Topics for today's investors
Spring 2016

Outlook

As published by the Chief Investment Office Wealth Management Research (CIO WMR)

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Does terrorism pose a threat to markets?

Along with causing chaos and loss of life, terrorists often seek to inflict economic and financial damage. So will the recent upsurge in terrorist activity, marked by the recent attacks in Brussels and Pakistan, achieve this goal?

Acts of violence have the potential to harm economies in several ways: consumers may delay or abandon purchases or trips; risk aversion can rise in financial markets; and more populist politicians may gain power, limiting the free movement of people and goods and, thus, reducing long-term growth.

Still, historical data suggests that terror incidents have only fleeting effects on consumer spending. For example, France's INSEE consumer confidence index is down just 2.5 points since the Paris tragedy on November 13. By comparison, the index lost 27 points in the wake of the U.S. sub-prime crisis.

Market sentiment has also tended to recover quickly. It took the S&P 500 just one month to regain the ground lost after the 9/11 attacks, and U.K. stocks rebounded within days of the July 2005 London terrorist acts. While the effect on some sectors like airlines and hotels can be more acute, Europe's leisure and transport sectors have actually outperformed the MSCI index by three percentage points on a total return basis since the Paris attacks.

The political effects of terrorism are harder to quantify. But we have seen some warning signs. Proponents of Brexit argue that the Brussels attacks show that Britain would be safer outside the EU. The odds of a British exit, as measured by bookmaker Paddy Power, did nudge higher from 33% to 36%. And the pound was also the worst-performing major currency on the day of the attacks, shedding about 1% against both the euro and the dollar. In the U.S., leading Republican presidential candidate Donald Trump claims the events in Europe prove the need for immigration restrictions, which could reduce the supply of labor to the U.S. economy. And in Europe, further attacks

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could weaken public support for the free movement of people within the EU, reducing labor mobility and hence economic efficiency.

An immigration clampdown would likely be a net negative. Migrants accounted for almost half the increase in the workforce in the U.S. over the past decade and roughly 70% of the rise in Europe, according to OECD data. Migrants, usually young, frequently fill important niches in fast-growing sectors and boost the working-age population.

Still, such political shifts, if any, would only materialize over a long period of time, and it is far too soon for investors to change their positioning. And while opponents of free trade and immigration have gained ground, the power in developed nations is still held by pro-globalization politicians. Institutional checks and balances also limit the ability of those proposing radical shifts to make changes. Meanwhile, in the U.K., the pro-EU campaign still leads in the polls.

The bottom line is that while terrorism is a human catastrophe, economies and financial markets in developed nations do not exhibit a high degree of sensitivity to such events. Barring a sharp spike in terror activity, we expect it to remain that way.

To summarize

Terrorists often seek to cause economic disruption along with loss of life. There is a threat that the recent upsurge in attacks could shift political power to opponents of immigration and free trade, which could harm long-term growth. But we believe pro-globalization politicians will remain in charge. Meanwhile, the impact of terror attacks historically on economic growth and markets has been limited in developed nations.

Two sides of the same quarter

Brian Nick, CAIA
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It's often said that the month of March "comes in like a lion and goes out like a lamb." That phrase could apply to the entire first quarter of 2016 for financial markets. How investors fared through the turmoil depended on two factors: their patience in the face of a steep equity market decline and the extent to which they held a globally diversified mix of assets.

Lessons learned: A quarter worth remembering

Twenty years from now, a UBS investment strategist looking at quarterly return data may not make much of Q1 2016. Our asset allocation models for a moderate investor are set to return close to 2%. That quarterly rate of return actually puts us slightly ahead of our annual forward-looking return assumptions, which range from 5.5% to 6.0%. Diversified investors are off to a solid if not spectacular start to the year.

Of course, those of us who lived through the first quarter of 2016 might see things a little differently. By the time most of our alarm clocks went off on the first trading day of the year, China's domestic equity market had already fallen 7% and was shut down for the day. Global investors reacted with alarm to this news and the broader risks surrounding China. Together with falling commodity prices and worrisome U.S. economic data, China macro fears contributed to a sharp decline in global risk asset prices through the middle of February.

As Mike Ryan wrote in his March 17 editorial, "Checking up on the checklist," we now see convincing signs that most of those fears were overblown. And judging from market performance, we're not alone. The S&P 500 has returned nearly 13% since its February low while the 10-year U.S. Treasury yield has begun to reverse its sharp decline. Perhaps most crucially, oil prices have climbed out of the cellar, rallying to just under USD 40/bbl from a low of USD 26/bbl. Along with this surge came a notably weaker U.S. dollar and a pronounced easing of financial conditions.

Grading performance

When investors examine their first quarter statements, they should evaluate the results based on two criteria. First, did they remain fully invested through the January equity market correction or put money to work that had been sitting in cash waiting for just such an opportunity? Asset allocation matters a lot for investment returns, but investor behavior often matters even more. Overreacting to market movements was not a recipe for success during a quarter in which many markets exhibited a v-shaped recovery in February and March.

Investors should also grade themselves on how well diversified their portfolios were heading into the year. U.S. corporate bonds, emerging markets and foreign currencies all have prominent roles in our recommended asset allocation models. And while each lost money in 2015, they have been star performers thus far in 2016. Reversals like this happen quite often, yet many investors still employ too much recency bias (i.e. expecting recent outperformers to continue to outperform) in their investment strategy. As of this writing, the S&P 500 is just barely in the black for the quarter, but U.S. large-cap equities have actually underperformed most other asset classes this year, including both U.S. high-yield bonds and emerging market equities.

Moving forward: Another coin flip?

Diversification has gotten a bad rap in recent years as the S&P 500 has outperformed most other major indexes. But we believe it will be necessary over the balance of 2016 for investors to look beyond the most familiar asset classes to achieve their desired rate of return. Despite its recent struggles, the U.S. dollar remains quite strong against most other currencies, making international assets more attractive to U.S. investors. Rather than reducing currency risk as we advised last year, investors should ensure they have enough.

Thankfully, we do not expect the rest of the year to be as much of a roller-coaster ride as the first quarter. But the lessons should be clear. Maintain composure when other investors are panicking, seek opportunities to invest during corrections and avoid selling out asset classes simply because they have been recent underperformers.

Preferred investment views

For more information, please see *UBS House View*, April 2016.

Asset classes	Most preferred	Least preferred
Equities	– U.S. ↗	– Emerging markets
	– U.S. small caps	
	– Eurozone	
	– North American energy independence	
	– U.S. technology	
	– Cancer therapeutics	
	– REITs	
	– e-Commerce	
	– Valuing your human capital	
	– The rising Millennials	
Fixed income	– U.S. investment grade	– Government bonds
	– Beyond benchmarks	
Currencies	– NOK	– EUR
	– USD	– JPY
	– CAD* ↗	– AUD* ↘

↗ Recent upgrades ↘ Recent downgrades

Source: UBS (as of March 23, 2016)
*Change was originally published on March 14, 2016.

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