

Global Perspectives

Multi Asset | July 31, 2016

Overview

Equities: Global equity markets continued to grind higher in July, shrugging off post UK Referendum concerns. Equities were boosted by expectations for a looser monetary policy backdrop and additional stimulus by developed world central banks. Away from developed world geopolitical risks, emerging market equities were among the best performing. The MSCI All Country World Index returned 4.0% in local currency terms.

Fixed Income: 10-year US Treasury yields rose over the month on stronger domestic economic data. Yields on major investment grade and high yield bond indices fell sharply relative to US Treasuries as investors' quest for yield continued.

Commodities: Oil prices fell sharply over the month as low gasoline refining margins caused gasoline stocks to rise and seasonal demand for crude oil to wane.

The month in review:

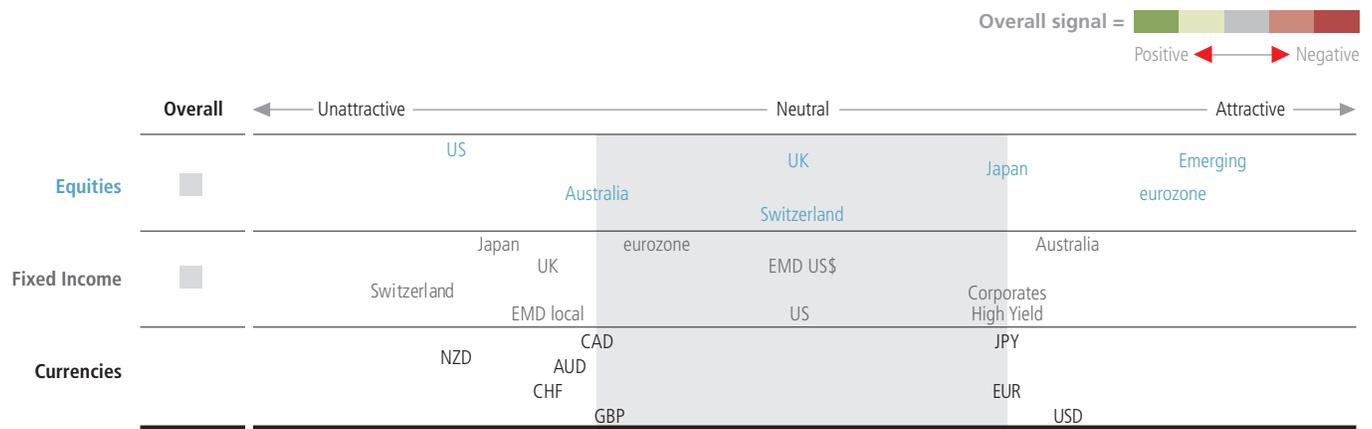
- Markets sustained their upward momentum through July with most asset classes producing positive returns on the basis that policy support is coming. The Bank of Japan (BoJ) announced what turned out to be an underwhelmingly modest monetary stimulus, redirecting the focus of Abenomics back to fiscal and structural action. The European Central Bank (ECB) indicated that they were "ready, willing and able" to act as needed post Brexit, but that existing measures need time to work first. Similarly, the US Federal Reserve (Fed) opted not to raise rates, sounding a relatively upbeat tone, but acknowledged global market uncertainty stemming from Brexit as potentially having repercussions for the US economy.
- The strong US jobs data injected some much needed confidence into markets as nonfarm payrolls significantly exceeded expectations, posting the largest gain in eight months. Futures markets are now pricing in a slightly higher probability of the Fed raising interest rates in the next 12 months.
- Japanese equities benefitted from expectations of further reform-minded policies from the Prime Minister and looser monetary policy from the BoJ. Meanwhile, robust economic data as well as loose monetary policy supported European market efforts to regain pre-Brexit levels. Emerging markets, US and UK equities also delivered strong positive returns. Most fixed income markets gained over the month, with government bond yields remaining at record lows in spite of increasing levels of risk appetite within markets. Within credit, spreads narrowed in July across the US, Europe and the UK. High yield debt also performed well over the month with the US and Europe marking positive gains. In commodities, oil prices experienced their largest monthly drop in a year.

