

UBS House View

Chief Investment Office WM
10 December 2015

Monthly Letter

The 2016 outlook

Equities look set for a positive year, supported by continued global growth, rising earnings, healthy corporate balance sheets, and accommodative central banks.

Years ahead

The turn of the year is a good time to look further into the future. Investors can achieve higher returns by allocating part of their portfolio to longer-term trends and riding out periods of market volatility.

Multi-decade trends

The growing global population, aging societies, and urbanization all have important implications for investors and present attractive investment opportunities in food, health, and infrastructure.

Asset allocation

For the coming year we favor Japanese and Eurozone stocks, which enjoy the most appealing combination of healthy profit growth and supportive monetary policy.



Mark Haefele

Global Chief Investment Officer
Wealth Management

Back to the future

In 1985, my favorite movie was Steven Spielberg's *Back to the Future*. It provided a glimpse of an imagined 2015, when we would all be flying around town in fusion-powered vehicles. The real 2015 is drawing to a close and our cars remain road-bound. This should remind us to make predictions with a degree of humility and care. Yet forecast we must in order to identify investments for a globally diversified multi-asset portfolio. For reflections on what we got right and wrong this year, along with over 200 investment predictions for next year, please see our just published *Year Ahead 2016*.¹ It is flying around town in a vehicle we did not imagine 30 years ago – cyberspace.

We still have some important hurdles before year's end – including the US Federal Reserve's expected December rate hike. But as of the time of writing, we can say that 2015 has been a muted year for investors, with global equities returning around 3% in local currency terms, slightly ahead of high grade bonds. The top-performing markets of the Eurozone and Japan have given returns of over 10%, while emerging markets have lost 6%. The S&P 500, though only slightly in positive territory, has now enjoyed its longest rally without a 20% correction since

World War II. As many of you know, we took commodities out of our portfolios in 2014. In 2015 this has been the most disappointing asset class, declining about 23%.

For 2016 we expect equities to return around 7%, supported by a moderate acceleration in global growth, rising earnings, healthy corporate balance sheets, and continued central bank stimulus. Yet volatility will likely increase and we hope to seize the opportunities it presents. We enter the new year preferring equities relative to government bonds. We favor stocks in the Eurozone and Japan, where central banks are set to maintain easy monetary policies. This fact also warrants an overweight position in investment grade and European high yield credit.

In addition to creating our outlook for next year, we also attempted a time traveler's jump into the more distant future with our new *Years Ahead* publication. It explores investment themes that we think will play out over coming decades. Although the end of the year is a natural time to focus on the upcoming 12 months, investors can often achieve superior returns by dedicating a portion of their portfolio to longer-term trends.

¹ubs.com/houseview

Private investors have the flexibility to persist with long-term ideas despite periods of volatility.

A long-term approach remains an important topic for many ultra high net worth clients I speak to, as they seek to preserve and expand their wealth for generations to come. Private investors have an advantage here over professionals; individuals can stick with farsighted ideas through periods of market volatility, while professionals can't control when money flows into and out of their funds.

But to stay the course, one often needs to have conviction in some longer-term growth stories. For the remainder of this letter I want to discuss some of the themes that we find most compelling. This vision of the future also lies behind some of our current equity overweight positions in growth sectors such as technology and healthcare.

So which long-term structural trends to focus on?

In some ways, the *Back to the Future* movies presented an accurate picture of how our world changes. In *Back to the Future II*, Marty McFly travels forward in time to 2015 and meets his own idealized two-child American family having dinner together, but everyone is showing signs of age. While the family structure and the human condition are about the same, technology has rapidly advanced and Hill Valley, McFly's small town, has grown into a city.

The global population is expanding, aging, and shifting to urban centers.

Three of the most powerful long-term structural trends that inform our view on investments are the conviction that the world's population is growing robustly, aging rapidly, and increasingly living in cities.

Because demographic changes unfold gradually, there is a lot we can say with confidence about the outlook for population shifts. The UN is predicting an additional 2 billion people by 2050. The population in much of Europe is aging and shrinking while Asia's headcount is on track to swell by close to 900 million – even allowing for a demographic contraction in Japan.

The graying of the world's population, meanwhile, is also a trend of interest to long-term investors. The number of 65 to 69-year-olds globally is likely to more than double by 2050, while the number of people between 90 and 94 may rise fourfold from today, to close to 60 million.

