Global Macro Strategy

2016 Global Macro Strategy Outlook

Strategy

Global

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Global macro and markets in 2016

We sketch the broad macro trends that we believe are likely to dominate markets in 2016; for each trend, we focus on the opportunities, the risks and the trades to consider.

The broad macro trends

Our economists' forecasts envisage another year of moderate global growth in 2016. Inflation will likely edge higher due to technical reasons but it is likely to remain at low levels. And persistent global disinflation is likely to continue to anchor monetary policy at accommodative levels.

The underlying macro themes and twists

But despite the broad similarities, 2016 will be a year with macro twists. The Fed will likely proceed with rate hikes, albeit at a slower pace vs past cycles and aiming at a lower terminal rate. In further contrast, 2016 is likely to be a year of accelerating growth in the Euro-area as the recovery in the credit cycle extends and as monetary and fiscal policy are set to ease. Finally, growth in China likely decelerates further, but in a controlled fashion. Instead, the side-effects will likely be more pronounced for EM economic growth (remaining weak) and DM inflation (likely to stay low).

The opportunities across assets

Our global macro backdrop is supportive for equities. However, the ex-ante risk-reward is likely to deteriorate, especially in the US. Although there are some downside risks to bonds (particularly in core Europe), we do not expect a meaningful departure from the environment of low global yields. The EUR and the USD are likely to appreciate on a trade weighted basis, while Asian FX, G10 small open economies' and EM currencies are likely to depreciate at varying degrees. Global credit trends will likely be mixed with Euro-area credits outperforming EM and low-quality US credits. Lastly, we remain broadly cautious EM assets, except perhaps for bonds from high credit quality sovereigns

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Global Macro and Markets in 2016

Welcome to our 2016 outlook for global macro and markets. Earlier today our economists released their global outlook on economic perspectives and over the next few days our regional economics teams will be unveiling their forecasts for key economic variables over the two years ahead. In today's publication we will try to sketch the broad strokes of this macro outlook. And along those lines, we will attempt to describe the macro trends that will likely dominate markets, the opportunities, the risks and the trades to consider.

2016: A year of moderate global growth, higher but overall low inflation, easy policy…

2016 is likely to be another year of moderate global growth, very much like the past 5 years (Figure 1). Inflation is set to rise from suppressed levels as the effect of declining commodity prices starts to fade, but it is likely to remain at low historic levels as global disinflationary forces persist (Figure 2). Globally, this should continue to underpin easy monetary policy across DMs and EMs.

…cautious Fed hikes amid macro uncertainty…

But there are twists; 2016 is the year where the Fed is likely to finally deliver monetary tightening. That said, tightening will come at a cautious pace as cyclical risks persist (primarily in the manufacturing/external sector) and as the interaction between policy rates and financial conditions requires fine balancing of the Fed's hawkish tone. The economy is expected to continue expanding at a reasonably robust pace.

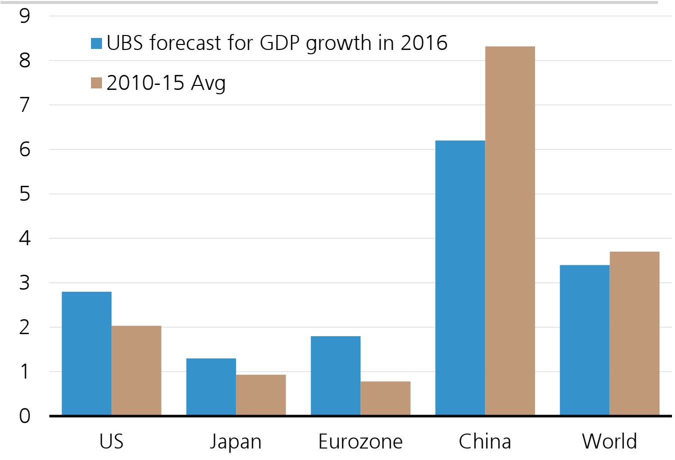
…Euro-area growth acceleration and policy easing…

On the bright side, 2016 should be a year of accelerating domestic demand dynamics in the Euro-area, against a backdrop of further ECB policy easing. This acceleration is a reasonable base case for us as fiscal policy is set to ease in 2016 for the first time since the Euro-area crisis commenced and as our leading indicators point to ongoing acceleration in Euro-area credit dynamics (see our European Impulse theme paper). A higher degree of openness implies a larger exposure to EM growth risks, but domestic demand remains the key determinant of broader activity trends.

…managed growth deceleration in China…

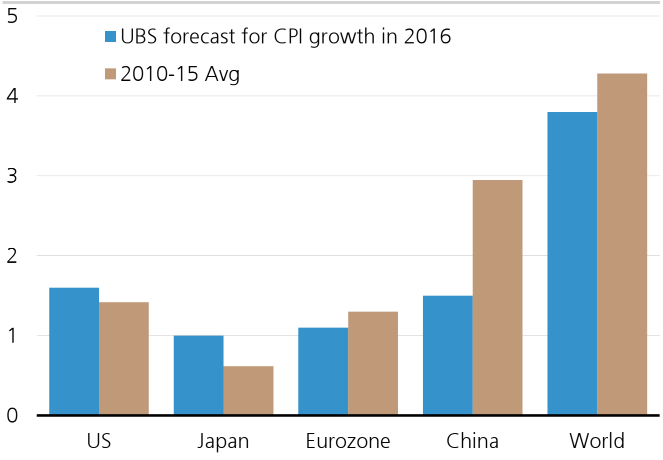
In contrast, the slowdown in Chinese activity is likely to extend as the economy remains on a multi-year adjustment trend away from an export driven growth mix and towards domestic growth drivers. Markets continue to worry about a potential hard landing. But, from a macro perspective, policies are geared towards reducing such risks.

Figure 1: Global growth remains moderate…



Source: UBS, Haver Analytics, IMF, Bloomberg.

Figure 2: …inflation to 'technically' rebound but stay low



Source: UBS, Haver Analytics, IMF, Bloomberg.

Instead, slower China growth should continue to reflect negatively on broader EM growth and growth across commodity exporting nations. EMs are entering a new dangerous phase of balance sheet deterioration. And this trend will gradually extend over the next few years. But crucially, there are positive offsets for the rest of the world, including low inflation and low yields (See Disinflation – felt locally, spread globally).

…and weak EM growth.

Overall, this is a friendly backdrop for risky assets in Developed Economies. But returns are likely to be moderate for equities. And in the meantime, volatility is likely to stay elevated. We prefer Euro-area and Japanese stock markets on the back of credit dynamics and the potential for easing.

Global macro backdrop: supportive for equities, but expect moderate returns and high volatility.

While, there are some upside risks to yields from current low levels (see Big Macro 01: Are low US Yields Here to Stay?), we do not expect a major upset to the environment of broadly low global yields. A wide global output gap implies the need for global financial conditions to remain easy (Figure 3). The earlier the Fed delivers, the more likely it is to deliver economic outcomes consistent with low yields in the long run (see Big Macro 02: Is The Fed's Hiking Path Mispriced?). There is room for lower yields in China. And while peripheral spreads tighten, core Euro-area yields should rise vis a vis the US and the rest of the world.

Low yield environment to persist, with upside risks to yields, particularly in the Euro-area.

In FX, the EUR and the USD should appreciate against a) EM FX and b) currencies from countries where authorities are likely to continue easing monetary policy (JPY, AUD, SEK, CHF, NZD, Non-Japan Asia FX).

EUR and USD trade-weighted appreciation ahead.

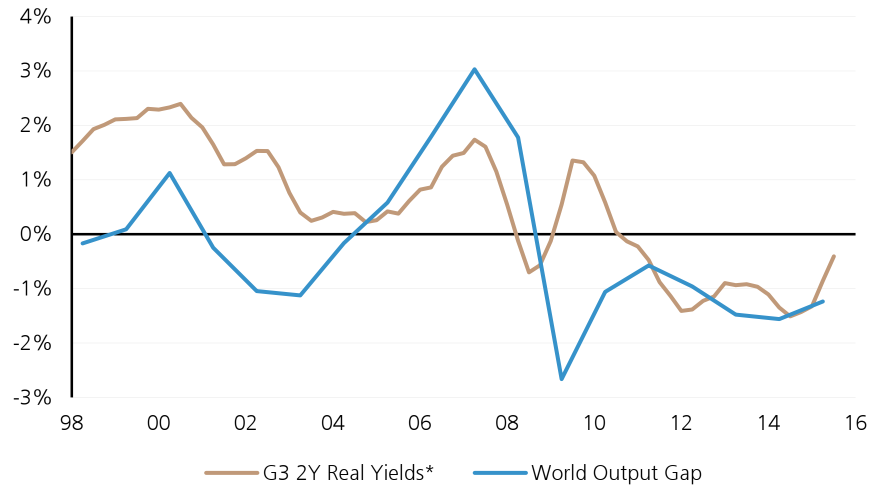
The credit picture is mixed with US credit priced for weaker credit dynamics already, EM sovereign credit set to underperform and Euro-area credit exhibiting room for tighter spreads amid easier policy.

Mixed trends in global credit with the Euro-area as the bright spot.

Finally, we are still broadly cautious on EM asset performance. Driven by weakening EM balance sheets, we think hard currency debt will post lower returns, with attendant negative consequences for FX, equities, and even term premia in certain local markets. FX will likely remain the weakest link.

Still cautious EM assets.

Figure 3: Low yields anchored by wide global output gap



Source: UBS, Haver Analytics, OECD, Bloomberg. *Average of 2Y Real US, Japan and German bonds

The macro developments, the market opportunities and the risks for 2016

Fed lift-off amid a wobbly cycle

The Macro:

The Federal Reserve did tighten financial conditions in 2015, but did so only passively – via expectations of policy liftoff and their ripple effects (such as a strong dollar and wider HY credit spreads).

A slower and shallower Fed tightening cycle….

