UBS

Global Perspectives

Global Investment Solutions | December 31, 2015

Overview

Equities: Equity returns were broadly negative across both the developed and the emerging markets in December. Eurozone equities suffered losses as the enhanced monetary easing announced by the European Central Bank (ECB) at the start of the month fell short of investors' high expectations. Other factors weighing on risk sentiment included political uncertainty in Spain and concerns about liquidity and defaults in the US high yield corporate bond market.

Fixed Income: In a highly anticipated move, the Federal Reserve raised its federal funds rate for the first time in around nine years. With asset prices already having adjusted to reflect a potential increase ahead of the announcement, the immediate impact on US government bonds was relatively muted.

Currency: Tighter monetary policy continued to lend support to the US dollar. The euro, which has been weak in a highly accommodative monetary policy environment, made gains as the ECB did not deliver further easing to the degree that had been anticipated.

The month in review:

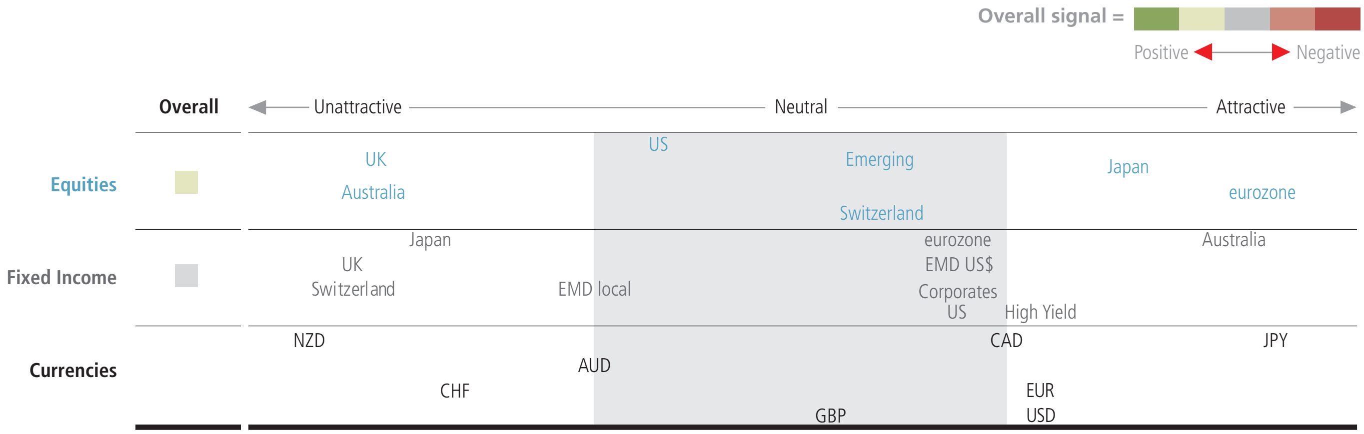
- The Federal Reserve (Fed) met the expectations of investors in December by delivering the first US interest rate increase in around nine years. In contrast, the European Central Bank (ECB) did not enhance its quantitative easing program to the extent that had been anticipated by investors. These developments were the main drivers of asset prices in the final month of the year, while political uncertainty in Spain and heightened volatility in the US high yield corporate bond market also had an impact.
- With markets largely having priced in the Fed's December action, the effect on Treasuries was relatively modest, with the yield on the US 10-year government bond rising by around six basis points (bps) over the month. European government bond yields rose more meaningfully, however, as the ECB's monetary policy actions fell short of investors' high expectations. UK and German government bond yields finished December up by 13 bps and 16 bps, respectively.
- Global equity returns were sluggish. There was no sharp divergence in the performance of developed and emerging market equities, with both suffering small declines and appearing to take the first US interest rate increase broadly in their stride. Eurozone equities were among the month's weakest performers, due primarily to investors' disappointment in the ECB announcement and the uncertain outcome of the Spanish election. On the basis of 12-month returns, the eurozone (particularly Germany) and Japan delivered the strongest developed equity returns of 2015.

Outlook:

- Although most developed market central banks remain firmly in monetary easing mode, a rising rate environment in the US increases the likelihood of a more liquidity-constrained investment environment in the year ahead. Such an environment could lead to bouts of heightened market volatility, particularly if investments are crowded in a few popular trades, as was frequently the case in 2015.
- China is likely to continue to provide investors with sporadic cause for concern. Differentiating between developments in China's real economy and its often erratically moving domestic stock market—and assessing their impact on global asset prices—will remain key.
- The European Union (EU) faces its own set of challenges, not the least in the form of the significant migratory flows into the region and the upcoming vote in the UK on the country's EU membership. Heading into 2016, investors can, however, take comfort in the gradually improving eurozone economy. Risk assets should remain supported by the ECB's accommodative monetary policy, euro and oil price weakness, as well as the potential for corporate earnings growth to gather momentum.

