UBS

Global Perspectives

Multi Asset | August 31, 2016

Overview

Equities: Equities continued to be supported by accommodative central bank policy in August and by the belief that key interest rates will stay lower for longer. Against this backdrop, emerging market equities outperformed their developed world peers. The MSCI All Country World Index returned 0.7% in local currency terms.

Fixed Income: Ten-year US Treasury yields rose marginally over the month, while UK gilt yields dropped sharply. Yields on major investment grade and high yield bond indices also fell as investors' quest for yield continued.

Commodities: Oil prices rose significantly on hopes for a supply cut by the Organization of the Petroleum Exporting Countries (OPEC) in the coming months.

The month in review:

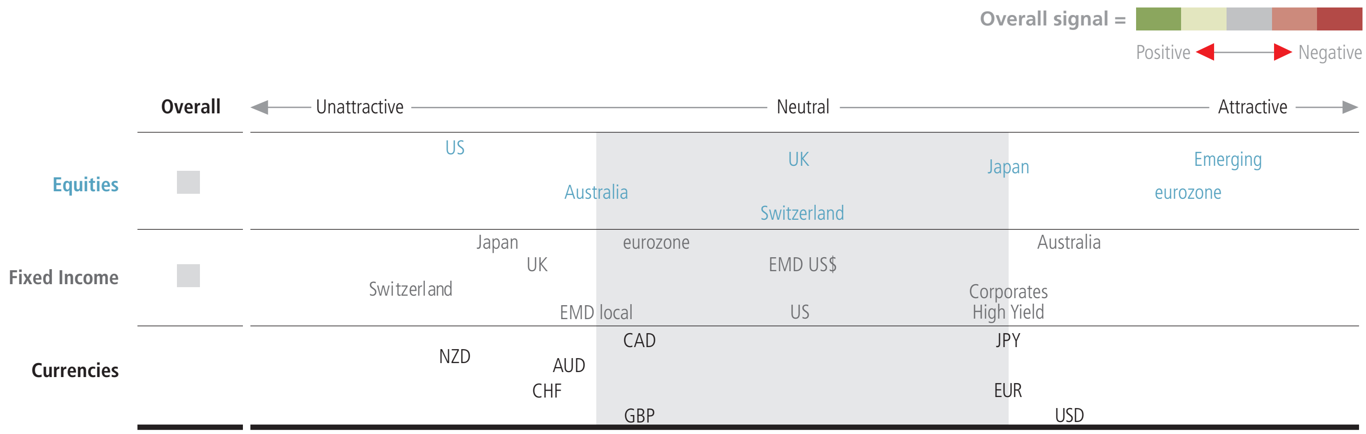
- August witnessed more central bank stimulus measures. In a bid to mitigate the risks posed by the UK's vote to leave the EU, the Bank of England (BoE) implemented a broad package including an interest rate cut of 25 basis points. Less expected was the BoE's decision to resume its quantitative easing (QE) program and expand its QE asset purchases to corporate bonds. Elsewhere, the Reserve Bank of Australia cut interest rates to new record lows in response to Australia's slowest rate of price growth in 17 years, resulting in a sell-off in the Australian dollar.
- Data released during August showed the pace of growth in US employment cooling more than what was expected, reducing the likelihood of policy tightening in September. This was despite Janet Yellen, Chair of the US Federal Reserve, taking a somewhat hawkish tone in an eagerly anticipated speech at a meeting of global central bankers.
- Risk assets continued to grind higher over the month, albeit at a slower pace than July. In aggregate, equities posted positive returns with emerging market and UK equities leading the way. Japanese, European and US equities also registered positive returns, while Asian ex-Japanese equities were slightly down on the month. Most key government bond markets were slightly weaker over the month. The UK was the notable exception in this regard, experiencing a pronounced fall in yields. Inflation-linked gilts fared even better than their nominal counterparts, posting very strong returns as a weak pound pushed inflation expectations higher. Within credit, spreads narrowed across the month in the US and Europe. In the commodity universe, oil prices rallied sharply in the first half of August due to hopes for a coordinated cut to supply by major producers.

Outlook:

- We believe that political risk is likely to be one of the biggest drivers of market sentiment, with the US presidential elections rapidly approaching. Meanwhile, investors continue to wrestle with the broader economic implications of the "Brexit" vote. While fears about a slowing Chinese economy have faded due to improving economic data, we believe that long-term challenges still remain a concern and need to be monitored closely.
- Within equities, we continue to prefer markets outside of the US and, within this universe, have a slight bias towards Europe. We believe European equities combine attractive valuations with a domestic-led recovery and a very favorable monetary policy tailwind. We also favor emerging market equities and have recently lifted exposure here. On our valuation analysis, emerging market (EM) equities have been cheap for some time. We now see them as supported in the short term by catalysts including the "lower for longer" backdrop plus improving economic and earnings momentum.
- Within fixed income, we favor investment grade corporate bonds which we believe remain well-supported when an ever-growing percentage of sovereign bonds trade on a negative yield. We continue to favor inflation-linked bonds in the US over their nominal counterparts due to emerging signs of wage inflation that we do not believe are reflected in prices.

