European Equity Strategy
What do Investors think is in store for 2017?

Equity Strategy

Europe including UK

Nick Nelson
Strategist
nick.nelson@ubs.com
+44-20-756 81960

Karen Olney, CFA
Strategist
karen.olney@ubs.com
+44-20-7568 8944

Joao Toniato
Strategist
joao.toniato@ubs.com
+44-20-756 74657

Andras Nagy, CFA
Associate Strategist
andras-a.nagy@ubs.com
+44-20-7568 3577

Feedback from Investor Outlook conferences…

After Outlook conferences in 8 countries, we highlight investor feedback, where we get pushback and key messages from our colleagues in macro and sector research.

Where do we get pushback on Outlook 2017?

Earnings growth is the key for European Equities in 2017. We forecast 8%: the bottom up consensus is 13.5%, but this has been downgraded for 6 years in a row and on average by 12 percentage points. We see earnings momentum and critically revenue momentum as stabilising and massive base effects at work (half of the consensus growth rate comes from Commodities and Financials). But given the many false dawns there is some (understandable) scepticism from investors. Interestingly, at our Outlook conference in Frankfurt only 14% of investors thought that earnings growth would be 10% and above (Figure 1).

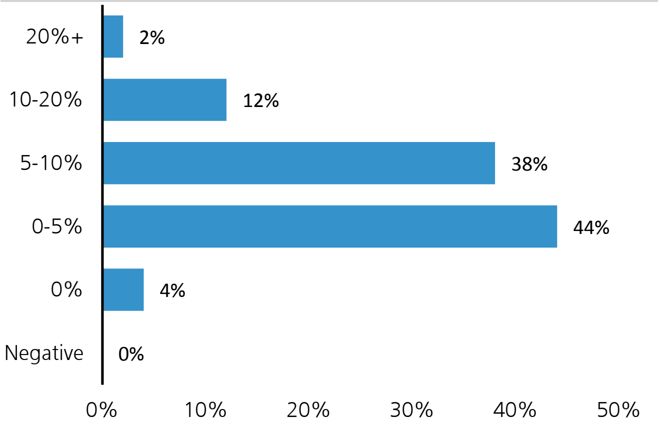
Cyclical Rotation: How much longer can it continue?

Cyclicals have outperformed Defensives by 27% since the low in bond yields on July 8. This is the 2nd best run in a decade and not far behind the 34% move in 2009 after the Financial Crisis. The move has even got ahead of the sharp rise in bond yields (Figure 2). Valuations have normalised somewhat – the DY relative and P/BV relative are now both close to long run averages. We stick with a slight tilt to cyclicals in our sector strategy, but would refrain from chasing all cyclicals here.

What did we learn from our colleagues?

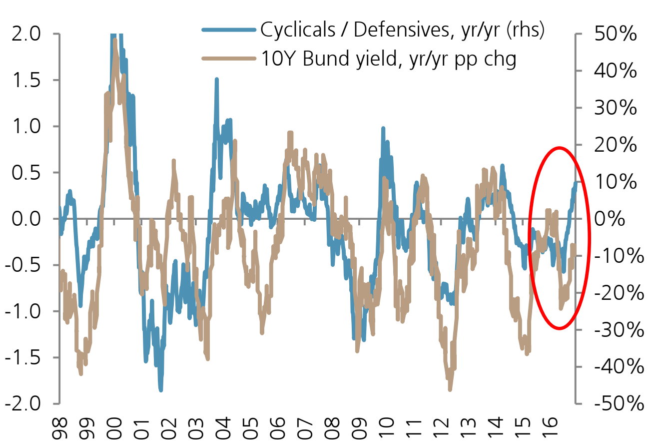
Our economics team expect 2017 to be the first time in 7 years that global nominal GDP growth accelerates. We highlight work from our macro strategy team on the impact of US fiscal policy on bonds and equities (p.18) and work from our Banks team on the correlation between Banks performance and inflation expectations. Finally, our Oils team highlight the estimated cut in upstream capex over 2014-2016 is close to the GDP of Belgium. We upgraded the Energy sector to overweight on November 15 and argue why it is still an overweight (see pp 14-15).

Figure 1: What do you think Earnings growth will be in Europe in 2017?



Source: UBS Outlook Conference, Frankfurt, December 8

Figure 2: Cyclicals vs Defensives (YoY) vs 10yr Bund Yields (YoY)



Source: Datastream, UBS European Equity Strategy

Feedback from marketing…

What has been the investor push back on our 2017 Outlook?

After Outlook conferences and marketing in 8 different countries, we take feedback from investors' views, where we get pushback on our Outlook for 2017 and what we've learned from our colleagues in macro and sector research.

So what were the key concerns / pushbacks?

(1) Earnings: really turning or yet another false dawn?

We expect 8% earnings growth for 2017

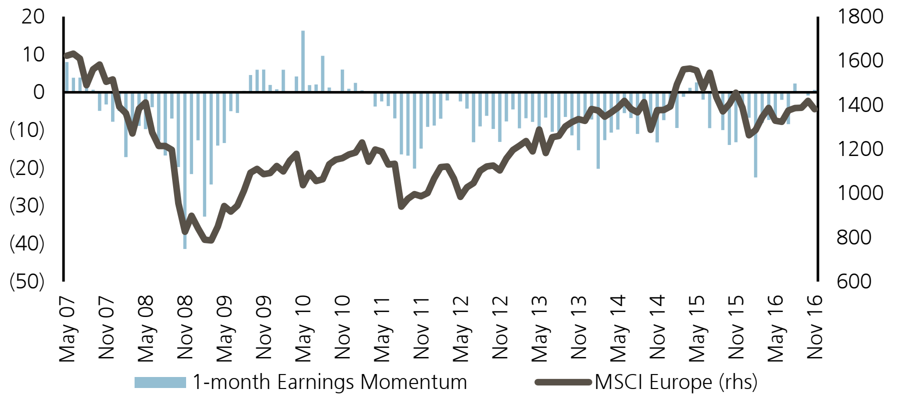
We titled our Outlook report – "*No More Excuses…*" given the fact that Europe has failed to deliver proper earnings growth for 6 years in a row now (link: Outlook 2017: No More Excuses… 15 November 2016). Looking into 2017, our thesis is that European corporates will finally deliver high-single digit EPS growth of 8%. Whilst this is below the consensus estimate of 13.5%, we suspect that 8% will be deemed a good result after the average downgrade of 12 percentage points per year over the last 6 years. We have argued that 2017 may be a window of opportunity given a reasonable macro backdoor combined with massive base effects from commodities and financials.

But what was the pushback?

Many investors acknowledged that there were clear signs that the earnings momentum was at the least stabilising: earnings momentum has been positive in 2 out of the last 4 months. (Figure 3)

There are signs of earnings momentum stabilising

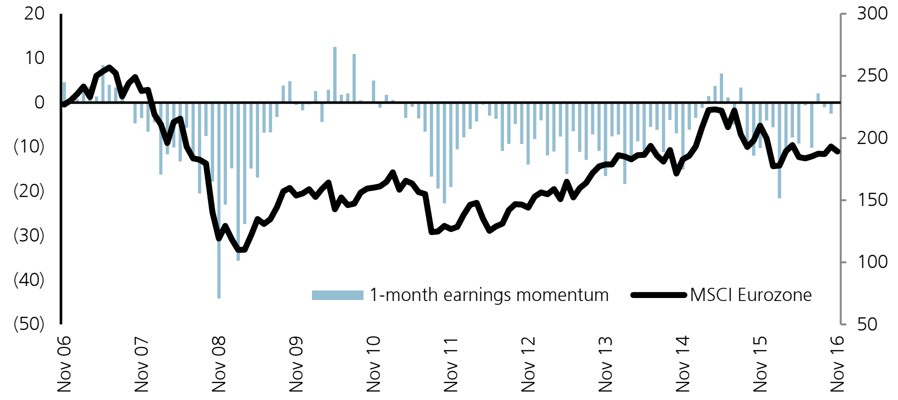
Figure 3: EUROPEAN Earnings Momentum



Source: Datastream, UBS European Equity Strategy

And the first question we got is – is it simply the UK impact at work here with the huge FX-related upgrades? The answer is no – there has also been a turn in earnings momentum in the Eurozone (Figure 4).

Figure 4: EUROZONE Earnings Momentum:



Source: Datastream, UBS European Equity Strategy

..and it is not just the UK "FX effect" – some stabilisation in the Eurozone too

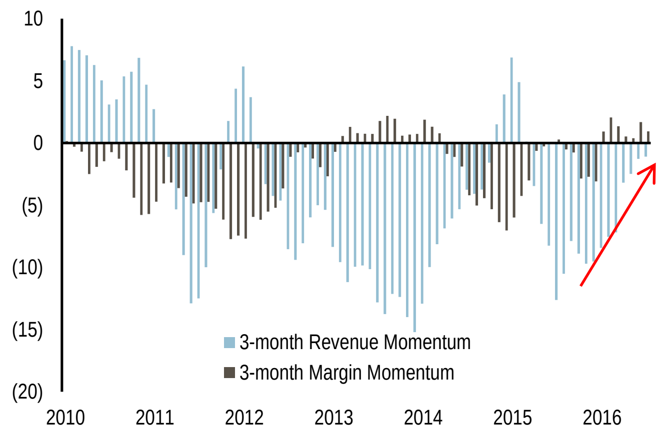
But there remains a degree of scepticism from investors…

After 6 years of downgrades, there is (understandably) some scepticism…

After 6 years in a row of misses and 62 out of 69 months of downgrades since January 2011, understandably there is a huge degree of scepticism. Investors need to see the "whites of the eyes" of the earnings turning to be convinced that this is a genuine inflation point rather than simply yet another "head-fake". We see a convincing year on year turn in earnings in Q1, in part because for the base effects in the energy complex – but also follow-through later in the year.