Current views[1]

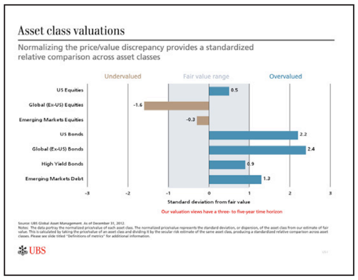
Asset allocation and currency attractiveness based on fundamental valuation and market behavior analysis



Asset Class	Overall signal	UBS Asset Management's viewpoint
US Equities		• Despite the relatively favorable domestic economic backdrop, the broader US equity market remains unattractive, in our view, primarily on valuation grounds. • We held an equity relative value trade in the market, positioned long US small and mid caps versus large caps, but have now closed this position due to our investment thesis being violated. While we had expected smaller- and medium-sized companies to be targeted in an environment of increased mergers and acquisitions (M&A) activity, and to be more earnings generative than their larger counterparts, this scenario did not play out as we had expected. In particular, US M&A activity in Q3 was mostly confined to the large cap space.
Global (Ex-US) Equities		• With the ECB stating that it is willing to provide further accommodation if necessary, the outlook for eurozone equities should remain positive over the medium-to-long term. The asset class should continue to benefit from the ongoing eurozone economic recovery. Data released shortly after month-end showed that eurozone output rose at the fastest rate in 4½ years in the final quarter of 2015 (Markit Eurozone PMI Composite Output Index). • Our view on the Japanese equity market remains fairly positive—although slightly less so than before—based on companies' ability to deliver solid earnings growth.
Emerging Markets Equities		• After month-end, the China A-share market recorded a decline of 7% during the first trading day of 2016, bringing trading to a halt under new rules. China H-shares fell by significantly less. We expect to see continued volatility in the domestic Chinese equity market, but anticipate that authorities will manage the impact of the slowdown in economic growth by providing adequate support through structural reforms and fiscal/monetary policy actions. • We continue to hold our long China H-share (Hong Kong-listed) versus China A-share (mainland) position. We do not expect a repeat of the strong rally in the A-share market, with the Chinese government having accelerated efforts to move towards more open capital accounts, while there are other initiatives to allow for more flexible capital movements in and out of China.
US Bonds		• The Fed raised the target range for the federal funds rate by 0.25%, to 0.25%–0.50%. Largely priced in by markets, the move was taken as a sign of the Fed's confidence in the health of the US economy. • We retain conviction in our long 10-year US Treasuries versus UK Gilts position. In our view, the spread between the Treasury and the Gilt yields is too wide given that the Fed has raised rates in December and the Bank of England looks set to follow in 2016.
Global (Ex-US) Bonds		• Further divergence in the monetary policy trajectories of the Fed and the ECB continued to suppress eurozone government bond yields. • In December, we converted our directional trade in peripheral eurozone government bonds into a relative one. This means that our long Spanish, long Italian 30-year government bond positions are now versus 10-year German government bonds. We continue to believe that these peripheral eurozone government bonds are attractively priced given that the Spanish and Italian economies are recovering, and that there is room for spread compression.
Investment Grade Corporate Debt		• We continue to prefer investment grade credit over sovereign bonds, and overall duration remains low. • The attractiveness of the investment grade segment of the market is primarily stemming from the positive carry, market liquidity and capital flows as investors are taking the closest substitute to sell government bonds.
High Yield Bonds		• The final quarter of the year saw credit spreads widen significantly amid concerns about liquidity and defaults, particularly in the US. In our view, the current yield to worst of 5.2% in Europe could compensate appropriately for the potential liquidity risk inherent in the asset class. US credit currently offers a yield to worst of 8.3%. • Sector and regional allocation remains key as the ongoing impact of weaker oil prices may lead to higher default rates among energy companies, which represent a higher weight in the index in the US, and increase the risk of retail outflows in a potentially demand-deficient market.
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		• Although the USD is likely to continue strengthening on account of tighter Fed policy, our preference remains for the Japanese yen. • Our long positions in the yen versus both the USD and the euro contributed positively in December. Japan's Q3 GDP was revised upwards, and the Bank of Japan made a technical adjustment to its quantitative and qualitative easing program that makes further expansion in its size less likely in the immediate future.

[1] Source: UBS Asset Management. As of December 31, 2015.

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

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 December 31, 2015

Valuation and market behavior indicators at work

Overall signal =

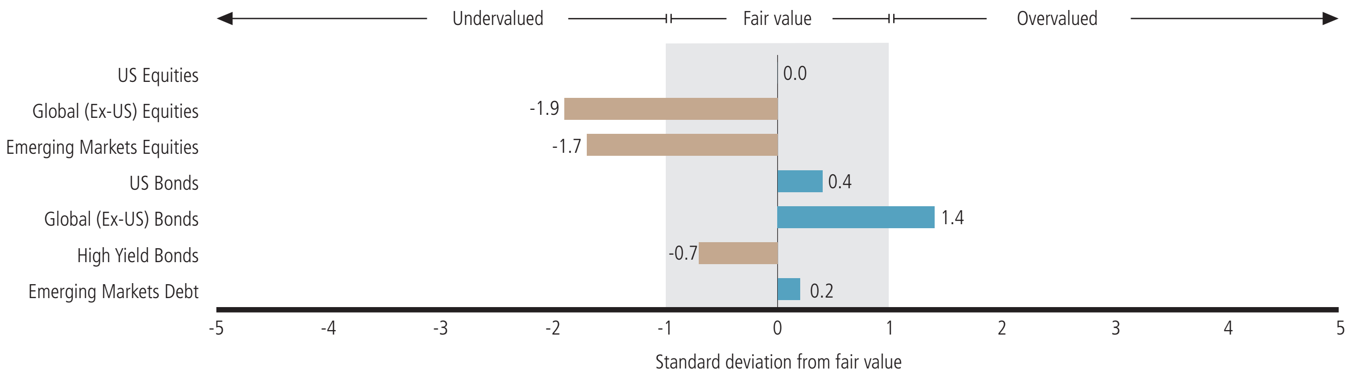
Positive ◄——► Negative

Valuation	+	Market themes	+	Momentum and flow	+	Market stress	+	Macroeconomic landscape	=	Overall signal
Neutral		Neutral		Neutral		Neutral		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 December 31, 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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