Financial Market Outlook – short term

Global Tactical Asset Allocation

- **Asset allocation**
  Global equities suffered a setback in October, falling over 6% before recovering in the last sessions. Triggers for the correction include the sharp rise in US Treasury yields as the market priced in a more aggressive pace of rate hikes, in addition to a belated pricing in of the potential cost of tariffs on US earnings. However, the economic backdrop remains solid, and we believe that the good growth momentum in the US should enable the economy to readily absorb higher rates, even if they continue to rise at a moderate pace. We keep a moderate overweight in global equities against high grade (HG) bonds.

- **Equities**
  Volatility picked up in October. Over a six-day streak, US large-cap stocks lost 7%. Technology stocks were especially hit hard. The slump extended to all regions, and in particular Asian technology stocks. In our view, the fundamental backdrop has hardly changed. Global indicators continue to signal robust economic growth. In the current 3Q earnings season, we expect US companies to deliver 23–24% earnings growth. We keep our preference of Canadian stocks over Australian equities on the back of more attractive valuations. Earnings dynamics are also stronger in Canada than in Australia.

- **Bonds**
  We hold an overweight on emerging market (EM) sovereign bonds in USD against HG bonds. EM fundamentals and the bonds’ attractive yield of 6.6% support the position. We are overweight 2-year Italian government bonds against EUR cash. Short-term Italian rates look appealing at current levels, given the low likelihood of Italy defaulting over the coming years, and the attractive carry and roll-down. We are overweight 10-year US Treasuries versus USD cash as we think this part of the curve has largely priced in the rate-hiking cycle, and the carry is attractive. We are underweight 10-year Japanese government bonds versus JPY cash. We believe the Bank of Japan will allow yields to move further upwards as inflation picks up.

- **Foreign exchange**
  We are overweight the Japanese yen (JPY) versus the Taiwan dollar (TWD). The long JPY position should benefit from either rising Japanese inflation prompting the Bank of Japan to allow yields to move further upwards, or a downturn in global financial markets creating demand for the JPY’s safe-haven function. Meanwhile, Taiwan is exposed to risks arising from US trade policy disputes.
Cross-asset preferences

We like...
- Global equities
- Canadian equities
- Global quality stocks
- US smart beta
- *Buy-write* strategy on US equities
- Some protection via US equity put options
- EM sovereign bonds in USD
- Selected EM bonds
- European leveraged loans
- 10-year US Treasuries vs. USD cash
- Long-dated USD high grade bonds
- 2-year Italian government bonds vs. EUR cash
- Japanese yen vs...
- Navigating rising US rates with hedge funds

We don’t like...
- Australian equities
- Developed market high grade bonds
- 10-year Japanese govt. bonds vs. JPY cash
- *Well-worn* bonds
- ...Taiwan dollar
- ...USD cash

Model portfolios (EUR & USD)*

Source: UBS, as of 18 October 2018; * Additionally, the portfolios include overweight positions in 2-year Italian government bonds and 10-year US Treasuries and an underweight in 10-year Japanese government bonds (via overlays)

Note: Portfolio weightings are for a EUR model portfolio and a USD model portfolio, with a balanced risk profile (including TAA). We expect the EUR balanced portfolio (excluding TAA) to have an average total return of 3.5% p.a. and a volatility of 8% p.a. over the next seven years. We expect the USD balanced portfolio (excl. TAA) to have an average total return of 5.2% p.a. and a volatility of 7.9% p.a. over the next seven years.
## Global tactical asset allocation

### Tactical asset allocation deviations from benchmark*

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<td>Italian 2-year govt bond overlay</td>
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*Please note that the bar charts show total portfolio preferences, which can be interpreted as the recommended deviation from the relevant portfolio benchmark for any given asset class and sub-asset class.

**We are holding a put option on the S&P 500 to partly protect the tactical asset allocation.

***Note: Equity risk profile only.

### Currency allocation

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Source: UBS, as of 18 October 2018

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Source: UBS, as of 18 October 2018
**Equities**

- **US smart beta**
  Certain stock characteristics (momentum, quality, small capitalization, risk-weighting, value, and yield) have been shown to deliver long-term investment outperformance relative to a market-capitalization-weighted index. Combining these characteristics, known in the industry as smart beta, makes the investment less cyclical and creates a “passive-plus” solution. Smart beta’s compelling value proposition has resulted in considerable growth in assets. Smart beta ETF assets have risen to over USD 650bn and are growing by more than 30% a year.