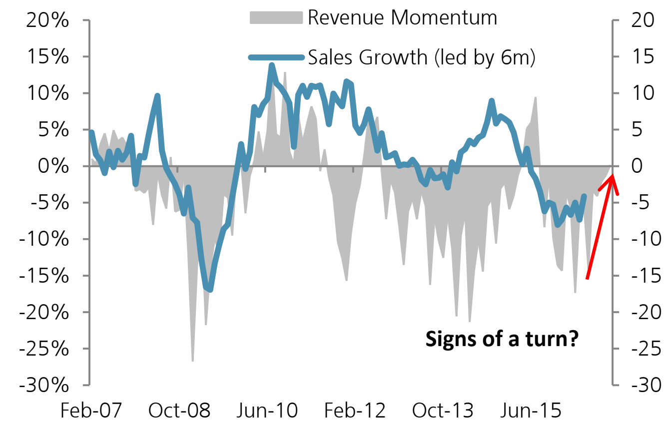
The good news is the make-up of earnings momentum is improving – it is no longer just the continued cost-cutting that we have seen over recent years, but top-line is now also improving. And this is important because revenue momentum tends to lead actual sales growth by 6 months (Figure 6).

Figure 5: Europe: Revenue Momentum (3m ave) vs. Margin Momentum (3m ave)



Source: Datastream, UBS European Equity Strategy

Figure 6: Revenue Momentum leads Sales Growth by 6 months and points to a turn…



Source: Datastream, UBS European Equity Strategy

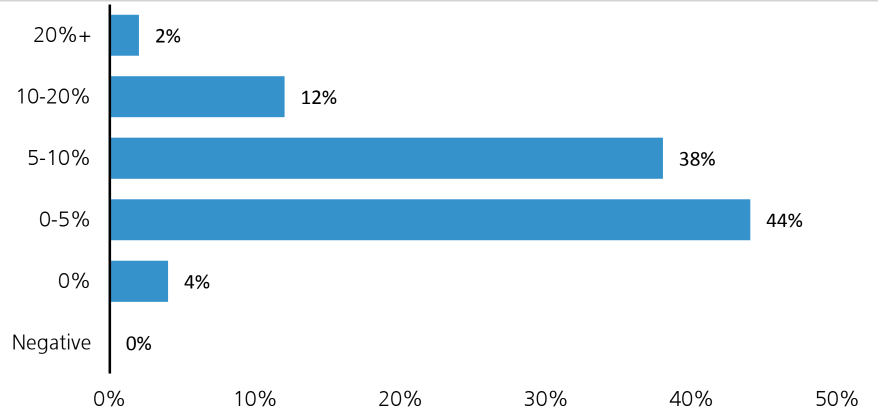
We also saw this in the Q3 results season – the best beat on revenues for 5 quarters

For more details on the long term bounce back potential in European profits please see: Europe differs to World = 4 unique buy ideas 15 November 2016.

Feedback from Outlook Conference in Frankfurt (November 8)

At our outlook conference in Frankfurt last week we took the opportunity to ask investors what they thought earnings growth would be in Europe in 2017. Bearing in mind the bottom-up consensus estimates are 13.5% - only 14% of the audience thought EPS growth would be above 10%. The most favoured range was a very pedestrian 0-5%.

Figure 7: What do you think Earnings growth will be in Europe in 2017?



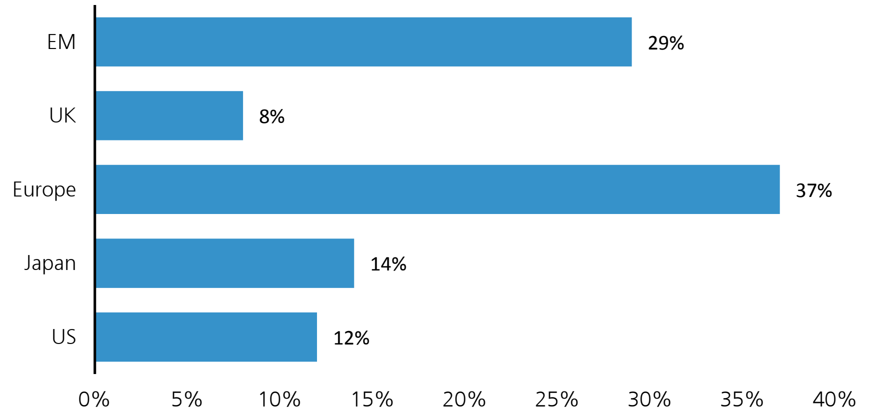
Source: UBS Outlook Conference, Frankfurt, December 8

Investor feedback from Frankfurt suggested only 14% expected double-digit and above EPS growth

Additionally, we asked investors which Equity region they thought would be the best performer in 2017.

Interestingly the UK came bottom of the pile; maybe as the delayed impact of the vote to leave the EU kicks and the economy slows (we forecast 1.0% GDP growth in 2017 after 2.0% this year).

Figure 8: Which Equity Region will be the best performer in 2017?



Source: UBS Outlook Conference, Frankfurt, December 8

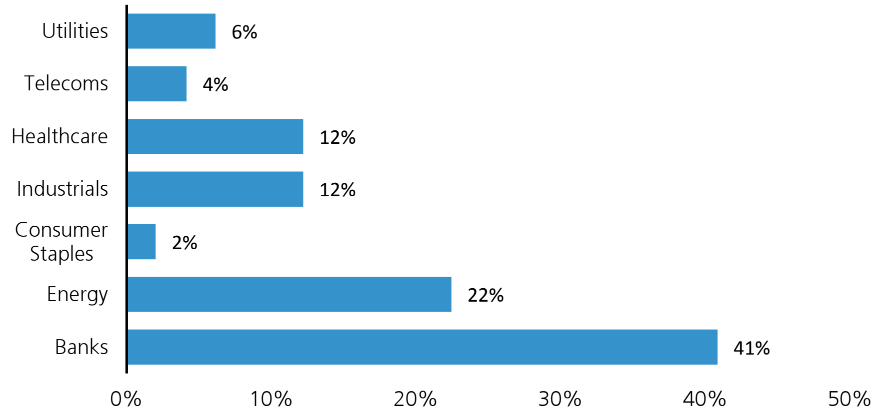
Europe was seen as a favoured region, with the UK at the bottom of the pack

One month ago at our European conference 81% of investors polled felt that European Banks were "uninvestable". What Your Peers are Thinking – UBS Conference 9 December 2016

But just last week at a poll in Frankfurt it was seen as one of the sectors most likely to outperform in 2017. There was a clear preference for cyclicals over defensives, with previous favourites, such as consumer staples, now languishing towards the bottom of the pack.

Banks, having been seen as "uninvestable" have become more popular…

Figure 9: What will be the best performing sector in Europe in 2017?



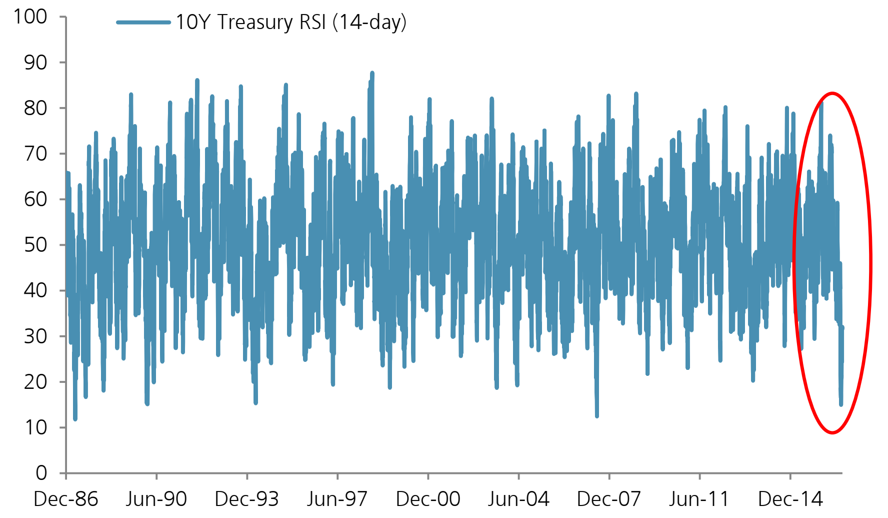
Source: UBS Outlook Conference, Frankfurt, December 8

(2) Bond Yields: At what point do they become a problem?

The move in Bond Yields since the July 8 low has been brutal. Much of this was occurring ahead of the Trump electoral victory, but then became turbo-charged after that. The RSI on the US 10yr Treasury hit one of the most oversold levels in 30 years.

US Treasuries hit one of the most oversold levels in 30 years

Figure 10: 10Y Treasury RSI (Relative Strength Indicator, 14-day)



Source: Datastream, UBS European Equity Strategy

So at what level do Bond Yields become a barrier to performance for European Equities?

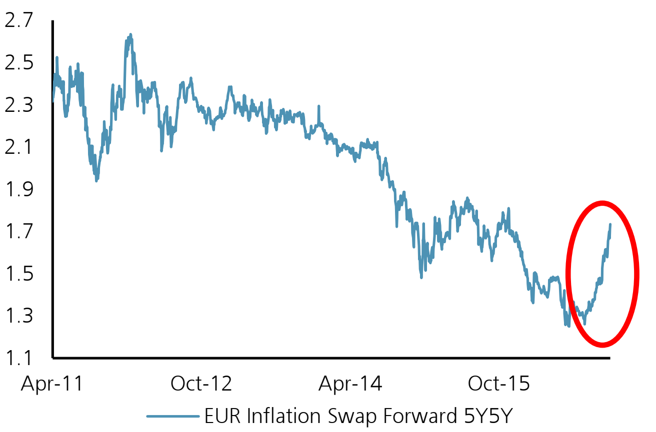
This has been the biggest incoming question since we published our Outlook reports. We would argue that it depends on 3 factors: (1) Why are yields rising? (2) What speed are they moving at? and (3) From what level? To date the vast bulk of the move up in bond yields has been because of inflation: German 10 yr bond yields have moved from c.-20bps to c.35bps and 5 year 5 year inflation swaps have moved 50bps.

