

UBS House View

Weekly

15 September 2016

United States
CIO WM Research

The UBS House View will be published on September 23. As such, the next edition of UBS House View Weekly will be published on September 29. We welcome your [feedback](#).

Deeper dive

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Market moves

	Level	1-w chg	YTD chg
S&P 500	2,147	-1.56%	5.66%
DJIA	18,212	-1.45%	5.60%
Nasdaq	5,250	-0.19%	4.33%
Nikkei 225	16,405	-3.27%	-13.81%
Eurostoxx 50	2,974	-3.56%	-8.99%
MSCI EM	885	-4.42%	11.46%
Gold	\$ 1313/oz	-1.89%	23.74%
Brent crude oil	\$ 46.4/bbl	-7.14%	24.52%
US 10-year yield	1.699%	0bps	-57bps
VIX	16.30	+0.3pts	-1.9pts

Source: Bloomberg, as of 15 September 2016, EST 4:30 pm.

Note: All returns are in local currency

MSCI EM as of 14 September 2016

Market comments

- Major global equity bourses have fallen in sympathy with bonds on diminished hopes for central bank easing. **Emerging market stocks** shed the most (-4.4%).
- **Fixed income** assets posted losses across the board. **US government debt** declined 0.8%, and **US investment grade bonds** fell 1.3%.
- In **commodity markets**, **gold** lost some glister, slipping 1.9%. **Brent crude oil prices** stumbled around 7% on renewed concerns of oversupply.

In focus

Walk the line. That is about all the additional cash the European Central Bank (ECB) gave investors at its September meeting last Thursday. It neither changed interest rates nor announced any extension of its asset purchase program beyond the March cut-off date. However, President Mario Draghi did outline that the ECB's base-line assumptions for growth and inflation were subject to downside risks. He also suggested that rate-setters would consider a redesign of quantitative easing if needed. *CIO is neutral on Eurozone equities in global portfolios.*

(Job) opportunity knocks. JOLTS job openings rose to about 5.9mn in July in the US, a record high. Consistent with the data on initial jobless claims, discharges and layoffs remain low and support a tightening trend in the labor market, as well as gradually rising US inflation. *CIO expects the Federal Reserve to hike rates by 25 basis points in December.*

Exasperating exports. For bulls on German growth, July trade data threw a monkey wrench into the works. Exports declined 10% year-over-year, their steepest decline since the dark days of the financial crisis. Imports also fell 6.5% from July last year. Industrial production and factory orders had disappointed earlier this month. *CIO expects German growth to moderate, from 1.4% this year to 1.1% next.*

Factory chill this fall? Eurozone industrial production slipped in July, down 0.5% year-over-year. This was better than the 0.8% shrinkage expected by

economists. But some softer recent data out of Germany implies a cooler pace of output growth for the single-currency bloc this autumn. *CIO is neutral on Eurozone equities in global portfolios.*

Move on up for manufacturers?

Chinese producer prices fell at a slower pace of 0.8% year-over-year in August, compared to 1.7% the previous month. The monthly figure was the least deflationary print in 52 months. Meanwhile, consumer price inflation moderated to 1.3% from July's 1.8%, as food inflation has remained on a disinflationary trend since March. *CIO expects full-year consumer inflation at 1.9%, while producer price deflation is expected to abate.*

Producer deflation hard to shake

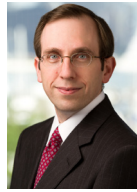
in Japan. Factory gate prices dropped 0.3% month-over-month in August, more than the 0.1% forecast by economists. On the bright side, the annual pace of deflation - 3.6% - was the least since February. *CIO is neutral on Japanese equities and the yen.*

Markets "Brent out of shape"

by oil glut. The International Energy Agency (IEA) noted that OECD countries' oil inventories reached a record high of 3.1 billion barrels in a report released Tuesday. Inventory growth is due to record supply from OPEC producers. The IEA also reduced its consumption growth forecasts, sending oil and energy stocks lower. *CIO believes that renewed setbacks may push the oil price down to USD 40 a barrel over the coming months, but prices should eventually move higher.*

Deeper dive

Will they or won't they?

