February 2017

UBS-SFA Investment Outlook

Free globalization, the retreat of globalization or just protectionism?

"Under a system of perfectly free commerce, each country naturally devotes its capital and labour to such employments as are most beneficial to each."

David Ricardo
"On the Principles of Political Economy and Taxation", 1817

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Stronger growth despite policy uncertainty

We still advocate a base case scenario of slightly higher global growth in 2017 than in 2016 as the US economy continues to improve thanks to full employment, solid private consumer expenditure and rising investment spending. Despite ongoing political uncertainty in the European Union (EU) over the UK's Brexit decision, as well as in the euro area (EA) due to the unforeseeable outcomes of the French and German elections, we are convinced that the EA economy has sufficient momentum, as shown by strong growth numbers for Germany of 1.9% in 2016. Emerging market economies have bottomed out and stabilized, which we expect to continue in the absence of any significant shocks. We are therefore cautiously optimistic. This is slightly more cautious than the current consensus view on the near-term prospects for the US and the world economy. With the election of Donald Trump as the 45th US President, a combination of tax cuts, infrastructure spending and lighter regulation should create above-trend growth. Moreover, even though these policies have not yet been enacted, growth is expected to increase immediately as "animal spirits" kick in (higher spending in anticipation of higher growth, income and change in regulation). Although there may be some positive correlation between "animal spirits" and future economic growth, this should be viewed with some caution given the potential setbacks and many cases of signals being misread in the past. In our view, many analysts are not placing enough weight on three near-term negatives:

– passing comprehensive tax reform is likely to prove quite difficult and many tax cuts will probably not kick in before 2018;
– House Republicans are unlikely to support significant infrastructure spending;
– trade tensions may undercut "animal spirits" in the coming months.

Many economists seem to view trade tensions as a "downside risk" rather than part of the baseline forecast. Yet, since the election, the President has continued to push for major changes in trade, with ongoing talk of tariffs and penalties on companies that move jobs overseas. Concerns about trade and China feature heavily in his tweets. However, we expect compromises to emerge, as the cost of a trade war would be very high for both the US and China and indeed the world. In our view, there is a rocky road ahead. The fact that it is hard to quantify the impact on confidence and the economy is not a reason to ignore the likely shock. While trade is our main focus, we think some analysts fail to fully appreciate some of the challenges for fiscal policy. A common view is that tax reform will sail through Congress and that significant infrastructure spending will materialize. We are skeptical on both counts.

Historically, tax reform has been one of the hardest pieces of legislation to pass because it creates so many winners and losers. It took two years to enact the 1986 tax reform. The current proposal is particularly challenging because it includes both corporate and personal tax reform and a new feature border adjustment of corporate taxes. These three aspects are likely to trigger a significant lobbying effort. Passing this reform is likely to require a very disciplined process because any attempt to preserve tax loopholes will make it harder to cut tax rates and may trigger attempts to preserve other loopholes. We therefore think it will take a number of months to enact a bill, and we would not be surprised if some of the reform does not make it through.

Even infrastructure spending may be fall short of current expectations. Fiscal conservatives still control the House of Representatives. They are likely to support tax cuts and reform because they believe such changes will trigger a sharp increase in investment and labor supply, boosting the tax base and preventing a surge in the budget deficit. On the other hand, they have been very reluctant to do the same for infrastructure spending. Once tax reform is complete, we expect little appetite for infrastructure.

It is worth noting that this would not be the first time the markets and forecasters have gotten ahead of themselves in this economic recovery. Indeed, confidence shocks and soft patches seem to be an annual event, including brinkmanship in Washington, crises in Europe, populist shocks like Brexit, oil shocks, and concerns about China. It is also worth recalling that before the election, the markets appeared to be more focused on the risks of a Trump presidency (protectionism in particular) rather than the rewards (lighter regulation and fiscal stimulus). For example, according to the Bank of America Merrill Lynch Global Fund Manager survey last September, "Republican wins the White House" was judged as the second highest "tail risk." Of course, on the night of the election, the markets reassessed, rallied on the Trump victory (and a strong showing by Republicans in Congress) and continued to move higher through mid-December. Our point is not that the original sentiment in the market was right, but rather, the swing in sentiment may be a bit overdone.

The Fed continues to trip, others continue to accommodate despite disinflation's retreat

As outlined in detail in our January "Investment Outlook", inflation expectations in advanced economies, especially in the US, appear to have bottomed out in the second half of 2016. After years of plummeting commodity prices, particularly energy, prices started to turnaround in 2016 and are rising due to higher industrial activity. With the US economy operating at full employment – some already argue that the current level of employment is no longer consistent with stable inflation – and wages growing much faster than productivity, US inflation is expected to overshoot the Fed's inflation target of 2% in 2017, even without the fiscal measures announced by the new US administration. Should this fiscal stimulus materialize, inflation will rise faster and stronger. Whether a stronger USD will offset this trend in inflation strongly depends on the extent of trade barriers and their impact on the USD. In the EA, higher-than-expected trend growth is helping to narrow the output gap. Nevertheless, for us, economic momentum in the EA is not yet strong enough, so inflation is only creeping up instead of accelerating toward the target of the European Central Bank (ECB).

