Global Perspectives

Multi Asset | October 31, 2016

Overview

Equities: Global equities were flat to slightly negative in October, as risk-off sentiment returned to markets later in the month. Europe, Japan and emerging markets fared best, with US stocks the laggard.

Fixed Income: Yields on government bonds continued that began in mid-September, with UK gilts in particular giving up more of the gains seen over the summer. Credit spreads generally narrowed.

Currency: The Mexican peso saw significant gains during October as the risk of a Donald Trump presidency seemed to reduce. The British pound sterling (GBP) fell sharply as it was confirmed that Article 50 of the Lisbon Treaty, the mechanism for leaving the EU, will be triggered by the end of March 2017. In addition, the rhetoric from the UK Conservative Party conference suggested a hard Brexit.

The month in review:

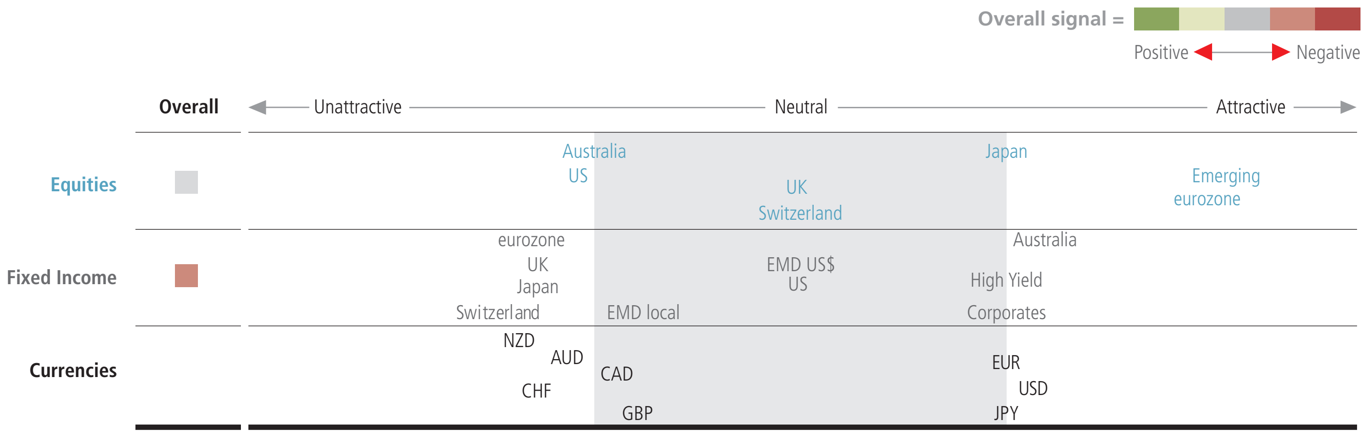
- Investors struggled to take their cue from a number of competing themes through October with political risk, central bank policy, persistent US dollar (USD) strength and scepticism around OPEC's ability to implement cuts in oil production all impacting sentiment and market levels.
- GBP reached lows not seen for many years. This followed UK Prime Minister Theresa May outlining an end of March 2017 deadline for enacting Article 50 in an opening gambit that was very much "Hard Brexit," with rhetoric suggesting border control would be given precedence over access to the single market.
- Risk-off sentiment largely prevailed in October. Japanese equities somewhat bucked this trend on the back of a weaker yen, following Bank of Japan policy action and comment that the timeframe for achieving their inflation target may need to be pushed back. European and emerging market equities delivered positive returns. The European banking sector got some respite with many of the region's largest institutions (including Deutsche Bank) beating earnings expectations. US stocks were the laggard, not helped by a strong dollar and political turbulence.
- Yields on government bonds continued the rise seen from mid-September, while credit spreads generally narrowed – especially within the US and Europe in both the investment grade and high yield universes.

Outlook:

- Short-term political risk remains a key concern for investors, with the US presidential election rapidly approaching. We believe that a Donald Trump victory is more likely to induce volatility and weigh on equity markets globally. However, we believe that neither Donald Trump nor Hillary Clinton is likely to be backed by a sufficiently large majority in the US Senate to progress their legislative agenda smoothly and avoid political gridlock.
- Based on our analysis, emerging market equities have looked attractively valued for some time. While our concerns about industrial capacity and external debt loads remain, we see a number of powerful catalysts supporting equity prices over a more tactical horizon. We continue to prefer developed equity markets outside of the US with Europe being a particular focus.
- Our positive view on investment grade bonds relative to sovereign debt is largely predicated on valuations and the former's attractive yield pick-up at comparable levels of credit quality. Against a continued backdrop of "lower for longer," we do not see a sharp rise in defaults amongst higher-quality corporate debt as likely, resulting in an attractive risk-and-return profile compared with government bonds. We continue to favor inflation-linked bonds in the US over their nominal counterparts due to emerging signs of wage inflation, which we do not believe is reflected in prices.

