UBS House View

Europe
Chief Investment Office WM

Weekly

29 October 2015

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Market moves

	CIO view	*–1w*	*– 3m*	*ytd*
S&P 500		3.5%	–0.3%	3.2%
Euro Stoxx 50	OW	1.5%	–4.5%	11.5%
MSCI EM	UW	0.2%	–3.8%	–7.9%
FTSE 100	UW	0.1%	–2.5%	0.7%
SMI		1.6%	–4.8%	2.4%
NIKKEI 225	OW	2.7%	–6.1%	10.2%
US high grade bonds	UW	–0.4%	1.6%	3.1%
Euro high grade bonds	UW	1.3%	2.4%	2.5%
US investment grade bonds	OW	–0.2%	1.4%	0.7%
Euro investment grade bonds	OW	0.5%	0.4%	–0.2%
US high yield bonds		0.1%	–1.2%	–0.4%
European high yield bonds	OW	0.7%	–0.1%	2.4%
EM sovereign bonds		0.5%	1.3%	3.0%
EM corporate bonds		0.4%	–0.2%	3.6%

Source: Bloomberg, UBS as of 29 October 2015
OW = tactical overweight
UW = tactical underweight

Market comments

Calculations are based on the past five days

- **Global equities** had a strong week, with the S&P 500 up 3.5%, Euro Stoxx 50 up 1.5% and the Nikkei climbing 2.7%.
- In **fixed income,** US high grade bonds were on the defensive, losing 0.4% while high yield bonds rose 0.1% in the US and 0.7% in Europe.
- Crude had a volatile week, with **Brent up 0.7% to USD 48.83/bbl** after a sharp rally on Wednesday.
- In **foreign exchange**, the EUR weakened 3% against the USD to 1.10.

In focus

The People's Bank of China cut interest rates and the Reserve Requirement Ratio (RRR) on Friday to aid the economy's structural transition. *CIO expects further easing and cuts to the RRR by another 300–400bps in 2016; CIO is neutral on Chinese equities.* After the market close on Friday, the PBoC announced a 25bps cut in interest rates, a 50bps cut to the RRR and removed deposit rate ceilings for banks. In other news, China stepped away from its 7% growth target, as Premier Li Keqiang said the government will not "defend it to the death."

President Mario Draghi struck a dovish tone at the ECB meeting, hinting at further monetary easing later this year. At a press conference, Draghi stressed the "downside risks" to economic growth and inflation, adding that the "degree of policy accommodation will need to be re-examined." We believe that rather than boosting the size of bond purchases, the ECB will opt to push the deposit rate further into negative territory, along with extending the duration of QE.

The Federal Reserve kept rates on hold at its October meeting. But the rate-setting committee appeared to set the stage for an imminent rate rise. The FOMC toned down a reference to the downside risks posed by "recent global economic and financial developments" in its September statement. The committee also specifically pointed towards the possibility of a December rate rise.

China's home prices are rising on a broad basis, up in 39 cities in September, adding to our confidence that the nation will avoid a hard landing. The average new home prices tracked by SouFun rebounded in September by 0.3% m/m, from a 0.95% fall in August. Year-over-year house prices fell by just 0.9%, versus –2.3% for August and –3.7% in July. In March and April, prices had deflated at a record –6.1%, based on a data series going back to 2011.

Eurozone business activity picked up in October, underlining our expectation for stronger economic data: we are overweight Eurozone equities. The Markit's Composite Flash Purchasing Managers' Index rose to 54 from 53.6, above even the most optimistic forecast in a Reuters poll. The manufacturing component of the index held steady at 52 and the services gauge climbed to 54.2 from 53.7.

Japan retail sales underscored the weakness in the economy, adding pressure on the Bank of Japan and echoing CIO's expectation for further easing. *CIO is overweight Japanese equities.* The latest consumption numbers join other falling economic drivers like exports and industry output to reinforce claims that the Japanese economy is not running at full steam. Retail sales rose 0.7% m/m in September, falling short of expectations, largely due to a sluggish demand for cars and fuel.

UK GDP growth for the third quarter undershot expectations. *CIO is underweight UK equities.* Output growth slowed to 0.5% for 3Q, down from 0.7% in the previous three months. The services sector provided the main engine of growth, expanding by 0.7%, while industrial production rose by only 0.3%. Construction was the main source of weakness, falling 2.2%.

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Deeper dive

Doubling down? The next phase of central bank easing

Watch this week's
UBS House View Weekly Video

Kiran Ganesh

Just when you thought interest rates couldn't go any lower…

The European Central Bank (ECB) last week strongly hinted that it intends to ease further: deposit rates are likely to go deeper into negative territory (we think from –0.2% to –0.3%) in December. Then, the People's Bank of China cut its policy rates for the sixth time since November. The Bank of Japan (BoJ), by our estimates, is soon likely to follow the easing trail too, in an admission that the negative effects of last year's hike in consumption taxes still need to be offset by yet more monetary accommodation. We're expecting the BoJ to announce that it will engage in still more equity buying (than the 52% of the ETF market it already owns), and maybe reduce interest rates to absolute zero, possibly as early as this week.