So far, much of the move in bond yields has been driven by inflation expectations…

So far, European equity returns have had a *positive* correlation with the inflation break-evens, but a negative one with the real yields. This makes sense given the lack of inflation we have seen in the last 3 years in Europe – the risk for European equities has been too little inflation / deflation not inflation that is too high. And this has been a key driver for the reversal of performance in the European Banks (Figure 12).

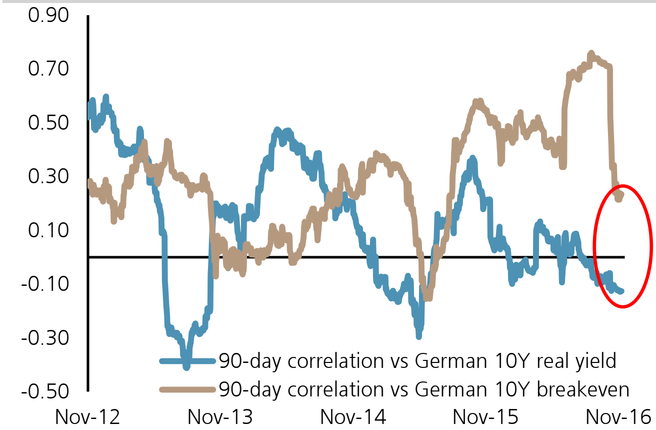
…for now a *positive* for European Equities

Figure 11: EUR inflation swap 5-year 5-year forward



Source: Datastream, UBS European Equity Strategy

Figure 12: Correlation of European equity returns with real yields and break-evens



Source: Datastream, UBS European Equity Strategy

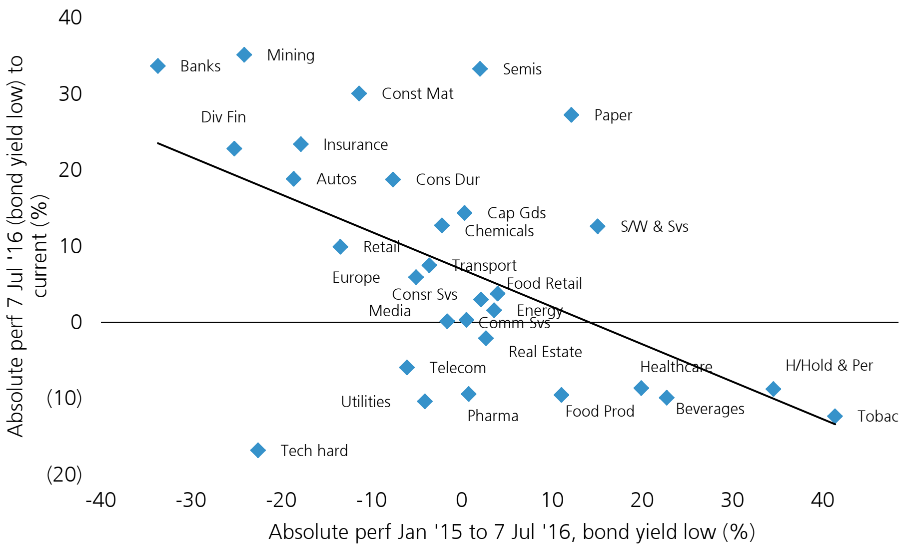
(3) Sector Rotation: When does it end?

Sector rotation has been brutal

The headline moves within the market have been modest – the Stoxx 600 has been in a narrow 8% range over the last 6 months. What has impacted investor performance more has been the rotation within the market. The scatter chart below shows the sharp reversal from the previous 18 months to the period post the low in bond yields. Very few sectors have been significant "winners" in both periods: just Paper and Software. The best performer since July 7 (Mining) was the 2nd worst in the previous 18 months and the second worst performer (Tobacco) was the best performer in the previous 18 months.

If we exclude the outliers the smaller sectors – semis, paper and tech hardware – only 2% of the index in aggregate - the R sq rises from 30% to 60%.

Figure 13: SECTOR ROTATION: European sector performance Jan 15 – Jul 16 vs. 7 Jul - now



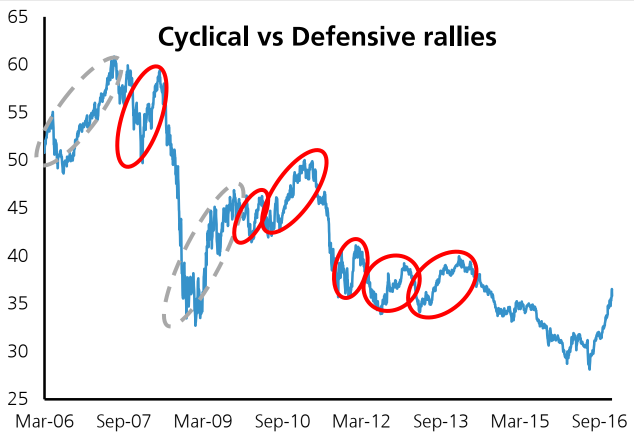
Source: Datastream, UBS European Equity Strategy

Where are the opportunities? If there is a stabilisation in Bond yields following the violent move over the last few months, we would look to those sectors that have underperformed in both periods, such as Utilities and Telecoms. Despite the recent underperformance of the Consumer Staples, we would be less tempted to put money to work there given the valuation premium (though admittedly a reduced one).

What does the current move look like compared to history?

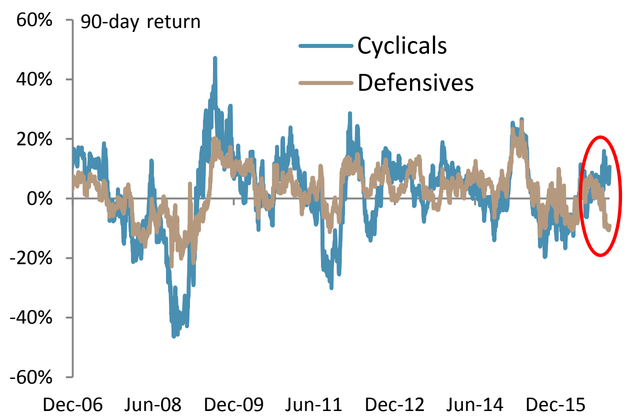
The current rally in cyclicals has been more powerful than most in the last decade. Indeed, this has been the only sustained period where 90-day returns from defensives have been negative as cyclicals deliver positive returns.

Figure 14: Previous Rallies in Cyclicals vs Defensives…



Source: Datastream, UBS European Equity Strategy

Figure 15: Cyclicals and Defensives Price Returns (90 days)



Source: Datastream, UBS European Equity Strategy

When we compare the current rally with those over the last decade, only the move from Q1 2009 at the end for the financial crisis has been bigger (34% outperformance vs 27% so far). It is also larger than the outperformance during the US "taper tantrum" in 2013 when US yields moved by even more than currently.

Figure 16: Previous Cyclical Rallies: Performance, Duration and move in Yields

Cyclicals have outperformed Defensives by 27%...not far off the 34% in 2009 after the crisis

Start	End	Length (days)	Cyclicals vs Defensives perf	Market perf	Chg in 10Y Bund yield (bp)
21 Jul 2006	16 Jul 2007	360	25%	27%	60
21 Jan 2008	19 May 2008	119	20%	10%	31
23 Feb 2009	11 Jun 2009	108	34%	21%	68
15 Feb 2010	26 Apr 2010	70	11%	11%	-15
30 Aug 2010	11 Apr 2011	224	16%	14%	138
28 Dec 2011	20 Feb 2012	54	14%	11%	5
24 Jul 2012	10 Jan 2013	170	15%	17%	30
19 Apr 2013	15 Jan 2014	271	17%	16%	58
Average		**151**	**15%**	**13%**	**41**
Median		**145**	**16%**	**12%**	**30**
Since 6 July		159	27%	11%	44

Source: Datastream, UBS European Equity Strategy

Cyclicals/ Defensives split:

Cyclicals: Basic Materials, Industrials, Travel & Leisure, Autos & Parts, Leisure Goods, General Retailers, Media, Banks, Technology[1]

Defensives: Personal Goods, Household Goods, Food & Drug Retail, Tobacco, Health Care, Telecoms, Utilities

Price momentum has also turned…

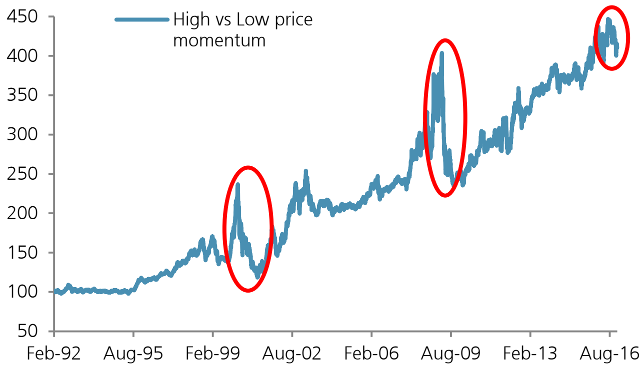
This has gone hand in hand with a reversal in price momentum

High 12m price momentum has worked well as an investment style over the last two decades. But it is prone to sharp periods of underperformance when the style goes into reversal. Since 2009 we have had 3 major periods of reversal.

