

Deeper dive

Has European populism had its day?

— p. 2

Regional view

French unhappiness: Plus ça change...

— p. 3

Market moves

	CIO view	-1w	-3m	ytd
S&P 500	OW	0.9%	6.2%	7.0%
Euro Stoxx 50		1.0%	6.0%	4.9%
MSCI EM		2.2%	10.7%	9.6%
FTSE 100		1.4%	6.9%	4.9%
SMI		0.3%	6.6%	6.7%
NIKKEI 225		1.4%	1.2%	2.6%
US high grade bonds	UW	0.5%	1.3%	0.3%
Euro high grade bonds	UW	-0.4%	-1.2%	-1.8%
US investment grade bonds		0.6%	1.7%	0.4%
Euro investment grade bonds		0.0%	0.4%	-0.1%
US high yield bonds	OW	-0.7%	1.7%	0.9%
European high yield bonds		-0.2%	1.8%	1.4%
EM sovereign bonds		0.7%	4.6%	3.3%
EM corporate bonds		0.6%	2.8%	2.1%

Source: Bloomberg, UBS as of 16 March 2017

OW = tactical overweight

UW = tactical underweight

Market comments

Calculations are based on the past five days

- **Equities** moved higher across the board, with the S&P 500 advancing 0.9%. The biggest gain was for emerging markets, where the MSCI EM climbed 2.2%.
- **Fixed income** markets were mixed. US high yield bonds fell 0.7%, undermined by the energy sector, which suffered from the falling oil price.
- **Foreign exchange** markets were notable for a broad weakening of the US dollar, which lost ground against all other G10 currencies. The euro climbed 1.3% versus the US dollar.

In focus

Once, twice, three times the rate hikes. The Federal Reserve raised the Fed Funds target range by 0.25% to 0.75%–1.00%, as expected by markets. The Fed's update statement language noted that inflation is now approaching, but remains "somewhat below" the 2% target (headline PCE registered a 1.9% year-over-year change in January). The median "dot plot" still called for a total of three rate hikes in 2017. CIO expects the US economy to expand at a moderate pace, allowing the Fed to raise rates twice more this year while supporting recovery and risk asset prices. *CIO is overweight global and US equities against high-quality bonds in global portfolios.*

Dutch root for Rutte. The euro touched a five-week peak against USD on Thursday as the country's election pointed to victory for Prime Minister Mark Rutte and his Liberal Party (VVD). Anti-EU candidate Geert Wilders is expected to secure 20 seats in parliament, second to VVD's projected 33. Populist risks to markets may ease in the short-term, before potentially resurfacing ahead of France's elections beginning in April. *CIO is overweight EUR and underweight USD in global portfolios. For more detailed analysis, please see this week's "Deeper Dive."*

Defending capital controls. China's central bank chief Zhou Xiaochuan has said the recent tightening of capital controls was a "normal" response to "over the top" overseas investing by Chinese citizens and firms. Some invested "blindly" and in a manner that had "no real gain for China" he said. *CIO believes that the yuan will weaken only gradually over the course of 2017 as the desire of Chinese investors and companies to diversify is matched by the government's determination to maintain economic stability.*

A jobs report well done. Nonfarm payrolls rose by 235,000 in February, beating the consensus forecast of 200,000. The unemployment rate fell to 4.7% from 4.8% in January. The details of the report were also strong, with the labor force participation rate rising 0.1% to 63.0% and average hourly earnings growing 2.8% year-over-year. Since the beginning of 2010 the US economy has added 16 million jobs – that's roughly equivalent to the populations of New York City, Los Angeles, and Chicago. *CIO believes that the strength of the labor market will continue to support US economic growth, and is overweight US equities versus high-quality government and corporate bonds in global portfolios.*

The Great Crawl of China? Chinese fixed asset investment (FAI) and industrial production growth accelerated to 8.9% y/y and 6.3% y/y respectively in January–February from 8.1% y/y and 6.2% y/y for 2016, both beating market expectations. However, retail sales slowed as growth edged down to 9.5% y/y from above 10% y/y last year. *CIO expects China's economy to gradually decelerate to 6.4% in 2017 amid structural reforms and an ongoing property downturn.*

Back to the 70s? The UK unemployment rate fell to 4.7% in the three months to January – the last time this jobless gauge was lower was in 1975. But labor market tightness is not feeding into higher wages. In fact wage growth declined to 2.2%, down from 2.6% in the prior three-month period. UK inflation looks set to climb this year, beyond the current 1.8% rate as sterling's post-referendum decline pumps up import prices. And the Institute for Fiscal Studies forecasts little wage growth ahead, suggesting 2022 pay could match 2007. *CIO does not expect UK inflation to rise to 1970s levels, but to average 2.8% this year. Real consumer spending power could therefore come under pressure. CIO is neutral UK equities in its global tactical asset allocation.*

Deeper dive

Has European populism had its day?



Ricardo Garcia



Christopher Swann

At the start of 2017 it looked possible that countries representing 70% of Eurozone GDP could change leaders by year end. Elections were scheduled for the Netherlands, France, Germany and potentially Italy. The main worry for investors was that Europe’s voters would veer toward populism, threatening the euro and the EU.

That risk now seems less urgent after Dutch voters refused to give a big electoral boost to the anti-EU Freedom Party of Geert Wilders. So does the Dutch result suggest that Europe as a whole, and France in particular, will avoid a populist uprising that could disrupt global markets?

