

Global Macro Strategy

2017 Markets Outlook: What needs to happen for '17 to be a game-changer year?

Global Macro Strategy

Global

Will 2017 see reflation?

The path is visible, but narrow. Following the US election, markets have been trading a higher likelihood of reflation, with a focus on the US, and we have revised our rates and dollar forecasts. Fiscal easing can help the reflation trade, but it is not a panacea. The devil is in the details: we've examined two highly stylized and symmetric scenarios of fiscal expansion, concluding that although recent market moves are premature in terms of macro foundations, we would not fade them yet. In the event of a significant package, our simulations suggest that the recent moves across assets can extend. Absent meaningful fiscal easing, we see a set of specific conditions that would need to be satisfied jointly for reflation to become a credible theme: Oil prices need to rise, but only gradually; global growth, ex-US, would need to hold up to contain dollar strength; financial markets need to avoid selling off in the face of global risk events; and the Fed needs to remain actively accommodative.

Dollar rallies have limits and would lean against them

Despite the visceral market reaction to the US elections, in our view the dollar has peaked vs major G10 currencies. Even with a modest Fed hike path until end-2017, policy divergence alone is insufficient to drive a rally, especially as a lot of this is already in the price. In addition, in a low growth environment, dollar rallies tend to be self-defeating due to the feedback loop with tighter financial conditions, while the dollar's overvaluation vs the EUR, raises the bar for a sustained rally higher.

Rates to stay relatively low; however, upside risks have increased

The potential for large fiscal easing and the risk of higher inflation expectations have increased upside risk to yields. We are less bullish on duration, but still expect US rates to rise less than market priced forwards. We continue to prefer receiving long-end real rates and see steepening potential for the US yield curve. In the euro area, core rates hold the potential to beat market forwards to the upside. We favour long-end curve steepeners as well as Gilt outperformance on cross market.

Equities should be able to withstand higher yields up to a certain level

We have argued that with a decline in the discount factor, high equity valuations do not represent a bubble. So, if yields rise, do equities suffer? It depends on why and by how much yields rise. A shock to yields unaccompanied by a better growth would be negative for equities. A reflationary lift would be associated with higher earnings expectations, and thus net positive for equities.

In credit markets, high yield under pressure, investment grade demand persists

With the US high-yield segment a likely exception, even relatively accommodative central banks in 2017 should continue to favour most developed market credits. It will take a taper-like move in rates or severe widening in spreads to reverse this dynamic.

EM rally to run out of steam as tailwinds subside and risks rise

Even with forecasts for broadly stable commodity prices, without further declines in DM real rates, further revaluation of EM assets will become harder and currencies will drift weaker. Equally though, there is no obvious trigger for EM assets to 'blow up.' On a risk adjusted basis, we see debt outperforming equities. Within EM debt, hard currency debt is most attractive, but we still find there are several investable dislocations within local currency debt.

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2017 Global Macro Strategy Outlook

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The path to reflation: visible but narrow.

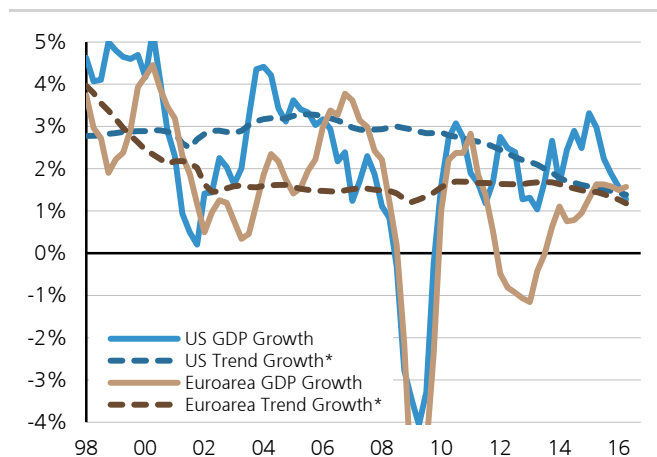
The recovery from the Great Financial Crisis began eight years ago. In past recovery phases, we would have already passed the point of peak growth and started to experience inflationary pressures. But this has been no ordinary cycle. Growth rates in major and emerging economies remain very low and evidence of trend growth deceleration is mounting (Figure 1). At the same time, more than 75% of central banks globally are facing inflation below target (and a good chunk of the remaining 25% are experiencing higher inflation due to FX depreciation locally) (Figure 2).

We have long and actively argued that this "lower for longer" macro environment implies deep and dominant trends for global assets (including lower yields, more expensive equities – driven by the quality of the dividend they yield and a weaker dollar).

Nonetheless, within these broad trends, 2017 may carry elements of moderate – yet tradable – reflation as per our freshly minted [2017-2018 Global Economic Outlook](#). More specifically:

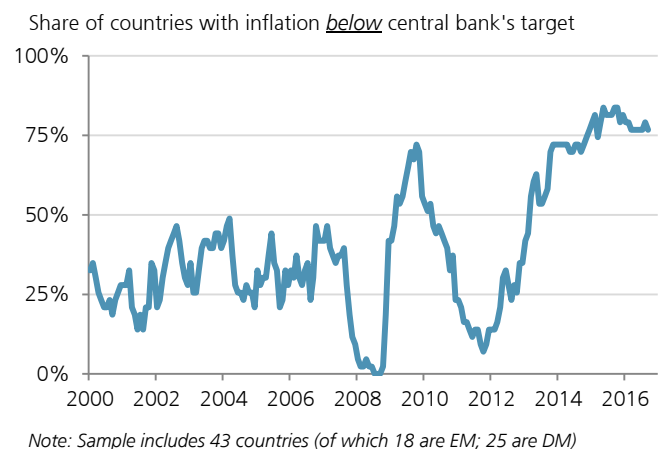
1. Wage growth in the US starting to exceed the ranges of the last few years (Figure 3). At the same time, a number of indicators signal labor market tightness.
2. The base is low. 2016 was a year of surprisingly low growth and inflation rates. In part, these low growth rates were driven by fundamental drivers but there were also one-offs (such as the inventory build in the US and the low levels of oil prices) that make the comparatives for 2017 look favorable and the threshold for a positive surprise theoretically lower.
3. Financial conditions have eased. Although in a world of [lower equilibrium real rates](#) monetary policy is not as loose as it optically seems, it is still fair to say that policy makers have allowed financial conditions to ease / market risk aversion to decline in 2016 from tight levels early in the year (see Figure 4).
4. The prospect of US fiscal easing is emerging. The details about the platform of the new US administration and its growth/inflation/rates impact are still scarce at the time of writing. It is possible that the election outcome with a single-party-led US government has the potential to create increased fiscal space.

Figure 1: Trend growth has slowed globally...



Source: Haver, UBS calculations. *Trend growth calculated using Okun's law with a rolling 8-year window of quarterly data.

Figure 2: ...and meeting inflation target seems increasingly difficult for central banks.



Note: Sample includes 43 countries (of which 18 are EM; 25 are DM)

Source: Bloomberg, UBS

Growth, inflation and rates are likely to stay at reasonably low levels for a while...

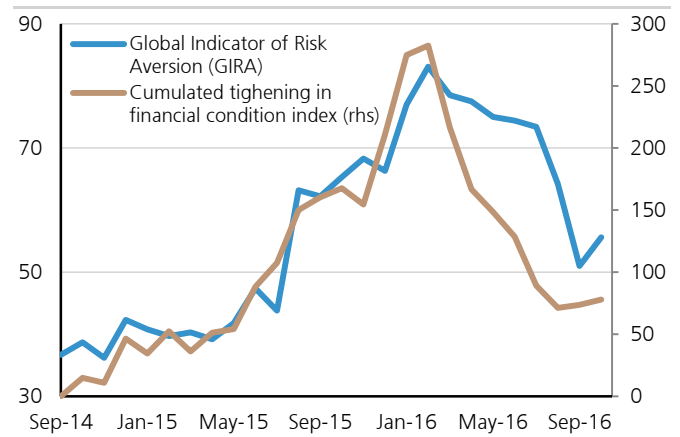
...yet within this broad trend, 2017 might carry credible elements of reflation.

Figure 3: Good news is that wage growth has shown signs of recovery both in nominal and real terms...



Source: Haver, UBS. Note: wage growth is calculated as an average of AHE and ECI.

Figure 4: ...and at the same time both the risk sentiment and financial conditions have eased.



Source: UBS calculations, Bloomberg, Haver.

Markets have started to trade this reflationary view with a focus on the US; curves have steepened, the dollar has rallied, US yields have picked up vs the rest of the world (esp Europe) and financials have outperformed dividend stocks. That said, the path to reflation is narrow and far from a foregone conclusion.

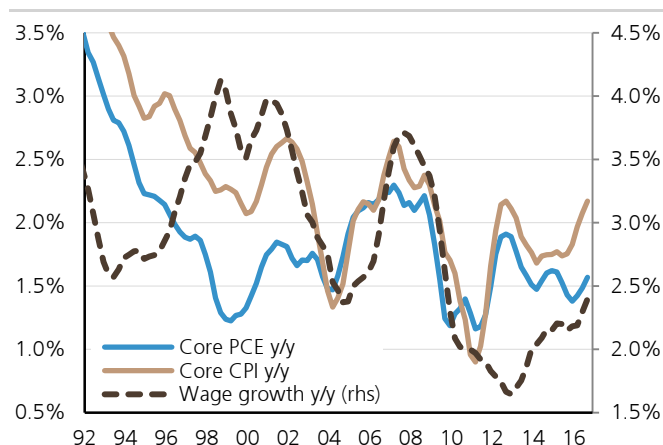
More specifically, it is far from clear that wage pressures and labor market tightness alone can push inflation much higher (see [Inflation Expectations, Uncertainty, The Phillips Curve and Monetary Policy by C Sims for an interesting discussion](#)). Specifically, there is little evidence pointing to a robust feedback loop starting from wage pressures, feeding into higher inflation and back again. Figure 5 shows that in the past 25 years, it has mostly been in the early and the late stage of the 2004-2008 cycle, when PCE and wages co-moved and even then, wages appear to respond to cyclical and PCE pressures with a lag.

Instead, it is a lot easier to think of price pressures when wages pick up at the same time (or even due to) accelerating output and productivity growth. This is important because both *GDP growth and productivity growth have been weak in the US and have moved in the opposite direction from wage growth* (Figure 6).

What investors need to be aware of: the path to reflation is narrow and far from a foregone conclusion...

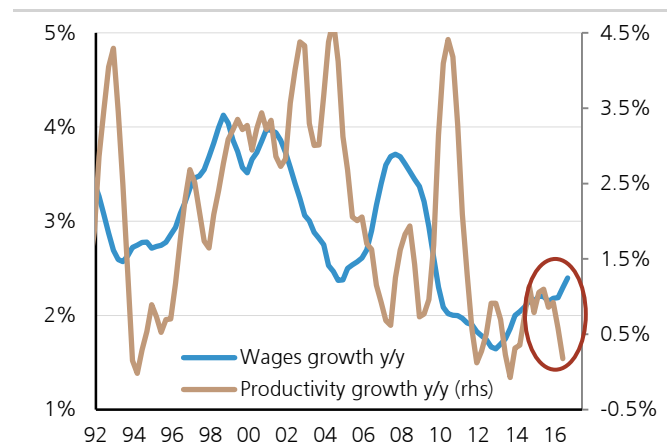
...given the weak link between wage growth and inflation when productivity growth decelerates.

Figure 5: That said, it's not crystal clear that wage growth leads to higher inflation acceleration.



Source: Haver, UBS. Note: wage growth is calculated as an average of AHE and ECI.

Figure 6: In addition, productivity growth has diverged from wage growth since start of 2016.



Source: Haver, UBS. Note: wage growth is calculated as an average of AHE and ECI.

For growth to pick-up, we need to see persistently easy financial conditions – potentially even easier than currently in place. As per our [Economics Outlook](#), as consumption normalizes from high levels, a pick-up in investment growth is a key driver of a potential growth improvement ahead. But as per Figure 8, it is hard to think of stronger investment growth without sustainably low funding costs.

For inflation and growth to pick up, financial conditions have to remain sustainably and persistently easy, if not easier...

Inflation expectations would also need to rise from very low levels. This is a key link between activity, slack and inflation. Easy financial conditions would help support inflation expectations (together with activity trends as discussed above). But this is not enough, as we would need to see supportive growth in commodity prices, which once again is far from certain (Figure 9).

Lastly, fiscal policy would need to deliver a large impulse via measures of significant size and impact over a long horizon, to meaningfully affect long-term growth & inflation expectations as well as term premia. We discuss in more detail below.

...and fiscal policy would need to help too.

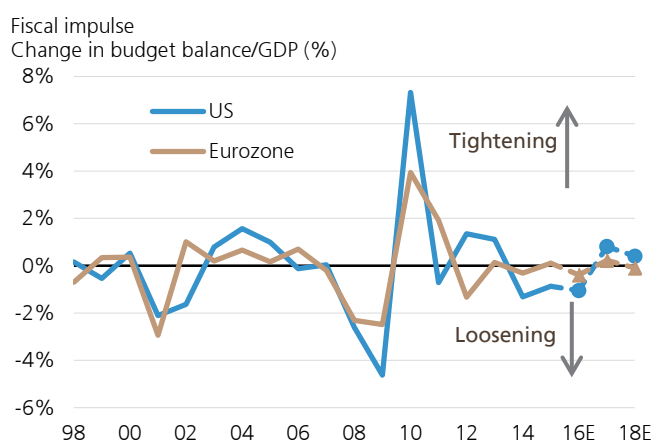
Without much fiscal easing, reflation crucially relies on the Fed fostering very easy financial conditions...

The fiscal impulse embedded in our Economists' base case involves a mildly tighter path for policy in the years ahead (Figure 7). Unless the new administration's package offsets this path, then, a set of very specific conditions would need to be satisfied, at the same time, for reflation to become a credible theme:

Without much fiscal boost, the Fed would need to keep financial conditions exceptionally easy...

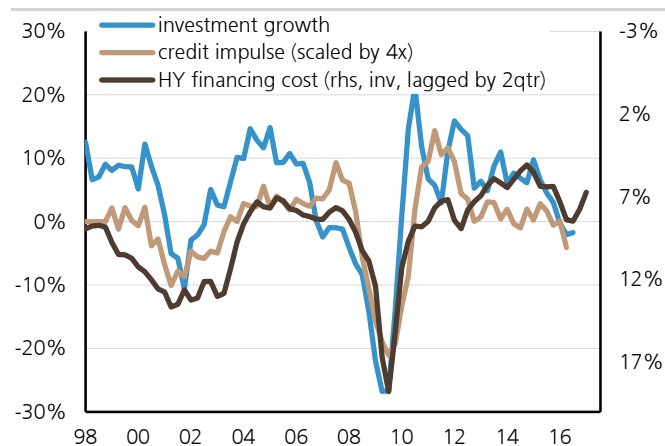
1. Oil prices need to rise but only gradually over the year and modestly towards the 60-70 area for inflation expectations to pick up without the market getting worried about growth damage.
2. At the same time, ex-US growth would need to hold up for dollar strength to stay contained. 2015 – 2016 were test cases on the bounds for policy divergence. A strong dollar did not only filter through to lower levels of inflation, as we will discuss in more detail in the fixed income section. It also produced mild downside to GDP growth, produced pressures in export firms earnings and may well have exacerbated the downside for oil. Figure 10 shows that, typically, oil and dollar tend to co-move.
3. Risk events would need to produce little sustainable damage to financial markets. And there is an abundance of risk events ahead (Italian referendum, European elections, China growth volatility, commodity price volatility, etc).

Figure 7: Any fiscal easing in the years ahead would need to counterbalance a tighter underlying trajectory



Source: Haver, UBS Economics

Figure 8: Financial conditions need to stay easy to support investment growth



Source: Bloomberg, Haver, UBS

It becomes clear that all the above boils down to one common denominator; **we need to see financial conditions remain exceptionally easy over the course of the next few months** for the path to reflation to be a sustainable one. And the most straightforward path for financial conditions to stay easy is a Fed that stays well behind the curve:

4. As all the above takes place and amid stronger growth, rising wage pressures and inflation acceleration, the Fed needs to remain actively accommodative. And this is perhaps the necessary (yet not sufficient) conditions for 1-3 to materialize above.

...and the Fed may still need to stay cautious.

A lot has been made of the recent suggestion from Fed Chair Yellen that the Fed should aim to run a [high pressure economy](#). Is this enough of an indication that the Fed is already there in delivering a reflationary policy mix? It is important to have a benchmark of where the Fed is and where it needs to be from a markets perspective.

We run our "optimal control" framework from [Big Macro 02](#). This is precisely the kind of framework that relies on the Fed's own tools and models to lay out the kind of policy path that the Fed would need to pre-commit to today to allow the economy to reach full employment and inflation rates close to target with a higher likelihood.

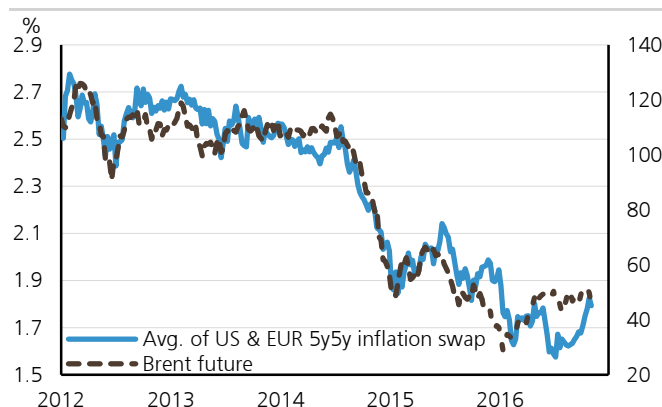
We use output gap estimates of -0.5% as estimated by the IMF. We use current rates of inflation and we use our estimates of long term neutral policy rates of slightly below 1% (as shown in [Big Macro 04](#)). Lastly we account for the fact that since Sep 14, financial markets have delivered the equivalent of 78bps of Fed hikes (see Figure 4; netting out the financial conditions tightening in the beginning of 2016 and the easing afterwards).