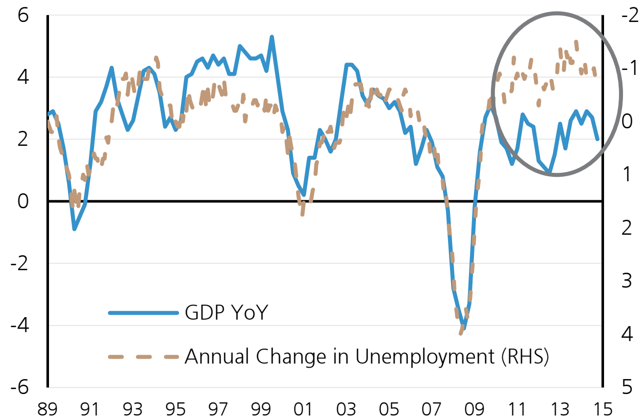
In 2016, we expect to see the progression of active Fed tightening and our US economists forecast 100bp of hikes that year. The fall from a high of 10% unemployment to near 5% today tells us that slack in the US is diminishing, and is likely to justify a fed funds rate above zero. That said, the Fed hiking cycle ahead will be quite different from past cycles; the pace is likely to be much slower and it will likely lead to a lower terminal policy rate.

First, while diminishing slack is a key motivation for hiking, the rapid unemployment decline coincides with just modest growth (Figure 4). This disconnect tells us that (1) the decline in the short-term unemployment rate may overstate the exhaustion of spare capacity; and/or that (2) trend growth may be lower than before, i.e., less growth is required to reduce unemployment. We suspect it is a combination of the two. The mix of some residual slack and lower potential growth justifies a more gradual and cautious approach to tightening.

…reflecting uncertainty on the stage of the cycle….

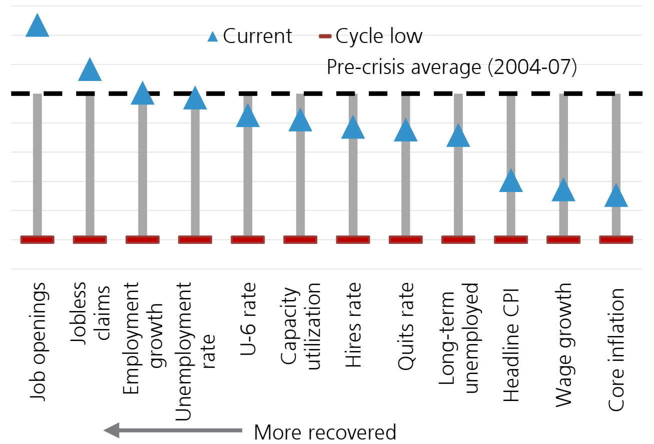
As opposed to past cycles, it has been exceptionally hard to pin down the exact stage of the current business cycle. Some labour market measures have fully recovered, such as new jobless claims and the rate of job openings. However, as Figure 5 shows, a number of metrics are yet to recover to pre-crisis averages. For instance, the absence of nominal wage pressure suggests limited labour market tightness. Lastly, as we discuss more below, some credit metrics exhibit late-cycle behaviour.

Figure 4: US unemployment falling faster than growth rising



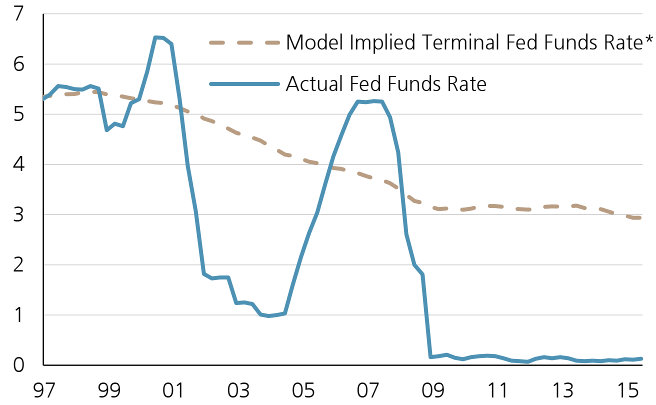
Source: UBS, Haver Analytics, Bloomberg.

Figure 5: Some US cyclical gauges have recovered, others lag



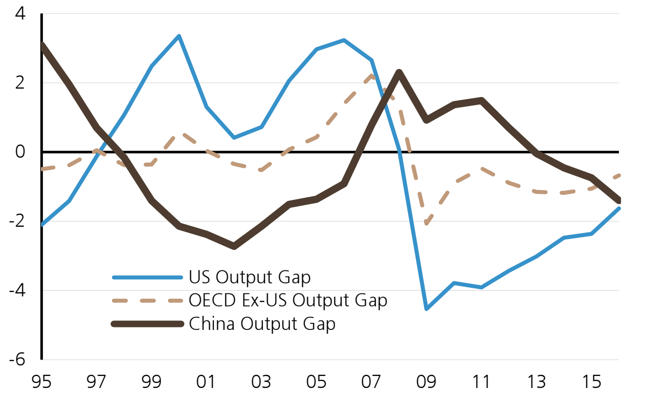
Source: UBS, Haver Analytics. *Triangle shows current levels as a proportion of the gap between pre-crisis average and crisis-low.

Figure 6: Neutral rate down ~200bps in the past 15 years



Source: UBS, Haver Analytics, Bloomberg. *Big Macro 01 estimate of equilibrium real rates + 2% expected inflation

Figure 7: US slack diminishing but ample slack outside US



Source: UBS, Haver Analytics, Oxford Economics, OECD.

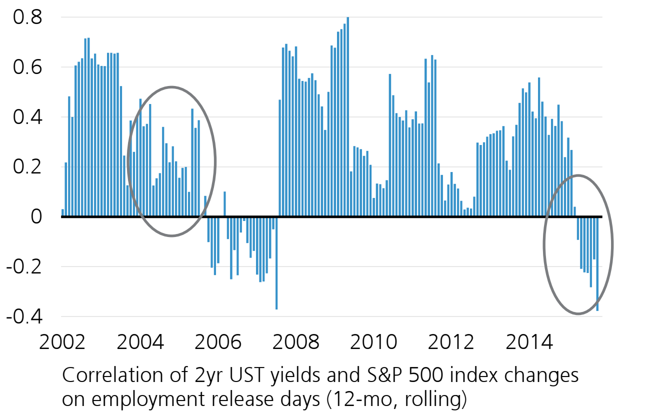
...and a lower neutral rate.

Second, the neutral policy rate is likely lower than in the past. The destination of tightening is important: the closer current rates are to "neutral", the closer we are to exhausting the rates cycle with each additional hike. As we discussed in Big Macro 1, our modelling exercises leave us to conclude that the neutral rate is more than 200bps below its level just 15 years ago (Figure 6). This decline largely reflects lower trend growth, and tells us that the peak in the fed funds rate is likely to be lower: nearer to 3% and well-below the 5-6% peaks of the past three cycles.

More now...less later

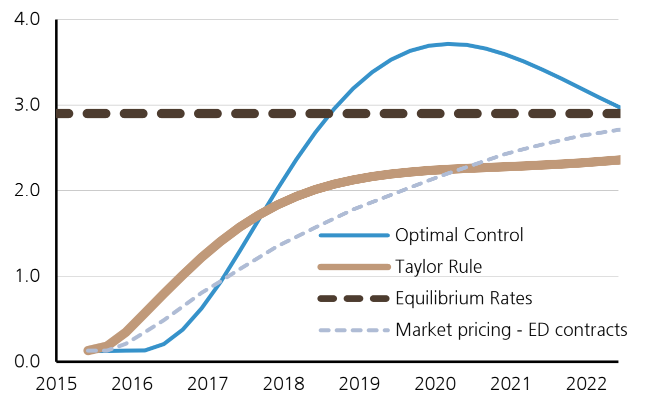
Third, the Fed may get more "bang for its buck" with every hike this time around. The lesson from the 2013 taper tantrum and from last year's experience is that, with the US output gap tightening against a wide output gap outside the US (Figure 7), higher US rates can trigger tighter financial conditions, either via a stronger dollar or via weaker risky asset performance. This is in contrast to the early parts of the 2004 hiking cycle, where the bond conundrum implied a weaker transmission between higher Fed fund rates and broader financial conditions. Figure 8 shows a shift in correlations between short rates and equities, with higher short rates hurting equity markets. As can be seen, this correlation was a lot more supportive at the onset of the previous cycle in 2004/2005. And it turned very negative during the late stages of the cycle in 2006 and 2007.

Figure 8: As opposed to the 2005-08 tightening cycle, jumping yields now associated with equity falls...



Source: Bloomberg, BLS, UBS calculations.

Figure 9: Fed Funds path assuming an output gap of ~1%



Source: UBS, Bloomberg, Market pricing from Eurodollar Futures contracts. For detailed notes on methodology see Big Macro 02: Is the Fed's hiking path mispriced?

Overall, there is a deep trade-off between near-term and long-term rates. As we show in Big Macro 2, the sooner and quicker the Fed raises rates, the more likely it is to deliver economic outcomes associated with weak equity performance and lower yields in the long run (e.g. soft growth and low inflation) (Figure 9). And vice versa, if the Fed proves patient in raising rates, it can help push long term inflation expectations higher from suppressed levels currently.

As opposed to the 2004 cycle, the transmission from Fed tightening to broader financial conditions tightening is stronger.

The Opportunities:

The uncertainties around the Fed cycle are bound to create investment opportunities.

Yields set to rise but not well above forwards.

First, short-term rates will start to rise, but do not expect 10 year yields to rise much above forwards. Barring some initial volatility, early Fed hikes will likely anchor long-term inflation and interest rate expectations at current suppressed levels. Later hikes will be associated with lower realizations in the near term – yet they are likely to help push the long end of the curve higher (Figure 10 shows that 5y5y nominal rates are trading close to the lower end of our fair value range).

Earlier hikes = flatter UST curve.

In terms of the Treasury curve, this means that early hikes will be linked to curve flattening. A more cautious Fed is likely to lead to curve steepening. Our Economics views and the latest guidance from the Fed are both consistent with a flatter curve (Figure 9).

