

Deeper dive

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Market moves

| | CIO view | -1w | -3m | ytd |
|-----------------------------|----------|-------|--------|-------|
| S&P 500 | | -4.2% | 0.3% | -2.6% |
| Euro Stoxx 50 | OW | -7.4% | -5.3% | -6.8% |
| MSCI EM | UW | -4.0% | -10.5% | -4.3% |
| FTSE 100 | UW | -5.8% | -6.0% | -5.3% |
| SMI | | -5.8% | -3.1% | -5.1% |
| NIKKEI 225 | OW | -6.4% | -2.9% | -6.7% |
| US high grade bonds | UW | 0.8% | -0.2% | 0.6% |
| Euro high grade bonds | UW | 0.9% | 1.5% | 0.9% |
| US investment grade bonds | OW | 0.7% | -0.4% | 0.5% |
| Euro investment grade bonds | OW | 0.3% | 1.1% | 0.3% |
| US high yield bonds | | 0.2% | -3.0% | 0.1% |
| European high yield bonds | OW | -0.1% | 0.1% | -0.1% |
| EM sovereign bonds | | 0.1% | -0.5% | 0.1% |
| EM corporate bonds | | 0.3% | -0.5% | 0.3% |

Source: Bloomberg, UBS as of 7 January 2016

OW = tactical overweight

UW = tactical underweight

Market comments

Calculations are based on the past five days

- **Global equities had a gloomy week**, with the major developed indices and emerging markets losing ground. Uncertainty about the economic outlook for China was the main drag on stock values. The S&P 500 dipped 4.2%, while the Euro Stoxx 50 lost 7.4%. The MSCI Emerging Market index was down 4%.
- **High grade bonds benefited**, as investors looked for safe havens. Euro and US high grade bonds rose by 0.9% and 0.8% respectively.
- **Brent crude markets continued to reflect oversupply**, along with fears over the economic and market outlook in China. The price of a barrel of Brent slid 10% to USD 33.5, a decade-plus low.
- **In foreign exchange markets commodity currencies lost ground**, with the Australian and Canadian dollars off 3.8% and 2% respectively against the US dollar.

In focus

China’s onshore A-share market was shut for trading several times after triggering the 7% “circuit breaker.” The CSI 300 index, a collection of blue-chip stocks in Shanghai and Shenzhen, fell 7.2% in early trading on Thursday, having also been closed after heavy losses on Monday. Sliding stocks partly reflected concerns over the course of the Chinese currency, which the People’s Bank of China allowed to depreciate this week. In addition the gap between the onshore and offshore renminbi widened to a record. *CIO maintains its view that the onshore A-share market is likely to remain highly volatile in the short run amid concerns over Chinese policy and growth uncertainties.*

China’s December manufacturing purchasing managers’ index (PMI) signaled a fifth straight month of contraction. Resolving overcapacity will be a key government task this year as was laid out earlier in the Central Economic Work Conference. The official manufacturing PMI ticked up slightly to 49.7 (from 49.6 in November) thanks to a modest improvement in new orders and output sub-indices. But the employment sub-index (which fell to 47.4 from 47.6) remained below the 50-threshold as disinflationary pressures continue to weigh on industrial sector profit margins and employment. *CIO maintains its view that China’s policy stimulus will help prevent a “hard landing.”*

Final Eurozone PMI confirmed more robust real economic activity for the region. The last reading of the Eurozone composite PMI was raised to 54.3 from 54. But the output price sub-index remained below the expansion-signaling mark of 50. Taken in conjunction with Eurozone inflation data, which held steady at 0.2% in December, the figures reinforce the case

for continued easy ECB policy to promote higher nominal growth and prices. *Encouraging real activity and loans growth imply higher Eurozone equity earnings this year. CIO continues to hold a tactical overweight to Eurozone equities within our global tactical asset allocation (TAA).*

Unemployment figures in Germany and Spain provided reason for cheer. In Europe’s largest economy the number of jobless fell by a higher-than-expected 14,000 in December. German unemployment is at a record-low 6.3%. This positive picture was mirrored in Spain, where unemployment declined by 55,800, also better than forecast. Last year, Spanish joblessness registered its largest annual decline in its recorded history.

US vehicle sales data disappointed market expectations. After seasonal adjustments, light vehicle sales in the US totaled 17.2 million units (saar) in December. This figure, lower than the consensus expectation of 18 million units sold, represented a 4.7% month-on-month (mom) decline. Auto sales (an indicator of consumer spending) fell 5.3% mom and light truck sales (more reflective of industrial activity) dropped 4.2% mom. *CIO remains neutral on US equities in our global TAA, and is watching nonfarm payroll prints later this week for signs of possible softening in US 4Q economic momentum.*

Global M&A volumes topped USD 5trn for the first time last year. Figures from Dealogic showed deals surpassing the previous peak of USD 4.6trn set in 2007. There were 69 deals of over USD 10bn, another high, and 10 deals worth USD 50bn or more. Close to half of the global volume was registered in the US. The most active sectors globally were healthcare and technology.

Deeper dive

What are the “crowded” trades?



