UBS

Global Perspectives

Multi Asset | January 31, 2017

Overview

Equities: Global equity markets continued to rise in January with emerging markets outperforming developed economies – a sharp contrast to the close of 2016. The first three weeks of the month saw financial markets in the US still profiting from expectations around the promised deregulation efforts and fiscal stimulus from a then president-elect Donald Trump. However, such hopes have been put on hold since President Trump took office on January 20.

Fixed income: European bond yields dropped with reductions being most pronounced within UK gilts. U.S. Treasuries improved from mid-month lows after President Trump made no mention of his plans to ramp up government spending in his first press conference.

Currency: The US dollar (USD) weakened in response to market concerns about President Trump's initial policy focus which was more protectionist than reflationary, as well as negative rhetoric on the overall strength of the US dollar. The British pound (GBP) was given a boost by Prime Minister Theresa May's aggressive speech outlining the principles of her government's Brexit plan, which reduced investor uncertainty.

The month in review:

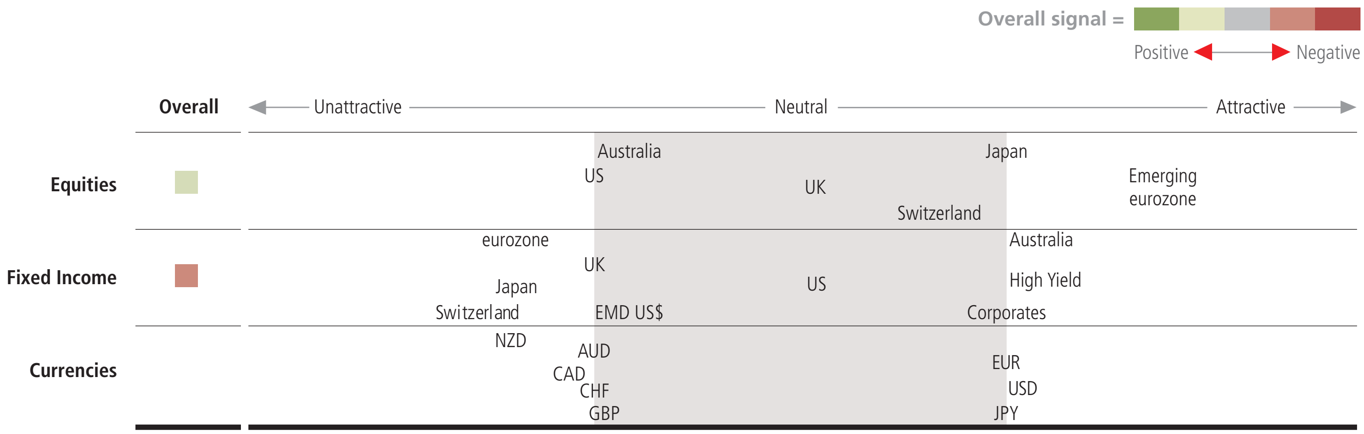
- Global equity markets continued to rise in January with emerging markets outperforming developed economies. However, markets became more nervous following President Trump's continued rhetoric on implementation of protectionist policies and renegotiating trade deals.
- Recent European economic data has been rather positive with GDP growth in the eurozone outpacing the US during the last quarter of 2016 – the first time since the financial crisis. Nevertheless, political uncertainty remained in focus.
- Whereas 2016 began with fears of an economic slowdown in China, data released in January showed China's full-year GDP growth rate was well within the government's target range of 6.5% to 7%, supported by loosened credit and ramped up spending by the government.
- Fixed income markets generally fared less well in January after a strong finish to 2016. While European Central Bank (ECB) president Mario Draghi has pledged to keep central bank stimulus in place this year, a sell-off in eurozone government bonds has left German yields at their highest level in a year, thus challenging investor's conviction in policymakers to retain low interest rates. U.S. Treasuries bucked the trend, improving from mid-month lows after President Trump made no mention of his plans to ramp up government spending in his first press conference. In the high yield space, US and European credit spreads narrowed significantly, while corporate bond credit spreads remained broadly flat.

Outlook:

- With President Trump's speech and early actions being a continuation of the campaign promises that led him to victory, a high level of uncertainty remains and the scale of fiscal action is likely to remain constrained by budgetary realities. In terms of positioning, we are currently taking a small overweight to global equities, while retaining a small underweight to global duration in general terms.
- Outside of the US we see more attractive valuations and the improving growth backdrop as broadly supportive to equities. In Europe, we continue to believe that the European recovery story is, finally, gathering momentum – supported in no small part by the ECB's loose policy and a weak euro. While geopolitical risks are clearly high ahead of major elections in a number of core eurozone countries, we see these risks as well flagged and, to a degree, already reflected in valuations.
- Against a backdrop of accelerating demand growth in the US, we see President Trump's campaign promises of lighter regulation for the energy sector as a positive for US high yield, in particular, where oil companies are a significant part of that universe. On a relative basis, we 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.

