UBS House View

Monthly Letter

21 June 2018
Chief Investment Office GWM
Investment Research

First half scorecard

Global stocks managed to grind higher in the first half of the year, with upward pressure from strong economic growth and earnings winning out over a host of political and economic concerns.

Risks ahead

Risks, notably from heightened trade tensions, remain in the second half, as well as worries about Eurozone growth slowing after the ECB withdraws quantitative easing and the US economy overheating.

Shifting growth

Synchronized global economic growth has recently given way to more US-biased global growth. As a result we prefer to reduce positions vulnerable to USD strength. We are closing our overweight EM equities and halving our EM sovereign bond exposure.

Asset allocation

We remain overweight global equities. But we are prepared for higher volatility and tail risks through countercyclical positions, such as an overweight in 10-year US Treasuries.

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Preparing for the second half

At the start of the year, my inbox was full of questions about Catalonia, Saudi Arabia, and President Donald Trump. Six months on and it's volatility, Italy, North Korea…and President Trump. (Some of) the narratives may have changed, but the sense of trepidation hasn't. At half time in the 2018 World Cup of investing, we ask ourselves: What's working well? What isn't? And what are our tactics for the second half?

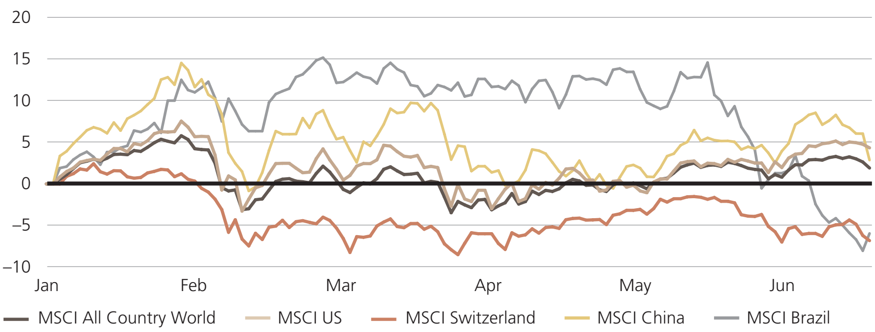
Our overweight position in global equities relative to bonds delivered positive performance. Despite a bumpy first half, at the time of writing, global stocks have returned 1.9%, while our corresponding bond underweights are relative underperformers. Global corporate earnings growth (9% in the first half alone) has been strong enough to boost global equities while higher interest rates weighed on bond prices.

Diversifying our risk across markets gave us a smoother ride than concentrating in local markets (Fig. 1): global equities suffered just two days of greater than 2% drawdowns versus eight days for US stocks, six days for Chinese equities, and

Figure 1

Diversification has served investors well in the first half of 2018

Total return in %, local currency



Source: Bloomberg, UBS, as of 19 June 2018

17 days for Brazilian shares. Our allocation to hedge funds supported performance: the HFRI fund-weighted index is up 1.4% in the first half while helping insulate investors from correlated moves in equities and bonds. And our tactical allocation benefited from the valuation recovery in the British pound, the Japanese yen, and local-currency emerging market (EM) bonds at the start of the year, as well as the good performance of Canadian equities relative to Swiss equities. We are also proud that we warned against "investment" in Bitcoin, which has plunged 53% this year.

We didn't, however, anticipate the appreciation of the US dollar. The US dollar index has rallied 3.3% this year and 7.4% since a February low, hurting our long EURUSD position and our overweights in EM equities, EM currencies, and EM sovereign bonds. We also lost performance earlier in the year from an overweight in the Swedish krona relative to the Norwegian krone.

Overall, with modestly positive equity performance and negative bond performance, balanced portfolios are broadly flat year-to-date.

Overall, with modestly positive equity performance and negative bond performance, balanced portfolios are broadly flat year-to-date, with precise performance depending on portfolio composition and currency.