Current views[1]

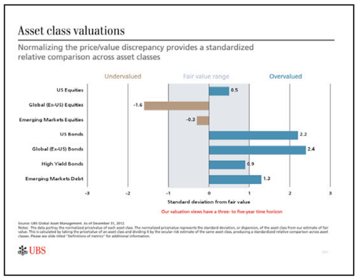
Asset allocation and currency attractiveness based on fundamental valuation and market behavior analysis



Asset Class	Overall signal	UBS Asset Management's viewpoint
US Equities		• Our analysis shows US equities as overvalued on a number of measures in a historical context. With revenues under pressure from a muted growth backdrop and the risk of margin pressure from wage growth, the scope for disappointment relative to expectations is high. We see no compelling rationale for further multiple expansion against this backdrop.
Global (Ex-US) Equities		• We continue to prefer developed equity markets outside of the US with Europe a particular focus. In contrast to their US counterparts, European equities look attractively valued. We also believe that the European recovery story is finally gathering momentum – supported in no small part by the European Central Bank's (ECB) loose policy and by its corporate bond buying program in particular. We expect the ECB's Quantitative Easing program to be extended before the end of 2016.
Emerging Markets Equities		• Emerging market equities have looked attractively valued by our analysis for some time. While our concerns about industrial capacity and external debt loads remain, we see a number of powerful catalysts supporting equity prices over a more tactical horizon. • For an equity universe which demonstrates material sensitivity to Fed policy and the USD due to high levels of dollar-denominated debt, the "lower for longer" backdrop and more gentle expected path for US interest rate rises are potentially supportive. • Meanwhile, the oil price is now high enough to benefit EM exporters but not too high to materially impact EM oil importers. With a welcome period of currency stability supporting investment, economic data and corporate earnings are now turning. • Finally, data suggests that institutional investors are still materially underweight EM equities.
US Bonds		• With the year-over-year base effects of oil rolling off and emerging wage pressures, there appears to be an unwarranted asymmetric outcome probability priced in to the wider market's dovish expectations on medium-term US inflation risks. We, therefore, prefer US Treasury Inflation-Protected Securities (TIPS) with low yields and with the potential for further rate rises, we see nominal US government bonds as unattractive.
Global (Ex-US) Bonds		• In aggregate, we see global bonds outside of the US as unattractive with German bunds standing out as one of the most overvalued markets. • We continue to see a number of geopolitical and fundamental risks to the bonds of peripheral eurozone countries, such as Italy, that we do not believe are reflected in current yields. • 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. 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 valuations and the former's attractive yield pick-up. Against a backdrop of "lower for longer" short-term interest rates, and government bond yields in the developed world, we do not believe that a sharp rise in defaults at the higher-quality end of corporate debt to be as likely. We see global IG corporates as continuing to offer an attractive risk and return profile compared with government bonds.
High Yield Bonds		• The pick-up in yield over sovereign debt is likely to continue to attract investors to high yield. However, after a sustained period of strong performance in which yields in European high yield, in particular, have fallen significantly in absolute terms, we now see the overall investment case as more balanced.
Emerging Markets Debt US dollar Local currency		• Our overall view on both local and external (USD-denominated) emerging market government bonds remains neutral. • A subset of currencies within this broad universe now looks attractive on a long-term basis while the improvement in current accounts and broader economic growth now balance out our concerns about high debt levels.
Currency		• Among developed market currencies we see the USD as attractively valued and the Swiss franc among the most expensive currencies globally on our long-term analysis. • As noted above we see a growing number of long-term opportunities within the emerging market universe.

[1] Source: UBS Asset Management. As of August 31, 2016.

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	Momentum and flow	Market stress	Macroeconomic landscape
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."	Attempts to capture money flows and market appetite for risky assets from the perspective of professional asset allocators, such as mutual fund managers.	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).	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 August 31, 2016

Valuation and market behavior indicators at work

Overall signal =

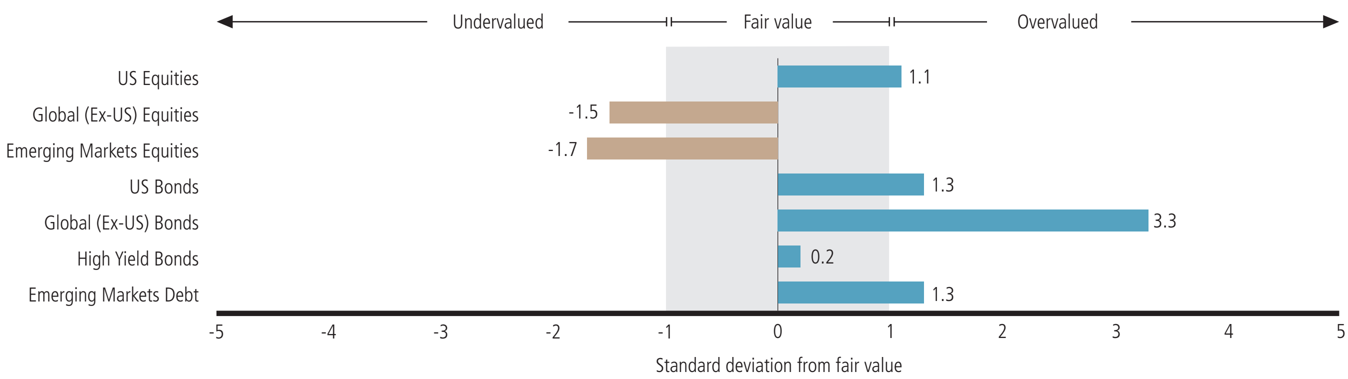
Positive ◀ ▶ Negative

Valuation	+	Market themes	+	Momentum and flow	+	Market stress	+	Macroeconomic landscape	=	**Overall signal**
Neutral		Neutral		Slightly negative		Neutral		Negative		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 August 31, 2016.

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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