Figure 11 shows the optimal path for the Fed juxtaposed against the Fed's dots. Relative to past simulations, our near-term "optimal" trajectory for the Fed looks less mis-aligned with the Fed's own projections (at least for the year ahead). Still, the balance of our analysis points to the notion that the Fed needs to be very cautious (perhaps more so than the dots imply).

... but the Fed may need to be cautious of the risks of running a "high-pressure" economy.

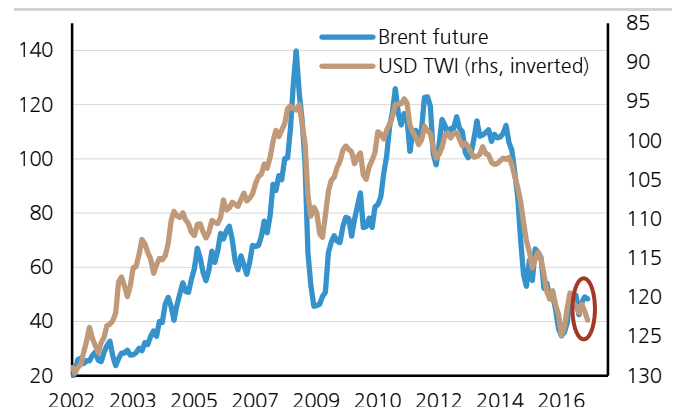
That said, compared with our estimated optimal path, the Fed's dot plot suggests they will remain relatively accommodative.

Figure 9: Oil prices need to rise to provide further boost to inflation expectations



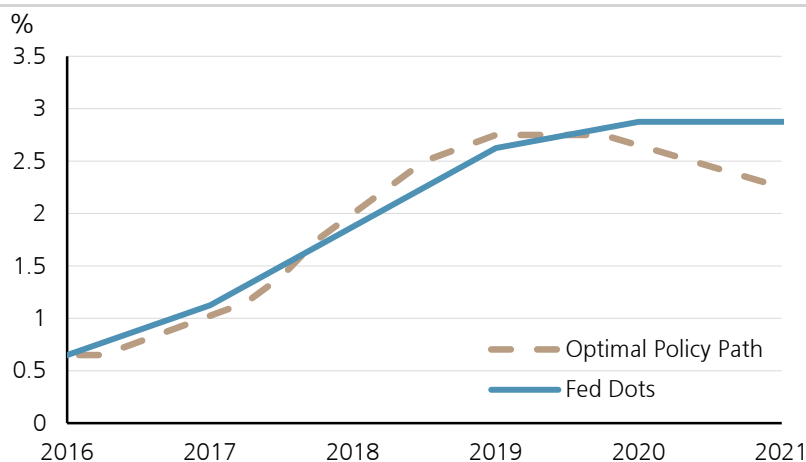
Source: Bloomberg, UBS

Figure 10: A weak dollar is a key component for reflation and would typically co-exist with higher oil prices



Source: Federal Reserve, Bloomberg, UBS

Figure 11: In the absence of a strong fiscal boost, the Fed may still be better off delivering less than the dots imply



Source: Bloomberg, UBS calculations. See [Big Macro 02](#) for detailed explanation of the applied methodology.

Fiscal easing is seen by markets as a potential game-changer, but the devil is in the details and the size

The Republican victory across the White House, Senate, and House has revived expectations of a meaningful shift in the US policy mix towards fiscal and structural policies that boost growth. On the day of the election result announcement alone, bond yields rose by 10bps and the dollar strengthened without much equity damage; chiefly reflecting "[fiscal easing hopes](#)".

At the time of writing this report, there is little certainty about the size, composition and areas of deployment of fiscal resources by the new US administration. How much of it will pass congress even less so. And lastly, the growth impact of those measures is likely to depend on the final composition of the package, which will not be known for a while.

Nevertheless, markets have moved to price a structural break for global bonds, stocks and the dollar. In this section we will attempt to gauge **the market impact of each 1 trillion of additional fiscal easing, spread out over a 10 year period**. Regardless of the growth impact of the package, the market factors in (at the time of announcement), an increase in the supply of mid/long-duration USTs of equal magnitude.

In terms of the growth impact of such a package, we examine two scenarios. In the **first scenario**, the measures deployed push growth expectations up by 0.1% per year (as they mainly focus on segments of the economy with low multiplier effects such as tax cuts for high incomes - as per our [economists' recent work](#)).

In the **second scenario**, we assume that measures of larger growth impact (coupled with structural, business-friendly interventions) are deployed, leading to an increase in growth expectations by 0.5% per year.

Lastly, we need to consider the offsets (negative side-effects) to assets. Regardless of the growth impact of the package, the market will factor in (frontloaded at the time of announcement), an increase in the supply of mid/long-duration USTs of equal magnitude. This will have an impact on the "discount rate" for assets via an increase in term premia. Keep in mind that the reduction in term premia has been a key driver of equity valuation expansion since '08 (see [Big Macro 03](#)).

The US election results have revived "fiscal easing hopes" in the markets

Although, it's not certain what fiscal package might come with the new US administration...

...markets have already moved to price a structural break.

One also needs to be aware of an offset of higher term premia from the issuance of mid/long-duration USTs of equal magnitude to finance the fiscal package.

Symmetrically, we assess the impact on markets via three main channels:

- 1) Higher long-term interest rate and earnings expectations. In [Big Macro 01](#), we estimated the impact of a slowdown in trend growth on equilibrium US interest rates (r^*). Based on our models we would estimate that in the first scenario, real yields go up by about 15bps, and in the second scenario, real yields would shoot up by about 70bps (see Figure 12).

In [Big Macro 03](#) we estimated the impact of growth-driven increases in interest rate expectations on equity valuations. Based on our estimates, the growth benefit to stocks from the first scenario would be 5%, all-else equal. From the second scenario, the benefit would be near 20%. (Figure 13)

- 2) Higher term premia for long duration assets. Our estimates for [Big Macro 03](#) have enabled us to assess the effects on 10y UST term premia from each trillion of duration removed from the market by Fed purchases. Symmetrically, our estimates would imply an increase in yields by 35bps due to higher term premia across scenarios (Figure 12). The damage to equities from such a move (again from Big Macro 03), would be estimated at about 10% (Figure 13).

- 3) Tighter Fed policy driving financial conditions and the USD. As alluded to before, beyond the impact on near-term growth dynamics, a credible fiscal scenario would affect trend growth and by extension estimates of r^* . All else equal, this would mean that the current Fed stance becomes more accommodative than it was before (Figure 14). We once again resort to our Optimal Control analysis to show the significant shift in the Fed's optimal path before and after the long-term growth boost from the second scenario.

Based on policy differentials, we estimate that the first scenario would imply little dollar strength vs majors (perhaps more vs EM FX given the rise in term-premia). In the case of the second scenario, we would estimate a 3% appreciation in USD vs EUR as a result.

The price action in markets so far has seen a significant pick-up in yields, a meaningful acceleration across equities and a small yet notable level of strength in the dollar. This is all consistent with the market reflecting the possibility of a sizeable fiscal package with some additional (high) odds of a composition that is impactful for medium-long term growth effects.

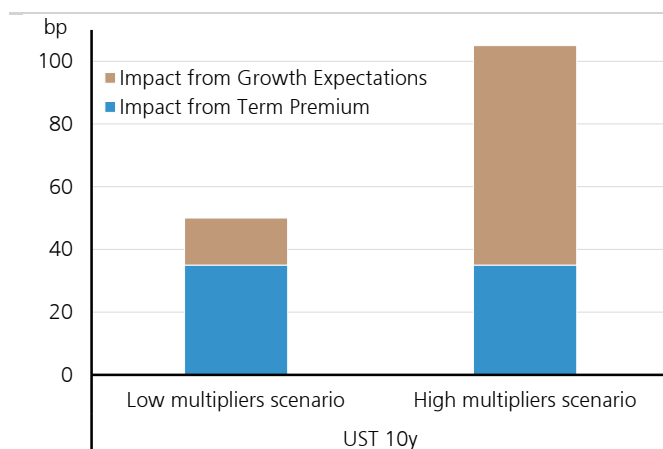
In simulations using our Big Macro frameworks, a substantial fiscal package would increase real yields...

...and push term premia higher as the market frontloads issuance of Treasuries...

...and thus weigh on financial conditions.

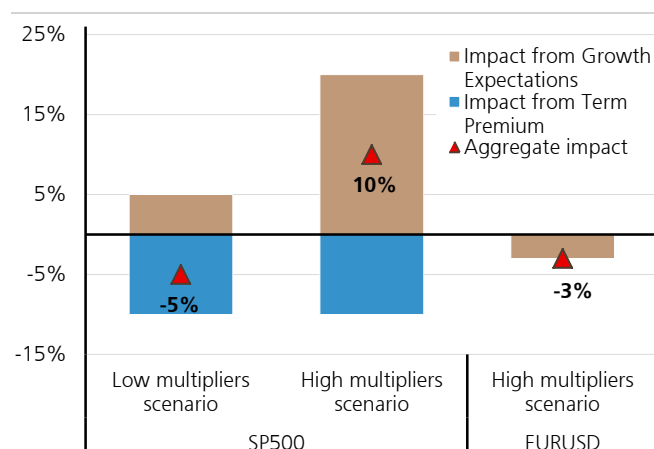
What to do...the recent market moves are premature, but we would not fade them.

Figure 12: In light of a potential fiscal stimulus package, UST 10y rates would move higher...



Source: Bloomberg, UBS calculations

Figure 13: ... while risk assets still seem to perform well in a high multiplier scenario.



Source: Bloomberg, UBS calculations

Yet, as we show in our simulations, the moves across assets are likely to be larger in the event of a meaningful package – whatever the odds of that may be. This means that, the market moves are not excessive and we would not fade them. In fact there are upside risks to bond yields, stocks and the dollar. We will constantly update our estimates as details become clearer.

The base case for 2017: pricing some probability of moderate US growth acceleration/reflation...

So where do all these cross-currents leave macro and markets for 2017? Our base-case forecasts embody the cross-currents discussed so far. In rough terms, our Economics team expects growth to accelerate mildly across EM and DM economies but to remain at low levels (Figure 16). US growth acceleration is (once again) expected to contribute the most to the broad trend of improving global growth. Instead, growth momentum in the Euro-area and in China is starting to lose some steam compared to last year. As discussed earlier, our forecasts already embody a level of US fiscal easing and we will look to assess further upside risks.

Inflation is coming somewhat higher but from a low base (Figure 17). One of the biggest drivers of this improvement is the increase in the price for commodities (primarily oil) which is *projected* to average \$60/bbl (Brent) in 2017. Annual CPI numbers are particularly striking in the early part of the year but mainly due to the striking comparatives against low oil prices in Q1 2016.

Our economists expect some policy normalization both in the US (two rate hikes in 2017) and in Europe (tapering asset purchases in H2) but late in the year, and of course assuming well behaved financial conditions and oil prices. Obviously, as discussed above, a robust fiscal package would further boost Fed normalization prospects.

Consistently, our forecasts are poised for an increase in long-term yields to factor in the odds of fiscal loosening and reflation. But our projections are below forwards in the US as the market has moved a lot already based on our analysis. We would need to see more evidence to project sustainable moves higher.

We expect the ECB's tapering to lead to slightly higher EA core yields towards the end of the year. Overall, G10 curves there are likely to steepen further.

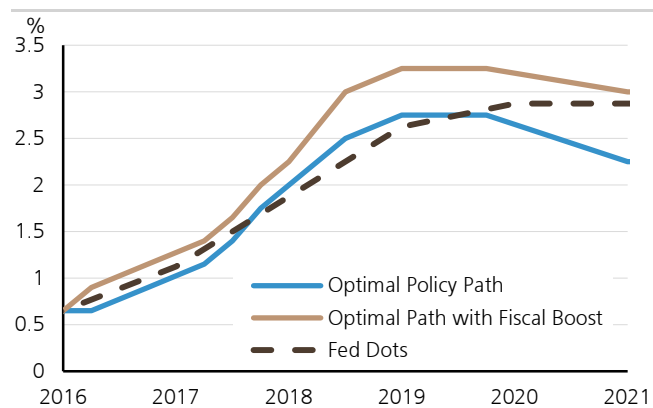
Improving growth dynamics...

...and higher inflation...

...should translate into marginally higher yields.

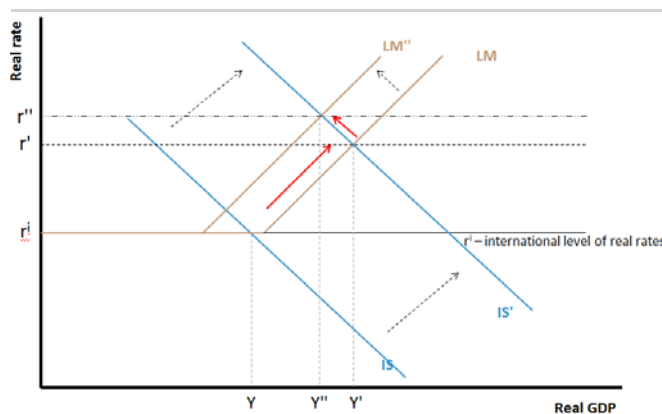
Curves should also steepen.

Figure 14: A fiscal boost would also make Fed's current stance would appear accommodative...



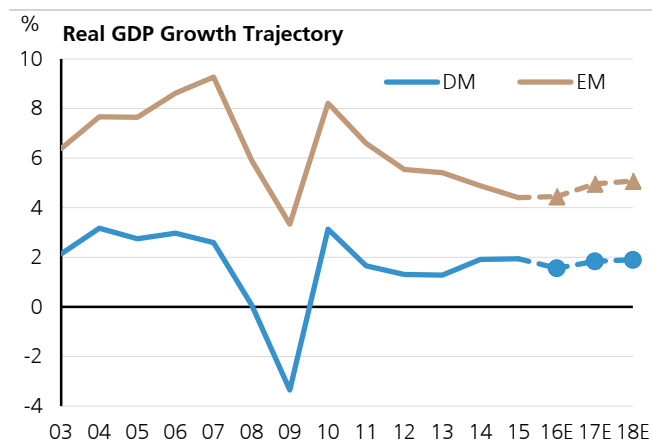
Source: Bloomberg, Haver, UBS calculations

Figure 15: ...as it raises growth and real rates.



Source: UBS Investment Research

Figure 16: We only see a mild growth acceleration going forward.



Source: UBS Economics

The path for policy normalization feeds through to financial conditions as discussed earlier. In that sense, dollar rallies may quickly prove self-defeating, as we will discuss in the FX section below in more detail. That said, the prospect of fiscal easing and monetary tightening would create clear upside risks to the dollar relative to our view (real rates will rise as a result, shown in Figure 15).

The tightening of the ECB's reaction function and the potential for some convergence between US and EUR yields should support the EUR. Having said that, the loss of growth momentum in the Euro-area probably also justifies a slower EUR appreciation trajectory. Especially, given that part of the TWI EUR appreciation will be absorbed by a weaker GBP, SEK and Asian FX.

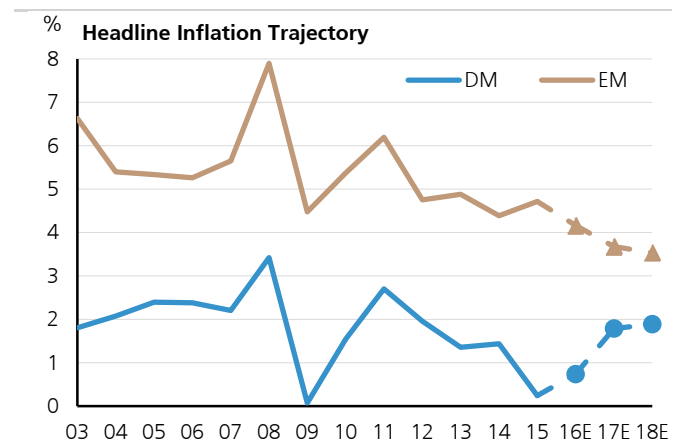
All else equal, accelerating growth bodes well for equity, but all else is rarely equal, and higher growth is likely to be accompanied by rising rates. Ultimately the balance between the two will drive equity returns. Indeed, post-election gains in equities despite rising bond yields may reflect the market's perception that growth acceleration will outweigh the impact from higher yields, but details around the fiscal package are too scant to come to this judgment with high conviction.

Marginally higher inflation (and yields) may justify some reflation trades such as buying financials and selling utilities and consumer staples. Our equity strategists have supported some of these trends, yet the market has already moved substantially to price a reflationary outcome. In that sense, the risk reward calculus is becoming more uncertain.

On the credit side, markets continue to benefit from strong inflows on the back of low absolute yields. An uptick in US rates is unlikely to change this materially but it may expose some of the vulnerabilities in HY credit, as we discuss in the credit section. Unless we see a material shift from the current low rates regime, which we don't forecast, the impact on investment grade credit should be limited.

EM Growth is more exposed to Europe and Japan than to the US. Indeed, our EM strategists think the pass-through from higher US rates would outweigh the benefits to growth. The impact is likely to be felt across the spectrum of EM assets, but EM FX and equity stand out as most exposed to higher US rates.

Figure 17: Despite a forecast rise in DM inflation, it's largely due to base effects.



Source: UBS Economics

Meanwhile, EUR still has potential to grind higher, albeit on a slower path

Equity returns will be driven by the balance between improving growth and higher rates

Credit is unlikely to see a meaningful impact without a regime change, but HY weakness may be exposed

EM benefits less from a US than a European growth surprise, but suffers the full consequences of higher costs of funding

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Equities

Equities

UBS Research THESIS MAP

PIVOTAL QUESTIONS

Q: Was "secular stagnation" a mirage?

No. The environment of low growth, low inflation and low yields has had profound implications for stocks including low revenue/earnings growth, high valuations, low expected returns and a strong incentive for investors to seek yield in dividend-rich equities. In this environment valuation gaps between sectors that benefit from low yields (utilities, staples, etc.) and sectors that get hurt in an environment of low yields (e.g., financials and insurance) have been large and persistent.

Q: Are we likely to see a reflationary 2017?

Tentatively. The outlook for 2017 carries elements of moderate yet tradable reflation. But as we have extensively discussed so far, the path is narrow. A lot of very specific pieces of the reflation puzzle need to fall in place simultaneously, for growth and reflationary dynamics to extend beyond what is priced in. The prospect of fiscal easing could boost equities from current levels but the mix of measures needs to be highly supportive for growth. And it is important to remember that certain policy outcomes may even outright weigh on equity markets (see the chart below).