We expect the Fed to continue gradually hiking rates throughout 2017 against the backdrop of an accelerating economy with upside risks from Trump's stimulus plan. The frequency and extent of the rate hikes will depend on the trend of future payrolls, the impact on wage growth and finally on inflation. Should the USD stay firm or even become stronger, this may absorb some inflationary pressure resulting from domestic forces and give the Fed some leeway to limit the number of rate hikes necessary to keep inflation under control. Otherwise, the Fed will be forced to balance the trade-off between upping the pace of rate hikes and falling behind the curve, which may risk weakening the recovery. Although economic momentum in the EA is positive and is expected to continue, helping to remove deflationary risks further, the ECB is adhering to its current bond purchase program. Given the heightened political uncertainty in Europe in 2017, the ECB is committed to more easing if it is needed. However, as we expect the economic recovery to continue, the improving economic oulook may justify a gradual end to the policy late in 2017. Given the impact of negative interest rates on bank profitability, we expect no further rate cut by the ECB in 2017. Whether quantitative easing comes to an end in 2017 depends on the strength of economic expansion and on inflation gradually approaching the ECB inflation target. The Bank of Japan will also maintain its current accommodative policy stance, although the economic recovery is continuing to gain traction, by targeting 10-year government bond yields close to zero. And while the British economy has proven resilient to the UK's decision to exit the EU, we expect the Bank of England to ease monetary policy further when the Brexit shock reveals its full impact on growth, unemployment, inflation and fiscal ratios. All in all, despite higher inflation and improved macroeconomic conditions, 2017 does not mark the end of easy monetary policy.

Investment conclusions

Global foreign exchange

USD: Leaning toward strength

There are many reasons for us to believe that USD strength will continue in 2017. In the US, late-cycle fiscal stimulus with a US economy already near full employment may boost real rates and cause inflation to accelerate, prompting the Fed to hike rates faster in the medium term. This raises the attractiveness of USD-denominated assets. Should lower border taxes initiate a repatriation of USD held outside the US, the currency could get a further boost. Abroad, as outlined above, monetary policy and to some extent political uncertainty are a drag on currencies such as the EUR, the GBP and the JPY.

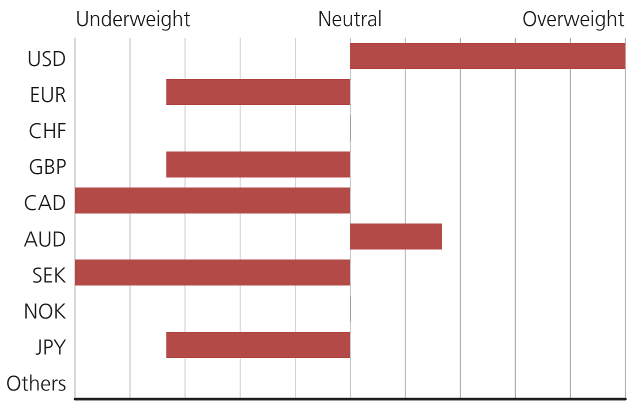
GBPEUR also looks set to break lower. UK Prime Minister Theresa May has outlined her Brexit strategy, putting forward a positive message on Brexit. There now seems to be less risk of the UK progressing along what the Conservative Party strategist Hilton called a "closed Brexit" as opposed to an outward-looking, open Britain. Brexit risks seem to be better understood as the government tries to deal with the "cliff edge" and offer an alternative strategy should the UK have to walk away from negotiations with its European partners. Although short-term uncertainty about the UK's position has faded, we are still confident that the GBP will remain weak.

The AUD has continued to perform well. In addition, commodity prices such as iron ore and other metals continue to rally, allowing AUDUSD to break out of the top end of a long-held channel at 0.74. With the USD rising, the AUD may slow its upward trend, but we are still waiting for catalysts on the domestic or external side (namely China) to confirm our holding. Longer term, we see the Reserve Bank of Australia (RBA) becoming more optimistic on domestic growth prospects and even rising rates as trade with China continues to normalize.

The SEK is expected to remain sensitive to Riksbank policy. Recent Swedish data supports a stronger SEK, should trends remain unchanged. Many investors believe that the SEK could be one of the strongest currencies if rising global inflation leads to a less accommodative ECB, allowing the Riksbank to turn. Nevertheless, there are of course heightened risks for the SEK, which tends to weaken in times of global trade concerns. SEKEUR correlates strongly with the difference between economic surprise indices in the EA and Sweden. If the global economic growth environment shifts, then the SEK will be the most vulnerable currency.

