UBS House View

Europe
Chief Investment Office WM

Weekly

26 January 2017

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Market moves

	CIO view	–1w	– 3m	ytd
S&P 500	OW	1.2%	8.0%	2.8%
Euro Stoxx 50		1.5%	8.8%	1.6%
MSCI EM		2.0%	0.5%	5.8%
FTSE 100		–0.5%	3.7%	0.4%
SMI		2.2%	7.1%	2.8%
NIKKEI 225		1.7%	11.7%	1.5%
US high grade bonds	UW	–0.1%	–2.8%	0.0%
Euro high grade bonds	UW	–1.0%	–2.6%	–1.5%
US investment grade bonds		–0.3%	–2.5%	–0.1%
Euro investment grade bonds		–0.3%	–1.3%	–0.6%
US high yield bonds	OW	0.1%	1.6%	1.0%
European high yield bonds		0.2%	1.6%	0.8%
EM sovereign bonds		–0.1%	–2.5%	1.4%
EM corporate bonds		0.8%	–0.3%	1.6%

Source: Bloomberg, UBS as of 26 January 2017
OW = tactical overweight
UW = tactical underweight

Market comments

Calculations are based on the past five days

- **Equity markets** marched higher almost across the board, with the S&P 500 climbing 1.2%. European, Swiss, and emerging market stocks also gained; the UK's FTSE 100 was a rare loser.
- **High grade fixed income** retreated: the euro market dropped 1% and the US declined 0.1%. High yield bonds, however, managed to push ahead in both the US and Europe.
- **Currency markets** were notable for the US dollar weakening versus other G10 currencies. The pound gained 2.5% amid signs that the UK government will adopt a conciliatory stance in Brexit talks.

In focus

Now what on TPP? The White House moved to withdraw the US from the 12-member Trans-Pacific Partnership (TPP) trade pact on Monday. But trade ministers in the Asia Pacific region have continued to press ahead despite the rejection. The Australian trade minister conceded the trade deal would need to be revised, while the Japanese government is said to be seeking a discussion with President Donald Trump. *CIO believes that the TPP's failure could be considered a positive development for countries like China that are not part of the agreement.*

On a high. US equity markets rallied on Wednesday, with the S&P 500 Index reaching a record peak as markets renewed their enthusiasm for Trump's growth-enhancing policies. US equity market volatility (as measured by the CBOE VIX Index) hit a 30-month low on Tuesday, in spite of the uncertainty about US policy execution. *CIO is overweight US equities versus government bonds in global tactical asset allocations, as economic and earnings momentum looks set to improve.*

Tipping the two level. US consumer prices recorded their highest yearly growth rate in two-and-a-half years in December. The consumer price index (CPI) gauge of inflation rose above 2% and climbed 2.1% year on year last month. Core consumer prices, stripping out volatile energy and food components, rose 2.2%. *CIO is overweight US Treasury Inflation Protected Securities versus government bonds in global tactical asset allocations.*

Hard landing? Or holding pattern? China's economy grew at an unexpectedly firm 6.8% in the final quarter of last year, bringing the full-year rate to 6.7%. Down only slightly from 2015's 6.9%, the pace of GDP growth was within the government's target of 6.5% to 7%. The data suggests that the economy remains in a holding pattern and should ultimately slow in an orderly way. *CIO does not forecast a hard landing that would imperil risk assets.*

Let Me Go the Right Way. A 1962 song from US Motown stars The Supremes could be ringing in the ears of the UK Supremes (lawmakers in the Supreme Court). They ruled that the right way for the UK to go (out of the EU) is for parliament to have a vote on the terms of Brexit before Article 50 (the formal process for leaving) is triggered. The pound shed 0.6% on Tuesday against the USD, but firmed above USD 1.26 on Wednesday. *Looking ahead, CIO expects the undervalued GBP to gain ground against the greenback, forecasting GBPUSD at 1.28 in six months.*

Strong start to the year. Japan's manufacturing sentiment gauge (or purchasing managers' index) spiked to 52.8, the highest figure since March 2014. Sub-indices for new orders and employment continued to increase, while new export orders picked up in January after two months of declines. However, *CIO is neutral on Japanese equities as valuations look full when accounting for low-single-digit rate of expected earnings growth.*

Steely resolve. Global steel production rose last year, led by higher production in China, according to World Steel Association data. That marks a turnaround from the contraction in Chinese output in 2015, which was the first fall in 30 years. Steel production and the question of pricing are likely to grow in importance as Trump reviews US trade policies. US production contracted 0.3% last year compared to 2015.

Deeper dive

Will President Trump's policies move markets?

Mark Haefele

Mike Ryan

America's 45th president was moving markets even before he took office. US equities rose in the first five weeks after Donald Trump's election win. But while the new commander-in-chief has hit the ground running since his inauguration with a spate of executive actions, the most important changes of the administration's legislative agenda will require more than just the stroke of a pen. So how might Trump's policies impact investors over coming years?

