CIO Year Ahead 2015

Chief Investment Office WM
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The diverging world
Dear reader,

Open any newspaper or scroll through the latest newsfeed and it’s clear that we’re living in a time marked by ambiguity. Across geographies, the pace of economic growth varies, government policy is clouded by uncertainty, and broader geopolitical instability persists. The title of our CIO Year Ahead, The Diverging World, reflects these realities and the ongoing shifts that are reshaping the way we think about the important issues of the day.

Inside, we explore themes that are going to influence our worldview in the coming years — topics like sustainability and increasing longevity — and offer insights about navigating a complex environment. We know that the lack of clarity in the markets today can be unsettling. Informed investors, however, will continue to identify and seize opportunities to strengthen their portfolios.

That’s what CIO Year Ahead 2015 is all about — providing clients with the information, advice and perspective they need to feel confident about the investment landscape and take control of their financial future.

Developed by our global team of experts, with crucial input from a number of leading fund managers, this publication is an important guide for investors looking to make sense of a diverging world.

Welcome to the CIO Year Ahead 2015.

Robert J. McCann  
CEO, UBS Group Americas

Mark Haefele  
Global Chief Investment Officer, Wealth Management

Mike Ryan  
Chief Investment Strategist, WM Americas
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“This is the diverging world.”

The diverging world
The theme that runs throughout this CIO Year Ahead 2015 is the diverging world that investors currently face. GDP growth is uneven, economic policy is taking different paths, and geopolitical tensions have rekindled. But divergences run even deeper – to contrasting levels of competitiveness within the Eurozone, gaps between reform agendas in emerging markets, and ultimately, we expect, to divisions in the performance of financial assets in 2015.

Debate and challenge
This year, CIO debated such issues not only internally, but also with top investment professionals from inside and outside UBS at our inaugural UBS Year Ahead Investor Forum (p10). CIO’s thoughts on the big investment questions of 2015, including a special section on sustainability, can be found in extensive interviews with our global and regional specialists (p16 to p47).

Investment positioning
On page 48, readers also can find the key details of our investment positioning in each major asset class as we head into 2015. In short, we remain positive on equities and credit. We concentrate these overweight positions in the US, and have a bullish stance on the US dollar relative to the euro. We are underweight both emerging market equities and dollar-denominated corporate debt.

Surprises for the year ahead
Finally, we ask our contributors what might surprise them in 2015, what excites and worries them, their top ideas for 2015, and their New Year’s resolutions. Find out more on page 60.
What stood out in 2014?
It’s been an interesting year. The big surprise came in the government bond market. Despite already low yields, an end to QE, and a stronger US economy, US Treasury yields fell further over the course of 2014. German Bund yields saw even larger moves lower. From here we still think government bonds represent a good funding source given the low level of yields, but the markets are wondering what will ultimately be the catalyst for higher yields.

We benefited from US growth by being overweight US equities. So far, diverging central bank policy has started to play out in the currency markets. We have been looking for a move down in the euro relative to the dollar, and it finally started to happen in the second half of the year.

What are the main risks that worry you for 2015?
There are good divergences happening and bad divergences happening, and we spend a lot of time thinking
about both. One bad divergence is the geopolitical turmoil in several areas around the globe.

Some of these risks remain extremely difficult to quantify and they have kept many investors away from the kind of long-term investment plans our Chief Economist Andreas Hoefert discusses (p32).

Even good divergences, and I would consider the self-sustaining growth developing in the US and UK to be of this kind, can be worrying because they raise questions about how this business cycle will play out now. We continue to sail deeper into uncharted waters with monetary policy.

We are not close to normalizing in large parts of the world. Something we were discussing at the Investor Forum was “where we are in the economic cycle” (p10). The consensus in the room was that the economic cycle has been redefined amid all these divergences in central bank policy. But one would assume that central bank support has to end at some point. And if we do see a slowdown in growth before central banks normalize policy, there are going to be big questions about whether central banks have already exhausted their tools to deal with any future crisis.

To say that inflation is dead is to say that central banks that control printing presses are unable to control the quantity of money in the system. That is clearly not true. Therefore it becomes a question of the velocity of money. Once again, there is good reason to believe that central banks are pushing for higher bank lending, so there are reasons to believe that the velocity of money can increase as well. Everyone talks about deflation in the Eurozone at the moment; it was one of the main points of debate at the Investor Forum. But as Themis Themistocleous, Head of our European Investment Office discusses (p20), the hopes of improvement in the Eurozone are very much tied to what the ECB can do to clean up the banks and boost lending. If both of those things happen, it is hard to see core inflation falling further from here.

There are good divergences and bad divergences, and we think about both."

A major effect of the central bank policies seems to have been increased valuations of financial assets. Are they now too high?

We don’t think valuations are so stretched that you can’t still see positive returns from financial assets this year. But people who expect financial assets to perform the way they have over the past three years are likely to be disappointed. There is certainly a good chance that if we look back, five years from now, that real returns will be subpar relative to historical norms.

Central bank action has so far not led to the high rates of inflation many expected. Is inflation dead or just dormant?

Debtor nations have absolutely no incentive to see deflation take hold, since they benefit so much from inflation.

So I think investors who consider themselves conservative should focus less on volatility, and more on protecting long-term purchasing power.

One way to maintain a long-term perspective but earn higher returns is to invest in themes with powerful growth drivers. Things like population growth, cutting-edge scientific developments,
“I think investors who consider themselves conservative should focus less on volatility, and more on protecting long-term purchasing power.”

Mark Haefele. Global Chief Investment Officer
balance sheets look healthier, and banks are recapitalized. Places that haven’t acted so quickly, like the Eurozone, are still suffering, and so we have this divergence.

We’re in a diverging world; is global growth too dependent on the US right now?
I’d argue that the US is an important “contributor” to overall global growth, but the rest of the world isn’t really “dependent” on the US as such. Our APAC Investment Office Head Min Lan Tan, makes an interesting point (p24) that we haven’t really seen export growth in Asia pick up in the years since the crisis. The flip side of this is that the US consumer isn’t really the driver of export growth around the world that he or she used to be.

So, yes, the risks increase if there is only one major contributor to improving growth rates in the world, but it is almost always the case that there is one big contributor. Before it was China, now it’s the US.

One of the main discussion points from the Year Ahead Investor Forum considered the effects of a strong dollar. What are the potential ripple effects of a stronger dollar?
As we start to see higher FX volatility, one of the things you can see is that people and/or nations that have funded debts in foreign currencies can experience pain.

Jorge Mariscal, Head of our EM Investment Office, makes a good point (p28) that the amount of pain they will feel will probably depend on the precise environment of dollar strength. If it’s an environment where the US is growing strongly, then maybe it isn’t so bad. But if it’s a “safe-haven” type flow into the US dollar, then things can be much worse.

Long-term – new technologies and shale gas. Revolution or hype?
On the drive to my sister’s house in Texas, you can look out the car window and see the change. In the Mid-west, there are places on the side of the road where fast food restaurants or houses have been replaced by new wells. That is not an unmitigated blessing, but it plays to a strength of the US, where natural gas has become dramatically cheaper than in the rest of the world. As Chief Investment Strategist for WM Americas Mike Ryan has discussed (p16), this is providing a huge boost to the US economy.

At a global level it’s important too. Since 2010, the US has added three million barrels of oil per day, the equivalent of Venezuelan production. Remember, not so long ago a few Nigerian individuals could disrupt a pipeline and send ripple effects across the entire oil complex. Today we don’t hear stories like that, and this is important for global economic stability.

If you had to give investors one piece of advice for 2015, what would it be?
One of the important trends that I have seen over my investment career is the realization that sustainability is more important to both individual company valuation, and to the way that countries spend their investment dollars. One of my colleagues, Stephen Freedman, has been taking a pretty close look at sustainable investing and has some good advice for people looking in that area (p44).

Apart from that, the importance of applying the fundamentals of investing which include diversification, rebalancing, and a focus on risk, will remain true and important in 2015, just as in every other year.
The diverging world.

This is the diverging world. Growth is uneven, economic policy is taking different paths, and geopolitical tensions, both within and between countries, have rekindled.

Against this challenging backdrop, we recently held our inaugural UBS Year Ahead Investor Forum, a roundtable discussion with a number of world-leading investment fund managers and strategists, to postulate the ways in which the diverging world could make itself felt in economies and financial markets in 2015 and beyond.

CIO’s conclusions following these discussions are as follows:

First, the notion of a global economic cycle is redefined. The traditional concept of business cycle boom and bust driven by private sector credit creation, inflation, and interest rates is not applicable, and central banks are still the incremental providers of new credit in parts of the world, while inflation is suppressed. Different countries and regions are in different stages in the transition away from central bank life support, and some are even heading deeper into it. Aggregate global growth seems set to remain slow and steady, if improving, yet the idea of a global business cycle is no longer apt. Divergences rule.

Second, with economic transmission channels impaired, the effects of the diverging world may result in highly concentrated outcomes. This applies both to the traditional transmission of monetary policy to the private sector, via the banking system, and to the transmission of economic growth across borders. Global trade and cross-border capital flows are still somewhat detached from growth. Therefore, divergences may be sharply felt in individual areas, but we also cannot wholly rely...
“Aggregate global growth seems set to remain steady, yet the idea of a global business cycle is no longer apt.”

on effects transmitting in the ways one might traditionally expect.

Third, despite living in a diverging world of concentrated outcomes, the global base case expectations of many investors are clustered in worrying proximity. This is perhaps understandable in a world where aggregate growth is likely to improve and policymakers are attempting to corral investors in their asset class choices. But while government actions are intended to create a “steady” world of low return and low risk, we need to consider the possibility that as the market begins examining tail risk scenarios, the magnitude and frequency of turbulent market events may rise.

Fourth, inflation requires attention as a particular tail risk. On the one hand, at a global level giant demographic and technological forces, obscured in recent decades by the rise of the emerging markets, are placing significant downward pressure on global rates of inflation, as is deleveraging in parts of the world. In contrast, at a local level, a rise in nationalism, protectionism, and geopolitical risk already evident in 2014 could equally conspire to generate

At a glance.

The idea of a global business cycle is no longer apt. Divergences rule.

Countries reliant on artificial external support, rather than genuine competitiveness and sufficient internal demand, will suffer.

With economic transmission channels impaired, the effects of the diverging world may result in highly concentrated outcomes.

Investors will need to offset the impact of a diverging world by ensuring their portfolios are well-diversified.

An environment of rising volatility and potentially outsized market moves will create tactical opportunities, but also increase risks.
"Economies that have enacted the proper reforms will fare best."

undesirably high rates of inflation, while a return of monetary transmission mechanisms to normal function could have a similar effect. The outcome, either way, will have important consequences for monetary policy and financial portfolios.

Finally, with 2015 likely to see a number of central banks tighten monetary policy, and a stronger US dollar tightening effective financial conditions in many parts of the world, countries reliant on artificial external support, rather than genuine competitiveness and sufficient internal demand, will suffer. Those economies that have enacted the proper reforms will fare best, while the market is likely to reward those making steps in the right direction.

Investing implications
All of this will make investing in 2015 and beyond challenging but manageable, provided investors follow some key tenets:

First, portfolio risk needs to be reexamined. As divergences make themselves felt sharply in individual asset classes and regions, it will be critical for investors to try and offset the risks of a diverging world by ensuring their portfolios are well-diversified and are not overexposed to any individual asset, asset class, or region. At times this will represent a cost to performance, but the commensurate reduction in risk and volatility will more than compensate. Practically, portfolios will need to be hedged against potentially outsized currency moves, home biases should be avoided, and asset allocation must be examined for concentration risks.

Second, opportunities in short-term tactical investments will likely be more frequent in a diverging world. But so
will the risks. On the upside, this should create greater potential for tactical positioning and investments to generate returns, and ample opportunities for alternative managers to create returns above benchmark. Indeed, with overall financial market upside likely to be limited from here, it will be essential for investors to take up such opportunities. However, investors need to ensure such positions are taken on in a risk-controlled manner. This is particularly important in an environment of rising volatility and potentially outsized market moves.

