

Deeper dive

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Market moves

	CIO view	-1w	-3m	ytd
S&P 500	OW	2.4%	8.5%	5.2%
Euro Stoxx 50		1.2%	10.0%	1.1%
MSCI EM		1.8%	11.6%	9.3%
FTSE 100		0.6%	8.5%	2.3%
SMI		0.3%	7.0%	3.0%
NIKKEI 225		2.3%	8.5%	1.2%
US high grade bonds	UW	-0.5%	-0.6%	0.2%
Euro high grade bonds	UW	-0.4%	-0.2%	-1.3%
US investment grade bonds		-0.4%	0.3%	0.3%
Euro investment grade bonds		-0.1%	0.5%	-0.1%
US high yield bonds	OW	0.2%	4.6%	1.8%
European high yield bonds		0.3%	3.4%	1.3%
EM sovereign bonds		0.0%	3.8%	2.9%
EM corporate bonds		0.3%	4.1%	2.4%

Source: Bloomberg, UBS as of 16 January 2017

OW = tactical overweight

UW = tactical underweight

Market comments

Calculations are based on the past five days

- **Equities** powered higher across the globe, led by a 2.4% rise in the S&P 500 as investors await fiscal stimulus plans from the Trump administration. The Nikkei 225 rose 2.3% while emerging markets advanced 1.8%.
- **High quality bonds** were on the backfoot. Expectations for rising inflation contributed to a 0.5% slide in high quality US government and corporate debt. Riskier US high yield bonds rose 0.2%.
- **Foreign exchange** traders pushed the US dollar weaker against most other G10 currencies, with the Australian dollar gaining 1.1% and the Canadian dollar up 0.8%.

In focus

Taxable gains. Benchmark US equity markets hit record highs after President Donald Trump hinted at upcoming tax reforms. The S&P 500, the Nasdaq Composite, and the Dow Jones Industrial Average all rose into uncharted territory in the days after the commander-in-chief promised a “phenomenal” tax plan in a meeting with airline executives on 9 February. White House Press Secretary Sean Spicer suggested fiscal announcements over the coming weeks would “address both the business side...as well as individual rates” of taxation. CIO estimates that a one percentage point (ppt) cut in the corporate tax rate could pump up S&P 500 profits by around 0.85ppt. *CIO is overweight on US equities versus high-quality debt in global tactical asset allocations.*

Build it, and the investors will come. Mutual and exchange-traded funds that focus on building and upgrading roads, bridges, and airports enjoyed inflows of over USD 450m between November and January, according to data from Morningstar. That was the largest three-month jump in almost two years. The growing interest reflects Trump’s promise to upgrade US infrastructure. *CIO believes fiscal stimulus will contribute to the positive outlook for the US economy this year.*

The 20 trillion dollar market.

The value of S&P 500 stocks topped USD 20trn for the first time ever on 13 February, driven by expectations for fiscal stimulus and optimism over earnings growth. The most watched US index is now up almost 25% over the past 12 months. With the fourth quarter reporting season drawing to a close, earnings per share for the index were on track to rise around 6%. *CIO expects EPS growth of around 11% this year, with energy and financial companies in the lead.*

Japanese GDP in the rough. Trump and visiting Japanese Prime Minister Shinzo Abe hopefully hit a few fairways when they played golf on the weekend, and did not end their round in the rough. Japanese GDP growth ended last year off the fairway, declining from 1.3% year on year in the third quarter to 1% in the fourth and missing the 1.1% expected by economists. The net export tailwind of a weaker yen – the JPY fell 15% against the US dollar in 4Q16 – failed to offset subpar private and household spending. CIO expects USDJPY to rally toward 105 in 12 months as the Bank of Japan dials down stimulus and the USD loses steam. *CIO anticipates fewer currency boosts to corporate earnings, and is neutral on Japanese stocks in global portfolios.*

Greek economy not bearing gifts.

An economic contraction is never good news. But the surprise 0.4% quarter-on-quarter shrinkage registered in Greece’s GDP in 4Q16 comes at a particularly bad time. The nation’s creditors have been at odds over the outlook for growth. While EU creditors have expected growth to rebound this year, the IMF is more skeptical that it will boost the public purse. The fund has demanded additional austerity measures to remain part of the bailout. CIO believes renewed concerns over Greece are unlikely to derail the Eurozone economy. *CIO is overweight on the euro versus the US dollar.*

UK inflation target in sight.

Consumer prices climbed 1.8% in January, within a whisker of hitting the Bank of England’s 2% goal for the first time since 2013. Only heavy discounting by clothing retailers diverted inflation from the target. Pressures have been building due to the fall in the pound and the rise in oil prices. *CIO believes UK inflation will accelerate to 2.8% this year, acting as a drag on consumer spending and slowing economic growth.*

Deeper dive

Can US stocks continue to climb?

After rising 12% last year, US equity markets have rallied a further 4-5% this year. But in the wake of a second consecutive year of flat S&P 500 earnings per share (EPS) in 2016, is the recent rise justified by fundamentals?

CIO expects further gains over the next six months and is overweight US equities relative to government bonds in global portfolios. The US profit cycle appears poised to accelerate, and CIO forecasts S&P 500 EPS climbing 11% this year. CIO identifies three key reasons for optimism.