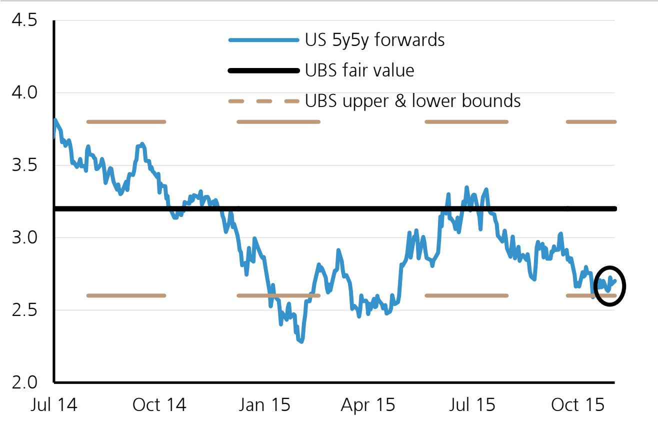
Deteriorating risk-reward for US equities.

US monetary policy uncertainty will likely lead to volatile price action in US equities and a deteriorating Sharpe ratio. Under the index, cash rich sectors with domestic exposures (healthcare, financials, tech) are set to outperform, as Julian Emanuel and team argue.

In equities, go for domestically oriented sectors, rich in cash vis a vis rate and USD sensitive sectors.

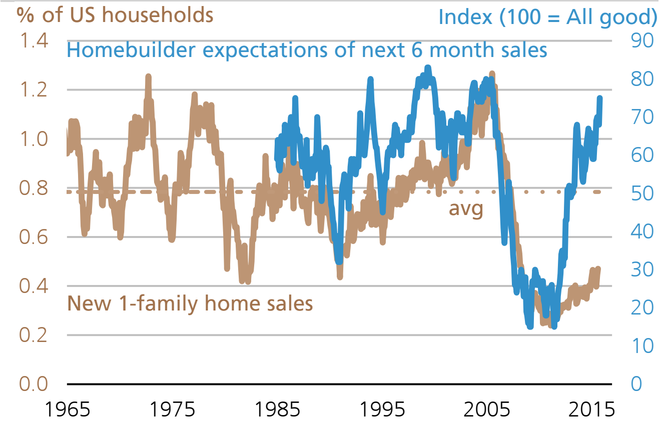
From a macro perspective we would also highlight the potential for further strength in US housing, continuing to support US homebuilders. The ongoing resilience in the US housing may extend as (1) mortgage rates are unlikely to rise meaningfully; (2) pent-up demand for new homes will continue to be released; (3) household formation is yet to fully recover; (4) bottlenecks for homebuilders (e.g., issues with land, labor, and lumber) will be reduced; (5) credit conditions for home purchases will ease further, allowing for more first-time home purchases. If that is the case, we should see the 10-year high in homebuilder confidence translate to house construction returning closer to historical averages (Figure 11).

Figure 10: US 5y5y forward rate approaching lower bound of our valuation range



Source: UBS, Bloomberg. UBS fair value, upper and lower bounds from "Big Macro 01: Are Low US Yields Here to Stay?"

Figure 11: Housing sector has room to accelerate further



Source: UBS, Census, NAHB.

In contrast, sectors with exposure to higher yields (utilities, consumer staples and telecoms) should underperform, while sectors with exposure to a stronger dollar (industrials) are likely to be more volatile.

Lastly, the dollar should appreciate vs EM FX and policy easers (JPY, AUD). The beginning of the normalization in US rates will allow space for the nations that are keen to ease monetary conditions to do so via weaker currencies against the USD. Having said that, the broad dollar strength of late 2014/early 2015 against G10 currencies and the EUR is unlikely to be repeated, as we discuss later.

The extent of the 2014/2015 dollar strength is unlikely to be repeated in 2016.

The Risks:

The underlying credit trends that first caused volatility in US credit markets in 2015 are likely to extend in 2016: 1. Corporate defaults are on the rise. Lower commodity prices are driving rising default rates in the relevant sectors, and further declines will heighten the risks of contagion to the broader market (Figure 12). 2. Credit fundamentals are eroding. Corporate debt growth is outpacing earnings growth (Figure 13), corporate leverage is near all- time highs, capital market access has tightened for lower rated firms and our non-bank liquidity indicators (low-rated HY issuance, trade credit) point to further deterioration.

Main risk comes from credit markets; credit conditions could tighten as default rates pick up.

That said, a lot more is in the price today. Our high grade and high yield spread forecasts into year-end are 160bp and 590bp, respectively, versus current levels of 159bp and 621bp. Over a six-month horizon our US IG and HY spread model spread targets narrow incrementally to 155bp and 577bp, respectively.

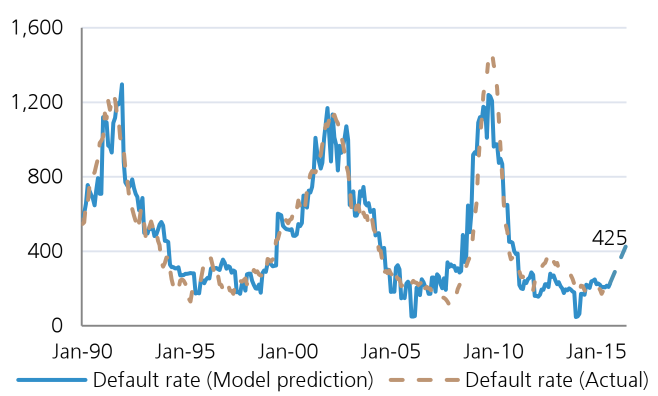
To gauge whether these risks imply further macro deterioration, we are closely watching the recent decline in non-bank liquidity (Figure 14). Further declines can have spill-over effects to broader credit trends and could lead to US downside growth risks. For now, recession risks still appear to be low. Our recently developed US economic recession indicator based on credit metrics (see Focusing the Credit Lens on the US Economy, 29th October 2015) indicates that the chance of a US recession by Q2'16 is only 15% (Figure 15). While this has ticked higher than most of the pre-crisis period, it is well below levels seen prior to past recessions.

Although non-bank liquidity is deteriorating, the probability of a credit driven recession is still low.

We would hedge the associated risks by selling equity and credit from lower-quality issuers. In particular, CCC spreads (ex-energy) are priced for perfection, not capturing the potential for a more elevated default cycle in the near-term.

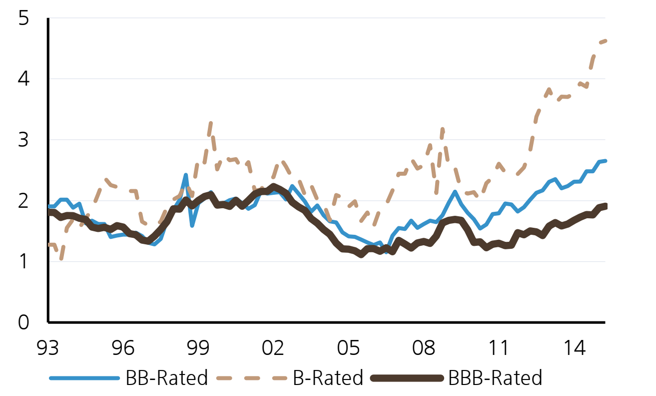
Hedge by selling credit and equity in low-quality issuers.

Figure 12: Defaults set to rise in High Yield



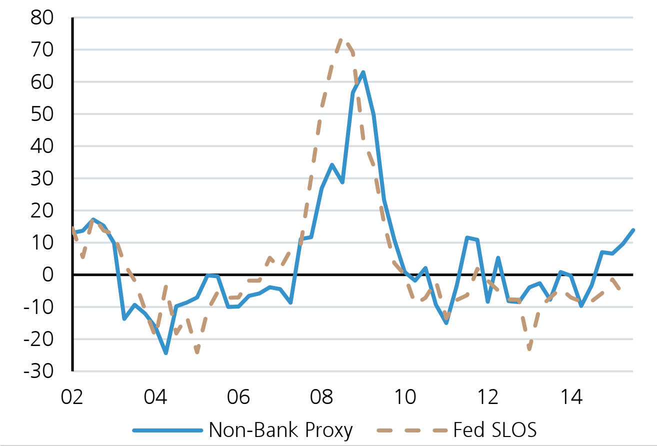
Source: UBS, Yieldbook, Bloomberg, Moody's

Figure 13: US Leverage fundamentals deteriorate *



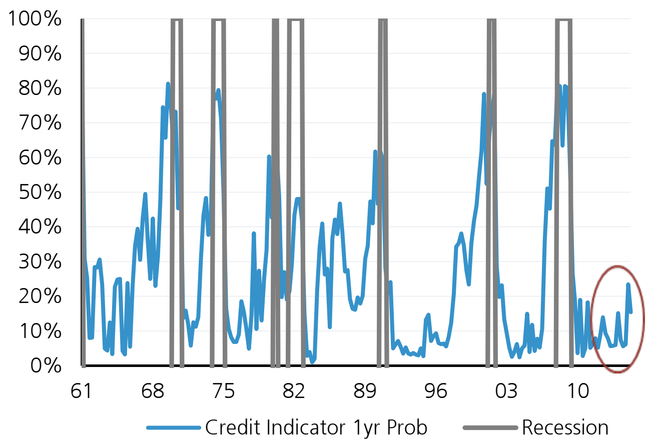
Source: UBS, Worldscope *Net debt / EBITDA

Figure 14: Non-Bank Lending proxy deteriorating… *(% of banks tightening)*



Source: UBS, FRED, Bloomberg

Figure 15: …leading to marginally higher risks of growth slowdown *(UBS recession probability based on credit variables)*



Source: UBS, Bloomberg

Europe puts its foot on the pedal

The Macro:

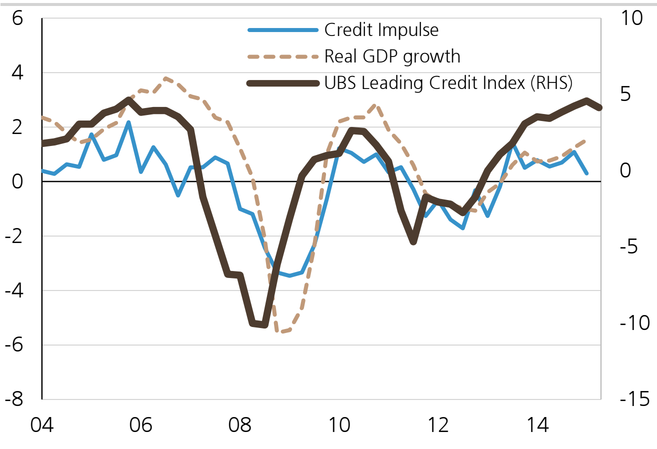
Euro-area growth set to accelerate…

2016 will be a year of accelerating Euro-area growth, from a projection of 1.5% in 2015 to a forecasted 1.8% in 2016 as per our European Economics team. Growth acceleration tends to be a driver of strong returns for risky assets (equities and credit). Policy is corroborating, with both fiscal and monetary policy set to ease in 2016. And the market is not reflecting the relevant prospects.

