UBS House View

Europe
Chief Investment Office WM

Weekly

18 February 2016

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Market moves

	CIO view	*–1w*	*– 3m*	*ytd*
S&P 500		–0.8%	–7.3%	–8.5%
Euro Stoxx 50	OW	1.8%	–15.2%	–13.0%
MSCI EM	UW	–3.1%	–13.0%	–10.4%
FTSE 100	UW	2.0%	–4.7%	–6.8%
SMI		0.9%	–10.6%	–11.2%
NIKKEI 225		–4.7%	–18.1%	–15.8%
US high grade bonds	UW	0.1%	2.2%	2.3%
Euro high grade bonds	UW	–0.1%	1.8%	2.5%
US investment grade bonds	OW	–0.3%	–0.2%	0.1%
Euro investment grade bonds		–0.5%	–0.3%	–0.1%
US high yield bonds		–2.1%	–7.2%	–4.6%
European high yield bonds	OW	–2.1%	–5.7%	–4.0%
EM sovereign bonds		–0.6%	–1.6%	–0.8%
EM corporate bonds		–0.5%	–1.9%	–0.4%

Source: Bloomberg, UBS as of 18 February 2016
OW = tactical overweight
UW = tactical underweight

Market comments

Calculations are based on the past five days

- Following sharp declines at the beginning of the week, **global stock prices rebounded in the last few trading sessions. European stocks (+1.8%) staged a strong recovery,** especially in markets with high sector exposure to financials and energy, such as Italy and the UK.
- Continued volatility in oil prices and fears that negative interest rates would impact bank profits weighed on high yield debt prices. **European and US high yield bonds both fell 2.1% over the last five days.**
- Despite demand for safe-haven assets, **US high grade debt rose a mere 0.1%.** The gold price shed around 3% over the week but is still 13% higher versus the start of the year.

In focus

Disappointing Japanese GDP data delivered a blow to Abenomics. The world's third-largest economy contracted by 1.4% annualized in the fourth quarter of 2015, an even worse result than the 0.8% decline forecast by economists. While Japan avoided a technical recession (defined as two consecutive quarters of GDP decline) in 2015, the economy expanded by just 0.4% for the year overall after a flat 2014. The outcome is a setback for Prime Minister Shinzo Abe, who swept to power in late 2012 on promises to revitalize the Japanese economy following decades of weak growth. *CIO is underweight the yen in its global tactical asset allocation.*

Chinese banks extended new loans at the fastest pace on record at the start of 2016. Lending increased to CNY 2.5trn for January, up from CNY 598bn in the previous month. The surge in activity from the banking sector, which is guided by the state, was taken as a signal of Beijing's determination to boost economic growth. China's GDP last year expanded at its slowest pace since 1990. Credit from all sources, including bonds and off-balance-sheet lending, hit CNY 3.22trn in January, a monthly record. *CIO expects China to avoid an economic hard landing, thanks to fiscal policy support.*

Oil prices rose as Iran supported a proposal from Russia and Saudi Arabia to freeze production. Shortly after Russia and Saudi Arabia agreed to cap production at January levels, Iran's envoy to exporter cartel OPEC initially said that asking his country to freeze output was "illogical." But following later talks between Iran, Qatar, Iraq and Venezuela, Iran's oil minister Bijan Namdar Zanganeh is said to have supported a cap to stabilize prices (albeit without giving a firm commitment that Iran would limit its own output). *CIO believes the possibility of a concrete near-term deal to curb oil oversupply remains uncertain, and that oil prices will remain volatile for the immediate future.*

Gold held close to its highest level in a year as investors sought refuge in traditional safe-haven assets. The yellow metal has climbed 13% since the start of 2016 and has even outshone the two-year US government bond – another favorite of investors in troubled times. Receding expectations of monetary tightening by the US Federal Reserve helped, since higher interest rates raise the opportunity cost of holding gold. *CIO believes that the rally in gold is likely to be relatively short-lived.*

Investors brace for G20 meeting in Shanghai. Expectation has been mounting that the summit could lead to coordinated policy in response to the recent turmoil in financial markets and the deterioration in economic data. *CIO does not expect any major policy shift, but expects financial policymakers to reiterate their commitment to measures for boosting global growth and inflation.*

UBS

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Deeper dive

Why not to fear financials

Watch this week's
UBS House View Weekly Video

Kiran Ganesh

The sudden concerns about global financials that erupted in February have caught markets by surprise.

The MSCI Europe Financials equity index is down by 20.2% year-to-date, and US financials have fallen 12.8% in 2016.

Credit default swaps on European subordinated bank debt are trading at 268bps, after breaching 300bps, which was the highest level since March 2013.

Behind the rout appear to be three main concerns:

Asset quality may be deteriorating, particularly given the weakness in oil and commodity prices, and signs of a slowdown in economic growth.

The yield curve is flattening. The difference between three-month deposit rates and 10-year lending rates in the US is now at its lowest level since August 2012, and approaching early 2015 lows in the Eurozone, indicating future pressure on bank net interest margins. This could grow more problematic if central banks cut interest rates into negative territory and commercial banks are unable to pass these through to consumers.

