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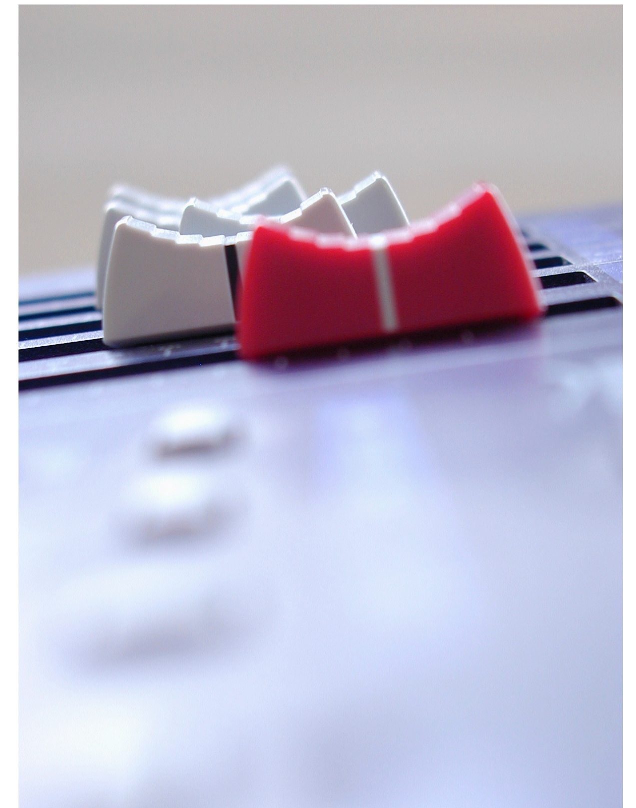
UBS House View

Monthly Base December 2015

Chief Investment Office WM



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This document is a snapshot view. We update the tactical asset allocation as changes occur and resend it to subscribers. For all other forecasts and information, we advise you to check the Investment Views section in your E-Banking or in Quotes.

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19 November 2015

Summary

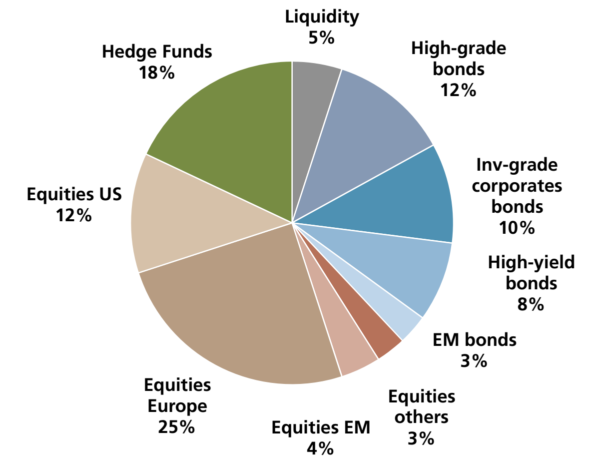
"A first rate hike by the US Federal Reserve in December looks likely, followed by a very gradual upward path. On the other hand, the ECB is expected to expand its monetary easing program further, as inflation remains close to zero."