…as strong credit dynamics set to support domestic demand.

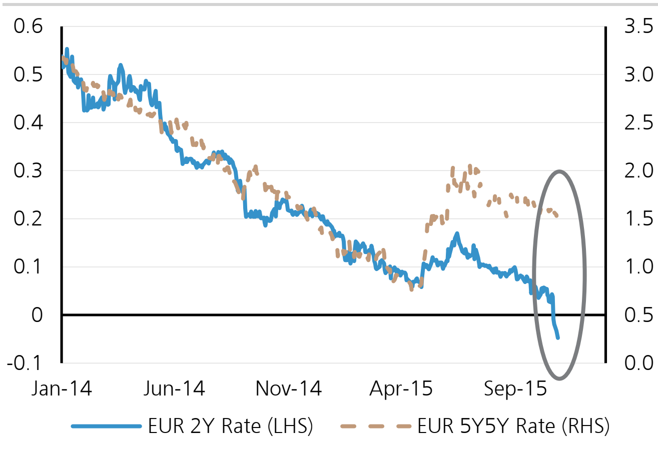
In particular, the ongoing easing in credit conditions is pointing to acceleration in private sector domestic demand. As we have shown in European Impulse (15th September 2015), the key driver of real GDP growth is not credit growth per se, but the change in credit growth (the credit impulse), and this metric continues to show further upside for the European recovery. Our UBS Leading Credit Index, based on the ECB Lending Survey, confirms that there are further upside risks versus consensus (Figure 16), signalling an uptick in the credit impulse and growth 3 to 6 months ahead.

Figure 16: Our leading credit indicator based on the ECB's bank lending survey continues to point to acceleration



Source: UBS calculations, Haver, ECB.

Figure 17: Markets begin to price ECB Cut/QE



Source: UBS, Bloomberg.

Against a backdrop of firming domestic credit conditions, both monetary and fiscal policy are set to ease further:

Against firmer domestic demand dynamics, fiscal policy and monetary policy are set to ease further.

1. In its October meeting, the ECB once again signalled another round of easing. Our economics team expects the ECB at its 3rd December meeting to deliver a 10bps deposit rate cut to -30bps (see "ECB: More policy action coming in December"). In addition, the dovish guidance President Draghi gave to markets implies that the ECB is likely to take the opportunity to extend the QE programme by 3-6 months, thus giving the markets early clarity about the longer-term policy outlook. As can be seen from Figure 17 the market has started to reflect the likelihood of further easing by pushing short rates and 5y forward 5y rates lower.

2. At the same time, after six years of fiscal consolidation, fiscal policy is set to become expansionary (Figure 18). Further fiscal stimulus may also be sparked by the ongoing humanitarian crisis in Europe, particularly in the Nordics and Germany. Recently, the Riksbank became the first central bank to note that policy may need adjustment in response to this crisis.

And there is room to grow – economy features ample slack.

And there is room to grow as considerable slack remains in the Euro area. The OECD estimates the output gap at a wide 2.7% by end of 2015. And unemployment is 11% (4% above pre-crisis levels, Figure 19). It is unlikely that policy accommodation will lead to a significant pick-up in inflation risks soon.

The Opportunities:

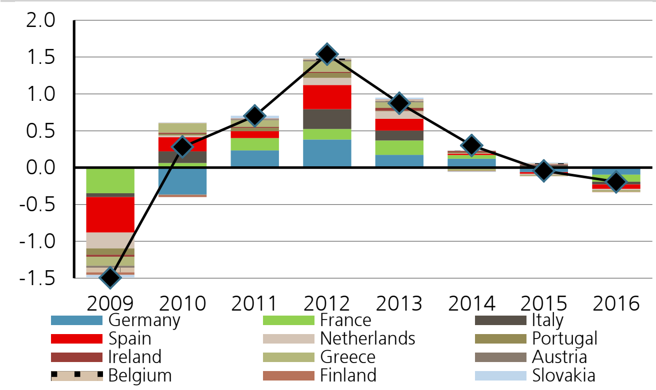
Euro-area assets have lagged the improvement in credit dynamics.

Asset prices have lagged the improvement in Euro-area growth dynamics. In particular, in our work on the European Impulse we have shown that during a cycle where credit dynamics accelerate as much as our leading credit indicator implies, asset prices can move a lot; the Euro-Stoxx Index for instance can strengthen by anywhere between 30 and 70%. Financials outperform and credit spreads tend to tighten strongly. Figure 20 shows our updated European Impulse model response estimates. It also shows that risky assets have moved by a lot less than one would expect.

Equities, financials, periphery and credit to rally further.

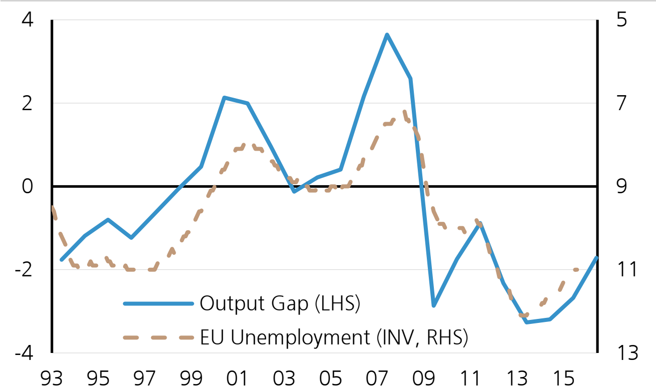
European equities and credit are also typically the assets that tend to perform the strongest following subsequent rounds of quantitative easing, as we have shown in our research. We continue to favour Euro-area equities, particularly in the financial sector and in the periphery, as Nick Nelson and team highlight see "ECB: will dovish talk be followed by action?". We would also recommend investors buy Euro-area high yield credit (the iTraxx for instance).

Figure 18: Fiscal policy about to turn accommodative, %



Source: Haver, European Commission, IMF, UBS. *Reduction in structural budget deficit. Contributions from individual countries are GDP-weighted.

Figure 19: Room to grow as slack remains ample, %



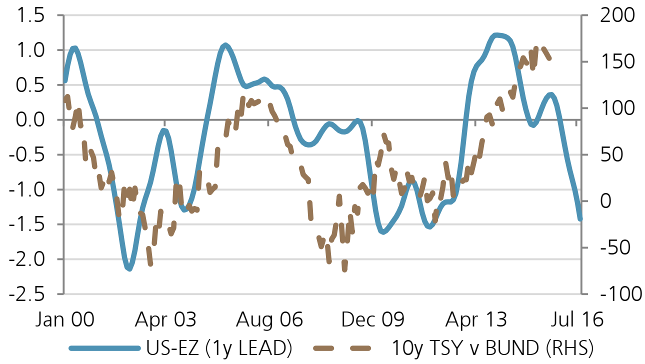
Source: UBS, Haver Analytics, OECD.

Figure 20: Scope for EUR assets to further reflect recovery

Assets	Model Estimate	Actual Move
Euro Stoxx 50	+ 33 to 73%	+17.6%
Financials/EuroSTOXX 50	+ 11 to 24%	-0.6%
EURUSD	+ 18 to 27%	-15.3%
Core yields	+ 110 to 201 bps	-87 bps
Peripheral spreads	- 91 to -128 bps	-220 bps
Itraxx XOVER	- 237 to -292 bps	-109 bps

Source: UBS Calculations, Bloomberg

Figure 21: OECD CLIs (with a one year lead) and the generic 10y Bund v Treasury yield spread (bp, RHS)



Source: OECD, Bloomberg, UBS

Although peripheral spreads have rallied considerably (even by the standards of our model), we note that most of the credit and investment spending improvement is coming from the periphery as our Evidence Lab research shows (see When will Eurozone firms invest again? And how will investment ...). Out of the different peripheral spreads we favour further compression in Italy vs Germany.

Core Euro-area yields set to rise post QE…

Instead we would avoid core Euro-area bonds as we expect core yields to rise. While quantitative easing will likely compress term premia for long-term bonds, stronger growth and inflation expectations are likely to rise. In fact, taking the international experience on QE dynamics into account, core yields at the long end of the curve are likely to edge higher overall in the aftermath of the announcement (see How to trade the ECB's dovish shift).

…and relative to the US…

Medium- and long-term rates in the Euro area are likely to rise vs the US. The Euro-area is re-coupling with the US and this typically tends to translate into a narrowing US vs EU long term interest rate differential (Figure 21). We continue to recommend short positions in 10y Bunds vs US Treasuries.

…which should limit the downside in the EUR/$. EUR set to strengthen vs JPY, AUD, SEK, CHF and EM FX.

