UBS House View

Europe
Chief Investment Office WM

Weekly

21 April 2016

Deeper dive

Is China's stimulus sustainable?

— p. 2

Regional view

Equities, ketchup and toothpaste

— p. 3

Market moves

	CIO view	–1w	– 3m	ytd
S&P 500	OW	1.0%	13.1%	3.6%
Euro Stoxx 50	OW	2.9%	7.7%	–2.9%
MSCI EM	UW	0.5%	23.9%	7.4%
FTSE 100		0.6%	12.5%	4.2%
SMI		2.0%	4.4%	–4.8%
NIKKEI 225		2.7%	9.3%	–8.0%
US high grade bonds	UW	–0.2%	2.1%	3.4%
Euro high grade bonds	UW	0.0%	2.6%	4.2%
US investment grade bonds	OW	0.1%	4.8%	4.7%
Euro investment grade bonds		0.2%	3.3%	2.9%
US high yield bonds		1.1%	10.4%	6.3%
European high yield bonds	OW	0.8%	6.6%	3.7%
EM sovereign bonds		0.7%	9.1%	7.0%
EM corporate bonds		0.6%	7.5%	5.8%

Source: Bloomberg, UBS as of 21 April 2016
OW = tactical overweight
UW = tactical underweight

Market comments

Calculations are based on the past five days

- Equities posted a second week of gains. **Eurozone equities (+2.9%)** led the pack, and **Japanese stocks (+2.7%)** reversed losses following tragic earthquakes. **US equities rose 1%**, helped by an encouraging start to the 1Q earnings season.
- Kuwaiti strikes and falling US production data boosted **oil prices (+4.3% for Brent, +6.3% for WTI). Silver (+7.6%)** rose to an 11-month high; **gold** rallied 2.5%.
- In **currency markets** the yen fell for a second week against the US dollar, down 0.4% ahead of next week's BoJ meeting. The **Australian** and **Canadian dollars (both +1.4%)** strengthened vs the USD as commodities climbed. Norway's krone also rose 1.1% against the euro.

In focus

Oil on the slide after disappointment in Doha. Sixteen producers reached no agreement to freeze oil production last weekend, as Saudi Arabia refused to risk losing market share unless Iran also agreed to curb its output. News of a public sector strike in Kuwait sparked a Brent oil rally toward USD 45/bbl, but prices slipped again on Wednesday as industrial action was called off. *CIO expects oil prices to fall toward USD 30/bbl in 2Q given continued oversupply, though capex cuts should reduce non-OPEC supply in the second half, boosting Brent oil prices toward USD55/bbl in 12 months.*

China's growth stabilized in 1Q, but debt is on the rise. The Chinese economy expanded by 6.7% y/y in the first quarter, versus the 6.8% growth in 4Q15 and in line with the government's forecast for 6.5–7% growth this year. Retail sales held steady, rising 10.3% y/y, slightly above the consensus forecast, while fixed asset investment in urban China climbed 10.7% y/y for the three months. More stable growth came at the cost of rising debt – overall credit rose 16.6% y/y in March, a 21-month high. *CIO expects China to use selective stimulus to support a gradual growth slowdown, but rising leverage may pose risks to its financial stability.*

US retail sales softened last month. March retail sales fell 0.3% m/m, largely due to a decline in auto sales. More positively, the US Federal Reserve's Beige Book was released and painted a brighter picture of the labor market as most districts saw modest or moderate growth in wages. *CIO expects tighter US labor markets to lead to higher wages and stronger consumption this year. We are overweight US equities in global portfolios.*

Easy does it for Eurozone bank-lending standards. The European Central Bank's (ECB) 1Q bank lending survey revealed further easing in net credit standards for corporate loans. Consumer credit was also more readily supplied by banks, and net demand continued to increase, albeit less strongly than in 4Q15. Unconventional policy is no panacea, however; Eurozone banks reported that negative interest rates were raising lending volumes, but reducing lending margins and net interest income. *CIO believes ECB policy easing should feed through into easier financial conditions and support Eurozone economic activity, but will compress bank profitability.*

Earthquakes in Japan killed at least 48 people. A 6.7-magnitude tremble late Thursday was followed by a second, 7.3-magnitude quake in Kumamoto on Saturday. The tragedies led to mass evacuations, as well as some shuttering of production capabilities. In financial markets the Nikkei traded lower on Friday and lost 3.4% on Monday. Despite the disfavor for Japan weakening its currency expressed by other G20 members at last weekend's summit, *CIO still expects Japan to ease fiscal and monetary policy further, perhaps as soon as next week's Bank of Japan (BoJ) policy meeting. We forecast USDJPY to rise to 117 in three months and 120 in six months.*

What to watch? The Fed concludes its two-day monetary policy meeting on Wednesday – *we expect no change in US interest rates this month.* Conversely, the BoJ may announce further policy easing when it convenes Thursday. Around 35% of S&P 500 Index earnings for 1Q are due for release next week in the US, the busiest week of the season.

UBS

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Deeper dive

Is China's stimulus sustainable?

Matthew Carter

Thomas Deng

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Recent Chinese data suggests growth has stabilized. For some, though, growth worries have been supplanted by debt concerns. Investors are rightly asking whether China's apparent credit-driven stimulus is sustainable.

