UBS

Global Perspectives

Multi Asset | May 31, 2016

Overview

Equities: In the absence of any material bad news, global equities rallied during May. European equities paced the gains after the International Monetary Fund (IMF) and eurozone agreed that Greece had done what was necessary to unlock fresh loans. Meanwhile, a weakening Japanese yen (JPY) helped Japanese equities outperform. Emerging market equities underperformed their developed world counterparts with Brazilian and Russian equities down sharply.

Fixed Income: Most global sovereigns posted positive returns in local currency terms in May. The exception was the US as yields spiked following the publication of the minutes from the May Federal Reserve meeting. Credit spreads generally tightened with high yield performing strongly due to the rebound in the oil price.

Currency: The major move over the month was the strengthening of the USD in the wake of more hawkish rhetoric from the Federal Reserve. Elsewhere, the British pound (GBP) rallied ahead of the June 23rd Referendum on EU membership. On a trade-weighted basis, the JPY and euro both weakened.

The month in review:

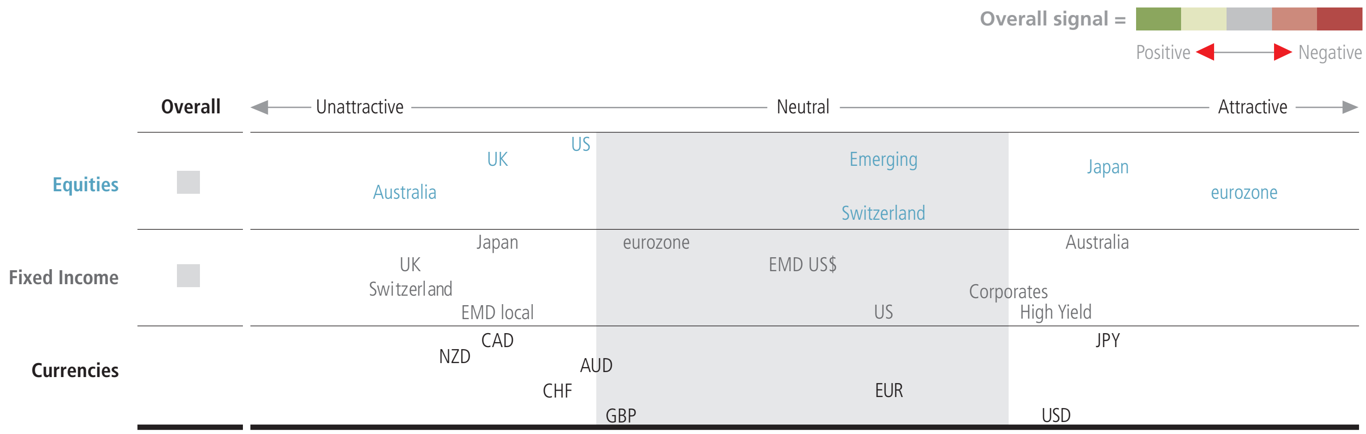
- Despite increased cautiousness among investors towards the end of the month, global equity markets in aggregate posted positive returns. This was largely supported by improved economic data in the US and eurozone. Sentiment was also buoyed by the Fed's view that the US economy was ultimately strong enough to weather higher interest rates later in the year, as well as the agreement Greece reached with its creditors, which eased eurozone-related investor concerns.
- Japanese data showed a continued recovery in industrial production, while the market was also helped by the weakening of the yen.
- Emerging market equities suffered negative returns largely in part due to the strength of the US dollar.
- Oil prices continued their recovery in May, reaching new highs for 2016. They have now gained over 80% from their February low, with the continued rally supported by a sharper-than-expected fall in inventories largely due to the wildfires in Canada.
- Within fixed income, US government bonds underperformed due to a re-pricing of interest rate expectations. In contrast, UK and German bonds fared well, while peripheral European bonds were especially strong given relief over the Greek deal. Within the corporate sector, credit spreads were generally lower with US high yield bonds faring quite strongly thanks to their strong, recent ties to the fortune of oil.

