UBS-SFA Investment Outlook

December 2017

Heading toward a boom?

Global economic growth remains robust and synchronized, but not booming
International organizations such as the World Trade Organization (WTO) and International Monetary Fund (IMF) have recently started to revise their projections for global economic activity upward. The WTO now predicts that world trade may expand by 3.9% and the IMF anticipates growth of more than 4% in 2018 – the biggest increase since the end of the Great Recession in 2008 – as a result of synchronized economic growth in all major regions and across developed and emerging markets. So is the world economy heading toward a boom or are the financial conditions too relaxed for such a strong expansion?

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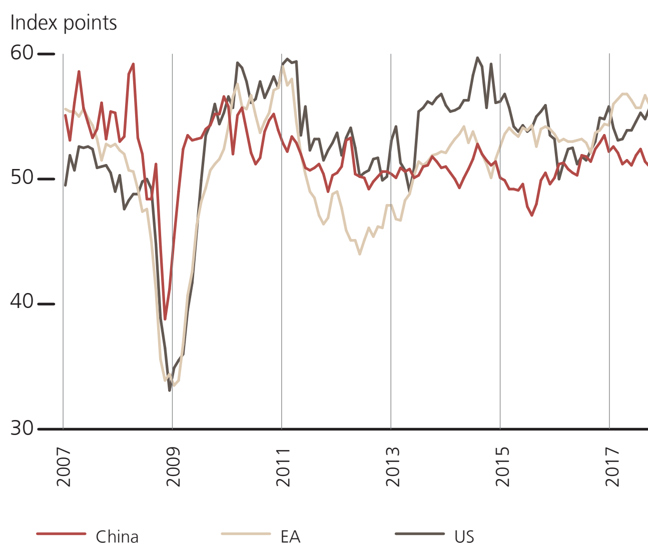
To be frank, world trade momentum is still far less pronounced than before the Great Recession, when it grew by approximately 5% on average each year. Although most economies are moving toward their potential growth capacities, global capacity utilization is below its long-term average and well below those levels seen during boom periods such as 2003 to 2007. During this time, capacity utilization was above 85%, with much higher potential growth for the global economy of around 4.5%. The current capacity utilization of the world economy hovers around 78% and potential growth is down to about 3.5%. There is still a lot of slack in the world economy with respect to structural imbalances and global economic growth is far from overshooting. While most of the uncertainties from last year have dissipated, concern over the outcome of the Brexit negotiations persists and this will be subject to close scrutiny. Other concerns have also emerged, including the conflict between the US and North Korea and the separation attempts of regions such as Catalonia in Spain and Lombardy in Italy, all of which may impact on private spending.

We acknowledge that global economic prospects have improved significantly in the course of 2017 based on a strong rebound of worldwide manufacturing. We now foresee with a high degree of probability that the global economy will retain its current strength in 2018, mainly driven by the above-mentioned expansion of world trade as a result of the globally synchronized economic upswing, continued sound financial conditions and strong private consumption fostered by growing payrolls in the US and falling unemployment in the euro area (EA).

PMI indices



Source: Bloomberg, UBS-SFA

As global demand is expected to rise strongly in 2018, the output gaps as a result of the excess capacity in the aftermath of the Great Recession should shrink significantly. As a result, we are increasingly optimistic that business equipment spending and manufacturing activity in developed markets (DM) but also in emerging markets (EM) will see greater growth than in past years. With respect to the regional contribution to global GDP growth, the EA is catching up quickly and emerging markets continue to improve, while the overall impact of the US economy on world GDP depends on the extent of the net fiscal stimulus (tax reliefs for corporates and private households minus funding by closing tax loops, the removal of subsidies and social grants, etc.).

In the US, consumption continues to be the main driver of growth, with full employment on the US labor market being a favorable development. As the US economy is operating at close to its growth potential, investment spending should continue to gain further traction. Job growth remains well above the replacement rate, and the unemployment rate of 4.2% is below most estimates of full employment. We expect it will fall to 3.8% by the end of 2018.