In May, we published our note *Volatility is back. Are you prepared?* Since then, Italian elections, turmoil in Turkey, Brazil, and Argentina, as well as renewed fears about protectionism, have kept uncertainty high. As we look ahead to the second half, conditions look ripe for volatility to continue. Even if some individual political concerns fade, from September on central banks will be withdrawing liquidity from markets, slowly removing a major suppressant of volatility in recent years. And this is happening at the same time as fears mount over US economic overheating, protectionism, and Eurozone growth, as I discuss more in this letter.

Nonetheless, global growth looks to be robust enough for stocks to continue their rise. A strong US labor market should underpin consumption and drive business investment. Eurozone growth has moderated, but we believe it remains solid. We expect China to maintain its controlled expansion. And with global earnings growth (9%) outpacing this year's equity market returns (1.9%), valuations have improved at the margin.

Investors will need to prepare for this environment by staying invested to benefit from economic growth, but also diversifying globally, considering hedging, limiting exposure to high yield credit, and seeking assets less correlated to market volatility, such as hedge funds, or those supported by secular growth drivers.

We enter the second half overweight global equities, but are also preparing for continuing volatility.

Our positioning as we enter the second half matches this approach. We hold a tactical overweight in global equities, but prepare for volatility with overweight positions in 10-year US Treasuries and the Japanese yen, and hedge against equity market risk with a 10% out-of-the-money put option on the S&P 500. We underweight euro high yield credit and high grade bonds. And we seek performance less correlated to overall market moves through our hedge fund allocation.

There are also shifts in global dynamics we need to account for in our tactical positioning. The period of synchronized global growth underway for the past year looks to be giving way to a period of more US-biased global growth. With this shift, we want to avoid being underweight US dollars, and avoid large overweights in emerging market assets. To account for this, we make four changes to our tactical asset allocation this month, removing our underweight position in the US dollar relative to the Canadian dollar, closing our overweight in EM equities relative to Australian equities, and halving the size of our overweight position in USD-denominated EM sovereign bonds. We also close our overweight in Canadian equities versus Swiss equities, following the strong recent performance of this position.

Key themes for the second half

How far will US protectionism go, and what will its impact be?
This month the Trump administration levied duties on USD 50bn worth of Chinese imports; threatened duties on USD 200bn more; and imposed tariffs on steel and aluminum from the EU, Canada, and Mexico. President Trump also leveled accusations of dishonesty and weakness at the Canadian prime minister and criticized the German chancellor, all while befriending the North Korean leader he used to call "little rocket man."

To date, tariffs are not economically significant, but the situation continues to escalate.

We think protectionism bears monitoring in the next six months. To date, the tariffs imposed are not economically significant. And trade disputes so far only involve the US – other countries have not slapped tariffs on one another. The US also accounts for just 13% of world imports, down from 18% at its peak in 2000. The current US strategy, implemented and contemplated, amounts to a tax on the US consumer.

But the retaliatory actions mean the situation continues to escalate, even if we know it can change with a tweet. China does not buy enough goods from the US to retaliate much further with goods tariffs, and so may consider broadening the dispute to include services, currency devaluation, or reserve management, although this would likely be a last resort. NAFTA negotiations are also uncertain as relations between the US and Canadian leaders have cooled (Fig. 2).

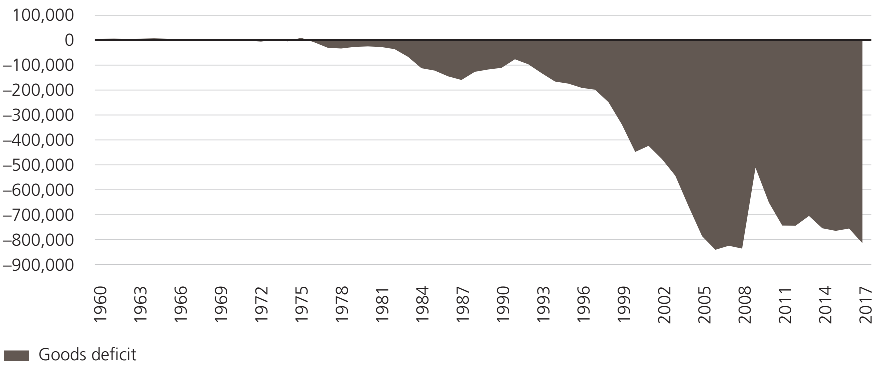
We mitigate the risk of further negative headlines around trade with some countercyclical positions, such as our overweight in 10-year US Treasuries, that would stand to benefit should a trade war or other disruptions arise, but we will continue to monitor negotiations to determine whether further changes in our positioning are warranted.

