January 2017

UBS-SFA Investment Outlook

Inflection point!

Last year, the world witnessed a momentous political outcome that completely upended the existing consensus. And for the second time in six months, the riskiest financial assets such as equities and credit have not only survived the aftermath, they have actually thrived – the exact opposite of what the consensus would have dictated.

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In addition to the political earthquakes triggered by the US presidential election and Brexit, there are two slower-moving, albeit important, changes under way. First, the political consensus about fiscal expansion: this had started to shift globally, even before the Trump win turbo-charged expectations in the US. Japan, China, the UK and parts of Europe have either moved away from fiscal consolidation or are pushing for fiscal expansion outright. Second, medium-term inflation expectations: these seem to have finally bottomed in mid-2016 after being years in decline, at least in the major economies, with the exception of Japan. Year-on-year growth may have been mediocre given the prevailing economic expansion, but the business cycle has been long-lived, with output gaps closing steadily and the major economies reporting full employment for quite some time now. This is finally being reflected in inflation data. The macro backdrop is consequently one where maturing economies with little slack and gradually increasing inflationary pressures are likely to receive an economic boost.

At the same time, we would like to red-flag that there is an unusually high dispersion of potential economic outcomes around our base case in this cycle. This is partly due to the uncertainty regarding President Trump's policies and their impact on the real economy and global financial system. In this issue of our "Investment Outlook", we will prudently analyze the most urgent open questions, such as the impact of the planned tariffs on global trade and how they will spill over into global growth. In addition, will President Trump be able to push through his intended fiscal stimulus without having to offset it by any spending cuts, a stance that goes against decades of Republican paradigm on public debt? The following analysis relies on seasoned assumptions based on our opinion. Only time will tell whether we have based our analysis on the correct prerequisites. But policy uncertainty in the US is not the only unknown in the equation. Three countries in Europe display elevated political risks in view of their upcoming national elections. The leading political forces in two of them – the Netherlands and France – are adopting a strong anti-European Union (EU) stance. If market-implied probability of a country's exit from the currency union rises sharply, the economic and financial consequences could be dramatic. Investors who dismiss European politics because of the relatively calm reaction to the UK's decision to exit the EU do so at their peril.

Growth acceleration likely despite policy uncertainty in the US and political risks in the EU

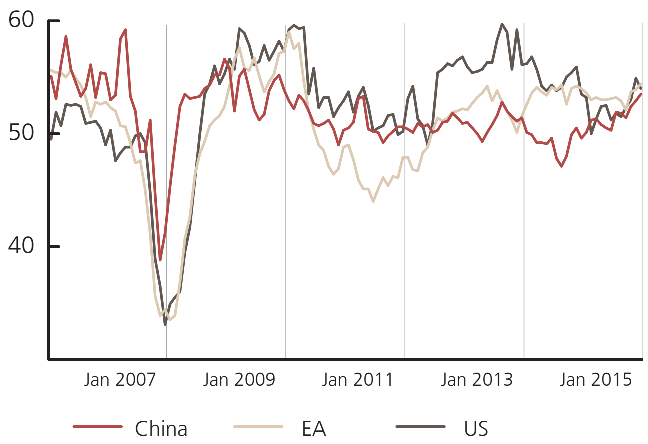
Next year's economic performance depends heavily on how Trump goes about implementing his (mainly) two-pillar economic agenda: trade-related tariffs and the possible "re-negotiation" of existing trade agreements, and an economic stimulus provided by tax cuts (and tax reforms) and fiscal spending. President Trump has already announced that his administration will suspend the Trans-Pacific Partnership (TPP) – a trade agreement between the US and 12 countries from Asia and the Americas whose aim is to reduce trade barriers between the countries in question. The US Trade Association estimates that the enactment of TPP would have resulted in a long-term GDP gain of around 0.5% for the US. To date, it is still unclear whether President Trump will immediately impose tariffs, as promised during his campaign. However, imposing tariffs on imported goods and services from targeted countries results in lower consumer spending and rising producer and consumer prices. In addition, projected weaker trade volumes and consumption, and uncertainty about the economy is making a rebound in business investment increasingly unlikely.
To sum up, the near-term economic effect would likely be a drag on growth. This may be offset by economic stimulus. Assuming tax cuts that bring about a 2% reduction in GDP revenues, as stated by Trump during his campaign, primarily through income and corporate tax reductions, private spending should rise by around USD 225 bn and help to stimulate economic growth by around 0.75% to 1%. This is based on the assumption of a propensity to spend of around 80% and an income multiplier of 1.5%. Whether the impact of expansionary fiscal policy under Trump is offset by restrictive trade policies depends on the magnitude of the tariffs imposed. By assuming tariffs of between 5% to 15%, respectively, on Mexican and Chinese goods, and retaliatory tariffs of a similar magnitude on US exports from targeted countries, this does not appear implausible, given that tariffs of such a magnitude will not require any legislative maneuvering as this falls under the president's executive privilege. The introduction of these tariffs would slow growth by approximately ¼ to ½ of a percentage point in 2017 as trade volume declines and higher consumer prices reduce real consumption and investment. Under these assumptions, US economic growth may accelerate to around 3% in the second half of 2017 as policy lags delay the implementation of such spending by approximately six to nine months. All in all, the US economy is expected to shift into higher gear next year, driven mainly by additional private consumption fueled by tax cuts – at the expense of a higher budget deficit. All things being equal, the impact of these tax cuts on GDP growth will only be temporary and will fade in the course of 2018.

