UBS House View

Europe
Chief Investment Office WM

Weekly

4 August 2016

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Market moves

	CIO view	–1w	– 3m	ytd
S&P 500	OW	–0.1%	6.1%	7.2%
Euro Stoxx 50		–1.5%	1.5%	–7.4%
MSCI EM	OW	–0.8%	8.1%	11.3%
FTSE 100		–1.5%	9.4%	8.7%
SMI	UW	–2.3%	4.2%	–5.7%
NIKKEI 225		–1.3%	0.8%	–13.7%
US high grade bonds	UW	0.1%	1.8%	5.8%
Euro high grade bonds	UW	–0.3%	2.6%	6.6%
US investment grade bonds	OW	–0.5%	2.8%	8.4%
Euro investment grade bonds		–0.2%	2.5%	5.5%
US high yield bonds		–0.5%	4.2%	10.5%
European high yield bonds		0.0%	2.1%	5.9%
EM sovereign bonds		0.1%	5.5%	12.2%
EM corporate bonds		0.0%	3.9%	10.2%

Source: Bloomberg, UBS as of 4 August 2016
OW = tactical overweight
UW = tactical underweight

Market comments

Calculations are based on the past five days

- **Equities** retreated over the past week, with Swiss stocks suffering the most – the SMI fell 2.3%. The S&P 500 index performed the best, declining just 0.1%.
- **Fixed income** markets were weak. US high yield bonds fell 0.5%, as global oil prices fell. European high yield bonds were flat.
- In **foreign exchange**, all Group of Ten currencies advanced against the US dollar. Japan's yen (+4%) climbed the most.

In focus

Fewer risks, Fed says. The US Federal Reserve did not change policy in July, as markets had widely expected. The rate-setters' statement included only one significant change, saying "near-term risks to the economic outlook have diminished," while also recognizing the better labor and consumer spending data. *CIO maintains that the Fed will wait until December before raising rates again.*

Bank of Japan disappoints… Governor Haruhiko Kuroda announced a doubling of the BoJ's ETF purchases to an annual pace of JPY 6trn (USD 59bn), and of its US dollar loan facility for banks looking to invest overseas. The interest rate or base money target, however, was left untouched. This was a letdown for markets, which had had higher expectations for a bolder easing package. *CIO is neutral on Japanese equities and the yen.*

…and fiscal stimulus underwhelmed. Prime Minister Shinzo Abe hopes the announced stimulus package, the biggest since December 2012, will resuscitate the Japanese economy after a period of weak growth. But the JPY 4.6trn package of new spending was slightly less than economists had expected. (The headline figure of JPY 28.1trn included previous commitments.) So the yen rose, trading at 101.4 per US dollar late Wednesday. *CIO is neutral on Japanese stocks, and expects the USDJPY to trade in a 100–105 range over the coming months.*

US ISM manufacturing PMI fell to 52.6 in July from 53.2 in June. Overall, the report was solid, with production, new orders, inventories, and customer inventories showing little change. Stronger economic momentum has helped boost *US equities, in which CIO has an overweight position.*

Gauging the growth gap. US output increased 1.2% annualized from the previous quarter, less than the consensus estimate of 2.5%. Eurozone GDP grew 0.3% over the same period, in line with forecasts and roughly the same pace of expansion as seen in the US. *CIO believes a return to second-half earnings growth in the US and stronger earnings momentum boosts the relative appeal of US equities versus high grade bonds. CIO remains overweight US stocks and neutral on Eurozone equities in global portfolios.*

US high yield and oil: Beware the bear. US crude oil prices edged up above USD 40 per barrel on Wednesday evening, but the 22% fall in WTI oil prices since 8 June highs has recently hit sub-investment grade debt. US high yield energy bonds (as measured by the BofA Merrill Lynch index) shed 3% over 11 straight sessions of decline through Wednesday. *CIO believes continued oversupply could push oil prices below USD 40/bbl in the short run. CIO is neutral on US high yield debt in global portfolios.*

Stress(ed) management? Last week's release of European bank stress-test results confirmed CIO's view that the sector does not have a capital issue. Even the one Italian bank whose core capital would be wiped out in the adverse growth scenario announced a restructuring plan just hours before the results. *CIO believes tepid earnings growth, not balance sheet strength, remains the main stress point for financials' C-suites. Investors should remain selective, and be conscious of value traps.*

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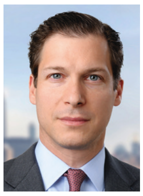
Deeper dive

What we have learned from the 2Q earnings season

Mark Haefele

Jeremy Zirin

According to the US National Bureau of Economic Research – the arbiter of US recession dating – the economic recession associated with the great financial crisis ended in June 2009. Since then, trailing 12-month S&P 500 operating earnings per share (EPS) have more than doubled, up 115% from under USD 54 to USD 116. Proportional to the US earnings recovery, the S&P 500 price index increased by nearly 130% in the seven-year period ending 30 June, dwarfing the market gains in non-US developed and emerging markets. Ultimately, equity markets in the Eurozone, the UK, Japan, and emerging markets have lagged the US over the past several years, since earnings in these regions failed to keep up with the V-shaped US profit recovery.

