

Macro Keys

Eurozone: Goodbye 2014, hello 2015

Economics & Macro Strategy

Global

2015 should eventually be better than 2014, but it won't be a 'piece of cake'

In the last Macro Keys of the year – we will be back on 5 January 2015 – we review some of the key Eurozone developments of 2014, and look ahead to 2015 and beyond. Eurozone growth has disappointed in 2014, mainly due to Germany, France and Italy. Economic performance over the coming months is likely to remain subdued, given various risk factors, which are likely to weigh on sentiment. But, over the course of 2015, improving external conditions, easy monetary policy and the weaker EUR, more accommodative fiscal policy, low inflation and depressed oil prices should increasingly support growth. Yet, if the Eurozone wants to leave its troubles behind on a more consistent basis, it needs to lift its growth potential – and for that nothing short of unpopular structural reforms will be needed. Events in Russia and the elections in Greece will require attention over the holiday period. Early next year, a focus will be the December inflation data (out 7 January), which might determine whether the ECB will trigger sovereign QE on 5 March (our base case) or on 22 January. A policy initiative we will hear a lot more about in 2015 is the EU Capital Markets Union.

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Growth in 2014: Weaker than expected

2014 has not gone according to plan when it comes to growth. A year ago, we expected Eurozone GDP to expand by 1.1% this year, but now a growth rate of 0.8% (perhaps 0.9%) looks more likely. The chief culprits are the three biggest Eurozone economies: Germany, where corporate confidence was hit by events in Ukraine, and France and Italy, where sentiment has remained weak, arguably also due to uncertainty over the reform outlook. In contrast, the economic performance of Spain and Ireland in particular, but also Greece and Portugal, has been better than expected.

2014: A lot of hard work for the ECB

The ECB has had a busy year. In light of sluggish growth and declining inflation, aggravated by falling oil prices, the ECB eased its monetary policy stance substantially, making use of conventional, but also increasingly unconventional tools. Key highlights were the move to negative deposit rates and the new Targeted Longer-Term Refinance Operations (TLTRO) announced in June, and the new ABS and Covered Bond purchase programme in September. In December, the ECB hinted strongly that it will widen its asset purchases, likely including sovereign bonds, in early 2015.

With the start of the Single Supervisory Mechanism (SSM) on 4 November, the ECB became the dominant Eurozone banking regulator. In the run-up, the ECB conducted an asset quality review (AQR) and stress test of the 130 largest Eurozone banks, results of which were released in late October. Many banks had already raised capital before, but those that failed the test will have up to nine months to bring their capitalisation to the required level. As such, the ECB has made good progress in repairing the European banking system – although credit growth is likely to catch up only gradually, as demand will likely be slow to recover.

Macro-Strategy Key Issue

Market stress or financial crisis?

Economics

Europe including UK

Fundamentally destabilising

The initial move in oil price was greeted as stimulating growth. The precipitous decline is triggering destabilising factors, especially in EM. As the US economy has accelerated, concern is growing that the Fed is about to shift policy in ways suited to its domestic objectives but not to the needs of increasingly stressed emerging and commodity producing countries and companies. In short, uneven global growth is simultaneously raising the spectre of unsustainable debt deflation across important parts of the (mostly emerging) world and a tightening of US dollar liquidity precisely when it is most needed.

What to watch for?

We think there are four variables to keep high in your radar screen: two control variables (oil price and Fed Funds) and two potentially worrying markets (US HY and EM).

(1) First oil price: Saudi Arabia could stabilise oil prices with production cuts. A return to more normal pricing would probably be seen as positive for the markets.

(2) Second Fed Funds: the recent Fed statement calmed markets, but the longer the Fed waits, the more abrupt the adjustment when it comes. Eventually a re-pricing of the curve seems almost unavoidable to us and the issue is that the curve is pricing a very sanguine scenario for now.

(3) The two markets also to keep on your radar screen, because they are the "weakest link" are US HY due to its exposure to energy and EM assets. In both cases our central case scenario is that the pricing reflects very low oil prices already. So absent a liquidity crisis (a plausible scenario, but NOT our central case) these markets should not generate a systemic crisis.

How to play it?

The economic imbalances are here to stay and the fundamentally destabilising factors will endure: we are fundamentally cautious, especially on EM space. Equally we acknowledge that valuations are now low and reflect a very poor scenario and we do not think it is tactically appropriate to aggressively cut risk in such a low liquidity environment. The recent move re-enforces our fundamental convictions: we prefer DM to EM, we prefer quality in EM. We re-iterate our sector preferences from our Q-Series® note on oil, namely: we see winners in European Beverages, General Retail, Transportation and Pharma, US Consumer Discretionary and Consumer Staples and in Asia we like Airlines. Conversely we see mostly losers in European Energy and Utilities, US Materials and Energy and Asian Commodities and Chemicals. We also include a detailed list of European companies with high exposure to Russia (see **Error! Reference source not found.**).

