

# UBS CIO Monthly Letter

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## *The muddle-through market*

A great ice-hockey player once said, "I skate to where the puck is going to be, not where it has been." For investors, there's wisdom in this quote on two levels. First, when we react to how things look today, we are often too late and find ourselves chasing opportunity, rather than taking advantage of it. Second, it is impossible for even the best players to anticipate exactly where the puck is going every time, so the key is to get the general direction right.

Today's financial markets seem largely driven by a titanic battle in the developed world between the forces of slow growth and deleveraging, and the money printing actions of central banks. A result of this battle is extreme market volatility and periods that alternate between euphoria and panic. In this environment, it is tempting to follow the news headlines from one end of the investing spectrum to the other, from risk-on to risk-off and back. Such an approach to investing will not work and when it inevitably leads to the wrong approach to asset allocation, there are negative consequences for wealth preservation. Investing is not a binary dynamic, whereby one either embraces risk or shuns it. Rather, it requires dispassionate analysis of the facts, a prudent balancing of risk and opportunity, and the patience to hold positions over a longer period of time. Today's fearful climate makes this hard, but it has never been more important.

Despite the market's significant volatility, our asset allocation remains broadly unchanged since my last *CIO Letter*. In the following sections, I explain why, and shed some light on the direction we think the puck is going.

### **Our view of the current environment**

It appears that Europe will continue to create policy responses that are adequate to keep the Eurozone together, but not sufficient to stave off renewed periods of extreme market stress. This has proven to be the case in previous phases of the crisis, and seems set to be true going forward. Greece recently elected a "bailout friendly" government and should enter constructive negotiations with the Troika, but remains in an economic depression with an unsustainable level of debt. Meanwhile, Spain accepted that its banks require more capital, but the move merely served to highlight the stressed nature of government finances and the problematic intertwining of the banks and the sovereign. Finally, this week's Eurozone summit is most likely to follow the form of previous summits – long on words and short on tangible actions. Once again, a "muddle-through" in Europe is more likely than a comprehensive solution, suggesting that we will continue to see periods of stress and heightened volatility.

In the US, growth weakened and non-farm payrolls disappointed for the third

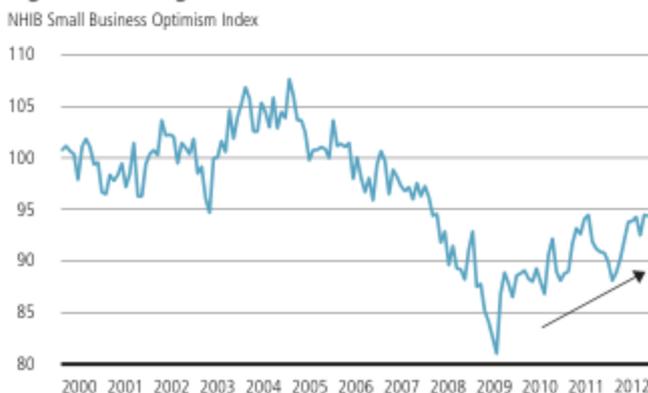
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consecutive month. Still, we believe that economic growth in the US is sustainable, if muted; the Federal Reserve has shown it is willing to support growth through its extension of Operation Twist, and the cyclical recovery remains broad-based, with small business confidence increasing (see Figure 1), loan growth improving, and the housing market stabilizing. Like Europe, the US will need to find a political bargain later in the year, when the fiscal deficit issues come to the forefront. Finding a consensus will be difficult, given that the political system is still gridlocked, but with approval for the Republican-controlled Congress at record lows, the party has as much to lose as the Democrats if the “fiscal cliff” is not avoided ahead of the election. As a result, we expect the majority of the fiscal tightening to be deferred. A “muddle-through” in the US seems the most likely outcome.

