

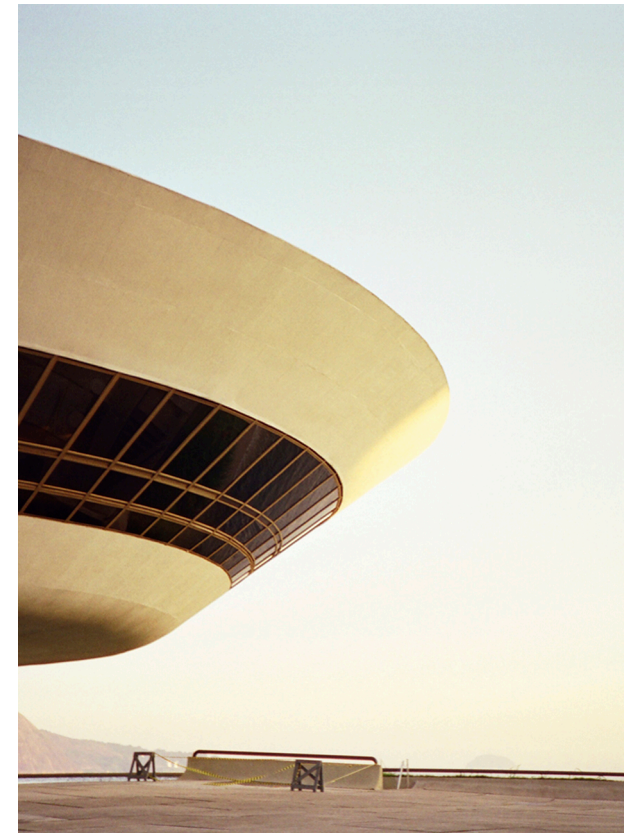
UBS House View

Monthly Base **January 2016**

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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10 December 2015



Summary

"It's becoming increasingly likely that the Fed's first rate hike will occur at the 16 December FOMC meeting, while the hiking cycle should be gradual, given the moderate pace of economic growth and inflation expected."

- **Economy**

The US labor market showed continued strength, with 211,000 jobs created in November, following October's upwardly revised figure of 298,000 and a first rate hike by the US Fed at the 16 December FOMC meeting is becoming increasingly likely. The hiking cycle should be gradual, given the moderate pace of economic growth and inflation expected. Against the backdrop of persistently low inflation, the ECB announced an extension to its QE program by six months to March 2017 and a 10bps cut in the deposit rate to -30bps, adding an additional EUR 680bn in liquidity, or 6.5% of the Eurozone's GDP. Euro area growth continued apace, with November PMIs remaining solidly in expansion territory. While emerging markets remain weak overall, China continues to show signs of stabilization at a low level as it adjusts its economic growth model.

- **Equities**

Against a backdrop of low bond yields, rising corporate earnings, and easy monetary policy, we recommend a tactical overweight position in Eurozone equities over high grade bonds. Eurozone companies are currently best positioned to benefit from solid global demand, in addition to low refinancing costs resulting in 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 the materials sectors, which are being pressured by commodity price weakness. Within equities, we furthermore recommend an overweight position in Japanese stocks against UK equities as Japanese companies are showing solid earnings growth, primarily driven by the strong export sector. A weak yen, solid developed market demand and a corporate tax rate cut in 2015 bode well for the future of the Japanese market.

- **Bonds**

We hold a tactical overweight position in euro-denominated high yield bonds as their yield pickup of almost 5% over German government bonds is attractive, particularly given the very low default rate, which was near zero in the past 12 months. Given the ongoing economic recovery, persistent monetary support and relatively low leverage levels on companies' balance sheets, we expect the default rate to rise only moderately towards 2% in the coming year. We also prefer short-dated USD investment grade bonds due to their yield pickup and limited credit and duration risk. We are underweight on high grade bonds as we expect weak to negative total returns due to gradually rising benchmark yields. Still, the asset class plays a key strategic role as a portfolio diversifier.

- **Foreign exchange**

We maintain our overweight position in the Norwegian krone against the euro. A stabilizing Norwegian economy should lead to monetary policy divergence and support a rising yield differential in favor of the krone. For EURUSD, we maintain our 6-month and 12-month forecasts of 1.08 and 1.10, respectively. Recently, the exchange rate rose towards 1.10 as the ECB's announced actions were less than the market had expected, but reversed some of the gains following the very strong US payroll report and the sharp fall in the oil price.

