

Weight Watcher

Bubble Trouble: Are We There Yet? Multi-asset strategy

Strategy

Global

The economic call: 20% chance of China's GDP falling to 5%

Tao Wang and our China economics team have published a risk analysis of a 10% property construction fall. Although Tao thinks there is only a 20% chance of this happening, she estimates in this risk scenario it could result in GDP growth falling to circa 5% next year. The below presents the main points of the paper, for more details, please see "Asian Economic Perspectives – Bubble Trouble: Are We There Yet?".

Asset Allocation: activity and risk aversion

A slump in Chinese growth would have a significant effect on global activity, which is one way we estimate the effect on asset returns. Using an update of our investment clock we find only three assets that could weather a China shock: US government bonds, US investment grade corporate bonds and Japanese government bonds. The second effect would be through a rise in risk-aversion which would again favour Treasuries but would also include US index-linked bonds and exclude JGBs. Based on historical curve analysis we find that Treasury 10y rates could go towards 2% or lower.

EM Equity Strategy: Cutting China to Neutral

The effects on EM equity markets as a whole of another downgrade to our GDP forecast for China and the rising risk of a property market collapse (and materially weaker GDP growth still) should come through in a variety of ways including: i) a new risk-off phase for global markets ii) weaker imports into China, notably of commodities, putting pressure on commodity prices and on these sectors in other EMs and iii) 'sympathetic' weakness in real estate stocks across EM. We cut China to neutral and upgrade Taiwan to overweight given the product composition of its Chinese exports. We keep our overweight in Korea, and Asia remains our favoured region. Our sector strategy is already well-aligned with these risks; we maintain our preference for domestic cyclical (Industrials, IT) and Financials and our underweight in Materials.

EM cross-asset strategy

If China lands hard then EM equity will underperform EM debt by a significant margin and EM HC will do much better than EM LC debt. On the basis of exports to China, trade gains to domestic growth and policy room available the most vulnerable EM markets are Brazil, South Africa, Chile, Russia and Indonesia. Our favoured investment opportunities would be negative views on Brazilian metals and mining companies and ZAR. The safest EM asset class would be HC and LC debt of A-rated economies: Korea, Poland, Israel and the Czech Republic.

G10 FX: Australian dollar the key loser

The Australian dollar is the most vulnerable of all developed market currencies to a sharp China slowdown, in our view. Australia stands out not only because of close and direct trade links with China, but also because Australia's exports consist largely of steelmaking ingredients. It is no coincidence that Australia's exposure to China increased sharply as investment-focused fiscal stimulus measures were rolled out in the wake of the Global Financial Crisis. AUDUSD is also vulnerable because it is seen as a liquid proxy for the overall health of the Chinese economy. Finally this should be yen-positive because risk-aversion would weigh heavily on USDJPY given the yen's correlation with US yields and a selloff in Japanese stocks. Also given Governor Kuroda's determination to act to maintain growth there is room to increase purchases of JGBs beyond the current 65% of gross issuance.

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The economic call

Tao Wang and our China economics team have published a risk analysis of a 10% property construction fall. Although Tao thinks there is only a 20% chance of this happening, she estimates in this risk scenario it could result in GDP growth falling to circa 5% next year. The below presents the main points of the paper, for more details, please see "Asian Economic Perspectives - Bubble Trouble: Are We There Yet?".

Three years after writing about the property bubble debate, we are increasingly worried about a property downturn in China. To some extent, the visible slowdown of property activity in recent months was expected after a strong rebound in H2 2012 and 2013. However, property supply has been growing faster than underlying demand while investment demand for housing is being eroded, and inventories are building up. We think a more persistent and sharper downturn in the property sector is the biggest risk for China's economy in the next couple of years.

We believe the government still has the means and willingness to mitigate a property downturn, including by increasing infrastructure investment and relaxing property policies. As such, our base case forecast is for the property downturn to remain manageable. We lower our 2014 and 2015 GDP growth forecast only modestly to 7.3% and 6.8%, respectively, to reflect the weaker-than-previously thought property sector.

It is hard to predict the magnitude of a property downturn in the absence of big household leverage, and with the government having a put option. Nevertheless, following the post GFC property and infrastructure boom and given the already high overall leverage, we think the room and effectiveness of policy support may be limited compared with 2009-2010. We think there is a 20% probability that a sharp property downturn could lead to GDP growth dropping to about 5 percent in 2015.

Typical analysis on property downturns focuses on price correction, but we think construction volume matters more in the case of China. A big drop in construction activity even without a large price correction will likely have serious negative impact on the industrial complex and through which, economic growth and bank balance sheets. Our sensitivity analysis suggests that a 10 percentage point drop in the growth of construction volume would result in a 2.5 percentage point drop in GDP growth including second round effects. In addition to property developers, heavy industries such as metals, construction materials, and construction machinery sectors would be affected the most. While the impact on mortgage lending could be limited owing to low leverage of home buyers, the financial sector could suffer more from worsening balance sheet of developers, corporates, and loans collateralized by property and land.

Property sector poses the biggest downside risk to the economy

Government can still use policies to mitigate the downturn

We see risk of a sharp property downturn leading to 5% GDP growth in 2015

Construction volume matters more than property price

Asset allocation

A framework to analyze China's impact

Starting with a top-down view, we believe that a Chinese slowdown would have two major impacts on markets: first it would imply that world growth would be lower, second it would mean an increase in the risk premium and risk aversion. We have previously used "investment clocks" which allow us to analyze the behavior of assets when markets are exposed to such shocks.

We have updated the investment clock to look at the various asset classes' sensitivity to activity. We tailor the chart specifically for a China shock, so we look at the reaction of assets after a China shock. The following Figure summarizes our finding. In the negative scenario, investors will want to hide in the assets that gather on the third quadrant (the South-West one) to invest in assets that generate return in a recessionary environment. Apart from the obvious usual suspects in those circumstances, namely cash, we find three asset classes perform this feat: US Treasuries, investment grade credit in the US and Japanese government bonds.

