

1) First, there are reports that sovereign wealth funds (SWFs) in oil producing countries are drawing down their investments to plug government spending gaps. The average per barrel (/bbl) budget breakeven price for OPEC countries was USD 95/bbl in 2015, according to the IMF, so USD 30/bbl oil is clearly a strain on many producing governments.

We are skeptical that SWF selling of stocks is having a material physical impact on global indices. Petro states account for 60% of global SWF assets under management, and allocate 16% of their holdings to equities, as the Sovereign Wealth Fund Institute estimates. This equates to a total stock exposure of less than 1% of global market cap.

That said, investor concerns about SWF asset sales can harm equity market sentiment.

2) Second, sub-USD 50/bbl oil prices make investment in most new projects uneconomic, leading to cutbacks and spreading the impact across the supply chain. Over the past six months, USD 380 billion of energy capital investment has been shelved, according to consultant Wood Mackenzie. Energy firms have punched far above their weight in terms of capital spending. The USD 891 billion spent by energy firms in 2014 represented 30% of global capex, according to Standard & Poor's, the largest contributor of any sector.

3) Third, with oil trading below USD 50/bbl for a prolonged period, some of the debt that funded the boom in US shale drilling is now turning bad, and bankruptcy rates are rising. The default rate among US high yield energy firms rose to 8% over the past 12 months. We expect it to touch 15% over the coming year. This is a risk to the wider economy, since higher risk aversion among credit investors has led to rising spreads for non-energy issuers too.

4) Finally, the expected boost to consumer spending in developed economies has been slow to materialize. Research at the end of last year suggested that Americans were spending half of their gasoline savings on buying performance-enhancing high octane gasoline, according to JP Morgan credit card data.

The problems associated with low oil prices will likely intensify in coming months, as an end to Iranian sanctions adds to global oversupply. But as capital spending cuts reduce new production, the glut – currently around 1–1.5 million barrels per day – should gradually decline in the second half of this year, pushing the price back to around USD 55/bbl in 12 months. This should ease some of the strain on oil producers, reducing the correlation with equities. Yet crude prices will still be low enough to benefit consumers. Cheap oil may return to being a blessing, not a curse.

Christopher Swann
Global Investment Office

Bottom line

Falling oil prices appear to be dragging on global equities. Rumors of stock sales by the sovereign wealth funds of oil states have harmed sentiment. The oil industry is also cutting back on capital spending, spreading the pain across supply chains. And the cost of borrowing for risky credits across the economy has risen, due to heightened risk aversion among investors stung by rising energy sector default rates. Our forecast recovery in the oil price to USD 55/bbl over the next 12 months should reduce the pain for producers, while preserving much of the gain for consumers.

Regional view

Buy low, sell low?

Podcast
www.ubs.com/podcast

Bert Jansen
European Equity Strategist

For those who like to shop, January is a much-anticipated sales season. After all, who doesn't appreciate a bargain? Shopaholics tell me that it can even be worth waiting a full six to eight weeks for unpopular merchandise to be marked down further.

The equity markets started the year in a similar fashion, offering major markdowns across the board, in particular for unwanted items. Bank, automotive and commodity stocks spring to mind.

But why is it that consumers are eager to buy at lower prices, while equity investors tend to do the opposite? Equities are one of the few "goods" in which the propensity to buy is positively correlated with the price. The higher stock prices go, the larger the inflows into equity funds are and vice versa.

During a recent conversation I had with a client, he expressed understandable concern about the sharp market declines this year and, in particular, the losses his equity portfolio incurred. But are these losses "real"? In my view, they are not, unless he realized them by selling the underlying holdings (the same principle applies, of course, to capital gains).

A chief reason investors lose money in the market is that they sell, often irrationally, as prices go south and put the proceeds into cash equivalents or bonds, thereby locking in losses and missing out on the gains during the market recovery. Far too often, investors buy high and sell low.

goes without saying that their valuations have become more attractive. But I would argue that they are not cheap by historical standards, despite the January sale. It still takes hard work to find bargains on a sector and stock level. In Europe we see value in financials and energy, though both sectors face, shall we say, structural challenges. Yet if they didn't, they probably wouldn't be beaten down. Nobody said that investing is easy.

"Within equities, the Eurozone remains our favorite market."

Of course, Warren Buffett's adage "be fearful when others are greedy and greedy when others are fearful" is not easy to follow. But it is exactly what successful investors such as Buffett do. For long-term investors, the recent sell-off presents opportunities to put some cash to work.

Indeed, Mr. Market's emotional volatility should be seen in this context: it might very well represent a time of excessive pessimism when share prices trade below their intrinsic value. A respected veteran fund manager once told me that bear markets are nirvana for "value" investors (i.e. bargain hunters), for they enable them to buy a dollar's worth of value for sixty cents.

Which brings us to the key question: Are equity markets undervalued after the recent declines? It

In our global tactical asset allocation, which has a six-month time horizon, we recently reduced our exposure to equities to neutral because of increased risks in China and wide credit spreads. Nevertheless, we expect markets to finish the year on a stronger note. Within equities, the Eurozone remains our favorite market.

Kind regards,
Bert Jansen

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