Third, holding cash is likely to represent a cost. The magnitude and frequency of turbulent market events is likely to rise, but with global growth still apparent overall, our base case should still be one of positive overall financial asset returns. Meanwhile, cash rates remain close to zero across most major currencies, and while this may be a diverging world, financial repression continues to be one of the few features uniting it. Real interest rates remain close to or below zero in most major currencies.

Finally, if one thing above all else has been proven over recent years, it is that assessing sustainability is critical. The developed world debt bubble was not sustainable, and it is slowly and painfully correcting. China’s investment-driven growth was not sustainable, and it too is slowly and painfully correcting. In the diverging world, investors will need to begin considering sustainability in all aspects of their portfolios.

“The effects of the diverging world may result in highly concentrated outcomes. Asset allocations must be examined for concentration risks.”
### Region by region

#### A diverging world.

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<th>GLOBAL</th>
<th>US</th>
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#### Growth

**GLOBAL**

Steady growth, but *divergences* rule. Global growth will increase to 3.5% in 2015 from 3.3% in 2014. Among major economies, US growth will accelerate most rapidly (2.9% from 2.2%), and Eurozone growth will slowly improve (1.2% from 0.8%). China will slow (6.8% from 7.3%).

**US**

Growth will *accelerate* to 2.9% as consumer and business spending increases, and as fiscal policy stops dragging on growth.

#### Inflation

**GLOBAL**

The sharp decline in commodity prices means global inflationary pressure is low. *Divergences* in spare capacity in different economies will affect local dynamics. There are some hotspots in emerging markets.

**US**

Inflation will average 1.8%, and be close to the Fed’s 2% target by the end of the year, as unemployment falls further and wage pressures steadily rise.

#### Policy

**GLOBAL**

2015 is the year when developed market policy *diverges*. The US and UK will begin raising interest rates. The Eurozone, Japan, and Switzerland could be forced to loosen policy further.

**US**

In response to increasing rates of inflation and declining unemployment, 2015 will be the year *tightening* arrives. The Fed will increase interest rates in the middle of the year, but will remain responsive to economic conditions.

#### Investments

**GLOBAL**

We expect an environment of steady *growth* to support both equities and credit, even if returns are more muted than in recent years. Global government bond yields should *rise steadily* from low levels.

**US**

We *overweight* US equities and US high yield credit, given strong corporate profitability and decent balance sheet health. Interest rates diverging from much of the rest of the world should support the US dollar.
**EUROPE**

Growth of 1.2%, supported by improved US growth, household consumption, and looser fiscal policy. The UK, Spain and Germany will outperform. Italy and France will underperform once again.

Inflation will increase but remain low, at 1.0% in the Eurozone. Amid a diverging world, rates of inflation within the region are actually converging, making competitiveness adjustments more difficult.

The ECB will keep policy loose and could be forced into full quantitative easing if rates of inflation do not improve. Meanwhile, the UK will hike rates in August in response to increasing wage pressures.

**APAC**

China’s growth will decelerate again, to a more sustainable pace below 7%. Most ASEAN economies will slow, but growth in India and Japan should improve slightly.

Japan’s headline inflation will fall (2.0% from 2.9%) but outstrip China’s (1.8% from 2.2%) again, boosted by sales taxes and other Abe government policies. India is bringing inflation under control (6.4% from 7.7%), inflation rates in parts of ASEAN will increase.

The Bank of Japan will keep policy loose and could intervene again if the economy shows weakness. China will use targeted stimulus measures to avoid any sharp downturn.

We are neutral on Eurozone equities given that corporate earnings momentum remains poor. We prefer the financials and energy sectors. We are underweight the euro due to the possibility of new ECB policies.

A strong US dollar will have an uneven impact on APAC. The Chinese yuan and Taiwanese dollar should prove most resilient. The Indonesian rupiah could suffer. Thanks to improving cyclical momentum and reforms, we overweight Indian equities and the rupee.

**EMERGING MARKETS**

APAC will outperform LatAm and EMEA. Growth in Mexico will increase substantially (3.3% from 2.2%), while Brazil (0.6% from 0.3%) and Russia (0.2% from 0.5%) will continue to disappoint in part thanks to their respective political situations.

Inflation will rise from already high levels in both Russia (8.1% from 7.6%) and Brazil (6.8% from 6.4%), but will fall in Mexico (3.4% from 4.1%). Parts of emerging EMEA currently close to deflation will also see inflation rise.

Higher global bond yields and a stronger dollar could lead to a divergence between the better prepared emerging markets and those that remain fragile (Indonesia, Brazil, South Africa).

We underweight EM equities and dollar-denominated corporate debt due to weak profitability trends. In equities we prefer those countries undergoing economic reforms – namely Mexico and India, and those which are positively exposed to US demand, such as Taiwan.
Can we be confident that economic growth in the US will continue in 2015?
I think we can be confident. What we are seeing is a broadening and a deepening of US growth drivers. In the initial stage after the crisis, the growth drivers were very narrow and the economic recovery process fragile. Now we see a recovery in the consumer sector based on the repair of personal balance sheets, the recapitalization of the financial system, and the abatement of fiscal headwinds. Against this backdrop we should continue to see gains in terms of employment growth and business investment spending.

What are the main worries you have about growth in 2015?
The US can lead, but it can’t carry. If the world continues to see diverging headwinds – with deflationary headwinds coming out of the Eurozone, and emerging markets failing to re-accelerate – there is a limit to how much the US can carry. So my concern is that the US would become burdened with providing growth for the entire globe.

What will influence the timing of interest rate increases, and how can we expect them to develop?
The Fed has been fairly transparent on its focus, and it’s pretty clear that the labor market conditions will top the Fed’s priority list. We have seen good employment growth, but there are lingering concerns within the Fed about “underemployment” and about those who may have dropped out of the labor market permanently. Another concern is inflation, which remains low.

Overall, this suggests that as the Fed goes through its process of raising rates, it will do so in a very pragmatic and cautious manner. Given the time, effort, and money that have been expended to get us to this point of the recovery, the Fed certainly doesn’t want to undermine those efforts by tightening too quickly. There’s a term from the medical profession that perfectly describes the Fed’s current policy approach: primum non nocere (first, do no harm). It is the first standard for healthcare professionals and may well become the Fed’s mantra.

What is your perspective on where we stand in the credit cycle in the US? Should investors be concerned about US high yield credit?
There is always a concern that the start of the Fed’s tightening process will lead to losses in fixed income markets. But we need to temper that in two ways. First, the rate increases will be gradual; the Fed is going to have a very deliberate pace with regard to this tightening cycle. Second, business conditions continue to improve, corporate balance sheets are in good shape, and we haven’t yet gotten to the point where
“We are seeing a broadening and a deepening of US growth drivers. We should continue to see gains in employment growth, lending activity and business investment spending.”

we are seeing a significant re-levering by corporate America. So high yield can continue to perform well through 2015 – even though the gains are going to be moderate.

At the UBS Year Ahead Investor Forum in London, there was broad consensus that 2015 would be another year of US dollar strength. What are the implications for the US itself?
The Fed is going to monitor the situation closely because what it doesn’t want to see is a dollar rising to the point where it actually jeopardizes the recovery in the US. This reinforces the point I made earlier that the Fed is going to have to move very pragmatically and slowly. Because if significant rate differences with the rest of the world continue to draw strength for the dollar, this could have significant implications for both domestic inflation and a dampening of growth.

What is your thinking on US equities today?
We still like US equities relative to equities elsewhere in the world, given the more favorable economic dynamics here. But markets are no longer cheap, and that suggests to me that gains will be more moderate in the year ahead. We therefore need to be more selective. We’re looking to the types of companies, industries, and sectors that are 1) geared to where we are in the business cycle; 2) can take advantage of growth drivers as we see them emerging; 3) are less sensitive to the beginning of Fed tightening; and 4) have relatively attractive valuations.
The US market segments that tend to fit that profile right now are small- and mid-caps, while the sectors are industrials, technology, financials, and consumer discretionary.

**Any developments in municipal credit?**
We’ve seen cyclical improvement and I think municipalities have done a very good job of addressing budget shortfalls by raising taxes and cutting costs, so credit conditions are actually in relatively good shape right now. But the benefits that have been promised to municipal workers – past, present and future – are likely to pose a big challenge for municipalities. As a result, municipal credit quality is going to be a focus for investors. It is not necessarily a 2015 story, but it is something we will have to deal with in the years ahead.

**The US has emerged as a major player in energy production and in developing new technologies. Equally, some seem worried about a “secular stagnation.” What does the long term hold for the US?**
I believe that the US is the most flexible, dynamic, resilient, and adaptive economy in the world. The US has an ability to reinvent itself, and we tend to allocate capital where growth prospects are strongest.

But this is probably less true than it was a decade ago. The US economy has become less dynamic as the public sector has expanded and the private sector has not yet fully recovered. We have to strike a balance between what we want to solve from a social standpoint, and what will sustain us from an economic growth standpoint.

That said, the energy story currently playing out in the US is a potential game changer. It has the ability to stimulate demand through exploration and production, but there is also a very short cycle that goes from exploration and production, to distribution and storage, to infrastructure and conversion, and on to manufacturing. So all these things could represent a game-changing dynamic in the US that could help our balance of trade, our budget situation, employment growth, and personal income growth.
US economic growth has both broadened and deepened

- We expect GDP growth to accelerate from 2.2% in 2014 to 2.9% in 2015.
- Consumer balance sheets have deleveraged – to 91% of GDP today from 115% in 2007.
- Banks now boast a Tier 1 capital ratio of 12.9%.
- Government spending cuts are no longer a drag on the economy.

Credit conditions have eased, a boost for jobs and investment

- Increased credit availability is traditionally a good leading indicator for employment and investment growth.
- An average of more than 220,000 jobs were created each month in 2014.
- Durable goods orders data suggest that spending on capital equipment has gotten started.

The Fed will raise interest rates in 2015

- The Fed will be pragmatic and cautious.
- Steady and responsive interest rate hikes are not likely to pose a risk to economic growth.
- The Fed will monitor the strength of the US dollar closely.

Overweight US equities and high yield credit

- We overweight US equities, and expect 8% earnings growth for the S&P 500 Index.
- Financials, industrials, technology, and consumer discretionary are best positioned, and we prefer small- and mid-caps over large-caps.
- We overweight US high yield credit. Default rates are likely to remain below 2% in 2015.

Long term, the US economy should be supported by secular trends

- US oil production has increased by 3 million barrels per day, the equivalent production of Venezuela, since 2010.
- The US stands at the center of new technological development in mobility, cloud computing, and additive manufacturing.

Source: Bloomberg, UBS
Europe

Playing catch up.

Themis Themistocleous.
Head of Europe Investment Office
2014 began with plenty of optimism about economic recovery, but at the Year Ahead Investor Forum, the discussion was centered on low growth and fears of deflation. Do you think we will see anything in 2015 to change the outlook?

Europe has been a disappointment in 2014. But for 2015 there are a number of elements that we think should be supportive of better growth. For starters we have the weaker euro, which moved from a peak of about 1.40 against the US dollar to a low of 1.25. Obviously we have also had the actions announced by the ECB. And if they don’t have a significant impact on the economy, we could still potentially see sovereign quantitative easing. The other element that could help the economy in 2015 is banks. Demand for credit has turned from negative to positive in recent months. And the completion of the ECB’s asset quality review should make banks more willing to extend credit, especially given the very low cost of borrowing. So we expect a better year in 2015 relative to 2014.

Growth rates are still not going to be stellar, however. For 2015 we are looking for GDP growth of around 1.2%, and that is recovering from a very low level. Long term, we have an aging population and mature economies. So for the next five years we would be looking for trend growth of around 1–1.5%.

Over the past two years, we have seen quite a calm political environment. Is there a risk of a return to the political and existential crises we had in 2011 to 2012?