For more details please see: Global Style Watch - Value plays a trump card 2 December 2016

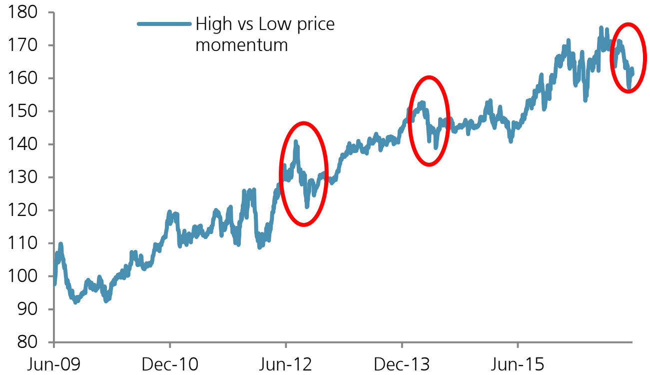
[1] Not included in either Cyclicals or Defensives: Oil & Gas, Financial Services, Insurance, Real Estate

Figure 17: High Price Momentum vs Low price Momentum since 1992



Source: UBS Europe Quants

Figure 18: High Price Momentum vs Low price Momentum since 2009

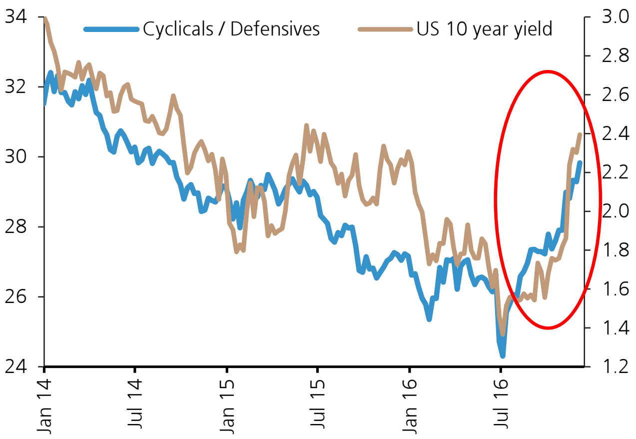


Source: UBS Europe Quants

This connects to the point above on the move in bond yields – the key driver had been rising bond yield and the low of the relative performance of cyclicals coincided with the low in bond yields on July 7.

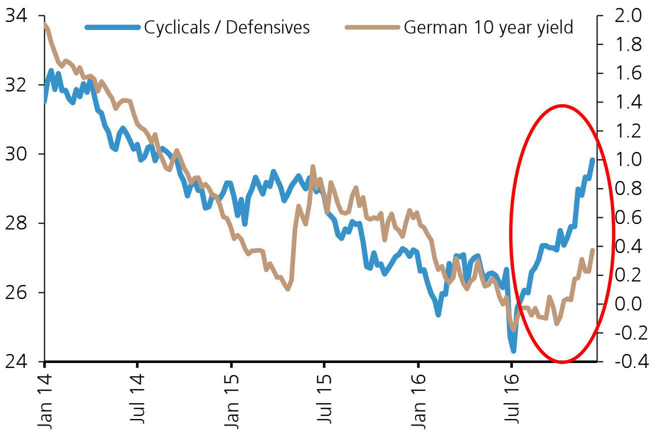
For performance to continue, we need to see a further rise in bond yields

Figure 19: Cyclicals vs. Defensives and US 10yr Yield (RHS)



Source: Datastream, UBS European Equity Strategy

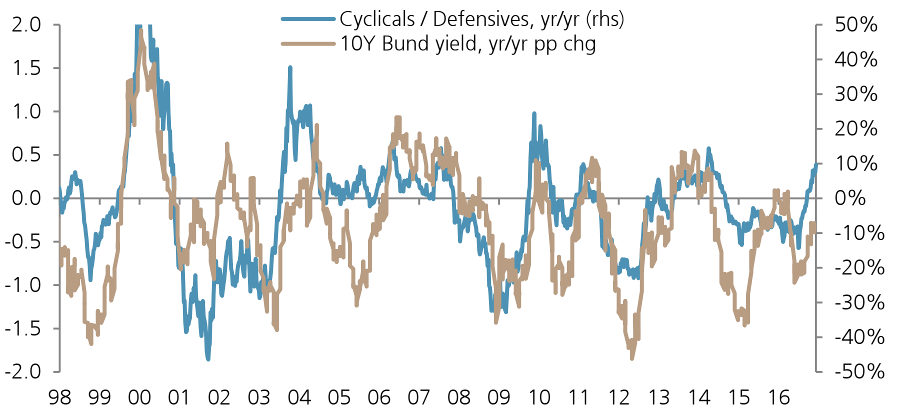
Figure 20: Cyclicals vs. Defensives and German 10yr Yield (RHS)



Source: Datastream, UBS European Equity Strategy

The longer run chart shows the relationship between the change in the performance of cyclicals vs defensives and the change in German 10yr Bond yields. This also suggest that the relative performance.

Figure 21: Cyclicals vs Defensives (YoY) vs 10yr Bund Yields (YoY)

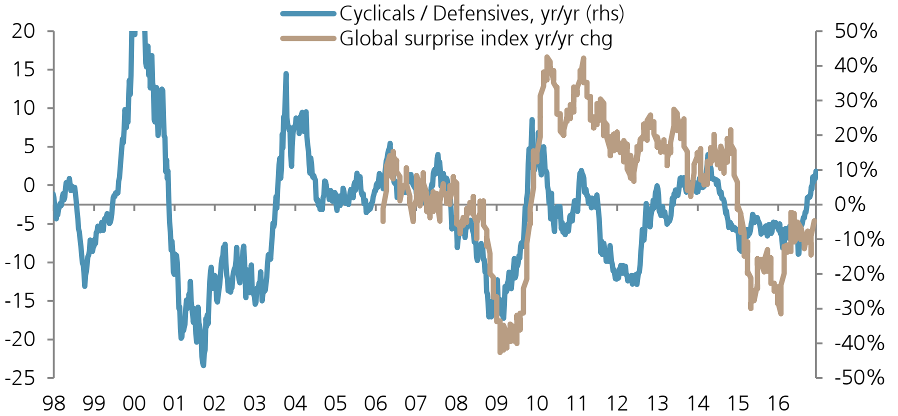


Source: Datastream, UBS European Equity Strategy

The move has outstripped the change in German Bond yields…

They have also been correlated to the move in our Global growth surprise index, which suggests that the current performance is "up with events" or maybe even beyond.

Figure 22: Cyclicals vs Defensives and macro surprises



Source: Datastream, UBS European Equity Strategy

…and the improvement in the macro backdrop

What about valuations?

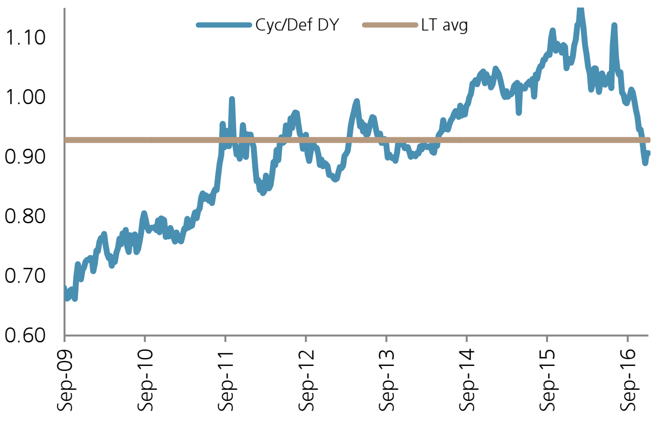
Valuations of cyclicals have normalised somewhat

Valuations have normalised somewhat after the outperformance of cyclicals. The dividend yield relative has fallen from a 13% premium at the market low on February 11 to a 6% discount - almost in line with the long run average.

The P/E relative has limitations as a measure given the massive cyclicality in earnings (it blows out to huge levels in 2009 as some cyclicals – such as autos - turn loss-making).

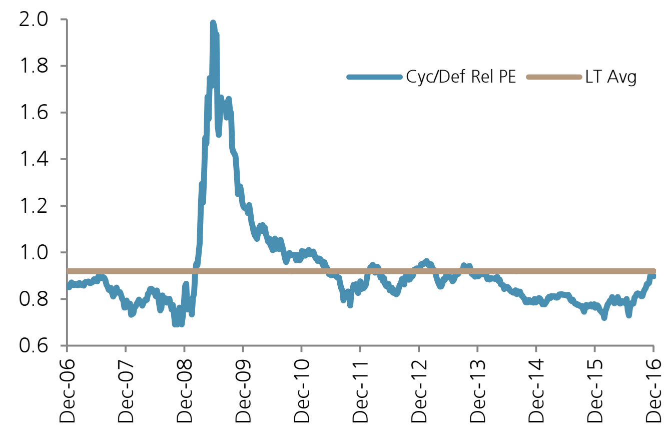
We are slightly overweight cyclicals in aggregate, but given our view on bond yields we would be more selective. The cyclical sectors we would overweight include: Energy, Autos, Software, Construction, Commercial Services and Tech Hardware.

Figure 23: Cyclicals vs Defensives DY



Source: Datastream, UBS European Equity Strategy

Figure 24: Cyclicals vs Defensives P/E

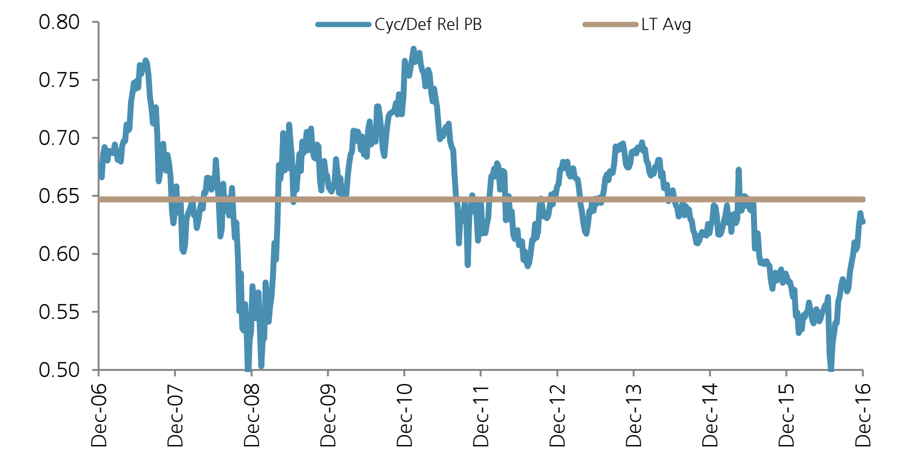


Source: Datastream, UBS European Equity Strategy

The P/BV relative is close to in line with the long run average, having hit a low of 0.5x on the low of the bond yields on July 7.