Outlook:

- While overall sentiment has improved since the start of the year, markets continue to be sensitive to new economic data as global growth concerns remain in the forefront of investors' minds. We believe volatility is likely to remain high in 2016. While political risks have moderated following the debt negotiation agreements reached in Greece, it is likely to remain one of the biggest drivers of volatility as we approach the UK referendum in June and US presidential elections later this year. Fears about a slowing Chinese economy have faded on account of improving economic data. However, we believe that long-term challenges still remain a concern and need to be monitored closely.
- Given risky assets remain relatively challenged in the short term, we have positioned our portfolios to be neutral in risk assets overall. We have reduced exposure to equities since the beginning of the year on a tactical basis, perceiving better opportunities to play cyclically through other asset classes, like investment grade corporate bonds, where we see scope for attractive risk-adjusted returns. Within equities, we continue to maintain our preference for European and Japanese equity markets over the US because of valuation support and more favorable monetary policy.
- In fixed income, we tactically favor inflation-linked bonds in the US over their nominal counterparts, believing US inflation risks are underpriced. Within the high yield universe, we prefer European exposure where spreads over European government bonds are attractive and quality remains high.

Current views[1]

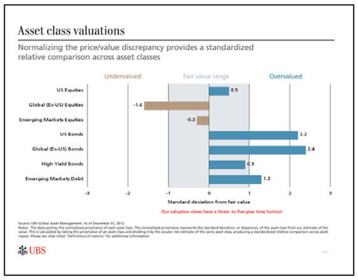
Asset allocation and currency attractiveness based on fundamental valuation and market behavior analysis



Asset Class	Overall signal	UBS Asset Management's viewpoint
US Equities		• Our analysis shows US equities at the upper end of fair value and bordering on overvalued in an historical context. With US corporate margins at historic highs, the outlook for profits growth remains and we see little scope for further multiple expansion. • We see a tightening policy environment as a headwind to further equity market gains, albeit the demand backdrop currently warrants only gradual increases. • We believe that recent data are, in aggregate, consistent with the Fed's stated expectation to raise rates twice more before the end of 2016.
Global (Ex-US) Equities		• We retain our preference for developed equity markets outside of the US. • We see eurozone and Japanese equities, as supported by attractive valuations relative to their own long-term history, on our discounted cash flow analysis. Within the eurozone, we see a more compelling valuation and earnings recovery story among more domestically focused smaller companies than more export-oriented large caps. • Overall policy in both the eurozone and Japan remain loose and broadly supportive to equities in our view. While neither the Bank of Japan nor the European Central Bank added to existing stimulus measures at their respective May meetings, we expect additional measures from the Bank of Japan in particular to support growth.
Emerging Markets Equities		• Emerging markets equities look attractively valued on pure earnings measures. However, the growth and profits outlook in many emerging economies is held back by excess industrial capacity and sizable external debt loads. • In China, the most recent data has been uneven but overall signals a stabilization following government stimulus. We see higher debt levels as unsustainable in the longer term and note recent "official" statements that the Chinese authorities will shift their focus from near-term liquidity measures to longer-term structural reform. • We see Latin American markets as overly reliant on commodity exports. After the very strong outperformance of Brazilian equities earlier in the year, we have a clear preference within the region for the healthier fundamentals and more stable economic growth outlook offered by Mexico.
US Bonds		• With low yields and a rising interest rate backdrop, we see nominal US government bonds as unattractive. • With the year-over-year base effects of oil rolling off and emerging wage pressures, there appears to be an unwarranted asymmetric outcome probability priced in to the wider market's dovish expectations on medium-term US inflation risks. We, therefore, prefer US Treasury Inflation-Protected Securities (TIPS).
Global (Ex-US) Bonds		• In aggregate, we see global bonds outside of the US as unattractive with German bunds standing out as one of the most overvalued markets. • We also see a number of geopolitical and fundamental risks to the bonds of peripheral eurozone countries, such as Italy, which we do not believe are reflected in current yields. • We have a preference for Canadian bonds, which we see as an attractive hedge for lower oil prices and high yield distress given the importance of energy to the Canadian economy. We also believe that the Canadian economy has a long process of restructuring ahead as its reliance on the energy sector diminishes. The diverging fortunes of the Canadian provinces make monetary policy very difficult for the Bank of Canada.
Investment Grade Corporate Debt		• Our positive view on investment grade bonds relative to developed world sovereign debt is largely predicated on valuations and the former's attractive yield pick-up. We do not believe that a sharp rise in defaults at the higher-quality end of corporate debt to be as likely, and see global IG corporates as continuing to offer an attractive risk and return profile compared with government bonds.
High Yield Bonds		• We continue to favor European high yield. Supported by the European recovery story and loose ECB policy, spreads over European government bonds are attractive and quality remains high.
Emerging Markets Debt US dollar Local currency		• Our overall view on external (USD-denominated) emerging market government bonds remains neutral. • While we continue to be negative on local currency-denominated emerging market sovereigns in aggregate, a subset of currencies within this broad universe now looks attractive on a long-term basis (e.g. Mexican peso, Columbian peso, Russian ruble, South African rand, Philippine peso.)
Currency		• Among developed market currencies we see the USD as attractively valued and the Swiss franc among the most expensive currencies globally on our long-term analysis. • Within emerging markets we see a growing number of opportunities. The New Zealand, Korean and Taiwanese economies, and their currencies, are all vulnerable to a China slowdown. In contrast, the Indian rupee is supported by stronger growth, rising real interest rates and a relatively low exposure to China.