Clearly the risk has subsided, but has not necessarily been fully eliminated. A number of countries in Europe are still highly indebted, and are still growing their debt ratios. Even with economic growth, some countries will struggle to consolidate their debt. We have also seen some negative political developments with certain Euroskeptic parties gaining prominence.

But if we get better growth in 2015, it will help the economies of countries that are under pressure and start stabilizing debt to GDP. So for next year, we think the probability of the Eurozone coming under attack again is low.

And where do we stand in terms of the economic reforms that were put in place since the crisis?

Speaking of a diverging world, we’ve had quite a divergence in what has happened in Europe. We have seen quite a lot of progress in the peripheral countries that were under pressure during the crisis, like Ireland, Spain, Portugal, and Greece. We have seen deflation and an adjustment in labor costs, which have clearly made these economies more competitive.

But there are still some big economies like France and Italy, where we have seen much less in terms of reform. If you look at France, without substantial reforms I suspect we can expect growth somewhere between 0–1%. In Italy we have had some changes and there is the will to do more, but it has a complicated political set up as well.

At a glance.

European growth has been disappointing in 2014. But a weaker euro, new ECB measures, and signs of loan growth should be supportive of better growth in 2015.

The UK will be the fastest growing major economy in Europe once again.

France and Italy have been relatively slow to reform their economies, and growth will remain muted.

Growth in Germany and Spain will be stronger, given their more competitive economies.

2015 should be a good year for the banking sector, and energy stocks also have scope for re-rating.
The UK seems to have performed well in 2014, despite disappointments in the Eurozone. Why do you think that is?
The UK has always had a more flexible economy, and is a lot closer to the US model than to the rest of Europe. When we had the recession after the financial crisis it was deeper, but with a more flexible labor market and regulatory framework, the improvement was a lot quicker.

What do the political tensions with Russia mean for Europe?
If you look at trade between Europe and Russia, it’s not that important, only 2.5% of Eurozone merchandise exports go into Russia. There are also links through gas supplies, but we don’t expect significant interruptions. Of course, this depends on how bad tensions become, but for now our base case is still for a manageable development between Russia and Ukraine. But clearly the proximity to Europe means that tensions in Russia lead to a bigger impact on equity market sentiment there, than in the US.

Over the past five years, we have seen European equities underperform the US quite substantially. Should we expect to see Eurozone equities catching up over the next five years?
European companies are way behind the US in performance, but also in terms of earnings developments. US earnings have strongly recovered and are currently slightly above trend. If you look at Europe, earnings are around 25% below trend and about 30% below the previous peak. So you could argue that there is a lot of upside potential in Europe.

But Europe is a much riskier market with more economic problems, as we saw in the volatility we experienced at the end of 2014 and the repeated disappointments on economic growth. And for earnings to recover to trend, banks have to play a big role because the big gap between the previous peak and current earnings is largely due to lower profitability of financials. Although it is probably unreasonable to expect banks’ profitability to recover to pre-crisis levels given the regulatory environment, we still expect the gap to narrow.

For 2015, what do you think are the sectors and themes that people should be focused on?
We think that 2015 should be a good year for the banking sector. The cost of borrowing has come down a lot, valuations are quite attractive, and the Asset Quality Review and stress tests are finished. The last hurdle in the recovery for the banking sector is litigation. We hope to get more clarity on that over the next couple of months, but once that is out of the way, we think that banks should perform much better.

One sector that is maybe a bit more controversial is energy, which sold off heavily in the second half of this year due to the weaker oil price. It has also underperformed a lot over the last couple of years, due to very high levels of capital expenditure. But we have seen increased signs of capex discipline from some companies in the sector, and the decline in the oil price should encourage more and more companies to review their capex plans. If they can reduce capex at the same time as the oil price recovers, we will get a sharp revival in free cash flow, and the sector could re-rate.

“Speaking of a diverging world, we’ve had quite a divergence in what has happened in Europe.”
Eurozone growth disappointed in 2014; we expect higher growth in 2015

The ECB’s actions will be critical in stimulating growth and inflation

* Deposit rates were cut into negative territory in 2014.
* The ECB has said it will look to expand its balance sheet back to levels reached in 2012.
* It may need to extend asset purchases into corporate, pan Eurozone, or sovereign debt to do this.

Eurozone equity opportunities

* We are neutral on Eurozone equities, given weak earnings growth trends.
* We prefer financials, given low valuations and borrowing costs.
* The energy sector should benefit from a rising oil price and increased capex discipline.

We expect euro weakness to persist into 2015

With Eurozone monetary policy diverging from the US and UK, we expect the euro to remain weak in 2015.

UK – the fastest growing major economy

* UK GDP growth will outperform the Eurozone once again, with growth of 2.6%. This will be supported by rising business investment, falling unemployment, and increased consumer spending.
* We expect interest rate hikes in August 2015. Ahead of this, we prefer UK value equities.

Source: Bloomberg, UBS
Do you think that China can maintain growth while driving on reforms in 2015, and when do we need to worry?

It is difficult for China to maintain a growth rate of around 7.5% while driving on with structural reforms. Some of the reforms the government is looking to implement such as interest rate liberalization and local government finance reform would actually have a negative short-term impact on growth. So what is likely to happen in 2015 is that the government will tolerate lower growth and in the meantime will use targeted stimulus policies and measured interest rate cuts to avoid any sharp downturn. This does entail a delicate balance between growth and reform, but we think they can manage it.

What kind of long-term growth rates should we be expecting from China?

I think a growth rate of 6–7% is more sustainable. The working age population in China is declining: even with the further reallocation of rural labor to the non-farm sector, the labor contribution to growth will fall. And demographics and improving social safety nets mean we think you’ll start seeing a gradual decline in savings, which essentially also implies slower capital accumulation.

Chinese equities look cheap on the face of it. Do you think that they are too cheap to ignore, and when would be the right time to buy?

The apparently cheap valuation is very much driven by financials, while non-financials are trading very close to five-year average valuation levels. Given that there is no easy solution in sight for structural issues such as rising credit risk and non-performing loans, the depressed valuation of financial stocks could actually remain for quite a sustained period of time.

If we see a major and broad-based policy loosening, then the market would probably rally sharply. But this is not our base case, and our sense is that the government is not going to engage in broad-based loosening, only more modest measures to prevent growth from falling too much. In the medium to long term, sustained reforms of state-owned enterprises resulting in an improvement of the return on equity potential of the market would be the key to a long-term re-rating of the China market.
Can Asian export growth return to the levels of the past in 2015?
Exports will benefit from stronger US business equipment investment. But our expectation is for Asian export growth to improve only modestly, to 7% in 2015, up from about 6% in 2014. This pace of growth is still going to be sharply below the 14% average trend growth rate that was seen over the past 10 years average. The swing factor will be demand outside the US. With the diverging world meaning overall developed market demand is still relatively weak, it is hard to see how Asian exports could reaccelerate to the historical trend growth rate.

What will a strong US dollar mean for Asia-Pacific?
The correlation between Asian equities overall and US dollar strength has historically been negative. Now having said that, we believe that the starting conditions by country will matter a lot and the impact of a strong dollar will not be felt evenly. So the starting conditions that we would look at include the health of the external sector, the degree of domestic leverage, and the level of domestic real interest rates. Our sense is that the two currencies that would be relative winners in an environment of dollar strength are the Chinese yuan as well as the Taiwanese dollar, simply because they are the

“The Chinese government will tolerate lower growth, and mainly use targeted stimulus measures to avoid any sharp downturn.”
currencies with the least volatility. On the other hand, the Indonesian rupiah is probably going to suffer given that Indonesia has not made sufficient progress in reducing its current account deficit while the high level of foreign holdings in its local debt markets is also a concern.

**Do you think investors are right to be enthusiastic about India and its economic reforms?**
India was considered one of the “fragile five,” along with Indonesia. But in India’s case we have seen a significant improvement in the macro conditions. The current account deficit was running at 4.8% of GDP in FY2013. But this year we think it will come close to 1.5% of GDP. At the same time, real interest rates are rising in India as inflation has been surprising on the downside. So we do think that India is going to be a lot less vulnerable, and we are positive on India for cyclical reasons.

But the prospects for reform are also a tailwind. Growth is now the highest in two years and in the months and years ahead, Prime Minister Modi’s reforms should support the manufacturing sector and foreign direct investment. Over the medium term, measures are now being put in to improve the flexibility of the labor market, and reduce red tape, which should help unleash productivity gains.

**Do you think that in 2015 we will start to see some genuine growth in Japan, or is it still going to be all about the Bank of Japan?**
We have seen recently how important the BoJ is, and it will provide a key support to export competitiveness and corporate earnings. However, we think that private sector demand is also going to be stronger in 2015. Consumption should recover because of better employment and wage conditions. Tourist spending is picking up ahead of the 2020 Olympics. And because of the tight labor market, spending on labor-saving equipment is also showing signs of improvement.

The key risk for Japan is likely to be the decision on a further VAT hike from 8–10%. If this transpires, we think there would be some sort of offsetting fiscal package. But obviously given the impact of the VAT hike this April, it is a risk event that one has to watch out for.
Growth continues in 2015

The APAC region is on track to deliver real GDP growth of 5.7% in 2015, similar to 2014.

<table>
<thead>
<tr>
<th>Country</th>
<th>2014 GDP Growth</th>
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<tr>
<td>Australia</td>
<td>3.1%</td>
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<tr>
<td>China</td>
<td>6.8%</td>
<td>5.5%</td>
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<tr>
<td>Japan</td>
<td>5.3%</td>
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<tr>
<td>India</td>
<td>1.1%</td>
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<td>South Korea</td>
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<tr>
<td>Asia Ex-Japan</td>
<td>3.3%</td>
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**CHINA**

Policymakers will be under pressure to both reform and re-energize the economy. *Risks lie in the property sector* – prices are falling in almost every city.

**INDONESIA**

After the election, focus will turn to tackling bureaucratic inertia, and cutting fuel subsidies. We are cautious on the rupiah.

**JAPAN**

The Bank of Japan’s continued easing will provide a good backdrop for Japanese exporters.

**THAILAND**

Political instability continues. Public spending is likely to be a key driver of growth in early 2015.

**INDIA**

India is exhibiting promising reform momentum and earnings momentum is improving. We are overweight Indian equities and the rupee.

**TAIWAN AND KOREA**

External demand, from the US in particular, should support exports. We prefer Taiwan due to greater exposure to electrical exports.

A stronger US dollar will have an uneven impact

- The Chinese yuan and Taiwanese dollar will prove most resilient.
- Investors with Indonesian rupiah exposure should consider hedging against downside risks. Its bond market is more than one-third foreign owned.

Source: Bloomberg, UBS
Emerging markets

Changing gears.

Jorge Mariscal.
Head of Emerging Markets Investment Office
CIO Year Ahead 2015

The diverging world means unevenness in global growth. What does this mean for the emerging markets?
The fact that Europe continues to be quite weak has implications not only for emerging Europe, but also for emerging markets as a whole due to the impact on commodity prices. The monetary policy response to try and arrest deflationary pressures isn’t likely to help emerging markets much, given how low yields already are. So I’m afraid the emerging markets might feel a lot of the downside of lower growth and commodity prices, but not necessarily a lot of the benefits of loose monetary policy.

At the Year Ahead Investor Forum there was a lot of discussion about what a stronger US dollar and higher yields might mean for emerging markets in 2015. What’s your perspective?
Interest rates are often seen as the bogey man for emerging markets, but I disagree. I think that if higher interest rates come together with global growth, this isn’t necessarily bad. Emerging markets did quite well back when the US 10-year yield was at 6% because growth was strong, and commodity prices were supported. So it’s not the level of interest rates we should be worried about, it is the combination of high interest rates with potentially low growth.

It’s similar with the dollar. If the dollar rises because there is strong US growth alongside relative stability in Europe and China, the effects can be more or less digested. But if the dollar rises because we have a flight to quality, then of course all bets are off and emerging market currencies and emerging market assets will be under pressure. So the growth context is important and risk appetite is important.