Two impacts: growth and risk aversion

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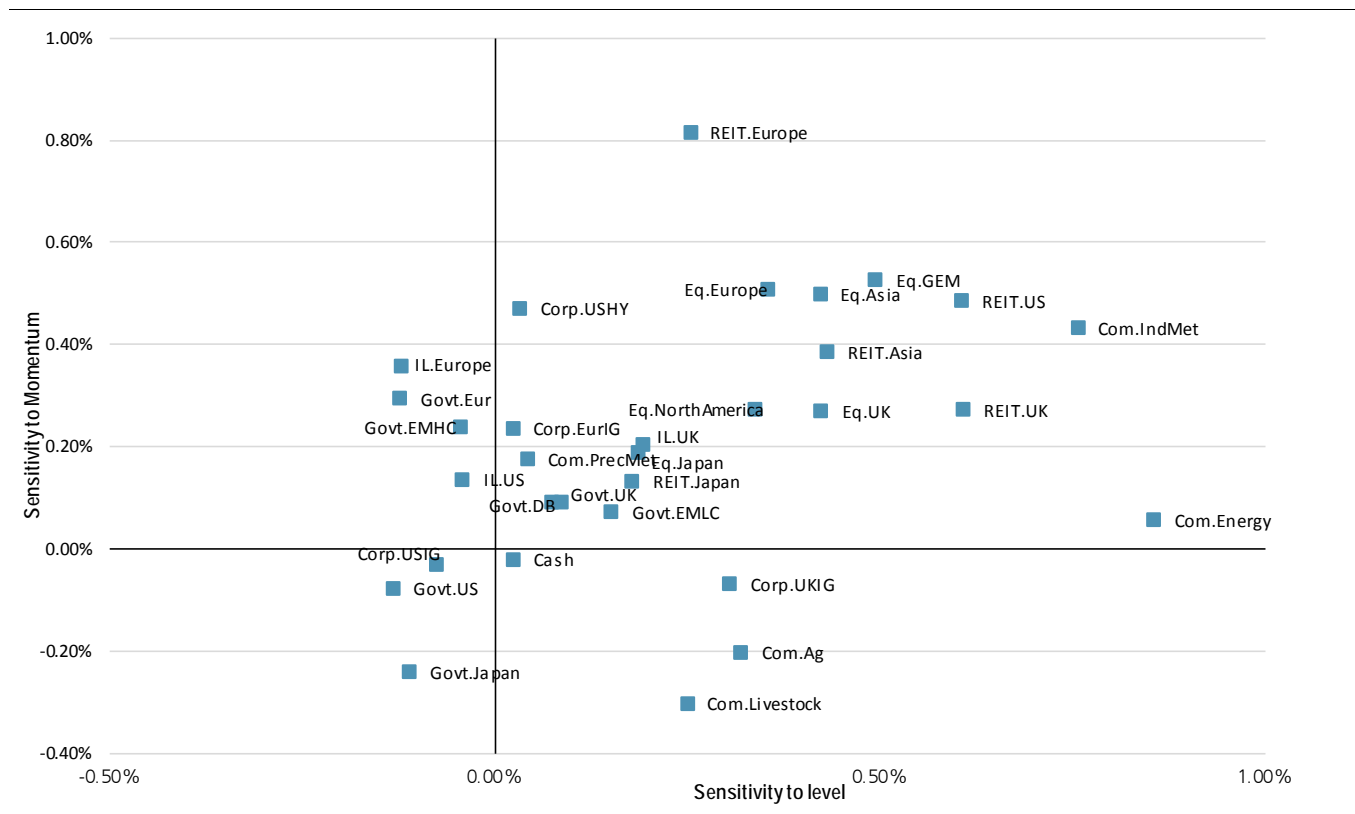
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Figure 1: Our investment clock depending on the level of activity in China



Source: UBS

But we would argue that the above approach captures only part of the issue. A Chinese slowdown will also produce a jump in risk aversion. The way to take that element into account in Asset Allocation space is to produce a second investment clock, one depending on risk. The following chart shows the dependency of asset class performance on the level of risk aversion and the change in risk aversion.

Risk aversion shock

A scatter plot showing the relationship between Sensitivity to Momentum (Y-axis) and Sensitivity to level (X-axis) for various asset classes. The X-axis ranges from -1.0% to 2.5% with major ticks every 0.5%. The Y-axis ranges from -5.0% to 3.0% with major ticks every 1.0%. A horizontal line is drawn at Y = 0.0%. Data points are represented by blue squares with labels. The plot shows a positive correlation between the two sensitivities for most asset classes, with some outliers like REIT.Asia and Com.IndMet having high momentum sensitivity but low level sensitivity.

Asset Class	Sensitivity to level (X)	Sensitivity to Momentum (Y)
Eq.Japan	1.4%	2.8%
Eq.Europe	2.0%	2.4%
Eq.NorthAmerica	1.6%	1.8%
Eq.UK	1.6%	0.1%
Eq.Asia	1.7%	-1.0%
Eq.GEM	2.0%	-0.9%
Eq.EMHC	0.4%	1.8%
Eq.EMLC	0.1%	0.8%
Eq.IL.Europe	0.3%	2.1%
Eq.IL.US	0.0%	-0.4%
Eq.IL.UK	0.5%	-1.9%
REIT.Japan	0.6%	1.4%
REIT.US	1.7%	1.3%
REIT.Europe	1.6%	-0.7%
REIT.Asia	1.6%	-4.9%
REIT.UK	2.0%	-2.3%
REIT.Livestock	0.8%	-2.2%
REIT.IndMet	1.6%	-4.4%
Govt.Japan	-0.4%	1.7%
Govt.Eur	0.0%	0.4%
Govt.EMHC	0.4%	1.8%
Govt.EMLC	0.1%	0.8%
Govt.DB	0.3%	0.6%
Govt.US	-0.4%	-0.2%
Govt.IL	0.0%	-0.4%
Govt.UK	0.1%	-1.8%
Com.PrecMet	0.2%	0.1%
Com.USIG	0.1%	-0.4%
Com.USHY	0.6%	-0.1%
Com.Ag	0.7%	-0.2%
Com.EurIG	0.4%	-0.6%
Com.Livestock	0.5%	-2.1%
Com.IndMet	1.6%	-4.4%
Cash	0.0%	0.0%

Although asset classes react differently to growth and to risk, we find a similarly small list in case of a fall in risk appetite. Again we find that the usual suspect (Cash) is present and the only other asset classes that would provide protection in this circumstance would be US government debt (nominal or via linkers) and US IG corporate debt. Why not also Japanese government bonds? Probably this is because we take USD indices and the JPY has weakened vs. the USD in these circumstances.

The only asset class that would provide protection to both the economic downturn and the jump in risk premium is US Treasuries

Weight Watcher 5 May 2014

of the UBS Global Risk Index. For simplicity the level of the risk index is split into low (less than -0.26), medium (between -0.26 and 0.55) and high (greater than 0.55) risk appetite and we use the sign of the one month change in risk appetite to determine momentum.

Currently we are in the “high and rising” risk appetite regime where historically it has been best to long equities and corporate bonds. In the case of a Chinese shock risk appetite could drop precipitously, we would quickly reach the “medium-to-low and falling” regime. In that case we find that historically a portfolio would have performed best with a government bond overweight (DM but also interestingly EM in hard currencies) but also more surprisingly to us HY corporate bonds. Equity becomes a sell which is a logical outcome in a risk-off environment and linkers also which again makes sense intuitively.

Figure 3: Optimal allocations in periods of low/medium/high risk appetite which is rising/falling over the previous month (data from 2002 onwards).

