

Global Perspectives

Multi Asset | May 31, 2018

Overview

Equities: Global equities edged higher in local currency terms in May. US and UK equities outperformed global equities as a whole, while emerging market equities' poor recent run continued.

Fixed income: Benchmark nominal 10-year government bond yields fell across all major markets amidst dovish rhetoric from major central banks and a general softening of global economic data. The one obvious exception was Italy, where yields rose sharply to reflect investors' concerns about on-going political risk and the fiscal discipline of the new anti-establishment coalition government.

Currency: Among major currencies, the US dollar posted a second month of strong gains as investors focused on the relative strength of the US economy. Elsewhere, the British pound continued to slide in the face of weak economic data and little progress on the UK's Brexit talks.

The month in review:

- Global equity markets advanced in May, although overall returns were muted amidst indifferent global economic data and rising geopolitical risks. The FTSE All World rose 0.9% in local currency terms. UK and US equities outperformed global equities as a whole, while emerging markets and Japanese equities declined. In Italy, initial attempts by the Northern League and 5 Star Movement to form an unlikely anti-establishment government coalition were rebuffed by the Italian president's veto of the parties' choice of an anti-euro finance minister. In the face of plunging Italian share prices and soaring Italian bond yields, a swift compromise was reached. Nonetheless, investors remain wary of the new government's fiscal discipline.
- Investors were disquieted after the US announced in late May that it would levy new tariffs on steel and aluminium from the EU, Mexico and Canada. There were also conflicting signals from the Trump administration regarding the likelihood of further action against China on trade issues. Tariffs of 50 bn USD on Chinese imports were announced less than two weeks after Treasury Secretary Mnuchin had declared the trade dispute "on hold." The decision by the US to withdraw from an international agreement with Iran, a major oil producer, and re-impose sanctions added to volatility in markets. Brent Crude prices reached 80 USD a barrel for the first time since 2014.
- In bond markets the less hawkish outlook for interest rate rises in the US, as well as political and trade uncertainties, led Treasuries to rally sharply. Gains were most evident amongst

longer-dated bonds. Elsewhere, while spreads on peripheral Eurozone bonds, such as Italy, Spain and Portugal fell back as May ended, they still were up sharply over the month. While US Treasury yields fell, the US dollar continued its recent rise with one of the strongest months since the presidential election in November 2016. Equities, bonds and currencies of emerging markets with material external funding requirements came under particular pressure.

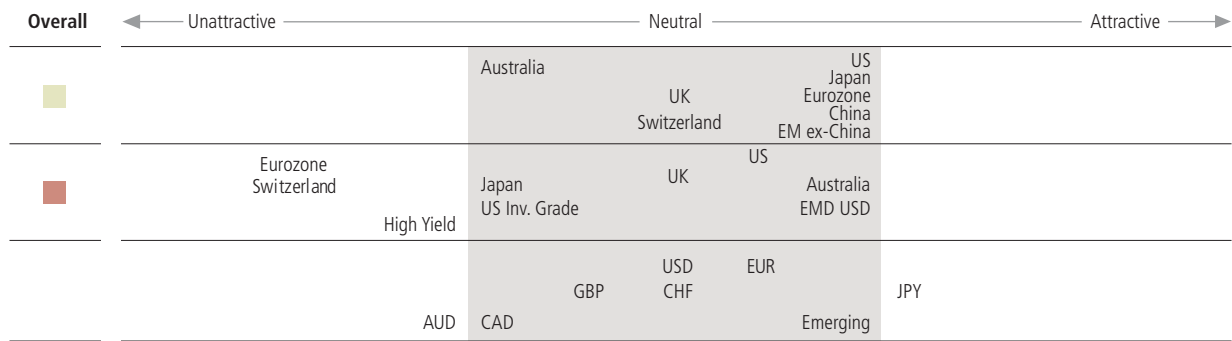
Outlook:

