

UBS Asset Management Flash Commentary

Update on December ECB Governing Council Meeting

What happened and why?

In line with expectations, the European Central Bank eased monetary policy at their December meeting. However, markets were disappointed by the extent of the measures. Those which were announced came in at the low end of expectations while other, widely anticipated measures were not introduced at all.

As forecast, the ECB cut the deposit rate by 10 basis points while the Quantitative Easing program (QE) was extended for a further six months – the smallest extension priced in by the market. However, the ECB made no move to increase the size of the current program, nor did they introduce a two tiered deposit rate – a possibility which seemed to be under discussion in the last few days.

Two additional modifications were made to the current QE program, namely the re-investment of the principal payments and the inclusion of regional or local government bonds, but these failed to produce a positive market reaction. The former will not start before 2017, and the latter is not seen as positive for sovereign yields as it re-directs some of the ECB purchases away from government bonds.

The ECB continues to see downward risks to the outlook for Eurozone inflation and, for this reason, it re-stated its commitment to do more if necessary. However, Draghi sounded less dovish than market had expected and expressed a high degree of confidence in the success of the QE program to support the recovery.

We think the ECB will continue to keep an easing bias and do not exclude further policy action in the first half of next year. While inflation should pick up somewhat in coming months driven by base effects in the energy sectors, core inflation is likely to remain very low as both domestic and external inflationary pressures remain subdued.

What was the market reaction?

Market expectations ahead of the ECB meeting had built up considerably fuelled by press leaks on the measures being discussed, combined with dovish

comments by ECB board members and the national central bank governors. In this context, markets were disappointed by the new measures introduced by the ECB and the press conference that followed the policy meeting. Consequently, we saw a significant sell-off of sovereign rates, given that the size of QE was not extended and the inclusion of regional government securities will decrease future demand for sovereign bonds. At the same time the smaller than expected extension of the QE program led to steeper yield curves, especially in the periphery.

Implications for our Fixed Income portfolios

Our global bond portfolios are positioned around the themes of central bank divergence and additional ECB monetary accommodation. Specifically, most global portfolios are overweight Eurozone exposure versus an underweight to US exposure. Within the Eurozone, portfolios are overweight the periphery versus the core sovereign markets. While the actions taken today by the ECB have disappointed the markets in the short term we expect the extension of the asset purchase program, re-investment of principal, and other measures taken to continue to play out. Moreover, we see the potential for an outright increase in the purchase program during 2016.

Similar to the global bond portfolios, our Euro bond strategies are also tactically overweight periphery versus core sovereign markets. With the ongoing policy easing by the ECB and low yield environment, it is our expectation that this spread should continue to narrow.

Despite today's initial market reaction, yields on peripheral Eurozone sovereign bonds remain lower than in November and well below levels earlier in the year, thus our positioning has played out to date.

Implications for our Multi-Asset portfolios

Despite today's movement the ECB's accommodative stance should continue to lend support to risk assets including Eurozone equities. Furthermore, the ECB provided reassurance that it



would not exclude the use of all other instruments if it were to decide that they were the right ones.

While market expectations of the scale of additional stimulus that the ECB is willing to provide – and indeed, the ability of the Governing Council to reach consensus on further expansionary measures – appear to have overshoot what is likely to be feasible in reality, these latest developments have limited impact on our current investment views. That the ECB has become more accommodative should continue to support Eurozone equities, which are also benefiting from the regional economic recovery, Euro and oil price weakness,

and the potential for earnings growth to gather momentum. Leading up to the meeting, however, we have been reducing Eurozone equity exposure across some of our portfolios, primarily to take profits. We also closed our long German vs. short Swedish equities position, with German companies having been among the biggest beneficiaries of continued Euro weakness relative to other developed currencies.

For details on specific portfolios please contact your usual client relationship manager.

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