The P/BV relative has bounced back from c.0.5x at the low in bond yields

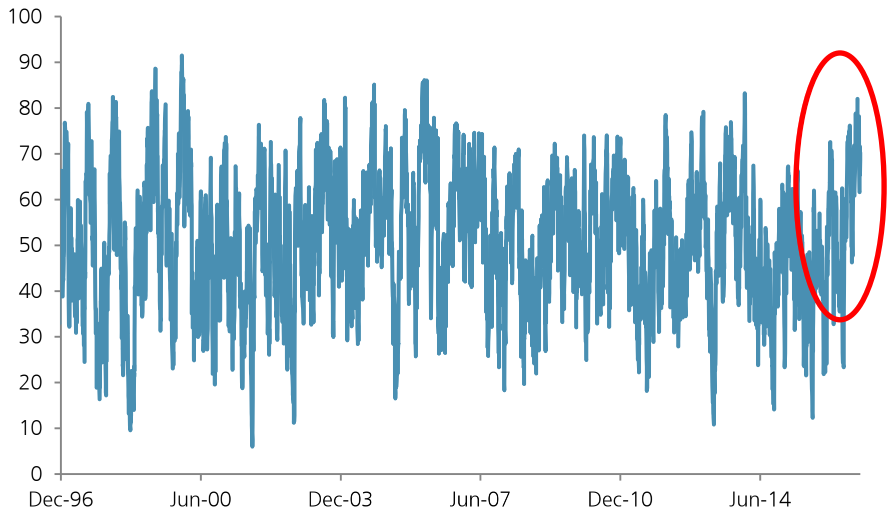
Figure 25: Cyclicals vs Defensives P/B



Source: Datastream, UBS European Equity Strategy

Finally, from a short term perspective the RSI of Cyclicals vs Defensives looks fairly extended.

Figure 26: Cyclicals vs. Defensives: Relative Strength Indicator



Source: Datastream, UBS European Equity Strategy

(3) Can European Equities survive the Political Calendar?

One of the downside risks that we highlighted in our Outlook report was the heavy political calendar in Europe

The Political calendar is busy into the New Year. We have navigated the Italian Referendum and the primaries for the centre-right in France, but still have the Dutch, French and German Elections in the next 9 months and presumably the UK triggering Article 50 at some point in Q1 2017.

For more details and analysis on some of the political risk and market impact please see:

Markets focus on the French elections 23 November 2016

Italy - The referendum and beyond 29 November 2016

Video: Italy – Referendum firmly rejected: What's next? 5 December 2016

Italian Banks - After the referendum all eyes on recapitalisation(s) 5 December 2016

Figure 27: Catalyst Calendar

Month	FOMC meetings	BoE MPC meetings	ECB MPC meetings	Parliamentary/Presidential Elections
Dec	13-14	15		
Jan'17	31-1	-	19	Singapore (parliament)
Feb	-	2	-	Germany*
Mar	14-15	16	9	Netherlands (parliament)
Apr	-	-	27	
May	2-3	11	-	France (president round 1) - 7
Jun	13-14	15	8	France (parliament round 2) - 18
Jul	25-26	-	20	India*
Aug	-	3	-	Singapore (president)
Sep	19-20	14	7	France (senate) - 24
Oct	31-1	-	26	Germany (parliament)
Nov	-	2	-	Slovenia (president)
Dec	12-13	14	14	South Korea (president)

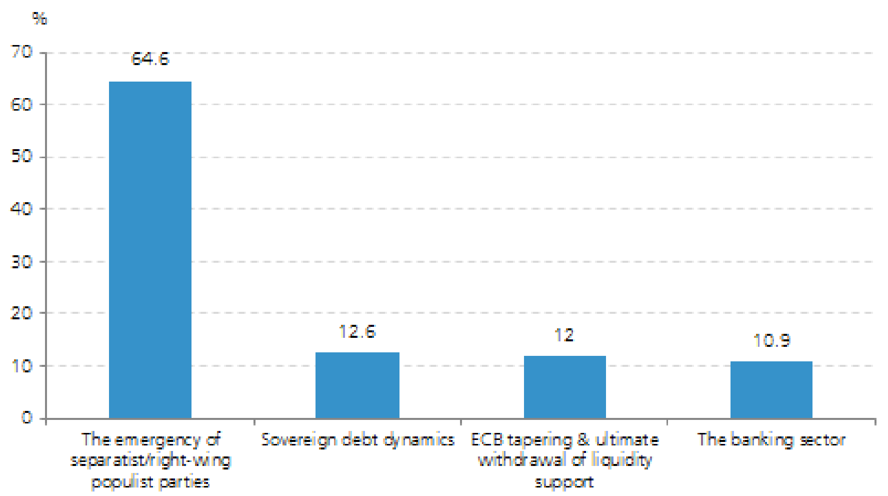
Source: UBS European Equity Strategy, BBC, FT, Google News - *President (by Parliament)

The Political calendar for Europe is busy

Politics seen as key by investors…

We see the politics as critical because it seems to be the biggest issue for investors, particularly international investors. Indeed, at our recent London conference, when asked what they thought was the biggest risk to European Equities for 2017, investors did not choose the banks, or the ECB tapering, but rather the rise of populist / extreme parties. What Your Peers are Thinking – UBS Conference 18 November 2016

Figure 28: What is your greatest concern about Europe right now?



Source: UBS London Conference, December 15

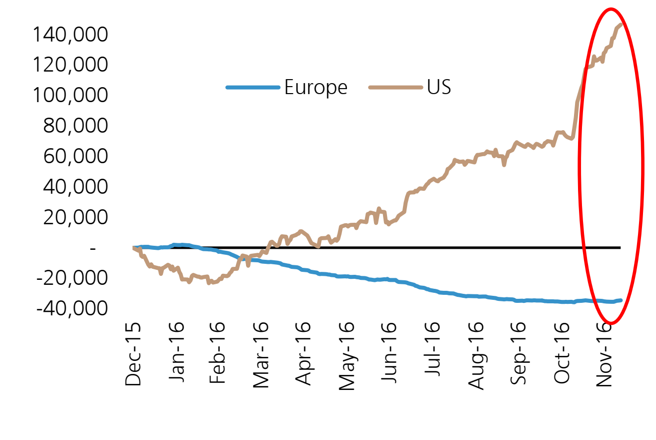
Investors - more concerned about politics than banks and the ECB

We would argue that the US investors are the key swing investors for Europe and we think they need two things to return to European Equities: (1) a convincing turn in earnings growth and (2) some stability in the political backdrop. We see the former coming through in Q1 as discussed above, the latter is maybe more tricky.

…which we can see in the flows: $145bn into the US YTD, vs $35bn out of Europe

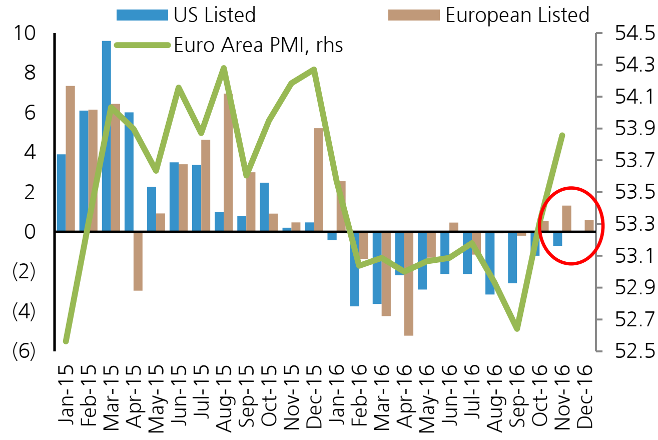
Below we show the ETF flows into US equities that have jumped up post Trump's election victory. At the same time, there had been steady outflows from Europe. Interestingly, the domestic have been buying in Europe over the last 3 months and post-US Election, even some early signs of US buying (Figure 30).

Figure 29: US vs Europe Equity ETF flows ($, mn)



Source: Bloomberg, UBS Global Equity Finance, UBS European Equity Strategy

Figure 30: US vs. European Net Buying of European Equity ETFs ($, bn)



Source: Bloomberg, UBS Global Equity Finance, UBS European Equity Strategy

(4) Sectors: Too late to be Bullish on the Energy sector?

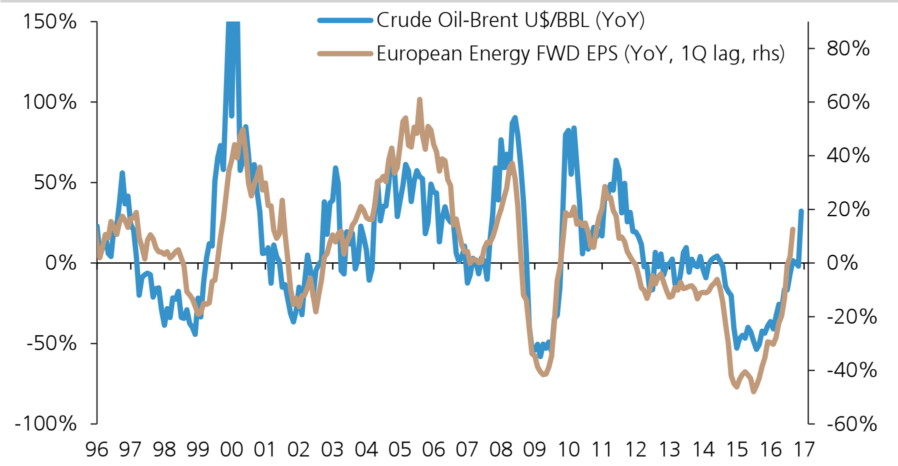
We upgraded the Energy sector 4 weeks ago…

We are Overweight the Energy sector as the commodity price drag on profits is likely to soon turn into a strong boost and the market does not appear to be pricing that in.