First, the profit cycle is gaining momentum. US GDP expanded 1.5% last year, but the growth trajectory was “back-end” loaded, stronger in the second half than the first. Likewise, corporate earnings growth bottomed in the first quarter and improved in each subsequent quarter.

Fourth-quarter S&P 500 EPS is on track to rise by 7% – the fastest year-over-year pace in more than two years. The quarter’s sales growth of 5% was the strongest since mid-2014, and profit margins stayed high despite a modest uptick in labor compensation.

Earnings look set to sustain their momentum given the improvement in leading economic indicators. The ISM manufacturing, NFIB small business optimism, and consumer confidence indexes have all recently advanced on a 12-month basis, and are currently at or near multi-year highs. Since 1985, 12-month growth in S&P 500 EPS has averaged 14.9% one year after a simultaneous rise in all three gauges.

Second, the drag from low energy prices is reversing. Earnings for the S&P 500 energy sector fell 90% from 2014 to 2016 as oil prices declined from over USD 100 per barrel to as low as USD 26. S&P 500 earnings would have been up by mid-single-digit rates the previous two years had the drag from the energy sector been excluded. But after aver-



Mark Haefele



Jeremy Zirin

aging USD 43 per barrel last year, oil prices, CIO believes, should hold in the mid-50s range this year, as slower production growth and improving demand balance the oil market. From a depressed base last year of just USD 12bn, energy sector earnings should quadruple this year to USD 45-50bn and add 2-3% to S&P 500 earnings growth.

Third, there is policy-driven upside. CIO’s favorable outlook also rests on the pro-growth aspects of Trump administration policies (corporate tax reform, deregulation, and infrastructure spending), which could boost S&P 500 EPS by 5-15% over the next two years. Potential regulatory reforms in the financial sector should also pave the way for somewhat easier bank-lending conditions, and such conditions have historically preceded accelerating S&P 500 profit growth by nine to 12 months.

There are risks that may prevent US equity gains from continuing. Current valuations of 19x trailing price-to-earnings (P/E) are nearly 20% above the long-term average. But it is not uncommon for US stocks to trade at a premium during periods of low unemployment (4.8% currently versus 6.1% on average since 1960) and low inflation (2.1% versus 3.8% on average). The S&P 500 trailing P/E has averaged 20x in such “investor-friendly” time frames.

Economic momentum, reviving energy sector earnings, and potential profit-boosting policies can lead to a continued earnings recovery. Firming fundamentals suggest the S&P 500’s 4.4% advance this year still has room to run.

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Bottom line

The post-election rally in US stocks rests on a solid foundation of improving economic momentum, accelerating earnings growth, reasonable valuation – especially relative

to government bonds – and upside from anticipated pro-growth policy measures.

Regional view

Inflation is back, and this time it's local



Podcast

www.ubs.com/cio-podcast



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During the past two years headline and core consumer price inflation was dominated by the falling price of oil, which plunged over 70% in dollar terms (peak to trough). Core inflation remains subject to oil moves because transport costs like air fares are included in it, and they are influenced by the price of refined crude. Now the exceptionally low oil price has reversed and inflation is reverting to normal.

Normal inflation is a local phenomenon. Even with some oil price impact on core measures, the correlation of core consumer price inflation rates across developed economies is extremely low. This tells us that local factors drive underlying inflation pressures.

Inflation in one country has little impact on that in another country, even for major exporters like China. China's trade in value added (what the country actually contributes to the goods it "exports") is 1.0% to 1.5% of the world economy.

A 10% change in export prices will add 0.1% to 0.15% to inflation in the rest of the world.

If local factors drive inflation, particularly core inflation, what should investors focus on? Domestic labor costs constitute around 70% of the components (weighting) of an advanced economy's inflation. They are, of course, less volatile than the oil price, and their high weighting explains the low correlation of global core inflation rates.

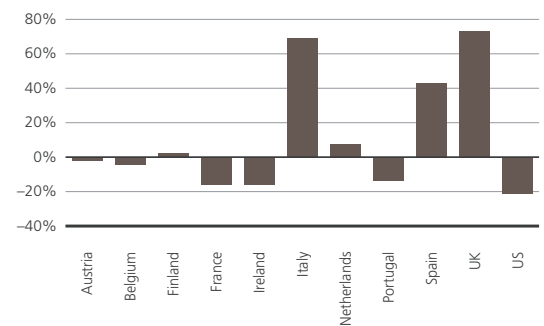
Pay bargaining power varies with the economic cycle and generates significant variation in cost and price pressures in different countries. Germany and the US have relatively

"Inflation in one country has little impact on that in another country, even for major exporters like China."

strong labor markets and are experiencing greater inflation pressures. The labor markets in many southern European economies remain weak, so inflation has less impetus there.

This inflation divergence matters for the European Central Bank (ECB). Having begun a cautious tightening of quantitative policy, the ECB has

2016 correlation of core German inflation with other core inflation rates



Source: UBS

experienced rising Eurozone inflation this year. But core inflation in Germany is triple the Portuguese rate, and if the headline consumer measure were to reach 3% (as has already happened in Spain), the existing German agitation for a tighter ECB policy would doubtless escalate substantially.

Our base case is for German inflation to remain below 3%. If Eurozone inflation diverges to the point that German inflation hits 3%, the political pressure that the Germans would bring on the ECB to tighten further may become overwhelming.

Kind regards,
Paul Donovan

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