Current views[1]

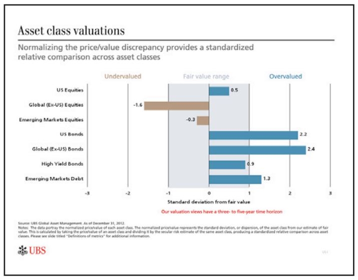
Asset allocation and currency attractiveness based on fundamental valuation and market behavior analysis



Asset Class	Overall signal	UBS Asset Management's viewpoint
US Equities		• Our analysis shows US equities as overvalued on a number of measures in a historical context. With revenues under pressure from a muted demand backdrop and the risk of margin pressure from wage growth, the scope for disappointment relative to expectations remains. However, weakness of the US Dollar in 2016 has softened our view somewhat.
Global (Ex-US) Equities		• We continue to prefer developed equity markets outside of the US with Europe being a particular focus. In contrast to their US counterparts, we think European equities look attractively valued. We also believe that the European recovery story is, finally, gathering momentum – supported in no small part by the European Central Bank's loose policy and by its corporate bond buying program in particular.
Emerging Markets Equities		• Our analysis has found emerging market equities to be attractively valued for some time. While our concerns about industrial capacity and external debt loads remain, we see a number of powerful catalysts supporting equity prices over a more tactical horizon. • For an equity universe which demonstrates material sensitivity to Federal Reserve policy and the USD due to high levels of dollar-denominated debt, the "lower for longer" backdrop and a more gentle expected path for US interest rate rises are potentially supportive. • Meanwhile, we believe that the price of oil is now high enough to benefit EM exporters but not too high to materially impact EM oil importers. With a welcome period of currency stability supporting investment, economic data and corporate earnings are now turning. • Finally, data suggests that institutional investors are still materially underweight EM equities.
US Bonds		• 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 in to the wider market's dovish expectations on medium-term US inflation risks. We, therefore, prefer US Treasury Inflation-Protected Securities (TIPS) with low yields and the potential for further rate rises as we see nominal US government bonds as unattractive.
Global (Ex-US) Bonds		• In aggregate, we see global bonds outside of the US as unattractive with UK Gilts and German Bunds standing out as among 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 difficult for the Bank of Canada.
Investment Grade Corporate Debt		• 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 is likely. We see global IG corporates as continuing to offer an attractive risk-and-return profile compared with government bonds.
High Yield Bonds		• We believe the pick-up in yield over sovereign debt may continue to attract investors to high yield. However, after a sustained period of strong performance in which yields in European high yield, in particular, have fallen significantly in absolute terms, we now see the overall investment case as more balanced.
Emerging Markets Debt US dollar Local currency		• Our overall view on both local and external (USD-denominated) emerging market government bonds remains neutral. • A subset of currencies within this broad universe now look attractive on a long-term basis while the improvement in current accounts and broader economic growth now balance out our concerns about high debt levels.
Currency		• 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. • We see a growing number of long-term opportunities within the broader emerging market universe and particularly those likely to benefit from a stronger oil price.

[1] Source: UBS Asset Management. As of October 31, 2016.

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

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Overall signal

Positive — Negative

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.

US Equities example as of October 31, 2016

Valuation and market behavior indicators at work

Overall signal =

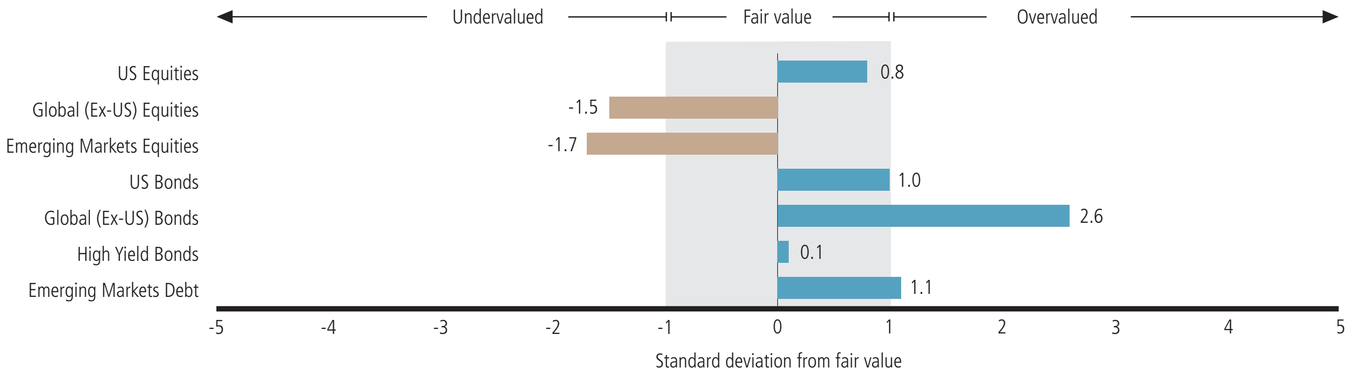
Positive ◄——► Negative

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

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

Normalized asset class valuations[2]

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



[2] Based on UBS Asset Management's views. As of October 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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