Q: Is the risk-reward for reflationary strategies favourable?

Increasingly unclear. Despite the shift in the market's macro views, the equity market has already moved significantly to reflect a high chance of a growth/inflation boost. Interest rate sensitive sectors have outperformed income/dividend heavy sectors to a scale not even justified by the pick-up in yields. Risk aversion has declined but it could pick up if front-end rates rise further on the back of a more hawkish Fed and tighter financial conditions. A stronger dollar is weighing on oil and that can hurt high yield credit in the US.

UBS VIEW

2017 will likely be a year of positive returns and earnings growth but it is important to keep expectations in check. Our equity strategists envisage a rebound in nominal growth leading to a recovery in earnings growth, which should underpin positive returns for stocks – yet not excessive ones. Similar to recent years, however, the risk-reward calculus is likely to remain challenging.

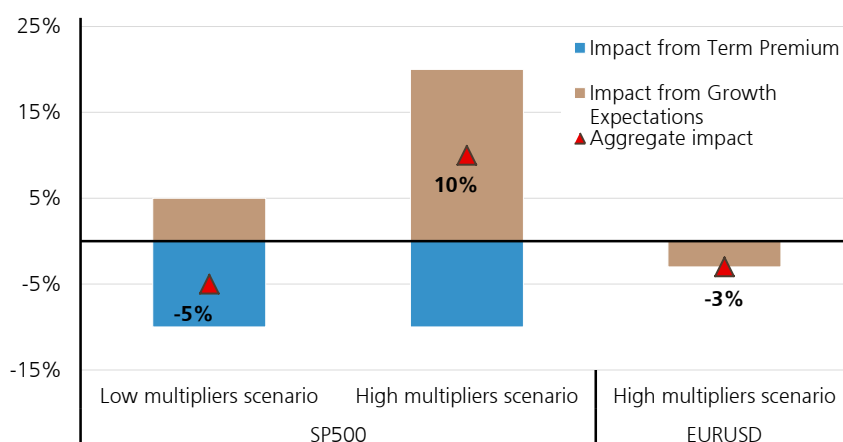
EVIDENCE

In our estimates more than 75% of the boost in valuations since 2010 can be linked to the decline in risk-free discount rates. A rise in yields is therefore a significant event for stocks. For it to remain an event that boosts the equity market, it needs to be backed by a strong growth rebound that is expected to last for a few years.

SIGNPOSTS

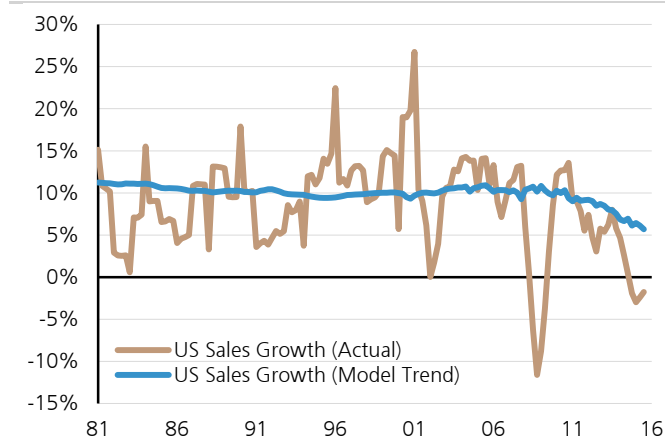
Fiscal policy outcomes and financial conditions trends. For reflationary trends to extend further, we would need to see evidence of broader growth positive policies being enacted – policies that persistently affect long-term growth trajectories by a significant margin. At the same time, we would need to see a Fed response that does not trigger excessive tightening in financial conditions and self-defeating market feedback loops (e.g., dollar strength suppressing oil significantly).

UPSIDE / DOWNSIDE SPECTRUM



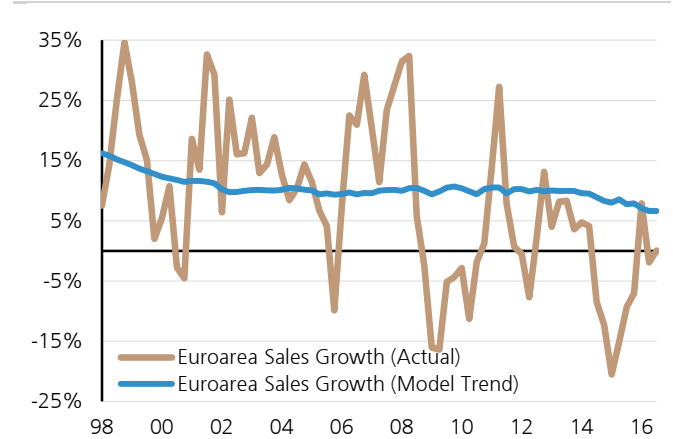
Source: Bloomberg, UBS calculations

Figure 18: Revenue growth has slowed in the US...



Source: Datastream, Haver, Bloomberg, UBS calculations.

Figure 19: ... and the same is true for the Euro area



Source: Datastream, Haver, Bloomberg, UBS calculations.

Reflation or "lower-for-longer" for stocks?

The global macro environment of slow growth, low inflation and low risk-free yields has had a profound impact on stocks. First, it has led to lower-for longer trajectories for long-term earnings growth. As Figure 18 and Figure 19 show, the continuation of the current market regime suggests that long-run revenue growth has likely moderated from 10-11% to 6-7% on average in Europe and US.

Second, it has led to a decline in the discount factor for stocks, which is not driven by valuation excess but rather from the impact of low long-term risk-free yields as Figure 20 and Figure 21 show. The mirror image of low risk-free yields is higher average valuations. Before the GFC, multiples of 14-15 were considered normal for stocks. After the "lower for longer" macro regime set in, the decline in long-term real yields likely justifies mid-cycle P/E's around 20 as per our [Big Macro 04](#) analysis.

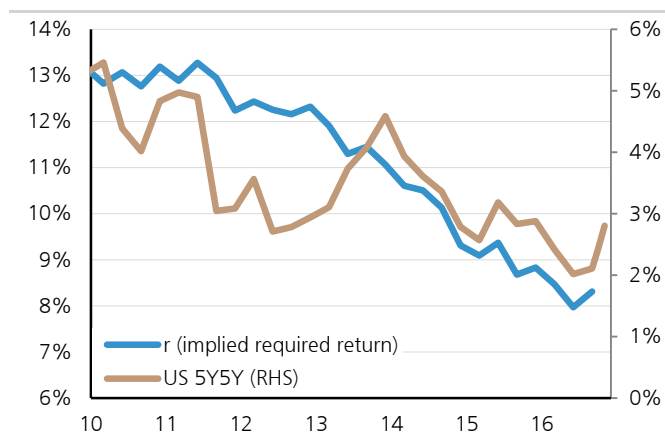
Third, it has created incentives for equities to become investable primarily on the basis of the income they deliver and less so on the back of the growth and value they offer. Since 2008, the gaps between equity dividend yields and risk-free bond yields have been extreme in historic context (Figure 24).

In the current low-growth, and low-rate macro backdrop, revenue growth has moderated...

... discount factors for stocks have declined, which boosted equity valuations by a mirror effect...

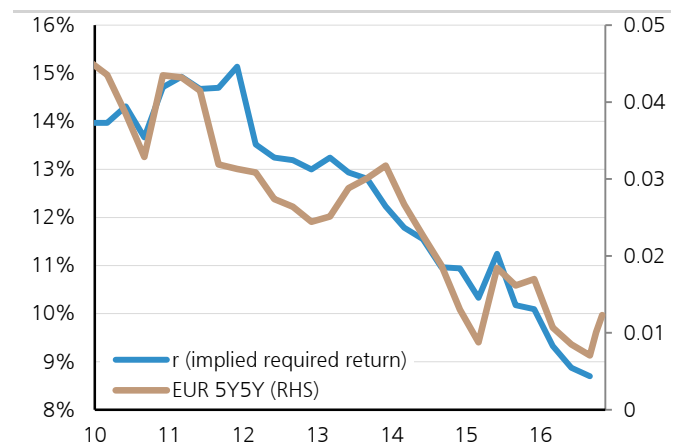
... and incentives to invest in equities have shifted to the income rather than the growth component.

Figure 20: The big fall in discount rate is driven by low long-term risk-free yields in the US...



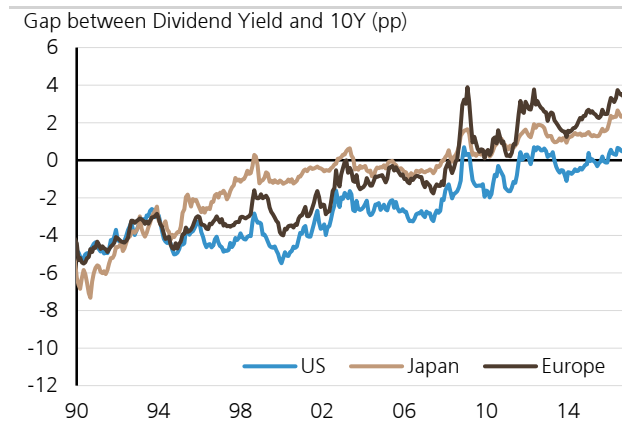
Source: Datastream, Bloomberg, Haver, UBS calculations

Figure 21: ... and the Euro area.



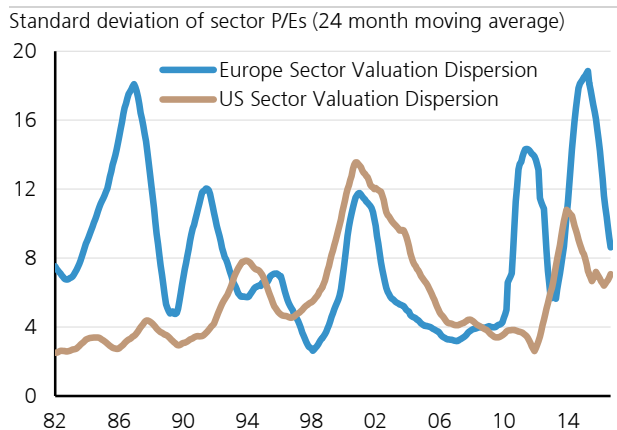
Source: Datastream, Bloomberg, Haver, UBS calculations

Figure 22: This has led to the widest gaps between dividend yields and risk-free rates...



Source: DataStream, Bloomberg, UBS

Figure 23: ... and very large and persistent valuation gaps across sectors.



Datastream, Haver, Bloomberg, UBS calculations

At the time of writing, the income in stocks is near historic highs vis a vis the income earned from bonds creating an attractive risk-reward for equities from an income perspective (Figure 22), particularly at a time of low risk aversion. The importance of dividend and quality thereof has led to very large and persistent valuation gaps across sectors and markets as well as within sectors (Figure 23).

Fourth, lower earnings growth discounted at a lower rate also coincides with lower expected returns and a deteriorating risk-reward ratio for stocks – yet still a better one than what bonds offer.

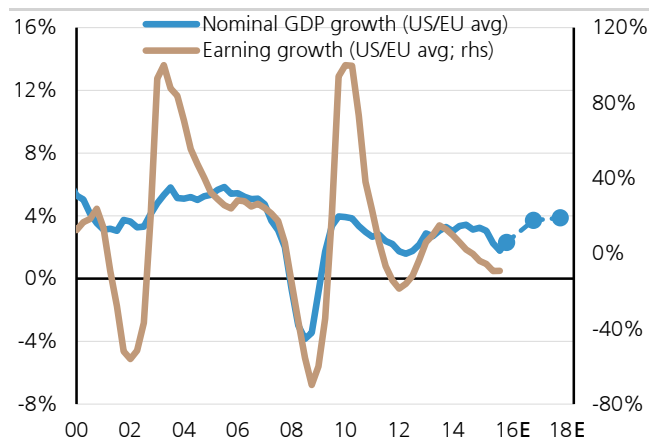
2017 offers a chance to deviate from these trends. Crucially, even if that deviation is temporary, it can still create powerful rotations among sectors, such as the ones we have observed over the last few weeks.

A simple extrapolation of our nominal growth projections implies cyclical earnings acceleration from current suppressed levels (Figure 24). Our equity strategists Nick Nelson & Karen Olney (Europe), Julian Emanuel (US) and Niall McLeod (Asia) project positive earnings growth and total equity returns of high single/ low double digits for the year ahead (a big chunk of which from dividends).

Although risk reward for equities has deteriorated, it still remains better than bonds.

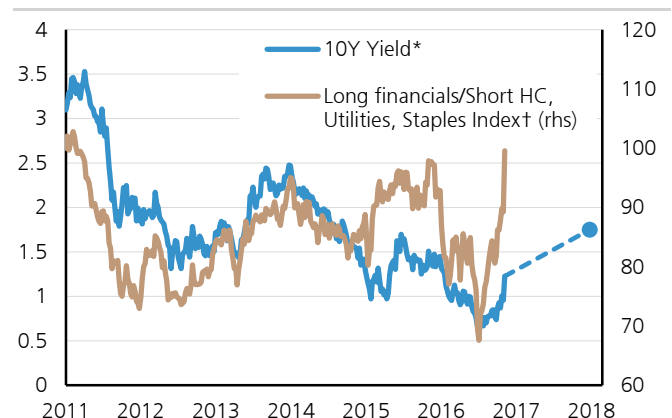
Better growth prospects in 2017 may lead to positive returns and powerful rotations...

Figure 24: Our growth forecasts imply a pick-up in earnings...



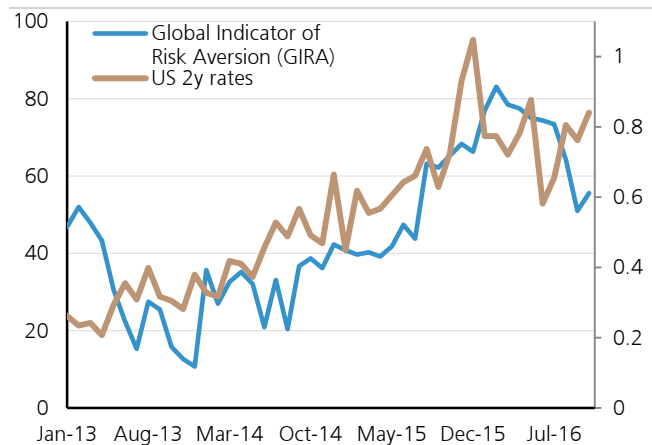
Source: Haver, Bloomberg, UBS calculations

Figure 25: ... but the market has already reflected this, perhaps to a larger extent than even bond markets have.



Source: Bloomberg, UBS. *Avg. of Germany and US †Using simple avg. of S&P and Stoxx 600 sectors

Figure 26: That said, financial conditions are unlikely to become easier on higher front-end rate expectations.



Source: Bloomberg, Haver, UBS calculations

The market has started to reflect these shifts. As Figure 25 shows, together with the post-election spike in US yields, reflecting hopes for higher growth and inflation, sectors hurt by the low growth and low yield regime such as financials have outperformed sectors mostly associated with income – such as utilities and consumer staples in the US and Europe. In fact, the equity market may have captured the relevant macro shifts more than even the bond market has.

At current levels the risk reward for refraction trades is particularly tricky. As discussed earlier, in the absence of true fiscal stimulation, refraction is a narrow and very risky path. And the tightening of financial conditions that higher yields imply does not bode well with that path. Figure 26 shows that a large part of the US equity rally since February has been driven by a decline in risk aversion, ever since Fed tightening expectations flat-lined. Inversely, the increase in front-end rate expectations does not bode well for risk aversion to moderate further.

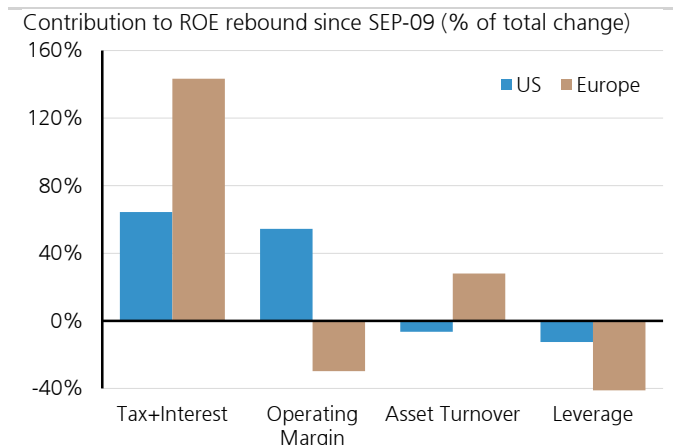
Also, a short term normalization in growth is not enough. As Figure 27 shows the recovery in US and European margins has primarily relied on tax benefits/efficiency and lower borrowing costs. Without some genuine long-term boost in growth and operating margins, higher yields may hurt the bottom line for companies.

Lastly, a stronger dollar can be a risk. Not just for US industrials, but also for the oil and high yield credit sector. As discussed earlier, all else equal, a strong dollar coincides with lower commodity prices.

A broad boost from fiscal and regulatory resources could offset some of those pressures. A growth intensive policy package can lead equities up by a total of 10% on average, which would be a big deviation from recent norms.

But again, as argued earlier, not all policies are created equal. Unless accompanied by measures that effectively boost long-term growth, the impact from higher bond premia (and thus borrowing costs) can lead equities lower in fact (please see [Thesis Map Figure](#)). We will be assessing information on policies as they become available.

Figure 27: Profitability might get hurt, as lower borrowing costs have been a main driver for recovery.



Source: Datastream, Datastream, Haver, Bloomberg, UBS calculations

... but the market has already priced a lot of it.

The risk is: the fiscal package has a low pass-through to growth...

...while financial conditions start to tighten on rising yields, higher borrowing costs ...

...and a stronger dollar.

So the devil lies in the details of the fiscal package.

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FX

PIVOTAL QUESTIONS

Q: Why has the dollar peaked?

