Global Perspectives

Overview

- **Equities:** Market movements remained fairly erratic in September, which made for a challenging environment for many of the positions that we hold. Our 12-month outlook for developed market equities (excluding the US) remains positive, with Japanese and eurozone equities among our high conviction holdings. In the current volatile conditions, we have focused on our relative value trades.
- **Fixed Income:** Federal Reserve chair Janet Yellen surprised investors by not raising rates in September, citing heightened concerns about growth in China and other emerging market economies. Yields fell across the government bond markets. During the month, we added a long Italian and Spanish government bonds versus cash position, as spreads on peripheral over core eurozone government bonds widened to an extent that we believe is unjustified.
- **Currency:** Monetary policy divergence continues to support gains in the US dollar relative to eurozone currencies. In our portfolios, we have benefited from a long US dollar versus short New Zealand dollar position. The Reserve Bank of New Zealand has the potential to cut rates further, while sluggish economic growth and low business and consumer confidence are also likely to weigh on the domestic currency.

The month in review: The Fed holds the key—or does it?

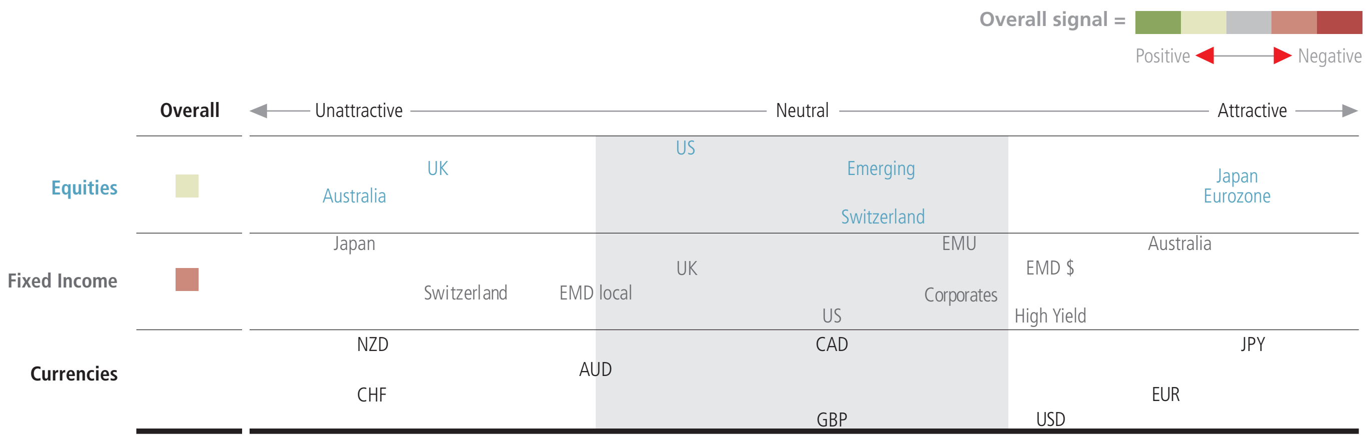
- Market movements in September were driven primarily by the US Federal Reserve's (Fed's) decision to keep interest rates on hold at their record-low level and ongoing concerns about a sharper-than-expected slowdown in the Chinese economy. Recent developments in US economic data have been viewed as broadly supportive of gradually rising rates. However, Fed chair Janet Yellen surprised investors by citing heightened concerns about growth in China and other emerging market economies, as well as notable volatility in financial markets, as a reason for not raising rates.
- Equity market returns for the month reflected the impact on investor sentiment of the Fed's decision to abstain from raising rates. Emerging markets equities outperformed their developed market counterparts, benefiting from a continuation of the lower-for-longer interest rate environment. In absolute terms, global equity returns remained sluggish across markets. However, most markets rallied on the last trading day of the quarter, which moderated the losses to an extent.
- The Fed's decision to leave rates unchanged led to falling yields across the government bond markets.

Outlook: Chinese slowing pains

- The tumultuous developments seen in the Chinese economy and financial markets in the third quarter do not necessarily presage a veering away from China's previously anticipated growth trajectory. Before the quarter's developments raised red flags for investors, most commentators were expecting the Chinese economy to slow gradually onto a path of more sustainable long-term growth—and it was factored into projections that official data from China could overstate growth rates by some margin.
- While our outlook for equities over the next 12 months remains positive, developments in China and, more broadly, the emerging markets are challenging our base case scenario. We have not yet seen a catalyst for our view that the Chinese economy will stabilize and react to the monetary and fiscal stimulus provided by authorities. China, therefore, remains at the top of our list of global economic developments to monitor.
- In the eurozone and Japan, accommodative central bank monetary policy and a positive outlook for corporate earnings growth should lend support to equity markets.