We hear a lot about emerging market reforms. Is this something we should take seriously? When will we see the returns? It is early days, but the hope for the next 5-10 years is that reforms will inject a new degree of competitiveness. Emerging economies have to shift gears and rely less on an export-oriented model. They have to free productive forces at a domestic level, attract foreign direct investment, promote domestic investment, create incentives for market mechanisms to work better, and foster a more inward-looking, self-reliant growth.

The historical drivers of growth will not be there to the extent that they were in the past, so it is an economic necessity to move in this direction now. These changes will take some time, and in the short term they could have a negative impact on some large companies. But the payoff could be quite significant in the medium and long term if these reforms are executed properly.

The diverging world also means higher geopolitical risks. Do these risks make Russia uninvestable?
Not yet, but it seems to be moving in that direction. The sanctions are designed to have greater and greater bite as time goes on, so companies will increasingly find it difficult to refinance their debt and access international capital markets. Liquidity has been declining and the appetite among dollar investors for Russian assets in general has been diminishing. Unfortunately we don’t think that there is going to be a quick resolution, and so the trend is probably going to continue that the market becomes less and less investable over time.

Many countries in Latin America seem to be suffering from high inflation and low growth. Is this a return to the 1980s or can we be more optimistic?
For the region as a whole, we are not going back to the stagflation years, but it’s a bit like the old spaghetti Western – the Good, the Bad, and the Ugly.
“Emerging economies have to shift gears and rely less on an export-oriented model.”

and the Ugly. The Good are countries like Colombia, Chile, Peru, and Mexico, where the macro framework remains quite solid. Inflation is below 5%, deficits are relatively low, the overall drivers of growth are more or less sustainable, and a fair amount of structural reform is on the way. Then you have the Ugly, which are countries like Argentina and Venezuela, where the macro framework has been lacking for some years. Fortunately, I believe that these are outliers. And then you have the Bad, which is primarily Brazil. They have had moderately high inflation and in the past two quarters have been immersed in recession.

The election was a close enough call that the government will have to listen to what the voters are saying – the people in Brazil want change. So I suspect we are going to see some adjustments ahead, but they are likely to be marginal. Brazil needs a big overhaul. Its large government is very bureaucratic, very interventionist in the setting or influencing of prices and credit allocation – and that affects entrepreneurs’ willingness to invest. Brazil has among the lowest investment-to-GDP ratios in the emerging markets, and that is not an accident. The second Rousseff government will have to review its approach.

On aggregate, emerging market equities are cheap relative to the developed world. Is cheap really cheap enough?

Probably, but that in itself is not what is going to trigger performance. You need a catalyst, and the number one catalyst for me would be a turn in the earnings outlook. Emerging market earnings had shown some signs of stabilizing, but the decline in commodity prices is likely to provide an additional negative.

While we wait, we need to remember that there are “new emerging markets” hidden within the “old” emerging markets. There are those sectors and companies positively impacted by the economic demands of the growing middle class in areas like healthcare, education, public infrastructure, electronic retailing and information technology. The old economy companies, which unfortunately are the largest weights in benchmarks, are likely to remain cheap until we see a strong global cyclical pickup. The new economy companies are not so cheap, but have been growing earnings rapidly and are probably going to continue doing quite well. So you have to be selective and look under the hood when you look at the emerging markets, because the benchmarks themselves do not present all the opportunities that are available.
Growth in emerging markets will be uneven in 2015

- Growth is primarily coming from Asia, which we expect to grow at 5.7%. LatAm is expected to grow 1.4% and EMEA 2.4%.
- Growth in countries actively pursuing economic reform, such as Mexico and India, should improve.
- Growth in China and Russia will slow, and Brazil will remain weak.

Relatively cautious on the outlook for EM equities

- Corporate profitability is weak. Earnings have been stagnant for more than three years.
- The sharp declines in commodity prices and US dollar strength are unlikely to be helpful.
- Investors in emerging market equities will need to be selective.

Parts of EM will benefit from US economic growth

Countries most leveraged to cyclical exports to the US stand to fare well. Taiwan in particular is highly leveraged to exports of electrical machinery, including semiconductors.

The “new emerging markets” exposed to reform will also perform better

- We are overweight Mexican equities, after the country approved a transformational reform package in 2014 that is expected to bear fruit in 2015.
- India is also exhibiting promising reform momentum and earnings momentum is improving. We are overweight Indian equities and the rupee.

Russia

Financial sanctions will have an increasing effect over time and reduce market liquidity.

Brazil

Following the election, business and investor confidence is likely to remain weak, and inflation high.

China

Reforms may be positive in the long run, but will have a negative short-term impact on growth.

Source: UBS
Once again, toward the end of 2014, we saw a sudden resurgence in market volatility that it seems no one saw coming. Why do you think this happens?

Plain and simple, we need to be conscious that forecasts are usually more wrong than right. We have so many examples of blunders in forecasts. Maybe the biggest forecast error ever made was by noted economist Irving Fisher, who claimed in September 1929 that “equities have reached a permanent plateau.” More recently we had Federal Reserve Chair Ben Bernanke saying in 2008 that he thought the economy would be better in the second half than in the first half.

So it shows you basically that we don’t know a lot about the future, and it seems quite impossible for us economists to correctly forecast a recession. So don’t rely on forecasts too much when you build your investment strategy.

Despite this, many people still do. There’s this anecdote by Kenneth Arrow, a Nobel Prize winning economist, which shows this phenomenon well. In World War II he was working as a statistician at the US Army weather office. He was looking at weather forecasts thinking, “they’re always wrong, so why are we doing them?” He decided to write a memo to his superiors saying, “We put a lot of money into these forecasts and it’s not worth it.” The reply came back, “We all know the forecasts are wrong. But we need them for planning.”

It’s amazing, these human biases mean that even if you think the forecasts you use are wrong, they give a sense of security.

Why do you think we see these behavioral biases occurring?

Most of the time these are emotional. People can actually act irrationally quite a lot of the time.

It’s something that two famous psychologists, Kahneman and Tversky, have done a lot of work on. They show that despite the fact that we all think we are rational beings, we do a lot of things without reason. We often act based on intuitive “heuristics” in our brain so we can act and think very fast. This is something that served us well when we were cavemen, but doesn’t serve us so well in this complex world.

Slower thinking usually leads to more rational decisions, but thinking can be very painful! Many people are attracted to thinking quickly, and it is basically unavoidable unless you have a clear, disciplined strategy, and always think twice and think slow before you make investment decisions.

Behavioral finance has developed a lot in recent years. What are the best ways for investors to avoid these biases?

If you look at successful investors, they have sound analysis, strategy, and discipline.
"If you look at successful investors, they have sound analysis, strategy, and discipline."

I always use the two examples of Warren Buffett and George Soros. Warren Buffett is a guy who has a strategy you can summarize by saying, “I buy things I understand, and I find cheap.” George Soros looks to invest against large macroeconomic disequilibria, and eventually expects the economy will go back to this equilibrium.

These are completely different approaches to investing, but both lead to success. So it’s not the approach they have in common, it is this combination of analysis, strategy, and discipline. They have sound analysis – if Buffett buys a company he knows exactly what he’s buying; if Soros is playing against a currency, he’s done his homework and knows there’s a problem. They have a strategy. And, most important, they stick to it; they have discipline.

For example, in the late 1990s, Warren Buffett was not heavily invested in internet stocks, and his portfolio was underperforming the market quite substantially. But ultimately he was right and he didn’t suffer in the crash in 2000 and 2001. His strategy was that he did not invest in things he didn’t understand, and ultimately it worked.

How can private clients employ an approach of analysis, strategy, and discipline?

The analysis part we are very happy to help with in publications like this, and with the work we have done looking at the best combinations of assets to help improve returns relative to risk. For strategy, this is something personal to every investor and everyone needs to consider both their financial objectives, but importantly also their tolerance for risks. Then the discipline bit is the hard part. Investors need to try and avoid making sudden changes to their strategies based on emotions when, for example, markets get volatile, or when certain assets or sectors look hot. Sudden shifts based on “quick thinking” can really hurt performance over the long run.
At a glance.

2015 is likely to see the Fed tightening, and this means volatility may go back to historical levels.

Portfolio returns are likely to be lower than those historically, due to the low level of yields across asset classes.

Higher allocations to hedge funds should help improve portfolio risk-adjusted performance.

Next year could be one when we get back to much larger performance differences between asset classes.

We are overweight US equities and US high yield credit.
How is the investment environment in 2015 likely to be different from recent years?

MP: One main difference is that we expect the US central bank to tighten in 2015. There was some implicit tightening in 2014 due to the lack of new easing, but in 2015 we are likely to see the first rate hike. And that means that volatility across asset classes should move back towards historical levels. This makes a balanced portfolio much more important, because if you have exposure to only one asset class, even if it is a good one, you may get a lot of unpleasant days or months.

Another thing that is different is that equities simply do not have as much upside as they had two or three years ago. People need to have realistic expectations about return, but also about volatility relative to return. In 2013, many asset classes generated very high returns with very little volatility. In 2015, we expect to see lower returns but for volatility to be more elevated. It will be a significantly more risky environment.

MA: It’s important to look at some of the similarities as well. While we expect yields to move up a bit, overall interest rates and yield levels on government and corporate bonds are extremely low, so it is still a generally supportive environment in terms of investments as we enter 2015. While the Fed might be tightening, we are currently in a diverging world, so we will not experience synchronized global tightening. We also enter 2015 with some of the same structural questions about growth in China and some of the emerging markets that we entered 2014 with.

Bond yields are close to all-time lows, and global equities have performed well in recent years. What can investors expect of return on a diversified portfolio from here, for 2015 and beyond?

MP: It depends on how much risk investors are willing to take, but for a well-diversified, balanced portfolio, we’re looking for a return of 4–6%. This return is lower than it has been in recent years, and that is because of the low level of yields we’re starting with. Something we’re doing to try and increase returns is looking to invest more in hedge funds – they are relatively stable in return and volatility, and represent a good substitute to some bonds which are offering low returns.

MA: Importantly for more conservative investors is that long-term real returns are not likely to be much more than...
1.5% to 2.5% per annum. Even if inflation is low today, even a small increase could easily make real returns for fixed income investors negative. If investors can tolerate the extra risk, a balanced portfolio of equities, hedge funds, and bonds offers a better risk-return profile.

“As market volatility gets higher, a balanced portfolio becomes much more important.”

What are key risks to diversified portfolios in 2015?
MP: For me, a key risk would be inflation. For now, we don’t see it with commodity prices under pressure. But for diversified investors it is one of the biggest risks. If we saw a persistent rise in inflation above central bank targets, it would push up yields for bonds, and would at least initially be negative for equities too. Anything that pushes down equity and bond prices at the same time is bad for diversified investors.

And it might sound relatively obvious, but growth falling or an outright recession are risks too. Normally, in a slowdown, diversified portfolios get some insulation against declining equity prices, since bond prices rise in anticipation of interest rate cuts. But today, with interest rates and yield levels already so low, there is less room for them to go down.

Thinking more tactically, we’ve been talking about a diverging world. Do you think we’re going to see a diverging world in market performance in 2015?
MP: I expect to see much higher dispersion. One of the difficult things about doing tactical asset allocation in 2014 has been that for most of the year, most asset classes, ex commodities, have given similar returns, so there hasn’t been so much to play relatively. Next year could easily be a year when we get back to much larger differences between asset classes.

At our Year Ahead Investor Forum there was a lot of discussion about which asset class might deliver the best return per unit of risk in 2015. What is your view?
MP: With current levels of spreads, we think high yield credit looks interesting, even if it delivers lower returns relative to risk than it has over the past few years. More conservative bond investors who don’t want high yield can look to medium-duration investment grade. We think it is better to be short-duration and lower in the credit spectrum, for example medium-duration A-rated bonds, than to be long-duration high in the credit rating, for long-duration AAA-rated bonds.

