

UBS CIO Monthly Letter



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Meteors and inflation

Last week, as one meteor exploded over the skies of Russia, a much larger one the size of the White House passed within 17,000 miles of earth, a mere "stone's throw" in astronomical terms. Fortunately, the skills of Hollywood's action heroes were not required to avert disaster, but it was undoubtedly a close shave; it is widely believed that an asteroid collision resulted in the extinction of the dinosaurs some 65 million years ago.

It seems that even with all our technology, there will always be things falling from the sky that we do not see until it is too late, as the residents of Chelyabinsk in Russia found out. It might be a meteor or the proverbial "falling piano."

So what should we, as investors, be looking out for now?

For savers, the economic equivalent of a meteor strike would be an unexpected period of high inflation. With the Fed engaged in seemingly endless rounds of quantitative easing, and other central banks including the Bank of Japan and Bank of England firing up the printing presses too, many investors are understandably anxious that fixed income assets could go the way of the dinosaurs in a big explosion of paper money.

If policymakers wait too long to normalize monetary policy once economies return to trend growth, it is very possible that inflation could accelerate rapidly over a 3–5 year period. A rise of US inflation to 4.2%, for example, or double its average level of the past five years, with interest rates at zero,

would leave savers suffering a near 20% loss in purchasing power over five years. And even if inflation were to stay at its current ultra low level of 1.7%, in five years about 8% of a saver's real wealth would still be destroyed.

However, we do not think it is time to worry about an inflation spiral just yet.

We believe inflation will remain mild over this year and that this economic environment remains supportive of corporate credit. Hence, we remain invested in some credit sectors like US high yield, where valuations relative to US Treasuries are attractive and US economic growth and monetary policy are supportive. Importantly, we are not seeing the kind of sharp increases in leverage that would normally be associated with a turn in the credit cycle.

Overall, we maintain our moderate pro-risk stance. The ongoing improvement in the global economy, positive market momentum, and loose monetary policy remain supportive of the outlook for equities and corporate credit. But, we refrain from adding to our risk positions further at this point. This week, NASA revealed it is monitoring 1,379 Potentially Hazardous Asteroids (PHAs), and in investment land we are closely monitoring four of our own PHAs. First, the Italian elections, where the February 24–25 vote could lead to an unstable government unable to enact reforms. Second, the situation in Cyprus, since German leaders are likely to be under internal pressure to resist a bailout, given how much resistance voters have to yet another rescue. Third, the bleak French

economic picture, where the February PMI fell to 42.3, the lowest level since March 2009. And finally, the March 1 sequester in the US, where USD 85bn of automatic spending cuts are scheduled to go into effect. We await "safe passage" before we consider adding more risk.

The following sections of our monthly investment letter delve more deeply into the inflation issue and also examine the credit markets and, in particular, the high-yield asset class. Finally, we describe our investment positioning in detail.

Inflation likely to remain tame in the near term

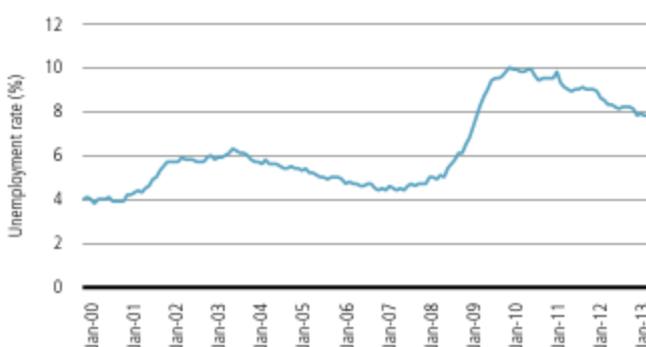
In simple terms, inflation is determined by two factors: the cost of producing goods, (in economist-speak, "cost-push" inflation), and the level of overall demand for goods relative to supply ("demand-pull").

On the production side, a glance at the labor market tells us we are unlikely to see rapid wage growth. Unemployment in the US is currently 7.9% (see Figure 1), far above the 5.5% that the Federal Reserve views as the "natural" rate of unemployment. This means that workers are in a weak bargaining position to negotiate higher wages. The story is similar in Europe, where unemployment is at a multi-decade high of 11.7%. And with over two million barrels of oil per day set to come on stream in the US and Canada over the next two years, we expect oil prices to remain in check too. So the recent rise in US gasoline prices towards USD 4 per gallon, a level that often worries investors, is likely to be a temporary one.

