

Global Perspectives

Multi Asset | January 31, 2016

Overview

Equities: Nearly all developed and emerging equity markets sold off in January as concerns about China's economic transition, slowing global growth and a rapidly deteriorating oil price weighed on returns. The apparent promise of an enhancement to the European Central Bank's (ECB) monetary stimulus program in March and the Bank of Japan (BoJ) introducing a negative interest rate policy helped resurrect investor sentiment towards month end, however.

Fixed Income: The risk-off environment of January meant that government bonds did well, with positive performance (in total return, local currency terms) led by UK Gilts, German Bunds and US Treasuries. Global investment grade returns were broadly flat, while high yield corporate bond returns were negative in both the US and Europe.

Currency: The US dollar strengthened on account of investors seeking out safe haven assets amid market volatility, benefiting our long US dollar/short New Zealand dollar positioning. Long euro/short Swiss franc exposures also contributed positively. The franc trended downwards amid expectations that the Swiss National Bank will be prompted to ease policy further if the ECB enhances its monetary stimulus in March.

The month in review: Investors overlook fundamentals as sentiment plummets

- Most risk assets had a very bad start to the year, as concerns about China's economic transition, slowing global growth and a rapidly deteriorating oil price weighed on returns. The Chinese economy grew at the slowest pace since 2009 in the fourth quarter of 2015—with GDP expanding by 6.9% on the previous year—while the adverse effects of oil and other commodity price weakness continued to be felt across the emerging economies, as well as financial market segments such as US high yield. The price of a barrel of WTI crude oil fell to just under USD 27, its lowest level in over 13 years.
- The latter half of January saw a sharp reversal in sentiment, however, with European Central Bank (ECB) president Mario Draghi appearing to deliver an aptly timed promise of an enhancement to the ECB's quantitative easing program in March. With investors taken by surprise, having anticipated that Draghi would once again fail to meet their expectations of further stimulus as was the case in December, risk assets rallied strongly. Eurozone equities made some of the biggest two-day gains of recent years. To wrap up an unusually eventful month, the Bank of Japan became the first non-European central bank to introduce a negative interest rate policy, sending the Japanese yen sharply lower against the other major currencies.

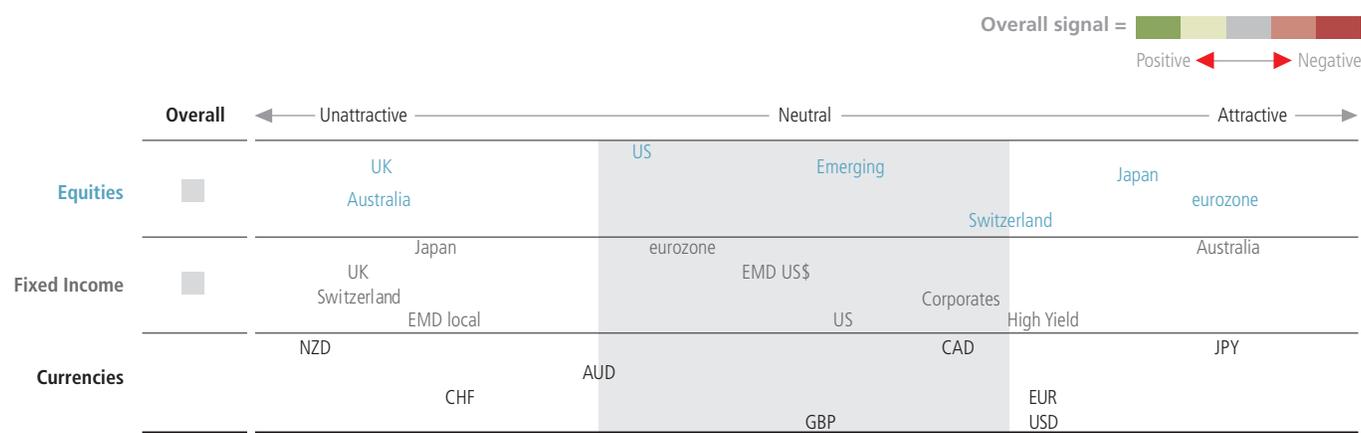
- Equity markets sold off across the board in January, with the MSCI EAFE Index (developed excluding US equities) finishing the month around 7.8% lower, while the MSCI Emerging Markets Index was down 6.2%. Investors sought refuge in the perceived safety of government bonds, with the yield on the 10-year German Bund down 37 basis points (bps) on the month, and yields on US Treasuries (-34 bps) and UK Gilts (-39 bps) falling equally sharply. High yield corporate bonds sold off amid the deteriorating risk appetite.