James Purcell

Given recent market volatility, investors are increasingly concerned about “crowded” trades – positions that have become overly popular and are hence vulnerable to a sharp unwinding and price correction.

Having assessed exchange data, fund flow reports and fund manager surveys, we consider the following positions crowded:

- Short euro
- Short US Treasuries

In contrast, equities appear to be an “uncrowded” trade.

Short euro

The Chicago Futures Trading Commission represents less than 5% of the volume traded in the FX market, but its exchange-traded contracts are the primary execution method for FX trend-following strategies. Commission data reveals that combined short euro speculative positioning is in the sixth percentile relative to the last 15 years, with the USD, GBP, CHF and AUD all favored as offsetting longs. This suggests any change in market direction could be violent as the trend followers react by cutting and reversing their positions. The Bank of America Merrill Lynch fund manager survey confirms extreme euro positioning – “short euro” is believed to be the biggest consensus position and cross asset globally. *CIO has a non-consensus 12-month EURUSD target of 1.10.*

Short US bonds

The Chicago Futures Trading Commission’s data also reveals that aggregate Treasury positioning exhibits the

largest net short since data began in 2004. The short interest is concentrated in 30-year Treasury bonds and to a lesser extent in the two and five-year notes.

This negative view on fixed income is compounded by fund flow data, which typically includes a large and often fickle retail component. Assets have been flowing out of emerging market debt funds for 28 of the last 31 weeks, and for 10 of the last 11 weeks in Treasury funds. *CIO is tactically underweight high grade bonds.*

What about equities?

Equities have given no indication of being a bandwagon favorite. For US long/short hedge funds the profit-and-loss contribution from US equities is the lowest it has been in two years, indicating that hedge funds do not own a lot of stock. Meanwhile, the premium paid for put options relative to call options is in excess of the ninety-fifth percentile (three-year window) for most tenors, suggesting that the market is well protected against downside risks.

This conservative stance is reinforced by cash being “on the sidelines.” A Citigroup US equity survey suggests institutional investors have over 10% of their assets in cash – the most in two years – while retail investors moved USD 1.5bn into money-market funds last week, the 11th inflow in the past 12 weeks. *While CIO has recently downgraded equities to neutral, reflecting concerns over China and commodities, overcrowded positions should not be among the worries for global investors in this asset class.*

James Purcell

Global Investment Office

Bottom line

In times of market volatility investors need to be aware of “crowded” trades, which can lead to sharp price reversals. We believe that the short positions in the euro and US Treasuries seem overcrowded. But equities

appear uncrowded. So while concerns about the impact of China have led us to downgrade to neutral on global equities, “overcrowding” should not have a place on equity investors’ “worry list.”

Regional view

What's in store for the Eurozone and UK?



Bill O'Neill
Head Investment Office UK

This is the first *UBS House View Weekly* editorial of 2016 – a fitting opportunity to consider what the year ahead might bring the Eurozone and the UK (no presumed outcome of the forthcoming UK EU referendum signaled here!).

“Despite the uncertainty, there is much to be encouraged by.”

2015 was defined by a number of dramatic events; other economic trends were more prosaic, but still notable. Growth outturns for the year in the Eurozone look to be coming in just ahead of the consensus expectation at the start of 2015; the UK is falling significantly short. The surprising fall in oil prices forced down inflation, leaving central bankers with little reason to dampen the ongoing stimulus, with the European Central Bank easing further.

Of course, we expect further “surprises” across the region this year. The problems confronting the region require more than just sticking-plaster solutions but instead an even more coordinated and integrated approach. Otherwise, in the face of another wave of refugees, will the Schengen zone survive the “emergency” re-impositions of border controls? Although not our base case, would a UK exit from the EU usher in a renewed drive toward integration?

Despite the uncertainty, there is much to be encouraged by. The Eurozone recovery is more firmly rooted. We forecast a GDP rise of 1.8%, which, if achieved, would

be the strongest since 2010. This increase should be driven primarily by private consumption, but investment spending should contribute too. Our forecast is in line with consensus for the year, with the trend being to raise forecasts as the year ended. That relatively optimistic bias applies across the main member economies, especially Italy.

We are similarly positioned relative to consensus on the UK, but here consensus is growing more nervous

 **Podcast**
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on the back of weak manufacturing and wage growth. We still see yet another year of UK growth out-performance versus the Eurozone (2.4% vs. 1.8%), but the gap will be the narrowest since 2011.

On inflation, we forecast Eurozone headline inflation at 1% (in line with consensus) in 2016, even if the latest falls in oil prices pose material downside risks. In the UK, we likewise expect the headline rate to converge to where core inflation is running and little more beyond that, leaving the outturn at 1.1%.

The course of inflation will likely be the key factor defining how central banks react this year. Our base case is that the weakening drag from lower oil prices will allow the ECB to remain on hold for now and the Bank of England’s Monetary Policy Committee to hike in May and again in November. If inflation undershoots forecasts or other threats materialize, there is a real risk both banks will have to stay accommodative for longer than envisaged today.

Kind regards,
Bill O'Neill

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