

Panorama

For marketing purposes
For global professional /
qualified / institutional clients
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clients and investors.

Mid-Year 2020 | UBS Asset Management



Investing in a new landscape

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the path
to recovery

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recovery –
what's next?

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to stay invested
in EM/China

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rebalancing?

In this edition of *Panorama*, our senior asset class and allocation experts assess the investment implications for investors in light of the COVID-19 pandemic.

The following pages offer distinct viewpoints and investment insights across our global capabilities, to help meet your investment challenges.

For additional content and previous editions of *Panorama*, including 'Investing in 2020: Expecting the unexpected', visit ubs.com/panorama or scan the below QR code.



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Reflection, recession, recovery...

Six months ago, as we discussed topics for our year-end edition of Panorama, our investment team debated the most significant events that investors were unprepared for.

One colleague suggested we include global pandemic, having read Laurie Guttrie's 'The Coming Plague'. Indeed, in

We can observe a further fracturing of global political trust and partnership despite the need for solidarity and knowledge sharing being greater than ever.

the years since the book was published, many luminaries had warned of the potential for a pandemic, and yet it is surprising how few investors were either positioned or prepared. We certainly didn't think it was around the corner so it didn't make our final list.

We were looking forward to utilizing the familiar playbook of resynchronizing global growth, which had given predictable results for over a decade. But a new paradigm was about to arrive.

As with most crises, what ultimately matters is how you equip yourself in the heat of battle. Does your investment process hold up? Are your operational practices resilient? In volatile and illiquid markets there are many ways investors can lose money.

While it is difficult to say that we have arrived in a new normal, we certainly now find ourselves in a world with lots of new information to digest.

We are witness to fiscal expenditures that normally only arise in wartime, despite no reduction in the productive asset base. We are seeing a downward conversion of US Treasury yields to the zero bound, not the upward convergence by other global sovereigns that seemed logical only last year.

We are witness to fiscal expenditures that normally only arise in wartime, despite no reduction in the productive asset base.

Technology growth stocks are benefiting from a 'heads I win, tails you lose' nirvana of tumbling discount rates and accelerated revenue growth. Rarely have investors been bombarded with so much change to so many drivers of investment decisions in such a short period of time, and for those that can process the implications of all this change and invest in the most dispassionate manner, the opportunities are potentially boundless.

In this edition, my colleagues take a deep breath and peer into the forecasting fog. Our Solutions team plots what a recovery might look like, and the factors that might hasten or hinder the return to growth, with a summary of how the pandemic has affected our five-year capital market assumptions.

Several of our portfolio managers discuss the relative merits and discrete opportunities of fixed income and equities. Our Emerging Markets team tests whether our long-held bullish stance on Chinese securities still holds water. And our Sustainability experts assess whether the burgeoning move towards climate and environmental awareness will be hijacked by governments' urgent need to focus on economic recovery.

Although we still face uncertainty in how markets will perform over the next several months and years, our investment experts point out several opportunities they see across markets in different scenarios, and our Sustainability team can point to evidence that integrating sustainability into investment decisions has shown its worth throughout the recent volatility.

I trust you will find our mid-year update both informative and provocative. Please don't hesitate to contact your UBS Asset Management partner should you seek further insight.



Plotting the path to recovery

Global macroeconomic outlook



Evan Brown
Head of Multi-Asset
Strategy



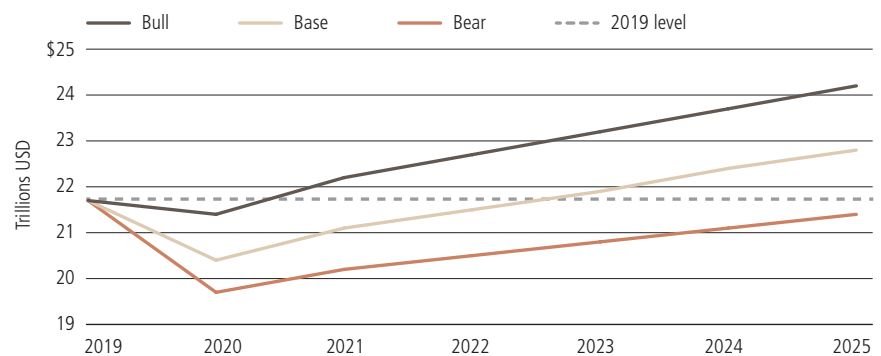
Ryan Primmer
Head of Investment
Solutions

A short, sharp shock or prolonged pain? We look at the potential shape of the COVID-19 economic recovery and explain why our base case is for gradual, uneven growth over the coming months.

After the forced freeze, an uneven thaw

The opening act of the 2020s may have produced the event that defines the decade. An immense human toll and financial market upheaval linked to the COVID-19 pandemic turned every prediction for the year upside down. An unparalleled shutdown of global economic activity occurred, soon answered by policy support and mass doubt about the long-term future of work as well as social interactions.

Exhibit 1: Real GDP across scenarios



Source: UBS Asset Management, data as of 30 April 2020.



Exhibit 2: Possible narratives for the post-pandemic recovery

Bull	Base	Bear
<ul style="list-style-type: none"> – Swift progress on vaccines/ treatments facilitates broad reopening of activity. – Governments pivot from income support for locked-down economies to initiatives that enhance the speed of the recovery. – Monetary policy remains highly supportive of both markets and the economy. 	<ul style="list-style-type: none"> – Gradual recovery begins as economies reopen, with the strength of the local public policy response to the crisis determining relative outperformers. – Conservative Chinese stimulus limits extent of global cyclical upturn in activity. – Consumer spending recovers, but fails to eclipse pre-COVID-19 levels. – Meager rebounds in capital spending, global trade. 	<ul style="list-style-type: none"> – Premature fiscal retrenchment in US; EU recovery plan proves underwhelming. – Material second wave of infections forces return to lockdowns. – Geopolitical, trade, or US election risks increasingly weigh on economic outlook.

Source: UBS Asset Management, 30 April 2020.

We believe the most powerful determinant of economic recovery will be the development of a still-elusive vaccine or proven treatment protocol, followed by a government pivot from providing a cushion to stimulus.

There is an upside scenario in which a faster than expected arrival of an effective vaccine allows for a comprehensive economic reopening.

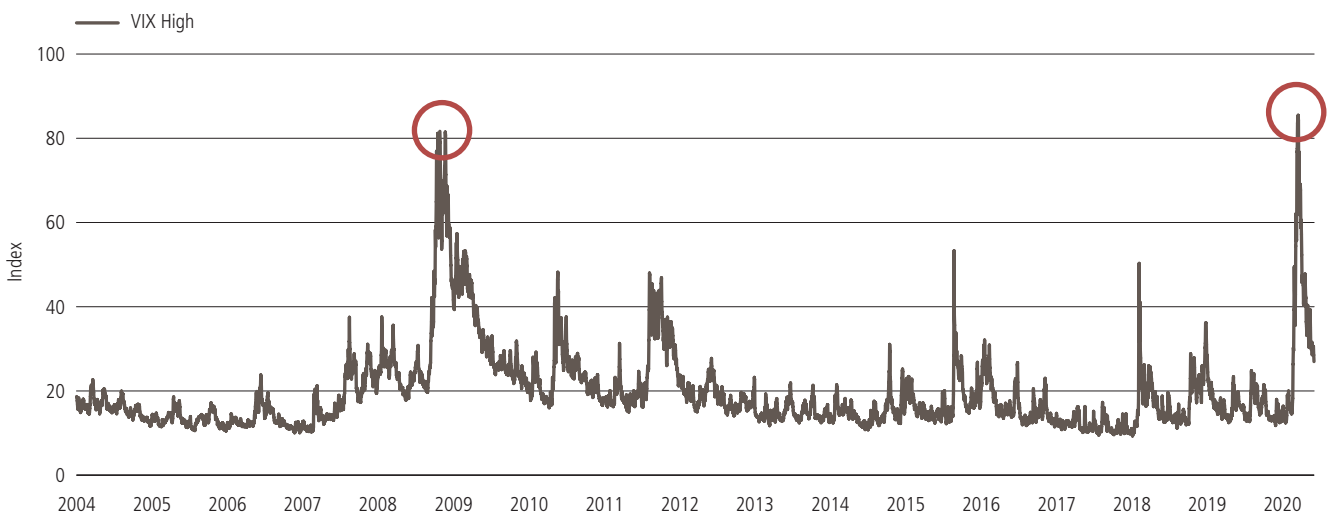
A gradual, bumpy recovery

Therefore our base case, given that uncertainty, is for a gradual, uneven economic recovery. Capital spending is likely to stay in the doldrums in this highly uncertain backdrop, and the scope for households reducing saving rates is limited.

