Forces shaping the investment landscape

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In this edition of Panorama, our senior asset class and allocation experts assess the potential challenges and opportunities investors may face for the remainder of the year.

The following pages bring you distinct viewpoints and investment insights across our global capabilities, to help meet your investment challenges.

For additional content and previous editions of Panorama, including ‘Investing in 2019: Navigating volatile markets’, visit ubs.com/panorama or scan the below QR code.

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Publishing information
Panorama is released bi-annually by UBS Asset Management
Editorial deadline: June 2019

Editors
UBS Asset Management Content Solutions team

Design
UBS Asset Management
Creative Studio, New York

ubs.com/panorama
As always, the investment landscape is complex and a number of risks still lurk on the horizon. The headline story of early 2019 for investors has been the dramatic upswing in global markets, especially in contrast to the drawdown and volatility spikes we saw in late 2018. The US Federal Reserve’s (Fed’s) move away from rate hikes, along with improving economic conditions in China, are the primary drivers behind this turnaround.

But as always, the investment landscape is complex and a number of risks still lurk on the horizon. The US economic expansion became the longest in history this month, which brings to mind the old saying, ‘nothing good lasts forever.’ Meanwhile, trade wars, the threat of new tariffs, Brexit, and European and US political risk are just a few factors that have the potential to drive volatility and threaten risk asset prices over the coming months. A big spike in inflation, though not expected, could change the environment rapidly. Asset allocators will need to be as nimble as ever in responding to a rapidly evolving and interconnected global macro and geopolitical environment.

It has always been our view that diversified risk premia form the essential foundation for investment portfolios. At the same time, we continue to believe investors will need to work harder for risk-adjusted returns than they have done for the majority of the post-financial crisis period. Below are some of the opportunities and risks we see across asset classes and markets in the coming months.

**China’s economic stabilization** should drive increased investment there. According to the International Monetary Fund, China is expected to drive 33% of global GDP growth in 2019, and is on track to surpass the US as the world’s largest economy by 2030. China is also on the verge of surpassing Japan as the world’s second largest bond market. Today, most investors are underweight China relative to its share of global markets. We believe there is
Investors have been diversifying their portfolios into real assets and related alternatives for the last two decades and we expect this to continue. An increasingly strong case that the time has come for asset allocators to consider a standalone allocation to China.

Investors have been diversifying their portfolios into real assets and related alternatives for the last two decades and we expect this to continue. But the evolving global macro forces impacting regional economies and currencies underscores the need for a local market focus vs. a regional or global focus for real asset investments. We believe the key to real estate is thoughtful asset selection, intensive asset management and selling to the best buyer at a very opportune time.

Sustainable investing has been around for at least 20 years. But in the last few years, investors have begun to understand that rather than just a ‘feel-good’ option, sustainability can also help improve and safeguard investment returns. A major survey of asset owners just released in collaboration with Responsible Investor mirrors what we are hearing: almost half of investors are convinced that sustainability can have a positive influence on a company’s financial performance. They also want to better understand the materiality of risks associated with not taking environmental, social and governance factors into account in their investments.

As a global leader in sustainable investing for many years, UBS Asset Management has been at the forefront of understanding the interplay of sustainability and corporate and social outcomes. One emergent topic we’ve recently explored is the changing role of asset owners as stewards of their portfolios, and how stewardship can be a powerful means of protecting shareholder value.

For fixed income investors, the US Fed’s decision to hold off on further rate hikes puts it in closer alignment with generally dovish central banks globally, which should help carry strategies continue to generate positive contributions to total returns for the remainder of 2019. But we are also keeping a close eye on central bank actions to lift inflation, which could create a new set of global opportunities and some new challenges for active fixed income investors.
The strengthening US and Chinese economies should support emerging markets assets, which have provided a rich source of potential alpha for investors. But these markets also require a long-term strategy. Not only are emerging markets, including China, expected to deliver two-thirds of global economic growth over the next five years, according to The World Bank, but the majority of the world’s growth in working-age population in the next 10 years will be centered there, making EM an essential part of an investor’s portfolio.

In the current economic environment, we believe active equity managers have an advantage with valuations that are no longer stretched on traditional metrics. In a world that is heavily exposed to passive equity and fixed income investments, we see a number of opportunities for excess returns that are only available to active managers.

