UBS House View

Europe
Chief Investment Office WM

Weekly

6 October 2016

Market moves

	CIO view	–1w	–3m	ytd
S&P 500	OW	–0.5%	3.4%	7.5%
Euro Stoxx 50		1.0%	9.7%	–4.1%
MSCI EM	OW	0.2%	12.6%	17.9%
FTSE 100		1.7%	9.9%	16.5%
SMI	UW	0.2%	3.8%	–3.9%
NIKKEI 225		1.2%	10.6%	–9.7%
US high grade bonds	UW	–0.7%	–0.6%	5.3%
Euro high grade bonds	UW	–1.0%	–0.3%	6.6%
US investment grade bonds	OW	–0.9%	–0.1%	8.6%
Euro investment grade bonds		–0.4%	1.0%	5.7%
US high yield bonds		0.8%	4.9%	14.2%
European high yield bonds		0.1%	3.2%	7.2%
EM sovereign bonds		–0.2%	2.9%	14.5%
EM corporate bonds		–0.1%	2.3%	11.9%

Source: Bloomberg, UBS as of 6 October 2016
OW = tactical overweight
UW = tactical underweight

Market comments

Calculations are based on the past five days

- **Equity markets** had a mixed week, with the FTSE 100 climbing 1.7%, helped by a sliding pound. The Nikkei 225 was also assisted by currency weakness. But US equities retreated slightly.
- **High grade bonds** were in decline, with US high grade down 0.7% and Euro high grade down 1%. Both European and US high grade bonds rose.
- **Foreign exchange markets** were marked by strength in emerging markets, with the Mexican peso and Brazilian real leading the pack, followed by the South African rand.

In focus

Temporary taper trepidation. Markets reacted to a Bloomberg report that the ECB is considering winding down bond purchases before the conclusion of quantitative easing. The article, which cited central bank officials, briefly depressed Eurozone stocks. Investors are starting to worry that both the Bank of Japan and ECB are running out of options to support growth. Eurozone stocks regained their poise in the latter part of the week. *CIO is neutral on Eurozone stocks.*

Hard Brexit talk hits sterling. The pound hit a fresh 31-year low versus the dollar at 1.272 amid mounting speculation that the UK government will choose to sacrifice full access to the EU market in return for greater control over immigration. *CIO is neutral on the pound and UK stocks.*

Relief for Deutsche Bank stock. The German bank shares regained some poise this week. Worries over Deutsche Bank have been a source of market angst following news in September that the US Department of Justice was seeking a USD 14 billion fine over allegations of mortgage mis-selling. Pressure has eased on reports that Deutsche Bank will negotiate a far smaller penalty. *CIO is neutral on Eurozone equities.*

First cut by committee in India. The Reserve Bank of India inaugurated its new monetary policy committee by reducing the benchmark rate to 6.25%, the first cut since April. The panel framework was part of a series of reforms to upgrade policymaking in India spearheaded by former governor Raghuram Rajan. *CIO is overweight Indian equities in our Asia ex-Japan and emerging market strategies.*

US service sector stronger. The ISM non-manufacturing index, a broad measure of economic conditions in the US services sector, jumped to 57.1 in September. The 5.7 point improvement over August set a new record and strengthens the case for the Fed to hike rates. *CIO expects the Fed to raise rates by 25 basis points in December.*

US car sales shift to lower gear. Light vehicle sales fell 0.7% in September from a year ago, adding to evidence that the industry has hit a plateau after climbing for six years since the low of the financial crisis. Even so, the plateau is still at a high level. *CIO is upbeat about the outlook for consumer spending and is overweight US equities.*

Chinese manufacturing keeps head above water. The Caixin China PMI edged up from 50 in August to 50.1 in September, slightly above the threshold indicating expansion. Nonetheless, *CIO expects China's GDP growth to slow gradually as the government reforms seek to eliminate spare capacity in the old economy.*

Eurozone activity slows. The September reading of the Markit private sector purchasing managers' index fell to 52.6, the weakest reading in 20 months. The decline was led by deterioration in Germany, the zone's largest economy.

Deeper dive

Is it too late to buy into the emerging market rally?

Mark Haefele **Christopher Swann**

Emerging markets (EM) have outperformed sharply so far in 2016. The Brazilian real, Russian ruble, and South African rand have topped the global rankings versus the US dollar. And the MSCI Emerging Market Index has risen more than twice as fast as the S&P 500, leaving EM stocks trading at trailing price/earnings ratios above their 10-year average. Investors might be wondering if this boat has sailed.

But looked at over the past five years, the picture looks very different. Both currencies and stocks still have a lot of catching up to do after a long malaise. On a real effective exchange rate basis, EMEA and Latin American currencies are still sharply lower, and the MSCI EM is down by 23% – compared to a rise of 68% in the S&P 500. Currencies did as expected during a period of economic weakness, depreciating to restore competitiveness.

