Global Macro Strategy
Top Macro Trades for 2016

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After a difficult 2015 for macro investors, 2016 is unlikely to get easier

Increased volatility, slowing EM growth, fluctuating quarterly US growth rates, and persistent uncertainty regarding US monetary policy have made 2015 a tricky year for macro trading. 2016 is unlikely to be much easier. Even after the first Fed hike, volatility should remain high as clarity on the Fed's future path will be limited, and EM continues to face a challenging growth environment.

Avoid strong directional bias, focus instead on risk-reward combinations

DM equities can still rise against this backdrop, and we remain cautiously positive, but expectations need to be tempered and portfolios adjusted, as strong equity gains from 2012 to 2014 pulled forward future returns. Combining long DM equities with short-risk positions in FX and rates can create portfolio combinations with strong expected returns. This is key to our market views and top trades for 2016, where we avoid strong directional positioning, and instead focus on trades that when combined, can produce positive expected returns under a number of potential macroeconomic outcomes.

Top cross-asset macro trades for 2016

1. Long Eurostoxx 50, currency unhedged

2. Sell EUR/USD puts, long USD/JPY

3. Long DM FX (EUR and USD) versus short EM FX (SGD, TRY, TWD, and ZAR)

4. Short Bunds versus long 10-year Treasuries

5. Receive 5yr5yr rates in Australia versus pay 1yr1yr rates in UK

6. Long US large cap versus short US small cap

7. Long CAD/MXN and long GBP/AUD

8. Long DM financials versus short EM financials

Macro backdrop to remain tricky in 2016

Another year of elevated volatility seems likely…

2015 has been a tricky year for macro investors, defined by persistent monetary policy uncertainty in the US and slowing growth in the emerging world. This has translated into higher market volatility and lower returns across asset classes, with the Sharpe ratio to being long both US equities and Treasuries falling to the lowest of the past five years (Figure 1). In FX, carry trades have been a particularly poor strategy, with both negative returns and significantly higher volatility (Figure 2).

Last month, we published our 2016 Global Macro Strategy outlook, focusing on our key macro themes. Here, we translate these themes to trades. In our base case, we see another year of moderate global growth, with headline inflation edging slightly higher due to base effects, but core inflation remaining low as disinflationary forces persist. Fed lift-off against such a backdrop should keep monetary policy uncertainty high and market volatility elevated.

…amid heightened uncertainty around Fed policy and EM.

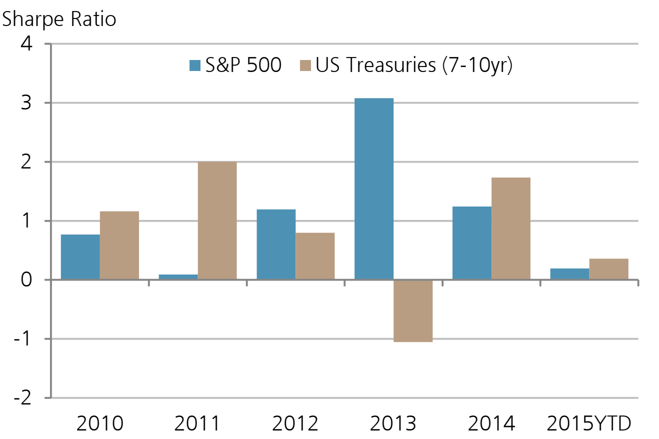
Even after the first hike, the future path of rates will remain data dependent, and feedback effects from higher US rates to tighter financial conditions will further complicate the Fed's task. EM growth may stabilize, but will be doing so at weak levels, as China's deceleration extends and pressure on EM balance sheets rises.

Given the uncertainty, we prefer to avoid strong directional bias, and instead focus on trades that when taken together, can produce positive expected returns across a number of potential macro outcomes. This broadly consists of:

Focus on combinations of trades that produce positive expected returns

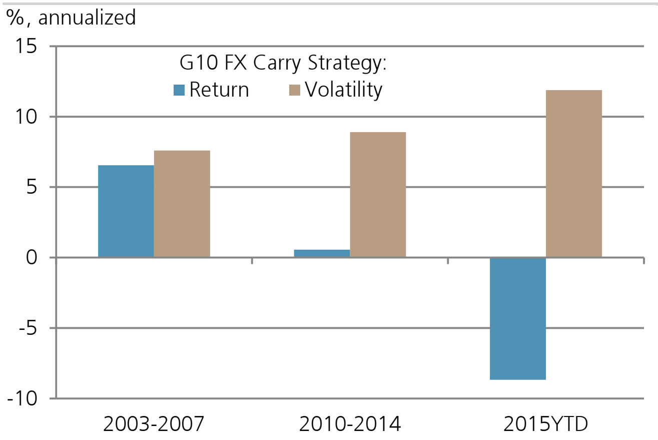
- **Long risk through DM equities**. We favour markets where central banks are easing (or have the potential to ease) and credit growth is strong. Europe stands out in particular.
- **Short risk through long DM duration and short EM FX**. In duration, we favour Australia and the US, where an early Fed hike against a backdrop of low inflation raises the odds of an inflation undershoot that ultimately results in a more restrained hiking cycle. In FX, we see continuing underperformance of EM, and favour shorts in SGD, TRY, TWD, and ZAR.
- **Relative value macro trades, focusing on skew and valuation.** Central banks remain wary of domestic currency strength, and with inflation below target, long USD/JPY offers good risk-reward. From a valuation perspective, we favour CAD against both AUD and MXN, and we are bullish GBP on the potential for an earlier-than-expected Bank of England hike.

Figure 1: Portfolios challenged by low returns, high vol



Source: Bloomberg, UBS.

Figure 2: With higher vol, "easy" strategies suffer



Source: Bloomberg, UBS. 2008-09 crisis period excluded.

Portfolio analysis of top trades

The trades we recommend below are consistent with these views. The trades are meant to be structural, reflecting our broad themes and views, rather than tactical. As such, although we will track and update the performance of these trades over time, we do not offer specific stop-losses and targets. Our intention is to offer these trades as a general expression of our views, and we assume investors will implement and risk-manage them in a variety of ways.

