UBS House View

Weekly

18 September 2017

United States
CIO Americas, WM

We welcome your feedback

Deeper dive

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Week ahead

- **Tightening talk from the Fed?** While rates are likely to remain on hold, the Federal Reserve could flesh out plans to trim its balance sheet at this week's meeting.
- **Will Merkel win big in Germany?** The chancellor looks likely to be returned to power in Sunday's election. But her margin of victory will be of concern to markets.
- **Will the Bank of Japan sound upbeat?** The nation's central bankers will give their views on the latest upturn in Japanese economic data at this week's rate meeting.

Market moves

	Level	*1-w chg*	*YTD chg*
S&P 500	2,500	1.58%	13.33%
DJIA	22,268	2.16%	14.75%
Nasdaq	6,448	1.39%	20.81%
Nikkei 225	19,910	3.29%	4.16%
Eurostoxx 50	3,516	1.97%	6.84%
MSCI EM*	1,100	0.90%	27.56%
MSCI World*	1,983	0.96%	13.26%
MSCI EAFE*	1,959	0.52%	16.33%
DXY	92	0.46%	–10.11%
Gold	$ 1321/oz	–1.87%	15.05%
Brent crude oil	$ 55.5/bbl	3.25%	–2.11%
US 10-year yield	2.199%	15bps	–24bps
VIX	10.17	–1.95pts	–3.9pts

Source: Bloomberg, as of 15 September 2017, EST 4:30 pm.
Note: All returns are in local currency
* As of 14 September 2017

Key messages

For more key messages on the week ahead from Jeremy Zirin, click here.

1. Bonds and equities send divergent signals.
The 10-year US Treasury yield bounced back from one-year lows this week, but bond investors appear to be taking a gloomy view of growth. The 2-year-10-year yield curve has flattened from 125 basis points to 82 basis points, typically a signal of worries that growth will weaken. That seems at odds with the upbeat message coming from global stocks – with the MSCI All Country World Index hitting a new high on 12 September. So which market is right? We believe the contrast is more apparent than real, with bonds reflecting safely anchored inflation rather than growth pessimism. Meanwhile, equity enthusiasm looks justified by strong global growth and earnings. Our score card suggests the end of the cycle is still some way off, with a limited risk of recession over the coming six months and global equity valuations still moderate.

Takeaway: We remain overweight global equities and underweight US government bonds.

2. China's slowdown should take the heat out of emerging markets.
Evidence mounted this week that the Chinese economy is slowing, after surprising positively for much of the year. The latest data for industrial production and retail sales indicated the slowest growth of 2017. Meanwhile the People's Bank of China took steps to stem the appreciation of the yuan, which is up around 6% this year versus the US dollar, by relaxing restrictions on shorting the currency. We expect a weakening of Chinese growth – from 6.9% in the second quarter of 2017 to 6.3% for the same period in 2018 – and a weakening of the yuan. The 19th Party Congress in October is likely to unveil further measures to curb credit growth. That should slow the rally in emerging market stocks, which are up 30% total return year-to-date.

Takeaway: We believe the best of the emerging market rally is over, but we maintain some exposure through our overweight in global equities.

3. Sterling strength likely to weigh on UK stocks.
UK inflation vaulted past expectations in August, rising 2.9% versus a consensus of 2.6%. That helped fuel a rise in sterling, which is up around 10% this year versus the US dollar. Sterling has also regained some ground against the euro, climbing around 4% since the start of September. While the pound is still vulnerable to setbacks as the Brexit negotiations progress, we believe the currency can hold on to recent gains. We have a 12-month forecast of USD 1.36, versus 1.35 at present. With around 76% of FTSE 100 revenues coming from overseas, the current move should keep UK equities under pressure. Since the start of September, UK stocks have underperformed Eurozone equities by around 3%.

Takeaway: Within Europe, we are underweight UK stocks versus Eurozone equities.