Given the relative resilience of business conditions in the euro area (EA) as a whole, as shown by the PMI and other forward-looking surveys, the EA ably tackled the weakness in the global manufacturing sector in 2016. We believe that the recovery in the euro area will be sustained, albeit at a slower pace, as the uncertain outcomes of the upcoming general elections in the Netherlands, France and Germany are likely to delay any sustainable rebound in business investment. Still-weak corporate profits and high corporate debt are not conducive to a further rebound in corporate investment spending. A recovery of gross capital formation should be possible, as most political uncertainty – apart from any further EU disintegration due to the UK's decision to exit the EU – may be dispelled in the second half of 2017.

The UK economy has proven resilient to the UK's decision to leave the EU and has benefited from the sharp decline in the GBP. However, economic activity in the UK will slow during 2017 as corporate spending may be increasingly postponed given the unknown outcome of the trade negotiations between the UK and the EU.

Purchasing manager indices (PMI) for developed markets still at expansionary levels

Index points



Source: Bloomberg, UBS-SFA, as of December 2016

Growth momentum continues to show signs of cyclical improvement in Emerging Asia. Chinas relatively long period of growth stability is positively impacting regional economies amid low price pressures and accommodative monetary policy conditions. This positive momentum is clearly visible in export-led North Asia, while South Asia continues to benefit from expansionary fiscal and monetary policies. However, recent political events in the US, namely the election of Donald Trump as President, have given rise to fresh uncertainty, especially with regard to trade, investment and long-term growth potential. We believe that some trade restrictions on large Asian economies such as China are inevitable. Overall, while uncertainty over the future path of growth and global demand will likely persist, we expect EM Asian policymakers to provide an accommodative backdrop to growth, and policy conditions to be eased further if trade barriers are raised or remittance-related restrictions implemented. The stabilization of growth and inflation continues across Latin America. However, trends differ between the north and south. Brazil and Argentina are emerging from recession more slowly than the markets expected, and we still anticipate a very timid expansion in 2017. In Mexico, in contrast, we expect growth in 2017 to be more of a robust nature. Despite the challenging environment, recent tailwinds from manufacturing could help boost growth in the quarters ahead.

The end of declining inflation – the end of loose monetary policy?