There is an upside scenario in which a faster than expected arrival of an effective vaccine allows for a comprehensive economic reopening, with governments nimbly turning to stimulus spending. Conversely, a downside case consisting of a second wave of COVID-19 that forces a return to

economic lockdowns or the premature withdrawal of fiscal support amid continued private retrenchment lies within the range of possible outcomes. We intend to stay flexible to capture these relative value opportunities as they appear.

Exhibit 3: COVID-19 drove equity volatility to financial crisis level



Source: Bloomberg, UBS Asset Management, data as of 3 June 2020.



A balancing act

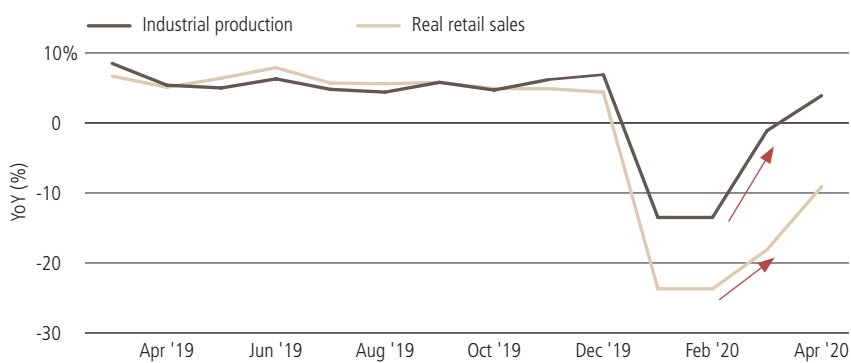
Asset allocation in any of these scenarios requires striking a delicate balance between fiscal and monetary support already deployed by central banks and governments to alleviate the economic damage, protecting against a possible protracted downturn and tepid recovery, and identifying opportunities

for asymmetric upside should a proven therapy or vaccine allow for a more enduring rebound.

We retain exposure to themes and geographies that we believe stand to gain the most from an upswing, while limiting our overall risk if a more pessimistic scenario comes to pass.

Risk assets around the world have enjoyed substantial rallies since late March, as initial policy enthusiasm was followed by incremental progress on both public health outcomes and economic activity across the developed world. Nonetheless, in our base case scenario, lingering safety concerns will keep demand and capacity below pre-COVID-19 levels in 2020 and beyond.

Exhibit 4: Example of COVID-19-driven supply/demand imbalance in China



Source: NBS, UBS Asset Management, data as of 30 April 2020.

In the US, the potential end of enhanced unemployment benefits in July and looming austerity at the state and local government level constitute potential risks to the US economy. The importance of US consumption and the depth of the nation's capital markets suggests that the policy response stateside will play an outsized role in mapping out the magnitude and contours of the global macroeconomic bounce as well as financial market performance.



Intense stress on firms, including a rash of bankruptcies during the economic standstill, has severed the links between employee and employers, introducing a source of friction that may prevent an immediate healing of labor markets and, in turn, consumption.

The Federal Reserve's swift policy support for credit markets and commitment to ultra-low policy rates is only one factor to consider. The potential for market-unfriendly tax and regulatory changes that would come with a Democratic win of the presidency and both houses of Congress in the November presidential election may command more attention as the vote nears.

Where does this leave us?

Within US assets, we prefer investment grade and inflation-linked bonds, which benefit from central bank accommodation. The magnitude of the rally in risk assets leaves us neutral on global equities. The S&P 500 Index is pricing in a complete earnings recovery by the end of 2021 while trading at valuations

rarely seen outside of the dot-com bubble. We prefer equities in markets including Japan and Germany, which are trading at much more attractive valuations.

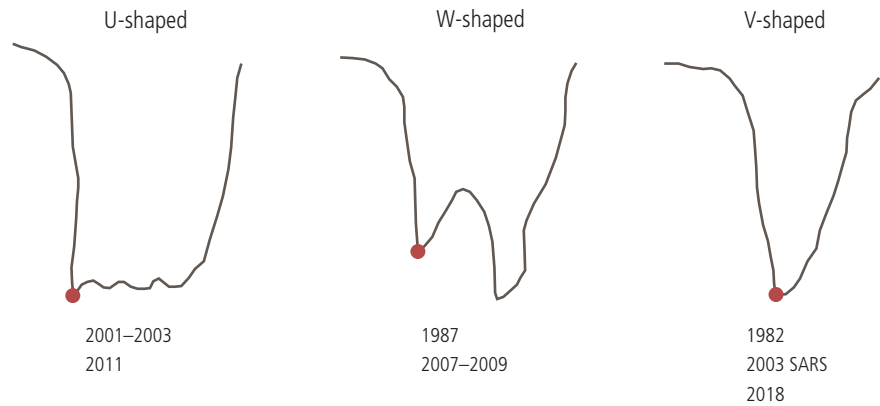
Relatively robust safety nets in European nations and the nature of the authorities' responses to the pandemic inspires optimism that the harm to the labor market, at least on a headline basis, will not be as severe as in the US. Attitudes towards government spending are shifting. A Franco-German recovery plan constitutes concrete progress towards the monetary union's development of a collectivist approach to fiscal policy,

The magnitude of the rally in risk assets leaves us cautious on global equities.

which if enacted could drive domestic demand increases during the recovery phase. Negative funding rates through programs introduced by the European Central Bank encourage the narrowing of sovereign periphery spreads and lending to bolster the real economy.

Policy support in Japan is ample, with the combination of highly accommodative central bank support and the government's recent doubling of an assistance package. The deployment of monetary and fiscal easing goes back to the advent of Abenomics, a period associated with superior local returns.

China and Korea, which suffered from virus outbreaks before their emerging market counterparts, could outperform that cohort due to their status as the first to stabilize activity and implement strong contact tracing infrastructure. Dollar-denominated emerging market debt, particularly Asian countries, represents another area in which relative returns are skewed to the upside should risk appetite remain resilient.

Exhibit 5: Potential types of recessions/recoveries

Source: Fundstrat, as of 3 April 2020.

The fiscal policy response from Beijing, meanwhile, is designed to do what is sufficient to support employment – but not much more.

An asynchronous snapback across nations will weigh on the ability of the world's second-largest economy to capture a meaningful impulse from global demand; so too will China's relatively limited fiscal thrust to date reinforce slower activity around the world.

Tensions between China and the US have also reemerged on a number of fronts, including both the COVID-19 pandemic and Hong Kong's status. An eventual reckoning on these issues threatens to fuel volatility not just in Chinese markets, but globally as well. Tactically, we believe the status of the phase one trade deal will stay at the forefront as a driver of local returns.

We believe the status of the phase one trade deal will stay at the forefront as a driver of local returns.

Markets have shown a relative inability to adequately price nebulous financial risks compared to well-defined disruption to the terms of trade. Nevertheless, we are underweight cyclical North Asian currencies against the safe haven Japanese yen, to hedge against an escalation of tensions or downside surprise in global growth

The rest of the emerging markets cohort is likely to be weighed down by lackluster global growth and trade, with the conservative Chinese fiscal response offering less of a lift for this group compared to prior periods of fiscal loosening. Despite this, the cupboard is by no means bare when it comes to the opportunity set in emerging markets, including selective undervalued currencies.