At the same time, investors with passive or smart beta allocations, which includes just about every large asset owner, may find that implementing or tweaking a multi-factor solution can help balance cyclical and defensive factors in coming quarters.

With insights across both traditional and alternative asset classes, we trust you will find our mid-year update thought-provoking and helpful in meeting the investment challenges that lie ahead.

With many moving parts in the macro environment, flexibility and diversification are key, along with the ability to respond quickly when opportunities present themselves. We therefore continue to advocate a bias to high conviction, focused investment styles.

You can explore these topics in more detail in these pages and online. Visit ubs.com/panorama for all our Panorama articles and up-to-the-minute video interviews with our key investment experts.

We look forward to our continued partnership with clients throughout the year.

The strengthening US and Chinese economies should support emerging markets assets, which have provided a rich source of potential alpha for investors. But these markets also require a long-term strategy.
The Fed’s January pivot from a tightening to a neutral bias was a powerful lift to risk assets, bringing down discount rates and increasing the probability of a longer economic cycle. China’s easing has also gained some traction, cushioning the economy from the pressures of deleveraging and trade tensions. With valuations for risk assets having rebounded, we have turned neutral from overweight global equities, given moderating economic growth and associated risks from the trade and technological conflict between the US and China. In our base case, tensions are dialed down given strong incentives on both sides to avoid major disruption. If we are right, we are likely enduring another mid-cycle slowdown in this record long economic cycle. We believe that this environment favors a neutral approach to risk assets with hedges against geopolitical risks.

Global economy bends, but doesn’t break

The global economy is enduring its third mid-cycle slowdown of the post-crisis expansion. We are closely watching Purchasing Manager Indexes (PMIs), which remain above the 50 line separating expansion from contraction but are now signaling somewhat below trend growth. Our base case for coming months is that the global PMI will stabilize above 50, implying a soft landing for the global economy. Our assessment is based on the view that while there has been pronounced weakness in the manufacturing and goods sectors, global services sectors have generally remained resilient. This underlying durability is linked to ongoing strength in developed economy household income growth and is supporting consumption, by far the largest driver of growth in developed...
Other emerging markets and even key developed markets like Japan and Europe have the potential to outperform.
countries. The dovish turn by central banks has led to a broad easing of financial conditions, providing a cushion for consumers and businesses.

Meanwhile, China’s easing of monetary, fiscal and regulatory policy is helping to cushion its economy. Credit growth has rebounded and infrastructure investment is showing signs of life. Ongoing trade uncertainties create risks for business confidence, but ultimately we expect some de-escalation given strong incentives on both sides to avoid unacceptable economic and market weakness.

The stabilization in China’s economy comes at an important time for economies integrated into the global supply chain. Other emerging markets and some key developed markets like Japan and Europe have the potential to outperform. Indeed, by some measures, ex-US valuations relative to the US are as cheap as during the height of the tech bubble and in the late 90s. The bar is low for ex-US outperformance assuming growth stabilizes as we expect.

An extended economic cycle
With this US economic expansion now the longest on record, it is unsurprising that investors are increasingly cautious on how long it can possibly go on. But a confluence of developments has materialized that suggest this economic expansion can continue even longer. These include rising productivity and prime age labor force participation, along with a Fed that is still providing accommodation. Having pivoted amid the sharp tightening in financial conditions late last year, the Fed has now shifted focus to the stubborn downside misses of inflation to its 2%

Exhibit 2: Fed funds rate surpassed nominal GDP growth ahead of every recession since 1970

Source: UBS Asset Management, Macrobond, as of 6 June 2019.
target over the last decade. This has led
to increasing discussion of the Fed’s strategic
framework and whether the central bank needs to think about erring
on the side of more accommodative policy in order to sustainably bring
inflation and inflation expectations to its objective.

The Fed’s dovish leanings comes at a
time when nominal growth in the US is quite healthy, even amid some expected
moderation. Note that the fed funds rate surpassed the rate of nominal GDP
growth ahead of every recession since 1970, but currently remains comfortably
below (Exhibit 2). Moreover, the fed funds rate is below the Fed’s estimate
of ‘neutral’ (where policy is neither accommodative nor restrictive). In prior
recessions, the Fed has raised rates above its estimate of neutral by 150
to 200 basis points. While there may be downside risks to growth from trade tensions, the Fed has signaled it stands ready to also lower the fed
funds rate if necessary.