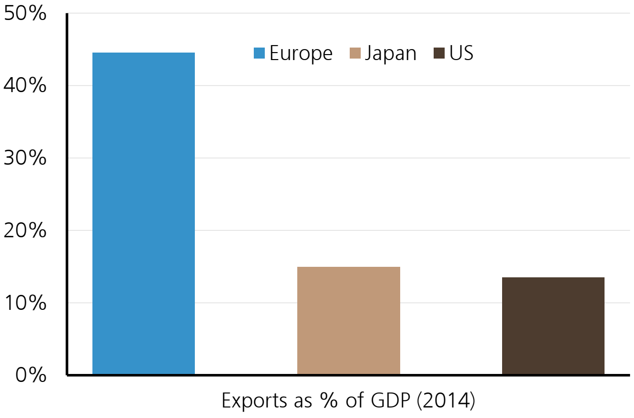
This narrowing rates gap should also support EUR/USD. It is important to note that the current starting point is very different from that of the ECB's QE earlier this year. At 1.10, EUR/USD is no longer overvalued on standard metrics, and with the OECD's measure of PPP suggesting fair value of around 1.29, it is likely undervalued. We continue to expect the EUR/USD range to hold, and our bias remains toward the higher end of this range, as valuation and continuing re-synchronization between the US and Euro area economies should support the euro. From a trading perspective, we see the best risk-reward for euro appreciation against currencies from nations set to ease policy, including the JPY (where the BoJ is likely to implement further easing measures against a back-drop of weak growth and improving but still below target inflation), SEK, CHF, AUD, NZD and EM FX.

The Risks:

Euro-area openness to trade means that it is more exposed to the EM slowdown and this is a risk.

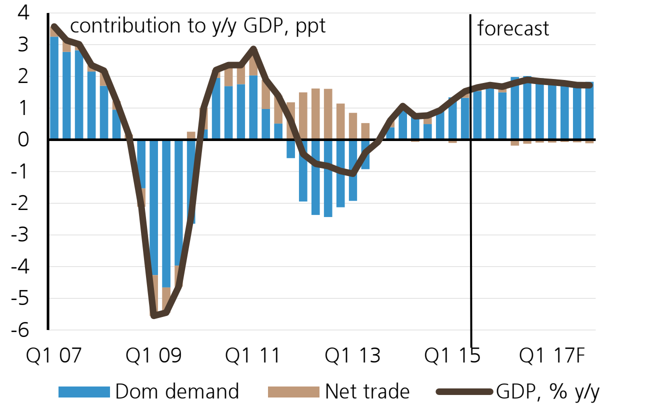
A higher degree of openness in the Euro-area economy, makes the region vulnerable to a further deceleration in EM demand and that, in our view is the main risk. More specifically as can be seen from Figure 22, exports as a percentage of GDP are higher in Europe than in the US or in Japan. With a higher exposure on international trade, broader slowdowns in China and EM could become a drag on European growth.

Figure 22: Exports of goods and services as a % of GDP are higher in Europe vs US and Japan



Source: UBS, Haver Analytics, World Bank.

Figure 23: GDP Eurozone real GDP and contributions (percentage points)



Source: Haver, UBS estimates.

That said, the most important driver of GDP growth is from domestic demand (Figure 23), and our Economics team's growth forecasts for the two years ahead are driven almost entirely by domestic demand contributions.

The risk can be hedged via exposure to more open economies with deeper China trade links; such as Australia.

One way to hedge against the exogenous risks (mainly stemming from China) is to trade Europe versus an economy that would be hit even harder by these risks materialising. Australia is a good example. In our recent research (see "Australia: Lower Rates and FX Down Under" 20th October 2015) we have recommended receiving 5y Aussie rates vs US. From a risk/reward perspective, receiving Aussie rates versus Euro area rates also makes sense. We expect growth differentials between these markets to favour spread compression in the quarters ahead and, in the event of a further downturn in China and EM, we would expect Aussie rates to outperform as Australian growth prospects are hit the hardest.

China's managed deceleration extends

The Macro:

In China, the managed slowdown is likely to extend. And tail risks of a more aggressive decline have a relatively low probability of playing out, as policies are geared towards stability.

China is in a trend of weaker growth…

China continues to slow. Our economics team forecast China's headline GDP growth to decline to 6.2% in 2016 and 5.8% in 2017, driven mainly by downward pressures from property-related adjustments and slowing investment.

…but is not a tail risk – policies are geared towards stability…

But this is a managed decline, not a tail risk. Intensified policy support, although not sufficient to offset the economic headwinds, will likely prove successful in managing the slowdown, ensuring minimal risk of a more aggressive decline. In October, the PBoC embarked on a further round of significant easing measures, including a 25bp cut to benchmark rates and 50bp cut to RRR. We expect this monetary easing to continue.

…and the combination of growth adjustment and policy accommodation will likely extend.

The combination of growth adjustment and policy accommodation is likely to extend. As our China economics team has outlined, the continued downward adjustments in the property sector, together with limited progress in cleaning up nonviable enterprises and excess capacity, will continue to weigh on domestic demand through the coming year. This will exacerbate industrial overcapacity to

fan persistent deflationary pressures, directly by depressing the prices of metals, raw materials and other industrial products, and indirectly by holding back wage and income growth. To manage the risk of a debt-deflation trap, we expect additional easing including two more rate cuts by early 2016, and the beginning of corporate and debt restructuring. These easing measures should help to stabilise credit and liquidity conditions, cushion the economy from the ongoing property downturn, and better manage financial risks as deflationary pressures mount.

The opportunities:

China rates have scope to decline.

China (ND)IRS rates and bond yields have scope to decline further. With the PBoC over-sterilising its FX interventions this year, banking system and money market liquidity is ample. This should pave the way for further downside in CNY (ND) IRS rates and CNY bond yields. We favour long positions in China onshore government bonds (see also "Rates Implications of PBoC Policy Easing", 23rd October 2015). Figure 24 shows the 10y CNY benchmark rate deflated by average CPI and PPI, demonstrating a significant rise in real yields with considerable scope for a rally.

Trade the side-effects; EM growth weakness to weigh on EM assets…

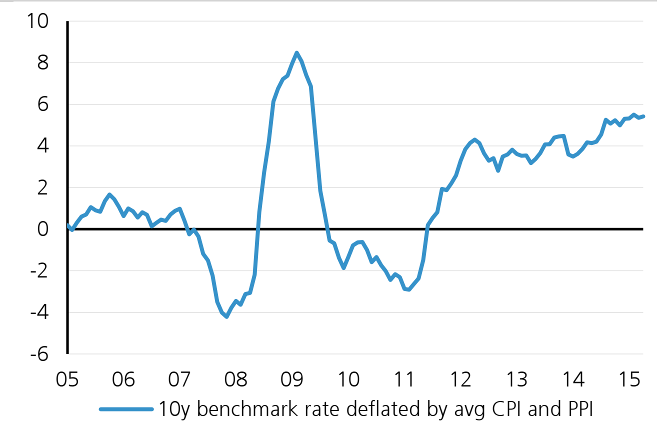
Perhaps more importantly, while the managed slowdown process is geared towards limiting the near-term downside risks to local activity, there are broader and possibly bigger side-effects to EM activity and DM inflation. More specifically, EM growth is likely to remain low (Figure 25) – not far from 2015 levels (between 4.1% and 4.3%), which should weigh on EM asset performance against a backdrop of intensifying balance sheet pressures.

…and on DM inflation, thus anchoring policy at accommodative levels.

The impact on DM is less sinister. Yes, the China growth slowdown is not particularly encouraging for external demand trends. That said, there is one key offset; DM inflation is set to remain low in 2016 beyond the base-effect driven bounce. And this should anchor DM monetary policy at accommodative levels.

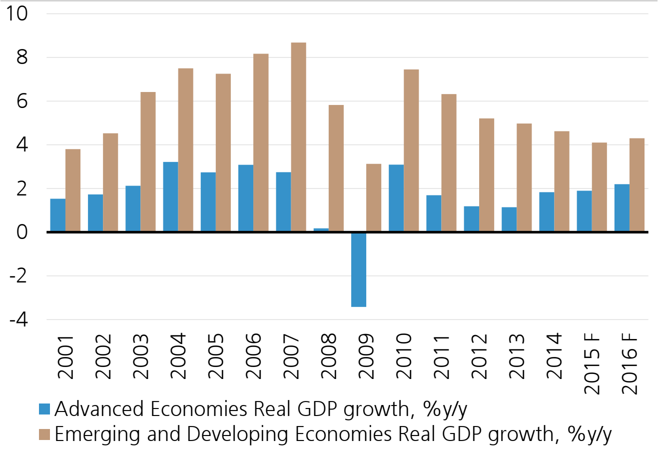
We will develop these two themes separately in the sections to follow.

Figure 24: China real rates high relative to cycle



Source: Bloomberg, Haver, UBS

Figure 25: Softer China growth to reflect into ongoing EM growth softness*



Source: UBS forecast, Haver Analytics, IMF.

The risks:

The main risk to the markets by China's managed growth slowdown process, involves a steeper transmission into weaker commodity prices. This can come as a result of ongoing shifts in the composition of Chinese growth; away from the sectors that have propelled the economy over the last few years – such as housing, and towards activities much more akin to stimulus; such as infrastructure spending. As can be seen from Figure 26 and Figure 27, while commodity price shifts are quite correlated with decelerating activity in the real estate sector, they are unlikely to be driven higher by additional infrastructure spending.

Commodities can weaken beyond what is expected.

Once again, lower commodity prices imply deteriorating terms of trade for commodity producers such as Brazil, Australia, South Africa, Chile, etc. For the sovereigns with the strongest credit fundamentals (Australia, Chile, etc), a weak currency should take the brunt of the impact from deteriorating terms of trade. For weaker credits (Brazil, South Africa), the spill-overs to credit, equities and bonds are likely to be broader and deeper, as we discuss later.

Emerging Markets entering a new and dangerous phase

The macro:

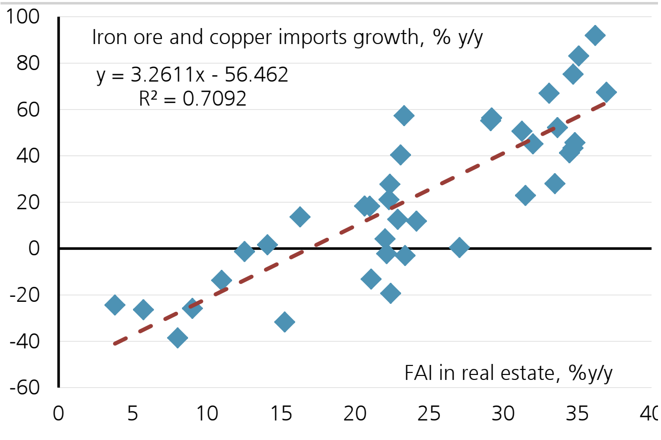
Emerging markets growth is likely to remain low, close to 2015 levels, not the least owing to the ongoing slowdown in China. But while, up until recently, weak EM growth was largely seen as part of an adjustment narrative, where currency depreciation and soft domestic demand allowed EM economies to transition away from unsustainable external balances, this narrative is now changing in one fundamental way. After several years of weak growth, EM macro balance sheets are eroding fast.

