

Macro Monthly

For global professional / qualified / institutional clients and investors and US retail clients and investors.
For marketing purposes.

UBS Asset Management | Economic insights and asset class attractiveness
January 2019



Evan Brown
Head of Macro Asset Allocation Strategy,
Investment Solutions

Roland Czerniawski
Asset Allocation Analyst
Investment Solutions

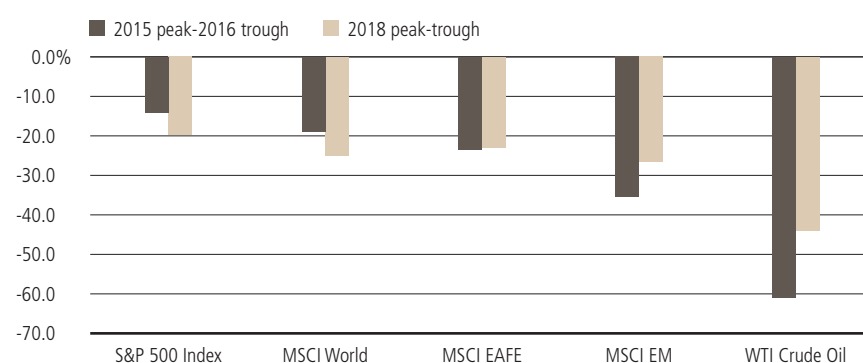
Something familiar

Highlights

- The market and economic environment is reminiscent of the late 2015 and early 2016 period.
- The global economy is in better shape this time around and equity valuations more attractive, but tighter policy and geopolitical tensions are headwinds.
- Three years ago, a one-two punch of a less hawkish Fed and China stimulus catalyzed a quick rebound in risk assets toward their highs.
- We expect policymakers on both sides of the Pacific to once again provide support for risk assets in 2019, but policy constraints may limit the effectiveness compared to 2015/16.

While the sharp drawdown in global risk assets in the fourth quarter of 2018 stands in stark contrast to their placid uptrends in 2017, there is still something familiar in recent price action. In several ways, market behavior late in 2018 and to start 2019 resembles that of late 2015/early 2016. Exhibits 1 and 2 show the drawdowns for major asset classes in 2015 until early 2016 compared to drawdowns in 2018. Drawdowns across global equity indexes in 2018 have generally been more severe than those of three years ago, while the rise in credit spreads and decline in Treasury yields have been roughly half those in the prior period. A sharp decline in oil prices, driven by both supply and demand factors, has been a common element that has fed into weakness in the prices of risk assets. Arguably, the underlying concerns among investors in these two periods are similar as well—fears of a Fed policy mistake amid slowing global growth.

Exhibit 1: 2015-2016 vs 2018 peak to trough equity performance



Source: Bloomberg as of December 26, 2018.

In Q1 2016, these concerns began to fade driven by a more dovish Fed and evidence of an improving global economy. Indeed, risk assets rebounded rather quickly towards their previous highs. Today there are enough similarities to ask the question of whether history might repeat itself, but enough key differences which we believe are likely to make the healing process for global risk assets longer and bumpier than three years ago. This Macro Monthly compares the macro backdrop, policy dynamics and valuations over the two periods and discusses implications for asset allocation.

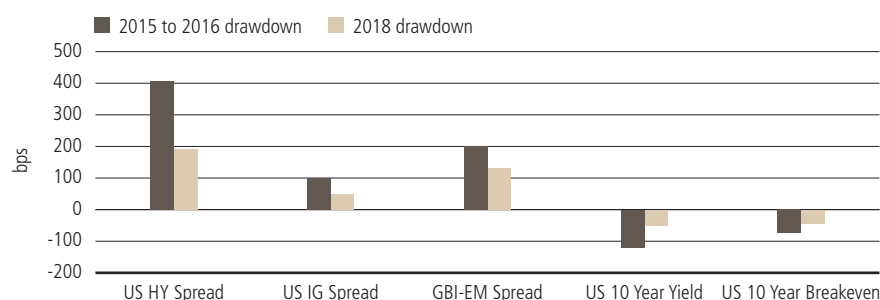
The macro backdrop

The stock market is certainly not the economy. But over time, equity market performance tends to broadly reflect the prospects of company earnings, which generally move in line with nominal economic growth. So a useful starting point is to examine where the global economy stands versus three years ago. Put simply, the economy is looking a lot healthier than it was back then. By the middle of 2015, global composite Purchasing Manager Indexes (PMIs) had declined sharply, and emerging markets turned below the key 50 level separating expansion and contraction. In contrast, today's PMIs, while down from elevated levels, remain comfortably in expansionary territory. Likewise, while nominal export growth for large economies had turned negative in 2014, it currently remains in positive territory. And while China's economy is slowing, its nominal GDP growth as of Q3 2018 was far above where it was three years ago, near post-crisis lows. Meanwhile, developed market consumers are in very good shape today, with incomes rising healthily across the US, Europe, Japan and UK.

