UBS House View

Europe
Chief Investment Office WM

Weekly

27 April 2017

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Market moves

	CIO view	*–1w*	*– 3m*	*ytd*
S&P 500	OW	2.1%	4.6%	7.3%
Euro Stoxx 50		3.4%	8.5%	9.1%
MSCI EM		2.5%	7.7%	14.5%
FTSE 100		1.8%	2.3%	2.9%
SMI		2.9%	7.9%	10.0%
NIKKEI 225		4.5%	–0.4%	1.4%
US high grade bonds	UW	–0.1%	1.7%	2.0%
Euro high grade bonds	UW	–0.4%	0.9%	–0.9%
US investment grade bonds		–0.2%	1.8%	2.1%
Euro investment grade bonds		–0.1%	1.2%	0.6%
US high yield bonds	OW	0.7%	2.0%	3.3%
European high yield bonds		0.5%	1.9%	2.8%
EM sovereign bonds		0.4%	3.5%	5.2%
EM corporate bonds		0.3%	2.3%	3.9%

Source: Bloomberg, UBS as of 27 April 2017
OW = tactical overweight
UW = tactical underweight

Market comments
Calculations are based on the past five days

- Equities climbed across the board this week as markets responded to the perceived reduction in political risk following the first round of the French presidential election. The Euro Stoxx 50 index was up 3.4%, with the S&P 500 rising 2.1%.
- Government bonds lost ground. A reduced demand for safe haven assets pushed euro high grade bonds 0.4% lower and US high grade down 0.1%. By contrast, US high yield bonds rose 0.7%.
- Currency traders bid the euro 1.8% higher versus the US dollar this week, again reflecting relief over the French vote. The British pound gained 0.6% amid hopes that the impending UK election will smooth Brexit talks.

In focus

It's Macron versus Le Pen. Global risk assets rallied on 24 April following the first-round vote for the French presidency. Market-friendly centrist candidate Emmanuel Macron secured 23.9% of the popular vote, while far-right candidate Marine Le Pen polled 21.4% after 97% of votes were counted. European banking stocks climbed 6.1% at the European open, approaching the highest levels since December 2015. The euro rose 1.2% and 1% against USD and GBP respectively. Although a victory for the Frexit-favoring Le Pen cannot be ruled out, polls of run-off vote intentions suggest Macron will become the next French president, assuaging fears of a potentially disruptive French exit from the euro. *CIO is overweight the EUR and underweight USD in its global tactical asset allocation. See the Deeper Dive for the global implications of the French election process.*

Trump trumpets tax trim. The White House publicly outlined President Donald Trump's tax reform proposal. The administration presented its rough plans as the "biggest tax cut" in US history. Suggestions included a cut in the corporate tax rate to 15% from 35%, and simpler personal income tax. *Although CIO expects Congress to settle on a limited corporate tax reform (with a tax rate reduction to about 25%), investors may now be too pessimistic on the outlook for a reduction in the US corporate tax burden. But even without such reforms, the US profit outlook justifies an overweight in US stocks in global tactical asset allocations.*

Bucking the regulatory trend. US President Donald Trump has pledged to cut regulatory burdens for US businesses in a bid to support economic growth. China wants to steady economic activity too – but is using tighter regulation as a means to promote stability. After China's insurance watchdog announced on 23 April that it would step up supervision of insurance firms, Chinese risk assets took a step back on 24 April. The Shanghai Composite of onshore stocks slid 1.4%, its worst day in four months. *CIO expects rising Chinese profit margins over the next couple of months to lead to a turnaround in investor sentiment and recent price trends – stay overweight Chinese equities in Asia Pacific tactical asset allocations.*

Another OPEC deal? The crude oil cartel may be close to agreeing to extend production curbs. Saudi oil minister Khalid al-Falih said "consensus was building." The oil-exporting nations meet on May 25 in Vienna. OPEC has benefited from the production curbs agreed in late 2016. For a supply cut of 4.4%, the cartel has helped prices rise 19%. That's a net revenue gain for oil-pumping nations of USD 215 million a day. *The UBS Chief Investment Office (CIO) expects Brent crude prices to rise to USD 60 a barrel over the coming six months as global oil markets move further into supply deficit.*

Japan's road to recovery? Japan's solid March trade data provided encouraging evidence of a healthy recovery in global as well as domestic demand. Stronger shipments to the US and Asia drove nominal exports up 12% year on year, the fastest pace in more than two years, and beat consensus expectations (6.2%). Meanwhile imports also increased by 15.8% year on year. *CIO expects Japan's trade balance to stabilize in 2017, with a recovery in domestic demand counterbalancing solid export growth. We're neutral Japanese stocks in our global tactical asset allocation.*

Swiss banking on the consumer. The UBS consumption indicator rose to 1.50 points in March, up from a downward-revised 1.45 in February. The gauge suggests solid private consumption over the coming months – at 50% of GDP, it's the most important component of Swiss GDP. Auto demand is solid – new car registrations rose strongly (4.8% y/y). Conversely, tourism and retail sector sentiment is still sub-par thanks to a strong Swiss franc. *CIO expects Swiss economic growth to accelerate modestly to 1.4% this year.*

UBS

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Deeper dive

Is "poll" vaulting the right strategy for investors?

Mark Haefele **Matthew Carter**

Investors had a tough time on 24 April…if they sat out the first round of France's presidential election holding cash. The vast majority of growth-sensitive assets posted gains as centrist, pro-EU candidate Emmanuel Macron reaped the highest vote total among the four contenders, including second-place finisher and far-right anti-euro candidate Marine Le Pen. Global equities also reached fresh highs.