- **Economy**
  Recent data confirmed the US economy's status as the world's growth engine at this point in the cycle. Following two disappointing months, job creation in the US picked up to an impressive 271,000 in October, and the all-important service sector saw its sentiment indicator rise close to all-time highs. Thus, a first rate hike by the US Federal Reserve in December looks likely, followed by a very gradual upward path. On the other hand, the European Central Bank (ECB) is expected to expand its monetary easing program further, as inflation remains close to zero. Meanwhile, the region is gradually recovering, with economic output growing by 0.3% in 3Q15. Finally, news from emerging markets remains mixed. While leading indicators are still signaling economic weakness, their downtrend has likely stopped by now.
- **Equities**
  We recommend a tactical overweight in Eurozone equities over high grade bonds, against a backdrop of low bond yields, rising corporate earnings, and easy monetary policy. Eurozone companies are currently best positioned to benefit from solid global demand thanks to a still weak euro and their rising profitability. Regionally, we prefer Eurozone over UK equities, as the latter are burdened by a relatively strong British pound and a large exposure to the energy and materials sectors, which are suffering from low commodity prices. Finally, we recommend an overweight in Japanese stocks against UK equities, as Japanese companies are showing solid earnings growth, primarily driven by the strong export sector. A weak yen, ongoing monetary easing, and a corporate tax rate cut in 2015 bode well for the future of the Japanese market.
- **Bonds**
  We are holding a tactical overweight position in high yield (HY) bonds denominated in euro, as their yield pickup of almost 5% over German government bonds is attractive, in particular given the very low default rate, which was almost zero in the past 12 months. Given the ongoing economic recovery, persistent monetary support, and relatively low leverage levels on corporates' balance sheets, we expect the default rate to remain below 2% over the coming year. Furthermore, we prefer short-dated USD investment grade (IG) bonds due to their yield pickup and limited credit and duration risk. We underweight high grade bonds as we expect weak to negative total returns due to gradually rising benchmark yields. Still, the asset class plays an important strategic role as a portfolio diversifier.
- **Foreign exchange**
  We are opening an overweight position in the Norwegian krone against the euro. The Scandinavian currency should benefit from solid Eurozone growth and stabilizing growth in Norway. We expect improving Norwegian economic momentum to lead to a rising yield differential and future monetary policy divergence. Meanwhile, the ECB is likely to ease monetary policy further, weighing on the euro.
- **Alternative investments and precious metals & commodities**
  Global commodity prices declined once again in November. Crude oil has lost more than 10% since the beginning of the month and gold is still down 5% despite recent tentative "safe haven" flows. Thus, the asset class remains highly volatile and we advise against holding strategic exposure. Hedge funds as well as private market investments offer good sources of alternative risk and return drivers, and should be considered by any investor who can tolerate limited liquidity.

Cross-asset preferences

	Most preferred	Least preferred
Equities	Eurozone Japan US share buybacks and dividends Eurozone "value" stocks Japanese share buybacks Water-linked investments	UK
Bonds	Global investment grade European high yield Corporate hybrids Rising stars European leveraged loans	Developed market high grade bonds
Foreign exchange	NOK (↗)	EUR (↘)
Hedge Funds & Private Markets	Hedge funds: Favoring equity hedge	
Precious Metals & Commodities		

Global model portfolio (EUR)



as of 19 November 2015

Note: Portfolio weightings are for a EUR model portfolio, with a balanced risk profile (including TAA). We expect a balanced portfolio (excluding TAA) to have an average total return of 4.3% p.a. and volatility of 7.9% p.a. over the next five years.

↗ Recent Upgrade ↘ Recent Downgrade

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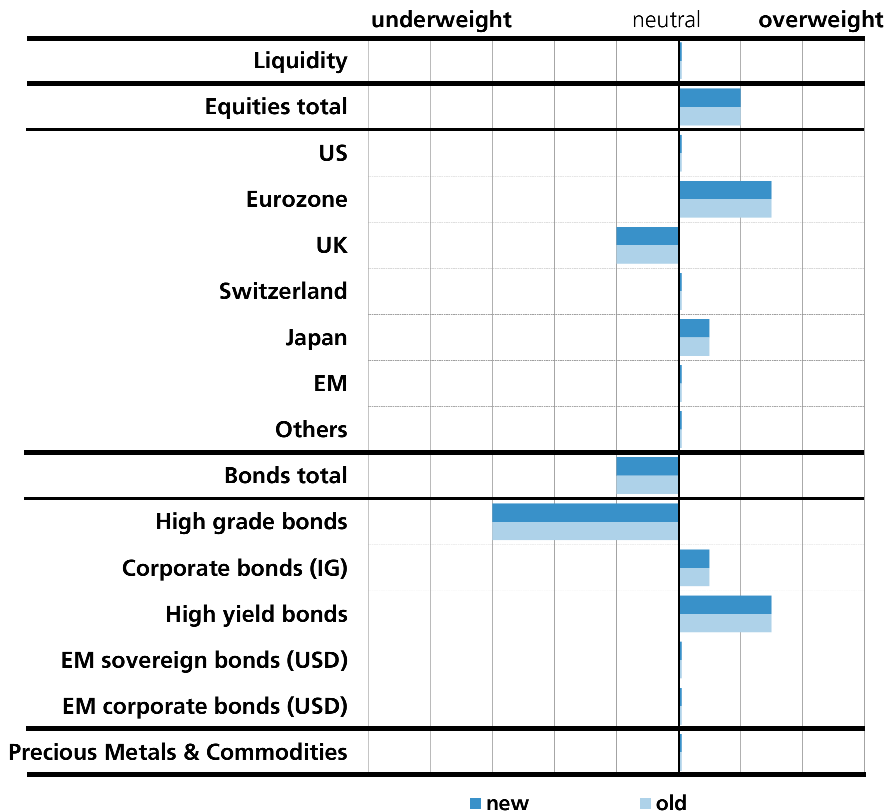
Global tactical asset allocation