- **Generate yield: “Buy-write” on US equities**
  An equity buy-write strategy involves the purchase of equities (the “buy” part) while systematically selling (or “writing”) call options that cover the position, typically on a monthly schedule. In exchange for giving a counterparty the right, but not the obligation, to buy the underlying asset at a predetermined price, the buy-writer receives a premium. Over an economic cycle, equity buy-write strategies generate attractive risk-adjusted returns as they capture both the equity and volatility risk premium. They are most appealing when equity returns moderate and market momentum decreases and, historically, perform strongly during periods of rising rates.

- **Global quality matters**
  The quality factor aims to reflect the performance of companies with durable business models and sustainable competitive advantages. It therefore targets companies with a high return on equity, stable earnings, and low financial leverage. In the mid-to-late stage of the business cycle, when monetary policy is less accommodative and volatility rises, quality matters. With increasing trade tensions, a global sector-neutral quality strategy can also offer added downside protection in a relative context.

**Bonds**

- **Time to be more selective in EM credit**
  With this theme, we provide advice on how to build diversified exposure to emerging market (EM) credit, drawing from our top-down view on the asset class, as well as the bottom-up insights of our credit analysts. Emerging market credit should benefit from sound global growth, reduced new supply, as well as its relative attractiveness against other credit market segments. While emerging economies are on aggregate at an earlier stage in the business cycle than developed markets, there are big differences between countries and market sectors. We think it is becoming increasingly important to invest in the right credits, and to actively adjust exposure toward the most promising opportunities.

- **Replacing well-worn bonds**
  Risk-free yields in some major developed markets are near or below zero. Even if rates stay unchanged, many short- to medium-term bonds would deliver negative total returns. We think investors can preserve wealth by taking profits on assets that will deliver negative returns (exceeding switching out costs) in most likely scenarios. More attractive alternatives can be found on CIO’s bond recommendation lists.

- **Opportunities in European leveraged loans**
  Financial market volatility has risen from last year’s lows, while attractive fixed income investments in Europe remain hard to find. We think European leveraged loans offer an appealing risk-reward profile due to their attractive yield and generally low volatility, and our outlook for low default rates. European leveraged loans currently offer a yield around 4%, which compares favorably with other bond alternatives. We expect 12-month total returns of 3–4% in EUR and 6–7% hedged into USD. Following the outperformance of US loans since the beginning of the year, we are starting to see better investment opportunities in European loans. We recommend investors in US loans to hold onto their investments, but for new investments to be made in European loans.

- **Long-dated USD high grade bonds: Buy now or never**
  Within a portfolio of equities and bonds, long-dated high grade bonds, in addition to their carry yield, can buffer losses from risk assets. Investors should use the current level of long-term US dollar yields, which we think are close to the highs of this cycle, to align the portfolio share and average tenor of high grade bonds with a strategic asset allocation reflecting their risk profile, for example by deploying excess cash or reducing potential over-allocations to lower-quality bonds.
CIO themes in focus

Alternative investments

• Navigating rising US rates with hedge funds

The US Federal Reserve has started to hike interest rates. Historically, most hedge fund strategies have been resilient to rising rates, while high grade bonds have performed poorly. Investors looking for an alternative to their high grade bond exposure should consider a diversified hedge fund portfolio characterized by low directional exposure to both fixed income and equities.

This selection of themes is a subset of a larger theme universe. It represents the highest conviction themes of the UBS Chief Investment Office GWM, taking into account the current market environment and risk-return characteristics.
CIO longer term investment themes in focus

**Equities**

- **Fintech**
  
  Driven by rapid urbanization, strong demand from millennials, and favorable regulations, the global fintech industry is at an inflection point and set to drive a major digital transformation in the financial services industry. We expect global fintech revenues to grow from USD 120bn in 2017 to USD 265bn in 2025, implying an average annual growth rate about three times faster than the broader financial sector.

- **Enabling technologies**
  
  We have identified five mainstream enabling technologies – artificial intelligence (AI), augmented reality/virtual reality (AR/VR), big data, cloud computing and 5G – that are set to transform many industries over the next decade. We expect them to grow in aggregate by an average 12.8% annually, from USD 420bn in 2017 to USD 1.1trn in 2025. Hence, we believe enabling technologies offer solid long-term growth as technological disruption is an irreversible trend. Investors can take part in this by investing in a diversified way in our theme of enabling technologies, with leading software and semiconductor companies emerging as winners.