- The rate of acceleration in global growth has moderated in recent months from very strong levels. Demand growth rates globally are also not as synchronized as they were. Importantly, however, while the pace of acceleration may be slowing in the short-term, the residual growth rate remains strong and above trend. Overall, we retain a positive view of global equity markets given above-trend underlying global demand growth, the prospect of continued strong earnings growth and increasing M&A activity. We do not see global equities rerating significantly in the face of such robust corporate profitability.
- Our view on global duration remains negative. The rising oil price is likely to continue to support higher nominal bond yields. Meanwhile, we see core inflation continuing to tick upwards as higher input costs spill over into consumer pricing, output gaps close and wage growth accelerates across developed countries. Structural deflationary forces including technology and demographics are still likely to limit the repricing of inflation risk however.

Current views¹

Asset allocation and currency attractiveness based on fundamental valuation and market behavior analysis

Overall signal = Positive Negative



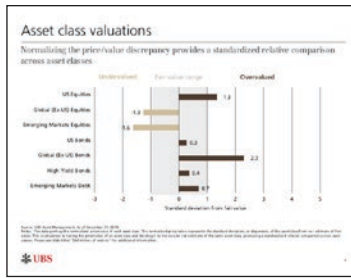
Asset Class	Overall signal	UBS Asset Management's viewpoint
US Equities		<ul style="list-style-type: none"> Global growth momentum has moderated since the beginning of the year but the residual growth impulse remains strong and above trend. Corporate capital expenditure in the US is increasing. This gives grounds for optimism in future US productivity growth and in the sustainability of the cycle. Stronger-than-expected corporate earnings growth and increasing capital returns to shareholders are likely to remain key supports in the coming months. In our view, US equities remain attractively valued relative to bonds despite the recent rise in yields. We do not believe that rising bond yields are a de facto negative for equities. However, a moderate increase in the volatility regime for all major US asset classes is likely.
Global (Ex-US) Equities		<ul style="list-style-type: none"> In Europe, we think that the sharp increase in volatility caused by recent developments in peripheral Europe will increase the risk premium on European equities and constrain upside potential until more clarity emerges around Italian politics. Despite these short-term headwinds, our longer-term base case remains positive, supported by demand growth that is still above-trend, and the potential support to earnings from re-gearing. In Japan core inflation remains muted despite the closing of the output gap. This supports a very gradual adjustment of current loose monetary policy. After the recent stock market underperformance triggered by an appreciation in the Japanese yen we view Japanese equities as moderately attractive.
Emerging Markets (EM) Equities including China		<ul style="list-style-type: none"> Emerging market equities have struggled in recent months in the face of a strengthening US dollar and rising US interest rates. We do not dispute that these factors present headwinds to EM countries with material external funding requirements, nor that within EM's broad universe there remain less favorable political and economic forces. But in aggregate EM demand growth is strong, inflation low, and policy in aggregate still accommodative. We remain broadly positive on China. A gradual economic slowdown is already priced in and growth remains impressive compared to other markets. However, we are watching Chinese industrial production for any early indications on a potential slowdown in demand for EM commodity export. In emerging markets our strongest preference is for Asia and our lowest preference is for Latin America. Concerns over debt sustainability in Brazil and upcoming elections in Brazil and Mexico will likely keep volatility high. Conversely, EM Asia continues to enjoy strong revenue growth and remains attractively valued compared to its own history.
US Bonds		<ul style="list-style-type: none"> US Treasury yields remain low by historical standards, but look attractive relative to most other developed government bond markets on an unhedged basis. In the absence of a material pick-up in inflation, yields are likely to remain range bound. Our overall assessment is neutral.
Global (Ex-US) Bonds		<ul style="list-style-type: none"> In aggregate, we see global sovereign bonds outside of the US as unattractive. Swiss and German bonds continue to look very overvalued and in our view they have an increasingly asymmetric risk profile. The Swiss economy is relatively strong and we see Swiss bonds as vulnerable to attempts to normalize monetary policy by a Swiss National Bank increasingly concerned by the strength of the housing market. Elsewhere we are more positive on Australian and Canadian duration on a relative basis. In our view, both economies are vulnerable to a housing market correction after very strong recent performance.
Investment Grade (IG) Corporate Debt		<ul style="list-style-type: none"> Geopolitical turmoil has recently spilled over into the credit markets and IG spreads have widened slightly in recent months. Although we do not believe that a sharp demand slowdown is imminent, we retain a neutral view on credit.
High Yield Bonds		<ul style="list-style-type: none"> Current default rates in High Yield are very low by historical standards. Given the relatively positive economic backdrop, we do not expect any material pick-up in US corporate debt defaults in the near term. However, while spreads have widened in recent weeks, we do not yet view the risk/reward as attractive.
Emerging Markets Debt US dollar Local currency		<ul style="list-style-type: none"> Spreads on EM debt relative to US treasuries have widened substantially in the face of higher geopolitical risks, a strengthening US dollar and higher US dollar funding rates – sparking particular fears for EM countries with large external funding requirements. Nonetheless, we see continued strong demand for EM debt's attractive real yield on a selective basis.
Currency		<ul style="list-style-type: none"> With the Fed now alone among major central banks in pursuing a more aggressive tightening regime and the US benefiting from fiscal stimulus while growth elsewhere eases, we see short-term support for the US dollar even if our medium-term view remains more negative. Over the medium- to long-term, we expect capital to flow from the US into earlier-cycle economies. Elsewhere, we continue to see strong valuation support for the Japanese yen.