Investor spotlight

- **Confidence rising in the US.** Stocks in the US enjoyed the biggest inflow in 13 weeks, at USD 1.9bn. The net move year-to-date is still an outflow of USD 4.7bn.
- **Japan in vogue.** Equity flows to Japan have been positive for nine consecutive weeks. Inflows for the week ending 13 September were also the largest in 44 weeks.

This report has been prepared by UBS Financial Services Inc. and UBS Switzerland AG.
Please see important disclosures and disclaimer that begin on page 7.

Deeper dive

Are bonds telling a different story to stocks?

Mark Haefele

Equity and bond markets appear to view the world differently. US and global stocks have been hitting all-time highs, suggesting optimism among equity investors. In contrast, bond investors seem far more pessimistic, with US 10-year yields of 2.2%, close to the year's lows and below the 3.2% 15-year average. The 2-year-10-year yield curve has also flattened from 125bps to 82bps since mid-March, traditionally a sign of concerns over growth.

But the tension between equity and bond investors may be more apparent than real. Current low yields and the flatness of the curve reflect not so much growth pessimism, but that long-term interest rates are lower than in the past and likely to stay that way. They are also not inconsistent with further equity gains:

1. Yields are low for reasons other than concerns about growth. Given lower productivity and population growth, US trend growth and hence the neutral real interest rate are structurally lower than before. Inflation expectations have also been well anchored close to the Federal Reserve's 2% target, and recent Fed commentary suggests they may even be moving lower. Structural reasons holding down rates will likely persist, while downward pressure on yields from central bank bond buying programs won't last forever.

2. An inverted yield curve, where short-term rates rise above long-term rates, is a good predictor of recessions; a flattening yield curve isn't. The seven recessions over the last 50 years were preceded by the Fed hiking rates enough to invert the 3-month-10-year yield curve. At about 1.2% currently, this yield curve is far from inverting.

3. Low bond yields have themselves contributed to the equity rally. The dividend yield on the S&P 500 is greater than the 10-year yield, increasing equities' attractiveness over bonds. Low bond yields have encouraged companies to borrow to fund share buybacks, fueling share price gains. They also make it cheaper for consumers to borrow, supporting economic growth. The average rate on a prime 30-year mortgage has dropped from 4.3% in March to 3.8%.

With the Fed soon likely to begin reducing its balance sheet, it may still seem odd that bond markets are so sanguine. Central bank bond purchases have pushed yields down for so long it may seem unlikely the policy can be reversed without some opposite impact. Even so, that impact needn't be excessive, unless the Fed acts too quickly by mistake.

So we see the yield curve shifting higher, but also flattening further, as structural factors keep long-end rates low. We are underweight two-year Treasuries and expect yields to increase from 1.39% to 1.8% over six months. We forecast 10-year yields to rise from 2.2% to 2.5%.

Higher rate expectations also needn't hurt equities. Despite four Fed rate hikes since December 2015, global stocks have returned 27%. Equity markets are underpinned by ongoing economic recovery and corporate earnings growth – we expect global GDP growth of 3.7% in 2017 and 3.8% in 2018, and both US and Eurozone earnings to rise 10-15% this year – and remain overweight global equities.

Mark Haefele
Global Chief Investment Officer WM

Bottom line

Equity and bond markets appear to view the world differently. All-time highs in equities suggest optimism, while depressed bond yields and a flattening yield curve appear to suggest pessimism. We believe it's easy to misinterpret this contrast. Yields reflect structurally lower neutral rates, well-anchored inflation expectations and central bank buying rather than growth pessimism. Meanwhile, equity enthusiasm looks justified by strong global growth and earnings.