Our risk exposures are designed to capitalize on opportunities with asymmetric upside amid a successful thawing of the global economy, guided chiefly by attractive valuations.

We will be guided by the knowledge that reopening is a necessary but insufficient prerequisite for a return to full economic health. In addition to breakthroughs in the medical field, public policy decisions will be instrumental in deciding the character – whether it be a V, a U, most likely in our view, a 'swoosh' – that defines the shape of differing recoveries, as well as that of the world at large.



Shaping long-term expectations

A look at the longer-term investment implications of the pandemic



Louis D. Finney
Co-Head of Strategic
Asset Allocation
Modeling



Michele Gambera
Co-Head of Strategic
Asset Allocation
Modeling

Uncertainty remains high across markets and economies but what are the longer-term investment implications of the pandemic, how will it accelerate trends, and what will the impact be on investing in the next five years?

Our base case is for a slow, bumpy return to growth in the latter half of 2020 that gradually trends back toward normal growth.

Our Investment Solutions team provides estimates of capital market returns across a wide array of asset classes and from multiple currency perspectives. This excerpt from our first-quarter Capital Market Assumptions update focuses on our five-year baseline expected returns. Since our June 2019 estimates, equities ended the decade with an admirable 10-year record and that momentum continued into February.

10 yrs



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Since our June 2019 estimates, equities ended the decade with an admirable 10-year record

Then, the COVID-19 pandemic hit, and equity markets plunged more than 30% before rallying sharply in April and May. Government bond yields across all maturities declined in the US – which lowered expected returns in local terms. Credit markets have had surprising ups and downs, but are still at relatively wide levels at time of writing.

Market expectations over the longer-term

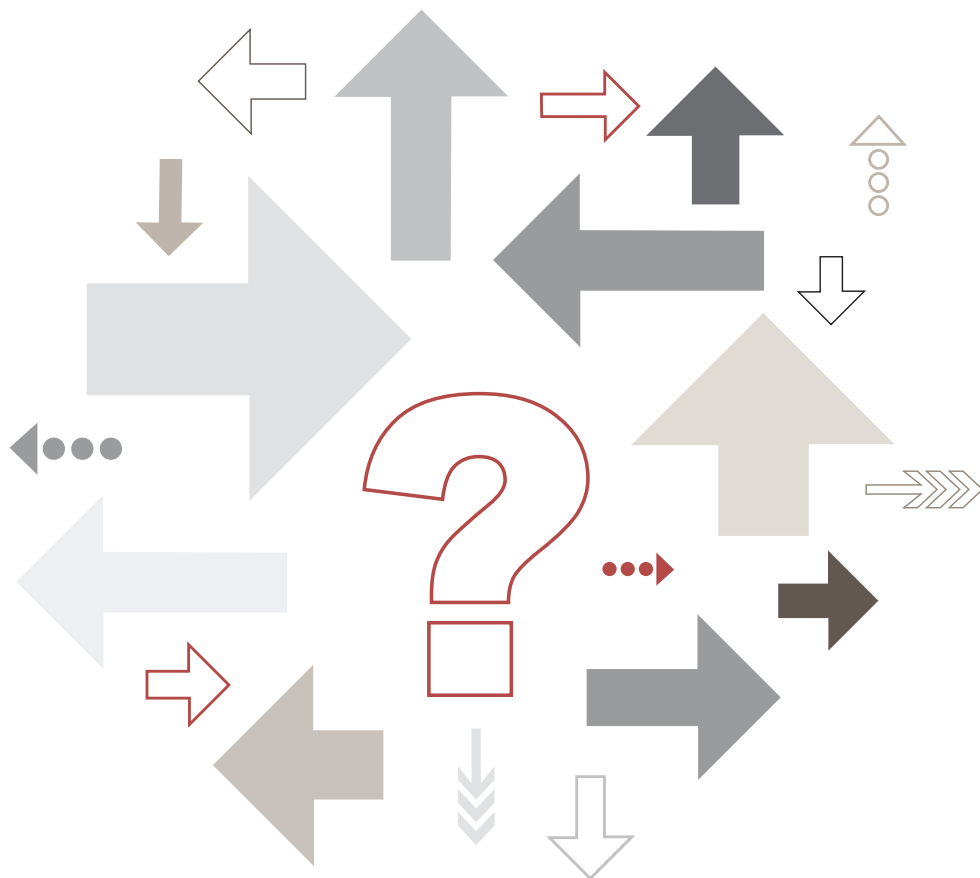
As the pandemic crisis resolves, some industries may quickly bounce back to something very recognizable. Other industries – such as airlines, cruise lines, hotels, restaurants, sporting events, theater, concerts, and public transportation – may be impaired for a lot longer as we struggle to find a new balance.

Balancing disruption is innovation. We already see the creation of new businesses and models from low tech to high tech: personal protection equipment (masks and plexiglass panels), video conferencing, and telemedicine.

The growth story going forward is also uncertain. A permanent rise in private sector savings could weigh materially on growth over the medium term, driving sovereign yields even lower.

In turn, if policymakers over-stimulate amid supply-side constraints, stagflationary pressures could erupt.

Although we have developed a number of scenarios for economic and capital market projections for the next five years, our base case is for slow, bumpy return growth that gradually trends back toward normal growth. This includes the likelihood that some deglobalization, lingering outbreaks of COVID-19 and precautionary behaviors by consumers and businesses hamper growth initially. Inflation starts low and rises back toward trend in our base case.



The main changes in our five-year capital market assumptions compared to our mid-2019 report

- Expected global equity returns in nominal terms are higher, as valuation is improved.
- Government bond yields are even lower, so expected returns are lower. European yields did not drop as much as US yields, but were lower to start with.
- In general, we lowered expected 10-year yields in developed countries in 2025 by 0.4% to 1.1%. This has offset some of the drop in yields in projected returns.
- Credit spreads are higher due to higher default risks, but returns are still more attractive relative to governments. They bottomed out in early January 2020 and then ballooned late in the first quarter of 2020 before tightening significantly in April and into May.

- The dollar appreciated against most, but not all currencies. Some emerging markets currencies had extremely large depreciations. In general, we view the dollar as overvalued against both developed market and emerging market currencies.

Global asset class returns

In nominal terms, the expected five-year return of equities rises to 7.5% in unhedged USD terms, an increase of 0.3% from the June 2019 version. A portfolio of global government bonds is expected to return -0.1% in hedged USD terms, a large drop from the 1.2% in June 2019. Global investment grade credit drops from 1.6% to 1.3% and high yield bonds grows from 3.7% to about 4%. Cash declines the most, dropping from 2.2% to 0.2%.

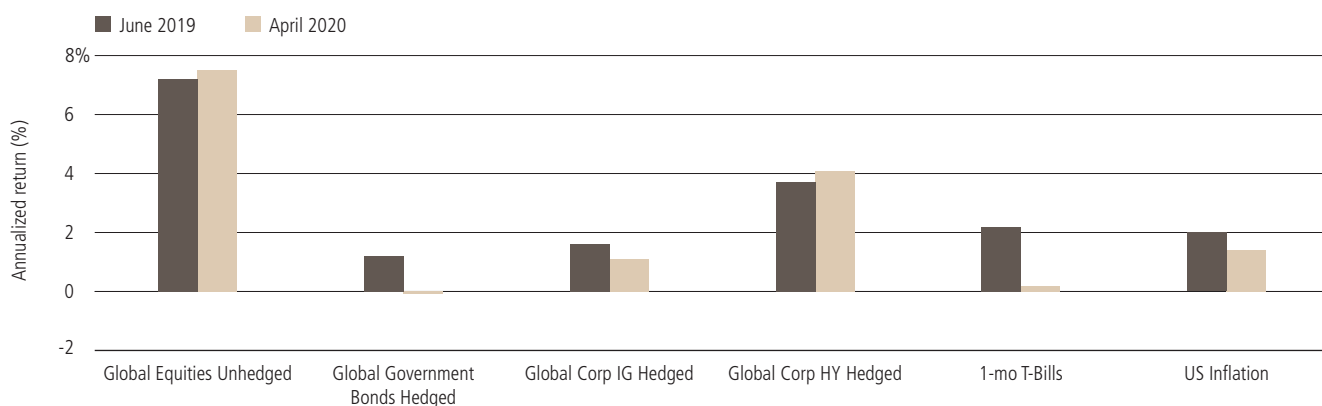
The resetting of valuations provides a more favorable backdrop for riskier assets over the medium term. Expected returns in global equities and high yield debt improved, whereas safe assets saw

expected returns decline. For most risk assets, this valuation improvement was quite large, but it was somewhat offset by declines in expected growth and inflation.