What happened?

Chinese GDP growth steadied to 6.7% in the first quarter, in line with the new 2016 6.5%–7.0% target. Industrial production growth quickened to 5.8% in 1Q from 5.4% at the end of last year. Steel production set records in March. And despite considerable inventory overhang, Chinese new property starts rose 27% y/y in March, and by nearly one-fifth in the first quarter. However, this has come at the cost of higher debt: overall credit rose 16.6% y/y in March to a 21-month high, and adding more debt to sectors already saddled with overcapacity is seemingly at odds with the consumer-led growth agenda.

Who wins from stimulus-led stability?

Chinese companies – at least some of them – do. In the first two months of the year, industrial profits grew 4.8% y/y, rising for the first time in 19 months. Better earnings contributed to offshore Chinese equities' 21% rebound from a February nadir. Yet with local stocks still near 20-year low valuation levels, we think further upside is possible. We remain overweight Chinese equities in Asia-ex-Japan asset allocations over a tactical six-month horizon.

Emerging markets and commodities have also benefited. We are underweight EM stocks in global portfolios, but note that higher Chinese demand for commodities, goods and services could support an EM growth bounce and lift profits over time.

Sustainable for now, but structural reforms key to growth

We believe China will continue to engage in further policy stimulus this year, potentially raising its non-financial sector debt beyond the 260% of GDP it closed last year with. It can manage this higher debt burden, however, since only 8% of it is external, and the country has a relatively closed capital account, a high and captive savings base, and is a net creditor to the world, with a USD 300bn annual current account surplus.

Medium term, however, stimulus at the current pace, particularly if credit-driven and directed toward sectors with high debt and low productivity, could lead to growing loan losses and weigh on bank balance sheets. Lower profits and slower economic growth could follow, especially if resources are diverted from more productive sectors as a consequence.

China should be able to stabilize its economy even more in coming years, but it must realize that stimulus can only be sustainable if accompanied by structural reforms, and the margins for error are narrowing.

Matthew Carter and **Thomas Deng**
Global Investment Office

Bottom line

In the near term, we believe China can maintain growth-supportive policies and manage higher debt thanks to its restricted capital account, ample FX reserves, and low levels of general government debt.

Chinese equities and EM equities broadly have benefited from firmer Chinese demand. Long term, though, China must walk a fine line between stimulus and structural reform.

Regional view

Equities, ketchup and toothpaste

Podcast
www.ubs.com/cio-podcast

Bert Jansen
European Equity Strategist

"By a continuing process of inflation, government can confiscate, secretly and unobserved, an important part of the wealth of their citizens."
John Maynard Keynes

Inflation has been undershooting expectations considerably for the past few years. Despite unprecedented central bank policy easing – the combined balance sheet of the US Federal Reserve, the Bank of Japan, the Bank of England, the European Central Bank and the Swiss National Bank has more than doubled over the last seven years – inflation in the developed world is close to zero, give or take a percent.

The message from the bond markets is that prices will continue to rise weakly. For instance, the breakeven, or expected annual inflation rate in Europe and Japan, is less than 1% for the next 10 years.

But what if the bond markets are wrong? What if the ketchup gushes out, suddenly and unexpectedly, after all those years of heavy bottle shaking (i.e. quantitative easing) by central banks?

It goes without saying that an unexpected rise in inflation will be bad for bonds. And what about equities? The conventional view is that stock markets are an effective hedge against climbing consumer prices. This is based on the principle that equity investors are owners of productive facilities, i.e. assets that retain their value in real terms in periods of escalating inflation.

But this conventional wisdom is not borne out by the facts. History shows that an increase in the inflation rate hurts equity returns. A one percentage point rise in the rate led to a fall in equity returns of 2.6 percentage points for US large caps in the 35-year period between 1973 and 2008, according to an IMF paper.

"Inflation is like toothpaste. Once it's out, you can hardly get it back in again."

Importantly, history shows that it is the change in the rate, rather than its absolute level, that affects equity returns. So, even a modest, unexpected rise from today's anemic figures could depress market P/Es (conversely, falling inflation has fueled P/E expansion over the last four years). Lower equity valuations would result from a higher risk premium (inflation variability usually increases as inflation does, creating more economic uncertainty), a loftier discount rate (which lowers the present value of future cash flows), greater input costs (squeezing profit margins), or any combination of the above.

But history never quite repeats itself. I would argue that, at least initially, equities would react positively to a pick-up in inflation expectations, outperforming bonds handsomely. If prices rose at a decent clip, the risk of deflation would decline. And deflation is a scenario the developed world is ill-equipped to cope with at this point because of the amount of debt in the system (the ratio of total public and private debt to GDP in the developed world stands at around 280% of GDP.)

The problem with inflation, however, is that it is famously difficult to control. To quote the late Karl Otto Pohl, Bundesbank president from 1980 to 1991: "Inflation is like toothpaste. Once it's out, you can hardly get it back in again."

The bottom line is that if inflation picks up unexpectedly, equities should initially outperform bonds. But any sustained, unexpected rise in it would likely drag hard on equity returns, in my view.

Kind regards,
Bert Jansen

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