Our trades are modestly long DM risk and duration, short EM

When viewed as a portfolio, we are taking little directional market risk with our top trades (Figure 3). As a portfolio, they have a slightly positive correlation to the S&P500, and a small negative correlation with both 2-year and 10-year US yields (long duration). The portfolio shows little correlation with the US dollar index, as the short EM basket is against both long USD and long EUR, while the G10 trades are relative value rather than dollar directional. Finally, with regard to crude oil, the portfolio has a slightly negative correlation to WTI.

Figure 3: Correlations of portfolio and trades with equities, bonds, USD, and oil

Correlation of daily changes (Jan 2014-Dec 2015)	S&P 500	2y UST yields	10y UST yields	Dollar index	Oil prices
Total Portfolio	*0.23*	*-0.21*	*-0.22*	*0.05*	*-0.04*
1. Long Eurostoxx 50, currency unhedged	0.49	0.09	0.25	-0.20	0.20
2. Sell EUR/USD put, long USD/JPY	0.46	0.42	0.46	0.18	0.12
3. Long DM FX vs. short EM FX	-0.47	-0.08	-0.09	0.23	-0.20
4. Short Bunds vs long 10-yr Treasuries	-0.28	-0.62	-0.63	-0.18	-0.11
5. Receive 5y5y AUD pay 1y1y GBP	-0.24	-0.55	-0.73	0.02	-0.14
6. Long US large cap vs. short US small cap	0.02	-0.08	-0.11	0.08	-0.04
7. Long CAD/MXN, long GBP/AUD	0.26	-0.01	-0.03	-0.19	0.01
8. Long DM financials, short EM financials	0.29	0.11	0.14	0.16	0.02

Source: Bloomberg, UBS. Note: Dollar index is Federal Reserve's broad trade-weighted. Portfolio positions weighted by inverse volatility.

Three big ideas

From a thematic lens, our year-ahead trades are predicated on three main ideas:

- **Any pick-up in core inflation will be modest**

Low inflation should keep yields low and monetary policy easy

With global growth remaining moderate, and fears around EM growth risks high, this is key to avoiding a global risk sell-off. Despite scepticism from many investors, easy monetary policy still benefits asset markets, and if core inflation remains low, equity performance can remain part of central bank reaction functions.

Of the four possible combinations of equity and 10-year rate outcomes, modestly lower 10-year yields and modestly higher equities is our base case over the coming months. Higher yields and lower equities should be the lowest likelihood combination, as low core inflation allows central banks to lean against any equity shock with marginally less restrictive policy.

- **European growth will accelerate in 2016**

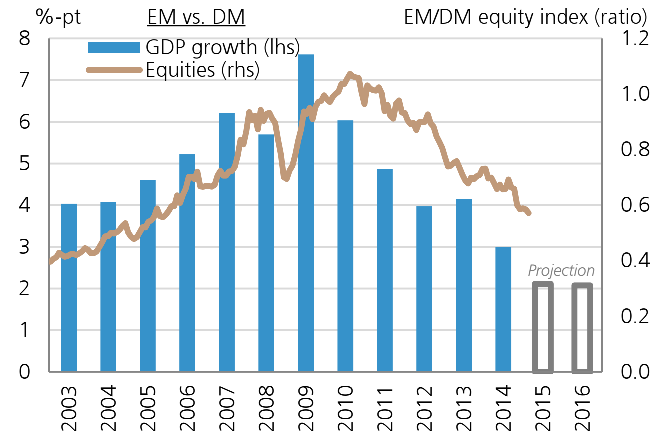
Eurozone growth should pick up as credit recovers

We have been arguing that markets are over-pricing the degree of future divergence between the US and Euro area (link), and a further improvement to European growth in 2016 is key to this view. Our European Economics team forecasts growth rising from 1.5% in 2015 to 1.8% next year. Policy in Europe is supportive, with both fiscal and monetary policy set to loosen, and the ongoing easing in credit conditions is pointing to acceleration in private sector demand.

- **Growth in China will continue to slow**

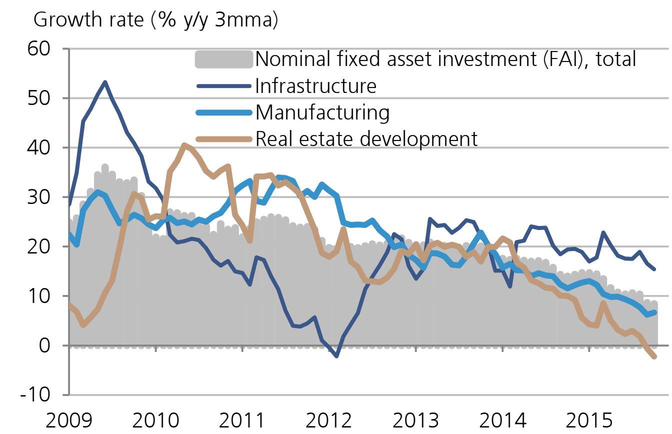
Policymakers should be able to manage this slowing (see China Outlook), and tail risks from a sharper growth slowdown are a relatively low probability event, in our view. Nonetheless, further slowing in Chinese growth is tradable, particularly through Australian and EM Asia assets, FX in particular. Against this backdrop, we also see pressure on EM balance sheets continuing to rise.

Figure 4: Narrowing EM-DM growth gap should be reflected in EM equity underperformance



Source: Datastream, Haver, Bloomberg, UBS.

Figure 5: Less Chinese investment, more challenges for commodity producers



Source: China NBS, UBS China Economic Research.

Where we can be wrong

Our recommended trades would underperform in the cases of:

Given the degree to which our year-ahead trades are driven by the three assumptions above, the main risks to our trades revolve around them.

1. A sharp rise in core inflation

A sharp rise in core inflation that called into question the ability of central banks to keep policy loose or retain their "equity put" would be negative for risk markets. However, keeping in mind our view that having offsetting risk in portfolios is key in 2016, our short EM FX positions should perform very well in such a scenario, compensating for some of the equity exposure in the portfolio.

