

Deeper dive

## How will the Fed react to weaker data?

— p. 2

Regional view

## Irrational investors – the good and the bad news

— p. 3

### Market moves

	CIO view	-1w	-3m	ytd
S&P 500	OW	0.9%	7.1%	4.7%
Euro Stoxx 50		-1.3%	2.0%	-5.5%
MSCI EM		4.1%	7.6%	6.9%
FTSE 100		1.1%	3.1%	2.4%
SMI		-1.5%	3.4%	-5.3%
NIKKEI 225		0.6%	0.9%	-11.7%
US high grade bonds	UW	0.6%	2.3%	4.3%
Euro high grade bonds	UW	0.3%	1.4%	4.8%
US investment grade bonds	OW	0.8%	4.8%	6.4%
Euro investment grade bonds		0.4%	2.5%	3.6%
US high yield bonds		1.5%	6.7%	8.7%
European high yield bonds	OW	0.6%	5.0%	4.9%
EM sovereign bonds		1.8%	5.5%	8.7%
EM corporate bonds		1.1%	5.4%	7.8%

Source: Bloomberg, UBS as of 9 June 2016

OW = tactical overweight

UW = tactical underweight

### Market comments

Calculations are based on the past five days

- **Equities** had a mixed week, with the S&P 500 advancing 0.9% and taking year-to-date gains to nearly 5%. But the Euro Stoxx 50 slid 1.3%, and is now down 5.5% since the start of 2016.
- **Fixed income** gained as government bond yields touched record lows in Germany, Japan and the UK. High yield EUR-denominated bonds gained 0.6% and US high yield 1.5%.
- **Foreign exchange** markets registered broad dollar weakness versus other G10 nation currencies. The New Zealand dollar (4.4%) and Swiss franc (3%) posted the biggest gains versus the USD.

## In focus

### US job growth slowest in six years.

Just when the Federal Reserve appeared ready to raise rates again, the US labor market appears to have refused to cooperate. Instead of the expected 164,000 net new jobs, the US economy generated just 38,000 in May. That contrasts with other signs of improving employment conditions, including a fall in joblessness to its lowest level since 2007. *CIO is overweight US equities.*

### Soothing sounds from Yellen.

Winter isn't coming. This was the reassuring message on the economy from Fed chair Janet Yellen following disappointing US employment data (see above). Speaking in Philadelphia, Yellen laid out the case that further increases in the fed funds rates would probably still be appropriate before too long. *CIO expects two rate hikes from the Fed this year.*

### Upbeat trade data lifts sentiment on China.

Imports rose in yuan terms for the first time since 2014, ending a 16-month run of declines. While the 5.1% increase does not suggest that domestic demand is on fire, *it supports the CIO view that China will avoid an economic hard landing.*

### China's reserves fell... or did they?

China's foreign exchange reserves declined by USD 28bn in May to USD 3.19trn. But this appears to reflect the impact of a stronger dollar in May rather than capital flight. Adjusted for valuation, reserves actually inched up by USD 9bn. And China still accounts for about one-third of global currency reserves.

### Clinton trumps Sanders.

Hillary Clinton has declared victory over Senator Bernie Sanders in the Democratic primaries, and will now face businessman Donald Trump in the race for the White House. For the first time in modern history both major party candidates will start the campaign with net negative approval ratings. *CIO believes this will make policy outcomes harder to predict, though US elections have not historically had a major impact on markets.*

### Oil back above 50.

Both Brent and WTI closed above USD 50 a barrel on Tuesday for the first time since July 21 of last year. But oil may slide below this symbolic milestone in coming months as supply disruptions clear in Canada, Nigeria and Libya. *CIO believes oil can fall back under USD 40 in the short run before recovering to USD 55 in the coming 12 months.*

### Thanks for nothing, Switzerland.

The Swiss National Bank has announced it will sell a 13-year bond with a zero coupon, its lowest fixed interest rate on record. The yield on Swiss government bonds on the secondary market is already negative up to 20 years. *CIO is underweight high grade bonds, and we expect returns to be negative on euro and Swiss franc bonds.*

### Eurozone growth revised up.

GDP expanded 1.7% annualized in the first quarter, slightly higher than previously forecast. It was also three times faster than in the US. That said, in recent years US growth has suffered a lull in the first quarter, and rebounded smartly in subsequent quarters. *CIO is neutral on Eurozone equities and overweight euro-denominated high yield credit.*

Deeper dive

# How will the Fed react to weaker data?

In a speech this week, US Federal Reserve Chair Janet Yellen clarified her thinking on the economy and the outlook for Fed policy following last Friday's surprisingly weak labor report, which showed payroll growth in May slowing to its lowest level since 2010. While Yellen called this "concerning" and repeatedly noted the uncertainty in the economic outlook, overall she was cautiously optimistic. In our view, if the incoming data is reasonably good, then the Fed will be hiking rates in the not-too-distant future.

