UBS

Global Perspectives

Multi Asset | February 28, 2018

Overview

Equities: The FTSE All World Index fell 3.5% in February – giving up most of January's gains as investor concerns about rising inflation and interest rates accelerated. The declines were widespread and uniform with major equity markets posting almost identical monthly returns.

Fixed income: Benchmark nominal US 10-year treasury yields continued to move higher in February, while there were small gains for 10-year government bonds across the eurozone.

Currency: The major move in currency markets over the month was the strengthening of the Japanese yen as data showed Japan's economic recovery accelerating. The US dollar reversed a portion of recent decreases.

The month in review:

- February saw sharp declines in equity markets at the beginning of the month and a significant change in overall equity market volatility. The principal catalyst to this increased uncertainty was January's US employment report on February 2. While payrolls were ahead of expectations, the news that average hourly earnings had risen more than expected stoked investors' concerns about the prospects for increased inflation and a faster pace of monetary policy tightening. The 4% decline in the S&P 500 on February 5 was the largest since August 2011.
- As the month went on, the positive economic background and continued strength of corporate earnings saw equities recover from their earlier lows. However, gains were limited by rising speculation that the Federal Reserve may raise interest rates faster than anticipated again weighed on bond and equity markets, as did the largest fall in more than six years in China's official monthly gauge of manufacturing activity.
- The picture for government bonds was more mixed. Yields on US Treasuries continued to rise, with the 10-year bond yield moving towards 3% before falling back later a little in the month. However, similar bond yields in the UK were little changed over the month, while yields on German bunds fell. Demand for broader government bonds remained strong, with Spain seeing a good sale for its first 30-year bond in two years. While credit and high yield assets fell in value, spreads only rose back to levels seen late in 2017 and sharp movements in price were less evident.
- Developments around the UK's preparations to leave the European Union were again to the fore on the political front with prime minister Theresa May hitting out at Brussels' first draft Brexit proposals. Elsewhere in Europe, there was agreement in Germany over the formation of a new grand coalition that would see Angela Merkel continue as chancellor.

Outlook:

- The synchronized global growth impulse persists. The drivers of growth remain broad and in our view, recession risks are consequently low. Nonetheless, given the very strong readings of global Purchasing Managers Indices, we expect the pace of acceleration to slow over the coming months. We expect leading indicators to moderate to a level consistent with slightly lower, but still healthy, demand growth that is likely to be bolstered by increasing fiscal stimulus in a number of major economies as the support from monetary policy wanes.
- Output gaps in developed economies are closing and we expect wage growth to accelerate from its current low levels relative to unemployment. But the structural deflationary forces including aging populations and low productivity have not suddenly disappeared. We expect a moderate increase in the overall consumer price environment in the US and other developed economies throughout 2018 and 2019. Against this backdrop, we expect the process of policy normalization in developed economies to continue gradually but will be watching closely the rhetoric of new Federal Reserve chair Jerome Powell for early indications of any change in approach or policy regime.

Current views[1]

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

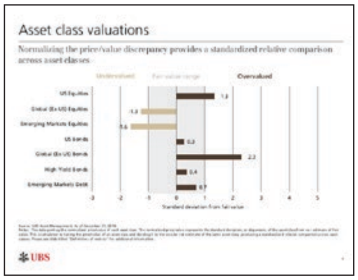
Overall signal = Positive ◄—► Negative

	Overall	◄ Unattractive	Neutral	Attractive ►
Equities			Australia UK Switzerland US China	Eurozone Japan EM ex-China
Fixed Income		Eurozone Switzerland High Yield	Japan UK US Inv. Grade US Australia EMD USD	
Currencies[2]		AUD	USD GBP CAD CHF	EUR JPY Emerging

