UBS House View

Monthly Letter

Chief Investment Office WM
20 October 2016

US election
A divisive US presidential race has not always done justice to the policy choices the nation faces. In this letter, I imagine what a more rigorous TV debate might have sounded like.

Diversification
More polarized policy debates around the world have underlined the importance of a diversified investment approach, to limit exposure to the political and social choices of any single nation.

Inflation
We are introducing an overweight position in US Treasury Inflation Protected Securities versus standard high grade bonds. Markets are underestimating the outlook for inflation in the US.

Asset allocation
We are overweight US equities versus high grade bonds. We are also overweight emerging market equities versus Swiss equities.

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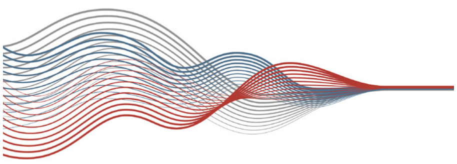
The debate that wasn't

"This was expected to be the most watched debate ever. The ratings were expected to rank up with the finale of *Cheers*, and the finale of *M.A.S.H.* Makes sense, in a way this election feels like the series finale of America."
–Jimmy Kimmel, US talk show host.

The underlying economic themes in this presidential race – weak real wage growth, high levels of government debt, rising inequality, and an aging population – are not problems that were created by any single US president. Nor will they be solved by the next. So we should moderate our expectations for the impact – positive or negative – that Donald Trump or Hillary Clinton might have on the story of our age.

The divisive US election campaign highlights different visions for how the US should address its economic problems, and we can expect the debates to continue long after 8 November. Furthermore, divergent economic choices are being debated by nations all around the world. As we are learning from Brexit and other political events, differing visions of how to organize societies may impact investors who are too concentrated in one currency or asset class. Faced with this challenge in the years ahead, I believe global diversification is an investor's best defense against any single nation's social and political decisions.

In our tactical asset allocation, we have opened an overweight position in US inflation-linked bonds against conventional high grade debt. The market is underpricing the risk of higher inflation, in our view. Tightening job markets should support wages and prices, and this month Federal Reserve Chair Janet Yellen indicated a tolerance for



Live conference – US elections

The day after the US elections CIO experts will debate the economic and investment implications.

UBS Forum Digital – 9 November, at 1pm CET on www.ubs.com/CIO-digital above-target inflation to improve labor participation. We are also overweight US equities versus high grade bonds, emerging market equities versus Swiss stocks, and a basket of emerging market currencies versus a group of developed market peers.

What could have been

In this presidential campaign, it has not been easy to look beyond the rhetoric. But as stewards of wealth, the CIO has a responsibility to identify the key issues affecting the world economy, the policy choices these issues create, and the potential impact and likelihood of subsequent political decisions.

In this vein, I wondered what a debate focused on the issues might look like, stripped of the "drama." What follows is a light take on how we imagine the two candidates would have answered debate questions on a range of topics.

Moderator: Mr. Trump, the US economy is now 10% larger in real terms than it was before the financial crisis (Fig. 1), and a net 5.7 million jobs have been created. Why do we need to change course?

Donald Trump: These economic figures only tell part of the story. Ordinary working Americans have not been feeling this apparent prosperity. The economy has grown and jobs have been added, but the median wage is still just USD 30,240, and real wage growth for the average worker has been just 3% since 2009, according to the US Census Bureau and the Bureau of Labor Statistics. The reason I'm here rather than a more traditional Republican candidate is because I realized that this election could be decided by the half of the people in this country who have seen almost no real wage growth in the past decade, and earn below that median[1] (Fig. 2).