Policy backdrop

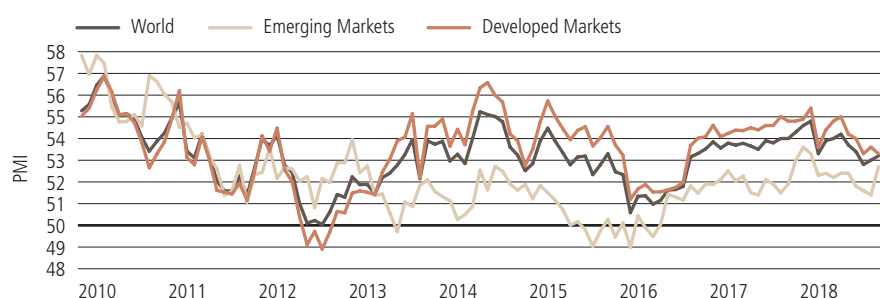
Of course, healthier economies encourage policymakers to remove accommodation. Back in December 2015, investors were concerned given the economic backdrop that the Fed was committing a policy error when it delivered just its first hike in this tightening cycle. Eight additional hikes

Exhibit 2: 2015-2016 Credit spread and Treasury yield changes vs 2018 (basis points) bps



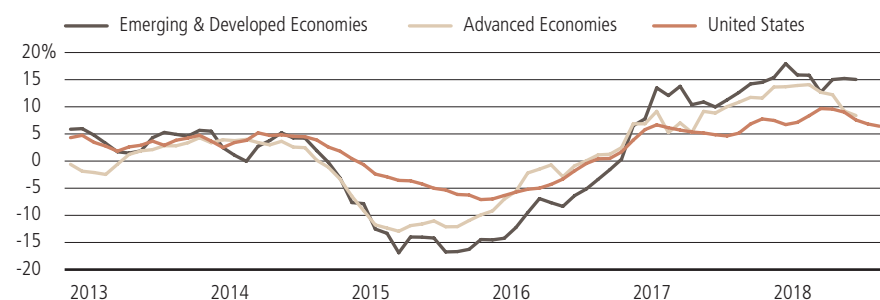
Source: Bloomberg as of December 26, 2018.

Exhibit 3: Global composite PMIs



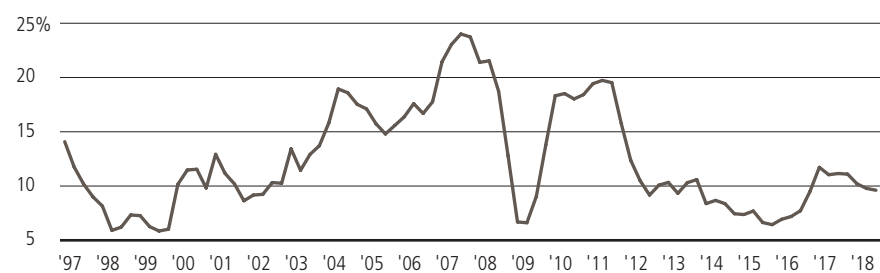
Source: UBS Asset Management, Macrobond, IMF, as of December 26 2018.

Exhibit 4: Nominal export growth (YoY)