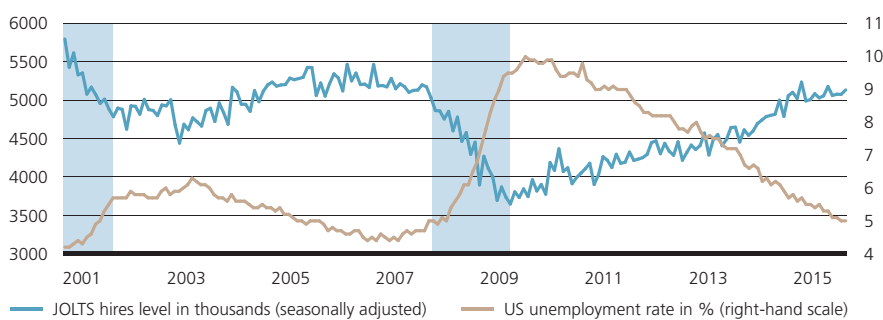
Migration from the countryside to the cities will continue in large emerging nations.

And the increasing urbanization of the world's population, especially in emerging markets, is another trend we can forecast with some confidence. The migration from the country to the city in emerging markets is well documented and well under way; the UN forecasts that Chinese and Indian cities will receive nearly 100 million and 50 million people respectively over the next five years.

The US labor market has largely recovered from the recession following the 2008 financial crisis.

Fig. 1: Labor market strength supports the case for the Fed's first rate rise in nine years

Hiring level and unemployment rate in the US, shaded area indicates US recession dates



Source: Bloomberg, UBS, as of October 2015

What long-term investment opportunities do these trends present?

Demand for water will continue to increase, benefiting companies involved in water treatment and infrastructure.

Businesses focused on boosting agricultural efficiency are also likely to enjoy a bright future.

Rising obesity is among the downsides to urbanization...

...but companies dedicated to weight loss, fitness, and the treatment of obesity-related diseases stand to gain.

The global population is continuing to expand despite contractions in Europe and Japan.

Food and water

The expanding global population – along with improving living standards and emerging market industrialization – is increasing the demand for clean water. We believe that the market for life’s most basic commodity will grow at roughly 6% a year for the foreseeable future. That is generating investment opportunities in such areas as water treatment, water management, and water infrastructure.

Then there is food. Every day there are about 200,000 extra mouths to feed. To meet this demand, agricultural efficiency will need to increase – a challenge that can be met through improved irrigation, the design of more resilient crops, and “precision agriculture.” This last innovation brings advanced information technology to the most ancient human industry, enabling farmers to collect data and adjust how they cultivate each square foot of land, even to the detail of “plant-by-plant” fertilizing. Companies focused on getting more food out of fewer resources are likely to flourish.

Health

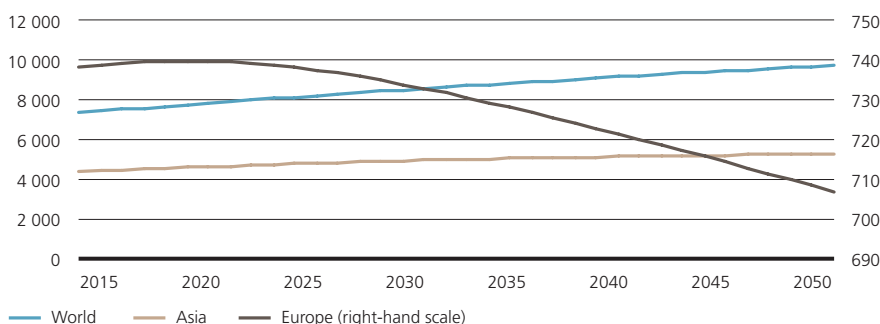
One unfortunate side effect of urbanization and rising emerging market incomes has been greater levels of obesity. Already in 2013 there were 2.1 billion obese or overweight people – more than the total world population of 1927. That figure could continue to rise as cities expand. Urban dwellers tend to walk and bike less, using more motorized transport. More desk jobs tend to promote a sedentary lifestyle while cities have more multinational supermarkets and fast-food chains that sell high-calorie snacks.

Healthy eating has also become a luxury. The cost of fresh fruit and vegetables has risen 90% above the general rate of inflation over the past two decades in leading emerging nations. By contrast, the cost of ready meals fell by one-fifth. Obesity has adverse implications for individuals and society alike.