Key indicators: US tariffs, NAFTA negotiations, retaliatory measures from China and Europe, exchange rates between USD and key trading partners, trade balance data.

Figure 2

The US trade deficit has ballooned since the 1980s

US trade goods deficit, in USDm



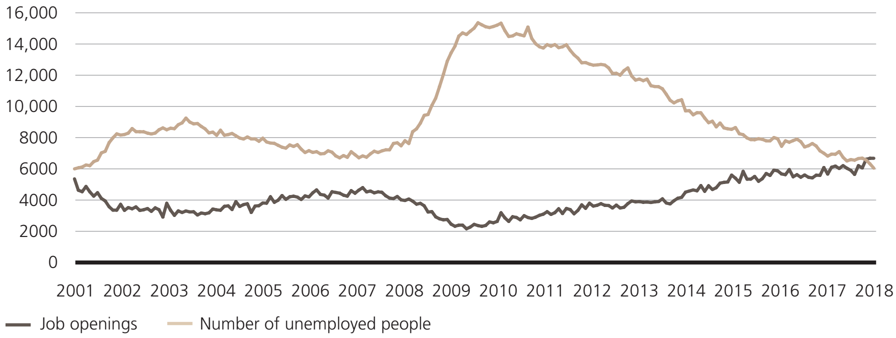
Source: US Census Bureau, UBS, as of June 2018

Will tight US labor markets spark higher US inflation and rates?
The latest US labor market data shows that there are now more job vacancies than there are unemployed people (Fig. 3).

Figure 3

There are more job openings than unemployed people in the US

US job vacancies versus unemployment, in thousands



Source: Bloomberg, UBS, as of June 2018

A key question for the second half is whether a tight US labor market translates into higher wage growth and inflation.

A key question for the second half will be whether US economic strength will translate into greater wage growth, higher inflation, and more than the four rate hikes we currently project for the next 12 months. Much faster rate hikes by the Federal Reserve would effectively bring forward the end of the global economic cycle.

For the moment, there are few signs that inflation is rising markedly. Though the most recent consumer price index (CPI) reading increased at an annualized rate of 2.8%, a six-year high, core inflation was a more moderate 2.2%.

But with the US economy expanding above its long-term trend (we estimate growth of 2.8% this year and 3% next versus trend growth of around 1.8%), we will need to be watchful for a sharper uptick in wages and inflation.

For now, we remain comfortable with our positioning in the context of this uncertainty. An environment in which US growth is strong enough to keep unemployment falling and wages rising should support corporate earnings growth and equities, at least initially.

Key indicators: US core PCE, US core CPI, US wage growth, 5-year inflation breakevens, Fed dots, Fed funds futures, Fed communications

Will China maintain its robust growth?
China's economy flirted with the high end of the government's target of "around 6.5%" GDP growth, reaching 6.8% in the first quarter.

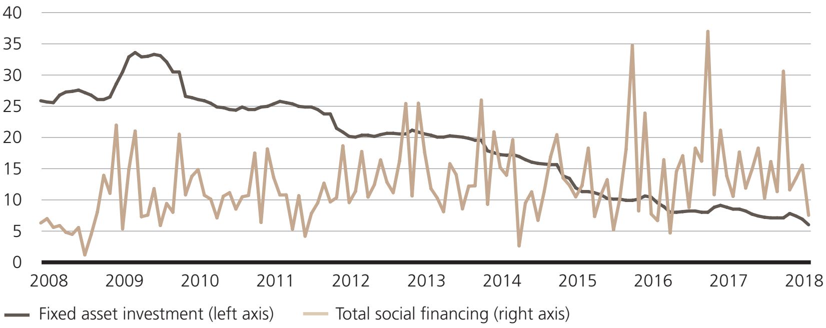
The question now is whether this rate is sustainable. China alone accounts for around one-third of global GDP growth, and so concerns about its economy could affect earnings prospects for companies around the world.

