The Decade Ahead

Ten major trends that will impact investors over the next 10 years

In the year 2000, a patient requiring surgery would have to contend with an invasive procedure and a lengthy recuperation period. By 2010, thanks to the advancement of robotic surgical techniques, that same procedure would be minimally invasive and the patient would be up and about in a matter of days. There were scores of other developments as well during that 10-year period; for example, iPods, Google and Skype were virtually unheard of in 2000, but are a part of everyday life today. What a difference a decade makes.

As with the last decade, the world will look very different in 2020. And while no one can say precisely what those changes will be, we turn to UBS Wealth Management Research–Americas (WMR), whose 10 prognostications can help us better prepare to meet the challenges and seize the opportunities in the decade ahead.

After reading this overview of future trends, have a conversation with your UBS Financial Advisor to discuss how these trends may impact your portfolio, and explore actionable solutions for you to implement.

1. The U.S. will remain the dominant power in the world, but...

...monumental budget deficits, persistent trade imbalances and lagging primary education rankings are a few of the challenges that threaten to topple it from its customary global leadership perch.

Mike Ryan, UBS Chief Investment Strategist and Head of WMR, notes, “The U.S. undoubtedly does face a number of serious challenges, but it also possesses many strengths that will enable it to not only cope with such difficulties in the next decade but to continue to flourish.”

If history is a guide, the U.S. will deal with any challenges and emerge even stronger. Think back to the 1960s, when many believed that the U.S.S.R. would eclipse the U.S. as a military power. In the 1980s, many more assumed that Japan would become the world’s dominant economic force. Instead, the U.S. adapted and thrived. We foresee a similar scenario in which the U.S. will remain the world’s largest and most important economic power but will be challenged by slow growth and such growing economies as China and India.
Chinawill flex its economic and other muscles

An economy that was roughly the size of Poland’s 20 years ago has grown to a point where it is now second only to that of the U.S. Explosive economic growth in China has benefited the global economy, but it now may be a source of conflict over:

• Competition for natural resources
  China is now the largest user of energy in the world, according to the International Energy Agency. Its continuing industrialization and urbanization over the next decade will further increase its demand for natural resources.

• Indigenous innovation
  In order to advance this goal, the government is requiring that foreign companies partner with domestic ones and hand over their technological and manufacturing expertise, if they want to gain a toehold in local markets.

China is seeking a more prominent global role in shaping international standards and policy.

We foresee a decade of slow growth in which the U.S. will remain the world’s largest and most important economic power but will be challenged.

Current sources of U.S. strength include:

- **Productivity drivers:** Technological innovation and a work force that absorbs highly skilled, foreign-born workers and remains less vulnerable to aging than the work forces of many other countries.

- **Entrepreneurial drivers:** A legal and economic framework that supports entrepreneurialism and a flexible system of free enterprise that rewards ingenuity and has always shown the ability to bounce back from economic hardship and reinvent itself.

- **Power drivers:** Military superiority and, notwithstanding a dependence on oil, resources that enable the U.S. to satisfy a sizable portion of its needs for energy and industrial metals.

While there is little question that the U.S. remains the dominant economic power, its share of total global economic output will continue to shrink. This should lead you to consider if your current weighting of U.S. equities is appropriate for this new reality.

3 Geopolitical risk is at its highest level...

...since the days before the Cold War ended. Generally, geopolitical tensions emerge as a result of natural resource scarcity, ideological clashes, income inequality, etc. Consider these potential flashpoints:

- The international community has been unable to deter certain nations from pursuing nuclear capabilities.

- Weak economies may try to spur growth with policies beyond traditional trade protectionism, like currency devaluation.

- Oil, natural gas and other resources are growing more concentrated in a few countries, while the largest...
consumers of these commodities have grown more dependent on unreliable suppliers.

- Terrorism continues to be a threat because of deeply entrenched ideologies intent on destabilizing world order.

It’s important to understand that some geopolitical events—such as military posturing between countries—may have only fleeting influence on financial markets, while others—e.g., if China decided to cut purchases of U.S. Treasuries—can depress economic growth and financial markets for long periods of time. Hedging against the former may not be feasible, but diversifying to protect a portfolio from the latter might be a sound strategy.