Moreover, there are organic improve-
ments in the US economy that also suggest this cycle can last for some
time. Productivity growth is clearly moving higher, suggesting that the
economy can continue to expand without generating a spike in margin
pressures, inflation, or a sharp move back to tightening by the Fed. Relatedly,
prime-age labor force participation is picking up which suggests the economy is not resource-constrained.

Risks to the base case
Of course, risk assets have priced in much of the good news from these
tailwinds. This leaves markets vulnerable to negative developments. As men-
tioned above, trade policy risks remain and are difficult to handicap. Another
crunch is that the China stimulus we are seeing is much more targeted at the
domestic economy than to the external sector. Indeed, this China stimulus is
focused on boosting consumer confidence and small and medium enterpris-
es. As such, we are seeing fewer positive spillovers to broader emerging markets and to Europe and Japan than in prior China stimulus cycles. This
unbalanced growth is a concern because if it continues alongside a US
economy which is outperforming, the already expensive dollar could strength-
en further. This could weigh on US corporate earnings and cause disruption
for emerging markets, creating a potentially negative feedback loop.

Finally, in the US, domestic political
uncertainty is rising. We may see
another fiscal showdown potentially
involving the debt limit showdown
between President Trump and the
House Democrats over coming months. Beyond that, uncertainty created by
the 2020 election may start to filter through into markets. The Democratic
primary debates are scheduled to start on 26 June, and during the primary
process, candidates tend to veer towards the extremes of their parties before moving to the center before the general election. There may be rather aggressive policy proposals that emerge from the Democratic debates which have the potential to unnerve markets. Perhaps most tangibly, uncertainty over
whether tax cuts will remain law and regulatory uncertainty could weigh
on investment and also on hiring as we move into 2020.

Bottom line
With an extended economic cycle and an accommodative Fed, we would not
underweight risk assets despite the potential for near-term volatility particularly around developments in trade policy. Within equities we see the US as more fully valued and prefer to tilt somewhat towards Europe and Japan, but would like to see evidence of a more durable recovery in global growth before becoming more aggressively exposed. In fixed income, we are
underweight European and Japanese sovereigns relative to US Treasuries, which maintain valuable safe haven status. Finally, we are short the Australian dollar against the safe haven Japanese yen to hedge against trade
risks and a more concerning fall in global growth.
Coming into its own

The case for a standalone allocation to China

China’s impact on global markets was made clear earlier this year when its return to economic growth, along with the US Federal Reserve’s policy turnaround, helped pull global markets out of a fourth-quarter downturn. China’s continuing growth and its standing as the world’s second largest economy support our experts’ belief that the case for a standalone approach to China is growing increasingly compelling.

Our experts

Hayden Briscoe
Head of Asia Pacific Fixed Income

Bin Shi
Head of China Equities

Gian Plebani
Portfolio Manager, China Allocation Opportunity

Rob Worthington
Head of Investment Specialists, Investment Solutions
Hayden Briscoe: the fixed income view
When Bloomberg put China bonds into its indices in April 2019 it sent a big message to the world, namely that Chinese bonds went directly into a developed market benchmark. That’s largely because of the size of the onshore bond market, which we believe will soon grow larger than Japan’s, to become the second largest in the world. So purely from a sizing perspective it makes sense to think of an allocation to China in a standalone sense, just as investors look at focused allocations to the US, UK, and Japan.

Moving away from size to returns, historically, China’s bond markets have offered relatively high nominal and real yields vs. developed markets. That’s vital for investors to remember, particularly if global growth slows. The world is starved of bond markets that offer defensive characteristics, and China is one of the few defensive markets offering spread pickup against US, German, Japanese, and UK yields.

Finally, when thinking of standalone allocations, investors need to think about where the world is going to be in five to ten years. In our view, that means preparing for an RMB currency bloc with a standalone allocation to China fixed income. China’s clout in terms of trade and investment in the Asia-Pacific region should only continue to grow, and we expect the RMB will move to reserve currency status, creating a RMB-bloc, similar to the USD- and Euro-denominated blocs of North America and Europe.