We believe EPS growth is key to drive performance for European stocks in 2017 since we have gone through a period of re-rating under no growth over the past few years. And on this point Energy appears to stand out as oil prices point to the sector being on the brink of a return to growth after nearly 5 years of declines. Crude prices are likely to hit close to 100% growth YoY by Q1 2017 and this could translate into a period of robust EPS growth for Oil stocks (Figure 31).

Figure 31: Oil prices point to earnings returning to growth soon and likely remaining there

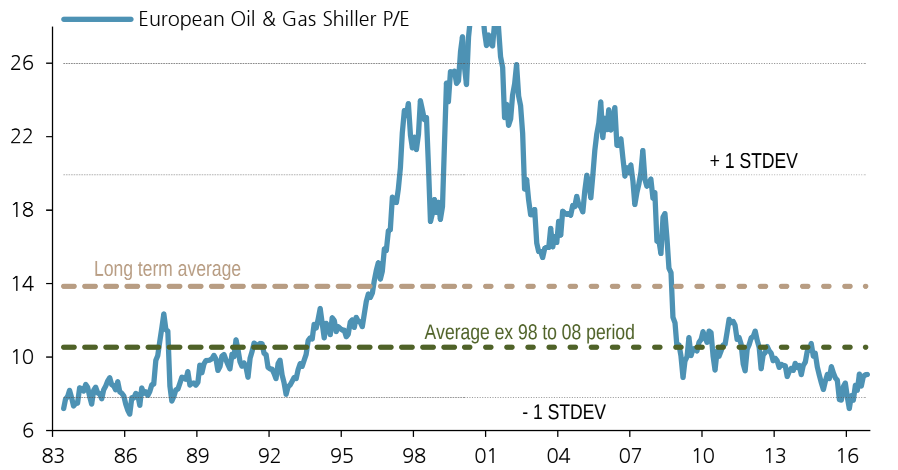
Energy EPS are returning to growth for the first time since late 2011



Source: UBS European Equity Strategy, DataStream

The Shiller P/E for the Oil & Gas sector is now at c8x. This is much lower than the long term average of c14x. Even if we disregard the decade between 1998 and 2008 as an abnormal "super cycle", the average valuation is still c10.5x and hence significantly greater than current levels (Figure 32).

Figure 32: The current Shiller P/E for the sector is significantly below historical average – even if we exclude the period between 1998 and 2008

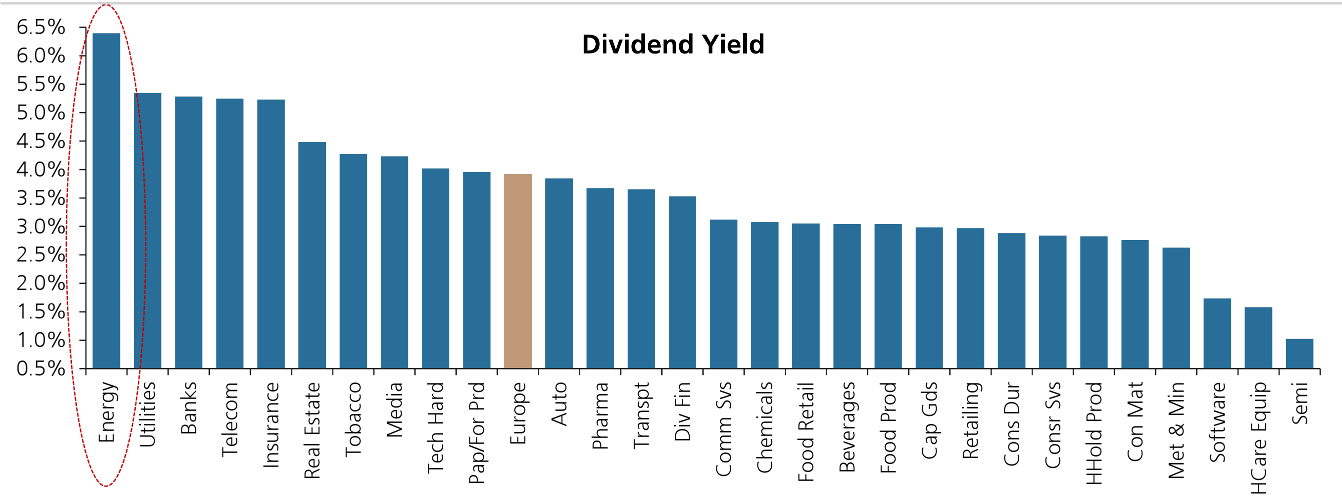


Source: UBS European Equity Strategy, DataStream

The sector trades at the lowest Shiller P/E since the early 90s

In addition, the sector offers the highest dividend yield in Europe by a significant margin (Energy offers c6.4% yield followed by Utilities, Banks and Telecoms).

Figure 33: Energy offers the largest Div Yield and is the second largest component of the European dividend



Source: UBS European Equity Strategy, DataStream

Moreover, the period of negative EPS growth that Energy corporates have gone through over the past few years was one in which cash flows were much more resilient than earnings. Hence, as the sector appears to be about to enter a period of profit growth Energy stocks could be in a stronger position to sustain dividend levels than current payouts might suggest and we could see payouts shrink via profit growth rather than dividend cuts.

What did we learn from our colleagues?

We spent the last 3 weeks marketing with our colleagues in macro strategy and sector analysts. We highlight some of their key points that have read across for European Equities and provide links to their documents for those who want to dig deeper.

What did we learn from our colleagues…?

(1) Economics: 2017 set to be first acceleration in nominal GDP growth for 7 years…

Our Global Chief economist, Arend Kapteyn, expects 2017 to be the first year of acceleration in global *nominal* GDP growth in 7 years.

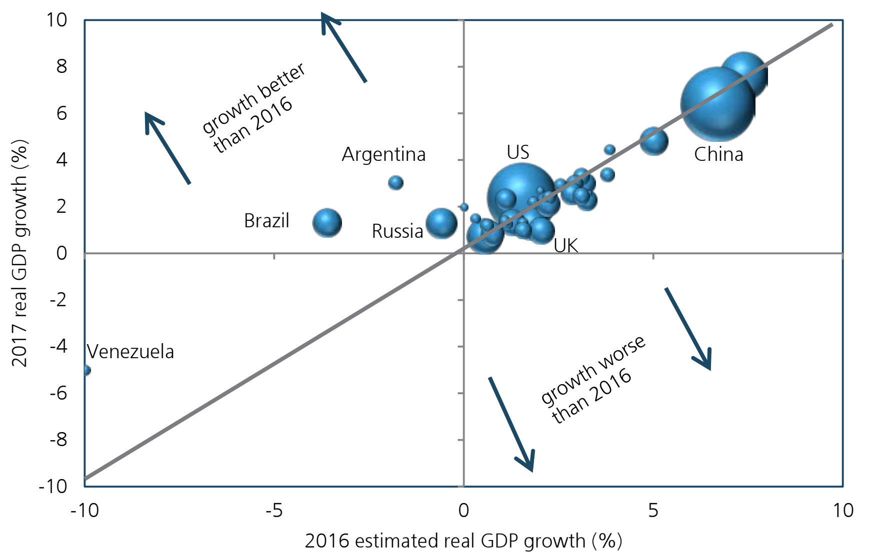
Nominal GDP growth set to accelerate for first year in 7yrs

We highlight below our Economics team's graphic that illustrates the delta for real GDP going into 2017. The size of the bubble refers to the size of the economy and those above the line are growing more quickly in 2017 than 2016. Roughly half of the pickup in Global growth is coming from the US where we see growth normalising to the post-crisis period (from 1.5% in 2016 to 2.4% in 2017). The other half of the pick-up comes from some of the larger EM economies, such as Brazil and Russia.

Global Economic Outlook 2017-2018 14 November 2016

Figure 34: The main growth acceleration is in EM (Brazil, Russia, Argentina rebound from contractions) and the US

Real GDP growth pickup driven by US and some larger EM (Brazil, Russia)



Source: UBS Estimates (Bubble size reflects PPP weight)

This fits with our PMI heatmap and the trend that we have been highlighting this year of emerging markets macro momentum getting better or "less bad".