Surveys suggest that a Le Pen win in the run-off would represent an election shock five to 10 times greater than the Brexit or Trump results. So, many investors have "vaulted" the polls, adding to their portfolio risk across regions and asset classes. Is this the right strategy?

CIO has marked down its estimated probability of a Le Pen victory to 25% from 40%. But we don't think her chances of becoming French president can be written off. She has already sought to position herself as the "anti-establishment" candidate. And a softening in her anti-euro stance could enable her to pivot toward a set of pro-employment policies that win over the voters of defeated far-left candidate Jean-Luc Mélenchon.

So how should global investors position their portfolios before the 7 May run-off?

1) **Review and rebalance Eurozone asset holdings:** Eurozone economic and inflation data looks set to pick up in the second half of the year. While the same is true in the US, markets, in our view, have underappreciated how these trends should boost the euro against the US dollar. We advocate an overweight EUR versus underweight USD position for global investors.

   Euro high yield credit still trades near all-time lows in yield terms. If France picks Macron, high yield is unlikely to outperform, though a Le Pen victory could push risky-bond spreads wider. These skewed risks favor an underweight to euro high yield credit in global portfolios.

   Eurozone stocks have extended their rally this year to 10% in the wake of France's first vote. With analyst earnings upgrades exceeding downgrades for the first time in seven years, fundamentals warrant some optimism. But the risk that a Le Pen win weighs on French stocks and stokes price turbulence suggests a large position in Eurozone equities may be premature. We prefer investing in them via an overweight to global equities in our tactical asset allocation.

2) **Favor stocks over bonds in emerging markets (EM):** Investors whose asset class choices are confined to developing markets should overweight equities against USD-denominated corporate bonds. Our EM specialists recently added to stocks over bonds in local asset allocations.

   Better investor risk appetite has increased the appeal of assets most geared in to the global economic cycle. And EM equities can benefit from strengthening industrial sentiment at home – the GDP-weighted purchasing managers' index for EM rose for a fourth straight month in March. Trailing earnings per share are now up 8% this year, and we recently raised our estimate for next 12-month profit growth to 6–10%. Investors in a global portfolio with an overweight to world equities are implicitly tilted to developing nation stocks too, and should benefit from the region's brighter prospects.

3) **Revisit gold allocations:** After an 11% rally this year, gold prices could consolidate over the next three months, in our estimate. We anticipate fewer political risks in Europe and the Korean peninsula reducing investor appetite for perceived safe havens. And we think markets may be underestimating the likelihood that the US Federal Reserve hikes rates twice more this year per our expectations – higher real rates increase the opportunity cost of holding gold and reduce its allure. We have marked down our three and 12-month forecasts for the yellow metal to USD 1,200/oz and USD 1,250 respectively (from USD 1,300/oz).

Mark Haefele
Global Chief Investment Officer
Wealth Management

Matthew Carter
Global Investment Office

Bottom line

The first-round vote for president lessened the risk of Le Pen winning and leading France out of the euro. But the specter of political risk in Europe has not been exorcised. Rather than vault the polls and take a blanket "risk-on" stance, investors would do well to rebalance and maintain a risk-controlled, diversified investment approach.

Regional view

Game on for Macron?

Dean Turner, CFA
Economist, UBS AG

In the end, the first round of the French presidential election didn't surprise anyone – except that the opinion polls called the result with remarkable precision. Emmanuel Macron will face Marine Le Pen in the second round vote on 7 May. If those opinion polls are accurate for a second time, Macron will be France's next president by a comfortable margin.

Markets rallied on the result – the sense of relief for investors was palpable. Although Le Pen, and her protectionist, anti-EU policies are still a feature of this election, Macron's commanding position in the race has, in the eyes of the markets, significantly watered-down the risks of Frexit. Catastrophe avoided for the time being, at least.

I think too much attention has been given to the headline result without enough consideration to what voters were saying. Sure, it looks on the surface as though the French are sticking with the status-quo by choosing Macron, but swathes of voters were seeking something different. Neither of the established Conservative or Socialist runners made it to the second round, which speaks of a desire for change. Nevertheless, with less than 1.6 million votes separating the first and fourth candidates – two of whom where promising protectionism on a level that would have threatened France's EU membership – Macron's victory perhaps isn't as resounding as it seems. On the whole, some 45% of French voters opted for an anti-establishment candidate. And then there is the small matter that the populist Le Pen made it to the second round. In the past, this would have been treated with astonishment; today it is accepted as normal. Clearly, all is not as well with French voters as the headlines have assumed.

> "Neither of the established Conservative or Socialist runners made it to the second round, which speaks of a desire for change."

Which brings us onto the second round. We assume, as the markets do, that Le Pen will not attract enough support to win the presidency, but we are not complacent. Le Pen is already trying to tear down Macron's claims of being "anti-establishment"; policy pledges aimed at attracting a broader spread of voters are also likely. Voter turnout could also be a factor that decides this election, with high rates of abstention possibly favoring Le Pen.

Nevertheless, it is unlikely that Le Pen will win a majority on the day. So what does a Macron presidency promise to deliver? Talk of labor market reforms, a pro-business attitude, and stronger ties with Europe may please investors' ears. Delivering the goods though, is another thing. For this Macron will need the support the National Assembly, elections for which are held in June. As things stand, it is unlikely Macron's movement will win a majority of seats, so, cross-party deal-making involving compromises on policy might be needed. The presidency might not be as plain sailing for Macron as the markets thinks. In this particular election saga, there are still many more acts to perform.

Kind regards,
Dean Turner

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