Our economists expect one hike from the Fed in December and two more next year. However, policy divergence by itself is not sufficient to support a dollar rally unless it is accompanied by solid growth, and we are not there yet. Indeed, in a low growth environment dollar rallies tend to be self-defeating due to the feedback loop with tighter financial conditions. In addition, a lot of this is already in the price. Despite elevated market expectations since the US elections, we think the path to reflation is narrow and requires easy financial conditions for longer. We remain, however, open-minded in the event the new US administration enacts growth enhancing policies that could boost activity substantially.

Q: What will drive the EUR higher?

The EUR remains undervalued both on a PPP basis and in current-account based models. In addition, the sensitivity of EUR/USD to rate differentials has declined markedly and is also increasingly resilient to political risks. Lastly, our economists expect the ECB to begin tapering its QE programme in H2 2017, which may not be in the price yet. That said the EUR is stronger than what is implied by EUR/USD due to the appreciation of EUR TWI. As a result, we have pushed down the expected appreciation path for EUR/USD.

Q: What could make us change our minds?

The enactment of wide ranging growth enhancing policies in the US. A higher level of trend growth would be consistent with higher equilibrium real rates and a more credibly hawkish Fed, thus leading to a stronger dollar. That said it will probably take some time before the details of any US policy package are finalised.

UBS VIEW

The dollar has likely peaked against G10 currencies. The recent rise in EUR TWI suggests a slower convergence of EUR/USD to fair-value. That said the outcome of the US elections introduces a level of uncertainty regarding the prospect for growth enhancing policies, shifting the balance of risks for the dollar to the upside relative to our current path.

EVIDENCE

Neither policy divergence nor risk aversion has prompted sustained dollar rallies in recent months while the dollar remains overvalued against the euro. In addition, the EUR is now more resilient to political risk.

SIGNPOSTS

US growth and inflation expectations; fiscal policy decisions. We are focusing on Fed communication in advance of the December 14th FOMC meeting to gauge the extent to which the Fed remains on track for a December hike. Over and above that, US growth and inflation expectations are key for the dollar. We focus in particular on the Fed's 5-year/5-year forward breakeven measure for any further gains in the coming months (currently around 1.6%). More importantly, we are looking for clarity on the new US administration's fiscal plans to assess their feasibility and impact on growth and the dollar.

UPSIDE / DOWNSIDE SPECTRUM



The dollar after the US elections

In our view the dollar has peaked vs major G10 currencies. Although we expect the Fed to hike interest rates in December, followed by [two more hikes next year](#), policy divergence alone is insufficient to drive a rally. Indeed, a lot of this is already in the price. In addition, in a low growth environment dollar rallies tend to be self-defeating due to the [feedback loop with tighter financial conditions](#). Hence, US growth needs to break away from the rest of G10 in order for the dollar to follow. Lastly, the dollar is already overvalued vs the EUR in particular, both on a PPP and a current-account basis, raising the bar for a sustained rally higher.

The outcome of the US elections has opened up the possibility that the new US administration enacts wide-ranging growth enhancing policies, which could go some way toward improving the economy's growth potential. At any rate, price action since the elections suggests that the markets [maybe pricing in this prospect](#). Indeed, a higher level of trend growth would be consistent with higher equilibrium real rates. The Fed would then presumably be able to raise interest rates without risking deterioration in broader financial conditions to the same extent, thus leading to a stronger dollar. At the moment, however there is little, if any, detail on the composition of any such reform package.

All told, then, as the path to reflation is narrow and requires policy and financial conditions to remain accommodative for longer, dollar rallies should be kept in check. We remain, however, open-minded in the event the new US administration enacts growth enhancing policies that could boost activity substantially.

In terms of our forecasts, we continue to expect EUR/USD to grind higher but have pushed down the expected appreciation path. We now see EUR/USD at 1.13 by end-2017, supported by favourable valuations and the prospect that the ECB begins to [taper QE from H2 2017](#), which is likely not in the price yet. That said the EUR is already stronger than EUR/USD alone suggests due to trade-weighted Euro strength (Figure 28), meaning that it will likely take more time to converge to fair value. The prospect for growth enhancing policies in the US has also shifted the balance of risks for EUR/USD to the downside relative to our projected path.

We have revised up our USD/JPY forecasts for 2017 to 110, from 100 previously. "QQE with yield-curve-control" has [increased the impact of US rates on the yen](#), and the recent back-up in US yields and the prospect of growth enhancing policies have shifted the balance of risks in favour of a mildly stronger USD/JPY (Figure 29).

The dollar has likely peaked vs major G10 currencies

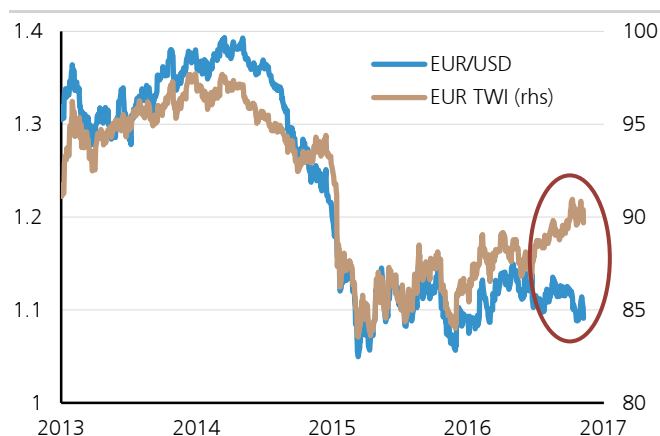
Active reflationary policies by the new US government could benefit the dollar in due course

For now however, the path to reflation is narrow and dollar strength stands in the way.

We have pushed down the expected appreciation path for EUR/USD ...

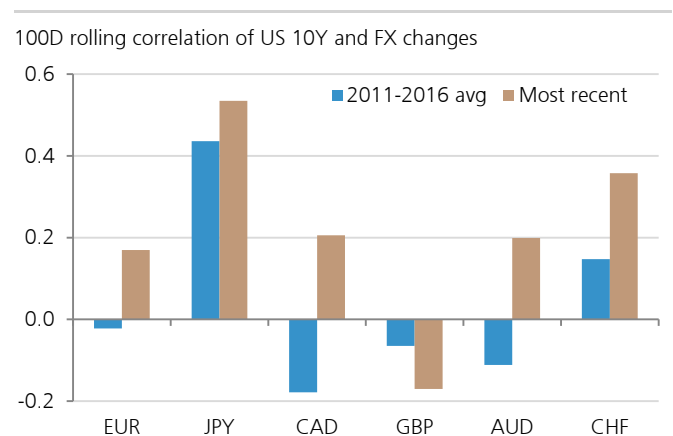
...and upgraded our yen forecast for end-2017

Figure 28: EUR/USD understates the rise in EUR



Source: Bloomberg, BoE, UBS.

Figure 29: The Yen-yields correlation is high – and rising



Source: Bloomberg, UBS.

G10 FX Opportunities: Sterling, Scandies, Commodity bloc

We remain bearish sterling

Staying bearish Sterling remains a high-conviction call of ours on the basis of macro fundamentals. The direction of travel is still one towards Leave despite the recent ruling by the High Court on the process leading to Article 50 being triggered, resilient activity data and a less dovish MPC (Figure 30). As a result, the correction of the UK's current account deficit via the moderation of the capital flows currently funding it remains the main longer-term driver of the currency (Figure 31). We continue to expect EUR/GBP to reach parity by end-17 and stay around this level for a considerable period thereafter.

We are bearish sterling as the current account correction will continue to drive the currency

NOK and SEK: Further room for divergence but the gap is narrowing

Bearish the SEK has been among our highest conviction views in 2016. We remain modestly bearish SEK, though given the sharp rise in EUR/SEK, risk-reward is less than it was before. We remain constructive on the NOK, as high inflation keeps Norges Bank tolerant of currency appreciation. Low inflation led us to [argue](#) for SEK weakness, and higher inflation supported [our expectations](#) that Norges Bank would turn neutral and boost the NOK. We see some scope for the moves to extend as the two central banks respond to divergent inflation paths (Figure 32). Growth is unlikely to be a game changer for the Riksbank. We continue to forecast further modest upside in EUR/SEK, expecting a rise to 10.2 by end-17. We still expect modest NOK appreciation in the coming years and forecast EUR/NOK at 8.9 and 8.9 at end-17 and end-18 respectively, as Norges Bank is likely to keep monetary policy tight in a more stable oil price environment.

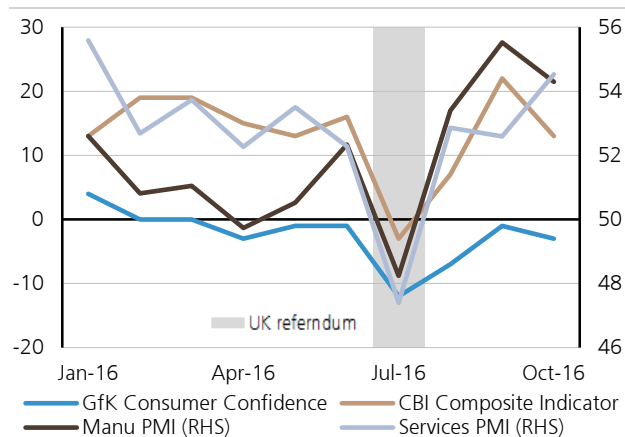
There is some additional scope for divergence between NOK and SEK

We are turning constructive on AUD and NZD and bearish CAD

In commodity currencies space there is another interesting dichotomy evolving between AUD and NZD on the one hand and CAD on the other. The carry appeal should continue to support AUD and NZD in a low rates environment. In addition, the turnaround in non-energy commodity prices is having a positive impact on the terms of trade for both countries, which, all else equal, lowers the probability of further RBA or RBNZ policy easing. We are now moderately constructive on the antipodes. We expect AUD/USD and NZD/USD to rise to 0.78 and 0.75 by end-2017, respectively, and would see USD strength as an attractive opportunity to buy both pairs.

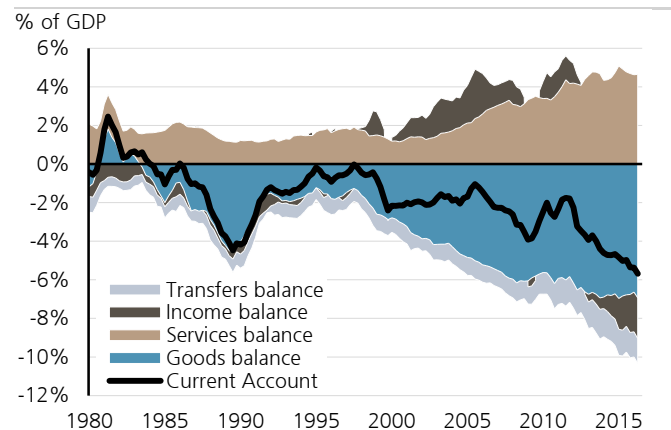
We have now turned more constructive on AUD and NZD ...

Figure 30: UK activity indicators may have bounced since the referendum...



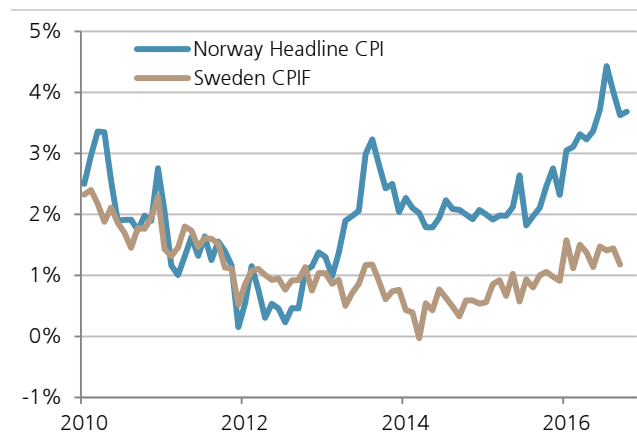
Source: Haver, UBS

Figure 31: ...but Sterling will be driven by the adjustment in the current account in the medium term



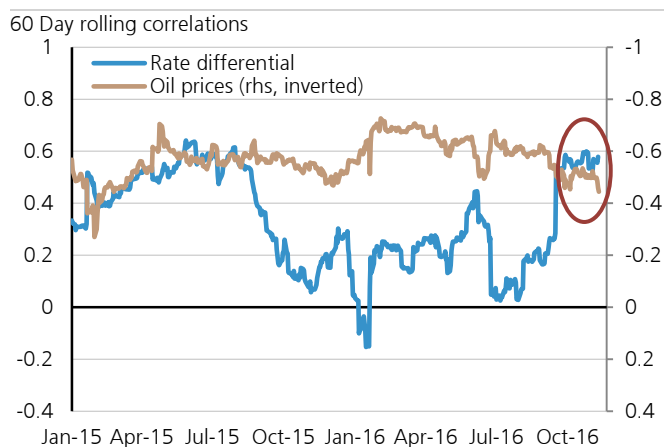
Source: Haver, UBS

Figure 32: Diverging inflation in the Scandies has led to policy divergence



Source: Haver, UBS Calculations.

Figure 33: Rate differentials are now driving USD/CAD more than oil



Source: Haver, UBS.

On the other hand we have turned bearish on the Canadian dollar as weak growth and especially inflation have prompted a dovish shift by the Bank of Canada. This coincides with a rising sensitivity for USD/CAD to rate differentials, whilst the relationship with oil has weakened (Figure 33). In fact, [our analysis](#) shows that the rates market is underpricing the probability of further easing from the BoC and this leaves the CAD vulnerable. We forecast USD/CAD to end the year at 1.38.

But have downgraded our outlook for the Canadian dollar

Figure 34: G10 FX Forecasts

	Spot	3-month	End-2017	End-2018
EURUSD	1.07	1.09	1.13	1.17
USDJPY	108	108	110	112
EURJPY	116	118	124	131
GBPUSD	1.25	1.21	1.13	1.17
EURGBP	0.86	0.90	1.00	1.00
EURCHF	1.07	1.08	1.11	1.13
USDCHF	1.00	0.99	0.98	0.97
EURSEK	9.84	10.00	10.20	10.20
EURNOK	9.09	9.05	8.90	8.90
AUDUSD	0.76	0.76	0.78	0.80
NZDUSD	0.71	0.72	0.75	0.76
USDCAD	1.36	1.36	1.38	1.34

Source: UBS estimates

Rates

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Rates

UBS Research THESIS MAP

PIVOTAL QUESTIONS

Q: Are real rates on average priced too low?

We do not think real rates are substantially too low, but upside risks have increased since the US election outcome. There is considerable uncertainty regarding US terminal real rate expectation given possible fiscal spending (see our stylized [scenario analysis](#)) and growth implications due to potential changes in US trade deals. In case of a [large growth enhancing measures in the US](#) and depending on its growth multiplier, **it is possible that our expectation of US terminal real rate increases to 75-150bp from currently 0-50bp** (see [Big Macro 01](#)). In the euro area, [we argued](#) in the past that core euro area (real) rates are too low given the macro picture. Changes to the QE design should reduce scarcity risks. However, in the absence of euro area growth picking up significantly, positive real rates in the periphery put a limit to a repricing of Bund real yields to substantially higher levels.

Q: Are inflation expectations too low?

After the US elections, market based inflation gauges have increased, but the University of Michigan's medium term inflation expectations and 5y5y US breakevens are still below past averages. With respect to the latter we see the potential for a move higher and large growth enhancing measures could push it further. Nonetheless, a retracement to pre-crisis levels is unlikely without tangible evidence that the global disinflationary environment is overcome. Prospects that the euro area will be the key driver reflation the global economy anytime soon are fairly contained. A meaningful joint fiscal effort is politically too complex in a euro area without a common fiscal authority, while the ECB's accommodation on its own remains unlikely to reflate the economy.

Q: Are term premia extremely compressed?

In the US, [we think](#) term premia are fair but they have potential to inflect higher based on fiscal stimulus, which is still unclear at this point. In the [euro area](#) QE explains most of the term premium compression. This is unlikely to reverse, but a higher US term premium and QE design changes in favour of lower scarcity risk for Bunds support a somewhat higher term premium.

UBS VIEW

Combining our outlook for real rates, inflation expectations and term premium, we think **US rates are still likely to be somewhat lower than market priced forwards**. With increased fiscal stimulus potential, the risks for UST yields are now clearly to the upside. We prefer receiving long-end real rates instead of nominal. **Bund yields hold the potential to end up above forwards** over our forecast horizon, but we prefer curve steepening and cross market underperformance against Gilts in the long-end.

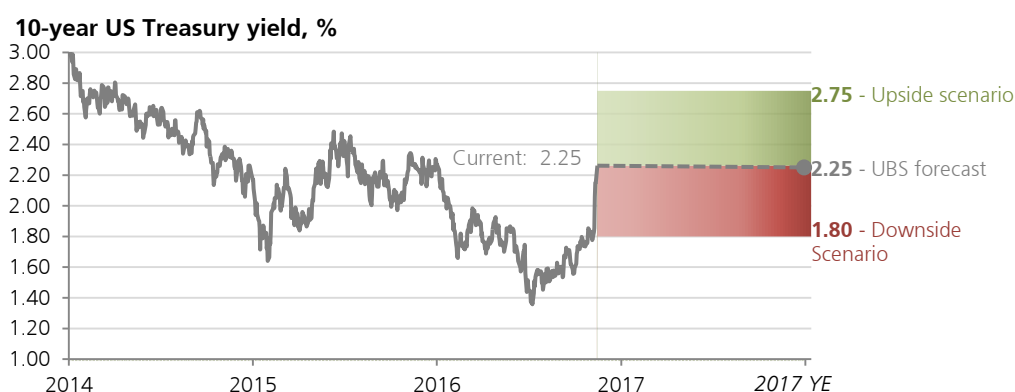
EVIDENCE

Subdued trend growth and disinflationary pressures have been firmly entrenched implying that the lower for longer rates theme will not be overcome easily. While markets have started to price a more genuine reflation attempt, it would take a major fiscal policy shock to reverse these trends.

SIGNPOSTS

Details about US fiscal policy plans will be in the spotlight followed by the US refunding announcements in February and March 2017. In terms of monetary policy the December meetings of FOMC (a hike is the base case, but alterations in the growth outlook will be scrutinised) and ECB (a 6-month extension of the APP is the base case, but QE design changes are key) will be in the spotlight.