Tactical asset allocation deviations from benchmark*

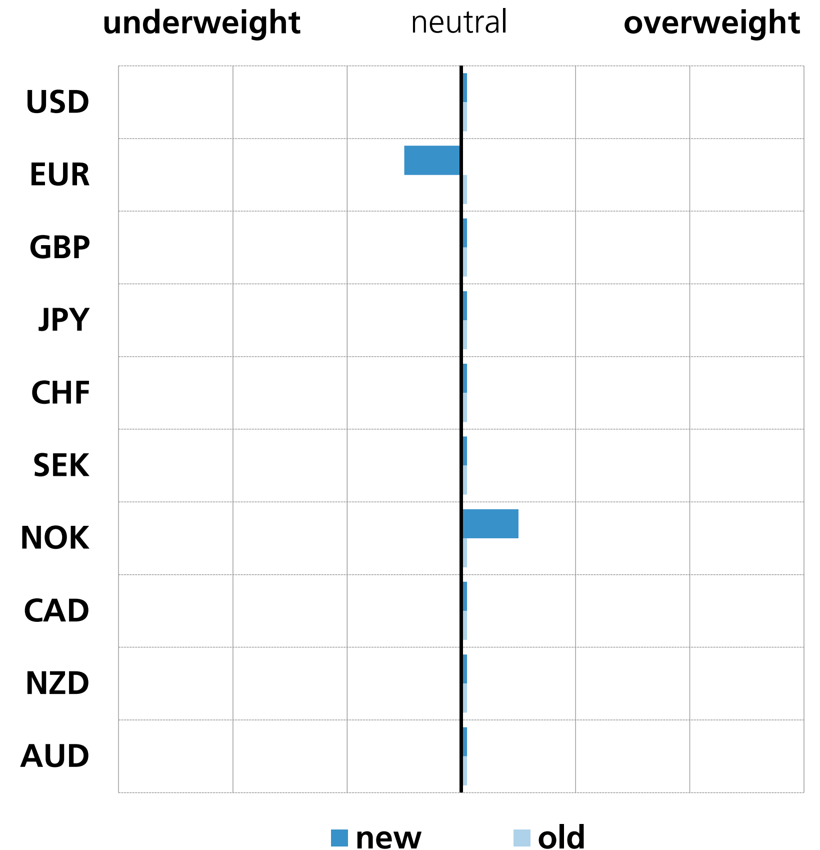


Source: UBS, as of 19 November 2015

*Please note that the bar charts show total portfolio preferences. Thus, it can be interpreted as the recommended deviation from the relevant portfolio benchmark for any given asset class and sub-asset class.

The UBS Investment House View is largely reflected in the majority of UBS Discretionary Mandates and forms the basis of UBS Advisory Mandates. Note that the implementation in Discretionary or Advisory Mandates might deviate slightly from the "unconstrained" asset allocation shown above, depending on benchmarks, currency positions, and other implementation considerations.