Trump has outlined a packed policy agenda, with initiatives ranging from defense spending, corporate tax reform, regulatory relief, and an infrastructure build-out. With such an ambitious platform, compromises will need to be made and investors are already eager to see how the administration and Congress will add flesh to the bones of Trump's campaign pledges. While the devil will be in the detail, *CIO believes key policy initiatives could boost US GDP by 0.5% and add an incremental 5–15% to S&P 500 earnings per share over the next few years.*

A key investor focus will be tax reform, where Congress will need to strike a careful balance – lowering headline tax rates without causing an excessive rise in government deficit or disadvantaging certain industries. The proposal for a "repatriation tax holiday" could help by widening the domestic corporate tax base and helping pay for modest cuts to taxation rates. However, a lack of politically palatable options to generate revenue in other areas limits the opportunity for more significant measures. These challenges are the focus of our POTUS 45 report, *The outlook for tax reform.**

Regulatory relief, another flagship Trump issue, should be more straightforward. Trump has already proposed policies to trim red tape for companies. But repealing and replacing the Affordable Care Act (ACA), which has a major impact on companies and individuals, are still fraught with risk. Increased trepidation around the ACA's replacement could result in significant economic fallout.

Boosting infrastructure and defense spending were popular aspects of Trump's campaign, and we expect details to start emerging soon. Public-private infrastructure programs have enjoyed limited success thus far as businesses have been reluctant to get caught up in the ulterior agenda of many public officials. The new Administration could alter this dynamic to turn rhetoric into reality, by employing a "no strings attached" approach.

The scope and scale of the proposals raise the risk of policy misstep or market disappointment. But ultimately this new policy paradigm should stimulate US economic growth and boost the performance of growth-sensitive financial assets.

Our US equity sector positioning reflects the need to position for fundamental growth while considering the balance of policy risks and opportunities. For example, we are overweight on technology and healthcare, where repatriation can boost earnings; energy, which could benefit from immediate expensing for capital expenditures; and financials, where regulatory relief could provide a positive catalyst.

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* For more details on CIO's POTUS 45 report series, please speak to your client advisor.

Bottom line

The post-election market rally has not fully priced in the successful implementation of the Trump administration's pro-growth policy prescriptions. These policies are poised to bolster the already-strong growth outlook, and add support to our preference for risk assets. We are tactically overweight on global equities, US equities, and Treasury Inflation-Protected Securities relative to US government bonds.

Regional view

Making America emulate again

Podcast
www.ubs.com/cio-podcast

Bert Jansen
European Equity Strategist

Donald Trump has made it clear that his administration will put America first. But if he is willing to entertain the idea that the US can learn from other countries to make good on his promise to bring back jobs from overseas, I can think of a few candidates for the US to emulate. In fact, one in particular stands out.

The nation in question, the Netherlands, has a GDP less than one-twentieth of the US's. Yet its strengths should interest Trump because, by mimicking them, the US could achieve the economic goals the president laid out in his inaugural speech last week. Consider the following.

The Dutch have engaged in exemplary infrastructure spending. Coincidentally, one of the largest public investments they have made is in a wall. They might call their walls dykes, but that is an exercise in semantics. These engineering marvels protect not against illegal immigration but an even more insistent and insidious force, flooding in a country one-quarter of which lies below sea level and only half of which rests one meter above the North Sea.

It took the Netherlands 25 years to finish this project, which is made up of barriers, tide gates and dams. But what better way is there of meaningfully boosting infrastructure spending than by constructing what some consider one of the seven wonders of the modern world.

"The man who would make America great again … might want to look beyond the US's borders to find the inspiration and ideas he will need."

Holland is also a fiscal paradise. Although its official corporate tax rate is 25%, the effective rate is much lower, in some cases as low as zero. An astute tax advisor can help corporates avoid paying any taxes on dividends and capital gains at all. This is why nearly half of the Fortune 500 companies have one or more limited liability companies in the country.

Despite this generous tax regime Dutch state coffers are in good shape: the budget deficit as a percentage of GDP is well below 2%, paling beside the US fiscal shortfall of 4%. Similarly, government debt, at 34% of GDP, is less than half the US's 80%.

One topic associated with the Dutch that Trump has already addressed is marijuana. He has indicated that he intends to maintain the status quo – allowing states to legislate and police their own drug laws – but he might be wise to keep an open mind here and consider legalizing cannabis nationally.

The US's disastrous war on drugs costs a fortune, up to USD 40bn a year*. Following the Dutch model, tax dollars from a legalized, regulated soft-drug industry could be better spent on programs educating people about the dangers of drugs and addiction.

The man who would make America great again has spent his first week in office making nationalistic statements. But he might want to look beyond the US's borders to find the inspiration and ideas he will need to tackle some of the challenges facing the world's largest economy.

Kind regards,
Bert Jansen

* "The budgetary impact of ending drug prohibition," by Jeffrey Miron and Katherine Waldock, CATO Institute.

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