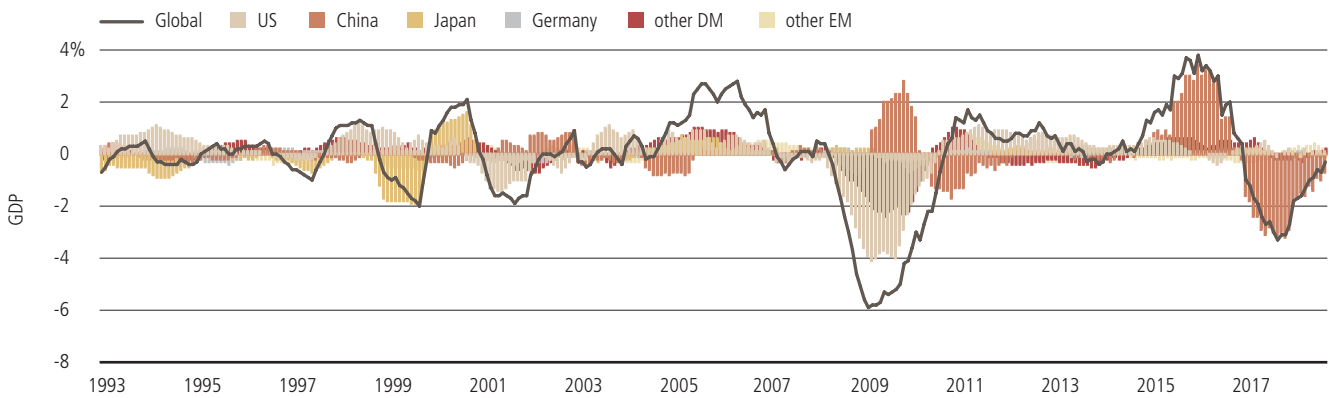
Source: UBS Asset Management, Macrobond as of December 26, 2018.

Exhibit 5: China nominal GDP (YoY)



Source: UBS Asset Management, Macrobond as of December 26, 2018.

Exhibit 6: Contributions to Global Credit Impulse (market GDP weighted)



Source: UBS Investment Bank, Haver as of September 2018.

later and the Fed is within the range of its estimates of neutral policy while the yield curve is close to inversion. Once again, some investors are fretting that the Fed has made a policy mistake. With real policy rates still just above zero for an economic outlook that remains generally healthy, we are less concerned about the impact of the Fed’s tightening to date on the real economy. But we do acknowledge the effect a higher long-term real discount rate has on equity and credit valuations. Still, given the sharp tightening of financial conditions, cooling of inflation and a more data-dependent Fed that is closer to ‘neutral,’ we expect that the Fed is likely to do just what it did in early

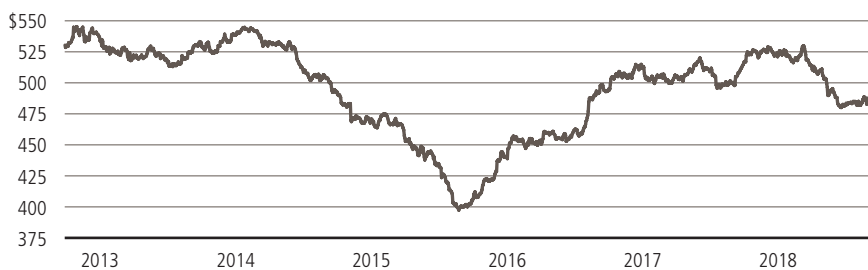
2016—take a pause to assess the underlying fundamentals of the economy and the effects of its tightening to date. We suspect that much like three years ago, a Fed sending an ‘on hold’ signal will ease market concerns and lead to a stabilization of risk assets.

The other key policy support in early 2016 came from China, as illustrated in Exhibit 6. After tightening credit in the years following the powerful post-crisis stimulus, China ramped up credit creation throughout 2015, and markets began to gain confidence this would be enough to support local and global economic data in early 2016. This easing set the stage for the accelerating global

synchronized growth of 2017, prompting China to reverse course sharply last year in the interests of long-term deleveraging and financial stability. With a slowing economy, China’s authorities have once again initiated monetary, fiscal and regulatory easing which should cushion the economy in 2019.