Risk Appetite	Low	Medium	High	Low	Medium	High
Change in Risk Appetite (1m)		Rising			Falling	
Equity World	1.2%	3.3%	25.1%	-10.6%	-10.9%	9.8%
Govt Bond DM	-7.2%	-20.4%	-16.7%	56.9%	7.3%	-30.0%
Govt Bond EMLC	10.1%	17.2%	-1.8%	14.4%	8.0%	0.3%
Corp Bond EurolG	21.5%	17.9%	56.7%	-12.5%	49.0%	50.4%
Corp Bond USIG	4.4%	28.7%	72.7%	-4.8%	3.3%	18.4%
Corp Bond USHY	85.5%	56.4%	-30.0%	72.2%	29.0%	43.5%
REIT World	-1.5%	-4.6%	-0.6%	5.2%	10.6%	4.6%
Linker World	-10.2%	-1.2%	-11.0%	-19.2%	-11.8%	-6.5%
Com Energy	0.9%	4.6%	0.9%	-0.7%	3.4%	-4.5%
Industrial Metals	-0.9%	-1.1%	4.8%	-3.6%	-1.2%	1.5%
Livestock	-3.4%	-0.4%	-0.8%	4.4%	11.2%	9.8%
Precious Metals	-0.4%	-0.6%	0.4%	-1.7%	1.9%	2.7%

Source: UBS

Transmission mechanisms

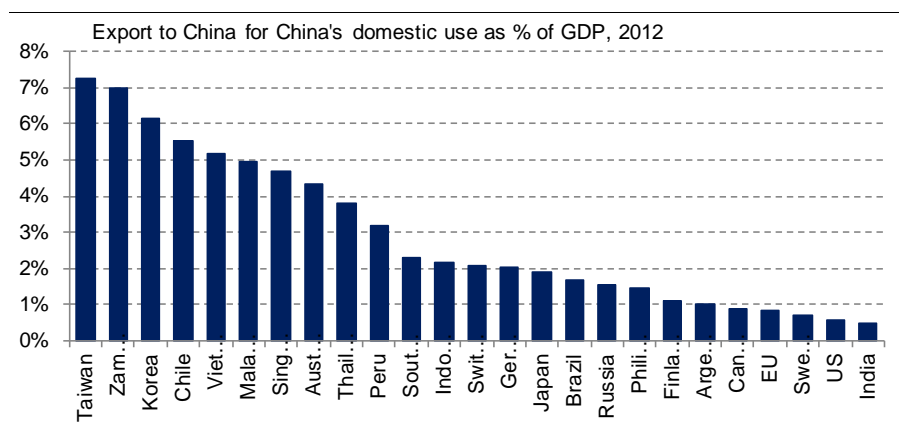
Now we look at the specifics of the Chinese shock. There are a numbers of ways a Chinese slowdown would impact markets. We try in the below to provide a view of the main transmission mechanisms.

Growth effects to the rest of the world

We argued above that the size of China has increased significantly in the world economy. Hence the impact of a slowdown would be much more important now. And indeed the following chart shows that there is a large reliance on Chinese exports for a number of countries. For more details on these economic ramifications, please see the companion piece “Asian Economic Perspectives - Bubble Trouble: Are We There Yet?” in which UBS economists provide a more detailed assessment of what a Chinese economic slowdown means for the rest of the world.

Chinese slowdown: significant impact on the rest of the world

Figure 4: The exposure of the rest of the world to China is large

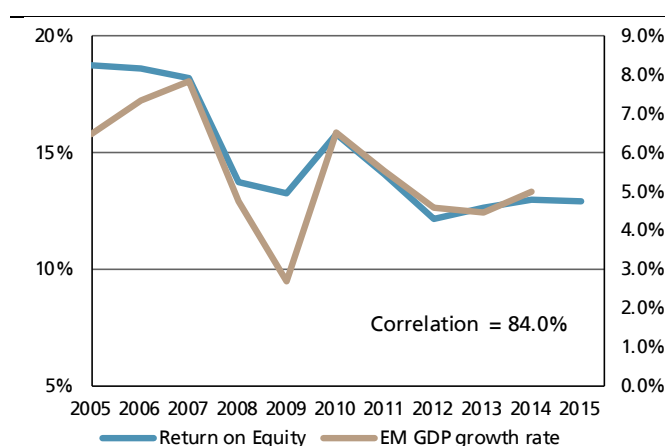


Source: UBS

It is trivial to imply that EM equity would suffer from such a move. And indeed our investment clock above shows that EM equity is very reactive to growth movements. The reason is that EM companies have a higher operating leverage than their DM peers. Indeed, using data since 2005, we find that a 1ppt increase in GDP growth rate in DM will add 1.42ppt to EM's RoE, while the same increase in DM GDP would add only 0.57ppt to DM's RoE. This highlights the fact that the return on equity in DM is considerably more stable and less cyclical. EM stocks would thus suffer disproportionately as the impact on their profitability would be greater. Figure 5 below illustrates that point; it shows that there is a high correlation between GDP growth in EM and RoE, although this is also the case in DM.

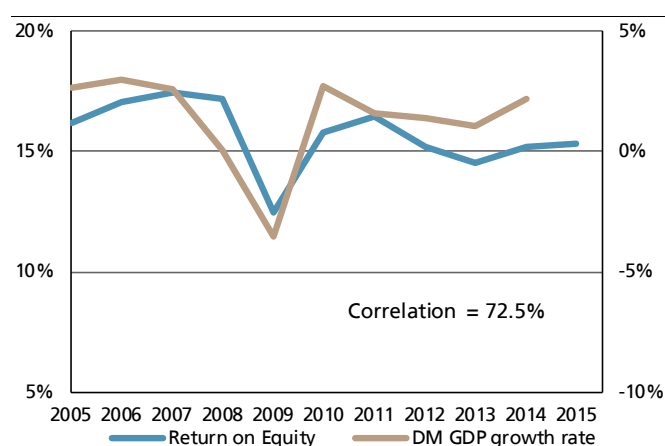
EM equity is especially sensitive to growth...

Figure 5: EM profitability is driven by the cycle



Source: UBS

Figure 6: Same for DM, although RoE reacts much more smoothly to the cycle



Source: UBS

We might actually push the argument a step forward. EM cross-asset strategist Bhanu Baweja has repeatedly underlined that EM corporate profitability is more linked to international trade than GDP growth. To the extent that a Chinese slowdown would have a disproportionate impact on international trade, this, again, could suggest an over-reaction.

... and trade

Commodity impact

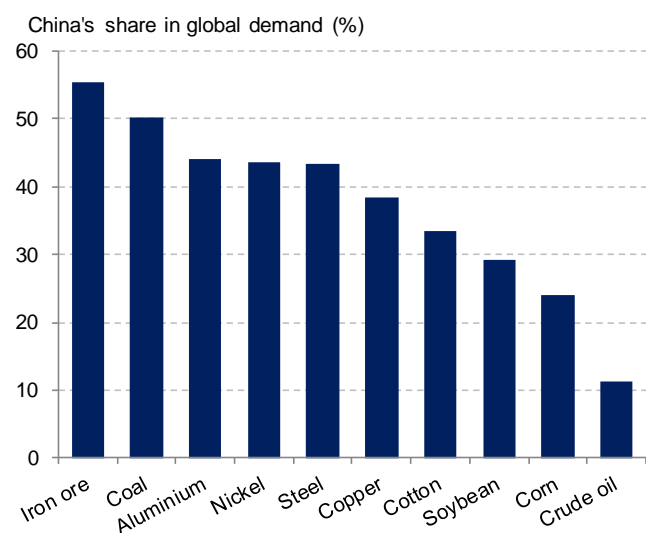
We would start with two stylized facts.

- First China is a dominant consumer of mined & processed commodities. This is an obvious assertion, but the scale of China in some markets is staggering as the Figure below shows.
- Second, a large driver of the commodity consumption is the housing market. Indeed, real estate directly accounts for 40% of China's steel consumption. The number is higher still, if we add housing-linked consumption such as home appliances, property-related infrastructure spending and the investment in new steel capacity to support all this movement. Our China economists estimate that housing-related demand accounts for close to two-thirds of total consumption. The second chart below shows a high correlation between construction and steel.