Finally, we continue to believe that China is on course to manage its economy to a soft landing. We expect 2012 growth of approximately 8%, despite the disappointing recent purchasing managers index (PMI) data. Inflation has fallen and will likely fall further, providing policymakers with scope to support the economy through appropriate steps. Encouragingly, new loan growth re-accelerated in May to CNY 793bn from the disappointing CNY 682bn in April, and the People’s Bank of China cut interest rates by 25bps. Meanwhile, 1Q GDP disappointed in India and Brazil, leading to questions over the sustainability of growth in the BRICs. However, we expect 2Q to represent the end of the growth deterioration. It is worth noting that for many EM countries, the slowdown has been policy-induced and designed to counter domestic inflationary pressures which built up in early 2011. With inflation now falling across many of the emerging markets, aided by the recent declines in the oil price, central banks are now entering a reflationary phase, which should help support EM growth through the second half of the year and into 2013.

**Figure 1: Strong US small business confidence**



Source: Bloomberg, UBS

A common response by investors to this turbulent environment has been to hide in the safest possible assets. Denmark issued two-year government bonds with negative yields (-0.08%) this month, joining Switzerland as a country where investors are actually willing to pay to hold their money for two years. Investors are avoiding the Eurozone, and three of the four best performing bond markets in Europe over the last three months are non-euro-denominated: UK, Denmark, and Sweden (see Figure 2).

These negative real yields, and extremely low yields on other “risk free” assets, essentially guarantee real wealth destruction if held to maturity. At the other end of the risk spectrum, valuations, earnings, and accommodative central banks support equities, but high volatility and political risk makes the picture very unclear.

As a result, we continue to believe the best course of action is a middle-ground strategy, focused on earning yield in corporate credit, particularly US high yield, global investment grade, and emerging market USD-denominated bonds.

Right now markets face an important few days. The European Union summit is taking place as I write this letter. Expectations for a constructive outcome are low, although this does provide room for a positive surprise in the unlikely event of a comprehensive solution. On Monday, we will see critical data from the US (Institute for Supply Management manufacturing indicator), and China (official PMI). Provided the ISM-manufacturing remains above 50, and non-farm payrolls next Friday remain above +60,000, we will likely leave our moderately pro-risk stance unchanged. *We will issue a CIO Note if necessary following these events.*

**Figure 2: Investors avoiding the Eurozone**



Source: Bloomberg, UBS

**Remain neutral on equities despite market volatility**

In this environment of low growth, high political risk, and elevated market volatility, it might appear that an underweight in equities is appropriate. However, we remain neutral for five reasons:

First, sentiment is already depressed. Financial markets are discounting weak global growth, so the hurdle for a market-neutral outcome to the European Union summit is not high. Second, while global growth is weak, it has not collapsed; in the US we expect about 2% growth, and growth in China in 2012 is likely to be c.8%. Third, central banks remain broadly supportive. In the past month alone, the US Fed extended Operation Twist, the Chinese authorities increased the bank loan quota and cut interest rates, the Bank of England boosted funding conditions for banks, and the European Central Bank again eased its collateral rules. Fourth, profit margins are likely to remain high, given interest rates should stay low and labor has weak bargaining power. Finally, our proprietary business cycle and market momentum indicators signal that a “neutral” position is appropriate.

**Our biggest overweight positions remain in US assets**

We continue to hold the majority of our overweight positions in the US market. Although economic growth has come under question recently, particularly after relatively weak labor market data, we continue to believe the positive trends in the US are sustainable. The National Federation of Independent Business (NFIB) small business optimism index is close to a four-year high, and bank lending growth remains positive. Furthermore, the Federal Reserve remains supportive, recently extending “Operation Twist,” its program of buying longer dated Treasuries to lower long-term financing costs. We also believe the Fed would step in with a broader quantitative easing program if economic conditions deteriorate. Meanwhile, housing indicators are trending higher (see

Figure 3), with data this week showing that new home sales jumped 7.6% m/m in May, the fastest pace since April 2010.