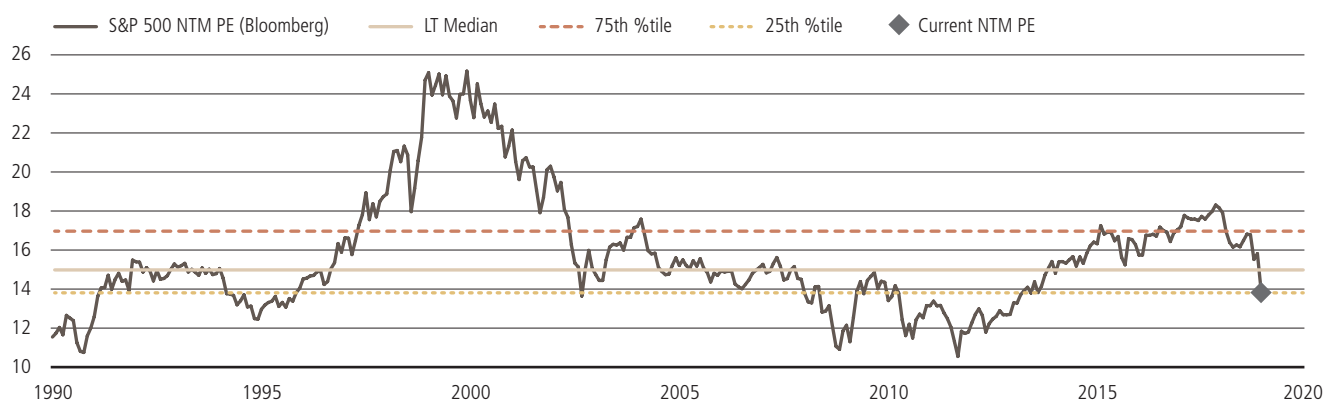
Still, there are reasons to believe the one-two punch of Fed-China policy support may be less powerful and fast-acting this time around compared to 2016. For now, China’s policymakers seem intent on avoiding the boom-bust periods of recent years and have maintained a strategic structural goal of de-leveraging. While China’s authorities have pulled policy easing levers in a number of areas, the stimulus appears more targeted and piecemeal than in prior reflationary episodes. This is reflected in the CRB’s raw industrial commodity index displayed in Exhibit 7. While prices of China’s key industrial commodity imports had declined much more sharply several years ago, the rebound was also sharp. 2018’s commodity price decline was shallower and seems to have been stabilized by recent policy actions, but a sharp reversal signaling powerful stimulus is absent for now.

Exhibit 7: CRB Raw Industrials Commodity Index



Source: Bloomberg as of December 26, 2018.

Exhibit 8: S&P 500 P/E ratio (Next 12 months)



Source: Bloomberg, Evercore ISI As of December 26, 2018.

And like China's policymakers, the Fed may find itself more constrained in its ability to take its foot firmly off the brake as it did in 2016. Remember that after hiking in December 2015, the Fed did not hike again until a full year later. While we do expect a pause in the 1st quarter, the reality is that with an unemployment rate below 4% and core inflation near target, we expect that it is more difficult for the Fed to completely abandon its tightening cycle and provide full relief for risk assets. This would particularly be the case if core inflation accelerates this year.

Finally, markets today are grappling with various geopolitical issues that were not major concerns three years ago, most notably the trade and technology tensions between the US and China. The uncertainty on future trade relationships, supply chains and technology regulations are likely to weigh on market multiples and remain an obstacle for quick return to market highs. While market and economic stress may incentivize both Presidents Trump and Xi to reach a deal

on tariffs, strategic competition and national security concerns are likely to make regulatory uncertainty an ongoing headwind for years to come.

Valuation

One important consideration is that a lot of this negativity is already in the price of major equity indexes. Even assuming a conservative S&P 500 earnings growth estimate of 5% in 2019, the next twelve-month P/E ratio is one standard deviation below its average since 1990, as shown in exhibit 8. This compares to a P/E ratio just at average when markets bottomed in early 2016. That this economic expansion is three years older, discount rates higher and geopolitical tensions stronger will likely limit a return of the multiple to the top of the recent range. But even a move towards early 2016 levels implies healthy returns for equities in 2019.