This time last year there were still fears of disinflation in the markets – concern that low commodity prices, global output gaps and depressed inflation expectations would keep inflation low or on the decline. By contrast, we saw the seeds of rising inflation. In reality, inflation has increased by 0.3 percentage points this year to 1.7%. With policy measures planned for introduction by the new US government such as limiting migration, tariffs and fiscal stimulus, in tandem with already full employment, we expect another further gain in inflation in 2017 to around 2%, and think it is possible that core inflation could jump over the 2% target next year. Hence, as widely expected, the Federal Open Market Committee raised the target range for the federal funds rate by 25bp to 50-75 basis points at its December meeting. In justifying this move, Fed Chair Janet Yellen highlighted the "considerable" cumulative progress toward the dual mandate, including the more than 2 million jobs added since the Fed first raised rates last year and the firming of the inflation backdrop. The decision to raise rates came as no surprise to either us or the financial markets. However, in our view, the Fed took less of a "wait and see" position on the effect of fiscal policy stimulus on monetary policy than we had anticipated heading into the meeting. Hence, the outcome of the meeting entailed more hawkish drift than expected, underpinning our expectation of at least two further rate hikes in 2017.

With respect to the other central banks in the developed markets, we feel that after years of repeated inflation undershoots, they will be hesitant to react quickly to any pick-up in inflation by tightening policy, particularly if much of the increase in inflation is due to (temporary) base effects and commodity price increases. Indeed, a number of central bank officials have recently noted that tolerance of (temporary) inflation overshoots may sometimes be appropriate, be it to re-anchor inflation expectations or to encourage higher labor force participation. Consequently, the ECB has announced its extension of its bond purchase program until the end of 2017, but is downsizing the purchased amount from 80bn to 60bn per month. The Bank of Japan (BoJ) re-iterated its "inflation overshooting commitment", under which it commits to expanding the monetary base until the inflation rate achieves its 2% target on a sustainable basis. In our view, these two central banks will maintain their current monetary policy stance instead of introducing any further incremental easing going forward. We expect the next Bank of England (BoE) policy rate cut to be after February 2017. After years of adopting an increasingly creative monetary policy stance and amid major uncertainties, it is conceivable that actual monetary policy in the advanced economies may remain relatively unchanged for a while.

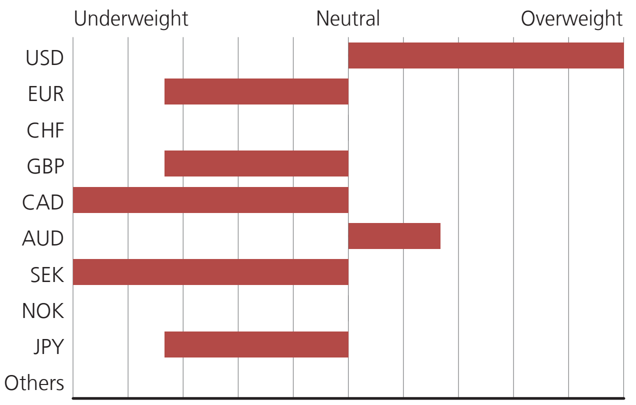
Investment conclusions

Global foreign exchange

USD: Leans towards strength

The changed political landscape in the US and the turn in Fed policy has already led to a strengthening of the USD. Higher consumer prices on the back of tariffs and rising domestic demand necessitate higher central bank rates and bond yields – in nominal and real terms. Corporate tax cuts and deregulation in some corporate sectors such as the potential abandonment of the Dodd-Frank Act for the banking sector may stimulate corporate earnings, and thereby also boost foreign demand for USD-denominated assets such as corporate bonds and equities. With most central banks in the advanced economies maintaining their current monetary policy stance, a Fed that is tightening financial conditions and the increasing growth divergence between the US and the rest of the advanced economies, a stronger USD is not an implausible outcome in the next few months. Can we expect a similar huge appreciation of around 75% in the USD as seen in the early 1980s, when government spending ballooned under President Ronald Reagan's regime and increased to more than 5% of GDP? We do not think so, as it is different this time round. At the beginning of the 1980s, the US experienced the highest consumer price inflation since World War II. Inflation peaked at 15%, and the Fed hiked rates to 17.5% in order to conquer inflation expectations. Due to the fiscal impetus of the Reagan administration, GDP growth climbed to over 7% in the mid-1980s. High interest rates, combined with a strong and accelerating economic expansion that caused sustained inflows into the USD, explained why the USD shot up during this period. Today, US inflation is still well below the policy target of 2%, long-term rates have just moved above 2% and long-term inflation expectations have been hovering unchanged around 2.5% for years. Although a fiscal stimulus is expected, it is highly unlikely that the crowding-out effect will push up rates to such an extent as to send the USD soaring, as was observed in the early 1980s, especially in light of the savings glut and excess liquidity. Hence the strong appreciation of the USD is pretty unlikely. However, assuming that President Trump gets approval for his proposal to invest heavily in infrastructure at the expense of a higher budget deficit and rising government debt, the USD may lose ground, especially as stronger economic activity coincides with a widening current account deficit. In such a case, investors would start to price in a higher risk premium for the USD as long as the funding of public sector spending remains unclear and is transferred to future generations. Long-term investors will find increasingly interesting entry levels into foreign currencies to diversify their USD wealth.