In Japan, the newly re-elected Abe administration should ensure the continuity of the Bank of Japan's (BoJ) monetary policy strategy with the re-appointment of current Governor Haruhiko Kuroda. Meanwhile, PM Abe declared his intention to implement the consumption tax hike slated for October 2019 as planned and to direct part of the increased tax revenues toward social security expenditures centered on free education. We estimate that the net fiscal tightening will be only about a quarter of that in financial year 2014, and will be partly offset by free education/preschool provision. The negative impact of the consumption tax hike will probably be smaller in 2019 than in 2014.

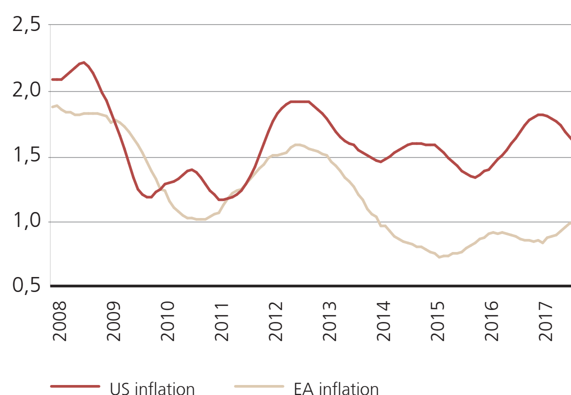
In the EA, the economic recovery remains broad-based across countries and sectors, and economic growth is well above trend. The modest decline of the recent Purchasing Managers' Index (PMI) was mainly driven by the future output component, which is surprising as hiring intentions were up, boosted by new orders mainly from abroad. This suggests that concern over past euro appreciation has waned to some extent. With the core economies of Germany and France in particular expanding with strong momentum, the EA economy is projected to grow at an unabated pace, sustained by household and corporate spending. An additional stimulus will be provided by the export sector, which will benefit from stronger world trade. Given the low exchange rate elasticity of EA export growth in the short-term, the recent appreciation of the EUR should not negatively impact export activity in the EA. For now, we do not

expect any meaningful impact from the increasing tensions in Catalonia on European economic activity. A snap regional election called by the central government, which has used Article 155 of the Spanish Constitution to assume control in Catalonia, remains our baseline.

Monetary policy – patient approach by the ECB
Although there is a high likelihood that the ECB may once again fail to achieve its inflation target of around 2% in 2018, we expect it to take the first steps toward normalizing its policy stance in light of the robust shape of the European economy, clear signs of improving monetary transmission and ample liquidity in the financial system. Thus, net asset purchases by the ECB will be gradually reduced and ceased over the course of 2018. Aside from the ECB's exit from quantitative easing, it is very unlikely that it will start hiking rates before mid-2019 to prevent further EUR strength. This would jeopardize long-term competitiveness of the manufacturing and export sector in the EA, especially in the economies that have suffered most from the European sovereign debt crisis such as Italy, Spain, Portugal and Greece. It would also elevate the bill for these countries by increasing structural unemployment and worsening fiscal ratios. ECB interest rates are therefore expected to remain in negative territory in 2018. After three interest rate hikes by the Fed in 2017, the US central bank is closely monitoring the outcome of the tax reform debate, including tax cuts and the respective funding. We believe the Fed may react more restrictively in the event of a strong fiscal stimulus for the US economy, in order to conquer the threat of overheating. The US economy has already reached full employment and is operating at close to its potential growth rate.