Current views[1]

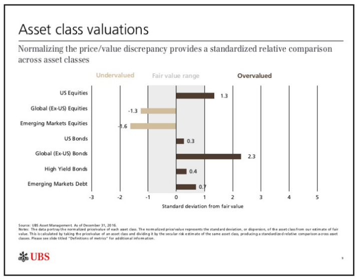
Asset allocation and currency attractiveness based on fundamental valuation and market behavior analysis



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. • However, on a sector and factor level there is a very significant valuation divergence. While the valuations of bond proxies and secular growth stories (i.e. Technology) became stretched amidst the highly consensual "lower for longer" narrative, more cyclical "value" sectors, including Energy and Financials, underperformed significantly. • Since President Trump's election that trend has reversed. But we believe that there is still further to go in the so-called "reflation trade" ahead of US budgetary discussions in late February/early March given the scale of "value's" underperformance in prior years and our belief that inflation expectations in the US are underpriced. Historically, "value" as a factor has outperformed when the US yield curve is steepening.
Global (Ex-US) Equities		• Outside of the US, we see attractive valuations and the improving growth backdrop as supportive to equities. In Europe, we continue to believe that the European recovery story is finally gathering momentum – supported in no small part by the ECB's loose policy and a weak euro. While geopolitical risks are clearly high ahead of major elections in a number of core eurozone countries, we see these risks as well flagged and to a degree, already reflected in valuations.
Emerging Markets Equities		• Emerging market (EM) equities have looked attractively valued on our analysis for some time. • We believe post-US election fears about the impact of a stronger USD and wider trade protectionism risks are overdone and more than reflected in valuations in some markets. We see the US dollar 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 US growth from an increase in infrastructure spending and lower tax rates as positives for demand growth in EM.
US Bonds		• While structural deflationary forces, including aging populations, are likely to act as a rebalancing mechanism to significant further U.S. Treasury yield rises in the medium term, we believe that the Federal Reserve is highly likely to lag the data in raising rates and will allow inflation to overshoot. • Despite the rise in nominal yields post-election, we do not believe that this is yet fully priced in by the wider market. We, therefore, continue to prefer inflation-linked to nominal U.S. Treasuries. • On a relative basis, globally (i.e. versus German bunds), we now see US nominal bonds as offering attractive carry.
Global (Ex-US) Bonds		• In aggregate, we see global bonds outside of the US as unattractive. • 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 bonds relative to developed world sovereign debt is largely predicated on the former's attractive yield pick-up. We see global demand for yield continuing to support IG. With a sharp rise in defaults at the higher-quality end of corporate debt unlikely – given the improving demand backdrop, balance sheet strength and generally loose monetary policy, we see global IG corporates as continuing to offer an attractive risk-and-return profile compared with government bonds.
High Yield Bonds		• Against a backdrop of accelerating demand growth in the US, we see President Trump's campaign promises of lighter regulation for the energy sector as a positive for US High Yield, in particular, where oil companies are a significant part of that universe. On a relative basis, we 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		• Our overall view on both local and external emerging market government bonds remains neutral. 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 ongoing support for the euro, while we view the Swiss franc as among the most expensive currencies globally on our long-term analysis. • In emerging markets, after recent strength, our positive view has tempered a bit in the past month. However, overall we retain a constructive view on selected EM currencies including the Indian rupee and Mexican peso.

[1] Source: UBS Asset Management. As of January 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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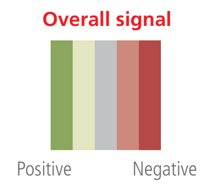


Market themes

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.

US Equities example as of January 31, 2017

Valuation and market behavior indicators at work

Overall signal =

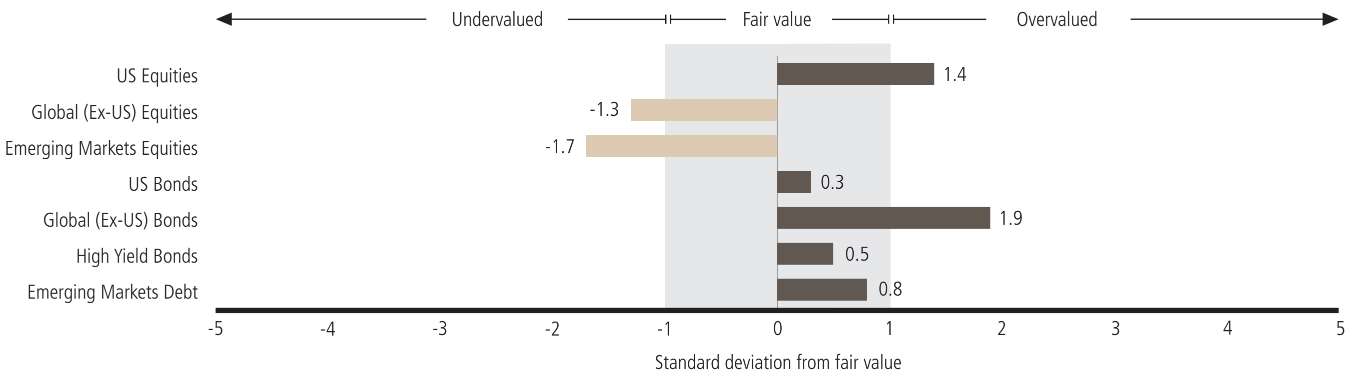
Positive ◀ ▶ Negative

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