4 In the U.S., inflation will trump deflation...

...but it will be close for awhile. The forces that lead to one or the other will likely battle one another over the next several years. Ultimately, we expect inflation to prevail and anticipate a CPI averaging 5% annually for most of the decade.

While we foresee inflation rates higher than those we’ve experienced for the past 30 years, we don’t see a return to the stagflation—slow or no economic growth with high inflation—environment of the 1970s. Here is the tally of the different factors affecting inflation:

<table>
<thead>
<tr>
<th>Price-changing pressure</th>
<th>Pro-inflation factors</th>
<th>Pro-deflation factors</th>
<th>Winner</th>
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<tbody>
<tr>
<td>Resource slack (the amount of productive resources in an economy that aren’t being used)</td>
<td>• Reduced interest rates have contributed to global demand</td>
<td>• Households/banks are deleveraging and reluctant to resume normal lending activity</td>
<td>Tie</td>
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<tr>
<td>Inflation expectations (self-fulfilling prophecy that can raise inflation)</td>
<td>• Fed is willing to go far to avoid deflation and may stumble in its attempt to manage inflation expectations</td>
<td>None</td>
<td>Inflation</td>
</tr>
<tr>
<td>Labor costs</td>
<td>• Wage pressures begin to mount as output gaps shrink</td>
<td>• Since the end of 2008, unit labor costs (labor cost per unit of GDP) have fallen by 3.5%</td>
<td>Tie</td>
</tr>
<tr>
<td>Commodity prices</td>
<td>• Emerging market urbanization and expansion will raise commodity prices</td>
<td>None</td>
<td>Inflation</td>
</tr>
<tr>
<td>Currencies</td>
<td>• Dollar will struggle but not collapse</td>
<td>None</td>
<td>Inflation</td>
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Investing during times of high inflation like the 1970s is radically different from investing in a low-inflation environment, like the one we have been experiencing for the last 30 years. Stocks that may have benefited from low inflation may not be the same ones that benefit from higher inflation. Similarly for bonds, a high-inflation environment alters the way a properly crafted bond portfolio may look.
Mining partners see continued high commodity prices and emerging market demand

Founders of American Metals and Coal International, Inc., Hans Mende and Fritz Kundrun, have seen coal and copper prices quadruple over the past 20 years and markets shift from Europe and Japan to China, India and Brazil.

“I’m optimistic about prospects for continued growth in these markets,” says Mr. Kundrun who, like his business partner, is a long-time UBS client. “Over the next 10 years, people in these countries will enjoy a higher standard of living which will fuel a long-term demand for our products.”

Mr. Mende is a bit more cautious. “We used to operate on a 5% margin,” he admits. “Because of high commodity prices, margins are now close to 200%. It’s hard to imagine any business sustaining margins like this for a long period of time.”

“One more factor to consider is that commodities are priced in U.S. dollars,” points out Mr. Mende. “With the currencies of producing countries strong and many experts bearish on the dollar, prices could remain high, whatever the demand.”

It has been over 30 years since investors faced an environment in which the demand for, and the price of, commodities have been so integral to a discussion of portfolio construction.

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Sovereigns struggle as bond yields rise

The days of risk-free assets and declining bond yields have come to an end. U.S. Treasuries and the sovereign debt of other advanced nations are under pressure from their enormous debt loads. This debt shows no sign of decreasing as aging populations in need of social services make it difficult for governments of developed countries to balance spending.

Additional pressure may come from:

- Higher interest expenses as the financial crisis recedes and central banks normalize their monetary policies, thereby leading to higher interest rates
- Increased inflation that may even be supported by the institution of a monetization policy by the Federal Reserve, enabling it to buy U.S. debt with newly printed money
- Deteriorating credit quality of U.S. government bonds and sovereign issues by some EU countries
- Possible reorganization of the EU accompanied by a change of membership and reintroduction of national currencies
Finally, foreign ownership of U.S. Treasury securities has jumped from 35% in the 1990s to 47%—a quarter of which is represented by the U.K., Japan and China.

