UBS House View

Europe
Chief Investment Office WM

Weekly

13 October 2016

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Market moves

	CIO view	–1w	– 3m	ytd
S&P 500	OW	–1.0%	–0.1%	6.5%
Euro Stoxx 50		–0.6%	3.1%	–4.5%
MSCI EM	OW	–1.6%	6.1%	16.3%
FTSE 100		–0.1%	6.3%	16.3%
SMI	UW	–1.5%	–0.8%	–5.2%
NIKKEI 225		–0.3%	4.1%	–10.4%
US high grade bonds	UW	–0.2%	–0.6%	5.1%
Euro high grade bonds	UW	–0.5%	–0.8%	6.1%
US investment grade bonds	OW	–0.1%	–0.6%	8.5%
Euro investment grade bonds		–0.2%	0.2%	5.4%
US high yield bonds		0.2%	3.0%	14.3%
European high yield bonds		0.0%	2.1%	7.4%
EM sovereign bonds		–0.7%	1.1%	13.8%
EM corporate bonds		–0.1%	1.5%	11.8%

Source: Bloomberg, UBS as of 13 October 2016
OW = tactical overweight
UW = tactical underweight

Market comments

Calculations are based on the past five days

- Global equities declined last week, with **emerging market equities (–1.6%)** the notable laggard. **Swiss stocks (–1.5%)** were not far behind. **UK equities (–0.1%)** held up thanks to the pound's weakness.
- Most fixed income markets lost ground, with the exceptions of **US high yield bonds (+0.2%)** and **European high yield debt (flat)**.
- In foreign exchange, the **British pound (–3.2% versus the USD)** was a significant mover, driven by concerns about a "hard" Brexit. In commodities, **Brent crude oil lost 1.7%** on higher OPEC supply.

In focus

GOP's grand new rift. A growing divide between the Republican presidential nominee and GOP leadership ignited on Tuesday, with House Speaker Paul Ryan declining to support Donald Trump. Trump's flagging popularity and unconventional campaign style have driven many Republicans to distance themselves from him. Growing divisions within the GOP raise the chances of the Democrats making sizable gains in their House and Senate races. *CIO expects that the US election will result in a divided government, with a 45% chance that Hillary Clinton will preside over a Democratic Senate and Republican House.*

Pounded. Sterling tumbled more than 6% against the dollar and below USD 1.20 in early Asian trading last Friday, in what many traders view as a "flash crash." The British pound had been on the defensive all week due to speculation that the UK is heading for a "hard" Brexit. It regained some poise on Wednesday as Prime Minister Theresa May announced that British lawmakers would have some say in the form of the UK's exit. *CIO now forecasts GBPUSD at 1.22 in three months, rebounding to 1.36 in 12 months.*

Labor lull? US nonfarm payrolls increased by 156,000 month-on-month in September, below the 172,000 consensus forecast. The unemployment rate rose from 4.9% in August to 5.0% (versus the 4.9% expected). Yet the labor force participation rate ticked up to 62.9%, suggesting there is more "hidden slack" in the labor market than previously thought. The report is good news for the economy, while also reducing the probability of a November rate hike. *CIO expects the Fed to hike rates by 25bps in December.*

Fall fumble or fallacy? Releases from early reporters sparked some concerns that the US 3Q earnings season may disappoint expectations. Missed numbers from several high-profile names caused the S&P 500 to close down 1.2% on Tuesday, the first day of this reporting season. However, third quarter profits can tick up as dollar headwinds wane and given strong US domestic growth. *CIO remains overweight on US equities in global portfolios.*

Zoom, ZEW, zoom. The ZEW Index of German economic sentiment rose in October to levels last seen in January. The gauge of current conditions rose to 59.5, above the consensus forecast (55.5) and well above the post-Brexit low of 49.8 recorded in July. Still, German economic conditions may not zoom forever. ZEW President Achim Wambach highlighted potential confidence-sapping risks arising from the nation's lenders. *CIO stays neutral on Eurozone equities in global portfolios.*

Rise of the machines? Japan's core machine orders, a leading proxy for investment, fell 2.2% m/m in August, less than the expected 4.7% drop. The figure is up 11.6% y/y from July's 5.2% gain and marks the highest reading since June 2015. The continuous improvement since June this year suggests that business sentiment is gradually picking up. *CIO is neutral on Japanese equities in global portfolios.*

Chinese FX stockpile lowest since 2011. Reserves fell 0.6% to USD 3.17trn in September, below the consensus estimate of USD 3.18trn. This marks the third consecutive month of contraction. *CIO forecasts USDCNY at 6.8 in three and six months and 7.0 in 12 months.*

UBS

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Deeper dive

The value of staying invested

Mark Haefele
Andrew Lee

Realized volatility in stock markets has increased over the past month from extraordinarily low levels over the summer. As the US presidential election, US rate hikes, and other potentially disruptive events near, investors should consider how they might react if higher volatility and uncertainty arise.

Typically, when equity markets start to correct, investors' gut instinct is to sell their most liquid positions to raise cash and await better entry points. Yet this emotion-driven reaction often means liquidating at inopportune times and prices, and – more damaging – failing to get reinvested quickly enough. "Missing out" can cost investors and undermine a long-term strategic approach.