RECENT PERFORMANCE



UST yields stay below forwards, but upside risk increased

In our base case scenario we have become less bullish 10yr UST yields over the course of our forecast period but still expect to beat current market forwards by some 30bp at the end of 2018. The risks to the upside for yields have clearly increased post the US election outcome due to the potential for a large US fiscal stimulus plan in an environment where labour markets are improving. However, to overcome the lower for longer rates theme (defined by lower trend growth in a global disinflationary environment that requires very supportive financial conditions), it would need a substantial fiscal policy shock. The market started to run with the theme of reflation prospects, pushing UST yields substantially higher and pricing a structural break. Even though we deem these moves to be premature in terms of macro foundations, we would [not fade them yet](#).

Given the uncertainties over the timing, size and composition of a fiscal outcome, we caution against taking outright duration risk in nominal UST. We prefer curve and linker positioning which provide a better risk reward in the current market environment. In the linker space, we stick to [our view](#) to receive long-end real rates as they are above our current expectation the Fed's current measure of terminal real rates is about 50bp (290bp terminal nominal rate minus 240bp CPI expectations). 30-year real rates in the US are trading at +93bp, well above this estimate. While a fiscal policy shock makes it possible that our expectation of US terminal real rate increases to 75-150bp from currently 0-50bp, 30yr TIPS provide a better protection for long positions than nominals under such a scenario.

As the knee-jerk repricing of the UST curve after the US presidential election already indicated, long-end rates are most susceptible to an increase in US Treasury bond issuance that would be required to fund a large fiscal stimulus plan. Against this backdrop, we see the potential for further steeping of the UST curve in 5s30s and 10s30s (against current market forwards) and look for good entry opportunities for these trades.

Less bullish 10yr UST yields, but our forecasts remain below market forwards

We prefer long 30yr TIPS providing a better risk reward than nominal, while...

... we see potential for steeper UST curves in 5s30s and 10s30s relative to forwards.

Figure 35: UST yield forecasts (%)

	2017				2018			
UST	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
2yr	1.00	1.10	1.15	1.20	1.35	1.50	1.65	1.70
5yr	1.55	1.65	1.70	1.75	1.90	2.05	2.20	2.25
10yr	2.15	2.20	2.25	2.25	2.30	2.40	2.45	2.50
30yr	3.00	3.00	3.10	3.10	3.15	3.20	3.20	3.20

Source: UBS Investment Research

Bund yields hold the potential to increase above forwards

For the euro area, we have [previously argued](#) that core euro area rates are too low, especially given the macro outlook for the region. A key driver behind the fall in nominal and real-rates in the euro area since early 2015 have been [scarcity concerns](#) in Germany bonds since the announcement of the ECB's QE programme. However, 30y Bunds have lost their relative strength on the curve as the market has started already to price changes to the QE design since the summer. We see more potential for ultra-long to remain the weakest link on the Bund curve going forward. In [our expectations](#) QE design changes are likely to be addressed in conjunction with a six month extension of the ECB's asset purchase programme beyond March 2017 at the December meeting.

We look for a gradual rise in 10yr Germany yields to 0.90% by end-2018 (above current market forwards).

Over the course of our forecast period we look for a gradual rise in 10yr Germany yields to 0.90% by the end of 2018. This is some 10bp above current market forwards and would come alongside a steeper curve driven by the ultra-long end in our view. Driving this view are our expectations for changes to the ECB's QE design over the near-term, the tapering discussion to become more prominent in H2 as well as an acceleration in nominal GDP growth in the euro area. Obviously the increased risk for higher UST yields is supporting our base case view as well.

However, the uncertain market environment post the US election is not attractive near term for the strategic selling of Bunds. Beyond that, political risk events, especially in H1 (the UK triggering Article 50 and upcoming elections in the euro area), could provide a temporary bid for Bunds. Hence, we prefer to approach duration risk tactically and prefer a more strategic positioning via 5s30s Bund and EUR 10s30s forward steepeners (4yF) as we outlined [previously](#).

We prefer 5s30s Bund and EUR 10s30s forward (4yF) steepeners over outright shorts.

Elevated political risk for the EGB spread complex

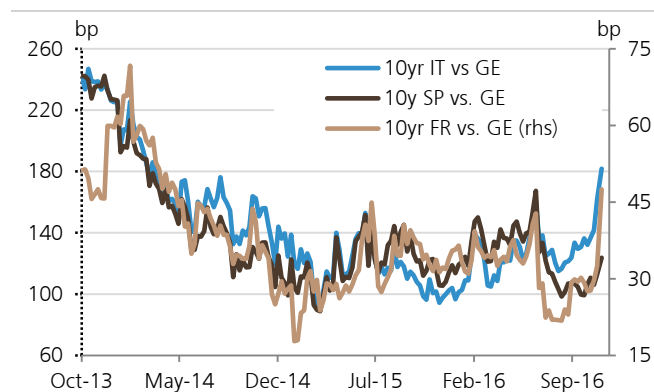
Even though we expect Bund yields to overcome their extreme compressed pricing since QE came into the picture, we do not expect a reflationary impulses to an extent that it would lead to a bear-tightening of EGB spreads. Despite ongoing ECB accommodation, the broad EGB vs. Bund spread compression trend has stalled since 2015. Excess yield due to systemic risk during the European debt crisis has compressed, but political concerns (emphasised by a structurally less liquid market environment) have introduced considerable volatility to the EGB spread compound compared to the level of spreads.

Political risk is high in Europe, starting already from 2016 with the Italian referendum in December, followed by general elections in the Netherlands, France (H1) and Germany (H2) in 2017. Naturally, uncertainty is higher as the predictive power of opinion polls has clearly diminished in the last few years at a time that anti-systemic parties have gained in popularity. The most recent relative and absolute underperformance of OATs in the EGB spread complex is a perfect example for this development (Figure 36). From a markets perspective, we have a bias towards slightly tighter peripheral spreads to Germany over our forecast horizon as the recovery continues. However, we do not find the risk-reward of these positions particularly attractive in the current environment of elevated political uncertainty. Instead, we prefer relative value positions within the periphery. We [maintain](#) a structural preference for Spanish government bonds vs Italy (Figure 36), in light of the recent political stabilisation and a stronger growth backdrop in Spain than Italy.

Political risk is high in Europe

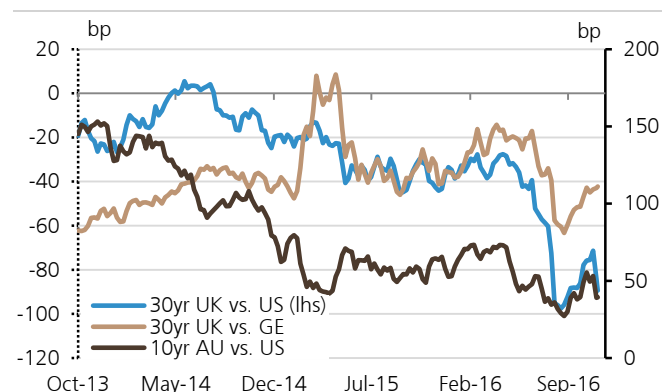
We maintain a structural preference for Spain vs Italy

Figure 36: Elevated political risk in EGB spreads



Source: UBS Investment Research, Bloomberg

Figure 37: 30yr Gilts and 10yr Aussie attractive vs. peers



Source: UBS Investment Research, Bloomberg

In the high-yield space we think Greek government bonds (GGBs) offer the most upside in the medium-to-long term. The downside in GGBs remains limited following the substantial reduction in systemic political risk since the summer of 2015. The upside, on the other hand, should gradually move closer to QE eligibility. Elsewhere we [remain cautious](#) on Portuguese government bonds (PGBs) due to the country's weak fundamentals and ratings situation and see far better risk-reward in Cyprus EMTNs due to stronger macro/fiscal fundamentals and a positive ratings trajectory and expect them to trade through PGBs.

In the high-yield space we think GGBs offer the most upside in the medium-to-long term.

Gilts to materially outperform forwards

We anticipate a material slowing of domestic private sector demand driven by much weaker real earnings and a sharp drop in investment in the UK. This will raise expectations of more QE, where Gilts will outperform forwards and cross market. The curve should flatten as investors extend duration to pick up yield.

In our view Gilts should outperform forwards with a flatter curve

Although the MPC moved back to a neutral bias following its November meeting and the publication of the Quarterly Inflation Report, we believe the next move in monetary policy will be further easing, and expect additional QE (and a small cut in Bank Rate) to be required by around the middle of 2017. This should be supportive of lower front-end yields in the UK. Specifically, we continue to [favour](#) receiving the front-end of the UK swap curve in forwards such as 2y2yF.

We expect the next move of the BoE will be further easing with additional QE and a small cut in Bank Rate around the middle of 2017

While net supply to the market (DMO sales less BoE QE purchases) at the long end may be somewhat lower than expected, we anticipate ongoing strong demand from UK institutional investors, as pension funds continue their asset reallocation. The rise in yields over the past three months has seen private sector DB scheme balances improve from a record £459bn deficit in August to £329bn in October, and as has occurred on previous occasions, this is likely to generate demand to receive long end rates to limit the risk of renewed deficit increases should those yields decline again in the future. These flows are likely to further boost the performance of long end UK sovereign debt relative to other markets.

Cross markets: Buy Gilts vs. Bunds or USTs as well as...

While US fiscal uncertainty complicates strategic duration positioning, we are substantially more comfortable in our cross market views. We expect long-end UK yields to materially outperform EGB peers and in particular the USTs. The sharp initial bear steepening of the US yield curve shows clearly that investors expect a Trump Presidency to lead to a big increase in long issuance to finance a large scale and aggressive infrastructure programme. While infrastructure spending is also expected to increase in the UK, the scale will be far smaller in relative terms. The UK Government has repeatedly made clear that any increase over the coming years will be modest, and will come from some front loading of existing pipeline projects rather than a new and sizeable wave of schemes. Some scheduled spending may be front loaded, but the quantum over the medium term is not likely to change, a distinctly different situation to the one now unfolding in the US.

We expect long-end yields in the UK to outperform materially against core EGBs and USTs.

We see no longer value in our previously advocated 10yr UST vs Bund tighteners (see [link](#)) given the uncertainty associated with the outlook for US nominal yields and the prospect of a large fiscal stimulus package resulting in higher inflation expectations. Instead, we continue to see value in cross-market positions involving our bullish view on Gilts and suggest [buying 30yr Gilts vs Bunds](#) or USTs (Figure 37).

In terms of cross markets we suggest buying 30yr Gilts vs. Bunds or USTs as well as...

... buy Aussie vs. USTs and Bunds

While Aussie bonds might not get as much of a beta boost from a move lower in yields as was the case in 2016, front-end rate compression vs. the US should still support longer tenors next year. Commodity headwinds no longer weigh on the economy, but the pick-up in inflation will be modest vs. global peers and downside risks remain. Against this backdrop buying Aussie vs. USTs and Bunds remains a strategic position we like (Figure 37). We see Kiwi bonds widening slightly to Aussie amid lesser drag from deflationary forces, but the carry appeal should limit the degree of underperformance. Our economists expect both the RBA and RBNZ to stay on hold in 2017, before hiking once (RBA) and twice (RBNZ) in 2018.

Inflation: We favour long-end TIPS breakeven wideners and also look for entry opportunities against euro area inflation

Despite the recent widening move in the US inflation-linked space, long-end and forward breakevens remain quite underpriced relative to realized core CPI inflation of 2.2% and the Fed's inflation objective (see Figure 38). We think relatively cheap US BEI valuations combined with an increased prospect of a meaningful fiscal stimulus, makes US breakevens quite attractive. Particularly, we prefer forward or 30yr breakevens to avoid sensitivity to oil futures and would use any tightening as opportunity to add. We do not think a potential repeal of the Affordable Care Act would have a meaningful impact on CPI healthcare as insurance premiums make up only small portion of core CPI. On a related matter, due to H.R.2 law, we continue to expect PCE healthcare inflation to remain below CPI healthcare. The former is affected by the H.R.2 law medicare payout caps. Thus, we expect core CPI-core PCE wedge to remain wide, which ultimately is bullish for TIPS and breakevens.

Also the euro area HICPxt has the potential to move higher from historically compressed levels. However, the potential to generate inflation expectations is more pronounced in the US. From this perspective we prefer strategic cross market trades and look to buy US breakevens relative to European breakevens if the relative spread narrows to less than 5bp in the 5y5y spread (Figure 38).

Long-end breakevens have risen more materially in the UK than the US during the recent sell-off in developed market sovereign debt (Figure 39). While 30y breakevens are now back at late 2013 levels in the UK, they are still some 50bp below those levels in the US. Even though we do anticipate acceleration in UK inflation over the next 2-3 years as a consequence of the big drop in the pound over the past year, this has very little relevance to long end valuations.

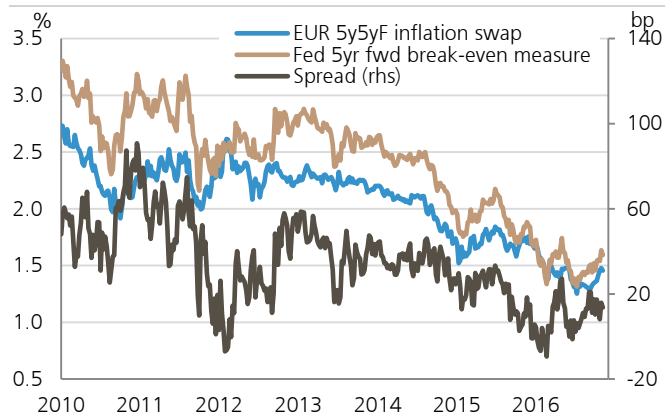
... buy Aussie vs. USTs or Bunds.

We would use any tightening to add to 30yr US breakevens wideners...

... and like buying US relative to European breakevens

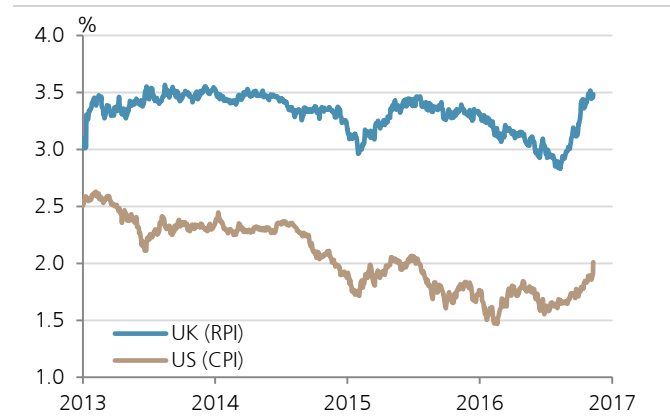
Long-end US breakevens also look low compared to UK equivalents

Figure 38: Forward inflation expectations: US & Eurozone



Source: UBS Investment Research, Fed, Bloomberg

Figure 39: Long-end breakevens have picked up some



Source: UBS Investment Research, Bloomberg

Figure 40: UBS global rates forecasts

	2017				2018			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US 10 year Bond Yield	2.15	2.20	2.25	2.25	2.30	2.40	2.45	2.50
UK 10 year Bond Yield	1.20	1.25	1.35	1.40	1.45	1.55	1.60	1.65
German 10 year Bond Yield	0.30	0.35	0.40	0.50	0.60	0.70	0.80	0.90
10y France spread to Germany (bp)	40	35	35	35	30	30	30	30
10y Italy spread to Germany (bp)	160	150	150	150	150	140	130	130
10y Spain spread to Germany (bp)	110	100	90	90	90	80	80	80
Swiss 10 year Bond Yield	-0.15	-0.15	-0.10	-0.05	0.00	0.05	0.10	0.15
Japan 10 year Bond Yield	-0.05	-0.05	0.00	0.00	0.00	0.00	0.00	0.05
Australia 10 year Bond Yield	2.60	2.60	2.60	2.60	2.60	2.70	2.80	2.90
NZ 10 year Bond Yield	3.00	3.00	3.05	3.10	3.10	3.25	3.40	3.55

Source: UBS Investment Research

Gold

PIVOTAL QUESTIONS

Q: Can gold rally in a rising yield environment?

Real rather than nominal yields matter for gold. Inflation, inflation expectations, the market's view on whether the Fed is ahead or behind the curve, as well as idiosyncratic factors in the gold market all need to be taken into account. Gold can rally as nominal yields rise if inflation/inflation expectations rise faster, such that real rates stay relatively low or even turn negative. A scenario where the Fed is perceived to be behind the curve would also be positive for gold. A fiscal package that has a modest growth impact would be neutral to moderately positive for gold given a more limited move in real rates and expected weakness in equities. On the other hand, a scenario where sizeable fiscal stimulus significantly boosts growth and real rates higher would mark a regime-change and be considerably negative for gold.

Q: Are risks to the base case symmetric?

No, we think there is more scope for downside from our base case. Downside risks have increased, following the US election, as markets have shifted focus towards the potential for expansionary fiscal policy to push real yields higher. There is still a lot of uncertainty around what the new administration's fiscal package might ultimately look like and the reality is that much is required to overcome the current environment of low rates for longer and slow growth. Nevertheless, the reaction across markets suggests that this is currently a major concern.

Q: What do gold fundamentals tell us?

We think gold's supply/demand fundamentals are broadly balanced, yet probably not sufficiently strong to provide the same support as in 2013 if the gold market was subjected to a similar pressure. Gold physical demand has been very weak this year, although the response in early Q4 did help stabilize the market and was quite encouraging. Given the recent weakness, the reaction of physical markets up ahead will be crucial. On the supply side, we expect mine production to be relatively flat and any hedging to remain limited to specific projects or some opportunistic transactions. And although scrap supply has increased this year, we do not view this as a huge threat.

UBS VIEW

Gold allocation within a portfolio is warranted given the low rates regime and macro risks. We think further gains in gold are likely to be driven by a continuation of strategic portfolio allocation from a diverse set of investors. While we've moderated our view to reflect recent moves in rates and risks up ahead, we think it's premature to call for a regime change. Gold remains under-owned and macro conditions should continue to encourage even broader participation in the gold market.

EVIDENCE

Gold has been tracking changes in real rates. Interest in gold emerged this year amid an environment of depressed global yields, sluggish growth and heightened macro uncertainty. That exposure to gold is still quite small relative to holdings of other asset classes has helped make the trend of diversification and strategic allocation into gold more resilient and sustainable.

