UBS House View

Europe
Chief Investment Office WM

Weekly

29 September 2016

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Market moves

	CIO view	–1w	– 3m	ytd
S&P 500	OW	0.4%	5.4%	8.0%
Euro Stoxx 50		–2.0%	6.0%	–5.1%
MSCI EM	OW	–0.9%	11.9%	17.4%
FTSE 100		–0.9%	8.7%	13.4%
SMI	UW	–1.1%	3.3%	–3.4%
NIKKEI 225		–0.7%	8.0%	–10.8%
US high grade bonds	UW	0.3%	0.5%	5.9%
Euro high grade bonds	UW	1.0%	1.5%	7.7%
US investment grade bonds	OW	0.4%	1.6%	9.4%
Euro investment grade bonds		0.2%	2.2%	6.2%
US high yield bonds		0.7%	5.1%	13.3%
European high yield bonds		–0.1%	3.5%	7.1%
EM sovereign bonds		0.5%	4.2%	14.7%
EM corporate bonds		0.3%	3.3%	12.0%

Source: Bloomberg, UBS as of 29 September 2016
OW = tactical overweight
UW = tactical underweight

Market comments

Calculations are based on the past five days

- **Equities** had a mixed week, with the US stocks advancing while the Euro Stoxx 50 lost 2% and the Nikkei 225 also lost ground.
- **Fixed income** rallied. Euro high grade bonds were the biggest gainer, rising 1%. US high grade bonds rose 0.3%.
- **Foreign exchange** markets were notable for a sharp rise in the Norwegian krone, after the central bank kept rates on hold and declared that the growth outlook had improved. The krone gained 1.3% versus the US dollar.

In focus

OPEC's deal short on details. The oil cartel announced that it planned to cut output for the first time since 2008 in a bid to prop up crude prices. But the plan came with no implementation date, duration, or details on how nations will split the output reduction. *As a result CIO advises investors not to chase the rally. Our 12 month forecast remains USD 55 per barrel.*

Shop like it's 2007. US consumer confidence reached a nine-year high, according to the September Conference Board Index. This bodes well for consumer spending keeping the economy on a moderate growth path in the months ahead. *CIO is overweight on US equities in global portfolios.*

King krone. The Norwegian currency hit its highest level against the euro in 15 months and its highest point versus the dollar in five months. The krone has been surging since the Norwegian central bank kept rates on hold last week and indicated that the country's growth outlook had improved. *CIO is overweight NOK versus the euro.*

Trump's debate letdown helps Mexican peso. The Mexican currency showed relief as the Republican nominee failed to score a convincing win against Democratic rival Hillary Clinton in the first televised presidential debate. Currency traders appear to be assuming that a Donald Trump victory in November's election would harm global trade, hitting Mexico. Since the peso has tended to move in the opposite direction of Trump's polling figures, shorting the currency is a potential hedge against this risk scenario.

L-IFO after Brexit? The IFO German business confidence index rose to a level unseen since May 2014 in September, after a slump in August. The reading suggests that uncertainty caused by the UK referendum is no longer impacting German business.

Japan's manufacturing PMI tops 50. Japan's flash manufacturing PMI rose to 50.3 in September from 49.5 in August. It's the first time the figure has exceeded 50 since February. Things are looking up for Japan's heavy industry. But a strong yen could easily turn this around, weighing on business sentiment and the country's exports. *CIO is neutral on Japanese equities in our global tactical asset allocation strategy.*

China's rebalancing suffers a setback. The government's goal of gradually shifting from investment-led growth to consumption missed third-quarter targets, according to the China Beige Book, a quarterly survey of the economy. While service sector activity weakened, the "old economy" manufacturing, property and commodity sectors drove growth. *CIO believes that China is trying to strike a balance between economic stability and reform. The reform of the old economy will continue, causing GDP growth to slow gradually.*

Creaking composite. Flash measures of Eurozone manufacturing and services activity suggest the bloc's growth recovery is flagging. The headline reading for September of 52.6 was still above the 50 watermark separating expansion and contraction, but was the lowest figure in 20 months, before the ECB unveiled its quantitative easing program. Also, jobs growth indicators suggest employment is rising at the slowest pace since April. *CIO is neutral Eurozone equities, and forecasts GDP growth for the region of 1.5% this year and 1.3% next.*

UBS

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Deeper dive

What if Trump wins?

Mark Haefele Mike Ryan

Taking stock as "implausible" becomes "improbable"

A Donald Trump presidency is no longer as "unthinkable" as some had initially believed. The gap separating the two candidates within the national polls is now within the margin of error. With Trump having wrested away some of Hillary Clinton's Electoral College advantage, he has now moved within plausible striking distance of victory.

Although Clinton arguably won the first presidential debate by most assessments, her performance was largely in line with expectations. There was no "knockout punch," and Trump also scored some key points while avoiding devastating gaffes.

If Trump can maintain his recent momentum and convert some of the larger-than-normal pool of undecided/independent voters, he can capture a lead in the "battleground" swing states (where he has closed the gap) and chart a path to the presidency.

What are the risks?