Outlook: Deploying active risk to benefit from changing market conditions

- The market turmoil of January, much of which was characterized by asset prices being determined by non-fundamental factors and risk assets selling off in concert, serves to emphasize the importance of holding a range of diversifying trades in portfolios.
- Entering 2016, we have been reassessing how we deploy active risk: instead of being directionally long equities as was the case last year, we will be more neutral equities as a starting point, moving under/overweight to benefit from changing market conditions. As of the end of January, however, we remained long the MSCI EAFE Index of developed market excluding US equities, retaining our preference for eurozone and Japanese equities.

Current views¹

Asset allocation and currency attractiveness based on fundamental valuation and market behavior analysis



Asset Class	Overall signal	UBS Asset Management's viewpoint
US Equities		<ul style="list-style-type: none"> Despite the relatively favorable domestic economic backdrop, the broader US equity market remains unattractive in our view, primarily on valuation grounds. A better-than-expected US fourth quarter earnings season could lend support to sentiment, however. US economic growth was estimated to have slowed to an annual rate of 0.7% in the fourth quarter of 2015, from the previous quarter's 2.0%. US consumption has not picked up to a degree that would be expected given the potential boost to demand provided by ongoing oil price weakness and conditions of labor market health.
Global (Ex-US) Equities		<ul style="list-style-type: none"> We retain our preference for developed equity markets outside of the US, particularly the eurozone and Japan. However, we have been reassessing how we deploy active risk, and instead of being directionally long equities as was the case last year, we will be more neutral equities as a starting point, moving under/overweight to benefit from changing market conditions. Monetary policy remains supportive of developed ex-US equities. The BoJ eased further in January by introducing a negative interest rate policy, while Draghi gave a strong hint that the ECB would enhance its stimulus program at its March 2016 meeting.
Emerging Markets Equities		<ul style="list-style-type: none"> Investors were alerted around the start of 2016 to the Chinese economy growing at the slowest rate since 2009 in the fourth quarter of last year. However, GDP expanded at an annual 6.9% in 4Q15, which suggests that China's official growth rate could be stabilizing around the government's target of about 7.0%. The Caixin China General Services PMI for January rose to 52.4, the highest level since July 2015. The Caixin composite index that covers both services and manufacturing also signaled expansion in business activity. We continue to believe that the equity markets of North Asian economies (Taiwan, Korea, China), which stand to benefit from developed market growth, are more attractive than the broader MSCI Emerging Markets Index.
US Bonds		<ul style="list-style-type: none"> The Fed left policy unchanged in January and issued a statement that was neither overly dovish nor hawkish, reassuring investors that rate rises will be gradual and data-dependent. We do not expect the Fed to raise rates at its March meeting, unless market conditions further stabilize and economic data shows marked improvement. We continue to hold a long 10-year US Treasuries/short 10-year UK Gilts position. Markets are pricing in an increase in UK interest rates in 9 months' time, but this timing seems too late to us given the strength of the UK domestic economic recovery. We are monitoring closely comments from the Bank of England and members of its Monetary Policy Committee, which have remained broadly dovish.
Global (Ex-US) Bonds		<ul style="list-style-type: none"> The monetary policy divergence of the major developed market central banks is now firmly entrenched. The Fed met the expectations of investors in delivering the first interest rate increase in around nine years at its December 2015 meeting. The ECB, the BoJ, the Swiss National Bank and Sweden's Riksbank remain firmly in easing mode. We retain conviction in our 30-year Spanish and Italian government bond holdings, which are attractively valued for economies in recovery. The magnitude of the remaining output gap (needs to be bridged for economy to be operating at full capacity) means that there is unlikely to be inflationary pressure to push up long-dated yields.
Investment Grade Corporate Debt		<ul style="list-style-type: none"> Our preference for global investment grade corporate bonds over sovereigns is a negative yield avoidance trade. With the trade not performing well amid recent spread widening we reviewed its profit and loss review levels, deciding to keep it on. We are looking to make the positioning duration neutral.
High Yield Bonds		<ul style="list-style-type: none"> We prefer the eurozone high yield market to the US. Concerns about heightened default risk and liquidity continue to weigh on the US high yield market. Eurozone high yield has relatively less energy-sector exposure and is therefore likely to fare better in an environment of continued commodity price weakness.
Emerging Markets Debt		<ul style="list-style-type: none"> Our overall view on external (US dollar denominated) emerging market government bonds remains neutral, while we continue to be negative on local currency denominated emerging market sovereigns.
US dollar		<ul style="list-style-type: none"> In some of our portfolios, we are positioned long Asian/short Japanese government bonds. Asian economies tend to benefit from commodity price weakness, being net oil importers. Much of the debt in the Asian universe is issued by high-quality, state-owned companies.
Local currency		
Currency		<ul style="list-style-type: none"> We are long the Mexican peso versus other emerging market currencies (such as the Malaysian ringgit) that we expect to be vulnerable to moderating Chinese economic growth. While investment in energy-related projects in Mexico is likely to slow due to the weak oil price, foreign direct investment (FDI) should rise as competitiveness versus China and low-cost producers increases. Higher US FDI in Mexico in particular is likely. While growth is expected to moderate in China, we believe this theme is best expressed by short positions in currencies linked to China's economy, rather than the Chinese yuan itself. Renminbi devaluation is likely to be negative for the ringgit.

