

Deeper dive

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### Market moves

	CIO view	-1w	-3m	ytd
S&P 500	OW	0.7%	6.6%	2.7%
Euro Stoxx 50		0.1%	7.2%	-0.7%
MSCI EM		0.7%	5.1%	6.9%
FTSE 100		0.9%	4.8%	1.0%
SMI		1.7%	6.6%	2.4%
NIKKEI 225		0.0%	16.5%	-1.1%
US high grade bonds	UW	0.6%	-0.8%	1.0%
Euro high grade bonds	UW	1.0%	-1.4%	-0.9%
US investment grade bonds		0.8%	0.5%	1.0%
Euro investment grade bonds		0.4%	-0.3%	0.0%
US high yield bonds	OW	0.4%	3.7%	1.6%
European high yield bonds		0.2%	2.4%	1.0%
EM sovereign bonds		1.1%	0.6%	2.9%
EM corporate bonds		0.6%	1.7%	2.1%

Source: Bloomberg, UBS as of 9 February 2017

OW = tactical overweight

UW = tactical underweight

### Market comments

Calculations are based on the past five days

- **Equities** had a strong week across the board, with the S&P 500 gaining 0.7% and the Swiss SMI 1.7%. Emerging market stocks were up 0.7%.
- **Fixed income** markets advanced, with US high yield bonds climbing 0.4% and European high yield 0.2%.
- **Currency markets** were notable for a broad appreciation of the US dollar, which advanced against the euro, Australian dollar and Swedish krona.

## In focus

**US payroll paradox.** The monthly jobs data was a head-scratcher. On the bright side, job growth was stronger than expected at 227,000 in January, versus a consensus forecast of 180,000. But the unemployment rate rose and wage growth slowed. The outcome suggests there is still slack in the labor market, allowing the Federal Reserve to refrain from rate rises for longer. The data mix suggests companies are still able to find workers easily without ramping up wages, a positive outcome for profits. *That supports CIO's overweight position in US equities versus government bonds.*

**U-turn for USD.** The US dollar rallied against a broad basket of currency peers on 7 February following comments from a Federal Reserve voter that a March US rate hike is possible. The Bloomberg Dollar Spot Index bucked four straight days of losses to rally 0.8% to its highest level since end-January. Philadelphia Fed President Patrick Harker backed three Fed rate hikes this year, and described a March hike as "a potential" in comments Monday. *CIO expects the US dollar to peak this year due to falling US real interest rates and potential disappointment on growth-boosting fiscal spending. CIO is underweight on the USD versus the euro in its global tactical asset allocation.*

**Who's afraid of Le Pen?** The yield gap between French and German 10-year bonds hit a four-year high. French yields briefly climbed to 79 basis points above their German counterparts on 8 February, before falling back to 76 bps. The recent widening of the spread reflects worries that National Front candidate Marine Le Pen might pull off a surprise victory in the upcoming presidential race. *CIO believes Le Pen, who has suggested a return to the French franc, has a 40% chance of becoming France's next leader.*

**Has India hit its rate floor?** The Reserve Bank of India (RBI) defied widespread expectations that it would cut

interest rates, instead maintaining its benchmark borrowing cost at 6.25%. The central bank's governor said he expected the Indian economy to rebound later this year, after a lull in activity due to the government's ambitious demonetization drive. But he added that the RBI had "flexibility in either direction." *CIO is overweight on Indian equities in its Asia-Pacific tactical asset allocations.*

**No rest for reserve falls.** China's FX reserves fell to USD 2.998trn in January, below December's USD 3.011trn mark and worse than market expectations that currency coffers would stay above USD 3trn. That's the seventh straight month of declines as capital outflows continue. A stronger yuan in January may flatter the capital exit – strip out currency effects, and outflows appear to have accelerated to USD 82.7bn in January, compared to around USD 75bn in December. CIO believes that Chinese FX reserves will stay under pressure this year, likely reaching USD 2.7–2.8 trillion by year-end. *CIO expects the yuan to weaken, forecasting a USDCNY rate of 7.2 in six and 12 months.*

**Angst in Athens.** Short-term Greek government debt yields rose to their highest level in eight months on 7 February, after news of a split on the board of the International Monetary Fund (IMF) appeared to throw into doubt the lender's participation in a bail-out program. Two-year debt yields climbed by more than 20 basis points and breached 9% at the time of writing. IMF participation in the EUR 86bn Greek rescue is required for other partners like the European Union to disburse more cash. Greece needs to repay close to EUR 7bn by July, but needs more funds to meet these payments. *CIO does not expect Greek woes to derail the gradual improvement in the Eurozone economy in the first half of this year. The real Eurozone economy is forecast to expand 1.5% this year.*

## Deeper dive

# Will Europe's elections derail markets this year?

Politics loomed large for Anglo-Saxon nations last year. Now it is Europe's turn. Elections in France, the Netherlands, and possibly Italy could unsettle investors by increasing the sway of anti-European populists. So how great is the threat?

The main worry for investors is that this year's elections might further undermine the EU and the single currency. Geert Wilders, whose Party for Freedom is on track to win the most seats in March's Dutch election, has called for a vote on withdrawing from the EU. France's Marine Le Pen, the National Front leader, implied that France will leave the euro if she is elected, and a referendum on EU membership could also occur. And Italians may be visiting the ballot box at a time when the anti-euro Five Star Movement rivals the incumbent socialist party in the polls.