MA: My top pick would be US high yield for the highest risk-adjusted return, followed by equities or hedge funds. I find it interesting how critical the investor community has become on lower-rated credit, when corporate balance sheets remain very strong, companies have funded themselves at low yield levels, and only have a small amount of maturing bonds in the coming years. I think this represents an opportunity for those who do not have allocations to US high yield credit.

Where should investors turn for equity market returns? The US has high growth but tightening policy. The Eurozone has weaker growth but loose policy. Then there’s EM, which has slowing growth and potentially tighter policy, but is cheap.
MA: Pretty much all “value” markets are cheap for a reason. We’d put emerging markets, Europe, and to an extent, Japan, in that category. Of these markets, the Eurozone is probably in a better position, as some of the structural issues have been addressed over the past few years and we have a European Central Bank that is very willing to support an economic recovery. In Japan it is very difficult to predict what is going on, since it’s all a bit of an experiment. For the emerging markets, there is a longer deleveraging story at play, and commodity prices are falling, which is bad for a number of them.

MP: The safest bet of all of them is the US, and this is why it is our biggest overweight. It is a much more stable market and has a solid earnings growth picture. The US is where I’m most confident we’ll get positive returns. It probably isn’t the market with the highest potential upside, but the central bank has flexibility, and the companies have very easy financing and very good cost control.

Central bank flexibility is an important factor. I think there is much less risk in the US and the UK, because you have a unified dovish central bank with relatively high yields. The European Central
Bank is not so united at the moment, but we could be at an important inflection point. If inflation in Germany is lower than people expect next year, there is very little room left before it actually becomes outright deflationary. This could encourage the Germans to buy their government bonds and do outright quantitative easing.

In EM, you have a mix of local central banks and US-influenced central banks with diverging goals, and they don’t have the kind of flexibility you have in the rest of the world.

What does a stronger US dollar mean for portfolios, and how should investors think about currencies in general?

MA: We recommend that investors try and hedge the largest parts of the FX exposure in their portfolio, particularly in fixed income. You don’t want to take currency risks that you’re not being compensated for. We think we are in for a period of US dollar strength and we would not be surprised to see the US dollar being one of the best performing currencies in 2015.

MP: It’s simple. If you have a strong view in FX, play it in FX. Don’t play it implicitly.

How should investors think about sustainable investing in their portfolios?

MP: They should think about impact investment and sustainable investing as a part of an existing asset class. For example, if it is a private market investment, it should be a substitute for existing holdings in private markets and hedge funds. Impact investing is a relatively a new marketplace, so investors need to do things gradually – there is a lack of available product, so it is better to spread it around. If people want to do things Gates or Buffett-style they need to take the same amount of time that these people took. It’s not good to rush in, better to build up exposure over a number of years.

“Something we’re doing to try and increase returns is looking to allocate more to hedge funds.”
Themes
Thematic investing.

Andrea Fisher. Investment Strategist

Which themes are you most excited about for 2015?
There are two. The first has to do with the revolution that is underway in the treatment of cancer, which is a real game changer. As our Healthcare Sector Strategist Jerry Brimeyer explains, a better understanding of the immune system and the biology of cancer cells has led to the discovery of new immunotherapies, which are more targeted and appear to be more effective when used in conjunction with traditional methods. This is a really exciting development and is one of our top themes right now. The commercialization of these new therapies represents a multi-billion dollar sales opportunity for the companies developing them. We’re looking for companies active in cutting-edge cancer research, with drugs in development that have a high probability of clinical success, and trading at valuations that do not yet fully reflect the opportunity.

Another theme for 2015 is the continued rebound in US business investment spending. In the US, economic momentum is positive, business confidence is higher, existing plant and equipment is old and needs to be replaced, and low-cost funding is still widely available. According to Jeremy Zirin and our Equity Strategy Team, all these factors are supportive of a pick-up in spending. Capex is highly pro-cyclical, which means when the economy is expanding business investment tends to expand at an even
higher rate. And right now, we’re forecasting the US economy to expand by a little over 3.0% and capital spending to grow by nearly 8%. We think the companies and segments of the stock market most leveraged to growth in capital spending will outperform the S&P 500 in 2015. This includes industrials and technology sectors, which benefit from business spending as well as the financials sector, which provides the funds.

Are there any long-term themes you are looking at?
North American energy independence is a great thematic opportunity espoused by our Energy Sector Strategist Nicole Decker. Since 2008, US crude oil production is up by nearly 50%, a significant turnaround after a declining trend that lasted almost four decades. In fact, US production is now in line with some of the world’s largest producing nations. While oil prices can be volatile – a risk to this call that was evident in the recent sharp decline in oil prices – we think there is a long-term shift underway in favor of a more stable energy future for the US, which provides a number of investment opportunities.

First, abundant natural gas supplies have pushed prices to low levels in the US compared to other major gas-consuming regions of the world. This creates a competitive advantage for companies involved in energy-intensive operations. Second, the rapid growth in production in the US and western Canada is good for those producers, but has also created infrastructure bottlenecks. So more transportation, processing and storage capacity are now needed. Third, policy initiatives are focused increasingly on ways to encourage US consumers to conserve and use fuel more efficiently. So there’s also an opportunity for companies focused on developing renewable fuels as well as those making equipment that enables more efficient production and use of energy.

What are you looking at outside of the US?
We think the reform story underway in Mexico is very compelling. The reforms recently passed are a pretty big deal because they open up the economy to private investment and encourage competitiveness, along with increased regulation and oversight. While the legislation is wide-reaching, the overhaul of the energy and telecom sectors should have the biggest impact on GDP growth. The Head of our Emerging Markets Investment Office, Jorge Mariscal, and team think the reforms could add 0.75 to 1.75 percentage points to Mexico’s long-term GDP potential.

This is a long-term story, but we’re expecting a positive performance

“At a glance.
A better understanding of the immune system and the biology of cancer cells has led to the discovery of new immunotherapies. This represents a multi-billion dollar sales opportunity. North American energy independence represents a good thematic opportunity across the value chain, from investing in transportation, processing and storage capacity, to creating a competitive advantage for energy users. 2015 will also be an important point in the Mexican reform story.

We are living in a world shaped by changes; technological advances, revolutionary discoveries and economic forces.”
divergence in Mexico versus other emerging markets in the near term. The country is benefiting from stronger manufacturing activity due to ties with US, higher levels of government spending and better labor market conditions.

We also think 2015 is an important point in the reform story. Now that the reforms are signed into law, we expect new business opportunities to emerge and foreign direct investment to flow in, particularly in energy infrastructure projects.

**What are the benefits for clients of investing in themes?**

Thematic investing is a very interesting approach because it provides exposure to powerful stories that resonate with investors. We are living in a world shaped by changes; technological advances, revolutionary discoveries and economic forces. We think that by expanding exposure to these developments, investors gain access to a richer opportunity set for creating value. And because each theme is unique and has different risk and return drivers, incorporating them into a portfolio can result in a better-diversified set of investments.

**What would you say are the main risks to this approach?**

The risks associated with thematic investing are really not much different than any other investment. Unexpected geopolitical or macro developments are always a threat and can weigh on investor sentiment to different degrees. There’s also the risk that theme drivers do not play out as expected. One final point probably worth mentioning is that some themes have long-term drivers that may be dominated by near-term factors, and might require patience.

**How should investors think about investing in thematic ideas in the context of an overall portfolio?**

One way investors can view thematic investing is as a way to personalize portfolios by gaining exposure to stories they believe in. Additionally, it can be thought of as a way to expand the opportunity set and diversify portfolios. Because each theme has different considerations, I don’t think there is a “one size fits all” investment approach. Some themes can be carved out of core portfolio holdings and held for a longer time period, while others may be riskier or more narrowly-focused, and consequently may be more appropriate as a satellite-type of investment.
Capex rising…finally

- Capital expenditures have been weak in recent years – spending has lagged other measures of activity and equipment is now aging.
- Today, corporate America is finally beginning to loosen its purse strings and invest: global growth is picking up, companies have ample access to low cost funds, and global M&A is accelerating.
- Financial, industrial, and technology companies stand to benefit from this trend.

Commercial mortgage-backed securities

- Commercial mortgage backed securities are bonds collateralized by commercial and multifamily real estate loans.
- The fundamental backdrop is supportive: a strong economic recovery has led to increasing commercial real estate prices, delinquencies are falling, and underwriting quality has improved.
- An allocation shift out of investment grade corporates and into CMBS offers the opportunity to decrease duration, increase credit quality, and pickup incremental yield.

Benefit from reform in Mexico

- Mexico has approved an ambitious reform agenda, which should boost GDP growth by 1–2% per annum. This should translate into stronger corporate earnings growth.
- In addition, Mexico’s cyclical position should be boosted by higher government spending, reactivation of consumption activity, and higher manufacturing and industrial production growth thanks to its close links with the US economy.
- We also expect a stronger peso.

North American energy independence: reenergized

- Energy extraction techniques of horizontal drilling and hydraulic fracturing have encouraged widespread development of America’s energy resources.
- Relatively inexpensive natural gas will create a competitive advantage for the US. We expect this to spur a manufacturing renaissance through the repatriation, relocation, and expansion of energy-intensive industrial operations.
- North America will likely achieve energy independence by the end of the decade, and the US will also become a net exporter of natural gas later this decade.

Major advances in cancer therapeutics

- A new wave of advanced cancer therapeutics is rapidly emerging, significantly increasing the sales potential of several new cancer agents.
- A better understanding of the immune system and cancer cell biology has led to more targeted immunotherapies – a treatment option that specifically interferes with molecules involved in tumor growth and progression. Pairing this approach with treatments can increase survival rates with a prolonged, better quality of life.
- Breakthrough therapies will permit much more effective cancer therapies to penetrate and expand the cancer therapeutics market. We see an investment opportunity in the pharmaceutical and biotechnology companies conducting cutting-edge cancer research with promising molecules in advanced stages of development.
Longevity planning is a comprehensive approach to reflect the realities of how our clients tell us they want to live in their 60s, 70s and beyond.

Today an average 65-year-old couple has a 50% chance that one member will live into his or her 90s. This should be addressed head on, possibly through hedging with guaranteed income products.

Younger generations need to consider their “human capital,” or the present value of their future earnings when making decisions with their financial capital.
What is longevity planning?
Longevity planning is a comprehensive approach to reflect the realities of how our clients tell us they want to live in their 60s, 70s and beyond – how they prepare for a retirement period that lasts 30 to 40 years in many cases.

Some of those issues are financial. We know from survey data that spending tends to go up early in retirement based on higher levels of travel and maybe other discretionary expenses that were postponed during employment. Then they start to decline during a client’s mid-70s. We also know that many individuals continue to work part-time or even have a second career in their 60s.

But many of the other issues that go into longevity planning are not financial – such as thinking about where you are going to live, who is going to help you with home repairs and maintenance, transportation, and who you are going to socialize with, especially if one spouse passes away.

These kinds of factors might not be touched upon in traditional retirement planning.

I assume that the increase in life expectancy has made planning more difficult...
Life expectancy data is very interesting. For a 65-year-old in a developed country, median life expectancy has jumped from 13 years to 15 years to 20 years between 1940, 1970 and 2010 respectively. Those are pretty impressive gains. But probably the most important change is in the distribution of mortality.

For example, 50 years ago, a 65-year-old faced roughly an equal probability of death every year until the age of 85. At that point, 90% of their peers had passed away. That is no longer the case. Today an average 65-year-old will have a 30% chance of living into his or her 90s. If you maintain a healthy body mass index, don’t smoke, and drink responsibly, that probability jumps considerably.

What is the impact of that for individuals when they are planning for their life following work?
When people think about planning for post-career life, they tend to think about issues like inflation decreasing their purchasing power, market returns not being suitable to grow their assets, or whether or not they are spending at a safe rate.

But based on our Monte Carlo modeling of retirement, we have found that the largest risk that a household faces during retirement is longevity itself. The other factors certainly matter, but uncertainty over how long household members will live presents a substantial challenge. It is something that we think should be addressed head on, possibly through hedging with guaranteed income products, like pensions or annuities, or handled less explicitly in the process by assuming that the members of the household will live well into their 90s and possibly to 100 or beyond.

