

UBS CIO Monthly Letter



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The rubber ducks

Gold's recent decline can help us grasp the interplay between major market performance and central bank stimulus efforts.

In the last few weeks, gold garnered a great deal of attention as its price fell approximately 10% (see Fig. 1). This led many investors to reconsider their notions of a "safe haven," and to reassess what fair value might be. Buyers of gold have long known that its price is divorced from the fundamental factors that move pure commodities, and is driven instead by more ethereal dynamics like private investor demand. Valuing gold as a simple commodity would imply a fundamental price of USD 1,150/oz. At that price, 10% of gold mines would be loss making, and the metal would trade 19% below current levels and 40% below 2011's all-time peak.

It would be wrong to conclude, however, that investing in assets purely based on fundamental value will always work. There may be good reason for asset prices to diverge from pure fundamental value. In the case of gold, investor demand to diversify away from paper money has helped gold rise by more than 300% in the past decade, and long-term holders are still sitting on tidy profits. John Maynard Keynes's quip that "markets can remain irrational a lot longer than you and I can remain solvent," is an enduring lesson.

The volatility in gold reminds us that investors must employ a critical eye when prices are divorced from pure fundamental value. In such cases, it is important to assess whether the "other" factors that are proping up prices are going to persist. This applies whether we are looking at gold, government bonds or bitcoins. And it

is particularly pertinent in a world where central banks are perceived as driving the prices of many asset markets, particularly the fixed income market.

I have now written four paragraphs of my monthly letter without employing a metaphor, but I can resist no longer.

We can picture markets today as a bunch of rubber ducks floating in bathtubs. The water flowing from the tap represents central bank liquidity, the ducks signify market performance, and the plug stands for the fundamental strength of the economy.

Concerns over the fundamental strength of the economy have grown in regions around the world. This concern is evident in the recent weakness in commodity prices and in the declines in some economic growth trends, like the purchasing managers indices, across the US, the Eurozone and China. Therefore, in each region, we must carefully assess: (i) the velocity of the flowing water; (ii) how long the tap will remain turned on; and (iii) whether the plug is secure. Broadly, as long as we're comfortable with two of these three factors, it can make sense to bet on the duck rising.

In the American bath, the tap remains on. There is some debate about how long the US Federal Reserve (the Fed) will keep it on, but over our tactical time frame of the next six months we are confident the water will keep flowing. Moreover, we believe the plug is secure given the recovery in the housing market and good corporate earnings growth. As such we feel comfortable with our overweight positions in US equities and US high yield credit.

In the Japanese bathtub, the plug has been out of place for years, but with the Bank of Japan (BoJ) now turning the tap fully open, the bath water is rising fast, and we are adding an overweight position in Japanese equities. We will fund this overweight position in Japan by reducing emerging markets to neutral.

In our Chinese bath, the government has become worried the duck is floating too near the top, so it has turned off the tap, and other emerging markets could suffer weaker earnings if commodity prices remain at current levels.

Finally, in the Eurozone tub, the European Central Bank (ECB) has put in place a secure temporary plug, but the tap is producing little more than a trickle and we know that longer term, the temporary plug must be replaced with a better one, a long-term structural solution (a big unknown at this point), so we are maintaining an underweight position in the euro.

There are many subtleties in each regional bath, and in the remainder of this letter I will discuss in more detail the underlying economic picture and the impact and future evolution of central bank stimulus measures.

The mighty US duck

In last month's letter, I described how the US economy and its consumers represent the most important driver for the global outlook. Since then there has been relatively weak data, with non-farm payrolls rising by just 88,000 in March (after climbing by 268,000 in February), retail sales declining 0.4% in the month (from +1.0%), and the ISM Manufacturing index dropping to 51.3 from 54.2. This has led many to question the stability of the US economic recovery, at the same time as investors have become worried that the Fed might "turn the tap off," by ending quantitative easing (QE), or even by starting to sell its USD 3trn pile of Treasuries and mortgage-backed

