UBS House View

Europe
Chief Investment Office WM

Weekly

4 February 2016

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Market moves

	CIO view	*–1w*	*– 3m*	*ytd*
S&P 500		3.3%	–7.3%	–5.0%
Euro Stoxx 50	OW	–1.7%	–12.7%	–8.5%
MSCI EM	UW	4.9%	–12.3%	–6.4%
FTSE 100	UW	1.2%	–5.4%	–4.1%
SMI		–1.3%	–8.1%	–6.9%
NIKKEI 225		6.2%	–4.9%	–6.7%
US high grade bonds	UW	0.3%	1.1%	1.6%
Euro high grade bonds	UW	0.8%	2.3%	2.4%
US investment grade bonds	OW	–0.1%	–0.8%	0.0%
Euro investment grade bonds		0.6%	0.5%	0.5%
US high yield bonds		0.9%	–6.1%	–1.4%
European high yield bonds	OW	0.7%	–2.6%	–1.2%
EM sovereign bonds		1.0%	–1.9%	–0.3%
EM corporate bonds		0.9%	–2.4%	–0.3%

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

Market comments

Calculations are based on the past five days

- **Global equity markets** diverged over the past five sessions, with the Euro Stoxx 50 and Swiss markets lagging, while Japan's Nikkei 225, the US S&P 500 and the MSCI Emerging Market Index all rose.
- **Brent crude** breached USD 35/bbl, having dipped below USD 30/bbl in late January. Oil prices were supported by indications that Russia was open to talks with OPEC, if the cartel can unite behind measures to reduce global over supply.
- **European high yield bonds** gained 0.7%, paring losses this year to 1.2%. US high yield rose 0.9%. Euro and US high grade bonds gained 0.8% and 0.3%, respectively.

In focus

The Bank of Japan (BoJ) adopted negative interest rates and again pushed back the timing for achieving its inflation target. The BoJ unexpectedly set a benchmark deposit rate of –0.1% from 0.1%, but will keep buying government bonds at JPY 80trn a year. This came after subdued macro data was released ahead of the monetary policy meeting. The outlook for the BoJ to achieve its 2% inflation target was also pushed back to 1H FY17 (between March and October 2017) from 2H FY16 due to persistent slack and falling producer prices. *CIO is maintaining its long USD versus short JPY recommendation in its global tactical asset allocation (TAA).*

In the US, survey data has recently been soft – the ISM purchasing managers' index for manufacturing came in at 48.2 in January, the fourth consecutive month below the 50 mark that separates expansion from contraction. It was also below forecasts for 48.4. The overall US employment outlook has been positive, but the jobs component of the reading declined to 45.9, the weakest level since 2009. On the brighter side, the production and new orders components both moved above 50 for the first time since October. Additionally the ISM non-manufacturing survey posted a broad-based decline (to 53.5 from 55.8), indicating that the sluggish manufacturing sector may be affecting other areas of the economy more than anticipated. At 52.9, the economy-weighted US ISM figure sits close to its lowest point since the end of the financial crisis.

Eurozone manufacturing PMIs, by contrast, signaled continued growth, albeit at a slower pace. The Eurozone-wide manufacturing PMI slipped modestly in January to 52.3, from 53.2 in December. But the composite Eurozone PMI fell to a four-month low in January, and significant falls in factory gate prices tie in with market-based expectations that inflation is still declining in the Eurozone. As such, CIO believes that low inflation, both realized and expected, will strengthen the case for further monetary easing at the ECB's March monetary policy meeting, in turn underpinning the economic and earnings recovery in the region.

China's services sector activity expanded to a six-month high. According to a private survey released by Caixin, the services PMI rose to 52.4 in January from 50.2 in December, after the manufacturing PMI data released earlier this week showed a decline amid deep traditional manufacturing adjustments. We expect this trend to continue given China's ongoing economic transformation from a prior reliance on investment and exports, to a consumption and services-driven economy.

China eased mortgage housing policy further. The minimum down payment for home purchases in cities without home-purchase restrictions – tier 2, 3, and 4 cities – will be cut to 20% from 25% for first-time home purchases, and to 30% from 40% for second-home purchases. This announcement, together with ongoing household registration reform, aims to support housing demand and mitigate the drag from housing market adjustments. CIO expects further easing of housing policy to resolve the inventory overhang, especially in third and fourth-tier cities.

UBS

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Deeper dive

A slowdown, not a recession

Watch this week's
UBS House View Weekly Video

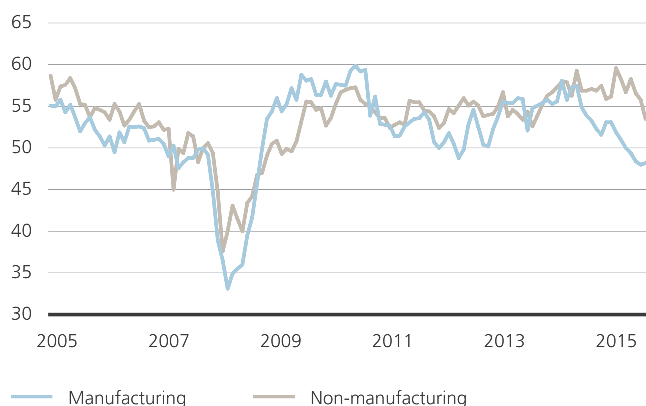
Brian Rose, PhD
US economist

Recent economic data has been generally disappointing, both in the US and other countries. Since near-term improvement appears unlikely, UBS Investment Research has reduced this year's economic growth forecast for the US to 1.5% from 2.8%. That would be the lowest rate since 2009, and projects the US to grow slower than the Eurozone – where the 2016 outlook was scaled back to 1.6% from 1.8%. Financial market turbulence has prompted stories in the media that the US is at risk of falling into recession. In our view, such fears are overblown; we expect growth to revive after the current bumps fade.