¹ Source: UBS Asset Management. As of January 31, 2016.

Valuations plus one or more market behavior indicators provide an overall signal



Market themes

Market opportunities that we believe will drive markets in the longer term but have an immediate impact. This helps put valuation into context. For example: "European debt crisis," "aging population" or "deleveraging."

Momentum and flow

Attempts to capture money flows and market appetite for risky assets from the perspective of professional asset allocators, such as mutual fund managers.

Market stress

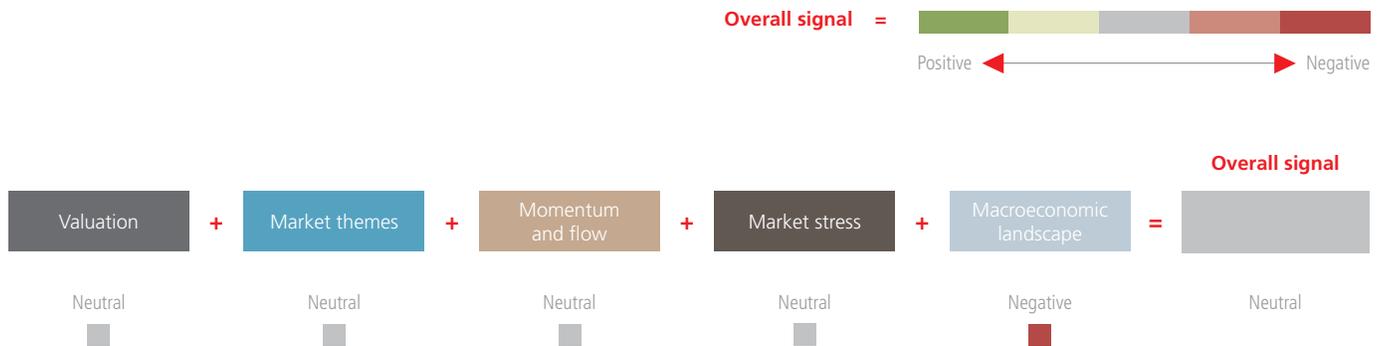
We created a proprietary stress index to help gauge price dislocations and investor risk appetite. It comprises several spread measures across credit markets, currencies and cash markets, as well as measures of market sentiment, such as the Chicago Board Options Exchange Market Volatility Index (VIX).