Given the large cohort of baby boomers now reaching retirement and possibly demanding annuities, is this impacting asset prices and returns?
Not so far as we can tell. One might think that as the older cohort grows larger relative to the rest of the population, bond yields would go lower based on that demand for safe assets, or that equity valuations would be lower because they are moving out of equities and into fixed income. But there is really very little historical evidence that the shift in the population cohort affects returns. One reason could be that we live in a global market. We have the baby boomers moving through a lot of developed markets, but investors in emerging markets continue to diversify into US assets.

That said, it is fair to point out that pensions were a pretty big buyer of Treasuries in the United States this year, and it looks like they will continue to do so, based at least in part on demographic trends. So I would say we need to wait and see whether the boomers are a big enough cohort to really make a difference.

Is longevity something that the younger generation should be thinking about when they are making their investment decisions today?
Absolutely, and key to this is the concept of “human capital,” which is really just another way of saying the present value of future earnings.

The younger generation, or “millenials,” will almost inevitably have longer working time horizons due to increased longevity. If they are going to work longer, the current value of future earnings increases, and it means that the vast majority of many “millenials’” wealth is actually tied up in their “human capital.”

There are two implications to that. One is that they should hedge their human capital. That is generally done through insurance products, like disability or life insurance. The second is that they should consider their financial investment accordingly. If they are in a career that provides a relatively stable income where the income could be seen as somewhat bond-like (e.g. a professor or a doctor), that would mean that they should invest more of their financial capital in equities to diversify that income stream. But if they are in a career that has an income stream that is more stock-like (like an entrepreneur), then they would want to invest more of their financial assets in bonds to offset that inherent market risk.
Sustainable investing
A coming of age.

Stephen Freedman. Head of Cross Asset Strategy

What does sustainable investing mean?
We define sustainable investing as a group of investment approaches that fulfill at least one of three types of goals, or often a combination of them. One motivation is to improve a portfolio’s return and risk characteristics by better understanding how sustainability factors impact the value of securities. A second one is the desire to achieve a positive social or environmental impact through investments. Finally, the desire to align the content of portfolios with an investor’s personal values is a third possible motivation.

The concept of sustainable investing has been around for some time now. How is it developing?
We are seeing considerable growth in the interest in sustainable investing. This is coming as a result of a change in expectations throughout society and among different stakeholders of companies such as consumers, employees, investors or regulators. There is a growing realization that there are some global challenges, which the corporate sector can and must solve. This is forcing a focus on sustainability.

What are the different approaches to sustainable investing?
The traditional approach to sustainable investing is what we call an “exclusionary approach.” Here, an investor
determines what type of activities he or she would like to exclude – very typical areas would include alcohol, weapons, tobacco, or pornography. Then firms engaged in those activities are excluded from a portfolio. This approach traditionally has been used a lot by faith-based investors over time.

But the evolution is going more towards approaches that are focused on integrating the analysis of environmental, social and governance factors into portfolio decisions. And here the idea is to combine the understanding of those factors together with traditional financial considerations that determine the value of securities to obtain a fuller picture.

A third approach which is worth highlighting because it is also growing, albeit from a lower level, is called impact investing. Here, the predominant objective is to have a positive and measurable impact on either society or the environment. This can be done through a variety of structures, including private equity or through lending-based solutions such as variants of microfinance.

**When you look at impact investing, is there a choice to be made between social gain and financial returns?**

As far as investing in financial markets and liquid investments are concerned, the evidence that has been gathered for the last 30 years does not seem to indicate that there is any trade-off between investing in a sustainable way and financial performance over full market cycles.

As far as impact investing is concerned, it is hard to generalize, because everything is very deal-specific. Some deals can offer very competitive returns, while for others there may be an explicit intention to accept a somewhat lower rate of return in exchange for having a stronger social or environmental impact. It has to be looked at on a deal-by-deal basis.

**How do you measure the success of a sustainable investment given that it has these dual objectives?**

It is important to realize that sustainable investing is not the same as philanthropy – financial returns still matter and should be measured in the traditional way. As far as the social and environmental impact measurement is concerned, it gets more complicated, but it is important to focus on investments where you have the ability to track some kind of number. For example, if you have an investment opportunity that is focused on education, you may want to track the number of students that are graduating from a program.

**What are the risks you see in sustainable investing?**

The risks depend on the approach. For instance, if you are using an exclusionary approach, there is always a question of how strictly it is going to be enforced. If the threshold is too strict, there is a risk that a portfolio becomes too concentrated in some industries, leading its risk-return behavior to become inferior to a more diversified portfolio.

In the case of the integrated approach, there is a risk of style bias. Often you end up with more small-cap exposure, where growth or quality factors are more prominent. That is not necessarily good or bad, but it does mean that depending on the phase of the market or business cycle you are in, such a portfolio may outperform or underperform relative to a standard benchmark.

Finally, a third risk may arise when investors try to embrace a more thematic approach to sustainability, focusing on such things as water or energy efficiency. Those are investments that can be quite attractive, and they are quite intuitive because there is a well-defined story behind them. But when taken in isolation those investments can be relatively risky, and there is also a danger that they may become overcrowded if a particular sustainability theme grows very popular. It is important to look at those in the context of an overall portfolio, making sure there is no excessive concentration on any one particular theme.
What do you think about when you look ahead in hedge funds?
Given the continued lower-return, lower-yield environment, I think it’s still important for investors to look for alternate sources of return. Some might have been disappointed with the performance from some funds in 2014, but it’s important to remember that hedge funds have exposure to many factors beyond just equities, so in any given year, hedge fund performance won’t necessarily align with equities. I think it is most important to evaluate risk-adjusted returns in a portfolio context over a multi-year horizon. That way, I’m confident that hedge funds will prove beneficial to most investors’ portfolios.

How should investors think about including hedge funds within their portfolio?
Overall, I think it’s important that investors keep their hedge fund exposure balanced across strategies, to avoid performance being overly dependent on or subject to a limited number of return drivers. Some of the unique and attractive features of hedge funds result from their exposure to non-traditional factors such as illiquidity or volatility risk. These drivers deliver attractive risk-adjusted returns most of the time, but they are also asymmetric and can add tail risk to portfolios. Of course, there is also always the risk that individual managers fail to deliver against performance expectations, whether because of poor risk management or judgment.

We’re in the process of introducing several analytical hedge fund tools, looking at systemic risk, liquidity risk, business cycle risk and market volatility. This “Hedge Fund Navigator,” as we call it, helps assess to what degree current market conditions are supportive or not of hedge fund investments. But the best way to minimize negative portfolio impact from these risks is to diversify. We will at times recommend tilting this balance in favor of certain styles and away from others in order to capture observed or anticipated market dynamics, but always recommend doing this within a portfolio context. For example, we currently have a cautious view on macro hedge fund styles overall, and would recommend a lower-than-normal allocation to these funds, but generally not a zero allocation.

After a disappointing few years, it seems like macro funds have started to perform better recently. Is this a sign of a turnaround?
Indeed, since August, the style has begun to show outperformance thanks to some of these diverging world trends we’re seeing in currency, commodity and fixed income markets. The backdrop is clearly improving for discretionary thematic managers, who should be able to capitalize on currency and rates trades arising from increasingly
divergent central bank policies. On the other hand, we maintain the view that many trend-following systematic strategies will continue to struggle. The historical reliance on fixed income exposure will no longer be a tailwind, and we believe most will not deliver consistent performance.

What are the most compelling opportunities within private markets?
One key theme that we continue to favor is European bank deleveraging. Following the asset quality review, we still think that European banks will continue rationalizing balance sheets and lending activity. This creates several types of opportunities for investors. First, as banks sell off non-performing loans or assets, opportunistic investors who have the expertise and platform to service and work out these investments will benefit. Selected and priced appropriately, these investments offer returns that should be less market correlated and cannot be found in liquid markets. And second, as European banks structurally reduce and refocus their lending activity in coming quarters, this dynamic creates a funding gap that alternative lenders are increasingly filling. Alternative lending solutions can be short or long term depending on the situation, but given that managers select, conduct due diligence and negotiate pricing and terms for these credits directly, this should improve downside protection.

What else in private markets are you excited about for 2015 and beyond?
In general, we look for opportunities whose returns should be less correlated to markets. Our objective is to identify ideas where managers have a proven ability to have tangible strategic and operational impact on investment outcomes. Given current valuation levels, we have a somewhat less favorable outlook on broad-based generalist buyout strategies, though we know that the smartest managers are being cautious about deploying capital and focusing instead on harvesting investments. Instead, we are focused on identifying what we characterize as more “niche” opportunities, where return drivers are largely uncorrelated with markets. We look forward to sharing a few specific ideas in the near term. Of course, clients should evaluate and apportion such investments appropriately.
We believe investors holding a well-diversified strategic asset allocation of equities, bonds, and alternatives, stand the best chance of navigating the diverging world successfully, with comparably low levels of volatility.

In the context of a well-diversified portfolio, we also currently recommend a number of tactical deviations to take advantage of some of the shifts taking place in this diverging world. In particular we overweight US equities relative to UK and emerging market equities, and we overweight credit relative to government bonds. In currencies we recommend overweight allocations to the US dollar and British pound relative to the euro and Swiss franc.

Please note that this tactical asset allocation positioning is accurate at the time of writing, November 20. Please consult the latest UBS House View for updates.

*Investment grade corporates are overweight in non-taxable portfolios but underweight in most taxable portfolios.
Long-term, strategic view

Equities
Valuations are no longer cheap, but corporate earnings growth should be sufficient to drive mid to high single-digit per annum returns over the medium to long term. These returns are attractive compared with other asset classes, even if they are lower than in the recent past, and come alongside comparably high short-term volatility.

Bonds
Yields are low by historical standards, and so bonds are no longer likely to be a major driver of returns for portfolios. However, we believe they will continue to provide portfolio stability during periods of equity market volatility. Bond investors increasingly need to look to credit as a source of return.

Alternatives
Alternatives play an increasingly important role in providing returns which are lowly correlated with bonds and equities. As equity and bond returns moderate, returns from alternatives may appear comparably more attractive. Hedge fund managers may be well placed to take advantage of the diverging world.

Currencies
In general, it is important for investors to hedge their foreign investments back into their domestic currency. Most currencies, over the long run, tend to add noise to portfolio performance without providing extra returns.

Short-term, tactical view

We prefer US equities over emerging market equities. US equities have superior earnings growth, and the US economy is demonstrating solid growth. Emerging market corporate profitability is weak, and equity markets there may be more vulnerable at times of volatility.

Bonds
We prefer credit over government bonds. With government bond yields low, we believe investors should seek higher yields in investment grade and US high yield credit. Both should be supported by the solid economic backdrop in the US, and low funding costs.

Alternatives
Within hedge funds, equity long-short funds should stand best placed to take advantage of a diverging world, and provide exposure to positive performance in US equity markets. Within private markets, private debt offers complementary exposure to existing credit holdings, and we like long-term energy infrastructure exposure.

Currencies
We currently see tactical opportunities in the US dollar and British pound, relative to the Swiss franc and the euro. The diverging world will see monetary policy taking different paths, with higher rates in the US and UK in 2015, while the ECB eases further.
We believe an environment of solid growth in the US and monetary policy which is loose by historical standards should prove supportive of equities in 2015. We expect global earnings growth of circa 8%, and global valuations of 16.6x trailing earnings are slightly below long-run averages.

We recommend an overweight allocation to equities relative to government bonds.

2014 so far

Equity performance was positive in 2014, with steady performance upset by three periods of volatility, related to concerns over emerging markets, geopolitics, and global growth, respectively. Overall, the US and Switzerland performed best, and the Eurozone and the UK worst. Large caps outperformed small caps. Healthcare and utilities outperformed, while energy and materials underperformed. Growth and value styles delivered similar performance.