US large cap equity was one significant outlier to this, as this expected return declined due to the large bounce back in valuations. US large cap returns fell to 4.9%; the valuation improvement since last June (0.5% increase) was offset by lower expected inflation (0.6% decline) and decline in aggregate earnings growth (a 0.1% decline).

In inflation-adjusted terms, prospective returns on global government bonds in April 2020 looked a bit better than the pure nominal rates indicate. With lower inflation, the real returns are boosted. In the short run, it is possible that with negative inflation and unchanged bond rates, real returns for bonds could be 2% to 3%, well within their historic performance.

Exhibit 6: Five-year expected returns in USD



Source: UBS Asset Management, data as of 30 April 2020.

In inflation-adjusted terms, prospective returns in April 2020 looked a bit better than the pure nominal rates indicate.

Along with bouts of volatility and normal rotations of performance, we need to prepare for regime shifts that alter some fundamental relationships in the markets.

Our estimate of expected inflation dropped sharply in the last 10 months. The 10-year breakeven inflation rate for the US, for example, declined from 1.7% in June 2019 to 1.1% at the end of April and reached a low of 0.9% in March. We have pegged cumulative inflation to be around 1.4% (annualized) for the next five years.

The pandemic of 2020 has dramatically shifted the starting point and path of the economy, leaving investors a wider array of potential economic outcomes. Along with bouts of volatility and normal rotations of performance, we need to prepare for regime shifts that alter some fundamental relationships in the markets.

The stock-bond correlation – time for a change?

One such potential regime change over the next five years is the stock-bond correlation. Over the last 22 years, stock returns have been negatively correlated with Treasury bond returns in most developed markets.

We believe that there is an increased likelihood that this negative correlation will break down sometime in the next five years. The historic data indicate that the stock-bond relationship is regime dependent. The critical threshold is sustained 2.5% inflation; below this, we expect the relationship to be negative;

above this, there has been a positive stock-bond correlation. For now, inflation has been negated by the pandemic, with the US price index dropping 1.3% for the three months ending in May.

One tool to help evaluate portfolio rewards and risks is scenario analysis, as it allows investors to understand the economic drivers of performance. Complementing this with standard tools and modern risk control analytics should prepare investors to build, better, more resilient portfolios.

The pandemic of 2020 has dramatically shifted the starting point and path of the economy, leaving investors a wider array of potential economic outcomes.

Crash to recovery – what's next?

Thoughts from four of our key PMs

Market volatility can create winners and losers. Our key portfolio managers look at the opportunities that could emerge from the current crisis and share their outlooks for equities, bonds, hedge funds and multi-asset investing during these unprecedented times.

Our experts



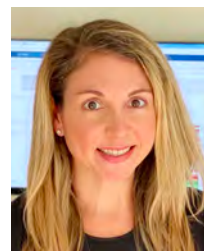
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Maximilian Anderl

Head of Concentrated Alpha Equity

Q: Within equities, which sectors may bounce back quickly? Is now the time to consider investing in healthcare, crude or travel?

A: While uncertainty regarding the implications of COVID-19 continues, some industries, such as pharmaceuticals, have already seen a bounce back amid strong buying support and increased demand. Currently, we believe pharmaceuticals are fully valued, though over the long term we continue to favor pharmaceuticals given their resilience and valuation support.

In the energy sector, we expect the price of crude oil to rise further but this is already reflected in equity prices. While there are some emerging signs of supply discipline, spare capacity will eventually be added back resulting in higher oil prices. We expect to see a longer-term decline in oil demand but expect the demand support for fossil fuel alternatives, such as renewables, to increase.

With the global pandemic drastically reducing travel and tourism demand and revenues, we don't expect that to change quickly, so our airline and tourism outlook remains cautious. We believe opportunities exist in quality cyclicals, most notably software companies and healthcare equipment providers, while industrials and semiconductors stocks have some way to go.

For normalization of the market to take place, a vaccine that is both effective and accessible is essential.

Q: Should investors be concerned by the increasing dominance of the US market by a smaller concentration of larger stocks?

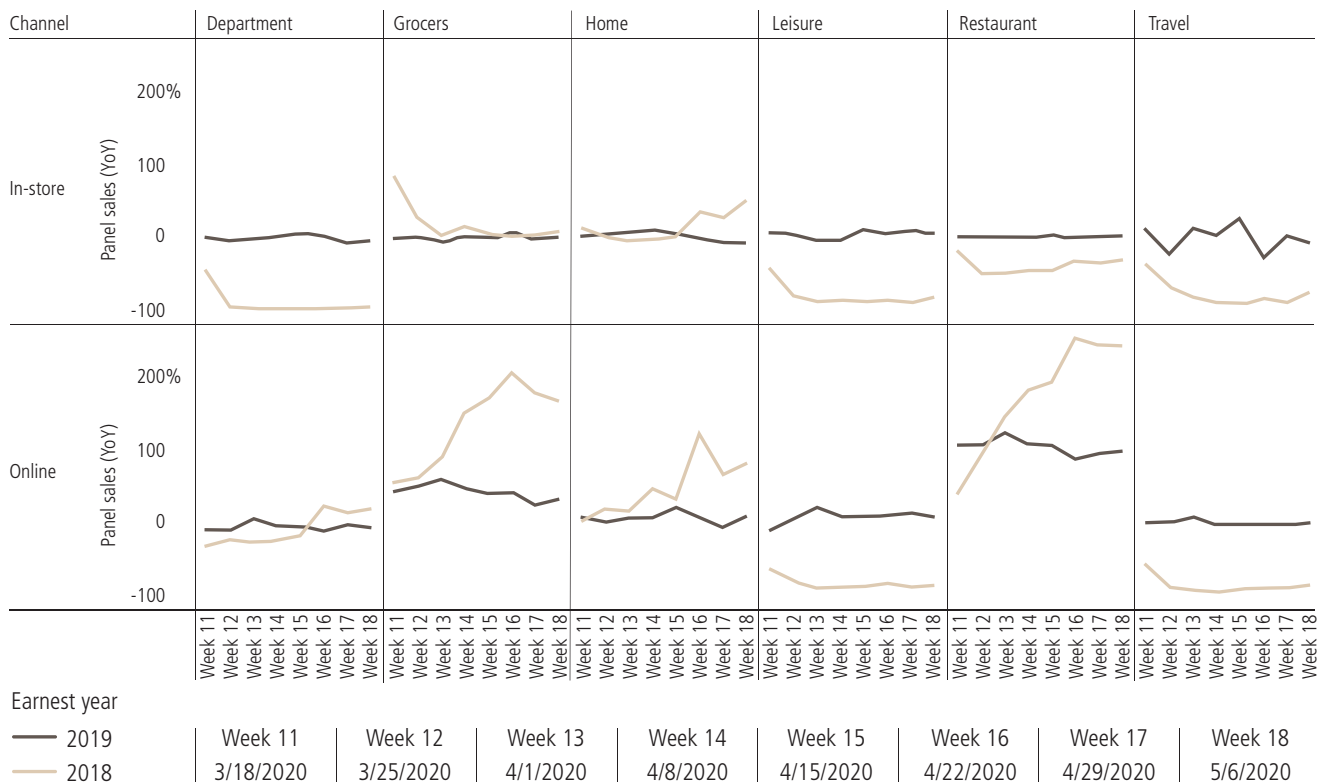
A: Among the winning sectors including cloud, semiconductor equipment and digitalization, there are interesting differences in how medium/smaller companies are perceived vs. larger companies. Smaller companies often struggle to generate profit and in some cases even suffer substantial losses. However, simply because their starting revenue base is small they benefit from enormous sales growth in the range of 30%–100%.