2. Slower Eurozone growth

The second risk – an idiosyncratic slowdown in European growth – would likely be the worst for our overall portfolio of recommended trades. It would negatively impact our pro-cyclical European trades, including Eurostoxx, EUR/USD, and German rates, with little overall offset in the portfolio.

3. Acceleration in China's growth

Finally, if Chinese growth were to accelerate significantly, our short-Australia risk positions (AUD and Australian rates) would perform poorly, as would our short EM FX exposure. Long Eurostoxx would likely do well in such an environment, but not well enough to offset the other positions.

Although we are not forecasting a sharp slowdown in China, if a tail scenario were to occur, the overall portfolio should perform well. Long equity exposure would perform poorly, but short EM FX and long duration positions should more than compensate.

Trade #1: Long Eurostoxx 50, currency unhedged

There is a strong case for Eurozone equities

The motivation: European equity valuations are favourable, and markets should benefit from a combination of improving credit growth, monetary stimulus, low energy prices, and a slightly positive fiscal impulse in 2016.

The details: After remaining stalled for years, credit growth has begun to recover in the Eurozone. Our Leading Credit Indicator for Europe, constructed from components of the ECB lending survey, has historically led both credit and GDP growth, as well as equity performance (see link). This leading indicator is pointing to a further acceleration in credit growth, yet markets are significantly under-pricing the possibility (Figure 6).

As credit improves and nominal GDP picks up…

The improvement in credit growth, combined with supportive monetary and fiscal policy, and lower energy prices, should lead to an acceleration in 2016 growth. Our European Economics team forecasts growth rising from 1.5% in 2015 to 1.8% next year. In particular, they see a pickup in nominal GDP growth as inflation turns – a key support for corporates' revenue growth. Policy in Europe is supportive, with both fiscal and monetary policy set to ease, and the ongoing easing in credit conditions is pointing to acceleration in private sector demand.

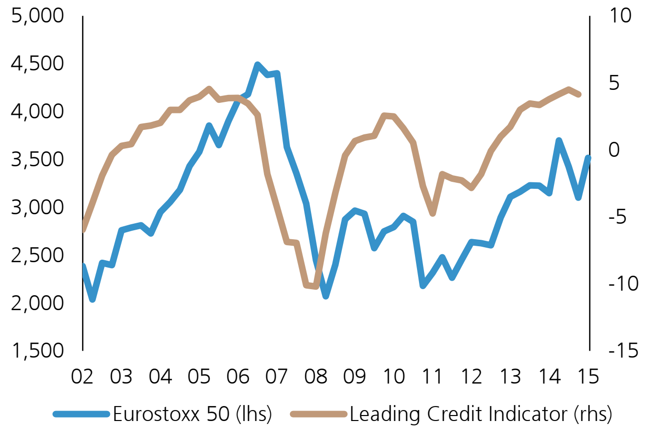
…earnings should grow for the first time in 5 years.

Against a backdrop of accelerating growth, continuing low inflation should allow accommodative policy to remain in place and enable credit reflation. This should be particularly positive for equities, and our European strategists have a 13% earnings growth forecast for 2016. This would be the first earnings growth in five years, driven by improving nominal GDP, rising margins, and high operational leverage as wage and material costs remain low. They also stress that actual lending to corporates by banks, which is the principal source of funding for European corporates, has turned positive for the first time in over three years.

Finally, it is worth noting that on a cyclically-adjusted basis, the European valuation gap to the US is at recessionary levels (Figure 7).

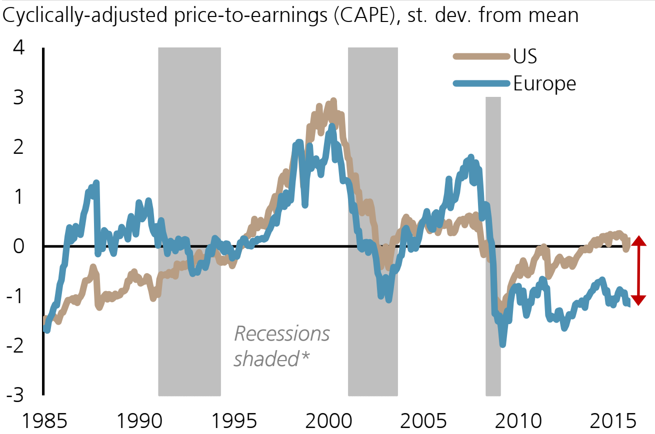
The risks: Some degree of European recovery is likely priced. Earnings disappointment due to European growth weakness or a rise in fears regarding the EM backdrop would be negative. EUR/USD strength would be a drag on earnings, though we are likely far from levels where it would be an issue, and would expect the ECB to lean against EUR/USD strength above 1.15 in the near term.

Figure 6: Leading Credit Indicator based on ECB bank lending survey suggests Eurostoxx upside from here



Source: UBS calculations, Haver, ECB.

Figure 7: US-Europe gaps are at recessionary levels



Source: Thomson Datastream, UBS European Equity Strategy.*German recessions.

Trade #2: Sell EUR/USD puts, long USD/JPY

We see limited downside in EUR/USD, but upside in USD/JPY

The motivation: Despite containing long and short dollar components, both legs of this trade are expected to profit in our base case. EUR/USD remains undervalued, and markets are still under-pricing re-synchronization between the US and Euro area economies. Although USD/JPY has risen significantly in recent years, the BoJ remains sensitive to the y/y level, and will be reluctant to let it fall below zero on that basis.

The fall in EUR/USD is boosting Eurozone growth and weighing on US growth…

The details: We think both legs of this trade provide positive skew. Downside in EUR/USD should be limited to around 1.05 given the negative impact dollar appreciation is having on US exports and manufacturing (Figure 8). A fall below that could impact Fed policy, and to the extent that dollar strength is predicated on a hawkish Fed, it becomes self-defeating. We recommend selling a EUR/USD put option with a six or nine-month tenor to take advantage of these dynamics.