The bottom line: Asset allocation

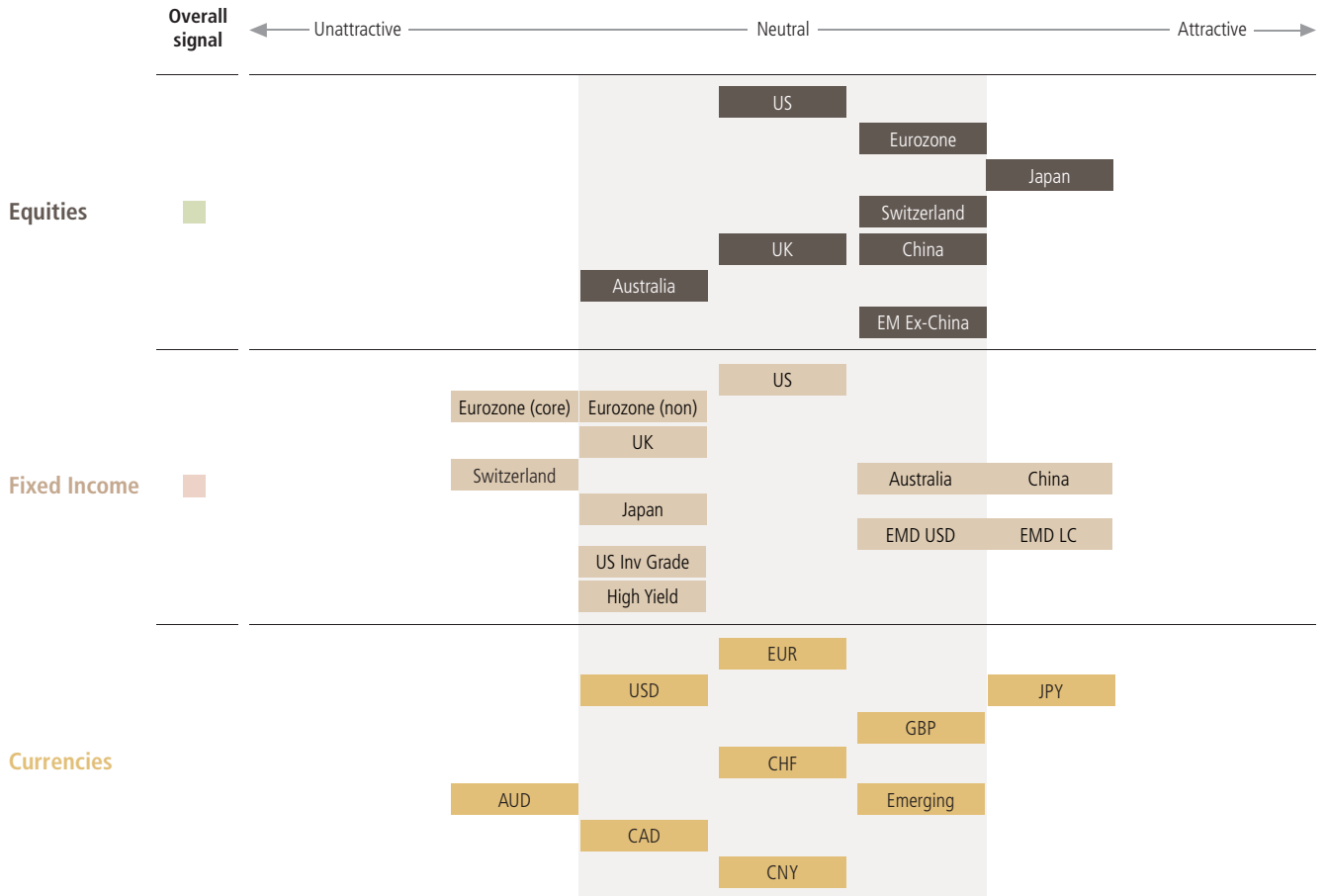
As was the case in early 2016, we expect that the twin policy response of a Fed pause and Chinese stimulus is

likely to provide support for risk assets in 1H 2019. But overarching policy objectives and economic conditions facing both sets of policymakers will likely prevent as swift a rebound as that witnessed three years ago. Concerns about cycle length and ongoing geopolitical uncertainties should also keep volatility elevated and the path to higher returns bumpy. The combination of a less hawkish Fed and Chinese stimulus should have clearer effects on the US dollar, which we expect to weaken over the course of 2019. This has made us more constructive on emerging market equities and debt, which we expect to outperform. Indeed, it is notable that EM equities and debt outperformed US equities and credit respectively during the Q4 selloff, suggesting a lot of negative news for EM indexes was already in the price. At current valuations we find global equities attractive, but maintain an underweight in US credit to hedge against further disruption in risk assets.

Overall signal = Positive ← → Negative










Asset class attractiveness

The chart below shows the views of our Asset Allocation team on overall asset class attractiveness, as well as the relative attractiveness within equities, fixed income and currencies, as of December 31, 2018.



Source: UBS Asset Management Investment Solutions Asset Allocation team as at December 31, 2018. Views are provided on the basis of a 3-12 month investment horizon, are not necessarily reflective of actual portfolio positioning and are subject to change. For illustrative purposes only.