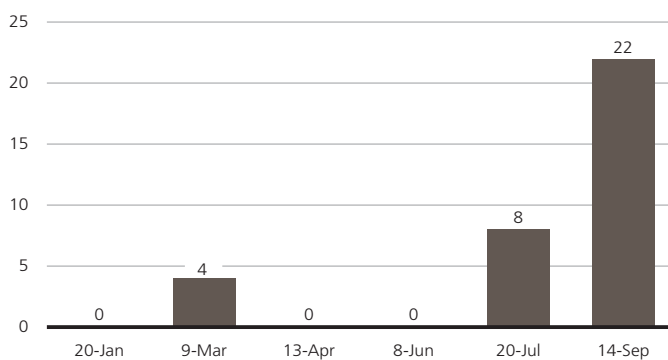

Brian Rose, PhD

Next week, the Federal Open Market Committee will gather to decide on US monetary policy. Since the Federal Reserve raised rates last December, prospects for the timing of the next hike have waxed and waned, but this is the first time that there is a realistic chance for a move going into a meeting (see chart). That's despite the fact that some of the recent data hasn't been encouraging. For example, in August the ISM non-manufacturing PMI, a broad measure of current economic conditions, fell to its lowest level in six years. So why does the market see a chance for a rate hike?

First and foremost, some of the public comments made by FOMC members have simply been too hawkish for the market to ignore. In a 26 August speech, Fed Chair Janet Yellen said that "the case for an increase in the federal funds rate has strengthened in recent months." More recently, Atlanta Fed President Dennis Lockhart said that conditions warrant a serious discussion of a rate hike, while Boston Fed President Eric Rosengren noted that failure to remove monetary accommodation could shorten rather than lengthen the duration of the recovery.

Market sees chance for a hike

Market implied probability of a rate hike one week before FOMC meetings, in percent



Source: Bloomberg, UBS as of 14 September 2016



Watch this week's video with Brian Rose. Click the photo to watch.

The other main reason to expect the Fed to raise rates is the ongoing improvement in the labor market. In the nine months of payroll data released since the December hike, the economy has added around 1.7 million jobs. That's about 900,000 more than demographics would suggest is a sustainable rate of job creation. It's hard to say just how much slack is left in the labor market, but it is certainly less than when the Fed last raised rates. The Beige Book, which gathers information from the 12 Federal Reserve Districts and is published two weeks before each FOMC meeting, includes many references to companies struggling to find qualified workers. Job openings hit a new record high in July, jobless claims are at historical lows, and it appears that the tighter labor market is promoting faster wage growth.

There are also numerous arguments against a September hike. Inflation has fallen short of the Fed's 2% target in all but three months since the global financial crisis, and has been stuck at 1.6% throughout 2016. Inflation expectations are also well below 2%, suggesting that markets are skeptical that the Fed will hit its target even in the long run. Another problem is that GDP growth has averaged just 1% over the past three quarters. While it is a fairly close call, in our view the Fed will want to see a bit more progress before hiking again, and we look for a move at the December FOMC meeting.


Brian Rose, PhD
US Economist

Bottom line

Several FOMC members have made hawkish comments recently, raising market expectations for a rate hike at next week's policy meeting. However, we expect the Fed to wait until December before raising rates. While the labor

market has improved, inflation remains stuck below the Fed's target and GDP growth has been weak. A bit more progress will be needed before the Fed can feel comfortable enough to hike rates.

Regional view

 **Top of the Morning daily podcast** “Week in Review/Preview” with Brian Rose, PhD, US Economist
www.ubs.com/topofthemorning

Heeding the buoy bells



Mike Ryan, CFA
 Chief Investment Strategist, WMA

Anyone who has ever experienced a significant change in the weather while out sailing can attest to the challenges this poses for navigation. Those who venture out in fair conditions and calm seas have little difficulty in avoiding the hazards posed by hidden reefs, floating docks, and even other boaters. But should a fog bank suddenly envelop the boat, the loss of visibility represents a serious threat to those careless enough to maintain speed and course. Seasoned sailors will compensate for this lack of visibility by using radar, nautical markers, and especially their ears to avoid hazard.

