Global Perspectives

Multi Asset | September 30, 2016

Overview

Equities: Global equities posted a small positive return in local currency terms in September with emerging markets outperforming as investor confidence remained high.

Fixed Income: While most developed market 10-year government bond yields were broadly unchanged over the month, UK gilts stood out in giving back some of their recent gains. High yield bonds were supported by the rising oil price.

Currency: An agreement among the members of the Organization of the Petroleum Exporting Countries (OPEC) to cut production boosted oil-related emerging market currencies, such as the Columbian peso and the Russian ruble against the US dollar. The Mexican peso depreciated significantly over the month as a result of the risk of Donald Trump becoming the next US President.

The month in review:

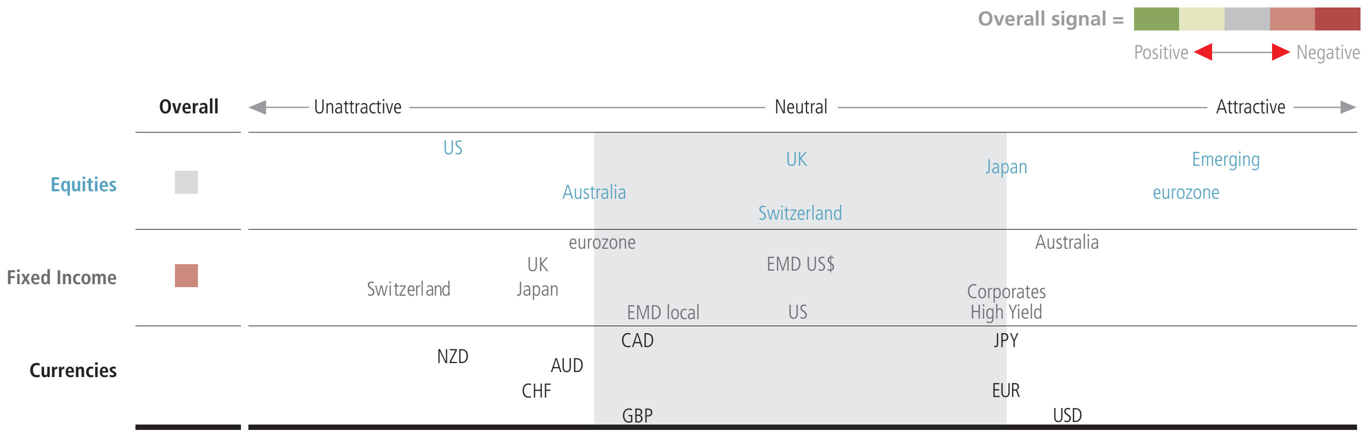
- Central bank action remained the key driver of financial markets. The European Central Bank (ECB) remained in "wait and see" mode much to the dismay of markets. As expected, the US Federal Reserve (Fed) also remained on hold and continued to lower their economic growth forecasts and trimmed the number of rate hikes they foresee in 2017. The Bank of Japan (BoJ) launched a new kind of monetary easing, targeting price rather than quantity in its bond-buying program.
- Uncertainty surrounding the UK's exit plan from the European Union remains. The status quo has been maintained by pushing back the negotiations and difficult decisions. In Europe, Italy will vote on electoral reform in early December.
- UK equities were at the forefront of risk assets, boosted by a weaker pound and firmer commodity prices. Emerging market equities continued their upward trend, benefiting from a boost in global risk appetite. Japanese equities also performed well as economic activity and labor markets strengthened modestly. European and US equities were more subdued, ending on a broadly flat note.
- Most key government bond markets registered negative returns. Although yields increased in the first half of the month, they moderated considerably in the final few weeks. Credit spreads remained broadly flat in the US and the UK, but widened in Europe in both the investment grade and high yield universe on lack of more stimulus from the ECB and on concerns over the strength of the European banking system.

Outlook:

- Political risk is thought to be one of the biggest drivers of market sentiment, with the US presidential elections rapidly approaching. We believe that neither Trump nor Clinton is likely to be backed by a sufficiently large majority in the US Senate to progress their legislative agenda smoothly and avoid political gridlock. Market concerns about China have remained subdued as stimulus measures such as fiscal loosening, reserve requirement ratio and interest cuts drive an improvement in data.
- Based on our analysis, emerging market equities have looked attractively valued for some time. While our concerns about industrial capacity and external debt loads remain, we see a number of powerful catalysts supporting equity prices over a more tactical horizon. We continue to prefer developed equity markets outside of the US with Europe being a particular focus.
- Within fixed income, we favor investment grade corporate bonds, which we believe remain well-supported when an ever-growing percentage of sovereign bonds trade on a negative yield. We continue to favor inflation-linked bonds in the US over their nominal counterparts due to emerging signs of wage inflation that we do not believe is reflected in prices.

