Global macro view and asset allocation

Strategies in Focus: Our macroeconomic and multi asset views

The current investment landscape is one in which nothing should be taken for granted. Each individual economic data release is heavily scrutinized while the frequent utterances of monetary authorities are subject to similarly detailed analysis.

While these factors certainly drive asset prices, they do not always do so in a very predictable way. A 24-hour news cycle and instant communication technologies effectively encourage reactions to individual data points and foster a culture of short-termism. Such an approach can make it harder for investors to see the bigger picture. And for long-term investors, it is the bigger picture that should matter the most.

To better understand the investment landscape as we enter 2016, and to help identify the most attractive investment opportunities of the coming quarter, we consider the following economic and financial market developments:

- China in transition
- High hopes for the Eurozone, some concerns about Japan
- Relative US economic strength paves the way for rate normalization
- Currencies
- Alternatives

In each *Multi asset investment insight* section on the following pages we take a closer look at key positions that we have implemented in some of our portfolios.

China in transition

In 2015, signs that China – the world's biggest economy in purchasing power parity terms, and second only to the US in terms of nominal GDP – could be slowing faster than anticipated gave investors heightened concern. This put pressure on the prospects of heavily resource-dependent economies such as Brazil and Russia, which have already suffered significantly as a result of China's transition from a manufacturing- to a consumption-led economic growth model. Brazil and Russia face structural and political obstacles, with ongoing oil price weakness posing a further headwind.

Establishing closer, intertwined links with the global economy and financial markets is likely to bode well for China's prospects

China, however, does not necessarily face such easily identifiable headwinds. A subdued global growth backdrop is likely to lead to more muted demand for China's exports, but the consequent negative economic impact may, to some extent, be offset by a resurgence in domestic consumption. While the effectiveness of the Chinese authorities' efforts to boost the economy via monetary and fiscal measures has, to date, been questionable, there is the potential for more meaningful policy action in 2016.

Consensus growth and inflation forecasts 2016/17

In %	GDP growth			CPI inflation		
	2015	2016	2017	2015	2016	2017
Developed economies	*2.1*	*2.1*	*2.0*	*0.2*	*1.4*	*1.9*
US	2.5	2.6	2.5	0.2	1.8	2.2
Eurozone	1.8	1.5	1.7	0.1	1.0	1.5
Japan	0.6	1.0	1.0	0.7	0.8	1.9
UK	2.4	2.3	2.2	0.1	1.3	1.9
Switzerland	0.9	1.2	1.7	-1.1	-0.3	0.4
Emerging economies	*4.5*	*4.9*	*5.3*	*4.3*	*3.6*	*3.3*
China	6.8	6.5	6.3	1.5	1.9	2.0
Russia	-3.7	0.0	1.2	15.1	8.1	6.8
Brazil	-3.1	-1.4	1.5	8.9	6.9	5.2
India	7.3	7.5	7.8	4.8	5.2	5.4
World	*2.8*	*2.9*	*3.0*	*1.4*	*2.1*	*2.3*

Data as of end-November 2015
Source: Bloomberg Finance LP, UBS Asset Management

The surprise steps taken by the People's Bank of China to devalue the renminbi in August, and the decision by the International Monetary Fund (IMF) to include the currency in its special drawing rights basket, are indicative of progress in China becoming a more fully fledged actor on the global stage. For the past five years, it has been the world‘s largest exporter. The IMF now considers the renminbi to be freely usable and regards foreign investors as having sufficient access to onshore markets. Establishing closer, intertwined links with the global economy and financial markets is likely to bode well for China's prospects over the longer term.

Multi asset investment insight
In the equity relative component of many of our portfolios, we have been expressing a preference for North Asia (Korea, Taiwan and China) over the broader MSCI Emerging Markets Index. We expect both the Korean and the Taiwanese economies to benefit from healthy global demand for the technology products and intermediary goods that they manufacture. Although the speed of the economic recovery in North Asia has been moderate in an absolute sense, it is significantly better relative to emerging markets overall. While from a valuation perspective emerging market equities appear attractive, we are not yet prepared to add directional exposure, although conditions could become more conducive to doing so in 2016.

High hopes for the Eurozone, some concerns about Japan
The Eurozone and Japanese equity markets have seen relatively strong performance in local currency terms this year, not least compared with US and UK equities. Riskier assets in both the Eurozone and Japan have been supported by fairly similar sets of conditions – continued monetary policy easing, currency weakness providing a boost to exporters, as well as a low oil price which has left consumers with more disposable income. The prospects for corporate earnings growth have been broadly favorable for both, too.

> Eurozone economic growth could surprise on the upside, while Japan's growth prospects look likely to remain broadly stagnant

On the economic front, however, there are tentative signs of divergence. Eurozone economic growth in the coming quarters could surprise on the upside, while Japan's growth prospects look likely to remain broadly stagnant, or even mildly recessionary. While there has been no marked change in the fortunes of either economy, investor sentiment on the Eurozone is likely to have taken a turn for the better due to clearer signs of improvement from a relatively low base. In terms of its economic recovery and stage of business cycle, the Eurozone lags far behind the UK and the US. While growth has remained relatively muted this year, the promising trend of clearer convergence in economic conditions between the peripheral and the core Eurozone countries has become more entrenched.