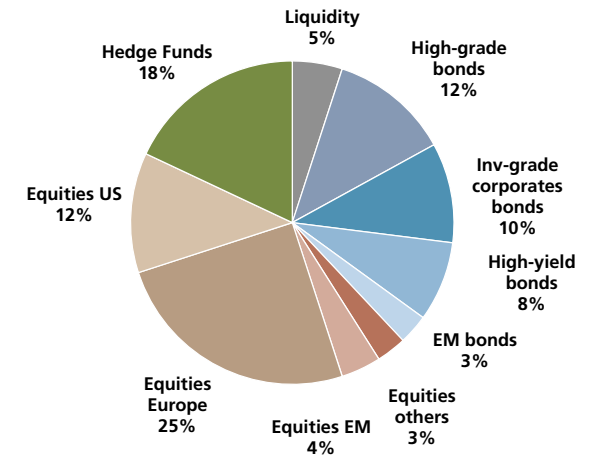
- **Alternative investments and precious metals & commodities**

Global commodity prices remained volatile during the month. Crude oil (Brent) fell towards USD 41/bbl as OPEC decided to maintain its current production of 31.5mbpd, thus sticking with its volume-maximizing strategy and placing the burden of supply adjustment on non-OPEC countries. Base metals also fell to multi-year lows on the back of slowing EM growth. Due to the high volatility of commodity prices, we advise against holding tactical or 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	<ul style="list-style-type: none"> ● Eurozone ● Japan ● US share buybacks and dividends ● Eurozone "value" stocks ● Japanese share buybacks ● Water-linked investments 	<ul style="list-style-type: none"> ● UK
Bonds	<ul style="list-style-type: none"> ● Global investment grade ● European high yield ● Corporate hybrids ● Rising stars ● European leveraged loans 	<ul style="list-style-type: none"> ● Developed market high grade bonds
Foreign exchange	<ul style="list-style-type: none"> ● NOK 	<ul style="list-style-type: none"> ● EUR
Hedge Funds & Private Markets	<ul style="list-style-type: none"> ● Hedge funds: Favoring equity hedge 	
Precious Metals & Commodities		

Global model portfolio (EUR)