Currency allocation



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CIO themes in focus

Equities

- **Profit from US share buybacks and dividends**
  US companies generally have healthy balance sheets. Many are sitting on significant cash reserves. The stock market has rewarded investors in companies that return capital through dividends and share buybacks. These companies offer attractive yields and, according to our analysis, outperform the underlying index. With borrowing costs low, companies have an incentive to return cash to shareholders, and rising free-cash-flow yields are a key factor for this theme. Since buybacks are made at management's discretion, we recommend investing in a diversified basket of stocks.
- **Water: Thirst for investments**
  A growing global population increases demand for clean water. However, climate change and urbanization pressure supply, which in emerging markets is constrained by insufficient water infrastructure and greater focus by governments on the industrial sector. We have identified two short-term trends that should add to the earning power of water-exposed companies: ship ballast water treatment and desalination.
- **Eurozone value: Investing in style**
  History shows that "value" tends to outperform at this stage of the business cycle. Before the onset of the financial crisis in 2007, European value outperformed in six out of the seven US economic expansion phases in the past 45 years. There is a strong, positive correlation between the relative performance of Eurozone value and US and German bond yields. Both should be supported by the prospect of accelerating growth and rising inflation in Europe and the US in 2016.
- **Japanese companies ready for share buybacks**
  This investment theme is the best positioned to take advantage of a historical turning point for Japanese companies in terms of corporate governance, in our view. With government support, the Corporate Governance Code was formally implemented in June 2015. The code should be a strong motivation for companies to increase return on equity and unwind cross-shareholding arrangements. As a result, we expect the new trend of share buybacks to accelerate.

Bonds

- **Rising stars**
  When an issuer is upgraded from high yield to investment grade, the spread of its bonds usually tightens markedly – often beyond the level implied by the higher rating – due to intense technical pressure. For investors who can hold individual bonds of weaker quality, we suggest investing in bonds of issuers that are potential rising stars over the next 24 months. If they are upgraded to investment grade, their bonds should outperform both the BB and BBB rating categories. In the absence of an upgrade, we still expect them to outperform investment grade corporates due to higher carry and potential further spread compression.
- **Opportunities in European leveraged loans**
  European leveraged loans currently offer similar yields as European high yield bonds. Our six-month total return expectation is 2–3%, an attractive opportunity for qualified investors. Loans benefit from having senior secured status, higher recovery rates than HY bonds, a floating-rate structure, low volatility, and a favorable risk-return profile, in our view. There is an established trading market for loans, though liquidity is generally lower than for HY bonds. We regard loans as longer-term investments.
- **Yield pickup with corporate hybrids**
  Corporate hybrid is a niche segment in the corporate bond market. At current spread levels, investors with a suitable risk tolerance are well compensated for assuming the risks associated with these bonds. We expect mid-single-digit percentage returns on selected instruments over 12 months.

CIO themes in focus

Alternative investments

- **Favoring equity hedge strategies**
  A gradual increase in US interest rates and a normalization of market volatility are likely to increase dispersion and stock mispricing. These dynamics should create a fertile environment for bottom-up stock-pickers to generate excess returns on long and short positions as company-specific fundamentals, rather than market movements, should fuel stock performance. We prefer managers running lower gross and net exposures with a strong focus on alpha generation (i.e., low beta long/short and market neutral managers).

This selection of themes is a subset of a larger theme universe. The selection represents the highest conviction themes of the UBS Chief Investment Office WM, taking the current market environment and risk-return characteristics into account.

Global economic outlook - *Summary*

Key points

- We expect global growth to show strong divergence between countries, while emerging markets remain the weakest link.
- We see the policies of major central banks diverging. The Federal Reserve is expected to start hiking interest rates in December, while the European Central Bank is set to lower its deposit rate.
- We believe inflation will remain subdued, even if divergences among countries are set to increase.

CIO view (Probability: 60%*) — **World growth to improve moderately**

- We expect global economic growth to improve moderately in 2016, but its composition will likely diverge. While we expect developed economies to advance, emerging economies should remain weak relative to historical levels given limited room for stimulus measures, capital outflows, and subdued export growth. High levels of private-sector debt also give reason for concern amid less favorable global liquidity conditions.
- We expect the US economy to be robust. In Europe, Britain's negotiations with the EU should have a limited effect on the Eurozone's solid growth outlook, even if the negotiations prove arduous given the EU's willingness to compromise only on soft measures but not on a treaty change. Within emerging markets (EM), Asia is still the strongest region despite China's slowing growth, while EMEA and Latin America are lagging due to the weakness in large economies like Russia and Brazil.
- An expected moderate increase in commodity prices in 2016 should support inflation rates going forward. However, subdued growth in emerging markets likely means that inflation-rate increases will mostly be visible in the developed world.
- We expect the Fed to hike rates in December. The Bank of Japan (BoJ) should continue with its expansive monetary policy, and the ECB is set to ease further in December by extending its quantitative easing (QE) program and cutting its deposit rate.