Private markets provide some useful lessons about staying invested during periods of market turbulence. These illiquid investments require capital commitments of 10 or more years. Investors' only option for liquidity is to sell their stakes on the secondary market, often at a substantial discount to fair value in volatile markets. This structural illiquidity tends to keep investors invested in private markets, avoiding the potential for emotion-driven missteps.

What can private markets teach us about staying invested during market turbulence?

1. Portfolios can benefit from less frequent marking to market. Private markets exhibit lower drawdowns during market corrections compared to public markets. This structural advantage results from less frequent valuations (quarterly), which lower reported volatility and improve portfolios' risk-adjusted returns. Reacting to these interim valuations is less relevant given the truly long-term nature of these investments; long-term oriented investors can apply a similar approach to liquid securities in markets where fear impacts pricing.

2. Maintain long-term focus and avoid emotion-driven selling. The advantage of private markets illiquidity is that these structures hold investors to their original long-term perspective, forcing them to stay invested through difficult market conditions. This prevents selling at depressed valuations and enables investors to benefit from long-term returns. Investors can apply this same approach across their listed portfolios as well to avoid emotion-driven missteps, making tactical adjustments but maintaining the long-term strategic core intact.

3. A long-term mindset provides the flexibility to be opportunistic. Private markets funds with dry powder and long lockups can take a long-term view on value and capitalize on dislocations, while other investors are paralyzed by short-term fears. Similarly, long-term oriented investors should take advantage of their time horizon and be willing to invest in volatile public markets where fundamentals justify the long-term case.

Private markets can help enable investors to take emotions out of their investment decisions, and thus act in a way that is better matched to their intended portfolio timeframe. Even though equities and bonds can easily be sold, investors that are focused on long-term returns should self-impose similar mental "illiquidity constraints" in volatile markets and avoid making suboptimal emotion-driven decisions. Investors should limit themselves to rational tactical adjustments during turbulent times, or alternatively implement ongoing portfolio hedges that can alleviate the fear of significant drawdowns. Either way, the objective should be to avoid being emotionally reactive and instead remain invested for the long term, just as in private markets (even though the structural constraint is not the same).

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Bottom line

We can all take a behavioral cue from private markets in times of market turbulence. Even though investors can sell their liquid securities, they should instead self-impose a mental "illiquidity constraint" and keep their long-term portfolio framework and objectives foremost in mind. Fundamental or signal-driven tactical adjustments make sense in this context, but emotion-driven selling can diminish long-term investor returns and should be avoided. As historical private market returns illustrate, investors with the fortitude to maintain a long-term mindset even in turbulent times should be rewarded over the long term.

Regional view

From QE to EPS

Podcast
www.ubs.com/cio-podcast

Bert Jansen
European Equity Strategist

"The problem with QE, it works in practice, but it does not work in theory."
Ben Bernanke, former Chairman of the Federal Reserve (2006–2014)

"Give me control of a nation's money and I care not who makes its laws."
Mayer Amschel Rothschild, founder of the Rothschild banking dynasty

European central banks have been in the spotlight again in recent weeks. A recent news report stated that the European Central Bank was considering gradually winding down bond purchases before the end of its quantitative easing (QE) program scheduled for the end of March 2017.

Meanwhile, the sharp fall of the British pound put the Bank of England in a difficult position because the weaker currency has led to a sharp rise in inflation expectations at a time when UK economic growth is expected to weaken considerably.

These two central bank events, together with rising oil prices and the likelihood of a US rate hike in December, drove bond yields higher. The muted impact on headline Eurozone equity indices disguised significant rotation at the sector level (the sharp rise of the UK market has been entirely driven by the weaker pound; measured in USD, the MSCI UK has *underperformed* the MSCI World by 3% over the last month and by 8% since the Brexit vote on 23 June).

"The upside for equity markets is limited, but they should outperform high grade bonds in a world in which QE is not infinite after all."

Although we don't expect European monetary policy to tighten in the foreseeable future, it is fair to say, in our view, that the era of *unlimited* QE is coming to an end.

What are the repercussions for European equity markets?

From a market perspective, higher bond yields are limiting the potential for higher valuations. Market price/earnings ratios (P/E) have risen for four consecutive years between 2012 and 2015, driven by falling bond yields. But more recently, with the prospect of inflation nudging higher and no *additional* easing of monetary conditions, market P/Es have been struggling to expand: the current market P/E for the MSCI Europe is lower today than it was in January.

This does not mean that equity markets cannot move higher. But they will increasingly depend on corporate earnings growth, which has been conspicuous by its absence in Europe over the past six years. The good news is that we expect Eurozone earnings per share (EPS) growth to pick up next year as the major drag from energy and financials should lessen (EPS in these sectors are expected to fall this year by 12% and 14%, respectively). In the UK, corporate earnings should be boosted by a sharply lower pound.

At the sector level, the end of falling (or even rising) bond yields should be positive for financials as it alleviates the pressure on banks' net interest margins. Sectors most affected by rising bond yields are those with high P/Es – such as consumer staples, healthcare, and technology – since the value of future cash flows is disproportionately influenced by higher discount rates.

Sectors with "safe", above-average dividend yields in mature industries may also be affected as fixed-income alternatives become relatively more attractive when bond yields rise.

All in all, the upside for equity markets is limited because of stalling P/Es and modest earnings growth. But they should outperform high grade bonds in a world in which QE is not infinite after all.

Kind regards,
Bert Jansen

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