- **Digital data**
  
  We expect the global digital data universe to grow more than 10 times between 2020 and 2030, reaching 456 zettabytes. Rising global internet penetration, increased emerging market data use, and secular consumer trends like the Internet of Things are fueling this growth, providing double-digit earnings growth potential for digital data companies. From an investment perspective, the theme offers solid long-term growth opportunities, as significant investment will be required to manage and take advantage of the surge in data. Investors can participate by investing in either data enablers or data infrastructure companies.

- **Medical devices**
  
  The aging population and growth of the over-65 age group will create more opportunities for companies selling medical products and devices. Other drivers of the medical device industry include better penetration in emerging markets due to improved infrastructure, new innovative treatments, increased affordability due to rising per-capita GDP, and a growing prevalence of “lifestyle diseases” like obesity due to urbanization. We expect sustainable mid-single-digit revenue growth.

- **Automation and robotics**
  
  Smart automation is powering the ongoing industrial revolution, combining the innovation capabilities of industrial and IT processes to fuel global manufacturing productivity gains. Rising wages and challenging demographic changes will pressure costs of manufacturing firms, driving automation investments. Also, the increasing digitalization of automation equipment is a key driver of higher efficiency and therefore more automation investments. Artificial intelligence employed in machines should take automation to the next level. The smart automation industry’s total annual revenue now stands around USD 177.5bn. We believe that over the cycle, the sector can grow by mid-to-high single digits, with industrial software, robots, and new trends – 3D printing, artificial intelligence, and drones – the clear outperformers.

This selection of themes is a subset of a larger theme universe. It represents the highest conviction themes of the UBS Chief Investment Office GWM, taking into account the current market environment and risk-return characteristics. The Longer Term Investment (LTI) theme series focuses on inevitable global trends, such as population growth, aging, and urbanization, that create a variety of opportunities, with certain companies and subsectors experiencing a higher-than-GDP rate of revenue growth. Here, we include a subset of a larger universe of LTI themes expected to offer good entry points for theme-oriented investors in the coming months, and highlight our preference for a diversified approach to themes.
### Key Investment Risks

<table>
<thead>
<tr>
<th>Selected Scenarios</th>
<th>Scenario Description</th>
<th>Expected market performance for select asset classes</th>
</tr>
</thead>
</table>
| **Base case**               |  Positive outlook with increased volatility  
Globally economic performance remains solid, but ongoing trade tensions and uncertainty about Eurozone growth keep volatility high. | - **US equities** +0-5% due to strong economic activity supported by tax cuts, government spending, business confidence and capital access  
- **Eurozone equities** +0-5% amid ongoing concerns in Italy, risk of US tariffs on autos and a stable ECB outlook  
- **EURUSD** between 1.15 and 1.20 |

| **Key upside scenarios**    |  Trade tensions abate  
Negotiations between the US and China restart, leading to actual progress and a reduction of trade barriers. | - **US equities** +5-10% as trade-related risk premia subside  
- **Chinese equities** +10-15% due to EPS growth and re-rating  
- **EURUSD** +5-10% to around 1.20-1.25 |
|-----------------------------|---------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------|
| **China growth surprise**   |  Chinese GDP growth remains in a 6.6-6.8% range as the current account balance goes back above USD 100bn. | - **Chinese equities** +15-20% due to a combination of re-rating and a positive earnings surprise  
- **EMBI** +7-9% as spreads tighten back to post-crisis lows (around 250bps) while US Treasury yields are not impacted significantly |

| **Key downside scenarios**  |  Global trade war  
US-China trade disputes induces a slowdown in China, considerable uncertainty and a rerouting of trade routes. More countries start to implement isolationist measures, leading to a global trade war. | - **US equities** -10-15% as multiples contract and earnings drop by ~5%  
- **Chinese equities** -20-25% in case of a growth shock and a drop in exports; possibly more in case of multiple contraction  
- **EURUSD** to around 1.10 |
|-----------------------------|---------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------|
|                             |  Oil supply shock  
Escalating tensions disrupt energy exports, causing oil prices to spike sustainably to USD 120/bbl – a level which would hurt for the global economy. | - **Crude oil** up to USD 120/bbl  
- **Energy equities** +15-20% due to oil price increase  
- **EURUSD** to around 1.10 |

| **Accelerated Fed tightening** | As US inflation rises rapidly, the Fed is forced to hike rates at each meeting. A US recession starts early 2020. | - **US equities** -10-15% in the first six months, followed by stronger drawdowns as a US recession becomes more likely  
- **US high yield** -6-9% in the first six months as defaults start to rise and spreads start to widen |

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**Expected total returns over a 6-month horizon**

Note: Upside and downside scenarios are possible events outside of CIO’s base case expectations.