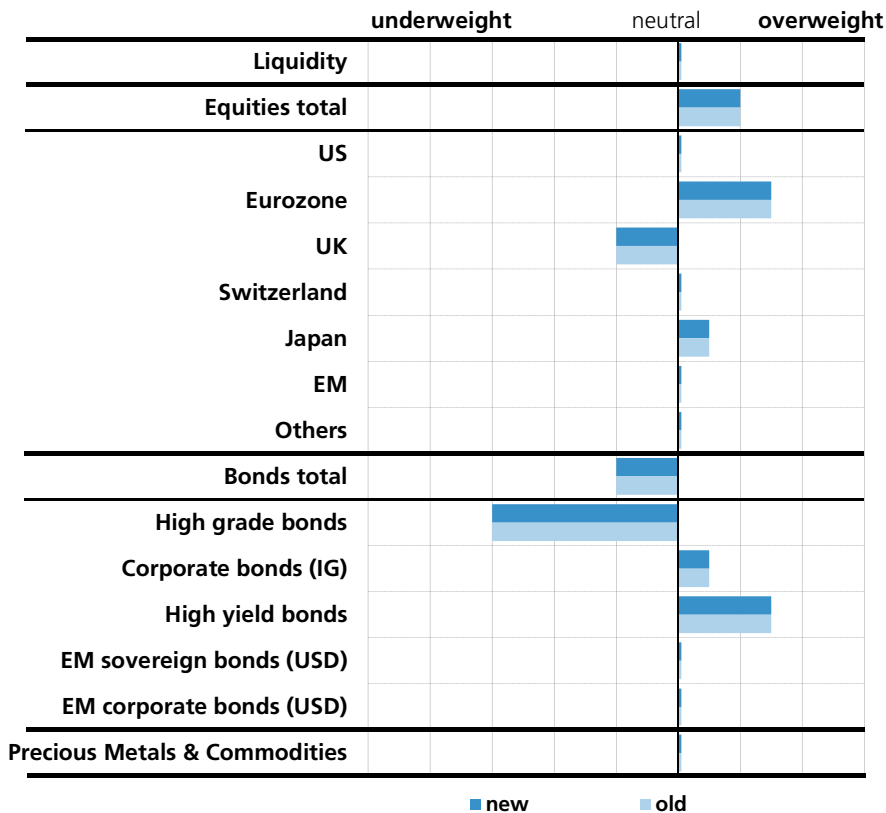
As of 10 December 2015

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

Global tactical asset allocation

Tactical asset allocation deviations from benchmark*

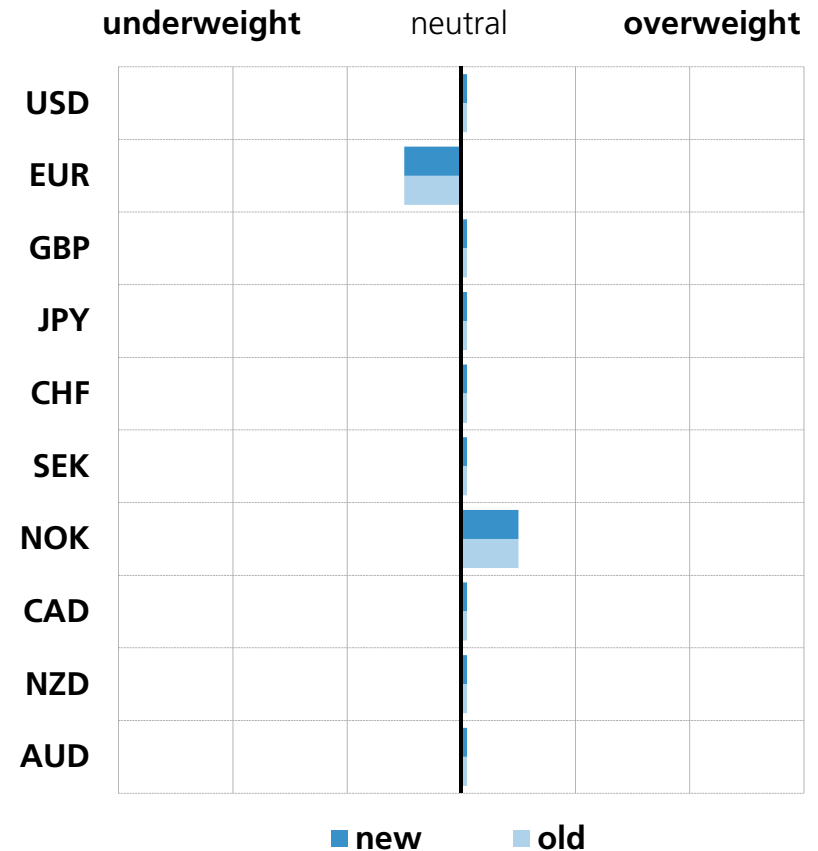


Source: UBS, as of 10 December 2015

*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



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 should be a strong motivation for companies to increase return on equity and unwind cross-shareholding arrangements. Japan's major banks recently unveiled plans to increase the unwinding of cross-shareholdings from the planned 20% of total holdings to 30%. As a result, we expect the new trend of share buybacks to accelerate through 2016.

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 an average yield of 5.2%. We think that is an attractive level given the persistent global low-yield environment, particularly as we expect default rates to remain low. Our six-month total return expectation is 2–3%, and we see the asset class as 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 now in wait and see mode.
- 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 the 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, the UK's negotiations with the EU on its relationship with the union should have a limited effect on the Eurozone's solid growth outlook. An expected softening of EU sanctions on Russia in 2016 should help the EU economy at the margin. Within emerging markets, Asia is still the strongest region despite slowing growth rates, 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. 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. The ECB is in wait and see mode now, but the recent oil price fall following the last OPEC meeting means that the risk of further monetary easing in 2016 has increased.

➤ 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 even further in a major way.
- 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 (in 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

16 Dec	FOMC
1 Jan	China manufacturing PMI (December)
21 Jan	ECB policy meeting

Global growth likely to improve slightly in 2016

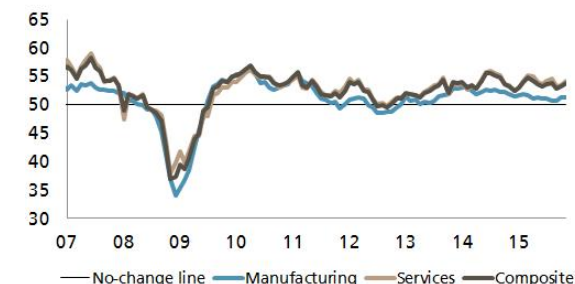
		Real GDP growth in %			Inflation in %		
		2014	2015F	2016F	2014	2015F	2016F
Americas	US	2.4	2.5	2.8	1.6	0.2	1.6
	Canada	2.4	1.1	2.2	1.9	1.5	1.9
	Brazil	0.1	-3.0	-2.0	6.4	9.9	6.4
Asia/Pacific	Japan	-0.1	0.6	1.3	2.8	0.9	1.0
	Australia	2.6	2.2	2.6	2.5	1.5	2.2
	China	7.3	6.9	6.2	2.0	1.5	1.5
	India	7.3	7.1	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	-1.1	-0.4
Russia	0.6	-3.7	-0.4	7.8	15.5	7.1	
World		3.4	3.1	3.4	3.3	3.5	3.8

Source: UBS, as of 08 December 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 likely to remain well above 50

Global purchasing managers' indices (PMIs)



Source: Haver Analytics, UBS, as of November 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 Fed to start hiking rates 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 to increase 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 costs. 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 and has lingered into the fourth quarter.