Investors must feel a bit like recreational boaters overtaken by the weather over the past several weeks. Following a period of exceptionally low volatility through much of the summer, financial markets have experienced some “choppy conditions” thus far in September. The combination of some softening in the economic data, renewed uncertainty over monetary policy decision-making, and a tightening in the polls for the upcoming presidential election has begun to weigh upon risk assets. As a result, the S&P 500 has declined about 2% so far this month while spreads on high yield bonds have widened by about 20 basis points over the same period.

So what can we expect for the balance of the year?

It remains our view that the expansion remains on track, central bankers will

continue to play a constructive role, the election outcome will largely maintain the political status quo in Washington, and an overweight in risk assets is still merited. While the high-frequency data has fallen short of consensus estimates of late, the economy still appears on track for relatively solid growth. The most recent reading of the Atlanta Fed’s GDP Now tracker pegs the GDP growth at 3.3% during the current quarter.

Meanwhile, recent comments by senior Federal Reserve officials reinforce the notion of a pragmatic and cautious Fed. We still envision a single rate hike in December, followed by two 25-basis-point moves in 2017 as the most likely outcome. Despite concerns over the available supply of bonds for purchase, both the European Central Bank and Bank of Japan also remain committed to an accommodative policy mix to bolster growth and ease deflationary risks.

Finally, the recent tightening of opinion polls likely overstates the prospects for a Donald Trump victory in November. Keep in mind that, with the exception of Maine, the Electoral College is a winner-take-all allotment of votes. So with Hillary Clinton leading in states representing 207 votes to Trump’s 154, Trump would have to win in most of the key “toss-up” and “swing” states in order to reach the 270 votes needed to win. This would be a pretty tall order even for a less polarizing candidate.

Still, with markets hovering near record-high levels, we are neither callous toward the heightened sense of anxiety nor sanguine about the potential risks to markets.

We therefore lay out some events to watch for – buoy bells, if you will – that can help investors navigate the current environment.

While both the unexpected decline in the ISM indices and recent sharp drop in oil prices have been cited as potential harbingers of slower growth, we would instead

keep our eyes fixed on the monthly employment report. Non-farm payroll gains have averaged 175,000 over the past six months, helping to drive the unemployment rate below the 5% level. Were payroll growth to slow sharply, this would not only represent a loss of potential consumer demand, but could also signify renewed concerns about the economic outlook on the part of employers.

As far as monetary policy is concerned, we would watch for any signs that Fed officials are either growing impatient with the pace of normalization, or other central bankers have exhausted extraordinary policy measures. The Fed under Janet Yellen has been prudent with regard to policy changes, and tended to tread carefully amid signs of softer growth. However, should core inflation begin to rise above the Fed’s 2% target rate, the hawks may well push for more aggressive action. With markets unprepared for anything other than modest and episodic moves, more aggressive rate action could trigger a sell-off.

Lastly, political junkies should keep their attention trained upon the margin within swing states rather than general election polls. If Trump were to make further headway in such critical states as Florida, Georgia, North Carolina, Virginia, Pennsylvania, Ohio, and Michigan, then the election could indeed be up for grabs. This could presumably happen if there are additional damaging disclosures with regard to the Clinton Global Initiative, the status of newly uncovered e-mails, or the state of Clinton’s health.

While it remains our view that risk assets will continue to grind higher amid a resilient expansion, supportive monetary policy mix, and status quo political backdrop, it’s still nice to know where those buoy bells are located.

Kind regards,
Mike Ryan

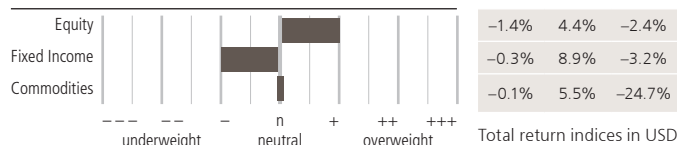


Watch this week’s video
 with Mike Ryan. Click the photo to watch.

