UBS House View

Europe
Chief Investment Office WM

Weekly

4 May 2017

Market moves

	CIO view	–1w	– 3m	ytd
S&P 500	OW	0.0%	4.5%	7.4%
Euro Stoxx 50		1.3%	11.4%	11.1%
MSCI EM		0.6%	7.8%	14.9%
FTSE 100		–0.4%	2.4%	3.1%
SMI		1.1%	9.8%	11.5%
NIKKEI 225		1.9%	3.6%	2.5%
US high grade bonds	UW	0.0%	1.7%	2.1%
Euro high grade bonds	UW	0.4%	0.9%	–0.5%
US investment grade bonds		0.1%	2.2%	2.3%
Euro investment grade bonds		0.3%	1.3%	0.9%
US high yield bonds	OW	0.3%	1.9%	3.5%
European high yield bonds		0.5%	2.3%	3.3%
EM sovereign bonds		0.3%	3.1%	5.9%
EM corporate bonds		0.0%	2.5%	4.3%

Source: Bloomberg, UBS as of 4 May 2017
OW = tactical overweight
UW = tactical underweight

Market comments

Calculations are based on the past five days

- Equity markets had a mixed week, with the S&P 500 flat while the Euro Stoxx 50 climbed 1.3%. The FTSE 100 was down 0.4%.
- Fixed income investors pushed US high yield bonds 0.3% higher, while euro high yield climbed 0.5%. US high grade bonds were flat on the week.
- Currency traders pushed the yen 1.4% lower versus the US dollar. But the US currency rose 0.5% versus the euro and 0.25% against the Swiss franc.

In focus

A hawkish hold from the Fed? At its May meeting, the Fed expressed confidence that the recent weakness in US data – including a soft first quarter GDP reading – is likely to be temporary. So although rates stayed on hold, the meeting caused investors to scale up expectations for a June hike to 90% from 67% prior to the meeting, based on Bloomberg data. *CIO expects the Fed to hike rates by 25bps in both June and December.*

A bigger Brexit bill? Could the price of leaving the EU rise to EUR 100bn for the UK? Media reports suggest this is the latest proposal from the EU negotiators, up from an initial EUR 60bn. While the sum itself isn't financially significant for the UK, a large exit bill could hamper negotiations on a trade deal. *Despite the discouraging start to talks, the UBS Chief Investment Office (CIO) believes the UK will come to acceptable terms with the EU.*

Eurozone growth on track. GDP growth held steady in the first three months of the year at 0.5%, in line with expectations. The Eurozone has now been growing continuously since the second quarter of 2013, recovering from a year-and-a-half long contraction. With unemployment at a seven-year low, the Eurozone economy continues to gain ground – a positive backdrop for the euro. *CIO believes the European Central Bank (ECB) will soon start to prepare the markets for a reduction in monetary easing, with bond purchases slowing early in 2018. We are overweight the euro versus the US dollar.*

Coming up roses in Switzerland? The Swiss Purchasing Managers' Index (PMI) slipped only slightly in April to 57.4 from 58.6 in March. Such a high level – a reading above 50 indicates an expanding economy over the coming months – reflects upbeat sentiment in Swiss industry and comes alongside with strong readings from France and Germany. This may even point to upside risk for CIO's GDP growth forecast of 1.4% for the alpine country this year. The outlook could be threatened if a Marine Le Pen win in the French election on 7 May pushes up the Swiss franc. *CIO attributes only a 25% probability that Le Pen will be elected the new French president.*

US volatility index at decade low. The VIX, Wall Street's fear gauge, closed at its lowest level since February 2007 on 1 May. The index at one point dropped below 10, down from a peak in April of 16 and well below the average since 1990 of 19.5. The expectation of calm trading appears to reflect the strength of US earnings growth for the first quarter, along with reduced geopolitical risk following the first round of the French presidential election. *CIO believes that such low volatility may not be sustainable but that equities are supported by strong earnings momentum.*

Welcome weakness for the yen. The Japanese currency fell to its lowest level in more than a month against the US dollar on 2 May, with the USDJPY trading at 112. The yen serves as a safe haven for investors at times of heightened risk aversion, so the recent burst of global investor optimism has undermined the currency. *CIO believes the Bank of Japan will see the yen's recent weakness as good news, since it supports Japan's export-oriented economy and should increase companies' willingness to raise wages. CIO is neutral on Japanese equities in its global tactical asset allocation.*

Eurozone inflation on the rise. Core inflation for the Eurozone hit its highest level since 2013, rising to 1.2% in March from 0.7%. The rise, if continued over the coming months, may help convince the ECB that headline inflation should follow and move sustainably toward its price stability target of near, but below, 2%. Assuming a market-friendly outcome of the French presidential race on 7 May, the ECB is likely to start preparing the market for a gradual reduction in monetary easing. *CIO is overweight the euro versus the US dollar in its global tactical asset allocation.*

100 days of Trump

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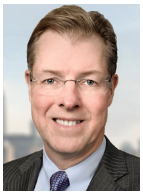
Deeper dive

Unfinished business: The first 100 days of the Trump presidency



Mark Haefele

Mike Ryan

While care must be taken not to exaggerate the importance of the first 100 days of an administration, the early days are nonetheless important for establishing priorities and setting the tone. For President Donald Trump, early indications are "mixed." Although the US president has signed 29 bills into law – the fastest pace since Harry Truman – two thirds of the bills have dealt with mundane matters unlikely to engender partisan opposition. The remainder repealed rules promulgated under former President Barack Obama. He did succeed in his effort to put Neil Gorsuch on the Supreme Court though. But he has enjoyed limited success on several of his oft-noted priorities:

Global engagement. Although geopolitics has been anything but quiet, Trump has taken a far more pragmatic approach to trade and immigration than many had feared. Most notably, his administration has not yet branded China a "currency manipulator" as he threatened to do on the campaign trail.