¹ Source: UBS Asset Management. As of May 31, 2018.

² Attractiveness measured relative to USD.

Source: UBS Asset Management Investment Solutions Asset Allocation team as of May 31, 2018. Views are provided on the basis of a 12-18 month investment horizon, are not necessarily reflective of actual portfolio positioning and are subject to change without notice.

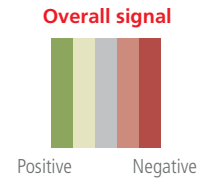
Valuations plus one or more market behavior indicators provide an overall signal



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Market themes

Market opportunities that we believe will drive markets in the longer term but have an immediate impact. This helps put valuation into context. For example: "European debt crisis," "aging population" or "deleveraging."

Momentum and flow

Attempts to capture money flows and market appetite for risky assets from the perspective of professional asset allocators, such as mutual fund managers.

Market stress

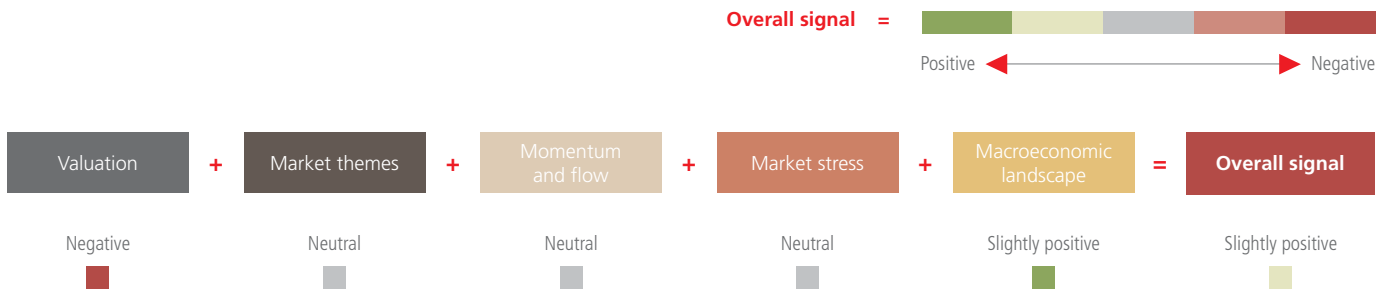
We created a proprietary stress index to help gauge price dislocations and investor risk appetite. It comprises several spread measures across credit markets, currencies and cash markets, as well as measures of market sentiment, such as the Chicago Board Options Exchange Market Volatility Index (VIX).

Macroeconomic landscape

Understanding the current position (recovery, expansion, slowdown, recession) in the economic cycle of a country or region. We also consider the baseline and alternative economic scenarios of countries and regions and how asset classes may react differently in these scenarios.