The prospect of a Trump presidency poses two primary sources of risk:

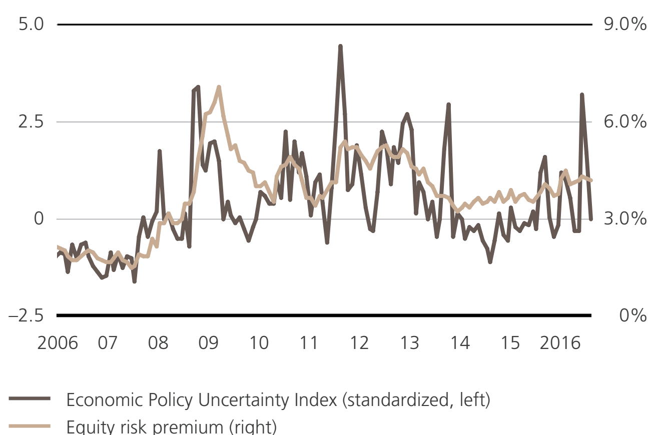
1. **Outcome unease.** The market is currently pricing in a near-certain Clinton victory, with the Iowa Electronic Markets implied probability at 69%. If this lead narrows, growing insecurity could create a short-term, "shallow" risk for markets, and could be the catalyst for a stock market correction.
2. **Policy uncertainty.** After markets have settled down following the initial surprise of a Trump victory, the focus of investors will likely shift to the policy implications of the result. Trump's lack of governing experience and unpredictable style widens the range of potential policy outcomes. This is a deeper and more pervasive risk, because markets tend to demand a higher risk premium for stocks when the policy outlook is murky (see chart). This would hamper equity markets, resulting in a lower equity market valuation.

How would markets be impacted?

- **Currencies.** The initial reaction to a surprise Trump victory could well be a rise in the dollar, as risk-averse investors turn to the US currency as a safe haven. But any dollar appreciation would likely revert amid worries over economic stewardship, trade policy, the abandonment of fiscal restraint, and the potential loss of Federal Reserve independence. While this would strengthen developed market currencies, emerging market currencies could face pressure due to the threat of trade wars.
- **Stocks.** Separately from the dynamics noted above, the sector impact would be mixed; healthcare would face significant uncertainty over Obamacare reform, while the prospect for fiscal stimulus and regulatory relief would boost several other sectors on a relative basis (technology, financial services, energy, consumer discretionary, consumer staples, and industrials).
- **Bonds** would likely suffer from the higher perceived risk of inflation, higher budget deficits, and uncertainty surrounding the conduct of monetary policy.

Policy and market valuations have been linked over the past decade

Equity risk premium and economic policy uncertainty index



Source: Bloomberg, FactSet, UBS, as of 28 September 2016

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Bottom line

Although still unlikely, Trump does have a path to the presidency. If his momentum continues, we expect to see near-term uncertainty and increased market volatility. Nevertheless, the executive branch's power is still limited, so the scope and scale of policy changes will also depend largely on the composition and disposition of the legislative branch. Congress could effectively temper the impact of a Trump administration.

For a more detailed analysis of the policy and sector-specific implications, please see *ElectionWatch: Asset class implications update*.

Regional view

Real estate – standing on its own, ominously

Podcast
www.ubs.com/cio-podcast

Bert Jansen
European Equity Strategist

"It's tangible, it's solid, it's beautiful. It's artistic, from my standpoint, and I just love real estate."
Donald Trump, US presidential candidate

"Real estate is the best investment on earth; however, when the music stops playing, which happens occasionally, don't be the one left without a chair."
Steven Ivy, attorney and entrepreneur

Real estate was added as a new sector in the Global Industry Classification Standard (GICS) on 1 September. The change promoted it from a subsector of financials to a distinct asset class in the MSCI and S&P benchmark equity indices. As a sector, it mostly consists of real estate investment trusts (REITs), companies that own, and in most cases operate, income-producing real estate.

The change recognizes real estate's "growing importance in today's global economy and [as] a foundational building block of a modern portfolio." But another, more relevant reason for elevating it to a stand-alone sector, in my view, is that it has not moved in tandem with other subsectors within financials. This lack of correlation stems primarily from its sensitivity to bond yields and is very different, if not diametrically opposed, to the way bank and insurance stocks behave.

"What worries me…is the 'skyscraper signal,' which suggests that newly built, record-setting skyscrapers point to a peaking stock market."

REITs have been among the big beneficiaries of falling bond yields, unlike banks and insurance. Over the past 15 years, on the basis of higher valuations fueled by lower capitalization rates, rising cash flows (thanks to cheaper debt), and a highly attractive yield (REITs are required to pay out 90% of their taxable income as dividends), the real estate sector has *outperformed* the MSCI World Index by 13%. This contrasts sharply with how financials' two main subsectors, banks and insurance, have fared; they have *underperformed* by 55% and 39%, respectively, over the same period.

The main reason we have a neutral stance, rather than an overweight, on real estate in our sector preferences is because its popularity has made it expensive. It trades at only a 1% discount to net asset value, which is unusually low by historical standards.

What worries me more from a broader market perspective of late, however, is the "skyscraper signal," which suggests that newly built, record-setting skyscrapers point to a peaking stock market, so to speak.

The construction of the Burj Khalifa, the world's tallest skyscraper (828m) in Dubai, accompanied the market's pre-financial crisis rise and abrupt fall; by the time it was completed in 2009, the MSCI World Index had more than halved from its high in October 2007. Similarly, Kuala Lumpur's Petronas Towers (at 452m the world's tallest at the time) were completed in 1996, a year before the Asian crisis led to a major bear market in Asian equities. Construction of the Taipei 101 skyscraper (509m) started in 1999, right at the top of the dotcom equity bubble.

The Jeddah Tower currently being erected in Jeddah, Saudi Arabia will be the world's tallest building, at a height of 1km, when completed in the next two to three years. Let's hope its construction turns out merely to coincide with a peak in oil prices (ground was broken on it in 2013, when the price of Brent was close to USD 110/bbl) rather than serving as the harbinger of another dramatic decline in equity markets.

Kind regards,
Bert Jansen

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