➤ 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.

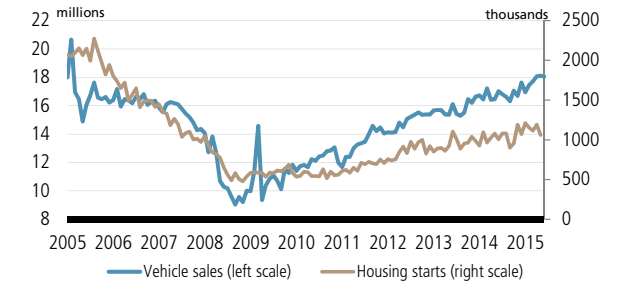
*Scenario probabilities are based on qualitative assessment.

Key dates

Dec 11	Retail sales for November
Dec 15	CPI for November
Dec 16	Housing starts for November
Dec 16	FOMC rate decision
Dec 23	Personal income and spending for November

Vehicle sales and housing starts support growth

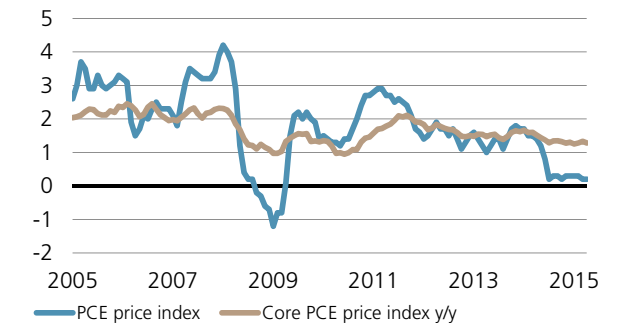
Vehicle sales and housing starts, annualized rate



Source: Bloomberg, UBS, as of 3 December 2015

Low energy prices are curtailing inflation

US headline and core PCE price index, year-on-year in %



Source: Bloomberg, UBS, as of 3 December 2015

Note: PCE = personal consumption expenditures

Key financial market driver 2 - *Improving Eurozone growth*

Key points

- Economic growth is set to improve in the coming quarters on the back of a very strong monetary impulse.
- Inflation is expected to resume its uptrend and rise to close to 1% in the first quarter of 2016.
- The ECB is now in wait and see mode, with the risk of easing at medium levels in 2016.

CIO view (Probability: 70%*)

- 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 boost. Negotiations with Britain on EU terms should have a limited effect on confidence, even if talks on issues such as immigration may prove arduous given the willingness to compromise only on soft measures but not on a treaty change. Some softening of Russian sanctions in 2016 should help the economy in turn. The renewed fall in oil prices following the recent OPEC meeting level means that the risk of further ECB easing in 2016 has increased, despite an accelerating Eurozone economy and rate hikes in the US.
- 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 hold up despite the tragic Paris attacks, supported by stabilizing construction 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 is set to moderate going forward given the uncertainty surrounding the upcoming elections.

Improving growth

↗ Positive scenario (Probability: 20%*)

- 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.

Better-than-expected growth

↘ Negative scenario (Probability: 10%*)

- 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.

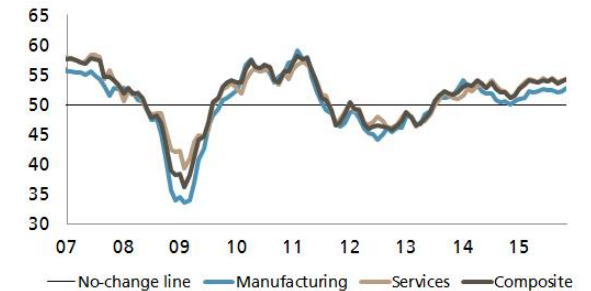
Deflation spiral

*Scenario probabilities are based on qualitative assessment.