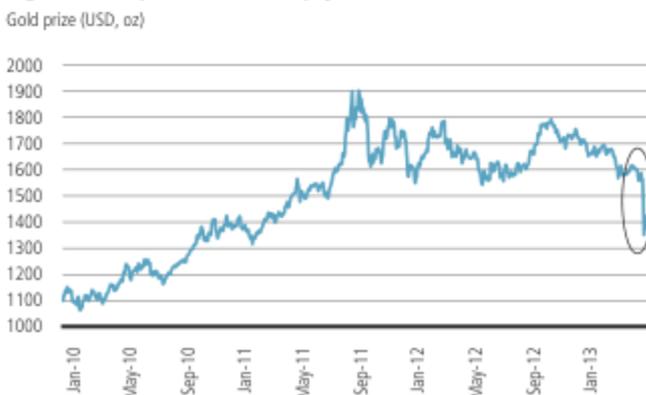
securities (MBS). This kind of market noise regarding the Fed is worrisome, as some investors believe the market is divorced from fundamental value, with even the Fed minutes stating that "a lengthy period of low long-term rates could encourage excessive risk-taking."

So we need to assess whether US asset prices are indeed divorced from fundamental value and, if so, what impact a withdrawal of Fed stimulus could have.

Our conclusion is that the strength of US risk assets year-to-date reflects an improved fundamental economic picture. However, the USD 60bn "sequester" series of automatic spending cuts has begun to have an impact on the wider economy. The direct negative hit of around 0.4% of GDP is manageable, but indirect effects could be higher. For example, consumer and corporate confidence is hardly likely to be boosted by the recent air travel disruption. As a result, we expect real consumption growth to slow in the second quarter to 2.4% annualized, from 2.9% in the first quarter. However, the underlying private sector remains healthy, and recent soft data has been largely attributable to lower government spending and inventory destocking (see Fig. 2). Over the balance of the year consumption should accelerate as a result of the improving labor market, lower gasoline prices, and stronger capital formation as businesses finally begin to invest their unprecedented cash balances. Finally, higher house prices have the potential to boost GDP growth through a combination of the wealth effect and construction spending; March saw the fastest pace of new home construction since June 2008.

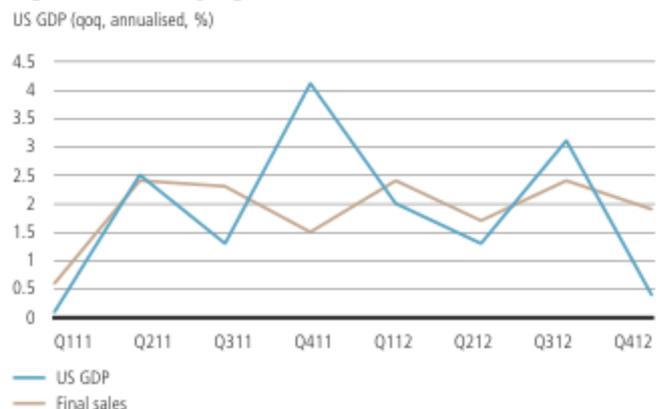
In the near term, there are a number of reasons we do not expect the Fed to scale down its stimulus. First, the Fed should remain accommodative while the full impact of the sequester spending cuts lies ahead. Second, the US labor market has improved, but the 7.6% unemployment rate remains well above the 6.5% threshold the

Fig. 1: Gold price falls sharply



Source: Bloomberg, UBS, as of 24 April 2013

Fig. 2: US underlying demand stable



Source: Bloomberg, UBS, as of 24 April 2013

Fed set as its target before it will consider tightening policy. Third, the Fed is well aware that, while funding costs have improved, overall credit availability remains tight. Recent results from the US banks show decelerating loan growth and declining net interest margins. And, finally, continued weakness in the Eurozone economies and flux in the European political situation support a continued loose monetary stance by the Fed.

Therefore, we expect only a steady tapering off of economic stimulus, and foresee the Fed reducing monthly asset purchases by USD 10bn per month starting around October, leaving the rate of asset purchases at USD 65bn by year-end. This is unlikely to have a major negative impact on risk assets.