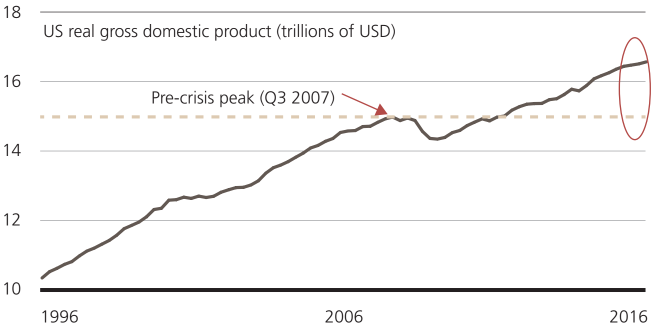
My rich friends around the world might not want to face it, but the fate of this election will be determined by people far less wealthy than they imagine. And this issue extends beyond the US. Almost every developed nation faces a version of the same problem[2].

1 U.S. Census Bureau, Current Population Survey, *2016 Annual Social and Economic Supplement*.

2 Edward Luce, "The Life and Death of Trumpian America," *Financial Times*, October 9, 2016, https://www.ft.com/content/96ff6958-8d7d-11e6-8df8-d3778b55a923

Fig. 1: The US has recovered from the financial crisis… hasn't it?

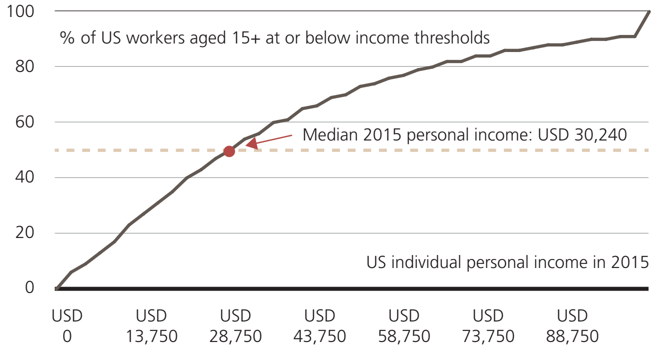
US real gross domestic product (GDP), trillions of chained 2009 USD, seasonally adjusted annual rate.



Source: US Federal Reserve Bank of St Louis, UBS. Data as of end second quarter 2016.

Fig. 2: For half of US workers, security of well-paid jobs is a critical election issue.

Personal incomes for US workers aged 15 and above, cumulative distribution by labor earnings in 2015, in %.



Source: US Census Bureau, UBS. Data as of 18 October 2016.

I believe that globalization is costing us. Unfair global competition is the key contributing factor to stagnant wages, and I want to level the playing field. Maybe if every country had free-floating exchange rates, harmonized environmental legislation, and outlawed state-driven industrial policy or subsidies, all these inequalities would work themselves out. But they don't. So there are a lot of countries whose labor and manufactured goods are cheaper than ours (Fig. 3)[3]. We have to protect our nation by limiting the negative impact on lower-skilled jobs here due to trade, outsourcing, and immigration. And we need to encourage American companies to manufacture and employ domestically.

Moderator: Let me now turn to you, Secretary Clinton. Do you also believe that we need to "level the playing field"?

Hillary Clinton: Absolutely, and I, too, see that this election could be decided by the half of the working population that makes less than USD 30,000. But my analysis of the situation is different. Donald Trump is wrong that globalization is costing us. Globalization is making our country richer, but more unequal. The stock market is up by more than 200% in real terms since March 2009, which primarily benefits our wealthier citizens. On the other hand, some lower earners have suffered greatly. For those without a high school diploma, real wages are lower now than they were in 1980.

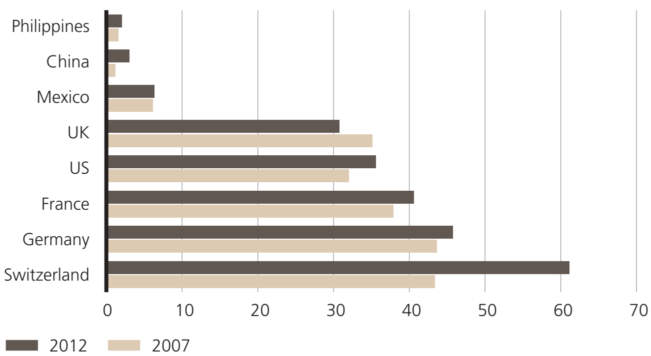
We also need to remember that this trend does not come purely from globalization. The fourth industrial revolution – the sharing economy, artificial intelligence, and robotics – makes for a very exciting time, but also a potentially very threatening one for people caught on the wrong side of it.