Figure 35: Composite PMI Heatmap

2014												
US	0.1	-0.2	0.1	0.4	0.6	0.7	0.9	1.1	1.0	0.7	1.4	0.8
Japan	1.1	0.7	0.9	-0.4	0.1	0.3	0.3	0.4	0.9	0.2	0.5	0.7
Eurozone	0.2	0.2	0.2	0.4	0.3	0.1	0.3	0.1	0.0	0.0	-0.2	-0.2
UK	1.0	0.9	0.7	1.2	1.1	0.9	1.0	1.2	0.8	0.3	0.8	0.2
Germany	0.4	0.6	0.2	0.6	0.5	0.1	0.5	0.1	0.1	0.1	-0.4	-0.3
France	-0.6	-0.8	-0.1	-0.3	-0.5	-0.8	-0.5	-0.5	-0.7	-0.7	-0.8	-0.5
Spain	0.7	0.6	0.6	0.9	0.8	0.8	0.9	1.0	0.8	0.8	0.6	0.7
Italy	0.1	0.6	0.1	0.4	0.4	0.7	0.5	-0.1	-0.2	0.0	0.1	-0.2
China	-0.7	-1.0	-1.1	-1.1	-0.8	-0.2	-0.4	0.0	-0.2	-0.4	-0.6	-0.5
India	-1.1	-1.0	-1.2	-1.1	-0.9	-0.3	-0.5	-0.7	-0.7	-0.9	-0.3	-0.5
Brazil	-0.1	0.1	0.2	-0.1	-0.1	-0.1	-0.2	-0.1	0.1	-0.4	-0.4	-0.2
Russia	-0.7	-0.6	-1.1	-1.1	-1.2	-0.6	-0.4	-0.4	-0.5	-0.8	-1.1	-1.2
South Africa	0.0	0.4	-0.3	-0.5	-0.5	-0.7	-3.5	0.0	1.0	1.3	0.1	-0.3
Emerging Mkts	-0.5	-0.6	-0.9	-0.8	-0.7	-0.3	-0.5	-0.2	-0.2	-0.5	-0.5	-0.4
Developed Market	0.5	0.2	0.4	0.2	0.6	0.8	0.9	0.7	0.6	0.3	0.2	0.0
GLOBAL	0.2	0.0	0.1	-0.1	0.3	0.6	0.6	0.5	0.4	0.1	0.0	-0.2

2015												
US	0.7	0.7	0.7	0.8	0.5	0.0	1.3	0.9	0.6	0.9	0.5	0.3
Japan	0.6	0.3	0.2	0.4	0.6	0.6	0.6	0.9	0.5	0.8	0.8	0.7
Eurozone	0.1	0.2	0.4	0.4	0.3	0.4	0.4	0.5	0.3	0.4	0.4	0.5
UK	0.5	0.6	1.0	1.0	0.4	0.8	0.6	0.2	-0.2	0.2	0.3	0.2
Germany	0.0	0.1	0.4	0.1	-0.2	0.0	0.0	0.3	0.1	0.2	0.4	0.4
France	-0.5	0.0	-0.1	-0.3	0.0	0.2	-0.1	-0.4	0.0	0.1	-0.2	-0.4
Spain	1.0	0.9	1.0	1.3	1.2	0.9	1.2	1.3	0.7	0.7	0.9	0.8
Italy	0.1	0.1	0.4	0.7	0.6	0.7	0.6	0.9	0.6	0.7	0.7	1.1
China	-0.6	-0.3	-0.4	-0.5	-0.5	-0.7	-0.9	-1.3	-1.6	-1.0	-0.7	-1.1
India	-0.4	-0.4	-0.4	-0.6	-0.8	-1.2	-0.7	-0.5	-0.8	-0.5	-1.0	-0.7
Brazil	-0.2	0.2	-0.6	-1.2	-1.4	-1.8	-1.9	-1.1	-1.5	-1.5	-1.1	-1.3
Russia	-1.5	-1.7	-1.3	-0.5	-0.3	-0.7	-0.5	-0.8	-0.5	-0.8	-0.5	-1.1
South Africa	-0.2	0.4	1.0	0.6	-0.3	-0.8	-1.0	-0.5	-1.5	-1.5	-0.7	-1.4
Emerging Mkts	-0.6	-0.4	-0.5	-0.6	-0.8	-1.1	-0.9	-1.1	-1.3	-1.0	-0.9	-1.1
Developed Market	0.1	0.4	0.7	0.5	0.4	0.3	0.4	0.5	0.2	0.3	0.4	0.2
GLOBAL	0.0	0.2	0.5	0.3	0.1	0.0	0.1	0.2	-0.1	0.0	0.1	-0.1

2016											
US	-0.2	-0.2	0.1	0.4	-0.2	0.6	0.4	-0.6	0.7	0.2	0.8
Japan	0.8	0.5	0.3	0.1	0.1	0.1	0.3	0.2	0.1	0.6	0.7
Eurozone	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.1	0.2	0.4
UK	0.4	-0.4	-0.2	-0.5	-0.3	-0.4	-1.6	-0.2	-0.1	0.1	0.2
Germany	0.2	0.1	0.1	0.0	0.2	0.2	0.4	0.0	-0.2	0.4	0.3
France	-0.4	-0.5	-0.4	-0.4	-0.2	-0.5	-0.4	-0.1	0.1	-0.1	-0.1
Spain	0.8	0.7	0.8	0.8	0.7	0.9	0.6	0.7	0.6	0.7	0.8
Italy	0.6	0.6	0.4	0.5	0.0	0.4	0.3	0.3	0.1	0.1	0.6
China	-0.9	-1.1	-0.5	-0.7	-0.8	-0.8	-0.3	-0.3	-0.5	0.0	0.0
India	-0.4	-0.8	-0.2	-0.5	-0.9	-0.8	-0.6	-0.2	-0.6	0.0	-1.2
Brazil	-1.0	-2.2	-1.9	-2.2	-2.4	-1.6	-0.7	-1.2	-0.8	-1.1	-1.0
Russia	-1.0	-0.5	-0.5	-0.4	-0.4	0.1	0.1	-0.1	0.0	0.1	0.5
South Africa	-0.2	-0.6	-2.1	-1.0	-0.1	-0.5	-0.1	0.1	0.2	0.6	0.3
Emerging Mkts	-0.9	-1.2	-0.8	-0.9	-1.0	-0.9	-0.4	-0.5	-0.6	-0.3	-0.5
Developed Market	0.1	-0.3	-0.3	-0.2	-0.3	-0.3	-0.3	-0.3	-0.2	0.2	0.3
GLOBAL	-0.1	-0.6	-0.4	-0.4	-0.5	-0.5	-0.4	-0.4	-0.3	0.1	0.1

Source: Haver, UBS European Equity Strategy; Note: PMI z-scores based on data from 2005 onwards

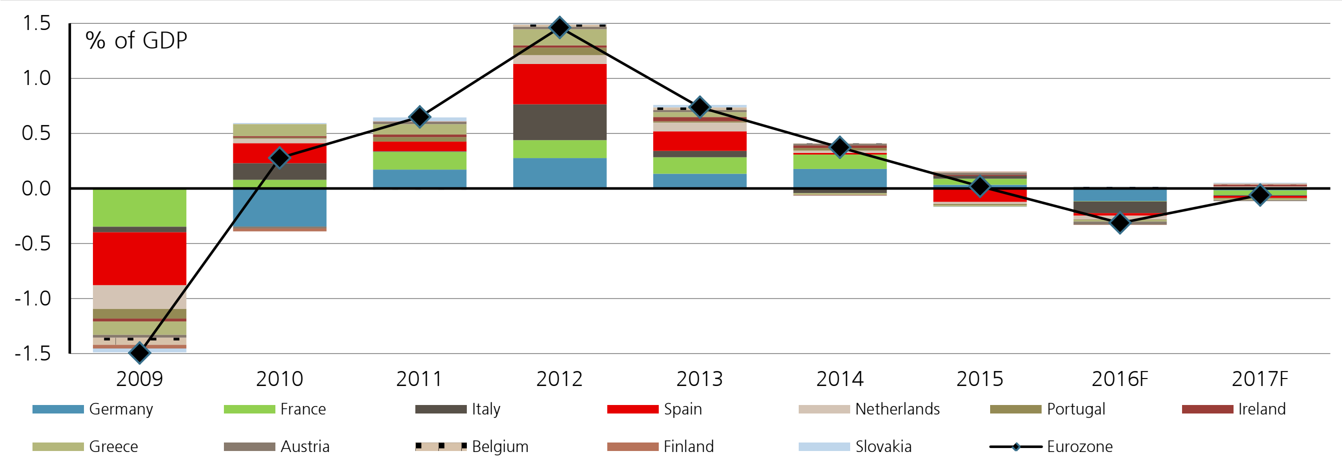
What about fiscal policy in Europe?

In the Eurozone, our Economics team do not expect a sharp acceleration in fiscal stimulus, but they see it as an upside risk to their central scenario for GDP growth if it were to occur.

Macro Keys - A big fiscal push in the Eurozone? 2 December 2016

We would highlight that for companies exposed even to a small amount of fiscal stimulus, if spent in the right direction, could be important – *please see*: Fiscal Fitness – Is Global Spending "Bulking Up"? 3 November 2016

Figure 36: "Fiscal effort" (reduction in structural budget deficit) in the Eurozone (% of Eurozone GDP)*



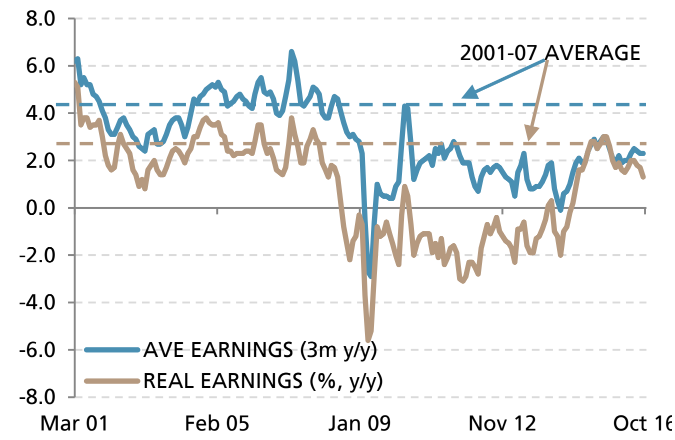
Source: UBS European Economics Team, European Commission * Contribution from individual countries is GDP-weighted

We are more cautious on the outlook for the UK than the rest of Europe and work from our UK economist, John Wraith, shows how real earnings growth may well turn negative next year as inflation picks up (Figure 37). In turn, this points to a potential slowdown in the domestic economy and is linked to retail sales (figure 38). Whilst 75% of FTSE 100 revenues come from overseas we still expect a drag from domestically exposed stocks.

