

UBS House View

Monthly Letter

Chief Investment Office WM
24 September 2015

Central banks

The ability of the world's central banks to deliver self-sustaining economic growth is being called into question, which has depressed markets and heightened volatility.

Emerging markets

Concerns about China and other emerging markets have caused investors to take a more pessimistic view of economic data worldwide.

Global economy

Markets are likely to remain volatile as we wait for third quarter economic and earnings releases. But we think developed market growth and earnings will hold up.

Asset allocation

We are closing our overweight position in US high yield bonds. As positive data is released, we think developed economy equity markets will resume their rise.



Mark Haefele

Global Chief Investment Officer
Wealth Management

Tired titans

Central bank contributions to raising global growth and markets since the financial crisis have been colossal – evoking the Greek titan Atlas bearing the weight of the heavens on his shoulders. Yet in recent months, confidence in the power of monetary policy makers has been shaken.

Chinese authorities have been dealt tactical defeats in their efforts to prop up the domestic equity market and fix their currency. Investors are now deeply skeptical of the Bank of Japan's (BoJ) ability to meet inflation targets without further stimulus. And the US Federal Reserve's decision to keep interest rates at record lows confused markets by adding new language about global growth concerns. With more central banks playing a role in how global growth evolves, investors require a high risk premium until the growth picture improves.

Recent market moves have investors questioning the efficacy of quantitative easing's (QE) upside impact on equity markets. Markets are likely to remain fragile in anticipation of economic growth data that are still a few weeks away.

But we do not believe central banks have exhausted their strength. Nor do we think that weak economic data represents more than a mid-cycle slowdown. Much of the recent weakness around the world has been concentrated in manufacturing, while service sectors continue to expand. In addition, developed economies have held up despite the downturn in emerging markets. With upcoming numbers likely to reflect ongoing economic and earnings growth, we expect developed market equities to move higher over the next six months. Thus, we are overweight risky assets.

We have made one change to our tactical positioning this month: a downgrade in US high yield from overweight to neutral. This position, which has performed well since initiation in 2011, no longer offers an attractive risk-adjusted rate of return. An increase to our equity overweight position is under consideration, but we need to see a reduction in market volatility and evidence that developed market economies are stable before taking action.

Despite aggressive stimulus measures by the Chinese government, economic data and markets have remained weak.

Doubts have mounted over the capacity of the Bank of Japan to boost growth...

...while US data has not yet been strong enough to give the Fed sufficient confidence to raise rates.

Volatility has climbed to the highest level since 2011.

Observe – what has happened over the past month?

The Chinese government continued its relatively aggressive efforts to mitigate the growth slowdown and stock market rout. Fiscal spending rose more than 25% year-on-year in August, and unusual price action in the closing hours of Shanghai trading suggests that stock market interventions have continued. Despite aggressive stimulus measures by the Chinese government, economic data and markets have remained weak. According to the latest Caixin flash PMI for September, manufacturing activity has fallen to its lowest level in six-and-a-half years due to weak demand.

In the Eurozone, QE has not yet led to an acceleration of growth. Optimism that the ECB's QE would drive equity markets higher has been undermined by slowing economic growth in emerging markets and the knock-on effects of capital spending cuts in commodity-related sectors. Inflation readings within the Eurozone highlighted that the threat of deflation still lingers.

Japanese economic growth and inflation readings have yet to fully respond to the BoJ's stimulus packages. Doubts are mounting over the BoJ's ability to boost growth. The economy started the year strongly, with GDP rising at an annualized 4.5% in the first quarter, but relapsed in the second quarter as reduced business investment and disappointing consumer spending contributed to a 1.2% contraction. Inflation remains exceptionally low.

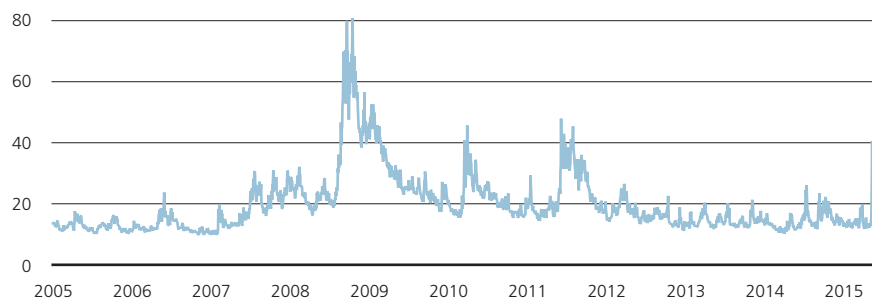
US data has remained firm, with the jobless rate declining to 5.1%, but not enough to give the Fed sufficient confidence to raise rates. The manufacturing ISM fell to 51.1, its lowest level in two years, due to concerns about exports and low capital spending. The manufacturing index may fall into contractionary territory below 50 in the coming months – though we expect services readings to remain healthy. In response to weaker growth in China and financial market volatility, the Fed opted to keep interest rates at a record low. Markets nonetheless have continued to decline, with the S&P 500 down 4% since the Fed's decision.