Strategy and performance

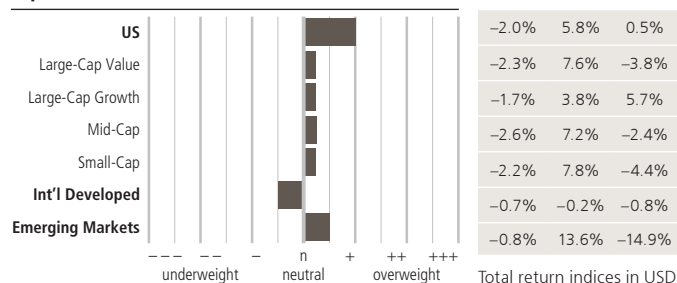
TAA and market returns: Cross asset and equities

Asset classes



Note: Indexes used to calculate returns are MSCI All Country World (for Equity), Barclays Capital Global Aggregate Index (for Fixed Income), Dow Jones-UBS Commodity Index Total Return
Source: UBS Chief Investment Office/CIO WMR, as of 14 September 2016

Equities



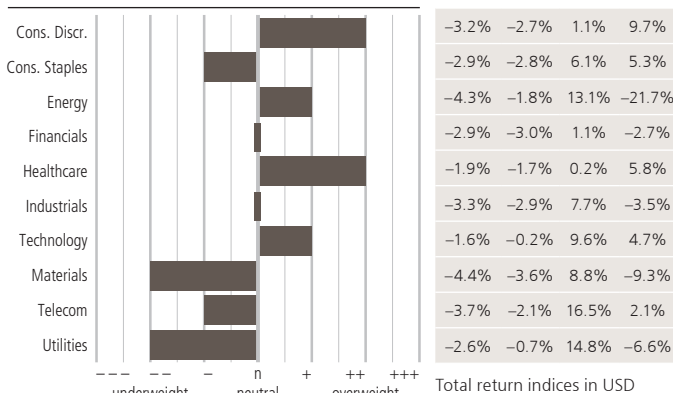
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Source: UBS Chief Investment Office/CIO WMR, as of 14 September 2016

S&P 500 forecast

	CIO WMR
6-month rolling price target	USD 2225
2015 earnings per share actual	USD 118
2016 earnings per share estimate	USD 122
2017 earnings per share estimate	USD 130

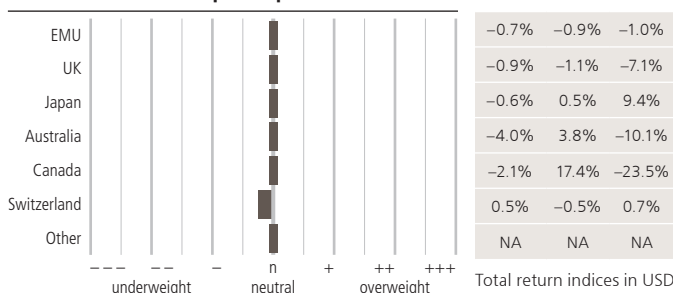
Source: UBS, as of 14 September 2016

US equity sectors



Note: S&P 500 Sector Indexes used to calculate returns.
Source: UBS, as of 14 September 2016

International developed equities



Note: MSCI Region or Country Indexes used to calculate returns.
Preference in hedged terms (excluding currency movements).
Source: UBS Chief Investment Office/WMR, as of 14 September 2016

Tactical deviations from benchmark symbols

+	Moderate overweight vs. benchmark
++	Overweight vs. benchmark
+++	Strong overweight vs. benchmark
n	Neutral, i.e. on benchmark
-	Moderate underweight vs. benchmark
--	Underweight vs. benchmark
---	Strong underweight vs. benchmark

Notes

These tables represent the tactical asset allocation for a moderate, taxable investor without alternative investments.

See the latest *UBS House View: Investment Strategy Guide* for an interpretation of the tactical deviations and an explanation of the corresponding benchmark allocation.

Tactical time horizon is approximately six months.

Total return market performance is from Bloomberg as of close of business on source date, using representative indices, and is provided for information only.

Past performance is no indication of future performance.

The overweight and underweight recommendations represent tactical deviations that can be applied to any appropriate benchmark portfolio allocation. They reflect CIO WMR's assessment of market opportunities and risks in the respective asset classes and market segments. The benchmark allocation is not specified here. Please see the most recent *UBS House View: Investment Strategy Guide* for definitions/explanations of benchmark allocation. They should be chosen in line with the risk profile of the investor. Note that the Regional Bond Strategy is provided on an unhedged basis (i.e., it is assumed that investors carry the underlying currency risk of such investments). Thus, the deviations from the benchmark reflect our views of the underlying equity and bond markets in combination with our assessment of the associated currencies.

