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The next steps for central banks

- *More than six years into quantitative easing, central bankers are warning that the path is narrowing and that the policy is not without risks.*
- *Our base case remains that just-right "Goldilocks" economic recoveries allow central bankers to retain loose policy before steadily pulling back.*
- *But investors will need to remain conscious of alternative scenarios, including a possible "tightening tantrum" or "QE infinity."*
- *In our tactical asset allocation, we remain positive on equities and high yield credit, and initiate an overweight position in the British pound relative to the Australian dollar.*

Since the financial crisis, the US Federal Reserve, the Bank of England, the Bank of Japan (BoJ), and the European Central Bank (ECB), have printed a combined USD 5.7trn. That's enough to build a six-lane freeway out of USD 100 bills that circles the globe twice.

Perhaps unsurprisingly, given the extent of the easing, global central bank policy has been the key factor in determining investment performance in that period.

Again this year, the general idea that investors should follow the lead of central banks has worked. The Eurozone and Japan, both running aggressive quantitative easing (QE) schemes, have been the best-performing developed markets. Chinese equities have also responded very well to easing from the People's Bank of China (PBoC).

"The fix" has been in for risk assets and investors expect it to remain in place. At our recent Davos investor forum, investors overseeing a combined USD 11trn unanimously agreed that policy would continue to support risk assets this year. Still, nothing lasts forever.

More than six years into QE, central bankers are warning that the path is narrowing and it is not without risks. ECB President Mario Draghi and Fed chair Janet Yellen have both recently warned that the possible threats arising from QE need to be carefully monitored. So while policy is likely to remain stimulative through 2015, we need to examine how this outlook might alter based on changes in such variables as growth, inflation, employment, wages, asset prices, and/or inequality.

I see three paths central banks can take in the near term. The most comfortable path, and our base case, is one in which just-right "Goldilocks" economic recoveries – with low inflation, gradually improving growth, and modest wage increases – allow central

bankers to retain accommodative policy before steadily pulling back. This environment should prove supportive of risky assets like equities and high yield credit. But on either side of our base case are the more troubling paths of a “tightening tantrum” and “QE infinity.”

Let’s look at some of the signposts that might indicate which path we are heading down.

Tightening tantrum: Fast-track interest rate hikes

In our base case, we expect the Fed to start increasing rates in September. Uncertainty about the precise path of rate hikes may increase equity volatility from current low levels. But with the Fed continuing to support growth, we think the rewards of staying positive on the likes of equities and high yield credit will more than make up for the risks.

One development that could cause our confidence to fade would be evidence that the Fed is falling behind the curve in containing inflation. This would likely lead to a more rapid rise in interest rates than we currently expect – raising the threat of a “tightening tantrum” similar to the bond and equity sell-off we saw in mid-2013 when the Fed hinted at tapering QE. A larger than anticipated Fed rate hike could occur in one of two ways: inflation with growth and inflation without growth.

The key signpost pointing to the first and more benign outcome will be wage growth. Most data suggests salary pressures are low. Overall average hourly wages grew by a modest 2.2% year-on-year to April. That isn’t notably higher than the 2% average rate of the past five years, despite a near halving of unemployment since its 2009 peak. But this figure may be depressed by the creation of more low-paid positions. Other data which better reflects existing individual worker situations (rather than a simple aggregate), suggests that wage demands could be rising. The Employment Cost Index data released this month hints that existing workers are succeeding in extracting slightly higher pay packets: it rose 2.6% in the year to March (see Fig. 1). While such early signs of wage inflation have proven misleading before, we will need to remain vigilant if this index rises any further.

More troubling still would be stagflation – a pick-up in price pressures without greater accompanying growth. The wage-price spirals typical of the 1970s seem unlikely today. However, a different type of stagflation – “asset-price stagflation” – is worth monitoring. As I described in my last letter, markets fuelled by QE are producing asset-price inflation that could continue until excess leverage and speculation sucks too many resources from productive sectors of the economy. Then the Fed or other central banks may pull the stimulus despite sluggish growth.