UK domestic economy set to slow in 2017 as real wages roll over…

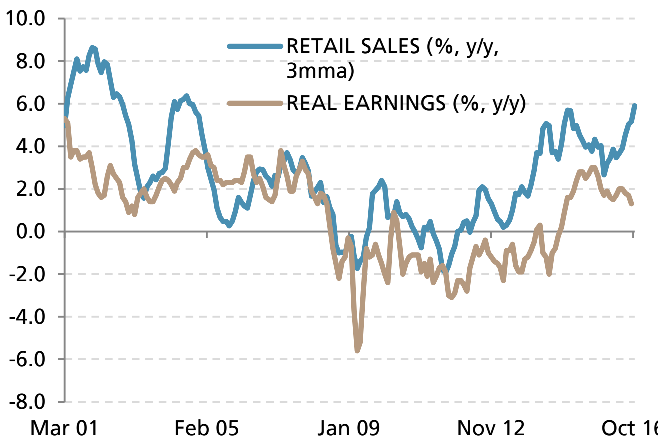
For more details please see the UK section of [Economic Outlook 2017-18](#) 15 November 2016

Figure 37: Real earnings growth: starting to roll-over…



Source: UBS Economic Team, Bloomberg, ONS

Figure 38: Real earnings are well correlated with retail sales…



Source: UBS Economic Team, Bloomberg, ONS

(2) Macro Strategy – potential fiscal impact…

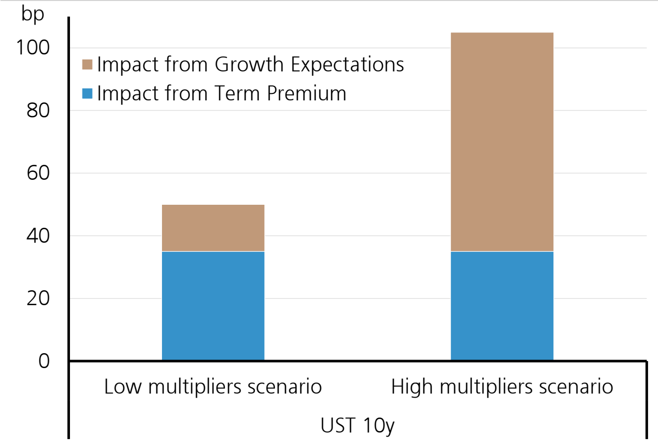
Our Global macro strategy team have looked at the potential impact of significant fiscal easing in the US, post Trump's election victory. Their conclusion is that the key question is whether there are powerful fiscal multipliers or not. Below we show their analysis of the impact on the US 10yr, USD and S&P 500 of each assumed impact of each $1trn additional fiscal easing spread over 10 years.

What's the potential impact of US fiscal easing?

For more details on this topic please see: *[Global Macro Strategy - Fiscal easing: How much hope is in the price?](#)* 10 November 2016

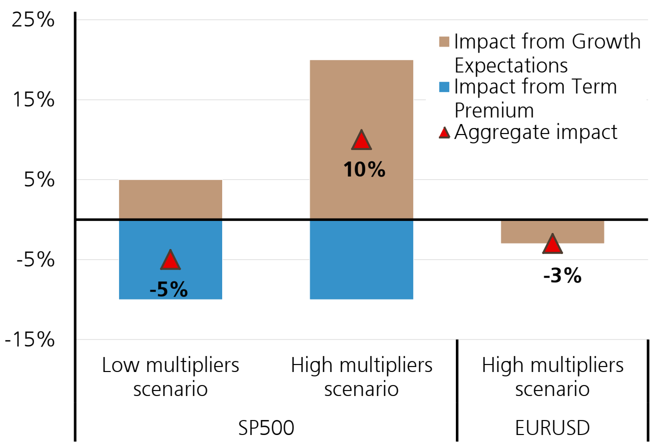
Also see their year ahead trades: [Top Macro Trades for 2017](#) 7 December 2016

Figure 39: In light of a potential fiscal stimulus package, UST 10y rates would move higher…



Source: Bloomberg, UBS Macro Strategy

Figure 40: … while risk assets still seem to perform well in a high multiplier scenario.



Source: Bloomberg, UBS Macro Strategy

(3) Oil – just how big have the capex cuts been?

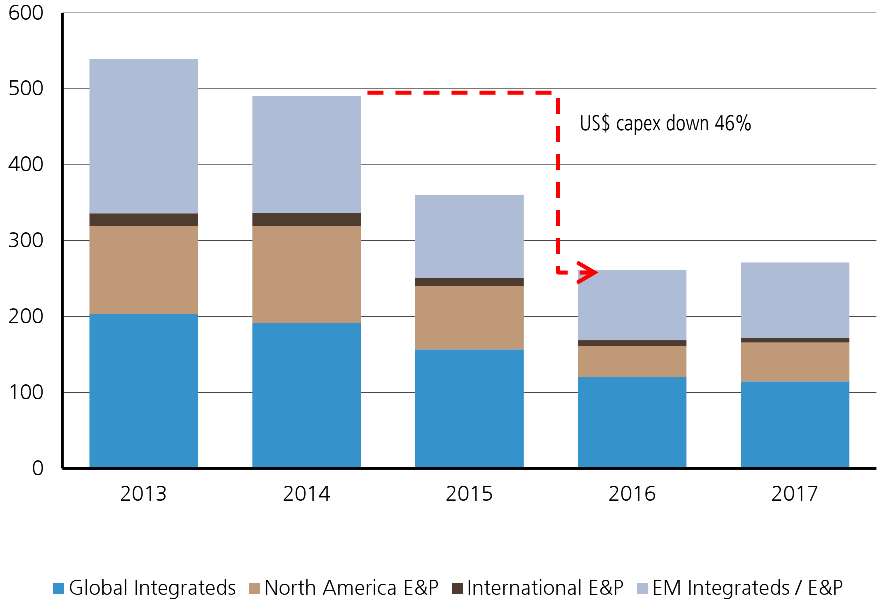
Oil capex cuts are set to lead to lower conventional supply

Our head of European Oil research, Jon Rigby, has highlighted the large cuts in upstream capex. UBS estimates that its global coverage universe of 79 major oil companies will cut upstream capex by 46% over 2014-16. This is equivalent to ~$220bn in annual upstream investment forgone. This figure would be closer to $530bn if we were to gross up for partner participation, roughly the GDP of Belgium.

The cut in capex has set up a dynamic that will likely mean lower supply in the future, meaning c. 4mbd lower conventional production capacity by 2020.

Within our European Sector Strategy we upgraded the Energy sector from Neutral to Overweight on November 15 – please see page 14 above for more details.

Figure 41: Global Upstream capex ($bn)



Source: UBS European Oils Research

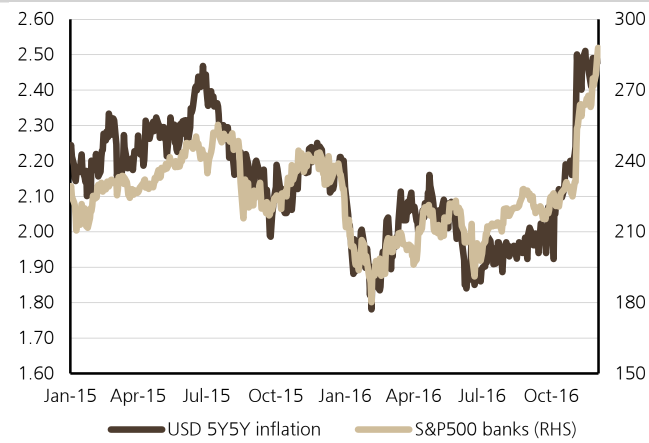
(4) Banks – Reflation trade?

Banks have followed the "reflation trade"...

Our banks team highlight that the US banks have tracked closely with the move up in inflation expectations, but the Europeans have been slightly less correlated in the last leg higher.

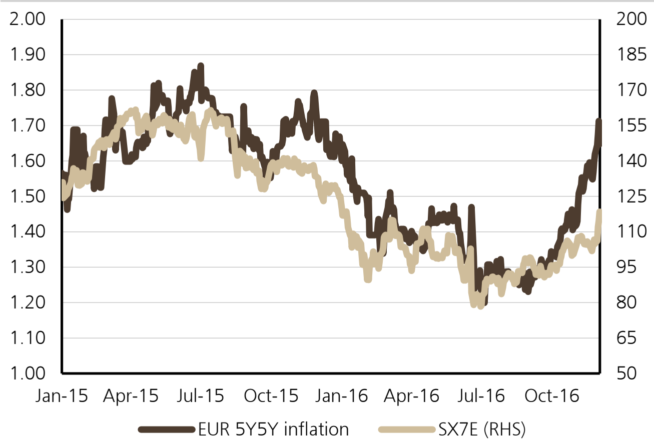
For more details please see our banks team's report [UK Banks - UBS Evidence Lab: Rising inflation, falling mortgage rates] 6 December 2016

Figure 42: US bank performance has correlated pretty well with inflation expectations the last 2 years…



Source: Datastream, UBS European Banks

Figure 43: … with the Euro area performance slightly less correlated in the last leg higher



Source: Datastream, UBS European Banks

Valuation Method and Risk Statement

Risks include macroeconomic variables (such as GDP growth rates and inflation), economic slowdown, a weakening currency, global economic events, and government policy changes.

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12-Month Rating	Definition	Coverage[1]	IB Services[2]
Buy	FSR is > 6% above the MRA.	45%	28%
Neutral	FSR is between -6% and 6% of the MRA.	39%	25%
Sell	FSR is > 6% below the MRA.	15%	17%
Short-Term Rating	**Definition**	**Coverage[3]**	**IB Services[4]**
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%

Source: UBS. Rating allocations are as of 30 September 2016.
1:Percentage of companies under coverage globally within the 12-month rating category.
2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.
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UBS Limited: Nick Nelson; Karen Olney, CFA; Joao Toniato; Andras Nagy, CFA.

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