…limiting Euro "divergence" trades.

At the same time, markets continue to underestimate the potential for Euro area growth to accelerate next year, when we see 1.8% growth. The wide growth and core inflation gaps that existed versus the US a year ago have narrowed. US and European PMIs have converged, and this suggests upside for EUR/USD (Figure 8). Price action following last week's ECB meeting made it clear that another move lower in EUR/USD is more challenging.

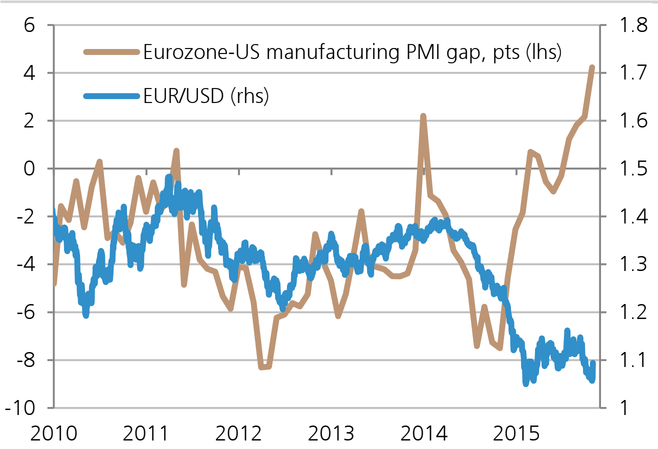
Japan still needs a weaker currency

If we are wrong in our EUR/USD view, we would expect gains in USD/JPY to offset any losses. Three years into "Abenomics", the Japanese economy faces significant challenges, with the inflation target remaining elusive, and continuing negative GDP growth. Trade linkages to China add to risks, and exports are now contracting year-on-year. In contrast to the booming Euro area trade position, Japan runs a trade deficit, suggesting greater need for FX weakness (Figure 9).

Although policymakers no longer view the currency as overvalued, we expect that they will want to keep USD/JPY rising on a y/y level, as this is what filters into imports prices, and then headline inflation, and inflation expectations. With a declining y/y USD/JPY, it is difficult to see inflation expectations rising. So, although the BoJ may not seek to actively weaken the yen, we do expect them to lean against downside.

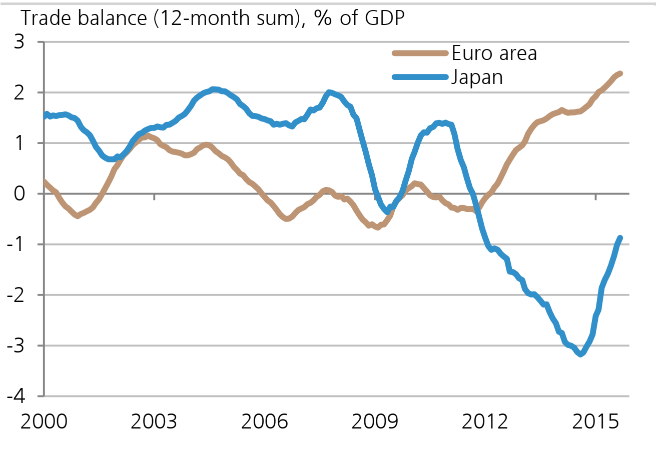
The risks: Global risk-off leads to a yen rally. Idiosyncratic risks in Europe, such as renewed deflation concerns, or another episode of Eurozone exit worries.

Figure 8: Industrial outperformance limits Euro downside



Source: Markit, ISM, UBS.

Figure 9: Based on net trade, Japan needs weak FX more



Source: Ministry of Finance, Bank of Japan, Eurostat, UBS.

Trade #3: Long DM FX (USD and EUR) vs. EM FX (SGD, TWD, TRY, ZAR)

EM currencies can fall further

The motivation: EM currencies have weakened, but aren't overshooting. EM FX will likely remain under pressure as weak global trade, tightening US financial conditions, and deteriorating EM balance sheets pressure capital account flows.

Leverage is rising and trend growth is falling

The details: Turkey and South Africa remain burdened by modest external competitiveness, and relatively large current account deficits with poor financing quality. Both rank among the most vulnerable major EMs in our macro balance sheet risk index. Turkey's 'core' non-energy and gold trade deficit has remained sticky at just over 5%/GDP, with 'other investment' flows (mostly pro-cyclical bank borrowing flows) constituting the bulk of financing. With trend growth slowing and corporate leverage having risen rapidly, these flows may not represent a sustainable source of financing, overwhelming the positive impact of low oil prices.

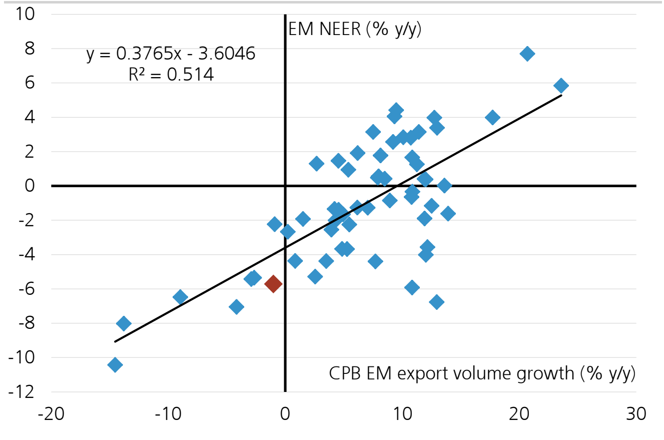
South Africa continues to be severely impacted by the shift away from commodity-intensive growth in China, a process we believe will continue. Despite a weaker ZAR, manufacturing as a % of GDP remains near the lows, industrial production has been stagnant, net FDI has moved further into negative territory, and our estimate of the ZAR ULC-based REER is merely back to 2009 levels. Fiscal pressures are likely to intensify, leaving the government with difficult choices. Investment grade credit ratings for both markets appear at risk in 2016.

