UBS

Global Perspectives

Multi Asset | January 31, 2018

Overview

Equities: The FTSE All World posted a healthy 4.1% local currency gain in January to begin the new year in much the same vein as it had ended 2017. Gains were strongest in the US and in Emerging markets. The UK was the only major developed equity market to fall over the month.

Fixed income: Developed government bonds fell across the board in January, with yields moving higher as investor growth and inflation expectations rose.

Currency: Pronounced USD weakness was a particular feature of the month, with the world's reserve currency falling against its major trading partners. On a trade weighted basis the GBP strengthened over the month.

The month in review:

- The FTSE All World Index rose 4.1% in local currency terms in January as the positive mood engendered by the tax reform passed in the US late in 2017 continued into the new year. Equities globally were buoyed by a particularly strong results season in the US while a weakening USD helped support Emerging Markets. The so-called 'greenback' fell over 3% on a trade weighted basis in January. The main developed world equity market laggard was the UK, where the bankruptcy of outsourcing specialist Carillion, the strengthening pound and continued Brexit uncertainty all weighed on investor sentiment.
- Economic data worldwide over the month remained positive in general, and the US Federal Reserve's rate-setting Federal Open Market Committee (FOMC) delivered an upbeat assessment of the US economy at its meeting in late January. While the FOMC left the key Federal Funds target interest rate unchanged, the comments accompanying the decision pointed to another rate rise in March with inflation expected to 'move up' over 2018 to the Fed's 2% target rate. This positive outlook for growth and the increased expectations for future rate rises saw yields on many benchmark government bonds rise over the month. Yield rises were particularly acute towards the end of the month, as the perceived likelihood of tighter monetary policy from central banks increased amid continued strong economic news. Measures of investors' inflation expectations also rose as a weak dollar helped support global commodity prices.

Outlook:

- The global economy continues to enjoy an expansionary impulse that is broad-based by geography and by economic sector. The rise in corporate capital expenditure reduces the global economy's reliance on consumption. We also believe that developed world fiscal policy is likely to play a more significant role in supporting demand growth in 2018 than it did in 2017. The increasing breadth of demand drivers gives us confidence that global recession risks are low and that the demand momentum reflected in buoyant lead indicators is sustainable. Against this backdrop, corporates are also delivering stronger than expected profits growth. We see the possibility for further upside surprise in earnings across developed and emerging markets as tax reforms boost capex and capital returns to shareholders in the US, and as operational gearing kicks in as the recovery accelerates in Europe, Japan and in Emerging Markets.
- We see bond yields in developed markets ticking higher as growth expectations rise, global output gaps close and as wage growth picks up from its current low base. We see a violent shift higher in global bond yields as unlikely in the context of powerful demographic drivers and the on-going expansion of central bank balance sheets globally. We do not believe that an orderly rise in yields materially threatens global equity markets.

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, Japan, China, EM ex-China, Eurozone
Fixed Income		Eurozone, Switzerland, High Yield	Japan, UK, US, US Inv. Grade, Australia, EMD USD	
Currencies[2]		AUD	USD, GBP, CAD, CHF	EUR, JPY, Emerging