> *The Fed should continue to support growth.*

> *But this could change if we see a pick up in inflation.*

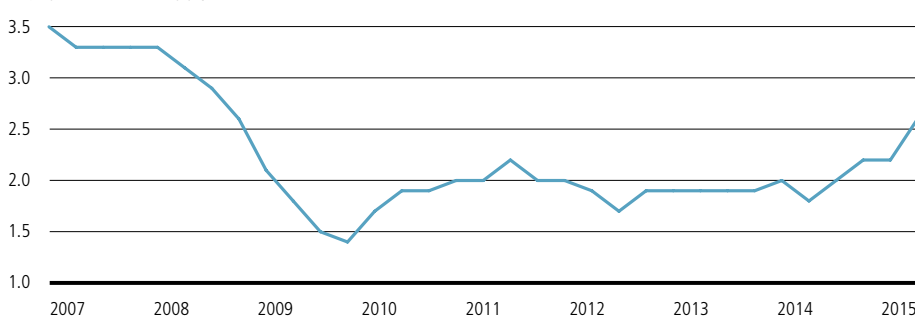
> *There are some early signs of higher wage growth...*

> *...and stagflation risks need to be closely monitored.*

> *Existing US employees are winning the largest pay increases since 2008.*

Fig. 1: Tightening tantrum? Early signs of US wage growth have emerged

Employment Cost Index, y/y growth in %



Source: Bloomberg, UBS, as of 20 May 2015

> So far, however, central banks do not need to prick asset price bubbles.

> QE may also fail to generate an economic lift-off.

> The Eurozone economy has not yet achieved self-sustaining growth.

> Indefinite QE increases the risk of over-leverage, speculation and excess inequality.

> Still global data outlook gives grounds for optimism that central banks can continue on their current path.

I don't think developed market central banks are poised to start pricking bubbles, real or imagined. Major equity markets are not cheap for sure, but neither are they dramatically overpriced. The MSCI AC World index currently trades on 16.9x price-to-forward-earnings, relative to a 15-year average of 14.8x. We also currently see few signs of overheating in wages, growth, or consumer spending.

QE infinity: An endless road

Another concern is that stimulus fails to generate sufficient growth. Even in the flexible US economy, there is a non-negligible chance that policy makers could be forced to resume easing. The US has, for the third time in succession, appeared to stall shortly after the end of a QE program. In structurally weaker economies like the Eurozone there is an even greater danger that QE will not stimulate enough growth, leading to monetary easing stretching out into infinity. Japan provides a cautionary tale on how this can happen (see Fig. 2).

Ultra-low bond yields, a weak euro, and low oil prices have given the Eurozone a temporary boost. But convincing evidence of a self-sustaining recovery is still missing, and recent market moves have shown how quickly such temporary effects can swing into reverse. Lifting growth on a lasting basis will require measures such as liberalizing labor markets and opening up industries to competition. Unfortunately, the pace of productivity-enhancing structural reform in the Eurozone continues to disappoint – notably in Italy and France.

Without a sustained pick-up in growth, the ECB could be forced into further bouts of QE. This need not be bad for equities in the near term: the QE “fix” has helped to fuel these markets the past six years and will remain a powerful force. But the longer QE drags out, the greater are the chances that some of its adverse side effects, such as speculation, over-leverage, and excess inequality, will materialize.

Staying the course

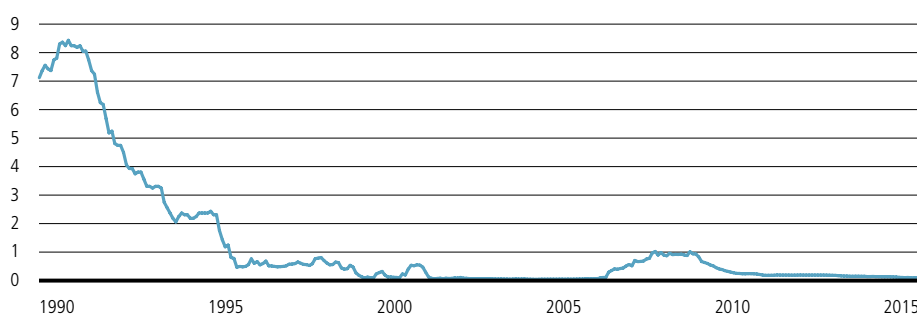
Over the past few years it could be said that the greatest challenge for investors was staying the course, and betting that central banks were determined to make “the fix” work. This challenge could become greater still in the months ahead if the volatility gripping currency and bond markets since the beginning of the year extends to the equity market. Still, overall, we believe that much of the data leads towards a benign outlook for central bank policy over our tactical horizon. Growth should be sufficient for risky assets to perform well (see Fig. 3).

