

The exceptional market conditions mean I have accelerated the publication of my Monthly Letter, and details of the outcome of our Global Investment Committee. The nicely formatted version of this, and all of the usual supporting material, will follow as usual tomorrow.

Mind the gaps

Currently, we consider the risk and reward for equities balanced. While low oil prices have never provoked a US recession, cheaper crude has not yet provided the expected boost to the US consumer. Fears of a China hard landing have made global markets acutely sensitive to even minor policy changes or slight disappointments in markets and data. The correlation between the Shanghai and US equity markets has soared, and the recent correction can be traced to a modest 1.5% devaluation of the Chinese yuan versus the US dollar.

These new sources of volatility need to be digested by the markets to enable them to find direction. Opportunities to overweight and underweight equity markets remain, but overall we consider it best to be neutral on equities in our global tactical asset allocation (TAA). Yet this is no time for investors to abandon long-term investment discipline. We should remember that market falls can represent good opportunities to rebalance portfolios toward long-term strategic allocations.

In the remainder of the letter, I address some of the 'gaps' we are watching to inform our investment positioning. These include the gap between strong consumption and weak manufacturing, which is now a global phenomenon; the gap between oil production and demand, which has caused a jarring 75% slide in prices since summer 2014; and the gaps that are popping up in markets related to pegged currencies, which are indicative of the current global instability. In the months ahead, investors will need to 'mind the gaps' that these transitions are creating, and watch for more potentially destabilizing changes, such as a possible 'Brexit' from the EU, or unexpected changes in Federal Reserve interest rates.

Some of the gaps caused by market volatility are also creating opportunities. A variety of divergences contribute to our global TAA positioning, such as an overweight to Eurozone equities and European high yield credit, and underweights to emerging market stocks, UK equities, and high grade bonds. We are making two changes to our global TAA this month, closing our overweight position in Japanese equities relative to UK equities, and initiating an underweight Japanese yen position relative to the US dollar.

Gap #1: Services vs manufacturers

My first gap to watch exists between services and manufacturers. This is something evident across the world, but perhaps most strikingly in the US and in China, where manufacturing is in recession, but retail sales growth remains good.

It is clearly a positive that the services sector is holding up well. Not only does the services sector make the greatest contribution to most developed economies (and a growing contribution to China's), its growth also tends to translate, labor intensive as it is, into greater levels of employment, confidence, and consumption, when it is humming along.

Investors will need to pay attention to how this gap closes, however. I think we all want to see a recovery in manufacturing sentiment, and this would be a clear and simple positive. But investors will need to watch for any indications that the weakness in manufacturing is infecting the services side of the economy. One potential source of contagion is through credit spreads, where borrowing costs have been on the rise in recent months, even for companies outside of the energy sector. We will need to remain alert for signs that higher borrowing costs are affecting economic investment and hiring across sectors.

Gap #2: Oil supply and demand

The world had grown used to oil costing more than USD 100 per barrel.

With prices now down by more than 75%, the world is (trying) to adjust. These adjustments are creating uncertainty and volatility: oil majors, US drillers, and state-run energy firms in EM have made dramatic job and investment expenditure cuts.

The extent to which many economies rely on oil investment and hiring has, like the scale of recent oil price falls, taken many by surprise. And investment write-downs, deleveraging, and tighter credit conditions will continue to stoke price instability and

global growth concerns until oil finds a floor.

Investors will need to watch oil inventories for indications that the dramatic supply-demand imbalance is easing. In OECD nations, crude stocks are approaching three billion barrels of oil – 300 million barrels more than the five-year average. Until signs that this excess is clearing appear, uncertainty about the sector and its knock-on effects is likely to hold sway. This should affect EM most severely, and we hold an EM equity underweight in our global TAA.

Gap #3: Pegs vs pressure

A third type of gap investors will need to watch is that popping up in the forward and interest rate markets of pegged currencies, indicative of potential trouble to come. These are most evident, at present, in Saudi Arabia, China, and Hong Kong.

Saudi Arabia's peg to the US dollar has held firm since 1986 but has recently come under speculative pressure, thanks to the sharp decline in oil prices. Forward markets are pricing in a 2% fall in the riyal (or a 20% probability of a 10% drop) against the US dollar. The government has since reportedly banned the sale of forward options to prevent a self-fulfilling crisis.

Similarly, China's delinking of its currency to the US dollar, and toward a broader basket of currencies has driven uncertainty and speculation about further depreciation. At one point earlier this month, the offshore yuan was trading at a record discount, before aggressive government intervention, including wild swings in offshore yuan borrowing rates quashed any speculation.