Currency allocation preferences (six months)



Source: UBS-SFA

Global bonds overview

Times they are a-changin'

With Trump's victory as President, the economic landscape for fixed-income investors has materially changed. Even with the details of his political agenda still uncertain, the new US government administration's policy package will most likely result in stronger domestic demand growth, and hence rising economic growth, and may lift economic activity above the rate of expansion of potential output, estimated at 1.5% by the US Congressional Budget Office. This projection is in line with the weak productivity trend. Stronger growth also means a further strengthening of labor demand and, given the low US workforce participation rate, rising wage inflation for an economy which already operates close to full employment. In an earlier edition of our "Investment Outlook", we showed that higher wages propel inflation, given low productivity growth. Most US consumer price inflation estimates were around the 2% mark at the end of 2016 and may rise to around 3% at the end of 2017, when additional fiscal spending kicks in. Going forward, bond investors are facing higher or even accelerating economic expansion in the US, along with rising inflation, implying that bond yields will be higher in the months ahead. One rule of thumb says that the central bank rate should be either as high as the sum of inflation and real GDP growth or equal to the nominal GDP growth rate. If inflation approaches 3% and real GDP growth is above 2.5% in 2017, this rule would require a fed funds rate of around 5% at the end of next year, which is far above all forecasts. At this stage, we do not yet provide an answer to the question of whether the Fed is already behind the curve. However, the rule says as an argumentum e contrario that the US yield curve may steepen further even after the setback of a 70 basis point increase in the 10-year US government bond yield in the aftermath of the US presidential election. However, a further rise in bond yields will very much depend on how additional public spending is to be funded. In the case of capital market funding, bond yields will be under pressure and may increase, while budget neutral funding may open the door for slightly declining yields again. This leads us to our first investment conclusion: keep duration neutral in the US bond market. Whether higher US bond yields translate into higher bond yields in other regions such as the EA depends on whether the

ECB significantly modifies the amount of its bond purchases, whether the BoJ alters the degree of quantitative easing in Japan, and whether higher yields in the US result in capital outflows from the emerging markets. However, given the high elasticity of capital mobility to yields, a translation of higher US yields into other regions cannot be ruled out. This leads us to our second and third conclusions: stay close to the respective market duration and remain underweight in government bonds.

Although government bond yields are on the rise, higher yields and funding rates will not undermine many firms' ability to raise the funds necessary to accommodate rising economic activity. With a prolonged and strong rebound in the US, including an improved earnings outlook for those companies with a domestic-oriented business model, defaults are likely to stay. US investment-grade corporate debt still offers an attractive risk-adjusted yield pick-up of around 130 basis points. In the EA, corporate bonds are still benefiting from the ECB purchase program. Although current spreads have fallen below their long-term averages, we view investment-grade corporate bonds as attractive and are maintaining our overweight allocation. The same holds true for non-investment grade corporate bonds in the EA, although spread compression appears limited, as the current spread already reflects sound balance sheets, low funding costs and improved credit availability in the EA. However, a spread of more than 400 basis points is attractive in such a low interest-rate environment.

