

# UBS Asset Management Flash commentary

# February 2018 | Technicals overpower fundamentals

# Erin Browne, Head of Asset Allocation, UBS Asset Management

# Why are equity markets selling off?

The catalysts for the sell-off in risk assets over recent days have been the rise in 10y bond yields globally over recent months and more specifically, the significantly higher than expected Average Hourly Earnings figure in the US on Friday. To investors cosseted and emboldened by a low inflation and low rates environment for so long, there seemed to be a sudden and violent repricing of the probability that higher inflation and higher rates may be on their way.

After a protracted period without any major drawdown, the equity market reaction has been sudden and severe. The S&P 500's 4.1% fall on Monday was the largest oneday drop in over six years, and the 20 point spike in the widely-watched VIX Index in the US was the largest one day percentage or absolute rise in the VIX's history. While other equity markets have also fallen sharply, the moves appear to have been most extreme in the US. Ironically given fears about the impact of higher bond yields, the risk-off environment has seen yields on 10yr US Treasuries pull back relatively sharply. Significantly, credit spreads have only widened marginally despite the scale of the equity sell-off

In our view, the contrast in risk asset behavior and the timing of the equity price action in recent days – with the sell-off accelerating materially into the market close – is consistent with the rebalancing of systematic trading strategies, risk parity funds and exchange traded products that invest in short-term VIX futures in particular. The popularity of low and short volatility exchange traded products, some leveraged, has increased dramatically over the past few years as investors seek any edge to boost returns. This reinforces our belief that while the initial catalyst to the sell-off was fear of a step change in the overall inflation and rates regime, that the subsequent risk-off momentum has been largely driven by technical rather than fundamental forces.

## What is the outlook from here?

It remains to be seen whether these technical forces will abate quickly. At the very least, events over the past few days serve as a salutary reminder of both the dangers of crowded positions and of the power of technical forces when combined with consensual positioning. But our view that the sell-off has been predominantly driven by technicals rather than fundamentals is a high conviction one and our central thesis remains unchanged. Importantly, we do not believe that the very strong global growth and earnings backdrop has suddenly evaporated. We see bond yields in developed markets ticking higher as growth expectations rise, global output gaps close and as wage growth rises from its current very low base. We see a violent shift higher in global bond yields as unlikely in the context of powerful demographic drivers and the on-going expansion of central bank balance sheets globally.

We believe it would take nominal 10yr US Treasury yields between 3.5% -4% with no change to growth and inflation expectations to restrict growth or to start impacting the overall earnings environment in a meaningful way. While equities are selling off it is worth remembering that they are doing do at a time when global monetary policy remains accommodative and as global economy continues to enjoy a stronger than forecast expansionary impulse that is broad-based by geography and by economic sector. In our view, the rise in corporate capital expenditure reduces the global economy's reliance on consumption and gives us confidence that global recession risks are low.

Against this backdrop, corporates are also delivering stronger than expected profits growth. We see scope for further upside surprise in earnings across developed and emerging markets as tax reforms boost capex and capital returns to shareholders in the US, and as operational gearing kicks in as the recovery accelerates in Europe, Japan and in Emerging Markets.

Given valuations are now more attractive, we will be looking closely at whether there is now an attractive opportunity to add risk to portfolios.

### An equity market perspective Kevin Barker, Senior Equity Specialist

The scale of the sell-off is not unusual after such a prolonged period, especially in what has been a particularly long duration bull market, and following a period of unusually low volatility.

However, given earnings momentum was strong throughout 2017 we see no reason to believe this has been stalled by recent events. So far we have seen a technical sell-off, driven largely by futures and most likely exacerbated by hedge funds and Exchange Traded products/funds. If this period of dislocation continues we may see further technical forced selling which could increase volatility across sectors and stocks. With valuation spreads currently quite narrow across markets, a widening of volatility would create more opportunities for stockpickers.

Looking across our equity strategies there has been no meaningful impact across funds relative to benchmarks, but we will be monitoring events closely over the coming days and weeks.

#### For marketing and information purposes by UBS. For professional clients / qualified / institutional investors only.

This document does not replace portfolio and fund-specific materials. Commentary is at a macro or strategy level and is not with reference to any registered or other mutual fund.

#### Americas

The views expressed are a general guide to the views of UBS Asset Management as of February 2018. The information contained herein should not be considered a recommendation to purchase or sell securities or any particular strategy or fund. Commentary is at a macro level and is not with reference to any investment strategy, product or fund offered by UBS Asset Management. The information contained herein does not constitute investment research, has not been prepared in line with the requirements of any jurisdiction designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research. The information and opinions contained in this document have been compiled or arrived at based upon information obtained from sources believed to be reliable and in good faith. All such information and opinions are subject to change without notice. Care has been taken to ensure its accuracy but no responsibility is accepted for any errors or omissions herein. A number of the comments in this document are based on current expectations and are considered "forward-looking statements." Actual future results, however, may prove to be different from expectations. The opinions expressed are a reflection of UBS Asset Management's best judgment at the time this document was compiled, and any obligation to update or alter forward-looking statements as a result of new information, future events or otherwise is disclaimed. Furthermore, these views are not intended to predict or guarantee the future performance of any individual security, asset class or market generally, nor are they intended to predict the future performance of any uBS Asset Management account, portfolio or fund.

#### EMEA

The information and opinions contained in this document have been compiled or arrived at based upon information obtained from sources believed to be reliable and in good faith, but is not guaranteed as being accurate, nor is it a complete statement or summary of the securities, markets or developments referred to in the document. UBS AG and / or other members of the UBS Group may have a position in and may make a purchase and / or sale of any of the securities or other financial instruments mentioned in this document.