Please refer to the latest published Global Risk Radar edition for further details on the risk scenarios.

For further information please contact CIO strategist Dirk Ehrenberger, dirk.ehrenberger@ubs.com
Key financial market driver 1 - Central bank policy

Key points

• Investors expect the Federal Reserve to stick to the rhythm of "hike, pause, hike, pause." This would suggest a December rate increase. Significant economic disruption from US President Donald Trump's trade tax increases may call that into question, but so far the disruption seems to be avoided or postponed. Fed bond holdings, a form of liquidity supply, should continue to decline to hopefully match the reduction in liquidity demand in the economy.

• The European Central Bank (ECB) is still expected to end quantitative policy bond purchases at the end of this year. Markets expect the ECB to raise interest rates in 2019.

• The Swiss National Bank (SNB) is unlikely to raise interest rates until 2H19, given the increased global uncertainty (and the potential for safe-haven flows). The Bank of England governor will stay in office for longer than expected, to provide stability as the UK and the EU separate.

CIO view (Probability: 75%*)

• The rate rise in September demonstrated the regular rhythm of the Fed’s tightening schedule, and markets view a December rate hike as a high-probability event. Trade tariffs, however, may prevent the Fed from raising rates in December (as tariffs are a form of fiscal tightening that may slow the US economy). The inflation consequences of trade protectionism are likely to be less of a concern than the growth consequences. The Fed continues to reduce liquidity supply to match a decline in liquidity demand in the economy. A deficit-financed fiscal stimulus by the US government at a time of full employment is a concern for the medium-term interest rate outlook.

• The ECB has slightly lowered its Eurozone growth outlook for 2019, but the general message is that its quantitative easing (QE) program will conclude at the end of this year in the absence of a more substantial negative economic shock. The program’s EUR 30bn worth of asset purchases per month falls to EUR 15bn in October.

• Central banks have expressed a clearer bias toward tightening rather than easing; this coincidence of views probably reflects the general improvement in global growth rather than an overt coordination.

• The tightening of central bank policy represents a shift from past cycles. This time, central banks have no desire to temper economic growth or inflation; the aim is to maintain them around current levels. Past episodes of policy tightening had deliberately sought to reduce company pricing power and inflation.

Positive scenario (Probability: 10%*)

• The Fed falls further behind the curve as US inflation surprises higher, with real interest rates slipping more rapidly. The ECB reverses its tone and puts a stronger emphasis on the potential to ease policy further.

Negative scenario (Probability: 15%*)

• The inflationary effect of a tighter US labor market and fiscal stimulus leads to a stronger Fed response and a combination of tight monetary policy and loose fiscal policy. Increased labor costs and commodity price pressures lead to higher European inflation, signaling a more rapid monetary policy tightening.

*Scenario probabilities are based on qualitative assessment

Key dates

Nov 1 Bank of England Monetary Policy Committee meeting

For further information please contact US economist Brian Rose, brian.rose@ubs.com, European economist Ricardo Garcia, ricardo-za.garcia@ubs.com or UBS GWM Global Chief Economist Paul Donovan, paul.donovan@ubs.com
Key financial market driver 2 - **Political risks**

**Key points**

- Markets have remained generally immune to the political noise that has marked the second half of this year. Generally speaking, political concerns have not changed economics, and so there has been little need for markets to react. The Italian budget disagreement is the notable exception given its direct economic consequences. Negotiations on the UK’s exit from the EU appear to be concluding – the question is whether the deal will pass the UK Parliament. The strength of the German coalition will be in focus in the wake of the Bavarian state elections.
- The world is not yet in a trade war (defined as global trade falling as a share of global GDP, in real terms). The risks of a Sino-US trade war have risen with additional threats from the US.
- Saudi Arabia may be a focus in the wake of recent events. This will be of relevance to markets only if financial or economic sanctions appear to be likely.