And on the demand side, it would appear that disinflation or even deflation should be more of a concern than inflation. Taking the US as an example, the output gap (the gap between actual and potential GDP) is currently 5.6%, the largest since the 1982 recession. Overall, our global inflation barometer currently points to lower inflation in the near term and we expect US inflation to decline to around 1.6% for 2013.

Figure 1: Unemployment rate remains high

US civilian unemployment rate (seasonally adjusted)



Source: Federal Reserve, as of January 2013

Higher risk of inflation over the long term

One of the most frequent questions I get asked by investors goes as follows: if inflation is about "too much money chasing too few goods," why has the huge amount of liquidity provided by central banks not led to higher inflation?

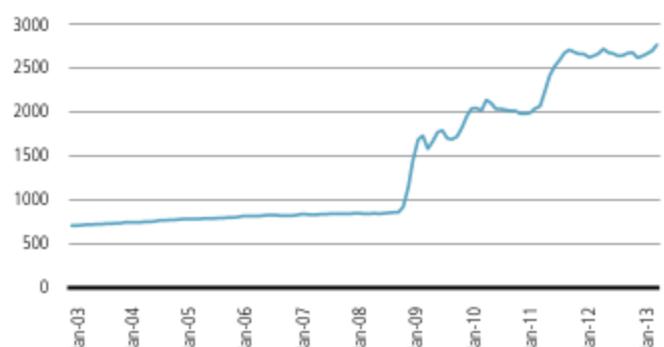
The key to understanding why it has not is that the transmission mechanism between base money and the wider money supply (the banking system) is impaired. Using the US as an example, since the crisis, the Fed has increased base money supply by 220% (see Figure 2), but banks have accumulated excess reserves of more than USD 1.5 trillion at the Fed (see Figure 3), rather than lending it to households and businesses. Similarly in the Eurozone, credit growth is in negative territory. This is symptomatic of the ongoing deleveraging process, and shows commercial banks are reluctant or unable to use all of the new money to create new credit. It is also illustrative of weak demand, resulting from a lack of confidence among consumers and corporate leaders.

In the longer run, however, we see a significant risk of higher inflation as the credit channel is gradually restored. And as house prices recover and the labor market improves further, the production and employment gaps will start to narrow. Some economists argue that the level of potential growth in developed market economies may have fallen since the recent crisis. Or put another way, perhaps "full employment" in Europe and the US won't be as 'full' as it was before the crisis. This means we could begin to see wage pressures at higher levels of unemployment than we have previously.

In and of itself, this doesn't need to cause *significantly* high inflation if central banks respond and raise interest rates in time. But after a brush with deflation in 2008, we believe central banks will be reluctant to jeopardize the economic recovery by raising interest rates too soon. And excessive levels of government debt mean

Figure 2: US monetary base has surged 220%

US base money (adjusted for changes in reserve requirements)



Source: Federal Reserve, as of 01 January 2013

central banks are more likely to err on the side of looser policy. To some extent, we have seen this already in the UK, where the Bank of England has kept rates at record lows despite inflation being above target for three years already, and set to remain so until 2016.

The bottom line is that we do not consider inflation an immediate concern. But the longer-term picture is more uncertain – if the Fed and other central banks were to mismanage their exit strategies, inflation could rise faster than expected.

How to protect against inflation over the longer term

The purest inflation hedge available is inflation-linked bonds, which have an adjustable face value that is linked to consumer price index (CPI) movements. However, these bonds today are prohibitively expensive. The real yield on 10-year US TIPS is -0.55%, and we recommend that investors wait for a better entry point. Fortunately, there are other ways of protecting portfolios, such as equities, real estate, and commodities. None offer a guaranteed link to inflation, but should offer some form of protection.

Equities represent claims on the future income produced by the real assets of a business, which should rise over time with overall prices. Hence, they can offer an inflation hedge, as long as price rises remain moderate. In case of rapidly rising prices, the negative economic consequences of inflation more than offset the positive aspects of equities. Companies and sectors in which higher inflation has little impact on input prices generally fare best in inflationary environments. These include capital-intensive companies that have a high proportion of fixed costs. Large-cap companies with dominant market positions, strong pricing power and an ability to grow dividends also tend to offer good inflation protection, as

do companies that directly own large amounts of real estate assets.

Real estate has long been recognized as a valuable hedge against inflation. In general, the higher the land component of a real estate investment, the greater its sensitivity to the inflation rate, and the greater the inflation protection provided. Greater protection is also afforded when the rent of an investment property is tied to a price index.