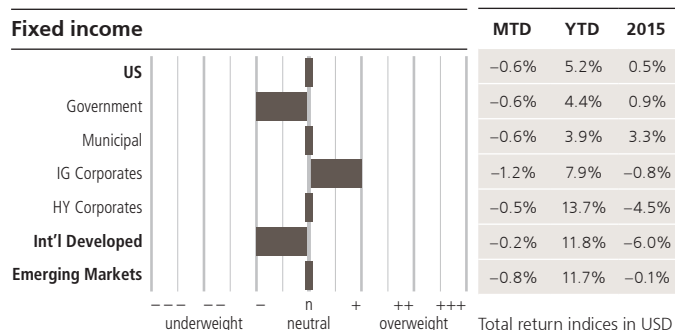
+ - Indicates +/- change

Terms and abbreviations

EMU = European Monetary Union and is comprised of European countries that have adopted the Euro as their currency. Int'l = international. YTD = year-to-date.
MTD = month-to-date. USD = US dollar. TAA = tactical asset allocation.

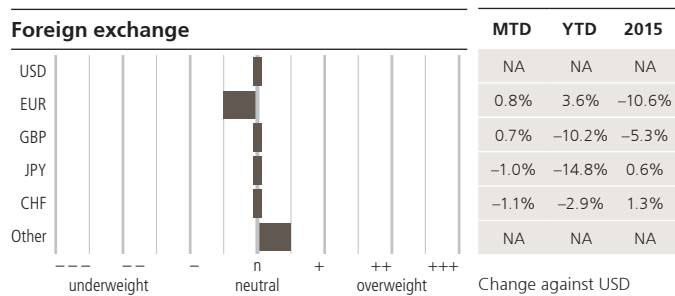
Strategy and performance

TAA and market returns: Fixed income and currencies



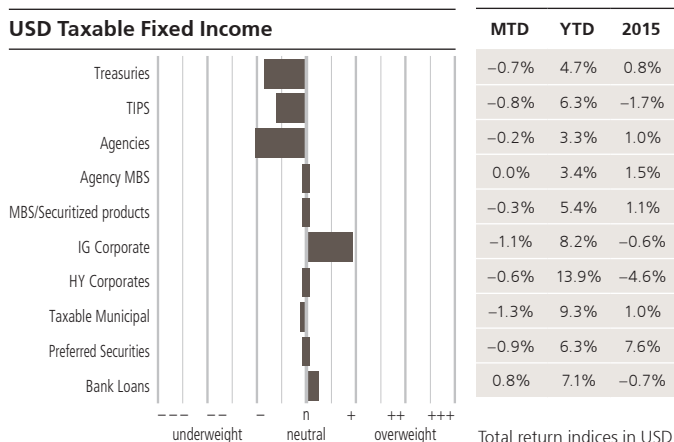
Note: Indexes used to calculate returns are Barclays Capital (BarCap) US Aggregate, BarCap US Aggregate Government, BarCap Municipal Bond, BarCap US Aggregate Credit (for IG), BarCap US Aggregate Corp HY, BarCap Global Aggregate ex-USD (for Int'l Developed), BarCap Emerging Markets Government and BarCap Global Emerging Markets USD (50% of each for Emerging Markets).

Source: UBS Chief Investment Office/CIO WMR, as of 14 September 2016



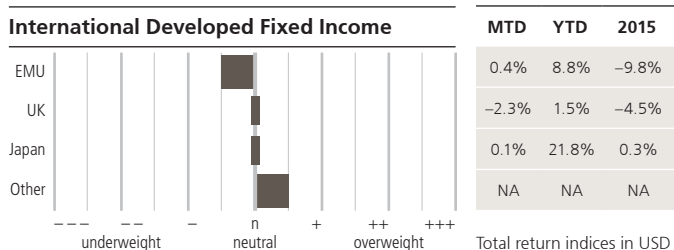
See CIO Note: Close US dollar vs. Australian dollar call, 3 August 2016.

