

CIO *Monthly Letter*

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Half full or half empty?

- *Global equity markets have suffered the largest sell-off in more than two years, despite economic and corporate fundamental data not deteriorating materially.*
- *We seek tactical positioning that can benefit when the markets are feeling more optimistic, while staying relatively protected when markets are feeling pessimistic.*
- *We are keeping a positive view on risky assets and have added to our overweight position in US equities, after adding to US high yield last week.*
- *At the same time, we have reduced exposure to EM equities because the region is experiencing weaker growth momentum, declining commodity prices and does not have much policy flexibility.*

Is a half-filled glass of water half full or half empty? Some people see it one way, and some the other. My children say I always see it as half empty. Yet, markets can frequently and quickly flip from optimism to pessimism – and back again. Since my last monthly letter, global equity markets have suffered their largest sell-off in more than two years although economic and corporate fundamentals have not deteriorated much.

While we did not reduce our portfolio's allocation to risk assets before the market turn, our strategy does not expect, or pretend, to be able to consistently and precisely time changes in the market's mood. In our view, trying to do this might be successful on occasion, but is likely to prove a costly strategy over the business cycle. A solid investment strategy involves good diversification, suitable risk limits, regular rebalancing, and tactical positioning that can benefit when the markets are feeling half full, but also be relatively protected when markets are feeling half empty. In this letter, I want to walk you through how we apply our investment process of observing, orienting, deciding and acting to the investment decisions we make today. Below, I review some of the more extreme market moves, try to explain the factors driving the recent market pessimism, counterpoint that with a more optimistic take on the world, and end with how we execute on our views in the portfolio – but investment letters are not mystery novels.

We are keeping a positive view on risky assets and adding to our overweight position in US equities, after adding to US high yield last week. Our overweight positions are now concentrated in the US, where growth is solid, consumers will benefit from declining oil prices, and the central bank has flexibility.

At the same time, we have reduced exposure to EM equities. Overall, the region has a weaker growth impetus, faces some threats from declining commodity prices, and does not have much policy flexibility outside of China. We believe this position will dampen the effects on portfolios of a renewed period of market volatility, and expect it to perform well even in a more normal market environment, given the cyclical and structural challenges facing many emerging markets.



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The past month in review

In the past month, in addition to the sell-off in global equities, currencies remained volatile, major government bonds rallied, and credit spreads widened. However, three things stood out:

- > *The VIX hit a multi-year high*
- > *There was extraordinary trading activity*
- > *The sell-off in oil continued*

The VIX index of implied volatility, a measure of the price of insurance against further market moves, hit an intraday peak close of 31. This was higher than the levels reached during the 2012 Eurozone crisis, and on a par with the Japanese earthquake in 2011 (see Fig. 1).

The outsized moves in derivatives markets, high levels of trading activity, and extraordinary moves in the US Treasury market suggest that some combination of systematic trading and low levels of market liquidity may have exacerbated the situation. For example, modestly disappointing monthly US retail sales (-0.3% growth rather than the -0.1% expected) were followed by a ~35bps fall in 10-year Treasury yields, the second-largest intraday move since 1989.

The sell-off in oil continued, with the market seemingly testing the resolve of oil producers, rather like its test of some Eurozone governments in 2011 and 2012. At the time of writing, oil is still trading below the estimated average fiscal breakeven for some OPEC members, and Russia.

The three market moves suggest to me that sentiment played a large role in the sell-off. But this is not to say sentiment should be dismissed as something transient. A deterioration can lead financial markets to remain relatively fragile for a period of time and more susceptible than usual to further shocks. Therefore, we should pay close attention to the things which upset markets.

Glass half empty?

So, what drove this change in market perception?

- > *The market may have been concerned over illiquidity...*
- > *...or that the global economy is too dependent on the US...*
- > *...or that the ECB lacks the ability to support growth*

The volatility in fixed income markets re-ignited concerns about liquidity. While liquidity certainly deteriorated last week, it was striking to see that the problem actually seemed most acute in the USD 12 trillion US Treasury market.

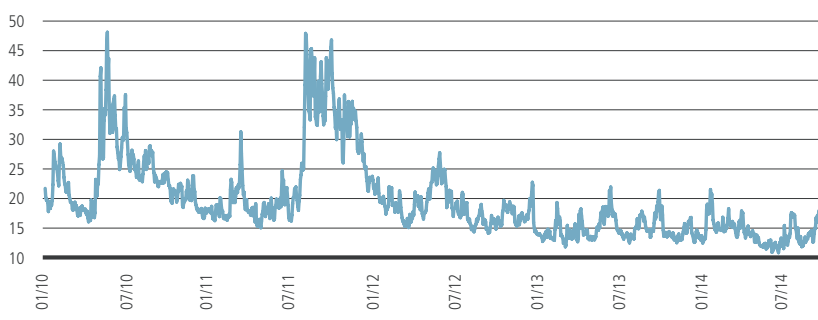
A more fundamental concern is that the US may be left as the sole positive economic inspiration in the world. As a result, even moderately below consensus US data had a disproportionate impact on investor sentiment. Global growth is clearly more dependent on the US than it has been, and reliance on just one country or region entails greater risk.