Inflation – what inflation?
We do not believe and do not subscribe to the view that the current global cyclical boost will lift inflation significantly. Admittedly, rising capacity utilization and the decline of excess capacity as a result of the robust global economic rebound in recent quarters should be reflected in moderately higher consumer prices. Therefore, inflation in DM economies should bottom out in the course of 2018. However, commodity prices and especially the oil price are expected to remain relatively stable and the soft trend of wage growth should continue as the participation rates in many DM economies rise. According to a recent analysis by the Organisation for Economic Co-operation and Development (OECD), wage dynamics remain subdued despite ongoing improvements in the labor markets and falling unemployment rates in DM economies. The main reasons for this are backward-looking wage indexation, nominal wage rigidities during the downturn and the underestimation of labor market slack. Fiscal austerity, low productivity growth coupled with a shift in the workforce composition toward less productive/lower-paid jobs generated by globalization and structurally rising participation rates have also suppressed wage and hence price inflation. Although economic momentum in DM economies is rising, we anticipate that the current and future economic strength is not enough to cause a reversal of these labor market trends. Therefore, inflation for most DM areas will continue to be below most central bank inflation targets of around 2% in 2018. According to the American economist Arthur Okun, payroll growth and sustainable changes in bargaining behavior can only arise if economic growth exceeds a specific threshold for an extended period of time. Recent empirical investigations show that this threshold is around 2% GDP growth for the US for at least two years, while the EA requires more than 2.5% economic growth for a minimum of three years to generate more employment and structural labor market changes. This is not yet the case, at least for the EA.

Global inflation trends – 12 months moving averages



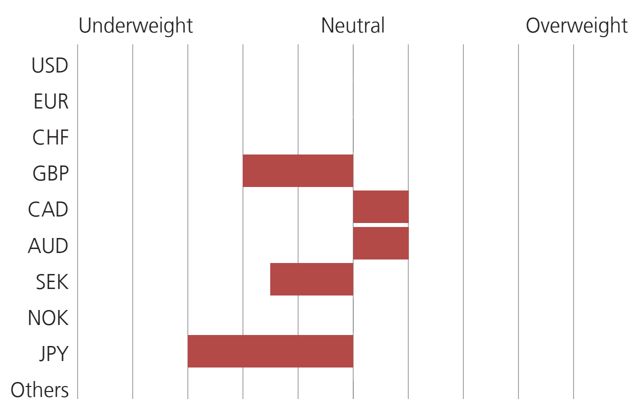
Source: Bloomberg, UBS-SFA

Investment conclusions

Global foreign exchange
The USD: waiting for US tax relief
In the past months, we have stressed the fact that the short to medium-term trend for the USD depends on the extent of the fiscal stimulus triggered by the potential tax reform and tax cuts in the US under the leadership of the Trump administration. To assess the potential impact on economic growth, inflation and asset prices, we looked back at past tax reforms in the US, most notably when tax rates were cut dramatically under the presidency of Ronald Reagan in the 1980s. Following the first tax reform in 1981, the USD appreciated strongly as the Fed hiked rates up to 14% to conquer

inflation and inflation expectations. In other words, the 1981 reform happened when global growth was weak and global capacity reserves were ample. For the tax reform to be self-financed, the US requires sufficient growth to boost tax revenues and compensate for the lower tax rate. With weak demand, the US economy faced significant global headwinds in self-financing the tax reform. The US federal budget deficit more than doubled from around 2.5% to 5.7% of GDP in 1983, increasing US capital demand when capital demand outside the US was weak. Consequently, the USD rallied hard. In return, the US was forced to offer its foreign creditors higher coupons on their additional issued debt to finance the budget deficit and the prospect of currency gains. The second tax reform in 1986 came as the global economy was strong as of today, allowing it to be self-financed and leading to a fall in the budget deficit from approximately 5% to around 2.5%. Less USD was needed to fund the declining budget deficit and hence the USD came under selling pressure. It is still not possible to foresee what impact a potential tax reform in the US may have on the net federal budget and hence on US monetary policy and the USD. However, should the USD strengthen in the light of expected tax cuts, we would be inclined to exploit the cheapness of foreign currencies, in particular by increasing the EUR exposure as we believe that the EUR has much potential in the medium run to post further gains. The European economy is catching up, the ECB will start to reduce the extent of accommodation in 2018 and political uncertainty has abated in the course of 2017.