Growth to remain slow, owing to the ongoing China slowdown.

As we have outlined in our research ("EM enters a new, dangerous phase", 9th September), weak income statements have now compromised EM's balance sheet strength. In recent years, we have pointed to a clear distinction between EM's weakening ability to generate earnings (weak income statements) and a healthy ability to service its debt (strong sovereign balance sheets). However, balance sheets can't remain independent of income statements forever. Weak global trade and delayed reform implementation have caused enough erosion in EM's leverage, fiscal and external dynamics to now make balance sheets a concern in their own right.

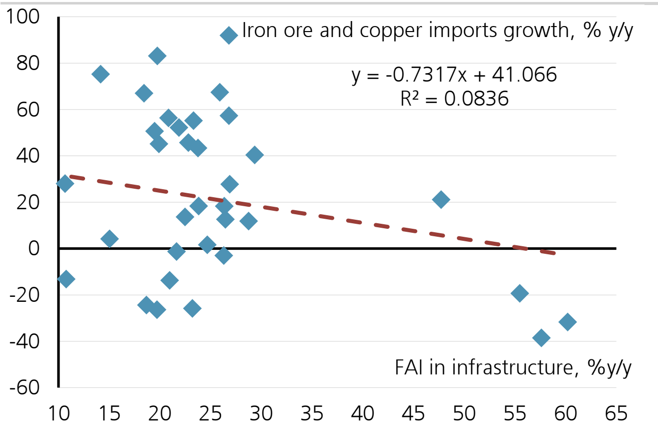
Balance sheets are deteriorating…

Figure 26: Iron ore and copper imports vs real estate



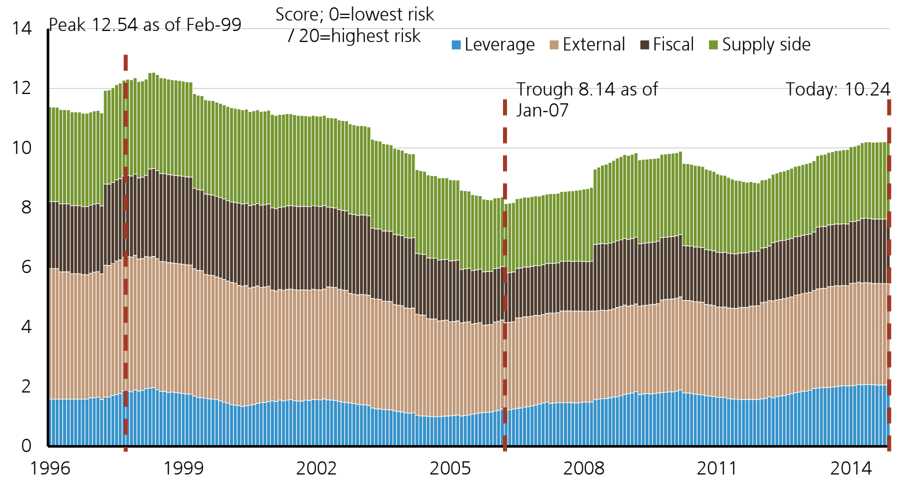
Source: Haver, UBS

Figure 27: Iron ore and copper imports vs infrastructure



Source: Haver, UBS

Figure 28: EM macro balance sheet risk score broken down by sub-components



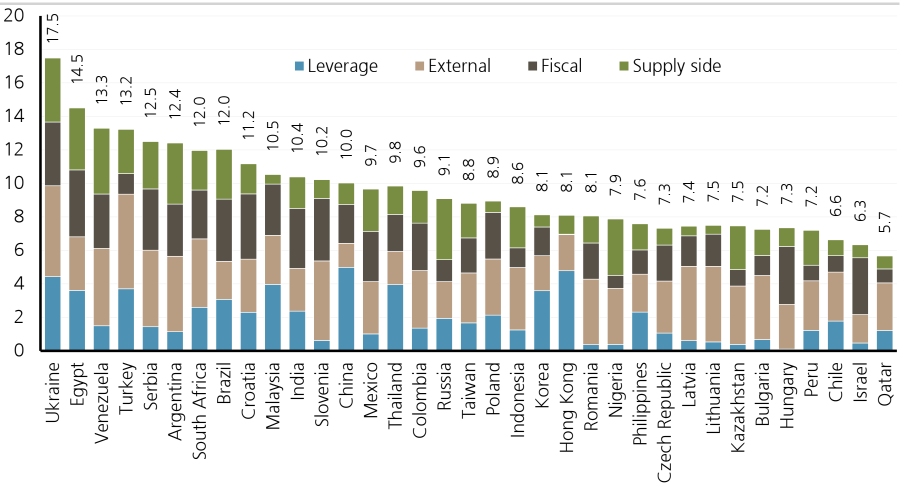
Source: Haver, UBS estimates. The EM aggregate presented here is EMBI+ weighted. MSCI EM and GBI EM weighted balance sheet scores are also available.

Based on our EM macro balance sheet risk score (Figure 28), EM sovereign risk has not risen to levels consistent with a crisis at an aggregate level. However, we do find EM balance sheets at their worst state in a decade, with the deterioration proving persistent. On a 10 year timeframe, EM balance sheets are at their worst state. This is important because it is only since 2005 that EM debt has attracted serious investment. The structural macro improvements that these EM debt investors enjoyed, and hoped would persist, has now all been reversed.

…and this time DM will not come to the rescue.

On an EMBI+ weighted basis, our aggregate EM macro balance sheet risk score has reached a level consistent with a sub investment grade rating and the momentum of the score is tilted the wrong way. And, unlike previous episodes of EM balance sheet deterioration, it is very unlikely this time that a big improvement in global circumstances comes to the rescue. In particular, Ukraine, Egypt and Venezuela score very high in macro balance sheet risk; while Turkey, Brazil and South Africa are not far from risk levels registered during previous crises in these countries (Figure 29).

Figure 29: Current macro balance sheet risk score by country & risk component



Source: Haver, UBS estimates.

The Opportunities:

Over the last few weeks, EM assets have staged a strong relief rally. While some of the drivers of the rally may persist for a bit longer, we think that the market is only preparing the stage for fresh EM underperformance across most assets ("Chase or fade the EM rally?", 27th October 2015). Past tactical EM rallies have been fueled by long and consistent declines in G10 rates, but at current levels, there is less room for such relief. Meanwhile, leading indicators in DM are worsening, and the imbalances in China are growing rather than narrowing. Refinancing needs from maturing hard currency debt are also likely to pick up noticeably in the coming quarters.

EM tactical rally will likely fade.

As EM balance sheets deteriorate, wider credit spreads will be the asset that paves the way for broad EM underperformance. EM credit is likely to underperform and current levels offer good risk reward to get long EM protection again (vs Europe for example). We are negative on credit in EM in Turkey, South Africa, Colombia, Mexico, India and Indonesia while believing that the very front end credit in Brazil now presents value.

Wider credit spreads will be the driving force of broad EM asset underperformance.

Whether via wider credit spreads in the economies with the weakest credit fundamentals or via monetary policy differentials vs the inflation easers (eg SGD, TWD etc), we expect EM currencies to continue to depreciate versus the USD. This time around, the bottoming out of the EUR, implies broader depreciation of EM currencies vs majors, which can add to volatile price action.

EM FX to depreciate vs USD and EUR.

EM fundamentals do not allow space for a strong rally in MSCI EM and, by and large, the market's growth assumptions may still be overly optimistic for next year relative to our views. There are some bright spots, some pockets of potential relative outperformance, according to Geoff Dennis, in India, China, Poland, Peru and Russia. In contrast, countries such as Indonesia and South Africa may underperform peers. At a sector level, materials and financials could turn lower, capping gains in the overall index.

Upside for EM equities is capped.

We see selective opportunities in EM local rates markets. We are currently receiving 5y5y swaps in Israel and Korea vs. the US, long India 10y bonds vs. Turkey, and receiving in the front end in Brazil.

With local bonds the brighter spot.

The Risks:

One key risk is that the strong sequential improvement in EM trade balances in recent months could lead to some early stages of stabilization, even in the beleaguered markets of Brazil, Indonesia, South Africa, and Turkey.

Can trade improvement save the day?

But we disagree. EM's current account healing, in its current form, is unlikely to drive a sustained rally in currencies, for a number of reasons. First, export growth matters more for EM currencies than the change in the trade/current account, and the weakness in EM FX this year does not appear to be a strong overshoot in the context of today's anemic export reality. Second, external adjustment continues to be driven by import compression, posing risks to EM balance sheets. Sequential export volume growth has recently been stagnant/modestly negative for EM as a whole, while forward-looking indicators such as new export orders for key manufacturing economies are continuing to deteriorate. Third, capital account vulnerabilities from reduced inflows may overwhelm current account improvements. And, finally, export competitiveness does not appear to be sharpening.

Not yet.

Beyond base effects: Global disinflationary forces to persist

The macro:

There is a dominant global driver of the low inflation regime over the last few years.

Since early 2012, inflation in developed economies has been declining. As discussed in our work on disinflation ("Disinflation-felt locally, spread globally", 9th September 2015), this decline has continued to come as a surprise to markets over the years. And it has been driven by global macro forces. As can be seen from Figure 30, 75% of the shift in DM inflation can be explained by a single global factor. To a large extent, a key driver of this broad and correlated decline in DM inflation has been a wide and persistent global output gap (Figure 3, page 4). At the moment, as slack diminishes in the US, increasing amounts of slack in EM (and China, in particular) are maintaining a level of global spare capacity persistent for nearly 6 years and as wide as only briefly seen in the mid 90's and the early 00's global recessions.