Such countries might choose to reduce their buying of U.S. Treasuries, requiring U.S. investors to fill the gap, in turn causing bond yields to rise. While this might adversely affect the dollar, as well as U.S. Treasuries, we believe that the dollar will continue to serve as the world’s reserve currency. Even with the additional credit and price risk, there is no other currency that could replace the dollar over the next decade. We do, however, expect that investors will have to more actively manage their bond portfolios as the notion of a risk-free asset becomes obsolete.

The combined pressures in sovereign debt—especially U.S. Treasuries and nascent inflation—may be a reason to think about how your fixed income portfolio is positioned for such a scenario, and to consider more active management for your portfolio of bonds.

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## U.S. stocks to outperform bonds

Who would have believed on December 31, 2000, that the S&P 500 would essentially be flat over the next decade? And with all the issues facing the U.S. and global economies, why do we foresee a rosier decade to come?

The answer lies in the three major forces that depressed market performance over the past 10 years:

<table>
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<th>Then</th>
<th>Now</th>
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<td><strong>Economic growth</strong></td>
<td>From 2000-2010, the U.S. economy grew more slowly than in any other decade at 1.7% annual real GDP growth—half the 3.4% growth rate from 1950-2000.</td>
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<td><strong>Valuations</strong></td>
<td>Price/earnings ratios were the highest they’d been in 100 years. The S&amp;P 500 was trading at 22 times earnings in 2000 vs. the long-run average of about 15.</td>
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<td><strong>Sector concentration</strong></td>
<td>The S&amp;P 500 became overconcentrated not once, but twice during the decade. In early 2000, the information technology sector accounted for 35% of S&amp;P 500 market capitalization, while in 2007, the financial sector represented 22%.</td>
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We foresee a return to normalcy for stock market earnings now that the valuation excesses of the early 2000s are few and far between. Specifically, we’re looking at a potential 8.5-9% annual total return, with an estimated fair value for the S&P 500 of 2450 by the year 2020.

While stock return projections are in line with historical returns, UBS understands that you may have redefined your personal risk tolerance and your need for liquidity. Accordingly, portfolios need to be constructed and managed to reflect your current sensibilities and the opportunities yet to come.
People will earn more and spend more. Emerging markets will transform from agrarian to urban economies.

**Emerging markets will emerge stronger**

“People will earn more and spend more,” says UBS WMR analyst Sally Dessloch. “Emerging markets will transform from agrarian to urban economies. We’ll see further investment in infrastructure, and domestic and multinational companies with a strong presence in these markets stand to benefit.”

The countries most likely to lead this trend include Russia, China, India and Brazil, but other emerging markets (EMs) like Indonesia, Mexico and some African countries may play a more important role in driving growth as the decade unfolds.

We project that EMs will account for almost half of the $30 trillion global GDP increase we envision by 2020. Population growth in these markets will outpace that of developed countries, and the combination of more people and more money will result in higher spending on consumer goods beyond food, clothing and shelter.

**Emerging markets are no longer relegated to Cinderella status among their asset class brethren. They’ve earned a newfound respect from a growing number of investors being drawn to stronger growth prospects and returns offered by developing nations. Look for a shift in portfolios from a modest allocation with a tactical focus on short-term opportunities to a greater, more sustained strategic allocation.**

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**Mexican trucking executive gears up for economic growth**

According to WMR, Mexico will be one of the fastest-growing emerging markets over the next 10 years. UBS client Manuel Albarran has already seen evidence of that growth and is contributing to it through the trucking company he founded 20 years ago, Metro Transportes. “Our industry has changed dramatically,” he explains. “Not too long ago, mom and pop outfits dominated, but rising diesel prices and a demand for more professional service have left many of them behind.”

The demand to which Mr. Albarran refers comes from two primary sources: large domestic companies and multinational firms. “The domestic firms are looking to reduce costs and improve productivity,” says Mr. Albarran, “so many of them are cutting back their internal trucking fleets and outsourcing transport services to trusted providers.”