Muted global earnings growth

Global 12-month trailing year-over-year earnings growth in September was 3.4%. Solid US growth helped support earnings in North America, while Japan continued to benefit from a weaker currency. A strong currency, and weak economic growth weighed on UK and Eurozone earnings respectively.

Valuations below long-run averages

Global equities performed in line with earnings growth, so valuations end the year close to where they started. On 16.6x trailing earnings, global equities are slightly cheaper than long-run averages. The US and Switzerland are marginally more expensive than average, Japan and emerging markets are cheaper.

<table>
<thead>
<tr>
<th>Returns</th>
<th>Valuation</th>
<th>EPS growth</th>
<th>EBIT margin</th>
</tr>
</thead>
<tbody>
<tr>
<td>Emerging Markets</td>
<td>–2.3%</td>
<td>3.8%</td>
<td>9.5%–10.5%</td>
</tr>
<tr>
<td>EMU</td>
<td>24.8%</td>
<td>2.9%</td>
<td>7%–8%</td>
</tr>
<tr>
<td>Japan</td>
<td>54.5%</td>
<td>3.8%</td>
<td>6.5%–7.5%</td>
</tr>
<tr>
<td>Switzerland</td>
<td>22.8%</td>
<td>9.6%</td>
<td>6.5%–7.5%</td>
</tr>
<tr>
<td>UK</td>
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<td>0.2%</td>
<td>7.5%–8.5%</td>
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<tr>
<td>US</td>
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<td>7%–8%</td>
</tr>
<tr>
<td>World</td>
<td>29.5%</td>
<td>7.5%</td>
<td>7.5%–8.5%</td>
</tr>
</tbody>
</table>

*consensus

Source: Thomson Reuters, Bloomberg, UBS
We overweight US equities

- Strong US corporate profits should continue to underpin the bull market in US equities.
- With over two-thirds of S&P 500 revenues derived domestically, US companies should benefit from robust US economic growth.
- Valuations are only marginally above average levels, so cyclical momentum and earnings will be the primary driver of returns in 2015.

![Graph showing US Earnings](image)

We underweight EM equities

- The region’s corporate profitability has been falling in 2014.
- The sharp declines in commodity prices and US dollar strength are unhelpful.
- Valuations are below long-run averages, but are not likely to prove a catalyst for performance.
- We remain somewhat cautious about the economic leading indicators in many of the large emerging markets.

![Graph showing EM Earnings](image)

US capex recovery

As the US economic expansion deepens, we expect capital spending on manufacturing, technology, property, and energy infrastructure to improve. Easing bank lending standards, improving small business and corporate confidence and rising capacity utilization have historically led “capex” cycles. Sectors most exposed to a pickup in capital expenditures are industrials, technology and financials.

e-Commerce: Beyond Amazon

Opportunities around the e-Commerce theme extend beyond just owning pure-play online shopping companies like Amazon. US-based companies in consumer-focused industries such as retail, apparel, consumer packaged goods and restaurants will benefit as they take an omni-channel approach to their business and more consumers shift their shopping and spending online.

Benefit from reform in Mexico

Mexican equities present an attractive investment opportunity benefitting from the recent approval of a far-reaching energy reform. This reform, as well as others in the areas of telecom, education and antitrust approved in the last 2 years could add 1-2 percentage points to the country’s long-term GDP growth potential.
Bonds.

Bond yields have rarely been as low as they are today. While a turning point in yields has been long expected and failed to arrive, what we can be more sure of is that low yields mean we can only expect meager returns from highly-rated bonds in coming years. In this environment, we prefer lower-rated bonds. We have a tactical preference for investment grade and US high yield credit.

We recommend an underweight allocation to bonds as a whole. We overweight credit, in particular US high yield credit and global investment grade credit, relative to government bonds.

### Government bonds in 2014
- Government bonds surprised in their strong performance in 2014.
- The rally came in spite of the Fed concluding quantitative easing and edging closer to interest rate hikes.
- Looser-than-expected policy from the European Central Bank, ongoing central bank balance sheet expansion, concerns over economic growth rates, low inflation, and structural buying from pension funds were key drivers.

### Credit in 2014
- Bond duration was a key driver of credit performance in 2014, with longer duration segments such as investment grade and EM sovereigns outperforming high yield and EM corporate.
- Spreads were broadly unchanged through the year. At the margin, investment grade and EM sovereign spreads tightened, and high yield spreads widened.
- Credit continued to exhibit low levels of volatility, allowing the segment to deliver attractive risk adjusted returns.

### Valuations – slightly tight
- Investment grade and US high yield credit spreads are marginally below average, but default rates are also below average. We continue to overweight both segments.
- EM sovereign and EM corporate spreads are more significantly below long-run averages, although ratings have improved over the past decade. We believe EM corporates are expensive relative to fundamentals and we thus underweight this segment.

<table>
<thead>
<tr>
<th>Rating</th>
<th>Spread (bps)</th>
<th>Av. (bps)</th>
<th>Default rate</th>
<th>Av.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment grade</td>
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<td>117</td>
<td>137</td>
<td>0%</td>
</tr>
<tr>
<td>US high yield</td>
<td>B+</td>
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<td>2.1%</td>
</tr>
<tr>
<td>EM Sovereign</td>
<td>BBB-</td>
<td>308</td>
<td>460</td>
<td>0%*</td>
</tr>
<tr>
<td>EM Corporate</td>
<td>BBB</td>
<td>323</td>
<td>360</td>
<td>0.6%</td>
</tr>
</tbody>
</table>

* + Argentina

Source: UBS, Moody’s, J.P. Morgan, Barclays
Overweight US high yield credit

- With a spread over US Treasuries of 4.5%, and a total yield of more than 6%, we believe the outlook for high yield credit is positive.
- We expect default rates among US high yield issuers to remain low in 2015, thanks to robust corporate fundamentals and favorable funding conditions.
- We are currently in the middle of the credit cycle; corporate activity is close to average levels and leverage is rising.

Overweight investment grade credit

- Investment grade credit still provides an attractive yield pickup over government bonds, with default risks low.
- Solid economic growth in the US and the ECB’s asset purchase program should prove supportive of the asset class.
- We prefer lower rated IG bonds (BBB), and selected subordinated bonds of non-financial issuers to pick up additional yield.

Underweight government bonds

- With an extremely low starting point for yields, we expect low returns from government bonds in the years ahead.
- We expect higher rates of growth and inflation in the US and UK, in particular, to drive bond yields higher in 2015.
- We forecast US 10-year Treasury yields of 2.8% in the next 12 months.

Underweight emerging market corporate debt

- The size of the EM corporate bond market has grown significantly in recent years, outstripping the EM sovereign bond market by a large amount.
- EM corporate default rates have been low because of the favorable funding environment for EM corporates, but default rates are expected to rise in 2015.
- We believe spreads are tight relative to fundamentals and we underweight the segment.
As discussed on the previous page, we remain underweight in US Treasuries. For this reason we are also underweight US TIPS as we feel longer duration and the current lack of inflation will result in lackluster performance going forward. As discussed, our recommendation is for an overweight to US credit markets such as investment grade corporates and high yield. Also in the US, we are neutral to the benchmark — though overweight versus US Treasuries — in US spread products such as mortgage-backed securities, preferreds, and municipals. The continued supply/demand imbalances, incremental yield and coupon will allow for these asset classes to outperform their US Treasury counterparts throughout the year ahead.

### US municipals

- In 2014, the municipal bond market’s performance was surprisingly strong, based on the sector’s longer duration, subdued muni new issue supply, and the market’s willingness to disregard adverse credit developments among a relatively small number of borrowers.
- For the year ahead, we expect munis to post more modest returns but still outperform US government securities.
- In an era when investors remain concerned about the mounting pension liabilities of local governments, we reiterate our conviction that investors should consider attractive alternative to tax-supported bonds.

### Neutral preferreds

- Preferred securities were among the best fixed income segments in 2014, posting double-digit returns.
- Higher rates would be a headwind for preferreds in 2015, however, high coupon income and spread compression can serve as an offset, providing single-digit return potential.
- We favor low duration preferred structures, including securities with floating rate or fixed-to-floating rate coupons, especially those with high back-end spreads.
Neutral mortgage backed securities

- Mortgages spreads tightened in 2014, due to FED buying and low volatility.
- The end of quantitative easing will not affect mortgage spreads since it is not whether they buy more but rather what they keep of what they own that is the driver.
- We expect MBS in 2015 to slightly outperform US Treasuries, with the Fed maintaining its mortgage reinvestment policy until 2016.

Underweight TIPS

- The TIPs break-even has fallen to their lowest level in 3 years due to the lack of inflation in the US and the rapid decline in commodity prices.
- The dollar strength and the global slowdown it has affected will keep commodities, oil, and gasoline at lower levels.
- Liquidity risk is a driving concern for TIPs given their longer duration and volatile price action.

Diversify into commercial mortgage-backed securities

Commercial mortgage-backed securities (CMBS) are bonds whose payments derive from a pool of mortgage loans on commercial and multifamily real estate. An allocation out of corporates into CMBS offers the attractive, but rare opportunity to decrease duration, increase credit quality and pick-up incremental yield.

US senior loans

Senior loans are issued by sub-investment grade rated companies but have a senior secured status within a company’s capital structure. The same positive fundamental trends evident in the US high yield market also apply to loans, including improved balance sheets and debt maturity profiles. Loan coupon rates reset regularly based on 3-month USD LIBOR, which has historically allowed loans to perform well when interest rates rise.
Hedge funds

We recommend that investors consider hedge funds as a means of improving the risk-return characteristics of an overall portfolio. A well-diversified portfolio of hedge funds offers mid single-digit return potential with low correlations to other assets.

Anticipating higher interest rates in the US, we foresee most hedge fund strategies still generating performance. The expected relative performance of these strategies is consistent with our positioning, with equity hedge anticipated to perform best.

2014 so far

Through 3Q 2014, hedge fund strategies performed broadly in line with our expectations. The temporary volatility spike in October impacted some managers due to large macro moves, poor performance of crowded trades, and legislation against tax inversion deals.

Below-average volatility and abundant liquidity continued to provide a supportive environment for some “beta-oriented” alternative strategies. Nevertheless, entering 2015, we expect this environment to change in favor of “alpha-oriented” strategies driven by the normalization in liquidity and volatility.

Prefer equity hedge

- We expect positive US equity market performance to be supportive of the strategy.
- We prefer managers running lower gross and net exposures, with a strong focus on alpha generation through fundamental stock selection.
- The continuing divergence of global economies requires different regional equity hedge approaches. Asia, Europe and EM are still beta driven. In the US, alpha should start to dominate performance.

Cautious on global macro strategies

- We favor discretionary macro funds over systematic trading strategies (CTAs).
- The diverging world and end of ultra-low market volatility should increase the opportunity set for discretionary macro.
- We are remaining cautious on systematic trading funds, since most trend-following managers still have relatively high long bond exposures.
Private markets

We still see opportunities in selected private market strategies. While credit availability and solid equity markets in 2014 drove a robust private equity exit environment, new deal activity was more constrained on valuation levels. Private debt can complement existing credit holdings, and we like long-term energy infrastructure exposure.

Investors accepting illiquidity can leverage private markets to diversify portfolio returns and achieve specific objectives. Locking up capital in private market funds grants access to differentiated investments organized around themes, assets and return drivers.

2014 so far

• 2014 is on track to reach or exceed record levels of realization.
• IPOs are the third exit path for private equity investments, behind trade sale and secondary buy-out.
• IPO activity might have peaked, as an increased number of offerings have been shelved.

Private equity

• High valuations, easy financing and significant dry powder drive acquisition multiples higher. We prefer small- and mid-cap to large-cap buyouts.
• Growth capital in emerging markets offers a way to enter sectors capitalizing on long-term shifts less accessible through liquid instruments.
• Due to high valuations, late-stage venture capital and secondary offerings are less attractive.

Private debt

• Ongoing European bank deleveraging creates structural opportunities for careful alternative capital providers, notably through direct lending.
• European banks also continue rationalizing balance sheets, creating potential opportunities in NPLs and other non-core assets.