Asset Class	Overall signal	UBS Asset Management's viewpoint
US Equities		• Given the positive domestic and external demand environments and core inflationary pressures likely to rise only moderately, we see strong corporate-earnings growth as the key support to US equities. • We believe that the extensive overhaul of the US tax code is also likely to boost equities via higher capital returns to shareholders and the prolonging of the domestic business cycle due to increasing capital expenditures. We look towards cyclical sectors to maintain their strong momentum. • After recent stock market declines, price-to-earnings per share multiples appear moderately more attractive. More importantly in our view, US equities remain attractively valued relative to bonds despite the recent rise in yields.
Global (Ex-US) Equities		• In Europe, we continue to believe that the earnings recovery story has further to run. The recent euro strength will likely only slightly moderate earnings momentum. Operational leverage has played a key role in driving European earnings ahead of expectations over the past year. We believe that there is further to go in this process as the recovery continues and margins continue to expand. • In Japan, core inflation remains muted despite the closing of the output gap. President Abe's re-election and continuity at the helm of the Bank of Japan suggest monetary policy will remain loose for the foreseeable future while increasing the potential for additional fiscal stimulus. Improving corporate governance, rising capital efficiency and Return on Equity (ROE) further support our positive view on Japan.
Emerging Markets (EM) Equities including China		• Better-than-expected trade continues to drive demand growth while more stable current account balances and lower currency volatility are key supports. Capital expenditure is starting to pick-up and in our view, emerging markets (EM) are at an even earlier stage of their recovery than Europe. We believe EM equities remain attractively valued relative to their own history and to international peers on a number of measures. • We remain broadly positive on China. A gradual economic slowdown is already priced in and growth remains impressive compared to other markets. Our most preferred EM region is Asia (ex. China); our least preferred Latin America. Concerns over debt sustainability in Brazil, NAFTA negotiations and high inflation in Mexico, plus upcoming elections in both countries will likely suppress investor flows. Conversely, EM Asia (ex. China) continues to enjoy strong revenue growth and remains attractively valued compared to its own history.
US Bonds		• US Treasury yields remain low by historical standards, but look attractive relative to most other developed government bond markets, particularly German bunds. In the absence of a material pick-up in inflation, yields are likely to remain range bound. Our overall assessment is neutral.
Global (Ex-US) Bonds		• In aggregate, we see global bonds outside of the US as unattractive. • Swiss and German bonds continue to look very overvalued and, in our view, have an increasingly asymmetric risk profile. The Swiss economy is relatively strong and we see Swiss bonds as vulnerable to attempts to normalize monetary policy by the Swiss National Bank increasingly concerned by the strength of the housing market and willing to move before the European Central Bank. Meanwhile, the eurozone economy also continues to display strength and rate expectations reflected in German bund yields appear too modest in light of this backdrop. • Elsewhere we are more positive on Australian and Canadian duration on a relative basis. In our view, both economies are vulnerable to a housing market correction after very strong recent performance.
Investment Grade (IG) Corporate Debt		• As credit spreads narrow, the yield pick-up on IG relative to developed world sovereign debt in particular has been diminishing. We do not believe that a sharp slowdown in demand is imminent. However, the reduction in global liquidity as quantitative easing programs are unwound may place some upward pressure on credit spreads, albeit gradually, and make credit instruments more susceptible to volatility spikes. Overall we retain a neutral view.
High Yield Bonds		• Current default rates in High Yield are very low by historical standards. Given the supportive low rates and accelerating global growth backdrop, we do not expect any material pick-up in US corporate debt defaults in the near-term. However, after the significant spread compression we do not view the risk/reward as attractive.
Emerging Markets Debt US dollar Local currency		• While the spread between EM debt and US Treasuries remains low by historical standards, we see continued strong demand for EM debt's attractive real yield. The improvement in current accounts and broader economic growth are also supportive. We view a subset of currencies within the broad local currency EM debt universe as attractive on a long-term basis.
Currency		• Among developed world currencies we continue to see the Canadian dollar as unattractive for the same reasons as we are positive on Canadian bonds. We also see strong valuation support for the Japanese yen. • In emerging markets we retain a constructive view on a number of EM currencies including the Indian rupee.

[1] Source: UBS Asset Management. As of February 28, 2018.
[2] Attractiveness measured relative to USD.
Source: UBS Asset Management Investment Solutions Asset Allocation team as of February 28, 2018. Views are provided on the basis of a 12-18 month investment horizon, are not necessarily reflective of actual portfolio positioning and are subject to change without notice.