China is an important consumer of commodities

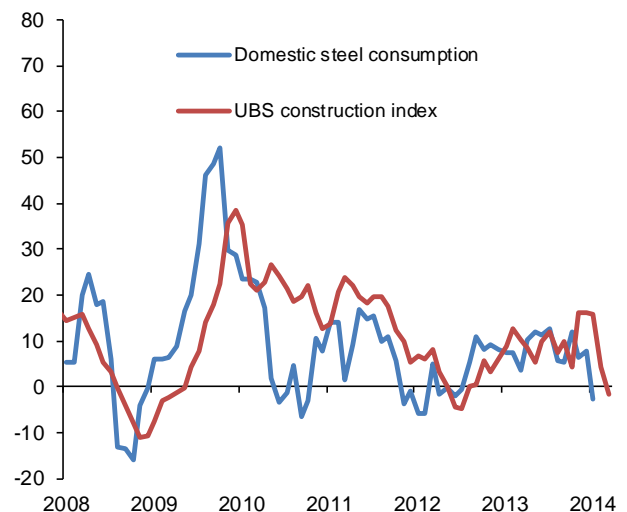
Housing is driving demand for commodities

Figure 7: China is a very large consumer of commodities



Source: UBS

Figure 8: Steel consumption is highly correlated with housing



Source: CEIC, UBS Estimates

The conclusion is thus straightforward. A decline in housing in China would have a large and significant impact on commodity prices. There is an additional dimension to the above Figure: consumption of steel is a lead indicator of the broader construction index. This makes sense and it is a general feature of the production chain: semi-finished goods or natural resources being at the early part of the production process, tend to have leading indicator characteristics. This makes the below Figure all the more worrying: if steel is indeed a leading indicator of construction in China, the recent weakness in prices would suggest that China's demand has indeed been quite weak. This bodes ill for construction.

Figure 9: The recent price action in the Iron Ore market bodes ill for construction in China



Note that part of the collateral damage of this view is that DM countries will import more deflation in commodity prices. This could deplete headline CPI further and prompt central banks to react, notably in Japan and in Europe.

Treasury curve impact

In the first chapter of this piece we saw that the only way to "hide" in case of economic slowdown or in case of risk aversion increase is to go into the Treasury market. We would indeed expect a rally in Treasuries in the case of a Chinese slowdown. The narrative would be a flight to quality coupled with lower growth and inflation numbers, but also a more subdued path for the Fed exit strategy. All these factors combined could combine to produce a quite significant rally. The question is how much.

How much of a rally?

Figure 10: Sensitivity of the level of each Treasury curve to the UBS Dynamic Equity Risk Indicator (ticker ULTADERI)

	US	UK	JP	DE	AU	SG	HK
Risk Indicator Sensitivity (bp/risk unit)	23.2	22.0	7.1	25.5	17.5	13.3	13.2
Sensitivity Error (bp/risk unit)	3.4	3.7	3.4	3.6	2.9	4.0	4.7

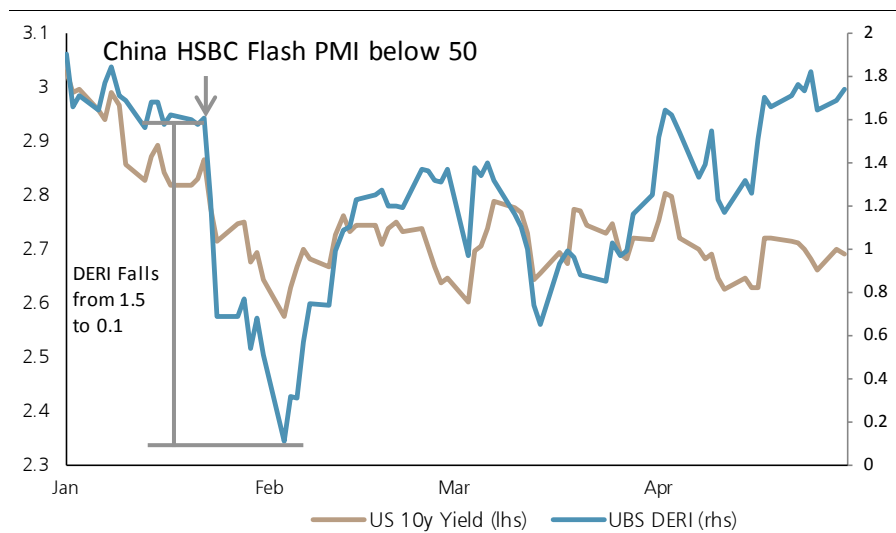
Source: UBS

We try to address this question by looking at how Treasury curves react to risk aversion. We use the UBS Dynamic Equity Risk Indicator (DERI) to measure risk aversion; a move of 1 unit in this index is equivalent to a one standard deviation move. We look at the reaction of yields to move in this index, and we find that for a 1 point move in the DERI, US Treasuries react by c23bp, as shown in Figure 10. This means that a one standard deviation retrenchment in risk appetite would reduce US rates by c23bp. Gilts and bunds have a reaction of similar magnitude. However we must confess there are large error bars around this sensitivity which we also show in the table. The way we estimate these sensitivities is by performing a principal component analysis on a variety of sovereign yield curves. We can find the sensitivity of the first principal component, which is a shift up and down of the yield curve, to the level of the risk index.

DERI is computed as a z-score, hence a 1 point move is equivalent to a one-standard-deviation move in risk aversion. Currently our risk indicator is close to 1.7, as risk appetite has increased recently. It is not unreasonable to expect that the risk index will plunge to 0 in the case of a Chinese accident in the housing market (or even in negative territory); such a large move is not unprecedented and happens in case of economic surprises large enough to change the central case scenario. For example this happened in February following the first sub-50 Chinese PMI print in January (see Figure 11). In short, this would be more or less a 2 point move in our risk index, with a 23bp decline in 10Y yield for each point that would mean a decline of 10Y Treasury yields towards 2%. A sharper adjustment in risk aversion is feasible, hence a number below 2% for the 10Y treasury is also possible. This would be a level unseen since June last year.

A sharp adjustment in risk aversion could easily push 10Y Treasury at 2% or below

Figure 11: A fall in the HSBC China Flash Manufacturing PMI below 50 caused a sharp fall in Treasury yields in Jan/Feb this year



Source: Bloomberg, UBS

One intriguing result we obtained in the first part of this article is that US IG performs well during risk-off episodes. This begs the question of the behavior of spreads: what happens during the risk off phase is a rise in risk-free rates and a widening of credit spreads or CDS. If the spread movement is slow enough, the total return of bond remains positive. This is a counter-intuitive result, but we think that credit in such an environment would perform well. EM debt, especially hard currency, would also probably fare well: last year, during the Treasury selloff, EM debt had a beta of c1.5, hence under-performed. During a Treasury rally we think EM could benefit. If however the rally is driven by a surge in risk aversion we doubt the beta will remain at 1.5. As for investment grade credit, EM could benefit, but would under-perform Treasuries.