↗ **Positive scenario (Probability: 15%*)** — **Return to above-trend growth**

- The US economy grows above 3%, with greater consumption and investment in equipment. Risks in the Eurozone, especially from the political side, peter out. Growth and inflation exceed forecasts, especially in the European periphery.
- Due to credible reform measures, emerging markets are able to attract capital inflows. Growth prospects improve due to rising trade and higher commodity prices support exporters.

↘ **Negative scenario (Probability: 25%*)** — **Global growth disappointments**

- The Eurozone crisis deepens again. Worsening deflationary pressures coupled with economic disappointments push the ECB to ease monetary policy more than expected.
- The Chinese economy weakens abruptly due to a sharper downturn in property investment, widespread credit events, and/or tighter liquidity conditions. EM currencies plunge and several central banks have to tighten monetary policy to stabilize exchange rates.
- Geopolitical tensions (Ukraine, the Middle East) deepen, affect global risk sentiment, and potentially push oil prices higher again.

*Scenario probabilities are based on qualitative assessment.

Key dates

Nov 25	US inflation (personal consumption expenditure)
Dec 3	ECB press conference
Dec 16	FOMC policy meeting

Global growth to improve slightly in 2016

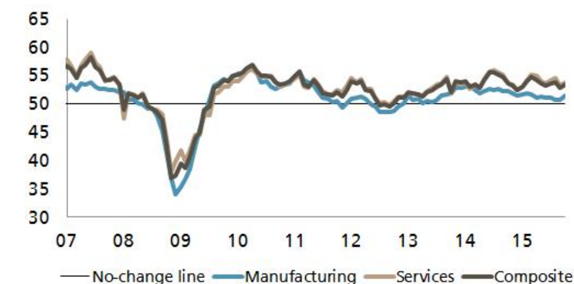
		Real GDP growth in %			Inflation in %		
		2014	2015F	2016F	2014	2015F	2016F
Americas	US	2.4	2.5	2.8	1.6	0.2	1.6
	Canada	2.4	1.1	2.2	1.9	1.5	1.9
	Brazil	0.1	-3.0	-2.0	6.4	9.9	6.4
Asia/Pacific	Japan	-0.1	0.5	1.3	2.8	0.9	1.0
	Australia	2.7	2.2	2.6	2.5	1.5	2.2
	China	7.3	6.9	6.2	2.0	1.5	1.5
	India	7.3	7.1	7.6	5.9	5.0	4.6
Europe	Eurozone	0.9	1.5	1.8	0.4	0.1	1.0
	Germany	1.6	1.5	1.9	0.8	0.2	1.0
	France	0.2	1.1	1.5	0.6	0.1	1.2
	Italy	-0.4	0.8	1.5	0.2	0.2	1.4
	Spain	1.4	3.2	2.7	-0.2	-0.6	0.6
	UK	2.9	2.4	2.4	1.5	0.1	1.1
	Switzerland	1.9	1.0	1.4	0.0	-1.2	-0.4
	Russia	0.6	-3.7	-0.4	7.8	15.6	6.9
World		3.4	3.1	3.4	3.3	3.5	3.8

Source: UBS, as of 10 November 2015

In developing the CIO economic forecasts, CIO economists worked in collaboration with economists employed by UBS Investment Research. Forecasts and estimates are current only as of the date of this publication, and may change without notice.

Global composite PMI to remain markedly above 50

Global purchasing managers' indices (PMIs)



Source: Haver Analytics, UBS, as of October 2015

Key financial market driver 1 - *Robust growth in the US*

Key points
- We expect robust growth in the US over the next 12 months.
- Core inflation should remain subdued but gradually trend higher as the recovery continues.
- We expect the first Fed rate hike in December and the pace of tightening to be gradual.