Before investing in a product please read the latest prospectus carefully and thoroughly. Units of UBS funds mentioned herein may not be eligible for sale in all jurisdictions or to certain categories of investors and may not be offered, sold or delivered in the United States. The information mentioned herein is not intended to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. Past performance is not a reliable indicator of future results. The performance shown does not take account of any commissions and costs charged when subscribing to and redeeming units. Commissions and costs have a negative impact on performance. If the currency of a financial product or financial service is different from your reference currency, the return can increase or decrease as a result of currency fluctuations. This information pays no regard to the specific or future investment objectives, financial or tax situation or particular needs of any specific recipient.

The details and opinions contained in this document are provided by UBS without any guarantee or warranty and are for the recipient's personal use and information purposes only. This document may not be reproduced, redistributed or republished for any purpose without the written permission of UBS AG.

This document contains statements that constitute "forward-looking statements", including, but not limited to, statements relating to our future business development. While these forward-looking statements represent our judgments and future expectations concerning the development of our business, a number of risks, uncertainties and other important factors could cause actual developments and results to differ materially from our expectations.

#### UK

Issued in the UK by UBS Asset Management (UK) Ltd. Authorised and regulated by the Financial Conduct Authority.

#### APAC

This document and its contents have not been reviewed by, delivered to or registered with any regulatory or other relevant authority in APAC. This document is for informational purposes and should not be construed as an offer or invitation to the public, direct or indirect, to buy or sell securities. This document is intended for limited distribution and only to the extent permitted under applicable laws in your jurisdiction. No representations are made with respect to the eligibility of any recipients of this document to acquire interests in securities under the laws of your jurisdiction.

Using, copying, redistributing or republishing any part of this document without prior written permission from UBS Asset Management is prohibited. Any statements made regarding investment performance objectives, risk and/or return targets shall not constitute a representation or warranty that such objectives or expectations will be achieved or risks are fully disclosed. The information and opinions contained in this document is based upon information obtained from sources believed to be reliable and in good faith but no responsibility is accepted for any misrepresentation, errors or omissions. All such information and opinions are subject to change without notice. A number of comments in this document are based on current expectations and are considered "forward-looking statements". Actual future results may prove to be different from expectations and any unforeseen risk or event may arise in the future. The opinions expressed are a reflection of UBS Asset Management's judgment at the time this document is compiled and any obligation to update or alter forward-looking statements as a result of new information, future events, or otherwise is disclaimed.

You are advised to exercise caution in relation to this document. The information in this document does not constitute advice and does not take into consideration your investment objectives, legal, financial or tax situation or particular needs in any other respect. Investors should be aware that past performance of investment is not necessarily indicative of future performance. Potential for profit is accompanied by possibility of loss. If you are in any doubt about any of the contents of this document, you should obtain independent professional advice.

#### Australia

This document is provided by UBS Asset Management (Australia) Ltd, ABN 31 003 146 290 and AFS License No. 222605.

#### China

The securities may not be offered or sold directly or indirectly in the People's Republic of China (the "PRC"). Neither this document or information contained or incorporated by reference herein relating to the securities, which have not been and will not be submitted to or approved/verified by or registered with the China Securities Regulatory Commission ("CSRC") or other relevant governmental authorities in the PRC pursuant to relevant laws and regulations, may be supplied to the public in the PRC or used in connection with any offer for the subscription or sale of the Securities in the PRC. The securities may only be offered or sold to the PRC investors that are authorized to engage in the purchase of Securities of the type being offered or sold. PRC investors are responsible for obtaining all relevant government regulatory approvals/licenses, verification and/or registrations themselves, including, but not limited to, any which may be required from the CSRC, the State Administration of Foreign Exchange and/or the China Banking Regulatory Commission, and complying with all relevant PRC regulations, including, but not limited to, all relevant foreign exchange regulations and/or foreign investment regulations.

#### Hong Kong

This document and its contents have not been reviewed by any regulatory authority in Hong Kong. No person may issue any invitation, advertisement or other document relating to the Interests whether in Hong Kong or elsewhere, which is directed at, or the contents of which are likely to be accessed or read by, the public in Hong Kong (except if permitted to do so under the securities laws of Hong Kong) other than with respect to the Interests which are or are intended to be disposed of only to persons outside Hong Kong or only to "professional investors" within the meaning of the Securities and Futures Ordinance (Cap. 571) and the Securities and Futures (Professional Investor) Rules made thereunder.

#### Japan

This document is for informational purposes only and is not intended as an offer or a solicitation to buy or sell any specific financial products, or to provide any investment advisory/management services.

#### Korea

The securities may not be offered, sold and delivered directly or indirectly, or offered or sold to any person for re-offering or resale, directly or indirectly, in Korea or to any resident of Korea except pursuant to the applicable laws and regulations of Korea, including the Capital Market and Financial Investment Business Act and the Foreign Exchange Transaction Law of Korea, the presidential decrees and regulations thereunder and any other applicable laws, regulations or rules of Korea. UBS Asset Management has not been registered with the Financial Services Commission of Korea for a public offering in Korea nor has it been registered with the Financial Services Commission for distribution to non-qualified investors in Korea.

#### Taiwan

This document and its contents have not been reviewed by, delivered to or registered with any regulatory or other relevant authority in the Republic of China (R.O.C.). This document is for informational purposes and should not be construed as an offer or invitation to the public, direct or indirect, to buy or sell securities. This document is intended for limited distribution and only to the extent permitted under applicable laws in the Republic of China (R.O.C.). No representations are made with respect to the eligibility of any recipients of this document to acquire interests in securities under the laws of the Republic of China (R.O.C.).

Source for all data and charts (if not indicated otherwise): UBS Asset Management

© UBS 2018. The key symbol and UBS are among the registered and unregistered trademarks of UBS. All rights reserved.

www.ubs.com/am