That's why I believe we need to use tax policy more actively to make sure that the gains of globalization and the fourth industrial revolution do not accrue purely to capital with little left for the labor that forms the majority of our population.

3 The Conference Board (International Labor Comparisons program), *International Comparisons of Hourly Manufacturing and Sub-Manufacturing Industries: Update to 2014 with preliminary estimates for 2015.* https://www.conference-board.org/ilcprogram/compensation/datatables

Fig. 3: US manufacturing is losing its competitive edge internationally.

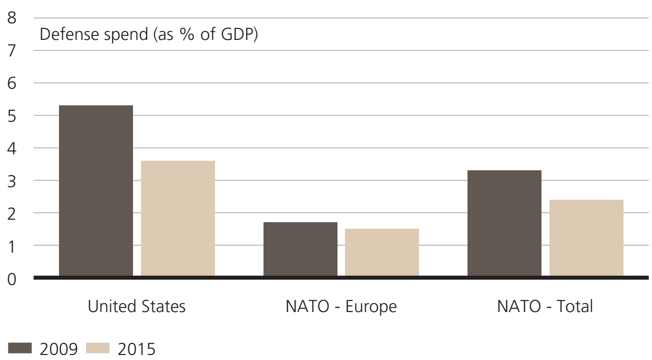
Hourly manufacturing compensation costs, in US dollars, in 2007 and 2012.



Source: The Conference Board (International Labor Comparisons program), UBS. Data as of end 2012 (latest available). NB Data for China is not strictly comparable with other countries.

Fig. 4: US presidential candidates are rethinking spending at home, and abroad.

Defense spending by the US and other NATO members, as a percentage of GDP.



Source: NATO, UBS. Data as of 1 July 2016.

Trump: I'm not surprised she is the favored candidate outside the US – her policy is to tax Americans, while I want to make our allies and trading partners pay more. Taxing companies can help in the short term, but a free world means they can increasingly choose to leave the US and locate anywhere. And there are simply not enough rich Americans to bear a greater tax burden – the top 2.7% of earners already pay 51.6% of individual income taxes[4]. So in the end most of her spending proposals would be paid for by the middle class.

We can also look at some of the things we offer the rest of the world "for free." We spend 3.5% of GDP on defense, whereas our NATO allies pay an average of 2.4% (Fig. 4). And Europe still has countries where workers can retire before Americans can. We have to fix these structural imbalances to make every tax dollar count.

Moderator: Now what about the domestic economy? One clear area of difference between your visions of the future is in your attitudes toward the Federal Reserve.

Trump: After so many years of an almost free-money policy that has failed to materially improve conditions for most Americans, we don't know how the Fed will deal with future recessions – start buying equities as the Bank of Japan has done, in effect nationalizing the stock market? And the Fed's forecasting has been terrible, continually marking down its forecasts toward the market price (Fig. 5). So what makes us think that it has the right policy now?

We're supposed to have an independent central bank to help protect us from governments that want to give away free money to win elections. Well that's exactly what the Fed, European Central Bank, and Bank of Japan are doing. I don't think we should end up like Japan; the government can spend whatever it wants, and the central bank will hold 10-year interest rates at 0%. It's all about letting the government increase the national debt.