**CIO view (Probability: 70%*)**

- Political uncertainty gets a lot of media coverage, but it has relatively limited impact on financial markets. Markets have seemingly developed some immunity to political rhetoric. The ongoing Mueller investigation in the United States would only impact financial markets if it was seen as changing policy outcomes.
- US trade taxes to-date have not generally impacted the overall volume of global trade, although imports may have accelerated to beat tariff increases. Extending trade protectionism into a trade war would be a more obvious tax on US consumers.
- Investors’ base case for the US midterm elections is for Democrats to control the House, but not the Senate. This would lead to policy gridlock and a deeper investigation of the US president, but is not expected to have significant market consequences.
- The base case is that a deal will be done for the separation of the UK and the EU. However, the necessity of UK parliamentary approval is likely to add uncertainty.
- The recent turmoil in Turkish assets is mostly local. Turkey’s linkages with the world economy are not meaningful enough to impact global activity. But it also highlights risks to several other weaker emerging markets with current account deficits that are very reliant on foreign funding, such as South Africa, Argentina, and Indonesia.

* Positive scenario (Probability: 10%*)

- Better labor market conditions for low-skilled workers lead to faster wage hikes; this eases income and consumption inequality. The costs of trade protection are made more apparent to US voters through the actions of corporations, and the US retreats from its isolationist agenda.

* Negative scenario (Probability: 20%*)

- Nationalist tendencies are encouraged by single-issue politics and social media. Traditional party structures fail to address the demands of large sections of the electorate. Political outcomes are increasingly unpredictable as opinion polls offer even less guidance. Trade protectionism escalates. Lower-income groups’ standards of living are hurt by populist policies and rising prices, fueling further demands for radical and unpredictable change.

*Scenario probabilities are based on qualitative assessment.

**Key dates**

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<thead>
<tr>
<th>Date</th>
<th>Event</th>
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<tbody>
<tr>
<td>Oct 28</td>
<td>Elections in German state of Hesse</td>
</tr>
<tr>
<td>Nov 6</td>
<td>US midterm elections</td>
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</tbody>
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For further information please contact Global Chief Economist, UBS WM Paul Donovan, paul.donovan@ubs.com
Key financial market driver 3 - US profits strong for now

Key points
- A solid economy and tax reform are driving strong earnings growth this year.
- However, growth will slow in 2019 to 4%, partly due to tariffs.
- A further escalation in trade frictions cannot be ruled out.

CIO view (Probability: 60%*)
- The US earnings growth outlook remains relatively healthy, driven by solid consumer spending, secular growth drivers in tech, steady gains in manufacturing activity, higher oil prices (which support the energy sector), and robust capital spending.
- Leading indicators of profit growth, such as bank lending standards and capital spending intentions, also remain supportive.
- But the US-China trade dispute is intensifying. The direct impact of the tariffs now in place will likely trim annual S&P 500 profit growth by 2–3%. If the US expanded tariffs to all Chinese imports, the impact could rise to about 4–5%.
- For full-year 2018, we expect S&P 500 EPS of USD 161 (up 21% from the previous year). Growth should slow in 2019 as the one-time benefit from a lower tax rate falls off. We also include a tariff-related drag of 2–3%. Our 2019 EPS estimate is USD 168 (4% growth).
- We expect robust third-quarter earnings results with S&P 500 EPS growth of 23–24% (15–16% excluding the lower corporate tax rate), driven by 7–8% revenue growth. Guidance should be mostly positive but more companies will likely highlight the negative effects of the recent tranche of tariffs.
- Fears that high profit margins will decline in the near term appear overblown. Excluding the tech sector, margins are not excessive. The tech sector’s high margins are supported by companies with dominant market shares. Other structural factors, such as industry consolidation and a secular decline in tax rates, support higher-than-average profit margins. Also, margins typically only decline in a recession. Finally, the prospect of higher wages is unlikely to dent the outlook. Labor cost inflation has virtually no correlation with earnings growth as higher consumer income is usually recycled into faster consumer spending.

Positive scenario (Probability: 20%*)
- Corporate tax reform and increased government spending generate even faster-than-expected profit growth. Higher interest rates and deregulation further boost financial sector earnings. Investment spending picks up.

Negative scenario (Probability: 20%*)
- Trade and geopolitical tensions flare up, depressing business and consumer sentiment. Wage pressures, without improving consumer and business demand, crimp profit margins and earnings growth rates. Declines in long-term interest rates pressure financial sector earnings.