Ironically, if the Fed were to consider withdrawing its stimulus more aggressively, the "safest" assets could prove the most dangerous. Merely signaling a sale of the Fed's Treasury holdings would risk bond market participants pricing almost USD 2trn of new supply, and could lead to disorderly bond markets. Chairman Ben Bernanke is well aware of this and Fed members have recently sought to highlight the interest rate mechanism as the primary "exit" tool. This would nonetheless be detrimental to (if not catastrophic for) the Treasury market, but, provided it came in response to better-than-expected growth, it is unlikely to affect riskier assets meaningfully.

In sum, we don't believe the Fed will turn off the bath tap and stop its support for our American rubber duck until it is confident of a more self-sustaining recovery. In the meantime, US assets will continue to benefit from the rather enviable situation of strong central bank support coinciding with an improvement in economic activity.

Japan calls in the fire truck hoses

If some believe the US market may be divorced from fundamentals, then the more than 50% rise in the Nikkei 225 equity index (calculated in yen) since November begs for discussion. The rally has taken on new impetus since the BOJ announced it would double its monetary base within the next two years. Using my rubber duck analogy, this is the equivalent of the BoJ turning the tap on full and then calling in the fire trucks to use their hoses as well. It is no surprise the water is rising.

To put this in context, the Fed is making annual net purchases of 7% of GDP. Japan will be purchasing assets at close to twice this rate, or about 13% of GDP. Additionally, the BoJ is not focusing purely on fixed income assets like government bonds and mortgage-backed securities, but is instead also buying equities through exchange-traded funds, as well as real estate investment trusts.

But will it help Japan achieve its 2% inflation target? It will be difficult, and indeed many economists would suggest that 2% consumer price inflation (CPI) in Japan is impossible. The country's output gap sits at roughly 3%, and, after a generation of deflation, resetting inflation expectations is extremely difficult. The most recent labor market data showing a 0.7% fall in wages for the first few months of this year is evidence of this.

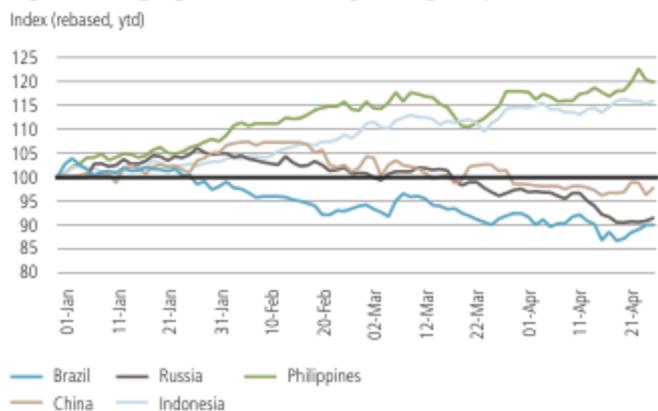
However, there is an argument that 2% inflation may be achievable. First, the yen's 25% fall in the past six months should translate into a 0.5% boost to inflation, and should "Abenomics," the economic policy promoted by Japanese Prime Minister Shinzo Abe, begin to have an effect, the yen could fall a further 10%. Second, there are signs that there may not be as much spare capacity in the labor market as deflating wages might suggest – the Tankan survey actually indicates the labor surplus is

Fig. 3: The Bank of Japan impacting earnings estimates



Source: Thomson Reuters, UBS, as of 24 April 2013

Fig. 4: Emerging markets seeing divergent performance



Source: Bloomberg, UBS, as of 24 April 2013

turning into a labor shortage. Third, inflation expectations are starting to rise, and the five-year inflation rate implied by the inflation-protected bond market is 1.5% ■, up from 0.5% just a year ago.

