Global Perspectives

Multi Asset | May 31, 2017

Overview

Equities: Global equity markets posted modest local currency gains once again in May, paced by the UK among developed markets and by China among emerging markets. Softer US economic data persuaded investors that the pace and scale of monetary tightening in the world's largest economy may both be lower than previously forecast.

Fixed income: Softer data also saw global bond yields fall. Peripheral European countries including Italy and France were among the best performing on perceptions of reduced geopolitical risks. There were also broad-based gains across credit markets.

Currency: The euro (EUR) strengthened at the expense of the British pound (GBP) and US dollar (USD) in May.

The month in review:

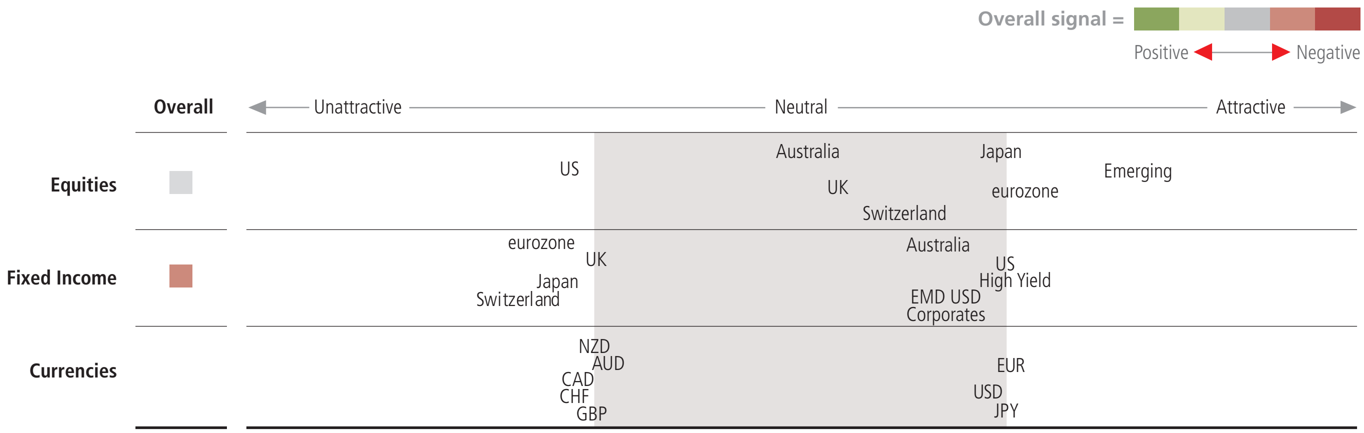
- Global equity markets proved resilient in May. The FTSE All World Index increased 1.6% in local currency terms. Both developed and emerging equity markets enjoyed a positive month as geopolitical risks dissipated and companies generally delivered stronger than expected profits growth.
- In the US, the recent trend of softer-than-forecast economic data continued, with May employment figures significantly weaker than expected, while Donald Trump's presidency came under renewed scrutiny for alleged ties with Russia. In Europe, financial markets reacted positively to the victory of centrist candidate Emmanuel Macron over right-wing candidate Marine Le Pen in the French presidential election. In the wake of the election, hopes are rising that an invigorated Franco-German relationship could deliver long-awaited structural reforms to the region.
- The euro area economy continued to perform solidly. The composite eurozone PMI was unchanged from the previous month at a very strong 56.8 in May, a level consistent with a rate of economic growth of around 3% per annum. In turn, the euro reached a six month high against the US Dollar. However, inflation fell back below the European Central Bank's target, easing pressure on the bank to curtail its powerful monetary stimulus to the bloc's economy.
- Elsewhere, Moody's downgraded China's sovereign credit rating for the first time in nearly three decades, citing rising liabilities and weakening financial strength as the main reasons for the cut.
- Against this backdrop, yields fell in most developed world government bond markets in May. Within credit markets, prices for high yield and investment grade assets continued to rise with spreads further tightening. This was particularly pronounced amongst European and US investment grade assets.

Outlook:

- The outlook for fiscal policy remains key to the global growth backdrop as monetary policy support is slowly withdrawn. But significant doubts remain around President Trump's pro-growth policy agenda. Markets moved rapidly in November to price in some of these promises but, in our view, equity markets in particular are vulnerable to disappointment. Although the Trump administration has briefly outlined its budget proposals for the US, doubts remain on the prospects for a successful implementation following the administration's defeat on healthcare policy.

Current views[1]

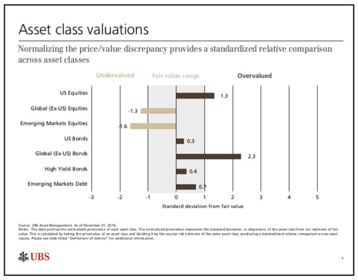
Asset allocation and currency attractiveness based on fundamental valuation and market behavior analysis