Policymakers likely to lean more on FX weakness to boost growth

Taiwan and Singapore remain burdened by high and rising leverage, weaker growth in China, and historically high real exchange rates. Core inflation in both markets has decelerated significantly and could come under further pressure if the RMB depreciates towards 6.80/USD next year as our economists expect. Taiwan's central bank (CBC) only began cutting rates in September, and we think will allow further FX depreciation amid a weak export and growth outlook. EM Asia is 46% of the SGD NEER basket, and structural long USDSGD positions provide generalized exposure to weaker Asia FX. In 2016 we expect the MAS to ease again by reducing the slope to 0%, in response to weakening real estate and labour markets. A downward re-center is possible, but is not our base case.

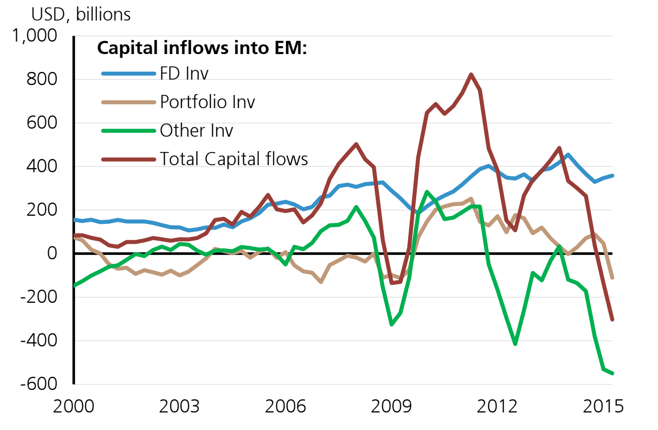
The risks: A stronger-than-expected rebound in China, providing support to EM growth and commodity prices. Political developments have sharply depreciated the ZAR in the days leading up to publication. The key macro drivers for ZAR are unchanged, though the entry point reduces risk-reward.

Figure 10: EM FX overshot? Weak exports suggest not



Source: Source: CPB World Trade Monitor, Haver, UBS estimates. Note: data based on quarterly data since 2001. Red dot denotes Q3-2015 values (latest available at writing). EM NEERs shown here as simple average of 22 markets.

Figure 11: Capital accounts offset better current accounts



Source: Haver, UBS.

Trade #4: Short Bunds versus long 10-year Treasuries

The motivation: Europe is recovering, but the market is not pricing it. We expect back-end German yields to rise, and given what is already priced into the US curve, we see little upside to yields, but potential downside. We expect the yield spread to fall to around 80bp from the current 170bp.

Europe is recovering…

The details: European nominal growth should run about 3% by the end of next year. We think this should equate to a 10-year Bund yield of 1.7% by year-end. Almost all of the headwinds perceived in Europe a few years ago have now turned into tailwinds, and the major risks to growth and inflation are now external. In particular, the credit impulse, fiscal policy, the level of the currency and that of energy prices are all supportive for Europe (Figure 12).

…as credit and fiscal policy turn from headwinds to tailwinds.

At the same time, there appears to be little upside to US yields versus the forwards. An early Fed hiking cycle risks a static 10-year yield versus the forwards rather than a higher one. This was the case during the last tightening cycle, when 10-year yields fell before ending the cycle unchanged. This time, we see downside risks as greater: terminal rates are lower than they were in previous cycles and credit markets appear more sensitive to rate rises than they were before.

It is possible that rising European growth and inflation fail to materialize, but we think European curves are already priced for such an outcome. Figure 13 shows that y/y inflation is not priced to meet the ECB's target of just below 2.0% for another nine years. Indeed, headline inflation is not priced to meet core inflation for another three years, even though this would happen in just four or five months if the volatile components remain unchanged.

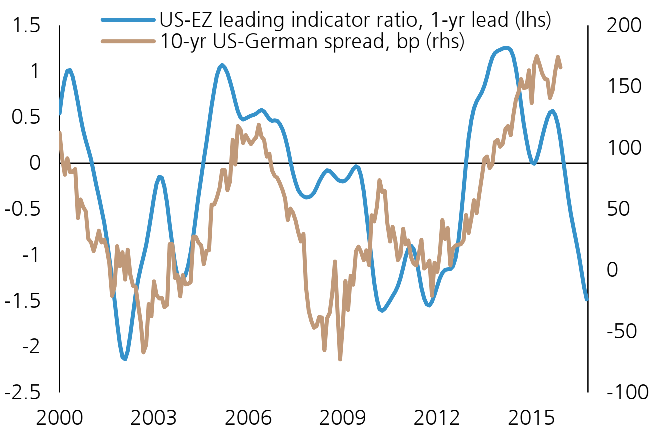
US-German yield spread near all-time highs…

Conversely, the US curve is priced for inflation to reach the 2.0% level in four or five years, and for real rates to turn positive after that. If any slowing in future inflation is driven exogenously (e.g. by a sharp slowdown in China), then the US curve should move more than the European curve, given that inflation is currently at 0% in both regions, also narrowing the US-German 10-year yield spread.

…should narrow, since economic gaps have narrowed.

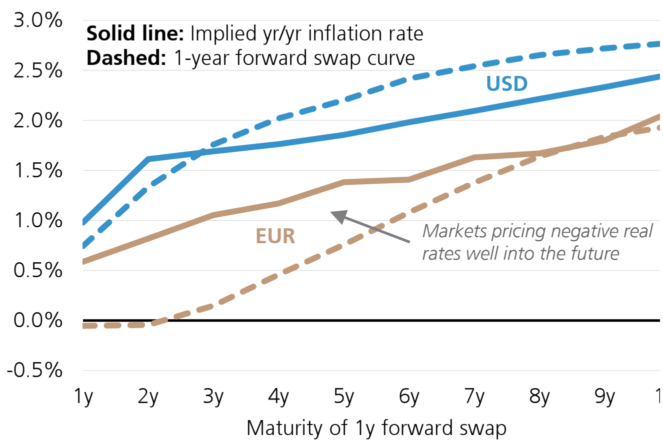
The risks: A faster-than-expected rise in US growth or core inflation would be negative for this trade, as would a growth slowdown in Europe, or a re-emergence of political concerns in the periphery.