Commodity prices are themselves a cause of higher inflation, so unsurprisingly they show a positive correlation with inflation. Investment in most commodities involves rolling futures contracts, meaning that total returns can be unpredictable in high inflation environments, but commodities which can be easily stored physically, such as gold, may offer more reliable protection.

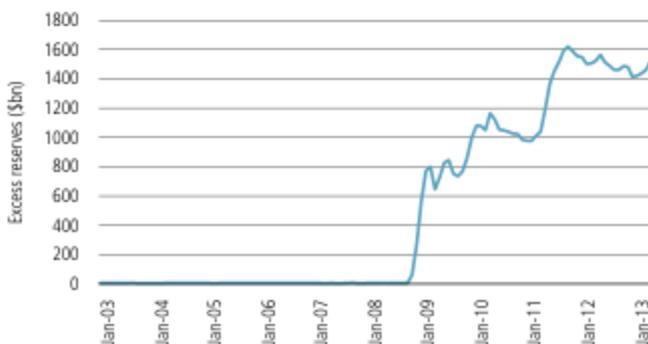
The outlook for credit

The performance of fixed rate bonds is always negatively correlated with the inflation rate, because their nominal return does not change over time. Therefore, the outlook for inflation is a key consideration in assessing the attractiveness of corporate credit. As I mentioned earlier, inflation is not likely to prove a major risk in the near term. But this is not preventing some investors from growing anxious that the corporate credit rally may have gone too far. In particular, there appears to be concern about US high yield.

One of the most common reasons cited for worry about high yield is that you can lose in high yield whichever way the economy goes. If the economy deteriorates, then spreads widen; if the economy improves, benchmark yields increase. Though seemingly logical, this argument falsely assumes that the global economy is a binary system. The US has not slipped into recession since the 2008–09 crisis, but growth does remain

Figure 3: US banks are sitting on massive reserves

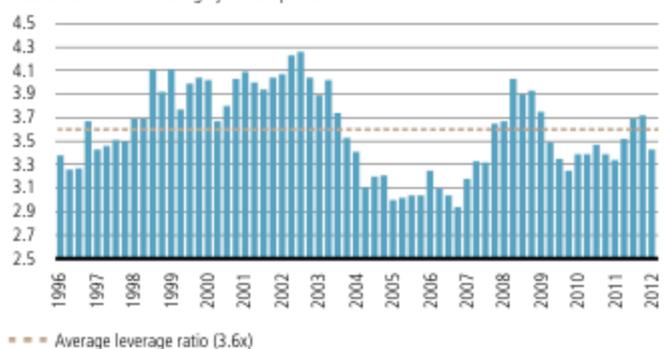
Excess reserves of US depository institutions



Source: Board of Governors of the Federal Reserve, as of 01 January 2013

Figure 4: Corporate leverage remains below historical average

Net debt / EBITDA of US high yield companies



Note: Data for Q4 2012 is based on a sample of the universe only (roughly 40% of the total) and thus preliminary
Source: BofA Merrill Lynch Global Research, as of 19 February 2013

relatively weak. We expect to see GDP growth in the US this year of 2–3%. Such an environment is actually ideal for credit: growth is too low to force benchmark yields up, yet high enough to prevent defaults. Furthermore, if investors are concerned about benchmark interest rate risk, they can easily hedge it. They can look at senior bank loans, for example, which reset interest rates every 90 days. Alternatively they can fund a high yield overweight with an equivalent underweight in government bonds, as we advise doing in portfolios.

Others argue that liquidity could dry up if there is a sudden “rush to the exit” in a risk-off environment. While high yield liquidity does depend on the market environment, the Fed is focused on keeping the credit market functioning, and any deterioration in market liquidity would likely prompt renewed policy easing.

And some bears point to the declining quality of issuance and an increase in buyout activity, citing recent cases such as Michael Dell’s USD 24.4bn acquisition of his former company Dell, Inc. Isolated instances of leveraged buyout activity do exist, but the important thing is that overall we are seeing no significant increase in net leverage (see Figure 4). The interest coverage ratio of companies, currently 3.5x, has barely declined in the past three years and remains above the 2007 level of roughly 3.0x. Issuer quality remains sound too, with less than 20% of newly issued bonds rated CCC or lower, relative to some 35% in 2007 (see Figure 5).

Overall, we still see value in holding a position in US high yield. Valuations are reasonably attractive, especially compared with government bonds, offering a spread of 506 basis points over US Treasuries, and we expect this spread to tighten further over the next six months to 450bps. While a return to pre-crisis lows of below 300bps is unlikely, we should not underestimate the commitment of central banks to provide monetary

support. Their actions will continue to force investors to “hunt for yield,” a backdrop that should support the asset class.