Overall signal = 

Asset Class	Overall signal	UBS Asset Management's viewpoint
US Equities		<ul style="list-style-type: none"> US equities remain supported by solid corporate earnings growth and increasing capital returns to shareholders. But the most recent earnings season exposed vulnerabilities in some momentum sectors and illustrates how difficult a return towards more normal growth expectations can be—especially after a period of exceptionally supportive fiscal and monetary policy. We do not expect current headwinds on the IT sector to abate quickly given the present political and regulatory environment. While the recent de-rating leaves US equity valuations below long-term averages, we continue to believe that the case for equities outside of the US is stronger.
Global (Ex-US) Equities		<ul style="list-style-type: none"> In Europe, the deal between the Italian government and the European Commission on the former's budget is a short-term positive, but with the likelihood of an extreme Brexit outcome increasing, significant geopolitical uncertainties persist. Together with the current headwinds on global trade this is likely to hamper the near term performance of European equities. However, our longer-term base case remains positive, supported by solid domestic demand dynamics, attractive valuations and by a likely stabilization of global economic conditions towards the second half of 2019. We remain constructive on Japanese equities despite the near term headwinds from weakening global growth. We believe that diminished political uncertainties and on-going structural reforms are supportive of higher price multiples while a solid underlying domestic economy suggests the outlook for profits growth is stronger than markets are currently discounting.
Emerging Markets (EM) Equities including China		<ul style="list-style-type: none"> Emerging market equities have recently outperformed despite continued USD strength and a further slowdown in global growth. Part of the outperformance comes from the expectation of a widening EM-DM growth differential. In aggregate fundamental conditions in EM remain relatively robust but we remain wary of the impact of sharply tighter US financial conditions and higher interest rates in several Emerging economies. We remain broadly positive on China in the expectation of further measures to cushion the domestic growth slowdown. Any broadening of the current trade stand-off with the US is likely to hamper Chinese growth, but we believe that a gradual economic slowdown is already priced in and the Chinese authorities have already shown themselves willing to provide monetary, fiscal and regulatory support to help smooth the on-going economic transition. Chinese equities still trade at a PE discount to other markets and further market liberalization could prompt a rerating as international capital starts to flow into Chinese assets following the inclusion of onshore Chinese equities in MSCI's widely followed EM equity indices.
US Bonds		<ul style="list-style-type: none"> After the recent downward re-pricing of US rate expectations, 10yr nominal US Treasury yields are close to the low end of the range of our estimate of fair value. Nonetheless, US nominal yields look attractive relative to most other developed government bond markets on an unhedged basis. In the absence of a material pick-up in inflation or term premium, we expect that yields are likely to remain range bound. Our overall assessment is neutral.
Global (Ex-US) Bonds		<ul style="list-style-type: none"> In aggregate, we see global sovereign bonds outside of the US as unattractive. The ECB has committed to low rates into 2019, so we see limited opportunity in Europe. Brexit is probably negative for UK gilts in the case of both a hard and soft Brexit. In a hard Brexit scenario, gilt yields are likely to fall first on lower growth expectations before rising on higher inflation risks and a higher credit risk premium. Should the current deal pass through parliament, we would expect UK 10yr yields to rise immediately due to improved growth prospects. Swiss bonds continue to look very overvalued and in our view they have an increasingly asymmetric risk profile. The Swiss economy is relatively strong and we see Swiss bonds as vulnerable to attempts to normalise monetary policy by a Swiss National Bank increasingly concerned by the strength of the housing market. Elsewhere we are more positive on Australian duration on a relative basis. We see the Reserve Bank of Australia taking a cautious approach to policy given elevated household leverage and slow inflation.
Investment Grade (IG) Corporate Debt		<ul style="list-style-type: none"> Fed tightening, growth concerns and geopolitical turmoil have spilled over into the credit markets, causing IG spreads to widen in recent months. Although we do not believe that a sharp demand slowdown is imminent, we retain a neutral view on credit.
High Yield Bonds		<ul style="list-style-type: none"> Current default rates in High Yield are very low by historical standards. Given the still relatively positive economic backdrop, we do not expect a material pick-up in US defaults in the near-term. However, after the significant recent sell-off, spreads have now widened to a point where we do not see a strong case in either direction.
Emerging Markets Debt US dollar Local currency		<ul style="list-style-type: none"> Spreads on EM debt relative to US treasuries widened substantially in 2018 in the face of higher geopolitical risks, a strengthening USD and higher USD funding rates. However, in recent weeks EM local currency bond yields have rallied both in absolute terms and relative to the US yields while EM hard currency bond yields have continued to sell off. We believe that this reflects wider investor expectations for a less aggressive Fed, less aggressive US trade policy, and/or more aggressive China stimulus. We upgrade EM local currency bonds given their attractive valuations.
Chinese Bonds		<ul style="list-style-type: none"> Chinese bonds have the highest nominal yields among the 10 largest fixed income markets globally and have delivered the highest risk-adjusted returns of this group over the last 5 and 10 years. We expect that slowing economic growth and inclusion to the Bloomberg Barclays Global Aggregate index next year should continue to push yields down during the next 3-12 months.