Smaller central banks are taking to the trail too. The Swedish Riksbank added to its quantitative easing program, potentially pre-empting ECB action. The Bank of England has adopted a far more dovish tone of late, part of the reason we recently removed our British pound overweight. And the Swiss National Bank may need to reconsider its position if ECB easing puts upward pressure on an already strong Swiss franc.

The hunt for yield is on again
With central banks attempting to boost inflation in a decidedly disinflationary world, we should expect more of the same at a global level in the months ahead.

We see three key consequences:
First, the hunt for yield is on again. Italy, its 132% debt-to-GDP ratio notwithstanding, was able to convince investors to pay to lend this week, and became the latest country to issue debt at a negative yield. We overweight European high yield credit, a potentially major beneficiary of this trend.

Second, the easing should support risky assets. Given the bumpy ride this year, it's easy to forget that the first quarter was a good one for global equities – thanks in part to a flurry of central bank easing. The magnitude of the rally may be smaller this time, but we think the principle of loose monetary policy supporting equity markets is unchanged. We remain overweight equities.

Finally, currency volatility is likely to stay elevated. Average currency volatility this year has been the highest since 2011. While it is tough to predict the precise sequencing of easing, we recommend that investors look to hedge their foreign currency exposure.

The Fed footnote
Of course, the one central bank conspicuous by its absence in the above discussion is the US Federal Reserve. After briefly flirting with more dovish policy last month, it seems to be back on the hiking path again. In its October policy statement released this week, it commented on the downside risks posed by "global developments" and hinted that it would discuss the appropriate level of rates at its "next meeting." Immediately after the statement, futures moved to price in a 50% probability of a December rate hike.

Kiran Ganesh
Global Investment Office

Bottom line

This past week saw the latest round of global easing. We think that loose global monetary policy is likely to drive a hunt for yield, supporting risky assets, particularly Eurozone and Japanese equities, and European high yield credit. The Fed seems more inclined to increase rates, but we expect it to exercise caution, and do not envision gently higher US rates as a major threat to growth.

Regional view

Turkey, the UK and the EU: Say hello, wave goodbye?

Podcast
www.ubs.com/podcast

Bill O'Neill
Head Investment Office UK

Recent developments in the Middle East have battered their way through European politics, driving home the economic, financial and political consequences of Syria's tragic five-year civil war*. The EU has proposed significant financial support to Turkey, as host to over two million (mostly Syrian) refugees, alongside efforts to better police its borders with Greece. This summer's migrant crisis may well shape the EU's relationship with Turkey, where lengthy accession talks have stalled in recent years amid political upheaval in Ankara. Meanwhile, the migrants' western surge has weakened support for continued UK membership at a delicate point in London's dance around the terms of any reformed relationship. We look at the dynamics behind both political narratives.

First the numbers. Turkey has spent around EUR 7.5bn to accommodate the migrants. The EU is proposing financial support of some EUR 3bn, or 0.02% of EU GDP. Turkey has not accepted the offer, but the amounts are tiny relative to the costs in establishing hosting centers for and processing migrants that have already arrived (EUR 20bn is an estimate for Germany alone). Chancellor Angela Merkel has offered to (potentially) open new chapters in the EU entry talks with easier visa conditions for Turkish citizens in return for closer cooperation. Some progress on Turkey's EU membership candidacy is possible, but opposition from different European countries and conflicting views on key issues will likely delay progress. Ankara wants a success story after a traumatic period. The escalation of terrorist attacks within Turkey, and the imminent parliamentary election have put the economy into "wait-and-see" mode. Inflation is high and private credit growth and consumption indicators have taken a sharp downturn. Turkey remains wary of EU motives; and the visa-free-travel issue is seen as a litmus test.

"Stand by for a volatile spring."

Meanwhile, nervousness persists in London over the course of UK negotiations with fellow EU members, ahead of an in-out referendum we expect in 3Q next year.** Opinion polls point to retreating support for membership. The CIO UK team still sees a 10–20% chance of BREXIT. At this point the UK is being (unwillingly) obliged to show its hand in negotiations ahead of a crucial EU summit in December. We envisage talks will fall under four basic "modules" – migrant welfare benefits reform; deregulation and reform of EU institutions; repatriation of powers to Westminster and protection of EMU-outs in the context of the single market. The government clearly wants to see something substantial emerge in each area, but is prepared to haggle to achieve a credible final package.

We should be prepared for an intense backlash from the euro-sceptic parties once a deal is agreed. The interregnum between the EU deal and the launch of the official campaign is one of acute risk for Prime Minister Cameron and the cabinet. Stand by for a volatile spring.

Kind regards,
Bill O'Neill

* For a broader discussion of the impact of the Syrian war, see Investing in Emerging Markets, Syria: Low but growing risk for investors, CIO, 27 October 2015

** See UK economy: EU Referendum: The long road to a "yes" vote, CIO, 9 July 2015

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