Top of the Morning daily podcast "Week in Review/ Preview" with Barry McAlinden, CFA, Senior fixed Income Strategist Americas
www.ubs.com/topofthemorning

Regional view

The UnlovaBull Market

Jason Draho, PhD
Head of Tactical Asset Allocation Americas

If the end of the bull market is near, you wouldn't know it based on investor sentiment. There are few signs of euphoria, excessive greed, or talk of "new paradigms" that are typical of late-stage bull markets. To the contrary, cautious and anxious are more apt descriptions of the current mood, although that's not evident in the very low levels of market volatility, such as the VIX index, which suggest investor complacency. Chalk this up as another unusual aspect of this bull market and economic cycle that makes them more difficult to assess.

Does it actually matter for the bull market's prospects that it is unloved, with a growing number of investors expressing concern about how long it can last? There's no doubt that sentiment influences market performance throughout the cycle, but market prices are ultimately an unsentimental reflection of the outlook for economic and earnings growth fundamentals. And right now, with the US economy firmly in the expansion stage of the cycle, we don't believe the bull market will end any time soon (see our recent report, "A 9-year bull market: What could go wrong?").

Still, sentiment is likely to affect how the bull market evolves. An old Wall Street adage is that the markets are driven by greed and fear. If one follows Warren Buffet's advice of being fearful when others are greedy and greedy when others are fearful, this current lack of love and growing skepticism about the bull market could be a sign that the markets will climb the proverbial wall of worry. There are three sentiment-related reasons why this is likely to occur.

First, investors may be underestimating the fundamentals, the opposite of what usually happens in the later stages of bull markets. While investors tend to be more rational when they're fearful – nothing focuses the mind like the potential loss of money – they often succumb to hype about the economy as they also become greedy in continuously rising markets. The latter hasn't happened in this bull market. In fact, some investors believe that the markets have moved too far ahead of the fundamentals, fueling doubts about the bull market's durability. But the S&P 500's 11.5% year-to-date price return is nearly the same as its 12% EPS growth (year-over-year) in the first half of 2017, with a similar relationship globally between returns and earnings. In other words, the markets are actually rising right in line with fundamentals.

Second, investors' cautious talk is reflected in their positioning and recent market performance. Portfolio cash holdings are higher than long-term averages, bond fund flows continue to outpace equity fund flows, and the use of options to protect against losses has increased. Meanwhile, defensive-oriented assets (e.g., utilities, gold, the Japanese yen) performed well during the summer, though that's started to reverse over the past week. Collectively, this suggests that investors already started to reduce risk.

Third, skepticism also describes investor attitudes about the prospects for tax reform and other fiscal policies. The markets have priced out almost all of their initial "Trumponomics" gains following the election. But we still believe that there's a slightly better than 50% chance that tax reform is passed in 2018. That would provide a relatively unexpected tailwind for corporate earnings and economic growth.

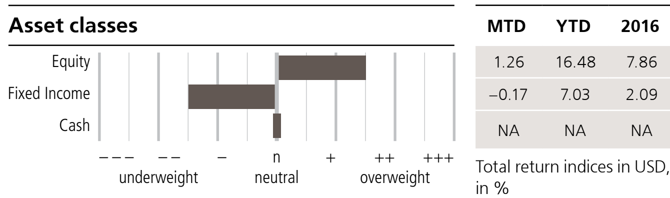
Between the solid fundamentals and these sentiment factors, this unloved bull market isn't likely to end any time soon. But sentiment is a fickle thing and it can change much more quickly than the fundamentals. A shock, such as North Korea launching a missile toward Guam, could be the catalyst for the first S&P 500 correction of more than 5% since June 2016. However, without a recession looming, such a sell-off is more likely to be a mid-cycle correction than the start of a bear market.
If there's a reason not to love this bull market in its ninth year, it's the prospect of lower returns in the years ahead.

