

Deeper dive

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**Market moves**

	CIO view	-1w	-3m	ytd
S&P 500	OW	0.2%	6.9%	1.7%
Euro Stoxx 50		-0.6%	10.0%	0.3%
MSCI EM	OW	0.6%	-1.6%	2.9%
FTSE 100		1.1%	4.3%	1.9%
SMI	UW	0.1%	4.1%	2.2%
NIKKEI 225		-2.3%	13.8%	0.1%
US high grade bonds	UW	-0.1%	-2.3%	0.4%
Euro high grade bonds	UW	-0.1%	-1.8%	-0.5%
US investment grade bonds		0.0%	-1.6%	0.6%
Euro investment grade bonds		-0.1%	-0.9%	-0.2%
US high yield bonds		0.3%	1.8%	0.9%
European high yield bonds	OW	0.0%	2.2%	0.5%
EM sovereign bonds		0.5%	-2.4%	1.5%
EM corporate bonds		0.6%	-0.1%	1.5%

Source: Bloomberg, UBS as of 12 January 2017  
OW = tactical overweight  
UW = tactical underweight

**Market comments**

Calculations are based on the past five days

- **Equities** had a mixed week, with stocks rising in the US, emerging markets, and the UK. Shares retreated in the Eurozone and Japan.
- **Fixed income** markets moved little. European high yield and investment grade bonds finished the week flat, as did US investment grade bonds.
- **Currency markets** were notable for broad weakness in the US dollar, which fell 2.2% versus its Australian and 1.3% against its Canadian counterparts. But the British pound weakened 1.2% amid renewed worries over a hard Brexit.

## In focus

**US payrolls pack a punch.** The winning streak for the labor market continued, with 156,000 net jobs created in December. More encouragingly still, wages rose by 2.9% year over year – the fastest clip since 2009. *This backs CIO's expectation for improving US growth and rising inflation this year, and our overweight position in US equities versus government bonds in global tactical asset allocations.*

**Eurozone inflation highest since 2013.** The region's consumer prices rose 1.1% in the year to December. That was the first time inflation has exceeded 1% in over three years. Core inflation, which strips out the effects of the recent climb in energy prices, also nudged higher. Yet the rate remains some distance from the European Central Bank's target, suggesting continued accommodative policies.

**Not yuan way.** Chinese authorities stepped up efforts to strengthen both versions of the nation's currency, in a signal that yuan moves against the US dollar are not one-way. The People's Bank of China strengthened the USDCNY midpoint by 0.9% on Friday, the biggest one-day move since 2005. And overnight interbank borrowing costs for the offshore CNH in Hong Kong hit 61.3%, making the price of shorting the yuan eye-wateringly expensive. *CIO still expects the yuan to depreciate against the USD, forecasting USDCNY to reach 7.20 in six months.*

**Out of the (factory) gates?** Chinese producer prices rose for a fourth month in a row in December, suggesting that the nation is winning its battle with deflation. The gauge of inflation for corporations jumped 5.5% year on

year in December, the most since 2011, from November's 3.3%. Meanwhile, the country's consumer price inflation dropped to 2.1% in December due to slower growth in food prices. *CIO thinks that the reflationary trend in China will continue.*

**Pity the peso.** Mexico's currency touched a record low versus the US dollar on Tuesday, falling by as much as 1.1% to 21.6. The peso has been under intense pressure since the election of Donald Trump as US president. Intervention by the Bank of Mexico on two trading days last week has failed to shore up sentiment. The peso was one of the worst-performing major currencies last year, falling 17% against the US dollar. *CIO expects Mexican consumer price inflation to climb to 4.2% by the close of the year, up from 2.8% when last year ended.*

**Depreciation let down?** UK data on Wednesday disappointed those hoping that a weaker pound would swiftly narrow the trade deficit. Imports climbed GBP 3.3bn in the year to last November, outpacing a GBP 700m rise in exports. As a result the UK's trade gap widened to GBP 4.2bn for the month. *CIO is neutral on UK equities and the pound in global portfolios.*

**Help wanted.** Australian firms are casting around for more staff, an encouraging sign that employment conditions are improving. Job vacancies in Australia rose 2.1% q/q in the September-November stanza, the second straight quarterly increase and the highest level since mid-2011. *CIO holds the view that local interest rates will remain unchanged this year, while the AUDUSD is expected to be at 0.74 in 12 months.*

Deeper dive

# Should investors worry about a falling yuan?



**Mark Haefele**



**Dominic Schnider**

Fears of Chinese currency depreciation have often been toxic for global markets. Both in summer 2015 and early last year such worries caused stocks to fall worldwide. So with the yuan under further downward pressure until recently, should investors be concerned?

Even those with no direct exposure to China have taken an interest in the yuan in recent years. The Chinese government's currency policy has been scanned for clues as to the outlook for the world's second-largest economy. When China adjusted its currency regime in August 2015, permitting a 3% depreciation of USDCNY in just a few days, fears arose that the government was responding to a sharp slowdown in economic growth and acknowledging that capital outflows had become problematic.