Some slowdown is inevitable. Construction spending may cool if property sales slow and developer financing tightens. Infrastructure investment is weakening. And regulatory tightening (to encourage needed deleveraging) has led to a drop in new credit creation: in May, total social financing growth recorded a historical low at 10.3% year-over-year, from 12% a year ago (Fig. 4). The trade dispute with the US poses another downside risk.

Figure 4

Chinese infrastructure investment and credit growth are falling

Total social financing (in CNYbn) and fixed asset investment (as % of GDP)



Source: Bloomberg, UBS, as of June 2018

Some slowdown in Chinese growth is inevitable, but our base case is that it will be controlled.

Our base case is that this growth slowdown will be controlled. We expect cuts to the reserve requirement ratio (RRR) if necessary, and the government has the scope for fiscal stimulus if the economy decelerates more abruptly than expected. Overall, we forecast 6.6% growth this year, but will continue to monitor the data.

Key indicators: Construction spending, property sales, fixed asset investment, retail sales, total social financing.

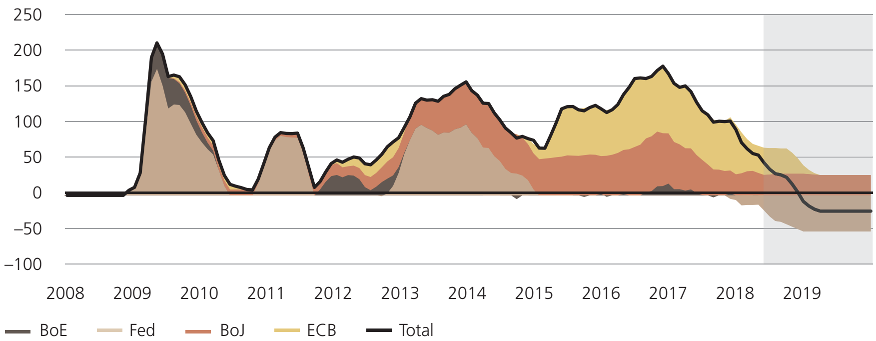
Can the Eurozone sustain growth after quantitative easing?

The European Central Bank (ECB) announced last week that it will end quantitative easing (QE) by the end of the year, by which point it will have been buying bonds for 46 months and have purchased EUR 2.6trn in assets (Fig. 5).

Figure 5

Central banks will be withdrawing liquidity by end-2018

Monthly net securities purchases by the world's major central banks (in USDbn)



Note: Includes securities purchases of the ECB, Federal Reserve, Bank of England and Bank of Japan (financed by central bank money creation). 3-month moving average until end of 2019.
Source: Haver Analytics, UBS, as of June 2018.

Will the withdrawal of QE put an end to the Eurozone recovery?

The question now is whether the Eurozone can maintain its growth rates. The end of QE could translate into higher borrowing costs, reduced business investment, and slower growth. And it comes at a time when investors are already feeling nervous about political developments, following the formation of a populist government in Italy, and challenges to Chancellor Angela Merkel in Germany.

Our base case is that consumer and business confidence will keep economic growth sound. But as we await further data, we hold a neutral stance on Eurozone equities in our global tactical asset allocation. We also remain cautious on euro-denominated high yield bonds, which could encounter a lack of demand when ECB purchases stop.

Key indicators: Eurozone PMIs and CPI data, Spanish and Italian borrowing costs, euro-denominated sub-investment grade yields, Eurozone bank lending data.

Tactical asset allocation

Overall, it is hard to be too negative on global equities at this point. The world economy is still set for its fastest year of growth since 2011 at 4.1%, global corporate earnings are slated to increase 15% this year, and even the relatively highly valued US stock market has a 4.4% trailing risk premium over bonds, versus a long-term average of 3.2% since the 1960s.