Private market opportunities

• New technologies have transformed energy supply and consumption trends in North America.
• We favor opportunities along the energy value chain in areas of energy infrastructure, renewables and energy efficiency.
The diverging world – monetary policy divergences will continue in 2015

- US and UK will begin normalizing their monetary policy. This will continue to support the US dollar and British pound.
- The ECB will need to ease monetary policy further to try and stimulate inflation and growth. This will weaken the EUR. Switzerland will continue defending the 1.20 EUR/CHF floor.
- The Bank of Japan will also keep an aggressive easing policy. The Bank of Japan’s 2% target.

Developed markets

- FX market volatility has been structurally dampened in recent years as central banks around the globe have kept markets artificially calm with liquidity injections.
- The US Federal Reserve and the Bank of England, which are now normalizing their monetary policies, will allow bond yields to fluctuate more strongly. This is likely to increase currency volatility.
- Higher yielding currencies, which profited from subdued yields in major currencies and low currency volatility, will find the period of Fed and BoE tightening challenging. As the actual rate hikes, such currencies will likely see further weakness.

Emerging market currencies

- Investors should look for divergences in growth-inflation dynamics. Mexico is seeing improving growth and will likely see a rate hike in 2015. Israel and Poland are less attractive due to weaker growth and inflation.
- The “fragile” countries (Brazil, Indonesia, South Africa) should be treated with caution. However, we see opportunities in India, where its current account balance has improved.
Headwinds persist

After a difficult year in 2014, many commodities are trading into their cost of supply curves. But decelerating demand growth from emerging Asia will remain a headwind. We favor energy and the grains, hold a neutral stance on base metals, and are cautious on precious metals. Overall, we expect low single-digit returns in 2015, but underlying commodities will likely be driven by a diverse set of factors.

We favor energy

- We expect crude oil prices to stabilize in 1H15 and recover in 2H15 as the supply and demand backdrop becomes more balanced.
- Excess supply growth by non-OPEC countries over global demand growth will likely moderate to 0.1 mbpd in 2015 from 0.7 mbpd in 2014.
- Considering that crude oil supply outside North America will likely remain challenged, OPEC’s ability to guide prices higher should improve.
- Selling tail risk insurance represents the most attractive way of benefiting from a more stable crude oil price in 2015.

Neutral on base metals

- In general, low base metals prices are required to motivate production discipline. But the base metals are not homogenous, given widely varied supply-side conditions.
- We favor zinc, nickel and lead, since the supply of these commodities cannot easily expand.
- Current aluminum prices are sufficient to motivate more supply.
- Our least preferred metal is copper, with mine supply growth still likely to outpace demand growth in 2015 and prices expected to decline to USD 6,350/mt.

Cautious on precious metals

- Rising interest rates in the US will increase the opportunity cost of holding gold.
- We expect ETF outflows in the range of 300–400 tons. This would bring gold down to USD 1,050/oz, at the marginal costs of production.
- At this point, Asian demand should increase, and we would likely see the first contraction in mine production since 2008.
- Gold and silver are not yet a buy. But if prices decline to marginal costs of production, gold could become an interesting underlying for volatility selling strategies.

Agriculture

- Corn, wheat and cotton farm-gate prices are at or below their production costs, while soybean prices remain above the costs of production.
- We see crop area adjustment as the most likely scenario, coming most quickly from corn and to a lesser degree, cotton.
- A similar adjustment in soybeans will likely be delayed, perhaps until the planting season in Brazil at the end of 2015.
- We remain optimistic for a bounce in corn and sugar before other crops. We believe soybeans will clearly be depressed for a longer duration.
2015 in short.

What might surprise us in 2015?

MH: Inflation  
MR: Common ground between the President and Congress  
TT: Geopolitics will play a larger role in markets  
MLT: The pace of Asian reforms  
JM: If investors got even more negative on emerging markets  
SF: US wage inflation  
MP: The Fed might return to easing  
MA: A larger correction in China property  
MC: Ex-US asset outperformance  
AF: Fed doesn’t raise rates

What won’t?

MH: Higher volatility  
MR: The Fed’s cautiousness  
TT: Mediocre growth from France and Italy  
MLT: The Asian property market adjustment  
JM: The bankruptcy of populism  
SF: No European recession  
MP: China won’t accelerate  
MA: You will still be able to make money in a difficult environment  
MC: The FOMC  
AF: Investors will still reach for income

What excites you most about 2015?

MH: Self-sustained growth in some countries  
MR: The potential for technology to change our lives  
TT: Market volatility creating investing opportunities  
MLT: Mutual market access possibly extending  
JM: Evidence that economic reforms are happening  
SF: The growing interest in sustainable investing  
MP: The ski season  
MA: We’re going to need to be more tactical in investing  
MC: Building out our goals based investing framework  
AF: Scientific developments in cancer therapeutics
What worries you most about 2015?

MH: Inequalities
MR: The rise of radical world views and rising inequality
TT: The fragility of the global economy
MLT: Chinese property market declines
JM: Global growth
SF: Rising tensions with Russia
MP: Inflation with no growth
MA: The possibility of stagflation
MC: Russia
AF: Eurozone growth

What’s your New Year’s resolution?

MH: Always ask better questions
MR: Take a view of the world that is not how I wish it but how it’s going to be
TT: Take time to think about the longer term
MLT: Read widely, travel less; more time for contemplation
JM: Making good investment calls in emerging markets
SF: To read more non-investment-related literature
MP: To help our clients invest in a portfolio context
MA: To help our clients stay invested in a diversified portfolio
MC: Travel more for pleasure and less for business
AF: Stay active and workout more

What’s your top tip for investors?

MH: Worry about the downside, and the upside will take care of itself
MR: US equities
TT: European banks
MLT: Selected subordinated financials perpetuals
JM: The Mexican peso
SF: Resist the urge to concentrate your portfolio in US assets
MP: If you see high yield yielding more than 7%, buy
MA: Buy more alternatives
MC: Less is almost always more
AF: Focus on goals and don’t get too caught up in daily headlines
Sources of strategic asset allocations and investor risk profiles

Strategic asset allocations represent the longer-term allocation of assets that is deemed suitable for a particular investor. The strategic asset allocation models discussed in this publication, and the capital market assumptions used for the strategic asset allocations, were developed and approved by the WMA AAC.

The strategic asset allocations are provided for illustrative purposes only and were designed by the WMA AAC for hypothetical US investors with a total return objective under five different Investor Risk Profiles ranging from conservative to aggressive. In general, strategic asset allocations will differ among investors according to their individual circumstances, risk tolerance, return objectives and time horizon. Therefore, the strategic asset allocations in this publication may not be suitable for all investors or investment goals and should not be used as the sole basis of any investment decision. Minimum net worth requirements may apply to allocations to non-traditional assets. As always, please consult your UBS Financial Advisor to see how these weightings should be applied or modified according to your individual profile and investment goals.

Deviations from strategic asset allocation or benchmark allocation

The recommended tactical deviations from the strategic asset allocation or benchmark allocation are provided by the Global Investment Committee and the Investment Strategy Group within Wealth Management Research Americas. They reflect the short- to medium-term assessment of market opportunities and risks in the respective asset classes and market segments. Positive / zero / negative tactical deviations correspond to an overweight / neutral / underweight stance for each respective asset class and market segment relative to their strategic allocation. The current allocation is the sum of the strategic asset allocation and the tactical deviation.

Note that the regional allocations on the International Equities page are provided on an unhedged basis (i.e., it is assumed that investors carry the underlying currency risk of such investments). Thus, the deviations from the strategic asset allocation reflect the views of the underlying equity and bond markets in combination with the assessment of the associated currencies. The detailed asset allocation tables integrate the country preferences within each asset class with the asset class preferences stated earlier in the report.

Appendix

Explanations about Asset Classes

Scale for tactical deviation charts

<table>
<thead>
<tr>
<th>Symbol</th>
<th>Description/Definition</th>
<th>Symbol</th>
<th>Description/Definition</th>
<th>Symbol</th>
<th>Description/Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>+</td>
<td>moderate overweight vs. benchmark</td>
<td>--</td>
<td>moderate underweight vs. benchmark</td>
<td>n</td>
<td>neutral, i.e., on benchmark</td>
</tr>
<tr>
<td>++</td>
<td>overweight vs. benchmark</td>
<td></td>
<td>underweight vs. benchmark</td>
<td>n/a</td>
<td>not applicable</td>
</tr>
<tr>
<td>+++</td>
<td>strong overweight vs. benchmark</td>
<td></td>
<td>strong underweight vs. benchmark</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: CIO WM Research
Emerging Market Investments

Investors should be aware that Emerging Market assets are subject to, among others, potential risks linked to currency volatility, abrupt changes in the cost of capital and the economic growth outlook, as well as regulatory and sociopolitical risk, interest rate risk and higher credit risk. Assets can sometimes be very illiquid and liquidity conditions can abruptly worsen. WMR generally recommends only those securities it believes have been registered under Federal US registration rules (Section 12 of the Securities Exchange Act of 1934) and individual State registration rules (commonly known as “Blue Sky” laws). Prospective investors should be aware that to the extent permitted under US law, WMR may from time to time recommend bonds that are not registered under US or State securities laws. These bonds may be issued in jurisdictions where the level of required disclosures to be made by issuers is not as frequent or complete as that required by US laws.


Investors interested in holding bonds for a longer period are advised to select the bonds of those sovereigns with the highest credit ratings (in the investment grade band). Such an approach should decrease the risk that an investor could end up holding bonds on which the sovereign has defaulted. Subinvestment grade bonds are recommended only for clients with a higher risk tolerance and who seek to hold higher-yielding bonds for shorter periods only.

Nontraditional Assets

Nontraditional asset classes are alternative investments that include hedge funds, private equity, real estate, and managed futures (collectively, alternative investments). Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. An investment in an alternative investment fund is speculative and involves significant risks. Specifically, these investments (1) are not mutual funds and are not subject to the same regulatory requirements as mutual funds; (2) may have performance that is volatile, and investors may lose all or a substantial amount of their investment; (3) may engage in leverage and other speculative investment practices that may increase the risk of investment loss; (4) are long-term, illiquid investments; there is generally no secondary market for the interests of a fund, and none is expected to develop; (5) interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer; (6) may not be required to provide periodic pricing or valuation information to investors; (7) generally involve complex tax strategies and there may be delays in distributing tax information to investors; (8) are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits.

Interests in alternative investment funds are not deposits or obligations of, or guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other governmental agency. Prospective investors should understand these risks and have the financial ability and willingness to accept them for an extended period of time before making an investment in an alternative investment fund and should consider an alternative investment fund as a supplement to an overall investment program.

In addition to the risks that apply to alternative investments generally, the following are additional risks related to an investment in these strategies:

- **Hedge Fund Risk**: There are risks specifically associated with investing in hedge funds, which may include risks associated with investing in short sales, options, small-cap stocks, “junk bonds,” derivatives, distressed securities, non-US securities and illiquid investments.
- **Managed Futures**: There are risks specifically associated with investing in managed futures programs. For example, not all managers focus on all strategies at all times, and managed futures strategies may have material directional elements.
- **Real Estate**: There are risks specifically associated with investing in real estate products and real estate investment trusts. They involve risks associated with debt, adverse changes in general economic or local market conditions, changes in governmental, tax, real estate and zoning laws or regulations, risks associated with capital calls and, for some real estate products, the risks associated with the ability to qualify for favorable treatment under the federal tax laws.
- **Private Equity**: There are risks specifically associated with investing in private equity. Capital calls can be made on short notice, and the failure to meet capital calls can result in significant adverse consequences including, but not limited to, a total loss of investment.
- **Foreign Exchange/Currency Risk**: Investors in securities of issuers located outside of the United States should be aware that even for securities denominated in US dollars, changes in the exchange rate between the US dollar and the issuer’s “home” currency can have unexpected effects on the market value and liquidity of those securities. Those securities may also be affected by other risks (such as political, economic or regulatory changes) that may not be readily known to a US investor.
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