Financial markets

Global equities are down 13% from their peak in June, the largest fall since 2011, leading investors to question the ability of central banks to protect downside and push markets higher. With concerns that central banks may no longer offer a free put, investors rushed to buy the old fashioned variety. The rise in equity options implied volatility for the S&P 500, a measure of the price of insurance, reached 53.3 at one

Fig. 1: Nervousness on financial markets has risen substantially

VIX index, in index points



Note: VIX index = Chicago Board Options Exchange Volatility index which reflects a market estimate of future volatility based on the weighted average of implied volatilities for a wide range of strikes
Source: Bloomberg, UBS, as of 23 September 2015

We believe disappointing data represents a mid-cycle slowdown and not a slide into recession.

Subdued inflation means that central banks have the ability to stimulate more if necessary...

...and the lagged effects of previous easing should still help economies over coming months.

What's more, economic data has not been bad enough to justify the steep slide in markets.

Manufacturing is less important than the services sector.

point on August 24. For context, in 2008 it took three weeks after the Lehman Brothers collapse for volatility to reach such a level, and a CBOE Volatility Index (VIX) level of 53.3 surpassed levels reached during any of the Eurozone crises or after the Japanese Fukushima tragedy.

Orient – What is our base case for the next six months?

While markets have reacted badly to the notion that central banks have lost their mojo, we believe investors are underestimating central bank capacity to influence markets. The progress made towards recovery has been largely overlooked, whereas the magnitude and breadth of the weak economic data has been overanalyzed. We believe disappointing data represents a mid-cycle slowdown, not a slide into recession. A combination of improving readings from the US and a gradual recovery in China should help restore faith in the global growth picture.

First, central banks have the power to do more in a low-inflation environment.

China still can trim its one-year official interest rate, making debt servicing easier, and lower its Reserve Requirement Ratio (RRR), permitting banks to lend more. In the Eurozone, ECB President Mario Draghi has been explicit in his willingness to unveil bigger monetary policy guns, saying on September 3 that “the size, composition and duration” of QE could all be enlarged. We consider it likely that the BoJ’s asset purchase program, running at JPY 80trn (USD 663bn) annually, will be increased in response to low inflation readings. And in the US, while debate rages about the merits of the Fed’s recent non-decision, Chair Janet Yellen and her colleagues have proven they are flexible enough to maintain ultra-low interest rates if they see fit.

Second, we should remember that stimulus takes time to feed through into hard data.

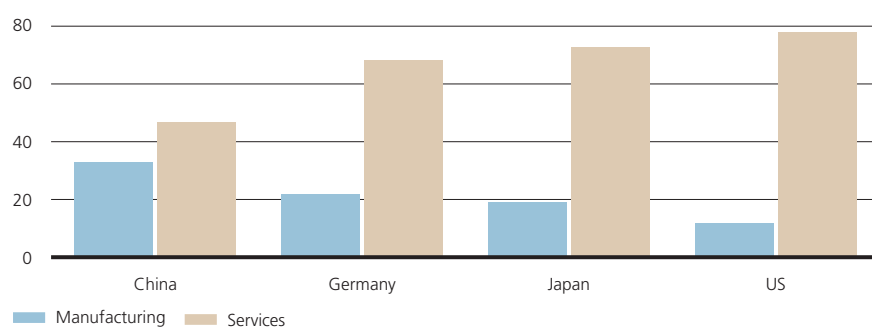
In China, the benefits of measures - such as increased fiscal spending, recent RRR cuts, and credit asset securitization schemes - are still working their way through the economy. In the Eurozone, ongoing QE is stimulating lending: loan flows to households and non-financial corporations have been the strongest in four years. And in the US, gasoline prices have fallen by 17% since the middle of the year, so for many Americans a gallon of gas is now cheaper than bottled water. Mortgage rates have dropped by almost 40bps, further depressed by the Fed’s non-action. Worldwide, then, the delayed effects of previous easing cycles should still help economies later in the year.

Finally, economic data has not deteriorated to the extent that a great deal of additional stimulus is required.

Most of the weakness is confined to the manufacturing sector, which makes up just 12% of US GDP and 19% of German GDP.

Fig. 2: Services make up the lion’s share of GDP

Value added for sector as of % of GDP for 2013



Note: Value added is the net output of a sector after adding up all outputs and subtracting intermediate inputs.
Source: World Bank, UBS, as of 23 September 2015

Even in China, commonly perceived as a manufacturing powerhouse, it represents just 31% of value added in the economy. We are encouraged by signs of a stabilization of China's housing market, with prices rising in 35 out of 70 cities in August. Given that about 40% of household wealth is held in property, this bodes well for consumer spending. Retail sales growth is on track to remain above 10%. In developed economies manufacturing weakness is being balanced by service sector strength, with non-manufacturing PMIs in the Eurozone at 53.9 and 59 in the US. The non-manufacturing ISM in the US, for example, has opened up the widest gap against the manufacturing gauge since 2008. Overall, we believe weak economic data does not justify the steep slide in markets.