Kind regards,
Jason Draho

Strategy and performance

TAA and market returns: Cross asset and equities

Asset classes

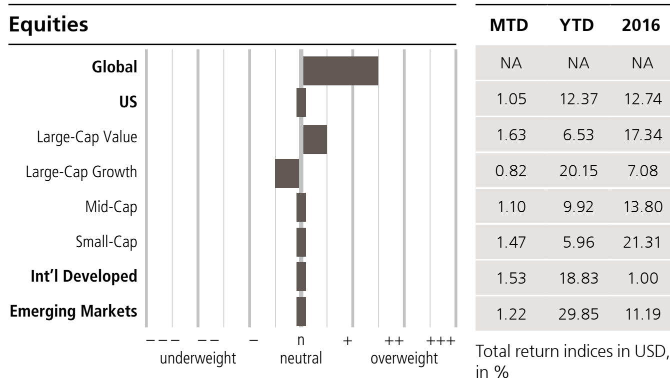


Asset classes	MTD	YTD	2016
Equity	1.26	16.48	7.86
Fixed Income	–0.17	7.03	2.09
Cash	NA	NA	NA

Total return indices in USD, in %

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, as of 15 September 2017

Equities



Equities	MTD	YTD	2016
Global	NA	NA	NA
US	1.05	12.37	12.74
Large-Cap Value	1.63	6.53	17.34
Large-Cap Growth	0.82	20.15	7.08
Mid-Cap	1.10	9.92	13.80
Small-Cap	1.47	5.96	21.31
Int'l Developed	1.53	18.83	1.00
Emerging Markets	1.22	29.85	11.19

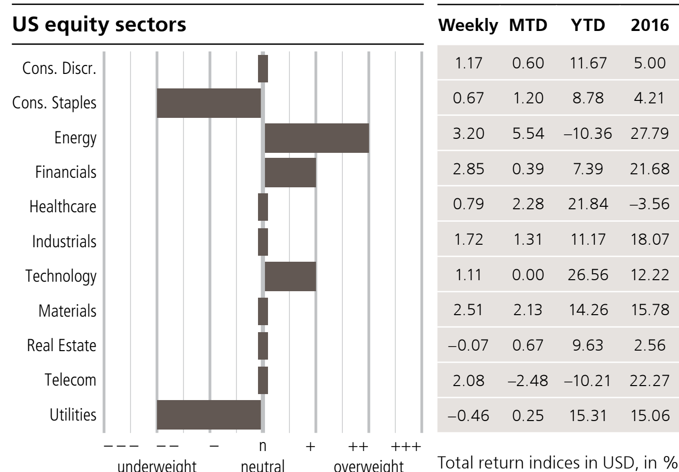
Total return indices in USD, in %

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, as of 15 September 2017

S&P 500 forecast	CIO-A WM
6-month rolling price target	USD 2525
2016 earnings per share actual	USD 119.1
2017 earnings per share estimate	USD 132.5
2018 earnings per share estimate	USD 145.0

Source: UBS, as of 15 September 2017

US equity sectors

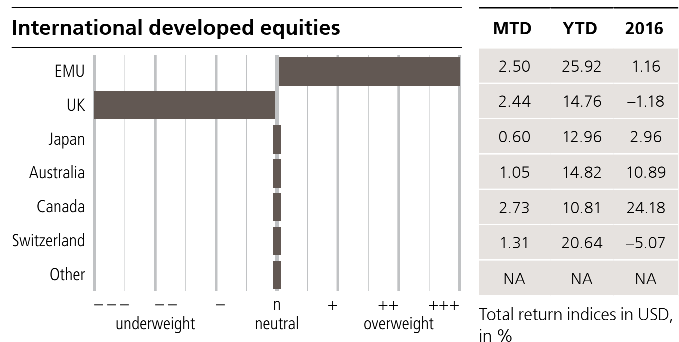


US equity sectors	Weekly	MTD	YTD	2016
Cons. Discr.	1.17	0.60	11.67	5.00
Cons. Staples	0.67	1.20	8.78	4.21
Energy	3.20	5.54	–10.36	27.79
Financials	2.85	0.39	7.39	21.68
Healthcare	0.79	2.28	21.84	–3.56
Industrials	1.72	1.31	11.17	18.07
Technology	1.11	0.00	26.56	12.22
Materials	2.51	2.13	14.26	15.78
Real Estate	–0.07	0.67	9.63	2.56
Telecom	2.08	–2.48	–10.21	22.27
Utilities	–0.46	0.25	15.31	15.06