Asset Class	Overall signal	UBS Asset Management's viewpoint
US Equities		• Our analysis shows the broader US equity market as overvalued in a historical context. The key question is whether the outlook for earnings has increased sufficiently to justify the post-election equity rally. Trailing earnings are no higher than they were two years ago and on a forward-looking basis, we estimate US earnings to be above their cyclically adjusted normal levels. The answer, therefore, would appear to be that US equities are expensive at current levels and with expectations elevated, vulnerable to disappointment. The most obvious source of that disappointment is likely to be President Trump's pro-growth policies as his ability to effect change at the pace and scale already priced into US equities is tempered by a small Senate majority and the realities of Washington dealmaking.
Global (Ex-US) Equities		• Outside the US, we see attractive valuations and the improving growth backdrop as supportive to international equities. We continue to believe that the European earnings recovery is gaining momentum. This recovery was initially supported by the ECB's loose monetary policy and a weak euro, but now that bank balance sheet restructuring is largely over, we think it is self-sustainable. Furthermore, we expect the long-term political risk premium reflected in European equities to partially unwind in the coming months. Attractive valuations also support a constructive view of Japanese equities.
Emerging Markets Equities		• Emerging market (EM) equities have looked attractively valued on our analysis for some time. • We believe that post-US election fears about the impact of a stronger USD and wider trade protectionism risks have been overdone. Thus far, at least, investors' worst fears about Trump's trade policy have not materialized. We see the US dollar (USD) as late cycle and do not believe that a strong USD will derail the improvement in overall demand momentum in EM or the earnings upgrade story. • Moreover, we see the potential boost to developed world growth from an increase in infrastructure spending and lower tax rates as positives for demand growth in EM.
US Bonds		• We see nominal US treasuries as broadly fair value on a standalone basis. Core inflation is edging higher. However, the market's initial expectations on the pace and scale of President Trump's change agenda, and its impact on US growth and inflation appear overly optimistic. Moreover, we expect structural deflationary forces, including aging populations, to continue to act as a rebalancing mechanism to significant yield rises in the medium term. • In relative terms globally, we see nominal US Treasuries as offering attractive carry, particularly versus German bunds.
Global (Ex-US) Bonds		• In aggregate, we see global bonds outside of the US as unattractive. German bunds are particularly expensive relative to their long-term history on our analysis. • 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. In our view, the diverging fortunes of provinces make monetary policy very difficult for the Bank of Canada.
Investment Grade Corporate Debt		• Our positive view on investment grade (IG) bonds relative to developed world sovereign debt is largely predicated on the former's attractive yield pick-up. We see the global demand for yield continuing to support IG. Given the improving demand backdrop, balance sheet strength and generally loose monetary policy, we think a sharp rise in defaults at the higher-quality end of corporate debt is unlikely. As a result, we see global IG corporates as continuing to offer an attractive risk-and-return profile compared with government bonds.
High Yield Bonds		• We see accelerating demand growth and deregulation in the US as positive for corporate cash flows and balance sheets and, therefore, as positive for US High Yield. On a relative basis, we also believe that more domestically biased high yield issuers are greater beneficiaries of the President's pro-growth "America First" agenda than more internationally diverse US investment grade borrowers.
Emerging Markets Debt US dollar Local currency		• We retain a neutral view of external emerging market government bonds. We have a more positive view of local currency EM debt. We believe 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 broadly balance the risks from high debt levels.
Currency		• Among developed market currencies, we see long-term valuation support for the euro and expect the political risk premium to slowly fade over time. Elsewhere, we view the Swiss franc as among the most expensive currencies globally on our long-term analysis and believe the New Zealand dollar is significantly overvalued in a long-term context. • In emerging markets, we retain a constructive view on a number of EM currencies, such as the Indian rupee.

[1] Source: UBS Asset Management. As of May 31, 2017.

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 May 31, 2017

Valuation and market behavior indicators at work

Overall signal =

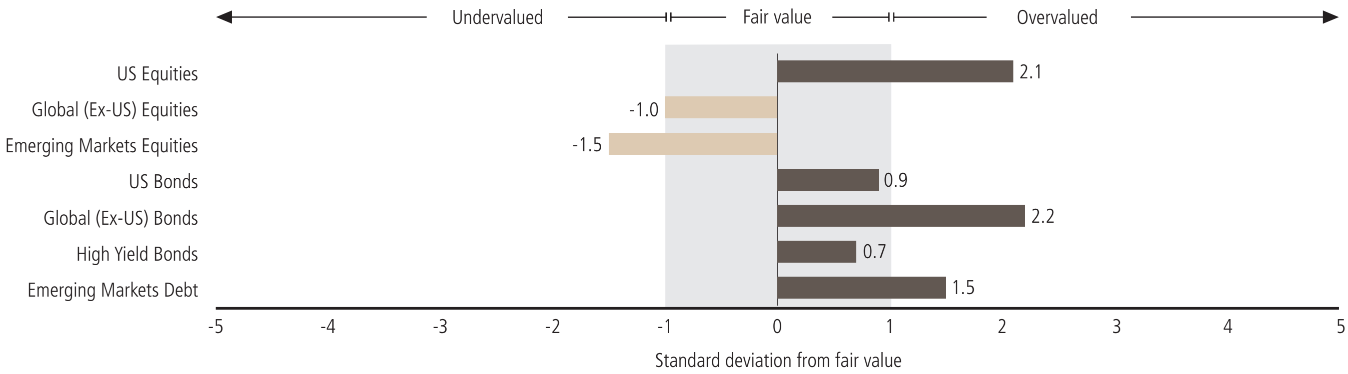
Positive ◄ ► Negative

Valuation	+	Market themes	+	Momentum and flow	+	Market stress	+	Macroeconomic landscape	=	Overall signal
Negative		Slightly negative		Negative		Slightly positive		Slightly positive		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 May 31, 2017.

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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