Nonetheless, we are mindful of the risks to the US economy, most notably from uncertainty surrounding the US fiscal deficit. At the end of this year, Bush-era tax cuts expire at the same time as USD 600bn (3.7% of GDP) of spending cuts are instituted. Unless a political agreement is reached to defer some of these measures, the “fiscal cliff” could tip the economy into recession; the Congressional Budget Office estimates that the US economy could shrink by 1.3% in the first half of 2013. However, the Republican-controlled Congress has an abysmal approval rating, and the party has as much to lose as the Democrats if the “fiscal cliff” is not avoided ahead of the election. Hence, while we monitor this key risk, our base case is that the majority of the fiscal tightening will be delayed. We expect income tax hikes and sequestration spending to be deferred, while unemployment benefits and the payroll tax cut will expire, in aggregate leading to only moderate fiscal tightening of approximately 0.9% of GDP in 2013.

In sum, we believe US economic growth is sustainable at current, sub-par levels.

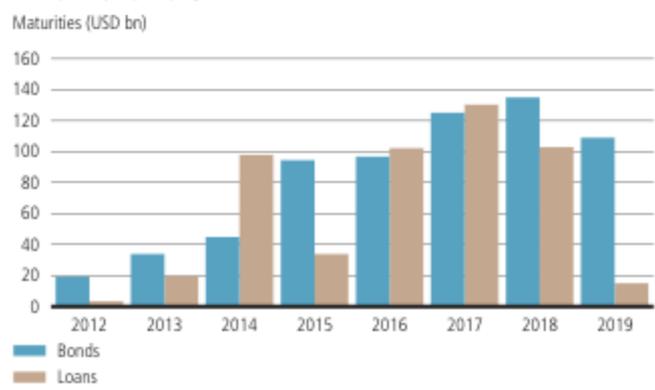
This economic backdrop is well suited to investments in credit, given that growth is high enough to prevent default rates rising substantially, yet too low for equities to meaningfully outperform. Of all the asset classes we cover, we believe US high yield credit offers the most attractive risk-reward profile, and we expect total returns of about 8% over the next six months. It is our biggest overweight position. US companies are sitting on record-high cash balances, while refinancing pressures have been alleviated by generally low leverage, long-term debt (see Figure 4), and robust primary bond markets.

**Figure 3: Housing sentiment at highest levels since 2007**



Source: Bloomberg, UBS

**Figure 4: Relatively few high yield and loan maturities in 2012 and 2013**



Source: IEA, UBS

Global high-yield companies have issued a record USD 150bn in bonds year-to-date, more than twice the average amount issued at this point in the year over the last decade. Despite these robust fundamentals, spreads of c.650bps are compensating investors for defaults of about 7.5% of high yield companies each year over the next five years. This default rate is significantly worse than our forecasts and recent observations. Over the last 12 months, 3.1% of US high yield companies defaulted, and we expect a moderate increase to 3.5% by the end of the year.

Part of the reason for this attractive fundamental picture is that markets today place a high premium on liquidity, and US high yield could suffer if market liquidity temporarily dries up in a significant "risk-off" event. Therefore, US high yield credit is most suitable for investors with the tolerance to hold over our six-month investment horizon or longer. For these investors, the ability to hold positions over a longer period of time is very helpful, since the elevated liquidity premium continues to offer an attractive investment opportunity. US high yield credit has traditionally quickly recovered its losses from illiquidity-induced bouts of weakness, and has exhibited resilient performance in the recent market turbulence. US high yield is both a CIO asset allocation overweight and a CIO preferred theme.

The US remains our preferred global equity market. US equities are priced at a premium to other global markets, but we believe this is warranted. Realized earnings have continued to grow in recent months, in contrast to the Eurozone, where earnings have fallen (see Figure 5). Prospective earnings should be supported by a still-growing economy, and we believe US companies can maintain

their near record-high profit margins, particularly with commodity prices falling and unemployment still high.