Decide – what are signs our base case is wrong?

We are on alert for signs that our base case for improving markets is wrong.

As we await improved data, ongoing volatility remains a concern. We face a murky period between now and the next Fed meeting, with a several-week hiatus until the next series of major data economic and corporate earnings releases. In the meantime markets will remain fragile and negative news is likely to be met with exaggerated selling pressure. Our quantitative models indicate that volatility has the potential to feed on itself. We are in multi-polar world. As the Fed moves to a tightening bias, the workings of central bank policy in several regions will become more important. With more variables to worry about, risk premiums could remain higher for longer.

Inflation could become too hot. If inflation appears to be rising above central bank targets, monetary policymakers would lose much of their power to stimulate growth further. On this front, however, we see no signs of danger on the immediate horizon. In the United States the core PCE index – excluding volatile food and energy - has been below 2% for four years. In China, underlying inflation has also been sub-2% since late 2011. At 0.9%, the core Eurozone inflation rate provides no immediate constraints on Mario Draghi. And core prices in Japan – which exclude food but include energy - are even lower at 0%, far below the official 2% target.

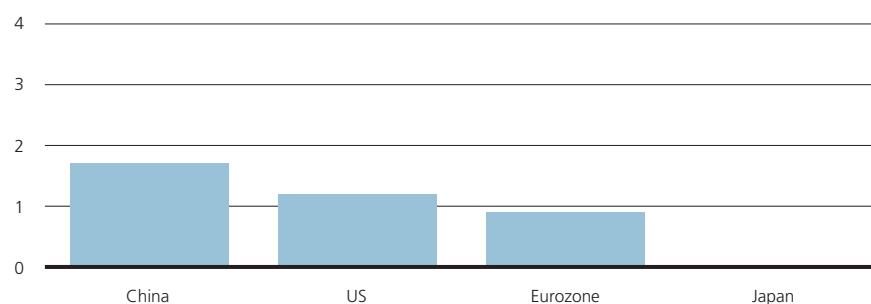
Growth could cool further. Our positive outlook for developed economies will need to be revised if we see signs of a slowdown from forward-looking indicators like business confidence, a sharp widening of credit spreads or disappointing 3Q15 economic data. We are already bracing for weak growth in emerging markets. But the figures could be worse than we anticipate. A further deterioration could be triggered by an acceleration of the recent capital flight from emerging markets. This would force central banks to draw down reserves in order to stabilize their currencies and inflation,

Our optimism would be called into question if inflation threatens to move above central bank targets.

Inflation remains low and is not restricting the freedom of central banks to support growth.

Fig. 3: Central banks are not out of ammunition yet

Core inflation measures, year-on-year in %



Source: Bloomberg, UBS, as of 23 September 2015

further reducing the amount of liquidity available to domestic banking sectors and exacerbating the slowdown.

Act - what are we recommending?

In times when both growth and rising rates are a concern, asset-class diversification can fail in its customary function of stabilizing portfolios. Recent weeks have been one such time, with equities falling and bonds offering less support than we would normally expect under conditions of heightened risk aversion. Yet such periods do not last indefinitely, which is why we believe diversification – both across regions and in terms of asset classes – is important.

We remove our overweight position in US high yield bonds, where debt dynamics have become less favorable.

We remain positive on Eurozone high yield bonds and overweight equities in the Eurozone and Japan.

Turning to our tactical six-month horizon, we are removing our US high yield bond overweight position. This asset class is becoming less attractive as levels of leverage have picked up, interest coverage has fallen, and exposure to low oil prices can still impact default rates over the coming 12 months.

Elsewhere, our tactical preferences also reflect our outlook for central bank policies. While the appeal of US high yield has declined, Eurozone high yield bonds benefit from the ECB's bond-buying program and a lack of exposure to depressed energy prices. The European high yield credit cycle is less advanced and ratings are higher than in the US. We remain positive on Eurozone high yield bonds and retain an overweight position in the Eurozone and Japanese equity markets, where monetary policy remains highly supportive.

During the recent bout of market turbulence, our long-standing underweight position in emerging markets has been advantageous. This position should continue to serve us well, given weak commodity prices, disappointing corporate earnings, and sluggish GDP growth. Our largest underweight tactically remains high grade bonds, whose low yields offer little protection from capital losses as the Fed funds rate rises.



Mark Haefele
Global Chief Investment Officer
Wealth Management

For comments please contact: ubs-cio-wm@ubs.com

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