SIGNPOSTS

We will be watching factors that affect real rates. A key focus right now is US fiscal policy and the impact on growth and inflation. Monetary policy at the Fed and other key central banks, nominal yields, oil and commodity prices are other factors to watch. We will also monitor cross-asset correlations as well as trends in physical markets by looking at trade data, differentials between local and international gold prices, changes in the loco swap rate between Zurich and London, scrap flows and producer hedging activity.

UPSIDE / DOWNSIDE SPECTRUM



Moderating our gold view

We have been positive on gold for some time and this view has been anchored on our expectation that rates would remain lower for longer, growth would continue to be tenuous and macro uncertainty would stay elevated. Against this backdrop, there is a compelling reason to hold gold within a portfolio as a diversifier and hedge. Recent market moves and the shift in focus towards fiscal policy after the US elections challenges this view in as much as the potential for significant fiscal expansion could drive growth and real rates substantially and sustainably higher. We think that it is premature to call for a game-changer for now, but it is prudent to acknowledge the recent sharp move in yields and the risks that lie ahead. We therefore moderate our positive gold view, now forecasting an average of \$1350 for 2017 from \$1400 previously.

To be clear, we are not changing our overall positive outlook on gold. We continue to see value in having gold exposure, considering the amount of macro uncertainty that lies ahead. Despite valid concerns about the potential for fiscal expansion to drive growth and real rates higher, the reality is that there is still much uncertainty around what the US fiscal package would look like under the new administration. Our view is that the bar is high for the low rates regime to be overcome. Given this scenario and considering that investor holdings of gold remain relatively small compared with other asset classes, there should be scope for the trend of strategic allocation into gold to continue up ahead. We therefore make no changes to our base case average price forecasts beyond 2017.

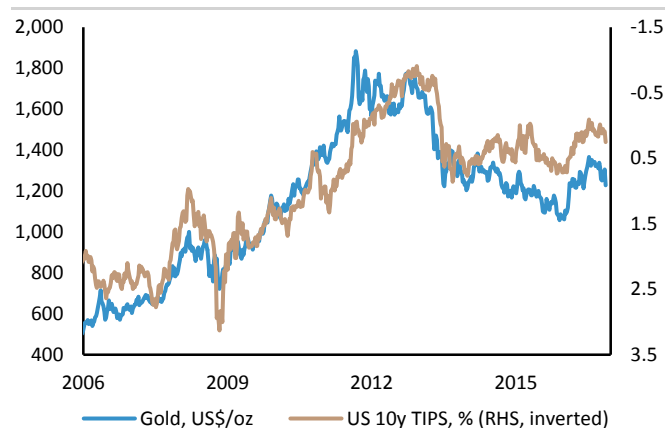
Looking ahead, we see the balance of risks skewed to the downside from here. At the extreme, the key risk at this point is that a significantly large fiscal package with measures that have a high growth impact – alongside structural, business-friendly interventions – would boost growth and real rates significantly and sustainably higher. The opportunity cost of holding gold would be much higher as the 'lower for longer rates' environment is overcome and as equities rally – the rationale for holding gold as a diversifier in a portfolio and as a hedge against uncertainty is considerably diminished in this scenario. In reality, there are a lot of hurdles and conditions that need to be met in order for this risk scenario to play out. We adjust our risk scenarios accordingly – we now see the upside case for gold next year at \$1450 from \$1500 previously and the downside case at \$1250 from \$1320.

We trim our positive gold outlook – we now expect gold to average \$1350 from \$1400 in 2017

The underlying story has not changed – we keep longer-term forecasts unchanged

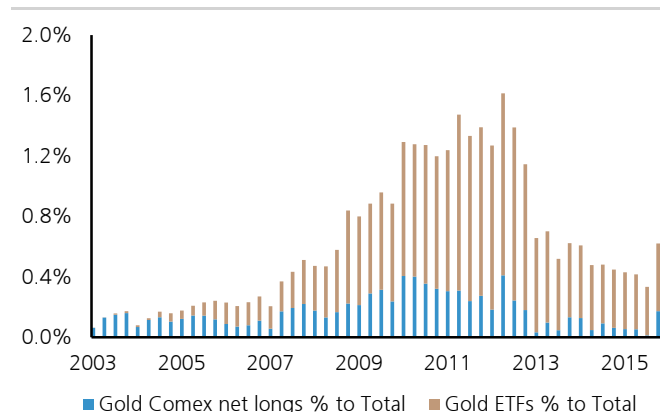
We see more downside risks to our base at this point, largely depending on how fiscal policy and real rates play out ahead

Figure 41: Gold and US 10y TIPS



Source: Bloomberg

Figure 42: Gold exposure as % to total AUM in US funds



Source: Bloomberg, CFTC, Morningstar, Various ETFs, UBS

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Credit

Credit

UBS Research THESIS MAP

PIVOTAL QUESTIONS

Q: Will the international demand for US credit persist given accommodative central banks?

A tidal wave of global investor cash is currently hitting US investment-grade and European credit markets. We expect central banks to remain relatively accommodative into 2017 which should continue to push investors into most developed market credits. It will take a severe widening in spreads to reverse this. However, US high-yield is an outlier as institutional and retail investors are actually pulling money out on net.

Q: How will credit market fundamentals evolve?

Fundamentally, conditions are weak, though not at dire levels. US corporate leverage is increasing and hitting new records for US high-yield firms. Earnings growth has been running well below S&P 500 reported earnings. We expect US high-yield default rates to remain elevated at 5-5.5% through mid-2017, but with the potential for this to move lower throughout the course of 2017, as oil prices increase and energy sector defaults subside. Developed market bank lending standards are mixed despite recent improvements for US corporates.

Q: Where are we looking for downside?

US high-yield is our weakest link. Asset class outflows, elevated leverage and sizable mutual fund and non-US investor holdings are worries. We would specifically avoid the retail/service, non-bank finance, and healthcare sectors. Retail/service names are facing headwinds from online retail penetration and consumer uncertainty. Non-bank finance lenders have eased standards and increased lending to low-quality borrowers. Potential political efforts to unwind the Affordable Care Act would likely hurt HY healthcare, given a concentration in hospitals and leveraged issuers needing to raise liquidity.

UBS VIEW

The technicals should trump fundamentals for most of DM credit, but perhaps not US HY.

We prefer BB-rated US floating rate bank loans. Yields are 4.2% and the asset class provides a lower beta to market and duration risk than US HY. US IG credit should earn carry in 2017, but more two-way rate risk makes a repeat of 2016 unlikely. We expect limited total return for EUR IG, underpinned by the ECB's continued support. On a relative basis, in EUR credit, we prefer HY as the ECB CSPP forces investors down the credit curve.

EVIDENCE

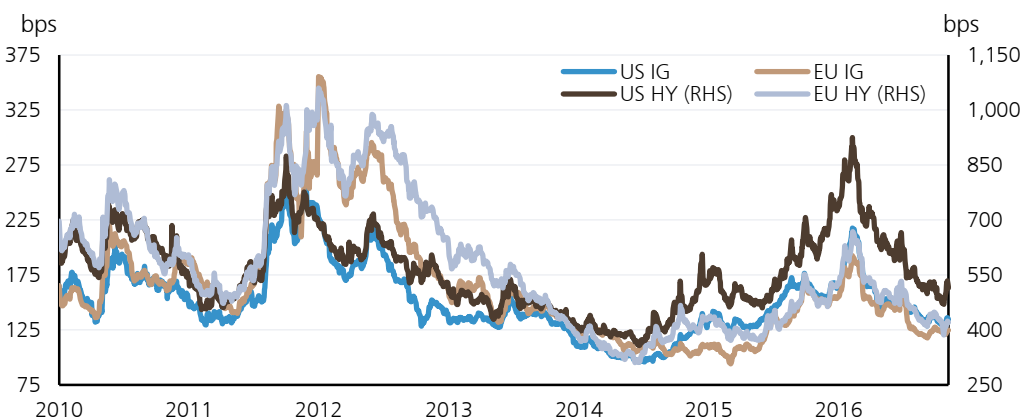
Global flows into US IG credit and EU IG/HY credit are soaring and we expect central banks to remain reasonably accommodative in 2017.

In particular, the ECB's QE program will still purchase a substantial share of net EUR credit supply next year. US floating-rate bank loans have yields that are historically attractive relative to US HY, with less risk. US high-yield remains an outlier with asset class outflows, near-record leverage, worse earnings, more tenuous lending conditions, and greater illiquidity risk.

SIGNPOSTS

Global credit flows and central bank monetary policy will be key to informing our technical views. More hawkish central banks would interrupt the story that has boosted credit this year. Sustained inflows to US high-yield would show that the bid for yield is spreading. **Corporate earnings will be key for our fundamental views.** Weak earnings would push high-yield leverage to record levels, and feed into tighter lending conditions and higher losses.

RECENT PERFORMANCE



The performance of 2017 developed market credit should resemble a tug of war between 1) strong technical inflows versus 2) weak fundamentals and expensive valuations. The technical picture should win out for most markets. However, there are concerns lurking in US high-yield. Accommodative central banks will continue to push yield-hungry investors into most developed market credits. A tidal wave of global investor cash has already splashed onto the shores of US investment-grade and European credit markets since the ECB announced its first sovereign QE program in Q1'15 and the BOJ introduced negative interest rates (Figure 43). This demand will be difficult to satiate, particularly from non-US investors. We do not believe a *measured* increase in sovereign yields will quell this demand; it will take a *material* spike in government yields, widening in credit spreads, increase in default rates, or uptick in rating downgrades to alter the preference for credit.

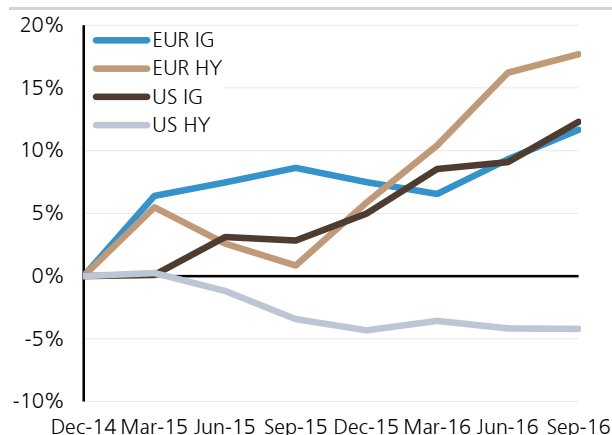
Yield hungry investors and ECB corporate bond buying will support 2017 US IG and EU credit

For Europe specifically, the ECB provided a strong bid for credit since the announcement of its corporate bond buying program (CSPP) in Mar-16, with rising fund flows seen thereafter from ETFs and mutual funds (Figure 44). In the aftermath, the Euro IG primary market was on track to have its busiest year ever, at 5% above last years' run rate. Purchases have ebbed and flowed, with the overall trajectory upwards to that averaging €1.7bn. European credit spreads tightened significantly in the run up to the operational start date of June 8th (CSPP) as the average yield on Eurozone high-grade corporate bonds more than halved. As a sign for how sensitive EUR credit is to monetary policy, ECB eligible bonds underperformed the wide index as the prospect of reduced ECB QE came to the forefront. For October, ECB purchased bonds and iBoxx EUR non-financial senior index returned -0.51% and -0.45% respectively. ECB purchased bonds had returned 0.02% in Sept vs -0.26% in Aug. At the 8-Dec-16 ECB meeting, our base case is the likely extension of QE for six months (beyond Mar-17) with purchases up to €80bn per month including both PSPP and CSPP.

However, US high-yield is an outlier to the story above. [Institutional and retail investors are pulling money out on net](#). And other factors that supported the 2016 rally are fading. According to the Investment Company Institute (ICI) high-yield manager cash balances have moved from elevated Q1 levels to now below average. In addition, after a massive 2016 rally, HY energy spreads may be pricing in long-run WTI of up to \$61 (Figure 45).

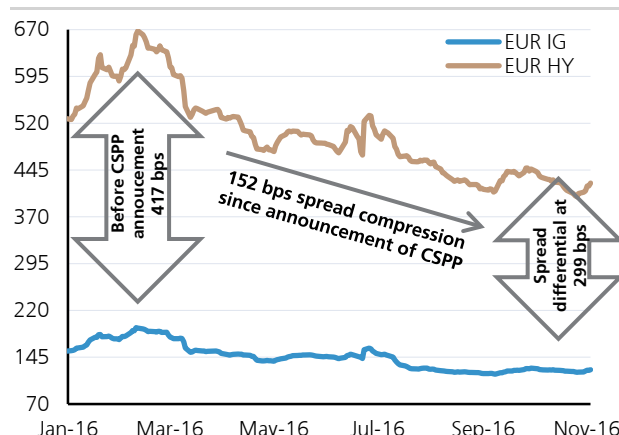
But US HY needs a new story. 2016 outflows were seen even with major tailwinds. Those tailwinds are abating.

Figure 43: Global flows are flooding most, but not all, global credit markets (cumulative flows % AUM)



Source: eVestment, UBS

Figure 44: The ECB has pushed European investors to move into European high-yield bonds.



Source: UBS, Markit

[Fundamentally, conditions are weak, though far from dire levels, and better for US investment-grade firms.](#) US corporate leverage is increasing, and is hitting new records for US high-yield firms (Figure 46). We expect more of the same in 2017. For US high-quality companies, robust demand for yield and modest revenue growth will likely encourage M&A activity and share buybacks. The one positive is that US investment-grade firms may have scope for earnings improvement, on the back of dollar base effects and low interest rates. High-yield faces more headwinds. [Earnings growth produced domestically has been running below S&P 500 earnings, and these profits will not benefit from a weaker dollar.](#) We expect US high-yield default rates to remain elevated at 5-5.5% through mid-2017, but with scope to move lower throughout 2017 as oil prices increase and energy defaults subside. We expect a continued increase in C&I bank NPLs and a [new increase in consumer bank NPLs](#). However, this will be offset by falling residential NPLs.

Bank lending standards are also mixed despite recent improvements for US corporates (Figure 47). Q3 EU bank standards show conditions for consumer and mortgage loans continued to ease, while standards for non-financial corporates were unchanged. Q3 US bank standards did improve notably, but does this mean we have started a new easing trend? [One way to gauge is to look at higher-frequency non-bank lending conditions.](#) While non-bank conditions have improved from the Q1 recession scare, they are still weak and they deteriorated slightly in October. Bond issuance is still down 38% YTD for firms at high risk of default (CCC-rated).

Lastly, modestly expensive valuations underlie our cautious stance. US high-yield credit spreads are 54bps too tight via our fundamental spread model. Current spreads are 515bps vs. our model estimate of 569bps in 6 months (Figure 48). [However, sizeable fund ownership of US high-yield in particular means that volatile 2016 price swings may be the norm for the foreseeable future](#) (Figure 49).

Our preferred views in **US credit** fall out of this framework (Figure 50). **BB-rated US floating rate bank loans remain attractive relative to US high-yield** (Figure 51). Current yields are 4.2%, and 3 Fed rate hikes through YE 2017 should further boost coupons. Loans boast a lower beta than US high-yield due to their seniority in the capital structure and higher historical recovery rates.

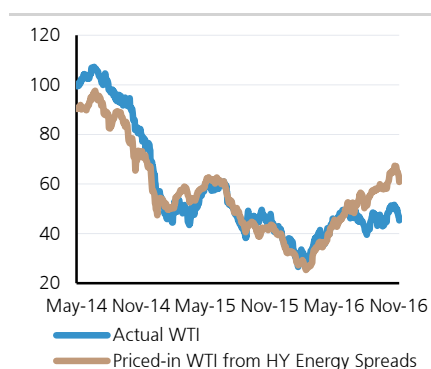
Leverage is near records. Earnings growth will be critical in 2017.

US and EU bank lending standards are neutral. US non-bank lending standards are stuck in tightening mode.

Credit spreads are now only modestly expensive. But remember illiquidity risk for HY.

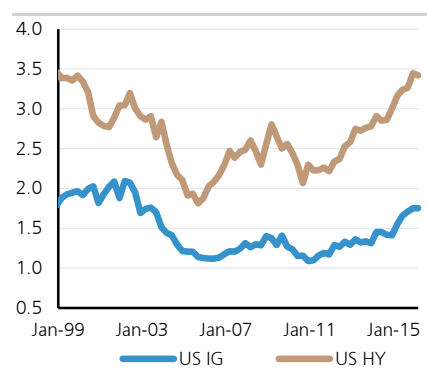
Floating-rate bank loans provide attractive yields, with less beta and duration risk than US HY

Figure 45: The rebound in oil prices is already priced into HY energy credit



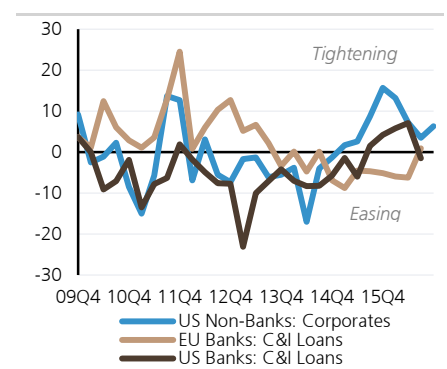
Source: Bloomberg, UBS

Figure 46: US Corp Leverage is Rising (Median Net Debt to EBITDA)



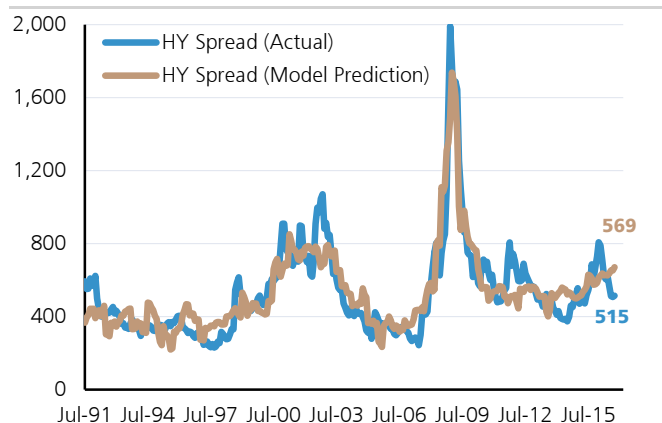
Source: Worldscope, UBS

Figure 47: Corp Lending Conditions: Still Tight, Will we improve further?*



Source: Bloomberg, UBS, *Net % of banks tightening (>0) or easing (<0) standards.