Fundamentals also remain positive. Corporate balance sheets are strong and the default rate for US high yield issuers ended 2012 at 1.5%, well below the long-term median of 4%. In addition, high yield issuance has been strong, reaching a record USD 366bn last year, and already topping USD 50bn in 2013. Importantly, around 60% of this issuance has been used for refinancing. This means there is little expiring debt ahead to default on – we estimate that less than USD 50bn will mature in the next two years.

What would compel us to change our view on credit?

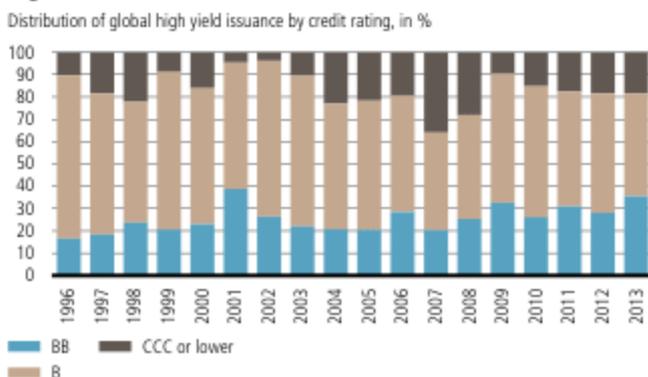
Of course, we are not “married” to any of our positions, including this one in high yield. Specifically, declining credit spreads are leading indicators of future equity returns, so if high yield spreads approached our 450bps target we would likely shift all or part of our high yield overweight into equities, continuing the move we began in early January. Equally, were the macroeconomic outlook to deteriorate markedly we would likely remove our overweight position. But currently the economic cycle is picking up and leading indicators are improving – the JP Morgan Global Manufacturing PMI has been flat or rising for five consecutive months.

Our current tactical investment positioning

Overall, an acceleration in global growth, low inflation and accommodative central banks continue to foster a positive backdrop for risk assets.

In equities, we are maintaining our overweight, and continue to prefer the US and emerging markets. We increased our overweight in the US this month on the back of positive economic data, as well as stronger

Figure 5: Average quality of HY issuance remains relatively high



Source: BofA Merrill Lynch Global Research, as of 19 February 2013

Figure 6: Euro looks overvalued relative to the British pound



Source: Thomson Reuters, UBS CIO, as of 19 February 2013

earnings growth and momentum than in most other regions. We expect US earnings to grow at a solid 6% pace in 2013.

The increase in our US equities overweight is financed by an underweight in Canada, where we have observed weaker earnings growth and price momentum than in the US. Another cause for concern about Canada is that financials account for roughly 1/3 of its equity market. Due to slower loan growth, and the risk of a downturn in Canada's housing market, we expect Canadian financials to lag their US peers.

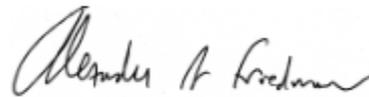
In fixed income, we expect close to zero returns for high grade government bonds this year. In line with this view, government bond returns have been slightly negative for 2013 to date, as yields have started to rise. We continue to prefer high yield, investment grade and corporate emerging market bonds to high grade government bonds.

In currencies this year we have seen an upsurge in volatility, with exchange rates increasingly driven by idiosyncratic factors, rather than simple "risk-on, risk-off" considerations. We recently re-established a long position in the British pound, where traditional correlations have broken down. Weak economic data, speculation that the Bank of England would adopt nominal GDP targeting, as well as talk of Britain exiting the European Union, have weighed on the currency. In the near term, such factors could continue to create volatility, but with a referendum on EU exit not likely before 2017, and future BoE

Governor Mark Carney recently backing away from nominal GDP targeting, this pressure should start to ease.

Furthermore, we expect UK economic data to pick up in the months ahead, following encouraging news in January when the composite purchasing managers index (PMI) showed a modest pickup in activity. With investor sentiment toward the pound very negative and short positioning at elevated levels, there is already a lot of bad news priced into the currency; the pound is now 13% undervalued relative to the euro (our least preferred currency) on a purchasing power parity basis (see Figure 6). This means that even moderately positive news could trigger a rebound. The timing of such a recovery is uncertain, but we believe that over our six-month tactical investment horizon, this contrarian call will be rewarded. However, as is often the nature with a call against consensus, patience may be required.

Thanks for reading this letter and for giving us the opportunity to work with you.



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