Some spread products could benefit: US IG and hard currency EM debt

Bank exposure to China

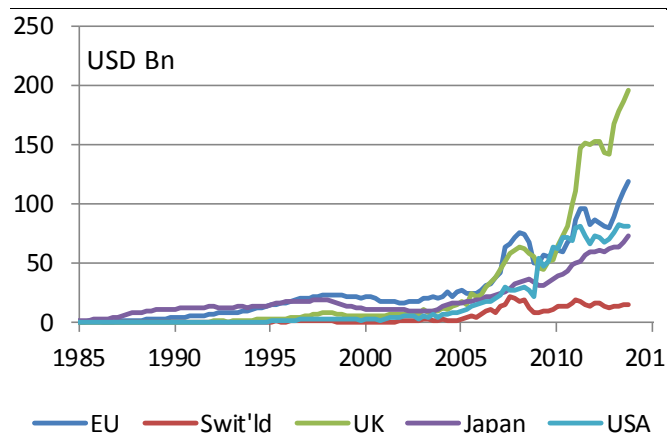
A final dimension to consider is the banks' exposure to China. In previous research (see "Global Banks Perspectives - EM risks to DM banks containable", 26 February 2014, published with the European Bank team, John-Paul Crutchley et al.) we have highlighted the surge in DM banks' exposure to EM. This is, for us, one key source of risk and one key source of contamination that did not exist in the past. We take a closer look at the data related to China. For that we use the "foreign claims"

Foreign claims have surged

published by the BIS, which measures bank cross-border exposure. We look at the claims to China but also the claims to Hong Kong.

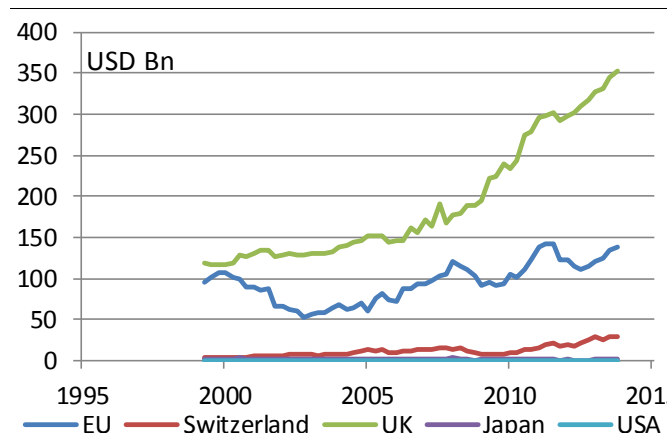
The two Figures below show that the exposure to China is by no way different from the underlying trend towards EM: a spectacular surge happened over the past decade.

Figure 12: Banks' claims to China have ballooned



Source: UBS, BIS

Figure 13: Claims to Hong Kong too

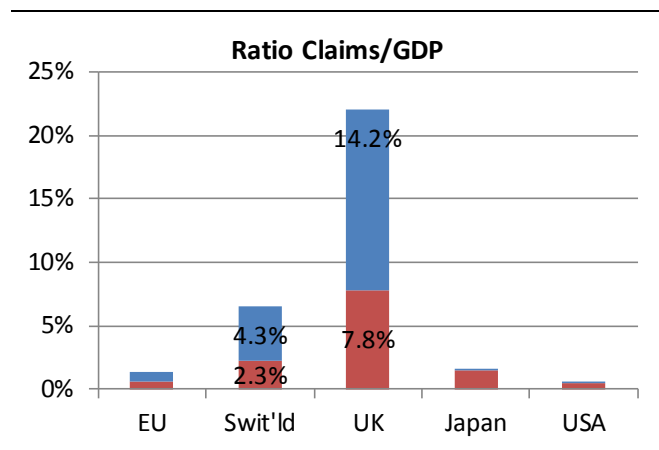


Source: UBS, BIS

So where does that leave us? To obtain an idea on the size of the exposure of the banking sector, the absolute numbers do not mean much, we believe that the exposure as a share of the GDP is a better way to estimate the degree of exposure. With this approach we generate the following Figure. The message is very simple: the China exposure is essentially a UK bank story, and, albeit to much smaller extent, a Swiss story. Direct exposure of EU banks is minimal (in the above mentioned research we showed however that the exposure to Eastern Europe is sizeable), the exposure of Japan and US is equally negligible.

Essentially a UK bank exposure to China

Figure 14: China exposure is essentially a UK bank story



Source: BIS, UBS

EM Equity Strategy: Cutting China to Neutral

The effects on EM equity markets as a whole of another downgrade to our GDP forecast for China and the rising risk of a property market *collapse* (and materially weaker GDP growth still) should come through in a variety of ways including: i) a new risk-off phase for global markets; ii) weaker imports into China, notably of commodities, putting pressure on commodity prices and on these sectors in other EMs; and iii) 'sympathetic' weakness in real estate stocks across EM (see below).

For our GEMs portfolio, we match our Asian strategist, Niall Macleod, by cutting China to Neutral, given the rising uncertainty over the growth outlook and the lack of momentum in the Chinese stock market. We upgrade Taiwan to Overweight (large share of exports to China, but not of the sort of products likely to be under heavy demand pressure from a faltering property market). We see no reason to alter our Overweight in Korea and Asia remains our favoured region. Our sector strategy is already well-aligned with these risks; we maintain our preference for domestic cyclicals (Industrials, IT) and Financials and our Underweight in Materials.

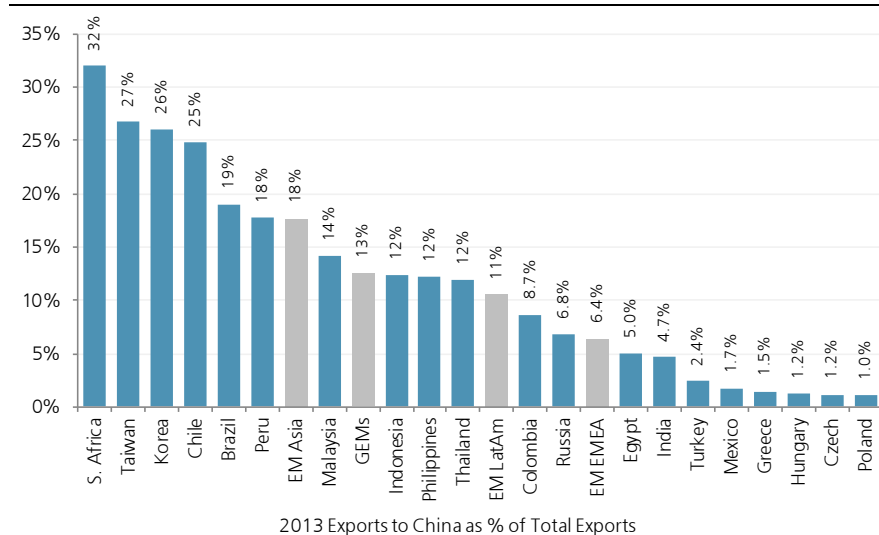
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Figure 15: MSCI GEMs Countries: Exports to China as % of Total Exports