As investors have no alternatives other than sales to value these companies, they resort to using enterprise value-to-sales as a valuation measure. As a result these companies are rewarded with greater multiples because of their significantly higher growth. We believe there is too much uncertainty as to whether these smaller companies will ever be able to reach profitability or generate cash flows.

In contrast, innovative large companies like Microsoft and Alphabet are highly profitable industry leaders dominating the market. Their sales growth is moderate in comparison due to the sheer size of their revenue base. These companies trade on profit metrics and tend to have very robust balance sheets. At this stage of the cycle, we find large, innovative companies more attractive on risk vs. reward as their free cash flows give them the flexibility and ability to reward shareholders.

Amid the pandemic-induced economic shutdown, some online spending categories rose, suggesting what may become a persistent pattern.

Exhibit 7: US consumer transaction weekly (YoY) data



Source: Earnest, UBS Asset Management (Quantitative Evidence and Data Science team), data as of 6 May 2020.



Jonathan Gregory

Head of Fixed Income UK

Q: What structural changes will we see – either temporary or permanent?

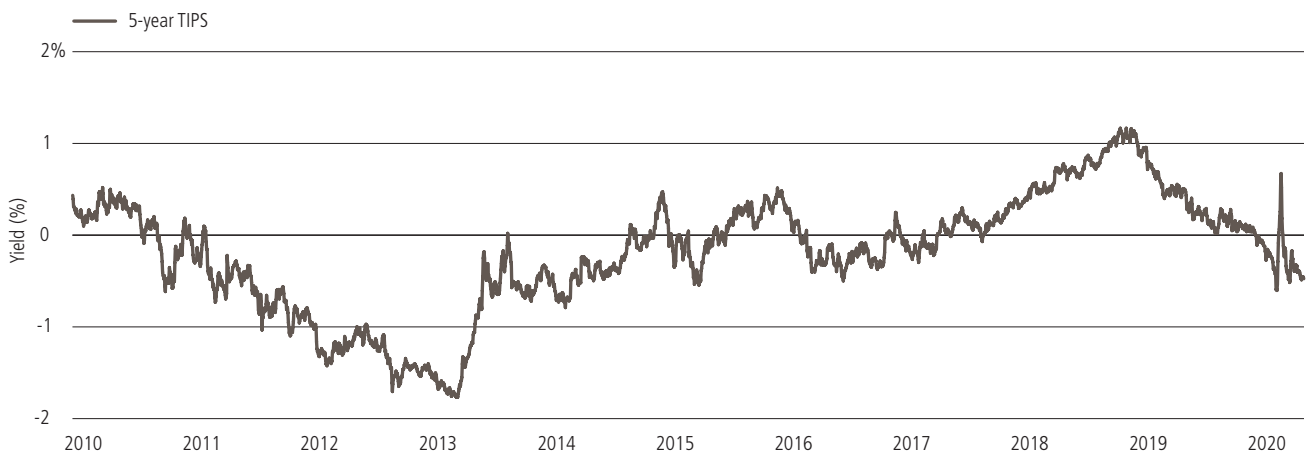
A: Arguably, the biggest question facing investors is what will happen to inflation? In many countries, structural factors have kept inflation below targets for years. In the short term, these structural factors have now been joined by the deflationary effects of COVID-19 via the dramatic curtailment of private sector spending and investment. But could things be changing?

On the one hand higher savings of ageing workforces and the impact of technology continue to depress inflation.

However, the sharp transition now from fiscal austerity to fiscal expansion in many countries or the interruption to the global supply chain through trade and other geopolitical tensions, particularly relating to China, may prove inflationary.

Finally, the balance of power may swing away from capital and towards labor, reversing a trend of the past 20 years. We cannot be certain how these themes will play out but higher inflation remains a risk which investors must now take seriously.

Exhibit 8: Evolution of 5-year TIPS yield



Source: Bloomberg, data as of 6 April 2020.

So, we believe holding some form of inflation protection in portfolios makes sense. In the US, five-year inflation protected securities (TIPS) currently yield about -60bp but we think yields could fall even further if the US Federal Reserve continues to keep the policy rate pegged at very low levels, and if inflation expectations start to rise. For example, the yield on 5-year TIPS fell as low as -1.7% in 2013.

Q: With the vast monetary and fiscal support seen this year, do you envisage further supportive measures?

A: We expect to see bond yields remain low and possibly move even lower, for at least the rest of 2020. In the short term it seems very unlikely that a COVID-19 vaccine or effective therapy will be available, which means the economic recovery could be protracted and highly unstable. Monetary and fiscal authorities will likely need to offset the shock to both the supply and demand sides of the global economy.

If bond yields start to rise, this may offset some of the positive effects of fiscal policy and the authorities will want to avoid this. In fact central banks will be buying a lot of the government bond issuance to help keep yields low. It is also likely that some central banks will look to exert more control over the term structure of rates (as we have seen in Japan and Australia) with an approach known as 'yield curve control' whereby central banks buy as many bonds as necessary to effectively cap yields along the yield curve.

Monetary and fiscal authorities will likely need to offset the shock to both the supply and demand sides of the global economy.



Kevin Russell

Chief Investment Officer, O'Connor

Q: How did the COVID-19 pandemic affect credit markets in the first half of the year?

A: In many ways the US corporate credit market has been the epicenter of both risk and opportunity so far this year. Although decisive US Federal Reserve policy intervention enabled a significant gap tightening, investment grade and high yield spread normalization occurred at spread levels roughly two times wider than in January, averaging around 190 bps for investment grade and 750 bps for high yield cash bonds. While the duration of the extreme risk aversion was brief due to the Fed's comprehensive credit market support and the CARES Act to offset economic contraction, the investment landscape for corporate credit investing has been dramatically altered as the market digests significant issuance and assesses both the magnitude and duration of the pandemic on corporate business models and the broader economy.

Q: What opportunities are likely to develop for investors in credit markets?

A: While we are constructive on elements of the corporate credit market on an absolute basis, especially defensive high yield bonds and short-duration investment grade bonds, we are positive on the relative value opportunities arising. The magnitude of issuance in the US investment grade credit market thus far in 2020 is breathtaking at over USD 1.2 trillion as of June 10, which has already outpaced full-year 2018 and 2019 issuance.

With the market having to digest such immense supply in just a few months amid market and economic disruption, we expect the credit markets to continue to be fairly choppy for the next 18 months, presenting ample opportunities for active and dynamic investors to capitalize on this volatility as the resumption of economic and business activity dictates relative winners and losers across the markets.

Similarly, the pandemic has opened up relative value and capital structure trades across high yield and convertible debt that allow investors potential to capitalize on mis-priced risk between both secured and unsecured debt, as well as debt vs. equity, as companies with more balance sheet leverage struggle to adjust to current conditions.

We expect a high level of dispersion in credit performance and faster-than-normal convergence on relative value trades within credit markets over the next eighteen months.

We are positive on the relative value opportunities arising.



Nicole Goldberger

Head of Growth Portfolios, Investment Solutions

Q: What are the top risks you are considering for the next 6–12 months?

A: Two-sided tail risks loom in this early cycle environment.

On the downside, a second wave of COVID-19, escalating US-China tensions, and concerns around the US election could lead to a more uneven recovery and stoke volatility that roils markets. Conversely, the momentum in risk assets suggests right-tail outcomes could be achieved if policy success begets incremental improvements in activity.