We believe EM equities and currencies remain attractive, at least on a relative basis.

1. The macro recovery of EM appears to be gaining strength. This time the boost to growth is not just coming from stimulus in China. Brazil and Russia have been turning too. On aggregate, the manufacturing purchasing managers' indices for EM rose to 50.7 last month, above the 50 level that separates expansion from contraction. The fact that the recovery is broad based makes it look sustainable.

2. This seems to be feeding through into earnings. The earnings revision ratio, which measures analyst upgrades versus downgrades, was at –40% in February, indicating far more downgrades. Now it is close to zero, pointing to a marked improvement in sentiment. This has been a reliable indicator of future returns. The actual earnings have stabilized too. The revival of energy and materials prices is contributing to this rebound.

3. A shortage of alternatives is also a positive. Net inflows into EM are set to be positive for the first year since 2012, according to EPFR data. Revealingly, 90% of the inflows have come after the Brexit vote. With Europe under stress, leading emerging nations seem less troubled by comparison.

Fed hikes can be damaging to EM, sucking out capital as risk-free US rates rise. But higher US rates have not proved toxic for EM equities in periods of positive growth. For example, EM stocks did well in 1999 and 2004 when tighter US monetary policy was accompanied by strong economic and earnings growth. (EM equities also performed poorly in 2015 and 1994 when US rates were steady, but growth was weak.)

The bottom line for investors is that there are good reasons to be positive about EM equities and currencies. For equities, much of the re-rating reflects gains in currency valuations, and the brighter earnings and macro outlook have not yet been reflected. On currencies, we are overweight a basket of EM currencies – ruble, real, rand, and rupee – versus a group of G10 currencies. These EM currencies offer an appealing interest rate differential – around eight percentage points – and at a time of improving economic growth there is less risk that these currencies will weaken.

Mark Haefele
Global Chief Investment Officer
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Bottom line

EM have outperformed developed nations so far in 2016. But it is not too late to join the rally. The macroeconomic and earnings outlook for EM is still improving. With Europe under stress, major EM look even more attractive on a relative basis. We are overweight EM equities versus Swiss equities, which are defensive and thus less well placed to benefit from global growth. We are also overweight a basket of EM currencies versus select developed market currencies.

Regional view

Brexit – kicking off the process

Podcast
www.ubs.com/cio-podcast

Themis Themistocleous
Head CIO European Investment Office

UK Prime Minister Theresa May has announced that she is planning to trigger article 50, which sets out the process for exiting the European Union, by the end of March 2017. In her speech to the Conservative party conference, she also highlighted control of the UK's borders and sovereignty as areas of the highest priority.

Theresa May's announcement provides a timeframe for the EU-withdrawal process, which allows for up to two years of formal negotiations, though article 50 also allows for a two-year extension. There is, however, no agreement regarding an interim stage if negotiations are not concluded by the end of the two-year period.

The Prime Minister's speech was interpreted by the market as an indication that she is aiming for a "hard Brexit", that is, prioritizing control of the borders and sovereignty and giving up access to the European single market if necessary. The response from Europe has been restrained and cautious, with President of the European Council Donald Tusk tweeting that the remaining 27 members of the EU "will engage to safeguard its interests".

"We expect the UK and the EU to find common ground, but negotiations to be though."

However, comments from both sides should not be taken at face value. It is difficult at this stage to determine whether comments from the UK are just posturing ahead of the negotiations starting in earnest early next year, indeed represent the government's views, or are simply initial thoughts expressed before any serious work has been done. We believe that it is a little of all three.

We expect the level of noise surrounding Brexit to increase ahead of and during the early stages of negotiations, which could affect asset prices, as evidenced by the significant drop of the pound sterling we witnessed this week.

Once negotiations are in full swing, this noise is likely to subside, although periodic flare-ups are possible. However, once we get closer to the two-year mark (towards the end of 2018) and no agreement is in sight, which is quite likely, the market is bound to start worrying again, especially if no interim stage is agreed by the two sides.

Our base case is for the UK and the EU to find common ground, but negotiations to be tough and possibly extend beyond the two-year period provided by article 50.

Trade between the UK and the EU is significant and very important for both sides. UK exports to the EU amount to 12% of UK GDP, while EU exports to the UK are around 3% of EU GDP, so it is not in the interest of either party to let the current set-up expire without a solution, or to severely restrict trade between the two parties. But as the negotiations between Greece and the EU showed, agreements can be delayed to the very last minute, creating a fair amount of tension in the market.

Kind regards,
Themis Themistocleous

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