Source: Haver, IMF, UBS

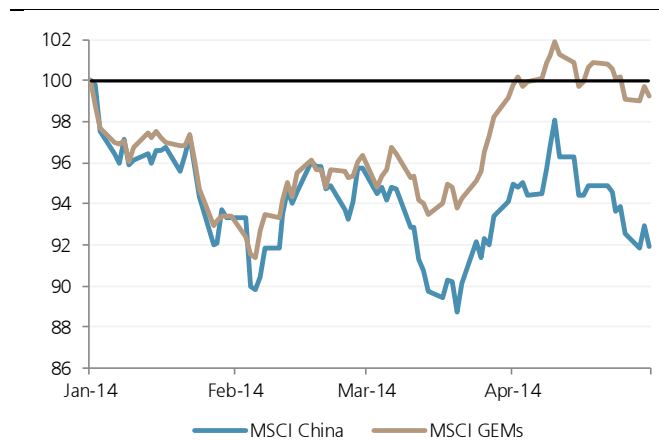
Tied in with the second point above (lower exports to China, as growth slows and the property sector weakens) is the risk of downgrades to GDP growth forecasts across EM as a result. We leave these changes and discussion of them to our economists over the weeks ahead. However, Figure 15 (above), showing the share of total exports that go to China for all 21 MSCI GEMs index countries, is a useful aide memoire for this whole debate. Perhaps surprisingly, the country most closely tied to China (measured in this way) is South Africa, with a Chinese export share of 32%. Taiwan and Korea – close neighbours with tech, autos and capital goods-heavy exports – come next with 26-27% of exports going to China, followed by the commodity exporters of Latam – in particular, Chile (25%), but also Brazil and Peru (both 18-19%). Beyond that, the dependence of EMs on exports to China is fairly low at around 15% for much of the rest of Asia and 7% for Russia. The most defensive countries, defined this way to a Chinese growth slowdown are likely to be in Central Europe, Greece, Turkey, Mexico and, interestingly, India.

A New 'Risk-Off' Phase?

The cut in our Chinese GDP forecast for 2014 take it down to consensus (7.3%) and pushes our 2015 forecast (6.8%) to below the market (currently, 7.2%). It is not clear that gradual cuts in Chinese forecasts for 2014 (assuming growth stays in a 7-7.5% range), need be a particular negative for EM equities; the markets are well-accustomed to data weakness and growth risk. MSCI China (-8%) has been a major underperformer of GEMs so far this year (-0.7%).

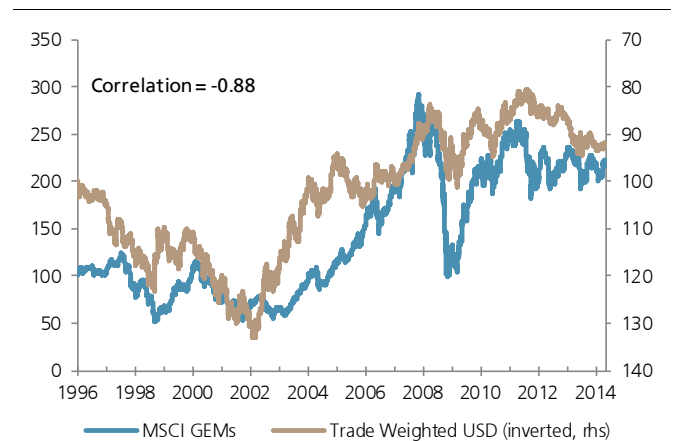
Moreover, we have already assumed a period of 'risk-off' in our scenario for 2014, as (per UBS forecasts) better (post-winter) weather in the US, combined with a hint of wage/price inflation, pushes Treasury yields and the dollar materially higher later in the year. This largely explains our ongoing Underweights in markets with vulnerable external accounts that need to attract capital inflows, and where currencies have benefited recently from the carry trade, such as Brazil, South Africa and Turkey. The real dangers to EM equities from China may be that 2015 growth falls below (perhaps, well below) 7% and the fear of a property collapse (given a 20% chance currently) comes to fruition; in this event, the risk is of further dollar strength (flight to quality), lower (not higher) US yields and even lower commodity prices. Given this, we do not change our preference for markets with sound external fundamentals (Korea, Taiwan, Mexico, Poland) nor our sector strategy.

Figure 16: MSCI China v. MSCI GEMs, 2014 YTD



Source: Datastream, MSCI, UBS

Figure 17: MSCI GEMs vs US Dollar Trade-Weighted Index



Source: Datastream, MSCI, UBS

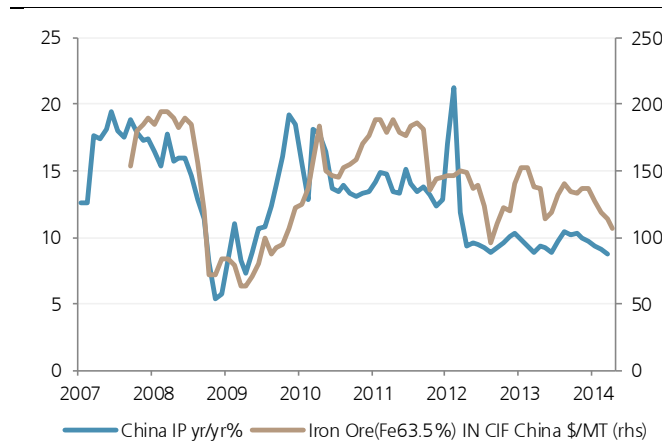
More Risk to Materials?

The Materials sector (-4.9% in 2014 and -1% in April) has been underperforming for some time and is now being hurt by the unusually weak seasonal performance of iron ore prices as markets factor in much weaker Chinese growth (Figure 18). In the event of a yet bigger event – a property sector collapse – further pressure on the Materials sector is likely, particularly on Metals/Mining. Figure 19 aims to capture this by plotting the weights of the three most relevant (for China) sub-industries of Materials (Metals/Mining, Chemicals, Construction Materials¹) in each EM market. With the Metals/Mining sub-sector being the most linked to Chinese growth, Latin America looks very exposed to Chinese weakness, particularly Peru and Brazil. The high sector weights in Colombia and Mexico are almost entirely due to cement and these sales to China will be small). Elsewhere, the high weights

¹ For this analysis, we omitted from the Materials sector: i) Paper and Forest Products; and ii) Containers and Packaging.

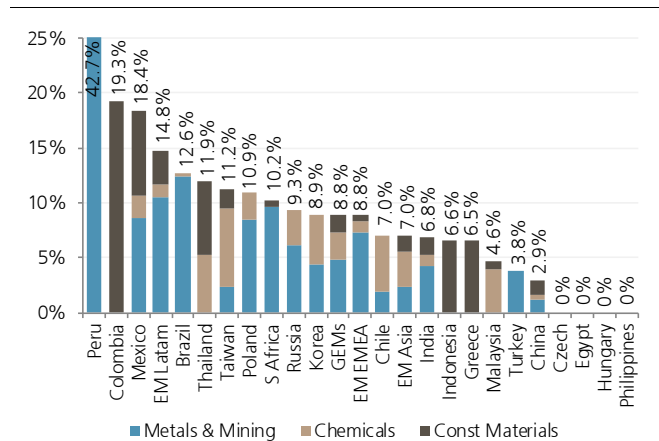
for Taiwan and Korea are dominated by Chemicals. Significant Metals/Mining segments also exist in Russia, South Africa and Chile. Exposure to China, defined in these terms, is zero for the Czech Rep, Egypt, Hungary and the Philippines. Interestingly, the combined weight of these sub-sectors in China itself is very small (2.9%).

