Global Perspectives

Multi Asset | February 29, 2016

Overview

Equities: Japan was among the weakest performers in conditions of contracting economic growth despite the Bank of Japan's (BoJ's) commitment to accommodative monetary policy. In the eurozone, Italian equities underperformed the broader market primarily due to the FTSE MIB Index's high exposure to banks. UK and US equities outperformed, with the FTSE 100 Index registering a small gain and the S&P 500 Index broadly flat on the month.

Fixed Income: Amid continued fragile investor sentiment, developed market government bonds outperformed global investment grade and inflation-linked bonds. In Japan, bonds at a government auction were sold with a yield below 0% for the first time. US high yield corporate bonds outperformed their European counterparts.

Currency: The Japanese yen strengthened against the US dollar in line with investor risk aversion, and despite the BoJ easing monetary policy further at its January meeting. The euro began to depreciate around the middle of the month in anticipation of further European Central Bank (ECB) monetary policy easing in March.

The month in review:

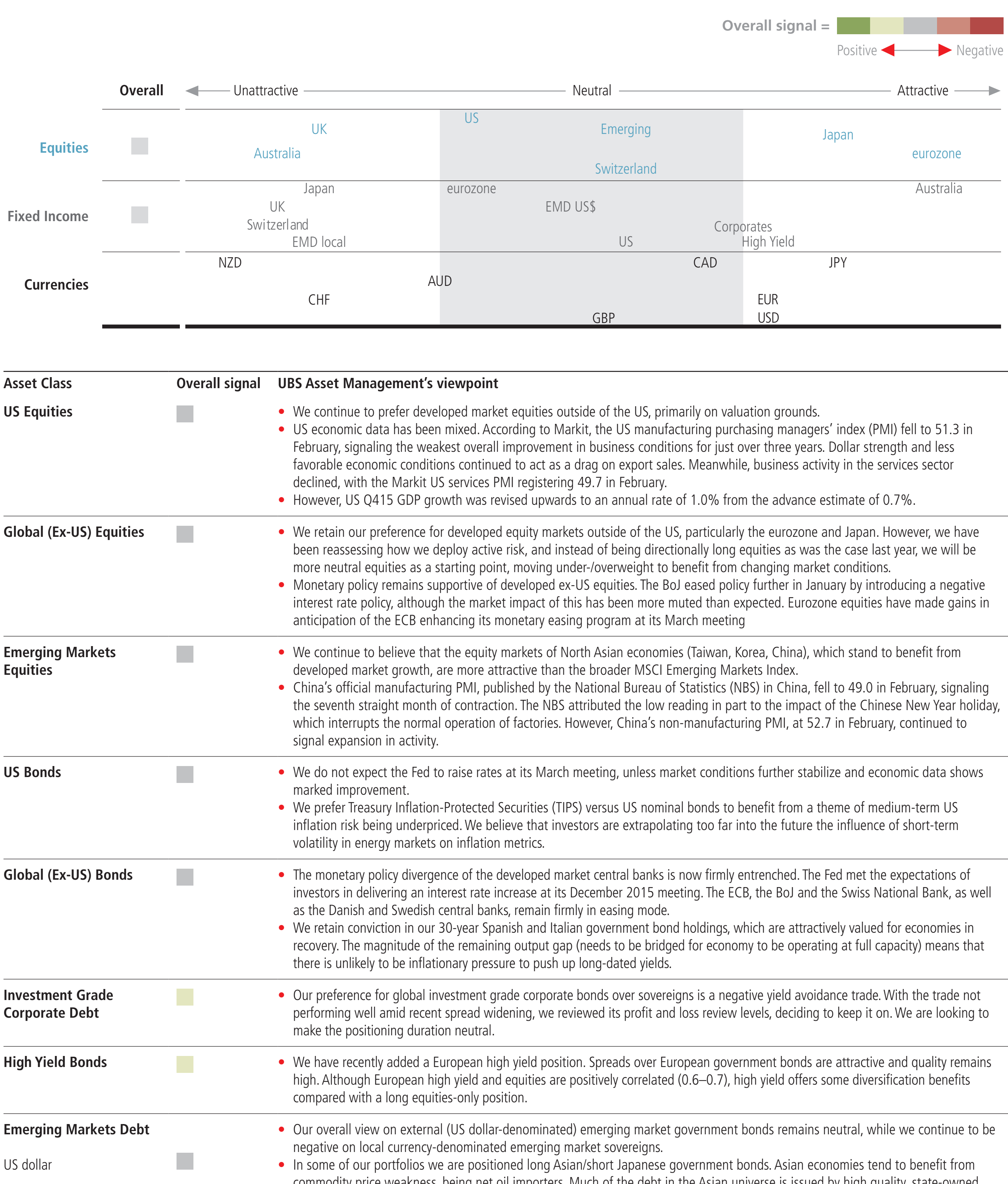
- Global equity markets regained some composure in February after a dismal start to the year. Equities and the global oil price began to trend upwards in the second week of the month due to a confluence of factors that served to support sentiment. These included tentative signs of oil producers' willingness to limit supply, a return of confidence in the health of the global banking sector and easing concerns about a China-led global growth slowdown.
- Despite the positive turn, sentiment remained highly fragile. The relatively muted impact on markets of the latest bout of easing by the BoJ added to fears that the effectiveness of central bank quantitative easing was diminishing. In the UK, the debate on the country's membership in the European Union (EU) gathered momentum. The British pound weakened significantly against the euro and the dollar amid uncertainty about the outcome of the June referendum and its impact on investor perceptions of the safe-haven characteristics of many UK assets.
- In the US, fourth-quarter GDP growth was revised upwards to 1.0% from the advance estimate of 0.7%. While consumer consumption has continued to support US economic expansion, some signs that weakness in the manufacturing sector may be spreading to services weighed on sentiment. The US corporate earnings season in the fourth quarter was sluggish, with profit growth constrained by continued dollar strength and the relatively weak oil price. Eurozone data, meanwhile, was broadly supportive of further monetary easing by the ECB in March. Eurozone annual inflation was expected to have fallen to -0.2% in February from 0.3% in January. Meanwhile, the rate of growth in the eurozone manufacturing sector continued to slow in February, with German manufacturing activity expanding at the slowest pace in over a year, according to Markit.