Returning to my bathtub analogy, it is unclear if Abenomics will be successful in “securing the plug” and transforming the Japanese economy after more than a decade of malaise. But the BoJ tap is clearly having an impact. The weakness in the yen has helped earnings growth estimates for the Nikkei for the financial year to March 2014 rise to over 50% in the past six months alone (see Fig. 3) from around 20%. If the yen remains at current levels we could even see earnings upgraded by a further 10%. The Nikkei has run ahead of these earnings upgrades, but on a 14.9x one-year forward price-to-earnings ratio, it is not obviously overvalued relative to its 10-year average of 16.3x.

Finally, the BoJ is nothing if not determined to give Japan a fighting chance with its massive dose of new liquidity. We therefore are initiating an overweight position in Japanese equities, and within this market we believe the best way of taking advantage of the Japanese reflation theme is through positions in Japanese exporters.

Emerging markets = diverging markets?

If the return of Japanese equities has been one of the great surprises of the past six months, the stark underperformance of emerging market equities is certainly one too. It seems almost counterintuitive that the region of the world with the fastest economic growth also suffers from the lowest equity valuations. But after a 12% underperformance year-to-date, emerging market equities are now trading on a 2013 price-to-earnings ratio of just 10.1x.

In the earlier discussion on gold, I said that investing in assets based purely on fundamental value is not an

optimal strategy. In this same vein, it should be noted that just because emerging markets as a whole are “cheap” doesn’t mean their underperformance will correct in the near term.

One of the most striking features about emerging markets this year, aside from their underperformance as a whole, has been the stark divergence between the market performance of individual countries. It has been less a case of emerging markets, and more a case of diverging markets. After a strong start to the year, Chinese equities have fallen sharply in recent months due to signs of policy tightening, particularly with respect to increased government regulation of wealth management products and the property sector. Furthermore, there are signs that economic growth is slowing – GDP data disappointed expectations, rising by only 7.7% in the first quarter (consensus 7.9%), and this week’s HSBC purchasing managers’ index fell to 50.5 in April from 51.6 in March. The associated weakness in commodity prices has weighed on Brazil and Russia too. Meanwhile, Korea’s competitiveness has been challenged by the Japanese yen’s 20% depreciation against the Korean won in the past six months. Partially as a result, Korean equities have lagged Japanese equities by close to 25% (in constant currency terms) year-to-date. Conversely, the more domestically oriented markets, such as the Philippines and Indonesia, have performed very strongly (see Fig. 4).

With such divergence, emerging markets as a group are testing investors. Near-term uncertainties over global growth, the future of Chinese policy, and the outlook for commodities all combine to make it hard to foresee a near-term catalyst to help emerging markets realize their significant longer-term valuation potential. Given this, it makes sense to focus on selected countries. Specifically, on a tactical basis, we recommend that investors seek exposure to the

Fig. 5: Weak German manufacturing data



Source: Bloomberg, UBS, as of 24 April 2013

Fig. 6: Positioning speaks in favor of the CAD vs AUD



Source: Bloomberg, CFTC, UBS, as of 24 April 2013

domestic recovery stories in Brazil and India, the out-of-favor Russian and Korean equity markets, and also to broader emerging market growth through Western corporations, via *Western Winners from Emerging Market growth*.

On a strategic basis, however, an adequate allocation to emerging markets overall remains important. Valuations are attractive, and emerging markets will continue to offer the world's highest GDP growth rates, with the lowest sovereign leverage. And, outside of equities, we continue to hold an overweight position in corporate emerging market credit, and emerging market currencies remain a *CIO preferred theme*.

Calm on the surface in the Eurozone

It is ordinarily a positive sign if I can get through the bulk of my monthly letter without lots of discussion of the Eurozone. The "good news" is the Eurozone appears to be diminishing in importance in terms of driving global markets, with the near-term fear of a break-up falling away. Spanish and Italian bond yields have begun to move more independently of wider risk sentiment, and the inverse correlation between their yields and global equity markets is near the weakest level it has been in a year.