Currency allocation preferences (six months)



Source: UBS-SFA

In Canada, the data and events since the September rate hike have been mixed, posing downside risks to the near-term rates path. Although real GDP growth has been somewhat below the Bank of Canada's (BoC) estimate of around 2% on dismal exports, we believe this dip in economic activity is temporary as labor demand remains robust and labor market conditions continue to improve. Furthermore, inflation gauges are ticking up and inflation expectations continue to rise. In addition, business sentiment is trending upward, making us confident that the BoC will maintain its course by delivering further rate hikes in 2018, depending on future inflation and economic growth. Therefore, we are retaining the small overweight exposure to the CAD in our EUR and CHF-based portfolios.

Global bonds overview

Bonds: range-bound

We remain skeptical that government bonds will experience a significant setback in the months ahead, despite the fact that monetary stimulus is set to decelerate in 2018 as the Fed reduces its balance sheet and the ECB begins buying fewer bonds than in 2017. As long as inflation remains subdued in the US and EA and inflation expectations remain in check, there is little chance for bond yields to rise, especially as the ECB keeps central bank rates in negative territory and the Fed continues to lift rates only gradually. The movement of nominal yields over the coming months will be determined by the movement of real rates. Are real rates expected to rise substantially in the foreseeable future? Given the excess capacity (the glut of capital/savings and labor) in the world economy, it is rather unlikely that the global economic momentum is strong enough to boost capital demand and hence real rates. One trigger for higher real rates may be the net fiscal stimulus in the US. However, the so-called crowding-out effect of additional public spending leading to significantly higher real rates has never been confirmed by empirical investigations.

Of course, the prospects of both the US winding down its balance sheet and the ECB contemplating the next iteration of its monetary accommodation put central banks in the spotlight, less bond buying by the ECB and outright balance sheet reduction plus further rate rises ahead from the Fed. This heralds the end of crisis-era monetary policies that kept financial conditions loose and buoyed risk assets. The reversal has implications for global bond markets and financial markets more broadly. Rising rates could, over time, help

restore the attractiveness of lower-risk government and shorter-duration debt at the expense of more richly valued credit sectors that have benefited from the hunt for yield in recent years. However, we believe it is too early to count on significantly higher bond yields. We are therefore maintaining a neutral duration stance in the US, reflecting the risk that tax cuts and fiscal stimulus may result in higher growth expectations and hence high yields. The extension of the ECB's net asset purchase program is a sufficient cushion for higher rates in the coming months. Hence we are sticking to a long-term view for EUR and CHF-denominated government debt as the Swiss National Bank is forced to follow the policy stance of the ECB to protect the CHF against further appreciation.

It is true that credit spreads for investment and non-investment grade corporate debt are close to historically tight levels. Yet we believe credit is an attractive source of income – and one for which there is persistent demand in the context of a low-yield, fixed-income universe. Spreads have widened slightly in the past few months in both the US and European investment grade markets, offering some value even if valuations look a bit rich at these levels. Today's valuations imply future returns will come from clipping coupons (carry) rather than tightening spreads. As a result, we believe credit offers less upside than equities on a risk-adjusted basis if our scenario of sustained global expansion pans out. But this environment of low market and economic volatility is one where corporate defaults are expected to be limited. However, non-investment grade corporate bonds have reached stretched valuations and we decided to eliminated our overweight allocation to this sub-asset class to underweight by selling our exposure to EA non-investment grade corporate debt and under-weighting US non-investment grade corporate bonds. Some of the proceeds are switched into investment grade bonds of the respective reference currencies and more importantly, into emerging market bonds denominated in local currencies. These bonds offer an attractive carry over government bonds and most emerging market currencies are attractively valued.