Current views[1]

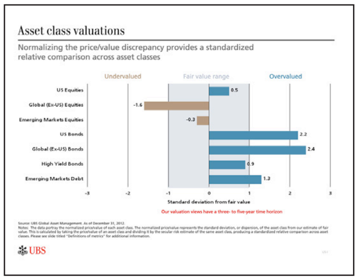
Asset allocation and currency attractiveness based on fundamental valuation and market behavior analysis



Asset Class	Overall signal	UBS Asset Management's viewpoint
US Equities	Negative	• Our analysis shows US equities as overvalued on a number of measures in a historical context. With revenues under pressure from a muted demand backdrop and the risk of margin pressure from wage growth, the scope for disappointment relative to expectations is high. We see no compelling rationale for further multiple expansion against this backdrop.
Global (Ex-US) Equities	Positive	• We continue to prefer developed equity markets outside of the US with Europe being a particular focus. In contrast to their US counterparts, we think European equities look attractively valued. We also believe that the European recovery story is, finally, gathering momentum – supported in no small part by the ECB's loose policy and by its corporate bond buying program in particular.
Emerging Markets Equities	Positive	• Our analysis has found emerging market equities to be attractively valued for some time. While our concerns about industrial capacity and external debt loads remain, we see a number of powerful catalysts supporting equity prices over a more tactical horizon. • For an equity universe which demonstrates material sensitivity to Fed policy and the USD due to high levels of dollar-denominated debt, the "lower for longer" backdrop and more gentle expected path for US interest rate rises are potentially supportive. • Meanwhile, the price of oil is now high enough to benefit EM exporters but not too high to materially impact EM oil importers. With a welcome period of currency stability supporting investment, economic data and corporate earnings are now turning. • Finally, data suggests that institutional investors are still materially underweight EM equities.
US Bonds	Neutral	• 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) with low yields and the potential for further rate rises as we see nominal US government bonds as unattractive.
Global (Ex-US) Bonds	Negative	• In aggregate we see global bonds outside of the US as unattractive with UK Gilts and German bunds standing out as among the most overvalued markets. • We continue to see a number of geopolitical and fundamental risks to the bonds of peripheral eurozone countries such as Italy that 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 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 provinces make monetary policy difficult for the Bank of Canada.
Investment Grade Corporate Debt	Positive	• 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. Against a backdrop of "lower for longer" short-term interest rates and government bond yields in the developed world, we do not believe that a sharp rise in defaults at the higher quality end of corporate debt is likely. We see global IG corporates as continuing to offer an attractive risk and return profile compared with government bonds.
High Yield Bonds	Neutral	• We believe the pick-up in yield over sovereign debt may continue to attract investors to high yield. However, after a sustained period of strong performance in which yields in European high yield, in particular, have fallen significantly in absolute terms, we now see the overall investment case as more balanced.
Emerging Markets Debt US dollar Local currency	 Neutral Neutral	• Our overall view on both local and external (USD-denominated) emerging market government bonds remains neutral. • A subset of currencies within this broad universe now look attractive on a long-term basis while the improvement in current accounts and broader economic growth now balance out our concerns about high debt levels.
Currency		• Among developed market currencies, we see the US dollar as attractively valued and the Swiss franc among the most expensive currencies globally on our long-term analysis. • We see a growing number of long-term opportunities within the broader emerging market universe and particularly those likely to benefit from a stronger oil price.

[1] Source: UBS Asset Management. As of September 30, 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

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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 September 30, 2016

Valuation and market behavior indicators at work

Overall signal =

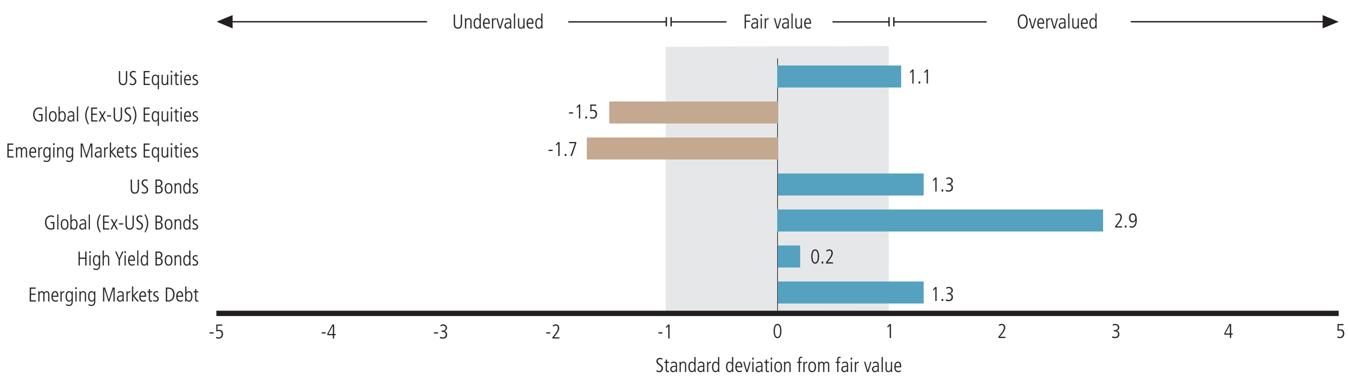
Positive ◄—————► Negative

Valuation	+	Market themes	+	Momentum and flow	+	Market stress	+	Macroeconomic landscape	=	**Overall signal**
Slightly negative		Neutral		Slightly negative		Slightly negative		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 September 30, 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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