In recent months, a wide gap has developed between the manufacturing sector and the rest of the economy (see chart). Globally, manufacturing is plagued by excess capacity and weak demand, partially due to slowing growth in China. For US manufacturers, the strong dollar exacerbates the situation. Manufacturing output is likely to remain weak until excess inventories decline, which could take several months if demand does not grow. While lower energy prices would normally be encouraging, the collapse in energy-related investment spending has hurt manufacturers that previously benefited from the investment boom. The auto industry has been a bright spot in manufacturing, but given record sales last year, the upside appears limited.

Economic indicators have fallen

ISM Purchasing Managers' Indicies



Source: Bloomberg, UBS, as of 3 February 2016

Most non-manufacturing industries, in contrast, remain reasonably healthy. Almost 90% of the US economy is non-manufacturing, and we do not expect the downturn in manufacturing to drag the rest of the economy into recession. The improving labor market and low inflation support real household income and consumer spending. The Affordable Care Act has given millions of people access to health insurance, boosting demand for medical services. Construction activity, hard hit by the financial crisis, has rebounded strongly over the past four years. While growth is starting to slow in some areas, home prices and rents are still rising at a solid pace, encouraging builders to continue increasing housing starts. We are therefore optimistic that the economy can go on growing modestly until the manufacturing sector gets past the bumps.

Brian Rose, PhD
US economist

Bottom line

Recent economic data in the US has been disappointing. The manufacturing sector is exhibiting recessionary conditions. We have cut our US GDP growth forecast for this year to 1.5%. But this doesn't mean the economy is headed for recession. Manufacturing is a small piece of the economy, and other economic sectors are healthier. Job growth, rising wages, and low inflation will continue supporting growth in real consumer spending. We thus foresee ongoing modest economic growth until the manufacturing sector gets past the bumps.

Regional view

Podcast
www.ubs.com/podcast

Introducing *Investing in Europe*

Themis Themistocleous
Head CIO European Investment Office

Last week, we introduced a new monthly publication, *Investing in Europe*, in which we highlight our highest conviction cross-asset ideas for Europe and our take on the latest economic developments. Each issue will include a focus article addressing a top-of-mind topic.

The Eurozone is currently our preferred region within global equities. Within Eurozone equities, we prefer the financials, healthcare, energy and the technology sectors, and our favored country is Italy. The benign economic backdrop should also support investment grade corporate credit, where we see attractive returns, and European high yield credit, another of our overweight positions.

In several recent publications we have focused on political risks that Europe will be facing this year, including the elections in Spain, the UK's "Brexit" referendum, and regional elections in Germany.

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

While all pose significant risks, our base case remains that none of them will develop in a way that could severely destabilize the European economic recovery.

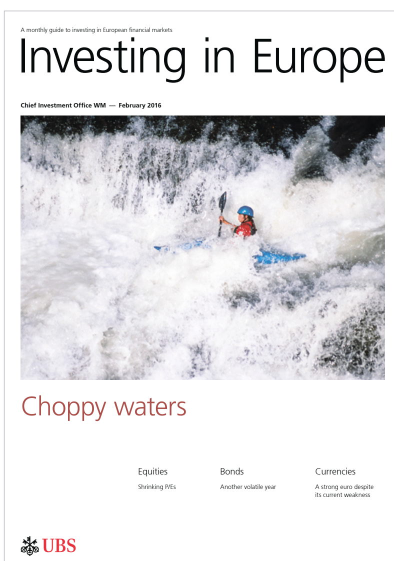
The UK Prime Minister's reaction to the European Council's draft proposal on EU reforms has been positive. Discussions will continue at the technical level with the aim that the Heads of State make a decision on February 18/19. David Cameron indicated that if an agreement is reached, he will lead the campaign for staying in the EU. We expect the referendum to take place this year, most likely in June, and assign a 70–80% probability to the UK staying in the EU.

The situation in Spain remains uncertain; the leader of the Socialist party (PSOE) Pedro Sanchez has been asked by King Felipe to form a government. Sanchez will start negotiations with left-wing Podemos and centrist Ciudadanos to get their support in an investiture vote. We still see considerable differences in the policies of the three parties, which would make a deal difficult. We assign a 30% probability to failed negotiations and the need for another election. And a last-minute deal between the center-right PP, PSOE and Ciudadanos is still possible. Any coalition that includes Podemos is likely to be viewed negatively by the markets.

Upcoming elections in three German states are expected to reflect the growing anxiety around the country's open immigration policy. In all three states, we think a coalition of CDU and SPD will be the most likely outcome. This should further improve legislative procedures at the national level. For the federal elections in 2017, we also expect a grand coalition of CDU/CSU and SPD to prevail. In fact, the rise of right-wing Alternative fuer Deutschland (AfD) increases the likelihood of such a coalition, in our view.

For more details, please refer to the inaugural issue of *Investing in Europe: Choppy waters*, published 29 January 2016. We hope you will find this new publication both useful and enjoyable.

Kind regards,
Themis Themistocleous



To receive a copy of *Investing in Europe*, in English, please contact your client advisor.

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