Regulatory relief. Uniting with congressional efforts, the administration has rolled back dozens of Obama-era rules using the Congressional Review Act and a series of 57 executive orders and memoranda aimed at simplifying and limiting federal regulation. Yet, these successes have been overshadowed by the GOP's high-profile failure to pass major legislation, especially with regard to health care.

Tax reform. Although not a fatal blow, the American Health Care Act failure threatens positive legislative momentum and delays Republicans' tax reform efforts. The measures proposed spending and revenue cuts would also build important room for tax negotiations. While tax reform may now appear more limited in scope, we still expect successful legislation that includes repatriation and a headline corporate tax cut to be implemented by early 2018.

Spending initiatives. Trump's unorthodox approach to governing presents both a risk (too much left unanswered) and an opportunity (room for compromise). His "skinny budget," aimed at finding USD 54bn to boost defense, required deep cuts to other departments and programs, foreshadowing some of the difficult compromises that will be required for larger-scale programs such as his hoped-for 10-year, USD 1 trillion infrastructure package. A staple of the president's campaign trail rhetoric, the framework for that initiative has yet to be devised and has taken a back seat to higher-profile debates over health care and taxes in Congress.

If we were to "grade" Trump's first 100 days, it would be an "incomplete." There has been little concrete progress on his pro-business priorities, but he still has 1,360 days of his 1,460, or 93% of his term left. As with other presidencies, it will take time for Trump's legacy to take shape.

In short, the administration still has a lot of "unfinished business." But it's important to keep in mind that it's not the first 3½ months that matter, but the next 3½ years or so.

Mark Haefele
Global Chief Investment Officer
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Bottom line

It's too early to weigh the impact of the Trump administration's policies, but fundamentals matter more than politics. Against a backdrop of a solid economic expansion, supportive global monetary policy, and accelerating earnings growth, the market is fundamentally well-supported. We remain tactically overweight on global equities, US equities, and high yield corporate bonds relative to high-quality corporate and government bonds.

100 days of Trump

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Regional view

Assembling the puzzle

Matteo Ramenghi
Chief Investment Officer UBS WM Italy

The European electoral calendar will remain eventful beyond the French elections. In just over a month, the UK will hold early general elections, it will be Germany's turn in September, and Italy's legislature ends in February next year, with early elections also possible.

Matteo Renzi resigned as PM and as leader of the center-left Democratic Party (PD) in December, after Italian voters rejected his proposed constitutional reform. But last Sunday, the PD held primaries and an overwhelming majority voted in his favor, paving his return to the front line of Italian politics.

The main surprise in the PD primaries was the very high participation. Nearly two million people voted, almost double the expected turnout, but still below the 2013 turnout. Renzi received around 70% of the vote, leaving his main competitors, Justice Minister Andrea Orlando and governor of Puglia Michele Emiliano, trailing in his wake.

The PD has struggled recently, and even lost its leftist wing when the latter split off to form a new movement. Renzi's clear victory should help bring greater unity to the PD ranks. In the medium term, this should be positive, particularly in light of the next elections.

Italy's general election, will most likely fall co in early 2018 in our opinion. If PD performs strongly in the local elections in June, Renzi may be tempted to use his recovered popularity to push for early elections in the fall. However, President Sergio Mattarella, and most of the political parties, favor waiting for the current parliamentary term to expire in February 2018, and would like a new electoral law reform to be approved before the next elections.

How that vote might turn out remains uncertain. As of today, we only know who will be the leader running for PD, but the other contenders remain unknown. The center-right remains highly fragmented, while the anti-establishment Five Star Movement has so far held onto its support despite Virginia Raggi's struggles as mayor of Rome. While surveys are sometimes unreliable, the most recent polls suggest that if an election was held today, there would be no political party or coalition boasting a clear majority. In such a scenario, a hung parliament – and quite likely yet another election – would be a clear possibility, while reforms would be inevitably delayed.

> "Investors probably need better visibility on political stability to reconsider their stance on Italian assets."

But there's a long way to go. Developments in the economic and employment data, immigration as well as the outcome of the French and German elections will certainly have some influence on the Italian political scene.

The market has also been worried about the falling support for the euro and the risk of an Italian referendum to pull out from the single currency. We see a euro referendum as a highly unlikely scenario. The Italian constitution does not allow a referendum on international treaties and fiscal matters; to change that would take a government with a strong majority in place for years – something that presently looks unlikely. Even the Five Star Movement, with no official position on the euro while demanding a referendum to give it democratic legitimacy, allowed that the Constitution would need to be changed for that to happen.

Political instability is overshadowing improving economic data, as well as a forceful restructuring of the banking sector, where we expect the largest players' valuations to benefit from falling risk premiums over time. Investors probably need better visibility on political stability to reconsider their stance on Italian assets.

Kind regards,
Matteo Ramenghi

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