Overall the outcome is reassuring. Opinion polls understated support for populism ahead of the US presidential election and UK referendum. Had the Freedom Party significantly outperformed the polls, this could have intensified fears that populists elsewhere in Europe were gaining ground. The resulting anxiety could have dragged on Eurozone consumer and business confidence, as well as raised borrowing costs in many parts of the continent to reflect higher country risk. The euro could also have come under pressure amid heightened worries that National Front leader Marine Le Pen could win the French presidency and try to lead the country out of the Eurozone.

But investors shouldn’t become complacent for several reasons:

- 1) Populism hasn’t subsided. While the Freedom Party didn’t become the largest group in the Dutch parliament, as polls earlier this year suggested it might, it did gain ground from the liberal VVD party of Prime Minister Mark Rutte. In addition, the VVD and Christian Democrats did shift to the right to capture voters attracted to Wilders. It could take many months for the VVD to form a coalition, so it is still possible – though unlikely – that the Freedom Party could become part of a new government.

- 2) The nationalist disappointment in The Netherlands could cause anti-Le Pen voters to stay at home on election day. The real threat of a Freedom Party win in The Netherlands appears to have contributed to the highest voter turnout in almost 40 years, at 82%. If this populist fear factor declines, the turnout in France may be less impressive and a lower turnout could favor Le Pen. (Radical voters are usually more certain of their choice and typically have greater influence when turnout is lower.)
- 3) Wilders is not Le Pen. The Dutch populist was a reluctant campaigner, giving relatively few speeches or televised appearances. Wilders also faced an experienced rival, who has been prime minister for seven years. In addition, the recent strength of the Dutch economy may have benefited the incumbent administration. By contrast, Le Pen has been a canny electioneer who has made the National Front less radical and more palatable to mainstream voters. The high rate of unemployment in France encourages voters to back novel solutions. And her rivals are more vulnerable; François Fillon is fighting a corruption scandal and Emmanuel Macron, though leading in the polls, is still a political newcomer.

After a period of tension leading up to the Dutch vote, investors are entitled to a sigh of relief. The outcome appeared to contribute to a gain of 0.7% in the Euro Stoxx 50 index on 16 March. And the 10-year Franco-German bond spread is well below its February highs of around 80 basis points. UBS Chief Investment Office believes that politics will not derail the Eurozone economic recovery or markets this year. But risks still lie ahead and investors should not drop their guard.

Ricardo Garcia
Head, European Macroeconomics

Christopher Swann
Global Investment Office

Bottom line

The Dutch election set an encouraging precedent for global markets, boosting confidence that anti-euro and anti-EU sentiment can be held at bay for the time being. The UBS Chief Investment Office (CIO) is overweight the euro versus

the US dollar, and believes that the European Central Bank will signal a gradual withdrawal of monetary easing once this year’s main elections are out of the way. But populist threats persist and investors should remain vigilant.

Regional view

French unhappiness: Plus ça change...



Bert Jansen
European Equity Strategist

"How can you govern a country which has 246 different kinds of cheese?"

Charles de Gaulle

"The state is that great fiction by which everyone tries to live at the expense of everyone else."

Frédéric Bastiat

"I have tried to lift France out of the mud. But she will return to her errors and vomitings. I cannot prevent the French from being French."

Charles de Gaulle

France presents a puzzling paradox. No, not its elections. If you'd like our view on the potential market impact of a Marine Le Pen win or loss in the upcoming presidential vote, please refer to our latest issue of "Investing in Europe," published on 2 March.

This is about the country's particular position, *l'exception française*. France fascinates, irritates and intrigues. The French are rude and arrogant yet charming, elegant and well educated.

In spite of a bloated civil service (nearly 25% of the working popula-

tion is a civil servant), a huge and still-rising national debt, a double-digit unemployment rate (which is falling) and an over-regulated economy, output per hour worked in France is roughly in line with Germany's, while over the past 20 years French workers have been 20% more productive than their UK colleagues.

The French drink, smoke and eat more fat than almost any other people in the world, yet they have fewer heart problems than US citizens and a miniscule obesity rate. France has

"France cannot go on living beyond its means."

one of Europe's most extensive and least-crowded road networks and as large a railway system as Italy and the UK put together.

One of the world's favorite holiday destinations, the country attracts 85 million visitors per year, more than Germany and the UK combined. Club Med established the model for informal, all-inclusive holiday resorts. Paris offers an impressive range of architecture and history. And for all the international rivalry and claims made for other cuisines, French food still sets the international benchmark. No other country has as many different cheeses or wines.

And yet the French are among the most pessimistic people on earth. A recent survey ranked the country as *the* most pessimistic one, with a mere 3% of French respondents saying the world was looking up, and 81% reporting that it was getting worse. And things are not improving:

 Podcast

www.ubs.com/cio-podcast

in last year's World Happiness Report, France ranked 101 out of 126 countries in terms of changes in happiness from 2005 to 2007 and 2013–15.

So why are the French miserable, despite enjoying one of the most comfortable lifestyles on earth?

Because, in my view, they have everything to lose. The World Health Organization considers their health-care system one of the world's best. Their social welfare system is one of Europe's most generous. Their education system of *Les Grandes Ecoles*

is world class and, unlike the top US and UK universities, free. In France people work 35 hours a week and take an hour and a half for lunch.

But as the US economist Herbert Stein once said, when something cannot go on forever, it has to stop. France cannot go on living beyond its means. The government has not balanced its books once since 1974. It needs to get a grip on its finances and reform the rigid labor market.

Although history is not on their side, let's hope that, after the spring elections, the new president and legislature can push through badly needed structural reforms, preferably within the embrace of the EU and the Eurozone. It is difficult to imagine them without France.

Kind regards,
Bert Jansen

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