The lofty levels to which equities have already ascended are expensive from an absolute perspective, reflecting expectations for a swift recovery in earnings that seem too optimistic. In our view, this setup leaves little margin for error with stocks vulnerable to downside risk if the virus returns, policy falls short or the economic rebound falters.

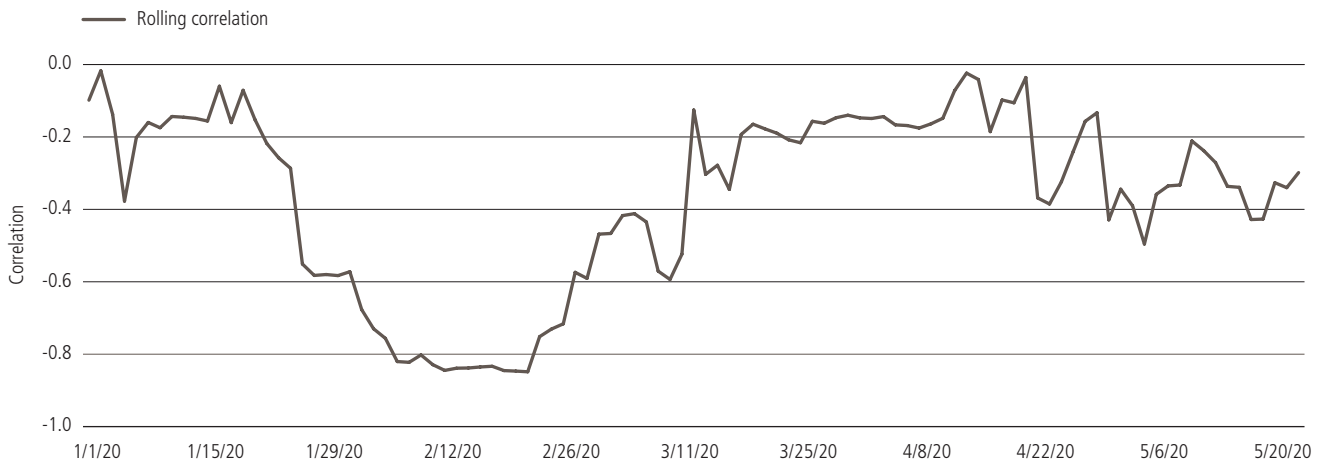
Q: How can asset allocation help smooth returns over the next year?

A: Despite volatility moderating from extreme levels reached in March, we believe that the shift to a higher volatility regime is likely here to stay for the next year. We are focused on staying nimble seeking to take advantage of market dislocations and evolving tactical opportunities, while emphasizing diversification in order to deliver a smoother ride.

With interest rates close to the effective lower bound, we seek out other hedging vehicles, such as gold and the Japanese yen that may serve as ballast in our multi-asset portfolios. We think that gold will also likely be a relative winner in the event of unintended consequences stemming from the enormous and powerful stimulus packages.

We favor relative value trades rather than taking large directional bets. We prefer to take a barbell approach by selectively adding to early cyclical exposures that we believe have the most room to run in an enduring recovery, while maintaining defensive positions with solid fundamentals looking to protect against a downturn. We prefer US investment grade credit relative to sovereign bonds given Fed support and attractive carry characteristics. Recently, we've boosted our exposure to dollar-denominated EMD, which has lagged the degree of recovery enjoyed by other segments in the credit space, providing greater scope for capital appreciation. We favor assets which we believe would benefit from upside surprises to growth and trade at extremely inexpensive valuations (such as selective emerging market currencies).

Exhibit 9: 25-day rolling correlation between equities and bonds



Source: Bloomberg LLC, data as of 22 May 2020.

We are focused on staying nimble to take advantage of market dislocations and evolving tactical opportunities, while emphasizing diversification to deliver a smoother ride.

Eight reasons

To stay invested in **EM and China**



Geoffrey Wong
Head of Emerging
Markets and
Asia-Pacific Equities

While the attention of the COVID-19 pandemic moves away from China, businesses are slowly resuming, but will China and EM continue to be global growth hotspots, and is investment in China still too big an opportunity to ignore? We take an in-depth look at the pace of recovery in Emerging Markets (EM) and explore whether the economic recovery is a roadmap for the West.

Some observers may draw parallels between COVID-19 and SARS, but the current pandemic is much more significant because of its severity and geographical spread, due mainly to the fact that world is now much more interconnected. Additionally, China is now a much more significant part of the world economy than it was before.

As we write, it is difficult to predict the shape of a COVID-19 recovery since a lot depends on how both the outbreak evolves and how the search for preventions and cures progresses. As such, this is likely to be a story that continues into next year.

But at a time when new cases, treatments and policies drive a global news cycle, the challenge for forward-looking investors is to focus on what matters. With that in mind, here are eight takeaways on our current view and the future outlook for EM equities:

Some observers may draw parallels between COVID-19 and SARS, but the current pandemic is much more significant because of its geographical spread.

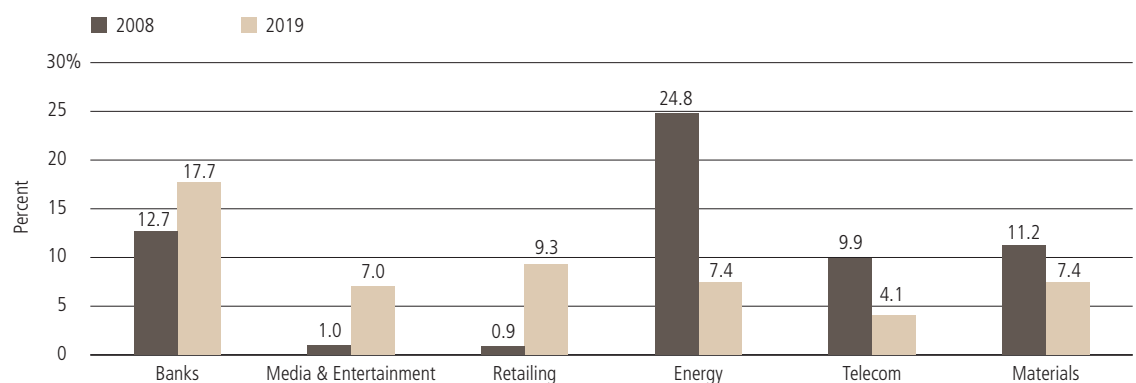
1

While the global economic impact this time may be larger than in 2008–09, EM have become more domestically driven over this period.

Over the years, the composition of EM has shifted towards domestic sectors like consumption, e-commerce, and financial services, and away from more global sectors like energy and materials, thus making EM less exposed to a global downturn than they were during both the Global Financial Crisis and the SARS outbreak.

However, the crisis this time is more global and the economic hit is larger. Countering this is the unprecedented amount of fiscal and monetary policy support globally.

Exhibit 10: Changes between 2008 and 2019 in MSCI industry groups



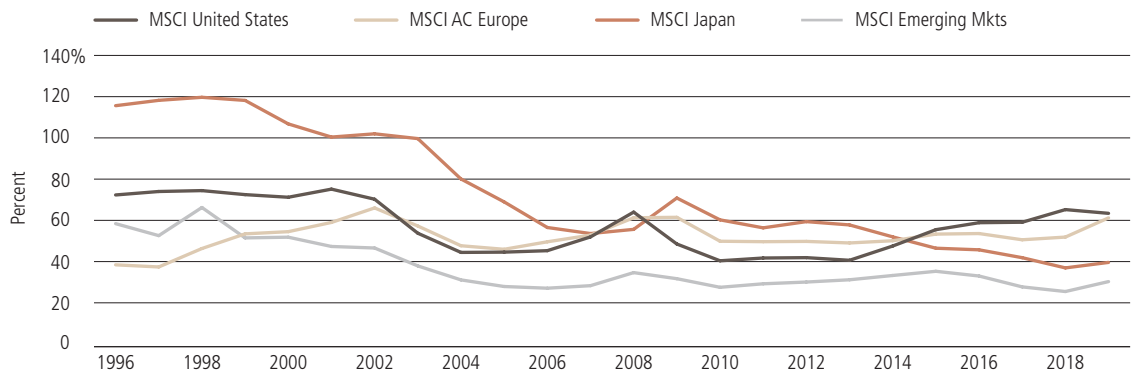
Source: UBS Asset Management, data as of 30 April 2020.