Source: UBS Chief Investment Office/CIO WMR, as of 14 September 2016



Note: Indexes used to calculate returns are Bank of America Merrill Lynch (BoA ML) US Treasury, BoA ML US Inflation-Linked Treasury, BoA ML US Composite Agency, BoA ML US Mortgage Backed Securities, BoA ML US Corporate, BoA ML US High Yield Constrained, BoA ML Fixed Rate Preferred Securities, BoA ML CMBS Fixed Rate, S&P/LSTA Leveraged Loan Index, Barclays Taxable Municipal Index. See the latest Fixed Income Strategist for more information.

Source: UBS CIO WMR, as of 14 September 2016



Note: BarCap Region or Country Indexes used to calculate returns.

Source: UBS Chief Investment Office/CIO WMR, as of 14 September 2016

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Earnings calendar

The Earnings Calendar provides publicly announced reporting dates and times of companies covered by Wealth Management Research Americas. Reporting dates and times are subject to change by the reporting companies.

Date	Company	Ticker	Company	Ticker	Company	Ticker
20-Sep-2016	Adobe Systems, Inc.	ADBE	KB Home	KBH	Lennar Corp.	LEN
21-Sep-2016	General Mills, Inc.	GIS	Red Hat, Inc.	RHT		
27-Sep-2016	NIKE, Inc.	NKE				
29-Sep-2016	PepsiCo, Inc.	PEP				

Source: Bloomberg, UBS, as of 14 September 2016

Key economic indicators

Date	Indicator	Period	Time (ET)	Unit	Consensus	Previous
16-Sep-16	Consumer Price Index	August	8:30 AM	m/m	0.1%	0.0%
16-Sep-16	CPI less Food and Energy	August	8:30 AM	m/m	0.2%	0.1%
16-Sep-16	University of Michigan Sentiment	September	10:00 AM	level	90.6	89.8
19-Sep-16	Housing Market Index	September	10:00 AM	level	60	60
20-Sep-16	Housing Starts	August	8:30 AM	level	1192k	1211k
20-Sep-16	Housing Permits	August	8:30 AM	level	1170k	1152k
22-Sep-16	Jobless Claims	For week, September 17	8:30 AM	level	264k	259k
22-Sep-16	FHFA Home Prices	July	9:00 AM	m/m	0.3%	0.2%
22-Sep-16	Existing Home Sales	August	10:00 AM	m/m	1.1%	-3.2%
22-Sep-16	Leading Indicators	August	10:00 AM	m/m	0.0%	0.4%
23-Sep-16	Markit Manufacturing PMI	September	9:45 AM	level	52	52

Source: Bloomberg, UBS, as of 14 September 2016

UBS forecast estimates are published on Friday evenings in *Economic Perspectives* by economists employed by UBS Investment Research, a part of UBS Investment Bank. m/m = month-over-month. q/q = quarter-over-quarter. y/y = year-over-year. k = thousand. mn = million. bn = billion.

Investing in Emerging Markets

Investors should be aware that Emerging Market assets are subject to, amongst others, potential risks linked to currency volatility, abrupt changes in the cost of capital and the economic growth outlook, as well as regulatory and sociopolitical risk, interest rate risk and higher credit risk. Assets can sometimes be very illiquid and liquidity conditions can abruptly worsen. WMR generally recommends only those securities it believes have been registered under Federal U.S. registration rules (Section 12 of the Securities Exchange Act of 1934) and individual State registration rules (commonly known as “Blue Sky” laws). Prospective investors should be aware that to the extent permitted under US law, WMR may from time to time recommend bonds that are not registered under US or State securities laws. These bonds may be issued in jurisdictions where the level of required disclosures to be made by issuers is not as frequent or complete as that required by US laws.

For more background on emerging markets generally, see the WMR Education Notes, “Emerging Market Bonds: Understanding Emerging Market Bonds,” 12 August 2009 and “Emerging Markets Bonds: Understanding Sovereign Risk,” 17 December 2009.

Investors interested in holding bonds for a longer period are advised to select the bonds of those sovereigns with the highest credit ratings (in the investment grade band). Such an approach should decrease the risk that an investor could end up holding bonds on which the sovereign has defaulted. Sub-investment grade bonds are recommended only for clients with a higher risk tolerance and who seek to hold higher yielding bonds for shorter periods only.

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