The influx of migrants to the currency bloc – while bringing with it new risks – also has the potential to boost GDP, if new workers can be successfully integrated into the Eurozone labor force. On the earnings front, while Japanese companies have been generating strong earnings on a sustained basis, Eurozone earnings growth is only now gathering pace. The short-termism of some investors may make them forget that the European Central Bank (ECB) only expanded its asset-purchase program to include public sector securities in early 2015 – at a time when even the concept of the ECB buying the bonds issued by Eurozone governments was still regarded as impossible by many. While the ECB's asset purchases have kept Eurozone inflation mostly out of negative territory, they have not yet had the effect of exerting sustained upward pressure on consumer prices. It remains to be seen whether the enhanced easing measures announced by ECB President Mario Draghi in December, and the prospect of further accommodation next year, will provide the intended boost to regional growth and inflation.

Multi asset investment insight
As in previous quarters, our preference is for developed equity markets outside the US. We have become slightly less positive on Japanese equities, given the lack of a clear catalyst at this point to drive growth and inflation higher. Nevertheless, we remain overweight, primarily due to the strong earnings growth still being delivered by Japanese companies which is lending support to valuations. Our outlook for Eurozone equities is positive. We have benefited from some European equity relative value trades, such as a long German DAX vs. short Swedish OMX position. German exporters have been among the biggest beneficiaries of continued euro weakness.

Relative US economic strength paves the way for rate normalization
The Fed finally raised interest rates for the first time in around nine years in December. The market widely expected the increase, so the focus was on the language of the announcement and the projections for future rate increases. Both of these were marginally more dovish than expected, with the Fed now using the term „gradual" to describe the likely path of monetary policy. It is also notable that Fed forecasts for growth and inflation did not come down markedly from previous forecasts, contrary to lower expectations issued recently by some market

participants. In part, that reflects the Fed‘s confidence in the US economy, and its belief that the global concerns it articulated in September (i.e. China) have lessened.

Over the longer term, the pace of further increases and their magnitude, as well as the length of the tightening cycle will be just as important as the first Fed rate hike. Tighter US monetary policy is a positive move since it signals the Fed's confidence in the domestic economic recovery. We will be closely monitoring its impact on US consumer price inflation, which remains below the Fed's 2% target, but could trend upwards in 2016. The effects of Fed tightening will also reverberate through the global economy and financial markets. Emerging market economies, particularly those with US dollar-denominated debt loads that stand to become more expensive to finance as their currencies depreciate against a strengthening US dollar, are likely to suffer.

However, with the downside risk of policy error having been mitigated by the clarity of the Fed‘s December announcement, the case for investing in select emerging market equity and debt securities that are trading at attractive valuations is growing. Despite the more positive domestic economic backdrop, US equity valuations look relatively full in a historical context. Based on our analysis, further substantial gains appear unlikely in the medium term.

Tighter US monetary policy is a positive move as it signals the Fed's confidence in the domestic economic recovery

Multi asset investment insight
Following the Fed, the Bank of England (BoE) looks like it could be the second developed central bank to begin raising interest rates. UK GDP growth trends have been fairly positive, the unemployment rate is trending downwards and, so far, the country's efforts to renegotiate the terms of its EU membership appear to have had only limited impact on investor sentiment. Markets, however, are not expecting the BoE to raise its benchmark interest rate until the latter half of 2016. This is being reflected in low UK Gilt yields relative to US Treasuries – we believe that this spread is too wide. Our view is that the BoE is likely to raise rates sooner than markets are expecting, and we are therefore long Treasuries vs. short Gilts.

Currencies
Currency market movements have continued to be driven by expectations of the monetary policies pursued by the major central banks. After the Fed refrained from raising rates in September to the surprise of many, consensus expectations converged on a December rate hike. This meant that the US dollar remained in a strengthening environment against most other currencies for much of the fourth quarter.

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However, when the ECB failed to enhance its quantitative easing program in early December to the extent that had been priced in by markets, developed currencies including the euro, the yen and the franc surged against the US dollar. Following the third quarter‘s sharp losses, many emerging market currencies recovered some ground against the US dollar early in the quarter but came under pressure again at the end of the year.

Multi asset investment insight
Across our portfolios, we retain our conviction in the long Japanese yen position, which we have paired with short positions in the euro and the US dollar. Real exchange rate levels signal that the yen is the most undervalued developed market currency. While both the ECB and the Bank of Japan (BoJ) continue to pursue very loose monetary policy, in our view, further easing is more likely on the part of the ECB – as seen in December. The BoJ has refrained from adding to its quantitative and qualitative easing, against the expectations of many. Our long yen, short US dollar position meanwhile tends to act as a diversifier in risk-off environments, which is a key reason for holding it in our portfolios.