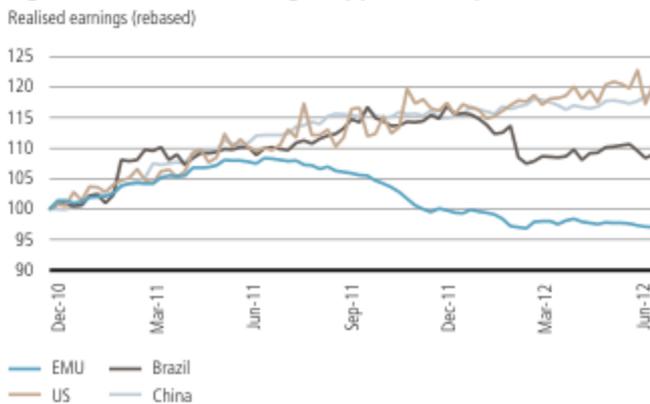
We also remain positive on the US dollar, as a combination of stronger growth and safe-haven flows emanating from the Eurozone should support the currency. Longer-term, continued stimulus from the Federal Reserve and concerns over the "fiscal cliff" could limit upside potential into the latter half of 2012.

**We remain underweight European assets**

We have long maintained a preference for US over Eurozone assets, due to relatively stronger growth in the US and the Eurozone's well documented troubles. This strategy has served us well, particularly in recent months as Eurozone growth deteriorated – last week's flash PMI fell from 45.4 to 44.8, the lowest level since June 2009. In the last three months, the S&P500 has outperformed the EuroStoxx 50 by 8.8%, and the USD is up 4.7% against the EUR. From here, the question we face is whether Eurozone assets are now cheap enough to merit more investment. In short, we believe valuations are not yet attractive enough, barring a more comprehensive solution to the crisis or an economic re-acceleration.

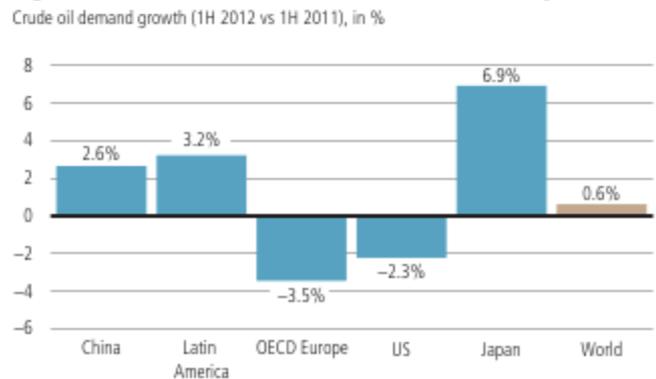
One of the few areas we recommend within Europe is investment grade credit; here we are overweight globally. Despite investment grade credit's relative safety, credit spreads have widened recently to their highest levels of the year. At current levels, spreads are compensating investors for extreme default scenarios which have not been observed since records began (over ninety years). Within investment grade we believe investors should keep a core focus on non-financial corporates, which offer comparatively safe and attractive total returns.

**Figure 5: Resilient earnings support US equities**



Source: Thomson Reuters, UBS

**Figure 6: Global demand for oil is flat over the year**



Source: IEA, UBS

**Asset allocation**

Overall, we maintain our preference for credit over equities, specifically US high yield, global investment grade credit, and emerging market USD-denominated bonds. Within our neutral equities position, we prefer the US to Europe, and are modestly overweight the UK and emerging markets, where valuations are attractive and central banks are relatively more supportive.

We remain underweight commodities, expressed through positions in energy, which remains oversupplied relative to sluggish demand growth (see Figure 6), and agricultural commodities, where high inventory levels are likely to depress prices in the third quarter. Our largest foreign exchange overweight is in the Canadian dollar, which may seem counterintuitive given our negative stance on commodities. However, we believe the Canadian dollar is now acting more as a US-proxy, and positive growth dynamics could give rise to expectations of an interest rate hike later in the year. We also continue to prefer USD and GBP to EUR and CHF.

We have made only one change following this month's Global Investment Committee, removing our slight underweight duration stance. While fundamental valuations of core government bonds remain far above fair value, with economic growth weakening and central banks tending toward looser policy, the near-term trigger for higher yields is unclear.

Kind regards,



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Wealth Management  
28 June 2012

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