2

EM companies have more defensive balance sheets

On the whole, EM company balance sheets have been improving since the Asian financial crisis in 1997/1998 and are more defensive, especially when compared to the US and Europe. That said, we may see a temporary increase in leverage in the coming months as EM companies work through the crisis period.

Exhibit 11: Net debt/equity, 1996–2019



Source: Worldscope, Datastream, UBS IB, data as of 31 March 2020.

3

EM policy response has been large, with further scope to ease

Governments across EM have stepped up with wide-ranging policy support.

On the monetary side, central banks in eleven EM countries cut rates in April (China, India, South Africa, Russia, Mexico, Poland, Turkey, Philippines, Peru, Colombia, and Pakistan). This has been possible because most countries in the EM space have maintained a prudent policy mix so far with respect to their real rates, and had room to cut rates.

On the fiscal front, governments are stepping up their efforts too. Russia for instance stated that the government plans to allocate ~3% of its GDP to fight the pandemic.

4

Supply chains continue to shift

Even prior to COVID-19, the move to reduce global dependence on the China supply chain had started, driven by rising costs in China and rising automation reducing labor cost differentials, the trade conflict and tariffs, and a general desire to diversify China risk.

COVID-19 provides an additional impetus to diversify from the China supply chain.

Many companies are however looking at a 'China plus one' strategy, hence China will likely continue to be both an important production base and final market for companies. South-East Asia and India are potential beneficiaries of the 'plus one' strategy, and we'll likely see more reshoring to North America, Korea or Japan.

5

Structural trends have accelerated

COVID-19-induced changes in behavior have accelerated the shift from offline to online services, benefiting business segments like after-school tutoring, financial services, and healthcare diagnosis.

Companies are also stepping up investment in R&D and innovation, and there is growing demand for automated solutions.

Additionally, the COVID-19 outbreak is spurring consolidation within many industries both in China and EM more widely.

6

China equities have outperformed, investment case remains intact

At the time of writing, Chinese equities¹ have outperformed US² and European³ equity markets YTD. We see three reasons for this: firstly, China made a decisive, successful response in controlling the outbreak and this gave investors confidence; secondly, China moved quickly and showed strong capacity to stimulate and support the economy and, finally, US equities started the year being much more expensive than China.

Additionally, China is showing signs of being one of the first economies to move toward a recovery, with a widespread relaxation of pandemic controls coming in early May and data on intra-city traffic and coal consumption showing incremental improvements over recent weeks.

Finally, the COVID-19 crisis has been a very good test of the standalone China thesis. China's equity market remains under-represented in global equity indices. Also, the correlation between domestic China and other equity markets remains low and this was again proven during this crisis.

¹ CSI 300, end of April 2020.

² S&P 500, end of April 2020.

³ MSCI Europe, end of April 2020.

7

Long-term fundamental drivers haven't changed

For all the disruption to everyday life from COVID-19, we don't see a meaningful impact on the long-term drivers that underpin EM.

Demographic trends within EM aren't going to change because of the pandemic; the population of working age people in EM is still expected to grow 0.81%, on average, per year between 2020 and 2050, while it will decline 0.3% per year in developed markets.

This demographic change is significant because it means that the world's new working population and consumer bases will come from EM and support domestic demand growth. And as incomes rise in EM, consumers are shifting their wallet share towards discretionary consumption and better quality goods and services.

8

Current EM valuations offer attractive entry points

EM went into this crisis with inexpensive valuations and are now trading around 1.5 price/book – meaningfully lower than their historic average of around 1.8 – and EM currencies are close to historic lows on a real effective exchange rate basis.

Current valuations could make for nice entry points from a long-term perspective.

Looking over the past twenty years, EM equities have tended to recover quickly after key outflow periods such as the SARS outbreak in 2002, and the Global Financial Crisis of 2008/2009.

So while it is difficult to predict the possibility and shape of a second COVID-19 wave, we are focused on companies that can withstand at least 12 months of very difficult conditions in terms of balance sheet and cash flows.

In terms of changes to our portfolio, we have reduced our exposure to banks across a number of countries. We like this sector structurally, but banks in many countries face near-term headwinds as they bear the brunt of the economic slowdown.

We have added to our positions in the internet and e-commerce sectors, especially outside Asia. Consumer and IT remain our key exposures both on absolute terms as well as relative to the index. We tend to be fully invested but continue to look for opportunities to rotate into potential long-term winners at appropriate price points.

Current valuations could make for nice entry points from a long-term perspective.

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Is ESG rebalancing?

Growing investor focus on social and governance considerations



Michael Baldinger
Head of Sustainable
and Impact Investing

Our Sustainability experts consider how the social aspect of Environmental, Social and Governance (ESG) investing has been highlighted by the COVID-19 pandemic and explain how this could contribute to a rebalancing of the ESG investment landscape.

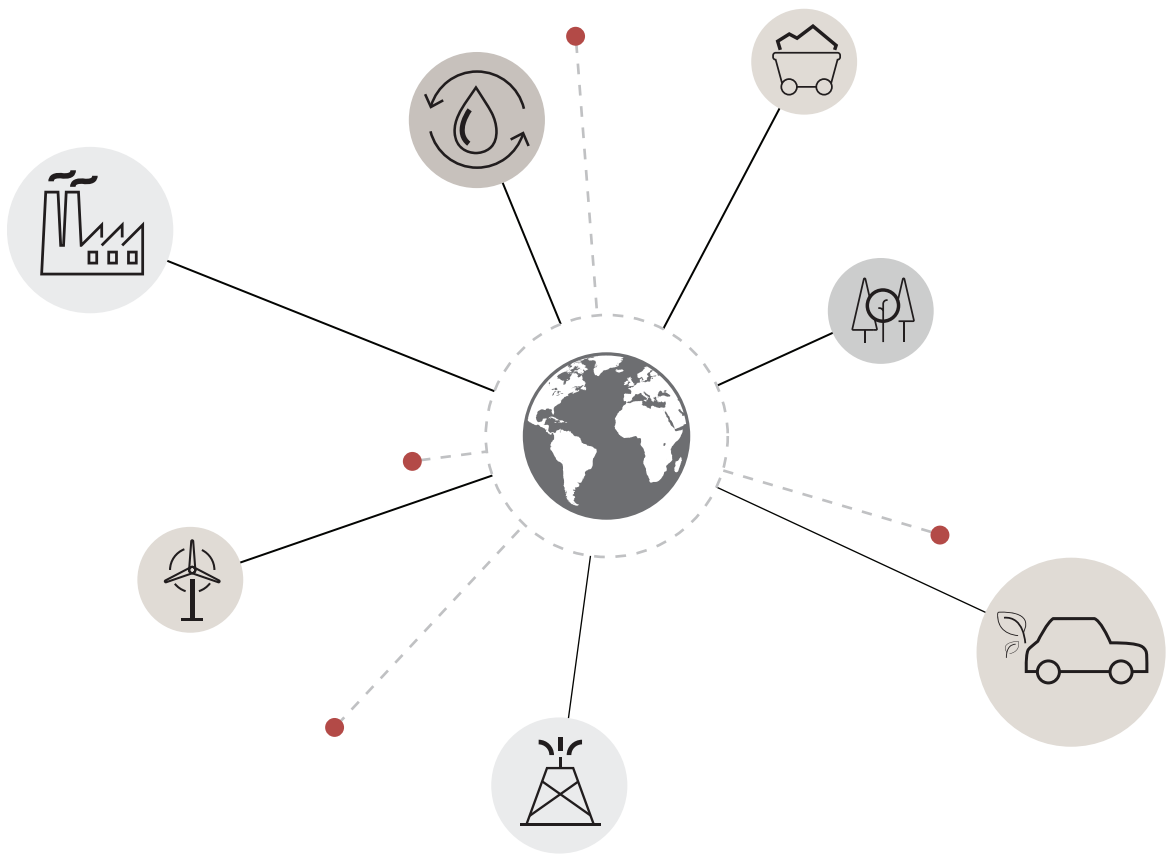
Michael Baldinger



Bruno Bertocci
Head of the Global
Sustainable Equities
team

What are the implications for the way in which capital is allocated post-COVID-19? Do you think we'll see ESG playing a greater role?