Similarly, since Sweden trades a lot with the EA, any worsening of the trading environment after Brexit could weaken the SEK. Our assumption is that the central bank is done with QE and will keep rates on hold until at least the end of 2018. A more dovish Riksbank that is unable move away from the ECB's current monetary easing program would not be good for the SEK. Against this backdrop, we maintain our underweight SEK allocation.

Currency allocation preferences (six months)



Source: UBS-SFA

Global bonds overview

Will Trump trigger a paradigm shift for global rates?

The main risk to the US economy over our cyclical horizon of six to 12 months is a pickup in inflation. It could be fueled by higher wages and a tight labor market as rising confidence and "animal spirits" translate into higher consumer and business spending. Fiscal policy changes could also be inflationary. Trump's proposed tax policy changes would likely be supportive for consumers and businesses, although they could increase import prices. At the same time, fiscal stimulus and infrastructure spending could further tie up scarce labor resources. Importantly, US fiscal stimulus is set to increase even as the economy enters its eighth year of expansion and labor markets tighten even further. This increases the risk of the US economy overheating, particularly if the Fed were to make a policy mistake. Simply put, the probability of higher bond yields and a significantly steeper yield curve in the US has risen given the shift from monetary to fiscal policy. Should growth and inflation surprise to the upside and should the Fed be forced to cut its balance sheet aggressively, the steepening trend of the US yield curve may intensify. We are therefore keeping a neutral duration stance in the US. Even though bond yields are highly correlated across regions and a potential overshooting of US rates may also translate into higher rates elsewhere, especially in the EA, we believe that yields for continental European government debt have the potential to decouple from domestic US trends, as the ECB is still committed to quantitative easing at least until the end of this year. As the Swiss National Bank (SNB) has implicitly pegged the CHF to the EUR, we are also less concerned about a sharp rise in Swiss rates. We are therefore maintaining a longer duration stance for EA and Swiss government bonds. This generates some yield pick as we avoid investing in debt with yields close to zero or even in negative territory.

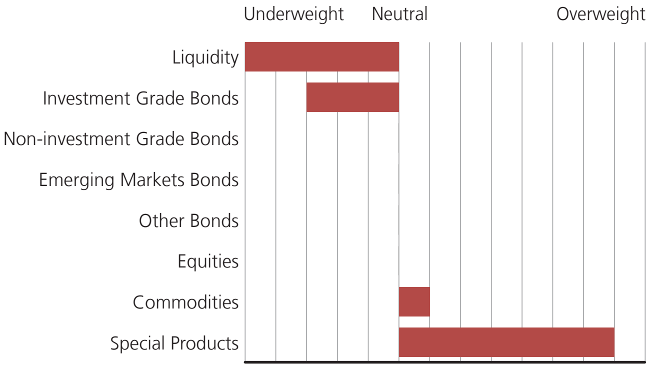
Although government bonds yields are on the rise in the US, higher yields and funding rates will not undermine many firms' ability to raise the necessary funds to accommodate rising economic activity. With the prolonged and stronger rebound in the US, including an improved earnings outlook for companies with a domestically oriented business model, default rates should stay low. This is also true for non-investment grade corporate debt. US investment grade corporate debt still offers an attractive risk-adjusted yield pick-up of around 150 basis points, while US non-investment grade corporate bonds offer an attractive spread of 430 basis points. With these attractive valuations, we are upgrading our underweight allocation to US non-investment grade corporate debt to neutral in our USD strategies. In the EA, corporate bonds are still benefiting from the ECB purchase program. Although current spreads have fallen below their long-term averages, we view investment grade corporate bonds as attractive and are maintaining our overweight allocation. The same holds true for non-investment grade corporate bonds in the EA, although spread compression appears limited as the current spread already mirrors sound balance sheets, low funding costs and improved credit availability in the EA. However, a spread of more than 400 basis points is attractive in such a low interest rate environment.

Global equity overview

Keep current equity exposure – neutral

We maintain a neutral allocation to global equities with a tactical tilt to US equities. We are still reluctant to add further equity exposure, given the significant downside risk of missteps on external trade. A neutral equity stance is – in our view – the best positioning to balance growth and earnings opportunities and the rising risk of protectionism and its impact on economic and political uncertainty. We acknowledge that the promise of income and corporate tax cuts may have the potential to boost earnings. At the same time, however, the negative impact of low oil prices and a strong USD on US earnings are fading, which should generate additional lift. The chance of financial market deregulation and the expected infrastructure stimulus should help the economy to further accelerate and support earnings growth. The repatriation of foreign profits to the US could boost buyback programs and may lead to higher dividend payments. Indeed, financial markets are trading expectations and if these expectations materialize, we would be in a perfect environment for additional equity investments. However, while the majority of the US Congress may be in favor of tax reforms and deregulation, the Republican Party is less in favor for fiscal stimulus programs. With the unknown outcome of Trump's de-globalization policy, we feel comfortable with our neutral equity allocation.

Asset allocation preferences (six months)



Source: UBS-SFA

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