Figure 12: Leading indicators imply spread tightening



Source: OECD, Bloomberg, UBS. Note: OECD composite leading indicator.

Figure 13: Euro inflation pricing too low, especially vs. US



Source: Bloomberg, UBS.

Trade #5: Receive 5yr5yr Australia rates versus pay 1yr1yr UK rates

The motivation: We expect medium-dated Australian yields to fall as a less optimistic nominal growth outlook becomes more widely anticipated. In the UK, short-dated forward rates are likely to rise as rate hikes become imminent and the subsequent tightening cycle is priced with more conviction.

Australian yields seem too high and UK yields too low

The details: In an environment of steady-to-falling 5yr5yr rates in the US, we see terminal rates in Australia as too high considering the divergent macro outlooks between the regions. As China slows and the capex cliff continues to weigh on Australian growth, we expect further convergence between Australian rates and those in the US, Euro area, and UK.

Our Australia economist expects the RBA to remain on hold for the foreseeable future, and if one assumes that the same exogenous risks that could threaten the US (and global) economic recovery would likely impact Australia to an even greater extent, receiving 5yr5yr rates in Australia at around 3.55% - compared with 2.70% in the US 5yr5yr and 1.20% in the UK 1yr1yr – is attractive (Figure 14).

The China drag should keep the RBA on hold…

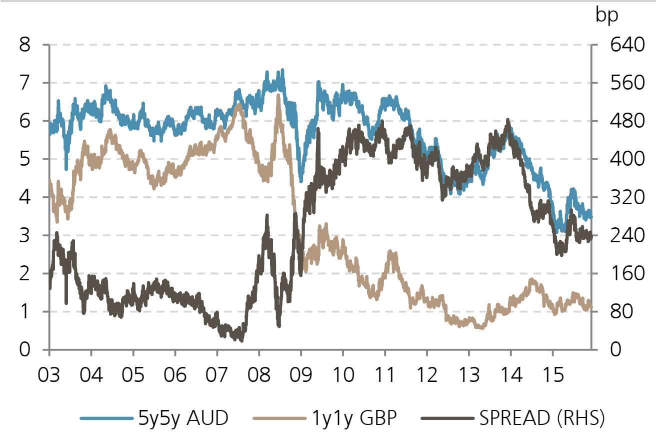
In the UK, our economist continues to anticipate a first Bank of England rate hike in May 2016, around six months earlier than the market currently expects. A tightening Fed, accelerating headline inflation in the UK, and robust real earnings due to a tight and strong labour market are the necessary pre-conditions in our view for the MPC to start raising rates. We expect that all of these conditions will be met by the middle of 2016.

As Figure 15 shows, firming expectations of imminent policy tightening consistently leads the 1yr1yr UK swap rate higher in the run-up to the first hike of each cycle. We expect the same dynamic to hold during the first half of next year.

…and the BoE has the potential to turn hawkish.

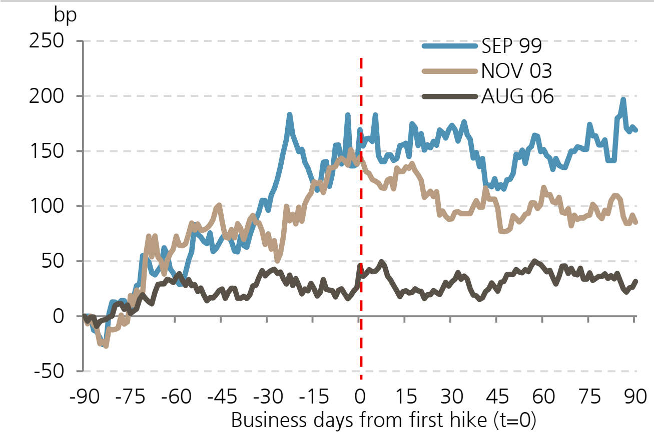
The risks: Given the opposing directions of these trades, the main risks to them are idiosyncratic: a growth slowdown or rising political fears in the UK, and a domestically-driven growth pick-up in Australia. If Australian rates rise due to a better-than-expected outlook in China, we would expect the UK rates trade to perform well. In the opposite scenario, where slower global growth leads to a decline in BoE rate hike expectations, we would expect the Australian rates side of the trade to perform well.

Figure 14: 5y5y AUD swap rate (%), 1y1y GBP swap rate (%), and spread (bp). Target a decline to 150bp



Source: Bloomberg, UBS.

Figure 15: The 1y1y UK swap rate has risen in the four months ahead of each hiking cycle conducted by the MPC



Source: Bloomberg, UBS.

Trade #6: Long US large cap (S&P 500) versus short small cap (S&P 600)

The motivation: We envision further pressure on high yield credit spreads and a replay of the late 1990's environment. Thus far, small cap valuations have proven resilient versus large caps. But we believe an inflection point is near, and see significant downside risks for lower quality firms stemming from tighter financial conditions, rising default rates, and market illiquidity.

We see more challenges for small caps in the coming year

The details: We recommend buying US large cap (S&P 500) and selling US small caps (S&P 600) to position for a decompression between higher and lower quality firm shares.

First, fundamental credit trends have diverged significantly. Smaller capitalized firms have increased leverage at a rapid pace following the financial crisis, propelling net leverage to levels last seen in the late 1990s. Similarly, interest coverage ratios have declined to levels last observed in 2008, and are likely to face pressure from higher funding costs in the HY bond market. Conversely, larger capitalized firms have considerably better credit metrics (Figures 16 and 17).