Figure 48: US High yield spreads are moderately expensive

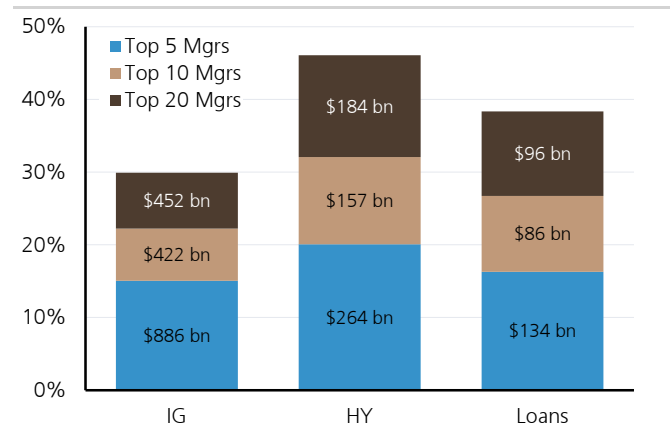


Source: Yieldbook, UBS

The desire for quality and yield in size means the \$6tn+ US IG market will hold in well. We do not believe rate risk will deter non-US demand for IG paper, unless this begins to materially impact growth. We could potentially see a 2017 technical tailwind if supply is reduced, due to political efforts on US corporate overseas cash repatriation. However, greater rate volatility and more expensive spread valuations make a repeat of high single digit to lower double digit 2016 returns unlikely.

On a relative basis, in EUR credit, we prefer HY over IG as the ECB CSPP forces investors down the credit curve. We expect limited total return for EUR IG, underpinned by the ECB's continued support. The flat yield curve favours going out the credit curve to lower quality HY credit. EUR HY has higher rated issuers, less duration, and low default risk. Only 2% of EUR HY bonds are CCC rated. Primary EUR HY issuance has not taken off as it has with IG, which is also supporting overall spread levels (EUR HY issuance is down 22%, whereas EUR IG is ahead 5% from the same period last year). We expect some continued investor rotation out of EUR IG into EUR HY supported by the lack of new issuance. We like fallen angels with liquid curves and hybrid bonds of IG rated issuers where we believe spreads levels should compress further.

Figure 49: Global asset manager holdings of US credit increase illiquidity risks *(% of total market value)

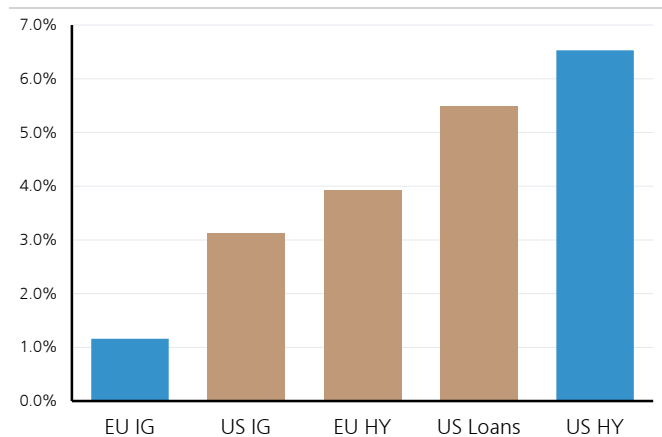


Source: eVestment, UBS

US investment-grade won't see 2016's lofty returns, but will do well; the bid for quality yield won't be broken easily

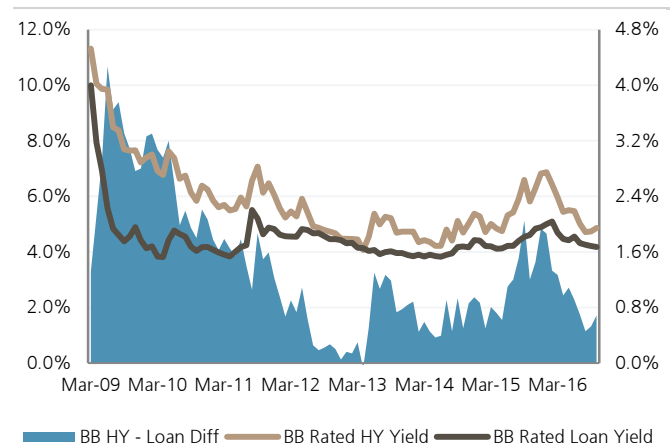
The ECB will still be purchasing most of net EUR credit supply in 2017. Investors will continue to migrate to EUR HY

Figure 50: DM Credit current yields (UBS preferred markets in brown)



Source: Yieldbook, Markit, UBS

Figure 51: BB rated loan yields are similar to BB US high-bond yields, with less risk.



Source: Yieldbook, S&P LCD, UBS

US high-yield is our weakest link. Asset class outflows, elevated leverage and sizable mutual fund and non-US investor holdings are worries. We would specifically avoid the retail/service, non-bank finance, and healthcare sectors. Retail/service names are facing headwinds from online retail penetration and [consumer uncertainty](#). [Non-bank finance lenders have eased standards and increased lending to low-quality borrowers](#). And healthcare firms are struggling due to regulatory/political concerns over drug pricing and major increases in healthcare costs that could slow consumer spending on these items.

US HY is the riskiest market. Avoid retail, non-bank finance, and healthcare (hospitals) specifically.

Figure 52: UBS global credit forecast

End-2017	
US IG	145bps
US HY	570bps
EUR IG	133bps
EUR HY	479bps

Source: UBS Investment Research

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Emerging Markets

PIVOTAL QUESTIONS

Q: What returns do you project for EM assets in 2017?

We forecast 5% returns in EM equities and 3% in EM debt in 2017. On a Sharpe ratio (risk adjusted) basis, though, we see debt outperforming equities. Within EM debt we usually find hard currency debt much more attractive, and over the long haul that remains our preference, but we find there are several dislocations within local currency debt that investors can take advantage of. We see EM FX depreciating 4% in trade-weighted terms next year.

Q: What would be needed for an encore of this year's strong performance?

EM assets prospered in 2016 amid a combination of falling US real rates and falling global volatility. The Fed's focus on a falling r^* regime, a 5-year high in China's credit impulse that fuelled property-centric growth and commodity price upside, and oil's rebound out of distressed territory all helped EM assets to re-rate strongly. With this degree of external love unlikely to be repeated in 2017, the onus will fall increasingly to EM growth to motor returns. Orthodox EM policy responses to recent uncertainty and stronger reform momentum will likely be needed to sustain recent re-rating.

Q: Won't EM bounce back as soon as US rates stabilise?

While UBS doesn't expect US real rates to rise aggressively next year, even stability stands in sharp contrast to the big declines in 2016. Without further declines in US real rates, we think further revaluation of EM assets will become harder, and find that currencies will drift weaker. Modest growth and gradually deteriorating balance sheets are the key culprits.

UBS VIEW

Slow motion commotion for EM assets. There is no obvious trigger for EM assets to 'blow up', assuming UBS' forecasts for broadly stable commodity prices and DM rates hold true. EM real rates and current accounts are on a stronger footing compared to 2013, and EM has witnessed lesser hot money inflow and a strong re-pricing of FX volatility. However, in an environment of slowing globalisation and modest growth, earnings and exports are likely to remain under pressure, posing a drag on total returns.

EVIDENCE

A host of our valuation frameworks point to headwinds for further EM asset re-rating. We model EM FX returns since 2005 and highlight the need for easy US liquidity and improving balance sheet quality for currencies to stand still. Our EM's macro balance sheet and measures of competitiveness point to a very limited reform drive within EM. EM's growth acceleration will be confined to a few commodity exporters, with US-EM growth differentials generally set to compress.

SIGNPOSTS

Trade protectionism has only contributed 7% to the slowdown in global trade so far, we estimate, but risks are clearly rising. A busy **political calendar in Europe** next year may tell us by how much. **China's property sales momentum** has spurred a rebound in construction, which should dissipate through 2017. The pace of any slowdown here should have a strong bearing on commodities and EM assets. Given its contribution to returns this year, **Brazil reform momentum** will be watched closely.

RECENT
PERFORMANCE

Summary of 2017 asset calls in EM

We believe 2017 will present a more challenging environment for EM assets. At a broad level we are expecting about 5% returns in EM equities next year and 3% in EM debt. Despite this configuration of total returns, on a risk adjusted basis we much prefer EM debt to EM equities. Within EM debt we usually find hard currency debt much more attractive, and over the long haul that remains our preference, but we find there are several dislocations within local currency debt that investors can take advantage of. We see EM FX depreciating 3% against the USD next year, with risks likely skewed towards higher depreciation.

3-5% returns in EM assets next year. On a risk-adjusted basis, debt should continue to outperform equity.

Will 2016's return drivers remain in place?

Let us briefly consider the drivers of EM's strong performance thus far into 2016, and, simultaneously try to assess whether these trends can extend their benign influence over the coming quarters and years.

EM r^*

In 2016 Fed communication was dominated by a loud and unanimous admission that the real neutral rate has declined precipitously. Both long dated Fed dots and the long term real rates declined sharply as a result, matched step for step by falls in real rates in Europe (Figure 53).

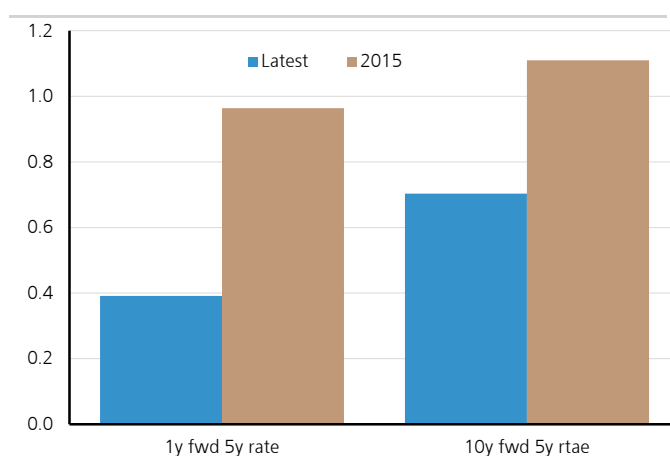
Falling rates and volatility (till recently) drove EM in 2016. This tailwind loses strength in 2017

While we still don't believe DM real rates will rise aggressively next year, even stability stands in sharp contrast to the big declines in 2016. DM rates will remain at very low levels, keeping a search for yield mentality alive, but without further declines we think further revaluation of EM assets will become harder.

Even stability in real rates will make for a big change from the backdrop this year

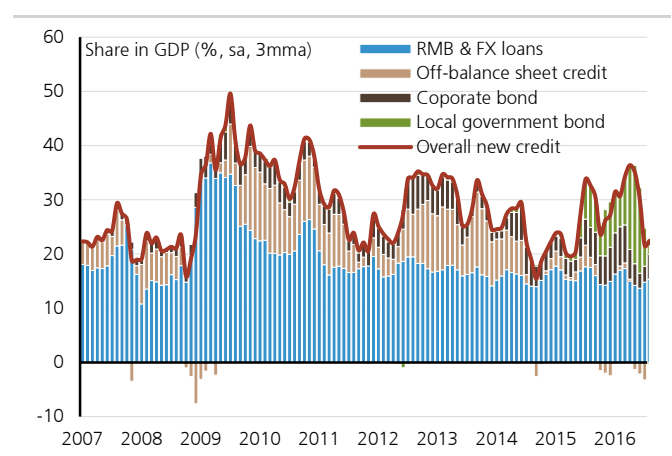
Importantly, in 2016, real rates declined in an environment of falling volatility. The Fed's focus on financial conditions was a crucial communications tool keeping the USD on the back foot and limiting volatility, but at least two other factors helped – China and oil.

Figure 53: US real forwards: Now and then



Source: Bloomberg, UBS

Figure 54: China credit impulse



Source: Haver, UBS China Economics

Safe as houses in China?

China's credit impulse in '16 (Figure 54) was of similar size to the 2012 expansion, and importantly property construction responded strongly to the phenomenally strong sales growth in tier 1 and 2 cities. In 2017 we are expecting only a 0.3 ppts decline in Chinese GDP growth but we think property construction growth could fall by up to 4 ppts from 8% y/y in 2016. While infrastructure spending growth should strengthen further, this form of investment makes far fewer demands on metals than does property construction.

Will oil continue to lubricate financial conditions?

Oil prices rose nearly 80% from their January bottom, easing global financial conditions, both in energy and non-energy sectors, and bringing risk premia down sharply. The combination of declining real rates and rising commodity prices made for a significant re-rating in EM assets. As a base case UBS assumes Brent crude oil prices average \$60/bbl in 2017.

If, however, oil upside remains driven by supply (rather than demand or USD weakness) our earlier research has found that EM assets will not necessarily respond positively (see Figure 55 and Figure 56; [Can higher oil prices reflate global markets?](#)) A supply-driven squeeze higher in oil did help to bring down risk premia from distressed levels in January this year, but at its present, more rational, level the correlation between oil and risk premia is diminishing.

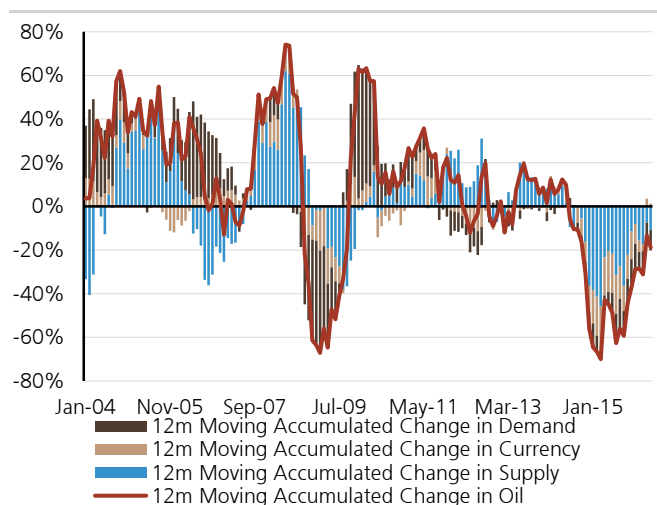
Isn't EM growth itself on the rebound?

Our narrative thus far suggests EM was the recipient of several tailwinds this year; that it got lucky, but that intrinsically it has done little to heal itself. That may be a bit harsh. EM growth has stabilised at around 4.4% and into next year is seen rising further 4.9%, and to 5.1% in 2018. Note, however, that growth improvements in commodity-producing countries – Brazil, Russia, and Venezuela – account for more than 110% of the growth improvement forecast in 2017. Most Asian economies meanwhile are seen decelerating modestly.

Oil prices may mean less for EM next year than they did in 2016 both because % changes will be lower, but also because supply side driven increases don't necessarily help EM assets

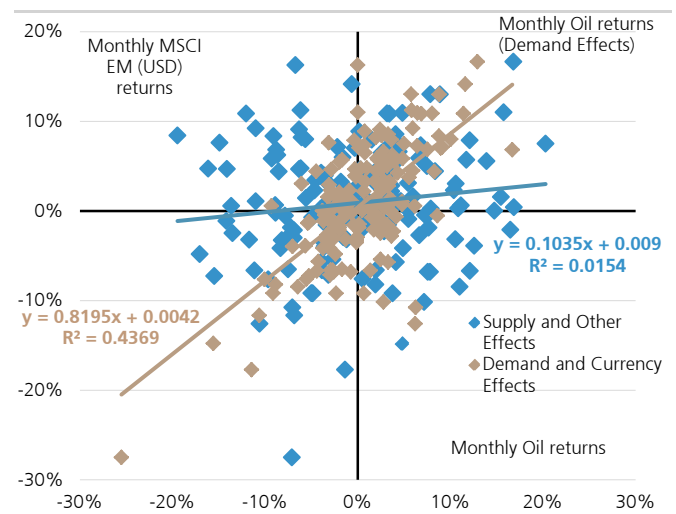
We are expecting some improvement in EM growth next year, but it is very narrowly based around LatAm economies

Figure 55: Demand and supply drivers of oil prices



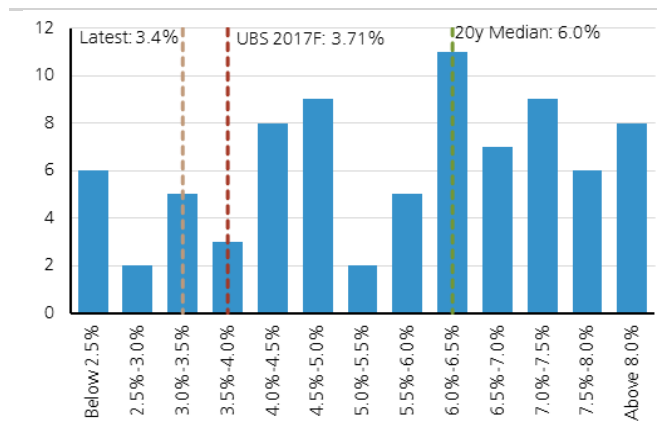
Source: UBS

Figure 56: MSCI EM \$ returns and supply induced changes in oil



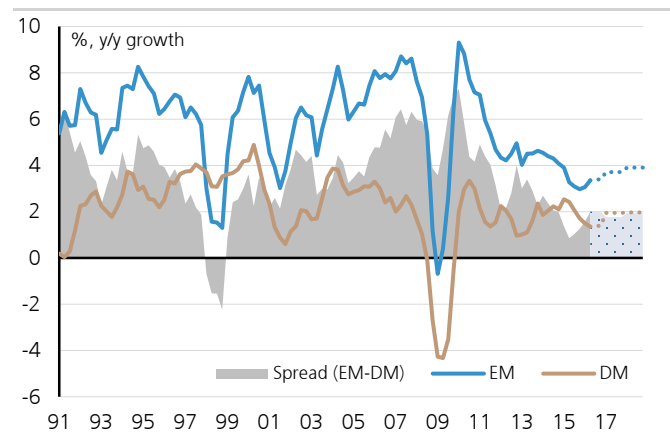
Source: Bloomberg, UBS

Figure 57: MSCI weighted EM growth : 20y distribution



Source: CEIC, Haver, UBS

Figure 58: MSCI weighted EM and DM growth, and spread



Source: CEIC, Haver, UBS *dotted lines represent UBS Forecasts

On an MSCI weighted basis our economists project EM growth going from 3.5% to 3.7% (Figure 57), but more importantly, on this measure the spread between EM and DM growth is actually slipping by from 2% this year to 1.7% as DM growth picks up, led by the US (Figure 58).

