UBS

Global Perspectives

Multi Asset | March 31, 2018

Overview

Equities: Global equity markets continued to weaken in March amid escalating trade tensions between the US and China in particular and following economic data that suggested the very strong recent acceleration in global growth may now be moderating.

Fixed income: Benchmark nominal 10-year government bonds rallied across the developed world over the month on reduced global growth expectations and amid increasing investor risk aversion.

Currency: Among major currency crosses, the British pound and the Chinese yuan both strengthened significantly against a weak US dollar.

The month in review:

– Global equity markets were roiled by fears of rising trade protectionism in March after the US announced intentions to impose wide ranging tariffs on Chinese goods in response to China's alleged theft of US corporate intellectual property. Fears of rising regulatory pressures on the technology sector also weighed on equities. Japan and the US were the worst performing major equity markets in local currency terms.

– In a widely anticipated move, the US Federal Reserve hiked its key short-term interest by 25 basis points while noting that the "economic outlook has strengthened in recent months." The Fed's counterparts in Japan and Europe left interest rates unchanged at their respective meetings, with the European Central Bank ("ECB") removing from its official statement the key phrase that it "stands ready to increase or extend Quantitative Easing." Despite the increase in confidence from central banks, nominal government bond markets benefited from investors' belief that the rate of acceleration in global demand growth may be moderating. German bund yields dropped sharply after the widely-watched Eurozone Composite PMI came in significantly below expectations. Spreads between US treasuries and both investment grade and high yield bonds widened notably.

– In political news, German Chancellor Angela Merkel secured her fourth term in power after the Social Democratic Party ("SDP") agreed to form a ruling coalition with Merkel's Christian Democrat party ("CDU"). In Italy, the general election resulted in a hung parliament. There were, however, large gains for the populist five Star Movement and La Lega parties. Elsewhere in Europe, the UK and EU agreed the outline terms for a 21-month transition period after the UK formally leaves the EU in March 2019. Despite the progress, a number of key issues remain unresolved. With the risks of a "cliff edge" Brexit diminishing, the pound rallied strongly. In Japan, the premiership of Prime Minister Abe was rocked by accusations of cronyism after the country's Finance Ministry admitted to altering documents relevant to the sale of land at a discounted price. Meanwhile, China's National Party Congress abolished presidential term limits and, in doing so, gave Premier Xi Jinping authority to stay in power indefinitely.

Outlook:

– The synchronized global growth impulse persists. The drivers of growth remain broad and, in our view, recession risks are consequently low. Nonetheless, we expect lead indicators to moderate to a level consistent with slightly lower but still healthy demand growth that is likely to be bolstered by an increasing fiscal stimulus in a number of major economies as the support from monetary policy wanes.

– In developed economies, output gaps are closing and we further 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.

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	Eurozone Japan China EM ex-China
Fixed Income		Eurozone Switzerland High Yield	Japan US Inv. Grade UK 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		– With both the domestic and external demand environment positive and core inflationary pressures likely to rise only moderately, we see strong corporate earnings growth as the key support to US equities. – 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 capex. – After recent stock market declines, price-to-earnings (P/E) per share multiples appear 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 moderate earnings momentum in the short-term. Operational gearing 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. Prime Minister 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; our least preferred is 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 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 a 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		– The yield pick-up on Investment Grade (IG) relative to developed world sovereign debt in particular has been diminishing as credit spreads narrow. We do not believe that a sharp demand slowdown is imminent. However, the reduction in global liquidity as QE 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 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 and we prefer local currency EM debt of the hard currency equivalent.
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 positive view on a number of EM currencies including the Indian rupee.

[1] Source: UBS Asset Management. As of March 31, 2018.
[2] Attractiveness measured relative to USD.
Source: UBS Asset Management Investment Solutions Asset Allocation team as of March 31, 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

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.

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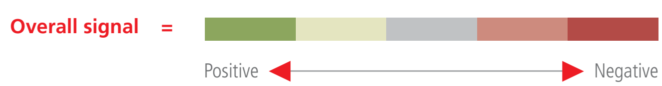
Valuation and market behavior indicators at work



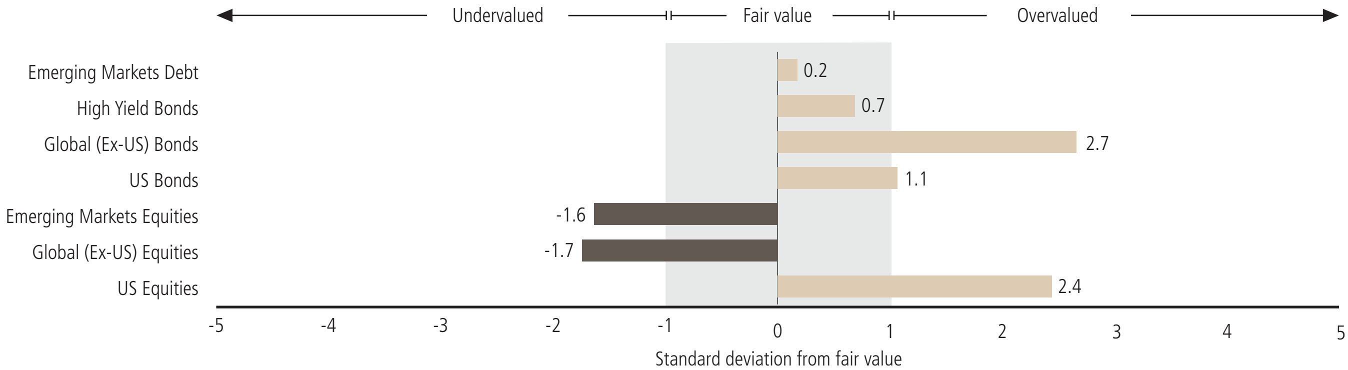
Valuation	+	Market themes	+	Momentum and flow	+	Market stress	+	Macroeconomic landscape	=	**Overall signal**
Slightly negative		Neutral		Positive		Slightly negative		Slightly positive		Slightly positive

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 of March 31, 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 March 31, 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.

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