Current views[1]

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

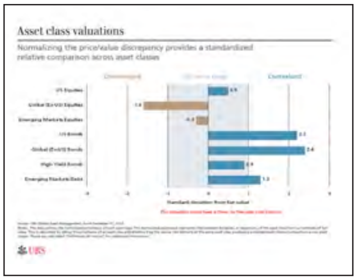


Asset Class	Overall signal	UBS Asset Management's viewpoint
US Equities		• In our view, the broad US equity market remains unattractive on valuation grounds. However, there are sound investment opportunities in the small- to mid-cap space. Smaller and medium-sized companies are likely to benefit from an environment of increased mergers and acquisitions activity as they become the targets for larger companies seeking to deliver higher earnings growth. • Prospects for US corporate earnings growth remain fairly muted. US companies, however, are more insulated against further slowing in Chinese demand than their eurozone counterparts, given that China is a less important export market for the US.
Global (Ex-US) Equities		• Loose monetary policy continues to lend support to global (excluding the US) equity markets. There are some doubts, however, about the degree to which additional quantitative easing would drive the prices of risk assets higher. • Our conviction in the Japanese and eurozone equity markets remains high. Both are supported by similar dynamics: an accommodative central bank, currency weakness boosting exporters, oil price weakness leaving consumers with more disposable income and a relatively positive outlook for corporate earnings growth.
Emerging Markets Equities		• We would need to see strong signs of stabilization in the Chinese economy for the fortunes of other emerging market economies to take a turn for the better. While trading at what we believe are attractive valuations, we do not yet see the case for adding exposure to emerging market equities. • We find attractive investment opportunities in the North Asian equity markets, including Korea and Taiwan, which export technology equipment and products to China, and demand for which should remain healthy. On the other hand, heavily resource-dependent economies such as Brazil and Russia, could see their equity markets suffer as Chinese commodity demand wanes further.
US Bonds		• We have added a long US inflation-linked bonds (TIPS) versus nominal government bonds position. The rationale for this position was that it would allow us to benefit from the theme of medium-term US inflation risk being underpriced. We remain short US duration. • Market participants and commentators appear to be assuming that the Fed remains on track to raise rates by the end of this year, and that the first hike would be followed by a very gradual pace of tightening. We believe that there remains scope for Fed policy error.
Global (Ex-US) Bonds		• Investors welcomed the re-election of Alexis Tsipras in September, and Greece's new government is expected to focus on implementing the reforms required by the country's third bail-out program. • Meanwhile, the European Central Bank stands ready to step in to calm bouts of volatility in the bond markets. Conditions should therefore remain favorable for peripheral eurozone bond markets. • In September, we added a long Spanish, long Italian 10-year government bonds versus cash position, as spreads on peripheral over core eurozone government bonds widened to an extent we believe is unjustified.
Investment Grade Corporate Debt		• Credit spreads widened meaningfully in September. Recent developments have raised some concerns about liquidity in the global credit markets. • Due to pension fund de-risking and structural buyers such as insurers, the demand for US corporate bonds is expected to exceed supply in the coming years. This helps reduce some of the concerns about liquidity, but we are monitoring market conditions closely.
High Yield Bonds		• Sector allocation remains key as the ongoing impact of weak oil prices may lead to higher default rates among energy companies, and increase the risk of retail outflows in a market potentially short of sufficient demand. Given the very low level at which developed government bond yields languish, spread products can offer relatively attractive returns.
Emerging Markets Debt US dollar Local currency		• Our preference remains for US dollar over local currency-denominated emerging market debt, in an environment of Fed rate rises on the horizon and weak global growth. In the US dollar debt market, a granular country-by-country assessment of economic conditions in emerging markets is crucial. • The prospect of further US dollar strengthening provides a headwind for the local currency-denominated debt markets in the emerging economies.
Currency		• Monetary policy divergence continues to support gains in the US dollar. In our portfolios, we have benefited from a long US dollar versus short New Zealand dollar position. The Reserve Bank of New Zealand has the potential to cut rates further, while sluggish economic growth and low business and consumer confidence are also likely to weigh on the domestic currency. • In our view, the Japanese yen remains significantly undervalued. Meanwhile, we expect the Swiss franc to depreciate against the euro given the challenges faced by the Swiss economy.

[1] Source: UBS Asset Management. As of September 30, 2015.

Market behavior analysis complements valuation

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

Positive Negative

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 September 30, 2015

Valuation and market behavior indicators at work

Overall signal =

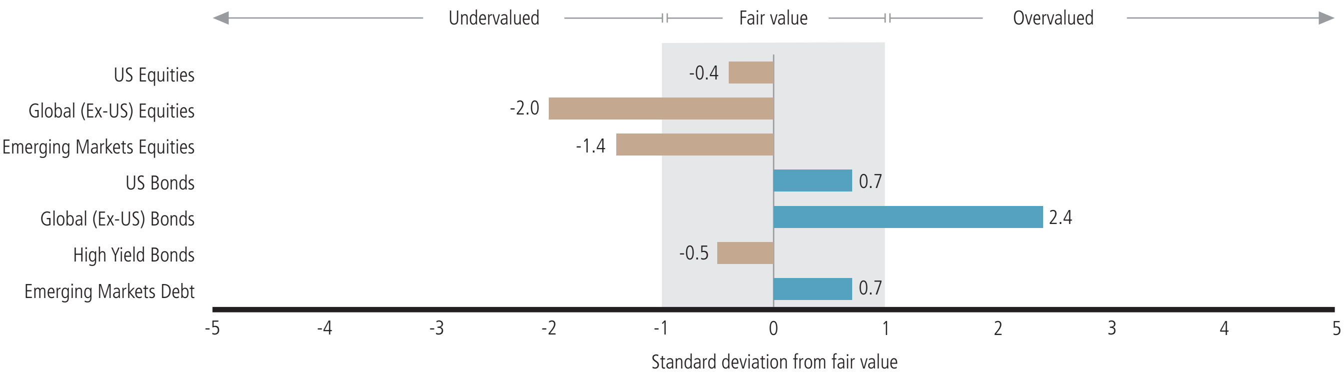
Positive Negative

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

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 September 30, 2015.

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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