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Company Disclosures

| Company Name | Reuters | 12-month rating | Short-term rating | Price | Price date |
|---|----------|-----------------|-------------------|-------------|-------------|
| adidas AG | ADSGn.DE | Neutral | N/A | €55.67 | 17 Dec 2014 |
| Aer Lingus ¹⁴ | AERL.I | Neutral | N/A | €1.82 | 17 Dec 2014 |
| Air France - KLM ^{3b, 5} | AIRF.PA | Neutral | N/A | €7.96 | 17 Dec 2014 |
| Alcoa Inc. ^{6b, 7, 16b} | AA.N | Neutral | N/A | US\$15.05 | 17 Dec 2014 |
| Allianz S.E ^{2, 4, 5} | ALVG.DE | Buy | N/A | €134.55 | 17 Dec 2014 |
| Avon Products ^{16b} | AVP.N | Neutral | N/A | US\$9.33 | 17 Dec 2014 |
| BASF SE ^{5, 14} | BASFn.F | Buy | N/A | €69.56 | 17 Dec 2014 |
| BAT UK ^{2, 3a, 4, 5, 8, 14, 16b, 18a} | BATS.L | Buy | N/A | 3,365p | 17 Dec 2014 |
| Beiersdorf | BEIG.F | Buy | N/A | €66.69 | 17 Dec 2014 |
| Bezeq | BEZQ.TA | Buy | N/A | NIS7.06 | 17 Dec 2014 |
| BP ^{2, 4, 5, 6a, 13, 14, 16b} | BP.L | Neutral | N/A | 398p | 17 Dec 2014 |
| C&C Group ¹³ | GCC.I | Neutral | N/A | €3.48 | 17 Dec 2014 |
| Carlsberg A/S | CARLb.CO | Neutral | N/A | DKr475.00 | 17 Dec 2014 |
| Cellcom Israel Ltd ^{16a} | CEL.TA | Neutral | N/A | NIS34.57 | 17 Dec 2014 |
| Coca-Cola Hellenic Bottling Company S.A ⁵ | CCH.L | Neutral | N/A | 1,242p | 17 Dec 2014 |
| Daimler AG ¹³ | DAIGn.DE | Neutral | N/A | €67.17 | 17 Dec 2014 |
| Dairy Crest | DCG.L | Buy | N/A | 489p | 17 Dec 2014 |
| Danone | DANO.PA | Neutral | N/A | €52.89 | 17 Dec 2014 |
| Dunelm Group ^{4, 5, 14} | DNLM.L | Neutral | N/A | 884p | 17 Dec 2014 |
| E.ON ^{2, 4, 5} | EONGn.DE | Neutral | N/A | €13.87 | 17 Dec 2014 |
| easyJet ¹³ | EZJ.L | Buy | N/A | 1,604p | 17 Dec 2014 |
| Ferrexpo Plc ⁵ | FXPO.L | Neutral | N/A | 49p | 17 Dec 2014 |
| Fortum | FUM1V.HE | Sell | N/A | €17.87 | 17 Dec 2014 |
| Greggs ^{2, 4, 14} | GRG.L | Buy | N/A | 694p | 17 Dec 2014 |
| Hays ^{4, 14} | HAYS.L | Buy | N/A | 139p | 17 Dec 2014 |
| Henkel | HNKG_p.F | Neutral | N/A | €86.76 | 17 Dec 2014 |
| Hochschild Mining PLC | HOCM.L | Neutral | N/A | 82p | 17 Dec 2014 |
| Husqvarna | HUSQb.ST | Neutral | N/A | SKr54.80 | 17 Dec 2014 |
| Imagination Technologies | IMG.L | Buy | N/A | 228p | 18 Dec 2014 |
| Inditex SA | ITX.MC | Neutral | N/A | €22.29 | 17 Dec 2014 |
| Israel Corporation Limited ⁵ | ILCO.TA | Buy | N/A | NIS1,956.00 | 17 Dec 2014 |
| Japan Tobacco | 2914.T | Buy | N/A | ¥3,275.0 | 18 Dec 2014 |
| JCDecaux | JCDX.PA | Buy | N/A | €27.59 | 17 Dec 2014 |
| KPN Telecom ^{4, 5} | KPN.AS | Buy | N/A | €2.51 | 17 Dec 2014 |
| Laird Plc ¹³ | LRD.L | Buy | N/A | 291p | 17 Dec 2014 |
| Marks & Spencer | MKS.L | Buy | N/A | 458p | 17 Dec 2014 |
| McDonald's ^{16b} | MCD.N | Buy | N/A | US\$91.65 | 17 Dec 2014 |
| Mondi ^{14, 18a} | MNDI.L | Neutral | N/A | 1,004p | 17 Dec 2014 |
| Next ^{4, 5, 14} | NXT.L | Neutral | N/A | 6,400p | 17 Dec 2014 |
| Nokian Renkaat Oyj ⁵ | NRE1V.HE | Neutral | N/A | €19.92 | 17 Dec 2014 |
| Nordea ^{2, 4, 6a, 22} | NDA.ST | Neutral | N/A | SKr86.05 | 17 Dec 2014 |