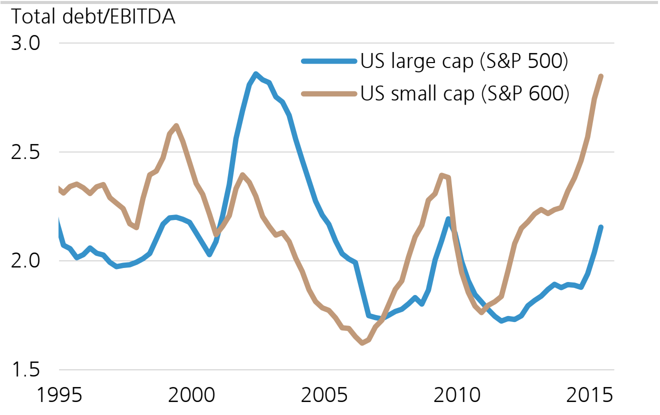
The lending environment should get tougher for firms with lower ratings and higher leverage

Second, our 2016 outlook is cautious on US high yield credit, anticipating further pressure on spreads as lending conditions tighten, default rates rise and liquidity deteriorates. Smaller capitalized firms, such as those in the S&P 600 with an average credit rating of BB, look increasingly vulnerable in a scenario of rising contagion and further market disruption. Investment grade yields should prove more resilient given stronger balance sheets, low Treasury yields anchoring funding costs, and strong overseas demand from investors. The S&P 500, with an average credit rating of A-, should maintain solid access to capital market funding.

Third, relative valuations in equity markets appear disconnected from credit markets. The S&P 600 has returned 3.7% year-to-date, matching the S&P 500 return of 4.1%. Conversely, US high yield returns of -2.8% have lagged high grade returns of 0%. Our analysis suggests that credit markets lead equity markets in times of stress (see link), and that the linkages are stronger between high yield and small cap stock returns than for high yield and large cap share returns. Moreover, although correlations between small and large cap stock returns have been elevated in recent years, we find small versus large cap valuations have decoupled significantly in past periods of broader high yield stress. The S&P 600 returned 12% annually from 1997 – 99 versus 27% for the S&P 500.

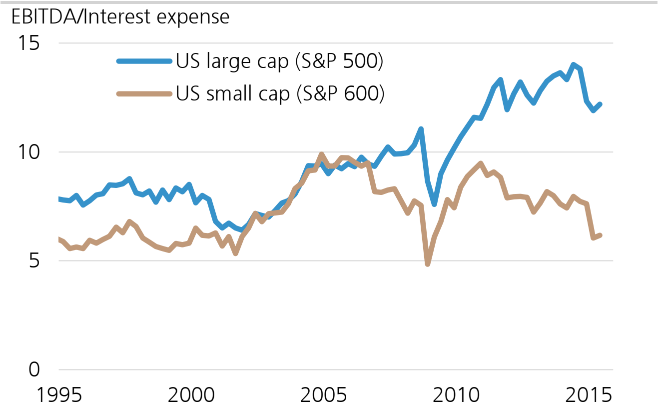
The risks: Near-term overshoot in equity valuations or a rally in commodity prices.

Figure 16: Small caps are more leveraged than large caps



Source: FactSet/Compustat, UBS.

Figure 17: Large caps have far better interest coverage



Source: FactSet/Compustat, UBS.

Trade #7: Long CAD/MXN and long GBP/AUD

The motivation: As DM outperforms EM, China decelerates further, and industrial metals stay challenged, we see upside for CAD/MXN and GBP/AUD.

The details: With 2016 likely to be another year of heightened uncertainty, we prefer trades that should do well in a range of scenarios. In broad strokes, our baseline view of stronger CAD and GBP reflects better growth in advanced economies, while AUD and MXN are likely to weaken as China-led industrial demand wanes, and EM concerns persist.

We expect DM FX to outperform EM and China-linked FX

As the MPC prepares to follow the Fed in tightening, sterling should rise. By some measures, the UK economy looks better than the US (see "Same difference"), and there is plenty of scope for the expected timing of the first BoE hike – currently only fully priced at the end of 2016 – to move earlier. The MPC will want to see CPI and nominal earnings rise in the first few months of 2016, and assuming this occurs, is likely to start sounding more enthusiastic about sanctioning a rate hike.

The UK economy looks as good as the US in many ways…

Australia's commodity drag persists, with capex continuing to contract amid slowing demand from China. But even as iron ore prices have fallen to new lows, AUD has remained supported, driven in part by an RBA that has turned less dovish. In contrast, despite relatively strong data, the BoE has remained more dovish than markets were expecting earlier in the year. We expect both stances to become softer on the margin, supporting a higher GBP/AUD.

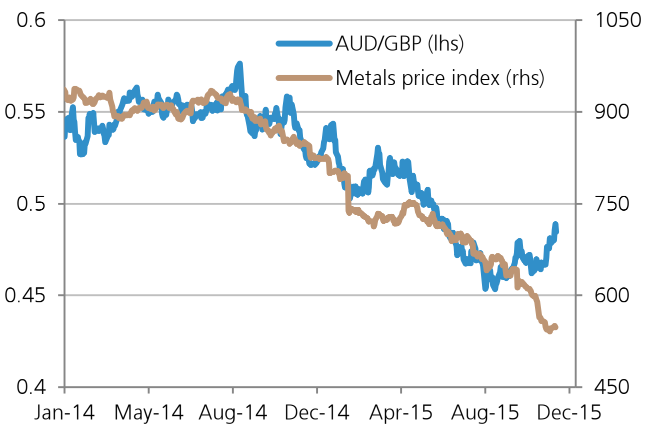
…while Australia faces more challenges.

Even if Mexico shines bright in an otherwise dim EM universe, we expect MXN to weaken against CAD. Fundamental improvement in Mexico will be overshadowed by the capital account, and with foreigners holding a large share of local debt, the currency is vulnerable to shocks elsewhere in EM. Upside surprises to Mexican growth are not necessarily positive for MXN vs. CAD, especially if the boost is US-driven, which we think would benefit CAD more. Historically, CAD/MXN has risen during Fed hiking cycles (Figure 19). Higher oil prices would likely benefit CAD more than MXN too, as continuing volatility should be negative for investment in Mexico's energy sector. Lower energy revenues are forcing Mexico to tighten fiscally, whereas Canada is likely to see fiscal easing in the coming year.