Still, companies that help reverse bulging waistlines will benefit. The market for their products and services will grow by mid-to-high single-digit rates in our projections. Companies that offer healthier foods and fitness products, as well as those focused on medical products or services to reduce weight or treat diabetes and other obesity-related conditions, are all poised to benefit.

Fig. 2: Demographic growth will not be evenly spread worldwide

Estimates of population growth (global, Asia and Europe) – in millions of people



Source: United Nations World Population Prospects, UBS, as of July 2015

Rising healthcare spending in emerging nations can be expected to lift the fortunes of drug manufacturers and medical device makers.

In last month's letter, I highlighted advances in cancer treatment and the opportunities they present for investors. On a broader note, emerging nations currently spend less than half as much on healthcare as developed countries, relative to GDP. That gap looks likely to narrow over the coming decade as their wealth increases and populations age; we think that their healthcare spending will climb at roughly double the global rate. Beneficiaries will include drug manufacturers, medical device makers, and medical services providers.

Social infrastructure

The increasing urbanization of the world's population can be expected to propel growth in the waste management and recycling industries. Add in the shorter lifecycles of electronic goods, and we expect global waste volumes to more than double by 2050.

Waste disposal facilities will require greater investment as cities expand in emerging nations...

Current disposal facilities are already failing to cope with the existing levels of trash. Less than half of the waste generated in low and middle-income countries is collected, and about 3.5 billion people have no access to garbage disposal at all. Emerging nations are attempting to remedy this as incomes rise, with private firms likely filling the supply gap. Tighter regulations should boost capital expenditures that will benefit a range of companies. For example, our analysis suggests that, between now and 2020, the capacity of China's urban waste incineration treatment sector will rise by close to 130,000 tons...per day. That's the equivalent of the refuse in over 10,000 loaded garbage trucks.

...and firms involved in producing mass transit systems will also enjoy strong demand.

Firms involved in producing mass transit systems also stand to profit. The number of Asians living in megacities (population of over 10 million) is on track to double by 2025. With vehicle ownership doubling every five years, congestion and air-quality problems are intensifying. More governments are looking to beef up public transport facilities. In the coming decade Asian nations are slated to spend 200 billion US dollars on new mass transit systems to combat congestion and air pollution.

Hurdles remain for 2015, including the Fed rate decision, and high volatility is likely to continue into next year.

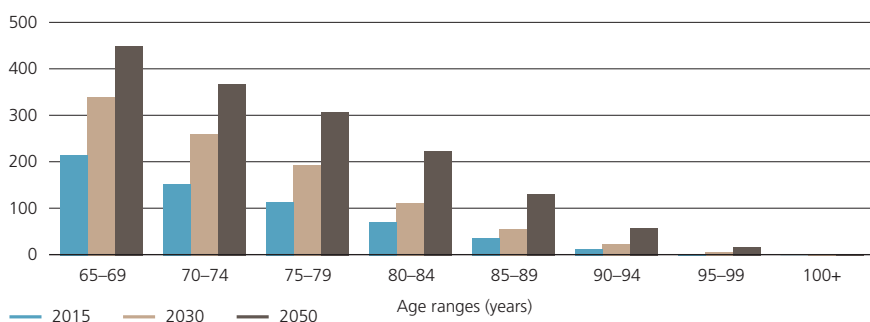
The bottom line

From the Fed hiking interest rates to China managing its slowing growth rate, we should be prepared for equity volatility – and to an extent we welcome it. Some of our favorite hedge fund strategies, for example, enjoy greater opportunities in choppy markets that feature large dispersions between stocks.

The number of people between 65 and 69 years of age is on track to more than double by 2050.

Fig. 3: The graying of the world's population has important implications for investors

Estimated millions of global citizens falling into different age ranges by 2050



Source: United Nations, UBS. Data as of 2015

The end of the year is a natural time to focus on more long-term investment goals.

The approach of a new year can be a good time for individuals to turn their thoughts to the more distant future and focus on areas where they have a potential edge over institutional investors. I hope this letter sheds light on the opportunities in food, health, and infrastructure offered by some key mega-trends. One thing will not change: a well-diversified portfolio will continue to offer a superior risk-return profile.

Let's make 2016 and beyond healthy and profitable. Even if we still don't have flying cars by 2050, I'm hoping for even more exciting developments – cures for cancer, universal access to clean water, robot butlers, and more *Back to the Future* sequels.



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Are you prepared?

UBS House View: 2016 and beyond

Is it time to know more about the world in 2016?
What about the years beyond? We have answers.

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