Total return indices in USD, in %

Note: S&P 500 Sector Indexes used to calculate returns.
Source: UBS, as of 15 September 2017

International developed equities



International developed equities	MTD	YTD	2016
EMU	2.50	25.92	1.16
UK	2.44	14.76	–1.18
Japan	0.60	12.96	2.96
Australia	1.05	14.82	10.89
Canada	2.73	10.81	24.18
Switzerland	1.31	20.64	–5.07
Other	NA	NA	NA

Total return indices in USD, in %

Note: MSCI Region or Country Indexes used to calculate returns.
Preference in hedged terms (excluding currency movements).
Source: UBS, as of 15 September 2017

Tactical deviations from benchmark symbols

Symbol	Meaning
+	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-A WM'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.

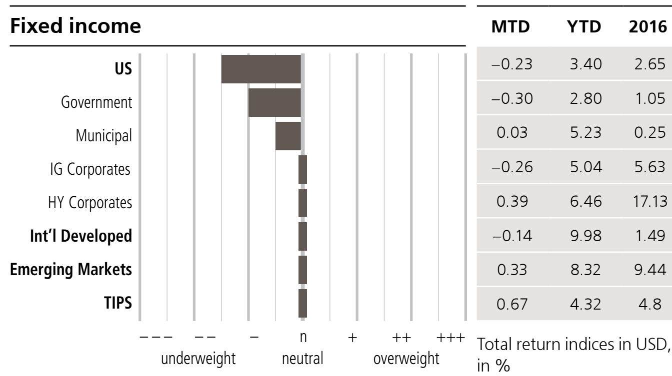
+ – Indicates +/– change

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

Fixed income

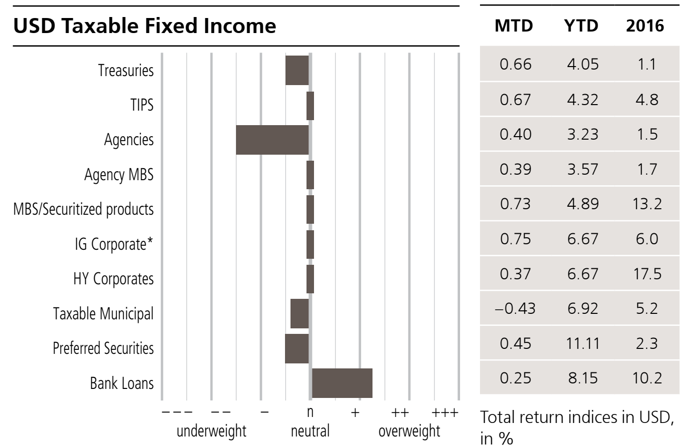


Fixed income	MTD	YTD	2016
US	–0.23	3.40	2.65
Government	–0.30	2.80	1.05
Municipal	0.03	5.23	0.25
IG Corporates	–0.26	5.04	5.63
HY Corporates	0.39	6.46	17.13
Int'l Developed	–0.14	9.98	1.49
Emerging Markets	0.33	8.32	9.44
TIPS	0.67	4.32	4.8