But after three consecutive quarters of year-over-year earnings declines, it is reasonable for investors to question whether the profit cycle – and the US bull market – has run its course.

Our research suggests that the recent profit slump is nearing its end. *Rebounding corporate profits should drive further US equity market gains again.*

The second-quarter earnings season has supported this view. With companies making up more than three-fourths of the S&P 500 market cap having reported, we note the following:

- **"Less worse" is a good start.** S&P 500 EPS fell by 6% in the first quarter, the worst year-over-year decline since 3Q09. The second quarter looks better. Aggregate EPS is on track to be flat to down 2%. We expect this sequential earnings improvement to continue in the second half of the year as earnings start to grow again as early as this quarter.

- **Excluding energy, there was no profit "recession."** Most of the damage to US corporate profits in recent quarters occurred due to the collapse in energy sector earnings, which fell by over 80% in 2Q to mark the sixth straight quarter of year-over-year declines of 50% or more. The silver lining is that: 1) energy earnings now make up just 2% of S&P 500 profits compared to 11% at the end of 2014; and 2) excluding energy, S&P 500 profits have actually only declined in a single quarter (1Q16, by just 1%). Ex-energy, US earnings were up 2–3% in the second quarter.

- **Big-cap technology, big earnings beats:** Overall, 73% of S&P 500 companies by market cap beat consensus estimates by an aggregate 3.5%. Some 83% of tech stocks exceeded consensus by an average of 7.4%. Accelerating revenue growth for mega-cap internet software companies has been propelling technology (the largest S&P 500 sector) shares into the third quarter.

Mark Haefele
Global Chief Investment Officer
Wealth Management

Jeremy Zirin
Head of Investment Strategy
Wealth Management Americas

Bottom line

The corporate profit cycle in the US has stalled over the past few quarters, largely due to collapsing energy prices. The combination of a reasonably healthy US economy and easier quarterly comparisons in the energy sector should cause US earnings to grow again in the quarters ahead.

Regional view

The ECB's rising external challenges

Podcast
www.ubs.com/cio-podcast

Geoffrey Yu
Head of UK Investment Office

"The ECB will hope that stronger growth in itself obviates the need for additional action…"

In the coming weeks, the European Central Bank (ECB) will start to weigh its policy options for its crucial September policy meeting. The Eurozone's economic picture remains favorable, but external forces beyond Frankfurt's control are clouding the horizon and markets may expect some kind of a reaction.

The first force is political risk, not only in the form of ongoing clashes between governments and monetary authorities in a growth-starved environment, but also the threat of rising populism amid an unusually crowded European electoral calendar. Sustained growth will help preserve the case for the Eurozone and the EU among national electorates. Conversely, this also means that if the economy begins to falter, the political disruptions could also intensify and in turn further weaken the economy.

While it may be tempting to call for additional policy measures to maintain economic stability and counter the rise of populism, most central banks would prefer to stay out of any debate and only react to political event risk if there is clear evidence of a data drag. The ECB is particularly exposed in this respect, having forcefully faced down accusations from German politicians earlier this year that negative rates and quantitative easing had contributed to the populist fervor in the country.

Policy differentials make up the second force. The Federal Reserve was less dovish in its July policy decision, to the presumed relief of the ECB. Yet fundamentals between the US and the rest of the world have diverged sharply. Two days later the Bank of Japan (BoJ) mildly increased monetary stimulus at its July meeting, its policy statement tellingly opening with the phrase, "Against the backdrop of the United Kingdom's vote to leave the European Union…".

Irrespective of data trends, many central banks may seek to use the uncertainty generated by Brexit to justify additional stimulus, lest they face currency war accusations. As of July, the euro trade-weighted index has strengthened over 11% in five quarters, a direct challenge to the ECB's inflation outlook.

Furthermore, Japan's government announced a large fiscal stimulus package this week, and markets expect much of the financing will come indirectly from the BoJ. Proposals in the package such as spending vouchers will be interpreted in some quarters as flirting with outright "helicopter money." If this is the direction many of the ECB's peers are heading in, some form of response may be necessary. A sharply higher EURJPY exchange rate would be very uncomfortable for Eurozone exporters that compete with Japanese companies.

The ECB will hope that stronger growth in itself obviates the need for additional action despite external deterioration. Nonetheless, in the face of unconventional challenges in unconventional times, maintaining "strong vigilance" (former ECB President Jean-Claude Trichet's most important phrase) is paramount.

Kind regards,
Geoffrey Yu

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