Credit conditions are tightening, raising the risk of a self-perpetuating spiral of tighter credit conditions, problems refinancing debt, and consequent difficulties for seemingly sound banks.

However, we believe the current stresses are overdone:

Exposure to the energy sector is manageable (average 5% commodity loans/total loans exposure for European banks) and, unlike in the sub-prime crisis, the debt is generally not repackaged and/or re-leveraged. Even in a stress scenario of 50% of sub-investment grade commodity-related loans becoming non-performing, the capital impact for European banks should prove manageable. Furthermore, there is presently no clear evidence that the global economy is headed for recession. *CIO is forecasting real GDP growth this year of 1.6% for the Eurozone and 1.5% for the US.*

Eurozone banks have improved capital ratios since the sovereign debt crisis, so any deterioration in asset quality should have less of an impact than in the past. The average capital ratio among the major listed European banks has risen to 12.6% in 1H 2015 from 9.7% in 2008, and the vast majority of European banks have already reached 2019 capital requirement targets.

Valuations are already discounting weak profitability in any case. The European sector's 0.6 times price/book value is comparable to 2008–12 valuations. In the US, large multinational banks are trading at a 33% discount to the S&P 500, below 10x forward price-to-earnings.

Central bank emergency provisions are still available. Banks in urgent need can exchange collateral for liquidity through the funding windows of the US Federal Reserve and European Central Bank.

Of course, banks are still inherently leveraged businesses, reliant on external confidence and funding. Investors will need to prepare for near-term volatility, and remain selective in their approach to investing in financial capital and equity. But we believe the system as a whole is not at significant risk. Within equities, we remain overweight European financials and market weight the US, where we favor the large cap multi-national banks over diversified financials and insurance companies. Within investment grade credit, we favor senior unsecured bonds for banks with the most stable credit profiles. US senior unsecured bonds remain less challenged relative to their European peers, as the largest US banks benefit from a more unified regulatory environment and from having met fully phased in capital, liquidity, and leverage requirements.

Kiran Ganesh
Global Investment Office

Bottom line

Concerns about asset quality, flattening yield curves, and tightening liquidity have meant a weak start to the year for financials. We believe the concerns are generally overdone given low valuations, manageable exposure to the energy sector, adequate capital positions, and continued central bank liquidity provision in case of emergency. *CIO is maintaining a preference for stocks in the European financial sector.*

Regional view

The topsy-turvy world of interest rates

Podcast
www.ubs.com/cio-podcast

Daniel Kalt
Regional CIO Switzerland

At the end of January another major central bank – the Bank of Japan – announced that it would push headline rates into negative territory. What the Danish and Swedish central banks, as well as the Swiss National Bank (SNB) had done as an emergency measure seems gradually to be growing socially acceptable. The European Central Bank (ECB) was the first to take this step, back in mid-2014.

Most economists might previously have viewed this as impossible – or at least extremely risky. Now observers consider it feasible, even suitable if unconventional, monetary policy. Breaking through the "zero lower bound" is now seen by some as a new tool for sparking investment and consumption in a world with deflationary tendencies.

But the world of negative interest rates is not quite so easy. These rates may spur investors to assume more risks, and lead individuals and companies to increase consumption. In Switzerland, they also likely helped make the franc less attractive as a safe harbor, weakening it. Increasingly clear, however, is that negative interest rates may also have harmful effects on the banking sector and the financial system as well.

In a recent study[1], we evaluated the risks of a persistent negative interest rate environment for the Swiss banking system. Extremely low and flat interest-rate curves could put banks' traditional lending margins business under further pressure, and cause problems for banks if interest rates rise sharply in the future.

"Breaking through the 'zero lower bound' is now seen by some as a new tool for sparking investment and consumption in a world with deflationary tendencies."

The recent sharp declines in share prices for banks in Japan and Europe can be interpreted as a response to the announcement and the prospect that interest rates will fall further into negative territory. Indeed, the ECB may well announce in mid-March that it will increase the volume of its monthly bond purchases, and thus continue to hold the yield curve flat. We also expect ECB President Mario Draghi to announce another reduction in the deposit savings rate. While the rate reduction, to –0.4% from –0.3%, may seem small, the signal is clear: Interest rates will remain extremely low for an extended period, in many cases at a negative level.

So what does this mean for the Swiss interest rate environment and financial system? We think the SNB will hold off reducing the headline rate further here in Switzerland if the ECB takes the above-mentioned interest rate step. On the one hand, the EURCHF exchange rate has stayed above 1.10 of late without any visible currency interventions. The SNB will therefore primarily combat any increase in the value of the Swiss franc through additional foreign exchange interventions. As the SNB is well aware of the side effects of even lower negative interest rates for the banking and pension systems, we anticipate that it will only consider a further reduction in interest rates if there are currency interventions that burst all of the dams. In the present topsy-turvy world of interest rates, this is cold comfort.

Kind regards,
Daniel Kalt

[1] See: "The topsy-turvy world of interest rates" at http://tinyurl.com/h5gu6te

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