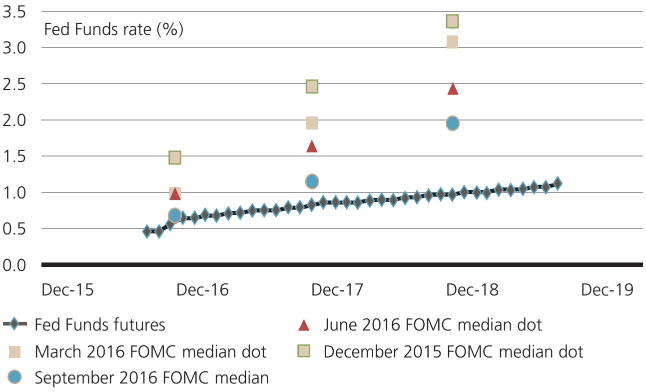
The fiscal plans proposed by both candidates, if implemented, would increase budget deficits, according to independent studies.

Clinton: It's true that the Fed's forecasts haven't been great. But at least they listen to the market and to economic data. What if the market is right, and a Fed move to

4 http://www.pewresearch.org/fact-tank/2016/04/13/high-income-americans-pay-most-income-taxes-but-enough-to-be-fair/

Fig. 5: Fed rate forecasts have consistently fallen.

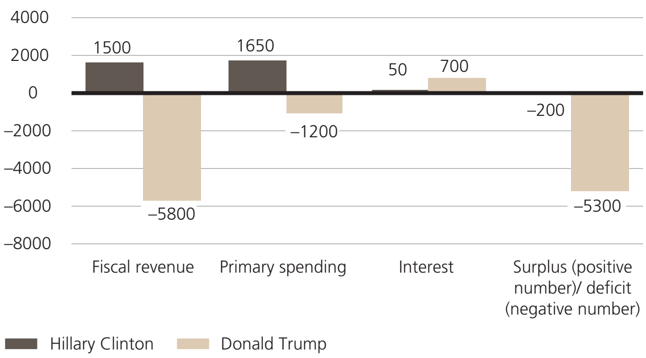
Fed funds futures and dots from FOMC Summary of Economic Projections, in %.



Source: Bloomberg Finance L.P., Federal Reserve, UBS. Data as of 17 October 2016.

Fig. 6: Both candidates are expected to increase US debt and deficit levels.

Announced fiscal policies of both US Presidential candidates and expected impact, in billions of USD.



Source: Committee for a Responsible Federal Budget, UBS. Data as of 22 September 2016. All figures rounded to the nearest USD 50 billion.

raise rates causes slower economic growth or recession? Then neither of us could run the policies we want. If we don't work with the Fed, you can't cut taxes, I can't spend on social policy, and neither of us can spend on infrastructure. Both of our economic plans are, according to independent sources, likely to increase budget deficits in the short and medium term (Fig. 6)[5]. The "side effect" of the Fed's policies – a soaring stock market and a "fix" for rich people with capital to invest – may not be optimal. But it may be something we can live with if we redistribute more of the wealth.

Moderator: Thank you, both. Unfortunately, we're out of time. This debate shows there are important economic, societal, and financial consequences to the way we, and other nations, adapt to a lower-growth "new normal."[6, 7] I'm glad we were able to discuss these important issues objectively, clearly, and openly. In one of the world's most closely watched unpopularity contests (Fig. 7), may the least bad candidate win.[8]

Tactical asset allocation

Over our tactical six-month horizon, we believe a moderate risk-on positioning is warranted. Leading indicators are improving, US job creation is strong, averaging 200,000 per month, and US consumption spending is still solid.

We are introducing an overweight in US Treasury Inflation Protected Securities versus high grade bonds.

We have opened an overweight position in US Treasury Inflation Protected Securities (TIPS) versus standard high grade bonds. Fed officials seem willing to accept a period of above-target inflation to ensure that economic growth and job market momentum is maintained. This was underlined in Yellen's comments on 14 October that the Fed was considering "temporarily running a 'high-pressure economy.'"