[1] Source: UBS Asset Management. As of May 31, 2016.

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



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Market themes | Momentum and flow

Market stress | Macroeconomic landscape

=

Overall signal

Positive Negative

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 May 31, 2016

Valuation and market behavior indicators at work

Overall signal =

Positive ◄——► Negative

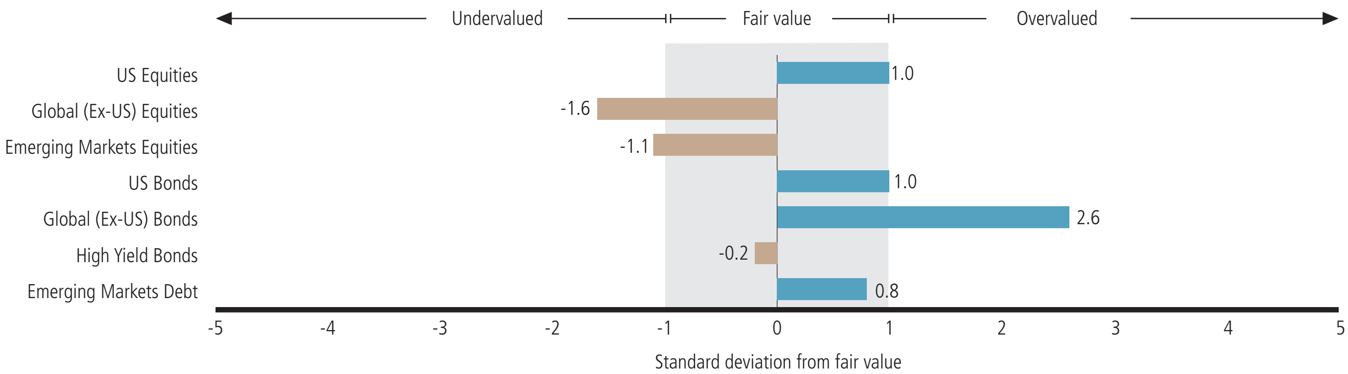
Overall signal

Valuation	+	Market themes	+	Momentum and flow	+	Market stress	+	Macroeconomic landscape	=	Overall signal
Neutral		Neutral		Slightly negative		Neutral		Negative		Slightly negative

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 May 31, 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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