Outlook: Deploying active risk to benefit from changing market conditions

- On a strategy level, we remain broadly neutral risk assets, and may look to move either under or overweight risk depending on financial market and economic developments. We have identified several catalysts that may prompt such a move, among them being: the evolution in the global oil price, Chinese economic growth prospects, the degree to which the US recovery becomes self-sustaining, the effectiveness of central bank monetary policy in achieving its objectives and the health of the banking system.
- Political risks are now firmly on our radar. The lead up to the US elections in November could well bring about bouts of heightened market volatility, and the discourse in the UK and elsewhere about the merits of EU membership could affect asset prices globally.

Current views[1]

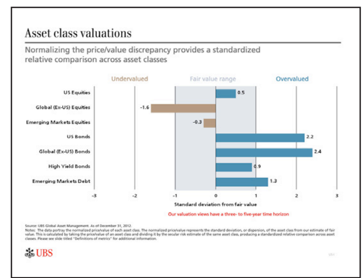
Asset allocation and currency attractiveness based on fundamental valuation and market behavior analysis



Asset Class	Overall signal	UBS Asset Management's viewpoint
US Equities		• We continue to prefer developed market equities outside of the US, primarily on valuation grounds. • US economic data has been mixed. According to Markit, the US manufacturing purchasing managers' index (PMI) fell to 51.3 in February, signaling the weakest overall improvement in business conditions for just over three years. Dollar strength and less favorable economic conditions continued to act as a drag on export sales. Meanwhile, business activity in the services sector declined, with the Markit US services PMI registering 49.7 in February. • However, US Q415 GDP growth was revised upwards to an annual rate of 1.0% from the advance estimate of 0.7%.
Global (Ex-US) Equities		• We retain our preference for developed equity markets outside of the US, particularly the eurozone and Japan. However, we have been reassessing how we deploy active risk, and instead of being directionally long equities as was the case last year, we will be more neutral equities as a starting point, moving under-/overweight to benefit from changing market conditions. • Monetary policy remains supportive of developed ex-US equities. The BoJ eased policy further in January by introducing a negative interest rate policy, although the market impact of this has been more muted than expected. Eurozone equities have made gains in anticipation of the ECB enhancing its monetary easing program at its March meeting
Emerging Markets Equities		• We continue to believe that the equity markets of North Asian economies (Taiwan, Korea, China), which stand to benefit from developed market growth, are more attractive than the broader MSCI Emerging Markets Index. • China's official manufacturing PMI, published by the National Bureau of Statistics (NBS) in China, fell to 49.0 in February, signaling the seventh straight month of contraction. The NBS attributed the low reading in part to the impact of the Chinese New Year holiday, which interrupts the normal operation of factories. However, China's non-manufacturing PMI, at 52.7 in February, continued to signal expansion in activity.
US Bonds		• We do not expect the Fed to raise rates at its March meeting, unless market conditions further stabilize and economic data shows marked improvement. • We prefer Treasury Inflation-Protected Securities (TIPS) versus US nominal bonds to benefit from a theme of medium-term US inflation risk being underpriced. We believe that investors are extrapolating too far into the future the influence of short-term volatility in energy markets on inflation metrics.
Global (Ex-US) Bonds		• The monetary policy divergence of the developed market central banks is now firmly entrenched. The Fed met the expectations of investors in delivering an interest rate increase at its December 2015 meeting. The ECB, the BoJ and the Swiss National Bank, as well as the Danish and Swedish central banks, remain firmly in easing mode. • We retain conviction in our 30-year Spanish and Italian government bond holdings, which are attractively valued for economies in recovery. The magnitude of the remaining output gap (needs to be bridged for economy to be operating at full capacity) means that there is unlikely to be inflationary pressure to push up long-dated yields.
Investment Grade Corporate Debt		• Our preference for global investment grade corporate bonds over sovereigns is a negative yield avoidance trade. With the trade not performing well amid recent spread widening, we reviewed its profit and loss review levels, deciding to keep it on. We are looking to make the positioning duration neutral.
High Yield Bonds		• We have recently added a European high yield position. Spreads over European government bonds are attractive and quality remains high. Although European high yield and equities are positively correlated (0.6–0.7), high yield offers some diversification benefits compared with a long equities-only position.
Emerging Markets Debt US dollar Local currency		• Our overall view on external (US dollar-denominated) emerging market government bonds remains neutral, while we continue to be negative on local currency-denominated emerging market sovereigns. • In some of our portfolios we are positioned long Asian/short Japanese government bonds. Asian economies tend to benefit from commodity price weakness, being net oil importers. Much of the debt in the Asian universe is issued by high quality, state-owned companies, which is favorable for our long position.
Currency		• In emerging market currencies, we have added long Indian rupee versus short Taiwanese dollar/short Korean won positions. With the Taiwanese and Korean economies likely to suffer amid broader emerging market and Chinese weakness, we believe that these short currency positions can help hedge against related tail risks.

[1] Source: UBS Asset Management. As of February 29, 2016.

Valuations plus one or more market behavior indicators provide an overall signal



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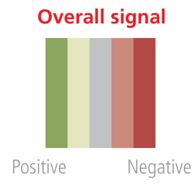


Market themes

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."

Momentum and flow

Attempts to capture money flows and market appetite for risky assets from the perspective of professional asset allocators, such as mutual fund managers.