When thinking about monetary policy, it's important to focus on the Fed's dual mandate: maximum employment and price stability, where stability is defined as a 2% inflation rate. Yellen stated, "I believe we are now close to eliminating the slack that has weighed on the labor market since the recession," and "I expect inflation to move back to 2%" as the impact of lower oil prices and the strong dollar fades. The big picture, then, is that the Fed is still on track to fulfilling its mandate.

Further, Yellen repeated previous comments that the "neutral" fed funds rate is around 1 percentage point above the current rate, and that it would likely rise over time. Yellen has also said many times in the past that she wants to hike rates at a gradual pace. Given that they are already well below neutral and the Fed is very close to fulfilling its mandate, we can only conclude that the Fed will want to raise rates in the months ahead unless bad news obstructs that path.

However, before hiking again, Yellen will want to verify that the payroll slowdown seen in May is only temporary. This probably rules out a June hike, and also makes



**Mark Haefele**



**Brian Rose**

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July unlikely, since there will only be one more labor report released before the July Federal Open Market Committee meeting. By the time of the September meeting, there will be three more labor reports, which should be sufficient to justify a hike as long as payrolls grow fast enough to diminish labor market slack further. Based on Yellen's previous comments on the relationship between population growth and labor supply, something above 100,000 new jobs per month should suffice. Of course, other economic data, especially on inflation and wage growth, as well as financial market conditions, will also influence the Fed's decision.

We think that even mediocre data would be enough for the Fed to hike in September. A July hike is still possible if the economic data between now and the meeting is very strong. In either case, another hike should follow in December, as long as the economic recovery remains on track.

**Mark Haefele**

Global Chief Investment Officer  
Wealth Management

**Brian Rose**

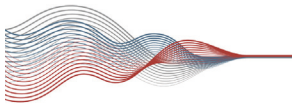
US economist

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## Bottom line

Despite the recent weak labor report, the Fed still appears on course to raise rates relatively soon. Economic data on jobs, wages, and inflation, as well as

financial market conditions, will influence the Fed's decision. *CIO expects 25bps of hikes in both September and December.*



Regional view

Podcast [www.ubs.com/cio-podcast](http://www.ubs.com/cio-podcast)

# Irrational investors – the good and the bad news



**Bert Jansen**  
European Equity Strategist

*“The markets can remain irrational longer than you can remain solvent.”*  
John Maynard Keynes

*“It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so.”* Mark Twain

The widely debated efficient market theory assumes that all information is reflected in market prices, and that rational investors compete with each other, thereby ensuring that share prices fairly reflect the present value of future cash flows. It is therefore impossible for investors to consistently outperform the market.\* Two practical aspects of the theory are worth highlighting.

First, efficient markets pose a paradox. The countless number of investors analyzing markets makes the equity market highly efficient because it ensures that all information is instantly reflected in market prices. But paradoxically, if every investor believed markets were effi-

cient, then no one would analyze stocks; ergo, efficiency would evaporate!

*“In recent years, market inefficiencies have been compounded by irrational investors whose aim has little to do with optimizing investment returns.”*

The second aspect, investor rationality, is more topical given widespread central bank asset price manipulation. The efficient market theory assumes that investors behave rationally, but behavioral economics, for example, provides ample evidence that this ain't so.

In recent years, market inefficiencies have been compounded by irrational investors whose aim has little to do with optimizing investment returns.

Central banks in developed markets, a prominent group by all accounts, have been buying assets irrespective of price. Over the last seven years the US Federal Reserve, the Bank of England, the Bank of Japan (BoJ), the European Central Bank (ECB) and the Swiss National Bank have expanded their balance sheets by more than USD 6trn combined. This unprecedented asset buying has attempted to support the real economy rather than to make a return on investment. When the ECB or BoJ buys assets as part of their quantitative easing programs, the price paid or the expected return is next to irrele-

vant. Is this rational from an economic perspective?

Regulatory pressures have led pension funds, insurance companies and banks down a similar path. Defined-benefit pension plans, for instance, are obliged to invest in inflation-protected bonds, even if such an investment locks in a guaranteed return of zero or worse over the long term (e.g. UK 50-year index-linked bonds currently yield -1%).

I would draw two investment conclusions from this. The good news is that irrational buyers lead to mispriced assets, thereby creating investment opportunities for rational investors. The bad news is that mispriced assets lead to a misallocation of capital, which has an adverse impact on economic growth. What worries me is, if irrational buyers became irrational sellers – for whatever reason – who would the marginal buyers be at current, inflated prices?

Kind regards,  
**Bert Jansen**

\* This does not mean that the market price will always reflect the intrinsic value of a stock. It simply means that deviations from the true value are random. In other words, the odds of finding an undervalued or overvalued stock are 50/50.

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