Mexico's currency may underperform, even if its economy outperforms

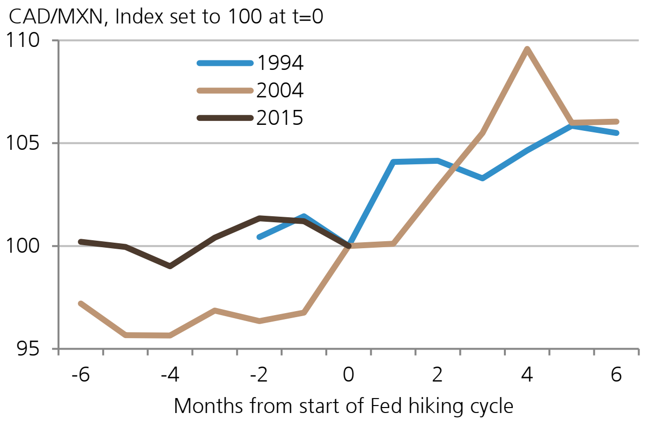
The risks: Policy stimulus in China that causes EM outperformance and boosts demand for industrial commodities.

Figure 18: AUD is likely to follow metals price lower



Source: Federal Reserve, UBS.

Figure 19: CAD/MXN tends to rise as the Fed tightens



Source: Banxico, UBS.

Trade #8: Long DM financials versus short EM financials

The motivation: Increased EM leverage and rising cost of equity to impact EM financials. Accounting for falling RoE, EM financials still look expensive versus DM.

The EM credit cycle looks "late stage"

The details: We think of EM financials as entering the late stage of the credit cycle, while DM financials, particularly in the US and UK, having de-levered since 2009, are better positioned to participate in a growth upturn in their economies. EM, having levered up steadily since the crisis, is likely to face a weak growth profile, negative credit impulse, and more severe asset quality problems moving forward. So far there has been no major increase in local currency money and bond market rates despite currencies having sold off for the last four years, but with credit spreads also slowly losing their mooring, the risk of rising cost of equity becomes much more real. Our analysts believe implied CoE for EM banks has already increased from about 11.7% to 13.8% during the last 6 months.

Both credit and nominal GDP growth are slowing

Credit growth is slowing, and nominal GDP growth is slowing even faster, implying leverage is still rising. This compromises both the ability to accumulate incremental assets, and also suppresses return on current assets. 56% of UBS analysts covering EM financials now expect downside risks to NIMs, compared to 40% in the previous quarter. The equivalent number for DM is 31%, unchanged from Q3.

EM financials look overvalued versus DM financials…

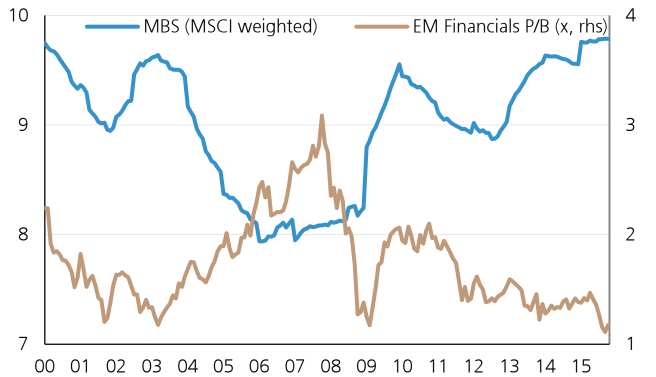
Although EM financials trade below DM financials on a price-to-book basis, we believe that trends in RoE are worse in EM as well. EM financials' RoE has dropped from 19% in 2012 to 15.6% today, and is likely to slip further. Also, if nominal GDP continues to fall at a faster pace than credit, we would expect EM financials to de-rate further. Already, valuations in EM financials seem high in this context.

…where US and UK banks show the most potential to outperform

We see DM financials not so much as a cheap play poised for a serious re-rating, as a defensive play that happens to be much better positioned than EM financials. We take the view that a slowdown in the emerging world is unlikely to substantially impact growth in the developed world. This is because a) DM economies are much less open than EM economies, so a hit from DM to EM cuts much deeper into EM than vice versa, and b) global liabilities are written in DM currencies, not EM currencies, so a tightening of liquidity in the latter owing to local banking or credit problems will not have nearly the same impact on global growth as a banking crisis in DM (as we saw in 2009). Within DM, our banks team led by Philip Finch has a preference for US and UK banks (see "When the tide goes out").

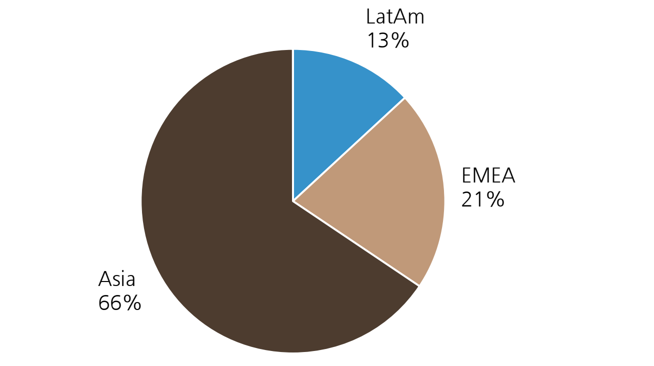
The risks: EM growth (particularly China/Asia) surprises to the upside, alleviating asset quality concerns and supporting credit demand.

Figure 20: Price to book EM financials vs EM MBS*



Source: Datastream, Haver, UBS. * represents MSCI weighted.

Figure 21: Regional breakdown of EM Financials



Source: MSCI, Datastream, UBS.

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Neutral	FSR is between -6% and 6% of the MRA.	40%	26%
Sell	FSR is > 6% below the MRA.	12%	18%
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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.
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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

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Issuer Name	Credit Rating	Outlook
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Federal Republic of Germany[2, 4]	-	-
Japan	-	-
Mexico	-	-
Singapore	-	-
South Africa (Republic of)	-	-
Taiwan	-	-
Turkey	-	-
United Kingdom of Great Britain[2, 4, 16, 22]	-	-
United States[22]	-	-

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