Outlook:

- We believe that markets will continue to be sensitive to new economic data and investor sentiment remains fragile. Political risk is likely to be one of the biggest drivers of volatility, with the US presidential elections coming up later this year and the Brexit vote creating vast uncertainty and economic implications for Britain, the EU and beyond. While fears about a slowing Chinese economy have faded as a result of improving economic data, we believe that long-term challenges still remain a concern and need to be monitored closely.
- Having previously reduced equities on a tactical basis based upon concerns about US valuation, monetary tightening, earnings headwinds and disappointments in economic data, we have become more constructive of late. The lasting impact of the UK Referendum result has been to spur central banks towards even easier monetary policy—and we have, therefore, considered it appropriate to lift equity exposure in light of a more supportive liquidity/monetary policy backdrop. In this regard, we have added back equity exposure with a particular focus on emerging markets. We continue to favor other markets outside of the US on account of valuation support and more supportive monetary policy.
- Within fixed income, we prefer what we believe to be a more attractive risk-adjusted returns profile in selected areas of credit, like investment grade bonds. In addition, we tactically favor inflation-linked bonds in the US over their nominal counterparts, believing US inflation risks are underpriced.

Current views¹

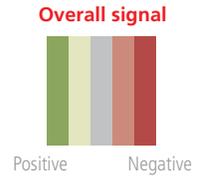
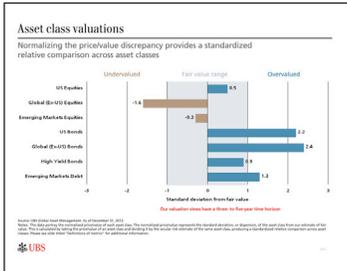
Asset allocation and currency attractiveness based on fundamental valuation and market behavior analysis