As for the multinational companies, “they are willing to pay more for transport,” continues Mr. Albarran, “but they have no tolerance for poor service and late delivery.”

As a result, Metro Transportes has upgraded its fleet and invested substantially in technology and communications to meet the requirements of large companies. “Our industry is a good indicator of the overall economy,” says Mr. Albarran. “If lots of goods are being transported among many locations, it’s a sign that demand and productivity are on the rise.”
Oil's share of energy consumption slips

How could oil’s relative share of energy production possibly decrease when emerging markets are fueling world demand and oil companies are spending unheard-of sums to extract crude from difficult-to-drill locations?

And yet, that’s the scenario that David Lefkowitz, WMR analyst, envisions by the end of the decade: “The price divergences between oil and other energy sources are unsustainable. Already they’re unleashing substantial intellectual and financial resources intent on taking advantage of today’s cheaper energy sources.”

The cheaper sources to which he refers are natural gas and electricity. Natural gas prices have declined over the past few years as a result of new drilling and distribution techniques. Electricity prices have followed suit because natural gas-fired power plants generate 20% of U.S. electricity.

Solar power is becoming a more viable energy alternative. With costs declining and expected to fall further, solar could be the least costly power generation source by decade’s end.

Further evidence that alternative energy sources will enter the mainstream comes from a few sources, primarily:

- Global governments that are trying to achieve energy security in the face of heightened resource competition. Reducing dependence on imports is becoming a major priority.
- Environmentalists who will play a major role in commercializing green technology by pressuring government and private industry.

So while oil prices are on the rise and show no signs of reversing themselves, they may be in for a rude shock as clean energy sources advance and green technology becomes more cost-competitive.

You may want to begin thinking about diversifying your energy company exposure to reflect these emerging energy sectors.

Technology continues to enhance productivity, but with more risk

If you needed milk, would you buy a cow? That’s the concept behind cloud computing, a phenomenon that promises to become the next big technological trend that will transform the way we do business over the next 10 years.

Essentially, cloud computing enables companies to buy only the services they need without investing in hardware, software, etc. Cloud computing offers the ability to purchase far more mission-critical functions on an as-needed basis. As a result, businesses can reduce cost, increase efficiency and gain the flexibility to innovate without substantial capital commitment.

At the same time, our continuing reliance on technology poses substantial risk. “We’ve grown so technology-dependent that doing without for a period of time could be destabilizing,” says WMR analyst Bob Faulkner.

Events that could deprive us of technology include cyber-attacks on infrastructure that generates electricity, distributes natural gas or performs other functions we take for granted. Another threat is electromagnetic pulses (EMPs) that occur naturally as the result of a solar flare or intentionally through nuclear explosion. EMPs can render computers inoperable and may erase any stored data. We foresee EMP protection eventually being designed into products.

While the markets have generally focused on technologies that allow us to live longer and healthier lives, there will be opportunities in companies that protect us against injury, inconvenience and property damage.

Cloud computing allows businesses to cut costs and have the flexibility to innovate without major capital commitment.
Coordinated care among healthcare providers, namely hospitals and physicians, not only streamlines processes and lowers costs, but it also improves the quality of care. By the end of the decade, all patients will have an electronic health record that contains their complete health history, thereby improving provider communication, reducing unnecessary tests and establishing the continuity of care many patients lack today.

• Personalized medicine applies the extraordinary breakthroughs in understanding the human genome, our individual genetic makeup, to the therapies we receive. Genetic analysis will be commonplace in future physician office visits, and drug and biological research will deepen its focus on targeted therapies for patients with specific gene types, altering or even removing defective genes. Advances could lead to cures for previously incurable diseases, such as Alzheimer’s, and various forms of cancers, while substantially reducing healthcare costs.

The net of all this suggests that the focus of your healthcare investments might shift toward managed care and medical device companies.

It’s time for a conversation

We’ve provided you a view of how the decade ahead may look. It is one that we believe will be rich with profound changes—changes that will present you with challenges and opportunities. We invite you to have a conversation with your UBS Financial Advisor, who will explore with you implementable strategies that can best position your portfolio now in order to capitalize on these future developments.