Key dates

Dec 16	Eurozone PMIs (December flash estimate)
Jan 5	CPI inflation (December estimate)
Jan 7	Unemployment rate (November)
Jan 21	ECB meeting (rate decision)

Eurozone composite PMI expected to improve further

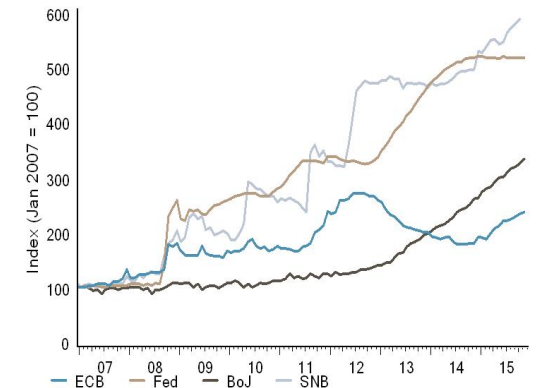


Source: Haver Analytics, UBS, as of November 2015

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 November 2015

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

Key points

- China's GDP growth is likely to decelerate in 2016, but the chances of a hard landing are small due to strong policy support.
- Rising new economy sectors in manufacturing and service will likely decide China's success in transforming into a new economy.
- Monetary policy should remain very accommodative so as to facilitate transformation.

CIO view (Probability: 80%*)

- We forecast China's GDP will grow by 6.4%-6.5% in 2016. Manufacturing PMI is likely to continue contracting, while services PMI is expected to stay above 50, as China's transformation continues.
- Investment may continue to decelerate dragged down by traditional manufacturing and real estate, while consumption may grow mildly, contributing 56% to GDP growth in 2016 versus 54% in 2015.
- CPI inflation will likely go up mildly to 2% in 2016 mainly due to rising pork prices and a low base. PPI inflation may recover slightly but remain negative.
- Monetary policy should stay very accommodative. In 2016, we expect 1-2 cuts in benchmark interest rates and 300-500bps cuts in the reserve requirement ratio. Unconventional monetary tools may also be applied actively. The introduction of the interest rate corridor, the new direction of China's monetary policy regime, brings the 7-day SLF (Standing Lending Facility) and repo rates into attention. We expect 50-100bps cuts in SLF rates in 2016.
- Fiscal policy will likely play a more active role in guiding the country's transformation. We expect structural tax deduction in 2016 given President Xi's recent emphasis on "supply-side reforms". Fiscal subsidies and fund supports are expected to continue.
- Destocking in the real estate sector may continue putting downward pressure on both prices and sales. Inventories in tier 3 and tier 4 cities are estimated to be around 25-30 months, implying 2-3 years' adjustment in the sector.

Policy support to moderate slowdown

➤ Positive scenario (Probability: 10%*)

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

Growth acceleration

➤ Negative scenario (Probability: 10%*)

- China suffers a hard landing, which we define as sub-5% real GDP growth for more than two quarters. The economy weakens abruptly due to a sharper downturn in property investment and more widespread credit events.

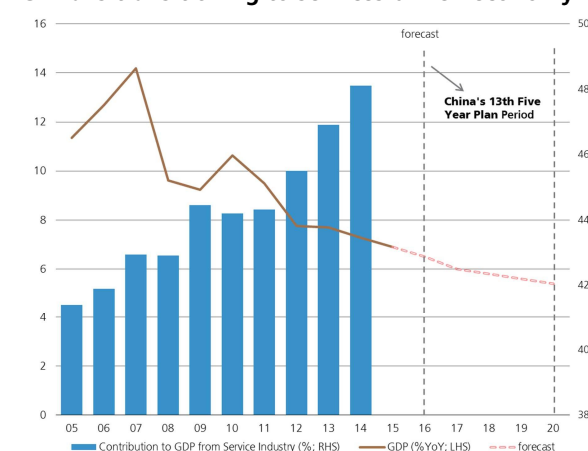
Sharp economic downturn

* Scenario probabilities are based on qualitative assessment.

Key dates

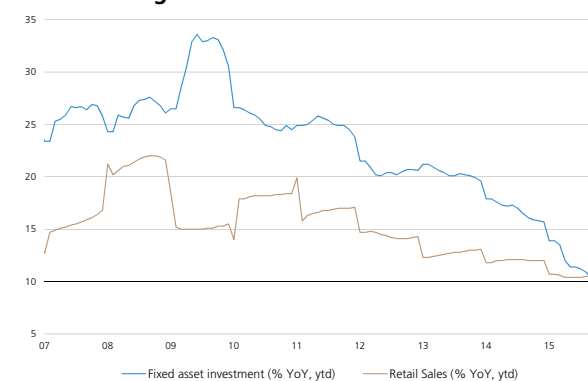
Dec 10-15	Monetary and credit data for November
Dec 12	Industrial production, retail sales, and fixed asset investment for November
Dec 27	Industrial profits

China is transitioning to services-driven economy



Source: CEIC, UBS, as of 3 December 2015

Retail sales growth has caught up with fixed asset investment growth



Source: CEIC, UBS, as of 3 December 2015

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