Macroeconomic landscape

Understanding the current position (recovery, expansion, slowdown, recession) in the economic cycle of a country or region. We also consider the baseline and alternative economic scenarios of countries and regions and how asset classes may react differently in these scenarios.

US Equities example as of January 31, 2016

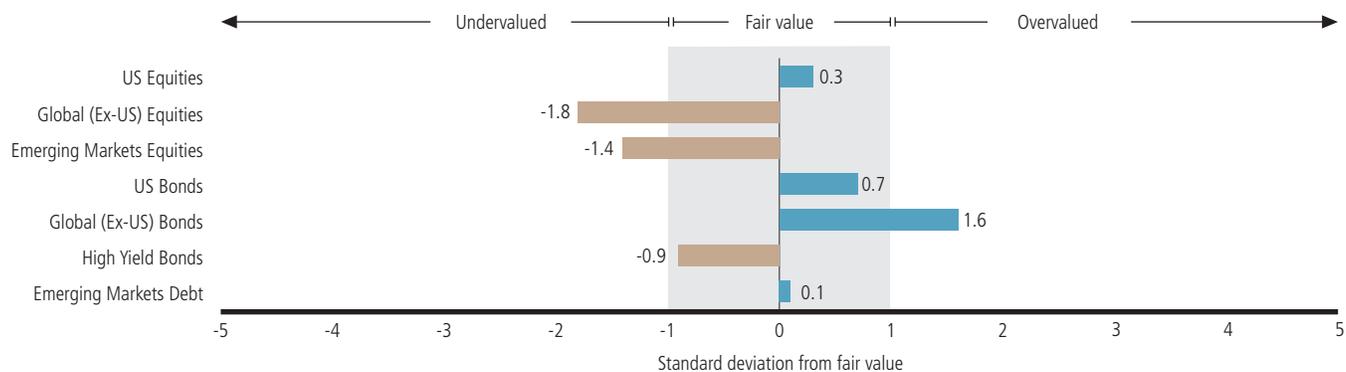
Valuation and market behavior indicators at work



Note: The contribution each component has to the overall signal will vary from month to month.

Normalized asset class valuations²

Normalizing the price/value discrepancy provides a standardized relative comparison across asset classes



² Based on UBS Asset Management's views. As of January 31, 2016.

Definitions of metrics:

1. Asset Class/Benchmark: All investment expectations displayed here are modeled from the discounted cash flows as replicated by the relevant publicly available index. This bears mentioning because these expectations are developed assuming no benefit from active management (i.e. security selection) within the asset classes themselves.

2. Price/Value: An intrinsic value based on the cash flows that an asset class provides—discounted at an appropriate rate of return (the required rate of return)—is identified for each of the asset classes listed. The cash flows would be those that would be expected to pass through to the asset holder; in the case of equities, the relevant cash flows are earnings and non-reinvested earnings (including, though not exclusively, dividends). That intrinsic value is then compared to the market price for the proxy index, and the degree of over- or undervaluation is thereby calculated in percent.

3. Normalized Price/Value: The normalized price/value represents the standard deviation, or dispersion, of the asset class from our estimate of fair value. Normalizing the price/value discrepancy provides a standardized relative comparison across asset classes. The normalized price/value is calculated by taking the price/value of an asset class and dividing it by the secular risk estimate of the same asset class.

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