Source: UBS Asset Management. As of December 31, 2018.

For marketing and information purposes by UBS. For global professional / qualified / institutional clients and investors and US retail clients and investors.

This document does not replace portfolio and fund-specific materials. Commentary is at a macro or strategy level and is not with reference to any registered or other mutual fund.

Americas

The views expressed are a general guide to the views of UBS Asset Management as of January 2019. The information contained herein should not be considered a recommendation to purchase or sell securities or any particular strategy or fund. Commentary is at a macro level and is not with reference to any investment strategy, product or fund offered by UBS Asset Management. The information contained herein does not constitute investment research, has not been prepared in line with the requirements of any jurisdiction designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research. The information and opinions contained in this document have been compiled or arrived at based upon information obtained from sources believed to be reliable and in good faith. All such information and opinions are subject to change without notice. Care has been taken to ensure its accuracy but no responsibility is accepted for any errors or omissions herein. A number of the comments in this document are based on current expectations and are considered "forward-looking statements." Actual future results, however, may prove to be different from expectations. The opinions expressed are a reflection of UBS Asset Management's best judgment at the time this document was compiled, and any obligation to update or alter forward-looking statements as a result of new information, future events or otherwise is disclaimed. Furthermore, these views are not intended to predict or guarantee the future performance of any individual security, asset class or market generally, nor are they intended to predict the future performance of any UBS Asset Management account, portfolio or fund.

EMEA

The information and opinions contained in this document have been compiled or arrived at based upon information obtained from sources believed to be reliable and in good faith, but is not guaranteed as being accurate, nor is it a complete statement or summary of the securities, markets or developments referred to in the document. UBS AG and / or other members of the UBS Group may have a position in and may make a purchase and / or sale of any of the securities or other financial instruments mentioned in this document. Before investing in a product please read the latest prospectus carefully and thoroughly. Units of UBS funds mentioned herein may not be eligible for sale in all jurisdictions or to certain categories of investors and may not be offered, sold or delivered in the United States. The information mentioned herein is not intended to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. Past performance is not a reliable indicator of future results. The performance shown does not take account of any commissions and costs charged when subscribing to and redeeming units. Commissions and costs have a negative impact on performance. If the currency of a financial product or financial service is different from your reference currency, the return can increase or decrease as a result of currency fluctuations. This information pays no regard to the specific or future investment objectives, financial or tax situation or particular needs of any specific recipient. The details and opinions contained in this document are provided by UBS without any guarantee or warranty and are for the recipient's personal use and information purposes only. This document may not be reproduced, redistributed or republished for any purpose without the written permission of UBS AG. This document contains statements that constitute "forward-looking statements", including, but not limited to, statements relating to our future business development. While these forward-looking statements represent our judgments and future expectations concerning the development of our business, a number of risks, uncertainties and other important factors could cause actual developments and results to differ materially from our expectations.

UK

Issued in the UK by UBS Asset Management (UK) Ltd. Authorised and regulated by the Financial Conduct Authority.