Elsewhere, our long US dollar vs. New Zealand dollar position has continued to contribute positively to performance. US economic strength and tighter monetary policy remains supportive of the US dollar, while it is our investment thesis that the Reserve Bank of New Zealand has the potential to cut rates further if growth disappoints. The vulnerability of New Zealand‘s economy to China‘s growth slowdown and sluggish consumer confidence at the domestic level are both factors that are likely to weigh on the New Zealand dollar.

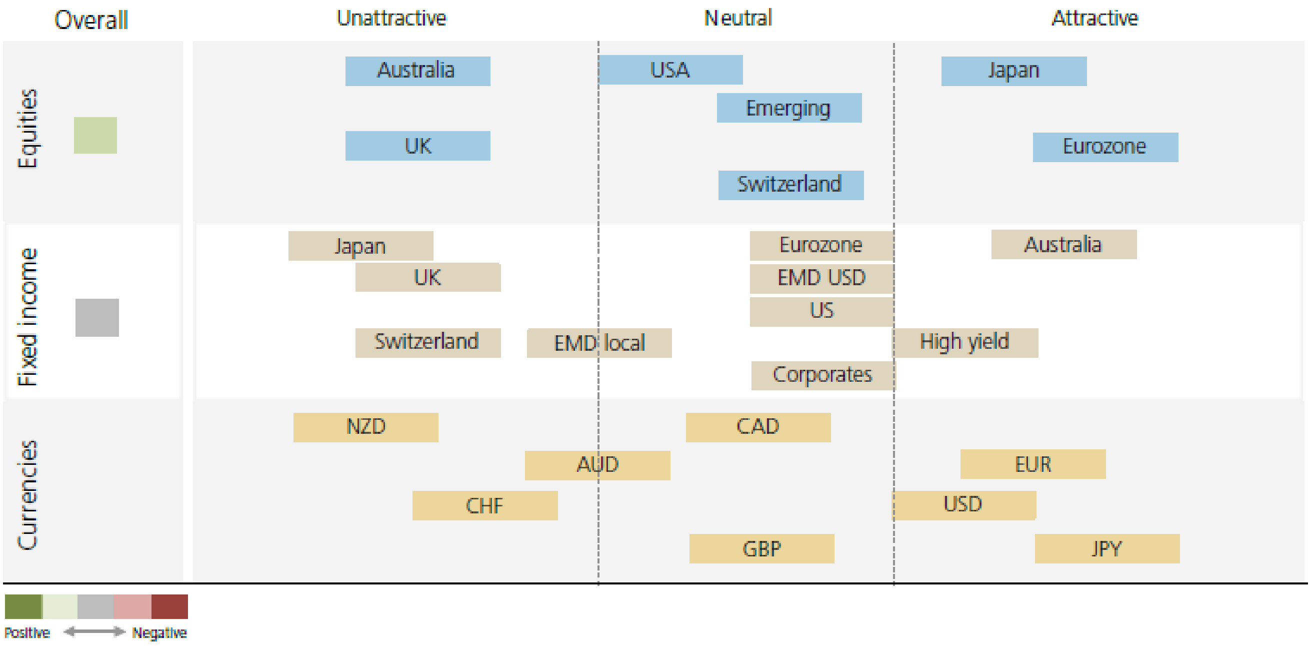
Alternatives
During December, global oil prices fell to levels last seen at the height of the financial crisis. Supply issues were the main drivers of the decline, with the lack of agreement between members of the Organization of the Petroleum Exporting Countries (OPEC) sending the price of Brent Crude below 40 US dollar per barrel. For the first time in two decades, OPEC failed to mention any quota or production target in its update to markets. Without a target, major producers will

continue to pump more oil. Elsewhere, the strong US dollar continues to negatively affect emerging market energy demand.

Over the medium term, our view remains that a more coherent OPEC strategy leading to production cuts will emerge in 2016 to support global oil prices. Meanwhile, the strong US dollar and concerns about Chinese demand have been the major contributors to recent weakness in copper, nickel, zinc and iron ore. Most metals now trade close to or below the marginal cost of production. With supply cuts already coming in nickel and zinc as the major mining companies cut back on higher cost operations, we expect more positive market forces prevailing into 2016.

Asset class attractiveness
The chart below shows the views of the Asset Allocation & Currency team on overall asset class attractiveness, aswell as relative attractiveness within equities, fixed income and currencies, as of end-November 2015.

Andreas Koester is Head of Asset Allocation & Currency. He has overall responsibility for setting strategy across the entire range of UBS Asset Management‘s asset allocation and currency capabilities, including both traditional benchmark relative and total return oriented mandates. Andreas also directs and conducts research and analysis in support of asset allocation strategy setting. He joined UBS Asset Management in 2009 and has 23 years of industry experience.



For illustrative purposes only.
Data as of end-November 2015 with a 12 to 18 month horizon, based on information available to us.
Views are not necessarily reflective of actual portfolio positioning and are subject to change.
Source: UBS Asset Management's Asset Allocation & Currency team

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Source for all data and charts (if not indicated otherwise): UBS Asset Management, a business group within UBS.

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