Figure 18: China IP yr/yr% and Iron Ore Spot Prices



Source: Datastream, UBS

Figure 19: MSCI GEMs: Share of Materials Sector (%)

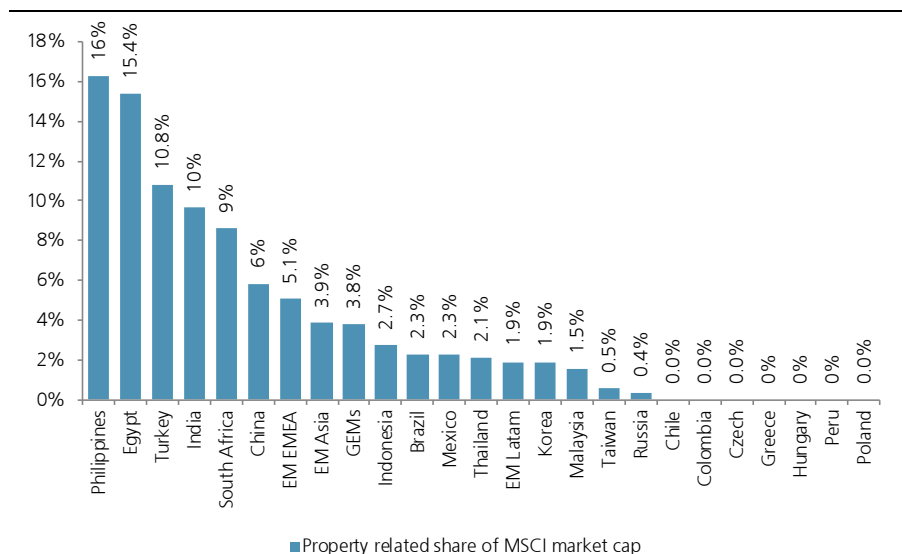


Source: Datastream, MSCI, UBS

Real Estate: Demonstration Effect

Finally, in the event of a collapse of the property sector and a further sharp fall in stock prices in the sector in China, there could be sympathy sell-offs in the sector across EM. In Figure 20, we plot the combined weight of the variety of real estate stocks in each EM equity market². The biggest relative real estate exposures are in small markets: Philippines (16%), Egypt (15.4%) and Turkey (10.8%). India (10%) and South Africa (9.5%) also have fairly high weights, while that for China itself stands at 6%. For all others, the weight of real estate is at, or close to, zero.

Figure 20: MSCI GEMs: Share of Real Estate Sector (%)



Source: Datastream, MSCI, UBS

² These stocks were drawn from the following sub-industries of MSCI GEMs: REITs, Real Estate Management & Development, Household Durables

EM cross-asset strategy

Falling US real rates and accelerating, investment-intensive growth in China have been the defining features of the EM boom years ahead of the crisis. Both these factors are now turning around slowly. Arguably, in their significant underperformance of DM assets over the last few years (particularly so in EM equities) some of this news is being priced. However, 5% growth in China is far from being in the price.

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In a world where China lands hard, EM equity will underperform EM debt by a significant margin. Within EM debt we expect hard currency debt will do much better than local currency debt. China impacts emerging markets through at least three channels: a) trade and commodity prices, b) financial flows, c) the global liquidity and risk environment. Of these the first, we believe, will be the most significant and long lasting.

It is very important to point out that from a global EM perspective Chinese growth matters, but what matters even more is China's investment. Investment is much more import intensive than is consumption, and Chinese investment is exactly what EM feeds through its exports to China. The impact of a big slowdown in Chinese property construction for EM may be more severe than apparent just by focussing on elasticities to Chinese GDP.

While assessing China's impact on EM assets one must along with valuations, also **weigh the policy room available to countries to try and neutralise the impact of a slowing China.** This is an area where emerging market buffers have been compromised since the crisis. Today, a modest increase in US yields and a stalling disinflation trend in EM have limited the room for cutting rates, while private credit and external debt metrics have deteriorated. Fiscal room is, in many markets, very limited.

Based on the proportion of exports headed for China, the importance of terms of trade gains to domestic growth, and policy room available, we feel the most vulnerable markets in EM to a **China slowdown are Brazil, South Africa, Chile, Russia and Indonesia.** To the extent that severe weakness in China by itself is likely to compromise flows to GEM as an asset class, which we think is very likely, India, a big recipient of global equity flows, stands as vulnerable despite being a net importer of commodities. Equities and currencies will likely be the clearest expression of the trade, although weakness in FX will certainly have spillovers onto the debt markets.

Within these bearish expressions, our favoured investment opportunities would be **negative views on Brazilian metals and mining companies and on the South African Rand.** Note that Brazil and South Africa have amongst the lowest savings rates in EM. Even if US rates decline on the back of a China slowdown, the pool of global savings available to EM may fall, exposing cracks within the funding structure.

'Relatively speaking', **the safest asset class in EM is likely to be hard and local currency debt of A rated economies** such as Korea, Poland, Israel and the Czech Republic. These are economies where the credit metrics are unlikely to deteriorate enough by a margin big enough to limit policy room.

G10 FX: Australian dollar the key loser

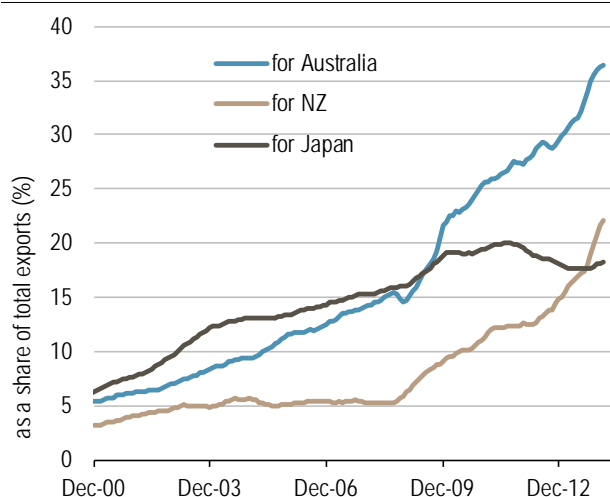
The Australian dollar is the most vulnerable of all developed market currencies to a sharp China slowdown, in our view. Australia stands out not only because of close and direct trade links with China, but also because Australia's exports consist largely of steelmaking ingredients (Figure 21 and Figure 22). It is no coincidence that Australia's exposure to China increased sharply as investment-focused fiscal stimulus measures were rolled out in the wake of the Global Financial Crisis.