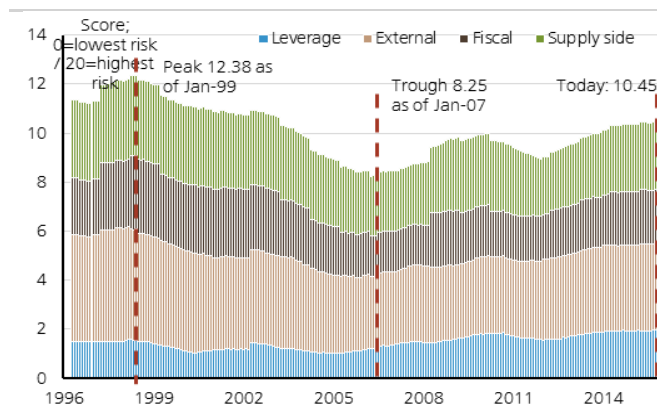
On an MSCI weighted basis, EM's growth spread over DM will fall next year.

Heading into 2017 EM's external imbalances are the smallest they have been in 5 years, barring a few commodity exporters. However the improvement in EM current accounts is largely behind us. In addition with fiscal metrics likely staying under pressure, we think EM macro balance sheet risk is unlikely to improve materially (Figure 59).

Overall, it is clear that thus far in 2016 EM assets have been helped by several tailwinds. In 2017 these benign influences are likely either to weaken (rates no longer falling, oil prices rising but by less and for supply-side reasons, MSCI EM growth rising but less than DM growth), or reverse (China property construction growth slowing down). This by itself says to us that gains in EM are likely to be more limited in 2017 than in 2016. This is even before we consider rising risks from trade protectionism. If protectionism intensifies and investment globally fails to pick up, EM trend growth risks falling to as low as 3.4% vs. 5% projected over the medium term by the IMF (Figure 60). We have written about these extensively in a series of publications on [What](#), [Why](#) and [So-What](#) of slowing globalisation.

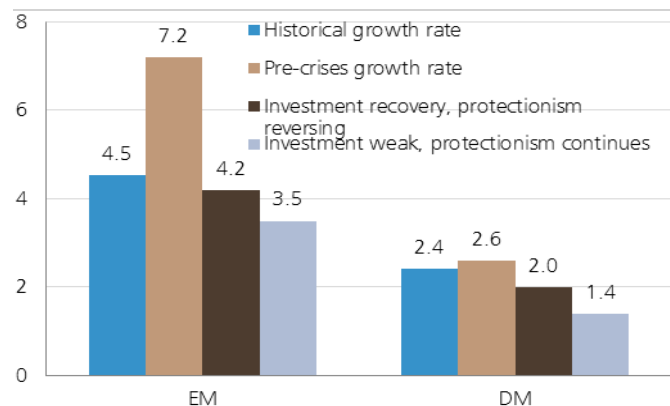
Although it doesn't feel like it after the last week, this has been a year of special tailwinds for EM.

Figure 59: EM Macro balance sheets: Watch fiscal risk



Source: Haver, UBS

Figure 60: EM and DM growth in different trade scenarios



Source: UBS

Local rates: Good opportunities in this asset class

The only asset class where EM spreads relative to DM are still quite attractive, at the 70th percentile of their 5 year history, is local currency bonds (Figure 61). There are three challenges that typically confront this asset class: a) weakening currencies, b) a big shakeout in global rates, and c) rising EM inflation.

Starting in reverse order, we don't believe higher inflation is a big risk for EM next year (Figure 62). Higher commodity prices have already pushed up PPI and headline CPI, but sequential core inflation remains weak due to negative output gaps, and high leverage. This will eventually pull down headline CPI as well. UBS sees the spread between headline EM and DM CPI falling to its lowest level in 15 years.

2013 brings back bad memories of a backup in US yields hitting EM duration. We find that controlling for other variables the beta of EM rates to US rates turns from less than 1 to greater than 1 only if US yields rise more than 40 bps over two months. This is what is happening at time of writing, particularly in some markets like Mexico, Turkey and Brazil, but we don't believe that the selloff in DM yields will continue. The widening of the spread today provides a good opportunity to get long.

Currencies do remain a big risk for duration in EM, and this is why the local bond trade has to be taken on in a very selective manner. However, we think this risk can generally be managed by a) either hedging for the currency risk directly in steep EM curves, or b) looking for low yielding commodity currencies in the developed market space to hedge away some of the commodity and USD risk. We think of CAD and AUD as potential funders in this regard. At an aggregate level the returns in this asset class may be in the range of 2-3% but individual opportunities such as Brazil bonds financed in the AUD, Russian bonds financed in CAD or receiving the front end to belly of Mexican swaps can give much higher returns.

EM Inflation will remain well behaved.

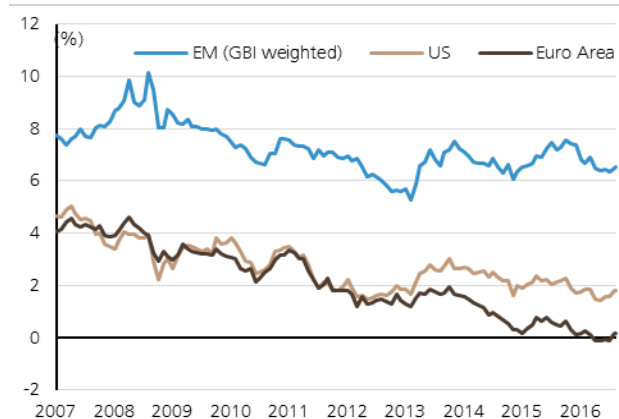
We are not expecting a continued back up in US yields

Currency weakness is the real risk, but it can be mitigated

Equities: Can EM build on its RoE improvement?

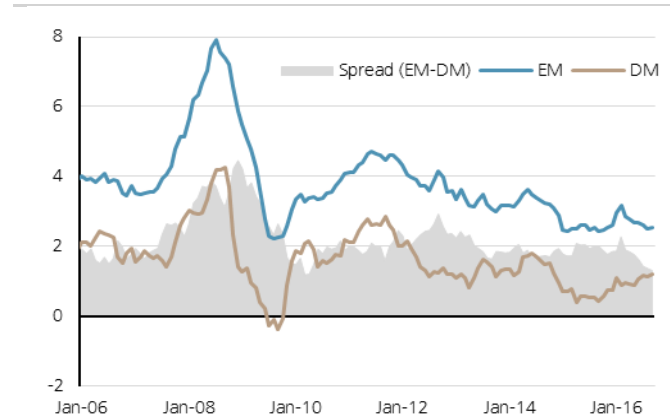
EM equities have had a very strong run this year, propelled in the main by a fixed income engine rather than a big rebound in non-commodity earnings. LatAm equities were the main beneficiaries of global love, helped by the promise of reform and bottoming growth in Brazil, which itself has accounted for 40% of MSCI EM's rally ytd.

Figure 61: GBI-EM, US(10y) and Eurozone (10y) yields



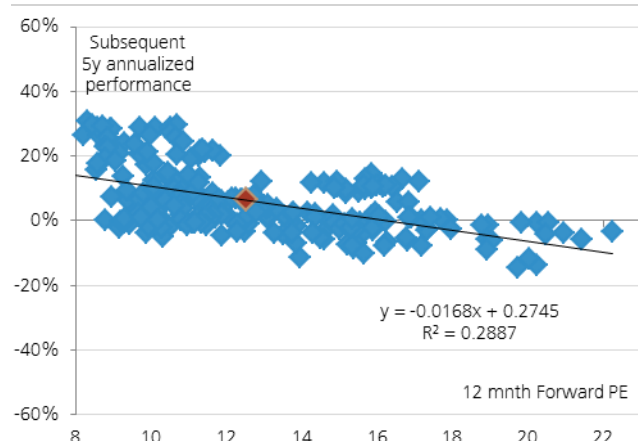
Source: Haver, UBS

Figure 62: EM DM CPI and spread: One big positive for EM



Source: Haver, UBS

Figure 63: MSCI EM Forward P/E and subsequent 5-yr. annualized returns



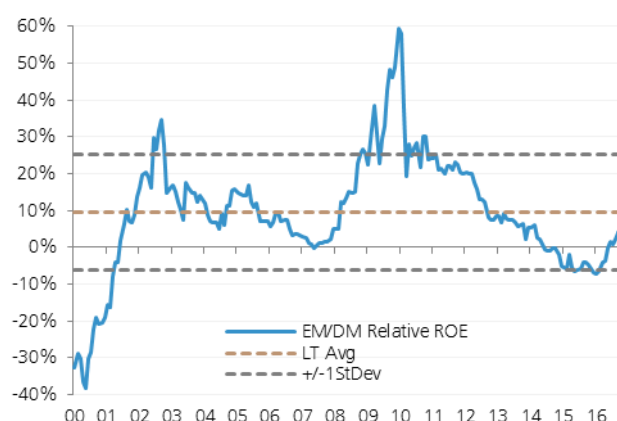
Source: Datastream, UBS

The 25% EM rally since late-January has pulled valuations on MSCI EM (around 12x forward) above long-term averages (10.9x)¹. From these levels of valuation, historically the 5 year annualised return has been close to 6.5% (Figure 63). However, we think historical narratives may be generous as they fail to pick up the structural change in trade growth, the drift weaker in EM FX and associated risk of a more volatile to cost of equity. We've noted in recent research how EM revenues are much more sensitive to weakening trade than DM (Figure 65).

Based on weaker headline and export growth, a modest continuing rebound in oil, and no improvements in macro balance sheets, we estimate 2017 EM earnings will come in at 6-8% vs. a consensus of 13%. Against this, as (MSCI weighted) currencies are likely to decline by roughly 3%, and the case for valuation isn't strong, we think EM equities can rise roughly 5% next year.

The big issue to look out for next year in EM is whether a nascent rebound in EM RoEs can continue. Thus far the rebound has really been concentrated in the commodity heavy sectors in EMEA and LatAm. A strong growth impetus in the US is an upside risk for the other sectors in EM, and will need to come through for EM to outperform developed markets on a sustained basis. Amongst the non-commodity sectors we are seeing some evidence of upticks in financials EPS, but thus far this is more because of a decline in provisions rather than a pick in credit growth.

Figure 64: EM/DM relative return on equity



Source: Datastream, UBS

There isn't a big valuation argument to be made in favour of EM

We look for 6-8% EM earnings next year. Aggregate returns should be lower at around 5% given some weakness currencies.

Stronger than expected US growth may help EM RoE

Figure 65: Assessing sensitivity to trade: a simple revenue growth model for EM and DM

		Trade Growth					Trade Growth		
EM		15% down	No change	15% up	DM		15% down	No change	15% up
Commodity Prices	15% down	-16.12	-4.98	6.15	Commodity Prices	15% down	-10.74	-3.13	4.47
	No change	-10.82	0.32	11.45		No change	-8.52	-0.92	6.69
	15% up	-5.52	5.62	16.75		15% up	-6.31	1.30	8.91

Source: Haver, IBES, UBS

¹ While EM looks considerably cheaper on a P/BV basis (1.56x v. LT avg of 1.83x), this discount is justified by weak average ROEs (10.4% v. LT avg of 13.1%).

EM currencies: When the music's over

After 4 years of intense weakness against the USD, EM currencies enjoyed strong total returns this year even if the overall gains were limited to a small subset of Brazil, Russia, Colombia, South Africa and Indonesia. The most apparent common thread amongst these is that they are all commodity producers, but the other, less obvious pattern is that most of them have seen strongly lower inflation, making for strong fixed income inflows. EM currencies have been driven by rates and commodities. We think the rates theme can persist, we are less confident about commodities and would prefer to hedge this risk.

We feel more confident that, owing to still tepid growth, high leverage and weak credit impulse, inflation will not pick up meaningfully in EM. But the picture for commodity prices is a mixed one from here – UBS expects oil to drift higher, but also sees slowing Chinese property construction leading to declines in iron ore. This is why thematically we'd be looking for structural FX positions in places where we also like the fixed income space. Brazil and Russia are cases in point.

We must state clearly though that we don't believe EM currencies are competitive, and for this reason at an aggregate level we see them drifting weaker over the long haul. In order to understand why, it is important to recognise the underlying drivers of EM currencies, both against the USD, and in trade weighted terms.

We find that movements in USDEM are driven mainly by US rates (lower US real rates = lower USD EM) and commodity prices (higher commodity prices = lower USDEM). EM growth and credit fundamentals are also significant, but less consistently. However, when we model changes in EM nominal effective exchange rates, it is changes in EM growth and credit fundamentals that emerge as exerting a more powerful and statistically significant influence.

What does this tell us? It says that in movements in USDEM are picking up factors that are associated the USD itself – US rates and commodity prices. We are not trading EM there, we largely trading the USD (which can also be traded against other currencies such as EUR or AUD). However, if we are looking for intrinsic, EM specific, appreciation, one typically needs to see EM trade volumes improving, productivity rising, and credit fundamentals improving. Failing this, the drift in EM nominal effective exchange rates is towards the weaker side.

For this reason, once we have identified the weak spots in EM, we think it is sensible to play them against a basket of currencies rather than just the USD alone. This is the way we are thinking about currencies in Asia, which continue to suffer weak export volumes. In 2017 we would look for about 3-4% weakness in trade weighted terms. USDEM should rise modestly less than this (as we still expect EUR to move higher) by about 3%.

Are we trading the USD or EM when trading USDEM?

To understand the fundamental drivers of EM itself it is necessary to look at EM in trade weighted terms. Export volumes and macro balance sheets and US real rates are key drivers here.

Play for trade weighted weakness in EM, particularly in Asia

Credit: The ageing rock star will hold its own, but don't expect the flair of its younger years

Combining EM's strength in its balance sheets (relative to their weak income statements), and limited issuance, hard currency sovereign paper in EM has been a great investment. Corporate issuance has been higher but this asset class has also been supported the fact that nearly 35% of outstanding paper is government backed, explicitly or implicitly.

When we model EM sovereign spreads relative to our macro balance sheet score, a proxy for global risk appetite and commodity prices, we find that current spreads are trading roughly 15 bps tighter to fair value. However, as we have noted before, EM's macro balance sheets are now slowly worsening as fiscal pressures increase at present low levels of growth. By our calculations this should make for a natural crawl wider of a further 20 bps a year in EM sovereign credit spreads. Assuming a 30-40 bps widening in credit, and a 15 bps rise in core rates yields a 2.5-3% estimate of total returns in hard currency sovereign bonds for 2017.

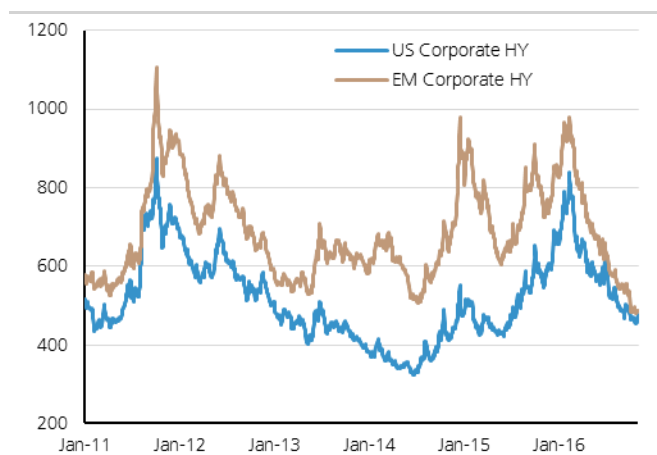
However, as with equities, there is a lot going on beneath the aggregate. Just a few weak credits are much wider relative to history, and have pulled up the EM aggregate towards its median. Without these small and low rated sovereigns EM is in fact much tighter relative to its past and relative to fundamentals.

The valuation stretch is even more true in the corporate space, particularly so in high yield corporates. Here spreads against US HY have shrunk to zero (Figure 66), and the prices have moved well ahead of underlying fundamentals such as commodity prices. Based on their past relationship, the current level EM HY corporate spreads are consistent with oil prices at USD 80 per barrel (Figure 67). Against a 30-40 bps widening in sovereigns we would look for a 50-70 bps widening in EM corporate yields, which would make for total returns between 1-2% next year. .

We would expect 2.5-3% total returns in EM hard currency sovereigns next year

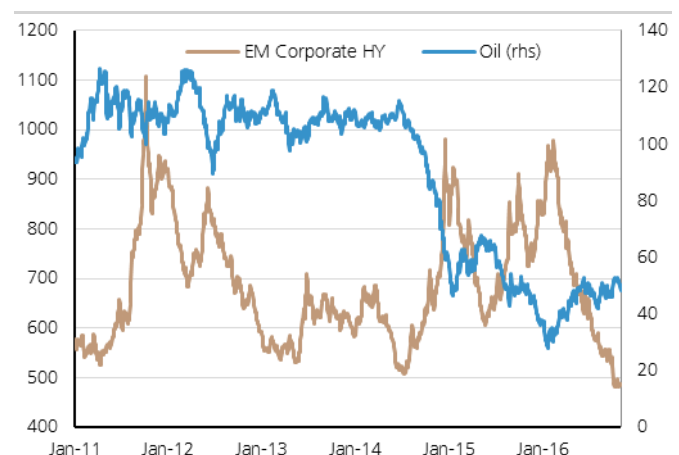
Valuations are way more stretched in EM corporates, particularly in the HY space

Figure 66: US v EM HY corporates: No premium left



Source: Yield Book, Bloomberg, UBS

Figure 67: EM HY corporates vs Oil: Good news more than priced in



Source: Yield Book, Bloomberg, UBS

Valuation Method and Risk Statement

Risks of multi-asset investing include but are not limited to market risk, credit risk, interest rate risk, and foreign exchange risk. Correlations of returns among different asset classes may deviate from historical patterns. Geopolitical events and policy shocks pose risks that can reduce asset returns. Valuations may be adversely affected during times of high market volatility, thin liquidity, and economic dislocation.

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