Market stress

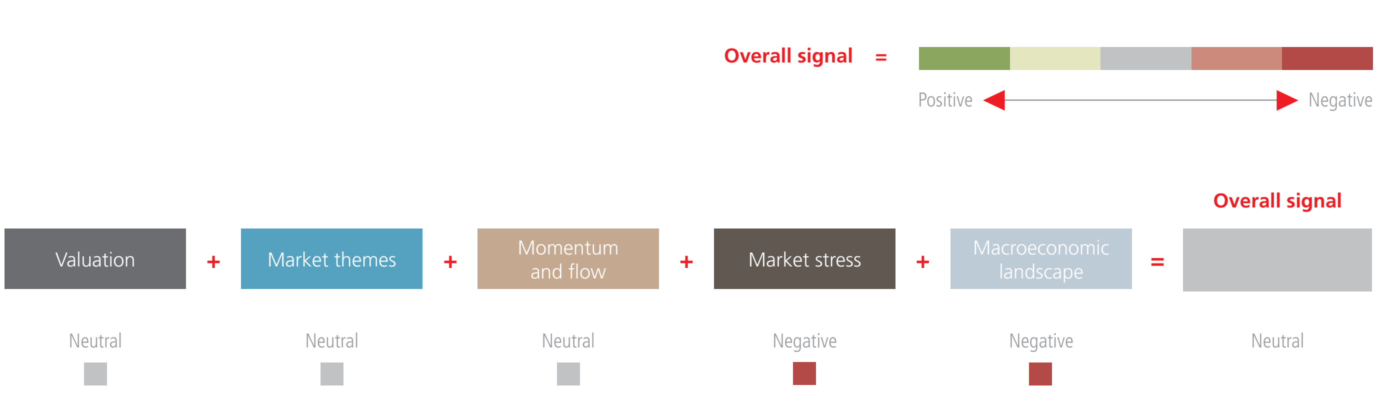
We created a proprietary stress index to help gauge price dislocations and investor risk appetite. It comprises several spread measures across credit markets, currencies and cash markets, as well as measures of market sentiment, such as the Chicago Board Options Exchange Market Volatility Index (VIX).

Macroeconomic landscape

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 February 29, 2016

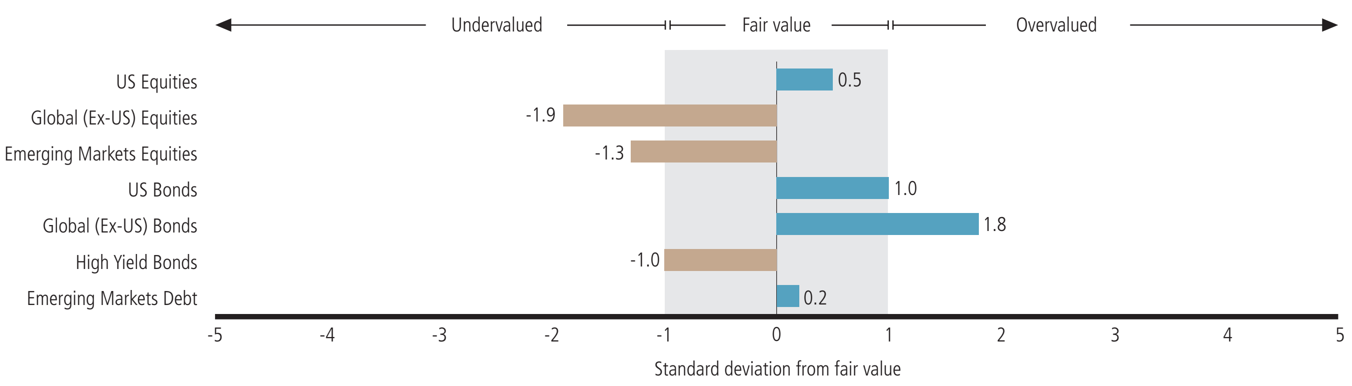
Valuation and market behavior indicators at work



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 February 29, 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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