Global equity overview

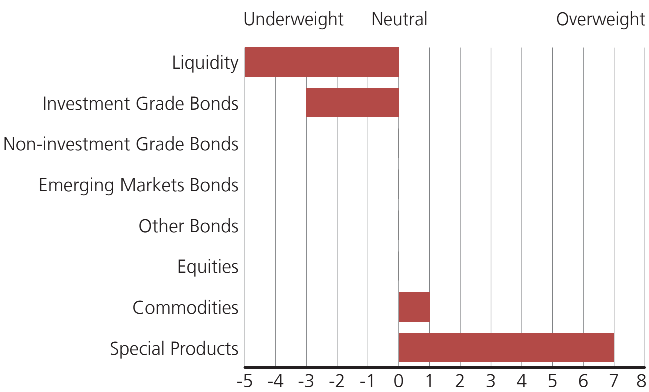
Keep current equity exposure – neutral

Equities still look cheap on a relative basis due to the precipitous 10-year drop in bond yields. Our measure of the gap between expected returns on global equities and real government bond yields – a proxy for the equity risk premium (ERP) – still sits well above its long-term average. In short, investors are still compensated for taking on equity risk in an environment where we expect very low returns across asset classes in the next few years. What could undermine this theory? A spike in bond yields – perhaps due to a rise in inflation and a steepening of the expected path of Fed rate hikes – would erode the ERP and diminish the relative attractiveness of equities. History has taught us that high valuations point to more muted returns across asset classes in the long run. Furthermore, slowing nominal GDP trend growth and aging populations argue in favor of lower bond yields than in the past – and sustained demand for high-quality bonds. This structural shift changes the prism through which today's valuations are assessed and makes risky assets such as equities, credit and selected alternatives look attractive on a relative basis.

The recent jump in rates has been predominantly driven by a rise in inflation expectations, although real US 10-year yields have ticked approximately 20 basis points higher. This stands in stark contrast to the taper tantrum, when real yields were reset from extreme lows. In our view, real rates remain the key driver of equity valuations, and real bond yields will remain relatively low. However, the boost to US equity multiples from falling real rates is complete, in our view, although there is a possibility that valuations will rise if real yields stay this low and growth delivers. Under the policy measures presented so far, earnings per share for the S&P 500 may grow by up to 7% in 2017. With rising economic activity in the US, we anticipate a recovery of top-line growth, which should set the stage for a rebound in EPS growth. After two years of stagnation, we also forecast that sales growth will recover in 2017, underpinned by a rebound in US nominal GDP as inflation picks up. The expansion in sales should stimulate a resurgence in EPS growth, although cost inflation dampens our expectations as wage inflation could be a headwind. We believe the reduction in the corporate tax rate proposed by President Trump could boost EPS growth in 2017. Hence we maintain our preference for US equities, especially as we see the USD leaning towards strength in the coming months.

Earnings growth in continental Europe in 2017 is expected to rise moderately. As economic activity should accelerate, we predict earnings growth to be higher than the 1% in 2016. We do not foresee a significant improvement in profit margins in Europe, which are still languishing near their prior-cycle lows. Low margins are a result of the anemic nature of corporate pricing growth. However, an improvement in inflation, which would lead to better pricing, could improve profit margins, but this is pretty unlikely in our view as it would imply upside risks to our earnings forecasts for continental Europe. As discussed above, politics remains a key risk in our economic and earnings projections. In the wake of elevated political uncertainty surrounding the outcome of the elections in the Netherlands, France and Germany, and the negotiations between the UK and the EU about the UK's exit from the EU, we remain cautious and are keeping a tactical underweight allocation in EA equities as we have already a high strategic allocation to EA equities.