When thinking of standalone allocations, investors need to think about where the world is going to be in five to ten years.
Bin Shi: the equities view

Ten years ago, investors used to talk about the BRICS economies, i.e., Brazil, Russia, India, China and South Africa, being the new drivers of the global economy. Things have clearly changed because these countries don’t get mentioned together in the same way anymore. That’s because China has emerged as the main driver of the global economy, and will contribute an estimated 33% of global GDP growth in 2019, according to IMF numbers. And that should continue. There are a whole range of estimates on this but it is widely accepted that China will continue to be one of world’s largest economies.

For equity investors, it means that China’s stock markets will likely continue their growth path and become some of the largest in the world. This is already being recognized in the index inclusion process. If, as we expect, onshore China markets are fully included into the MSCI EM benchmark, China equities will account for an estimated 40% of that index alone.

The question for investors then is, given the size and growth of China’s economy and equity markets, is a general exposure in an EM-focused strategy enough? We don’t think so, and that’s not just because of the projected size of China’s economy and financial markets.

We believe that an active, standalone allocation gives investors a better chance of capturing growth opportunities in China than a generic allocation within an EM strategy. As China transitions to a services and consumer-led economy, many new drivers and innovative companies in the consumer, IT, healthcare sectors are emerging and outpacing the traditional investment-led sectors.

An active approach, supported by on-the-ground, bottom-up research, may cherry-pick the best opportunities in these fast-growing, emerging sectors in China before they are discovered by index-linked passive investment strategies. Additionally, active strategies may take advantage of inefficiencies in China’s equity markets. Retail investors drive China’s markets, making them volatile and influenced by ‘collective behavior.’ This opens opportunities for disciplined, active strategies to exploit mispricing in ways that passive strategies may not.

In summary, given the ongoing growth story, the size of the economy, and the nature of Chinese equity markets, we believe that an active, standalone allocation, with strategies supported by on-the-ground knowhow, offers investors the best chance of capitalizing on the many opportunities emerging from China’s growing role in the global economy.
Capturing alpha with a multi-asset China allocation

Gian Plebani and Rob Worthington

As China’s onshore markets are included in global indices and their weighting increases, China will soon become the largest component for any emerging market index. It would be a prudent and probably natural step to consider China separately from EM ex-China, much like the case for the US vs. the World ex-US.

The relatively low correlation of China’s financial markets with broader overseas markets provides ample opportunities for portfolio diversification. And the large set of potential alpha opportunities, as discussed by our sector specialists, may make a China allocation even more attractive. To capture such alpha, however, could prove tricky and requires special skills and dedicated efforts.

Clearly the appropriateness of any allocation to China is dependent on each individual investor’s risk and return objectives. Our analysis shows that adding 5% and 10% dedicated China exposure to a portfolio, split 50/50 across equities and fixed income, can improve the risk-adjusted return profile of a hypothetical global portfolio, based on historic data, and that adding 10% exposure to Chinese assets improved the risk-adjusted returns potential more than adding 5%, based on historic data.

There may be investors convinced of China’s growth story who just don’t have the risk tolerance for a dedicated allocation to Chinese equities. In which case, China multi-asset strategies may offer investors a more ‘risk-aware’ exposure to Chinese assets that combines the undoubted growth potential of the China equity story with the more defensive, diversifying and income-generating characteristics of a China fixed income allocation.
Appointed in March, Joe Azelby leads the Real Estate & Private Markets (REPM) global investment platform with over USD 100bn in AuM, operating out of 14 countries and with more than 550 employees worldwide (as of May 2019). Joe was previously CEO of JP Morgan’s Global Real Assets business for 18 years and most recently, Senior Partner and Head of Real Assets at Apollo Global Management. Joe is also a former professional American football player for the Buffalo Bills.

Real assets are by nature a long-term investment. However, for the remainder of 2019, we believe that with favorable economic conditions and a low interest rate environment, investor demand for real assets will continue to strengthen. Here, Joe gives his views on the opportunities real assets provide to long-term investors.
1. There has been a rise of confidence in real assets over the last two decades – why is that?
The major driver behind the increasing popularity of real assets is low interest rates and in some countries negative interest rates. As interest rates fell during and after the Global Financial Crisis, investors began looking for other yield assets that could be substituted for bonds.

Real estate, infrastructure and other tangible operating assets with contractual cash flows have been pursued aggressively, as persistently low interest rates have taken hold. Asset managers recognized this trend and built out their real asset investment capabilities to satisfy this great demand.