5 Committee for a Responsible Federal Budget, *Promises and price tags: A Preliminary Update,* 22 September 2016. http://crfb.org/papers/promises-and-price-tags-preliminary-update

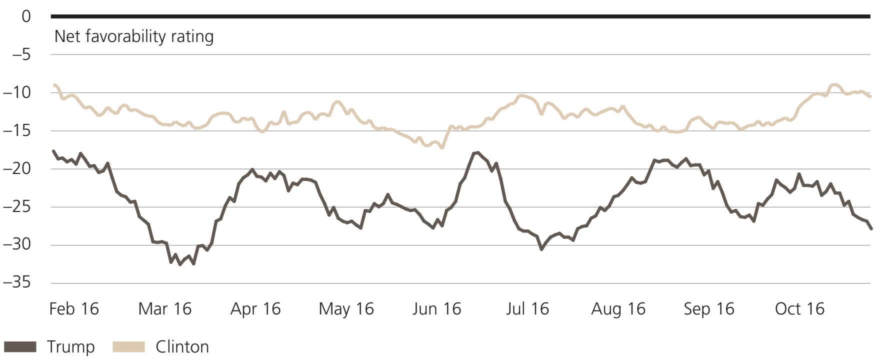
6 Governor Lael Brainard, "*The 'New Normal' and What It Means for Monetary Policy.*" Speech at the Chicago Council on Global Affairs, September 12, 2016. https://www.federalreserve.gov/newsevents/speech/brainard20160912a.htm

7 Marc Levinson, "Why the Economy Doesn't Roar Anymore," *Wall Street Journal,* October 14, 2016, http://www.wsj.com/articles/why-the-economy-doesnt-roar-anymore-1476458742

8 Huffpost Pollster, average of 10 last polls, as of October 18, 2016. http://elections.huffingtonpost.com/pollster/

Fig. 7: The race for the White House still an unpopularity contest.

Net favorability scores for Hillary Clinton and Donald Trump, ten poll moving average.



Source: Huffpost Pollster, UBS. Data as of 18 October 2016.

The market is currently pricing medium-term inflation at around 1.4% to 1.6%. The Fed's inflation target of 2% is referenced to the personal consumption expenditures (PCE) index, while TIPS are linked to the consumer price index for all urban consumers (CPI-U), which typically runs 0.3 of a percentage point higher. As long as PCE inflation runs above 1.25% or so, TIPS should outperform nominal bonds. Given the steady economic backdrop and the Fed's attitude, we believe this is likely.

We are overweight US equities versus high grade bonds. We expect the third-quarter earnings season to register the first year on year earnings per share increase since mid-2015.

We are overweight US equities versus high grade bonds. The third-quarter earnings season is now under way, and we expect S&P 500 earnings per share to rise year on year for the first time since the second quarter of 2015, thanks to more favorable US dollar and oil base effects. This should mark the start of an earnings recovery.

We are also overweight emerging market equities versus Swiss equities. Economic and earnings indicators in emerging markets improved over the past month. Easy global financial conditions and stronger demand should underpin an ongoing recovery in emerging market earnings. Swiss equities are tilted toward less growth-sensitive sectors, and may underperform as global economic momentum improves.

In currencies, we overweight a basket of emerging market currencies (the Brazilian real, Indian rupee, Russian ruble, and South African rand) against a basket of developed market currencies (the Australian dollar, Canadian dollar, and Swedish krona) given the attractive relative carry of emerging market currencies in a low-interest-rate world. The emerging market leg of this trade is roughly flat since we initiated the position. Diversification has helped offset a politically driven fall in the rand. Our underweight to developed market currencies has benefited from a fall in the krona, due to lower inflation and declining industrial production in Sweden.

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UBS Investor Forum Insights

At this monthly gathering, we invite thought leaders to debate the key topics affecting financial markets, and to challenge the UBS House View.

- The US presidential election was a key focus topic this month. A victory for Donald Trump was seen as unlikely. Should this occur, however, most participants felt markets would experience heightened volatility.
- A victory for Hillary Clinton was considered the base case by all participants. Should the Democrats also win the House of Representatives and the Senate, the potential for more significant policy shifts would increase.

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