Earnings are strong for now

Fiscal policy boosts earnings more than expected

Downturn in sentiment

Key dates
- Oct 25  Peak of third-quarter earnings season

For further information please contact CIO strategists Jeremy Zirin, jeremy.zirin@ubs.com, David Lefkowitz, david.lefkowitz@ubs.com or Edmund Tran, edmund.tran@ubs.com.
Global economic outlook - Summary

Key points
- Global growth has continued to offer very few surprises. Some moderation has been expected in the second half of the year, in particular as the impact of US tax cuts fades. However, overall growth remains around trend.
- Companies are finding it easier to hike prices. The producer price index (PPI) excluding energy is high in the US and the UK. Consumer prices are noisy, but almost every US and European consumer price index (CPI) is around its 20-year average.
- Domestic demand remains firm in most major economies, with the strength of the labor markets an important support. Global trade is threatened by US action, but it is important to stress that this is US-focused and not a general trade dispute.

CIO view (Probability: 70%*)
- The world economy continues to perform well. Economic trends suggest that growth this year will match that of last year. In developed countries, strong labor markets are slowly lifting wages. Income growth is being spent. In the US and the UK, retail sales volumes are growing faster than last year. In Europe, volume growth rates are generally slightly slower, but still good.
- About a third of the US tax cuts are likely to be spent on imports, widening the trade deficit. Most of the US trade tariffs (tax increases) to-date are likely to redistribute, rather than reduce, global trade.
- US investment is reportedly being delayed by trade tensions, and trade issues may slow US growth later this year. However, US consumer savings are stronger than previously thought, adding potential spending power.
- Companies are finding it easier to raise prices. PPI is generally higher than in the recent past. Wage growth in both the US and Europe is consistent with some modest rise in price inflation. Labor costs typically make up about 70% of a developed economy's inflation.

Positive scenario (Probability: 15%*)
- European economic growth surprises positively, with better labor markets and stronger domestic demand. US economic growth data continue to be revised higher, and labor market shortages increase household incomes and consumer demand at a faster pace than expected. Fiscal stimulus adds to the pace of economic activity, and taxes on trade are reversed.
- Emerging markets see stable domestic demand. Those markets that have experienced volatility pursue market-friendly policies. Pro-business forces guide the US policy agenda and produce growth-supportive regulatory and legislative changes.

Negative scenario (Probability: 15%*)
- Credit growth suffers as capital flows are disrupted and uncertainty undermines normal bank lending.

*Trend-like growth, normal inflation

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<tr>
<th>Geographic region</th>
<th>Trend-like growth</th>
<th>Normal inflation</th>
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Source: UBS, as of 18 October 2018
Forecasts and estimates are current only as of the date of this publication, and may change without notice.

Employment participation rates in the US and EU

Europeans are more likely to work (in the legal economy)

Source: Eurostat, US Bureau of Labor Statistics, via Haver, UBS, as of 14 October 2018

Key dates
- Nov 6: US midterm elections
- Nov 8: US Federal Reserve meeting

For further information please contact UBS WM Global Chief Economist Paul Donovan, paul.donovan@ubs.com
US economy - Moderate growth in the US

Key points
• The US economy should grow at a moderate pace although trade disputes are a downside risk.
• Inflation should gradually trend higher as fiscal stimulus causes mild overheating.
• The Fed will likely continue to hike interest rates and shrink its balance sheet gradually.

CIO view (Probability: 60%*)
Moderate expansion
• The strong labor market and income tax cuts should support robust consumer spending.
• Business investment should continue to increase, encouraged by strong profits and labor shortages, although trade disputes will likely act as a constraint.
• Conditions in the manufacturing sector have improved and output should rise at a moderate pace.
• Recent housing data has been weaker than expected, but housing starts and home prices should trend higher over time.
• Tax reform and increased government spending are providing a substantial stimulus to growth that will start to fade in 2019. Deregulation should provide some economic benefit over time.
• Trade disputes are negative for growth. The tariffs imposed on US-China trade are particularly damaging, although should not be enough to end the economic recovery.
• Inflation has risen to the Fed’s 2% target and is likely to move somewhat higher as the US economy begins to overheat and tariffs raise import prices. However, we expect core inflation to remain within the limits that the Fed will tolerate.
• We expect the Fed to continue hiking interest rates and shrinking its balance sheet at a gradual pace, reaching a neutral stance by the end of 2019.
• Risks to the recovery should increase toward the end of 2019 as fiscal and monetary policy offer less support.

Positive scenario (Probability: 25%*)  
• US real GDP grows above 3%, propelled by an accommodative monetary policy, looser fiscal policy, strong household spending, and breakthroughs in trade negotiations. Inflation overshoots the Fed’s 2% target, potentially leading the central bank to raise rates at a faster pace.

