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Market moves

	CIO view	-1w	-3m	ytd
S&P 500		-3.9%	-2.7%	-5.1%
Euro Stoxx 50	OW	-0.8%	-3.0%	-4.7%
MSCI EM	UW	-4.8%	-15.2%	-8.9%
FTSE 100	UW	-1.3%	-4.8%	-3.9%
SMI		-1.9%	-2.4%	-4.2%
NIKKEI 225	OW	-3.6%	-2.7%	-6.9%
US high grade bonds	UW	0.5%	0.2%	1.2%
Euro high grade bonds	UW	-0.1%	1.1%	0.6%
US investment grade bonds	OW	0.2%	-0.4%	0.7%
Euro investment grade bonds	OW	-0.4%	0.5%	-0.1%
US high yield bonds		-0.6%	-4.6%	-0.6%
European high yield bonds	OW	-0.7%	-0.9%	-0.8%
EM sovereign bonds		-0.9%	-1.5%	-0.7%
EM corporate bonds		-0.5%	-1.6%	-0.4%

Source: Bloomberg, UBS as of 14 January 2016

OW = tactical overweight

UW = tactical underweight

Market comments

Calculations are based on the past five days

- **Global equities fell over 4% (in USD) on the week**, with markets unnerved by continuing worries over China and a sharp fall in the oil price. The decline was broad based; European, US and Asian markets all slid.
- **Oil had another gloomy week**, with Brent falling 9% to USD 30.7/bbl. The US West Texas Intermediate contract at one stage fell below USD 30 a barrel for the first time in 12 years.
- **The Norwegian krone was the strongest major currency against the dollar** over the past five trading days, climbing 1.4%. Sterling was down 1.2%, following weaker industrial data.
- **US high grade bonds were up 0.5%**, as investors opted for safe assets. Euro high grade bonds were stable, edging down only 0.1%. Meanwhile US high yield bonds fell 0.6%.

In focus

The MSCI All Country World Index has fallen in seven of the past nine days to January 13, and major indices were in the red again at the time of writing on Thursday. The S&P 500 declined by 2.5% on Wednesday, its largest one-day fall since September. The VIX index of volatility stands at around 27, more than double its May lows. The recent falls appear to stem from worries over China, the slumping oil price, and uncertainty over the next step for US Federal Reserve policy makers.

China's trade surplus for December rose unexpectedly to CNY 382bn (USD 58 billion), with both export and import figures providing encouragement. Exports in yuan terms increased 2.3% year on year, against expectations of a decline of 4.1%. This was the first y/y gain since June and the biggest increase since February. Imports fell 4%, against a forecast 7.9% slide. This was the smallest contraction of 2015. In addition, the People's Bank of China (PBoC) kept its daily fix for the yuan almost unchanged during the week, after it depreciated sharply at the start of the year. The relatively positive news may calm nerves regarding China's economic slowdown; *CIO still expects China's growth to decelerate, but believes that a hard landing is unlikely.*

China's foreign exchange reserves registered a record slump in December. China's currency war chest dropped by USD 108.3bn to USD 3.33trn in December 2015 after November's USD 87.2bn decline, likely implying heavy intervention in the FX market by the PBoC. The CNY still depreciated 1.5% against the USD in December, however. In the first four

trading days of the year, the CNY shed a further 1.5% against the USD due to panic selling on markets. But *CIO does not think this trend will continue; we expect the PBoC to try to calm fears and intervene in the FX market.*

Industrial production in the Eurozone disappointed, falling by 0.7% in November. Economists had expected a fall of just 0.3%. Year-on-year industrial production climbed by 1.1%, also failing to hit forecasts. The final readings of the purchasing managers' indices for the Eurozone suggested that the Eurozone economy grew by 0.4% in the final quarter of 2015.

UK industrial and manufacturing production were surprisingly weak in November. Economists had expected a 0.1% slide in manufacturing production and a flat industrial production reading. Instead, industrial production declined 0.7% and the manufacturing sector contracted 0.4%. Sterling dropped to a 5.5 year low against the dollar of USD 1.44 on Thursday, adding to recent evidence of headwinds facing industry. A study by EEF this week showed that twice as many manufacturing companies say risks outweigh opportunities in 2016.

The US small business sentiment indicator remains resilient. While the NFIB survey was conducted in December, before the recent market volatility, it does suggest that there was no significant change in the outlook from small businesses as 2015 closed. The details of the survey suggest that small companies plan to pick up the pace of hiring a bit, but at the same time the assessment of the economy did deteriorate somewhat.

Deeper dive

Taking stock

We foresaw a rise in asset price volatility for this year. But its scale in these first two trading weeks has taken almost everyone by surprise, including us. Markets have now fallen for seven days of the past nine, and we are 16% off the May peak in the MSCI All Country World Index. Let's take stock and ask:

How much, if anything, has changed?