Those fears contributed to a 4% fall in global equities that September, and global stocks also declined early last year for the same reasons. After all, China accounted for around one-third of global GDP growth between 2008 and 2015 in purchasing power parity terms.

The yuan looks set to drop further this year. But CIO considers the factors behind this depreciation manageable, so we do not expect it to derail global risk assets. Instead of resulting from a looming economic or banking crisis, the pressure on the yuan stems primarily from an understandable desire for diversification among Chinese companies and investors after decades of impressive economic growth and wealth creation – a desire that generates and exacerbates expectations for further yuan weakness.

For example, Chinese businesses spent a record USD 146bn buying non-financial overseas firms in the first 10 months of last year, according to Commerce Ministry data, beating the 2015 full-year figure of USD 121 bn. (These outflows far exceed foreign demand for Chinese assets that is only gradually increasing due to government efforts to internationalize equity and bond markets.) And while slower economic growth will also weigh on the yuan, the deceleration is likely to be gradual, with GDP expanding by 6.4% this year from last year's 6.7%.

Better communication from Chinese policymakers has further reduced the threat of an adverse market reaction to moderate currency moves. The authorities appeared to have learned their lesson from the anxiety caused by August 2015's abrupt policy shift. Since then the fall in the yuan has been better managed. The People's Bank of China (PBoC) has intervened to prevent rapid slides, reassuring investors of its opposition to a sharp depreciation.

This year the PBoC has expanded the basket of currencies it uses as a reference point for the yuan. The move reminds investors that its policy focus is on a broad index rather than solely against the US dollar, which now accounts for only 22.4% of the basket.

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## Bottom line

Capital outflows and slowing growth in China should push the yuan lower this year, and CIO expects USDCNY to hit 7.2 over the coming six months. But this gradual move largely reflects an understandable desire for diversification among Chinese investors and firms

rather than a looming economic crisis. While it makes sense for investors holding Chinese assets to hedge yuan exposure, a better understood currency regime is unlikely to disrupt global markets.

## Regional view

## Surpriiise!



**Bert Jansen**  
European Equity Strategist

*“What can no longer be imagined must happen, for if one could imagine it, it would not happen.”*

Karl Kraus, Austrian satirist

It's the time of the year when we're bombarded with “Year Ahead” economic and financial market forecasts. We know from experience that the conventional view is nearly always wrong, so it's tempting and popular to be a contrarian. Have you ever heard a fund manager or stockbroker bragging about his views that are in line with the consensus?

But being a contrarian is easier said than done. How many investors do you know who turned bullish on equities this time eight years ago, four months after Lehman Brothers went bankrupt in September 2008? Exactly. And yet, it turned out to be an exceptional investment opportunity.

To simplify, I would describe the current consensus view as “cautiously optimistic.” Deflationary fears are fading, corporate earnings are increasing again and US interest rates are expected to rise only modestly. The “cautious” bit refers to

political uncertainty and elevated valuations.

So what are the potential surprises for European equity investors this year? There are likely to be many, but I will focus on three.

*“History shows that those who are convinced they understand the future will be surprised the most.”*

At a market level, a major one would be earnings growth exceeding consensus expectations (of 14% for MSCI Europe). Indeed, such a scenario would be highly unusual since EPS growth has bettered estimates in only four of the last 29 years. The bad news is that should it do so, it would likely signal the end of the equity bull market, as history teaches. The four times EPS growth in Europe exceeded consensus estimates were in 1999 and 2005–07. Both periods were marked by rising US interest rates and were followed by nasty bear markets.

Politically, perhaps the biggest surprise would be Marine Le Pen, president of the *Front National*, winning the French presidential election, aided by voters on the left scared off by the radical economic reform proposals of right-wing presidential candidate François Fillon. This turn of events could cause the euro to tank amid concerns of a Eurozone break-up.

It would also likely, against current market expectations, boost Eurozone equities because of the positive foreign exchange impact on corpo-

 Podcast

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

rate earnings (50% of MSCI EMU constituents' revenues are generated outside the Eurozone). This same scenario has played out for UK equities, which have benefited from the falling pound since last June's Brexit vote.

Finally, at a sector level, financials underperforming the broader market would run counter to the current consensus call. The conventional view may turn out to be right, but the overweight in financials and underweight in bond proxies like utilities and telecoms has become a crowded trade. This suggests that a lot of the popular deflation scenario is already priced in.

So, what to do as an investor about potential surprises?

First, remain humble and expect to be surprised. History shows that those who are convinced they understand the future will be surprised the most. Second, stay diversified. And last but not least, don't get emotional. As Warren Buffett says, if you cannot control your emotions, you cannot control your money.

Kind regards,  
**Bert Jansen**

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