Global equity overview

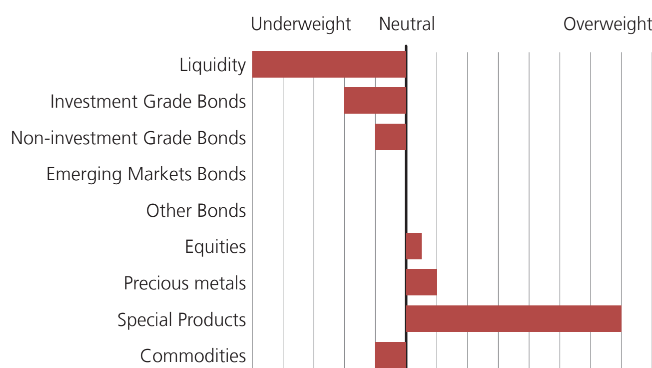
Sustained global expansion provides a positive backdrop for corporate earnings

Earnings are growing at a pace of more than 10% in all major regions for the first time since 2005, excluding the post-crisis bounce. Analyst forecasts are holding steady in the US and Europe, are up in Japan and have improved this year in EMs. These trends give us comfort in taking stock risks. We favor the US and European equity markets. Economic reform momentum, improving cash flows and reasonable valuations make a solid investment case.

The world is enjoying a "Goldilocks" economic recovery, strong enough to keep markets afloat but not so hot as to prompt rapid monetary tightening. Yet many investors are skeptical about equity valuations after an eight-year rally. Do equity market multiples need to adjust to historical levels or perhaps to a new "fair value"? And how much do equity valuations matter anyway?

In brief, here are some explanations. We find that starting valuations have historically been a poor indicator of future equity returns in the short run. They show a strong relationship with long-term returns in the US, but have been a less reliable guide in other markets. Market composition matters. For example, the US valuation premium over Europe vanishes when a handful of fast-growing technology stocks are removed. Regions or indexes with a greater share of higher-margin sectors may trade at sustainably higher valuations, we believe. Elevated equity valuations today could drag down future returns, but we expect dividends and earnings growth to pick up the slack over the medium term. We believe valuations are not as stretched as they may appear – multiples are unlikely to revert to historical means in a world of structurally lower interest rates.

Asset allocation preferences (six months)

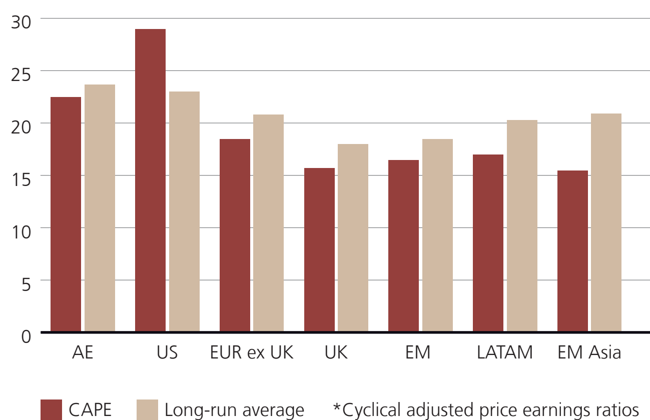


Source: UBS-SFA

Against the backdrop of reducing our exposure in non-investment grade corporate bonds and the improved prospects for the global economy we increase our overweight allocation to EA and move emerging market equities to a neutral exposure, as both market are still attractively valued. At the same time, we reduce UK equity exposure based on the reasoning that Brexit uncertainty may become a rising drag for UK corporates to generate sufficient cash flows and appropriate earnings.

Nevertheless, low volatility at the equity index level masks a lot of action below the surface. Worries about widespread technological disruption are causing major valuation swings within sectors, as disruptors chip away at traditional business models saddled with high fixed costs and real estate footprints. Retail is a prime example. A boom in online shopping and shifting consumer preferences (towards experiences versus things) are challenging business models. Returns for online retailers once trailed their traditional counterparts but have skyrocketed since 2016. Some of these moves look overdone, and may lead to opportunities for stock pickers. We like innovative retailers that can differentiate themselves and are looking for opportunities in other sectors hit by disruption.

World equity valuation*



Source: Datastream, UBS-SFA

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