CIO view (Probability: 70%*) **Robust expansion**
- We expect robust US real GDP growth over the next 12 months. Improved US household and business fundamentals should support private domestic demand growth, though with a moderate drag due to a strong USD. Against a backdrop of above-trend growth, falling unemployment, and faster wage growth, the Fed will likely start raising rates in December. We expect the pace of rate hikes to be much more gradual than in previous tightening cycles.
- Housing starts should continue growing by double digits, and house prices should remain on a modest upward trend.
- The negative impact of lower oil prices on energy sector fixed investment has been a significant drag on growth, particularly in the manufacturing sector, which remains stagnant.
- Fiscal policy should turn slightly positive for growth in FY2016. Major reforms are unlikely until after the presidential election.
- Core personal consumption expenditures (PCE) price inflation is being held in check by the strong USD, low energy prices, and smaller-than-usual increases in healthcare prices. We expect these factors to fade, but inflation is likely to remain well below the Fed's 2% target over the next 12 months.
- An inventory correction hurt third-quarter GDP growth, but this impact should be temporary.

↗ **Positive scenario (Probability: 15%*)** **Strong expansion**
- US real GDP growth rises significantly above 3%, propelled by an expansive monetary policy, improved business and consumer confidence, strong housing investment, and subsiding risks overseas. The Fed raises policy rates significantly more than markets anticipate.

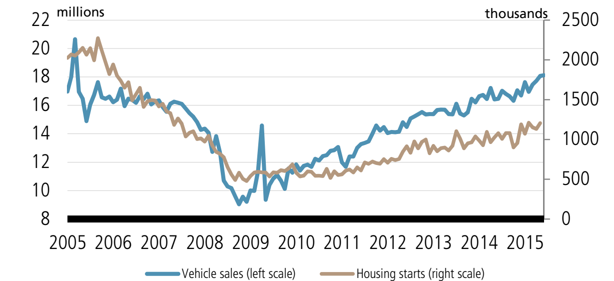
↘ **Negative scenario (Probability: 15%*)** **Growth recession**
- US growth stumbles. Consumers save rather than spend the windfall from lower energy prices, while businesses lack the confidence to hire workers and boost investment spending. The Fed remains on hold.

*Scenario probabilities are based on qualitative assessment.

Key dates

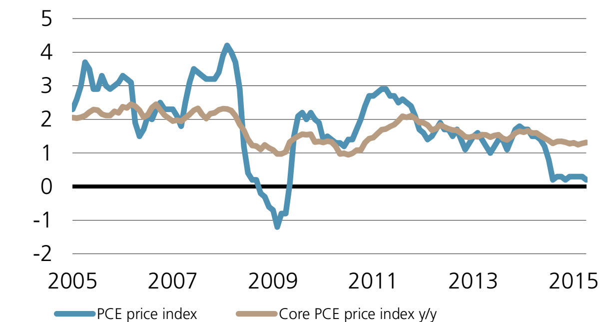
Nov 25	PCE price index for October
Dec 4	Labor report for November
Dec 11	Retail sales for November
Dec 16	Housing starts for November
Dec 16	FOMC rate decision

Vehicle sales and housing starts support growth
Vehicle sales and housing starts, annualized rate



Source: Bloomberg, UBS, as of 12 November 2015

Low energy prices are curtailing inflation
US headline and core PCE price index, year-over-year in %



Source: Bloomberg, UBS, as of 12 November 2015
Note: PCE = personal consumption expenditures

For further information please contact US economist Brian Rose , brian.rose@ubs.com

Key financial market driver 2 - *Improving Eurozone growth*

Key points

- Economic growth is set to improve in the coming quarters on the back of higher capital expenditures.
- Inflation is expected to resume its uptrend and rise to around 1% in the first quarter of 2016.
- The ECB loosens monetary policy further, supporting economic acceleration further.

CIO view (Probability: 70%*) — **Improving growth**

- The Eurozone economy is likely to accelerate in the coming quarters as the monetary impulse reaches its peak, with easy financing conditions supporting a capital expenditure revival. Negotiations with Britain on EU terms should have a limited effect on confidence, even if negotiations around issues such as the ever closer union and immigration may prove arduous given the willingness to compromise only on soft measures but not on a treaty change. The ECB in turn is expected to loosen its monetary policy further through an extension of its QE program and an additional cut to its deposit rate. Further out in 2016, the expected acceleration of the Eurozone economy and the swing of inflation to around +1% in the first quarter should ensure that the ECB stays on hold.
- In Germany, fundamentals, such as consumer confidence and the propensity for capital expenditures, remain robust. In addition, the immigration situation is leading to greater-than-expected government spending, helping the economy to continue growing solidly.
- French growth is set to normalize as inventories have been reduced and as construction should slowly stabilize in 2016. Strong QE-related wealth effects support consumption, and companies are expected to increase investment spending.
- In the periphery, Italy should consolidate its return to growth, supported by strong QE-related wealth effects, signs of life in its housing sector, and a fast pace of reforms. Spain, in turn, is posting strong growth rates. However, growth rates are set to moderate going forward given uncertainty related to the forthcoming elections.