China's moves have had a notable impact on Hong Kong too, where USDHKD has hit an 8-year high, albeit remaining within the Hong Kong Monetary Authority's trading band.

These gaps are important not because they present easy trading opportunities – heavy government intervention in all markets make bets on peg breaks highly risky propositions – but inasmuch as they give us an indication of market stress and the direction of capital flows. Until the global tension between market forces and government policy is resolved, markets are likely to remain volatile.

Gap #4: European togetherness

A fourth gap to monitor will be that between European states with respect to views on integration. The migrant crisis has placed strains on relations in recent months, and, following events in Cologne over the New Year, is now a major political topic in Germany. Question marks around freedom of movement of people could lead to questions about the wider European project, creating a potential repeat of the kind of instability we saw previously around Greece.

An important barometer of this will be the UK's vote on EU membership, which looks increasingly likely to take place this year. Our base case remains that the pro-EU camp will prevail, but the latest polls give the camp only a 5 percentage point lead, down from about 16 points in September. This data has led us to raise our 'Brexit' probability to 20-30%, and this will remain a crucial gap to watch in the months ahead.

In a 'Brexit' scenario, UK assets would clearly be in the firing line. The pound has already been under pressure in recent weeks due to concerns about the economy, and more weakness is probable if concerns about a 'Brexit' mount. And even if an exit were arranged on favorable terms, it would create prolonged uncertainty, darkening the investment outlook for one of Europe's largest economies.

Gap #5: The Fed 'dot plot' vs. market expectations

Only one month on from the Fed's first rate hike in nine years, some investors are already questioning whether the US economy could catch a cold, as China sneezes and oil markets sputter. Futures markets seem to suggest it might, pricing in fewer than two quarter-point Fed increases this year. Our models broadly agree.

Charting the Fed's course will be tricky, and investors will need to mind the gap between investor expectations and the median forecast of Federal Open Market Committee members that is calling for three to four quarter-point hikes.

Should the Fed reduce the pace of hikes toward market expectations, it would still need pitch-perfect communication to avoid exacerbating fears of a US slowdown.

Equally, staying the course with four rate hikes would accord with US labor market strength, but it could fuel the fire for further declines in emerging markets (EM), given how much many of them depend on the dollar.

No matter how the gap closes, it won't be an unqualified success for monetary policy.

Bottom line

I've looked at a (non-exhaustive) list of gaps to watch as markers of what could go wrong globally. When you factor in their recent volatility, global stock markets appear especially sensitive to negative news, or the opening of any new gaps. In light of this, we are maintaining a neutral stance on equities in our global TAA.

But we also have to consider the possibility that things will go right, not wrong, and that investors could stay pessimistic too long, missing a rebound. Growth scares in recent years have passed rapidly, especially after central banks took further policy action. While we suggest waiting for some of the highlighted gaps to close before taking on too much short-term risk, investors with a longer-term time horizon may find the sell-off creating opportunities in selected financial assets. Now could be a good time for far-sighted investors to put cash to work, especially if they are underinvested relative to their long-run equity benchmark or reference.

Tactical positioning

We are changing our positioning around the Japanese 'reflation' trade in our global TAA. We close our relative overweight to Japanese equities versus UK equities. Inflation in Japan has tailed off recently, and we expect a more modest earnings growth outlook for the market this year, after a double-digit rate of increase last year. Conversely, UK stocks may enjoy an earnings tailwind from a weaker pound, and from an eventual bottoming out in oil prices. That said, we still expect to see the Bank of Japan do more to combat deflation, particularly in light of the decline in oil prices, and so see this as a good time to initiate underweight positions in the Japanese yen relative to the US dollar.

Overall, we hold a neutral allocation to equities, with a relative overweight in the Eurozone against underweights in the UK and EM.

In credit, we are keeping an overweight position in European high yield credit, where leverage remains contained and where we consider widening spreads unjustified in light of improving fundamentals. The US sell-off is opening up opportunities for longer-term investors, but the latest oil slide is likely to increase default rates among the most highly geared producers. We forecast the US default rate to rise to 5.5% this year.

Finally, in currencies, we maintain an overweight in the Norwegian krone relative to the euro. The markets still appear to be expecting the Norwegian central bank to ease further, despite core inflation at 2.9%. While Norway is suffering from the depressed oil price, its monetary policy does not need to be eased further, in our view. By contrast there is a greater chance that the European Central Bank will have to cut rates, especially if inflation disappoints.

For any comments or questions on this CIO Note, please email ubs-cio-wm@ubs.com.

Best,
Mark Haefele

Appendix

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