Negative scenario (Probability: 15%*)  

Key dates
Oct 26 GDP for 3Q18
Oct 29 Personal income and spending for September
Oct 31 Employment Cost Index for 3Q18
Nov 1 Labor report for September

For further information please contact US economist Brian Rose, brian.rose@ubs.com
Eurozone economy - *Growth to remain stable*

**Key points**
- We expect economic growth to remain range-bound until macro risks dissipate.
- Inflation is set to hover around the ECB’s target.
- We expect the ECB to start raising rates in September 2019.

**CIO view (Probability: 60%*)**
- We expect economic growth in the Eurozone to remain fairly stable until uncertainties on the back of global protectionism, Brexit, and Italy dissipate. The ECB is in wait-and-see mode as inflation hovers around its target and until key risks fade away. We think the central bank may start raising rates in September 2019.
- In Germany, fundamentals such as consumer confidence, wage increases, and construction remain robust, mitigating the impact from global protectionism. In France, President Emmanuel Macron’s reforms should start to support GDP growth.
- Italian economic expansion should stabilize at moderate growth rates, supported by the forthcoming fiscal stimulus. Spain is still growing strongly, but the momentum is likely to continue to normalize.

**Positive scenario (Probability: 15%*)**
- The global economy accelerates again and the euro weakens. Eurozone loan demand and the economy recover faster than envisaged. Political risks fade.

**Negative scenario (Probability: 25%*)**
- The Eurozone suffers a disinflationary setback as markets lose faith in Italy’s debt sustainability, trade tensions escalate sharply, Brexit talks fail, the Ukraine conflict escalates, or the Chinese economy suffers a severe downturn.

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**Growth to stabilize at solid levels**

- We expect economic growth in the Eurozone to remain fairly stable until uncertainties on the back of global protectionism, Brexit, and Italy dissipate. The ECB is in wait-and-see mode as inflation hovers around its target and until key risks fade away. We think the central bank may start raising rates in September 2019.
- In Germany, fundamentals such as consumer confidence, wage increases, and construction remain robust, mitigating the impact from global protectionism. In France, President Emmanuel Macron’s reforms should start to support GDP growth.
- Italian economic expansion should stabilize at moderate growth rates, supported by the forthcoming fiscal stimulus. Spain is still growing strongly, but the momentum is likely to continue to normalize.

**Key dates**
- Oct 30: GDP estimate for third quarter
- Oct 31: Inflation estimate for October
- Oct 31: Unemployment for September
- Nov 2: PMI flash for November
- Dec 6: ECB press conference

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**Eurozone growth consolidating in 2018**

**Business and consumer surveys**

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**ECB balance sheet to top out**

Total assets in national currency (index: 2007=100)

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Source: Haver, UBS, as of September 2018

*Scenario probabilities are based on qualitative assessment.*
Chinese economy -  *Policy easing to cushion slowdown*

**Key points**
- Policy easing will continue amid rising external trade pressure and internal headwinds.
- Key macro data in August remained weak but showed signs of stabilization.
- Escalating China-US trade tension remains a key risk.

**CIO view (Probability: 80%*)**

- Monetary policy stance has turned "stable" with "reasonably ample" liquidity since July. The central bank announced on 7 October a Reserve Requirement Ratio (RRR) cut by 100bps, effective 15 October. We expect an additional 100-200bps of RRR cuts over the coming 6–12 months and the application of other lending facilities. Besides easing monetary policy, we expect more proactive fiscal policy, credit policy as well as tax and fee cuts to stabilize growth amid rising external trade pressure and internal headwinds.
- Key macro data in August remained weak but showed signs of stabilization. August fixed asset investment (FAI) growth improved to 4.6% y/y from 2.9% in July, retail sales edged up to 9% y/y driven by consumer staples, and overall credit stabilized with rising corporate and government bond issuance. We forecast China’s GDP growth to moderate to 6.4% y/y in 2H from 6.75% y/y in 1H.
- August CPI inflation rose to 2.3% y/y mainly driven by food and rental prices. We expect the whole-year inflation at 2.2%, but with upside risks on food inflation. Mild inflation leaves room for policy easing.
- Sino-US trade tension continued escalating, with the US imposing a 10%/25% tariff on another USD 200bn of Chinese goods effective 24 September/1 January 2019. China responded with tariffs ranging from 5–10% on USD 60bn of US goods effective 24 September as part of mixed retaliation measures. We expect China to continue retaliating against US trade actions, and investors should prepare themselves for a lengthy period of Sino-US trade tensions.