May 31, 2018

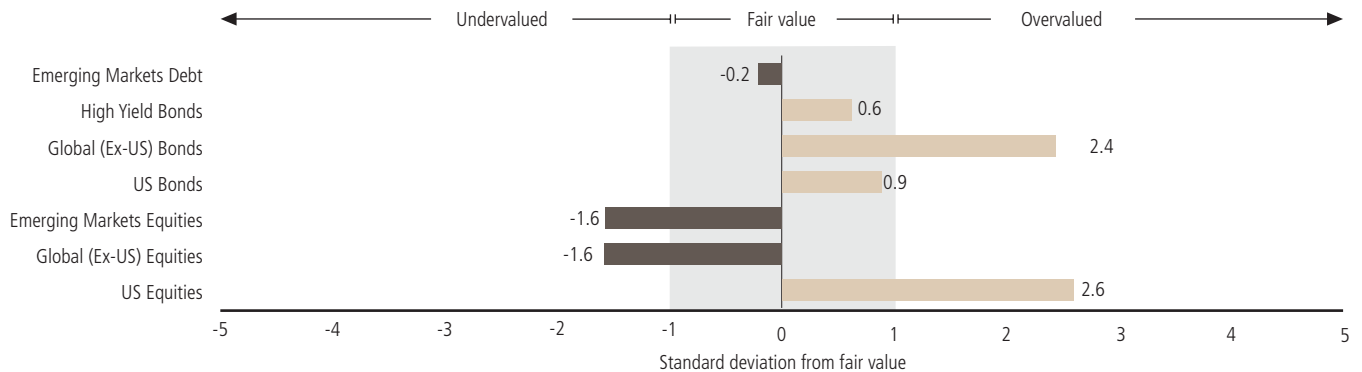
Valuation and market behavior indicators at work



Note: The contribution each component makes to the overall signal will vary from month to month. This example is for illustrative purposes only.
Source: UBS Asset Management Investment Solutions Asset Allocation team as of May 31, 2018. Views are provided on the basis of a 12-18 month investment horizon, are not necessarily reflective of actual portfolio positioning and are subject to change without notice.

Normalized asset class valuations³

Normalizing the price/value discrepancy provides a standardized relative comparison across asset classes



³ Based on UBS Asset Management's views. As of May 31, 2018.

Definitions of metrics:

- 1. Asset Class/Benchmark:** All investment expectations displayed here are modeled from the discounted cash flows as replicated by a relevant publicly available index. This bears mentioning because these expectations are developed assuming no benefit from active management (i.e. security selection) within the asset classes themselves.
- 2. Price/Value:** An intrinsic value based on the cash flows that an asset class provides – discounted at an appropriate rate of return (the required rate of return) – is identified for each of the asset classes listed. The cash flows would be those that would be expected to pass through to the asset holder; in the case of equities, the relevant cash flows are earnings and non-reinvested earnings (including, though not exclusively, dividends). That intrinsic value is then compared to the market price for the proxy index, and the degree of over- or undervaluation is thereby calculated in percentage terms.
- 3. Normalized Price/Value:** The normalized price/value represents the standard deviation, or dispersion, of the asset class from our estimate of fair value. Normalizing the price/value discrepancy provides a standardized relative comparison across asset classes. The normalized price/value is calculated by taking the price/value of an asset class and dividing it by the secular risk estimate of the same asset class.

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Asset allocation content schedule update

We are pleased to announce a number of improvements to our asset allocation content schedule. From July we will be combining our two main monthly asset allocation publications. The key elements of *Global Perspectives* will be added to *Macro Monthly* to give you a single monthly touch point for our latest views on major asset classes and our thoughts on the most important issues confronting multi asset investors.

The new format *Macro Monthly* will be published during the first week of the first two months of the quarterly cycle, with the third month bringing a more in-depth look at the major macroeconomic themes driving asset class performance.

All of these publications as well as insights on a broad range of important investment themes can also be found on our website ubs.com/am.