Asset allocation preferences (six months)



Source: UBS-SFA

Emerging market (EM) equities witnessed a strong performance in 2016. Whether this trend continues in 2017 depends heavily on the prospects for world trade, which have become cloudy after the US election. The outcome isn't necessarily one which is EM-friendly. A rise in protectionism via higher tariffs for foreign-made products would impact trade flows globally, which would hurt profits, liquidity and flows towards EM. Until we know more about the Trump administration policy stance, we are assuming that it is generally not an environment that is friendly towards risk assets in emerging markets. Equities are a risk asset, and within that, EM account for the riskier part of the distribution. Changes in global security arrangements as mentioned during the electoral campaign are also likely to increase the home bias amongst global investors. These are likely to have a broad impact on EM. The biggest risk we see is a sharp contraction in the US trade deficit on the back of increased tariffs. As the trade deficit shrinks, the availability of USD will diminish. This will drive up the value of the USD, which has historically been negative for EM. It will depress both profits and impact the volume of global trade, neither of which are good for equity markets. Whilst EM continue to offer value both vs. self and vs. DM, investors will focus on the policy risk more than on the opportunities. Indeed, earnings are recovering, but trade barriers or a stronger USD can very quickly alter this dynamic. Liquidity too is improving; but again, a risk-off move with associated outflows from both equity and EM fixed-income markets can lead us back to negative year-on-year growth rates. Whenever this occurred in the past, multiples contracted, and did not expand.

The difficulty is knowing where to hide in EM. Usually the answer would be to head to ASEAN, as Indonesia and the Philippines in particular are more domestic than international. Go long India, also a good alternative, as it is both a defensive market and its exports-to-GDP ratio is low. The risk of playing the defensive game in Asia is that you are buying well-held markets that are consequently at risk of investor outflows. At the same time, their high valuations make them vulnerable to the rising risk premium for all EM assets. The final risk is that though small, both India and Indonesia run current account deficits.

Other investments

Gold – not so magnificent

Trump's victory in the US election shifted USD and interest rate expectations higher, both of which have an inverse relationship with gold prices and point to a bearish outlook for gold. Despite this outlook for the underlying trade, we are maintaining our gold allocation for the following reasons. As outlined in detail in our analysis of potential risk scenarios, gold adds diversification to portfolios during times of market stress. In light of heightened political risk in Europe, including uncertainty about the outcome of the exit negotiations of the UK with the EU and the forthcoming elections in the Netherland, France and Germany, gold may serve as a diversifying asset. Gold may also benefit from a decline in long-term rates, and a reversal of the current USD trend on the grounds of the fiscal stimulus expectations may prove to be exaggerated. Gold could also regain strength should inflation unexpectedly increase as a result of wage pressure from rapidly rising employment.

Risk premium strategies – diversifying the sources of return

The basic idea is that those investors who take on risk exposures that other investors seek to avoid can in the long term harvest additional excess returns that have a low correlation with long-only equity and bond investments. These dynamic factors or risk premium strategies capture the alternative sources of excess returns available in the capital markets. As many of these investment strategies are independent of each other, they can be wrapped into an index, thereby offering access to a multiplicity of risk premium strategies.

Risk premium strategies – a year of bad luck!

These strategies worked well in 2015, especially those involving the equity risk premium, such as long-short strategies. Even at the beginning of 2016 and amid rising concerns about the resilience of the global economy, as expected these risk premium strategies delivered uncorrelated returns during the equity market sell-off. Against a backdrop of rising uncertainty about the future US monetary policy stance and during the run-up to UK's referendum to leave the EU, equity risk premium strategies – the main drivers of performance of risk premium strategies – started to post negative returns, resulting in their substantial underperformance relative to traditional asset classes such as equities and bonds. In other words, the non-correlation of equity risk premium strategies with equity market movements was mutated by heightened policy uncertainty during the course of 2016. This underperformance was more pronounced for those strategies with a high exposure to equity strategies. Other strategies such as credit and yield curve arbitrage did well. However, their gains or positive contribution to the annual returns on these trading rules could not offset the losses generated by equity risk premium strategies. The period is somewhat comparable to the taper tantrum in 2013, which also caused equity risk premium strategies to underperform, but was followed by very strong performances after the market was provided with clarity on the direction of US monetary policy.

With the recent guidance on the next steps in US monetary policy and the first indications of the future policy stance of the new US administration, policy uncertainty is fading, which should cause equity dispersion to widen. Multiple equity performance trends may help equity risk premium strategies to perform better than in 2016. We are therefore keeping our current allocation to risk premium strategies given its diversification benefit.

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