With more investment managers participating and more products offered, we have seen the market mature over the last decade. Increased transparency, strategy segmenting, improved performance data and benchmarking along with better valuation processes, governance and reporting are all part of a growing and maturing asset class.

2. As institutions seek to diversify their portfolios, do you expect to see even greater exposure to alternatives?
Investors have been diversifying their portfolios into alternatives for the last two decades and we expect this to continue. Real assets have benefitted from the need to diversify as have private credit strategies and hedge funds. Within alternatives there are ebbs and flows as asset types become more or less popular based on prior performance or expectations of future performance. The overall trend to increase alternatives allocations has been helped by the trend towards low-cost indexing and ETFs. By decreasing the cost of accessing traditional assets, investors have more ability to invest in higher fee alternative strategies offering some combination of diversification and return enhancement.

3. Which regions do you expect to boost returns the most in the next 20 years?
Real asset investing requires a local market focus vs. a regional or global focus. Real assets compete in a very local market and the investments you make must compete successfully in their immediate neighborhood. The game is won and lost through thoughtful asset selection, intensive asset management and selling to the best buyer at a very opportune time.

Areas of interest include residential and office assets in Europe and industrial assets in the US. With the retail sector in both the US and Europe under significant pressure, we will look to take advantage of falling asset prices on a highly selective basis. Global macro forces impacting regional economies or country currencies can swamp the good work being done on the ground especially in emerging markets. However, proper asset selection, a good business plan for the asset and stellar execution will most often result in a profitable ending.

4. What are the main challenges you think will impact the industry in the coming years?
Economic cycles and interest rate changes in response to them are important but beyond our control.

Our focus is on the assets we own and the forces around them that are likely to make them more or less valuable. Is the new office tower being built next to ours going to help or hurt our asset’s position in the marketplace? If its Google’s new headquarters it may help our building by attracting related tech tenants to the neighborhood. If it is a speculative office tower development we run the risk of losing tenants to our shiny new neighbor. If our infrastructure team is buying a regulated utility providing power to a state, we need to understand the regulatory regime of that state and discern whether it is likely to change for the better, worse, or stay the same. Real assets are impacted more by local competition and other resident forces than the big macro trends and trades.

5. What have you learnt most from playing professional football? Do you apply any of these principles in your work today?
Both you and your team need to improve constantly if you want to win consistently. Football and the asset management industry are both highly competitive, full contact and played in an ever-changing environment.

Both require you to recognize when things are changing and adjust quickly and appropriately while running at full speed. If you are not improving you will fall behind, because you must assume everyone else is changing for the better.
Engaging for long-term impact

Becoming better stewards

It seems like common sense that companies that manage their environmental, social and governance (ESG) issues well, are in a good position to outperform competitors that don’t. Investors are seeing the benefit of taking ESG into account. Now, many are looking for ways to become better stewards of their investments by helping companies improve their sustainability.

Robust portfolio risk management and due diligence may involve investors engaging with companies in order to gain information and influence behavior. This engagement can give investors a real understanding of the state of a company and its commitment to a certain strategy.

We find that large investors are eager to engage if they believe it can help improve performance. A large-scale study of asset owners conducted this year by Responsible Investor found that asset owners rank fiduciary duty and the risk of not taking ESG into account as two of the top three reasons for incorporating ESG into their investment management. Engagement can be a vital tool for meeting these goals.

Michael Baldinger
Head of Sustainable and Impact Investing
Dialogue enables investors to monitor and, where necessary, seek to drive corporate conduct on issues that affect the long-term value of investee companies across asset classes. It is a way to build relationships, collaborate with company management and look to enhance performance on issues such as capital structure, corporate governance, climate change and human capital.

The stewardship function comprises both engagement and voting activities (in the case of listed equity) and means being active owners rather than passive traders of stocks. Rather than basing investment decisions solely on an analysis of a company’s reported results, investors who are stewards of capital, work with corporate management to improve long-term drivers of value. It is an opportunity for companies to demonstrate how sustainability approaches influence everyday business decisions, focus on engaging with investor audiences around metrics and commit to implementing tangible changes to proactively enhance financial performance. Investors can share their expectations of corporate management and encourage working practices that seek to enhance long-term value.