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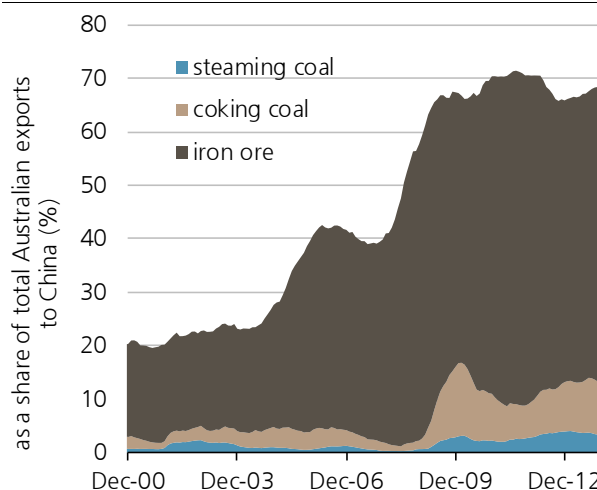
Heavily exposed due to size and nature of exports

Figure 21: Exports to China as a share of total exports for each of Asia's three developed economies (12mma)



Source: Bloomberg, ABS, NZ Statistics, UBS FX Strategy

Figure 22: Australia's export basket to China (12mma)



Source: ABS, UBS FX Strategy

Admittedly, AUDUSD has proven resilient to sharp iron ore price declines in the past – for example during Q3 2011 and Q3 2012 (Figure 23). However, on both occasions the currency was enjoying unprecedented portfolio inflows as reserve manager diversification picked up steam and the Eurozone sovereign debt crisis boosted the appeal of AAA assets. Economic news out of China had also been relatively upbeat during this time.

Immunity was due to a confluence of events, which mostly no longer apply

Since then portfolio inflows have cooled somewhat and this has allowed the currency to rediscover some of its "commodity currency" character. Immunity to commodity price declines in future can no longer be taken for granted.

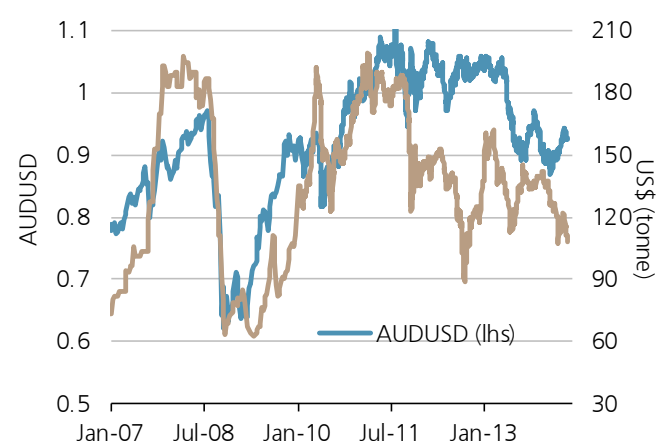
Rediscovering forgotten roots

AUDUSD is vulnerable for another reason too – its proxy status in the minds of FX investors for the overall health of the Chinese economy.

An instinctive reaction

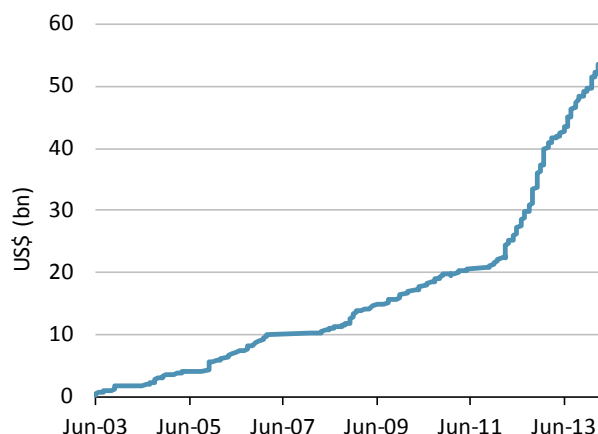
China's capital account is slowly opening with the expansion of the Qualified Foreign Institutional Investor program (Figure 24). But this quota-based system is still too small and the qualification criteria too onerous for many. Trading the AUDUSD has become, and remains, a preferred liquid vehicle for expressing a macro view on the outlook for China, and the urge to sell the Australian dollar on worrisome headlines has become almost instinctive.

Figure 23: AUDUSD Sensitivity To Iron Ore



Source: Bloomberg, UBS FX Strategy

Figure 24: Cumulative Size of Approved QFII Quotas



Source: SAFE, UBS FX Strategy

Although New Zealand's exposure to China is also considerable, at least the prevalence of soft commodities in the export basket should mitigate some of the selling pressure on the currency in our view (Figure 25).

That brings us finally to Japan – another developed market in Asia with significant exposure to China. Despite almost 19% of Japanese exports being bound for China, the wave of global risk aversion sparked by a sharp decline in Chinese house prices would likely weigh heavily on USDJPY, at least initially. The yen's correlation with US yields has weakened somewhat in recent years, but it is still a force to be reckoned with. And falling US yields combined with a likely selloff in Japanese stocks is likely to generate a powerful yen positive effect.

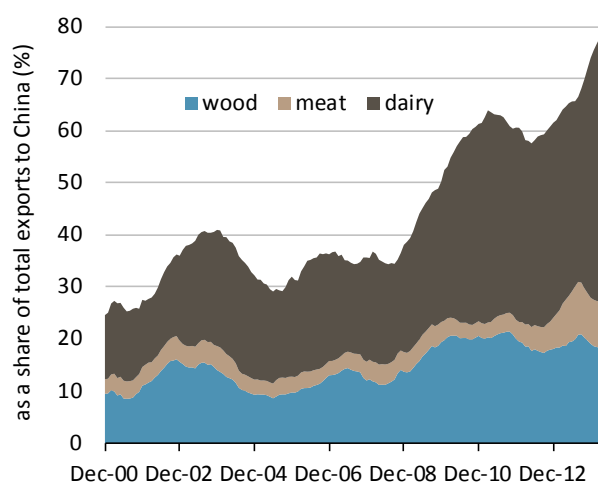
What happens next depends on the Bank of Japan's readiness to launch another blast of monetary stimulus. Governor Kuroda has made it clear he will not hesitate to act if risks to Japan's growth outlook materialise, and a sharp downturn in China property prices would seem to qualify here. The monthly pace of asset purchases has been ramped up several times before (Figure 26) and given the BoJ is currently buying 'only' 65% of fresh gross JGB issuance, there is room for more. Further easing should help underpin USDJPY in our view after the initial dip.

NZDUSD to falter too, but not as much

Falling US yields and Japanese stocks to support the yen

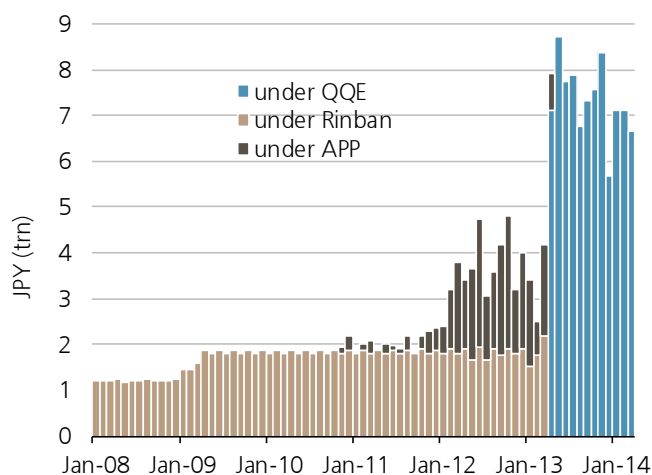
USDJPY to dip then bounce

Figure 25: Composition of NZ exports to China (12mma)



Source: NZ Statistics, UBS FX Strategy

Figure 26: BoJ's Monthly Pace of JGB Purchases



Source: Bank of Japan, UBS FX Strategy

Statement of Risk

Asset allocation is subject to general market risk.

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Source: UBS. Rating allocations are as of 31 March 2014.

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