Sadly, this calm on the surface does not reflect an improvement in the Eurozone's underlying prospects. This week's sentiment indices show the ongoing weakness in the economy: the German Manufacturing PMI fell to 47.9 from 49.0 (see Fig. 5), and the German Ifo business climate index dropped to 104.4 from 106.7. Structural solutions remain elusive, and ahead of the German elections in September, progress is likely to be non-existent. Italy has finally found a new prime minister, but he faces challenges in enacting reforms. Elsewhere, credit rating agency Moody's retains a negative outlook on Spain, threatening it with a downgrade to junk status, potentially exacerbating an already difficult funding situation for the country's corporations. Cyprus retains its capital controls, which if maintained for a long period of time, endanger the integrity of the euro. And there is speculation that Slovenia could be the "next domino to fall;" a potential loss of access to the bond market could force the country into an ESM bailout.

These dim economic prospects lead us to believe the ECB will cut its refinancing rate from 0.75% to 0.5% at its upcoming meeting on May 2. If this materializes, it would support our underweight position in the euro.

Troubling commodities

The problems in the Eurozone may not be influencing global equities as strongly as they have previously, but they have had a huge influence on the price of gold in recent weeks. ECB President Mario Draghi's comments that the profits of any gold sales by the Central Bank of Cyprus must be used to cover any losses made on its

loans to commercial banks appeared to send the gold market into a tailspin, with prices dropping as much as 15% over three trading sessions.

To be clear, Draghi's comments were misinterpreted. It was always the case that *if* the Cypriot central bank sold its gold it would have to cover its own losses before transferring any money to the Cypriot government. Draghi was merely clarifying this, not ordering the asset sale. As such, we believe the move is overdone. However, with over one-third of global gold demand attributable to investment demand, gold relies greatly on the trust among investors that it can truly act as a hedge against expansionary central bank policies. The recent gold price move may have dented that trust, and so we are maintaining a neutral position, forecasting gold to trade in a range of USD 1,150–1,550 per ounce over the next three months.

Asset allocation and themes

Within equities, we are replacing our tactical overweight position in emerging markets with one in Japan, for the reasons described earlier. We also are maintaining our overweight position in the US relative to Canada, since the Canadian housing market recovery is likely to lag that of the US, and since the sharp downward move in the gold price is likely to hinder Canada's large gold mining sector.

Elsewhere, within fixed income we remain overweight global investment grade credit as well as US high yield bonds, which continue to offer an attractive premium of 466bps over US Treasuries. We expect low corporate default rates, and a strong appetite for yield from investors to offer support for the sector.

We are making a number of additions to our currency positioning. First, we are adding an overweight position in the US dollar. Economic growth is stronger than in other regions, and discussions over a potential reduction in QE could support the currency, particularly relative to the euro where an ECB refinancing rate cut is likely. With economic growth expected to stay weak in the Eurozone, we will increase our underweight in the region, but instead of adding to our euro short, we will introduce a long USDCHF position. The EURCHF 1.20 floor remains solid, and as such the franc could weaken further from current levels.

Second, we are taking an overweight position in the Canadian dollar. Canadian consumer confidence, business sentiment, and investment spending are picking up, while the recent rise in inflation should calm any dovishness at the Bank of Canada. Meanwhile, positioning data suggests the market is very short the Canadian dollar (see Fig. 6), meaning positive surprises could have an outsized impact. We suggest setting this against the Australian dollar. It is overvalued, its positioning is long

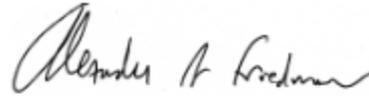
and Australia's most recent economic data suggests a potential slowdown in employment growth.

These two currency positions also will help diversify our overall portfolio. While a return to a "risk-off" environment is not our base case, such currency positions should perform particularly well if global growth deteriorates, balancing some of the potential weakness that could be seen in our overweight positions in equities and credit.

Finally, we continue to favor the British pound over the euro. This week's announcement of an extension to the Funding for Lending scheme could see some Monetary Policy Committee members back away from calls for more QE, and concerns over a change in Bank of

England policy should continue to recede following March's Budget Statement.

Thank you for your consideration in making it all the way through this letter. As always, any comments are appreciated.



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