

Deeper dive

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Market moves

	CIO view	-1w	-3m	ytd
S&P 500		0.1%	-2.5%	-2.2%
Euro Stoxx 50	OW	0.3%	-7.2%	-7.2%
MSCI EM	UW	1.0%	0.3%	-0.6%
FTSE 100		0.3%	2.0%	-0.5%
SMI		0.2%	-6.5%	-8.4%
NIKKEI 225		-0.6%	-11.3%	-11.4%
US high grade bonds	UW	-0.2%	1.7%	2.0%
Euro high grade bonds	UW	-0.1%	2.6%	3.4%
US investment grade bonds	OW	0.3%	0.9%	1.5%
Euro investment grade bonds	OW	-0.1%	0.8%	1.1%
US high yield bonds	OW	0.7%	0.9%	1.9%
European high yield bonds	OW	0.7%	-1.3%	-0.1%
EM sovereign bonds		0.7%	2.5%	3.0%
EM corporate bonds		0.9%	1.8%	2.3%

Source: Bloomberg, UBS as of 10 March 2016

OW = tactical overweight

UW = tactical underweight

Market comments

Calculations are based on the past five days

- Global equity prices were volatile during the week. **Emerging market equities (+1%)** benefited from higher commodity prices, with **European stocks (+0.3%)** and **UK shares (+0.3%)** making smaller gains.
- **Oil prices climbed 10%** due to temporary supply outages in Iraq, and renewed expectations for falling US output. **US high yield (+0.7%)** rallied, given energy issuers' 15% weight in the index.
- Commodity currencies rallied against the US dollar last week, with the **Russian ruble (+3.3%)** leading the pack. As oil rebounded, the **Norwegian krone rose 0.7% versus the EUR.**

In focus

Services PMIs solidified, indicating firmer sentiment. February's final reading of 53.3 in the Eurozone suggested that sentiment looks to be stabilizing. The US ISM non-manufacturing slid to 53.4 in February, from 53.5 in January (beating consensus of 53.1). *We expect service sector stability to support gradual economic growth in the US and Eurozone, and probable discussion of "balanced" risks at next week's US Federal Reserve policy meeting.*

Chinese Premier Li Keqiang scaled back the official target for 2016 economic growth at the National People's Congress. Key takeaways were: 1) a GDP growth target of 6.5–7.0% (versus 7.0% last year), still consistent with the promise to double 2010 GDP by 2020; 2) an M2 growth target of 13% y/y (versus 12% last year); 3) a total social financing target of 13%, rather than the previous CNY new loans target. A larger fiscal deficit target of 3.0% may be used to increase infrastructure and social spending, *supporting our forecast for 6.2% economic growth this year, but no hard landing.*

Japan revised its 4Q15 real GDP figure, but the economy still contracted. The second estimate of Japan's 4Q15 real GDP indicated that the economy shrank by -1.1% q/q (annualized) instead of -1.4%, given upgrades to inventories and capex. However, private consumption and net exports remained subdued. *CIO expects further Bank of Japan easing in the coming months (despite its*

recent comments) in a bid to support economic growth and reflation. CIO maintains an underweight position in the Japanese yen in global portfolios, as interest rates remain below zero.

Political uncertainty anticipated in Germany, the US, and the UK.

Regional elections take place in three German states this weekend. Populist right-wing party Alternative für Deutschland (AfD) may rise in the polls. More US primary results will follow next week – can Donald Trump continue his march toward the Republican nomination? Meanwhile, the debate over EU membership rumbles on in the UK. Brexit uncertainty has already hit sterling, but *CIO foresees a reversal after June 23, in our base case scenario for a "remain" vote.*

The outlook for global stocks remains mixed, and we remain neutral in global portfolios.

What factors support equities? US labor data and consumption are solidifying, as nonfarm payrolls posted a consensus-beating 242,000 gain last Friday. And investor sentiment is mending – last week saw the strongest inflow since 1992 into US high yield credit. *CIO has a tactical overweight position here.* On the negative side, earnings trend growth appears to be flattening, while political uncertainty and populism may shake investor confidence. *Our take: stay neutral over a six-month tactical investment horizon, and follow a rebalancing strategy while keeping close to long-term strategic weights.*

Deeper dive

ECB looks to the banks for growth

The European Central Bank (ECB) has put its faith in the banks. President Mario Draghi's latest package of easing measures included cuts to the deposit, refinancing, and marginal lending rates, along with an expansion in the size and scope of its quantitative easing (QE) program. But the most notable change for us was the introduction of a second round of targeted long-term refinancing operations (TLTROs) for banks – which gives them access to cheap funding to make loans.

The ECB's decision could offset some of the potential drag on banks from negative interest rates. We will be watching to see whether other central banks deploying negative rates, such as the Swiss National Bank, implement similar policies to boost bank lending.

Markets have reacted negatively to suggestions from Draghi that rates may not move much lower from here. But within equity markets we believe that the ECB package is supportive of our tactical overweight position in Eurozone equities versus emerging markets. We retain overweight positions in US and European high yield credit.