**Positive scenario (Probability: 5%*)**

- Annual GDP growth accelerates above 6.8% on easing trade tensions and cyclical global growth. Aggregate debt-to-GDP ratio stabilizes. Annual current account surplus increases over USD 100bn.

**Negative scenario (Probability: 15%*)**

- The US makes good on its threat to impose investment restrictions and tariffs on most Chinese products, introducing a sweeping 25% tariff on some USD 500bn of Chinese imports before 2020. In 2019, China experiences a sharp growth slowdown (5% real GDP growth for two quarters), and its current account deteriorates fast and turns into a deficit. The CNY slides to 7.5 or even weaker per USD within a quarter, China’s FX reserves fall dramatically, and authorities tighten capital controls. Asian and emerging market assets sell off.

**Key dates**

<table>
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<td>3Q GDP, Fixed asset investment, industrial production and retail sales</td>
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<td>Oct 31</td>
<td>Manufacturing and non-manufacturing PMI for October</td>
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<td>Trade data for October</td>
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<td>Nov 9</td>
<td>CPI and PPI data for October</td>
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<td>Nov 14</td>
<td>Fixed asset investment, industrial production and retail sales for October</td>
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* Scenario probabilities are based on qualitative assessments.
Swiss economy - *Strong 1H18 – weaker 2019 outlook*

**Key points**

- The Swiss economy grew by a solid 0.7% q/q in 2Q18 due to strong net exports. GDP growth for 1Q18 was revised up to 1% q/q. On the back of these strong 1H18 numbers we expect Swiss GDP to grow by 2.9% this year.
- The outlook for the Swiss economy deteriorated somewhat, however. Global political risks, a stronger Swiss franc, slower growth in the Eurozone and the lack of catch-up potential may slow GDP growth in 2019 to 1.6%.
- A stronger Swiss franc and political uncertainty in the Eurozone will keep the SNB cautious. We expect a first SNB rate hike in 3Q19 when the ECB is set to increase its target rate.

**CIO view (Probability: 60%*)**

- The acceleration of Swiss GDP benefited from a strong uptick in manufacturing. Trade data showed a broad-based improvement in the export sector.
- Robust GDP growth was mirrored by a 6% y/y increase in industrial production; employment grew by 2% y/y.
- Swiss manufacturing PMI fell sharply in September, from 64.8 to 59.7, reflecting the recent appreciation of the Swiss franc.
- The outlook for the Swiss economy has turned more opaque. Political risks (trade tensions, Italian budget discussion and emerging market turmoil), the recent appreciation of the Swiss franc and slower-than-expected growth in the Eurozone are likely to rein in Swiss GDP growth in 2H18 and 2019. We forecast GDP to grow by 1.6% in 2019.
- After recording strong levels of growth in 1H18, the Swiss economy has little further catch-up potential, which will weigh on the 2019 outlook.
- Inflation fell back to 1.0% y/y in September. We expect inflation at 1% this year as well as next year, underpinned by a weaker franc and higher oil prices.
- With risks having increased notably in recent months, we don’t see a first rate hike by the SNB before 3Q19 when we also expect the ECB to lift its target rate. We only expect FX interventions from the SNB should the EURCHF exchange rate should fall below the 1.10.

**Positive scenario (Probability: 10%*)**

- A further drop in Eurozone unemployment leads to a rebound in Europe and shores up domestic demand, which in turn supports Swiss exports.

**Negative scenario (Probability: 30%*)**

- Protectionist measures by the Trump administration lead to a global downturn, which would hurt Swiss exports. Also, increased uncertainty about Italian politics and emerging markets could cause the franc to appreciate.

* Scenario probabilities are based on qualitative assessment.

**Key dates**

| Nov 1 | PMI manufacturing (Oct)       |
| Nov 1 | CPI (Oct)                     |
| Nov 1 | SECO consumer confidence (Oct) |
| Nov 8 | Unemployment rate (Oct)       |

**Stronger Swiss growth and inflation ahead**

GDP growth and CPI inflation, with UBS forecasts

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Source: Macrobond, UBS, as of 11 October 2018

**Labor market benefits from the rebound in activity**

Employment growth y/y, full-time equivalent

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Source: Macrobond, UBS, as of 11 October 2018

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