APAC

This document and its contents have not been reviewed by, delivered to or registered with any regulatory or other relevant authority in APAC. This document is for informational purposes and should not be construed as an offer or invitation to the public, direct or indirect, to buy or sell securities. This document is intended for limited distribution and only to the extent permitted under applicable laws in your jurisdiction. No representations are made with respect to the eligibility of any recipients of this document to acquire interests in securities under the laws of your jurisdiction. Using, copying, redistributing or republishing any part of this document without prior written permission from UBS Asset Management is prohibited. Any statements made regarding investment performance objectives, risk and/or return targets shall not constitute a representation or warranty that such objectives or expectations will be achieved or risks are fully disclosed. The information and opinions contained in this document is based upon information obtained from sources believed to be reliable and in good faith but no responsibility is accepted for any misrepresentation, errors or omissions. All such information and opinions are subject to change without notice. A number of comments in this document are based on current expectations and are considered "forward-looking statements". Actual future results may prove to be different from expectations and any unforeseen risk or event may arise in the future. The opinions expressed are a reflection of UBS Asset Management's judgment at the time this document is compiled and any obligation to update or alter forward-looking statements as a result of new information, future events, or otherwise is disclaimed. You are advised to exercise caution in relation to this document. The information in this document does not constitute advice and does not take into consideration your investment objectives, legal, financial or tax situation or particular needs in any other respect. Investors should be aware that past performance of investment is not necessarily indicative of future performance. Potential for profit is accompanied by possibility of loss. If you are in any doubt about any of the contents of this document, you should obtain independent professional advice.

Australia

This document is provided by UBS Asset Management (Australia) Ltd, ABN 31 003 146 290 and AFS License No. 222605.

China

The securities may not be offered or sold directly or indirectly in the People's Republic of China (the "PRC"). Neither this document or information contained or incorporated by reference herein relating to the securities, which have not been and will not be submitted to or approved/verified by or registered with the China Securities Regulatory Commission ("CSRC") or other relevant governmental authorities in the PRC pursuant to relevant laws and regulations, may be supplied to the public in the PRC or used in connection with any offer for the subscription or sale of the Securities in the PRC. The securities may only be offered or sold to the PRC investors that are authorized to engage in the purchase of Securities of the type being offered or sold. PRC investors are responsible for obtaining all relevant government regulatory approvals/licenses, verification and/or registrations themselves, including, but not limited to, any which may be required from the CSRC, the State Administration of Foreign Exchange and/or the China Banking Regulatory Commission, and complying with all relevant PRC regulations, including, but not limited to, all relevant foreign exchange regulations and/or foreign investment regulations.

Hong Kong

This document and its contents have not been reviewed by any regulatory authority in Hong Kong. No person may issue any invitation, advertisement or other document relating to the Interests whether in Hong Kong or elsewhere, which is directed at, or the contents of which are likely to be accessed or read by, the public in Hong Kong (except if permitted to do so under the securities laws of Hong Kong) other than with respect to the Interests which are or are intended to be disposed of only to persons outside Hong Kong or only to "professional investors" within the meaning of the Securities and Futures Ordinance (Cap. 571) and the Securities and Futures (Professional Investor) Rules made thereunder.

Japan

This document is for informational purposes only and is not intended as an offer or a solicitation to buy or sell any specific financial products, or to provide any investment advisory/management services.

Korea

The securities may not be offered, sold and delivered directly or indirectly, or offered or sold to any person for re-offering or resale, directly or indirectly, in Korea or to any resident of Korea except pursuant to the applicable laws and regulations of Korea, including the Capital Market and Financial Investment Business Act and the Foreign Exchange Transaction Law of Korea, the presidential decrees and regulations thereunder and any other applicable laws, regulations or rules of Korea. UBS Asset Management has not been registered with the Financial Services Commission of Korea for a public offering in Korea nor has it been registered with the Financial Services Commission for distribution to non-qualified investors in Korea.

Malaysia

This document is sent to you, at your request, merely for information purposes only. No invitation or offer to subscribe or purchase securities is made by UBS Asset Management as the prior approval of the Securities Commission of Malaysia or other regulatory authorities of Malaysia have not been obtained. No prospectus has or will be filed or registered with the Securities Commission of Malaysia.

Singapore

This document has not been registered with the Monetary Authority of Singapore pursuant to the exemption under Section 304 of the SFA. Accordingly, this document may not be circulated or distributed, nor may the Securities be offered or sold, whether directly or indirectly, to any person in Singapore other than (i) to an institutional investor pursuant to Section 304 of the SFA.

Taiwan

This document and its contents have not been reviewed by, delivered to or registered with any regulatory or other relevant authority in the Republic of China (R.O.C.). This document is for informational purposes and should not be construed as an offer or invitation to the public, direct or indirect, to buy or sell securities. This document is intended for limited distribution and only to the extent permitted under applicable laws in the Republic of China (R.O.C.). No representations are made with respect to the eligibility of any recipients of this document to acquire interests in securities under the laws of the Republic of China (R.O.C.).

Source for all data and charts (if not indicated otherwise): UBS Asset Management.



www.ubs.com/am-linkedin