Total return indices in USD, in %

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, as of 15 September 2017

USD Taxable Fixed Income

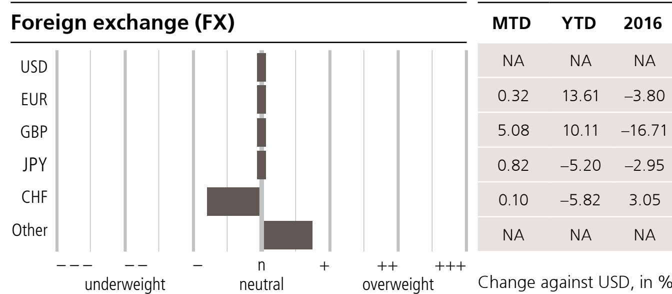


USD Taxable Fixed Income	MTD	YTD	2016
Treasuries	0.66	4.05	1.1
TIPS	0.67	4.32	4.8
Agencies	0.40	3.23	1.5
Agency MBS	0.39	3.57	1.7
MBS/Securitized products	0.73	4.89	13.2
IG Corporate*	0.75	6.67	6.0
HY Corporates	0.37	6.67	17.5
Taxable Municipal	–0.43	6.92	5.2
Preferred Securities	0.45	11.11	2.3
Bank Loans	0.25	8.15	10.2

Total return indices in USD, in %

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, as of 15 September 2017

Foreign exchange (FX)

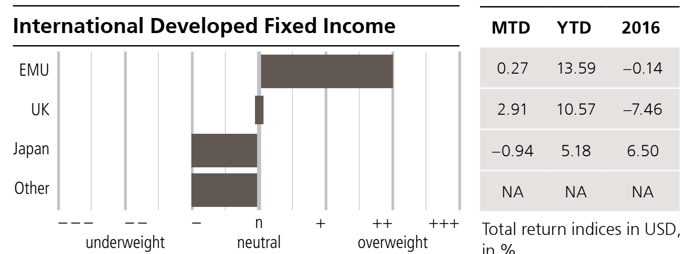


Foreign exchange (FX)	MTD	YTD	2016
USD	NA	NA	NA
EUR	0.32	13.61	–3.80
GBP	5.08	10.11	–16.71
JPY	0.82	–5.20	–2.95
CHF	0.10	–5.82	3.05
Other	NA	NA	NA

Change against USD, in %

Source: UBS, as of 15 September 2017

International Developed Fixed Income



International Developed Fixed Income	MTD	YTD	2016
EMU	0.27	13.59	–0.14
UK	2.91	10.57	–7.46
Japan	–0.94	5.18	6.50
Other	NA	NA	NA

Total return indices in USD, in %

Note: BarCap Region or Country Indexes used to calculate returns.
Source: UBS, as of 15 September 2017

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Earnings calendar

The Earnings Calendar provides publicly announced reporting dates and times of companies covered by CIO Americas, WM. Reporting dates and times are subject to change by the reporting companies.

Date	Company	Ticker	Company	Ticker	Company	Ticker
14-Sep-2017	Oracle Corp.	ORCL				
15-Sep-2017	The Charles Schwab Corp.	SCHW				
19-Sep-2017	Lennar Corp.	LEN	Adobe Systems, Inc.	ADBE	FedEx Corp.	FDX
20-Sep-2017	General Mills, Inc.	GIS				
21-Sep-2017	KB Home	KBH				

Source: FactSet, UBS, as of 14 September 2017

Key economic indicators

Date	Indicator	Period	Time (ET)	Unit	Consensus	Previous
18-Sep-17	Housing Market Index	September	10:00 AM	level	67	68
19-Sep-17	Housing Starts	August	8:30 AM	level	1180k	1155k
19-Sep-17	Housing Permits	August	8:30 AM	level	1220k	1230k
19-Sep-17	Import Proces	August	8:30 AM	m/m	0.3%	0.1%
19-Sep-17	Export Prices	August	8:30 AM	m/m	0.2%	0.4%
20-Sep-17	Existing Home Sales	August	10:00 AM	m/m	0.6%	–1.3%
21-Sep-17	Jobless Claims	For week, September 16	8:30 AM	level	300k	284k
21-Sep-17	Philadelphia Fed Business Outlook	September	8:30 AM	level	17.0	18.9
21-Sep-17	Leading Indicators	August	10:00 AM	m/m	0.2%	0.3%

Source: Bloomberg, UBS, as of 14 September 2017
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. CIO-A WM 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, CIO-A WM 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 CIO-A WM 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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