Although weaker economic data may have played some part in the underperformance of Eurozone equities, the exceptionally sharp drop in market-based Eurozone inflation expectations between five and 10 years into the future, the decent performance of the euro, along with the relative underperformance of Eurozone government bonds, suggest that the market also lost some faith in the ECB's ability to support growth, and create inflation.

- > *The VIX index of implied volatility hit an intraday peak close of 31. This was higher than the levels reached during the 2012 Eurozone crisis*

Fig. 1: Volatility in US markets rose to its highest level since December 2011

VIX index reflecting a market estimate of implied volatility in S&P 500 options



Source: Bloomberg, UBS, as of 23 October 2014

Many had hoped for greater accord to come out of the recent International Monetary Fund meeting in Washington DC, but the chorus of disagreements between ECB Governing Council members only grew louder at a time when the ECB will soon wrap up its stress test for Eurozone banks. Last Wednesday, peripheral bond spreads widened, while financials led local equity markets lower. The price moves brought back memories of the bad days in the 2011 and 2012 Eurozone crises, so markets will remain alert for similar price action in the weeks and months ahead.

While not a primary cause of the sell-off in the past month, the Ebola virus began infecting people outside Africa. Until fears of this tragic disease are contained, it will weigh on sentiment.

Glass half full?

But what of the fundamental situation? Here, the half-full view of the world, which has prevailed for much of the past three years, has by no means been destroyed.

> *Corporate bond markets remained orderly*

Despite concerns over illiquidity, corporate bond markets remained orderly, bid-ask spreads remained tight, and the sell-off in the high yield bond market actually came on higher-than-average volumes. This contrasts with the sell-off in 2008–09 when volumes were low, spreads wide, and many markets froze. For context, US high yield prices declined 3% from peak to trough, less than some of the intraday moves we saw in Eurozone equities.

> *The US continues to demonstrate solid growth*

The concerns about growth outside of North America are unlikely to drag the US into recession – we estimate a 1% decline in European GDP will have a negligible –0.1% direct impact on US GDP. And the recent outperformance of US equities suggests that the market agrees with this assessment.

The economic data from the past month has also continued to demonstrate that growth in the US is still robust. Non-farm payrolls, jobless claims, industrial production, consumer confidence, and manufacturing sentiment all point to an economy expanding at a decent pace (see Fig. 2).

> *Eurozone data could improve*

Some Eurozone data disappointed earlier in the month, but the more recent German PMI suggest improvement. Looking forward, we expect this weekend’s asset quality review to help boost banks’ confidence in lending, and, as I write this, there is speculation that the ECB could extend its asset purchases beyond covered bonds, a possibility I discussed in last month’s *CIO letter*.

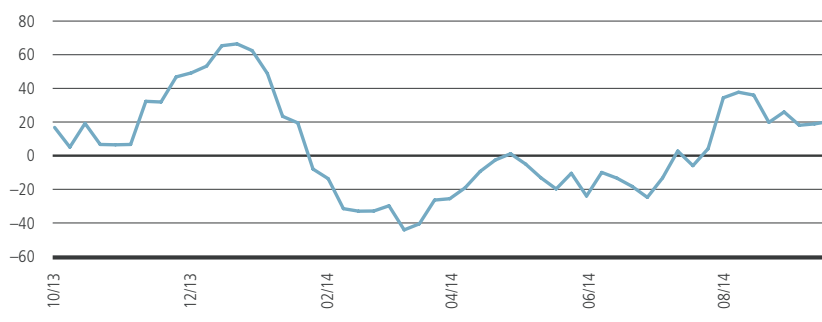
And from all observable facts, Ebola is not likely to pose the same threat to financial markets as the 2002–2003 SARS outbreak did, given that it is not as easily communicable, and is currently primarily impacting smaller economic regions.

In addition, some of the recent market moves should also prove supportive for a more glass-half-full view:

> *The economic data from the past month continued to demonstrate that growth in the US is still robust*

Fig. 2: The recent sell-off was not due to fundamental changes in US growth

Citigroup Economic Surprise Index – US, index points



Source: Bloomberg, UBS, as of 23 October 2014

- > *Declining oil prices and bond yields will support consumers*

The average US household spent USD 2,600 on gasoline in 2013. If sustained, the 16% decline in average US gasoline prices over the past four months should have a positive impact on consumption. Meanwhile, the average 30-year fixed-term mortgage rate has dropped below 4% for the first time in more than a year.