Why do these activities matter?
Investors having a key role in driving sustainability integration and stewardship is an intrinsic part of the investment process. It offers unique opportunities for innovation that may realize positive material change for companies and better long-term returns for clients while benefiting the environment and society as a whole. It is no surprise therefore that the role of stewardship is becoming increasingly important for many investors. According to the 2018 annual report of the Principles for Responsible Investment1, 90% of signatories have engaged with investee companies in listed equity and 70% in corporate fixed income.

But how does stewardship or active ownership differ from the traditional notion of activism? Activists often feel emboldened to challenge a company’s strategy in a more forthright way and they undertake public practices that may affect a company’s governance. The ultimate goal of the activist is often achieving high internal rates of returns in a short period of time. According to data from Lazard, a record USD 65 billion in capital was connected to activist campaigns in 2018, up from USD 62.4 billion the previous year, targeting 226 companies in 2018, compared to 188 in 2017.2

Activists are often associated with a “renter” mentality versus an “owner” approach. This type of activism can be negative for the existing management, often imposing decisions on boards that may result in the sale of part of the company, the unseating of management, proposing new slates of directors and reductions in capital expenditure. In comparison, active owners are long-term shareholders, focused on sustainable returns. That said, activism can also be regarded as a force for good and bring about positive change particularly when boards are not performing in a way expected of them. Sometimes, activist and active owner interests align and collaborations are possible. Ultimately however, the distinction between activism and active ownership remains, and we view the approach of stewardship, with its orientation toward long-term collaboration with management, as a more productive and ultimately sustainable means of realizing shareholder value.

1 The Principles for Responsible Investment is a UN-supported initiative encouraging institutional investors to consider ESG factors in investment processes. To date, it has collected support from more than 2,200 investors representing more than USD 80 trillion in assets. The data reported are from the 2018 PRI Annual report: https://www.unpri.org/annual-report-2018/blueprint-actions/responsible-investors/foster-a-community-of-active-owners.

2 https://www.barrons.com/articles/mutual-fund-managers-activist-investors-51554498763?emailToken=cbc55bada37e6a88019d1af87930c9aaf9wip-1wilKeleNl0zrMHNROwcOtjRyRCiAaXOM5jF3Y2qhdk1Y1v9/RIVwH58K72ZjF2ONjQDksXH5QwvCHJ08tyF09xJGzuDv65g=
Why UBS Asset Management

Drawing on the breadth and depth of our capabilities and our global reach, we turn challenges into opportunities. Together with you, we find the solution that you need. At UBS Asset Management we take a connected approach.

### Ideas and investment excellence
Our teams have distinct viewpoints and philosophies but they all share one goal—to provide you with access to the best ideas and superior investment performance.

### A holistic perspective
The depth of our expertise and breadth of our capabilities allow us to have more insightful conversations and an active debate, all to help you make informed decisions.

### Across markets
Our geographic reach means we can connect the parts of the investment world most relevant for you. That’s what makes us different—we are on the ground locally with you and truly global.

### Solutions-based thinking
We focus on finding the answers you need—and this defines the way we think. We draw on the best of our capabilities and insights to deliver a solution that is right for you.

### What we offer
Whatever your investment profile or time horizon, we offer a comprehensive range of active and passive investment styles and strategies designed to meet your needs across all major traditional and alternative asset classes. We also offer platform solutions and advisory support, to institutions, wholesale intermediaries and wealth management clients. We are a truly global firm with principal offices in Chicago, Frankfurt, Hartford, Hong Kong, London, New York, Shanghai, Singapore, Sydney, Tokyo and Zurich. Our invested assets total USD 824 billion and we have around 3,400 employees, including around 900 investment professionals, located in 23 countries.

### Who we are
We are one of the largest managers in Alternatives: the second largest fund of hedge funds manager and fifth largest manager globally of direct real estate. We are a leading fund house in Europe, the largest mutual fund manager in Switzerland, the best-selling European active fund house and the top foreign firm in China. UBS’s unique passive offering, encompassing index and systematic strategies, provides smart beta, alternative indices, and other custom solutions to meet our clients’ needs. We are the second largest European-based indexed player and the fourth largest ETF provider in Europe.

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Past performance is not indicative of future results.

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1. As of 31 March 2019.
2. As of 31 December 2018 (updated annually). Around 1,150 internal and external FTE from Corporate Center (excluding staff supporting AM less than 80% of the time).
8. UBS Asset Management analysis of AUM from company disclosures, November 2018.
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EMEA
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