I'm confident that in the aftermath of the COVID-19 crisis the sustainable investing (SI) trend will accelerate faster still. Over the last few years, we have already witnessed a remarkable transformation in the way the world's largest asset owners are allocating capital and their focus on sustainability issues. I believe the pandemic will intensify this trend as markets acknowledge ESG factors as critical elements of investment research which they can't afford to ignore. Going forward, investors will likely have even less tolerance for bad corporate citizens – funding those businesses will become expensive and capital could prove scarce.



We've already got ample evidence showing better managed companies tend to score well across ESG criteria, and that they outperform the market over the longer term.⁴ We've seen ESG indices, such as the MSCI SRI global and ACWI indices, outperform their traditional counterparts by 10% over the past three and five years. Based on

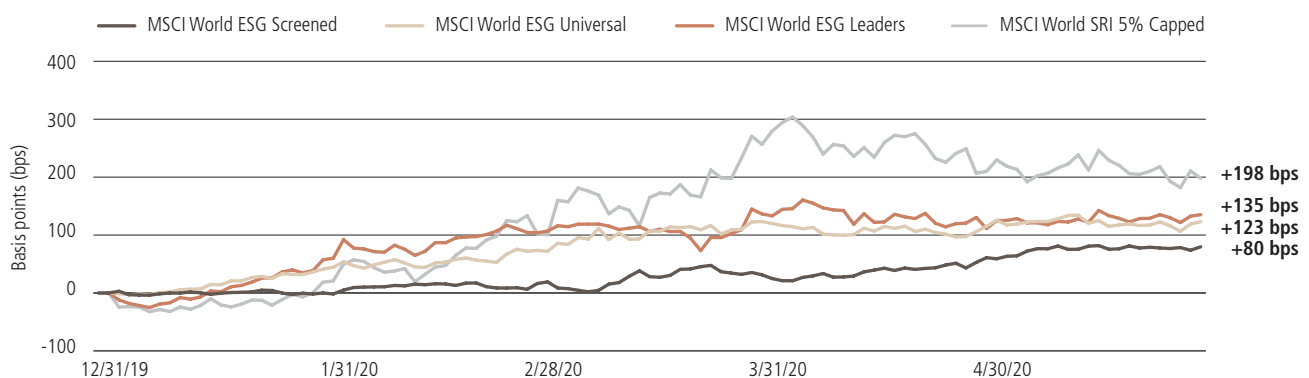
initial indicators over the past few months⁵, the companies held by sustainable investors have seen a surge in demand.

Will there be a greater focus on the social and governance factors of ESG in the aftermath of the pandemic?

Evidence suggests that environmental

threats sit at the heart of this pandemic. Biodiversity loss and the degradation of natural habitats are contributing to the rise of zoonotic diseases, such as COVID-19, which jump the animal/human barrier. These same factors are also key contributors to climate change, a far-reaching existential threat which still demands urgent action.

Exhibit 12: Excess returns vs. MSCI World TR Net in USD



Source: MSCI Inc., UBS Asset Management, data as of 8 June 2020.

⁴ Gunnar Friede, Timo Busch & Alexander Bassen (2015) ESG and financial performance: aggregated evidence from more than 2000 empirical studies, Journal of Sustainable Finance & Investment.

⁵ MSCI Five Lessons for Investors from the COVID-19 Crisis Dimitris Melas, Roman Kouzmenko, Zoltan Nagy, Navneet Kumar May 2020.

The current situation should bring about significant change and will likely demand alterations in the way we approach the integration of ESG data into our sustainability strategies.

But the pandemic has shone a light on the equally crucial roles of the society and governance. The importance of human capital in some of our most critical corporate sectors, like health, food supply and retail, has become crystal clear, as has good corporate conduct. How effective are a company's emergency and business continuity plans when problems strike? How rigorous are their processes, and how motivated are their employees to support the company through difficult times? Can the company protect existing markets and pivot to new priorities and opportunities?

For decades, sustainable investors have had these issues on their radar: Now they're on the radar for everyone and I believe they will grow even further in importance after the crisis.

The current situation should bring about significant change and will likely demand alterations in the way we approach the integration of ESG data into our sustainability strategies. The recent focus on environmental factors might, in the short term at least, need to give way to a greater emphasis on social factors, but long term, we may well see a more equal weighting between the E, S and G.

Bruno Bertocci

Has the pandemic changed the way you're looking at any sectors?

Any business model, no matter what sector, that puts people in close contact will have to change, including restaurants, airlines, cruise ships, theme parks, movie theatres and many more. That said, humans are adaptable and clever so there will be solutions to these problems.

Perhaps the biggest change has been the incredibly effective shift to working from home and we have seen this positive impact inside our own company. With strong IT and support it is possible to be just as productive and connected from home as we were in the office. We also feel safe by not having to commute, and we can manage our own schedules more flexibly. Some companies have already said that their employees are likely to work from home at least until to year-end, or longer. We believe this could easily be a permanent trend, freeing up many millions of square feet of office space. That in itself will have long-lasting implications for the real estate sector and in particular office occupancy.

We're hearing a lot about the purpose of the company – do you think this will gain greater prominence going forward?

I believe so, and of course a company has to make money to stay in business. But a company without strategic direction or one that does not care for its employees or the society and the environment around it won't succeed either. Employees are reluctant to come to work if they don't feel safe. They may not change jobs now but they will in the future, if they can find a more inspiring opportunity.

Without a healthy, vibrant society and a healthy environment, economic growth will be low and opportunities limited. The COVID-19 crisis has also helped shine a light on the social purpose of asset management not only to safeguard and grow our clients' assets but to vigorously represent them to make the companies in which we invest more responsible, better managed and more successful. That is the power of engagement that we are seeing today and it ties in very well with the long-term purpose of companies; to contribute to the world in a meaningful way.

Any business model, no matter what sector, that puts people in close contact will have to change.

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Drawing on the breadth and depth of our capabilities and our global reach, we turn challenges into opportunities. Together with you, we find the solution that you need. At UBS Asset Management we take a connected approach.



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Who we are

We are one of the largest managers in Alternatives: the second largest fund of hedge funds manager⁸ and fifth largest manager globally of direct real estate.⁹ We are a leading fund house in Europe, the largest mutual fund manager in Switzerland,¹⁰ the best-selling European active fund house¹¹ and the top foreign firm in China.¹² UBS's passive offering, encompassing index and systematic strategies, provides smart beta, alternative indices, and other custom solutions to meet our clients' needs. We are the second largest European-based indexed player¹³ and the fourth largest ETF provider in Europe.¹⁴

Past performance is not indicative of future results.

⁶ As of 31 March 2020.

⁷ As of 31 December 2019 (updated annually). Around 1,250 internal and external FTE from Corporate Center (representation functions within the Corporate Center spending 80% or more of their time on UB AM – serving as a conservative proxy for Corporate Center).

⁸ HFM InvestHedge Billion Dollar Club, March 2020.

⁹ INREV / ANREV Fund Manager Survey 2019 (dated as of 31 December 2018).

¹⁰ Morningstar/Swiss Fund Data FundFlows, March 2020.

¹¹ Ignites Europe, January 2019.

¹² Z-Ben Advisors: April 2020.

¹³ UBS Asset Management analysis of AUM from company disclosures, March 2020.

¹⁴ ETFGI European ETF and ETP industry insights, March 2020.

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