We also shouldn't forget the ideas I discussed in a previous letter, "The Galton Board," that what can at first look like risk may ultimately produce positive results. For example, higher US wage growth needn't trigger inflation if it is accompanied by greater productivity. Trade negotiations could lead to market-friendly outcomes, like China's agreement to strengthen intellectual property protections in May. A Eurozone expanding without stimulus would be better equipped to respond to economic challenges. And an absence of bad news out of China would mean another USD 460bn added to world economic output in the second half alone, equivalent to an economy the size of Portugal and Greece put together.

As such, we maintain a moderate overweight in equities relative to high grade bonds and euro high yield credit.

To account for the risks discussed earlier in this letter, we also hold several positions that will help cushion our portfolio against equity market volatility:

We overweight the 10-year US Treasury versus cash.

- **We overweight the 10-year US Treasury versus cash.** US Treasuries typically reduce volatility in a portfolio during equity market corrections. While rapid Fed rate hikes are a risk to this position, last week's Fed meeting suggests this risk is limited, and historically the 10-year yield has priced in the full series of rate hikes relatively early in the cycle.

We overweight the Japanese yen (JPY) versus the US dollar.

- **We overweight the Japanese yen (JPY) versus the US dollar.** The position also provides an effective cushion during periods of global risk aversion, since Japanese investors, who hold a large positive net foreign asset position, typically pull funds back home in such an environment. And regardless of the risk backdrop, we believe the JPY is undervalued versus the USD, with our purchasing power parity estimate at USDJPY 74 compared to the spot rate of 110 at present.

We underweight euro high yield credit versus global equities.

- **We underweight euro high yield credit versus global equities.** In an environment of higher volatility, clients with excessive exposure to credit risk should rebalance and seek yield elsewhere, notably in higher credit quality, longer-duration bonds. Euro high yield has been the worst-performing asset class within credit (on a spread basis) this year, yet we still believe yields are too low to compensate for their risk.

We underweight 10-year JGBs versus cash.

- **We underweight 10-year JGBs versus cash.** We expect the Bank of Japan to start to reduce monetary stimulus later this year by increasing its target yield for 10-year Japanese government bonds.

We also need to account for shifts in global growth dynamics. Growth momentum in the US is holding up and economic data has surprised to the upside at a time when the rest of the world has been going through a softer patch. In this environment, we want to avoid being underweight the US dollar, and avoid large overweights in EM assets. So we make three changes to tactical asset allocation this month:

We close our overweight in emerging market equities versus the Australian market.

- **We close our overweight in EM equities versus the Australian market.** The MSCI EM Index has been constrained by a 7% rebound in the trade-weighted US dollar, pressuring central banks in emerging markets to tighten monetary policy, and presenting a headwind to the region's economic growth. Although the growth outlook remains positive overall, first-quarter growth figures were disappointing, notably in South Africa and Brazil, and business sentiment, as measured by purchasing managers' indexes, is falling.

We halve our overweight in USD-denominated EM sovereign bonds.

- **We halve our overweight in USD-denominated EM sovereign bonds.** The asset class offers an attractive yield of 6.5%, 3.5% over duration-equivalent US Treasuries, but weaker relative economic momentum and heightened political risk in Mexico, Turkey, and Brazil present a risk, as do trade tensions between the US, Mexico, and China.

We close our overweight in the Canadian dollar (CAD) versus the USD.

- **We close our overweight in the Canadian dollar (CAD) versus the USD.** The Bank of Canada has been slower than we expected to signal tighter monetary policy, while the US is set to deliver close to 4% annualized growth for the second quarter. The CAD is also likely to be held back in the near term by uncertainty over the outlook for NAFTA.

Finally, we also close one of our relative value positions after strong performance:

We close our overweight in Canadian equities versus Swiss equities.

- **We close our overweight in Canadian equities versus Swiss equities.** Since we adopted this trade last month, MSCI Canada has returned around 2%, while the Swiss market has fallen around 3%.

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UBS Investor Forum Insights

At this month's Investor Forum there was a general consensus on three main themes:

- The majority of participants argued that we have reached full employment in the US.
- Several participants stated that the US government debt is problematic.
- A 2020 recession is a key concern and risk for all participants.

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