↗ **Positive scenario (Probability: 20%*)** — **Better-than-expected growth**

- Oil prices and the euro decline more than expected, with loan demand and the economy recovering faster than envisaged. France follows a credible reform path and speeds up fiscal consolidation. Political risks fade further.

↘ **Negative scenario (Probability: 10%*)** — **Deflation spiral**

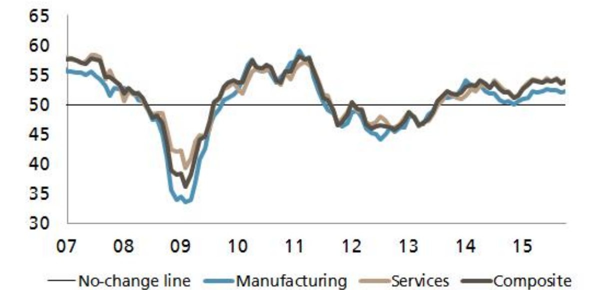
- The Eurozone slips into a deflation spiral due to a shock, such as Greece leaving the Eurozone, a sharp escalation in the Ukraine conflict, or China suffering a severe economic downturn.

*Scenario probabilities are based on qualitative assessment.

Key dates

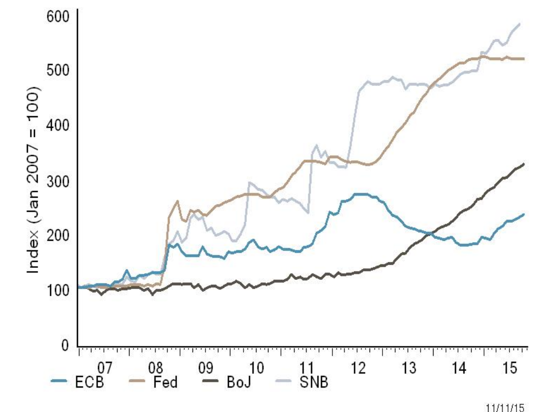
Nov 23	Composite PMI (November estimate)
Dec 2	HICP inflation (November estimate)
Dec 3	ECB press conference
Dec 14	Industrial production (October)
Dec 17	European Council

Eurozone composite PMI expected to improve further



Source: Haver Analytics, UBS, as of October 2015
Note: PMI = purchasing managers' index

ECB balance sheet boosted by QE and TLTROs
Total assets in national currency (Index: 2007=100)



Source: Haver Analytics, UBS, as of October 2015

Key financial market driver 3 - *China's transformation*

Key points

- The weakness in industry continued in October, while the pace of policy easing increased in September.
- China's GDP growth is likely to continue to decelerate in 2016, but the risk of a hard landing is small thanks to policy support.
- New economy sectors in manufacturing and service will help China's rapid modernization for the coming decades.

CIO view (Probability: 50%*) **Policy support to moderate slowdown**

- **Economic weakness continues.** October PMI and industrial output flagged continuous weakness in manufacturing, dragged down by mining and heavy industries. Manufacturing will continue to face pressure, as new manufacturing is not large enough to offset deep adjustments in traditional manufacturing. October Fixed Asset Investment (FAI) growth edged down - real estate FAI remained the major drag. October retail sales growth edged up thanks to rising auto sales, especially new energy cars and SUVs. Sales in telecommunications continued to take the lead while oil sales fell most. New CNY loans and total social financing dropped significantly in October, disappointing market expectations. In sum, China's fundamentals remain weak, and will continue to decelerate. There might be more fiscal policy support to announce before the year-end. However, a hard landing is very unlikely thanks to policy support.
- **Policy support to moderate slowdown.** We forecast China's GDP to grow by 6.2%-6.5% in 2016. Policy support will continue in 2016; we believe 1-2 interest rate cuts and 2-3 Required Reserve Ratio cuts will occur next year. Unconventional monetary tools will be applied actively. Fiscal policy, including tax reduction and government-involved private equity funds, should play an active role in guiding the country's transformation, although we do not expect a massive stimulus package.
- **New manufacturing sectors to shine.** The rise in new manufacturing is likely to gradually offset the downturn in traditional manufacturing in 2016. New manufacturing sectors include high-end machinery and next generation IT, healthcare, transportation, and new energy and environmental protection, which includes new energy equipment, new environment protection equipment to control air, soil and water pollution, and new materials.
- **CNY to depreciate mildly.** We expect the CNY to depreciate against the USD with higher volatility and to reach 6.6 by the end of 2016. We remain confident on the CNY in the medium and long run and believe a one-off devaluation is unlikely.