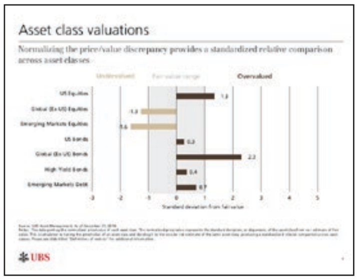
Asset Class	Overall signal	UBS Asset Management's viewpoint
US Equities		• With both the domestic and external demand environment positive and core inflationary pressures subdued, we see greater-than-forecast earnings growth as a key support for continued positive US equity market performance. • The extensive overhaul of the US tax code is likely to continue to boost equities. We see higher capital returns to shareholders and the prolonging of the domestic business cycle due to increasing capex as the key supports. • On some measures, valuations of US equities look elevated. But we believe a high rating is fully warranted and do not see valuations as concerning or precluding further upside. On an earnings yield basis (inverse of the PE ratio), US equities remain attractive relative to bonds.
Global (Ex-US) Equities		• Outside of the US, we see attractive valuations and the improving growth backdrop as supportive to international equities. In Europe, we continue to believe that the earnings recovery story has further to run. Earnings are still supported by the ECB's loose policy and with bank balance sheet restructuring now largely over, we see the recovery as advancing. The recent euro strength will only slightly moderate earnings momentum. • The economic recovery in Japan also supports a constructive view of Japanese equities. While Japan's output gap has closed, inflation remains muted. President Abe's larger-than-expected victory in last year's elections bolsters support for 'Abenomics' and increases the potential for additional fiscal stimulus. These positive macroeconomic drivers coupled with improving corporate governance and efficiency support our positive view on Japan.
Emerging Markets 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 to equities. Capital expenditure is accelerating and in our view, emerging markets (EM) are at an earlier stage of their recovery than Europe. Despite strong returns in 2017, we believe EM equities remain attractively valued. With improving margins and Return on Equity, our conviction remains high. • China's strong recent performance might limit further upside in the short run but we remain positive. Our preferred EM region is Asia (ex. China); our least preferred is Latin America (LatAm). Concerns over debt sustainability in Brazil, NAFTA negotiations and high inflation in Mexico, plus upcoming elections in both countries will likely suppress investor flows to LatAm. Conversely, EM Asia (ex. China) continues to enjoy strong revenue growth and remains attractively valued compared to its own history.
US Bonds		• While US Treasury yields remain low by historical standards, they 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 normalise monetary policy. Meanwhile, rate expectations reflected in German bund yields appear too modest in light of the strength of the Eurozone economy. • Elsewhere we are more positive on Australian and Canadian duration on a relative basis. In our view, both economies are exposed to slowing Chinese demand and vulnerable to domestic house price corrections.
Investment Grade Corporate Debt		• The yield pick-up on IG corporate debt 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 accelerating global growth backdrop we do not expect any material pick-up in US corporate debt defaults in the near-term. However, after the recent 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 EM currencies as attractive on a long-term basis.
Currency		• Among developed world currencies we continue to see the CAD as unattractive for the same reasons as we are positive on Canadian bonds. We also see strong valuation support for the JPY. • 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 January 31, 2018.

[2] Attractiveness measured relative to USD.

Source: UBS Asset Management Investment Solutions Asset Allocation team as of January 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



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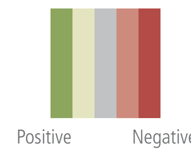
Market themes	Momentum and flow
Market stress	Macroeconomic landscape

=

Overall signal

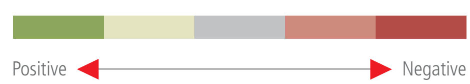


Market themes	Momentum and flow	Market stress	Macroeconomic landscape
Market opportunities that we believe will drive markets in the longer term but have an immediate impact. This helps put valuation into context. For example: "European debt crisis," "aging population" or "deleveraging."	Attempts to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

January 31, 2018

Valuation and market behavior indicators at work

Overall signal =



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

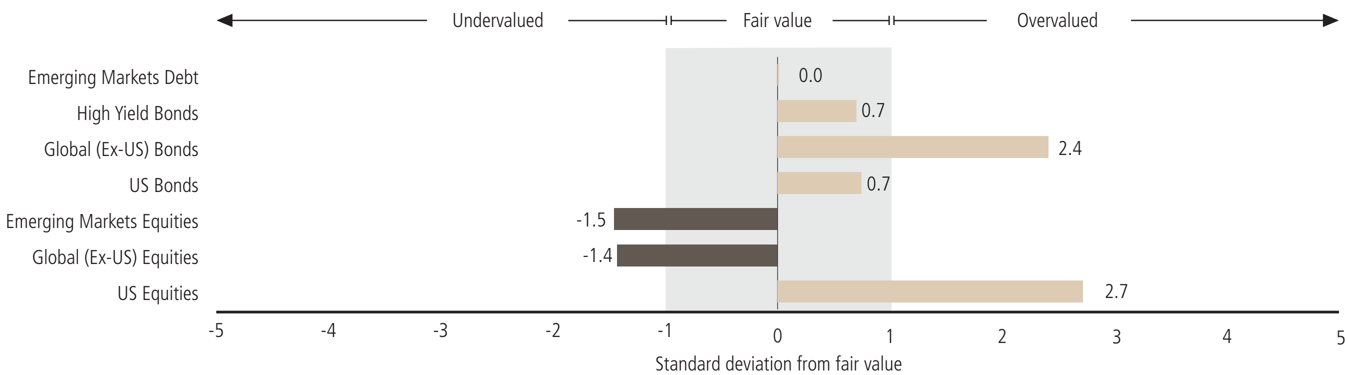
Note: The contribution each component makes to the overall signal will vary from month to month.

This example is for illustrative purposes only.

Source: UBS Asset Management Investment Solutions Asset Allocation team as at January 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 January 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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