In the US, GDP growth, though slightly below par, is heading for 2.3% this year. Prices remain under control, and there may be more scope for non-inflationary job growth as discouraged workers return to the labor market.

> Japan has been stuck with interest rates near to zero since the late 1990s.

Fig. 2: QE-infinity: in the footsteps of Japan?

Japan 3-month LIBOR, in %



Source: Bloomberg, UBS, as of 20 May 2015

In Europe growth has surprised positively so far this year, and with unemployment still elevated, the ECB should be able to maintain loose monetary policy without fearing a sharp rise in inflation. The ECB's willingness to be pro-active about addressing potential market disruptions, as demonstrated again in the past week, is a further positive – especially if the Greek situation deteriorates.

Japan is also making some progress. BoJ Governor Haruhiko Kuroda recently claimed that the nation's output gap has closed to "about zero" and inflation will soon start to rise to healthier levels.

In addition, there are grounds for optimism about the Chinese economy, in the near term at least. The PBoC has extended some local government debt maturities and already cut borrowing costs three times over the past six months. The Chinese government's ability to influence economic activity should not be underestimated.

Asset allocation

So where does this leave us? We will remain vigilant for any signs that central banks will be forced away from their preferred path of pro-growth policies. But over our tactical six-month investment horizon we do not currently see economic pressures emerging that will cause central bankers to deviate. While the threat of deflation has abated, there are no immediate indications that inflation is accelerating too fast. The growth trajectory looks relatively promising in the US, Europe, and Japan, without any immediate signs of overheating.

> *We remain overweight in risky assets, both in equities and high yield credit.*

We therefore remain overweight in risky assets, both in equities and high yield credit, with our largest overweight position in Eurozone equities. They should continue to benefit from policies of the ECB, which seems to be the central bank most committed to staying the course with its QE program.

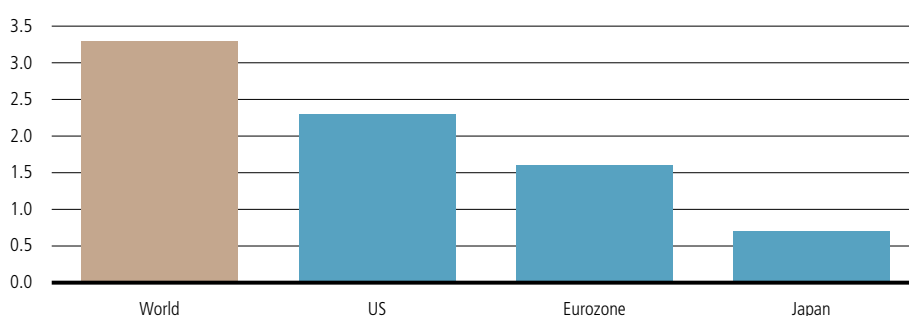
To become incrementally more positive on risk assets, we would like to see greater low-inflation growth in the major economies – ideally including some combination of a pick-up in US consumer spending, a sustained improvement in Eurozone domestic demand, greater global earnings momentum, and a rise in business confidence that translates into stronger capital spending.

> *We are adding a tactical overweight position in the British pound relative to the Australian dollar.*

In our tactical asset allocation this month, we are initiating an overweight position in the British pound relative to the Australian dollar. We believe the recent strengthening of the British economy and the weakening of commodity-reliant Australia will lead to a divergence in monetary policy. An unwinding of existing carry trades in the AUD has yet to be fully priced into the market. AUDGBP is currently overvalued by 18%, in our view.

Fig. 3: Economic growth should be sufficient for risky assets to perform

Full-year GDP growth forecasts for 2015, in %



> *US GDP is expected to grow by 2.3% this year, against 1.6% in the Eurozone and 0.7% in Japan.*

Source: UBS, as of 20 May 2015

> *Eurozone equities are our most preferred asset class over our tactical investment horizon.*

Elsewhere, we maintain our overweight positions in equities and high yield credit. Global economic growth should remain underpinned by central bank policies that support near-term growth. Eurozone companies in particular are well-placed to benefit from a weak euro, low debt-refinancing costs and the region's accelerating economy. Eurozone equities are our most preferred asset class over our six-month investment horizon.



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