What happened?

The ECB deployed a broad range of tools, which Draghi said would "complement each other" in encouraging lending and economic growth. Among them:

- The deposit rate was cut by 10 basis points to –40bps.
- QE was increased by EUR 20bn a month (to 80bn a month).
- The central bank announced four new TLTROs ("TLTRO II"), to be launched in June 2016 and to last four years, at borrowing costs potentially as low as the deposit rate.



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Mark Haefele

What does this mean for investors?

Equities: While equities initially fell, looser monetary policy should increase the relative appeal of Eurozone equities. QE and lower rates should support profits, and we expect 3–7% earnings growth in 2016. This compares favorably with other markets, such as emerging markets (where we expect 0–5% growth).

Banks: Amid concerns that negative rates could hurt bank profits, several of the measures announced today could support the sector. The ECB's purchases of a wider range of bonds should help lower funding costs, boost credit quality, and support margins. And TLTRO II gives banks an additional incentive to step up lending. Overall, we expect a recovery in banking equities in the coming weeks supported by compelling valuations. That said, negative interest rates will remain a drag on sector profitability over the medium term, and could raise systemic risks, as banks could be encouraged to make riskier loans.

Fixed income: The expansion of QE should support credit, and we are overweight Eurozone and US high yield credit in our global TAA. In Europe, default rates remain close to zero and greater liquidity should support the segment. We will remain watchful of the impact of negative interest rates on bank profitability, given that banks comprise around 20% of the index.

The euro: Although the euro is now trading higher than before the announcement, we expect it to depreciate against the US dollar in the near term. The ECB is loosening policy at a time when US economic data has been strengthening, and we believe the market may be too complacent in pricing in only one further rate increase from the US Federal Reserve this year.

Mark Haefele
Global Chief Investment Officer
Wealth Management

Bottom line

Overall, we believe the ECB's stimulus measures should support the Eurozone economic recovery, and risky asset prices. We maintain an overweight position in

Eurozone equities versus emerging markets, and hold overweight positions in US and European high yield credit.

Regional view

From the ECB back to immigration



Podcast

www.ubs.com/cio-podcast

Ricardo Garcia

Head, European Macroeconomics

Two European institutions met this week to address a pair of intractable problems. The European Central Bank (ECB) held its March meeting today with the matter of inflation, or the lack thereof, front and center, while Monday the European Council (EC) convened to tackle the immigration issue.

Investors can be forgiven for wondering whether the measures ECB President Mario Draghi and his crew announced today, which include a 10-basis point (bp) deposit rate cut to -40bps and a monthly EUR 20bn expansion of quantitative easing (QE), will boost inflation and the inflation outlook. The ECB has been adopting rate cuts and various boosts to its QE program for some time now, and we are being rightfully asked whether this one will work.

Short term, inflation remains hostage to the price of oil, but over the medium term we do think that the ECB will succeed in bringing it near its target of below, but close to, 2%. Indeed, we have observed the benign impact of monetary easing doses in the past. In the current case,

the effect of low oil prices should filter out over the next 12 months as well, so we are optimistic.

“‘This is a real game changer’ is the way Jean-Claude Juncker termed Turkey’s proposed solution at Monday’s EC meeting.”

Are we as optimistic about the latest immigration plans discussed at Monday’s EC gathering? The “situation is very tense,” Angela Merkel said afterward. As are the stakes. Immigration has become the chief concern of EU citizens, and crucial political votes loom, starting with the UK referendum on EU membership on 23 June.

In the UK, immigration worries have intensified markedly. The integrity of the EU is at stake and a humanitarian crisis is unfolding at its doorstep, so heads of state are scrambling to find solutions. Something decisive needs to be done, but the risk is that a rushed solution could cost the EU severely in the form of the UK leaving it and the further rise of populist parties in member countries.

The number of immigrants has plunged since last fall, but the return of better travel conditions might lead to a pick-up – just before the UK vote. Even if the total stabilizes at its current reduced level, it exceeds Europe’s capacity to absorb refugees, so something has to give.

“This is a real game changer” is the way EC President Jean-Claude Juncker termed Turkey’s proposed solution at Monday’s EC meeting.

It involves returning all illegal new immigrants on Greek islands to Turkey. The EU would accept

one Syrian refugee from Turkey for every illegal refugee from a Greek island who was sent back to Turkey. Although the details have yet to be agreed, this proposal should break the business model of the smugglers, according to Juncker.

Turkey hosts more refugees than any other country worldwide, and has already spent USD 10bn on camps. The EU will have to make concessions to Turkey for helping it resolve the crisis, by increasing funding to it for the refugees on its soil and by advancing negotiations on its accession into the EU.

We expect EU heads of state to reach a final agreement with Turkey on 17 and 18 March, which opens the prospect of normalization in Europe. This solution should underpin consumer confidence, which retreated due to the market turmoil early this year.

Now if inflation finally cooperates too, the future should look much rosier for Europe.

Kind regards,
Ricardo Garcia

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