…which is likely to continue to anchor G10 inflation at low levels, beyond base effects.

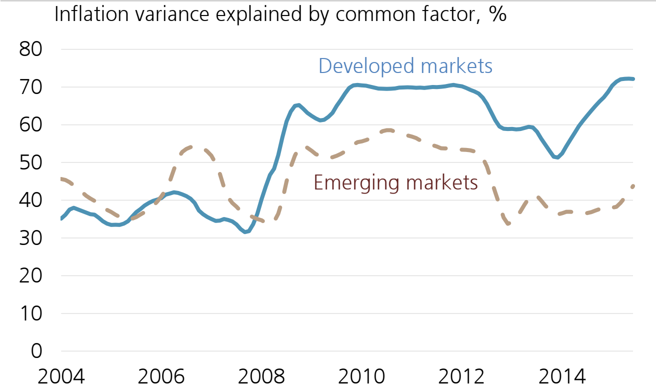
Base effects will drive global inflation higher in 2016 as can be seen from our forecasts (Figure 2, page 2). But, it will remain low. And the odds are that, under the surface, disinflationary forces will persist. This is important for DM central banks. Not just because inflation will likely undershoot targets for yet another year. But mostly because inflation tends to be persistent; as Figure 31 shows, inflation persistence tends to be high, which means that low inflation in the past will likely affect inflation expectations and weigh on future inflation rates, too. Indicatively, in line with lower inflation rates, measures of global inflation expectations have fallen, too (Figure 32).

Low inflation will likely continue to anchor G10 monetary policy at accommodative levels.

Central banks have eased policy on the back of disinflation. Not since 2008-09 have we seen the same breadth of easing as this year. And as disinflationary forces persist, global monetary policy is likely also to remain extraordinarily accommodative in 2016. Central banks such as the ECB, the Riksbank, the RBA, the RBNZ have either moved in that direction or indicated they are about to.

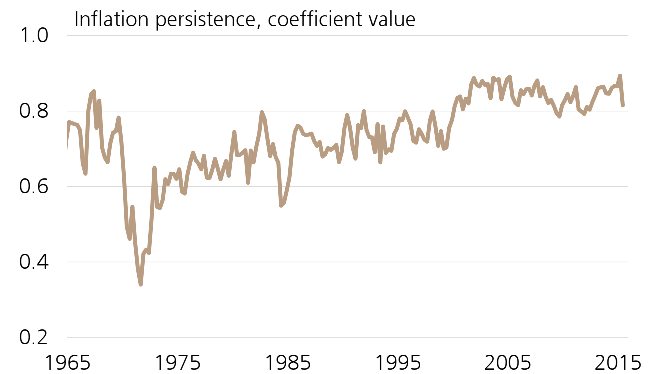
In addition to the Fed, the Bank of England is also likely to tighten next year; our economists expect the UK cycle to begin in May. But importantly, these rates are likely to be lifted only gradually, and easing remains in vogue elsewhere. Local labour markets are likely to tighten further, but owing to a weak transmission mechanism between labour markets and price dynamics (a flat Phillips curve as in Figure 33, next page), these dynamics may take longer before they dominate broader inflation dynamics.

Figure 30: Much of DM inflation explained by one factor



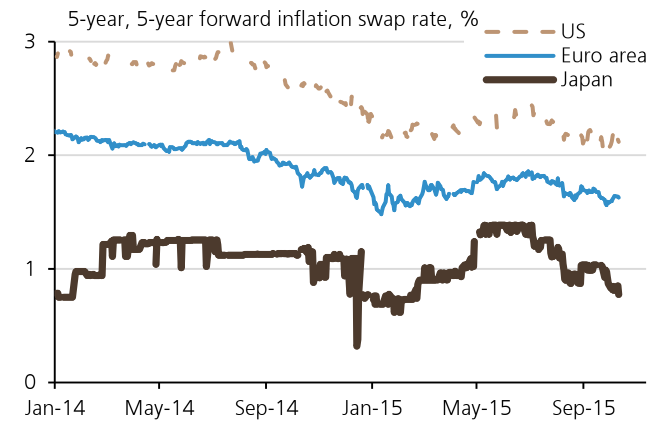
Source: Haver, UBS. Proportion of variance explained by first principal component of inflation for 18 EMs and 33 DMs over rolling 4-year windows.

Figure 31: Low inflation now more likely to stay low



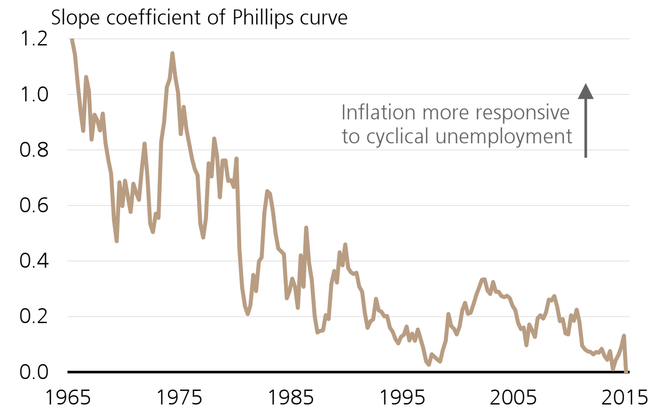
Source: IMF, OECD, Haver, UBS. Median coefficient on lagged inflation from Phillips curve models for 20 advanced economies, rolling 5-year estimations

Figure 32: Inflation expectations fall, easing follows



Source: Bloomberg, UBS.

Figure 33: The link between inflation and slack is severed



Source: IMF, OECD, Haver, UBS. Median coefficient on unemployment gap from Phillips curve models for 20 advanced economies, rolling 5-year estimations.

The opportunities:

Prefer Euro-area and Japan equities, where policy easing can be amplified by solid credit dynamics.

Historically, low inflation and easy policy has been beneficial for equity markets in economies where credit growth dynamics are accelerating. The two major equity markets featuring these dynamics are the Euro-area (discussed above) and Japan. In Japan, Niall MacLeod also highlights additional potential support to local equities from the Kakusei (corporate restructuring) theme (see "A theme for all seasons", 9th September 2015).

JPY, SEK, CHF, AUD, NZD and Asian FX to weaken vs EUR and USD.

In FX, the incentive for small open economies where global disinflation is likely to be felt more intensely, is to deflect the relevant pressures via FX weakness (either directly or indirectly via lower rates). In that sense, we expect currencies such as SEK, CHF, AUD to weaken against the EUR and the USD. And in EM, we expect policy linked FX weakness across Non-Japan currencies.

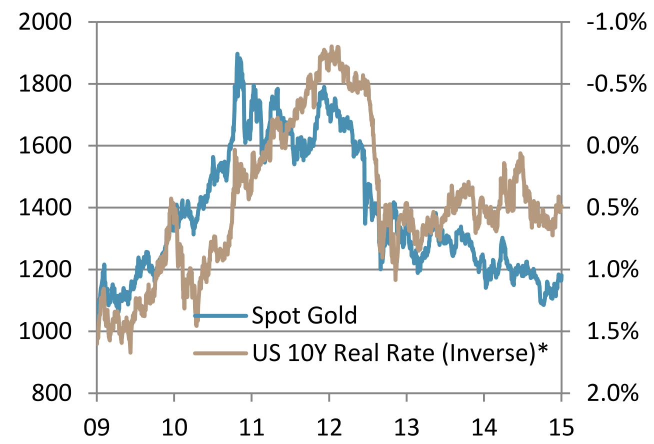
In Japan, we expect persistently low inflation rates and a loss in momentum for the JPY should spur another round of easing to be delivered in the months ahead. In turn, this should catalyse JPY weakness against EUR and USD.

Low real rates to support Gold.

Finally, we are constructive on gold over the coming year and expect gold prices to average $1250. The gold market has already made considerable adjustments in terms of price and positioning over the past couple of years to anticipate Fed policy normalisation. However, the potential for US real interest rates to settle lower versus previous cycles and versus the market's initial expectations suggests that the correction in gold may also have been overdone (Figure 34). This creates some room for gold to recover from here. Supply and demand fundamentals suggest that market is getting close to finding a good base from which it can moderately recover. Data suggests that core demand trends in key physical markets are more resilient than market sentiment currently suggests.

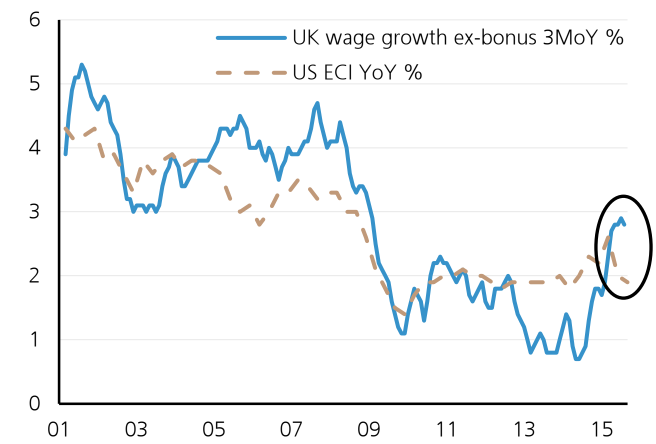
We are not calling for another bull run in gold and we acknowledge that it is not going to be a straightforward journey higher. Nevertheless, we think that the risk/reward has shifted, particularly against the backdrop of broader macro uncertainty. Given light positioning relative to history, there is scope – especially for medium- to long-term investors – to rebuild gold exposures to hedge against tail risks.

Figure 34: Gold has room to recover



Source: UBS, Bloomberg.*US 10Y Real Rate = 10 Swap Rate – 10Y Breakeven

Figure 35: UK wage growth overtakes US…



Source: UBS, Haver

The risks:

The risks to our views are balanced in both directions. But obviously, given our biases, our views are more negatively exposed to an increase in global inflation above and beyond base effects. One way to hedge that risk is to position for earlier hikes in the UK relative to the US. As discussed in our most recent Global Rates Landscape (25th October 2015), the market reflects an implausible gap of 10 months between the time the Fed starts raising rates and the BOE follow-through, when in fact relative activity and wage dynamics are probably arguing for a tighter gap (Figure 35). A key trigger would be the recovery in inflation from very low rates.