On the bright side, the risk of anti-EU populists getting their way is low in most cases. Polls still show that Le Pen, though in the lead for the first round of the presidential elections, would be soundly defeated by either of her two main rivals in a second round. And even if she were to claim the French presidency, an outcome to which CIO assigns a roughly 40% probability, she would still need to secure parliamentary agreement for a Frexit vote, and to win it.

Polls suggest that close to 70% of French voters oppose a return to the franc, one of Le Pen's campaign pledges. Similarly, if Wilders emerges on top in the Netherlands, his party would struggle to find coalition partners or convince the Dutch public to back an exit from the EU. Among this group of nations only Italy exhibits relatively fragile support for the euro.

Of course, populists don't need to take the reins of government to impair the outlook for growth or markets. If anti-EU parties gain ground in national parliaments, they



**Mark Haefele**



**Themis Themistocleous**

could hinder economic reforms and European integration, while blocking further help to struggling Eurozone peers such as Greece.

In the meantime, uncertainty could put upward pressure on the bond yields of vulnerable countries. (Worries over the political outlook in France have already caused the 10-year government bond spread over German bunds to widen to a three-year high of around 75 basis points.) This trend, if continued, could contribute to a slowdown of economic growth, which has recently been holding up well.

Yet the worst-case scenario of a euro or EU exit by France, the Netherlands, or Italy still looks unlikely. In addition, the German election may lift markets. Chancellor Angela Merkel and her Christian Democratic Union look likely to hold onto power. Even a win for her main rival, Social Democratic candidate Martin Schulz, might prove market friendly as it could shift policy toward higher government spending and greater tolerance of deficit spending by governments in Europe's periphery. This outcome could provide additional support for the Eurozone economy as a whole.

Finally, as was the case last year, solid economic growth and improving earnings should enable risk assets to cope with heightened uncertainty. Global real growth should speed up to 3.6% this year from 3% last year – higher nominal growth is already expanding profits in major regions.

### **Mark Haefele**

Global Chief Investment Officer  
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### **Themis Themistocleous**

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## Bottom line

Political surprises remain possible. Investors should remember that betting markets assigned only a roughly 20% chance of the UK voting for Brexit or a Trump victory on the eve of the results. But while Europe's elections may

cause volatility and could exert modest downward pressure on growth, a blow to global risk assets looks unlikely. Solid global growth and improving earnings should help offset the dampening effect of political uncertainty.

## Regional view

## M&amp;A – does it pay?



**Bert Jansen**  
European Equity Strategist

*“Go for a business that any idiot can run – because sooner or later, any idiot probably is going to run it.”*

Peter Lynch, stock investor

*“I have never cared what something costs; I care what it’s worth.”*

Ari Emanuel, co-CEO of WME

*“Investors can always buy toads at the going price for toads. If investors instead bankroll princesses who wish to pay double for the right to kiss a toad, those kisses had better pack some real dynamite. We’ve observed many kisses but very few miracles. Nevertheless, many managerial princesses remain serenely confident about the future potency of their kisses – even after their corporate backyards are knee-deep in unresponsive toads.”*

Warren Buffett

Despite all the political surprises, last year was a good one for European merger and acquisition (M&A) activity. The total value of corporate deals in Europe amounted to just over USD 1.0trn. This number was exceeded only in 2006–2007, at the top of the credit bubble.

The main factors behind this boom were boardroom confidence, an exceedingly low cost of corporate debt and pressure to improve profits and profitability in a slow-growth economy. Although equity markets have risen significantly over the past eight years, the value of M&A deals as a percentage of the total market value has risen as well, to 5%, close to the all-time high of 6% reached at the top of the dotcom bubble in 2000.

*“Identifying potential targets is one thing, but getting the timing and the price that will be paid right are quite another.”*

Such buoyant corporate activity leaves investment bankers giddy with delight, but does M&A pay off from an investor’s point of view?

The short, unsatisfactory answer is yes and no. Plenty of academic, industry and informal studies have delved into the topic. Unsurprisingly, history shows that target shareholders earn sizable excess returns (i.e. investment returns over and above those of the wider market), given the handsome takeover premiums acquiring companies are usually willing to pay (30%, on average, last year).

But the picture is mixed, at best, for the shareholders of those companies. The range of outcomes is wide, with some bidders having lost and some having gained substantially. On average, excess investment returns have been close to zero.

In my experience, investing in potential M&A targets is a mug’s game. Identifying potential targets

Podcast

[www.ubs.com/cio-podcast](http://www.ubs.com/cio-podcast)

is one thing, but getting the timing and the price that will be paid right are quite another.

What we do know is that merger activity tends to move in tandem with the ups and downs of equity markets. Global M&A volume, for instance, soared in the 1990s and peaked in 2000 at USD 3.5trn, coinciding with the dotcom bubble that ended in tears. Similarly, M&A reached a new peak in 2007 at

USD 4.6trn, which was followed by the Great Financial Crisis and a short but vicious bear market in 2008.

In that context, the steady climb in European M&A over the past seven years, including the whopping 22% increase in volume last year, can make for an uncomfortable sense of déjà vu in an investor. The good news is that M&A activity generally serves as a lagging rather than a leading equity market indicator.

With that in mind, CIO is overweight on global equities and US equities versus high-quality bonds. Central bank policies remain supportive and the outlook for earnings growth is encouraging, with the US appearing on track for 11% EPS growth this year.

Kind regards,  
**Bert Jansen**

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