Asset Class	Overall signal	UBS Asset Management's viewpoint
US Equities		<ul style="list-style-type: none"> Our analysis shows US equities as overvalued on a number of measures in an historical context. With revenues under pressure from a muted growth backdrop and a strong dollar, and the risk of margin pressure from wage growth, the scope for disappointment relative to expectations is high. We see no compelling rationale for further multiple expansion against this backdrop. Meanwhile, Fed Funds futures are currently pricing in a very low probability of any hike in benchmark US interest rates over the coming year. We do not believe that this view is consistent with the strength of recent US economic data. A more hawkish tone from the Fed and a 25-basis-point hike before year-end are likely to act as a headwind to equity market progress in our view.
Global (Ex-US) Equities		<ul style="list-style-type: none"> We continue to prefer equity markets outside of the US. In Europe, we believe the recovery story remains largely intact, supported in no small part by the ECB's loose policy. We, therefore, currently prefer smaller, more domestically focused companies over more export-oriented large caps.
Emerging Markets Equities		<ul style="list-style-type: none"> Emerging market equities have looked attractively valued from our analysis for some time. While our concerns about industrial capacity and external debt loads in a number of countries remain – these have abated somewhat. We believe there is now scope for a positive earnings surprise in the short- to medium-term, particularly as emerging market currencies stabilize and, in some cases, appreciate. Crucially for an equity universe which demonstrates material sensitivity to Fed policy due to high levels of USD-denominated debt, the "lower for longer" backdrop is potentially supportive. We do not necessarily see the USD weakening but believe that a stable USD is sufficient in itself to drive improved sentiment. Surveys also show EM equities as an area in which global fund managers remain neutral at best. Looking ahead, we see higher quality, lower volatility stocks with more sustainable earnings streams outperforming the broader EM equity universe.
US Bonds		<ul style="list-style-type: none"> With low yields and the potential for further rate rises, we see nominal US government bonds as unattractive. With the year-over-year base effects of oil rolling off and emerging wage pressures, there appears to be an unwarranted asymmetric outcome probability priced into the wider market's dovish expectations on medium-term US inflation risks. We, therefore, prefer US Treasury Inflation-Protected Securities (TIPS).
Global (Ex-US) Bonds		<ul style="list-style-type: none"> The recent drop in global government bond yields has further stretched valuations relative to long-term history. In aggregate, we see global bonds outside of the US as unattractive with German bunds standing out as one of the most overvalued markets. We continue to see a number of geopolitical and fundamental risks to the bonds of peripheral eurozone countries, such as Italy, that we do not believe are reflected in current yields. We have a preference for Canadian bonds, which we see as an attractive hedge for lower oil prices given the importance of energy to the Canadian economy. We also believe that the Canadian economy has a long process of restructuring ahead as its reliance on the energy sector diminishes. The diverging fortunes of provinces make monetary policy very difficult for the Bank of Canada.
Investment Grade Corporate Debt		<ul style="list-style-type: none"> Our positive view on investment grade bonds relative to developed world sovereign debt is largely predicated on valuations and the former's attractive yield pick-up. Against a backdrop of "lower for longer" short-term interest rates and government bond yields in the developed world, we do not believe that a sharp rise in defaults at the higher-quality end of corporate debt as likely. We see global IG corporates as continuing to offer an attractive risk and return profile compared with government bonds.
High Yield Bonds		<ul style="list-style-type: none"> After a sustained period of strong performance in which yields in European high yield, in particular, have fallen sharply in absolute terms, as well as relative to US Treasuries, we no longer see the valuation case as compelling on a stand-alone basis.
Emerging Markets Debt		<ul style="list-style-type: none"> Our overall view on external (USD-denominated) emerging market government bonds remains neutral.
US dollar		<ul style="list-style-type: none"> A subset of currencies within this broad universe now look attractive on a long-term basis while the improvement in current accounts and stabilization in growth now balance out our concerns about high debt levels.
Local currency		
Currency		<ul style="list-style-type: none"> Among developed market currencies, we see the USD as attractively valued and the Swiss franc among the most expensive currencies globally on our long-term analysis. As noted above, within emerging markets we see a growing number of long-term opportunities away from developed world geopolitical risk.

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

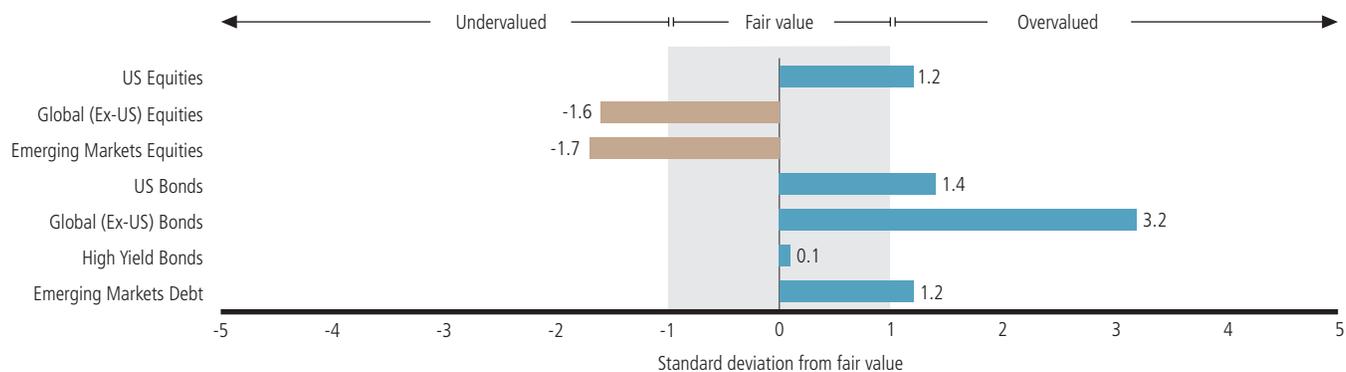
Valuation and market behavior indicators at work



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 July 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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