| Company Name | Reuters | 12-month rating | Short-term rating | Price | Price date |
|--|---------|-----------------|-------------------|-------------|-------------|
| OTP Bank Nyrt | OTPB.BU | Neutral | N/A | HUF3,735.00 | 17 Dec 2014 |
| PepsiCo Inc ^{2, 4, 5, 6a, 6b, 6c, 7, 16b} | PEP.N | Buy | N/A | US\$93.72 | 17 Dec 2014 |
| Persimmon | PSN.L | Buy | N/A | 1,510p | 17 Dec 2014 |
| Pirelli & C SpA ^{2, 4} | PECI.MI | Neutral | N/A | €10.66 | 17 Dec 2014 |
| Procter & Gamble ^{2, 4, 5, 6a, 6c, 7, 16b} | PG.N | Neutral | N/A | US\$90.70 | 17 Dec 2014 |
| Raiffeisen Bank Intl ^{2, 4, 5} | RBIV.VI | Neutral | N/A | €11.79 | 17 Dec 2014 |
| Reckitt Benckiser ⁸ | RB.L | Sell | N/A | 5,070p | 17 Dec 2014 |
| Renault SA | RENA.PA | Buy | N/A | €58.37 | 17 Dec 2014 |
| Salvatore Ferragamo SPA ⁵ | SFER.MI | Neutral | N/A | €19.50 | 17 Dec 2014 |
| Schneider Electric ⁵ | SCHN.PA | Sell | N/A | €58.41 | 17 Dec 2014 |
| Signet Group ^{16a} | SIG.L | Neutral | N/A | 7,946p | 17 Dec 2014 |
| Sodexo | EXHO.PA | Neutral | N/A | €77.48 | 17 Dec 2014 |
| Swedish Match | SWMA.ST | Buy | N/A | SKr236.00 | 17 Dec 2014 |
| Swisscom ^{2, 4, 5} | SCMN.VX | Neutral | N/A | CHF566.00 | 17 Dec 2014 |
| Syngenta ^{2, 4, 5, 16b, 18b} | SYNN.VX | Neutral | N/A | CHF302.10 | 17 Dec 2014 |
| Telenor | TEL.OL | Buy | N/A | NKr146.90 | 17 Dec 2014 |
| TeliaSonera ^{2, 4, 5} | TLSN.ST | Sell | N/A | SKr49.28 | 17 Dec 2014 |
| Uralkali | URKAq.L | Neutral | N/A | US\$10.24 | 17 Dec 2014 |

Source: UBS. All prices as of local market close.

Ratings in this table are the most current published ratings prior to this report. They may be more recent than the stock pricing date

| Issuer Name | Credit Rating | Outlook |
|---|---------------|----------|
| Federal Republic of Germany | - | - |
| Gazprom ⁵ | - | Negative |
| Gazprombank ^{2, 4} | - | Negative |
| Rosneft | - | Negative |
| Russia | - | - |
| Russian Agricultural Bank ⁵ | - | Negative |
| Russian Railways | - | Stable |
| Sberbank ⁵ | - | Negative |
| United Kingdom of Great Britain ^{16b, 22} | - | - |
| Vnesheconombank | - | Negative |
| VTB ^{2, 4, 5} | - | Negative |

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

2. UBS AG, its affiliates or subsidiaries has acted as manager/co-manager in the underwriting or placement of securities of this company/entity or one of its affiliates within the past 12 months.
- 3a. UBS Limited is advising BAT on discussions regarding the potential acquisition by its associate company Reynolds American International of Lorillard Inc.
- 3b. UBS Limited is acting as sole financial adviser to Intesa Sanpaolo in relation to Alitalia's recapitalisation
4. Within the past 12 months, UBS AG, its affiliates or subsidiaries has received compensation for investment banking services from this company/entity.
5. UBS AG, its affiliates or subsidiaries expect to receive or intend to seek compensation for investment banking services from this company/entity within the next three months.