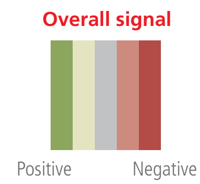
Valuations plus one or more market behavior indicators provide an overall signal



+

Market themes | Momentum and flow
Market stress | Macroeconomic landscape

=



Market themes	Momentum and flow	Market stress	Macroeconomic landscape
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."	Attempts to capture money flows and market appetite for risky assets from the perspective of professional asset allocators, such as mutual fund managers.	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).	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.

February 28, 2018

Valuation and market behavior indicators at work

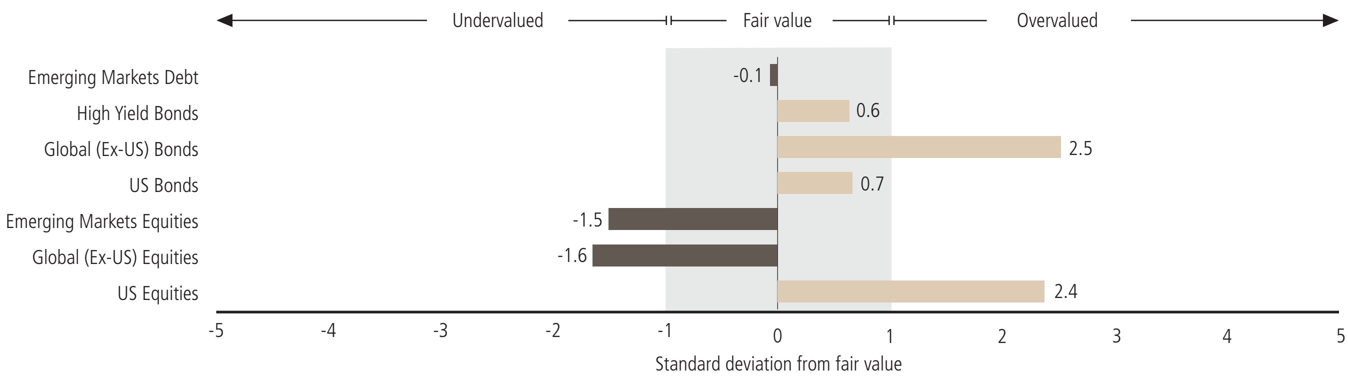
Valuation	+	Market themes	+	Momentum and flow	+	Market stress	+	Macroeconomic landscape	=	Overall signal
Slightly negative		Neutral		Positive		Neutral		Slightly positive		Slightly positive

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

This example is for illustrative purposes only.
Source: UBS Asset Management Investment Solutions Asset Allocation team as at February 28, 2018. Views are provided on the basis of a 12-18 month investment horizon, are not necessarily reflective of actual portfolio positioning and are subject to change without notice.

Normalized asset class valuations[3]

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



[3] Based on UBS Asset Management's views. As of February 28, 2018.

Definitions of metrics:

1. Asset Class/Benchmark: All investment expectations displayed here are modeled from the discounted cash flows as replicated by a 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 percentage terms.

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.

The views expressed are as of February 28, 2018 and are a general guide to the views of UBS Asset Management. 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. This document is intended for limited distribution to the clients and associates of UBS Asset Management. Use or distribution by any other person is prohibited. Copying any part of this publication without the written permission of UBS Asset Management is prohibited. Care has been taken to ensure the accuracy of its content but no responsibility is accepted for any errors or omissions herein. Please note that past performance is not a guide to the future. Potential for profit is accompanied by the possibility of loss. The value of investments and the income from them may go down as well as up, and investors may not get back the original amount invested. This document is a marketing communication. Any market or investment views expressed are not intended to be investment research. The document 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 contained in this document does not constitute a distribution, nor should it be considered a recommendation to purchase or sell any particular security or fund. 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. 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 is 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.

© UBS 2018. The key symbol and UBS are among the registered and unregistered trademarks of UBS. All rights reserved.
18-0200 C-0318 03/18
www.ubs.com

UBS Asset Management (Americas) Inc. is an indirect asset management subsidiary of UBS Group AG.

UBS