Unexpected inflation upticks can always occur, but they can also be hedged: market reflects an implausible gap between the time the Fed starts raising rates and the BOE follows along.

Investment implications across asset classes

Equities – Long Japan & Europe, avoid EM, US risk-reward deteriorates

Developed market equities should grind higher throughout 2016 as the majority of central banks reassert their dovish stance and the growth outlook slowly but gradually improves. We are particularly in favor of Japanese equities where we expect continued BoJ easing against a backdrop of weak growth, below target inflation, and declining exports.

Macro environment remains equity friendly, but risk-reward in stocks to deteriorate, especially in the US. Japan and Europe set to outperform.

We also like European equities where investors are yet to price-in the improving credit dynamics (See European Impulse) and the ECB is inclined to follow through with more easing to reaffirm the recovery. The EM slowdown poses some risks to external demand but European activity is predominantly driven by domestic demand which we expect to remain strong – the retrenchment in fiscal spending is set to reverse in 2016 for the first since the debt crisis which should provide a further boost in this regard.

Our outlook on US equities, while still positive in 2016, is relatively more cautious (see US Equities: Signs of The Top?). First, the US is at a more mature stage in its growth cycle with less favorable implications for earnings growth. Second, rising wage growth and low levels of unemployment should translate into lower corporate margins. Third, and perhaps most importantly, 2016 is likely to be the year the Fed finally delivers monetary tightening. In this environment we prefer to be more selective, underweighting FX/rates sensitive stocks (e.g. utilities, consumer

staples) in favor of companies with large cash reserves and consistent earnings growth, particularly in the consumer discretionary, healthcare and IT sectors.

We are less constructive on EM equities where weak balance sheets continue to result in a gradual but sustained deterioration in fundamentals. The most recent rally is likely to prove a temporary bounce in a broader trend of negative EM returns in 2016 (Chase or fade the EM rally?, 27th October 2015).

Rates – Low yield environment to persist with EUR yields rising versus US

Low yield environment to persist, with upside risks to yields, particularly in the Euro-area.

While there are some upside risks to yields from current low levels, we do not expect a major upset to the environment of low global yields. A wide global output gap implies the need for global financial conditions to remain easy and we expect this to be the case. But flat curves will likely steepen somewhat, with Europe underperforming the US.

The earlier the Fed hikes, the more likely it is to deliver economic outcomes consistent with low yields in the long run – in the US and globally. Later hikes will be associated with lower rates in the near term, but are likely to help push the long end of the curve higher (curve steepening), as explained in our Big Macro 2 framework. But given recent Fed communication and the views of our economists, this later scenario is less likely.

In Europe, while peripheral spreads tighten, core Euro-area yields should rise versus the US and the rest of the world. We would avoid core Euro-area bonds as we expect core yields to rise following the announcement of further easing. Instead, we continue to recommend short positions in 10y Bunds vs US Treasuries, as the Euro-area re-couples with the US. We like the risk/reward of receiving Aussie rates versus Euro area rates, in the event that China slows by more than expected and creates downside risks to our Euro-area growth views.

In China, there is room for lower yields. With the PBoC over-sterilising its FX interventions this year, banking system and money market liquidity is ample. This should pave the way for further downside in CNY (ND) IRS rates and CNY bond yields. Meanwhile, 10y yields deflated by CPI and PPI are as high as 5.5%. We favour long positions in China onshore government bonds.

Finally, as a hedge to inflation globally, we see value in positioning for earlier hikes in the UK relative to the US, as discussed above.

FX – EUR & USD to strengthen vs EM currencies & policy easers

EUR and USD trade-weighted appreciation ahead…

In FX, the EUR and the USD should appreciate against a) EM FX and b) currencies from countries where authorities are likely to continue easing monetary policy (JPY, AUD, SEK, CHF, NZD Non-Japan Asia FX). The beginning of the normalization in US rates will allow space for the nations that are keen to ease monetary conditions to do so via weaker currencies against the USD. Having said that, the broad dollar strength of 2015 against G10 currencies and the EUR is unlikely to be repeated.

We continue to expect the EUR/USD range to hold, with a bias toward the higher end of this range. We see bigger scope for EUR to gain versus JPY, where the BoJ is likely to implement further easing measures against a back-drop of weak growth and improving but still below-target inflation.

We expect a rally in DM FX versus EM FX. As detailed in our recent research ("Can narrowing trade imbalances boost EM FX?", 21st October 2015), trade balances in EM have experienced strong sequential improvement in recent months and these might be perceived as perfect ingredients for an extended period of stabilisation in EM currencies. But we disagree. EM's current account healing, in its current form, is unlikely to drive a sustained rally in currencies, for a number of reasons: external adjustment continues to be driven by import compression, capital account vulnerabilities might overwhelm current account improvements, and export competitiveness does not appear to be sharpening.

…while EM FX is likely to weaken

Credit – Europe credit to outperform vs EM credit and low credit quality US credits

The credit picture is mixed with US credit priced for weaker credit dynamics already, EM sovereign credit set to underperform and Euro-area credit exhibiting room for tighter spreads amid easier policy.

Mixed trends in global credit with the Euro-area as the bright spot.

In the US, we see headwinds to credit markets, especially at the lower credit quality parts of the market. We are closely watching the recent decline in non-bank liquidity to gauge for further deterioration. We favour selling credit from lower-quality issuers. In particular, CCC spreads (ex-energy) are priced for perfection, not capturing the potential for a more elevated default cycle in the near-term.

In Europe, we recommend investors buy Euro-area high yield credit (the iTraxx for instance), on the back of a strong credit impulse not yet priced in to the market and ECB easing driving risk assets higher.

EM credit shorts can be a good global macro hedge for broader portfolios. EM credit is likely to underperform and current levels offer good risk/reward to get long EM protection again. EM sovereign credit has rallied more aggressively than developed market credit in the US or EA. We were long European credit relative to EM credit, and although this position has theoretically done well after the first week of October, we were stopped out in the EM squeeze prior to that. Current levels offer good risk reward to get long protection again, both in absolute terms and against developed market credit. We are negative on credit in EM in Turkey, South Africa, Colombia, Mexico, India and Indonesia while believing that the very front end credit in Brazil now presents value.

Statement of Risk

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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12-Month Rating	**Definition**	**Coverage**[1]	**IB Services**[2]
Buy	FSR is > 6% above the MRA.	49%	33%
Neutral	FSR is between -6% and 6% of the MRA.	40%	26%
Sell	FSR is > 6% below the MRA.	12%	18%
Short-Term Rating	**Definition**	**Coverage**[3]	**IB Services**[4]
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%

Source: UBS. Rating allocations are as of 30 September 2015.
1:Percentage of companies under coverage globally within the 12-month rating category. 2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.
3:Percentage of companies under coverage globally within the Short-Term rating category. 4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

KEY DEFINITIONS: Forecast Stock Return (FSR) is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months. **Market Return Assumption (MRA)** is defined as the one-year local market interest rate plus 5% (a proxy for, and not a forecast of, the equity risk premium). **Under Review (UR)** Stocks may be flagged as UR by the analyst, indicating that the stock's price target and/or rating are subject to possible change in the near term, usually in response to an event that may affect the investment case or valuation. **Short-Term Ratings** reflect the expected near-term (up to three months) performance of the stock and do not reflect any change in the fundamental view or investment case. **Equity Price Targets** have an investment horizon of 12 months.

EXCEPTIONS AND SPECIAL CASES: UK and European Investment Fund ratings and definitions are: Buy: Positive on factors such as structure, management, performance record, discount; **Neutral:** Neutral on factors such as structure, management, performance record, discount; **Sell:** Negative on factors such as structure, management, performance record, discount. **Core Banding Exceptions (CBE):** Exceptions to the standard +/-6% bands may be granted by the Investment Review Committee (IRC). Factors considered by the IRC include the stock's volatility and the credit spread of the respective company's debt. As a result, stocks deemed to be very high or low risk may be subject to higher or lower bands as they relate to the rating. When such exceptions apply, they will be identified in the Company Disclosures table in the relevant research piece.

UBS Global Credit Strategy and Research: Rating Definitions
UBS ranks potential investment opportunities within non-government fixed income markets and sectors. Issuers are rated on one or both criteria shown below, and specific securities may be recommended as well.

	UBS Terminology	Time Horizon	Definition
Issuer Ratings			
Credit Rating	AAA, AA, A, BBB, BB, B, CCC, CC, C (+/-)	Up to 12 months	UBS' assessment of a company's creditworthiness
Outlook	Positive; Stable; Negative	Up to 6 months	UBS' expected trend in a company's creditworthiness
Security Recommendations			
Bond Recommendation	Outperform; Marketperform; Underperform	Up to 3 months	A corporate bond's expected relative performance versus a defined reference
CDS Recommendation	Buy Protection; Sell Protection	Up to 3 months	Recommendation to hedge a company's creditworthiness

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Source: UBS

Company Disclosures

Issuer Name	Credit Rating	Outlook
Brazil[22]	-	-
China (Peoples Republic of)	-	-
Colombia	-	-
Commonwealth of Australia[2, 4, 5]	-	-
Dominion of New Zealand[1]	-	-
Federal Republic of Germany[2, 4]	-	-
Hungary	-	-
India (Republic Of)	-	-
Indonesia (Republic of)	-	-
Israel (State of)	-	-
Mexico	-	-
Poland	-	-
Republic of Italy[2, 4, 5]	-	-
Singapore	-	-
South Africa (Republic of)	-	-
Taiwan	-	-
Thailand (Kingdom of)	-	-
Turkey	-	-
United Kingdom of Great Britain[2, 4, 16, 22]	-	-
United States[22]	-	-

Source: UBS. Ratings in this table are the most current published ratings prior to this report.

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