Following the correction, global equities are trading on a trailing price-to-earnings ratio of 15.8x, against their long-run average of 18.8x. And the start of the US earnings season has been positive, with 70% of companies beating EPS estimates.

The sharp downward moves in US and UK government bond yields demonstrate the two-way flexibility of central banks supposedly getting closer to rate hikes. Indeed, the recovery in financial markets from last week's lows coincided with non-voting Fed member James Bullard stating that the Fed could delay its tapering process. Meanwhile, we have moved our forecast for the likely first rate hike by the Bank of England out to mid-2015. Both adjustments should prove supportive.

Our view

Our view is still that the glass is half full. As markets have rebased their expectations for global growth lower, there is now greater scope for positive surprises. We expect equity markets to recover and credit spreads to contract over our six-month tactical investment horizon.

The past month reminds us how quickly perceptions can change in a slower growth environment. Sentiment is a powerful force and if market sentiment remains poor for an extended period of time, it can eventually lead to weaker fundamentals due to declines in consumer and business confidence. We will be watching the global growth story closely in the months ahead, given that the market will remain sensitive to this topic in a world where regional growth trajectories seem to be diverging.

We are trying to position in a way that can perform well when the market sees the glass as half full, but also be better insulated when it sees it as half empty.

- > *We retain a positive view on risky assets*

While we retain a positive view on risky assets, we are concentrating our overweight positions in the US, specifically US equities and US high yield credit. As outlined above, the US is where growth is strongest, consumers will benefit from declining oil prices, and the central bank still has flexibility. These positions should benefit when the market is feeling half full, and be relatively insulated during market sell-offs. We are adding to our overweight position in US equities, following our move last week to increase our overweight position in US high yield credit.

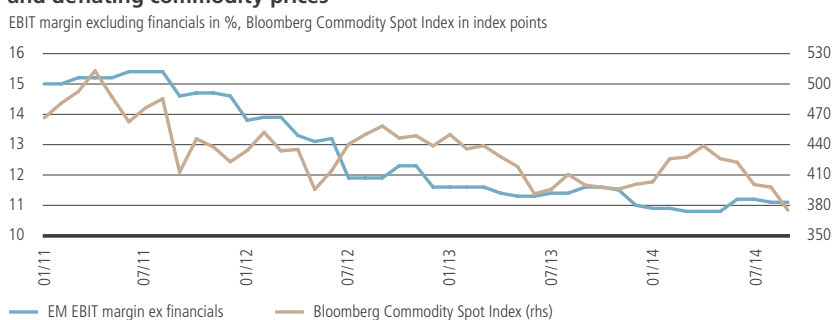
- > *We add to our overweight position in US equities*

Meanwhile, we are reducing exposure to more cyclical markets, where the growth impulse is weakest, where declining commodity prices pose a threat, and where central banks have less flexibility.

We made the first step in this direction last week, by removing our overweight position in Canadian equities, where declining oil prices have made their risk-reward profile less attractive.

- > *EM corporate profitability has been falling*

Fig. 3: Emerging market companies are suffering from declining profitability and deflating commodity prices



Source: Bloomberg, Thomson Reuters, UBS, as of 23 October 2014

- > *We initiate an underweight position in emerging market equities*

We are now initiating an underweight position in emerging market equities. This underweight position should protect our overall portfolio in the event of a renewed period of market volatility. Looking back at the previous 16 sell-offs of more than 5% in the MSCI World Index since 2009, emerging market equities have underperformed in 10 of them, with an average underperformance relative to global equities of around 1%.

We also believe that emerging markets could underperform global equities even in a glass-half-full world. The region's corporate profitability has been falling and neither the sharp declines in commodity prices nor US dollar strength over recent months are likely to help, due to the high weighting of commodity sensitive sectors within emerging markets, and the presence of some dollar-denominated debts (see chart 3). We remain somewhat cautious about the economic leading indicators in many of the larger emerging markets. Growth in Russia and Brazil is very low, and China's state-owned enterprises are vulnerable to reforms and potential recapitalization over the next six to 12 months.

- > *We shift our underweight position in EM sovereign debt to EM corporate debt*

We are shifting our underweight position in emerging market dollar-denominated sovereign debt to an underweight in emerging market dollar-denominated corporate debt. Spreads on sovereigns have widened relative to corporates in the recent sell-off, and the EM corporate earnings environment represents a risk to balance-sheet health.

Thank you for reading this letter. I hope it has been useful in putting the recent market events in context, and that it helps guide portfolios in the current environment.



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