↗ Positive scenario **(Probability: 10%*)** **Growth acceleration**

- Annual growth is 7% year-on-year as a result of more substantial policy stimulus measures from the government or a strong pick-up in external demand.

↘ Negative scenario **(Probability: 40%*)** **Sharp economic downturn**

- Despite policy easing measures, the economy fails to stabilize and weakens abruptly in the next 6-12 months due to a sharper downturn in property investment, more widespread credit events and/or tighter liquidity as the government reins in shadow banking activity. Within this scenario we see a 15% risk of a more extreme 'hard landing' outcome (<5% economic growth).

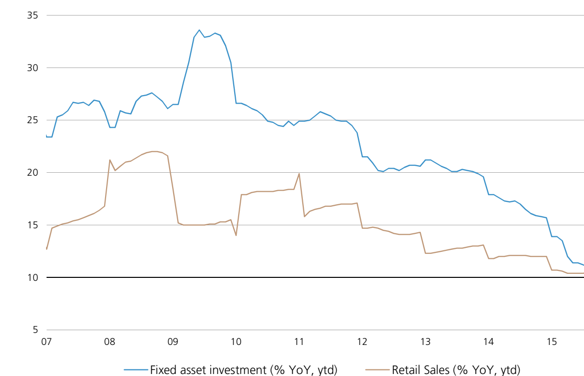
* Scenario probabilities are based on qualitative assessment.

Key dates

Dec 8	Trade data for November
Dec 9	CPI, PPI for November
Dec 10-15	Monetary and credit data for November
Dec 12	Industrial production, retail sales, and fixed asset investment for November

Retail sales growth caught up to FAI growth

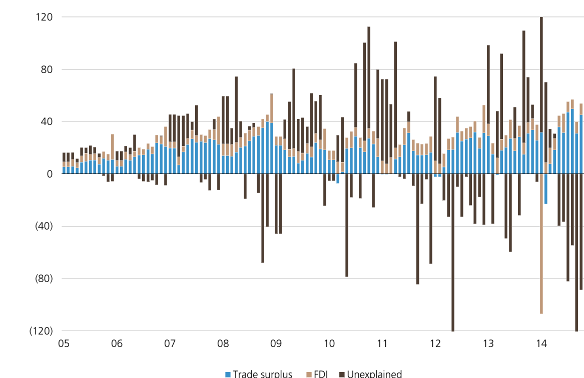
Values in percentage



Source: CEIC, UBS, as of 13 November 2015

Capital outflows continued but at a slower pace

Values in USD bn



Source: CEIC, UBS, as of 13 November 2015

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Contact list

Global Chief Investment Officer WM

Mark Haefele
mark.haefele@ubs.com

UBS CIO WM Global Investment Office

Regional Asset Allocation
Mark Andersen
mark.andersen@ubs.com

Global Asset Allocation
Mads Pedersen
mads.pedersen@ubs.com

UHNW & Alternatives IO
Simon Smiles
simon.smiles@ubs.com

Investment Themes
Philippe G. Müller
philippe-g.mueller@ubs.com

UBS CIO WM Regional Chief Investment Offices

US
Mike Ryan
mike.ryan@ubs.com

APAC
Min Lan Tan
min-lan.tan@ubs.com

Europe
Themis Themistocleous
themis.themistocleous@ubs.com

Switzerland
Daniel Kalt
daniel.kalt@ubs.com

Emerging Markets
Jorge Mariscal
jorge.mariscal@ubs.com

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