US growth on track: The labor market continues to heal, with the latest payrolls number near 300,000. US banks have shown four straight months of core loan growth. And despite softer manufacturing survey data, the more significant non-manufacturing figures look firm.

Eurozone's ongoing uptrend: The latest PMIs for the Eurozone confirmed strengthening real activity, broad-based across countries. Better lending growth and continued loose monetary settings suggest credit recovery for the bloc.

China's slowdown still manageable: China is on a well-flagged path to steadier, more consumption-led growth that we do not expect to result in a proverbial "hard landing." Its latest commitment to a larger fiscal deficit close to 3% of GDP should smooth the growth transition.

So what's different?

Chinese policy shifts: China's onshore renminbi has weakened modestly but persistently against the US dollar. A "circuit breaker" to halt equity price declines was



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Christopher Swann

triggered twice before being abandoned. Despite China's efforts to clarify its intentions, global markets see its forays into freer markets as uncertain.

Renewed oil price declines: Second-order spillovers from oil hovering near USD 30/barrel have heightened investor uncertainty and price swings rather than boosting developed market sentiment and consumption.

Perception of central banks: December's initial interest rate hike from the US Federal Reserve, and some disappointment regarding the European Central Bank's stimulus last year, led the market to question the ability of central banks to minimize price volatility.

So what to do?

In our global, six-month tactical asset allocation, we recently trimmed the size of our Eurozone equity overweight, and reinitiated an underweight to emerging market stocks. Overall, our overall stance remains risk-on, but neutral on equities.

Neutral on equities does not mean no equities. Investors should neither over- nor under-allocate to them at this point in light of a balanced set of possible global outcomes. But they might benefit from taking stock of their stock holdings, and use market moves to rebalance their equity allocation and realign it toward their long-run investment objectives.

Christopher Swann
Global Investment Office

Bottom line

We recently reduced our tactical asset allocation position in equities to neutral. Markets have now fallen for seven days in the past nine, and uncertainty in global risk markets seems set to persist near term. But the recent market

price shake-out could offer opportunities for those with excess cash balances, and a long-run investment horizon. We reiterate our overweight positioning in Eurozone and Japanese stocks, and European high yield debt.

Regional view

Europe after Greece



Ricardo Garcia
Head, European Macroeconomics

Last year Greece and the rest of the EU came to a “real confrontation,” as Angela Merkel put it. A catastrophe was ultimately averted and the Greek government has since largely complied with its creditors’ requirements. It even submitted its contentious pension reform for review, a satisfactory outcome of which should ultimately pave the way for much-hoped-for debt restructuring.

Nonetheless, new clouds have appeared on the horizon. The refugee chaos and the forthcoming UK referendum on EU membership highlight that the continent is not out of the woods yet. Both raise questions about where it is headed and what forces are at play in- and outside it.

In our study *The future of Europe*, we take a deeper look at these questions. We find that positive and negative long-term forces alike are shaping the continent. Its weak demographic outlook raises the specter of low growth in the coming decades. Immigration is unlikely to solve this issue as Europe would have to accept twice the annual number of refugees it currently does to match the US labor force

growth rate, and public opinion is likely to prevent that.

At the same time, the continent is split by debt, with the public generally unwilling to fund bailouts of other member states. The resulting fiscal straitjacket imposed on debtor countries has spurred the rise of populist parties. Little noticed, they are slowly growing giants waiting for the next crisis to erupt. Euro-zone imbalances are now the largest they’ve been since 1999 despite the recent economic upswing, and European safety nets are ill equipped to handle major crises.

“More integration ... requires a shift in mindset.”

On the positive side, the Greek standoff last year showed the power of the population’s preference for the euro, which is close to record highs. Indeed, Greek public support for it was decisive in holding the Eurozone together. But as European Central Bank President Mario Draghi says, the Eurozone should thrive, not just survive. More integration is required to encourage member states to rise above local interests and adopt reforms that could double the EU’s economic trend growth rate.

More integration, however, requires a shift in mindset. The booming populations in the EU’s neighborhood – i.e. Africa and Middle East, whose combined working age population will reach six times the EU’s by 2050 – will gain an increasingly

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geopolitical dimension, we believe. But a unified EU foreign policy is needed to deal with the growing number of challenges a globalizing world presents. The current instability along Europe’s borders exacerbates the problems caused by the lack of a cohesive policy, as it is unclear to foreign parties when and how the EU will react to aggression and conflict.

This dynamic will only intensify in the coming decades, which should serve to promote a stronger European mindset and more integration. The EU, it appears clear, is here to

stay, even if the composition of the Eurozone might change along the way. What is less clear is how it will react to the challenges of an aging population and a diminished standing in the world. If it can meet them head on and respond with resolve and imagination, we see an encouraging future.

Kind regards,
Ricardo Garcia

To receive a copy of *The future of Europe*, please contact your client advisor.

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